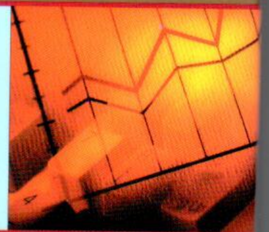
THE MARKET IS ALWAYS RIGHT

The 10 Principles of Trading Any Market



What You Need to Know to Trade Stocks, Options, and Futures Markets

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is usually followed by fear. That trader who uncovers some negative news regarding the stock making new highs begins selling. At first, it is called profit taking. Pretty soon we all know the bubble has burst, and it looks like pandemonium in the pits.

It is these abnormal swings that technical analysis is supposed to alert you to and protect you from. And in my opinion, it can—if you stay rational. Nothing can help you if you give in to greed and fear. When a high is peaking, the trading volume can be your guide. It will give you a sign to exit. But it does not mean volume will not pick up again after a top and the entity will go to even higher highs. That happens, but it can just as easily crash. As noted earlier, you can get rich selling too soon. But you can't by selling too late. Let technical analysis rule your normal instincts of greed and fear. Remember, human beings create the price patterns you see on the charts.

Now I would like to give you a brief description of a professional trader's shtick. First I must apologize to Brian Shannon, a professional trader and instructor of technical analysis at the Market Wise Trading School for oversimplifying his approach to the market. As with any trading approach, many subtle aspects go by virtually unnoticed. My objective is to offer a simple overview of one of the ways Brian trades to illustrate how it can be done simply and efficiently. Keep in mind, it is only an overview of one of the many strategies Brian has learned and used over years of trading. Brian's approach to the market changes as the market does. As you become more experienced, you will see many of the strategies you initially learned become obsolete. The market is like the ocean, always changing while always being the same. Your "old" setups are replaced by new ones as you and the markets evolve.

TRADING IS A LONG, ARDUOUS JOURNEY

Here is a concrete example of how fast a trading strategy can vanish from the trading floors. When I first became involved in day-trading stocks about 5 years ago, one of the most popular and reliable strategies was called "following the ax"—the ax being the dominant market maker for a specific Nasdaq stock. It might have been Bear Stearns or Merrill Lynch manhandling Cisco, for example. When you saw the ax on the bid, you joined the bid and let the ax run the stock up a quarter point, a half point, or more. Traders would often join the ax by SOESing it for 1000 shares. SOES is basically Nasdaq's ECN and stands for Small Order Execution

System. Market makers were obligated by exchange rules to honor the first SOES order received. They could not "back away." It was common knowledge among the pros who the axes were for all the active issues. You could always check one of Nasdaq's web sites for a list of the major market makers by share volume for whatever stock you are interested in trading.

The ax was often trying to buy (or sell) a large amount of shares for a customer. For example, the ax might need 50,000 shares to fill an institutional order, say a retirement or mutual fund. The ax would sit on the bid as long as needed to get the order filled. The client might give the ax as much as $2 (plus or minus) discretion in price, which would give the ax some wiggle room. If too many traders hit the ax, it might back off for a while or even join the offer, but not at the inside bid. Sooner or later, it would be back on the bid moving the stock higher. It was a great cat and mouse game to match wits with the ax by reading the Level 2 quotation screen and the buy-sell tape. The objective was to piggyback the bid for a $500 or more gross profit on 1000 shares.

Following the ax has gone the way of the once famous SOES bandits, the boys who put electronic day trading on everyone's radar screen. The culprits that did away with the following-the-ax trading strategy were revisions in the SOES rules in favor of the market makers and decimalization. New SOES rules set up tiers of stocks, which reduced the number of shares a market maker must buy or sell on a SOES order. Therefore, a trader could not always SOES for a thousand shares. Decimalization substantially reduced the amount a market maker must increase the bid to stay on top of the inside market, thus offering the best price. The market maker now only has to go up a penny to stay on top, whereas previously it was a sixteenth ($0.0625) or, more commonly, an eighth ($0.125). Multiply these fractions by 1000 shares and you get $62.50 and $125, respectively. The financial incentive is no longer there for day traders since the market makers can head-fake the trades more easily, with less financial risk, by moving their bid or ask up or down a penny at a time.

It is for these and other reasons I'll mention as we go along that I strongly recommend you begin your trading with a mentor at your side. Look to the mentor to fill you in on how the markets you trade are in flux before your very eyes and how you must adapt.

Now let's get back to Brian's trading shtick. First of all, he carries around a list of stocks of interest to him at the moment, called a watch list. This is a list of securities that match a criterion he has devised for

himself that will offer him multiple trade opportunities every day on either the long or short side of the market. He carries this list on his person whenever he is not trading. It is attached to his money clip. My point is that you cannot underestimate the value of developing a good watch list of your own. To Brian it is just as much money as the actual greenbacks in the clip.

When you first begin, what are you going to use for your watch list? More importantly, what will your selection criteria be? This is an area that you may need some professional assistance developing. The criteria will vary depending on the complexion of the market you will be trading and your experience level. For example, Brian has many years of trading behind him. He is at his trading station an hour before the market opens, all through the daily sessions, and for another hour or so after—every trading day. That's 220 or so days a year. He trades a lot of stocks that are way too lightly traded for my taste and experience. But he has the skill to handle these skinny minis. Because these stocks have low daily volumes, they tend to be volatile, as we have discussed earlier. Volatility leads to opportunity, but the flip side of the opportunity coin is risk.

Therefore you must devote much thought to the selection of the stocks or futures contracts you put on your watch list. With futures, it is not as difficult because there are considerably fewer choices than with stocks. To begin with, I would recommend only trading on exchanges in the United States. It is not patriotism, but liquidity, that prompts this remark. Plus you get some regulatory protection from the Commodity Futures Trading Commission and the National Futures Association. Second, there are fewer sectors or complexes to evaluate. Here is a brief summary of your choices:

- *The grains complex.* Corn, oats, soybeans, soybean oil, soybean meal, and wheat
- *The meat complex.* Live cattle, lean hogs, pork bellies, and feeder cattle
- *The food and fiber complex.* Coffee, cocoa, sugar, FCOJ (frozen concentrated orange juice), cotton, and lumber
- *The energy complex.* Crude oil, heating oil, gasoline, natural gas, propane, and electricity
- *The metal's complex.* Gold, silver, palladium, platinum, aluminum, and copper

make a decision. Here is another job for your mentor. Follow his or her lead in the development of your initial watch list.

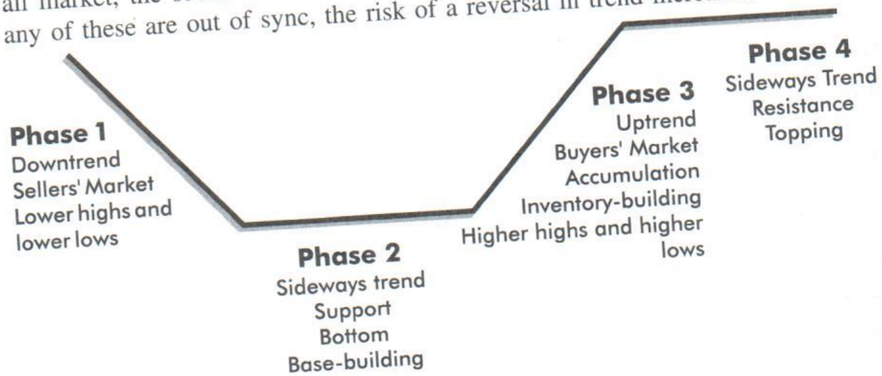
Returning to Brian's shtick, he does not use filters or scans. He has developed his own list over time by studying the technical factors of stocks. Each day before the market opens, he searches several news sites, The Drudge Report being one of his favorites, looking for news that will impact the overall trend of the market. He prefers stocks that are not going to be affected by things like earnings reports or news stories. When he spots one, he does some technical analysis. Never take stock selection casually or do it haphazardly. It is one of the most important parts of the ritual you must perform before trading, equivalent to the sniper assembling his gear before heading out. If you have to stop trading, after the market opens, to figure out what stock to trade, immediately stop trading for that day because you are not properly prepared.

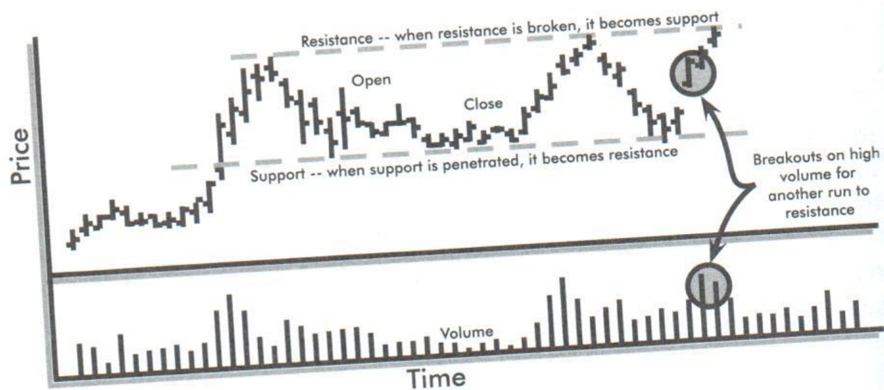
TRADE BY THE 7 P'S

"Proper prior planning prevents piss-poor performance," as Sergeant Ross used to tell us. There are a few things I just can't stress enough. One of them is preparation. Once you begin to trade, nothing should be allowed to distract you.

Each morning, Brian pulls out his watch list and reviews each stock on the list. He does this by pulling up a 45-day chart. He is looking for setups (Figures 6-1 and 6-2). To him, a setup is a chart formation that indicates that the stock is about to make a move that day which may last from a few hours to a few days. In this example, let's say he is looking for a breakout setup. That is one in which the stock (or commodity) has moved lower (phase 1) for a few days. It has reached an area of support and has traded sideways (phase 2). Trading volume has increased and the stock has started to move higher (phase 3). The next area of resistance is $2 higher. In other words, the stock has room to run up another dollar or two. On a thousand shares, it could be a nice profit opportunity. If it is Friday, Brian might pass on this trade, depending on how strong the volume increase is, and wait to enter the trade on Monday. He only looks for day trades on Fridays because he wants to be flat over weekends. Holding short-term positions over weekends is not for stock market survivors. One survives by being cautious and avoiding all unnecessary risks, like the possibility of news about another Enron-type scandal taking the whole market down when you can do nothing about it. Holding positions

FIGURE 6-1. Phases of the Market
Markets move up, down, and sideways. Traders must know what phase the overall market, the sector of the entity being traded, and the entity itself are in. If any of these are out of sync, the risk of a reversal in trend increases.





overnight, as you do with swing trading, is as risky as you want your short-term trading to get.

When Brian sees the breakout setup on the 45-day chart, he will look at other views of the potential trade. For example, viewing a daily chart of the last 5 months shows him where the most reliable areas of support and resistance are located. He'll note or memorize them. Remember from our earlier discussion of technical analysis, support holds prices from going lower and resistance restricts prices from going higher. He also determines from the 5-month charts which phase the stock is in long term (i.e., base building, bullish, topping, or bearish—see Chapter 4) and what the long-term trend is (up, down, sideways), and this view provides a reading on average daily volume and volatility. Naturally, Brian will plot

the 10- and 20-day moving average to get a feel for what long-term investors may be thinking so he can get a fix on the supply-demand situation. He is always in touch with the direction of the Nasdag 100 futures and the strength or weakness of the sector the target stock is in. All this analysis only takes a minute or two for an experienced chartist using a trading platform like RealTick®.

Once satisfied that there are no potential problems on the long-term charts, Brian switches back to the short-term charts. He must orient himself to whichever short-term phase is in play. He is considering a long position, and this stock is in the bullish phase, which is perfect. The chart preference for the day or swing trader is the 60-minute-interval chart. Each bar represents 1 hour of trading. You need to be able to generate a chart that provides at least 45 days. A chart with 65 days is even more preferable because it represents 2 weeks of trading on the major exchanges. (This is a function of the software platform being used.) The major exchanges are open 6½ hours a day, 5 days a week, or 65 hours over 2 weeks. As was discussed in Chapter 3, the moving averages tell you the trend and alert you to changes in the trend.

On the 60-minute chart, Brian plots the 65- and 130-minute moving averages. These will be the moving averages that indicate the longer-term trend in this example. When trading short term, just as you would when investing for the long haul, you must keep the trend at your back. Brian plots the 8- and 17-minute moving averages to monitor the short-term trends, and he uses them for entry and exit signals. When you first begin trading this way, it helps to mark the areas of support and resistance on the chart on your trading software platform. You can easily do this with most trading platforms. In time, recognizing them becomes second nature to you.

Also keep in mind that all technical analysts do not use the same moving averages. Some will use longer or shorter-term averages, such as the 10-, 20-, 50-, and 200-period moving averages. Brian developed his own (the 8, 17, 65, and 130) to more closely match the fact that the trading day is 6½ hours in duration. Halting trading on the half hour means that over a normal trading session there are 390 minutes (6½ × 60 minutes). Therefore it is impossible to divide the trading session into even increments, and that is why he uses moving averages of 8, 17, 65, and 130 for the hourly charts. As you develop as a trader, you will learn what works best for your style and experience level.

The next step would be to compare the 60-minute chart with the daily chart, noting at what points the trends and support-resistance are in sync.

This gives you a better perspective. As you become more adept in technical analysis, you discover that the more directional indicators that are aligned, the stronger and more reliable the signal. Brian also checks 10-minute–10-day, 5-minute–5-day, and 2-minute–2-day charts using 10-, 20-, 50-, and 100-minute, 20-, 40-, 100-, and 200-minute, and 10-, 20-, 50-, and 100-minute moving averages, respectively.

Prices rarely move up or down smoothly. They usually move in stair-stepping patterns up and down in a jerky, sometimes erratic, motion. Price momentum swings from overbought to oversold and from bullish to bearish. Rarely does any stock or futures contract have supply and demand in balance for any period of time. If the price is above one of the long-term moving averages, it is considered bullish. If below, bearish. Naturally if the signal is bullish, you prepare to open a long position or buy. If bearish, you look to short.

The short-term moving averages are the most sensitive to price changes. The 10-interval moving average turns direction first, followed by the 20, 40, 50, 60, 100, and 200. Or using Brian's moving averages, the 8, 17, 65, and 130. (Commodity traders may find the 4-, 9-, and 18-day moving averages more common.) For a signal to enter a stock on the long side, look at your support levels. Is the stock in one or approaching one, either on a downtrend or a pullback during an existing bullish move? Does the support hold? If support holds and the shortest moving average begins to turn up, load your weapon. You do this by moving to the order entry window on your computerized trading platform; entering the stock symbol, number of shares, type of order (I recommend you almost always use limit orders), preferred routing, and marking the buy box.

Before squeezing off a round, calculate the risk-to-reward ratio of the proposed trade. This is a two-step process. Step one is determining where the stop-loss order should be placed. It should be in the neighborhood of the next support level for a long trade. You also take recent volatility into consideration when picking a stop-loss price. If it is a long distance to the next support level, let's say a few dollars south and the daily trading range is approximately $1, consider placing a stop at $1.05 or just below the daily trading range. Some traders have a fixed percentage, usually 5 percent or less, that they use. Your stop limit order becomes a market order when hit, and you will be out of the stock with not much more than a dollar loss under normal conditions. Commodity traders must also consider limit trading days when evaluating volatility and setting stops. On a 1000-share-lot stock trade, the loss is $1000, or 3⅓ percent of the equity in a $30,000 account. A worse case, the stock gaps to the next

support level, $2 down, and you take a $2 hit. This, or even worse, can happen if the stock, the sector, or the entire market is extremely volatile. If the trend of the sector and the market as a whole is up, the risk of a downside gap diminishes geometrically. This is the rationale for constantly tracking these factors.

Now determine the upside or reward potential. If you expect a 1:2 risk-to-reward ratio, you must see that there are no price resistance areas preventing the stock from moving $2 higher. If there is no resistance for $3 or $4, it is all the better. For some a 1:2 ratio may sound minuscule, but we are discussing day trading or very short-term trades. The expectation is to execute multiple trades over single trading sessions. Tiny drops of water can fill a large bucket over a trading session.

As you do these calculations, also estimate the amount of time you will be in the trade. The longer you expect the trade to last, the greater the risk and the more that can go wrong. You must always be rewarded for accepting risk or at least have the potential of an adequate reward. Therefore, if you think the trade will take 4 days for the stock to increase $2, or a risk-reward ratio of 1:2, you might want to pass. Estimating the time for a move to materialize is speculation at best. With experience, you can look at average daily moves of the last 30 days, volatility, and volume trends and make a good estimate.

At this point, you should have a pretty good idea of how the trade is expected to unfold. One of the keys to survival is visualization. You run the trade though your mind's eye. If the trade does not begin to unfold as you imagined, you bail out. For example, you get in the trade and the stock futures indexes make an about-face, heading south. The uptrend of the stock being traded stalls, and volume evaporates. Run for the exit marked survival or discipline.

I would like to spend a moment on volume because it is usually one of the key factors, at least for me. If volatility is the speed of the market, volume is its power. It is your signpost alerting you to how strong or weak the change of direction will be. Spend some time just studying price charts. Begin by looking for points where the trend of any stock or commodity made a substantial change in direction. Use long-term monthly charts at first. Then check out the volume bars at the bottom of the charts. Notice how volume changed. It could have increased or decreased, but it did change compared with the previous few trading sessions.

Think back to our discussion of supply and demand. It just stands to reason that if there are a lot of buyers clamoring to get a hold of a stock or futures contract, they will increase volume. This, of course, results in

an uptrend. The opposite is equally true. If everyone in the pits decides to sell, volume goes up and prices go down. Prices also fall when volume dries up and there are no buyers left in the market. The market is said to "fall of its own weight." Pay close attention to places where prices have gapped higher or lower or made limit moves. The beauty of paying close attention to volume is that you will often notice a change in volume before the change in direction occurs. This is because not everyone with a strong enough opinion about a stock or futures contract gets the word (news) at the same time. It is for this reason the Securities and Exchange Commission is so sensitive about insider trading. A classic example is Enron. Key executives were selling, knowing things were not as they seemed to outsiders (including employees), while telling the public everything was copacetic. Trading volume increased while per-share price stalled and then began a free fall.

Once you get a good feel for the big moves on long-term charts, move to weekly, daily, and eventually hourly and minute charts. Volume and trend changes tend to be more noticeable on the longer-term charts at first. Next start looking for subtle changes on volume, which are harbingers of ½-, 1-, or 2-point moves. At the same time, pick the spots you would put your stop. Mark up these charts and discuss them with your mentor.

Traders of real commodities, such as the grains, metals, softs, meats, etc., that have commercial hedges supporting their markets should combine their analysis of volume with open interest and the Commitment of Traders Report (COT). Commercial hedgers are somewhat equivalent to the institutional buyers in the stock market. Open interest quantifies the number of futures contracts outstanding long or short at the end of every trading day. These are contracts held overnight. The volume of open interest shows the bullish or bearish conviction of a large segment of each market. The COT, made available by the Commodity Futures Trading Commission (www.cftc.gov) every Friday at 3:30 p.m. EST, contains a breakdown of the previous Tuesday's open interest for all futures markets with 20 or more traders holding reportable positions. A second COT Report that includes options is also worth following. It is released every Monday at 3:30 p.m. EST. You are looking for two things: Who is holding what, and is the open interest increasing or decreasing? It's important to know who is holding the commodity, because if it is a commercial hedger that will take physical delivery to use the commodity in its manufacturing, say copper in electrical equipment or corn and beans in a

feeding operation, you then know that a bottom in prices may be imminent or at least an area of support.

GOOD TRADERS ARE LIKE SNOWFLAKES!

Although most traders are very similar to one another, the top performers seem to have something unique about their approach to the market—some call it an edge on the market. Our friend Brian, for example, uses the short interest indicator as a way of predicting or anticipating trend changes and runaway markets. He likes to keep tabs on the shorts for two reasons. First, the professional short trader often has stronger opinions than the average trader. More importantly, Brian knows from experience that many big moves occur because of a favorite Wall Street play, i.e., the short squeeze.

Short players take naked short positions when they are convinced a particular stock is headed lower. The objective is to buy it back at a lower price and keep the difference. But what if they are wrong and the stock moves to go higher? How long do they hold on? When do they cry uncle and buy back the stock at a higher price and take a loss? Tough questions. When the shorts try to offset losing short positions, the market makers and specialists become like sharks that catch the scent of blood in the water. They buy, buy, buy, driving prices even higher and squeezing all the shorts out of the water, often missing important limbs.

Brian makes a point of knowing the price and size of the short positions in the stocks he shepherds. This gives him some early warning about when a short squeeze might take place. Naturally, he wants to be in position to take advantage of the opportunity, and he does it by monitoring web sites that track short selling. This approach is not unlike the commodity trading tracking done by the Commitment of Traders Report.

As you do your analysis and study the charts, think of your trading plan. What are you going to be looking for in a trade? Is your plan to make 5, 10, or more half-point trades each trading session for a net profit after commissions and losers of $500, $1000, or more? Or do you want to be a swing trader and take large per-point profits utilizing a weekly time frame? Hone your chart reading skills to the time and profit frame you anticipate. Do not begin trading without committing your plan to writing. Your plan should never be vague. You must write explicit objectives you expect to reach on a daily, weekly, quarterly, and annual

basis. It is the only way to know if you are on track and when you n
make adjustments.

Please do not think the above discussion is anywhere near a definit
discussion of volume, volatility, trading strategies, or anything else. I
just a few books—but libraries—are full of information on each of th
subjects. The purpose of this chapter is just to point you in the ri
direction.

thing was not quite right. The terminology used by analysts reinforces the bullish slant of their advice. Everything is a strong buy, a buy, or a hold. An analyst with a sell on his or her list is as rare as an ethical politician.

ALL TRADERS ARE ISLANDS

John Donne probably wouldn't like this last rule, but it is true. You begin your career by assimilating as much as you can of what has been learned. I call them the rules. From there you must develop your very own trading system. You have two basic choices, intuitive or mechanical. Intuitive traders are spontaneous. They trade by instinct and hunches. The most successful intuitive traders have years of experience behind them and most started as mechanical. Once they mastered the rules and developed a keen instinct for certain markets, they "became" intuitive traders. The most common ones you will run into on a trading floor are momentum day traders. Their shtick is to find the fastest-moving stocks and just jump from the long to the short side or bounce in and out of a market as the momentum ebbs and flows. This type of trading was very profitable before decimalization and during the blow-off top of the bull market of the 1990s.

The trader with a mechanical system is most likely a technical trader. This is what I would recommend for starters for any short-term or swing trader. Once you have developed a repertoire of trading strategies and have mastered all the basic trading skills, you can begin to go out on your own. This is when you really become a trader. You develop your special technical signals, much like Brian Shannon has developed moving averages that may be unique to him. These modifications of an existing and proven approach put Brian on his unique island. When you get to this stage, your confidence soars, permitting you to occasionally bend the rules. But please don't break them, at least not often—it won't be a pleasant experience to try to fool Mother Nature.

Let's talk a little about swing trading rules since a good percentage of short-term traders use this technique. I define swing trading as holding a position from one trading session to at least another. That could end up to be only a few hours of actual trading—from the end of one session to the beginning of the next. Theoretically, a day trade could last longer. The distinction I make is holding the trade between sessions.

One big question that often comes up is what do you do if a weekend occurs between the sessions. If you totally rule out holding positions over