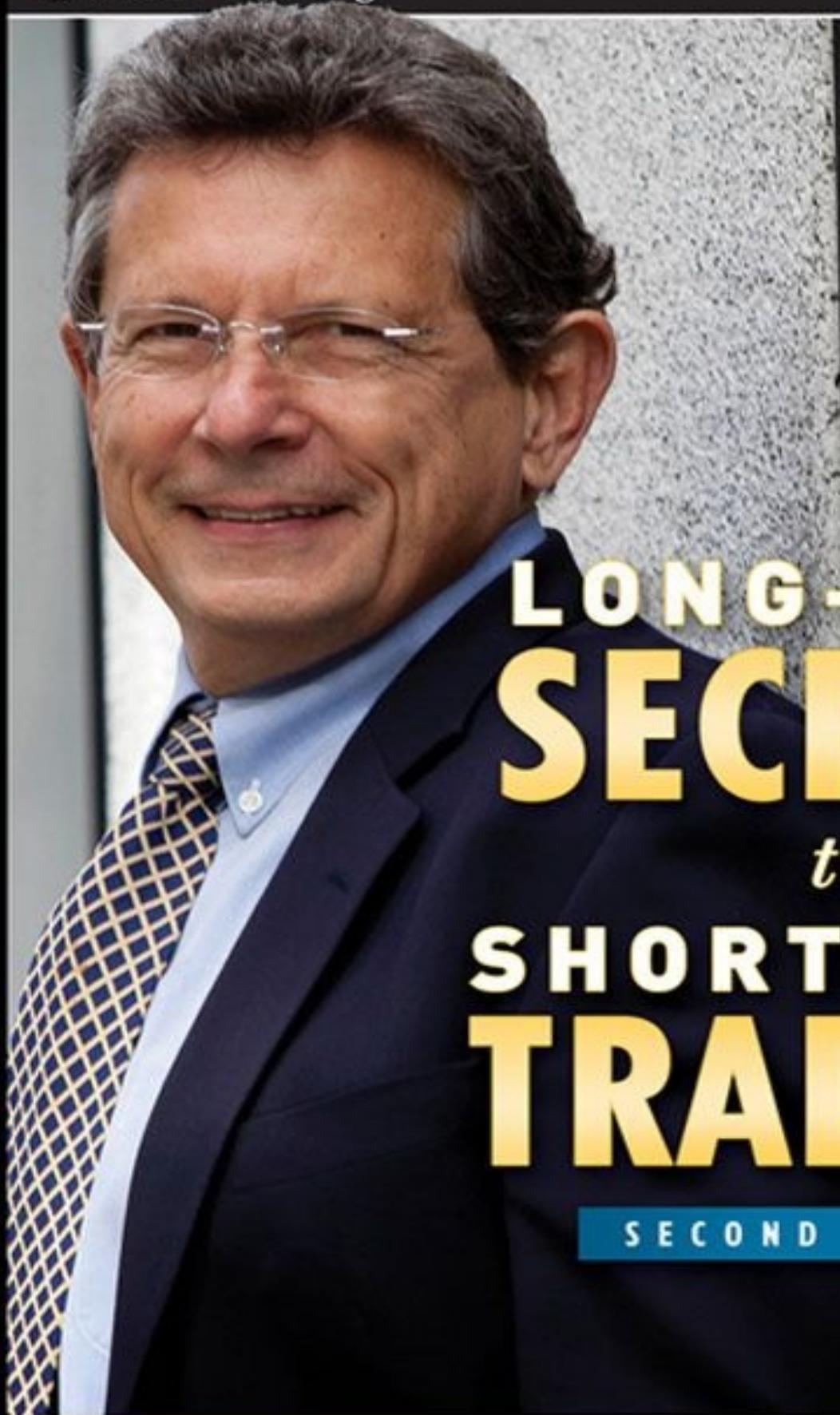


WILEY Trading



LONG-TERM
SECRETS
to
SHORT-TERM
TRADING

SECOND EDITION

LARRY WILLIAMS

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Long-Term Secrets to Short-Term Trading

Second Edition

LARRY WILLIAMS



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With best wishes to all.

Larry Williams, 2011
St. Croix
US Virgin Islands

INTRODUCTION

You Are Already a Commodity Trader

In the ensuing years since the first edition of this book was published, more and more people have become stock, commodity, and Forex traders. The guy who does our yard work trades, as does my dentist and favorite chef. Why?

I suspect there is more to it than the thrill of speculation; now, more and more people want a *way out*. They don't want to be an employee, nor do they want to be a boss. They want to be independent and that seems to be possible only as a trader. It is a dream that many have followed, and which has become a surprising reality for countless traders. There is a way out ... that's what this book is really all about: showing you the tricks and techniques of my craft.

Whether you know it or not, you have been trading commodities all your life. Sure, you may have never traded a contract of Pork Bellies, but you have almost certainly traded a possession like a car, house, or antique for someone else's money or possession. If you have never done that, for sure you have traded time for money. You have traded your time as a teacher, lawyer, pipe fitter, or ditch digger for someone else's money. So, you are halfway there, you just never knew it!

When we trade our time, we are actually trading our time plus our skills. That is why a brain surgeon gets more per hour than a knee surgeon. That is also why an outstanding quarterback gets more than a tackle and surgeon combined. He has a greater career risk. It is not that one skill is inherently more valuable than the other, it is that one is more difficult to come by and carries higher risk. This characteristic generates more dollars for the person selling his or her time and skills.

There is no intrinsic value to Michael Jordan's dribbling and shooting skills, but the owner of the Chicago Bulls saw an opportunity to make a great deal of money with those seemingly valueless skills by packing stadiums and getting television revenues. Thus, something of "no value" may have great value.

At a trading seminar, I once demonstrated this point by placing a personal check in a sealed envelope and then added it to 14 similar, sealed envelopes in a clear plastic bag. The attendees each had the opportunity to reach in and draw out an envelope. The person who drew the one with the \$5,000 check would be allowed to keep it.

The bag contained 14 worthless envelopes, but suddenly they had value! Although

all but one were empty, there was a 1 in 15 chance of winning \$5,000; thus each envelope, or opportunity to take out an envelope, was worth \$333.33. Once the participants began taking envelopes out of the bag, those empty, worthless envelopes gained in value. After all, once five empty envelopes were removed, there was now a 1 in 10 chance and the value had risen to \$500. When just two envelopes were left in the bag, people in the audience were willing to pay \$2,500 to dip their hand in and pull out an envelope! Suddenly, what was worthless had great value!

That is your first lesson in becoming a more aggressive commodity trader. Value, like beauty, is in the mind of the beholder. As a trader, the lesson is to never second-guess what value really is: It is what the market will pay. It (the market or collective judgment of other traders) may not pay that value for long, but price is king: It is what is. I learned long ago not to argue with what is.

In 1974, I reached a value judgment that the price of Cattle would skyrocket so I began loading up, taking my first position at 43 cents a pound. I “knew the value” of Cattle; at this price, it was way under value, offering a sure trade. So, as price drifted to the 40-cent area, I bought more. After all, if 43 cents was cheap, 40 cents was even better.

At 38 cents, where price next went, I had a steal, and being no dummy, I stole some more, only to see price plummet to 35 cents, then 30 cents, and finally 28 cents—where, dear reader, I was tapped out. My resources were limited; this move cost me about \$3 million, all in less than 30 days.

Two months later, the price of Cattle soared to over 60 cents a pound. But I was not there—a sure-thing trade had set me back dearly and helped contribute to rumors, afloat still today over a quarter of a century later, that I blew out trading, despite a few successes I will get to later in this book.

Reflecting on this experience over the years has enabled me to formulate two important rules. The first is that value is ephemeral: It can be anything, and anything can and will happen when trading commodities, or stocks for that matter.

The second rule, which carries greater weight, is that although market trend and direction are major concerns, knowing how to deal with your resources has the highest priority. After all, had I marshaled out my resources on the Cattle trade so I could have ridden through the bad times, I would have made a respectable killing.

You never know when the markets will do what you think they are supposed to do. Many times, like God, the market does not deny, it just delays. Serious traders weave protection against this delay into the fabric of their program. There is no greater rule to learn than that of money management. All the horror stories you have heard about commodity trading are true. Good people have been totally wiped out by doing the wrong thing. That wrong thing has never been the market, nor the fact the trader made a bad call. Indeed, every successful trader will have bad calls and losing

trades. And lots of them.

The wipeouts you have heard about, every single one of them, have come from placing too large a bet on a trade or holding onto a losing position too long. The sooner you learn to master your defeats, the sooner you will be on your way to amass the wealth that is possible in this business. It is your failures, not your successes, that kill you in this business. Failures do not build character; instead they destroy your bank account.

The foundation to all your success can be found in the preceding paragraph. Psychics may or may not be able to predict the market, and value may or may not prevail. The world of speculation is about predicting the future and that is difficult at best. The fabled U.S. intelligence community, which has supposedly bankrolled and trained the brightest of the bright, was not able to predict the fall of the Berlin Wall! So how can you and I hope to do better?

Our inability to see the future is proved yearly by such august sports magazines as *Sports Illustrated*. In 1997, their oracles predicted Penn State would be the number-one football team, ranking Michigan number 18. By the end of the season, Michigan was number one and Penn State was floundering. Washington was supposed to be number three, but was beaten by lowly Washington State, a team not mentioned in any top 20 list, that went on to win the Pac 10 championship and almost upset Michigan in the Rose Bowl!

History repeats itself; Mike Tyson is living proof of that. An interesting side note here: Montana's banker of the year, a few years back, was actually embezzling bank funds. To redeem himself and pay back the thievery, he took out another \$1,000,000 to bet on "Iron Mike" Tyson, who of course lost the fight against Buster Douglas. The bank buster was tapped out, discovered, and went to prison.

Who could have predicted the demise of newspapers, or Tiger Woods?

People who make their living looking into crystal balls are destined to eat a lot of broken glass.

But take heart: Although neither you nor I can divine the future, especially price action, we can learn to control our losses. That is a certainty, based on math, that will provide the building blocks for your successes. Each and every one of them.

For years, I chased the prophets of profit, those financial soothsayers who claimed that they, or their indicators, could reveal the future. Eventually, I realized that God does not want us to see the future. It is as simple as that.

If we could see "out there," we could all be millionaires many times over. We would bet the ponies, spin the roulette wheel, and roll dice, except, of course, that no casino would back the other side of an unwinnable wager. Besides, how thoroughly boring would life become if we could know today how every day of our future would be? Who would want to live that way? Where's the joy of discovery, the

magic of the unknown, the thrill of victory, the challenge of overcoming limitations?

If we could all be rich from our powers of foresight, who would work for us, grow wheat, or raise cattle? There would be no phone company, no movies, and no television, as no one would need to work. Worse yet, who would hire us?

As I have said, God in His infinite wisdom does not want us to know much about the future and, certainly, very little about the future of futures. Would-be speculators think that this is a game of knowing the future, of knowing what cannot be known. It is not. This is a game of developing strategies with winning advantages, getting the odds on your side, working those odds, and staying alert to any potential changes in the game, including new players or new ideas and concepts.

The word *speculate* comes from the Latin *specular*, meaning “to observe,” as also found in the word *spectacle* (such as your eyeglasses). We are not like gamblers, who enter a game they cannot win over time. All they can do is hope that chance will run their way, not the way of the house. We speculators observe how things should happen in the future, but because we know there are no guarantees, we protect our positions with appropriate techniques to preserve capital, so that we can win at our game.

The art of speculation requires one part observation tossed together with one rather large dose of preservation.

MY MOST IMPORTANT MARKET BELIEF

Based on my research and experience, I have developed a powerful and profitable belief system:

I believe the current trade I am in will be a loser ... a big loser at that.

This continues to be my most important market mantra. Winners we can handle, it's the losses that kill you.

This may sound pretty negative to all you positive thinkers, but positive thinking can give way to thinking you will win—a surefire formula for buying and selling too many contracts and holding on too long. After all, if you are positive things will work out, you are certain to hold for a bounce or turn that never comes.

I look at it this way: If you get all pumped up over positive beliefs about your market success, your conviction will lead you to mismanage losing trades. That is why belief systems are so important to a trader. If your belief system tells you that your current trade will be a winner—and it isn't—the need to confirm that belief in your mind will literally force you to let losses run, to stay with losers, which is something that no successful trader ever does. An outrageously positive belief that

the next trade or two will turn your account around or make a small fortune for you is most dangerous.

Now let's look at my belief that the current trade I am in will be a loser, that I have no pact with God for success on this trade. Indeed, I genuinely believe the market is not precisely perfect. Keep in mind that the data for this belief overwhelmingly supports it: 75 percent of mutual fund managers do not outperform the Dow, 80 percent of short-term traders lose their risk capital. On a personal note, many of my own trades do not make money, and I can positively guarantee that many of yours will not succeed.

No major loss I have ever had, and I have had more than my fair share of them, has been the market's "fault." "They" were never out to get me. I got myself by believing my current trade would be a winner, which led me to neglect to follow the rules of the game.

I agree with those who say you are only as powerful as your belief system because that belief will give you the power of taking an action with more certainty and less hesitation. We act out what we believe: Those mental beliefs are the scriptwriters for our play of life.

Adopt my belief that the current trade will most likely not work out, and you sure as heck will protect yourself with stops. You will control disasters, taking the first lifeboat possible instead of going down with a sinking ship.

Adopt my belief that the current trade will most likely not work out, and you sure as heck will not load up on a trade, banking on it to bail out all your problems. A tiny loss can wipe you out when you have taken a very large position or number of shares or contracts.

Positive beliefs about future results cause us to take on undue risk. Doing that in a game where the odds are unfavorable to begin with is a sure invitation to disaster.

THE BEGINNING OF MY CAREER AS A SPECULATOR

I ride rodeo because I'm too lazy to work and too honest to steal.

—Freckles Brown, world champion bull rider

My career as a speculator began in the seventh grade when a kid named Paul Highland showed me how much money could be made flipping coins, matching quarters, or odd-man-out for the shiny silver dollars we lugged around in our Levi's. Growing up in Billings, Montana, was an excellent precursor to speculation. Flipping quarters was my start; sure I lost some, but if there was anything I

understood, other than my art classes and playing football, it was that there was plenty of really easy money to be made gambling for quarters and dollars.

It may well be that everything I needed to know about speculation I learned in junior high school. It took a while, but I finally figured out that Paul and Virgil Marcum were taking my money by teaming up. One would control his coin so a head came up, the other a tails so I could not win. Later they split the proceeds, and I had my first lesson on market manipulation.

I did not call the police or any authorities. I handled it in my own way, and to this day distrust the bureaucrats that are supposed to right such wrongs. They don't ... at least not in time to help you or me.

Jack McAferty was the toughest kid in Billings. Fact is, he was the toughest kid in the entire state of Montana and that's saying a lot, considering the number of cowboys, roughnecks, and miners we had in the Treasure State. When a big guy hits you on the arm it hurts. When Jack, who was not a big guy, socked you on the arm, your bone ached. He had unbelievable power, which served him well in every single fight I ever saw him in. No one came close. Fighting became his way of life, but Jack was killed by an L.A. policeman, supposedly on a freeway chase. The truth, however, is that Jack, a real ladies' man, had been dating the cop's wife.

Most of the guys who were coin-matching speculators would not play with Jack. Usually he would pay off and give you his quarter, but if he decided not to, what was your choice? Threaten him and get the living crap beat out of you? Ah, another lesson in speculation: Choose your partners and business associates carefully.

Years later, we took a \$5,000 account to over \$40,000 by trading a Cattle system that Richard Ulmer developed. This happened at a brokerage firm owned by George Lane, a guy who claims he is the originator of the widely followed Stochastics Index. Well, George did not invent Stochastic, and I did not get my \$40,000 from the brokerage. The regulators closed old George up, and just before they did the funds were drained from my account!

Another thing I learned from Jack was that strong people do not respect weak ones. I had put up with enough of Jack's renegeing on our coin flips so that when he decided not to pay up and kept his quarter, I blasted him in the stomach as hard as I could. Astonished, he glared at me, asking, "Why the hell did you do that? You know I'm going to clean your clock now."

All I could say was, "Well, go ahead and do it, I'm just tired of you not playing by the rules. I know you're going to break every bone in my body and you'll get a lot of pleasure out of that, but it won't compare to how I feel knowing I stood up to you."

Jack shot back, "I like that, I respect you," handed me the quarter I had just won, and walked away. We became pretty good friends after that, but we never matched coins again.

Everyone in Montana works hard. Certainly, my dad worked as hard as anyone, putting in over 40 hours a week, then more hours on weekends at Doc Zinc's stinky sulfur refinery. And as if that weren't enough, he would stay up late at night reading books, taking courses on electronics so he would be more valuable to Conoco, his career employer. The gambit of hard work and loyalty paid off—he got promoted.

One of the advantages of having a father working at the refinery was that his kids could get summer jobs there if they were in college. I did that, too, and it reinforced my strong desire to not do what these guys did: work. They worked long hours, ever-changing shift work. One week, you went to work at 3:30 PM, the next week at 11:30 PM, and the following week you might pull the 3:30 shift or start at 7:30 AM. There was neither rhyme nor reason to the schedules that I could see. All I saw was the unending hours of voluntary servitude in a hot, stench-filled, noisy refinery, a place where nothing made sense to me.

There must be a million valves in an oil refinery and I am certain they all turn on and off the same way. My problem was I could never figure out which way was the right way. That was frustrating, not only because it showed my ineptitude, but also because it also reflected on my father, who had all this mechanical stuff down pat. There really was nothing mechanical he could not fix. If I were to have open-heart surgery, I would trust him more than a doctor.

Dad knew how to build things (our house, delicate cabinetry for Mom) and knew how to fix things—in part, I am sure, because we did not have money to pay to get things fixed. Poor people develop more skills than rich people.

My ineptness also held me up to ridicule when people compared me with my older brother, who just naturally knew what to do at the refinery, and seemingly got along well with the older men. My general laziness coupled with a desire to be alone and a total inability to do anything well, but draw, caused me to feel inadequate. My initial response to find self-esteem came from sports. But that sense of approval only lasts through the game. I would lay awake in bed dreaming, scheming about a way to have a better life, wondering how the few people with really big houses achieved success. I was not content; what I wanted was a way out.

Flipping coins seemed reasonable; making fake driver's licenses (for \$5 each, and fake birth certificates for \$20) paid a lot better. My limited artistic talents made more money and let me work by myself. It also included a healthy dose of risk. I liked knowing that I was doing something the average person couldn't or wouldn't; and I certainly was not going to find that kind of satisfaction in what I saw at the time as my father's humdrum existence. My dad did everything by the book and followed all the rules—with one exception.

When deer season came, the rulebook went out the window. We killed enough deer, antelope, and elk to feed our family for the year. We used the same deer tag or

license three or four times. When it comes to survival, I learned there are no rules: People must take risks, even my Pops. What did I like most about those hunting trips: bagging my deer or taking the chance of getting caught with too many deer, fish, or other game? I have often thought about that. In their own way, they are both thrilling—my speculative career began on a roll.

Really good speculators like thrill, indeed they seek it out, as some sort of intellectual rush.

Maybe that is why I liked selling newspapers on the street corners after school, or selling Christmas cards and garden seeds door-to-door to pick up spending money. I was at risk, never knowing if I would make a sale, but I also might make some decent money for just being there, talking, and showing some stuff.

I had seen enough hard work to know I did not covet it. Like rodeo riders, I was “too lazy to work” and had been raised to be “too honest to steal.” Hence going to college or joining the Navy after high school seemed to be the right direction, and it was one that my mom and dad encouraged. They always told us to do better, that there was an easier life, and that college was the door to that life.

In 1962, I asked someone what the “most active” list of stocks in the newspaper meant. I was hooked when he replied, “Well, see that the stock for General Motors was up 1.5 for the day? Had you bought it yesterday, you would have made \$150 today.”

\$150 in one day!

Wow, this sure beat flipping quarters! Back then, \$150 was more than guys at the refinery made in a week. This looked easy, and the winnings were staggering. My only two questions were, how did one get started and where had I been all my life? There was an instant affinity between me and what looked like easy money!

That affinity led to the greatest challenge of my life, something I have worked hard at just about every day since 1962. Really, my only time off from the markets occurred when I ran for the U.S. Senate in 1978 and 1982. Other than those two interruptions, I have spent every day of my life “working,” much to my father’s pleasure, I am certain, but it has never resembled work at the refinery or the jobs I held during and after college.

From this experience, I believe three motivators are found in the heart of a successful speculator: an intense desire to make a lot of money, a longing or yearning to show somebody else up, and an internal discontent with how things are. Great big chunks of unrest seem to be an important asset for a speculator. Although most people seek balance in their life, I have never found that very healthy; no great achievements were ever made by perfectly normal people. Sometimes I think about living a more balanced life. That thought usually lasts a couple of seconds. I guess my unrest will never go away, but if my lifestyle suggests anything, it is that unrest

fans the flames of a speculator's internal fires.

THE RIDE OF A LIFETIME

I would probably trade the markets without wanting profits if it proved my worth to the world, to an old girlfriend, to my parents, my brother, or even to someone I cannot identify or dredge from the recesses of my mind. Saying I am ego-driven may be correct, but it is not about bragging, it is about showing them that I can overcome adversity.

It is about letting the world know that I found a way out. This book is about showing you that same door; it is about showing you what I learned over the past few years, how the markets have changed, and what we can do to continue as successful traders.

There is so much more I have learned in the past few years; above all, I have learned to adapt to market changes, so you will be learning more than a few more *Long-Term Secrets to Short-Term Trading* ... you will also learn the art of adaptation.

If these words have resonance for you, cinch up your seat belt, you are going on the ride of your life.

The ride has continued for me, while most who are my age, the cusp of 70 years now, are retired and content to surf the Internet and doze away while watching *American Idol*. I am still fascinated by these damn markets. They keep me alive and thinking as I continue to trade, often more than 1,000 contracts a month. You can read more about these exploits on my web site, www.ireallytrade.com.

The markets keep you alive; I cannot imagine another way to live or a life more fortunate than the one I have.

My father's great life lesson to me was this: "Son, you only get out of life what you put into it." If you want to succeed at speculation, give it your heart and soul. The rewards run deep.

CHAPTER 1

Making Order Out of Short-Term Chaos

There are two primary ways we make money trading: catching a big price move with a small position or having a large position and catching a small move.

—Bill Meehan

If what I have written so far has meshed with your speculative goals, it is time to learn how markets operate. Speculation—stock and commodity trading—is not for everybody; it may not be for you. I have even wondered at times if it is for me!

It's striking how little has changed in this chapter. The concepts presented here are the same now as 10 years ago, or 20, or 100. This is the foundation for my trading. My view is that there is definite market structure and a map or way that price moves from one point to another. Once you identify that, it will hold just as true in the pit session markets as it will in the electronic session markets. There is a language to how prices move that is based on an alphabet of each day's opening, high, low, and closing price. It has been my mission to decode these hieroglyphics so we can all "read" the markets better. I am still at that task, like some archeologist hunched over the Sumerian Records, seeking truth.

The curve ball we have been thrown since the first edition of this book is this: Thanks to computers, trading pits have given way to electronic trading. These new electronic markets now open somewhere in the world just a few hours after they closed. The influence of pit trading in open outcry markets has vanished.

HOW I LEARNED ABOUT THE MARKET

My career as a trader began in Portland, Oregon, where I had met a Merrill Lynch broker who thought we could make some money together. He was half right: We got lucky immediately. He made good money on his commissions and I lost money. Worse yet, the money wasn't mine; a fellow I had never met had asked me to invest it. In hindsight, the initial beating I took was more than fortunate, it was life changing.

That event hardened my desire to learn the business; after all, if it was that easy to lose, it had to be pretty easy to win, right? My broker was as new to the game as I

was and really had very little advice or suggestions. His market insight was to buy good stocks and hold on to them (a brilliant insight), but my aptitude or desire was to make money from catching short-term market swings. Thus began my education as a short-term trader.

I had no teacher and knew no other traders, so I naturally turned to books to help solve my problems, just as you have in buying this book. The authors all made it sound so easy. I read Joe Granville's classic work on technical analysis and began keeping track of daily open, high, low, and closing prices on stocks as well as other indicators that Joe said we should follow. Joe, a true legend, is still worth reading. Before I knew it, I was not only totally consumed by the markets but spending five to six hours a night and all my weekends trying to beat Wall Street, in the meantime gaining a fortune and beginning to lose a marriage.

My first wife, Alice Fetridge, had become a "chartist's widow" yet still supported my habit. We eventually left Portland and moved to Monterey, California. We both had jobs, and I was also working on my law degree. I even sat for and passed the "Baby Bar Exam" (the test given to night school and correspondence students). By then, however, I had pretty much given up on becoming a lawyer, especially after working for one. I had thought being a lawyer meant being in court, saving people's lives; the reality was that it mainly meant collecting money from judgments, finding deadbeats, and representing bums and outright criminals. It was not like trading.

Fortunately in Monterey, I met two brokers who, like me, kept charts. Joe Miller and Don Southard were soon swapping war stories with me, teaching what they knew about the markets. We were all big followers of Joseph Granville's on-balance volume (OBV) work and kept OBV charts on the 30 to 50 stocks we followed. I also started to keep moving averages, another tool espoused in all the books back then, just as they are today.

My stock trading met with some success, but what accelerated my career was a book by Gil Haller, unabashedly called *The Haller Theory of Stock Market Trends* (Gilbert Haller, 1965). I learned a lot about stocks and speculation from the book, then got to know Gil and to this day appreciate the support and encouragement he provided. Gil's concept—we are talking 1963—was to buy stocks that had already moved up a lot. This is now a methodology used by the funds to buy what they call "momentum stocks." Haller was doing it way back in 1964 and making a living. But, he didn't live the way I wanted to! His desk was an old door atop cinder blocks, stationery was the back of a letter someone had written to him. Gil was not cheap, just a frugal spender who precisely counted and saved every extra penny.

Eventually, I began to envision a theory of how markets work: In the short term, markets spurt in rallies and declines, moving above and below a balance point I could call the "average" price. My object was to determine when price was low and should move back to the average. That meant I needed to identify an overextension

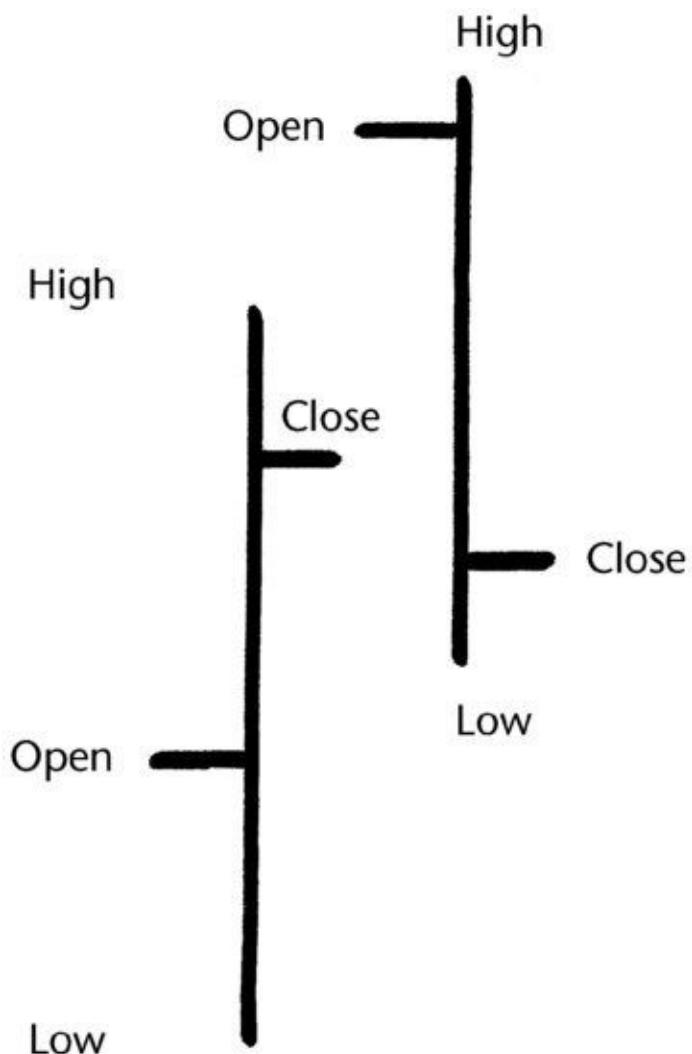
of price and then have something that would tell me when this move was over and the spring back to the average had begun. Because it all seemed so easy, I was sure there must be some master theory or code to how all this was done. There must be some basic undeniable way the market—all markets—moved from point A to point B, I reasoned.

What I eventually found out is that this original thesis is true: There is a way markets move. The good news is that there is a structure in how prices move from point A to point B. The bad news is that the structure is imprecise. Nevertheless, there is a semblance of order to price action, and, like a foreign language, it can be learned. It has taken most of my life to figure out the basics of this language that the market speaks, and I am more than happy to help you learn to use my magic decoding ring.

CHARTING THE MARKET

If you have begun your study of the markets, you already know it is a visual world, where charts prevail. As shown in [Figure 1.1](#), the common charts represent each day's opening price with a horizontal slash mark to the left side of each bar and the closing price with a horizontal slash on the right side of the bar. The topmost point of the bar reflects the highest price reached by the stock or commodity during the day while the bottom of the bar represents just the opposite, the lowest price the commodity traded at on that day.

[Figure 1.1](#) Typical Chart Showing Openings, Closings, Highs, and Lows



The opening price, as you will see later on, is the most important price of the day. I developed this notion with Joe Miller, Don Southard, and Curt Hooper, a naval postgraduate student who—in 1966—was the first person I ever worked with while using a computer to arrive at answers. While we were impressed with OBV, we wanted a more reliable formula, and once we learned that the original OBV work came from two guys from San Francisco, Woods and Vignolia, we thought that we, too, could create a better approach.

Our chart-reading problem begins and leads to chaos when we start combining these daily bars of price action on a chart. These graphic representations of price action were “read” for years by folks calling themselves “chartists.” By and large, chartists were about as welcome as your unemployed brother-in-law until the early 1980s.

This crowd gleaned over chart formations, found patterns, and gave them names like wedges, head and shoulders, pennants, flags, triangles, W bottoms and M tops, and 1-2-3 formations. These patterns were supposed to represent the battle of supply and demand. Some patterns indicated selling, others professional accumulation.

Fascinating stuff, but wrong-headed. These same precise patterns can be found in charts of things that do not have a supply/demand factor.

[Figure 1.2](#) shows a chart of the 150 flips of an old silver dollar that graphs out to look much like a chart of Pork Bellies. Next, [Figure 1.3](#) is a chart or graph of temperature extremes, or is it Soybeans? Who knows? What we do know is that plotted data of nonmarket or economically driven information charts out just like data for stocks and commodities, producing the same patterns that are supposed to reflect buyers and sellers. I caution you against confusing chart forms with intelligence.

Figure 1.2 A Flip of the Coin Heads and Tails on Accumulative Basis

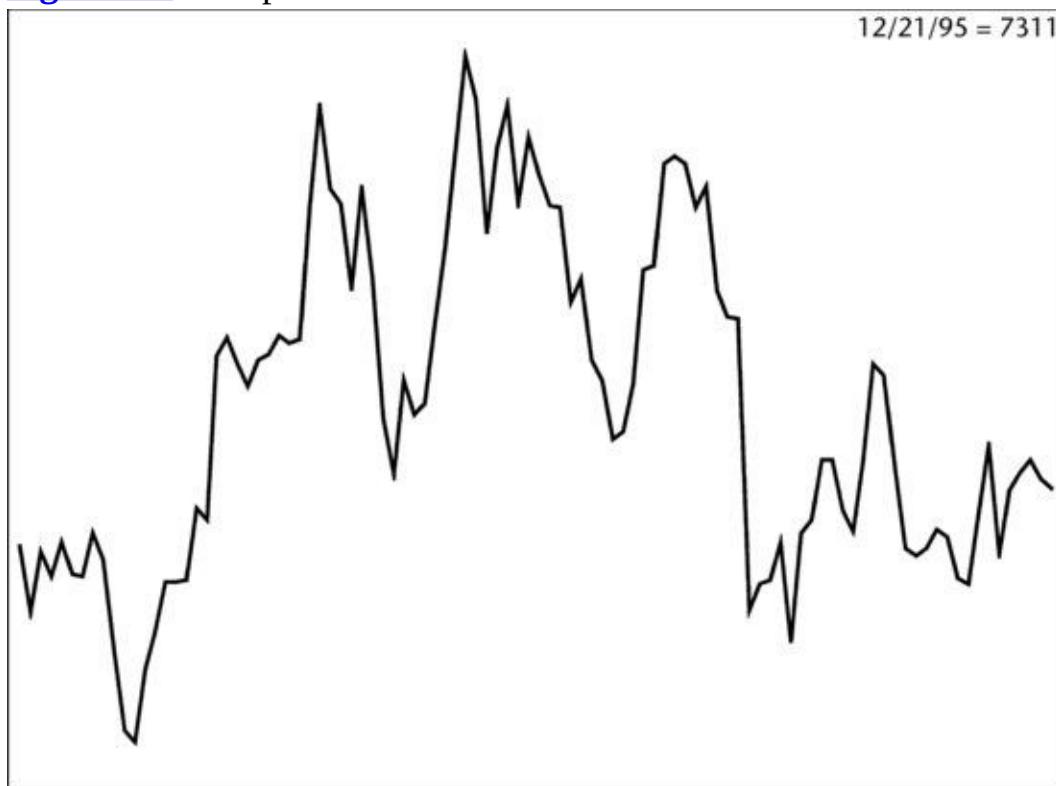


Figure 1.3 A Stock? No, Daily Temperature; High for the Day; Low for the Day; Last Reading



Chartists became “technical analysts,” severing their ties from Ouija boards and charts in favor of computers. Computers made chartists look and sound more respectable, like scientists. In fact, many books came out with titles like *The New Science of ...* or *Scientific Approaches to ...* Is there science to this madness?

By and large, I think not.

Prices do not dance to the beat of some mystical, magical drum that hides deep in the recesses of a plush room in New York City, and has a rhythm only a few insiders recognize. Prices jump all over the place, and our charts become erratic because human emotions are influenced by news and brokers’ hot tips of immediate boom or gloom.

THE NONRANDOM MARKET

For the most part, commodity prices are like a drunken sailor, wandering down the street without any knowledge of where he is going, or where he has been. Mathematicians would say there is *no correlation* between past price activity and future trends.

My trading friend Vic Niederhoffer has written extensively about this to his beloved “Spec-List” followers as well as in his magnum opus, *The Education of a Speculator* (John Wiley & Sons, 1997). I suspect we differ on how prices meander around the charts, but I will suggest there is *some correlation*. Why? Because,

although that drunken sailor does swagger, stagger, and seemingly move in a random fashion, there is method to his madness. He is trying to go someplace, and we can usually find out where. We must understand his madness to know where he is headed.

While price action involves a large degree of randomness, it is far from a totally random game. If I cannot prove that point, right now, early on in this book, the remaining chapters should be devoted to learning how to throw darts. In a random game, the dart thrower will outperform the experts.

Start with a given—if we flip a coin 100 times, it will come up heads 50 times and tails 50 times. Each time it comes up heads, on the next flip we will have 50 percent heads and 50 percent tails. If heads has now appeared two times in a row and we flip again, the results continue to be 50/50 that a head will appear on the next flip. As you have probably heard, the coin, die, or roulette wheel has no memory. The odds are fixed, as this is a random game.

If that were true of the market and prices close higher 50 percent of the time, then after each up close we would expect to see another up close 50 percent of the time, and following that up close again 50 percent odds of another up close. The same thing should apply to a down close: 50 percent of the time following one down close, we should see a repeat; and again 50 percent of the time following two in a row, a third down close should appear. In our real world of trading, it does not turn out that way, which can only mean *price action is not totally random!*

[Table 1.1](#) shows the percentage of time that prices closed higher in a wide variety of markets. There were no criteria; the computer just bought on the open each day and exited on the close. Instead of having a 50/50 result we have a slight skewing, in that 53.2 percent of the time price closed higher than the opening. This shouldn't be.

Table 1.1 Commodities: Closing Price Compared to Opening Price

| Commodity | Percentage of Times That Close > Open |
|-----------------------|---------------------------------------|
| Bellies | 51 |
| Cotton | 53 |
| Beans | 51 |
| Wheat | 52 |
| British Pound | 56 |
| Gold | 52 |
| Nekii | 55 |
| Eurodollar | 57 |
| U.S. Bonds | 52 |
| Standard & Poor's 500 | 53 |
| Average % Higher | 53.2 |

Well, if this “shouldn’t be,” how about buying on the opening following a down close? In theory, we should see the same percent of up closes shown in [Table 1.1](#). The problem is (for college professors and other academics who are long on theory and short on market knowledge) that it does not turn out this way. [Table 1.2](#) shows the number of times price closed higher following a number of down closes.

Table 1.2 Commodities: Percentage of Times Higher Closing Prices Follow One-Down Closes and Two-Down Closes

| Commodity | Number of Times after One-Down Close | % Up Next Day | Number of Times after Two-Down Closes | % Up Next Day |
|-----------------------|--------------------------------------------|------------------|---------------------------------------------|------------------|
| Bellies | 3,411 | 55 | 1,676 | 55 |
| Cotton | 1,414 | 53 | 666 | 55 |
| Beans | 3,619 | 56 | 1,612 | 56 |
| Wheat | 3,643 | 53 | 1,797 | 55 |
| British Pound | 2,672 | 57 | 1,254 | 56 |
| Gold | 2,903 | 58 | 1,315 | 55 |
| Nekii | 920 | 56 | 424 | 60 |
| Eurodollar | 1,598 | 59 | 708 | 56 |
| Bonds | 961 | 54 | 446 | 52 |
| Standard & Poor's 500 | 1,829 | 55 | 785 | 53 |
| Average + Close | | 55.8 | | 55.2 |

This is not earth-shaking news to a trader; we know market declines setup rallies. The exact percentages were not known in the past, and I would never use these tables to take or stay in a trade. That is not the point: The point is we should have seen an average up close of 53.2 percent following the one minus close as well as two consecutive minus closes. The fact we did not suggests that the market is not random; patterns do “predict” and now we can proceed, sans darts.

Here is an update on the Dax index from 1998 to mid 2011: If you buy after every down close, and exit on the same day's close, there are 1,591 trades with 52 percent winners but a staggering loss: -\$60,558. Allow for two consecutive down closes and we find 724 trades with 52.2 percent winners and we also see losses, but a lot less: -\$1,568.

If you have the patience to wait for three down closes in a row you are rewarded with 334 trades, and 55 percent made substantial money: +\$25,295. Want to do better than that? Some days of the week the Dax is more prone to rally than others, so let's buy only on Tuesdays, Thursdays, and Fridays when there have been three down days in a row. The results are far better: 204 trades, 58 percent accuracy, and a net profit of \$44.795.

What you see is that years later and in a different market, not active when this book was first written, the same principles are still afoot in price action.

UNDERSTANDING MARKET STRUCTURE

Whereas chartists have strange names for almost every market wiggle and waggle, they have seemingly missed the major point of the market, which is that price (as represented by daily bars, where the top of the bar is the highest point prices traded on that day and the bottom of the bar the lowest price traded) move in a well-defined and amazingly mechanical fashion. It is similar to learning to read a new alphabet—once you understand the characters, you can read the words, and once you know the words you can read the story.

The first letter to master tells you what market activity causes the formation of a short-term high or low. If you learn this basic point, the meaning of all market structure will begin to fall into place.

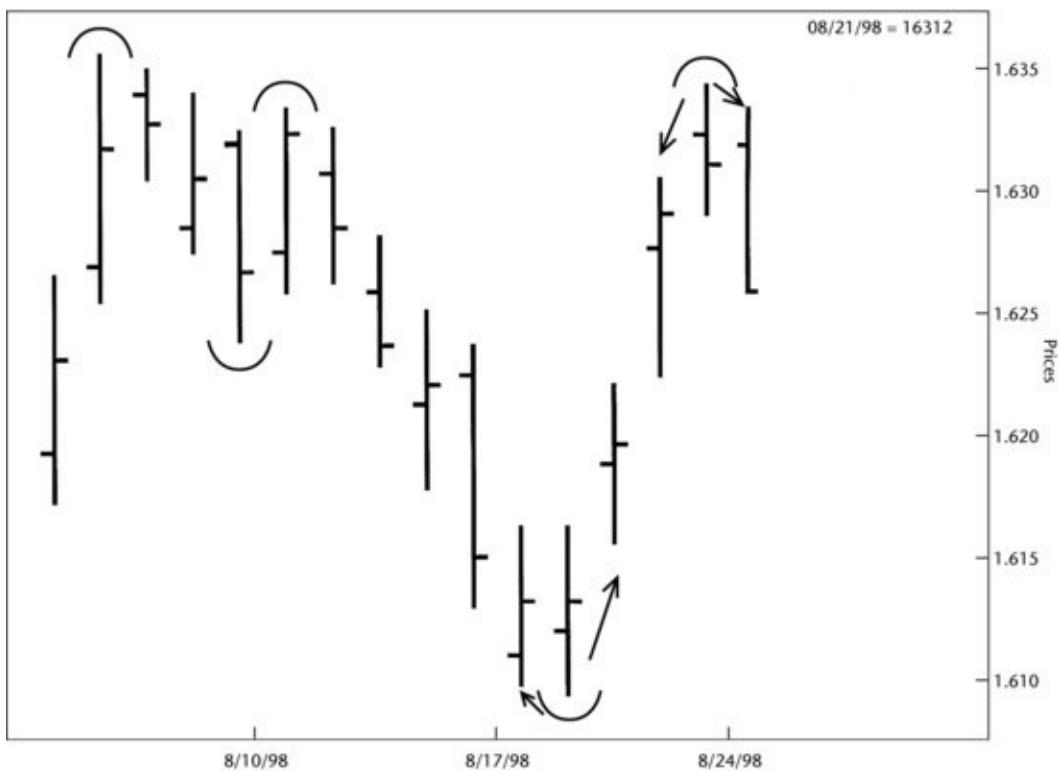
I can define a short-term market low with this simple formula: Any time there is a daily low with higher lows on both sides of it, that low will be a short-term low. We know this because a study of market action will show that prices descended in the low day, then failed to make a new low, and thus turned up, marking that ultimate low as a short-term point.

A short-term market high is just the opposite. Here we will see a high with lower highs on both sides of it. What this says is that prices rallied up to the zenith of that middle day, then began to move back down, and in the process formed a short-term high.

I initially called these short-term changes “ringed” highs and lows in deference to the work done in the 1930s by Henry Wheeler Chase. In the days before computers, we kept notebooks of prices, and to identify such termination of a move, we simply circled or “ringed” these points in our workbooks so we could see them more easily.

[Figure 1.4](#) shows several short-term highs and lows. Take a minute now to see what this pattern is all about.

[Figure 1.4](#) British Pound (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



If you understand this concept, we can begin the building process of putting these elements together. You may have already figured out the sequence; the market swings from short-term highs to short-term lows. This is exciting; we can actually measure market movement in a mechanical and automatic way. There is no need for complex chartist talk, nor will we be as inclined to fall into the illusory world of the chartist or technician.

Two specific types of trading days can cause confusion with our basic definition. First, there is what we call an inside day. It is so named because all the trading on this day took place inside the previous day's range. These days are identified by having a lower daily high and a higher daily low. In a study of nine major commodities covering 50,692 trading sessions, I noted 3,892 inside days, suggesting that we will see these days appear about 7.6 percent of the time.

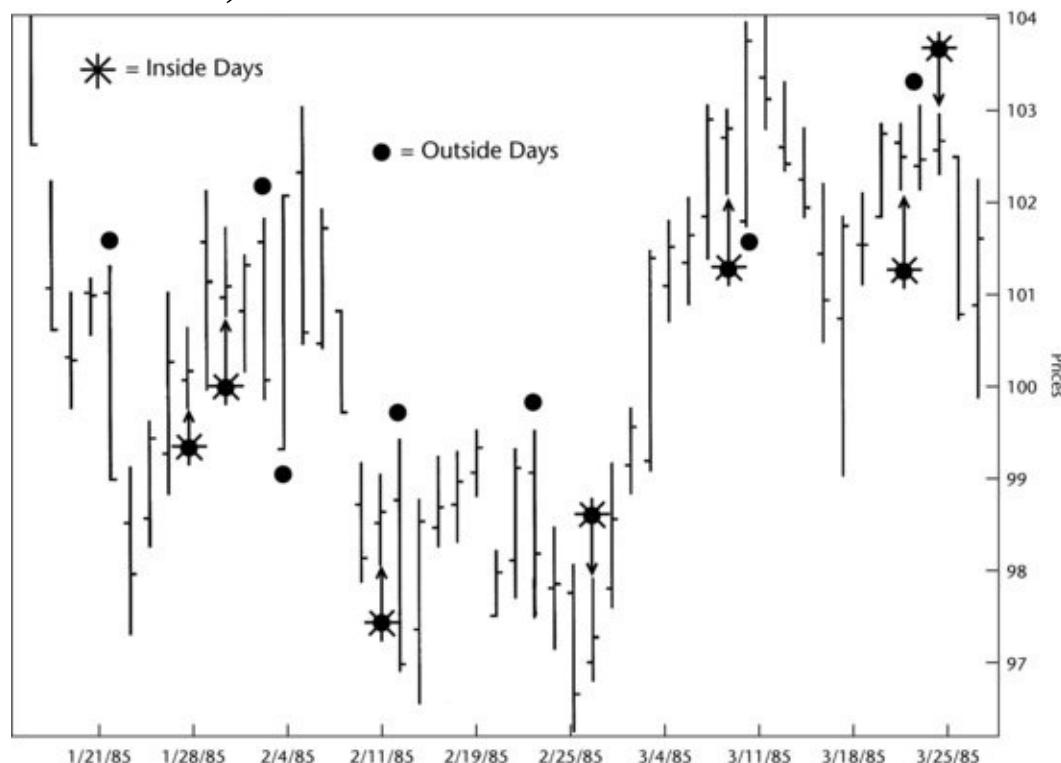
For our purposes in identifying short-term swing points, we will simply ignore inside days and the possible short-term points they produce. An inside day means the market has entered congestion, the current swing did not go further, but then again it did not reverse, thus until this condition is resolved, we must wait and not use the inside day in our identification process.

Next we have outside days. These days are easy to spot because they have both a higher high than the prior day and a lower low! When these days occur (and they do so about 3 percent of the time), we will have to study the flow of prices during that day by looking at the way price moved from the opening of the day to the close of that same day. In that study of 50,692 trading sessions cited earlier, there were 3,487

outside days, suggesting they are not as frequent as inside days, yet account for almost 7 percent of all days.

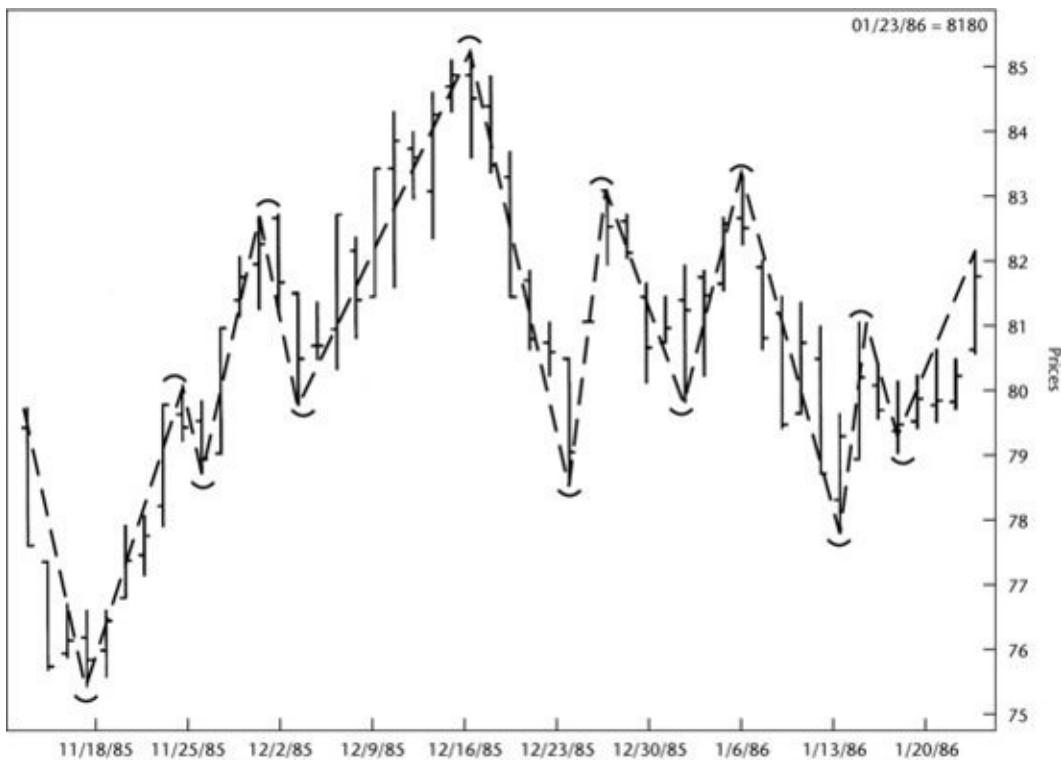
With the preceding information in mind, turn your attention to [Figure 1.5](#), which illustrates these inside and outside days. Remember, we are attempting to identify the short-term swings as traders move price from one terminus to another.

Figure 1.5 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



By now you should understand the basic concept, and be able to see how prices move in swings. In [Figure 1.6](#) I have marked off these terminal points and connected a straight line from point to point to show the swing patterns.

Figure 1.6 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



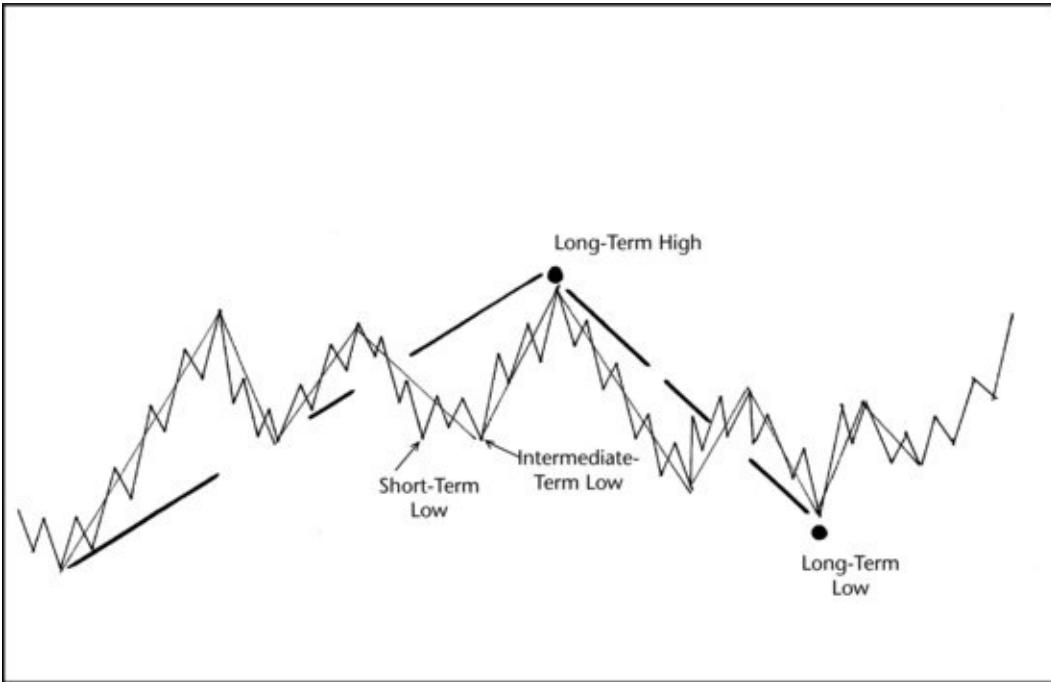
Defining Intermediate Highs and Lows

Now the fun begins! Consider this, if we can identify a short-term high as any day with lower highs (not counting inside days) on both sides, we can take a gigantic step forward and identify an intermediate-term high as *any short-term high with lower short-term highs on both sides of it*. Hold on to your seat belts because we can take yet another step and say any *intermediate-term high with lower intermediate-term highs on both sides is*—you've got it—a long-term high.

In just one paragraph, we have been able to define the three dominant swings in a market, going from short-term to intermediate to long. The identification of market lows is done in just the same fashion: First find a day with higher lows on both sides—this is a short-term low. Then find a short-term low with higher short-term lows on both sides and you have found an intermediate-term low. Locating a long-term low is simple: It is any intermediate-term low with higher intermediate-term lows on both sides.

It is time for a picture of what this all looks like. In [Figure 1.7](#), I have marked off all short-term swings, then located the intermediate-term points, and finally gone to the next level and marked off the longer-term points. This chart tells all; it is really all there in a simple format. If you look at it now, you will understand market structure and will see that we can create order out of much of the chaos.

Figure 1.7 Charting Creates Order Out of Chaos



With the preceding in mind, I have moved from a sample chart to a real one of the Swiss Franc and Coffee (see [Figures 1.8](#) and [1.9](#)). My first step was to circle or ring all short-term swings; then I began the overlaying pattern of higher/lower short-term points. After that, I identified the next layer of higher/lower intermediate-term points to arrive at the long-term points. While words are great, until you study these charts, it will be difficult for you to get the picture. Go study.

Figure 1.8 Swiss Franc (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

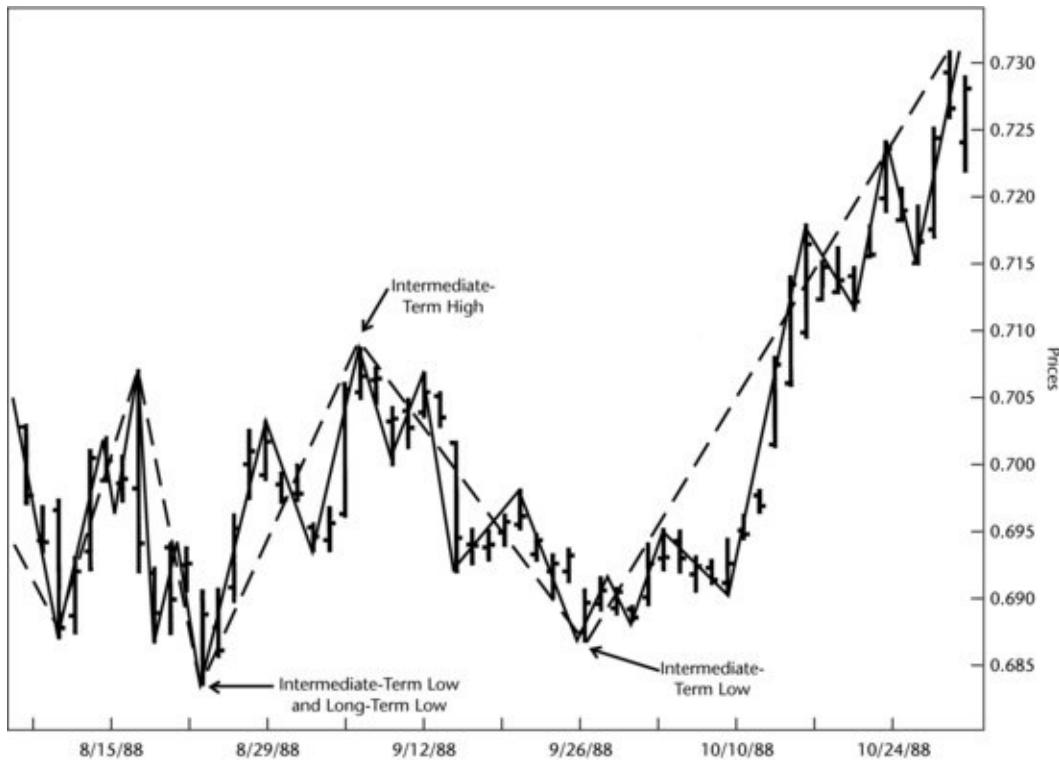


Figure 1.9 Coffee (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Why This Is Important

Once you have this basic understanding of market structure you can identify, very early on, these market turns. You will always know that a short-term low has been made when you rally above the high of a day with a lower low than the prior day. By the very nature of this penetration, we know the short-term down swing has terminated. By the same token, whenever price declines below the low of a day with a higher high than the prior day, a short-term high has been formed. This means we can know, during the trading session, when these points are established.

As short-term traders, we also can tell when intermediate-term highs and lows are made. How? Simple, if the formation of a short-term high will confirm an intermediate-term high, which in turn confirms a long-term high, we can get in at some optimal turning points.

[Figure 1.10](#) shows how this can all be combined. By going above the high of the day marked at (A), we have formed a short-term low that is in turn higher than the prior short-term low. This means the low at (B) is a long-term low and we can be buying at the start of an up-leg in what is a type of long-term move.

Figure 1.10 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



It is really all about nesting swings together, fitting the pieces of the puzzle into their proper place, to give us an understanding of the structure of market activity. The beauty is you can now identify, at all times and for all markets, whether the trend (based on price structure) is up or down and pick your points to get in and out.

For years, I made a pretty good living using just the formation of these points as buy and sell entries. These points are the only valid support and resistance levels I have ever found. They are highly significant and the violation of these price points provides important information of trend and trend change. Thus I can use them for my stop-loss protection and entry techniques.

MARKET STRUCTURE WILL NEVER CHANGE

Since the market staggers from one point to another, we can identify these swings. That is a powerful statement as identification leads to being able to quantify and define, on a mechanical basis, all market movement. These swings allow us to then determine (1) the trend of the market and (2) when trend has changed. The beauty of market structure is that it clearly delineates price action for us.

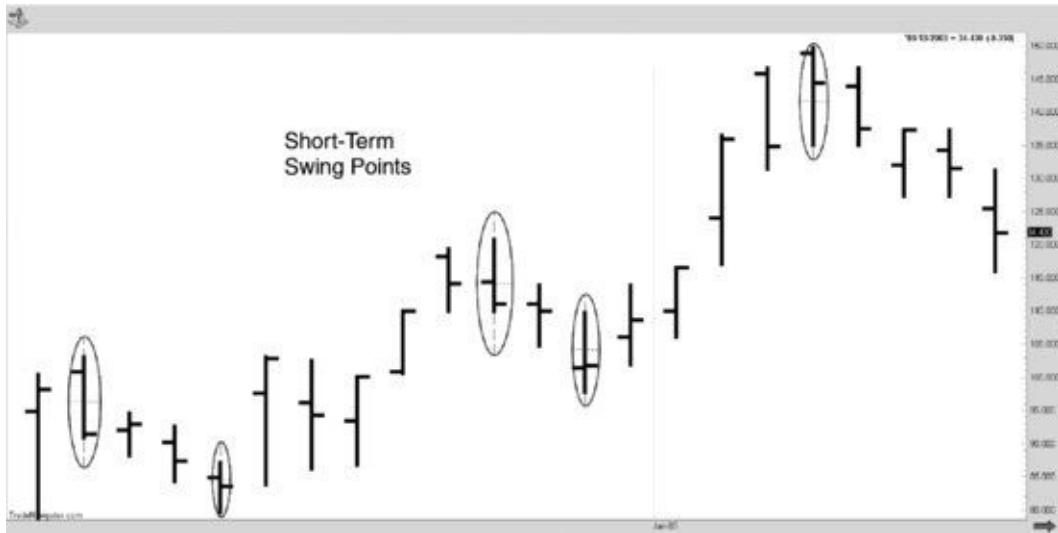
This is how it works: Markets move in cycles, swings, sprints if you will, from one point to another. I will teach you how we can identify virtually all of the swing points and then, once that has been done, identify when these swing points set up buy and sell signals. With that in mind let's start at the beginning ... with the initial understanding of market swings.

We can identify virtually all short-term market highs and lows with one very simple rule:

A market has made a short-term low when we have a day (or bar if you are using different time periods) that has a higher low on both sides. By the same token a short-term high will be a day (or bar) that has lower bars on both sides of it.

Sounds simple doesn't it? There is a wealth of information and market understanding in these swing points. I want to make certain you understand this concept before we proceed further. [Figure 1.11](#) shows an example of swing points marked off, so you understand how they can be identified on a chart. (I am using charts here from the Australian markets; it does not matter what country or what time frame ... market structure is always at work.)

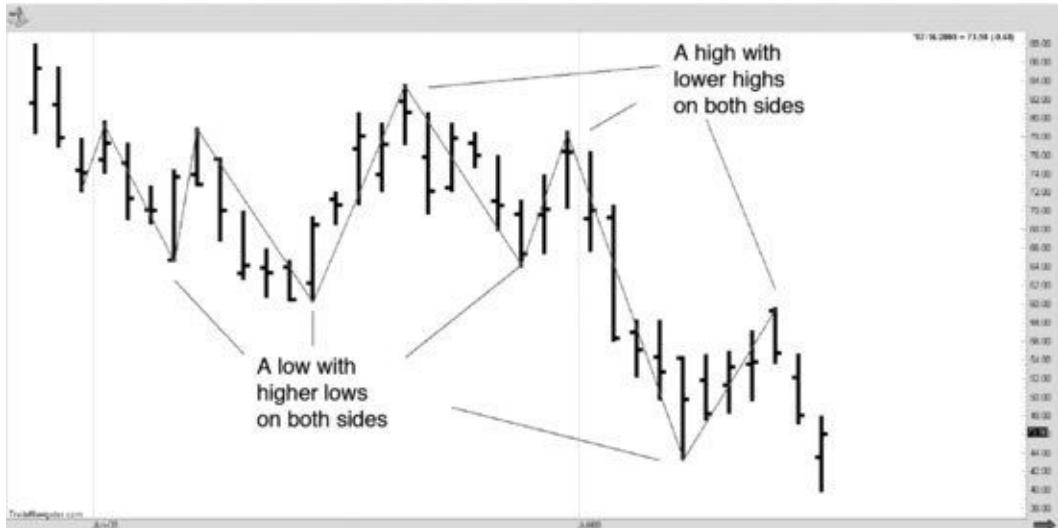
[Figure 1.11](#) Rio Tinto: Short-Term Swing Points



This is where it all begins. It is critical you understand that prices run in swings or streaks. We can say a “run” to the upside is over when price fails to move higher the next day *and* falls below the prior day's low. Price action alone will unfold to reveal the swings of price movement.

Once we have that understanding we can then start to lay in the blocks of market structure by simply connecting these swings, as shown in [Figure 1.12](#).

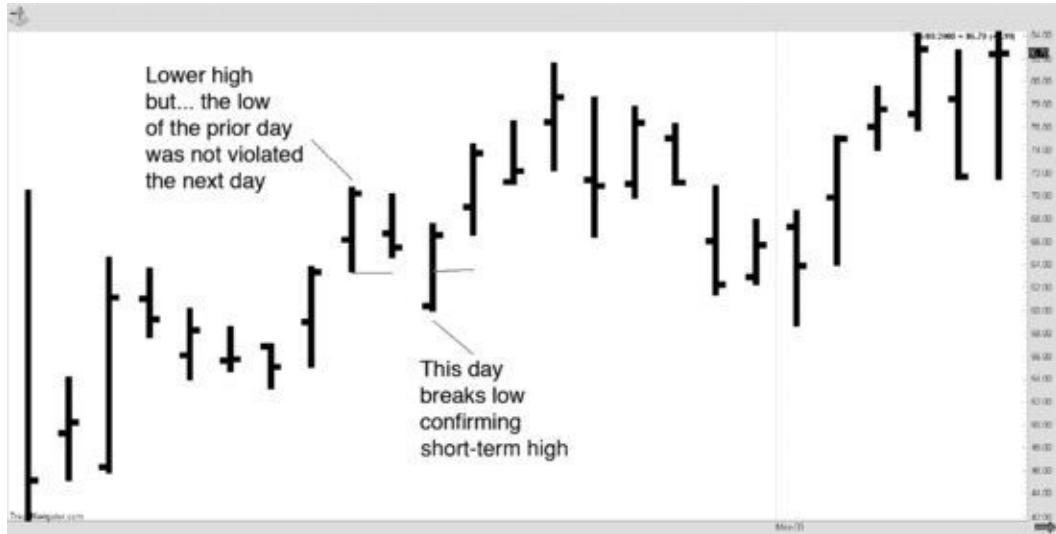
Figure 1.12 BHP: Short-Term Swing Points



It's critical to understand the formation of these short-term highs and lows, so we can know precisely when the short-term high or low becomes locked into place.

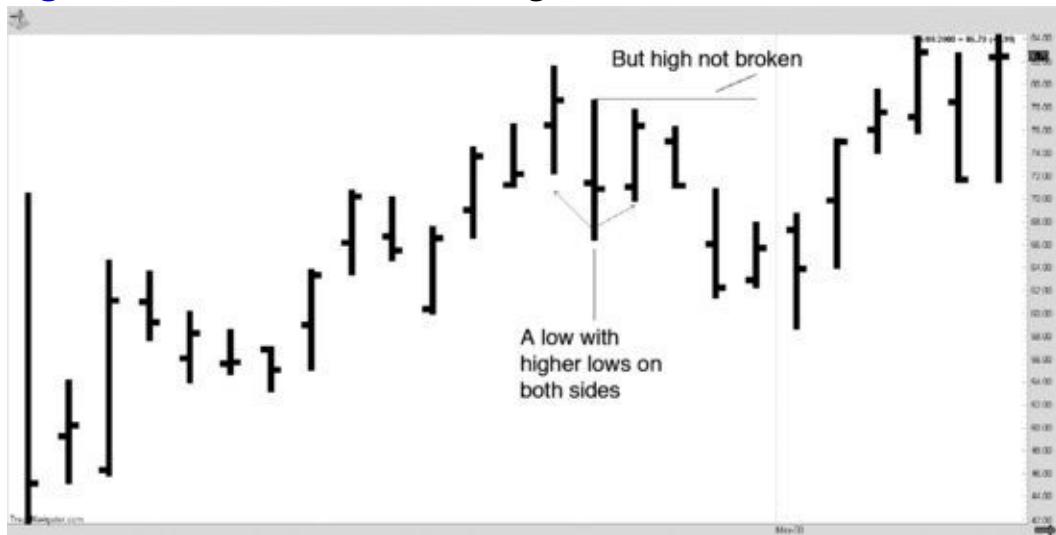
In the case of a short-term high, we know that a day is a short-term high the instant the low of that day has been violated by price falling below that low. It is not just the fact that we have a lower high, but that also that the low of the high day has been penetrated. [Figure 1.13](#) illustrates this: As they say, a picture is worth a thousand words.

Figure 1.13 BHP: How Short-Term Highs and Lows Form



In the case of a short-term low ([Figure 1.14](#)), we know that a day is a short-term low the instant the high of that day has been violated by price to the upside. It is not just the fact that we have a higher low, but that also the high of the low day has been penetrated.

Figure 1.14 BHP: Noted Bar's High Not Penetrated—Not a Short-Term Low

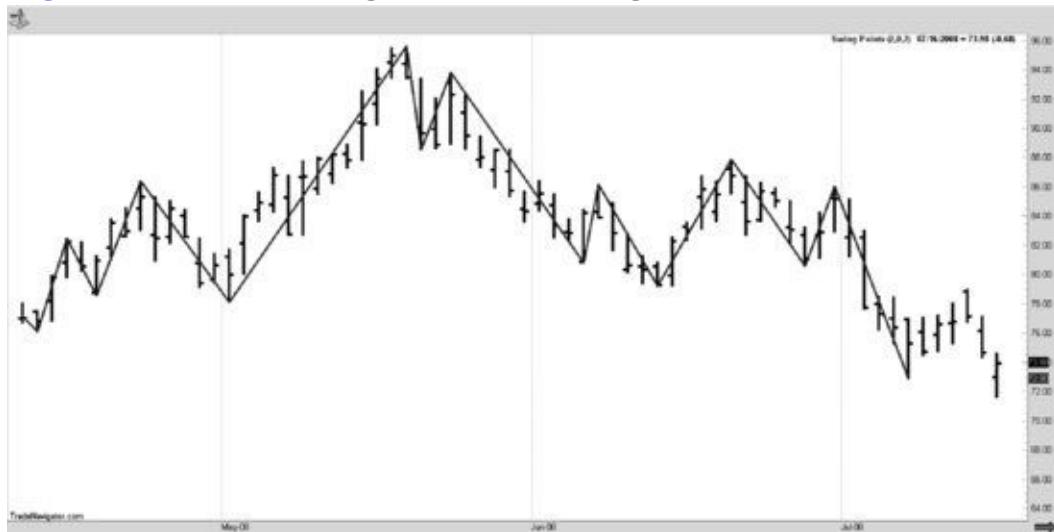


We can wrap all of this up by putting it this way: When a market has been in a downtrend and a day exceeds the lowest day's high, then the short-term downtrend has ended. The end of a short-term uptrend will be known when the low of the highest point seen in the rally is violated to the downside.

[Figure 1.15](#) is here to help reaffirm the information above. You have learned how to correctly spot all short-term swings in the marketplace, but is there more here than what you are seeing? Yes, indeed there is, because if we know that a short-term high is a day with lower highs on both sides, then we can also state this:

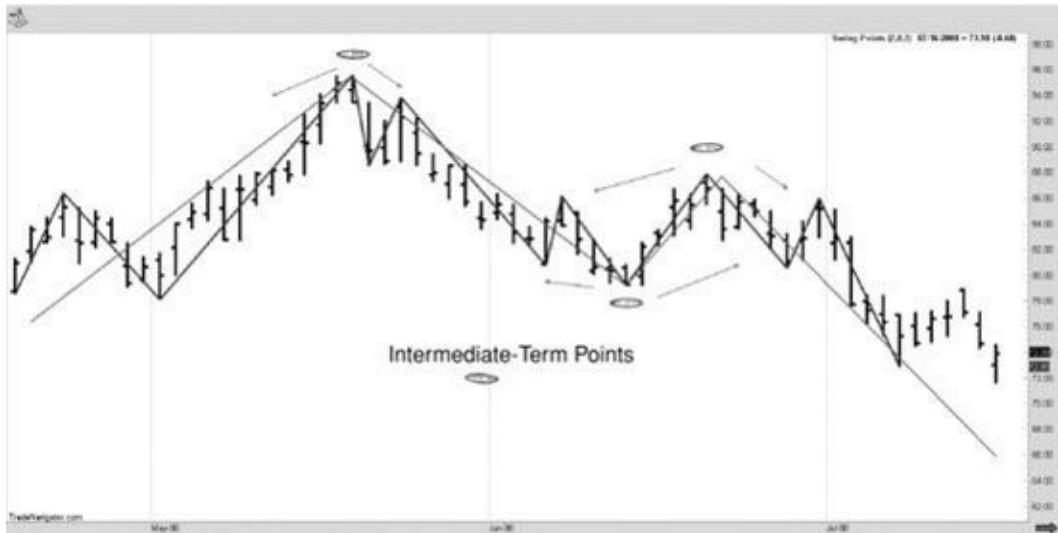
- A short-term high with lower short-term highs on both sides is an intermediate-term high.
- By the same token, a short-term low with higher short-term lows on both sides is an intermediate-term low.

Figure 1.15 Connecting Short-Term Highs and Lows



Now with that simple definition in mind, let's look at the same chart, where I have now marked off the intermediate-term points. See [Figure 1.16](#). What we have been able to do is quite amazing. Without using a calculator, computer, or a mathematical formula, we have been able to define short- and intermediate-term trends of the market. As I understand this, market structure allows us literally to determine *the real trend of any market*. Up to July 2008, a trader would probably say the market was sideways or trendless. Market structure, though, was clearly showing we had formed an intermediate-term high in the middle of June, which was lower than the prior intermediate-term high! This was telling us the stock was in a downtrend and could be sold short.

Figure 1.16 BHP Intermediate-Term Points

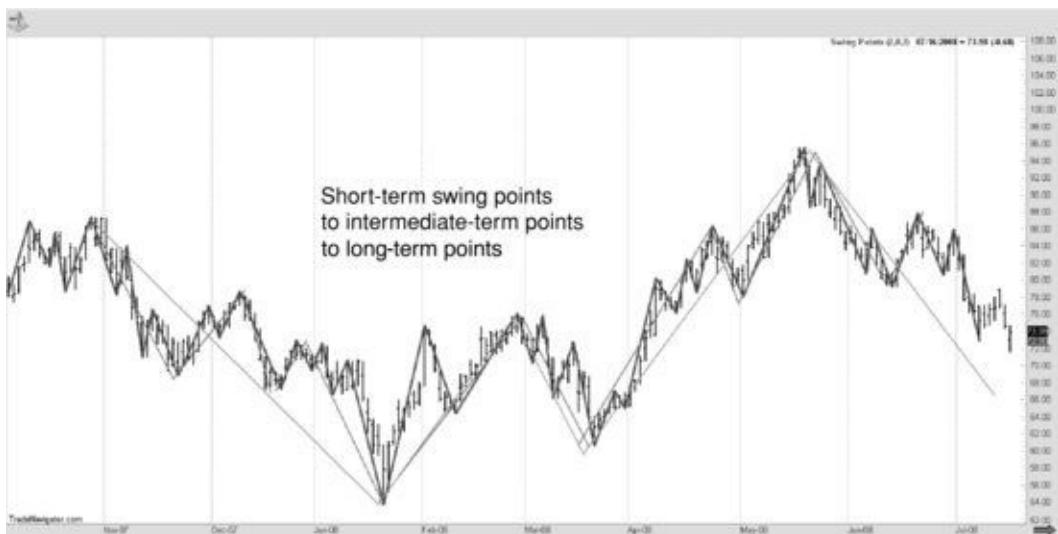


Before we get into our exact entry point, I want take this one step further. If a short-term high can be used to identify an intermediate-term high, doesn't it then make sense to take it to the next level, which is that intermediate-term highs and lows can be used to find long-term highs and lows?

- An intermediate-term high with lower intermediate-term highs on both sides of it is just naturally a long-term high by our definition, thanks to understanding market structure.
- An intermediate-term low with higher intermediate-term lows on both sides of it is just naturally a long-term low by our definition, thanks to understanding market structure.

Look at what we have done in [Figure 1.17](#). We have been able to identify all the short-term swings in the market, which gives further evidence to enable us to determine the intermediate swings, which then are used to identify long-term swing points!

Figure 1.17 BHP: Short-, Intermediate-, and Long-Term Swings



There are many things you can do with these individual points, but I would like to make this as simple as possible by driving home the basics of the concept. The most profitable trades, and certainly the easiest ones to locate, are going to be based on the intermediate-term trend of the market. These offer more profit opportunity. However, they don't occur every day, which is frustrating to people who want to trade 10 times a day or 10 times a week. It's been my experience that is not how you make serious money in this business. The money comes from loading the dice in your favor and seldom rolling them. The more times you trade, the more opportunities you have to stuff up your speculative activities. In other words, the more decisions you have to make, the more open you are to making the wrong ones.

SHORT-SELL PATTERN

Now, let's start with what the ideal short-sell pattern would look like. What you will be looking for is an intermediate-term high that is lower than the prior intermediate-term high. This pattern clearly tells us the trend of the market is down. The formation of the lower intermediate-term high should carry the momentum on the longer-term time frame illustrated for us by market structure.

The conceptual pattern for the best buying opportunity occurs when we are forming an intermediate-term low higher than the last intermediate-term low, telling us the intermediate-term trend is up. It is a question of swings: Which is the larger current swing in the market? Find it and you know the current trend of that time period. With just these two patterns you have the optimal approach to trading, as you are indeed trading with the power of the intermediate-term trend.

Now let's take a look at what a buy signal looks like, so you can see what I am talking about. In [Figure 1.18](#), you are looking at price bars reflecting the open of

trading, the highest and lowest prices reached during the day and then the final settlement price: the close. (Keep in mind these could be five-minute, daily, monthly, or weekly bars: The same rules apply to each.)

Figure 1.18 BHP: Market Structure Reveals Upside Move



Understanding market structure revealed a dynamic move to the upside in BHP. This was known. We had a higher short-term low, higher than the prior one, confirming the intermediate-term low. That in turn told us the trend of the market was up, and purchases could be made. The entry point, and it is a precise one, comes at the high of the day that has a higher high on the right side of it. In this case it came on April 1 at 66.80.

Notice these signals do not come every day. A trader will need a great deal of patience to work this particular price formation. But as you can see, it is well worth waiting. Also this allows one to follow several stocks and commodities, taking the best possible trades as shown by the formation of intermediate-term highs and lows.

Okay, we are in the trade on the long side. The next questions are: How do we get out? Can we develop a target for this trade? What should our trailing stop be?

TARGET TIME AND TRAILING STOPS

Markets don't always go to targets, which is why it is critical you also learn to have a trailing stop.

Price targets can be determined in several ways. Many people think Fibonacci ratios and such have value and work for targets. I don't. I have done several thorough research projects on this and could not demonstrate that they work. Nor have I seen any other real research to back up any significant Fibonacci levels. But to each his own. As they say, this is just one man's opinion.

What I have found is that markets do have a strong tendency to rally above the last intermediate-term high by the same amount it moved from the intermediate-term high to the lowest point prior to advancing to new highs.

In other words, if we have an intermediate-term high, you take the distance from the high to the intermediate-term low, then add that value to the intermediate-term high. That gives us our target or upside potential.

I just use my “Target Shooter” (from the Genesis software). Applied now to the same chart we were just looking at ([Figure 1.19](#)), we see where our target would have been.

Figure 1.19 BHP Intermediate-Term Target Diagram



All that's left for us is to have some form of protective stop in the event the trade doesn't work if we don't exceed the prior intermediate-term high. Trading is like boxing, “Come out fighting and protect yourself at all times.” Stops and trailing stops are our protection, for a battle where there is no referee.

We can also use market structure for our trailing stop, as shown in [Figure 1.20](#). The higher “ringed,” or short-term, lows are our stop loss point for this trade.

Figure 1.20 BHP: Lows Become Trailing Stops



Another idea or approach using market structure would be the formation of the next intermediate-term high (after our entry) as our exit prior to reaching the target, that is, our trailing stop.

Trading is an imperfect world and that's where art meets science—determining which point you want to use—how bullish or bearish you think the market is will determine how long you want to hold your position. There are four possibilities:

1. Trading below the most recent short-term low
2. Trading below the second short-term low back in time (foregoing a stop at the current low if you are really bullish)
3. Forming a subsequent intermediate-term high
4. Going to the target

Along the way, as the trade is maturing, you may see additional higher short-term lows being formed, producing another entry. Each successively higher pattern in turns has short-term targets you can use as long as it does not exceed the longer, intermediate-term target. As I said, there is a lot more depth to market structure than you might suspect.

That is the basic buy pattern to use as your template for trading in stocks or futures, daily or intra-day, it makes no difference ... this is how prices move. Now let's turn our attention to selling opportunities.

Rio Tinto's pattern is shown in [Figure 1.21](#), but it doesn't matter what stock is analyzed. This could be the price of soybeans or silver, copper or cocoa. All markets have the same structure. The problem comes from making certain your short-term highs and short-term lows fit into the intermediate. Sometimes, thanks to inside and outside bars, it is not perfectly clear. But nothing in the markets is always clear all the time

Figure 1.21 Rio Tinto: Intermediate-High Sell Pattern



Nonetheless, this pattern is so repetitive you should not have much problem finding it, time and again. *If it's not clear, why trade?*

In [Figure 1.21](#), I have marked with lines on the chart the intermediate swings based on the short-term swings. As you see, a lower intermediate-term high was formed in March of 2004. We knew then that we had an intermediate-term high lower than the prior one. So we knew we were in a down-trending market and wanted to take short-selling opportunities.

The question, of course, is where to enter once we know an intermediate-term high is in place. On March 9 prices fell below the prior day's low, which made the March 9 high a short-term high. That short-term high was lower than the prior short-term high made on March 3. So we knew at that point in time that the March 3 high was an intermediate-term high. We also knew it was lower than the prior intermediate-term high. So we could have easily taken a short position, which I have marked off at 124.55. The pattern was complete.

Once in the trade, the initial stop should be the intermediate-term high sold off ... in other words, the high of March 3 cannot be exceeded. If it is, price has moved back to the upside. We would want to reverse to being long as we would then know the intermediate-term trend was up. *Why?* Because an intermediate-term low, higher than the last one, would have been established.

So that is your initial stop. To give the trade even less room you could place the stop above the high of March 8, as exceeding that bar's high would mean we have a higher short-term low and probably have formed an intermediate-term low.

Isn't it neat how all of the information from these simple swings tells us the structure, and the structure shows us the trends of the marketplace?

Let's next turn our attention to targets and trailing stops for this trade (see [Figure 1.22](#)).

Figure 1.22 Rio Tinto: Trailing Stops and Targets



The target is arrived at by taking the swing from the low in February to the March 3 high, then subtracting that from the February low to give us a target at 85.42. In fact, price did go there, but I'm certain we would have been out of the trade before then, unless you had some compelling reason stay short.

Why do I say that? Because I think most likely you would have been stopped out with a trailing stop; a short-term swing high formation of the intermediate-term low (which also set up another short-selling opportunity). To better explain this, let's take a look at [Figure 1.23](#), which show a continuation of the trade.

Figure 1.23 Rio Tinto: Exiting the Trade



All was going well with our trade into late March until prices began to rally, warning an intermediate-term low had been formed. (I have marked the intermediate swings with the flying-saucer-shaped figures). We knew that once we got above the high of April 4, we had a higher short-term low, and thus would have had to exit at that bar's high the next day. Perhaps there are some other techniques you could have

used, but sticking strictly with market structure that would have been our exit point. After all, we are short-term traders, and short-term traders are in the business of taking profits and not in the business of forcing the market to do what it won't do.

Another excellent selling opportunity was established, as yet another lower intermediate-term high was formed according to our rules. Notice it was lower than the one we originally took for our short position. So, we knew the larger trend was to the down side. This trade was also profitable and went immediately to our exit. Regardless of the trailing stop you would have been using, such as exiting at a higher short-term low or breaking above any short-term high, none of those events took place. We got lucky: Prices simply went to the target.

RECAP

A quick review of what I hope you have learned is that the market will tell us exactly how it is structuring itself for the next move ... it really does reveal almost everything to us if we will take the time and patience to look and study its moves. In fact, there is a rhyme and reason, logic and science to what I call market structure.

This can be applied to any time frame: intraday, daily, weekly, and even monthly.

CHAPTER 2

It's a Question of Price and Time

Like a circle being squared,
Going 'round and 'round
A wheel within a wheel
Spinning a syncopated sound
Creating cycles that we find
Will o'wisps of our mind.

ALL YOU WILL EVER NEED TO KNOW ABOUT CYCLES

Our charts are a record of price activity over time, with the horizontal scale representing time and the vertical scale representing price. An entire technical school is devoted to the study of time: the cycle watchers. These good-thinking people count the number of minutes, hours, days, weeks, months, and years between high and low points in search of some master time cycle that will tell us *when* price will behave in the future as it has in the past. Being a somewhat slow learner (and an even slower unlearner), I spent almost 15 years of my life trying to figure out these time cycles.

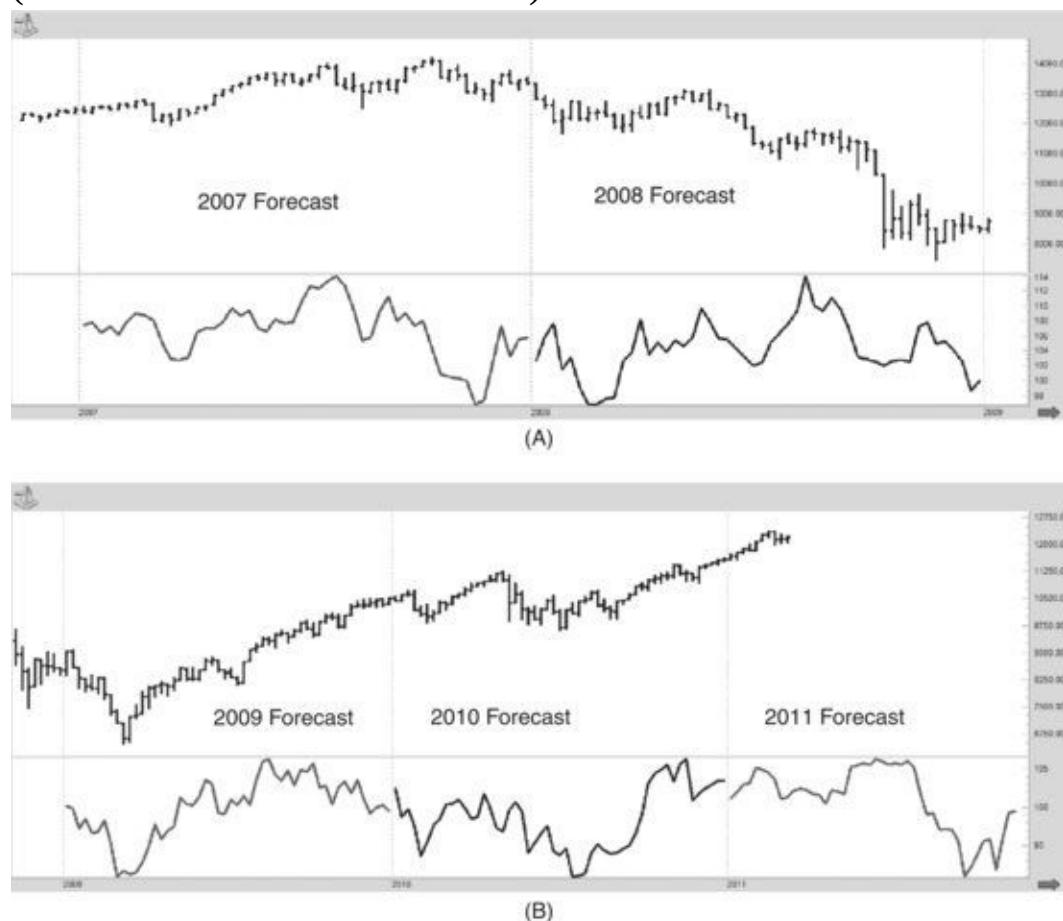
I am still convinced there are cycles in the market, in fact three of them, but they are not time cycles. The root of the problem of time cycles is that there always seems to be a current, or *dominant*, cycle that we can easily see on our chart right now. The rub is that another cycle is always about to become dominant, overpowering the one we have just located and invested in.

Although our first problem is cycle dominance, if there are such cycles, they change direction more often than a politician looking for votes. In the 1960s and early 1970s, the hope was that a combination of high-powered math and high-powered computers would solve this master cycle problem. It has yet to be done. Just what the heck cycle we should lay our bets down on at any given time is impossible to tell. But an even greater problem is the one of magnitude.

The problem is still with us in 2011. I have been making yearly forecasts for quite

some time now: [Figure 2.1](#) shows a forecast for 2009–2011 for the Dow Jones 30 stocks. As you can see, we were able to forecast with a good deal of accuracy when the significant tops and bottoms should be seen in the markets. The difficulty is in determining how significant the move will be: What will be the magnitude of the rally or decline? That information seems to be best found by studying the current conditions when we get to the cyclical high and low points. (I post these forecasts from time to time on our web site, www.ireallytrade.com, and you can find updates there.) Now let's look at my forecast for the past few years so you see that cycles can have value for traders and investors.

Figure 2.1 Forecast for Dow Jones (Weekly Bars). Graphed by the Navigator (Genesis Financial Data Services)



These forecasts are arrived at by a close scrutiny of long-term market data, patterns from individual years as well as what is commonly referred to as market cycles. I then combine all of that, in a blender, if you will, to come up with a forecast for each year. The problem is, the data is all time-based, so it is very difficult to estimate the magnitude. As you can see in the figure, we have traced the general swings that the markets follow, but capturing the exact magnitude of the move remains a mystery. I am working on that part.

The point is that these forecasts were made from market activity, many years before we went into the electronic markets, yet they have an application in correctly forecasting what has taken place in the new era of market trading.

The cycle crowd deals exclusively with time. But I have yet to find a banker who allows me to deposit days, weeks, or months! By that, I mean that a cyclist might ferret out a market low, say an 18-year low, but price does not necessarily respond as much as desired on the upside, climbing up that vertical scale of dollars that is the reward mechanism of the game. In theory, a major cycle low or high, if you could identify it, could produce a move of some magnitude. But in the real world where I live and trade, that has seldom been the case; instead the cycle has quickly faded. Sure, price stopped there—in time—and hobbled along for a few days or weeks, but there was not enough price magnitude for a profit.

I will prove my point with an actual study of past price activity. [Figure 2.2](#) shows the result of a test of a timing system for Soybeans. I fired up my computer, asking it to buy when a short-term moving average of price crossed above a longer-term moving average. This is standard technical stuff. The only variable was time, the number of days in the moving average. Thus it is impacted by cycles. A moving average is simply the average closing price for the last X number of days. There are no other variables, only time.

Figure 2.2 Test of a Timing System

| | | | |
|----------------------------------------------------------------------|---------------|-------------------------|---------------|
| Data | : | SOYBEANS | 67/99 |
| Calc Dates | : | 04/29/75 - 01/01/87 | |
| <hr/> | | | |
| Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName | | | |
| ----- | | | |
| 17 -1 \$ 6.250 \$ 50 \$ 0 \$ 3,000 CSI C:\GD\BACK67\F051.DTA | | | |
| <hr/> | | | |
| ////////// ALL TRADES - Test 1 /////////// | | | |
| Total net profit | \$40,075.00 | Gross loss | \$ -86,137.50 |
| Gross profit | \$126,212.50 | | |
| Total # of trades | 153 | Percent profitable | 35% |
| Number winning trades | 54 | Number losing trades | 99 |
| Largest winning trade | \$13,000.00 | Largest losing trade | \$ -2,362.50 |
| Average winning trade | \$2,337.27 | Average losing trade | \$ -870.08 |
| Ratio avg win/avg loss | 2.68 | Avg trade (win & loss) | \$261.93 |
| Max consecutive winners | 2 | Max consecutive losers | 8 |
| Avg # bars in winners | 35 | Avg # bars in losers | 10 |
| Max closed-out drawdown | \$ -13,625.00 | Max intraday drawdown | \$ -13,687.50 |
| Profit factor | 1.46 | Max # of contracts held | 1 |
| Account size required | \$16,687.50 | Return on account | 240% |

Our first test was on Soybean prices from 4/29/75 through 1/1/87, and it looked at all possible combinations of short-term averages from 5 to 50 days against the longer-term or second average from 10 to 60 days. The best result, during the time period shown here, used a five-day average against a 25-day average. This time-based “system” made \$40,075 with 54 profitable trades out of a total of 153. Wow, have we discovered a money machine?

[Figure 2.3](#) shows what would have taken place had we traded this system from January 1, 1987 through April 23, 1998. What I like most about updating this book is that it shows my research from the past, which allows us to review the way markets were then and how what worked then can be applied to today's trading. It is possible to use many of those ideas in conjunction with my new ideas and what my ongoing research shows about the new markets that we are now trading.

[Figure 2.3](#) What Might Have Happened

| | | | |
|---------------------------------------------------------------|---------------|-------------------------|---------------------------------------------|
| Data | : | SOYBEANS | 67/99 |
| Calc Dates | : | 01/01/87 - 04/23/98 | |
| <hr/> | | | |
| Num. Conv. | P. Value | Comm | Slippage Margin Format Drive:\Path\FileName |
| ----- | ----- | ----- | ----- |
| 17 | -1 \$ 6.250 | \$ 50 | \$ 0 \$ 3,000 CSI C:\GD\BACK67\F051.DTA |
| <hr/> | | | |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | |
| Total net profit | \$ -9,100.00 | Gross profit | \$ 81,612.50 |
| Gross loss | | | \$ -90,712.50 |
| Total # of trades | 163 | Percent profitable | 31% |
| Number winning trades | 52 | Number losing trades | 111 |
| Largest winning trade | \$ 10,062.50 | Largest losing trade | \$ -2,950.00 |
| Average winning trade | \$ 1,569.47 | Average losing trade | \$ -817.23 |
| Ratio avg win/avg loss | 1.92 | Avg trade (win & loss) | \$ -55.83 |
| Max consecutive winners | 5 | Max consecutive losers | 9 |
| Avg # bars in winners | 30 | Avg # bars in losers | 11 |
| Max closed-out drawdown | \$ -28,612.50 | Max intraday drawdown | \$ -29,412.50 |
| Profit factor | 0.89 | Max # of contracts held | 1 |
| Account size required | \$ 32,412.50 | Return on account | -28% |

The results are not promising. Whereas our accuracy at 31 percent winners on 163 trades has improved, we actually lost money, \$9,100 to be specific, and along the way suffered a drawdown (how much the system went against you before getting back in the black) of \$28,612. Putting up \$28,612 to lose \$9,100 is hardly a good wager! The average profit per trade was -\$55. What happened to the original cyclical or time influence? Beats me!

Reversing the process, I checked to see what two moving averages worked best in the second time period from January 1, 1987 into April 23, 1998 (see [Figure 2.4](#)). The best combination was a 25-day moving average against a 30-day. This made \$34,900 with a nice 59 percent accuracy. This system made \$234 per trade and had a drawdown of \$13,962. This too, was not a good bet.

[Figure 2.4](#) Testing Another Time Period

```

Data : SOYBEANS      67/99
Calc Dates : 01/01/87 - 04/23/98

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
----- 17 -1 $ 6.250 $ 50 $ 0 $ 3,000 CSI C:\GD\BACK67\F051.DTA
// ALL TRADES - Test 39 //////////////////////////////////////////////////

Total net profit      $34,900.00
Gross profit          $101,262.50    Gross loss           $ -66,362.50

Total # of trades     149    Percent profitable   59%
Number winning trades 89     Number losing trades 60

Largest winning trade $3,812.50    Largest losing trade $ -7,237.50
Average winning trade $1,137.78    Average losing trade $ -1,106.04
Ratio avg win/avg loss 1.02       Avg trade (win & loss) $234.23

Max consecutive winners 8        Max consecutive losers 4
Avg # bars in winners 14       Avg # bars in losers 25

Max closed-out drawdown $ -13,962.50  Max intraday drawdown $ -20,525.00
Profit factor          1.52       Max # of contracts held 1
Account size required   $23,525.00  Return on account 148%

```

Applying the best case results back on the earlier data, out of sample, produced a loss of \$28,725, as shown in [Figure 2.5](#). Forward or backward, the time or length or cycle of the moving average that worked in one time period does not work in another time period.

[Figure 2.5](#) Applying Best-Case Results

```

Data : SOYBEANS      67/99
Calc Dates : 04/29/75 - 01/01/87

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
----- 17 -1 $ 6.250 $ 50 $ 0 $ 3,000 CSI C:\GD\BACK67\F051.DTA
// ALL TRADES - Test 1 //////////////////////////////////////////////////

Total net profit      $ -28,725.00
Gross profit          $ 96,750.00    Gross loss           -125,475.00

Total # of trades     138    Percent profitable   56%
Number winning trades 78     Number losing trades 60

Largest winning trade $4,600.00    Largest losing trade $ -12,750.00
Average winning trade $1,240.38    Average losing trade $ -2,091.25
Ratio avg win/avg loss 0.59       Avg trade (win & loss) $ -208.15

Max consecutive winners 8        Max consecutive losers 4
Avg # bars in winners 14       Avg # bars in losers 30

Max closed-out drawdown $ -43,775.00  Max intraday drawdown $ -46,150.00
Profit factor          0.77       Max # of contracts held 1
Account size required   $49,150.00  Return on account -58%

```

“Perhaps,” you query, “the problem is not that time does not work but that Soybeans do not trend enough.”

The best-case study in [Figure 2.6](#) shows a moving average crossover system on the British Pound, a very trending market. From 1975 to 1987, the best such crossover system was a five-day average versus a 45-day, making a most impressive \$135,443.

The next time period, 1987 through 1997, the same system made money all right, \$45,287 as [Figure 2.6](#) shows, but suffered a \$29,100 losing spell! Not such a hot bet. The best crossover to use on this current set of 10-year data was a 20/40, which

cleaned up making \$121,700, the problem is it only made \$26,025 on the first time period and got tagged with a \$30,000 drawdown. Sorry, the problem was not beans or the pound—the problem is that time-based studies simply do not hold up. Using time exclusively as a consideration in speculation is one of the surer ways I know of getting a free pass to the poorhouse.

Figure 2.6 Using This System on the Next Time Period

| Data : BRITISH POUND | | 67/99 | | | | | |
|-------------------------------------------------------------------------------|-------|---------------|-------|-------------------------|----------|--------|-----------------------|
| Calc Dates : 01/01/87 - 01/01/98 | | | | | | | |
| Num. | Conv. | P. Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
| 26 | 4 | \$ 6,250 | \$ 50 | \$ 0 | \$ 3,000 | CSI | C:\GD\BACK67\F003.DTA |
| ////////////////// ALL TRADES - Test 1 /////////////////////////////// | | | | | | | |
| Total net profit | | \$45,287.50 | | | | | |
| Gross profit | | \$134,175.00 | | Gross loss | | | \$ -88,887.50 |
| Total # of trades | | 104 | | Percent profitable | | | 31% |
| Number winning trades | | 33 | | Number losing trades | | | 71 |
| Largest winning trade | | \$17,262.50 | | Largest losing trade | | | \$ -4,575.00 |
| Average winning trade | | \$4,065.91 | | Average losing trade | | | \$ -1,251.94 |
| Ratio avg win/avg loss | | 3.24 | | Avg trade (win & loss) | | | \$435.46 |
| Max consecutive winners | | 3 | | Max consecutive losers | | | 12 |
| Avg # bars in winners | | 54 | | Avg # bars in losers | | | 13 |
| Max closed-out drawdown | | \$ -29,100.00 | | Max intraday drawdown | | | \$ -29,450.00 |
| Profit factor | | 1.50 | | Max # of contracts held | | | 1 |
| Account size required | | \$32,450.00 | | Return on account | | | 139% |

I have duplicated this study at various times, on wildly different sets of data and have yet to see the cyclical-based approach to trading that is even close to being the best in the next test on out-of-sample data.

My advice is to forget cycles of time: They are the will-o'-the-wisp of Wall Street.

There are cycles (maybe it is a pattern) to the way price moves that you can quickly see on any chart, in any time frame, any market, any country in the world where I have traded. Once you understand these patterns, you will be better able to align yourself with where prices will be most likely to go.

Over the years, I have codified and identified three cycles and now refer to them as (1) small range/large range, (2) moving closes within ranges, and (3) closes opposite openings.

It is time for your first lesson in chart reading; we will begin with a study of changing ranges. When I refer to ranges, what I am talking about is the total distance traveled by a stock or commodity in a day, week, month, or year, or even in one minute. Think of range as the price distance traveled in whatever time period you are using. For all three cycles that we discuss, the rules work equally well in any time frame. The rules I have uncovered are universal to markets as well as to time-frame references.

THE NATURAL CYCLE OF RANGE CHANGE

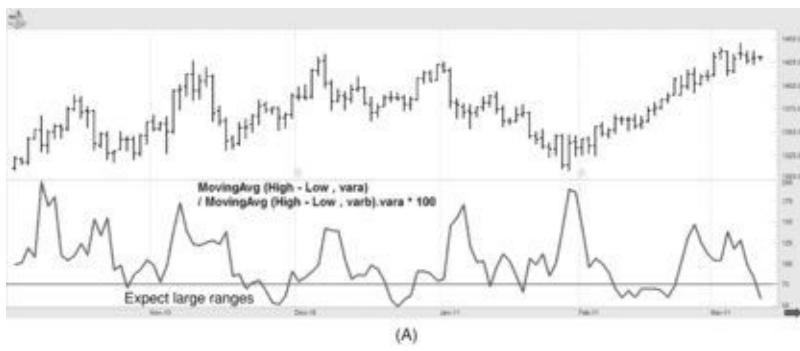
On any given day, the range of price in a commodity can do anything. That is what causes so much chartist confusion. But over any time period you want to study, you will notice a clear-cut, precise cadence to range activity. At all times, all markets, ranges fluctuate from—and this is critical—a series of small ranges to a cluster of large ranges.

The cycle continues repeating itself year-in and year-out; small ranges are followed by large ranges, large ranges are followed by small ranges. This is clockwork; this is the basic key to profitable short-term trading.

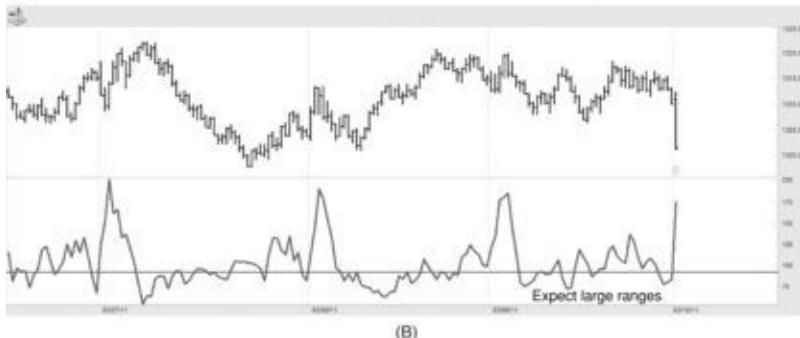
This seemingly obvious cycle is so powerful and important to us because speculators must have price change to make money. The greater the change, the greater the potential for profit. If there is no, or little, price change, a speculator is simply stuck in the mud as price fails to trend.

This was as true when I first penned those words as they now are, 14 years later. There is a natural cycle markets must follow: Expect large range moves after small range moves (see [Figure 2.7](#)).

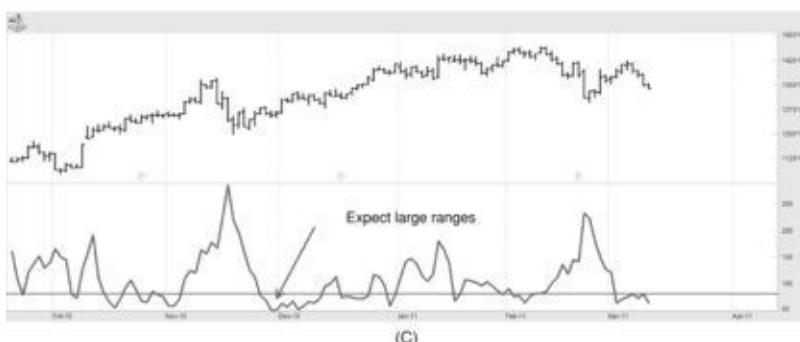
[Figure 2.7](#) Cycle of Large to Small Ranges (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



(A)



(B)



(C)

That is why short-term traders need explosive price moves over a few hours or days. Without this, we will wither on the vine. Got it? I hope so, because here comes the fascinating part. What usually attracts the public or uninformed to a market is large price change. They, usually incorrectly, think the current large change will continue.

You now know better.

Large ranges give way, most often, to small ranges. Your objective is to establish a position in advance of large price change. It is a classic sucker play to see a market that has been hot, with large ranges for a day or two, pull in the public just before a sideways or congestion move. Most short-term traders are losers. The reason they are is that they go from one hot market to the next because they have no understanding of how the drunken sailor swaggers, or how prices move across the great wasteland of their chart books.

On the other hand, we, who are the knowledgeable few, play just the opposite game. We look for markets that have been volatile in the past and are known for large daily ranges, but have recently produced small daily ranges because we know

a large-range day is out there not too far away!

You can eliminate the madness of charts by laying low on the sidelines, carefully waiting until ranges have dwindled, dried up. Once that part of the natural cycle is about over, it is time for short-term fireworks.

By the same token, large-range days tell us we may soon get stuck in the mud of small ranges where we cannot make money. This is certainly no time to overstay our welcome. Let me prove this point with some charts. [Figure 2.8](#) shows gold in the September 1997 to January 1998 time frame.

[Figure 2.8](#) Comex Gold (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Do yourself a big favor. Mark off all the large-range days you see in this time period. Then study the size of the ranges just prior to these explosive up-and-down days. See what I see? We were given ample warning of virtually every large-range day by the shrinkage of ranges a few days earlier.

Voilà! We are on the edge of a major market discovery here. I know—I have not yet told you how to tell in which direction these ranges will take off, but don't get ahead of the teacher. For now study every chart you can so that you can imprint on your brain, your very speculative spirit, the first undeniable short-term truth of the market:

Small ranges beget large ranges. Large ranges beget small ranges.

Look at [Figure 2.9](#), which shows the always volatile S&P 500 from October 1991

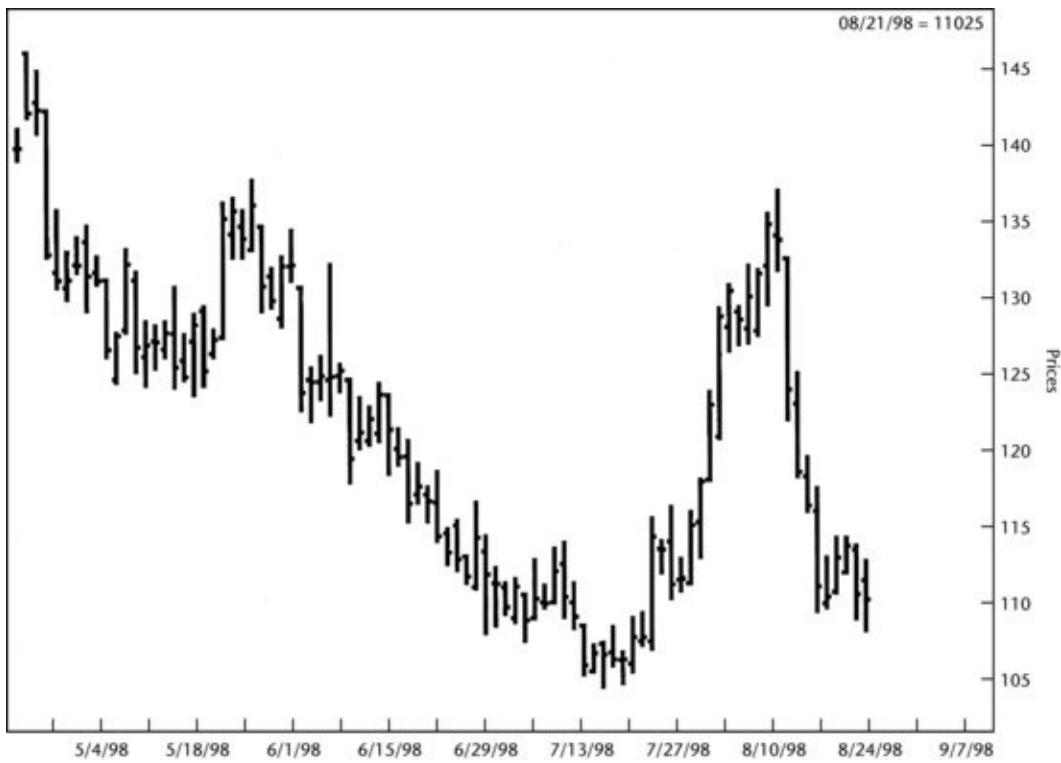
through January 1992. Grab a pencil, mark off the days with smallest ranges on the chart and then note what happened shortly thereafter ... a large-range day or two or even three, then a contraction of ranges, small to big, big to small—on and on it goes as it always has and always will.

Figure 2.9 S&P 500 Index (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Our next study in speculative technique is that of Coffee ([Figure 2.10](#)), a fast-paced market, ripe with opportunity for the trader with an understanding of the truth. Again, mark off the small-range days, then observe what follows: large-range days when we can make money while the public gets all lathered up about these days, hopping aboard only to lose patience as the ranges contract into decaffeinated days and the supposed opportunity evaporates. Just about the time when most of the public has been bored out of their positions ... *zingo!* ... away go prices, switching gears back to large ranges.

Figure 2.10 Coffee (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

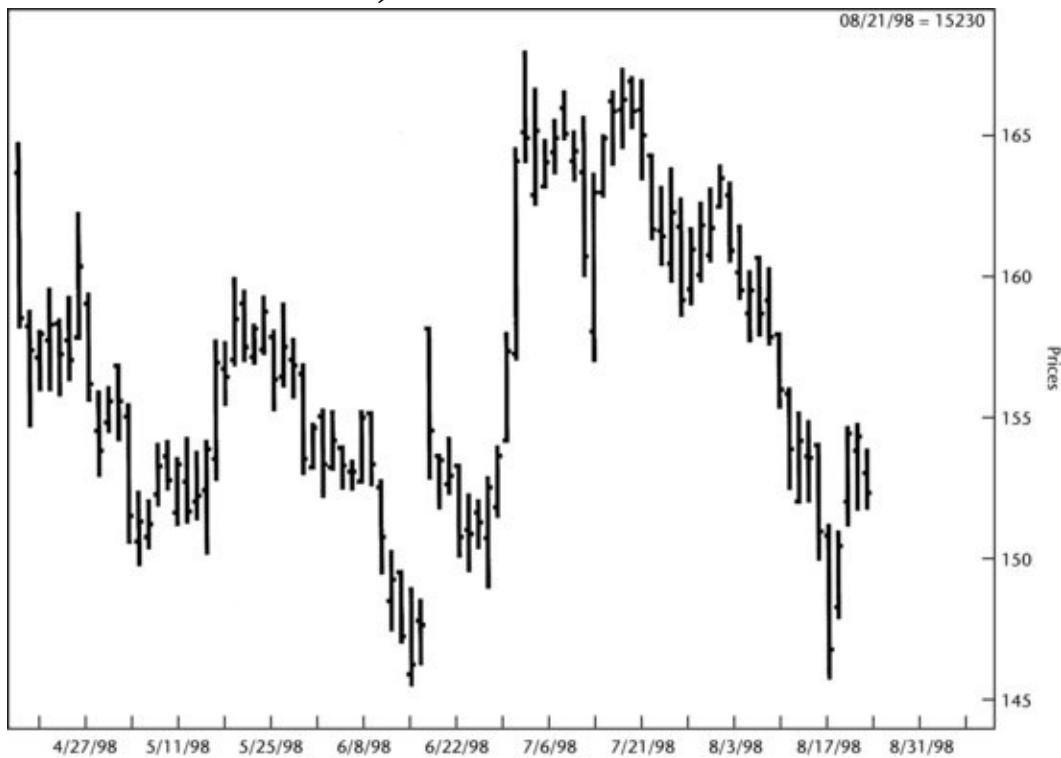


Finally, I'd like you to take a close and hard look at [Figures 2.11](#) and [2.12](#), which are for markets not traded in the United States, the Australian Dollar and the Nikkei (the Japanese answer to the Dow Jones Industrial average).

Figure 2.11 Australian Dollar (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 2.12 Nikkei Stock Index (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



If you are still not convinced that we have uncovered a major cycle to price movement—a cycle without time—I am next presenting three charts of the S&P 500 (see [Figures 2.13](#), [2.14](#), and [2.15](#)). In [Figure 2.13](#), each bar reflects the high, low, and close of every five-minute time period for two days, chosen at random. As you can see at almost a glance, the large bars are preceded by smaller bars. [Figure 2.14](#) shows the use of a 30-minute bar to capture the market's swings for a full week. Again the facts speak for themselves: Virtually every long-range bar, the only place we short-term traders make our money, has been set up by one or a series of small ranges. [Figure 2.15](#) is based on hourly bars and again the phenomenon is present. It takes no tea-reader or mumbo-jumbo spin-doctor to hype or stretch these facts. What's there is there, always has been, and always will be—we are continually alerted to those moneymaking large-range bars by the early warning of small ranges.

Figure 2.13 S&P 500 Index (Five-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)

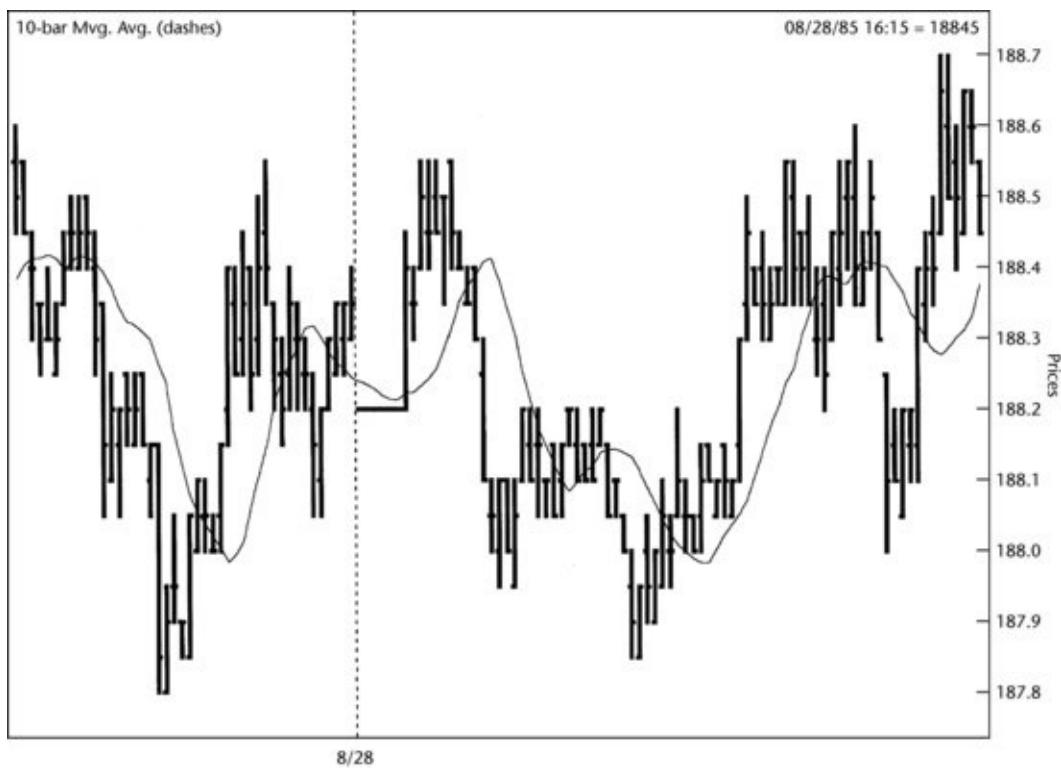
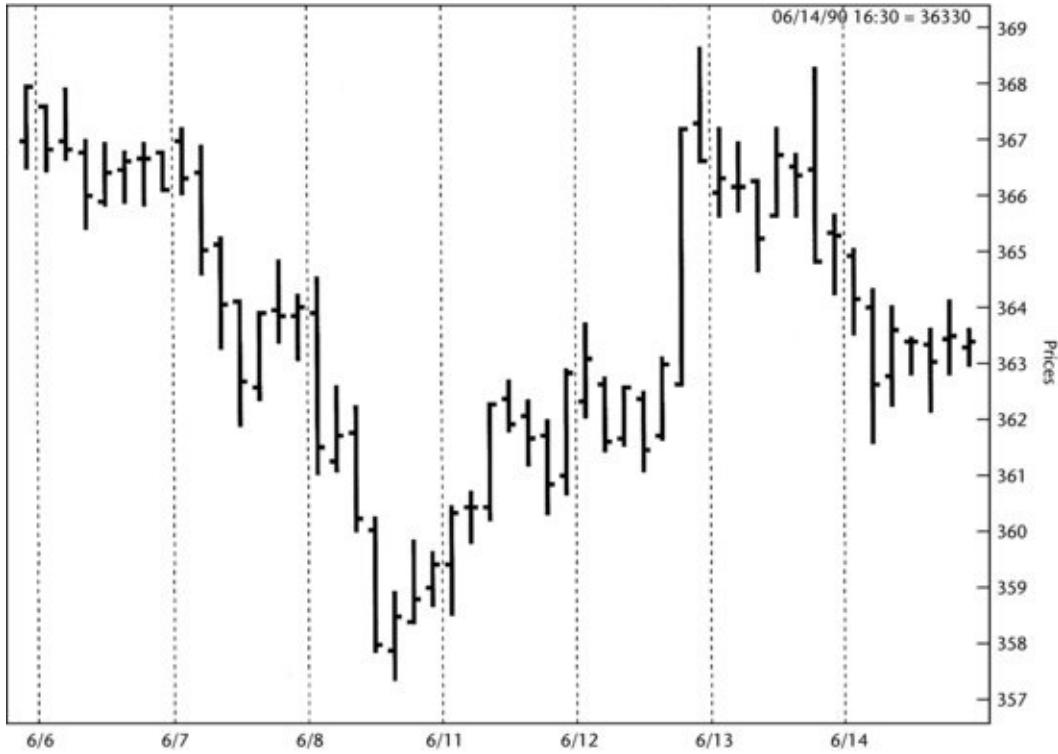


Figure 2.14 S&P 500 Index (30-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)

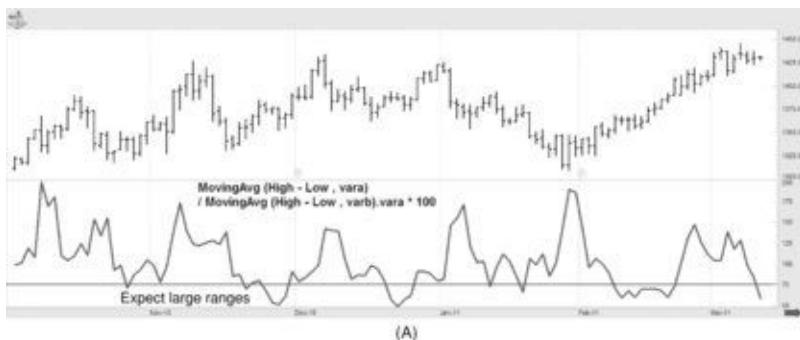


Figure 2.15 S&P 500 Index (60-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)

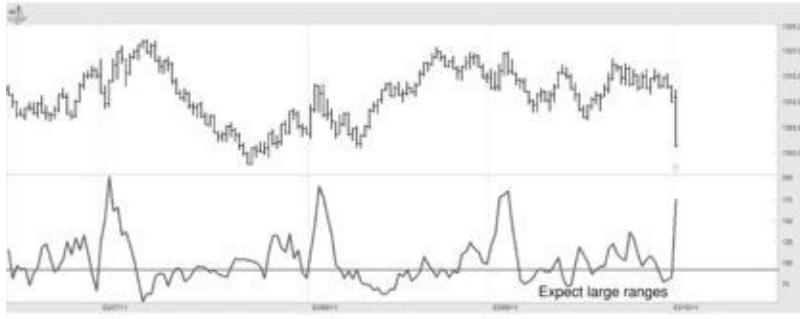


There is a natural cycle markets must follow: Expect large range days after small range days. You can see this in [Figure 2.16](#). This is a market truth. Why? Because investors and traders lose interest, producing small ranges, then gain interest, producing large ranges. It has always been that way and always will be so, a natural cycle of emotions and the human span of attention.

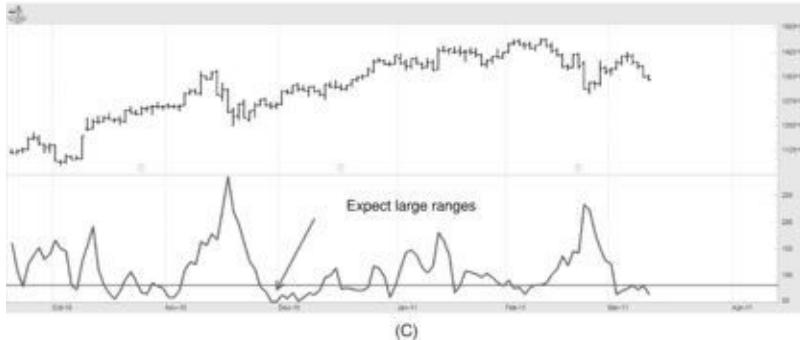
[Figure 2.16](#) Visible Cycle of Natural Emotions



(A)



(B)



(C)

The Importance of the Open to Low or High of the Day

Here is the second absolute truism about large-range days, those big blast-off days we short-termers simply must have to come out ahead: *Large-range up close days* usually open close to the low and close on the high and *large-range down close days* open around the high of the day and close near the low.

This means you must take two things into consideration in your trading. The first is that if we are aboard a day that we think will be a large-range up day, do not look for a buying point very far below the open. As I said, large-range up days seldom trade very much below the opening price of the day. This means *you must not look for much of a buying opportunity below the opening price*.

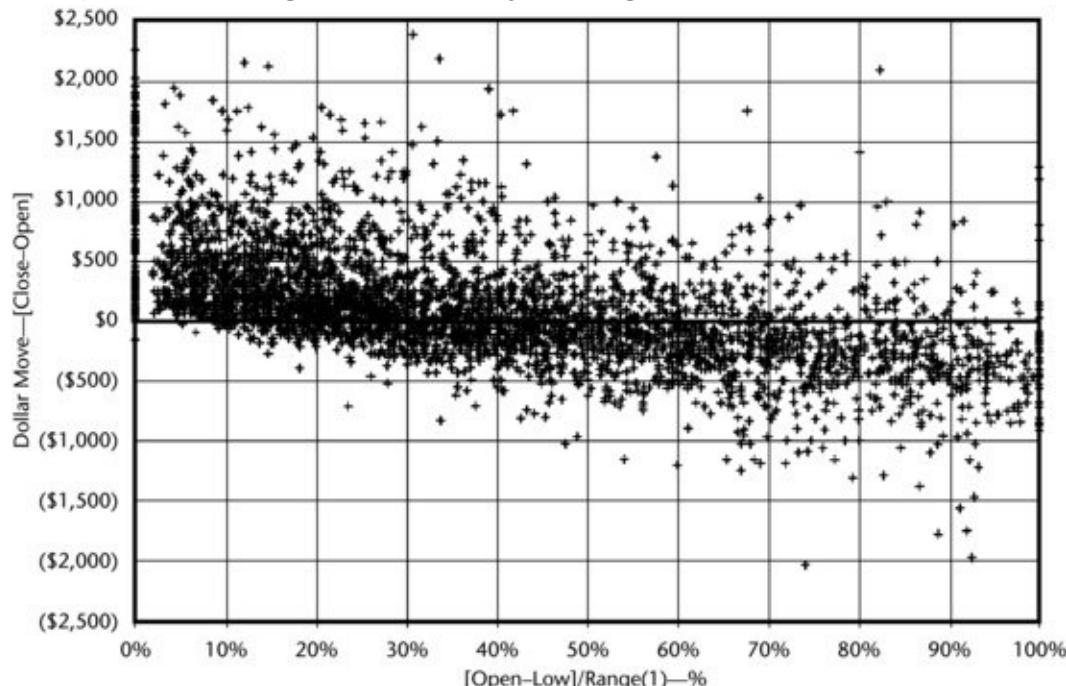
Catch A Tiger By The Tail

By this same token, if you think you have a tiger by the tail—the possibility of a

large-range day—and price dips very much below the opening, the probability of a large-range *up close is greatly reduced*.

This is a major insight into profitable short-term trading. Do not blow it off. Here are several studies that prove the validity of this concept. [Figure 2.17](#) shows on the horizontal scale the distribution of the difference from the opening to the close of all days in Treasury Bonds from 1970 to 1998.

Figure 2.17 T-Bonds: Distribution of Dollar Value of Open to Close versus (Open-Low) as Percentage of Yesterday's Range

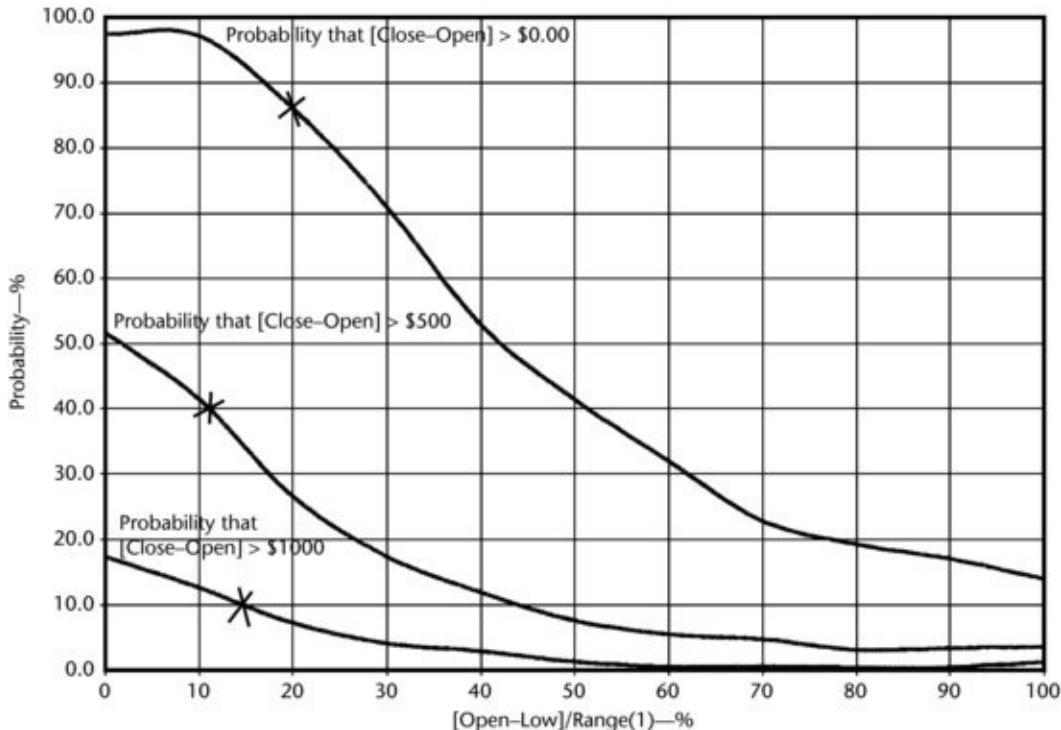


The vertical scale reflects the net change for all days, that is, the open minus the close. The fewer price points below the open (the zero horizontal line) and the closer those price points are to the zero line, the more days there are with positive—and large—open-to-close patterns. As you read the scale moving to the right, the farther below the zero line the price points are, the fewer positive price points we see above the zero line.

Looking on the left side of this chart, we see that large-range profitable closes seldom have large open minus close values. This trend is clear as the mass of data slants from left to right, that is, the profitable side of trading. The large opens to closes are pulled down by large opens to lows. This is also convincing proof that markets are not random. If they were, the distributions of highs minus opens would be the same as opens minus the lows. This data, as simple as it might seem, reveals a powerful fundamental truth for becoming a successful speculator. [Figure 2.18](#) shows three different lines: The top one represents the probability that the close will be greater than the open, dependent on the bottom scale of the open minus the low.

At the point I have marked, the data tell us that about 87 percent of the time we will close above the open if the dip from the open to the low is less than 20 percent of the day's range.

Figure 2.18 T-Bonds: Probability of Dollar Value of Open to Close versus (Open-Low) as Percentage of Yesterday's Range



The next line coming down the chart deals only with days on which the distance from the open to the close would have made a trader more than \$500. At the point I have marked on this line, we see that about 42 percent of the time we closed above the open by an amount making \$500 or more, if we did not take more than a 10 percent dip below the opening. Finally, the third and bottom line represents days that closed with more than \$1,000 of profits above the opening. These are the biggest range days in the bond market.

At the point marked, we see that 15 percent of the time, we get these huge blast-off days if there is a dip less than 10 percent. By the same token, there is an almost zero chance of getting a large blast-off close above the opening if price has dipped 70 percent to 80 percent below the opening.

This is true of all three lines, again telling us the greater the price swings below the open, the less of a chance we have of a positive open to close. This proves my rules:

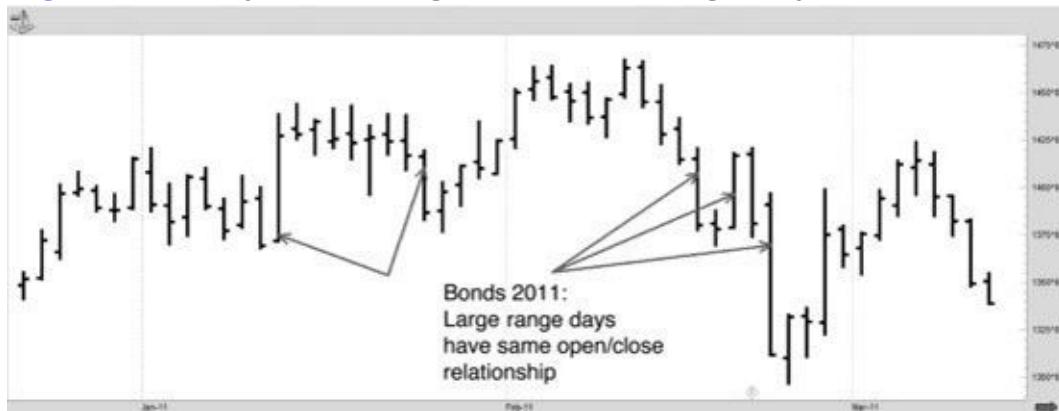
1. Don't try to buy big dips below the open on expected up-close days.
2. If long and price fall much below the open on expected big up-close days, get out.

3. Don't try to sell big rallies above the opening on expected large down days.
4. If short and prices rally much above opening on expected large down days, get out.

Don't try to argue with these statistics, they are the laws of gravity controlling how stock and commodity prices move. The tabulations shown here can be replicated in any freely traded market, thus representing a universal truth of how, on average, trading transpires during any given day. Yes, you will occasionally see large-range days that work both sides of the opening, but that is the exception, not the norm. The averages are against bucking this law. As a trader, I want as much going for me as I can. My winning trades don't come from luck, they come from having the tables tilted in my favor.

[Figure 2.19](#) of Soybeans in 2011 shows the same formation taking place. I have marked off the largest range days on the chart. You can see in a glance that the vast majority of these days take place with the opening at one end of the range at the closing price of the other end of the range. We cannot predict, for certain, when we will have a large-range day, but we can predict that large-range days will close on their extreme. This means short-term traders need to learn to hold on until the end of the day to maximize their profits.

Figure 2.19 Soybeans: Large and Small Range Days



WHERE THE TREND IS WITH YOU—THE SECOND POWER-PLAY PRICE PATTERN

Is the market in an up- or downtrend? Will prices most likely go up or down from here? Indeed, is there anything that might help us understand what is in store for future price activity? These are the big questions that speculators have failed to answer since trading began.

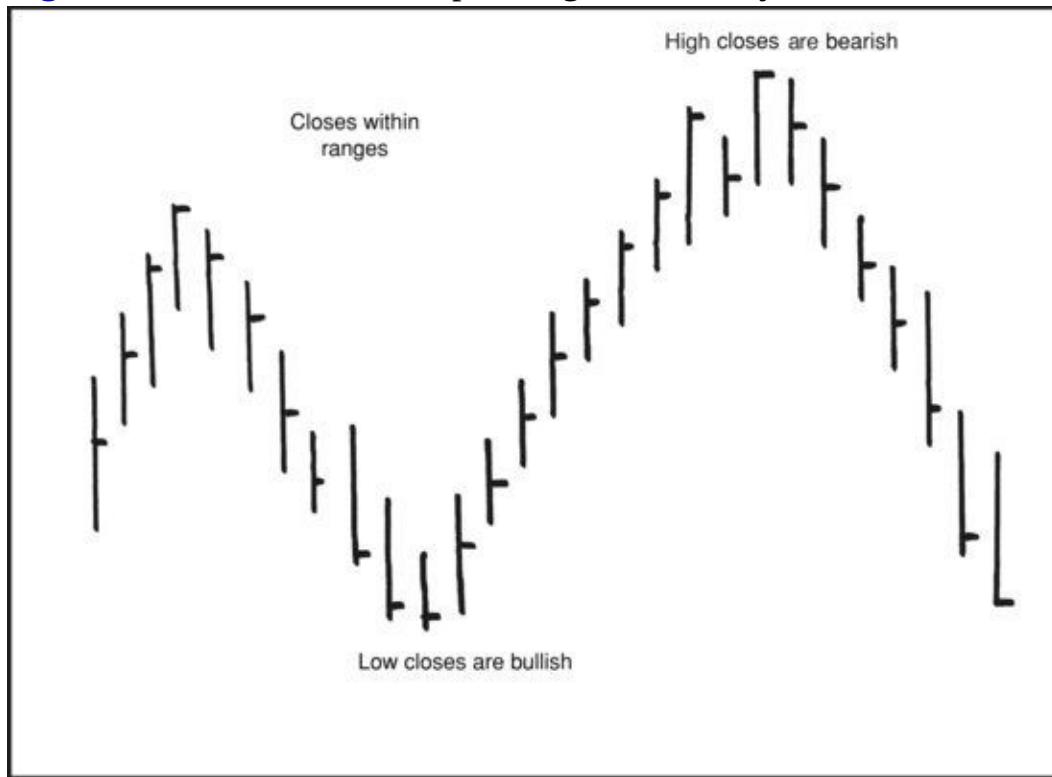
Just as we have learned that, generally speaking, small ranges set up large ranges, there is another fundamental design to the way prices of stocks and commodities move across the march of time in any country, any time frame.

Thus we begin your first lesson in understanding trend analysis in the marketplace. The basic principle is that as prices move from a low to a high there is a shift from where the close is in each day's range. Remember, it makes no difference whether we are using five-minute, hourly, or weekly charts. The same rule applies.

As a market low is made, the close of the day, or time period, is right at or very close to the low of that day's range. Then seemingly from out of nowhere, a rally begins, and as this rally unfolds, there is a marked relationship change. The change is that the further along this uptrend matures, the higher the close will be on the daily bars. [Figure 2.20](#) presents a stylized view of this relationship change.

Markets bottom with price closing on the low of the daily range, while they top out when closes are at or near the high of the daily range.

Figure 2.20 The Relationship Changes as a Rally Occurs



The uninformed think “smart money” comes into the market with buying, thus reversing the trend. Nothing could be further from the truth. As my long-time friend Tom DeMark says, “Markets don't bottom because of an influx of buyers, they bottom because there are no more sellers.”

We can look at this relationship of buyers to sellers at work on virtually every day

or bar that takes place. My operating rule, which I first wrote about in 1965, is that sellers in any time period are represented by the price swing from the high of the day to the close, while buying is represented by the close minus the low. My point is that the distance price closes off the low tells us the power of the buyers, the distance from the high to the close illustrates the impact sellers had on prices.

This understanding came from the work I did in trying to understand the on-balance volume (OBV) charts that Joe Miller and Don Southard were keeping at Dean Witter. At the time, the early 1960s into the mid-1970s traders, or just old duffers looking for a free cup of coffee and a place to chat, would sit around watching the flow of prices on the ticker tape, a trade-by-trade display of each trade made during the day.

There were two notable old codgers, Jack and Murray, who appeared daily to freely dispense their wisdom, and we hung on their every word. Murray, the older of the two, had been a boardroom marker boy during the crash of 1929 and recalled how he had marked down the price of the stock of Bank of America exactly 100 points on the first day of the crash! We could imagine a young Murray at the boards, writing down in chalk the last price B of A traded at, then erasing it to replace that value with a lower one. Murray said the biggest price markdown was 23 points from one trade to the next.

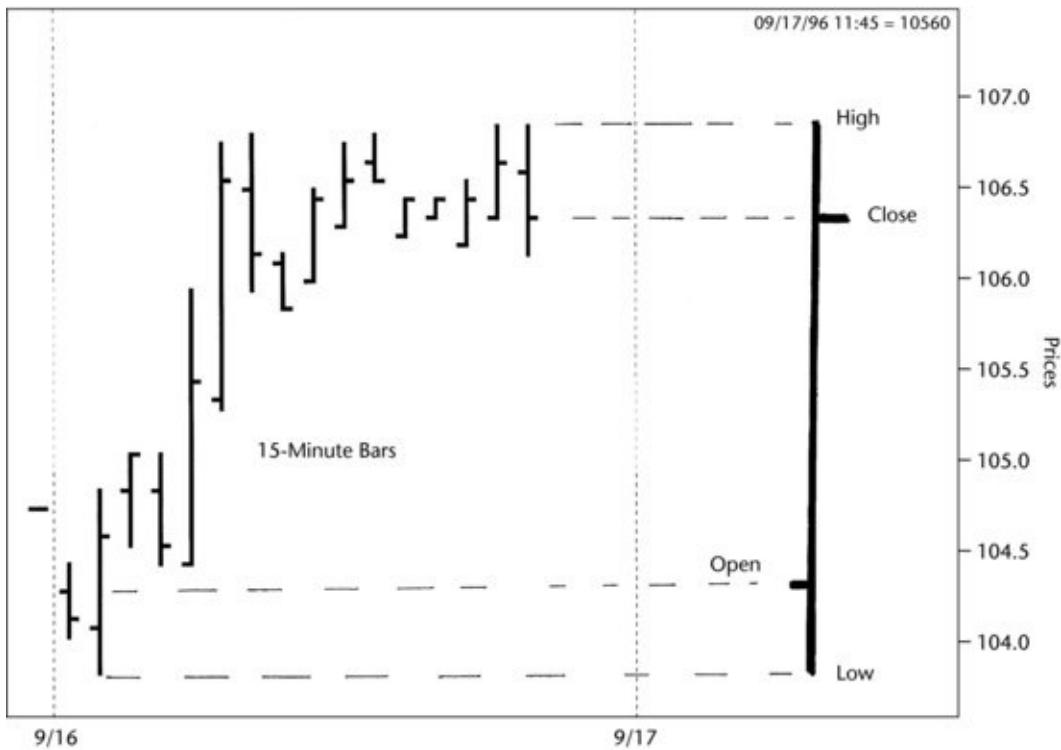
His story fit right in with the other oldsters' favorite saying, which still rings in my ears. Jack would tell us at least once a day, "What you don't want to do is catch falling daggers," and then he would add, "You wait until they stick in the floor and stop quivering, and then and only then do you pick them up. That's the best lesson I've learned in over 50 years of watching people lose money."

For short-term traders, I took this to mean that I should not try to buy market sell-offs, should not stand in the way of freight trains. I lost lots of money thinking I could tell when price had "bottomed" and would turn around for the day. My early trading accounts are pretty convincing proof that I could not perform that particular magic trick.

I eventually learned not to try to pick tops and bottoms, but it wasn't until years later that I fully understood what was really going on in the market and how I could take advantage of this market truth. My account balance had convinced me of the folly of buying abject weakness, but I did not know why. I do now.

Figure 2.21 should make this lesson in speculation come alive for you, so you don't have to waste time or money learning the hard way, the way I did. [Figure 2.21](#) illustrates how prices traded during an actual market day in Coffee; on the right-hand side, the chart shows the way the bar for the full day appeared.

[**Figure 2.21**](#) Coffee (15-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



Price opened, dipped to a low, rallied to make the high of the day, then got hit by selling until the close. You have been aware that every day there is a battle between buyers and sellers, and now you know how and where to look for the buyers and sellers. More important, you have learned about shifting relationships: that the higher the close is on a bar the closer we are to a top, while the lower the close is on a bar, the closer we are to a bottom. Here are two of my rules:

1. Almost all market highs can be found to occur at or shortly after a market closes right on the high of the day.
2. Almost all market lows can be found at or shortly after a market closes right on the low of the day.

Got it? Good, now let's look at actual examples of my theoretical concept at work. I will begin with [Figure 2.22](#), a chart of the Treasury Bond market from 1982. Look at the price turns, which are pretty easy to see, then focus on the terminal high and low days, at or just before, the end of each up- and downswing. See it? There it is, the end of the uptrend could be foretold by the mere fact the daily closes were near the highs of the day, the lows, or end of the downtrend, foretold by closes near the low of the day.

Figure 2.22 Day T-Bonds (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



This is not an isolated occurrence, nor is it limited to daily charts, as the next few examples will show. [Figures 2.23](#) through [2.27](#) show, in sequence, a 15-minute chart of the S&P 500, then an hourly chart, a daily chart, a weekly chart, and finally a monthly chart. In each instance, you will note these same repetitive phenomena. The closer the daily close is to the high of a bar, especially if there are several such bars together, the closer we are to a market high.

Figure 2.23 S&P 500 Index (15-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 2.24 S&P 500 Index (60-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)

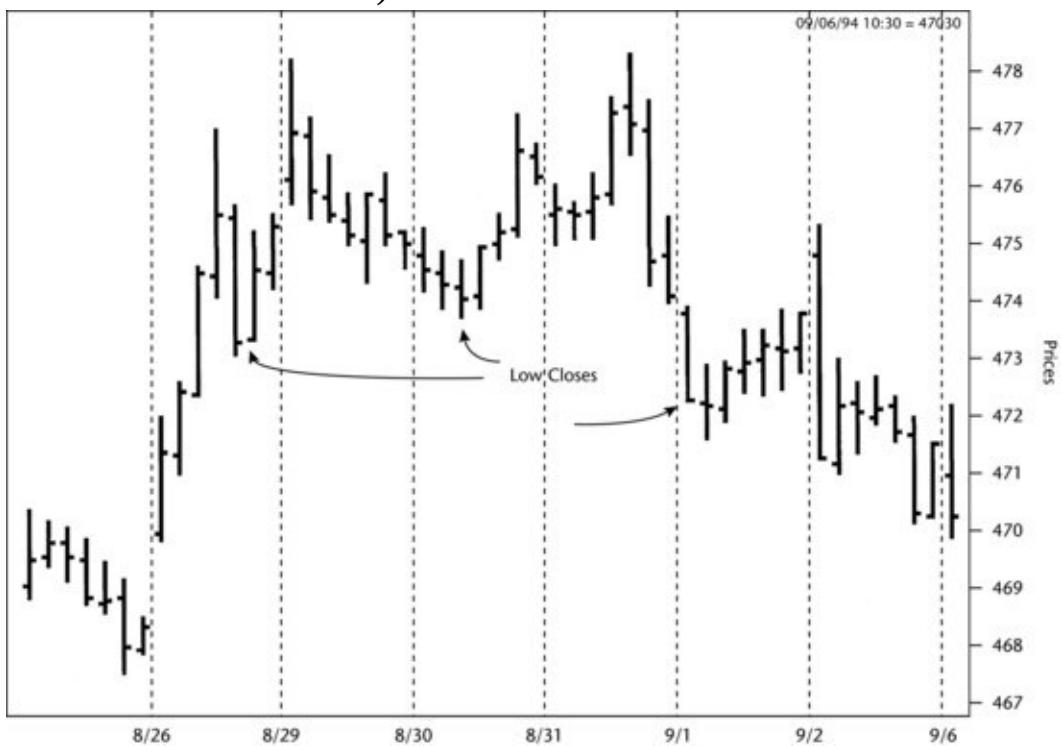


Figure 2.25 S&P 500 Index (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 2.26 S&P 500 Index (Weekly Bars). Graphed by the Navigator (Genesis Financial Data Services)

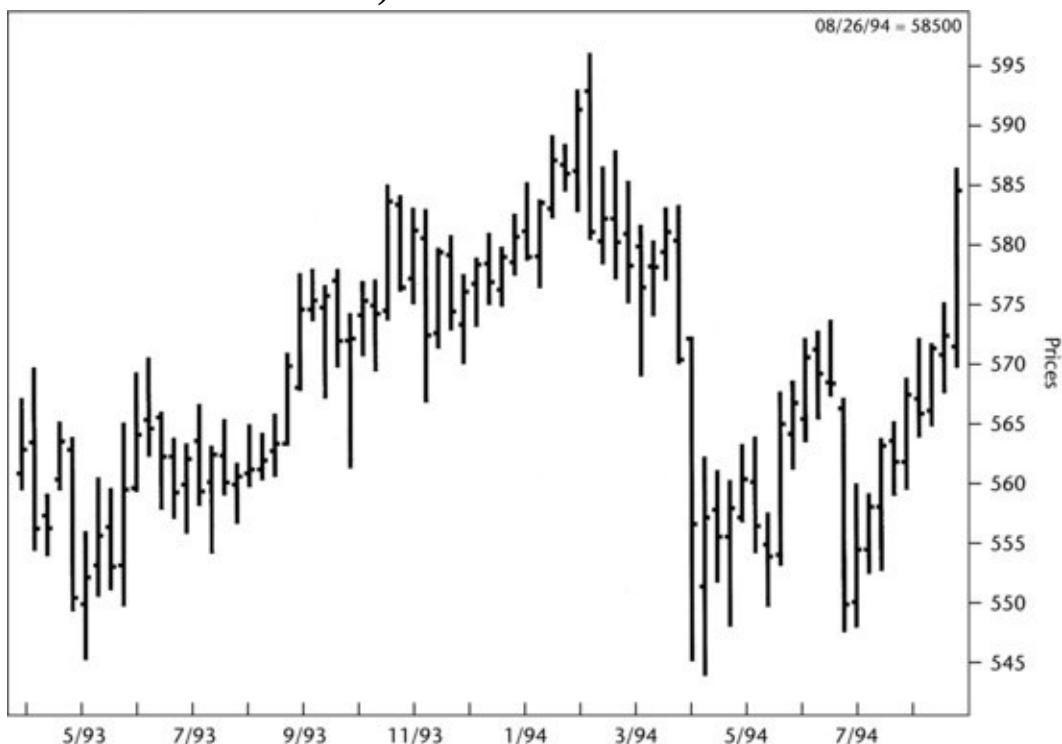


Figure 2.27 S&P 500 Index (Monthly Bars). Graphed by the Navigator (Genesis Financial Data Services)



Market lows, in all time frames, are just the reverse: The closer the closes of the bars are to the low, the closer we are to a market upturn. This is market reality; this is how the world of speculation works, always has, always will.

RECAP

The most telling point, I hope, I made in this chapter is the importance of studying, not only my writings but others as well, and also looking at charts. As you can see from [Figure 2.28](#) (2011 Soybean Oil), this continues to be the way markets trade.

Figure 2.28 Soybean Oil and the Natural Cycle of Ranges



I urge you to get as many daily charts as you possibly can so that you can observe and study this particular relationship: Markets do not top out because they run into

selling pressures—instead, they top out because there are no more buyers. Bottoms are just the opposite. When everyone has sold, which we can identify by market closing close to the low of the day, a rally to the upside is the most probable direction.

Like so many of the techniques taught in this book, that is the way of the marketplace, and it remains unchanged.

CHAPTER 3

The Real Secret to Short-Term Trading

The “secret” is that the shorter your time frame of trading, the less money you will make.

Sad but true. Think about any investment you have ever been in. Did you make a killing in one day? And, if you were so lucky, how many times were you able to repeat it? Not many. That is because the universal rule of life, *of gain*, is the same as the universal rule of speculation: *It takes time for profits to grow*.

It is a question of basic mathematics. A short-term trader has only a few hours to capture a large move to generate profits. The clock is running against him from the get-go. His timing of entering his trade as well as his exit must be precise. There is no room for error.

The only way a short-term trader can make a large amount of money is to have a large position on, since he or she cannot capture a large move. Here's a simple example: I can have of a five-lot position in Silver and over the next month make \$50,000. But it is virtually impossible to make \$50,000 with a five-lot position trading Silver tomorrow. The only way I can make \$50,000 playing the Silver market tomorrow is to have a large position on.

These numbers are relative: What is a large win to me is a small win to other traders and vice versa. But the truth remains; the only way a short-term trader can get a relative leave large gain is to have a large position.

And therein lies the problem. If you have a large position, you will have a large loss. In my five-lot position in Silver, I would have to be an idiot to carry the position to a loss of \$50,000: I would be stopped out with a loss of probably \$5,000. The risk/reward ratio for short-term traders is a disaster. Their average profit is about the same as their average loss. To win big, they have to bet big. Bet big and you're guaranteed at some point to lose big ... in a game where only one loss can destroy you.

Here's what you need to know: The trend is the basis of all profits. No trend, no profits. Trend is a function of time, and therefore the more time you can be in a trade, the larger the trend move you can capture. Day traders place themselves at a distinct disadvantage. Time is their enemy, they have to be out at the end of the day, and they have limited the size of the move they can capture. Position traders know

that time is our ally and prosper accordingly.

This rule will be valid until the end of time.

Successful traders know that a market can move only so far in a minute, that a market can move further in five minutes, even more in 60 minutes, and a heck of a lot more in a day or a week. Losing traders want to trade in a very short time frame and thus automatically limit their profit potential.

By definition, they have limited their profits and kept an unlimited loss scenario. It is no wonder so many have done so poorly at this business of short-term trading. They have boxed themselves into a no-win situation under the guise, often promoted by brokers or system sellers, that scads of money can be made calling market highs and lows during the day. The argument is bolstered with the seemingly rational statement that by trading within just one day and never holding anything overnight, you cannot be exposed to news or major changes; thus you limit your risk.

That's flat-out wrong, for two reasons.

First, your risk is under your control. The only control we have in this business is to set a stop-loss point, a level at which we exit the trade, all trades. Yes, a market could gap beyond your stop the following morning, but that is a rare experience, and even then we are still able to limit our loss with our stop-loss and absolute willingness to get out of losing trades. Losers hold on to losses, winners don't.

Once you establish a position with stops, you can only lose about that much money. No matter when or how you got into the trade, your stop limits your risk. Your risk is the same if you buy at an all-time new market high, or low.

Not holding overnight limits the amount of time your investment has to grow. While sometimes the market will open against you, *if we are on the right track* even more of the time, the market will open in our favor.

More important, by ending our trading at the end of the day, or worse yet at some artificial cutoff point such as a 5- or 10-minute chart, we have drastically limited the potential for profits. Remember I said that the difference between losers and winners is that losers hold on to their losses? Another difference is that winners hold onto their winning positions while losers get out too early. It is almost as if losers can't stand being in a winning trade; they are so damn happy to get a winner, they bail out of it far too early (usually, by getting out during the day of entry).

You will never make big money until you learn to hold on to your winners, and the longer you hold, the more potential you have for making a profit. Successful farmers don't plant a crop and then dig it up every few minutes to see how it is doing. They let it germinate, let it grow. We traders could learn a great deal from this natural process of growth. Our success as traders is no different: It takes time to create winners.

IT'S ALL ABOUT TIME

What I have just told you is an absolute unequivocal investment truth. It takes time to make money regardless of the activity. Thus short-term traders, by their very definition, are limiting their opportunities.

The fallacy of day traders is their belief that they can actually call the short-term swings of the market and tell where price is going the vast majority of the time, as well as predict the highs and lows and the precise time when markets will top and bottom. Sorry to tell you this, folks, but it cannot be done with any consistency. It is a day trader's dream, a pipe dream at that.

But don't give up hope, my years of market analysis and trading have revealed one fundamental truth about market structure, which is the secret to making "short-term" trading profitable.

By now you understand that (1) short-term swings are very difficult to predict; (2) we must limit losses; (3) as short-term traders, we will only do well when there is an explosive move in our favor; and (4) time is an ally because we need time to create profits.

To make significant money as short-term traders, we have to be able to sense how long the most profitable short-term swings usually last. This is not just a question of time, it is also one of price. Just as there are no straight paths to heaven, price can only go straight up, or down, to a certain point. The question that needs to be answered is: What usually represents that balance of price and time? Note the use of the word *usually*: Many times, price swings will go further and take longer than you could ever imagine, and just as often, they falter and fizzle out just when you think you finally have outwitted the market.

Keeping all this in mind, I am now going to reveal my biggest short-term secret of trading to balance the trade-offs of price and time swings. This secret consists of two components:

1. We make money only on large-range days.
2. Large-range days usually close at or near the high, if an up day, or the low, if a down day.

I am willing to let the fancy-dancing day traders figure out the machinations of interday swings. I doubt they can do it, but even if they can, it is very hard, frustrating, and demanding work. Despite the two old codgers' knowledge of tape reading and years of market wisdom, they had no more ability to correctly call market moves from tape watching than any of the rest of us. We have gone from tape reading to quote machines, but the game, or myth, is the same, and so is the degree of difficulty. It is pressure city to sit in front of a quote machine for seven hours a day battling, guessing, and being proven wrong more often than not.

BANKROLLING HOTSHOT TRADERS

About twice a year, I get talked into bankrolling some hotshot trader who thinks he or she can profit from these short-term swings. Let's see, two traders a year for 35 years, that's 70 times that I should have learned the lesson I am teaching right here. I just don't think it can be done. The only caveat I would put here is that it cannot be done with a system or mechanical approach. I have seen traders with a "feel" succeed at this, but that feel often soon deserts them and is something they cannot pass on to another person. Therein my work is different: You or anyone else can replicate what I do.

I place my trade knowing only one of three types of days will develop: a small-range day that will produce a small loss or gain; a day that reverses against my position; or a large-range day that, if I am on the correct side, means I will finish the day very near the high of an up day or the low of a down day. Although no one can predict what will be the high or low of a large-range day, I can predict that such days will most often close at their extreme—thus *there is no need to try to play any silly technical games* of wiggling and waggling, buying and selling during the day.

I can prove my point about large-range days with the following charts. [Figures 3.1](#) through [3.6](#) show different time periods of Copper, Cotton, Soybeans, Pork Bellies, Gold, and T-Bonds, a pretty wide diversity of markets. Carefully go through each chart, note the large-range days, and then notice where they opened and closed.

[Figure 3.1](#) High-Grade Copper (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 3.2 Cotton #2 (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 3.3 Soybeans (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 3.4 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 3.5 Comex Gold (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 3.6 Day T-Bonds (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



In the vast majority of the large-range, up-close days, you should have noted that price opened near the low of the day and closed near the high. The down-close, large-range days reveal just the opposite trading pattern: openings near the highs

and closes near the low of the day.

What this all means to short-term traders is that, to catch a winning trade, the most profitable strategy is to hold to the close.

I cannot emphasize this enough. The most profitable short-term trading strategy I know and use is to enter the trade, place my protective stop, then shut my eyes, hold my breath, quit looking at the market, and wait to get out on the close. Or later! If I am lucky enough to get a large-range day, I will have captured a major move that can pay off the small-range days. If I try to dance in and out, I will invariably not make as much money as I would if holding to the close. The truth is that whenever I have tried fancy dancing, I have had to pay the piper a stiff fee.

PROVING THE POINT

To further prove this point, [Figures 3.7](#) through [3.9](#) show the results of a simple little system for trading the S&P 500. The rule is simply to buy on the open every Monday if that open is lower than Friday's close. This is the start of short-term system building, so don't get enamored with the results or the system quite yet. My point is to show you the tremendous advantage of knowing you can make more money if you hold until the close.

Figure 3.7 A Trade with a \$500 Target

| | | | |
|-------------------------------------------------------------------------------------------------------------------|--------------|------------------------------------|--------------------------------------------------|
| Data | : | S&P 500 IND-9967 | 06/98 |
| Calc Dates | : | 07/02/82 - 08/24/98 | |
| <hr/> | | | |
| Num. | Conv. | P. Value | Comm Slippage Margin Format Drive:\Path\FileName |
| 149 | 2 | \$ 2,500 | \$ 50 \$ 0 \$ 3,000 CServe C:\GD\BACK67\F58.DAT |
| <hr/> <hr/> <hr/> <hr/> // ALL TRADES - Test 1 ////////////////////////////////////////////////////////////////// | | | |
| Total net profit | | \$-8,150.00 | |
| Gross profit | | \$84,875.00 | Gross loss \$-93,025.00 |
| Total # of trades | 389 | Percent profitable 59% | |
| Number winning trades | 232 | Number losing trades 157 | |
| Largest winning trade | \$450.00 | Largest losing trade \$-3,050.00 | |
| Average winning trade | \$365.84 | Average losing trade \$-592.52 | |
| Ratio avg win/avg loss | 0.61 | Avg trade (win & loss) \$-20.95 | |
| Max consecutive winners | 19 | Max consecutive losers 7 | |
| Avg # bars in winners | 0 | Avg # bars in losers 0 | |
| Max closed-out drawdown | \$-12,837.50 | Max intraday drawdown \$-12,837.50 | |
| Profit factor | 0.91 | Max # of contracts held 1 | |
| Account size required | \$15,837.50 | Return on account -51% | |

Figure 3.8 A Trade with a \$1,000 Target

Data : S&P 500 IND-9967 06/98
 Calc Dates : 07/02/82 - 08/24/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|------|-------|----|-------|-------|----------|----------|--------|----------------------|
| 149 | 2 | \$ | 2,500 | \$ 50 | \$ 0 | \$ 3,000 | CServe | C:\GD\BACK67\F58.DAT |

////////////////// ALL TRADES - Test 2 /////////////////////

| | | | | | |
|-------------------------|-------------|-------------------------|--------------|-------------|---------------|
| Total net profit | \$13,737.50 | Gross profit | \$115,537.50 | Gross loss | \$-101,800.00 |
| Total # of trades | 389 | Percent profitable | | 55% | |
| Number winning trades | 217 | Number losing trades | | 172 | |
| Largest winning trade | \$950.00 | Largest losing trade | | \$-3,050.00 | |
| Average winning trade | \$532.43 | Average losing trade | | \$-591.86 | |
| Ratio avg win/avg loss | 0.89 | Avg trade (win & loss) | | \$35.31 | |
| Max consecutive winners | 9 | Max consecutive losers | | 7 | |
| Avg # bars in winners | 0 | Avg # bars in losers | | 0 | |
| Max closed-out drawdown | \$-8,887.50 | Max intraday drawdown | | \$-8,887.50 | |
| Profit factor | 1.13 | Max # of contracts held | | 1 | |
| Account size required | \$11,887.50 | Return on account | | 115% | |

Figure 3.9 A Trade That Follows the Basic Rule: Minimum \$100 Profit per Trade

Data : S&P 500 IND-9967 06/98
 Calc Dates : 07/02/82 - 08/24/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|------|-------|----|-------|-------|----------|----------|--------|----------------------|
| 149 | 2 | \$ | 2,500 | \$ 50 | \$ 0 | \$ 3,000 | CServe | C:\GD\BACK67\F58.DAT |

////////////////// ALL TRADES - Test 1 /////////////////////

| | | | | | |
|-------------------------|-------------|-------------------------|--------------|-------------|---------------|
| Total net profit | \$39,075.00 | Gross profit | \$145,937.50 | Gross loss | \$-106,862.50 |
| Total # of trades | 389 | Percent profitable | | 53% | |
| Number winning trades | 210 | Number losing trades | | 179 | |
| Largest winning trade | \$6,575.00 | Largest losing trade | | \$-3,050.00 | |
| Average winning trade | \$694.94 | Average losing trade | | \$-597.00 | |
| Ratio avg win/avg loss | 1.16 | Avg trade (win & loss) | | \$100.45 | |
| Max consecutive winners | 9 | Max consecutive losers | | 7 | |
| Avg # bars in winners | 0 | Avg # bars in losers | | 0 | |
| Max closed-out drawdown | \$-6,550.00 | Max intraday drawdown | | \$-6,550.00 | |
| Profit factor | 1.36 | Max # of contracts held | | 1 | |
| Account size required | \$9,550.00 | Return on account | | 409% | |

Figure 3.7 depicts what most short-term traders want to do: that is, make about \$500 a day so that the results reflect a stop of \$3,000 (large, but that's what this volatile market requires) and an automatic \$500 profit. Although the accuracy is high at 59 percent, the speculator loses money ... \$8,150 to be specific.

Figure 3.8 reflects all the same rules except a \$1,000 target. This time we make money, \$13,737, again on the same number of trades, 389, giving us a small average profit per trade of \$35. I have deducted \$50 for commissions (as all results shown in this book do). To make our \$13,737, we were down \$8,887 at one point, and had 55 percent winning trades.

Finally, we are able to turn the corner and make money by following my basic rule of holding until the close and then exiting the position. What a difference, we actually clean up, banking \$39,075 of profits with a \$100 average profit per trade,

which is three times better than when taking an automatic \$1,000 profit. Our drawdown, how much we had to lose during our worst run to make what we did, was less at \$6,650; the \$500 target trader had a \$12,837 drawdown. The facts speak for themselves. Traders can argue all day long about what works and what does not work, but what you have just seen settles the argument for me. It is sitting tight, not trading in and out, that will make for profits.

I hold to the close, at least, for an exit point. Until someone can do the impossible, that is, call all short-term fluctuations, there will be no better strategy for a short-term trader, as you will capture the large-range days where serious money is to be made. The only difference in the preceding results was how long the trade was held: The shorter the holding period, the less opportunity for profits. Never forget that rule.

HOW TO MAKE THE MOST MONEY

There is even more money to be made holding over, past the close, but that should be true if what I said earlier is valid, that it takes time for profits to accrue. As we discuss individual markets, I will give you more specific rules of how to further capitalize on this phenomenon of profitable trading.

As final proof for my thesis, [Figure 3.10](#) shows the same system we just looked at, buying on Mondays when the market opens below Friday's close. But this time, we are going to hold the position in the first example until the next close; that is, the first close after our entry day or until we are stopped out, whichever comes first. The product of this strategy nets \$68,312, making an additional \$30,000 and increasing our net profit per trade by \$71.

[**Figure 3.10**](#) Using Timing to Increase Our Profits

Data : S&P 500 IND-9967 06/98
 Calc Dates : 07/02/82 - 08/24/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|-------|-------------------------|----------|--------|----------------------|
| 149 | 2 | \$ | 2,500 | \$ 50 | \$ 0 | \$ 3,000 | CServe | C:\GD\BACK67\F58.DAT |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | | \$68,312.50 | | | | | |
| Gross profit | | | \$224,450.00 | | Gross loss | | | \$-156,137.50 |
| Total # of trades | | | 397 | | Percent profitable | | | 55% |
| Number winning trades | | | 222 | | Number losing trades | | | 175 |
| Largest winning trade | | | \$7,025.00 | | Largest losing trade | | | \$-3,500.00 |
| Average winning trade | | | \$1,011.04 | | Average losing trade | | | \$-892.21 |
| Ratio avg win/avg loss | | | 1.13 | | Avg trade (win & loss) | | | \$172.07 |
| Max consecutive winners | | | 10 | | Max consecutive losers | | | 5 |
| Avg # bars in winners | | | 0 | | Avg # bars in losers | | | 0 |
| Max closed-out drawdown | | | \$-11,000.00 | | Max intraday drawdown | | | \$-11,000.00 |
| Profit factor | | | 1.43 | | Max # of contracts held | | | 1 |
| Account size required | | | \$14,000.00 | | Return on account | | | 487% |

Finally, look at [Figure 3.11](#), which depicts holding for the close six days after entry or being stopped out. Following this strategy proves my point and should cure you of the notion that big easy money can be made catching small swings. We now make \$71,600, almost doubling the exit on close results while boosting our average trade up to a now-respectable \$251. Remember, the only difference in these results is how long we stayed in the trade; all the other rules are the same.

[Figure 3.11](#) The Timing Makes All the Difference

Data : S&P 500 IND-9967 06/98
 Calc Dates : 07/02/82 - 08/24/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|-------|-------------------------|----------|--------|----------------------|
| 149 | 2 | \$ | 2,500 | \$ 50 | \$ 0 | \$ 3,000 | CServe | C:\GD\BACK67\F58.DAT |
| ////////////////// ALL TRADES - Test 2 ////////////////////// | | | | | | | | |
| Total net profit | | | \$71,600.00 | | Gross loss | | | \$-226,800.00 |
| Gross profit | | | \$298,400.00 | | | | | |
| Total # of trades | | | 285 | | Percent profitable | | | 52% |
| Number winning trades | | | 151 | | Number losing trades | | | 134 |
| Largest winning trade | | | \$10,750.00 | | Largest losing trade | | | \$-4,175.00 |
| Average winning trade | | | \$1,976.16 | | Average losing trade | | | \$-1,692.54 |
| Ratio avg win/avg loss | | | 1.16 | | Avg trade (win & loss) | | | \$251.23 |
| Max consecutive winners | | | 7 | | Max consecutive losers | | | 6 |
| Avg # bars in winners | | | 5 | | Avg # bars in losers | | | 4 |
| Max closed-out drawdown | | | \$-19,725.00 | | Max intraday drawdown | | | \$-19,725.00 |
| Profit factor | | | 1.31 | | Max # of contracts held | | | 1 |
| Account size required | | | \$22,725.00 | | Return on account | | | 315% |

The legendary Jesse Livermore said it best, “It was never my thinking that did it for me, it was my sitting that made the big money. My sitting!”

He added, “Men who can be right and sit tight are uncommon.”

What I am trying to get across to you is that catching the big swing (within the

time frame you are trading) is the only way I have been able to make millions of dollars trading. I finally figured out that I had to let my profits run to be able to pay off the losses that are as natural to this game as breathing is to life. Losses will absolutely inevitably come to you. That is a given, it will happen, which gives rise to the obvious question, What can we do to offset these chunks out of our rear ends? There are only two ways to overcome this negative: We must have either a very low percentage of losing trades and/or a substantially higher average profit than loss. Time, and time alone, will give you larger profits, not thinking, not fancy dancing, not trying to buy and sell every top and bottom. That is a fool's game. It is not a matter of opinion—it is provable, as the simple system presented in this chapter so clearly demonstrates.

By now, you should have learned how the market moves, the three most dominant time cycles, and should be developing a sense, or feel, for the underlying order in what appears to be chaos. But most of all, you should have learned to hold on to winners to the end of the time frame you are trading for. In my case, I'm trading for two- to five-day swings. Whenever my greed factors have convinced me to take a quick profit—or overstay my time period—I have paid dearly.

This idea is as powerful now as it was many years ago, as we see next, that of the E-Mini S&P's daily chart. The same pattern persists: large range days (money-making days for short traders) close around the high or low of that day. When you get a winner, "Hold 'em, don't fold 'em." How can you possibly catch a large move if you get out before it's over?

This is not unique to stock market indices. The chart of Gold ([Figure 3.12](#)) makes the same point. Time is our ally.

Figure 3.12 Gold Shows Importance of Holding



RECAP

The takeaway point in this chapter is that time is your friend—it is your ally and you need a trading mechanism that allows you to stay in winning trades for as long as possible.

CHAPTER 4

Volatility Breakouts—The Momentum Breakthrough

Necessity may, or may not, be the mother of invention, but it is certainly the father of taking chances.

This is the chapter that deals with the biggest change in trading in recent decades: the demise of the pit sessions and the tumultuous turnover of power to the electronic sessions. It has become a brave new world for traders, as we have had to learn and understand what the new, important market references are.

As you will read in my earlier work, traders in the era from 1965 to the late 1990s focused on the opening price of each day and how prices moved from that point. The opening was just that: where the action began each day.

Back then, the stock market closed at 4:15 each day and opened at 9:30 the next, giving traders almost 18 hours for more market inputs, news, and events of the day to drive prices up or down. The lack of trading meant the opening price was (1) explosive, (2) seldom close to the prior close, (3) potentially a large gap in price from the prior close, and (4) where trading began: It was our starting point.

You can see in [Figure 4.1](#) of the S&P 500 in 1990 that there is usually a large price difference between the close and the next opening.

Figure 4.1 Gaps in S&P 500



In 2011 we no longer see this phenomenon (except in the gap from Friday's close to Monday's opening, which actually takes place Sunday night). A single chart says

more than an entire chapter, so I will let [Figure 4.2](#) of the E-Mini S&P make the point.

[Figure 4.2](#) E-Mini S&P



The reason that this is so, is that this contract closes at 4:15 and reopens just a few moments later. There is no time for an imbalance of orders. Then it gets worse. The opening, now in the late afternoon, is no longer a reference point from where “the real trading” begins.

That can best be seen in [Figure 4.3](#). Notice price range and volume come to a halt at 3:15 EST or so, and then a great many orders, volume, come into the market.

[Figure 4.3](#) Daily Ranges Influenced by Trading Hours



The problem a trader is faced with is that, despite the low volume, there can still be price changes that can continue until the market becomes active again the following morning, as you can see in [Figure 4.4](#).

[Figure 4.4](#) “No-Man's Land” Night Trading Bars Contract



A true, and important, point to make here is that from 9:30 until 3:15 the ranges of each of the 15-minute bars are larger than during the "no-man's land" of night trading. In other words, volume increases liquidity, yet earlier in the small volume areas we still get price change. This is the problem short-term traders get to deal with, a new turn of events.

Because of this change of events, what I wrote in the first edition is not as applicable now as then. Today we can use the close of the session for our reference point in the concepts that follow.

Momentum is one of the five concepts that can bring us short-term trading profits. It is what Newton was talking about when he said an object once set in motion tends to stay in motion. (One of the advantages of trading is that you meet so many interesting people, like Lord and Lady Limington of England who were fellow traders and direct descendants of Isaac Newton and who let me gently handle some of Newton's calipers and don his hat. What a great photo that is! That was an experience my broker Al Alessandra and I treasured.) So it is with stocks and commodities: Once price starts to move, it will most likely keep going in that direction. There are almost as many ways to measure momentum as there are traders. I will not delve into all of them, just the ones I have found to work, and the concepts I trade with. There are other approaches; anyone with a fertile mind should be able to go past where I have. Mathematicians, this is the chapter where you can bring all your techniques, concepts, and formulas to play. This is where you have a distinct advantage over those of us who are limited to basic addition, multiplication, and subtraction.

I doubt that anyone fully understood how the markets worked until the mid-1980s. Sure, we knew about trend; about overbought and oversold markets; about a few patterns, seasonal influences, fundamentals, and the like. But we really did not know what caused a trend or, more correctly put, how it began and ended. We do now and it is time for you to learn this fundamental truism of price structure and movement.

Trends are set in motion by what I call "explosions of price activity." Succinctly, if price, in one hour, day, week, or month (pick your time frame for trend

identification) has an explosive move up or down, the market will continue in that direction until there is an equal or greater explosive move in the opposite direction. This has come to be known as an expansion in volatility and is captured by the term coined by Doug Brie, *volatility breakout*, based on my early 1980 work.

It gets down to this: Price has an explosive breakout, up or down, from a center point. That is what sets or establishes the trend. Thus we have two problems: (1) What do we mean by an explosive breakout (how much of an up or down move)? and (2) From what point do we measure this expansion in price?

Let's start at the beginning: What set of data should we use to measure the expansion?

Since my working thesis is that we need a very quick explosion of price change, I like to use daily range values—the difference between the day's high and close. This value shows how volatile the market has been each and every day. It is when this volatility increases beyond recent proportion that trends change.

There are several ways of taking this measure. You might use the average range for the last X number of days, various swing points, and the like. By and large though, I have found that using just yesterday's range as my comparison of volatility works wonders. Let's say yesterday's range was 12 cents in Wheat. If today's range exceeds that range by some percentage, the trend probably changed—at least, that is the way to wager. This would be a clear indication price has had a new impetus driving it in a direction, and price, like any object once set in motion, tends to stay in the direction of that motion.

It is really as simple as that: A pickup in range that is substantially greater than yesterday's range implies a change in the current market direction.

That also leads to the second problem: From what point do we measure the expansive move, up or down? Most traders think we should measure from today's closing price. That is typical thinking; we usually compare price change from close to close. But it is not the correct answer. I will get to that in a moment, but first let's consider points from which to measure this expansion: We could use the close, the average price of the current day, or perhaps today's high for a buy or today's low for a sell.

Let's look at the very best results of several nonrelated commodities using a variety of points for measuring the explosion. [Table 4.1](#) shows buying tomorrow at a percentage of today's range added to today's close. The data, listed in order, shows the commodity, percentage of range, dollar profit, accuracy, and average profit per trade.

Table 4.1 Adding or Subtracting to the Close

| Commodity | Of Range % | | Number of Trades | Percent | Average Profit |
|-----------------------|----------------|------------|------------------|---------|----------------|
| | Buy/Sell Value | \$ Profits | | | |
| Cattle | 70/50 | 24,556 | 265/117 | 44 | 92 |
| Pork Bellies | 70/50 | 352,044 | 1,285/2,817 | 45 | 124 |
| Cotton | 50/150 | 54,485 | 200/465 | 43 | 117 |
| Coffee | 70/50 | 145,346 | 88/178 | 49 | 816 |
| Orange Juice | 70/50 | 129,720 | 906/2,028 | 44 | 63 |
| Soybeans | 70/50 | 164,287 | 1,277/2,998 | 47 | 55 |
| British Pound | 70/50 | 228,631 | 981/2,358 | 41 | 96 |
| Gold | 190/70 | 64,740 | 289/717 | 40 | 90 |
| Heating Oil | 50/130 | 66,397 | 182/418 | 43 | 158 |
| Bonds | 110/110 | 197,781 | 420/905 | 46 | 218 |
| Standard & Poor's 500 | 100/190 | 85,350 | 133/330 | 40 | 258 |

In this table I have even provided the best percent of the previous day's range to add to the close for a buy and to subtract for a sell. In this, and all data shown, no stop was used and you were always long short.

This table shows only the best percent volatility add-ons for buys and subtracts for sells; and again, in the data for [Table 4.1](#), we added the volatility factor or filter to the previous day's close. Using Cattle as an example, if price rallied 70 percent of the previous day's range above the close, we bought and sold short at 50 percent of the day's range subtracted from the close.

Next, look at buying tomorrow at a percentage of yesterday's range added to yesterday's high or subtracting that same amount from yesterday's low for a sell signal (see [Table 4.2](#)).

Table 4.2 Adding or Subtracting to the High or Low

| Commodity | Percent Buy/Sell | \$ Profits | Number of Trades | Percent + | Average Profit |
|-----------------------|------------------|------------|------------------|-----------|----------------|
| Cattle | 70 | 17,012 | 191/456 | 41 | 37 |
| Pork Bellies | 110 | 141,288 | 278/608 | 45 | 232 |
| Cotton | 90 | 46,945 | 150/357 | 42 | 131 |
| Coffee | 60 | 120,573 | 36/86 | 41 | 1,402 |
| Orange Juice | 110 | 60,825 | 261/582 | 44 | 104 |
| Soybeans | 80 | 99,568 | 444/1,022 | 43 | 97 |
| British Pound | 120 | 175,506 | 295/698 | 42 | 251 |
| Gold | 130 | 57,600 | 198/504 | 39 | 114 |
| Heating Oil | 60 | 43,117 | 168/435 | 38 | 99 |
| Bonds | 90 | 154,968 | 290/605 | 47 | 256 |
| Standard & Poor's 500 | 100 | 80,787 | 569/225 | 40 | 141 |

Although this concept makes money, again, on the best-fit basis, it does not do as well as adding or subtracting a value from the close. A simple way to compare the results is to determine the size of the average profit per trade. In the add-to-the-close method, it is \$327 a trade and \$313 for the add-to-the-high and subtract-from-the-

low technique.

The next set of data adds a percentage of today's range to tomorrow's open and buys there for a long entry or subtracts a percentage of today's range from the opening for a sell. The results appear in [Table 4.3](#).

Table 4.3 Adding or Subtracting to Tomorrow's Open

| Commodity | Percent Buy/Sell | \$ Profits | Number of Trades | Percent + | Average Profit |
|-----------------------|------------------|------------|------------------|-----------|----------------|
| Cattle | 140 | 37,992 | 124/230 | 53 | 163 |
| Pork Bellies | 70 | 303,792 | 1,076/2,236 | 48 | 135 |
| Cotton | 60 | 71,895 | 988/454 | 45 | 73 |
| Coffee | 130 | 135,915 | 38/63 | 60 | 2,157 |
| Orange Juice | 50 | 169,140 | 1,184/2,754 | 52 | 75 |
| Soybeans | 100 | 228,293 | 620/1,293 | 47 | 176 |
| British Pound | 130 | 242,062 | 300/600 | 50 | 403 |
| Gold | 130 | 95,070 | 290/634 | 45 | 149 |
| Heating Oil | 140 | 42,163 | 87/196 | 44 | 215 |
| Bonds | 100 | 227,468 | 464/919 | 50 | 247 |
| Standard & Poor's 500 | 50 | 247,850 | 768/1,727 | 44 | 143 |

A careful look at the data shows us the average profit per trade is higher at \$389 and the accuracy is also higher; five commodities in this test showed an accuracy of 50 percent or higher while none of them did in the first two tests.

My conclusion is that the best point to add or subtract a volatility expansion value to is tomorrow's open. I have always traded this technique with the open, but in preparation for this book, I did the preceding tests to see whether my judgment was right and was pleased to see the facts fit my intuitive conclusion.

As short-term traders, we can use this concept to tell us there is a high probability of a further extension of price we can capitalize on. I will not trade *just because of such an entry*, but will use this as my entry technique when the time and conditions are correct.

Of all the trend entry approaches I am aware of, from moving averages to trend lines, oscillators to Ouija boards, and fancy math to simple charts, I have never seen a more consistently profitable mechanical entry technique than volatility breakouts. It is the most consistent of all entries I have ever traded, researched, or seen. Now let's look at some ways of using this basic concept.

SIMPLE DAILY RANGE BREAKOUTS

From my comments at the start of this chapter you know that the importance of the opening price has changed, but still, as a point of reference and history I think this still makes for good reading,

From the preceding we have learned that we should *add our breakout value to tomorrow's opening*. Now the question is: What's the best value? There are several good ones, but the simplest is to take today's range adding a portion of it to tomorrow's opening. Just that simple approach has been a consistent moneymaker since I first discovered it almost 20 years ago.

It is now time to go a bit beyond these results and create a trading model that is actually tradable (i.e., it makes money in an acceptable fashion). [Figure 4.5](#) shows the result of buying and selling bonds on the open every day at a distance of 100 percent of the previous day's range above the open for a buy and 100 percent below the open for a sell.

[Figure 4.5](#) A Trading Model That Works

| | | | |
|----------------------------------------------------------------------|--------------|-------------------------|-------------------------------------------------------|
| Data | : | DAY T-BONDS | 67/99 |
| Calc Dates | : | 01/01/90 - 08/25/98 | |
| <hr/> | | | |
| Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName | | | |
| <hr/> | | | |
| 144 | -3 | \$ 31.250 | \$ 0 \$ 0 \$ 3,000 CSI C:\GD\BACK67\F061.DTA |
| <hr/> | | | |
| ////////// ALL TRADES - Test 1 ////////// | | | |
| Total net profit | | \$73,468.75 | |
| Gross profit | | \$213,156.25 | Gross loss \$-139,687.50 |
| Total # of trades | 651 | Percent profitable | 80% |
| Number winning trades | 523 | Number losing trades | 128 |
| Largest winning trade | \$3,968.75 | Largest losing trade | \$-1,812.50 |
| Average winning trade | \$407.56 | Average losing trade | \$-1,091.31 |
| Ratio avg win/avg loss | 0.37 | Avg trade (win & loss) | \$112.86 |
| Max consecutive winners | 20 | Max consecutive losers | 4 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |
| Max closed-out drawdown | \$-10,031.25 | Max intraday drawdown | \$-10,031.25 |
| Profit factor | 1.52 | Max # of contracts held | 1 |
| Account size required | \$13,031.25 | Return on account | 563% |

A protective stop of \$1,500 or 50 percent of the previous day's range subtracted from our entry is used as our protective stop while our exit is the bailout or the first profitable opening after entry technique. This does make money, \$73,468 with 80 percent accuracy on 651 trades. On average, the system makes \$7,000 a year and would require a \$13,000 bankroll to net the 70 percent a year gain. The drawdown of only \$10,031 is quite good for such a basic system. A problem can be seen in that the average profit per trade is only \$112.86; this needs to be higher. The data set is from 1990 through August 1998.

Any idea how we might accomplish such a lofty goal? For now, let's try our basic TDW (trading day of the week) strategy to see what happens if we only take buy and sells on certain specific days. To get a sense of this, [Figures 4.6](#) through [4.10](#) show the buys for each day of the week, then the sells for each day, and finally we put together the best buy/sell days for a working model we can actually trade.

[Figure 4.6](#) Trading Day of the Week: Monday

| ////////////////// ALL TRADES - Test 5 ////////////////// | | | |
|-------------------------------------------------------------|--------------|-------------------------|---------------|
| Monday | | | |
| Total net profit | \$9,500.00 | Gross loss | \$ -13,468.75 |
| Gross profit | \$22,968.75 | | |
| Total # of trades | 77 | Percent profitable | 87% |
| Number winning trades | 67 | Number losing trades | 10 |
| Largest winning trade | \$1,437.50 | Largest losing trade | \$ -1,500.00 |
| Average winning trade | \$342.82 | Average losing trade | \$ -1,346.87 |
| Ratio avg win/avg loss | 0.25 | Avg trade (win & loss) | \$123.38 |
| Max consecutive winners | 15 | Max consecutive losers | 1 |
| Avg # bars in winners | 1 | Avg # bars in losers | 4 |
| Max closed-out drawdown | \$ -2,843.75 | Max intraday drawdown | \$ -2,968.75 |
| Profit factor | 1.70 | Max # of contracts held | 1 |
| Account size required | \$5,968.75 | Return on account | 159% |
| ////////////////// SHORT TRADES - Test 5 ////////////////// | | | |
| Total net profit | \$5,218.75 | Gross loss | \$ -6,437.50 |
| Gross profit | \$11,656.25 | | |
| Total # of trades | 37 | Percent profitable | 86% |
| Number winning trades | 32 | Number losing trades | 5 |
| Largest winning trade | \$1,437.50 | Largest losing trade | \$ -1,500.00 |
| Average winning trade | \$364.26 | Average losing trade | \$ -1,287.50 |
| Ratio avg win/avg loss | 0.28 | Avg trade (win & loss) | \$141.05 |
| Max consecutive winners | 15 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 5 |
| Max closed-out drawdown | \$ -3,406.25 | Max intraday drawdown | \$ -3,406.25 |
| Profit factor | 1.81 | Max # of contracts held | 1 |
| Account size required | \$6,406.25 | Return on account | 81% |

Figure 4.7 Trading Day of the Week: Tuesday

| ////////////////// LONG TRADES - Test 1 ////////////////// | | | |
|------------------------------------------------------------|-------------|------------------------|---------------|
| Tuesday | | | |
| Total net profit | \$21,718.75 | Gross loss | \$ -16,343.75 |
| Gross profit | \$38,062.50 | | |
| Total # of trades | 108 | Percent profitable | 89% |
| Number winning trades | 97 | Number losing trades | 11 |
| Largest winning trade | \$1,687.50 | Largest losing trade | \$ -1,500.00 |
| Average winning trade | \$392.40 | Average losing trade | \$ -1,485.80 |
| Ratio avg win/avg loss | 0.26 | Avg trade (win & loss) | \$201.10 |
| Max consecutive winners | 42 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |

| ////////////////// SHORT TRADES - Test 1 ////////////////// | | | |
|-------------------------------------------------------------|---------------|-------------------------|---------------|
| Total net profit | \$ -6,375.00 | Gross loss | \$ -28,000.00 |
| Gross profit | \$21,625.00 | | |
| Total # of trades | 79 | Percent profitable | 75% |
| Number winning trades | 60 | Number losing trades | 19 |
| Largest winning trade | \$1,437.50 | Largest losing trade | \$ -1,687.50 |
| Average winning trade | \$360.42 | Average losing trade | \$ -1,473.68 |
| Ratio avg win/avg loss | 0.24 | Avg trade (win & loss) | \$ -80.70 |
| Max consecutive winners | 14 | Max consecutive losers | 3 |
| Avg # bars in winners | 1 | Avg # bars in losers | 4 |
| Max closed-out drawdown | \$ -11,156.25 | Max intraday drawdown | \$ -11,593.75 |
| Profit factor | 0.77 | Max # of contracts held | 1 |
| Account size required | \$14,593.75 | Return on account | -43% |

Figure 4.8 Trading Day of the Week: Wednesday

////////////////// LONG TRADES - Test 2 //////////////////

| Wednesday | | | |
|-------------------------|-------------|------------------------|--------------|
| Total net profit | \$5,218.75 | Gross loss | \$-18,125.00 |
| Gross profit | \$23,343.75 | | |
| Total # of trades | 77 | Percent profitable | 84% |
| Number winning trades | 65 | Number losing trades | 12 |
| Largest winning trade | \$1,406.25 | Largest losing trade | \$-1,625.00 |
| Average winning trade | \$359.13 | Average losing trade | \$-1,510.42 |
| Ratio avg win/avg loss | 0.23 | Avg trade (win & loss) | \$67.78 |
| Max consecutive winners | 17 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |

////////////////// SHORT TRADES - Test 2 //////////////////

| Wednesday | | | |
|-------------------------|-------------|-------------------------|--------------|
| Total net profit | \$12,250.00 | Gross loss | \$-15,250.00 |
| Gross profit | \$27,500.00 | | |
| Total # of trades | 68 | Percent profitable | 85% |
| Number winning trades | 58 | Number losing trades | 10 |
| Largest winning trade | \$1,562.50 | Largest losing trade | \$-1,718.75 |
| Average winning trade | \$474.14 | Average losing trade | \$-1,525.00 |
| Ratio avg win/avg loss | 0.31 | Avg trade (win & loss) | \$180.15 |
| Max consecutive winners | 14 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |
| Max closed-out drawdown | \$-3,000.00 | Max intraday drawdown | \$-3,000.00 |
| Profit factor | 1.80 | Max # of contracts held | 1 |
| Account size required | \$6,000.00 | Return on account | 204% |

Figure 4.9 Trading Day of the Week: Thursday

////////////////// LONG TRADES - Test 3 //////////////////

| Thursday | | | |
|-------------------------|-------------|------------------------|--------------|
| Total net profit | \$15,875.00 | Gross loss | \$-16,687.50 |
| Gross profit | \$32,562.50 | | |
| Total # of trades | 88 | Percent profitable | 87% |
| Number winning trades | 77 | Number losing trades | 11 |
| Largest winning trade | \$1,687.50 | Largest losing trade | \$-1,687.50 |
| Average winning trade | \$422.89 | Average losing trade | \$-1,517.05 |
| Ratio avg win/avg loss | 0.27 | Avg trade (win & loss) | \$180.40 |
| Max consecutive winners | 17 | Max consecutive losers | 1 |
| Avg # bars in winners | 1 | Avg # bars in losers | 1 |

////////////////// SHORT TRADES - Test 3 //////////////////

| Thursday | | | |
|-------------------------|-------------|-------------------------|--------------|
| Total net profit | \$15,937.50 | Gross loss | \$-18,000.00 |
| Gross profit | \$33,937.50 | | |
| Total # of trades | 81 | Percent profitable | 85% |
| Number winning trades | 69 | Number losing trades | 12 |
| Largest winning trade | \$2,406.25 | Largest losing trade | \$-1,500.00 |
| Average winning trade | \$491.85 | Average losing trade | \$-1,500.00 |
| Ratio avg win/avg loss | 0.32 | Avg trade (win & loss) | \$196.76 |
| Max consecutive winners | 13 | Max consecutive losers | 1 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | \$-3,343.75 | Max intraday drawdown | \$-3,937.50 |
| Profit factor | 1.88 | Max # of contracts held | 1 |
| Account size required | \$6,937.50 | Return on account | 229% |

Figure 4.10 Trading Day of the Week: Friday

| LONG TRADES - Test 4 | | | |
|-------------------------|-------------|------------------------|--------------|
| Friday | | | |
| Total net profit | \$7,250.00 | Gross loss | \$-31,968.75 |
| Gross profit | \$39,218.75 | | |
| Total # of trades | 117 | Percent profitable | 82% |
| Number winning trades | 96 | Number losing trades | 21 |
| Largest winning trade | \$1,656.25 | Largest losing trade | \$-2,000.00 |
| Average winning trade | \$408.53 | Average losing trade | \$-1,522.32 |
| Ratio avg win/avg loss | 0.26 | Avg trade (win & loss) | \$61.97 |
| Max consecutive winners | 17 | Max consecutive losers | 2 |
| Avg # bars in winners | 2 | Avg # bars in losers | 2 |

| SHORT TRADES - Test 4 | | | |
|-------------------------|-------------|-------------------------|--------------|
| Friday | | | |
| Total net profit | \$12,468.75 | Gross loss | \$-23,437.50 |
| Gross profit | \$35,906.25 | | |
| Total # of trades | 95 | Percent profitable | 82% |
| Number winning trades | 78 | Number losing trades | 17 |
| Largest winning trade | \$3,968.75 | Largest losing trade | \$-1,531.25 |
| Average winning trade | \$460.34 | Average losing trade | \$-1,378.68 |
| Ratio avg win/avg loss | 0.33 | Avg trade (win & loss) | \$131.25 |
| Max consecutive winners | 12 | Max consecutive losers | 3 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | \$-4,093.75 | Max intraday drawdown | \$-4,093.75 |
| Profit factor | 1.53 | Max # of contracts held | 1 |
| Account size required | \$7,093.75 | Return on account | 175% |

The listings indicate that the best days to buy have been Tuesdays and Thursdays, whereas the best sell days have been Wednesdays and Thursdays. [Figure 4.11](#) shows that if we restrict trading to just these days, we don't make as much money, only \$56,437, but just about cut the number of trades in half and boost our profits up to \$173 on average, a number worth trading for. Your lesson here is that the Trade Day of Week (TDW) can make a big difference in your system's performance. Best yet, the drawdown plummets to only \$3,500 from \$10,031 and the accuracy jumps to 84 percent. This is a big improvement, as explained in the discussion of money management in Chapter 13.

[Figure 4.11](#) Restricting Trading Days Makes a Big Difference

```

Data : DAY T-BONDS 67/99
Calc Dates : 01/01/90 - 08/25/98

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
-----  

144 -3 $ 31.250 $ 0 $ 0 $ 3,000 CSI C:\GD\BACK67\P061.DTA

////////////////// ALL TRADES - Test 1 ///////////////////  

Total net profit $56,437.50
Gross profit $122,375.00 Gross loss $-65,937.50

Total # of trades 326 Percent profitable 84%
Number winning trades 277 Number losing trades 49

Largest winning trade $2,406.25 Largest losing trade $-1,718.75
Average winning trade $441.79 Average losing trade $-1,345.66
Ratio avg win/avg loss 0.32 Avg trade (win & loss) $173.12

Max consecutive winners 23 Max consecutive losers 2
Avg # bars in winners 1 Avg # bars in losers 2

Max closed-out drawdown $-3,500.00 Max intraday drawdown $-3,500.00
Profit factor 1.85 Max # of contracts held 1
Account size required $6,500.00 Return on account 868%  

////////////////// LONG TRADES - Test 1 ///////////////////  

Total net profit $30,406.25
Gross profit $64,406.25 Gross loss $-34,000.00

Total # of trades 186 Percent profitable 86%
Number winning trades 161 Number losing trades 25

Largest winning trade $1,687.50 Largest losing trade $-1,687.50
Average winning trade $400.04 Average losing trade $-1,360.00
Ratio avg win/avg loss 0.29 Avg trade (win & loss) $163.47

Max consecutive winners 16 Max consecutive losers 1
Avg # bars in winners 1 Avg # bars in losers 1

////////////////// SHORT TRADES - Test 1 ///////////////////  

Total net profit $26,031.25
Gross profit $57,968.75 Gross loss $-31,937.50

Total # of trades 140 Percent profitable 82%
Number winning trades 116 Number losing trades 24

Largest winning trade $2,406.25 Largest losing trade $-1,718.75
Average winning trade $499.73 Average losing trade $-1,330.73
Ratio avg win/avg loss 0.37 Avg trade (win & loss) $185.94

Max consecutive winners 15 Max consecutive losers 3
Avg # bars in winners 1 Avg # bars in losers 3

Max closed-out drawdown $-3,812.50 Max intraday drawdown $-3,812.50
Profit factor 1.81 Max # of contracts held 1
Account size required $6,812.50 Return on account 382%

```

A LOOK AT VOLATILITY IN THE S&P 500

Does this concept have application for the S&P 500?

Although there can be no doubt about this technique working with a 50 percent volatility expansion, we can improve on it a great deal. How? By using something we already know about, the impact of TDW. The next set of data shows the volatility breakout performance by each day of the week for the S&P 500. The exit is the same as with the bonds shown earlier. Clearly, some are days better than others to trade. [Figures 4.12](#) through [4.16](#) show the buy signals by day of week; [Figures 4.17](#) through [4.21](#) show sell signals by the day of week.

[**Figure 4.12**](#) Trading on Mondays

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

Mondays

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 5 ////////////////////// | | | | | | | | |
| Total net profit | | | \$75,712.50 | | | | | |
| Gross profit | | | \$167,200.00 | | Gross loss | | | \$-91,487.50 |
| Total # of trades | | | 347 | | Percent profitable | | | 85% |
| Number winning trades | | | 298 | | Number losing trades | | | 49 |
| Largest winning trade | | | \$4,975.00 | | Largest losing trade | | | \$-4,400.00 |
| Average winning trade | | | \$561.07 | | Average losing trade | | | \$-1,867.09 |
| Ratio avg win/avg loss | | | 0.30 | | Avg trade (win & loss) | | | \$218.19 |
| Max consecutive winners | | | 26 | | Max consecutive losers | | | 3 |
| Avg # bars in winners | | | 1 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-9,150.00 | | Max intraday drawdown | | | \$-9,750.00 |
| Profit factor | | | 1.82 | | Max # of contracts held | | | 1 |
| Account size required | | | \$12,750.00 | | Return on account | | | 593% |

Figure 4.13 Trading on Tuesdays

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

Tuesdays

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | | \$63,075.00 | | | | | |
| Gross profit | | | \$150,725.00 | | Gross loss | | | \$-87,650.00 |
| Total # of trades | | | 294 | | Percent profitable | | | 83% |
| Number winning trades | | | 246 | | Number losing trades | | | 48 |
| Largest winning trade | | | \$8,512.50 | | Largest losing trade | | | \$-3,962.50 |
| Average winning trade | | | \$612.70 | | Average losing trade | | | \$-1,826.04 |
| Ratio avg win/avg loss | | | 0.33 | | Avg trade (win & loss) | | | \$214.54 |
| Max consecutive winners | | | 24 | | Max consecutive losers | | | 2 |
| Avg # bars in winners | | | 1 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-10,800.00 | | Max intraday drawdown | | | \$-10,800.00 |
| Profit factor | | | 1.71 | | Max # of contracts held | | | 1 |
| Account size required | | | \$13,800.00 | | Return on account | | | 457% |

Figure 4.14 Trading on Wednesdays

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

Wednesdays

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 2 ////////////////////// | | | | | | | | |
| Total net profit | | | \$73,297.50 | | | | | |
| Gross profit | | | \$163,372.50 | | Gross loss | | | \$-90,075.00 |
| Total # of trades | | | 326 | | Percent profitable | | | 85% |
| Number winning trades | | | 278 | | Number losing trades | | | 48 |
| Largest winning trade | | | \$4,462.50 | | Largest losing trade | | | \$-3,912.50 |
| Average winning trade | | | \$587.67 | | Average losing trade | | | \$-1,876.56 |
| Ratio avg win/avg loss | | | 0.31 | | Avg trade (win & loss) | | | \$224.84 |
| Max consecutive winners | | | 28 | | Max consecutive losers | | | 3 |
| Avg # bars in winners | | | 1 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-6,762.50 | | Max intraday drawdown | | | \$-7,187.50 |
| Profit factor | | | 1.81 | | Max # of contracts held | | | 1 |
| Account size required | | | \$10,187.50 | | Return on account | | | 719% |

Figure 4.15 Trading on Thursdays

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

Thursdays

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 3 ////////////////////// | | | | | | | | |
| Total net profit | | | \$56,400.00 | | | | | |
| Gross profit | | | \$152,175.00 | | Gross loss | | | \$-95,775.00 |
| Total # of trades | | | 307 | | Percent profitable | | | 84% |
| Number winning trades | | | 260 | | Number losing trades | | | 47 |
| Largest winning trade | | | \$6,687.50 | | Largest losing trade | | | \$-5,575.00 |
| Average winning trade | | | \$585.29 | | Average losing trade | | | \$-2,037.77 |
| Ratio avg win/avg loss | | | 0.28 | | Avg trade (win & loss) | | | \$183.71 |
| Max consecutive winners | | | 30 | | Max consecutive losers | | | 2 |
| Avg # bars in winners | | | 2 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-9,700.00 | | Max intraday drawdown | | | \$-12,537.50 |
| Profit factor | | | 1.58 | | Max # of contracts held | | | 1 |
| Account size required | | | \$15,537.50 | | Return on account | | | 362% |

Figure 4.16 Trading on Fridays

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

Fridays

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|-----------------------------------------------------------|-------|----------|--------------|------|-------------------------|--------|------------------------|----------------------|
| 149 | 2 | \$ 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\P59.DAT | |
| ////////////////// ALL TRADES - Test 4 ////////////////// | | | | | | | | |
| Total net profit | | | \$60,162.50 | | | | | |
| Gross profit | | | \$148,387.50 | | Gross loss | | | \$-88,225.00 |
| Total # of trades | | | 297 | | Percent profitable | | | 86% |
| Number winning trades | | | 256 | | Number losing trades | | | 41 |
| Largest winning trade | | | \$4,387.50 | | Largest losing trade | | | \$-8,800.00 |
| Average winning trade | | | \$579.64 | | Average losing trade | | | \$-2,151.83 |
| Ratio avg win/avg loss | | | 0.26 | | Avg trade (win & loss) | | | \$202.57 |
| Max consecutive winners | | | 21 | | Max consecutive losers | | | 2 |
| Avg # bars in winners | | | 1 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-13,125.00 | | Max intraday drawdown | | | \$-13,125.00 |
| Profit factor | | | 1.68 | | Max # of contracts held | | | 1 |
| Account size required | | | \$16,125.00 | | Return on account | | | 373% |

Figure 4.17 Short Trades Test: Monday

| | | | | | | | | |
|-------------------------------------------------------------|--|--|--------------|--|-------------------------|--|--|---------------|
| ////////////////// SHORT TRADES - Test 5 ////////////////// | | | | | | | | |
| Monday | | | | | | | | |
| Total net profit | | | \$-4,812.50 | | Gross loss | | | \$-140,337.50 |
| Gross profit | | | \$135,525.00 | | | | | |
| Total # of trades | | | 277 | | Percent profitable | | | 73% |
| Number winning trades | | | 203 | | Number losing trades | | | 74 |
| Largest winning trade | | | \$16,712.50 | | Largest losing trade | | | \$-5,875.00 |
| Average winning trade | | | \$667.61 | | Average losing trade | | | \$-1,896.45 |
| Ratio avg win/avg loss | | | 0.35 | | Avg trade (win & loss) | | | \$-17.37 |
| Max consecutive winners | | | 27 | | Max consecutive losers | | | 5 |
| Avg # bars in winners | | | 2 | | Avg # bars in losers | | | 4 |
| Max closed-out drawdown | | | \$-26,225.00 | | Max intraday drawdown | | | \$-26,900.00 |
| Profit factor | | | 0.96 | | Max # of contracts held | | | 1 |
| Account size required | | | \$29,900.00 | | Return on account | | | -16% |

Figure 4.18 Short Trades Test: Tuesday

| | | | | | | | | |
|-------------------------------------------------------------|--|--|--------------|--|-------------------------|--|--|---------------|
| ////////////////// SHORT TRADES - Test 1 ////////////////// | | | | | | | | |
| Tuesday | | | | | | | | |
| Total net profit | | | \$-21,400.00 | | Gross loss | | | \$-164,225.00 |
| Gross profit | | | \$142,825.00 | | | | | |
| Total # of trades | | | 329 | | Percent profitable | | | 75% |
| Number winning trades | | | 248 | | Number losing trades | | | 81 |
| Largest winning trade | | | \$9,987.50 | | Largest losing trade | | | \$-14,125.00 |
| Average winning trade | | | \$575.91 | | Average losing trade | | | \$-2,027.47 |
| Ratio avg win/avg loss | | | 0.28 | | Avg trade (win & loss) | | | \$-65.05 |
| Max consecutive winners | | | 15 | | Max consecutive losers | | | 4 |
| Avg # bars in winners | | | 2 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-37,275.00 | | Max intraday drawdown | | | \$-37,975.00 |
| Profit factor | | | 0.86 | | Max # of contracts held | | | 1 |
| Account size required | | | \$40,975.00 | | Return on account | | | -52% |

Figure 4.19 Short Trades Test: Wednesday

| SHORT TRADES - Test 2 | | | |
|-------------------------|--------------|-------------------------|---------------|
| Wednesday | | | |
| Total net profit | \$-15,987.50 | Gross loss | \$-157,500.00 |
| Gross profit | \$141,512.50 | | |
| Total # of trades | 312 | Percent profitable | 74% |
| Number winning trades | 232 | Number losing trades | 80 |
| Largest winning trade | \$4,837.50 | Largest losing trade | \$-4,975.00 |
| Average winning trade | \$609.97 | Average losing trade | \$-1,968.75 |
| Ratio avg win/avg loss | 0.30 | Avg trade (win & loss) | \$-51.24 |
| Max consecutive winners | 22 | Max consecutive losers | 3 |
| Avg # bars in winners | 2 | Avg # bars in losers | 3 |
| Max closed-out drawdown | \$-24,737.50 | Max intraday drawdown | \$-25,475.00 |
| Profit factor | 0.89 | Max # of contracts held | 1 |
| Account size required | \$28,475.00 | Return on account | -56% |

Figure 4.20 Short Trades Test: Thursday

| SHORT TRADES - Test 3 | | | |
|-------------------------|--------------|-------------------------|---------------|
| Thursday | | | |
| Total net profit | \$36,250.00 | Gross loss | \$-147,525.00 |
| Gross profit | \$183,775.00 | | |
| Total # of trades | 318 | Percent profitable | 75% |
| Number winning trades | 241 | Number losing trades | 77 |
| Largest winning trade | \$8,737.50 | Largest losing trade | \$-4,212.50 |
| Average winning trade | \$762.55 | Average losing trade | \$-1,915.91 |
| Ratio avg win/avg loss | 0.39 | Avg trade (win & loss) | \$113.99 |
| Max consecutive winners | 19 | Max consecutive losers | 5 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | \$-12,950.00 | Max intraday drawdown | \$-13,187.50 |
| Profit factor | 1.24 | Max # of contracts held | 1 |
| Account size required | \$16,187.50 | Return on account | 223% |

Figure 4.21 Short Trades Test: Friday

| SHORT TRADES - Test 4 | | | |
|-------------------------|--------------|-------------------------|---------------|
| Friday | | | |
| Total net profit | \$26,350.00 | Gross loss | \$-156,050.00 |
| Gross profit | \$182,400.00 | | |
| Total # of trades | 347 | Percent profitable | 76% |
| Number winning trades | 267 | Number losing trades | 80 |
| Largest winning trade | \$9,262.50 | Largest losing trade | \$-4,250.00 |
| Average winning trade | \$683.15 | Average losing trade | \$-1,950.62 |
| Ratio avg win/avg loss | 0.35 | Avg trade (win & loss) | \$75.94 |
| Max consecutive winners | 42 | Max consecutive losers | 4 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |
| Max closed-out drawdown | \$-32,812.50 | Max intraday drawdown | \$-32,812.50 |
| Profit factor | 1.16 | Max # of contracts held | 1 |
| Account size required | \$35,812.50 | Return on account | 73% |

[Figure 4.22](#) shows trading on just the more influential days. The best days to be a buyer were all days other than Thursday and Friday, while the best sell day was Thursday, with Friday a push, but it is used in the following listing. This is not a bad system: It “made” \$227,822 with 75 percent accuracy on 1,333 trades and had a very small drawdown of only \$13,737. I would prefer a larger average profit per trade than the \$170 shown here.

[Figure 4.22](#) Trading on More Influential Days

Data : S&P 500 IND-9967 01/80
 Calc Dates : 07/02/82 - 08/25/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|----------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | | \$227,822.50 | | | | | |
| Gross profit | | | \$642,447.50 | | | | | |
| Total # of trades | | | 1,333 | | | | | |
| Number winning trades | | | 993 | | | | | |
| Largest winning trade | | | \$8,737.50 | | | | | |
| Average winning trade | | | \$646.98 | | | | | |
| Ratio avg win/avg loss | | | 0.53 | | | | | |
| Max consecutive winners | | | 24 | | | | | |
| Avg # bars in winners | | | 1 | | | | | |
| Max closed-out drawdown | | | \$-13,737.50 | | | | | |
| Profit factor | | | 1.54 | | | | | |
| Account size required | | | \$16,737.50 | | | | | |
| Total net profit | | | \$227,822.50 | | | | | |
| Gross profit | | | \$642,447.50 | | | | | |
| Total # of trades | | | 1,333 | | | | | |
| Number winning trades | | | 993 | | | | | |
| Largest winning trade | | | \$8,737.50 | | | | | |
| Average winning trade | | | \$646.98 | | | | | |
| Ratio avg win/avg loss | | | 0.53 | | | | | |
| Max consecutive losers | | | 4 | | | | | |
| Avg # bars in losers | | | 1 | | | | | |
| Max intraday drawdown | | | \$-13,737.50 | | | | | |
| Max # of contracts held | | | 1 | | | | | |
| Return on account | | | 1,361% | | | | | |

An astute, thinking trader should be asking questions like, “Could we use a closer volatility expansion number to be a buyer on the more bullish days and a farther-away entry value on the days that don't work so well with the 50 percent value? And how about our exit: Would it pay off to hold longer on the more bullish/bearish days?”

These questions can continue indefinitely, but do need to be asked to optimize performance. Proof that research pays off is offered by [Figure 4.23](#), which shows the use of the preceding rules, except that the buy entry comes at 40 percent of the previous day's range added to the open, the sell entry at 200 percent of the range subtracted from the open. There is a big difference here; while it actually makes a little less money (\$14,000), the accuracy goes to 83 percent, the average profit per trade is escalated to \$251, and our number of trades is reduced by 46 percent!

[Figure 4.23 Research Pays Off!](#)

Data : S&P 500 IND-9967 01/80
 Calc Dates : 07/02/82 - 08/25/98

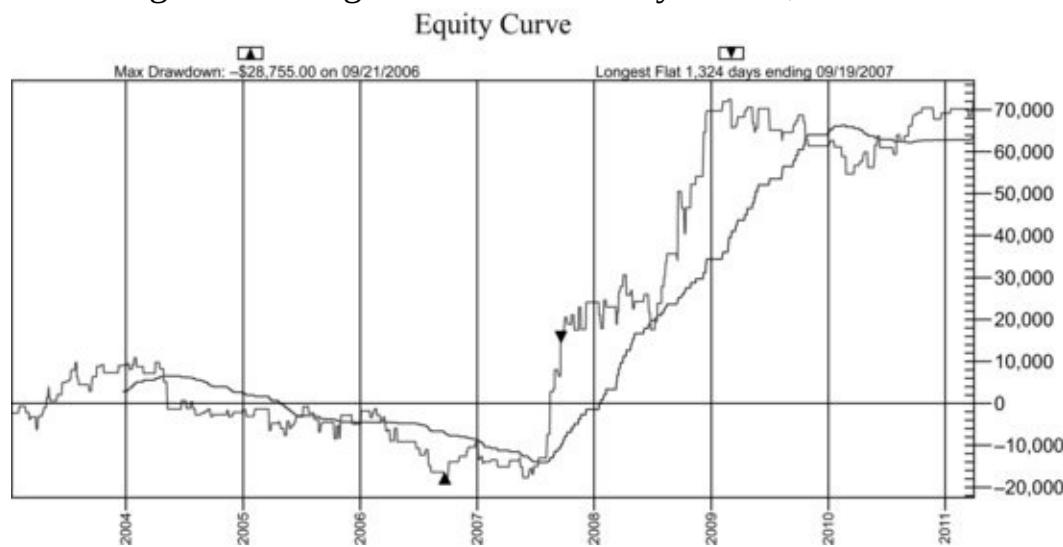
| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|----------------------------------------------------------------|-------|----|--------------|------|----------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 68 ////////////////////// | | | | | | | | |
| Total net profit | | | \$213,560.00 | | | | | |
| Gross profit | | | \$473,110.00 | | | | | |
| Total # of trades | | | 850 | | | | | |
| Number winning trades | | | 709 | | | | | |
| Largest winning trade | | | \$10,250.00 | | | | | |
| Average winning trade | | | \$667.29 | | | | | |
| Ratio avg win/avg loss | | | 0.36 | | | | | |
| Max consecutive winners | | | 40 | | | | | |
| Avg # bars in winners | | | 1 | | | | | |
| Max closed-out drawdown | | | \$-9,712.50 | | | | | |
| Profit factor | | | 1.82 | | | | | |
| Account size required | | | \$13,087.50 | | | | | |
| Total net profit | | | \$213,560.00 | | | | | |
| Gross profit | | | \$473,110.00 | | | | | |
| Total # of trades | | | 850 | | | | | |
| Number winning trades | | | 709 | | | | | |
| Largest winning trade | | | \$10,250.00 | | | | | |
| Average winning trade | | | \$667.29 | | | | | |
| Ratio avg win/avg loss | | | 0.36 | | | | | |
| Max consecutive losers | | | 3 | | | | | |
| Avg # bars in losers | | | 2 | | | | | |
| Max intraday drawdown | | | \$-10,087.50 | | | | | |
| Max # of contracts held | | | 1 | | | | | |
| Return on account | | | 1,631% | | | | | |

Reflecting on these ideas 10 years later, here are my thoughts. So that we might

learn more about markets since 2000, I did some tests to help us determine what might be the best reference point to key off. In the following tests I looked at adding a volatility factor to (1) today's close, (2) tomorrow's opening, (3) today's low, (4) today's high, and, finally, (4) today's mid-price (the average of the high and low).

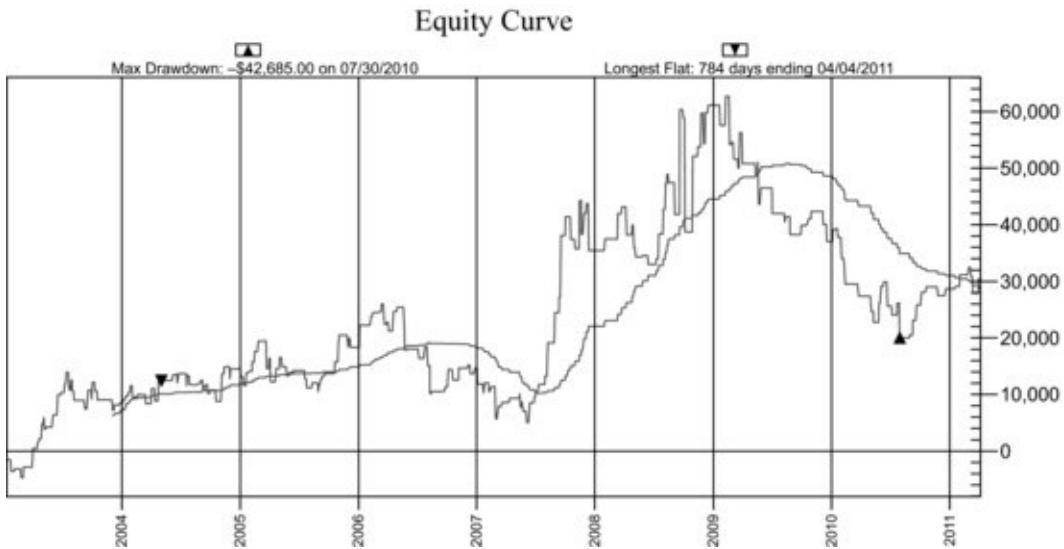
The test explored whether today had been down close, that is, whether today's close was less than today's opening *and* less than the prior day's close. In testing for an up day, it looked for just the opposite case: an up close and a close above today's opening. Here are the results showing each reference point and the *best percentage of the average true range of the past three days* as our volatility factor. These values are highly optimized; I selected the best performance of results There is no indication they will be the best in the future, but they were in the past, and are chosen for that purpose only: to show the best you could have done, had you known. After you look at these results in [Figure 4.24](#) I will share my observations.

Figure 4.24 Down Close and Close < Open Day, Buy at Next Bar Open + 60 Percent of Average True Range of Past Three Days + \$70,000



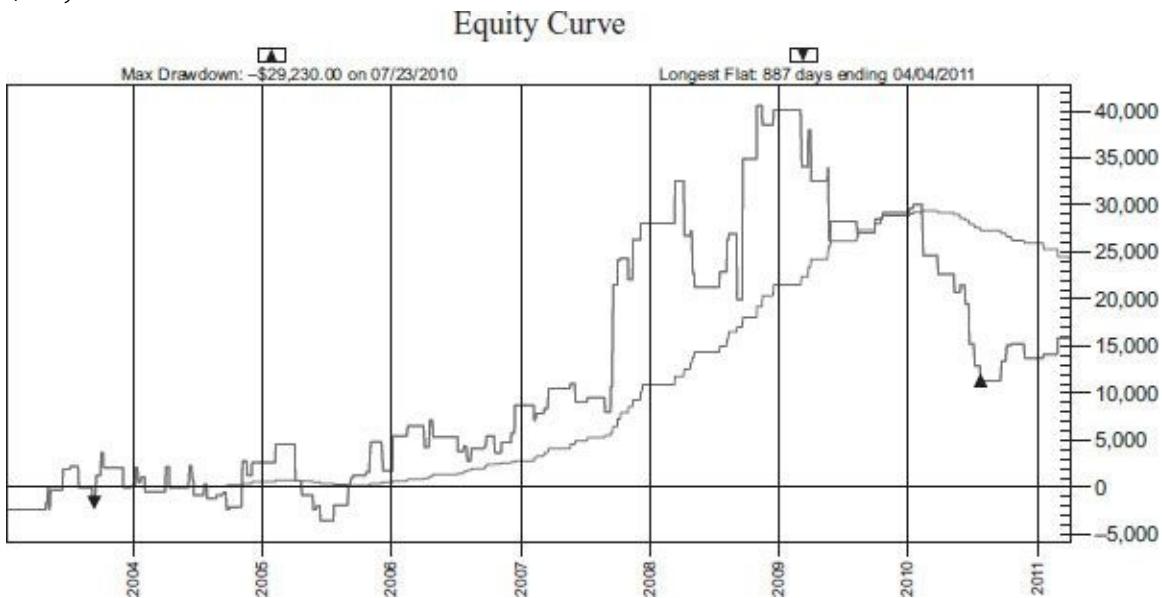
Clearly this did not work well until 2007, when it kicked in and began working. You see this in [Figure 4.25](#). I would prefer to see something that is more consistent, yet the net profits of \$70,000 are better than any of the other clips you will see.

Figure 4.25 Buy at Close + 60 Percent of Average True Range of Past Three Days + \$30,000



This is typical of what usually happens with systems: They work for a while, work really well and then fall apart, as this method did from 2008 onward. Perhaps if you're a very long-term follower of this approach, [Figure 4.26](#) would not bother you. If so, this might work for you but the equity line is too choppy for those who live in the here and now.

Figure 4.26 Buy at High + 30 Percent of Average True Range of Past Three Days + \$15,000



This equity line intrigues me. It worked quite well until 2008, when the bear market began, but unfortunately did not start making money in 2009 when the market turned back around to the upside. Look at [Figure 4.27](#); what is happening here? If you can't answer that, we probably don't have a good trading approach.

Figure 4.27 Buy at Low + 20 Percent of Average True Range of Past Three Days + \$60,000

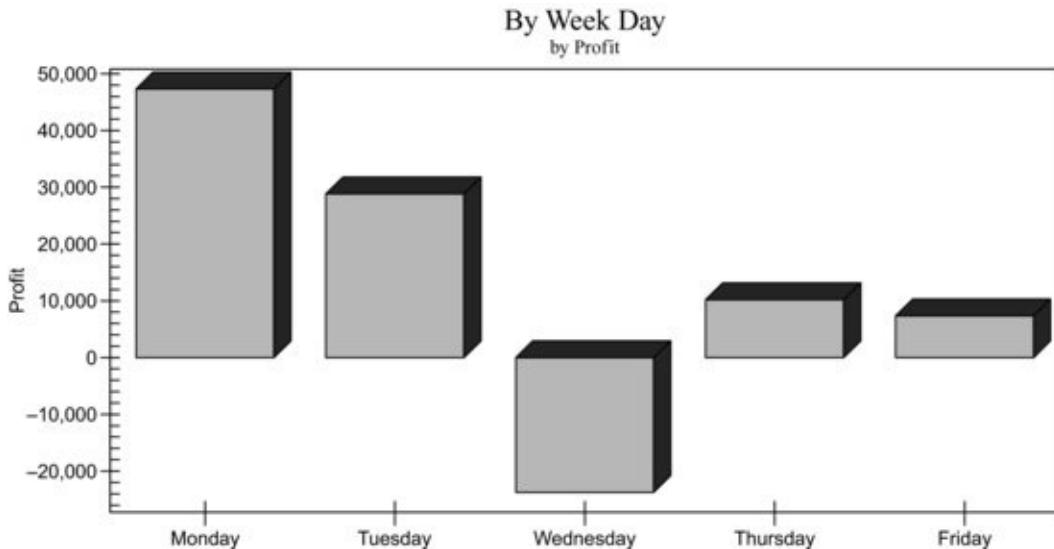


This seems to be the best fit. It worked in the early years as seen in the chart above and with the exception of the 2008 bear market, we see a consistently rising equity line. I do like the net profits of up close to \$70,000. This certainly grabs my attention along with the first chart.

The most certain conclusion to draw is that there is a *huge difference based on what reference point* one chooses and each point requires a different volatility expansion for optimal results. None are perfect. My call on this is based on using the next day's opening and tacking on 60 percent of the three-day range or using the low and adding 20 percent: These are the most productive, but not necessarily tradable . . . just a start on our path to develop a working strategy

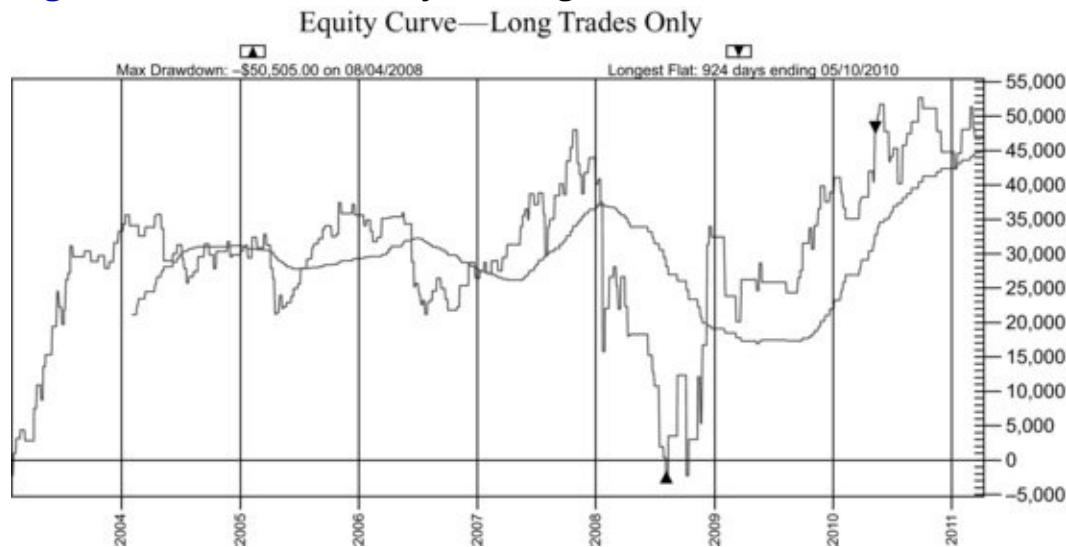
Using the low as our reference point, I want to see if some days of the week have been better than others as our first test. [Figure 4.28](#) shows the 20 percent entry from the low results for each day of the week.

Figure 4.28 Lows Used as Reference Point



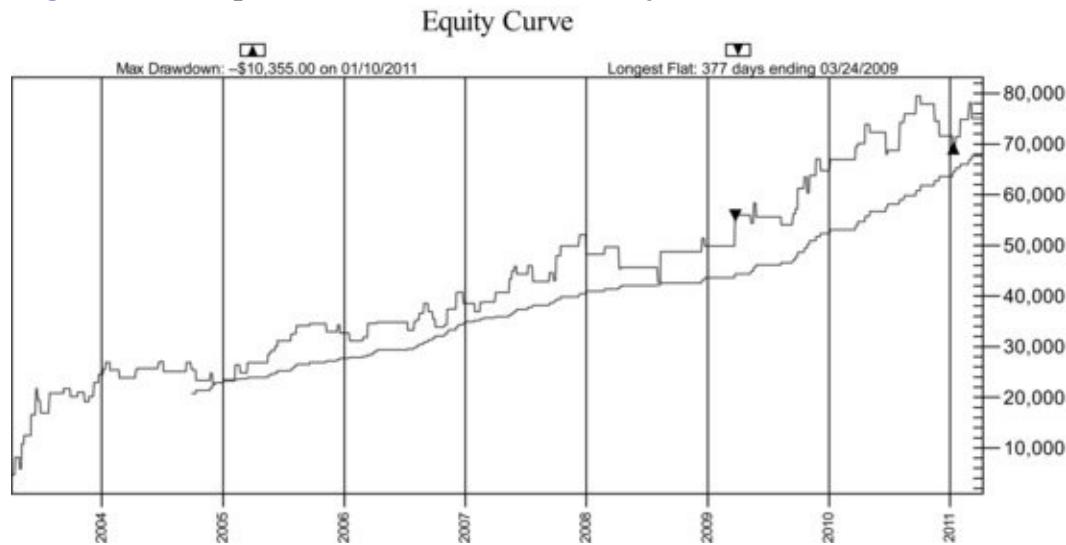
Well, would you look at that! (See [Figure 4.29](#).) The best days are Monday and Tuesday, followed by Thursday and Friday. This is the same bias that was found when this book was first written almost 20 years ago, so we know we have a consistent bias in the marketplace. Knowing that, let's drop Wednesdays and see if what, if any improvement, we get.

Figure 4.29 No Wednesday Trading



We see a good deal of improvement but look at 2008, a bear market year. The performance in 2008 took away all of the profits garnered earlier. That's not good! So let's think about this. Does a light bulb turn on? Why not take these trades only when in an up trend? Good idea, but how do we mechanically define an uptrend? One of my favorites is to say that if a 20-day moving average of closing prices is greater today than yesterday, the trend is up. The results of that test are presented in [Figure 4.30](#).

Figure 4.30 Up Trend and No Wednesday Trades



What we have done here is make certain the trades that we are going to take on a volatility expansion are only when the market is in an uptrend. And that certainly makes a difference. The trend is our friend and we can use it to our advantage.

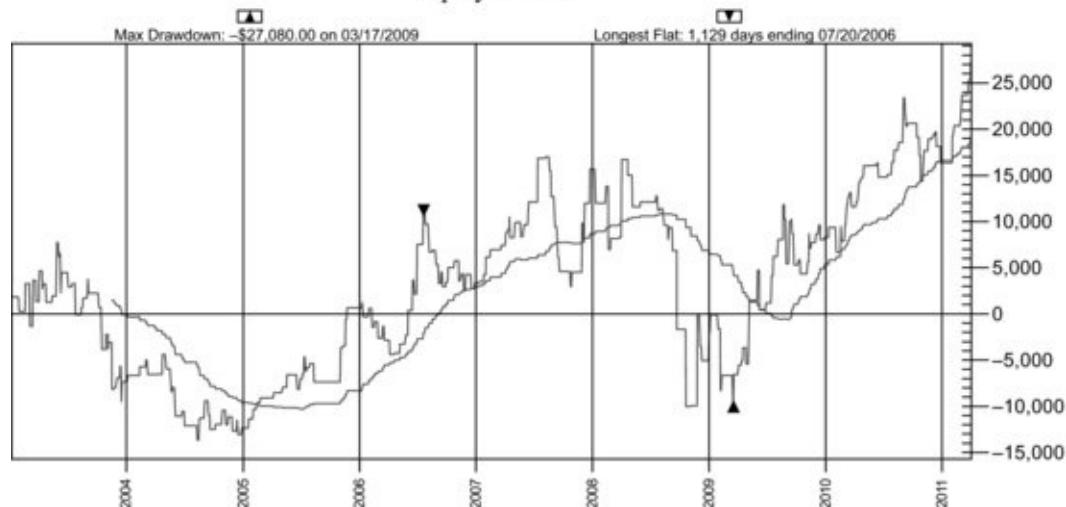
We have been looking at what happens when we have a down close day, now what about when we have an up close day? Let's take a look at those days next. The results are shown in [Figure 4.31](#).

Figure 4.31 Up Close and Close > Open Day, Buy at Low + 90 Percent of Average True Range of Past Three Days



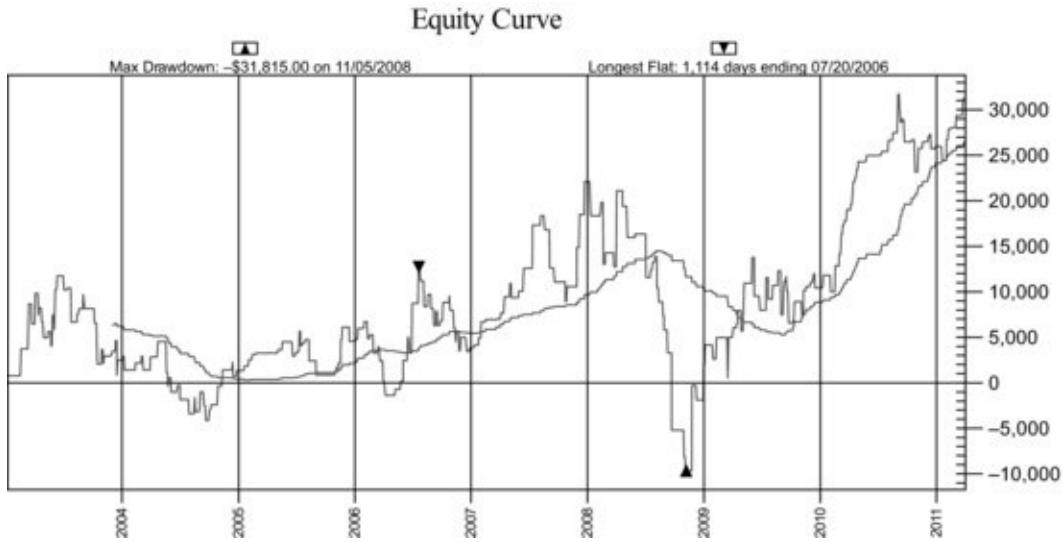
As [Figure 4.32](#) shows, on balance, this loses money despite having a hot streak in 2006 and 2008 as well as 2009 forward. Perhaps if we can escape the bear market this approach may have some value. The more you look at the equity line, the choppier and irrational it appears.

Figure 4.32 Buy at High + 40 Percent of Average True Range of Past Three Days



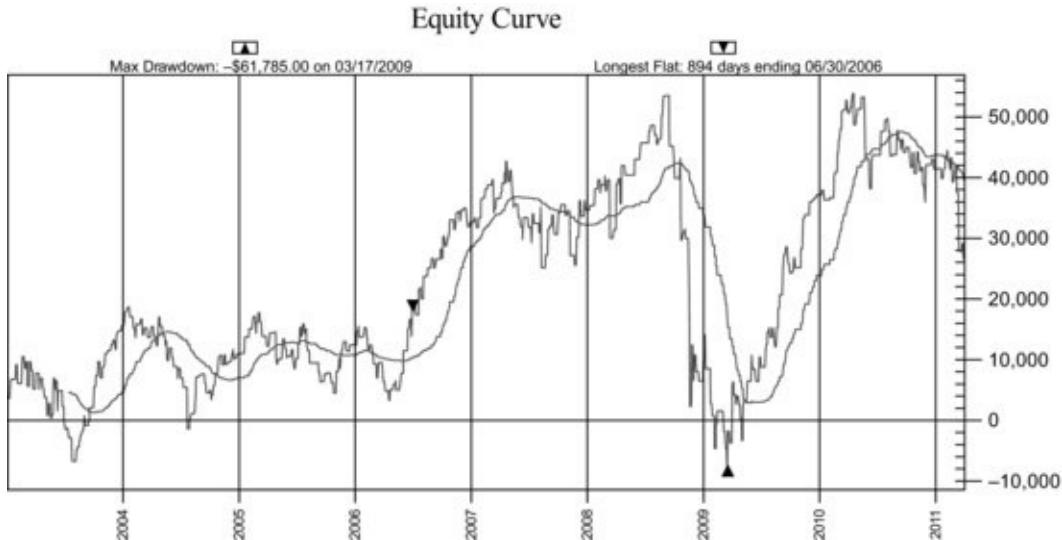
The equity curve in [Figure 4.33](#) is indeed, choppy and goes all over the place, but on balance it makes new highs. That is quite impressive as it shows consistency. Certainly there is room for work to be done on this approach.

Figure 4.33 Buy at Mid Price + 90 Percent of Average True Range of Past Three Days



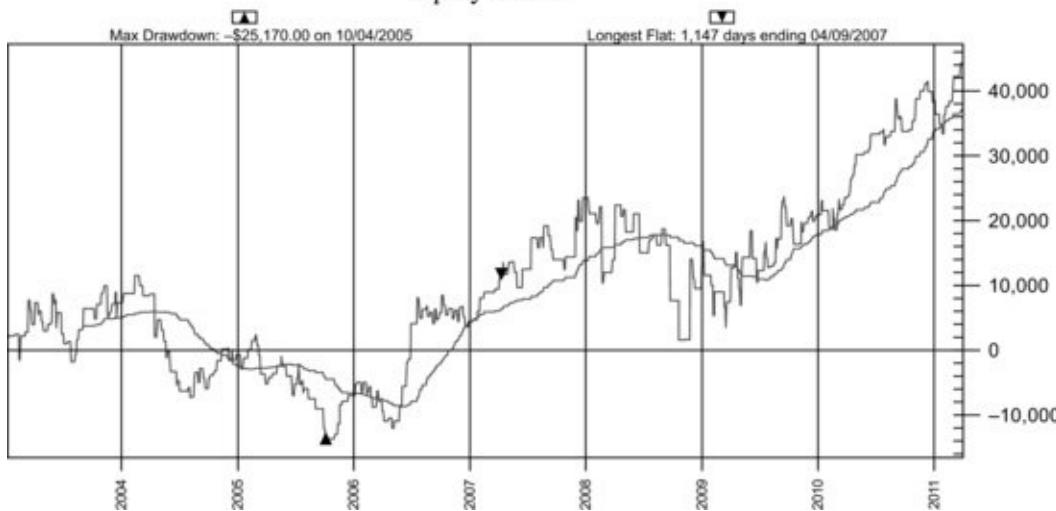
Again, we see in [Figure 4.34](#) that performance has been good, with the exception of the 2008–2009 bear market. There is room for improvement here, as we see overall consistency and new equity highs. We have some trading advantages and they are apparent in [Figure 4.34](#).

Figure 4.34 Buy at Next Bar Open + 20 Percent of Average True Range of Past Three Days



Using the next bar open as our reference point, we see that profits were made. If it were not for the losses of the 2008 debacle, we might have something. [Figure 4.35](#) shows what I don't like to see: the erratic performance up to 2006.

Figure 4.35 Buy at Close + 40 Percent of Average True Range of Past Three Days
Equity Curve

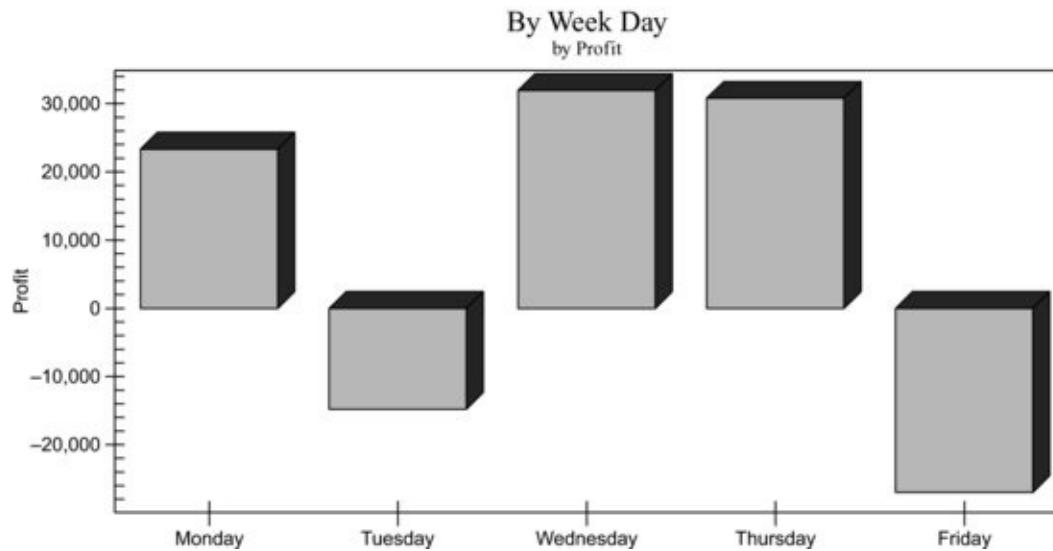


As I see it, that is clearly the best performing of all of the volatility breakouts if we await an up-close day. The performance was not that bad, even in the 2008 bear market, and has been quite consistent since then. We do have a problem with the earlier data in that this volatility breakout did not produce profits on a consistent basis until 2006.

What is a trader to do? We've already seen the power of making certain that we only take buy signals in an up-trend. There are two options for a trader in this situation. We could test all of the above volatility breakout buy signals in conjunction with the trend or simply take the ones we think look the best to see if a trend qualifier would help. Buying at the close plus 40 percent of the average range of the past three days is clearly the most consistent moneymaker of these approaches. So let's see what happens when you combine trend with this volatility breakout.

Of course, our first step would be to see if this volatility breakout works on some days better than others. What I discovered, as you can see in [Figure 4.36](#), is that signals taking place on Tuesdays and Fridays lose money. We have a choice here: We can take signals on those days in the hopes that some will be profitable, or sidestep them altogether. The latter would be my choice.

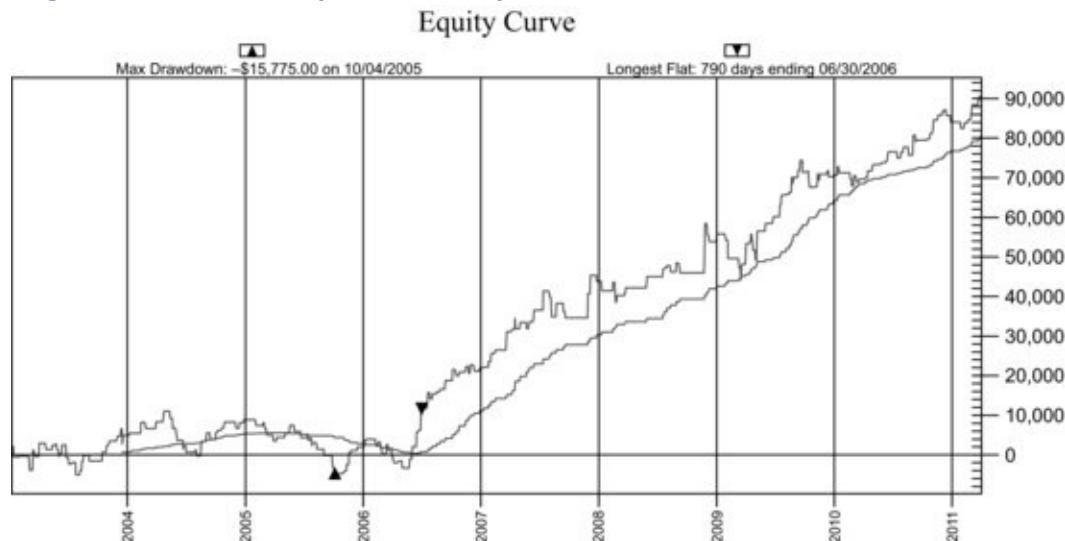
Figure 4.36 Tuesday and Fridays Don't Fare Well



If we do that, the equity curve suddenly starts to look much better. Not only is it more consistent, it makes more money. I would enjoy profits such as \$40,000 going to over \$90,000. That is a gargantuan gain from simply knowing that some days of the week are better to trade on than others. But what about the trend? Can we make this even better by adding trend to the equation?

The following results are arrived at with the same volatility expansion; the exception is that no trades are taken on Tuesdays or Fridays. As you can see in [Figure 4.37](#), the equity line advances sharply 2008 . . . despite the bear market. Buying at this volatility breakout, on the best days of the week was profitable, despite the bear market.

Figure 4.37 Tuesday and Friday Trades Deleted

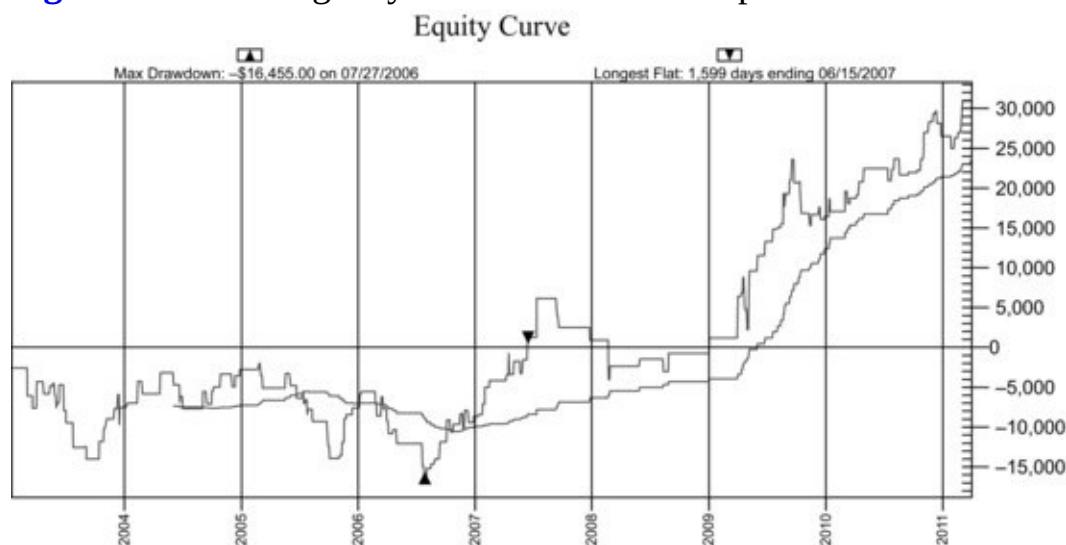


Figures 4.37 and 4.38 show what happens when we bring the same 20-day moving average trend qualifier into the equation as for the down close trades. The rules are the same; no trades are taken on Tuesdays or Fridays, and we are using the same

percentage of volatility breakout from close. What happens is that we don't make nearly as much money. In Figure 4.37 we see we made almost \$90,000, and in Figure 4.38 about \$30,000. The reason is that the trend factor eliminated many trades that were profitable. So it looks as though when the pattern is an up close we may not want to pay too much attention to trend. For down closes we clearly want to pay attention to trend. In short, down closes set up better rallies.

In any event, be it an up or down close day, [Figure 4.38](#) says we certainly want to pay attention to which trading day of the week it is.

Figure 4.38 Trading Days of the Week Are Important



There you have it . . . the beginning steps in creating a trading approach. We began with a good idea; volatility expansion or range breakout (notice how almost all of them did make money), but then used a little common sense and testing to learn how the markets work.

SEPARATING BUYERS FROM SELLERS TO FIND VOLATILITY USING MARKET SWINGS

A third way to measure potential volatility expansions comes from looking at price swings over the past several days. Mike Chalek deserves credit for this concept, which he developed into a system he designed and named "Talon." The basic idea is to look at the various swings price has taken from one point to the next over the past few years. There are many such points to study.

The ones I have chosen for this next glimpse into market activity, measure the amount of price movement from the high three days ago to today's low. That is Step

1. Step 2 is to take the swing distance from the high one day ago minus the low three days ago. Finally, we will use the largest of these values as our basic volatility measurement to begin the process of designing a filter or price cushion to add to tomorrow's opening for buying or subtract for selling.

The system does okay; it makes money as the following results on the S&P 500 from 1982 to 1998 demonstrate (see [Figure 4.39](#)). The rules are to buy at 80 percent of the swing value above the opening and sell at 120 percent of the swing value below the opening. Use a dollar stop of \$1,750 and my bailout exit. This makes \$122,837 from 1982 to 1998 with an average profit per trade of \$228.

Figure 4.39 Using Market Swings

| Data | : | S&P 500 IND-9967 | 01/80 |
|-------------------------------------------------------------------------------|--------------|-------------------------|------------------------|
| Calc Dates | : | 07/02/82 - 08/25/98 | |
| <hr/> | | | |
| Num. | Conv. | P. Value | Comm |
| 149 | 2 | \$ 2,500 | \$ 0 |
| <hr/> | | | |
| Slippage | Margin | Format | Drive:\Path\FileName |
| \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| <hr/> | | | |
| ////////////////////////////// ALL TRADES - Test 4 ////////////////////////// | | | |
| Total net profit | \$122,837.50 | Gross loss | \$-142,100.00 |
| Gross profit | \$264,937.50 | | |
| Total # of trades | 538 | Percent profitable | 84% |
| Number winning trades | 454 | Number losing trades | 84 |
| Largest winning trade | \$10,675.00 | Largest losing trade | \$-8,150.00 |
| Average winning trade | \$583.56 | Average losing trade | \$-1,691.67 |
| Ratio avg win/avg loss | 0.34 | Avg trade (win & loss) | \$228.32 |
| Max consecutive winners | 83 | Max consecutive losers | 5 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |
| Max closed-out drawdown | \$-13,025.00 | Max intraday drawdown | \$-13,112.50 |
| Profit factor | 1.86 | Max # of contracts held | 1 |
| Account size required | \$16,112.50 | Return on account | 762% |

RESULTS

As always though, the question becomes, can we do better? Our last attempt at doing better was to use TDW as our filter to substantially improve performance. We will now go beyond this and bring in a fundamental consideration—the impact of bond prices on stock prices.

We will now try this concept as a filter ([Figure 4.40](#)). The rule is quite simple, we will only take buy signals if the closing price of bonds is greater today than five days ago, and only take sells if bonds are lower than 35 days ago. Our reasoning is well founded in the somewhat common knowledge that higher bond prices are bullish for stocks, and lower bond prices bearish.

Figure 4.40 Impact of Bond Prices on Stock Prices

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----------|--------------|------|-------------------------|--------|------------------------|----------------------|
| 149 | 2 | \$ 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT | |
| ////////////////// ALL TRADES - Test 7 ////////////////////// | | | | | | | | |
| Total net profit | | | \$82,987.50 | | | | | |
| Gross profit | | | \$148,350.00 | | Gross loss | | | \$-65,362.50 |
| Total # of trades | | | 295 | | Percent profitable | | | 87% |
| Number winning trades | | | 258 | | Number losing trades | | | 37 |
| Largest winning trade | | | \$10,675.00 | | Largest losing trade | | | \$-2,075.00 |
| Average winning trade | | | \$575.00 | | Average losing trade | | | \$-1,766.55 |
| Ratio avg win/avg loss | | | 0.32 | | Avg trade (win & loss) | | | \$281.31 |
| Max consecutive winners | | | 59 | | Max consecutive losers | | | 3 |
| Avg # bars in winners | | | 1 | | Avg # bars in losers | | | 3 |
| Max closed-out drawdown | | | \$-5,250.00 | | Max intraday drawdown | | | \$-5,250.00 |
| Profit factor | | | 2.26 | | Max # of contracts held | | | 1 |
| Account size required | | | \$8,250.00 | | Return on account | | | 1,005% |

What a difference this makes! Our average profit per trade goes from \$228 to \$281, while our drawdown plummets from \$13,025 to only \$5,250. Best of all though is that in the original “nonfiltered” trades we had a largest losing trade of \$8,150, whereas with the bond filter the largest loss was only \$2,075!

ONE STEP FURTHER

Your education is nearing completion it you are wondering what happens in this model if we take signals only on the best TDWs while the trend of the bond market is giving us bullish or bearish confirmation!

Again, the results speak for themselves: By combining all these ingredients we increase our chances or odds for short-term trading success. Notice the number of trades is substantially reduced, this means our exposure is less, but our average profit per trade increases. Our profits decline to “only” \$76,400 but the average profit per trade jumps to \$444, drawdown stays about the same at \$5,912, but the percent of winning trades goes to 90 percent.

What we have done here is filter out trades that are not backed by all three of our conditions. Filtered trading for short-term swings will put you a light-year or two ahead of all the other short-term traders. There is an extra advantage here; by using filters you are placing demands on the market, demands that mean you will not trade every day, demands that naturally force you to trade less, not more. Active traders are usually losing traders. Those of us who pick and choose our spots to speculate are more inclined to come out winners as we have tipped the scales in our favor, which is what intelligent speculation is all about.

RECAP

What I hope you learned in this chapter is that there are various ways of taking apart each day's trading activity to determine buyers and sellers and how they impact the volatility of a market.

In addition, I hope you see how we can use the volatility in the market for our entry points.

CHAPTER 5

The Theory of Short-Term Trading

In the short term, theories work, but in the long term, reality prevails.

While nothing has changed since this chapter was written, it must not be skipped. The truths of this chapter will keep you financially and emotionally on top. You see, the way markets trade is ever changing, but the rules for correct trading remain the same. We need to master both.

I have trained thousands of traders . . . most have become successful, some wildly so, and what we all have in common is that we follow the lesson of this chapter. When we deviate, when we snooze . . . we lose.

Now that you have an understanding of how markets move from point to point and the basic strategy of how to best take advantage of these swings, it is time to examine the theory of what we are doing so I can then take you back to practical application.

Our basic concept or working theory is that something causes explosive market moves. These explosions put the market into a trend phase, and these trends, for our purpose, last from one to five days in most markets. Our object is to get aboard as close to the start of this explosion as possible.

Which gives rise to the questions, “What causes these explosions in market activity, when are they most apt to occur, and is there anything here we can use to pin down the time and place of these moves?”

Succinctly stated, these are the problems I have dealt with most of my life. Long ago, I recognized that if I could not identify a problem, there was no way on earth I could find its solution. You now know the problems, so let's look for some solutions. Let me hastily add that I do not have all the answers to this gigantic puzzle. There is nothing like losing to bring you to your senses, to teach you that you are not so damned smart, that you need more education. I still have losses, plenty of them, so I, too, still need more education. And always will.

The biggest cause of these moves is probably news. But we have trouble trading on news because, first, the news can change as quickly and as unpredictably as the weather. News, or changes in world events and marketplaces, can be random; thus, the markets wobble around from one unknown news event to the next. The drunken sailor analogy mathematicians have used is most likely due to news knocking prices

back and forth. Second, we may be the last person on the food chain getting such news, so we receive it too late. Third, there is nothing we can look at or observe that tells us what specific future news might be. Fourth, my years of trading strongly suggest that those who are close to the news usually position themselves prior to the announcement. (Note: There is not one group taking advantage of news; the group varies from source to source.) Bankers might have inside news about the T-bond market, but not on cattle futures, whereas feedlot operators might have that data, but nothing on bonds. There is no Illuminati controlling all news sources. While Mel Gibson's character Jerry Phillips was right on in the movie *Conspiracy Theory*, that theory does not extend to the markets. For those who are not fans of Mel's work, just think of Matt Damon or Tom Cruise in their conspiracy laced flicks.

At the time I was writing the first edition of this book, a book that discussed some of my archeological exploits, *The Gold of Exodus* by Howard Blum (Simon & Schuster, 1999), was reviewed in several magazines and newspapers. In one of the reviews, the location of my home is stated incorrectly, as is my occupation, my age, the type of car I drive, and my description of what the book is all about! In short, if I can't believe what I read about myself in the writings of a reporter who personally interviewed me, I suggest you probably can't trust much of what is written about Orange Juice, Oats, and Oil.

The supposedly prestigious *Wall Street Journal* is no exception. In early 1998, they told readers that their source inside the Federal Reserve System was certain that the Fed Open Market Committee was about to raise interest rates. Six weeks later when the Fed released their notes on the meeting, we learned the truth: They had voted 11 to 1 to *not* raise rates! On at least two occasions, *Wall Street Journal* reporters were found to be touting stocks they, themselves, had already acquired a position in. Television is not exempt from this same problem: CNBC's lead "inside source," Dan Dorffman, is no longer on the air for the same allegation of misleading viewers. A few years ago, even Ralph Nader's mother was charged by the Securities and Exchange Commission with selling short stocks in General Motors and a tire company just before her son attacked them with his consumer complaint lawsuits.

So what else can we look at if we can't really examine news?

"Price action! Charts!" scream technicians and most short-term swing players. The nice thing about price action, as reflected on charts, is that there are plenty of things to look at and analyze, the most common three aspects being (1) price patterns, (2) indicators based on price action, and (3) the trend or momentum of price. Not so common, and the fourth one of my big tools, is the relationship one market may have on another. Remember the S&P 500 system and how much better it was when we required that bonds be in an uptrend as a setup to a trade? That is an example of market relationships that I discuss in detail a little later on.

Our final and fifth set of data comes from following the crowd most often found to be wrong, in comparison to the crowd most often found to be right. On a short-term basis, the great unwashed public trader is a net loser. Always has been, always will be. The figures I have heard bandied about over the years are that 80 percent of the public lose all their money, be they stock or commodity traders. Thus coppering their wagers should lead us to those short-term explosions and profits. There are various ways to measure the public; these are called *sentiment indicators*. I believe in this so much that I have developed my own sentiment indicators available through Genesis Financial Data. I first wrote about them in Rick Bensignor's 2000 book, *New Thinking in Technical Analysis: Trading Models from the Masters* (Bloomberg Press).

What we do is measure each week how many advisors, web sites, etc., are bullish or bearish on a market. This has been one of the most powerful set-up tools I have ever used. Don't take my word for it; look at [Figures 5.1](#), [5.2](#), and [5.3](#). The first charts show weekly price action and my LW Sentiment Index. It is easy to read; when the index is low, advisors are very bearish—since they are usually wrong, I expect rallies. When the index is high they are very bullish, so I expect they will be wrong and prices will decline.

[**Figure 5.1**](#) Chart of Sentiment Index



[**Figure 5.2**](#) Chart of Sentiment Index



Figure 5.3 Chart of Sentiment Index



Smart money (those most often found to be right) are best represented by the Commercials (the large producers and users of commodities) and tracked each week in the CFTC's Commitment of Traders (COT) report. I have written extensively about this since 1970, including the first book ever published on the subject, *Trading with the Insiders* (John Wiley & Sons, 2006). The problem for the short-term trader is that the impact of the COT report is not specific to one or two days; its forecasting power is of a longer-term nature.

Well, there you have it, the five major elements I have found that can help with ferreting out short-term explosions. We will overlay these “tools” or events on market structure to enable us to hop aboard up and down moves. Since all these tools can be quantified, the logical procedure is to convert these observations and tools into mathematical models. The next leap of logic that traders make is that since math is always perfect (two plus two always equals four), there must be a perfect solution to trading, and mathematics can provide that answer.

Nothing could be further from the truth. There is not a 100 percent correct mechanical approach to trading. There are tools and techniques that, based on observation, usually work, but the reason we lose money is that we either reached an incorrect conclusion or did not have enough data to make a correct one. So math is not the answer, and mechanics is not the answer. The truth of the market comes from ample observations, a dose of correct logic, and correct conclusions from the data at hand.

I am telling you this right up front so that you do not get lulled into the idea that speculation is a game of blindly following the leader, a system, or absolute approach. If any one thing is certain about the markets it is that things change. In the early 1960s, an increase in money supply figures was considered very bullish and always put stock prices higher. For whatever reason, in the late 1970s and early 1980s, an increase in money supply figures, as released from that largest of all privately held corporations, the Federal Reserve, put stock prices down. In the 1990

time period money supply is barely looked at or felt in the marketplace. What was once sacred became apparently meaningless.

One of the markets I trade the most heavily in, bonds, traded in a totally different way after 1988 than prior to that date. Why? Prior to October of that year there was only one trading session, then we went into night sessions and eventually almost a 24-hour market. That changed trading patterns. What is more confusing to researchers is that “in the old days” the Fed released reports on Thursday that had huge impact on Friday’s Bond prices. This effect was so great a popular novel used it as the central theme of a Wall Street swindle. As I wrote this, in 1998, there were no Thursday reports, hence Fridays looked and traded differently.

If you are to do me any favor as a reader of my work, you will not only learn my basic tools but also learn to stay awake and current to what is happening. Great traders, which I hope you become, are smart enough to note and respond to changes. They do not lock themselves into a “black box,” an unchangeable trading approach.

One of the truly great traders from 1960 to 1983 was a former professional baseball player, Frankie Joe. Frankie had a great wit and a deep understanding of his approach to trading. He was quite a guy, sharp as a tack and a delight to talk with. After we had developed a three-year friendship, he revealed to me his technique: to sell rallies and buy back on dips in the stock market. That is all there is to it, no more, no less. This was a great technique during that time period, and it amassed a fortune for Frankie.

Then along came the most predictable, yet unpredictable, bull market of all time, triggered by Ronald Reagan’s tax and budgetary cuts. It was quite predictable that the bull market would come about. What no one realized was that there would be no pullbacks along the way, as we had seen during the previous 18 years. Not even one of the greatest traders of all time, Frankie Joe. He kept selling rallies and was never able to cover on dips; there just weren’t any. Eventually, he became so frustrated with losses and the lack of success (like all great traders, he was also compulsive about winning), that he apparently committed suicide.

What works, works in this business, but often not for long, which is why I so admire ballerinas: They stay on their toes.

WHAT IS WRONG ABOUT THE INFORMATION AGE

Fundamental principles do not change—that is why they are called fundamentals. “Do unto others as you would have others do unto you” was good advice 2,000 years ago and will be good advice 2,000 years from now. The principles I’m laying

out in this book are enduring; I have lived with them for close to 40 years and have literally made millions of dollars trading.

Yet, were I to fall into a coma today and wake up 10 years from now, I might not use the exact same rules with these fundamental principles. Whereas fundamentals are permanent, the application and specifics do change and will vary. [In updating this sentence, I realize how prescient that comment was! Fourteen years later, I would not be caught dead trading markets now that I traded at that time. The markets, like life, are full of change.]

Technology has become king, speeding up every facet of life. We can now learn about anything faster, communicate faster, and find out about price changes faster. Indeed, we can buy and sell faster; get rich quicker; go broke faster; and lie, cheat, and steal at unbelievable speeds. We can even get sick or healed faster than ever before in the history of the world!

Traders have never had so much information and so much ability to process this information, thanks to computers and to Bill and Ralph Cruz, who invented the first and best workable software, System Writer, which evolved into Trade Station. Thanks to these products from Omega Research, average Joes like you and me can now test market ideas. For more than 10 years now, thanks to Bill's foresight, it has been possible to ask just about any question to find the "truth of the markets."

But guess what? This technical revolution in the age of information has brought no concomitant breakthrough to the world of speculation. We still have the same numbers of winners and losers. Guys and gals with state-of-the-art computers still get blown out on a regular basis. The difference between winners and losers is largely based on one simple turn of events, winners are willing to work, to notice changes, and to react. Losers want it all without effort; they fall for the pitch of a perfect system and an unchanging guru or indicator they are willing to follow blindly. Losers don't listen to others or to the market: They are unyielding in their minds and trades.

On top of that, they consistently fail to abide by the fundamental of successful business, which is to never plunge, to manage your money as well as your business by getting rid of bad deals and keeping the good ones. Me? I will stick to the fundamentals, as taught, with a healthy willingness to adapt to change. When I stay flexible, I do not get bent out of shape.

E. H. HARRIMAN'S RULE OF MAKING MILLIONS

The Harriman family fortune, which endures to this day, was created in the early

1900s by “Old Man Harriman,” who had started his career as a floor runner and went on to become a major banking and brokerage power. He made a \$15 million profit in 1905 from one play in Union Pacific. This speculator king focused on just railroad stocks, the hot issue of his era.

In 1912, an interviewer asked Harriman about his stock market skills and secrets. The trader replied, “If you want to know the secret of making money in the stock market, it is this: Kill your losses. Never let a stock run against you more than three-quarters of a point, but if it goes your way, let it run. Move your stops up behind it so that it will have room to fluctuate and move higher.”

Harriman learned his cardinal rule from studying trading accounts of customers at a brokerage firm. What he discovered was that of the thousands upon thousands of trades in the public accounts, 5- and 10-point losses outnumbered 5- and 10-point gains. He said, “by fifty to one!” It has always amazed me that businesspeople who have tight control and accounting practices in their stores and offices lose all control when it comes to trading. I cannot think of a higher authority than E. H. Harriman, nor a more enduring rule of speculation than what this man gave us in 1912.

Loss control is still what separates winners from losers. Think of it as a game of Russian roulette: It takes only one unlucky spin of the chambers to come up with the bullet that kills you. In trading it takes only one trade that gets away from you to wipe out your bank account. Just one.

RECAP

The truths of trading 100 years ago are the same as today. Like I said, fundamentals don't change. Never have and never will, hence this is the reality you need to learn to deal with.

CHAPTER 6

Getting Closer to the Truth

Beginning proof that the market is not random and presenting our first “key” to market explosions.

Losers of any game typically lament that either the game was rigged or that no one can beat it; thus, their failure is excusable. Well, the game of the market has been beaten by many people for many years. I have read the laments of the academicians such as Paul Cootner in his classic *The Random Character of Stock Market Prices* (MIT Press, 1964), with its morose verdict that prices cannot be predicted—that past price activity has no bearing on what will happen tomorrow, or next week for that matter. This is true, he and a host of other apparently nontrading authors suggest, because the market is efficient. All that is to be known is known and thus is already reflected in current prices. Therefore, today's price change can be caused only by new information (news) coming to the marketplace.

Tell this to legendary Steve Cohen, who has dominated the markets like no one ever before in the history of the world, with an annual gain of 30 percent per year for about 25 years now, after taking out his 50 percent of profits management fees. In hopes that you too can create fortunes like Steve, I added comments to this chapter where I felt change was needed and further research has given us more market insights.

The bottom line for these authors is that returns from one day to the next are independent, and thus price is impacted by random variables, which accounts for the notion that prices move totally by random, thus defy prediction. Believing in this random walk means acknowledging that the market is efficient, that all is known. Obviously, you do not accept this concept; you spent hard-earned money on this book thinking that perhaps I know, and can teach you, something most other traders or investors do not know.

You are right! Cootner and his crowd apparently tested for dependence on future action of price in a one-dimensional approach. I suspect they may have tested future price change based on some sort of moving averages. Thus, while looking for the right direction, they used the wrong tools.

If there is no dependency on price action, over a long time period, 50 percent of the days a market should close higher and 50 percent of the time lower. It is

supposed to be like flipping a coin—the coin has no memory. Each new toss is not biased by what went on in the past. If I were to flip a coin on Tuesdays, I would get the same 50/50 chance of heads or tails as I would by flipping a coin on any other day of the week.

THE MARKET IS NOT A COIN FLIP: RANDOM WALK OR COOTNER VERSUS COHEN (COHEN WINS)

If the Cootner random walk theory is correct that market activity is random, then a test of day-to-day price change should be easy to establish. We can start with a very simple question: “If market activity is random, should not the daily trading range, each day's high minus the close, be just about the same regardless of which day of the week it is?”

Also one should ask, “If all price action is random, would you not expect the daily change, regardless of being up or down, just the absolute value of daily changes, to be about the same for each day of the week?”

And finally, “If price is random, is it not true that no one day of the week could or would show a strong bias up or down?” If the market has no memory, it surely should not matter which day you flip the coin or take your trades. The truth is it *does* matter, *a great deal*.

Instead of listening to the theorists, I went to the market to see what it had to say. I asked the preceding questions and many others to see whether there is dependency from one day to the next or one pattern or past certain price action that consistently influences tomorrow's price past the critical random walk point. The answer was clear: The market does not reflect Cootner's claim. [Tables 6.1](#) and [6.2](#) prove my point. I have sampled two of the biggest, and thus most efficient, markets: the S&P 500, a measure of 500 stocks, and U.S. Treasury Bonds.

Table 6.1 S&P 500 1982–1998

| | High-to-Low | Low-to-High |
|-----------|-------------|-------------|
| Monday | 4.22 | .631 |
| Tuesday | 4.30 | .130 |
| Wednesday | 4.29 | .221 |
| Thursday | 4.19 | -.044 |
| Friday | 4.45 | -.1164 |

Table 6.2 Treasury Bonds 1988–1998

| | High-to-Low | Close-to-Open |
|-----------|--------------------|----------------------|
| Monday | .708 | -.001 |
| Tuesday | .781 | .064 |
| Wednesday | .767 | .010 |
| Thursday | .823 | -.017 |
| Friday | 1.05 | .022 |

You have read my comments based on research done in 1998 in an effort to dispel the radical notion that Cootner gained so much popularity advancing; that markets are a flip of the coin. As you read what I wrote then and what my studies showed, you will note I have interspersed the same tests from 1998 forward. Facts speak louder than anything I might say or add. My conclusion remains the same: While the markets are chock-full of randomness, there is order and bias that we can find and use in our trading.

Let's take a look at what time has proved to be true.

My first question was: Is there a difference in the size of the range for different days of the week? Next, Does the distance change from the open to the close depend on the day of the week? And finally, I looked at the net price change each day. In Cootner's world, all these questions should produce a homogeneous response; there should be no or little variance.

For the S&P 500 Tuesdays and Fridays consistently had daily ranges larger than any other time period. For the Bond market, Thursdays and Fridays had the largest daily ranges. Could it be that not all days are created equal?

You bet, or had better bet, because the second column for each market shows that the absolute value of the price swing from the open to the close also varies widely. In the S&P 500 the largest open to close change takes place on Mondays at an average of .631, while the smallest takes place on Thursdays with -.044.

In the Bond market the difference is even larger: Tuesdays saw the largest open to close change, .645, and the smallest on Mondays, with -.001!

Finally, check out the last column to see that in both sets of data for the S&P 500 Fridays have a negative value, and in Bonds Monday and Thursday show negative changes for these days. Cootner would say this is impossible, that in an efficient market one day should not be predisposed to rally or decline more than any other. The market tells us otherwise: Some days of the week are in fact better for buying or selling than others!

I want to drive this point home: Cootner and his crowd apparently did not test for day-of-the-week dependency. I conducted a study where we asked the computer to buy on the opening each day and exit on the close. I ran this test on all the grain markets. While not a trading system on its own, the data opens a door and gives an

advantage to those who read this book over those who put this book back on the shelves. The data makes clear:

All the grain markets have a pronounced pattern of rallying more on Wednesdays than any other day of the week.

This has held up far better than even I expected. In the ensuing years Soybeans have sparkled on Wednesdays, as you can see in [Table 6.3](#).

Table 6.3 Soybeans Day of the Week Test

| Day of Week | # Trades | \$ Profits | Average \$ per Trade |
|-------------|----------|------------|----------------------|
| Monday | 522 | 24,238 | 46 |
| Tuesday | 506 | 39,138 | 77 |
| Wednesday | 558 | 65,075 | 117 |
| Thursday | 551 | 7,925 | 14 |
| Friday | 512 | 30,875 | 60 |

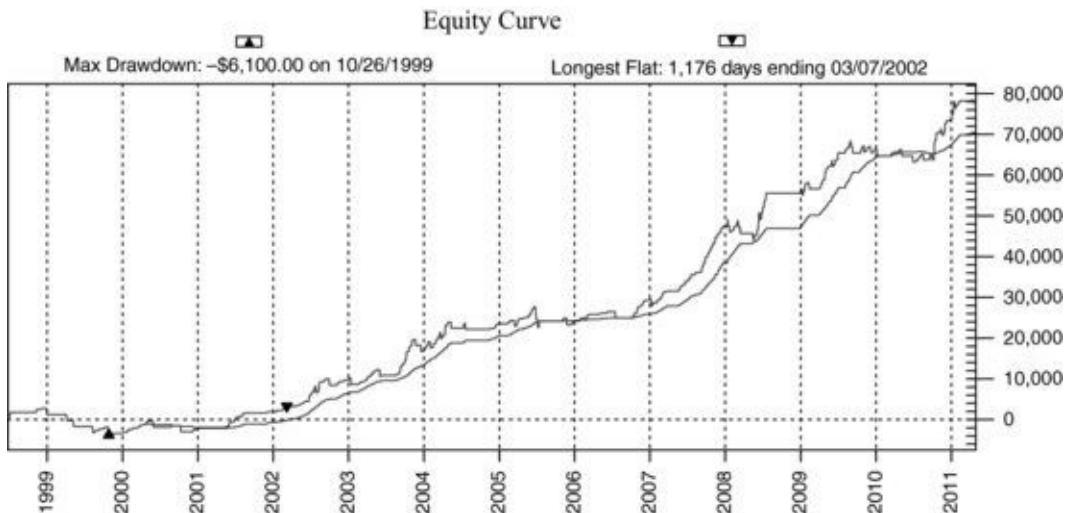
Applying the same test to Wheat ([Table 6.4](#)), I see it has also performed well and that Wednesdays are still the day for short-term traders to expect a bullish market bias.

Table 6.4 Wheat Day of the Week Test

| Day of Week | # Trades | \$ Profits | Average \$ per Trade |
|-------------|----------|------------|----------------------|
| Monday | 473 | 16,225 | 34 |
| Tuesday | 449 | 19,375 | 43 |
| Wednesday | 465 | 41,800 | 90 |
| Thursday | 465 | 20,675 | 44 |
| Friday | 447 | 23,875 | 52 |

Given numbers like these it is very easy to create a trading strategy for Soybeans. Let's buy on Wednesdays if we are in an up trend (close today > close 30 days ago). The exit, as in all the earlier tests, is a \$1,600 stop or first profitable opening. The results can be seen in [Figure 6.1](#).

Figure 6.1 Soybean Strategy Results



Go ahead, check it out, what happened to that random walk? Sure looks like it gets stuck on Wednesdays in the grains. What is evident here is an advantage to the game. Granted, it is small, but casinos profit with an advantage of usually 1.5 percent to 4 percent in most of their games of random chance. It is that tiny percentage, played often enough, that builds all those hotels and subsidizes the buffet lines.

Although the grains, especially Soybeans, offer some short-term trading opportunities (this was written at the turn of the twenty-first century) and there are more explosive short-term markets to focus on: the S&P, T-Bonds, the British Pound, and Gold. The first two are the best for us short-termers and short-timers.

[Table 6.5](#) shows the impact that the day of the week has on price changes in these markets. Again, traditionalists would argue there should be little if any differences assuming price change is random. What we find is that the trading day of the week (TDW) does indeed produce a bias of future price activity, a bias we can turn into profitable trading.

Table 6.5 Day-to-Day Change in Price

| | Gold | British Pound | Bonds | S&P 500 |
|-----------|------|---------------|-------|---------|
| Monday | 50% | +\$ 7 | 53% | +\$13 |
| Tuesday | 48 | -2 | 54 | 15 |
| Wednesday | 49 | -3 | 49 | 0 |
| Thursday | 51 | 0 | 49 | -21 |
| Friday | 49 | -13 | 54 | 53 |

One of my favorite short-term trading advantages is trading day of the week. My focus here is the price change from the opening of the day to the close, as opposed to just close to close. The reason should be clear to you: The day for a short-term trader begins on the open and, at least for a day trader, ends on the close.

[Table 6.6](#) shows the results of such a study where the Bonds or S&P 500 were purchased on the open and exited on the close each TDW. Random walk theorists

should be gasping their last breath about now. Here's a thumbnail sketch: The British Pound rallies off the open 55 percent of the time on Wednesdays and "makes" \$18 per trade. "Makes" is in quotation marks because, after commissions and slippage are taken into consideration, not much is left, but the pattern sheds light on a market bias that we can develop into tradable material.

Table 6.6 Open-to-Close Change in Price by Day

| | Gold | British Pound | Bonds | S&P 500 |
|-----------|------|---------------|-------|---------|
| Monday | 53% | +\$8 | 54% | +\$10 |
| Tuesday | 52 | -3 | 58 | -12 |
| Wednesday | 53 | +4 | 55 | +18 |
| Thursday | 52 | +1 | 55 | +11 |
| Friday | 53 | -9 | 56 | +13 |

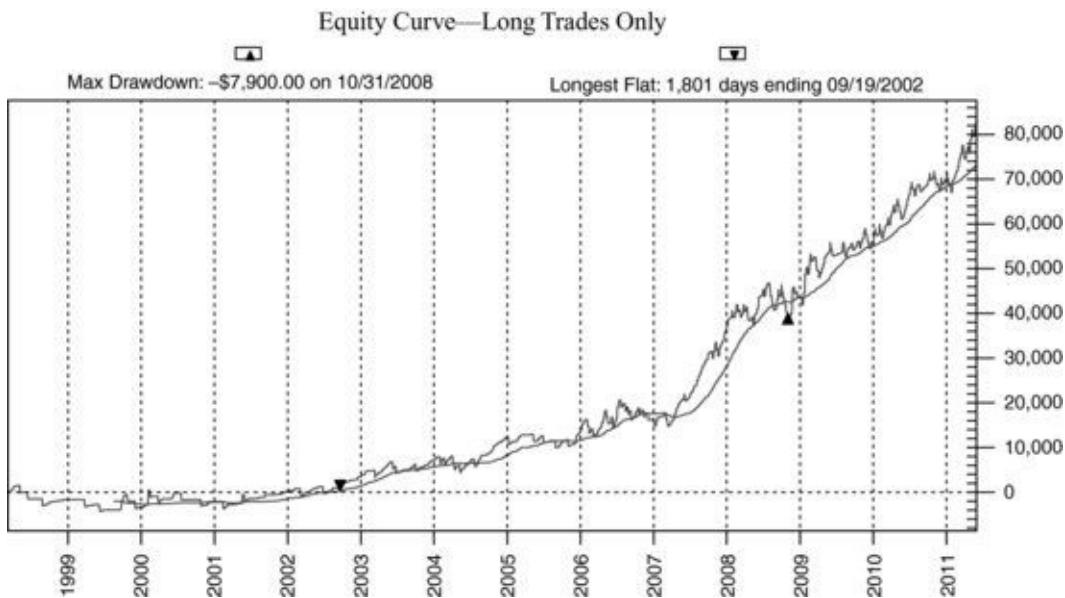
Gold has rallied 52 percent of the time off Tuesday's opening making -\$3, while things are not much better with Tuesday buys on the Bond market: 47 percent winners and an average of -\$35 per trade. The biggest display of this bias comes from the S&P 500 ([Figure 6.2](#)). This is where I first discovered the bias and I have continued to trade it since 1984. On Mondays, this kingpin of volatility has closed above the opening 57 percent of the time with an average profit of \$109! Bond traders should note that the open to close change on Mondays has been positive 55 percent of the time, with an average gain of \$53.

Figure 6.2 Trading on Bias

| | | | |
|----------------------------------------------------------------------|-------------|-------------------------|------------------------|
| Data | : | S&P 500 IND-9967 | 01/80 |
| Calc Dates | : | 07/02/82 - 08/25/98 | |
| <hr/> | | | |
| Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName | | | |
| ----- | | | |
| 149 | 2 | \$ 2,500 | \$ 0 |
| | | \$ 0 | \$ 3,000 |
| | | CT/PC | C:\GD\BACK67MS\F59.DAT |
| <hr/> | | | |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | |
| Total net profit | | \$76,400.00 | |
| Gross profit | | \$104,787.50 | Gross loss |
| | | | \$-28,387.50 |
| Total # of trades | 172 | Percent profitable | 90% |
| Number winning trades | 156 | Number losing trades | 16 |
| Largest winning trade | \$10,675.00 | Largest losing trade | \$-2,075.00 |
| Average winning trade | \$671.71 | Average losing trade | \$-1,774.22 |
| Ratio avg win/avg loss | 0.37 | Avg trade (win & loss) | \$444.19 |
| Max consecutive winners | 34 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 4 |
| Max closed-out drawdown | \$-5,912.50 | Max intraday drawdown | \$-5,912.50 |
| Profit factor | 3.69 | Max # of contracts held | 1 |
| Account size required | \$8,912.50 | Return on account | 857% |

Friday was the best day to buy gold on the tests run up to 1998. A quick test using the same stop and exits as for the grains again showed Friday to have a bullish bias, and a strong one, at that, as seen in [Figure 6.3](#).

Figure 6.3 Friday Bullishness



I am certain there is much you could do here to make a successful trading strategy for gold late in the week.

In case you are wondering about the close-to-close relationship, it is shown in and again the bias or advantage to the game becomes apparent. Study them for yourself.

[Table 6.7](#) shows the results of buying on the opening and exiting three days later. Any remaining random walk enthusiasts will tell you we should not be able to find any differences between days of the week over a three-day period. An efficient market should wipe that out. Yet when we look at just the best performing day of each week, based on the open-to-close change, we see a large bias and taste the sweetness of knowing markets are not totally random. The only random market was Gold; the rest of the markets I studied beat the random walk. Bonds and the S&P 500 led the way showing some decent profits.

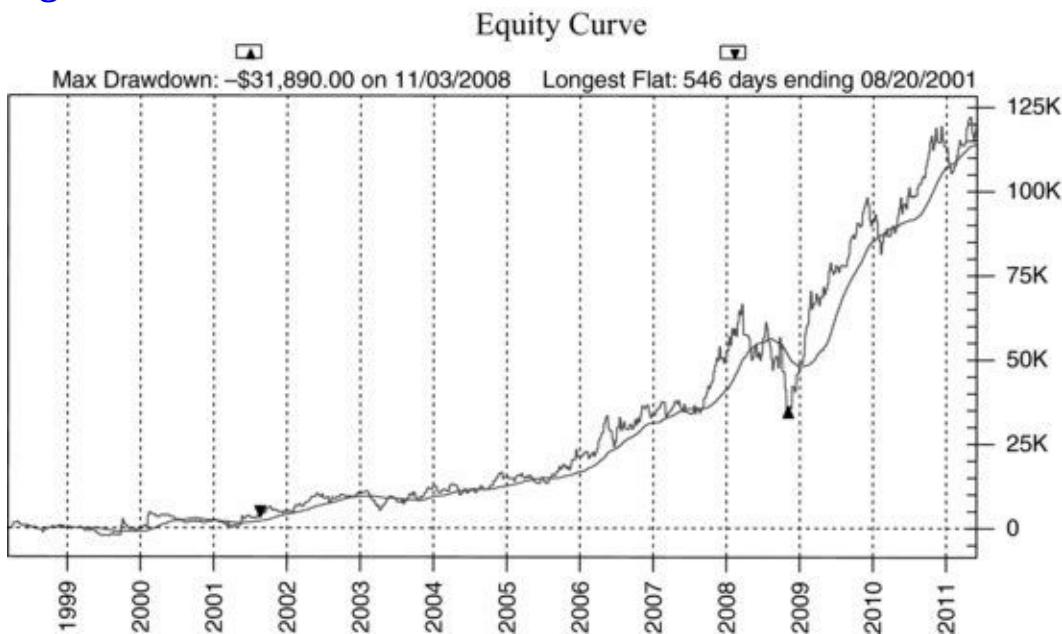
Table 6.7 Best TDW with a Three-Day Hold

| Commodity | Day | Percentage Up | Average Profit |
|-----------------------|---------|---------------|----------------|
| Gold | Tuesday | 50 | \$0 |
| Pound | Friday | 54 | 36 |
| Bonds | Tuesday | 52 | 86 |
| Standard & Poor's 500 | Monday | 57 | 212 |

TDW does make a difference and can give us a workable bias to trade with. There are numerous ways to begin milking this cow, and you probably have already thought of some on your own. Certainly, it is a bias you want to understand, and consider, for any market you are going to trade on a short-term basis.

Gold was true to form with \$119,650 of profits after this was written, using no stop and exiting three days later. [Figure 6.4](#) shows the equity chart.

Figure 6.4 TDW for Gold



Earlier, I said the open is critical; if we start to expand or move away from the opening, price will probably continue in that direction. Now I will demonstrate one such approach. We will combine our TDW bias with one simple rule: Buy on the opening of the bias day plus X percent of the previous day's range. We target our bias day, and buy that day at an expansion off the opening price. Our exit is simple; we hold the trade to the close and take our profits/losses at that time. (There are better exit techniques, which I will get to later.)

The S&P 500 results of buying the opening Monday plus .05 percent of Friday's range are pretty spectacular for trading just one day a week (see [Figure 6.5](#))! This approach shows a net profit of \$95,150 with 435 winning trades out of a total 758. Thus the average profit per trade is \$125 with 57 percent accuracy. Bonds make money buying on Tuesday opening plus 70 percent of Monday's range with \$28,812 profits and 53 percent accuracy netting \$86 a trade which is a little small, but a better exit technique will radically change this number (see [Figure 6.6](#)). The long and short of all this data is that a simple filter, TDW, enables us to do what the professors say is impossible ... beat the market.

Figure 6.5 Buying on the Opening: Monday

Data : S&P 500 IND-9967 01/80
 Calc Dates : 07/02/82 - 08/26/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|---------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 6 ////////////////////// | | | | | | | | |
| Total net profit | | | \$95,150.00 | | | | | |
| Gross profit | | | \$286,037.50 | | Gross loss | | | \$ -190,887.50 |
| Total # of trades | | | 758 | | Percent profitable | | | 57% |
| Number winning trades | | | 435 | | Number losing trades | | | 323 |
| Largest winning trade | | | \$6,950.00 | | Largest losing trade | | | \$ -3,000.00 |
| Average winning trade | | | \$657.56 | | Average losing trade | | | \$ -590.98 |
| Ratio avg win/avg loss | | | 1.11 | | Avg trade (win & loss) | | | \$125.53 |
| Max consecutive winners | | | 11 | | Max consecutive losers | | | 7 |
| Avg # bars in winners | | | 0 | | Avg # bars in losers | | | 0 |
| Max closed-out drawdown | | | \$ -16,337.50 | | Max intraday drawdown | | | \$ -16,337.50 |
| Profit factor | | | 1.49 | | Max # of contracts held | | | 1 |
| Account size required | | | \$19,337.50 | | Return on account | | | 492% |

Figure 6.6 Using a Better Exit Technique

Data : DAY T-BONDS 67/99
 Calc Dates : 12/02/77 - 08/26/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|-----------------------|
| 144 | -3 | \$ | 31.250 | \$ 0 | \$ 0 | \$ 3,000 | CSI | C:\GD\BACK67\F061.DTA |
| ////////////////// ALL TRADES - Test 8 ////////////////////// | | | | | | | | |
| Total net profit | | | \$28,812.50 | | | | | |
| Gross profit | | | \$66,781.25 | | Gross loss | | | \$ -37,968.75 |
| Total # of trades | | | 334 | | Percent profitable | | | 53% |
| Number winning trades | | | 180 | | Number losing trades | | | 154 |
| Largest winning trade | | | \$1,625.00 | | Largest losing trade | | | \$ -1,750.00 |
| Average winning trade | | | \$371.01 | | Average losing trade | | | \$ -246.55 |
| Ratio avg win/avg loss | | | 1.50 | | Avg trade (win & loss) | | | \$86.26 |
| Max consecutive winners | | | 10 | | Max consecutive losers | | | 6 |
| Avg # bars in winners | | | 0 | | Avg # bars in losers | | | 0 |
| Max closed-out drawdown | | | \$ -3,718.75 | | Max intraday drawdown | | | \$ -3,718.75 |
| Profit factor | | | 1.75 | | Max # of contracts held | | | 1 |
| Account size required | | | \$6,718.75 | | Return on account | | | 428% |

To recap, stocks have a proven proclivity to rally on Mondays, Bonds on Tuesdays, and virtually all the grains on Wednesday. To arrive at this opinion, we examined grain prices as far back as 1968 (30 years of data), Bonds to 1977 (21 years of data), and the S&P since they began trading in 1982 (17 years). In short, we rolled the dice enough to draw some reliable conclusions and observed enough data to determine there are biases; price is not solely motivated by a drunken sailor's random walk through the pages of the *Wall Street Journal*.

From this research, we have a leg up on other traders, an advantage in the game, and a window of opportunity to focus on when trading. It is not how often you trade that makes you a winner; after all, any fool can trade every day of the week. Old punters like myself know it is how often you don't trade, how selective you are, that will lead to a successful career.

Astute traders are probably already asking the next question I will now answer, "If

there is a bias to the TDW, could there be a bias to the trading day of the month?"

The answer is yes, and here comes the proof. The following results were arrived at by buying/selling on the opening of the trading day of the month shown and exited with either a \$2,500 stop in the S&P 500 or \$1,500 in Bonds or on the close of the third day after entry.

The entry day *was not* the calendar date, but the trading day of the month (TDM). A month can have 22 trading days, but because of holidays, weekends, and the like, we don't always get 22 days. Our entry rule is to buy or sell on the open of the TDM shown. This means you will have to count how many trading days have taken place so far this month to set up the trade.

This concept, TDM, is akin to seasonal influences. Most other authors and students of market activity have focused on calendar days, but that approach has inherent problems: if the computer spits out that the 15th calendar day is the best for a buy, yet this year the 15th is a Saturday and the day before is a holiday, just when do we take action? On Wednesday, Thursday, or the following Monday? TDM eliminates this question, giving us a focus on a specific tradable day.

I do not trade these days as exclusively, or should I say, inclusively, as TDWs. I use TDMs as setups, leading indicators of when to take what type of action. I may or may not take a TDM trade; I reserve judgment about that specific trade until that time rolls around. I will want to see what else is going on, because this is a thinking person's game that deals in reality, not a robotic virtual reality experience. My research shows that all markets have TDM setup periods in which the odds of a rally or decline are definitely tipped in our favor. If you trade markets other than the ones discussed in this book, you should get a computer, or programmer, to provide you with this information on your trading vehicles.

Indeed, there is a time to sow and a time to reap each week and each month of the year. Some times are better than others, but only a very inexperienced trader would blindly take such trades. My strategy is to find a bias such as TDW and TDM and then couple it with another bias to load or stack the deck in my favor. Should you and I play cards, for money, trust me to come with a marked and stacked deck, which is exactly how I want to trade; with as many odds in my favor as possible. If the scales are not heavily unbalanced in my favor, why trade? There are plenty of trades every year that are stacked deck trades; I will wait for them to materialize.

Enough said. [Tables 6.8](#) and [6.9](#) show the best TDMs for Bonds and the S&P 500, respectively.

Table 6.8 Best TDMs for S&P 500 1982–1998

| TDM | \$ Profit | Number of Trades | % Wins | Average Trade | Drawdown |
|-----|-----------|------------------|--------|---------------|----------|
| 6 | 48,787 | 166/97 | 58 | 293 | 13,025 |
| 7 | 54,212 | 168/212 | 60 | 322 | 6,100 |
| 8 | 51,312 | 175/102 | 68 | 293 | 10,675 |
| 19 | 64,162 | 145/84 | 57 | 442 | 8,187 |
| 20 | 55,600 | 110/60 | 54 | 505 | 11,825 |
| 21 | 70,875 | 75/48 | 64 | 945 | 7,750 |
| 22 | 42,375 | 61/40 | 65 | 694 | 10,075 |

Table 6.9 Best TDMs for T-Bonds 1977–1998

| TDM | \$ Profit | Number of Trades | % Wins | Average Trade | Drawdown |
|-----|-----------|------------------|--------|---------------|----------|
| 8 | 38,375 | 230/128 | 55 | 166 | 7,125 |
| 18 | 46,562 | 231/132 | 57 | 201 | 12,656 |
| 19 | 43,593 | 195/116 | 59 | 223 | 12,343 |
| 20 | 30,131 | 148/84 | 56 | 292 | 7,093 |
| 21 | 31,562 | 106/59 | 55 | 297 | 7,406 |
| 22 | 21,687 | 76/49 | 64 | 285 | 7,250 |

These results are actually staggering. By following some very simple rules, \$211,910 of profits could be had from trading Bonds just six days a month, and \$387,320 from trading the S&P a mere seven days per month. The S&P results reflect no stop on entry day, but a \$2,000 stop after entry day, whereas the Bonds used a \$1,500 stop starting on entry day.

Although you may not want to blindly follow these trade dates, we certainly want to be awake and aware around these pivotal trading periods because we have a definite advantage in the game: We know when strong rallies are most likely to take place.

GOLD TDOM STUDY

[Figures 6.7–6.12](#) update this study. [Figure 6.7](#) depicts the results of buying on the opening each trading day of the month and getting out on the close of that same day. [Figure 6.8](#) shows buying on the opening of the trading day in question and exiting at either the first profitable opening or with the dollar stop loss, as I have demonstrated throughout this chapter.

[Figure 6.7](#) Buying on Open of TDOM, Exit Close of Same Day (1998–2011)

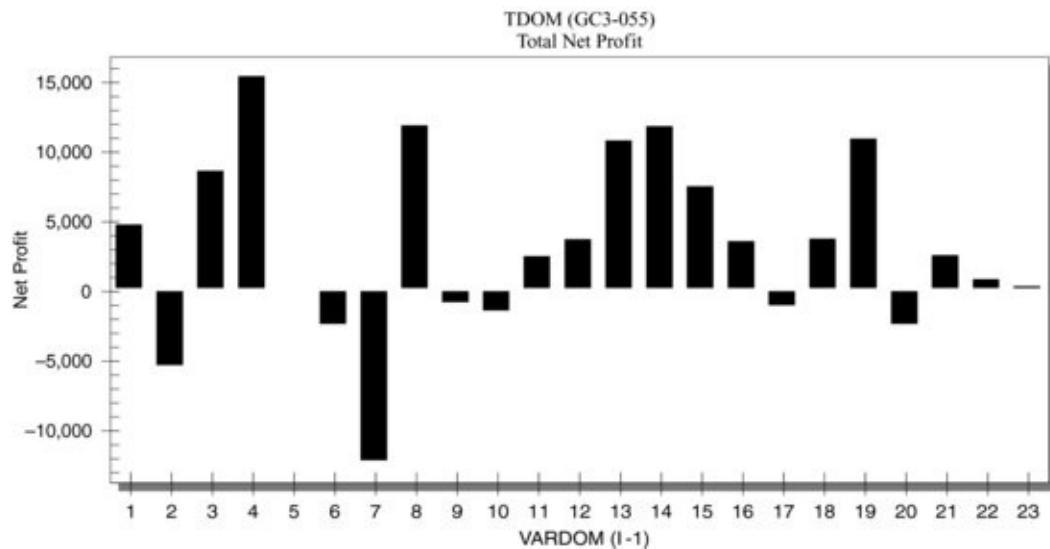


Figure 6.8 Buying on Open of TDOM: Exit Is Profitable Open or Stop Loss (1998–2011)

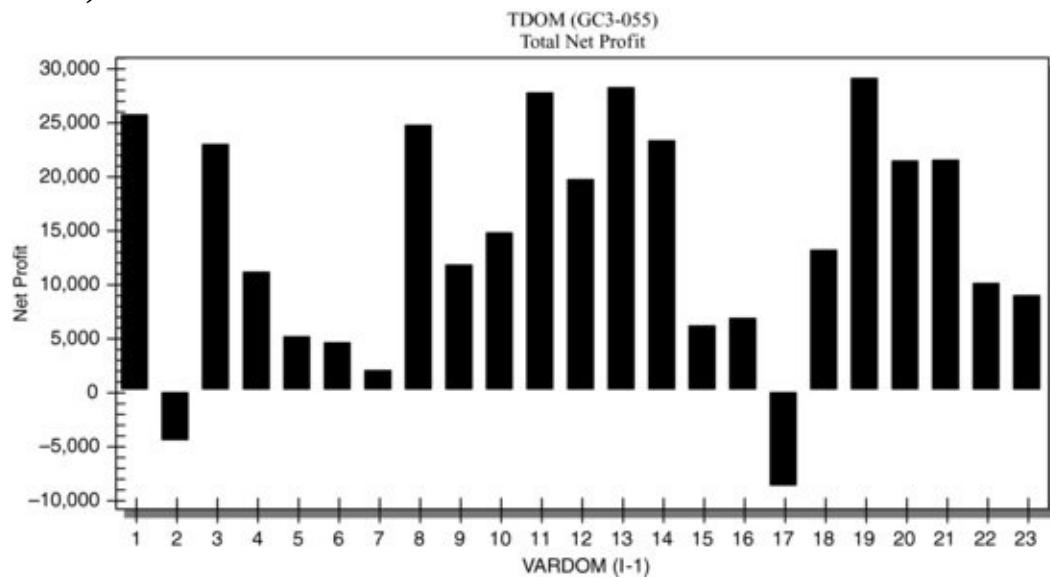
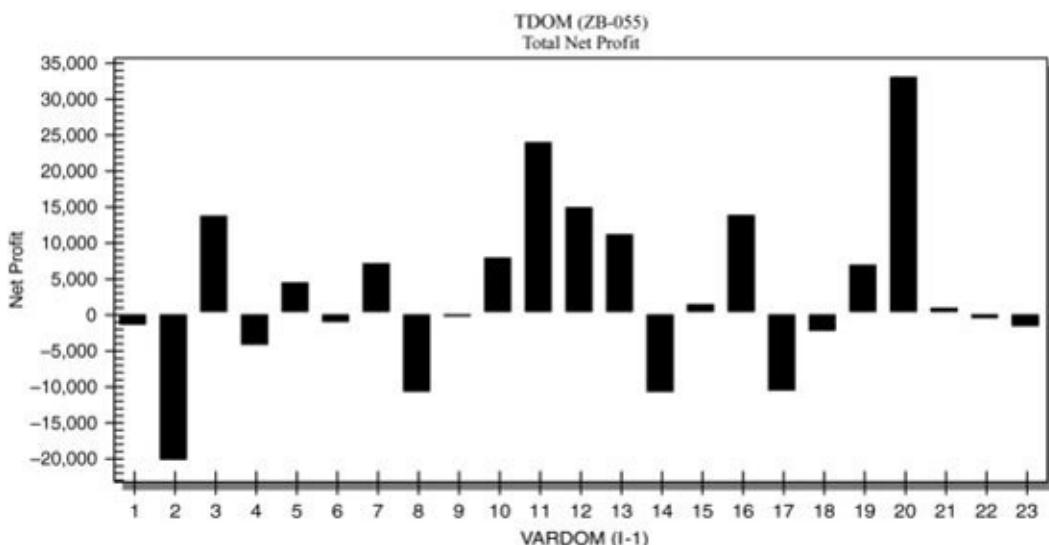


Figure 6.9 Bonds and TDOM (1998–2011)



Buying on the opening and getting out the same day has been the most profitable in Gold starting on trading day of the month 11 through trading day of the month 16. There seems to be a very sweet spot around the middle of the month for Gold to rally. Trading days three and four have also been quite successful for the bulls, while it is noteworthy that trading day seven has been the worst possible day for buying. That means, of course, that it is the day you would look for short signals.

[Figure 6.8](#) tells us very little about holding trades in the Gold market, because it has been in a very strong rally since 1998, almost every day has been profitable! Seemingly every day makes money! That is only because of the strong trend. Further analysis, however, shows what we saw in [Figure 6.7](#): The sweet spot continues to be around the middle of the month. We also see that trading day three has been quite profitable, but trading days six and seven as well as trading day 17 in either example did not present excellent trading opportunities.

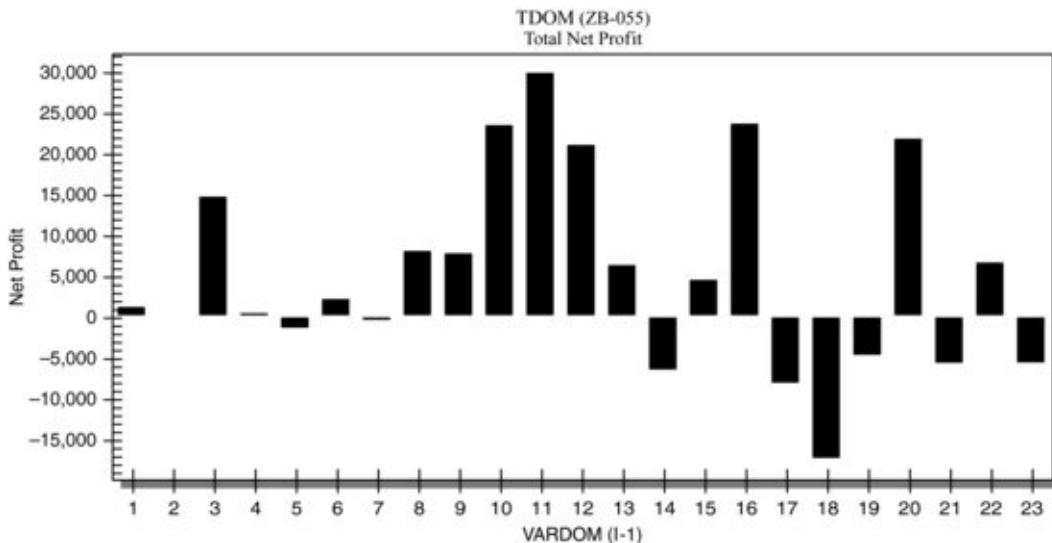
BOND TDOM STUDY

What you saw at work in Gold also works for Bonds.

Bonds, like Gold, have also shown success for those who choose to do their buying on the opening and exiting on the close of the same day. I show this in [Figure 6.9](#). Traditionally Bonds rally around the end of the month, with TDOM 20 standing out as the best opportunity for profits on the long side.

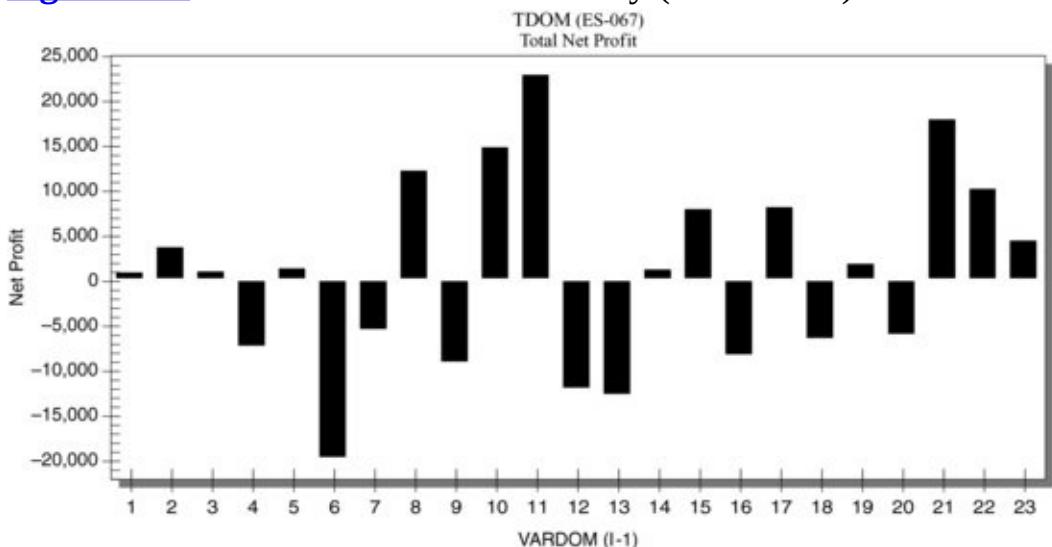
When it comes to buying bonds and holding for the first profitable opening, midmonth strength has been the order of the day since 1998 and is a bias traders should attempt to take advantage of. That is shown in [Figure 6.10](#).

[Figure 6.10](#) TDOMs Show Midmonth Strength for Bonds (1998–2011)



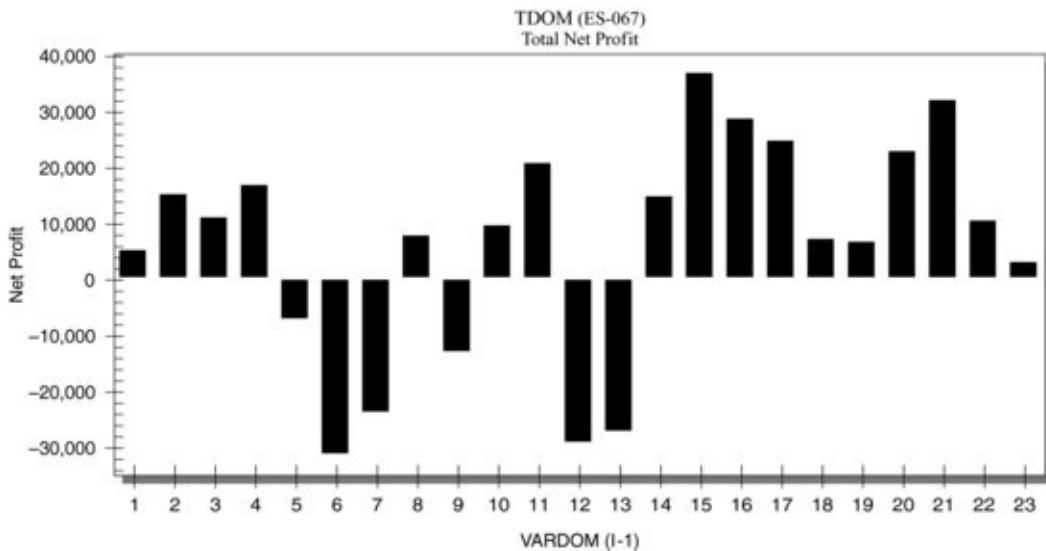
[Figure 6.11](#) shows the clear tendency for the S&P 500 to rally at the end of the month. Notice that this is the only instance where we have three consecutive days, all showing profits. Considering that we are using very tight restrictions, that is, we must exit and enter the same day, this bias is significant.

Figure 6.11 S&P End of the Month Rally (1998–2011)



When it comes to holding the S&Ps for a few days, Figure 6.11 paints a very clear picture; expect weakness starting at trading day five through seven as well as trading days of 12 through 13. Month-end strength washes over into the first of the new month. That is seen in the string of four consecutive profitable days at the start of each month ([Figure 6.12](#)).

Figure 6.12 First of the Month Strength (1998–2011)



I would be remiss if I did not point out that if you choose to carry the studies further, you should also break it down to each month of the year. Just as we have learned not all days are the same, not all months are the same. Some months are more bullish than others. So why not do the TDM tests based on individual months to optimize results?

MONTHLY ROAD MAPS

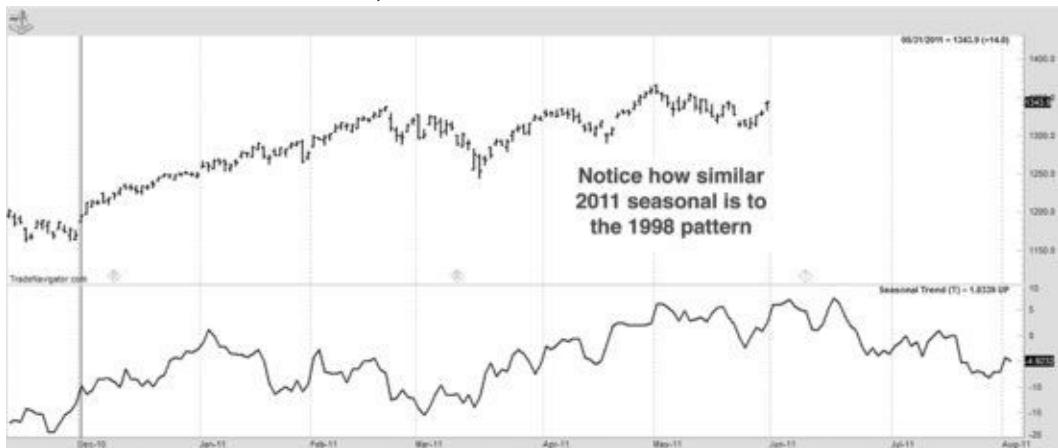
To give you a better feel of how prices usually move during *each month* of the year, [Figure 6.13](#) shows a daily chart that reflects how price changes on each TDM. Again, these are general outlines of what price has done in the past. Like road maps, price may or may not follow the same pattern this year and this month. Usually though, these price formats will be followed. [Figure 6.13](#) charts T-Bonds for 1998; underneath the price activity is a line that reflects the daily movement during each month. No one should expect price to follow this index exactly, but it generally follows the ups and downs. This index shown was created on data from the past and extended out into 1998. As you can see, the January peak came on schedule, as did the May lows, June rally, and late July pullback.

[Figure 6.13](#) Day T-Bonds (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Is this a fluke? Could be, so let's look at another TDM road map, this time for the S&P 500, again created on data ending in 1996, and then look at how prices moved in 1998 (see [Figure 6.14](#)). Although not a perfect representation, the similarity is remarkable and some excellent “stacked deck” trading time periods did appear in the future, as the past suggested they might.

Figure 6.14 S&P 500 Index (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



The best example is the major stock market slide that started in July 1998, right on schedule, congruent with the TDM road map. This index is one of the tools I used to get all my stock subscribers out of the market in June 1998.

I do not believe the past precisely predicts the future. My view is that the past is an indication of what is likely to happen in the future, thus it is a general guideline, an outline or bias we can and should take into consideration. It is time to think about what we should be doing on this day, this month, this year.

I am closing this chapter with an actual example from my own trading in 1998. Based on a system I use for trading Bonds, I was short a little over 300 contracts of Bonds at the point where the arrows are marked on [Figure 6.15](#). This was not a very

good place to be short; price moved against my position to the tune of almost \$250,000. I was emotionally fraught as my automatic dollar stop was close at hand, calling for me to exit and take my licking at 22/32nds.

Figure 6.15 Day T-Bonds (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Had I not known of this map or pattern, I would have been stopped out. But, knowing about the pattern of weakness that usually starts on the 12th TDM, I chose to not only raise my stop to the 28/32nd area but also went short on the 2/19 in hopes that the TDM influence would come to play, as it usually does. Fortunately, the market “knew what to do” and declined from that point until February 24, when my system called for going long. I still took a loss on the initial trade, but far less than the one I would have taken had I not known of this market bias.

Admittedly, the market could have moved higher; the possibility of being wrong never takes a vacation, which is why I still used a stop. I just slightly altered it based on the information at hand. This is a thinking business. Always has been, always will be, which is why I am interested in teaching the elements that can lead to successful trading. One of the vital elements I have used with a good degree of success is the TDM/TDW concept. I am not really certain who first came up with this idea—Sheldon Knight, one of the nicest guys and best researchers in the commodities business, or myself. But I think I have relied the most on the technique.

Several of my trading friends reject the TDW concept and insist there is no difference from one day of the week to the other. I disagree: In fact, it is the first

building block I use in determining what I will do tomorrow. The data in this chapter indicate the existence of bias on certain days of the week. It is my job as a trader to maximize this opportunity.

RECAP

Your takeaway from this chapter should be that days of the month present reliable patterns for traders to take advantage of. Not all days are the same; the commercial users and producers of commodities have their time frame, each month, when they are most likely to be buying or selling.

CHAPTER 7

Patterns to Profit

My evidence that there is method to the madness of market movement is the subject of this chapter.

Chartists have believed that certain patterns or formations on their charts can predict market behavior. For the most part, this crowd has looked at long-term patterns of market activity. Serious students of such phenomena should start with the Robert Edwards and John Magee classic, *Technical Analysis of Stock Trends* (CRC Press, 1998).

In the 1930s, Richard Wyckoff, Owen Taylor, H. M. Gartley, and George Seaman (my favorite), spent a great deal of time on these long-term patterns in an attempt to build a systematic approach to trading. In the 1950s, Richard Dunnigan took a big step forward by focusing on price patterns of 10 to 15 days while the older crowd was still looking at 30- to 60-day price patterns.

As mentioned, these same price patterns can be found in any chartable activity. Flip a coin, chart it, and you will see the same formations found on a Pork Belly or Corn chart! This has turned some analysts away from price structure analysis, and for good reason: Generally speaking, these patterns do not forecast or tell us much about the future. This may be because there is no predictable ability in chart formations, or the time period studied is not correct. W. L. Linden, writing in *Forbes* magazine, found that economic forecasts made by leading economists have consistently been incorrect at virtually every major turning point since the 1970s. A chilling thought here is that the study included forecasts done by Townsend-Greenspan—the latter name is that of the man who became head of the Federal Reserve System (the world's most powerful private corporation), Alan Greenspan.

The only ray of hope to be found in the article is the statement that these forecasts were correct in only a short time frame. This makes sense; it is far easier to forecast the next five minutes of your life than the next five years. As time progresses, more variables, more change, comes into play. Hence forecasts stumble in the unknown dark, black holes of the future altering what was once known or thought to be the path of righteousness.

I guess this may explain why I have actually made money (for many years, I might add) trading off patterns. The patterns I have used are for calling very short-term

market fluctuations of from one to five days. There may be some grand scheme of things, some master pattern of all major market highs and lows. If so, it has never been revealed to me, but certainly there are many short-term market patterns that give you a big—in some cases, I would go so far as saying huge—advantage in the game.

THE COMMON ELEMENT

First, I need to prove that patterns can and do work or at least bring an advantage to the table, a cow for us to milk. Then I can tell you why I think these patterns do work, what the method to the madness is, what my working premise to these patterns to profits is all about.

Let's start with a basic pattern using the S&P 500, a broadly traded market. What we know is that 50 percent of the time this market should close up for the day, 50 percent of the time down for the day. What will happen tomorrow on any given day is supposed to have the same odds as a coin flip, if we don't consider TDW.

Patterns can change all that rather dramatically.

We begin by establishing a basic parameter. What happens if we buy the S&P 500 every day and exit on the next close with a \$3,250 stop? From July 1982 through February 1998, there were 2,064 trades with 52 percent accuracy and an average profit per trade of \$134. From 1998 forward there were 1,739 trades making \$151,000 with an average profit of \$87 on 52 percent winners.

In [Table 7.1](#) you see this test from 1984 to 1998, the time frame of the original book. As you will note, Mondays and Wednesdays were the best days to buy and Monday was the only day to get hot and bothered about.

Could this pattern hold up in the future?

Now we add our first pattern: What if we buy tomorrow only if today closed down? In this case, there were 1,334 trades with the same 52 percent accuracy, but the average profit per trade escalated to \$212. Carrying the test forward I found 55 percent accuracy on 1,218 trades with an average profit of \$79.

Finally, if our pattern consists of three consecutive down closes, the accuracy jumps to 58 percent to 248 trades and the average profit per trade skyrockets to \$353! Could it be there is something to this pattern stuff? We see the same thing moving forward with 54 percent accuracy on 579 trades and an average net profit of \$179!

Let's mock up a simple pattern to see what happens tomorrow if the following conditions exist: First, we want today's price to be greater than the close 30 days ago so we are in some sort of up trend. Next, we would like to have seen a slight

pullback against the uptrend, so we will want today's close lower than the close 9 days ago. If that condition exists, we will buy on the open tomorrow and exit on the next day's close. If the market is really random, 52 percent of such trades should make money (not 50 percent because during the time period of the study there had been an overall trend bias to rally, best evidenced by the fact that the initial study showed higher closes 52 percent of the time).

The facts of the matter are far different. This meek little pattern produced 354 trades with 57 percent accuracy and an average profit of \$421 a trade. Accuracy jumps from 52 percent to 57 percent and the average profit per trade increases almost fourfold! Hold on to your hat, it gets better.

[Table 7.1](#) expands on that data, showing the day-by-day results of this pattern from 1984 to 1998, profit of \$84,600 on 321 trades with 63 percent, as the table shows.

Table 7.1 By Weekday Report (1984–1998)

| Weekday | Trades | Win (Percentage) | Win (Average) | Loss (Average) | P/L | Average Trade | Maximum Loss | Profit |
|-----------|--------|---------------------|------------------|-------------------|------|------------------|-----------------|-----------|
| Monday | 385 | 60.00% | \$723 | -\$650 | 1.11 | \$174 | -\$3,450 | \$66,813 |
| Tuesday | 413 | 47.70% | \$684 | -\$680 | 1.01 | -\$29 | -\$4,300 | -\$12,063 |
| Wednesday | 413 | 52.30% | \$696 | -\$682 | 1.02 | \$39 | -\$10,000 | \$16,088 |
| Thursday | 404 | 50.99% | \$615 | -\$767 | 0.80 | -\$62 | -\$4,675 | -\$25,000 |
| Friday | 408 | 49.02% | \$696 | -\$761 | 0.91 | -\$47 | -\$3,650 | -\$19,213 |

To add some wallop to this updated version of the book, I am showing the exact same test forward from when the book was written through May 2011. (See [Table 7.2](#).)

Table 7.2 By Weekday Report (May 1998–May 2011)

| Weekday | Trades | Win (Percentage) | Win (Average) | Loss (Average) | P/L | Average Trade | Maximum Loss | Profit |
|-----------|--------|---------------------|------------------|-------------------|------|------------------|-----------------|-----------|
| Monday | 360 | 50.00% | \$2,801 | -\$2,229 | 1.26 | \$286 | -\$9,575 | \$102,925 |
| Tuesday | 382 | 47.12% | \$2,610 | -\$2,372 | 1.10 | -\$24 | -\$4,250 | -\$9,325 |
| Wednesday | 420 | 49.05% | \$2,629 | -\$2,385 | 1.10 | \$74 | -\$5,750 | \$31,150 |
| Thursday | 372 | 47.31% | \$2,557 | -\$2,368 | 1.08 | -\$38 | -\$6,625 | -\$14,100 |
| Friday | 400 | 47.75% | \$2,733 | -\$2,436 | 1.12 | \$32 | -\$8,925 | \$12,750 |

Would you look at that! Again Mondays and Wednesdays were the winner and again Mondays are the winner by a great deal. I wonder what Paul Cootner would say about this?

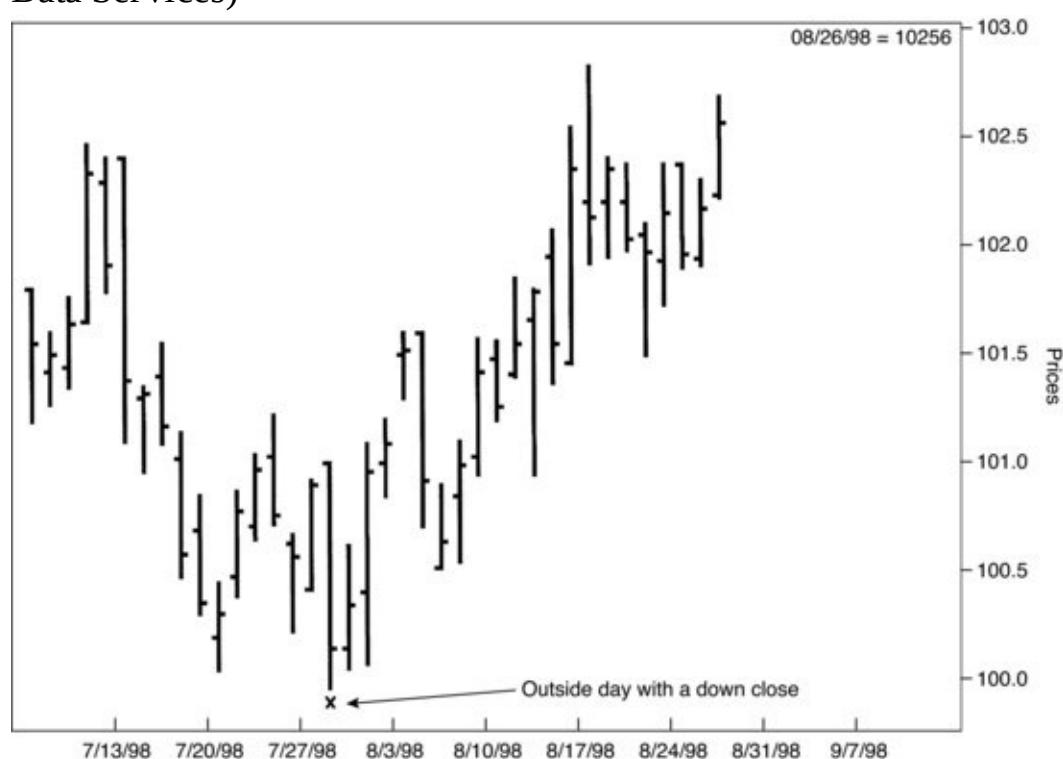
The best patterns I have found have a common element tying them together: Patterns that represent extreme market emotions reliably set up trades for price swings in the opposite direction.

In other words, what the public sees on their charts as being negative is most often

apt to be positive for short-term market moves, and vice versa. A case in point is an outside day with a down close. The day's high is greater than the previous day's high and the low is lower than the previous day's low and the close is below the previous day's low. This looks bad, like the sky is indeed falling in. In fact, the books I have read say this is an excellent sell signal, that such a wild swing is a sign of a market reversal in favor of the direction of the close, in this case down.

Whoever writes these books does not spend much time looking at price charts! As dollar index in [Figure 7.1](#) shows, this can be a very bullish pattern or market configuration.

Figure 7.1 U.S. Dollar (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Reality is far different than conjecture as a quick computer test shows and reveals the power of one of my favorite short-term patterns. It does not take much to prove the validity of patterns or to check to see what is really going on. Given this outside day pattern I have noticed, there is a final filter, or event that can happen to further influence the pattern tomorrow. This event is the direction of tomorrow's opening, as shown in [Figure 7.2](#). If, in the S&P 500 index, tomorrow opens lower than the outside day's down close and we buy on the next day's opening, we find 109 occurrences with 85 percent accuracy making \$52,062 with an average profit per trade of \$477.

Figure 7.2 A Bullish Pattern

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/27/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | | \$52,062.50 | | | | | |
| Gross profit | | | \$84,062.50 | | Gross loss | | | \$ -32,000.00 |
| Total # of trades | | | 109 | | Percent profitable | | | 85% |
| Number winning trades | | | 93 | | Number losing trades | | | 16 |
| Largest winning trade | | | \$4,887.50 | | Largest losing trade | | | \$ -2,000.00 |
| Average winning trade | | | \$903.90 | | Average losing trade | | | \$ -2,000.00 |
| Ratio avg win/avg loss | | | 0.45 | | Avg trade (win & loss) | | | \$477.64 |
| Max consecutive winners | | | 44 | | Max consecutive losers | | | 4 |
| Avg # bars in winners | | | 2 | | Avg # bars in losers | | | 1 |
| Max closed-out drawdown | | | \$ -8,000.00 | | Max intraday drawdown | | | \$ -8,000.00 |
| Profit factor | | | 2.62 | | Max # of contracts held | | | 1 |
| Account size required | | | \$11,000.00 | | Return on account | | | 473% |

I know, you are wondering if this carried forward. It sure did, kicking the random walk guys in the tail with 53 percent winners on 76 trades making \$39,500 with an average profit per trade of \$500.

If we buy on any day but Thursday, a day we know tends to see selling pressures spilling over into Friday, we make a little less, \$50,037, but bump our average profit per trade up to \$555 and increase accuracy to 86 percent with drawdown going from \$8,000 to \$6,000. These results use a \$2,000 stop to exit or the first profitable opening exit rule (see [Figure 7.3](#)).

[Figure 7.3](#) Using the First Profitable Opening Exit Rule

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/27/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | | \$50,037.50 | | | | | |
| Gross profit | | | \$74,187.50 | | Gross loss | | | \$ -24,150.00 |
| Total # of trades | | | 90 | | Percent profitable | | | 86% |
| Number winning trades | | | 78 | | Number losing trades | | | 12 |
| Largest winning trade | | | \$4,887.50 | | Largest losing trade | | | \$ -2,150.00 |
| Average winning trade | | | \$951.12 | | Average losing trade | | | \$ -2,012.50 |
| Ratio avg win/avg loss | | | 0.47 | | Avg trade (win & loss) | | | \$555.97 |
| Max consecutive winners | | | 39 | | Max consecutive losers | | | 3 |
| Avg # bars in winners | | | 2 | | Avg # bars in losers | | | 1 |
| Max closed-out drawdown | | | \$ -6,000.00 | | Max intraday drawdown | | | \$ -6,000.00 |
| Profit factor | | | 3.07 | | Max # of contracts held | | | 1 |
| Account size required | | | \$9,000.00 | | Return on account | | | 555% |

We can use this same pattern for setting up trading opportunities in the Bond market as well. This pattern is so powerful that it can be used in all markets as a standalone trading formation, but stacked-deck Larry still prefers to have additional confirmation to make certain I use only the best of the best trades. [Figure 7.4](#) shows the results of taking all outside day down closes followed by a lower opening the

next day in Bonds. To get out of the trade, we will take a \$1,500 loss or exit on the first profitable opening. Few traders realize that such a mechanical approach to trading can be so good that we scored an 82 percent accuracy and \$212 average profit per trade on the 57 occurrences since 1990.

Figure 7.4 All Outside Day Down Closes

| | | | |
|---------------------------------------------------------------|--------------|-------------------------|-----------------------------|
| Data | : | DAY T-BONDS | 67/99 |
| Calc Dates | : | 06/10/90 - 08/27/98 | |
| <hr/> | | | |
| Num. Conv. P. Value | Comm | Slippage Margin | Format Drive:\Path\FileName |
| ----- | | | |
| 144 -3 \$ 31.250 | \$ 55 | \$ 0 \$ 3,000 | CSI C:\GD\BACK67\F061.DTA |
| <hr/> | | | |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | |
| Total net profit | \$12,115.00 | Gross loss | \$ -15,550.00 |
| Gross profit | \$27,665.00 | | |
| Total # of trades | 57 | Percent profitable | 82% |
| Number winning trades | 47 | Number losing trades | 10 |
| Largest winning trade | \$2,101.25 | Largest losing trade | \$ -1,555.00 |
| Average winning trade | \$588.62 | Average losing trade | \$ -1,555.00 |
| Ratio avg win/avg loss | 0.37 | Avg trade (win & loss) | \$212.54 |
| Max consecutive winners | 11 | Max consecutive losers | 3 |
| Avg # bars in winners | 2 | Avg # bars in losers | 1 |
| Max closed-out drawdown | \$ -5,416.25 | Max intraday drawdown | \$ -5,510.00 |
| Profit factor | 1.77 | Max # of contracts held | 1 |
| Account size required | \$8,510.00 | Return on account | 142% |

Can we make this a better performing pattern? You bet. Got any ideas how? You should by now; in fact, you are probably wondering whether the pattern is better on some days of the week than others. It is. If we take the trade on any day but Thursday, just as in the previous S&P results, we skyrocket the accuracy to 90 percent and make \$17,245 on 41 trades for an average profit per trade of \$420 (see [Figure 7.5](#)). Folks, it doesn't get much better than this.

Figure 7.5 Trade on Any Day but Thursday

| | | | |
|---------------------------------------------------------------|--------------|-------------------------|-----------------------------|
| Data | : | DAY T-BONDS | 67/99 |
| Calc Dates | : | 06/10/90 - 08/27/98 | |
| <hr/> | | | |
| Num. Conv. P. Value | Comm | Slippage Margin | Format Drive:\Path\FileName |
| ----- | | | |
| 144 -3 \$ 31.250 | \$ 55 | \$ 0 \$ 3,000 | CSI C:\GD\BACK67\F061.DTA |
| <hr/> | | | |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | |
| Total net profit | \$17,245.00 | Gross loss | \$ -6,220.00 |
| Gross profit | \$23,465.00 | | |
| Total # of trades | 41 | Percent profitable | 90% |
| Number winning trades | 37 | Number losing trades | 4 |
| Largest winning trade | \$2,101.25 | Largest losing trade | \$ -1,555.00 |
| Average winning trade | \$634.19 | Average losing trade | \$ -1,555.00 |
| Ratio avg win/avg loss | 0.40 | Avg trade (win & loss) | \$420.61 |
| Max consecutive winners | 11 | Max consecutive losers | 1 |
| Avg # bars in winners | 2 | Avg # bars in losers | 1 |
| Max closed-out drawdown | \$ -1,555.00 | Max intraday drawdown | \$ -1,555.00 |
| Profit factor | 3.77 | Max # of contracts held | 1 |
| Account size required | \$4,555.00 | Return on account | 378% |

The problem is that these outside day patterns do not occur as often as we would

like! The next time you see an outside day with a down close lower than the previous day, don't get scared, get ready to buy!

Time for another bullish-looking pattern in the S&P 500. We will now look for any day that closes above the previous day's high and is preceded by two consecutive up closes, making it the third up day in a row (see [Figure 7.5](#)). Such seemingly strong showings of strength have been known to lure the public into buying.

For example, checking this pattern from 1986 to 1998 in the S&P 500, there were 25 occurrences of this pattern on Tuesday, setting up sells for Wednesday. Of these, 19 were winners, netting \$21,487. In the Bond market, the same pattern set up 28 trades on Thursday, to sell on Friday, making \$13,303, which challenges the random walk professors with a thought-provoking 89 percent accuracy. The Bond test was on data from 1989 to August 1998! A \$1,500 stop was used in Bonds and \$2,000 in the S&P 500.

For both markets, we used the simple bailout exit that I will teach later. There are several major short-term patterns like this that I take advantage of in my trading. The search is on each day to see what the current pattern foretells. I have some stock patterns that I have used for years, but am always on the lookout for new ones.

I tested these patterns on the S&P E Mini from 1998 forward and found similar results. Outside days, even in the new electronic markets, are bullish.

THE QUESTIONS TO ASK

Patterns work. I know. I have cataloged hundreds of them over the years and suggest you do the same, starting with the ones I am providing here. It is best to think about why these patterns work. What do they represent? Can I find the pattern at work in all markets? Does the trading day of the week matter? Those are my stock questions, but the underlying germ of truth I am looking for is some visual pattern that emotionally sucks the public into buying or selling at just the wrong time ... for them ... and right time for me. Understanding emotions as reflected on charts is the key to "chart reading."

"Trader Rick," a recent seminar attendee, e-mailed me this note as I was writing this section. Read it to understand what to look for and reflect on your own stories at the same time:

Would you like yet another story that proves you should not be an emotional trader? Well here goes; you'll find it interesting.

Last weekend I decided to place a buy stop in May Copper at 77.80, first thing Monday morning. Shortly after Copper opened, I called my broker

(unfortunately my regular broker does not come in until around 8 AM) and asked, “What's Copper called this morning?” He replied, “I don't follow Copper, I really don't know, I'd have to look it up” (Oh brother, never mind).

“Okay,” I said, “what's the last price?” and was told it was trading at 77.00 down from 77.90, this told me price had already gone above my stop so I thought I'd wait for a pullback.

I called back later, price was at 77.30. Again, I did nothing. Why, you ask? I really don't know, except I thought I'd “watch the market” to see what I should do. The funny thing is I now know if it went higher I would have waited for a pullback, if it went lower I would have been afraid to buy. Up or down would scare me out, and that's just what happened! What would I have “seen” anyway, handwriting from God?

Later in the day I called back, now Copper was at 80.30. “Damn ... okay, buy one at the market.” Now I knew Copper was really hot, and buying it violated everything you had taught us that weekend. But something, almost a mysterious force, “pushed” me into the trade. I bought pretty much at the high of the day, because I was upset I had not gotten in earlier.

The very next day Copper began a pullback, fortunately it eventually went higher, but it cost me \$500. Dumb, dumb, dumb. Haven't I learned anything yet? Yeah, I have, it's simply this: Plan your trades and don't deviate, don't let emotions push you over the cliff at just the wrong time.

Rick's comments reminded me of fishing, how I'll toss a worm in and wiggle it just a little, no bite, then a little more, still no bites, then just a little twitch and ... *Blam!* I've hooked a nice fish. The market seems to hook us just like a fish with those little wiggles that keep testing us until we fall for it—hook, line, and sinker.

The problem is that this is not catch and release, it is bite and lose: No more “forced feeding frenzies” for me!

The next time old man greed taps you on the shoulder or you hear an emotional call luring you to the bait ... don't bite!

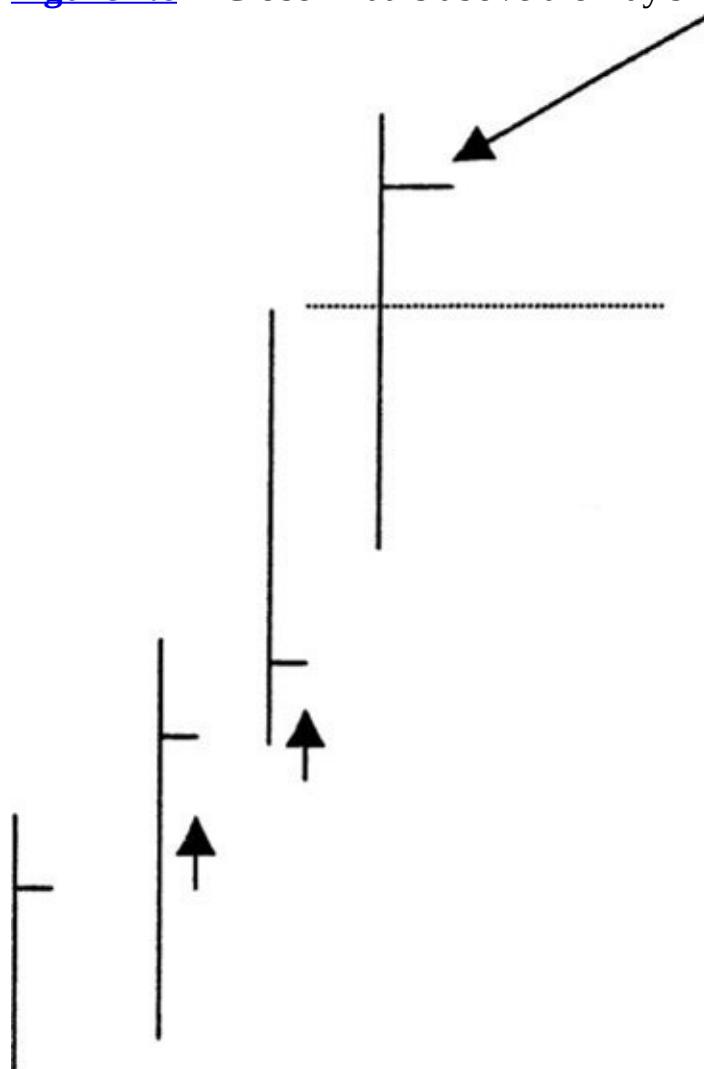
MY SMASH DAY PATTERNS

The siren song of greed is what keeps the public on the losing side of the ledger in this business. That is bad for them but good for us, if we can figure out what it is that gets them to bite, what sucks them into wrong decisions. One such “event” is what I have labeled *smash day reversals*. These are days in which the market has a major break, up or down, and this violent action pulls the public in to the foray.

There are two types of smash days. The first is pretty obvious. A “smash day buy setup” consists of a day that closes lower than the previous day's low; a “naked close” is what Joe Stowell, who's got a great eye for charts, calls these. Such days may take out the previous three to eight days' lows as well. To the chartist, the public, or professional technical analyst, this looks like a breakout to the downside, and thus the extreme selling brings them to the table.

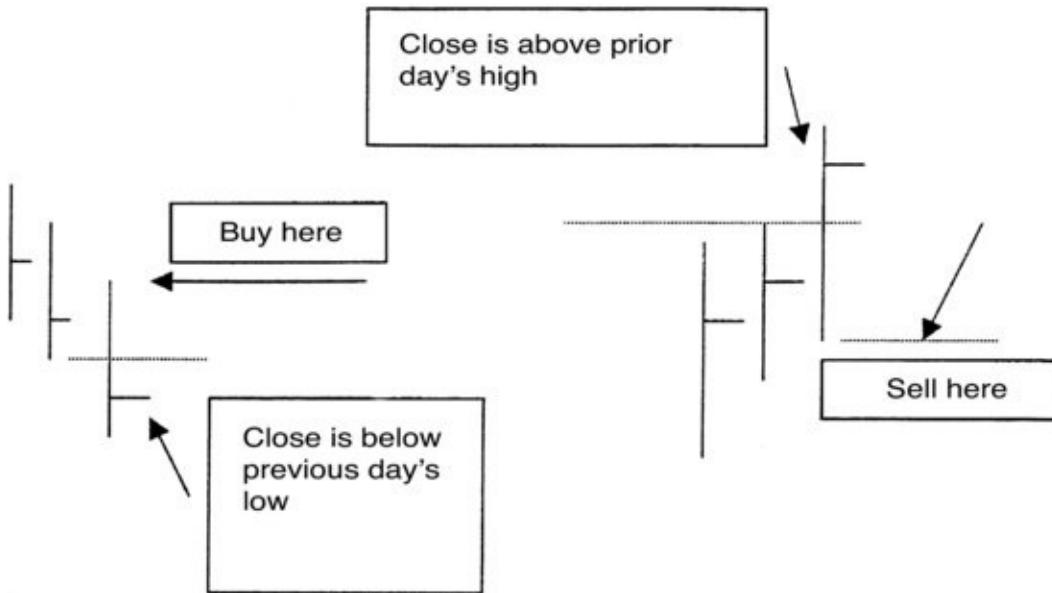
Sometimes they are right, but usually they are dead wrong if the market immediately reverses itself. See [Figure 7.6](#).

Figure 7.6 A Close That Is above the Day's High



A smash day sell setup is just the opposite (see [Figure 7.7](#)). Here what you will be looking for is a day that closes above the prior day's high and most likely “breaks” out to the upside to close above a trading range. This is the twitching worm that causes the public to leap before they look. The illustration shows how this usually looks. What you have here are the buy and sell setups.

Figure 7.7 A Smash Day Sell Setup



As mentioned, sometimes this is a valid break. However, if *the very next day* price moves opposite the smash day and trades above the high of a down close smash day, you have a great buy signal. By the same token, a smash day up, one of those strong closes above the prior day's high, alerts us to a sell signal if *the very next day* price trades to the smash day's low.

The phenomenon is that there is an immediate reversal the very next day, which means the public (sellers on the down close, buyers on the up close) are now in a world of hurt; their envisioned breakout has failed! They swallowed the hook, again, and now price responds with a reversal, giving us an excellent entry. That is the pattern and the rationale, the reason it should work. I am a firm believer that when “what should happen in the market doesn’t,” we have powerful evidence to take a trade in alignment with the new information.

I have selected a few examples of this pattern at work ([Figures 7.8](#) and [7.9](#)). Once we review the other type of smash day reversal, I will explain how I use this pattern.

Figure 7.8 Smash Day Pattern at Work

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/27/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|------|-------------------------|----------|--------|------------------------|
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 2 ////////////////////// | | | | | | | | |
| Total net profit | | | \$21,487.50 | | | | | |
| Gross profit | | | \$33,487.50 | | Gross loss | | | \$ -12,000.00 |
| Total # of trades | | | 25 | | Percent profitable | | | 76% |
| Number winning trades | | | 19 | | Number losing trades | | | 6 |
| Largest winning trade | | | \$4,850.00 | | Largest losing trade | | | \$ -2,000.00 |
| Average winning trade | | | \$1,762.50 | | Average losing trade | | | \$ -2,000.00 |
| Ratio avg win/avg loss | | | 0.88 | | Avg trade (win & loss) | | | \$859.50 |
| Max consecutive winners | | | 6 | | Max consecutive losers | | | 2 |
| Avg # bars in winners | | | 2 | | Avg # bars in losers | | | 6 |
| Max closed-out drawdown | | | \$ -4,000.00 | | Max intraday drawdown | | | \$ -4,775.00 |
| Profit factor | | | 2.79 | | Max # of contracts held | | | 1 |
| Account size required | | | \$7,775.00 | | Return on account | | | 276% |

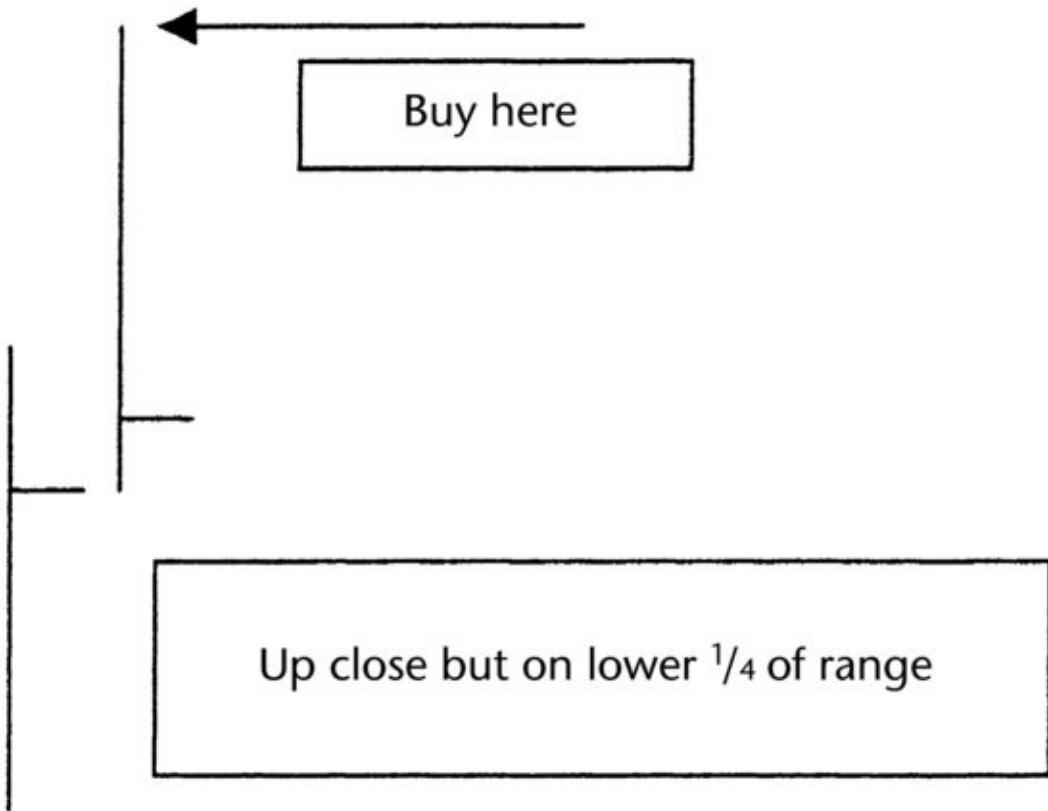
Figure 7.9 Another Smash Day Pattern Example

Data : DAY T-BONDS 67/99
Calc Dates : 01/26/89 - 08/27/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|----|--------------|-------|-------------------------|----------|--------|-----------------------|
| 144 | -3 | \$ | 31.250 | \$ 55 | \$ 0 | \$ 3,000 | CSI | C:\GD\BACK67\F061.DTA |
| ////////////////// ALL TRADES - Test 4 ////////////////////// | | | | | | | | |
| Total net profit | | | \$13,303.75 | | | | | |
| Gross profit | | | \$18,000.00 | | Gross loss | | | \$ -4,696.25 |
| Total # of trades | | | 28 | | Percent profitable | | | 89% |
| Number winning trades | | | 25 | | Number losing trades | | | 3 |
| Largest winning trade | | | \$2,413.75 | | Largest losing trade | | | \$ -1,586.25 |
| Average winning trade | | | \$720.00 | | Average losing trade | | | \$ -1,565.42 |
| Ratio avg win/avg loss | | | 0.45 | | Avg trade (win & loss) | | | \$475.13 |
| Max consecutive winners | | | 9 | | Max consecutive losers | | | 1 |
| Avg # bars in winners | | | 3 | | Avg # bars in losers | | | 6 |
| Max closed-out drawdown | | | \$ -1,586.25 | | Max intraday drawdown | | | \$ -2,648.75 |
| Profit factor | | | 3.83 | | Max # of contracts held | | | 1 |
| Account size required | | | \$5,648.75 | | Return on account | | | 235% |

My second smash day reversal ([Figure 7.10](#)) is a bit more difficult to identify but works on the same principle of the market not following through on one day's action and reversing the very next day. The pattern you will be looking for, to establish a buy setup, will be a day that has an up close, *not a naked down close*. But, and this is the key or secret to the pattern, the day's close will be in the lower 25 percent of the up day's range and will also be closing below the opening of the day in the very best patterns. I call this a "hidden smash day" because of the up close.

Figure 7.10 A Hidden Smash Day Buy

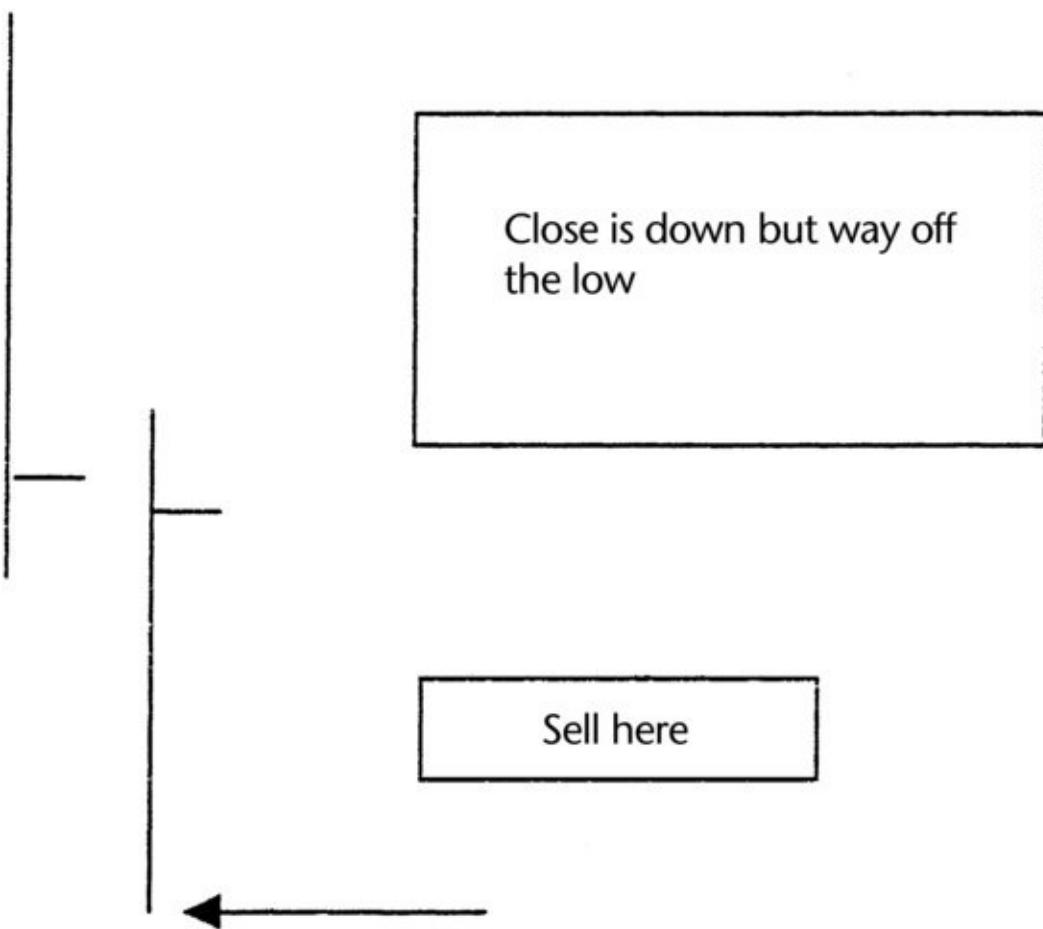


What has happened on these days is that price has either opened much higher and then closed up for the day but way off the highs, or opened a little higher, rallied way up and then failed to hold the day's gains. Sure, it closed up a little for the day, but way below the high. The buyers got smashed, in either pattern, and chartists will now come in looking for the kill.

But the chartists will only be killed themselves, if the next day price rallies back and takes out this smash day high. Again we see the pattern of a market failure immediately reversed *the very next day*. This is a most bullish set of events and calls for going long—if the stage has been set for a rally by our background tools such as TDW, TDM, market relationships, overbought/oversold, and trend.

A hidden smash day sell is just the opposite. Look for a down close that is in the upper 25 percent of the day's range and above the open of the day. Our entry comes when price falls below the hidden smash day's low *the very next day*, indicating that the rally has failed. A quick look at [Figure 7.11](#) should establish what this pattern looks like.

Figure 7.11 A Hidden Smash Day Sell



HOW TO USE SMASH DAY PATTERNS

There are two ways to use these patterns. Let's first look at the pattern in sharp up-and downtrends—trends you wish you were in or where you want to add a position. In such tight trend up moves, the appearance of a smash down day, hidden or not, sets up our buy for the following day and is precise evidence that the trend is intact and ready for traders to have another go at it, another race to the sun.

In a downtrend, the reverse situation will be found to produce excellent indications of when to get back aboard the decline. Here you will be looking for either the naked up close day or a down day that closes in the top of its range. If the very next day prices smash below that day's low, it is time to get short. The examples shown here should help you understand the importance of this technique.

The other way I like to use these smash day setups is to look for a market that has been in a choppy trading range. I then note a smash day and act accordingly once the high or low of the smash day is penetrated. My thinking is that we will probably see a breakout of the congestion if the smash day is immediately reversed. Such action is suggestive of a market that moved to where all the stops were, and elected all the

“breakout babies” who had orders there. The breakout is a magnet for the public to take action and they do. What kills them is the immediate reversal the very next day. They cannot believe their “luck” and decide to hold on despite the reversal; a few days later, they pitch their positions, adding momentum to the move we hooked up with, thanks to the smash day pattern.

Confucius must have been a chartist when he said that one picture (one chart) is worth a thousand words. I have marked off examples of the smash day pattern in trading ranges for your study. These appear as [Figures 7.12](#) through [7.17](#).

Figure 7.12 Comex Silver (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.13 Day T-Bonds (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.14 Day T-Bonds (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.15 Soybean Meal (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

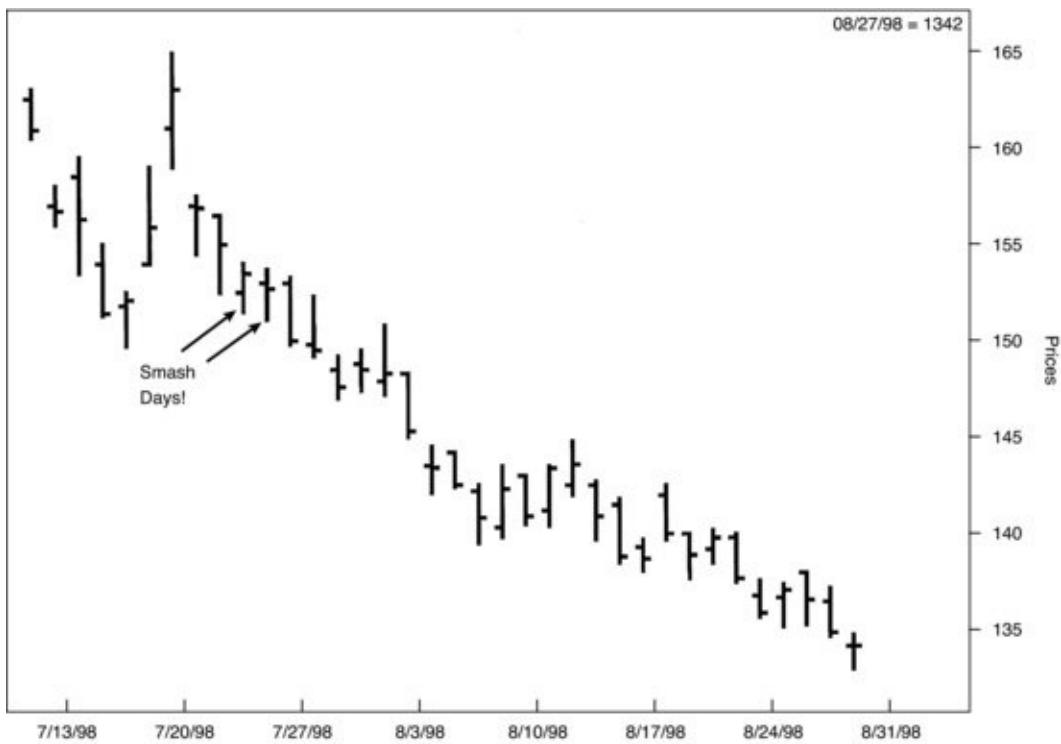


Figure 7.16 Comex Silver (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.17 CBT Wheat (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



These patterns continue to be among my favorite tools to enter a trade; they worked when I was a kid trading in the 1960s, and they still work in the year 2011. Treasure them; they are your allies.

SPECIALISTS' TRAP

Here is a pattern that uses the smash day idea in yet another fashion. This idea comes from Richard Wyckoff, who authored a course on stock trading in the 1930s. I have a good degree of affinity for Wyckoff's work, because in 1966 and 1967, I worked right across from the library in Carmel, California, where Wyckoff wrote much of the material that in later years he donated to the library. As fate would have it, I stumbled on his donation on my lunch hour one day and thereafter broke bread with his writings for the next year.

The Wyckoff concept is that markets are “manipulated” perhaps not by a manipulator, as you would think, but more by a collective consciousness, the great anamorphic “them” or “they.” This group of “them,” Wyckoff suggests, moves the market to draw the public into the game at the wrong times. The specialists on the floor of the New York Stock Exchange, who keep book on stocks, have often been accused of “running” and rigging prices to trap the public, hence my term *specialists’ trap*, but I do not assign any manipulation to them, only to a much more cosmic notion of price movement. I know specialists: One, Bill Abhrams, has been a friend for 15 years and has convincingly proven to me that they do not rig stock

prices.

The selling “trap” consists of a nice up trending market that moves sideways in a box or congestion for 5 to 10 days, then breaks out to the upside with a naked close above the entire trading range. The true low of the breakout day then becomes a critical point. If it is broken below, or taken out in the next one to three days, there is a great probability the upside breakout was false and the public bought a bill of goods. They were trapped into an emotional buy, and the distributors of stocks or commodities most likely unloaded, on strength, to the masses.

A specialists’ buy trap is just the opposite. Look for a down-trending market that stabilizes sideways for 5 to 10 days, then breaks out to the downside, with a naked close lower than all the daily lows of the trading range. In theory, you would think this would plummet prices much lower. The truth is it usually does. But, if a snapback takes place, lifting price above the true high of the break day, a market reversal has most likely occurred. All the sell stops below the market were triggered; the public started the breakdown and is now afraid to buy the trend reversal.

I am showing a few actual examples for your observation ([Figures 7.18](#) through [7.25](#)). [Figure 7.25](#) is for Exxon, a stock.

Figure 7.18 Comex Gold (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.19 Comex Gold (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.20 Feeder Cattle (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.21 Cotton #2 (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.22 Cotton #2 (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.23 New York Light (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 7.24 Cocoa (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

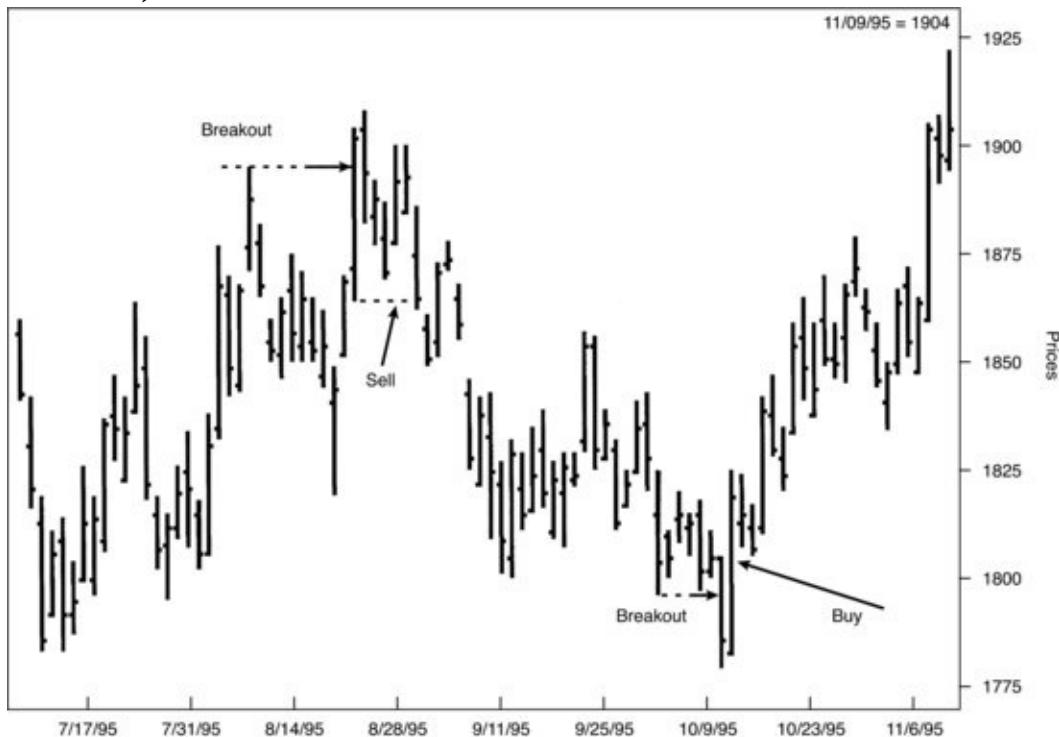


Figure 7.25 Exxon Corporation (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



A VITAL NOTE—THIS WORKS ON SHORTER TIME FRAMES AS WELL

Over the years, I have seen many successful trades using these smash day and traps on five-minute, 30-minute, and hourly price charts of market activity. Very short-term traders will want to add this to their intraday arsenal of trading techniques. These patterns represent excellent points of entry for short-term traders. The key, though, is to make certain you have something else backing the trade, something suggestive of the action you are taking, otherwise you are just using price to predict price. Your best trades will come from loading the trade with several qualifiers, not just a price structure.

OOPS! THIS IS NOT A MISTAKE

If there is any mistake to the pattern I am about to reveal, it is my mistake in going public with this pattern. It is the most reliable of all short-term patterns I have researched and traded. Numerous other authors and system developers have incorporated it in their work. A few (e.g., the highly talented Linda Bradford Ratschke; Bruce Babcock, the critic's critic; and Jake Bernstein) have been honorable enough to give me credit, whereas many more fail to, or even claim

credit for this pattern, which I first taught to my followers in 1978.

The pattern is based on an overemotional response, then a quick reversal of the concomitant overreaction of price. The overreaction is a large gap in price from last night's close to the next morning's opening. The precise overreaction we are looking for to give us a buy signal is *an opening that is below the previous day's low*. Such a rare occurrence indicates a potential market reversal. The setup is the extreme selling that causes people to panic with a rush of selling as price opens, so much so that price opens less than the prior day's range. This is a most unusual occurrence as price almost always opens within the prior day's range.

That is the setup. The entry comes when, following the lower open, price then rallies back to the previous day's low. If the market can muster enough strength to do that, most likely, the selling pressures have been abated and a sharp market rally will follow.

As you might suspect, a sell is just the opposite. You will be looking for an open greater than the prior day's high. The emotional response or setup is a huge amount of buying right on the open that causes a large gap, driving price above the prior high. Our entry then comes from price falling back to the prior high, telling us the gap could not hold, giving us a strong short-term suggestion of lower prices to come.

The name Oops! comes from the price action as the public pitches their positions and sells short on the opening based on news, charts, and the like. For a moment, they appear to be on the right track; but about the time price rallies back to the prior day's low, their broker calls to tell them price is moving against them usually saying something like, "Oops! We may have done the wrong thing [again], price is coming back pretty strong. Do you want to stay short?"

A note added in 2011: I am leaving in here the results from the original book. Oops! is a pattern I will never forget; I estimate I made over \$1,000,000 trading this pattern, but, sadly, it no longer works. The reason is simple: We no longer have pit trading sessions. It used to be that markets were closed for 16 to 18 hours, allowing orders and emotions to build up causing torrent of order, to buy or sell, forcing markets to gap open in the morning. Now there is a scant few minutes, or hours, between the electronic close to the next open, so the "blow-off" effect of pent-up orders is an advantage we have lost. With that in mind, the following is still good reading.

By the time the public makes up their mind to get out of the losing trade, price is above yesterday's low and their new buying or short covering adds momentum to the rally for which we positioned ourselves. [Figures 7.26](#) and [7.27](#) show how the Oops! signals will appear.

[Figure 7.26](#) The Oops! Buy Signal

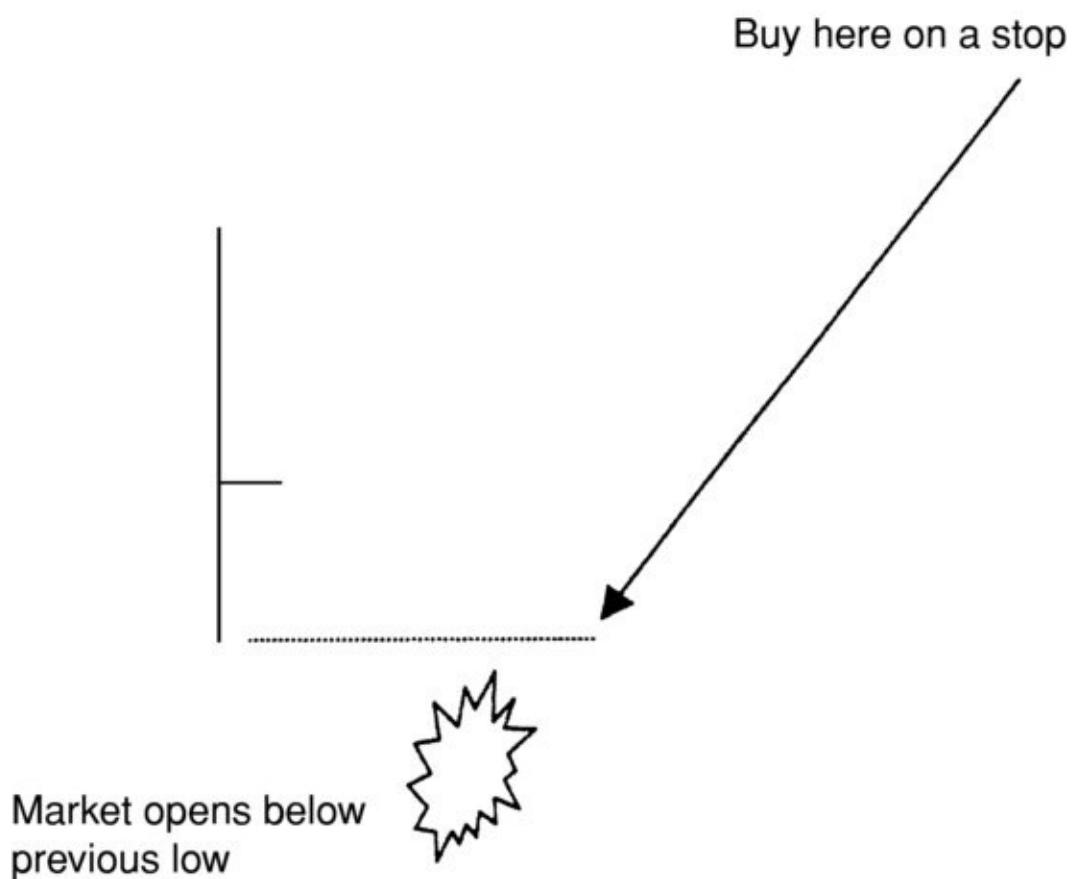
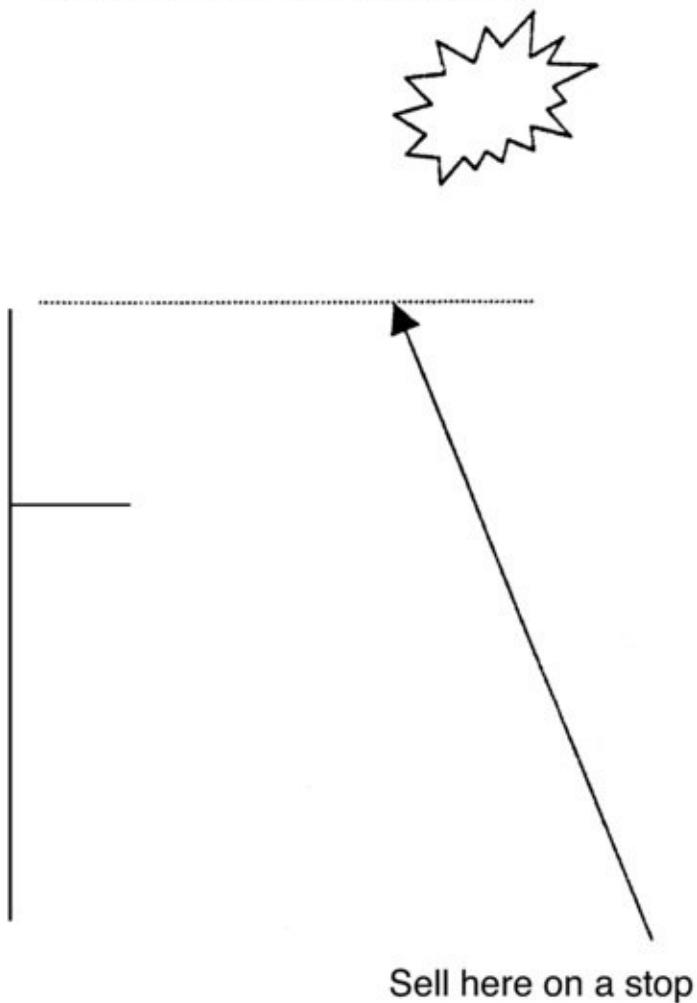


Figure 7.27 The Oops! Sell Signal

Market opens above prior high



Okay, now let's see how we might use this pattern as short-term traders. We can start with taking buy signals in the S&P 500 on any day of the week except Wednesday or Thursday, the days of the week we know are most apt to lead to declines (see [Figure 7.28](#)). The results speak more loudly than anything I might say about this pattern: the 82 percent plus accuracy, \$42,687 of profits, and a very large average profit per trade of \$438 are quite remarkable, considering the trade usually lasts 1½ days. That is, we buy today and are out on the opening tomorrow. The stop was a flat \$2,000 loss. You may want to read about stops and exits (Chapter 11) to improve on what I am presenting here.

Figure 7.28 The Oops! Pattern at Work

Data : S&P 500 IND-9967 09/80
Calc Dates : 09/15/87 - 08/28/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|--------------|-------|------|-------------------------|--------|------------------------|----------------------|
| 149 | 2 | \$ 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT | |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | \$42,687.50 | | | Gross loss | | \$ -34,000.00 | |
| Gross profit | | \$76,687.50 | | | | | | |
| Total # of trades | | 98 | | | Percent profitable | | 82% | |
| Number winning trades | | 81 | | | Number losing trades | | 17 | |
| Largest winning trade | | \$3,950.00 | | | Largest losing trade | | \$ -2,000.00 | |
| Average winning trade | | \$946.76 | | | Average losing trade | | \$ -2,000.00 | |
| Ratio avg win/avg loss | | 0.47 | | | Avg trade (win & loss) | | \$435.59 | |
| Max consecutive winners | | 23 | | | Max consecutive losers | | 3 | |
| Avg # bars in winners | | 1 | | | Avg # bars in losers | | 1 | |
| Max closed-out drawdown | | \$ -6,000.00 | | | Max intraday drawdown | | \$ -6,000.00 | |
| Profit factor | | 2.25 | | | Max # of contracts held | | 1 | |
| Account size required | | \$9,000.00 | | | Return on account | | 474% | |

How about the Bond market? Here we will take long trades any day of the week except Wednesday, and a stop-loss of \$1,800 from the point of entry. Our exit is the bailout technique, soon to be discussed. As shown in [Figure 7.29](#), the results here sure blow the random walk academicians out of the water and out of their ivory towers with 86 percent accuracy, \$27,875 profits, and a very nice average profit per trade of \$201, after commissions of \$50.

Figure 7.29 Using Oops! on Bond Trades

Data : DAY T-BONDS-9967 01/80
Calc Dates : 01/01/90 - 08/28/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|-------|--------------|-------|------|-------------------------|--------|------------------------|----------------------|
| 44 | -5 | \$ 31.250 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F62.DAT | |
| ////////////////// ALL TRADES - Test 1 ////////////////////// | | | | | | | | |
| Total net profit | | \$27,875.00 | | | Gross loss | | \$ -32,937.50 | |
| Gross profit | | \$60,812.50 | | | | | | |
| Total # of trades | | 138 | | | Percent profitable | | 86% | |
| Number winning trades | | 120 | | | Number losing trades | | 18 | |
| Largest winning trade | | \$2,031.25 | | | Largest losing trade | | \$ -2,125.00 | |
| Average winning trade | | \$506.77 | | | Average losing trade | | \$ -1,829.86 | |
| Ratio avg win/avg loss | | 0.27 | | | Avg trade (win & loss) | | \$201.99 | |
| Max consecutive winners | | 24 | | | Max consecutive losers | | 3 | |
| Avg # bars in winners | | 2 | | | Avg # bars in losers | | 3 | |
| Max closed-out drawdown | | \$ -5,812.50 | | | Max intraday drawdown | | \$ -5,812.50 | |
| Profit factor | | 1.84 | | | Max # of contracts held | | 1 | |
| Account size required | | \$8,812.50 | | | Return on account | | 316% | |

On the sell side, the rules are to sell on Wednesday if our Oops! opening gap and failure occur. Since 1990, there have been 55 trades with 31 winners netting \$9,875 using a closer \$1,000 stop and 4-day bailout exit. In the S&Ps, the best day to sell has been Thursday, which shows 78 percent winners and \$14,200 of profits. Check out the results as shown here to solidify the value of this technique (see [Figures 7.30](#) and [7.31](#)).

Figure 7.30 The Results of the Oops! Technique

```

Data : DAY T-BONDS-9967 01/80
Calc Dates : 01/01/90 - 08/28/98

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
-----
44 -5 $ 31.250 $ 0 $ 0 $ 3,000 CT/PC C:\GD\BACK67MS\F62.DAT

////////////////// ALL TRADES - Test 1 //////////////////////

Total net profit $9,875.00
Gross profit $34,031.25 Gross loss $ -24,156.25

Total # of trades 55 Percent profitable 56%
Number winning trades 31 Number losing trades 24

Largest winning trade $2,687.50 Largest losing trade $ -1,093.75
Average winning trade $1,097.78 Average losing trade $ -1,006.51
Ratio avg win/avg loss 1.09 Avg trade (win & loss) $179.55

Max consecutive winners 5 Max consecutive losers 3
Avg # bars in winners 4 Avg # bars in losers 3

Max closed-out drawdown $ -4,437.50 Max intraday drawdown $ -4,437.50
Profit factor 1.40 Max # of contracts held 1
Account size required $7,437.50 Return on account 132%

```

Figure 7.31 More Results with the Oops! Technique

```

Data : S&P 500 IND-9967 09/80
Calc Dates : 09/15/87 - 08/28/98

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
-----
149 2 $ 2.500 $ 0 $ 0 $ 3,000 CT/PC C:\GD\BACK67MS\F59.DAT

////////////////// ALL TRADES - Test 1 //////////////////////

Total net profit $14,200.00
Gross profit $40,200.00 Gross loss $ -26,000.00

Total # of trades 60 Percent profitable 78%
Number winning trades 47 Number losing trades 13

Largest winning trade $4,612.50 Largest losing trade $ -2,000.00
Average winning trade $855.32 Average losing trade $ -2,000.00
Ratio avg win/avg loss 0.42 Avg trade (win & loss) $236.67

Max consecutive winners 14 Max consecutive losers 2
Avg # bars in winners 2 Avg # bars in losers 2

Max closed-out drawdown $ -6,725.00 Max intraday drawdown $ -7,012.50
Profit factor 1.54 Max # of contracts held 1
Account size required $10,012.50 Return on account 141%

```

The most value will come, not from a mechanical rote approach to trading, but from using this technique with some intelligence layered on top of a setup market. Here is one such example of this type of thinking. The results in [Figure 7.32](#) are derived from taking my Oops! buy signals in the Bonds on any day but Thursday, if Friday's nine-day moving average is less than Thursday's. The entry is Oops! as taught. The exit is the close on the first profitable opening after 3 days in the trade: 81 percent of these trades made money, \$24,625, in fact. Check out the high average profit per trade of \$373. On the sell side, the results reflect taking Oops! sell signals on Wednesday if the 9-day average is greater on Tuesday than Monday, which reflects an overbought market. These signals have been 79 percent accurate, netting \$13,406 and a surprising \$394 profit per trade—not bad for a short-term trade, using the same rules as above for stop and exit as on the long trade (see [Figure](#)

[7.33\).](#)

Figure 7.32 Buying on Any Day but Thursdays with the Oops! Technique

| Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName | | | | | | |
|----------------------------------------------------------------------|--------------|-------------|------|-------------------------|----------|------------------------------|
| 44 | -5 | \$ 31.250 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC C:\GD\BACK67MS\F62.DAT |
| ////////////////// ALL TRADES - Test 3 ///////////////////// | | | | | | |
| Total net profit | | \$24,625.00 | | | | |
| Gross profit | | \$46,750.00 | | Gross loss | | \$ -22,125.00 |
| Total # of trades | 66 | | | Percent profitable | | 81% |
| Number winning trades | 54 | | | Number losing trades | | 12 |
| Largest winning trade | \$2,625.00 | | | Largest losing trade | | \$ -2,125.00 |
| Average winning trade | \$865.74 | | | Average losing trade | | \$ -1,843.75 |
| Ratio avg win/avg loss | 0.46 | | | Avg trade (win & loss) | | \$373.11 |
| Max consecutive winners | 20 | | | Max consecutive losers | | 2 |
| Avg # bars in winners | 3 | | | Avg # bars in losers | | 6 |
| Max closed-out drawdown | \$ -5,500.00 | | | Max intraday drawdown | | \$ -5,500.00 |
| Profit factor | 2.11 | | | Max # of contracts held | | 1 |
| Account size required | \$8,500.00 | | | Return on account | | 289% |

Figure 7.33 Oops! Sells on Wednesday.

| Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName | | | | | | |
|----------------------------------------------------------------------|--------------|-------------|------|-------------------------|----------|------------------------------|
| 44 | -5 | \$ 31.250 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC C:\GD\BACK67MS\F62.DAT |
| ////////////////// ALL TRADES - Test 4 ///////////////////// | | | | | | |
| Total net profit | | \$13,406.25 | | | | |
| Gross profit | | \$25,281.25 | | Gross loss | | \$ -11,875.00 |
| Total # of trades | 34 | | | Percent profitable | | 79% |
| Number winning trades | 27 | | | Number losing trades | | 7 |
| Largest winning trade | \$2,375.00 | | | Largest losing trade | | \$ -1,812.50 |
| Average winning trade | \$936.34 | | | Average losing trade | | \$ -1,696.43 |
| Ratio avg win/avg loss | 0.55 | | | Avg trade (win & loss) | | \$394.30 |
| Max consecutive winners | 8 | | | Max consecutive losers | | 1 |
| Avg # bars in winners | 4 | | | Avg # bars in losers | | 6 |
| Max closed-out drawdown | \$ -2,781.25 | | | Max intraday drawdown | | \$ -3,312.50 |
| Profit factor | 2.12 | | | Max # of contracts held | | 1 |
| Account size required | \$6,312.50 | | | Return on account | | 212% |

S&P OOPS! TRADING

The same idea meets with success in trading the S&P; here the best buy days, given the oversold criteria as established by the nine-day trend, are Tuesday, Wednesday, and Friday. This combination shows 81 percent accuracy and \$22,650 of profits with an average profit, after losses, of \$456, a remarkable feat for getting in and out the same day (see [Figure 7.34](#)). The idea of the nine-day moving average to set up the trade is based on work by Joe Krutsinger, a protégé of mine and avid system developer.

Figure 7.34 Oops! Buys in a Down Trend on Tuesday, Wednesday, and Friday

| Data | | : S&P 500 IND-9967 09/80 | | | | | | |
|---------------------------------------------------------------------|-------|--------------------------|--------------|------|----------|-------------------------|--------|------------------------|
| Calc Dates | | : 09/15/87 - 08/28/98 | | | | | | |
| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 1 ///////////////////// | | | | | | | | |
| Total net profit | | | \$22,362.50 | | | | | |
| Gross profit | | | \$40,600.00 | | | Gross loss | | \$ -18,237.50 |
| Total # of trades | | | 49 | | | Percent profitable | | 81% |
| Number winning trades | | | 40 | | | Number losing trades | | 9 |
| Largest winning trade | | | \$3,875.00 | | | Largest losing trade | | \$ -2,237.50 |
| Average winning trade | | | \$1,015.00 | | | Average losing trade | | \$ -2,026.39 |
| Ratio avg win/avg loss | | | 0.50 | | | Avg trade (win & loss) | | \$456.38 |
| Max consecutive winners | | | 28 | | | Max consecutive losers | | 2 |
| Avg # bars in winners | | | 1 | | | Avg # bars in losers | | 0 |
| Max closed-out drawdown | | | \$ -4,925.00 | | | Max intraday drawdown | | \$ -4,925.00 |
| Profit factor | | | 2.22 | | | Max # of contracts held | | 1 |
| Account size required | | | \$7,925.00 | | | Return on account | | 282% |

The best sell in this market, using the nine-day overbought technique is to take sells on Wednesday to make \$18,962 with 89 percent accuracy on 35 trades (see [Figure 7.35](#)). The average profit of \$486 per trade drives home the validity of the approach.

Figure 7.35 Oops! after the 17th Trading Day of the Month

| Data | | : S&P 500 IND-9967 09/80 | | | | | | |
|---------------------------------------------------------------------|-------|--------------------------|--------------|------|----------|-------------------------|--------|------------------------|
| Calc Dates | | : 09/15/87 - 08/28/98 | | | | | | |
| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| ////////////////// ALL TRADES - Test 2 ///////////////////// | | | | | | | | |
| Total net profit | | | \$18,962.50 | | | Gross loss | | \$ -8,000.00 |
| Gross profit | | | \$26,962.50 | | | | | |
| Total # of trades | | | 39 | | | Percent profitable | | 89% |
| Number winning trades | | | 35 | | | Number losing trades | | 4 |
| Largest winning trade | | | \$3,175.00 | | | Largest losing trade | | \$ -2,000.00 |
| Average winning trade | | | \$770.36 | | | Average losing trade | | \$ -2,000.00 |
| Ratio avg win/avg loss | | | 0.38 | | | Avg trade (win & loss) | | \$486.22 |
| Max consecutive winners | | | 26 | | | Max consecutive losers | | 2 |
| Avg # bars in winners | | | 1 | | | Avg # bars in losers | | 2 |
| Max closed-out drawdown | | | \$ -4,000.00 | | | Max intraday drawdown | | \$ -4,000.00 |
| Profit factor | | | 3.37 | | | Max # of contracts held | | 1 |
| Account size required | | | \$7,000.00 | | | Return on account | | 270% |

Now let's look at another way of using our Oops! entries in the S&P 500. For years, researchers have noted that stock prices tend to rally around the first of the month. This sets up a perfect Oops! trade. Should this pattern occur at the end of the month, and on a trading day after the 17th trading day of the month, our pattern and the monthly influence come together. These are good trades!

Knowing that this end-of-the-month rally spills into the next month, I tested taking all Oops! in Bonds after the first TDM through the 5th. The results are equally

impressive. This combination setup is one of the most powerful short-term trades you will find to consistently appear, month in and month out.

Some observers may suggest we are curve-fitting things here by taking the Oops! signals only during a limited window of opportunity. That could be, but let me hastily add that I first became aware of this “window of opportunity” in 1966 when I read Art Merrill’s classic, *The Behavior of Prices on Wall Street*. I believe Merrill, a delightful, white-haired grandfather figure, was the first to note the rally tendency at this time and fully discussed it in his works.

All I have done is add my Oops! entry, a reasonable stop and exit, to a known market bias. To the best of my knowledge, no one noticed this same pattern or tendency exists in Bonds until 1988 when I revealed it to my students; so again, we have lots of out-of-sample experience. This is not a conclusion looking for a promise. Merrill and others, notably Norm Fosback and Glen Parker, have suggested the end-of-the-month stock rally is due to mutual funds balancing and window-dressing their holdings. Once I discovered that Bonds rally at this time, I took the position that stocks rally not because of the funds but because of Bonds. As go Bonds, so go stocks. Always keep in mind that Bonds (interest rates) are the dog that wags the tail, which is stocks.

Virtually any time you have a bullish outlook or bias in the market, Oops! buys are worth taking, just as Oops! sells are worth taking when you have a bearish outlook. This pattern works wonders, given an underlying reason. It is the single best pattern I have discovered: Enjoy it, treat it with care, and use it with wisdom.

RECAP

By now you should understand why so many people look at charts ... they can be helpful, but most traders are not aware of the patterns that can lead to market reversals or buy and sell signals. Now you know the ones I use.

CHAPTER 8

Separating the Buyers from the Sellers

If it is true there is a buyer for every seller, how can prices move up and down? Which came first, the chicken or the egg, the buyer or the seller? I suppose this is the ultimate Zen koan that speculators must answer before attaining enlightenment. On the surface, it seems prices should never vary much if you must have a seller to give shares or contracts to a buyer. Shouldn't they balance each other out?

In a perfect world they would, but this is an imperfect world and an even more imperfect game of chance. Reality, as represented in your daily newspaper or in quotes from your broker, tells us prices do move, often wildly. The reason for price changes is not the amount of shares or contracts bought and sold; after all, they are matched. The reason price fluctuates is that one side, the buyer or the seller, blinks.

In other words, one side in this equation wants to establish a position and will pay up, or sell down. The imbalance that causes price change is not one of volume but of immediacy ... the side that wants it and wants it now, is the side that pushes prices higher or lower.

As mentioned, we can break down the amount of buying and selling that took place in a given day by using the opening price. This chapter describes the elements of a trading system and approach that I used to make more than \$1,000,000 in 1987.

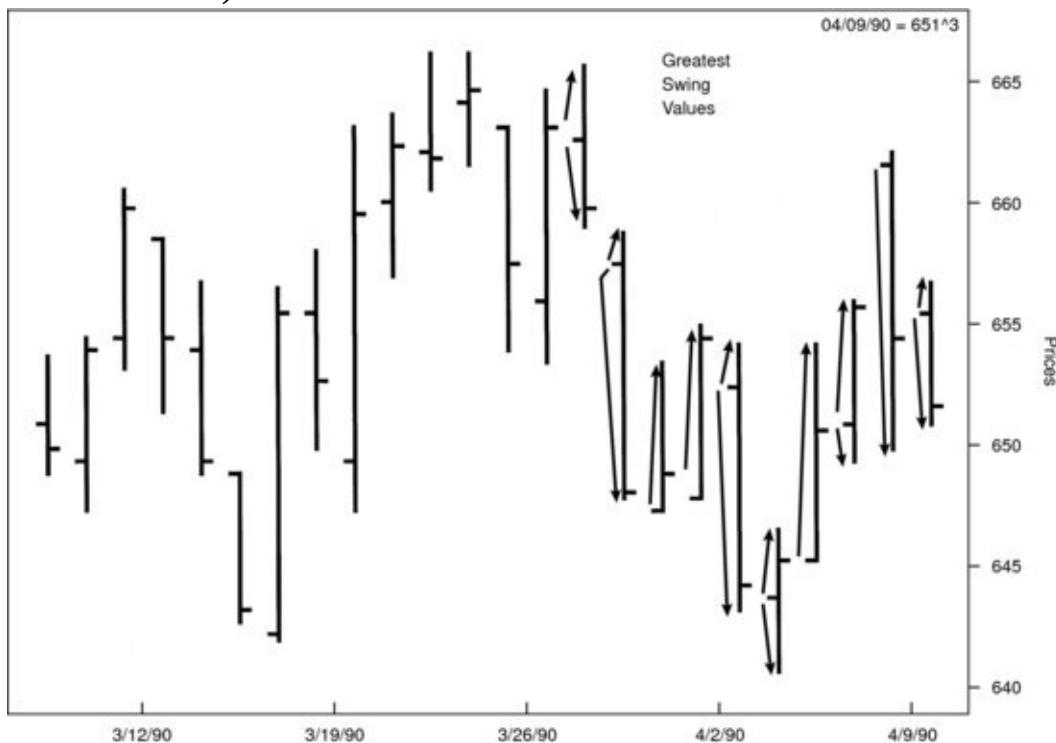
Consider this: Each day the commodity opens for trading at a price established by an open outcry based on the buy and sell orders that have built up overnight.

On March 27, 1998, May Pork Bellies opened at 46.20, traded down to a low at 45.95 and up to a high at 48.60. Buyers were able to push prices 2.40 points above the open and .25 points below the opening. We have two swings here, the upswing of 2.40 points and a downswing of .25. Price closed for the day at 48.32 up from the previous day's close at 46.40.

[Figure 8.1](#) shows the greatest swing values marked off, so that you can see the actual workings in a real market: Soybeans in March 1990. Each day you have a buy swing and a sell swing. The direction of the close compared to the open tells us which side won the battle. In this case, after the open, a selling wave was established and price went down.25 in Pork Bellies; we then closed higher. If the day after the up close, price moves more than .25 points below the opening, we have a new amount of sellers in the marketplace. Thus a sell signal may be in effect as we have drawn

more sellers in today than yesterday.

Figure 8.1 Soybeans (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)



We can take this a little further. If I add up all the open to low swings for the past few days, I have an average of the amount of selling swings that have taken place and suspect that any swing from today's open that exceeds this average may be indicative of a sell signal.

But hold on, it is a bit more complicated. To really get a handle on the sellers, you need to take this measure on just days that closed above the opening, as this swing value is the amount price could decline *without* triggering a down close day.

By the same token, if you were to add up the swings from the open to the daily highs (on down close days), you would arrive at the swing values the market could rally without setting off a wave of buying resulting in an up close.

GREATEST SWING VALUE

The use of the greatest swing value (GSV) has been greatly diminished by electronic trading. As discussed earlier, we no longer have the gap from last night's close to this morning's opening, thus the measure of volatility that I was using in the late 1990s of the price swing from the open to the high is no longer valid.

And it gets worse ... back then I was adding this filter value to the next day's

opening. But since next day's opening is essentially at today's close, with the exception of Sunday evening markets, our reference point has also shifted. What once worked no longer works.

Perhaps there are other ways you can address this issue, is what you are most likely thinking. Let me share the approaches I have taken to resurrect the greatest swing value concept. I have tried using the prior day's high, low, and close as the reference points to add some value to. I tested a variety of different values from these reference points. I tried the average true range for the last X number of days from the opening and the close as well as the prior day's close. A variety of reference points were tested with a variety of volatility factors used.

Despite this extensive research I was not able to create anything worthy of stepping into a real trading system. The only consistent thing, which fascinates me, is the trading day of the week (TDW) data still held up. Fridays are still strong for the Bond market, Tuesdays are still the strong day for the stock market ... these observations have held up. And the trading day of the month (TDM) concept has held up, as well.

But with the advent of electronic markets it is difficult to establish what precise point triggers traders to hop aboard for a potential rally. I wish I could report otherwise, but the world of trading is about facts, and those are the facts.

The markets change. It is our obligation to change and adapt to the markets, because they're certainly not going to adapt to what we will do. When what once worked no longer works, it is foolish to continue in the wrong direction.

Thus, while much of what was written back then is interesting, it is time we turn our attention to new ways of using market swings or perhaps volatility to help short-term traders.

GSV can be used in many profitable ways. The more work you do with the concept, the more you will appreciate the logic of finding the upswings on down days and downswings on up days. I categorize these swings as "failure swings": The market could swing that much, yet not hold it or follow through, and then closed in the opposite direction.

Let's look at some things you could do with these values. You could determine the average failure swings, say for the past few days, and use that as your entry, added or subtracted to the next day's opening. Or how about taking all the failure swings for X number of days and then take one or two standard deviations of that value added to the value to trigger your entry?

I will start with a simple and profitable way of using these values for trading the Bond market. My first step is to create a setup for the trade, as I don't want to trade on just one technical goody all by itself. My setup will be an oversold market: Prices have been declining, so a rally of some sort should be in the future, and I am

combining this with one of my prized possessions, the TDWs, as discussed earlier.

In this case, the first part of the setup is to have today's close lower than the close five days ago, suggesting Yin may turn into Yang. I also want to limit my buying to only one of three days of the week: Tuesday, Wednesday, and Friday.

Once that part of the setup exists, I will take the difference from open to the high for each of the past four days and divide that by four to get the average "buy swing." I want real proof the market is tracking in fresh ground, new territory, so I will be a buyer above the opening at an amount equal to 180 percent of the four-day swing value average.

The *sell signal* is a mirror image in that I take the distance from the open to the low for each of the past four days and divide by four to get the average. This is also multiplied by 180 percent and subtracted from the opening *if the sell setup exists*.

The sell setup consists of Bonds closing greater than the close six days ago, and for even better performance, I would also like to see the price of Gold lower than the price of Gold 20 days ago.

Whether long or short, my stop is \$1,600. I will take profits on the first profitable opening after being in the trade for two days. The results of this program from 1990 to 1998 are shown in [Figure 8.2](#). As you can see, they are rather remarkable, telling us the importance of setup criteria coupled with the greatest swing value concept. Frankly, I do not know of any Bond systems being sold by all the technical hotshots that can match these results.

[**Figure 8.2**](#) GSV in Bonds

Data : DAY T-BONDS-9967 01/80
 Calc Dates : 01/01/90 - 08/28/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|----------------------------------------------------------------|-------|--------------|-------|-------------------------|----------|--------|------------------------|----------------------|
| 44 | -5 | \$ 31.250 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F62.DAT | |
| ////////////////// ALL TRADES - Test 1 ///////////////////// | | | | | | | | |
| Total net profit | | \$52,812.50 | | | | | | |
| Gross profit | | \$105,000.00 | | Gross loss | | | | \$-52,187.50 |
| Total # of trades | | 161 | | Percent profitable | | | | 75% |
| Number winning trades | | 122 | | Number losing trades | | | | 39 |
| Largest winning trade | | \$3,437.50 | | Largest losing trade | | | | \$-1,718.75 |
| Average winning trade | | \$860.66 | | Average losing trade | | | | \$-1,338.14 |
| Ratio avg win/avg loss | | 0.64 | | Avg trade (win & loss) | | | | \$328.03 |
| Max consecutive winners | | 13 | | Max consecutive losers | | | | 2 |
| Avg # bars in winners | | 4 | | Avg # bars in losers | | | | 3 |
| Max closed-out drawdown | | \$-6,343.75 | | Max intraday drawdown | | | | \$-6,781.25 |
| Profit factor | | 2.01 | | Max # of contracts held | | | | 1 |
| Account size required | | \$9,781.25 | | Return on account | | | | 539% |
| ////////////////// LONG TRADES - Test 1 ///////////////////// | | | | | | | | |
| Total net profit | | \$48,187.50 | | Gross loss | | | | \$-40,093.75 |
| Gross profit | | \$88,281.25 | | | | | | |
| Total # of trades | | 122 | | Percent profitable | | | | 77% |
| Number winning trades | | 94 | | Number losing trades | | | | 28 |
| Largest winning trade | | \$3,437.50 | | Largest losing trade | | | | \$-1,687.50 |
| Average winning trade | | \$939.16 | | Average losing trade | | | | \$-1,431.92 |
| Ratio avg win/avg loss | | 0.65 | | Avg trade (win & loss) | | | | \$394.98 |
| Max consecutive winners | | 13 | | Max consecutive losers | | | | 2 |
| Avg # bars in winners | | 4 | | Avg # bars in losers | | | | 4 |
| ////////////////// SHORT TRADES - Test 1 ///////////////////// | | | | | | | | |
| Total net profit | | \$4,625.00 | | Gross loss | | | | \$-12,093.75 |
| Gross profit | | \$16,718.75 | | | | | | |
| Total # of trades | | 39 | | Percent profitable | | | | 71% |
| Number winning trades | | 28 | | Number losing trades | | | | 11 |
| Largest winning trade | | \$1,593.75 | | Largest losing trade | | | | \$-1,718.75 |
| Average winning trade | | \$597.10 | | Average losing trade | | | | \$-1,099.43 |
| Ratio avg win/avg loss | | 0.54 | | Avg trade (win & loss) | | | | \$118.59 |
| Max consecutive winners | | 6 | | Max consecutive losers | | | | 2 |
| Avg # bars in winners | | 2 | | Avg # bars in losers | | | | 2 |
| Max closed-out drawdown | | \$-2,500.00 | | Max intraday drawdown | | | | \$-2,500.00 |
| Profit factor | | 1.38 | | Max # of contracts held | | | | 1 |
| Account size required | | \$5,500.00 | | Return on account | | | | 84% |

STOCK INDEX TRADING WITH GREATEST SWING VALUE

The same basic formula works for trading the S&P 500. Again, we will take 180 percent of the four-day average buy swing value (the highs minus the opens) and, for sell, the four-day average swing sell value (closes minus the lows). As you might suspect, the results can be dramatically improved by demanding Bonds close higher than 15 days ago for a buy and lower than 15 days ago for a sell. Fundamentals do make a difference; don't let any frayed-cuff chartist or fast-talking technician tell you otherwise. Our TDW filter will be to buy on Monday, Tuesday, or Wednesday. Shorts will be taken any day but Monday. The setup also consists of a close lower than six days ago for a buy, higher than six days ago for a sell, giving us an overextended market condition.

The results say it all, \$105,675 of profits with 67 percent winning trades using a

flat dollar stop of \$2,500 and the bailout exit ([Figure 8.3](#)). Not as much money was made on the short side, but money was made; and considering the gargantuan bull market this took place in, the results are pretty good. Proof comes from the average profit per trade of \$427.

Figure 8.3 Greatest Swing Value at .80 in the S&P 500

| Data : S&P 500 IND-9967 09/80 Calc Dates : 09/15/87 - 08/28/98 | | | | | |
|-------------------------------------------------------------------|-------|----|--------------|-------------------------|---------------------------------------------|
| Num. | Conv. | P. | Value | Comm | Slippage Margin Format Drive:\Path\FileName |
| 149 | 2 | \$ | 2,500 | \$ 0 | \$ 0 \$ 3,000 CT/PC C:\GD\BACK67MS\F59.DAT |
| ALL TRADES - Test 4 | | | | | |
| Total net profit | | | \$105,675.00 | Gross loss | \$-171,575.00 |
| Gross profit | | | \$277,250.00 | | |
| Total # of trades | | | 247 | Percent profitable | 67% |
| Number winning trades | | | 167 | Number losing trades | 80 |
| Largest winning trade | | | \$10,962.50 | Largest losing trade | \$-3,587.50 |
| Average winning trade | | | \$1,660.18 | Average losing trade | \$-2,144.69 |
| Ratio avg win/avg loss | | | 0.77 | Avg trade (win & loss) | \$427.83 |
| Max consecutive winners | | | 10 | Max consecutive losers | 5 |
| Avg # bars in winners | | | 4 | Avg # bars in losers | 4 |
| Max closed-out drawdown | | | \$-12,500.00 | Max intraday drawdown | \$-13,462.50 |
| Profit factor | | | 1.61 | Max # of contracts held | 1 |
| Account size required | | | \$16,462.50 | Return on account | 641% |
| LONG TRADES - Test 4 | | | | | |
| Total net profit | | | \$51,575.00 | Gross loss | \$-96,862.50 |
| Gross profit | | | \$148,437.50 | | |
| Total # of trades | | | 123 | Percent profitable | 65% |
| Number winning trades | | | 81 | Number losing trades | 42 |
| Largest winning trade | | | \$10,962.50 | Largest losing trade | \$-3,587.50 |
| Average winning trade | | | \$1,632.56 | Average losing trade | \$-2,306.25 |
| Ratio avg win/avg loss | | | 0.79 | Avg trade (win & loss) | \$419.31 |
| Max consecutive winners | | | 8 | Max consecutive losers | 4 |
| Avg # bars in winners | | | 4 | Avg # bars in losers | 3 |
| SHORT TRADES - Test 4 | | | | | |
| Total net profit | | | \$54,100.00 | Gross loss | \$-74,712.50 |
| Gross profit | | | \$128,812.50 | | |
| Total # of trades | | | 124 | Percent profitable | 69% |
| Number winning trades | | | 86 | Number losing trades | 38 |
| Largest winning trade | | | \$9,125.00 | Largest losing trade | \$-3,100.00 |
| Average winning trade | | | \$1,497.82 | Average losing trade | \$-1,966.12 |
| Ratio avg win/avg loss | | | 0.76 | Avg trade (win & loss) | \$436.29 |
| Max consecutive winners | | | 9 | Max consecutive losers | 6 |
| Avg # bars in winners | | | 4 | Avg # bars in losers | 6 |
| Max closed-out drawdown | | | \$-16,575.00 | Max intraday drawdown | \$-16,662.50 |
| Profit factor | | | 1.72 | Max # of contracts held | 1 |
| Account size required | | | \$19,662.50 | Return on account | 275% |

Better Than It Looks

The results shown may also be considerably better than they appear. This is because my computer software does not allow us to bring into play a protective stop on the day of entry, that you can use in real-time trading. Thus our real-time trading stop is most likely going to be closer to the market than what the computer shows. In real-time trading, I will use a stop at or slightly above or below the open, once I am filled on a long or short.

If price goes back there, after rallying the percentage of the swing value required to trigger a signal, the move we were playing for is questionable, we got a

momentum run, but it didn't stick. In absence of this stop, you certainly must have one taking out the low of the day, this would be a sure sign of failure, thus resulting in less loss than illustrated by the computer printout.

More Uses for the Concept

I have also used this idea to help me when I am confused. If I am in a position and looking for a place to exit, or maybe want to establish a position but do not have any clear-cut entry points, I will use the GSV to tell me when the current spate of buying/selling has been reversed. All I need to do is calculate the buy and sell swing values running the average as a tight stop or entry point.

Intraday traders can use this value a bit differently. What many of them want to do (not me, though) is sell what should be an overbought area and, buy an oversold area. In this case, the GSV will tell you about how far above the open you can sell, the largest failed value of the past few days, and then you would place a stop and reverse slightly above that value. You would buy below the open a distance of the largest failed down swing value, with a stop below that.

Here is a case in point. [Table 8.1](#) shows the daily action of the S&P 500 in March 1998 along with the *sell swing values*. Once we arrive at the four-day average on March 16 and multiply it by 180 percent we have a buy point (5.50 points) that much below the opening on the 17th with a fill at 1086.70. [Table 8.1](#) shows how it looked.

Table 8.1 Daily Action of the S&P 500

| | Open | High | Low | Close | GSV |
|---------------------------------------------------------|----------|----------|----------|----------|------|
| 3/11 | 1,078.00 | 1,082.40 | 1,077.20 | 1,080.80 | 0.80 |
| 3/12 | 1,080.00 | 1,085.20 | 1,075.50 | 1,084.00 | 4.50 |
| 3/13 | 1,087.00 | 1,088.60 | 1,078.40 | 1,080.90 | 8.60 |
| 3/16 | 1,085.00 | 1,092.40 | 1,084.60 | 1,091.70 | .40 |
| GSV Four-Day Average = $14.30/4$ or $3.57 * 180 = 6.45$ | | | | | |
| 3/17 Open is $1,092.20 - 6.45$ Buy at 1,085.75 | | | | | |
| 3/17 | 1,092.20 | 1,094.50 | 1,086.00 | 1,094.20 | |

Your stop on the long should be 225 percent of the four-day average swing value of 3.57 or 8.00—the 1092.20 open giving us a stop at 1084.20.

You can always determine the general area where a market should find support and resistance with the GSV concept. My work suggests contratrend moves of 180 percent with a 225 percent stop work quite well.

Yet another way I have traded and made money with this idea is to wait for a down close in the S&P 500 on Friday. I then buy Monday at the open plus Friday's high minus Friday's open swing value. I back this with Bonds closing on Friday greater than they did 15 days ago. The following results show simply using the bailout exit

and a \$2,500 stop. Practically speaking, I exit the trade at the open minus the swing value, unless the swing value is very large. In that case, I admit defeat if price trades below the lowest price seen in the day prior to going long. The time period here is from 1982 through March 1998. This is the most successful interday mechanical trading technique I know of.

It does not require a quote machine, any software, or constant phone calls to your broker. Once the setup is present (Bonds greater than 15 days ago, and Friday closes down), you buy at the next day's open plus the buying swing value from Friday. Certainly, this takes no great skill, only the willingness to patiently wait for trades, then the gumption to put them on (see [Figure 8.4](#)).

Figure 8.4 Greatest Swing Value Buying on Mondays Following a Down Close

| Data | | : S&P 500 IND-9967 | | 09/80 | |
|---------------------------------|-------------|-----------------------|-------------------------|-------------|--------------|
| Calc Dates | | : 09/15/87 - 08/28/98 | | | |
| Num. | Conv. | P. Value | Comm | Slippage | Margin |
| 149 | 2 | \$ 2,500 | \$ 0 | \$ 0 | \$ 3,000 |
| <hr/> // ALL TRADES - Test 1 // | | | | | |
| Total net profit | | \$57,087.50 | | Gross loss | \$-60,500.00 |
| Gross profit | | \$117,587.50 | | | |
| Total # of trades | 161 | | Percent profitable | 86% | |
| Number winning trades | 139 | | Number losing trades | 22 | |
| Largest winning trade | \$7,625.00 | | Largest losing trade | \$-2,750.00 | |
| Average winning trade | \$845.95 | | Average losing trade | \$-2,750.00 | |
| Ratio avg win/avg loss | 0.30 | | Avg trade (win & loss) | \$354.58 | |
| Max consecutive winners | 26 | | Max consecutive losers | 2 | |
| Avg # bars in winners | 1 | | Avg # bars in losers | 2 | |
| Max closed-out drawdown | \$-5,500.00 | | Max intraday drawdown | \$-5,500.00 | |
| Profit factor | 1.94 | | Max # of contracts held | 1 | |
| Account size required | \$8,500.00 | | Return on account | 671% | |

Similar trading strategies can be developed for all markets using the GSV concept; just make certain you first define valid setups for the buys and sells. My favorite setups are days of the week, highly correlated data streams, seasonals, market patterns, and overbought/sold conditions.

SOME POINTERS

Over the years, I have tried various time periods to see whether there is any ideal number of days to use in the calculation. My original thought was that one would want to use a 10-day period to arrive at the best average; after all, the more observations of swing value variance the more stable the answer should be, or so I thought. I was wrong on that. In almost all cases, the previous one to four days produce the best value in trading or developing systems.

The basics here involve volatility breakouts above or below the opening. The amount of breakout we are looking for is the amount that contained moves up to this

point. Thus a critical element is to take buy signals only after down days, sells after up days.

Finally, keep in mind that this is a “dumb” technique: It knows not when a big trade will come or even when a winning trade will be delivered on a silver platter. That is why you cannot pick and choose these trades, you must simply take them, one at a time, as they come out of the hopper. If you pick and choose, you will invariably pick the losers and walk away from the winners. It is nothing personal, we all do, and *the way to beat this devil is to take ‘em all.*

To my way of thinking, the GSV concept is the most solid and logical approach to volatility breakouts. This failed swing measure has such great merit that I hope someone else, maybe you, will take it past the point I have reached. Perhaps the better answer lies in the standard deviation approach mentioned earlier, perhaps in using the GSV in relationship to the previous day's range. I am really not certain. What I am certain of is that this is one of the most powerful techniques in my bag of tricks and perhaps the most durable. It has served me well since I had the insight into the idea in 1977. Fancy math may improve the results, but it is not necessary to make this work.

RECAP

What I hope you learn from this chapter is that we can define volatility or swings and use this as a measure of price action from which to key off. Markets create swings from point to point and exceeding the average of these means something out of the average has just taken place.

CHAPTER 9

Short-Term Trading from a Quote Screen

The markets can be understood looking backward, but must be traded looking forward.

What I have shared with you so far is the general way that I trade. I use daily bar charts to set up patterns and relationships that usually spur short-term moves of two to four days. This is my style; it may not be yours.

People like the idea of day trading as there is no risk of anything happening overnight. Their fear is that a large adverse move may take place from today's close to tomorrow's opening. Their fear is news, change, and uncontrollable price action. They like the idea that at the end of the day it is all over, win, lose, or draw. There are no agonizing losses to take home and interrupt your sleep. Make no mistake about it, all this is true, but for everything you get in life you give up something in life. What you give up when you day-trade is any opportunity at all to catch a large and sustained move, as mentioned earlier.

To most people, the term “short-term trading” means being glued to a quote screen throughout the market trading day. They envision a high-pressure guy or gal with a phone in each ear, screaming something like “Buy Chicago, sell New York.” Certainly, this type of trading is hectic, and if you are going to trade this way, you had better make certain you have the temperament required for the job. I will tell you what I think that temperament is, and then tell you what my quest for this Holy Grail of commodity trading has revealed.

Quote screen traders need three qualities: intensity, the ability to make intelligent choices, and the capacity to react, without any more thinking, to the conditions at hand.

If you are the type who *needs time* to make a decision, or who freezes, refusing to take action once a decision has been made, this is not your game. Winning at this game requires making instant decisions and immediately reacting; there is no time for pontificating or reconsidering. If you cannot make decisions this way, you will be slaughtered in a matter of months. It is a game of the quick and the dead. If you are not quick, you will be dead. It is as simple as that. Short-term trading of this nature requires the physical ability to instantly pounce on a market and just as instantly reverse the decision you made just a few seconds ago, if that is what

conditions dictate. It is a good thing the meek inherit the earth, because they will never get rich as day traders.

Following the intraday ebb and flow of prices on a screen, day after day after day, requires the ability to be focused and intense every hour of each trading session. This is not an occupation for daydreamers. If you cannot maintain concentration, you will get hurt; it is forgetting to do what you should do, not being there (physically or mentally) at that one critical minute—only 60 seconds—that spells the difference between life and death in your trading. It is not easy work to maintain this focused and intense attention, particularly when your spouse calls to ask you some mundane question about the garden or plumbing at home, or a close friend calls to chat. Do you have the guts to tell them you can't talk now, to hang up on a close friend, to refuse to take calls from your wife or husband? If so, you are qualified for the job; if not, better rethink day trading.

I assure you that the instant you get distracted by that phone call is the instant the market will have a major move, catching you off guard. Well, don't say I didn't warn you. Now let's look at the object of this game. You must also be able to change your view of the future in an instant. This is not a career for inflexible people.

For some unknown reason, people flock to day trading thinking it will limit their risk. After all they ask, "If you're out by the end of the day, how can you possibly lose money overnight?"

To paraphrase the poet Elizabeth Browning, "How many ways can I lose money day-trading? Let me count the ways." While on the surface of things it may appear that day trading should be an easy way to pick up some extra money, the truth is far different. Day traders are defying the mathematical odds of investing.

Let me explain what I mean by that. Trend is the basis of all trading and investment profits. When there is no trend, there is no ability to reap a profit. So you ask, "What causes trend?"

I reply, "Trend is a function of time. The more time you have in a trade the more opportunity you have for a trend to develop."

This then, is the Achilles' heel of short-term traders ... time is not on their side. They are in and out of the trade in a matter of minutes, or if they can hold for an entire day, then for just a few hours. That means they limit themselves. It is literally impossible for them to capture a large trend (profit) because they curtail the potential trend based on the time limitations applied to themselves. The most certain way to make money in the market is to have a small position and capture a large move.

Day traders do it upside down. The only way they can make a great deal of money is to have a large position and capture a small move. See how they have turned the mathematical tables upon themselves? They have put themselves at a disadvantage

because when they have a large position ... at some point in time ... they most definitely will have a large loss.

Since day trading is neither easy, nor a guaranteed way to instant wealth, numerically speaking you tend to have more losses than profits. That is exactly when the large losing trades catch up with us. One large loss can wipe out numerous profitable trades. So, while you were correct 80 percent of the time, the one large loss destroyed all of the small profits.

When my father, who was much smarter than I will ever be, retired from working in an oil refinery (he was the instrument foreman for refinery rats), he thought he could make some money in short-term trading by visiting the brokerage firm and watching prices on television. It took him about a month to realize how difficult that was. He told me, "Larry, it was even more difficult than trying to raise you."

I doubt if what I have just written has thwarted you from becoming a day trader, but at least you cannot say you that you were not warned. All too often the dream of day trading becomes a nightmare. Tread softly here.

Here I am 13 years later with the same message; Day Trading most often leads to nightmares ... but for those that want to give it a try, here are some proven approaches.

HOW A QUOTE-SCREEN TRADER MAKES MONEY

A short-term trader has one objective: to catch the current trend of the market. That is it. That is all you should try to do!

It sounds easy, but trust me—it is far from simple, and for two reasons. The first is that trend identification is an art and science unto itself, and more abstract art at that. It is a blend of Picasso and Cézanne with a splash of Chagall tossed in for fun. Second, even if you correctly spot the trend change, your reactive mind may screw things up and blow it for you. This is especially true if you are long with a loss or nominal profit and suddenly get a sell signal.

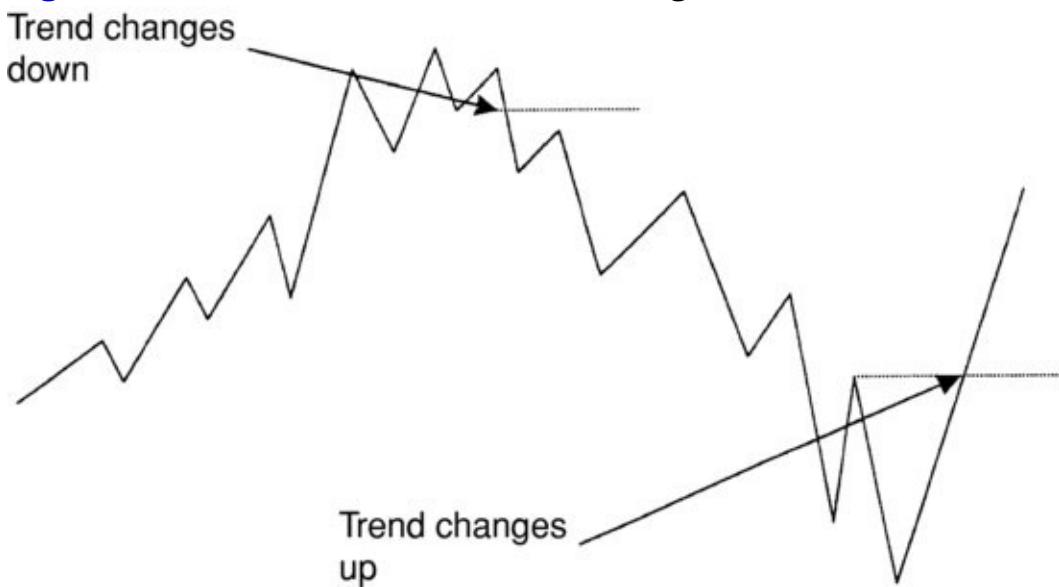
Do not confuse day trading with your long-term outlook; that is about something happening in the future. Day traders don't—can't—care about the future. Your only concern is being in phase with the current short-term trend. Your mission, should you accept this assignment, is to mimic what the market is doing. If it is up, you should be long, if down, short. Trying to forecast short-term tops and bottoms is a surefire way to rapidly deplete your bankroll. You want to be with the trend; it is your only friend.

Since greed is a stronger emotion than fear, your response will most often be to

“hold and hope,” which means you bypass the current new trend, holding on to the long position, hoping the sell will be wrong when you should have spun on a dime. Dopes hope, winners are spinners.

My point is that we are trying to do two very difficult things: beat the identification of trend changes and beat our “brains” by outsmarting ourselves. That is the challenge. My first technique for identifying trend changes comes from the short-term “ringed” high and low concept we went over in Chapter 1. This concept allows us to identify short-term swing points. A trend change from up to down occurs when a short-term high is exceeded on the upside, a short-term trend change from down to up is identified by price going below the most recent short-term low. [Figure 9.1](#) depicts such trend changes in a classic manner; study it well because reality comes next!

[Figure 9.1](#) Classic Patterns of Trend Change

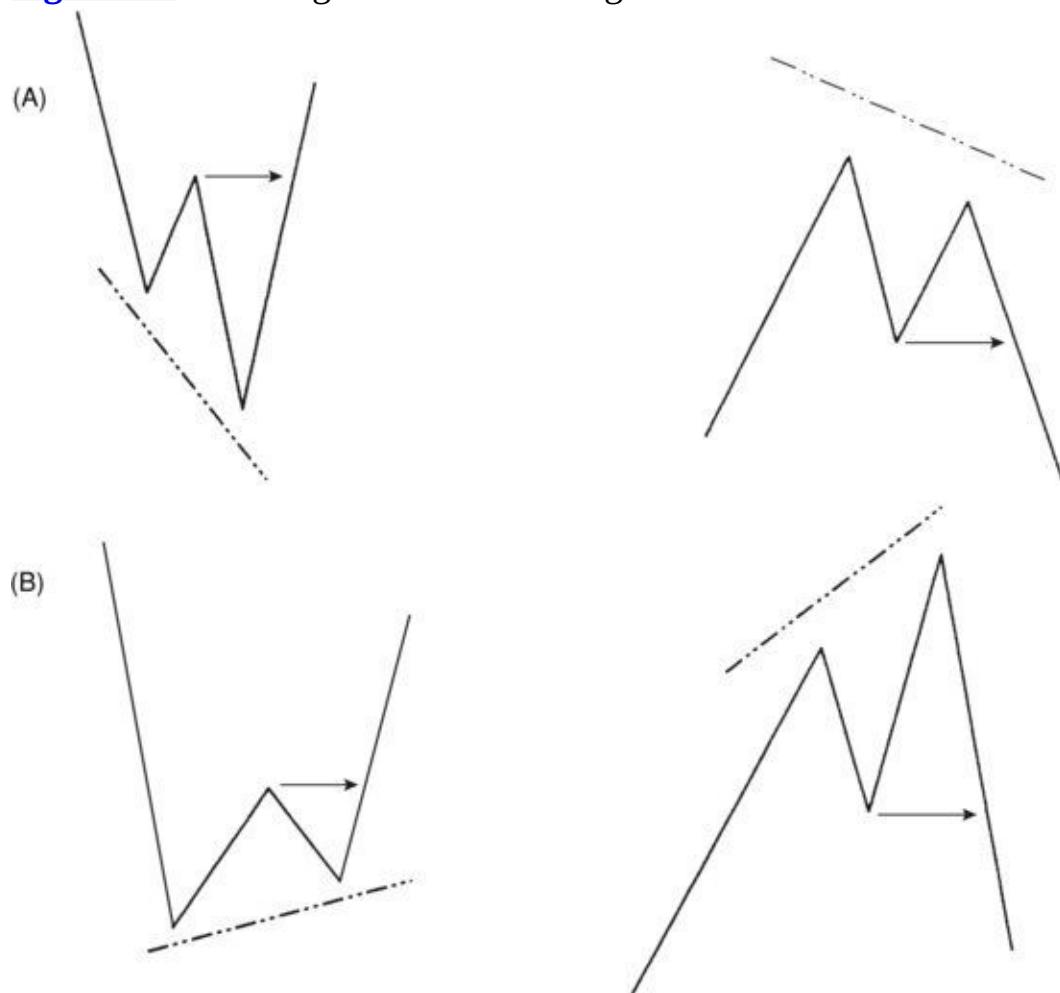


SWING POINTS AS TREND CHANGE INDICATION

Here are a couple of pointers on this technique. Although the penetration of one of these short-term highs, in a declining market, indicates a trend reversal to the upside, some penetrations are better than others.

There are only two ways a short-term high or low is broken. In an up trending market, the low that is violated or fallen below will be either a low prior to making a new rally high, as shown at (A) in [Figure 9.2](#), or a low that occurs after decline of a high that then rallies making a lower short-term high; it then declines below the low prior to the rally that failed to make a new high, as shown at (B).

Figure 9.2 Breaking a Short-Term High or Low

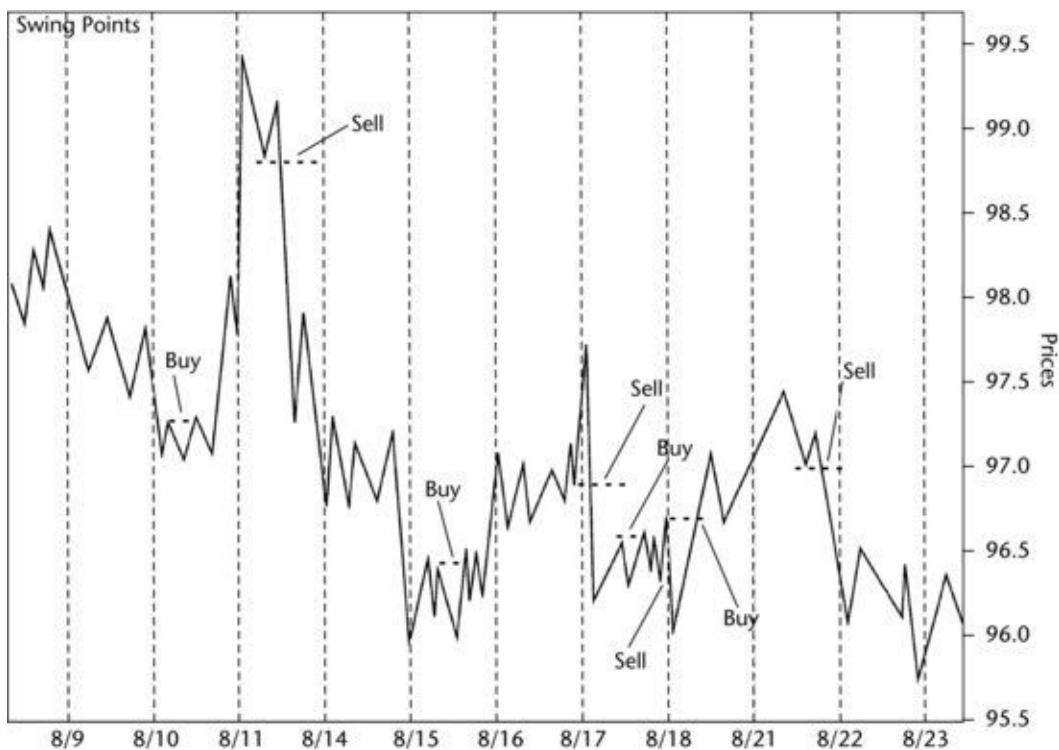


The better indication of a real trend change is the violation of the low shown at (A).

By the same token, a trend reversal to the upside will occur in one of the two following patterns: in (A) the rally peak prior to a new low is violated to the upside, or in (B) the market makes a higher low, then rallies above the short-term high between those two lows. In this case, again, the (A) pattern is the better indication of a real trend reversal.

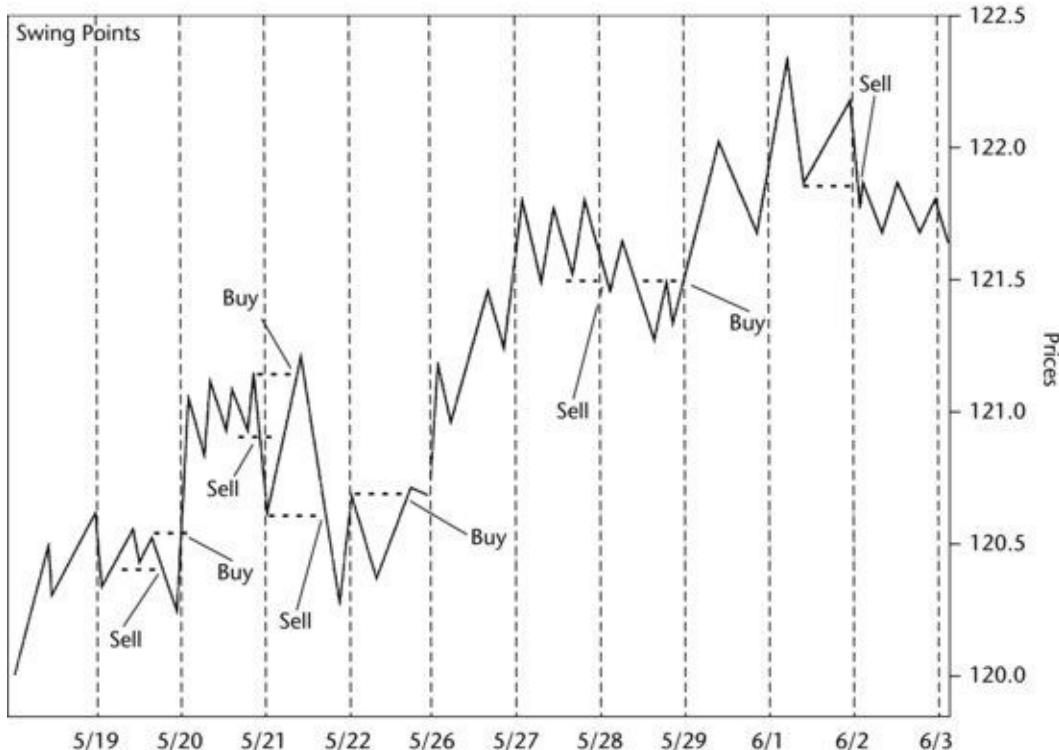
With that in mind, look at [Figure 9.3](#), which shows a 15-minute bar chart of the September Bonds in 1989. The major trend moves were adequately captured by this technique.

Figure 9.3 T-Bonds (15-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



[Figure 9.4](#) again shows Bonds, this time in April 1998, and again you see how the penetration of short-term high and low points enables a trader to be in phase with most of the trend moves for a 10-day time period.

[**Figure 9.4**](#) T-Bonds (15-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



You can use this technique two ways. Some traders may simply buy long and sell short on these changes in trend. That's a basic simplistic way to use this technique. A more educated approach would be to take buy/sell signals when confirmed by TDW, TDM, secondary data, and so on, thus filtering our trades with something other than wiggles and waggles on a chart.

Finally, we may use this indication of trend to tell us we can buy on pullbacks, and sell on rallies in unison with the underlying trend. If our indication of trend is positive, and there has been a reversal to the upside, then we can take buy signals from short-term measures or techniques.

THE THREE-BAR HIGH/LOW SYSTEM

At one point in my career, I had over 30 consecutive winning trades using this next short-term trading strategy. You will first have to calculate a three-bar moving average of the high and a three-bar moving average of the lows. (Each bar represents the time period displayed on your chart. Use five-minute charts for lots of signal, or 15-minute charts if you want a little less hectic trading career.) This is automatically done on all quote machines, although “in the old days” I did it by hand. You can have the old days!

The strategy is to buy at the price of the three-bar moving average of the lows—if the trend is positive, according to the swing point trend identification technique—and take profits at the three-bar moving average of the highs.

Sell signals are just the opposite. This means you will sell short at the three-bar moving average of the highs and take profits at the three-bar moving average of the lows. It is downright foolish to do this unless there is a reason to take only short sales. Our reason might well be that our swing point reversal system has told us the trend is down. Then, and only then, sell the high and cover at the lows.

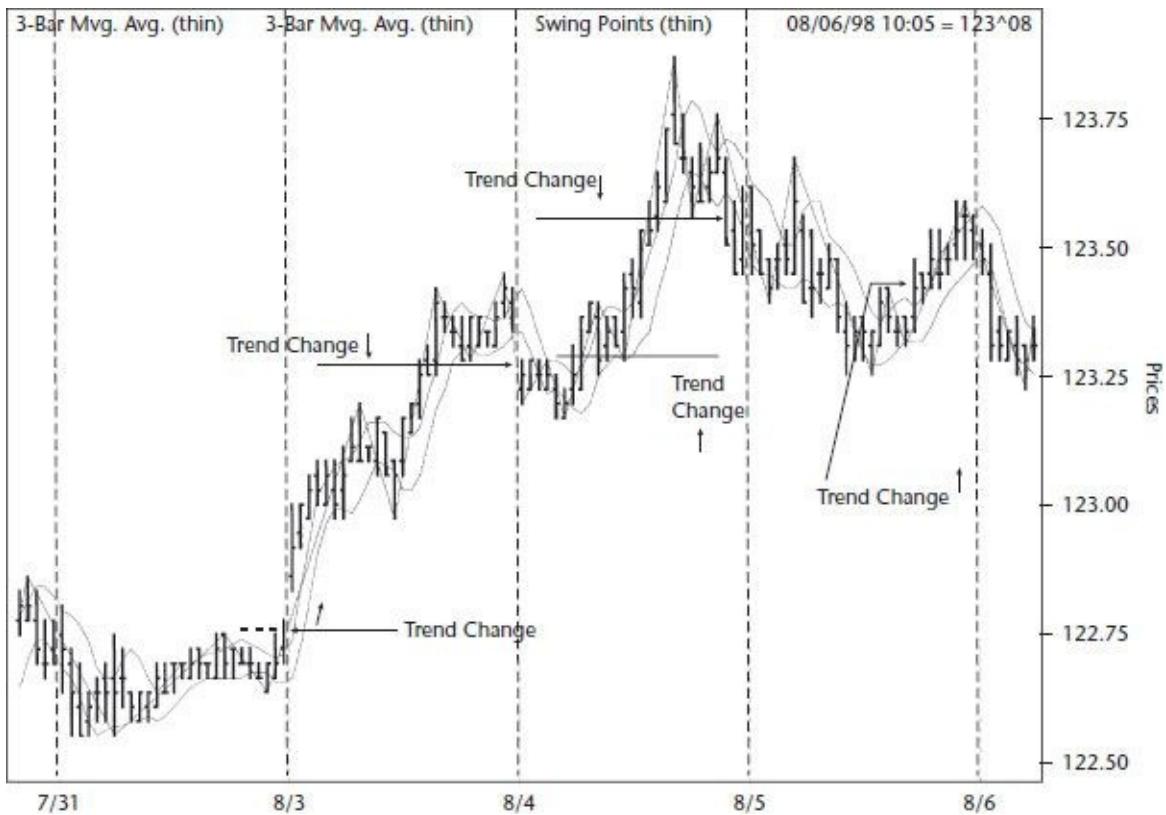
Now let's try to make some order out of all this. [Figure 9.5](#) shows the addition of the three-bar moving averages and the swing lines. I have marked the points where trend changes; we switch from buying the lows to shorting the highs following these reversals. The three-bar high and low entry points are also shown. The game goes like this: Trend reversal is up, so we buy the three-bar low line and take profits at the three-bar high and await a pullback to the three-bar low. If the three-bar low would create a trend reversal for selling, however, pass on the trade. Sells are just the opposite: await a trend reversal down, then sell all the three-bar highs and take profits at the three-bar lows.

[Figure 9.5](#) T-Bonds (15-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



[Figure 9.6](#) has all the trend reversals marked off, so you can begin paper trading by looking for the buy and sell entries and exits. I suggest you walk through this chart to get a sense of how one can trade this very short-term approach. Note these are 15-minute bars, but the concept will work on five-minute to 60-minute bars as well.

[Figure 9.6](#) T-Bonds (15-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



A NEW INDICATOR FOR SHORT-TERM TRADERS: WILLSPREAD

Markets move for real reasons, not because of technical whirling dervishes. Things happen in life because there are consequences to actions. Charts do not move the markets. Markets move the charts. In keeping with that, I also think short-term swings occur because of some external factor. Price never rallies because it is rallying, the rally is the symptom of a cause. Detect that cause and we are several lightyears ahead of the average short-term or day trader.

One of my favorite causative indicators is my *Willspread* index, a measure of the flow of price between the primary market we are trading and a secondary market that influences the primary. As you know, Bonds influence stocks, and Gold influences Bonds; Willspread allows us to spot the inner workings of these market relationships. The index is constructed or calculated by first dividing the price of the market we are trading, the primary market, by the secondary market and multiplying by 100. This creates a spread between the two markets, allowing a basic comparison of market interaction.

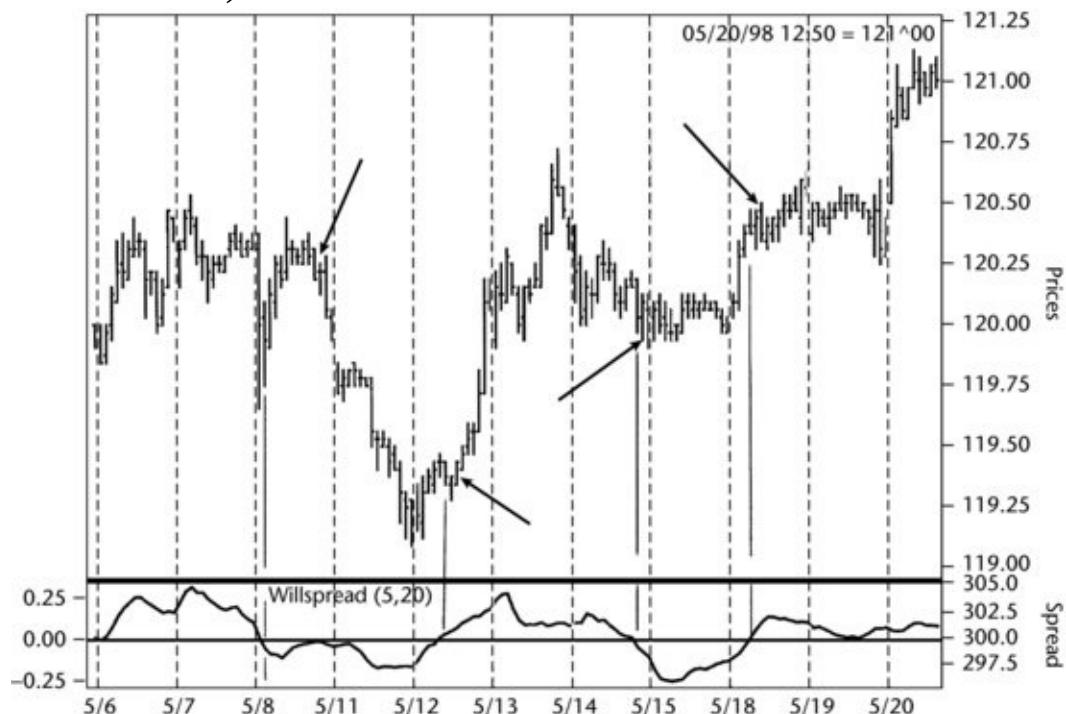
For short-term trading on 15-minute bar charts in particular, and most other time frames as well, I then create a five-period exponential of the spread and subtract that

from a 20-period exponential of the spread. By so doing, we can see when one market is heating up over another and get a better sense of these inner-market influences. Granted, this is not a perfect system, but the only perfect approach to day trading I have ever seen is the myriad ads in commodity magazines and newspapers. You can absolutely trust me on this: Those are 90 percent hype and 10 percent substance. If anyone really had such an outstanding system, he or she could make 100 times more money trading without the hassle of having to deal with the public. In addition, the tax advantages of trading are gargantuan compared with hawking systems. I have yet to see a totally mechanical day trading system that consistently makes money. Day trading is an art form that must be based on good concepts to be successful.

An Actual Example

[Figure 9.7](#) shows a 30-minute bar chart of the June 1998 Treasury Bonds. Willspread, based on the spread between Gold and Bonds, is the index at the bottom of the chart. Our trading strategy should be to look for market rallies whenever this index moves from negative territory, below the zero line, to above it, into positive land. A sell is just the opposite: When the index has been positive and then falls below the zero line, it is probably time to sell.

[Figure 9.7](#) T-Bonds (30-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



I do not use this index as a be-all, know-all system. I use it as a tool to keep me in

correct alignment with the true trend of the market I am trading. In this case, we are looking at Bonds versus Gold. Once price goes from being negative to positive, I will almost always wait for one more thing to happen:

- I want the very next trading bar to rally above the high of the bar that switched the index from negative to positive.
- I am looking for final confirmation that the trend is still alive.

My Comfort Level

I am not nearly as comfortable without this confirmation taking place. An exception can be made if other technical gauges such as trendlines or positive oscillator readings are appearing on your chart or screen. You can take such trades, but there is no better proof of a market's ability to rally than taking out the high or falling below the low when a crossing from positive to negative has taken place.

Let's start with the May 8, 1998, chart. The first 30-minute bar saw a big down move resulting in a negative crossing, but the following bar did not fall below that bar's low, so no entry. Finally, on the 13:50 bar, we would have sold short as the index was negative and we traded below the prior bar's low. Our entry would have been \$120^{7/32}.

Willspread stays negative all that day as well as the next, finally turning positive on May 12 on the 9:50 bar. Now comes the acid test ... will the rally continue? And it does as the 10:20 bar trades at 14/32, netting us a gain of 25 ticks or \$750 per contract.

We are now long at 14/32 and looking for a negative crossing to go short. The first break below zero occurs on May 14 on the 12:50 bar. Again, we wait for confirmation, but none comes on the next bar. We now wait for that bar's low to be violated. Our "trailing" stop to exit and reverse is finally elected when the 14:20 bar trades down to 4/32. Our net gain is 20 ticks or just a little over \$600 per contract.

We steel our nerves for the short trade and await a new development, a penetration of Willspread back into the positive zone. This does not take place until the 8:50 bar on May 18. The rally continues with a full-fledged buy at 14/32 on that day. We lost money on the short; in fact, our net loss was 10 ticks or \$312.50.

Could We Have Done Better?

Could we have prevented this loss? Sure, in retrospect, in the manner of Monday morning quarterbacks, but by blindly following the rules, you would have taken the

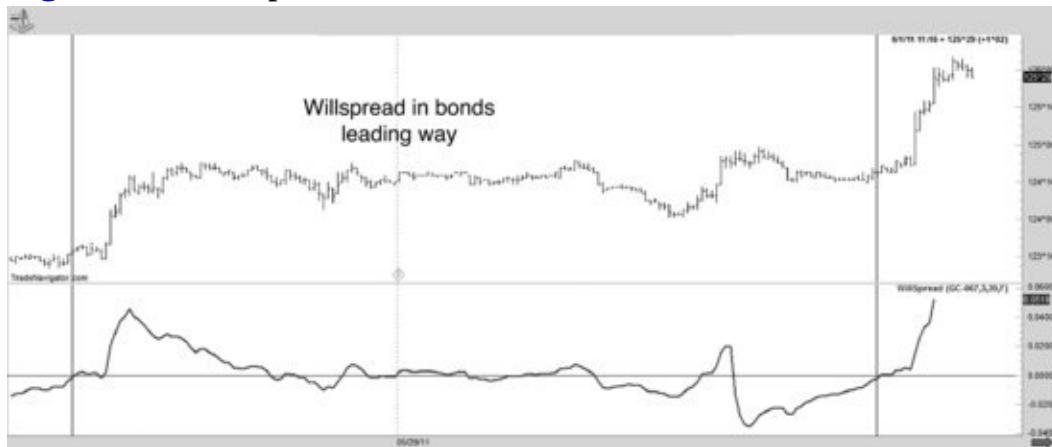
hit. When this happens, and it most certainly will, I take consolation in the following statement: Casinos do not win on every roll of the dice, either.

We did end the day with a five-tick profit or about \$150 to help lick our wounds and offset the loss, and the next trade (remember, traders fight wars, not battles) would have made \$500 per contract.

An astute trader may have exited the short position on the second bar of trading when it took out the previous bar's high. Reasons? Willspread was quickly approaching the zero line. We should limit losses, and price had a volatility breakout at 1205/32 for a net loss of just one tick or \$32.50 plus commissions. You may not have chosen to exit, but that would have been my choice, based on the strength of the action of Willspread in conjunction with the breakout of the trading range. As I have stated before, this is a thinking person's business. If you were in a quandary about what to do, you could have looked at a five- or 15-minute chart on May 18. There you would have noticed both time frames giving a clear-cut penetration of Willspread to the upside, suggesting that the best course of action would have been—at the very least—to pitch your short position. With that much evidence, the path of correct action is easier to see.

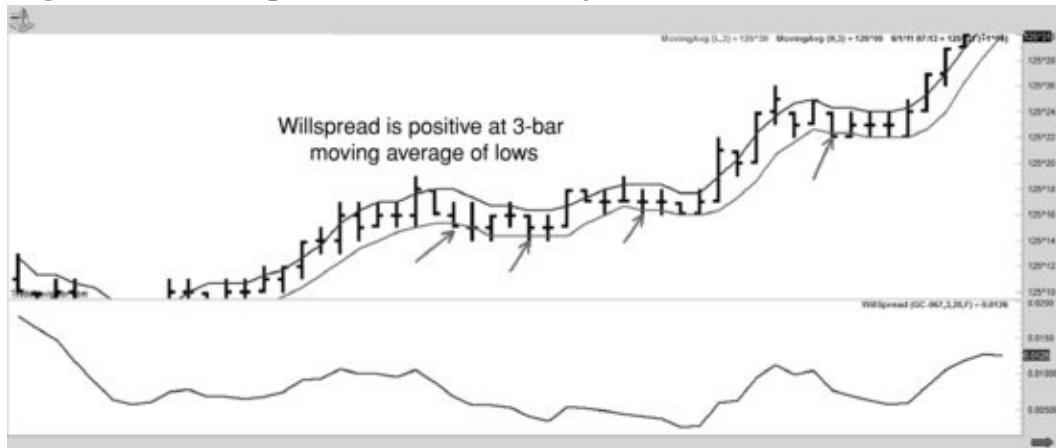
[Figure 9.8](#) shows Willspread is still working 13 years later. This just happens to be a chart from the day I was reviewing this chapter. It was not chosen for any other special reason. As you can see, the crossings of the horizontal line clearly indicate a trend move was most likely about to occur. What is taking place is that bonds are getting stronger than gold, which is typically a harbinger of a rally in the bond market. This can be used on a daily basis or, as I have shown here, on a 30-minute chart.

[Figure 9.8](#) Willspread at Work



[Figure 9.9](#) combines the use of Willspread with the three-day channel discussed earlier. If Willspread is positive, we can assume bonds should rally, thus we can buy at the low of the three-day moving average of the lows and take profits at the three-day moving average of the highs.

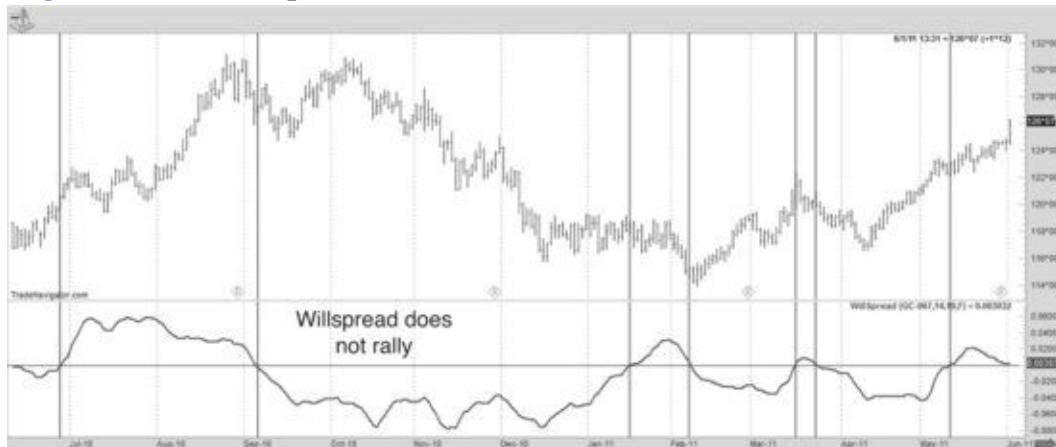
Figure 9.9 Willspread and Three-Day Channel



What we have done here is to combine two time-proven trading techniques to take advantage of market trend and antitrend. A short-term trader needs to really focus on this concept: First determine the longer-term trend and then buy pullbacks in an uptrend on the assumption that the uptrend will continue. Short sales are just the opposite. There you need to look for a downtrend of some consequence, then sell rallies against that trend.

My original work with Willspread and bonds took place in the mid-1980s, when I used a 14/19 day measurement of Willspread to determine the longer-term daily chart trend of bonds. I thought you might appreciate looking at the current chart of bonds to see how that indicator has continued working. See [Figure 9.10](#).

Figure 9.10 Willspread Still Works



As you can see, it has done a credible job of ferreting out which market rallies are good and which ones are not. The high in September 2010 is a great example in which Willspread simply refused to give a buy signal all the way down. Admittedly, when it did give a signal in January 2011, it was not a strong one. The lesson is: Don't rely on any one thing, but examine everything to gain additional insight.

WILLSPREAD AND THE S&P 500 STOCK INDEX

This same idea works quite well in helping us catch short-term swings in the various stock index contracts such as the New York Stock Exchange, Dow Jones, Value Line, and the Mini S&P, in addition to the S&P 500 full-size contract.

Although Gold makes the world of Bonds go around, it does not have as strong an impact on stocks. As you now know, however, interest rates do, so I suggest you use either T-Bills or Bonds in your Willspread setup. Using 30-minute bar charts, I am employing the difference between a three-period and 15-period exponential average. Admittedly, this is a lot of work to do by hand, but the better quote software such as Omega's Trade Station and Genesis Data have now built my indicator into their programs.

Instead of just randomly choosing time periods to present to you to illustrate the value of Willspread I am first going to show you "The Anatomy of a Crash," by highlighting the biggest crash of all time, the 1987 debacle, as well as the 1997 and 1998 waterfall slides.

The Crash of 1987

Here it is in all its glory: the largest stock market decline in the history of the world! A decline that changed lives and fortunes, a decline of such disastrous proportions lawyers were still suing for damages from the drop five years later. Even now, books are written claiming to know why it took place or explain it away. Academics have suggested many ways to prevent the damages of such speculative busts in the future. Big deal, I say; it was predictable—then, not now—with Willspread (see [Figure 9.11](#)). This amazing index dipped into the negative zone on October 14 at 311.50, staying short all the way through the debacle and thus informing its followers that the bottom was not yet in sight. Interest rates vis-à-vis T-Bills were not supportive of the market and without that confirmation we should not look for any buy signals. Indeed, just about any buying, other than the absolute low, would have proved costly.

[**Figure 9.11**](#) S&P 500 Index (30-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



The exit or first crossing-back into positive territory came on October 20, 1987, with the S&P bloodied and battered at 219.50, a profit of \$46,000 per contract. The margin at the time was only \$2,500 ([Figures 9.12](#) and [9.13](#)).

Figure 9.12 S&P 500 Index (30-Minute Bars). Graphed by the Navigator (Genesis Financial Data Services)



Figure 9.13 S&P 500 Index (30-Minute Bars). Graphed by the Navigator (Genesis

Financial Data Services)



Stand Alone Is Okay, But We Can Do Better

Although Willspread can stand on its own, it can be used in conjunction with other known facts about the market. As just one example, you have read about a huge bias for stocks to rally at the first of every month, especially in February, March, May, July, September, October, and November. Thus one possible short-term strategy you could employ at the start of every month would be to take Willspread buy signals when the positive crossings occur, with special focus on the previously named months. Here is a recap of all such signals for 1997 starting with January. Stay with me as I walk and talk you through what happened and what you could realistically have done using this combination of ingredients.

January 1997. Willspread did its thing, crossing on January 2, 1997, with an entry at 744.70, staying positive until the negative crossing on January 6; by then the S&P rallied to 752.00 with a profit of 7.30 points!

February 1997. On January 29, the first-of-the-month rally was clearly indicated by a positive crossing at a price of 774.60 with an exit two days later on the close of January 31 as Willspread had begun to deteriorate. We know this is a two- to three-day bias, so let's take the 13.90 profit at the end of our time window, unless the index is particularly bullish.

March 1997. We did not get an entry until March 3 at 792.90. This was not

much of a trade, but took out 1.10 points profit with a crossing on March 4 when the S&P was trading at 794.00.

April 1997. Oh, I just love Willspread. A conventional month-end trader would have bought and lost money. But you and I are smarter; we do not trade just technical and seasonal stuff alone, we know inner-market relationships provide meaningful insights into what is going on. That is why we bypassed the trade. Willspread did not give a buy signal until April 7, way outside the hot zone.

May 1997. We could see the month-end rally coming on April 28 when a bullish signal was given at 772.40 with an exit on May 1, 1997 at 800.50. This was a quick and explosive trade for an amazing 28.10 points profit!

June 1997. Here comes our first losing trade: A buy was given on May 28 with a positive crossing that went negative just a few bars later at 851.20. I would have pitched this trade the same day at 849.00 for a loss of 2.3 points. But the hot zone of month-end/start was still there, so when Willspread turned positive on May 30 there was no reason not to take the trade—we were still in the time zone. Entry price was 844.70 with an exit on June 2 at 848.00, making up the loss on our first shot at the trade.

July 1997. We are given another lesson in humility, going long on a positive crossing on June 30 at 896 with an exit the same day, a 6.0 point loss at 890! Wow, that was quick and ugly. But just like the end of June, we see another positive crossing on July 1, so we go long at 898. Our strategy is simple: Wait for a negative crossing or two days in the trade. We wait. Willspread crosses to the downside just a few hours later at 897.80 for a .20 loss. Another crossing comes late in the day on July 1, so we reenter at 900.25 and hold until our sell on July 7 at 927.55, netting 21.10 points in July.

August 1997. Along comes the first of the month, but Willspread is tracking in the negative area so we have no trade. Again, our filter has kept us out of what appeared on the surface to be bullish. As the time approached, we could see the fundamentals were not there to justify the trade.

September 1997. More humility. There is a clear-cut crossing on August 29 with an equally clear-cut exit and loss the same day at 902.55 for our biggest loss of the year of 3.20 points.

But we stick with it, taking the buy signal on September 2 at 912.50 and watch a very powerful rally unfold lasting until September 3, when we close out the trade at 928.90, again recouping our earlier loss. That was close, but the combination of the time influence and inner market

influence coupled to keep us in the black, with this 15.50 point gain

October 1997. We had to wait until the first of the month, when a crossing took place, forewarning us that a rally was on the way. There was an additional chance to buy again as Willspread dipped into negative for one bar, but with no follow-through for a sell and an immediate upturn on October 2 at 965.30, giving another positive crossing until time ran out with a negative crossing. The rally stopped, for us at least, at 968.75, a 3.45 point gain.

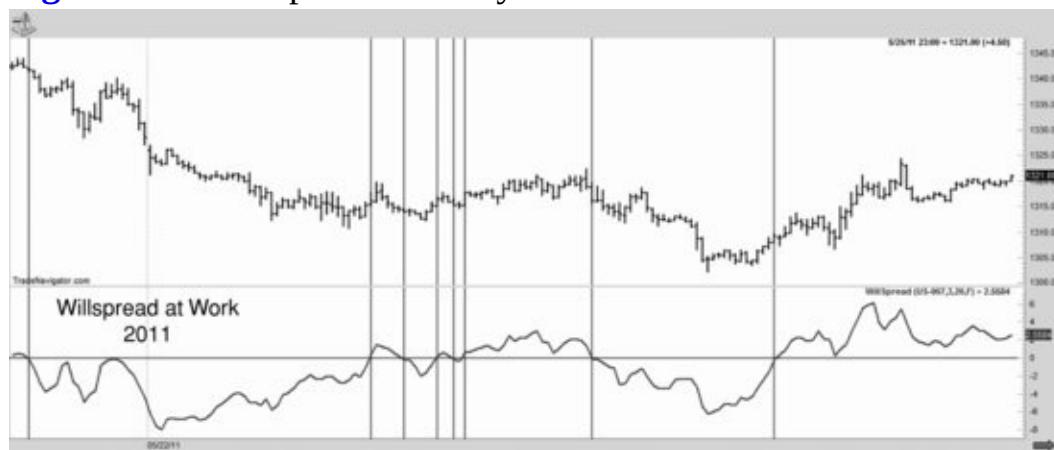
November 1997. This was almost too easy. The crossing came on October 31 at 919.00 with an equally clear exit at 947 for a very profitable trade of 28.0 points. This is how I wish it worked every month!

December 1997. Another storybook trade with a positive crossing on the first of the month at 962.50 and an exit on December 2 at 973.20. It was, as Old Blue Eyes used to sing, a “very good year,” with 13 total trades including 10 winners. More important, the net profits of 99.70 points, or \$24,925, illustrate the validity of combining fundamentals with time influences. The time influence is always there, but without a valid underpinning—the stage being set on a fundamental basis—I will pass, thank you. There are too many good trading opportunities where we can get such high odds that there is no reason to go slumming for trades just because there is one element “that may work.”

The more the merrier; that is my adage!

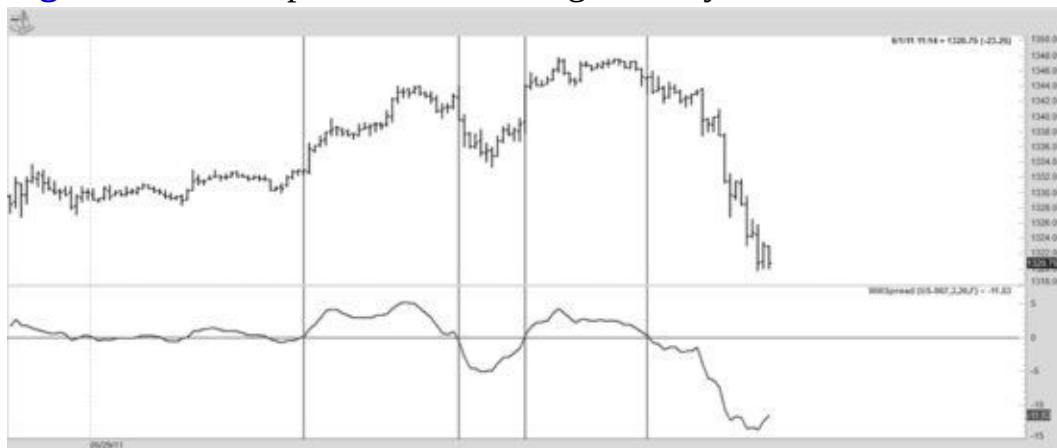
Figure 9.14 shows a current example of the E-Mini S&Ps, again using the Willspread concept on an intraday basis. The figure shows one example of how a stop loss can be trailed. Obviously it is not perfect—nothing is—but it is unusual in that it can stay negative while price rallies. In other words, we have an indicator that tells us about the quality of the current short-term rally.

Figure 9.14 Willspread Intraday 2011



Often, as you saw in my work from 1998, Willspread leads the way, just as it did in [Figure 9.15](#) before the selloff on June 1, 2011. Price was in a trading range going back and forth, but Willspread turned down, crossed below zero, and then large selling pressures hit the market.

Figure 9.15 Willspread Still Leading the Way



The reason that happened was that a negative unemployment report came out. Prior to the report, Willspread was showing that stocks were considerably weaker than bonds and that a trader could expect a negative unemployment report.

RECAP

The point of this chapter is to show you another way of skinning the cat. There are relationships between markets, and one moves based on the movements of another. This can often give us advance notice. More important, it gives you a tool that goes beyond traditional technical analysis and that is one that other traders are not using.

CHAPTER 10

Special Short-Term Situations

History does repeat itself, just not with precision.

In this chapter you'll see one of the most successful and profitable trading strategies for the S&P 500 and Bonds. Since this book was first written, these particular patterns—seasonal monthly biases—have been remarkably consistent in both markets. If you're concerned about whether or not a trading strategy will hold up, there is no better place to go than this area. I knew these trading strategies in the 1960s, traded while using them in the 1980s and 1990s, and now you can see for yourself how successful they continue to be.

It is time to develop a checklist of possible short-term trading opportunities that we can accept or reject each month. You can do this yourself by gleaning out of my work trading opportunities that appeal to you. To give you a feel for doing this, I devote this chapter to setting up specific trades you should be looking for each month. These trades are based on times of the month and holidays.

The trading-day-of-the-month (TDM) concept is hardly a new idea. As noted earlier in the book, this has been known for years. Here are my improvements and adaptations to a long-standing market truism: Stock prices rally around the first of the month. The light I shed on this play was to find out that Bond prices experience this same monthly uplift as demonstrated earlier. We will now develop a winning strategy based on these insights.

MONTH-END TRADING IN STOCK INDEXES

There are now several vehicles speculators can use to catch these swings. The S&P 500 stock index has been the kingpin of trading stock market moves, but lately, the lower margin E-Mini S&P contract has been grabbing the attention of smaller investors. The newcomer in this group, though, is the Dow Jones 30 Index, a futures contract that mimics the world-famous Dow Jones Average. I expect this to become an even more important index to trade in the future.

The strategies discussed here are based on the S&P 500 for one simple reason; we

have more data because this stock index began trading in 1982, the Dow 30 in 1997. But, the strategies can be applied to all the stock indices: simply alter your stop based on margin, contract size, and current volatility.

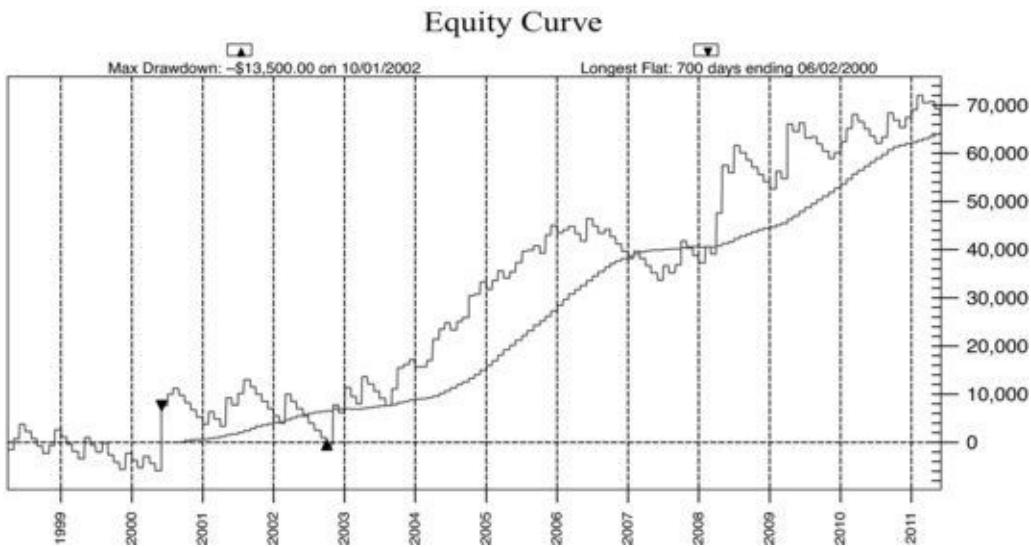
I went back to 1982 and tested buying the S&P 500 index on the open of the first trade day of every month with an exit on the first profitable opening. The stop I chose was only \$1,500, but was not used on the day of entry; however, after the entry day it was in place at all times. There have been 129 trades making a net gain of \$73,437, about \$7,000 a year for an approach that trades only once a month. The numbers of this system are excellent: The accuracy is 85 percent average profit per trade (that's net gain, winners minus losers, divided by total trades) was \$569. Drawdown came in at \$3,325, less than 5 percent of total gains. This is good stuff (see [Figure 10.1](#)).

Figure 10.1 S&P 500: Buying First Day of Each Month

| Data | : | S&P 500 IND-9967 | 09/80 | | | | |
|-------------------------------------------------------------------------|-------|---------------------|-------|-------------------------|----------|--------|------------------------|
| Calc Dates | : | 09/18/87 - 08/31/98 | | | | | |
| Num. | Conv. | P. Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
| <hr/> | | | | | | | |
| 149 | 2 | \$ 2,500 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |
| <hr/> | | | | | | | |
| //////////////////////////// ALL TRADES - Test 3 ////////////////////// | | | | | | | |
| Total net profit | | \$73,437.50 | | | | | |
| Gross profit | | \$103,250.00 | | Gross loss | | | \$ -29,812.50 |
| Total # of trades | | 129 | | Percent profitable | | | 85% |
| Number winning trades | | 110 | | Number losing trades | | | 19 |
| Largest winning trade | | \$6,700.00 | | Largest losing trade | | | \$ -2,437.50 |
| Average winning trade | | \$938.64 | | Average losing trade | | | \$ -1,569.08 |
| Ratio avg win/avg loss | | 0.59 | | Avg trade (win & loss) | | | \$569.28 |
| Max consecutive winners | | 20 | | Max consecutive losers | | | 2 |
| Avg # bars in winners | | 1 | | Avg # bars in losers | | | 1 |
| Max closed-out drawdown | | \$ -3,325.00 | | Max intraday drawdown | | | \$ -3,950.00 |
| Profit factor | | 3.46 | | Max # of contracts held | | | 1 |
| Account size required | | \$6,950.00 | | Return on account | | | 1,056% |

However, in this business the recurring question is, “What have you done for me lately?” You are only as good as your last trade; this is truly a business where you are quick or dead. With that in mind, let’s follow up on the above study of buying on the first trading day of the month (see [Figure 10.2](#)). I’m certain you are doubtful that the 85 percent accuracy can be maintained over the ensuing 13 years.

Figure 10.2 Buying at the First of the Month



Let's fire up the computers and see. The test below is exactly as shown above.

The results show profits—lots of them, as you can see in the equity line of this simple pattern. From 1998 to June 2011 this “secret trade” produced over \$67,000 profits with an average profit per trade of \$426 and an acceptable drawdown of \$13,000. The problem is the accuracy, which declined to 42 percent. Why, you ask? Because the contract size changed and volatility increased, the best stop became \$3,500.

In [Figure 10.3](#) we see the same trade with a \$3,500 stop. Net profits were \$106,000 with 66 percent winners. Yet, in the smaller E-Mini contract, using the same stop has produced 81 percent accuracy and the equity shown in [Figure 10.4](#). Net profits were \$29,650 with an average profit of \$426. Nice, very nice. Just look at that equity curve. This can be improved by not taking trades on Mondays, and the best E-Mini stop has been \$1,600.

[Figure 10.3](#) Using a \$3,500 Stop

Equity Curve

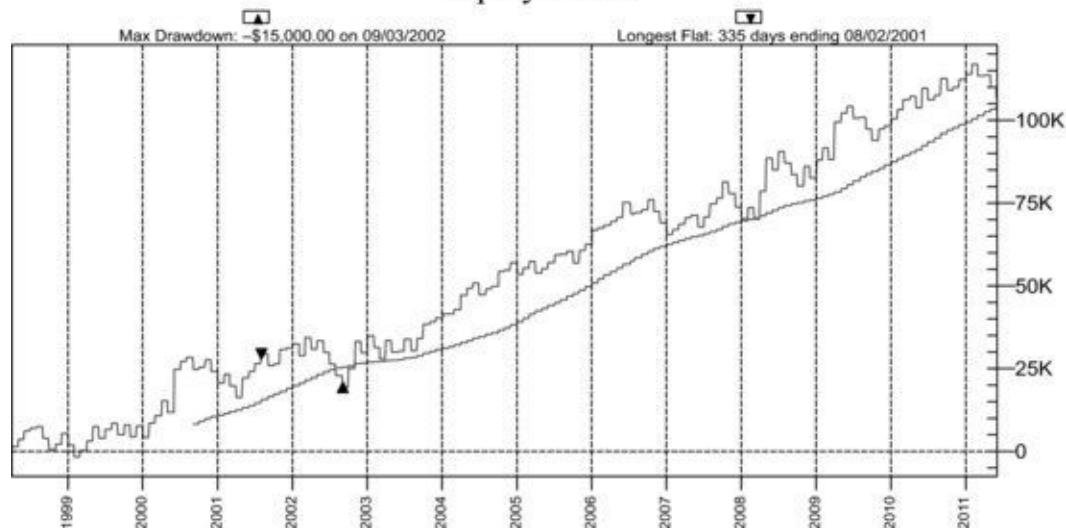
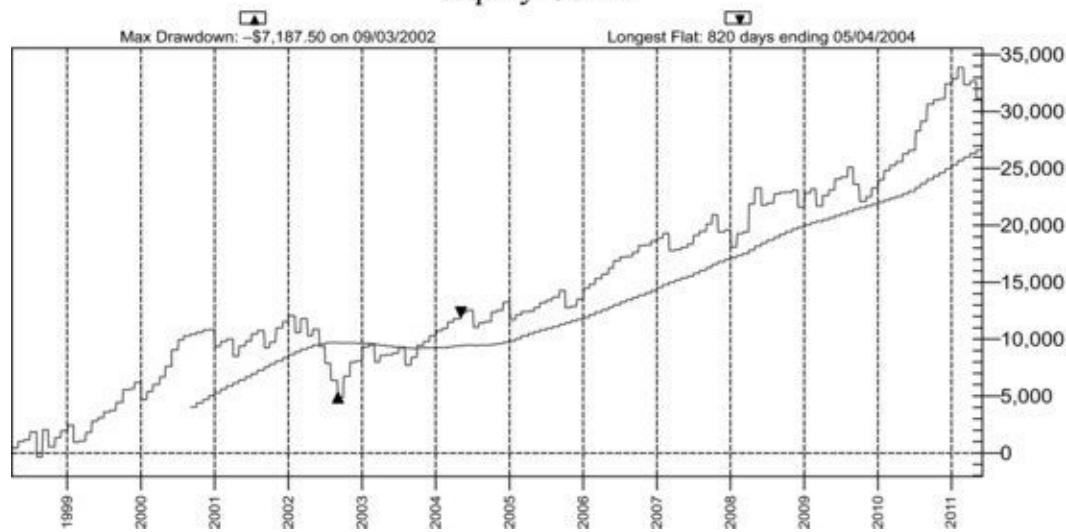


Figure 10.4 Using the \$3,500 Stop in E-Minis
Equity Curve



TARGET MONTHS

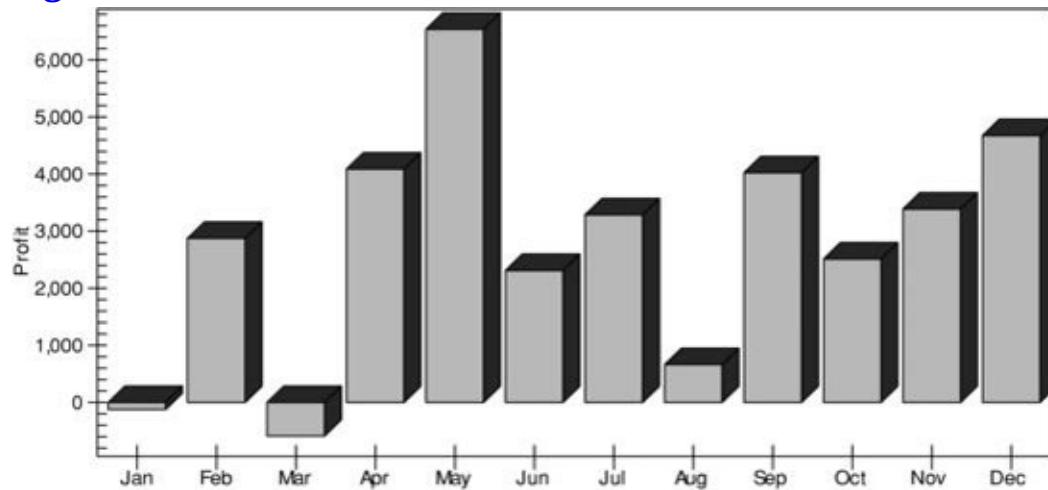
If you are getting the hang of this game, you may have already asked yourself if some months do better than others. The answer is yes, as the following printouts show. The story they tell is that the worst months in the past 16 years have been January, February, and October. These should be your target months to avoid or to be cautious of, in seasonal trading. I suggest you study the month-by-month recaps presented in [Table 10.1](#).

Table 10.1 Profitable S&P Trades by Month

| Month | Net Profit | Number of Trades +/- Total |
|-----------|------------|----------------------------|
| January | 2,325 | 9/11 |
| February | 3,437 | 8/11 |
| March | 5,650 | 9/10 |
| April | 5,437 | 10/11 |
| May | 6,075 | 9/10 |
| June | 6,500 | 10/11 |
| July | 5,875 | 9/11 |
| August | 12,500 | 9/10 |
| September | 5,557 | 9/10 |
| October | 1,150 | 8/11 |
| November | 10,500 | 11/11 |
| December | 8,150 | 9/11 |

This has continued to be true from 1998 forward, as [Figure 10.5](#) shows. Again, we see January and March were not profitable, while February was. It certainly seems that something is going on in January and March!

Figure 10.5 1998 Forward Results

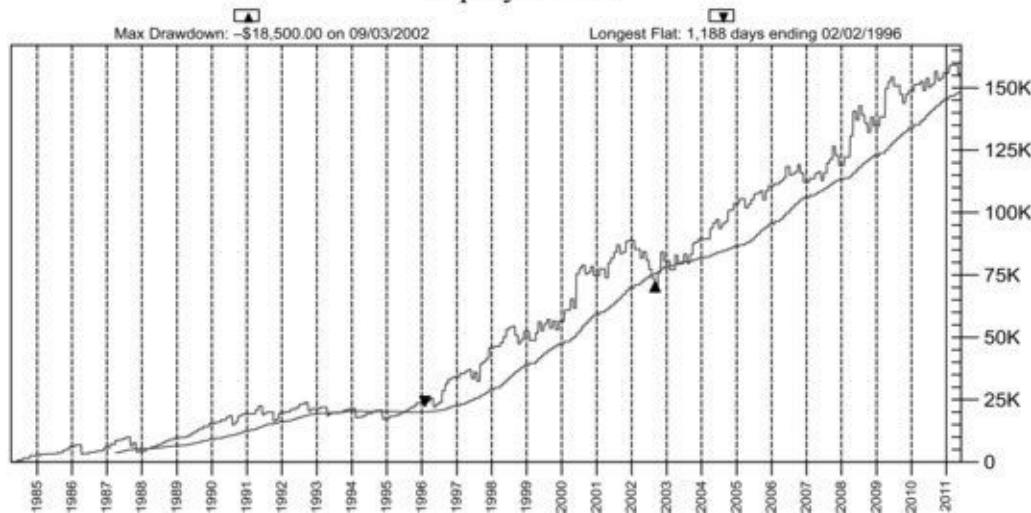


MAKING IT BETTER

It is hard to get results better than those that you see in [Figure 10.6](#), by buying on the first trading day of every month except January and March. There have been 270 trades with 80 percent winners in the large S&P contract, using a \$3,500 stop as reflected in the following equity chart of this trade. The average profit has tipped the scales at \$546.

Figure 10.6 S&P 500: First Trading Day of Month

Equity Curve



Although some of our speculative competitors are aware of this repetitive pattern,

most do not consistently take advantage of it nor have they figured out about skipping some months. That is a big improvement, but we can do even better.

How? By taking only these first-of-the-month trades when Bonds are in an uptrend. As I demonstrated earlier, an uptrend in Bonds is conducive to stock market rallies. A pretty good rule, and one that is easy to follow, is to only buy on the first of a month—any month—if Bonds have closed higher the day prior to our anticipated entry than two days earlier. This is evidence that Bonds should be supportive of a stock market rally.

MONTH-END TRADING IN THE BOND MARKET

Next, let's look at buying the first trading day of every month in Bonds, as we did in the S&P 500. The results are quite profitable, based on the rules of using an \$1,100 stop and exiting on the first profitable opening. This approach to trading comes close to 70 percent accuracy and has a very large average profit per trade, considering that we are in for only one day on average (see [Figure 10.7](#)).

Figure 10.7 Bonds: Buying on the First Day of Each Month

| Data | | : DAY T-BONDS-9967 | | 01/80 | |
|----------------------------------|--------------|-----------------------|-------------|-------------------------|---------------------------------------------|
| Calc Dates | | : 01/01/86 - 08/28/98 | | | |
| Num. | Conv. | P. | Value | Comm | Slippage Margin Format Drive:\Path\FileName |
| 44 | -5 | \$ 31.250 | \$ 0 | \$ 0 | \$ 3,000 CT/PC C:\GD\BACK67MS\F62.DAT |
| <hr/> // ALL TRADES - Test 1 \\\ | | | | | |
| Total net profit | | | \$32,593.75 | | |
| Gross profit | | | \$83,531.25 | Gross loss | \$ -50,937.50 |
| Total # of trades | 149 | | | Percent profitable | 69% |
| Number winning trades | 104 | | | Number losing trades | 45 |
| Largest winning trade | \$2,593.75 | | | Largest losing trade | \$ -1,375.00 |
| Average winning trade | \$803.19 | | | Average losing trade | \$ -1,131.94 |
| Ratio avg win/avg loss | 0.70 | | | Avg trade (win & loss) | \$218.75 |
| Max consecutive winners | 8 | | | Max consecutive losers | 6 |
| Avg # bars in winners | 2 | | | Avg # bars in losers | 1 |
| Max closed-out drawdown | \$ -6,812.50 | | | Max intraday drawdown | \$ -7,437.50 |
| Profit factor | 1.63 | | | Max # of contracts held | 1 |
| Account size required | \$10,437.50 | | | Return on account | 312% |

We can dramatically improve these results by simply bypassing the poorer performing months which, as shown in [Table 10.2](#), are January, February, April, and October, with December being a question mark.

Table 10.2 Profits in Bonds by Month

| | Net | Number of |
|---------|--------|------------------|
| Month | Profit | Trades +/- Total |
| January | -31 | 8/13 |

| | | |
|-----------|--------|-------|
| February | -1,718 | 7/13 |
| March | 2,781 | 9/12 |
| April | -343 | 8/13 |
| May | 6,125 | 9/12 |
| June | 3,125 | 13/9 |
| July | 1,093 | 8/13 |
| August | 4,343 | 9/12 |
| September | 7,187 | 11/12 |
| October | -218 | 12/7 |
| November | 8,150 | 12/12 |
| December | 1,500 | 7/12 |

As mentioned, the month-end up move in stocks has been written about for years; all I have done is figure out how to better qualify trades for this time period. Until now, the tendency for Bonds to rally at this same time has been known by only a few of my students. My research and actual trading over the years show this is also an excellent time for short-term swing moves in Bonds and Bills.

[Figures 10.8](#) and [10.9](#) should give you an overall view of this technique's strength. [Figure 10.8](#) shows the growth in an account that would have bought one contract of T-Bonds on the third to the last trading day of each month and held for six trading sessions, exiting at that time or taking a loss of \$1,500 with a protective stop. This chart, from one of the Bond market's best students, Mike Stock, offers convincing proof of the phenomenon. The same opportunity presents itself in the S&P 500, as well, as [Figure 10.9](#) illustrates.

Figure 10.8 End-of-Month T-Bonds System (U.S. T-Bonds Day Sessions, 1983–1996)

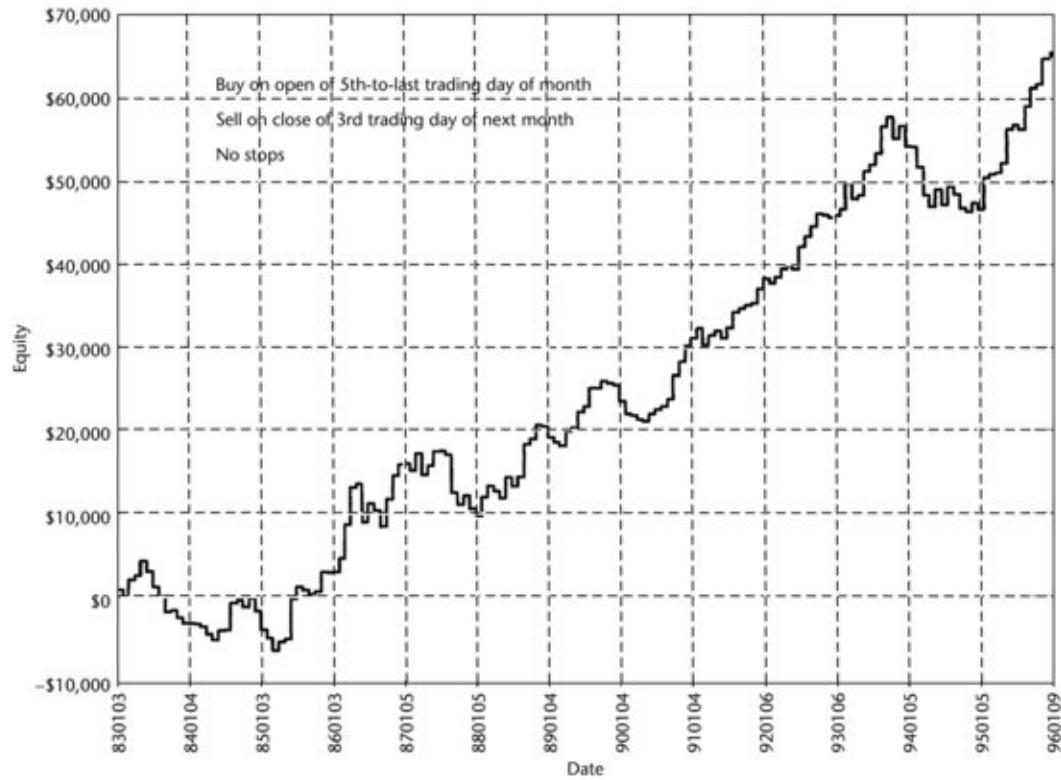
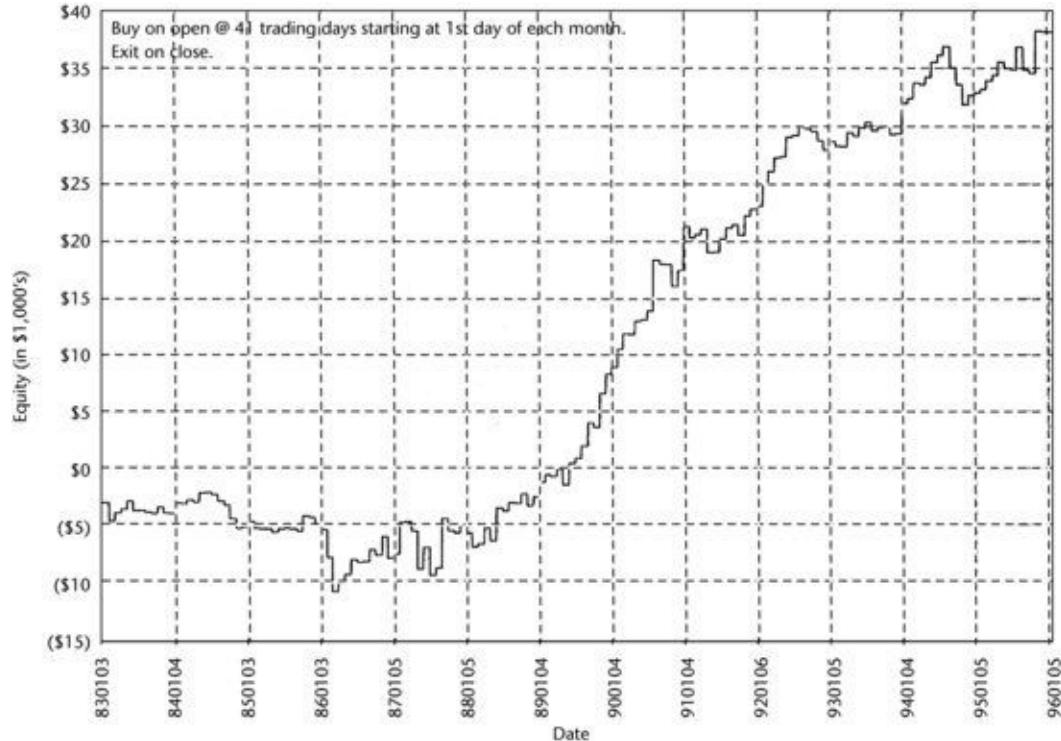


Figure 10.9 End-of-Month S&P 500 (1983–1996)



GETTING SPECIFIC

The rally usually begins in Bonds prior to the first of the month as evidenced by [Figures 10.10](#) and [10.11](#). [Figure 10.10](#) shows the results of buying Bonds on the opening of TDM 18 with a \$1,500 stop and exiting on the close three days after entry. The 139 trades since 1986 netted \$34,875 with a comfortable average profit per trade of \$250. This is tradable, despite the \$8,625 drawdown.

[Figure 10.10](#) Buying Bonds on TDM 18

| Data | : | DAY T-BONDS-9967 | 01/80 |
|---------------------------------------------------------------|------------------------|----------------------|------------------------------------|
| Calc Dates | : | 01/01/86 - 08/28/98 | |
| <hr/> | | | |
| Num. | Conv. | P. Value | Comm |
| 44 | -5 | \$ 31.250 | \$ 0 |
| | | \$ 0 | \$ 0 |
| | | \$ 3,000 | |
| Margin | Format | Drive:\Path\FileName | |
| CT/PC | C:\GD\BACK67MS\F62.DAT | | |
| <hr/> | | | |
| ////////// ALL TRADES - Test 3 ////////////////////////////// | | | |
| Total net profit | | \$34,875.00 | |
| Gross profit | | \$95,843.75 | Gross loss |
| Total # of trades | 139 | | Percent profitable 71% |
| Number winning trades | 99 | | Number losing trades 40 |
| Largest winning trade | \$2,812.50 | | Largest losing trade \$ -1,906.25 |
| Average winning trade | \$968.12 | | Average losing trade \$ -1,524.22 |
| Ratio avg win/avg loss | 0.63 | | Avg trade (win & loss) \$250.90 |
| Max consecutive winners | 17 | | Max consecutive losers 4 |
| Avg # bars in winners | 3 | | Avg # bars in losers 3 |
| Max closed-out drawdown | \$ -8,625.00 | | Max intraday drawdown \$ -8,656.25 |
| Profit factor | 1.57 | | Max # of contracts held 1 |
| Account size required | \$11,656.25 | | Return on account 299% |

We can do better, however, by bringing a subset of the trend of the Gold market to filter out bad or marginal trades. As described in the works of such major contributors to our understanding of the markets as Marty Zweig or John Murphy (whose books are must reading), Gold exerts a great impact on Bonds. When Gold is in an uptrend, it acts as an impediment to Bond market rallies; conversely, when Gold is in a downtrend, Bonds are more apt to rally.

[Figure 10.11](#) reveals the power of filtering trades with Gold. In this case, trades were taken at the same time period with the same stop and exit as before. The difference is that trades were only taken if Gold was in a downtrend (i.e., the close of Gold on the day prior to entry was less than 24 days ago). Although total profits dip \$2,000, the accuracy slightly increases while our “all-important” average profit per trade jumps up over \$100 per trade and drawdown improves substantially by being cut almost in half!

[Figure 10.11](#) Bonds: TDM 18 Buy Signals Backed by Gold

```

Data : DAY T-BONDS-9967 01/80
Calc Dates : 01/01/86 - 08/28/98

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
----- 44 -5 $ 31.250 $ 0 $ 0 $ 3,000 CT/PC C:\GD\BACK67MS\F62.DAT
//////////////////////////////////////////////////////////////// ALL TRADES - Test 3 /////////////////////////////////
Total net profit $32,062.50
Gross profit $65,093.75 Gross loss $ -33,031.25
Total # of trades 90 Percent profitable 75%
Number winning trades 68 Number losing trades 22
Largest winning trade $2,812.50 Largest losing trade $ -1,531.25
Average winning trade $957.26 Average losing trade $ -1,501.42
Ratio avg win/avg loss 0.63 Avg trade (win & loss) $356.25
Max consecutive winners 11 Max consecutive losers 3
Avg # bars in winners 3 Avg # bars in losers 3
Max closed-out drawdown $ -4,500.00 Max intraday drawdown $ -4,500.00
Profit factor 1.97 Max # of contracts held 1
Account size required $7,500.00 Return on account 427%

```

BETTER AND BETTER

We can do even better than the preceding results by delaying our entry until TDM 22. There are a lot less trades, as [Figure 10.12](#) shows, only 50, but a higher accuracy, 76 percent, an amazing \$496 average profit per trade, and a very tolerable drawdown of a little over \$4,500.

Figure 10.12 Bonds: TDM 22 Buy Signals

```

Data : DAY T-BONDS-9967 01/80
Calc Dates : 01/01/86 - 08/28/98

Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName
----- 44 -5 $ 31.250 $ 0 $ 0 $ 3,000 CT/PC C:\GD\BACK67MS\F62.DAT
//////////////////////////////////////////////////////////////// ALL TRADES - Test 3 /////////////////////////////////
Total net profit $24,812.50
Gross profit $42,812.50 Gross loss $ -18,000.00
Total # of trades 50 Percent profitable 76%
Number winning trades 38 Number losing trades 12
Largest winning trade $2,718.75 Largest losing trade $ -1,500.00
Average winning trade $1,126.64 Average losing trade $ -1,500.00
Ratio avg win/avg loss 0.75 Avg trade (win & loss) $496.25
Max consecutive winners 7 Max consecutive losers 3
Avg # bars in winners 3 Avg # bars in losers 2
Max closed-out drawdown $ -4,500.00 Max intraday drawdown $ -4,593.75
Profit factor 2.37 Max # of contracts held 1
Account size required $7,593.75 Return on account 326%

```

I know, I know, you want to know what happens when we back this trading opportunity with the trend of Gold. Well, [Figure 10.13](#) shows the answers and they are very impressive: \$20,156 in profits. Again, the trend criteria is that Gold close lower than 24 days ago, and same stop and exit as in the previous results. Although our drawdown has a major improvement, crashing all the way down to \$1,500, the accuracy skyrockets to 89 percent and average profit literally zooms to \$719 per

trade.

Figure 10.13 Bonds: TDM 22 Buy Signals Backed by Gold

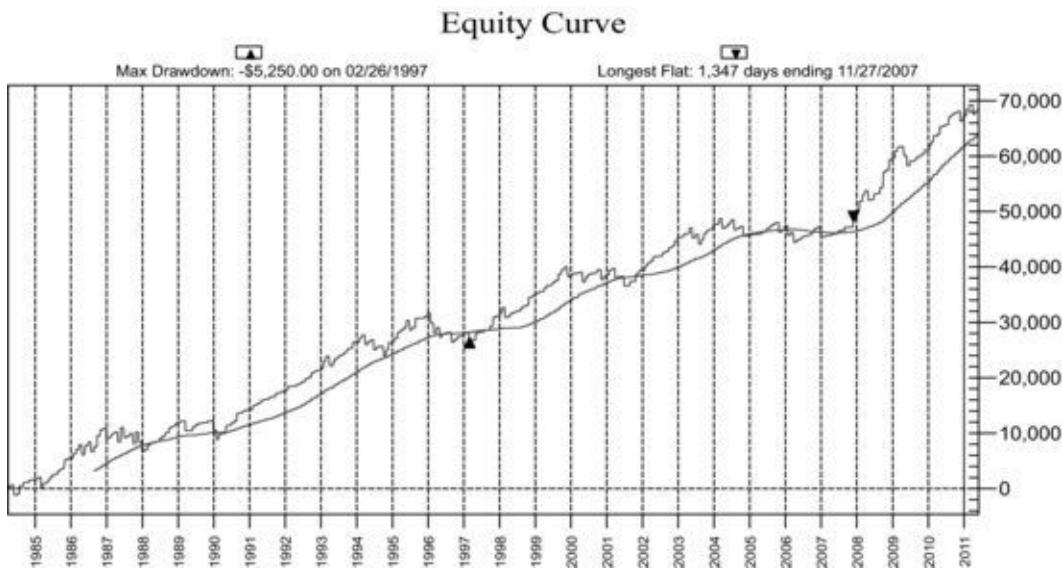
| Num. Conv. P. Value Comm Slippage Margin Format Drive:\Path\FileName | | | | | | |
|------------------------------------------------------------------------------------------|--------------|-------------|-------------------------|------------|--------------|------------------------------|
| 44 | -5 | \$ 31.250 | \$ 0 | \$ 0 | \$ 3,000 | CT/PC C:\GD\BACK67MS\F62.DAT |
| <hr/> ////////////////////////////// ALL TRADES - Test 2 /////////////////////////////// | | | | | | |
| Total net profit | | \$20,156.25 | | Gross loss | | \$ -4,500.00 |
| Gross profit | | \$24,656.25 | | | | |
| Total # of trades | 28 | | Percent profitable | | 89% | |
| Number winning trades | 25 | | Number losing trades | | 3 | |
| Largest winning trade | \$2,468.75 | | Largest losing trade | | \$ -1,500.00 | |
| Average winning trade | \$986.25 | | Average losing trade | | \$ -1,500.00 | |
| Ratio avg win/avg loss | 0.65 | | Avg trade (win & loss) | | \$719.87 | |
| Max consecutive winners | 17 | | Max consecutive losers | | 1 | |
| Avg # bars in winners | 2 | | Avg # bars in losers | | 1 | |
| Max closed-out drawdown | \$ -1,500.00 | | Max intraday drawdown | | \$ -2,093.75 | |
| Profit factor | 5.47 | | Max # of contracts held | | 1 | |
| Account size required | \$5,093.75 | | Return on account | | 395% | |

This is an exceptional trading opportunity; the problem is that not many months have a TDM 22, but when they do, I will be buying. Check out the string of winners with the Gold filter, 17 winners in a row, whereas without the filter, we had only five winners in a row.

As an update to the incredible lasting power of how the bond market really trades, I offer the next chart. The results were accomplished by buying on the opening of the fifth trading day prior to the end of the month. This is typically trading day of the month 18, which I have referenced above. Since these initial tests were done in 1990, this elementary approach to trading generated over \$32,000 of profits on 119 trades. The average profit per trade was \$275 and the worst drawdown was ... get ready for this ... less than \$3,700!

In [Figure 10.14](#), you see the entire performance. This trading occurred from the 1980s through May 2011. When talking about patterns holding out, be sure to include a phenomenal aspect of the Bond market: its habitual tendency to rally and each and every month.

Figure 10.14 Entire System Performance



A TIME TO SELL

Bonds have also dipped around mid-month most of the time, as [Figure 10.15](#) reveals. The rules called for selling on the open of TDM 12 with our usual three-day exit and \$1,400 stop. From 1986 to the middle of 1998, this dip has been profitable to trade 76 percent of the time with an average profit per trade of \$133 on the 152 trades. Drawdown is acceptable at \$6,093, but larger than the ideal ratio of profits to drawdown. Ideally, drawdown should be no more than 15 percent of the profits of \$20,281. In this case, the drawdown was 20 percent profits. So, although we are certainly onto something here, I would like a shot at making it better.

Figure 10.15 Bonds: Sells on TDM 12

| Data | : | DAY T-BONDS-9967 | 01/80 |
|-------------------------------------------------------------------------|---------------|-------------------------|------------------------|
| Calc Dates | : | 01/01/86 - 08/28/98 | |
| <hr/> | | | |
| Num. | Conv. | P. Value | Comm |
| 44 | -5 | \$ 31.250 | \$ 0 |
| <hr/> | | | |
| Slippage | Margin | Format | Drive:\Path\FileName |
| \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67MS\F62.DAT |
| <hr/> | | | |
| //////////////////////////// ALL TRADES - Test 3 ////////////////////// | | | |
| Total net profit | \$20,281.25 | Gross profit | \$73,375.00 |
| Gross loss | \$ -53,093.75 | | |
| Total # of trades | 152 | Percent profitable | 76% |
| Number winning trades | 117 | Number losing trades | 35 |
| Largest winning trade | \$3,000.00 | Largest losing trade | \$ -2,000.00 |
| Average winning trade | \$627.14 | Average losing trade | \$ -1,516.96 |
| Ratio avg win/avg loss | 0.41 | Avg trade (win & loss) | \$133.43 |
| Max consecutive winners | 13 | Max consecutive losers | 3 |
| Avg # bars in winners | 2 | Avg # bars in losers | 3 |
| Max closed-out drawdown | \$ -6,093.75 | Max intraday drawdown | \$ -6,250.00 |
| Profit factor | 1.38 | Max # of contracts held | 1 |
| Account size required | \$9,250.00 | Return on account | 219% |

Whereas traditional commodity market analysts would try to filter this trading

opportunity with technical “junk” like the trend, oscillators, or momentum flows, I would rather go back to what matters: fundamental relationships, that of Gold to Bonds. After all, charts and oscillators do not move the market; instead, underlying conditions do.

In addition to now having a real way to trade this mid-month dip, we are also able to again see the power of fundamentals in [Figure 10.16](#). The trade entry and exit rules are exactly as in the previous clip, the only difference—and what a difference it makes—is that trades were only taken when Gold had closed greater than the close 10 days ago. In other words, Gold was in an uptrend, which suggests to us that sell signals should be more effective in this monetary environment. The average profit per trade more than doubles, profits get bumped up \$6,000, accuracy goes from 76 percent to 78 percent—no big deal, but our drawdown to profit percentage is just about halved from 20.9 percent to 11 percent. Perhaps best of all, the average profit per trade jumps to \$359 from \$133.

[Figure 10.16](#) Bonds: Sells on TDM Backed by Gold

| | | | |
|------------------------------|--------------|-------------------------|--------------------------|
| Data | : | DAY T-BONDS-9967 | 01/80 |
| Calc Dates | : | 01/01/86 - 08/28/98 | |
| <hr/> | | | |
| Num. | Conv. | P. Value | Comm |
| <hr/> | | | |
| 44 | -5 | \$ 31.250 | \$ 0 \$ 0 \$ 3,000 |
| CT/PC C:\GD\BACK67MS\F62.DAT | | | |
| <hr/> | | | |
| // ALL TRADES - Test 4 \\ | | | |
| Total net profit | | \$26,250.00 | |
| Gross profit | | \$50,250.00 | Gross loss |
| Total # of trades | 73 | Percent profitable | 78% |
| Number winning trades | 57 | Number losing trades | 16 |
| Largest winning trade | \$2,656.25 | Largest losing trade | \$ -1,500.00 |
| Average winning trade | \$881.58 | Average losing trade | \$ -1,500.00 |
| Ratio avg win/avg loss | 0.58 | Avg trade (win & loss) | \$359.59 |
| Max consecutive winners | 14 | Max consecutive losers | 3 |
| Avg # bars in winners | 3 | Avg # bars in losers | 3 |
| Max closed-out drawdown | \$ -4,500.00 | Max intraday drawdown | \$ -4,593.75 |
| Profit factor | 2.09 | Max # of contracts held | 1 |
| Account size required | \$7,593.75 | Return on account | 345% |

Here we have a very tradable opportunity. All one need do is have the patience to wait for the mid-month time periods when Gold has been in an uptrend: That is the fundamental setup that created these results.

RECAP

Patience seems to be the one commodity that traders have in short supply. Most people must like to trade for the heck of it, I suppose. I want to wager or speculate only when I have a distinct advantage in the game. If it is not there, you know where I will be ... on the sidelines ... where I belong. I hope you will be there with me!

The purpose of this chapter is to give you more depth in trading strategies, as well as present some absolute trading approaches that I use. There is an unmistakable, strong, dominant pattern in the influences at the end of the month/first of the month, and now you know what to do about it.

CHAPTER 11

When to Get Out of Your Trades

Never begin anything until you have reflected upon the end of it.

I have three rules for you to follow to get out of your short-term trades:

1. Always use a dollar stop on all trades so that in the event that all else fails, you will have some measure of protection.

2. Use my “bailout” profit-taking technique, developed with the help of Ralph Vince. The basic rule is to exit on the first profitable opening. If the profit is only one tick, take it.

This works best for the S&P 500; for slower-moving markets I will delay the bailout a day or two to give the market time to grow, thus increasing my average profit per trade.

3. Exit and reverse if you get an opposite signal. If you are short and get a buy signal, don't wait for the stop or bailout exit; instead, go with the most current signal.

That is all I have to tell you about exits. Don't get greedy, and let the rules, not your emotions, take care of your trades.

There are other exit techniques, of course. Many people use Fibonacci numbers for buying as well as exiting their trades. I am not one of them, as I have not found Fibonacci numbers to be optimal.

One valuable consideration is to exit your trade within a certain number of days. After all, if you don't have a profit by X days, then the condition you were trading for, whatever it may be, has probably evaporated.

I have noticed there is always a dilemma in short-term trading. When the market is overbought, the temptation is to take your profit, but you are hopping off the trend move—and only all too often, you are hopping too soon. Is there a resolution for this?

Perhaps. When you are trading a short-term time frame—for sake of argument, let's say four days—if the market is overbought, you may consider it a good place to take profits if you are long, but you may be getting out of the move too soon. So why not use an overbought reading twice the length of the time frame you're using for entry into the trade?

In other words, you could use an eight-day overbought measurement to tell you to exit your trade on the assumption the market is probably going to have some type of a pullback. It really is overbought. This allows you to stay in the trade longer by using one time frame for entry and another time frame for profit taking.

CHAPTER 12

Thoughts on the Business of Speculation

Speculation is not bad, but bad speculation is a disaster.

It is one thing to correctly call the twists and turns of the markets, but that is not how long-term wealth is created, nor is that talent sufficient, in and of itself, for a career in this business.

Career success does not mean you have ferreted out a winning trade or two. Anyone can do that at any given time. That is not a career that is either getting lucky or getting good. The business end of speculation amounts to consistently doing the right thing—not getting off track, down in the dumps over the current losing trade, or floating in the sky because you have had two winners in a row. I am much more interested in the career aspect of this art than I am in the last trade or two. Anyone can drive a nail or two into a board, but that is not what builds a house. To build a house, you need not only the skills, but also a plan, the intentions to follow and complete the plan, and the ability to show up every day, rain or shine.

EXITS BEFORE ENTRIES

Any fool can get into a fight ... winning it is another matter.

I was always the fool.

As a kid I was not particularly good at fighting, but I was great at starting fights, usually getting my clock cleaned in the process. I would come home from school with a ripped shirt and bloody nose and my dad would look at me, shaking his head and saying, “Any fool can get into a fight, Larry, it is a wise man who avoids them.”

We market educators will have done a great disservice to the industry, as I now see it, if virtually every book and course written about trading begins with entry techniques as opposed to exit techniques.

It's easy to get into a trade, any fool can do that, but exiting the trade ... that's where the profits are made. I will show you my actual account statements in a later chapter so you will see that I have made millions of dollars in real trading. What I am teaching you here is not hype and hyperbole, but reality.

As some of my long-term followers know, in the late 1990s I managed several

heavyweight champion fighters. If you follow boxing, you certainly recognize the names of Jimmy Thunder, Mike “The Bounty” Hunter, and Ray Mercer, and I also helped to promote George Foreman’s last fight in Tokyo.

While boxing may not seem germane to you in terms of trading, I assure you that there is no greater battle you’ll ever be engaged in, in your entire life, that is tougher than the market. The inspiration for this thought comes from what is perhaps the all-time best-selling stock market book, *The Battle for Investment Survival* (Kessinger, 2010), by Gerald Loeb. He was spot-on: Investment survival is a battle. That battle is you versus the market, that battle is you versus other participants, and that battle is also you versus yourself.

It is for that reason that I think we can learn a great deal about successful trading by using the analogy of boxing.

At the time, while we were trying to develop the next heavyweight fighter, I met an interesting man, Tommy Peacock, a boxing trainer. It took me a few years to absorb much of what Tommy was talking about and to apply the basics of his training course to trading.

There were two points Tommy continually drilled boxers on over and over. The first was: You don’t want to get hit. In our business, we would call that risk-control money management.

Tommy had a series of drills he put fighters through that seemed unusual. He would have them pretend that they had been decked, drop to the mat, and practice getting up from the canvas. Watch an inexperienced fighter and you will see that he tries to roll over to sit up, then stand up; this drains all the blood and oxygen out of the brain. The well-trained fighter will stay on his stomach, pushing himself up, keeping his head low, then stand up as he regains full consciousness.

His initial emphasis was not on throwing a punch, or learning how to pop a jab into the opponent’s face. Tommy’s first emphasis was on footwork, the spacing of your feet relative to your shoulders, how your right foot needed to be slightly back of your left foot, and the importance of never crossing your feet.

Every book I have ever read on trading begins with getting into a fight, using this moving average or that technique or pattern to get into the battle, but none have discussed correct posture, how to hold your hands … and most important, when not to get into the fight.

One of the dirty little secrets of the fight game is that, as you develop your fighter, you carefully choose your opponents. You don’t want your guy to lose, so you deliberately match him against fighters, the first three to five fights, that you know your boxer will beat. If your guy loses one of those fights, he’s toast. If he can’t beat these guys, your guy is history.

The lesson here is that you can win any fight. I could beat up Mike Tyson even in

his prime ... given the right conditions. Mike would have to be blindfolded, he would have to have his right hand tied behind his back, and, most important, I would want to have his legs hobbled together. The power of Mr. Tyson's punches came not from his upper body, but from the incredible spring he had in his legs. Knockout punches start from the feet; that is where the power comes from.

While I learned to select fights for my fighters, I didn't quite get the message that I needed to be just as selective in the trades that I take. There is a natural reason for this: It is just so much fun to get into a fight, or get into a trade, that we don't stop and think. I think traders, by their nature, like action and excitement. Being on the sidelines watching the markets move means we are not in the game, which can be very difficult. Sometimes Dow Jones 30 index traders would rather be in a losing trade than be on the sidelines in a comfortable seat.

I'd like to discuss exit strategies in greater depth, how to get up from the mat when you have been decked, and how to carefully choose your trades. I want you to understand that a buy or sell signal alone is not enough: You first need to learn to protect yourself, to know what to do when you're in either a winning trade or a losing trade.

Any fool can get into a trade ... I'd like to share with you a little bit of what I have learned about how to handle a trade before we begin to discuss the art of trading. That is because the purpose of this book is to make you a successful trader. To do that you need to learn how to deal with losses, which you will certainly have, you will not be able to take full advantage of your abilities to make money in the markets until you learn to recover from losses.

There is another thing that fighters do, as do many professional athletes: They watch films, to study their opposition as well as watch themselves in their past outings. There is a great deal of help that will come to us naturally by reviewing our trades and watching how the market has performed in the past. Most people are unwilling to do that. Maybe it is the desire for a thrill that causes this. I assure you that the modicum of success I have had in trading has come from studying the markets—from reviewing past films, if you will, as well as analyzing my trading failures.

There are two great reads on this. The first is *The Fighter's Mind* (Grove Press, 2010) by Sam Sheridan, the second one is *The Art of Learning: A Journey in the Pursuit of Excellence* (Free Press, 2008) by Josh Waitzkin. You may have seen the movie about his childhood, *Searching for Bobby Fischer*. Both authors make points that traders can learn from, as well as being delightful reads. Following are some of the points I took away that I think can make both you and me better traders.

In the art of fighting, or playing the violin or piano, one thing has been found to consistently predict success. Any idea of what this is? It is not natural skill: It is the

amount of time the student puts into practice. Nothing is a better indicator of future success. In fighting, this is also apparent, as the fighter in the best shape wins the fight. In *Outliers* (Little, Brown & Company, 2008), Malcolm Gladwell writes, “When psychologists looked at violinists they found a very simple correlation … the more they practiced the better they were. The students who ended up best in their classes practiced more than everyone else. The virtuosos who went on to become world-class talents, ‘geniuses,’ were practicing 30 hours a week. Those who practiced eight hours a week were destined to become music teachers.”

What about us? How can we practice trading? How do we get in shape?

Getting in physical shape means going to the gym each day, running X miles a week; it is largely a matter of using repetitive practice to increase strength so we can endure or overpower. I know from my former life as a marathon runner that success depended on my ability to sustain discomfort for long periods of time. This is an invaluable mental asset for a trader, as there are no straight paths to instant wealth in this business.

I think my trip to the “Traders Gym” each day occurs after the close, with the market analysis that I do each and every day. What I have noted is that I certainly put more into some of these sessions than others. Traders usually do not focus on this kind of analysis due to distraction or fear … fear of facing the beast.

“If practice is what creates winners, how can we practice?” This is an obvious question.

There is an answer right in front of us. Do you want to know the secret of how I developed my trading style, the tricks and techniques in this book? It was pretty simple: I looked at thousands upon thousands of days of charts and data looking for patterns, relationships, and all that goes into trading. In a very real way I was paper trading—practicing—on the past.

As I see it, this is what we all need to do more of: Study the past, look at charts. Without doing this, you have not done everything possible to be a successful trader.

I am still the fool: I still have losing trades, I still do dumb things in my trading, but I have learned how to handle these things. I have learned that exits are more important than entries. If I’m going to get into a fight, that is, get into a trade, I sure as hell better know how to get out of it without being destroyed.

Let’s step into the ring; there are a few things I want to show you.

WHAT SPECULATION IS ALL ABOUT

The art of speculation is about figuring out the most probable direction the future will take. The future is seldom predictable to any precise level or event, yet all such

investment predictions will entail three elements: *selection*, *timing*, and *management* of the prediction. Mastering one of these aspects is not adequate: You must understand and be proficient in all three of them, so let's take a look at each element.

There are two aspects of selection: One is selecting a market that is ready to move; the other is selecting so you can focus. Just because a market trades, don't expect your favorite commodity to suddenly have a rip-roaring move that will enrich your bank account. A study of any charted history of any stock or commodity will divulge an amazing secret that separates the would-be speculators from folks like you and me: Price usually moves sideways in a meandering back-and-forth pattern, perhaps with a slight trend direction. There are only three or four optimum times a year to take advantage of immediate and substantial changes in price. Go ahead, check some charts, see and learn for yourself that big price changes do not occur every day. In fact, they are less likely, rather than more likely, to take place ... they are the exception, not the rule.

That is why trade selection is so important. You don't want to get stuck in the mud of a choppy, trendless market; it will wear you out or shake you out. In either event, you lose, if not money, then time. It is imperative, then, that you learn to know when a market has been set up and is ready to roar.

I have given you numerous setup considerations in this book that include TDM, TDW, holidays, and intermarket correlations. There are others, such as the net long or short positions of the largest (and therefore smartest) traders, the invariably wrong positions of the public, and even major news events that alter market activity. A successful speculator plays a waiting game. Most people cannot wait; they would rather wager, and the sooner the better. Speculator kings and queens have the patience to put off taking action until the tumblers have clicked into place, knowing that profits are then more likely to prevail.

There is another reason why selection can be of paramount importance to profits. I have always done my best when I have traded just one or two markets. By eliminating all the others, the distractions, I have been able to thoroughly learn how my selected markets operate, what moves them, and perhaps of even greater importance, what does not move them. No great accomplishment has ever come about without focusing talent, intentions, and action. This business is no different. The more focused you are on what you are doing, the more successful you will become.

This thought fits well with the way business works. Heart specialists make more money than general practitioners. In this day and age of complexity, specialization has a large payoff. Years ago, I heard about a wise trader who made millions in the stock market. He lived high in the Sierra Mountains and would call his broker about three times a year, always to buy or sell the same stock. His broker told me the man had indeed amassed a fortune, all from this one stock, by using financial focus.

IT'S ABOUT TIME

If you are now focused on a specific commodity that your new tools, techniques, and dreams say should soon have a tradable move, it is still not time to rush in. Selection is about what should move; timing, the next element of speculation, is about precisely when that should happen. Timing is about narrowing down when price change should begin. Tools you can use here are simple trendlines, volatility breakouts, patterns, and the like. The essence of timing is to let the market prove to you that it is ready to explode in your selected direction.

Just what does that mean? In the case of wanting to go long, I can tell you this: A decline in price sure as heck does not mean the upside explosion has begun. *Au contraire!* A price decline suggests further price decline: It is that simple Newtonian idea that an object, once set in motion, continues to stay in motion. Traders have a great conflict going on at all times: We want to buy, thus conventional logic says to buy at the cheapest possible price. Yet trend analysis says don't buy what is going down! My advice is to forget buying cheap. Buy when the explosion has begun. Yes, you will miss catching the low, but that is far better than having new lows in price catch you!

Trade Management

The third aspect of speculation has to deal with how you manage the trade itself as well as the money you are committing to the trade. Traditional wisdom is that you should not trade with money you cannot afford to lose.

Maybe.

But consider this: If your mind-set is that this is play money, I assure you that you will play with it. And probably lose. If it is real money—*money you cannot afford to lose*—the chances that you will pay close attention are much greater, and so are your chances of winning. Necessity is not only the mother of invention, but also the control of speculation.

Trade management goes beyond money management as it relates to how long you will stay in the trade and how much profit to take. It directly concerns itself with your emotions: This means not getting carried away, it means not overtrading and not undertrading, and it means doing the right thing and managing your emotional state during the trade.

Knowing how to trade is not the same as knowing how to win at trading. The art of trading combines selection and entry techniques with money management. That is the essence of what needs to be done, but the superior trader understands that it is the

management—the control or the use of these techniques—that maximizes market profits.

ESSENTIAL POINTS ABOUT SPECULATION

Rich People Don't Make Big Bets

Rich people, who are generally smart, have learned that you don't bet the farm on one spin of the wheel, investment deal, or trade. Wannabe speculators are consumed with the notion that they will amass tons of money very quickly by making a killing. They become the hapless victims, as in the process they have become plungers. Yes, you can plunge once or twice in your life, but if you consistently plunge, you will lose on one of these wagers, and since you are betting it all, you will lose it all. That is why rich people don't make big bets.

They are far too shrewd to risk all they have on an investment, as they know investment decisions can be random. In their wisdom, they know the future is somewhat unpredictable; hence they play the game that way. Years ago, I was on the board of directors of a small bank in Montana, and in that position reviewed many loan requests. The business applications always included a pro forma, a projection of how the business would do, and how the loan could be repaid.

I don't think I ever saw any pro forma of what should happen become a reality! They were always off target, and as you might imagine, the reality of the business was not as prosperous as the pro forma would have led one to believe. An old-time banker had a great saying, "Nothing good ever comes in certified mail and pro formas are never right."

Rich people make more money by finding a good investment or two, and investing an optimal amount in those investments. There is no need to take the risk of being wiped out in exchange for the thrill of plunging; it simply is not worth it.

To Make a Thousand, You've Got to Bet a Thousand

This is a favorite expression of pit bosses in Las Vegas and is a subset to the idea that rich people don't bet big. However, it's dead wrong. Here's the right way to "make a thousand."

There is not that much difference between gambling and speculation. The most compelling contrast is that gamblers can never get a leg up on the game; the odds are against them all the time (unless they count cards and play blackjack). It has

always amazed me that in a game where the odds are against us, we flock to the table to play.

Las Vegas stays open 24 hours a day for a simple reason; players won't quit. In any endeavor where you have an advantage, especially a slight one, the longer you play the more certain you are of winning. So they never stop. To casinos, the public is the bank account they tap every minute of every day.

Weaknesses of the Pit Boss Adage

Pit bosses are supposed gurus of gambling knowledge; after all, they have seen it all. But the advice that to make a thousand you need to bet a thousand is “house talk” that will get you into serious trouble.

Last year, my daughter traded \$10,000 to \$110,000, while I took an account from \$50,000 to over \$1,000,000. At no time did we make “a big bet.” It was quite to the contrary: Our bet size was small, never risking more than 20 percent of our stake, and *even that was larger than it should have been or needed to be.*

If you have an advantage in the game, as a speculator must before he decides to play, then play by the real rule that has kept Las Vegas building all those extravagant Meccas of money: Risk little and play around the clock.

The problem with betting a thousand to make a thousand is that you can lose that thousand just as quickly. So why not seek out a strategy that makes a thousand by the natural growth of the game, not by the luck or lack of it on the next trade? There is plenty of money to be made in trading and the game is not going to get shut down anytime soon, so learn to harvest your winnings over time, not on one roll of the dice.

In my 36 years of following the markets, I have seen more people lose fortunes than make them. The losers—all of them—did the opposite of the winners: They bet big thinking they could make a killing on one or two trades. The winners made their fortunes by consistently doing the right thing. When you step out to make a killing, you are more likely to be killed than to survive.

Rich People Don't Make Big Bets

Really rich—and smart—people don't make big bets. First, they are not out to “prove” anything, they are out to make more money; and second, they know that risk control is as important as the other two legs of speculation, selection and timing. That is all that this business of commodity trading comes down to: selection, timing, and risk control.

Speculation Is for People Who Love Roller Coasters

Trust me on this: If you don't like the thrill and up-and-down gyrations of a roller coaster, put this book down, ask for your money back, and go on with your humdrum life. The life of a speculator is literally one roller coaster ride after another; it is a series of ups and downs, highs and lows, in which hopefully the lows are progressively higher, but the reality is often that the lows are lower. Worse yet, so are the highs!

Although many are attracted to the life of speculation because of the thrill, they don't envision the ups and downs: They think it will be a steady stream of Rolls Royce limousines and lollipops. It is not; it's a steady stream of unknown, free-form verse that at times seemingly leads nowhere. In this business, thrill kills.

You must, at heart, be a thrill seeker. But you cannot let that take over your trading style; indeed, if you do not learn to corral or harness your thrill-seeking nature, you will never make it as a speculator. That is probably what makes this business so difficult; while it takes a thrill seeker to speculate, it takes a risk-aversive person to make a career out of speculation. What you must have to succeed in this business, you also must learn to regulate, to control. Clamp down on the roller coaster or it will jump the track. My advice to be a long-term winner in the game of speculation is this: kill thrill.

If You Don't Have the Patience to Wait, There Will Be Nothing to Wait For

This is one of the elements of thrill you must learn to control. Thrill seekers, like you and me (I include you because you didn't put this book down and are still reading), enjoy the rush we get from the experience so much that we want it all the time; hence the neophyte speculator will trade, wager, at the drop of a hat. Set up a proposition and he or she will plunk down her money, simply because, win or lose, there's one sure payoff—the rush.

The core problem new commodity traders have is what we call “overtrading.” This comes about when traders look more for an adrenaline high than for market profits. They find this by either (a) trading more often than they should, or (b) trading more contracts than they should.

It is really a question of intensity: The more contracts you have on, the more thrill you will experience. The more often you trade, the more often you will get an injection of endorphins pumping through your brain. These, then, are *your mortal enemies*: too many trades or too many contracts. Rich people don't bet big and they don't bet every day.

Patience dictates that you trade for a reason beyond the rush, beyond the swashbuckling images we carry in our minds of what a speculator does and thinks.

Frequency and intensity, in my world of speculation, are not bigger and better. I want to be selective, to wait for the ideal time to take my very best shot. This is certainly not a business of scattergun shooting; we are like hunters waiting in the bushes until our game is in full view and about three feet away. Then and only then should we fire away!

Impatient traders literally use up all their ammunition, money, and emotions, so when it is time to shoot, their guns are empty.

If You Can't Follow It, What Good Is a System or Strategy?

Technicians and the like are forever developing trading systems to beat the pants off the market. They spend thousands of hours and dollars in pursuit of profits. That is good; I do the same thing almost every day of my life in an attempt to seek greater understanding of the markets.

The difference is that once they have arrived at their “master system” they take a trade or two and then begin either tinkering with the system or overruling what it is telling them to do. Years ago, my long-time friend Lin Eldridge put it best, “Why keep a system and do all that work if you’re not going to follow it?”

Be honest with yourself. If you are not going to abide by the rules you create, why create the rules? You should be spending your time doing something else. When it comes to speculation, rules are not made to be broken unless you want to end up broke. The rules of speculation exist to tell the ideal time to get in and out, but more important, the rules exist to protect us from ourselves.

Maybe you think this is not your problem, that following a system is an easy thing to do. It isn’t.

Last year in America almost 52,000 people were killed—about 1,000 a week—in car accidents because they failed to obey two very simple rules: don’t speed and/or don’t drive if you have been drinking. Those are easy rules, not complex, not chock-full of emotions like the rules of speculation. Yet families went through major turmoil and grief due to those unexpected wrecks caused by not following a very simple system. Should you choose to speculate in a swashbuckling fashion, trust me, the financial results will be the same. There most assuredly will be carnage and ruin on your speculative highways.

The law of gravity always prevails and the law of gravity in our business must be obeyed.

Christmas Doesn't Come in December

Here is the real rub with this business of being a commodity trader or speculator: we never, ever, know when we will make our money for the year.

Jewelry storeowners know they will make most of their money around the holidays or at Christmas. That is true of most retail stores; they know when the money is going to roll in and can plan for that event.

We cannot. That's one reason why I have written books and published a newsletter: I wanted a sense of some steady income in my life, and it is profitable! I may make money hand over fist for 12 months running or make nothing or, in fact, lose money for the first six or seven months of the year, then hit the jackpot. One never knows in this world of roller coasters what will happen.

That is why commodity fund managers take a flat percentage of the assets under management. That way, they have steady income to offset their costs, despite the typical 20 percent of the profits they charge. They, like anyone else, need to have a consistent income stream.

To my way of thinking, most of you should not quit your jobs and become traders. Your job, as bad as it might be, is your security, your source of income, the guaranteed Christmas. Yes, I know you don't like your job, but you know what? I don't like mine every day, either. It is no piece of cake getting beat up in the markets for two to three months at a stretch. It is no joy to have a series of bad market calls in a newsletter where everyone can see the errors of my way—errors my enemies love to magnify and that my best friends chuckle over.

But none of that matters. In my world, I know you don't have to like it, you just have to do it. That means I must continue following a system, even while it is in a drawdown and losing money, I must use stops when I don't feel like it, and I must keep telling myself Christmas may be delayed this year. What is more, I had better budget and plan my personal life accordingly; I must have enough cash to get me through an extended Christmas drought. And finally, if I do get lucky and find Christmas comes this year in January or February, I sure as heck can't expect it will be Christmas every day until December 25. There are no straight paths to heaven, my account equity is not a straight-up line, it is a meandering back road that encounters plenty of peaks and valleys. That is why I never know when Christmas will come. I just know that if I do the right things, eventually Santa will find my chimney.

If You Have an Advantage in the Game, the Longer You Play the Greater Your Chances Are of Winning

If you know you have an advantage in the game, you know that at some point you will be collecting the chips, that Christmas will come.

This is a vital concept for all speculators, it is a concept to build a belief system on, but the concept itself cannot be built on a belief. Casinos don't operate on a belief. They operate, run their business, on pure math: They know that eventually the laws of the wheel or dice will prevail. Thus they keep the wheels spinning. They don't mind waiting; they don't stop. They also play 24 hours a day for a reason; the longer you play their negative expectation game, the more certain they are of getting your money.

I guess that is why I have always been amused by people who think they can go to Las Vegas to tap the casino's bank. Casinos look at you and me as fodder for their bank accounts, and judging by the size of the megahotels as well as stock performance, they are on the right side of the ledger.

As traders, we must realize that time is our ally. Legal contracts say time is of the essence; that may be so when it comes to performance of obligations, but time is not of the essence when it comes to trading because, given an advantage in a game, the more time that elapses, the more certain your eventual winnings.

Casinos don't close for another reason; the players won't quit. Players *overtrade*, in our vernacular.

We are not casinos, but we can sure learn a great deal from them. We need to know for sure that our approach has a statistical advantage in the game. You need to test, to prove your strategy. You cannot just assume what you are doing will make money because you are so darn smart or good-looking. Once you have proven through research that your approach works, it is then just a question of backing your convictions by following the system.

Press Your Winners, Not Your Losers

This is the most important underlying rule of speculation. Losers do the opposite: They increase the size of their bets when losing and decrease their bets when winning! Losers see a guy lose all his money at a slot machine and rush in to take his place!

Winners look for positive streaks and press their advantage. I vividly recall a string of 18 winning trades in a row in the S&P 500 on a hot line I used to do. After three winning trades in a row, 75 percent of the subscribers would not take the next trades; after six winners in a row, no one took any more trades!

What is going on here is that the human mind cannot stand success and seemingly loves failure. People fear that winnings will turn into failure, whereas they apparently have more hope that failure will turn into success, so they willingly invest or speculate following losses.

The truth is success is the result of strings of winning trades, and to succeed you

must not stop because you have been successful. Press the winnings. Failure is the result of strings of losing trades; the most certain indication that a system is failing is that it is experiencing strings of losses greater than seen in the past, exactly what the typical speculator is seeking to take advantage of! Admittedly, there is wisdom in waiting for short-term failure to start investing in a long-term successful system, but there is no wisdom at all in stopping because something has been “too successful”!

Press your winnings, gang, not your losses.

Success Kills—Affluence Is Dangerous

Although we must, and will, press our winnings, we cannot let success go to our heads because affluence leads to overconfidence, which in turn leads to not following the rules that led to our success.

I have heard countless stories from traders who started following my approach and did very well, in some cases making over \$100,000, then gave it all back. When pressed on what had happened, the bottom line is always the same: The speculator confused luck and consistent application of valid rules with ego, and ego prevailed.

Their ego told them they had finally arrived: They had enough money to take chances and didn't need the basics anymore. They were in charge! Thus they got into a “damn the torpedoes—full steam ahead” mode. No longer were stops so important, and since they were now trading too many positions or too many markets, when the hits came they were big. Too big—it was wipeout time.

How is this cured? There is a simple concept that I keep telling myself: You dance with the person you brought to the dance. Don't change because you see some other beautiful system or trading approach. If you are making money, stay with it, with the same rules, the same logic, and don't tinker. It has never been me that has made the money trading, it has been my following of some well-tested and proven systems or methodology. On my own, on your own, flying by the seat of your pants, you are headed for a crack-up. The more ego you indulge in and the further you stray from the operating rules of speculation, the sooner the crash, and the more spectacular.

The Fear/Greed Dilemma

Let's face it right now at the first of the year ... fear and greed and the emotional tug of war we will have with them all year long.

Overcome this dichotomy and your profits will skyrocket.

For many traders, greed is a stronger emotional force than fear. I believe we are a greedy lot (that's why we enter an arena others pass on). Thus, one needs to know what emotion is gaining the upper hand in his or her daily life, be it in the markets

or business.

Greed, as I have come to understand it, causes us to do that which we should not! It is greed that is the active force, kicking us in, causing us to jump the gun, to hold on too long, to buy too much. Hence if you feel greed seeping inside you, I suggest you look it directly in the face to see if it is leading you into more trouble than reward.

Fear is different. Our fears cause us to not do what we should do. President Roosevelt made the all-time worst comment when he said, "... the only thing we have to fear is fear itself." But then, what would you expect from a socialist who, along with Colonel House, did more to damage this country on a long-term basis than anyone before or since? I digress ...

Fear is prohibitive—it puts on the brakes. It is preventive and it is very primal, as it is more closely connected to survival. Indeed, we need a healthy dose of fear to keep on living. But life, or event fear, is not the same as market fear. For some unexplainable reason, we pass on the best or largest winning trades out of pure adrenaline-spouting fear. We don't place stops for fear we will be stopped out. My advice is that when your fear emotions tell you to not do something, in this business, as Nike says, "Just do it." A scary thought, but that is why top traders are successful. They *just do it*.

There are two important parts to fear: The first is why it happens, the second is what it makes you do.

Fear is the product of unknowing. A SEAL Team buddy of mine said it best: "Whenever we went on a shoot and loot mission, my heart was pumping, but it was not from fear. We were so well trained and armed that every unknown was known. We knew what to do and how to react to any contingency."

Traders are not so well prepared. They have not thought out the future, they trade with no stops (protection), and they trade with no idea of where or how to take profits. Hence all of the future is unknown. It's a black hole and they are afraid of the night.

To shut down on your fears, prepare for the future and have all bases covered, and you will be able to act, not react, to market events.

The next point is that fear causes us to lie. Traders lie about their trades, wins or losses, especially to their spouses, so they are in a state of constant denial and fabrication, a dream world. It's no wonder they don't deal well with reality.

I hope these insights from my career, my fears and my greed factors, give you some understanding of yours.

When to Get In, When to Get Out: Trend Change Signal

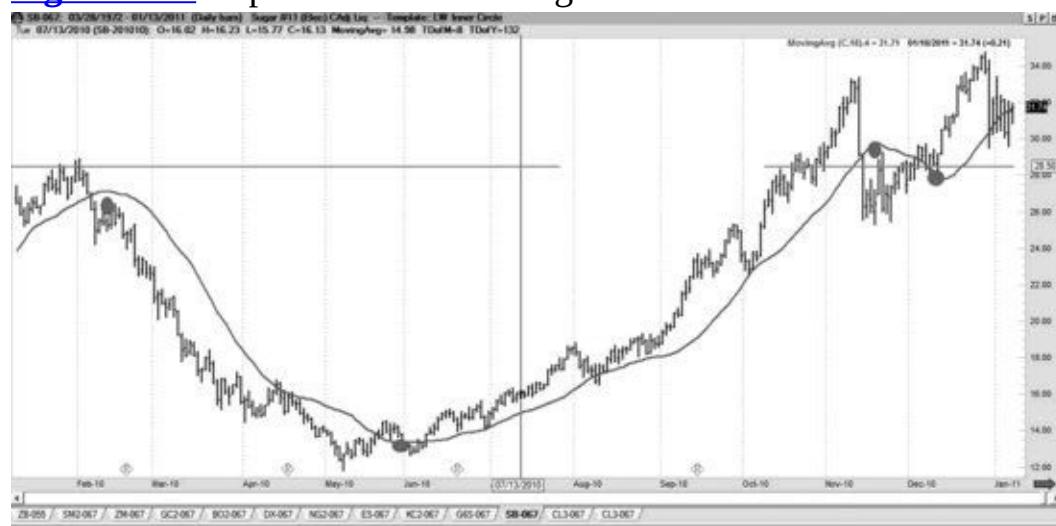
There are probably as many ways to determine trend change as there are traders! In this day of computers, the fancy math boys have really beaten the numbers up to develop a trend change mechanism. In a very large way, trend change is a moot point, as it just tells us what has transpired with no assurance it will continue in the future.

Here is my central thesis on the subject:

Conditions cause major up and down moves, trend change. Without the conditions being present, trend change has little validity. Back a trend change with conditions and you get rip-roaring bull/bear markets.

I would like to think you now understand some of these conditions, such as the commercials. Let me add to your arsenal a trend change tool. The tool illustrated in [Figures 12.1](#) through [12.6](#) is a simple 18-day moving average of closing price. That's it, nothing fancy here. Notice the dots and how they appear at important trend change points.

Figure 12.1 Important Trend Change Points



The dots on all of the charts appear when there have been two days totally above the average for a buy and two days totally below the average for sells. This is the setup for the change. Then some select short-term buy/sell signals can be used for your entry.

I teach more specific entries in my Sure Thing Commodity Trading online course but, as you can see, there is power to these points.

For examples, I have taken three big trend markets (see [Figures 12.2](#) through [12.4](#)): The up move in T-Bonds and the down move in Lumber, as well as a choppy one, Gold.

Figure 12.2 Two Bars above 18-Day Moving Average



Figure 12.3 Two Bars above 18-Day Moving Average



Figure 12.4 Two Bars above 18-Day Moving Average



As you will note, the appearance of the dots usually kicks off trend changes of

consequence. That's the good news for the start of the year; we can determine trend change. This is not a new phenomena: see [Figures 12.5](#) and [12.6](#) from 2000 (note the changes in software since then as well!). I used these charts back then, to illustrate the same point I am making in 2011.

Figure 12.5 Two Bars above 18-Day Moving Average

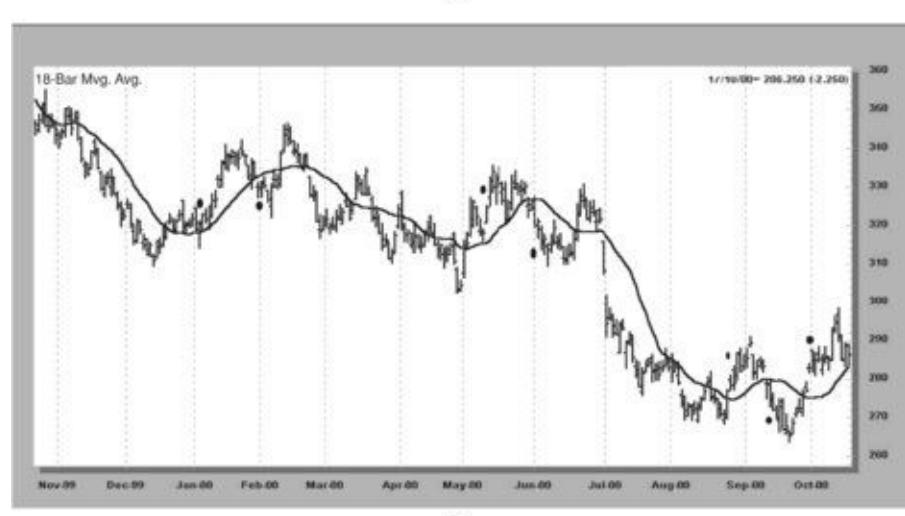
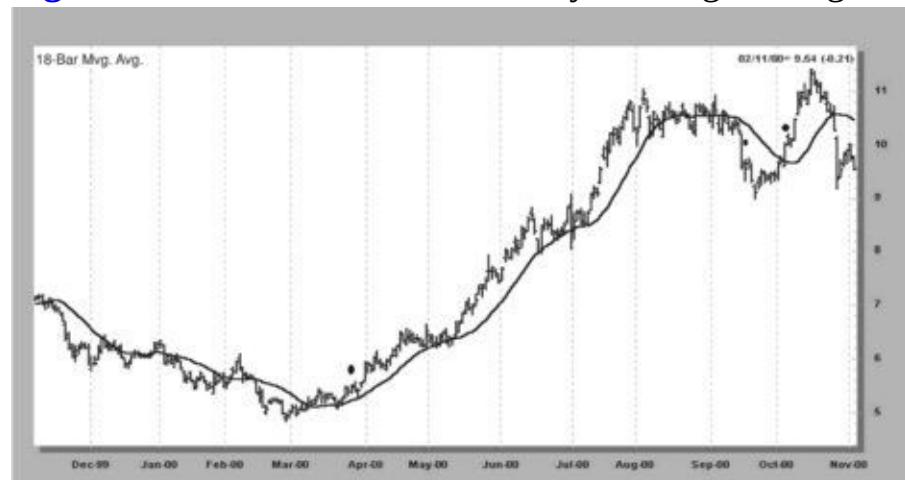
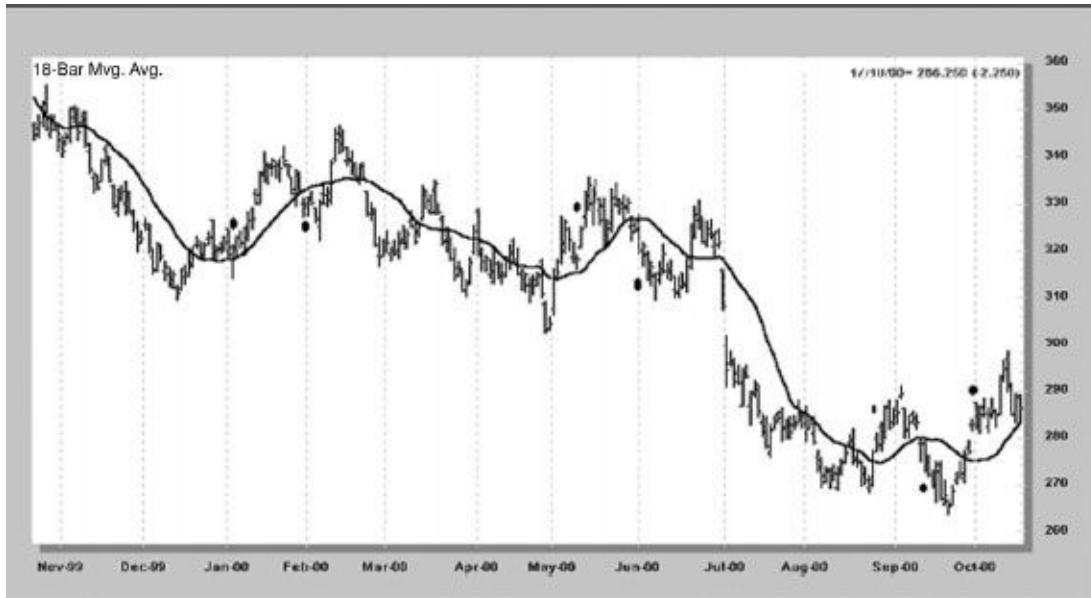


Figure 12.6 Two Bars above 18-Day Moving Average



There is much to learn here: A mere crossing above the moving average on one day, or touching it with no further extension of the move, is not enough to bring about trend change.

As I see it, moving averages act as support and resistance. What's needed to bring about a long-term trend change is for a powerhouse move to follow on a short-term basis, once prices get into the area of the average.

It should go without saying, but there are so many technicians out there I'd better say: Do not take these signals on their own. These signals are just a sign, a symptom of what matters, the underlying bullish/bearish fundamental condition.

Your homework is to get some old chart books or fire up your computer to study this relationship of price, the 18-day average and trend change. This moving average is in all the chart books and software, so you have no excuses.

Confidence, Fear, and Aggressiveness

The meek will never make it as speculators, so they had better have an inheritance.

The three traits speculators must learn to manage within themselves are confidence, fear, and aggressiveness: I will discuss them in this order.

Confidence

You need to have some confidence, but not too much. The confidence comes from your study of the market and not from your feelings about yourself. Forget that entire warm fuzzy inner-child good feeling about your self-confidence. What you need is confidence based on experience and research that allows you to take correct

action without choking when it is time to place a trade. Losers choke. Winners feel nervous about the trade, but they have enough confidence in the approach they are using, not themselves, that they place the trade.

Without confidence, you will never be able to pull the trigger and take your trades, especially during tumultuous market times, which is usually when the best trades pop up out of nowhere.

The meek probably do inherit the earth because they sure as heck are not going to make any money on their own as speculators. The inner assurance I have seen in big-time commodity traders is inspirational. Its essence is not pluck or conceit, nor a sense of self-possession. What is at the core of their confidence is trust or faith that things will work out.

Winning traders see or believe in the future, to that extent that they are full of faith. I believe in God, and that good prevails, that all things do work out favorably. If I don't let God down, I will not be let down. My belief that God prevails gives me the trust in the future to have enough confidence to trade when others fail to take action. I know my life will work out okay; that I have never doubted for an instant. Fear can be limiting, to the point a trader does not believe in the future.

We Have More to Fear than Fear Itself

President Roosevelt had it all wrong about fear. That should come as no surprise, he singlehandedly screwed up this great country more than any other leader ever has with his New Deal socialism and welfare state programs. Worse yet, he persuaded the masses and the media that his programs got us out of the Great Depression. Sure, like America would not have recovered or grown without him? I will never forget campaigning for the United States Senate in the general election and knocking on doors in a heavily Democratic district. Behind one of those doors was a wizened lady of at least 80 whose vote I asked for, only to have her tell me she didn't vote. When I asked why, she said, "I voted only once in my life, that was for FDR, and after seeing what he did, I told myself that if I was dumb enough to vote for that son of a bitch, I should never vote again!"

Fear is a powerful force to help speculators perform at their peak. The best example of the use of fear that I know of was expressed by Royce Gracie. You may not know who Royce Gracie is, so let me tell you a bit about him.

Gracie is a world-class athlete. He is the guy in those Ultimate Fight pay-for-view TV shows. In case you haven't seen one, they are real fights, no boxing gloves, and just about anything is legal, from kicking to gouging. This is for-real violence. What is interesting about Gracie is that in over 100 fights he has never been beaten. That is *never* as in *never, ever* by anyone: boxers, kickers, elbow punchers, Tai kickers. No one has been able to beat this man.

Considering that most of these would-be tough guys weigh from 225 to 300 pounds, Gracie's accomplished victories are even more awesome when you find out he weighs about 180 pounds and looks better in a Mr. Rogers-style cardigan than fighting attire. You would never know the guy is a giant killer. Since I am fascinated with fighters and winners (they have a lot in common with speculators), I have followed his career and listened intently to his words of wisdom.

In one interview, these television thugs were asked if they felt any fear going into these fights because, after all, they are real—guys have been maimed, lost their sight, broken bones, suffered numerous severe concussions, and at least one fighter has died. All the tough guys machine-gunned out their male macho line about having no fear of anyone or anything.

That is, all of them but Gracie. He freely admitted he is scared to death every time he enters the ring. He went on to say that he uses that fear to his advantage, as it enables him to respect his opponent and not take reckless action or deviate from his personal fighting style. “Without fear,” he said, “you cannot win. Fear pumps me up for the fight but also assures that I will not lose control. What we do is very dangerous; my best protection is to be afraid, so I protect myself in all the ways of my craft.”

Like Gracie, I have an immense fear of trading, I have seen people wiped out, losing all they owned from poor speculation. Some went bankrupt, some really did go crazy, and several killed themselves. I suspect all these people had one thing in common: They did not fear the markets.

I think you need to fear the markets and fear yourself.

Although the markets are frightening, the emotions you and I interject into trading are downright scary. Without fear, there is no respect; if you do not respect the markets and fear yourself, you will become one more dead body on the long trail of commodity market casualties scattered across the land.

The Right Dosage of Fear and Confidence Create Aggressiveness

There comes a time in every trader's life, about once a week in fact, when you have to get aggressive, either in protecting yourself or asserting your market expectations. It is kind of like that eye-of-the-tiger idea in the first *Rocky* movie. Unless you have a killer instinct, you had better fold your tent and go home. This is not a business for passive people, who seemingly don't care whether they win or lose, people who lack that cutting edge to pick up a challenge and proceed.

I don't mean hostility, as most people usually envision aggressiveness. Winning traders have a certain boldness to their action, and that boldness is the culmination

of confidence, fear, and aggressiveness. In this battle for speculative profits, a well-thought-out plan with boldness will go a long way toward carrying the day.

RECAP

The point of this chapter is that, when we look at charts and numbers crunched by computers, all that information needs to be applied to a strategy or unified concept of how to trade.

My experience has been that most highly educated mathematicians blow up in their trading. Why? They cannot see the forest (strategies and concepts) for the trees (numbers and formulas). There are emotions to trading, and the better your responses to these natural emotions, the better your trading will be.

CHAPTER 13

Money Management—The Keys to the Kingdom

The creation of a speculator's wealth comes from how they manage their money, not some magical, mysterious system or alchemist's secrets. Successful trading makes money and successful trading with proper money management can create immense wealth.

Here it is, the most important chapter in this book, the most important chapter in my life, the most valuable thoughts I can transfer from me to you. I have nothing of more value that I could possibly give you than what you are about to read. This is not an overstatement.

I am going to explain the formula that I have used to take small amounts of money like \$2,000 to more than \$40,000, \$10,000 to \$110,000, and \$10,000 to \$1,100,000. These were not hypothetical victories; we are not talking Monday morning quarterbacking—we are talking about real time, real money, and real profits that you can spend to buy all the luxuries of life.

Until you use a money management approach, you will be a two-bit speculator, making some money here, losing some there, but never making a big score. The brass ring of commodity trading will always be out of your grasp as you sashay from one trade to another, picking up dollars but not amassing wealth.

The truly shocking thing about money management is how few people want to hear about it or learn the correct formulas. When I am at a dinner or cocktail party, invariably the conversation turns to the markets. People want hot tips, or to know how I have been able to make a living without working. They want my secret. As if there were one!

The public or the typical noneducated speculator thinks there is magic to trading, that somewhere, somehow, someone has a magic decoder ring that correctly signals market action.

Nothing could be further from the truth. Money is made in this business by getting an advantage in the game, working that advantage on a consistent basis, and coupling this with a consistent approach regarding how much of your bankroll you have behind each trade.

MOST TRADERS USE A HIT-AND-MISS APPROACH

Most traders who are confident enough to risk large sums of money are also confident enough to think that they can figure out the future. That translates into two problem areas.

First, we think we can select the winning trades from the losers in our system or approach. Worst, though, is thinking we are smart enough to do that and therefore trading an unequal number of contracts or shares on our various trades.

Just as we must consistently follow our battle plan to succeed, we must also be consistent in the amount of money we marshal behind each trade. The instant you get the notion you can “for sure” spot the big winners and back those trades with more contracts than you have been trading, trouble will find you.

Every now and then, you will hit it right and score big but, eventually, you will have a loss on that large position. The loss is bad enough, but since you have overstepped good money management, you will then become emotional and probably hold onto the trade too long in hopes of recouping the big hit. Thus things don't get better . . . instead, they get worse!

Let me turn to our well-worn Las Vegas casino analogy one more time. Casinos all over the world limit their losses by having a maximum amount that the player can bet on any one decision in every game. A good commodity trader should limit losses in the same way. Can you imagine a pit boss suddenly allowing a high roller to bet more than the house limit because the boss “feels” the customer is going to lose on the next roll? Of course not; the pit boss would be fired on the spot for breaking a cardinal rule of money management: Avoid risking too much.

Trading too much and betting too much will cost you far more than bad market calls.

APPROACHES TO MONEY MANAGEMENT —ONE IS RIGHT FOR YOU

There are many ways to go about this problem, many formulas to follow. But all the superior systems to manage your investment dollars have a common tenet; you will increase the number of units, contracts, or shares as you make money and decrease them as you lose money. That is the essence of the sweet science of the correct marshaling of your funds. This basic truth can be arrived at in several ways.

I am going to show you the major ones, hoping you will find the shoe that fits

you. No discussion on the subject could be complete without bringing up the name Ralph Vince. In 1986, I ran across a money management formula for playing blackjack, originally developed in a 1956 paper, “A New Interpretation of Information Rate,” regarding flow of information and now called the Kelly formula by commodity traders.

What I know about math, you could add up on your thumb and first finger, but I know “math works” so I began trading commodities using the Kelly formula. Here it is, with F representing the amount of your account that you will use to back each trade:

$$F = ((R + 1) \times P - 1)/R$$

where

P = Percentage accuracy of the system winning

R = Ratio of winning trade to losing trade

Let's look at an example using a system that is 65 percent accurate with wins 1.3 times the size of losses. The math is done as follows using P as .65 and R as 1.3:

$$1.3 + 1 \times .65 - 1/1.3$$

$$2.3 \times .65 = 1.495 - 1 = 0.495/1.3 = 38\text{ percent of account used to trade.}$$

In this example, you would use 38 percent of your money behind every trade; if you had a \$100,000 account you would use \$38,000 and divide that by margin to arrive at the number of contracts. If margin was \$2,000, you would be trading 19 contracts.

THE GOOD, THE BAD, AND THE UGLY OF MONEY MANAGEMENT

What this formula did for my trading results was phenomenal. In a very short time, I became a real-life legend, as very small amounts of money skyrocketed. Using a percentage of the money in the account, based on Kelly divided by margin, was my approach. It was so good that I was kicked out of one trading contest because the promoter could not believe the results were accomplished without cheating. To this day, people on the Internet claim I used two accounts, one for winning trades and one for losers! They seem to forget or not know that, in addition to that scheme being highly illegal, all trades must have an account number on them before the trade is entered; how could the broker, or myself, know which trade should have the winning account number on it?

But what would you expect when no one, to my knowledge, had ever before turned in that type of performance in the history of trading? To make matters “worse,” I did it more than once. If they aren't calling it a fluke or a matter of luck,

the losers lament that it must have been done by pinching some numbers or trades along the way!

What I was doing was revolutionary. And, as with any good revolution, some blood flowed in the streets. The blood of disbelief was that first the National Futures Association and then the Commodity Futures Trading Commission commandeered all my account records, looking for fraud!

The CFTC went through the brokerage firm's records with a fine-tooth comb, then took all my records and kept them for over a year before giving them back. About a year after getting them back, guess what, they wanted them back again! Success kills.

All this was due to market performance that was unheard of. One of the accounts I managed went from \$60,000 to close to \$500,000 in about 18 months using this new form of money management. Then the client sued me: Her lawyer claimed that she should have made \$54,000,000 instead of half a million. Now my believers were willing to put me on a pedestal, if they could collect some money. The revolution was more than anyone could handle.

What a story, huh?

But there are two sides to the edge of this money management sword.

My extraordinary performance attracted lots of money for me to manage. Lots of money . . . and then it began to happen: The other side of the sword flashed in the sun. Besides trying to be a business manager (i.e., running a money management firm) with precious few skills at doing something I am no good at anyway, my market system hit the skids, with a cold streak that saw equally spectacular erosions of equity. Whereas I had been making money hand over fist, I was now losing money hand over fist!

Brokers and clients screamed, and most took the off-ramps; they simply could not handle this type of volatility in their account balances. My own account, which had started the first of the year at \$10,000 and had reached \$2,100,000, was hit along with everyone else's . . . it, too, was caught in the whirlpool, spiraling down to \$700,000.

About then, everyone jumped ship but me. Hey, I am a commodity trader, I like roller coasters, is there another form of life? Not that I knew, so I stayed on, trading the account back to \$1,100,000 by the end of 1987.

What a year!

Watching all this over my shoulder every day was Ralph Vince, while we worked together on systems and money management. Long before I could see it, he saw it; Ralph found a fatal flaw in the Kelly formula. I was too blind: I kept trading it, while Ralph, math genius that he is, began intensive research into money management, the culmination of which was three great books. His first was *The Mathematics of Money Management* (1992), followed by *Portfolio Management Formulas* (1990),

and, my favorite, *The New Money Management* (1995). These are all published by John Wiley & Sons, and are must-reads for any serious trader or money manager.

Ralph noticed the error of Kelly, which is that it was originally formulated to assist in implementing the flow of electronic bits, and then used for blackjack. The rub comes from the simple fact that blackjack is not commodity or stock trading. In blackjack, your potential loss on each wager is limited to the chips you put up, whereas your potential gain will always be the same in relationship to the chips bet.

We speculators don't have such an easy life. The size of our wins and losses bounces all over the place. Sometimes we get big winners and sometimes minuscule ones. Our losses reflect the same pattern: They are random in size.

As soon as Ralph realized this, he could explain the wild gyrations in my equity swings; they came about because we were using the wrong formula! This may seem pretty basic as we are about to enter a new century, but back then we were in the midst of a revolution in money management and this stuff was not easy to see. We were tracking and trading where, to the best of my knowledge, no one had gone before. What we saw were some phenomenal trading results, so we did not want to wander too far from whatever it was we were doing.

Ralph came up with an idea he calls Optimal F; it is similar to Kelly, but unlike Kelly can adapt to trading markets and gives you a fixed percentage of your account balance to bankroll all your trades. Let's look at what can happen with this general approach.

On the End of a Limb and Sawing It Off

The problem with an optimal F approach or fixed fraction of your account is that, once you get on a roll, you roll too fast. Let me prove my point: If your average win/loss trade is \$200 and you have 10 trades per month and you will increase on contract at every \$10,000 of profits, it will take you 50 trades or five months to add that first additional contract. Then it will take only two and a half months to go from two to three; about seven weeks to boost it up to four contracts; five weeks to jump to five; one month to reach six; 25 days to reach seven; or 21 days to reach eight contracts. Eighteen days later, you are at nine, and at 16.5 days, you trade a 10-lot order.

Then disaster strikes, as it surely must. You have now scooted out on the end of a limb and are sitting there with lots of contracts on. Although the limb snaps when you have a large losing trade (three times the average of \$200 or \$600 per contract times the 10-lot order, so you just dropped \$6,000), you have not given back \$10,000 yet. So you trade a 10-lot order on the next trade and lose another \$6,000. Now in two trades, you are down \$12,000 from your equity high at \$100,000.

The next trade is also a loser: That's three in a row, for the average of \$200 times

the nine-lot order you are now trading, and you get tagged for another \$1,800 (let's call it \$2,000). You are now down \$14,000.

Meanwhile, a "smarter" trader decreases faster than you, cutting back two contracts for every \$5,000 lost, so on the first hit he or she is back to eight contracts, losing only \$2,400, sidestepping another \$6,000 hit, and on it goes.

And It Can Get Worse by Far . . .

Let's take a winning system. It wins 55 percent of the time, and you decide to trade 25 percent of your bankroll, starting at \$25,000 on each trade. Wins are equal to losses at \$1,000 each. [Table 13.1](#) shows the way the trades played out.

Table 13.1 Winning 55 percent of the Time

| | | |
|-----|--------|--------|
| 1. | -6,000 | 15,000 |
| 2. | -3,000 | 12,000 |
| 3. | -3,000 | 9,000 |
| 4. | +2,000 | 11,000 |
| 5. | -2,000 | 9,000 |
| 6. | -2,000 | 7,000 |
| 7. | +2,000 | 9,000 |
| 8. | +2,000 | 11,000 |
| 9. | +3,000 | 14,000 |
| 10. | +3,000 | 17,000 |
| 11. | +4,000 | 21,000 |

You made \$1,000 yet had a 65 percent drawdown, while a single contract trader would have dipped \$16,000 with a 20 percent drawdown!

Let's look at another scenario where we hit it right from the get-go, winning five of eight trades ([Table 13.2](#)), which is a great deal, right?

Table 13.2 A Winning Combination

| | | |
|----|---------|-----------------|
| 1. | +5,000 | 25,000 |
| 2. | +6,000 | 31,000 |
| 3. | +7,000 | 38,000 |
| 4. | +9,000 | 47,000 |
| 5. | +11,000 | 58,000 (Wow) |
| 6. | -14,000 | 44,000 |
| 7. | -11,000 | 33,000 |
| 8. | -16,000 | 13,000 (What!?) |

Look at this . . . five winners, three losers, and you are down. How can this be? Well, it is a combination of two things: The money management that got you to the

\$58,000 also brought you down, and I also threw in a kicker, the last trade was just like trades the market gives us all the time, a loss two times greater than the average loss. Had it been the traditional loss, your account would be at \$26,000. The smart trader who cut back twice the amount after the first loss would have lost \$5,000 on trade number 7, taking him to \$29,000 and -\$8,000 on the double hit on trade number 8 to show a net of \$31,000!

LOOKING IN NEW DIRECTIONS, DRAWDOWN AS AN ASSET

My trading stumbled along with spectacular up-and-down swings, while we continued looking for an improvement, something, anything that would tame the beast. From this search came the basic idea that we needed a formula that would tell us how many contracts to take on the next trade.

One such thought was to divide our account balance by margin plus the largest drawdown the system had seen in the past. This sure makes a lot of sense. You are sure to get hit by a similar, if not larger, drawdown in the future, so you had better have enough money for that plus margin. As a matter of fact, it struck me that one would need an amount equal to margin plus drawdown times 1.5, just to be on the safe side.

Thus, if margin were \$3,000 and the system's largest drawdown in the past had been \$5,000, you would need \$10,500 to trade one contract ($\$3,000 + \$5,000 \times 1.5$). This is not a bad formula, but it does have some problems.

I am now going to show several money management schemes applied to the same system. The system is one of the best I have, so the results will look a little too good. You should also notice the almost unbelievable gains the system produces: millions of dollars of profits. Now the reality is that this system may not hold up in the future exactly like this. Most of you will not want to trade up to 5,000 bonds, as this test allowed, which means one tick, the smallest price change bonds can have, will cost you \$162,500 if that one tick is against you. Let me add, it is not unusual for bonds to open 10 ticks against you, on any given morning, and in this example that is, \$1,625,000! So don't get carried away with the profits, instead focus on the impact money management can have on the results.

What you should focus on is the differences in performance produced by different approaches to managing your money. The system trades bonds, which have a \$3,000 margin. [Figure 13.1](#) shows no money management; it simply reflects the complete results of the system from January 1990 through July 1998, starting with a \$20,000 account balance.

Figure 13.1 Bond Trading System without Money Management
System Report

9/11/98 11:54:44 AM

System Number: 387

Description: Bonds 7/98 no bail

System Rules:

Market:

Test Period: 1/1/90 to 7/16/98

Summary

| | | | |
|-------------|-----------|----------------|-----------|
| Trades | 310 | Begin Balance | \$ 20,000 |
| PL Ratio | 1.4 | Ending Balance | \$251,813 |
| Drawdown TT | (\$3,988) | Equity Peak | \$251,813 |
| Drawdown PV | -18.3% | Return | 1159.1% |

Profitable Trades

| | |
|------------------|-------------|
| Wins | 230 |
| Win Pct | 74.2% |
| Win Avg | \$1,350.68 |
| Largest Win | \$10,137.50 |
| Most Consec Wins | 31 |
| Avg Consec Wins | 4.11 |

Losing Trades

| | |
|--------------------|--------------|
| Losses | 80 |
| Loss Pct | 25.8% |
| Loss Avg | \$985.55 |
| Largest Loss | (\$1,956.25) |
| Most Consec Losses | 6 |
| Avg Consec Losses | 1.45 |

Number of trades to reach the maximum units traded

Number of days to reach the maximum units traded

Base Unit Calculation Rules

ONE CONTRACT
ONLY

Now we will take this same system and apply a variety of money management strategies so you can see which one might best work for you. To arrive at the inputs, I ran the system for just the first seven years, then traded forward with money management for the remaining time period so the drawdown, percent accuracy, risk/reward ratios, and the like were developed on sample data and run on out-of-sample data. I allowed the system to trade up to 5,000 bonds, which is a heck of a lot.

Ryan Jones and Fixed Ratio Trading

Another friend, Ryan Jones, wrestled with the problems of money management like a man possessed. I met him when he was a student at one of my seminars; I later went to his seminar on my favorite subject, money management. Ryan has thought about the problem a great deal and spent thousands of dollars on research to formulate his solution, which he called Fixed Fractional Trading.

Like Ralph and me, Ryan wanted to avoid the blowup phenomenon inherent in the Kelly formula. His solution is to wander away from a fixed ratio approach of trading X contracts for every Y dollars in your account.

His reasoning is based largely on his dislike of increasing the number of contracts too rapidly. Consider an account with \$100,000 that will trade one contract for every \$10,000 in the account, meaning it will start trading 10 contracts or units. Let's assume the average profit per trade is \$250, meaning we will make \$2,500 (10 contracts times \$250) and need 5 trades to increase to trading 11 contracts. All goes well, and we keep making money until we are up \$50,000 with a net balance of \$150,000, meaning we are now trading 15 contracts, which times \$250 nets us \$3,750 per win. Thus we increase an additional contract after only three trades. At \$200,000 of profits, we make \$5,000 per trade, thus needing only two winners to step up another contract.

Ryan's approach is to require a fixed ratio of money to be made to bump up one contract. If it takes \$5,000 in profits to jump from one to two contracts, it will take \$50,000 in profits on a \$100,000 account to go from 10 to 11 units. The fixed ratio is that if it took 15 trades, on average, to go from one to two contracts, it will always take 15 trades, on average, to bump that to next level, unlike Ralph's fixed ratio, which requires fewer trades to go to higher levels.

Ryan accomplishes this by using a variable input (one you can alter to suit your personality) as a ratio to drawdown. He seems to prefer using the largest drawdown times two. We will now look at the same trading system for the bond market with the Ryan Jones formula.

As you can see in [Figure 13.2](#), this approach also “creates wealth” in that it brings about an exponential growth of your account, in this case \$18,107,546! However, to achieve the same growth as with the other formulas, you need to pony up a larger percent of your bankroll on each bet. This can result in a wipeout scenario as well, unless you use a very low percentage of your money, which in return guarantees a less rapid growth in your account.

Figure 13.2 Varied Results Based on Risk Percentage of Account

System Report

9/11/98 3:06:15 PM

System Number: 387

Description: Bonds 7/98 no bail

System Rules:

Market:

Test Period: 1/1/90 to 7/16/98

Summary

| | | | |
|-------------|-----------|----------------|--------------|
| Trades | 310 | Begin Balance | \$ 30,000 |
| PL Ratio | 1.4 | Ending Balance | \$18,107,546 |
| Drawdown TT | (\$3,988) | Equity Peak | \$18,107,546 |
| Drawdown PV | -61.3% | Return | 60258.5% |

Profitable Trades

| | |
|------------------|-------------|
| Wins | 230 |
| Win Pct | 74.2% |
| Win Avg | \$1,350.68 |
| Largest Win | \$10,137.50 |
| Most Consec Wins | 31 |
| Avg Consec Wins | 4.11 |

Losing Trades

| | |
|--------------------|--------------|
| Losses | 80 |
| Loss Pct | 25.8% |
| Loss Avg | \$985.55 |
| Largest Loss | (\$1,956.25) |
| Most Consec Losses | 6 |
| Avg Consec Losses | 1.45 |

Number of trades to reach the maximum units traded

Number of days to reach the maximum units traded

Base Unit Calculation Rules

BASE UNITS = account balance/(draw down*2)

If Account Balance Increases by: units last trade

INCREASE units on the next trade by: 1

If Account Balance Decreases by: units last trade

DECREASE units on the next trade by: 1

... And Now, My Solution to the Problem

In talks with Ralph and Ryan, I became aware that what was causing the wild gyrations was not the percent accuracy of the system, nor was it the win/loss ratio or drawdown. The hitch and glitch came from the largest losing trade, and represents a critical concept.

In system development, it is easy to fool ourselves by creating a system that is 90 percent accurate, making scads of money, but will eventually kill us. Doesn't sound possible, does it? Well, it is, and here's how. Our 90 percent system makes \$1,000 on each winning trade and has nine winners in a row, leaving us ahead by a cool nine Gs. Then comes a losing trade of \$2,000, netting us \$7,000: not bad. We get nine more winners and are sitting pretty with \$16,000 of profits when we get another loss, but this one is a big one, a loss of \$10,000, the largest allowed by the system, setting us back on our fannies with only \$6,000 in our pocket.

But, since we had been playing the game by increasing contracts after making

money, we had two contracts on and thus lost \$20,000! We were actually in the hole \$4,000 despite 90 percent accuracy! I told you this money management stuff was important.

What ate us alive was that large losing trade. That is the demon we need to protect against and incorporate into our money management scheme.

The way I do this is to first determine how much of my money I want to risk on any one trade. I am a risk seeker so, for the sake of argument and illustration, let's say I am willing to risk 40 percent of my account balance on one trade.

If my balance is \$100,000, that means I have got \$40,000 to risk and since I know the most I can lose is, say, \$5,000 per contract, I divide \$5,000 into \$40,000 and discover I can trade eight contracts. The problem is if I get two large losers in a row, I am down 80 percent, so we know 40 percent is too much risk . . . way too much.

Generally speaking, you will want to take 10 to 15 percent of your account balance, divide that by the largest loss in the system, or the largest loss you are willing to take, to arrive at the number of contracts you will trade. A very risk-oriented trader might trade close to 20 percent of his or her account on one trade, but keep in mind, three maximum losers in a row and you have lost 60 percent of your money!

The final product of such a money management approach is shown in [Figure 13.3](#). The \$582,930,624 of “profits” came from determining a risk factor of 15 percent, taking that percentage of the account to arrive at a dollar amount, which was then divided by the largest loss in the system.

[Figure 13.3](#) Varied Results Based on Risk Percentage of Account

System Report

9/11/98 3:00:45 PM

System Number: 387

Description: Bonds 7/98 no bail

System Rules:

Market:

Test Period: 1/1/90 to 7/16/98

Summary

| | | | |
|-------------|-----------|----------------|---------------|
| Trades | 310 | Begin Balance | \$ 30,000 |
| PL Ratio | 1.4 | Ending Balance | \$582,930,624 |
| Drawdown TT | (\$3,988) | Equity Peak | \$582,930,624 |
| Drawdown PV | -29.7% | Return | 1943002.1% |

Profitable Trades

| | |
|------------------|-------------|
| Wins | 230 |
| Win Pct | 74.2% |
| Win Avg | \$1,350.68 |
| Largest Win | \$10,137.50 |
| Most Consec Wins | 31 |
| Avg Consec Wins | 4.11 |

Losing Trades

| | |
|--------------------|--------------|
| Losses | 80 |
| Loss Pct | 25.8% |
| Loss Avg | \$985.55 |
| Largest Loss | (\$1,956.25) |
| Most Consec Losses | 6 |
| Avg Consec Losses | 1.45 |

Number of trades to reach the maximum units traded

Number of days to reach the maximum units traded

Base Unit Calculation Rules

BASE UNITS = account balance* 15/largest loss

As your account increases in value, you trade more contracts; as it declines, you trade fewer. This is what I do and this is the general area of risk I am willing to assume. It does not matter too much; a lower, and thus safer risk of 10 percent still makes millions of dollars.

What I find fascinating is that the Ryan Jones approach, which did very well, "made" only \$18,107,546, while a one-contract trader would have made a mere \$251,813, and my approach, at least on paper, makes a staggering \$582,930,624. Clearly, how you play the game does matter: It matters immensely.

[Table 13.3](#) shows the system with various risk percentages being used. The graph in [Figure 13.4](#) depicts the increase in the account equity with the increase in percent risk drawdown directly next to it. As you can see, there is a point where the amount you make rises faster than the drawdown, then as the risk percent increases, drawdown increases faster than the increase on profits in your account. This usually takes place between 14 percent and 21 percent; in most systems, any risk percent value greater than 25 percent will make more money, but at a sharp increase in the drawdown.

Table 13.3 Top 10 Optimization Results

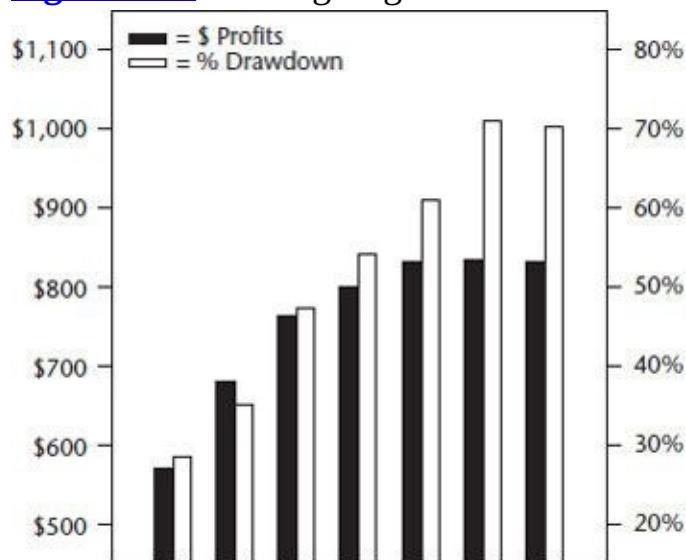
| System | | | | | | | | | |
|----------------|----------------------|----------|---------------|-------------|----------------|---------------|----------------|------------|--|
| Begin Balance | \$0.00 | | | | | | | | |
| Ending Balance | Peak/Valley Drawdown | Risk Pet | Maximum Units | Restart Pet | Minimum Profit | Trading Style | Recover Losses | Margin | |
| \$845,429,594 | -66.9% | 40% | 5000 | 100% | \$0.00 | All Trades | No | \$3,000.00 | |
| 844,881,388 | -77.1 | 50 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 842,428,863 | -72.2 | 45 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 835,954,544 | -61.5 | 35 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 802,829,038 | -54.4 | 30 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 759,721,131 | -46.6 | 25 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 686,869,688 | -38.2 | 20 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 560,344,731 | -28.4 | 15 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |
| 18,606 | -7.0 | 10 | 5000 | 100 | \$0.00 | All Trades | No | 3,000.00 | |

So here it is, my money management formula:

$$(\text{account balance} \times \text{risk percent})/\text{largest loss} = \text{contracts or shares to trade}.$$

There are probably better and more sophisticated approaches, but for run-of-the-mill traders like us, not blessed with a deep understanding of math, this is the best I know of. The beauty of it is that you can tailor it to your risk/reward personality. If you are Tommy Timid, use 5 percent of your bank; should you think you are Normal Norma, use 10 percent to 12 percent; if you are Leveraged Larry, use from 15 percent to 18 percent; and if you are Swashbuckling Sam or Dangerous Danielle, use in excess of 20 percent of your account . . . and go to church regularly.

Figure 13.4 Trading Sugar



I have made millions of dollars with this approach. What more can I tell you? You have just been handed the keys to the kingdom of speculative wealth.

BACK TO RALPH: 2011 MONEY MANAGEMENT BREAKTHROUGH

If you have traded commodities, most likely you have blown out an account. Like all of us, you started out with some amount of money, and by the time things were all said and done, lost most if not all that money. I suppose there isn't a single commodity trader that has not had this experience.

How do we overcome this?

To begin, obviously the trading system you are using is of great importance. But I think you would be surprised to find out how difficult it is to make money at this, and that difficulty has nothing to do with your trading ability or the markets: It simply has to do with mathematics.

If someone told you, "I have a system in which you will be right half of the time, wrong half of the time, your average profit will equal your average loss, and your trades will alternate, winner to loser. Will you trade this?" What do you think the chances are that will you make money, lose money, or break even?

The correct answer is: You will lose money. All your money if you trade long enough.

How can that be, you ask? It is true because if you start with \$1,000, and you begin the sequence of trading with a loss (and alternately, a gain) of 10 percent on every trade, then after your first losing trade, you now have \$900 in your account. And there is the rub: A 10 percent gain on the \$900 is only \$90, so you have \$990 as your balance. So after your second trade, despite an equal risk/reward ratio and 50 percent accuracy, you're behind the eight ball. The next trade is a loser and now you have \$891 in your account. Of course, that was followed by a winner, but your account now shows \$980. That will not change . . . despite having a 50-50 chance and an equal risk/reward ratio . . . even before commissions, you lose money.

What follows is a clip from an Internet ad for trading FX, with my comments in parenthesis. What do you think the chances are of being a consistent winner when you leverage your account by a power of 500?

Why Traders Choose FXpro

- *Competitive spreads from 0.5 pips* (yea, right)
- *No hidden fees and no extra charges* (no need to)
- *Flexible leverage up to 1:500* (no comment needed)
- *Trading account from as low as \$500* (get serious)
- *More than 140 tradable instruments* (only need one)

- *Exclusive up to the minute market news (that'll help)*

Let's see . . . on your first trade you use a stop-loss that is 5 percent of your account balance, let's say that is \$5,000 or \$250. But, smart guy that you are, you margin the trade by a factor of 250; after all, you are conservative. Guess what? That would be a loss of \$62,500, so that won't quite work. Oh, but you just place your stop closer . . . like two to three ticks away.

I'm not the best trader ever, but I'm also not too bad at it, yet I doubt if I have had more than a handful of trades in the past year that did not move two to three ticks against my entry price at some time.

Now you know why I have more respect for the honesty of crack cocaine dealers than for the "Forex Funny Money" crowd that offers you 500 to 1 magnification of your trading problems.

THE KELLY RATIO MIRAGE

The Kelly ratio is something that I used to win the Robbins World Cup championship in 1987. I had no idea what I was doing, but was fortunate. Because I was correct a high percentage of the time, I survived. But my thinking now is that Kelly or anything close to it means you lose most if not all of your money. It is a mathematical mirage.

I do not use Kelly now, nor do I recommend it. Yet many do not understand what I learned the hard way. It is for that purpose I am commenting, extensively, in this chapter on the ratio: for historical purposes to explain what I did and why, now, I don't.

This ratio looks at the percentage of wins in your system and the average risk-reward ratio. That this is purely theoretical and has nothing to do with real trading is the problem. I don't know of any system or any trader that will have consistent results. Kelly is about consistency, something that does not exist in our world.

In our real world, it is not unusual to have three or four losing trades in a row on a system that has a good risk/reward ratio and a high percentage of accuracy. The Kelly number for such a trading methodology would be about 25 percent of your account on each trade.

Use that ratio and get four clunker trades and a \$1,000 account ends up at \$105. Hmm. . . . That doesn't sound very impressive, especially in the business where there's a high probability of having three or four losing trades in a row. In one system I have developed that is 86 percent accurate there have been five times when there were at least four losing trades in a row. Four times you, most likely, tapped

out. Beware of the mirage.

Of course you could back that off, and not be as aggressive as Kelly. You say you use a 10 percent risk factor. Do that, and after four trades you've lost 34 percent of your account . . . a place where most traders or clients will force you to quit.

In a seminar this year, Ralph Vince made a great point that in using his Optimal F, there is a sweet spot where it works best. Kelly, Optimal F, and so forth, all present a bell-shaped curve, and if you used the number on the left side of the peak you get the same results as using a number on the right side; however, you're closer to ruin using the number on the right side of the curve. In other words, there is a less aggressive value that can be used that accomplishes the same results.

During his seminar I got to thinking that in my life as a trader, *All that matters is my next trade*. It doesn't matter if my system is 90 percent accurate, nor does it matter if my system has a 6–1 risk/reward ratio. All that matters is the next trade I am in. What should happen, what may happen and what has happened in the past, I think, has no bearing on the trade I am in now. “One trade at a time” is my new motto!

Which got me to thinking . . . *Shouldn't my money management program be totally about this trade, the one I'm in now?*

I think so; not only that, I know there's a very high probability of having three or four losing trades in a row, so:

It is more important to build my money management strategy around the idea of four losing trades in a row than perhaps anything else.

You saw earlier how the Kelly ratio will blow out your account in just four losing trades.

The trade I am in right now, has precisely a 50 percent chance of being a winner or loser. Thus the accuracy of the system has no bearing on this trade . . . because . . . it only takes one large loser, or a string of four smaller losses to wipe out your account.

So for my money management strategy I am going to assume that my percentage of accuracy will be 50 percent. (Hopefully it will be higher, but I cannot bank on that.)

The next question is, What will be my risk/reward ratio? We can debate that all day long, but in my trading experience for almost 50 years now, I think the average risk reward ratio is somewhere between 1.5 and 2.0. Kelly says that 25 percent of your account wagered on each trade. We know that's not going to work. A 1.5 risk reward ratio Kelly has you betting 16.6 percent of your account. That does not bode well for a commodity trader either. If you start out with a losing trade, your equity is \$834, then you get a winning trade to bring your account equity back to \$972 . . .

you can see the problem beginning, can't you?

What if you happen to run into a string of four consecutive losers? From any place in your trading, you will lose 48 percent of the equity peak. That's all it takes: four trades and you're up against the wall.

Not being a mathematician, I simply sat down and calculated various risk percentages as to what number would work the best for survival, after four consecutive losing trades, and still keeping us in the game. Here they are, and they are most illuminating:

| Risk Factor per Trade | Equity Decline with Four Losers |
|-----------------------|---------------------------------|
| 10% | 34% |
| 5% | 19% |
| 4% | 15% |
| 3% | 11.5% |
| 2% | 8.0% |

The reality in my world of trading is that a 34 percent equity whack is too much to handle. If you're a money manager, that's the point where you will lose customers. What happens if you have five losing trades? Adios, mi amigo.¹

Obviously then, a 10 percent risk factor is too high. So let's look at the other extreme, a 2 percent risk factor. That is certainly appealing, to see that given four losing trades we are down only 8 percent. But the big question is, "Is there any upside to trading such a small amount of our bankroll?"

Of course a mathematician can give you an answer to that, but let me give you mine from my real-time trading experience. I began trading an account in Australia in 2007 with just about \$100,000. That account has grown to over \$1.2 million at its equity high in 2010. That's an elevenfold gain: 12,000 percent or approximately 400 percent per year. The Australian answer is that lots of money can be made with a 2 percent bet risk.

That was accomplished with an average bet size of 2 percent. Occasionally my bet size was 3 percent, but many times it was less than 1 percent. I really placed tight boundaries on how many contracts I was trading on each trade. And just like you, I never had a large bet on the winning trade. My full 2 percent risk bets were always on losing trades, it seems!

Nonetheless, the account has appreciated in a very consistent and steady pace. There have been ups and downs, there have been times with four consecutive losers in a row, and times with four consecutive winners. Nothing that I have experienced in real-time trading has ever seriously challenged the equity in the account.

You might be interested in knowing what the account has been through: I took delivery of Cattle when in Australia that was a real stuff up on the part of the broker, and myself. I also got delivered Gold another stuff up because of these wonderful

electronic trading platforms that may or may not let you know delivery is today

Each and every order was placed on a trading platform, and then I walked away. I was not watching the markets. I would not interact with the markets, and yet was able to achieve what I think is a very decent rate of return, from which I can only conclude that a 2 percent risk factor works. If you want the optimal or ideal risk factor that ensures security and does not jeopardize your account balance, and can also be very aggressive, that number may actually be 4 percent. A 4 percent risk factor means that I can lose 15 percent of my money with four consecutive losing trades.

I suppose I'm willing to sit through that, because the upside can be equally spectacular: \$1,000 will grow to \$1,169, about a 17 percent gain. (Here math works in our favor; four winning trades produce a larger gain than the loss of four losing trades.) For the average trader, I expect a 3 percent risk factor is more than adequate to allow for a rapid increase in your account balance while protecting against any serious equity declines that would bench you on the sidelines.

This recommendation also assumes that you, like me, have had four losers in a row in the past and expect that this will again take place in the future. If that is not your reality, then forget everything I have written about here; trade Kelly, and pray.

If you see the problem and the solution the same way that I do, you're probably asking, "So, Larry, how do I use this in my actual trading?"

Let me show you how.

If you're going to use a 3 percent risk factor, that number will actually tell you how many contracts to trade. What I do is take, say, a \$100,000 account, and 3 percent of that is \$3,000. I cannot lose more than that amount on my trade, and that's all there is to it!

What I need to establish is where my stop-loss for this trade will be. That means I determine on the chart where I will place my stop-loss and then determine the amount of dollars at risk from that point to where my entry will take place. In other words, I'm just figuring out how much I will lose on this trade, on a one-contract basis.

Let's say I'm going to lose \$3,000 on the trade . . . my stop is a long way away. Since I'm using a 3 percent risk, I can trade only one contract. If I traded two contracts and was wrong I would lose \$6,000 . . . a lot more than the risk factor I am trading. If the stop is \$1,000 away I could then trade three contracts. And on it goes. I determine the dollars that may be lost in the trade, then divide that into the total amount of money my risk factor tells me I can accept for the trade.

If my stop is \$2,000 away, I am trading a \$600,000 account with a 3 percent risk, I have accepted the fact that I may have a loss of \$18,000 on a bad trade. The next step, of course, is to divide the \$2,000 into the \$18,000, telling me that on this trade they

take nine contracts.

Ralph put it this way:

What matters is not the mathematical expectation, but whether we expect to be profitable by playing and quitting at our horizon, and whether we can manage the worst case, should that manifest.

This is the (dual) criteria upon which all wagers should be judged. In the case of a positive expectation with the sum of the probabilities of the data greater than .5, wherein we expect, on average, to be profitable for any given horizon, we must still consider the B part of the dual criteria—can we manage the manifestation of the worst-case scenario?

There you have it: what I think is the safest, most realistic, approach to determining how many contracts you should have on each of your trades. We have met the worst-case scenario and built our fortress of bricks, not Forex straw.

RECAP

My takeaway for you from this chapter is that how you manage your money dictates your chances for failure—even more than how you trade. A good trader with bad money management will blow up at some point.

A bad trader with good money management skills will survive.

1. All of this, of course, assumes you are in just one trade at a time, which is also not reality; we usually have on numerous trades, on average at least three. Use the Kelly formula you will be down 25 percent on each trade, should they all go bust, you will have lost 75 percent of your money. Some suggest using one-half Kelly, in this case 12.5 percent, dropping your equity 37.5 percent. Most likely all on the same day. Use a 3 percent risk factor, with three losers at the same time, and you're only down 9 percent.

CHAPTER 14

From Kennedy to Obama, Thoughts from 50 Years of Trading

Success in trading comes from knowing the markets well and knowing yourself better.

If that's true, that your success in trading comes from knowing the market as well as yourself, I should, after 50 years of doing this, be pretty successful at trading. And I am, and I'm proud of that. I'm proud that I have made millions of dollars doing this. But ... let me tell you ... I still have losing trades. I still get discouraged in my trading, still have streaks where it seems I can't do anything right, and also streaks where it seems I can't do anything wrong.

I have followed the market on a daily basis, many times on an hourly basis, while the markets were being massaged under the influence of nine different presidents and six different Federal Reserve Chairmen.

Each president and each Fed chairman has approached the market and the economy in a different way. There is precious little that they have in common, with the exception of the Fed's insistence to increase money supply when times are bad and increase interest rates when times are good. Short of that, there seems to be no commonality.

So what is a trader or investor to do?

There are core concepts that we can follow today, just as they did 50 years ago, that will still work 50 years into the future. Monitoring people who accumulate and distribute commodities and stocks worked 100 years ago, and it will work 100 years in the future. Value has always worked in the past and will always work in the future. Value does get rewarded ... the reward may just be delayed.

New people coming into this business seem to want some specific formula or indicator that they can use now and forever. Clearly, there are indicators and information about the market that can be of great value. *But frankly, I would throw them all out the window in exchange for wisdom.*

Wisdom trumps any indicator. It is wisdom that keeps you in the game when others fail. Sure, it takes intelligence, at times it takes a sense of a swashbuckler's daring coupled with an angel's fear to tread ... but what will carry the day is pure

wisdom.

Wisdom places everything into perspective, giving us a better view than the microscopic one of the trader next to us who doesn't understand where the parts and the players fit into the grand scheme of things.

The problem with wisdom is that there is no formula to follow. It is very difficult to acquire, except through experience. After all the years of experience I have garnered, I'm not certain I have that much wisdom. But I do know wisdom can be passed on from one person to another. My father gave me a great deal of wisdom. Some of it was shared while fishing on Spring Creek in Lewistown, Montana. Dad instilled some very good wisdom to me when we worked together at the Conoco oil refinery in Billings, Montana.

Mostly his wisdom was passed on in stern lectures that were well deserved for things I shouldn't have done. I didn't understand the wisdom then ... it took a long time to "get it."

Clearly, though, he did pass on wisdom and in that same vein I would like to pass on to you the little bit of wisdom I have learned from trading. For that reason, I have selected what I think are some of my most useful writings from back issues of my newsletter, *Commodity Timing*. I hope they can help you, as they have helped me, to become more balanced and controlled in trading.

For this edition I have added my recent writings, wherein I have attempted to explain my observations and philosophy.

TRADING AND COLLECTING HONEY

When I was a kid, my dad raised bees part-time and sold their honey to the local stores in Lewistown, Montana, to help make ends meet. We had all the usual protective gear you have seen beekeepers use, but you probably have never seen the filters to trap propolis, pollen filters and separators. It was quite an operation.

There were jars for Mom to clean and for us to fill up. Our honey was never heated like that store-bought stuff you probably have in your cupboard. If you heat honey it will stay in solution and not turn solid when cold. However, as pretty as that looks, the heat kills all the good stuff in honey, practically turning it into inert glucose with a nice flavor.

Anyway, I was always afraid of the bees. It was for good reason. I had been stung several times, none of which felt good. Dad also got stung a few times, but that did not seem to bother him as much.

One day I asked him about bee bites as we were extracting the sweet honey from the combs. He said, "Son, I do all I can to not get stung. I wear the right clothes and

nets. Smoke my cigar as well ... but still, every now and then I get stung just like you. If you are going to get honey, as you see, it takes a lot of work and sometimes you will get stung; that's just the way it is.

"And I'll tell you this; I know those stings hurt you a lot more than they hurt me. That's because you have not been stung much before, so there is a shock effect to that, but you will get used to it. Part of growing up is learning to endure pain."

"There's another thing as well: When I get stung, I think of the money I can pick up from selling our honey. Kinda' takes the entire hurt out of it."

Honey gathering and trading have so much in common.

LOW-HANGING FRUIT

Just as some days are better than others, some trades are much better than others. Most traders are looking for the big-kill trade, the home run.

I am certain everyone knows that home-run hitters strike out more often than they hit a homer. That's okay in baseball because the size of your loss is equal to the size of your gain. However, in trading, just one large loss can wipe out everything you have accomplished. Barry Bonds or Babe Ruth could strike out one or two times, even ten times, and still be in the game. It's not that way when it comes to trading.

So why not go for the easy trades?

Most traders are trying to do something spectacular. They are like the highflying trapeze artists or the Evel Knievels of the investment world. They want to call the high, buy the low, thinking that is where the big money is to be made. Certainly if you look at the charts that seems be the ideal game.

To me a difficult trade is one where the trend is straight up, and you try to call that high. Yes, we know the market will top at some point. But that doesn't mean that point is now or that you or I have the ability to correctly predict when the ride is over.

Why is it so extremely difficult to accomplish in real-time trading? Simple: You can't tell when the party is over until it is over.

So why not wait until we can see that it is over, or more likely to be over, before we hop aboard on the short side? Why are we so attracted to stepping in front of speeding freight trains? Beats me.

Wouldn't it make more sense to sell a market that is in a downtrend than one that is in an uptrend? It certainly seems that way to me and, more important, my experience shows this to be the wisest choice. In other words, the old adage is true: *The trend is your friend.*

That is the low-hanging fruit on the vine ... that is the fruit that is ready to be

picked; it takes the least energy to harvest and should be the sweetest. There is more certainty of getting that fruit off the tree than trying for fruit that is way up there hanging on a delicate limb.

It is far easier to find the trend of the market and react in line with the trend.

For my money, I prefer to pick the low-hanging fruit, and I prefer to ride the horse in the direction he is going.

LOOK BEFORE YOU LEAP

Look before you leap is one of the first adages we are taught as children. It should be the first one we are taught as traders.

I am certain I have lost more money trading, had more losing trades because I got in too soon, rather than because I got in too late. I should have looked before I leapt.

This is a real problem I have had. So I am certain you will have it as well, if you have not already experienced it. The attraction to making money, for people like us, is greater than the potential risk. We are driven more by greed than we are by fear.

We have learned to essentially see what markets are going to do. We learn to predict things, and we have learned to look forward. Thus, we are afraid more of losing the money we “could have made” than losing money we have in our pockets. That’s the emotional Achilles’ heel of traders. Overcome it, and you will succeed.

So how do we get around this? What we do to resolve the situation?

To me, the most helpful thing I have done is to have a checklist to make certain that at least three or four elements of a winning trade are in play. Not on my checklist? Then I simply can’t take the trade. I need my checklist to make certain I am not just playing Kamikaze Cowboy. This forces me to delay my emotions and use my strategies.

It’s a little bit like hunting. Once you get your game in sight, there are three steps to go through; the first is to breathe, second is to aim, and finally, it’s time to squeeze the trigger. You can’t rush into this, and it’s the same with trading.

I have learned to wait, to be deliberate, to realize that almost every trade I have entered in my entire life has gone against me—which means 98 percent of the time there has always been a better place to get in. And for certain, the more emotional I have been about getting into a trade, the worse my entry was. The path of correct action is not an easy one to follow.

It really is *the fear of losing money* that drives us to act too quickly, to leap before we look. So keep in mind that there is plenty of money to be made trading, and there’ll always be plenty of trades just around the corner. It’s not the good trades that kill you. It is the bad trades we jumped into too quickly. *For big pay, learn to delay.*

REMEMBER THE GAME CALLED PICK UP STICKS

I loved to play Pick Up Sticks as a kid. Most games became boring after a while, like Monopoly or even Chinese Checkers, but toss those sticks out, and I was in seventh heaven.

Not that I was good at it when I began playing. But from the get-go I enjoyed the game, despite the drubbings that Bob, my older brother, gave me and every other kid we knew. He was unbeatable at this game. Getting thrashed was a great motivator to figure out what I was doing wrong, and what Bob was doing right.

Every time I played, my eyes were glued on how Bob approached the game. It took me awhile to see he had a strategy that was different than mine. My approach had been to take away the stick that would allow me to get the most sticks after that. His approach was to take the easiest shots or picks, letting others go for the hard ones as they almost always blew it ... which left the field wide open for him. Bob went for the low-hanging fruit before we even knew what that meant.

Bob's other skill was that, when it was his turn to pick a stick out of a logjam, he did not rush right into it. He took his time and looked at the problem from all angles. Then, and only then, did he proceed, after he had his plan of action.

Another thing he did differently was to play the game by himself.

That looked boring to me. After all, who are you going to beat? I asked him one day how it could be any fun to win against yourself.

I will always remember what he said: "I'm not playing now to beat myself, I'm playing now to beat you."

Slowly, ever so slowly, and with great focus, my brother would begin to make his move. The rest of us would talk and joke as we picked up the sticks. Not Bob. No siree, he was all business, totally focused on the task at hand.

Eventually I got so that I could beat the other kids, even my sister Pam, but never Bob. I sure learned from him, though, and from that simple little game, what it takes to trade.

AND IT CAN GET WORSE BY FAR ...

I'd like to give you an example of why *how* you bet is as important as *which way* you bet. Many are shocked to see that a winning percentage of accurate trades can actually lose money. For example, assume you have a \$100,000 account and are an

aggressive trader willing to risk 25 percent of your money on each trade.

For this example we will always take losses of \$1,000 and profits of \$1,000 and win on 50 percent of our trades. My 25 percent risk of \$100,000 is \$25,000, so I can trade 25 contracts as I start trading. When I make more money, I can increase the number of contracts, and I will decrease should I lose. Watch what can happen.

My first trade is a loser; I lost \$1,000 each on 25 contracts.

My second trade is also a loser but since my account balance was \$75,000 (it declined due to the loss) I now trade an 18-lot order and lose \$18,000, so my account balance is now \$57,000. Therefore, I am wagering 14 contracts on the next trade.

Again, sad to say, I lose, so my account drops by \$14,000 to a balance of \$43,000.

On my fourth trade I finally get it right and have a winner but my bet size was 10 contracts (25 percent of \$43,000), so my balance is now \$53,000.

With the improved balance I risk 25 percent and have another winning trade, making \$13,000 and increasing the balance to \$66,000.

The next trade goes against me so I lose \$16,000 (25 percent of \$66,000) and am back to \$50,000.

Finally I hit a hot streak, bagging three winning trades in a row; the \$50,000 called for a 12-lot order, so my balance grew to \$62,000. The next trade is for a 15-lot order. I'm making it back with a balance of \$77,000, which calls for an order of 19 contracts, and again I am blessed with a winner and a bank balance of \$96,000! The problem is that I have had an equal numbers of winners and losers but am in the hole! Had I bet an equal amount of contracts on each trade I would be even.

Do you see why money management is so important?

LOCK-UP TIME

October 1995 (Volume 32, Issue 10)

More comments on why traders “choke,” freeze, or lock up, thus not trading, or worse yet, bypassing winning trades in favor of taking guaranteed losers.

At least once a week someone calls, telling me they know what to do in the markets but just can't pull the trigger. They are afraid to do anything. Strangely, this is even more true for traders with less to lose. The \$10,000-and-under traders have more of this fear than the heavily capitalized traders.

Let's Take a Good Look at Fear Itself

We fear only two things. They are either things we don't understand, hence there is no way to rationally deal with the situation, or they are similar to things that have hurt us in the past.

It's no wonder then the markets stir up so much fear. No one really fully understands the markets ... and we are continually being bitten by market alligators. So what's one to do for this self-inflicted catatonia?

Since fear is largely emotional, you need to reframe yourself with valid data to offset the fear. Here are some of those data.

First, if you use stops, you really can't get clobbered too badly. Ever. Sure, you will have losing trades. But wiped out, killed? That's not going to happen. Next, if you trade with only 30 percent of your bankroll at any one time, you can never get blown out. Again, never. Ever. The quickest way to bring sanity to trading is to use stops and only a fixed fraction of your bankroll.

By so doing, you have full understanding that you are trading with a huge safety net. You will survive, because you have controlled the seemingly uncontrollable game.

At a more cosmic level, you need to check out if your deck of cards in life is one of blowouts, crashes, cycles of major success leading only to cycles of failure. For most, it isn't. You can trade (with stops and percentage of bankroll) knowing blowouts are just not your thing, not your spiritual calling. Speaking of spirituality, I'm a firm believer that God will not let us down. Knowing that gives me ample courage ... sometimes too much, in fact ... to trade, to pull the trigger.

ENOUGH ON GREED ... NOW LET'S DEAL WITH FEAR

June 1995 (Volume 32, Issue 6)

I've written at length about Greed being the dominant and most difficult emotion to deal with. Now it's time to walk through Fear.

There are several things that distinguish winning traders from losers. Perhaps the least discussed is what I refer to as "locking up." I've seen it in countless traders, and experienced it myself many a time.

The repercussions of locking up are numerous, and all bad. A locked-up trader doesn't get out of winners or losers ... he/she is too frozen to act. Or, the lock-up prevents you from pulling the trigger on getting into positions. This is the worst of

all problems ...a trader who can't trade! When this happens, know that fear is motivating you. The good news is that there are several things you can do to release the grasp that Old Man Fear has on your mind.

There Is a Lot More to Fear Than Fear Itself

Roosevelt was as poor at understanding emotions as he was at being a president. Have you ever noticed that sometimes it seems impossible to do something, maybe even something physical, like take action, step on the brakes, get out of harm's way, and so forth? You can be so locked up with fear that your attention is on the fear, not on taking the correct action. Yes, fear is the great immobilizer.

Proof? Okay, remember the last time you looked at a truly frightening person, someone so ugly, so big, or so dangerous that you "just knew" the person was a killer? Okay, good, recall that. Then recall what you did ... you turned away. You would not look into the object of fear. You froze, and not because you were hurt or because you were about to be harmed!

When you see fear, you MUST look directly into its ugly face before your fear will diminish. The vile villain that we traders look at (the market) evokes the fear of being hurt. Hurt in our case means losing money and ego. There is no other harm that can come to you in this business—ego and money, that's all there is to lose. So which is it for you?

The more you focus on losing, the better off you will be. Winners plan what to do if their trades don't work out. Losers have no plan for disaster; when it occurs, they don't know what to do ... and are stuck in fear's grip.

Think about it. You, and you alone, have absolute and total control over what and how much you will lose. You control the number of contracts you trade, you control the stop or dollar risk (you set your fear level). Knowing that, what's there to be afraid of? That you might have another losing trade?

Let me tell you, O loyal follower, I have losing trades all the time. I had about 20 in a row a few years ago ... losing trades are as much a part and parcel to this business as breathing is to living. It happens, always has, always will. Once you fully acknowledge that at a deep inner level (looking it in the face), and learn to only commit money up to your "Fear Level," fear will no longer have you in its ugly grasp.

RUNNING, TRADING, AND LOSING

May 1996 (Volume 33, Issue 5)

Winning is easy to handle, but what about when all goes not quite so well?

I know a little bit about losing. More than most, I suspect, because the truth is that while I have had some spectacular wins and gains as a trader, I've also had my "fair" share of drubbings. Fact is, the last month or so have not been very pleasant around my house. A winning trade has been harder to find than a character witness for Mike Tyson.

In my case it's even worse than for you ... I'm supposed to be an expert and not have this happen, plus I have several thousand people looking over my shoulder (at all times) seeing how positively poorly I am doing. Gads, that's enough to make one want to stop publishing.

So how does one handle these streaks of seemingly doomed failure?

My marathon running experience may have helped the most to answer this question. In every marathon I have ever run, 17 and counting, there has always been a spot where I ran better and faster than ever expected. And, by the same token, in every marathon I have run there's always been an "equity dip," a point of seemingly no return, no recovery. I'm not kidding here. At mile 23 in one run, I literally lay down in the street for about five minutes while runners I had passed earlier (during my winning streak) sailed by.

What I learned about running was that the only way to snap out of those terrible, terrible letdowns was ... to slow down ... to walk a bit ... even lie down in the street. In short, by stopping the pace and collecting myself, I was able to pick the pace back up and resume the race. Guess what, gang? It's the same with losing streaks. When they hit you, as they surely will, back off a bit, slow down, even stop trading, but stay in the race.

DOING THE WRONG THING ... IT'S SO EASY, ISN'T IT?

November 1995 (Volume 33, Issue 11)

This business of trading commodities can get pretty funny.

Pretty rough, too. Take, for example, what I think is the number-one fault of all traders: the love of a good debate.

It seems we are, or like to think we are, pretty smart cookies. Therefore "we know better," we argue our politics, religions, and, worst of all, our markets. Thus when we can plainly see a market is in a downtrend, we become bottom pickers, trying to

outargue the market itself.

Believing in some omnipotent power, we muster up all we have to argue with cold hard facts.

But that's not the half of it ... the larger problem comes from us wanting to "beat" the system or the crowd. We attempt to do this by jumping the gun ... by getting in ahead of time as we "know" the market, indicator or whatever will give a signal tomorrow and we want to be there first to prove we outsmarted everybody.

How to Prevent Jumping the Gun

We are a darned sight more concerned with showing off than we are with showing our winnings. That's costly in this business. Jumping the gun, arguing with the market (that means not doing what you know you should do) is just an immature attempt to prove our superiority. There are better, and far less expensive ways to establish such points. Trading is not a race, jumping the gun serves up no advantage. Speed without direction will never win a race.

The root problem is that we have probably defined intelligence incorrectly. We "smarty pants" perceive intelligence as an *us versus them* game, and in that process use our supposed superior intellect to prove either (1) how big we are or (2) how small they are.

Intelligence is not about that, nor has it anything to do with IQ. *Intelligence is the ability to resolve problems.* Successful trading is the resolution of market direction, nothing more or less. The more you focus on this, and the less on proving something—anything—the more money you will bank at the end of the year. Take action because it is correct, not because it might get you in quicker or prove how great a trader you are. That's how one builds a bank account in this business.

IT'S NOT THE TRADE, IT'S THE BATTLE

July 1996 (Volume 33, Issue 7)

Notes to myself on winning and losing.

Traders are like gunfighters: We are only as good as our last trade. Or so we tell ourselves, thus committing one of the major mental errors in the game. The truth is there is little if any relationship between our current or last trade and how we will do overall. Jack Schwager makes the point that the best way to manage money between funds is to give some money to traders that are in large equity downswings.

It is no different with us.

But, we think the one battle (our current or last trade) is the entire war. In so doing, we get so bummed out, or elated, that we lose focus of the fact that trading is an ongoing war that never ends. It absolutely never ends. I will be trading until the day I die, that's a given. So, should I be concerned with the outcome of my current trade?

Proud Ponies or Broken-Down Nag Syndrome

Well, sure, to an extent, but it is not the be-all, end-all trade that will make or break my career. Yet we act like it is, prancing around like either a proud pony or roll over and play dead like an old nag. Which is also why I'm not betting the ranch on that one trade ...there's more to my career than just the next spin of the wheel. The reason I am a short-term trader is that I don't have a long-term perspective (trust?). This then is my largest enemy; the inability to perceive that this is an ongoing process that will, hopefully, never end. Because of that we need to carefully marshal our energies and capital to not scatter our talents across those multispecked charts.

My battle plan is to wage a war, not a battle.

THE ART OF FLY-FISHING REVISITED

August 1996 (Volume 33, Issue 8)

Fly-fishing and today's commodity traders have much in common that we can all learn from ...

While talking to a subscriber who owns a motel on one of the premier fishing streams back east, I stumbled onto an interesting analogy I'd like to share with you. My daddy taught me the fine art of catching trout long before the fly-fishing fad set in. Pops was never much of a fly-casting type, but could do an adequate double haul, carefully selected his tippets, and knew the difference between a front-end weighted line and a double taper.

But he didn't use that stuff very much ... fact is, he looked down his nose on the L.L. Bean "fancy-dancer fishermen" as much as they shook their heads at his beloved worms, grubs, and grasshoppers. You'd never catch my dad at a Trout Unlimited meeting ... but he could be seen after dark chasing night crawlers around our back yard with a flashlight.

I asked him once why he didn't fly-fish more often, to which he replied, "Son, I came out here to catch fish to take home to eat. Crawlers and 'hoppers are the best thing I know of to catch fish with. Believe me, if those dainty little nymphs caught

lots of fish I'd use them ... but I sure as hell wouldn't get all dressed up in those fancy vests and pricey waders. This sport is about catching, not dressing."

Maybe that's why I don't have real-time quotes in my office, am fairly computer illiterate, don't read the *Wall Street Journal*, and don't hobnob at futures conferences decked out in Brooks Brothers suits. Invariably, successful traders tell me they became winners after they stopped keeping a jillion indicators, watching three or four monitors, and following five hot lines every night. "It's the simple stuff that works" is the most common comment winning traders make.

Sure, you can get all duded out to trade, but the truth is you'll catch more fish with worms and hoppers on a bent pin than any fly ever tied.

FEAR AND GREED, LOOKING THEM IN THE FACE AGAIN

November 1996 (Volume 33, Issue 11)

Since they are the strongest emotions to screw up traders' psyches, I know we can never spend too much time dealing with these demons ...

There's More to Fear Than Fear Itself

Obviously FDR was not only not a capitalist, he was also never a trader. There is a lot to fear about fear. But what it all boils down to is that fear is a blocking mechanism, a self-protection device, designed to keep us out of trouble.

While it's wise for fear to block or stop you from going into dark alleys after midnight, it's not wise to be afraid of taking trades.

My personal experience, plus that of talking to thousands of traders, is that the very best trades are the ones we fear the most. The greater your level of fear, the better the chances for a winning trade.

This makes absolute sense when you look at the opposite side of the coin, that the trades we fear the least are the most dangerous. Why is this? Because in the world of speculation, the rules of investment profits are turned upside down; what looks good is bad, what looks bad is good. Trades that look like "sure things" seldom are, which is why trading is so difficult.

The point is that trades that make you tremble late at night are the ones you must take. But you can't. Wrong! You can take them once you have the realization that the risk on all trades is the same—the amount of your stop-loss. A trade that looks like

it's designed by Stephen King has no more risk than one from Mr. Rogers. *As long as you use an absolute dollar stop, you will blast away the potential risk of what appears to be a risky trade.* In short, stops allow smart traders to take the trades everyone else passes by.

Getting a Grip on Greed

Greed is a different breed of cat. The purpose of greed is to motivate, to cause us to excel, to strive for perfection ... but since this never has been and never will be a perfect game or business ... greed causes us to hold our losers, and winners, too long.

Plus, as I've learned the hard way, greed is the strongest of these two emotions. More money is lost due to overstaying positions (greed) than exiting due to the fear of losing money. Greed kills just as speed kills as we get out of control. The solution?

Systematic exit points.

The purpose of a system is to control your emotions of fear and greed, that's really why we have systems ... to make it easy. So if you know where to take profits, you eliminate the power greed has over you ... as long as you follow the system's rules. By getting a handle on fear (with stops) and greed (with known exit points or rules), we can trade free of emotional baggage.

WHY MOST TRADERS LOSE MOST OF THE TIME

April 1997 (Volume 34, Issue 4)

I've spent years pondering why we are not more successful in our trading and think I may have the answer ...

It really gets down to this ... markets can spin on a dime and most traders cannot. That's why so many people fail at what looks like an easy game.

The scenario is that you get a signal to buy long. While you do that, your mind, being only human, affixes itself to the idea the markets will, should, and must go up. Damn the torpedoes, full speed ahead!

But a funny thing happens along the way: The market, being as fickle as it is, decides to head South. In that process, your technical bag of tricks clearly issues a warning if not an out-and-out sell signal. See ... technical analysis "works."

Problem is, your reactive greed-filled mind does not. It still wants that buy signal to be correct, so it tells you to hang on; that what was, may yet become reality. Meanwhile reality is telling you that what was, was. Was, as in past tense. To compound the error, you have taken a few self-images or positive thinking classes or had a high school coach teach you the value of “hanging in there.” So you do ... to the chagrin of your real self-image.

We want to be right so badly that once our mind establishes a viewpoint (the market will rally), it takes hell and high water (that translates into a margin call) to get us to face up to reality.

Let me drive the point home. There's a bank robber (they've got about as much larceny in their hearts as traders) whose stakeout man tells him there's plenty of time to raid the vaults, so he begins the chicanery, gleefully picking up the cash he's been hoping for. But, then the lookout beeps to say “the cops are coming.” A bank robber would split, he'd change his plans. That's the difference between traders and bank robbers ... traders would stay in the bank hoping the cop alert was a false signal!

The last signal, or indication in your work, is what you should be following, not the one before last that you are still hoping will work. Hope does not work in this business. Following the market does, that's reality. The instant you learn to trade reality, not wishes, you will break through the wall of fire to become a successful trader. Go for it!

A REVIEW OF LOSING TRADES SHOWED THAT

May 1997 (Volume 34, Issue 5)

Subscribers sent me their trade recaps and I found that they are all doing pretty much the same thing.

What Beginning Traders Have in Common

I'm spending a lot of time on losing this year, not because we are so inexperienced with it but because I figure that if you don't lose while trading, you should do pretty well in this game.

After a scrutiny of several subs' trades, a couple of things popped out that I'd like to share with you this month.

In Trading, the Weight of Evidence Does Not Prove the Point

The first thing I noticed is that these guys (which means all of us) were almost always buying at the end of a move. Why would that be? I suspect that's because novice traders wait and wait until it looks or feels like all the evidence is in ... then they take action ... buying at the high or selling the low.

This got me to thinking our problems are in buying too soon—we are afraid of missing the move—or buying too late—we want proof the move is really underway.

The balance point to this, I think, is that we cannot buy until price has stopped going down, nor can we buy during the emotions of a strong rally. You need some indication from the market that it will rally, but not too much: You can't wait until all the lights are green. The market will always try to scare you out/in or wear you out/in. It is these two extremes you must stay away from. If you are getting in because of emotions, afraid the move has gotten away without you, pass on the trade ... it's already too late.

Plus, once in a position we must give the market some room to move in our favor. That was the second most glaring error. These traders noticed many of their trades would have been correct if they used no stop. Well, we do need stops; the problem was their stops were too close. Since they didn't want to lose much, they used close stops ... and just lost more often! No one I know really has pinpoint precision timing, *until someone does*. Stops need to be a good distance away from the market if we are to find success in trading.

THE NUMBER ONE REASON WE LOSE MONEY TRADING

August 1997 (Volume 34, Issue 8)

Let others talk about how much they make, I want to work on losing less!

There are as many ways to lose big money trading as there are traders, yet there is a strong common denominator to each and every loss I have taken. If I can avoid this, I should be able to sidestep much of the pain usually associated with this business.

Here it is, then, the biggest reason we have big losses ...

Large losses come about when we let our belief systems override reality.

What I mean by this is that we pay more attention to our advisors, prejudices,

hopes, and aspirations than we do to what's really going on. That literally forces us to hold onto losing trades ... and to keep holding on. The secret to winning in this business is to get out of the losers as soon as possible and hold onto the winners.

While I have a strong belief that I will make money trading, I have an equally strong belief that every possible trade I enter may well wipe out my account.

My belief system used to be that every trade would work out okay, and I had some very disastrous equity dips. I held onto what I should have pitched, which also *forced me* to pitch what I should have held onto! My positive approach to life, my belief system, was killing me, as I was not listening to reality: *Rocks are hard, water is wet, bad things happen, commodities are risky*. Believe that and you will sure as heck protect your hard-earned dollars. I trust my systems and trading techniques, but I don't believe for an instant that they will work on the next trade! That's a healthy, profitable attitude.

This is a universal truth. How many people do you have in your life whom you should have "stopped out" of the relationship long ago? I know my life works best when I cut away from so-called friends who are really emotional drains and stay with those who enhance my enjoyment of life. If that works in living, it will work in trading!

THE MOST IMPORTANT TRADING BELIEF YOU HAVE

September 1997 (Volume 34, Issue 9)

In this business a positive mental attitude and affirmations can kill you. Instead, try this.

Belief Systems

While it is true that you are only as powerful as your belief system, the real advantage a belief system can bestow upon you is that a firmly held belief will give you more certainty to take action.

Traders have trouble taking correct action, as we lack certainty, thus the study of what we believe is critical to our success.

If you get all pumped up with positive beliefs about your market success you will believe so much (in that coming about) that you will mismanage losing trades. After all, if your belief system is that your current trade will be a winner—and it isn't—the certainty of that belief will have you holding onto losers, something no

successful trader does. Ever. An outrageously positive belief about your success (on any one to two trades, not your total career as a trader) will have you rushing in where angels themselves fear to trade.

My strange belief system is that the current trade I am in will be a loser ... A big loser at that!

Sounds negative, but it is most positive. If that is my belief, I will certainly be careful in taking the trade and for sure will manage the trade “by the books”: That means my stops will be in—at all times—I will exit when my methodology says to, not my whims, wife, or broker. Every major loss I have had trading (and I’ve had more than my fair share) has come from believing my current trade would be a big winner, so I did not follow the rules of the game.

Adopt my belief system, that this trade will most likely be a loser, and you sure as heck will protect yourself!

A Note on Fear and Greed

Some years ago I postulated that greed is a greater motivating factor than fear. Recently a student, and psychologist, questioned that with convincing evidence that most people fail as fear (of failure or loss) keeps them from taking action.

My reply was that those of us who have decided to trade are not “most people”: We have already broken the shackles of fear, evidenced by the fact that we are trading. Back to his studies went the PhD and discovered this is true in animals as well. Rats when hungry (motivated by “greed”) will take risky action to get food that they will not take when not hungry. We traders are like the hungry rats ... motivated by greed.

THE WORST DOG I EVER HAD COST ME THE MOST

May 1998 (Volume 35, Issue 5)

It was the snippiest, most belligerent untrainable mutt you could imagine and it cost the most because it had been bred for a couple of hundred years to be the perfect dog. Instead it was a disaster.

Commodity trading systems are a lot like that damned dog. The more you tweak and refine them, the more you optimize and try to improve the breed of trades the system kicks out, the worse the dog performs.

So far this year my personal trading sucks. I've been up as much as 30 percent, down the same amount, and sit today with about a 10 percent gain for the year, not much considering all the risk and effort. Naturally, I had to ask myself why.

The answer came pretty quickly. Last year was a great year, the account I traded went from \$50,000 to over \$1,000,000. And guess what ... that wasn't good enough for me, so I kept breeding the system, tweaking it, thinking I was fixing it. Some fix! The peak of perfection in commodity trading is not attainable, yet we strive, and in my case, overstrive for it.

What works is to keep it simple, understanding perfection or anything close to it does not exist in this business. In short, forget the glitz impossible, the show dogs, find a mongrel and take good care of it.

More on What Works

Well, well, *Commodity Traders Consumers Reports* just came out and gives us an immense insight into how to make money in trading commodities. Let me explain. This service, started by Bruce Babcock and now aptly run by Courtney Smith (a for-real guy who actually trades, by the way), monitors 26 of the most popular market letters' *real performance*. It is a tedious task, to say the least: In the past 12 months they have had to follow each of the 3,590 trades we services have cranked out!

Here's some observations I've made about the services that make money: To begin with, the services with the greatest number of trades have been consistent losers. Guess that old saw about overtrading is correct. By the same token, services that don't trade often seem to be consistent winners. But, the most consistent winnings have been picked up by services that have about 200–300 trades in any given 12-month time period. Services with more trades than that perform poorly. Currently the best performing services are Futures Factors, up \$92,761 on 252 trades in the past 12 months, Taurus up \$94,307 on 355 trades in the past 12 months, and Commodity Timing, up \$119,716 on 290 trades in the past three months. The service with the most trades, 655, was down close to \$50,000.

We can also break down the newsletters into trading approaches. Generally speaking they are Seasonal, Trend Following, Chartists, and Gann/Elliott/Arcane, and here are the differences.

The performance figures are revealing. I went back the past three years and found that the poorest performers in 1995, 1996, and 1997 have consistently been Gann, Elliott, and Arcane, who, as a group, averaged a loss of close to 100 percent a year. This from the crowd that claims that all can be known, that you really can buy bottoms and sell exact tops.

Here's another interesting point, the most expensive service has lost money on

balance the last three years (they charge \$5,000 a year) while the cheapest service, \$45 a year, is a net winner!

The seasonal letters did well a few years ago but in the last 12–18 months have not fared so well. The long-term trend followers led by Commodity Research Bureau and Commodity Trend Service have shown consistent profits. In the past three years no service has been in the top five performers each year. But the following have been in the top performing group two of the past three years: Commodity Trend Service, Commodity Timing, and Futures Factors. Hope all this helps you place performance, and the performers, into some sort of viable and working understanding of this business.

ATHLETICS ARE SUCH A PARALLEL TO TRADING

June 1998 (Volume 35, Issue 6)

The most important athletic ability is the talent to come back from behind.

Harmon Killebrew

Maybe it's just my personal athletic background, but I think not. Over the years I've written about the similarities between winning on the court, track or field, and the pits in Chicago. I don't think it's any fluke that the most successful bond trader in the history of the world was also a high school All-American football star, Paul Tudor Jones, a pretty darn good boxer, and Frankie Joe, an outstanding professional baseball player.

So, when I heard the above quotation from Harmon Killebrew, I was really rocked. Killebrew, Mantle, Jordan, Namath, Ali, were all born with and developed great athletic abilities, but, then so do many other individuals, who never become such superstars.

I've always wondered why that is. What are the differences between the superstars and the others? I used to think it was media flash, but then noticed guys like Brian Bosworth, Dion Sanders, or even Bo Jackson never attained superstar status though they had all the trappings of making it.

There are many brilliant market lecturers, authors, analysts, and traders, but the really great ones have the same unique quality as Wilt Chamberlain ... the ability to not blow up when the team started losing—the ability to turn on scoring power when things looked pretty bleak. That's what makes a champion.

Not raw ability, not learned ability, and not luck, which clearly wins some games

but never establishes legendary champions. Luck is too infrequent and too easy to see when it does appear.

The point then is that as traders we need to devote a great deal of time and energy into figuring out how we handle “getting behind” and what our response is. Do we give up, do we fold, get angry? Or do we take the emotions of the moment and turn the anger or frustration into not just scoring points, but winning the game?

If we are to win at this game, we must develop the ability to score when we are behind; that's the key ingredient to develop in your psyche.

WHAT CAUSES STOCK AND COMMODITY MARKET TRENDS

June 1991 (Volume 28, Issue 6)

Freight Train Theory Explained

The first 17 years of my market research revolved around trying to figure out when in the heck a trend was about to begin, had begun, or was in the process of reversing.

I read all the fancy math books, studied all the chart systems from Gann to Z charts, got totally lost in angles and confused by exponential. I had about resolved that the PhD crowd was correct in their assumption that it is impossible to know the trend of a stock or commodity.

An Important Analogy

The problem, they said, is that the market is not a fixed energy vehicle like, say, a rocket. A rocket starts with a certain thrust and runs into a certain resistance. Hence, we can measure its speed, project where it will go, and tell when it is spent.

The market, though, is more like a ship at sea ... we see its wake ... the chart book price pattern ... and try to tell from the wake where the ship is going. That's fine ... if the ship stays on course.

Our problem is that the ship does not stay on course very often, as external energy flows—new ship captains—are always trying to take over the helm and redirect the ship.

So, while we measure the wake, all we can learn is where the ship has been. The new captain, or even the old one, can and will change the course at will ...

seemingly without warning.

From Boats to Trains

My biggest research breakthrough came in 1983, and then again in 1985, when I discovered what I loosely call the “Freight Train Theory.” My theory is that once a train gets rolling to a certain speed it is damn well impossible to bring it to an abrupt halt.

Sure, go ahead and pull the emergency brake ... it will still take time for the train's forward force to grind to a halt.

Ditto, Pork Bellies and Bonds, S&Ps or Soybeans. Once any market really picks up a head of steam, it will keep rolling, and in the process a trend will be established.

Critical Mass

The last paragraph above explains it all ...

Trend, I always thought (and so does the PhD crowd), was a function of slope, angle, slant, and so forth. It is not.

Trend is begun by an explosion in price. The resulting new trend stays in effect until there is a new explosion in the opposite direction.

What happens between the explosion points is the construction or definition of trend, but not the creation of trend. Trend is begun with a big reversal and stays in effect until there is a new reversal.

This means all we have to worry about is catching the explosions and then letting the trend that follows take us along for the ride.

HOW TO MEASURE THE PUBLIC VERSUS THE PROS

October 1991 (Volume 28, Issue 10)

There is a big difference in the emotional state of the “public” and the “professionals” that I think one can measure through watching the entry and exit styles they are most apt to use.

I'd like to explain this fascinating technique that will help you spot major divergences in the attitude of professional and amateur traders.

Let's Begin

Let's begin with an understanding of the typical "public" trader. Most likely he/she is short of cash either by having a small bankroll or, if fortunately possessed with a large bankroll, carries too many contracts, thus landing in the same fix as the small-time trader.

It is usually because of this pressure—which we bring on ourselves—that the trader becomes emotional and easily influenced by his broker, the *WSJ*, astrology, or gracious-who-knows, maybe even charts that look like candlesticks.

Think about it: When you are pressed for money, what is your natural reaction? Isn't it to run scared ... to cut your losses very (too) quickly and to play catch-up ... hopping aboard whatever looks like a good way to make money to balance out your losses?

That's the way it was for me, and I suspect it's pretty much the same for you.

What Does This All Mean?

What this means is that the "public" trader becomes emotional or irrational in style. In fact, pressure destroys style, so neither style nor a system are followed. It becomes a willy-nilly game of catch up and *the trader dances to the flow of the most current wind, even if it is a breeze*.

The key difference is the public or (almost always wrong) trader appears to be unduly influenced by opening prices. In fact, this relationship is so consistent that since 1969 I have advocated the use of opening prices for all market measures. In recent years, many analysts have finally gotten the message. For 22 years, this same powerful relationship has beat through all markets, stocks, or commodities.

The Key

The key you need to understand is that the public action can be measured by taking the difference between last night's close and this morning's open.

Conversely, professional activity, or true underlying price direction, best shows up by taking the difference between the opening and the close of the same day.

FOLKS, IT JUST CAN'T BE DONE

August 1992 (Volume 29, Issue 8)

Admittedly, our last market letter clearly explained and laid out a projected market high and advised you to “focus on August 14th–17th for the high to appear.” Beginning on the 17th a bear market attack was begun on stock prices, as we now know.

If we were like other services, we'd probably go out and buy a big ad in *Investor's Daily* telling you how great we are (were).

But, folks, 27 years of trading has proven to me that forecasting prices, politics, and our lives is difficult, if not damned near impossible. Please, let me explain ... because as soon as you get this point you will become a successful trader.

Gracious, What a Messy Drawer

I've used the top right-hand drawer of my desk now for the last 18 months as a vault to store predictions from a wide array of market letters (stocks and/or commodities) as well as other prognostications of what was to happen.

Last night I delved into this pile to rummage around with yesterday's news and possibilities. What I found was thrilling, enlightening, and most rewarding.

This culmination of hard work and multifaceted predictions of the future illustrates quite clearly that—it can't be done. Let's see, how do I prove it to you? Should I show you the chart from a leading computer-type letter that used a Neural-Net to scribe out that bonds would stage a big bull rally—in February? Nope, maybe I should quote from an *Investors Daily* interview with Guru Elaine Garzarelli, wherein she expected (as of March this year) that “Stocks should provide 20 percent returns over the next six to twelve months.” Garzarelli follows fundamental indicators. Others follow astrology. Frankly, compared to the fancy fundamentalists, they have not done a bad job. What I mean is that they are no worse than the better-educated Wharton or Harvard forecasts.

I could belabor the point by showing you one of this country's major forecasters whose graphic forecast showed a continued bear market all the way down to a low in December ... in Bonds. But, so what? Would that better prove the point I trust I have already made? If not ... do what I did ... collect all the forecasts that cross your desk. Store them up for a year and let the point prove itself.

When I was younger I had this silly notion that my personal future could be divined by some psychic means. Hence, I tried them all, palmistry, astrology, Tarot. The method did not matter, the outcome did. I learned a lot, which all boils down to this: “There are better ways to spend your money.”

After all, I began as an art major in college, switched to journalism, and here I end up using math to trade the markets. None of those seers of what's to come, came remotely close to forecasting my future.

Politics, Too

Heard “Slick Willie” say the recent DJIA spill-off was Wall Street's reaction to the Bush acceptance speech? That's almost as bad a statement as to say our call for the August high predicted a bad Bush speech, which would lead to the tumble. Speaking of politics, where are the spin doctors today who so boldly predicted that it would be folly to run against Bush, as he was unbeatable?

Okay—Let's Wrap This Up

It all gets down to this; in 27 years of trading I have yet to see anyone who can consistently forecast the future of anything. Every few years we have a Granville, Prechter, Inger, or Williams who holds a hot hand, but not for long.

That's right—27 years—and not one of us have yet been right for long with prediction. Moral of the Month: “Just Say No” to anyone who claims such an ability. God does not grant us that power, it appears. But, he did give us the ability to have a better understanding of things so that we might develop a systematic way of driving, flying, living ...even trading commodities.

It Gets Down to This

You do not need to know the future of the world to make money trading (you'll never have that view anyway). What you need is a consistent advantage in the game. No more. No less. That's where commodity trading systems come into play: They, or any consistent approach, can give you an advantage in this game ... and that, folks, is all you need.

THE RUSH OF TRADING

September 1992 (Volume 29, Issue 9)

Dostoyevsky, the Russian author and gambling addict, said the greatest thrill in life is making money on a speculative wager.

The second greatest thrill was losing money. Perhaps that's what led to the title *Notes from the Underground* for his most famous writings. The point is well taken. Making money is a great rush; strangely enough, so is getting out of a loss. Few things feel better than getting out of that much pain and anguish.

The Dilemma

This sets up a mental conflict. Negative action, losing, creates a “rush” or feeling of exaltation that our minds scramble. Just maybe, the lot of men and women like us, is that we just like that rush, thrill, and excitement ... to the point that we'll pay for the experience ... with margin calls.

Think I'm kidding? In written interviews with almost 600 traders, when asked to list the three primary reasons they were trading, not a one of them put down (as their first choice) to make money. That's right. They listed things like, thrill, challenge, excitement ... but not one put “to make money” as their first choice.

Here's my next point: When people call wanting to learn a system, or subscribe to this letter, they seldom ask if we make money ... instead they want to know how many trades we have each week and if we trade XYZ commodity, their current love. Many callers lose interest when they find we don't trade XYZ, because that is what they want to trade. Period. Even though they have been losing money doing it!

This Leads to Psycho Babble

There has been a spate of books and seminars in the last few years claiming that all you had to do to make money is “get clear” to arrive at some sort of psychological understanding about you and the market. People have paid tens of thousands for this “enlightenment.” Now it happens that I know a little bit about this.

First, let me give my qualifications about what I'm going to tell you. I have my minor in psychology, I'm as comfortable in front of a Skinner Box as a chart book, and understand the subject matter from more than just a “pop” vantage point.

More important, though, there was a time in my life when I did indeed think it was our minds that screwed us up and kept us away from the unlimited wealth the markets seemingly offer. With that belief system operating at full speed, I dabbled in them all. Geez, I could never admit it before now, but turning 50 as this is being written makes confession of the soul much easier.

I tried Scientology, rebirthing, ARICA, EST, Rolfing, Reichian, sat for countless hours in a Zen meditation center by Big Sur ... listened to subliminal tapes for a message I could not hear, chanted, panted, prayed, and pranced with the Sufis all to “get clear” so I could tap the market's till. In short, I went through more mental processes than coleslaw does in a Cuisinart.

It was fun, I learned a hell of a lot about myself, my body, and the rest of the people out there—like you. But you know what? None of that stuff helped one iota in making money trading. Not a whit.

My experience had been to make big money—with splash, as you all know—then give a little back, play some games, and hit it big again. It seemed I was good, but

haphazard.

The Unvarnished Truth

Finally it hit me ... all this time and money had been a waste.

My trading success had nothing to do with my mental state. The market did not care that I'd rather drink vinegar than kiss my mother. My mind-set about her, a Rorschach blot, or my first-grade teacher ... no, not even my concept of God ... made any difference.

The reason I lost money was not because I wanted to ... or that I was retentive, possessive, and so on. Nope, I lost because I did the wrong thing and losing was what screwed up my mental attitude or approach.

It is not the other way around.

So, for my money you can forget the psychobabble currently being offered. You don't need six hours in a flotation tank, mind-altering drugs, or hypnosis. All you need is ...

A Winning System and Patience

Frankly, I don't know which is the most important, the winning system or patience. It takes both. Why? Because even the best of systems does not make money every day. When you plant a crop, you don't dig it up every week to see how it's doing. Ditto systems, market letters, gurus, and so forth. It always takes time to make money. Making money is about time, time is about patience. Moral of all this: Forget Freud; shut down your Primal Scream; activate your reactive mind if you want. It doesn't matter. Just find a reliable approach to trading and stick with it. And, for the record, of the 25 services monitored by *Commodity Traders Consumers Reports*, we are in the top five or so for profits for the year, one of the few that made money in 1991.

BEATING THEM TO THE PUNCH

December 1992 (Volume 29, Issue 12)

In a matter of days, pundits will be telling you what 1993 has in store. All sorts of claims will be heard and sage, crystal-ball advice given based on these oracles. Will they be any good?

Sometimes You Can Judge the Future from the Past

Listen up here real good ... people (analysts) tell you all the time that you can foretell the future from studying past events. That's true, but not as often as you might think. If that was totally true, all we market soothsayers would be multimillionaires. Few of the talking heads you see on CNBC, who judge from the past, have more than cab fare to get to the TV station.

But ... there are some things you can judge from the past—one of these things is past predictions. I've been waiting 12 months to pull out last year's predictions for this year, to prove that prognosticators' ability to see the future is no better, and probably worse, than yours.

It Means Millions of Dollars

Say what you want, the *National Enquirer* is a multimillion-dollar operation that would just love to take bragging rights to being able to predict the future. Every year they have their psychics tell us what will unfold. If they could be right, certainly the *NE* would shout it out to the world and make more money. Ditto all market letters. Guess what? Sneaky me kept the *NE*'s 1992 forecast as well as the market letters that make yearly forecasts to see how their 1992 expectations came out. Here are the results:

The National Enquirer. These journalists paid the top 10 psychics for their predictions and printed them last January. Here's the scorecard; of 41 forecasts for 1992 not a single cotton-picking one of them was correct. The closest was that "an AIDS epidemic will devastate resorts." Well, AIDS devastated Magic, but there was certainly no epidemic. Chicago psychic Irene Hughes (who charges a pretty penny to forecast markets, and I've seen make major misses) saw that Vanna White would be "nearly killed" from a shock while turning the Wheel of Fortune ... Angie Dickinson was to appear nude in *Playboy* at 60 years of age and Cybill Shepherd would renounce acting in favor of running a medical clinic for the poor. None of these hotshots predicted Bill Clinton's victory, most all gave the nod to Bush.

Moving Right Along. Reading the *Enquirer*'s predictions is a stop far removed from reality ... Donald Trump was to lose it all but become a successful late-night talk show host ... Michael Jackson was to have lost his voice ... and Liz Taylor was to have children ... maybe one would think that market forecasters would have a better grasp on reality.

The truth is, they don't. Several of the more respected soothsayers were looking for a December 1992 (that's now) drop of 1,000 DJIA points. Another said George Bush's New World Order troops would take the United States over on December 19, complete with a bank holiday!

Some market analysts said we would be in a rip-roaring bull market, others, a

devastating bear market. What became of the best-selling author of the 1992 depression book? And what became of his depression and stock market crash? I hold in my hand an October 19th epistle that proclaims, “Have no doubt about it, a Crash will occur ... there is a fast fortune to be made ... \$2,000 will become \$20,000 ... THE DECLINE WILL BEGIN NOW.” Of course you are given the opportunity to call, with credit cards, for their recent update. The point is that no crash came.

Like the *National Enquirer* crystal-ball gazers, the markets pundits I kept book on also had a perfect record—of not being right. None of their “projected major turning points” were on the money. Several of them called for a major high in March with new lows for the year to be seen in October. Instead, October was an excellent time to buy (it usually is).

The Moral of All This

Avoid like the plague attaching any significance to anyone's predication of the future. The future happens, certain laws come into play. But, the truth is good thinking and reasoning will get you much farther along than oracle reading. If you take correct action in your life, trading, or investing, you will come out on top. Chasing guru forecasts is not right action. Prove my point—take 30 minutes right now to make your sensible notion of what will happen in 1993. Read it one year from now and you will see how accurate you are, compared to the headline mongers. Thinking and taking the correct action will always beat the crystal-ball crowd. Sure, it's work, but it works.

In 30 years of this game I have tried hundreds of “magic” forecasts and crystal ball crap. I used to believe. But reality has taught me an important lesson I hope I can pass on to you—don't let forecasts get in the way of doing what needs to be done. Savvy?

IT'S JUST OVER MY HEAD

Mine too

I've had a flurry of phone calls and letters this past week that I found revealing about folks like you and me and the markets.

The call or letters generally go like this, “Gee, Larry, this stuff of trading commodities is hard, I don't understand it, it's just over my head. Would you please refund my subscription fee?”

We do.

But I don't want to ... I want to grab them by the lapels and tell them this is not an

easy business, that whoever told you this seriously misled you. After almost 30 years of trading most all of the market is still over my head. As trite as it sounds, I am still cobbling away, learning how very little I know about the market ... it seems to me I will never be able to learn very much and some things I have to relearn. Over and over.

Yet despite all this, I've made millions of dollars trading ... something few people can say ... and I never would have made those hard-earned dollars had I let the notion of "stuff being over my head" thwart my intentions of making money. That's my first reaction. But upon some reflection what I should say is ...

"Where did you ever get the idea that making money is easy—in this or any other business? Is it easy to make money in your business? If so, stay there. Refrain from trading.

"Money is made, in any endeavor, by an exchange of one thing of value for another. In this business the exchange that a winning trader makes is his dollars and his intelligence at risk. He or she pays for his earnings with hours of study.

"There is just no way you can blindly follow some market guru and blissfully make money day after day, year after year. At some point you *must* go to work, figure this stuff out yourself, walk on your own. I'll help you, but bear in mind this is not an easy business, that to get money from any source requires an output of energy. There is no bliss or Nirvana in this business."

As my daddy used to tell me, and my children's father tells them, "There ain't no free lunches ... we don't deserve anything. We earn it."

I LOOKED FEAR AND GREED IN THE FACE

And here's what I found ...

It's no secret that a trader's worst enemy is his/her emotions. Some have even gone on to identify that the emotions that kill us are the mutually entwined powers of fear and greed.

But, so what, you ask. Is just knowing this enough to help a trader? The mumbo-jumbo crowd tells us that on that basis we can deal with the identified problem.

No way. I've known of these Gemini-like emotional forces for years, but it was not until recently that I fully understood (I think) how to avoid the negative downside of all this.

First, let me establish once and for all that greed is the strongest of these two emotions.

Indeed, greed may be the strongest motivator, after sexual drive, that we all possess.

How do I know this, from watching my trading—and people like you—who hope to recoup losses. We do it in a host of ways. Why do you not use stops? Greed, pure and simple. You want to make money so you hang on too long. Alexander Pope said it best, “Hope springs eternal in the human breast.” We all hope to make money, hope to get out of margin calls or bad marriages. We want to make money so badly that some of us cheat, steal, lie, even rob the local 7-Eleven. Why, because of our greed to have more.

The secret of winning as a trader is simpler than most think. The operating rule is that if you lose, or can control your losses, you will probably become a winner.

What causes loss is greed. We get so greedy—crying for profits—that we either (1) get sloppy in our money management or (2) fail to cut our losses as our hopes are too high that every trade will turn into a winner at some point. The desire for profits is the killer. Just last week I held onto a long position, refusing to bailout and take my profit as I wanted to believe the market would move higher. I bucked the system. Why, because I wanted to make more. It is not my fear that screws me up, it is my greed. When looking these two emotions in the face, I found that it is my greed that causes me to not follow my systems (do the right thing).

You can bet that from now on I will be on alert when I “want” to make more money. I know my enemy, I have stared it in the face, it is not fear ... it is my greed. And you know what? You are just like me.

THE SHOW MUST GO ON

October 1993 (Volume 30, Issue 10)

A loss I am not proud of and a reaction I am.

Just because I've had the audacity to write several books about the market and publish a letter, some subscribers seem to think I never have the same problems trading they do.

That's wrong ... real wrong. I go through the same emotions, and though I may harness them better, they still tug away at my heart and soul. Daily.

About a month ago I screwed up, big time. Oh, not enough to wipe me out, like maybe I would have done in the old days. But, enough to get my attention, provoke my anger, and raise those old questions of self-doubt I thought had been put to rest years ago.

Probably the first step to being a winning trader is getting rid of most of the self-doubt. When you “know that you know,” you are on your way, mentally and physically; at that point you have become a professional. Why? Well, I think it's because you are no longer the effect of the market ... you are the cause of what you are doing.

That's an important edge ... my screw-up had cut me like some giant pack rat slipped into my office to chew away at the fibers of my being. The self-doubt built as I went through several losing trades, until, naturally, the worst screw-up of the year came.

I was humiliated by what I had done, felt as stupid as I'd felt in years, and just wanted to stop trading. “Forever,” that voice in my head screamed. While I don't know much about the market, or trading, I do know there are no losers ... only quitters. Professional people all have “off nights.” Did that stop Joe Montana? I remember he had an off-season just before elevating himself to the status of the greatest quarterback to ever play the game. Nor did similar poor performances end the careers of other greats.

Clearly, I'm not a “great,” but I can sure learn from them. That's what I decided.

So, the morning after my screw-up, there I was, at 5:10 AM, placing an order to buy the S&P. The show would go on. Both trades won, not much, but they were my biggest wins of 1993.

BROKEN NOSES, CAULIFLOWER EARS, AND BAD TRADES

October 1997 (Volume 34, Issue 10)

Like boxing, trading is not only risky; it is also a very difficult and dangerous business.

As I write this ... I'm angry. The last few days I haven't been able to find subscribers a winning trade for love or money and my own trading, which was ablaze with glory and domination a few days ago, has lost quite a bit of its luster.

I'm angry about the markets. I'm angry with myself and I'm angry about this business where people advertise seemingly unlimited and easy wealth to be made by trading commodities. So I reflect on my limited days as a boxer; I got beat up, and quite a bit, yet still enjoyed the sport. Why? And how does this relate to trading? Why do I always turn to sports to find parallels or analogies to trading?

Fights, like the markets, are not fixed. Guys really do get hit in the ring. They

bleed, their eyes puff up and stay that way for days, and their facial cuts take weeks for the transformation to a scar. The differences between a true champion fighter and the wannabes is that the champs climb back, continue fighting, and, after a loss, still work at their craft (yes, it is a craft, no more brutal than trading). They stay in condition, they rethink strategy ... but above all, they continue. It is anger that propels them. When younger, my anger was abated with drinking until I learned that well-channeled anger is a powerful force, so I now focus anger, using it to help push myself.

When I ask fighters how they can continue, I'm told, "This is what I love, this is really all I know, and getting beat up *is just the nature of the game*." The ones that cannot *accept* the bloody noses and cauliflower ears never make it to the top. I have yet to see a champion without a marked-up face; even Ali, up close, shows plenty of damage.

Champions, just like traders, get beat up. That's par for the course, the sooner you accept and constructively channel your anger behind the losses, the sooner you will also rise to champion status.

LEARNING HOW TO LOSE MONEY

May 1995 (Volume 32, Issue 5)

Ha, bet you thought you didn't need help in learning how to drop your hard-earned dollars trading. My bet is that you have no idea how to lose; hence, you lose.

Anyone can win ... It takes no great feat to win in commodity trading, all you have to do is get in and out at the right places. Winning is a glorious feeling, hence something you can pretty well control, handle, or take care of in your own fashion. The world loves a winner, and a winner loves the world. Life is easy then ... all green lights and blue skies.

But losing, man, that's another story. Life's a bitch when you're down 30 percent to 40 percent of your money ... even tougher when you are down 80 percent to 90 percent. I know: I've been there, only all too often. I took some nasty trips in my younger days I hope never to see the likes of again. However, they did teach me a few things I'd like to pass on to you.

Profits pretty well take care of themselves, losses don't. This means *you* must take care of the losses. Indeed, this is more a business of damage control than it is price exploitation. Control the losses, and you are probably going to come out a winner.

So, how do you control loss? There is only one correct answer. Are you ready? Do you really want to hear it? And will you follow it? (I doubt if you honestly

answer “yes” to all of the above.)

The answer is to always use a stop. Always.

Before you continue reading, grab a dictionary. Check out what “always” means. It does not mean some of the time. Believe me, those “some of the times” you leave off stops will be the times that losses wipe you out. At a younger age I traded with no stops, believed in my fiscal immortality, and ended up going deficit. Several times I had to sign notes to brokerage firms. That’s a bitter reality. It’s not fun and games being hounded by brokerage firms’ lawyers. (Ah, the 1960s ... what a glorious time period.)

The only question left is where should one place his or her stops. There are two answers: (1) Place them with your broker, not as “desk” stop. And again, that’s always. (2) Since the purpose of a stop is damage control, it should be based, most often, on limiting risk. The best rule of thumb I have is that stops should be about \$800 to \$1,200 away, except in the S&P, where I use stops of \$1,750 to \$2,500.

Sometimes I use what looks like a key market turning point as a stop, or perhaps an opposite signal, or even the end of the day. The end of the day (a time stop) may be coupled with a dollar stop. But in any event, *never forget* that the closer your stop is, the more often you will be stopped out.

Only a genuine masochist uses tight stops. *No one* knows absolute highs, lows, and turning points. We can only be generally correct, which is why stops must give the market some leeway ... just not too much.

HILLARY, HIGH HOPES, AND HEARTACHES

April 1994 (Volume 31, Issue 4)

Over the last two weeks, I've carefully reviewed—at the request of the *New York Post*—all the commodity trading activity of our First Lady. What an entertaining account it is! Since much of Hillary's trading was not correctly covered by the media, I thought you might like to know what I unearthed.

Hillary (by the way, she used her maiden name, Rodham, and not Clinton, on the account) had a great introduction to trading; on her first trades she made right at \$10,000. What looks particularly irregular, though, is that the trades required close to \$8,000 in margin. Yet she pulled it off on only a \$1,000 check, which may not have been placed in the account until after the first profitable trade had been recorded.

If there is a trading pattern to the account, it is one of day trades for winners, and holdovers for losers ... as well as a real gutsy approach. As an example, on 2/12/80 she was long 10 Wheat, which she exited on 2/21. The margin back then was about \$1,000 per contract. Hillary had \$3,911.20 in the account. While newspaper articles have largely focused on her Cattle trading, the records I was given also show numerous transactions in Copper, Wheat, Lumber, Sugar, and Bonds. She paid \$41 for sugar commissions, \$50 on everything else. So she paid a little high, but then look at what she got! On many occasions she had positions totaling over \$45,000 in margin, while she actually had less than \$10,000 in the account.

Like you and me, she did have margin calls. Unlike you and me, she never had to meet them. In one case, March 13, 1979, she had \$53,478 worth of positions—with some \$26,000 in the account. There are lots of 1- and 2-lot orders that did make money, but the vast majority of the profits come from huge positions on day trades, or huge positions where margin calls were never met. Here is another confounding sample of Hillary's trading style. In early June 1979, she carried a bewildering 45 Cattle ... on a mere \$3,765.

Also a distinguishing characteristic in Hillary's trading is that the instant she made profits, she cashed them out of the account. Even her famous first trade of \$1,000 down on 10/11/78, with an immediate profit of \$6,300 the next day, shows she siphoned \$5,000 out of the account before any more trading transpired. I suppose this is a lesson we can all learn from. The long and short of it appears to me as this: Mrs. Rodham had a broker who did her some big-time favors.

NERVOUS NELLIES—HEAVEN BOUND

February 1995 (Volume 32, Issue 2)

If money is made only by holding on, we'd better learn how to hold on!

There is nothing easier than making money in commodities. It's a piece of cake. All you have to do is catch a move, and hold on until price mingles with the angels of speculation someplace up in the clouds.

You're thinking to yourself, "Easier said than done," right? And very easy to do in hindsight. Yet there are some lessons we can learn—from hindsight—that I would like to write about this month.

We currently have pretty nice trades going ... long the Canadian Dollar, short Copper and Cotton. *If these are long-term plays*, our objective will be to hold them until they bottom/top out, or reach an area of major support. That's the game plan. Piece of cake.

Not really; following the game plan is very difficult. It's no wonder there are so few winners. So few people can sit tight and hold onto their positions long enough to allow time to maximize winnings.

As an aside, but a most important one, never, ever forget that it is time that creates large winnings. The longer a system's time frame, the greater the potential for a large profit. It takes time for redwood trees to grow. Seldom do huge profits come overnight. That's why short-term traders are doomed to small profits. They tighten down the hatches of their frame so much that profits are never given the time to "mature" or "grow."

The problem really is twofold. It is essential to develop a state of mind that allows you to sit through corrections on the way to the ultimate prize zone. The second problem is developing an indicator or system that tell us when to bail out, regardless of our mental conditioning. After all, even the tallest trees in the forest never quite reach heaven.

"Preframing" Ourselves

Now there's a term I wish I had bumped up against earlier in life. The idea is that if you preframe your belief system as to what the future will be like, you can better handle the future. It is one of the most valid psychological concepts I have ever used.

At the start of every trading year, I preframe myself to equity dips by telling myself that at some point during the year I will lose money ... and a good amount of it at that. I reframe an equity dip, preframe that it may last a month or longer, and that to get through it, I simply have to get through it.

When it comes to holding on to trades, it's the same thing ... usually we mere mortals get shaken out by the flames of eternal damnation, just before the trend move resumes.

However, if we preframed ourselves to realize that in all large trend moves there will be substantial trend moves, I have found it easier to suffer through the brimstone.

SECRETS OF SYSTEM DEVELOPING AND TRADING

March 1991 (Volume 28, Issue 3)

Over 20 years ago I uncovered an amazing little secret that I have been trying to disprove ever since ... and so have subscribers.

The “secret” is that effective commodity systems do better without a protective stop loss than with one—if they are not reversal systems.

It is strange but true. If you have a system that is always in the market ... and does a decent job of it ... you cannot improve its performance by tinkering around with tighter money management stops!

I will reiterate the point. If you have a decent system—forget about “improving” it with a protective dollar risk stop loss. The reason I have repeated this point is that I find myself, 20 years later, still trying to twist and improve systems with protection stops. They continue not making much difference, and usually hurt system performance.

Many subscribers have written, called, or canceled their subscriptions because our stops “are so big.” About that they are correct. Our stop and reverse points are a good distance away from the market ... but ... it works better that way.

As strange as it seems ... for 20 years I have kept trying to improve good systems by using money management stops and they have yet to make much difference. What you gain in protection, you lose in accuracy and profit per trade. Typically a dollar stop will cut your percentage on winning trades by 10 percent to 15 percent and lop your average profit per trade by up to one third. What you get for what you lose, is not worth it.

Here's the proof: results of a system I have been working on this past week for short-term trading in Coffee (see [Table 14.1](#)). Notice that as the stop gets larger, the accuracy—net profits and total dollars won—all increase!! At the same time drawdown on the \$1,000 stop of \$12,553 gets bumped up to \$14,855 with a \$4,500 stop, but you make almost \$30,000 more!

Table 14.1 Coffee Trading System with Different Stops Produces Drastically Different Results

| Net Profits | % Wins | Average Profit | Worst Loss | Drawdown | Stop |
|--------------------|---------------|-----------------------|-------------------|-----------------|-------------|
| 63,391 | 71 | 196 | 3,987 | 12,553 | 1,000 |
| 71,250 | 74 | 188 | 3,987 | 13,875 | 1,500 |
| 69,356 | 77 | 228 | 3,987 | 12,792 | 1,500 |
| 69,407 | 80 | 226 | 3,987 | 11,802 | 1,750 |
| 73,761 | 81 | 232 | 3,987 | 12,755 | 2,000 |
| 82,091 | 83 | 252 | 3,987 | 14,202 | 2,250 |
| 76,042 | 85 | 288 | 3,987 | 15,751 | 2,500 |
| 80,417 | 85 | 266 | 4,175 | 19,651 | 2,750 |
| 78,345 | 87 | 287 | 4,175 | 14,752 | 3,000 |
| 77,536 | 88 | 283 | 4,700 | 16,217 | 3,250 |
| 81,785 | 89 | 285 | 6,987 | 19,362 | 3,500 |
| 81,506 | 89 | 308 | 6,987 | 21,997 | 3,750 |
| 90,391 | 90 | 345 | 6,987 | 17,330 | 4,000 |
| 83,721 | 90 | 333 | 6,987 | 17,858 | 4,250 |
| 91,775 | 91 | 352 | 6,987 | 14,855 | 4,500 |

The Second Secret

This one is even wilder ... you cannot improve, appreciably, a good system by using targets.

Go ahead, reread what I just wrote just for you. The knack of a trend-following system's ability to make money is that it catches some really big trend moves. Those large wins pay off all the little losses.

We all know the rule—let your profits run—and it is proven when you try to add targets (cutting your profits short) with objectives. This also bothers new traders ... they want to take profits or get out once price hits some magic number: a Gann line, cyclical window, support/resistance, or the like.

For 20 years my studies keep coming back with the same answer ... you dampen the efficiency of a system by using fixed targets. I am certain that few, if any, subscribers will be able to ride our big winners all the way. The recent bases-loaded home run we scored in the currencies is a good case in point.

You would think our phones would be ringing off the hook with people talking about their profits. That, Red Ryder, is not the case. People are calling up wanting to know “where to get back in.”

THE DIFFERENCE BETWEEN WINNERS AND LOSERS

February 1993 (Volume 30, Issue 2)

The results of modeling over 20 winning and 30 losing traders.

Most everything we learn to do well in life, we have learned by studying those who do it well. I learned to throw a football by watching a kid named Russ Powers, learned to throw a handball by watching Paul Haber.

In hi-tech-talk this is called modeling: Find someone good and scrutinize their every action *and* beliefs to uncover what makes them good at what they do. You then imprint that winning form into your mind and body.

Tony Robbins is today's leading advocate of this technology and has probably spent as much time modeling people as anyone I know. Tony defines modeling as the process of discovering the sequence of internal representations and behaviors that allow someone to accomplish a task. The components of the strategy are beliefs, behavior, and language.

Belief systems are the bottom line to the difference between winning and losing commodity traders. First some facts: In a recent test, cancer patients were given chemotherapy, and over 60 percent of them responded with the typical symptoms of this "cure"—vomiting, nausea, hair loss, and decreased energy.

However, they had all been given an inert placebo.

Their belief created their reality. So it is with us. I know. I've spent the last two to three years carefully recording conversations with losers and winners getting inside their heads to discover not only trading styles, but also their beliefs. You have read about some of the traders I modeled in books and magazines. Some of the winners are more private. But, what a discovery! There are major differences in how winners and losers play the game.

Perhaps my most fascinating discovery was that there are also major similarities between these sets of traders. Let's look at them first.

What They Share in Common ...

Both winners and losers were found to be consumed by the idea of trading. It is their life. Winner or loser, it is their passion, and they are extremists. The biggest loser I know plays with the same intensity and energy as any of the winners. So, scratch off desire or motivation as the ingredient that makes the difference.

Another commonality I uncovered was that both camps had few close same-sex friends. The men had, at most, one strong male buddy, ditto the women. Win or lose, it looks like passionate commodity traders are not great social mixers.

The point of being extremists that I touched on earlier permeates their lives. Both groups seemed to go to extreme lifestyles and beliefs. They see the world as black

and white in most categories with very few grays. I assume this is what gets the losers in so much trouble ... they absolutely commit to trading, but since they are doing the wrong thing to begin with, their disasters have been pretty big—or steady.

And Their Differences

First, let's look at the losers. This is what I found they share in common:

Most of all them are into the idea of turning \$10,000 into \$1,000,000, the quicker the better. Quick and substantial profits are a goal. All had internal dialogue “chatter” with themselves about their trades from before entering a position to days after exiting!

All losers spoke of having anxiety pushing them into a trade. They could not refrain from taking a trade ... sitting on the sidelines with no position is apparently unbearable for these people. They are happier when they are in a trade, win or lose, than not being in a trade. They seemed addicted to having the rush of trading pumping thorough their bloodstream.

Two other common points revolve around trading decisions and money management. Losers pay little attention to money management. One boldly told me, “This game is not about money management it is about being right and wrong.” I also observed few of them would stomach a look at their equity ... their account balance. They were amazed someone actually looked at it daily as they did not see what that had to do with getting into winning positions.

Finally, they all asked me if I knew of anyone that really made a living at this. They seemed very uncertain that anyone could. They lacked the belief ... even in the face of the evidence from countless fund managers ... that profits are made rather consistently.

Now for the Winners

Where do I begin this? My surprise was that the winning traders asked me as many questions as I asked them! The losers asked very few questions. None of the winners traded options. They all had a form of money management and were all technical traders. To a man and woman, they could all recount one big loss that seems embedded in their mind that they will not let happen again ... ever. So, they use stops and speak of “kicking out” trades just because they weren't doing anything. Thus, there is little internal “chatter” with themselves about their trades.

A big difference is that winners fix their attention on a very small number of key “favorite” markets. One winner has only traded Soybeans—nothing else—since 1956. The losers seemed to change markets, and gurus or newsletters, about as often as I get slippage. While the winners do (or buy) a lot of research that they study, the

losers seem to be looking for a personality to bail them out or make their money.

All the winners totally believe they will make money and simply refuse to let bad things happen to them. They have an aura of protection around them; they just don't do dumb things in the market. They are amazed more people don't do what they do; they realize it has lots of pressure, but believe that anyone of reasonable intellect can do what they do.

RECAP

This chapter has one purpose: to pass on wisdom. Wisdom trumps systems and numbers and charts and such, because those things are "dumb" on their own. Wisdom gives us the perspective to correctly use the tools at hand. I hope I am able to pass on a little wisdom in this chapter.

CHAPTER 15

Just What Does Make the Stock Market Rally?

Charts don't move the markets. The markets move the charts.

Just what does make the stock market rally? I will answer that question. But first let me say that it is impossible to know at all times why the market does what it does. Unlike other aspects of our lives and occupations, the market deals us unstable data, day after day.

Some say astrology is what really moves prices. Could be. Last week, every commodity on the board was down but Yen. Why should that be? It is not intellectually feasible to have Gold and the Bonds down at the same time, or the meats and the grains. Yet it happens. Time after time, I have seen this phenomenon.

Others say trend or speed resistance lines are what move the market. The Gann crowd has their angles, origin points, and so on; now, I for one don't believe in them. Yet time after time I have seen markets top the bottom right where these electric tools said they would.

Then, of course, there are fundamentals. Sometimes bullish news "makes" the market rally; just as often, though, the market declines following positive news and rallies after bad news!

It is no wonder that no one I have known in my 33 years of trading has consistently predicted what the market would do. Invariably, the hottest most brilliant hands turn cold. I do not accept that this is a case of "them" getting "us." It is a case of dealing with unstable data.

Fortunately though, we can make money trading, as there are a few indices, patterns, and techniques that will make money. Not always, but usually.

One of the best of these is the powerful impact that interest rates have on stock prices. This is not a new conclusion. In my book, *The Secret of Selecting Stocks* (Windsor Books, 1986), I discussed Will Go, an index that I created at that time to give an idea of future stock trends based on yields (yields are impacted by interest rates).

An easier way of looking at the problem is to monitor the price of Treasury Bonds against the S&P 500. Not only is it easier but, thanks to the computer we can see what, if any, relationship exists between these markets.

LOGIC 101

I had a great logic professor at the University of Oregon, Albury Castell. Many of you used his books in your logic and ethics classes. His class was the most stimulating one I took, outside my major, in four years of college. Looking back on it, I would also say it has been the most useful in life after college.

Have you ever thought about how much “stuff” we teach kids, or had taught us, that we never, ever use? All that math, and 90 percent of us actually only use about 10 percent of it. When’s the last time you squared a circle or cuddled up with a copy of *Beowulf*? Or forgot and ended a sentence with a preposition? I suspect all this forced feeding of education is why we are not very “street smart” and fall prey to well-argued fallacious arguments and have been easily misled by market gurus.

THESE WORDS ARE MY BOND

Back to Logic 101. One of the first rules of logic is that you cannot predict A with A. Yet day after day, we market analysts use price to predict price. Oh, we might cover it up and say we are predicting price with an oscillator or a moving average, or trend line. But the simple truth is that we are using tools created from price to predict price. Dr. Castell would flunk 90 percent of technicians.

Here is something really wild ... the tabulation displayed in [Figure 15.1](#) showing \$141,792.50 profits from trading the S&P 500 was accomplished without ever once using the price of the S&P! These buy signals were given in a fashion that said that when conditions A in data A happens then and only then buy long in data B, the S&P. Given the average profit per trade of \$1,750, which is 2.20 times greater than the average loss and a drawdown of less than 13 percent of monies earned, I think it is safe to conclude that data A is highly predictive of data B.

[**Figure 15.1**](#) S&P 500 Buy Signals Based Exclusively on Bonds

Data : S&P 500 IND-9967 03/99
Calc Dates : 08/09/82 - 03/01/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|-----------------------------------------------------------------------------------|-------|----|--------------|-------|-------------------------|----------|------------|----------------------|
| 149 | 2 | \$ | 2,500 | \$ 45 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67\F59.DAT |
| ////////////////////////////// ALL TRADES - Test 1 ////////////////////////////// | | | | | | | | |
| Total net profit | | | \$141,792.50 | | | | | |
| Gross profit | | | \$236,952.50 | | Gross loss | | | \$-95,160.00 |
| Total # of trades | | | 81 | | Percent profitable | | | 53% |
| Number winning trades | | | 43 | | Number losing trades | | | 38 |
| Largest winning trade | | | \$24,980.00 | | Largest losing trade | | | \$-14,107.50 |
| Average winning trade | | | \$5,510.52 | | Average losing trade | | | \$-2,504.21 |
| Ratio avg win/avg loss | | | 2.20 | | Avg trade (win & loss) | | | \$1,750.52 |
| Max consecutive winners | | | 5 | | Max consecutive losers | | | 4 |
| Avg # bars in winners | | | 46 | | Avg # bars in losers | | | 12 |
| Max closed-out drawdown | | | \$-18,722.50 | | Max intraday drawdown | | | \$-19,880.00 |
| Profit factor | | | 2.49 | | Max # of contracts held | | | 1 |
| Account size required | | | \$22,880.00 | | Return on account | | | 619% |
| Highlights - All trades | | | | | | | | |
| Description | | | Date | | Time | | Amount | |
| Largest Winning Trade | | | 02/25/98 | | - | \$ | 24,980.00 | |
| Largest Losing Trade | | | 10/22/87 | | - | \$ | -14,107.50 | |
| Largest String of + Trades | | | 08/15/89 | | - | | 5 | |
| Largest String of - Trades | | | 06/24/94 | | - | | 4 | |
| Maximum Closed-Out Drawdown | | | 10/26/87 | | - | \$ | -18,722.50 | |
| Maximum Intra-Day Drawdown | | | 01/08/88 | | - | \$ | -19,880.00 | |

A LOOK AT DATA A AND DATA B

These results were attained by buying the S&P 500 (market on close) any day that the Bond market closed higher than the highest high of the past 14 days.

The trade was exited in one of two fashions: either a trailing stop of the lowest low of the last 17 days—in Bonds—or a 3,000 stop from the point of entry.

Thus, when Bonds break out of a 14-day channel, buy the S&P, exit at a dollar loss or a 17-day channel breakdown in Bonds. Here is an even more important point ... channel breakouts in the S&P make for very poor systems. Yet, channel breakouts in Bonds obviously have a strong impact on stock prices.

Now here is what is really fascinating. A 14-day breakout of S&P prices on their own produces a miserable track record. In fact, there is little to offer a trader taking channel breakouts in this market. The “best” numbers are between a 15-and 20-day break. But even then, while money is made, the drawdown is insufferable and most of the profit comes from one large winning trade.

On the other hand, it does not matter too much which channel breakout you use in Bonds to trigger an S&P entry ... they all make money ... and most make money rather nicely.

As an example, I offer the tabulations in [Figure 15.2](#), the result of using a 14-day

Bond market breakout for your entry and exiting at the lowest low of the past 12 days in the S&P. We will use the Bonds to get us long and protect ourselves with S&P price data.

Figure 15.2 (A) S&P 500 Buy Signals Based on Bonds with Stop from the S&P 500 and (B) S&P 500 Buys Based on Bonds with One- to Two-Day Hold

| Data | | : S&P 500 IND-9967 | | 03/99 | | |
|---------------------------------------------------------------------|-------|-----------------------|--------------|-------|-------------------------|----------------------------|
| Calc Dates | | : 08/09/82 - 03/01/98 | | | | |
| Num. | Conv. | P. | Value | Comm | Slippage Margin Format | Drive:\Path\FileName |
| 149 | 2 | \$ 2,500 | \$ 45 | \$ 0 | \$ 3,000 | CT/PC C:\GD\BACK67\F59.DAT |
| ////////////////// ALL TRADES - Test 8 ///////////////////// | | | | | | |
| Total net profit | | | \$123,355.00 | | | |
| Gross profit | | | \$205,865.00 | | Gross loss | \$-82,510.00 |
| Total # of trades | | 106 | | | Percent profitable | 45% |
| Number winning trades | | 48 | | | Number losing trades | 58 |
| Largest winning trade | | \$37,892.50 | | | Largest losing trade | \$-5,857.50 |
| Average winning trade | | \$4,288.85 | | | Average losing trade | \$-1,422.59 |
| Ratio avg win/avg loss | | 3.01 | | | Avg trade (win & loss) | \$1,163.73 |
| Max consecutive winners | | 5 | | | Max consecutive losers | 5 |
| Avg # bars in winners | | 35 | | | Avg # bars in losers | 9 |
| Max closed-out drawdown | | \$-15,017.50 | | | Max intraday drawdown | \$-17,280.00 |
| Profit factor | | 2.49 | | | Max # of contracts held | 1 |
| Account size required | | \$20,280.00 | | | Return on account | 608% |
| Highlights - All trades | | | | | | |
| Description | | | Date | Time | Amount | |
| Largest Winning Trade | | | 08/08/97 | - | \$ | 37,892.50 |
| Largest Losing Trade | | | 11/20/87 | - | \$ | -5,857.50 |
| Largest String of + Trades | | | 08/31/87 | - | | 5 |
| Largest String of - Trades | | | 07/06/93 | - | | 5 |
| Maximum Closed-Out Drawdown | | | 10/11/90 | - | \$ | -15,017.50 |
| Maximum Intra-Day Drawdown | | | 10/29/90 | - | \$ | -17,280.00 |

(A)

| Data | | : S&P 500 IND-9967 | | 03/99 | | |
|---------------------------------------------------------------------|-------|-----------------------|--------------|-------|-------------------------|----------------------------|
| Calc Dates | | : 08/09/82 - 03/01/98 | | | | |
| Num. | Conv. | P. | Value | Comm | Slippage Margin Format | Drive:\Path\FileName |
| 149 | 2 | \$ 2,500 | \$ 45 | \$ 0 | \$ 3,000 | CT/PC C:\GD\BACK67\F59.DAT |
| ////////////////// ALL TRADES - Test 7 ///////////////////// | | | | | | |
| Total net profit | | | \$88,055.00 | | | |
| Gross profit | | | \$178,002.50 | | Gross loss | \$-90,947.50 |
| Total # of trades | | 480 | | | Percent profitable | 82% |
| Number winning trades | | 398 | | | Number losing trades | 82 |
| Largest winning trade | | \$6,392.50 | | | Largest losing trade | \$-4,170.00 |
| Average winning trade | | \$447.24 | | | Average losing trade | \$-1,096.92 |
| Ratio avg win/avg loss | | 0.40 | | | Avg trade (win & loss) | \$183.45 |
| Max consecutive winners | | 22 | | | Max consecutive losers | 2 |
| Avg # bars in winners | | 2 | | | Avg # bars in losers | 3 |
| Max closed-out drawdown | | \$-11,752.50 | | | Max intraday drawdown | \$-13,580.00 |
| Profit factor | | 1.97 | | | Max # of contracts held | 1 |
| Account size required | | \$16,580.00 | | | Return on account | 531% |
| Highlights - All trades | | | | | | |
| Description | | | Date | Time | Amount | |
| Largest Winning Trade | | | 10/21/87 | - | \$ | 6,392.50 |
| Largest Losing Trade | | | 07/05/96 | - | \$ | -4,170.00 |
| Largest String of + Trades | | | 08/25/88 | - | | 22 |
| Largest String of - Trades | | | 10/30/97 | - | | 2 |
| Maximum Closed-Out Drawdown | | | 11/22/94 | - | \$ | -11,752.50 |
| Maximum Intra-Day Drawdown | | | 12/08/94 | - | \$ | -13,580.00 |

(B)

Finally, those of you who have gone to my seminar will find that very short-term

Bond channel breakouts (in conjunction with what we know as one-half bailout) produce outstanding results. In the past year, something like 42 out of 49 trades were winners with an average profit per trade of \$527. [Figure 15.2\(B\)](#) shows this technique. While the profits are less at \$88,055, you may be attracted to the high accuracy at 82 percent.

LET'S BREAK SOME BAD HABITS

Three things lead to the demise of commodity traders: a bad system, no money management, and ... bad habits.

Bad habits—no, that's not the name of a rock group your kids listen to (it would probably sell a lot of records, though). What do I mean by bad habits? Well, on analysis, it breaks down into two areas.

The first area includes the bad habits you already know about. On the West Coast, a lackadaisical attitude can lead to not going to bed early enough to be alert at 5:10 AM—every single day of the year. On the East Coast, it may mean putting off your morning work until just before the opening bell.

Worse yet, we may not maintain our health and equanimity with the noncommodity world, the one we live in with our families and friends. But these bad habits are all ones that we know of, deal with, and fight with all the time in our total sense of living as well.

The second area involves the *real bad habits*. In the business of trading, these are the habits we have learned while thinking they are right (or good habits), although nothing could be further from the truth.

Bad habits ingrained in this fashion become operating rules that are the very building blocks for what we think is success, but since the foundation is wrong, we can never create profits. Ayn Rand was right: always check your premise.

The most common bad habit I have seen in traders—good and bad ones—is the inability to react correctly to market action. There is nothing outside market action, other than what we ascribe to it ... that's the rub. When you input something “overlaid” on the market action, you are telling the market instead of listening.

The most common form of doing this is a very bad habit—you want to sell strength. Or, just as bad, once you see a very strong market—say limit up—that little voice inside your head tells you to await a pullback—not to chase this move—and that it must come back.

In short, it scares the hell out of you to buy new highs, sell new lows.

HOW TO BREAK BAD HABITS

I know of only two ways to break bad habits. The first is to repeat, time and again, the correct action to build up a Pavlovian response that brings about the right action.

The other way is to have an intellectual understanding that the bad habit is wrong and replace the “knowledge” with correct data ... the truth. So here are two doses of market truths.

Truth Number 1

Buy when a market closes on or near its high; sell when a market closes on or near its low (limit up/down moves see a continuation of surge).

Yes, I know, it is really tough—intellectually and emotionally—to buy or sell up or down limit moves. But the truth is lots of money can be made in so doing. Here, let me show you: I went into System Writer and asked a simple question, “If price today closed in the upper 65 percent of the day's range, what would happen if I bought on that close and exited 5, 10, 15, and 20 days later?” The results are shown in [Table 15.1](#). With a stop for protection, this information is powerful. In all markets, this basic strategy made money as the following table depicts.

Table 15.1 Buy S&P 500 Market on Close if Close is above 65 Percent of Range for the Day

| Exit Number of Days Later | Profits | Percent Wins | Number of Trades | Average Profit |
|---------------------------|----------|--------------|------------------|----------------|
| 5 | \$95,745 | 53 | 533 | \$179 |
| 10 | 86,507 | 53 | 334 | 259 |
| 15 | 133,745 | 56 | 537 | 537 |
| 20 | 152,115 | 54 | 199 | 764 |
| 25 | 118,390 | 51 | 178 | 665 |

Even more staggering is that, as explained in an article I wrote for *Futures* magazine a year ago on candlestick charts, I took the “most bullish” candlestick formations and exited in the fashion described here. In the test, none of the patterns worked across all markets. Yet, here, one simple pattern, produces profits on all fronts? Egad, ... buying incredibly strong markets is a good habit.

This is strange stuff. In our guts, we want to sell these strong days and buy the weak ones. You got it, we all like a discount. But, in this business of trading, discount leads to bankruptcy.

If any one good habit separates the pros I know from the public, it is their willingness to buy strength. Bill Meehan first tried to break me of my bad habit of buying pullbacks many years ago, and I can vouch it does not take a person that

long to unlearn. Fix into your mind that strength is power and a market needs power to continue its trend.

To further get this point through our thick skulls, I will add that the best “chartist” buy signal I know of is when the price literally goes off the top of your chart, so you have to add chart paper. That is the ultimate buy.

Truth Number 2

Buy new highs and sell new lows.

If I had to guess, my guess would be that more money has been made by buying new highs and selling new lows than with any other techniques known to traders. The converse is equally true; more has been lost (forever and ever) selling new highs, buying new lows.

Usually we see a new high and—if not long—decide to bypass the trade or await a pullback. That is wrong, very wrong, as the following study reveals. This study only bought breakouts to new X day highs! It, the computer, did what the public and poorly “trained” trader can never do.

This truth is confirmed by the computer. The next set of data in [Table 15.2](#) shows what happens if today's high is less than the highest high of the last X days and price makes a new high tomorrow, which puts us long, buying a new X day high.

Table 15.2 Results of Lower High Breakouts

| Number of Days of Breakout | Profits | Percent Wins | Number of Trades | Average Profit |
|----------------------------|-----------|--------------|------------------|----------------|
| 1 | \$106,945 | 58 | 209 | \$511 |
| 5 | 67,197 | 51 | 187 | 359 |
| 10 | 58,270 | 50 | 169 | 344 |
| 15 | 75,325 | 56 | 145 | 519 |
| 20 | 55,342 | 53 | 136 | 406 |

Again, we exit some days later. A \$3,500 stop was used. We are chasing strength to buy. Buying new highs is a successful strategy. The preceding is not a system, rather an illustration to drive home the importance of letting strength lead the way. Most traders are frightened or intimidated by excessive strength. Thus they do not buy, or worse yet, sell short.

As it has been said, the race or the fight may not always go to the biggest, the fastest, or the toughest. But, my friend, that is the way to bet.

COMMENTS ON SETTING STOPS—

DOLLAR LOSS AND UNPREDICTABILITY

There are only two givens to this business: (1) you *must* control loss, and (2) price is highly unpredictable. The goal of system development is to create the ultimate moneymaking machine that, like an oil well, just keeps pumping out profits. Although you may never attain that goal, you can acquire an amazing amount of insight into correct trading from system development.

What Is the Purpose of a Stop?

Correct stop placement provides an example of what system development has taught us. We use stops for one and only one reason—to protect us when our system fails. Systems fail all the time; if that potential liability did not exist, stops would not be needed. Stops are our defensive shield and what they protect us from is the unpredictability of (1) our system and (2) the market itself.

The game of trading involves so much unpredictable behavior that stops can hurt you, if they are too close. Indeed, the closer your stop, the more times “they will have gunned for you,” the more you will be stopped out, and the more paranoid you will become. Since no trader I have met can predict down to a gnat's eyelash (due to all the random activity of price), our stops must be beyond—or past—random fluctuations. They must be far enough away that if they are hit it will be because of real—not random—activity. That is Lesson 1.

Now Comes Reality

Here's the next important thing about stops: Since their purpose is to defend against ruin, they need to also be based on money management principles. As an example, here is the same S&P 500 Day Trading system but with three different stops.

Figure 15.3 S&P System with a \$500 Stop

Data : S&P 500 IND-9967 03/98
Calc Dates : 01/01/86 - 01/01/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|-----------------------------------------------------------------------------------|--------------|------|---------------|-------------------------|----------|----------|---------------|----------------------|
| 149 | 2 | \$ | 5,000 | \$ 45 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67\F59.DAT |
| ////////////////////////////// ALL TRADES - Test 1 ////////////////////////////// | | | | | | | | |
| Total net profit | \$-41,750.00 | | | | | | | |
| Gross profit | \$165,665.00 | | | Gross loss | | | \$-207,415.00 | |
| Total # of trades | 510 | | | Percent profitable | | | 26% | |
| Number winning trades | 133 | | | Number losing trades | | | 377 | |
| Largest winning trade | \$11,955.00 | | | Largest losing trade | | | \$-2,045.00 | |
| Average winning trade | \$1,245.60 | | | Average losing trade | | | \$-550.17 | |
| Ratio avg win/avg loss | 2.26 | | | Avg trade (win & loss) | | | \$-81.86 | |
| Max consecutive winners | 4 | | | Max consecutive losers | | | 14 | |
| Avg # bars in winners | 0 | | | Avg # bars in losers | | | 0 | |
| Max closed-out drawdown | \$-77,725.00 | | | Max intraday drawdown | | | \$-77,725.00 | |
| Profit factor | 0.79 | | | Max # of contracts held | | | 1 | |
| Account size required | \$80,725.00 | | | Return on account | | | -51% | |
| Highlights - All trades | | | | | | | | |
| Description | Date | Time | Amount | | | | | |
| Largest Winning Trade | 03/27/97 | - | \$ 11,955.00 | | | | | |
| Largest Losing Trade | 03/17/97 | - | \$ -2,045.00 | | | | | |
| Largest String of + Trades | 12/15/97 | - | 4 | | | | | |
| Largest String of - Trades | 11/07/94 | - | 14 | | | | | |
| Maximum Closed-Out Drawdown | 04/08/96 | - | \$ -77,725.00 | | | | | |
| Maximum Intra-Day Drawdown | 04/08/96 | - | \$ -77,725.00 | | | | | |

[Figure 15.3](#) uses a \$500 stop, [Figure 15.4](#) a \$1,500 stop and finally [Figure 15.5](#) uses a \$6,000 stop. There are some huge differences here we need to explore. Keep in mind this is the exact same system; all that has changed is the amount of risk we are willing to accept as determined by the stop.

Figure 15.4 Same S&P System with a \$1,500 Stop

Data : S&P 500 IND-9967 03/98
Calc Dates : 01/01/86 - 01/01/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|--------------------------------------------------------------|--------------|------|--------|-------------------------|---------------|----------|--------|----------------------|
| 149 | 2 | \$ | 5,000 | \$ 45 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67\F59.DAT |
| ////////////////// ALL TRADES - Test 3 ///////////////////// | | | | | | | | |
| Total net profit | \$116,880.00 | | | Gross loss | \$-276,680.00 | | | |
| Gross profit | \$393,560.00 | | | | | | | |
| Total # of trades | 506 | | | Percent profitable | 56% | | | |
| Number winning trades | 287 | | | Number losing trades | 219 | | | |
| Largest winning trade | \$14,205.00 | | | Largest losing trade | \$-2,045.00 | | | |
| Average winning trade | \$1,371.29 | | | Average losing trade | \$-1,263.38 | | | |
| Ratio avg win/avg loss | 1.08 | | | Avg trade (win & loss) | \$230.99 | | | |
| Max consecutive winners | 11 | | | Max consecutive losers | 7 | | | |
| Avg # bars in winners | 0 | | | Avg # bars in losers | 0 | | | |
| Max closed-out drawdown | \$-20,970.00 | | | Max intraday drawdown | \$-20,970.00 | | | |
| Profit factor | 1.42 | | | Max # of contracts held | 1 | | | |
| Account size required | \$23,970.00 | | | Return on account | 487% | | | |
| Highlights - All trades | | | | | | | | |
| Description | Date | Time | Amount | | | | | |
| Largest Winning Trade | 10/13/89 | - | \$ | 14,205.00 | | | | |
| Largest Losing Trade | 03/17/97 | - | \$ | -2,045.00 | | | | |
| Largest String of + Trades | 05/25/93 | - | | 11 | | | | |
| Largest String of - Trades | 03/07/86 | - | | 7 | | | | |
| Maximum Closed-Out Drawdown | 01/08/88 | - | \$ | -20,970.00 | | | | |
| Maximum Intra-Day Drawdown | 01/08/88 | - | \$ | -20,970.00 | | | | |

Figure 15.5 Same S&P System with a \$6,000 Stop

Data : S&P 500 IND-9967 03/98
Calc Dates : 01/01/86 - 01/01/98

| Num. | Conv. | P. | Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---------------------------------------------------------------|--------------|------|--------|-------------------------|---------------|----------|--------|----------------------|
| 149 | 2 | \$ | 5,000 | \$ 45 | \$ 0 | \$ 3,000 | CT/PC | C:\GD\BACK67\F59.DAT |
| ////////////////// ALL TRADES - Test 10 ///////////////////// | | | | | | | | |
| Total net profit | \$269,525.00 | | | Gross loss | \$-239,205.00 | | | |
| Gross profit | \$508,730.00 | | | | | | | |
| Total # of trades | 490 | | | Percent profitable | 70% | | | |
| Number winning trades | 346 | | | Number losing trades | 144 | | | |
| Largest winning trade | \$14,205.00 | | | Largest losing trade | \$-5,920.00 | | | |
| Average winning trade | \$1,470.32 | | | Average losing trade | \$-1,661.15 | | | |
| Ratio avg win/avg loss | 0.88 | | | Avg trade (win & loss) | \$550.05 | | | |
| Max consecutive winners | 16 | | | Max consecutive losers | 4 | | | |
| Avg # bars in winners | 1 | | | Avg # bars in losers | 0 | | | |
| Max closed-out drawdown | \$-19,825.00 | | | Max intraday drawdown | \$-19,825.00 | | | |
| Profit factor | 2.12 | | | Max # of contracts held | 1 | | | |
| Account size required | \$22,825.00 | | | Return on account | 1,180% | | | |
| Highlights - All trades | | | | | | | | |
| Description | Date | Time | Amount | | | | | |
| Largest Winning Trade | 10/13/89 | - | \$ | 14,205.00 | | | | |
| Largest Losing Trade | 10/10/95 | - | \$ | -5,920.00 | | | | |
| Largest String of + Trades | 09/14/88 | - | | 16 | | | | |
| Largest String of - Trades | 07/27/95 | - | | 4 | | | | |
| Maximum Closed-Out Drawdown | 01/15/87 | - | \$ | -19,825.00 | | | | |
| Maximum Intra-Day Drawdown | 01/15/87 | - | \$ | -19,825.00 | | | | |

With a \$500 stop the system actually loses money, \$41,750 to be specific! Our

accuracy at 26 percent on the 510 trades suggests this is certainly not a very good system.

Or is it? The next tabulation shown in [Figure 15.4](#) reflects the same system, that is, the exact same buy and sell entry rules, but uses a stop loss of \$1,500. What a difference the stop makes! The accuracy screams up to 56 percent and we turn a losing system into a winner taking profits from a negative \$41,750 to a positive \$116,880, close to a \$160,000 change. Gee whillikers, could there be something to this stop-loss stuff after all?

Our next test of the system is to use a \$6,000 stop (see [Figure 15.5](#)). Does this improve the performance? Well, yes and no. It does make more money, netting \$269,525, and the accuracy gets boosted up to 70 percent. But we pay for it. Notice in [Figure 15.5](#) how the largest losing trade gets bumped up to \$5,920 as opposed to \$2,045 with a \$1,500 stop. Worse yet, the average losing trade was \$1,263 with a \$1,500 stop and rises to \$1,661 as the risk amount increases, while the average winning trade at a \$1,500 stop is \$1,371 and only increases to \$1,477 as the stop backs off.

The problem is that when you get tagged with the larger stop you can drop too much of your bankroll, \$6,045, on just one trade. This is a critical point. If you don't want to risk more than 5 percent of your account on any one trade on a \$100,000 account, you can trade only one contract with the \$6,000 stop, while the \$1,500 stop allows you to trade two contracts, which effectively doubles the profits on your \$100,000 account. This may not sound like much but when you use my money management formula the results are dramatically different.

The lesson you have learned, I hope, is that dollar stops are far more effective than the whirling dervishes of technical analysis.

AN OVERVIEW OF HOW I TRADE

Okay, enough information on the short-term machinations of the markets. All these tricks of the trade come in handy all the time. Yet they work best when placed into the proper perspective.

For that purpose I am adding in this edition a simple overview of how I actually trade. Here are the nuts and bolts of what I do every day.

It is time now to show you one of the most powerful market indicators of them all. Many of my students trade with just this one indicator: It represents trillions of dollars invested by the big guys. The big guys are the ones who move the market, they know more than we do.

Here's how to follow them ...

Each week the United States government publishes the *Commitment of Traders Report* (COT), which shows all of the buying and selling done the prior week by the various “players” in the market. Essentially there are three groups; they are Commercials, Large Speculators, and Small Speculators. The report is issued at the end of each week based on information through Tuesday of that same week. It can be accessed at www.cftc.gov/marketreports/commitmentsoftraders/index.htm.

I began following these groups of traders in 1970 before anyone else was aware of the reports. I think I can truthfully say that no one has had more experience with them. Several of my students have based careers on this information. They have done good work. I have always found it best to go to the source for any information. In this case, the source is me, and you are here at the source. Not only because I have four decades of experience working with the data, but also because the newest innovations in using the COT report have all come from my work.

It is critical that you understand these three different groups of traders or investors. Let's begin with the Small Speculators. For the most part this group of people *is just like you* ... these are people looking to buy low, sell high, and made a quick dollar or two from actually trading the markets. By and large, this group is selling at market lows and buying at market highs. In other words, they tend to do the wrong thing, most of the time.

The second group, Large Speculators, has changed over the years. They used to be people like myself who trade in large quantities. Now, for the most part, *it is the commodity funds* that make up this data. It used to be there were no commodity funds. Now they have become one of the largest players in the marketplace, trading billions of dollars. *They are primarily trend followers*. It is very difficult to use this information, from this group, to predict market moves. That is because the way they buy is to buy on a scale-up or sell on a scale-down.

The last group, the Commercials, represent what each industry is doing. The Commercials are the people *that produce or use the commodity*. A good example would be someone who grows soybeans—that's a producer, as is someone who mines gold. On the other side of that you have the user, someone who processes soybeans into a variety of products, or someone who takes physical delivery of gold and make jewelry or uses it for computer chips. In other words, *this group represents the industry*. They represent the smartest money, and they're not trend followers. They are not speculators in the marketplace; they do not try to buy bottoms and sell tops.

They use the market to facilitate their business they hedge ... by definition ... They are hedgers in the marketplace that is also explained in more detail in my course. For now, let's just look at their track record.

[Figure 15.6](#) shows a chart of Gold. In the top pane you see the daily price of gold.

In the bottom pane, you see the net long position of the commercials. When that line is rising they are buying, when it is declining they are selling. Additionally, you can see the large Speculators by the line, and total open interest is represented by the black line.

Figure 15.6 Gold and the Commercials



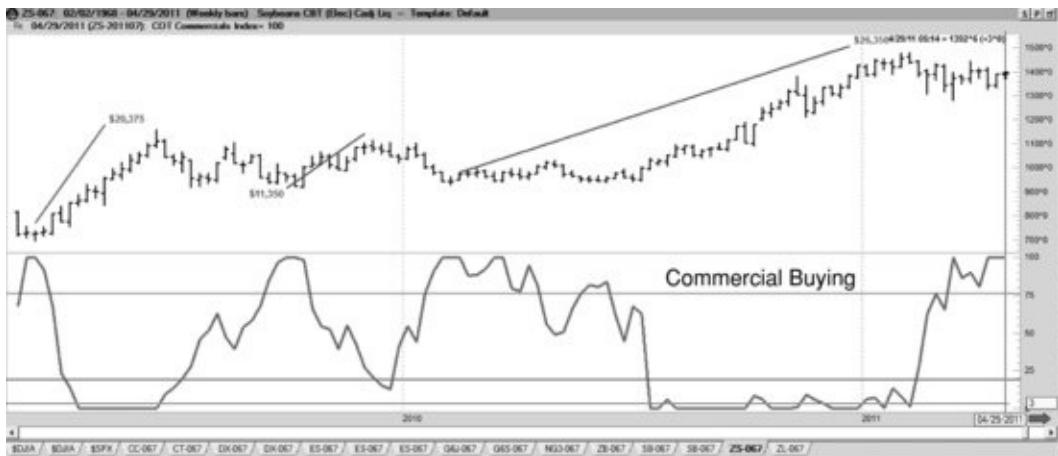
It was very clear in early February of 2011 that the commercials were heavy buyers in the Gold market; week after week they increased their long position. That was a tipoff to the potential rally, which resulted in almost \$22,000 per contract. As you can see, the commercials move the price of Gold. This has nothing to do with chart formations, waves, astrology, or some mystical approach to the market.

Markets move because of conditions; when the commercials are heavy buyers, prices usually rally; when heavy sellers, prices usually decline. It is as simple as that.

To make it easier to see what the commercials are doing. I have developed what I call my Williams COT indexes. I have these for the Small Speculators, Large Speculators, and Commercials. They are unique to my work and *no one else uses them as I do*. Let me show you an example in another market where we will *use the index* as opposed to the net position of the commercials.

[Figure 15.7](#) looks at Soybeans on a weekly chart. The rules are really quite simple. When the index is high, above 75 percent, we want to look for buy signals in the market if the market is in an uptrend. If the market is in a downtrend, we want to take sell signals when the index falls below 25 percent.

Figure 15.7 Soybeans and the Commercials



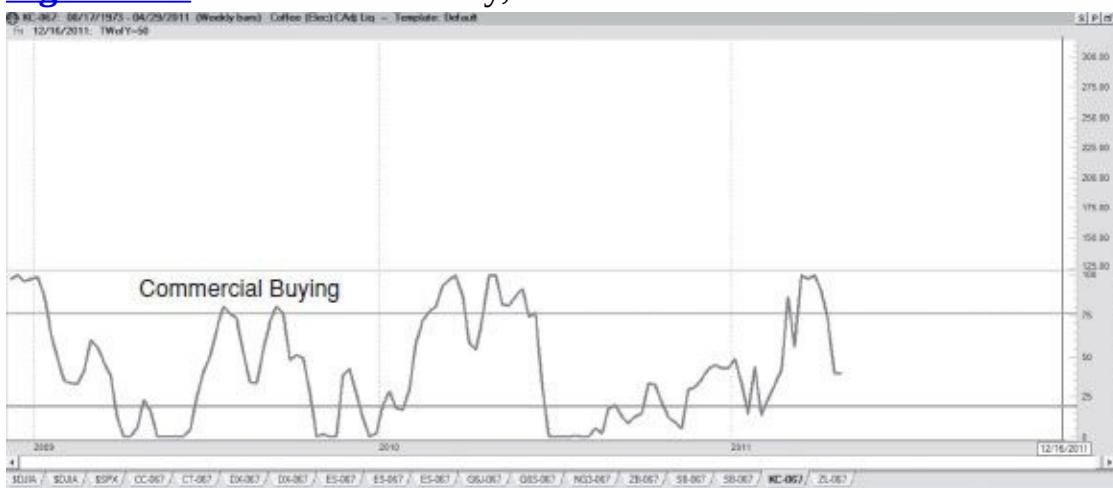
That's not too difficult, is it? You can see the magnitude of some of the rallies that were triggered by my COT index. Some are of great significance while others made only \$10,000 or so. But the point is that, thanks to the COT, we can see what the Commercials are doing ... and they drive the marketplace.

Now you know why I'm not so enthusiastic about all the wiggles and waggles that the technical analysts talk about. Their wedges and heads and shoulders and all those indicators only show what price did in the past, *they are not indicative of where prices are going*, as they are not fundamental to the markets.

It's time for a pop quiz!

I'm going to show you a chart of a market you are not aware of, but I'm not going to show the price of the market (see [Figure 15.8](#)). I'm just going to show the COT index. What I want you to do is to determine the times and would-be a buyer in this marketplace. What you should be looking for is when the index is above 75 percent. At those times, you should be taking buy signals, right? You did learn that, didn't you?

Figure 15.8 Commercials Only, Not Price: You Decide



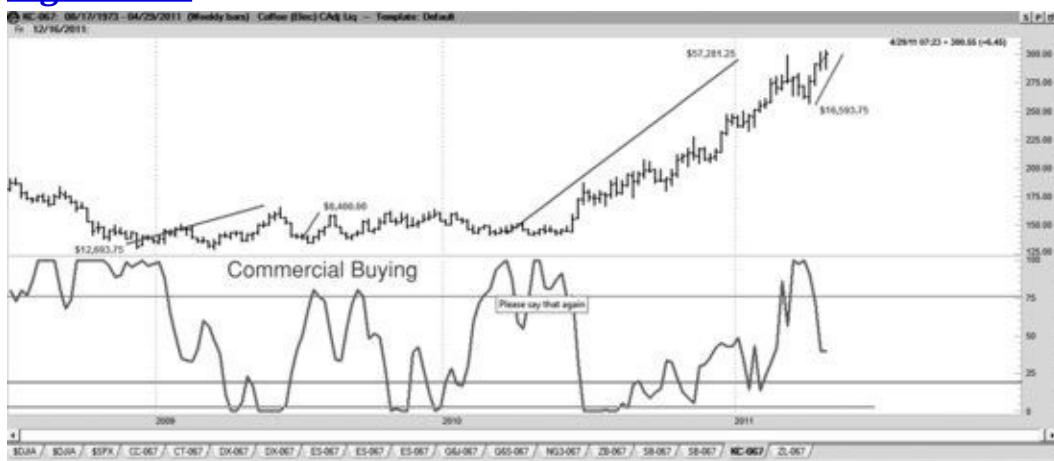
Okay, take a look at [Figure 15.8](#) and then determine when you would have been a

buyer for whatever market this is.

[Figure 15.8](#) is a chart of Coffee on a weekly basis. You cannot see the price action. You have no clue what exactly did happen, but you can see my COT index and determine when Coffee is in the buy zone, above the top line. Of course, falling below the bottom line when prices are in a downtrend would set up sell signals.

[Figure 15.9](#) pulls back the screen so that you can see price as well as the indicator together. How did you do? Were you able to determine the times when price would rally or decline?

Figure 15.9 Price and Commercials



How about that? Without knowing what the commodity was, without understanding much about commodities, you have been able to correctly calls significant rallies and declines in the coffee market. This is not an unusual or hand-selected example. Once you learn how to use my indicators, you will see many similar instances of the power of this indicator.

There are two closing comments I would like to make. First of all, my COT indicators are different from everyone else's. I also look at more than just the indicators: I show my students how to look at the interrelationship between these three groups of traders in the marketplace and in combination with open interest. This is very eye-opening when people see how the traders are actually interacting with each other. This is of great value in determining when the market will rally or decline.

I hope by now you understand that *there are things that cause markets to rally*. These things are not complex. They can be learned, just as you learned in the last few minutes. If you want to become a good trader, you need to know about the markets, you need to study them, and that's why I offer our courses. If you haven't taken a look at them yet, you may want to click [here](#) and see what is covered in the courses. I have been doing this for almost 50 years ... my courses will save you years of looking and wondering and wandering.

MY TRADING STRATEGY ... HOW IT WORKS

Without a written-down trading strategy, you are always chasing your tail ... in repetitive circles, like 90 percent of traders. You are lost, because you do not have a plan. My students don't do that, because we have an absolute strategy. Here it is ...

The lesson is very simple but critically important. When I meet with traders and ask them what their strategy is, they are usually clueless. Their strategy, they tell me, is to buy low and sell high. But they have no approach or strategic way of accomplishing that. They're just looking to buy without understanding the markets on a broader basis ... in short they are trading on a wing and a prayer.

Our trading strategy can be explained in three steps: (1) First of all, we look for a set of markets; (2) then we look for entry into that market; and finally (3) we look for an exit which could be (a) a stop loss, (b) a trailing stop, or (c) a price target. Consider this your road map to trading, as we have defined our parameters.

Set-Up Market

The first step is to find a market that we think has a high probability to rally or decline. You have already learned how we can use the COT report to find such opportunities. Indicators can be of great value ... they focus our attention on the select few markets that have a high probability success.

Entries

Of course, it is not enough to have a market that is just set up; we need to know when to get in. In our course I use five different entry techniques, because markets do not top and bottom the same way every time.

The problem most traders have is that they are simply one-trick ponies. They have one, and only one, entry technique. In actuality markets top and bottom (trend reverse) in a wide variety of ways. That's why I teach more than one entry strategy. If the market bottomed, or topped, the same way every time this would be an easy business. Tops and bottoms do have some things in common, but they are not all the same, so we need several approaches to catch the turns.

Exits

The fun begins once we are in a trade. Eventually one of two things will happen: We

will have a loss or we will take a profit. That sounds simple, but trust me, it isn't. I will show you one of my exit techniques. For now, let's just think of strategies and ways that we might get out the trade.

To begin with, once I'm in a trade *I place a stop loss to limit my losses*. Let's say I'm buying, so my stop loss is below market, not too far away ... I don't want to have a massive loss, but not be so close that there's a high chance of the market randomly stopping me out. I think there is a precise point where stops should be, another thing that I teach in our courses.

By placing that protective stop-loss, I have my losses covered, I can only lose so much. The complexity begins when the market starts to rally and I'm wondering ... where should I get out?

My strategy is to *have a trailing stop somewhat below the market* to allow the market to run, hopefully a long way. As you've already learned, I want to have small positions and catch big moves. The best way to catch a big move is to give the market room to trade back and forth. What is needed here is something that informs me if the market has pulled back too much and I'd better get out; the trend is probably over. I should take profits.

My last exit technique is *to sell at a predetermined target*. I don't determine my targets the way other people do: Most traders just take a certain percentage of daily range or look at Fibonacci numbers. These are things I have studied but did not find of great value. I use my "Target Shooter" for taking profits; it's a tool I have been using since 1966. It has a wonderful record of getting me out very close to market highs and lows. It isn't perfect, but it has done a wonderful job of getting me out before markets reverse. It is based on recent price swings to suggest where price is most likely to go; I exit at that targeted price.

[Figure 15.10](#) shows a very clear example of a trade we made on Larry TV (see at [Ireallytrade.com](#)) in April 2011. This market was set up to rally because the commercials had been buying. The entry came from a variety of techniques, but you can see that the trailing stop, which revolves around daily price action, was penetrated to the upside, giving a buy signal. The stop was placed below the low of that upside day and then started to move up, exactly where you see the line, which is my trailing stop.

[Figure 15.10](#) Actual Set-Up Trade



Also note the target was where profits would be taken if we rallied there prior to falling below the trailing stop.

What you should note is that we have our entry, then protective stop-loss, trailing stop, and target. All of those techniques are mechanical ... you can see them right on the chart. There is no judgment as to where they are. Any two Larry Williams students will come up with the exact same price points.

So here's my strategy: I find a market that is set up and I then look for a change in trend, at which point I get into the position. I place my stop-loss for protection and begin using a trailing stop underneath the market, while hoping price goes to the target. I could have used other entry techniques discussed in this book, like Oops! days, and so forth.

RECAP

The point of this chapter is to show you that I know ... every single second that I am in the trade ... what to do. There is no confusion. I have my stop-loss, I have my trailing stop, and I have my target. I know where to get into a trade. I may be wrong (that does happen), but I know exactly what I am doing ... I am never trading blind. None of my students trade blindly.

You shouldn't, either.

CHAPTER 16

Hard Facts about a Very Hard Game to Win

This business of making money from looking at charts and such is not an easy one. It has been made even more complex in recent years because so many online Internet vendors of so-called market trading systems make it appear easy. The only easy money they have made is from selling their systems. All of the articles on short-term trading, day trading, and so forth mislead the average person into thinking that trading is an easy and simple approach to making money.

It is not.

This business requires an extreme amount of focus, and sometimes it's impossible to stay focused consistently for long time periods. It also requires the intellectual understanding of how the markets work. I hope I have shown you some of that in this book. This is clearly an intellectual game.

In athletics, the biggest, toughest, and strongest guy is usually the one who wins. In trading, it is the one who has the most information and, probably, is the most intelligent. But beyond having an intellect, it also requires the ability to control one's emotions and not be overly reactive to market influences. I have seen a lot of very bright, very intelligent, and extremely well-educated people lose all their money trading. Intelligence and education are not enough; there's another ingredient that makes for great traders.

The challenge is not only intellectual but also an emotional one wherein you must take control of yourself. Emotions cause us to do the wrong things, even when we know they're wrong. Emotions cause us to overbet, or underbet, to trade too often, or not at all. Until you are in charge of your emotions, and not allowing them to be in charge of you, your trading successes will be limited.

As I said ... this is not an easy business. We are subject to constant change, not only in things that we trade (It was a sad day in my life when Pork Bellies were suspended from trading. They used to be one of my favorite things to trade ... my first love. Now they've gone the way of the buggy whip.)

All of this change is overlaid against a background of business and politics. Whenever money or power is at stake you will find corrupt people playing in the game. In our world of high finance, we have almost instant availability to both power and money. You can well imagine the genre of people who are attracted to

this business. You need to be on guard at all times against the other players in the game. Generally speaking, most of them are honest and decent people. But it only takes one to upset your apple cart.

The most frustrating thing to me in 2011–2012 is the intellectually corrupt political agenda that we see operating throughout the world. Who doesn't realize that the foundation of a strong, stable economy is a strong, stable currency? What idiot can't see that deficit spending will cause instability in the marketplace and higher taxes on rich and poor alike, which are the worst possible things for both groups?

And yet these ideas persist. Why cut the budget, when we can just increase deficit spending? Let's raise taxes so we can come up with more programs to get more people to vote for us. That is a sad state of affairs, throughout the world.

That's what it's about. Buy votes through more programs without thinking of the consequences beyond your own personal reelection. Hopefully that will be corrected with a grand awakening but, until it does, the markets will most certainly dance to the gyrations of political debacles. I want to offer some long-term perspective to all of this. The market is going to do, largely, what it is going to do, irrespective of news and political events.

My view, based on my studies of market cycles, is that, as an example, 2015 will be a very strong bull market ... I'm looking forward to trading that one. The 2015 bull market will happen irrespective of political power. However, it will be enhanced or magnified by the political conditions at that time.

Those same cyclical studies lead me to believe that in mid-2017 we will see a substantial stock market decline. The extent of that decline will be enhanced, or muted, by the economic, political conditions of that time.

That's why we need to be aware of what is happening around us, but also be aware of the long-term cyclical aspects of economic activity.

Following the crash of 2008 and the economic malaise seen since then, many investors as well as market prognosticators have taken the view that the greatness of America ... and perhaps the world ... is becoming a thing of the past.

Nothing could be further from the truth. The future of America, and indeed the world, is still in front of us. The big economic debate going on in 2011 is, did the economic fiasco of the past few years alter the economic landscape for decades to come? Or was it merely a blip in a long-term upward movement?

It was neither.

What it was, was a reminder that markets and the economy have huge upswings and huge downswings ... they always have ... they always will. Will something like this happen again in the future? Absolutely. Without a doubt. If we learned anything from the past, it is that there will be economic upheavals in the future.

Of course, that same study of the past can only lead one to believe that there will also be economic growth and many fortunes to be made in the future. Things will get better until we have another economic binge to the upside with the concomitant crash to the downside as the market seeks equilibrium.

My cyclical studies suggest that by 2014 the economies and markets of the world will have digested the problems of the past few years and we will be back to a more stable economic environment.

Only a Cassandra, a purveyor of pessimism, could possibly think that there'll be no more economic growth and that there will not be good times in the future. There will.

The sun has not shone brightly the past few years on economic activity, but the sun also rises, and it shall rise again. Yes, we are undergoing a restructuring of the economies of the world as well as a new power structure. So what? Hasn't that always been the case?

Let me put it this way: Things are better now than they were 15 years ago, and things were better 15 years ago than they were 15 years before that. Economics or evolutionary ... things get better.

The overly optimistic soothsayers will see what we have gone through as a blip. I suggest a much better view is that it is a lesson in economics and a warning that this will happen again ... not for quite some time, but it will. Never forget, it is impossible for any government of the world, or any banking monopoly such as the Federal Reserve system, to overcome the long-term cyclical fluctuations that exist. Why these fluctuations take place is beyond anyone's guess, but certainly they have not been something that anyone has been able to control so they will happen in the future. That is a certainty, just as certain that good times will also take place in the future.

Never sell America short and never sell yourself short.

I have shared a lot of my life with you in these pages and almost all of what little I know about the markets. And, while this book is my gospel of trading, it should not be your gospel. You need to implement what I have written that works for you. Twist it around, come up with better ideas and new approaches, but the basis I have presented here is sound, workable trading material. This chapter wraps things up with some comments on how to use my material, or anyone else's. In a nutshell:

This is not a black-and-white business.

“But you said ...”

“Page 63 says to ...”

“This line crossed that one ...”

“It's trading day of the month 11, shouldn't I ...?”

Those are typical comments that I hear every day from readers of my books and that illustrate an important part about being a winning trader.

IT IS JUST LIKE LIFE

Not only is this business not black and white, neither is life. We all know that (I think), yet as traders we want absolutes so badly that we absolutely forget to think. For example, math is an absolute, but when applied to the imperfect world of stocks and commodities, it reverts to being a tool that simply gives more clarity and definition to the imperfections. Please, never forget that above all else, speculation is a thinking business. If you are not good at thinking, or at least at getting correct answers, I suggest that you look for the off-ramps.

This problem begins with a wish or hope that there is some be-all automatic/systematic approach to trading. The two greatest bits of bad information so-called advisers and authors such as myself foist on the great unwashed masses is either extreme and continual bearishness, or the belief that somewhere, someplace, there exists an absolutely perfect system—that there is precise cadence, order, and structure to the markets. These are the two great myths of speculation.

Yes, there are times to be bearish on stock and the economy, but there's an entire camp of newsletter writers making a pretty good living by deliberately pandering to fears of gloom and doom, of another 1929 ... starting tomorrow. I know these folks; I have appeared at the same symposiums with them, and I have seen them consistently bearish—in one case, since 1962! One of these Negative Nellies, in a private conversation, told me that there was a huge market of investors who feared the future and actually believed things were falling apart quickly and it was his business to fan these flames. He added, “It's easier to sell subscriptions to these people, they are an easy-to-target market, and if I'm wrong on stock picks, it doesn't matter, performance does not count, it's reaffirming the belief that they want to hear.”

This crowd is full of pontificators, good people who have overanalyzed everything and concluded the future for the United States, and the world, is behind us. And yet, even the most cursory study of history will establish one dominant fact: *Our condition and lot in life is constantly getting better.* Yes, there are some downs, but they are far outweighed by the ups.

There is another side to this coin, the “cosmic trader” who is convinced there is an explanation for every market high and low, that every up-and-down tick in price is fully explainable, and usually for a pretty stiff fee payable up front to them! When I was young and ignorant of the ways of the market, and my fellow traders, I fell for this pitch. After all, these people had a track record of success and could explain

away all the market moves that had taken place in the past.

Usually the foundation for this belief is based on the legend of W. D. Gann. I have already written about the “legend” and that it was just a good dose of showmanship mixed with some winning trades, a bit a braggadocio, and an aggressive public relations campaign. Again, this is not my opinion, but facts as related to me by F. B. Thatcher, the advance man for old W. D.

The more time I spent in outer space with this crowd, the more losing trades I saw. Although their explanations of the past were brilliant, their forecasts of the future were right about one time out of twenty and, naturally, that's the one they talk (brag) about in all their advertisements. There is no reality here; the fact that they were dead wrong in the past did not prevent them from again attempting to predict the future! Accuracy, making money, has nothing to do with their life—it is all about “proving” their mumbo-jumbo works. I have been on the speaking circuit with these folks as well, and have come to have little respect for this crowd, with some exceptions.

Of the thousands of traders applying this cosmic logic, I have only seen two do well: Arch Crawford and Jerry Favors. Two out of thousands is not a great batting average. In addition, Arch and Jerry are not only exceptionally smart people, but well-trained, experienced traders who use more than just one approach.

The bottom-line problem with the “all can be known” thesis is that it causes you to throw away fear, to place your convictions, and money, on a thesis, not on what is actually going on in the market. If your focus is the market, what is happening now, and not a belief that stock or commodity prices must do something, your chances for success will skyrocket:

A perfect system or approach does not exist. Never has, never will.

If there were such a thing as perfection in this business, then that would mean (1) the markets contain no random inputs and (2) someone else would have already found the magical solution and own most of the free world by now. Since we know the markets do have a high degree of random influence from ever-changing news, weather, and traders' outlooks, and that even the best traders and funds tap out, we must realize that the markets are not to be traded with a 100 percent mechanical approach. Things change.

Does this sound strange coming from someone who has just about spent his entire adult life developing systematic approaches to trading? Probably so, and it should not be taken to mean that all my work or systems or courses don't work:

Life is a judgment call, but that call is based on having data and systems to make life work better. So it is with trading. I need a systematic approach to get me into and out of trades, I need absolute stops, and I sure as heck need precise entry rules.

But above all, I need to use some judgment of when to use this “stuff.” Let's look at an example from real life.

If you are driving down the road and a truck is dead ahead of you coming at you in your lane, do you stay in that lane or swerve across to the empty lane where you are not supposed to be? The rules are clear: You are not supposed to be over there. The system says don't do it, but reality is an 18-wheeler coming toward you in your lane. Do we follow all the rules of safe driving, or do we adapt to the situation at hand? Survival is a function of adaptation.

Reality rules. On the road, and in the markets:

The first rule of life is to survive; the second rule is that all rules can be broken if that supports the first rule.

Speculation follows the same rules we use for life; they are integrally the same. Successful trading is the art of using knowledge (systems) at the right time. This means that when it is time to use the system or rule, you check for an oncoming 18-wheeler. That is what thinking is all about. We do need systems of living and systems for trading. But it is not mandatory that you *follow all systems exactly all the time*. The reason is that systems do not adapt to any new bits of reality. That is what our mind is for, to observe, to record, to note changes, and then to develop an optimum use of the system.

If you do not know what to do as you are trading, you must follow the rules because they will keep you alive. If you like market conditions and they fit what your rules suggest, go for it; if the rules don't fit conditions or conditions don't fit the rules ... pass. You don't have to trade every day. The object of having systems and rules is to run them to your best advantage, and not to let them run you.

MAYBE YOU ARE NOT CUT OUT FOR THIS

• • •

Not everyone can be a doctor, baker, or trader. Is this really for you?

Let's find out ...

My goal is to create winning traders; I have probably done more of that than anyone in recent memory. We have students in almost every country of the world. So we don't want just any student, we really don't want you to become a student unless the chances are good you can do this successfully.

That means it's time for you and I have a heart-to-heart talk. We need to know if you are really cut out for this.... . If you are, you need to run away from this stuff as quickly as you can because it will not end up well for you. It will not be good for me

and will not be good for you, nor will it be good for your family. Those things concern me much more than you paying a small amount of money to become a student.

Let me tell you what I think is the personality that is needed to be a good trader ... then you can judge for yourself if this fits you or not.

I think the most important thing that I have seen in highly successful traders is their ability to accept that the markets are imperfect and that we will never be right or correct as traders. We never have enough contracts on the winning trades, and we have too large a position on the losing trades. On it goes: There's always a better point we could've bought, or a better point we could've exited. This is not a business for people that "have to be right."

If perfection is important to you, then find the delete button. Now. This is not a perfect business. We use math to help us in this business and math is perfect but you cannot make an imperfect thing, like the markets, perfect by using math. There are many irrational things that happen; news shocks can be the largest.

This business has two parts to it: The first is intellectual ... you must study and research what works in trading. The other is emotional. *Just because I understand the market doesn't mean this is a creampuff job.* When I have a position move against me I get frustrated; when I get out too early or too late, I am frustrated, often angry at myself. You have to have an ability to handle or modulate your emotions to succeed.

My son, Dr. Jason Williams, is a psychiatrist trained at Johns Hopkins and George Washington University. Recently he began looking at commodity traders, successful ones, with a test that was devised at Johns Hopkins. A couple of things popped out that I think are highly significant and will help you understand if this business is for you or not.

There seem to be two critical elements. The first is your ability to stay focused and do what needs to be done. Can you see a task through to completion? Can you handle basic details without getting distracted? If you answer yes to those things, you can probably handle the day-to-day dealings in the marketplace.

Unless ...

Unless you are too emotional or too neurotic. Do your emotions run from hot to cold? Do your emotions bounce all over the place? Do people tell you that you fly off the handle or that you have large emotional swings? If you do ... or if you are taking any medications for depression or anxiety ... *I don't think you should be trading.*

A good trader doesn't have to be the best detail person in the world but he or she needs to be able to handle details. Additionally, a good trader needs to be able to handle their emotions. If your emotions take control of your trades, it is a surefire

formula for disaster.

A final point is that I think you must thoroughly enjoy doing what you do—if you thoroughly enjoy trading, then you should be a trader. Do you have an unrealistic expectation that you can make \$1,000,000 starting with \$10,000 by just reading a book? Then you should not become a trader. This is not an easy business: The highs are wonderful, but there are also lows. *All the money in the world is not worth making yourself a nervous wreck.*

What I love about this business is that our *opportunities to the upside are unlimited*. My dad went to work in a refinery every day of his life knowing that his income would not exceed a certain level. How he did that, I will never know. My admiration for him skyrocketed when I fully realized what he went through. As a trader you can create a profitable business, on a full- or part-time basis. Best of all, that can be done without any employees, without a boss, and *without even having any customers!* That's what attracts me to this business ... I hope that's what attracts you.

Market success comes from acceptance and alignment ...

The path to success is the one that works for you ...

YOU ARE IN A TOUGH SPOT ...

You want to learn to become a successful trader, perhaps trade well enough to live the “Island Life,” like I do in the U.S. Virgin Islands. Maybe you just want to have an additional stream of income, but there are problems that need to be addressed.

The first problem is *risk*. Some people simply can't handle risk and others enjoy the sense of danger: You have to figure out for yourself how much you can tolerate. Can you successfully deal with that emotion? What I want to share with you is that you need to overcome the fear of risk to master trading. The solution for me was to understand that risk is always there. That means that I need to face it head on ... *accept* it ... don't run from it. I then learned to control it with stop-loss techniques.

Next comes the question: What approach to trading should you take? It seems to me there are hundreds upon hundreds of people offering to teach you to trade with just about as many theories.

The person you should follow, in my judgment, is the person whose *ideas you have the most affinity* toward. That person's ideas must make sense to you. That person's logic must fit with your logic. It is critical that you easily understand what they have to say. I may not be the coach for you, and that is fine by me: I want you to find “the shoe that fits” for your trading personality.

BUT THERE'S A LITTLE BIT MORE ...

Finally comes what I call *alignment*. It's not enough to simply work hard or be smart ... you can run as hard as you want, but if you're going in the wrong direction, you're never going to get there. You have to have the correct blueprint to build a house. The wrong blueprint, and you have a disaster. You must *know what right action is and take right action* in this trading business or you will bust out. You must be in alignment with the truth of the markets. That's the real secret of trading. How can you know that? That's easy: Right action produces profitable results.

Don't confuse what you wish is true with what is true.

"Good" in this business is profitable trades. "Bad" is losing trades. That is reality for a trader ... hold everything up to that test and you will be just fine.

This means that you *must* make certain that the person you choose to follow has a demonstrably proven track record of successful trading. I may not be the best teacher for you. Just make certain you get one that is successful ... trading, not marketing! Align yourself with winners.

I will show you my trades, *any day, any time*. You can see my account statements and see for yourself that I really trade successfully, often handling thousands of contracts a month. If an educator is not willing to show you his trades, *it can mean only one of two things*: he doesn't trade, or is not successful at trading. If you were a teacher, wouldn't you show your track record? No real-time track record is a huge red flag.

If you haven't already, you may want to visit our web site and look at our "Hall of Fame" to see how my students have done (www.ireallytrade.com/halloffame.html). My students have gone on to win trading championships, manage millions of dollars, and to quit their day jobs to become full-time traders. They have also been nice enough to give me a little credit for helping get them on the right track. I would like to help you, too, get on the right track of trading.

In the lessons of this book, I have shown you some of my indicators, have discussed my strategies, and shown you how I think about the markets and approach them. I hope you have gotten to know me a little and, above all, I hope you have come to respect how much teaching and trading means to me. Most people want to focus on tables, data, and charts, but data such as that do not contain wisdom, just results. What little wisdom I have to pass on is in the lessons and more personal writings.

Success is a product of endless instruction and doing, not natural instincts.

If what I have said makes sense to you ... then I would like to be your teacher ... it would be an honor to see you one day in our Hall of Champion Traders.

IN CLOSING

I want to end the book by personally wishing you well. I wish you good luck and good trading. I hope you'll join me online at www.ireallytrade.com. Most of all I remind you to remember those three little words:

Always use stops.

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