

# THE MARKET MAKER'S EDGE

Day Trading Tactics from a  
Wall Street Insider

Josh Lukeman

**McGraw-Hill**

New York San Francisco Washington, D.C. Auckland Bogotá  
Caracas Lisbon London Madrid Mexico City Milan  
Montreal New Delhi San Juan Singapore  
Sydney Tokyo Toronto

**McGraw-Hill**



*A Division of The McGraw-Hill Companies*

Copyright © 2000 by Joshua Lukeman. All rights reserved. Manufactured in the United States of America. Except as permitted under the United States Copyright Act of 1976, no part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written permission of the publisher.

0-07-137664-X

The material in this eBook also appears in the print version of this title: 0-07-135975-3.

All trademarks are trademarks of their respective owners. Rather than put a trademark symbol after every occurrence of a trademarked name, we use names in an editorial fashion only, and to the benefit of the trademark owner, with no intention of infringement of the trademark. Where such designations appear in this book, they have been printed with initial caps.

McGraw-Hill eBooks are available at special quantity discounts to use as premiums and sales promotions, or for use in corporate training programs. For more information, please contact George Hoare, Special Sales, at [george\\_hoare@mcgraw-hill.com](mailto:george_hoare@mcgraw-hill.com) or (212) 904-4069.

## **TERMS OF USE**

This is a copyrighted work and The McGraw-Hill Companies, Inc. ("McGraw-Hill") and its licensors reserve all rights in and to the work. Use of this work is subject to these terms. Except as permitted under the Copyright Act of 1976 and the right to store and retrieve one copy of the work, you may not decompile, disassemble, reverse engineer, reproduce, modify, create derivative works based upon, transmit, distribute, disseminate, sell, publish or sublicense the work or any part of it without McGraw-Hill's prior consent. You may use the work for your own noncommercial and personal use; any other use of the work is strictly prohibited. Your right to use the work may be terminated if you fail to comply with these terms.

THE WORK IS PROVIDED "AS IS". MCGRAW-HILL AND ITS LICENSORS MAKE NO GUARANTEES OR WARRANTIES AS TO THE ACCURACY, ADEQUACY OR COMPLETENESS OF OR RESULTS TO BE OBTAINED FROM USING THE WORK, INCLUDING ANY INFORMATION THAT CAN BE ACCESSED THROUGH THE WORK VIA HYPERLINK OR OTHERWISE, AND EXPRESSLY DISCLAIM ANY WARRANTY, EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO IMPLIED WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE. McGraw-Hill and its licensors do not warrant or guarantee that the functions contained in the work will meet your requirements or that its operation will be uninterrupted or error free. Neither McGraw-Hill nor its licensors shall be liable to you or anyone else for any inaccuracy, error or omission, regardless of cause, in the work or for any damages resulting therefrom. McGraw-Hill has no responsibility for the content of any information accessed through the work. Under no circumstances shall McGraw-Hill and/or its licensors be liable for any indirect, incidental, special, punitive, consequential or similar damages that result from the use of or inability to use the work, even if any of them has been advised of the possibility of such damages. This limitation of liability shall apply to any claim or cause whatsoever whether such claim or cause arises in contract, tort or otherwise.

DOI: 10.1036/007137664X

# CONTENTS

Preface *v*

## PART I

### RISK CONTROL

- 1 **Managing Money to Succeed As a Day Trader** 3
- 2 **Five Steps to Determine the Proper Position Size** 12
- 3 **Profit by Managing Loss** 17
- 4 **Mind Games That Propagate Financial Havoc** 26

## PART II

### UNDERLYING CONDITIONS

- 5 **Trend Spotting Is the Key to Profits** 39
- 6 **Four Trading Signals for Spotting a Trend** 49

## PART III

### FUNDAMENTALS

- 7 **Fundamental Catalysts** 67
- 8 **Ratio Power** 74
- 9 **Economic Indicators and Their Impact on Day Trading** 82
- 10 **Organize Your Information Flow** 92

**PART IV****THE TRADE**

- 11 **Entry** *103*
- 12 **Exit** *114*
- 13 **Execution and Control** *119*

**PART V****TECHNICAL ANALYSIS**

- 14 **Candlestick Charting Techniques** *137*
- 15 **Support and Resistance** *161*
- 16 **Basic Chart Patterns** *171*
- 17 **Oscillators and Reversal Indicators** *190*

**PART VI****THE PULSE OF THE MARKET**

- 18 **Volume** *209*
- 19 **The Leading Indicators** *220*

**Part VII****ADVANCED TRADING TACTICS**

- 20 **Advanced Chart Patterns** *231*
- 21 **Trading the Gap** *248*
- 22 **Event-Driven Trades** *260*

**Part VIII****PSYCHOLOGY**

- 23 **The Trading Mind** *271*
- Conclusion** *285*
- Index** *287*

# PREFACE

The on-line trading revolution is transforming the investment world at a dizzying speed. In a single year, between April 1998 and April 1999, the number of trading accounts opened on-line in the United States increased 25 percent, rising to over six million. At the beginning of the year 2000, over 8 million on-line accounts exist. The potential growth rate for on-line accounts is startling, given that they comprise fewer than 10 percent of all brokerage accounts.

CNBC reported that a majority of day traders go broke within their first six months of trading. Active day traders are responsible for 30 percent of the million-plus on-line trades executed daily. The combination of the huge number of Americans who are trading on-line and the high expected failure rate for beginners results in a potential powder keg: In the first years of the new millennium, more Americans will lose money day trading than ever before. There is a national need for an all-encompassing, simple, and effective day trading guide; thus, *The Market Maker's Edge*.

Day traders have been around since the inception of the stock market in 1792. Human beings have speculated on prices since the dawn of currency, and this trend will continue regardless of the state of the market.

Public interest, demand, and participation in day trading increased dramatically during the roaring bull market of the 1990s. Higher rates of return, advances in technology, ease of entry provided by on-line brokers that charge lower commissions, and a public that cannot afford to retire have all contributed to the explosion in ownership and interest in the stock market. Almost 50 percent of the American public had some sort of equity ownership in 1999. The

majority of these investors and traders have unrealistically high expectations of the amount of money they can expect to receive from their investments, creating a need for education.

Many of the principles behind profitable day trading are simple. Yet time and again, people tend to complicate the decision-making process due to a number of factors, both internal and external.

Day trading magnifies the emotional pitfalls people face in everyday life, including greed, fear, attachment, shame, regret, and the search for security. These emotional and psychological traps that I call the internal factors are the most common causes of financial loss in the trading world.

To be successful, every trader needs an effective trading plan. The best plans are simple and comprehensive, addressing external factors such as risk control, entry and exit, technical and fundamental analysis, trend spotting, and trading tactics.

This book stands out from most books on trading in that it places special emphasis on both the internal and external factors. It is also unique because it is written from the perspective of the sell side of the trading world, shedding light on tactics and methods used by professional Wall Street traders.

The information that has not been readily available to the public is what market makers actually do, and what makes many of them effective day traders. Day traders have all sorts of misconceptions about market makers' roles and objectives. Market makers are incorrectly stigmatized as the enemy of day traders, when in fact the main enemies of day traders are day traders themselves.

Market makers come in all shapes and sizes. They range from small retail order flow shops that do not put up any risk capital, to the largest institutional global banks that consistently take large risk to facilitate order flow. Institutional market makers' strengths lie in their experience and technical expertise. One advantage they enjoy is that they understand the way that order flow works. Large buyers or sellers always leave traces through their activity. Their activity is visible to all who know how and where to look for it. *The Market Maker's Edge* helps to clarify this activity, providing traders who lack market making experience with information about how order flow works. This book sheds light on a simple way to take advantage of identifying short-term trends emanating from volume.

Another advantage market makers have over day traders is their large financial backing, which permits them to expand their risk profiles in order to withstand larger losses. The large global banks that have market making operations have the deepest pockets. A \$10,000 loss may be large to a day trader, but to an institutional market maker it is simply the cost of doing business. Day traders can make up for their lack of large financial backing with proper risk control and realistic expectations, both of which they will learn about in this book.

Day traders who are in the early stages of development have to overcome their lack of experience, which is often only acquired either by learning what not to do or by making mistakes. This process can be very expensive, more so than many can afford. *The Market Maker's Edge* provides guidance in the form of a step-by-step process for developing and maintaining a diligent risk profile, which will help beginning day traders to weather the initial storm.

Information used to be a commodity that the top market makers enjoyed as a result of having well-endowed research departments. The Internet has broken down the information barrier between global banks and individual investors. The best research is now easily accessible on the Internet for all to see. Sometimes market makers are the last ones to catch wind of important information that is released on the Internet.

*The Market Maker's Edge* will teach you how to trade with the best market makers, not against them. You will become adept at overcoming short-term gyrations by sticking to the methods and tactics provided in this book. *The Market Maker's Edge* will help you overcome fears or weaknesses by developing successful trading habits and focusing on your strengths. Your conviction and staying power will increase and you will become a better trader, less susceptible to the influences that are outside of your control.

JOSH LUKEMAN

*This page intentionally left blank.*





# ACKNOWLEDGMENTS

I would like to thank my talented agent, Noah Lukeman of Luke-man Literary Management, whose guidance and foresight helped make this book a reality.

I would like to thank my fiancée, Yana Polischuk, for her understanding and support throughout the whole project. I would also like to thank my mother and father and Adam, Melissa, Abram, and the rest of my family for their continued support and encouragement, without which this book would not be possible.

I would like to thank Joseph Ferrarese for his instruction and influence, whose guidance was instrumental in my development as a market maker. Matthew Desalvo and Keith Brickman have also been of great help and support and I thank them for their guidance.

Thank you to John Mulheren for his direction and tutelage during my earliest stages of development as a trader. David Schulman and Lenny Destefano were also supportive during this period and I would like to acknowledge them for their help.

Many thanks to Stephen Isaacs, Jeffrey Krames, and Philip Ruppel of McGraw-Hill for their help and belief in the book from its earliest stages. Their professionalism and talent are of the highest caliber in the publishing industry.

I would like to thank Paul Bracco, John Procopion, Tommy Crocamo, Josephine Siciliano, Steven Suslow, Ron Commerchero, and Dan Uslander for their help and support in the trading world.

Thank you to CTS Charts and QMS Systems of Brass Utilities for allowing me to display their charts and NASDAQ Level III screens throughout the book.

Finally, I would like to acknowledge R. Aaron Mehlman, Sensei Toyotaro Miyazaki, Darrin Giglio, John Procopion, Anthony Tricario, and Carl Ashmowey for their expert advice and guidance along the way.

P A R T  
I

# RISK CONTROL

*This page intentionally left blank.*

# CHAPTER 1

## MANAGING MONEY TO SUCCEED AS A DAY TRADER

*After graduating from college, Avi Levichuk was eager to make big cash by day trading. He heard many stories about SOES bandits making thousands of dollars a day flipping in and out of stocks. Avi believed that all he needed to do was catch a couple of waves a day trading Internet stocks. If he did this, he would make anywhere from five to ten points, or five to ten thousand dollars, per day using 1,000-share lots.*

*Avi went to a SOES shop on Broad Street and plunked down his bar mitzvah money, \$25,000, plus another \$25,000 he borrowed from his grandfather. With the \$50,000 he would qualify for 4 to 1 intraday leverage, providing him with \$200,000 of buying power. He estimated this would be enough to allow him to trade high-priced Internet stocks such as Yahoo, Ebay, or Amazon.*

*On his first day of trading, Avi was briefly up \$4,000 on a 1,000-share position in Ebay. Then the stock turned against him and he was quickly down \$3,000—a \$7,000 reversal. Instead of cutting his losses,*

*Avi bought another 1,000 shares, in order to “average down.” Ebay sold off another 6 points and suddenly Avi was down \$15,000, or 30 percent of his \$50,000, in less than two hours. Unable to take the pain anymore, Avi sold his 2,000 shares—at the bottom of the move. Within three weeks Avi had lost all of his \$50,000 dollars, and on top of that he owed the firm \$3,000. If he had understood the principles of risk control, his chances for success would have increased dramatically.*

Risk control is the foundation of survival for all traders. It is one of the few aspects of the marketplace that a trader has control over. The most common error made by beginning traders is a disregard for risk control by taking overly large positions. Unreasonable expectations can cause beginners to gamble 50 to 100 percent of their portfolios on a single trade. Taking wild shots with huge positions is not trading—it’s gambling. Successful trading is developed over time, by winning consistently and conserving capital.

Trading positions that are too large often results in huge losses; it is the most common reason beginning traders go broke quickly. Large positions go hand in hand with large emotions: The bigger the position, the more intense the feeling of either greed or fear. The large P&L swings associated with big positions usually cause traders who are just beginning to abandon discipline and to trade subjectively and emotionally. On one hand, it is harder for them to take the loss because of its size; on the other hand, it is harder to let the profits run on a position that’s too big. Traders end up cutting their profits short and letting their losses run—the opposite of what they should be doing in order to be successful.

## **TRADE ONLY WITH MONEY YOU CAN AFFORD TO LOSE**

Sun Tzu said that “Every battle is decided before it is ever fought.” He meant that through meticulous planning and preparation before a conflict, a person should be able to get into a position such that victory is assured. When the battle occurs, it will take place against

an opponent that is already defeated—a result of the prior planning.\* The same methodology should be applied to trading. Before trading, traders should put themselves into a position such that the victory can be assured by substantially reducing the meaning of their losses.

The emotional pitfalls of trading are magnified exponentially when you have to trade successfully in order to survive. The most successful traders have an almost complete disregard for money. The need to make money forces a person to be attached to the outcome. This attachment normally influences the decision-making process for the worse, because fear is magnified, distorting reality.

Traders must be comfortable with the worst-case scenario before they even consider the best. The most successful traders have become comfortable with the idea that they can lose it all; paradoxically, that idea provides them with a sense of security.

Only you can determine how much money you can afford to lose. The money you trade with should be money that you are comfortable with never seeing again. If you decide to invest in a career as a day trader, ponder this question carefully.

## **SMALLER IS LARGER**

The importance of financial management when applied to position size cannot be overemphasized. Wall Street is filled with stories about experienced traders who went broke after long and successful careers because they ignored the oldest and most important rule of money management: Don't take positions that are too big for your financial comfort level.

The urge to make money quickly will always tug at you when you're trading. Fight this urge so you don't have to learn a painful lesson the hard way. Successful trading is first and foremost about survival through financial preservation and consistency, not about

---

\*Sun Tzu, *The Art of War*. James Clavell, ed. Delacorte Press, 1983.

hitting home-run trades with huge positions. It takes strict discipline and careful preparation to match your positions to your risk profile. The smaller your positions, the easier it will be to maneuver in and out of trades, whether you are adding to a winner, cutting a loss, or taking a profit.

There is a direct correlation between correct position size and higher profitability. Losses are inevitable; but smaller positions produce smaller losses, allowing quicker recovery and less emotional attachment. The key here is emotional attachment. Traders tend to develop a comfort zone for position size, given their financial capacity to take risk. If you trade a position that is too big, then your sense of detachment can be thrown out of whack, adversely affecting your ability to maintain objective discipline.

What causes a trader whose comfort zone is 2,500 shares to buy 10,000 shares? Traders take positions that are too large for a variety of reasons: greed, lack of understanding of money management techniques, faulty trading tactics, the ever-present ego, and unrealistic expectations.

Larger losses are the product of bigger positions. A big loss requires a higher gain in the future to offset it, because of slippage, time, and commissions.

It is much harder for a trader to trade out of a large hole than out of a smaller one. If a trader is down around 6 percent on the month, chances are that the trader's confidence and buying power will remain intact. Successful traders are not afraid of reasonable losses, because they have confidence that they will persevere to make back what they lost and more.

However, if a trader is down 50 percent on the month, it will be a lot harder to regain confidence and stability. Large losses sting, and can cause a trader to be gun-shy in the future.

It becomes increasingly difficult to recapture an unusually large loss when you trade position sizes that are not evenly distributed. In addition to making back the equivalent percentage lost on the bigger position, you'll have to make back the spread and commissions. Many traders who experience a skewed loss resulting from a position that was too big believe that the only way they can make it back is to take a large position again. When this occurs, a trader is oper-



ating at a psychological disadvantage arising out of desperation. The result is that the risk profile is endangered, and the trader loses the best source of protection.

## TRADE WITH BALANCED POSITION SIZE

Position size in trading should be adjusted for broadly uneven stock price levels. Uneven stock price levels result in uneven probabilities that a large percentage move will occur. If you hold both a \$10 stock and a \$100 stock, a one-point price change in each one will have an equal impact on the profit or loss of your portfolio if the position sizes are equal. However, a one-point move in each stock would represent very different percentage changes. A one-point move in the \$10 stock represents a 10 percent price move; a one-point move in the \$100 stock represents a 1 percent price move. The 1 percent price move in a stock is statistically less significant, and thus more likely to occur, than a 10 percent move. Therefore, it does not make sense for traders to take equal position sizes in stocks that have broad price discrepancies, although they do it all the time.

A \$100 stock would have to move 10 points in order to yield an equivalent percentage change to a 1-point move in a \$10 stock. The 10-point move would have 10 times the dollar impact on a portfolio if the position sizes were the same, an unbalanced risk allocation. Position sizes should be adjusted according to the price and number of stocks you are trading, such that an equal percentage price change will have an equal profit or loss impact on the portfolio.\*

## THE 2 PERCENT RULE

One of the principles of risk management is the 2 percent rule. The rule states that no more than 2 percent of a total portfolio should be lost on any individual trade. Ideally this figure should include the costs of commissions and slippage. This means that the largest loss you should tolerate on any single trade is 2 percent of your portfolio. Some people misinterpret this rule to mean that only 2 percent

---

\*Schwager, Jack, *Technical Analysis of Stocks and Commodities*. Technical Analysis, Inc., June 1999, p. 26.

of your trading equity should be allocated to each trade, but that's not the case. The 2 percent rule is designed to limit a trader's losses while preserving capital. It is powerful insurance because it provides a trader with a number; you know before you enter a trade how much you can afford to lose. Applying this principle, a trader can afford to be wrong numerous times and still live to see the next trading day.

Keeping your losses to 2 percent per trade often means that you will have to trade smaller positions. Many traders who are just starting scoff at the idea, thinking that bigger positions will allow them to strike it big and make a large monthly income through big profits. Nothing could be further from the truth. When beginning traders take on bigger positions, it often causes them to lose money faster because they have not built up the tolerance for accepting larger losses or bigger profits. They tend to take profits off the table faster when they are winning, because of the immediate gratification associated with being right. They also tend to let their losers run longer, because they are not willing to accept the pain associated with being wrong.

It is not uncommon for traders to enter into positions not knowing beforehand how much they are willing to lose, because they think they are going to win. When expectations for a trade are not met and no exit strategy exists, a trader is often forced to cut a position based on either emotion or financial pain. The goal of a trader should be to accept losses without letting them affect his confidence. This is accomplished through preparation *before* the trade, budgeting for losses just as you budget for an insurance bill.

The 2 percent rule is pivotal because the success of an individual is not necessarily correlated to the number of winning trades: Some of the most successful traders on Wall Street earn up to 80 percent of their profits from just 20 percent of their trades. This means that the majority of their trades may not earn them the big money. The reason they are profitable as a trader is that they have learned to quickly accept and manage loss, not disregard or try to eliminate it. Successful traders aim to keep loss controlled. When losses are controlled a trader is free to focus on and add to winning trades.

By limiting individual losses to 2 percent or less of your portfolio, you increase the odds that you will experience more break-even and winning trades. Over time, these trades tip the scales toward profitability, as long as losses are managed. The 2 percent rule is par-

ticularly beneficial for beginning traders. Your probabilities of success increase with the number of times you play. A 2 percent maximum loss guideline increases the life span of beginning traders, providing them with the opportunity to learn from their mistakes.

A loss of 6 percent to 8 percent is the maximum a trader should accept for the entire month. A trader who has four consecutive 2 percent losses should stop trading for the month and evaluate what's going wrong. You can always begin anew the following month. Taking time off after a string of losses is beneficial, because it provides you with an opportunity to regain your confidence. A trading time-out is similar to a basketball time-out after the opposing team has scored a number of unanswered points. The time-out slows the winning team's momentum and helps the losing team regain confidence with a pep talk and a breather. If you enter a trading day lacking confidence, close the shop and begin again tomorrow. Confidence in yourself and what you are doing is your strongest ally.

## MARGIN MADNESS

Using margin to increase buying power is an accepted and common practice among most day traders today. It is important for day traders to be aware of the risks of margin, and to learn how to handle the augmented buying power effectively if they choose to use it. Using excessive leverage through margin is a dangerous game. The sell-off in Internet stocks in the spring and summer of 1999 resulted in a huge number of margin calls for day traders and investors. The risks associated with margin require careful planning and tighter stop-loss criteria. Many investors are not aware of the risk inherent in using leverage, and should stay away from it. When the market turns against a highly leveraged position, a trader is often forced to liquidate it at the worst possible moment.

Even the brightest and most highly regarded traders on Wall Street are not immune to the danger of trading with excessive margin. During the predicament in the global financial markets in September 1997, the Long Term Capital Management (LTCM) hedge fund reported that it had lost \$2.3 billion in high-risk trades and was on the verge of bankruptcy. Fund founder John Meriwether and his partners, Nobel laureates Myron Scholes and Robert Merton, traded with ridiculously high levels of margin. At times

they took huge positions, putting only 5 percent down. Although they attempted to diversify the risk with long and short spreads in their bond funds, the bloated margin ultimately proved fatal. The amount of margin power that LTCM used is the equivalent of a stock trader buying \$100,000 worth of stock with only \$5,000 cash down. A small hiccup in price could easily wipe a trader out with such high degrees of leverage.

In a report issued on August 9, 1999, the North American Securities Administrators Association stated that it is not uncommon for some day trading firms to encourage day traders to borrow money from other traders in order to meet margin calls. This practice flies in the face of the most basic risk management practices and should be avoided at all costs. It is a clear sign that the trader is acting out of financial desperation and that the end is near.

When you choose to trade on margin, enforce strict risk-control standards geared to the amount of underlying cash you have to trade with. If you have \$50,000 to trade with and you are using leverage through margin, your risk standards should be focused around the \$50,000 in underlying cash, not the amount of buying power you are using. Applying the 2 percent rule, your maximum permissible loss will be \$1,000 per position.

Success in day trading is first defined as survival. Your ability to survive as a day trader depends on your money management techniques. When you manage your money properly, you provide yourself with valuable risk insurance, which any business should have. The best way to control risk when trading is to manage your losses. Determine the most that you are willing to lose on any one position, which should not exceed 2 percent of your underlying equity.

Keeping your individual losses to 2 percent or less often requires that you trade smaller positions to start. Smaller positions can be empowering because they allow you to trade with less attachment, permitting you to cut your losses sooner and easier. The key to success in trading is to have the least possible emotional attachment to your positions. If you are trading because you have to win, chances are that your attachment to the outcome will be high, adversely affecting your decision-making process. When you trade only with money that you can afford to lose, your attachment will be minimal and your results will be better.

Risk control is a crucial component to successful trading. Improper risk standards result in trades that can easily wipe out even the most experienced traders. Traders last in the business because they have learned to manage their expectations and control their exposure. When addressing the risk factor, remember the importance of position size. Never allow yourself to trade a bigger position than you can afford. The temptation will always be there, but managing this urge through discipline is the mark of a successful trader. It is always better to start out small and add to your position, rather than starting out large and regretting it afterward. Remember the old saying:

*Discipline weighs ounces while regret weighs tons.*

# C H A P T E R 2

## FIVE STEPS TO DETERMINE THE PROPER POSITION SIZE

Endurance in trading is the first step toward success. Especially when a trader is beginning, surviving means you can learn and become better. Living to see the next day in trading is the most basic and important goal of any trader. This sounds simple, but its importance cannot be overemphasized. The outcome of any trade is not within a trader's control; how much money you lose is. Controlling loss is the only security a trader has; without that security, catastrophe can strike.

The way to maintain a 2 percent maximum loss risk profile is to determine beforehand the proper position size. Determining the proper position size involves five simple steps. These steps should be taken methodically, every day, before trading.

## STEP 1. ALLOCATE CAPITAL PER POSITION

The first step is to determine the maximum capital per position, or the most money that should be invested in a single trade. This figure is calculated by dividing the total capital in your account by the number of positions you wish to take. If you have \$100,000 of risk capital to trade with and you want to take four positions, allocate an equal dollar amount to each position:

$$\text{Capital per Position} = \frac{\text{Risk Capital}}{\text{Number of Positions}}$$

$$\text{Risk Capital} = \$100,000$$

$$\text{Number of Positions} = 4$$

$$\text{Capital per Position} = \$100,000 / 4 = \$25,000$$

The maximum capital per position you should be willing to invest is \$25,000.

## STEP 2. CALCULATE MAXIMUM SHARES PER POSITION

Once your capital per position is allocated, the next step is to calculate how many shares of each position to trade. Divide the risk capital per position, or \$25,000 in this example, by the share price. Assuming there are four stocks you want to trade with prices of \$100, \$50, \$25, and \$10, the calculation is:

$$\text{Maximum Shares per Position} = \frac{\text{Capital per Position}}{\text{Stock Price}}$$

$$\text{Capital per Position} = \$25,000$$

$$\text{Stock Price} = \$100, \$50, \$25, \text{ and } \$10$$

$$\text{Maximum Shares per Position} =$$

$$\$25,000 / \$100 = 250 \text{ shares}$$

$$\$25,000 / \$50 = 500 \text{ shares}$$

$$\$25,000 / \$25 = 1,000 \text{ shares}$$

$$\$25,000 / \$10 = 2,500 \text{ shares}$$

These figures are maximums that take into account your buying power per position.

### STEP 3. DETERMINE 2 PERCENT DOLLAR RISK PER TRADE

To determine the maximum amount of money you can withstand to lose per trade, multiply 2 percent times your capital per position. In the example, using \$25,000 per position:

Maximum Dollar Risk =  $.02 \times$  Capital per Position

Capital per Position = \$25,000

Maximum Dollar Risk =  $.02 \times$  \$25,000 = \$500

In this example, \$500 is the most you are willing to lose on a trade, given your capital allocation per position. Taking another example, if you have \$100,000 to trade with and decide that you want to take two positions, then your dollar risk per trade is \$1,000:

Capital per Position =  $\frac{\text{Risk Capital}}{\text{Number of Positions}}$

Risk Capital = \$100,000

Number of Positions = 2

Capital per Position = \$100,000 / 2 = \$50,000

Maximum Dollar Risk =  $.02 \times$  Capital per Position

Capital per Position = \$50,000

Maximum Dollar Risk =  $.02 \times$  \$50,000 = \$1,000

### STEP 4. DETERMINE THE STOP-LOSS POINT

Various stop-loss strategies are covered in detail in Chapter 3. For now we'll determine our stop-loss point from initial entry. Stop-loss exit points vary greatly given the different price of stocks. In our example, a one-point move in the \$100 stock (1%) would represent a small percentage change compared to a one-point move in the \$10 stock (10%). It is prudent to use wider stops for higher-priced stocks and tighter stops for lower-priced stocks. Assume that, based on your calculations, you have identified a lower-priced stock with one point of risk. Using the \$25 stock as an example, if the current market is quoted \$25—\$25<sup>1</sup>/<sub>8</sub>, then \$24 is the stop-loss exit point if you are trading from the long side with one point of risk.



Adjusting for slippage on entry and exit can be difficult because many different elements determine what sort of executions you may receive, including liquidity, volatility, technology, the market environment, and the execution medium (see Chapter 13). Always provide enough room for a poor execution on exit. When adjusting for slippage, it is always better to prepare for the worst and be glad if you receive the best. For this example, we'll factor in an extra 1/4 of a point on each side of the trade for slippage.

Stop-Loss Risk = Current Bid – Exit Point + Slippage

Current Bid = \$25

Exit Point = \$24

Slippage = 1/4

Stop-Loss Point = \$25 — \$24 + 1/4 = 1<sup>1</sup>/<sub>4</sub> points

## STEP 5. CALCULATE MAXIMUM POSITION SIZE

After determining the 2 percent maximum dollar risk and the stop-loss point, you can calculate the maximum position size:

$$\text{Maximum Position Size} = \frac{2\% \text{ Maximum Dollar Risk per Trade}}{\text{Stop-Loss Point per Trade}}$$

2% Maximum Dollar Risk per Trade = \$500

Stop-Loss Point = 1<sup>1</sup>/<sub>4</sub> points

Maximum Position Size = \$500 / 1<sup>1</sup>/<sub>4</sub> points = 400 shares

If you have \$25,000 allocated for a trade and you have picked a stock that you believe has 1<sup>1</sup>/<sub>4</sub> points of risk, then the maximum position size is 400 shares. If the price of the stock is \$25, you will use only \$10,000 of buying power (\$25 × 400 shares = \$10,000), which is appropriate given your 1<sup>1</sup>/<sub>4</sub> stop-loss point and your \$500 maximum tolerance for loss. In our example, because you're using only \$10,000 of buying power for the \$25 stock, you free up \$15,000 in capital to allocate toward another position.

Step 2 provides guidance for the maximum position given your capital allocation:

Maximum Shares per Position =

\$25,000 / \$100 = 250 shares

\$25,000 / \$50 = 500 shares

$$\$25,000 / \$25 = 1,000 \text{ shares}$$

$$\$25,000 / \$10 = 2,500 \text{ shares}$$

Even though the maximum position size for a \$25 stock is 1,000 shares given your capital allocation, you would not trade with that size because the loss you might sustain with a 1¼ point stop-loss would be larger than your \$500 maximum loss risk tolerance. On the other hand, if you selected a \$100 stock with the same 1¼ point stop-loss risk profile, then your maximum position size should be limited to 250 shares, because that would be the maximum you could buy given your \$25,000 capital allocation.

Higher-priced stocks also normally require wider stops. Chances are that the \$100 stock would have a wider stop-loss point because of higher slippage and volatility. With the 250-share position in the \$100 stock, the maximum stop-loss point would be 2.

When you carefully prepare to manage risk before trading, the outcome will always be manageable. Trading with appropriate position sizes is extremely important for beginning and professional traders alike. Appropriate position size is determined by knowing beforehand how much you can afford to lose on any one position. When you know that figure, you can determine how large your position should be given your initial stop-loss point and the price of the stock.

# C H A P T E R 3

## PROFIT BY MANAGING LOSS

Being wrong about a trade is okay. In fact, the only way for a trader to become comfortable with the notion of loss in trading is to experience it regularly, while developing the discipline to cut it out quickly without even thinking about it. Some of the most profitable traders are right marginally more than they are wrong. The most successful traders have developed the ability to accept loss as part of the game, and to cut it out before it cuts them out. This allows them to spend their time focusing on the winners rather than the losers.

*Substance is the inner quiet of mind, free of individual failings.*

ZEN SAYING

### **HOW TO WIN WITH THE STOP-LOSS**

Enter into trades only when you have established a sensible game plan, with a stop-loss exit strategy mapped out in case the trade is a

loser. A stop-loss is your only insurance if the stock does not perform the way you hoped. If and when that initial stop-loss point is reached, it is crucial to get out of the position *without thinking about it*.

A protective stop can be entered on the actual books of the New York Stock Exchange. However, most NASDAQ market makers do not accept stop-loss orders, so you have to keep track of stop-loss points mentally or on paper. There will be times when a stock will turn around moments after you were stopped out, but keep in mind that in the long run, this makes absolutely no difference.

Managing loss is what risk control is all about. Losing correctly requires inner strength, discipline, and resolution. It takes strict control to set a stop before you enter a trade. Setting a stop before trading means that you are considering the risk before going after the reward. The only way to last in trading is by preserving capital; adhering to predetermined stops will allow you to do this.

After you enter a stop, do not adjust it to give yourself more leeway if the trade is not working out. Why a trade is not working doesn't matter; you can always find rationalizations and excuses for loss. Price action, however, does not warp reality. The sooner your stop announces to you that your position is faulty, the better off you will be. By way of an analogy, on a multiple-choice exam, usually the first answer you pick is the best one. Statistics show that if you second-guess yourself by going back and changing your answer, you will probably be incorrect. Moving stops or ignoring them is similar to second-guessing yourself on a test—your first choice for a stop-loss is probably the best, and you should adhere to it.

There are different strategies for placing stops. With practice, most traders develop their own stop-loss strategies based on individual preferences.

## INITIAL STOP-LOSS

Initial stop-losses can be placed in many different areas. Depending on why you entered a position, the initial stop-loss will ensure that your original thought process remains intact. When a trade is initiated, a stop-loss should be placed immediately. There are various technical levels to place a stop, but a general guideline for long positions is that the initial stop-loss should be placed 1/8 point beneath the previous day's low. For short positions, the initial stop-loss should be placed 1/8 point above the previous day's high. Only

after you choose an initial stop-loss can you take the steps, described in Chapter 2, to determine your proper position size.

The previous day's low and high prices represent the first technical price levels of daily support and resistance. Yesterday's low or high point was the furthest that the bears or bulls could push the stock before it changed direction. Stops tend to accumulate just below or above these price ranges. A move through the lows or highs of the previous day may trigger stops and tend to clear the path for further momentum. If, for example, Dell Computer is 40 bid and yesterday's low was  $38\frac{1}{2}$ , your protective stop-loss order should be placed at  $38\frac{3}{8}$ .

## BREAK-EVEN STOP-LOSS

After the initial stop-loss is set, the next stop-loss order to use is a break-even stop-loss. After you have entered into a position and have your initial stop-loss protection in place, your objective would naturally turn toward implementing a superior exit strategy to use when the trade is earning you money. The first step toward exiting a winning trade is to protect your profits by moving the stop-loss order to your entry point.

With a break-even stop, you are in a sense catching a free ride on the tail of the market, and the worst-case scenario is nothing lost, except for commissions. A tightened stop-loss does increase the possibility of being prematurely stopped out while the trade still has a shot to meet your original objectives, but you can always get back into the position. The break-even stop-loss provides peace of mind along with a sense of detachment. When the trade is working and the break-even stop-loss is in place, you have successfully created an opportunity with little or no cost to you.

The best time to raise your stop-loss to the break-even level is subject to individual trading styles. A guideline that seems to work well when adjusting stops to the break-even point is the  $1\frac{1}{2}$  percent move. The  $1\frac{1}{2}$  percent move suggests that you should adjust your stop-loss to break-even after your position has moved at least  $1\frac{1}{2}$  percent above your entry point. For example, assume you bought DELL at 50 and your original stop-loss was 49. When DELL moves  $1\frac{1}{2}$  percent above 50, or  $\frac{3}{4}$  points to  $50\frac{3}{4}$ , you should slide your stop-loss up to your entry point of 50. The  $1\frac{1}{2}$  percent adjustment yardstick is useful because it can be applied across the board to

broadly ranging prices. It is recommended that for lower-priced stocks, the minimum move before raising your stop-loss to break-even should be at least  $1/2$  point. For example, a  $1\frac{1}{2}$  percent move in a \$25 stock is approximately  $3/8$  of a point. In this case you would wait for  $1/2$ -point move first before using a break-even stop-loss.

The  $1\frac{1}{2}$  percent break-even parameter is meant to be flexible according to each trader's individual style and comfort level. Some traders raise their break-even stops immediately after the stock has moved  $3/8$  of a point in their favor. Others wait for a move of at least \$1 or more. Experiment with this parameter and utilize its psychological advantage.

## TRAILING STOP-LOSS

If stocks have lingered in no-man's-land for the day—that is, they have not moved above the  $1\frac{1}{2}$  percent break-even stop-loss barrier or have fallen beneath the initial stop-loss point—they require a trailing stop. A trailing stop is an adjustment of the initial stop taking into account the price action of the current day when the market has closed. If the initial stop-loss was placed  $1/8$  below the previous day's close, then the trailing stop would be moved  $1/8$  beneath the current day's close. Assume that after you go long DELL at 50, it trades in a  $49\frac{1}{4}$ — $50\frac{1}{2}$  price range. During the day it fails either to pierce the initial stop-loss at  $48\frac{3}{4}$  or to move above the  $1\frac{1}{2}$  percent mark of  $51\frac{3}{4}$ . In this case, the new stop-loss would be moved up to  $49\frac{1}{8}$ , or  $1/8$  below the current day's low. Remember that you can always reenter a position after getting stopped out if you believe the trade still has potential. It's always better to reexamine the position with a clear mind and nothing at stake. If you still like the position after being stopped out, then your strategy was probably sound, based on objective reasons.

## PROFIT-TAKING STOP

Another type of stop-loss is one used to protect your profits. This is used when your position is working well and has moved at least  $1/2$  point above the  $1\frac{1}{2}$  percent break-even stop-loss zone. At this point your break-even stop-loss is in place and it's time to preserve some of your gains. Your objective is to move your break-even stop to  $1/2$  point below the  $1\frac{1}{2}$  percent profit-taking barrier. In our example, if after you go long DELL at 50, it moves to  $51\frac{1}{4}$ , your break-even stop

would be moved upward from 50 to  $50\frac{3}{4}$ . The  $51\frac{1}{4}$  price represents a  $\frac{1}{2}$ -point move above the  $1\frac{1}{2}$  percent break-even stop-loss entry zone.

Locking in some profits using a stop-loss strategy is an effective way to trade without worrying about losing your gains. It helps a trader to let profits run longer while not missing out on a solid gain. Depending on the trader's style and the type of stock traded, the stop-loss level used to lock in some gains could be adjusted. More aggressive traders may use wider stops to protect profits, while less aggressive traders would use narrower ones.

Developing a comfort level when using stops takes practice and discipline. Each stock has its own personality and reacts differently throughout the day. Some stocks advance and pull back quickly, while others may creep along steadily. After becoming familiar with the stock you're trading, you will be able to place stops more effectively.

Stop-loss orders are protective measures and are not perfect. Market forces can swing prices through stop points, resulting in larger-than-anticipated losses. Stops are still the most effective form of insurance a trader has. Successful traders have learned to exit their positions quickly when their stops are hit, without thinking about it. They understand that tomorrow is another day and they will have another chance. Stops give traders breathing room, discouraging them from being "psyched" out of a position due to choppiness or indecision. Stops provide peace of mind because they represent a decision that was made before the trade. Placing a stop-loss order means there is one less decision traders have to make while they have a position. When you take action and exit a position because of a prearranged stop, you are reinforcing discipline and confidence in your game plan. Remember to always stick to prearranged stops.

## TRADE LIQUID NAMES

Properly evaluating the liquidity and the volatility of a stock may mean the difference between a successful or a hapless outcome for market makers and day traders alike. One of the toughest jobs a market maker has is to properly size a market. This means correctly assessing the proper risk, given the current liquidity and volatility of a stock. Market makers are constantly putting up risk for accounts to capture larger order flow. This involves either buying or selling a

block of stock at or very close to the inside market. For example, if AAPL's current inside market is 53—53<sup>1</sup>/<sub>8</sub>, with 2,600,000 shares traded on the day, what is the proper amount of stock the trader should be willing to buy or sell on the inside bid or offer? What is the most the trader should be willing to sell up or down 1/8 from the inside market? What kind of slippage, or movement, if any, would be involved before buying back or selling the size bought or sold?

A market that is oversized can easily lead to a large loss. If a market maker were putting up risk for a large order, the object of the next part of the trade would be to trade the order for a small profit, for a small loss, or flat. This would eliminate the up-front risk, allowing the market maker to trade the rest of the order for a profit, generally without risk. Day traders who are about to enter a trade should also be careful to judge how much slippage may be involved before they will be able to exit or enter the position.

Part of a market maker's job is to broadcast buy and sell interest messages in stocks through an electronic system called Autex (owned by Thompson Financial Services). These messages are sent out before market opening and throughout the day, with the goal of letting the street know what you want to do in a stock in order to attract an order. Brokers or traders can view these messages at will and respond accordingly with a phone call, depending on their particular interest.

Here's an example of a super message followed by an order: Apple Computer is trading actively, with 2,600,000 shares traded so far on the day. The market maker wants to get involved and notices that the stock is acting strong, with blocks of 25,000 and 50,000 going up on the offering side. He decides to offer the stock for sale, with the objective of accepting risk up front in order to get an order in the door. With AAPL's market quoted 113—113<sup>1</sup>/<sub>8</sub>, the market maker "supers" 100,000 shares at 113<sup>1</sup>/<sub>8</sub>, on the offer. An institutional trader who wants to buy sees this message and calls the firm.

*Jack, you just "supered" 100 AAPL at 113<sup>1</sup>/<sub>8</sub> and I'm a buyer. I'd like to own the 100 here, and take 100 more to buy behind that.*

The salesperson relays to the trader:

*Apple, you just supered 100 at 113<sup>1</sup>/<sub>8</sub>. I bought those. Work 100 behind it at the market.*



The market maker is now short 100,000 shares of Apple on the offering at  $113\frac{1}{8}$ . The success of this trade will depend on the market maker's judgment as to the liquidity and volatility of AAPL, given the super message. His objective now is to buy back the stock that he shorted with the least market impact. He will adjust his market discretely in order to reduce his risk by buying as much AAPL as possible in order to service the account quickly.

## DIVERSIFY YOUR POSITIONS

Traders can spread out their positions in order to minimize market risk while optimizing their chances for success. Many professional Wall Street traders look for ways to increase their probabilities for success in a trade by diversifying the number of positions they take within a given sector. Diversification tends to increase the odds that if the sector does move in the anticipated direction, other stocks that the traders have selected will move that way too.

Diversification among individual stocks within one sector spreads out the alpha, or individual, risk inherent in each stock. Every stock in the marketplace is subject to both market risk (beta) and stock-specific risk (alpha). The market risk (beta) of a stock refers to how it moves in conjunction with the motions of the broader market. The beta risk of a position is the risk that the broader market will turn against you, pulling the stock you are long with it. Some stocks have higher betas than others, which means more exposure to the fluctuations of the market. Stocks that have a beta of 1 should move in step with the market. If the market is up 2 percent, a stock with a beta of 1 on average should also be up 2 percent. If a stock has a beta of 2, then it moves at twice the rate of the broader market. If the market were up 2 percent, a stock with a beta of 2 would be up 4 percent.

The alpha risk of a stock is the individual risk inherent in every issue. This includes risks that cannot be foreseen, such as fundamental news specific only to that stock. By selecting several issues within a given sector, traders protect their portfolios from the chance of having individual positions turn against them or alpha risk.

Suppose a sector trader is bullish on the hardware sector, for example. Instead of putting all your money into one stock, you can go long in several stocks by allocating less money to each one. Instead of buying \$50,000 worth of International Business Machines

(IBM), you would buy \$10,000 worth of five different stocks, such as IBM, Dell Computer (DELL), Hewlett-Packard (HWP), Compaq Computer (CPQ), and Gateway (GTW). The number of shares you purchased of each would depend on their prices. All five of the issues are correlated. This is called basket trading, and it reduces the alpha risk of a portfolio but not the beta risk. Basket trading involves added expense in terms of commissions and spreads, but it provides insurance against individual stock risk.

Some traders look to reduce the beta risk as well. There are various ways to reduce the broader market risk, including hedging with futures and options, pair trading, diversifying among sectors, and using different long to short ratios.

One way to reduce broader market exposure is to hold both long and short positions of correlated stocks. The ratio of your long to short exposure should be in accordance with the current underlying trend of the market, combined with individual stock selection. If the trend as you perceive it is up, and you want to reduce broader market risk, then your long to short exposure ratio should be long by 2 to 1, but a minimum of 2 to 2. This means that for every two long positions you hold, you hold at least one short position.

The long to short exposure ratio could be spread out among sectors so it would not adversely impact the conviction you have on a specific industry. Reducing the beta risk by taking concurrent long and short positions only works when the different sectors you have selected have similar betas. For example, if you like the hardware sector but don't especially like the software stocks, and you think the broader market will rally as a whole, your strategy might be to go long two hardware stocks and short one software stock. If you are more neutral on the market, then you might hold two longs in the hardware sector and two shorts in the software stocks. Because the hardware and software sectors have similar betas, this strategy should reduce your beta risk.

## **STICK TO YOUR GAME PLAN**

Sticking to your game plan is the hardest thing to do as a trader. The reason it's so hard is that it takes strict discipline and an emotional detachment from the outcome. Knowing what to do and doing it are

two separate issues. Trading involves so many unforeseen elements and market forces that mishaps and fuzzy thinking materialize even at the most advanced levels. The only way to trade successfully through this sea of uncontrollable elements is to have the discipline to stick to your game plan. Your plan is the shield that no market force can penetrate, unless you let it.

The main reason experienced traders lose is that they fail to follow their own rules. There are hundreds of reasons and excuses for deviating from a trading plan—for breaking your rules. In the long run, the reasons make zero difference. In the end, people are judged by their results, not the quality of their excuses. In an unstructured environment with multiple sources of reason pulling you in different directions, rules become the cornerstone for success.

A trading plan is predictable. It provides sources of reason given any number of existing circumstances. It filters out noise and encourages discipline. Remember that having a trading plan and sticking to it is invaluable. The simple recognition of this fact can provide the stimulus to adhere to your own plan.

The association a person attaches to losing can be deep-seated. Feelings of unworthiness or shame usually have their roots in childhood and can cause people to act in unpredictable ways. Loss in trading is unavoidable. The best traders do not get upset when they lose; they maintain equilibrium. Seasoned traders do not perceive loss as a personal or professional setback. Instead they acknowledge loss as a necessary and important step on the path toward success. Do not be afraid to lose. Act quickly to cut your losses without thinking about it.

# 4

C H A P T E R

## MIND GAMES THAT PROPAGATE FINANCIAL HAVOC

It is easy for traders to get hooked into subjective interpretations of what the market is doing, because their minds are playing tricks on them. Different people react in different ways to stress. Day trading takes an enormous amount of mental exertion, which requires physical energy. Successful trading is the by-product of a ruthless mentality that allows you to make quick decisions when there is a lot at stake. The best traders can make decisions objectively under stressful circumstances, without looking back.

Many traders fall into a middle ground wavering between subjective and objective interpretations. This happens because they are more attached to the outcome and what it represents than they should be. A trader who falls into a losing rut, for example, is more likely to perform poorly because of a negative state of mind. You tend to attract what you focus on. If you are in a losing streak, chances are that you are focusing on loss, thus attracting more loss.

Detrimental mind games start to kick in when you refuse to accept the fact that you were not able to achieve your desired outcome. When you accept loss gracefully and refrain from beating yourself up, your mind-set will improve and you will be able to focus on where you want to go. This will improve your chances for success.

## WHAT NOT TO DO

*When you learn what not to do in order not to lose, only then can you begin to learn what to do in order to win.*

EDWIN LEFEVRE, *REMINISCENCES OF A STOCK OPERATOR*

Successful trading involves two spheres of choice: action and inaction. The proactive course of offensive action is a step taken in order to win. It means that you have made a decision and are acting on it by putting yourself on the line. It should stem from a plan that provides contingencies for entering and exiting positions. It's an approach that requires doing something in order to benefit from it. It requires taking action now.

Playing offense by taking action, however, is only half of the equation. The other half of the equation that leads to successful trading involves inaction, or negative selection. Inaction involves refraining from trading in order not to lose; it is a preventive posture used for insurance. Not taking action under certain circumstances can be harder than taking action. It is very hard to be patient when you are bored, looking for excitement, and eager to make some money.

Many traders wrongly believe that they need to have a position in the market at all times. They ask themselves, "Should I be long or short here?" They rationalize that if they don't want to be long a stock anymore, then they have to be short it, or vice versa. Choosing not to trade, however, is also a decision. It's hard for some traders to admit that they may have no conviction on the current stock or market trend. There are times that having no position will statistically improve your chances of winning in the long run. If you consider being flat, along with being long or short, then you will begin to look at opportunities with more patience and less effort.

An example of defensive inaction in day trading is refraining from chasing a stock too far past your ideal entry point. Not chasing a stock is, in many cases, a way to avoid unnecessary loss. In day trading, entry is a crucial part of the equation and should not be

done impatiently. If an entry point is missed, so be it. Take non-action. Choose not to chase. Wait for the next opportunity.

Traders should consider themselves to be on sentry duty throughout the trading day. Sentry duty is one of the hardest military assignments because most of the time nothing happens: It gets very boring. Even so, it requires careful attention to detail and concentration at all times, even though you may be bored. One little slip-up during a cigarette or coffee break could mean the difference between life and death, for the individual as well as the whole squad.

The human mind will go to great lengths to avoid boredom. Yet in trading the natural human tendency to avoid boredom is a negative quality that must be recognized and controlled.

Avoiding certain actions preserves a trader's life and provides a shield from unforeseen difficulties. Defensive trading means not taking a course of action that might cause you harm or lost money. Inaction in trading is like defensive driving: It's a technique that involves knowing what not to do in order not to get into an accident, such as not changing lanes before you look, or not gunning the gas when a light is about to turn.

In order to win, a successful trader must first learn how not to lose. Knowing what action not to take is just as important as knowing what action to take.

## **BOTTOM FISHING**

No stock is ever cheap or expensive; it just is. A common rationalization is that because a stock was trading at 80 last week and now it's at 40, it's cheap! Stock prices reflect the current supply and demand for an issue, regardless of past or future. A day trader's goal is to make money today, not to analyze long-term value. Each trading day must be approached with complete disregard for the past and future. Here and now is all there is. Today is when the money will be made, not yesterday and not tomorrow.

As a day trader, do not believe for a minute that the way to make money trading is to buy low and sell high. This is false in day trading. Attempting to buy low or to short high is the way to lose money, not to make it. Buying low and selling high is a description of bottom and top fishing, which are the enemy of all traders. Bottom fishing is the by-product of a faulty ego-based approach to trading. It

involves a guessing game in which you are pitting yourself against the broader consensus. Let go of your desire to bottom fish.

*In a bull market one should trade only from the long side. In a bear market one should trade only from the short side.*

WALL STREET PROVERB

Although the above proverb sounds deceptively simple, experienced traders who attempt to pick bottoms and tops of trends lose fortunes. Bottom and top fishing seem like the comfortable, rational thing to do. However, in the less than zero-sum game of trading, comfort and rationalization are costly goals that should be avoided whenever possible.

The most successful traders make their profits from buying high and selling higher or from selling low and buying lower. The market does not take your opinion into consideration when it decides where it wants to go. When you buy high and sell higher, you eliminate a large part of the guessing game that so many traders get entangled in. Always allow the market to show you where it plans to go. Do not try to guess when it is going to stop. Allow yourself to do the uncomfortable thing, which is to buy strength and sell weakness.

## THE MYTH OF AVERAGING DOWN

A trader should never average down under any circumstances. Averaging down is buying more stock below the price that you paid for it, or shorting more stock above the price where you originally shorted it. Averaging down means adding to a loser and hoping it will turn around. Whenever you hear the phrase “average down,” run for the hills. “I’ll average down” is really a coined excuse that means “I’ll refuse to admit that I’m wrong.”

Remember that you want to buy stocks that are moving in your direction, not against you. Your objective is to trade with the momentum. If you throw money into a losing position, you are fighting the momentum. Losses can easily become compounded in a snowball effect when you average down. Adding to a loser is similar to rolling the dice out of frustration or desperation. If you maintain discipline in the first place, you will not be caught in the painful position of watching the size of your loss grow exponentially because you have thrown more money into a losing pit.

When you add to a loss, you are throwing good money after bad. That money could much better serve you if it were put to work in a winning position. When you average down, a small manageable loss can easily be transformed into a large unmanageable one. As a simple rule, never, ever add to a losing position, under any circumstances.

## ROLLING THE DICE

Great traders have proven time and again that they can consistently win by speculating when the odds are in their favor. They have the ability to correctly assess and integrate a risk–reward ratio that statistically favors a profitable outcome. The outcome is based on a statistical distribution, whereby the probabilities are measurable when the same strategy is employed consistently. Both novices and professional traders often confuse speculation with gambling.

Speculation is derived from probabilities; pure gambling, on the other hand, is based on hope. Gambling is a less than zero-sum game in which the outcome is not based on any measurable probability. Traders sometimes gamble with positions, and gamblers sometimes count cards and play when the odds are stacked in their favor. When you become aware of the difference between speculation and gambling in trading, you'll be able to repeat profitable trading scenarios while cutting out blind gambling shots.

In gambling, the house is the one that stands to collect, because the odds are in its favor. A gambler who wins will never really be able to explain why, except to say that "luck" was favorable. If you are trading for excitement, you are probably gambling. Gambling will force a trader's hand when no plan or discipline exists.

Gambling is a sickness and an addiction in many people. Gambling is believed to increase dramatically during times of stress and pressure; many gamblers are unaware of or just don't care about their real probabilities of success. They rely on some untouchable or unexplainable gut feeling. There are between 4 million and 16 million compulsive gamblers in the United States, and a number of day traders may fall into this category. Gamblers in trading fall into the low end of the performance spectrum, if they last. They are usually influenced by some hyped-up sector that is receiving all the attention in the media. The impulsive gambling instinct causes



them to trade from the hip, sometimes with an all-or-nothing destructive urge. It is hard for some gamblers not to trade if they fear they will miss the current craze.

Successful traders are diametrically opposed to the gambling types. They do not look for excitement in the marketplace; they come thoroughly prepared with a clear plan and a search routine that is methodical. Rational traders maintain superior discipline, which shields them from the human emotional biases, such as hope and boredom, that are prevalent in gamblers.

## **SWINGING FOR THE FENCES**

The desire to hit a home run in trading is the earmark of a beginner. The key to earning profits in day trading is consistency. Steadily hitting singles and doubles is how the pros fill the coffers with profits and produce dynamic results over the long run. Statistically speaking, a large swing occurring in a given stock at the precise time an order is entered is an anomaly. The stocks that make large and fast moves regularly are the ones that require a more diligent risk profile, translating into a smaller position with a wider stop-loss point.

Focusing on hitting singles and doubles does not mean that you cannot maximize your gains. It simply means that you are focusing on technique. When a batter hits a home run in baseball, it happens naturally, usually without any effort. The same holds true with a home run trade. The home-run trade should not be the focal point. Successful traders pile on the profits by focusing on technique and risk control, letting the profits take care of themselves. Successful traders tend to view trading as a business, like any other, in which wishful thinking is kept to a minimum.

A baseball batter who is attached to the idea of hitting a home run is distracted by the thought and usually performs worse for it. Successful batters first visualize correct technique before getting up to the plate. They stay focused on the motions and technique that lead to consistency and greatness, such as stance, eye contact, grip, swinging motion, and other details. Proper technique leads to home runs; home runs do not lead to proper technique. Correct routine in trading revolves around visualizing and implementing proper methods, not around the big swing.

Swinging for the fences in trading is destructive on several counts. The first reason it's destructive is that it's the product of unrealistic expectations. Having unrealistic expectations may set you up for a let-down in the future, because the odds can be slim that the hoped-for event will occur. When high expectations are not met, traders generally experience a sense of disappointment and frustration; emotions that interfere with optimal trading performance and could result in a downward confidence spiral.

Another reason swinging for the fences is destructive is that it often fosters an-all-or-nothing mentality, and traders risk far more than they should on a single position. The extra-large position makes it harder for the trader to cut losses if the position turns the wrong way. A trader who is not willing to cut losses quickly will not last long. When traders focus on hitting home runs, their attention is diverted from other, profitable possibilities.

## POSITION SIZE ENVY

Traders often take larger positions than they should because they are experiencing size envy. Position size envy occurs when your ego whispers to you, "The sky's the limit." You may be in an environment in which other traders are taking positions larger than yours. You decide that if they can do it, so can you: You jump in without sticking your toe in the water first. If the water is ice cold, you could be in for the shock of your life. A trader's risk tolerance develops over time, given experience, confidence, and the emotional and financial ability to withstand losses.

Someone who can trade large positions has arrived at that point through a long and painful learning process. Most people cannot walk into a gym and bench-press 300 pounds if they are used to putting up only 150. The only way to get to the 300-pound mark is to slowly build up your strength and tolerance over time through a gradual increase in the weight lifted. The same holds true for increasing your position size. It should be a slow process based on your financial capacity and psychological and emotional development, discipline, and strength. *Traders should judge themselves by their own goals and nothing else.*

One reason traders take positions that are too big is the almighty greed instinct. Greedy traders have an insatiable attachment to

money. Remember, the most successful traders on Wall Street have a disregard for money. When you are glued to your P&L as a trader, your ability to act objectively is limited. Everyone experiences greed to some extent, but traders have to keep this human trait under control. Attachment in trading is detrimental because it represents emotionally charged subjectivity. The fewer associations and attachments a trader has, the better.

Emotional attachment to money and what it represents is the main reason traders freeze and have a difficult time taking losses, especially large ones. They find themselves in situations they're unprepared for financially or mentally. One of the hardest things for a trader to do is to stick to a game plan when emotions blow things out of proportion. A trader who freezes is unable to act or think quickly. This hesitation usually makes the difference between a profit, a loss, or a huge loss.

Another reason why a trader might have a position that is too large is because he adds to a loser, or averages down. Adding to a loser is probably the most deadly sin in trading, but the vast majority of traders do it at one time or another. Many do it out of sheer hope or desperation, refusing to acknowledge that they were wrong. Adding to a loser is the worst excuse for a trader to have a position that is too big. Wishful thinking and hoping to make back what was lost often result in huge losses. A snowball effect is created, gaining size and momentum in the wrong direction.

One way to avoid adding to a loser is to realize that you can always cut your losses now and get back in later. Successful day traders are constantly selling stocks for small losses and reentering the position when they think the momentum has begun to move in their favor. Successful traders add to winning positions, not losing ones.

If losses set in that are above your risk tolerance, it becomes much harder to act quickly and to face the truth that you are wrong. As your account accumulates money, your position sizes should increase gradually. This will allow you to slowly build up your risk tolerance based on financial soundness. Position size in trading should be dictated by risk control, not high hopes. The anguish of being wrong in a trade grows exponentially when your positions get out of control. If the mind and wallet are not accustomed to taking large hits, it becomes very difficult to act swiftly and to cut your losses.

## VENGEANCE TRADING

Vengeance trading occurs after a trader takes a hit on a trade and wants to get even with the stock. The reason the trade went sour doesn't usually matter; the trader is angry, but not wanting to accept blame, will quickly place it elsewhere. This misdirected emotional firestorm usually translates into pure revenge. The only solution in this cloudy state of mind is for the trader to avenge honor and money lost by getting them back from the stock that took it. The stubbornness festers, and pretty soon it's an all-out battle.

*"The Internet stocks seemed likely to sell off hard this morning," thought Scott O'Riley, a market maker for a large firm. "They had a nice run yesterday, and with negative news out in AOL and AMZN, they should be down further." The Internet index was weak when Scott decided to short 2,000 shares of EBAY, which at the time was down 2 points. For some reason, AOL started to bounce off its lows and AMZN and EBAY followed along with it. "I can't believe this stock! This thing should be down ten points and for some stupid reason it's now up two dollars! I'll prove that I'm right and that the market is wrong and I'll get my money back by shorting another two thousand shares here." Scott added to his losing position and shorted 2,000 more shares. Soon after, EBAY ran another three points. By this time, Scott was red in the face and could not think of anything else but getting back at EBAY. He was cursing at EBAY, at the market in general, and at the computer screen.*

*Throughout the day, EBAY continued to rally along with all the other Internet stocks. Scott refused to cut his losses. As the day progressed, he became completely irrational and frozen with fear. His eyes were glued to the computer screen and he even punched the computer and the desk. He kept blaming EBAY and continued to short more stock so he could get even, until he was short 7,000 shares with EBAY up ten points. By the end of the day, EBAY was up 15 points and Scott was down \$100,000, and almost out of a job.*

The problem with vengeance trading is that the initial loss probably occurred because the original direction of the trade was incorrect. Vengeance trades rarely take place in the opposite direction of the original losing trade. It takes a seasoned pro to change directions on a position after initially being wrong. The vengeance trade goes in the same direction because vengeance traders need to prove that they were right in the first place, that it wasn't their fault they lost

money. They need to get even so their egos can be restored to their original perches.

The common misperception is that when you are trading, you are fighting the market, which is the enemy that must be defeated. Ameritrade recently ran an advertisement pitching on-line day traders and asking them if they were ready to take on the market with the following quote: "I don't want to just beat the market. I want to wrestle its scrawny little body to the ground and make it beg for mercy." This is faulty, ego-based, unrealistic thinking that will lead toward losses, not profits. The market is never wrong and it cannot be defeated. It is selfless. It does not experience feelings of victory or defeat. The market is a cold battlefield and its participants are engaged in a life-or-death battle against themselves.

*Every battle that takes place, whether within the body and mind or outside of it, is always a battle against oneself.*

ZEN SAYING

Vengeance trading can quickly turn into disaster, because revenge is one of the strongest and most stubborn of emotions. Vengeance trading is a futile exertion of time, energy, and money. Its grip only tightens, clogging clear thinking and profit; it drains the resources of a trader, sucking time away from other profitable opportunities by encouraging the trader to focus on where the losing trade did not go, rather than where another trade could go.

Instead of fretting over lost money and trying to get even with a market that does not care, use your time and energy to focus on other situations that will be more profitable.

You will immediately begin to improve as a trader when you stop wanting to control the outcome. The desire to control that which cannot be controlled creates a distorted reality, leading to stress and mind games that will thwart your success. It will be easier for you to acknowledge objective circumstances when you treat yourself kindly, and when you realize that each trade is just one step in the sphere of things to come. Acknowledging that you are not your results will help you to step outside of yourself and to trade with increased detachment and objectivity.

*This page intentionally left blank.*

P A R T  
II

UNDERLYING  
CONDITIONS

*This page intentionally left blank.*



# CHAPTER 5

## TREND SPOTTING IS THE KEY TO PROFITS

One of the most powerful methods in day trading is identifying and trading with the underlying trend. The underlying trend represents the gravitational pull of the market. The trend is the true force behind price action and sector momentum. It carries everything in its path with it.

Technology has made identifying trends easier than ever. The tools necessary for spotting trends are readily available in software packages today. The most effective way to spot a trend is to have a simple check and balance system.

Many who are interested in trading have heard the saying, “The trend is your friend.” Why then do many novices and professional traders alike disregard the concept of trading with the trend? This is because many are not sure how to define a trend for their own trading objectives. Even when traders have developed a clear-cut definition of a trend, they often disregard their own rules because of their desire to catch the bottom or top of a move.

The middle part of the trend, or the “meat of the move” as many call it, is the part of the move that you should focus on catching and trading. The beginning or end of a move is inconsequential. You have not missed much when you miss the bottom or the top of a trend.

As a trend gets close to completion, it is the most ferocious, and it battles for every last breath. This occurs because as trends mature, they usually attract more attention and more volume. When a hot stock or sector’s popularity is the greatest, many buyers already own the stock. When optimistic bulls or pessimistic bears push a trend to its very limits, heavy volume is often associated with the last desperate assault. This is called volume capitulation, which is a surrendering of the force moving it because they used up all of their buying or selling power. The reason the trend capitulated is that the supply–demand equilibrium shifted. If you are fighting for your life, you get a burst of adrenaline that allows you to push your strength to its limit. When the adrenaline wears off, you are weaker than ever. Volume capitulation is the market equivalent of adrenaline capitulation.

In effect, the top or bottom of a move is only a small part of the entire move. There is still a great deal of profit to be made when you climb on board to catch the middle of the trend. Traders who disregard the middle of the trend and instead attempt to buy the lows and sell the highs of a move are caught in never-never land. They have a strong desire to be completely right and to gain acknowledgment for calling the top or the bottom.

Trends come in many shapes and sizes. Short-term day traders should have different trend definitions from long-term investors. A long-term investor can use a 50-day moving average to define a trend; a short-term day trader would be better off using an 8-day moving average to define one. As a short-term day trader, your holding period will be from 2 minutes to 3 or more days. Three days is usually sufficient time for a short-term trend to play itself out. Most day traders prefer to go home flat overnight, so the daily trend is the most important. Regardless of whether you hold a stock for 2 minutes or 3 days, your short-term definition of a trend can be the same.

Many traders get caught up in the belief that identifying a legitimate trend is a complicated endeavor. This is far from the truth. A few of the basic techniques that will allow you to spot a trend are the 8-period moving average, the opening price signal, and the net price

rule. When you know how to spot a trend, your profitability and entry effectiveness will immediately increase.

If you become comfortable with the idea that it is okay to miss the bottom or the top of a move, you will immediately become more profitable. Traders who look to catch the meat of a trend will be rewarded twofold. First, they will lose less money and time because they have stopped trying to guess when the stock or the market is going to stop. Second, they will earn more consistently, because they have developed the habit of trading after price confirmation, not before it. The odds of your making a successful trade increase dramatically after the price of a stock, its sector, and the broader market confirms your idea. By trading with the trend, you are listening to the market and letting it lead you, rather than trying to impose your own opinion upon it.

Some of the greatest traders have the simplest rules for defining trends, allowing them to trade with less effort. People tend to complicate trading because they believe that effort and strain will increase their effectiveness. Great traders win with simple plans and quiet minds. They have developed the ability to block out the noise and stay focused on what the market is telling them.

## NEWTON'S LAW OF MOTION

Isaac Newton developed scientific theories that explained the laws of momentum. Although it couldn't be seen at the time, Newton's famous laws of motion provided the first clue for successful day trading, some 350 years ago.

Newton's most significant discovery was the science of how objects move, or in day trader's terms, how prices move. Represented mathematically by the equation  $F = ma$ , Newton put forth that the acceleration of an object (the rate at which its velocity changes) is equal to the net force on the object divided by the object's mass.\* For the trader, this law of physics applies to trends: It can be interpreted to mean that the acceleration of a stock's price, or momentum, is equal to the volume (net force) on the stock divided by the float (object's mass). Stocks that have a large net force and a small mass will move forcefully.

---

\*Michael Hart, *The 100: A Ranking of the Most Influential Persons in History*. Citadel Press/Carol Publishing, 1989.

Newton's law of motion states that objects in motion tend to stay in motion until an outside force stops them. When applied to trading, the law of motion could be translated to mean that buying strength and selling weakness, or trading with the trend, is the right thing to do. This is because buying or selling stocks that are moving in your direction is compatible with the laws of probability. Probabilities show that prices, like objects, will continue to move along the path of least resistance until some outside force stops them. It takes more effort for an outside event or seller to halt the momentum than for the momentum to continue. If a train is moving at full speed, it takes time and effort to slow it down and to ultimately reverse its course.

## THE MOMENTUM OF A TREND

Momentum is the juice behind the development of overbought and oversold oscillators. According to Newton, momentum is the combination of mass and velocity. Newton said that momentum represents the ability of an object to move in one direction at an even speed until an outside force slows it down or stops it.

The risk involved with trading along trend-following techniques is the prospect of missing the initial reward when the trend is changing direction. The risk–reward ratio of picking the top or bottom of a trend does not work in favor of traders or investors in the long run. Attempting to go long at the bottom or short at the top of a trend has destroyed more traders than any other trading technique. The risk–reward ratio improves dramatically for traders who focus on catching the meat of the move by going long or short once a trend is in place.

One reason traders feel such a need to pick the bottom or top of a move is that many have a deep-seated desire to be proven right. Rather than selling part of a long position if they think the trend is at the top, or waiting for confirmation that a top has indeed formed, their egos coax them on, encouraging them to take a shot and go short. If the initial guess was wrong and the trend was not at the top, their egos tighten the grip. The traders, not wanting to feel half-witted, either add to their losers or let them run.

It seems reasonable to short a stock that has risen high, or to buy a stock that has swooped low; but what is high and what is low? Most traders have their own definitions of high and low. Successful traders

do not make money by buying low and selling high; they make money by buying high and selling higher, or shorting low and buying lower.

Methods such as oscillators and basic chart patterns will help you isolate when a trend is in the process of changing, and allow you to wet your beak on some of the volatility that takes place when markets turn. The first step, however, is to use perceived inflection points of tops and bottoms of trends as areas to trade around existing positions. Rid yourself of the belief that for every successful trade there is one entry point and one exit point. The most profitable traders trade around a core position, constantly scaling in and out. If your signal is telling you that the market is forming a top, use that signal to sell part or all of your long position. Refrain from trying to short a perceived market top.

## SECTOR POWER

The first step toward trading with a trend is knowing what trend to look at. For every stock that you are trading, there are a handful of highly correlated issues that trade along with that stock and compose its underlying sector. The sector's movements as a whole have a strong impact on the direction the individual stock will take in the short term.

Along the road, many traders acquire the habit of focusing solely on the stocks they are trading, without regard for the price action of the underlying sector that the stock is part of. Traders have a tendency to become attached to an idea. When this happens, they have difficulty relinquishing the idea if the stock's sector or the broader market is not cooperating.

In order to trade with the trend, you should monitor three underlying instruments before determining whether to take a position. When all three are pointing toward the same conclusion, the chances are greater that your trade will be successful. The first instrument is the individual stock; the second is the individual stock's underlying sector; and the third is the broader market. Having the patience to wait for confirmation will increase your conviction, effectiveness, and profitability.

For example, if you are considering going long Dell Computer, the first thing that you should look at is the individual stock, DELL. The second is DELL's underlying sector, which is the Computer Hardware Index (HWI), traded on the American Stock Exchange

(AMEX). The third item to monitor is the broader market, which in this case is the NDX 100. The NDX 100 is one broader market to monitor when you are trading tech stocks.

DELL's price movements are correlated with other hardware stocks, such as Compaq Computer (CPQ), Gateway (GTW), International Business Machines (IBM), and Hewlett-Packard (HWP). These stocks are all part of the HWI. The HWI can be charted and tracked intraday just like any individual stock. The sector's trend throughout the day has more influence than any other factor on how an individual stock within that sector will perform.

The NDX 100 and the S&P 500 are two measurements of the broader market that should be monitored carefully before determining what side of the fence to be on. Your odds for success will increase dramatically when you go long a stock in the midst of an uptrend in the broader market, or if you short a stock when the market is selling off.

Taking the other side of the trend is a losing game. Although you may be intellectually right and the trade may eventually go your way, you could still be wiped out because of the short-term force of a trend reaching the end of its move. Remember that your objective is to earn profits today, not to sit with losing positions and hope they will turn around in order to bail you out.

Before taking a position, it is important to know which stocks are the leaders in the underlying sector that you are trading. Bigcharts.com has an extensive listing of stocks and their related sectors. Stocks that are leaders within groups should be monitored if the stock that you are trading has a high degree of correlation to it. For example, Applied Materials (AMAT) is a leading semiconductor capital equipment stock. Before you take a position in KLA-Tenor (KLAC), another semiconductor capital equipment stock, you should see what AMAT is doing. Stocks that have the heaviest weighting in their sectors often lead the rest of the group. It is a good idea to monitor the individual leaders along with the sectors that you are trading.

If there is strong price divergence within a sector between two leading stocks, then it may be better to look for a trade in a sector where there is no price divergence. A stock that is under pressure in a sector can act as a drag on its correlated stocks, even if the damaging news is company-specific. Sometimes it takes a while for analysts to sort out whether negative news in a company is really company-specific, or whether it suggests deeper problems within the industry.

For example, when Compaq Computer (CPQ) blew up in the spring of 1999, the bad news was attributed to the internal problems associated with assimilating Digital Equipment (DEC) in their recent merger. On the opening, all the P.C. stocks fell under the gun even though the news was company-specific. Later in the day, the other P.C. stocks did rally, but the news caused correlated stocks to come under pressure early on.

## **TIME PERIODS FOR TRACKING THE TREND**

Monitor multiple time frames when tracking a daily trend. The multiple-time approach will provide you with various degrees of confirmation, ranging from a weekly time period to 2 minutes. This approach requires that you track trends with a weekly chart, a daily chart, and two to three intraday charts.

The weekly chart is useful to help you initially identify an idea or appraise a current one. Weekly charts allow you to examine the broader picture, determining which direction the wider trend points to. Weekly charts do not have to be monitored intraday, but you should look at them before looking at the daily chart. When you receive weekly confirmation for an idea, you can flip over to daily and intraday charts.

Weekly trends do not always produce confirmation for daily ideas. There are times when a weekly trend will point in one direction while the daily trend points in another. Your odds for success increase when the weekly chart confirms the daily one.

There are daily ideas and trends that can be taken advantage of without weekly confirmation. At times day traders may lack the patience to wait for weekly confirmation before acting. Under these circumstances, it is still possible to trade the daily trend successfully; however, consider trading smaller positions than you normally would, with tighter stop-losses and increased flexibility.


When you have received weekly confirmation, the next time period to look at is the daily. The daily chart is the main medium for finding trading ideas. The daily chart should be monitored intraday, along with other intraday charts. Most software charting packages allow you to plot at least four charts on a single page. The daily chart should be one of the main charts on your page.

After the daily chart, you should monitor intraday time periods, preferably two or more, with each focusing on different time periods.

To view this  
image, please  
refer to the print  
version of this  
book

**Figure 5-1** Daily and Intraday Charts Showing Sell-Off in the NDX





To view this  
image, please  
refer to the  
print version  
of this book

**Figure 5-1** *(Continued)*

Depending on your preference, the 60-minute and 15-minute periods work well as the first two time periods. The 60-minute and 15-minute are susceptible to less noise than the 5-minute or 2-minute periods. The 5-minute and the 2-minute are useful, but can be susceptible to faulty signals and insignificant price moves. They should be used in conjunction with the 60-minute and the 15-minute time frames.

The charts in Figure 5-1 (see pages 46 and 47) show the NDX selling off on November 30, 1999. The charts track different time periods: daily, 15-minute, 5-minute, and 60-minute. The NDX formed a daily shooting star on November 26, which is a short-term reversal pattern. It then confirmed this short-term reversal pattern on November 30, after it broke beneath the daily 8-period moving average. You can see that on the 29th, the NDX fell beneath the 8-period moving average on the intraday charts as well, which confirmed that the short-term trend had changed.

The advantage of tracking multiple intraday time periods is that your objectivity is enhanced. Intraday charts provide day traders with a good method for timing entry and exit and for staying with the current trend. When you are tracking intraday time periods, first look at the largest time period for confirmation, and end with the smallest time period. For example, if you are watching the 60-minute, 15-minute, and 5-minute intraday charts, you should receive confirmation first from the 60-minute chart, then look at the 15-minute chart then the 5-minute chart.

If you receive weekly, daily, and intraday confirmation of a trend for your individual stock, the underlying sector, and the broader market, then your conviction should be at its highest; your chances for being on the right side of the trend are very strong. When you stack the underlying conditions in your favor with multiple time frames and multiple underlying confirmations, you are choosing to win the game before you enter it.

The best way to catch a trend is to be prepared to catch one. First, it is important to be at peace with yourself when you miss the bottoms and tops of moves. Refrain from feeling regret because you didn't sell at the highs or buy at the lows. Remember that your objective is not to initiate trades at these levels; it is to exercise the discipline to trade the meat of the move. When you trade with the objective of catching the middle of the move, you can stop playing the guessing game and start trading when the probabilities are most in your favor.

# C H A P T E R 6

## FOUR TRADING SIGNALS FOR SPOTTING A TREND

There are four signals that every trader can use to isolate and catch a trend. These signals are simple in nature. Their power resides in their objectivity and in their ease of use. As a market maker, it is crucial to be able to make a split-second decision as to whether the short-term trend is in your favor. These four trading signals will relay to you the market's opinion as to what the trend is, and they will clue you in to a change in the underlying sentiment.

### **THE PREVIOUS SESSION'S HIGH AND LOW**

The previous day's high and low serve as the shortest-term measures of support and resistance. These prices mark the extreme ranges of the strength of the bulls and the bears from the previous day. Stops tend to accumulate just above or below these prices, because once the price is broken the momentum usually carries the

price further. Buyers or sellers are usually there to defend these prices. Buyers who missed the opportunity to get on board at the low prices the previous day will be back; they remember having missed that price and they regret it. Sellers who missed the previous day's high will often be back to sell; they regret having missed the opportunity to get out at the highs on the previous day.

A window of opportunity for entry presents itself when a stock crosses above its previous day's high or below its previous day's low. When a stock breaks above resistance or beneath support, the path is cleared toward further gains or declines. The stops that are triggered and accumulate just above or below these levels act like a spring, jolting prices further because of the sudden increase in demand or supply.

Stocks that are breaking down tend to fall harder with less volume than stocks that are breaking out. This is because more people are long the market than short the market, so fear tends to be greater on the downside. Day traders tend to be biased to the long side because of the great bull market of the 1990s, and because it is harder for them to go short due to the uptick requirements.

Market makers are often keyed in to important support and resistance levels. Their alarms go off when these levels are approaching or are reached. If they see that offers are starting to lift when the stock is at resistance, or that bids are starting to fade when it is at support, they may gun the stock, sweeping the street with as many as 25,000 shares going out to each market maker. This push may be all the stock needs to burst into new territory, like opening the walls of a dam.

An increase in demand or supply kicks in on a grander scale when prices break out to all-time highs, or collapse to all-time lows. When this happens, traders may scramble all at once to buy or sell the stock. The stops that are triggered are either physical with listed stocks and futures, or mental with NASDAQ stocks. Stops that are triggered in the S&P futures market cause a concurrent reaction in the stock market.

Locals in the S&P futures pit attempt at times to bid up the market just enough to trigger stops that are set above the previous day's high, in order to flip them out in short order when the market pops

higher. These momentum plays carry prices quickly, so traders should be aware of the support and resistance levels in the S&P 500 and the NDX 100 futures markets.

The first levels of support and resistance that should be recognized are the previous day's high and low prices. When these prices are broken, the short-term daily trend will be clearly defined. Trade stocks that are trading above the previous day's high from the long side; and trade stocks that are trading below the previous day's low from the short side.

## THE 8-PERIOD MOVING AVERAGE

A short-term moving average is a simple and effective trend-following tool. It provides a powerful way to smooth out price action in order to determine the short-term trend, areas of support and resistance, and when a trend is reversing. For a short-term trader looking to capture the meat of the move, short-term moving averages offer an ideal way to decide what side of the price action you want to be on.

Many chartists believe that the only proper way to define a trend is by drawing trendlines. While trendlines are useful, they can leave too much open to subjective interpretation, deliberation, and fudging. Day traders need a quick and consistent method to determine if an idea has immediate short-term trend confirmation. Trendlines leave too much room for a trader to rationalize away a losing position. For example, a trendline drawn for a three-month daily chart might look completely different from a trendline drawn for a one-year daily chart. This sort of uncertainty is exactly what you want to avoid.

It is not uncommon for traders to use charts to rationalize a bad position or to distort reality. Without clear-cut trading rules and the discipline to stick to them, traders can look at charts and see only what they want to see. They might have a position that's causing some pain and, rather than cut the loss, use charts to provide them with a glimmer of hope. Sticking to the correct side of the short-term moving average will provide factual evidence of the short-term trend. This will discourage agitated day traders from cherry picking chart patterns to rationalize a loss.

A moving average smooths price action for a select number of periods. Moving averages usually default to the last closing price, but the closing bid price or ask price can also be used. Simple, exponential, and weighted moving averages are three types that can be employed. Exponential is the most widely used today, because it allocates greater weight to the last trading day, responds to changes faster, and factors in older data rather than dropping it.

If the price of a stock or sector has been consistently trading above its 8-period moving average on a daily chart, the short-term uptrend will be broken once the price opens and closes beneath the 8-period moving average. You can use that as a signal to take some profits if you are long, to be flat, or to trade from the short side. If a trader wants to catch a longer-term move and has wider tolerance for loss, you can use a longer-term moving average, such as the 15-day, the 21-day, or the 50-day.

Short-term moving averages can be used as discipline measures for keeping a trader out of trouble. As a simple trading rule, you should only have a position in a stock that is on the same side of the moving average. If a stock is trading above its 8-period moving average, you can trade from the long side but you should not trade it from the short side. If a stock is trading beneath its 8-period moving average, you can trade from the short side but not from the long side. If you stick to this rule, you will prevent yourself from bottom or top fishing because you will be trading on the same side of the short-term trend as defined by the moving average.

A simple and effective trading tactic is to initiate positions only on the side of the 8-period moving average. If the last price is above the 8-period moving average, then the trend is up. If the last price is below the 8-period moving average, then the trend is down.

The 8-period moving average should be used for individual stocks, sectors, and the broader market. For example, if you are considering going long Dell Computer, the ideal scenario would be for DELL, the hardware index (HWI), and the NDX 100 all to be trading above their 8-period moving averages.

The exponential 8-period moving average can be applied across multiple time frames, including the weekly, the daily, and the intraday. It can be used in conjunction with the opening price signal and the net price to key you in to the broader trend as well as the intraday movements of the market.

Which short-term time period you are using is not as important as remaining consistent with the time frame. For example, if a 5-day moving average works well for you, then stick to it. Don't switch to an 8-period from a 5-period in the middle of a trade because you want to nurse a losing position. The reason you are using the moving average in the first place is to remain disciplined in spotting and trading with the trend. From a short-term perspective, the 8-period time frame works well. Experiment with various periods. When you find one that you are comfortable with, give yourself time to get used to it.

The weekly 8-period moving average should be the first trend to look at, as it provides the longer-term trend picture and the broader measure of force. If the last price on the weekly time frame is above the 8-period moving average, then the weekly trend is positive. If the last price is below the 8-period moving average, then the weekly trend is negative (see Figure 6-1).

The chart in Figure 6-1 on page 54 shows Adobe Systems breaking above its weekly 8-period moving average on March 5, 1999. After it opens and closes above its 8-period moving average, it trends above it for the next 10 months in a stellar move. Any trader who used the 8-period moving average trend rule would not have traded ADBE from the short side during this entire period.

After looking at the weekly time frame, the next time frame to look at is the daily one. The daily charts provide a tighter measure of a trend than the weekly charts do. If the last price on the daily chart is above the 8-period moving average, then the daily trend is positive. If the last price is below the 8-period moving average, then the daily trend is negative (see Figure 6-2).

The chart in Figure 6-2 on page 55 shows Veritas Software (VRTS) breaking out above resistance and its daily 8-period moving average on September 2. From September 2 on, VRTS closed above its daily 8-period moving average in all but two instances. A trader following the 8-period moving average rule would not have shorted into this uptrend, and quite possibly would have profited nicely by simply trading on the right side of the trend.

The strongest measurement of a trend occurs when both the weekly and the daily trends confirm one another. Weekly trends often dictate daily trends. However, the daily trend is more important to the day trader, because you are concerned with the immediate market action today. If the situation you are interested in trading

To view this  
image, please  
refer to the  
print version  
of this book

**Figure 6-1** Adobe Systems Breaking Above Its Weekly 8-Period Moving Average



To view this image, please refer to the print version of this book

**Figure 6-2** Veritas Software Breaking Out Above Its Daily 8-Period Moving Average

does not have mutual confirmation of the weekly and the daily trends, then go with the daily trend.

When you have received daily trend confirmation, the next step is to narrow down what the trend action looks like intraday. The intraday trend is positive when the last price is trading above the 8-period moving average, and it is negative when the last price is trading beneath the 8-period moving average. When examining the intraday trend, always begin by looking at the longer time periods. First determine if the last price is trading above the 60-minute, 8-period moving average. If it is, then determine if it is trading above the 15-minute, 8-period moving average. The 5-minute and the 2-minute 8-period moving averages are less reliable as trend indicators because they are subject to interference from false moves. These shorter-term time periods can be useful for taking profits on reversals, because they will lead the longer time periods first.

The most effective way to integrate intraday moving averages with entry is to make sure that the broader measures of the trend are intact. For example, if the last price is above the 8-period moving average on the daily chart, but beneath the 8-period moving average on the 60-minute chart, don't initiate any new longs or initiate any shorts. Use the move beneath the 60-minute, 8-period moving average to take profits if you are long. If the last price is above the 8-period moving average on the daily chart and on the 60-minute chart, but beneath the 8-period moving average on the 15-minute chart, don't initiate any new longs or any shorts. Use the move beneath the 15-minute chart to take profits if you are long.

Staying on the right side of the 8-period moving average is an excellent risk management practice. Depending on your holding tolerance, you can use the daily, the 60-minute, or the 15-minute time frame. This simple method will prevent a lot of traders from fighting the trend or from bottom fishing. It is a protective intraday entry and exit tactic that, when followed, prevents doubling down and allows you to spot short-term price direction.

Part of the advantage of watching the intraday 8-period moving averages is that you can spot when a trend has almost run its course and is in the process of reversing. When prices first break above or beneath the average after an extended move, take profits and adjust yourself for a possible price reversal.

Day traders should use the 8-period exponential daily moving average as the first category for determining if price action confirms

their opinions. If the price is above the 8-period moving average, trade from the long side, but not the short side. If the price is below the 8-period moving average, trade from the short side, but not the long side. This simple rule does not dictate that you must have a position simply because the price is above or below the moving average. It does, however, give you an objective measurement for weighing ideas.

## THE OPENING PRICE SIGNAL

The opening price signal is a simple and effective gauge for determining the daily trend of a stock. The opening price signal is the last price minus the opening price. If the net difference between the last price and the opening price is positive by 1/4 point or more, it is a positive opening price signal. If the net difference is negative by 1/4 point or more, it is a negative opening price signal. Trade only in the direction of the opening price signal. The opening price signal formula is:

Opening Price Signal = Last Price – Opening Price

When the opening price signal turns from negative to positive, it is the first indication that the stock's underlying sentiment has changed to the upside. When the opening price signal changes from positive to negative, it is the first indication that the underlying sentiment has switched to the downside.

Trade only on the side of the opening price signal. From a short-term risk perspective, the opening price signal allows you to be on the correct side of the daily trend. If you adhere to this principle and respect what it is telling you, it will prevent you from fighting a trend and bottom or top fishing.

While the net price of a stock shows the market sentiment from yesterday's close to today's opening, the opening price signal displays the immediate market sentiment from today's opening price to the last price. With the opening price signal, you can determine whether the opening price was set by real demand or was due to an artificial markup. The opening price signal will let you know what kind of force is behind the market opening, which creates the opening price.

Market makers watch opening prices carefully. After the market opens, if the last price falls beneath a marked-up opening price, it is

a signal to refrain from initiating longs or to possibly go short. If there is an excessive down opening and the last price rises above the opening price, it is a signal to refrain from initiating shorts or to go long. When stocks gap up or down, the opening price is the one gauge that market makers can use to determine whether stocks are going to go higher or lower.

Here is an example of a market maker using the opening price signal to take advantage of an artificial markup:

*At 9:28 AM the S&P futures were up 15 points, pointing toward a big opening for the Dow Jones Industrial Average and the rest of the market. The retail buy orders were lining up on a market makers' desks with smaller investors eager to buy stocks. The latest positive PPI report was noninflationary, signaling that the Fed would probably not raise rates any time soon. Retail order flow derives mainly from the nonprofessional trading community and is usually driven by emotional extremes. The majority of the larger sophisticated players do not chase excessive markups in the morning, but instead use them as opportunities to take profits or to sell the markup along with the market makers.*

*With the positive market sentiment, WCOM was marked up in Instinet to 83, up 2 points from the previous night's close. The market makers with the retail buy orders in WCOM were jockeying for position on the inside 83<sup>1</sup>/<sub>4</sub> bids. With the market locked, many market makers were using Select Net to preference other market makers who were at 83<sup>1</sup>/<sub>4</sub> and let them know that they had to either sell stock or move off the offering.*

*After the market unlocked, WCOM soon opened up at 83<sup>3</sup>/<sub>8</sub>, up 2<sup>3</sup>/<sub>8</sub>. The market and WCOM soon pulled back from the excessive markup on the opening retail orders. After WCOM opened at 83<sup>3</sup>/<sub>8</sub>, within 15 minutes it sold off to 82<sup>1</sup>/<sub>2</sub>. Some market makers used the initial markup as an opportunity to short their retail buy orders at prices ranging from 83 to 83<sup>1</sup>/<sub>2</sub>, and earned a quick profit. The immediate clue of an excessive markup in WCOM was a negative opening price signal. Although on the surface the market and WCOM looked like they were in a strong uptrend, the opening price signal betrayed a different picture.*

In the above example, the short-term trend for WCOM and the market looked as though it was positive, but it was actually in an overbought condition. The negative opening price signal provided the first clue that the short-term trend was negative, not positive.

The strongest trend indication occurs when both the opening price signal and the net price both point in your direction. When both the net price and the opening price signal are positive, trade

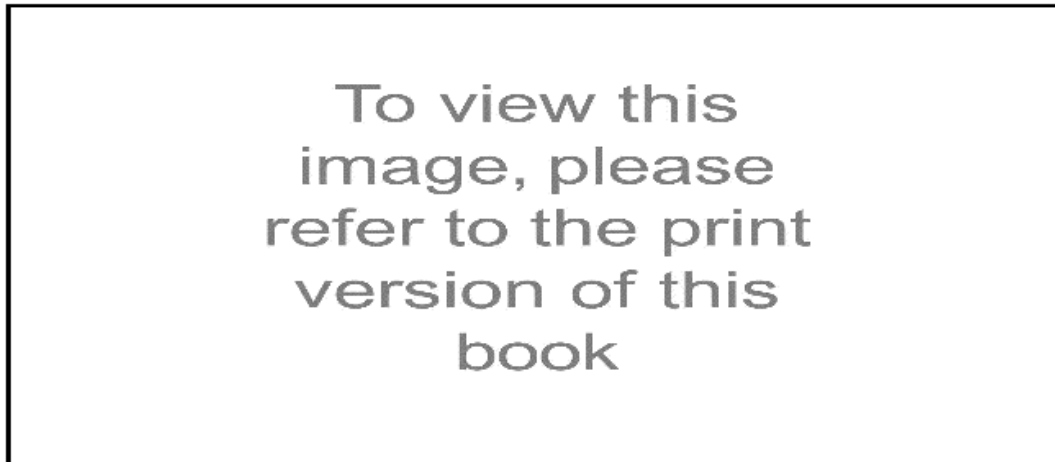
from the long side. When both the net price and opening price signal are negative, trade from the short side.

A gap-up on the opening above the previous session's close produces a positive net price. If the stock sells off beneath the opening price but remains above the previous session's close, the result is a positive net price with a negative opening price signal. For example, if a stock opens up 2 from the previous session's close, and then pulls back 1/2 point, the opening price signal is  $-1/2$ , and the net price is  $+1\frac{1}{2}$ . In this situation, market makers will use the opening price signal as their first measurement to determine what side of the market they want to be on for the short term.

It pays to wait patiently for both the opening price signal and the net price to point in your direction. When these two signals act in harmony, you have optimal conditions for trading from the correct side of the daily trend. Many times, however, market makers have to make a decision when the circumstances are not perfect, and the net price and opening price signal conflict with one another. When this occurs, the opening price signal serves as the more useful short-term trend indicator, because it evaluates how the stock is trading from today's opening, not just from yesterday's close. It also tends to act as a leading indicator for a change in net price. The opening price signal compares the last price to the current market sentiment, by taking into consideration all the news events that have materialized overnight or early in the morning.

The opening price signal can easily be monitored throughout the day with most software packages. Simply enter in the formula for each stock you are following, which is the last price minus the opening price. Tracking the opening price signal as it turns from positive to negative, or vice versa, provides a profitable entry tactic for timing a change in the underlying trend. The point in time when the opening price signal changes from one side to the other is called the inflection point. Always wait for the opening price signal to point in your direction by at least 1/4 of a point. The point when the opening price signal changes within 1/4 to 1/2 of a point is the best spot to enter.

Figure 6-3 is a snapshot of a monitor page with symbols and is an example of how a market maker tracks stocks. The monitor page includes the net price, the opening price signal, the bid price, a



**Figure 6-3** Monitor Page Showing Opening Price Signals and Other Indicators

short-term moving average, and the amount by which the stock has bounced off its lows or retraced off its highs.

Here is another example of a trader using the opening price signal to position a trade.

*EBAY was trading up 4 points at 134 with a positive opening price signal of +2. It had gapped up 2 points on the open from the previous day's close of 130, to open at 132, and had rallied 2 points from there. As the Internet index began to sell off, EBAY's opening price signal went from +2 to -1, with the last price moving from 134 to 131. EBAY was still up 1 point on the day, but was now trading beneath its opening price by 1 point. This change in the opening price signal forecasted a change in momentum. A Wall Street trader named Bin shorted 15,000 shares EBAY, which was half of his intended position. He only shorted half of his intended position because EBAY was still net positive on the day.*

*Soon after the opening price signal turned negative, EBAY broke beneath its previous night's close of 130. At this point, Bin shorted another 15,000 shares, bringing his total short position to 30,000 shares. EBAY continued to sell off and ended up closing at 123, down 7 points on the day. Bin rode EBAY for the meat of the move and ended up making a tidy profit on the trade.*

The change in the direction of the opening price signal was the first clue to sell longs and to be prepared to trade from the short side.

The inflection point is a valuable entry area for an intraday change in net price. When a stock's net price changes from positive to negative or vice versa, the underlying daily sentiment has changed. Use this change as an entry point or as a stop-loss point. A change in the opening price signal will always lead a change in the net price, so it can be used as a leading indicator for a change in the underlying psychology and market tone.

## THE NET PRICE RULE

The net price rule states that you should trade only on the side of the net price. If you want to go long a stock, the net price should be positive. If you want to go short a stock, the net price should be negative. If the net price is positive, you should not be short; if it is negative, you should not be long.

The net price rule should be used for a stock, the stock's underlying sector, and the broader market. If you are contemplating trading an Internet stock, the first thing to look at is the net price of the stock itself. If it is net price positive, trade from the long side but not the short side. If the net price is negative, trade from the short side but not the long side.

After looking at the net price of the individual stock, look at the stock's underlying sector. If you are trading an Internet stock, you might look at the Internet Index (DOT). If the DOT is net positive on the day, trade from the long side but not the short side. If the DOT is net negative on the day, trade from the short side but not the long side.

After looking at the net price of the DOT, look at what the broader market as a whole is doing. If the NDX 100 is net positive on the day, trade from the long side but not the short side. If it is net negative on the day, trade from the short side but not the long side.

You will not always receive mutual net price confirmation between a stock, its sector, and the broader market. The odds of being on the right side of the trend increase when all three are in your favor. If all three are not in your favor, use the net price of the stock and its sector as the two guidelines to follow.

The net price of a stock or sector indicates which side the market consensus is on. A positive net price votes in favor of the bulls, while

a negative net price votes in favor of the bears. The net price reflects the market's judgment as to whether this stock should be higher or lower today than yesterday's closing price.

The reason a stock is trading higher or lower than the previous day's close is irrelevant. Traders can get caught fighting a trend or bottom fishing when they analyze and think too much. Once a rigid opinion is formed, it is hard to admit defeat because your ego is involved. This is even more evident when you announce your opinion to others. Traders make up all sorts of rationalizations to avoid looking "stupid" or wrong in front of other people.

The net price is the quickest measurement of the market's opinion of how a stock should trade today compared to yesterday. When you listen to the market's opinion, your trading will take place along the path of least resistance. The direction of net price is a crucial piece of information that does the thinking for you.

One of the benefits of trading on the side of the net price is that it will prevent you from fighting the trend. If you isolate a trade for the long side and you're itching to trade it, a negative net price will prevent you from buying it. The negative net price tells you that the gravitational force is not pulling in your direction.

Nonprofessional traders often go long in stocks that are net down on the day because they think the price is low. People love to get a bargain, especially when they are eyeing a piece of merchandise that was more expensive a few days before, or even a few hours before. When traders buy stocks that are down on the day because the stock looks "cheap," they get what they pay for—something that is not worth very much.

Remember, it takes more energy and power for an object in motion to stop and reverse course than it does for it to continue along its path of motion. Always remember that, as a day trader, you should buy or sell stocks that are moving in your direction, not against you. Prices do reverse course intraday; there is no question about that. Big price reversals are more the exception than the rule, however. When prices do reverse course, you will still have ample opportunity to profit after the net price has turned in your direction. Price reversals normally provide excellent opportunities to climb on board after the net price turns in your favor, because large price reversals have momentum on their side, and that normally continues.



Here is a summary of the time periods to examine along with the most favorable conditions for catching a trend. You will not always be afforded the luxury of locating an idea when all the trend factors point in your direction. When you do find ideas that have the maximum trend signals pointing in your favor, then your conviction should be at the maximum. When all the factors are not in your favor but you still like an idea, the more of the signals that are in your favor, the better.

### **Weekly**

The first chart to look at is the weekly chart. The strongest measure of a weekly uptrend includes price action with these characteristics:

- a. Price above the previous week's high.
- b. Price above the weekly opening price.
- c. Price above the 8-period moving average.
- d. Price above the previous week's closing price.

### **Daily**

After determining the strength of the weekly trend, the next trend to look at is the daily one. The strongest measures of a daily uptrend are similar to those for a weekly trend:

- a. Price above the previous session's high.
- b. Price above the previous session's close.
- c. Price above the 8-period moving average.
- d. Price above the opening price.

### **Intraday**

Intraday trends are the most immediate signals for short-term price action. These trends provide the first clues for entry or exit. The distinction between an intraday trend and the daily trend is the intraday price action. The intraday moving average provides a quick way to assess which way the wind is blowing. If a sector is trading above its 8-period moving average on 60-minute and 15-minute intraday charts, the short-term trading trend is positive. The last price should also be above the opening price and the previous session's close:

- a. Price above the intraday 8-period moving average.

Remember that your objective as a day trader is not to catch the entire move. Attempting to catch an entire move is unrealistic and the by-product of faulty guesswork and wishful thinking. As a day trader, you are best served when you resist the urge to being completely right, and instead stay focused on trading with the middle of the trend. The probabilities for catching a trend increase with the number of signals that are in your favor.

One reason it is important to stay focused on catching the middle of the trend is that it is the easiest part to catch. It is the easiest part to catch because prices in motion tend to stay in motion. The objective tools you can utilize to identify a trend in motion include the daily and the intraday short-term moving averages, the opening price signal, the net price, and the previous sessions high and low price. When all three factors point in your direction, then you can act decisively.

P A R T  
III

FUNDAMENTALS

*This page intentionally left blank.*

# C H A P T E R 7

## FUNDAMENTAL CATALYSTS

Market makers act with increased conviction when the fundamentals and technicals work together in harmony. Both fundamental and technical analysis are of great value. There is no reason why you should not combine the two so you can act with increased conviction. From a strategic standpoint, a day trader should know what fundamental news has the strongest tendency to trigger a forceful streetwide reaction.

When you are trading with fundamentals, always wait for the price action to confirm your opinion. Remember that your objective as a day trader is to make money, period. Do not get caught up with excessive thought or analysis. It is better to make money than to be right. Allow the market to interpret the fundamental information for you through price action. Remember that the market's opinion is what really matters, not yours.

Knowing why an institutional trader takes action can help you think and act with the pros. There are fundamental catalysts that cause large holders to act with ruthless speed. Although mutual funds classify themselves under broad categories such as value, growth, momentum and so forth, many act on fundamental information, especially when the news is negative. Portfolio managers have a low tolerance for certain chinks in the armor of the companies that they hold near and dear to their hearts.

Market-moving fundamental catalysts change from year to year, depending on the state of the market and on what approach has garnered the most attention through recent performance. During aggressive cyclical bull markets, an aggressive-oriented momentum approach is favored because investors are looking for capital appreciation instead of conservative income. During correctional phases or cyclical bear markets, investors are more nervous; the defensive-oriented approach that targets stocks with stronger book ratios and higher yields is the favorite.

A *Barron's* article pointed out a survey of institutional investors, asking them the main reasons they buy or sell stocks. Among the responses, earnings surprises, return on equity, and analyst revisions to earnings ranked as the top three.\*

## EARNINGS SURPRISES

Institutions act quickly when a company surprises to the downside. A quick reaction on the part of an institution means that some of the biggest holders could be out in force, slamming the stock. An earnings surprise is viewed as a fundamental trend that is likely to continue.

Portfolio managers do not want to be held accountable for holding onto a losing position when a company disappoints. A negative earnings surprise is a hard and cold fact that says something is wrong. At the end of the year, when performance is reviewed, portfolio managers do not want to have to explain why they decided to hold a large position in a company that produced evidence that it could not deliver the goods. Day traders should be extremely wary of trying to scoop up bargains after negative earnings surprises,

---

\*"Trigger-Happy: Merrill Lynch Poll Sheds Light on the Vicious Punishment." *Barron's*, December 8, 1997.

because the catalyst and panic will always be to the downside. Bottom fishing on an earnings disappointment is a fool's game and should be avoided.

A positive earnings surprise is valuable confirmation that the company is in good shape and has delivered on its promise. Portfolio managers believe that action speaks louder than words, and good news in the form of earnings is the best possible reflection of positive action. With a positive earnings surprise, the main panic that occurs is the shorts that get squeezed.

## THE NEW EARNINGS RELEASE

An area of earnings reports that creates confusion and faulty trading tactics is the new way that companies release their earnings.\* An increasing number of companies today release their numbers with a twist of propaganda, including both pro forma and regular earnings numbers. Some of the different ways companies report their numbers today include pro forma, operational, adjusted, consolidated, pre-currency, diluted, and undiluted. This can slow the decision-making process for a trader who wants to trade in a split instant when the number hits the tape.

This tactic is used mainly by technology companies that have no earnings, to put a better spin on the numbers. They highlight their pro forma or operating earnings, numbers that don't include one-time charges for items such as acquisitions, goodwill, or employee-based compensation. When they exclude these costs, their overall numbers look better; but it can distort what the company is really doing and create confusion among the public.

Analysts often have to interpret these reports for ordinary clients so they can grasp what the numbers really mean. In some cases, analysts follow the lead of the tech companies by adjusting their estimates to focus on operating numbers.

For example, Amazon reported its earnings in July 1999 with multiple headlines. They reported a pro forma operating loss of \$67.3 million. They reported another pro forma net loss of \$82.8 mil-

---

\*MacDonald, Elizabeth. "Varied Profit Reports by Firms Create Confusion." *Wall Street Journal*, Heard on the Street, CI, August 1999.

lion (this number did not include an acquisition charge); and they reported a net loss of \$138 million. This slew of numbers could easily have caused traders to make mistakes if they acted before digesting the headlines. Remember that Internet companies trade off factors other than earnings, including quarter-to-quarter revenue growth, registered subscriber growth, media metrix numbers.

Before reacting to an earnings headline, take a deep breath and make sure that you understand what the headline means. Don't be fooled by numbers that look good on the surface but really tell a different story. The immediate minutes following an earnings release are filled with confusion, volatility, and a small army of winners and losers.

## EARNINGS MOMENTUM

Five-year estimates of profit growth have become popular gauges for portfolio managers to follow because the estimates discount short-term fluctuations in earnings, focusing on longer-term earnings growth potential. With the explosion of Internet IPOs in 1999, almost all of which had not earned a penny, the five-year earnings potential brought some sort of future rationalization to extraordinarily high present valuations. One way to analyze the five-year estimates of profit growth is to examine the growth ratio, which is the ratio of a company's five-year projected earnings to its projected price-to-earnings (P/E) ratio for the next fiscal year.

Analysts and portfolio managers also examine earnings velocity indicators, which gauge the net change in a company's quarterly earnings when contrasted with the same quarter a year ago. This number is then divided by the company's stock price and used as a ratio to compare its performance with competitors in the same industry.

Another important velocity figure that the street examines is the sequential growth number for earnings, revenues, and cash flow. Portfolio managers tend to key in on sequential growth rate figures for revenues and earnings. If an Internet company has had year-to-year quarterly revenue growth of 50 percent, this may look on the surface like a stellar accomplishment. However, if revenue growth has slowed from the previous quarter on a sequential basis, red flags might go up to indicate that something in the growth model has reached a sticky point.



## CASH FLOW

In industries where the majority of the companies do not have positive earnings—such as the Internets, cable TV, telecommunication, and wireless stocks—portfolio managers and analysts focus on non-earnings-related items, such as cash flow in its various forms. Many portfolio managers and analysts believe that cash flow is an important yardstick for gauging the vitality of a company regardless of its earnings.

Investors, analysts, and portfolio managers look at cash flow in various ways. Simple cash flow is net income plus bookkeeping charges that eat into net income such as depreciation, amortization, and depletion. These charges don't physically take any cash away from the company, but they are treated that way on the books. A more important measure of cash flow is operating cash flow, which is the cash a company generates before taxes or the cost of financing. Operating cash flow is a favorite item of takeover specialists, because they can take on as much debt as the operating cash flow will pay for. Because all of the operating cash flow is used for debt payment, the company will not show any profits and will not have taxes to pay.

Free cash flow is an even tighter measure of a company's discretionary funds when compared to operating cash flow. Free cash flow is the cash that a company could tuck away without any reciprocal effects. It can use its free cash flow in any number of ways: to pay dividends, to buy back shares, to pay off debt, or to expand.

Cash flow can tell a completely different story from reported earnings. If a company has strong profits but low cash flow, it could be vulnerable to a bump in the road in the future due to an inability to pay its debts. There can be various reasons, however, for a company to have weak earnings but strong cash flow. In this case, cash flow provides a better picture of the health of a company.

The three types of cash flow measures used as a yardstick when assessing the overall financial health of a company are described here.\*

Cash Flow = Net Income + Depreciation + Depletion + Amortization

**Net Income (Profit)** is the income a company reports after all its taxes and expenses have been paid. Net income is usually reported as a diluted and undiluted earnings per share figure. The

---

\*Laderman, Jeffrey M., *Earnings, Schmernings—Look at the Cash*. Business Week, July 24, 1989, p. 56.

diluted figure is the bottom line number that the street focuses on. It takes into account earnings per share after tax charges due to acquisitions or other taxable items. The undiluted figure is net income before taxable items are accounted for.

**Depreciation** is a non-cash accounting charge that is deducted from revenues in determining operating income. This charge writes off the cost of an asset over its life span. When a company has assets that decline in value over time, each year that diminishing value can be written off as an expense, taking away from reported profits but saving money in taxes.

**Depletion** is an accounting charge that writes off the cost of an asset over its life span when that asset is a natural resource. Some natural resource assets are oil, gas, and minerals.

**Amortization** is a write-down of intangible or short-term assets. Some amortized items are tax deductible; others are not.

$$\text{Operating Cash Flow} = \text{Cash Flow} + \text{Interest Expense} + \text{Income Tax Expense}$$

**Interest Expense**—Interest charges can be added back to cash flow for a more extensive measure of the cash that is generated by a company's operations.

**Income Tax Expense**—When a company is the target of a takeover, the debt that is generated can eat away at most if not all of the reported profits. When there are no reported profits, there are no taxes due.

**Operating Income (EBIT)**—Pretax income that a company earns, which includes all of the operating income before taxes and interest expense.

$$\text{Free Cash Flow} = \text{Cash Flow} - \text{Capital Expenditures} - \text{Dividends}$$

**Capital Expenditures**—Expenditures on new and replacement items that a company needs to function, such as property, plant, and equipment. The necessary capital expenditure items are deducted from cash flow to determine free cash flow.

**Dividends**—Dividends should be deducted from cash flow to determine free cash flow. This holds true for a company that has always paid dividends and would not eliminate them.

As a day trader, your effectiveness will increase if you have a handle on the important fundamental catalysts that move the market. With the growing number of Internet companies listed on the NASDAQ stock market, most of which have no earnings, it has become increasingly important to understand what sort of earnings report makes the largest shareholders tick. When there are no earnings to speak of, sequential revenue growth and cash flow figures become the focal point. When you understand why the largest shareholders act, you will be prepared to trade when the fundamentals and the technicals work in tandem.

# C H A P T E R

# 8

## RATIO POWER

Ratios are potent mathematical tools that interpret fundamental data in order to produce a picture of a company's health. Ratios offer a simple way to evaluate a company compared to its peers and against a benchmark. Some of the fundamentals that ratios examine and integrate include equity, assets, liabilities, income, cash flow, and stock price.

Ratios allow you to examine trends within a company or an industry, highlighting when current performance diverges from past performance. As lagging, not leading, indicators, ratios look at past performance to predict future results. Past performance sheds light on fundamental trends and momentum, which is useful for developing an overall picture of the company's strengths and weaknesses.

Statistical analysis of ratios can be employed when determining the consistency of management methods and the earnings viability

of the company. One statistical tool used to examine ratios is the standard deviation. The standard deviation can be useful for evaluating the volatility of management's control over operations.

Used in isolation, a financial ratio is meaningless. For example, suppose a company has a P/E ratio of 35. Unless you know what the P/E ratios of that company's competitors are, you will not know if that is a high or low P/E ratio. Analysts and portfolio managers have been known to diverge in their interpretations of ratio benchmarks within various industries.

## PROFITABILITY RATIOS

Profitability ratios gauge a company's capacity to generate revenues, control costs, increase profitability, and produce results. In order to properly evaluate profitability, other areas of a company's business should be taken into account. These areas include total sales and the total capital invested. Some of the most important profitability ratios are shown in Table 8-1.\*

**Table 8-1** Profitability Ratios

To view this  
image, please  
refer to the print  
version of this  
book

\*Also see Griffis, Michael. *Ratio Analysis*. Stocksguide@About.com, 1998.

**Table 8-1** *(Continued)*

To view this  
image, please  
refer to the print  
version of this  
book

**Table 8-1** (Continued)

To view this  
image, please  
refer to the print  
version of this  
book

## RETURN ON EQUITY (ROE)

The return on equity of a company (ROE) is a calculation used to examine how much the company earns on the investment of its shareholders. Dividing a company's net income by the common shareholders' equity results in the ROE figure. Portfolio managers examine return on equity very carefully and use it when deciding whether to buy or sell. ROE is used when evaluating whether a company eats up cash or creates assets. If a company makes \$2,500,000 for \$10,000,000 invested, then the ROE is 25 percent.

A high ROE figure can mean that the company has a high return on leverage or debt, or that it has a high return on assets. If the company does not have a lot of debt on the books and has a high ROE figure, chances are that management is earning higher profit margins on the assets. If the company is highly leveraged and has a high ROE figure, its return on assets is lower.

Like all financial ratios, the ROE is most effective when used to evaluate a company against its peers. Because return on equity is derived from earnings or net income, an earnings surprise provides a first hint of a change in the ROE trend.

## LIQUIDITY RATIOS

Liquidity ratios evaluate the capacity of a company to pay its short-term liabilities. They examine how a company converts cash to meet its obligations from the time an order is received until accounts payable and debts are met. Two of the most commonly used liquidity ratios are described in Table 8-2.

**Table 8-2** Liquidity Ratios



Current assets include cash, marketable securities, short-term cash convertible instruments, trade receivables, other receivables, inventories, prepaids, and miscellaneous current assets. Current liabilities include short-term claims against the company, which must be paid within 12 months. These include accounts payable, wages, salaries, dividends, taxes, and other short-term obligations, including bonds, debentures, and bank loans.



## LEVERAGE RATIOS

Leverage ratios examine how much debt a company uses for finance, and what sort of liability that debt imposes on the company's welfare. When subordinated debt exists, the ratios that are used take into account a company's senior liabilities and capital funds, or tangible capital funds. This is because subordinated debt increases a company's net worth on the books; it is considered to be capital as long as the loan exists. Some of the important leverage ratios are described in Table 8-3.

**Table 8-3** Leverage Ratios

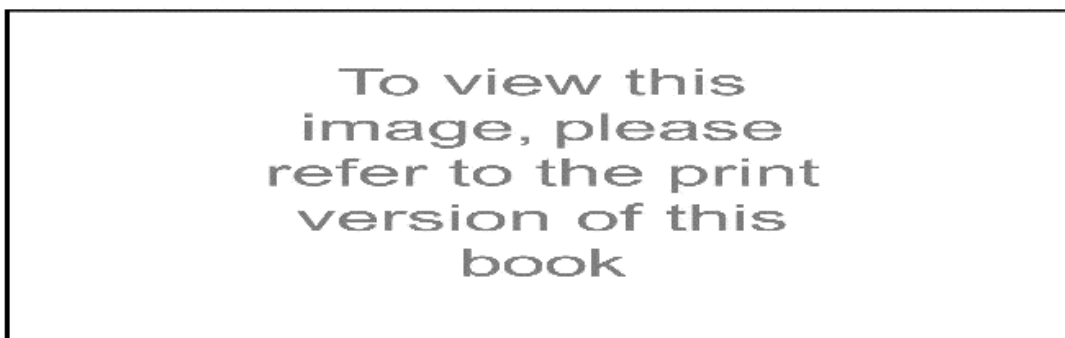



To view this  
image, please  
refer to the print  
version of this  
book

**Table 8-3** *(Continued)*

## ACTIVITY RATIOS

Activity ratios gauge how effective a company is in utilizing its assets. These ratios compare the income of a company to its asset base. Some of the most important activity ratios are described in Table 8-4.

**Table 8-4** Activity Ratios

**Table 8-4** *(Continued)*

To view this  
image, please  
refer to the print  
version of this  
book

Financial ratios are tools for interpreting the financial statements of a company. Different ratios are applied across different industries because of digressing capital frameworks. Because of this divergence of use, ratios are most valuable when used in comparison to an industry benchmark or to a company's peers. The objective in using ratios is to determine if the company is profitable and if it can meet its debt obligations; how the company is doing compared to previous quarters or years; how the company compares to its competitors; and how the business performs against its benchmark.

# 9

C H A P T E R

## ECONOMIC INDICATORS AND THEIR IMPACT ON DAY TRADING

There is a broad range of economic statistics that have an impact on the financial markets. On a weekly basis, economic numbers are reported that often generate powerful undercurrents for the day's market activity. Because there are numerous indicators tracking various segments of the economy, it is easy to lose track of the significance of each report. This chapter provides a snapshot of the most important numbers and how they affect the markets.

Economic news affects stocks, bonds, the U.S. dollar, foreign currencies, and the global markets. Positive economic news suggests a growing economic climate and possible inflation on the horizon. Negative economic news suggests a slowdown in production and economic growth. The best possible bullish combination for stocks is economic growth combined with low inflation. This powerful duo was the driving force behind the great bull market of the 1990s. Technology and the Internet fueled the economic growth of

the 1990s, increasing production without having an inflationary impact on prices.

A vibrant economy with strong growth tends to lead toward stronger demand, which in turn creates higher prices. Higher prices normally produce inflation, which the Federal Reserve Board is designed to avoid. At signs of inflation, the Federal Reserve Board adopts a tightening bias, which means that they take the objective of slowing down economic growth by tightening the money supply through higher interest rates.

The stock market tends to react positively when economic growth is stimulated, and negatively when economic growth is slowed. A rise in interest rates by the Fed tightens growth and generally causes stocks and bonds to fall. A lowering of interest rates loosens money supply, stimulating growth, and generally causes stocks and bonds to rally. Stocks and bonds can also rally with a rise in interest rates if the perception is that the Fed will not hike rates again in the near future; or they can fall with a drop in interest rates if the consensus is that it is the last such drop on the horizon.

Economic growth combined with inflationary pressures creates a bias for higher interest rates and lower stock prices. Economic growth combined with noninflationary pressures creates a neutral bias for interest rates and a positive bias for stock prices.

Negative economic news includes a slowdown in production and economic growth. Economic decline is associated with lower demand. When demand is slowing, prices fall because supply increases. During this environment, inflation is not a concern. In a weak economy, the Federal Reserve is more interested in stimulating economic growth. It does this by lowering interest rates in order to stimulate borrowing and spending. Weak economic news creates a bias toward lower interest rates, higher stock prices, and higher bond prices.

## **ECONOMIC NEWS AND THE U.S. DOLLAR**

Positive economic news, which is associated with lower bond prices and higher interest rates, rallies the U.S. dollar against other foreign currencies. The value of the U.S. dollar represents the strength of the U.S. economy. When the economy is doing well, other people want to own a piece. For example, the sharp rally of the yen against the U.S. dollar during the early fall of 1999 was the by-product of a perception of a strengthening Japanese economy.

Negative economic news, on the other hand, which is associated with higher bond prices and lower interest rates, weakens the U.S. dollar against other foreign currencies. If the U.S. economy is perceived to be weak, the dollar represents that weakness. The U.S. dollar posted its all-time post-World War II lows against the yen just before the great bull market of the 1990s kicked into full force. During this period, the American economy was in recession, just starting to come up for air.

## ECONOMIC INDICATORS AND THEIR EFFECT\*

As with earnings reports, perception is key when economic numbers hit the tape before the market opens. Markets move based on the change in the number reported relative to what the expectations are on the street. The total change in the number when compared to the previous quarter or year is not important to the short-term impact. It's important to be prepared before the number hits the tape. Know what the street expectations are, and what it will mean for the market if the number exceeds or misses those expectations.

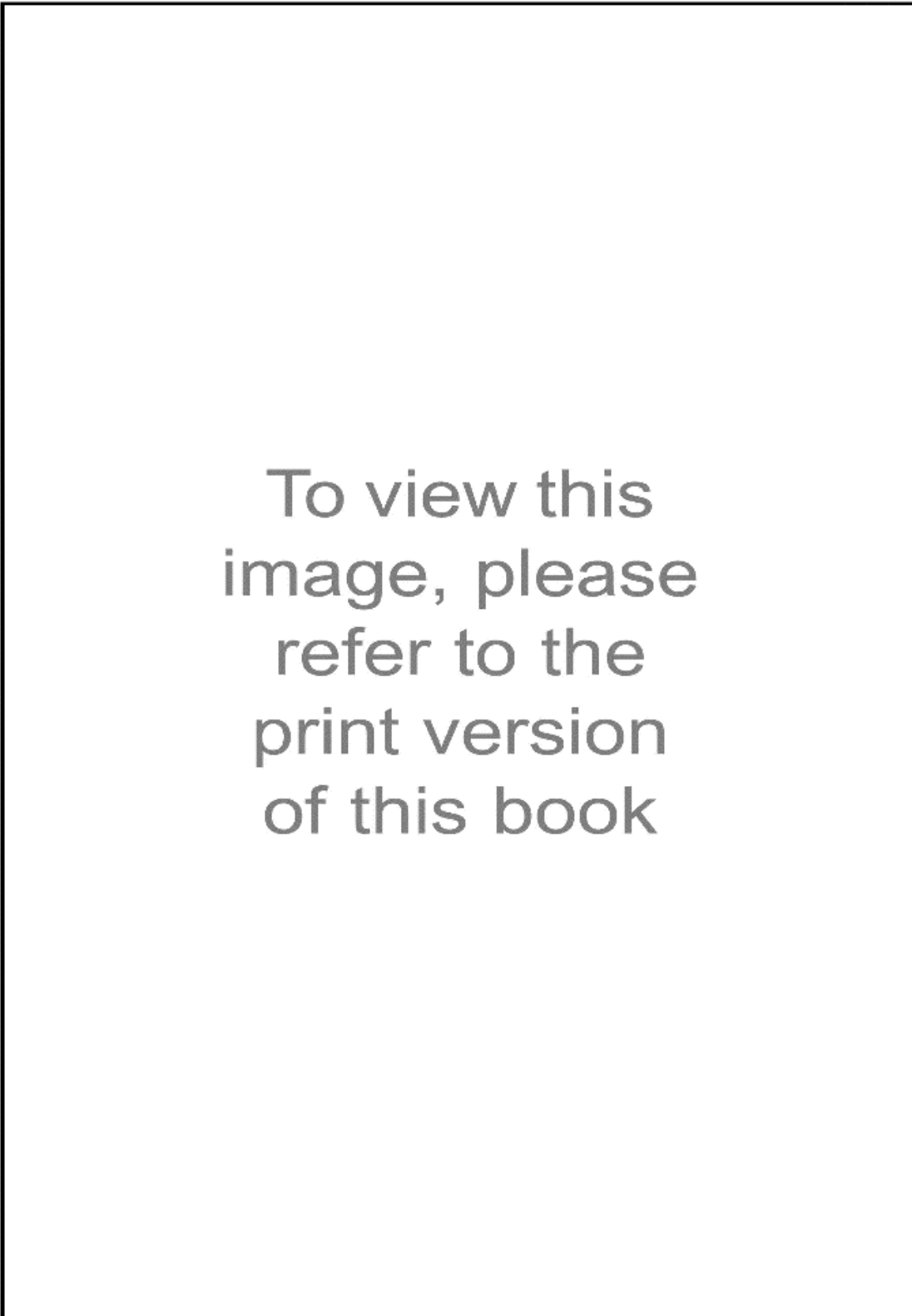
With the advent of trading around the clock, there has been an increase in pre-opening and after-hours trading by all types of traders and individual investors. The increased liquidity means additional trading opportunities immediately following economic reports.

How the market will react has a lot to do with perception about what the policy will be in the future. As already mentioned, there are instances when the Fed raises rates and stocks and bonds rally, or when it lowers rates and stocks and bonds fall. For example, on November 16, 1999 the Federal Reserve Board hiked interest rates by 1/4 of a point. Stocks rallied following this news, because the Fed concurrently adopted a neutral bias toward raising rates again in the future, allaying fears. Many times stocks and bonds move in anticipation of an event, then change directions after the event is announced, because the price action has already been accounted for in the move. Stocks and bonds can rally prior to an anticipated interest rate cut and sell off when the cut takes place.

Table 9-1 lists economic indicators and their impact on the markets, or the most likely course of action for prices, all else being equal. These reports affect prices because of uncertainty about what

---

\*See also *Economic Indicators and Their Impact on the Financial Markets*. NatWest Financial Markets Group, 1995.

**Table 9-1** Economic Indicators

To view this  
image, please  
refer to the  
print version  
of this book

**Table 9-1** *(Continued)*





**Table 9-1** *(Continued)*

To view this  
image, please  
refer to the  
print version  
of this book

the Fed will do in reaction to the number. There are times when stocks and bonds do not react according to expectations, given the strength or weakness of the indicator. Many other factors can come into play when interpreting these numbers, including price action leading up to the report and biases of the Fed.

## THE FEDERAL RESERVE AND ITS MONETARY POLICY

The Federal Reserve Board's objective is to foster a strong and steady economy in the United States. It oversees the availability of money and credit, with the objective of advancing sustainable growth and price stability. The Federal Reserve is guided by a Board of Governors whose job it is to create and institute policies for regulating the money and credit flow in America. The Fed's monetary policy has a direct effect on economic growth, price inflation, and employment.

The Federal Reserve Board utilizes three main techniques for instituting its monetary policy:

1. Regulating the reserve requirements for depository institutions.
2. Adjusting the discount rate, which is the rate the Fed charges depository banks for overnight credit.
3. Buying or selling U.S. Treasuries in the open market. This activity has a direct impact on interest rates, because these operations either increase or decrease the reserves in the U.S. banking system, which affects the demand and supply relationship.

Open market operations are the devices most used by the Fed for implementing its monetary policy. The policy for open market operations is determined by the Federal Open Markets Committee.\* The Federal Open market Committee is a 12-member committee that sets credit and interest rate policies for the Federal Reserve System. The FOMC sets short-term monetary policy for the country's central bank. This policy is derived from economic measurements, both domestic and international.

---

\*Federal Reserve Bank of Minneapolis. <http://woodrow.mpls.frb.fed.us/index.html>. Minneapolis, 1999.

The FOMC's 12 members include 7 members from the Federal Reserve Board of Governors, the president of the Federal Reserve Bank of New York, and 4 alternating seats that are held by presidents of the 11 other Reserve Banks. The FOMC must meet a minimum of four times each year, in Washington, D.C. Since 1980, the FOMC has scheduled eight meetings annually, which have been held at interims of five to eight weeks.

When the FOMC meets, the main focus is whether or not they will change the short-term Federal Funds Rate. The Federal Funds Rate is the interest rate banks charge one another for overnight loans. Once the FOMC sets a target for that rate, it uses its open market operations to buy or sell government securities in order to move the Treasury market to the level it has set. A change in the Federal Funds Rate in turn moves all of the other short- and long-term interest rates.

When the Fed announces that it has increased the Federal Funds Rate, it means that it is engaging in a tightening of monetary policy. This occurs during periods of strong economic growth when the Fed is concerned about an increase in inflation. Under these circumstances, the Fed sells U.S. Treasuries, which subtracts from the reserves of the banking system and in turn causes the Federal Funds Rate to rise to the announced rate.

When the Fed announces that it has lowered the Federal Funds Rate, it means that it is engaging in an easing of monetary policy. This happens during periods of weak economic growth when the Fed is concerned about stimulating the economy. Under these conditions, the Fed buys U.S. Treasuries, which adds to the reserves of the banking system and causes the Federal Funds Rate to fall to the announced rate.

## **BOND PRICES AND INTEREST RATES**

The most important thing to remember about bond prices and interest rates is that they have an inverse relationship, which means that they move in the opposite direction. Positive economic news generally has the effect of causing bond prices to fall, which in turn creates a higher yield.

When bond prices rally, the yield falls; when bonds prices fall, the yield rallies. When interest rates rise, bond prices fall because the value of the present bond is worth less than the value of the new bond, which has the higher interest rate. When interest rates fall,

bond prices rise because the value of the present bond is worth more than the value of the new bond, which has a lower interest rate.

The yield curve portrays the connection between the yield of bonds and their date to maturity. The yield curve has a normal upward bent representing interest rates that increase with an increase in their date to maturity. Investors receive a higher premium for holding bonds with a longer maturity, because of the risk factors involved with time, including inflation, higher interest rates, and opportunity cost.

If the marketplace expects positive economic growth in the future, then the yield curve increases. This is because higher premiums will be factored into the farther end of the yield curve due to an expected increase in interest rates and inflation associated with a stronger economy in the future.

A flat yield curve comes into play when the Fed has adopted a tightening bias and has thus increased short-term interest rates. With an increase in rates, the marketplace reduces their expectations for inflationary pressures in the future, and the premiums on the farther end of the yield curve will be lowered. The yield curve becomes flat because the shorter end rises with the rates, and the farther end falls lower with the diminished premiums.

Yield curves become inverted when long-term interest rates fall below short-term interest rates. This normally happens when the Fed has raised short-term rates consecutively, usually in a strong economy. The farther end of the yield curve falls because the marketplace believes that the increase in short-term rates is enough to slow future inflation.

Important economic numbers often dictate the market tone for the rest of the day. The Federal Reserve watches these numbers carefully and uses them to dictate future policy. Numbers that point toward strong economic growth tend to be associated with inflationary pressures, which the Fed frowns upon. If the Fed senses that inflation is on the rise, it adopts a tightening policy, which means higher interest rates and lower stock prices.

Economic indicators that point toward strong growth and low inflation are the best of both worlds for the stock market. In this scenario, the Fed has no inclination to adopt a tightening policy, so the economy can continue to grow unimpeded. Weak economic numbers point toward a slowdown and can prompt the Fed to adopt a

loosening policy, which means lower interest rates and higher stock prices. Low interest rates make it cheaper for companies to borrow, which means they can spend and grow. Higher interest rates make it more expensive for companies to borrow, so growth is slowed.

The economic numbers that are reported provide insight as to which actions the Fed might take in the future. When you have a handle on these numbers before they come out, knowing which direction the Fed is most likely to take if the number exceeds or misses expectations, then you will be prepared to act quickly and more profitably.

# CHAPTER 10

## ORGANIZE YOUR INFORMATION FLOW

It is easy to become overwhelmed by the sea of information that every day trader is inundated with. There are thousands of Web sites alone dedicated to educating and informing investors about topics ranging from hot news on stocks to tax tips. You will be at a disadvantage if you allow your valuable time to be spent focusing on information that is not directly relevant to your goals and objectives for the current trading day. When you can effectively locate, manage, and organize the information that is available, you will be in good shape to trade unencumbered.

### **UTILIZE INTERNET RESOURCES EFFECTIVELY**

There are a number of financial Web sites that are extremely useful in helping to pinpoint and organize information flow that is pertinent to making informed trading decisions. The abundance of infor-

mation available on the Internet today can be a mixed blessing for the day trader. On the plus side, information works to the trader's advantage when it can be managed and used as a backdrop for uncovering ideas or supporting trading decisions. On the minus side, a trader who does not really know what sort of information to look for or where to look for it can easily get lured into excessive analysis that interferes with day trading.

Information overload is a problem that many investors, traders, and portfolio managers have to deal with on a daily basis. In the spring of 1999 a number of prime-time news features discussed the information assault that has accompanied the on-line revolution. The average business executive today receives upward of 50 e-mail messages a day, 30 voice mail messages, and 10 pieces of unsolicited regular mail daily. For the day trader, the information deluge is even worse. If it is not managed, this information overload can easily encourage a dangerous trading condition known as "analysis paralysis."

Excessive analysis is a trap. Too much analyzing causes procrastination and indecision. The most successful traders have a few simple ways to determine what course of action to take. They are able to act when their entry criteria are matched—and they don't look back.

The Web sites listed later in this chapter represent a comprehensive set of investment and financial resources. The list is an aggregation of the most popular Web sites that are used most often by market makers and the financial community. They offer valuable technical and fundamental tools to enhance your decision-making process. The key to using them successfully is to know what you are looking for and avoid being sidetracked.

## THE WATCH LIST

A watch list is a powerful organizational tool that a trader should utilize in order to be prepared. A watch list is a dynamic list of stocks, updated daily, that you can track with price alerts. The price alerts will let you know when a stock you are tracking enters into your price range. When you maintain a watch list comprised of your focus stocks, you can use the list to zero in on the information that is most important to you.

Watch lists can easily be constructed on a blank monitor page contained within most software packages. Some of the Web sites

listed later in this chapter offer free watch lists that will send you pertinent information by e-mail. Clearstation.com is one Web site that allows you to set up an effective and dynamic watch list.

Watch lists are especially effective because they encourage you to stay with an idea until its completion. If you are scanning charts and you come up with a number of trading ideas, develop the habit of entering them onto your watch list. An idea that does not work today might still be viable tomorrow, or even a week from today. It is also worthwhile to look at stocks you placed on your watch list that never worked. These stocks can serve as valuable and inexpensive learning experiences.

Areas of support and resistance for broader sectors should also be monitored on your watch list, with limit price alerts. For example, if the daily resistance in the NDX is 4,000, a limit alert will provide you with timely information if that level is pierced and a breakout is in play.

## EMPOWERING WEB SITES FOR DAY TRADERS

The Web sites listed here are used actively by market makers and the professional trading community.

**BigCharts.com**—BigCharts is the place to go for an extensive array of efficient charting tools. BigCharts is a user-friendly investment research Web site that provides access to interactive charts, quotes, news, and analysis, with intraday stock scanning capabilities. BigCharts also provides the capacity to view up to 50 intraday quotes at one time with option pricing and dynamic charting.

**Bloomberg.com**—Bloomberg.com is a comprehensive financial news and services site that provides extensive financial information. Bloomberg furnishes its services to over 140,000 users in more than 91 countries.

**Briefing.com**—An excellent place to visit regularly for current briefings and snapshots of the most important events affecting the current day's trading action in stocks and bonds.

**Cbsmarketwatch.com**—A hot spot for premier market-moving news and award-winning analysis, research, and educational articles.

**Clearstation.com**—ClearStation focuses on trading techniques and ideas utilizing an easy-to-use and effective interface, watch



list, and alert feature. ClearStation integrates three main investment viewpoints: technical analysis, fundamental analysis, and input from the trading community.

**Cnbc.com**—All the best CNBC has to offer, on-line, in a user-friendly, comprehensive, and educational format with access to past and present features.

**Cnnfn.com**—CNN's financial news site with subsections on markets and investing.

**Companysleuth.com**—Companysleuth.com tracks down hard-to-find information and e-mails the results to you on a daily basis. The site acts as a private investigator by giving you useful clues about the companies you are trading. If a stock is on the move and you do not know why, this site could be the place to go.

**Dailystocks.com**—A must-have bookmark. DailyStocks.com provides passage to prevalent Web sites for all the market information you need, including market updates, news, earnings calendars, research reports, stock screeners, IPOs, public filings, corporate changes, and much more.

**Edgar-online.com**—Provides quick access to up-to-the minute SEC filing information.

**Finance.Yahoo.com**—A comprehensive financial site covering domestic and international investing issues ranging from taxes to loans to U.S. stocks. A must-see if you are searching for a good chat room on a broad range of trading topics.

**Financialweb.com**—FinancialWeb publishes financial content, stock quotes, charts, securities data, and news. It is a conglomeration of various other financial sites, including Quote Central, Rapid Research, Stock Detective, Wall Street Guru, The SmallCap Investor, Stock Tools, The Bear Tracker, NewsVest, Mr. EDGAR, Strike Price, YourFunds.com, Strike Price, Bull Mart, Annual Reports Online, and InvesToons.

**Fool.com**—Provides financial information in an interface that specializes in educating users in an amusing way.

**Hoovers.com**—A superb information resource that provides in-depth company information, including company capsules. The content is presented in a fun and easy-to-read format. Hoovers is also an excellent source for finding and narrowing down a company's main competitors.

**Investext.com**—A division of Thomson Financial Services, the Investext Group furnishes investment research including business reports and analysis on a large electronic collection of companies throughout the world.

**Investorama.com**—A leading Internet directory for individual investors, investorama.com provides the largest collection of financial resources available on the Web. It also displays a wide array of educational material for individual investors, ranging from stocks to real estate.

**Investors.com**—The official Web site of *Investor's Business Daily* provides helpful utilities for uncovering trading ideas. The Web site is unique in that it will clue you in to stocks and sectors that are in play before they receive widespread attention. *Investor's Business Daily* pinpoints potential winning stocks through its unique tables, charts, and evaluation measures.

**IQC.com**—ICQ.com is unique because it allows its users to search for stock ideas using candlestick parameters. If you are looking for tech stocks that have formed a bullish reversal pattern, for instance, then IQC is it. IQC.com can also search for ideas using fundamentals, and has an educational section that includes topics such as candlestick charting and technical indicators.

**Justquotes.com**—Provides quotes, comprehensive company research, analysis, charts, and information on the competition.

**Marketguide.com**—A source for quality research covering areas including market commentary, quick links, real-time quotes, upgrades and downgrades, headlines, story stocks, DRIPS, and broker research.

**MarketHistory.com**—A great spot to visit if you are searching for quantitative ideas. MarketHistory.com utilizes quantitative research for delivering high-reward and low-risk trading ideas. This site is used by the professional trading community and is one of a kind. It is one of the more expensive sites for a full subscription, but well worth it.

**Money.com**—A financial strategy center covering topics including markets, news, investing, real estate, insurance, autos, retirement, taxes, and trading tools.

**Moneycentral.com**—Top-rated MoneyCentral.com provides one-stop shopping for your financial needs. MoneyCentral.com is the largest financial Web site that provides you with in-depth information on a variety of securities, funds, and investment tools. The MSN Investor section focuses on portfolio management, stock screening, investment tracking, news, investment ideas and performance, research, and e-mail notifications and alerts.

**Moneypaper.com**—A Web site and monthly publication focused on enriching the financial health of independent investors through education. This site provides specific investment recommendations about the proper course of action to take given your current strategies.

**Morningstar.net**—Morningstar.net is the leading provider of research, analysis, and investor information for mutual funds and stocks. This site walks investors through the investing process with important data, news, market information, interactive tools, and education.

**Mredgar.com**—Provides access to SEC filings, company profiles, and a watch list with e-mail notification when a new SEC filing is submitted.

**Multex.com**—A main source for garnering research reports, multex.com links brokers, investors, and institutions with investment research and information services.

**Mutualfundsinteractive.com**—Provides comprehensive educational material geared toward educating consumers focused on investing in mutual funds.

**Nasdaq.com**—The home page for the NASDAQ stock market; provides up-to-the-minute information affecting the world of NASDAQ stocks.

**Nasdaqtrader.com**—Provides information on the trading activities and regulations affecting NASDAQ stocks, including market maker trading data. This site is the place to go to gain a monthly perspective on market maker volume activities.

**Newsvest.com**—A comprehensive news source for the financial community.

**Nyse.com**—The home page for the New York Stock Exchange, providing information on the trading floor, the stock market, listed companies, members and institutions, regulations, and news affecting listed stocks.

**Professionalcity.com**—Provides expansive information on targeted professions ranging from law to investing.

**Quicken.com**—Quicken.com is a personal finance site that offers a sweeping set of virtual tools created with the goal of becoming a one-stop shopping financial network. Quicken.com and Moneycentral.com are the two main Web sites that attempt to address all your financial needs. Quicken.com has areas on the site that assist with topics ranging from insurance, home loans, and tax preparation to investment and retirement planning needs. After locating what you need on Quicken.com, you can take it a step further and complete interactive forms that will get the ball rolling.

**Quote.com**—Provides a comprehensive array of financial market data including quotes on stocks, options, commodity futures, mutual funds, and indices. Quote.com also provides news, market analysis, charts, company profiles, and fundamental data.

**Ragingbull.com**—A favorite for message boards, news and commentary, and quotes and data, provided in a fun and easy-to-use format.

**Redherring.com**—The official Web site for *Red Herring* magazine, redherring.com provides information on IPOs, insider news and analysis, venture capital, and important industry news.

**TechStocks.com (Silicon Investor)**—The main place to visit for message boards and hot topics. This site is a favorite for traders who are searching for information that is not widely available. The site includes trading tools, market insight, and a portfolio section.

**Thestreet.com**—TheStreet.com is unique for its compilation of top-notch financial journalists producing articles and editorials with a Wall Street insider perspective. TheStreet.com offers highly regarded, in-depth daily market analysis that spans markets ranging from domestic equities to international debt.

**WSJ.com (Barrons.com)**—The *Wall Street Journal* on-line provides all the goodies the newspaper has to offer in a user-friendly format for less than \$10 a month. With this subscription you also get *Barrons* on-line and a comprehensive database that allows you to search for past articles. This is an inexpensive and easy way to organize and save valuable articles.

**Zacks.com**—Zacks is known as a main source for earnings information, including reports, estimates, revisions, upgrades, and downgrades.

**ZDNetinteractiveinvestor.com**—Ziff-Davis is one of the world's leading technology media companies. It is a prime Web site for gathering data on the latest trends, technology, and Internet trends affecting the economy.

The Internet has put valuable information at the fingertips of all users. Information that was previously very expensive and hard to come by is now available to anyone who knows where to look for it. The Web sites listed here can provide you with the technicals, fundamentals, tools, educational materials, and commentaries you need to enhance your trading knowledge and capacity.

*This page intentionally left blank.*

# IV

P A R T

## THE TRADE

*This page intentionally left blank.*



# CHAPTER

# 11

## ENTRY

Correct entry is a crucial component of the trade. When entry is carried out properly, your odds for success increase dramatically. Most traders have experienced trades that were planned out well, only to be foiled in the moment of entry, turning a potential profit into a loss.

Successful entry is composed of three parts: price, timing, and execution. When you learn how to recognize the best entry price zone and the best time to enter, your profitability will increase. You will also develop the habit of acting more quickly and with less thought, resulting in better probabilities for success. The advantage of being prepared to act is that you have already made the decision, so you will be able to execute the trade with little hesitation.

The remaining aspect of entry is whether or not you receive a good execution. Sometimes you will receive good executions and sometimes you will not. The executions you receive are not always within your control. They depend on different factors including

your speed, the broader market action, the stock's liquidity, the execution system you are using, and what is going on in the stock at that particular time.

The premium you are willing to pay for a stock when you do not receive the execution you were looking for is within your control. Paying a costly premium by chasing a stock on entry when you missed your targeted entry zone is one of the most common mistakes made by traders. Through preparation, discipline, and patience, this mistake can be avoided; we discuss entry premiums in further detail later in the chapter.

## THE SCALED ENTRY APPROACH

The scaled entry approach involves entering into a position on a scaled basis. Instead of buying or shorting the entire position in one shot, you first take part of your intended position, preferably one-half to two-thirds. After the initial entry, you add to your position only when and if it is working in your favor, thus at a higher price than you originally paid.

The scaled entry approach provides flexibility, price discovery, and a stronger risk profile. By using more than one level to enter into a position, you gain flexibility for entry, because you do not need to be entirely right on entry. Market makers often use multiple levels to trade into and out of positions.

Successful market makers have controlled the ego-based need to be absolutely correct. Because markets are constantly in motion, it is almost impossible to be exactly right on a trade by entering or exiting at the very high or low point of a move. Traders who relinquish this ego-based desire free themselves to trade more aggressively by adding to a position if it is moving in their favor, and by cutting a position if it is not. In essence, they are trading after they have received price confirmation, not before.

The price discovery that you achieve with scaled entry is a valuable commodity. It is easier to act with conviction when you have confirmation that your strategy is correct. The best confirmation is achieved only through action, after executing a trade. You'll confirm not only price action and timing, but your own strategy as well. Action is the only cure for fear and doubt. If you buy a stock and it goes in your favor, you have valid confirmation that your strategy is correct. If it turns against you, then you know your strategy was not

correct. When the stock moves in your favor, you not only have confirmation but you also have a profit and the psychological advantage of a positive P&L buffer. If the stock turns against you, you have lost less than you might have because you entered with only a partial position.

When you add to a winning position, always do it in increments of half or less. This way, when you add to a trade, even if it is at the worst possible time, your P&L will still be positive even if the stock suffers as much as a 50 percent retracement off its highs. When adding to a winning position, always wait for the motion to stop on the downside after a small pullback. Add to a winning position only when the pullback stops above your initial entry zone.

*A market maker wanted to go long 50,000 shares of ABCD with a scaled entry approach. It was currently quoted  $40-40^{1/16}$ , with 37,500 offered out loud at a  $1/16$ . The trader used Select Net to take the offerings and immediately bought 25,000 shares at  $40^{1/16}$ . The stock immediately moved higher, to  $40^{1/4}-40^{5/16}$ . After 5 minutes, ABCD pulled back and stopped at  $40^{3/16}-40^{1/4}$ . At this point the market maker bought another 12,500 shares at  $40^{1/4}$  and the stock moved higher again. The trader was now long 37,500 shares. After the stock moved above  $40^{1/2}$ , the trader bought the remaining 12,500 shares at  $40^{9/16}$ , ending up long 50,000 shares at an average price of  $40^{1/4}$ .*

Many successful day traders utilize the scaled entry technique in order to test stocks first, before they go in full blast with their normal size. For example, if your objective is to buy 25,000 shares of ABCD, first buy 10,000 to 15,000 shares. By doing this you will quickly discover if your short-term assessment about the direction, timing, and momentum is correct.

As a general principle, stocks that are hard to buy are going higher, and stocks that are hard to sell are going lower. If you bought ABCD and it immediately moved lower, you would know that something about your short-term strategy might not be correct.

If you had a hard time buying ABCD because it quickly moved higher, then you would know that your short-term plan was correct, and you could feel confident about adding to that position, preferably in increments of half or less. If you bought 15,000 shares, your

next purchase would be 7,500, or half of the 15,000. After going long the stock, if it moves more than 2<sup>1</sup>/<sub>2</sub> percent in your favor, take profits before adding to your position.

Adding to a winner is different from chasing a stock. When entering into an initial position, it is important to identify at what price the motion began. Once the motion begins, refrain from chasing the initial point of entry past your buffer range. The buffer criteria depend on the price of the stock and should be used as a general benchmark, not a rigid number. Use your knowledge of the stock you are trading and your common sense to stay flexible with your entry approach, centered around the entry buffer zone (see Table 11-1).

Most of the time stocks do not move in a straight line without first consolidating and pulling back. The odds are that prices will take a breather at some point before continuing their ascent. More volatile Internet stocks have a wider entry parameter from the point where the motion began. Usually, when you chase an entry you are ignoring the fact that stocks move forward in a steplike fashion: They move, stop, and pull back; move, stop, and pull back. It is important to give yourself a buffer for entry, but if that buffer is exceeded too strongly, move on to the next trade.

If you miss your buffer entry zone, you can reenter on a pullback if the initial move does not exceed double your entry criteria. For example, if you want to buy a \$50 stock, your initial buffer zone is 3/8 of a point. If the stock moves up 3/4 of a point before you bought any, you can still get in if it pulls back to within your initial 3/8 of a point area of 50—50<sup>3</sup>/<sub>8</sub>. If the stock moves higher than 3/4 of a point and then streams back in, leave it alone. Market conditions could have changed, and the initial move that you were aiming for could have been missed.

A stock that shoots significantly past your entry area and then falls back in is called a fallen star (discussed in more detail later in the chapter). Fallen stars have a difficult time regaining momentum in their original direction, because they were met with strong opposition. When this occurs, reassess market conditions and consider any entry a new trade if you still want to get in.

An advantage of scaling into a position is that you have extra buying power in reserve to use if the trade is a winner. This buying power should never be used to add to a losing position. No matter how tempting it may be, resist the urge to buy or sell stocks that are moving against you. You should only be willing to pay prices that

are higher than your initial entry. Don't get lured into doing the comfortable and easy thing, like buying a stock because the price seems low or selling a stock because the price seems high.

Large mutual funds have the luxury of averaging down in order to improve their volume-weighted average price (VWAP). Day traders have different objectives than mutual funds. Remember that as a day trader, your objective is to make money today. Half of the equation of making money is not losing a lot of money. The two ways novice and professional traders alike lose the most money are averaging down and bottom fishing. Once you become aware of how dangerous and costly these faulty trading tactics are, your profitability will immediately begin to improve.

Scaled entry is a key to successful trading. Successful day traders and market makers stay profitable because they have mastered the art of keeping their losses small while maximizing their gains. If you initiate a position with half of your normal size and the position moves against you, then you have cut your losses in half. If the position moves in your favor, you have not cut your gains in half because you can still add to it. You have only cut your initial gains in half, and depending on the stock that is not the meat of the move that you are looking for anyway. Scaled entry provides you with confirmation that your initial strategy is sound, and with the ability to stay flexible in your approach.

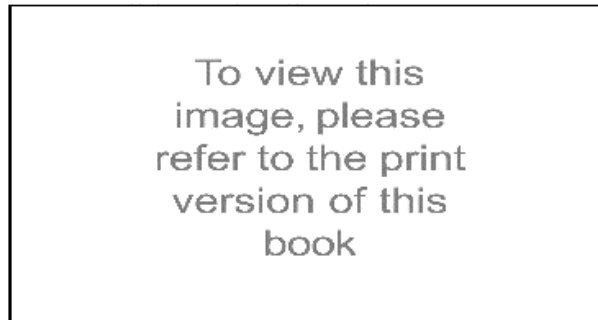
## THE CHASE

Knowing how to enter into a position is just as important as knowing how not to enter into one. The two most common ways of botching an entry are chasing a stock past your ideal entry point and anticipating a move to an entry point too early.

When you decide to enter into a position, refrain from chasing a stock too far past your ideal entry target range. This does not mean that you cannot get into the stock; it simply means that instead of paying an immediate premium for it, you are waiting for it to pull back before getting in. You can get in on a pullback as long as the stock does not move excessively past your entry point. If it does move too far past your entry point and then falls back (a fallen star), it should be avoided. The chart in Table 11-1 can be used as a general guideline of the buffer zone ranges for entry, given the price of the

stock. These ranges are meant to give you general criteria to prevent excessive chasing. They are not set in stone and should be used with a flexible approach, given the stock that you are trading or the circumstances you are trading under.

**Table 11-1** Buffer Ranges for Stock Entry



Most market makers are unwilling to chase a stock too far past an entry range in order to execute a customer's retail order. They prefer to short a stock to a retail buyer if the stock moves up excessively, rather than pay up for it. This is because stocks tend to pull back in a steplike fashion after moving higher.

For example, if a stock is quoted  $39^{15}/16$ —40 and it begins to move, you should resist paying more than  $40^{3}/8$  to get in. If you miss the move, wait for it to pull back into your entry range before getting in. If the \$40 stock moves more than  $1\frac{1}{2}$  percent above  $40^{3}/8$ , or in this case above 41, and then falls back into your initial entry zone, stay away from it. Market conditions could have changed. Your objective should be to buy stocks that are moving in your direction, not against you. The law of diminishing returns states that the higher the cost of entry, the lower the profit. When you understand this rule and abide by it, your profits will increase steadily.

Stocks that move more than  $2\frac{1}{2}$  percent past your entry point without pulling back and consolidating before lifting off again are more the exception than the rule. If you have acquired the habit of chasing prices too far past the price where the motion began, then you are consistently paying a premium for entry. The disadvantage of paying a higher entry cost is evident across all businesses, not just trading. Any entity that regularly pays above the average price for its goods will have smaller margins and a tougher time earning profits.

Many traders tend to disregard entry cost. A  $1/2$  point move in a \$20 stock is  $2\frac{1}{2}$  percent; that is a stronger move in percentage

terms than a 1/2 point move in a \$100 stock, which is only 1/2 percent. Trading is a game of probabilities. Your chances for success in trading increase when the odds for continued motion are in your favor, not against you. Paying a premium for entry on a consistent basis after the motion has begun decreases your odds for successful continued motion under most circumstances.

The higher the price of the stock, the larger an entry buffer you should provide yourself with. For stocks that are priced at over \$100, widen your entry buffer zone to roughly 3/4 of a point after the motion has begun. If your entry point is missed, you can always get back into the stock, but you should regard it as a new trade and a new short-term trend that you are attempting to catch.

Internet IPOs, for example, are not normal trading circumstances and should be considered a completely different trading ballgame. Day traders who try their hands at Internet IPOs use a different strategy than they use for most of the other stocks they trade. Because of the wild price swings with Internet IPOs, chasing the stock is often the only way to get in or out. Entry zones have to be huge, as do slippage adjustments. It is not uncommon for day traders to chase entry by 5 percent to 10 percent of the stock's price. The two most important things to watch when trading Internet IPOs are the AX, or the leading underwriter, and the spot where the motion began. These two items often go hand in hand, because the AX has the power to move the market due to a large natural customer order flow. If you trade Internet IPOs, use a predetermined limit for chasing entry and stick to it. Emotions of greed and fear run the highest with new issues. Resist the urge to hit the ball out of the park, and stay disciplined.

Traders usually chase stocks because they get emotional about having missed a move, and they want in at all costs. Buying a stock with upward momentum is a plus, but if the initial move is missed, you are better off letting it go. The chances are that another opportunity will materialize. Remember, missed money is better than lost money. Chasing stocks is the most common way to lose money when entering into positions.

Another common mistake made by professionals and novice traders alike is to anticipate a move into your entry zone before it gets there, with the motive of getting a cheaper price. When prices do not move to your level, there is usually a good reason. By anticipating the move, you are nullifying the reason for getting in.

Always wait for the price to enter into your sweet spot before acting. Use caution and refrain from anticipation. Anticipation is a dangerous quality to possess as a trader. Regardless of how tempting it may be to get onto the wave early, when you anticipate you are projecting your will onto the market. Allow the market to open the door for you before you act. Read the market's will, and refrain from imposing your own.

The problem with anticipating a move through support or resistance is that these levels are called so for a reason. The buyers or sellers of yesterday usually fortify those levels with increased resolve. The bulls or bears may be waiting in the wings to protect their territory. The very reason you are entering into the position in the first place is because of the evidence that the selling resistance or buying support has been nullified by today's stronger action. Anticipating a move to these levels is wishful thinking and has no basis in reality.

## FALLEN STARS

Fallen stars are stocks that have met your entry requirements and have proceeded to make a significant move in your direction, only to fall back into your initial entry zone. Traders who miss an original move often hope for a stock to fall back into their original entry range so they can get in and redeem themselves for having missed the move.

It is frustrating to watch a stock move significantly in your direction when you intended to get in but missed the move for one reason or another. The regret factor is one reason behind support and resistance levels. Traders and investors remember having missed a move and often try again if they get another chance. However, market conditions often change between the time the stock rises and when it falls.

Fallen stars should be avoided because they indicate that the initial move ran out of steam, and that the opposing force has counter-attacked and is now in control. If there was significant buying power behind a move up, then the chances are that the stock would not fall back that easily into your original entry area. When you go long a fallen star, you are buying a stock that is moving against you. It is not a momentum play; it is rather an emotional play. As a rule of thumb, most stocks that have moved 1<sup>1</sup>/<sub>2</sub> percent to 2<sup>1</sup>/<sub>2</sub> percent



past your initial entry area and then fallen back are fallen stars and should be avoided.

## THE SWEET SPOT FOR ENTRY

There exists a sweet spot for entry that, if acted upon, will increase your chances for a successful trade. The sweet spot is a price pattern that can be exploited on a consistent basis. Prices tend to spring through these areas when they are penetrated, so knowing where they are and how to take advantage of them will provide you with a sharp advantage.

The sweet spot for a long entry is right above the previous day's high. (Refer to Table 11-1 for targeting your entry price for longs and shorts.) The previous day's high is the shortest-term measure of resistance that, when broken, often results in a burst of momentum, clearing the path for further gains. (See Chapter 6 on the previous day's high and low.) The advantage of waiting for a stock to cross above its previous day's high before going long is that you are assuring that the short-term trend is positive. A move above yesterday's high suggests that the sellers who took a stand have succumbed to the stronger buying force of today. Once broken, the previous day's high turns into a new price support, and provides you with a floor for a tighter stop-loss point.

The sweet spot for shorts is right below the previous day's low. The previous day's low is the shortest-term measure of support. If you are trading from the short side and you wait for prices to cross beneath yesterday's low, you are assuring that the short-term trend is negative. Yesterday's low marks the point where the buyers took a stand and were able to push back the bears. A move below that line represents a victory for the bears of the current day, and represents new price resistance. A break beneath the low point means further lows are in store.

When a stock moves above the previous day's high or below the previous day's low for the first time, you have confirmation that two other powerful daily trend and entry indicators are in your favor. The two other indications that the short-term trend is in your favor are the net price and the opening price signal. (See Chapter 6.) The net price is a short-term measurement of a stock's health. It displays how the market players in that stock at any given time have rated the stock compared to the previous day's price action. A positive net price is equivalent to a green light. A negative net price is

equivalent to a red light. Your probabilities for success increase when you trade in the direction of the net price. When a stock crosses from positive to negative or negative to positive it provides an excellent signal for further momentum in that direction.

The opening price signal is an even shorter-term measurement of a stock's health. It rates a stock on how it is trading when compared to its opening price. A stock that is trading above its opening price indicates that the short-term trend is positive. A stock that is trading beneath its opening price indicates that the short-term trend is negative. The best scenario is to have both the net price and the opening price signal pointing in the same direction that you want to trade from. When the opening price signal changes sides on the day for the first time it provides a trading signal that a further move is on the way.

As a day trader, it should be your goal to act quickly when your risk-reward ratio for a profitable trade is the highest. This ratio is the highest when the net price, the opening price signal, and the support or resistance levels are in your favor. These three conditions will always be in your favor when prices initially break through the previous day's high or low. If you can enter just when these support or resistance levels are pierced—the sweet spot—your chances for success increase dramatically.

## TIMING THE ENTRY

It is important to realize that your odds for catching a profitable trend increase dramatically during the first and last hour and a half of the trading day. Between 9:30 and 11 AM and between 2:30 and 4 PM, the motion in the market is the greatest. Volatility and momentum during these periods produce the maximum opportunity for profit. Day traders should stay focused on entering into new positions that are in motion during these periods.

The first 5 to 15 minutes of trading in the early morning should be avoided when entering into new positions. Just after the market opens, trading is often the most unpredictable, subject to powers not easily recognized. It is usually during this period of time that the early morning pullback occurs. This is when specialists and market makers make money the easiest, because retail investors and novice traders have a tendency to chase stocks that are being marked up or marked down on the open. When a stock is being marked up, it will open higher than the previous night's close. When a stock is being marked down, it will open lower than the previous night's close.

Market makers and professional traders like to take the opposite side of markups in the morning, which results in an early morning contra move. S&P futures that gap up in the morning often close that gap at some point throughout the trading day. This fill-in often occurs within the first half-hour of trading and is commonly referred to as the early morning contra move.

It takes time after a stock has an aggressive opening for the orders to pan out. During this period of time, unpredictable volatility can cause havoc for day traders. There is no hard-and-fast formula for pinpointing the exact window when this volatility will end. It could take 5 minutes, or it could last for half an hour. All too often stocks gap on the opening with excessive enthusiasm or pessimism, only to reverse course quickly once the professionals take the other side of the markup. By waiting patiently after the opening for a stock to settle in, you will reduce the risk of getting whipsawed, and you will have a better picture of what side the real demand or supply is on.

Amateurs usually dominate the openings, while professionals dominate the close. Amateur investors send in market opening orders after reading news that has already impacted the price of the stock. Because of this, they end up paying the highs or selling the lows of the opening.

With the dramatic increase in equity ownership by the American public, the equilibrium of buying power has shifted in part to the smaller investors. These investors like to act in the morning. When the masses act in unison with thousands of small orders, these orders become a potent force and have the strength to move stocks around and dictate openings.

The late morning and midafternoon hours of trading taper off, with lighter volume and trendless ranges. This is when traders often try to force things to happen, entering into positions that go nowhere. Instead of catching a trend in motion, they end up frustrated by losses that could have been avoided. As a day trader, you have the power to pick your time and place to trade. Exercise that right.

Profitable entry requires a combination of careful preparation, patience, and quick action. When entering into a position, wait for the stock to enter into your ideal price range before trading. Refrain from chasing the stock past your ideal price range. If you missed the trade, then so be it; another will materialize. Don't indulge yourself by looking back at what could have been.

# CHAPTER

# 12

## EXIT

When carried out properly, correct exit will make the difference between a small profit or no profit, and a large one. There are various techniques for getting into and out of positions. Traders often come up with excellent trading ideas and execute them properly upon entry, but give back or cut short their gains in the moment of exit. Correct exit is an art. The reason exiting properly takes time to master is that it requires the application of two opposing forces, which requires discipline: staying power and hard-nosed action. The key to prevailing when exiting or entering a stock is preparation. As Benjamin Disraeli once said, "The great secret of success in life is for a man to be prepared when his opportunity comes." When you are prepared to exit, your profitability will increase measurably.

## THE SCALED EXIT APPROACH

The solution to balancing the forces of greed and fear when exiting a position is the scaled exit approach. The scaled exit approach is exiting a position incrementally. Rather than selling your whole position in one shot, in a scaled exit you initially sell only part of your position, while letting the other part run. Like the scaled entry approach, the scaled exit approach provides you with flexibility, price discovery, and the potential for greater profits.

The scaled exit satisfies your urge to lock in a profit, while allowing you to maximize your gains by letting some profits run. This approach is empowering because it reduces the illusive ego-based desire to be entirely right on a trade. Another advantage of having locked in a partial profit is that you are playing with the market's money on the second half of the trade. This provides you with an emotional and psychological advantage. If after selling part of your position the stock drops back into the area where you initially bought it, you have still locked in a partial profit. If the stock rallies past the point where you made a partial sale, you can rest at ease because you still have part of your position. You always have the option of reentering the stock if you want a larger position.

Scaling into and out of positions when you believe the market is in an overbought or oversold state can allow you to take advantage of market turns while maintaining the discipline of trading the meat of your position with the trend. It is important to remember that when markets are turning, volatility increases, making it harder to get good executions. The best-case scenario is to lighten up existing positions that are working into support or resistance. Cover part of your short going into support; sell part of your long going into resistance. If you want to short at resistance or go long at support, establish a position with only half or less of your normal size, and do so only when the opening price signal (see Chapter 6) is in your direction, providing you with confirmation.

One scaled-exit criterion is to sell part of your position after it has moved at least  $2\frac{1}{2}$  percent in your favor. For example, if you go long 25,000 shares of ABCD at \$50, you would immediately place a partial profit-taking limit order to sell part of your position, let's say 12,500 shares, at  $51\frac{1}{4}$ , or  $2\frac{1}{2}$  percent above your entry price of 50. If the stock continues to rally, you are still long 12,500 shares, so you have not cut your profits short. If the stock moves through  $51\frac{1}{4}$  and

then fails, you can rest assured because you have already taken profits off the table, so you are still making money.

Since you have already locked in a partial profit, you have increased flexibility for your remaining position. If the stock continues to move higher, you can scale out of half of your remaining long, or 6,250 shares, and keep the other 6,250 until the daily uptrend is broken (see Chapter 6). You can also use the trailing profit protective stop method (see Chapter 3). It is important to develop the habit of letting your profits run as long as possible after you have locked in an initial profit through the scaled exit method.

## MAXIMIZING YOUR GAINS

If your initial entry was successful and you have locked in the first and important part of the daily trend, you can relax and focus on letting your profits run. Successful traders focus on maximizing their gains, not on the number of times they win. Many times this is easier said than done. It is very tempting to lock in small profits for immediate gratification. This is especially true if you have acquired the habit of continuously focusing on your P&L. Knowing your P&L is important; but when you are glued to it, you are essentially glued to what it represents, which is subjective and clouds your decision-making process, encouraging greed and fear.

Rather than focusing on the profit or loss, the best traders stay focused on doing the right thing, and let the profits take care of themselves. Locking in small profits is a fear-based approach. The fear is that you'll lose what you have already gained.

The Wall Street saying that you can never go broke taking profits is false. If you consistently take small profits, commissions and slippage will eventually eat you alive. The larger profits are the ones that will make up for your smaller losses and your cost of doing business. The majority of successful traders are correct on trades just above 50 percent of the time. The reason they come out on top after paying for commissions and slippage is that they let their profits run longer than they let their losses run.

On the other hand, the greed-based approach of never locking in profits can also work to a trader's detriment. There are many occasions when a market maker or day trader enters into a position successfully and lets the profit run, only to watch it reverse and end up with nothing or a loss as a result of not taking any profits.

Giving money back in a stock because you did not take any profits is one of the most frustrating experiences for a trader. It is easy to get stubborn about a position that was working for you and is now a loser. Under these circumstances, regret runs high. Instead of getting more, you got less. Many traders who give back hard-earned gains blame themselves and reinforce their resolve not to let it happen again. If you end up holding yourself responsible in this situation, you will end up where you started by locking in small profits, because you fear giving your gains back again. Take partial profits off the table after a successful entry and let the other part ride.

## SITTING

In *Reminiscences of a Stock Operator*, Edwin Lefevre said, "It never was my thinking that made big money for me. It was always my sitting. Got that? My sitting tight!" Sitting with a position that is working is an important key to success. The main way professional traders make up for smaller losses, slippage, and commissions is through the larger gains they earn by sitting with positions that are moving in their favor.

The importance of sitting when trading also refers to sitting on your hands when a trade is missed. If the trade is missed, then wish it good riddance. The probabilities are in your favor that you will find another profitable trading opportunity. Instead of fretting about missed opportunities, use your valuable time to uncover other good possibilities. Looking back, in trading, as in life, should be avoided at all costs.

The practice of sitting will help you avoid aggressive overtrading, a practice that is expensive on three counts—the bid–ask spread, commissions, and time diverted from other winning possibilities. Statistics demonstrate that trending markets normally retrace a solid part of a move before reestablishing their trend. These mini corrections occur against the major trend, and they provide excellent opportunities to get back into the trade. When a trade is missed, be patient; the opportunity to reenter a trade generally presents itself. Having the patience to refrain from overtrading will help you become more profitable.

Exercise the practice of sitting after you have established a trade that is not yet working nor has it proved itself wrong. Give the trade a chance to demonstrate its merit. Don't be so anxious to kick out a

position at the first sign of a little head fake. If the position is not immediately working, sit on it. When a trade begins to work, give it time to play itself out.

Prices will arrive at their own equilibrium regardless of the short-term head fakes and moves of the market. Maintain the conviction to sit with your position either until it makes you money or you are stopped out. If you have a position and you abandon it too early out of fear, you are second-guessing yourself and overtrading, both detrimental practices. Acting with conviction and confidence is a habit that can be developed through practice. Every time you second-guess yourself and disregard your plan, you negatively affect your development as a trader.

Once you have established a trade, give the idea an opportunity to develop. Allow yourself to be stopped out. Do not get caught up by the insignificant head fakes caused by market makers that accompany most moves. Always know where you plan to exit a position once you get in. Have two exit points before establishing the position: an initial stop-loss point and a profit-taking range. Pre-determined profit-taking orders will help you to take partial or total profits when the position is moving in your favor, not against you.

Use a scaled exit approach to take advantage of trading around a position. The scaled approach will help you to relinquish the need to pick the bottom or the top of a move. When a position is moving in your favor, try to maximize your gains as much as possible. Taking a partial profit through a scaled exit will help you to do this.



# CHAPTER 13

## EXECUTION AND CONTROL

A good execution can make the difference in terms of profitability on a trade. Different factors determine whether you receive a good fill, a bad fill, or no fill. The increase in volatility combined with the swelling number of day traders today creates an environment in which the competition for the best executions is fierce.

The executions you receive when entering or exiting positions depend on elements in and outside of your control, including the liquidity of the stock you are trading, your speed, the execution medium you are using, the type of order you place, market conditions, and the unforeseen. Knowing the nature of the stock you are trading is crucial when determining what sort of execution you can hope to receive.

## MARKET ORDERS

When a stock enters into your ideal target range, always use a market order to attain execution. As a day trader looking to catch momentum, your objective is to buy or sell stocks that are on the move. Market orders are often the only way to get executions when a stock is in play. The risk with a market order is that you will pay a slippage premium, which means that you will pay more than you wanted to in order to get into your position. The premium, however, is often necessary to a certain degree. The degree to which you should be willing to pay a slippage premium is the maximum amount of your entry buffer zone, as explained in Chapter 11. If the price range exceeds the amount that you are willing to pay, cancel your market order immediately.

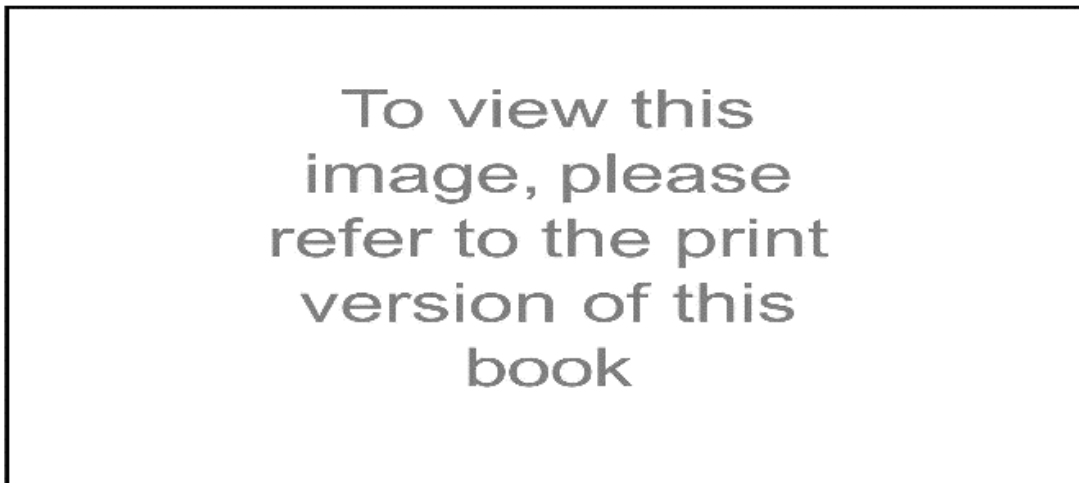
Professional traders refrain from initiating positions in the direction of a markup on the opening. As a day trader, you should resist entering market orders to buy or sell on the opening. Wait for either the early morning contra move or for confirmation that the markup or markdown is followed by institutional interest in the form of block prints, as well as a move above the important opening price.

One way to insure that the slippage you pay on a market order is kept in check is to place a marketable limit order. For example, if you have an entry buffer of 1/2 point, then you could use a variation of a market order, called a marketable limit order, taking into account your buffer range.

The NASDAQ Level II screen in Figure 13-1 shows Adobe Systems (ADBE) quoted at  $95\frac{1}{8}$ — $95\frac{5}{16}$ . Your buffer zone is 1/2 point and you want to buy 5,000 shares. You think that the stock is about to move because it just broke through resistance. To go long, you would enter an order to buy 5,000 at  $95\frac{13}{16}$ . If you have access to Select Net, you can execute by sweeping the offerings right through your target price of  $95\frac{13}{16}$ , bidding for a total of 5,000 shares. This is a combination of a market order and a limit order.

## SHADOWING THE AX

A popular entry and exit tactic that day traders employ is a technique called shadowing the AX. The AX is the market maker who has the dominant order flow in a particular stock. On the Discovery



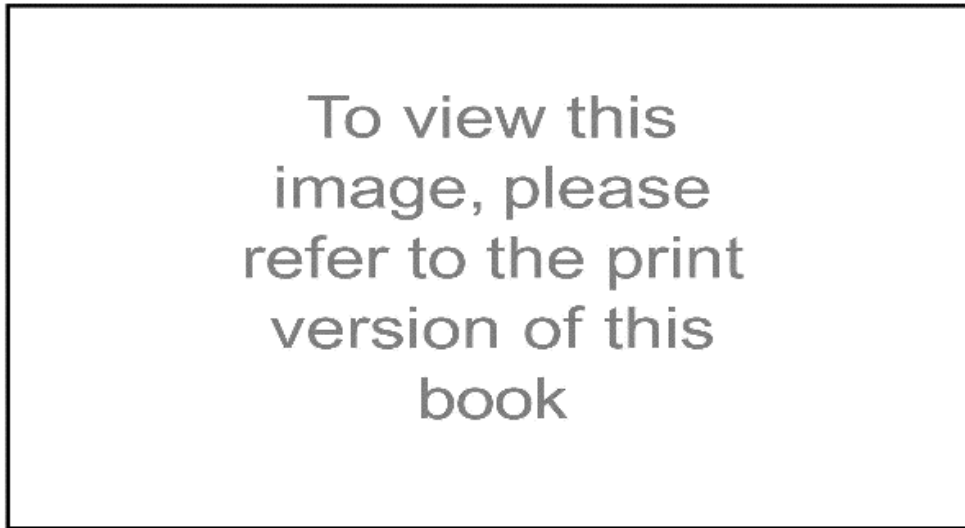
**Figure 13-1** Adobe Systems Quotes on a NASDAQ Level II Screen

channel, when you watch a large whale swimming under the sea, you always see a group of smaller fish that are latched onto the whale. These fish are feeding off the whale while catching a free ride in the process. This is the same principle day traders use when they shadow the AX.

If you have spotted the AX in a stock and that stock trades with a wide spread of  $3/8$  point or more, you can use an ECN to place a bid  $1/16$  above the AX's best bid. When you buy the stock  $1/16$  in front of the market maker, you can immediately offer the stock  $1/16$  below the best inside offer. This technique takes patience and works better with stocks that have a larger spread. It can also be employed when you are not sure who the AX is, but nevertheless you feel confident that you have identified the short-term trend in a stock with a wide spread. Always establish your position in the direction of the trend first, before attempting to shadow the AX and trade for a spread profit.

## **THE SLIPPAGE FACTOR**

Slippage refers to the difference between where you would like to have a trade executed and where it actually gets filled. The difference can be vast in some cases, given the extraordinary volatility of many Internet-related issues today. These stocks move faster than the broader market and can be up or down points in a heartbeat.



**Figure 13-2** EBay Selling Off from Its Daily High

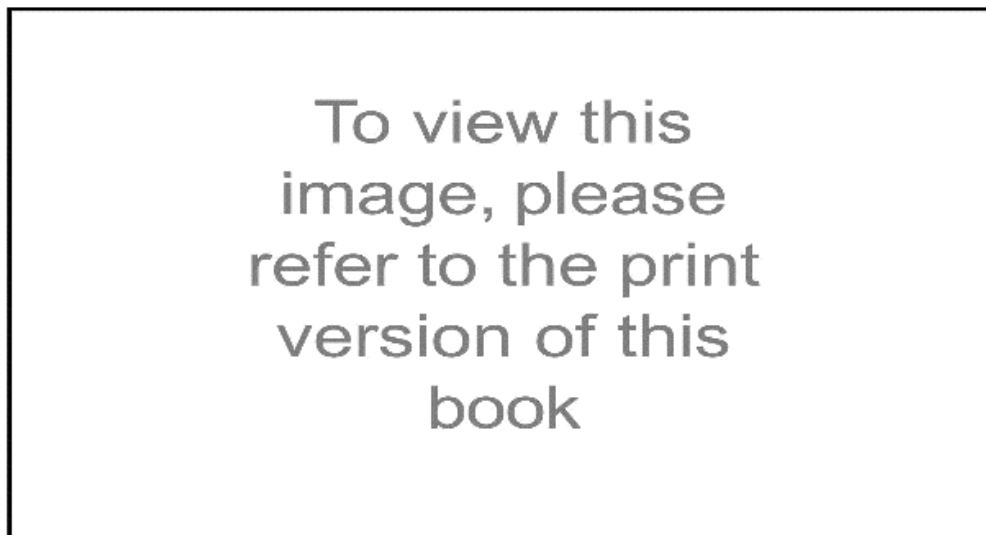
*On August 18, 1999 at 3:53 PM, EBAY was up  $9\frac{5}{8}$ , trading at  $127\frac{3}{8}$ —its high of the day. (See Figure 13-2.) Believing that the upward momentum would carry it to even higher prices into the close, Ron decided to go long 5,000 shares. He bought them with ease in Instinet, usually a bad omen. When a stock is easy to buy, it means that short-term supply is greater than short-term demand. Suddenly, a vicious sell program kicked in. Within 2 minutes, EBAY sold off almost 3 points, to  $124\frac{3}{8}$ , where it closed. After going long the stock, Ron realized almost immediately that he was wrong but hesitated for too long before doing anything. By the time he started to try to sell his position, 5 minutes after he entered, it was already down 2 points. He ended up selling the position for a loss of \$12,500 in less than 5 minutes.*

Ron experienced slippage the hard way on his long position in EBAY. More than 35 percent of the volume in Internet stocks trades through Electronic Communication Networks (ECNs). This requires traders to get in and out of positions when they can, usually by bidding for or offering stock. This means that in the short term, they may be wrong because someone else is hitting or lifting the stock.

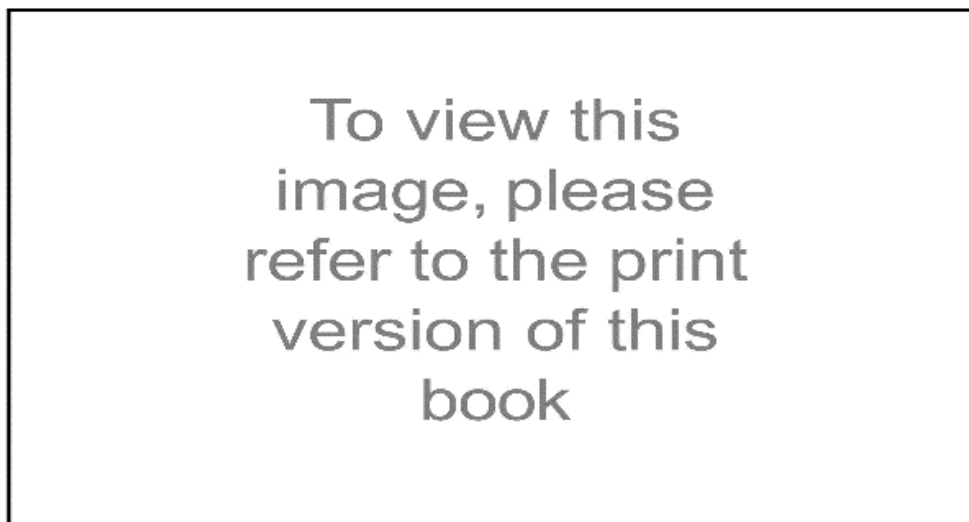
It takes patience and awareness to ascertain what sort of slippage you may experience in any given stock. In some very liquid names on the NASDAQ market, it's not uncommon to see 100,000 shares or more, out loud, being bid for or offered. Generally as you approach the "round" number in these stocks, which refers to the

whole numbers without fractions, the size gets even larger due to psychological stop-loss points.

On the NASDAQ Level II screen shown in Figure 13-3, on August 18, 1999, Dell Computer was the most active, trading more than 100 million shares. At any given time during the day, you could have bought or sold large sizes on the inside market. On that same day, as displayed in Figure 13-4, at certain times you would have



**Figure 13-3** Dell Computer Quotes on a NASDAQ Level II Screen



**Figure 13-4** Inktomi Quotes on a NASDAQ Level II Screen

been lucky to buy or sell 1,000 shares of Inktomi (INKT), another Internet stock, on the inside market.

It is crucial for a trader to factor into the 2 percent maximum loss risk profile, the worst-case scenario for poor executions. If you were trading DELL on August 18th, with all of the liquidity, factoring in 1/8 point for slippage would be reasonable. On the other hand, if you were trading EBAY or INKT on the same day, anywhere from 1 to even 3 points of slippage would be more reasonable to factor in, depending on the size of the position.

Liquidity refers to the density of volume traded in a given stock on a given day. Stocks that have a larger market float, or more shares outstanding, usually trade with thicker volume. Heavier volume allows institutions and traders to take larger positions, because they can enter and exit with less slippage or market impact.

Every stock has its own personality, subject to various outside influences. The more influences the trader is aware of, the better equipped you will be to correctly judge and size the market. Some of the influences that impact a stock's personality include market capitalization, float, average daily volume, institutional ownership, sector correlation, beta, standard deviation or volatility, which market maker has the AX, ECN volume percentage, and other fundamental and technical factors.

It is unrealistic to believe you will be able to get out of a losing position in a stock that is not liquid. A large part of day traders' losses are attributed to slippage. This is one reason paper trading is unrealistic. This is a crucial component of risk evaluation, because many traders fail to properly factor in the possibility of poor executions. It is always better to err on the smaller side with positions, expecting the worst executions; that way you'll be pleasantly surprised when you get the best.

The reason thinly capitalized names are susceptible to large slippage is that market makers move stocks single-handedly in order to achieve price discovery.

A trader's position size should always be smaller if the stock you are trading is less liquid. Your stop-loss point should also be wider, given the hit-or-miss nature of illiquid stocks. If you are trading a stock that you are unfamiliar with, evaluate the average daily

volume for the last 20 days. If the stock begins to trade with more volume, you can always add to an initial smaller position if the stock is moving your way.

## SHORT SELLING

The NASDAQ short sale rule is in force between the normal market hours of 9:30 AM and 4 PM EST. NASDAQ members and the customers they represent are not allowed to short a NASDAQ stock on the bid when that bid is a down tick. To short a NASDAQ stock when the bid is a down tick, the trade must be executed at least 1/16th above the inside bid. Market makers who are conducting bona fide market-making activity are deemed qualified by the NASD and are exempt from the NASDAQ short sale rule. This means that market makers can short a NASDAQ stock on a down bid, but a day trader cannot.

Many day traders are biased toward trading from the long side because it is easier for them to get executions, due to the NASDAQ short sale rule. Market makers, on the other hand, have more of a neutral bias toward long or short positions. A long side bias works well in times of a bull market. Because many day traders today have only experienced a bull market, trading from the long side has been the profitable thing to do. However, in a bear market, trading from the short side is obviously the more profitable endeavor. If you are biased toward trading from the long side, the odds are that in a bear market you will have more difficulty trading profitably.

For example, day traders were shaken out of the stock market in droves during the short-lived bear market in Internet stocks of the spring and summer of 1999. Many day traders have never witnessed such consistent selling pressure as the Internet stocks experienced during this period of time, and they lacked the experience and flexibility to take advantage of the sell-off from the short side.

When you short stock during a bull market, or into strength, you are fighting the trend. If the trend is positive and you short into it, the chances of that stock rising against you increase considerably. When you short during a bear market, or into weakness, your odds for a successful trade increase because you are trading with the underlying force and trend.

Shorting a stock because the price is high is a losing game. The greatest gains in terms of percentage of a move occur at the end of the move. The last 10 percent of a bull move has been known to encompass as much as 50 percent of that move. The price that might look high to you right now can actually be the starting point at which the stock begins to make its greatest move forward.

Short interest is the total number of shares that have been sold short and are still outstanding. Stocks that have greater short interest are susceptible to panic buying on the upside when they break above resistance, especially on the way to new all-time highs. The short interest ratio measures the number of days of average trading volume it would take to cover the short interest. It is measured by dividing the outstanding short interest by the average daily trading volume.

Always be mindful of the type of stock you are shorting. When you short a stock with a high short interest ratio or one that is thinly capitalized, you are at the mercy of larger market forces that can move the stock on a whim. All it might take for you to be squeezed is one phone call from a large institution in a thin name. A stock that might have looked weak on the charts could be up a number of points in a heartbeat. If you are shorting illiquid names, you should anticipate maximum slippage, and accordingly enter with a wider stop and a smaller position.

## SEC ORDER HANDLING RULES

The SEC implemented two new order handling rules in January 1997 that changed the way investors' and traders' orders are reflected to the general market. The first rule changed the way limit orders are displayed, and the second changed the quoting standards. The new order handling rules have worked to improve prices and narrow spreads, creating increased transparency and liquidity for individual investors and traders. With the move to quoting stock prices in sixteenths, the average spreads have shrunk, by some estimates, 40 percent or more. The new order handling rules affected both traders and individual investors.

First, the limit order handling rule requires market makers to change the way they had historically handled customer limit orders.



Under the new rule, market makers who receive and accept customer limit orders have to either fill the order, display the order at the improved price through their quote, or send the order to an ECN and have it displayed there.

This rule requires market makers to reflect the actual size and price at which they are willing to execute customer limit orders that are on the inside of the market and are not greater than 10,000 shares or more than \$200,000 in value. If a market maker receives an execution at or better than the customer's price, the customer will receive execution first.

All market-making firms have the obligation to protect their customer limit orders by giving them equal or improved price executions before executing orders for themselves. Market-making firms are not required to accept limit orders; but if they do, they must abide by the NASDAQ limit order handling rule.

Under the limit order handling rule, when a market maker has a limit order on the books, that order will receive a partial or complete fill when the market maker trades any stock at that price or through that price. For example, if a market maker has a customer limit order to buy 1,000 shares at  $50\frac{1}{8}$ , the market maker cannot buy any stock personally at  $50\frac{1}{8}$  or lower without first giving the customer the execution.

The second order handling rule instituted by NASDAQ was the quote rule. The quote rule requires market makers to publicly display their most competitive quotes in a consolidated format. Under this rule, traders and investors have access to the best price at which market makers or other individuals are willing to trade. The quote display rule prohibits market makers from displaying two separate quotes on more than one trading system. This rule requires ECNs to collectively post their internal order books to the public, to insure that the best quotes are available on one screen for all to see. Day traders using ECNs, like Island, can now have their orders reflected. This means that if a trader is willing to buy or sell a stock at a more competitive price than a market maker, the trader's order will be displayed first and get filled first. This has put individual traders on par with market makers, because they can display their orders similarly.

## SELECT NET

Select Net is an electronic execution system sponsored by NASDAQ, and is the main instrument used by market makers to trade with each other and with other traders. The system replaced the telephone as the main execution medium for transacting trades. Tools of the Trade was the first widely implemented software package designed for market makers to use with Select Net. With Tools of the Trade, market makers were able to quickly buy and sell stock without taking the time to make a telephone call. There are now numerous software packages that incorporate Select Net and allow market makers to buy or sell stock with the click of a button.

## FRAGMENTATION VERSUS CENTRALIZATION

The current market structure, in which orders are executed within NASDAQ and the New York Stock Exchange, has become increasingly fragmented. The onslaught of competing ECNs and various exchanges has resulted in a segmented system in which the customer who enters the most competitive order may not be the one to receive execution. This occurs because other broker-dealers can use a customer's posted order as a reference point to internally match their own orders, or to trade in front of an order. This scenario has become increasingly common with the explosion in volume of orders from on-line brokers who route their orders to specific market makers.

In response to the increasing fragmentation of executions in the marketplace, five powerful Wall Street firms approached the SEC in February 2000 with a proposal to move toward a centralized order system that would include a central display of all quotes and be operated by one self-regulating group. A centralized order system would route all orders to one execution system where customers' orders would be filled in price-time priority. This means that an order to buy or sell stock at a specific price would be executed in the order it was received, across all markets, regardless of which execution system it was entered on.

Some argue that a centralized order book would provide a disincentive for market makers to compete for order flow, resulting in a lack of innovation. However, with customer interests and efficiency as the objectives, the structure of the market is quickly mov-

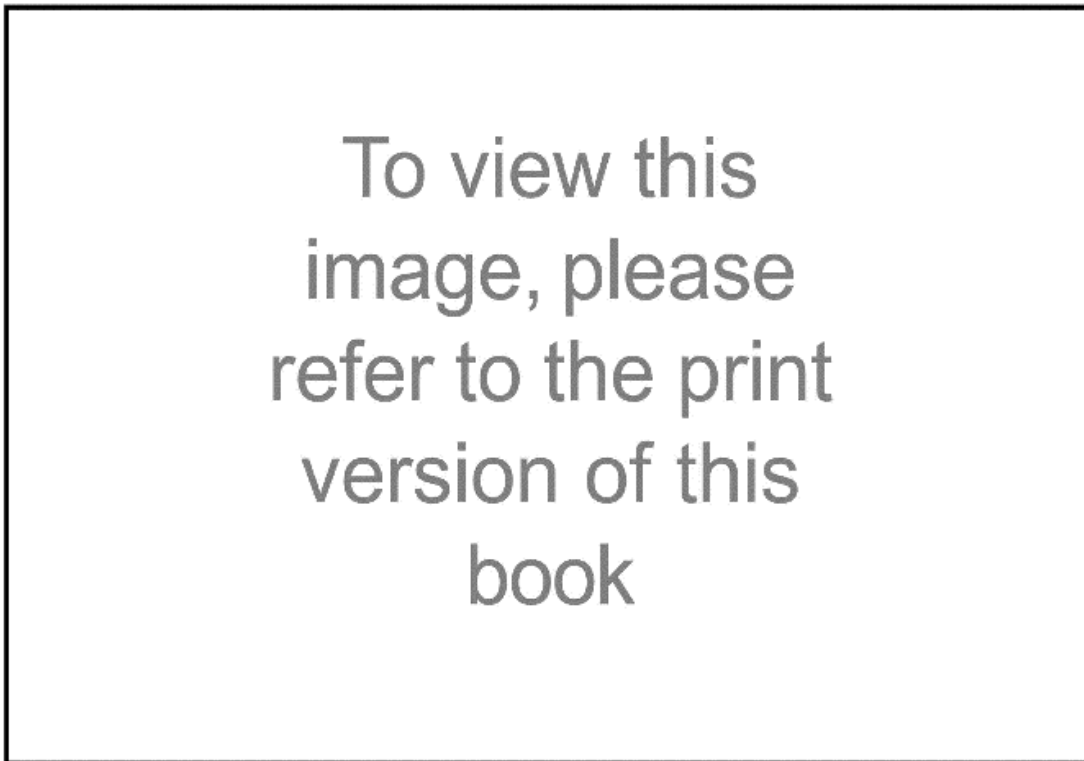
ing toward consolidation and centralization, and away from fragmentation. In February 2000, NASDAQ and the New York Stock Exchange reported that they had held merger talks, with the objective of preserving a central and primary role in the abruptly changing marketplace. It was also reported that the two largest ECNs, Instinet and Island (a division of Datek), had held merger talks with the goal of preserving their role as the largest contenders among ECNs. These rounds of merger talks indicate that consolidation and centralization are on the horizon. The form the new marketplace will take, however, is still open to debate.

Another signal pointing toward a unified exchange or a single execution medium came in December 1999, when the New York Stock Exchange's board of directors repealed Rule 390. Rule 390 prohibited NYSE member firms from trading stocks listed before April 26, 1979 on anything other than a national exchange. While the rule was in effect, NASDAQ broker-dealers could not act as principles on these stocks by trading them on their own exchange. Stocks listed before April 26, 1979 account for 23 percent of NYSE-listed issues, producing 46 percent of its volume.

In the short term, the revocation of Rule 390 will serve to increase the competition for and fragmentation of executions in listed stocks among competing exchanges. For the longer term, however, it is a significant step toward the centralization of executions. The move sends a message that the barriers between exchanges are being broken down and that establishing one centralized execution medium makes more sense now than ever.

## **NASDAQ SUPER MONTAGE**

The introduction of Super Montage will be the next major change in the NASDAQ architecture. Super Montage will replace the NASDAQ Level II and III screens with a dual-mode display. On the top of the screen, Super Montage will anonymously display the aggregate size and three-tier depth of a quote. Priority in execution of limit orders will be determined based on displayed interest, not on reserve interest. Only at the time of execution will market makers' identification be displayed, not before. On the bottom of the screen, Super Montage's display will allow market makers and ECNs to line up their orders and interest as they did on Levels II and III.



**Figure 13-5** NASDAQ Super Montage

Super Montage was created with the objective of providing greater transparency by rewarding liquidity. For example, if you want to buy 5,000 shares and you are willing to bid for them out loud at the most competitive price, you will be able to buy the shares before another trader who wants to buy the same amount but is only willing to show 1,000 shares. Super Montage will provide reserve size accessibility at all levels, which will allow market makers and traders to display a limited amount while keeping a larger size in reserve.

With accessibility to Super Montage in mind, NASDAQ is currently making modifications to the antiquated SOES and Select Net execution mediums. The modifications will reduce the current dual liability of market makers to SOES and Select Net by routing both mediums through one pipeline. This will increase the speed with which you can access Super Montage by reducing message traffic. Also, negotiating for executions will be automatic, so traders who enter orders will know immediately whether their orders were executed. The market maker receiving the order will be forced to either execute or move immediately. This will eliminate the frustrating

time delay that is currently permitted to give market makers a window to decide whether or not to execute.

NASDAQ will also implement the decimalization of quotes by the fourth quarter of 2000. Quotes will appear on NASDAQ in nickel increments, as they do now on NYSE. Executions will be possible in penny increments. This change will act to further narrow spreads, benefiting customers.

## **ELECTRONIC COMMUNICATION NETWORKS (ECNS)**

Electronic Communication Networks are broker-dealers that facilitate two-sided order flow through an electronic medium. An ECN is a privately maintained market, employing various methods of electronically matching orders. The popularity and liquidity of ECNs exploded in the late 1990s, after NASDAQ changed its order handling rules in 1997 requiring increased visibility, which is the ECNs' specialty. ECNs today account for almost 30 percent of the total volume traded on NASDAQ. It is estimated that by the year 2001, more than half of the total volume traded on NASDAQ will emanate from ECN order flow.

With the limit order regulatory changes imposed by NASDAQ, ECNs have become a popular way for on-line investors and traders to display their orders. Institutions and market makers often frequent ECNs for anonymity and liquidity, resulting in less market impact cost.

The NASDAQ stock market is primarily a dealer-driven market that requires human involvement in order to facilitate order flow. ECNs are automated systems that match orders on an electronic book. NASDAQ is electronic, but it is decentralized, acting as an electronic messaging system dependent upon market makers.

The long-term viability of ECNs is questionable, however, because of the inevitable move of NASDAQ away from fragmentation and toward centralization and automation. If NASDAQ has its own central order book, then the need for the fragmented ECNs will disappear.

When a market maker receives an institutional order, the first objective is to buy or sell the stock discreetly, so as not to attract any unwanted attention. Institutions are best served when their orders

are executed without any market impact cost. Institutions prefer to trade their merchandise with other “natural” merchandise, so they receive better prices without affecting the natural price of the market. Market makers are increasingly using ECNs to lessen the market impact of an order.

The advantage of a market maker using an ECN instead of its own name is that it will have less of a chance to alarm other players. If a market maker who is a known AX in a relatively illiquid stock suddenly moves the market to the inside bid, other market makers and traders may scramble to buy the stock first.

Market makers utilize all the tools at their disposal, including ECNs, to get the job done effectively for their clients or for themselves.

### **(SOES) COMMISSIONS AND SCALPERS**

Scalping is a day trading tactic used to capture small discrepancies in price, as little as 1/16. Scalping for small fractions has become an increasingly hazardous path toward successful day trading. Popularized through the SOES day trading tactics of the late 1980s and early 1990s, scalping for fractions was less complicated then than it is today. At first, all a SOES day trader had to do was pick off a market maker and offer the stock back out to the street at a better price. This tactic was easy and profitable when competition for the prime executions was minimal because of the smaller number of SOES traders. Market makers also displayed larger sizes on the inside market, and were slower to react to an SOES trade because of antiquated technology.

Today, however, scalping for fractions is much harder. Now there are thousands of traders using SOES, many competing for the same print from a single market maker. It has also become increasingly difficult for SOES scalpers to receive 1,000-share executions, because market makers on NASDAQ can now represent the inside market with as few as 100 shares. If an SOES scalper is being charged \$25 per one-way execution, then SOES prints for fewer than 1,000 shares, which are common today, are not cost-effective.

For the day traders who do pay up to \$25 for a one-way trade, proper entry is extremely important, because a break-even trade is

really a loss of \$50. Assuming the SOES trader is using 1,000-share lots to trade, a gain of  $1/8$  on a trade is only a \$75 win, while a loss of  $1/8$  on a trade is a \$175 loss. Just like in a casino, with these odds, the probabilities clearly favor the house. Actively trading with the objective of scalping for small fractions is a losing proposition over time.

If you are focused on scalping for small fractions, make sure that your commissions are as small as possible. Remember that every battle is won before it is ever fought. Take pains to insure that the odds are in your favor before going into battle.

The combination of enhanced visibility brought on with the SEC's order handling rules and ECNs, together with the explosion of competition among on-line brokers for customer order flow, has created a dynamic and rapidly progressing execution environment that benefits day traders. Day traders can now pay under \$10 to have a limit order reflected through an ECN or a market maker with the click of a button. As little as five years ago, this ease of access at such a low cost would have been unfathomable.

For day traders, this means that the execution tools are at their disposal to trade on par with market makers—and it's only going to get better. With the increase in consolidation among ECNs today, by the year 2002, only a few will be left standing. The consolidation will act to increase liquidity even further.

*This page intentionally left blank.*



P A R T  
V

# TECHNICAL ANALYSIS

*This page intentionally left blank.*

# C H A P T E R 14

## CANDLESTICK CHARTING TECHNIQUES

There is no question that mass psychology has an impact on a stock's price: Prices are driven by emotions, mainly fear and greed. Perception is reality for the day trader, and charts reflect this. Technical analysis incorporates price action and volume to produce a blueprint of where a stock has been and where it may go. It traces the emotional extremes of the bulls and the bears to produce clues as to where the greed or fear is the strongest. Knowing how to spot repeating price patterns in the market will provide you with a valuable advantage.

Technical analysis works because investor psychology has a massive impact on price action. Traders and investors remember what a stock did in the past, and that memory often causes pain or regret because of missed opportunities. The emotional attachment to missed opportunity increases a trader's resolve not to miss the trade the next time around.

When you become familiar with important support and resistance levels and recurring patterns, you will be able to take advantage of significant technical events in your market and in related markets. For example, a breakdown in the long bond or a drop in the U.S. dollar below an important level of price support can result in related selling in the equity market.

*On May 2, 1999 at 10:30 AM, the equity market sold off sharply for no apparent reason. Savvy traders, however, knew what was going on: The bond market was in a free fall after slipping through a technically significant 120 mark, which served as a major prior support. The technical break was a perceptual catalyst that caused related selling in the stock market.*

There are a number of fundamental, technical, and emotional catalysts that cause individual stocks and the market as a whole to move with force. Research analysts and value-type investors have been known to discount the value of technical analysis. They believe that technical analysis is an art that attempts to neutralize the importance of a company's fundamentals; this is false. Technical analysis traces, confirms, and makes evident the underlying fundamentals that cause prices to move. Whether or not the public knows these fundamentals, they must be reflected through price and volume. Price action displays the true hand of the fundamentals.

Charts provide significant leverage when used in conjunction with fundamental analysis. Value-oriented investing focuses on stocks that are cheap based on fundamentals alone. Value investors pick stocks that have "good value" based on the theory that a stock's price will rise in due time to match its earnings and book value. However, it could be years before a value stock climbs to meet expectations. Investors who pick stocks on value alone could fight a trend for a long time, while adding to a losing position unnecessarily.

Technical analysis supplements fundamental investing by incorporating price action and volume to produce a comprehensive picture of a stock's health. By integrating basic charting tools such as candlesticks, moving averages, oscillators, and support and resistance levels, technical analysis provides value investors with a sharp edge, encouraging them to trade with the trend, which will save them time and money. Technical analysis supplements a fun-



damental approach that can narrow down the choice between a few stocks, and it could provide levels for profit taking.

With access to charts easier than ever today, almost anyone can learn to read and understand them. Many people are intimidated by technical analysis, believing it to be complicated and hard to decipher. This is far from the truth. There are some very basic techniques that can provide a trader with insight and ammunition for successfully entering and exiting trades. Some of the very best traders have the simplest trading plans. Trading should not be made complicated. Technical analysis helps to block out the noise when used with basic principles and a few choice indicators.

One problem with technical analysis is that because there are so many charts and indicators easily available, many traders are overwhelmed and develop what's known on Wall Street as "analysis paralysis." They become paralyzed with indecision by attempting to trade off multiple indicators, some of which may be producing conflicting signals. A trader who is prone to indecision in the first place could easily find a reason to procrastinate by overanalyzing charts or indicators. All the colors and interesting patterns can have a hypnotizing effect, acting like candy for the brain.

Every stock has its own character. A chart can be used as an objective reflection of the stock's trading character, or, if you are not careful, as a mirror of your own character. It is easy to look for confirmation of an inflexible opinion by interpreting charts to fit your need. When you develop a consistent game plan for trading with charts, it will help you to maintain discipline. As you spend more time watching charts throughout the day, you will develop increased conviction for making decisions.

Charts can be displayed in multiple time frames, ranging from monthly to tick by tick. The guidelines applied to one time frame can generally be applied to another. There are groups of time periods that can produce multiple confirmation of a pattern when used together. Daily charts are the most common and are used to generate daily ideas before, during, and after market hours.

Intraday charts are powerful tools used to reflect the short-term intraday pattern of a stock or the market. Weekly charts allow a trader to step back a little longer in order to determine the longer-term trend with less noise or daily interference. Monthly charts are interesting for a longer-term perspective, but are hard to integrate into a short-term trading plan.

## CANDLESTICK CHARTS

Candlestick charts were developed in Japan in the eighteenth century. Munehisa Homma developed these charting principles to amass a huge fortune trading rice coupons. Homma used candlestick techniques to trade unconventionally as a warrior; he had a ruthless ability to seize opportunity and take action, due in part to candlestick conviction. Eventually Homma won the honorary title of Samurai because of his demonstrated mastery.\*

Many credit Steve Nison, author of the groundbreaking book, *Japanese Candlestick Charting Techniques*, with introducing candlestick charts to the United States in the 1980s. In his book, Steve provides a comprehensive, easy-to-understand guide to reading and applying candlestick charts.

Japanese candlestick charting techniques provide a fun, simple, and extremely effective means for charting stocks. Once you become familiar with candlestick charts, you'll have a difficult time looking at bar charts. Candlesticks provide a fresh, powerful dimension for traders and charting enthusiasts.

Candlestick charts display a stock's price action in a multi-dimensional view, utilizing color and symmetry. Candlesticks allow the viewer to take into account the important opening price, as well as the high, low, and close.

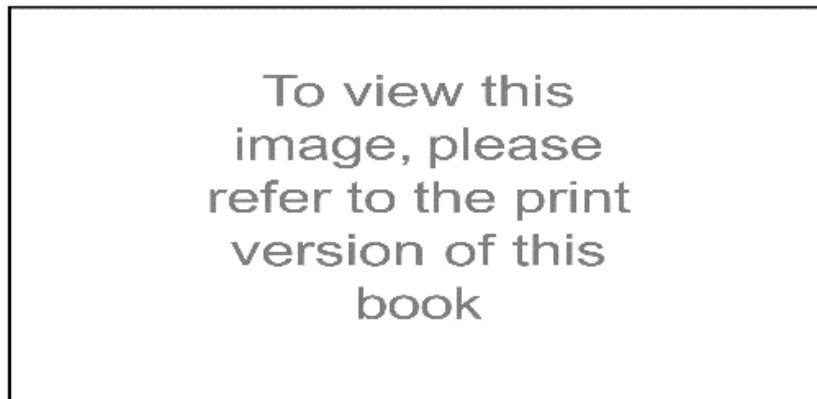
Japanese candlesticks utilize the opening price, the closing price, the high price, and the low price to form a pattern. Each candlestick has a body and a wick. The color of the body reflects the relationship between the opening and the closing price, and is one of the most important characteristics.

A white body is formed when the closing price is above the opening price. White bodies are bullish, illustrating that the bulls won the battle for the day. A black body is formed when the closing price is lower than the opening price. Black bodies are bearish, illustrating that the bears won the day's battle. The wick or shadow is the high or low range outside of the body.

Candlestick charts produce potent reversal patterns as well as valid continuation patterns. When combined with Western charting techniques, candlestick charts provide a potent one-two combination for increased decision-making leverage.

---

\*Nison, Steve. *Japanese Candlestick Charting Techniques*. Simon & Schuster, 1991.



**Figure 14-1** Candlestick Construction

## THE OPENING PRICE

The opening price is the starting gate in candlestick trend analysis, and is more important than the previous night's close. A lot can change between the previous day's close and the current day's opening. By using the opening price as the starting point for the color of the candle, candlesticks place more emphasis on the here-and-now aspect of the market.

The opening price is especially important for market makers, because it is often determined by the emotional extreme reflected in nonprofessional order flow. (See Chapters 6 and 21 on the opening price signal and gaps.) Because of this emotional extreme, the opening price is often close to the high or low of a stock's price action for the day. Market makers who have buy or sell orders that have accumulated from the night before and from the early morning dictate the market's opening. These orders are usually the product of novice investors or panicky traders who are acting on old news from the previous night or from the early morning.

Market makers enjoy a unique advantage at the opening, because they have an inside look as to the real demand or supply for a stock. Specialists or market makers gap a stock on the opening when they have one-sided order flow affecting the supply-demand relationship.

If the markup or markdown is due to small order flow with no institutional demand behind it, market makers may deem it to be artificial and will often sell or "fade" the opening. This means taking a position on the opposite side of the gap. (See Chapter 21 on



artificial gaps.) For example, if a stock is marked up 2 points on non-institutional order flow, market makers may short the stock on the opening for their own inventory. The same holds true if the stock is marked down on noninstitutional order flow, in which case market makers would buy it for their own inventory.

New York Stock Exchange specialists are the sole proprietors of the order flow for their stocks, so they have single-handed control of the opening price. Market makers on the NASDAQ have to compete with one another for order flow, so they do not have a complete picture for the pre-opening demand. In many instances the opening price is close to the high or low point of the day because it was dictated by the emotional capitulation of amateur players at the opening bell.

## THE CLOSING PRICE

While the opening price is often the product of retail investors and novice traders, the closing price is often the product of the professionals and the institutional heavyweights. Candlestick bodies reflect that the closing price is often the opposite extreme of the opening price.

Part of the reason professionals dominate the close is that many buy-side institutional traders are compensated on their ability to meet or beat the almighty VWAP (Volume Weighted Average Price). As the name suggests, the volume weighted average price is the average price at which the stock traded for the day when volume is weighted. If institutional traders can beat the VWAP, their performance benchmark is raised and at year-end they are compensated better. The institutional traders usually save part of their orders until the end of the day so they can improve their VWAPs if they have the chance to do so. If a stock has been better to buy all day and then falls back a little during the early afternoon hours on light volume, the stage could be set for a rally into the close, as long as the market holds. A buy-side trader who was unable to attain price improvement will have to buy the stock anyway, thus forcing prices higher and dictating the close.

## THE HIGH PRICE

The high price in candlestick charting is the top end of the upper wick, or the top part of the body if there is no wick. The high price

represents the maximum strength of the bulls for the day. This is the point of short-term resistance because it represents sellers who managed to hold their line of defense.

Stop-loss orders for shorts tend to accumulate just above the high price of the day. The previous day's high is the first point of resistance for the current day's trading action. Trade either from the long side or the flat side when a stock is trading above the previous day's high. Refrain from shorting short stocks that are trading above the previous day's high or at the current day's high.

## THE LOW PRICE

The low price in candlestick charting is the bottom of the lower wick, or the bottom part of the body if there is no wick. It represents the lowest point at which the bears were able to force a stock down before the bulls halted the onslaught and fought back.

The low of the previous day serves as the first area of short-term price support. Stop-losses for longs often accumulate just beneath the low price of the previous and current trading day. New lows for longs represent new losses, some of which may be intolerable to traders, forcing them to liquidate their positions.

## CANDLESTICK REVERSAL PATTERNS

Candlestick charts produce effective reversal signals on a daily and intraday basis. Reversal patterns provide two-sided clues: what to do and what not to do or selection and negative selection.

The reversal patterns imply that a trend has run its course. Trends can and do turn around quickly. However, the goal of astute day traders should be to seize the middle of the move, not the top or bottom. Always wait for prices to confirm that the reversal pattern was authentic. The short-term risk of waiting for this confirmation is that you'll miss the top or bottom part of a trend. This part of the trend has the highest risk. When you stick to trading the middle of the move, your risk profile is lowered.

You'll know that a pattern is confirmed if prices follow in the direction of the reversal. As a day trading entry rule, when prices move above the high price of the bullish reversal pattern, use that as a signal to go long, using 1/8 of a point below the low of the pattern

as a stop-loss point. When prices move below the low for bearish reversal patterns, use that as a signal to go short, using  $1/8$  of a point above the high of the pattern as a stop-loss point.

For example, suppose you spot a hammer, which is a bullish reversal pattern that occurs at the bottom of a downtrend. If the hammer was formed on day 1, with a high price of 21 and a low price of 20, on day 2 you should wait for the price to move above 21 before initiating a long. Once the long is initiated, your initial stop-loss should be placed  $1/8$  of a point below the low point of the hammer on day 1, or at  $19\%$ .

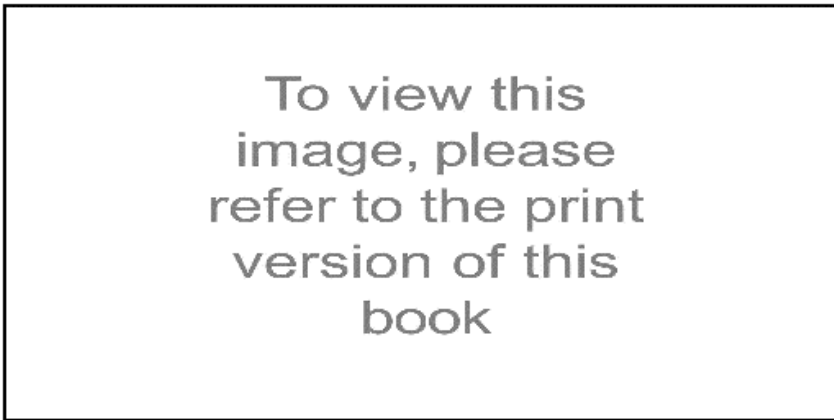
A danger when trading based on reversal patterns is the temptation to anticipate a change in the trend without waiting for confirmation. This is the equivalent of bottom or top fishing and should be avoided. It is more prudent to use the reversal pattern to take profits from an existing position if there is no confirmation. For example, if you are short 10,000 shares of an NDX stock and the NDX sector puts in an intraday hammer on the 15-minute chart, use that as a sign to cut your short position in half rather than to go long. If prices close above the intraday hammer and your other entry criteria are met, then go long. Remember to wait for confirmation before initiating trades based on reversal patterns. Confirmation means price action taking place above a bullish pattern or below a bearish pattern.

You will increase your risk-reward ratio when you check the intraday sector action with candlesticks before you trade. You will lose less because you will refrain from trading against the odds by going long against bearish reversal patterns, or by going short against bullish reversal patterns. This is negative selection. Develop the habit of watching the NDX 100 and the SPX on intraday candlestick charts. This practice will almost immediately increase your effectiveness as a day trader, because you will have a better view of the mood of the market knowing where your risk-reward is the greatest.

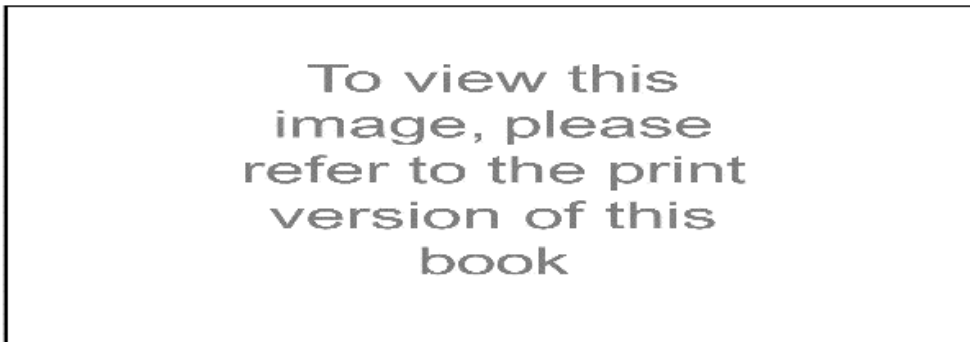
The intraday 15-minute NDX chart in Figure 14-2 shows a bullish reversal pattern. On December 1, 1999, the NDX formed a triple bottom accompanied by three bullish candlestick reversal patterns: a morning star, a bullish engulfing pattern, and a hammer.

Figures 14-3 through 14-15 depict the candlestick patterns described here.

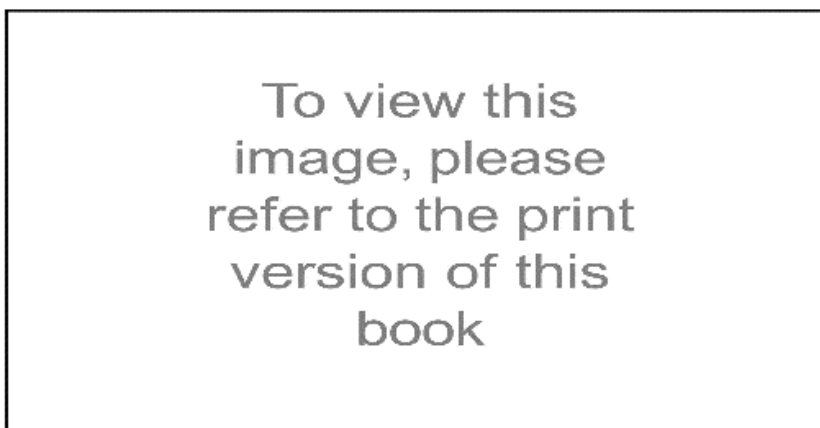
To view this  
image, please  
refer to the  
print version  
of this book



**Figure 14-3** Abandoned Baby



**Figure 14-4** Dojis



**Figure 14-5** Engulfing Patterns

**Abandoned baby**—This is the most powerful variation of the morning or evening star patterns. It occurs when the second day of the pattern is a doji or small body that has gapped away from both bodies; thus, it's abandoned. The gap that the small body has formed is closed by the third part of the pattern, which is a long body. This gap or window in candlestick terms indicates important resistance or support.

**Doji**—Dojis are reversal patterns that represent an equal tug of war between the bulls and the bears. A doji is formed when the opening and closing prices are the same. The wicks outside of the opening and close could vary in size, ranging from very long to nonexistent. The doji reversal signal is most effective when it is formed near the top or bottom of a trend.

**Dragonfly doji**—This doji has a long lower wick with the opening and close at the top of the formation. This is a bullish reversal pattern when formed at the bottom of a move and is similar to a hammer. When formed at the top of a move, it is bearish and is similar to a hangman.

**Gravestone doji**—This pattern is the opposite of a dragonfly doji. It has a long upper wick with the opening and close at the low price of the day. The gravestone doji is a bearish pattern when formed at the top of a move, especially after a breakout, similar to a shooting star. If the pattern is formed at the bottom of a move, it is similar to an inverted hammer and is bullish.

**Engulfing patterns**—An engulfing pattern is a reversal pattern that is formed at the bottom of a downtrend or at the top of an uptrend. An engulfing pattern occurs when the current day's body engulfs the previous day's body. When this occurs, the opening and close must be wider than the previous day's opening and close.

**Bullish engulfing**—This pattern forms when a large white body engulfs a black body at the bottom of a downtrend. The low point of the white engulfing candle becomes the new price support.

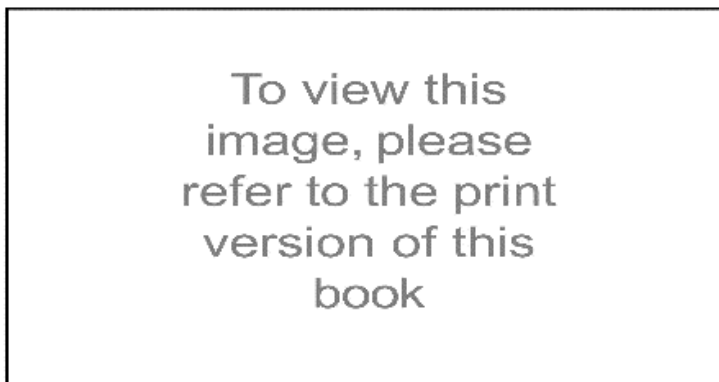
**Bearish engulfing**—This pattern forms when a large black body engulfs a white body at the top of an uptrend. The high point of the black engulfing candle becomes the new price resistance.

**Hammer**—A hammer is a bullish reversal pattern that is formed at the bottom of a downtrend. The name comes from the concept of hammering out the bottom of a move. Hammers have a long lower wick with a small upper body. The wick should be at least two to three times the size of the body. The body can be any color. The hammer is a powerful and popular reversal pattern. The chart of Microsoft (MSFT) in Figure 14-6a shows the stock putting in a daily hammer on the last trading day of January, at an area of support. MSFT rallied powerfully after the hammer was put in.

**Inverted hammer**—This formation is a hammer turned upside down at the bottom of a downtrend. It has a long upper wick that is two to three times the size of the small lower body. It is an excellent reversal indicator, and is especially useful in intraday charting. The inverted hammer looks like a shooting star at the bottom of a downtrend. It represents that the bears lost the battle to the bulls early in the session, and only through a last-ditch effort were they able to force prices down again.

**Hangman**—A hangman is a bearish pattern that is formed at the top of a move. It has the same look and feel as a hammer, except that it's at the top of an uptrend. Hangman patterns have small upper bodies with long lower wicks that are at least two to three times the size of the bodies.

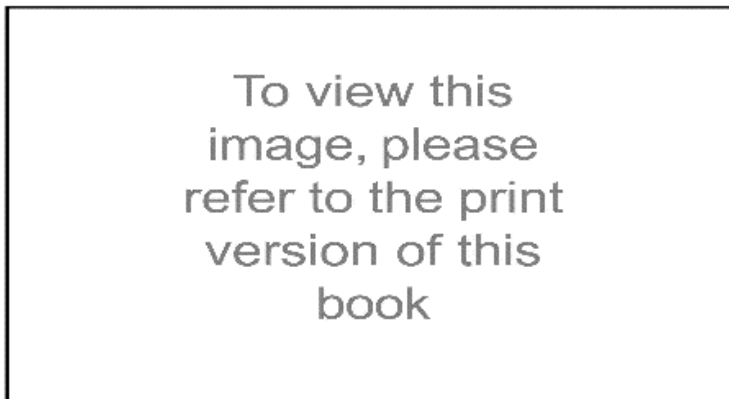
A hangman shows that the bears were able to knock the stock lower before the bulls managed to muster their last bit of strength to bring the stock back to its opening. This is significant when it is the first time after the uptrend that the bears were able to take control; it could be an indication for future activity. The color of the body is insignificant.



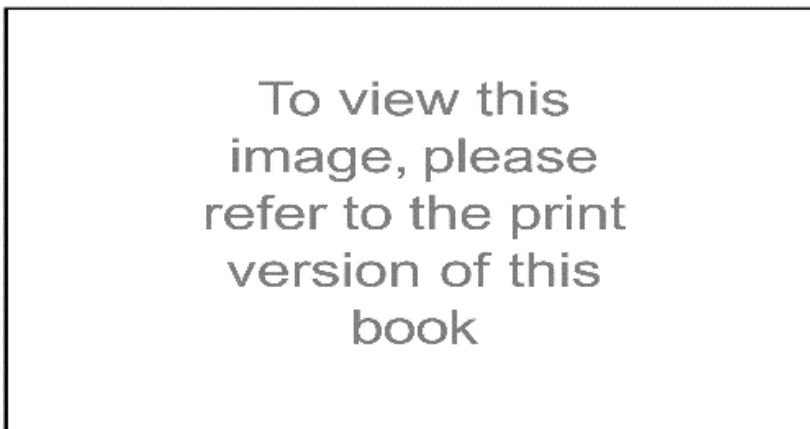
**Figure 14-6** Hammer

To view this  
image, please  
refer to the  
print version  
of this book

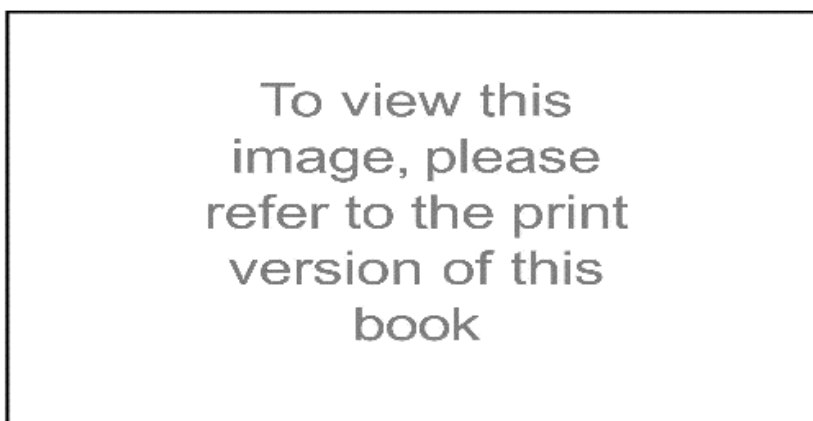




**Figure 14-11** Marubozu



**Figure 14-12** Morning and Evening Stars



**Figure 14-13** Piercing Line and Black Cloud Cover

**Morning star**—The morning star is a powerful bullish reversal pattern. It is a long black body followed by a small white or black body, followed by a long white body. The small body on the second day ideally would have gapped down from the black body. The morning star is usually followed by a small pullback toward the middle of the long white body, before the reversal pattern continues upward. The small body represents the waning of momentum after a down move, while the long white body represents confirmation of the reversal.

**Evening star**—The evening star is the opposite of the morning star. It occurs at the top of an uptrend and is composed of a long white body followed by a small black or white body, followed by a long black body. Ideally the small body would have gapped up from the long white body. The small body represents stalled uptrend momentum, while the long black body provides confirmation that the trend is reversing. The long black body is usually followed by a small pullback toward the middle of that body before downward momentum kicks in.

There are variations of the morning and evening star patterns in which the smaller body could be a doji or a spinning top, or could be placed at various distances from the first long body.

**Piercing formation**—This is a bullish reversal pattern that has a long white body that pierces through the midpoint or higher of a long black body. This occurs after a downtrend. It is similar to a bullish engulfing pattern except that the bulls did not show up in complete force to completely engulf the previous day's move.

**Dark cloud cover**—The opposite of a piercing formation, this bearish reversal pattern occurs at the top of an uptrend. It is a long black body that covers half or more of a long white body. It is similar to a bearish engulfing pattern except that the bears did not force prices down far enough to cover the previous day's up move.

**Shooting star**—This is a bearish reversal pattern that forms at the top of an uptrend. It has a long upper wick that is two to three times the size of the small lower body.

The shooting star in Figure 14-4a shows that the bears attacked in force and rescinded most of the gains that the bulls had made for that session. The shooting star represents the first change in sentiment since the uptrend began.



To view this  
image, please  
refer to the  
print version  
of this book

Figure 14-14b Shooting Star Pattern on the NDX



To view this

To view this  
image, please  
refer to the  
print version  
of this book

Figure 14-17 Candlesstick Patterns in DEEL

true intraday as well. When you trade on the side of the opening price signal, you insure that you are on the correct side of the color of the candlestick.

Rising and falling windows make up another powerful continuation pattern. If a stock is in an uptrend and gaps higher, it means that the trend is a powerful one and should continue higher yet. If a stock is in a downtrend and it gaps lower, then the downtrend is gaining force to the downside. Always trade in the direction of continuation windows. Long white or black bodies often precede continuation windows.

In the chart in Figure 14-18, JDS Uniphase (JDSU) broke out above resistance on October 2. After breaking out, it pulled back and consolidated before marching forward to gain 80 points in less than a month. During this uptrend, it formed a number of continuation patterns, including three rising windows and a number of long white bodies. If you had caught just the middle of this move, you would have profited handsomely.

Technical analysis is the footprint of the market. It takes into account the rational as well as irrational components of price action. Price levels of support and resistance as displayed through technical analysis can become self-fulfilling prophecies. Stocks often move fast because of technical breaks through support or resistance levels. Traders who are keyed into these levels have an advantage, because they understand why the stock is moving.

Candlestick charts are powerful tools when used in conjunction with basic chart formations. Candlestick charts provide a simple, quick, and effective way to utilize technical analysis when making trading decisions. Candlestick charts provide a multi-dimensional view, utilizing color and symmetry to highlight reversal indicators and continuation patterns. Candlesticks incorporate the important opening price, the closing price, and the high and low price ranges to help you interpret a stock's path of least resistance. Candlesticks are effective trading tools from a daily and an intraday standpoint. The more you watch candlestick price patterns develop on an intraday basis, the more effective you will become as a trader.

Under certain conditions, human beings act similarly and predictably. If you develop the habit of watching these patterns as reflected through charts, you will become more effective at spotting those recurring human tendencies.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 14.10: Curriculum Framework for School Education



# CHAPTER 15

## SUPPORT AND RESISTANCE LEVELS

Support and resistance levels are prices at which stocks or futures lose momentum due to previous buying or selling pressure. These levels can be spotted on weekly, daily, and intraday charts. Support and resistance levels are important in determining the risk–reward ratio of a trade.

Support and resistance levels can be used in two basic ways: Buy at support and sell at resistance; or buy when resistance has been broken and sell when support has been breached. If prices break through resistance, the old resistance becomes new price support. If prices break through support, the old support becomes new resistance.

It is important to know the price levels for support and resistance for the broader market, the sector in which you have positions, and the individual stock you are trading. For example, if you are trading Yahoo (YHOO), it is important to know where the sup-

port and resistance levels are for the NDX, the Internet index (DOT), and the individual stock.

Significant support and resistance levels cause prices to reverse. They mark the end of a trend and are usually accompanied by above-average volume. The volume in many cases can be climactic, marking a grand finale of a battle waged between the bulls and the bears at that price. These battles provide important signals to the shrewd trader who knows how to spot them. You will be able to increase your trading effectiveness should those levels hold or be violated.

## SUPPORT

Support is the price level at which the buyers have turned the tide on the sellers, causing a stock's or sector's downward momentum to halt. The low point of this move serves as support because the buyers who missed the low point of the rally feel regret. They remember the price and will be waiting to buy the stock—thus supporting it—if it dips back.

Significant levels of support have large numbers of buyers waiting to get back in. Less important levels of support have smaller buy interest. Sell orders usually accumulate just beneath areas of support. The first level of short-term support for a stock is usually the previous day's low price. The previous day's low is also the first level of support for the broader market.

The daily Amazon (AMZN) chart in Figure 15-1 shows resistance and support that were formed in September. Once resistance is broken, it turns into the first level of support. AMZN broke above resistance toward the end of September, and then fell back beneath the first level of support to stop at the second level of support toward the beginning of November. After reaching the second area of support, AMZN rallied.

## RESISTANCE

Resistance is the price level at which the sell orders have overwhelmed the buy orders, causing rallies to fail. Resistance causes buyers to stumble and to reassess where they think prices are headed. Traders who were long and did not sell at the high point of the rally will be anxious to unload their positions if prices rise back



To view this  
image, please  
refer to the  
print version  
of this book

Figure 15-1 Resistance and Support Levels in AMZN

up to the levels that they missed—causing resistance. Also, sellers who wanted to short the stock or sector when it was higher feel regret for having missed the opportunity and will be waiting to sell at the higher price if it gets back up there. The previous day's high price is short-term resistance for stocks and the broader market.

Sharp market makers use levels of price support and resistance to take the other side of order flow by selling incoming buy orders at areas of price resistance, or buying incoming sell orders at levels of price support. The incoming buy or sell orders that reach the market maker's desk when a move has just about run its course near resistance or support is usually retail-driven. Retail order flow generally comes from nonprofessionals, who normally chase stocks if they missed their ideal entry points, due to a spate of greed or fear.

It is not uncommon for market makers to see orders originate from the same source when a move has just about completed its course. These orders tend to be predictable contrarian indicators because the traders who are entering them are driven by their emotions. Emotion-driven traders have the habit of panicking at the same recurring price patterns.

When market makers take a stand at levels of support or resistance, they use short-term sentiment indicators to confirm that the market may be holding and reversing. They watch fair value to see if the futures are trading at a discount or premium. They watch the tape to see what size prints are hitting the tape: Are they block prints or smaller retail prints? If the market is falling to a level of support, a market maker may test the bids to see what sort of buy interest is out there before going long. It is not uncommon for a market maker to hit the street with anywhere from 5,000 to 25,000 shares, depending on the liquidity of the stock, simply to see if there are any real buyers out there. If the bids fade and no one buys the market maker's stock, then chances are that the support level was not valid. If buyers in the street step up to buy the market maker's stock, then the market maker knows that the support level is valid at least for the short term, and can quickly reverse the position, using the support area as a stop-loss point.

## **PRICE CONFIRMATION**

Support and resistance levels are not always exact. Attempting to trade off them by shorting into strength or buying weakness with-

out first receiving confirmation that prices have halted should be avoided. When the price level that you have pinpointed as support or resistance is tagged, watch the broader market sentiment indicators to see how the market is reacting. Allow the market to be your guide.

By watching fair value, the TICK, and the AX (see Chapter 19), you can put together a realistic picture of whether the support or resistance zone is a valid one. These three leading indicators lead price action. If support is reached and the S&P futures suddenly start to trade at a premium to fair value, and the TICK turns positive, then the support level is probably a valid one at least for the short term. If the market maker with the main institutional order in the stock moves to the bid while the market is touching support, this can provide additional confirmation that support has been reached.

*After falling in a steady downturn for the better part of the morning hours, the NDX was down 53 points, trading at 4525. A stronger than expected PPI number at 8:30 AM had spooked traders, causing them to fear that the Fed would adopt a tightening bias. The previous day's low in the NDX was 4522, so it looked like the first level of price support for tech stocks.*

*The S&P futures were trading at a consistent discount to fair value throughout the morning, trading between 7.5 and 8.5. Fair value for the day was 10, with sell programs kicking in below 8.5 and buy programs kicking in above 11.5.*

*The S&P futures suddenly moved from 7.5 above cash to 12 above cash, and the TICK steadily climbed from -500 to +300.*

*A market maker in MSFT was short 50,000 shares and noticed that the S&P futures were in a rally mode, trading at a premium to fair value for the first time since the morning sell-off. The market maker also recognized that the NDX had halted at an area of support, producing the first intraday 15-minute white candle. At this point, MSFT reached 90 or 1/4 point above the previous day's low, which served as support.*

*Taking these factors into consideration the market maker bought 100,000 shares of MSFT at 90, covering a 50,000-share short position and going long 50,000. It turned out that 90 was the low point in MSFT for the day.*

Establishing a position at support and resistance levels is different from trading around one, or from taking profits off the table. The difference is in the risk-reward ratio: If you are buying stock at prices you think could be support in order to cover or trade around a short position, the very worst that can happen is that you cut part

of your profits short. On the other hand, when you initiate a long or short position at prices that you think could be support or resistance, you risk losing your own money, not just the market's. The market maker who bought the 100,000 shares of MSFT used support to cover a short and to go long. The market maker had a positive P&L from a successful short, and so had the psychological advantage of trading with the market's money, not the market maker's own money. The market maker also received price confirmation that the support level had held. The NDX and MSFT had rallied off their low points of the day.

When you initiate a position by buying low or shorting high without price confirmation, your psychological edge diminishes. The correct way to use support and resistance to initiate a position is to wait patiently for prices to break through these levels, and then establish a position in the direction of the momentum and trend. Remember that, as a day trader, your goal should be to trade stocks that are moving in your direction, not against you. Refrain from bottom or top fishing by trying to cherry pick support and resistance prices.

Support and resistance levels provide a trader who has a position with a target price for taking some profits off the table. Once you have established a position, immediately offer part of the position if you are long or bid for part of the position if you are short, at a price that you have identified as resistance or support. This forces you to maintain the discipline of creating realistic trading goals by scaling out of positions when your objectives have been reached. Remember that you can always reenter a position if you scaled out of it too easily.

By scaling out of a long at resistance, you are trading with the trend. If resistance breaks and prices move higher, you are in good shape because either you have a partial long position or you are flat. If you short into resistance without price confirmation, you are attempting to pick the top, disregarding the meat of the move. When significant resistance or support levels are split, stocks burst through them like a punctured dam. In this case, the risk-reward ratio is not in your favor because you stand to lose more from being short at resistance should prices continue higher than you do if prices turn lower.

The first confirmation of support or resistance should come from the price action of the sector you have an interest in. If you are

considering covering a short in a hardware stock such as DELL Computer at support, first look to see what the hardware index is doing on an intraday chart, using more than one time frame.

The 8-period moving average on a 15-minute intraday chart works well as a short-term trend-following tool (see Chapter 6). If the HWI index moves above its 8-period moving average for the first time during the session, then the short-term market sentiment has changed. If the HWI sector is net down on the day, and the 15-minute candlestick chart moves above the 8-period moving average, use that as a signal to cover part or all of your short position, but not to go long. If the HWI sector is net positive on the day, and the 15-minute candlestick chart moves below the 8-period moving average, use that as a signal to sell part or all of your long position, but not to go short.

The best way to identify levels of support and resistance is through a multiple time frame approach (see Chapters 5 and 6), integrating daily and intraday charts. For example, you might use a 5-minute, a 15-minute, a 60-minute, and a daily chart to provide a manifold evaluation of consequential price levels. All four of these charts can be viewed on one charting page that is divided into four segments.

Support and resistance levels often become self-fulfilling prophecies. They exist because buyers and sellers remember where they bought or sold something, or where prices stopped before. Many feel regret or pain for having missed the prior move and are waiting for the opportunity to get back on board if they have another chance to do so.

Traders who bought stocks at the highs, which is resistance, feel anguish for having top-ticked the move. They are upset because they were wrong, and they would do anything to get out flat. They stubbornly hold onto their long positions, hoping to unload them if prices rally back.

Those who shorted at resistance just before the stock sold off—nailed the trade—wish that they had shorted more. If prices rise back to the original area, they tend to use that as an opportunity to lay off more stock. Whether it's from being right or wrong at price levels that hold and reverse those areas become emotional firestorms where traders look to make amends for past action.

Support and resistance regions come in many shapes and sizes. Some areas are significant, established by heavy volume and mas-

sive congestion over an extended period; other areas are shorter-term and less substantial in nature. Massive support might come from prices that have held a level for years or have never traded through certain prices before, such as a stock's all-time high or low. Shorter-term support comes from intraday price action with a time frame as small as 15 minutes.

If prices linger and churn within tight density zones for an extended period, then those territories become more meaningful support or resistance areas. An intraday example of an extended congestion zone is the NDX on Thursday, August 19, 1999. The NDX quietly traded within a very narrow range for most of the day after having swung around in the morning. As the day wore on, the odds increased that when prices broke this congestion area, they were going to move big.

This was especially true because the NDX whipped around wildly on the previous day's close and on the morning's opening. During the last half-hour of trading, after a couple of short-lived head fakes, the NDX broke beneath its range with a vengeance, selling off hard into the close and throughout the following morning. Traders who shorted into this move were rewarded generously for their patience and discipline.

Longer-term charts display the best support or resistance, while shorter-term charts provide less significant levels of support or resistance. The best way to get a broad view of the playing field is to examine multiple time frame charts, starting with the weekly, the daily, and intraday—on at least two multiple time frames. If you receive confirmation from all time frames, the probabilities for a successful trade increase dramatically.

The weekly chart should be the first time frame you look at. It will provide you with a wider snapshot of what the longer-term underlying force is behind the current move. If you like a stock from the long side and the daily chart is confirming your opinion, but the weekly chart is telling you that the trend is down, be cautious: Look for a different trade, or take a smaller position than you normally would and use tighter stops.

If the daily chart is a screaming buy, but the intraday chart says that the market is running into some resistance and should sell off, be cautious: Take some profits off the table, or wait until the intraday price action confirms the broader daily picture to the upside. On an intraday basis, look for confirmation from at least two vari-



ous time periods. The 60-minute and the 15-minute work very well together.

Many day traders are accustomed to monitoring short intraday time periods, such as a tick chart or a 2-minute or 5-minute time period. The problem with shorter intraday charts is that they are prone to noise and head fakes. The most effective way to integrate shorter intraday time periods is to combine them with the longer time periods. For example, integrate the 2-minute, the 5-minute, the 15-minute, and the 60-minute on one page with four windows. Most charting packages allow traders to watch at least four charts on one page. As the standard page, you should have a daily, an hourly, a 15-minute, and a 5-minute chart. Your weekly chart could be on a separate page, because its intraday movements will not usually affect the weekly trend to the point that you need to monitor it constantly throughout the day.

The right way to use support levels is:

1. Use support as a stop-loss point on long positions; sell a long position after support has broken, not before.
2. Go short after support has been broken, using the support level that was broken as resistance for your new stop-loss point on the short.
3. Take profits if you have a short position headed into support, while keeping part of your position.
4. Wait for upward price confirmation that support has held, then go long with half your normal size, using support as a stop-loss point.

The wrong way to use support is to bottom fish by going long when prices have fallen to support, and hoping that the level holds, without first receiving price confirmation that the support region is valid.

The right way to use resistance levels is:

1. Use resistance as a stop-loss point on short positions; cover a short position after resistance has broken, not before.
2. Go long after resistance has been broken, using the resistance level that was broken as new support for your stop-loss point on the long.
3. Take profits if you have a long position headed into resistance, while staying long part of your position.

4. Wait for price confirmation that resistance has held, then go short with half of your normal size, using resistance as a stop-loss point.

The wrong way to use resistance is to top fish by going short when prices have risen to resistance, anticipating that the price level will hold, without waiting for downward confirmation.

If you become familiar with spotting support and resistance levels, you will increase your profitability on different fronts. You will refrain from initiating trades from the wrong side when these levels are reached; you will hold back from going long at resistance or going short at support. You will also hold onto positions longer, instead of trading out of them for a loss when they should hold; you will keep your long at support, and keep your short at resistance.

You will also become adept at spotting breakouts sooner, which will provide you with an edge for going long when resistance has been broken, and from going short when support has been broken.

# CHAPTER

# 16

## BASIC CHART PATTERNS

There are basic chart patterns that produce potent reversal signals that all traders should be aware of. These patterns can be used in combination with candlestick patterns, volume, and oscillators to produce buy and sell signals. They display emotional extremes that have been subdued by the opposing sentiment. These patterns are often accompanied by heavy volume, because the optimistic and pessimistic forces battling for right of way are usually defending their turf in full force. These patterns will help you to recognize and exploit a move more quickly. They will also help you to take profits sooner if you are on the wrong side of the formation.

### **BREAKOUTS**

Breakout patterns are continuation patterns that occur at important levels of support and resistance. Many times the resistance or sup-

port levels that the price is breaking away from are the all-time highs or all-time lows. Pinpointing breakout areas before they occur will prepare you to take advantage of the move when it happens. Knowing where breakout areas are will also warn you what side of the market you should not be on.

Breakouts occur when prices move forcefully through price resistance on above-average volume. The more significant the price resistance, the more powerful the breakout. Volume and the length of the trading range prior to a move are the two important facets to watch when determining whether a breakout is real. An ideal breakout has an opening and close above price resistance. The more often a stock tests price resistance, the more bullish that price action becomes. Stocks usually hold price resistance on the second and third tries. When prices test resistance more than three times, it is more likely that a breakout will occur.

The longer prices have been channeling in a range, the more significant the price resistance or support tends to become. A stock that has been channeling within a trading range for weeks or even months is prone to false breakouts. On the other hand, a stock that has been channeling in a tight trading range for less than five days has weaker price resistance or support, so a breakout above that range will occur more easily but might not last as long.

The market has become prone to false breakouts today because of the increase in the number of day traders who artificially move stocks through levels and then attempt to take profits, resulting in knocking the stock back down. If day traders are the ones responsible for moving a stock through a breakout zone, those same traders will be the ones looking to take profits once the momentum has waned. When a breakout above a trading range occurs on light volume, market makers have the tendency to take the other side of the breakout by selling into the short-term strength once the move has retraced off its highs.

It is important to understand what forces are behind the price action that causes a breakout. If a market maker has the main institutional order and is driving the breakout above resistance with institutional block prints, chances are that the move is legitimate. Short sellers who step in front of such a breakout tend to be squeezed easily, forced to cover at a loss and driving the price up even higher. Often before stocks break out they consolidate in a tight trading range just beneath a previous high or an important

area of price resistance. When the breakout occurs, it often takes place within the first 15 minutes of trading, led by a strong broader market, a strong sector that the stock is a member of, and institutional demand. Fundamental news on the stock or sector is often the catalyst for pumping the stock through important price levels, creating breakouts.

When you are tuned in to important price resistance levels of stocks that you are following, and are prepared to act, especially if the broader market looks poised to rally, your chances for success increase dramatically. Immediately after the breakout occurs, there is usually a small pullback before the stock explodes upward. Prior resistance levels quickly become price support after the breakout. The small pullback should not fall back beneath the support zone.

The chart in Figure 16-1 pictures the NDX breaking out above resistance on October 29, 1999. This breakout occurred on strong volume; after a small breather the next day, NDX resumed its climb upward and never looked back.

Figure 16-2 pictures Amazon (AMZN) breaking out after channeling in a tight range for most of September. This breakout occurred on powerful volume. Note that the Bollinger bands (see Chapter 17) were contracted and very narrow at the time. When Bollinger bands contract into a narrow channel, they act like a spring after prices break out of that range.

Figure 16-3 shows that Oracle (ORCL) broke out above a long, narrow trading range, first in the beginning of September 1999 and again in the beginning of November 1999. Both breakouts occurred on above-average volume.

## BREAKDOWNS

Breakdowns occur when prices move forcefully below price support on above-average volume. The more significant the prior price support, the more powerful the breakdown will be. Volume and the length of the trading range prior to the move are the two important facets to watch to determine if a breakdown is real. An ideal breakdown has an opening and close beneath price support.

Breakdowns can occur on regular price moves or on gaps. The longer a stock has consolidated (traded in a narrow range on light volume) before the breakdown, the more important the lower move on heavy volume will be. Stocks tend to consolidate immediately

To view this  
image, please  
refer to the  
print version  
of this book

Figure 10-1 INDA Breaking Out Above Resistance

To view this  
image, please  
refer to the  
print version  
of this book

To view this  
image, please  
refer to the  
print version  
of this book

Figure 10-3 ONCL Breaking Out Above Resistance



above price support for two or three days before breaking below. The more often a stock tests price support, the more bearish that price action becomes. Stocks usually hold price support the second and third times they touch that level. After a stock tests price support more than three times, the chances for a breakdown are better.

Similar to a breakout, the best place to short a breakdown is always after the stock price has pierced through its support zone. Depending on the price of the stock, always provide yourself with an entry buffer zone. (See Chapter 11, Entry, and Chapter 12, Exit.) With a \$50 stock, your buffer zone should be about 1/2 point. If this price zone is missed when you attempt to short the stock and the stock moves more than 2<sup>1</sup>/<sub>2</sub> percent beneath the breakdown zone and lingers there for a period of time before roaring back to the initial entry zone, leave it alone. It could be a rising star (the opposite of a fallen star), which means that market conditions and sentiment about the stock have changed, and you're better off forgetting about this particular trade.

The chart in Figure 16-4 shows Microsoft (MSFT) breaking down on two separate occasions. The first breakdown occurred on October 15, 1999, when prices ratcheted beneath 90, which was price support. After rallying back through that level, MSFT broke down through 90 again on November 8, on negative fundamental news.

## DOUBLE BOTTOM

The double bottom is one of the most powerful reversal formations, after which stocks and indices tend to advance formidably. They are powerful patterns because stocks or sectors have retested lows but have failed to break through on the downside, indicating that the selling pressure has subsided. At this point, shorts stop pressing and start covering—sometimes in a panic. Buyers who missed the last dip become aggressive because they're worried that they may miss the new buying opportunity. Bottom fishers also jump on board because they smell a "bargain" and want to be on board for the ride.

The first leg of the double bottom is usually accompanied by above-average volume; prices hold and then rally. After the initial rally, the prices retest the lows of the first leg of the move on lighter volume, then hold and rally from there, producing a solid double bottom foundation.

To view this  
image, please  
refer to the  
print version  
of this book

FIGURE 10-4 VISIT DRESSING DOWN ON TWO OCCASIONS

The mass psychology after a double bottom has been formed switches from panic on the downside to exuberance on the upside, creating an emotional pendulum. Double bottoms are often accompanied by engulfing patterns, hammers, or morning stars. Double bottoms can be spotted on different time frames, especially on daily and intraday charts. They are confirmed when the second rally crosses above the peak of the first rally. Look for bullish divergence signals with oscillators to confirm double bottoms.

Figure 16-5 shows America Online (AOL) forming a double bottom. The first part of the double bottom took place on August 4, 1999. It occurred on record volume of more than 33 million shares, representing a volume capitulation (see Chapter 18) at the low of a move. It also formed a hammer on that day, which is a bullish reversal pattern. After briefly pulling back two days later, AOL rallied and then retested its low in mid to late September, forming the second part of the double bottom. The second part of the double bottom was formed on lighter volume. AOL rallied from that point on, gaining more than 70 points in two months.

Another example of a double bottom is shown in Figure 16-6, formed in the Internet Index (DOT) on a 60-minute intraday chart. The first part of this formation occurred on August 5, coinciding with a piercing and bullish engulfing reversal pattern. On August 10, the DOT retested its low and held, forming a bullish engulfing pattern. After the second part of the double bottom was formed, the DOT rallied above its 60-minute, 8-period moving average, and stayed above that moving average for the next 9 trading days. (See Chapter 5 on trend spotting.)

## **DOUBLE TOP**

The double top, which is the opposite of a double bottom, occurs at the top of a trend, with the first leg occurring on above-average volume. It is a powerful indication that the uptrend has stopped and that a large sell-off is likely. The second leg of a double top is another attempt by the bulls in their exuberant state to lift a stock or sector

To view this  
image, please  
refer to the  
print version  
of this book

Figure 10-3 Acetylating a Double Bond

To view this  
image, please  
refer to the  
print version  
of this book

Figure 10-0-12 Public Domain Foundation Inc. DOI

back to new highs. On the second try, however, the bulls are weary and have diminished willpower and less cash to buy with, so the volume is lighter and the attempt fizzles out.

When the double top fails to breach the previous high, traders and investors who are long decide to take profits, and they bail out. Shorts who missed the first move wait with increased resolve to short on the second try. The selling momentum picks up, and pretty soon the mass psychology has changed from bullish optimism to bearish pessimism. Double tops are often accompanied by shooting stars, bearish engulfing patterns, or evening stars. Look for bearish divergence signals with oscillators to confirm double tops.


The chart in Figure 16-7 shows a daily picture of IBM forming a double top. The first part of the double top formed in mid-July 1999. The second part formed in the beginning of September, and was accompanied by a bearish marubozu (see Chapter 14), a candlestick reversal pattern. After the second part of the double top was formed, IBM moved beneath its 8-period moving average, and stayed below it for 95 percent of the move down.

Figure 16-8 depicts an intraday double top formed in the DOT during the end of September 1999. The page has four charting time frames—a daily, a 60-minute, a 15-minute, and a 5-minute. Looking first at the daily chart, the first part of the double top took place with a bearish engulfing pattern occurring in mid-September. The high of this move occurred at the 650 level, marking that point as short-term resistance. Four trading days later, the DOT retested the highs of this move and failed.

Looking at the 60-minute chart, you can see that the DOT was unable to close above the high that took place on September 23. The DOT formed a shooting star on the 60-minute chart during the second test, which is a short-term bearish reversal pattern. The 5-minute and the 15-minute charts both formed intraday double tops on September 29. What we have here are two intraday double tops within the context of a wider double top, with the first part occurring on September 23 and the second occurring on September 29.

When the price action broke beneath the 8-period moving average on the 15-minute chart, that was a signal to sell longs, and not to go long. Because the net price was still positive on the day, and the last price was above the opening price, traders would not want to go short yet.


To view this  
image, please  
refer to the  
print version  
of this book



To view this  
image, please  
refer to the  
print version  
of this book

**Figure 16-8** DOT Forming a Double Top



A large rectangular frame with a thin black border. Inside the frame, centered, is the text: "To view this image, please refer to the print version of this book".

To view this  
image, please  
refer to the  
print version  
of this book

**Figure 16-8** (Continued)

## HEAD AND SHOULDERS TOP

A classic bearish reversal pattern, the head-and-shoulders pattern forms at the top of a trend. It is composed of a left shoulder, a head, a right shoulder, and a neckline. It is similar to a double top, except that it has a peaking formation, which juts up between the right and left shoulders on high volume. The right shoulder should be slightly lower than the left and usually occurs on lighter volume.

The best time to sell short following this pattern is after a bounce upward toward the middle of the right shoulder and then a reverse downward through the neckline. A head-and-shoulders top produces heavy resistance and a change in sentiment. Refrain from trading from the long side until price action clears above the top of the head-and-shoulders pattern. This pattern can be spotted on a weekly, daily, and intraday basis.

The chart in Figure 16-9 shows a head-and-shoulders top formed in EBAY. Remember that charting is part art and part science. Patterns do not always look picture-perfect, and they are open to interpretation. Once you have the basic concept down, you will be able to spot patterns that portray the same messages as the classic formations. This chart of EBAY is a good example of a head-and-shoulders pattern that could be interpreted as having two right shoulders.

## REVERSE HEAD-AND-SHOULDERS BOTTOM

This is a classic bullish reversal pattern formed at the bottom of a trend. It is composed of a left shoulder, a lower middle head, a slightly higher right shoulder, and a neckline. The right shoulder normally occurs on lighter volume than the left shoulder. This pattern resembles a double bottom, except that in the middle is a lower formation that occurs on high volume.

The best time to go long following a reverse head-and-shoulders bottom is after a retracement toward the middle of the right shoulder and then a bounce upward through the neckline. This pattern can be found on a daily and an intraday basis.

The chart in Figure 16-10 pictures the Dow Jones Industrial Average forming a reverse head-and-shoulders pattern. The pattern displayed in this daily chart took a month to form. Reverse head-and-shoulders patterns, like all charting patterns, vary in time and scope. They can take months to form, or they can develop in a shorter time period, such as on the intraday 5-minute chart.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 16-9 Head-and-Shoulders Top Formed in EBAY

To view this  
image, please  
refer to the  
print version  
of this book

Chart formations that develop with price support and resistance levels leave traces and can be exploited consistently. When you become familiar with spotting these basic chart patterns, you will increase your profitability on three fronts. First, you will take profits at better price levels because you will know that there is support or resistance. Second, you will refrain from entering into new positions when the risk–reward ratio is not in your favor. Third, you will be able to take advantage of chart patterns in order to enter and exit new positions in the right direction, after you have price confirmation. This will allow you to catch trends sooner and to increase your profits.

# 17

C H A P T E R

## OSCILLATORS AND REVERSAL INDICATORS

Oscillators and trend-following indicators are valuable tools that help traders to locate trading ideas and to find additional confirmation of what they're seeing in the charts. Technical indicators are broken down into two areas: trend-following tools and oscillators. Both will help you to identify trending markets, overbought and oversold conditions, pullbacks, and turning points. You'll find that certain indicators resonate with you, while others don't. The object of using them is to help you narrow down an idea, not for confirmation alone. Price action and volume are the only factual confirmations available to a trader. Indicators will help you locate the potential for price action.

Combining charting with indicators will provide you with additional objective confirmation of what you see. Charting is part art and part science. If your charts and indicators point toward the same conclusion, you will be able to trade with more conviction.

This will give you the impetus to stick to your game plan. The best way to get the most out of indicators is to find one or two that you like, and combine them with another indicator from a different area.

For example, the Relative Strength Index is a popular oscillator that is a leading indicator. It measures overbought and oversold conditions by tracking the changes in a stock's closing price. Bollinger bands are statistical tools that use a 21-day moving average and two standard deviations to produce overbought and oversold signals. You can increase your conviction by combining these two separate measurement sources to see if they confirm one another.

Oscillators are powerful tools for confirming a pullback during a trend. It is during the period of time when trends consolidate that oscillators produce potent signals for reentry onto the trend. Going long during a pullback within an uptrend is referred to as trading the up hook. The up hook is a second chance to enter a move that you might have missed earlier. If a stock is in an uptrend and the oscillator pulls back beneath its lower oversold line and then crosses above it, you have a potential signal to trade the trend from the long side. During a downtrend, if the oscillator pops up above the overbought line and then crosses beneath it, you have a potential signal to trade from the short side.

Many traders mistakenly believe that oscillators work best when stocks are caught within a trading range. They may go short with an overbought signal or go long with an oversold signal, and hope to hang on until the stock reaches the other side of the range. This technique is simply bottom or top fishing a range because it looks like prices are either low or high. This sort of trading mentality should be avoided. A trader's objective should be to buy or sell stocks that are moving in your direction, not against you.

Oscillators can be used to produce overbought and oversold signals within a range; but the danger is that sooner or later the range will be broken, and you'll be caught on the wrong side of the trade. Oscillators produce overbought and oversold signals when prices are in a trend and pull back within that trend.

Oscillators also produce potent overbought and oversold signals when they diverge from price action. Some of the strongest reversal patterns oscillators produce are with divergence signals. When prices continue to move toward new highs or new lows, and the oscillator indicators do not confirm that price action, you have price divergence.

Illustration 17-1 presents diagrams of the different types of divergence that occur between prices and the indicators.\*

Be careful not to get overwhelmed by using multiple indicators. The simpler your trading rules the better. Trading is not meant to be a complicated endeavor. The best traders are successful because they have a high degree of confidence in their particular trading plans. If a trader is constantly looking at various indicators and jumping from one to the next, then it will be difficult to develop the conviction and belief necessary to win.

If you get overwhelmed by indicators, you'll increase the odds for procrastination, indecision, and overall analysis paralysis. Remember that trading is a game of action, not thought. Too much tinkering and thinking inhibits a trader. Soon after you enter into a position, you'll know whether you're right or wrong. Distractions are a trader's enemy and should be avoided at all costs. Select only a few simple indicators that you understand and believe in.

## BOLLINGER BANDS

Bollinger bands form a standard deviation channel in which the width changes with price volatility. The upper and lower bands are two standard deviations away from the 21-day moving average. This means that 95 percent of all price action would be contained within those bands. Bollinger bands can be used as momentum indicators or as overbought and oversold indicators.

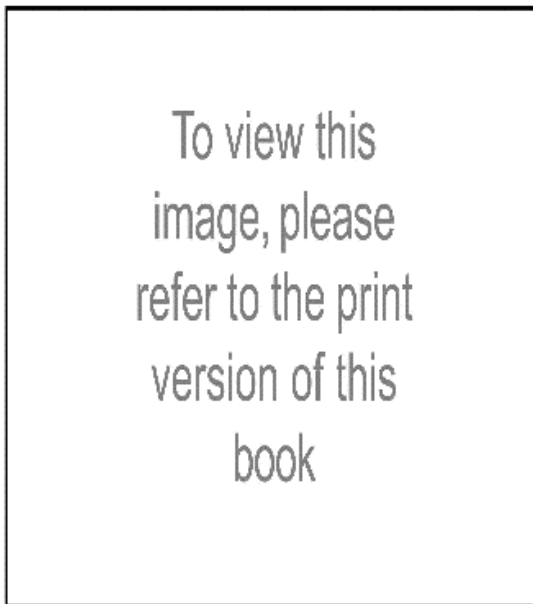
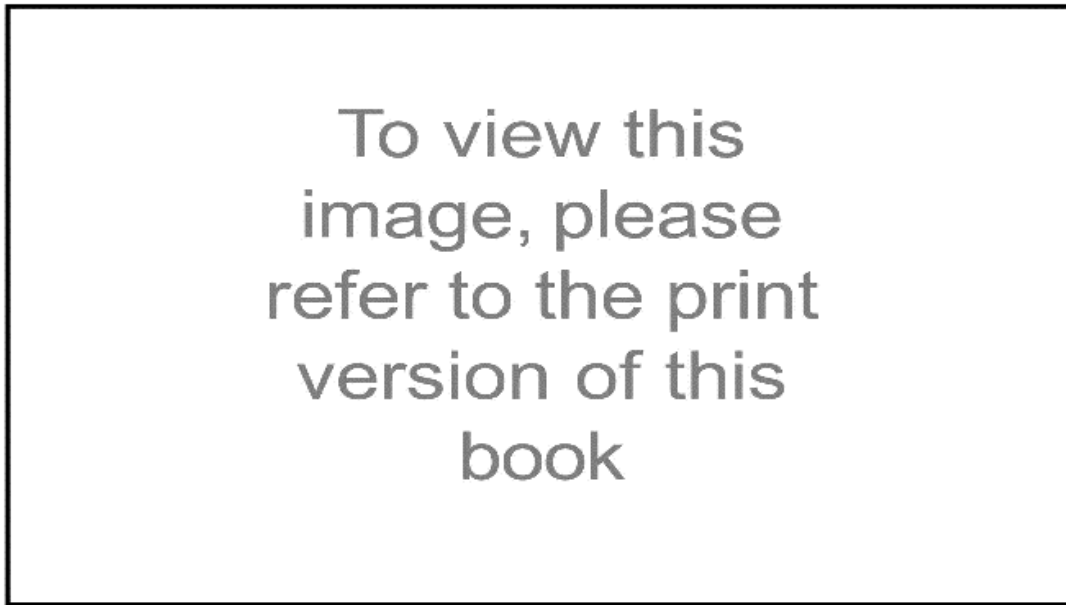
When stocks are channeling with light volatility, the Bollinger band channel contracts and can be used as a momentum signal. In this situation, wait for prices to pierce the upper band to go long, or to pierce the lower band to go short. This is usually a short-term momentum play.

Bollinger bands can also be used effectively as overbought and oversold indicators. During times of increased volatility, the bands expand. During this period, when prices pierce the upper band, wait for confirmation in the form of a pullback beneath the upper band, and then go short. Place your stop-loss just above the high point of the move above the upper band.

---

\*Elder, Alexander. *Trading for a Living*. Wiley, New York, 1993.





**Illustration 17-1** Types of Divergence that Occur Between Prices and Indicators

If prices break below the lower band, wait for a bounce above the lower band, and then go long. Place your stop just below the low price of the move beneath the band.

Candlestick patterns can be used effectively when Bollinger bands are brought into the picture. For overbought conditions, wait

for the first red candle to dip beneath the upper band before you go short. For oversold conditions, wait until the first white candle appears before you go long. Reversal patterns often form above or below the Bollinger bands. These patterns provide additional confirmation that a reversal is at hand.

The right way to use Bollinger bands is:

1. After prices cross above the expanded upper Bollinger band, wait for them to fall back beneath the upper band, then trade from the short side, using a stop-loss on the short just above the high point of the move.
2. After prices cross below the expanded lower Bollinger band, wait for them to rise back above the lower band; then trade from the long side, using a stop-loss on the long just below the low point of the move.
3. When Bollinger bands have contracted to a narrow range, wait for prices to break above the upper band; then trade from the long side, using a stop-loss on the long just below the upper band.
4. When Bollinger bands have contracted to a narrow range, wait for prices to break beneath the lower band; then trade from the short side, using a stop-loss on the short just above the lower band.

The chart in Figure 16-2 (page 175) shows Amazon (AMZN) piercing its upper Bollinger band toward the end of April 1999. During this period, the Bollinger bands for AMZN were in an expanded state, representing volatile trading activity. After piercing its upper Bollinger band with a large white candle, AMZN formed a spinning top followed by a dark cloud cover (see Chapter 14), a bearish candlestick reversal pattern. Afterward AMZN pulled back beneath its upper Bollinger band, representing a sell signal and confirming the bearish candlestick reversal patterns.

On the same chart, in late September 1999, AMZN channeled in a tight range for almost a month, creating contracted Bollinger bands in the form of a bottleneck. When Bollinger bands are contracted like this, they produce excellent signals for getting long volatility, or for trading a breakout. Option traders can use Bollinger bands to buy contracts that will increase in value with volatility when the bands are contracted, or to sell options that will increase in value when volatility decreases when the bands are expanded.

Figure 17-1 shows an example of Bollinger bands working well as an overbought and oversold indicator in Cost Plus Inc. (CPWM), used in conjunction with candlestick charting reversal patterns. At the end of October, CPWM broke above the upper Bollinger band and formed a shooting star reversal pattern. The next day CPWM formed a bearish engulfing pattern, falling beneath the upper Bollinger band. This confirmed the shooting star reversal pattern above the upper Bollinger band and created a sell signal. After CPWM sold off, it reached its low toward the beginning of November, beneath the lower Bollinger band, forming a hammer followed by a bullish engulfing pattern and a morning star pattern. The day after the hammer was formed, the large white candle produced a buy signal when it crossed above  $30^{3/4}$ , which was above the lower Bollinger band and above the high point of the hammer formed the day before.

## MOVING AVERAGE CONVERGENCE-DIVERGENCE (MACD)

This leading trend-following indicator consists of three exponential moving averages that give buy or sell signals when they cross. The MACD consists of a solid line and a dashed line. The solid line is the MACD line and the dashed line is the signal line. When the fast MACD line crosses above or below the slower signal line, then a buy or sell signal kicks in.

The MACD line is the difference between two exponential moving averages (EMAs). The standard moving averages used are the 26-day EMA and the 12-day EMA. The difference between these two averages produces the fast line. To calculate the slow line or signal line, use the 9-day EMA of the fast line. The advantage of using the MACD is that it will provide a bullish or bearish consensus with less choppiness than plain moving averages do.

The right way to use MACD is:

1. Trade from the long side when the fast line crosses above the slow line, and when it stays above the slow line.
2. Trade from the short side when the fast line crosses beneath the slow line, and when it stays beneath the slow line.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 17-1 Bollinger Bands in CPWM

## MACD HISTOGRAM

Subtracting the slow line (signal line) from the fast line (MACD line) creates the MACD histogram. Plot the difference in the form of histogram bars. When the fast line is above the slow line, the histogram bar is plotted above the zero line. When the fast line is beneath the slow line, the bar is beneath the zero line. The slope of the histogram depends on the difference between the fast line and the slow line. Stronger bull action will cause the fast line to be farther above the slow line; thus the histogram will have longer lines above zero. The same holds true to the downside when the bears take control.

The right way to use the MACD histogram is:

1. Trade in the direction of the slope of the histogram. If the slope is positive, trade from the long side; if it is negative, trade from the short side.
2. Sell longs or trade from the short side when the histogram is above the zero line and the slope heads downward. This indicates that the bulls have lost steam and a reversal is in the making.
3. Cover shorts or trade from the long side when the histogram is below zero and the slope turns upward. This indicates that the bears are out of gas and the bulls are taking back the reins.
4. Go long with bullish divergence between lower prices and a higher histogram.
5. Go short with bearish divergence between higher prices and a lower histogram.

Figure 17-2 shows a chart of Dell Computer (DELL) with MACD lines superimposed on top of the chart, and with an MACD histogram displayed beneath the chart. The chart also has an 8-period moving average. Toward the end of July and the beginning of August, DELL formed bullish divergence with the MACD histogram. On the second higher bottom of the MACD histogram, DELL also formed a hammer followed by a bullish engulfing pattern. During this period, the fast line on the MACD crossed above the slow line.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 17-2 WACD Lines and Instagram in DELL

## STOCHASTICS

Stochastics trace the correlation between the closing price and the recent price range. They track the power of the bulls or bears, represented by their ability to close a stock near the extreme end of the high-low range. If the bulls are strong, they will be able to close prices at or close to the highs. If the bears are strong, they will force prices lower and will be able to close them at or near the low end of the range.

If stochastics rise and then turn down, it shows that the bulls attacked but had to retreat due to a stronger force, so a sell signal lights up. When stochastics turn upward after prices were beaten down, it shows that the bears are now the ones running for cover, and produces a buy signal.

There are two types of stochastics that traders can follow: the fast stochastic, which is comprised of the %K and the %D lines; and the slow stochastic, which is a smoothed function of the fast stochastic. Stochastics are plotted between 0 and 100, with reference lines usually drawn at the 30 and 70 percent levels to mark overbought and oversold conditions.

Five days is the default in most charting packages for plotting %K. The fast line (%K) is calculated by taking today's close and subtracting it from the low price for the 5-day period. Let's say that today's close is 50, and the low price for the 5-day period was 45; the result is 5. Divide that number by the high price for the 5-day period subtracted by the low price for the 5-day period. If the high price for the 5-day period is 55 and the low price is 45, the result is 10; 5 divided by 10 is .5. Multiply the result by 100. ( $.5 \times 100 = 50$ ) The current day's level for the fast line (%K) is 50. The slow line (%D) is calculated by smoothing the fast (%K) line. Taking the 3-day sum of the %K equation and multiplying that number by 100 will smooth the %K.

The fast stochastic calls market turns faster than the slow stochastic, but also produces more false signals due to noise and interference. The slow stochastic eliminates the hullabaloo of the market, removing the head fakes associated with the fast stochastic. The slow stochastic is calculated by taking the slow line (%D) of the fast stochastic and making it the fast line (%K) of the slow stochastic.

The right way to use stochastics for bullish signals is:

1. If prices make a new low, but the stochastics do not confirm that low by making a higher bottom, cover shorts or go long. This indicates bullish price divergence.
2. If prices are in an uptrend and the stochastic lines move below the oversold 30 line, and then cross above the 30 line, cover shorts or go long. This indicates a pullback within the context of an uptrend and presents the opportunity to reenter the uptrend from the long side.

The right way to use stochastics for bearish signals is:

1. If prices make a new high, but the stochastics do not confirm that high by making a lower top, then sell long or go short. This indicates bearish price divergence.
2. If prices are in a downtrend and the stochastic lines move above the overbought 70 line, and then cross below the 70 line, sell longs or go short. This indicates a bounce within the context of a downtrend, and offers an opportunity to reenter the downtrend from the short side.

The chart in Figure 17-3 is a weekly picture of Adobe Systems (ADBE) with stochastic lines. In the middle of February, the fast line crossed above the slow line when the stochastics were in an oversold state, trading beneath the 30 line. After the fast line crossed above the slow line, both lines moved above the lower reference line. ADBE formed a bullish engulfing pattern and moved above the weekly 8-period moving average.

ADBE also formed weekly bullish divergence with the stochastic lines. The first bottom in the stochastic lines occurred on June 12, and the second one occurred in the beginning of August, when prices made a lower bottom but the stochastic lines made an equal bottom to the June 12th low.

## **RELATIVE STRENGTH INDEX (RSI)**

The RSI is a leading indicator that measures the overbought and oversold condition of a stock by tracking the changes in its closing price. RSI is plotted between 0 and 100, with 30 as the default oversold line and 70 as the default overbought line. When the RSI line dips beneath 30 and then crosses back up above it, that represents



To view this  
image, please  
refer to the  
print version  
of this book

FIGURE 17-3 STOCHASTICS ON AN AR(1) CHAIN

an oversold condition that is about to bounce. When it extends above the overbought 70 line and then crosses beneath it, that marks an overbought condition that is about to sell off.

When calculating the RSI, use the formula:

$$RSI = 100 - 100 / 1 + RS$$

where RS equals the average of net up closing changes for a specific number of days, divided by the average of net down closing changes for the same number of days. The common default number of days used is 7.

The right way to use the RSI for bullish signals is:

1. If prices make a new low, but the RSI does not confirm that low and instead makes a higher bottom, cover shorts or go long. This indicates bullish price divergence.
2. If prices are in an uptrend and the RSI line moves below the oversold 30 line, and then crosses back above the 30 line, cover shorts or go long. This indicates a pullback within an uptrend, and presents the opportunity to reenter the uptrend from the long side.

The right way to use the RSI for bearish signals is:

1. If prices make a new high, but the RSI does not confirm that high and instead makes a lower top, then sell long or go short. This indicates bearish price divergence.
2. If prices are in a downtrend and the RSI line moves above the overbought 70 line, and then crosses back below the 70 line, sell longs or go short. This indicates a bounce within a downtrend, and offers an opportunity to reenter the downtrend from the short side.

The chart in Figure 17-4 shows that EBAY formed a bullish engulfing pattern in the beginning of August with the RSI line crossing above the oversold 30 line for the first time since mid-June. This took place with strong volume and a move above the daily 8-period moving average.

## MOMENTUM

Momentum can be defined as a speedometer for price change. The speedometer gauge of momentum measures the trend accelera-

To view this  
image, please  
refer to the  
print version  
of this book

Figure 17-4 RSI Line in EBAY

tion—the rate and quantity of change—not the actual value. Momentum is measured as the difference between the closing price today and the closing price X number of days ago; 7 is usually the default value for X. When the momentum of price has run its course, it indicates that a stock or sector has reached its overbought or oversold level. During this period of time, oscillators are useful in cautioning traders as to a reversal of price at support or resistance, indicating an oncoming reversal in trend.

The momentum oscillator will rally when price changes increase at an accelerating rate from X number of days ago. If the momentum indicator flattens out as prices continue to rise, it could indicate that the trend has matured and prices will reverse. If prices were falling at an escalating pace, then the momentum indicator would be in a downtrend. If prices continue to fall but not as sharply, the momentum indicator would flatten out or move above the oversold line and would indicate that the sell-off has run its course and a reversal is at hand.

You can adjust the overbought and oversold reference lines on the momentum oscillator according to your preference. Using  $-20$  as the oversold line and  $+20$  as the overbought line is effective. You can also use the 0 line as a crossover line, with a cross above the 0 line bullish when prices are in an uptrend, and a cross beneath the 0 line bearish when prices are in a downtrend.

The right way to use the momentum oscillator for bullish signals is:

1. If prices make a new low, but the momentum oscillator does not confirm that low by making a higher bottom, cover shorts or go long. This indicates bullish price divergence.
2. If prices are in an uptrend and the momentum oscillator lines moves below the oversold  $-20$  line, and then cross above the  $-20$  line, cover shorts or go long. This indicates a pullback within the context of an uptrend and presents the opportunity to reenter the uptrend from the long side.

The right way to use the momentum oscillator for bearish signals is:

1. If prices make a new high, but the momentum oscillator does not confirm that high by making a lower top, then sell long or go short. This indicates bearish price divergence.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 17-3: Momentum Oscillator in ITC

2. If prices are in a downtrend and the momentum oscillator lines move above the overbought 20 line, and then cross below the 20 line, sell longs or go short. This indicates a bounce within the context of a downtrend, and offers an opportunity to reenter the downtrend from the short side.

In the daily Yahoo (YHOO) chart in Figure 17-5, the momentum oscillator formed a double top above the overbought 20 line in late June and then crossed beneath the 20 line, with prices crossing below the 8-period moving average. Then, in early August, the momentum oscillator formed bullish price divergence in conjunction with a bullish engulfing pattern before moving above the 8-period moving average. When the price action moved above the 8-period moving average and the momentum oscillator crossed above the 0 reference line, that was a buy signal.

Oscillators can be used as a supplement to charting to help you uncover overbought and oversold conditions. They work most effectively to uncover oversold pullbacks within the context of uptrends, or overbought bounces within the context of downtrends. Oscillators are also excellent tools for spotting bullish or bearish divergence. Divergence occurs between the price of the stock and the reading of the oscillator. The most popular oscillators are leading indicators that will give you the first clue that a stock or sector is ripe to enter or exit. When using oscillators to enter a position, abide by your overall trading plan, utilizing price confirmation and stop-loss areas.

# VI

P A R T

## THE PULSE OF THE MARKET

*This page intentionally left blank.*



# CHAPTER

# 18

## VOLUME

Volume is the second dimension of technical analysis. It indicates the active interest in a stock at any given time. If charts represent a map of the territory you are planning to embark upon, then volume measures the depth of that territory. Just as it is impossible for elephants to tread in the jungle without leaving footprints, it is also hard for institutional accounts to enter or exit positions without leaving traces through volume.

Volume provides traders with clues. Significant levels of support and resistance are often marked by high volume. High volume represents intense emotional and monetary interest. This conviction in the form of volume creates memories for future reference points. For example, if a stock trades to its all-time high on heavy volume and then sells off, there will be winners and losers. The winners are the ones who sold a long position, or shorted close to the top. The losers are the ones who went long, covered their short, or didn't sell

close to the top. If and when the stock rallies back up toward its all-time high, the losers will be waiting with a vengeance for another opportunity to sell. When significant volume reference points are retested, emotions resurface and the buyers or sellers come back, attempting to amend past actions.

Volume spikes are often the result of numerous buyers or sellers reacting to some significant piece of fundamental news. Volume tends to attract volume. Large holders of stocks do not want to miss the opportunity to scale around a position if the stock is in play and is trading actively. The largest institutions are usually active in their largest positions most of the time, either adding to them, scaling them back, selling them, or just day trading them for short-term profits. When stocks move on volume that is above the 20-day moving average, price action and chart patterns have increased validity.

## **BLOCK PRINTS**

A block print is defined as a trade of 10,000 shares or more. Depending on the average daily volume, block prints of at least 25,000 shares represent meaningful institutional interest that could dictate a stock's movement in the short term. Volume of 25,000 shares is a significant number, because if there is a large order, the institution with that order will be able to buy or sell at least 25,000 shares—or more—from an institutional market maker, in order to work the rest of the order.

Block prints should be monitored closely throughout the day, because they can easily tip the hand of a large buyer or seller, alerting traders to market-moving institutional interest. As a general rule, block prints that go up on the offering side indicate buy interest, and block prints that go up on the bid side indicate sell interest. Block prints that go up on both sides mean that stock was crossed between buyers and sellers. Multiple block prints on the same side of the market denote that more than one institutional buyer or seller is working through the same market maker. Multiple block prints on the same side of the market provide an excellent sign that the stock should continue to move in the same direction the prints went on the tape.

Market makers who are working two large orders simultaneously on the same side of the market will give both accounts equal prints. If an institutional account knows that there is additional buy

or sell interest in a stock, the institutional trader will be more aggressive about getting the order done, because he knows that he is participating with other volume. The institutional trader is the representative from the institutional fund who gives the market-making firm the order, with instructions. At the market-making firm, there is a sales trader who is the intermediary between the market maker and the institutional trader.

Mutual funds, hedge funds, and pension funds are considered to be buy-side institutions. These funds give market makers, who facilitate institutional order flow, orders to buy or sell stock. There are market makers who specialize in institutional order flow; and there are market makers who specialize in noninstitutional order flow, or what is called retail and Internet-driven order flow. The market makers who specialize in institutional order flow put up initial risk capital in order to get the order in the door. If a stock is quoted  $50-50\frac{1}{8}$ , and an institution calls an institutional market maker with 100,000 shares to buy, the market maker would normally sell that account at least 25,000 shares at  $50\frac{1}{8}$  in order to work the rest of the order. This means that the market maker is at risk on the first print, or is now short 25,000 shares. If the stock moves in his favor after this print, he will make money; if it moves against him, he will lose money. If the stock is liquid, the market maker would likely sell the institution the entire 100,000 shares at  $50\frac{1}{8}$ .

Prints of less than 25,000 shares in relatively liquid stocks are not as meaningful as larger prints, because they are not generally followed up with more stock coming from the same source. If a large institution had a lot of stock to buy in a liquid name, then the market maker would put up a larger print for the institution to get the order started.

After a market maker puts up risk capital for an institution, the institution normally leaves a working order with that market maker to buy or sell more stock. In our example, if the market maker sold an institution 25,000 shares at  $50\frac{1}{8}$  to work 75,000 shares behind it, the market maker now has the objective of eliminating risk. In order to eliminate risk, the market maker wants to buy back stock for a small profit, flat, or for a small loss. Once he eliminates his risk, his objective is to trade the remaining 75,000 shares for the bid-ask spread of  $\frac{1}{16}$  or  $\frac{1}{8}$  of a point. If he buys back 12,500 shares at  $50\frac{1}{16}$  and 12,500 shares at  $50\frac{1}{8}$ , he is now free to participate with volume at zero risk in order to trade the rest of the order for a profit.

He may do this by sitting on the  $50\frac{1}{8}$  bid and buying stock there, and then selling it to the institution at  $50\frac{3}{16}$  or  $50\frac{1}{4}$ . This means that although he made a marginal profit or zero profit on the first 25,000 shares, he will now make  $\frac{1}{16}$ th to  $\frac{1}{8}$ th of a point profit on the remaining 75,000 shares.

Institutional traders who have market orders have the objective of participating with volume in order to complete their orders. This means that if volume trades outside of the market maker with the order, then the institutional trader will expect to also have part of her order completed. In our example, after the market maker sold an institution 25,000 shares at  $50\frac{1}{8}$  to work 75,000, if the volume on the stock increases by 100,000 shares or so, the institutional trader will expect to have bought more stock. Depending on the liquidity of the stock, and what kind of volume is printing (whether block prints or smaller volume), the trader will expect more volume because the market maker has had ample opportunity to cover his short and to buy more stock.

In another example, WXYZ is 40 bid and has an average daily volume of 1.5 million shares—a semiliquid name. A market maker is long 25,000 shares at 40 after buying stock from an institutional seller in order to work a larger order. The institutional trader who sold the market maker the 25,000 shares has 75,000 shares for sale behind it, and she wants to get her order completed at the market as quickly as possible. After the market maker prints the 25,000 shares at 40, the 40 bids start to fade because the block print hitting the tape on the bid spooked other players.

The market maker who is long the 25,000 at 40 has two choices: Sit and do nothing and watch the stock drop; or participate with volume by selling stock lower than the price where it was bought. When market makers want to sell stock in a semiliquid name, they often have to lead the price to a level at which other buyers might care to step in. When a market maker puts up risk in a semiliquid name, he wants to cut his loss as quickly as possible, if stock is trading lower, and if he knows he has more stock for sale behind it.

The market maker who sits and watches a stock fall if he has it for sale, without acting, runs the risk of being shut out from the additional volume that might trade. This would be negative for the market maker on two fronts: First, the market maker would lose money from a long position, which he inherited to work the order; second, the institutional trader who has more stock for sale would

be angry because of not selling any more stock with the increase in volume. Because the market maker has more stock for sale at the market from the institutional seller, it would not make any sense to hold onto the initial long position without acting.

Like all successful traders, the best market makers act quickly to cut their losses without hoping for things to be different. Good market makers do not fight a losing position with hope by watching it or by adding to it. Instead they cut out the loss as quickly as possible and move on to the next trade. In the case of WXYZ, the market maker could always roll the 25,000-share long position again on a clean-up after cutting his initial loss at a lower price.

## CLEAN-UP PRINTS

Clean-up prints are large block prints that mark the end of a short-term move. They represent the end of an institutional order that caused a market to move to a certain level. Because the order is complete, it alleviates the pressure, allowing the stock to reverse course.

It takes patience and a trained eye to spot a clean-up print. They take the form of many shapes and sizes. Clean-up prints occur at the extreme end of a trading range, and occur after an institution has been applying consistent buying or selling pressure that could last minutes, hours, or even days, depending on the liquidity and size of an order. Many times market makers take the opposite side of a clean up print. Clean-up prints occur after a market maker with the large order has walked the stock up or down multiple levels with numerous block prints. For example, if there are 50,000 shares left for sale out of a total of a million shares when the order began, the market maker may go long the 50,000 shares for his own position to clean up the order.

Because the market maker has completed the order, and because the order was the reason the stock moved to the oversold or overbought level, the stock should change directions after the final print. Stocks reverse hard off a clean-up print, especially when the institutional buyer or seller was too aggressive about completing the order.

When you have identified an AX forcing a stock in one direction, and then notice a large print at the high or low end of the intermediate move followed by a sharp price reversal, chances are that is a clean-up print. The market maker will fade out of the picture after the clean-up print, sliding away from the inside market. If it was a

clean-up print from an institutional seller, then the market maker will fade off the offering, not having any more stock for sale. If it was a clean-up print from an institutional buyer, then the market maker will fade off the bid as a result of no longer being a buyer.

## **VOLUME CAPITULATION**

Volume capitulation is a volume crescendo that occurs at the top or bottom of a trend and marks the end of that trend. It is caused by emotional exuberance that has reached an extreme, resulting in a washout of buyers or sellers. If the volume capitulation occurs at the top of a trend, the buyers are washed out, with no one left to buy. If the volume capitulation occurs at the bottom of a trend, the sellers are washed out, with no one left to sell.

Volume capitulation creates a top or bottom and a new level of significant support or resistance. The reason an eruption of volume at the high or low end of a move may signal an end to that move is that the bulk of traders who either missed the move or had a position in the wrong direction threw in the towel and ran for the hills. The financial and emotional pain was too severe for those who let their losers run too long or who missed the move for too long.

Price-volume divergence is a potent reversal indicator that often kicks in when prices retest previous volume capitulation levels. Prices that were created on a volume climax are usually retested. When prices retest previous tops on lighter volume, an excellent opportunity arises to go short. When prices retest previous lows on lighter volume, an excellent opportunity arises to go long. Watch volume carefully with double tops and double bottoms. Always look for the second leg to be lighter than the first.

## **VOLUME BREAKOUTS**

Volume breakouts are price moves through significant support or resistance levels that are accompanied by above-average volume. Price breakouts that are accompanied by institutional interest in the form of block prints have significant staying power. The way to identify a valid breakout is to watch the volume that accompanies the move. Legitimate breakouts should be forged with an eye-popping increase in volume. Without institutional interest, a stock that

breaks through a level can fall back quickly, because the traders who pushed it through the level are going to push it back by taking profits. If a large account is moving a stock through an important technical level, then the volume accompanying the break will spark the interest of other large players, who may also want in or out.

If above-average volume accompanies an uptrend, then prices are likely to go higher. If above-average volume accompanies a downtrend, then prices should proceed lower. A descent in prices can endure longer on lower volume than an ascent in prices. Remember that stocks need buyers to rise, but tend to fall easier on their own accord because more people are long the market than short it, so fear tends to be magnified to the downside.

## **ON-BALANCE VOLUME (OBV)**

On-balance volume is a volume indicator created by Joseph Granville. It is a cumulative total of volume that tracks the relationship between the volume of a stock and its net change on the day. If a stock closes higher than the previous session, the volume for that day is added to a running total of OBV. If a stock closes lower than the previous session, the volume for the day is subtracted from the running total of OBV. If prices close unchanged from the previous day's session, the OBV remains static. When the trend of the OBV line confirms price action, it indicates that the trend in prices should continue. An effective way to use OBV as an indicator is when the OBV line diverges from price action.

The right way to use OBV for bullish signals is:

1. When prices make a new low but the OBV line makes a higher top, that is bullish divergence and should be used to cover shorts or initiate longs. The divergence shows that the bears are losing their selling power because the volume does not confirm the lower price action.
2. When prices are in an uptrend or make a new high and the OBV line confirms this price action, trade from the long side.

The right way to use OBV for bearish signals is:

1. When prices make a new high but the OBV line makes a lower top, that is bearish divergence and should be used to

sell longs or initiate shorts. The divergence shows that the bulls are losing their buying power because the volume does not confirm the higher price action.

2. When prices are in a downtrend or make a new low and the OBV line confirms this price action, trade from the short side.

The chart in Figure 18-1 shows the OBV line of Yahoo forming a double bottom in early August 1999, and then turning upward into a steady uptrend, confirming YHOO's price action above its 8-period moving average.

## ACCUMULATION/DISTRIBUTION

The accumulation/distribution (A/D) line, created by Larry Williams, adds a portion of the current day's volume to a bullish or bearish side in order to calculate its signal. The A/D line uses the opening price of a stock as the benchmark to calculate the winner, rather than using the previous night's close. The A/D line is calculated by subtracting the previous night's close from the current day's open, and dividing that figure by the range of the day (high minus low), then multiplying the result by the volume.

What's interesting about the A/D line is that it only attributes a portion of the day's volume to the winning side, based on the net difference between the opening and close, compared to the entire range for the day. In candlestick charting terms, the A/D line compares the body of the candle to the wick, and uses the body's percentage of the move to calculate the volume weighting.

The right way to use the A/D line for bullish signals is:

1. When prices make a new low but the A/D line makes a higher top, it indicates bullish divergence and should be used to cover shorts or initiate longs. The divergence shows that the bears are losing their selling power because the volume does not confirm the lower price action.
2. When prices are in an uptrend or make a new high and the A/D line confirms this price action, trade from the long side.

The right way to use the A/D line for bearish signals is:

1. When prices make a new high but the A/D line makes a lower top, it indicates bearish divergence and should be



To view this  
image, please  
refer to the  
print version  
of this book

Figure 10-10-10

used to sell longs or initiate shorts. The divergence shows that the bulls are losing their buying power because the volume does not confirm the higher price action.

2. When prices are in a downtrend or make a new low and the A/D line confirms this price action, trade from the short side.

The chart in Figure 18-2 shows a picture of Intel Corp. (INTC) breaking above its short-term, 8-period moving average beginning in June of 1999. The A/D line formed a triple bottom during the same period and then broke above resistance toward the end of June, climbing in an uptrend and confirming INTC's positive price action.

Volume represents an integral part of a stock's price action throughout the day. By carefully tracking a stock's volume, you will acquire insight as to important support and resistance levels, and on which side the path of least resistance lies. Throughout the day, monitor the quantity and location of block prints and use that information to confirm price action. Above-average volume usually confirms a stock's price movements. Below-average volume usually indicates that price movements are inconsequential.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 18-2 A/D Line in ITC

# CHAPTER

# 19

## THE LEADING INDICATORS

Short-term day traders need to have a quick, reliable method for tracking the intraday pulse of the market. There are many times when a widely watched index like the Dow Jones Industrial Average, the S&P 500, or the NASDAQ Composite could show a large gain or loss in one direction, when in reality some important market internals are telling a different story. When the panic reaches an extreme, it is usually a sign that the end of the move is at hand, and the market should do just the opposite. When a short-term trader knows what to look at, you will be able to use other people's panic as an opportunity to cash in.

There are a handful of market gauges that will tell you which direction the intraday market sentiment is pointing in and when it is about to change. When these internal market measures are used in conjunction with charting, you will be able to judge quickly on which side of the market your best risk–reward ratio

lies. These intraday timing tools provide the first green lights for entry and exit.

## TICK

The TICK measures the net number of stocks that are upticking versus the net number of stocks that are downticking. If a stock is trading with an uptick, someone is paying for the offer to buy it. If a stock is trading with a downtick, someone is selling the stock on the bid.

The TICK reading is available for the NYSE composite index, which represents all of the stocks traded on the New York Stock Exchange. The TICK is also available for other sectors, including the Dow Jones Industrial Average, the NASDAQ 100, and the S&P 500. The NYSE TICK reading is one of the most widely used. All of them are valuable measures.

For example, if the TICK reading on the NYSE is +500, it means that 500 more stocks are being bought than are being sold. This number is meaningless as an absolute value, but it is useful as a relative number when compared to the net number of upticks or downticks preceding the measurement.

The TICK identifies overbought and oversold conditions when it diverges from broader market measures. When prices have reached their highs or lows and are about to reverse, the TICK is a leading indicator. You can plot the TICK, which will point toward that reversal, on a chart using a short-term moving average, such as the 8-period, to identify changes in market sentiment and the trend.

If the broader market has been selling off all morning with the TICK in negative territory, a jump into positive territory indicates that a short-term rally is under way. A change in sentiment displayed by a rally in the TICK can be plotted on a chart using an 8-period moving average. A move above the 8-period moving average indicates positive sentiment; a move below the average indicates negative sentiment.

Excessive enthusiasm or gloom is associated with market tops and bottoms. When the NYSE TICK reaches an extreme reading of +1,000 or -1,000, it is a sign that a rally or sell-off is reaching a capitulation point, and an overbought or oversold condition may be in place. An extreme reading indicates that frantic bulls or bears have thrown in the towel and have either sold their longs at the bottom or covered their shorts at the top in an emotional frenzy. It is usually

when the pain is the greatest that most people tend to give up. After these people give up, things start to turn around because all the weak hands are washed up.

## TRIN

The Trader's Index (TRIN) is a leading indicator that is effective in measuring overbought and oversold conditions that are the result of emotional extremes. The TRIN measures the ratio of advancing stocks to declining stocks and compares it to the ratio of advancing volume to declining volume. The TRIN changes dynamically and can be tracked with the symbol TRIN on most market minders. It can also be plotted on an inverse overbought or oversold scale, with upper and lower reference lines, included with most charting packages.

The formula for the Trader's Index is:

$$\text{TRIN} = \left( \frac{\text{Advancing Issues}}{\text{Declining Issues}} \right) \left( \frac{\text{Advancing Volume}}{\text{Declining Volume}} \right)$$

The objective of the TRIN is to produce a dynamic snapshot of volume and price action to assess the market's health. The TRIN has a reading of 1 when the advancers move proportionately with advancing volume and when the decliners move proportionately with declining volume. For example, if 10 issues advance on 100,000 shares, and 5 issues decline on 50,000 shares, then the TRIN has a reading of 1. If 5 issues advance on 50,000 shares and 10 issues decline on 100,000 shares, the TRIN still has a reading of 1.

A TRIN reading below 1 is considered bullish, and a TRIN reading above 1 is considered bearish. As the TRIN widens from the neutral 1 reading, it indicates that the bulls or bears are gaining force. The TRIN declines beneath 1 when the volume of the advancers is greater in proportion to the number of stocks that are advancing. Bulls tend to become exceedingly optimistic at market highs, and the increase in volume without an increase in prices reflects this bullish sentiment. For the day trader it is important to remember that a dropping TRIN is considered bullish.

For example, if advancers are outpacing decliners by 3 to 2, and if advancing volume is outpacing declining volume by 3 to 1—a higher proportion—then the TRIN will have a bullish reading of .50. In this case, the price action is not keeping pace with the strong vol-

ume. A low TRIN can produce an overbought signal on an inverted scale. It produces a sell signal when it crosses below its upper reference line.

The TRIN rises above 1 when the declining volume is greater in proportion to the decliners. Excessive pessimism is reflected at market lows, when the bears want out and are selling stock without a correlated number of issues declining. If decliners are beating advancers by 3 to 2 and declining volume is leading advancing volume by 3 to 1, the TRIN has a bearish reading of 2. A high TRIN can produce an oversold signal on an inverted scale. It produces a buy signal when it crosses above its lower reference line.

The right way to use the TRIN for bullish signals is:

1. When the TRIN crosses above its lower oversold reference line, it indicates that the bears have lost power, and a bullish reversal could be at hand.
2. When prices make a new low but the TRIN makes a higher low, it represents bullish price divergence.
3. A falling TRIN is considered bullish.

The right way to use the TRIN for bearish signals is:

1. When the TRIN crosses below its upper overbought reference line, it means that the bulls have lost power, and a bearish reversal could be at hand.
2. When prices make a new high but the TRIN makes a lower high, it represents bearish price divergence.
3. A rising TRIN is considered bearish.

## FAIR VALUE

The fair value spread is monitored by subtracting the S&P cash from the S&P futures. For example, if the S&P futures were trading at 1,500 and the S&P cash was trading at 1,490, the spread would be +10. If fair value is calculated for the day to be 10, with the upper bound at 11 and the lower bound at 9, buy programs will kick in when the futures are trading at more than 11 points above cash. Sell programs will kick in when the futures are trading at less than 9 points above cash.

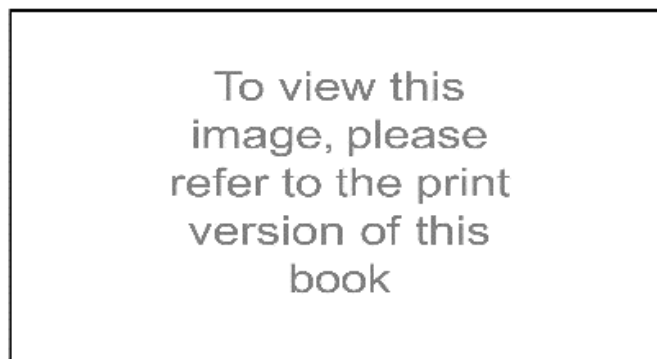
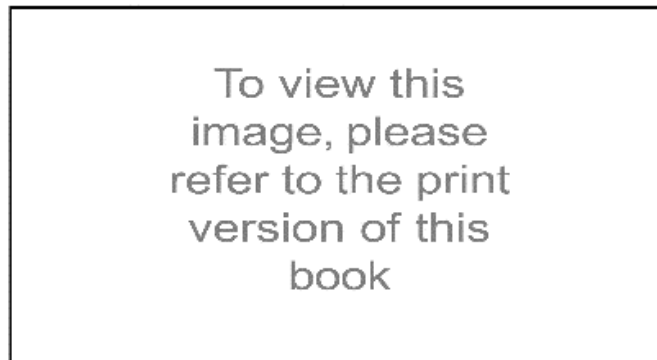
If the S&P futures have been trading at a consistent discount to fair value throughout the morning, and then suddenly they

trade at a consistent premium, chances are that a short-term bottom has been reached and a rally is under way. The validity of this change in sentiment would be reinforced if it occurred at a support level.

If the S&P futures are trading at 1,500 and the S&P cash is trading at 1,488, the spread is +12, one point above the upper bound, so the market is in a short-term rally mode. (See Table 19-1.) If the S&P futures are trading at 1,496 and the S&P cash is trading at 1,488, the spread is +8, one point below the lower bound, so the market is in a short-term sell mode. (See Table 19-2.) Most software programs allow traders to monitor the fair value spread dynamically with a symbol.

Certain trading packages have the futures-cash spread built into their market minders. When the futures are trading at a premium above the upper bound, a green light signals it is time to buy. When the futures are trading at a discount to the lower bound, a red light signals it is time to sell for a short-term move.

**Table 19-1** S&P Futures in a Buy Mode





Fair value interprets the relationship between the S&P futures and the S&P cash. This relationship is important, because the S&P 500 index is the main benchmark for portfolio managers and is the most widely used measure for broader market sentiment. The S&P futures is the main derivatives instrument used to put large amounts of money to work quickly and efficiently when institutions or traders want to own or hedge the S&P cash.

The S&P futures leads the S&P cash in price action, because traders go there first when they need to increase or decrease their broader market exposure. The S&P futures are popular because they are equivalent to a one-stop shopping deal for a trader wanting to buy or sell the broader market quickly and efficiently. They are extremely liquid, the cost of entry is significantly less than the underlying cash due to spreads and commissions, they can be shorted on a downtick, and there are lower margin requirements for trading them.

Because the S&P futures trade at a premium or discount to the S&P 500 cash index throughout the day, a fair value for the spread is calculated daily. The fair value determines the appropriate distance that the futures should be trading above the cash. The fair value spread is determined by applying a formula that calculates the dividend payments of the S&P 500, the short-term interest rate (using either the T-bill or the LIBOR [London Interbank Offered Rate]) and time decay (the time descent until the quarterly expiration) for the futures contract.

When the premium or discount of the futures to the cash becomes overextended, buy and sell programs kick in to take advantage of the discrepancy in price. Traders attempt to sell the futures and buy the underlying cash when the futures are trading at a premium to fair value, above the upper bound. They attempt to buy the futures and sell the cash when the futures are trading at a discount to fair value, beneath the lower bound.

The spread between the S&P futures and S&P cash is the best short-term directional indicator available to day traders. When the S&P futures trade at a premium to fair value, a flurry of buy orders kicks in and the market rallies. When the S&P futures trade at a discount to fair value a flurry of sell orders kick in and the market falls. Bulls are showing a burst of optimism when the premium is high, and bears are showing extreme disenchantment when the discount is low.

As a word of caution, when the futures are trading at an excessive premium or discount to cash it becomes tough to get good executions. It will also be hard to buy stock by bidding for it, if in a buy mode or to sell stock by offering it, if in a sell mode. Trading off fair value requires a quick, aggressive market order. Depending on your speed and the liquidity of the stock, sometimes you'll get good fills and at other times you won't.

Fair value is used most effectively in conjunction with other entry criteria. Going long or short just because the spread jumps above or below the upper or lower bound is faulty trading. Because it is a leading indicator, fair value is susceptible to false moves and can jump around easily when the market is quiet, especially during lunchtime.

## THE LONG BOND AND FINANCIAL STOCKS

The long bond, or the 30-year Treasury, provides a backdrop and a pulse for the fixed income markets. The long bond net and yield are important to monitor when you are trading interest-sensitive sectors such as bank and brokerage stocks, insurance stocks, Internet stocks, and any other sectors that rely heavily on interest rates. (See Chapter 9.)

Interest-rate-sensitive sectors favor a low interest rate environment because that makes money cheaper to borrow. Because bond prices and interest rates move with an inverse relationship, as bond prices fall, yields rise; the perception is that the interest-rate-sensitive stocks will fare worse. As bond prices rise and yields fall, the perception is that interest-rate-sensitive stocks will fare better.

The banking and brokerage stocks are interest-rate-sensitive and are important elements when assessing the internal strength of the broader market. When the financial sector is performing well, the S&P 500 tends to rally. If banks and brokers are fairing poorly, then the S&P 500 has difficulty holding its ground.

The financial stocks are key indicators because they have a pulse on the financial and economic health of America. When financial stocks are doing well, the perception is that America is in good shape because more people are borrowing money, investing in

stocks, and spending. When interest rates are low, money is cheaper; so the demand for loans increases, which is followed by an increase in spending. A low interest rate environment is associated with a bias on the part of the Fed toward stimulating economic growth, which bodes well for financial stocks. A strong financial sector should stimulate the S&P 500 sector, because it is comprised of America's largest companies, who borrow from the banks to spend more.

When financial stocks are performing poorly, they tend to drag down the broader market. This happens when the Fed has a tightening bias toward interest rates, usually due to inflationary fears. If interest rates are high, banks will not loan as much money because it is more expensive and demand decreases. With fewer loans being made, the spending level of the S&P 500 companies decreases and growth slows.

**Table 19-3** Banks and Brokers in Two Key Indices

*Philadelphia Bank Index (BKX)*

To view this  
image, please  
refer to the print  
version of this  
book

To view this  
image, please  
refer to the print  
version of this  
book

Perception of future action by the Fed can determine the short-term price action of the financial sector. If interest rates are raised, with a neutral bias toward raising them again in the future, financial stocks could stage a relief rally. If interest rates are lowered, with a neutral bias toward lowering them again in the future, financial stocks could stage a sell-off.

There are a few key financial institutions that you can monitor intraday and that will key you in to whether a strong or weak foundation is supporting the day's price action for the broader market. Table 19-3, shown on page 227, lists some of the heaviest-weighted banks and brokers in two key indices.

Leading indicators can be used the way a lighthouse is used in a storm: They can guide you toward your goal. They allow you to keep your eye on the prize without getting distracted by the flood of incoming information that every trader is besieged with. The arsenal of leading indicators provides you with a first look at the market internals, and alerts you to the fact that a trend you are looking for is about to begin or is about to reverse. The leading indicators tell you when not to enter into a position as well as when to enter one. With a quick glance, they can provide you with the quickest measure of short-term market direction.

# VII

P A R T

## ADVANCED TRADING TACTICS

*This page intentionally left blank.*

# C H A P T E R 20

## ADVANCED CHART PATTERNS

When scouring for day trading ideas, certain recurring chart patterns produce excellent opportunities to profit. These chart patterns work well because they provide entry points that occur within the context of a trend. When you uncover these chart patterns, you can feel confident that the risk–reward ratio leans in your favor. These patterns occur just above or below important support and resistance levels after a trend has started. They provide you with a chance to time the entry as well as an ideal place to enter your initial stop-loss.

### **THE DEAD CAT BOUNCE**

The dead cat bounce is a short-lived bounce that occurs when a stock has gapped down excessively—usually at least 10 percent or more—due to a piece of disenchanting fundamental news affecting the company or industry. The gap down is accompanied by heavy

volume and creates a gap or window between the previous night's close and the current day's opening.

The dead cat bounce is a knee-jerk reaction that kicks in off the stock's lows and offers an opportunity to go short the stock when the bounce stops on the upside. Profit takers and amateur investors are lured into buying the short-lived bounce because they think that the low prices make it a bargain. Market makers and professional traders recognize this bounce as an opportunity to sell or short the stock.

Knowing when and how a dead cat bounce rears its head will help a trader to take advantage of it from the right side of the market. It is very easy to get sucked into bottom fishing a stock that has had a large move down in a single day. Investors smell a bargain and rush in, sometimes without regard for what they are buying. The people who buy a stock after the price has corrected sharply are usually the ones who were thinking about buying it at higher levels, before the stock fell. Now that the stock is much cheaper, they jump on board, believing they are getting a deal.

Institutional investors, however, see a different story. When a stock has had bad news, and that news is reflected in its sharply lower price, many of the big holders want to partially or completely cut back their long exposure. The mutual funds do not want losers on their books at the end of the year. They may have already realized a significant gain in the stock and see this piece of news as a reason to take profits. Stocks that are battered down in a single session tend to stay down for a long time after a dead cat bounce, depending on how negative the news was.

Stocks that make new lows on heavy volume and bounce almost always retest those lows. The holders who are long the stock and witnessed a sharp reduction in the value of their holdings regret that they did not foresee that the company had problems. These holders would be eager to have the opportunity to sell their holdings at prices close to where they were before the correction. Any bounce that approaches those levels is normally met with renewed selling interest.

The dead cat bounce provides an ideal low-risk, high-reward trading opportunity. The way to trade a dead cat bounce is not to buy it for the bounce, but rather to short it after the bounce, knowing that stocks normally continue on the downward path after bad news. It is a favorite tactic of professional traders to short the dead



cat bounce, because they know that it was mainly bought by bargain hunters and shorts covering their positions.

As the dead cat bounce approaches levels closer to the previous night's close, the risk–reward ratio favors the shorts. Logically, this makes a great deal of sense. If a stock has had negative fundamental news and has moved sharply lower because of it, but then bounces to a price close to where it was before it fell, what would make it a better buy now than it was before the negative news came out? Unless the fundamental news was incorrect and refuted, it would not make much sense for the stock to be priced equal to or higher than where it was before the news came out.

A dead cat bounce begins after the stock that has gapped down has stopped making new lows. There are usually two dead cat bounces after the big move down. The first happens right away, usually on the same day as or the morning after the initial decline. This bounce reaches for the price at which the stock opened on the gap-down day. This opening price serves as resistance, and often halts the bounce dead in its tracks. After the stock bounces and halts at resistance, it reverses course and heads south again. The reversal downward after the first bounce is similar to an aftershock following an earthquake: Just when everyone thinks the worse is over, another quake hits.

The second dead cat bounce takes a little bit longer to develop, but fails nonetheless. After the sell-off following the first bounce, the stock usually forms an interim bottom. After this short-term bottom, the stock catches a second wind and attempts to rally back toward the high point of the gap-down day. This second bounce normally takes place one to three days after the initial sell-off. It is met with heavy selling from the longs who missed their first chance to sell at a better price, and from the shorts who regret not having shorted the stock on the first bounce up.

The charts in Figures 20-1 and 20-2 display a daily and an intraday picture of a dead cat bounce in EBAY. EBAY gapped down on June 14, 1999 on heavy volume after negative news over the weekend. After EBAY gapped down, the first dead cat bounce occurred in the morning during the first hour of trading. EBAY briefly rallied, as displayed in Figure 20-2 by the white intraday 60-minute candle marked 1. After this rally failed, three trading days later, on June 18, the second dead cat bounce occurred, when EBAY rallied to test the high of the gap-down day and then failed, 2 on the chart.

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-1 Dead Cat Bounce in EBAY

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-2 Dead Cat Bounce in EBAY

Three days later, on June 22, EBAY once again attempted to rally and stopped dead in its tracks at resistance, which is the top of the gap-down day. This rally is marked 3 on the chart. After one more attempt at a rally on July 1, EBAY failed and went into a downward spiral lasting 80 points.

The opening price signal and candlestick charts (see Chapters 6 and 14) are superb trading tools for tracking and taking advantage of the dead cat bounce. The first dead cat bounce that occurs during the day of the gap down can be followed using the opening price signal. Day traders should look for the first negative opening price signal at the highs of the gap-down day after a bounce to confirm that the bounce is coming to an end. When the opening price signal is negative, you have the clearance to short the dead cat bounce.

The second dead cat bounce takes place a number of days after the initial decline. After the initial decline, stocks usually gravitate higher, as displayed on candlestick charts as short white daily bodies. After the daily white bodies have been formed, look for the first daily black candlestick body, usually at an area of resistance, then go short.

The chart in Figure 20-3 shows a daily picture of a gap down in Nike (NKE) followed by a dead cat bounce. The gap down occurred on November 3. The first dead cat bounce occurred during the same day. The second dead cat bounce occurred the next trading day, November 6. The high point of the gap-down day serves as the first area of resistance and can be used as a zone for an initial stop-loss point.

Earnings surprises represent the single largest reason why institutional investors mercilessly unload stock. Earnings is the hard-core performance benchmark that mutual fund managers watch. Managers have little tolerance for companies that disappoint. During earnings season, you will find more opportunities to pinpoint and to short dead cat bounces.

## GOING LONG THE UP-HOOK

The up-hook is a chart pattern that provides an excellent opportunity to trade from the long side during a pullback within the context of a breakout. Breakouts that occur above resistance on heavy volume usually pull back on light volume toward the initial breakout zone due to profit taking. These pullbacks usually occur during the

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-3 Dead Cat Bounce in NKE

same day, and again a few days later, after the initial breakout. Both pullbacks create excellent opportunities for going long after the pullback bounces off support. The ideal area to go long an up-hook is when the hook begins to turn upward.

The base of the up-hook, which was the previous price resistance, becomes new price support.

After a stock pulls back to support for the first time, it usually halts, regains confidence, and continues on its prior upward path. Up-hook traders go long this second wave and place a stop-loss immediately beneath the support area.

The charts in Figures 20-4a and 20-4b picture an up-hook formed in Electronic Arts (ERTS). ERTS created two up-hook trading opportunities during its breakout in October 1999. The first up-hook, as displayed in the intraday charts, occurred after ERTS gapped above 75 on a breakout. ERTS pulled back to retest the breakout area of 75 in mid-afternoon, before resuming its course upward. The opening price on this day was 76. After pulling back to test support at 75, ERTS resumed its climb. As soon as ERTS traded above its opening price of 76 after the pullback, an up-hook formed and a signal to go long.

The second up-hook ERTS formed occurred six days after the initial breakout. During this period, ERTS pulled back and retested support, which was the bottom of the breakout zone at 75. Although ERTS did not touch 75 on the second try, it came close enough. Support and resistance areas are used as estimates. Remember that charting is part art and part science. The important thing to recognize on the second pullback is that ERTS was approaching support. As a day trader, it is not your objective to buy stocks that are moving against you. You should not use the support to buy ERTS; instead you should wait until ERTS bounced off the support area and started to climb higher, and then go in. This occurred on November 4, as demonstrated by the first white candle body after the pullback in Figure 20-5. Figure 20-5 is a 60-minute chart that shows why the pattern is called an up-hook. The 60-minute chart shows the first up-hook pattern occurring on November 4.

To view this  
image, please  
refer to the print  
version of this  
book

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-4a Up-Hook in ERTS

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-4b Up-Hook in ERIS



To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-5 Up-Hook in ERTS

Oscillators can be used in conjunction with the up-hook pattern, creating confirmation that the light sell-off after the breakout was really a pullback within the context of an uptrend. With oscillators, a dip beneath the oversold line and then a move up above it produces the signal that the up-hook has been confirmed and it's time to go long.

Let's say ABCD breaks out above 50 on double the normal volume. Over the next two days, ABCD climbs to reach a high of 55. At 55 the profit takers and the short sellers start selling the stock. ABCD eventually falls back down to  $50\frac{3}{4}$  on relatively light volume and a weaker broader market. The \$50 price, which was previous resistance, is now solid support. After closing at  $50\frac{3}{4}$ , the next day ABCD starts to climb higher again. Up-hook traders now go long ABCD, using a stop-loss  $\frac{1}{4}$  point beneath the support area of 50.

Trying to buy ABCD at 50 is bottom fishing. Support areas are not always clear-cut. Broader market forces could be contributing to the sell-off with a temporary disregard for the \$50 price support and could force the stock down lower. Remember that, as a day trader, your objective is to make money today, not tomorrow or the next day. Always wait for the market to confirm your view through price action. This will tell you that your opinion has been acknowledged and it's time to act.

The ideal spot to buy the up-hook pattern is not when the preceding pullback is on the way down, but rather after the stock's downward momentum has stopped. When the stock bounces off support and marches higher once again, the up-hook is formed and it's time to go long.

Candlestick charts provide a clear picture for recognizing when the trend has turned in your direction after bouncing off support. This is portrayed in the color of the candlestick. A black candlestick indicates that the momentum for the day is down. A white candlestick indicates that the momentum for the day is up.

When a candlestick turns white for the first time after testing a level of support, you have price confirmation that the support area is a valid one. When the last price crosses above the opening price, it will produce the first white candlestick body since the pullback. This is your signal to go long.

There are two entry points you can use to go long the up-hook. The first entry point is when the last price crosses above the opening price, after prices bounce off support. This is the more aggressive entry point, because there is still short-term resistance emanating from the previous day's high. When a move up occurs above the

opening price and above the previous day's high, you will have dual confirmation for going long.

When the last price crosses above the opening price, you receive a positive opening price signal that tells you to go long. Remember that you should monitor the opening price signal dynamically to give you intraday signals. A positive opening price signal is the first clue that your stock is on the move upward above resistance and that it is time to go long. When the opening price signal turns positive after the base has been formed, jump on the long side.

Your initial stop-loss can be placed in one of three areas: 1/4 point beneath the opening price, 1/8 point beneath the low price of the day, or 1/4 point beneath the support zone where the initial breakout took place. All three points are valid areas. You can use a scaled stop-loss approach if the stock you are trading is more volatile, using a combination of the stop-loss points.

The second entry point to use when going long the up-hook is when the stock trades above the previous session's high. By waiting for the up-hook to move above this point, you will have confirmation that short-term resistance has been cleared. You will also know that both the net price and the opening price signal are in your favor. One effective scaled-entry approach is to buy half of your position when the last price moves above the opening price, and buy the other half when the last price moves above the previous day's high.

The chart in Figure 20-6 is another example of an up-hook formed after Chrysler gapped above resistance on October 28. Chrysler pulled back to test support 9 trading days later and then resumed its climb, forming an up-hook. The large white candle body that formed after the up-hook above 53 was the signal to go long. When the last price crossed above the opening price at 53, it was a positive opening price signal and a signal to go long the stock.

The chart in Figure 20-7 depicts an up-hook formed in the NDX on a 5-minute intraday chart. Up-hook patterns can be captured across various time periods.

## **SHORTING THE REVERSE HOOK**

A reverse hook is the opposite pattern of an up-hook. It occurs after a stock has broken down through support, and then bounces back to the original breakdown area. The reverse hook is formed when a stock that has sold off on heavy volume bounces back toward the

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-6 Up-Hook Formed in Chrysler

To view this  
image, please  
refer to the  
print version  
of this book

Figure 20-7 Up-Hook Formed in the NDX

old support range, which is new price resistance, on lighter volume. The new resistance area causes the stock to halt and reverse course back downward, creating a reverse hook. The bounce back toward old price support is a short-covering and bottom-fishing rally within the context of a downtrend, and it is usually short-lived.

Oscillators can help to clue you in as to when a stock has reached this overbought condition within the context of a downtrend. An oscillator that climbs above the overbought line and then turns beneath it, when a stock has recently broke through significant support on heavy volume, produces a sell signal that allows you to spot and take advantage of a reverse hook.


Breakdowns that occur on above-average volume tend to bounce back toward the initial breakdown point on lighter volume over the next two to ten days. The bounce back to the initial breakdown level is normally met with heavy selling from the longs, who missed the first opportunity to sell their positions, and the short sellers, who regret not having taken advantage of the break in price earlier.

The first clue that the stock is rolling over to produce a reverse hook can be found using candlestick charting techniques. The rally on lighter volume toward previous price support after a breakdown produces smaller white candlestick bodies. The first black candlestick body to form after the white candlestick bodies is the sign that the reverse hook is forming.

After momentum has stopped at the area of resistance,

wait for the last price to cross beneath the opening price, then go short. This is the first negative opening price signal since the bounce began. When you have a short position, place a stop-loss in one of three places: 1/4 point above the opening price, 1/8 point above the high of the trading day, or 1/4 point above previous price support. All three areas are good spots to choose. You can select a combination of them to set a stop-loss on a scaled basis.

For example, WXYZ broke down beneath 35 and sold off to 32 within a day. Over the next two days it managed to rally back toward the old price support of 35, to close at 34<sup>1</sup>/<sub>4</sub>. The next morn-



To view this  
image, please  
refer to the print  
version of this  
book

ing the stock opened for trading at  $34\frac{1}{2}$  and then sold off to 34, producing a negative opening price signal of  $-1/2$  point. In this case, you should short WXYZ as soon as the opening price signal turns negative by  $1/4$  point, anywhere beneath  $34\frac{1}{4}$ . Your first stop-loss should be  $1/4$  point above the opening price, or  $34\frac{3}{4}$ .

For examples of reverse hooks after gap downs see Figures 20-1, 20-2, and 20-3.

After you have identified a potential pattern, it is crucial that you enter the stock on a watch list and follow it to its completion. It will do you no good to uncover a potential pattern only to lose track of what the stock is doing a few days later because you were focused on a different situation. Always follow up on your ideas; you can learn from them whether or not they pan out.

When you become seasoned at spotting chart patterns, you will be able to act more quickly with increased confidence. Your risk will be lower while your potential for reward will be higher. Stocks that make strong moves usually fall back within two to five days on profit taking and light volume. When this sort of pullback or bounce occurs within the context of a defined trend, it produces an opportunity for prepared traders to catch the move.

# 21

C H A P T E R

## TRADING THE GAP

A gap or window is a chart pattern that is created after a stock has broken away from the previous session's close. Gaps form the best levels of support or resistance. When gaps are accompanied by strong volume, the support or resistance becomes increasingly significant. When a stock gaps higher, the low point of that gap or window becomes price support. When a stock gaps lower, the high point of that gap or window becomes resistance.

The larger the gap, the more significant the support or resistance tends to become. Aside from providing support and resistance levels, gaps also furnish continuation, breakaway, and exhaustion patterns. The continuation gap occurs in the direction of the current trend and points toward further gains in an uptrend or losses in a downtrend. The breakaway gap is a sharp breakaway from a cur-



rent channel or trend and indicates a new trend in the making. Exhaustion gaps occur when a trend has run its course. They represent capitulation and a reversal of the current trend.

## **BREAKAWAY GAPS**

Breakaway gaps are created in response to overwhelming supply or demand for a stock triggered by fundamental news that came out overnight or early in the morning. Breakaway gaps usually occur after a stock has been range-bound for a period of time. The longer the stock has been caught in the range, the greater the significance of a breakaway gap outside that range. Breakaway gaps create a new level of support or resistance that could remain valid for an extended period of time. They can be spotted when a large gap is accompanied by a huge increase in volume and a significant piece of news that propels a stock into a new price range, creating a new trend.

The chart in Figure 21-1 shows Placer Dome Inc. (PDG) breaking above resistance at 18 with a large breakaway gap. PDG gapped up to open at  $20\frac{1}{8}$ , and then traded above its opening price to gain another 2 points. Once PDG traded above its opening price after the early morning pullback, you would have a signal to go long. On the day after the breakaway gap, PDG gapped up again to open above 25. This gap, however, closed quickly. The opening price signal (see Chapter 6) turned negative quickly after the opening, producing a sell signal. (See Figure 20-6 for another example of a breakaway gap.)

## **CONTINUATION GAP**

A continuation gap takes place during the middle of a trend and confirms that the trend is a strong one and likely to continue. A continuation gap occurs when a trend is picking up momentum and exuberance is running high. The bulls or bears, worried that they may miss the move in this stock or sector, may pile on in force. Volume increases above its average volume on the day of the continuation gap, and new highs or lows within that trend should follow. When a trend is strong, it is not uncommon for a number of

To view this  
image, please  
refer to the  
print version  
of this book

Figure 21-1 Breakaway Gap in PDG

continuation gaps to occur within that trend. Never short into continuation gaps. (See Figure 14-16 for an example of a continuation gap.)

## EXHAUSTION GAPS

Exhaustion gaps represent the end of a move. They occur at the top of an uptrend or at the bottom of a downtrend on heavier-than-normal volume. They represent a grand finale and final exuberant push of the forces behind them. Exhaustion gaps are often the product of amateurs who are late to the party. They also occur because of panic shorts in response to an up exhaustion gap, or panic longs in response to a down exhaustion gap.

Exhaustion gaps can be spotted easily with candlestick charts, because they often take the form of island tops or bottoms, rising or falling dojis, or abandoned babies. All of these patterns are reversal patterns with gaps. Exhaustion gaps also take place at levels of support and resistance. Exhaustion gaps are often accompanied by strong moves in the stock's sector, which adds fuel to the fire.

## ARTIFICIAL GAPS

Artificial gaps occur when everything about the stock is status quo: The volume is average, the price patterns are inconsequential, and the fundamentals are the same as the day before. Many stocks have an artificial gap up or down in the morning because market makers are moving the price in conjunction with what the S&P futures are doing, and because of smaller order flow. Usually, when the S&P futures have a large gap up or down opening, they pull back or bounce to fill in the gap partially or completely. Many S&P traders like to fade this sort of gap opening, counting on an early morning pullback.

As a day trader, you can take advantage of artificial gaps by fading them like the market makers do. When fading artificial gaps, it is imperative to keep your eye on the opening price signal. Artificial gaps occur mostly with a mark up or down in the S&P futures in the

morning. If the morning markup is overdone short-term, then you will receive that confirmation with the direction of your opening price signal within the first 15 minutes of trading. If a stock gaps up on an artificial markup, it will usually pull back to below the price where it opened within the first 15 minutes of trading.

You can take advantage of an artificial markup by shorting the stock when the opening price signal turns negative. You can also go long artificial markdowns by buying the stock when the opening price signal turns positive. This is a short-term trading tactic that is used to take advantage of volatility in the early morning.

Many software packages today have data displays that list the ten leading stocks that have gapped up and gapped down on the NYSE and the NASDAQ markets. The gap listings can be displayed in terms of absolute points or in percentage terms. Both are worth looking at, but the gap movement in terms of points is more effective for day traders. A stock that is low-priced could be listed as one of the highest gap openings in terms of percentage if it has gapped up small in terms of fractions. The largest gap-up and gap-down listing can be used to produce trading ideas.

## **GAP-UP SHORT**

When a stock gaps up in the morning more than 1 point above its previous session's close with no important news pumping it as a catalyst, it may be a shorting opportunity. There are five facets to monitor to determine whether the gap-up is real or artificial. The five facets to monitor are volume, price resistance or support, time, the opening price, and the AX.

As discussed earlier, artificial gaps have a tendency to be short-lived and are often the highs of the trading day. Gap-ups that are valid are the product of large institutional buyers. Positive fundamental news or important breakouts through technical resistance usually signify breakaway gaps that are not artificial.

If a stock gaps up and then sells off and remains beneath its opening price after the morning pullback has stabilized, it's possible that the stock has reached its high of the day. However, if a stock gaps up and pulls back during the morning pullback, but then ral-

lies to break above its opening price, the markup was probably not artificial and the stock should make new intraday highs.

Monitoring time, especially the first half-hour of the trading day, is tricky. Specialists on the New York Stock Exchange and market makers on NASDAQ make a good part of their profits during market openings. Many stocks pull back after a gap-up within the first 15 minutes of trading. This is because, after the initial exuberance, the smaller nonprofessional orders and the panic short covers are flushed out.

Refrain from shorting a gap-up on the opening bell. Wait for at least 5 minutes, until the market flushes out the nonprofessional buy orders and the panic short covers. When this period of time has elapsed, you'll have a clearer picture of what kind of order flow has caused the initial markup. After the first 5 minutes have elapsed, wait for a negative opening price signal (see Chapter 5) to provide you with short-term confirmation that the markup was artificial and that the short-term trend is pointing downward. Remember shorting an artificial gap up is an aggressive trading tactic, employed to capture the contra-move associated with markups on the opening.

After the first 5 minutes of trading, if the opening price signal turns from a positive signal to a negative one by at least  $1/4$  point, this is the go-ahead to go short, using a tight stop-loss point. The reason a buffer of  $1/4$  point is used for confirmation of the opening price signal is that trading with the opening price signal is not an exact science.

The best spot to place your stop-loss on the short is  $1/8$  point above the high of the day. If you are trading a volatile stock, use two areas to place protective stops when shorting an artificial markup. The first is  $1/4$  point above the opening price, for half of your short position; the second stop is  $1/8$  point above the high of the day. Traders who want to fade gap-up openings on Internet stocks should adhere to  $1/4$  point above or below the opening price as the first stop-loss point. Internet stocks often swing around wildly on an opening markup, so it is prudent to provide yourself with additional leeway by picking two spots for a scaled stop-loss.

A common fault of amateurs and professionals alike is impatience when it comes to putting on a position when the market opens. Order flow is all over the place in the first minutes of the opening, and market makers are often trading defensively, negotiating to unload unwanted positions and get orders off their desks as soon as possible.

Depending on the market-making firm, each market maker might have as few as 10 or more than 100 stocks that he and an assistant are responsible for trading. During a busy opening, a market maker and his assistant have their hands full with market orders emanating from various sources, including buy-side institutions, retail brokers, agency orders, the Internet, option firms, internal orders, and other broker-dealers. This early morning order flow causes choppiness, volatility, an undefined trend, and small inefficiencies in price. Don't let these false movements lure you into believing that something is happening when it really isn't. Choose to trade when the timing is working in your favor, not against you.

It is important to watch the volume carefully, when determining if a gap is valid. If a stock has gapped up high, ask yourself what kind of volume is printing on the tape at these levels? Does the volume warrant a move in price this high? If a stock has gapped up high, institutional block prints should hit the tape to confirm that the move is real. If institutional block prints do hit the tape and the price of the stock remains above its opening price after the early morning pullback, which usually occurs within the first 15 to 30 minutes of trading, it is an excellent sign that the stock has further to go on the upside.

On the other hand, if the stock has gapped up high but then slips beneath its opening price with no large prints hitting the tape, chances are that the markup was artificial, with the institutional players on the sidelines, waiting and watching.

During a gap-up it is important to keep your eye on the AX of the previous day to see if he is accumulating stock on the bid. Depending on the liquidity of the stock, it could take institutions with large orders several days to buy all the stock they intend to. These institutions normally give the order back to the same market maker until the order is complete.

If the stock was strong on the previous day and you identified the market maker who traded most of the volume, that market maker was the AX for that day. If that same market maker is back the next morning accumulating stock on the bid after it has gapped up, it is possible that the institution has given the market maker more stock to buy.

One of the best risk–reward trades available for a day trader during a gap-up situation occurs when a large institution takes advantage of an artificial markup to sell a large chunk of stock on the opening bell to the market maker. Market makers dread this situation, but are nonetheless placed at risk this way at one point or another. This happens when a stock is marked up and an institution offers a large block of stock to the market maker within a 5-minute window before or after the market opens.

Market makers advertise themselves as large buyers or sellers pre-opening in their largest and most active stocks. They do this through the electronic medium of Autex, Bridge, and the FIX for natural customer merchandise. When a stock gaps in the morning, the market maker often has to determine which side he wants to advertise on pre-opening. The market maker's objective is to identify the side where he thinks the institutional interest will be the greatest, and to take the opposite side in order to get the order.

If the market maker thinks that the stock will be better to buy, he will advertise himself as a seller. If he thinks that the stock will be better for sale, then he will advertise himself as a buyer. This is a risky way of capturing order flow, because it forces the market maker to take the opposite side of the short-term trend. If he misprices the merchandise, or if he is wrong in his evaluation of the trend, then he will lose money quickly. When the market maker is caught on the wrong side of the market on an artificial gap, the gap closes very quickly.

*AMAT opened up 2½ at 64⅓ bid, with the S&P futures trading 10 handles above fair value. A market maker who trades AMAT wanted to get involved. He had buyers the day before and he believed that the stock would be better for sale, so he advertised himself as a buyer on Autex pre-opening. An institution called his firm with a large order., "Dan, I see that you're out as a large buyer of AMAT this morning. I'll sell you 250,000 shares at 64 to work 500,000 behind it."*

*The market maker is now going to be long 250,000 shares of AMAT, regardless of the final price that is negotiated. The market maker countered with a  $63\frac{7}{8}$  bid for the 250,000 shares, and the institution sold it to him. After the print hit the tape at  $63\frac{7}{8}$ , the bids faded, and AMAT sold off 1 in a hurry, to  $62\frac{7}{8}$ . The market maker was able to sell 100,000 shares to the street along the way, but still ended up with a large loss.*

If a sizable print hits the tape after a gap-up and the stock immediately comes under selling pressure, chances are that this print was a seller. If a large print hits the tape in a gap-up situation and the stock runs higher, then chances are that it was a buyer—probably the reason for the gap-up in the first place. The market maker will support the stock if he has the buyer, or he will sell stock in a hurry if he has the seller. Institutions do not generally chase stocks in the direction of the gap in the early morning unless there is a fundamental reason for doing so.

## GAP-UP LONG

A stock that gaps up on the opening on positive news and heavy volume should continue to go higher. A gap-up that is accompanied by institutional buying provides an excellent opportunity to trade from the long side.

The way to tell if a gap-up is real is to wait and see if the stock trades above its opening price after the morning pullback. The morning pullback takes place sometime within the first 15 to 30 minutes of trading. If a stock that has gapped up trades above its opening price after the pullback, this produces a positive opening price signal. An opening price signal that is positive by at least  $\frac{1}{4}$  point or more after the morning pullback usually bespeaks further gains. Block prints taking place above the opening price in this case provide excellent confirmation that the institutionals want to own a piece of the stock and that the gap-up is legitimate.

In a gap-up situation, when the opening price signal is positive, after the first 15 to 30 minutes of trading, go long and use a stop-loss at  $\frac{1}{8}$  point beneath the low of the day. If the stock is a high-priced volatile issue, you can use two stop-losses in case it sells off. The first should be placed  $\frac{1}{4}$  point beneath the opening price, for half



the position; the second should be placed  $1/8$  below the low of the day. Remember that the best way to trade volatile stocks is on a scaled basis.

In Figure 19-1, on the first day after PDG gapped up through resistance, the opening price signal was positive, as represented by the white candlestick. On the second day after the initial breakout, PDG gapped up again, but produced a negative opening price signal almost immediately on the opening and throughout the day, as represented by the long dark candlestick. The second day after the initial gap up was a gap-up short.

## GAP-DOWN LONG

Unlike the dead cat bounce, the gap-down long provides an opportunity to go long after an artificial gap-down. The artificial gap-downs usually occur with light volume, and usually when the S&P futures or the NDX 100 futures are marked down excessively. Market makers gap stocks lower in this situation due to nonprofessional order flow piling up on the sell side, usually the product of panicky longs selling their positions or eager shorts chasing a stock down on the opening.

Artificial gap-downs are not associated with negative fundamental news or a move through heavy technical support. When the S&P futures are trading at a steep discount to fair value in the morning, the broader market acts as a drag, bringing other stocks down with it. This synthetic markdown furnishes day traders with a chance to buy the opening when the opening price signal turns positive.

The timing objective in trading a gap-down from the long side is to catch the morning rally, which occurs within the first 15 to 30 minutes of trading after the market has been marked down excessively. To buy an artificial gap-down, wait at least 5 minutes for the market opening orders to pan out, then watch for the last price to cross above the opening price by at least  $1/4$  point. When it does, go long, using a stop-loss that is  $1/8$  point beneath the low of the day.

If the stock is extremely volatile, use two prices for your stop-loss. The first should be  $1/4$  point below the opening price, for half of your position; the second should be  $1/8$  of a point beneath the low price of the day, for the other half of your position.

In Figure 16-4, MSFT gapped down on November 11, opening at its lows and rallying almost 7 points from there. MSFT produced a positive opening price signal after the opening, as represented by the large white candle. This was a gap-down long opportunity.

## GAP-DOWN SHORT

A gap-down short provides an opportunity to short a stock after it has gapped down in the morning. Stocks that gap down on heavy volume and negative fundamental news usually have further to go on the downside. The gap-down short is associated with institutional selling pressure in the form of block prints, which normally demonstrate that there is more force behind it.

Gap-downs that are real occur because of negative fundamental news, a technical break beneath support, an identified AX that is sitting on the offer, or some other reason. Why a gap-down occurs is not as important as knowing how to identify whether the gap is real or artificial. As a trader, you should not concern yourself with analyzing and thinking about why stocks are moving where they are moving. Instead, you should develop quick, simple methods for identifying trends and trading signals, and then take action.

To trade a real gap-down from the short side, wait for the stock to trade beneath the opening price by at least 1/4 point after the morning bounce. When the opening price signal turns negative, go short using a stop-loss 1/8 point above the high of the day.

If the stock is a high-priced volatile mover, use two points for a stop-loss to encourage a scaled method. The first stop-loss should be placed 1/4 point above the opening price, for half of your short position; the second stop-loss should be placed 1/8 point above the high of the day, for the second half of your short position.

In Figure 17-4, EBAY gapped down on June 14, and immediately produced a negative opening price signal, as represented by the long dark candlestick body. This was a gap-down short opportunity.

Gaps provide numerous day trading opportunities. They clue a trader in to new and important support and resistance levels, to trends that have picked up strength, to price inefficiencies on the opening, and to forceful breakouts and breakdowns. Gaps that occur on important fundamental news indicate that a new trend is in the making. When used correctly, gaps provide some of the best risk–reward opportunities available to day traders. Gaps provide a discernible picture that is easy to spot on a chart. When used correctly, they will increase your profitability.

# CHAPTER

# 22

## EVENT-DRIVEN TRADES

Event-driven trades represent fundamental ideas that produce opportunities to profit. Fundamental ideas always work best when price action confirms the underlying event. At times it is confusing to interpret how fundamental news will affect a stock's price. Day traders should avoid subjective interpretations and excessive analysis. If your fundamental interpretation is valid, then others will see what you're seeing and the price of the stock will change in accordance with mass perception. When the price begins to change, you will have the confirmation you are looking for. As a day trader, you do not want to be too early or too late to the party. You want to enter the party when it is in full swing, so you can quickly enjoy the best part of it.

### **THE EARNINGS RELEASE**

Earnings announcements often provide pockets of volatility that traders can take advantage of. The volatility usually begins a day or

two before the company announces, and ends a day or two after the report. A common error made by novice traders is to enter in an opening market order to buy a stock after a positive earnings announcement has hit the tape. If a stock is expected to beat the street earnings estimates, and more importantly the whisper number, then this positive news is usually factored into the opening price by the time the report is made public.

Professional traders and market makers buy the rumor and sell the news. Rumors of positive earnings start to circulate a few days or more before the news actually hits the tape. The pros trade the stock from the long side before the report, and sell their positions to the public after the report comes out on the tape.

After a positive earnings report, stocks tend to gap-up in the morning, because buy orders stack up on the market makers' desks from smaller nonprofessional investors and from traders who are short the stock in anticipation of a poor report, and are subsequently getting squeezed. A stock that has had a significant move up in price the day prior to an earnings report, and gaps higher still the morning after the report is out, could be forming an exhaustion gap that signals the end of the interim move. In many cases this is considered to be a sellable event, and profits can be taken if you are long or shorts can be initiated.

To short an exhaustion gap-up opening on a positive earnings report that had a strong run-up on the preceding day, wait for at least 5 minutes to elapse and then keep your eye on how the stock trades compared to its opening price. When the stock crosses beneath its opening price by at least  $1/4$  point, go short using stop-losses at  $1/4$  point above the opening price and  $1/8$  point above the high of the day.

If the earnings report blows away the whisper number and the stock did not move up much in price prior to the report, this could mean that the report has caught people off guard. Under these circumstances, the stock will usually move forcefully above its opening price after a gap opening. In this case, if the stock gaps up and trades above its opening price after the initial morning pullback, you should go long, and use stop-losses at  $1/4$  point beneath the opening price and  $1/8$  point beneath the low price. On gap-up earnings scenarios, always watch how the last price trades in regard to the opening price within the first half-hour or so of trading. Remember that it is during the first half-hour of trading that the

morning pullback usually occurs. If a stock can trade above its opening price on a gap-up after the morning pullback, then it is a winner.

Many times the conference call following the earnings release is even more important than the number itself. Many professional traders wait for the conference call to hear what management has to say. There are numerous occasions when stocks trade higher or lower following the immediate number, only to change direction in a heartbeat after the conference call. Sometimes the conference call is available to the public and sometimes not. Either way, after the call is under way, headlines will light up the tape, explaining what is being said. The best indication as to how the call is going is how the stock is trading on Instinet during and after the call. Remember to let the market confirm your opinion through price action. Refrain from imposing your opinion of what the stock price should do after the number is released.

EBAY's earnings release in July 1999 is a prime example of the havoc, panic, and loss that can follow a convoluted earnings release. On the day prior to the earnings release, EBAY closed at  $103\frac{5}{8}$ . After the number was reported, the stock traded as high as 110, only to reverse course to trade below 100 within minutes following the conference call. This sort of volatility is dangerous for short term traders.

Institutions generally unload a good part of their positions when a company disappoints with earnings.

Market makers who want to get involved in a big way are willing to put up sizable risk in order to get a large order in the door. When a company disappoints, market makers begin the bidding process in the late afternoon, after the report hits the tape through early morning. The market makers put out indications in Autex, showing where they are willing to buy a large piece. Market makers base their indications on where stock is currently trading in an ECN, if it is, or where price support appears to be on a chart.

*ABCD closed at 30 the night before it announced a negative earnings surprise of 10 cents per share, when the mean estimate for street was at 15 cents per share. After being halted, the stock reopened for trading at 5:30 PM, and offers immediately appeared in an ECN at 27. The following morning, 10,000 shares traded in Instinet at  $26\frac{1}{2}$ , with current bids*

*appearing at  $26\frac{1}{4}$  and offers at  $26\frac{3}{4}$ . Prior price support was 26. With the intention of capturing a buy order, a market maker put out a menu of buy indications. Because the stock had high average liquidity, the buy indications the market maker entered were:  $26\frac{1}{2}$  for 100,000;  $26\frac{1}{4}$  for 250,000; 26 for 500,000; and  $25\frac{1}{2}$  for 1,000,000. After seeing the indications, an institution called and sold the market maker 250,000 shares at  $26\frac{1}{4}$ , with an order to sell 750,000 shares behind it.*

Institutions that want to unload stock may go to the market maker with the best bid, sell stock pre-opening, and then give the sell order for the rest of the day to the same market maker. The market maker may take a hit on the first risk bid, but will usually make it back and more with the remaining sell order.

## **INITIAL PUBLIC OFFERINGS (IPOS)**

Internet Initial Public Offerings (IPOs) have created some of the most volatile trading opportunities available today. The extraordinary price swings occur so quickly that only the most flexible and seasoned of traders should consider trading them. The spreads on IPOs are often treacherous and can cause an enormous amount of slippage. Some day traders focus mainly on trading IPOs. If you are going to be trading these new issues, make sure that you have access to the best technology, and that your executions are quick and reliable.

The main way to enter or exit these issues is to do it when you can, not when you have to. This often involves bidding for them in an ECN if you want to buy, or offering them in an ECN if you want to sell. When you do bid and buy, it means that the stock will be moving against you in the short term because someone is out there hitting the bids. If you are long an Internet IPO and it starts to gain momentum on the downside, it is not uncommon for it to take several points before you can sell your position. Traders should expect the maximum amount of slippage on IPOs, and always begin with smaller positions than normal.

Because the AX is the one with the institutional buy orders, many traders attempt to shadow the AX's movements on the bid side if they want to buy, or shadow movements on the offering side

if they want to sell. (See Chapter 13.) A favorite day trading tactic is to wait for the IPO to sell off after the opening and then wait for it to stabilize with the lead underwriter on the bid. When the bids stabilize and the market begins to move higher again, many day traders try to pile on from the long side, attempting to front-run the AX by taking the offerings or bidding through an ECN.

Because the spreads are normally so wide and the pockets of volatility and momentum are so vicious, if you do go long you should immediately put out an offering in an ECN up a certain number of levels. That way, when the stock moves in your direction, you will sell it when you can, into strength.

Using a scaled approach for entry and exit is important when you are trading an Internet IPO. Rather than attempting to pick a spot and hold on for dear life, you should constantly scale into and out of your position. Maintain the discipline to immediately put out an offering once you are long. This might mean that you are putting out part of your position up 1/2 point, part of it up 2 points, part up 4 points, and so on. The last thing you want to worry about when trading Internet IPOs is the commission for entry and exit. Commissions when trading Internet IPOs can be minuscule compared to the cost of slippage and spreads.

The lead underwriter has the institutional order book coming from clients who received allocations, and so can accurately judge where the large demand lines up. These market makers are not the ones who gap the stocks up to sky-high levels before the opening. The noninstitutional market makers who specialize in Internet and retail order flow are often the ones who bid up the IPO pre-opening, so they can short the market opening orders at a high price and thus earn greater profits.

A large markup is often followed by a sharp retracement off the stock's highs. This sell-off often ends up at a lower level, where the AX, who is the lead underwriting firm, is waiting with the larger institutional buy orders.

## SECONDARY OFFERINGS

Secondary offerings occur when companies issue additional stock to the public. Companies do this because they want or need to raise additional capital. Secondary offerings increase the public float and



can be perceived as a positive or negative move for the company issuing the shares.

If the company is doing well, with consistent earnings growth in a positive market environment, then the secondary offering could be well received. If the company is doing well fundamentally, and moves forward with a large secondary offering in a weak market environment, investors may question why the company was in such a rush to unload its stock, and it could be taken as a negative sign. If the company has negative fundamentals in a weak market environment, a secondary offering could be a favorite for the shorts, and the stock might be in for a double whammy to the downside.

Profit takers and shorts love to take a shot at companies that have large secondary offerings on a day when the market is under a lot of pressure. In a situation of this sort, the investment bank that is leading the books on the secondary will do everything in its power to stabilize the offering at its issue price. This involves invoking what is called the green shoe option, which provides the underwriter with a predetermined quantity of shares to use in order to stabilize the stock at or below the offering price. It is up to the investment bank whether to invoke the green shoe, and how much of the green shoe to use.

In a weak market environment, sellers hit the stabilizing bid with size, using the liquidity to take advantage of what they believe to be an artificially high price. In a well-received secondary that opens in a strong market environment, buyers go long, using the spot where the secondary was priced as a stop-loss, knowing that the stabilizing bid should be there to defend the stock.

## **STOCK SPLITS**

Going long a stock that has announced a stock split has gained so much popularity for retail investors in the bull market that a markup the morning after the news has become a self-fulfilling prophecy. Stock splits are usually announced after the close, along with an earnings release, when a stock has been performing well. A stock split is a marketing strategy utilized by the company to create the impression that its stock is more affordable for the average individual investor. A stock split, however, does not create any additional value whatsoever.

Shorting the markup following a stock split announcement is a risky and dangerous move. Stocks are usually better to buy up until the actual day or two following the split. If you want to short a stock split, wait until after the split has occurred and then use a stop-loss  $1/4$  point above the opening price. If the stock is volatile, use two stop-losses: the first at  $1/4$  point above the opening price, and the second at  $1/8$  of a point above the high of the day.

The best time to trade a stock split from the long side is after the stock has pulled back following the initial markup. The most important thing to remember when trading a stock split from the long side following an announcement is to wait for the opening price signal to be positive. This will be your first clue to go long. The opening price signal may not be positive for a day or two after the announcement, if the initial markup was too extreme. The lower part of the window caused by the gap-up should serve as the first area of price support and can be used as a potential target for entry. (See gap-up long and up-hook techniques in Chapters 20 and 21.)

To trade a stock split announcement from the long side, wait for the last price to cross above the opening price by at least  $1/4$  point or more; then go long, using a stop-loss  $1/4$  point beneath the opening price. If the stock you are trading is volatile, choose two places for stop-losses. The first is  $1/4$  point beneath the opening price, and the second is  $1/8$  point beneath the low of the day.

The best time to trade a stock split from the long side is after the announcement but a day or two immediately preceding the split. At this time, the stock has normally already pulled back from the initial exuberance following the announcement, and it is ready for a second wave of buyers leading into the split, especially if the broader market is strong.

On the day of the actual split, the stock can act weak due to traders taking profits or shorting the stock. Often, the split is old news on the day it takes place. Remember that the professional traders tend to buy the rumors and sell the news. Let price action confirm your opinion, regardless of the fundamental news.

Over the long term, stocks that split normally trade higher because there already exists a strong underlying force that bid up the stock in the first place, allowing it to declare a split.

Splits occur during periods of high demand. However, if a company delivers numerous splits within a relatively short period of

time, it is not necessarily positive news for the company. It can indicate that the company is splitting its price as much as it can quickly because it believes that the run-up is coming to an end. This phenomenon was witnessed during the Internet run-up preceding the sell-off of the spring and summer of 1999. Many of the split announcements took place rapidly, one after the next, and were eventually met with a strong selling force because they were perceived as indications that a top was near.

Always rely on technicals and a game plan to provide you with an assessment of what to do. It is easy to get lured into a trading situation because of news or rumors. A common mistake made by professional traders is to buy or sell a stock because the story was great, when in fact under normal circumstances they would not be in the stock to begin with because the price action and volume did not confirm the trading idea. Price action will always tell you how the public perceives a fundamental event such as a stock split. Refrain from doing the obvious and comfortable thing when trading off fundamental news. Whenever you can, trade when the technicals and fundamentals work together in harmony.

*This page intentionally left blank.*

# VIII

P A R T

## PSYCHOLOGY

*This page intentionally left blank.*

# CHAPTER 23

## THE TRADING MIND

All the great traders attest to the impact psychology has on trading. Many believe that psychology has the greatest impact on trading decisions. Crucial psychological elements, both conscious and unconscious, affect the decision-making process for traders. Many of these mental elements and psychological profiles are ingrained from childhood, and traders are unaware of them. Prices move with emotional extremes, triggered by psychological associations with gain and loss. The first step toward successful trading is developing an awareness of the influence of psychological and emotional factors on your actions.

### **NO FEAR**

*There is only one thing that makes a dream impossible to achieve—the fear of failure.*

THE ALCHEMIST

Fear is perhaps the most debilitating emotion a trader can experience. Painful memories produce fear, which warps a trader's focus. When you are afraid to lose for one reason or another, you will end up focusing on loss and, by doing so, will attract precisely the opposite of what you hope to avoid.

When you operate out of the fear of being wrong, you are focusing your energies in a losing direction. Fear is the main reason traders cut their profits short and let their losses run. With winning positions, traders fear that they will lose what they have gained. Because of the fear of loss, they look for signs that indicate that the trade will reverse course, instead of looking for reasons why it should work out. They eventually find a reason that confirms their fears, so they cut profits short instead of letting them run.

The fear of loss is a double-edged sword that will convince a trader to do the wrong thing not only when you have a winning position, but also when you have a losing position. If you have a position that is going against you and is losing money, your fear of loss will cause you to look for signals that the trade will work, because you do not want to accept the fact that you are experiencing loss. Because of this fear, you will let the loss run instead of accepting it and quickly cutting it short.

The Reticular Activating System\* (RAS) is a mechanism in your brain that determines what you observe and how you pay attention to it. The RAS attracts information to support what you are focusing on and alters your conscious experience. An example of the RAS in action is when you suddenly notice an item that you just purchased everywhere.

If you believe that you will win at trading and you focus on where you want to go, then the RAS will attract information that supports your focus and belief. On the other hand, if you continually harbor fear in your heart about losing money on a position, your RAS will draw pieces of information that support your fear. If you enter into a trade that is working but you are afraid to lose what you have gained, the RAS will feed off the emotional intensity of fear, and will attract you to information on why the trade might not work, encouraging you to cut your profits short.

Because your brain can only focus on a limited number of items at once, the RAS blocks out whatever it does not hold important. It

---

\*Robbins, Anthony. *Awaken the Giant Within*. Fireside, New York City, 1991, p. 287.



filters out the noise it believes to be unimportant to your priorities. When you are trading stocks, innumerable tidbits of information about the market come streaming in, all of which require your interpretation. Because it is impossible for your brain to absorb all of the information coming at you at once, your RAS will determine what you will notice. When you focus on where you want to go, the RAS will block out information that is nonessential for you to achieve your objective.

Anthony Robbins describes fear as "...the anticipation that something that's going to happen soon needs to be prepared for." Regardless of whether the event ever takes place, fearful anticipation is a reality. Preparing for the anticipated event beforehand is a crucial step toward managing fear. The worst thing a trader can do is deny that fear exists. Fear delivers a message that will not disappear until it is acted on. *Action cures all fear.*

If you relinquish control to fear, then you allow it to increase its grip over your actions. If you ignore fear completely, then you are not respecting the potential value behind its message. The first step toward managing fear is to acknowledge that it exists. Be aware of its presence and determine what steps you need to take in order to diminish its power.

Fearful emotions in trading range from small quantities of worry, unease, and apprehension to extreme levels of anxiety, panic, and horror. The associations a trader has developed about what a loss means to you on a personal, professional, or financial level will dictate your various levels of fear. The very best traders are comfortable with the notion that they can lose it all. This acceptance of and detachment from loss eliminates a large part of their fear. Because their fear is managed, they have the mental freedom to focus their energies on winning.

One of the best recipes for conquering the fear of loss is to prepare for the loss beforehand with proper risk control. Detachment from loss comes with the knowledge that you can financially withstand to lose everything you have riding on your current positions. If your liquid net worth is \$500,000, and you have a large percentage of that riding on a few positions without an adequate stop-loss risk profile, the fear of loss will be magnified dramatically. This holds true especially if you are trading stocks that are volatile and less liquid, with a large slip-page factor.

When a day trader is trading with high levels of margin in volatile stocks, and the lion's share of his portfolio is riding on a few positions, his level of fear will be magnified because a loss under these circumstances will mean a lot. If he loses under these circumstances, it will be easy for him to get caught up in a losing cycle. Desperation may set in and he will trade emotionally and subjectively to win back what he lost. The emotions he will experience at this point are not just fear of financial ruin, but also feelings of guilt, shame, and unworthiness. Under these circumstances, his confidence and conviction will be close to zero, which just happens to be the very worst time to be trading.

When you invoke the financial discipline to trade with only a portion of your liquid net worth, and use a stop-loss risk profile of about 2 percent of your portfolio, then your fear of loss will be substantially reduced because you can afford to lose. This requires keeping expectations realistic about the amount you can expect to earn from trading, especially when you are just beginning.

If you have \$500,000 in liquid assets and you earmark 20 percent or \$100,000 to trading, using a \$2,000 maximum stop-loss level per day, you have made a realistic preemptive strike against fear of loss. As you trade this money and if you are successful, you can reinvest your gains and use the profits to expand your base for larger trades.

Managing and reducing the fear of loss also requires a willingness to understand and accept the fact that the money you have invested in day trading is money that you may never see again. When you come to this understanding beforehand and you are willing to lose the money, then you will not be attached to or afraid of loss. When you trade in this state of mind, your chances for success increase because you are free to act objectively, without hesitation or inhibition. When you reach this state, you are levels ahead of most of the other traders. Don't be afraid of the worst-case scenario when you are trading. If you understand that failure is a natural and necessary part of the trading process, you will have increased confidence to take risks and to cut losses quickly.

## **LISTEN TO THE MARKET**

The current price of the market represents the belief and perception of all the traders who are participating in the market at the

current time. The last price represents the emotional unanimity of the masses that are currently acting on their perceptions. The reason a stock or the market has reached a certain price level is irrelevant. Price action represents the interpretations of all the players, whether they are valid or not. If someone has inside information about a stock and acts on this information, the price action will be portrayed for all to see. Information that is acted upon cannot be hidden, because price and volume will always uncover it.

Being right and making money when you are trading can be two separate issues. Your goal as a day trader is to make money, not to be right. Prices move in the direction of the strongest energy behind them. When you listen to the force behind the prices and jump on board for the ride, your actions will not conflict with the market's opinion. For example, suppose you have done research on a company and you know that it is undervalued relative to its peers. Because of your conclusion, you buy 5,000 or 10,000 shares, only to watch it drop two points. Who was right—you or the market?

Waiting for the market to confirm your initial opinion is crucial. The market provides clear signals for the best course of action, regardless of your opinion. You must let go of any preconceptions about what the market is going to do, and instead remain focused on what the market is doing here and now. The clues and signals about what is happening are readily available to all who are willing to put aside their opinions and listen to the market instead.

To increase your ability to listen to the signals of the market objectively, you should develop a mental state of mind that Deepak Chopra calls detached awareness. Detached awareness occurs when you observe what's going on with little at stake to your ego. Detached awareness occurs when you step outside of yourself and calmly observe your actions. For the trader, this detachment means abandoning your associations about what a stock's move will mean for you emotionally, financially, and personally.

## **ACCEPT RESPONSIBILITY**

Taking responsibility for all your actions and all your trades at all times, regardless of the rhyme or reason, takes a great deal of matu-

riety and can be a hard thing to do. Even if something happened that was outside your control, act as though you alone were responsible for the outcome.

You alone are in control of your mind, and therefore your actions and your results. When you accept responsibility for all your actions, you will be empowered with the ability to choose how you want things to be. You alone will be the cause and effect for your outcomes.

Time and again, traders rationalize their actions by passing the buck for something that went awry onto someone or something outside of themselves. Rationalization has a corrupting influence on a trader, because it encourages you to dodge responsibility. There will always be excuses and reasons why a trade or anything in your life did not work out the way you planned or hoped for. The strongest traders are the ones who recognize that excuses and rationalizations are folly.

As soon as you relinquish responsibility by rationalizing your actions, you lose the power to learn from your mistakes, which is the best way to learn. You can always think up reasons for holding on to a loser or adding to a losing position. Even when your reason for doing the wrong thing is sensible and learned, if you do not accept responsibility for the loss, you will not learn from it.

Rationalization forms a barrier between what you know is the right thing to do and what you hope will ultimately happen. It indicates that you are having trouble admitting that you are wrong. When you catch yourself making excuses for things that went wrong, it is a sure sign that your ego is swelling up and getting in the way of your improved future performance.

You immediately empower yourself as a trader when you accept the consequences of all your actions, regardless of how painful it might be to do so. Trade with the belief that you are the cause in your universe of trading results. Do not believe for a second that there is such a thing as an accident in trading. When you accept the principle of cause and effect, you will be empowered to take responsibility for everything that happens on your trading pad and in your life.

There will be many times when you are faced with a situation you do not want to take responsibility for, one that may not be your

fault. Some common excuses in trading include faulty trading systems, slow executions, backing away, an assistant who made a mistake, misinformation, false rumors, listening to others' opinions, and fuzzy thinking. Many of these could be valid, but resist the urge to fall back on them.

When you do not accept responsibility, you relinquish the power to make things different in the future. This is a short-term fix used to alleviate discomfort, but a long-term blunder. When you accept responsibility for everything that happens in your life, you empower yourself to create the trading world you would like. By accepting responsibility for your trades, you empower yourself to consistently improve your performance in the future.

## **GREED IS AN OBSTACLE**

Webster's dictionary defines greed as excessive or reprehensible acquisitiveness. The problem with greed is that it feeds on itself and fosters a state of lack: the opposite of what you are trying to achieve by being greedy. When you are driven by greed, as you attain more you want more, so you have less instead.

Wanting can actually be defined as a state of lacking. When you want something badly, your brain is sending you signals of destitution. If you live in a state of wanting something, then you will attract scarcity. Whatever you focus on and attach emotional significance to expands in your life. If you are driven by greed, then you are trading in a state in which you are constantly aware of what you do not have. This is called poverty consciousness, and it will work against your goals of creating abundance in your life.

Greed indicates that your attachment to money is ironclad. It arises from the belief that you lack something because there is not enough to go around. This belief is destructive and false. The universe's natural state is one of abundance and wealth. Deep down, if you did not believe this was true, then you would not be trading with the objective of fulfilling your potential. Greed is unfulfilling because there will never be enough to satisfy what you believe you lack, so the more you get, the more you believe you need.

Greedy traders are attached to what money represents to them on a personal level. Most people go through life with the belief that

money and the material objects that it secures represent the acknowledgment, approval, and validation of others. The thirst for approval is one of the strongest emotions human beings experience. These feelings are ingrained from early childhood and are dominant in the subconscious.

The quest for approval causes traders to act in all sorts of weird ways, disregarding their trading plans in the search for the stronger desire to attain approval in all forms—from their peers, their parents, their childhood teachers, themselves; the list goes on. Acknowledging the fact that you are seeking approval and recognition in a given situation is the first step toward releasing that emotion, which will provide you with freedom to trade objectively and without greed.

## CONQUER FRUSTRATION

Traders make some of the worst decisions when they are frustrated. Frustration clouds thought and destroys objectivity. Frustration is a state of insecurity or discontent stemming from unconcluded problems or needs that have not been fulfilled. This dissatisfaction can be commonplace among traders who are experiencing losses. It is very easy to become frustrated when you are trading. Hundreds of factors in trading can leave a door wide open to feelings of frustration.

Trading is one of the most intense and physically demanding occupations. With so much dependent upon technology, and with so much at stake, little mishaps can pile up to create a state of agitation and frustration. Frustration is a common emotion in trading because so much effort is put into preparing for the moment when it's time to trade. Because loss in trading is natural and common, a trader can get frustrated quickly if you experience a string of losses without experiencing any reward.

The perpetual motion of markets and prices causes discrepancies in price that will often test a trader's mettle and conviction. If you let yourself become frustrated due to a lack of immediate results, you are setting yourself up for a blurred subjective vision. When you experience frustration, realize that it is a sign for you to complement your approach to trading with increased flexibility and patience.

Your success as a trader at times hinges on your ability to conquer frustration. Frustration will always appear on your path toward greatness. Some will triumph over it, while others succumb to its pettiness. When you encounter obstacles on your trail toward achieve-

ment, remind yourself that they were placed there in order for you to overcome them, so you can learn from them and become better than you were before. Remember, little things affect little minds.

## **DON'T LOOK BACK**

Regret is a poisonous emotion that traders experience all too often. It can be very painful to watch a stock move forcefully in your direction after you missed the chance to get on board for one reason or another. Because of the vast number of trading opportunities in the market, it is impossible not to miss many of them.

Let go of regret and instead treat yourself kindly when trading. Do not beat yourself up for having missed an opportunity. Remember that there will be many, many more chances for winning trades. Regret is toxic because it encourages you to look back and to focus your energies on the past, when you should be using your valuable time and energy to focus on the here and now in order to uncover trading opportunities.

When you acknowledge that you are feeling regret, then you have taken the first step toward diminishing its power over you. Regret can serve a purpose when you admit that it exists, learn quickly from its message by accepting responsibility, and then pardon yourself and move on.

Rather than living in the past by regretting what could have been, resolve to live here and now, in the present. Remind yourself that if you could have taken action, you would have. Excuses have no place in trading, because in the end they never make a difference anyway. Admit to yourself that for some reason, something within you prevented you from action. Only you know what it was, and only you can fix it. By accepting responsibility without blaming yourself, you will learn from the experience and develop into a stronger trader, without regret. Growth in trading is a continuous process. There is always room to become better, so give yourself the space to breathe and to learn unencumbered by feelings of regret.

## **EXUDE CONFIDENCE**

The best traders are successful because they are able to maintain unshakable confidence in themselves and in their decisions. This serene self-confidence creates a positive state of mind and the will to act.

There is an old saying: "If you would be powerful, pretend to be powerful." One technique for developing confidence when you are trading is to role-play. Think of a confident role model, preferably a successful trader whom you look up to, and pretend to be that trader. Imagine that you have the power to act decisively when trading, without hesitation, letting your winners run and cutting your losses short. This will transform the way you perceive yourself and how you make your decisions.

We communicate more with our body language and tone of voice than with our words. When your body language and voice portray a confident person, then people will respond to you as if you were a confident person. Practice sitting, talking, and acting confidently in everyday life and watch your conviction and decision-making process on the trading desk improve.

Exercise also substantially boosts your confidence. When you feel positive about yourself and how you look, you are more inclined to act confidently. Exercise also has a number of other positive side effects for traders, including alleviating stress and reducing anxiety. Because trading is such a physically demanding occupation, you owe it to yourself to exercise as often as possible. Consider exercise an investment in your trading career.

Dress well when trading, because looking good will increase your self-esteem. High self-esteem will positively affect your everyday decisions and help you feel more optimistic in general.

Developing confidence in yourself and in your actions is a continuous, lifelong process. This is an area that you should devote time to every single day. As your confidence increases, you will feel better about yourself and the world around you. As you practice using a confident tone of voice and body language on a regular basis, that confidence will be readily accessible when you need to use it in your decision-making process. When you look, sound, and act confident, you yourself will believe that you are. Others also react to you as a confident person, which in turn will empower you.

## **MAINTAIN PROSPERITY CONSCIOUSNESS**

Deepak Chopra says that "all relationship is a reflection of your relationship with yourself." If you feel guilty or insecure about hav-

---

\*Chopra, Deepak. *The Seven Spiritual Laws of Success*. New World Library, 1994, p. 19.



ing wealth or good things in your life, those feelings are a part of your character that you have to address. Profitable trades will not solve these issues. As a trader, an important question to ask yourself is whether you feel that you truly deserve to be wealthy. This question must be answered honestly. If you do not believe you deserve to be wealthy, sooner or later you will sabotage your chances for success.

Many people carry around feelings of unworthiness ingrained from childhood. These feelings often stem from the association parents or a religion attaches to money. The first step toward changing these destructive and unrealistic feelings is awareness. Only when you allow these feelings to surface consciously can you address them, release them, and let them go.

You are your own harshest critic. The feelings of guilt and shame that people carry around have no bearing on reality. People may have distorted memories of how they injured or hurt someone else, when in fact that was not the case. To achieve success in life, you have to learn to have compassion for yourself. Feelings of self-worth translate into positive outer manifestations in all areas of your life. Those who feel that they deserve only the best in life attract other people and circumstances to themselves that will confirm those beliefs. When you understand that abundance and wealth are the natural states of the universe, and you recognize that you deserve to be wealthy, your actions will begin to model your inner beliefs.

## **SECURITY IS AN ILLUSION**

Are you trading for security? If you are, you may be in the wrong business. If a trader is trading with the objective of being secure, you are juggling two opposing forces. You are attempting to derive stability and safety from market forces that are inherently unstable and insecure.

Is there such a thing as security? Helen Keller said, "Life is either a daring adventure or nothing at all." If you are attached to the concept of security, it will have the effect of making you feel insecure. An attachment to something outside of yourself is unfulfilling, because you feel empty without it.

There is no security in the markets. Time and again, some of the so-called smartest names in trading have gone bust practically overnight.

When you are trading for security, you are attempting to keep what you have because you are afraid to lose. This fear will inhibit your actions and will make you a less effective trader. When you fear losing, you will actually create losses. You will be unable to cut your losses when they are small, and you will miss great trading opportunities because you are afraid to lose.

The same fear of loss infects the actions of people in everyday life, holding them back from living the lives that they always dreamed of. Security is a very fleeting thing and can never come from money itself. Attachment to money or profits creates anxiety and a feeling of lack. This attachment means that your sense of well-being is dependent upon something outside of yourself, which there could never be enough of. If a person cannot afford to lose, fear and attachment will always reign.

A good question to ask yourself is what is the worst that could possibly happen to you, the worst outcome that you can imagine? You've managed to live up until now. You've always been provided for and cared for, or else you would not be reading this book. There has always been enough food on the table. Life will go on. You will be okay.

The acceptance of loss puts into perspective the fact that each trade is only a single trade in the design of things to come. Ten years from now, when you look back at the loss, it will seem like an insignificant speck, a learning experience that happened for the best. The only thing that is sure in trading is that you'll win some and you'll lose some. The markets will always change. Nothing is permanent.

The samurai lived by the code of the warrior, or Bushido. Bushido dictated their lives and provided a discipline and philosophy for them to live by. A famous samurai of the seventeenth century named Yamamoto Tsunenori wrote a book called *Ha Gakure* or *Hidden Leaves*,\* in which he summed up the Way of the Warrior as resolute acceptance of death, or as we'll call it, resolute acceptance of loss. Tsunenori said the way of the warrior *is* death. What does this mean? Tsunenori said that "...to die having failed is not a shameful thing. It means that if you keep your spirit correct from morning to evening, accustomed to the idea of death, and resolved on death, and consider yourself as a dead body, thus becoming one with the Way of

---

\*Musashi, Miyamoto. *The Book of Five Rings*. Bantam Doubleday Dell, 1992.

the Warrior, you can pass through life with no possibility of failure and perform your office properly." When the possibility of death or failure is accepted, which everyone will face eventually, then what is the worst that could happen to you? If you are trading with money that you can afford to lose, then you have accepted the worst-case possibility up front. Anticipation of failure or loss is worse than loss itself. Not being afraid to fail or to lose is true freedom.

*To foster life all must be killed.  
Once all is killed you can dwell at ease.  
If you understand this meaning,  
an iron boat will float across water.*

ZEN SAYING

## WRITE DOWN WHAT YOU WANT

*You have to be specific with your goals because the universe will deliver what you want. The universe will give you what you dwell upon. If you dwell upon ambiguity it will give you just that.*

TAD JAMES

Write down your trading goals, and be as specific as possible. The goals need to be measurable, so when you achieve them you will know it. Remember to be very specific. Once your brain has the target, it can begin to figure out ways to best achieve it. Your profit and loss objectives should be broken down into yearly, monthly, weekly, and daily goals.

Develop goals for all areas of your trading development. Focusing on the reward aspect of trading alone is a faulty approach. Certain areas of your trading approach will require more development than others. Only you know what you need to work on the most. This requires honest introspection and diligent analysis.

You may be an expert at letting your profits run, but you may have trouble cutting your losses or taking profits. Perhaps you chase stocks past your ideal entry point too often, or it could be that you are not aggressive enough at executing trades. At the end of the day, record in a journal the correct and incorrect trades you made throughout the day, so you can learn from them. Keeping a daily journal is a potent way to zoom in on your strong and weak points as a trader. Once you are aware of shortcomings as a trader, you can convert them into positive written goals.

All your goals should be written down in the present, as if you have already achieved them. When working with goals, act and feel as if you already have that which you are seeking. When you act and feel and believe that you have achieved your goal, your confident state of mind will reject the obstacles that stand in your way. If your objective is to earn \$100,000 a month, write down the goal as follows: "I now earn \$100,000 a month trading." If your objective is to stick to your stop-loss criteria, then your written goal could be: "I always stick to my prearranged stop-loss points." Read these goals out loud in the evening before you go to sleep and in the morning when you wake up. When reading them, use as much emotion as possible so you can work yourself into a state of experiencing the outcome.

Your trading goals should be as realistic as possible. If you do not believe inside that you can accomplish the result, then it will be hard for you to internalize it. A goal that is unrealistic is discouraging. The way to make your goals realistic is to start where you are today. Decide what specific action you can take and what sort of results you can expect to receive from that action. Begin with a more conservative goal for the near term. Use your past achievements as the immediate benchmark for what you can expect in the future.

Your goals need to be timed toward your objectives. Setting specific dates is very important. Once you write down and commit to a deadline, your brain takes over, sometimes in mysterious ways. We use only a very small part of our brains consciously. Having a written goal accomplishes amazing things. Write out your goals as far as possible into the future, with as much detail as possible.

Remember that you should always judge yourself by your goals only, not by anyone else's. What others are doing or have done should be of no concern to you. Financial goals in day trading can range from as little as \$200 a day to over \$1,000,000 a day. Just remember that it is important to maintain realistic expectations about your abilities and your resources.

Psychology has a powerful impact on trading results. It is impossible to separate your psychological makeup from your results. Being aware of the way your mind works is the first step. You must know your own strengths and weaknesses before you can hope to grow stronger and to overcome the obstacles that will inevitably appear in your path toward trading greatness.

# CONCLUSION

This book was written with the goal of carefully laying out the various ingredients it takes to trade successfully. As you practice applying its principles and techniques, your profitability will increase and you will develop progressively as a trader. This book's themes are applicable to all traders, not just NASDAQ market makers or day traders.

Trading on the right side of the market and profiting from it requires a different set of talents and traits than intellectual brainpower. The traits and talents required to succeed as a day trader involve using your brain in a different way. The internal qualities necessary are often hard to develop and to maintain, because they are often the opposite of what most people have acquired growing up. They require constant maintenance and fine-tuning for the rest of your trading days. Some of the qualities are mental discipline, courage, confidence and conviction, detachment from the outcome, a small ego, acceptance of loss, patience, acceptance of responsibility for all your actions, open-mindedness, and a strong belief that you deserve to prosper.

Thinking too much when day trading will only confuse you. Intellectuals are usually poor traders. For example, if you use your brain to think about the great bull market of the 1990s, do you come to the conclusion that the astronomical valuations really make

sense? Would you have surmised that it is rational for people to be paying hundreds, even thousands, of times what a company earns because of future speculation? Maybe you would have thought it rational and maybe not.

If you spent your time thinking about it too much, you probably would have had a hard time deciding to trade—thus you would have ended up missing a large part of the most profitable bull market in history. Even worse, those who did not think that the valuations were reasonable and acted on those thoughts by shorting the roaring bull at the wrong time ended up losing fortunes—because they allowed their doubts to creep up and to cloud their objective day trading vision as confined by price action.

The characteristics that make a market maker or any trader successful are grown and nurtured from within. It is rare to find a successful trader who started out successful. The best way to learn is by making mistakes, often more than once. Many of the greatest traders started out by losing all they had. Many of them were able to ride out the storm in the beginning, only to lose everything once again because they allowed old bad habits to disrupt their game plans. The process of learning to trade requires action in the form of capital commitment. Many beginning traders do not last because they do not have the funds to survive after learning the lessons the hard way, without proper risk control.

The qualities that make a trader successful will work for you whether you are a market maker trading NASDAQ stocks or a day trader trading S&P futures. Just as success is an attitude, trading is a discipline.

Learning to trade is like tuning a piano. Piano tuners don't simply tune a piano once and then leave it for complete. They tune it once a week for a number of weeks. After that, they tune it once every two weeks, then once a month, then once every six months for the rest of its life. Through consistent application, piano tuners refine and reinforce the tunes they taught the piano on the first try.

A successful trader has to do the same thing. The fine-tuning process never ends. You must always strive to develop profitable trading habits. This can be accomplished through the application of discipline and patience, combined with open-mindedness. Trading is a way of life, not just an occupation. It is impossible to separate who you are as a person, including your thoughts and beliefs, from your results as a trader. As you make the effort, there will always be new insights. The way to success is through continuous training.

# INDEX

- Abandoned baby reversal pattern, 147, 157  
Accumulation/distribution (A/D) line, 216-219  
Action, 27  
Activity ratios, 80-81  
Advanced chart patterns, 231-247 (*see also* Chart patterns, advanced)  
Advanced trading tactics, 231-267 (*see also* Trading tactics, advanced)  
Alpha risk of stock, 23-24  
Amortization, 72  
"Analysis paralysis," 93, 137, 192  
Anticipation, danger of, 110  
Artificial gaps, 251-252  
Autex, 22, 256  
Averaging down, myth of, 29-30, 33, 107  
AX as leading indicator, 165, 254, 264
- Basket trading, 24  
Bearish engulfing reversal pattern, 147, 182, 184-185  
Bearish harami reversal pattern, 151
- Beta risk of stock, 23-24  
Block prints, 210-213 (*see also* Volume)  
Body language, 280  
Bollinger bands, 173, 175, 191, 192-195, 196  
Bond prices and interest rates, inverse relationship of, 89-91, 226  
    yield curve, 90-91  
Bottom fishing, 28-29, 107  
Breakaway gaps, 249, 250  
Breakdowns, 173-177, 178  
Break-even stop-loss, 19-20  
Breakouts, 171-173, 174, 175, 176  
Bridge, 255  
Bullish engulfing reversal pattern, 147, 179, 180, 181, 200, 202, 203  
Bullish harami reversal pattern, 151
- Candlestick charting techniques, 137-160  
    advantages, 140, 159  
    closing price, 142

- Candlestick charting techniques (*Cont.*)  
 volume-weighted average price (VWAP), 142  
 construction, 141  
 continuation patterns, 156-160  
 dead cat bounce, 236  
 emotional impact on stock price, 137-138  
 and exhaustion gaps, 251  
 going long the up-hook, 242  
 high price, 142-143  
 history, 140  
*Japanese Candlestick Charting Techniques*, 140  
 low price, 143  
 opening price, 141-142  
 "fading," 141-142  
 reversal patterns, 143-156  
 negative selection, 144  
 technical analysis, value of, 137-139  
 "analysis paralysis," problem of, 139  
 as footprint of market, 159
- Capital expenditures, 72
- Cash flow, 71-73
- Catalysts, fundamental, 67-73  
 amortization, 72  
 analysis, avoiding excessive, 67  
 capital expenditures, 72  
 cash flow, 71-73  
 depletion, 72  
 depreciation, 72  
 dividends, 72  
 earnings momentum, 70  
 earnings surprises, 68-69  
 earnings velocity indicators, 70  
 five-year earnings potential, 70  
 growth ratio, 70  
 income tax expense, 72  
 institutional trader, understanding action of, 68  
 interest expense, 72  
 net income, 71-72  
 new method of earnings release, 69-70  
 operating income (EBIT), 72  
 sequential growth rate figures, 70, 73
- Centralization of order system, 128-129
- Chart patterns, advanced, 231-247  
 dead cat bounce, 231-236  
 candlestick charts, 236  
 institutional investors, 232  
 as low-risk, high-reward trading opportunity, 232-233  
 opening price signal, 236  
 going long the up-hook, 236-243  
 candlestick charts, 242  
 shorting the reverse hook, 234, 235, 237, 243-247  
 oscillators, 246
- Chart patterns, using, 43, 137-160 (*see also* Candlestick charting techniques)
- Charts:  
 as art and science both, 186, 190-191, 238
- candlestick charting, 137-160 (*see also* Candlestick)  
 patterns, basic, 171-189  
 breakdowns, 173-177, 178  
 breakouts, 171-173, 174, 175, 176  
 double bottom, 177-179, 180, 181  
 double top, 179-185  
 head-and-shoulders top, 186, 187  
 reverse head-and-shoulders bottom, 186, 188  
 profitability, increasing by using, 189  
 using to indicate support or resistance levels, 167-170
- Clean-up prints, 213-214
- Confidence, expressing, 279-280  
 dressing well, 280  
 exercise, importance of, 280  
 role-playing, 280
- Consistency, essential, 31-32
- Continuation gap, 249-251
- Dark cloud cover reversal pattern, 152, 153
- Day trader, managing money to succeed as, 3-11  
 (*see also* Managing money to succeed as a day trader)
- Dead cat bounce, 231-236 (*see also* Chart patterns techniques)
- Depletion, 72
- Depreciation, 72
- Detrimental mind games, 26-35 (*see also* Mind games that spell financial havoc)
- Diversifying positions, 23-24
- Dividends, 72
- Dojis, 147
- Double bottom reversal formation, 177-179, 180, 181
- Double top reversal formation, 179-185
- Dow Jones Industrial Average, 220, 221
- Dragonfly doji reversal pattern, 147
- Dressing well, 280
- Early morning contra move, 113, 120
- Earnings release, 260-263  
 new method for, 69-70
- Earnings velocity indicator, 70
- Economic indicators, effect of, 84-88
- Economic numbers and their effect on day trading, 82-91  
 bond prices and interest rates, 89-91  
 yield curve, 90-91  
 Federal Reserve Board, monetary policy of, 83, 84, 88-89  
 Federal Funds Rate, 89  
 Federal Open Markets Committee (FOMC), 88-89  
 indicators, 84-88  
 and U.S. dollar, 83-84



- 8-period moving average, 40, 51-57, 167, 197
- Electronic Communication Networks (ECNs), 122, 131-132
- Emotional catalysts, impact of on stock prices, 137-138
- Emotional pitfalls of trading, 5-7, 10, 33
- Engulfing reversal patterns, 147
- Entry, 103-113
  - anticipation, danger of, 110
  - buffer ranges for stock entry, 108
  - chase, 107-110
  - early morning contra move, 113
  - fallen stars, 106, 107, 110-111
  - Internet IPOs, 109
  - price, timing and execution, 103-104
  - scaled entry approach, 104-107
    - fallen stars, 106, 107, 110-111
    - as key to successful trading, 107
  - sweet spot for, 111-112
  - timing, 112-113
  - volume-weighted average price (VWAP), 107
- Evening star reversal pattern, 152, 153
- Event-driven trades, 260-268
  - earnings release, 260-263
  - initial public offerings (IPOs), 263-265 (*see also* Initial public offerings)
  - secondary offerings, 265
    - green shoe option, 265
  - stock splits, 265-267
- Execution and control, 119-133
  - Electronic Communications Networks (ECNs), 131-132
  - fragmentation vs. centralization, 128-129, 131
  - institutional orders, 131
  - liquidity, 124
  - market orders, 120
  - marketable limit order, 120
  - NASDAQ limit order handling rule, 126-127
  - NASDAQ quote rule, 127
  - NASDAQ short sale rule, 125
  - NASDAQ Super Montage, 129-131
  - scalping, 132-133
  - SEC order handling rules, 126-127
  - Select Net, 120, 128
  - short interest, 126
  - short selling, 125-126
  - slippage factor, 121-125
  - slippage premium, 120
  - Small Order Execution System (SOES), 132-133
  - Tools of the Trade, 128
- Exercise, importance of, 280
- Exhaustion gap, 251, 261
- Exit, 114-118
  - gains, maximizing, 116-117
  - scaled exit approach, 115-116, 118
  - sitting, 117-118
  - Exponential moving average (EMA), 52, 195
  - "Fading" opening, 141-142
    - artificial gaps, 252
  - Fair value as leading indicator, 165, 223-226 (*see also* Leading indicators)
  - Fallen stars, 105, 107, 110-111
  - Fear, impact of on trading, 271-274
    - Reticular Activating System (RAS), 272-273
  - Federal Reserve Board, 83, 84
    - Federal Funds Rate, 89
    - Federal Open Markets Committee (FOMC), 88-89
      - monetary policy, 88-89
  - Financial stocks, 226-228
  - Five-year earnings potential, 70
  - FIX, 256
  - Fragmentation of order system, 128-129
  - Free cash flow, 71
  - Frustration, conquering, 278-279
  - Fundamentals, 65-99
    - economic numbers and their effect on day trading, 82-91
    - fundamental catalysts, 67-73
    - information flow, organizing, 92-99
    - ratio power, 74-81
  - Gambling vs. speculation, 30-31
  - Game plan, sticking to, 24-25
  - Gap, trading, 248-259
    - artificial gaps, 251-252
      - fading, 251
    - breakaway gaps, 249, 250
    - continuation gap, 249-251
    - definition, 248
    - exhaustion gaps, 251
    - gap-down long, 178, 258
    - gap-down short, 203, 258-259
    - gap-up long, 257
    - gap-up short, 252-257
      - artificial, 252-253
      - fading, 254
      - institutional block prints, 255
      - monitoring time, 253
      - opening price signal, 253-254
  - Gap-down long, 178, 257-258
  - Gap-down short, 203, 258-259
  - Gap-up long, 256-257
  - Gap-up short, 252-256 (*see also* Gap)
  - Goals, writing, 283-284
  - Going long the up-hook, 236-245 (*see also* Chart patterns, advanced)
  - Gravestone doji reversal pattern, 147
  - Greed as obstacle, 277-278
  - Green shoe option, 263
  - Granville, Joseph, 215
  - Growth ratio, 70

- Hammer reversal pattern, 148, 149, 157, 158, 179, 180, 195
- Hangman reversal pattern, 148, 150
- Harami reversal pattern, 150, 151
- Head-and-shoulders top reversal pattern, 186, 187
- High and low of previous session as signal for spotting trend, 49-51
- Homma, Munehisa, 140
- Inaction, 27
- Income tax expense, 72
- Indicators, leading, 220-228 (*see also* Leading indicators)
- Inflection point, 59-61
- Information flow, organizing, 92-99  
     "analysis paralysis," 93  
     Internet resources, using effectively, 92-93  
     overload, 93  
     watch list, 93-94  
     web sites for day traders, 94-99
- Initial public offerings (IPOs), 263-264  
     Internet, 263-264  
     scaled approach for entry and exit, 264  
     volatility, extreme, 263
- Instinet, 128, 253
- Institutional investors, and dead cat bounce, 232
- Institutional orders, 131
- Institutional traders, 210-212  
     understanding action of, 68
- Interest expense, 72
- Interest rates:  
     and bond prices, inverse relationship of, 89-91, 226  
     yield curve, 90-91
- Internet:  
     initial public offerings (IPOs), 109, 263-264 (*see also* Initial public offerings)  
     bear market in 1999, 125  
     resources, using effectively, 92-93  
     stock most volatile of NASDAQ market, 4
- Intraday trends, 63
- Inverted hammer reversal pattern, 148, 150
- Investor psychology, impact of on stock prices, 137-138
- Investor's Business Daily*, 96
- Island, 127
- Japanese Candlestick Charting Techniques*, 140
- Journal, keeping, 283-284
- Leading indicators, 220-228  
     charting, use with, 220  
     fair value, 223-226
- S&P 500 Index as main benchmark for portfolio managers, 225
- S&P futures, 225
- financial stocks, 226-228  
     banks and brokers, key, 227
- long bond, 226-228
- TICK, 221-222
- TRIN (Trader's Index), 222-223
- Lefevre, Edwin, 117
- Leverage ratios, 79-80
- LIBOR (London Interbank Offered Rate), 225
- Limit order handling rule, 127
- Liquidity, 124  
     ratios, 78
- London Interbank Offered Rate (LIBOR), 225
- Long bond and financial stocks, 226-228
- Long Term Capital Management (LTCM) hedge fund, 9-10
- Loss, profiting by managing, 17-25  
     basket trading, 24  
     break-even stop-loss, 19-20  
     diversifying positions, 23-24  
     game plan, sticking to, 24-25  
     initial stop-loss, 18-19  
     liquid names, trading, 21-23  
     market risk (beta), 23  
     1 percent move, 19-20  
     profit-taking stop, 20-21  
     stock-specific risk (alpha), 23  
     trailing stop-loss, 20  
     winning with stop-loss, 17-18
- Managing money to succeed as day trader, 3-11  
     margin madness, 9-10  
     NASDAQ market, volatility of, 4  
     position size, 5-7  
     preparation before trade, 5, 8  
     risk control as key to survival, 4  
     trading only with money you can afford to lose, 4-5  
     2 percent rule, 7-9
- Margins, 9-10  
     excessive leverage through, dangers of, 9
- Market, listening to, 274-275
- Market orders, 120-121
- Market risk (beta), 23-24
- Marketable limit order, 120
- Marubozu reversal pattern, 151, 152, 182, 183
- "Meat of the move," 40-41, 64
- Meriwether, John, 9-10
- Merton, Robert, 9-10
- Mind games that spell financial havoc, 26-35  
     averaging down, myth of, 29-30, 33  
     bottom fishing, 28-29  
     consistency essential, 31-32  
     gambling vs. speculation, 30-31

- size envy, 32-33
  - vengeance trading, 34-35
  - what not to do, 27-28
    - action and inaction, 27
    - avoiding boredom, high cost of, 28
  - Momentum, 202-206
    - of trend, 42-43
  - Morning star reversal pattern, 152, 153
  - Moving average convergence-divergence (MACD), 195-198
    - histogram, 107-198
  - Moving averages, 138
    - exponential moving averages (EMAs), 195
    - histogram, 197-198
  - Relative Strength Index, 191, 200-202, 203
  - shorting the reverse hook, 246
  - simplifying use of indicators, 192
  - stochastics, 199-200, 201
    - bearish signals, how to use for, 200
    - bullish signals, how to use for, 200
    - fast, 199
    - slow, 199
  - trading the hook, 191
  - use of, 43, 138
- NASDAQ:
- Composite, 220
  - limit order handling rule, 127
  - nasdaq.com, 97
  - nasdaqtrader.com, 97
  - 100, 221
  - quote rule, 127
  - SelectNet, 120, 128
  - short sale rule, 125-126
  - Super Montage, 129-131
  - volatility of, 4
- National Association of Securities Dealers, 248
- NDX 100, 44, 46-48
- Negative selection, 144
- Net income, 71-72
- Net price, 111-112
- Net price rule, 40-41, 61-64
- New York Stock Exchange, 9, 128-129
  - nyse.com, 97
  - Rule 390, 129
  - TICK, 221-222
- Newton's Law of Motion, 41-42
- Nison, Steve, 140
- North American Securities Administrators Association, 10
- On-balance volume (OBV), 215-216, 217
- 1 percent move, 19-20
- Opening price signal, 40-41, 57-61, 111-112
  - dead cat bounce, 236
  - formula, 57
  - gap-up short, 252-256
- Operating cash flow, 71
- Operating income (EBIT), 72
- Oscillators and reversal indicators, 190-206
  - Bollinger bands, 175, 191, 192-195, 196
  - and charting, combining, 190-191
  - going long the up-hook, 238
  - momentum, 202-206
  - moving average convergence-divergence (MACD), 195-198
    - advantage in using, 195
- Piercing line reversal pattern, 152, 153, 157
- Position size, 5-7
  - envy, danger of, 32-33
  - profit-taking stop, 20-21
  - steps (five) to determine proper, 12-16
    - allocating capital per position, 13
    - maximum shares per position, calculating, 13
    - position size, maximum, calculating, 151-16
    - stop-loss point, determining, 14-15, 16
    - 2 percent dollar risk per trade, determining, 14
- Poverty consciousness, 277
- Price-volume divergence, 214
- Profitability ratios, 75-77
- Prosperity consciousness, 280-281
- Psychology, 269-284 (*see also* Trading mind)
  - impact of on trading decisions, 271
  - trading mind, 271-284
- Quote rule, 127
- Rationalization, 276-277
- Ratio power, 74-81
  - activity, 80-81
  - advantages, 74
  - as lagging indicators, 74
  - leverage, 79-80
  - liquidity, 78
  - profitability ratios, 75-77
  - return on equity (ROE), 77
  - standard deviation, 75
- Regret, poison of, 279
- Relative Strength Index (RSI), 191, 200-202, 203
- Reminiscences of a Stock Operator*, 117
- Resistance levels, 138, 157, 161-170 (*see also* Support and resistance levels)
- Responsibility, accepting, 276-277
- Reticular Activating System (RAS), 272-273
- Return on equity (ROE) ratio, 77
- Reversal pattern oscillators, 190-206 (*see also* Oscillators and reversal indicators)

- Reverse head-and-shoulders bottom reversal pattern, 186, 188
- Risk control, 1-35, 273
  - as key to survival, 4
  - loss, managing, profiting by, 17-25
  - managing money to succeed as day trader, 3-11
  - mind games that propagate financial havoc, 26-35
  - position size, proper, five steps to determine, 12-16
- Risk-reward ratio, 112, 165-166
  - not favorable with Internet IPOs, 263
  - in trend spotting, 42-43
- Role-playing, 280
- Rule 390, 129
  
- S&P 500, 44, 220, 221, 226
  - as main benchmark for portfolio managers, 225
- S&P futures, 225
- Scaled entry approach, 103-107 (*see also* Entry)
- Scaled exit approach, 115-116, 118 (*see also* Exit)
- Scalping, 132-133
- Scholes, Myron, 9-10
- Secondary offerings, 264-265
- SEC order handling rules, 126-127
- Security as illusion, 281-283
- SelectNet, 120, 127, 129
- Sequential growth rate figures, 70, 73
- Shooting star reversal pattern, 153, 154, 155
- Short interest, 125-126
- Short selling, 124-126
- Shorting the reverse hook, 234, 235, 237, 243-247 (*see also* Chart patterns, advanced)
- Simple cash flow, 71
- Simple moving average, 52
- Sitting, 117-118
- Size envy, danger of, 32-33
- Slippage factor, 121-125
- Slippage premium, 120
- Small Order Execution System (SOES), 132-133
- Speculation vs. gambling, 30-31
- Spinning top reversal pattern, 154, 156, 157
- Standard deviation, 75
- Stochastics, 199-200, 201 (*see also* Oscillators and reversal indicators)
- Stock splits, 265-267
- Stock-specific risk (alpha), 23-24
- Stop-loss: (*see also* Loss, profiting by managing)
  - break-even, 19-20
  - determining point, 14-15
  - initial, 18-19
  - profit-taking, 20-21
  - trailing, 20
  - winning with, 18
- Support and resistance levels, 138, 157, 161-170
  - charts, use of, 167
  - definition, 161
  - multiple time frame approach, 167
  - price confirmation, 164-170
    - fair value, RICK, and AX as leading indicators, 165
  - resistance, 162-164
    - right way to use, 169-170
  - support, 162
    - right way to use, 169
  - two ways to use, 161
  
- Technical analysis, 135-206
  - candlestick charting techniques, 137-160
  - chart patterns, basic, 171-189
  - oscillators and reversal indicators, 190-206
  - support and resistance, 161-170
- 30-year Treasury bond, 226-228
- Thompson Financial Services, 22, 96
- TICK as leading indicator, 165, 221-222
- Time periods for tracking trend, 45-46
- Timing entry, 112-113
- Tools of the Trade, 127
- Tracking pulse of market, 207-228
  - leading indicators, 220-228
  - volume, 209-219
- Trade, 101-133
  - entry, 103-113
  - execution and control, 119-133
  - exit, 114-118
- Trader's Index (TRIN), 222-223
- Trades, event-driven, 260-268 (*see also* Event-driven trades)
- Trading as action game, 192
- Trading mind, 271-284
  - confidence, 279-280
    - dressing well, 280
    - exercise, importance of, 280
    - role-playing, 280
  - fear, 271-274
    - Reticular Activating System (RAS), 272-273
    - risk control, 273
  - frustration, conquering, 278-279
  - greed as obstacle, 277-278
    - poverty consciousness, 277
  - market, listening to, 274-275
  - prosperity consciousness, maintaining, 281
  - regret, poison of, 279
  - responsibility, accepting, 276-277
  - security as an illusion, 281-283
  - writing goals, 283-284
- Trading plan, sticking to, 25
- Trading signals, four, for spotting trend, 49-64
  - 8-period moving average, 51-57
  - exponential moving average, 52
  - high and low of previous session, 49-51
  - net price rule, 61-64
  - opening price signal, 57-61

- inflection point, 59-61
  - simple moving average, 52
  - time periods to examine, 63-64
  - trendlines not sufficient for day trader, 51
  - weighted moving average, 52
- Trading the gap, 248-259 (*see also* Gap, trading)
- Trading the hook, 191
- Trading tactics, advanced, 229-267
  - chart patterns, advanced, 231-247
- Trailing profit protective stop method, 116
- Trailing stop-loss, 20
- Trend spotting as key to profits, 39-48
  - chart patterns, use of, 43
  - 8-period moving average, 40
  - "meat of the move," 40-41, 64
  - momentum, 42-43
  - net price rule, 40-41
  - Newton's law of motion, 41-42
  - opening price signal, 40
  - oscillators, use of, 43
  - risk-reward ratio, 42-43
  - sector's movements, 43-45
  - time periods for tracking trend, 45-48
  - trading signals, four, 49-64 (*see also* Trading signals, four, for spotting trend)
  - volume capitulation, 40
- TRIN, 222-223
- 2 percent rule, 7-9
  
- Up-hook traders, 236-245 (*see also* Chart patterns, advanced)
  
- U.S. dollars, economic news and, 83-84
- Underlying conditions, 37-64
  - trading signals, four, for spotting trend, 49-64
  - trend spotting as key to profits, 39-48
  
- Vengeance trading, 34-35
- Volume, 209-219
  - accumulation/distribution (A/D) line, 216-219
  - block prints, 210-213
    - definition, 210
    - institutional traders, 210-212
  - clean-up prints, 213-214
  - on-balance volume (OBV), 215-216, 217
    - as second dimension of technical analysis, 209
  - volume breakouts, 214-215
  - volume capitulation, 214
    - price-volume divergence, 214
- Volume breakouts, 214-215
- Volume capitulation, 40, 214
- Volume-weighted average price (VWAP), 107, 142
  
- Watch list, 93-94
- Web sites for day traders, 94-99
- Weighted moving average, 52
- Williams, Larry, 216
- Writing goals, 283-284
  
- Yield curve, 90-91

## **About the Author**

Josh Lukeman is an institutional NASDAQ market maker at Morgan Stanley Dean Witter, concentrating on technology stocks. He produces a daily technical analysis bulletin, incorporating candlestick charting methods, which analyzes and interprets the movement of sectors for Morgan Stanley's OTC group. Josh was previously employed at Buffalo Partners, where he traded listed stocks and futures.