



MASTERING THE TRADE

SECOND EDITION

PROVEN TECHNIQUES FOR PROFITING FROM
INTRADAY AND SWING TRADING SETUPS

JOHN F. CARTER

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FOREWORD BY PETER BORISH



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*To everyone out there who is giving trading for a living a shot.
And here's to courage. Have the courage to take a loss
so that you will have a chance at keeping some of your profits.*

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The exchanges have undergone a lot of upheaval since this first book came out, with the Chicago Mercantile Exchange (now the CME Group) consolidating nearly everyone under its wing. Continued thanks to Barbara Schmidt Bailey as well as Chuck Farra, Rich Jelinek, and the team in Asia for our overseas adventures. I’ve learned a lot on those trips (such as, don’t combine red wine with frog belly soup), and I am all the better for it. Also thanks to Mark Omens for continued input and ideas and Super Bowl adventures. At Infinity Futures/Transact, Jim Mooney, Jim Cagnina, and Sabby continue to keep things entertaining, while Patrick Zielbauer keeps me in line. At TradeStation, Stan Dash and Michael Burke continue to be a fount of wisdom and humor, while Michelle Moore keeps us all in line (I’m sensing a trend here). Over at thinkorswim, aka TOS, Tom Sosnoff has been a source of great encouragement and knowledge, while Beth Snyder has, of course, kept us all in line. And I’m loving your new venture over at TastyTrade.com. Of course a big thank you to Morgan Ertel and Mary Glenn at McGraw-Hill for making me man up and update the content of this book. Although I hated every minute of it (okay, not every minute, but many of those minutes), I knew it was something I had to do.

Since the first book came out, Trade the Markets has grown into a “real business” with an amazing group of team members in Austin, Boston, Chicago, and Kentucky. We continue to get great feedback, and we try to learn from our mistakes as best we can. A big thank you to the team for running the business and just letting me follow my passion, which is trading (first) and talking about trading (second). It’s been fun to watch Henry Gambell make the transition from “techie” to “trader.” Just relax; the process takes many years. Also to Jill Malandrino over at The Street. You are truly awesome to work with, no matter what goes on under the desk. The adventures with my partner (that’s “business” partner) Hubert Senters continue to unfold in ways we never thought possible. John Clayburg, aka “Doc,” you’ve been a real pleasure to work with. It is truly difficult finding islands of sanity in the trading world at times, but you are one of them. Rob Hoffman, thanks for diving in with enthusiasm and helping me make my e-mails more friendly! Thanks to my cousin/niece/adopted daughter, Adelita Campos Flores, for your quirky sense of humor and unique outlook on life. Good luck with whatever path you choose. To the Amigos, Michael Palmieri and Tom Tuohy, thank you for your insights, even when I clearly did not need them. But alas, of course, I did. Aline Hanle and Honali Austin, thank you for your awesome and sometimes scary awareness and insights. And finally to every one of our clients. It’s an honor to work with you.

Foreword

In early 2003, I was attending an online trading conference in an effort to educate active traders on a new class of products called security futures. I had joined OneChicago after having been in the managed money business for more than 20 years because I believed that these products would enhance equity trading in the cash, futures, and options markets. Having avoided these events for many years, I was surprised when I had the pleasure of listening to someone who was incredibly articulate and thoughtful. I said to myself, "He really gets it."

John Carter was not speaking about security futures; rather, he was presenting his intellectual framework and approach to trading. It was a method to which I could relate strongly, so I introduced myself. We spoke at length on many subjects, including the idea that his methodology could be applied to security futures and that successful trading is one long journey, not a destination. John became an early supporter of and trader on OneChicago, another indication of his innovativeness. We have continued to exchange ideas, and therefore I was honored when John asked me to review *Mastering the Trade*.

I judge a book on trading according to one simple criterion: have I learned something new? *Mastering the Trade* not only introduces new concepts, but is insightful and easy to read. This is indeed a rare combination in the trading literature. In addition, John stresses that there is neither a single approach nor a single answer to successful trading. In fact, he emphasizes that before one can be a profitable trader, one must fully understand one's own personality. Every decision, from the holding period of a trade to the amount of one's capital to risk per trade, is a reflection of the trader's inherent preference curves. In fact, *Mastering the Trade* begins by emphasizing the importance of the proper approach to trading prior to discussing methodology.

Once the book turns its attention to the process of trading, it sparkles once again. Regardless of how long one has been in the markets, there are new approaches or enhancements to existing ones that I find quite beneficial. For example, from an active participant in the stock index futures markets, John's unique application of extreme tick readings is very insightful. I can then decide whether to apply it to my own trading, test it further, or ignore it entirely. The beauty of trading is that there is not one size that fits all, and John does not try to force fit his ideas on anyone. They are presented, discussed, and then demonstrated. Amazingly enough, not every trade is always a winner. The setup is a probability outcome that, if followed over time, should lead to trading success. That is the essential message that John drills repeatedly. Bad trades happen all the time; it is how one reacts to them that determines one's future success.

Another point that *Mastering the Trade* makes is that there is no single answer to the question: should one be short or long a market? There are always valid reasons to be both ways. The markets provide some clues, but one's trading style needs to provide the rest. That is why John shows how to use everything from monthly charts to one-minute pivots. A full-time trader should have different volatility and risk parameters from one who can examine the market only before the open and after the close.

Trading is an emotionally debilitating business. One can always explain yesterday perfectly. The weekly trader says, "If I had only followed the one-minute chart, I would not have gotten caught in that position." The one-minute, intraday trader says, "If I had only leaned against that weekly pivot point, I wouldn't have gotten stopped out, and I would have had a huge winner." John doesn't play this game. He applies an intellectually honest process to trading, suggests risk/reward setups, and then lets the markets do the rest. Remember, the market is always right. It is the analysis or setup that is wrong.

Mastering the Trade reinforces what successful traders intuitively do every time they place a position: trade small, stay in the game, and try to let time be your ally. Losing streaks are bound to occur, but knowing that they will occur and living through them are two different things. Diversify across markets. Some setups will be working well in a market and then stop. The market hasn't changed or the setup failed; the more opportunities, the greater the chance of success. But if one is trading too large, then one may not be able to initiate the next trade after a series of losses. John is very helpful in outlining what unit sizes to trade.

I would suggest studying the list of markets recommended and being prepared to participate in many of them. We all have a tendency to pick and choose the setups in those markets for which we have a predefined bias. The message of *Mastering the Trade* is that the setups are objective and can help eliminate the emotional battles that are constantly being fought. Today a single-stock future will look great on a chart, but the setup will indicate that it is time to sell. If you are looking for excuses not to follow the signal, then don't buy *Mastering the Trade*. However, if you are tired of saying, "I knew this would happen," but you do not have anything to show for that knowledge, then John Carter's new book is an outstanding place to start a realistic, grounded approach to mastering the trade!

PETER BORISH
Chairman, OneChicago
Former Head of Research for Paul Tudor Jones

Introduction

The best lesson I've ever learned about short-term trading happened while I was on a white-water rafting trip. Eight of us were in the raft when it hit a rock and flipped, launching us into the air like a catapult and sending everyone headfirst into the icy water. Half of us remembered that, in the event of a spill, we needed to stay calm and position ourselves on our back, feet facing downstream. We zipped around rocks and through cascades of water, eventually dragging ourselves safely ashore. An hour passed before we learned what had happened to the rest of the group. For them, a rescue operation went into effect, and the end result was a gashed leg, a concussion, and a near drowning. Later, when speaking to the other group, I learned that all of them had experienced a type of brain freeze. They could see the danger around them. They knew they were in trouble. They even knew that they needed to act, to do something. But they literally could not make a decision about what action they should take. So, they took the one option left to them: they froze like the proverbial deer in the headlights and did nothing. In the absence of a decisive path of action, the river grabbed them by their lapels and, like an angry pimp with bills to pay, slapped them senseless.

I remember one member of the group saying, "That river was out to get me!" Extreme paranoia and self-centeredness aside, the river was not out to get anyone. It did what it was supposed to do: move quickly and rapidly through a canyon in order to get to the ocean. The riders who understood the nature of the river were prepared and took the roller-coaster journey in stride. The riders who fought this trend got thrashed.

The similarities between this event and a typical trading day are nearly identical. The unprepared trader (newbie) is in the same situation as the unprepared white-water rafter. In the event of extreme conditions, both will freeze, and both will be lucky to survive the experience. One bad trade can wipe out months or years of profits.

Professional traders make money not because they are right more often than not, but because they know how to take advantage of all the "fresh meat" that is sitting out there in the form of amateur, unprepared traders. "Fresh meat" refers to anyone who has been trading for less than 10 years. That said, many traders never make the leap, and remain in this victim-like state all of their trading lives. The minority who endure and join the ranks of consistently winning traders are the ones who have learned the following truths:

- The financial markets are naturally set up to take advantage of and prey upon human nature. As a result, markets initiate major intraday and swing moves with as few traders participating as possible. A trader who does not understand how this works is destined to lose money.
- Traders can know more about a market than anyone else in the world, but if they apply the wrong methodology to their trading setups, they will lose money.
- Traders can know more about an indicator or group of indicators than anyone else in the world, but if they apply the wrong methodology to those indicators, they will lose money.
- Traders can know exactly what they are doing, but if they are trading the wrong market for their personality, they will lose money.
- Traders can know exactly what they are doing, but if they apply the same strategies that they used to make themselves successful in other areas of their life, they will lose money.

Without this knowledge, a trader is like a wounded antelope in the center of a pride of lions: it is not a question of "if" the antelope is going to get torn to shreds and swallowed, but rather of "when." For a trader without this knowledge, the possibility of ruin is not a question of "if." It's only a matter of "when."

Nevertheless, even with the odds stacked against them, each year tens of thousands of unprepared traders flock to the markets like lemmings to the sea, their heads filled with visions of easy cash, first-class tickets, and telling their boss to go pound sand. By the time most of them sense the spark of an idea that would have allowed them to understand how trading really works, they have already flung themselves over the cliff and are plunging toward the rocks below. All they have to show for their hard work is ample amounts of frustration and despair, perhaps a furious spouse, and a trading account that has been ravished and ripped off by a professional.

Trading is not about everyone holding hands, belting out the lyrics to John Lennon's *Imagine*, and making money together. The financial markets are truly the most democratic places on earth. It doesn't matter if a trader is male or female, white or black, American or Iraqi, Republican or Democrat. It's all based on skill.

The only way to become a professional trader is to obtain an edge, a weapon that can separate you from the rest of the migrating sheep. That edge is gained by utilizing specific chart setups and trading methodologies that take into account the five key points listed previously, as well as the psychology of the trader taking the other side of the trade. Without this, as you enter the revolving door to the financial markets, filled with excitement and anticipation, the predators are merely licking their lips, because what they see is a slab of freshly cured meat, ripe for the eating. And feast they will.

Who Should Read This Book?

This book discusses a unique approach to the markets that focuses on the underlying reasons that really cause market prices to move; it is applicable to trading stocks, stock options, futures, and forex. In reality, markets don't move because they want to, they move because they have to. Margin calls, stop runs, and psychological capitulation all force a series of rapid-fire market orders in a very short period of time. These generate sharp intraday moves lasting from a few minutes to a few hours, and, on a bigger scale, swing moves that last for a few days to a few weeks. These moves inflict pain on a lot of traders who do not understand how this process works. Yet, there is always a group of traders who profit from these moves. This book discusses specific ways to get positioned "on the other side of the trade" in order to take advantage of these moves, relying on a unique interpretation of many classical technical analyses and chart patterns.

More specifically, in discussing strategies, the book gives exact entry, exit, and stop loss levels for the intraday trading of stocks, options, ETFs, various futures and commodity markets, and the forex currency markets. Strategies focus on day trading, swing-trading, and position-trading various markets and asset classes.

It is my hope that traders at all levels of experience will welcome this book's broad market overview and specific trading strategies. Beginners will be treated to a no-hype reality check on how the markets really work, will be introduced to clear concepts and trade setups, and will come to understand why newer traders are destined to lose money until they grasp the basic market mechanics that are constantly happening behind the scenes. They will also understand how they are repeatedly taken advantage of.

It is my goal that intermediate traders will appreciate the knowledge included in this book, which is designed to take them to the next level of trading. In addition, I hope that professional traders and other market insiders will find that this book is able to clarify some of the truths that they have instinctively found to be true, in addition to providing fresh ideas to improve their bottom line. Stock traders who have never traded E-mini futures or forex will learn how these markets work and how to get enough information to decide whether the addition of these markets would be appropriate for their own trading. They will learn how the futures markets affect specific stocks and will thus be able to better position themselves to profit from their stock trading.

Day traders will learn why relying on indicators alone is a losing game, discover specific strategies for getting into a trade early, and learn the differences that will let them know when to bail and when to hang on for the ride. Swing traders and pure stock pickers will learn how to read the ebbs and flows of the market, and know whether they should be focusing on the long or the short side. Investors who are overseeing their retirement accounts will discover specific ideas for timing their investments on a monthly and quarterly basis in order to improve their returns. While this book is aimed at full-time traders, there are special sections throughout the book that focus on individuals who are working full time and are able to trade only part time. This does have advantages if it is done correctly.

While I feel that this work will be a welcome addition for anyone who is interested in the financial markets, it is important to realize that it assumes a working knowledge of the basics. There won't be a chapter discussing the nuances of support and resistance, or a chapter with 25 examples explaining the differences between an uptrend and a downtrend. While I'm going to spend a chapter on option plays and I dig into some basic option strategies, it's not my intention to cover all the different ways in which options can be utilized. In other words, if it has already been written about, or if it can be Googled, then it won't be rehashed here. This book focuses on new concepts that have not been written about before. That said, the work does provide an introductory chapter on futures and forex trading and the types of markets that are focused on in this book. If you're not sure what a bond tick is worth, or what 10 euro pips mean to your P&L, then this section is for you. I will also discuss websites and other books that are great for getting up to speed.

In addition to specific trading setups, the book discusses practical aspects of trading, such as the type of hardware and software to use, money management allocation, and developing a game plan that fits the trader's personality. Finally, there is a strong focus on specific information that can be used during the next trading day.

A Few Notes on This Updated Edition

I first wrote this book during most of 2005. While I still utilize many of the techniques described in the original book, I've updated some of them, thrown out others, and added techniques, chapters, and examples that are completely new. I'm the first to admit that I had mixed feelings about updating the book. A common question I receive is something along the lines of, "If these trading strategies are working for you, why in hell would you want to share them, and aren't you worried that once everyone starts using them, they will become less effective?" Those are fair questions. One of the casualties of writing *Mastering the Trade* was "the 3:52 trade," which was one of my favorite setups for a long time. As more people read the book and started doing that trade, it became less and less effective. The main issue was that it was a low-volume setup at a specific time of day, so it didn't take a lot of additional volume pouring into the trade to make it less effective. I've had to toss that one out and replace it with an "end-of-day trade" that is based more on market internals. However, I left this chapter in the book because it illustrates very clearly who is on the opposite side of a trade. Understanding this will lead you to find similar situations in other markets into the closing bell. The rest of the setups haven't been affected. Much of this has to do with the markets I'm trading, which are highly liquid. Hedge funds are too big to do these setups on an intraday basis, and there aren't enough retail traders out there to move these markets and offset what the hedge funds are doing. In addition, in working with traders over the years, I've learned that even if you do show a trader a winning setup, about seven trades into that setup, she will start tweaking the parameters to fit her own personality—especially if the setup loses money two times in a row (hey, I can tweak that so it doesn't happen again!). The net result is that there isn't a massive button being pushed every time one of my setups fires off.

In terms of, "Why in hell would I want to share them?" I'm not totally sure. Although I enjoy writing, putting together a book is a huge ordeal and requires a lot of time, focus, and commitment. I meet a lot of people who tell me that one day they, too, would like to write a book, although most of them have yet to get started. I don't blame them a bit—it's a bitch! From talking to other writers who have published books in multiple areas of interest, I've discovered a trend: the only way a book will get written by your own hand (that is, without using a ghostwriter) is if you feel obsessed to push it out of your body. For whatever reasons, I had to get *Mastering the Trade* out of my head the first time around, and the same feeling emerged six years later when I realized that I had to get these updates I kept thinking about out of my head as well.

I suspect the reasons are both short-term and stupid as well as long-term and lasting. By short-term and stupid, I mean things like being able to say, "Look, Ma, I wrote a book" (although I don't think she's read it yet; it's too technical). Medium-term, the book has helped our online research business, which will grow only so long as we are putting out high-quality, straightforward information. Longer-term, I fully realize that one day, a day that's going to sneak up on me much sooner than I'd like (hey, it doesn't seem like that long ago that I was a teenager), I'm going to die. Maybe this is a way to have a part of me still live on long after I'm rotting in the ground. I don't know anything about my great-grandfather. Maybe this is a way for my great-great-grandkids to get to know me a little bit. And if they do decide to trade, hopefully I can share with them enough information so that they can cut their learning curve way down. Trading evokes painful lessons. If my great-great-grandkids can read this book and pick up a few things that help them navigate the path toward being successful traders (with a minimal amount of screaming at their computers in frustration), then I've accomplished what I've set out to do.

I'm grateful for everyone who has read the book and truly gotten something out of the material and my own lessons along the way. I meet a lot of people at Traders Expos who have read the book, and I've signed copies and heard the stories. This book isn't for people who are looking for the Holy Grail of trading, or for some simple system that they can trade mechanically for the rest of their lives. It's for people who are going down the path of testing their trading skills and personality against the market. It's a day-to-day process, which is what makes trading for a living so damn interesting. In the end, I'm flattered and grateful than anyone would deem this work important enough to read, learn from, or critique. It's truly an honor.

In terms of specifics, there are simply things in the original book that needed to be updated. The first two chapters have been updated with extended and more in-depth thoughts on the psychology of trading. The chapter on technology, of course, had to be expunged and updated. One gig of RAM just ain't what it used to be. Technology continues to change at a lightning pace. The chapter on commodity descriptions also had to be updated. After this, there is one chapter on market profile that I threw out—there are entire books on the subject. Since the book was first published, I've done a lot with reversion bands, trend bars, waves, and a few other strategies. These are included in this updated edition. One of the biggest pieces of feedback I received concerned the section on health—and I've continued on that trend and updated that section as well as continuing to act as the proverbial guinea pig.

Trading and life are tightly intertwined. The better you understand yourself, the more likely it is that you will be able to find a market, a strategy, and an overall trading philosophy that best fit your personality. Let's dive in.

Written April 9, 2011, London, Leister Square, Costa Coffee shop at the corner of Wardour Street and Shaftesbury Avenue during the London Traders Expo.
(What a cool place to write about trading!)

PART I

TRADER'S BOOT CAMP How Do the Markets Work and What Are the Best Ways to Get Mentally Prepared for Successful Trading and Investing?

I don't want the cheese; I just want to get out of the trap.

SPANISH PROVERB

Some of us think holding on makes us strong; but sometimes it is letting go.

HERMANN HESSE

What *Really* Causes the Markets to Move?

Did You Know That Most People Who Lose Money in the Markets Do So Because of These Four Things?

Individual traders live in a state of constant flux, stuck between two worlds that combine both the best and the worst that trading has to offer. On the one hand, they can move into and out of markets with an ease and efficiency that large funds can only dream of. Have you ever wondered what it would be like to have to dump 200 million shares of AAPL (Apple) stock—without drawing attention to what you are doing? Well, like trying to hide a pregnancy, it ain’t easy. It’s a process, not a mouse click. On the other hand, you can get into and out of 1,000 shares of AAPL or 10 E-mini S&P 500 futures contracts instantaneously, and it won’t even register as a minor blip on the day’s trading activity. In other words, a smaller trader can move about undetected—a huge advantage. Funds need days, and sometimes weeks or months, to move into and out of sizable positions without showing their hand. If they do show their hand, then other funds will front-run them (jump in front of their orders) and bury them if possible. That is how money is made in the markets—by taking it from other traders. If you think this sounds ruthless, you are right. It is. This isn’t a holistic coming together of like-minded souls to celebrate the meaning of life. This is trading.

Then why are so many people attracted to this profession? It’s exciting, yes. It’s engaging, definitely. It’s a chance to make a lot of money. In a word, though, it’s freedom. In every area of our lives, we are told what to do. Some people don’t like that. Traders have the freedom to carve out specific niches for themselves that other people on the planet can never achieve or duplicate. Most centimillionaires and billionaires don’t have freedom. They have obligations, although they can fulfill those obligations in style. Retirees have a sort of freedom, but at what price? And many that I talk to are bored out of their minds. Stay-at-home moms? That’s the hardest job on the planet (as is marrying rich). The only professions I’ve seen that have a large amount of freedom are prostitution, homelessness, and trading. Since I knew I didn’t have much of a future as a prostitute (I got nothin’), and since I’m a wimp when it comes to sleeping (I need a clean mattress), trading won out. Traders, at least traders who learn the art of being consistent, have the opportunity to create an independent life, free from the hassles of the average Joe. These perks are extremely appealing and impossible to duplicate in many other professions.

Reasons for trading full or part time are many, and can include wanting a career change, a wish to be more independent, the desire to escape the responsibilities of running a large corporate division or individual business, or choosing to be a stay-at-home parent. A lot of would-be traders I meet are already successful in other areas of their lives—they are just bored with those other areas of their lives. I call these folks “doctors who hate their jobs,” although they can include anyone who is in a high-paying career. They like the income and the prestige … they just don’t like the bubble in which they are now trapped. Others have been burned by the financial markets and are now interested in taking control of their financial future. And many have put together a small stake and want to give it a go and pursue their dreams of becoming a trader. I see this firsthand in my office, watching guys like Henry go through the painful cycle from “the excitement of discovering trading” to “wow, I can’t believe that option expired worthless.” This is a “job” that provides the chance to make a very nice living, and it’s a lot more interesting and fun than any other profession—except being a rock star, of course. But if sharing the stage alongside U2 seems slightly out of reach, then trading is a good alternative.

It can be done from anywhere that has reliable Internet access—and as I’m writing this update in 2011, that means just about anywhere. There are no bosses spewing forth inane, ever-changing contradictory orders as they struggle within a system that has promoted them right up to—and through—their level of competence. For some people, working for a corporation is a way to gain power, which is more important to them than financial independence. Working for one of these clowns is enough to drive anyone to drink. In addition, in trading, employees are not necessary, although at some point they can be very helpful if you decide to trade many markets and watch many different time frames (I’d love to trade the European session, but I have to sleep sometime—however, I can hire someone to do that for me). Those of us who have survived the corporate world can find nothing on this earth that’s equal to the freedom and beauty that come from no longer having to manage a large group of dispassionate human beings: “I’ll pretend to praise you, and you’ll pretend to love your job.” The good news is that if you hire someone to help you out with your trading, he will generally be as passionate and excited as you are about the adventure.

Start-up costs are minimal thanks to leasing programs from companies like Dell. Trading in your robe or nothing at all is perfectly fine. Best of all, a trader can choose her own working hours. Some examples of schedules from successful traders I work with include trading actively from October through April and then taking the remaining five months off; trading only the first two hours of the market open and taking the rest of the day off; and trading until they make 50 percent on their capital and then taking the rest of the year off. The list goes on and on. By the way, one of the common fallacies of trading is the idea that “to make more money, I need to trade more.” Nothing could be further from the truth. Trading smarter and less frequently is one of the hidden secrets of doing this for a living. There is no need to catch every move.

Since trading has so much to offer, it is no wonder that tens of thousands of people toss their hats into the ring, trying to make a go at this most appealing of professions. It truly represents the proverbial American dream, and traders from all over the world are giving it a shot. Since this book first hit the shelves, I’ve had the opportunity to speak to traders in China, Taiwan, India, Sweden, Australia, England, France, Singapore and many other countries. The bottom line is that traders sweep aside political and philosophical differences when speaking to other traders. Traders around the world are linked together by a single idea—to generate cash with their mind and to reap the benefit that this cash creates: freedom. It’s a beautiful thing. I love traders and all the craziness they represent.

And I’m not kidding when I say “craziness.” The University of St. Gallen, Switzerland, has come out with a study that compares traders with psychopaths. The study reviewed the results from an existing study comparing 24 psychopaths in German high-security hospitals with a control group of 27 “normal” people. The funny thing is, this control group of “normal” people turned out to be traders. Stock guys, currency and commodity traders, and derivative types happened to be the normal control group that was stacked up against the high-security, barbed-wire-enclosed psychopaths. In the end, the performance of the trading group was actually worse than that of the psychopaths. The study indicated that traders, “Have a penchant for immense destruction,” and that their mindset would lead them to the logical conclusion of “beating one of the neighbor’s expensive cars with a baseball bat with the sole objective of owning the most beautiful car in the neighborhood.” In other words, traders are nuts. Indeed if you look up the textbook definition of a psychopath, here are some of the tidbits you’ll uncover: antisocial behavior, poor judgment and failure to learn from experience, inability to see oneself as others do, inexplicable impulsiveness … sounds like a typical trader who is struggling against the market and can’t figure out why.

So it’s the freedom that attracts traders. And it’s the freedom that is the undoing of many, because with so much freedom comes a cruel price. Simply put, the markets cannot protect a trader from herself. Individual traders, unlike fund managers (most of them, anyway), are unsupervised and have the freedom to act unchecked

in any way that they choose. And for many traders, this means they live a life where they are one mouse click away from disaster. The markets lull them, encouraging and even reinforcing bad habits. Have you ever removed your stop and had the trade then go on to hit your target? Well, the market just taught you that it is perfectly okay to do that, at least once in a while. That can work 999 times in a row. It's the one time where it doesn't work that wipes out the profits from all your previous trades, and can potentially wipe out your entire account. It's the day you buy gold on a dip, remove your stop, and it falls \$80 an ounce. "Wow," you think, "I can't believe it fell that far!" Exactly. It's what we don't see coming at us like a runaway freight train that destroys us. It's the classic bad habits—chasing a market higher or lower, trading too large for your account size, not having a firm idea of your loss limits, and so on—that creates a market that moves and thrives in such a way as to prevent as many people as possible from consistently making money. Remember the psychopath trait, "Failure to learn from experience"? Why is this? Why are traders so good at sabotaging themselves? After all, nobody, and I mean nobody, enters a trade with the idea of losing money. In a nutshell, it has to do with traders being the best salespeople in the world. Introverted, yes, but salespeople nonetheless.

Although used-car salespeople are saddled with the reputation of being pushy and dishonest, they don't hold a candle to the average trader. A trader, once in a position, can deceive himself into believing anything that helps to reinforce the notion that he is right—or at least "not wrong"—on this particular trading idea. Nobody likes to be wrong. In a job, a person who is wrong can typically blame it on someone else. "It was those stupid delivery people," he says. "They screwed it up." In trading, there is nobody to blame but yourself. And human beings have a very difficult time accepting that they might, in fact, be wrong. "If a husband expresses a thought alone in the middle of the woods," so the joke goes, "is he still wrong?" Probably so.

When faced with a loss, Joe Trader will look at a chart and tell whoever is nearby, "See that spike? That's the hedge funds running stops." He then says with a knowing grin, "As soon as they're done, just watch; this market is going to rip higher." Net result: he does not exit the position, and his losses mount. When faced with a profit, Joanne Trader hesitates to pull the trigger, telling her cat, "The market is acting fantastic here. There is a ton of good news on CNBC. I bet it goes a lot higher." Net result: she does not exit the trade, and it turns into a loser. The mistake these traders are making is a common, yet fatal affliction that most traders suffer from: *they are unaware that the market naturally programs their reactions into a losing trader's mindset*. And they are unaware of the key factors that really move the markets. The net result is a trader who "eats like a sparrow and defecates like an elephant." This is a situation, of course, that no account can withstand. Worse, this cycle of emotional slavery will not end until it's met head on, until a trader can "pull his head out" and realize that trading is unlike any other activity on earth. Trading has a lot more to do with repeatedly admitting that you are wrong than with trying to make a lot of money. Unfortunately, professional traders understand this all too well, and they set up their trade parameters to take advantage of these situations, specifically preying on the traders who haven't figured out why they lose. One trader's disaster is another trader's bread and butter.

And there you have it, the four things that cause traders to lose money. First, anyone who is attracted to trading shares the same characteristics as a psychopath. Second, the inherent freedom is destructive—after all, we spent our first 18 years of life learning that it's better to follow the rules and do what we are told. Third, the markets actually encourage and reinforce bad habits. And fourth, traders are seduced into taking every opportunity to sell themselves on the idea that they are right.

There is always someone on the other side of your trade. Start being that trader. Not the one who chases, but the one who knows that other people are chasing. Not the one who removes stops, but the one who knows that traders tend to remove stops. Not the one who trades too big for her account size, but the one who trades just the right size, or smaller, for her account size (two points a day is fine, even though deep down we all want ten). Not the one who frantically feels that he has to be in every move, but the one who is content to wait patiently for the one setup that falls within his trading plan, even if it means not having a trade that day.

Be the trader that wants to make money over time, not the one that needs to be right, right now.

How Do Our Odds for Success Increase Once We Understand the Pain and Suffering of Individual Market Participants?

The problem is simple and twofold. First, although traders certainly know that not all their trades are going to work out, they do get a distinct feeling right after placing every trade that *this trade is going to work out*. A study done by a pair of Canadian psychologists documented this fascinating aspect of human behavior. Just after placing a bet at the racetrack, people are much more confident about their horse's chance of winning than they were immediately before laying down the bet. Obviously, there is nothing about the horse that has changed, but in the minds of those bettors, its prospects improved significantly once they placed their bet and got their ticket. Without getting into a large psychological treatise on why humans behave like this, it has to do with a strong, underlying social influence to appear consistent with our choices. Once we make a choice, we respond to external and internal pressures in such a way as to justify our earlier decisions. If we made a good choice, then this process works out very well for us, and we will continue to build upon our good choice. However, if we made a bad choice, whether it is regarding a trade, a job, a significant other, or a business deal, then this process will take this bad choice and make it emphatically worse. We will simply refuse to let go and move on, as we are more concerned about trying to act consistent with our earlier decision. People can waste an entire lifetime living within the justifications of a bad choice: trying to make it work, trying to be nice and look good and not hurt anyone's feelings, and trying to make it look as if they were right.

Doing and saying things just to prove to others that your choice was right leads down a slippery slope of not being true to yourself. And if you aren't true to yourself, it just leads to frustrations, some of them popping up for no apparent reason. Did you ever get ticked off at your mom when she simply told you to eat more veggies? Bingo. There is some stuff going on there, and, believe it or not, it will affect your performance as a trader.

By the way, your personal life is a good place to test this out, and it's a lot cheaper than working it all out in your trading account. Just start paying attention to what annoys you.

I worked with Rosa, my awesome sister-in-law, for a while on our website back in 2005. We are very close, like brother and sister. I've known her since she was seven years old. While we were working together, we would get into arguments, and essentially I would calmly try to show her why I was right and she was wrong. I didn't think much about it (because, hell, I was right!), but eventually our working relationship became very frustrating for both of us, to the point where she moved on to "explore other opportunities."

I had no idea what was going on. I just knew that even though I loved my sister-in-law dearly, I just couldn't work with her. I discussed this issue with some friends. They pointed out to me that "my having to look like I knew what I was doing at all times" was the real issue, and that if I wanted to learn more about this, I should go to a workshop called the Landmark Forum. I Googled it and initially decided to pass—after all, it looked like a damn cult. Then I read that it had made a top 10 list of weekend adventures, and that piqued my interest. An adventure? And I could see the positive change in my buddies, Michael Palmieri and Tom Tuohy. They were becoming more effective in their chosen fields of work, and they were happier and more engaging. And they pointed out that my frustrations with Rosa were really a reflection of something that was going on with me. If I wanted to find out what it was, then I should man up and take the course. Fine. I didn't go in kicking and screaming, but let's just say I was very skeptical.

I attended, and I can honestly say I'm glad I did. A year later, my wife also attended, and our lives are the better for it. She's empowered. Our communication is better, and we are more open and honest with each other and not worried about "hurting each other's feelings" or anything. If she's pissed at me, she just lets me know

instead of holding it in for days. Straight talk. In other words, we can be authentic with each other, which is a much easier and more pleasant way to live. For my own trading, it led me to develop a “cash flow trading plan,” which I’ll share later in the book. It’s a purely discretionary trading concept that focuses in on the mental game of trading.

Like developing a solid trading plan, I took from Landmark what was helpful to me and discarded the rest. I also sent Rosa to the course, and it changed her life as well. We now have a much more open and honest relationship, and we can have discussions without trying to be right. We just say what needs to be said without worrying about hurting the other person’s feelings. It’s great. And that is what the trading journey is all about—taking bits and pieces here and there that make sense to you, and then turning those bits and pieces into a trading plan that works for you and your personality. I see a lot of traders wrestling with personal issues that they try to “take out or work out” in the markets. Doing the Landmark Forum is one way to experiment with working those issues out of your system before you take them out on your account.

I think there are a lot of parallels between being a good trader and living a good life. The market truly is the ultimate psychologist. To be a happy trader, you must cut off bad trades at the knees and throw them on the trash heap. Clinging to a bad trade like a limpet “in order to be right” is like stabbing yourself in the throat with a pencil. Think about it.

Second, many traders feel that they can rely on their judgment *while they are in a trade*. On paper, this makes a lot of sense. After all, before a trade is placed, traders are at their most objective. However, once the trade is on, the degree of objectivity diminishes immediately and in direct proportion to the number of shares or contracts being traded relative to the account size. Think of it this way: if one trader is long 10 E-mini S&Ps in a \$10,000 account using day-trading margin, and another trader is long 1 E-mini S&P in a \$100,000 account, who is going to be sweating bullets over each tick? Not only does the first trader already have the feeling that “this trade is going to work out,” but now she is trapped with the additional pressure of having to manage a position that causes huge equity percentage swings with every tick. Traders who rely on their judgment when they are in a position that is churning their brain with extreme emotions is like trying to row a boat upstream with a piece of Swiss cheese—it simply does not work. Ever. And, believe it or not, studies show that the intensity with which you stare at the price charts on your computer screen actually has zero correlation with what the markets are going to do next.

These factors perpetuate a vicious cycle, with the end result being traders who, like bad used-car salespeople, are consistently selling themselves a faulty collection of beliefs that set them up for slaughter. Instead of following a game plan with which to exit a position, traders in this situation spend their time justifying *why they are right* (if you are married, you’ll know why this is a waste of time) and will end up closing a position only for one of two reasons. First, the pain of holding becomes so great that they cannot “take it” any longer. Once they reach this “uncle” point, they start frantically banging their keyboard to sell (or cover) “at the market” in order to relieve the pain. Second, their broker politely offers to help them out by giving them a phone call, gently letting them know that they should exit their position. This is also called “getting a margin call.” This trade is also placed “at the market.” In these situations, there is no plan, no thought, and no objectivity. There’s just a batch of forced sell orders or, in the case of someone who is short, a batch of forced buy orders, or covering. This act of capitulation—traders exiting a position because they have to, not because they want to—is emotions-based trading at its finest, and this is what moves the market. Whether it is a sustained multimonth move to the downside because of continuous capitulation selling or a quick 10-minute rally because of shorts being forced to cover, these acts are responsible for the major moves in all markets, in all time frames. In the end, markets don’t move because they want to. They move because they *have to*.

The pressure from traders who are trying to act “consistent with their original choice,” combined with that from traders who are trading way too big for their account, leads to more disasters in trading than anything else. However, right on the other side of disaster is opportunity. For 20 traders who are blowing up their account, there is another trader out there on the opposite side of that blowup. After all, the money doesn’t just disappear. It simply flows into another account—an account that utilizes setups that specifically take advantage of human nature. One person’s panic stop loss is another trader’s entry level.

Don’t let the markets seduce you into having to be right.

The Case Study You Will Never Read About at Harvard Business School, or, Has This Ever Happened to You or Your Spouse?

I thought about updating this example for the new edition, but this really is a classic case that would apply equally well to trading today’s hot stocks such as PCLN (Priceline) or GC (gold futures) or anything else that is actively traded today. I did go through and update and expand the text. Let’s take a look.

[Figure 1.1](#) is a chart of an actively traded stock with the name deliberately removed for now. During 2004 it was vigorously bought by one side of the trading community and energetically shorted by the other side. Both parties had plenty of opportunities to make money. On December 29, 2004, this stock made a new 52-week high, hitting \$33.45 the next trading day. Over the next five sessions, it pulled back to support at point 3, at \$27.62, which represented a solid buying opportunity, replicating the buying opportunity that had taken place at point 1, with the same oversold stochastic reading as point 2.

This chart represents a classic case of an inflection point at which a group of traders has to make a decision. A trader who bought the stock as it broke out to new highs will be feeling pain, while a trader who shorted the highs will be feeling euphoria. Traders who are long the stock way back from \$10.00 will feel excited and wonder whether they should add to their positions on this pullback. A trader who is flat the stock is anxious, not wanting to miss the next move, and will be looking to buy the stock here at this pullback to support. Take a moment to look at this chart. What would you do here? Would you short the stock or buy it? What would you be willing to risk? These are questions all traders need to know before they actually place the trade.



Figure 1.1

Let's work with someone I will call Joe Trader. Joe has been trading for a while and has learned a lot about risk/reward levels and about being patient and waiting for high-probability setups. He looks at this chart and sees a decent buying opportunity in this stock. He has a \$100,000 account. Near the close, he buys 2,000 shares at \$27.80, using about half his cash buying power and not even getting close to using any margin. He places a stop limit order at \$26.20 and also places a GTC (good till canceled) sell order at \$32.60, which is just below the recent highs. He's risking \$1.60 (\$3,200) to make \$4.80 (\$9,600), a very comfortable 3:1 risk/reward ratio. If he's stopped out, he will lose 3.2 percent of his account's value, which he deems an acceptable risk against making a potential 9.6 percent return on the trade.

The next day, January 7, 2005, the stock gaps lower, opening at \$23.78, well below Joe's stop limit order. (See [Figure 1.2](#).) This leaves Joe in the stock, as his stop limit order won't fire unless the stock rallies back to \$26.20. (A stop market order at \$26.20 would have been liquidated at the open at the market price, incurring a larger loss.)

Joe doesn't panic. He's been down this road before. He is negative on his trade, but it's not the end of the world. He gets that he is going to lose money on this trade, and he's not going to do anything stupid like triple down to bring down his average cost. He is going to follow his plan and take his stop loss like a man. He is trying to exit gracefully. "Do I dump the stock here," he wonders, "or do I wait for a small retracement?" He understands that when stocks break down, they will almost always retrace a portion of the move before ultimately moving lower. He might even be able to get out at his original stop loss. He checks the daily chart and sees that the stochastic is oversold, setting the stock up for a bounce, even if only of the dead cat variety. He decides to leave his limit stop order in for this eventual retracement, and he plans to see where the stock ends up near the close.



Figure 1.2

Fifteen minutes before the closing bell, he checks the stock and notices that it never reached his stop limit order, but it also bounced off its lows on the day. He thinks there is a good chance that the stock will start to retrace a portion of the move the next trading day. He is calm. He is objective. He decides to hang on. He is following a logical plan.

Unfortunately, the next trading day isn't until Monday, and he spends most of the weekend thinking about his stock, not really reacting to the environment around him. On Sunday, his wife notices that he has been quiet, almost listless, all weekend and keeps staring at charts on his computer screen. She flips through her latest issue of *Cosmopolitan* magazine to see if she can get any tips on how to cheer him up, and perhaps invigorate their sex life, but by the time she is done reading the insightful articles, she wonders why she ever married this submissive little mouse of a man in the first place. The guys in the articles are so much more daring and fun, and, best of all, it sounds like they don't spend a lot of time staring at charts. By the time she goes to bed Sunday night, she is angry. She calls out, "Are you coming to bed, honey?"

Joe, oblivious, is still up looking at a chart. "Still doing research, babe," he tells her.

Monday morning finally arrives. Joe jumps out of bed early after a restless sleep, just in time to see that the stock is trading lower premarket. It gaps down by almost \$3.00 at the open of the regular session. (See [Figure 1.3](#).) Joe looks at this and shakes his head. Now he knows he's in trouble. How could this have happened?



Figure 1.3

As Joe numbly sips his coffee, he looks at the chart “objectively” and sees all the reasons why the stock should bounce. It’s now down by more than 40 percent from its all-time highs in only seven days. It’s near major support on the daily charts. The daily stochastic is now deeply oversold. He is realistic. He knows this stock is done for, and he knows he is going to lose money on this trade, but he also knows that at some point the stock will at least retrace, and he will be able to exit gracefully and keep his losses to a minimum. He watches the stock all day, chewing his dirty nails, slurping cold coffee and warm Red Bull, and getting nothing done. The stock closes at more than \$6.00 below his stop. Aghast, he locks up. This is not a situation he remotely believed could happen with this trade. He simply can’t sell this stock now. The loss is just too big. He decides to hang on for another day, as the stock is way, way overdue for a bounce.

**Figure 1.4**

It is not until he hears the garage door opening downstairs that he remembers that he was supposed to drop off his wife's pile of clothes at the cleaners. He grabs them, pauses in the entry way, and races out the front door, timing it perfectly so that she doesn't see him.

On Tuesday, January 11, the stock (okay, it's TASR) gaps down yet another 3 points, opening at \$17.01. (See [Figure 1.4](#).) Joe takes a deep breath and grits his teeth. A part of him seems to die a small death. He is dead tired from not being able to sleep last night, and to top it off, his wife has suddenly been acting downright hostile. He wonders if she saw his P&L on the computer screen, but he's confident that he's kept that covered up really well, always minimizing his execution platform when he leaves the room. He knows he should talk to her, and he will, as soon as he exits this position and goes flat. After all, she is the one holding down a real job so that he can pursue his dream of becoming a trader.

He focuses on the chart. He tells himself not to panic like a stupid newbie and to react like a professional trader. He knows he will never let himself get into a situation like this again, ever, ever, ever. But in the meantime, he has to keep a cool head and get out of this mess. He asks God for help, though from past experience he suspects that He doesn't care much about the financial markets.

Joe reflects that over the past four months, he has been able to generate an income averaging \$5,000 per month from his trading account. If he closes out his TASR position here at \$17.00, he will be down \$21,600 on just this one trade. It would take him more than four months just to rebuild his capital. He says to himself, "Okay, forget about your original order. Let's say you just entered the trade here. What would be a reasonable target?" He quickly sets up a series of Fibonacci retracement lines on his chart to see where the 50 percent retracement level of the entire move down is. That level is \$22.79, well below his original stop, but if the stock rallies to that level, it means \$11,580 in recovered open losses, leaving him with just a \$10,020 "hard loss" to make back instead of \$21,600. Okay, that makes some sense. He starts to feel better and places his new sell order, confident that this is going to work. He sits back to watch the action. He contemplates doubling down ... and almost does it. But he's learned the hard way that it's not the right thing to do. He holds back. He waits.

Amazingly, the stock continues to drift lower during the day. Joe stares at the chart, getting quite close to his screens. He is blinking about once every 30 minutes. He now has it on seven different time frames, continually reminding himself to keep a cool head, that the stock is desperately oversold and that it will soon bounce. *Be patient; wait for the retracement; don't be an idiot and sell at the dead lows.*

As the markets near the close, TASR breaks new intraday lows yet again, cracking \$14.00 a share. Joe pushes back from his desk and yells in disgust, "This is freaking impossible!" TASR is down by nearly 60 percent in eight days. About to explode with rage, he realizes he simply cannot deal with this any longer. His

nervous system is a wreck, and his neck muscles feel like plywood. He sells near the close for \$14.02, a mind-numbing loss of \$27,560. He still cannot believe how far and how fast TASR has fallen. How much lower can it go? Is this company going bankrupt? Is it going to be the next Enron?

On impulse, he looks at the weekly chart and notices that there isn't any support until \$10.00 a share. He immediately reverses and goes short 4,000 shares at \$14.04, just minutes before the closing bell. Although disgusted with himself, he feels better now that he has taken action, and at least he won't miss out on the remaining down move for this stock. He is anxious to see where TASR opens the next day. Maybe they'll announce a financial scandal?

TASR - Daily NASDAQ



Figure 1.5

He decides not to tell his wife about any of this, but he does leave a Post-it note on his computer screen reminding himself to pick up the clothes from cleaners the next day. After a moment's hesitation, he also scribbles the words, "Buy flowers for wife."

TASR opens flat the next day, and then steadily starts to rally. (See [Figure 1.5](#).) Joe is confident that the rally will be short-lived. However, he does place a stop just above yesterday's highs. This time he places a stop market order, as it was the stop limit order that got him in trouble in the first place. He feels very confident that this trade is going to work out. This is a good horse!

TASR closes near its highs on January 12, but it does not exceed the previous day's highs, so Joe's stop is not hit. He can't believe his bad luck, although he is still optimistic that this trade will work out. He certainly hopes the stock will gap down the next day. His wife calls to say that she is going out with the girls. He grabs a bottle of Grey Goose from the freezer and turns on HBO to see how Tony Soprano is dealing with the problems in his life.

Well, the next day comes around, and the stock gaps up by almost \$4.00. Joe's stop order gets him out at the open, as this turns into a market order when the price is above his stop, which is \$20.83. He lost \$6.79 on the play. On 4,000 shares, that is \$27,160, nearly identical to the loss on his first trade. His \$100,000 trading account is now down to \$45,280. He needs to make 121 percent just to get back to breakeven. He is so angry that he doesn't know what to do, and eventually he picks up his keyboard and slams it against the wall. About an hour later, his wife calls to say that they should seek counseling. Joe pours himself a large shot of Don Julios (since he's now out of Grey Goose) and contemplates the meaning of life. He mutters out loud, "What the hell happened to me?"

Joe did not have a bad plan, and he treated this trade as well as he could have—with one minor, but very important, exception. He got the stock long based on a credible entry method. He used a low-risk entry point, had a great risk/reward ratio, and was risking only 3 percent of his portfolio. He didn't even get a margin call like

many traders did in this same situation. The bottom line is, it was a great plan, but it turned into a disaster. This is something that could happen to any trader. It's not the fault of Joe Trader that the stock gapped through his stop. However, once it happened, *he stopped focusing on the risk and instead focused only on the gain*—in this case, how much of his loss he could make back. It was this small detail that derailed an otherwise solid trading plan and blinded him to the possibility of ruin. “Live to fight another day” is the mantra of all traders who have survived their first 10 years dancing with the markets.

A Note from My Wife: How Have I Dealt with Being Married to John Carter the Trader?

Living with a Trader

BY MARIA M. CARTER

For those of you who are beginning or well on your way in your trading journey with a significant other or loved one in the wings, I suggest you share this chapter with him.

John and I have been married for 15 years, and we've shared a life together for 20 years. I can almost map my dating and married life to John's level of trading experience. For many years, I was waiting to be issued a medal for “standing by my man” during the rough patches of his trading. Now I realize that sticking through those learning experiences has created the life and freedom we have today through his trading career. May you learn from our collective experience, and be sensitive to the journey of a novice trader trying to make a living at trading.

The Couple's Trading Litmus Test

Every trader will have bad trades, and in most cases, he will have at least one or two *really* bad losses. If you are involved with a trader who is on a consistent losing streak, it would be unrealistic and frankly irresponsible for you to just ignore it. These are some areas of discussion you can have together to help you navigate those rough spots and see if your partner is still going down the trading path for the right reasons. Use these “three Ps” before you get to the big P, Pissed Off, that leads to a whole lot of pain.

PASSION. To become a professional at anything, you have to love what you do. If you are looking for trading to get you out of debt or give you a quick cash fix, you are going to get burned. John has been intrigued with the markets since the day I met him, when I was 19 years old and in college. In fact, even back then, he taught me how I could invest some of my financial aid money in a little stock called Iomega. (He had me hooked at Iomega.)

An aspiring trader should be intrigued by the markets, enjoy the process of learning about them, and recognize whether the lifestyle of a trader and the markets she is trading fit her nature. I've met many potential clients and friends who probably shouldn't be trading—it does not suit their personality or the type of life they want to create. If you are dreading your trading day or becoming secretive, or if your gut or your health is nagging at you, these are all probably pretty good indicators that something is not right, or that you are not pursuing something you may be passionate about for many years to come.

PERSPECTIVE. Emotional management is critical to a trader. Having activities and interests outside of trading allows a trader to gain perspective and de-stress. Does your trading partner have other outlets outside of trading? How does he decompress or blow off steam? For John, that includes spending time with our kids, working out and running, traveling to exotic locations, staying involved with business networking groups where not all the members are traders, and, of course, hanging out with his awesome wife. Allow time for vacation days and days off, just as you would in any other career. Sometimes it will take the nontrader to rip the trader away from the monitor and push him in this direction. In our house, I like to call this “the Gollum.” If your partner begins to look like Gollum from *Lord of the Rings*, hunched over his computer and stroking the keys lovingly like “his precious”—it’s time to help him unplug. All the successful traders I have met who have made the leap to becoming professional traders have found a way to bring perspective to their trading. Finding a passion outside of trading and having a bigger-picture vision of what is important to you that keeps your trading in check is the only way to make it work for the long term.

PLAN. I may not know much about the technical aspects of the market, but one thing I've learned from hearing all the blowout stories over the years is that a trader is only as good as her trading plan. Everybody deviates from a plan occasionally, but without one, you are toast. John has boxes and boxes filled with trading journals logging not only his trading plans, but also his emotional state when those plans did or did not work. By retrospectively looking at his actions and behaviors, he can reset his course and avoid making the same mistakes over and over. I believe this also helped him find the niche in the markets that best suited his own personality. A loss on the day doesn't get me worried now; it's when I don't see John writing in his trading journal that does.

Rules of the Road

Living with a trader is much like riding the ups and downs of the markets. In fact, the way the markets behave is often the barometer for the trader's emotional state at the dinner table. If you are living with a trader, here are a few rules of the road to make the ride a little more pleasant—for you and for him.

Here's a Quarter, Call Someone Who Cares

Traders, if there are times when you come home or come downstairs, as the case may be, from your trading cocoon, itching to talk to a human about your trading adventures, remember this: your deep passion for the markets may not be shared by your significant other, and that can be a very good thing. Balance is a blessing in a relationship. Don't always expect your partner to hang on your every word as you talk ad nauseam about the details of your trading day. Just as John doesn't want to hear me talk about the 20 fabric samples I want him to look at for our new drapes, my eyes might roll back in my head if I hear about Russells and E-minis and Fibonacci clusters while I am trying to sip on my Pinot Grigio on date night. In fact, we have a code word we use to cease diarrhea of the mouth related to our obsessive interests: “Drapes.” Hearing about one another's day is lovely, but hashing out the nitty-gritty should be reserved for your trading buddies. So, cut your partner some slack; she may not be the next Maria Bartiromo, but that doesn't mean she doesn't care.

The Pain Principle

There is a pain scale that is inversely proportional to your trader's level of experience. It seems that the less experienced the trader, the more intense her feelings of pain at the full realization of a poor trading day. In those early days of trading in our marriage, I wish I had had a Hallmark card that said, "Sorry for your loss. Thinking of you." There is not much you can say in words to make someone feel better after losing \$500 or \$5,000 in a day. But creating a relationship in which your partner can come to you even when she is feeling the pain of a huge loss without total fear of hellfire and damnation judgment at each drawdown is critical in building her character and her confidence as a trader. Being able to keep her trading successes and failures somewhat transparent will force her to go back to the drawing board because she realizes that she is not going at this alone. If you attack at each loss, that's when the rash decisions happen that make traders take stupid trades to quickly recover their losses to appease themselves or those around them. It's better to digest and go back with a plan.

The Do Not Enter Zone

A trader's day can be volatile, filled with ups and downs. But certain times of day are critical, and the most critical are probably market open and market close. During these hours, treat his trading space like Harry Potter's Chamber of Secrets. Do not enter. I learned this the hard way. John's business partner actually has installed a soundproof, bolted locked room in his home specifically for trading. While this is a little extreme, it can give you an inkling of how serious the level of focus of some traders can be.

If you want to see a pissed-off trader or, worse yet, a passive-aggressive pissed-off trader, call on the phone repeatedly until he picks up or burst into his trading office at his critical trading hours. Do this day after day, and not only is it a recipe for frustration, but it becomes downright disrespectful. Imagine that your husband is an open-heart surgeon and you burst into his open-heart surgery procedure midstream—no bueno. During opening bell and closing bell, a trader's level of concentration is probably as intense, and like the patient on the table, his heart and soul are splayed out there just waiting to get stomped on by the markets.

Taming Your Trading Beast

"Raising" a trader in your household is a little like birthing a trading beast. In those early days of her trading life, she is raw, rough around the edges, and foaming at the mouth occasionally at a losing trade. Periods of poor hygiene may even occur on those long trading jags.

Have faith; if your trader is consistently abiding by the three Ps mentioned earlier, she will begin to mature. My beloved trading beast John evolved something like this:

Years 1–5: The Novice Trader

DEVELOPMENTAL MILESTONES. The novice may devour and regurgitate every trading strategy he can get his hands on. Sleep patterns are highly irregular at this stage. Irritability and tantrums mixed with periods of jubilant elation and lots of high-fiving is common. Onset of delusions of grandeur may occur.

SPOUSAL SKILL DEVELOPED. Tolerance.

Years 5–10: The Intermediate Trader

DEVELOPMENTAL MILESTONES. Sleep patterns become more regulated, with short periods of fitfulness. New interests may develop. Trader may experience need for social interaction with other traders. Emotional bipolarism at wins and losses less pronounced. Writing habits and homework skills improve.

SPOUSAL SKILL DEVELOPED. Acceptance.

Years 10–15: The Successful Professional Trader

DEVELOPMENTAL MILESTONES. Trader regains humanlike countenance once again. Trader can be taken out in public and social situations. Body functioning optimally. Bank account functioning optimally.

SPOUSAL SKILL DEVELOPED. Elation.

Take Stock

Taking risks and managing risk is a huge percentage of what trading boils down to. In our case, John took the huge risks and the big hits very early in our relationship. It was definitely a test for our relationship, and a testament to his character. John took risks when the things we had to lose were truly only monetary. In my twenties, I could live on ramen noodles for a couple of weeks if I had to. I could wait on having our first starter home if I had to. However, if you have three children, have a job that is barely paying the rent, and are in debt to high heaven, you are playing a game with very high stakes. If you are making trades that eat away at your life and the lives of those around you without being honest with yourself about following your passion, keeping perspective, and having a plan, it's not going to be pretty. If you and your partner have highly different values concerning lifestyle, material goods, and timing of your life plan, that's something you need to look closely at before you begin pursuing life as a trader (or begin pursuing a marriage, for that matter). There are many ways to make a go at this life, and trading is a great one. But take stock and figure out whether trading is the right path and whether it is coming at the right time for you. Determine the level of risk you are willing to take, and manage a plan accordingly.

How Do I Top That?

OK, it's John again. I didn't know my lovely wife, Maria, had been paying attention over all these years! It truly goes to show that this is a team effort, and being a team has nothing to do with actually trading together. It's about working together in this game called life.

That was great information, and reading it made my life as a trader flash before my eyes. I think I choked back both vomit and a tear. Maria doesn't trade or have any interest in trading, just as I have zero interest in fabric colors, and it works and brings a healthy balance to our relationship. That said, I did learn early on to just

“get it out there” and let her know when I had had a crappy trading day. And by crappy I don’t just mean a normal loss. I mean a situation that got out of control, like a big gap against me on an options play. That way, she would know that I wasn’t upset at her, I was just retreating inside my head in order to dust myself off and get back in the saddle again. Trading truly is an adventure. If you liked Maria’s insights, you can see more of them at her blog, www.renaissancemoms.com, which covers some interesting ground on a variety of subjects.

One thing that clicked into place when I reached, as Maria would say, “intermediate trader status” was that whenever I had a situation that went horribly wrong, it struck me that someone else was having a joyous occasion taking all that money away from me. Was there a setup in there somewhere that I had completely missed?

We saw in detail how the trading disaster unraveled for Joe Trader. And yet for someone else, this was simply a great trading opportunity. This chart of TASR represents a different view. (See [Figure 1.6](#).) This is a common setup that is created when large funds want to get out of a stock. They push the stock to new highs, sucking in the retail crowd, and then they start unloading. They know that the retail crowd will buy the new highs, and they also know that the retail crowd will feel comfortable buying all the way down to support. This gives the institutions ample time to sell their holdings. By making the stock look great, even though it isn’t great, institutions fool the masses. I call this setup the “fake orgasm.” It certainly looks good, but there really isn’t anything to get excited about.

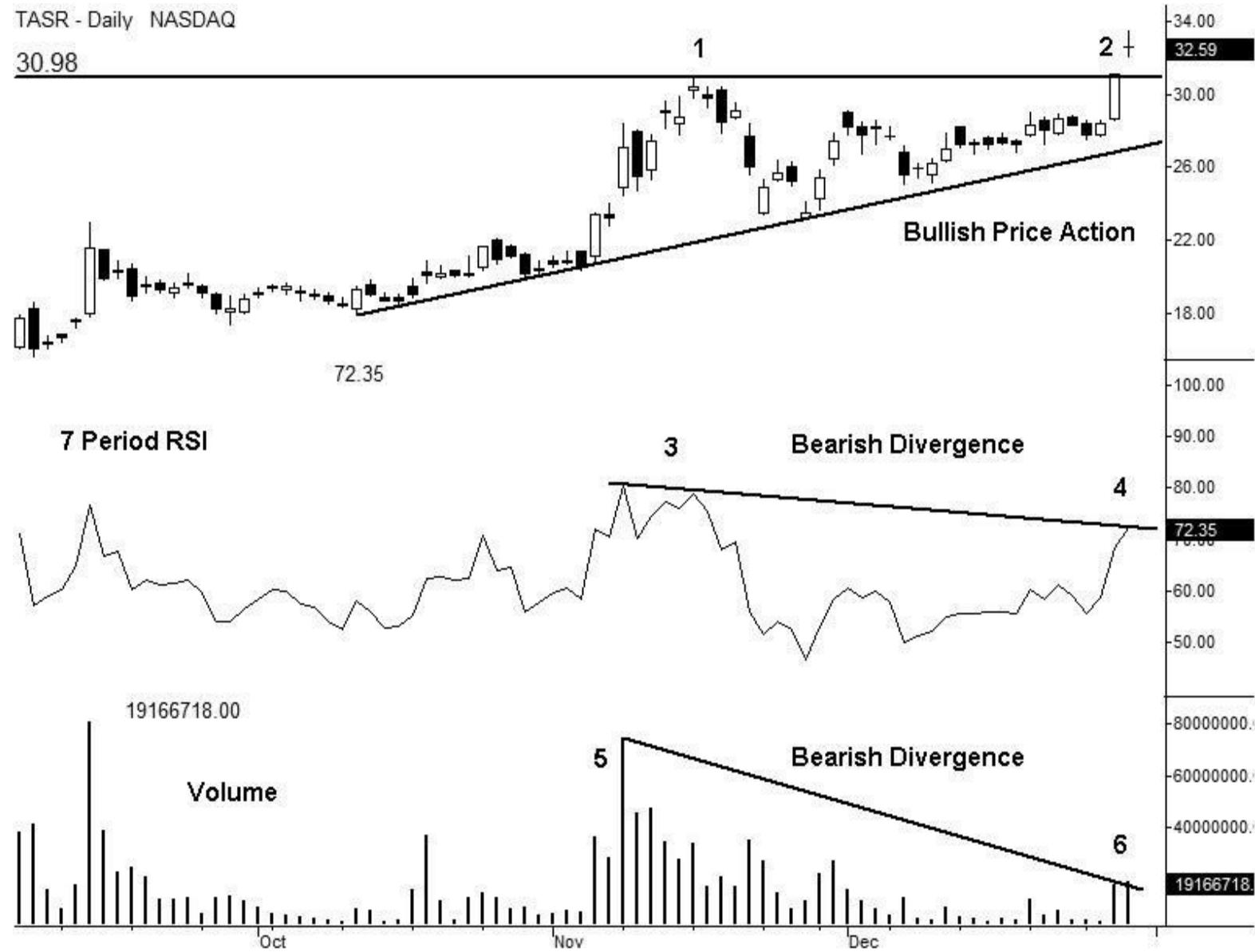


Figure 1.6

I use it as a fade play for swing trades on stocks. (To *fade a market* means to take a trade in the opposite direction from the move.) In other words, if a stock is rallying with this setup, then I’m looking to short it.

How Does a Person Make Money from a “Fake Orgasm” Setup?

These are the rules I use in trading with the fake orgasm setup. I use this setup on individual stocks.

Trading Rules for Sells/Shorts (Buys Are Reversed)

- Look at stocks that are making new 52-week highs. On December 30, having made new 52-week highs the day before at point 1, TASR gapped up and hit a new all-time high of \$33.45 (point 2).
- For stocks making new highs, look for a bearish divergence using a seven-period RSI (relative strength index). When TASR made new highs on December 30, the RSI hit 72.35 (point 4), well below the level it had hit on November 15 when the stock made its last 52-week high (point 3). When prices make higher highs and, at the same time, the RSI makes lower highs, this is called a *bearish divergence*. The RSI measures the power of the move, and this is telling the trader that the stock is losing power.
- For stocks that are making new highs, look for a significant decrease in volume. When TASR made new 52-week highs, it was on one-fourth of the volume of the last thrust to new highs. This is the equivalent of a car running out of gas. There is no sustained price movement without volume.



Figure 1.7

- Short the stock the day after it closes below the previous 52-week high. On January 3, TASR closed back below \$30.98, the previous 52-week high established on November 15. Utilizing this setup, the trader, let's call her Joanne, goes short 2,000 shares at the open on January 4, getting filled at \$30.27. She places a stop 25 cents above the all-time highs. Since the all-time highs are \$33.45, the stop is placed at \$33.70. This is a stop market order, not the stop limit order that Joe used.
- To exit, use a close above the high of the low day while above key support. If key support is broken, stay in the trade until there is a close above the high of the low hour on a 60-minute chart. We take a look at this briefly here, but this is a concept I talk about in much detail later in the book.
- Don't trail stops. The exit is the price reversal signal.

Let's now take a look at Joanne Trader, who was on the opposite side of Joe's trade. After she entered TASR short, the stock never rallied enough to close above the previous day's highs. So Joanne was still in the stock short once it broke key support on the daily charts in the form of the key uptrend line. Once it broke this key support level, the selling got ugly.

[Figure 1.7](#) is a 60-minute chart that shows the increase in volume once TASR broke key support on the daily charts, at point 1.

During the three large sell-off days, at points 2, 3, and 4, at no time did the market rally enough to close above the high of the low 60-minute bar. The next day, at point 5, TASR rallied enough to close above the previous 60-minute bar, which was the low bar of the entire move down. This close was the signal to cover, and once

the next bar opened, Joanne covered her 2,000 shares of TASR at \$16.17, pocketing \$28,200. She also reversed and went long 4,000 shares at this same level, using the lows of the move as a stop.

She stayed in the move until the 60-minute price action created a close below the low of the high 60-minute bar. This happened the next day at point 6, and Joanne closed out her long at \$20.54 for a profit of \$17,480. As Joe was berating himself for being such a stupid fool and sitting through his first day of marriage counseling, Joanne was counting her profits, totaling \$45,680, and wiring a portion of them out of her account to pay for a one-week vacation to Maui.

When a trader loses money, it isn't gone. It has just been moved into another trader's account. This is true even of the great financial crisis of 2008. The money lost by AIG was simply a trading gain on Goldman Sachs's books. When AIG couldn't pay the loss, the government was nice enough to step in and lend it taxpayer money so that it could, in turn, pay Goldman Sachs. Nice work if you can get it!

What Is the Only Economic Principle That Matters in the Markets?

TASR didn't lose 60 percent of its value in eight trading days because it wanted to. Desperate traders and mutual funds that had loaded up on this stock to sell covered calls were the main victims. Covered call writing was one of the most reliable forms of income generation for most of 2004. This was because the market was choppy and didn't go anywhere. Because this method was doing so well, Wall Street announced plans to start a couple of mutual funds that specialized in covered calls. Although there are no guarantees in the markets, here is one "almost" guarantee: as soon as Wall Street announces a special vehicle for trading a particular market or strategy, then that market or strategy is done for. Once the covered call funds got started, the markets roared higher during the last two months of 2004, invalidating this strategy as the best way to take advantage of current market conditions. Another example? Wall Street's pushing of home-loan-backed CMOs (collateralized mortgage obligations) was a clear signal that the housing market was about to go in the toilet. The moral of the story? When Wall Street decides to package something up, put a bow on it, and sell it to the public, that move is over. But I digress.

TASR lost 60 percent of its value because a lot of people were caught on the long side, like Joe Trader, and froze. Many of them didn't make a conscious decision to sell the stock. They held on until they couldn't take the pain any longer, or their brokers got them out because of margin calls. It was the margin calls that caused the worst of the selling when TASR closed near \$14.00 a share. These forced market orders caused riplike movements in the stock that resulted in even worse fills for traders like Joe, who were trying to use their skills to finesse their way out of the trade.

Disgusted with themselves and red in the face, the victims of these trades stalked off to contemplate the insanity of the universe. Meanwhile, as we saw, another group of traders took the opposite side of this "capitulation trade" and made great profits. How does a trader get on the winning side of these trades? To fully understand how to do this, we must first step back and understand how the markets really work, and why traders continually and instinctively sabotage themselves in the first place.

Well, the first part is easy. The markets are not that complex, and they work very simply. Markets rise on a day-to-day basis because current demand exceeds current supply—period. It has nothing to do with being in a secular bear market or a cyclical bull market, high price/earnings ratios (P/Es), or Maria Bartiromo's choice of a necklace. (For anyone who actively traded during the [dot.com](#) bubble, traders would look for a rally when Maria wore pearls. Very rational, of course.) It has everything to do with what traders are willing to pay for a particular market or an individual stock *today*.

It doesn't matter whether the demand is falsely created by a hedge fund "taking the street" (buying large amounts of a single stock to drain a market maker of its inventory, forcing it to buy the stock back at a higher price), a squeeze that whacks shorts and forces them to cover, or a rumor that a biotech stock is being cornered by Martha Stewart. Demand is demand, and that is what drives markets higher. The inverse is equally true: if there is too much supply in the market, prices will fall. The best source of "too much supply" hitting the markets is generally margin calls and other means of forced selling all hitting the markets at once, such as the Joe Traders of the world throwing in the towel and dumping their positions. This is why markets can erase gains so quickly; they take the stairs up, but they ride the elevator down. It is very important for a trader to remember this. Yes, the stock may be acting great and its prospects may be bright, but if there are 1.5 million shares being offered for sale all at the same instant and only 50,000 shares are being sought by buyers, then that stock is going to crash. It isn't rocket science. It's supply and demand at its finest.

Trading the long or the short side is very easy, once a trader learns to ignore his own personal opinions, quits trying to be right, and quits trying to make money. And by the way, that's the hard part. This means pushing aside any and all prejudices about the market and focusing on the current supply and demand situation. When you're dancing with the market, it's best to let the market lead. Once traders understand this, the next thing they need to work on is their own mental trading outlook and how they process this information, and to fully understand how the human brain naturally and emphatically causes traders to do things that make them lose money in the markets. It could be a whopper of a bad trade like Joe Trader's or a series of smaller bad trades that grind down an account—death by a thousand cuts. Either way, it's the human brain that's letting it happen. To succeed in trading, you have to get your arms wrapped around the idea that your brain is naturally wired to sabotage your dreams of becoming a trader. And ironically, it's doing this because it thinks it's protecting you. Understand this and you have an edge.

And that is what we discuss in the next chapter.

Lose as if you like it; win as if you were used to it.

TOMMY HITCHCOCK, POLO PLAYER

When you have got an elephant by the hind legs and he is trying to run away, it's best to let him run.

ABRAHAM LINCOLN

Psychology 101: What Didn't They Teach About Trading and Investing in School?

Only a fool tests the depth of the water with both feet.

AFRICAN PROVERB

Respect your limitations; your limitations will not respect you.

SWEDISH PROVERB

Emotions Are Fine at Weddings and Funerals; Why Aren't They Fine When It Comes to Trading and Investing?

Trading is the most deceptive profession in the world. Do you know anyone who has recently walked into an airport, jumped into the cockpit of a jumbo jet loaded with passengers, and taken off down the runway without any prior training? Yet people will routinely open an account and start trading without any guidance whatsoever. And that is equally insane. Little do they know that their emotions and the natural functions of their brain are against them right from the opening bell. They are the freshest of meat.

Just as a chatty masseur is the enemy of a relaxing spa treatment, emotion is the enemy of successful trading. Remember, the markets are set up naturally to take advantage of and prey upon human nature, moving sharply only when enough people get trapped on the wrong side of a trade. This sweeps a burst of fear, frustration, and rage into the markets—and creates fabulous trading opportunities for the prepared trader. To head into this adventure called *trading* (note that it is called trading, not guaranteed income) without having a firm grasp of how human emotions move markets and how human emotions can sabotage your own trading is like trying to hail a taxi in Manhattan during a thundershower. In other words, the odds are overwhelmingly against you.

The whole idea of this chapter is to lay the groundwork for the setups we discuss later in the book. With this foundation, traders will be able to understand how to control their “inner demon” with respect to trading. This is the creature that mentally blocks them from following the parameters of a particular setup once they are in the trade. It is very similar to the brain freeze that occurred during the river rafting incident discussed in the introduction and to Joe Trader in the TASR trading example. It is also important to remember that every trader has different dominant personality traits that he uses to absorb information and relate to the world around him. Some traders are more visual, others more auditory, and still others more kinesthetic—they relate to the world based on how events make them feel on the inside. These three traits can have a big impact on a person’s trading. Traders who are dominantly kinesthetic are doomed from the outset—until they realize that this is how they relate to the world and the impact that it has on their trading. If you buy a stock only when you feel good about it, you are a kinesthetic trader. Your best entries will be the ones that are scary and make you feel nervous. If you buy only when you feel good, the stock is probably near the top of a move. Think about it. Near the end of the book, there is a chapter on tips for when trading “isn’t working for you.” In this chapter there is a personality test that can help you determine what type of personality you are and the pros and cons for each personality trait. The cons will work against a trader without her even knowing it—until she learns about them and realizes what’s going on.

In addition, the trader needs to realize the importance of utilizing a specific methodology for each setup, because each setup takes advantage of a different aspect of human emotions. *A trader cannot apply the same trading rules to all setups across the board.* This is one of the biggest mistakes I see newer traders make. A two-point stop in the E-mini S&Ps can work well with one setup but cause nearly every trade to get stopped out in another. Trading five lots per \$50,000 can work well with one setup but be devastating with another. By understanding the psychology behind the trade, the individual will also then understand the right parameters and the right allocation to use for each setup. Each setup really is unique, and it has to be treated that way.

The end result of this chapter is for you to develop what I call a *professional trading mindset*. Although we discuss setups for most of this book, traders have got to have the trading psychology nailed down or their trading experience will be shortlived and painful. The other option, of course, is to go to a purely mechanical system and have your computer trade for you. Although this sounds like a good idea, I’ve found that traders who don’t understand the psychology start tweaking the system every time there is a losing trade, which negates the whole idea of having an automated system. The bottom line is that if you understand the trading brain, you have a distinct advantage over (1) those individuals who don’t and (2) those large funds that are trapped in larger positions that will take them days to liquidate.

Why Is a Guy with a System Always Welcome in a Casino?

This is an old Las Vegas saying that applies equally well to the financial markets. Having a system gives people a sense of security—nothing can go wrong. Every time I walk into Mandalay Bay or Bellagio in Las Vegas, I am reminded that all these fabulous structures were paid for by people who thought they could beat the blackjack tables. The owners of the Luxor borrowed \$550 million over 20 years to build their place. They were able to pay it off in less than three. Tell them at the front desk that you have a system, and you’ll most likely get a presidential suite and a private table.

Why don’t systems work in Vegas? The reason for this is twofold: the house has an edge with percentages, and as soon as the system falters a couple of times, the human mind gets to work trying to tweak it to make it perfect. This eventually screws up the entire process. In the casinos, as in trading, it takes only one stupid bet to blow your whole wad. Casino owners know this, and this is why they sell the strategy books right there on the property, prominently displayed in their own gift shops. This elevates the concept of the fox guarding the henhouse to a whole new level.

Craps is a great game for studying the trading mindset. The board is set up to encourage more of the “stupid bets” as the game goes on. Instead of just focusing on the higher-probability pass and no pass bets, participants get sucked in and start betting the hard ways and all the other exciting, low-probability bets. It’s a crowd mentality case study right before your eyes. Guess who wins consistently in the end? And that’s why the drinks are free.

It’s the same process with the markets. The odds are against the trader surviving because the market has an edge: it doesn’t have any emotions. Like the river making

its way to the ocean, the markets ebb and flow with total disregard for the objectives of the people who are hanging on for the ride. Humans have a tendency to try to imprint their will on the markets. This is like trying to get a tornado to shift course by yelling at it, or trying to convince your wife that making returns to the department store is not the same as saving money.

What Is the Right Mental Outlook for the Markets, and Why Shouldn't I Turn On My Computer Without It?

He who conceals his disease cannot expect to be cured.

ETHIOPIAN PROVERB

I will not allow yesterday's success to lull me into today's complacency, for this is the great foundation of failure.

OG MANDINO

First traders must understand the psychology, and then they can learn about the setup. It's like two pieces of a puzzle, and these two pieces have to snap together snugly in place before a trader can expect to trade for a living without repeating the same mistakes over and over again. I've shown many traders setups that work. The ones who don't get the psychology part always screw it up. Usually this takes place right after their first losing trade: "I wonder what would happen if I added a MACD filter and changed the settings of this moving average. I bet if I'd done that, I wouldn't have been stopped out." And a good setup dies an early death as the trader heads down the path most traveled—that of the never-ending tweak.

I've spent a lot of my career focused on trader psychology—not only working on myself, but working with hundreds of other traders. I've spent a lot of time in large trading rooms with hedge funds and prop traders, executing orders right alongside hundreds of other traders. I've watched the fear and the elation and the greed permeate a room and a group of traders like a disease. I've literally seen money from accounts on one side of a room flow into the accounts on the other side of the room as each group of traders focused on different setups and parameters. In addition, I've worked with hundreds of traders who have come up to my office to sit beside me and watch me trade, and to have me look over their shoulder while they trade. I'm the first to say that I'm not a shrink, but let's just say that my experiences have left me with a clear road map of the process most traders go through when they first start to trade. Every person is unique, but when it comes to money, the differences are quickly stripped away. Doctor, lawyer, surfer, or engineer—it doesn't matter. A herd of thirsty cattle will quickly drop all pretenses and stampede to get to water.

In addition to my experiences in working with other traders, it shouldn't be surprising to hear that I learned a lot of this firsthand from the best teacher that the market has to offer: extensive pain and suffering.

By the time I was a senior in high school, I'd saved \$1,000 working a \$4 an hour job slinging cookie dough and sodas at the local mall and running my own small mail-order business, buying and selling rare coins.

My stepfather, Lance, noticed my stash of cash and my entrepreneurial spirit and said, "Have you thought about putting your capital to work?"

I had no idea what he meant, but he was a Morgan Stanley broker, and I watched him meet with his friends every Sunday night as they visited and mapped out their Monday morning buying strategy. When they told me they were going to buy Intel call options and asked me if I wanted in, I said, "Sure," even though I had no idea what in the hell a "call option" was. But I was and always have been a risk taker, so the next morning I spent my entire \$1,000 savings on 10 Intel calls for a buck each. Four days later, my stepfather told me to sell, and I did ... at \$1.50 per option, earning a 50 percent profit of \$500. I never went back to that cookie store again, at least not as a boy flipping cookie dough for \$32 a day, less taxes. I was hooked on putting my capital to work.

For eight years, through college and for four years after college, I maintained a routine of staking myself with \$10,000 in order to buy and sell low-priced stocks and options until I increased my portfolio to the \$120,000 to \$130,000 range. During those eight years, I repeatedly did a smart thing, followed by a stupid thing, whenever I ran my account up that much. The smart thing I did was when I had built up my account, I would withdraw \$20,000 to \$30,000 of profits to invest in real estate (this was, of course, before the credit bubble crash, when real estate was actually trending up).

Minnesota Stupid

The stupid thing I did was sit back and say, "Gee, I managed to take \$10,000 and turn it into a little over \$100,000. Now I'm going to try to take this remaining \$100,000 and turn it into \$1,000,000. Let's do this!"

The first time I tried this, the experiment ended quickly, much like taking a Band-Aid and ripping it off with a flick of the wrist. It took all of six weeks to grind my capital down from \$100,000 back toward the neighborhood of \$10,000. Sure, it surprised me, but I chalked it up to bad luck. I rolled up my sleeves and went back to work. About a year later, I had built up my account to just over six figures, and then I paused and did the same thing. First, I took money out to buy real estate. Next, I decided to try turning \$100,000 into a million dollars yet again. This time I lasted four months, but the result was the same: back to \$10,000 and change. Hmm. Third time's the charm?

A few years after graduating from college, I was engaged to be married. I was in a nice swing trading rhythm. I had built up my small stake back into a \$150,000 trading account. I took modest profits out of the account at the end of the month, and I was getting closer to my goal of quitting my job as a financial analyst to become a full-time trader. At the time, my fiancée and I were living in Austin, Texas, but we were contemplating a move to Korea to teach English and just to try something different. We thought it'd be a bonding experience.

Then the company I was working for offered me a promotion and a transfer to Minneapolis, Minnesota. We thought about it, and in our youthful "wisdom" decided that Minnesota was probably a lot like Korea—cold. We moved to Minneapolis in the mid-1990s, during two of the coldest winters in the history of the city. Outside our apartment, the wind chill hit 40 below zero, and our cars wouldn't start. Inside our apartment, my fiancée, who had never seen snow before, sat. She was miserable.

I took taxis to and from work and came home to find her in the living room with a mask over her nose, sanding the apartment walls for the second time. Even I could

see that she was stir-crazy. Then she issued an ultimatum: "Get us a house with a garage so that our cars will start; we're getting the hell out of here."

It took a few months, but by May, just as the snow had melted, we found a house with a heated garage. I'd never heard of such a thing, but it sounded like the right thing to have. I planned to put down \$30,000 at closing. About a week before closing, I sat and stared at my \$150,000 trading account and wondered how it was going to affect me—psychologically—to take my account down to \$120,000. I was in a comfortable rhythm. The money I was pulling out of my account I mostly put into rare coins that I planned to hold for years, so I didn't have a lot of liquid assets other than my trading account. I liked my account size. I didn't want to change it. I had only a week before the closing to decide what to do.

As I thought about it more, I chose to make just one big trade, enough to earn \$30,000 so that I could take out the down payment and still maintain my \$150,000 trading account. It was so logical that I truly thought it was a genius idea. I would do one of my normal setups—just with much bigger size. And I would watch it like a hawk. I started flipping through the charts, and there it was. The OEX 100 was knocking up against a serious downtrend line on the daily charts.

The next day at the office, I set up my laptop, poured myself a cup of coffee, and watched the charts. (By this time I'd been promoted into my own office, so it wasn't difficult to do some swing trading while I worked.) The market started to rally, and it hit right into that mega-downtrend line. My heart rate quickened. I phoned my broker and bought 100 OEX puts at \$8.00. Immediately, the market came down, and in 20 minutes I was up \$10,000.

I thought, wow, this is going to work out faster than I'd hoped! The next thing I saw was a small kickback rally that brought new highs, and the options dropped to \$7.00. I believed this was the deal of the century. I mean, I loved them at \$8.00! I called my broker and bought 100 more puts at \$7.00, which put my entire \$150,000 into the trade. I skipped meetings and didn't go to lunch. I did not take my eyes off the screen. By the end of the day, the market had edged down off its highs and I went home with an open position that was up around \$12,000. I wasn't going to take home a loser, so this fit into my plan of taking a "green" position home overnight. In fact, my thought was that I could close out this trade at the open, hit my goal, and live happily ever after.

But when I woke the next morning and turned on CNBC, I saw a green arrow indicating that the Dow futures were up +130 points. I turned off the TV, shook the remote, and turned it back on. The green arrow was still there. Ouch. I was hosed. I'd been trading long enough at this point to realize a couple of things. First, I wasn't going to make \$30,000 on this trade. Second, my main goal now was to contain my losses. I knew that this opening gap had a high probability of retracing half its opening range (to where the Dow was only up +65). I calculated that if I sold my puts at that level, I'd be out with about a \$20,000 loss on the trade.

I got to my office. I turned on the charts. I watched and watched, and I waited and waited, but the retracement never came. Dazed, I stared at my account. The next day the markets gapped up again and rallied. For good measure, they did that for the following two days as well. I don't remember this time at all. I do remember at some point that it was the day before we were supposed to close on the house, and I needed to sell out my position so that I could have money to buy the house. I had no idea what the options were even trading for (I couldn't look). I just told my broker to sell. By the time the dust settled and I was able to check my account balance, I noticed that my \$150,000 trading account had evaporated into the tidy sum of \$8,000 and change. At this point I did what any man in his right mind would do—which means that I sure as hell did not tell my fiancée. For good measure, I stared at the charts a little longer. Maybe I was only dreaming this and I would wake up at any moment.

Finally I got up, went to the bank, and maxed out my credit cards in order to get the down payment. I went to the closing and handed over the \$30,000 check, at which point the mortgage officer said, "Wait. I thought this was coming from an investment account. We need to see where this money came from."

I acted ignorant. "Uh, what are you talking about? There's the money right there. Right in front of you." My real estate broker started to get angry at the closing agent (he didn't know what was going on). An hour later, the agent finally allowed us to close on the house. I kissed my fiancée good-bye (she had no clue what was going on), drove to the par 3 golf course down the road, and attempted to play a round of nine holes. I drove. I chipped. I putted. And I threw up. I did that for five holes. My nerves were shot, and I felt horrible. After I'd calmed down, I asked myself, "What do I want?" I knew I could raise another trading stake. All I had to do was sell one of my real estate holdings. But did I want to continue to go down this road of uncertainty? How could I quit my job and rely on a trading income if I did stupid crap like this?

I loved—and still love—analyzing the markets. I love placing and managing the trade. It's an intellectual challenge. And it's an emotional challenge—not letting your emotions actually zip down your arm and into your fingertips and onto the keyboard. But most of all, it's where my passion lies, and where it has lain since I placed my first trade.

Still, I decided that I wouldn't trade again until I figured out what I'd been doing right and wrong up to this point. I knew I could make money trading—why couldn't I keep it? For the next year, I thought, studied, talked to other successful traders, and read.

During this time I came across a book by Mark Douglas called *The Disciplined Trader*. This book was a real eye-opener in that Mark showed how to turn everyday stressful trading situations into "normal" trading behavior. His follow-up book, *Trading in the Zone*, is also excellent. His books have had a huge impact on me, and they are required reading for anyone I'm working with. Mark's insights, as well as my long discovery period, finally gave me the answer: whenever I focused on the setups and not the results, I did fine. *But whenever I focused on the results and not the setups, I got killed.* Why is this? Once I got my hands on a decent-sized trading account, I would start to think things like, "I want to turn this account into a million dollars." Or even better, "I just need to make a quick 30 grand for the down payment on the house."

Instead of focusing on the setups, I was focusing on making a million dollars or, in the case of the house, a \$30,000 down payment. This caused me to jump into the trading habits that ruin all traders: betting it all on one trade, not using a stop because the trade "had to work out," and focusing on making a million bucks instead of waiting patiently for a high-probability trade setup. All of these habits guarantee trading failure in the long run. Yes, it would have been easier to just blame it on my mother for hitting me with a wooden spoon once when I was a kid, but at some point we have to step up and take responsibility for our own actions. By focusing on "making money," a trader will see a lot of opportunity where there is none.

Once this revelation sank in, I started to do two things differently. First, I started wiring any profits out of my trading account at the end of each week. This kept me focused on producing a smaller, steady income, as opposed to making a grand killing. I later refined this and today call it "cash flow trading," and I'll talk more about this specific trading methodology shortly. (In trading, there is trading for cash flow and trading to create wealth—they are very different.)

I also discovered that wiring money out was a great way to protect profits—the market can't have them if they are safely tucked away out of reach. I use these profits mostly for longer-term investments like land and gold, but I also set aside some of the money for fun—after all, we are only here once, as far as I know. And one important thing I realized from another successful trader is that there is no need to trade every day. I started to notice that there were days when I didn't take a trade—not because I didn't want to, but simply because the setup I was waiting for didn't occur.

Second, I started a competition among the various setups I used. This way, I could measure the performance of every one of my setups at the end of each month. The setups that made money I kept using. The setups that lost money I dumped. This was incredibly important to my trading. The only way I could keep my competition going was to execute my trade setups the same way each and every time. I did this in blocks of 25 trades. This had the added benefit of removing much of

the importance from any trade I happened to be in at the time. It was just “trade 13 out of a series of 25”—no big deal. And any time I deviated from a standard setup, I marked this down in my trading journal as an “impulse trade.” I kept track of my performance on these, too. After about six months of tracking my impulse trades (wow, this market is going higher; I have to get in), I realized that they were not making me any money and were in fact preventing me from making a living as a trader. Yes, they were fun. But they weren’t helping.

In working with other traders, I see impulse trading as one of the most common reasons for people getting their heads handed to them. They don’t have a plan. They just get long when that feels right, and they get short when that feels right. Or they just get bored. I’ve literally had traders in my office who have visited to work specifically on their impulse trades—only to sneak in orders when I wasn’t looking. The urge to jump in and be a part of the action is that powerful. It’s like a drug addiction, and like most addictions, it never works in the long run. My method for dealing with them is to simply sit next to them and watch them trade—and to do exactly the opposite of what they’re doing. At the end of the day or the week, we compare our profit and loss statements, and that usually tells the story. This is a win/win situation because it is a great lesson for the impulse traders—there are actually people out there doing the exact opposite of what they are doing and making money—and it is a mostly profitable exercise for me.

The cure for impulse trading is patience, and also understanding integrity—a topic that we are sneaking up to shortly. Patience is such an important quality for a trader—both in learning what setups best work for you, and in waiting for those setups to occur. Impulse traders who cannot own up to this bad habit need to stop trading and go to Vegas. The end result will be identical—they will lose all their money. But at least in Vegas the drinks are free.

If people are stuck in a relationship with an individual who berates their best efforts and undermines their dreams, then it is time to leave this individual and move on. It was in this vein that I “broke up” with my impulse trading. I liked my impulse trading. It was fun. It made me feel good. It was exciting. But the bottom line was that my impulse trading was undermining my potential and preventing me from realizing my dreams of being a full-time trader. Once this realization took hold, I took immediate steps to cut that cancer out of my life. This included a reward and punishment system that I discuss later in this book, in the chapter on formulating a business plan.

In the end, I stuck with my friends who believed in me—the setups that worked when I gave them half a chance. Once I was able to follow my setups consistently, exactly the same way each and every time, I was able to make the transition to trading full time. A large part of my transition was mental and developing what I call a “professional state of mind.”

Oh, and by the way, it wasn’t until years later, when I was doing a talk at a Traders Expo in Las Vegas and telling the story about the “Minnesota Stupid House” that my wife actually learned of the event. She was sitting in the audience, and I’d totally forgotten that I had never told her. Everyone around her started asking, “Wow, how did you handle that?!” Afterwards she came up to me with a sweet smile and a few blinks of the eyes and said, “So what else haven’t you told me?”

Why Do Most Traders Have to Blow Out an Account Before It All Sinks In?

Trader psychology is one of those subjects that doesn’t seem to matter until it really matters, like when you’re changing a flat tire or when your three-year-old daughter yells out in the middle of traffic, “No, Dad, I have to go poop now!” You think the issue will never arise, or it won’t apply to you, or you’ll figure it out before the moment of truth. However, that moment of truth tends to happen at the least convenient moment, typically when things are about to go from bad to much, much worse. It’s one thing for your daughter to say she has to poop in the car, but it’s a whole new ballgame when she actually cuts one loose.

The term itself, *trader psychology*, inevitably gets thrown around with greater and greater frequency as a trader nears the goal of trading the markets successfully, because the closer a trader gets to being consistent, the more apparent it becomes that his greatest enemy is rarely the individual on the opposite side of the trade. Far more often—as is the case in so many aspects of life—our worst enemy is the person we look at in the mirror each morning. Unfortunately, most traders, myself included, never realize this until they blow out an account. “Wow,” they say. “I didn’t think that would ever happen to me.” Seasoned traders call this the price of tuition.

The first psychological issue that traders find themselves butting up against is addiction. When people hear traders talking about addiction, they often think about gambling, an addiction to the rush of placing the trade, the anticipatory thrill as a trader establishes a position and hopes that it goes her way and brings in tons of cash. And yet that all pales in comparison to the addiction to being right or, worse, not being wrong. It drives human behavior into the realm of absurdity.

For example, placing a trade that will make money as long as that market doesn’t crash overnight is a reasonable setup and a reasonable assumption. Stops can be used. Risk can be assessed. In the early morning of January 17, 1995, an earthquake hit in Japan, causing its stock market to take a nosedive. One particular trader saw this unfolding, watched his losses mount, and started doubling and tripling up in order to recoup his position and make money on the trade by bringing down his average cost. When the bounce failed to materialize, the trader, Nick Leeson, bolted out the door, leaving a note that said, “I’m sorry.” This trade lost \$1.3 billion and bankrupted Barings Bank. Although this is an extreme example, it happens every day around the world with much smaller accounts. Maybe \$5,000 doesn’t seem like much in comparison, but if that is your entire trading stake, losing that amount can be just as devastating as losing \$1.3 billion. Okay, maybe not quite as devastating, but you get the idea.

In many facets of life having to do with careers, an addiction to being right is a strength. It forces us to work harder to meet our goals and to prove to ourselves and to others that we can, in fact, accomplish what we’ve set out to do. It can cause us to view a potentially devastating setback as a mere learning experience, and onward we go, dusting ourselves off and getting back on the horse for another ride. It’s like the movie *Rocky* each and every trading day. No one thought an uneducated but kind-hearted debt collector for a loan shark could get a shot at the world heavyweight championship. But he did, and he proved that everyone was wrong and showed everyone that he was right, and it made a great movie. It’s a fantastic life lesson in persistence and in following your dreams. But if you try that in trading—try holding on to a losing trade until it turns back into a winner, just so you can prove to everyone that you aren’t wrong—you’ll get your ass handed to you. Maybe it won’t happen on this current trade and maybe not on the next one, but it will happen, and it will lead to a blown-up account. True, not many of us will ever bring down a bank, but wiping out your life savings is a close second. Trading is the only profession that punishes tenacity by taking your money. Be tenacious in learning how to become a better trader, not in proving that you are right on this current trade.

But it’s not just the human need to be right that makes trader psychology such a complex battle, it’s that other great power of the human mind—the power of rationalization. This is a topic I’ve already touched upon, but it’s worth another quick look from a slightly different angle.

In the film *The Big Chill*, Jeff Goldblum’s character discusses this subject in a particularly salient manner.

Michael: Don’t knock rationalization. Where would we be without it? I don’t know anyone who’d get through the day without two or three juicy rationalizations. They’re more important than sex.

Sam: Ah, come on. Nothing's more important than sex.

Michael: Oh yeah? Have you ever gone a week without a rationalization?

Rationalizing the events on your screen means rewriting the story of what's actually happening in a way that feels comfortable to you, that makes your position seem like the correct one. "This trade isn't going to go against me for long," thinks Joe Trader. "They aren't going to shake me out!" And if it works out, Joe Trader compliments himself for being the genius that he is. He just knew it would work out, especially this particular trade. Call it a gut feeling. And, of course, since it did work out, it just proves that his analysis was spot on. "You know," he muses, "I think it's time for me to up my trading size on this next one."

A person can gloss over reality in nearly all areas of her life, reshaping her interpretations of events to put her in a favorable light and keeping that pristine image intact. After all, it's okay to ignore your kids when you're on the computer if you've got VITTD (very important things to do)—or so goes the rationalization. None of us wants to admit when we are being a shitty parent.

In trading, however, at the end of the day, the result is right there on your profit and loss statement. No matter how "right" you persuaded yourself you were, a loss that was incurred when you were trying to prove yourself right is still a loss, and your story doesn't mean a thing to a neutral-minded market. The P&L is the great equalizer. It reveals you for who you really are, and in many instances the picture ain't pretty. Unfortunately, most people would rather do anything other than confront themselves, their ideal image of who they are. It's not fun. Believe me, I thought I had much better qualities as a person before I got into analyzing my trading personality. And this is why trading has such a high failure rate. Flaws explode onto the P&L. They must be addressed—not just in theory, not just through a few notes in a trading journal, but in practice, on each and every trade. The game changed for me when I committed to becoming a better trader on each and every trade, as opposed to rationalizing why I was right on every trade.

The Trader Mindset: What Is the Best Way for Getting, and Keeping, Your Head in the Game?

Great trading, like greatness in any profession or art, is a kind of balancing act. Each trade requires us to split ourselves into two parts: caution and boldness. We need the caution to be patient, the courage to get in and the courage to stay in a winning trade, and the caution to protect our gains once we have them—but not too aggressively, so that we don't get stopped out on a mere wiggle. And most important is the courage to admit that our trade is wrong and to get the hell out. Great trading is all of these things, which is why great traders are so rare. This balancing act is the reason so many type A personalities perform so badly in the markets. While they may possess boldness, courage, and decisiveness, they frequently lack the caution, patience, and ability to accept that their first impression was the wrong one. Or, more simply, they lack the ability to concede that, while their setup might have been as attractive as a Swedish au pair, it just didn't go the way they expected it to go. The market doesn't care if the setup was a good one. It's still going to do whatever it wants to do.

Something happens at the beginning of a trade, a psychological battle. It's that classic scene of a devil on one shoulder and an angel on the other. One tells you to hang in there with all your might, that things are going to go your way eventually, no matter what the evidence suggests, and the other screams in your ear to preserve your capital, to get out, to take a tiny profit or a tiny loss. Just get out! It's a powerful sensation, especially for the beginning trader, which is why a clear trading strategy is critical. A trading plan in which you can place your faith is like a pair of mufflers, blocking out the sound of that noisy chorus. Trading without a game plan is like swimming in the Amazon River with a couple of raw steaks strapped to your waist. You might get some good exercise, but the longer you are in the water, the greater your chance of a violent end.

It's when you're not trading your plan that fear takes hold, and when fear takes hold, it's easy for you to lose perspective and exit too early, cutting your opportunity for profitability off at the knees. Yet fear can also cause traders to do something that seems the total opposite of fear. It can cause traders to ratchet up their nerve and stay in the trade long after signs of danger have presented themselves. That is, fear triggers an irrational boldness. It takes courage to stay in a trade, that much is certain, but the lesson that too many traders learn too late is that it takes just as much courage, if not more, to get out of a trade that's clearly not working. The greater a trader's nerve, the greater his chances of ruin.

I often think of the words of a great general who said, "Retreat is a perfectly legitimate military tactic." Of all the parallels between war and trading, none may be truer than this one. There is no shame in taking a small loss. In fact, when taking a small loss prevents you from taking a big one, it should be considered a victory. If things aren't going the way you hoped, preserve your capital and live to fight another day. And always remember, reentry is only a commission away. Go flat, take a walk, and clear your head. The market isn't going anywhere.

It sounds simple enough, as if you could simply resolve at the start of every trade that you will exit neither too early nor too late, and you will have courage in the right measure at the right times, but it's actually a tremendous shift in perspective for most traders. We are all geniuses when we're looking at the charts in hindsight. It's making decisions in real time, clearly not knowing what exactly is going to happen next, that makes or breaks a trader. Any one can tell you what you should have done.

Great flexibility is required when you're looking at the markets. There is a certain Zen attitude that is reached by the greatest of traders. In fact, this is one of the terrific, sometimes hilarious, paradoxes of the trading world: meeting serious traders in their seriously expensive suits, who amidst their talk about the hard-core daily battle between the bears and the bulls sprinkle in Zen proverbs. "There's no meaning to a flower unless it blooms." Or, perhaps more relevant, "No ego, no pain." The people who have learned these lessons are the ones who make money in the market, because they have learned that when you are forming an opinion of the market, that's all you are doing: forming an opinion. You must leave room for chance. And when you see that your opinion was the wrong one, you must have the courage to get out and the faith to accept another difficult truth: the opportunity will always come around one more time. Again, the markets aren't going anywhere.

Once a trader accepts the constant flow of the market, that endless renewal of opportunity, then he understands that there is no need to enter the market on half-convictions. Just sit back and wait until a setup has laid itself out with clarity. Not a maybe or an almost—it's simply there, period. In the meantime, a trader's main job is to fight off his boredom and stay flat. Traders who take on a position out of boredom then spend their time managing that mediocre trade while good ones pass them by. Getting in too early and getting out too late just means that someone else is eating your lunch that day. Your stop loss is another trader's first target.

The markets change daily. Literally—there is never the exact same combination of orders and trader actions from one day to the next. The gravity of that fact can be hard to grasp when you read about the same kinds of setups or anticipate the same kinds of moves day after day. But the market truly is continually changing and forming new combinations. There is an infinite number of possibilities on any given day, at any given minute. Did you know that each time you shuffle a deck of cards, the odds are that no deck of cards in history has ever been in that precise order? In fact, the odds against it are staggeringly astronomical. Imagine what that suggests about the markets, in which the variables are tremendous by comparison. For that reason, it is critical that you take a fresh look every day to consider the possibilities, not merely in relation to what you saw yesterday or the day before, but in terms solely of this moment, today. You must always ask yourself, "What is the market

telling me now?" bringing to the table no preconceptions or intentions of your own.

What Is the Easiest Way to Establish a Consistently Winning Outlook?

Just as a professional gambler is unfazed by his winning and losing streaks, great traders learn to roll with the punches (because they are so used to taking them), while managing their money in such a way that no one session leaves them broke.

One strategy in establishing the proper outlook is to stop thinking of your money as money. Anyone who had a job as a teenager will surely remember the way in which every hour of work could be translated into a real-life desire. An hour of work might have been a bit of gas for the car, a night out at the movies, or dinner with a girlfriend. In trading, there is the temptation to do precisely the same thing: to say, "I just won my car payment," or, "I could have bought a new home entertainment center with that loss." Don't think of it as money. In the world of trading, remember that money is only a tool of the game, a means to keep score.

Though this removal from the literal value of money could certainly be a hazard in real life, it is an excellent habit for removing an emotional element from the trading day. The moment you lose sight of money as a tool of the game and revert to thinking of it in terms of its purchasing power, you have sentenced yourself to playing less skillfully and more emotionally, which is poison to any trader.

What Does Personal Integrity Have to Do with Successful Trading?

In the game of life, everything is in play: your time, your money, your relationships, your social position. Every element of your day-to-day existence is in your hands, and you protect each part of your life by investing wisely in each category. In fact, your quality of life is entirely determined by the way you handle those investments. You invest in your health by treating your body in a certain way and asking only reasonable things of it. You invest in your relationships by fostering them, treating them respectfully and with care. The way in which you invest in your life for a positive outcome can be boiled down to a single word: integrity.

Integrity is often thought of as doing what you say you are going to do with regard to other people. When you say you'll be at a meeting, you show up at the appointed time. When you promise to take out the trash, you get it to the curb before the trash man cometh. Other people's faith in you grows each and every time you keep your word. People who don't keep their word are not treated seriously. If you have an opportunity for a new business venture and you need to find a partner, whom are you going to choose? Not someone who can't even keep his word on the little things. Integrity is its own type of currency in the world. It is how we show others that we deserve their respect, their love, and their compensation for our hard work.

The problem comes when we don't treat ourselves with the same integrity. We do have a sense of self that we come to rely on when the chips are down. We have varying degrees of faith in ourselves in various situations, based on how we've handled those situations in the past. In trading, it is critical that we are able to trust ourselves to follow our plan, preserve our capital, and not freeze when the going suddenly gets very rough. How do we build integrity with ourselves? Simple: we keep our word. If we write down that we are going to go to the gym at 3:00 p.m., then come hell or high water, we get to the gym at 3:00 p.m. And if we also tell ourselves, "Today I'm not eating any dessert," then we stick to the plan, honor our word, and pass on the dessert. With each missed workout, with each slice of cheesecake, another shred of integrity is lost. This chips away at our own sense of self, creating a growing sense of unreliability. The end result? For traders, it's being scared to take a trade because you don't know if you can trust yourself to follow your plan once you are in it. And not trusting yourself as a trader is a guaranteed route to disaster.

How do you build up this sense of self, this sense of trust in yourself? It's very simple: keep your word with others and yourself, starting today. More important, learn to say no so that you don't overcommit. But when you agree to do something, whether it's meeting someone for a drink or going to the gym at a certain time, then fight like hell to make it happen. Be unreasonable if you have to—after all, you are building up your most important trading tool, and that is faith in yourself that you will follow your trading plan, which is following your word.

There's no one else there to hold you to it. You have to rely on yourself, and you have to know with absolute conviction that you are someone who can be counted on.

As traders, we are confronted each moment with opportunities to violate our plans. Every new bar or candlestick is a chance to let just one of our rules slip. Whether the outcome is a win or a loss, toying with your rules in the heat of the moment is more than merely a bad idea; it's a message to yourself that you aren't reliable, that you don't play with integrity. Eventually your integrity with yourself erodes to the point where you don't even trust yourself. "Man, I hope I don't screw this up again," Joe Trader thinks.

Integrity in trading is the most critical component of your trading plan. Building up that integrity is easy to do. Start with the next trade. Follow your plan and follow your word, and your trading skills will increase.

Where Are You Now in Your Trading Journey?

It is critical that traders understand this process and recognize where they are on their journey. This is obviously important for a trader's own development, but there is a more subtle reason why it's essential to grasp this concept—so that a trader can understand what mistakes other traders are making and how to profit from those mistakes. This is the biggest poker game on the planet, and the money that's flowing into your account isn't appearing as if by magic. It's coming from someone who is still learning how the markets work, and who most likely followed her gut and got suckered into taking the wrong side of the trade.

Believe it or not, everyone who is trading today has about the same odds of making money on his very next trade. There is simply not a lot of skill involved in making money on one trade. The difference is over the course of 60 trades, 100 trades, or 1,000 trades ... who is going to be able to generate an uptrending equity curve over the course of that many trades? It's the traders who have graduated from the four basic phases of trading:

- Phase I: Destined to lose—six months to a year
- Phase II: Fear-based trading—two to six months
- Phase III: Search for the Holy Grail—six months to death
- Phase IV: Learning how not to lose

I've found that most traders go through these phases in one fashion or another. Unfortunately, by the time they get through Phase III, they are typically out of money and can't even move on to—or grasp—learning how not to lose.

Phase V, of course, represents the time when a trader has become consistently profitable. This doesn't mean on every trade—it means creating an equity curve that

has an overall upward slope. It means having the ability to be strict enough in your discipline to be able to make a consistent income from the markets. This means trusting yourself that you won't break down and screw it up yet again. Remember, the moment a trader wavers from her plan, the market is ready to attack. It's waiting ever so patiently, ready to suckle those emotions, ready to lure traders back into their old habits ... just one more time! And the trade might even work. If it does, it doesn't matter. That's not the point. If you break your rules once and win, you'll break them again. At some point, this will come back to haunt both you and your trading account. This discipline and patience has to be utilized on every trade, period. Are you starting to see that this is 90 percent of the battle here?

Phase I Trading: Destined to Lose—What Are the Traits That Make People a Success in Life but Routinely Get Them Killed in the Markets?

He that lives on hope will die fasting.

BENJAMIN FRANKLIN

It has been said that the road to hell is paved with good intentions, and nowhere is this more apparent than in the world of trading. (It also becomes very apparent when you start hiring relatives to help you with your business, but that story is for another book.) I have yet to meet one individual who went into trading with the goal of losing money. Everybody's intentions are quite the opposite, and the first thing people do when they enter the world of trading is tap into what has worked for them successfully in the past. The problem is that the tactics that an individual uses to achieve his goals in everyday life do not work in trading; in fact, they are one of the main reasons for failure. While good judgment is critical for an individual who wants to climb the corporate ladder or start a business, we have already seen why "good judgment" didn't work in the middle of the TASR trade. This leads us to what has to be the most painful lesson ever inflicted on the optimistic nature of the human species: *the tactics that an individual uses to achieve her dreams and goals in everyday life do not work in trading; in fact, they are one of the main reasons for a trader's failure.* The determination, courage, positive thinking, and resoluteness that have made people a success in one area of their life simply set them up for slaughter in the markets. It is these types of traders who obstinately hold on to a losing position, adding to it on the way down, using positive thinking techniques to visualize this fiasco eventually turning into a winning trade. I don't care how many Tony Robbins tapes the employees of Enron listen to; it's not going to get their stock back up to \$90 a share. The trader who is unaware of this phenomenon is set up for failure from the very beginning. This doesn't mean that a person shouldn't be positive about her ability to eventually become a successful trader. Far from it. However, a trader will be much better off assuming that every trade she takes is going to fail. This way, she learns to focus on protecting her downside and minimizing her risk. The upside can take care of itself, thank you very much. It's the downside that can easily get out of hand. Be positive on life, but pessimistic on your next trade.

Traders who "play the markets" with a mental framework oriented toward how external society rewards and punishes "good" and "bad" behavior are set up to lose from day one. For example, "cutting one's losses short" is difficult when there is the possibility of the market's coming back to the breakeven point. At breakeven, the trader is not a "loser." Thus, according to the benchmarks of society, if traders can exit a position with a gain, they are "successful." This leads to the removal of stops "once in a while" in the hopes of getting out at breakeven—in order to be a winner in the eyes of society (sigh). This can work 10 times in a row, even 100 times in a row, but it is the one time when it doesn't work that knocks traders flat on their back. On this particular day, these traders will be among the many who cause a "rip like movement" in the markets as they pound their keys in disgust to get out of a trade that is killing their account. This habit of removing stops, even if it is done only once in a while, is reinforced by the societal belief of what defines a winner versus a loser. This habit will destroy a trader's account faster than anything else—and the smaller the account, the more quickly it will be destroyed. By using hard stops and sticking to them, a smaller trader at least has a fighting chance of being able to do this for a living. If he can't at least do that, he will not make it as a trader. Period.

What happens to traders in the beginning is that they naturally end up on a cycle in which they label themselves as good traders on days when they make money and as bad traders on days when they lose money. This is an ordinary reaction instilled into them based on the principles that apply to general society. After all, straight As mean that a student is a success, while Fs mean that he is a failure, right? If there is anything I can emphasize in this book, it would be this: *trading has nothing to do with general society.* In fact, the markets are set up in such a way as to use what most people hold near and dear to their hearts as a means of taking advantage of them. The markets thrive on taking the rules and ideals that govern general society, wadding them up into a ball, setting them on fire, and then shoving them down a new trader's throat. Any trader who is unaware of this phenomenon is being played like a fish right from the opening bell.

General society tells us that losing money equates with failure and making money equates with success. After a losing day, the trader unconsciously thinks, "I've lost money. I can't do this. If I had just removed my stop, the market would have come back and got me out at breakeven, and then I'd still be a contender." So what happens is that the trader starts looking for opportunities to remove her stops in order to not end up with a losing trade. Not on every trade, of course. Just on some trades. And how do traders determine when to do this? It's easy enough; they just use their "judgment" while they're in a trade. And this is exactly when professional traders step in for the kill.

This society focus on money traps traders into the very habits that cause their ruination. Removing a stop in the hopes of getting out at breakeven is one of the worst habits a trader can develop. Sure, it will work some of the time, but it has to turn into a disaster only once to wipe out half or more of an account. While the rest of the world views losing as a bad thing, in trading, small losses are the best sign of success. Nobody outside of trading will ever understand this, so don't waste a lot of time telling your in-laws how losing only \$2,000 yesterday is part of your success plan. Yes, this means you are doing your job, but as long as the sun continues to rise in the east, other people will never get it. The only people who understand traders are other traders. Personally, when I'm at a cocktail party and people ask me what I do for a living, I've found it's easier to say that I do charity work. People at least understand that and can empathize.

The biggest issue for newer traders is to reprogram their brains into realizing that in trading, losing is winning. A professional trader's job is to take small losses. Period. Most traders don't realize that there are only a few days each month where big profits can be made. The rest of the time, traders are doing their job if they are keeping their heads above water. The idea is to keep the trading account intact for when the big moves come along. If on Monday some traders take three small losses in a row and end up down on the day, they are doing their job and have the chance to be successful professional traders, because they will have maintained the bulk of their account to use on one of the few days when the markets really move. That is what trading is about. It's about traders sticking to the parameters that they have set for themselves and sticking to the setups that they've decided to follow. It's not about gut reactions and chasing the latest sound bite mentioned on CNBC. That is the path to trading annihilation.

I remember getting a call in mid-2003 from a guy who was running a \$10 million hedge fund for his family. It was never made clear to me how he qualified for this

role, although I think he mentioned something about knowing how to use the Internet. He sent me an e-mail about YHOO, asking me for my thoughts. I looked at the chart. The stock was trending higher on nice volume, and I told him about a couple of different setups I would use to get long the stock. Apparently that wasn't the answer he was looking for, because he called me the next day and told me that I was reading the chart wrong. As I listened to him rant on about page views and price/earnings (P/E) ratios, a light went on. I interrupted him and asked, "Where did you short this stock?" After a moment of silence followed by a cough, the story emerged. He had shorted it at \$12.00 based on a newsletter recommendation. As the stock rallied, the newsletter had shorted more, and so did he. By the time I talked to him, he had shorted 400,000 shares at an average price of \$16.25, for a total outlay of \$6.5 million.

I asked if the newsletter was still short, and he said no. I checked my quote screen and saw that YHOO was trading at \$22.50 and had just cracked out new 52-week highs. He asked me if he should short some more to raise his average cost, "so it won't have to go down as much for me to get back to breakeven."

Here he was down \$2.5 million on the trade, his family hadn't seen the statements, and he was trying to salvage his career as the family financial guru. There was zero rationality in his thinking. I told him he needed to get out of the trade, or at least buy call options for a hedge. I even said that YHOO was going to keep on rallying until all the people who were short cried uncle and covered. Apparently that wasn't the advice he was looking for, either. He ended up shorting another 100,000 shares. He finally caved when YHOO hit \$30, for a loss of \$6.25 million. It's an excruciating story, but this happens all the time with all types of different account sizes. This guy didn't want to take a small loss because he didn't want to look like a loser to his family. His motto became, "As long as I hold on to this position, it's not really a loss." This is like having blood pour out of your bowels and choosing not to go to the doctor. "As long as I don't go to the doctor, no one will know I'm dying." Trust me, once you are dead, people will figure it out.

Averaging down on a losing position is like a sinking ship taking on more water. When the family fund manager kept shorting YHOO as it made new highs, he might as well have been driving nails into the *Mona Lisa*. Both are deliberate acts of destruction. Financial planners always talk about *dollar cost averaging*. I call it *dollar loss averaging*. Adding to a winning trade is okay, but adding to a losing trade is insane (unless scaling into a full-sized position is part of your trading plan). If you caught some of your employees stealing from you, would you give them a raise or fire them and find somebody else? This guy trading YHOO would have given them a raise, a housing allowance, and a comfortable pension.

As traders approach the end of Phase I, assuming that they still have any capital left, they have some solid experience under their belt. However, they haven't quite figured out why they are getting hammered by the markets. It's not as if they have lost money on every trade. In fact, they've had some great trades. Unfortunately, they've also been knocked down pretty hard on a number of occasions, and their account is under water. They started off optimistically, but now they just want to be a little more careful. And the bottom line is that they don't want to lose any more money. Welcome to Phase II.

Phase II Trading: Fear-Based Trading, or, "Why Does Everything I Touch Turn to Crap?"

Many traders think that once they become more cautious, their trading will improve. They're wrong.

When traders decide that they don't want to lose any more money, they unwittingly turn themselves into the "late entry" champions of the trading world. They wait and they wait and they make doubly sure that a trade looks good before they take it. In this scenario, the markets start to rally, but by the time the trader is absolutely convinced that this rally is for real, she is jumping in near the dead highs of the move. She and the rest of the traders who did this just gave the markets the fuel they needed to start moving down. Why? Because suddenly the market has a lot of stops being placed beneath it, and like wind on a forest fire, these stops will ignite a sell-off. This safe, cautious entry quickly turns into a loss. The difference this time is that prudent traders religiously stick to their stops. The problem is that this overcautious behavior gives them terrible entries, and their odds of getting stopped out are extremely high. Yes, small losses are good, but if nearly every trade results in a small loss, the account will eventually be worn down.

Phase II usually doesn't last very long. Traders in this phase generally don't lose a lot of money, but they lose enough. Once traders figure out that they can stick to their stops, but that their entries are suffering, they reach what alcoholics refer to as a "moment of clarity." If their entries are bad, then obviously their indicators are bad. So they go looking for some better ones. And thus begins the search for the Holy Grail.

Phase III Trading: Why Is the Search for the Holy Grail Guaranteed to Limit Your Success as a Trader and an Investor?

The search for that fail-safe indicator that's going to work nearly every time takes a trader down a path that's littered with corpses, broken dreams, and stuttering fools. Many traders stay in this search for the rest of their lives. The irony is that individuals in this phase think they are developing as traders, when in reality their development as traders is dead in the water, having been stopped faster and with greater intensity than Monica Lewinsky's future in government. Traders in Phase III are stuck in quicksand, entrenched in a losing game that can last years, decades, or longer. The end result is a trader who spends this time repeating the same mistakes over and over again or happily discovering new ones.

The cycle that takes place is one of always looking for the next best thing. It's the search for that oh-so-special indicator or system that is going to give the traders their lodestone reward. In a typical scenario, this means diving headlong into a couple of different trading programs or ideas and tweaking them endlessly until they reveal their magic. One typical scenario involves traders who develop a simple set of mechanical rules, which are kept secret, of course, that will help them attain a substantial profit each year with virtually no risk and using only a small amount of capital. They get especially excited when they see that these methods, when carefully applied to selected historical data, work amazingly well. The ones that didn't work out could easily have been "filtered out." This type of trader typically dies with a one-page summary of how well the trade works and a stack of 68 pages that explain when not to take the trade.

Other traders who are stuck in Phase III will go to seminars and learn about trends, and learn the importance of never fighting the trend. They discover the magic of moving averages and how they cross over when the trend changes. Oh, the power! When the market is trending, these methods work beautifully. Eventually, though, these traders get discouraged when they figure out that 75 percent of the time, markets are trading sideways, as professionals chop the Holy Grail seekers into mincemeat.

This may lead traders to the world of options, where they start looking at spreads to contain risk and writing premiums to generate monthly income. This works great when the markets are chopping around, but then when the markets start trending again, these positions can, and often do, get killed.

The list goes on and on. At various stages throughout this journey, after traders have studied a number of systems, strategies, and indicators, one day they sit down and create what they think is the perfect chart with the perfect indicators. Then they start to use it. It may work well for the first couple of days, or even the first couple of weeks, but then the traders get burned on what they thought was a perfect setup. So, instead of using an MACD (moving average convergence divergence) with a setting of 12, 26, 9, they read somewhere that a setting of 12, 17, 10 is faster. They go in and reformat all their charts with the new setting and eagerly await the next trading day. Their setups work for a couple of days or a couple of weeks, and then a couple of trade setups don't work out. Back into cyberspace the traders go.

They are determined. They are focused. They neglect their family, miss their daughter's softball game, and lose track of time. But it's all worth it, because seven days later, at 3:45 in the morning, they discover what they've been looking for. On their stochastic, they've been using the settings 14, 3, 3 when they should have been using 15, 3, 1! They put it on a chart and apply it to historical data. It works much better! The traders once again reformat all their charts and, once again, eagerly await the next trading day.

And when this doesn't work, they go from a 15-minute chart to a 13-minute chart. And when that doesn't work, they switch from trading the E-mini S&P to trading the E-mini Nasdaq. And when that doesn't work, they learn that the euro is the place to be. And when that doesn't work, they become gold bugs, because, don't you know, it's the only real money? It's always, always, always the next best thing. This cycle repeats itself forever until the trader gets sick of this roller coaster and jumps off at the next stop. Most never figure this out and remain stuck here for the rest of their trading lives. Their kids go from diapers to dormitories, and they barely notice because they're still lost, tweaking the next best thing, never realizing that they're the chump with the strategy who would be welcomed with open arms in any casino. Like Duluth, Minnesota, in February, it's a terrible place to be.

This whole situation is summed up succinctly by one of the hedge fund characters in Ben Mezrich's entertaining book *Ugly Americans: The True Story of the Ivy League Cowboys Who Raided the Asian Markets for Millions*: "The whole game of arbitrage is spotting who the asshole is. If you can't spot the asshole—well, then you're the asshole."

What Are the Signs That a Trader Is Stuck in Phase I, II, or III?

Here are a few additional anecdotes and situations that let traders know that they are still stuck in these beginning stages of trading.

Good Till Close

A popular order type for swing traders is called a GTC order, or "good till canceled." This means just what it says: "Keep my order in place until my target is hit or until I cancel the order." My partners and I, as well as many brokers, refer to GTC orders as "good till close." This is because many traders will keep their "good till canceled" order in place right up until price action gets "close" to their order. What happens is that the stock they are in is rallying hard and approaching their GTC sell order. They start looking at the stock and think, "Wow, this stock is acting great! I don't want to get out of it because it's going to keep heading higher." So they call their broker and cancel their GTC sell order. The stock rallies, pushes up through that order level, and then eventually starts to sell off. The trader has no exit strategy, and the stock continues to fall and turns into a losing trade. This starts off as a greed play and turns into a fear play. When this happens to traders often enough, they start to get really fearful about losing money.

Size Really Does Matter

When traders get scared and start to put most of their focus on not being wrong, a variety of bad things start to happen. The most common is that the traders get into a new position, and as soon as they see a small profit, they take it. They buy the minisized Dow at 10,100, and it goes to 10,104. Even though there are screaming buy signals in place and there are zero sell signals, they, miracle of miracles, have a profit, and they'll be damned if they are going to let the market take it away from them. So they pocket the four Dow points, which amount to \$20 per contract, or about \$14.00 after commissions. Never mind that the Dow goes on to rally another 40 points before it gives an exit signal.

What happens is that these traders are taking a four-point profit, a three-point profit, and a six-point profit, and then the last trade of the day goes 30 points against them. So the traders have three winners out of four, but they are down on the day. And this is kind of a typical thing that'll happen to traders who are in this frame of mind of not wanting to have to go through the pain of watching a profitable position go all the way back into the red.

Many brokers actually analyze their clients' accounts in order to predict when they are going to blow up. This way they can hedge the traders before the losses actually occur, essentially trading against their clients. The number one indicator that a trading account is going to blow up is an increase in the frequency of trading combined with an increased use of market orders instead of limit orders. Firms that hedge see this situation develop, begin to lick their chops, and fade their customer's account, taking the opposite side of every trade. In general, traders who suddenly start taking smaller profits are also trading much more frequently than they used to. It is important to realize that some firms will see this activity and take specific action, because 90 percent of the time this means that a trader is about to blow up his account. Don't be the trader who comes up on the broker's radar screen as a hedging candidate.

Yes, size does matter. Bigger losses are a lot worse than smaller profits. However, a trader who takes small profits because of fear is not following a plan. A trader who is not following a plan, who is reacting only to internal emotions, is going to get beaten. Not maybe. Not probably. *Going to*.

Greed Is Bad Nourishment for the Brain

There are limitless ways in which traders can sabotage their accounts, but this is a particularly good one. What happens is that traders get into a comfortable routine. Maybe they are averaging \$250 a day trading the mini-sized Dow on a \$50,000 account. This, for them, is a reasonable goal with the capital they are trading. One night such a trader is at dinner with his spouse, who asks how the trading is going. The trader responds that all is going great. The spouse is pleased and says something like, "Well, since your trading is going so well, I've been thinking that I'd really like to get a BMW. Can we go ahead and get one?"

And so the next day, the trader wakes up and thinks, "Okay, if I'm going to get this BMW, I've got to step up my trading and start making \$750 a day. This way I can set aside a large down payment, and I can get the car in the next six to eight weeks." The very second a trader utters those words, a trigger clicks in the remote recesses of his mind, and he has unknowingly entered a period in which he will not be able to do anything right. Instead of sticking to his original parameters, he is going to start reaching for more. What used to look like a perfectly good 20-point profit in the mini-sized Dow now looks puny—it certainly won't have much of an impact on the BMW purchase. So the position doesn't get sold, and the trader sits back and waits for the market to give him more money. The market inevitably turns, and the trader ends up getting stopped out for a loss. In this mindset, what once used to look like a reasonable profit becomes too small, and this throws the entire trading plan out the window.

I remember working with one trader who was in almost exactly this situation. He was a good trader, but he had recently entered a losing streak, and he couldn't figure out why. I asked him if he suddenly was trying to trade his way into any big, specific purchases. Yes. Aha. Something for his wife. We talked about this

phenomenon for a while, including the story about the fur coat, which is described in *Reminiscences of a Stock Operator*, by Edwin Lefevre, a book that is a must read for all traders. My friend paused for a moment and rubbed his chin. "Well, I think I know how to fix this problem," he said. "I'll just divorce my wife."

This is the home run mentality, and it's a pitfall for all traders. It's important for the trader to remember that the market is not going anywhere. Like an all-you-can-eat buffet in Vegas, it's going to be there all the time. There is no reason to try to load up your plate to the max on your first trip through the buffet line. You can grab your plate, mosey on over to the buffet, pick up a couple of pieces of shrimp, and saunter back over to your table and enjoy them. Then, when that's done, you can go back and pick out a few slices of brie. There is no need to be a hog and load up your plate. The buffet is always going to be there. A person can sit there all day and take little nibbles from the buffet all day long. Remember, in the markets, bulls can win and bears can win, but pigs get slaughtered.

Speaking of Jesse Livermore

Many traders know that *Reminiscences of a Stock Operator*, by Edwin Lefevre, is a book about Jesse Livermore, the famed trader who made approximately \$100 million in 1929 dollars in the stock market crash (about a billion in today's dollars). What many people do not know is that on March 5, 1934, he filed for bankruptcy, and on November 28, 1940, he blew his brains out in the bathroom stall of a hotel. Although this may not sound like a strong endorsement for the book, it is a must read for any serious trader. While this book talks about the trading strategies that made him his fortune, the book *Jesse Livermore, World's Greatest Stock Trader*, by Richard Smitten, also goes into detail about the years and days leading up to his suicide.

I majored in history, and I was trained to take pieces of historical data and form an opinion, based on facts, about what really happened in the past. From what I've read about Jesse Livermore's life and eventual demise, my opinion is that he suffered a bout of euphoria after the 1929 crash. This euphoria caused him to trade recklessly and with huge size, and this caused him to lose his fortune in less than five years. Although he had gone broke and made a fortune three times before, the size of this loss did permanent psychological damage, and the pressing weight of "trying to make it all back" is what eventually did him in. Let's take a look at what euphoria can do to a trader.

Euphoria: Redefining Stupid

Euphoria is the worst emotion for a trader to succumb to, even worse than greed. What happens with euphoria is that traders have such a great day in the markets that they proclaim themselves king of the trading world. Let's say they normally trade 10 contracts. Well, now, since they are "king" they are going to start off with 50 contracts, and go up from there if they feel like it. After all, they are now "the world's greatest trader" and can do no wrong.

This happens to traders frequently, and the resulting act of insanity is just like doubling each bet on a roulette wheel. People can sit on red and keep doubling up on each bet until they win. This works great right up until the time that they have maxed out their capital on red, and the color comes up black. Doubling and tripling up on positions just because a trader is feeling confident is yet another sucker's game. What's worse is that this strategy always leads to traders giving back all the fantastic gains that made them euphoric in the first place. This places added pressure on them—now they have to trade in order to get back to where they were. This, of course, causes a multitude of bad habits.

Increasing trading size just because you are feeling awesome about your trading is like being in a marriage that is going fantastically well. The conversations are sparkling, the mutual adulation is adoring, and life under the covers is grand. Happiness abounds in spades. How can you make this better? Double up! Have an affair. It may seem like a good idea in theory, but this is going to turn out only one way—very, very badly.

Paper Trading—Why Is It More Worthless Than an Iraqi Dinar?

When I wrote the title of this section in 2005, I never imagined that there would be a growing popularity of advertisements from firms pushing paper Iraqi dinars as an investment. Admittedly, the ads sound very appealing. For just a few thousand dollars, you can buy a million dollars worth of dinars, and "when the dinar goes to parity with the U.S. dollar," it will then be worth a million U.S. dollars. And of course the firm that is selling these dinars is also the only place where a market is being made. Never mind that this exchange rate is a hoax and that the black market for dollars in Iraq is many multiples of what is being shown in the advertisements (that is, the Iraqi dinar is even more worthless than advertised because people prefer having U.S. dollars). Hopefully I'm not the first person to give the heads up that this is one of those scenarios where "if it sounds too good to be true, then pull your head out of the sand, because it is too good to be true." Yes, at some point the dinar may be pegged to the U.S. dollar, but that is not even in the ballpark of going "to parity" with the U.S. dollar. And if it does go to parity with the U.S. dollar, guess how that will happen? It will be revalued. Iraqi dinars can be printed at will. That does not constitute rarity and value. The few thousand dollars you are tempted to throw at this in the hopes of turning it into millions would be better served by putting them toward a vacation or something tangible like silver. And even if you want to sell it, who is going to buy it? There is no market for it. Ah, but there is! Go on eBay and sell it to someone who thinks it's going to parity with the U.S. dollar. But hurry before the jig is up. If you have any doubts, then think of it this way—if this were a legitimate opportunity, then George Soros would already have cornered this market. He knows a little more about currencies than you and I do.

This reminds me of the "ostrich scam" that hit Texas a decade or so ago. Breeder ostriches were going for \$50,000 each because of the high nutritional value of the meat. Unfortunately, no one bought the meat, so the breeders just kept selling their stock to other people who wanted to breed ostriches, and so on, until everyone who wanted to breed ostriches had them. After that, you literally couldn't give the large birds away, and to this day there are some of them roaming free on the Texas plains. Which brings us back to paper trading.

There are a few good reasons for people to paper trade. Paper trading will help a trader learn a new execution platform. This way, she can figure out how to use the software through a demo account and save herself the costly errors that can arise when people they try to place orders on an unfamiliar system. Also, paper trading is good for forward-testing a system or strategy to see how it works before committing real money. However, paper trading does have one distinct disadvantage—it can be worthless in a way because it does not take into account how a trader will act when there is real money on the line. That is what makes or breaks a trader. It's okay to trade smaller size, but without real money on the line, a trader won't understand how she holds up under pressure. This is also a good way for a trader to test how far apart she is mentally from "paper trading vs. real trading." A trader should feel the same, or at least as close as possible, when trading paper as she does when she is trading with real money. To the extent that she feels extreme emotions when she is really trading rather than paper trading, it will give her a clue as to where she is on the psychological trading scale. In other words, how screwed up is she psychologically when she is actually trading with real money? When a trader freaks out on a real trade, it is a red flag that she is trading too big for her account size. Her judgment goes to zero, and financial ruin is just around the corner. In this case, a trader should

keep trading smaller size until she feels the same emotionally as when she is in a paper trade.

Building up trading size is very similar to building up muscle with weights. The first time a person goes into the gym, he may only be able to bench-press 140 pounds for 10 repetitions. A month later, he is able to push 140 pounds 15 times, at which point he ups the weight to 150 pounds for 10 reps. This continues over the course of a few years, at the end of which he is cranking out 200 pounds for 10 repetitions. Yet had he tried benching 200 pounds at the outset, he could literally have killed himself. It's the same in trading. The first time I lost \$1,000, I threw up. The next time, I merely choked on my own bile. By the tenth time, it became something that my intestines could handle. At that point, I realized it was time to up my trade size to where I could risk \$1,500 on a trade without getting "too intense" emotionally. And as the years went by, I was able to increase that to larger and larger amounts as mentally and emotionally I got used to the dollar swings on my scoreboard. And it has to be treated as such—a scoreboard. The moment you start thinking in terms of purchasing power, of something that you could buy with your winnings or could have bought with the current losing trade, all is lost. Emotions at that point rule the day, and that strategy only works to the trader's detriment. One thing I've studied over the years, and we've come out with irrefutable proof—staring harder at the screen does not make the market do what you want it to do. If you find yourself staring intently at the screen, it's a heads-up that you are trading too big for your account size.

The most dramatic instance I've seen of this is in working with traders in Asia, specifically in Taipei, Hong Kong, Tokyo, and Shanghai. Asians are fantastic gamblers, willing to risk huge sums. This can be a problem with trading, and it takes only one bad trade to ruin an account. One guy I worked with was trading 100 lots at a time in a \$100,000 account (obviously using the maximum day-trading margin). Each 1-point move in the S&Ps represented \$5,000. The first day he made 5 points (\$25,000), and the next day he lost 7 points (\$35,000). These were normal fluctuations for him, and it showed. He'd get so excited and animated that I thought he was going to implode. I had him cut his size down to 10 lots. At first he was bored, but then a strange thing happened. He wasn't excited, so he traded objectively ... and he made money. We got him to trade in the same mental state he was in when he was paper trading, and it made all the difference. Being able to work with traders overseas is a great win/win for me, as I get to learn how other people view the U.S. markets, as well as see how U.S. news is filtered through their local news channels. Being able to put yourself in another person's shoes brings more understanding of how the world really works. That may not help you decide whether or not to take the next trading setup that comes your way, but it does help you form a macro view of the world—and it does make life more interesting.

But What About Phase IV—How Does a Person Learn How Not to Lose Money?

This is the trickiest part for traders to get their arms around. Learning how not to lose? In trading, first you lose, then you learn how not to lose, and then, and only then, can you get on the road to generating a consistent income. "Learning how not to lose" is a simple way of summing up everything we've talked about up to this point. It's about having the patience to wait, the courage to get out, and the integrity to follow your plan—all of that leads to learning how not to lose. It's about focusing on limiting risk, not having to be right, and limiting the downside so that the upside can take care of itself. And once this starts to sink in and you get comfortable with "learning how not to lose," then and only then can you make the transition to generating a consistent income from trading. Ironically, though we all think we are different and unique human beings, people who lose consistently in the markets over time all do exactly the same things. They (1) overtrade, or trade way too frequently, (2) use too tight stops (their fear of loss is so strong that they don't even give the trade a chance to work out), (3) trade with too much leverage (they would be far better off trading smaller size), or (4) have one big loss that wipes out a big chunk of their account. Losing traders consistently do at least one—if not all—of these four things. I've looked at hundreds of brokerage accounts, and they all tell the same story. In fact, I know traders who fixed their trading simply by doing the opposite of this. They (1) undertrade, or trade one or two solid setups each day, (2) use too wide stops, staying outside of the market noise, (3) trade with appropriate leverage, which is why they are able to use wider stops, and (4) never have a big losing trade. It really can be that simple.

Why Does the Plateau Money Management Method Work?

Up to this point, I haven't talked about a specific money management method, but there is one I'd like to talk about now. It's something I've been surprised to find that not many traders think much about. The usual mindset is, "Get some setups, follow them, and make some money." Yet once a trader has his psychology in check, the next issue that has to be resolved is money management. There are innumerable methodologies and schools of thought where money management is concerned. And plenty of them work, at least up to a point.

What many money management systems fail to acknowledge is that as traders inch up the ladder of profitability, they frequently hit mental plateaus. Maybe a trader can start with a \$25,000 account and run it up to \$40,000, but then, instead of climbing still further and taking the account to the next level, the trader plateaus, and things begin to fall apart. This \$40,000 plateau becomes an invisible barrier that holds the trader down and prevents him from moving to the next level. Plateaus can easily turn into very real stumbling blocks. They can trigger bad habits, usually based on the idea that a trader now has a "comfortable cushion of cash" to work with in his account. This makes him lax, more prone to break his rules. This amount will be different for everyone. Maybe you have a \$5,000 account and you do a great job running it up to \$7,500, but when you reach that, you hit a big losing streak. Or maybe you have \$75,000, and every time you hit \$100,000, you start trading with "house money" and getting more aggressive, and soon you find yourself back at \$75,000.

I've struggled with this problem myself over the course of my trading life, although my plateaus have grown over time. It's almost like lifting weights. You have to reach new levels all the time, not just in terms of your trading skills, but in terms of figuring out how to wrap your mind around specific amounts of money. You have to get comfortable with progressively larger and larger sums.

I have solved this problem by employing a particular strategy that I call "the plateau method" of managing my day-trading accounts. Specifically, this is for trading shorter-term, highly leveraged accounts such as futures, forex, and options. I don't use this methodology for swing and position trading.

Let's use a \$10,000 hypothetical starting account. Your initial goal is to run the account up to 2.5 times your starting capital, which is \$25,000. (This is an example; your amount to reach may be different.) Under this methodology, when you reach your desired target (\$25,000, in this case), you withdraw your original \$10,000, plus a profit of \$2,500, leaving you with a balance of \$12,500 in your trading account.

Now you tweak your goal. Instead of \$25,000, your aim is to run your account up to 2.5 times your new starting capital, which equals \$31,250 ($\$12,500 \times 2.5$).

Once you reach your target of \$31,250, withdraw half of the account (\$15,625) and reset your goal.

Now your goal is to take the \$15,625 and increase it 2.5 times yet again, making your goal \$39,062.50. When you reach that target, take out half, and continue.

The time it takes to do this isn't critical. You aren't focused on achieving your target in a week or a month or a quarter. You're simply following your plan and taking your setups, and when you hit the plateau, you'll take money out and establish a new goal. When you're trading leveraged instruments, one solid runner can make a big impact on your account. This is why it is so critical to keep your losses small.

Here's the key: you aren't trading your whole stake. If you have \$50,000 with which to trade, then use only \$10,000 as your stake to get started. This allows you

the freedom to take bigger risks, because it's only \$10,000 of your \$50,000. And if your \$10,000 gets wiped out, then you have another \$10,000 to put in and try again until you've got the hang of it.

Naturally, not everyone is going to have \$50,000 in starting capital. If \$5,000 or \$10,000 is all you can manage, that's fine. Just be careful not to piss your capital away on undeserved risks, trades that are typically taken out of boredom. Wait for the "Porsche setups" and pass on the "Pinto setups" that I talk about later, and establish a trading plan that insists on only the highest-probability trades. And now you know you'll keep your word and follow your plan, because you're committed to trading with integrity, remember?

The plateau method works because it assumes that you have passed the first few phases of the trading journey and are now content to simply wait for the best setups that work with your plan. As with any trade, you'll want to consider the market within more than one time frame, always "zooming out" to see the bigger picture, which helps you maximize winners (more on this later). And remember that there will be days when nothing is setting up for you. When those days come and go, review your charts at the end of the session and take a good, hard look at all the crappy trades that some poor bastards stuck in Phase II took, and then pat yourself on the back as you think about all the money they lost that you held on to (because you have learned how not to lose). Some of the best trades are the ones not taken.

People who overtrade or trade without money management plans are trading an incomplete system and fall into that category we're all so eager to avoid—the 90 percent of traders who are going to lose their accounts to those of us who have trading plans in place that include quantifiable and specific money management plans.

Trading with small sums—ideally just a part of your trading capital, not all of it—on a limited number of reliable, proven setups opens up the opportunity for extraordinary results. When you add the plateau method of managing your gains, you have the added benefit of holding on to the capital you worked so hard to acquire. When you have a working methodology to focus on, you're not just looking for the next winning trade. Though individual trades are obviously critical, when viewed through the lens of your grander plans, each trade becomes just a brick in the wall of wealth you are building. Yes, some of those bricks will fall off the wall, but you are building tools to replace those bricks and continue building.

When Trading and Investing, What Are the Best Ideas to Keep in Mind?

A trader's relationship with the market is really like a dance, and it's best to let the market lead. It's important not to come into the market with an overly bullish or overly bearish outlook. The more strongly a trader believes in an idea, the easier it will be for her to get suckered into taking the wrong side of a trade. In an upcoming chapter, I talk about how to read market internals, and this is a great way to get a reading on what's happening in the markets. Instead of coming into the day a raging bull or a roaring bear, I just come in as an interested observer. The "radar screen" that I watch keeps me in the loop and gives me odds on the path of least resistance. As long as we're dancing together, I'd like to know when my partner is going to try to dip me.

The reality is that the markets do move in cycles. My studies in history had a huge impact here. I could clearly see that since the beginning of modern civilization, the world had gone through a number of repetitions of similar events, all driven by human decisions. This insight really changed my focus and how I looked for opportunities in the markets. I stopped looking for the next great indicator and started looking for repeatable market patterns based on human nature.

A great book that falls within this theme is *The Secret Life of Real Estate and Banking*, by Phillip J. Anderson. The dry title does not do this book justice. It's a great and fascinating read, and the author is incredibly passionate about his subject matter. With great stories and examples, he documents how a real estate price cycle that has repeated every 18 years since the United States was formed peaked right on schedule in 2008. More fascinating is how the actions of speculators, bankers, and politicians—all of whom are reacting to the price movement of real estate—were all nearly exactly the same during each one of these 22 cycles. In other words, none of the stuff you are seeing on TV today is new. Politicians, banks, and speculators have been reliving their lives and policies right on cue in predictable, 18-year cycles. This knowledge is priceless when it comes to financial planning and real estate investing—not to mention keeping the latest headlines in perspective.

And there's a little saying that I always like to remember; it's called "discipline before vision," which is something I first heard from Peter Borish, the former head of research for Paul Tudor Jones. I may think that the market is going to crash today, but I'm still going to have a stop in place in case I'm wrong. The vision of being short during a crash is a pleasant one, and the thought of a big move leads traders to do stupid things, like doubling up and adding to losing positions. Disciplined traders live to fight another day. Through most of 2004 and 2005, I heard many traders who were "staying positioned for the next, inevitable terrorist attack." After the events of September 11, they saw how that had affected the markets, and they wanted to get positioned for the next attack. (Yes, this is a terrible way to look at a disaster, but this is how traders think. If there is a hurricane in Florida, then it's time to go long lumber because they will have to rebuild a lot of houses.) The funny thing is, this vision of being positioned for a crash totally clouded their judgment. The only thing the market hates is uncertainty. The events of September 11 were unexpected, and the market got crushed. However, terrorist activity is now a certainty. It is no longer an unexpected event, and therefore the market has already priced in future terrorist attacks. Sound insane? On July 7, 2005, America woke up to the news of the London bombings. At one point, the Dow was down more than 200 points before the market open. All of these people got heavily short. The markets rallied and closed positive on the day, and these "waiting for the next disaster traders" got crushed. Discipline before vision.

This also ties in with one of the main themes of this chapter: do you want to be right, or do you want to make money? Just think if you had kept buying the dip on the day of the flash crash. You would have been wiped out.

Another reason to rely on discipline before vision is that a stock or a market can move for any reason. It doesn't have to be logical or rational. It could be world events: war in the Middle East, a fragile European economy, or politicians who refuse to work together. But it could be something completely different—something that Maria Bartiromo can't tell you, can't predict, and can't figure out.

For example, one day when I logged into my trading account to set up some buy orders, I was told that my buying power had been exhausted. I keep solid mental track of my stock and option positions, and I knew that I should have plenty of buying power. I checked my records, knowing that I'd be flat. But what I saw on my computer was that I'd depleted my buying power on 60,000 shares of IAG, a gold stock. I called to confirm that and was told that, yes, I'd made that trade. But I knew I hadn't.

Then I got an instant message from a new employee named Henry Gambell. Henry, who'd recently set up a demo trading account, told me that his "demo" account had come up nicely on 60,000 shares of IAG he'd purchased.

Really?

I started looking at all gold stocks. Every one was down except for IAG, which was up by 50 cents.

I looked at the markets, and I couldn't figure out why IAG was up. Was there news? No. So I went back to a one-minute chart and found a huge volume spike—right at the open—in IAG. Henry, having thought that he had logged into my demo account but in fact having actually logged into my real account, had purchased 60,000 shares of IAG at the open, at the market price. To this day, I'm convinced that other black box systems saw this "volume spike" and started buying the stock

based on “unusual activity.” Single-handedly and inadvertently, Henry, a demoaccount trader for all of two weeks, had driven up the price of IAG, while all other gold stocks were going down. I brought Henry into my office and explained what had happened. He turned white as a sheet and got very nervous, very quickly. I told him he needed to manage the trade now and get out of the position. He started to sell all 60,000 shares at market, but I stopped him. I explained the need to scale out of the trade 1,000 shares at a time, waiting a few minutes in between sell orders. He did that for the next hour and eventually closed out the entire position for a nice profit—it covered his salary for a year.

It was a good lesson for me—watch those demo account logins. It was a good lesson for Henry as well—market movements are not rational, so control your risk on each and every trade.

Toward the end of the day, he did ask, “So do I get to keep any of the profits?” My response? “If it had lost that much money, would you have been able to help cover any of the losses?” We called it even.

Since market moves can be irrational, one needs to focus on limiting one’s risk on every trade, not obsessing over why the stock price is going up or down. It is also important to remember that there is no need to spend wasted years looking for complicated setups or the next Holy Grail. There are very simple setups out there to use. Some of the best traders I know have been trading the same setup, on the same time frame, on the same market for 20 years. They don’t care about anything else, and they don’t want to learn about anything else. This works for them, and they are the masters of this setup. They have nothing else coming in to interfere with their focus. If a setup doesn’t happen that day, then they don’t take a trade.

Other successful traders I know have learned to discipline themselves whenever they break their stop loss rules. One trader I know would jump into his Chicago outside swimming pool … in January. It took two times, but he hasn’t broken his stop loss rule since. Another trader writes a check to a charity he doesn’t support, in this case the ACLU. (That’s going to be different for everyone.)

When Jesse Livermore was in the process of making his fortune, one of his favorite quotes was, “If I bought a stock and it went against me, I would sell it immediately. You can’t stop and try to figure out why a stock is going in the wrong direction. The fact is that it *is* going in the wrong direction, and that is enough evidence for an experienced speculator to close the trade.” Small losses make all the difference, and traders must learn to reward themselves for doing their job in this regard.

It is important to remember that traders are not trading stocks, or futures, or options. Traders are trading other traders. There is another person or system out there that is taking the opposite side of the trade. One side is going to be right, and the other side is going to be wrong. Whoever has the better psychological perspective and money management system in place on this trade is going to win. Is the trader on the other side of the trade an amateur or a professional? That trader should be wondering the same thing about you. The next time you succumb to greed and chase a trade, remember that there is a professional somewhere else in the world who has been waiting patiently for this setup and is doing just the opposite.

I have found that the most important step in becoming a successful trader is just learning how to accept a loss without any anger or frustration or shame. It’s just part of trading. It’s not a big deal. I take losses every day, and I do it live in front of people all the time. It’s just part of the process. Okay, this trade just hit its stop. Next. It’s like Tom Hanks’s character in the movie *A League of Their Own*, who screams at his female player and makes her cry. “Are you crying?” he asks, shocked. “There’s no crying in baseball!”

And there’s no crying in trading and no throwing your coffee cup against the wall or screaming at your monitor. Losses and missed trades are just part of the deal. On some days, things are just not going to come together. If I’m using a setup and I’m stopped out two times in a row, then I just stop using that setup for the rest of the day. For whatever reason, it is out of sync with the markets on that particular day. It’s no big deal. There is no need to reformat the MACD. It’s just part of trading.

The key is to have two specific sets of rules. First, there needs to be a trading methodology. For this setup, do the traders go all in or scale in? Do they scale out or get all out at a specific target? Do they trail a stop or leave it? Where is the stop placement in relation to the target? These are all things that have to be set in stone before the trade is placed. Once the trade is placed, there is no room for rational thought. The setup has to be followed the same way each and every time, or the traders will never be able to gauge whether the setup is going to help them or hurt them in their trading. Without that information, they are just making impulse trades, and those are the sucker trades. Second, there has to be a money management rule. How many shares or contracts does a trader allocate toward this setup? How much equity is a trader willing to risk on this setup over the course of a day, a week, a month, or a year? After traders do this for a while, what happens is that they develop the habit of following their rules and they eventually learn to trust themselves.

Once traders learn to trust themselves, they can then free their mind to focus on the market opportunities that present themselves, instead of being wrapped up tight in a ball of fear, frustration, and doubt. This is where traders make the transition out of the first three phases and begin to really have an opportunity to do this for a living. The transition involves focusing on developing their own trading skills instead of focusing on the money. And the skills are easy—keep your emotions in check and have the discipline to follow the setups. Don’t focus on making \$1,000. That is what the amateurs do. Focus on developing your skills and executing the setups the same way each and every time. It sounds simple enough, but I’ve worked with enough traders to know that most of them can’t do it over the long haul. They get impatient and don’t want to miss out on the action, so they jump in and chase without a clear setup. Once they do this, they go back into the barrel with all the amateurs.

Most of trading involves waiting. First, it involves waiting for a setup. Once the setup occurs, then the professional trader takes it without hesitation. The skill comes in waiting for it to set up and not succumbing to an impulse trade. Then, once she is in a setup, a trader has to have the discipline to wait for the exit parameters to be hit and not cave and bail out too early. Waiting is the hardest thing for many traders to do, but it’s the waiting that separates the winners from the losers. Even for a day trade, it can be hours before a setup happens or a parameter is hit. And that’s the whole key: just being patient and waiting. The person who chases four rabbits catches none.

Also, it is important to realize that professional traders are not in every move. It is okay to have the market leave the station without you. Catching every move is impossible, but chasing every move is the mark of an amateur. This is why it is imperative for traders to have a set of rules to follow for both entries and exits, as opposed to relying on their own gut feelings to manage a position. Develop a set of rules and have the discipline to follow them; they exist for your protection.

For me, the biggest difference in my trading occurred when I learned to ignore my brain and just focus on a handful of good setups. Once I learned the setups, the next challenge was to have the discipline to follow them the same way each and every time. No thinking, no hemming and hawing. I did this by recording my trading activity and grading myself on how well I executed each setup, instead of on how much money I was making or losing. Whereas focusing on the P&L automatically encourages the bad habits that plague many traders, a setup-based approach encourages habits that can push a trader into the realm of consistent profitability.

In the end, professional traders focus on limiting risk and protecting capital. Amateur traders focus on how much money they can make on each trade. Professional traders always take money away from amateurs. Amateur traders start to turn into professional traders once they stop looking for the next great technical indicator and

start controlling their risk on each trade.

For additional information on trading psychology, visit www.tradethemarkets.com/psych for updated free videos on the business of getting into the right frame of mind for trading.

You cannot be disciplined in great things and undisciplined in small things.

Brave undisciplined men have no chance against the discipline and valor of other men.

Have you ever seen a few policemen handle a crowd?

GENERAL GEORGE S. PATTON

Quotes by Paul Tudor Jones

Every day I assume every position I have is wrong.

Losers average losers.

There is no training, classroom or otherwise, that can prepare for trading the last third of a move, whether it's the end of a bull market or the end of a bear market.

You adapt, evolve, compete, or die.

Trading is very competitive and you have to be able to handle getting your butt kicked.

Failure was a key element to my life's journey.

Where you want to be is always in control, never wishing, always trading, and always, first and foremost protecting your butt.

At the end of the day, the most important thing is how good are you at risk control.

Hardware and Software— Top Tools for Traders

Any sufficiently advanced technology is indistinguishable from magic.

ARTHUR C. CLARKE

Let's put some lipstick on this pig!

MERRILL LYNCH STOCK ANALYST

(As per Former Attorney General Eliot Spitzer)

Hardware: When It Comes to Your Trading Computer, What Are the Most Important Things to Know?

First off, I want to thank Henry Gambell for updating the technology part of this chapter. When I first wrote this book, I did pay some attention to technology, but now that I'm working with Henry, I let him handle it, as he pretty much knows everything there is to know about it. The first time I met Henry was when I called the Geek Squad. I was having some problems with my PC that I couldn't figure out, and they sent him over, a wide-eyed kid from Odessa, Texas. We got to know each other, and about six months into our knowing each other, I offered him a job. In addition to keeping our office up to speed on the latest and greatest computer hardware and software, he is cutting his teeth in the world of options trading and learning just like everybody else—the hard way! Let's dive in.

This chapter is about creating a level playing field for all traders with respect to the equipment and software they are using to tackle the markets. If traders can get this part right, they are at least going to have a fighting chance to compete on a level playing field with everybody else. If traders are behind the technology curve, they are going to be at a distinct disadvantage in their trading. In trading, someone without an edge in terms of equipment, mental outlook, and methodology is like a newborn, wounded wildebeest trying to snatch a drink at the edge of a crocodile pond. In other words, he ain't gonna make it. Why would people deliberately create a weakness in their trading plan by having trading software or technology that is outdated? It would be like entering the Daytona 500 with a Winnebago. This is the easiest part of a solid trading plan, and it is 100 percent under a person's control.

The amount and type of trading equipment that a trader has is going to depend a little on her own financial resources, and a lot on the type of trading she is doing. There are several things to remember when purchasing a new PC, the first being that you're purchasing a depreciating asset. Intel cofounder Gordon E. Moore stated in 1965 that the number of transistors that could be placed on a circuit board would double every two years. His prediction was uncannily accurate, and processing speed continues to grow exponentially. The semiconductor industry uses this law in its long-term planning, and you should too. As this law continues to hold true, cost continues to drop, and the PC you buy today is likely to be eclipsed in three to four years, if not sooner. Rather than spending \$5,000 on a be-all and end-all system, a trader can buy a well-equipped PC for under \$2,000 (not including displays), upgrade in two years, and still be ahead of the pack.

There are several key components of a PC's performance. For traders, the most important is RAM. Random-access memory is the storage medium used for running applications. Every chart, Word document, or Internet browser you open occupies RAM. If you notice that your PC runs great when you have a single application open, but is sluggish or unusable when you are running several charting platforms, RAM is probably the culprit. RAM prices continue to fall rapidly. As I'm writing this on August 10, 2011, Newegg.com boasts 8 GB of DDR3 (very fast RAM) for \$48.99. That's 10 double lattes at Starbucks. These prices make it very feasible for you to have a desktop that's stuffed to the gills with RAM, and this is one investment you won't regret. Now, before you go out and order three pallets of the stuff, be sure to check your existing system specifications. RAM is limited physically by the number of available slots in your PC and limited in software by what's referred to as the *4-GB limit*. In short, traders who are looking to use more than 4 GB of RAM should make sure that their motherboard and BIOS support it and be running a 64-bit version of Windows. (Now you understand why I have someone like Henry helping me out instead of trying to figure this out for myself. Keep reading, however, as this will get easier.)

The next component to decide on is your processor. In the mid-2000s, the focus of chip manufacturers was all about speed, or how many gigahertz they could squeeze out of a chip. The focus has now shifted to the number of cores, and as a result, overall performance has grown exponentially. Think of this as follows: would you rather commute to work on a 1-lane highway with a 70-mile-an-hour speed limit, or on a 12-lane highway with a 60-mile-an-hour speed limit? The new chips have 12 lanes, making getting to your destination that much faster.

Traders really benefit from this technology, as it allows them to do more things at once without having wait for their computer to catch up. Intel currently dominates the high-performance market with its flagship i7 2600k processor. This is the first chip to ship "unlocked," meaning that users can turbocharge their PC to speeds that were just dreamt about five years ago.

A trader's computer should be set up specifically for trading and have a minimum of other stuff going on. If there are kids in the house, make sure they have their own computer for Internet surfing and computer games. Believe me, gaming manufacturers fully understand that kids know how to click buttons, and many of those buttons automatically start downloading a variety of crap and spyware right onto your computer. When you're on your PC, follow the Golden Rule—if you don't know who it's from or what it is, don't open it. Or if it seems like an odd request, don't follow it. Assume it is a trick (because it probably is). If it's real and important, the person will get back to you. Let me put it this way: every time I've shown Henry a link I didn't click, he said, "Thank you for not clicking that and destroying your computer." When in doubt, think it out.

What About Monitors, Graphics Cards, and Other Gizmos?

One question I receive a lot from traders is, "How many monitors do I need?" This really depends on what you are trading. I personally utilize six monitors for viewing charts and two additional monitors for other tasks such as e-mail, instant messaging, and Internet surfing. These are set up on two different computers, using software called Input Director to share a mouse and keyboard across both computers. This means I don't need a separate keyboard and mouse for each computer, which is really awesome. The mouse arrow just glides along from one computer to the next and makes it seem like the setup is all part of one giant monster computer,

instead of two separate ones. (Note: I also like to sit on a balance ball for about half the day. This keeps your core strong and helps prevent backaches.) I used to trade out of my house, and then we had ... three children. I now trade out of an apartment a few miles away from my house. It was quiet for a while, and then I started hiring people to help with the website, so that I could actually keep trading. That got too noisy (like having ... three kids), so I got another apartment for them to work out of. I guess right now if we keep growing, we will keep adding more apartments.

Most traders do not need six or eight monitors, and I know traders who make a great living with just two. There's a real danger in having too many monitors, as a trader can quickly find himself with information overload. I visited one trader who had 25 monitors shooting data at him from all directions. Shockingly, he could never decide when to pull the trigger to get into a trade. It is important to remember that traders don't need to know everything that is going on in the markets. They just need enough information to be able to decide whether or not to take their setup, to understand their small corner of the trading universe. All of the successful traders I know focus on just a handful of setups. They don't need a confirming move in crude oil in order to take their buy signal on the S&Ps. If traders have found one or two setups that really work for them, then they can, and should, ignore a lot of the data out there. Laserlike focus on a small part of the markets brings expertise and a better understanding of when to take a trade. Remember, the goal is to make money, not to "know it all."

As the cost of LCD displays continues to drop, setting up your desired number of monitors becomes feasible on almost any budget. For traders, several of the high-end features available in monitors today are not necessary. One feature that you will want to be sure you have is that the display complies with the VESA standard. The VESA standard is what is used for mounting displays and ensures that your monitor can be removed from its factory stand and secured to a third-party mounting device. The other key feature you need to focus on is the monitor's native resolution. Native resolution tells you how many pixels wide by how many pixels tall your display is. The number of pixels can be adjusted, but in order to get the best picture possible, you'll want to run the display at its native resolution. The higher the resolution, the more content you'll be able to fit on your screen. If you and a trading partner have the exact same monitor, but one of you is able to fit more onto a chart than the other, resolution is the likely culprit.

The monitors we use and recommend are Dell UltraSharp U2410s. These 24-inch monitors have accurate color reproduction, a native resolution of $1,920 \times 1,200$, and six different inputs, meaning that you could run your TV's cable box into one of the monitors via an HDMI cable and use it as your television if you like. How you connect these displays to your PC can vary depending on the video card you choose, but DisplayPort is quickly becoming the standard for digital video connections. The adoption of DisplayPort technology is exciting because it is a royalty-free standard. This means that companies won't have to pay to include DisplayPort technology with their devices the way they did with Sony's MemoryStick format (currently JPY 500,000, or roughly \$6,500 U.S. as of this writing). Anytime a standard like this is adopted, it's great for the consumer, as more devices will include the technology and there's a better chance of the standard's sticking around.

Another area of interest for traders is setting up multiple monitors in such a way that they fit comfortably on a desk, don't take up a lot of space, and are easy to access. One site I like for this is www.lcdarms.com. Here traders can get different wall- and desk-mounting solutions for their monitors. In terms of desks and chairs, this is really wide open. A door across two file cabinets works really well as a desk. There are desks available from medical supply companies that are interesting in terms of how they are set up. The desk isn't that big a deal, however. Traders just need a place to put their computer equipment. For chairs, I switch between what might considered Porsche and Pinto setups, using a Herman Miller Aeron chair and a 75-cm aerobic balance ball. Both are good for posture, and I find that switching throughout the day keeps me more alert. The balance ball is awesome because it strengthens your lower back and core muscles as your body works to keep you "in balance" while you are sitting on the ball.

Now that you've got your displays lined up and mounted, what are you going to use to push them? Most desktop PCs ship with support for dual monitors. Once you step outside that realm, things can get a little exotic. The Nvidia NVS line of graphics cards provides some of the best I've come across and offers a reliable solution at an affordable price. This line of cards is geared toward traders and features slim video cards that push high-resolution displays. It also features Nvidia's Mosaic multidisplay technology. Mosaic allows you to span any application across multiple displays or projectors from a single workstation without sacrificing performance or power. You can learn more about this technology at <http://www.tradethemarkets.com/technology>.

Why Are SSDs Important to Traders?

The typical progression for technology is to grow incrementally up to a plateau, then leap to the next level. One example would be the processor scenario I mentioned at the beginning of the chapter. Speeds get faster and faster until a physical barrier is reached, then we leap over it by introducing several cores to replace one. The same is true for hard drives. A hard drive is the physical disk that your data are stored on. Every document that you create and every cookie that attaches itself to your browser is stored on your hard drive. Hard drives have grown in capacity for years, but they continue to use the exact same technology of storing your data on spinning magnetic disks. We've gradually drifted into the 3-terabyte range, where the limits of data storage are being pushed. This spurred the next leap in technology for consumer hard drives, and once you try a solid-state drive in your PC, you won't go back.

Solid-state drives (SSDs) have revolutionized the hard drive market. Rather than using spinning disks to store your data, they use flash memory. The key difference between the hard disk drives that traders are used to and SSDs is that SSDs have no moving parts. This means that when you pull up your favorite trading platform, your drive doesn't have to spin up, seek the location of the software on the drive, and then, finally, launch. It just launches. Boom.

SSDs are also much more durable. For the traveling executive who is prone to dropping laptops, an SSD is crucial. Since these drives have no moving parts, not only are they much faster, but they are able to withstand things such as falling from a desk. Then there's PCIe SSDs. While this is still bleeding-edge technology, it makes even SSDs look slow. These drives use the same flash memory as a normal SSD, but then stripe the disks for faster read and write times and connect to the PC through a different connection. The current price for a 220-GB PCIe SSD is \$480, so they're not giving them away just yet, but if you demand the fastest performance from your PC, this is the only way to go.

Have Apple Computers Arrived in the Trading World?

Apple computers were once thought of as PCs for musicians and artists, with no real place in the business world. This belief is quickly losing ground as the company continues to make some of the most reliable computers money can buy. As far as hardware goes, the part of the machine you can actually touch, Apple excels. Its most recent line of MacBook Pros has a solid aluminum body and touchpads that are easy to use. I don't leave home without mine, and I highly recommend them. This recommendation doesn't come without a few caveats, however. Despite Apple's increase in popularity, 98 percent of trading software still requires Microsoft Windows to run. For a long time, this kept most traders from even considering the purchase of a Mac. Then two pivotal events changed all that. The first of these came

in 2005, when Steve Jobs announced that Apple would make the transition from PowerPC processors to Intel x86 processors. With the integration of these high-performance Intel chips, the door was opened for major advances in virtualization. Virtualization is the creation of a virtual (rather than an actual) version of something, in this case an operating system. What this meant for traders was that they could have the benefits of Apple hardware and stability, and still run their trading applications on Windows.

There are several ways to do this, with the most popular being Apple's Boot Camp software or Parallels Desktop. The key difference between the two is that Boot Camp runs Windows on "bare metal," so to speak, and has direct access to the processing power of your machine. Parallels runs Windows inside an application, similar to opening a workspace inside your trading platform. This method will have some overhead, but this is usually negligible provided you have a powerful enough machine. If this is something you're interested in, the Intel i7 line of processors with plenty of RAM is a clear-cut choice. For users of the thinkorswim platform, the developers programmed it to work equally well on Windows or a Mac.

Taming the Technological Beast: What Dangers Should I Be Aware of When It Comes to My Computer?

Once traders have their hardware in place, it is time for them to turn their attention to the software. There are a lot of software choices available for traders, but what this boils down to for most people is a charting program and an execution package. While these are important, there is another category of software that is vital to the trader, and this is software aimed at keeping a computer in top working order. This is by far the most neglected area for traders. Let's take a look at this first, and then we will dive into the trading software.

Trading in and of itself can be one of the most stressful occupations on the planet. One day's worth of market activity can determine whether a trader drives a new Shelby Mustang or takes the bus to work. Technological problems or disruptions increase the stress factor and cause drains of both real and mental capital. Traders who are stuck behind the technology curve are at more of a disadvantage than those who are up to speed. From software that is outdated to those Windows Updates that sit idle in your system tray for months (or years), traders who choose technological ignorance are setting themselves up for disaster. Having a trade go wrong because of technological issues is inexcusable for the serious trader who is trying to make a living at this profession.

The bottom line is that traders who want to maintain a competitive edge in this business must first be aware of the technological dangers facing them in today's world. Once they are aware of the hurdles, determined traders must then take a proactive approach and take the time to attack these issues head on. The three main technological problems for traders today are as follows:

- *PC invaders.* Where the trend used to be attacking users' PCs for group recognition or to maim your data, the biggest threat now is intruders that infect your PC and then sit idle. Once this type of software is on your PC, it waits for commands from its creator, then uses your PC's resources and Internet bandwidth to attack other PCs or networks. One of the more recent examples was Koobface, an anagram of "Facebook" that spread through the social networking site. The authors of these viruses are paid per machine infected by "bot masters," who are looking to use their newly assembled army for everything from extortion to DDoS attacks. A study by the Information Warfare Monitor, a joint collaboration between SecDev Group and the Citizen Lab in the Munk School of Global Affairs at the University of Toronto, has revealed that the operators of this scheme have generated more than \$2 million in revenue from June 2009 to June 2010. In other words, if you are online, your computer is open for attack.
- *Badware.* Badware is software that fundamentally disregards a user's choice about how her computer or network connection will be used. Like most jargon in a field, terms such as spyware, malware, and scareware just confuse the consumer and should all be grouped under the badware umbrella. This gamut of software can cause a slew of PC problems, from slow performance to false blue screens of death and identity theft. Keeping this software off your computer is a must.
- *General technology problems.* This category includes power failure, data loss, and hardware failure, and a trader should have a plan for each.

Ignoring these preventable issues is like trading without a stop loss. Take the time to take care of this right now and get on the path to smooth trading.

What Is the Best and Easiest Way to Build a Strong Defense for Your Trading Computer?

Traders can have the best software available for trading, but if their computer isn't properly cared for, protected, and maintained, then the greatest trading software in the world becomes worthless. For the trader who is serious about making this business a full-time job, neglecting these next steps is the same as a professional football player drinking a 12-pack of beer the night before he is supposed to play in the Super Bowl. In other words, it ain't gonna help.

The first step in avoiding these pitfalls is connecting a router to your network. A router is a simple device that most users know as the hub for their wireless Internet access. Routers not only direct the user's traffic, but, more important, provide a hardware firewall. Hardware firewalls are superior to software solutions because they take up zero PC resources and can't be modified by an infection that might make its way onto your PC. Even if you have only one hardwired PC, you should have a router.

The next step is choosing your security software. Antivirus software is one of the easiest forms of computer security to manage and is often overlooked. It's fairly common to find traders using the expired trial version of a security package that came with their computer or a "free" version of enterprise security software that a friend installed for them. This is risky not only because you don't know the origin of the software, but also because you can't guarantee that the software will operate as expected.

I prefer a basic antivirus program rather than a full-fledged "Internet security solution." Security solutions often try to do too many things within a single program and end up doing none of them well. Norton 360 5.0 offers PC tune-up, data backup, parental controls, a "safe web" social media scanner—the list goes on and on and on. When programs have this many things running inside a single application, not only do they tend to be subpar, but they also take up a large amount of resources. The more resources that are consumed by security software, the less that are available for your trading applications.

There are two antivirus solutions I recommend, Microsoft Security Essentials and NOD32. Security Essentials is a totally free solution provided directly from Microsoft. This program sports a clean user interface that's easy to understand and provides automatic updates. The other solution is NOD32. NOD32 is what I recommend for users who like to have more hands-on control of their security. This program offers a good range of features without being a burden and can be purchased at www.eset.com for \$60.

Another way to keep your PC free of badware is to stop using Internet Explorer, or at least make sure you're running the latest version. All spyware programs are written for this browser, since this is what comes with Windows. In 1997, Internet Explorer made up more than 50 percent of the browsers used on the web. This number has dropped significantly and now is about 25 percent of browsers used, as Firefox and Chrome have snuck into the market, taking 42 percent and 30 percent

of traffic, respectively. There are a few other browsers that make up the remaining percentage, but most users should stick to the big three. I personally use Chrome first, Firefox second, and, if I truly have no other choice, I'll use Internet Explorer. It's now the chunky old dinosaur.

What's the Best Way to Keep a Machine Running Like New?

Once traders have their antivirus software configured and happily scanning, they need to make sure the everyday junk is cleared out of their PC. Just like a car, PCs need to have basic maintenance if they're expected to perform. This used to be as simple as making a quick trip over to Internet Explorer's preferences and clearing out your cache and cookies. Now traders can have two or three browsers storing these files, not to mention temporary files that Windows creates through normal use. Fortunately there's a program called CCleaner that handles all this in one fell swoop. This program is 100 percent free with an option to donate and does a good job of cleaning out cookies, temporary files, and all the other miscellaneous junk that sits on a trader's PC.

Defragmenting is quickly becoming a thing of the past as SSD drives enter the market (where defragmenting is not needed), and for users running hard disk drives, Windows 7 schedules this task automatically. By the way, Windows 7 is the best choice for traders. Vista is horrible, and XP is old and outdated.

Why Are Cookies and Spam Bad News for Trading Computers, and How Can I Prevent Them?

Another device that companies use to track information on the trader's PC is called a cookie. This is a small text file that can be good or bad. It's good when you're visiting a favorite website, such as [Amazon.com](#). With a cookie installed, Amazon will remember who the users are, so they don't have to always log in when they visit the site. However, there are also bad cookies placed by companies such as Double-Click that track site usage, coordinate pop-up ads, and generally invade the trader's privacy. The best thing to do here is to start from scratch and delete all the cookies on your computer. This can be accomplished by using the previously mentioned CCleaner or by going to Start, Settings, Control Panel, Internet Options. Under Temporary Internet Files, there is a button that says, "Delete Cookies." Click this. After the cookies are deleted, go to Privacy, Advanced. Once you are there, check the box that says "Override automatic cookie handling." Below that I check "Prompt" for First-Party Cookies and "Block" for Third-Party Cookies. This way, when the trader goes to Amazon, a message pops up asking whether the trader wants to accept the cookie. I say yes because that is a site I visit often. Any third-party cookies like DoubleClick will automatically be blocked. This will prevent pop-up ads and keep the trader's computer running in top form. If I am asked to accept a cookie from a site I rarely visit, I will say no (only because "hell, no" isn't an option), and the cookie will not be planted on my computer.

Spam is a big problem for everyone, and I owe my eternal gratitude to Gmail (Google's e-mail service) for solving this problem. Gmail has the most powerful spam filters on the planet. I've been using the service since it was in its invite only stage, and I'm still a diehard fan. Gmail is a web-based e-mail solution, meaning that you don't have to have any software installed on your PC to receive e-mail like you do with Outlook. Gmail supports POP3 and SMTP, so you can still use a Gmail address in conjunction with your personal domain. It also supports Google Labs, a user community that creates plug-ins for your e-mail and enables a wealth of features. Gmail also supports IMAP, a standard that allows users to read a message on their phone, reply to it, and have these changes immediately reflected anywhere they log on to the account. If you're still struggling with syncing your e-mail between multiple devices or find yourself buried under a pile of spam, it's time to give Gmail a try. Yahoo! and Hotmail are old school. Gmail is new school. Speaking of old school, I was a diehard Microsoft Outlook fan for about 10 years. Henry showed me the light in terms of making the transition to Gmail and Google Calendar. It took me a few months to get used to it, but once I embraced it, I never looked back. With Outlook, I was tied to one computer, and it was clunky. With Google Calendar and Gmail, I can easily access my information from any computer, sync everything automatically with my phone, and easily share my calendar and key documents with other people via Google Documents. No more e-mailing documents back and forth, wondering which one is the current version. Welcome to the future.

the trend used to be attackingShould I Be Using a 32-or 64-Bit Operating System?

We've been able to keep the tech jargon to a bare minimum thus far, but it's worth taking a moment to explain the difference between 32-and 64-bit operating systems. The amount of information traders need to know on the topic is fairly basic, and we'll keep it that way.

Everything with computers is just 1s and 0s. A bit is either populated or not, on or off. So for a 32-bit operating system, we have 2 to the 32nd power, giving us 4,294,967,295, or 4 GB of RAM. Any 32-bit operating system is limited by definition to this 32-bit virtual address space, and if you install more RAM than the operating system can handle, it will simply ignore it. It has no way to address this additional storage. You'll remember that toward the beginning of the chapter, we mentioned RAM and how the more of it you had, the faster your system would be. So how do we get past the 4-GB limit? The easy answer is moving to a 64-bit machine. We now have hardware and software that can take advantage of these advances, and when we take the on or off state of a bit, and then take it to the 64th power, we're given enough address space to have several terabytes of RAM. If you're looking to really max out your PC, you'll want to be aware of the amount of memory that each version of Windows supports, and I've listed a few here. Windows Starter and Home Basic editions support a maximum of 8 GB, Home Premium supports 16 GB, and Professional and above support 192 GB. Obviously some of these numbers aren't yet practical in a normal computer, but I have no doubt they will be in the near future.

This same 32- vs. 64-bit theory applies to applications you install. Once an application can access more than 4 GB of RAM, you can have much more going on within that application. While trading platforms now are limited in the amount of data that can be accessed at one time, 64-bit platforms are emerging and will be able to handle much more data efficiently. What this means for traders is the ability to run more charts and more platforms and have fewer platform snags than we currently do.

The 32/64-bit issue will eventually be a thing of the past, just like 8- and 16-bit computing. Until this transition is complete, just remember that 64 bits equals more memory and more performance.

What Are the Best Solutions for Protecting Data?

Anyone who's been around computers long enough will tell you that the most expensive part of a PC is the data. Anything like a hard drive crash, a power surge that fries internal components, or this morning's espresso that didn't play nice with your laptop keyboard can destroy data. Once data are lost, data recovery procedures can be tedious and expensive, and do not guarantee recovery of your precious data. This includes everything from pictures and music to platform workspaces,

indicators, and portfolio spreadsheets. Fortunately, data backup procedures have advanced with technology, and in this day and age, there's no excuse to ever lose a single document. Services like Carbonite will back up your data automatically to the cloud, where they are encrypted and stored should you need them.

In discussing the preservation of your digital life, it's important to understand the two main types of backup. The first, and my preferred method for backing up critical data, is the easiest and entails simply dragging the files from your local drive to an external drive. This keeps your data in their exact original form, and should you experience a crash, you can plug the drive into another PC and quickly have access to your files. This method can also be used in conjunction with services like Dropbox. Dropbox creates a new folder on your PC. Anything that is placed inside that folder is uploaded to its storage service and is accessible from all your connected devices. Not only does this accomplish the task of backing up data, but it makes it easy to make changes to a file at the office and have the exact same changes reflected on the document when you return home. For example, when working on this book, I had a Dropbox folder on five different computers. I could access this folder from any of the five computers, open up a chapter, make a few updates, and, voilà, this chapter was automatically updated across all five computers. This is way easier than e-mailing files back and forth to different computers. I also keep my TradeStation workspaces in this Dropbox folder, so that I can access them from any PC.

The second type of data backup is known as imaging. Think of an image backup as just that: a snapshot, or image, of your PC. While the backup methods discussed up to this point back up only user data, imaged backups literally back up everything: user data, temporary files, the operating system with updates—literally everything. This is taken and stored in such a way that if your hard drive were to crash, you could replace the drive, run the imaging software, and not miss a beat. Trading platforms, indicators, pictures, and documents, along with every personal setting and application on your machine, are preserved with an imaged backup. I do both methods of backup on anything that's important to me. I then take those backups and make sure they're available in three different forms. Backups should be stored locally for quick recovery and off site for protection against natural disasters and theft, and then having a copy in the cloud completes the trifecta. While I do love cloud storage, I typically do not upload image backups to online data storage simply because of their size. I do keep physical copies in multiple remote locations, however.

Data aren't the only thing that traders need to have backups of. Power outages can and will happen, and battery backups are a must. These are available at any major office supply shop. In the event of a loss of electricity, these will give the trader around 30 minutes of power, which is plenty of time to close out positions or reset parameters in case the power is going to be down for a long time. This also gives the trader time to shut down the computer manually, which is much safer than having it go out suddenly because of a power loss.

The third thing a trader needs to be prepared for is a loss of Internet. Cable and DSL connections can go out even when the electricity is still on, and this will undoubtedly happen at the absolute worst time. Broadband saturation has grown in the United States, and it's now affordable for a trader to have not only a cable connection, but also a fiber or DSL line as backup. These connections can be run into a single device called a dual-WAN (wide-area network) router, and should one go out, no action is necessary on the part of the trader. The second connection simply picks up where the first left off, and ideally the end user never sees this hiccup. If this fails, the next step is direct contact with your broker.

The trend in the industry is for brokers to let computers do all the work. Although this provides for efficiencies and cuts costs, the bottom line is that if I have a problem, I had better be able to get hold of my brokers right away. If I call my brokers and can't get hold of them, I start foaming at the mouth—a signal that it is time for me to switch brokers. If I want to be put on hold, I will call the airlines, not my brokers. My suggestion here is to take advantage of technology and get your broker or brokers hooked up on an instant messaging program. This is an incredibly efficient way to stay in touch throughout the day. If my data feed goes down, I can IM (instant message) my broker for a quote. My expectations for my brokers are that I can contact them via phone or instant message right away. If they are not available, then I have the number and instant message as a backup. In trading, there is no excuse for not being able to get a live person to help out with an order or question right away. What else are we paying them all the commissions for? Of course, another option now is having a broker who is wired into your mobile phone. I use my iPhone to check quotes on my thinkorswim platform all the time. And, if need be, I can place a trade over my iPhone or iPad as well.

If the trader's data feed goes down, much of what already has been discussed will help. Being able to contact a broker to get a quote or place a trade in this situation is imperative. Yahoo! Finance is also a great site to get free quotes on stocks, options, and futures.

Trading successfully requires an edge. Traders who choose to remain in ignorance about what is really going on with their computer, or who are "outta luck" when the power goes out, are leaving themselves at a decided disadvantage compared with traders who are prepared. By staying up to date on the technological front, the trader has an advantage over those who don't. And having an advantage over other traders is the only thing that will make the trader a winner in this business.

Technology can, of course, get outdated quickly. Henry has put together a free video and list of specs at www.tradethemarkets.com/hardware to keep everyone up to date.

Why Aren't All Quotes Created Equal?

Now that we've beaten the nontrading technical issues to death, let's look at issues geared specifically to trading. This typically comes down to three areas:

1. Quote software
2. Trade execution software
3. Market-related subscriptions and services

Let's look at quote software first. Much of the decision to use a specific charting software package typically comes down to "whatever a person stumbled across" as he began the trading journey, typically as the result of a commercial he saw during the Super Bowl. For most traders, this is not a good thing. I remember when I first started trading online in the early 1990s, and I had to hit "refresh" every time I needed a new quote. I was charged a fee each time I hit "refresh" if I didn't trade enough. I stayed with that brokerage for about three weeks, and that was three weeks too long. It is important for the trader to have a quote system that is robust, is in real time, and has the flexibility to easily add a variety of indicators and tools. *The ultimate goal of traders is to develop a trading style that best fits their own personality.* A flexible quote system gives people the ability to try different markets until they find the setups and techniques that work best for them. There are only a few quote vendors that fit this bill, and there are many that do not. The bottom line is that good quotes are not free and can easily run a few hundred dollars a month. Skimp on the desk, not on the quotes.

Since this book was first published, thinkorswim (www.thinkorswim.com) has developed a quote system and trading platform that is not only robust but free. Tom Sosnoff had a great idea when he decided to give the client everything for free. It was such a great idea that clients flocked to this platform, and it grew so fast that

it attracted the attention of TD Ameritrade, which recently purchased thinkorswim (TOS) and is incorporating this platform under its umbrella. This is a platform that I started using shortly after this book was first published in 2006. It has continued to deliver the goods, and I continue to use it for quotes, charting, and execution for trading options and stocks. It is also in the process of moving into futures—the first powerhouse broker to do so. It is going to change the playing field by bringing futures trading within reach of anyone (see [Figure 3.1](#)).

I also utilize TradeStation (www.tradestation.com). TradeStation makes it possible for me to easily add my own indicators and studies, and I like its chart functionality and its ability to back-test specific setups and data. I also love its Radar Screen tool, which allows me to look at signals on multiple markets and time frames (see [Figure 3.2](#)). TradeStation is also in the process of coming out with a lot of awesome new trade analysis tools, and I'm looking forward to utilizing them as it rolls them out. I typically use TradeStation to trade options and futures. I like eSignal because it has fast reloading time and is robust and easy to use. Recently I also started using the charts at Infinity Futures (www.infinityfutures.com), as this company has also come out with a robust free quote platform for futures. I primarily use its platform to day-trade futures. As of this writing, thinkorswim and Infinity provide free quotes, while TradeStation and eSignal charge monthly fees for data.

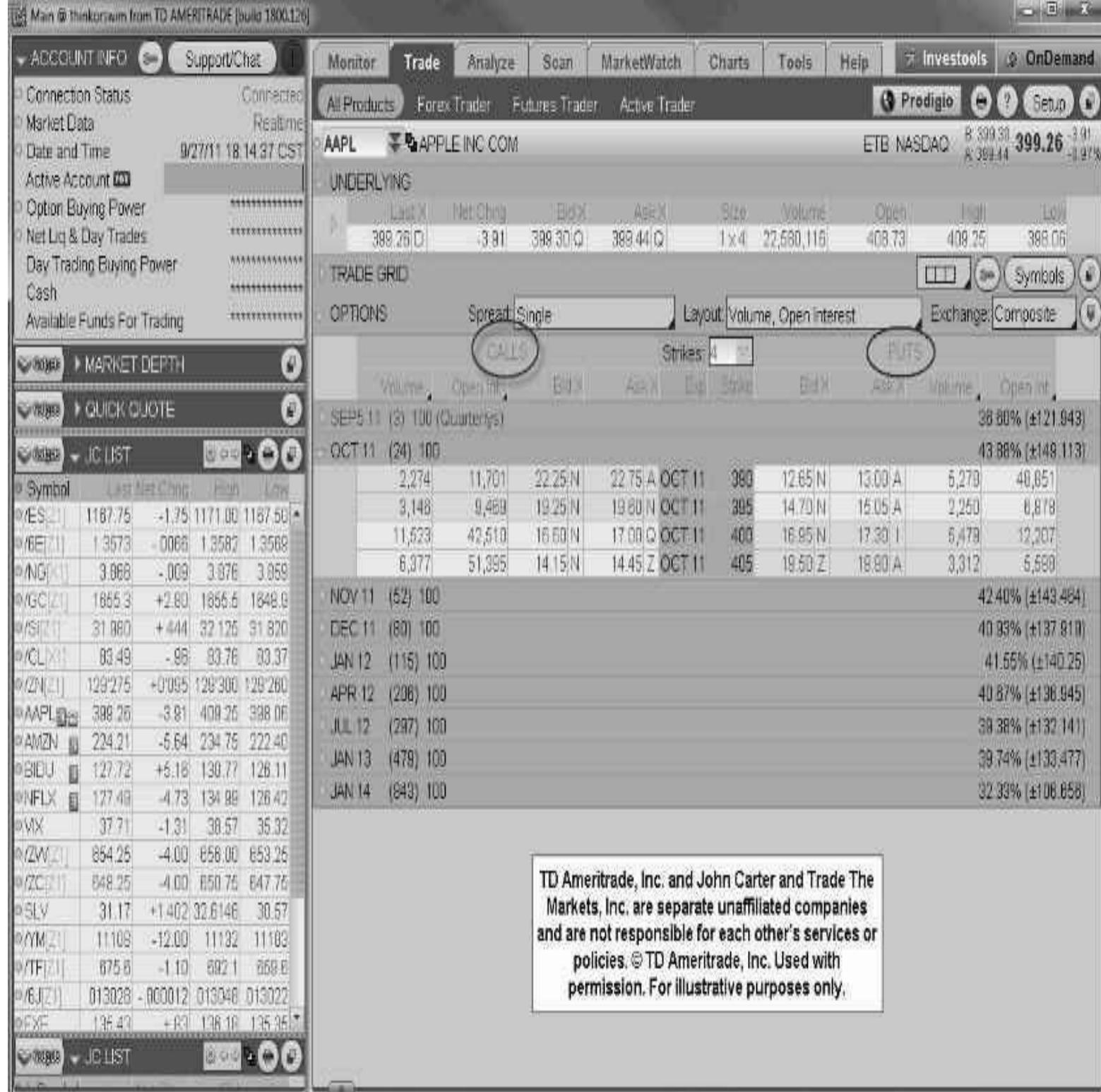


Figure 3.1

TradeStation RadarScreen - Page 1

Symbol	Last	Net Chg	Interval	TTM Squeeze Radar			
				Status	Signal	Bars	Momentum
1 @ES	1188.50	30.00	Daily	Squeeze	Short	7	
2 @YM	11275	303	Daily	Fired	Short	3	
3 @NQ	2281.75	55.75	Daily	Squeeze	Long	3	
4 @TF	690.20	28.30	Daily	Fired	Short	4	
5 \$DXY	77.49	-0.87	Daily		Long	16	
6 @EC	1.3625	0.0470	Daily		Short	16	
7 @BP	1.56				Short	17	
8 @AD	0.98				Short	62	
9 @CD	0.98			Fired	Short	4	
10 @JY	1.30			Squeeze	Long	18	
11 @SF	1.11				Short	53	
12 @CL.C	84.				Fired	Short	3
13 @NG.C	3.8				Fired	Short	3
14 @GC.C	1650.				Fired	Short	3
15 @SI.C	31.7				Fired	Short	4
16 @TY	129'18.5	-0'24.5	Daily	Squeeze	Long	1	
17 @US	140 29/32	-1 31/32	Daily		Long	15	
18 CZ11	650	2	Daily		Short	31	
19 SX11	1265 6/8	6	Daily		Short	36	
20 WZ11	656 6/8	8 4/8	Daily		Short	25	
21 BIDU	130.10	7.54	Daily	Fired			

TradeStation's Radar Screen showing the "squeeze" setting up on the ES, NQ, JY and TY

Page 1

TradeStation®

Figure 3.2

Another good source that I use for futures quotes is the market data available at the Chicago Mercantile Exchange (CME Group). Its website is www.cmegroup.com. For futures traders, information on quotes, open interest, front month, option activity, trading hours—it's all there, especially now, since the CME Group owns the Chicago Board of Trade and the New York Mercantile Exchange. There are, of course, other good quote systems available. The key is to utilize a robust and flexible version that best fits a trader's needs. For the most part, traders will get what they pay for in this area. The best way to find a good quote system is, first and foremost, to ignore any marketing material that is put out by the company itself. Looking at that is like believing that a can of soda is good for you because it says "diet" on the label. One of the biggest marketing gimmicks in trading is "free level II data." Level II data are worthless and shouldn't be watched in the first place. Larger traders use level II to trick and fool smaller traders by putting up fake size and using every method at their disposal to hide what they are really doing. They also cause traders to overtrade, which is the number one way to get out of this business in a hurry. Traders will save themselves a lot of frustration simply by turning this off. In sum, ignore the marketing and ask other traders who have been actively slinging stocks and futures for at least five years.

How Can a Bad Execution Platform Ruin My Account?

In the late 1990s and early 2000s, it was all about faster executions. A trader who had an execution platform that was faster than the others had an edge. Online web-based brokers caught on and started offering "60-second guarantees" on fills. Those of us who were using direct access laughed in their faces. Sixty seconds might as

well have been a week. Today, nearly every broker has adapted, and everybody has lightning-fast executions. So what platforms have the edge?

Think back to what I said about trader psychology in [Chapter 2](#). Most of the mistakes that traders make are emotional. I've watched traders get flustered, especially in futures trading, and make mistakes with their orders. They go long five contracts of the euro FX and then make an error in trying to place the stop that ends up liquidating their position. Other times, they put a target in place and end up doubling up on their position because of a mechanical error. Or, worse, they don't feel like going through the entire process of placing a stop, then placing a target, and then remembering to cancel the remaining open order once either the stop or the target is hit—so they don't place a stop or a target. These are the traders who "rely on their judgment while they're in a trade" and create great opportunities for the rest of us when they inevitably freak out. Manual order submission and trade management is a tedious, error-prone process. Coupled with heightened emotions, it is a recipe for trader blowout. Maybe it won't happen today, and maybe not tomorrow, but that day is always lurking on the horizon.

In addition, some traders simply are not computer savvy. They are not comfortable on computers, and it is easy for them to fumble an order. The best computer users are kids (people in their twenties—I now refer to them as kids), and it's because they have grown up playing video games on their PCs. Some traders I know have deliberately learned to play "one-person shooter" games on their PCs in order to improve their speed on the keyboard. The most popular of these is called Call of Duty. This game places you in various battles during World War II, and it is literally act fast or die—kind of like trading. By the time people get through this adventure, their eye-hand-mouse-keyboard coordination will have improved exponentially. My trading partners and I have all gone through the game, and it improved our hand-eye coordination considerably. This game is available at stores like Best Buy for \$30. Since this book was first published, multiple editions have come out—just be careful you don't get so hooked on the games that you stop trading!

Trading execution software today has evolved to help traders protect themselves from themselves. Think of a typical trade. Let's say I go long 10 contracts of the E-mini S&P 500 futures (ES) at 1204.25. I place a 2-point (8-tick) stop, and I want to exit half my position on a 1-point (4-tick) move to 1205.25. For the rest of my position, I will trail my stop—every time the ES moves 1 point (4 ticks), I will move my stop up 1 point. This requires active trade management, with the pressing of a lot of keys and many mouse clicks. One mistake and I can turn this winning trade into a loser.

What if, each time I bought the ES, my trading execution platform knew that I would be using a 2-point stop and a 1-point target on the first half of my position? If it knew that, then it could place the orders for me automatically, and I wouldn't have to do a thing. What if it also knew that when my first target was hit, I wanted to bring my stop up to breakeven? And what if it also knew to change the number of contracts in my stop from 10 to 5 when the first target was hit? What if it also knew to then trail the stop? What if I had a target, and it knew to cancel my stop order once my target was hit? And what if it did all this automatically, so that all I had to do was get into the trade, and after that I could essentially walk away because the software was managing the trade for me according to my specifications? The purpose of my day would be to sit back, relax, and focus on finding high-probability entries, instead of having to scramble around once I was in the trade and actively manage it—a process that can be mentally straining and cause many emotional fluctuations.

That is the kind of software that is available today. All traders have to do is wait and be patient for an appropriate entry level, take the entry, and then the software can manage the trade for them according to their own specifications. This process removes a lot of the mental stress involved in trading and helps to prevent traders from making the common mistakes that ruin many of them. This type of functionality was not readily available with many brokers even in 2005, but as I'm updating this today in 2011, these are common features, and additional improvements continue to catch on.

I've tried many of the platforms that are available today, and there are a few standouts from the crowd. However, it doesn't take long for a new version to emerge and triumph over all its rivals. There are some that are great but add too many fees. Others work fine but are memory intensive and really slow down a computer. The perfect one is fast, doesn't take up much memory, and doesn't tag on a lot of extra fees. If you are interested in the list of platforms I am currently using, send an e-mail to support@tradethemarkets.com or call our office. Let's take a look at a more or less generic example of what I'm talking about.

[Figure 3.3](#) illustrates a shot of a "Strategy Manager" window, where traders can enter their predetermined trade entry and exit points. The Strategy Manager is open, and the Position Strategies tab is selected. The strategy that is highlighted is called TradeTheMarkets, which is a strategy that I created. In the position type box (Pos Type), I have selected the bottom choice (Stop/3T). This means that this strategy will have three profit targets and one stop order. In other words, I can buy six lots of the E-mini S&Ps and scale out of my position two lots at a time, at predetermined exit points. The details are entered in the middle of the screen. For this trade, when I get in long or short, the software will automatically place a 2-point stop, and it will automatically place orders so that I can scale out of two contracts when I'm up 1 point, scale out of another two contracts when I'm up 2 points, and scale out of the final two contracts when I'm up 3 points. In addition, once I am out of my trade, the open stop order is automatically canceled.

This screen focuses on my "target exit strategy." My "stop exit strategy" is different, and you can see that a stop strategy called "JohnCarter" is selected. (See [Figure 3.4](#).)

Strategy Manager



Position Strategies | Stop Strategies |

ES 1 TARGET EXAMPLE

ES 3 TARGET EXAMPLE

RUSSELL SCALP EXAMPLE

TradeTheMarkets

Strategy Name

TradeTheMarkets

Instrument

ES 06-05

Help?

Order Type

LMT

Stop Strategy

JohnCarter

Pos Type

- Naked
- Stop Only
- Stop / 1T
- Stop / 2T
- Stop / 3T

SE

CIT on Targets

Contracts

Chase Limit

6

0

Entry

- CIT
- Chase

Time Stop

TIF

0

DAY

Stop Loss

T2 Qty

T3 Qty

2

2

2

T1 Profit

T2 Profit

T3 Profit

1

2

3

Auto-Reverse

- at Stop
- at Target

Shadow Trade

- On

ADD

DELETE

UPDATE

CLEAR

Figure 3.3

Strategy Manager



Position Strategies Stop Strategies

ES LOOSE

ES TIGHT

JohnCarter

RUSSEL TIGHT

Strategy Name

JohnCarter

Instrument

ES 06-05

Simulated Stop

Auto Breakeven

Trigger

Plus

0

+

0

+

AutoTrail

1 Step

2 Step

3 Step

Stop Loss

Frequency

Profit Trigger

Step 1

1

1

2

Step 2

0.5

0.5

4

Step 3

0.25

0.25

6

ADD

DELETE

UPDATE

CLEAR

Figure 3.4

The “Stop Strategies” tab allows the trader to create a single stop or a trailing stop. The trailing stop will automatically move based on the parameters put into this screen. As the various profit targets are hit, the stop loss will move up a specified amount, ensuring that an increasing portion of any profits is protected.

Traders may have just one setup that they use, or they may have half a dozen or more that they have created over the years. Each setup that a trader uses should have a different set of rules for exiting the trade. Some of the setups may utilize a 3:1 risk/reward ratio (risking 1 point to make 3), while others utilize a 1:2 risk/reward ratio (risking 2 points to make 1). Some of the setups may use trailing stops and multiple targets, and some may have stationary stops and single targets. All the various exit and stop strategies can be created for each setup on each market in which it is going to be utilized and matched together. Once these are all created, all traders have to do is tell the software which setup they are about to take, on which market, and then focus on the entry level. Once they enter the trade, the software does the rest of the often very tedious and error-prone work. What is also nice is that a trader can have a couple of plays running simultaneously in different markets and not get frazzled watching after all of them. This type of technology automatically brings discipline and focus into the trader’s life and generally makes the trading day smoother and more deliberate, leaving a trader refreshed at the end of the day instead of worn out.

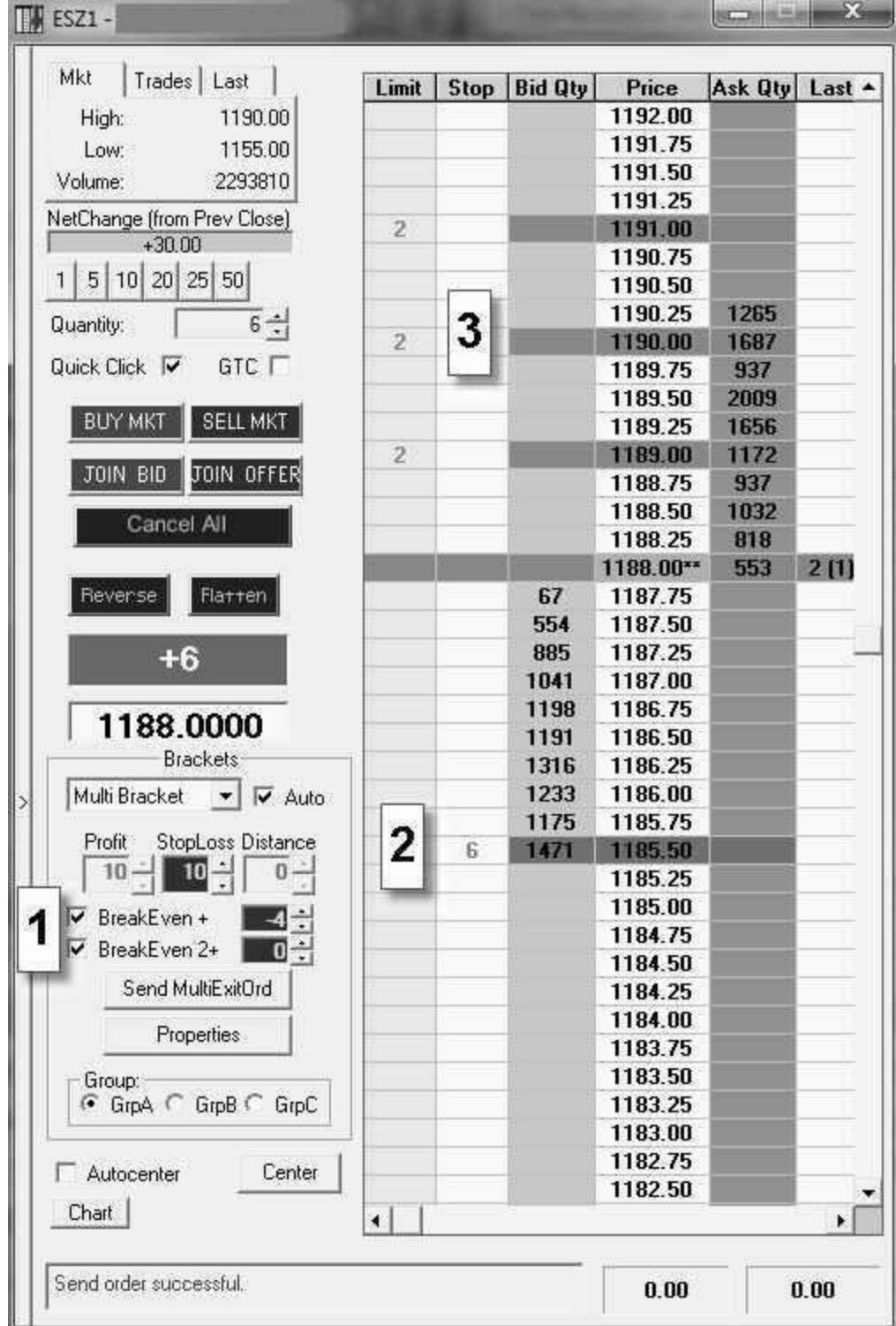


Figure 3.5

What is also nice is that, once the trade is placed, all these orders are easy to follow and are marked visually on a screen of the market being traded.

In [Figure 3.5](#), the screen shows that an order was filled for six contracts on the E-mini S&Ps at 1188.00. That is also where the market is currently trading, so the P&L at the bottom of the screen says 0.00, as there isn't a profit or a loss at the moment. The total number of contracts being traded is displayed on the middle left side, showing +6, since the position is long. If I were short here, it would have said -6. At point 1, this is where I can choose my initial stop (in this case, 10 ticks) and then how I want my stop to change if targets are hit. In this case, if the first target is hit at 1189.00, my stop will automatically move from my entry -10 ticks (see point 2) to entry -4 ticks. In addition, the stop quantity will automatically change from 6 contracts to 4 contracts. If the second target is hit at point 3, at 1190.00, then my stop will automatically move from -4 ticks to my entry point, creating a "breakeven" stop on the last part of my trade. This just means that while I have booked gains on the first two-thirds of my trade, the worst I can do on the last third is break even. Of course, if my second target is hit, my stop quantity also changes automatically from 4 contracts to 2 contracts. The "Flatten" button in the middle left of the screen is also very useful. This closes out all open positions and cancels all orders with the click of a mouse. There are other things that these platforms can do, but this should give you an idea of what your software, at the very least, should be capable of doing for you.

Why Do Most Financial Newsletters Suck?

This section isn't about recommending good financial market subscription services that are available. It's about how to treat them. There are many market-related services, newsletters, and Internet chat rooms that are operating today. These services typically offer opinions on the markets, and they usually charge a fee for accessing their information. They offer thoughts on market direction and sometimes specific market picks. I used to be a newsletter junkie, and I still am to some extent. However, these days I'm much less interested in individual opinions and more interested in websites that offer a quick synopsis of the current state of the markets through a variety of technical data. To that end, one of the best sites on the Internet is Decision Point, run by Carl Swenlin (www.decisionpoint.com). This site allows traders to get a quick feel for the markets and offers an endless amount of drilldown detail, which I like to peruse on Sundays. In addition to getting quick readings on key numbers such as NYSE (New York Stock Exchange) Member Net Buy/Sells, Investor Sentiment, and key put/call readings, traders can sort sectors and markets by relative strength and quickly see where the next rallies and declines will emerge. I find this tool priceless for gauging market direction and for seeing firsthand where the big money is flowing. It's the best \$20 a month ever spent. I also like to read comments by John Mauldin in his weekly newsletter, *Thoughts from the Frontline* (www.2000wave.com). His writing is lucid, far-reaching, and entertaining.

I also find it useful to read and balance the views of the people who think the Dow is going to 3000 with the views of the people who think the Dow is going to 30,000. There are both rational and ridiculous arguments for both cases. I personally don't have an opinion on where the stock market is going to be by March 27, 2023. I'm more focused on what its range over the next several months is going to be. Also, it is important to take these views with a grain of salt. With Wall Street, if everyone is expecting the same thing to happen, then it's not going to happen. It is certainly important to stay on top of the major trends affecting the world today, namely, an aging population, the great deleveraging process that is taking place as a result of the 2008 financial crisis, and the explosive economic growth of China and India. These are real trends that affect nearly everything in our lives. Where there are trends, there are opportunities to make money.

The main thing to keep in mind is that everyone is offering an opinion, especially if it's regarding a specific trade recommendation. The writer may sound absolutely convinced that this is the best trade on the planet, and this conviction can easily pass into the brain of the reader. The bottom line is this: first, great conviction is in no way correlated with a greater chance of said recommendation actually happening. (Remember, even newsletter writers would rather be right than make money.) Second, if traders take a recommendation from a subscription service, they still have to set appropriate risk parameters and decide how much they are willing to lose on the pick. They also must realize that it is just an opinion—it doesn't mean that things are going to unfold the way the writer says. Just because a guru thinks the market is going to crash doesn't mean that it is going to crash. I've heard more stories about people blowing out their accounts because "they put it all on a newsletter recommendation." There is a tendency for traders to feel more confident in a trade because it is being recommended by somebody else. A tip! In reality, it's just a trade setup like any other, and it is important that a trader not get lured in with a false sense of security that this particular trade is going to work out exactly as planned. Whether traders found a setup for themselves or whether they are following a trade setup recommended in a newsletter, the ultimate responsibility is the traders'. Don't get overconfident just because you read about something online.

How to Establish Priorities: If You Are Getting Interrupted During the First Two Hours of the Trading Day, Why Is It Your Fault?

I talk more about this at the end of the book when I discuss the business plan, but it does touch a little on technology here. The bottom line is that a trader needs focus and concentration in order to be successful in this business. The most critical hours in the stock market are generally the first two hours of the trading day. This is where most of the setups occur. It is up to a trader to communicate to his colleagues or, if he is trading from home, to his spouse and children that he cannot be disturbed during this time. When I am trading, I am not checking e-mail, I am not answering the phone, and I am not accepting uninvited visitors. If my wife wants to be dropped off at the gym before the trading day starts, she knows the deadline. If she lets me know after the deadline, my answer is always the same, "Honey, you know I love you. The trade is on." Click. (I usually remember flowers on those days.)

It can be hard to communicate things like this directly. You'll find it is helpful to write out a fully developed trading plan and then share it with the people in your life. Once they understand that this is important to you and that you are serious, they will generally respect any boundaries that are clearly outlined in what they are reading. Think of it from their perspective. I know that when my wife visits me at my office, it doesn't look as if I'm working very hard. I'm just kicked back, looking at charts. Of course, I'm actually very focused, and I'm watching and waiting for the market events to unfold. "Just because I'm not digging a ditch," I like to tell her, "doesn't mean I'm not working."

In terms of communicating with people throughout the day, for anyone who doesn't utilize instant messaging software, this is an incredibly efficient way to stay in touch. People can call at exactly the wrong moments during a trade. With instant messaging, people can type in a question and the trader can get back to them at her leisure. Instant messaging was built for traders. This is free software, and I used to utilize the three most popular programs: MSN, Yahoo!, and AOL. I now mostly use Skype and the chat feature that comes with Gmail (Google's e-mail service). The key with instant messaging software, however, is to block everybody except for

people that the trader has specifically permitted on her list. If everyone knows you are online, then everyone will bug you. For traders, instant messaging between their brokers and other traders is appropriate. It is inappropriate from anyone else who could interrupt a trader's workday, and this includes family members and clients. There are very few people who are on my list, but they are all important to my trading day. My wife did make the cut, however, and it has proved to be a useful way to stay in touch when the markets are moving. It is your life. Life is short. Put a stake in the ground and own your time.

Why Is Watching *Harry Potter* on DVD After 12 Noon Eastern Better Than Watching CNBC?

I am bringing this up because I've seen too many traders who quit their jobs and follow what I call the "CNBC setup." They are excited because they are finally able to trade full-time. They feel they've been at a disadvantage all these years, getting quotes from the Internet, sneaking trades onto their computers in between meetings, and hearing about key news events only after the markets have already closed. So what do they do? They plop a TV down right next to their computers, turn on CNBC, and glue themselves to the screen, looking for trading opportunities.

CNBC has a very specific job: to provide viewers with enough entertainment so that they tune in and watch. When a lot of people are watching, the network makes more money from the commercials. It's as simple as that. CNBC is fun to watch, and when things get serious, it does a great job of reporting. I found out about 9/11 as it unfolded live before my eyes from Mark Haines. I flipped to some of the other channels, but I ended up parking it on CNBC that day because it did, hands down, the best job of reporting about it. Who can forget Maria Bartiromo reporting about the event, covered in ash and soot just after the first building collapsed? It was a gut-wrenching experience to watch, and the reporters and the network did a great job.

That said, traders must realize that they cannot make a living "trading the news" off any financial news channel. By the time something appears on television, it is way too late to react. Trading floors have already heard the news, and by the time it makes it to the public, the floor traders are closing their positions, ideally to suckers who just saw the headlines. If anything, CNBC can be used as a fading tool—taking the opposite side of the news. Once it runs out of stories and starts repeating the same things over and over, I turn down the volume and either turn on a commercial-free music radio station or, once in a while, plop in a DVD. Who can get tired of watching *Gladiator*?

Traders who do this for a living spend their days waiting for specific setups to take shape. Yet one of the biggest weaknesses of most traders is a need to be in every move. If the markets start running away, many traders just can't help but jump in, fearing that they may be missing something big. This is a fatal flaw that will ruin any trader who can't control this habit. If there is anything I can hammer into your brain as you are reading this book, it is this: it is okay to miss moves. Professional traders miss moves; amateur traders try to chase every move. By listening to music or keeping a DVD on in the background, traders have something they can use to pass the time while they wait for their specific setup to take shape. This makes them less prone to jump impulsively into trades just because they are bored or because they can't stand missing out on a move. The goal is not to catch every move in the market. The goal is to take the specific setups that you have outlined as a part of your business plan. Otherwise you are just a gunslinger, and sooner or later all gunslingers get killed.

We've set up www.tradethemarkets.com/platforms with information on discounted commissions and VIP service with the brokers discussed in this chapter.

Futures Markets 101— Understanding the Basic Mechanics of the Futures and Commodity Markets

To the brave man every land is a native country.

GREEK PROVERB

The World Beyond Stocks: Why Is It Important?

We've covered why markets move, how traders sabotage themselves, and what to do with your computer. That was the equivalent of prep school. It's time for you to graduate and start looking at the markets. Deciding what markets to trade is critically important. The reality is, some markets offer much better opportunities than others. Where would you rather open up a hot-dog stand—inside Yankee Stadium or at the side of a dirt road in the middle of Nebraska?

I wrote this chapter specifically for stock traders who have never ventured beyond those borders into the world of futures contracts, which include stock indexes, currencies, interest rates, gold, oil, grains, and a variety of other asset classes. My goal is to provide a straightforward guide to these markets from a trader's perspective. I'm not going to go into a dissertation on contract specifications or all the other mechanics of these contracts. This information is readily available at www.cmegroup.com. I'm just going to focus on the mechanics of buying or selling these contracts from a trader's perspective, and the key things to know if you do decide to give them a try. I also am not going to try to talk a person into trading these markets—more individual traders get eaten for lunch in these markets than anywhere else. Why? Because they jump right in without understanding the leverage involved and end up trading way too many contracts for their account size. We already know what happens to a trader who is not psychologically ready to do this for a living. Add leverage to that equation, and a trader is behind the eight ball from the get-go. That said, futures are great once you understand them. They provide 24-hour access to all the major asset classes in the world, they are great for day trading or longer-term trades, and there is always something that is moving. That is, if the stock market is having a quiet week, a trader can always check out what is happening in the gold market.

I also will not attempt to discuss how all these markets interact with and influence one another on a global level (although I will hit upon some of the basics). That would involve a macro discussion of how the world works, and it is not within the scope of this book. I just want to show you how I trade them for a living. Ultimately, if you decide not to trade them, that is completely fine. At least you'll know how they work, how they affect the stock market, and even how to use them to time your stock picks.

For traders who are already familiar with these markets, feel free to skim through this chapter and move on to the next—although I would read both the next section and the part that compares trading the mini-sized Dow (YM) to trading the E-mini S&Ps (ES).

Although I say in the introduction that I won't be focusing on basic trading terminology such as *uptrends*, I do want to explain the other markets outside of stocks that I refer to in this book. The reason for this is that most traders I've met are stock traders only. Some might have a little experience with the E-mini futures, but for the most part, their focus is on actual stocks and that's it. To put this in perspective, there are roughly 25 million stock brokerage accounts in the United States. When I wrote this book in 2005, there were only about 450,000 futures accounts. However, that number has grown exponentially as large brokers such as TD Ameritrade have embraced futures trading. For people who are familiar only with stocks, contracts such as the 30-year bond, soybeans, S&Ps, euros, and gold often seem nebulous, scary, and out of reach. But are they really? Not really, and they provide a lot of flexibility that can't be found in stocks alone.

[Figure 4.1](#) shows a very good reason for knowing how all these various markets work, and that reason is as follows: there are always going to be some markets that are trending and some that are stuck in a trading range. Some are going to be moving higher while others are moving lower. While [Figure 4.1](#) shows uptrending gold and 10-year note markets, the S&P 500 is forming a double top, and the euro currency is range-bound. Although [Figure 4.1](#) is based on a weekly time frame, this same kind of thing happens on all intraday time frames as well. While one market is chopping, another market is trending. I have setups for both types of markets that I review later in this book.

Markets Are a Reflection of the People Who Trade Them: Is Your Competition Wired on Starbucks or Methodically Filling In a Crossword Puzzle?

In addition to traders exposing themselves to a wider variety of potentially trending markets, it's important to at least understand how these other markets work for three reasons. First, these other markets affect stock prices. A lasting rally in bonds can force large funds to start buying stocks in order to readjust their allocations. A surge in oil prices can place downward pressure on stocks. Rising lumber and steel costs can hurt some companies' earnings but help others. Second, there are going to be times when the stock market is dead in the water, and these other markets will provide opportunities for traders to continue making a living. Third, each market has its own personality. Traders who have been exposed only to stocks are betting it all that this is the market that best suits their personality. There may be another one out there that fits like a glove, so to speak, which makes the traders' job that much easier. For example, the ES (E-mini S&P 500) isn't that great to trade if you are looking for momentum-type moves. For momentum moves, it's better to look to GC (gold), EC (euros), and S (soybeans).

@GC.C - Weekly COMEX

**Figure 4.1**

In the end, all charts and all markets are the same. They always have been, and they always will be, because all chart patterns depict the same thing—emotional reactions and decisions made by human beings. Even if it is a mechanical system that is making the trades, it was still written by a human. A trader is always trading with other traders, no matter what the market.

Yet each market is made up of different types of traders. What are these traders like? If they are S&P traders, then it's possible that they are wired on Starbucks and are super-aggressive. If they are trading bonds, it's possible that they are methodically filling in a crossword puzzle in between trades. If they are trading corn, it is possible that they are napping at their desk, as they are more concerned with hedging a cash crop. Which type of trader would you rather trade against? Compete against? One of the key differences between most successful traders and unsuccessful traders is this: successful traders are in markets where their personalities shine.

A stark example of this can be found in a friend of mine who trades 10-year notes. He routinely makes just over seven figures a year trading this market. A few years ago, he got bored and decided to start trading the S&Ps. He liked the excitement and the action, and he wanted to be a part of that game. The result? It was a struggle from the first trade, and he lost hundreds of thousands of dollars. Licking his wounds, he went back to trading 10-year notes—and making just over seven figures a year. Boring is not necessarily a bad thing. I can't emphasize enough the importance of trading the right market for your personality.

Also keep in mind that many firms realize that there are many newer traders out there who are buying the latest software packages in order to "beat the markets." These firms buy the same software and use it to trade against the newbies. This is in addition to these firms having a full-time research staff and access to tons of information. These types of firms usually focus on the S&P futures. Are you prepared to trade against these guys in the S&Ps and make a living off their occasional

mistakes and bad judgment?

I started off as a stocks and options trader. I liked these markets, did well in these markets, and continue to trade in these markets. However, I was always curious about the other markets that were available. For a long time I didn't do much about this curiosity. Why? Frankly, the futures markets seemed scary. Yet I really just wanted to see how these other markets worked and at least to see how I would do trading them. Maybe I would find something I liked better than stocks. However, I felt that futures and foreign exchange currency trading (forex) were suited only to traders sitting behind a desk at a large bank or institutional trading firm, so it took me a while to finally venture into these markets. This isn't so much the case today because these markets have become more accessible. Ironically, however, some of these same institutional traders now visit me at my offices to learn the various trade setups I utilize in these markets. They had no problem trading these instruments with the firm's money, but when they left to try it with their own money, the psychological factors kicked in, and they struggled.

I eventually worked with some traders in these markets in the mid-1990s, and they helped to strip away the myths, showing me how these markets worked and how to reduce risk and create solid trading opportunities. In my search to understand the futures and forex markets, I had to pull bits and pieces together from different sources over the course of several months before I finally understood how all these trading instruments worked. Most of the information was elusive at best—a more apt description would be worthless. I never was able to find a consistent, easy-to-understand summary that told me everything I needed to know about trading these instruments, and this process was frankly frustrating and annoying. As a trader, I just wanted to know the basics—how do I trade them, how much money do I need to trade them, and how does the price movement affect my P&L? I'll use the rest of this chapter to create the summary information I wish I'd had then. In the end, I'm glad I tried out these other markets, as it is these other markets that allowed me to make the jump to trading full-time for a living.

Why Should Traders Learn About the Futures Markets?

Think of this as a quick blurb designed to help a trader better understand the futures markets. This account is by no means comprehensive—there are entire books written on the subject. However, to an individual who has traded only stocks, the futures markets are probably a mystery, and maybe even a little menacing. Yet traders who have already learned the importance of strict money management will appreciate what futures trading has to offer. Typically, once people try trading futures, they simply stop trading stocks. The ease of entry on both the long and the short sides, the ability to focus on a few markets instead of hundreds of stocks, and the lack of market-maker games make them a refreshing change from the world of stocks. Let's begin.

First off, there are many types of futures contracts. A person can trade anything from copper to coffee, from stock indexes to silver, or from pork bellies to palladium. It's not important to worry about most of these contracts in the beginning, but it is important to understand a core group of them and how they work. I know many traders who focus on only one of these contracts and are doing quite well. However, it took them time to find the right market and the right setup within that market that was best suited to their personality. This can often be a long and perilous journey, but once they found the right fit, they never looked back. These are the main futures markets that I follow and trade outside of stocks:

- E-mini S&P (ES)
- E-mini Nasdaq (NQ)
- Mini-sized Dow (YM)
- E-mini Russell (TF)
- Full-sized 100-oz. electronic gold (GC), 5,000-oz silver (SI)
- Mini-sized gold (YG), mini-sized silver (YI)
- Full-sized 30-year bond (US—pit, ZB—electronic)
- Ten-year notes (TY—pit, ZN—electronic)
- Soybeans (S)
- Corn (C)
- Wheat (W)
- Currencies (EC, BP, AD, CD, SF, and JY)
- Crude oil (CL) and natural gas (NG)
- Mini-crude oil (QM)
- Various single-stock futures (referred to later in the book as SSFs)

Note that some of these are mini and some are full-sized, although that can be a misnomer. For example, trading the E-mini S&P ES contract has about the same specs as trading the full-sized corn contract. This is why, as a trader, the most important thing is to get an idea of the daily range of these markets, and what that means for your P&L. In other words, what is a tick worth in each contract? What about a full point?

[Figure 4.2](#) shows a move in the full-sized 100-ounce gold contract (GC). As it states, this contract represents 100 ounces of gold. The trading dome shows a purchase price at \$1,650.20 per ounce. The contract is currently trading at \$1,651.70 per ounce, a gain of 15 "ticks" (ticks are the smallest price increment in which a futures market moves). A move from \$1,650.20 to \$1,650.30 (1 tick, which in this case is 10 cents) is worth \$10.00 on 100 ounces of gold. This move of 15 ticks (\$1.50) on 1 contract shows a gain of \$150.00. If I'd had 10 contracts, then the gain would be \$1,500.00, and so on. There are two things to be gained from this. First, the move on 1 contract isn't actually that scary—\$10.00 per tick is manageable. Second, buying and selling a futures contract is just like buying and selling a stock.

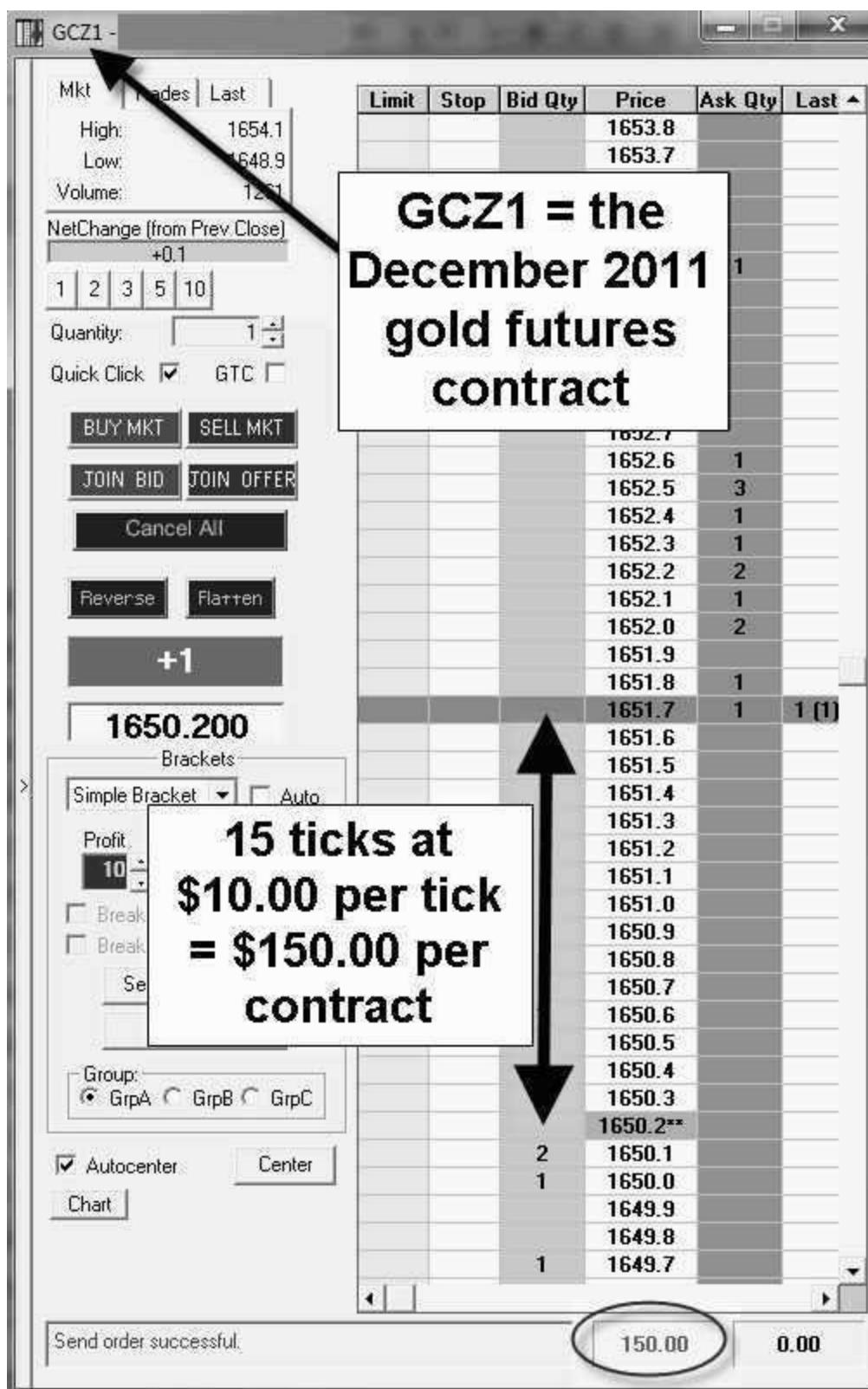


Figure 4.2

The minis on these stock indexes have huge volume and great liquidity. I very rarely trade any of the pit-traded contracts. Nearly everything is available today in electronic format, right on your computer screen.

To get charts on these, traders will have to instruct their quote vendor that they want to add quotes from the CBOT (Chicago Board of Trade) (for the mini-sized Dow, bonds, 10-year notes, and grains), the CME (Chicago Mercantile Exchange) (for the E-mini S&P, E-mini Nasdaq, and currencies), and the NYMEX (New York Mercantile Exchange) if they want quotes on oil and gold. There is an “E-mini only” quote feed that is cheaper, but a trader will want the full version to get quotes on the full-sized contracts. It will cost around \$80 a month for full versions of both the CME and the CBOT. And it should be noted here that all of this is available for free on the thinkorswim trading platform, as well as a few other platforms.

One thing that throws newer traders off is that futures trade in contracts months. The stock index and currency futures trade quarterly: March, June, September, and December. If it's May 7, then you'll be trading the closest month out, which in this case is the June contract (letter code M), also called the “front month.” In June,

this contract will stop trading, and the new “front month” will be September (letter code U). [Figure 4.3](#) shows the letter code for each of the contract months. The stock index and currency futures months have been highlighted. Other contracts, such as soybeans, oil, and gold, trade a little differently with regard to contract months. If you are ever unsure, just go to www.cmegroup.com and look up the contract specifications, or, better yet, just ask your broker.

In a Nutshell, What Do Traders Really Need to Know?

When traders buy a futures contract, they are not physically buying anything. This is simply a way of participating in the price movement of the market of their choice. If they think a market is going to move 10 points, they can buy a futures contract, long or short, and make money on the move if it goes in their direction. Obviously, they can also lose money on the move if it goes against them. Also, if they own a stock index futures contract that expires, they are not going to get a bunch of stock certificates dumped on their doorstep. The expired contract will be converted to cash, and they will see the cash deposited in their account. Other contracts, like soybeans, are “deliverables,” meaning that a person can be the proud owner of 5,000 bushels of soybeans per contract upon expiration. Is this really a worry? Brokers never like it when a contract expires in a trader’s account. They will call and badger a trader to get him to close it out, so there is little danger of his forgetting. And if they can’t get you on the phone, they typically will simply close it out for you. They just don’t want to have to deal with an actual delivery. If for some reason it still happens, you won’t have a truckload of soybeans dumped on your doorstep. It’s all handled on the brokerage end, and people there can get the account back to normal.

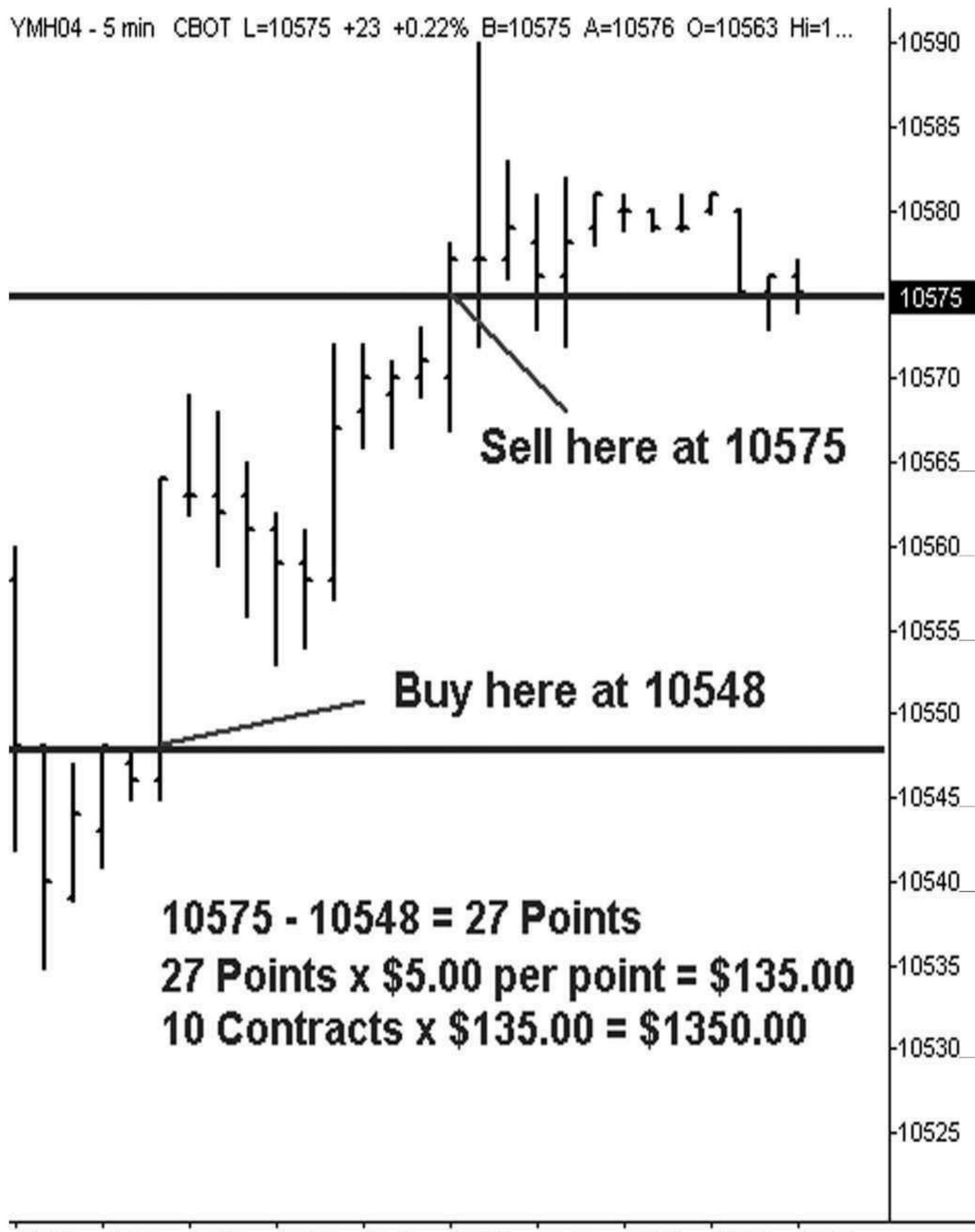
Month	Code	Month	Code
January	F	July	N
February	G	August	Q
March	H	September	U
April	J	October	V
May	K	November	X
June	M	December	Z

Figure 4.3

For price movement, if a trader has one contract in the E-mini S&P futures, for example, and it moves 1 point (for example, from 1,032.75 to 1,033.75), that translates into \$50 on her P&L. For the Nasdaq, a 1-point move equates to \$20. For the mini-sized Dow, a 1-point move is \$5. Therefore, if a trader buys three E-mini S&Ps and catches a 2-point move, that is \$50 times 2 points times 3 contracts, or \$300. There is leverage here, indeed, but it is more manageable than most people think. Where traders get in trouble is when they trade too many contracts in relation to their account size, something I talk more about later. By the way, when the S&P moves a point, the Dow moves roughly 10 points, so these two contracts are nearly identical to trade. If traders say that they just made 50 points in the YM (mini-sized Dow), that is just like making 5 points in the ES (E-mini S&Ps).

[Figure 4.4](#) shows a mini-sized Dow trade with 10 contracts. The chart reflects a 27-point move, which is worth \$1,350 to a trader’s P&L. I summarize all these contract specifications for bonds, euros, soybeans, and so on, at the end of this chapter. Of course, these price fluctuations go both ways, so money management is the absolute key to trading futures. It is imperative that traders know their stop before they enter a trade, and that they stick to it and not play any psychological games. In futures, as in stocks, hoping and praying can, and do, lead to ruin. However, the nice thing about futures is that they are so quick and the fills so clean that a trader can get stopped out, and then a few moments later get right back in. A trader can’t be afraid to take small losses, period. Reentry is only a commission away.

YMH04 - 5 min CBOT L=10575 +23 +0.22% B=10575 A=10576 O=10563 Hi=1...



14:45 15:00 15:15 15:30 15:45 16:00 16:15 16:30 16:45 17:00

Figure 4.4

In addition, electronic contracts were set up specifically for traders: they are super liquid, and fills are instantaneous. There are no market-maker games such as those that happen daily with individual stocks. And with electronic contracts, a trader is out of the pit, where outsiders can sometimes be treated little better than a cockroach. Here are a few other things I like about futures:

- If traders think the market is going to break out, they can buy a stock like INTC (Intel Corp.) and watch it sit there while the market roars on without them. They were right about the market—but their stock pick didn't move with the market. With the stock index futures, a person is trading the market instead of watching the market. It is what it is.
- A trader can short on a downtick—this makes a huge difference in trying to get filled during a breakdown. If traders try to short the stock KLAC (KLAT-encor Corp.) “at the market” on a breakdown, they may not get filled for 20 cents until it has an uptick. If they short the futures “at the market” on a breakdown, they get a quick fill at the current market price. Recently this is becoming less of an issue, as the exchanges continue to see the wisdom of allowing more and more stocks to be shorted on downticks.
- I used to be a big trader of OEX (S&P 100 Index) options for day trades. After trading futures, I stopped trading OEX options. The spreads and premium of OEX options now look ridiculous. Where else can a person be dead right on an intraday move and still lose money? The OEX options market! Although I do use OEX options (or, more likely, SPY options) for swing trading, I wouldn't day-trade them with my mother-in-law's trading account. Not when the mini-sized Dow and the E-mini S&P futures are so clean and efficient.
- A person can do most of his trades “at the market” and get good fills, unlike stocks and especially unlike options.
- For stocks, a person needs \$25,000 to day-trade. For futures, a trader can open an account with \$5,000 (or less) and day-trade. There are no day-trading rules or classifications. That said, I recommend that people start with a larger-sized trading account, but I also realize that everyone has to start somewhere. My first trading account was \$2,000. Can people quit their job, open up a futures account with \$5,000, and trade for a living? Absolutely ... not. I talk more about this later.

To buy one of the futures contracts discussed in this book as a day trade, under day-trading margin, traders generally need about \$2,000 in their account. This varies by broker and can be lower, but this is an average. This money is called *margin*, and a trader can think of it as making a 4 percent down payment on a \$50,000 house. By making the down payment, the trader controls the house, so to speak, and she benefits from any price increase and loses on any price decrease on the house itself. So if a trader has a \$10,000 account, she can buy five mini-sized Dow contracts (five \$50,000 houses) and sometimes more by utilizing lower intraday margin rates. However, for money management purposes, I heartily recommend that you give some thought to how many contracts you are trading in an account. This is a critical part of your trading plan, and it is something that I discuss in more detail at the end of the book. You can certainly choose to trade five contracts in a \$10,000 account. You can also choose to visit India without getting any shots in advance—but that doesn't mean it's a good idea. (My Internet guru, Priyanka, is from India, and she keeps daring me to eat at a roadside food stand next time I visit.)

I typically trade one contract for every \$10,000 to \$15,000 that is in my account. This way, the account swings will not be as severe, and I can trade with a level head. One trader friend of mine trades one contract for every \$50,000 in his account. He makes money and is never stressed out. Conversely, I've seen programs that say that a trader should take a \$5,000 account and trade five contracts, and by doing this, she can make six figures a year. This is insane; the trader would be better off donating that \$5,000 to charity, because she will lose it all if she trades that way. There are few guarantees in the futures industry, but losing all of your money if you trade with this much “maxed out” margin is the one sure bet available today. Here are some other key points about futures:

- There are also now futures available on stocks. Called *single-stock futures*, they are great to use as swing trades in combination with index futures. Although some of the symbols have low actual volume, the “real volume” is based on that of the underlying stock. (I talk more about single-stock futures in the chapter on propulsion plays.)
- With futures, at the end of the year, traders don't have to list each individual futures trade for their tax return the way they would have to do with stocks. They get a 1099 form from their broker with their total profit or loss for the year. All they have to put on their tax return is the number that's on the 1099. That is much easier and much less time-consuming than listing every trade. Tax treatment is also favorable. For stocks, a trader has to hold them for more than a year to get classified at the cheaper “long-term gain” rate. For futures, a trader gets a 1099 that says, for example, that he had \$20,000 in gains for the year. Of this, 60 percent of the money is treated as long-term gains (lower tax rate), and 40 percent is taxed at the short-term rate. This is the 60/40 rule. This rule holds true even if you go flat at the end of every trading day. This applies to all futures contracts except single-stock futures, which are treated as stocks in this regard.
- It is possible to trade futures in an IRA or retirement account through a trust company. I don't recommend this unless traders have already developed a proven track record in their own speculative accounts. And if this is the case, I recommend that they then allocate no more than 15 percent of any retirement funds to these vehicles. Traders have no business starting out in futures using their retirement funds. This is like deliberately choosing to go into battle without a bulletproof vest, or, for that matter, a weapon.

As already discussed, each stock index futures vehicle has four contracts that are traded each year: March (H), June (M), September (U), and December (Z). A trader will want to trade the closest month, because that is where the volume is concentrated. For example, if today is February 15, 2012, then the closest month is the March 2012 contract. To get a quote for the March 2012 contract on the E-mini S&P (ES), a trader would enter the symbol, month, and year. In this case, that would be ES (symbol), H (month = March), 12 (year = 2012). The full symbol would be ESH12. This is for TradeStation. For eSignal, it would be ES H2. For thinkorswim, it's/ESH2. Each quote service is a little different. When one contract expires, just start trading the next contract out. The four times a year that the contracts expire are always a little choppy as traders make the transition from one contract to the next.

Just remember that although the E-mini futures expire the same day as options expiration, on the third Friday of the month they are being traded in, the volume actually jumps into the next contract month on Thursday of the preceding week. For example, in March 2011, options and futures expiration was on the third Friday, which was March 18. The volume jumped into the June stock index futures contracts on Thursday, March 10. Bonds actually switch three weeks early. Each contract is a little different. If traders aren't sure, they just need to ask their broker, write it down, and put it next to their PC. Also, because these are futures contracts, there is

always a price difference between two contracts. When the March 2011 contract says 11,686 for the mini-sized Dow, the June contract may say something like 11,698. A trader shouldn't be confused by this too much. Futures contracts really are based on "future prices," which accounts for the difference. Just remember that each contract is its own entity. It's possible to wake up on rollover day and see that the S&P futures are up +8.00 points, when in actuality they haven't moved. It's just that the new contract month is being quoted, since the new June contract was trading higher than the old March contract. Most quote systems get a little confused by this. They end the day with the closing price of the old contract, then start the next day with the opening price of the new contract, and voilà, a price gap is created on the charts.

Also note that there is usually a 10- to 20-point difference between the mini-sized Dow futures price and the Dow Jones Industrials cash price on any given day. There is a very complicated explanation for this, involving "basis," "future price projections," and so on, that is not really important to the short-term trader. It's just something to be aware of so that traders don't think something is wrong with their quote systems.

That sums up the basics with regard to the mechanics of trading futures. The key is just to get comfortable with a futures execution platform and how it works. Buying a mini-sized Dow contract is just like buying IBM (International Business Machines) or GOOG (Google) in terms of mechanics. I also recommend starting off trading one lot at a time. A new futures trader will make mistakes, and a mistake on one lot is much cheaper than a mistake on ten lots or more. A trader who has never used a futures broker before should talk with other traders to check out rates, levels of service, and so forth. And you can always e-mail us at support@tradethemarkets.com with any questions.

The Mini-Sized Dow Versus the E-Mini S&P 500: Does It Matter?

Now that we have covered Futures 101, I'd like to review some of the basic differences between the mini-sized Dow and the E-mini S&P. I'm focusing on these two contracts because, in my experience, these are going to be the contracts that most of the people who are reading this either currently trade or will consider trading. I trade both contracts actively, but the mini-sized Dow has a few advantages over the E-mini S&P that I want to point out. This applies even more for newer traders.

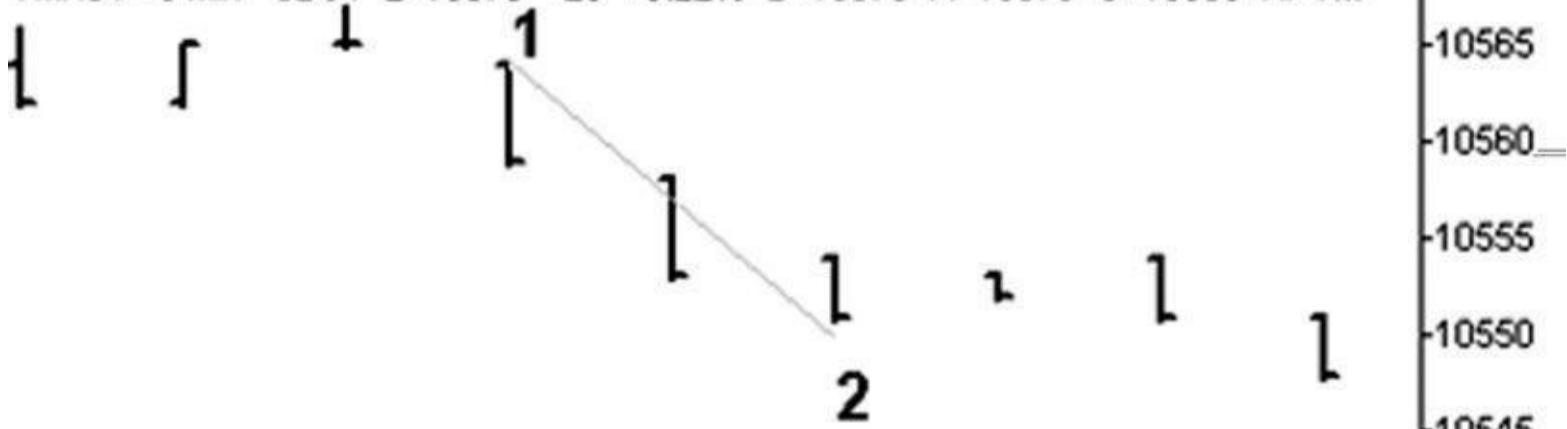
Why Is It Important to Understand the Difference Between the Various Stock Index Futures Contracts?

The mini-sized Dow (YM) has the same specifications as the popular E-mini S&P (ES) contract:

- One point in the E-mini S&P equals about ten points in the mini-sized Dow.
- One point in the E-mini S&P equals \$50; ten points in the mini-sized Dow equals \$50.

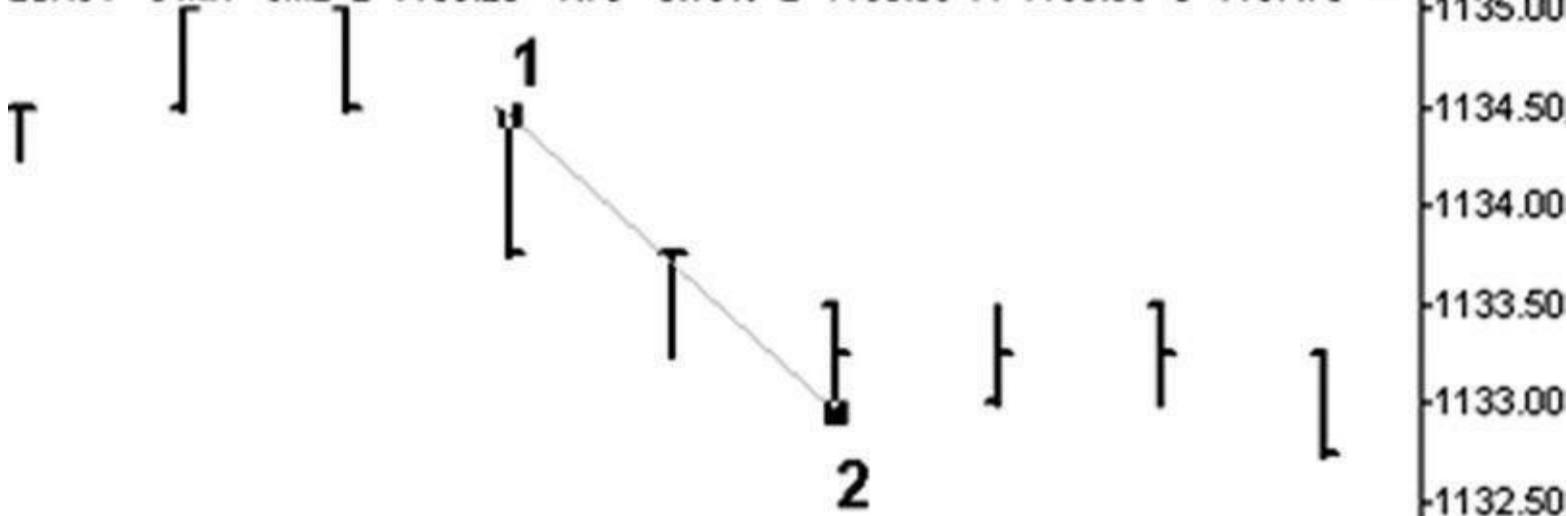
[Figure 4.5](#) shows movement on the Dow and the S&P over exactly the same time frame. The Dow has moved 13 points lower (from the high at point 1 to the low at point 2), and during this same time, the S&P has moved 1.5 points lower. The Dow moved lower in 13 one-point increments. However, the S&P made a similar move in six quarter-point increments. To break this down more simply, when the Dow moves 10 points, it does so in 10 one-point increments. When the S&P moves an equivalent one point, it does so in four quarter-point increments. This is a 60 percent difference in the spread. People who are trading the YM over the ES are putting that spread differential right into their pocket. Commissions and spreads are a cost of doing business, and anything that can be done to reduce costs will improve a trader's bottom line.

YMH04 - 5 min CBOT L=10575 +23 +0.22% B=10575 A=10576 O=10563 Hi=1...



10564 - 10551 = 13 Dow Points

ESH04 - 5 min CME L=1136.25 -1.75 -0.15% B=1138.50 A=1138.50 O=1137.75 ...



1034.50 - 1133.00 = 1.5 S&P Points

3:30 3:35 3:40 3:45 3:50 3:55 4:00 4:05 4:10

Figure 4.5

Another interesting phenomenon is that nearly all setups on the ES also can be executed identically on the YM. In fact, I often watch the ES for trade setups, and then take them on the YM. However, by using the YM instead of the ES on these setups, a trader will get picked off on stop runs less frequently. Why is this? It goes back to the spread. A 2-point stop on the ES is the same as a 20-point stop on the YM. There are many times when the ES will run 2 points on a stop run, and this

moves the YM 18 or 19 points, missing the stop. The YM has 12 extra places to place a stop or target over the ES in a 20-point move. Because of this, I prefer to do my pivot trades almost exclusively in the YM.

When Is Liquidity King?

When the mini-sized Dow first came out, it was trading very little volume. However, the contract caught on fast, and today it trades volume in six figures nearly every day. The ES is still the big boy when it comes to volume, trading millions of contracts per day. This is something that some traders need to consider. If you are trading 1 lot at a time, or even up to 10 lots, then the YM is fine. But if you are trading a larger account and are using 40 or 50 contracts, then you'll want to trade in the ES, where there is greater liquidity. The reality for me is, though I would love to do more trades in the YM, I am mostly limited to the ES when trading stock index futures because of liquidity. That said, I will typically "spread the love" across multiple contracts. If I see a solid setup taking shape as a day trade, where I plan to allocate a total of 50 contracts, I might buy 40 ES and 10 YM. Finally, if you do become an active stock index futures trader, seriously consider getting a seat lease through the CME Group. There is one for the YM called an "IDEM" and one for the ES called an "IOM." These will reduce your exchange fees by about 80 percent, thus reducing your costs. For the YM, a seat lease is currently around \$75 per month, and for the ES, it's around \$550 a month as of September 2011. These prices can fluctuate based on the amount of volume being traded. There is a healthy application fee of around \$1,500.00 for each of these. If you trade around 2 YM contracts per day or 20 ES contracts per day, then the lease is a "breakeven" venture. If you make any more trades than that, you start saving money. If you are interested in this program and need any help navigating through the process, feel free to e-mail us at support@tradethemarkets.com.

What Is the Easiest Way to Stay on the Path of Least Resistance?

A trader can watch the 30 stocks in the Dow to get a very good idea of how the index is acting or is going to act. I like to place all 30 Dow stocks in a window and have them automatically sorted from strongest to weakest each day on a Net % Change basis. Getting a feel for all 500 stocks in the S&P 500 at a glance is impossible. By doing this with the Dow, I can look at my sorter list and see at a glance that, for example, 26 out of the 30 stocks are red (down on the day).

[Figure 4.6](#) shows all 30 Dow stocks sorted from best to worst on a Net % Change basis. I can watch the list and see that at this moment in time, 7 stocks are down on the day, while 23 stocks are up on the day. Later in the day, I might see that 11 are up on the day and that 19 are down, and I can tell at a glance that the Dow is getting stronger—even if the index is still chopping around. If the individual components of the Dow are getting stronger, the entire index will eventually make a run higher. This filter gives me a clean downward or upward bias to the market, as I can watch more stocks going red or going green as the markets start to fall apart or try to improve. This type of "at a glance" analysis is very difficult to do with the 500 stocks that make up the S&P 500 index.

Also, with the Dow components, it is easy to see which ones have more weight. If IBM (International Business Machines), CVX (Chevron), and MCD (McDonald's) are all down on the day, this is going to have more of an impact on the Dow than if BAC (Bank of America), AA (Alcoa), and GE (General Electric) were all down on the day.

[Figure 4.7](#) shows a listing of all of the Dow stocks and the current percentage weighting each has within the index. Again, this would be very difficult to do with all 500 stocks of the S&P 500.

Why Are Futures Easier to Trade Than Stocks?

If traders currently are in an individual stock, there can be all kinds of outside influences that can move the price. Maybe insiders are dumping their own stock. Maybe an analyst has just issued an upgrade while the analyst's trading department is dumping shares on an unsuspecting public. Maybe the company is giving positive forward guidance as its last hope to stave off bankruptcy proceedings. The factors affecting an individual stock are endless.

	Symbol	Description	Last	Net Chg	Net %Chg	Volume Today
1	IBM	Intl Business Machines Corp	178.71	4.20	2.41%	7,640,243
2	CVX	Chevron Corporation	93.62	2.13	2.33%	11,080,157
3	UTX	United Technologies	73.16	1.61	2.25%	6,842,824
4	MMM	3M Co	76.67	1.48	1.97%	4,875,385
5	XOM	Exxon Mobil	72.95	1.23	1.72%	26,691,728
6	HPQ	Hewlett-Packard	23.90	1.19	5.24%	39,530,129
7	JNJ	Johnson & Johnson	63.76	1.07	1.71%	13,118,567
8	CAT	Caterpillar Inc	77.68	0.83	1.08%	10,817,079
9	DIS	Disney (Walt) Co	31.08	0.78	2.57%	15,724,577
10	TRV	The Travelers Companies Inc	49.10	0.76	1.57%	4,967,682
11	DD	Dupont(E.I.)Denemours	42.26	0.72	1.73%	10,415,216
12	PG	Procter & Gamble	63.26	0.72	1.15%	10,732,339
13	MCD	McDonald's Corp	89.99	0.65	0.73%	8,043,755
14	BA	Boeing Co	62.61	0.60	0.97%	6,410,587
15	KFT	Kraft Foods'A'	34.86	0.60	1.75%	10,629,338
16	KO	Coca-Cola Co	69.31	0.55	0.80%	11,124,681
17	MRK	Merck & Co	32.00	0.39	1.23%	15,236,322
18	T	AT&T Inc	28.67	0.33	1.16%	29,439,979
19	INTC	Intel Corp	22.50	0.26	1.17%	88,219,615
20	VZ	Verizon Communications	36.61	0.25	0.69%	18,013,432
21	MSFT	Microsoft Corp	25.64	0.20	0.79%	55,623,705
22	CSCO	Cisco Systems	16.17	0.18	1.13%	64,908,155
23	GE	General Electric	15.72	0.15	0.96%	80,397,287
24	JPM	JPMorgan Chase & Co	31.64	-0.01	-0.03%	58,242,837
25	AA	Alcoa Inc	10.43	-0.02	-0.19%	30,932,667
26	PFE	Pfizer, Inc	17.74	-0.03	-0.17%	44,488,700
27	WMT	Wal-Mart Stores	51.80	-0.03	-0.06%	11,492,543
28	BAC	Bank of America Corporation	6.52	-0.08	-1.21%	231,598,818
29	HD	Home Depot Inc	33.70	-0.30	-0.88%	13,172,942
30	AXP	American Express Company	46.77	-0.79	-1.66%	9,141,861

Figure 4.6

However, when investors in general want to sell stocks, the Dow reacts by heading south. If they want to buy, the Dow spurts green. The “Dow effect” encompasses individual investors, hedge funds, program traders, and arbitrage traders. In addition, the Dow moves actively in all buy and sell programs. It is supply and demand at its finest, and this is what makes the mini-sized Dow futures contract such a great instrument to trade. Even better, while an individual stock may be halted, the YM trades on. Even on days where the YM could reach a daily price limit—which is currently a 10 percent move in the entire index—this could still be offset in the cash market using the Dow Exchange-Traded Funds (DIA). If traders have a stock that they own halted, there is nothing to do but wait—generally for pain.

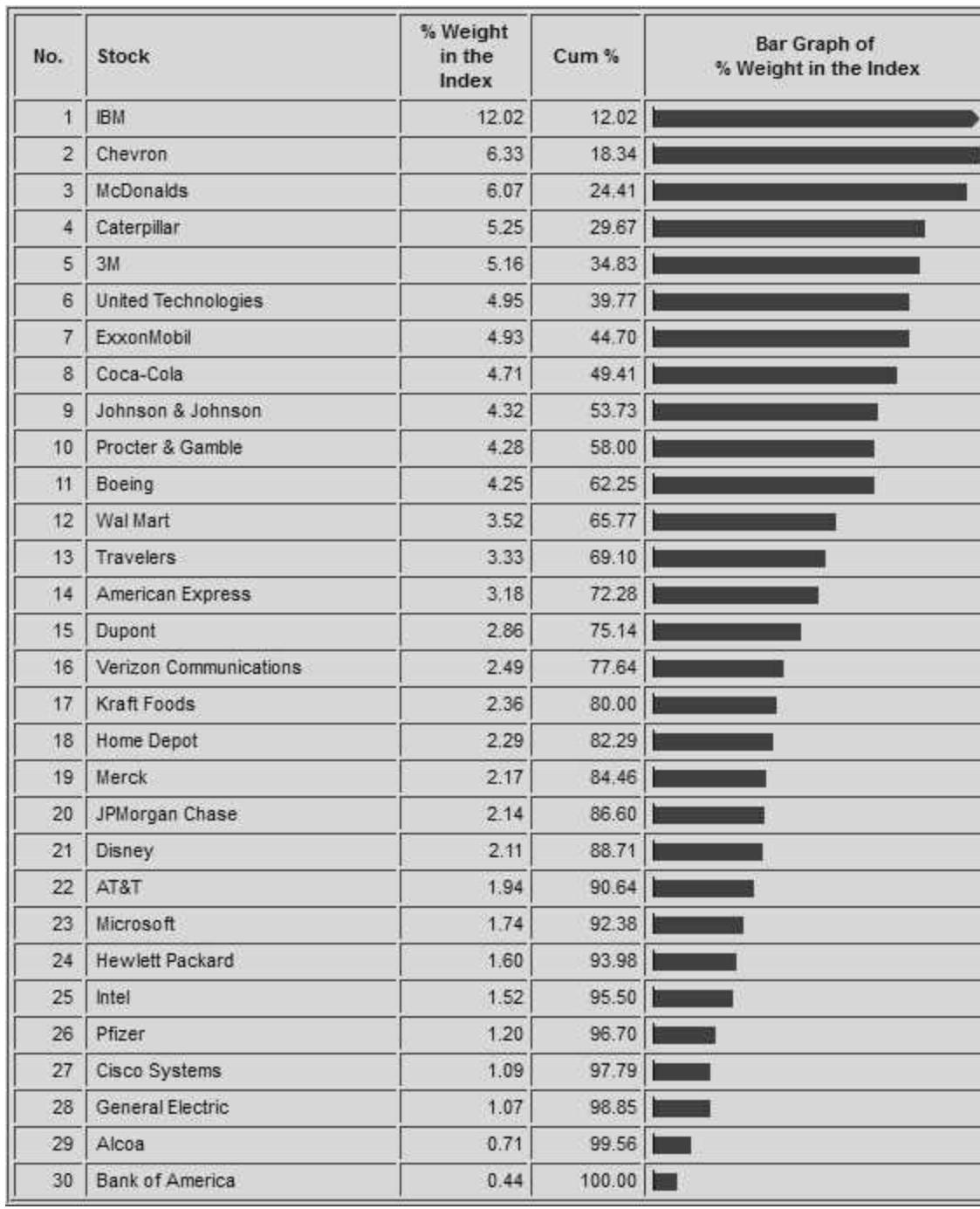


Figure 4.7

Why Do Newer Traders Do Better with the YM?

It is not an assumption that new traders do better with the YM. It is based on my observation of watching hundreds of traders go through a process in which they move from trading stocks and jump into the futures markets. They start trading the ES, and they lose money. Then they switch to the YM, and things start taking shape and they make money. I've even watched newer traders start off in the YM, then try the ES, then the NQ, and then the TF—and they always come back to the YM. Why is this? Part of the reason is psychological—it just sounds better to take a 13-point profit as opposed to an equivalent 1.25 points in the ES. I've watched ES traders let a "small" 1.25 profit turn into a loss, whereas a YM trader with an equivalent 13 points will automatically and unhesitatingly sell off a couple of contracts in order to cash in some profits. Finally, it is important to realize that the best traders in the world are trading the ES. As a newer trader, it is not the best idea to go up against these people. If you are just starting out in Tai Kwon Do, do you want to spar with a beginning white belt or an advanced black belt? The YM doesn't have the intensity of the ES crowd. Remember, traders are not trading a market—they are trading other traders. Cut your teeth on the YM, then venture into deeper waters.

This may seem like I'm knocking the ES, but I'm really not. It's an awesome contract to trade, and later in the book there are plenty of setups in which I utilize this contract. However, this is a contract for professionals, and I do think it is better for newer and intermediate traders to stick with the YM in order to improve their odds of success.

Contract Specifications—What Does a Trader Need to Know to Trade the Key Commodity Markets?

I want to spend a little time going into the contract specifics for some of the markets I just discussed. For newer traders, the most confusing thing about futures contracts is that, unlike stocks, each futures market has different pricing specifications and trades in different months. This makes it tricky to figure out how much a move is worth to a trader's P&L, and it is a pain to try to figure out how to bring up a quote. (Note that I have listed all the month codes in the chapter on propulsion plays, but I will also review some of them here.)

If a stock trader is buying IBM or RIMM, they both work the same way, even though they are different stocks. A move of \$1 in either stock has the same impact on a trader's P&L. Unfortunately, that's not how it works in the futures markets. Again, if you are already familiar with these, feel free to skim. My intention for newer traders is that you'll be able to use this as a quick reference guide now and down the road as you look at trading additional contracts. *Please note that all times discussed are based on the eastern time zone.*

Mini-sized Dow (YM). The YM trades on the CBOT (now CME Group). It opens for business at 6:00 p.m. eastern time on Sunday, and trades until 4:15 p.m. eastern on Monday afternoon. It reopens for trading 15 minutes later, at 4:30 p.m. eastern, shuts down for maintenance from 5:30 p.m. to 6:00 p.m., then trades continuously again until 4:15 p.m. the next day. It does this all week, closing for the weekend at 4:15 p.m. eastern time on Friday. The contract months are March (H), June (M), September (U), and December (Z). The YM moves in increments of 1 point, which equals \$5 per contract. Catching a 30-point move using one contract would equal \$150. Although this contract trades nearly 24 hours, I usually focus on it only during the regular cash market session, from 9:30 a.m. to 4:15 p.m. The quote format on TradeStation for the March 2012 contract is YMH12. The continuous symbol on TradeStation is @YM. For thinkorswim, the March 2012 contract is /YMH2./YM is the continuous symbol. *Continuous* means that the contract will automatically change from March to June to September, and so on, on rollover days. This is used for charting purposes so that there is literally one "continuous" chart of all the different contract months. This is useful for looking back over several months or years of data. You actually can't trade the "continuous" contract—only a specified month.

E-mini S&P (ES). The ES trades on the CME, with the same hours as the YM. The contract months are March (H), June (M), September (U), and December (Z). The ES moves in increments of 0.25 point, which equals \$12.50 per contract, or \$50 for a full 1-point move. A 3-point move in the ES using one contract would equal \$150. Although this contract trades nearly 24 hours, I usually focus on it only during the regular cash market session, from 9:30 a.m. to 4:15 p.m. Quote formats are the same as those for YM; just substitute ES for YM.

E-mini Nasdaq (NQ). Hours are the same as for the ES and YM. The NQ moves in increments of 0.25 point, which equals \$5 per contract, or \$20 for a full 1-point move. A 3-point move in the NQ using one contract would equal \$60. For quotes, use the same formats as those for YM and ES, but substitute the NQ symbol.

E-mini Russell (TF). The TF (formerly ER) used to trade on the CME, and now trades on the ICE (Intercontinental Exchange). Although retail traders don't know about this or frankly care, there was a huge battle between the CME and the ICE to get this contract. The ICE paid more than \$50 million for the rights to trade Russell products, and the contract switched over from the CME to the ICE. This is all "invisible" to retail traders, as it's still just a clickable trade on your computer, no matter what the exchange. This contract is attractive to trade because it jumps around and has large P&L swings. It opens on Sunday evening at 6:00 p.m. eastern time, then trades through 6:00 p.m. eastern time the next day. It then stops trading for two hours, reopens at 8:00 p.m. eastern time, and trades through until 6:00 p.m. eastern time the next day, repeating the process through the rest of the week. *One of my favorite ways to use the Russell is as a leading indicator.* It will often time a breakdown or breakout before the other three indexes just discussed. The contract months are March (H), June (M), September (U), and December (Z). The TF moves in increments of 0.10 point, which equals \$10 per contract, or \$100 for a full 1-point move. A 3-point move in the TF using one contract would equal \$300. For quotes, use the same formats as given previously and substitute the symbol TF.

German DAX and Euro STOXX 50. I want to include a brief note on these indexes, because I've seen a lot of press on them in recent months. First, the DAX. This is the German equivalent of the Dow. This is a good market to trade, but it is not for beginners. I've seen many traders who normally trade 10 YM or 10 ES lots, which are interchangeable, jump into the DAX and also trade 10 lots. They heard that the DAX was like the Dow because it has a trading range similar to the Dow, and it's made up of 30 big stocks like the Dow, so they go ahead and use a 20-point stop, just like they would on the Dow. When their stop is hit, they think they should have lost only \$1,000, but it ends up being \$6,500. The bottom line is that the DAX is a large contract. It trades in a similar range as the YM, but instead of \$5 a point, it's worth 25 euros a point. If the exchange rate is 1.2937 (that is, how many dollars a euro is worth), that makes each point worth \$32.34. This is like trading a little over 6 YM or ES contracts. In the 10-lot example, it would be the equivalent of trading 65 lots on the YM or ES. This is obviously important to know. The DAX trades from 2:00 a.m. until 1:00 p.m. eastern standard time in the winter. With daylight savings, that changes to 3:00 a.m. to 2:00 p.m. eastern standard time. To get quotes on this contract, you have to sign up for Eurex with your data feed, which runs about \$9 a month. The contract trades March, June, September, and December. The Euro STOXX 50 Index is a futures contract that provides a blue-chip representation of the Eurozone and is much more comparable to the ES in size and liquidity. If you are up late at night and want to trade Europe, then trade this contract. The symbol on TradeStation for the DAX is @FDAX for the continuous contract. For the Euro STOXX 50, it's @FESX.

Full-sized 100-oz. gold (GC) and 5,000-oz silver (SI). I've talked a lot about the stock index futures, so let me talk briefly about gold and silver. If you trade gold, you will be in good company. No other market in the world has the universal appeal of the gold market. For centuries, gold has been coveted for its unique blend of rarity, beauty, and near-indestructibility. Nations have embraced gold as a store of wealth and a medium of international exchange, and individuals have sought to possess gold as insurance against the daily fluctuations of paper money. Gold is also a vital industrial metal, as it is an excellent conductor of electricity, it is extremely resistant to corrosion, and it is one of the most chemically stable of the elements, making it critically important in electronics and other high-tech applications. That's all well and good, right? But as a trader, all I really care about is whether the market in question provides good trading opportunities. Over the last several years, gold has become a great market to trade, with plenty of volatility and trending price action. The pit starts trading at 8:20 a.m. and ends at 2:00 p.m., and during this time there is a lot of action and volume. The electronic version trades right along with the pit, then continues trading into the night, giving nearly 24-hour access to gold prices. The contract months for gold can get complicated. The official months are "the current month, the next two months, and any

February, April, August, and October falling within a 23-month period and any June and December falling within a 60-month period.” For the setups I’m using I’m looking at the front month or the next month out, which means that every month is in play. The rest of the available trading months are for people who are looking at hedging many years into the future. I like to establish trades in this contract during pit session hours for day trades, but I will also trade it overnight if the setup is strong. Gold moves in increments of 10 cents, and each 10 cents is worth \$10 per contract. A full \$1 move in the price of gold is worth \$100 per contract. Note that to get quotes, traders have to be signed up for COMEX data through their quote vendor. What about silver? The 5,000-oz silver contract is a big one. Each 1-point move is worth \$5,000, and it moves in $\frac{1}{2}$ -cent increments. Each 1-cent move is \$50.00. Silver is a thinly traded contract, and frankly, it’s not for beginners.

E-micro gold (MGC). This is a newer contract that is $\frac{1}{10}$ the size of the GC contract and answers the question, “What if I don’t really want to trade 100 ounces of gold at a time?” This contract represents 10 ounces of gold, so instead of a full \$1.00 move affecting your P&L by \$100.00, it would affect your P&L by only \$10.00.

Full-sized 30-year bond (US—pit, ZB—electronic). Interest-rate futures were pioneered by the CBOT in 1975 in response to a growing market need for tools that could protect against sharp and frequent swings in the cost of money. U.S. Treasury bond futures were introduced first, followed by futures on 10-year, 5-year, and 2-year U.S. Treasury notes. Over the past two decades, contract volume has exploded, reflecting the growth of the underlying instruments and profound changes in the marketplace. If you focus primarily on the stock market, it is critical that you become familiar with bonds. The bond markets dwarf the equity markets. Therefore, it is important for you to know when money is flowing out of bonds or into bonds. The bond markets and the stock markets also have an interesting relationship. Sometimes they move directly opposite each other, during periods of portfolio reallocation. This happens when huge funds have to sell stocks and buy bonds to readjust the percentage of capital that they have invested in each. During these times, new highs in the bond market lead to new lows in the stock market, and thus bonds become a great leading indicator. The pit contract trades from 8:20 a.m. to 3:00 p.m., Monday through Friday. The electronic version trades until 5:00 p.m. and reopens three hours later, at 8:00 p.m., Sunday through Thursday. I always trade the electronic version. The contract months are March (H), June (M), September (U), and December (Z). The bonds move in increments of $\frac{1}{32}$, which is called a *tick*, and are worth \$31.25 per contract; $\frac{32}{32}$ equals 1 full point, which is \$1,000 per contract.

Ten-year notes (TY—pit, ZN—electronic). The 10- year notes trade on the CBOT (now CME Group) and are the same as the 30-year bonds in terms of trading hours and trading months. The notes move in increments of $\frac{1}{64}$, which are called *ticks* and are worth \$15.625 per contract. These are very liquid contracts and are great for both swing and day trading.

Soybeans (S). My appreciation of the grain markets came about through an accident. I own a 1,000-acre farm in Palisade, Nebraska, and because of that I started watching the grain futures prices. I liked the way they traded, and, once I learned about the contract specifications, I realized that they trade very similarly to the E-mini S&Ps and mini-sized Dow. Soybeans trade in the pit from 10:30 a.m. to 2:15 p.m., Monday through Friday. There is also an electronic session that runs from 8:31 p.m. to 7:00 a.m. The symbol for this is ZS, but I don’t watch this session or trade it. I focus on this contract during the pit hours, but I trade the electronic contract. Soybeans move in increments of $\frac{1}{4}$ cent, and each $\frac{1}{4}$ cent is worth \$12.50. A full cent is worth \$50. This is just like the E-mini S&Ps, where they move in quarter-point increments worth \$12.50, and a full point is worth \$50. An 8-cent move in soybeans is just like an 8-point move in the ES or an 80-point move in the YM and is worth \$400. Soybeans trade in September (U), November (X), January (F), March (H), May (K), July (N), and August (Q). Soybeans are the most volatile of the three grains. They generally trade in a range equal to $1\frac{1}{2}$ times that of the ES and YM.

Corn (C). Everything about corn is the same as that for soybeans except that the contract months are December, March, May, July, and September. This is the quietest of the three grains. A one-cent move is worth \$50, just like in soybeans. There is a saying in trading circles that goes, “If you can’t make money trading then trade corn.”

Wheat (W). Everything about wheat is the same as that for corn, and a one-cent move in this market is also worth \$50. Note that all quarter-cent moves in grains are recorded as eighths. So a price of 3414 actually means 3.41 $\frac{1}{2}$ (3.41 and $\frac{4}{8}$), and 3416 means 3.41 $\frac{3}{4}$ (3.41 and $\frac{6}{8}$).

Currency futures. I’m lumping all of these together in one category. Currencies trade in both the futures market and the “cash” market, which is commonly known as forex. I’m not a big fan of the forex cash market, as it is unregulated. The cash forex guys completely outmarketed the regulated exchanges when it came to trading currencies, which is why a lot of people are surprised to hear that you can actually trade currencies on a regulated futures exchange. The currencies that matter are called the majors (the major world currencies as they trade against the U.S. dollar), and they are as follows: the euro (EC/6E), the Australian dollar (AD/6A), the Canadian dollar (CD/6C), the British pound (BP/6B), the Swiss franc (SF/6S), and the Japanese yen (JY/6J). For the symbols, I listed those for both the pit session (EC) and the corresponding electronic contract (6E). There is no need to trade the smaller markets, such as the Mexican peso/U.S. dollar or the krona/shekel cross. There are plenty of opportunities in the big contracts, which of course are also the most liquid. Also note that if you hear quotes for the “eurodollar,” that’s the bond market. The currency is just called the euro or euro FX. Currency futures trade nearly 24 hours, kicking off the week at 6:00 p.m. eastern time on Sunday. The contract months are March, June, September, and December. The contracts all move in 1-cent increments, with 100 cents equaling a full “big figure” move (for example, from 1.4300 to 1.4400 is a 100-tick or “full point” move). It is important to note that the contracts do have different tick values, and they are as follows: EC, JY, and SF: \$12.50 per tick and \$1,250.00 per full point; AD and CD: \$10.00 per tick and \$1,000.00 per full point; BP: \$6.25 per tick and \$625.00 per full point. Note that those prices are for both the pit and the electronic contracts. Note that you can also trade “U.S. dollar futures,” and the symbol is DX. This symbol is a composite of all the major currencies listed previously as they relate to the U.S. dollar.

Mini (E-micro) currency futures. These are the newer kids on the block, and they are $\frac{1}{10}$ the size of the full-sized contracts listed previously. The symbols are M6E, M6A, M6S, M6J, M6C, and M6B. Not surprisingly, M6E refers to the “E-micro euro,” and so forth. Whereas the full-sized EC contract moves \$12.50

per tick, the M6E moves \$1.25 per tick. For those who are new to currencies and futures in general, these are good contracts in which to get the proverbial feet wet.

Crude oil (CL). Oil has become a big focus for stock prices ever since it shot above \$70 a barrel and kept on going. This is not a market for beginning traders, but it is helpful to understand how it works from a trader's perspective. This contract trades on the NYMEX (New York Mercantile Exchange, now part of the CME Group). Oil moves in increments of 1 cent. A 1-cent move equals \$10 per contract, so a full \$1 move in the price of oil equates to \$1,000 per contract. The pit opens at 10:00 a.m. and closes at 2:30 p.m. After-hours trading starts at 3:15 p.m. and goes through until 9:30 a.m. There are contracts for each month for many years out.

(NQ #F - NASDAQ 100 E-mini Futures - Globex,10) Dynamic,0:00-24:00

Buy NQ at 1420

Stopped out at 1408

Equals -12.00 points

 $12.00 \times \$20 = -\240.00 per contract

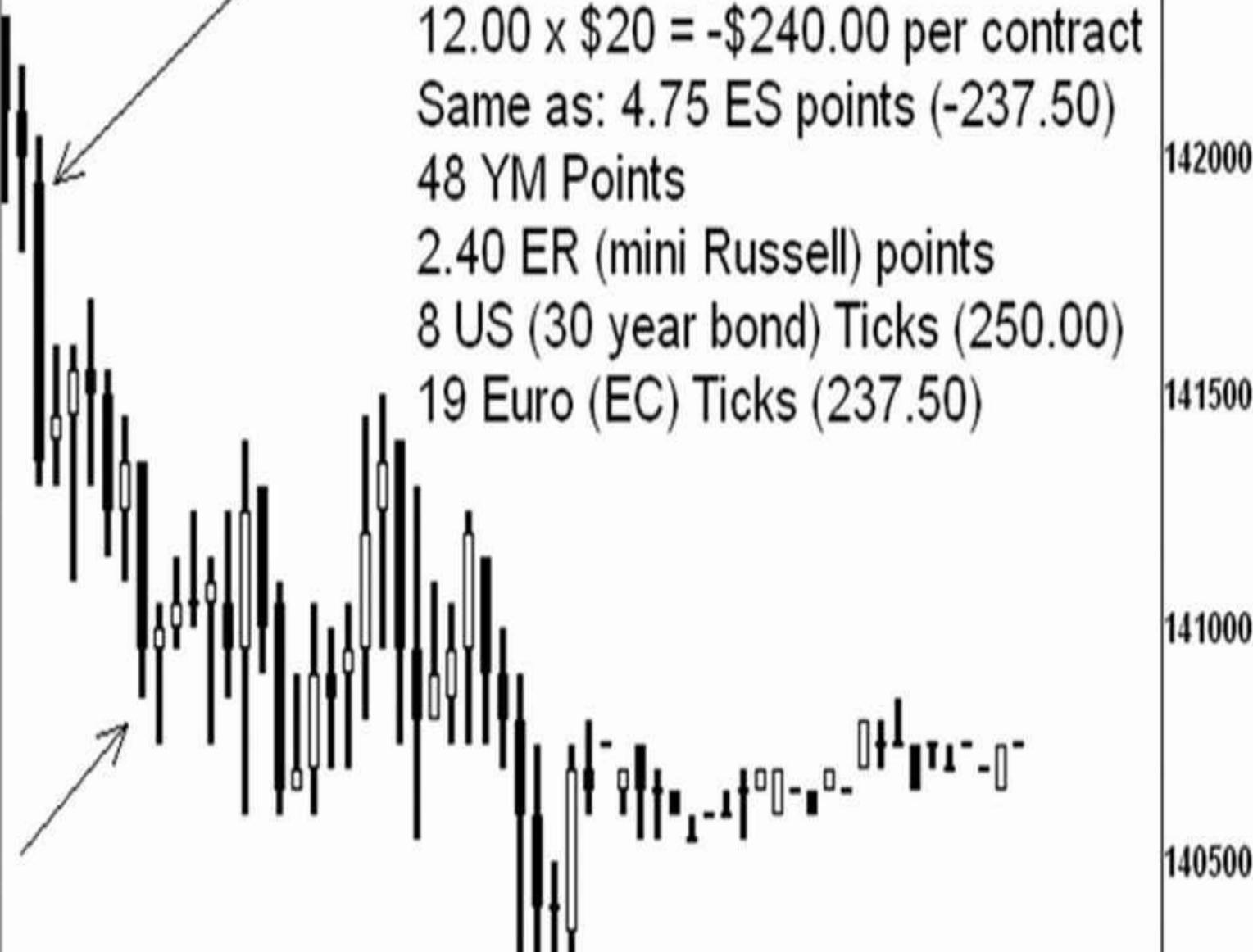
Same as: 4.75 ES points (-237.50)

48 YM Points

2.40 ER (mini Russell) points

8 US (30 year bond) Ticks (250.00)

19 Euro (EC) Ticks (237.50)



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11:00 12:00 13:00 14:00 15:00 16:00 18:00 19:00 20:00

Figure 4.8

Mini-crude oil (QM). The contract for mini-crude oil is the same as the big contract, except that a 1-cent move is worth \$5 per contract, and a full \$1 move is worth \$500 per contract. For oil, be aware that contracts expire early—a September contract will expire in August.

Various single-stock futures. These are discussed in detail in the chapter on propulsion plays. One contract represents 100 shares of stock, so a 1-point move with one contract represents \$100 to a trader's P&L.

That is the basic information for the trader on these futures contracts. One important thing to keep in mind is how all these contracts translate in terms of price movement with respect to the risk management techniques traders choose to utilize in their own trading plan. Let's take a look at an example stop loss taken in the NQ.

[Figure 4.8](#) shows a 12-point loss that was taken in the NQ, which equates to a loss of \$240 per contract. If a trader wants to use a monetary stop of approximately \$240 for every trade in every market, then it is helpful to create a reference sheet of how this translates into other markets. This way, a trader will be less prone to making a pricing error when it comes to figuring out appropriate stop losses in various futures markets. In this chart, we can see that a 12-point stop in the Nasdaq is equal to a 4.75-point stop in the S&Ps, which is equal to a 48-point stop in the YM, which is equal to a 2.40-point stop on the Russell (on the chart, this is shown as symbol ER; it now trades under the symbol TF), which is equal to an 8-tick stop on the 30-year bonds, which is equal to a 19-tick stop on the euro. This also equals a 24-cent stop on crude oil, a 48-cent stop on mini-crude oil, a 2.40 stop on gold, a 7.20 stop on mini-gold, and a 4¾-cent stop on the grains. That's the golden rule in futures—know your monetary stop, and then be able to know what that means in tick values across the contracts you'd like to trade. Whereas I might trade 10 ES contracts on a setup, I would trade only 2 SI (silver) contracts on the same setup.

Easy enough? Let's take a quick peek at the forex markets.

Currencies and Forex for Newbies: How Do They Really Work?

Again, this section is geared toward traders who are not familiar with the forex cash markets, so experienced forex traders should feel free to skip ahead, although the section on "How Can You Hedge Your Own Life in the Forex Markets?" might be of interest. Also note that I trade these currencies on the previously listed futures exchanges. However, I think it is helpful to understand the cash markets, as they do give a detailed overview of how the currency markets work. There is no difference in trading currencies in the "forex cash markets" or the "futures markets" except for one minor detail: the futures markets are regulated. I'm more comfortable putting my hard-earned cash into a regulated environment.

This section started off very, very long—as any section that starts with the phrase "In the beginning" inevitably will. A fellow forex trader, Todd Gordon, helped me to go through this several times and cut it down to the bare essentials. On a side note, when I first wrote this book, Todd worked as a corporate flunkie. Now, in 2011, he's got his own company and his own show on CNBC. Ah, to see the baby birds leave the nest.

The foreign exchange market, also referred to as "forex" or "FX," is the largest financial market in the world, with a daily average turnover of well over \$1 trillion—30 times larger than the combined volume of all U.S. equity markets. "Foreign exchange" is literally the simultaneous buying of one currency and selling of another. Currencies are traded in pairs; for example, euro/U.S. dollar (EUR/USD) or U.S. dollar/Japanese yen (USD/JPY). The most liquid of these currencies are called the *majors* and make up more than 85 percent of all daily transactions in this market. The majors are made up of the following:

USD	=	U.S. dollar
JPY	=	Japanese yen
EUR	=	euro
GBP	=	British pound
CHF	=	Swiss franc
CAD	=	Canadian dollar
AUD	=	Australian dollar

Forex trading begins each day in Sydney and moves around the globe as the business day begins in each financial center, first to Sidney and Tokyo, then the Eurozone, then to London, and finally to New York. This is truly a 24-hour market, and investors can respond to currency fluctuations caused by economic, social, and political events at the time they occur—day or night.

One thing I like about the forex markets is that the 24-hour trading day includes four major market opens that offer the same volatility and liquidity found in the one-time-per-day 9:30 a.m. EST stock market opening. The first is the Japanese open at 8:00 p.m. EST, then the Eurozone opens at 12:00 a.m. EST, the third is London at 3:00 a.m. EST, and bringing up the rear is the New York open at 8:30 a.m. EST. Although I generally stick to the New York open and sometimes the Japanese open, there are many traders I know who trade all the opens or whose schedules are dictated by their work, which for some people can include odd hours. With the availability of these four opens, a trader can fit at least one of these times into any schedule.

The FX markets are also the deepest, most participated-in markets in the world. Daily turnover equates to more than \$1.2 trillion, 16 times the volume of the Nasdaq and the NYSE combined. (See [Figure 4.9](#).)

FX Market Comparison

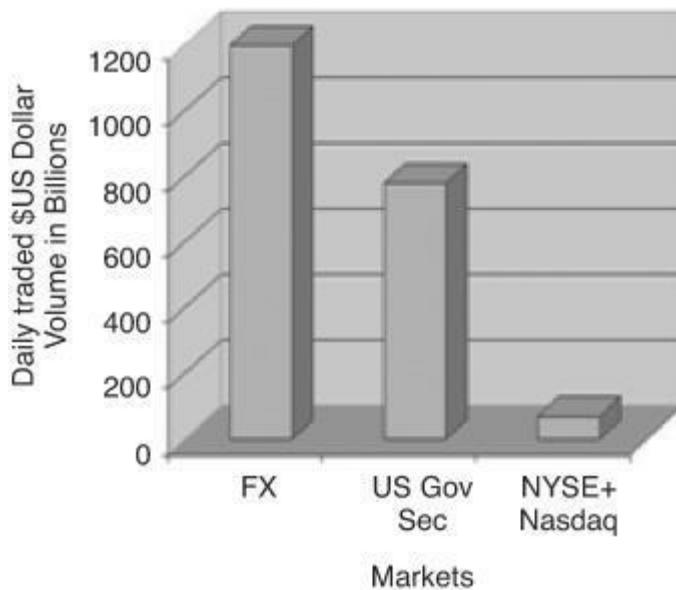


Figure 4.9

The forex markets are among the most technical markets in the world, meaning that they respond well to most technical analysis studies. It is not uncommon to see a 300-pip breakout move stop and change trend at a technical level to within 5 pips. (A “pip” is to forex as a “point” is to the stock index futures.)

A trader also doesn’t have to worry about contract rollovers in the forex market. It is possible to buy a few lots of the EUR/USD, GBP/USD, and AUD/USD, place a stop, and forget about it for months at a time. FX dealers automatically roll your position from one day to the next for you to prevent the event of delivery.

In addition, most FX dealers offer a negative-balance protection guarantee that ensures that your account will never reach a position of negative equity, which can happen in the stock market for traders who are maxed out on margin as well as the futures market. There is an interesting way to take advantage of this. People can open up FX accounts at different dealers and deposit a small portion of their overall trading capital. They can go long a currency in one account and short the same currency in another account, then just leave both accounts alone, with no stops or targets. While the two positions are open, they will offset each other equally, so it’s a perfect hedge. If one of the currencies then gets into a prolonged move, one of the accounts will get closed when the account equity gets to zero. At this point, the trader is still at breakeven on the trade because the losses in one account are offset by gains in the other account. If the currency then continues to trend in the open account, the trader benefits from already being “in the move.” I don’t do this personally, but a few traders I know have done this and have had instances where accounts in the neighborhood of \$20,000 have turned into accounts in the neighborhood of \$400,000 on the backs of a couple of great moves. The key is that these traders take the positions and literally forget about them for six months. The currency just has to trend one way or the other. This obviously involves some luck, and I wouldn’t call it a “core strategy of any wise retirement plan.” My favorite reason for trading the forex markets (and this applies equally well to currency futures markets) is that they trend better than any other markets. Once a market gets going, it can easily trend for weeks and months in a nice steady march higher or lower. Unlike the stock market, which can often consolidate for years at a time (although not since the financial crisis of 2008), there are real trends happening all the time in the forex markets. Stock market traders talk of missing the big moves of the dotcom days. Today the dot-com moves are happening in the forex markets.

The biggest complaint I’ve heard people say about forex is that the FX dealers are taking the other side of their trade. I usually hear this from people who have overtraded their account and have lost all their money. This is really true in any market—somebody is always taking the other side of your trade. In my experience with forex, however, it is the high-frequency day traders who don’t last. On the other hand, the traders who place smaller positions and let them work out over the course of a few days to a few weeks or longer do well. As in any trade, market makers can mess with a position in the very short term, but over the course of a swing trade, they have no power. When George Soros was short the British pound and was told that the British government had allocated the equivalent of 20 billion U.S. dollars to stabilize the currency, he shrugged and said, “That will help them for 30 minutes. Then what are they going to do?” He made more than a billion dollars on that trade.

How Are Forex Moves Measured?

Forex trading, like many new things, is confusing yet simple. If a quote for the EUR/USD is 1.23, this simply means that 1 euro is equal to 1.23 U.S. dollars. A quote for the USD/JPY at 109.50 simply means that 1 U.S. dollar is equal to 109.50 Japanese yen (see [Figure 4.10](#)).

Quoting Examples

USD base currency quote

USD/JPY 109.50/55

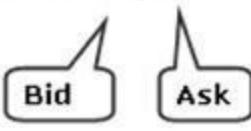


In this example, if you 'hit the bid' you will sell US\$1 and buy 109.50 Yen

If you want to buy dollars and sell Yen, you will 'lift the offer' and pay 109.55 Yen for US\$1

Non-USD base currency quote

EUR/USD 1.2815/18



In this example, if you sell 1 Euro (€), you will buy US\$ 1.2815

If you want to buy Euros and sell dollars, you will pay € 1.2818 for US \$1

Figure 4.10

Forex markets move in what are called *pips*. A pip (price interest point) is the smallest unit of price for any foreign currency.

- EUR/USD trading from 1.2300 to 1.2301 = a gain of 1 pip
- USD/JPY trading from 108.01 to 108.09 = a gain of 8 pips
- GBP/USD trading from 1.8302 to 1.8311 = a gain of 9 pips
- EUR/USD trading from 1.2300 to 1.2401 = a gain of 101 pips

A full one-cent move in the currency is equal to 100 pips.

How Do You Calculate Pip Values?

First, we start with the complicated way pip values are calculated, which is as follows:

- (1 pip, including decimal point/current exchange rate) × (notional amount)
- For the EUR/USD this translates into:

$$(0.0001/1.2935) \times (\text{€} 100,000) = \text{€} 7.73096$$

- But we want the pip value in U.S. dollars, not euros, so we go one step further:

$$7.73096 \times \text{current exchange rate (1.2930)} = \$10.00 \text{ per pip}$$

What this boils down to is this: any forex contract that ends in USD is worth \$10 per pip, or \$1,000 for a full 1-cent move (100 pips). The euro, for example, moves in a range of 80 to 150 pips per day. This \$10-per-pip calculation would include the euro (EUR/USD), pound (GBP/USD), and other such contracts. These are the contracts that most people trade. It gets a little trickier when this is not the case. For example, on March 29, 2005, a USD/JPY contract and any additional contracts that ended in JPY were \$9.35 per pip. On this same day, any contract that ended in CHF was \$8.29 per pip. The EUR/GBP was \$18.70 per pip, and so on, based on the various exchange rates. Again, most traders seem to focus on currencies that end in USD, so the \$10 per pip has become a universal number when talking about forex. There is also a mini-version of these contracts in which each pip is worth \$1.

What Happens to Currencies When Prices Change?

If a quote for the USD/JPY is at 108.00, it means that it takes 1 U.S. dollar to buy 108 Japanese yen. If the price moves to 109.00, this means that the yen has weakened against the dollar, because it now requires more yen to obtain the same 1 U.S. dollar. If the EUR/USD is trading at 1.20, this means that 1 euro can buy 1.20 U.S. dollars. A move to 1.22 means that the euro has strengthened against the U.S. dollar because it requires more U.S. dollars to obtain the same 1 euro.

How Can You Hedge Your Own Life in the Forex Markets?

There are many trade setups for forex that work in smaller time frames, and I talk more about these setups later in the book. However, the fascinating thing about the forex market is traders' ability to participate in world events on different scales and essentially "hedge their life."

EURUSD - Daily FOREX



Figure 4.11

For example, my wife and I visited Spain, France, and Italy from December 18, 2003, through January 14, 2004. (Yes, it's colder then, but there aren't any lines.) Excluding airfare, I added up the estimated costs in euros. On the day we booked this trip, September 30, 2003, the exchange rate was 1.1675. Based on this rate, I estimated that the trip would cost U.S. \$15,000. This cost would fall if the euro fell, but would increase if the price of the euro also increased. I pulled up a chart (see [Figure 4.11](#)).

In this figure, point 2 shows where the market was trading on the day we booked the trip. Point 1 shows the all-time highs at 1.1932 that had been hit on May 27, 2003. For our trip, I wanted the euro to fall so that our costs would also fall. However, just because I wanted the euro to fall didn't mean that it would. If the euro took off, our trip could get considerably more expensive. Since a regular contract represents \$100,000 worth of U.S. currency, it was much too large to use as a hedge. The minis each represent \$10,000 worth of U.S. currency, so this is where I looked to set up a position.

Looking at the chart on this day, I decided to place a buy stop order for two mini EUR/USD contracts at 1.1933, one pip above the all-time highs. This buy stop order meant that I would get into the market only if the euro traded up and through 1.1933. Instead of getting stopped out of a short position, I would be getting stopped into a long position, since I was currently flat.

I decided to do this at this higher level, instead of at the immediate price, in case the euro did roll over and fall. If it fell from where it was when we booked our tickets, it would be a plus for us, as our trip would get cheaper with each decline. However, if the euro broke out to new highs, it could ignite a huge rally and really inflate our trip budget. One mini-contract represents \$10,000, so I was essentially hedging \$20,000 in U.S. currency with the two mini-contracts. Since I underestimated how much the trip would cost, this actually worked out perfectly in the end.

On November 18, almost two months later, my buy stop was hit at point 3. By the time we left for our trip at point 4, the euro had moved more than 500 pips from my entry. By the time we got home at point 5, I closed out the position at 1.2665, a gain of 732 pips. Two mini-contracts equaled a gain of \$1,464, which paid for the increased exchange rate we had to pay while we were over there. Had the euro hit my buy stop and then sold off to 1.10, I would have lost money on the trade, but this would have been offset by the money saved during the trip because of the more favorable exchange rate. Had I set this up as a "normal" trade using five regular-sized contracts, a 732-pip move would have equaled \$36,600.

There are many other ways in which people can "hedge their life" in the forex markets. For people who think the value of the U.S. dollar is going to continue to decline and are worried about the value of their savings deteriorating against other world currencies, they can hedge their savings account by going long the EUR/USD. If a person has \$240,000 in savings, she can buy two regular contracts and four mini-contracts, and have a perfect hedge.

For Traders, Is This All You Need to Know?

The biggest question traders always ask is, "How much money do I need to buy one contract, and what happens after I buy it?" For forex, it can vary based on your broker, but in general, to buy one regular-sized contract, a trader will need about \$1,000, and to buy a mini-contract, a trader will need about \$100. This depends on the leverage that the broker is offering. A typical scenario is that traders will open up a small mini-account with \$500 and get 200:1 leverage. They will then buy two mini EUR/USD contracts, and this will cost them \$130. Their \$500 account now has \$371 in available equity, after the \$129 in margin has been deducted. In the worst-case scenario (which can happen), the trade goes completely wrong. It will have to move 185 pips against the traders (which wipes out their \$371 in equity) before their position is closed out by the dealer—provided they have zero-balance protection. The \$130 in margin that was used to establish the position is returned to the account, bringing the balance down from \$500 to \$130. If the trade works out, gains 55 pips on two mini-contracts, and is sold, then this \$110 profit is put into the account along with the initial margin, and the total balance then becomes \$610, less transaction costs. If a trader is using the big contracts in this scenario, everything is the same except that it is times 10.

How much does this cost in terms of transaction fees? Well, the spread is typically 3 pips wide in the EUR/USD for most FX dealers, which is what the trader pays instead of commissions. It's still a transaction cost—anyone who calls this "commission-free" trading should be hanged. For the minis, it equates to \$3 per side, and for the regular contracts, it's \$30 per side. The spreads will continue to narrow, and this will get cheaper. This isn't much different from trading the ES. In this case, the spread is \$12.50. Add, say, an \$8 round turn cost, and now you are really trading \$20.50 a round turn. A trader should always add the spread into his transaction costs.

I personally spend most of my time watching the following eight currency pairs. For each, I have given their TradeStation (TS) quote symbol, their thinkorswim (TOS) quote symbol, the corresponding futures contract symbol, and (in parentheses) the nickname that many traders use when referring to the contract.

1. EUR/USD (Euro). TS: EURUSD; TOS: EUR/USD; Futures: EC
2. GBP/USD (Cable). TS: GBPUSD; TOS: GBP/USD; Futures: BP
3. AUD/USD (Aussie). TS: AUDUSD; TOS: AUD/USD; Futures: AD
4. USD/JPY (Dollar Yen). TS: USDJPY; TOS: USD/JPY; Futures: JY
5. USD/CHF (Swissy). TS: USDCHF; TOS: USD/CHF; Futures: SF
6. USD/CAD (Loonie). TS: USDCAD; TOS: USD/CAD; Futures: CD
7. EUR/GBP (Euro Sterling). TS: EURGBP; TOS: EUR/GBP; Futures: RP
8. EUR/JPY (Euro Yen). TS: EURJPY; TOS: EUR/JPY; Futures: RY

Although there are many other minor currency pairs, these eight will provide plenty of trading opportunities, and they all tend to move together. It is also important to have a chart of the dollar composite index (\$DXY on both TradeStation and TOS). In general, if the dollar index is moving higher, then USD/JPY, USD/CHF, and USD/CAD are also moving higher. This action will push EUR/USD, GBP/USD, and AUD/USD lower. When the financial news networks mention that "Warren Buffett is short the dollar," he is really long EUR/USD, GBP/USD, and/or AUD/USD and short USD/CHF, USD/JPY, and/or USD/CAD. If the dollar goes lower, then

the first three currency pairs will move in the opposite direction from the dollar and go higher, and the last three currency pairs will move lower with the dollar.

For the futures markets, the price movements on EC, BP, and AD are identical to their cash counterparts in EURUSD, GBPUSD, and AUDUSD. However, the futures quotes on JY, CD, and SF are inverted. This is because they are quoted based on dollars (just as EURUSD is quoted in dollars). For example, USDJPY may be trading at 115.12, which tells a trader that 1 U.S. dollar is equal to 115.12 yen. Meanwhile, JY is trading at 0.8692, which tells a trader that 100 yen are worth \$0.8692 dollar (or 1,000 yen are worth \$8.692 or 10,000 yen are worth \$86.92, and so on). The reason for this is that the JY futures chart is based on a pairing of JPYUSD, whereas the cash market is based on USDJPY. Simple, right? For currency futures, if you want to play a short on the dollar, then you just buy any one of those six futures contracts. If you want to play a dollar long, then you short any of the six futures contracts. For newer traders who are trying to decide between trading cash forex and currency futures, I would suggest going into the currency futures markets because of the additional advantages described earlier.

As I'm writing this book, the MF Global mess has been unfolding before my eyes. For those of you who aren't familiar with this, MF Global was a major global financial derivatives broker, and many traders, especially hedge funds, traded futures contracts through MF Global. On Monday, October 31, 2011, MF Global admitted a transfer of \$700 million from customer accounts to its U.K. subsidiary to mask liquidity shortfalls at the company that resulted from wrong-way bets on European debts. Customer accounts were frozen, and MF Global filed the eighth-largest U.S. bankruptcy. As I'm writing this, clients have received about 75 percent of their funds back, and are still waiting to see what happened to the rest. (Canadian clients, because of stricter Canadian banking laws, received all of their funds back in 10 days.)

This incident has put a blemish, to put it lightly, on the futures industry. Hedge funds have gone out of business, careers and businesses have been destroyed. Individual traders continue to wait for the remaining 25 percent of their funds. I didn't have any accounts at MF Global (sometimes it's better to be lucky than smart) but I know many traders who did. The questions that keep surfacing are, "Should I keep trading futures? Is my money safe?"

I'm personally still trading futures for the reasons I've already described. I of course don't have all of my assets exposed to futures or sitting in a futures account. I've also re-double-checked the brokers that I use (the ones I've listed in this book) to make sure they aren't making any ridiculous bets on European debt (they aren't). Does that mean all is good? Unfortunately, no. This incident raises a ton of issues, and I predict that the CME Group will need to lead a taskforce to set up account guarantees, much like what is already in place in the stock industry. In the long run, that would be good for traders, and it would restore confidence in the futures markets. In the short term, this is an ugly mess that is not going to go away. The net result is that I'm still trading futures and am awaiting the next steps taken in the industry with keen interest.

For additional information, we've set up www.tradethemarkets.com/markets for current updates to the markets we are trading.

Stock Options: How Do They Work and What Is the Best Way to Trade Them?

Why Is Option Trading Awesome to Some and Scary to Others?

Options trading is the most fascinating type of trading, simply because there are so many different things you can do with options. And when it comes to options, there are generally two types of retail traders. The first doesn't know anything about them. The second tried buying an option (most likely an out-of-the-money call), lost money, and then discovered that a person could also sell options and collect the premium. This type of trader now knows the 300 different ways to collect premiums (for example, a clipped-wing, four-legged, three-eyed butterfly) and spends a lot of time legging into and out of option positions, making a little money each month. This tends to work for many months—until it doesn't, and then it gets very ugly very quickly. In other words, even though these people know everything there is to know about options, they still can't make a consistent income trading them. With options, too much knowledge isn't necessarily a good thing.

I utilize a few basic strategies when it comes to options trading. I like to keep things simple. I focus both on directional plays and on collecting premiums. I'm going to explain options quickly for newbies, focus on the few key things you need to know, and then discuss my favorite strategies. Then, when we get into Part 2 of this book, where I discuss setups, this chapter will have laid the foundation for the option strategies that I discuss in that part of the book. Did you forget what a delta is? Or an implied volatility (IV) crush? Then you can come back to this chapter for a quick reference.

What Would You Pay for a First-Class Plane Ticket to Singapore?

Imagine that you are on a flight from Chicago to Singapore. It's a mind-numbing 17-hour oxygen-depleted journey. By a stroke of luck, you get upgraded to first class. Score! You sit down, get comfortable, and get ready to enjoy this 17-hour flight in style. Just before takeoff, a hedge fund manager walks up to you and whispers, "Hey, I got stuck back in coach. I'd like to give you money to switch seats with me. How much do you want?" Well, this is a new twist. You love your seat. You don't want to leave your seat—but how much is this guy willing to give you for it? You go back and forth, and he says he is willing to give you no more than \$1,500.00 for the seat. You tell him it would have cost him \$20,000.00 if he had booked it online. "True," he says. "But you got it for free. The question here is how much money do you want for it." You think about it and tell him that \$1,500.00 is too low—but if he lets you sit there for the first 5 hours, he can have it for the last 12. "Deal," he says.

Five hours go by, and he comes back to your seat, ready to switch. He hands you \$1,200.00. "Wait a second," you say. "I thought we agreed on \$1,500.00." He gives you a funny look and says, "Well, yeah, that was when there was a 17-hour flight in front of us; now it's only 12 hours. Time is running out." You tell him you want to think about it. Disgruntled, he walks off. You unwittingly pass out in your seat. Later, after 9 hours of glorious sleep, you wake up. "Hey buddy," he says, looking as if he's been stuck in coach for 14 hours, "Are you ready to switch seats yet?" Sure, you say. He hands over \$300. "Where's the rest of it?" you ask. He explains, annoyingly, that you slept for 9 hours, and there are only 3 hours left in the flight. At this point, he might as well sit in coach, but he's still willing to give you \$300 to have possession of your seat for the last few hours. You think about it, realize that in 3 hours your seat will be worthless (this guy isn't going to pay anything after the plane lands), and you take the \$300 to switch seats. That is essentially premium decay in action on an "at-the-money" call. The closer you get to the end of the flight, the lower the price you could get for your first-class seat.

In my first options trade, I bought call options on Intel (INTC), and I hadn't the foggiest notion what they were or what that meant. Later I found out that a call option increases in value if the underlying stock moves higher, and a put option increases in value if the underlying stock moves lower. So buying a call is like going long, and buying a put is like going short. And one option represents 100 shares of stock. So when you see a stock option priced at \$4.30, that is per share of stock. Since each option represents 100 shares of stock, one option at \$4.30 costs \$430.00. Easy enough?

Then I learned about strike prices, and how options were either in the money, at the money, or out of the money. Great. So if AAPL (Apple) is trading at \$399.26 per share, and I'm looking at call options, then the \$390 call is in the money (trading below the current stock price, also called ITM for short), the \$400 call is at the money (trading at or near the current price, also called ATM for short), and the \$410 call is out of the money (trading above the current price, also called OTM for short).

The \$390 call is "in the money" because it gives the option buyer the right to buy the stock for \$390. Simple math shows that if the stock is trading at \$399.26, then the \$390 call option is worth \$9.26. It works like this. If that option gives me the right to buy the stock at \$390.00, and the stock is trading at \$399.26, then I can immediately go out into the open market and sell the stock I acquired for \$390.00 for \$399.26, thus making a \$9.26 profit. This portion of the option price is known as the real or *intrinsic* value of the option. But if it were this simple, then wouldn't both the \$400 and the \$410 strike be worth nothing, since the stock is actually trading at \$399.26, below both of those levels?

AAPL	APPLE INC COM	ETB	NASDAQ	B: 399.40	399.26	-3.91			
				A: 399.45		-0.97%			
UNDERLYING									
Last X	Net Chng	Bid X	Ask X	Size	Volume	Open			
399.26 D	-3.91	399.40 P	399.45 P	1 x 2	22,589,1...	408.73			
High	Low								
409.25	398.06								
TRADE GRID									
OPTIONS Single									
Layout: Volume, Open Interest Exchange: Composite									
CALLS		Strik...	8	PUTS					
Volume	Open Int	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Volume	Open Int
SEP 5 11 (3) 100 (Quarterly)									
OCT 11 (24) 100									
1,767	6,158	25.45 N	25.95 I	OC...	385	10.80 X	11.00 Z	3,132	47,774
2,274	11,701	22.25 N	22.75 A	OC...	390	12.65 N	13.00 A	5,278	48,851
3,146	9,469	19.25 N	19.60 N	OC...	395	14.70 N	15.05 A	2,250	6,878
11,523	42,510	16.60 N	17.00 Q	OC...	400	16.95 N	17.30 I	5,479	12,207
8,377	51,395	14.15 N	14.45 Z	OC...	405	19.50 Z	19.90 A	3,312	5,598
14,716	57,174	12.00 X	12.30 A	OC...	410	22.25 Q	22.65 A	3,361	10,561

Figure 5.1

And that is where premium comes in. [Figure 5.1](#) shows the actual prices of these options. These options have 24 days of life left, at which point they will expire. When an option expires, it is literally worth only the real value that a person would get if he exchanged it for stock. That is, if it was expiration day and AAPL was at \$400.00 a share, then any call options above that price would be worth zero (expire worthless, since they have no intrinsic value), and any call options below that price would be worth the price of the actual stock less the strike price. So, in this case, the \$390 calls would be worth \$10 (if AAPL closed at exactly \$400.00). And the \$410 calls, which give the option holder the right to buy AAPL at a price of \$410.00, would be worth zero. After all, you can go out in the open market and get it for \$400.00, so why would you pay anybody for the “right” to buy it at \$410.00?

And yet when we look at the prices of these options 24 days out from expiration, we notice a very strange thing. The \$390.00 calls are not trading at just the intrinsic value of about \$10.00; they are trading at a whopping \$22.75, well above the \$10.00 they would be worth if this were expiration day. The \$410 calls, which would be worth zero in this example if it were the close of options expiration day, are trading for \$12.30 (\$1,230.00 per option contract). The \$400 calls, which would also be worth zero in this example if it were the close of expiration day, are trading at \$17.00 (\$1,700.00 per options contract). What gives?

Just as with that first-class seat, there are people out there who will pay a premium to buy the option, even if it’s trading out of the money. Why? The stock could have a huge rally, and the option could be worth a lot more in the future. And the further out the expiration date (that is, the longer the flight), the more premium they are willing to pay. Why not just buy the stock? Because they don’t want to shell out a lot of money to buy the actual stock. Thus they are willing to pay a premium to own the right to buy the stock and to take advantage of the limited risk and leverage involved in buying the option. Note that while the \$390.00 option has some real value priced in, the \$400.00 and \$410.00 options are pure premium. The in-the-money call is a mixture of intrinsic value and premium.

On the flip side, someone who owns the stock has to make a similar decision. Does she sell an option against it and collect the premium? She wants to keep the stock, so her goal is to sell an option against it that will expire worthless. That is, she hopes that the stock price doesn’t close above the strike price by the expiration date. As a buyer of an option, just like the guy who wanted to buy the right to sit in your first-class seat, you are buying with the expectation of a better experience. Instead of shelling out \$40,000.00 to buy 100 shares of AAPL at \$400, you could pay \$1,700.00 to buy a \$400.00 call option. With each passing day, the premium on that option erodes a little bit. And the closer that option gets to expiration (that is, the closer the plane gets to the airport), the faster that premium starts to lose value. Your bet in this case is that AAPL has a fantastic move higher, perhaps to \$450.00. If it does, at expiration, your \$400 option will be trading at \$50.00, and your profit on the trade will be \$3,300.00 (the \$5,000.00 sale price less the \$1,700.00 purchase price). In other words, you were able to participate in AAPL’s rally without having to shell out all the money required to buy the stock. In fact, in trading owning the stock is sort of like sitting in coach.

On the flip side, the woman who sold you the option does not want to see AAPL go to \$450. She is hoping that the stock stays near \$400 and that the option you bought for \$1,700.00 expires worthless. Where did your \$1,700.00 go? To the person who sold you the option. That goes right into her pocket. It’s like the AAPL stock she owns is a piece of property, and she just charged you \$1.700.00 for a month’s rent, thank you very much.

Everything that we’ve just talked about has focused on the “call” side of the options world, but the same story holds true for the put side. In [Figure 5.1](#), where AAPL is trading at \$399.26, we can see that the out-of-the-money put at \$390.00 is trading at \$12.65, the at-the-money put at \$400.00 is trading at \$16.95, and the in-the-money put at \$410.00 is trading at \$22.25.

Why Wouldn’t I Buy These Particular Options with My Mother-in-Law’s Trading Account?

Okay, up to this point, I’ve been talking about what options are and how they work. Now let’s talk about the main reason that people lose money trading options. It’s very simple: it’s because they focus mainly on buying cheap out-of-the-money call options. In [Figure 5.1](#), the \$410.00 AAPL call options are trading at \$12.30. This is 100 percent premium. There is zero intrinsic value here. In this case, the trader looked at the \$390.00 call options, but found them to be “too expensive” at \$22.75. AAPL is currently at \$399.26. Let’s say it had a nice steady move into expiration, rallying just over \$10.00 per share, and closed at \$409.75. A trader bought the

\$410.00 call option because he thought AAPL would go up. He was right. It did. How much money is his option worth at expiration? A big goose egg. He lost every dime. In fact, AAPL would have had to close above \$422.30 for him to make a profit on this trade. At \$422.30, the \$410.00 call option at expiration is worth \$12.30—the exact price that he paid for the option. Although he didn't lose money on the trade, he didn't make anything either. In other words, when buying out-of-the-money call options, not only does a trader have to be right, but he has to be right in a big way. A steady move higher won't do. It has to be explosive.

In this same scenario, had the trader bought the "expensive" \$390.00 call option at \$22.75, a move to \$422.30 would price the call, at expiration, at \$32.30, resulting in a profit of \$9.55 (\$955.00) on the trade. Would you rather buy an option for \$2,275 and make \$955 or buy an option for \$1,230 and make \$0.00? Buying an option "just because it's cheap" is a ridiculous trading strategy. In the options world, a fairly common scenario is (1) retail traders buy out-of-the-money calls (without paying attention to fair value or implied volatility; more on that later), and (2) professional traders gladly sell them these calls all day long. "Hey, you want some more?" they ask eagerly. "Because we've got more to sell you." I've known guys who have traded options on the floor for more than 20 years. They have never bought an out-of-the-money call. Not one. To them, there could be nothing worse on this planet than buying an out-of-the-money call.

That's not to say that out-of-the-money options don't have their place. Believe it or not, there are scenarios where it can make sense to buy them, but these are the exception rather than the rule. And this brings me to my first options strategy.

Directional Plays: Why Is Delta 0.70 or Better Superior?

Buying a cheap out-of-the-money option is enticing because if it works out, the trade could win in a big way. Everyone wants to be able to buy an option for \$1.00 and sell it for \$15.00. That's the "quit your job and travel the world" trade if it's done right. Yes, this *could* happen with an out-of-the-money option, just like you *could* get a royal flush when you're playing poker. The odds aren't great, but the chance is there, however remote. Personally, I'm more interested in increasing the odds for creating a consistent income stream than crossing my fingers and swinging for the fence.

[Figure 5.2](#) lays out an option diagram with "the Greeks," known as delta, gamma, theta, and vega. The good news is that, for what I like to do, a trader doesn't need to know too much about these. The only one I want to talk about here is delta. This is important. Delta simply tells us how far the option price will move in relation to each \$1.00 move in the underlying stock. A delta of 1.00 means that the option price will move right along with the stock, dollar for dollar. If the stock moves up \$1.00, then the option will move up \$1.00. A delta of 0.10 means that if the stock moves up \$1.00, then the option will move up only 10 cents. The deeper in the money the call option is, the higher the delta. The further out of the money it is, the lower the delta.

For purely directional plays, I simply view the option as a cheaper way to participate in the price movement of the underlying stock. One of the plays I'll talk about later in the book (the squeeze play) is a favorite of mine for option plays. This setup indicates a high probability that the stock is ready to make a larger-than-average move. In this case, I simply want to participate in the movement of the stock, without having to fork over all the money required to buy the actual stock. For these trades, I simply buy an in-the-money option with a delta of 0.70 or higher. This means that as the stock price moves in my favor, the option will move right along with it at the rate of 70 cents for every dollar the stock moves. As a bonus, as the stock moves my way, placing my option even deeper in the money, the delta also increases. For the first 2 points of a move, my option might move \$1.40 (70 cents per dollar). For the next 2 points, it might move \$1.60, as the delta increases from 0.70 to 0.80. A far-out-of-the-money option, on the other hand, will stay at a low delta for quite some time. Buying far-out-of-the-money options is a lose/lose, unless you have some inside information, such as Bear Stearns being about to collapse. Someone actually bought \$1.4 million in far-out-of-the-money put options a few weeks before Bear Stearns went bankrupt. He knew what was coming down the pipeline, and he made a fortune.

AAPL	▼	APPLE INC COM	ETB	NASDAG								
UNDERLYING												
Last X	Net Chng	Bid X	Ask X	Size								
400.27 P	+1.01	400.27 P	400.40 J	1 x 3								
Volume												
12,902,404												
Open												
400.19												
TRADE GRID												
OPTIONS												
Spread		Single	Layout: Delta, Gamma, Theta, Vega									
CALLS												
Strikes: 12												
Delta	Gam	Theta	Vega	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Delta	Gam	
SER 5 11 (2) 100 (Weekly)												
95	.01	-.25	.03	25.40 A	25.75 B	SEP ...	375	.20 X	.24 N	-.04		
93	.01	-.32	.05	20.55 I	20.90 A	SEP ...	380	.33 X	.37 X	-.06		
1	.89	.01	-.41	.07	15.80 C	16.15 B	SEP ...	2	385	.59 Z	.63 X	-.10
89	.02	-.53	.10	11.40 X	11.80 Z	SEP ...	390	1.15 Z	1.19 C	-.18		
89	.03	-.66	.13	7.50 W	7.85 Z	SEP ...	395	2.24 A	2.28 X	-.31		
52	.04	-.72	.14	4.40 X	4.55 A	SEP ...	400	4.10 Z	4.15 X	-.48		
33	.03	-.64	.13	2.25 X	2.33 A	SEP ...	405	6.90 N	7.00 X	-.67		
3	.18	.03	-.45	.10	.97 X	1.02 Q	SEP ...	410	10.65 Q	10.75 X	-.82	
08	.01	-.26	.06	.37 Z	.40 Z	SEP ...	415	14.85 B	15.20 A	-.92		
04	.01	-.15	.03	.15 N	.18 Q	SEP ...	420	19.70 Q	20.00 X	-.94		
.02	.00	-.09	.02	.06 Q	.11 X	SEP ...	425	24.55 X	24.90 X	-1.00		
.01	.00	-.06	.01	.04 C	.05 A	SEP ...	430	29.50 A	29.85 X	-1.00		
OCT 11 (23) 100												
73	.01	-.32	.34	33.15 A	33.30 A	OCT ...	375	7.75 N	7.80 N	-.26		
4	.70	.01	-.33	.36	29.50 I	29.85 Z	OCT ...	380	9.10 A	9.20 X	-.30	
66	.01	-.34	.38	28.10 A	26.25 Z	OCT ...	385	10.70 N	10.80 X	-.34		
62	.01	-.35	.39	22.90 N	23.05 N	OCT ...	390	12.45 A	12.55 X	-.38		
57	.01	-.36	.40	19.90 Q	20.00 Q	OCT ...	395	14.45 A	14.55 C	-.43		
52	.01	-.36	.41	17.10 X	17.25 A	OCT ...	400	16.70 N	16.80 N	-.48		

Figure 5.2

In [Figure 5.2](#), on the left-hand side, we can see the corresponding delta values for the AAPL call option strike prices from \$375.00 up to \$430.00. At point 1, we see the strike prices with a delta of 0.70 or higher (the \$395.00 call has a delta of 0.69, which is close enough). These are for the recently introduced September weekly option series, which have 2 days left till expiration. As a side note, up until recently, all stock options traded monthly, expiring the third Friday of every month. Now we also have “weekly options” on some of the bigger names, like AAPL and AMZN. These options have a very high premium because—you guessed it—retail traders are clamoring to buy these “cheap” options. I would never buy one, ever, ever, ever. But I’m happy to sell them to any one who thinks she’s getting a bargain.

A glance at point 4 shows the deltas for the monthly options, which expire in 23 days. Note that the delta levels are not the same for each strike price. The further out the expiration, the deeper in the money a trader needs to go in order to achieve a delta of 0.70. At point 3, we see the delta levels for the out-of-the-money options, which fall precipitously the further away from the current price we move. That is, a trader could buy the \$430.00 call option for a nickel, and if AAPL moved \$10.00 a share the next day, the option price would barely budge. For put options, the story is the same, just in reverse. The delta levels we want for puts are -0.70 or greater, as highlighted at point 5.

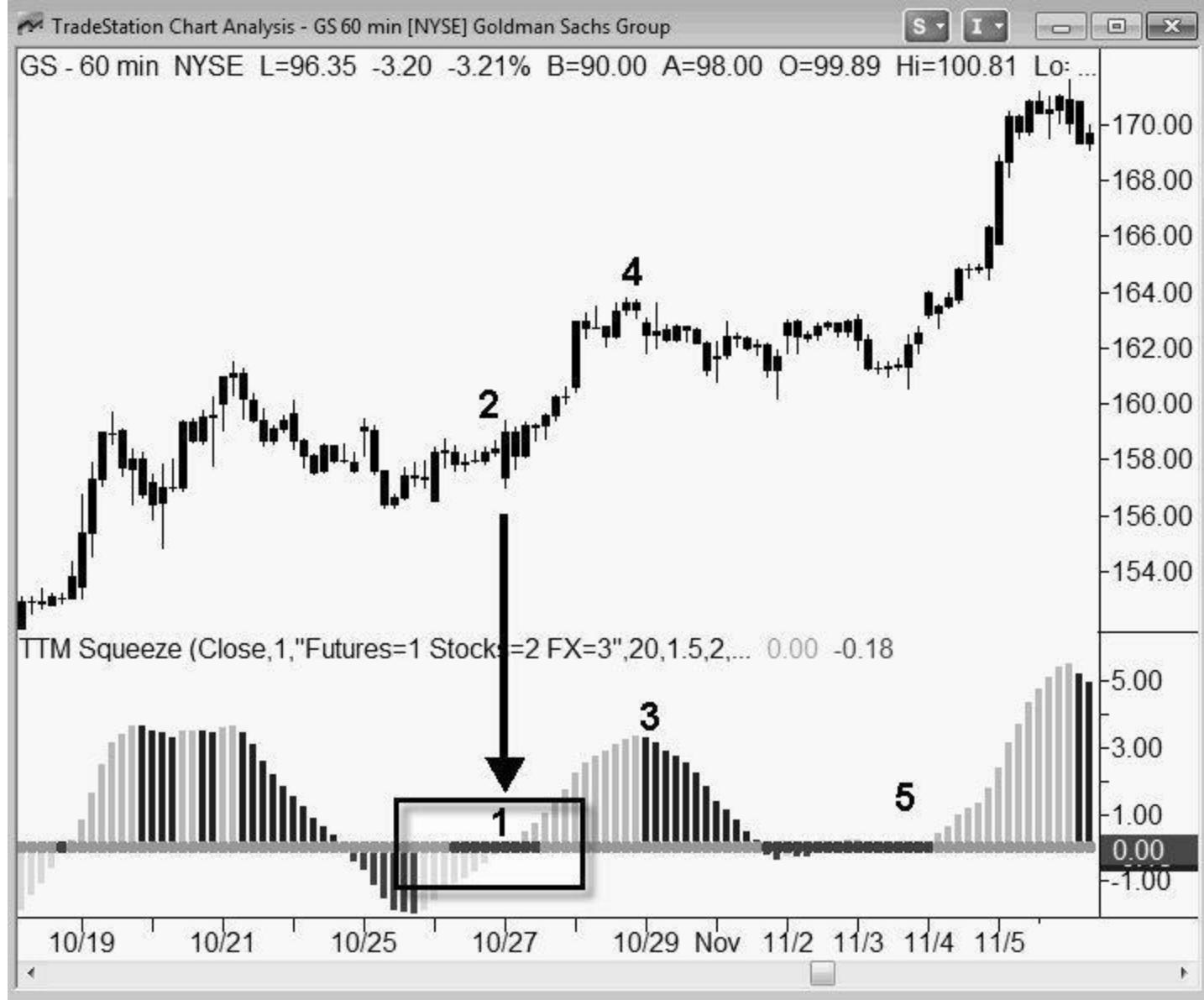


Figure 5.3

I'm the first to admit that purely directional plays aren't sexy. They are just simple, and they work. Let's take a look at [Figure 5.3](#), which details one of my favorite "short-term swing trading strategies" in options. By short-term, I mean a trade that I'm generally in for one to three days. For these types of trades, I look at hourly charts, and one of my favorite setups on the hourly charts is a "squeeze."

1. At point 1, a squeeze sets up on the hourly chart of GS (Goldman Sachs), as indicated by the darker-colored dots within the square. When the dots turn back to lighter-colored, the trade is a buy if the histogram is above zero and a sell (short) if the histogram is below zero (note: there is more about the squeeze in a later chapter). In this case, it's a buy.
2. At point 2, GS is trading near \$159.00. I want to buy calls, as the squeeze has generated a buy signal. Of course, I want to go for a delta 0.70 call, which in this case turns out to be the 155 strike price. I buy over the course of the next hour at prices of \$7.25, \$7.35, and \$7.40. I'm willing to risk a move of \$2.00 against me on the underlying stock, at which point I would close out the options at their current price. With a delta of 0.70, I already know that means that the option would drop about \$1.40 if the stock dropped \$2.00.



Figure 5.4

3. At point 3, the squeeze indicator has issued a sell signal, as the move has started to lose momentum. This is indicated by the darker-colored histogram. As a result, I start closing out this position at point 4.
4. For this particular trade, as seen in [Figure 5.4](#), I scaled into 300 contracts at prices of \$7.25, \$7.35, and \$7.40. I then scaled out of these 300 contracts at prices of \$9.05 and \$9.25, for an average profit of \$1.85 (+\$185.00) per contract. This trade was done during one of our quarterly live trading mentorships, so I was able to take screen shots of it as the trade unfolded.

The main idea here is that when I'm looking for a stock to move a few dollars, I want my option to move up as much in lockstep with that price movement as possible. With a delta of 0.70, a \$2.60 move in GS resulted in a \$1.85 move in the price of the option. I'm more than happy to buy an option for \$7.30 on Thursday (GS October 155 call) and sell it for \$9.20 on Friday. There is no need to hold it to expiration to "see what happens" or hope that the option will quadruple in value. I buy based on an underlying signal in the stock, and then close out the option based on an underlying signal in the stock.

And that's the last point on this trade. Most of the literature on options talks about buying or selling an option and "holding it until expiration." I rarely do that. As traders, it is perfectly okay to make a living practicing what I call BASAARP: buying and selling at a reasonable price.

For more advanced options traders, there are of course a couple of ways to play this GS trading signal. The signal gives a high probability that the "stock will move up a point or two." Traders who are more familiar with option strategies could also initiate a variety of spreads on this position, some of which I'll talk about shortly.

This list could go on and on, but hopefully you get the idea. The key is first having a clean signal on the underlying stock, and then stepping in with option strategies in an attempt to leverage that move. For the most part, I'm fine with a pure directional move, where I just buy a delta 0.70 option and exit that same option based on the underlying movement of the stock. It's simple and clean.

The Importance of Implied Volatility Crush, or "Look, Ma, They're Panicking!"

The biggest mistake newer option traders make is not understanding the role of implied volatility (IV) and how it affects the price of an option. Although a portion of the option price is calculated based on the underlying stock, another significant portion of the price is based on its implied volatility. Have you ever bought a call option on AAPL the day before earnings, watched AAPL trade \$20.00 higher overnight, and then been unable to sleep because you were mentally counting all the money you were about to make at the open? Then, the next day, you looked on in horror as your option actually opened lower in price than where you bought it, and you ended up *losing* money on the trade instead? WTF? Welcome to the world of implied volatility.

In this case, the market makers know that the earnings report is going to be a high-volatility event, so they price the options much higher to account for this anticipated volatility. In other words, they are pricing in the expected stock movement. If a trader bought AAPL calls the day before earnings, then the earnings report came and went, and AAPL opened the next day at about the same price where it had closed, the options price would actually open much lower, even though the stock didn't move from the day before. The reason for this is that the event that caused the price gouge has now disappeared. And once that happens, the options price gets crushed. Hence the term *IV crush*.

Implied volatility increases with panic, uncertainty, or a looming big event. Implied volatility decreases right after those events, and also remains low when there is nothing on the horizon to be worried about. For example, implied volatility on AAPL options is currently around 35 percent (this is a number that is available on most option trading platforms). Right before earnings, this can jump to 100 percent, which essentially triples the premium portion of the options price. In general, a trader wants to buy options only when implied volatility is low. If implied volatility gets too high, it's really a losing proposition to buy the option, though it does become attractive to sell (more on that in a bit).

Just how important is implied volatility? Here is a story courtesy of Jeff Roth, from our office. During the 1987 crash, when the stock market dropped 20 percent (that is like the Dow dropping more than 2,300.00 points in one day in 2011, a total and utter panic), some of the floor traders who owned call options on the market actually made money. Uh, say that again? Aren't calls supposed to make money only when the markets go up? Yes, but if the implied volatility explodes, it increases the price of all options. On that day it exploded to an unprecedented level ... to the point that even the call options, the very options that should have collapsed in

value, made money.

Here is one way a trader can utilize this knowledge to her advantage. [Figure 5.5](#) shows an hourly chart of GS (Goldman Sachs). On August 18, 2011, the stock gapped down more than \$3.00 per share. A “gap down” event is a situation where some panic ensues at the open. People who own GS panic to buy puts to protect themselves, and the gap itself creates uncertainty in the market. There is a window of about 5 to 10 minutes at the open when the put option prices are artificially high because of all this—in other words, the implied volatility increases. It pops at the open, and the premium price of the option expands accordingly.



Figure 5.5

The thing about gap downs is that most of the news is already in the price once the stock opens. After the gap down and the initial flurry of activity, a stock will often spend the rest of the day trading in a choppy, quiet range. As things quiet down, the implied volatility drops ... and so does the price of the options. This is called an implied volatility (IV) crush. And there is a way to take advantage of this.

In this particular trade, we aren't looking to buy puts; we are looking to sell them to someone who is panicking. Since this person is panicking, he will pay up to buy the puts. We will gladly sell those puts to him, and then buy them back when the market quiets down. The trade goes like this:

1. About half an hour before the cash open at 9:30 p.m. eastern, I scan for stocks that are gapping down of their own accord. This is mostly due to a news event specific to that stock. In [Figure 5.5](#), we can see at point 1 that we have a nice gap down in GS from the previous day's close.
2. Within a few minutes after the open, I sell puts that are one strike out of the money (remember, we want to buy in-the-money options but sell out-of-the-money options). In this case, GS opened at \$114.07 and quickly traded lower. The first out-of-the-money puts are the \$110.00 strike, and I sell these at current market prices at point 2.
3. The goal with this trade is to then close it out that day. As we near the close at point 3, GS rallies back toward the \$114.00 level. At this point, the uncertainty is no longer there, and the implied volatility gets “crushed” back to what it had been the day before. The option that I sold for \$1.20 drops back down to \$0.60 by the

close, even though the stock hasn't really moved since the open.

4. For stop losses, I'm looking at a 1:1 risk/reward ratio. That is, if I'm looking to make \$1.00, then I am willing to risk \$1.00. It's important to figure out a stop, because there will be instances where the stock could just keep falling. Selling a naked option is risky in this regard. In this case, if GS kept selling off and ended up down \$10.00, the option I sold for \$1.50 could be trading for \$5.00 or even higher. (Of course, I could also buy the next strike out-of-the-money put as protection against this situation.) As a seller in this case, any price over \$1.50 represents a loss, and it's wise not to let that loss get carried away. This is why selling naked calls and holding them overnight is inherently dangerous; it is the riskiest option strategy alive. If a trader sells 20 naked call options at \$5.00 (collecting \$10,000.00) on a stock, and then wakes up the next morning to see that the stock is up \$80.00 a share on a takeover, then that trader is hosed. That option is now worth \$160,000.00, and the guy who sold it has just lost \$150,000.00. This is where "verticals" and "credit spreads" come into play, because they protect an option seller against a "takeover situation."

To summarize, if I'm buying options, I try to avoid buying them when IV is high. This is typically right after a huge move (wow, AAPL is up \$10.00 today—I'd better buy some out-of-the-money calls!) and right before earnings. I'd rather wait for a "quiet period" to buy options, such as a squeeze play, which forms when a market is quiet. However, high IV does give a trader the opportunity to sell options. For example, back in the day, there was a period of several years when every time IBM approached \$280.00, it would then sell off. Thus, every time IBM approached this level, the floor traders would sell naked the \$280.00 call options on IBM and collect the extremely high premium. Of course, the retail traders who bought these call options (hoping that IBM would blast through \$280.00) got hosed. The saying for years was, "Sell the 80s and buy a Mercedes." This party ended the day IBM finally broke through \$280.00 and kept on going.

In the GS example, I sold "naked" puts (they weren't backed by underlying stock) at a high IV, and bought them back when the IV normalized.

How Do You Know When to Hold 'Em and When to Spread 'Em?

When you're trading options, you have two choices: buy an in-the-money option during a quiet IV period for a directional play, or sell options during high-IV periods. As we have already seen, selling naked options is riskier than buying options, even though they have a higher probability of working in our favor. When buying an option, we are limited to losing only the amount we paid for the option. If we sell a naked call, our loss is theoretically unlimited, as the stock could go to infinity. Of course, I have yet to see a stock do that, but in theory it could happen.

Other than an IV crush situation, the main reason to sell options, especially out-of-the-money options, is that they are literally losing premium value each and every day. Think of the premium portion of the option as a bright, juicy peach ... covered with ants. Every day those ants are going to work on that peach, little by little, stripping away the flesh, until at some point there is nothing left but the seed in the middle. This happens all the way to options expiration until the premium portion of the option price is zero, and all that's left is the real or intrinsic value of the option. If that option is out of the money, then it expires worthless.

This premium decay is actually measured by theta, which is one of the "Greeks" that is readily available on most option platforms. If a call option is trading at \$11.50 (total value is \$1,150.00) and the theta is 53.80, then this option is losing \$53.80 in premium each and every day. That is, the \$11.50 option is losing more than 50 cents per day just in premium. To put this in perspective, if the underlying stock traded sideways for three days and didn't budge in price, this option price would plummet to \$10.00, a loss of \$150.00 per contract, even though the stock hasn't budged. If this option had a delta of 0.50, then the stock would have to move up \$1.00 a day just to keep this option at the same price. Even more brutal, if the stock drops \$2.00 today, but has a fierce \$3.00 rally the next day, your option is back at ... merely breakeven. The closer an option gets to expiration, the higher the theta—that is, the faster the premium erodes. This is critical to keep in mind, and it's why buying far-out-of-the-money call options a few weeks out from expiration is such a low-probability event.

And that is also why selling options is so attractive. They literally lose value each and every day. The only problem in selling them is that the risk of loss is great should the stock have a big move against you. You could literally have 15 winning trades in a row and then get wiped out on the sixteenth trade. The way around this risk is to initiate what is called a vertical spread. Spreads are attractive because a trader doesn't have to be "dead right" in order to make money on the trade. I'm not going to spend a lot of time on this concept because there are entire books written on the subject. Let's take a quick look.

If we revisit the GS trade from [Figure 5.3](#), I could have initiated a bullish vertical spread on this trade to lessen the risk. I could have still purchased the \$155 calls at \$7.30, but instead of having a \$2.00 stop based on the underlying movement of the stock, I could at the same time have sold the same amount of \$160 calls at the then-current price of \$3.80. Remember, this out-of-the-money call is all premium, and the ants are eating away daily at that juicy peach. It is losing value each day. Because of this, had the GS position traded sideways for a few days, I could still have closed out the position for a small profit, making money on the premium erosion. I could also have

1. Legged into the same spread as described earlier, instead of initiating it all at once. That is, I could have bought in-the-money calls initially, and then, when the squeeze signal finished the next day, stepped in and sold out-of-the-money calls. Once the signal finishes, a stock will generally trade sideways for a few days. The small price spurt gooses the IV, thereby increasing the pricing on the out-of-the-money calls. In other words, it's a good time to sell them. Ideally, the stock then trades sideways for a few days, and I'm able to close out both legs of the trade for a profit.
2. Sold a naked at-the-money or one strike out-of-the-money put, buying it back when the squeeze signal was done. The risk with this is if GS receives bad news (for example, an SEC investigation) and drops \$20.00 a share quickly, this trade can get very ugly very fast.
3. Initiated a vertical bull put credit spread. Once the squeeze signaled a long trade, I could have sold an at-the-money put and then bought an out-of-the-money put. This is similar to strategy 2, except that now I have downside protection in the event of a disaster.

This list could go on and on. The more a person knows about option strategies, the more she can do with this, but I want to emphasize that it's not necessary to make this that complicated.

With the advent of weekly options on some of the highly liquid stocks such as AAPL and AMZN, a unique opportunity has been created. I personally like to buy an in-the-money monthly option, and then each week initiate a vertical spread by selling an out-of-the-money weekly option against it. There are times when a trader can sell a weekly option each week for three or four weeks and have it expire worthless each week. During this entire time, the trader can still hold on to the monthly option, and end up closing it out for a gain as well. It's the best of both worlds. Holding a deep-in-the-money option is like owning a piece of real estate. Selling the weekly options against it is like collecting rent on your property each and every week. It beats working for a living.

A final note for those of you who are interested in commodity options: these take a while to get your arms wrapped around if you aren't used to them. Whereas one stock option represents 100 shares of stock, one commodity option represents just one futures contract. For pricing, just take the current price and multiply it by the multiplier of the underlying futures contract. For example, if you see that an at-the-money call option on the E-mini S&P 500 is trading at 52.25, then multiply $52.25 \times \$50.00$ (the per point price), and you get a price of \$2,612.50. This means it would cost you that much to buy the call option, which represents one futures contract. Of course, you could buy the actual futures contract for about the same price. This is why I'm not crazy about futures options. You might as well just buy the actual futures contract. Commodity options do have their place. They are good for hedging a futures position, and also for anticipated bigger moves (like a weekly squeeze, as discussed in [Chapter 11](#)), where it makes sense to buy an out-of-the-money option. Otherwise I'll tend to stick to the actual futures contract.

Now that we understand how all these different futures and options markets work and the trading opportunities that they represent, it's time to move on to market internals. Let's jump in and review what I start looking at with the opening bell of the regular stock market session.

For more information on options, we have set up a website called www.Simpler_Options.com. Here we initiate trades every day, explain strategies, and discuss what's going on in the market. Updates to this chapter can be found at www.simpleroptions.com/updates, where we have posted free videos discussing the latest option strategies we are using in our trading. You can also download a free report at www.simpleroptions.com/report that digs deeper into options trading and teaches more about how they work, along with additional strategies that can be used to trade them for a living.

The Stock Market Is Now Open— What Is the Best Way to Predict Market Direction Throughout the Trading Day?

Unless you enter the tiger's den, you cannot take the cubs.

JAPANESE PROVERB

Musicians Know How to Read Music; Can Traders Learn How to Read the Markets?

For any one who day-trades the E-mini S&P 500 futures (or any of the stock index futures), or anything having to do with stocks such as SPY (Standard & Poor's Depository Receipts for the S&P 500), options on SPY, or even individual stocks, this is the most important chapter in the book. Not understanding the material in this chapter and then going on to trade these instruments intraday is like not knowing how to swim and then trying to qualify for the 100-meter backstroke. Although I will swing-trade almost anything, a large percentage of my intraday trading is confined to instruments that reflect the movement of the stock indexes. There is a good reason for this—there is a ton of data available during the trading day that will show a trader what is happening behind the scenes in the stock markets. By understanding how to read and interpret these data, a trader will have a better feel of whether the predominant pressure in the markets is on the buy side or the sell side and can make trading decisions accordingly. There are plenty of traders out there who have only the vaguest idea of how to interpret these tools, and an even larger group of newbies that has no clue that they even exist. This represents a large pool of cash that is ripe for the plucking, and knowledge of this information gets traders closer to the front of the handout line.

There is another critical reason for thoroughly understanding this material. Every single trading day is going to present both setups on the long side and setups on the short side. By understanding how to interpret these internals accurately, a trader will know the following:

- Which days to ignore all short setups
- Which days to ignore all long setups
- Which days to focus on setups that do best in choppy markets
- Which days to focus on setups that do best in trending markets

This knowledge is critical and has a big impact on whether a trader is going to have a winning day or a losing day, and, as the weeks and months progress, an upward-trending equity curve or something that's, well, less amusing to your spouse. Let's get started.

How Do You Track Institutional Trading?

The NYSE (New York Stock Exchange) ticks (TradeStation symbol \$TICK) summarize the number of stocks on the NYSE that are increasing in price versus the number that are decreasing in price from the previous price quote. Many times this is not purely buying and selling, as an uptick may indicate only that the ask was hit, while a downtick may indicate only that a bid was hit. This type of information is like learning that James LeBron is holding another press conference. In other words—who cares? Yet I've watched traders stare at the ticks, mesmerized by a move from -300 ticks to +200 ticks, and think this was a positive thing for the markets. In reality, this type of move is not positive—it's immaterial, and the information is useless. This brings us to the first rule I follow when watching the ticks:

Any tick reading that is below +400 or above -400 is noise and should be ignored.

I start paying attention to the ticks whenever readings are over +600 or under -600. These types of moves tell me that there is sustained buying or selling pressure hitting the markets. This doesn't signal any actions on my part, but it does give me a heads-up. If the ticks continue to move and hit +800 or -800, this does trigger specific action on my part, because only a sustained buying or selling program can move the ticks to this level. This brings us to my next rule in using the ticks for day trading:

If I'm long intraday and my stop hasn't been hit and the markets generate a -800 tick reading, I will close out my position at the market. Similarly, if I'm short and the markets generate a tick reading of +800 and my stop hasn't been hit, I will close out my position at the market.

Readings this high are telling the traders loud and clear that, on an intraday basis, they are either right or wrong, depending on their position. If I'm short, and the market is telling me that I'm wrong through a +800 tick reading, I take the hint and close out my trade. This also has the nice benefit of increasing a trader's risk/reward ratio, as it is possible in many instances to get out of trades early that would otherwise have been stopped out for the maximum loss. This technique applies to shorter-term trading on 5-minute charts or less.

I want to make one thing perfectly clear before I move on: *I never exit a trade early just because "I think I'm wrong."* I have learned the hard way over many years of trading to stick to my original parameters—unless I have designated a specific, measurable event that alerts me to get out of the trade early. A reading of +800 or -800 ticks is one of these specific events. My deciding to get out of a trade early has nothing to do with gut feel or interpretation—I've already discussed in [Chapter 2](#) how woefully inadequate human beings are at making objective decisions while they're in a trade. Luckily, there is no way around a tick reading of +800 or -800. Either the markets hit that level or they don't. There is no emotion involved.

I'm emphasizing this point because I've had the opportunity to sit next to many traders who come to visit me at my trading office. We trade next to each other, side by side, for one week. For the first two days, it's straightforward and low key. I do my trades; they do their trades. It may seem relaxed and laid back, but there is a very specific reason I do this—I can learn more about people in one day by watching them trade live, with their own money, than I can learn about them through normal conversations over the course of five years. In mere talking, people put their best face forward—the image that they think they are or should be. However, when their money is on the line, this façade lasts about 12 minutes, and then the underlying dominant personality springs forth. Sometimes this ain't pretty.

In working with this many other traders, I've seen firsthand the reason that most people never make it in this business. In the final analysis, most traders are atrocious at managing their exits. This is indisputably the one thing that prevents most people from making a living as a trader. To put it simply, many traders manage their exits based on how they feel about the trade. Worse, if they are down on the day, they will manage trades differently from the way they do when they are up on the day (because, of course, they want to be "right" and make money on the day), and they don't even realize this. To illustrate this point, there are many times when I will take a trade, and they will take it with me. We will get into the same trade at exactly the same time, and five minutes later, I will see them selling out half their position. Of course, I'm perplexed by this because they said, "JC, I'm going with you on this next trade." The ensuing conversation goes something like this.

Me: Steve, I thought you said you were going to follow me on this one. Did you just sell some of your position?

Steve: Uh, well, no, I ...

Me: I heard the software execution platform say "sell."

Steve: Oh, that, yeah, well, I'm selling some here to book gains.

Me: Why?

Steve: Didn't you say it was a good idea to scale out of your position as it goes your way?

Me: Yes, but I said only if you had a specific exit strategy. You can't exit a trade based on your gut feelings. So why did you sell?

Steve: Uh, the ticks were going higher, and I wanted to sell into strength.

Me: The ticks are only at +200.

Steve: But they were at +284.

This goes on for some time. As a matter of faith, I let these traders try to convince me that they are justified in their actions, but my eventual goal is to get them to admit to what they are doing—selling because they are nervous or scared or excited or whatever, and that surge of emotion is what made them push the button. In other words, there was absolutely no rational reason for them to take the action that they did.

Trading is an extremely private world for most people, with friends and spouses kept totally in the dark about the emotional ups and downs that traders feel and experience each and every trading day. Getting a trader to admit to what's really going on internally is like trying to pry open a walnut with your fingers. It's challenging because most traders are masters at masking what they are really feeling. Whether a trader is up \$25,000 or down \$25,000, many times the outside world will never know. I've been there, and I know the feeling. Armed with this knowledge, I go on the "friendly attack" and eventually get most of them to fess up. I don't pull any punches. I tell them that no one is ever going to understand their trading journey like another trader. Speak now or be stuck in your rut forever. Usually this works, and it gets traders to open up and confront their trading demons—trading therapy 101. Let's look at the rest of the tick reading rules that I follow.

The next thing I'm looking for in the ticks is if they hit +1,000 or -1,000. This is the most important reading of the day for two reasons. First, it usually represents the maximum amount of sustained buying or selling pressure that the market can handle. It's like a sprinter getting to the end of a 100-yard dash and having to stop and gasp for breath. Second, it represents a specific new trading opportunity. These extreme readings set up a "fade" play that I follow. If we get a reading of +1,000 ticks, I will set up a short. If we get a reading of -1,000 ticks, I will set up a long. I discuss this play in detail in [Chapter 9](#).

This brings me to the next rule I use with the ticks:

If I am long and the markets hit +1,000 ticks, I will use that as a signal to exit the remainder of my position. If I am short and the markets hit -1,000 ticks, I will use that as a signal to exit the remainder of my position.

[Figure 6.1](#) is a snapshot of the ticks from March 29, 2005. This is how I have them set up on my TradeStation charts. I use a five-minute chart, but the interval is not important—the key for me is that I want to be able to see a full trading day's worth of data. (Side note—all the charts you see in this book have a white background. This is for printing purposes. When I'm watching these on the screen, I set the background to black, and the chart colors are usually blue or green for up moves and red for down moves.)

STICK - 5 min NYSE L=560.00 +381.00 +212.85% B=0.00 A=0.00 O=253.00 Hi=1166.00 Lo=-508.00 C=560.00 V=0

1200.00

1200.00

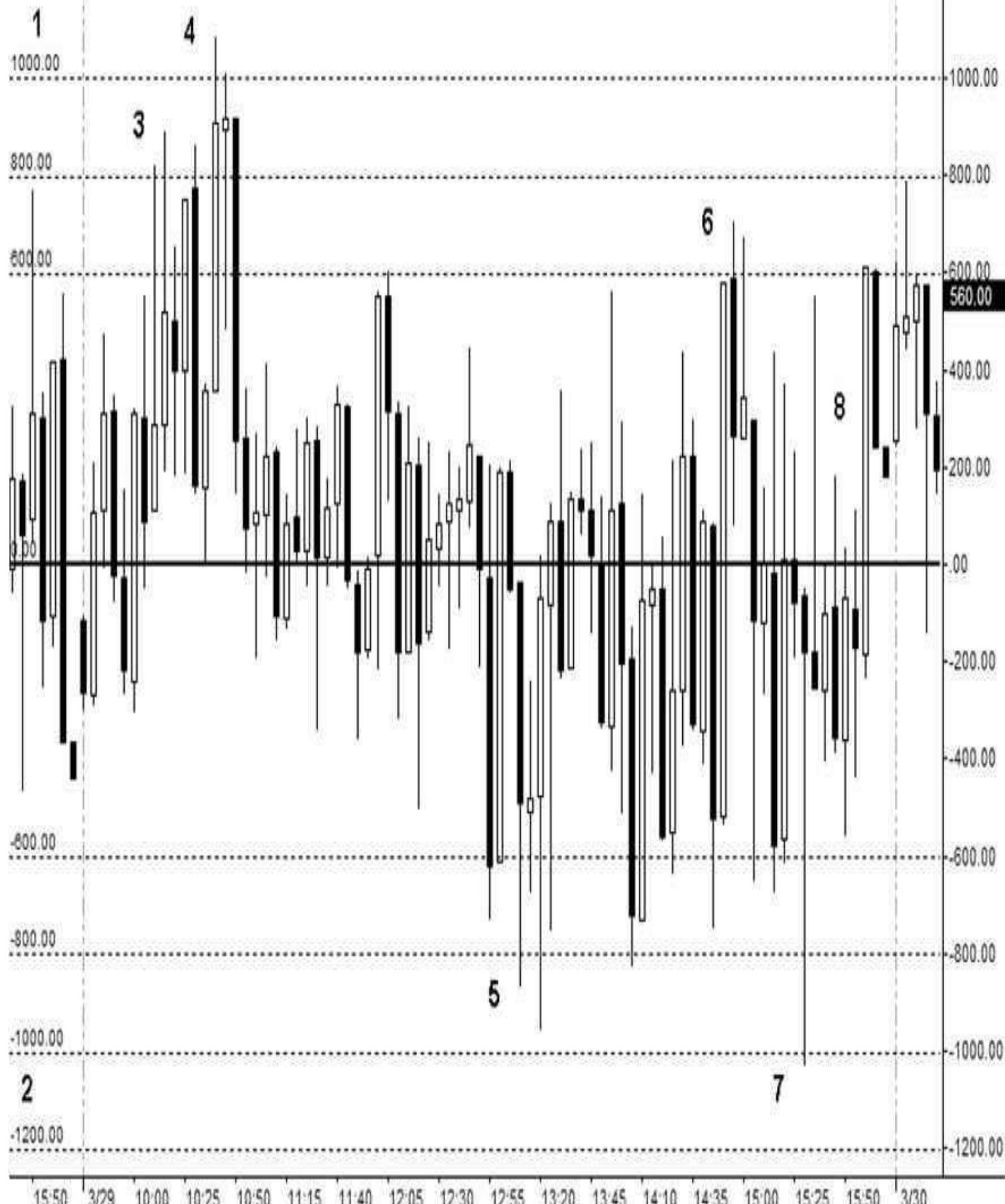


Figure 6.1

In this chart, we can see at points 1 and 2 that there are horizontal lines placed at +1,200, +1,000, +800, and +600 ticks, and also at -1,200, -1,000, -800, and -600 ticks. These horizontal lines serve a very specific purpose, which brings me to my fourth rule in using ticks:

I set up audio alerts at all the key tick levels. This way I don't have to stare at the chart, and I never miss a move.

These audio alerts are a key part of my trading plan. I can be on the phone, down the hall, or in the bathroom, and I will hear if the ticks make a move. Remember that at the 800 and 1,000 levels, I take action, so I don't want to miss them, no matter what I'm doing. Yes, there have been times when I've had to initiate a new trade with my pants around my ankles, as I'm stumbling out of the bathroom. I spend a lot of time staring at computers, so I like to make these alerts halfway entertaining. When the ticks hit +1,000, I hear Daffy Duck screaming, "I'm rich! I'm rich!" and when the ticks hit -1,000, I hear the Wicked Witch from the *Wizard of Oz* crying "I'm melting! I'm melting!" Visiting traders raise their eyebrows when these alerts first start to hit, but they get their attention—which is the whole idea.

I want to point out that I specifically use a bar chart or a candlestick chart for anything having to do with audio alerts. Another popular chart, the "line on close," is also good when watching the ticks, because it helps to show a trader when they are rolling over or "hooking." However, these types of charts can, and do, miss many audio alerts because the line is literally created on the close of the bar and misses the high and low fluctuations—which is what sets off the audio alerts.

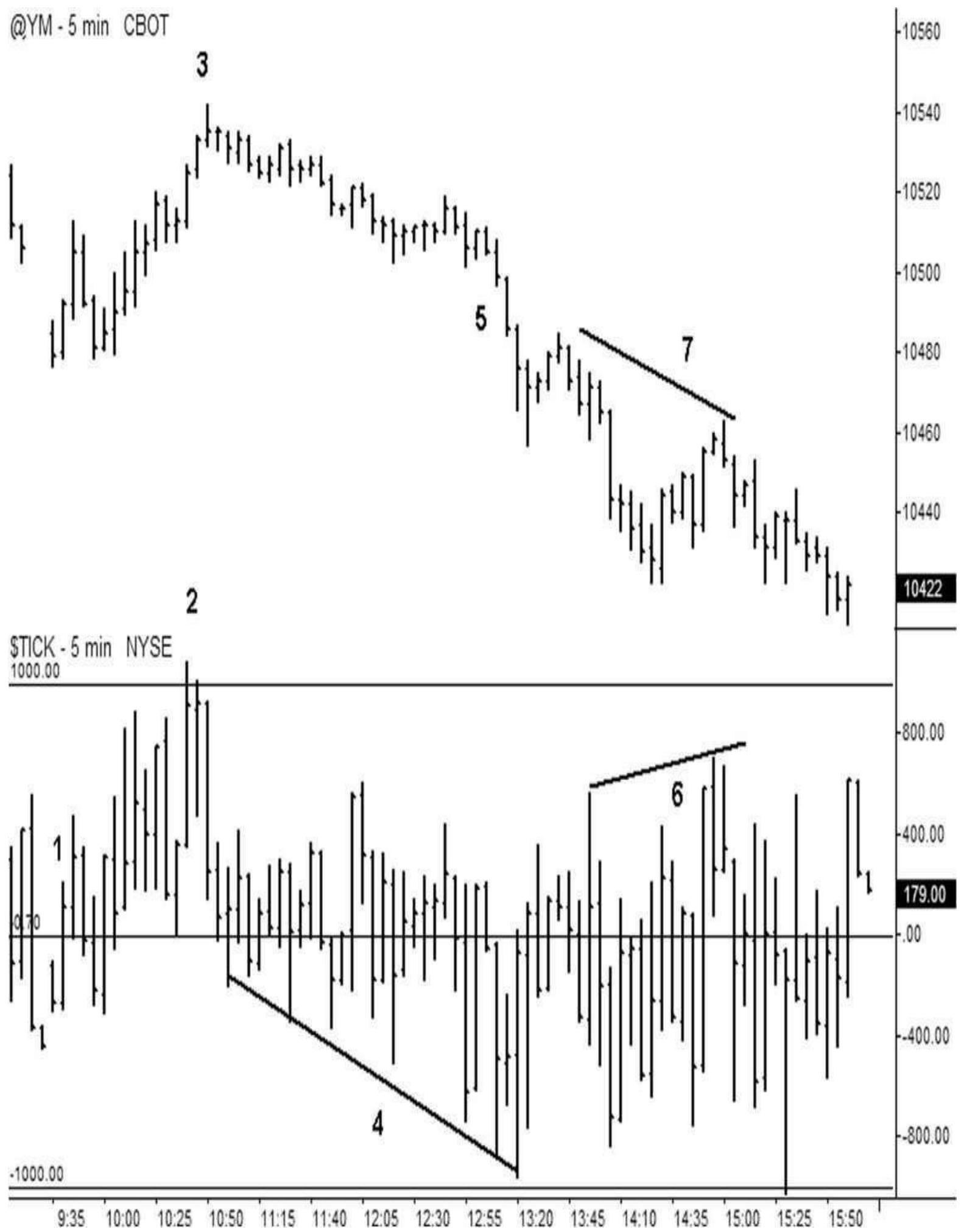


Figure 6.2

In this chart, we can see that at point 3, the ticks hit +800. On this day, I had a short in the mini-sized Dow with a 20-point stop. When the ticks hit +800, I covered my short for a 9-point loss. When the ticks hit +1,000 ticks 25 minutes later, I heard the audio alert for this level, and I set up a new short in the YM. (This is a trade setup that is covered in [Chapter 9](#).)

Between about 10:30 a.m. EST and 12:30 p.m. EST, nothing happened. The ticks were twitching back and forth like a freshly caught tuna on a boat deck. At around 1:30 p.m., the action picked up enough to the point where the ticks registered a reading of -800, and they even hit -1,000 later in the day. Let's take a look at this same chart with the actual market action overlaid on top of it (see [Figure 6.2](#)).

1. The ticks are usually quiet at the open, and at point 1 we can see that the ticks just flopped back and forth for the better part of an hour. The markets did a whole lot of nothing during this time.
2. By 10:25 a.m., we get the first notable tick reading at +600, and this drives the markets higher, with the ticks eventually hitting +1,000. (Remember, this is a shorting opportunity that is discussed later in the book.)
3. The mini-sized Dow futures hit 10,542 when the ticks move over +1,000, and this ends up being their dead highs of the day.
4. I like to watch how the markets react when the ticks start stair-stepping and making higher highs or higher lows. The ticks shot up to +600 at around 12:00 noon EST, but the markets did not move higher. Yet when the ticks started making lower lows, so did the market. This is key information. If high ticks of over +600 can't move the markets higher, then that is a tip-off that the selling pressure is predominant.
5. This series of lower lows in the ticks leads to an eventual steep sell-off. The market generally works up to "abrupt" rallies or sell-offs—the ticks can clue a trader as to which way the "out of the blue" move is likely to be.
6. Here we see the ticks make higher highs, forming an uptrend.
7. Yet when the ticks made higher highs, the YM made lower highs. This is a bearish divergence and a signal that the rally can be sold because there isn't enough "juice" to get things rolling.

There are rare days when the markets rocket higher and keep on going, or gap down and keep on selling. On these days, consistent extreme tick readings are generated, usually in the neighborhood of 1,200 to 1,400. These consistent high readings are rare, but when they happen, I don't fight them. This brings me to my last rule regarding the ticks—this is something that I take into account after 10:30 a.m. EST and watch throughout the day:

When the ticks spend 90 percent of their time above zero with repeated extreme high tick readings, I ignore trading short setups all day and focus on longs. When the ticks spend 90 percent of their time below zero with repeated extreme low tick readings, I ignore trading long setups all day and focus on shorts.

The ticks are a great way to see what is going on "underneath" the price action. The charts can tell you if prices are going higher or lower, but they can't tell you if the buying or selling pressure is merely fleeting or unrelenting. Leave that job to the ticks. As an update to this chapter, I've found that I've increasingly been using this indicator in more and more of my day trading. On days when the ticks are repeatedly hitting +1,000, I will use any pullbacks to the 0.00 line as buy entry opportunities. The opposite is also true. On any days when the selling is brisk and we are getting repeated -1,000 tick readings, I will use any rallies in the ticks back to the 0.00 line as shorting opportunities. Even better, these tick readings help a trader to stay in a trend. For example, if I'm short, and each time the ticks rally back to 0.00, they get pushed back down, I'll just stay short until we get a +600 reading. The opposite, of course, is also true. This is imperative on those occasional runaway days where the S&Ps are up or down 30 or more points, as has been the case for much of August and September 2011.

What Is the Fastest Heads-Up That Stocks Are About to Make a Move?

The tiki (TradeStation symbol \$TIKI) is similar to the ticks, but it measures the net upticks versus downticks on the 30 Dow stocks instead of the entire NYSE. Because this reading follows only 30 stocks, it is the first thing that fires off when a buy or sell program hits the markets. (See [Figure 6.3](#).)

\$TIKI - 5 min US L=-2.00 +6.00 -75.00% B=0.00 A=0.00 O=14.00 Hi=28.00 Lo=-28.00 C=-2.00 V=0

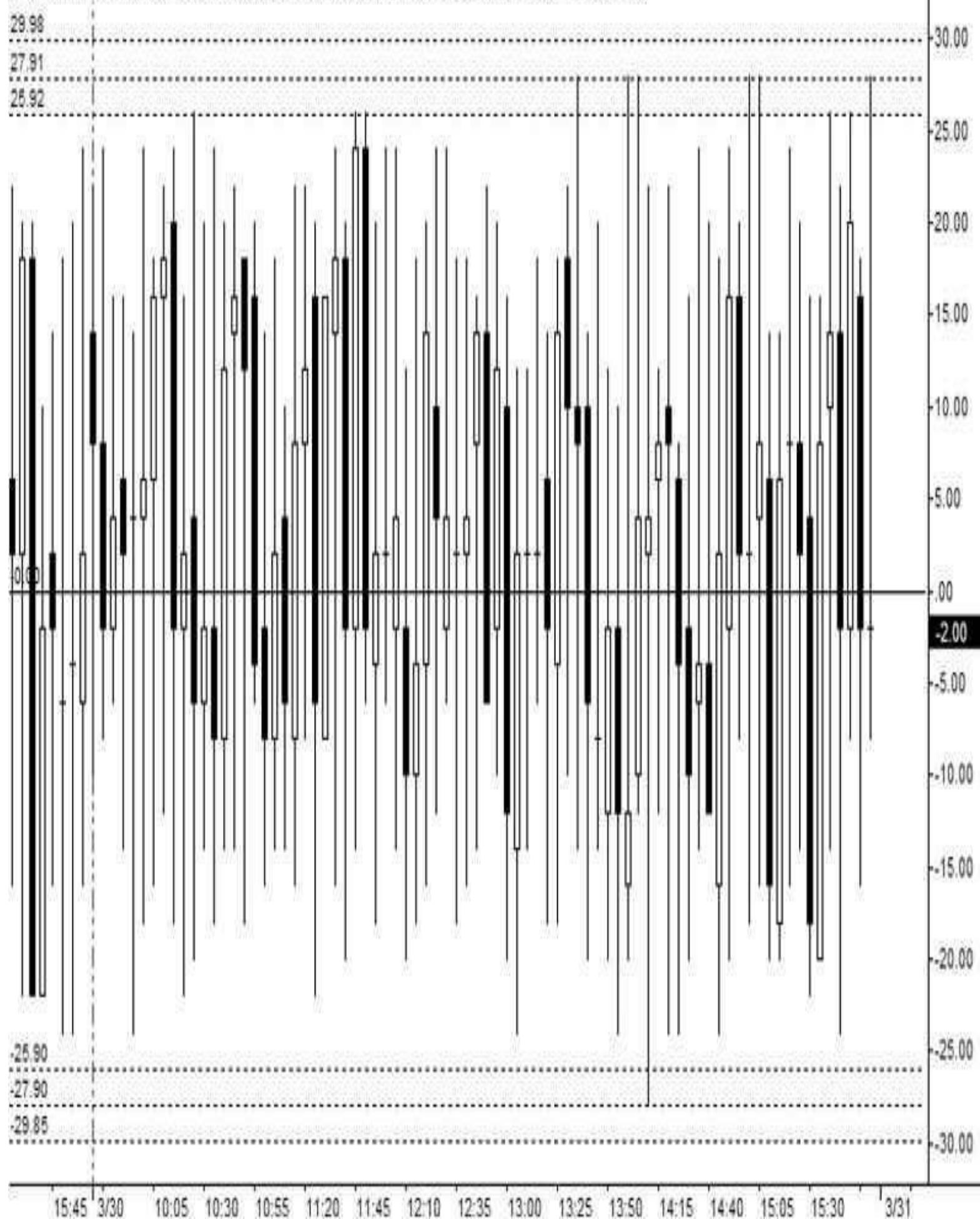


Figure 6.3

Tiki charts are filled with noise, and at first glance they look useless to watch. The key with them, however, is to set up alerts in the same fashion as for the ticks. On the tiki, I set up alerts to fire off at +26, +28, and +30 on the upside, and -26, -28, and -30 on the downside. When buy or sell programs hit the markets, these alerts fire off instantly. In general, small programs generate the 26 level, medium programs hit the 28 level, and massive programs hit the 30 level—meaning that all 30 Dow stocks are moving in the same direction. These readings are rare and highlight significant and sustained periods of buying or selling.

Surprisingly, I don't use these signals for any actionable exit strategies. If I'm short, and a +28 tiki level is generated, I'm probably wrong on the move, but I will wait until the ticks get to +800 before I exit. This is because a buy or sell program can be swift and over in a blink, causing the tiki movement to be erratic. This brings me to my first rule with the tiki:

For exits, tiki readings are only the heads-up; ticks are the confirmation.

[Figure 6.4](#) shows the tikis on March 29, 2005. When comparing this to the ticks, the first thing that is evident is that the tiki looks like it's all over the place and hard to read. However, upon closer inspection, immense value can be found.

1. I always like to see what type of program hits the market first—a buy or a sell program. This represents the first real “try” of the day, and I want to see how it pans out. In this chart, the first program of the day is a buy program that hits at 10:25 a.m. EST.
2. This sends the Dow to new highs.
3. The next program is also a buy, and it hits at 11:30 a.m.

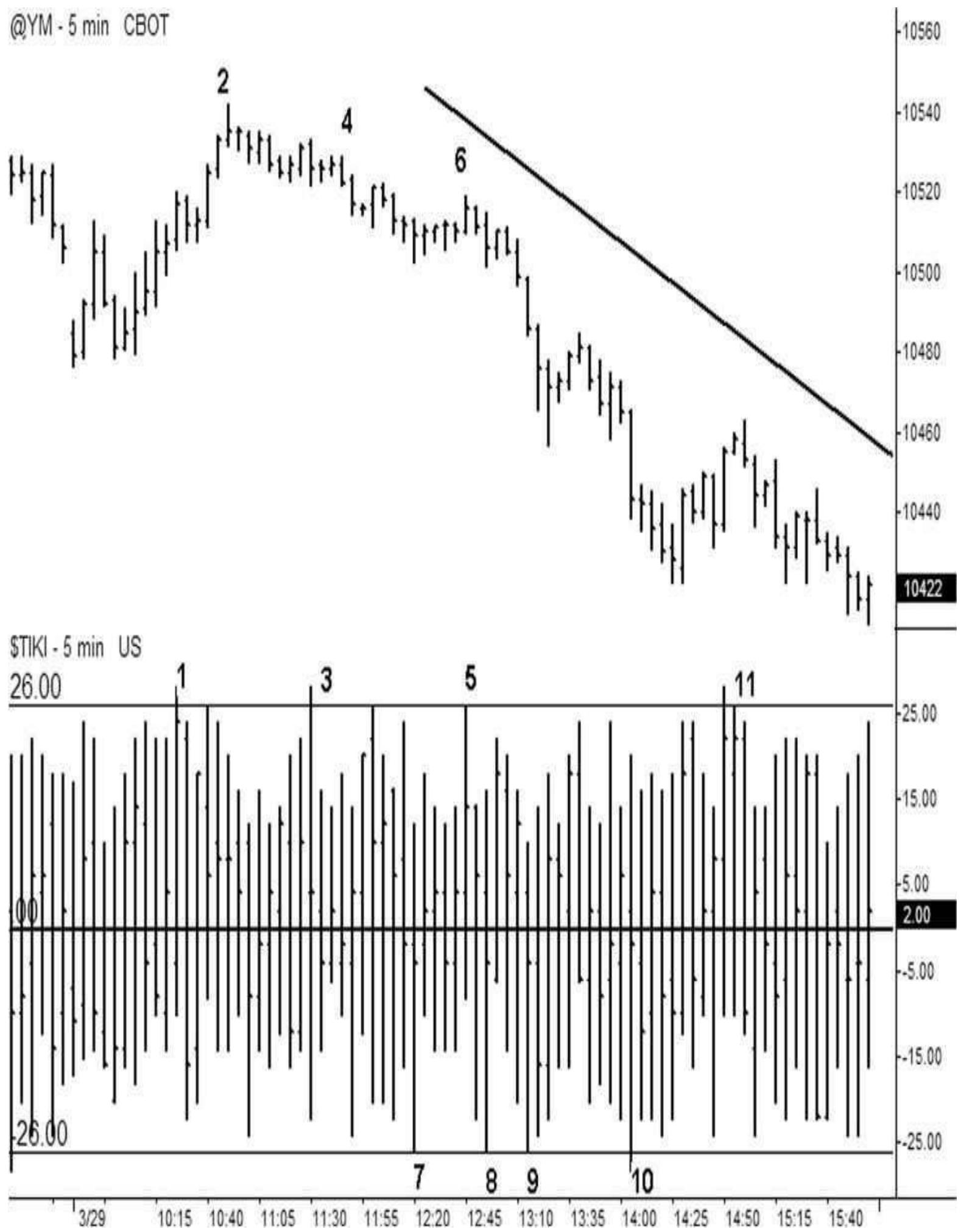


Figure 6.4

4. However, this time the Dow does not make new highs, but in fact continues to drift lower. This is a heads-up that “even a buy program” is not able to move the market higher.
5. There is another buy program at 12:45 p.m., and this one is after the first sell program hit the markets.
6. This buy program causes a small pop in the markets, but this buying dries up quickly.
7. At points 7, 8, 9, and 10, a series of sell programs hits the market, and each time a sell program hits, the markets make new lows. When this happens, the next opposing signal is a fading opportunity.
8. At point 11 there is an opposing signal with a buy program—an opportunity to go short.

This brings me to the next and last rule I use in following the tiki:

If buy programs are driving the markets to new highs, then the occasional sell program is a buying opportunity. If sell programs are driving the markets to new lows, then the occasional buy program is a shorting opportunity.

I like to see where most of the programs are hitting. Are they mostly buy or mostly sell programs? This is important, because most of the time markets are doing nothing. They are chopping back and forth. If most of the programs on the day are buy programs and these programs are pushing the markets up to new highs, then I want to use the quiet selling opportunities to get long. This way I’m getting into the market when it’s quiet, *before the next move higher*, instead of chasing it higher. A good example of a setup that works well in this situation is the pivot plays that I discuss in [Chapter 8](#).

What Is the Best Tool for Reading Buying Versus Selling Pressure?

The trin (TradeStation symbol \$TRIN), also known as the Arms Index after its creator, Richard W. Arms, measures the relative rate at which volume is flowing into advancing or declining stocks on the New York Stock Exchange. To calculate the trin, the following formula is utilized: (advancing issues/declining issues)/(advancing volume/declining volume). If more volume goes into advancing issues than into declining issues, the Arms Index falls below 1.0. If more volume goes into declining stocks than into advancing stocks, the Arms Index rises above 1.0. Most educational material on “how to use the trin” tells traders that “over 1.0 is bearish, so consider shorting, and under 1.0 is bullish, so consider buying.” That statement is annoying and misleading, and it brings me to my first rule when using the trin:

I don’t care what the current reading is.

I care about the current reading only in relation to where it has been.

In other words, what I care about is not the trin reading itself, but the trend of the trin. A reading of 1.50 might seem bearish, but if the reading started the day at 2.00 and we are now an hour into the trading day and 1.50 is the low, this is bullish. This means that volume is flowing into advancing issues and that there is sustained buying pressure in the markets. Conversely, a reading of 0.85 might seem bullish, but if the reading started the day at 0.45 and we are now two hours into the trading day and 0.85 is the high, this is bearish. This means that volume is flowing into declining issues and that there is sustained selling pressure in the markets. Let’s take a look at [Figure 6.5](#).

1. [Figure 6.5](#) is a shot of the mini-sized Dow on March 29, 2005, the same day we used for the tick and the tiki. At point 1, we can see that the trin started the day near 1.40. The first 15 to 20 minutes are volatile, as listed issues open on a delayed basis on the NYSE. Because of this, I dismiss the first five-minute bar, but I like to note the opening levels based on the start of the second five-minute bar.
2. The trin settles in, and by 10:40 a.m. it is trading near its lows of the day at 0.81.
3. The YM hits its highs of the day in correlation with the low trin reading.
4. By 12:00 noon, the trin has been in a steady uptrend, making new highs on the day (after discounting the first five-minute bar).
5. The YM is quiet and choppy, and it is trading in the middle of the day’s range. However, even though the markets are quiet, the trin continues to rally. This is the key action I’m looking for—which way is the trin trending? A trend higher indicates that volume is flowing into declining issues, and this means that when the market actually does break, the odds are strong that it will be to the downside. As we can see on the chart, a little later in the day, the market breaks down.

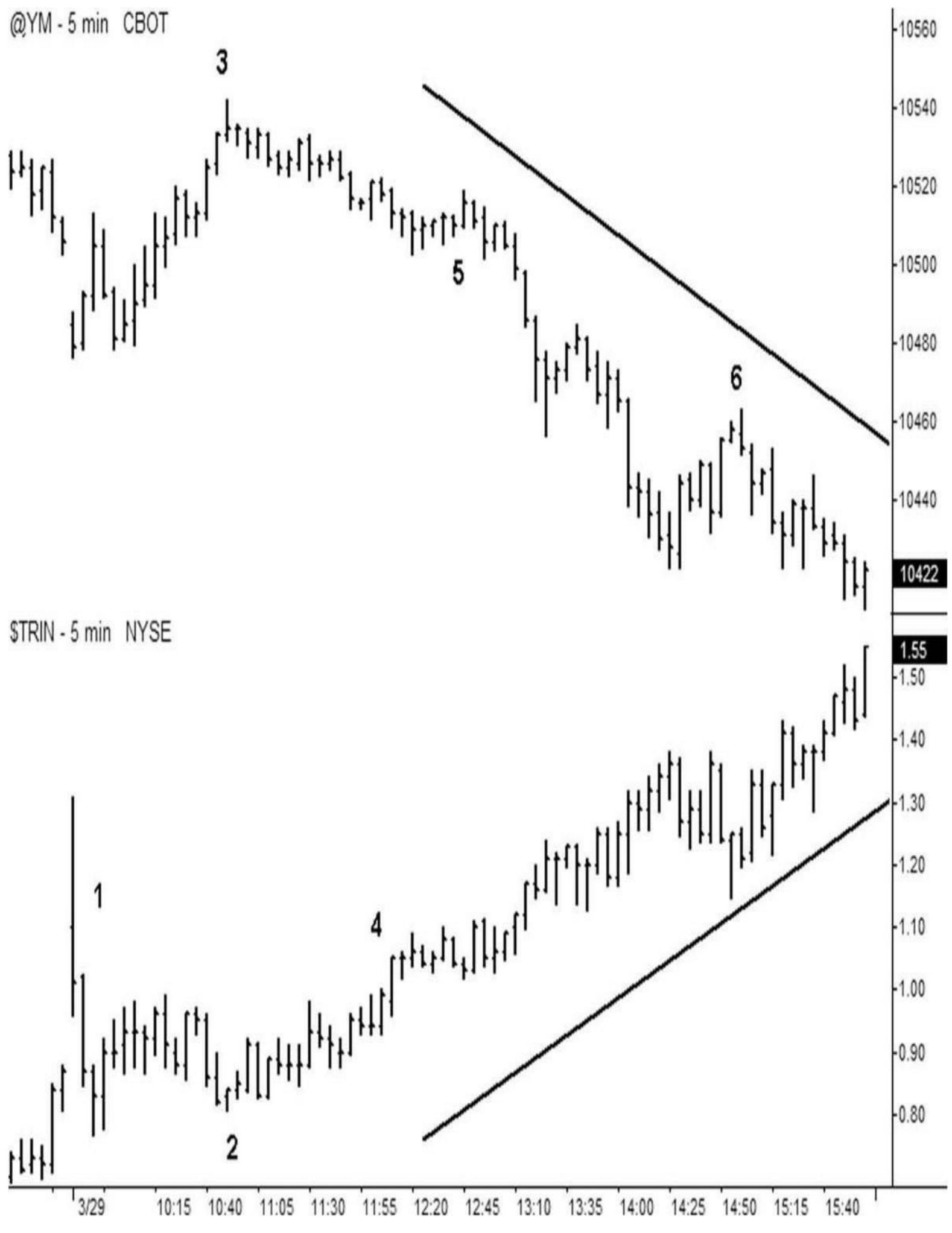


Figure 6.5

6. The YM tries to rally here, but it is in vain, as the trin is staying in a nice uptrend. The YM soon rolls over and drifts down into the close.

This brings me to my next rule for the trin:

If the trin is trending higher and making higher highs on the day, I will ignore all long setups.

If the trin is trending lower and making lower lows on the day, I will ignore all short setups.

Let's take a look at another multiday chart and the trin action (see [Figure 6.6](#)).

[Figure 6.6](#) shows a good overall representation of what various trin patterns mean. On the first day, February 22, 2005, the trin started off low. Some would call this bullish. Yet the trin then proceeded to rally all day long, and the Dow fell more than 120 points. The rule of "no longs on this type of day" serves a trader well. Conversely, if I am in a short and the trin is making new highs, I realize that there is no reason to cover, as the eventual market break has a high probability of being in my favor.

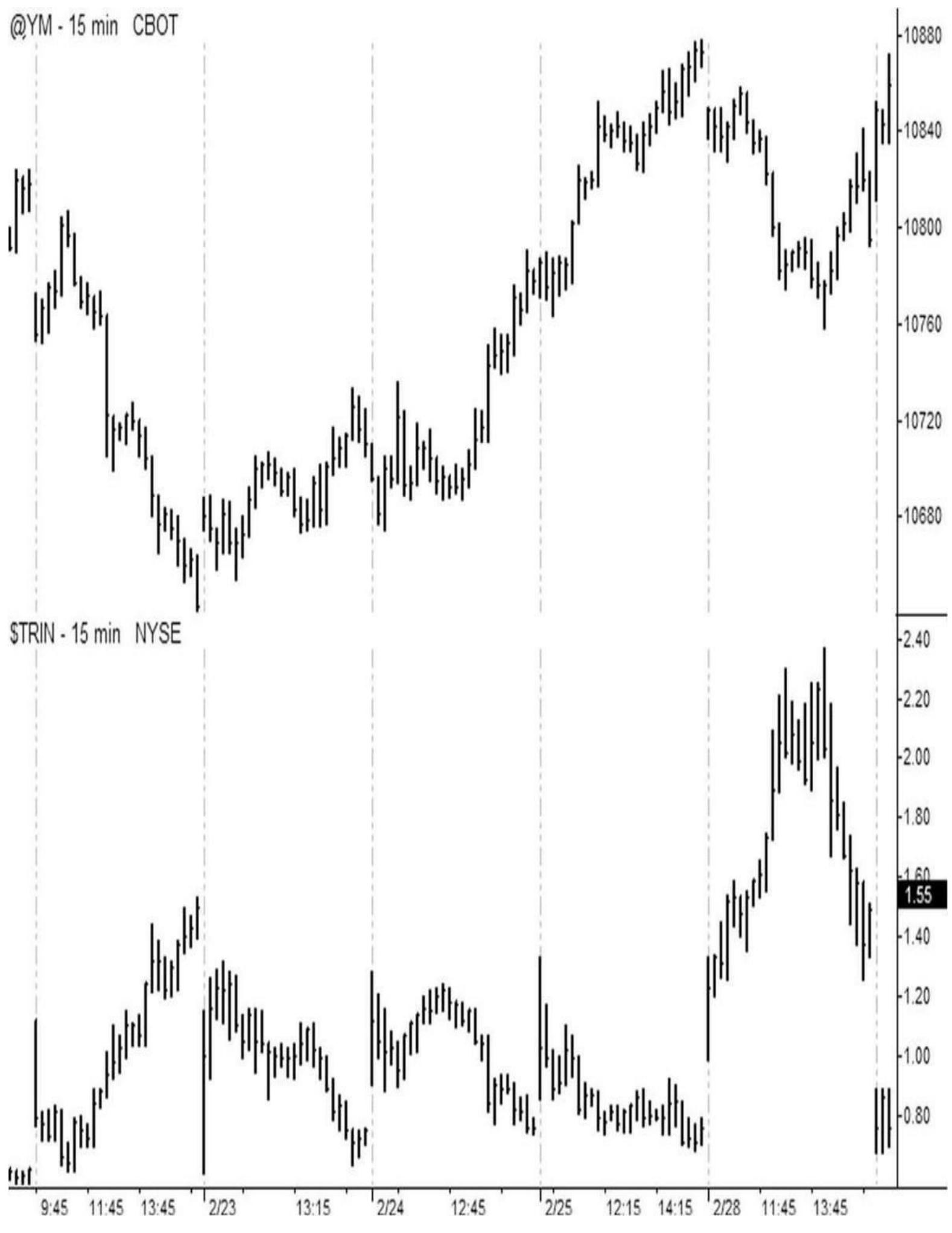


Figure 6.6

On February 23, 2005, the trin started off high, but then proceeded to trend lower all day long. Although many traders will get caught up in the previous day's selling and use this initial strength as a shorting opportunity, they would realize the folly of this idea if they knew that they should follow the trend of the trin. With the trin heading lower, the markets stabilized early in the session, and a modest rally ensued. Because the trin continued to make lower lows on the day, I just focused on long setups. On February 24, 2005, the trin started off high once again, then proceeded to spend the rest of the day grinding lower. Based on this, I ignored short setups on the day. The YM broke nicely higher later in the day. On February 25, 2005, the trin once again started off high and spent the day working lower. Finally, on February 28, 2005, the trin started off high—but moved higher. While it was making new highs on the day, I ignored long setups and focused only on short setups. During the last two hours of the trading day, the trin reversed, and the markets rallied into the close. The most bullish days are gap ups where the trin starts off low, say around 0.50, and stays at that level all day long. On such a day, it doesn't trend lower because it can go only so low—it won't make it to a zero reading. The sustained lower reading looks like a consolidation pattern on a chart, and it is extremely bullish. On these types of days, I ignore all short setups, and a breakout to new highs is a buying opportunity.

The key with the trin is to watch to see if it is making new highs on the day or new lows on the day. Whenever this is happening, I just ignore the opposing setups. I've read that some people recommend using levels such as 1.50 as "oversold" and start looking for a bounce, or 0.50 as "overbought" and start looking for a sell-off. I am not a fan of oversold or overbought, and I generally ignore this with most indicators, and the trin intraday is no exception. The biggest rallies take place when the trin hovers under 0.50 all day long. Just because something is overbought doesn't mean that it's going to reverse. For reversals, I will look only at price action, and I discuss these types of setups in later chapters.

Although I'm not a big fan of overbought and oversold in general and I don't worry about overbought or oversold readings intraday on the trin, I will pay attention to where it closes on the day. This closing number actually is valuable when it comes to gauging an extreme overbought or oversold reading. These readings are rare and happen about a dozen times a year, and this brings me to my next rule when using the trin:

If the trin closes above 2.0, the market has an 80 percent chance of rallying the next day.

If the trin closes below 0.60, the market has an 80 percent chance of selling off the next day.

The moves the next day won't necessarily be big moves, but they will generally be opposing moves. I will keep this in mind as I'm viewing my setups the next trading day. If the previous day's close was over 2.0, then the next day I'm going to focus more on long setups and ignore short setups. Here's where it gets interesting—if after a 2.0 reading, the markets can't rally on the next trading day, then the markets are in deep trouble and are setting up for a major slide. This happened during the first week of July 2004 (see [Figure 6.7](#)).

On this daily chart of the trin and the mini-sized Dow, the trin closed on July 1, 2004, with a reading of 2.80 (point 1). The next day, the markets tried to rally early in the session, but ultimately collapsed and ended lower on the day. This is always an ominous sign, and the Dow went on to lose 673 points before bottoming out on August 6, 2004. On July 6, 2004, the trin closed at 2.12 (point 3) and the Dow managed to rally the next day (point 4), but the bulls' moment of glory was short-lived. This same scenario unfolded during the second trading day of 2005, January 4, when the trin closed at 2.53. The next day, the markets couldn't rally, and they ended up selling off 410 points through the rest of the month.

Is There a Similar Tool Just for Nasdaq Stocks?

The trinq (TradeStation symbol \$TRINQ) is just like the trin, except that it's for the Nasdaq. The same rules apply here—all I'm interested in is the trend of the trinq.

[Figure 6.8](#) is the same chart we were looking at on March 29, 2005, but I've added the trinq and the Nasdaq. With the trinq going higher, the Nasdaq is going lower. In general, I place more weight on the trin, but I like to see what is happening in the Nasdaq as well. There are times when the trinq will be the leading mover, making new highs or new lows before the trin. On days where the trinq is mixed and the trin is trending, I will pay more attention to the trin. The strongest moves in the market occur when both the trin and the trinq are moving more or less in alignment.

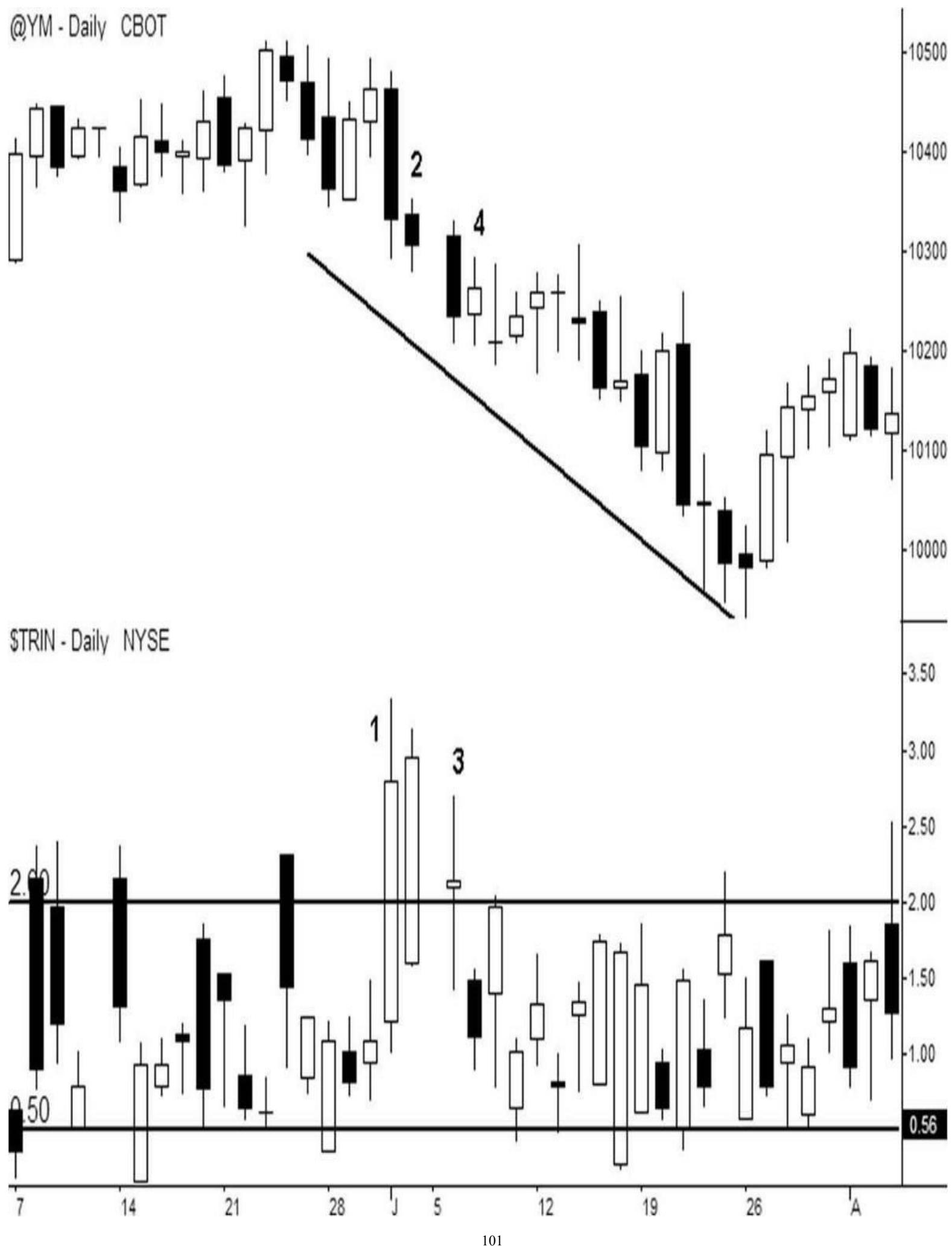


Figure 6.7

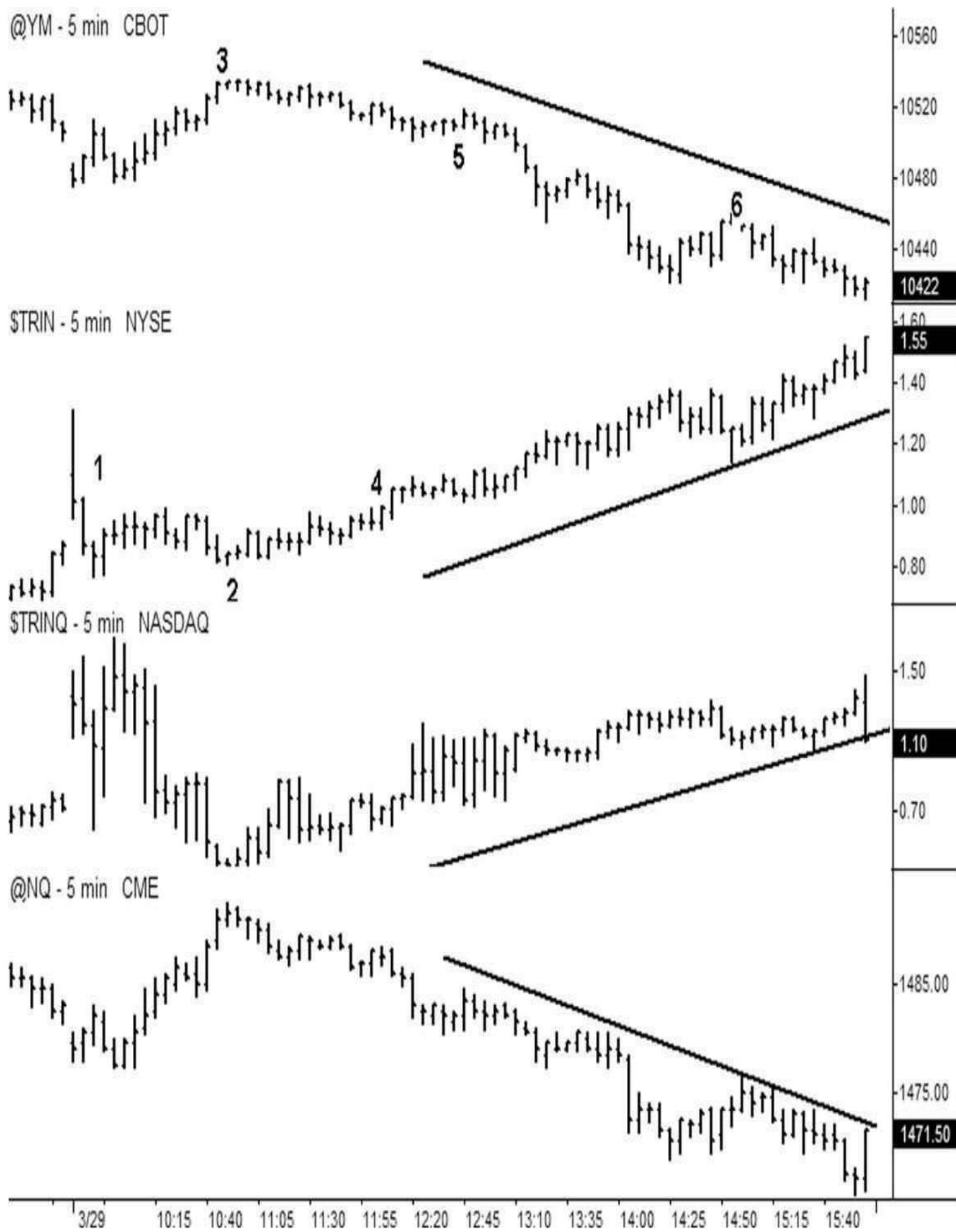


Figure 6.8

Put/Call Ratio—Is This the Key to the Kingdom?

As a trader, what would you give to be able to know what the rest of the market participants are doing at any given time? If a broker told me that he could provide me with that information each and every day, I'd be so appreciative that I might even let him charge me \$25 a round turn for an E-mini futures contract. While a secret report is not going to magically appear in your in-box, the put/call ratio (TradeStation symbol \$PCVA and referred to during the rest of this section as PC) is as close to actually having this information as a trader is going to get.

The PC ratio measures how many put options are bought relative to call options. The formula is very simple to calculate—take the volume for puts and divide by the volume for calls. (For anyone who is not familiar with options, buying a put is making a bet that the market is going to fall, and buying a call is making a bet that the market is going to rise.) If there are 50,000 puts sold and 100,000 calls, the ratio is 50,000/100,000, or 0.5. If there are 125,000 puts sold and 85,000 calls, the ratio is 1.47.

There are three main PC ratios that are generated throughout the day: the equity PC ratio, the index PC ratio, and the combined equity/index PC ratio. The equity PC ratio is generally very low, which reflects a retail crowd that has a tendency to favor the long side (more call buying). The index PC ratio is usually very high (more put buying), which reflects an institutional mindset that wants to stay hedged against any unexpected move lower. The combined equity/index PC ratio reflects the behavior of both of these groups and gives a trader the best gauge of what the overall market participants are thinking, and, more important, where they are placing their bets. It is this combined equity/index PC ratio that I watch during the trading day.

To illustrate how I use this indicator, let's assume that the market is made up of exactly 100 participants. Let's further assume that all 100 of these people are bearish on the markets, and that because of this prevalent feeling, they have established short positions in stocks, ETFs, and index futures, as well as through the buying of puts. With all 100 market participants bearish and now short, a very interesting turn of events takes place—there is nobody left to sell. With nobody left to sell, the markets don't have any downward pressure, and they start to drift higher. This drifting eventually hits the first set of stop orders placed in the market by the 100 market participants who are short. Within any given group of traders, some will be using tight stops, some medium stops, and some wide stops. The group of tight stops gets hit first, and this generates fresh buying pressure in the form of short covering that drives the markets higher, right into the next range of stops. This next series of stops kicks off yet another short-covering spree, which, once triggered, drives the markets even higher into the next range of stops, and so on until all the stops are taken out.

At this point, the 100 market participants get bullish, and they start buying stocks and index futures, as well as call options. Once they have all scrambled to establish their positions, a very curious thing takes place—there is nobody left to buy. With nobody left to buy, the markets begin to drift lower and take out the first set of tight stops, which in turn creates enough selling pressure to drive the markets down to the next set of stops, and so forth. It's a vicious cycle.

Obviously this is a simplified scenario, and in the real world, not every single market participant is going to be bullish or bearish at exactly the same time. However, the amount and intensity of bullish and bearish bias does fluctuate regularly, and this shift in attitude causes markets to move in a fashion related to the oversimplified scenario just described. This brings me to my first rule regarding the PC ratio:

If the combined equity/index PC ratio gets over 1.0 intraday, I will ignore all short setups and start looking at long setups.

A PC ratio of over 1.0 represents extreme bearishness and put buying, and, as a result of the scenario just described, places a floor in the markets. It's not an immediate floor. When the ratio goes to 1.0, the markets don't suddenly stop declining and then immediately rally. It's a process, and a visible support level does take shape because of the simple fact that there are too many bears in the market—and lots of buy stops sitting overhead, just waiting to be taken out. These 1.0 readings usually happen when the markets have fallen for a number of days in a row, or when bad earnings or economic data hit the tape, suddenly infecting many market participants with a bearish outlook. In fact, many times a market will continue falling until the PC ratio gets over 1.0. The opposite extreme is also true, which brings me to my next rule:

If the combined PC ratio falls under 0.60 intraday, I will ignore all long setups and start looking at short setups.

A PC ratio of under 0.60 represents extreme call buying and puts a ceiling on the markets. This represents a scenario in which there are too many bulls and very few people left to buy. Now there are lots of sell stops sitting beneath the current levels, just waiting to be hit. This usually happens after the markets have rallied for a number of days in a row, or after seemingly great earnings or economic news hits the tape. Also, people who have missed the move start chasing it in the fear of being left behind. In fact, many times a market will continue rallying until the PC ratio gets under 0.60.

[Figure 6.9](#) is a 15-minute chart that shows the mini-sized Dow overlaid on top of the equity/index PC ratio. On February 22, 2005, the PC ratio stayed low most of the day, dipping below 0.60. This represents a bullish outlook and the buying of stocks, index futures, and calls. This placed a lot of stops below the markets, and the Dow subsequently sold off over 120 points to clear them out. On February 23, the PC ratio spent a little time over 1.0, which represents a bearish outlook, the establishment of short positions, and the buying of puts—and the placing of many stops above the market. This was enough to kick-start a modest rally into the close, as the overhead stops provided the fuel for the market rally. On February 24, the PC worked itself to an extreme high reading, while the markets gapped down and stayed under pressure early in the session. However, with so many people bearish and with so many buy stops sitting above the markets, the market had little choice but to rally. On February 25, the PC started the day low but quickly rallied and stayed near 0.80 for most of the day. On February 28, the PC started off low and spent nearly an hour under 0.60. This means that everyone was excited and was buying calls because of the rally on February 25, and now, with so many sell stops in the market resulting from all the fresh long positions, the markets drifted lower and took them out.

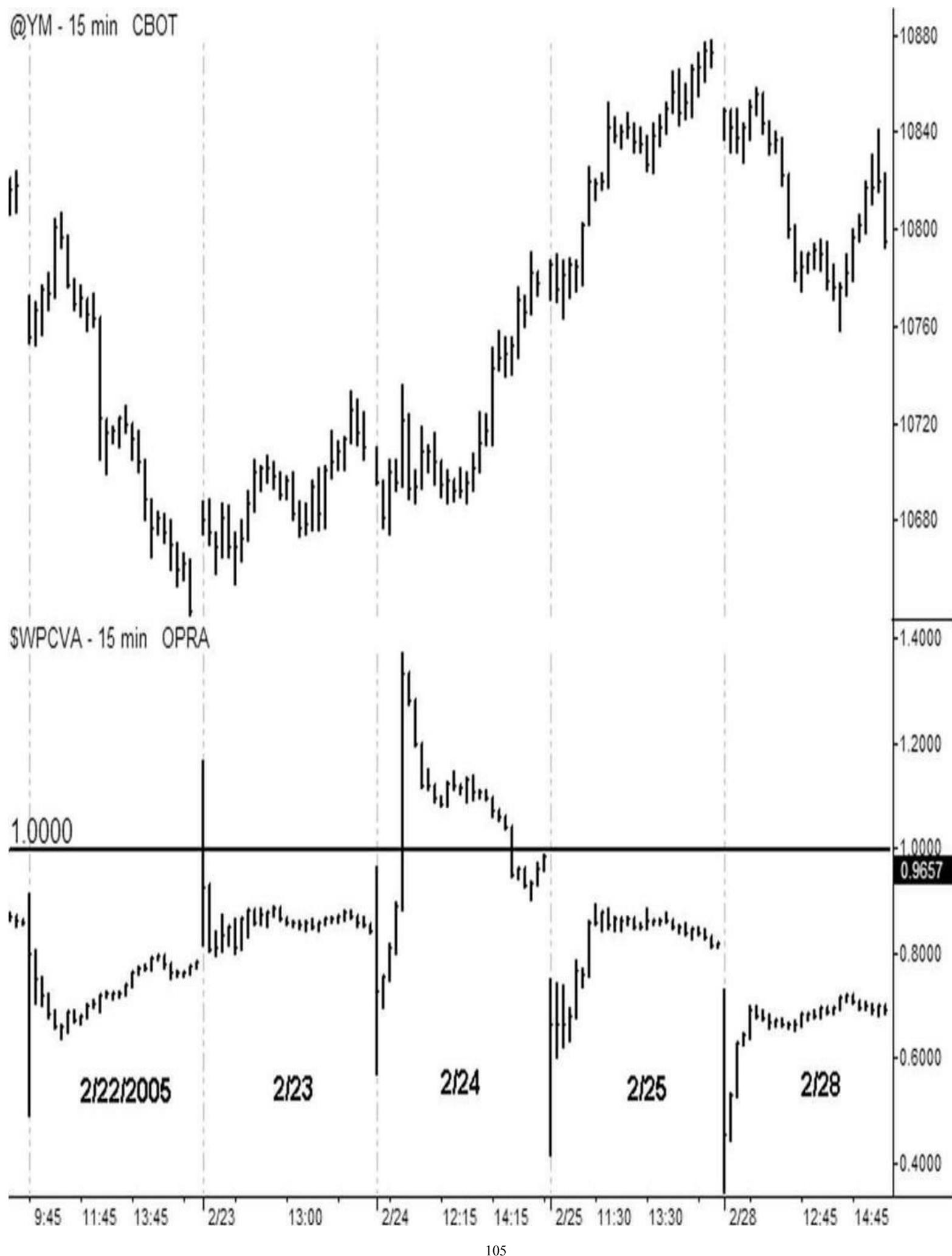


Figure 6.9

To reiterate, the main thing I'm looking for in the PC ratio is whether or not it is at an extreme range. This indicator doesn't spend a lot of time in the extreme ranges, but they are hit often enough to have an impact on the markets. What about when the PC is not generating an extreme reading?

The PC actually spends a lot of time in what I call "neutral" territory. This is between 0.70 and 0.90. During these periods, the PC is generally not a factor in my trading decisions. However, there is another aspect of the PC that I will watch during the day, and that is the "trend" of the PC. And this brings me to my next rule:

If the market is rallying, I want to see the PC rallying to confirm the move. If the market is falling, I want to see the PC falling to confirm the move.

If the PC is rallying, this means that more people are getting bearish, and they are shorting stock, shorting indexes, and buying puts. This means that people don't believe in the rally, and they are using the strength to establish short positions. Little do they know that their act of shorting merely adds fuel to the next leg higher, as the market now has a series of stop orders sitting overhead, just waiting to be ripped through. If, however, the market is rallying and the PC is falling, this is because people believe in the rally and are chasing it—a sign that it has run its course. Naturally, the opposite is also true. If the market is falling and the PC is falling, this means that more people are bullish, and they are using the market weakness to buy stocks and buy calls. They are merely providing fuel for the market to continue on its downward path in the form of new sell orders placed below the market. If the market is falling and the PC is rallying, this means that people are getting scared and are chasing the market lower—a sign that the decline is about to end (see [Figure 6.10](#)).

1. On March 29, 2005, the mini-sized Dow futures gap down and try to push lower.
2. The PC rallies as people scramble to establish short positions and buy puts.
3. This increases put buying. Even though it doesn't push the PC above 1.0, it is enough to get the markets to reverse course and take out the overhead stop orders.
4. Traders view this rally in the YM as a positive thing, and they start buying calls as the market pulls back. This call buying intensifies, driving the PC ratio to under 0.65.
5. With the aggressive call buying, the YM drifts lower for a few hours and then cracks, falling more than 120 points.
6. With the decline, traders start to worry that they are going to miss the down move, and they start shorting stock and buying puts. This drives the PC ratio to its highs on the day.
7. Although the markets don't rally into the close, they stabilize, as a high PC ratio starts to establish a floor in the markets.

[Figure 6.11](#) shows the markets the next day. With the markets closing near their lows on March 29, people get bearish the next morning, and on the gap up, they start shorting aggressively and buying puts for the "inevitable" move lower. The PC ratio gets very high as the traders race to get positioned on the short side. How does the market respond? By closing more than 140 points higher than the previous day's close.

I do want to point out that I largely discount the PC ratio until after 10:00 a.m. EST. There are a lot of listed stocks that take time to get opened, and a lot of overnight option orders that take time to get executed. This causes a lot of erratic movement in the PC ratio. Also, I ignore the reading on options expiration day, as it tends to get out of whack because of all the specific options-related activity.

The PC ratio is a valuable intraday trading tool. As of this writing, there are many data feeds that do not carry this indicator. On TradeStation, you have to be permissioned for "opra" in order to receive the PC ratio. For example, while it is available on TradeStation, it is currently not available on eSignal. More quote vendors will supply this information if their customers ask for it. Also, this information is available for free at www.cboe.com in its "Market Data" section. These numbers are updated every half-hour.

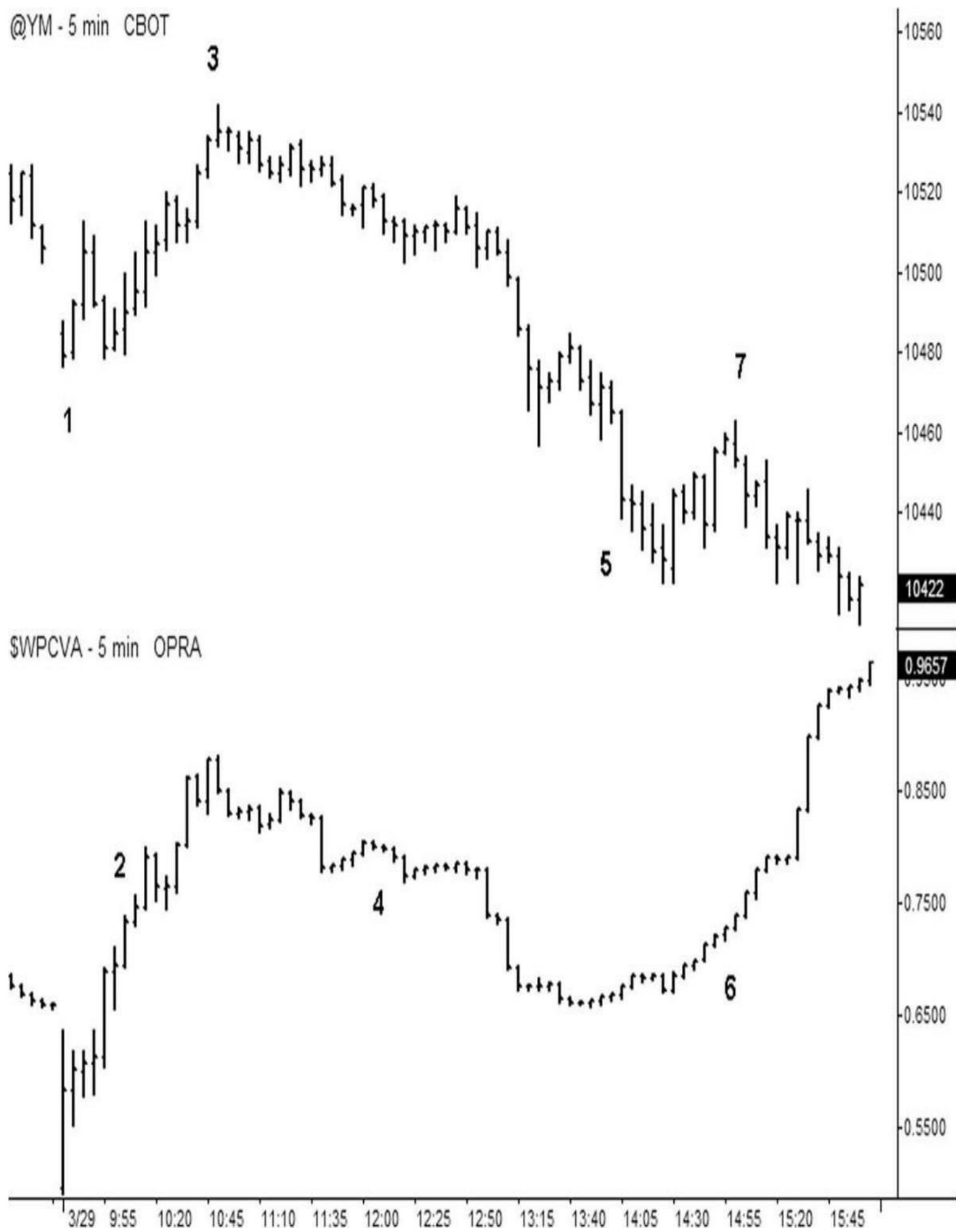


Figure 6.10

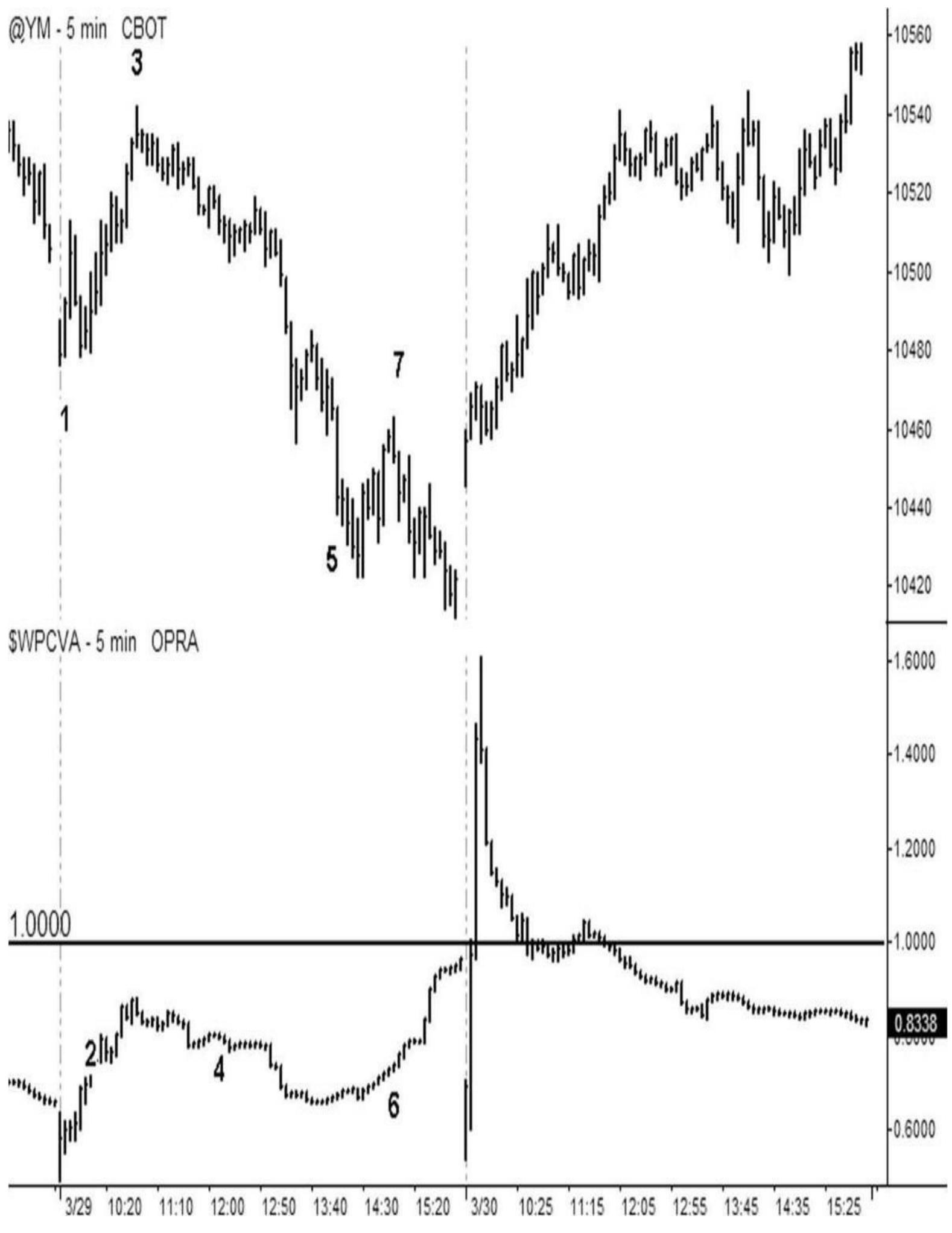


Figure 6.11

What Is the Most Effective Way to See What's Really Going On in the Stock Market During the Day?

The sector sorter list (SSL) is a simple tool that I use to gauge what is going on “beneath the indexes.” I list all the key sectors and have them sorted automatically every few seconds throughout the trading day based on their net percent change. This tells me at a glance which sectors are leading the markets higher or lower, and this brings me to my first rule regarding the sector sorter list:

Any move without the banks (BKX), brokers (XBD), and semiconductors (SOX) is suspect and most likely will not last.

On April 1, 2005, the only sectors up on the day, for the most part, were energy, housing, and gold. (See [Figure 6.12](#).) One of the worst sectors of the day was the semiconductors, and not far behind it were brokers and banks. I like knowing where these sectors are in the mix for three reasons: First, the giant money-center banks represent the biggest (or almost biggest, depending on current prices) market capitalization sector in the market. The markets need participation from this index if they hope to make any headway. Second, brokers are a great market proxy. As go the brokers, so go the markets. Third, everyone participates in the semiconductor stocks. They have a strong following among retail and institutional investors alike. If I see a decline with these three sectors leading the way lower, I am confident that the decline is going to last. The reverse is also true.

TradeStation RadarScreen - Sectors

S
I
-
X

	Symbol	Last	Net Chg	Net %Chg	V	Description
1	SOSX.X	142.28	2.87	2.13%		Phlx Oil Service Sector Index
2	\$XNG.X	333.76	6.86	2.10%		Amex Natural Gas Index
3	SXOIX	870.23	17.75	2.08%		Amex Oil Index
4	SHGX.X	481.75	3.21	0.67%		Phlx Housing Sector Index
5	SUTY.X	393.85	1.86	0.47%		PHLX Utility Sector Index
6	SGSO.X	157.45	0.61	0.39%		Gsti Software Index
7	SXAUX	94.01	0.26	0.28%		PHLX Gold And Silver Sector In
8	\$GIN.X	155.94	0.01	0.01%		Gsti Internet Index
9	SBMX.X	111.79	0.00	-0.00%		Phlx Computer Box Maker Sector
10	\$HMO.X	1357.03	-0.81	-0.06%		Morgan Stanley Healthcare Payo
11	SDFX.X	261.06	-0.24	-0.09%		Phlx Defense Sector Index
12	\$INX.X	183.89	-0.82	-0.44%		CBOE Internet Index
13	SXCIX	672.76	-4.10	-0.61%		Amex Computer Technology Index
14	SGSV.X	132.64	-0.84	-0.63%		Gsti Services Index
15	\$IIX.X	146.07	-1.01	-0.69%		Amex Interactive Week Internet
16	SCYC.X	741.75	-5.15	-0.69%		Morgan Stanley Cyclical Index
17	SMSH.X	452.24	-3.19	-0.70%		Morgan Stanley High-Technology
18	SBKX.X	95.84	-0.71	-0.74%		PHLX KBW Bank Sector Index
19	STRAN	3686.61	-29.36	-0.79%		Dow Jones Transportation Index
20	SDRG.X	312.31	-2.53	-0.80%		AMEX Pharmaceutical Index
21	SIXF.X	2634.55	-22.28	-0.84%		Nasdaq Financial-100 Index
22	SGHA.X	301.12	-2.69	-0.89%		Gsti Hardware Index
23	SCMR.X	572.08	-5.73	-0.99%		Morgan Stanley Consumer Index
24	SXBD.X	144.12	-1.52	-1.04%		Amex Securities Broker/dealer
25	\$NWXX	202.80	-2.18	-1.06%		AMEX Networking Index
26	SBTK.X	486.83	-6.02	-1.22%		AMEX Biotechnology Index
27	SGSM.X	203.35	-2.82	-1.37%		Gsti Semiconductor Index
28	SSOX.X	411.22	-5.77	-1.38%		Phlx Semiconductor Sector Inde
29	\$RLX.X	424.07	-6.16	-1.43%		S&p Retail Index
30	SXAL.X	47.96	-0.99	-2.02%		AMEX Airline Index

Figure 6.12

The other way I like to use this list is when the markets are quiet and choppy. Often there are stealth moves in the markets. This happens when the overall indexes are restricted in a tight range, but underneath the surface, a couple of key sectors are deteriorating or firming. This often is not picked up in the index itself. This brings me to my next rule:

During these quiet periods in the market, the more sectors that go red, the greater the odds are that, when the market finally does break, it will be to the downside. Conversely, the more sectors that go green, the greater the odds are that, when the market finally does break, it will be to the upside.

Like a doctor's relationship to a patient's medical chart, the sector sorter list helps a trader gauge the overall health of the current market environment. ETFs can also be utilized for this. The nine I like to follow are XLY (Consumer Discretionary), XLF (Financial), XLB (Materials), XLP (Consumer Staples), XLV (Health Care), XLK (Technology), XLE (Energy), XKI (Industrial), and XLU (Utilities).

How Do You Know When It's Going to Be a Choppy Day?

One of the most frustrating things for traders is dealing with a tight-range, choppy day in the stock indexes. Choppy days occur when the stock indexes spend most of the day trading in a slow, narrow range, providing minimal volatility. Most traders don't realize that the trading is choppy until about halfway through the day. They can tell by looking at the chart, and they can tell by the amount of losing trades that they have taken. In addition, there are specific trade setups that work great in choppy markets. If a trader relentlessly pursues a setup that works best in trending markets, she is going to get killed. Two of my favorite choppy market strategies are described in Chapters 8 and 9 (pivots and tick fades).

My goal is to identify what type of market it is going to be as early as possible in the trading day. To do this, I set up a five-minute chart of the E-mini S&P 500 futures, and the only indicator I place on this chart is volume. Once this is done, I place a horizontal line at the 25,000 level on the volume chart (or as close to 25,000 as I can place it).

In [Figure 6.13](#), we can see that the trading during the first hour on September 27, 2011, had the vast majority of the volume bars going over 25,000. This is typical, as the first hour of trading is typically hectic. This means that more than 25,000 contracts were traded every five minutes. The markets traded quietly higher for most of the day, and then started to ease back into the final hour. Once volume spiked above 25,000 contracts and then stayed above that level, it indicated that bears were swooping in for the kill. And kill they did, sending the S&Ps 30 points lower into the close. Volume is extremely helpful in measuring the conviction of the move. Had the market started to sell off on light volume, I would have known that there wasn't much conviction in the move. It was just a probe that would most likely fail, and it would indicate a buying opportunity for a continuation rally into the close. However, once the volume backs the move, it's continuation at its best, and there is no reason to fight it, just go with it. In [Figure 6.14](#), we can see the \$TICK from that same day. For much of the day, the \$TICK spent quality time above zero, frequently hitting the +1,000 level. During this time, any pullbacks to the zero lines were buying opportunities, with moves back up to +1,000 an opportunity to sell that position. However, once volume spiked higher and the \$TICK hit its first -1,000 reading into the close, the nature of the market changed. As you can see, all rallies back to the zero line were rejected (offering shorting opportunities) as the bears kept pounding the bulls into submission. In fact, the \$TICK got as low as -1,200, which indicates extreme selling taking shape. Watching both the volume and the \$TICK together offers a great map of what's going on underneath the surface on any given day. This brings me to my rule for watching this volume chart:



Figure 6.13

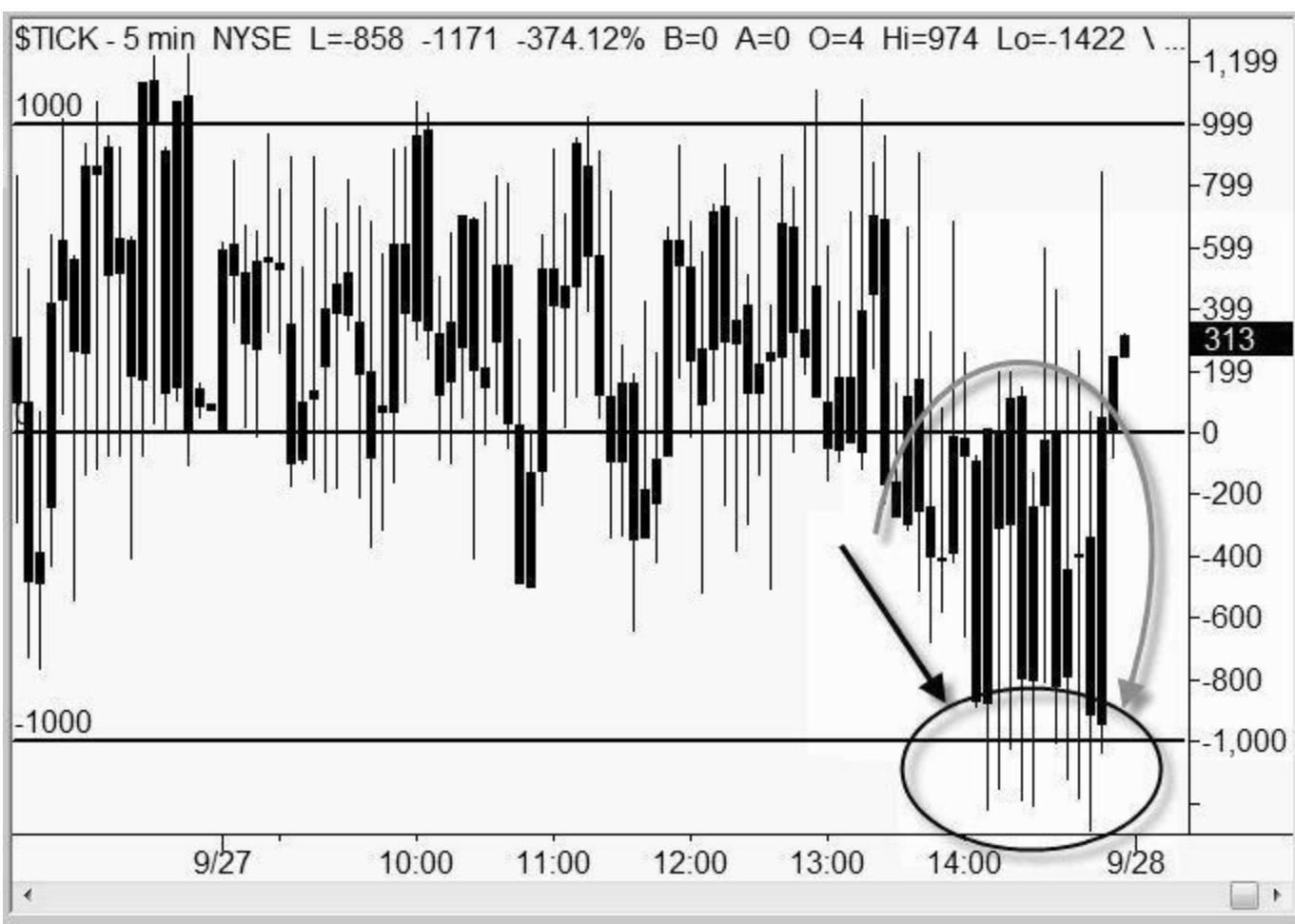


Figure 6.14

If the first six bars on a five-minute ES chart have most of the volume at or well under 25,000 contracts, expect a choppy, tight-range session. If the first six bars on a five-minute ES chart have most of the volume at or well above 25,000 contracts, expect a more volatile session with better trends.

This is a simple way to determine early on if the markets are going to be choppy or more volatile on the day. This allows traders to choose the setups that are more appropriate for these types of markets early in the day. To put it simply, on choppy days, it's best to fade extreme \$TICK readings. On trending days, it's better to go with extreme \$TICK readings by fading moves back to the 0.00 line. (See [Chapter 9](#) for more information on \$TICK plays.)

Listening In on the Floor—What Is the True Value of Pit Noise?

There are feeds available from people who are standing just outside of the S&P futures pit at the Chicago Mercantile Exchange. They will stand there and call out the current bid/ask prices and make comments on the market action. I like to have this playing quietly in the background on those crazy days when the stock market is moving hard. One of my trading partners, Hubert Senters, likes to play it loud every day, as he pays attention to all the nuances coming out of the pit. Hubert introduced me to pit noise, and the first few months I listened to it, the noise nearly drove me to drink, so I turned it off. After three days, I realized that I missed it just enough. These days I like to day-trade the stock index futures on the “crazy days” with the pit noise playing in the background. If it's a quiet or “normal” day, then I'm fine without it. Here is how it works and how I use it.

First off, it's important to understand what the people in the pits are talking about. All day long, a trader is going to hear the bid/ask being quoted, and it typically goes like this: “six twenty by a half, six twenty by a half,” and so on. This is a quote for the big S&P contract, which is quoted in tenths instead of quarters like the E-minis. This means that the current bid/ask is 1,136.20 by 1,136.50. The quotes just focus on the last few numbers instead of the entire price.

The person doing the talking will frequently refer to “paper versus local.” Paper coming into the market means that it is a retail order and was placed by a broker such as Goldman Sachs or Merrill Lynch. “Local market” means that the locals are trading among themselves; this happens when the action is slow and the volume is light. I have listened to many pit broadcasters, and by far the best one is Ben Lichtenstein with www.tradersaudio.com. He absolutely loves what he does, and this comes across each day in his broadcasts. Every summer, we hold a four-day seminar in Chicago. We have Ben come in for an hour and talk about how he reads the tape and what listeners should key in on. Then, the next day, we take the group down to the CME floor so that they can watch Ben in action calling out the pit noise live. They see exactly what he is looking at, what he is calling out, and why he is doing it. It's a great experience. We did manage to get one of these sessions filmed, and it is fun to watch on DVD.

Here's some terminology. A “thin top” means that there are not a lot of bids at these levels—look for the market rally to fail. If Ben mentions a scale buyer or a scale seller, I pay attention to what that seller is doing and at what levels.

When Ben mentions a “top tenner,” this means that one of the 10 biggest guys in the pit is doing something. Once in a while, you will hear that a “top tenner” is

stuck short, and this provides great opportunities to jump in on a trade as the top tenner is forced to cover hundreds of the big S&P contracts to get out of his position. This is information that you can't learn from watching a chart.

I also like to listen to the overall noise level. Is it quiet and slow, or is it loud and fast? If the noise explodes, it is almost like the ticks reaching the +1,000 level. This level of activity is unsustainable, and the markets will reverse. If the sound is quiet and then it gradually gets louder, I will go in the direction of the market until the noise "explodes," and then I'll get out.

My favorite way to use the noise from the pit is to listen and figure out whether the noise is louder on the up moves or the down moves. If a market is rallying and the pit noise is loud, and then the market pulls back and the pit noise is quiet, this is a crystal-clear signal that the momentum is higher, and I will aggressively buy all pullbacks on these days. The reverse is also true. Once I got used to this, I found it very hard to look at a chart without having this "pit noise indicator" in the background.

There are many other ways to use pit noise. If someone is above or below the market with size and the locals fill it, go in the direction of that move. This means the locals are pushing the markets instead of fading the markets.

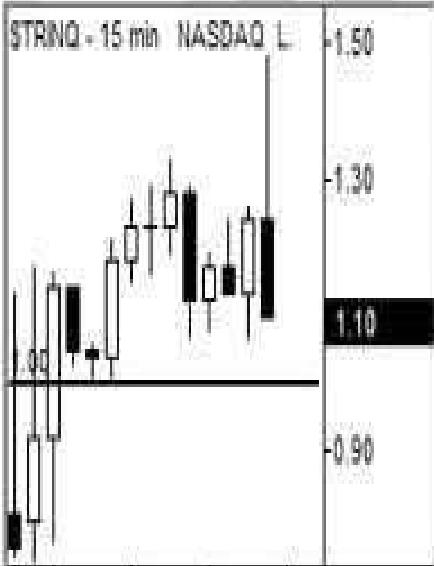
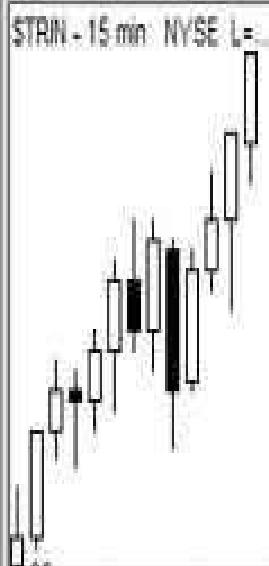
If the pit moderator tells you what the low is, and that low is below the lows of the day you see on your charts, the market is going lower and is about to make new lows on the day. If the pit moderator says look for a stop run at 1,136, pay attention to that number if you are below it.

The most important thing with pit noise is not to get caught up in the excitement. It is easy to think that this is the Holy Grail when you first get it. But it's not. It's just another tool. Traders who get caught up in the excitement of the pit buy the highs and sell the lows, just like any other amateur.

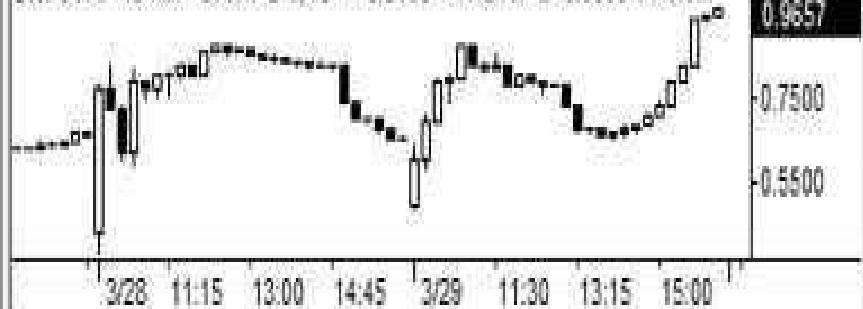
Putting It All Together—How Can You Size Up the Trading Day from the Opening Bell?

It is easy to get overwhelmed by too much data, and the key for reading all of these data is to do it in such a way that your brain can take in the information as quickly and as efficiently as possible. I do this by looking at these data in a certain order, in two columns, top to bottom, left to right.

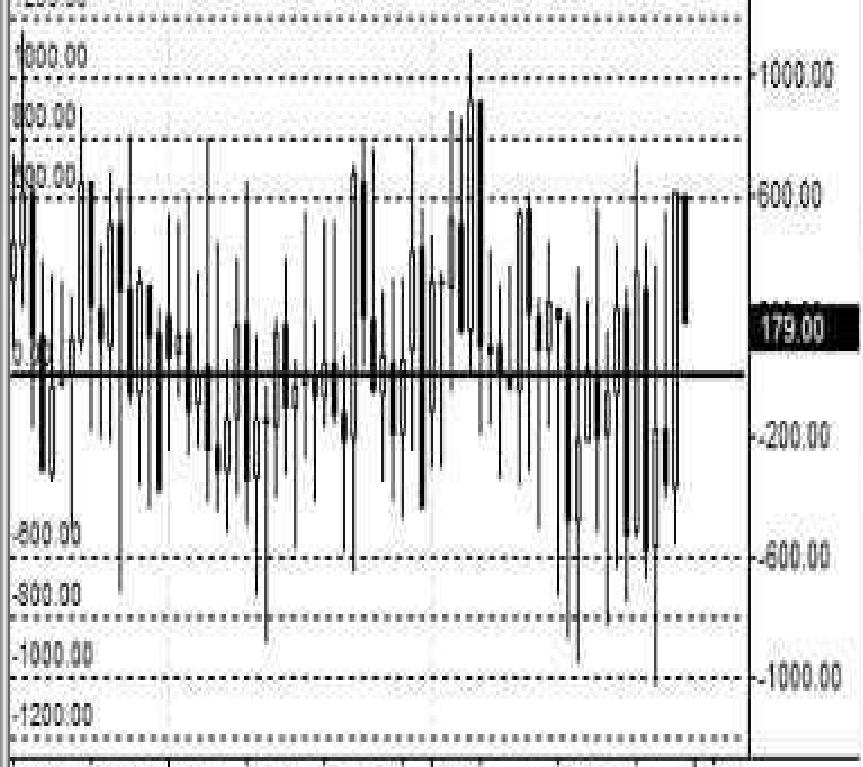
[Figure 6.15](#) shows how I tie all this information into a single screen. The trin and the trinq are in the upper left, and these are what I look at first. Then my eyes go below this to the PC ratio, which is what I look at second (note that the symbol for this is now \$PCVA instead of \$WPCVA). After this, I look at the ticks, which are at the bottom left of the screen. From here my eyes jump to the upper right and to the sector sorter list. Finally, I look at the tiki. I don't even have to look at a chart to know that the market has been selling off steadily all day.



SWPCVA - 15 min OPRA L=9734 +0.3150 +47.84% B=0.0000 A=0.0



STICK - 15 min NYSE L=179.00 +619.00 -140.68% B=0.00 A=0.00 O...



	Symbol	Last	Net Chg	Net %Chg
1	SOSXX	133.80	-3.38	-2.46%
2	STRAN	3873.57	-67.16	-1.80%
3	SCYCX	733.31	-12.58	-1.69%
4	SHGXX	472.43	-7.67	-1.60%
5	SBTKX	491.81	-7.97	-1.59%
6	SXBDX	142.48	-2.26	-1.58%
7	\$XNGX	314.09	-4.79	-1.50%
8	SGSMX	202.87	-2.67	-1.30%
9	SUTYX	382.61	-5.02	-1.30%
10	SSOXX	410.16	-5.34	-1.29%
11	SGSOX	154.87	-1.90	-1.21%
12	SDFXX	257.51	-2.82	-1.08%
13	SRLXX	422.32	-4.39	-1.03%
14	SGNX	151.46	-1.42	-0.93%
15	\$XOLX	829.63	-7.39	-0.88%
16	SGSVX	131.63	-1.17	-0.88%
17	SDRGX	311.86	-2.77	-0.88%
18	SIXX	144.20	-1.11	-0.76%
19	SMSHX	449.62	-3.45	-0.76%
20	SNWXX	202.65	-1.53	-0.75%

STKJ - 15 min US L=2.00 +10.00 -125.00% B=0.00 A=0.00 O...

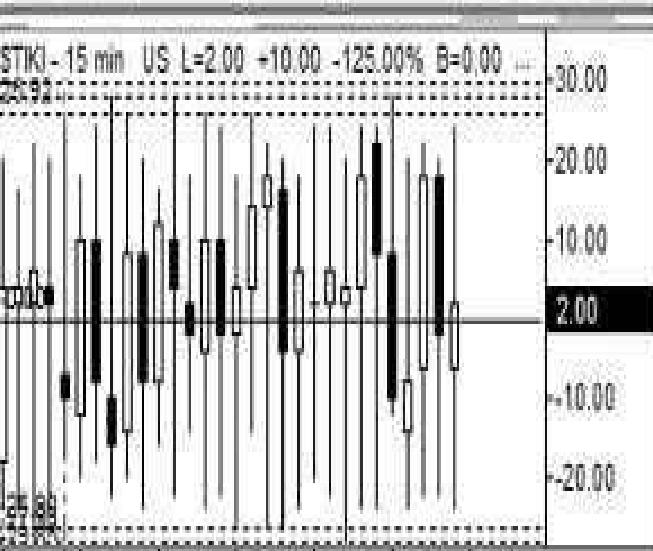


Figure 6.15

[Figure 6.16](#) shows these key indicators against the backdrop of a strong market. At a glance, I can see that the trin and trinq are trending lower, and that the PC ratio started off well at over 1.0 on the day. I can see that the ticks are spending a lot of quality time above zero, and that most of the sectors are in positive territory. I can also see, with the tiki, that there have been a lot more buy programs than sell programs. On this type of day, I want to focus on long setups and ignore short setups.

In addition to being able to get a solid feeling for whether the market has upside or downside pressure, this will also help a trader understand when the markets are in “chop mode.” This will happen when these different indicators conflict with one another. For example, the trin is making new highs (bearish), but the ticks are spending all their time above zero (bullish). One of my favorite ways to see whether or not we have a choppy market is also the simplest. I look at the sector sorter list, and if about half the sectors are green and half the sectors are red, well, it can’t get more neutral than that.

I don’t include the ES five-minute volume chart on this layout simply because there is not enough room. I watch this on another screen.

I created this layout in TradeStation. You can recreate it by looking at [Figures 6.15](#) and [6.16](#), or by going to www.tradethemarkets.com and downloading a copy complete with all the audio alerts.

What Are the Other Main Things to Keep Track Of?

Not a whole lot has changed since I wrote this chapter back in 2005. In fact, my updates to this chapter have been minimal, with the exception of the volume numbers on the ES from [Figure 6.13](#), which have grown to 25,000 from 10,000. I’ve also been using the \$TICK a little differently, utilizing the 0.00 line as an entry opportunity on those strong days, of which we’ve had so many in August and September of 2011. The \$TRIN is still good, although its impact has been muted a bit with all of the reverse ETFs that are on the market now, which are trading good volume and skewing the \$TRIN numbers—not a lot, but they are skewed a touch. To make up for this, there are two “new” internals that I also watch these days. I say “new” only because they aren’t really new—I just watch them a lot more intently now than I did a few years ago. These indicators are the \$VOLSPD (S&P 500 Up-Down Volume Difference) and the \$VIX, which is of course the CBOE Volatility Index.

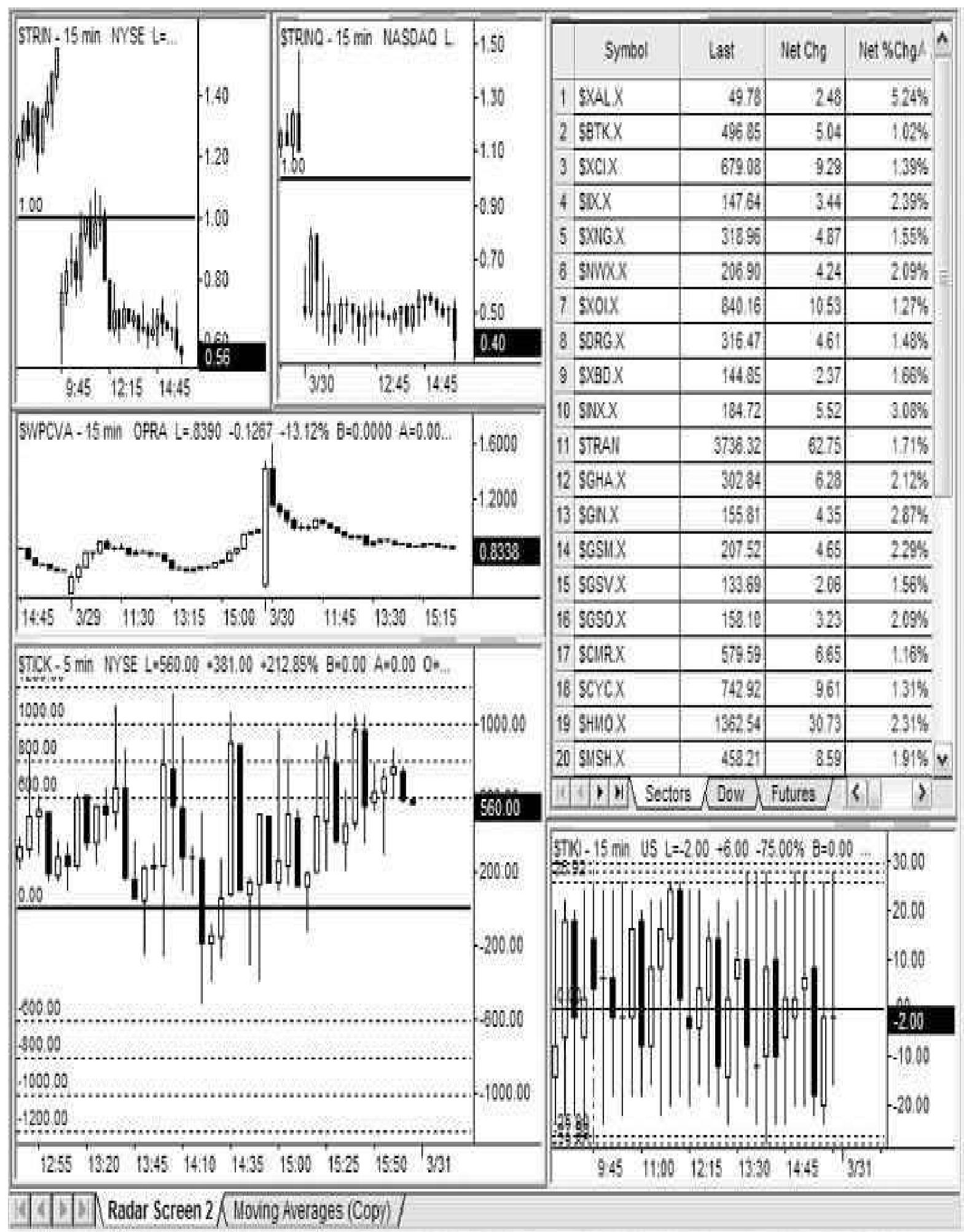


Figure 6.16

The \$VOLSPD is worthless at the beginning of the day, but it's priceless into the last hour of trading. When I look at this indicator, I think of selling pressure and buying pressure. If selling pressure is sustained into the final hour, then look for a sell-off into the close. If buying pressure is sustained, then look for a rally. This may seem overly simplistic, but there are a lot of fake-outs during the last half-hour of trading. If the stock market sells off seemingly hard, but the \$VOLSPD continues to grind higher, guess what? The stock market is going to reverse and rally into the close. The opposite is also true.

In [Figure 6.17](#), we see a chart of both the \$VOLSPD and the SPY on a five-minute chart. Around 1:45 p.m. central at point 1, the stock market begins to rally, and the rally is persistent for nearly half an hour. Is this real buying, or is it a fake-out? By looking at the \$VOLSPD, we can tell not only that it is a fake-out, but that the market has a high probability of selling off into the close. Not only does the \$VOLSPD not confirm the rally, but it actually starts to make new lows on the day, which in this case is the death knell for bulls. The markets crater into the close.

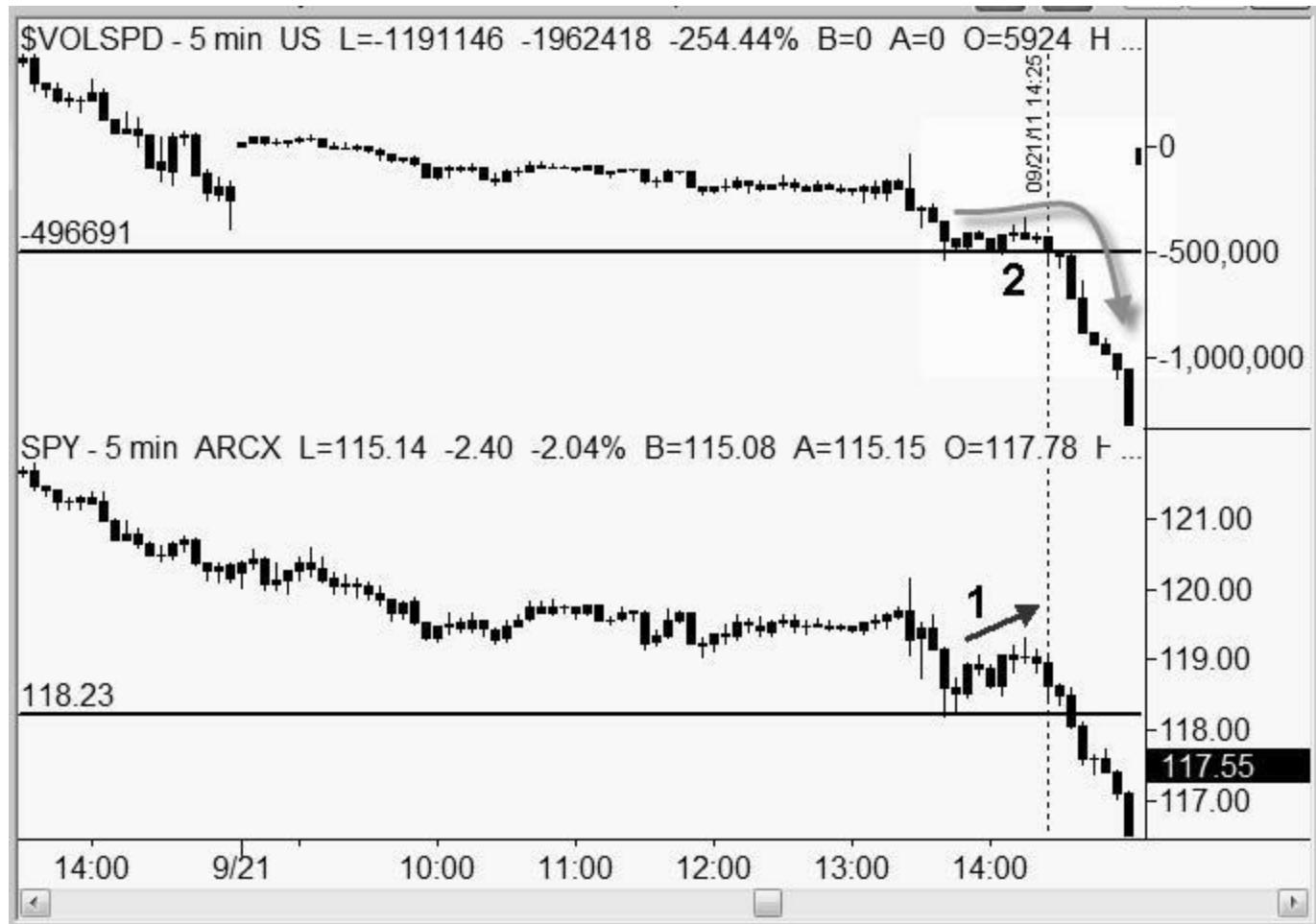


Figure 6.17

The \$VIX has, of course, been around forever, and its importance increases as market volatility increases. This is also known as the “fear indicator,” as it does a good job of measuring panic. Panic, of course, can get overdone, and too much panic is a buy signal.

In [Figure 6.18](#), we see a daily chart of the \$VIX on the upper half with a set of standard Bollinger Bands with the settings at 20 and 2. The bottom half of the chart is the SPY. Note that anytime the \$VIX rallies up to the top of the Bollinger Bands, and especially when it closes above the Bollinger Bands, not only is a market bottom in the making, but a potentially violent rally as well.

At point 3, see what happened on the day of the infamous “flash crash,” where the market went nuts to the downside for part of the day. The \$VIX spiked higher. People were freaking out. And what happened? The market had a violent multiday rally that exceeded the highs just prior to the flash crash. Going along the chart, you can clearly see that any extremes in the \$VIX reading, indicating extreme fear in the markets, indicated that the selling had exhausted itself. The lesson? Don’t get too excited on the downside if the \$VIX is extended.

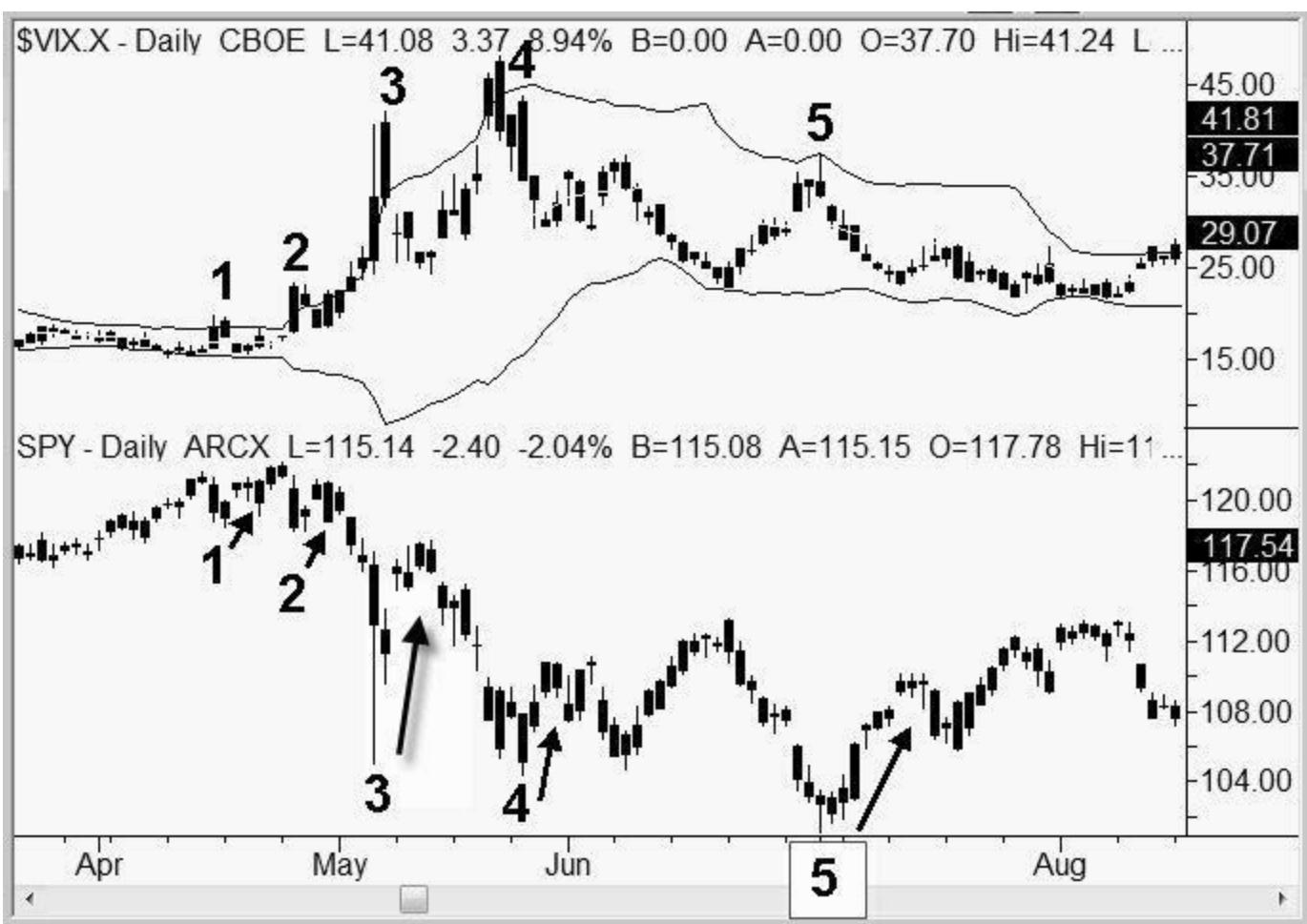


Figure 6.18

I'll also watch the \$VIX on a five-minute chart intraday, as seen in [Figure 6.19](#). With this, I'm just looking for the \$VIX to make any breakout or breakdown moves. The \$VIX is fast and will typically break before the market. At point 1, the \$VIX popped higher, and shortly thereafter the markets broke down. As long as the \$VIX is trending higher in this case, the market will continue to sell off.



Figure 6.19

For the \$VIX, I utilize the five-minute chart to measure the “immediate fear” in the market. For the daily chart, I utilize the daily chart to see when the fear has gotten out of hand and it’s time for a relief rally.

And, Oh Yes, Did You Know That If You Ignore This One Thing, You Don’t Stand a Chance?

There has been a lot in the press over the past few years about the “carry trade,” but most traders and investors don’t give it much thought. “That’s some weird thing the hedge funds are doing” they think. “It doesn’t apply to me.” And that is where the traders are wrong. Dead wrong.

The carry trade affects the markets today more than nearly anything else. Stripping it down to its simplest measure, it works like this: hedge funds borrow a low-interest currency like the yen or U.S. dollars, and then put those funds into higher-yielding currencies like the Australian dollar. Then they borrow against these Australian dollars and go out and buy appreciating assets such as stocks, gold, silver, grains, oil … you name it. Why do they go to all of this trouble? Simple: to make big returns so that they can collect big fees.

Why is this important? Because when funds are putting on the carry trade, also known as “putting risk on,” then most asset classes rise in value—the funds are buying them hand over fist. More important, however, is when funds are “taking risk off.” When they do this, it means that they are winding down portions of their carry trade. To do this, they have to (1) sell off the assets they bought, (2) dump the high-yielding currency they own, and (3) pay back the cheap currency they borrowed. These three steps all happen very close to simultaneously.

Why is this important to know? Because when hedge funds are taking risk off, nearly all asset classes will sell off, regardless of what’s going on in the news.

That’s great, but how does a trader know when hedge funds are putting risk on or when they are taking risk off? By watching CNBC? No. They aren’t really sure what happened until way after the fact. If hedge funds could hide their footsteps and their actions, believe me, they would. Surprisingly, this information on whether hedge funds are putting risk on or taking it off is very easy to obtain. All you need is a data feed.

[Figure 6.20](#) is a chart of the AUDJPY cross, where the current price is 73.739. This just means that 1 Australian dollar is equal to 73.74 Japanese yen. Believe it or not, this chart represents what hedge funds are doing in real time. The price of AUDJPY isn’t critical. What is critical is whether the chart is moving higher or lower.



Figure 6.20

It's not that AUDJPY represents all carry trade activity. However, it does represent one very common carry trade, which is to borrow Japanese yen and then put that money into Australian dollars. The more yen that are being borrowed, the more the Australian dollar is being bought, and thus the higher AUDJPY goes (that is, as risk is being put on, 1 Australian dollar can buy more and more yen). Thus, when the carry trade is “on,” AUDJPY will rise. And when the carry trade is being taken off, AUDJPY will fall as Australian dollars are sold to pay back the yen loans. If that seems a little complicated, this is all you have to remember:

AUDJPY moving higher = risk on = assets rise

AUDJPY moving lower = risk off = assets fall

[Figure 6.20](#) shows a chart of AUDJPY with the stock market (SPY) plotted below it. The dates represented are from October 2010 through October 5, 2011. Points 1 and 2 show both a rising AUDJPY and a rising stock market. Points 3 and 4 show both a falling AUDJPY and a falling stock market. That's easy enough. Where this gets interesting is when AUDJPY acts as a leading indicator, which it did at point 5. On this date, March 29, 2011, AUDJPY broke out and made new highs. What did the stock market do? Nothing. It was in turmoil over yet another European country being on the brink of insolvency. And yet AUDJPY kept moving higher and higher, indicating that funds were aggressively putting risk on. Lo and behold, about a month later, on April 26, 2011, the stock market broke out and made new highs. A trader who was listening to every word of the financial press got short stocks because of the continuing coverage and worry over the European debt crisis. Traders who understood the importance of the carry trade bought stocks, or call options on stocks, to await the inevitable catching up of the stock market to the actual risk being

put on by hedge funds. Long story short, the money that the funds are borrowing has to be put to work.

In [Figure 6.21](#), we have an intraday five-minute chart of AUDJPY and the E-mini S&Ps. I like watching this during the day and gauging the intensity of a sell-off in the ES. Point 1 shows a big sell-off in the ES midday on October 5, 2011. If, during this sell-off, AUDJPY has a mere “mild pullback” (as it does at point 2), then the chances of the ES turning around and rallying are very strong (as it does here). If the ES sells off and the AUDJPY also takes a nosedive, then you know that the selling in the stock market is for real.

Finally, the last reason it is important to understand the carry trade is because it explains what many people find unexplainable. For example, during the 2008 financial crisis, everyone and his mother was talking about how the U.S. dollar was dead, and how it was critical to put all available funds into gold and gold stocks. What happened during the heat of the financial crisis in October 2008? Gold got annihilated, selling off from \$1,080 an ounce down to \$707 an ounce. Gold stocks fared far worse. Goldcorp Inc. (GG), a very solid and popular gold stock, fell from \$52.65 to \$13.84. This was a typical move for gold stocks during the heat of the financial crisis from July to October 2008. Everyone who thought she was smart and did “the wise thing” got taken out back and shot. What happened?

[Figure 6.22](#) shows exactly what happened. The top chart is AUDJPY, and we can see that risk was coming off in a big way, as AUDJPY plummeted from just over 100.00 to below 60.00. Remember when I said that markets move because they have to, not because they want to? Bingo. This was essentially the largest margin call in the world. Funds were forced to sell everything that counted as an asset, and that included gold. It didn’t matter what the asset was or whether or not it had intrinsic value. All of the assets that they had bought with borrowed money had to be sold so that they could pay back their loans. And this is also why the U.S. dollar rallied during this time. The U.S. dollar is also used in the carry trade, along with the yen, because it is such a low-interest currency (at least it has been over the past few years). As the carry trade was “taken off” and yen and U.S. dollars got “paid back,” guess what happened? The U.S. dollar rallied. Why? Borrowing money is the equivalent of selling it; paying it back is the equivalent of buying it. That is, paying back U.S. dollars applies upward pressure on the U.S. dollar chart. This is why the U.S. dollar did not collapse as many pundits predicted. It may collapse some day, but not while it is a low-interest currency and hedge funds are taking risk off.



Figure 6.21

Where does the left-over cash go once all the assets are sold? Into U.S. Treasury bonds, which is why the 10-year note futures and other bond futures rocket higher

during these times.

The carry trade is on? Great, buy everything.

The carry trade is off? Get out of the way.

Summing Up

It is important to realize that the markets spend the majority of the day, even the majority of most weeks, consolidating and resting and backing and filling and pretty much doing nothing. Traders who wait for a move and then have to chase it will always be at a disadvantage to traders who get in before the move takes place. The way to do this is to watch these internals and look for clues concerning the path of least resistance. When the markets are quiet, get positioned for the next move in this direction. Once the move takes place, the amateurs will chase it, and you can sell your position to them.



Figure 6.22

Finally, it is critical to understand that all of the stock index intraday setups described in this book are based on using all of these intraday readings as a filter. For example, [Chapter 11](#) discusses squeeze plays. If I get a two-minute squeeze short play, but the trin is trading at 0.53 and is near its lows on the day, guess what? I'm not going to take it because the internals are so bullish. Rather, I will sit back and wait for the next long setup. Because of this factor, it is very difficult to back-test

these setups, as I would never take all of them as they come up—it's all based on what the internals are telling me. I've set up www.tradethemarkets.com/internals with a series of free videos that show live trading and how the internals work in real time. These videos also show updated internals I'm using that aren't included in the book—sometimes it is easier to “show how I use it live” than to paste a chart in a book. For anyone interested in managed accounts utilizing these techniques, we have set up www.razortrading.com with more information on how the process works and how to get started.

Congratulations, you've made it through the first part of this book. Now let's dive into Part 2 and start looking at actual trading setups.

PART II

WHAT ARE THE BEST INTRADAY AND SWING-TRADING SETUPS FOR FUTURES, STOCKS, OPTIONS, AND FOREX?

Be not afraid of going slowly; be afraid only of standing still.

CHINESE PROVERB

Some long for the glories of this world; and some sigh for the Prophet's Paradise to come. Ah, take the cash and let the promise go....

OMAR KHAYYĀM: *The Rubaiyat*

The Opening Gap: Why Is This the First and Highest-Probability Play of the Day?

How Is Trading Without a Specific Setup in Mind Like Hiking in the Amazon Without a Compass?

If I had a dollar for every time someone asked me, “Of all the setups you have, what’s the one setup that works best all of the time?” I’d have my kids’ college already paid for, as well as their graduate school and their weddings. And I’d probably be able to take care of my in-laws, too, and their numbers are considerable. There is no easy way around it: different setups work better in different market conditions. Another question I get asked a lot is, “What’s the win ratio on that setup?” I’ve never been asked that question by an experienced trader. It’s always a newbie. Win/loss ratios have very little to do with the setup and everything to do with the parameters that are being applied to that setup. Are you interested in a setup that has a win ratio of 99 percent? Great. Every time the \$TICK goes to -1,000, buy one ES contract and use a 1-point target and a 100-point stop. This setup will win 99 percent of the time. “Fantastic,” you might think. But, alas, when it is stopped, you’ll wipe out all of the profit of the previous incredible string of winning trades. To put it in perspective, I know many traders who have a 50 percent win ratio and make a lot of money trading. How? Their winners are, on average, three times bigger than their losers. Yes, it all comes back to trading psychology and letting your winners run and cutting your losers off at the knees.

Before we jump into the first of the setups, the opening gap play, I want to quickly review one absolute truth about this business. That truth is as follows—when it comes to trading for a living, all investors fall into one of three categories:

1. Those who have a system that they follow each and every day
2. Those who are developing a system and are on the lookout for the Holy Grail
3. Those who have never believed in utilizing a specific system and just trade on instinct—and are still explaining to their spouse how they lost all their trading capital.

The point of this, of course, is to emphasize the importance of facing each trading day with a game plan and of establishing a trade setup with a three-pronged approach. In addition to the actual setup, there also needs to be a foundation from which to operate the setup. This foundation consists of the following: the trading methodology, the money management technique, and the knowledge of the best markets to trade for that particular setup. In other words, it’s a lot more than just “What’s the entry?” Do traders scale into a trade or go all in? Do they scale out or go all out? Is it better to use a tight stop and bigger size, or a wider stop and smaller size? Does this trade work better on the mini-sized Dow or the euro currency? Each market is unique. Each setup is unique. Each time frame is unique. Without these additional data, traders are destined to fail, and they are only kidding themselves if they think they can do this for a living. They may have a lot of fun for a few months or a year, and they may get an incredible high out of a great trade, but it won’t last over the long haul. These are the traders that act quickly when trying to make money and that act too slowly when trying to protect what they have. The idea is to create a situation that allows a person to do this for a living—each and every day.

This section focuses on a series of setups for the active trader and provides a collection of strategies that I currently use in my own trading. Specific markets are highlighted, with exact entry, exit, and stop loss levels, focusing mostly on intraday setups. Swing-trading setups are also discussed, and these are noted as such. In general, any setup that is used on the stock index futures can also be used on individual stocks. Exceptions to this guideline are noted. I like to use day-trading strategies in one account and swing-trading strategies in another account. This keeps everything separate and easy to track. I chose to show setups that had a successful resolution in order to demonstrate how to manage the exits on these setups. In instances where these setups get stopped out, and that does of course happen, sometimes frequently, that is an easy exit to manage—the stop was hit. As a trader, it is important that you realize that not every trade will work out. It is quite possible to get stopped out two or three times in a row before you catch a successful move. This is a normal part of trading, and it is important that a trader not get frustrated. This is why it’s important to “keep losses small and let winners run.”

A typical scenario I’ve witnessed with traders is that they get stopped out of a setup and then hesitate to take the next one, which of course turns out to be a winner. Or they get stopped out of a setup, so the next time that setup occurs, they take profits too fast. Or if the last one was a winner (or a loser), then they double up on the next one. The point of this is that a trader needs to become like a machine and just do the setups, not operate based on “how he feels about the last trade.” On any given day, I will take five intraday setups. One of these will get stopped out, two will be scratched, and two will be winners. On days where my first three trades are winners, I will usually stop for the rest of the day and book my gains. If I hit a day where my first three trades are stopped out, I take the hint and go hit golf balls.

I utilize a variety of specific setups in my daily trading routine. I started off trading stocks and stock options, so most of the setups focus on some aspect of the stock market, whether it’s through individual stocks or through the mini-stock index futures. There are also setups in other markets that I discuss, particularly in gold, silver, and some of the currencies. Some of these I developed myself, and some of them were developed by other people whom I trade with. The purpose of this section is to give you specific setups that you can utilize on the next trading day. It should also give you a blueprint for developing and tweaking your own setups. For me, the biggest difference in my trading occurred when I learned to ignore my brain and just focus on a handful of good setups. Once I learned the setups, the next challenge was to have the discipline to follow them the same way, each and every time. I did this by recording my trading activity for more than a year and focusing on the results *for each setup*. If I deviated from the setup, if I tried to outthink it and got out too early or in too late, I noted this in my data and marked it as an “impulse play.” After a while, I noticed that these impulse plays didn’t make me any money. I saw the light, so to speak, and suddenly my trading focus took a dramatic shift. Instead of focusing on the potential gains of a trade or worrying about missing a move, I focused on executing a flawless setup. That is the key difference between a trader who can do this for a living and a trader who lives a life of quiet frustration. I’m not going to beat around the bush on this: following setups without letting the day’s or week’s or month’s P&L affect your thinking is very, very hard to do. But it’s the difference between life and death.

It's like quitting smoking. Either people choose to light up another cigarette or they do not. They take it one day at a time. For each day they don't light up, the better the odds that they will never smoke again. It is no different in trading. For each day traders can actually be totally disciplined and follow their setups exactly as planned—even if it means standing aside when the market is racing away without them—the better the odds that they will make it in this business. If you want thrills, go to Disneyland.

Although I can't stand over your shoulder and help you with your discipline, I can show you the setups that I use to trade for a living. I have loosely organized these in the order in which I look at them throughout the trading day. As you try these out on your own, you will find that you naturally gravitate toward some rather than others. Key in on this, as a trader will tend to move toward setups and markets that seem to fit her personality. Let's jump right in with the first setup and one of my favorites—the opening gap play.

Why Aren't All Gaps Created Equal?

With regard to gaps, very little has changed since this book first came out. I still find gap plays to be the best way to start off my trading day. Not only are they the first trades of the stock market session, but, more important, they can also tell a person a lot about the upcoming market action for the day. Because of this, I spend more time talking about this setup than the others.

Gaps are contrarian plays, or “fade plays,” as I like to call them. Opening gaps create a lot of excitement and emotion in the market participants, and I like to step in and take the opposite side of this emotion. The play is completely against the crowd, which I like, and it is one of the lowest-risk trades available. What exactly is a gap? A *gap* occurs when the opening price of the next day's regular cash session is greater or lower than the closing price of the previous day's regular cash session, creating a “gap” in price levels on the charts, similar to that space we see each night between David Letterman's two front teeth. It is important to note that traders will not see this gap on their charts unless they specifically set up a “gap” chart. With a 24-hour chart, traders will not see the gaps. This is discussed in more detail shortly.

When it comes to gaps, not all markets are created equal. Gaps in “single-item” markets do not act the same way as gaps in “multi-item” markets. Examples of single-item markets include bonds, currencies, grains, and individual stocks. These gaps typically fill at some point, but not necessarily on the same day. For this play, I'm specifically interested in gaps that have a high probability of filling on the same day they are created. For single-item markets, a news item controls the entire order flow for that day, instead of affecting just a small portion of an entire index.

This is especially true of individual stocks. Individual stocks are like politicians, in that each day they can produce a fresh skeleton from the proverbial closet. Earnings announcements, corporate scandals, and insider deals can create gaps in price that never get filled. Ken Lay and Bernie Ebbers certainly wished that their Enron and WorldCom stock would fill their overhead gaps. Unfortunately, the odds of this happening are about the same as that of Republican and Democratic senators working together for the good of the country. In other words, it's never going to happen. Because of the unpredictable nature of individual stocks, they make poor candidates for gap fills. The exception to this is gaps on individual stocks that are gapping with the market and not on any particular news. How does a person tell this? If a stock is gapping about the same percentage as the overall market, and there isn't any news on that stock, then that stock can be played as a gap play. For example, if AAPL gaps up 1.00 percent, the overall S&P 500 is also gapping up 1.00 percent, and there isn't any specific news on AAPL, then it can be played as a gap play. It's just moving with the overall market.

As compared with single-item markets, multi-item markets such as the E-mini S&Ps and the mini-sized Dow futures, as well as their equivalent ETFs (exchange-traded funds) via the Spiders (SPY) and Diamonds (DIA), make great candidates for gap plays. This is because there are individual components of these indexes that will respond differently to various news items. Good news for oil companies is bad news for transportation companies. Good news for defense stocks can be bad news for travel-related stocks, and so on. This means that, although the market may gap up on a news item, there will be individual stocks within the index that will either ignore the news or sell off on the news. This, coupled with an initial pullback in the strong issues that are gapping up, weighs down the entire index, creating an opportunity for the market to fill its gap. In addition, many fund managers watch the open gaps. They've been doing this for a long time, and they know that the markets hate to leave “messy charts” in the form of open gaps. If the markets gap up, they will generally wait to start committing to the long side until the market has pulled back and filled its gap. In this way, it is also like a self-fulfilling prophecy.

What about the Nasdaq and the Russell? I've watched these markets as well, and although they do fill their gaps a large percentage of the time, that percentage is lower than those for the Dow and the S&Ps. In the end, my favorite gap plays are in the mini-futures and ETFs representing the Dow and the S&P 500.

What Is So Magical About Premarket Volume?

The great thing about gaps is that they are like an open window, and, like all windows, at some point they are going to be closed. The key, then, is to be able to accurately predict when the day's gap (window) is going to be filled (closed). What is as important as analyzing the gap itself is analyzing the *market conditions* that produce the gap. The reason for the gap is immaterial. Upside earnings surprises, terrorist threats, takeover announcements, economic reports—each morning the markets are bombarded with news. It's not the actual news, but how the markets respond to that news that is important. To understand how the markets are really reacting to the news, all a person has to do is look at the premarket volume. In addition to news gaps, which are more or less fishing expeditions, there are also professional gaps. Professional gaps are designed to keep the retail investor out of the market. These occur when the Dow gaps up 100 points and then trades in a tight range for the rest of the day. The move essentially happened before the market opened. The professionals who were positioned for the move benefit, while the average retail investor is left with nothing and no opportunity to participate in the move. Again, premarket volume can tell a trader if the gap is going to be a professional breakaway event or is going to lead to price action that has a high probability of filling the gap on the very same day it was created. A professional gap with high premarket volume can take weeks to get filled. Much more common are gaps that are news reactions or fishing expeditions. These are smaller in nature, are highlighted with low to moderate pre-market volume, fill quickly, and can be faded regularly.

The question, then, is, if I ignore the reason for the gap, what is it that I'm looking for that determines whether or not I will take the setup? Premarket volume in what, exactly? The key action I am watching is the premarket volume in a specific set of cash stocks, typically the big names of the day. When I first wrote this in 2005, I liked to watch KLAC (KLA-Tencor Corp.), MXIM (Maxim Integrated Products Inc.), NVLS (Novellus Systems Inc.), and AMAT (Applied Materials Inc.). I liked these stocks because they were traded actively in the premarket session and were traded aggressively by both individual traders and fund managers. Today, I've replaced these stocks with AAPL (Apple), GOOG (Google), PCLN (Priceline), BIDU (Baidu), and AMZN (Amazon). These are the movers and shakers today. Ten years from today, the set of stocks may be different, though it's hard to imagine AAPL and AMZN leaving this list.

Even though these stocks are not part of the Dow, they still provide a clear map as to how the market is handling any particular news that is out on the day. If the volume on these stocks is heavy, then it is obvious that the market is taking this news very seriously. If the volume on these stocks is light, which is more common, then the market either is not interested in the news or, more likely, has already priced it in. It is on these days that the gaps have a very high probability of filling on the same day in which they were created.

What I'm looking for is the premarket volume in these stocks as of 9:20 a.m. eastern, 10 minutes before the regular cash session opens. The premarket session opens at 8:00 a.m. eastern, so these are data on 1 hour and 20 minutes' worth of trading. If these stocks are trading less than 30,000 shares each at this time, the gap (up or down) has an approximately 85 percent chance of filling that same day. However, if the volume jumps up to 50,000 shares each, the gap has only about a 60 percent chance of filling that same day. On these particular days, however, the midpoint of the gap has an 85 percent chance of being hit, so I do take this into account and adjust my target accordingly. For example, if the gap is 50 points on the Dow and the premarket volume is moderate, then my target is going to be 25 points from my entry instead of the full 50 points, which would constitute a gap fill. Finally, if the premarket volume jumps to more than 70,000 shares each, the chances of the gap filling that same day drop to 30 percent. These are typically the days that involve a professional breakaway gap. On these days, I don't fade it. I typically stand aside and wait for one of my other setups to unfold.

These figures are for "normal" market conditions. As I write this in September 2011, the markets have been extremely volatile, and I've had to double these numbers, especially for AAPL. One way to get an idea of these levels is to look at the \$VIX. A few months ago, the \$VIX was trading at around 20.00, which is essentially "normal" and is what the volume numbers given here are based upon. It's currently trading at 40.00, which indicates much higher volatility—double, in fact. Hence the volume levels have also had to be doubled. Take a look at where the \$VIX is trading and you'll be able to get the approximate volume numbers you'll need. If it's trading at 60.00, you'll need to triple the numbers given here; if it's trading at 10.00, you'll need to cut them in half; and so forth.

Why does this premarket volume indicator work? Think about it as driving a car uphill on an empty tank of gas versus a full tank of gas. If the market is really set up to move, then there will be real volume coming into the cash market to propel that car "up and over" the hill. If the market is just setting up a head fake, then the volume in the cash market will be low, as there won't be any real conviction in the move. Ignore the news and follow the money. [Table 7.1](#) shows how I use this information to manage my trades.

Table 7.1

Pre-Market Volume in Key Stocks	Position Size	Trade Target
Less than 30,000	Full size	Exit entire position at gap fill
Between 30,000 and 70,000	2/3 size	Exit half at 50 percent of gap fill, half at gap fill
Above 70,000	No fade trade	No fade trade

There are many days when three of the stocks are trading under 30,000 shares and another stock will be trading 95,000 shares. In these cases, I will first check to see whether there is specific news on that stock. If there is, I will throw it out. If there isn't, I will then take an average, call this a "moderate" gap, and play it accordingly—meaning that my target on the first half will be 50 percent of the gap fill instead of holding on to the entire position for a full gap fill. For moderate gap plays, I do not trail down the original stop, even when I get out of half my position.

What Are the Best Days of the Week to Take This Trade?

We keep a tab on raw gap data, meaning the percentage of the time that a gap fills, regardless of how big the gap was or how much premarket volume traded. Just the clean, raw, "it is what it is" data. In [Table 7.2](#), these data are sorted by day of the week and show what percentage of the time the markets filled their opening gaps on the same day in which they were created.

Table 7.2

Day	Percentage of Gaps Filled
Monday	65%
Tuesday	77%
Wednesday	79%
Thursday	82%
Friday	78%

As is evidenced by these data, gaps in and of themselves have a very high probability of being filled on the same day on which they are created. If a person could get these same odds at a blackjack table, Las Vegas would be put out of business in three months. That said, it is important to note that Mondays are the days with the lowest percentage of filled gaps. The main reason for this is that most breakaway gaps happen on Mondays—there are a lot of developments that can happen over the weekend. On Mondays, I typically pass on the gaps; in fact, I typically just let the markets open without me, in order to give them a chance to “settle in” before I start looking for setups.

Finally, I’ve noticed that expiration day (the third Friday of every month) and the first trading day of the month have low probabilities, in the range of 55 to 60 percent. I generally pass on fading the gaps on these two days. The only exception is if the premarket volume is very low. The bottom line is that if the premarket volume gets confusing and a trader doesn’t understand the reading on any given day, the odds are still there, and the trade is worth taking.

What Are the Trading Rules for Gaps?

Trading Rules for Gap Down Buys (Gap Up Sells Are Reversed)

This set of rules for gap down buys is based on a gap with low premarket volume. If the volume is moderate, then I will do exactly the same thing, except that I will take off half my position when the markets reach the price level that represents 50 percent of the gap fill. If the premarket volume is high, then I pass on this trade setup. Remember, this is a fade play. I will buy a gap down and short a gap up. The following set of rules is for a gap down:

1. I first set up a special intraday gap chart that starts collecting data at 9:30 a.m. eastern and stops at 4:15 p.m. eastern. This is so that I can view the gaps. These gaps won’t appear on charts that carry 24 hours’ worth of data or as “regular session” data on the futures markets.
2. A gap must be at least 10 YM points or 1 ES point—otherwise I will pass.
3. If a gap is more than 70 YM points or 7 ES points, I pay careful attention to the premarket volume. Most breakaway gaps are big gaps. However, if the premarket volume is low to moderate, I will still take these.
4. With a gap down, when the regular cash market opens at 9:30 a.m. eastern, I buy the YM or ES at the market. The DIA and SPY can also be used. It doesn’t really matter which market is utilized, with two exceptions. First, if one of the stocks in the Dow is “out of whack,” then I will play the gap in the S&Ps. By this I mean that if a stock like IBM is up 10 points on earnings, then this index is going to be out of whack with the rest of the markets. The other exception is if I am specifically using the Dow in another setup, say a squeeze or a pivot play (these are discussed in upcoming chapters). Then I will take the gap in the S&Ps. This way, if I am still in the gap play when this next setup fires off, I can just take it in the Dow and leave my gap trade on.
5. Once filled, I set up a protective sell stop with the following parameters:

- For gaps that are under 40 YM or 4 ES points, I use a 1½:1 risk/reward ratio. (For example, for a 20-point gap, I use a 30-point stop.)
- For gaps that are over 40 YM or 4 ES points, I use a 1:1 risk/reward ratio. (For example, for a 45-point gap, I use a 45-point stop.)

6. My target is the gap fill itself. If yesterday's closing price was 1058.50 on the S&Ps, then that is my target for the gap fill. For a moderate-volume gap, I will split this order up, having half my target at 50 percent of the gap fill and leaving on the remaining half for a potential full gap fill.
7. I don't trail stops for this setup.
8. If I'm stopped out, then the gap play is over for the day.
9. If neither the target nor the stop is hit by the closing bell, I exit my position at the market.
10. For the gap play, there is only one potential setup per trading day.

Who Is Getting Hurt on This Trade?

One of the most important steps for traders is to understand why they are making money in a particular trade—which also means understanding who exactly is losing money on the other side of the trade. Who is getting hurt and why?

When markets gap down, there are generally two groups that are going to get hurt. First, there are the people who are long from the day before. When the markets gap down, these people are either getting stopped out or panicking and selling. Second, there are people who are flat, see the gap down, think it is the end of the world, and start shorting. In this setup, I want to be on the opposite side of the trade from both these groups, because both of them are having a strong emotional reaction to the market, and this emotion is causing them to get into a trade. Therefore, when they are selling, I am buying. These same groups will provide the fuel for the rally through, in the case of the first group, panic buying in trying to make back their early losses and, in the case of the second group, short covering via the stops they placed when they put on their short trade. Let's take a look. The charts that follow are numbered in specific places where price action is taking shape. Each of the lists that refer to the chart is numbered so that the text following "2" describes point 2 in the chart to which the text is referring.

What Are Some Specific Examples of Trading the Gap?

Mini-Sized Dow—December 2003 Contract, October 15, 2003

1. The mini-sized Dow contract closes at 9717 on October 14 (see [Figure 7.1](#)).



Figure 7.1

2. On October 15, the opening trade at 9:30 a.m. eastern is 9762, producing an opening gap of +45 points. I “fade the gap” right at the open and short the YM at the market. My protective stop is 45 points away from my entry, at 9807, and my target is the gap fill, which is the previous day’s close at 9717.
3. The gap fill is complete once the price levels reach the previous day’s close. This occurs 35 minutes after the opening bell. This is a relatively smooth trade. I refer to these quick fill gaps as “Bahamas gaps” because they are relatively smooth, quick, and stress-free. This trade nets a profit of \$225 per contract.

Mini-Sized Dow—December 2003 Contract, October 16, 2003

1. The market closes at 9704 on October 15 (see [Figure 7.2](#)).



Figure 7.2

2. The opening trade at 9:30 a.m. eastern on October 16 is 9645, creating a 59-point gap down. I buy at these levels and place a stop at 9586.

3. Many people who play gaps would get stopped out right here at point 3, as they would trail up their stop to breakeven to protect their gains. For these people, the gap play is now over.

4. Yet by holding on to this play with parameters that were made especially for gaps, I end up staying in profitable trades that shake many other traders out (see

[Figure 7.3](#)). The reason for this is that the other traders are using blanket types of parameters for every play, instead of utilizing specific parameters that are tailored for specific plays. Although many gaps are filled within the first hour, many can take a couple of hours or more. I like to set the parameters and focus on something else while the market “does its thing.” I refer to gaps of this type as “Somalia gaps.” Unlike Bahamas gaps, they tend to cause a lot of stress in the people who are watching them. It’s okay to feel stress; professional traders simply don’t act on it, maintaining the parameters they have set for themselves. This trade nets out a profit of \$295 per contract.



Figure 7.3

Note that one of the best signs of an amateur trader is a person who uses only tight stops or a 3:1 risk/reward ratio on every trade. Most beginning traders are taught by their brokers to use this tight stop formula, risking 1 point to get 3 points. As the traders wonder why they always get stopped out just before the market turns,

their broker is tallying up the commissions generated on the day. In general, wider stops produce more winning trades. The key with wider stops, of course, is to play only setups that have a greater than 80 percent chance of winning. The gap play I'm describing, with the parameters that I use, has a greater than 80 percent chance of winning with the risk/reward ratios that I utilize. When you use a tight stop on a gap play, the probabilities of the trade's working out fall dramatically—to less than 30 percent. In essence, one of the reasons many traders fail to make it in this business is that they are using stops that are too tight. This might seem like a contradiction, but if almost every trade is stopped out, it's tough to make any money.

What is also important to remember for gap plays is that an active program of trailing stops will negatively affect your win/loss ratio. Once the parameters are set in place, the best thing a trader can do is to walk away and let the orders do their job. Although tweaking is a good thing to do when giving a car a tune-up, tweaking the parameters of a gap trade won't work.



Figure 7.4

Mini-Sized Dow—September 2004 Contract, August 2, 2004

I've found that most traders get too caught up in the reasons for the gap. In reality, the reason is meaningless. Gaps happen because a flurry of emotion hits the tape at the opening bell. However, the reason for the gap has little significance with regard to whether or not the gap fills. On Sunday, August 1, 2004, the U.S. government issued a terrorist warning claiming that there was chatter on the airwaves about a plan to blow up a large financial institution. The markets got nervous, and the markets gapped down in a big way on Monday morning, August 2 (see [Figure 7.4](#)).

1. On Friday, July 30, 2004, the mini-sized Dow futures closes at 10,142.
2. On Monday, August 2, 2004, the markets open for trade at 10,091, down 51 points. I buy here right at the 9:30 a.m. eastern open. I place a stop at 10,040. The markets spend a good part of the day chopping around, and I talk with other traders who are nervous about the terrorist threat news. Do I let this "nervousness" get into my own trading? Should I listen to the reasons for the gap?
3. Later that same day, the markets grind higher, and I am out at the gap fill (see [Figure 7.5](#)). Gaps are the ultimate contrarian play; don't get caught up with the crowd. This trade nets a profit of \$255 per contract.



Figure 7.5

E-mini S&P—September 2004 Contract, August 24, 2004

1. On August 23, the ES closes at 1097.00 (see [Figure 7.6](#)).

@ES - 5 min CME L=1116.75 -1.25 -0.11% B...



Figure 7.6

2. The next morning, the 9:30 a.m. opening trade prints at 1101.00, 4 points above its close. I short at the open, placing a stop at 1105.00.
3. A little over an hour later, my target is hit as the E-mini S&Ps fill their gap, for a total gain of \$200 per contract.

E-mini S&P—September 2004 Contract, August 4, 2004

1. On August 3, the ES closes at 1097.50 (see [Figure 7.7](#)).



Figure 7.7

2. The next morning, the market gaps down and opens at 1094.25. This gap is 3.25 points, so I use a 1½:1 risk/reward ratio and place my stop at 1089.25.
3. I buy at the open. The market chops up, then pushes down to new lows. A little over an hour later, the market has firmed, and I'm out of my position at the gap fill. The markets spend a good portion of the day in a tight, choppy range, rallying only in the final half-hour of trading. On many days, the gap play is not only the safest, but really the only trade to take. We call the market *choppy* when it trades in a narrow, low-volume range because it chops up newer traders to death. This trade nets a total of \$162.50 per contract.

E-mini S&P—September 2004 Contract, July 14, 2004

1. On July 13, the E-mini S&Ps closes at 1114.75 (see [Figure 7.8](#)).



Figure 7.8

2. The next morning, the market opens down 5.75 points at 1109.00.

3. I buy at the open and place a stop at 1103.25.

4. The gap fills in a little under an hour. This is another example of a Bahamas gap, as it is very relaxing to trade with a minimum of false moves. This trade nets a total profit of \$287.50 per contract.

What's the Secret to Unfilled Gaps?

One important thing to remember: if 80 percent of these plays win, that means that 20 percent of them lose. I actually like losing trades for one main reason: this leaves an “open gap” in the markets. An open gap is like a black hole or a tractor beam, eventually sucking prices back to their opening gap levels. Whenever the markets leave an open gap, I mark that level on a Post-it note and place it on my computer. Let’s look at an example (see [Figure 7.9](#)).

Let’s get a little more specific on how to play this, using a \$100,000 account and utilizing nine contracts for a full position, or approximately one contract for every \$11,100 in the account. Yes, a person can trade a lot more contracts than that in a \$100,000 account, and many brokers will encourage a person to trade more than that. With some brokers, a trader can get enough leverage to trade 100 contracts on a \$100,000 account. This is purely and simply insane. Just because people can do something doesn’t mean they should. The leverage here is far too much. Traders who are using a modest 2-point stop on the S&Ps could get stopped out four times in a row. Where does this leave them? $2 \text{ points} \times \$50 \times 100 \text{ contracts} = \$10,000$. Four stops in a row = $\$40,000$. I’ve seen more than my fair share of people do this, and it is just inexcusable. There are many things people can do in life. They can drink one glass of wine or the whole bottle. They can drink one cup of coffee or the whole pot. They can go to the gym each day or sit and watch TV. It all comes down to choice. Just because people can do something doesn’t mean that it’s a good idea. Choose with your best interests in mind. Let’s go back to the example.

Mini-Sized Dow September Futures

Gap of +13 points fills in 1 bar

Gap of -52 points fills in 9 bars

Gap of +44 points fills in 9 bars

Gap of +62 points fills in 6 bars

Short break of bear flag. Target is gap from 8/18

Gap on 8/18 of +44 points fills on 8/25!

Figure 7.9

On August 18, we gapped up a modest 44 points in the Dow prior to some economic numbers. I shorted at the open. We rallied, sold off into the economic numbers, and then shot higher once the numbers were released. I had a 44-point stop, and the markets rallied just through that level, producing a loss of \$220 per contract, or \$1,980.

I headed into the next trading day knowing that there was now a “black hole” gap below. I could actually hear the sucking sound. The next day we had a modest low-volume 13-point gap higher that worked out quickly for \$65 per contract (\$585). The day after, we got a nice 52-point gap lower that took a few hours to fill, but created few headaches, for \$260 per contract (\$2,340). The next day we got a 44-point gap higher that was on moderate volume. It came close to our stop, but eventually filled the gap for \$255 per contract on four contracts. I covered the first five contracts when we got to 50 percent of the gap fill level, which was 22 points. $4 \text{ contracts} \times 44 \text{ points} \times \$5 = \$880$, and $5 \text{ contracts} \times 22 \text{ points} \times \$5 = \$550$, for a total of \$1,430 on the play. Finally, on August 22, we got the “sucker gap” when Intel announced “cautious upside earnings revisions.” The market exploded and gapped up 62 points, right into key resistance—on low premarket volume.

I shorted the gap. Six bars later, my target was hit for 62 points, or \$310 per contract (\$2,790). *The sucking sound of the black hole below was getting louder.* During the afternoon session, we got a bear flag consolidation. I set up a sell stop at 9392 to let the market take me into a breakdown of that flag formation. I got the fill and set my stop above intraday resistance at 9455. My target was the August 18 black hole open gap at 9304. The market spent the rest of the day on its hands and knees, dry heaving, trying to hold back the internal pressure. This pressure proved to be too much, and, like a freshman college student during his first year away from home, the market eventually fell over and vomited. The gap filled for an 88-point gain, or \$440 per contract (\$3,960).

When there are open gaps left in the market, I always write them down and mark them on my chart. The markets will take them out eventually, usually within 5 to 10 trading days.

What Are the Best Strategies for People Who Can't Trade Full Time?

Gaps are one of the best strategies for people who are holding down a full-time job. On the West Coast, this is particularly easy, as the markets are open well before most people have to head to the office. The main consideration to keep in mind is that a person will want a trading platform (see [Chapter 4](#)) that will automatically cancel a stop once the target is hit. Another, often overlooked alternative is to have a broker who can be called with the parameters. Typically these brokers will cost a little more in commissions, but it is worth it to have someone watching out for the trade. The biggest advantage of doing this trade as a part-time trader is that you won’t be prone to making the very mistakes most full-time traders make while watching the trade progress. They get antsy, they get fidgety, and they end up bailing out too soon. Someone who is at the office and doesn’t have time to watch the trade actually has a big edge over most of the traders who haven’t learned to control their emotions.

How Does a Trader Position Size for This Setup?

One frequent question I get is, “How many contracts or shares are you trading with this strategy?” These same plays can be executed in five different markets. There are the mini-sized Dow and E-mini S&P futures, the SPY and DIA ETF shares, and also futures on the DIA available through One Chicago. [Table 7.3](#) shows the different instruments and the number of shares or contracts I would trade on a \$100,000 account using this setup. The DIA futures are nice if a trader is using a smaller account. They are a happy medium between having a lot of leverage with the minisized Dow and E-mini S&P futures and having no leverage with the DIA and SPY stock. The example shown in [Table 7.3](#) is with a gap that occurred on July 24.

Table 7.3

Quantity	Market	7/23 Close	7/24 Open	Gap: Points	Stop	Profit
9	mini Dow	9,169.00	9,233.00	64	9,329	\$2,700
9	E-mini S&P	987.00	993.50	6.50	1,003.25	\$2,925
20	DIA futures	91.96	92.58	0.62	93.51	\$1,240
500	DIA	91.91	92.50	0.59	93.38	\$295
500	SPY	99.29	99.99	0.70	101.04	\$350

Summing Up the Gaps

Gaps are the one moment of the trading day where all the players have to show their poker hand, and this creates the single biggest advantage for the short-term trader. Understanding the psychology behind the gaps is paramount for playing them successfully on a daily basis. The gaps are so powerful that many traders make a nice living playing these setups alone. The key is to know how they work and to develop a solid methodology and set of rules to trade them. One consideration to keep in mind while playing gaps is the 50 percent retracement level. At the beginning of this chapter, I mentioned that I would take half of my position off when there is moderate premarket volume. The reality is, the 50 percent retracement level is the highest-probability exit on any gap. It is okay to modify your trading plan to take off half your profits on any gap that reaches the 50 percent retracement level, regardless of whether premarket volume was moderate or low.

After reading about this setup and understanding the specifics behind it, the serious trader will have a better foundation for a plan to trade the markets successfully on a full-time basis: a proven setup to play, markets that best fit that setup, and a plan of action to maximize the play. That is pretty much all a trader needs in order to survive and thrive in this greatest of professions.

For updated information on gap plays, visit www.tradethemarkets.com/gaps for a series of free videos with any updates to the gap play, live gap trading videos, and current examples.

Pivot Points:

Why Are These Good Pausing Points for Trending Days and Great Fading Points for Choppy Days?

What Is the Best Way to Beat Indicator-Based Traders?

One of the simplest and most effective position entry techniques that I use is based on what I call the multipivot levels, which consist of the daily, weekly, and monthly pivot points, along with the midpoints between the daily levels. This is a setup I use primarily on the stock index futures, although they can also be utilized on some individual stocks (the big names), as well as the corresponding stock index ETFs via the DIA, SPY, QQQ, and IWM. In addition, I like to use the weekly pivots on most other futures contracts, such as gold, currencies, oil, and so forth. The daily pivots on these are okay, but I've found that the weekly levels hold much better on these other commodities. Like the gap play, the pivot play hasn't changed much since this book first came out, and I've left the examples here intact that still ring true today.

The main advantage of this system is that it is price-based rather than indicator-based. By the time most indicators generate a buy or a sell signal, the move is already well under way. By following this price-based methodology, I will get into a trade before the indicator-based traders, and I usually end up handing off my position soon after a buy or sell signal is being generated on a stochastic or other oscillator type of system. This is especially true on choppy days. Just as the Johnny come-latelies are jumping in, I'm closing out my position and looking for the next setup. On choppy days, it's the indicator-based traders who get taken out back and shot. Their buy signals get them in at the top of the move, and their sell signals get them in at the dead lows, leading to a frustrating day with a negative P&L. Pivots are set up to naturally take advantage of their mistakes, essentially siphoning money from these trading accounts into your own.

This is also a good system for traders who don't have time to stare at the charts all day long or, not surprisingly, for traders who have a bad habit of chasing the market higher and lower. Playing the pivots automatically creates trader discipline, because the entries and exits are determined before the trading day even starts.

The other thing I like about the pivots is that they can be used as a tool to quickly determine what kind of trading day it's going to be. On a trending day, markets will move to a pivot level, consolidate for 15 to 20 minutes, and then continue to march in the direction of the trend. On these days, I wait for the move through the pivot level and then buy the first pullback to that level. On choppy days, however, the markets will move up to a pivot level, hang around for a short time, and then drift back in the direction whence they came. Many traders get "chopped up" during these types of trading days, losing money and making their brokers rich in the process. The pivots are naturally set up to be faded on these days and are one of the few profitable ways to trade the low-volume, narrow-range chop.

There are two very easy ways to tell whether the market is trending or chopping. The first is to look at how the market reacts to the pivot levels once it reaches them. The second is to set up a five-minute chart of the E-mini S&Ps and see what kind of volume is coming into the market after 10:00 a.m. eastern (see [Chapter 6](#)). If the volume is more than 25,000 contracts on each bar, then the market has power and volatility behind it. These types of days usually have wide ranges and strong trends. However, if the volume after 10:00 a.m. eastern is consistently below 25,000 contracts on a five-minute chart, then there is little power to move the beast, and the end result will be a slow, choppy day. On the first type of day, I wait for the markets to move through pivot levels, and then I set up an order to get in on the first retracement. On the choppy days, I place open buy and sell orders against the pivots and have standing orders to fade these moves throughout the day. There is nothing to watch on these types of days, so I generally let my orders do the work for me while I spend some quality time at the driving range. Is there a bonus play? On a choppy day, a high or low \$TICK reading (+1,000 or -1,000) right into a pivot level. That is, the market rallies right into a key pivot, and during that rally, a +1,000 \$TICK reading is reached, exhausting all of the buying pressure. Bingo. That is the short setup of the day.

Why Aren't All Pivots Created Equal?

So what exactly are the pivots? There is no big mystery or secret to them, and many readers will have heard about them and have used them in their own trading on a regular basis. For the uninitiated, I explain how I set them up and why they work, and then we can jump into the setups that I use with them.

Pivots are readily available and have been around for a long time. They are support and resistance levels calculated by floor traders using a simple mathematical formula. These levels became widely known and have moved off the floor. Today many traders are aware of them and try to use them, but in my experience, they are using them incorrectly. To add to the confusion, there are different formula versions and different time frames that are used when calculating pivots. So, to get started, let's look at what I use, which is one of the standard pivot formulas:

- R3:** $R1 + (High - Low)$
- R2:** $Pivot + (High - Low)$
- R1:** $2 \times Pivot - Low$
- PIVOT:** $(High + Low + Close)/3$
- S1:** $2 \times Pivot - High$
- S2:** $Pivot - (High - Low)$
- S3:** $S1 - (High - Low)$

Once a trader has this formula, then the key data needed are the high, low, and close of the previous session. For my own trading, I like to utilize 24 hours' worth of data to capture the highs and lows. However, it is absolutely imperative to use the settlement price for the close, as this is the only closing price that matters. Often a 24-hour setting on a chart means "midnight to midnight," and that will destroy the validity of the data. We will go over this in more detail shortly.

Once I get this high, low, and close, I plug them into an Excel spreadsheet with the formulas listed previously. This information generates seven important levels for the next trading day: a central pivot, then three levels above (R1, R2, and R3) and three levels below (S1, S2, and S3). The central pivot has the most weight of the seven levels. In addition to these daily levels, I also utilize the midpoints between these levels. Finally, I like to know where the weekly and monthly levels are located. These are calculated by taking the high, low, and close of the previous weekly or monthly bar. While the daily pivots change each day, the weekly pivots change only once a week, and the monthly pivots only once a month. As a side note, indicators can also be programmed with these formulas so that the pivots are set up automatically on your charts without the need for you to do it all manually each morning—though doing it all manually does make you remember where those pivots are located.

It is important to note that it is rare for a stock index to hit its daily R3 or S3 level. This is important to know because if a market rallies to R2 or sells off to S2, that usually ends up being the dead high or the dead low for the day. This knowledge will help temper a trader's emotions and keep him on track to follow this system. This is, of course, under normal market conditions. As I'm updating this in September 2011, the \$VIX is at 40.00 and the markets are incredibly volatile, regularly testing the R3 and S3 levels. The lower the \$VIX, the tighter the ranges.

How Exactly Should I Set Up the Pivots on My Charts?

I'm going to go through the process of how I update the pivots on my charts each day. This is based on updated exchange trading hours as of September 29, 2011. To calculate the daily pivot numbers, I use the following data to generate my high, low, and close numbers:

- YM: Start Wednesday at 4:30 p.m. eastern; end 4:15 p.m. on Thursday
- ES: Start Wednesday at 4:30 p.m. eastern; end 4:15 p.m. on Thursday
- NQ: Start Wednesday at 4:30 p.m. eastern; end 4:15 p.m. on Thursday
- TF: Start Wednesday at 8:00 p.m. eastern; 6:00 p.m. on Thursday

This range of data gives me all the price action for when these markets are trading, allowing both pre- and postmarket price action to be factored into the next trading day's numbers. The times are slightly different on the different contracts because of the times they are traded on the exchange. The settlement price is the key. If traders are ever unsure about the settlement price, they can check it for the YM, ES, and NQ at www.cmegroup.com. For the TF, go to www.theice.com.

The easiest way to get an accurate high, low, and close is to just set up a daily chart with the time frames listed for each contract. In TradeStation, this is very easy to do. Just enter the continuous symbol, such as @YM or @ES, and set it on a daily chart. The data will default to the "regular session," which refers to the times listed earlier. With many other charting programs, a trader has to go in and set this up manually, as many of them default to the regular stock market session from 9:30 a.m. to 4:00 p.m. eastern. Once the chart is set up, just wait for the 4:15 p.m. eastern close on the ES, NQ, and YM and wait until after 6:00 p.m. eastern on the TF. After these times, the markets will then reopen shortly with a new daily bar. Just take the high, low, and close reading on the daily bar generated for that trading day to get the correct numbers. This closing price will almost always match the settlement price, although I like to check to make sure. For Monday, then, I want the high, low, and close for Friday. Let's take a look (see [Figure 8.1](#)).

Daily Bar on Friday, March 18, 2005

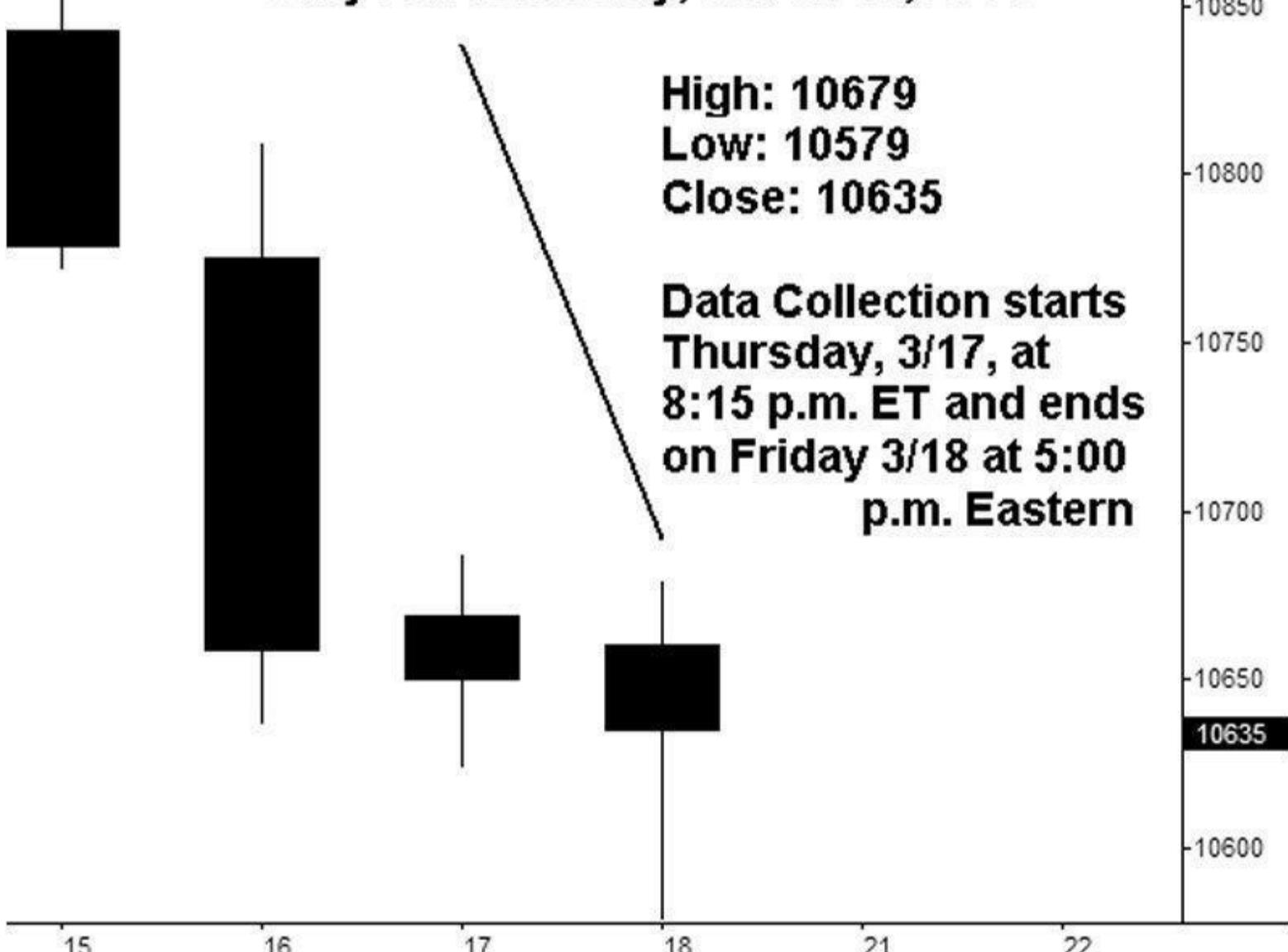


Figure 8.1

On Friday, March 18, 2005, we have a daily bar on the YM that started after the 4:15 p.m. eastern close (it starts again when the market reopens at 4:30 p.m. eastern) on Thursday, March 17, and ended at 4:15 p.m. eastern on Friday, March 18. This range gives us the following numbers:

- High: 10,679
- Low: 10,579
- Close: 10,635

By changing the chart to a weekly time frame, I can also take the high, low, and close of the completed weekly bar and get the numbers I will use for the weekly pivots.

- High: 10,870
- Low: 10,579
- Close: 10,635

On Monday, the daily and weekly close will be identical, since they are both based on Friday's close. In this instance, the lows are also identical because the lows on Friday were also the lows of the week. The process can be repeated with the monthly levels, but I won't need new monthly inputs until the first trading day in April.

Now that I have my key levels, I want to figure out the key pivot points that I'll be using for Monday, March 21, 2005. The first thing I do is take these high, low, and close figures and plug them into the formula. To figure out the daily pivot, I take the high + low + close and divide by 3: $10,679 + 10,579 + 10,635 = 31,893 / 3 = 10,631$. We now have our pivot point for the day. To figure out R1, which is the next level above

the pivot, I multiply the pivot by 2, and then subtract the low. So we take $10,631 \times 2 = 21,262$ – the low at $10,579 = 10,683$.

We continue this process until we are done, and we come up with the following levels:

- R3: 10,783
- R2: 10,731
- R1: 10,683
- Pivot: 10,631
- S1: 10,583
- S2: 10,531
- S3: 10,483

Once I have these levels, I place them on my chart. I also like to note the midpoints between the daily pivot levels. These are calculated very simply, as they are literally the midpoint. The pivot is 10,631, and R1 is 10,683, 52 points away. Half of 52 is 26. I add that to the pivot, and I get a midpoint of 10,657. These are all formulas that can be set up in Excel, making this a very quick and easy process. I don't calculate the midpoints for the weekly and monthly levels.

Once I have created the chart and added the appropriate pivot levels, the first thing I will note is where the daily pivot is in relation to where the market closed. The daily pivot is at 10,631, and the market closed at 10,635. The second thing I will be watching for is where the markets are trading at 9:30 a.m. eastern on Monday. How far away are they from the daily pivot? This will work in relation to the gap play. The markets test their daily pivot level at some point during the day 90 percent of the time. I will always fade the first move to the daily pivot. For example, if the markets are trading above the central daily pivot, and they sell off to this level, I will fade the move by buying it when it reaches the pivot. I will talk about specific entry methods in a moment.

By setting up these formulas in an Excel template, I can quickly obtain all the key levels for the YM, ES, NQ, and TF. I did that, and all I do today is just enter the high, low, and close. Once this is done, the spreadsheet fills in the rest of the numbers for me automatically. It takes me just a few minutes to look up the high, low, and close and then plug them into this spreadsheet. I then instantly have my levels for the next trading day. Of course, I have to update the weekly pivots only once a week, and the monthly pivots once a month. The spreadsheet for the chart we are working on is shown in [Figure 8.2](#).

Daily Futures Pivots & Midpoints

	S&P	DOW	NASDAQ	RUSSELL	
High	1197.00	10679	1503.50	626.60	High
Low	1186.50	10579	1483.00	619.90	Low
Close	1190.75	10635	1491.00	622.00	Close
R3	1206.83	10783.00	1522.50	632.47	R3
Mid	1204.38	10757.00	1517.75	631.00	Mid
R2	1201.92	10731.00	1513.00	629.53	R2
Mid	1199.13	10707.00	1507.50	627.65	Mid
R1	1196.33	10683.00	1502.00	625.77	R1
Mid	1193.88	10657.00	1497.25	624.30	Mid
Pivot	1191.42	10631.00	1492.50	622.83	Pivot
Mid	1188.63	10607.00	1487.00	620.95	Mid
S1	1185.83	10583.00	1481.50	619.07	S1
Mid	1183.38	10557.00	1476.75	617.60	Mid
S2	1180.92	10531.00	1472.00	616.13	S2
Mid	1178.13	10507.00	1466.50	614.25	Mid
S3	1175.33	10483.00	1461.00	612.37	S3

Weekly Pivots

	S&P	DOW	NASDAQ	RUSSELL	
High	1216.25	10870	1532.00	637.70	High
Low	1186.50	10579	1483.00	619.90	Low
Close	1190.75	10635	1491.00	622.00	Close
R3	1238.92	11101.33	1570.00	650.97	R3
R2	1227.58	10985.67	1551.00	644.33	R2
R1	1209.17	10810.33	1521.00	633.17	R1
Pivot	1197.83	10694.67	1502.00	626.53	Pivot
S1	1179.42	10519.33	1472.00	615.37	S1
S2	1168.08	10403.67	1453.00	608.73	S2
S3	1149.67	10228.33	1423.00	597.57	S3

Monthly Pivots

	S&P	DOW	NASDAQ	RUSSELL	
High	1214.75	10864	1565.00	641.50	High
Low	1179.50	10467	1490.50	615.90	Low
Close	1204.00	10778	1513.00	634.70	Close
R3	1254.58	11336.00	1629.67	671.10	R3
R2	1234.67	11100.00	1597.33	656.30	R2
R1	1219.33	10939.00	1555.17	645.50	R1
Pivot	1199.42	10703.00	1522.83	630.70	Pivot
S1	1184.08	10542.00	1480.67	619.90	S1
S2	1164.17	10306.00	1448.33	605.10	S2
S3	1148.83	10145.00	1406.17	594.30	S3

Figure 8.2

I also like to note where the extreme levels are, because it is very rare for the stock indexes to hit their R3 or S3 level. This is important to know because if the markets rally to R2 or sell off to S2, that usually ends up being the dead high or the dead low of the day. This knowledge will help temper a trader's emotions. When a market is going up, it is easy to think that it will go up forever. On this same note, when the market is heading down quickly, it is easy to assume that it's the end of the world. The emotion of greed is, of course, a disaster for anyone who succumbs to it because of the surge of adrenaline that runs through the body. By understanding the odds of a move above and beyond these outer levels, a trader will be able to stay more objective and take the money away from the people who are panicking.

The pivots help to keep a trader grounded. Instead of getting overexcited and hoping for a market crash, the pivot trader knows that there is a 90 percent chance that the markets will not close above R2 or below S2 on any given day. A move to that level signals a time for the trader to take profits instead of pyramiding into a bigger position that will lead to disaster.

Let's take a look at the pivot levels that we calculated for Monday, March 21, 2005, on a five-minute chart (see [Figure 8.3](#)).

This chart looks very busy, with the daily pivot levels labeled on the left, the midpoints of the daily levels in the middle, and the weekly pivot levels on the right. For the sake of space, I left the monthly levels off. I like to take a look at this wide view first in order to see where the extreme levels are located for Monday's trading. Once I've done that, I will then reduce the chart to a more manageable level (see [Figure 8.4](#)).

In this chart, I've zoomed in so that I can see where the key close levels are for Monday's trading.

The Psychology Behind the Pivots—Who Is Getting Burned?

Before I jump into the rules and specific setups that I use to trade the pivots, I want to cover briefly why they work. The first, and most obvious, reason is that a lot of traders watch these daily levels, so there is a self-fulfilling prophecy involved. However, the same can be said for Fibonacci levels, but they do not hold nearly as well as the pivots. Why? I elaborate on this in the next two points.

@YM - 5 min CBOT

B=10636 A=10637

Hi=1...

Weekly R1 10810.33

Daily R3 10783.00

Daily R2-3Mid 10757.00

Daily R2 10731.00

Daily R1-2Mid 10707.00

Weekly Pivot 10694.67

Daily R1 10683.00

Daily PivRMid 10657.00

Daily Pivot 10631.00

Daily PivSMid 10607.00

Daily S1 10583.00

Daily S1-2Mid 10557.00

Daily S2 10531.00

Weekly S1 10519.33

Daily S2-3Mid 10507.00

Daily S3 10483.00

9:35 10:10 10:45 11:20 11:55 12:30 13:05 13:40 14:15 14:50 15:25 16:00

Figure 8.3

Weekly Pivot 10694.67

Daily R1 10683.00

Daily PivRMid 10657.00

Daily Pivot 10631.00

Daily PivSMid 10607.00

Daily S1 10583.00

10631

9:35 10:10 10:45 11:20 11:55 12:30 13:05 13:40 14:15 14:50 15:25 16:00

Figure 8.4

On the floor, it is generally a trader's goal to grab smaller moves, typically 2 points in the S&P 500, which is about 20 points in the Dow, or smaller depending on what is going on in the pit. The floor traders all operate in a big circle, with the brokers standing on the first step that surrounds the pit. This gives them the best view of all the locals so that they can get the best price for their customers. Since it is easier to trade with someone who is right in front of you, the prime space for locals to stand is just inside the top rail that separates the top-step brokers from the locals. Experience, politics (whom you know), and the ability to take orders of all sizes (not just single lots) can get a local a prime position near the top-step brokers. Usually this space is determined by how long the local has "held the spot" and his ability to continue to make markets. New traders must find space where available. This is usually at the farthest point from the brokers, which is the center of the pit. Because of this layout, there are several different scenarios being traded at one time. The locals on one side of the pit are making markets based on order flow coming from the brokers on their side of the pit. If a broker in one corner is selling size (a very large position) while a broker on the other side of the pit is buying, the two brokers don't always hear each other or even know what the other side is doing. It would be very easy for them to do their trade together if they knew that they could meet each other's needs. Instead, locals near the broker who is buying start "racing" the broker by buying from other nearby brokers and then turning around and selling their contracts to him. This causes many price fluctuations throughout the day and often results in the public's getting stopped out before the action settles down again. In its purest form, the traders on the outside will get in on a trade, let's say it's a long, and then sell their position to the guys on the inside of the circle who can't really see what is happening way out on the top steps. What happens is that the traders on the inside, by the time they see the market moving, are the last ones in the pit to get in on the move. If they are lucky, they will then be able to turn around and sell it to the public. As the guys on the inside are selling to the public and closing their positions, the guys on the outside are also selling to the public, but they are opening new short positions, essentially fading a public that is chasing the up move. And the cycle renews itself like this throughout the day. This causes a specific dynamic in the markets, generating specific cycles of speed and rest on an intraday basis. The traders focus on the pivot levels to base their entries and to also gauge market action. The pivots play on this in that they are spaced out to catch these "patches of momentum." Dow pivots are usually 30 to 50 points apart, and this is the type of movement that perpetuates the cycle I just described. The floor traders in the center of the circle are catching half this move, dumping it, and waiting for the next level to be hit. The key is to get in when the market is quiet and get positioned for the next round of activity.

One of the main reasons that these pivots work has to do with the inexperience of the vast majority of traders out there. The floor traders start a trade, and the inexperience of most traders causes the momentum that finishes a trade. How? Because average traders rely on a lot of different "indicators." They are getting into and out of their positions far too late, which causes losing trades and leads to a specific cycle of market movement as their stop placement slowly and steadily increases the velocity of market movement in the direction of their stops. Indicators are just that, an "indication." This is like your significant other slapping you across the face, and you taking it as an "indication" that this person might be angry with you. If it takes a slap across the face for you to realize this, then you are following the wrong indicators. By the way, all market indicators are the wrong indicators, because they are all lagging. Price action is pure. This overreliance on indicators by the majority of traders is what helps this system to work. By the time the average trader gets a buy signal, the pivot play is almost over, and users of this system will be selling their position to the indicator-based traders. Then the subsequent reversal that takes place results from all the stop losses sitting out there, like trout sunning themselves at the top of a lake—easy targets for the hawks who come swooping down from overhead. The market pauses, drifts down, then picks up steam and rips through all the stop losses, pausing when the run is over. This pause generally happens at a pivot level. It's where the floor traders are beginning to accumulate their next position for the next cycle of play.

Let's jump into the trading rules and look at some setups.

What Are the Trading Rules for Pivot Buys on Trending Days?

Sells, of course, are reversed.

1. Unlike with the gap charts, I want to see 24 hours' worth of data, so that I can view any overnight highs and lows. Each day I update the appropriate pivot levels on the charts to reflect the previous day's action. On Mondays, I also update the weekly pivots, and on the first trading day of a new month, I update the monthly pivots.
2. The first pivot play is done in conjunction with the gap, if there is one. If there is a gap down, then I buy a decline into the closest pivot level. If there isn't a playable gap (more than 10 YM points or 1 ES point), then I will wait until 9:45 a.m. eastern to initiate the first play.
3. If the volume on the five-minute ES chart is more than 25,000 contracts, then I'll wait for the markets to penetrate a pivot level and move up at least a quarter of the way to the next pivot level. Once this happens, I will then set up a bid to buy the first retracement back to the violated pivot level.
4. I enter my trades with limit orders only. I place orders "just in front of" the pivot. For the YM, I use 3 points; for the ES, 0.25 point; for the NQ, 0.50 point; for the TF, 0.20 point; and for individual stocks, 5 cents. For example, if I'm trading the YM and the pivot level is 10,000, then I would buy a decline to 10,003 and short a rally to 9997. Sometimes the pivot will be an odd number, such as 1117.38 on the ES. In this case, I always round in the direction of the trade. So, if I'm bidding for a long, I will round 1117.38 to 1117.50, and my bid will be 1117.75. If I'm offering a short, I will round 1117.38 down to 1117.25 and place my offer at 1117.00. My stops and targets, then, would be "just in front of" these appropriate long and short levels.
5. Once filled, I place an order to close the first half at the next pivot level and the second half at the pivot level after that, using the same "just in front of" parameters.
6. I place a stop at 20 points for the YM, 2 points for the ES, 4 points for the NQ, and 1.50 points for the Russell. For stocks, I will use a stop based roughly on the price of the stock. If the stock is under \$10 a share, I will use a stop of 20 cents. If it is between \$10 and \$20, I will use a stop of 30 cents; if it is between \$20 and \$30, I will use a stop of 40 cents, and so on, adding another 10 cents for each \$10 increment in price. (A \$75 stock would have an 80-cent stop, for example.)
7. If the first target is hit, I will then move up the stop to my entry-level pivot, minus the "just in front of" fractions discussed in rule 3. For example, if I get in a YM long at 10,003 and the pivot is at 10,000, then my new stop would be 9997 once the first target is hit.

8. If I am in a trade at the market close and neither my stop nor my target has been hit, I will close out my position “at the market” at 4:10 p.m. eastern for futures, and at 3:58 p.m. eastern for stocks.
9. I don’t initiate any new positions after 3:30 p.m. eastern, but I will manage existing positions into the close.
10. The markets rarely have a sustained move above R3 or below S3. If I trade to those levels, I will always fade the move.
11. After two losers in a row, I’m done with pivots for the day.

What Are the Trading Rules for Pivot Buys on Choppy Days?

Once again, sells are the same, just reversed. The rules for choppy days are identical except for the targets. On choppy days, I just focus on the YM and the ES. My first target is mechanical: 10 points for the YM and 1 point for the ES on half of my position. Once this is hit, I will trail up my stop in the same way I would for a trending trade. The second target becomes the “just in front of” level for the actual next pivot level. In working with other traders, I’ve found that they grasp the concept of the “choppy day” setup easily, but they struggle with the “trending day” setup. Therefore, I focus most of the examples on the trending day setups, and we go through those first.

What Are Some Specific Examples of Trading the Pivots?

E-mini S&P—September 2004 Contract, September 10, 2004

1. The S&Ps gap down into daily S1 (see [Figure 8.5](#)). I have a limit order to buy placed at 1114.00, just above daily S1. The market comes very close to this level, but not close enough. I am not filled, and the market rallies away without me. Once the market pushes up through the midpoint, I move my bid to buy the next pullback to the midpoint. The midpoint is at 1115.88, so I get a little in front by placing an order to buy at 1116.25. I am filled quickly at this level. I place an initial 2-point stop at 1114.25, and my first target is just in front of the next pivot. The pivot is 1118.00, so my first target is 1117.75.

@ES - 5 min CME L=1123.75 +5.75 +0.51% B.

Daily R2 1126.50

Daily R1-2Mid 1124.38

Daily R1 1122.25

Daily PivRMid 1120.13

Daily Pivot 1118.00

Daily PivSMid 1115.88

1

Daily S1 1113.75

6

5

3

9/10

10:50

11:40

12:30

13:20

14:10

15:00

15:50

1127.00

1125.00

1123.75

1123.00

1121.00

1119.00

1117.00

1115.00

Figure 8.5

2. My first target is hit, and I move my stop up to 1115.50 (just below the midpoint where I entered the trade). Shortly thereafter, my second target is hit at 1119.75, and I am out of the trade.
3. I place an order to buy a pullback to the pivot at 1118.25. I am filled, and I place a 2-point stop at 1116.25. My stop is hit. The market rallies back through the pivot, and I place another order to buy a pullback to 1118.25. I am filled, and I place the same 2-point stop at 1116.25.
4. My first target is hit just in front of the next pivot level, at 1119.75.
5. I move my stop on the second half of my position up to 1117.75, which is just below the pivot where I entered my trade.
6. I exit the second half of my position at 1122.00, just in front of the next pivot level. Once the market pushes decisively through this pivot level, I place a bid to buy

at 1122.50, just above R1. I am not filled, and the market goes on to make new highs. At this point it is past 3:30 p.m. eastern, and I am done with my pivot plays for the day.

E-mini S&P—September 2004 Contract, September 9, 2004

1. The S&Ps gap open, and I place an order to short just below the midpoint at 1121.00 (see [Figure 8.6](#)). I am filled, and I place a 2-point stop at 1123.00. My first target is just in front of the next pivot level at 1120.00. This target is hit, and I move my stop down to 1121.75, which is just above the pivot level I used for my entry. My second target is just in front of the next pivot level at 1118.00.

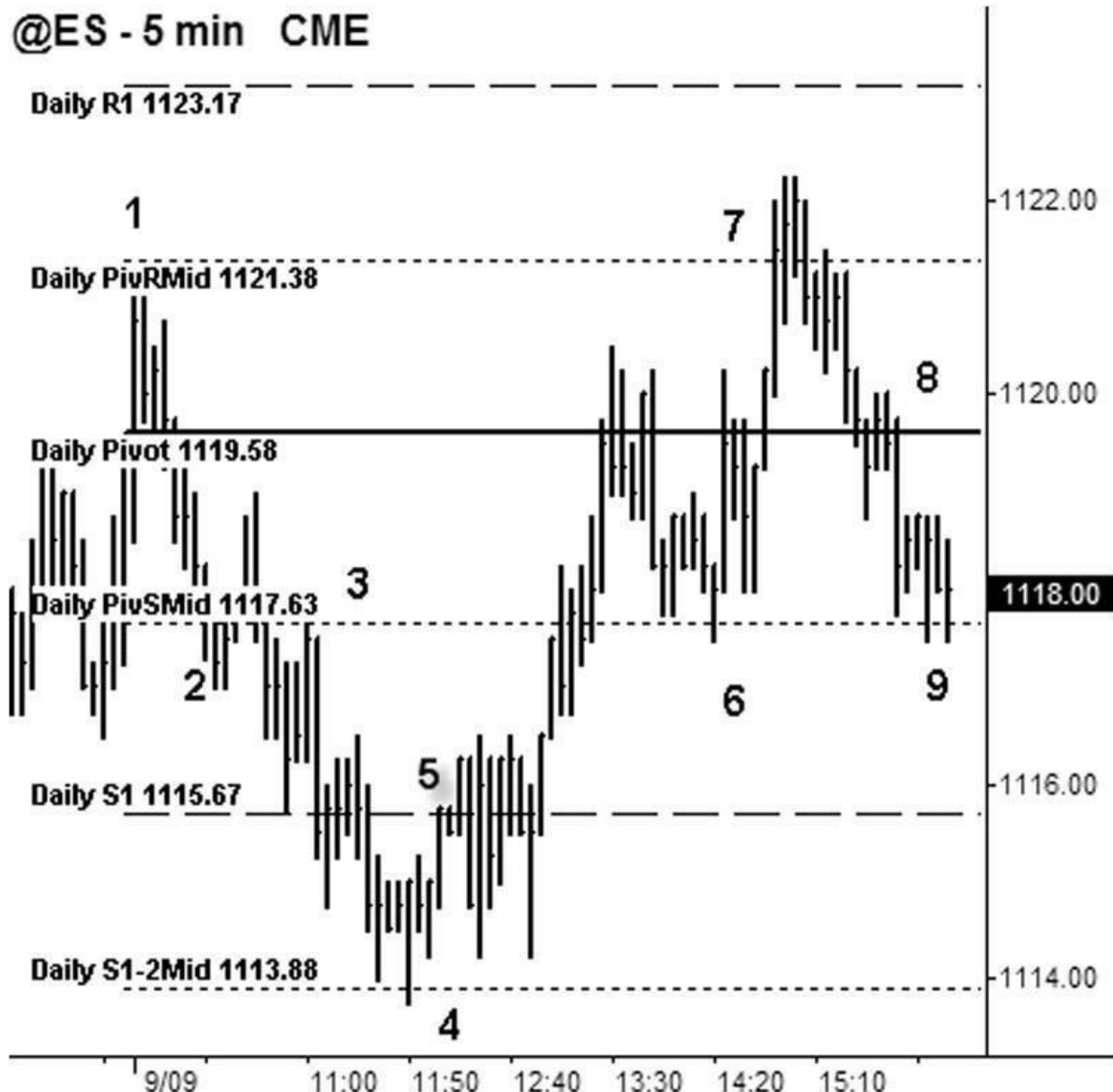


Figure 8.6

2. My target is hit on the second half of my position. The market bounces and starts to move up to the daily pivot, and I place an order to short at 1119.25. I am not

filled, and the market rolls over and moves quickly into daily S1.

3. I move my order to short down to the next pivot level, and my order is now at 1117.25. I am filled, and I place a stop at 1119.25. My first target is 1116.00. This target is hit, and I move my stop to 1118.00.
4. My second target is hit at 1114.25, and I place an order to short a rally back to S1 at 1115.25.
5. I am filled, and I place a 2-point stop at 1117.25. I get stopped out as the market rallies hard.
6. I'm filled at 1118.00. I place a stop at 1116.00.
7. The market rallies to the next pivot level, and I'm out half at 1119.25. I move my stop up to 1117.25. My next target is quickly hit at 1121.00.
8. Normally I would place an order to buy the next pullback here at 1120.00. But I don't. Why? Because I'm following the rules. It is now past 3:30 p.m. eastern, and I'm not initiating any new trades!
9. This trade would have been stopped out.

E-mini S&P—September 2004 Contract, September 8, 2004

1. The markets gap down, and I place an order to buy at 1118.75 (see [Figure 8.7](#)). This order is not filled. When the markets rally through the daily pivot, I raise my bid to 1120.75. I am filled, and I place a stop at 1118.75. My first target is 1123.00.

@ES - 5 min CME

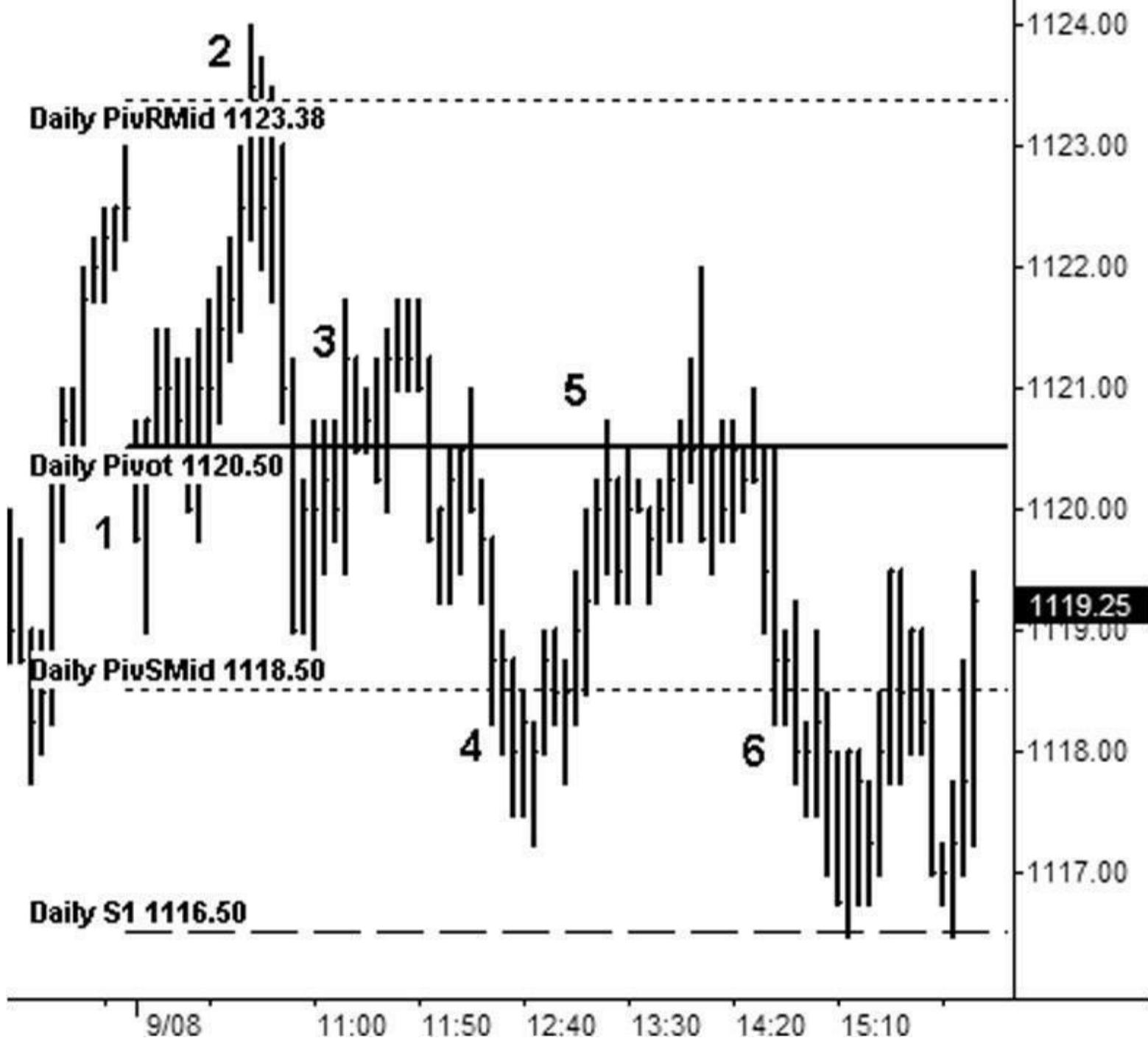


Figure 8.7

2. My first target is hit. I move my stop up to 1120.25.
3. I am stopped out of my second half, and I wait for the next setup.
4. The market continues to trend down, so I want to short the next move to the overhead pivot.
5. The market rallies, and I get short at 1120.25. I place a stop at 1122.25, and my first target is 1118.75.
6. My first target is hit, and I move my stop to 1120.75. Shortly thereafter, my second target is hit at 1116.75. I place an order to short the next rally to an overhead pivot, and I am filled at 1118.25. I place a stop at 1120.25. My first target is hit at 1116.75, and I move my stop down to 1118.75. The market rallies into the close, and I am stopped on the second half.

1. The Russell 2000 futures gap down, and I place a bid at 561.90 (see [Figure 8.8](#)). I am filled, and I place a stop at 560.40. My first target is 563.80, and this is filled quickly. I move up my stop to 561.50.

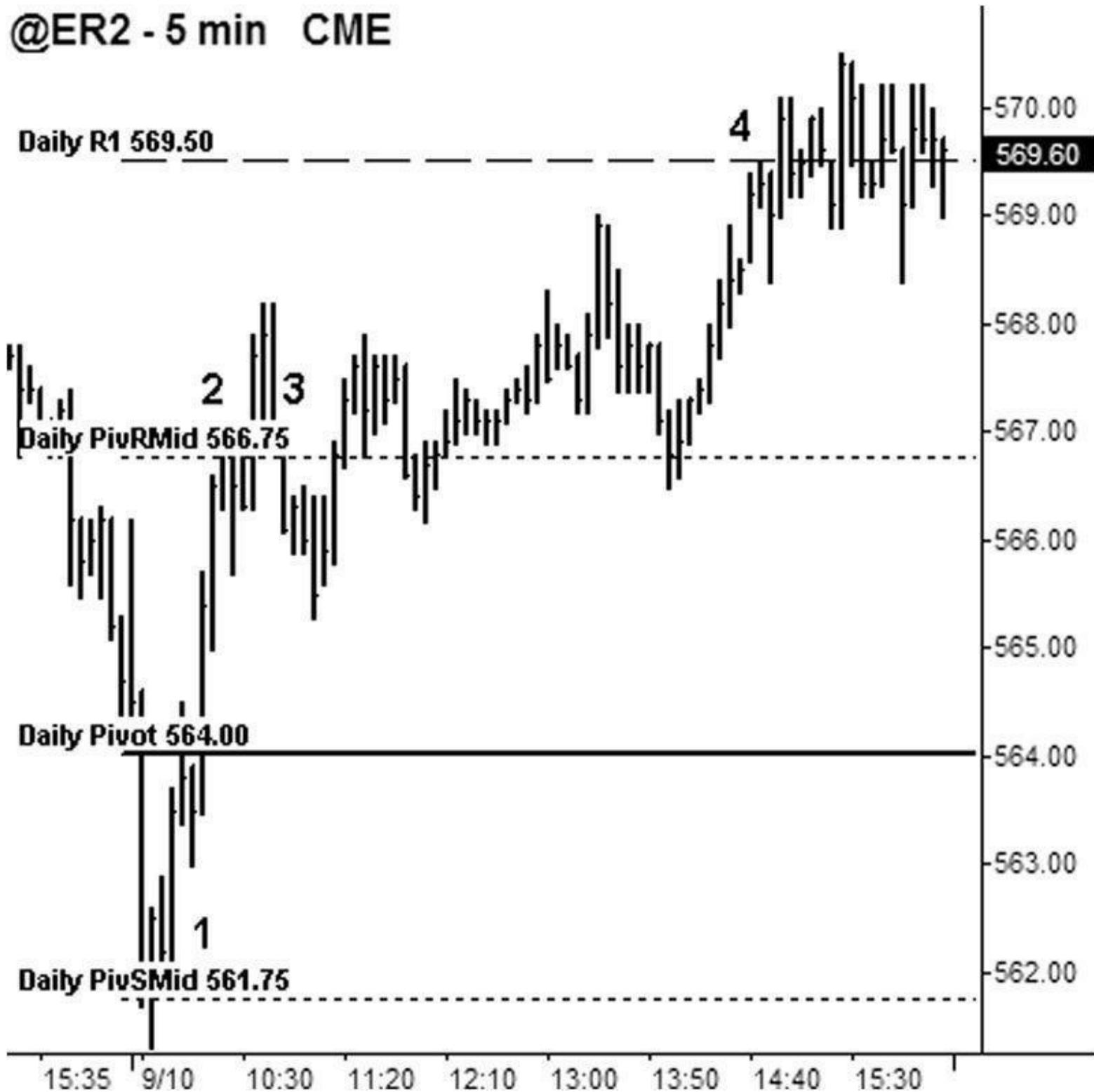


Figure 8.8

2. My second target is hit at 566.50, and the market continues to rally through this midpoint.

3. Once the market pushes through the midpoint, I place a bid at the pivot below at 564.20. The market never comes down to this level, but in fact makes new highs. Once this happens, I move my bid up to the next pivot level, and my new bid is 566.90. I am filled close to 2:00 p.m. eastern. I have been bidding long for 3½ hours. With pivots, patience is a virtue!

4. I place a stop at 566.40, and my first target is 569.30. My first target is hit, and I move my stop up to 566.50. The market hangs around this same level into the close. Since neither my stop nor my target is hit, I exit “at the market” at 4:10 p.m. eastern and get out at 569.40.

E-mini Russell—September 2004 Contract, September 2, 2004

1. The Russell 2000 opens flat and pushes higher, right into daily R1 (see [Figure 8.9](#)). I set up a bid to buy the next pullback to the midpoint at 554.90. I am filled, and I place a stop at 543.40. My first target is the next pivot level at 557.20. This level is hit, and I move my stop up to 554.40.



Figure 8.9

2. The markets spend the next four hours consolidating, then finally push up and hit my second target, once again showing that patience with the pivots pays off.

- The market pushes through the midpoint and starts to pull back. I place a bid at 560.10. The market comes close, but I am not filled. The Russell pushes through daily R2, and I move my bid up to 562.60. I get filled here and place a stop at 561.10. My first target is 564.90.
- My first target is hit. I move my stop up to 562.10. The market approaches the close without hitting either my stop or my second target. I exit at the market at 4:10 p.m. eastern and get out at 566.30 on the second half of my position.

E-mini Nasdaq—September 2004 Contract, September 3, 2004

- The Nasdaq gaps down, and I place a bid at daily S1 at 1380.50 (see [Figure 8.10](#)). This isn't filled, and when it moves up through the midpoint, I raise my bid to 1386.50. I get filled, and I place a stop at 1382.50, with my first target at 1391.00. The first target is hit, and I raise my stop to 1385.50.



Figure 8.10

- I'm stopped on the second half. The market goes on to make new lows, and I place a short at 1385.50. I don't get filled.
- The market continues to fall and slams into the next pivot level.
- I move my short bid down to the next level at 1379.50. I don't get filled, and nothing else sets up for the day. A good day to rearrange the sock drawer.

E-mini Nasdaq—September 2004 Contract, August 5, 2004

- The Nasdaq has a slight gap up into the midpoint, and I short at 1383.50 (see [Figure 8.11](#)). I place a stop at 1387.50, and my first target is at 1379.50.



Figure 8.11

2. My first target is hit, and I move my stop down to 1384.50. The market rallies, and I am stopped out on my second half.
3. The Nasdaq sells off through the next pivot level.
4. Once it is through this level, I place an order to short a rally back up to this level at 1373.50. I get filled, and I place a stop at 1377.50, with my first target at 1369.50. The first target is hit quickly, and I move my stop down to 1369.50. My target on the second half is 1364.50.
5. My target on the second half is hit, and I am now flat.
6. I place an order to short a rally to the above pivot level at 1368.50. I am filled, and I place a stop at 1372.50. My first target is the pivot below at 1364.50. This gets hit, and I move my stop down to 1369.50.
7. My second target is hit at 1359.50. I place an order to short a rally to the next overhead pivot level at 1364.00. I come right up to this level but am not filled, and that is the last pivot play that sets up for the day.

Mini-Sized Dow—September 2004 Contract, August 5, 2004

1. The mini-sized Dow futures open mixed and begin selling off early in the session (see [Figure 8.12](#)). I place an order to short the next rally to the midpoint at 10,118, but I don't get filled. Once it breaks down through the daily pivot, I move my order to short down to 10,091. This time I get filled, and I place a stop at 10,111 and an order to cover half my position at 10,069. I'm filled on the first half of my order, and I then move my stop down to 10,097. My next target is 10,041.



Figure 8.12

2. My next target is hit, and I'm now flat.
3. The market continues to move lower and tests the next pivot level. I place an order to short at the pivot level above, right at 10,035. The market is acting really slowly. I put my orders in place and go grab some lunch. By the time I get back, I'm still not filled, which is why I absolutely love the low-volume August trading. It takes a couple of hours, but I end up getting filled later in the afternoon. I place a stop at 10,055, and my first target is 10,015. This target is hit quickly, and I move my stop down to 10,041.
4. My second target is hit at 9988, and I'm now flat. Since the market continues to trend lower, I place a bid to short at the next overhead pivot level, and I place an offer at 10,008.
5. The market trades right up to this level, but I don't get filled. When the market collapses, I move my offer down to 9982, but this doesn't get filled either.

Mini-Sized Dow—September 2004 Contract, September 2, 2004

1. The markets open mixed and rally into the midpoint at 10,189 (see [Figure 8.13](#)). I set up to buy the first pullback, and I place an order at 10,163. It comes very close to this level, but not quite, and I don't get filled. The market rallies through the next pivot level, and I move my bid up to 10,192. The market doesn't even look back and keeps on going moving up through yet the next pivot level.

@YM - 5 min CBOT



Figure 8.13

- I move up my bid again, to 10,221. This time I get filled and place a stop at 10,201, and my first target is 10,238. The first target is hit quickly, and I move up my stop to 10,215.
- My second target is hit at 10,261, and I am now flat.
- The market rallies, and I place an order to buy at 10,267. I don't get filled, and the market closes near its highs.

Mini-Sized Dow—September 2004 Contract, August 25, 2004

- The Dow gaps down, and I place a bid at 10,077 (see [Figure 8.14](#)). I get filled, and I place a stop at 10,057, with my first target at 10,090. My first target is hit, and I move up my stop to 10,071.



Figure 8.14

2. The Dow continues to rally, and my second target is hit at 10,104.
3. I place an order at 10,096 in order to buy the next pullback. I get filled, and I place a stop at 10,076. The market slows to a crawl for the next hour, and nothing happens. Then momentum begins to pick up, and I'm out of my first half at 10,104. I raise my stop to 10,090.
4. My second target is hit at 10,118.
5. The Dow continues to rally to the next pivot level. I place an order to buy a pullback at 10,124. I don't get filled.
6. The market pushes higher to the next level, and I raise my bid to 10,144. I get filled, and I place a stop order at 10,124, with my first target at 10,157. My first target is hit quickly, and I raise my stop to 10,138.
7. My second target is hit at 10,171, and I am now flat. The market continues to rally to daily R3. This is a rare event. The markets hardly ever get through R3, and I always fade initial moves to these levels. I place an order to short at 10,185. I am filled, and I place a stop at 10,205. The market pushes up to 10,200 and fades into the close. Since neither of my parameters is hit, I cover at 4:10 p.m. eastern at 10,176.

KLAC (KLA-Tencor Corp), September 10, 2004

1. KLAC gaps down on this day, and I place an order to buy at 38.48 (see [Figure 8.15](#)). I am filled, and I place a stop at 37.93. My first target is hit at 38.89, and I raise my stop to 38.38.



Figure 8.15

2. The stock continues to rally, and my second target is hit at 39.39.
3. I place an order to buy the first pullback at 38.99. This order doesn't get filled, and the stock runs away.
4. When it breaks the next pivot level, I raise my bid to 39.49. It takes a while, but I get filled, and I place a stop at 38.99.
5. My first target is hit at 39.72, and I raise my stop to 39.39.
6. By the time the market approaches the close, neither of my parameters has been hit, and I close out at the market right at 4:00 p.m. eastern at 39.78.

Trending versus Choppy Markets

For the most part, the setups we just went through cover trending markets. I also wanted to take a look at choppy markets to show how the pivots work under those circumstances. [Figure 8.16](#) shows the mini-sized Dow on a day when it stayed locked in a confined, narrow trading range through the majority of the day. In fact, most of the initial move down happened before the 9:30 a.m. eastern open for the cash markets. I also inserted some basic indicators onto this chart to show how far they can lag behind on a choppy day compared with a setup that is based purely on price. The indicators I'm looking at are basic exponential moving averages as well as an RSI index. This doesn't mean that these indicators don't have any value—it's just important to keep in mind that for the most part, an indicator-only-based trading approach is a lagging approach, and this fact is heightened on a choppy trading day.



Figure 8.16

- As the markets chop along and the volume on the ES chart continues to run under 25,000 contracts, this becomes the appropriate time to set up the pivot plays in the following “chop-enhanced” manner (see [Figure 8.17](#)). At point 1, the YM is quiet, and I am looking to fade a move to the nearest pivot level. I don’t want to sit and stare at the markets while this mind-numbing action unfolds. Therefore, I place a buy limit order at the nearest pivot level below the current price action, plus 3 points, so I’m just in front of the pivot. I also place a sell limit order at the next level above current price action.



Figure 8.17

2. The sell limit order is hit first. I came close to the buy limit order, but I didn't quite make it. Once the sell limit order is hit, I place a 20-point stop. My first target is a mechanical 10 points away from my entry, and my second target is the next pivot level below. It is a weekly pivot level at 10,532, so I would set up a buy limit order at 10,535 to cover the second half of my short.
3. Both of my targets are hit, and I am taken out of the trade. Note that when the moving averages finally crossed over, the markets were almost at our final target. Indicators like moving averages work amazingly well on trending days, but they are a killer on choppy days. Price rules on the choppy days.

This example shows something that traders will notice quite often when they trade this system: they will be trading exactly the same levels multiple times during a given day. The level at which a trader would get long on a decline is also the level at which the trader would close out a short, and vice versa.

Let's take another look at the same chart ([Figure 8.17](#)), but we'll look at all the setups that occurred that day.

1. At point 1, the YM falls to one of the weekly levels, but doesn't quite touch it. I manage to get into the market long because my limit buy order is the weekly level + 3 points. The weekly level is 10,532, so my limit buy order is placed at 10,535. I'm out for +10 points quickly on the first half, and then I bring my stop up to "pivot - 3," which is breakeven - 6.
2. At point 2, we come up and ease just through the daily midpoint. I am out of the second half of my long on a limit order to this level. Note that the moving averages have barely crossed higher when the markets have reached the target. I try to reverse and short, but the market moves too quickly, and I miss the short. One way around this is to keep a resting order in for the stop and also for a new position. If traders are long 10 contracts and want to reverse and go short when they exit, then they just set a sell limit order for 20 contracts. This way, they will exit their long and establish a short position simultaneously.
3. For point 3, I am bidding long for a decline back at the weekly level + 3 points. The weekly level is 10,532, so my bid is that plus 3 points, which is 10,535. When two levels are close together like this (by at least 10 points—in this case a weekly level and the daily pivot), I will place my bid based on the level closest to the

price action. I am filled on my long. The market eases through and trades around this level for half an hour. My stop is not hit, although it comes close. My initial target for "half at 10 points" is hit quickly, and I trail my stop. It is not until a couple of hours later that my second target is hit at the midpoint. This is an important note: some of these trades will last a few hours in duration, while others can last 10 minutes. The key is to wait for the levels to be reached and not try to hurry things along or get out because of anxiety or boredom. Although human emotions are a good idea in building relationships with other people, in trading they have to be ignored.

4. I am out of the second half of my long more than three hours later, at a daily midpoint level. Since this is a choppy day, I just reverse and go short, placing the target on the first half of my position 10 points away from my entry. My second target is the next level below + 3 points.
5. The market actually moves quickly, and I'm out of the first half in 15 minutes, and the second half another 15 minutes after that. I reverse and go long and set up the same parameters: +10 points on the first half, and back to the other pivot on the second half.
6. I'm out of the first half quickly for +10, and the market continues to trek higher into the close. The market doesn't quite reach my second target, and I end up getting out at the market at 4:10 p.m. eastern, a few points below my target. Note again that by the time the moving averages crossed higher, I was already out of half my position.

Trailing Stops in This Fashion Is the Key

I'm not a big fan of aggressively trailing stops. By this I mean that if the market moves in my favor by 1 YM point, I will keep my stop static instead of trailing it up by 1 point. This auto-trailing stop strategy generally will stop a trader out on the first normal retracement, and these are moves I'm willing to sit through. However, if I've established multiple targets and my first target is hit, then and only then will I generally move up my stop to protect gains on the entire trade. For pivot plays, I treat stop movement the same way on both trending and choppy days. I'm just waiting for my first target to get hit. Once that happens, then and only then will I move up my stop.

1. Here we have our original 20 stop from our long entry on a decline to the weekly pivot + 3 points (see [Figure 8.18](#)).



Figure 8.18

2. If this was a trending day, then I would wait until my first target—the next pivot level—is hit. At that point, I would trail up my stop. On a choppy day, my first target would be +10 points on the YM, so in this example, that would mean that my stop would have been moved up sooner, right after my first lower target was hit.

Tips and Tricks for Using the Pivots

The key with this setup and all the setups I use is that the trader gets everything prepared on her charts in advance of the opening. Once everything is set up, all the trader has to do is watch and wait, or, better yet, utilize audio alerts to give her a heads-up that a setup is either forming or firing off. With pivots, traders can place orders in advance, as the exact targets, entries, and stops are known before the trade is entered. This way, the traders can also focus on other things if they come up. When the traders hear the alerts going off, they know that it is time to go back to their charts and see what is going on. There is no chasing. Either the orders will get hit or they will not. This system, like all the systems I use, is constructed in such a way as to naturally enforce the mindset of a professional trader, which is the only consistent way to make money in the financial markets.

The important thing to know about midpoints is that you don't need to use them all the time. I use them on days when the distance between two YM daily pivot levels is greater than 40 points. This is a general rule, and it is okay to use them if the pivot level is only 30 points. If the pivots are closer together than 30 points, the midpoints don't play as much of a role, as the markets will move straight to the next pivot, since the pivots are so close together.

On my charts, I typically use a black background, which can't be shown in the context of this book. I then make the daily pivots yellow, the weekly pivots light blue (cyan), the monthly pivots purple, and the midpoints white. I also make the central pivots solid lines and the rest of the pivots dotted or dashed lines. This way it is very easy to pick out what the markets are butting up against.

The use of pivots has gotten a lot easier over the years. I used to calculate these manually, using a calculator, but I eventually switched to an Excel spreadsheet where all I had to do was enter the high, low, and close, and the spreadsheet did the rest. However, I still had to draw the horizontal lines manually on my charts each day, and this took a good part of half an hour. There is software that will calculate the pivots for a person automatically, but it generally uses the wrong time frames and can create errors because of bad ticks. I'm anal-retentive when it comes to this, and I have to enter my pivots manually each day—I want to make sure they are correct. I finally found a programmer who could help me out on this, and the end result is a piece of software that automatically calculates the correct daily, weekly, and monthly pivot levels and automatically draws them on the various charts I watch. Manually is fine too, but this does save time, something that I have less of now that I have kids!

What About Fibonacci Numbers?

One question I frequently receive with regard to the pivots is how they relate to Fibonacci retracement levels. For the uninitiated, Fibonacci numbers are used by traders to determine support and resistance levels, with the most commonly used retracement levels being 0.382, 0.50, and 0.618. In my experience, sometimes these work great, and sometimes the market doesn't even know they exist and blows right through them. However, I do like to see where the Fibonacci cluster numbers are on any given trading day. These are more accurate than regular Fibonacci numbers because of the use of more data points and the way the Fibonacci ratios are calculated. Getting these numbers takes a lot of work, and for a while I calculated them myself. Then I discovered Carolyn Boroden's work at www.fibonacciqueen.com, and from then on I just subscribed to her service, as this is her area of expertise. She works on both the time and price axes of the markets, using the confluence of Fibonacci ratios. For price, she runs retracements of prior swings using the ratios 0.382, 0.50, 0.618, and 0.786. She also runs price extensions of prior swings, which are essentially retracements beyond 100 percent. For extensions, she uses the ratios 1.272 and 1.618. Carolyn also runs price projections comparing swings in the same direction. For projections, she uses 100 percent and 1.618. In doing this, she runs all possible levels from the key swing highs and lows in a chart and looks for the confluences. When she sees a confluence, these become the key levels in the markets to buy and sell against.

Personally, I'm interested in the bigger levels found on 60-minute and daily charts, and I use these mostly for swing trading. However, there will be days when these clusters line up with some of the daily pivot levels, and of course on these days those particular levels become that much stronger. I also like to look at these Fibonacci cluster levels on other markets, as they provide key levels across all markets. Let's look at a few examples from Carolyn Boroden's work.

Mini-Sized Dow—June 2005 Contract, April 6, 2005

[Figure 8.19](#) is on the 15-minute mini-sized Dow futures contract. You can see the obvious uptrend that developed from the April 4 swing low. For this reason, we wanted to focus on setting up clusters on the buy side of the market. We saw a nice zone develop between 10,489 and 10,492. This zone included the coincidence of a 1.618 price extension, a 0.50 percent retracement, a 0.382 retraction of another swing, and a 100 percent price projection of a prior corrective decline. The initial low was made directly within this cluster zone at the 10,489 level. From there, we saw a rally to 10,578, or 89 points.

Euro FX—June 2005 Contract, April 27, 2005

In the five-minute euro currency example in [Figure 8.20](#), we found a confluence of three key Fibonacci price relationships between 1.2970 and 1.2971. This included a 0.618 retraction of the 1.2961 low to the 1.2988 high, a 0.786 retrace of the 1.2966 low to the 1.2988 high, and a 100 percent price projection of the 1.2984 high to the 1.2966 (swing) low. The actual low was made at 1.2972. The initial rally took you to 1.2990.

Mini-Sized Dow—June 2005 Contract, April 4, 2005

For entries into the market, we ideally want to set up “price clusters” in the direction of the trend in the time frame we are trading. We sometimes use “countertrend” clusters for exits or to tighten up stops on a position. The example in [Figure 8.21](#) in the mini-sized Dow futures contract shows a confluence (clustering) of at least five Fibonacci price relationships in the 10,132–10,141 area. The focus of these levels came in the 10,132–10,136 area. In this case, the actual low was made at 10,140. A “trigger” for an entry against this zone could be as simple as taking out a prior bar high. At that point, your initial stop could be placed either below the low made prior to the trigger (10,140) or below the low end of the cluster zone (10,135). The initial move off this cluster was 58 points.

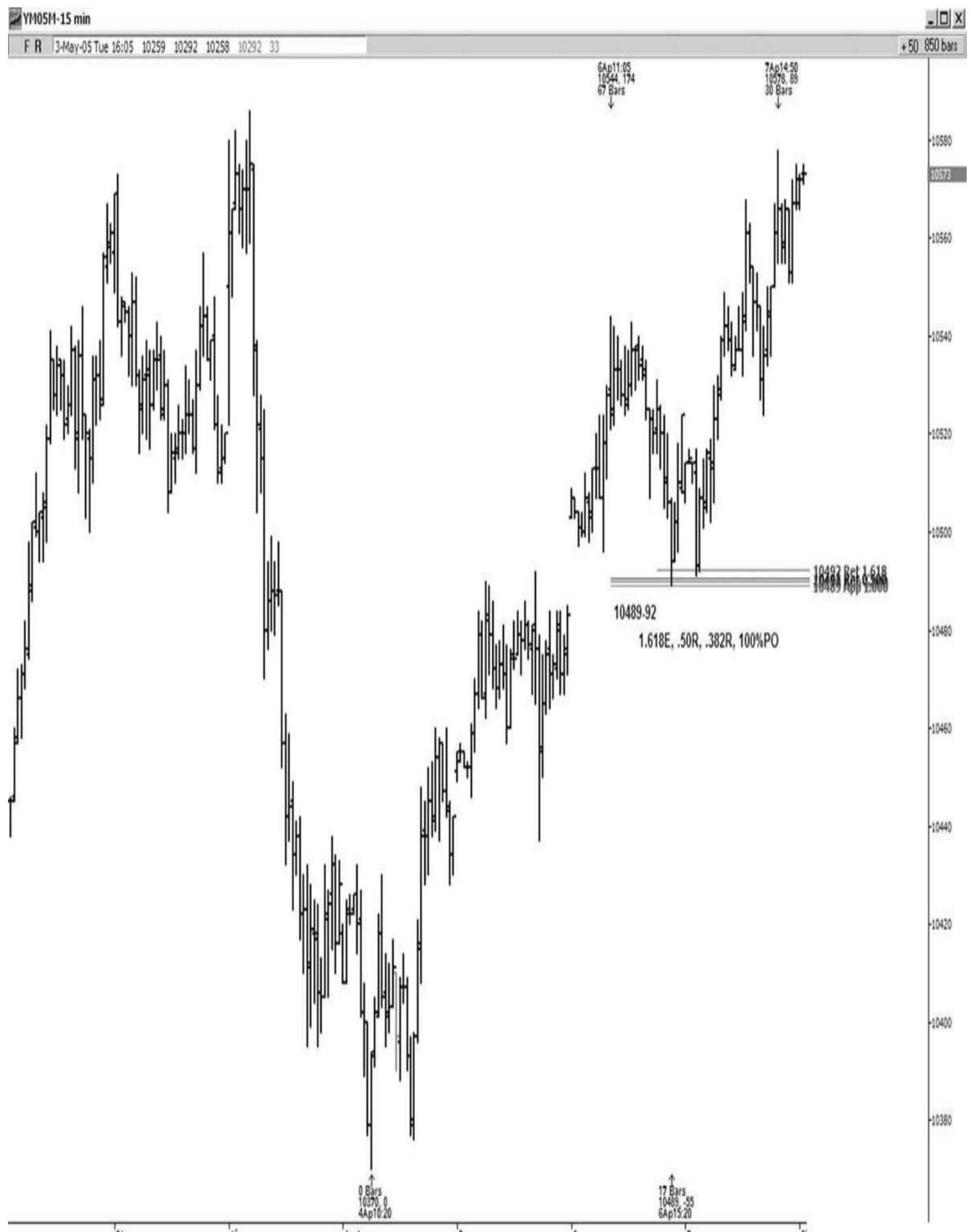


Figure 8.19

F R 27-Apr-05 Wed 14:55 1.29570 1.29600 1.29540 1.29560 -0.00360

+50 280 bars

26Apr10:45
1.29840, 0.00230
5 Bars
↓26Apr12:10
1.29880, 0.00220
10 Bars
↓26Apr14:15
1.29900, 0.00180
22 Bars
↓

-1.30200

-1.30100

-1.30000

1.29980 Ret 1.618

target 1

1.29920 Ret 1.272

1.29910
1.29900

-1.29800

1.29710 Ret 0.618

1.29700 App 1.000

-1.29700

12970.71 .618R, 786R, 100% PO

-1.29600

↑
0 Bars
1.29610, 0.00000
26Apr10:20

↑
7 Bars
1.29660, -0.00180
26Apr11:20

↑
3 Bars
1.29720, -0.00160
26Apr12:25

Figure 8.20

F R	27-Apr-05 Wed 15:02	10211	10220	10209	10210	54	+ 50 200 bars
-----	---------------------	-------	-------	-------	-------	----	---------------

27Apr9:50
10113, 0
0 Bars
↓

27Apr10:32
10132, 53
6 Bars
↓

27Apr11:32
10166, 64
16 Bars
↓

27Apr12:05
10198, 58
6 Bars
↓

10210
10200
10190

10180
10170

10160
10150

10141 Ret 1.272
10136 App 1.000
10134 App 1.500
10132 App 0.500

10132.41***
focus on 32-36

↑
8 Bars
10079, -34
27Apr10:14

↑
4 Bars
10102, -30
27Apr10:44

↑
5 Bars
10140, -26
27Apr11:47

10:02

11:02

12:02

Figure 8.21

These examples of Carolyn's work show how these Fibonacci clusters act as support and resistance levels in the markets, and I use them intraday just as I use the pivot levels. They can also be used to initiate swing trades on larger time frames, as these can be used on any time frame, from a three-minute chart to a weekly or even a monthly chart.

Carolyn also has a great book out on the subject entitled *Fibonacci Trading: How to Master the Time and Price Advantage*. It's available on Amazon.

What's the Best Way to Trade Commodity Markets with Pivots?

I mentioned at the beginning of this chapter that I prefer to utilize only weekly pivot levels on the other commodity charts. This includes anything other than stock indexes, and could be currencies, gold, oil ... literally anything other than stock indexes. There are two reasons for this. The first is that while I don't mind trading the stock indexes for smaller moves, I generally like to trade the other commodities for larger moves, trades that last a few hours or more as opposed to a few minutes. In that respect, I look at hourly charts on the rest of the commodities, and I utilize the weekly pivots on these charts so that I can see these key levels in relation to the current price action.



Figure 8.22

In [Figure 8.22](#), there is a chart of the euro currency futures contract from September 29, 2011. My main focus on this chart, as well as for other hourly commodity contracts, is the location of the main central pivot. On this chart, that is represented by the 1.3542 price point. Over the course of this week, the euro has been attracted to this level like a magnet, and this is typical. This weekly "central pivot" is a key area for both initiating positions and taking profits.

Summing Up the Pivots

The pivot levels work mainly because of the psychology pain/pleasure cycle that perpetuates the markets each day. Traders who follow only indicators will chase a position when it is already half to three-quarters of the way off its pivot, and it is these traders who provide the stop losses to perpetuate the next cycle of market movement. If you rely only on indicators for your entries, instead of using the price action of the pivots, you will get in and out of these cycles too late, and you won't make any money trading.

What is nice about this system is that traders don't have to watch it very closely once they are in a position. I'm not an aggressive trailer or stops. I like to get in a position, set my parameters, and then focus on other things. Depending on a trader's work situation, he could do this at the office, especially on the West Coast, and especially if he had an order system that automatically bracketed trades. This way he can place the parameters and then go to the next meeting or appointment. *Let the parameters babysit the position.* This is much better as well because it takes human emotion out of the equation.

I've created a video at www.tradethemarkets.com/pivots that gives additional, updated examples of pivot plays as well as live trading examples of the pivots in action.

Tick Fades: Are They Really the Best Way to Take Money Away from Newbies?

What Is the Number One Action Alert Available to Traders Today?

The stock markets spend the majority of their time backing and filling. That is, they drift up to a resistance level, then turn around and drift back to a level of support, not really doing much of anything. For most of this time, there isn't much for a trader to do except wait, and that usually requires extreme patience. Many traders fail in this regard. After all, they are traders, right? They should be taking a trade or managing a trade, not just sitting around doing nothing. This is and will always be one of the biggest misconceptions about trading—the idea that a trader has to be in a trade nearly every minute or every hour of the day. In reality, there are always three positions traders can be in at any given time: they can be long, short, or flat. For day trading, being flat, meaning not having any trades on, is the best course of action 60 percent of the time. Cats don't chase the first bird they see. They crouch and wait, sometimes for hours, for the right time to pounce. And that's what the active trader should do. When something interesting actually does happen, such as a buy or sell program hitting the markets, this creates a great scalping opportunity for the alert trader. The key for traders is to be patient, sit on their hands, and wait for these moments to occur. Actively trading really means actively waiting. Overtrading is the number one reason most day traders fail.

There is no easier way to do this than by watching the \$TICK, or, I should say, “listening” for the \$TICK. When the \$TICK gets over +1,000 or under -1,000, this represents extreme buying or selling, and at this stage of the move, most of the bullets have already been fired. Many amateur traders get caught up in the froth and excitement, get scared that they are missing out on a big move, and jump onboard in the direction of the move—just as it is starting to peter out. These are the bag holders that will get shaken out on the reversal. Rather than join the move, I like to wait until an extreme tick reading is registered and then fade the move. Earlier I mentioned that I liked to listen for the \$TICK. By this I mean that I have set up audio signals to alert me when these levels are hit. This way, I don't have to stare at the charts and potentially miss a move because I'm not paying attention. I can be down the hall, but if I hear the alert, I know exactly what is going on.

Getting down to specifics, whenever I see or hear readings of over +1,000 or -1,000 \$TICK, I fade the move by placing a market order. If we get a +1,000 tick reading and I am flat, I short the move at current levels. If I am already long based on another signal, I start exiting that move and initiating a short position. The reverse is also true. If the markets are selling off and traders are jumping in on the move down to the point where a tick reading of -1,000 is registered, I want to step in and buy. There isn't any cleaner way to get on the opposite side of amateur traders who are chasing the market. I've been shown a couple of different renditions of this setup by other traders. The \$TICK has been around for a long time, and many people who have been doing this for decades have a portion of their trading tied into the \$TICK movement.

In this chapter, I'm going to first cover the fading strategies. Toward the end of this chapter is new information on how and when to “go with” extreme tick readings, meaning that when a +1,000 reading is hit, how to know when to wait for a pullback to the 0.00 line to actually buy and “go with” that extreme \$TICK reading. Note that I use the terms \$TICK, tick, and ticks interchangeably, and they all mean the same thing. When I'm trading, I'll tell someone, “The ticks are high here.” I don't say, “The dollar sign tick is high here.”

What Are the Trading Rules for Sell Fades (Buys Are Reversed)?

1. I have studied three different setups that I have learned from other traders and have modified to fit my own trading plan and style. Let's look at the parameters I use for this “extreme emotion” play. I take trades only between 10:00 a.m. and 3:30 p.m. eastern. A lot of sporadic action can happen during the first and last half-hour of trading. I like to let the markets settle in before I take trades.
2. I play tick fades in two markets, the E-mini S&Ps (ES) and the mini-sized Dow (YM). These can also be played in the SPY, DIA, E-mini Russell, E-mini Nasdaq, and any stocks that are mirroring the action of these indexes. For option traders, it is perfectly okay to use options on the SPY to do this trade. Of course, you should choose slightly in-the-money options when doing this. My preference, of course, is options with a delta of at least 0.70.
3. When the ticks reach +1,000, I short at the market. I like to set audio alerts for +1,000 and -1,000 readings. That way, I don't have to stare at the chart. If the ticks get to +988 and fall back, I don't take the trade because I won't hear my audio alert. This keeps the setup clean and very specific, and not subject to trader interpretation.
4. For the YM, I use a 30-point stop and a 20-point target. I also set a time limit of 35 minutes on this trade. If my stop or target isn't hit within the 35-minute time span, then I exit my position at the market. I like to use a timer with a beep so that I'm aware of when the 35-minute time limit has passed. Most traders have very little sense of time when they're in a trade.
5. For the ES, I use a 3-point stop and a 2-point target, as well as the same time limit.
6. If I am stopped out twice in a row on this trade, I am done with tick fades for the day. By “stopped out,” I mean that my physical hard stop is hit, as opposed to the time stop. Note that it is on these days that I will switch to a “go with” strategy, which I will talk about later in this chapter.
7. If by 12:00 noon eastern the ticks have spent more than 85 percent of their time above zero, I will pass on all other tick fade plays for the day. This shows an extreme level of buying in the market, indicating that funds are accumulating stocks. These “power days” are rare, but they do happen about once every four to six weeks. They are accompanied by many extreme tick readings above 1,000, typically between 1,200 and 1,400 ticks. In addition, if it is past 10:00 a.m. eastern and

the ticks have all been one-sided, for example, all positive on the day, I will wait until the ticks have spent some time in negative territory before setting up the first tick fade play. On these days, this is a sign to “go with” the ticks.

What Are Specific Examples of Tick Fade Setups?

Mini-Sized Dow—September 2004 Contract, September 1, 2004

1. Shortly after 10:00 a.m. eastern on September 1, 2004, the ticks move up through +1,000 (see [Figure 9.1](#)). I short the minisized Dow at the market and am filled at 10,192. I place a stop at 10,222 and a target at 10,172. I also set my timer for 35 minutes.

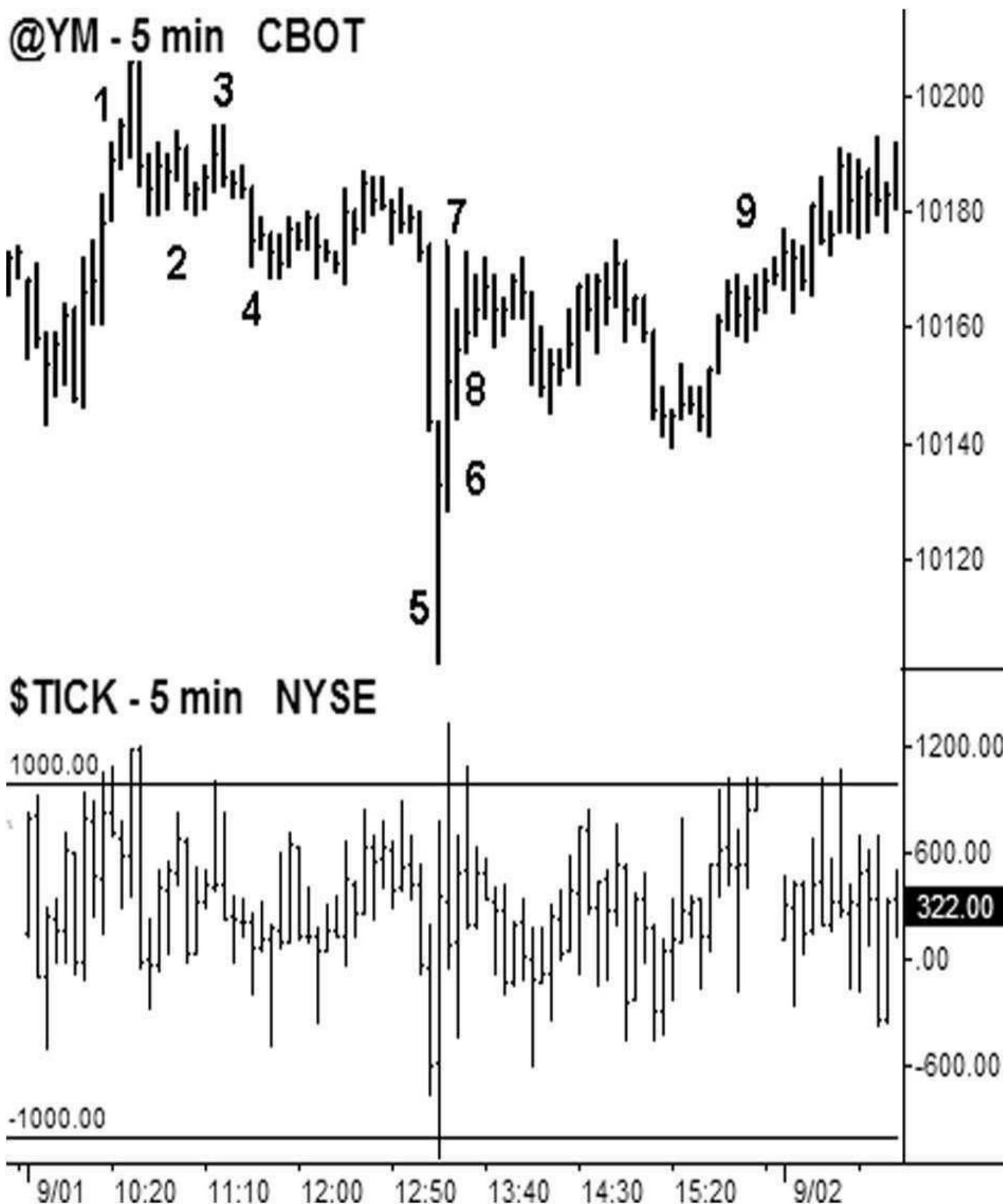


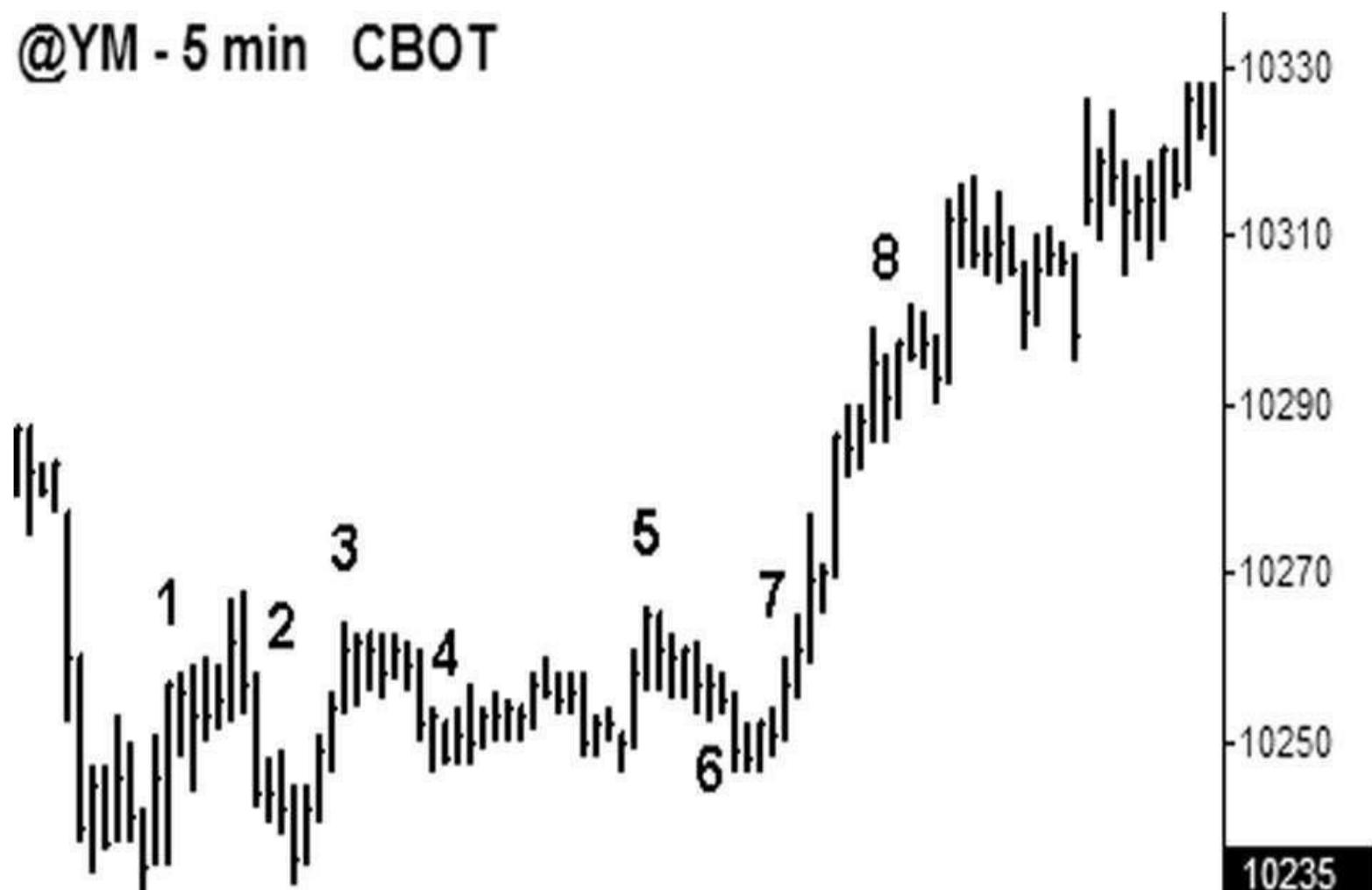
Figure 9.1

2. The markets drift lower, but after 35 minutes, neither my target nor my stop has been hit, so I exit at the market. I am filled at 10,182 for +10 points.
3. The ticks hit +1,000 again at point 3, and I short at the market. I am filled at 10,194. I place a 30-point stop and a 20-point target.
4. The markets roll over, and my target is hit 20 minutes later at 10,174, for +20 points on the trade.
5. The markets sell off hard, and the ticks get down to -1,000. I buy at the market and am filled at 10,118. I place a stop at 10,088, 30 points below my entry, and a target at 10,138, 20 points above it.
6. My target is hit within eight minutes, and I am out for +20 points.
7. The ticks reverse and quickly hit +1,000, and I short at the market. I am filled at 10,168.
8. The markets roll over quickly, and I am out at 10,148 for +20 points.
9. The ticks hit +1,000, but it is 3:50 p.m. eastern, so I don't take the trade. Remember, according to my trading rules, I don't take any new tick fade trades after 3:30 p.m. eastern.

Mini-Sized Dow—September 2004 Contract, September 10, 2004

1. On September 10, 2004, the ticks hit +1,000 shortly after 10:00 a.m. eastern (see [Figure 9.2](#)). I short at the market and am filled at 10,252. I place a 30-point stop and a 20-point target from my entry level, and I set my timer.

@YM - 5 min CBOT



\$TICK - 5 min NYSE

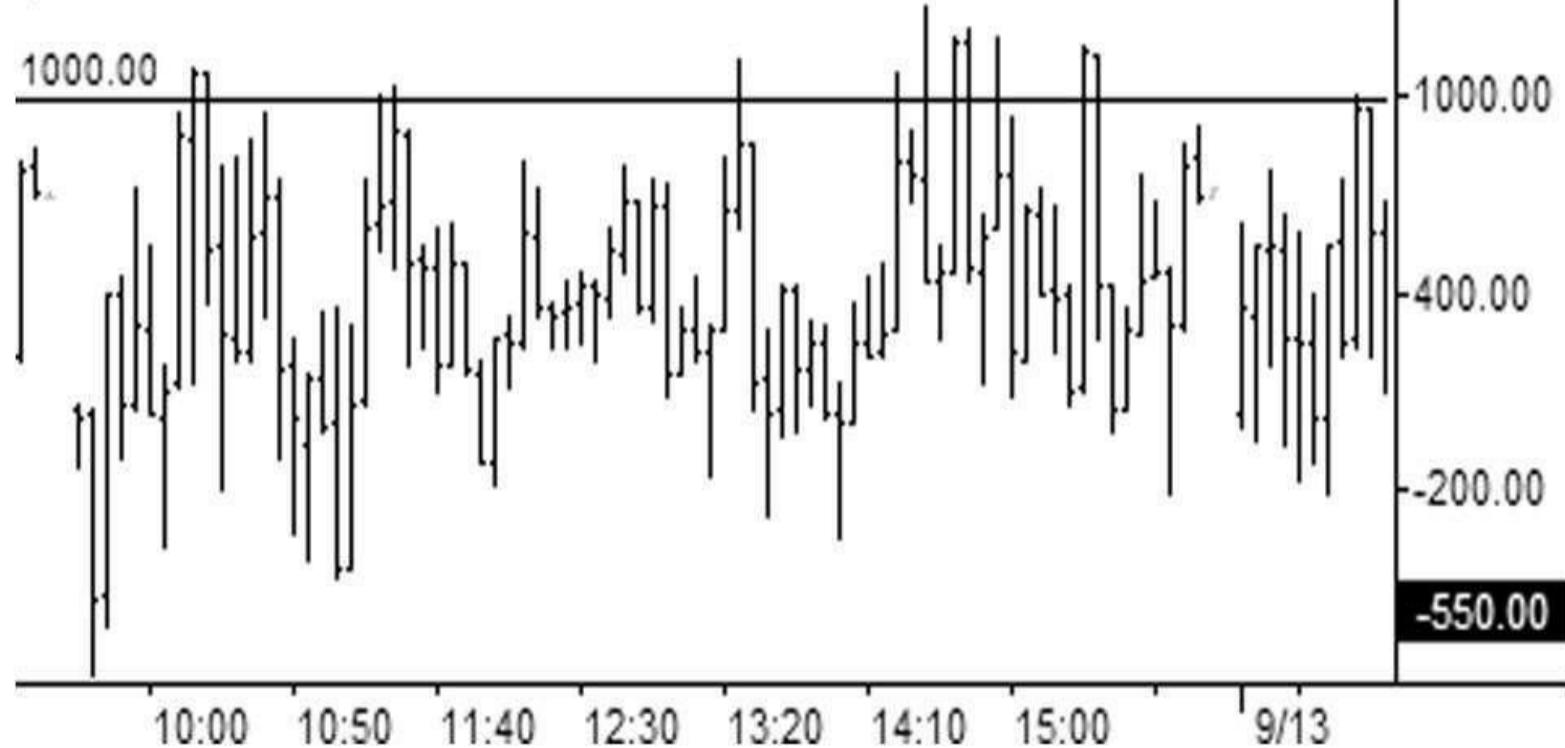
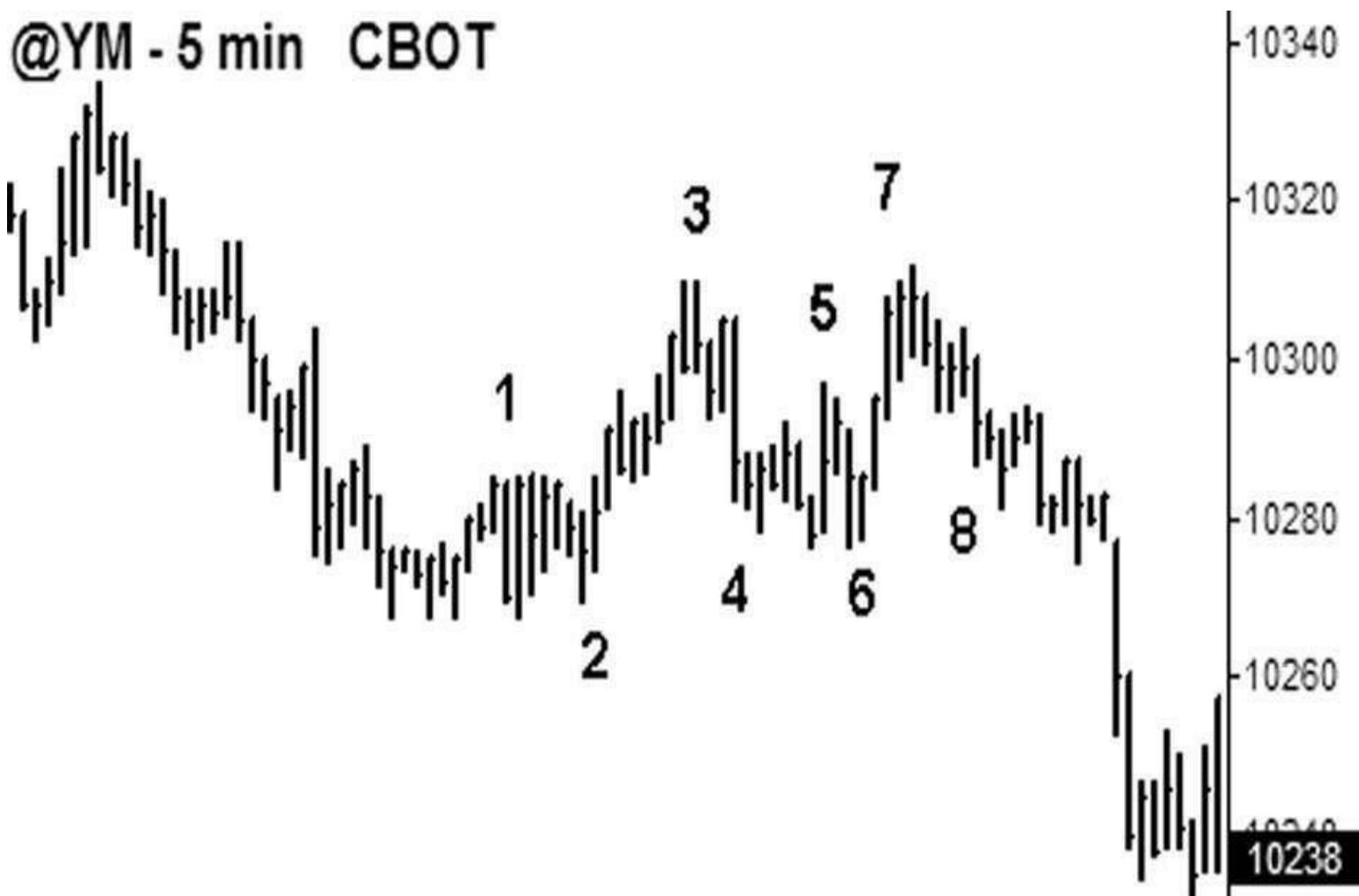


Figure 9.2

2. Thirty-five minutes pass, and my timer goes off, so I exit at the market and am out at 10,257, a loss of 5 points.
3. The ticks ramp up again and hit +1,000, so I short at the market and am filled at 10,262.
4. Time flies when you are having fun. My timer goes off after 35 minutes, and I exit at the market. I'm out at 10,252 for a gain of 10 points.
5. The ticks head north of +1,000 in the middle of the day. The only reason I'm aware of this is that my audio alert goes off. At the time, I was on the phone. I drop it and run over to the computer, short at the market, and am filled at 10,264. I set my parameters, set my timer, and go back to my phone call.
6. I hear my timer go off again, and I come back to my computer and see that I am still in the trade (that is, neither my stop nor my target has been hit), and I exit at the market. I get out at 10,255 for +9 points. I don't try to finesse these timer exits—I just get out.
7. The ticks push past +1,000, and I short at the market. I'm in at 10,257. I place my stop and place my target.
8. The ticks continue to push higher, and the market rallies. My hard stop is hit for a loss of 30 points.

Mini-Sized Dow—September 2004 Contract, September 9, 2004

1. Around noon on September 9, 2004, the ticks hit +1,000, and I short at the market (see [Figure 9.3](#)). I am filled at 10,283. I place my stop and my target, and I set the timer.



\$TICK - 5 min NYSE

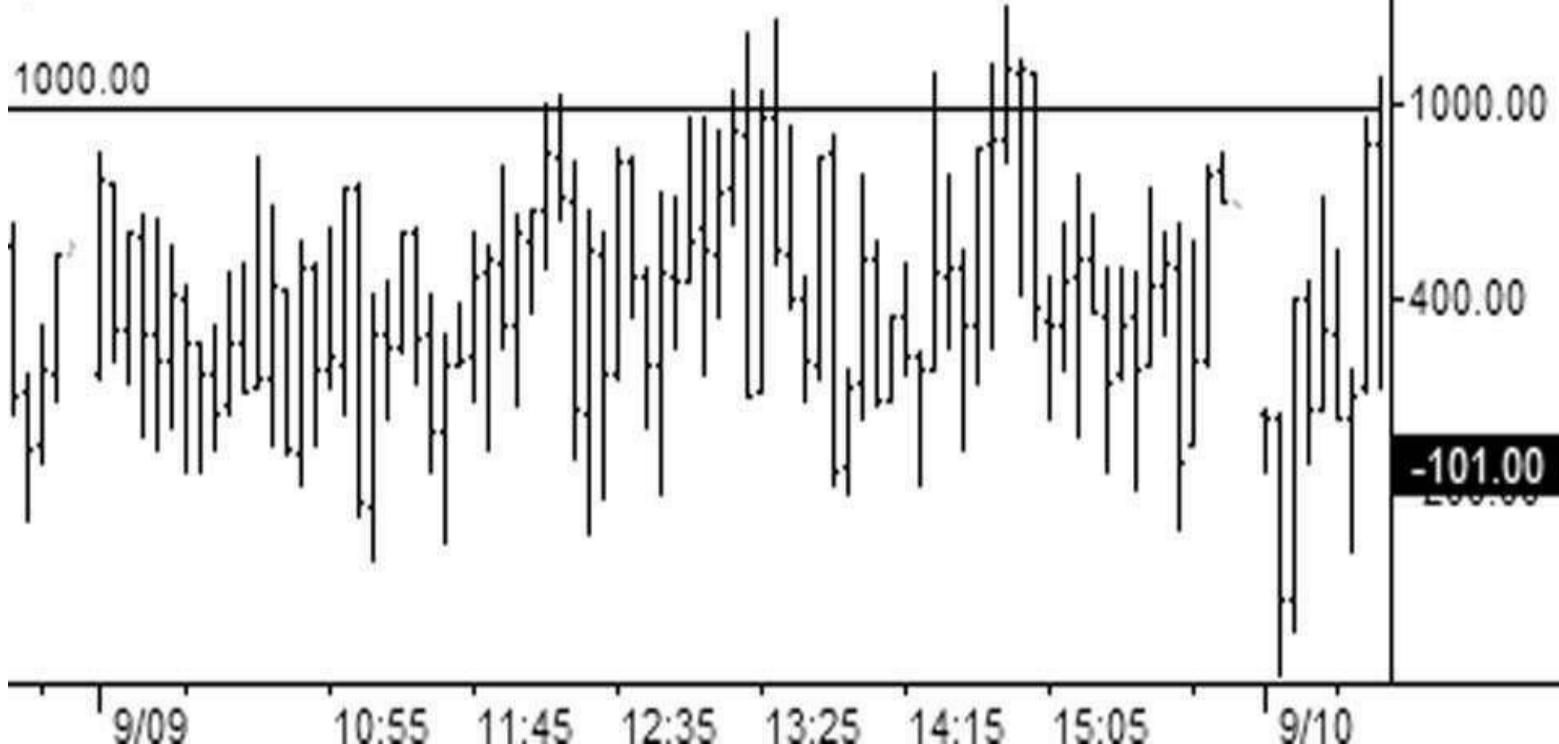


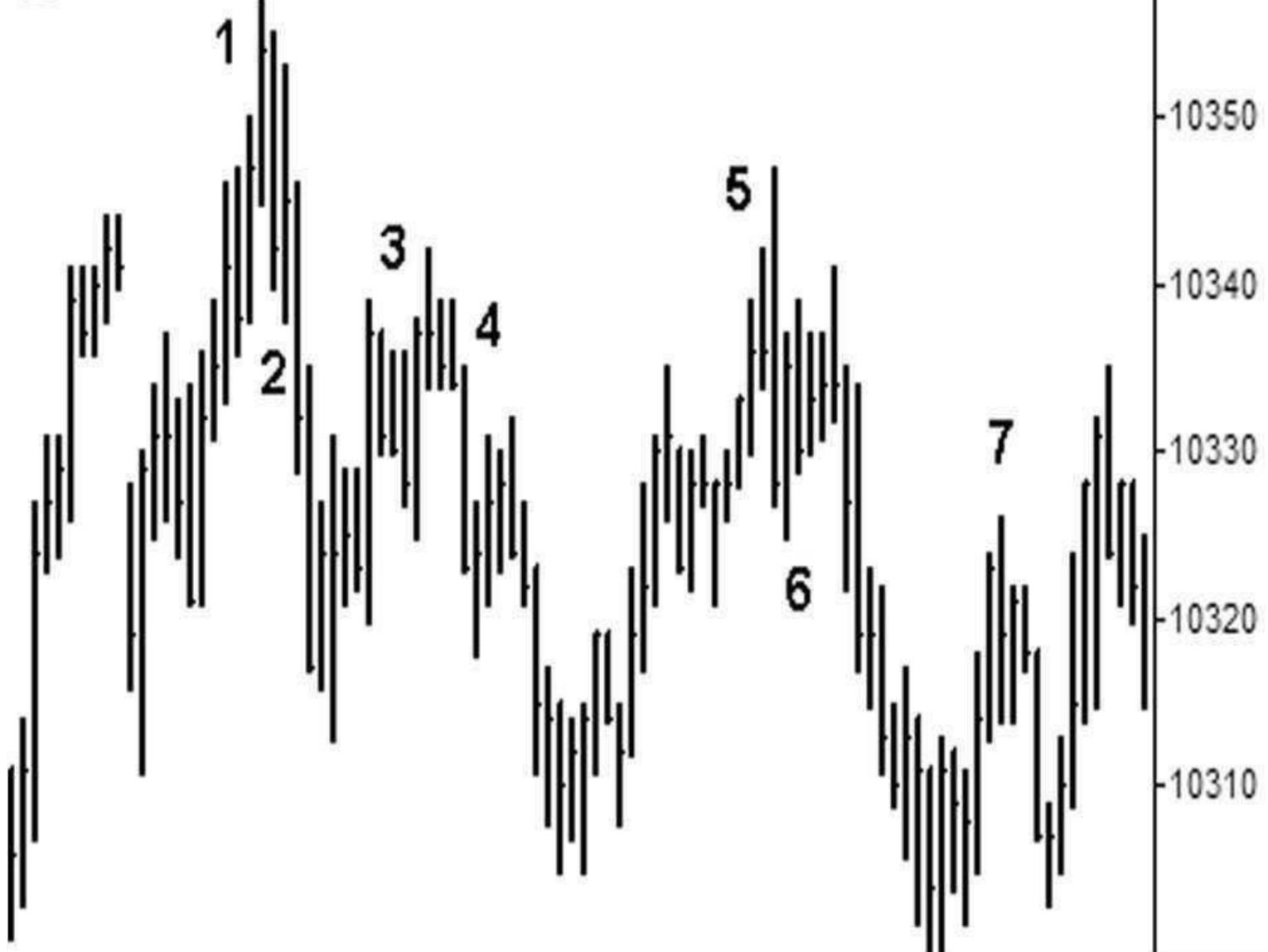
Figure 9.3

2. After 35 minutes pass, I exit at the market at 10,272 for a gain of 11 points.
3. The ticks again push up past +1,000, and I short at the market. I get in at 10,306, and I place my parameters.
4. The market drifts down, and after 25 minutes my target is hit at 10,386, and I am out for +20 points.
5. The ticks pop up again, and I short at the market. I am in at 10,297.
6. Fifteen minutes later, my target is hit at 10,277, and I am out for +20 points.
7. The markets shoot higher on ticks of +1,000, and I short at the market. I'm filled at 10,308.
8. The markets roll over, and my target of 10,288 is hit, for a gain of 20 points. In the end, this beats working for a living.

Mini-Sized Dow—September 2004 Contract, September 8, 2004

1. On September 8, 2004, the ticks register a +1,000 reading shortly after 10:00 a.m. eastern, and I short the YM at the market, getting filled at 10,355 (see [Figure 9.4](#)). I place my stops and targets and kick back. Once I get into these trades, there is nothing to do but wait.

@YM - 5 min CBOT



\$TICK - 5 min NYSE

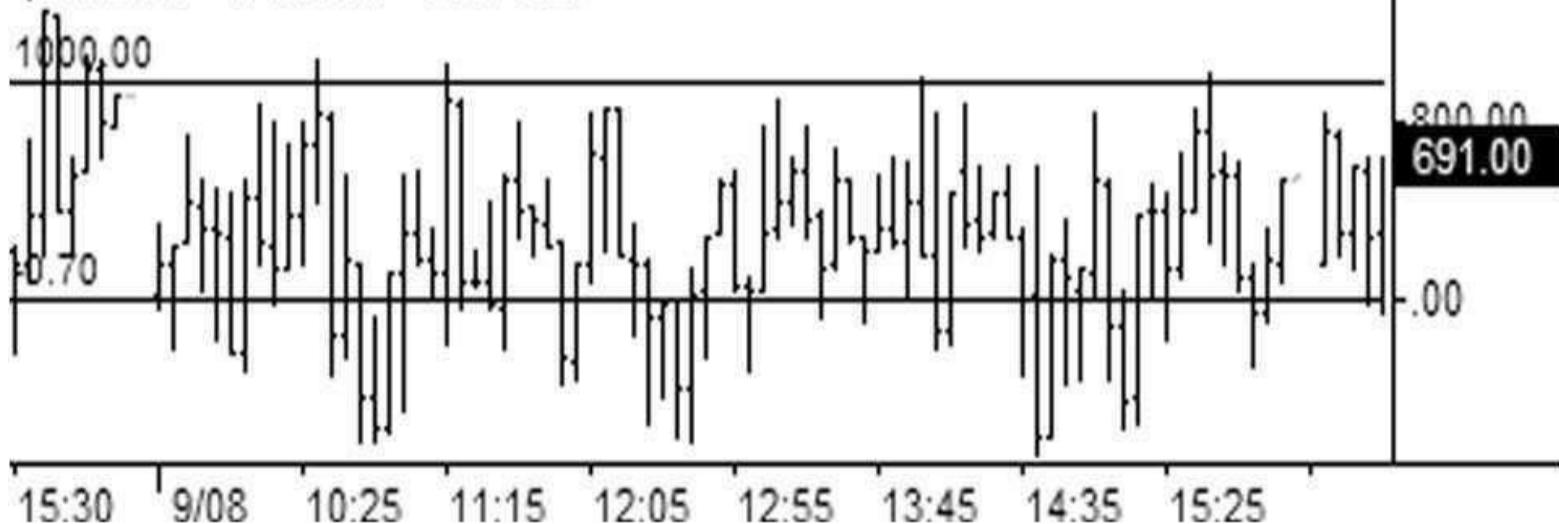


Figure 9.4

2. The market rolls over quickly, and my target at 10,335 is hit in 10 minutes for +20 points.
3. About 40 minutes later, the ticks act up again, and I short at the market, getting in at 10,337.
4. The markets go into chop mode, and 35 minutes later my timer goes off and I exit at the market, getting a fill at 10,335 for a whopping +2 points.
5. A few hours later, the ticks start getting “jiggy with it,” and I short and get filled at 10,346.
6. About 15 minutes later, my target is hit at 10,226, and I’m out for +20 points.
7. The ticks ramp up again, but I pass on this trade because it is now past 3:30 p.m. eastern. The trade would have worked out at a +20-point trade, but I have found that tick plays in the last half-hour tend to be less reliable.

Mini-Sized Dow—September 2004 Contract, July 26, 2004

1. On July 26, 2004, the market action starts off weak, but there aren’t any extreme tick readings until just after 11:00 a.m. eastern (see [Figure 9.5](#)). At this time, I get a -1,000 tick reading, and I buy the YM at the market, getting a fill at 9912. I place my orders for my stop and target, and I set my timer.

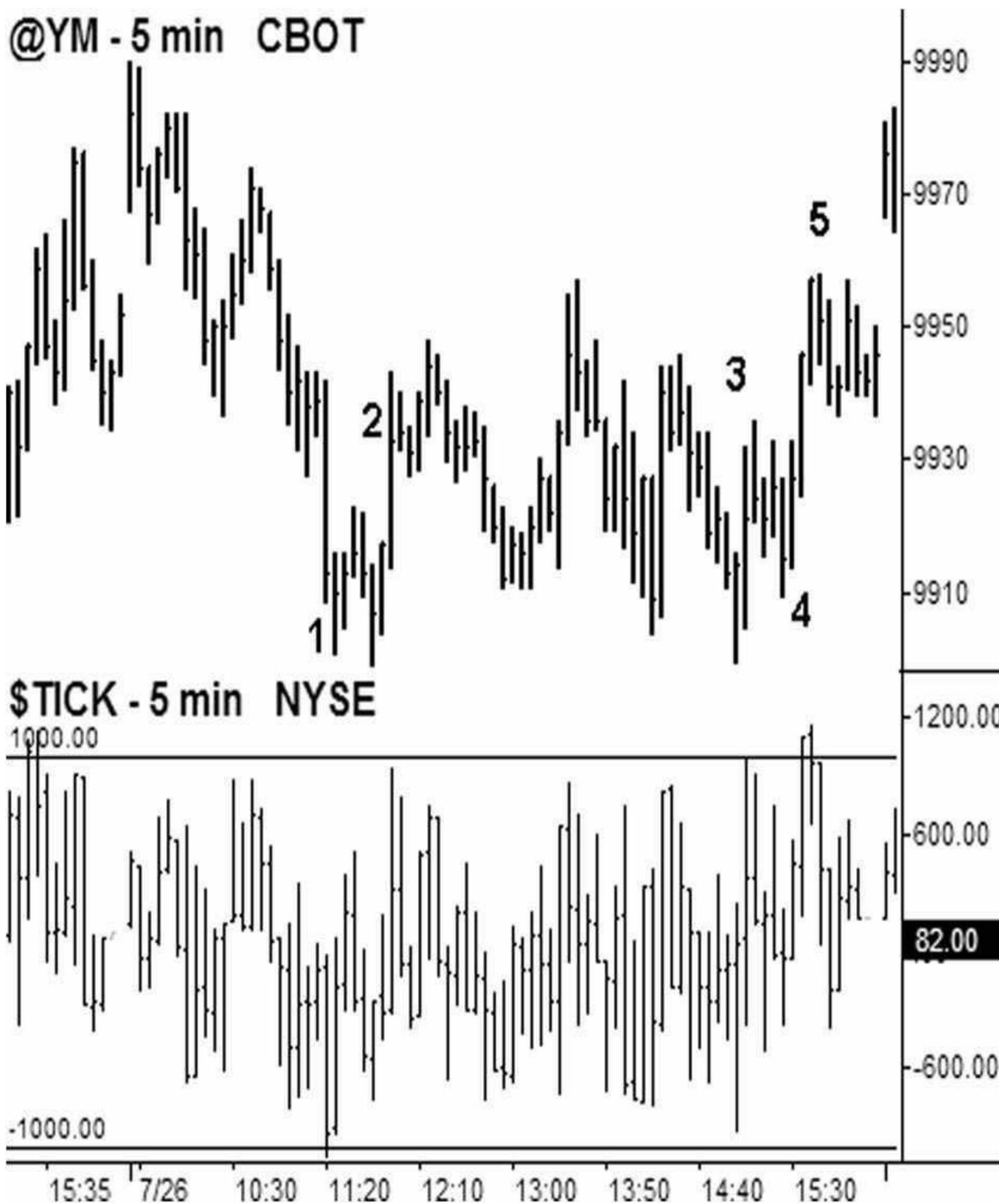


Figure 9.5

2. After about 30 minutes in the trade, the market firms, and I get out at my target of 9932 for +20 points.
3. The market is quiet for most of the day, and then as it approaches 3:00 p.m. eastern, we get a +1,000 tick reading. I short at the market and get filled at 9932.
4. About 20 minutes later, my target is hit at 9912, and I am out for +20 points.
5. There is another extreme reading in the markets, but it is past 3:30 p.m. eastern, so I sit on my hands and do nothing.

E-mini S&P—September 2004 Contract, September 7, 2004

1. On September 7, 2004, I get an early +1,000 tick reading (see [Figure 9.6](#)). I'm watching the E-mini S&Ps, and I'm tempted to short, but I look at the time, and it is near 9:50 a.m. eastern. This is before my parameter of 10:00 a.m. eastern, so I pass on the trade. Although this trade would have worked out in my favor, I have found that tick trades in the first 30 minutes of trade are haphazard at best.

@ES - 5 min CME



\$TICK - 5 min NYSE

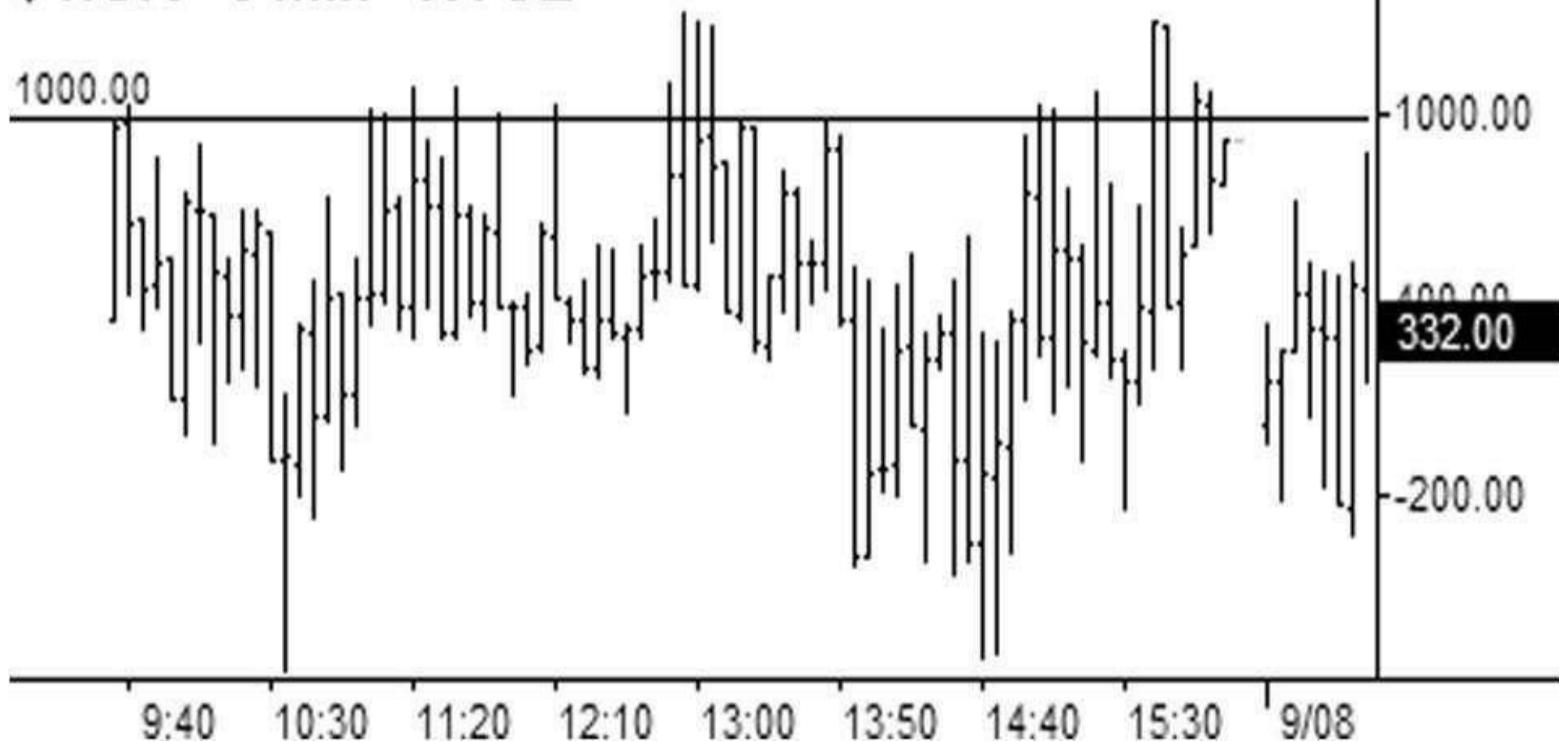


Figure 9.6

2. I wait for the next setup, and it hits the tape near 11:30 a.m. eastern with a +1,000 tick reading. I place an order to short the E-mini S&Ps at the market, and I get a

fill at 1119.75. I place a 3-point stop at 1122.75, and I place a target at 1117.75. Of course, I also set my timer to buzz me when 35 minutes have elapsed.

3. The 35 minutes pass by rather quickly, and the only interesting thing that has happened is that my two-foot-long arrowana (a tropical fish from the Amazon that looks like a tarpon) tried to jump out of its tank, causing me to jump like I'd been hit with a cattle prod. Regardless of this distraction, I hear my alarm go off, and since neither my target nor my stop has been hit, I execute an order to get out of my position at the market. I am out at 1121.25 for a loss of 1.50 points.
4. Soon thereafter, an episode of "ticks gone wild" hits the tape, and they move back up to +1,000. I short at the market and am filled at 1122.00. I place my stop and target and set my timer.
5. My timer goes off while I'm enjoying a smoked turkey breast sandwich from Panera Bread Company. I exit at the market at 1121.50 for -0.50 point.
6. The markets pop higher on a +1,000 tick reading, and I short at the market. I'm filled at 1123.50. I set my parameters, kick my feet up, and watch the action.
7. The next 35 minutes pass by swiftly, and at the sound of my buzzer, I execute an order to cover at the market. I'm out at 1123.50 for a scratch trade.
8. The ticks hit +1,000 again, and I short at the market. I am filled at 1124.75.
9. This time the markets roll over, and my target is hit at 1122.75 for +2.00 ES points.
10. As we move into the last hour, the ticks dare to hit +1,000 yet again. I short at the market and am filled at 1119.75.
11. The market rolls over, and I am out at my target at 1117.75 for +2.00 points.

E-mini S&P—September 2004 Contract, September 3, 2004

1. On September 3, 2004, the pickings are slim. The ticks get close to +1,000 and close to -1,000, but they never actually hit these levels (see [Figure 9.7](#)). I don't mess around with these kinds of plays. Either the ticks hit 1,000 or they don't. We don't get an extreme reading on this day until the final hour, when the markets register a +1,000 reading. I leap at this opportunity to do something, and I short at the market. I am filled at 1117.25. I set my stop and my target, and I turn on my timer. I kick back and watch the action.

@ES - 5 min CME

1121.50

1121.00

1119.00

1117.00

1115.00

1

2

\$STICK - 5 min NYSE

1500.00

1000.00

500.00

187.00

0.00

-500.00

1000.00

9/03

10:55

11:45

12:35

13:25

14:15

15:05

Figure 9.7

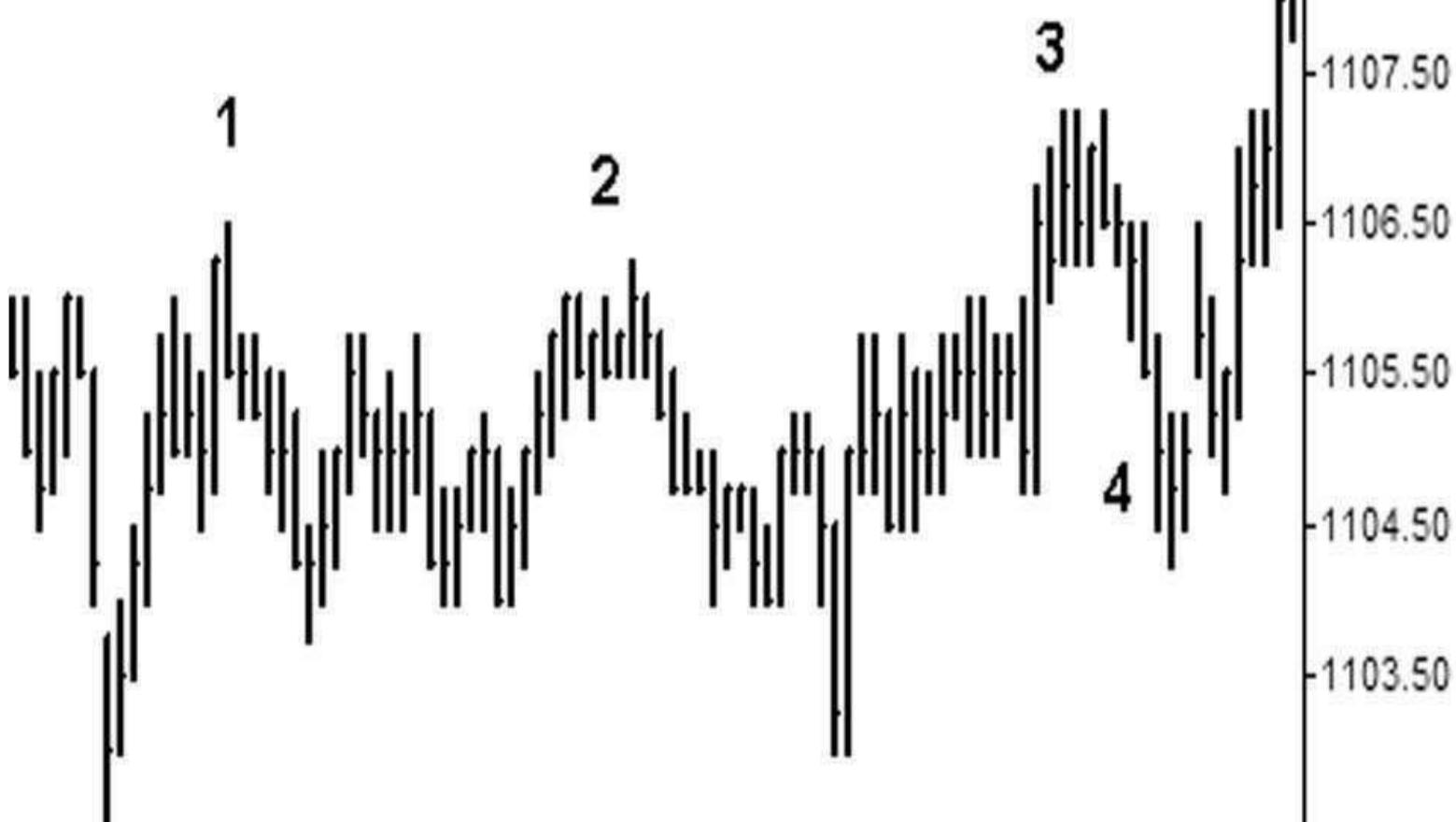
2. About 30 minutes after my entry, my target is hit at 1115.25, and I am out for +2.00 points. Conveniently, the market is approaching its close for the day, and I can

now do something more exciting, such as arrange the soup cans in the pantry alphabetically. This is a good example of why it is so important to have a specific setup to wait for. Without one, a trader can spend a day like September 3 overtrading and chopping himself up. It is tempting at times to take a trade just to alleviate the boredom. But this begs the question—is the goal of trading “not to be bored” or to make money?

E-mini S&P—September 2004 Contract, August 26, 2004

1. The ticks approach an extreme reading early in the day, but they don't quite get there, registering a high of +978 (see [Figure 9.8](#)). Since this is not a game of grenades or horseshoes, I stand aside and wait until we get an actual reading of over +1,000.

@ES - 5 min CME



\$TICK - 5 min NYSE

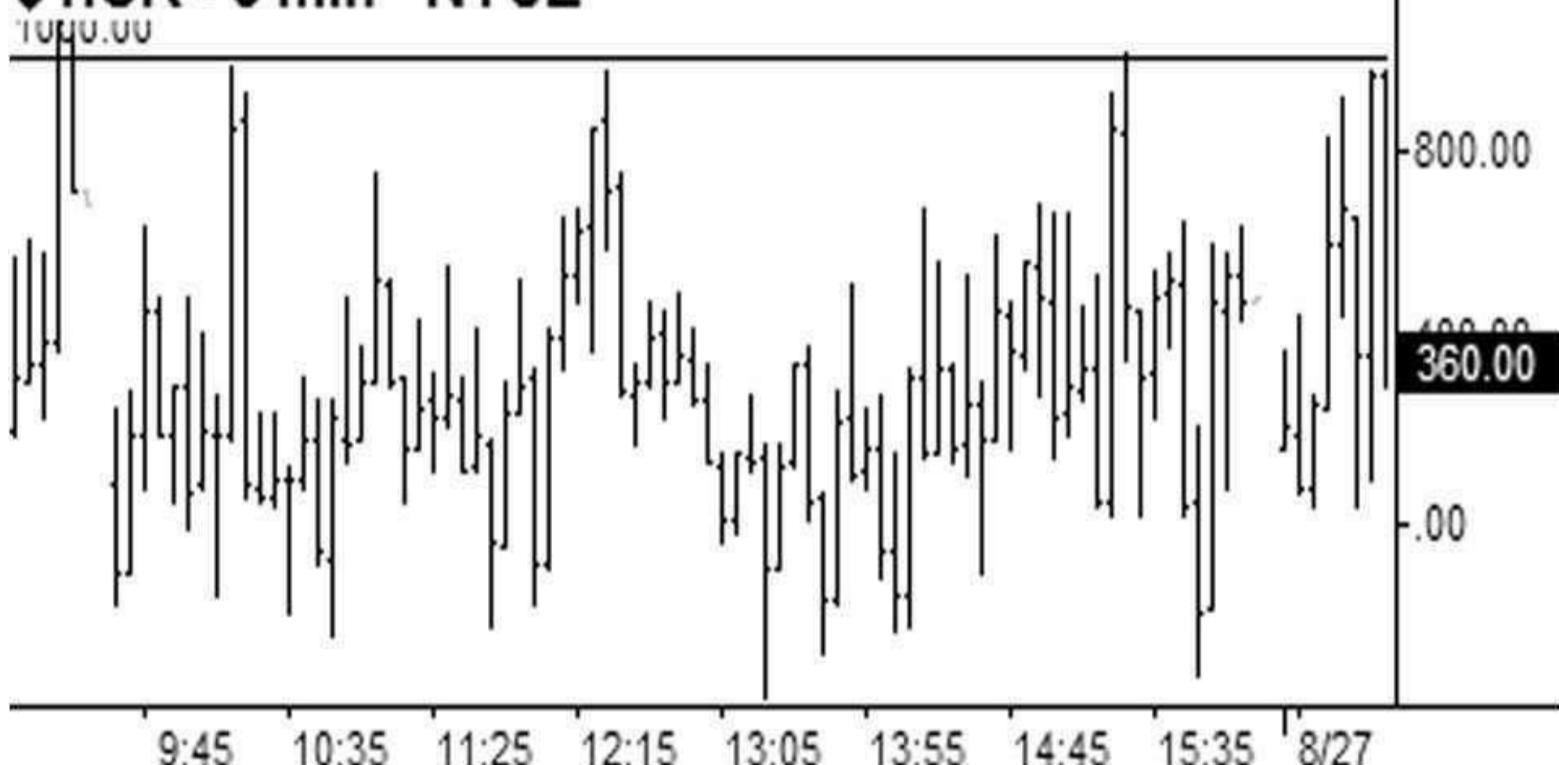


Figure 9.8

2. Again, we come close to 1,000 ticks, but we don't quite cut the mustard. I stand aside and do nothing. This actually isn't as hard as it may seem. I don't stare at the tick chart; I'm taking action only if I hear the audio alert.
3. Finally, we get a reading of over +1,000. I short at the market, and I'm filled at 1106.75. I set my parameters and await the action—having done nothing all day at this point with regard to this setup.
4. About 30 minutes later, my target is hit at 1104.75, and I'm out for +2.00 ES points.

E-mini S&P—June 2004 Contract, May 24, 2004

1. On May 24, 2004, the markets gap higher and register a +1,000 tick reading early in the session (see [Figure 9.9](#)). This is before 10:00 a.m. eastern, so I treat it just like a phone call that pops up as “out of area” on caller ID—I ignore it. Closer to 10:30 a.m., we get another +1,000 reading, and I short this action with a market order. I am filled at 1098.50, and I set my parameters.

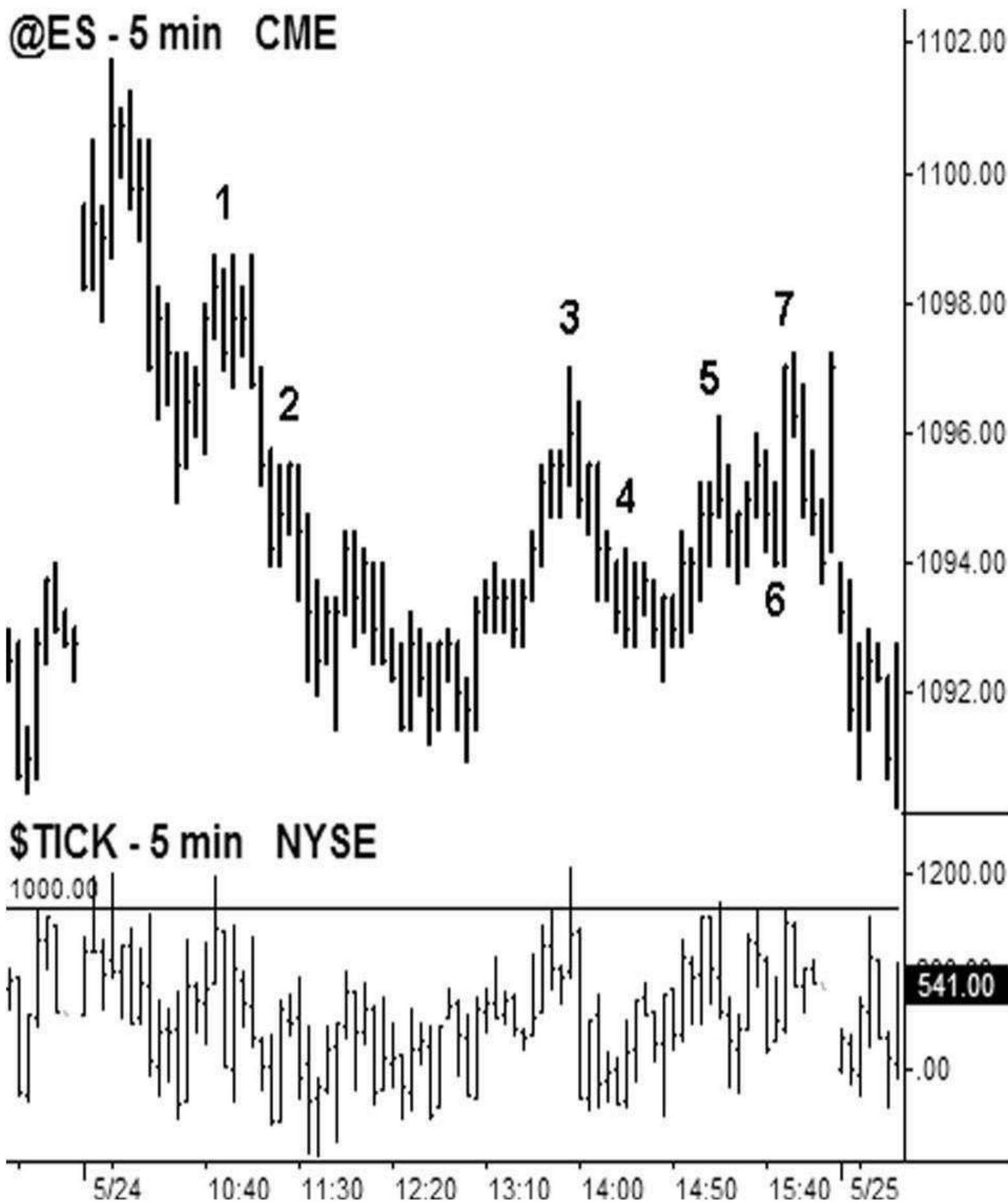


Figure 9.9

2. About 20 minutes later, my target is hit, and I'm out at 1096.50 for +2.00 ES points.
3. Most of the rest of the day is quiet, but as we approach the last few hours, we get an extreme tick reading, and I take a short at 1096.50.
4. About 25 minutes later, my target is hit, and I'm out for +2.00 ES points.
5. The ticks get wild and crazy again, hitting +1,000, so I short, and I'm filled at 1096.00.
6. The markets remain choppy, and my time buzzer goes off. I cover at the market, and I'm out at 1095.50 for a gain of 0.50 ES point.
7. The markets pop higher again and register an extreme tick reading. However, it's past 3:30 p.m. eastern, so I don't take any action on this signal.

E-mini S&P—June 2004 Contract, June 7, 2004

1. The markets gap up, and the ticks spend the vast majority of their time over the zero level (see [Figure 9.10](#)). If at 12:00 noon eastern the ticks have spent more than 85 percent of their time above zero, then I pass on any further tick fades on the day. Remember, it is on these days that there is serious buying taking place. Only consistent and steady fund buying can keep the ticks above zero all day long. That hasn't happened yet, but it's in the back of my mind.

@ES - 5 min CME

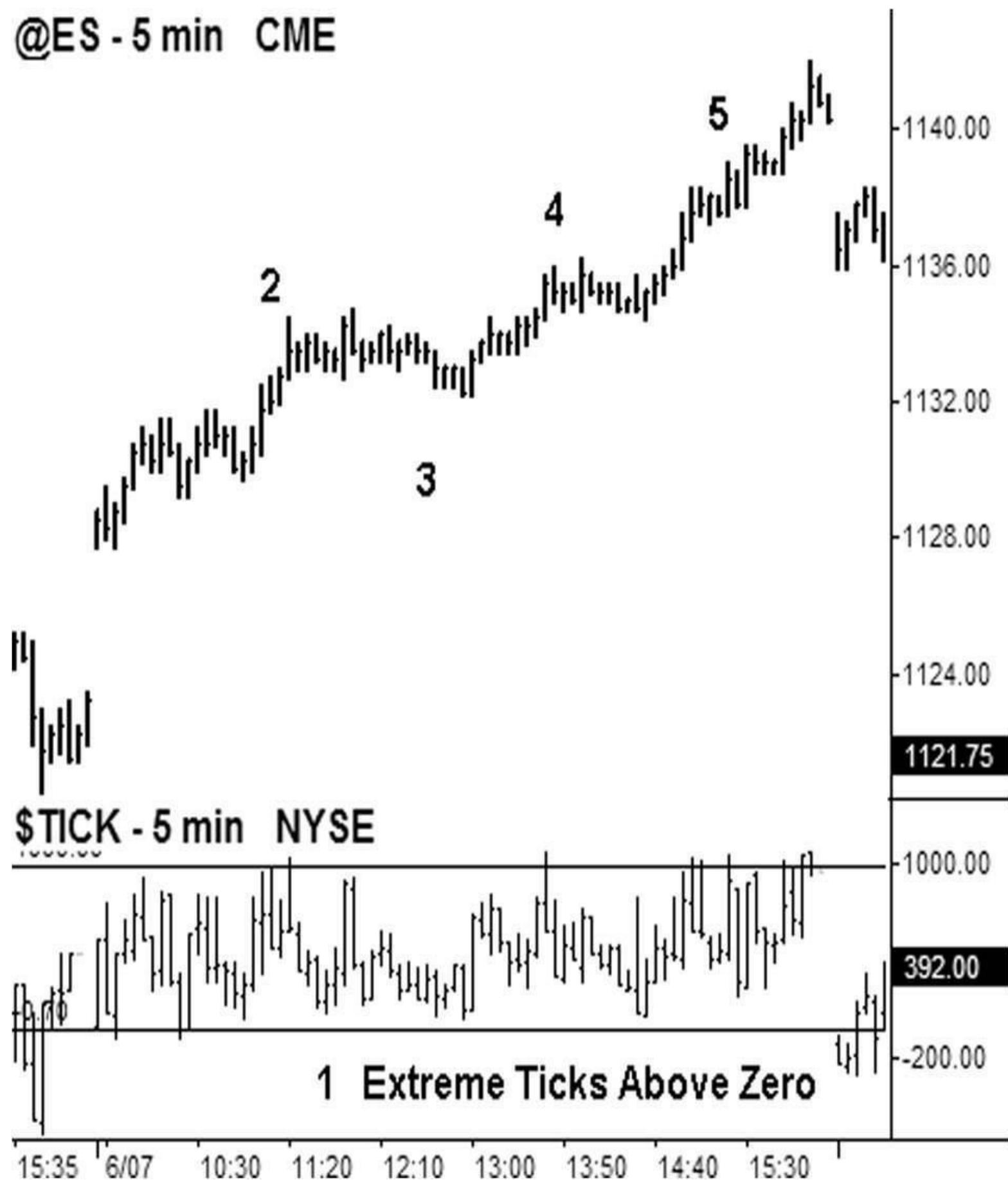


Figure 9.10

2. At around 11:00 a.m. eastern, the ticks register an extreme reading, and I short at the market. I'm filled at 1134.25, and I set my parameters. I take this short because

at this point we haven't passed the 12:00 noon eastern deadline. Also, in the rules, I mentioned that if the ticks have spent all of their time above zero by 10:00 a.m. eastern, I'd like to see at least one move below zero before taking a trade. In this case, we did get some moves just below zero. These aren't ideal conditions, but they do pass the test.

3. Time passes by quickly, and my time stop expires. I exit at the market, and I'm out at 1133.00 for +1.25 ES.
4. A little after 1:00 p.m. eastern, the ticks register another +1,000 reading. I ignore this reading because the ticks have spent more than 85 percent of their time above zero, indicating massive fund buying.
5. This happens again near 3:30 p.m. eastern, and I ignore this signal for the same reason. The markets are "on fire" today, as is evidenced by the consistent high tick readings, with hardly anything dipping below the zero level. I therefore pass on fading these extreme tick readings. Although these days are rare, it is important to know what they look like so that they can be avoided in terms of a "tick fade" day.

Summing Up the Tick Fades

As I state in the introduction, the financial markets are naturally set up to take advantage of and prey upon human nature. When traders see a market running away without them, their natural instinct is to jump onboard and participate in the run. Although this makes sense on paper, this feeling of "missing the move" causes more trading errors than almost anything else. This blinding urge forces amateur traders to jump into markets based solely on the fear that they are missing out on a lot of profits—as opposed to entering the market as a result of a specific setup that they have mapped out and are patiently waiting to set up. This extreme panic buying and selling is measured accurately by the ticks, and extreme tick readings provide traders with the opportunity to jump into the markets and teach the amateurs a valuable lesson.

How Do You Know When Fading Ticks Won't Work?

In the first edition of this book, I focused exclusively on the "fade" setup. During most of 2004 and 2005 (when I wrote the first edition), the stock indexes were extremely quiet, and most of the big momentum moves were found in the currency markets. And that's one great thing about becoming a trader of setups—the market you end up trading is irrelevant. In truth, I don't trade markets; I trade setups and patterns. I couldn't care less whether a setup takes place in the stock market, oil, or gold. Just give me something that is ready to make a move.

Since the 2008 financial crisis, however, big stock market moves have become the new normal—big moves to the upside and big moves to the downside. Either is fine with me, and the ticks play a crucial role in these types of markets as well. The bottom line is this: if the markets are crashing today, then we aren't going to try to buy a -1,000 tick reading. We are, in fact, going to use modest tick strength (instead of extreme tick strength) as an opportunity to go short.

The question comes down to this: how do we know whether we should be fading the move or going with the move? And, if we are going to go with the move, how do we play that move?

Let's jump in and take a look.

How Do We Trade "Going with" the Ticks Instead of Fading Them?

This chapter ties in a lot with the chapter on internals. The first half hour of trading is typically very telling concerning what kind of day it's going to be. It's like when I wake up in the morning and try to gauge my wife's mood. I've learned that if she's had dreams of happy things and happy places, then the day will start off positive and trend that way well into the evening. If, on the other hand, she had a dream about me and our Swedish au pair, then I know the first half hour of the day is going to be dicey at best, and the rest of the day will depend on how I navigate that early session. During those shaky times, I try to reassure her that I'm a trader at heart, and that swapping out half my net worth for a quickie with the au pair is, at best, a bad trade. Sometimes that logic seems to help. Sometimes.

Quite simply, the ticks are a road map to what the elephants are doing and where they are going. In July 2010, I traveled to South Africa for two weeks to see the World Cup. It was an amazing trip. The first week I stayed at Ulusaba, which is Richard Branson's game reserve, located in Kruger National Park. Although the terrain looked a lot like Texas, it was amazing to see the "Big 5" in their natural habitat, up close and personal. Of the Big 5 animals, the easiest to find were the elephants. Not only could you see their tracks, but you couldn't help seeing the knocked-over trees and their huge piles of dung. For them, hiding was impossible. (As opposed to the jaguar, which was extremely difficult to find. In trading, just be the jaguar quietly following the elephant.)

Large-scale coordinated institutional buying and selling is the same. It is impossible for them to hide if you know where to look. The \$TICK marks their trail through the bush, along with their steaming piles of dung. As traders, all we have to do is follow along for the ride.

In [Figure 9.11](#), we have a snapshot of the \$TICK and SPY from Friday, September 30, 2011. On this particular day, the first few hours of trading are on the quiet side. The market gaps down big, about 15 ES points (150 Dow points), which is \$1.50 on the SPY. It takes time for traders to digest this move, and the first few hours see choppy action. The first extreme \$TICK reading occurs at 11:20 a.m. eastern, when the ticks hit the +1,000 level. The first extreme \$TICK reading of the day is a good one to fade. It's the first probe, and probes generally fail. In this case, the markets chop around for about 20 minutes and then promptly sell off.



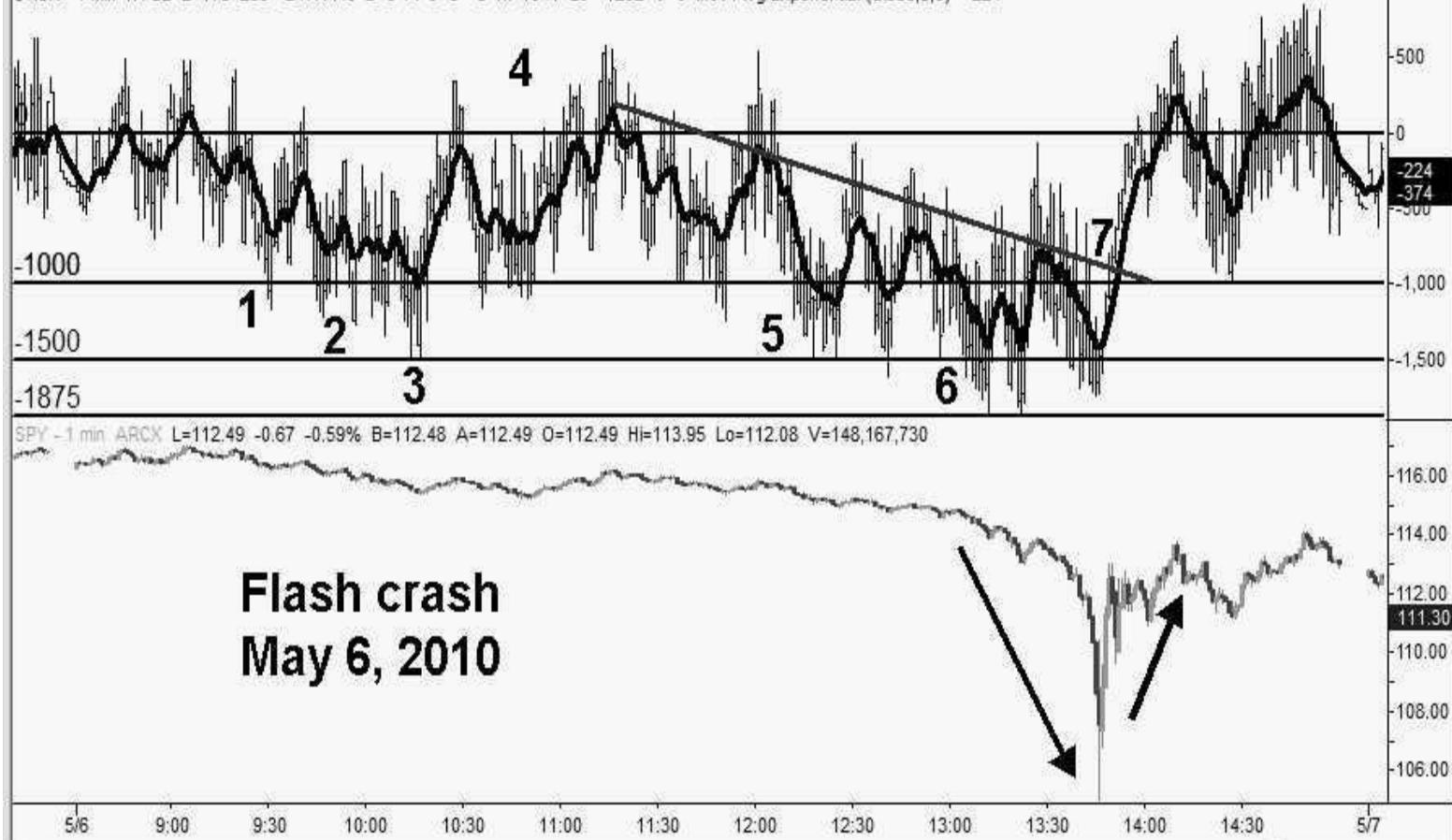
Figure 9.11

The \$TICK goes back into quiet mode, and then about an hour later we get the first extreme \$TICK reading to the downside. At this point, even though the market has gapped down more than 15 ES points, it is still choppy. There isn't any real trend in place. This might seem like a scary \$TICK reading to buy because the market is down so much, but in reality it's the first real probe to the downside during the cash session (the rest of the selling occurred during the overnight session). It's worth a shot. After the extreme \$TICK reading, the market did indeed set up a nice rally, so fading the first extreme \$TICK reading of the day is working nicely.

At point 3, the dynamics change. First and foremost, the market is no longer choppy. It's making new lows on the day. That's not chop; that's trend. It is after this point, however, that things get interesting. Try as they might, the ticks cannot push much above the +200 level, and when they do, they are rejected handily. Not only are they now spending most of their time below zero, but they continue to probe the -1,000 level and beyond. And that's the real key here. If a market tests -1,000 and bounces back, that's a probe. If, on the other hand, a market tests -1,000 and then keeps hanging around at that level, even testing lower \$TICK levels, then there is some real selling coming into the markets. The final stake in the coffin here is when any move back toward the 0.00 line is quickly rejected. Then we know that the elephants are selling, and they are selling hard.

In situations of this type, there are two strategies. First, any move to the 0.00 line is a shorting opportunity. The stop loss is a market that stays above +600 for more than a minute or 4 to 6 ES points, whichever comes first. The target is another move to -1,000. Into this ferocious selling, it's okay to cover your short, and then reload at the next retracement \$TICK move to the 0.00 line.

Let's look at an extreme example. Sometimes, as in all areas of life, it helps to look at an extreme situation in order to get a better reading on how to handle something that's "normal." In [Figure 9.12](#), we see the \$TICK and how it behaved on the day of the infamous "flash crash," May 6, 2010. This is a one-minute chart, on which I've placed an eight-period exponential moving average (EMA). The moving average is helpful for watching the "trend of the \$TICK" intraday. As I've mentioned already, moving averages are a lagging indicator, and they aren't useful for spotting "immediate" changes in trend. However, they are useful for clarifying that a trend "has now changed." Many traders blow out their accounts trying to prove they are right. Moving averages are glaring road signs that indicate when it's time to throw in the towel and change tactics. Still shorting when the moving averages have crossed and turned higher? Good luck with that.

**Figure 9.12**

This day starts out normally enough. We can see that at point 1, we get the first extreme \$TICK reading of the day at -1,000. This is a normal reading. At point 2, we start to get consistently extreme readings, which is the first heads-up that this is going to be a “go with” day. At this point, however, there is nothing telling us what is about to unfold. At point 3, we get the first -1,500 \$TICK reading of the day. This is unusual and shows that there is extreme downside pressure in this market. At this point, we are looking at all rallies in the \$TICK as an opportunity to get short.

For a few hours, the market then goes into chop mode. Rallies to the 0.00 line (point 4) can be shorted and then covered when the \$TICK heads down to -1,000. Easy enough?

And then something very unusual happens. At point 5, we start to get consistent readings at the -1,500 level, which shows an incredible amount of selling pressure. This is a rare reading, and it shows that there is some “ugliness” going on out there and that this day might, in fact, be a “crash day.” Crashes can occur only when there are consistent \$TICK readings in the -1,200 to -1,500 range. If the \$TICK hangs out at these levels, the selling eventually cracks the markets. And then things get even more intense at point 6, when the \$TICK hits -1,875 and in fact tests the -1,700 to -1,800 level multiple times. The markets start selling off steadily for about 15 minutes, to the point where the Dow is down just over 300 points. And then all hell breaks loose, and the Dow drops another 600 points over the course of five minutes ... only to then recover that move in the next five minutes. “The world is coming to an end,” I hear a few people say. “Never mind, it’s not.”

Was there any way to tell that the “flash crash” was going to happen this day? Of course not. Were there telltale signs that intense selling pressure was hitting this market, and that there wasn’t any reason to be long? Yes, absolutely. Finally, was there a way to recognize that the selling pressure had come to an end? Yes.

At point 7, we can see that the downward trendline of the eight-period moving average has been broken. Moments like this represent key areas of “mentality shift” in the herd of elephants that we are trying to follow. For a while, they were heading south, and we followed them south. Now they’ve changed direction and are headed north, and there is nothing to do but follow them north. This doesn’t mean that we are able to catch the dead bottom of a move; it just means that once we are able to see that the herd has shifted, we can then also shift our focus. Once the \$TICK shifted, it became time to focus on long setups, although every ounce of rational thought fought against that idea.

In [Figure 9.13](#), I’ve zoomed in on the flash crash portion of the day. Points 1 and 2 show the extreme -1,500 \$TICK readings and the even more extreme -1,800 \$TICK readings. These are very hard for the market to “shake off.” They indicate persistent selling, with more to come. Anytime I see something like this, I expect any rallies to continue to be sold and for new lows to continue to be made on the day. The underlying intensity of this type of selling cannot be underestimated.

Shortly after point 2, the eight-period EMA turns higher and a small bounce ensues. However, remember from the previous chart that what we are looking for here is a change in trend. That doesn’t happen until point 3, when we break the trendline shown in [Figure 9.12](#) at point 7. It’s all about going with the flow and not fighting the action unfolding on the computer screen.



Figure 9.13

With [Figure 9.14](#), we have slightly more “normal” conditions. This is from Monday, October 3, 2011. The market shows some choppy strength early in the session, then rolls over into steady selling. One thing I’ve found helpful in “watching the flow of the \$TICK” is to place an 8- and 21-period EMA on the one-minute chart. On this chart, the 8-period EMA is the thick line, and the 21-period EMA is the thin line. Although I spend more time watching the actual \$TICK, these moving averages are helpful in gauging the “trend of the \$TICK,” which drives the price action throughout the day. If I see these moving averages above the zero line, then I’m inclined to focus on the long side, and if they are below the zero line, then I’m going to focus more on the short side. The crosses on these moving averages are also helpful. If the ticks are below zero, a cross of the 8-period EMA below the 21-period EMA indicates massive selling pressure. A cross of the 8-period EMA above the 21-period EMA (while below zero) indicates a pause in the selling pressure, and the reverse is also true when the ticks are above zero.

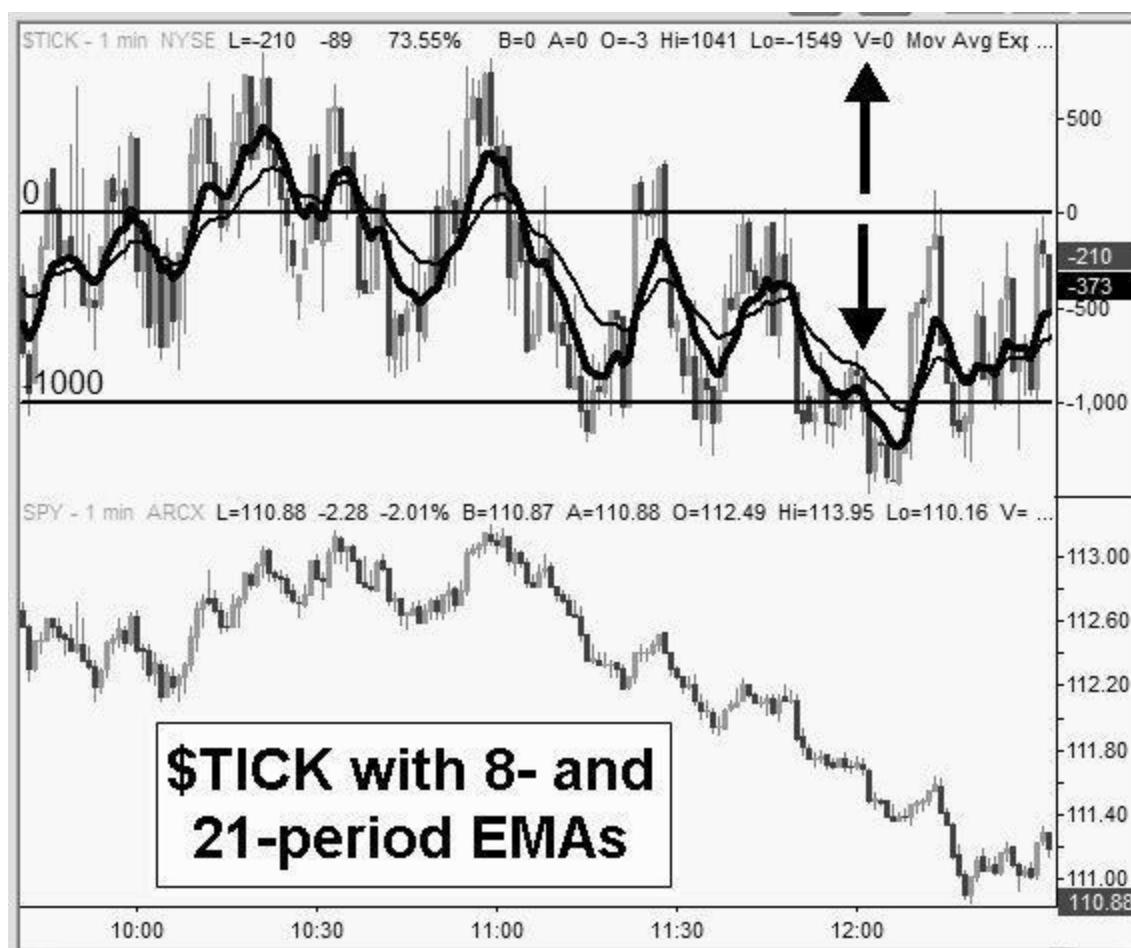


Figure 9.14

[Figure 9.15](#) shows the remainder of October 3, 2011, with the vertical line at point 1 representing the cutoff point on [Figure 9.14](#).

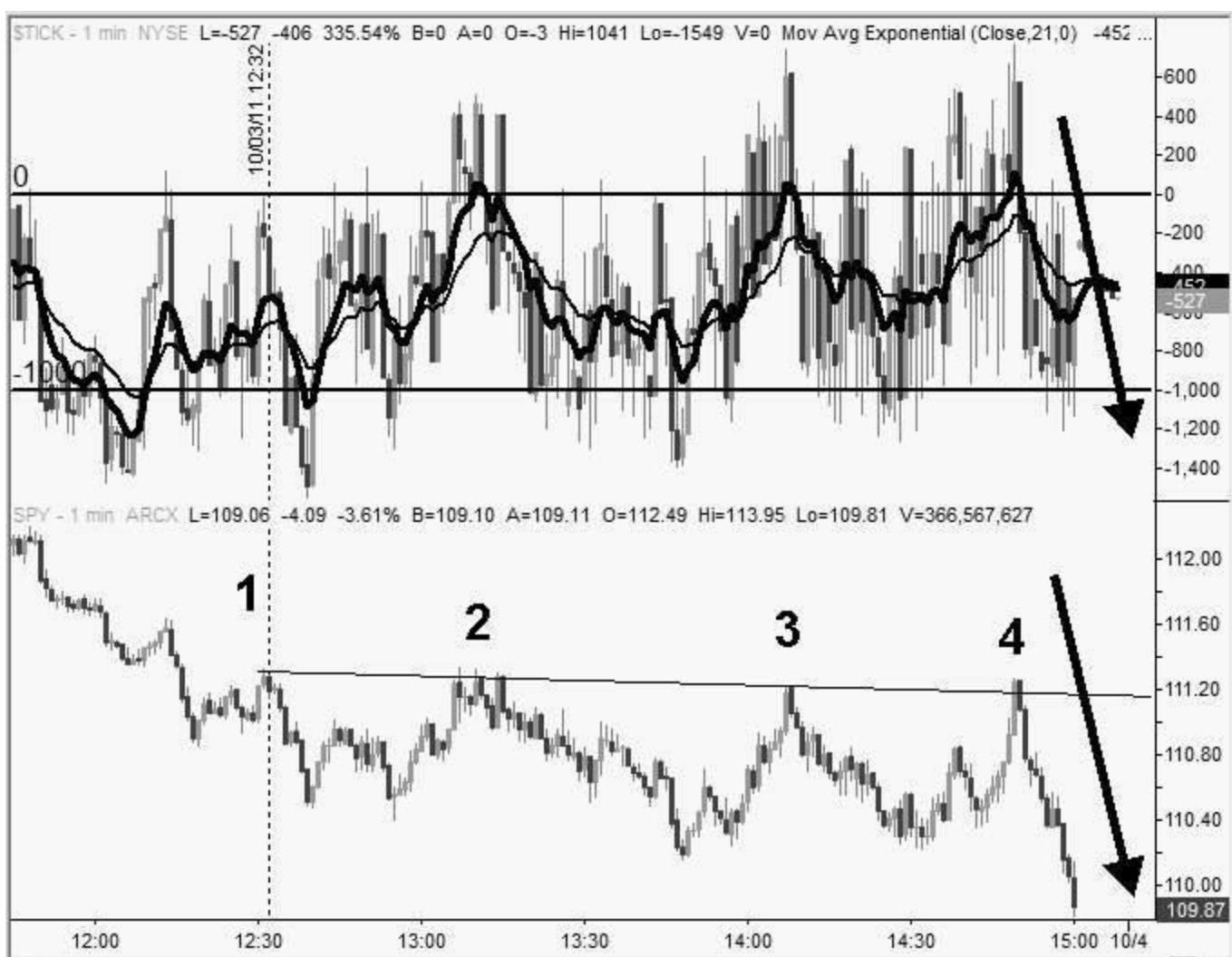


Figure 9.15

On this chart, the \$TICK rallies and the SPY rallies into point 2, only to be rejected, forming an intraday swing high, a key level that will need to get broken for there to be a significant short-covering rally into the close. At point 3, the \$TICK goes positive and the markets rally hard, only to get rejected again. Finally, at point 4, a time of day when a reversal is most likely to happen, the \$TICK rallies above zero and the SPY rallies hard, only to get handily rejected at this level once again. This time the markets plummet into the close. What do all of these key rallies have in common? Although the \$TICK went positive and a market rally looked promising, the 8- and 21-period EMAs could not both cross above zero. As long as they are staying below zero, the pressure is to the downside.

In quiet markets, fading \$TICK moves and the occasional wayward high \$TICK reading is a solid way to make a living. Watch it, though, when the elephants are moving. During those times, it's best to follow the herd.

I can't imagine day trading stocks or stock indexes without using the information provided by the \$TICK indicator. The best way to learn about how to use this indicator is simply to start using it. I've logged over 20,000 hours watching how the \$TICK interacts with the market. I've created a page at www.tradethemarkets.com/ticks with additional updates to this setup as well as live trading examples. Watching this with live examples is really the only way to learn how to maximize this trading asset.

Reverting Back to the Mean, or, “When Is the Best Time to Take a Profit?”

Where Do Markets Stop Their Current Trend and Run Out of Gas?

The pivots are great for establishing ranges in markets on an intraday basis. But what about for larger time frames, such as daily and weekly charts? Is there a way to establish extension levels to buy and sell against on a swing basis—positions that can be held for days or weeks instead of minutes or hours? Although this chapter has nothing to do with pivots, the general idea is the same. A daily pivot level represents an “average price” from the prior day’s trading, which is one of the reasons price is attracted to that level on the next trading day. It just needs to test it out and see if it will hold.

The concept of *average price* is an important one. Any particular market at any given time is either expanding away from its average price or reverting back to its average price—also known as “reverting to the mean.”

In [Figure 10.1](#), we see a daily chart of gold with a set of exponential moving averages, the 13-period EMA and the 21-period EMA. These levels, which represent the average prices over the past 13 days and 21 days, respectively, are also a continually adapting representation of a market’s key average price levels. These are the specific levels that the market is either expanding away from or reverting back to. The key question is, then, “How far away from its average price zone does a market need to get before it needs to start reverting back to that level?” That’s a great question.

This is where the concept of average true range comes into play. The average true range, referred to as ATR throughout the rest of this chapter, literally represents the average price range of the prior 14 periods of trading.

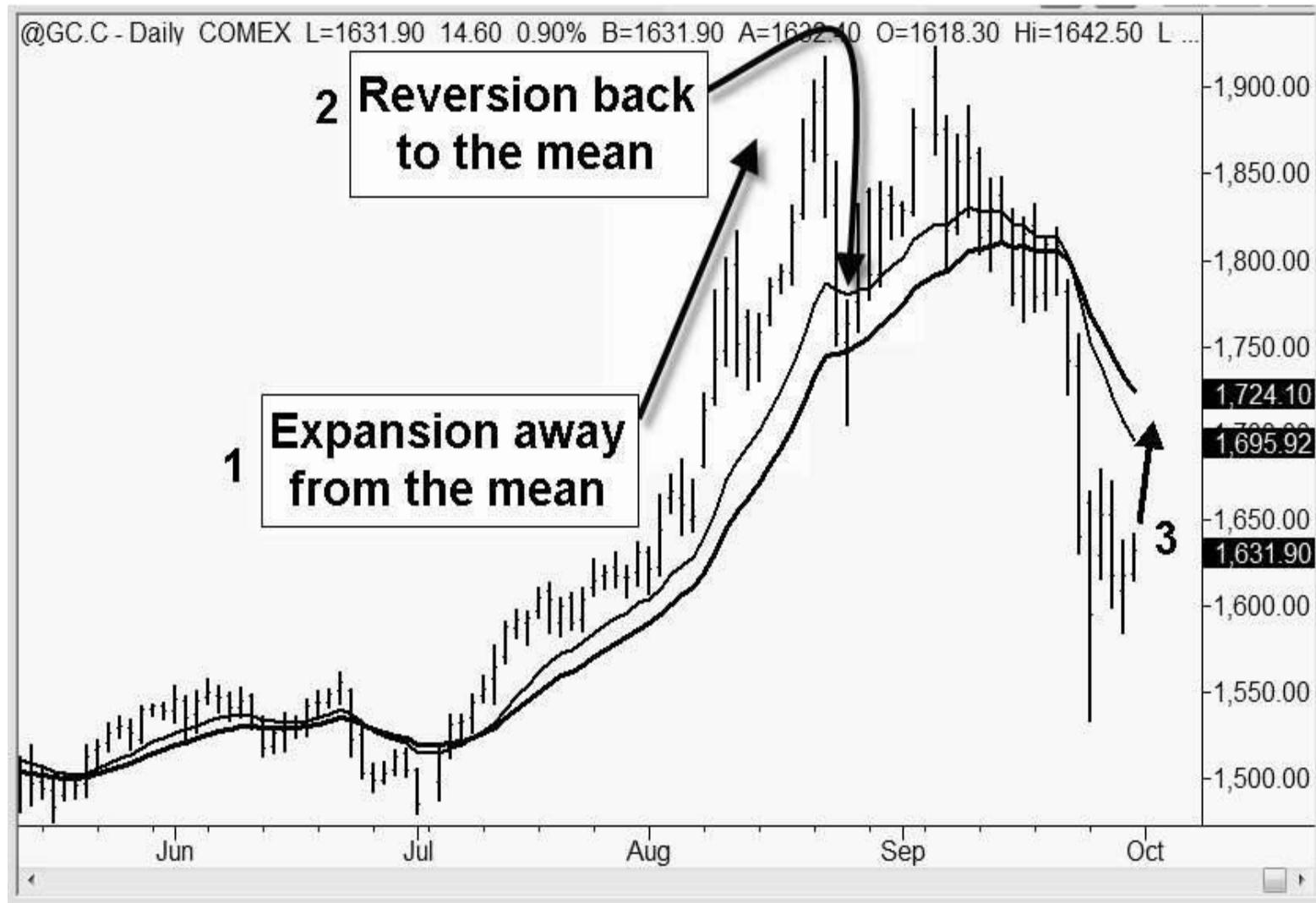


Figure 10.1

In [Figure 10.2](#), we see the same gold chart with its ATR inserted at the bottom of the chart. At point 1, the ATR is around 20, which in this case means \$20.00 an ounce on the price of gold. Why is this important? It means that most of the time, if the price action moves about \$20.00 away from the mean (the zone represented by the 13- and 21-period EMAs), then it’s going to have to start reverting back to the mean. At point 1, prices extended above these moving averages by \$20.00 an

ounce, and then started making their way back. At point 2, prices extended about \$20.00 an ounce below these levels, and then promptly made their way back to the mean. Later in the year, we can see that the ATR increases to \$60.00 an ounce, at point 3, which means that the price action could move this far away before it needed to start working its way back.

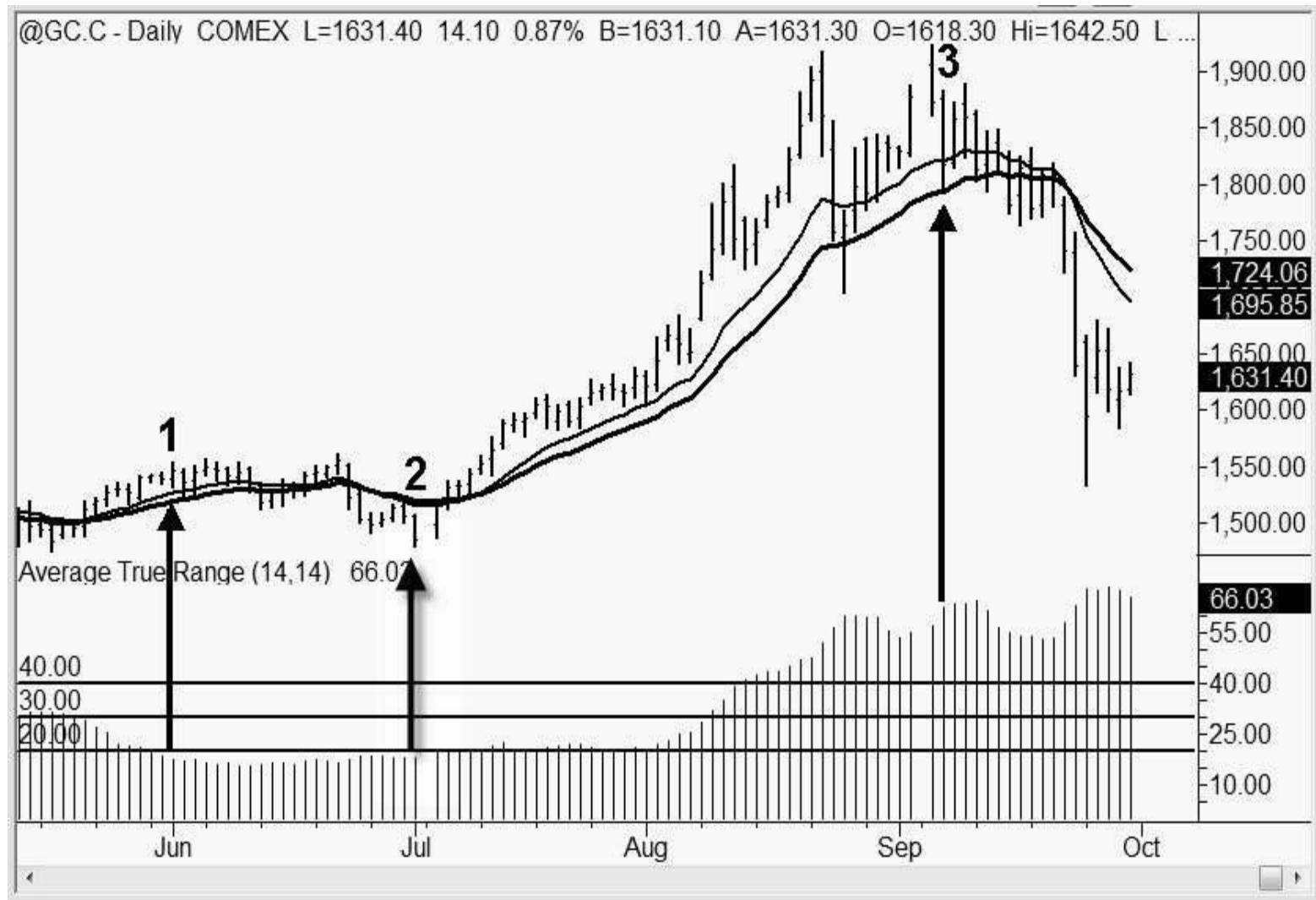


Figure 10.2

In [Figure 10.3](#), we have a daily chart of the Swiss franc (SF). On this chart, I've placed a modified version of the Keltner Channels, which plot the average true range as outer-range bands. I have the “mean” price (the middle dotted band) set to 13, and I set the bands to be 1.5 times that average true range. This means that at any given time, both the upper and lower bands will be 1.5 times the current ATR reading away from the middle band. For example, at point 1, we have an ATR reading of 0.0100, which translates into 100 ticks. Multiply this by 1.5, and you get 150 ticks. At point 2, we see that the lower band is 150 ticks away from the middle band, and at point 3, the upper band is also 150 ticks away from the middle band. Why multiply it by 1.5? The ATR is a lagging indicator, and by multiplying it by 1.5, we give a little more room to accommodate the most current price action.



Figure 10.3

There are now a couple of key concepts we need to understand in order to trade this setup on this chart.

1. The bands are sloping upward, indicating surprise, an uptrend. Because of this, I'm interested in initiating only long trades. I could initiate short trades at the upper bands, but since the upper bands are continually rising, this is an inherently lower-probability strategy than going long. For example, if we initiated a short at point A, the market would just keep moving higher and stop us out. The market is still trading within its ATR, just on a steep uprising slope.
2. At point 4, we get a pullback to the mean. I initiate a long. When SF moves back to the outer band at point 5, I close out the position. Then when SF pulls back to the mean again at point 6, I go long, and I sell at point 7. I then buy the pullback at point 8 and close it out at point 9. Wash, rinse, repeat.
3. *Tip:* there is no need to try to capture every tick of these moves. Remember that I said that the bands were set to 1.5 times the ATR? Well, I'm really interested in capturing only 1 ATR worth of movement, or even slightly less than that. So I'm getting out of the trade at point 7, even though it hasn't hit the band. This is because I'm trying to get only 1 ATR (about 100 ticks) instead of 1.5 ATR (about 150 ticks). In other words, I'm constantly selling too soon. There's no need to be a pig at the trough.
4. What about stops? For best results, have stop losses, in this case, just outside the lower bands. This keeps a trader completely out of the wiggle room, and a stop out usually occurs only when there's a change in trend. This is one of those setups where stops that are too tight will have a bad impact. Trade smaller size and let the trade work itself out.
5. *Bonus:* if the move gets too near the lower band, indicating a potential change in trend, as happened at point B, the trader has the option of bailing out on the trade on a move back to the mean, closing out the trade at a "scratch" or small loss. Double bonus: A trader can also start out with half size, double up to full size on a move toward the lower band, then get out on a move back to the mean for a profit. This is one of my favorite ways to turn losing trades into small winners. The key, of course, is money management and fully understanding what a full-sized position means for your account. It does not mean "doubling up" to position sizes that are too large for your account. It is critical to still keep a hard stop in place during these types of trades.
6. *Another tip:* one of the most common questions I get is something along the lines of, "What kind of stop would you use on the Swiss franc on the hourly chart?" or, "What kind of stop would you use on Amazon on a daily chart?" or even, "What kind of stop would you use on crude oil on a 512-tick chart?" or, perhaps,

something like, “What kind of stop would you use on the ES on a 15-minute chart?” or, quite possibly, something along the lines of, “What kind of stop would you use on the euro on a five-minute chart?” (After about the 10th time in a matter of minutes, I start to get a nervous tick in my left eye.) Here’s the answer: no matter what market you are looking at and no matter what your time frame, you can put a 14-period average true range indicator on your chart. Whatever that value is, double it, and you have your stop. Voilà!

7. Also note that at point A, the market just runs away, and during a move like this, it’s typical not to get filled on a reversion to the mean for days, sometimes weeks at a time. This setup is geared to catch bits and pieces of a market that is in a quiet trend or quietly trading sideways. It’s not meant to capture momentum.
8. *Key point:* the one major flaw with this setup is that it can miss entire big moves, as big moves will push beyond the ATR bands. This is where the squeeze comes into play, which we will look at next.

This Sounds Awesome—Why Isn’t Everybody Doing This?

Okay, at this point, you are probably thinking, “If it’s that easy, why isn’t everybody doing this setup?” Alas, a lot of people have tried. The concept of reversion to the mean is not original by any stretch of the imagination. There are two things that I’ve seen that throw traders for a loop on this setup. The first is the temptation, in referring to the same SF chart, for traders to short moves to the upper band in a clearly defined uptrend. Yes, it will work at times, but it’s inherently dangerous, as we saw at point A. Just go with the trend, don’t fight it. This also holds true for downtrending markets—there is little need to pursue a strategy of buying the lower bands when you can just short retracements back to the mean. That’s rule 1. (Advanced traders with large accounts and a scale in methodology can pull this off—shorting uptrends to the upper bands and buying downtrends to the lower bands. Newer traders with smaller accounts get chewed up and spit out trying to do this. However, using options, vertical credit spreads can safely be initiated at these levels, which I’ll discuss shortly.) The second rule is that this trade becomes irrelevant once a squeeze fires off.

[Figure 10.4](#) shows the SF daily chart with a squeeze at the bottom of the chart. I’ll explain the squeeze setup and mechanics in more detail in the next chapter. For now, here’s the short version. The darker-colored dots at point 1 indicate a tight compression of volatility that is about to be released. This compression lasts, in this case, for 13 bars. The first lighter-colored dot after the series of darker dots (as indicated at point 2) signifies that this energy is ready to be released. At this point in time, a trade is triggered. If the histogram is above zero at this time (as it is here), it indicates a long trade. If the histogram had been below zero, then it would have indicated a short trade.

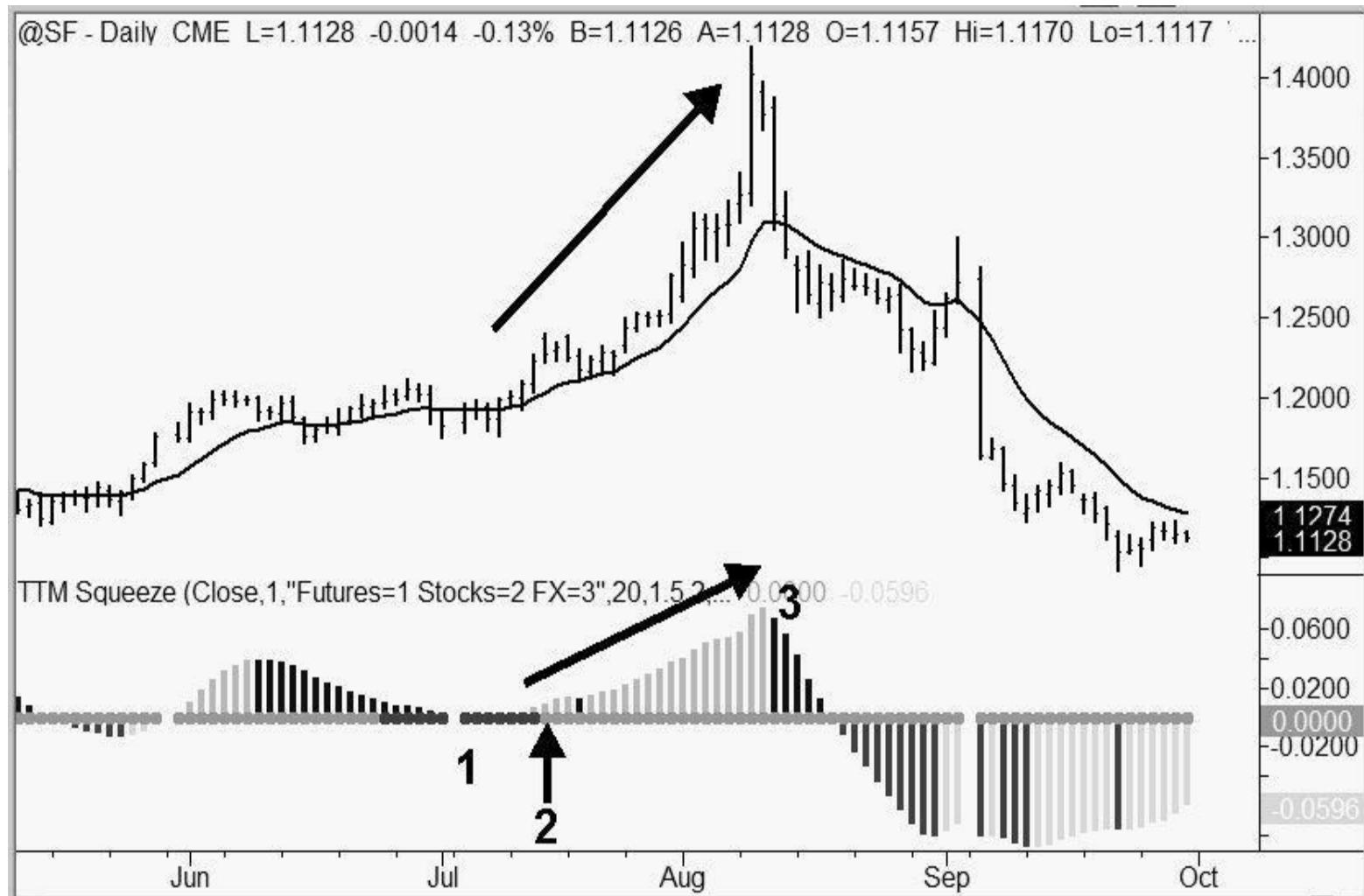


Figure 10.4

This squeeze is valid as long as the histogram continues moving higher. When the histogram finally loses momentum (as indicated by the darker-colored bars) the squeeze is no longer “in play.”

There are a few key things to know about the squeeze in relation to the reversion to the mean trades, as well as some general tips on how I utilize this setup.

1. I typically focus on reversion to the mean (RTM) plays on daily charts only. I don’t use them on intraday charts. I will sometimes utilize weekly charts for longer-term plays.
2. I look at various commodities, including stock index futures, and also individual stocks with this setup. For individual stocks, I’m utilizing these RTM setups to do option strategies, such as buying delta 0.70 options to capture the move back to the upper band (in the case of an uptrending stock).
3. The RTM trade is valid all the time … except when a squeeze has fired off.
4. Once a squeeze fires off, disregard the bands completely. They are now utterly worthless. The bands will not hold prices in check when a squeeze has fired off. In fact, once a squeeze has fired off (that’s what I call the first lighter-colored dot, such as point 2 in [Figure 10.4](#)), I just take the bands off the chart. Once the squeeze is over, I’ll put the bands back on the chart.
5. For the squeeze, I’ll enter a trade for a directional momentum play. Here’s where it gets interesting.
6. A squeeze actually expands the average true range of a market. This is why doing reversion to the mean trades during a squeeze is an exercise in futility. Imagine all the people out there trying to do these trades that don’t know about or understand the squeeze. This trade works out great for them 70 percent of the time, but then they give back all their profits and then some the remaining 30 percent of the time. This is typically when a squeeze is in play and they have no idea about the concept.
7. For a squeeze, I generally like to scale out based on the concept of expanding average true range levels. For example, if and when the trade is up 1 average true range (in the case of the Swiss franc, 120 ticks), I’ll take off a quarter of the position. Then I’m looking to see if we can move to 2 ATR, or 240 ticks. If we get there, I’ll take off another quarter and tighten my stop to my entry. Then if we get to 3 ATR, I’ll take off another quarter. For the last piece, I’ll hold on until the momentum rolls over, as indicated by point 3 in [Figure 10.4](#). Of course, if the squeeze loses momentum at any time during the trade, it means that the squeeze is over and it’s time to bail on the position, even if the first ATR target hasn’t been hit yet.

In [Figure 10.5](#), we have a daily chart of AMZN with the RTM bands and the squeeze. At points 1 and 2, a squeeze fires off long. During this time, I buy in-the-money calls (delta of 0.70 or better) on AMZN, and my plan is to scale out of the first part as we hit the various ATR levels, and then hang on to a chunk of it for the entire ride, which in the case of the first squeeze is considerable. This is the type of move where an option can go up 500 percent or more. AMZN moves steadily higher from \$125.00 a share to \$160.00 a share in about one month. Note: with option plays on daily squeezes, plan on being in the trade for one to three weeks. Therefore, if you are one week out from expiration, go ahead and buy the options on the next month out. Of course, during this squeeze, the RTM bands are to be completely ignored until the squeeze loses momentum, as indicated by the two darker-colored momentum bars. Once this takes place, the squeeze is officially over, and we can go back to RTM trading. We did get another squeeze at point 2. This resulted in a nice pop in the stock, but the move was short-lived.

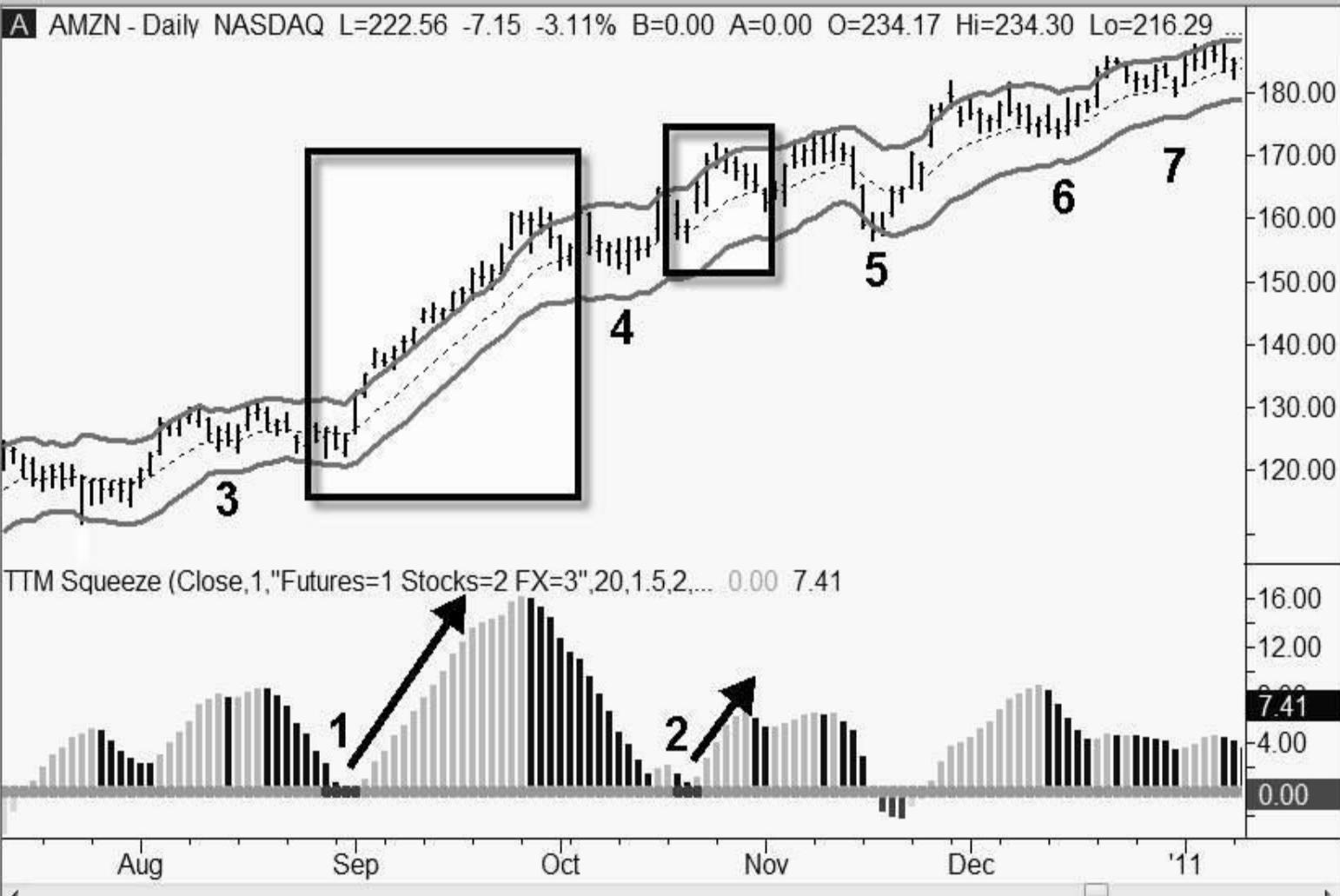


Figure 10.5

For the reversion to the mean trades, there are examples at points 3, 4, 5, 6, and 7. The distance between the middle band and the upper band is about \$6.00. In these cases, I'm buying in-the-money calls on pullbacks to the band, then closing them out when AMZN moves up about \$4.50. Remember, the bands are 1.5 times the ATR, and I'm interested in capturing only 1 ATR. With a delta 0.70 option, this means that I'm capturing \$3.15 in the option. A typical scenario here would be buying a call option at \$9.00 and then selling it a few days later for \$12.15. One thing that is nice about RTM trades that go with the trend is that they are typically quick. This is great for option trading, as we already know how fast the clock is ticking on the premium decay from reading [Chapter 5](#).

At point 5, this trade gets stopped out. I bought the calls on the pullback to the band, then the stock plummeted. Of course, a few days later it was back to its upper band again. This is why they call it "trading" and not "how to know exactly what's going to happen next in the markets."

We've looked at plenty of uptrending examples, so let's look at a downtrending example. [Figure 10.6](#) is a daily chart of GS (Goldman Sachs), which on principle is a stock that I will only short. Now that we are familiar with this setup, I'll start moving more quickly. At points 1, 2, 3, and 4, I'm able to buy in-the-money puts (yep, delta of 0.70) and close them out on a move back to the lower band. Trade 4 took nine days to hit its target, while the other trades all hit their targets in one to three days. At point 5, a squeeze fired off short, and it turned out to be a very quiet trade, in essence a normal reversion to the mean trade. That happens sometimes with a squeeze. Not every squeeze trade is a big trade, but a lot of big trades are the result of a squeeze. At point 6, I initiate another RTM trade, as the squeeze has lost momentum.

I will use this setup on just about anything, although to reiterate, I do not follow it on intraday time frames. The daily chart is my first choice, although I will also check the weekly chart for longer-term plays. Are there other ways to utilize this setup with options? Absolutely.

[Figure 10.7](#) is a screen shot of AMZN on a daily chart, rallying right into its upper band on October 12, 2011, as it hit a high of \$241.84. On October 11, via our [www.SimplerOptions.com](#) options trading alert service, we placed an order to sell a vertical credit spread at \$2.30 on the weekly options, which was the price that this spread would hit should AMZN actually rally into that level. It did rally, and we got filled.

For those who aren't sure what "selling a vertical credit spread" means, I'll do a quick walk-through. The goal with this trade is to sell premium and take advantage of the rapid premium decay into expiration. This is especially attractive when a stock gets extended (up or down) right into its TTM reversion bands. *It's even more attractive if this happens with only a few days until options expiration.* With the advent of weekly options, these types of setups happen with increased frequency. The goal is to sell an at-the-money option (the higher-priced option), and then hedge your risk by buying the next strike out (the cheaper option).

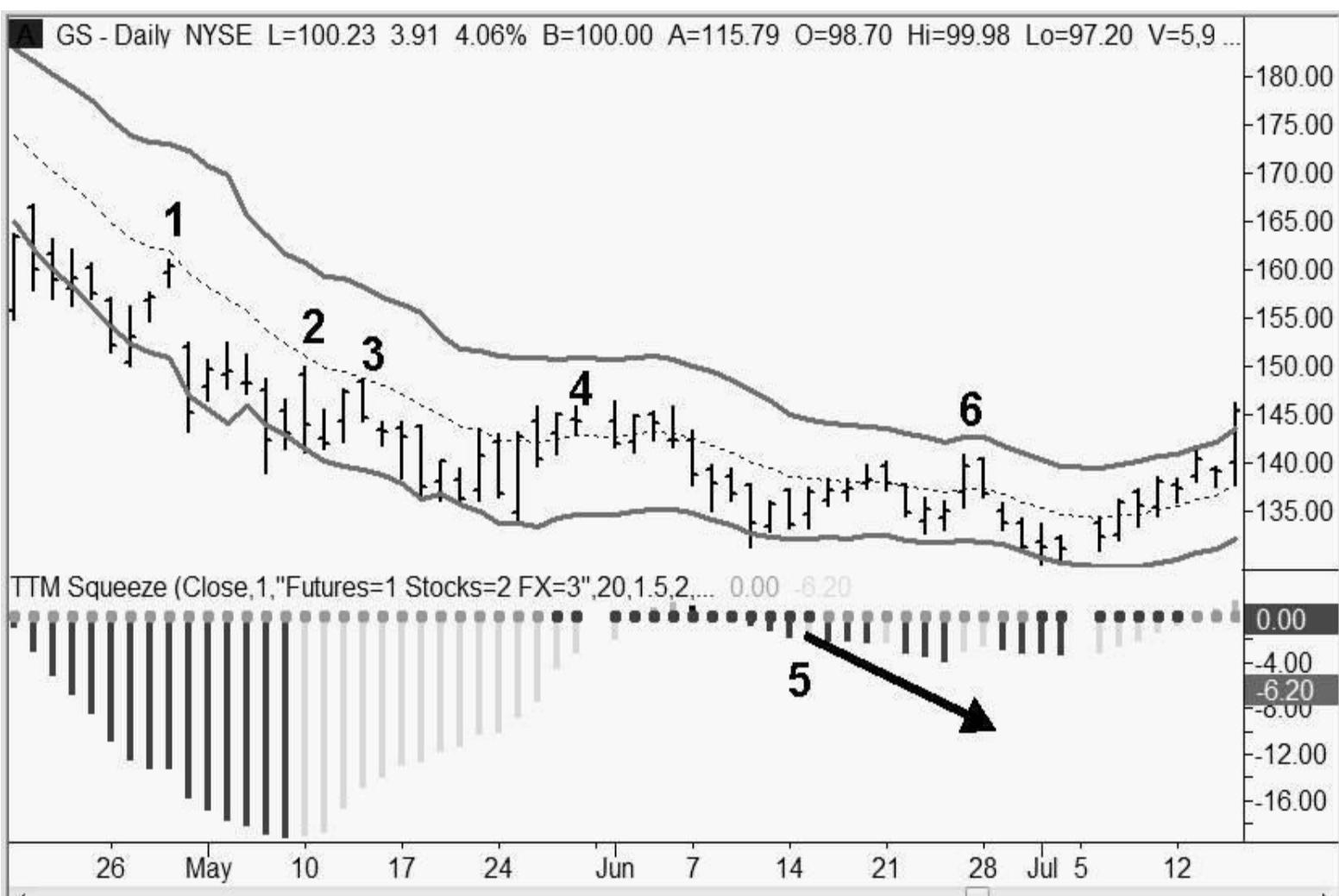


Figure 10.6

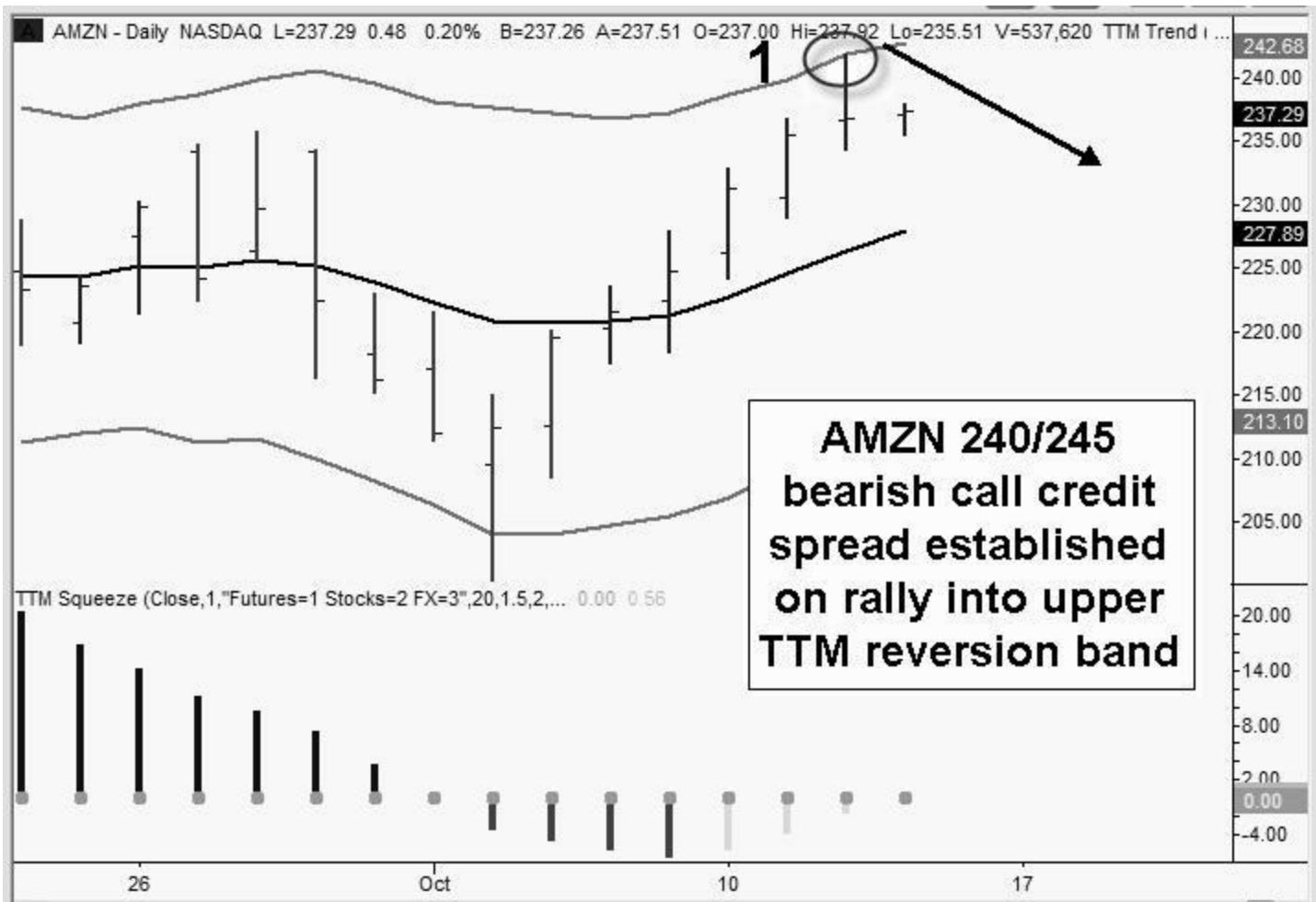


Figure 10.7

Figure 10.8 shows the actual position. At point 1, I'm short 100 of the 240 call options (shown as -100 on the TD Ameritrade thinkorswim platform). This means that I sold them to someone else, and I hope they expire worthless so that I can collect the entire premium. However, I didn't want to have completely open exposure, either. What if AMZN gapped up \$50.00 the next day on some crazy news? I'd be hosed. That's just not worth the risk, however unlikely the event. To protect myself and limit my losses, I also bought 100 of the 245 calls, as seen at point 2. This way, if AMZN does skyrocket higher, my loss is limited, as the 245 calls would increase in value, and my loss would be limited to the spread between the two strikes. In this screen shot, you can see that I'm making money on the options I sold. They are up \$31,300.00. I'm losing money on the options I bought; they are down \$17,150.00. My net profit on the trade is +\$14,150.00. Since I sold this spread for \$2.30, my maximum profit (should AMZN close under \$240) is \$230 per contract, or \$23,000 on 100 contracts. My maximum loss is the spread difference ($245 - 240 = \$5.00$), which is $5.00 - 2.30 = \$2.70$, or \$270 per contract. Of course, there is no need to hold the trade into expiration. If the spread is "in the money" there is a risk of being assigned the stock before expiration. This happens rarely but it happens, and isn't a big deal. Once assigned the stock, you just close out the stock position. This is why I started www.SimplerOptions.com. There are a lot of ways to make option trading more complicated. This site is designed for both newer and advanced traders to "trade along" with our trades on a step by step basis and be able to ask questions and learn as you go.

POSITION STATEMENT										Click to setup group	Reset Groups	Return To Old Layout
Group:	Type	Arrange Positions:		INSTRUMENT	Watch spreads						<input type="checkbox"/> Beta Weighting NO	
Equities and Equity Options												
Instrument	Qty	Days	Mark	Mrk Chng	Delta	Gamma	Theta	Vega	P/L Open	P/L Day		
AMZN					-1800.16	-222.62	2570.04	-264.37	\$14,150.00	\$2,700.00		
AMAZON.COM INC COM	0	1	236.07	-.74	.00	.00	.00	.00	\$0.00	\$0.00		
100 (Weeklys) OCT21 240 C...	-100	1	1.28	-.53	-2944.21	-491.60	6047.92	-602.19	\$31,300.00	\$5,300.00		
100 (Weeklys) OCT21 245 C...	+100	1	.395	-.26	1144.04	268.97	-3477.88	337.82	(\$17,150.00)	(\$2,600.00)		
Selected Totals												
Subtotals					-1800.16	-222.62	2570.04	-264.37	\$14,150.00	\$2,700.00		
Overall Totals									\$14,150.00	\$2,700.00		

Figure 10.8

This “difference” between the two option prices is calculated continually, so it’s easy to track. [Figure 10.9](#) shows the actual vertical price of the “240/245.” Since I sold it for 2.30, and it’s currently trading at 1.39 bid/1.56 ask, I’m up on the spread. My stop loss on the spread was 3.50, and if the vertical combination had reached that level, I would have been stopped out. Once you understand the power of this concept, it then becomes a matter of just being patient and waiting for a nice extended entry, such as a slam into the one of the bands right before expiration.

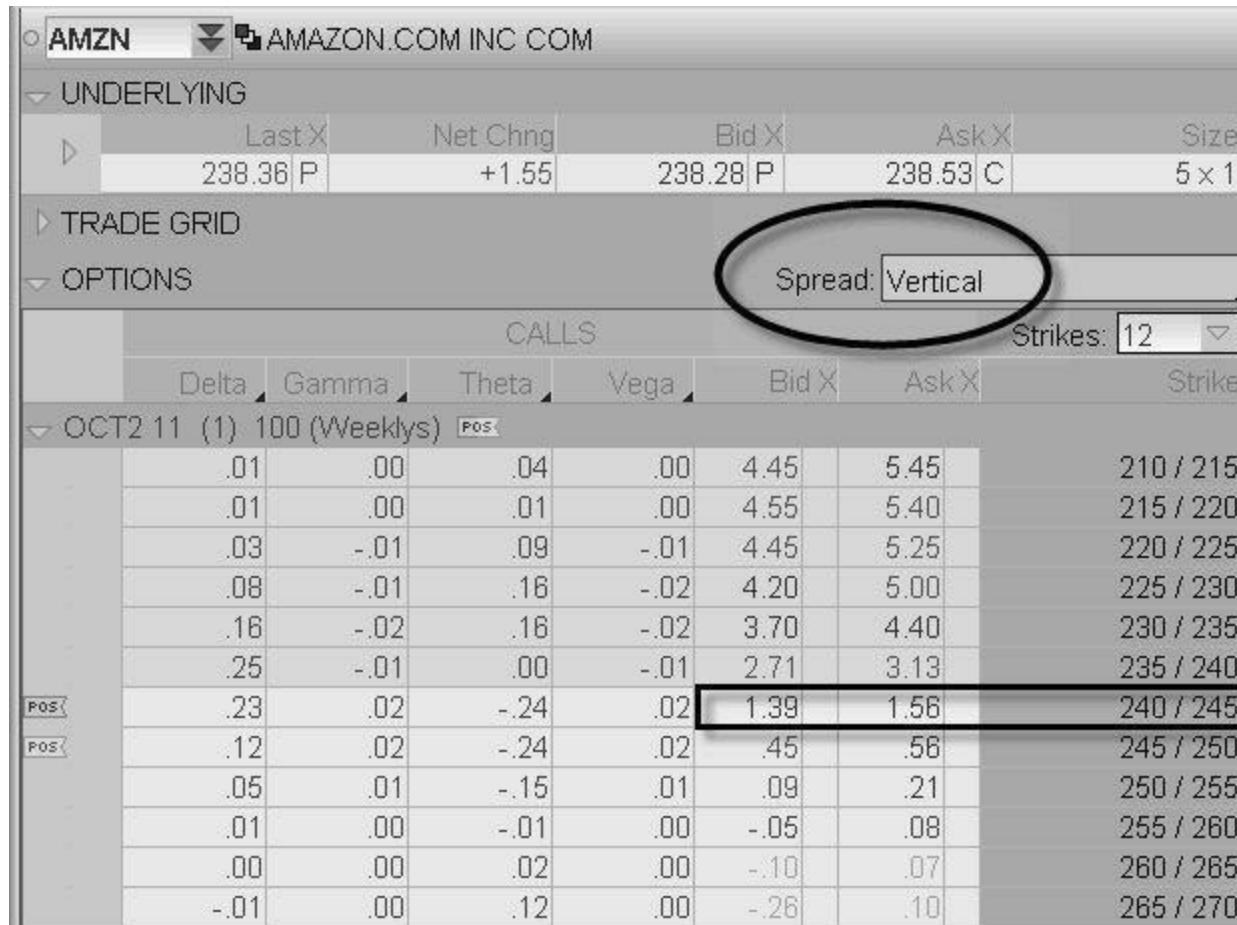


Figure 10.9

Now that we have covered reversion to the mean, it’s time to dive into the squeeze. For more examples, visit www.tradethemarkets.com/rtm to see how this works across different markets. For traders interested in options, visit our sister website www.simpleroptions.com/trades for a series of video tutorials on the best ways to trade options.

The Squeeze: What Is the Best Way to Get Positioned for the Big Market Moves?

Is It Better to Trade for Cash Flow or to Create Wealth?

In the previous chapter, we discussed reversion to the mean (RTM) trading, and how it's the best type of trading to do "unless there is a squeeze." And that really is trading in a nutshell—playing the reversion back to the mean via something like a pivot, an extreme STICK reading, or an outer reversion band test, or riding a freshly released burst of momentum via something like the squeeze. If one of these isn't being set up, then the other is. Be patient and pick your poison.

The squeeze is a setup that I use for everything: day trading, swing trading, and position trading. It's the best indicator I've found for setting up longer-term moves, especially on the larger daily, weekly, and monthly time frames. In fact, I find it very difficult to look at a chart without this indicator. It gives me a lot of information about the nature of the current market and time frame with a quick glance. We aren't talking about "overbought or oversold," which, like most Twitter updates, is both self-serving and useless. We are talking about seeing whether a market is neutral (in which case we focus on RTM trading) or, if it's not neutral, whether it's building up energy, about to release energy, or about to run out of energy. This is very useful information for deciding when and where to allocate trading capital, as well as deciding what type of trading strategy to utilize with that capital. Want one quick example of how this information is useful? You might think that when a trade is "about to run out of energy," it is merely a signal to exit a current position. It is that, yes, but it is also so much more. When a squeeze is running out of energy, it's also one of the best times to start selling options premium. (Buh-bam!) But I digress. We still need to discuss what a squeeze actually represents.

In a nutshell, I like to use RTM trading for the creation of income (taking profits out of an account) and squeeze-type momentum trades on larger time frames for the creation of wealth (gradually building up the value of an account over time). Can a trader utilize squeezes on smaller time frames, though, for day trading? Like a five-minute chart? Absolutely, and I'll cover specific examples that utilize smaller time frames for day trading. But where this setup really shines is on the bigger time frames. Hourly charts, two-hour, daily, weekly, monthly ... there is never any reason to not understand what is going on with the bigger time frames, and, should a squeeze be firing off on one of these larger time frames, there is never any reason to fight it on the lower time frames. For example, if a 60-minute chart has fired off a long squeeze on the S&P 500, then only the uninformed are pulling their hair out entering short signals on the five-minute chart during that time. "Jeez," they say, "this thing just keeps going higher!" Yep.

Even if a weekly squeeze is too long a time frame for your own trading plan, at the very least it pays to be aware of it so that you are not "fighting against it" on the smaller time frames. That is, if the weekly squeeze on AAPL has fired off a short signal (hey, it could happen), then why waste time buying the dips on the daily chart? These trades are very likely going to be stopped out until that weekly squeeze short signal is over. It's as if one person offered you \$8.00 an hour to flip burgers, and another guy offered you \$100.00 an hour to do the exact same job. Which offer would you take? Fighting the weekly squeeze is like taking the \$8.00-an-hour job, when you could just "go with the squeeze" and get the \$100.00-per-hour job. By following the larger time frames, a trader is always moving along the path of least resistance—trading in alignment with the larger time frames. Knowledge is power.

On average, a squeeze signal lasts about six bars. This means that a signal on a monthly chart can last for six months, while a signal on a one-minute chart can last for six minutes. The signal is the same no matter what the time frame; it's just the duration of "being in the trade" that changes.

Why bother with swing trades and overnight exposure? I know that some traders freak out when they have overnight exposure, and that's fine. I, for one, have trouble sleeping if I don't have a position on. The benefit of these types of swing trades is that a person is "in" the market and already positioned for the move. While day traders can catch a few points here and there, it's the swing traders that catch big multiday and even multiweek moves. It's okay to prefer one type of trading over the other. The key with trading is to find the niche in which you will shine.

The markets spend a lot of time in trading ranges, building up energy for their next major move. By the time the move fires off, it is usually out of the blue and violent, leaving many day traders behind. This includes the times when a market will gap open and then spend the rest of the day stuck in a narrow range, totally bypassing the day traders. That's why we call this move a "gap and crap." By keeping some exposure in positions on a swing-type basis, I will frequently participate in larger moves that leapfrog over many of the day traders. The secret to swing trading is realizing that "being positioned" is half the battle, and not stressing out over a position that is not working out right away. The markets never break when they are expected to, and they will do so only when they are good and ready, usually when the greatest number of people are unprepared. Sometimes being positioned means waiting weeks for the move to finally unfold. This requires patience and the ability to step aside and not obsessively stare at the charts all day. This is a huge problem for most traders. They sit back, they watch the charts, they get emotional, and they get faked out and close the trade. Typically, once that process has completed itself—faking out as many traders as possible—the markets will make their move. If everybody is expecting a move, then everybody will already be positioned for it. If everybody is positioned for a big down move, then everybody is already short and there is no one left to sell. It's a great system. It's also how the markets always have worked and always will work.

One of the best trading books I've ever read on managing "swing trader anxiety" is called *How I Made Two Million Dollars in the Stock Market*, by Nicolas Darvas. This book was written a few decades ago and remains one of my favorites. It's a quick, easy read and very entertaining. For anyone who has trouble hanging on to swing positions and jumps out too early, this book is a must read.

It is important to position size correctly for swing trades. In general, if traders cannot sleep because they are worrying about their overnight positions, then they are trading too large in relation to their account size. Swing trades have larger stops, and their position size must be reduced accordingly. There is a very easy way to manage this—establish a monetary stop and work backward from there. For example, if traders are not willing to lose more than \$500 on a trade, then all they have to do is look at the parameters for the setup and do the math to figure out the position size. Using \$500 as a benchmark, a day trade that requires a 20-point stop in the mini-sized Dow futures would equate to a position size of five contracts. However, if a swing trade in the mini-sized Dow called for a 100-point stop, then these same traders are going to use one lot. Monetarily, these stops are identical because of the reduced position size on the swing trade.

How Does a Trader Redefine Volatility and Use It to His Advantage?

The squeeze takes advantage of quiet periods in the market, when the volatility has decreased significantly and the market is building up energy for its next major move higher or lower. My wife and I have three young children, and recently she deemed me responsible enough to watch them by myself on a Saturday at the house. After she left, I made sure all the doors that led outside and into the bedrooms were closed and locked so that I wouldn't lose track of them. I discovered very quickly that if they were making noise, they were fine. But if things suddenly got very, very quiet, then something bad was fixin' to happen. This is when I would come around the corner and see the two older ones trying to stuff the younger one into a potted plant. Energy, having been built up, was being released.

For students of Bollinger Bands, periods of low volatility are identified as the times when the bands "move closer together." This is the equivalent of "the kids being quiet around the corner." That is, this particular market has gotten "too quiet" and is about to release a truckload of energy.

This is always great in hindsight, but in real time, how does a trader know that the current narrowness of the Bollinger Bands is really narrow enough to qualify as low volatility and to qualify as "just about to release a lot of energy"? This setup answers that question by adding the Keltner Channels as well as a momentum index oscillator.

For readers who are unaware of how these indicators work, I'll take a few moments to explain them here. *Bollinger Bands* are a type of envelope that is plotted at standard deviation levels above and below a moving average. This produces an effect of having the bands widen during periods of higher volatility and contract during less volatile periods. During periods of lower volatility, in sideways-moving markets, the bands contract toward the moving average. *Keltner Channels* are based on a standard moving average. The actual band lines are offset from the central moving average value by a positive and negative standard deviation value to provide upper and lower bands. While the Bollinger Bands expand and contract as the markets alter between periods of high and low volatility, the Keltner Channels stay in more of a steady range. The momentum index oscillator is used to estimate the direction, velocity, and turning points of market movements. Does this make sense? If not, that's fine. I don't understand how electricity works, but I know when I plug my computer into an electric outlet, it will turn on. Now let's look at how I use all this for a setup.

The quiet periods I'm looking for are identified when the Bollinger Bands narrow in width to the point where they are actually inside of the Keltner Channels. This marks a period of reduced volatility and signals that the market is taking a significant breather, building up steam for its next move. The trade signal occurs when the Bollinger Bands then move back outside the Keltner Channels. I use a 12-period momentum index oscillator to determine whether to go long or short. If the oscillator is above zero when this happens, I go long; if it is below zero, I go short. These are all canned studies that come with most charting packages. For the parameters, I just use the default settings on TradeStation. These readings are 20 and 1.5 for the Keltner Channels and 20 and 2 for the Bollinger Bands. We also took an extra step and turned all these into an indicator that makes them easier to read on the chart; I'll explain this in a moment.

What Is the Best Way to Get in Right Before a Big Move?

I use the squeeze signal on various time frames, as I like it for both day trading and swing trading. On the mini-sized Dow, for example, a squeeze can move the market 10 to 20 YM points on a two-minute chart or a 377 tick chart, 30 to 50 points on a 15-minute chart, and several hundred points on a daily chart. The kicker, of course, is that the smaller the time frame, the more frequent the signals. A two-minute chart may fire off three to five signals in a day, while the daily chart will fire off six to seven signals over the course of an entire year.

Although I spend a large amount of my trading day focused on the E-mini S&Ps and the mini-sized Dow, there are also plenty of times when these indexes are dead in the water. On days when the indexes are trading in a range that is narrower than Donald Trump's political ambitions, I look to the currencies, gold, bonds, oil, and individual stocks for my next setup. My two favorite setups in the currencies are the squeeze play and what I call the box play—a setup that comes up in a later chapter. For currencies, I execute these on the eight currency pairs I've already mentioned, and I prefer to do these in the futures markets when possible. Let's take a look at some setups.

What Are the Trading Rules for Buys (Sells Are Reversed)?

1. Set up a 24-hour chart so that the overnight activity can be accounted for in this indicator setup.
2. The "heads-up" on this indicator is the first black dot. This is not a trade signal, but rather a heads-up that a trade signal is setting up. This indicates when the Bollinger Bands are trading inside the Keltner Channels.
3. The signal on the indicator is the first gray dot after a series of black dots. This indicates that the Bollinger Bands have come back outside of the Keltner Channels. This is shown in detail in the charts that follow.
4. Once the first gray dot appears after a series of black dots, I go long if the histogram is above zero. Once the signal fires, I just place a market order. This is a momentum play, and I don't want to be messing around with limit orders that may not get filled. Note: though unusual, there are also instances in which, when the signal fires, momentum is below zero, yet it is ascending. This also constitutes a long signal.
5. For day trades (five-minute charts or smaller), I place the following minimum money management stops. If the stop is also near a key price support level, I will take that into consideration and adjust accordingly. For example, if my entry is 1104.00 on the S&Ps and the daily pivot is at 1101.75, I would move my stop to just below that pivot level, or 1101.50, for a stop of 2.50 instead of 2.00. I find that nine times out of ten, I just use the default stop. Remember, too, that if you are unsure of what stop to use, then you can place the 14-period average true range (ATR) on your chart, double the current value, and use that as your stop.
 - YM: 20 points
 - ES: 2 points
 - NQ: 4 points
 - TF: 1.50 points

- EC: 20 ticks
- EURUSD: 20 pips
- US: 7 ticks
- Gold: 1.50
- Stocks: 50 cents

6. For swing plays and position trades (taken off the daily charts), I place the following stops. I take into consideration the same key levels as discussed in item 4, and of course it is very beneficial to look at a 14-period ATR on the daily charts, as the range on this time frame can expand and contract dramatically with increases and decreases in volatility. The main point here is that if you are trying to catch a bigger move in the ES, there is no point in using a 2-point ES stop because the probability of being stopped out is too high.

- YM: 150 points

- ES: 15 points
- NQ: 25 points
- TF: 8 points
- EC: 100 ticks
- EURUSD: 100 pips
- US: 35 ticks
- Gold: 20.00
- Stocks: \$2.50

7. My target is based purely on the momentum of the trade. Once the momentum index signal starts to weaken, I get out of the trade at the market.

8. I don't trail stops.

Let's first look at examples from the first edition of this book, and then we will take a look at some updated examples.

Mini-Sized Dow—September 2004 Contract, August 18, 2004

1. [Figure 11.1](#) shows how to set up the elements of this play in whatever time frame a trader wishes to view. For intraday trading, I like to watch the five-minute chart. The one-and two-minute charts are good for scalping, but these signals are not as powerful as those of the five-minute chart, though they are tradable. The Keltner Channels are the pair of thick black lines and are set at the default parameters of 20 and 1.5 on TradeStation. The Bollinger Bands are the thinner gray lines and are set at the default settings of 20 and 2.0. At the bottom is a 12-period (on the close) momentum index oscillator. At point 1, the Bollinger Bands have gone inside the Keltner Channels. This indicates that the market is going into a quiet period, and it is a heads-up. This is not a signal—it is just a heads-up that when the Bollinger Bands pop back out, it will be time to take a trade.

@YM - 5 min CBOT

B=10315 A=10318

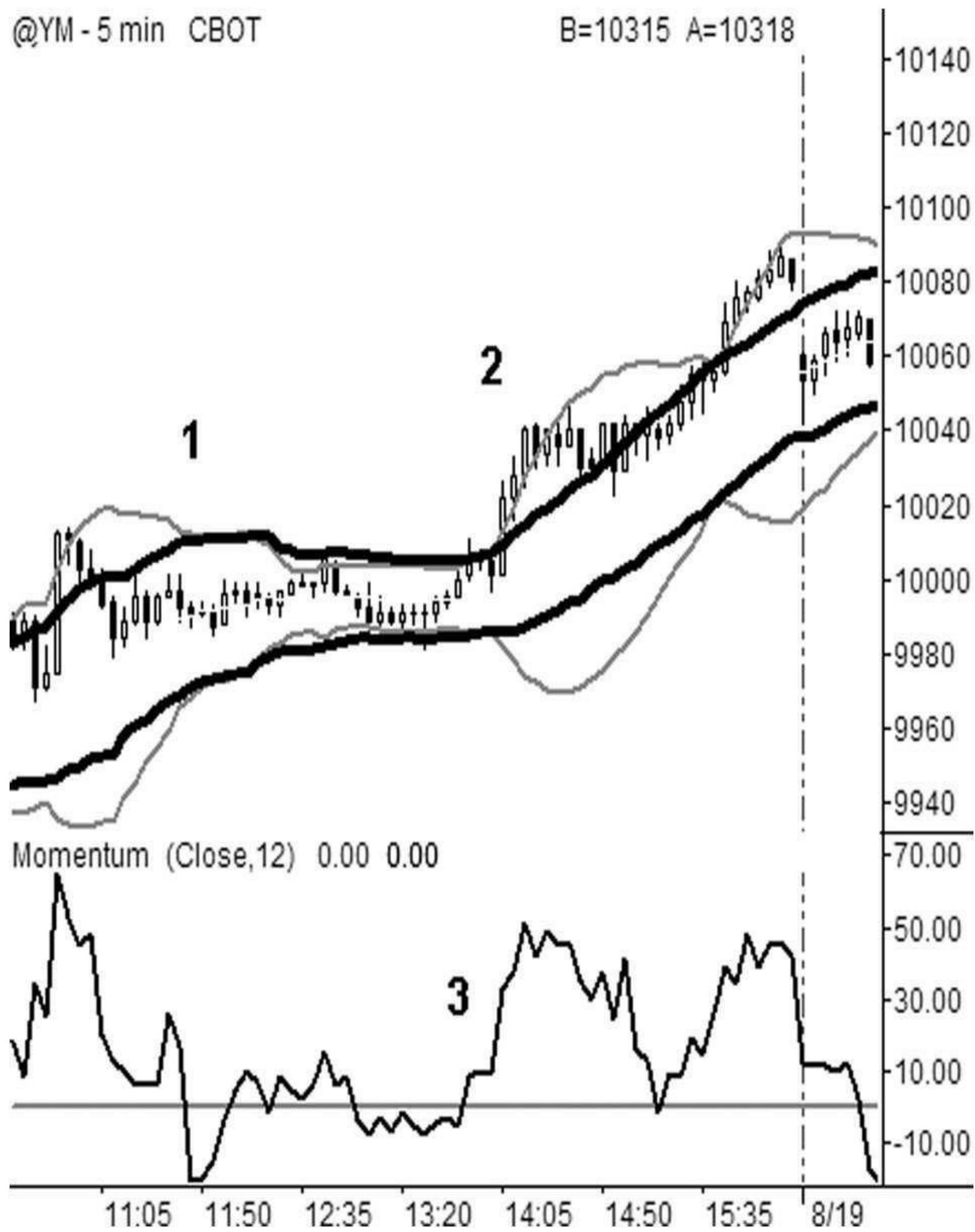


Figure 11.1

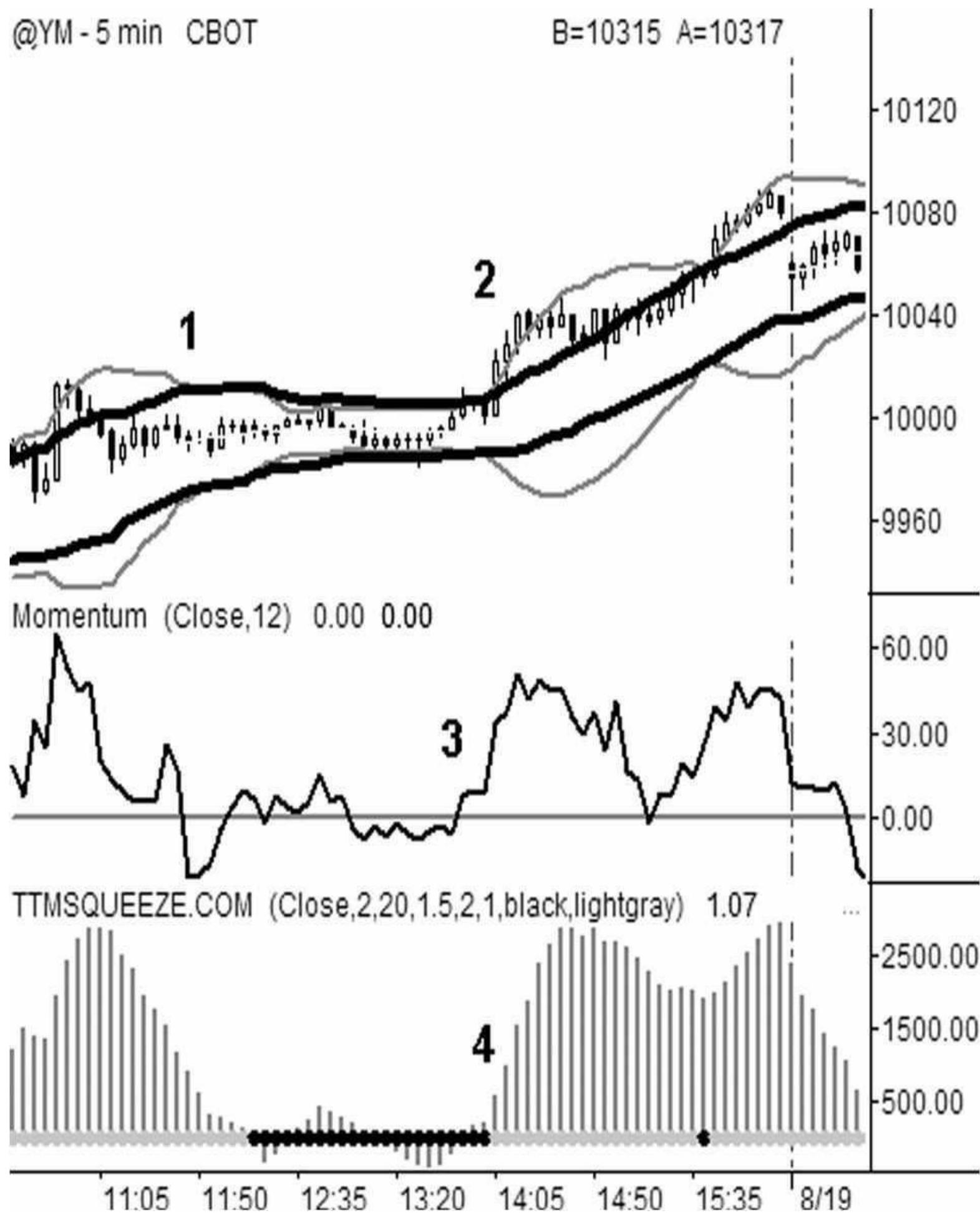
2. At point 2, the Bollinger Bands have come back outside the Keltner Channels. It is time to take a trade.
3. If the momentum index oscillator is above zero at the time of point 2, I go long. If it is below zero at this point, I go short. I don't mess around with limit orders. I just jump it at the market, hitting the current offers. This is just an example of what triggers the entry and exits. I look at specific plays in a moment.

Mini-Sized Dow—September 2004 Contract, August 18, 2004

1. One of the things we did was turn all the things in [Figure 11.1](#) into an easy-to-read indicator, which is what I now use on my own charts, as seen in [Figure 11.2](#). We have developed this for TradeStation, eSignal, thinkorswim, Infinity Futures, Ninja Trader, and other platforms as well. When the Bollinger Bands go inside the Keltner Channels, the dots turn black. This is a heads-up that the markets have entered a quiet period.

@YM - 5 min CBOT

B=10315 A=10317



2. At point 2, the Bollinger Bands come back out of the Keltner Channels.
3. Since the momentum index oscillator is above zero at point 3, this is a long signal.
4. On the indicator itself at the bottom of the chart, this is all measured by when the dots turn back to gray after being black. This occurs at point 4. The black dots are the heads-up that the market has “gone quiet” and is about to release a truckload of energy. When I see that first gray dot after the series of black dots, I know it is time to take a trade. If the histogram is above the zero line, I go long, and if it is below the zero line, I go short. Again, this is just to show you how the indicator works. In the next examples, I go over some actual plays. I prefer to take off all the “clutter” that is on the price chart and just use the indicator. But now you know how the indicator works.

Mini-Sized Dow—September 2004 Contract, August 20, 2004

1. On this two-minute chart of the mini-sized Dow, we get a black dot a little after 10:00 a.m. eastern (see [Figure 11.3](#)). This is a signal that the Bollinger Bands have narrowed and are now trading inside the Keltner Channels. I know that when I get the next gray dot, I will have a trade signal. In this case, the gray dot happens right away. Usually there is more than one black dot, but once in a while it will have just the single instance, and that’s okay. Common sense dictates that the more black dots there are, the more powerful the potential move will be. In my experience, this is not true, as I have seen one-dot signals that have bigger moves than twenty-dot signals on numerous occasions. I find it is best to just take the signal when it comes. Humans tend to mess up their trading when they try to outthink their positions. When the next gray dot appears, the histogram is above zero, so I place an order to buy the YM at the market. I am filled at 10,164. I place a 20-point stop at 10,144. My target is open, as I’ll be waiting for the momentum index to falter as my exit signal.

@YM - 2 min CBOT

B=10325 A=10326



Figure 11.3

2. The market pushes higher, and I'm watching the histogram. As long as it makes higher highs, I stay in the trade. When it makes its first lower high, I will get out. At 10:30 a.m. eastern we get a lower high on the histogram, and I exit at the market. I'm out at 10,198 for a gain of 34 points.

Mini-Sized Dow—September 2004 Contract, June 28, 2004

1. On June 28, 2004, the markets trade in a tight range all morning, creating a long series of black dots on the five-minute YM chart (see [Figure 11.4](#)). Remember, the black dots indicate that during this time frame, the Bollinger Bands are trading inside of the Keltner Channels, marking a period of very low volatility. A little after 1:30 p.m. eastern, the first gray dot appears in the sequence. The histogram is below zero, so I take a short at the market. I'm filled at 10,426, and I place a 20-point stop at 10,446.



11:55 12:40 13:25 14:10 14:55 15:40 6/29

Figure 11.4

2. The goal is to stay in the trade as long as the histogram is making lower lows (or in the case of a long, higher highs). It makes its first higher low nearly two hours later, and I exit at the market. (If you were just watching the momentum index oscillator, you would exit as it starts to turn higher.) I'm out at 10,325 for a gain of 101 points, or \$505 per contract—a very smooth, low-stress, and profitable trade. This is a great example of a trade where it pays to sit on your hands until you are given a clear exit signal. In fact, part of my reward system isn't focused on profits—it's focused on my ability to follow a setup from entry to exit. Every trader should have a reward system like this: not for making money, but for hanging in there and following the setup—staying in the trade until you get a specific exit signal. Taking tiny profits is easy, which is what most traders do. And that is why most traders fail; they always succumb to the easy way out, the bad habits that the markets naturally encourage and reinforce. When a trade is going your way, stick your hands underneath your butt cheeks.

Mini-Sized Dow—September 2004 Contract, September 10, 2004

1. On September 10, 2004, the five-minute squeeze on the YM fires off (see [Figure 11.5](#)). About an hour earlier, there was a single gray dot, and I went long here. However, the very next dot went back to black. This means that the Bollinger Bands came out of the Keltner Channels, but then went right back in. This is a rare occurrence, but when it happens, I just get out and wait for a solid signal. In that case, I was in and out and lost 6 YM points. About 50 minutes later, we get the setup again, and the dots turn gray. For this next trade, with the histogram above zero, I go long and place a 20-point stop. I am in at 10,263, and I place a stop at 10,243.

@YM - 5 min CBOT

B=10325 A=10326



Figure 11.5

2. The histogram continues to move higher until 1:30 p.m. eastern, at which point it starts to lose momentum. I cut the position loose at 10,309 for a gain of 46 points.

Mini-Sized Dow—September 2004 Contract, July 1, 2004

1. A little after 10:00 a.m. eastern on July 1, 2004, the first gray dot appears on the five-minute YM chart (see [Figure 11.6](#)). The histogram is below zero, so I go short at the market. My entry is at 10,402.

@YM - 5 min CBOT

B=10325 A=10326



Figure 11.6

2. The markets drift down, and the histogram begins to level off. The markets continue to make lower lows, and suddenly the selling accelerates, pushing the histograms down deep into their range. They begin to bottom out at around 11:20 a.m. eastern, and I cover at the market. I'm out at 10,312 for a gain of 90 points.

Mini-Sized Dow—September 2004 Contract, September 2, 2004

1. On September 2, 2004, the five-minute YM chart goes into alert status at around 1:15 p.m. eastern (see [Figure 11.7](#)). Six black dots appear, showing that the Bollinger Bands are trading inside the Keltner Channels. When the next gray dot appears at 1:50 p.m., the histogram is above zero, so I go long at the market. I am filled at 10,183. I place a 20-point stop at 10,163.

@YM - 5 min CBOT

B=10325 A=10326

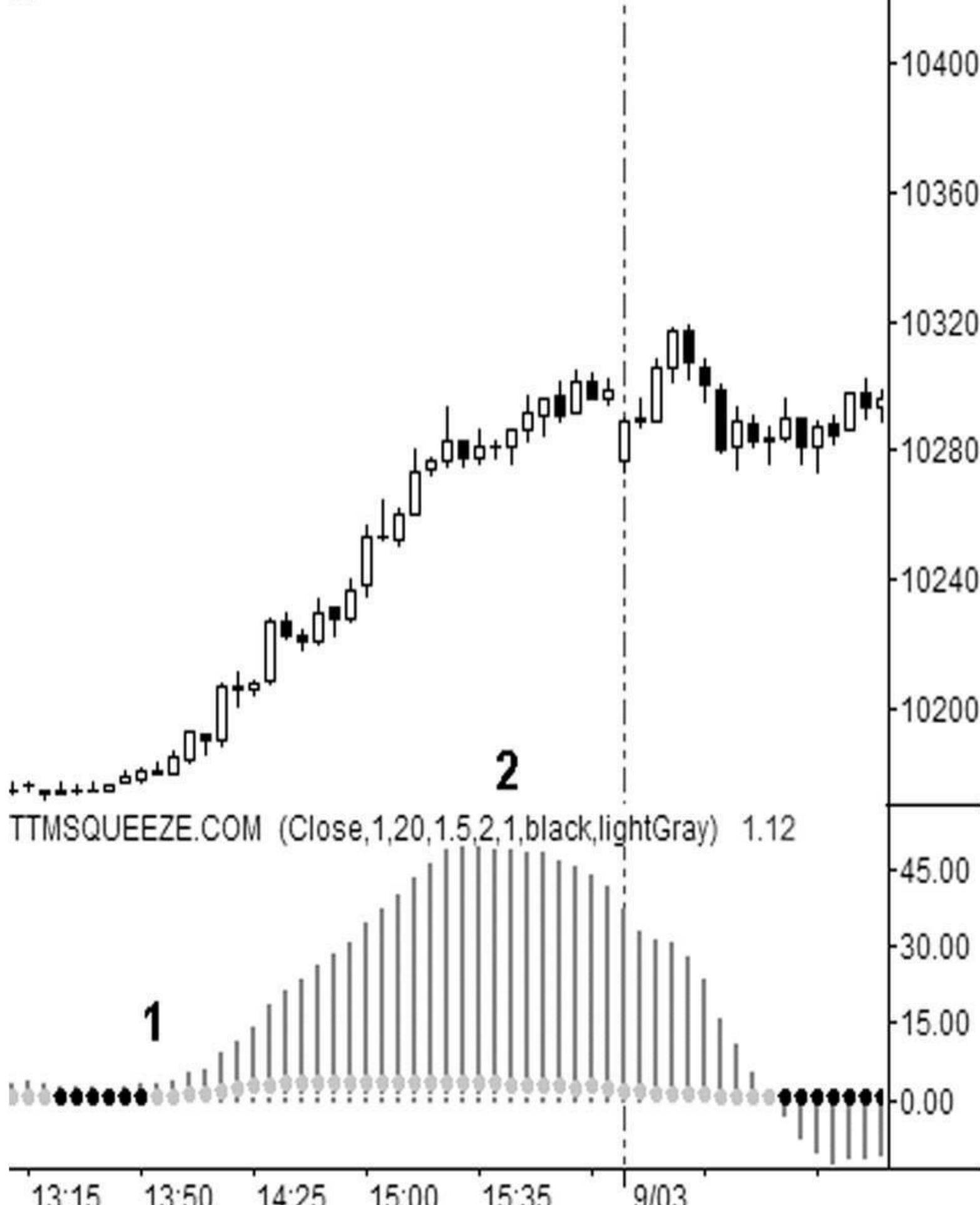


Figure 11.7

2. The market cruises higher, and the histogram begins to start making lower lows at 3:30 p.m. eastern. I exit at the market and am out at 10,278, for a gain of 95 points. Not every five-minute squeeze ends up with a big move like this, but I've found that when there is a big move, it is generally kicked off by a squeeze on the five-minute chart. I have a rule in trading that says, "Never fight the direction of the five-minute squeeze!" It supersedes all my other intraday trading rules and setups. Remember when I talked about all these plays working in conjunction with one another? If there is a five-minute long squeeze in place and we are rallying up to a pivot level, then I'm not going to place a short at that pivot level. Never fight the five-minute squeeze.

Mini-Sized Dow—September 2004 Contract, August 25, 2004

1. On August 25, 2004, the five-minute squeeze goes into alert status at around 11:45 a.m. eastern, as evidenced by the first black dot (see [Figure 11.8](#)). About 20 minutes later, the dots change back to gray. The histogram is above zero, so I take a long at the market. I was filled at 10,113, and I immediately place a stop at 10,093 and leave my target as open.

@YM - 5 min CBOT

B=10325 A=10326

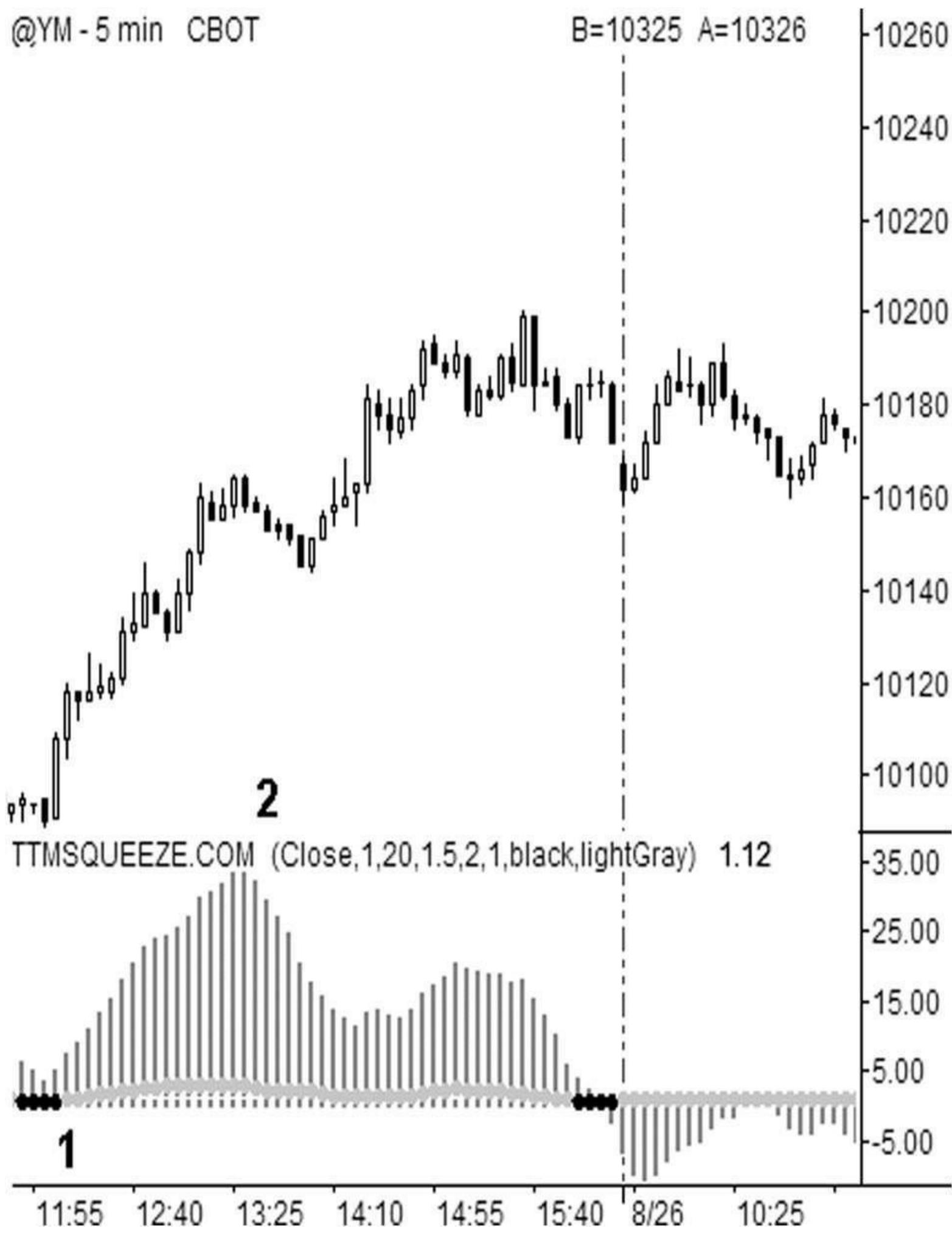


Figure 11.8

2. About an hour and a half later, the histogram starts to make lower highs, and I get out at the market. I'm out at 10,149 for a gain of 36 points.

Mini-Sized Dow—September 2004 Contract, August 20, 2004

1. I like this example because it clearly shows the power of an intraday consolidation move (see [Figure 11.9](#)). It's like a chart of the young wife's life played by Geena Davis in *Thelma and Louise*. There is the narrow consolidation of life energy for a while, and then Thelma busts out and nothing can hold her back. Her personality explodes, and she finally experiences life—just like the squeeze. The first gray dot appears just after 2:00 p.m. eastern, and the histogram is above zero, so I go long at the market. I'm filled at 10,172, and I place a 20-point stop.

@YM - 5 min CBOT

B=10325 A=10326



Figure 11.9

2. The market pops higher, and a little less than an hour later, the momentum starts to slide. I exit at 10,221 for a gain of 49 points.

Mini-Sized Dow—September 2004 Contract, August 18, 2004

1. On August 18, 2004, the market spends most of the morning consolidating, and, as the volatility comes out of the market, the Bollinger Bands contract and start to trade inside the Keltner Channels (see [Figure 11.10](#)). This shows up in the form of black dots. When I get the first gray dot, the histogram is above zero, and I go long at the market. I'm filled at 10,003, and I immediately place a 20-point stop at 9983.



Figure 11.10

2. The markets push higher and start to lose momentum. I exit at 10,034 for a gain of 31 points.
3. A few hours later, we get a single black dot that is quickly followed by another gray dot. I take the signal. Since the histogram is above zero, I go long at the market, and I'm filled at 10,056. I place a 20-point stop.
4. The histogram is strong right into the close. I stay in the trade until 4:10 p.m. eastern and exit at the market. I'm out at 10,082 for a gain of 26 points.

Mini-Sized Dow—September 2004 Contract, July 28, 2004

1. On July 28, 2004, the YM creeps higher for most of the day, and then a little after 2:00 p.m. eastern, I get a black dot (see [Figure 11.11](#)). Shortly thereafter, we go back to gray, and since the histogram is above zero, I go long. I'm filled at 10,028, and I place a 20-point stop at 10,008 and leave my target as open.

@YM - 5 min CBOT

B=10325 A=10326

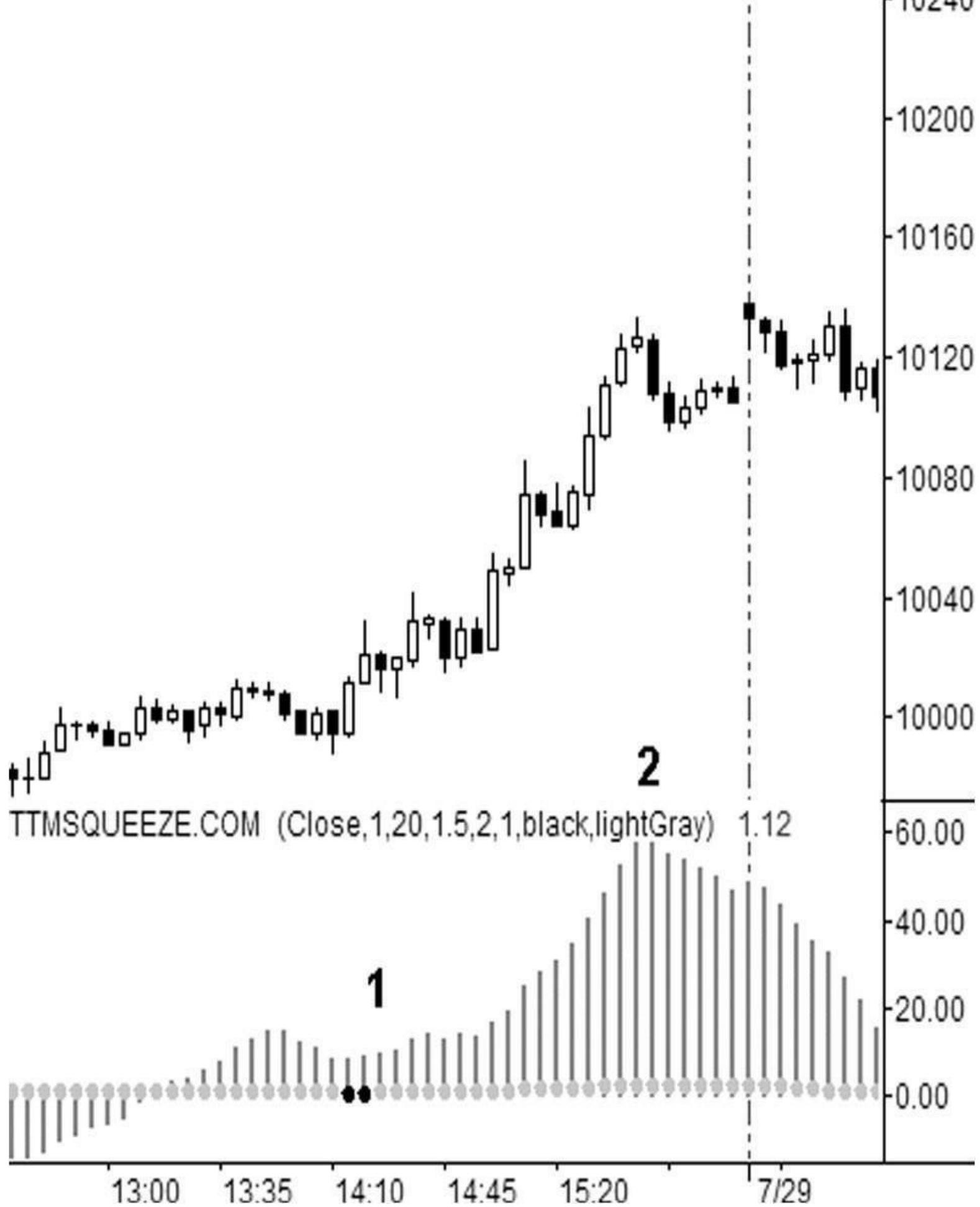


Figure 11.11

2. A little more than an hour later, the histogram makes a lower high. I exit at the market, and I'm filled at 10,103 for a gain of 75 points.

30-Year Bond—September 2004 Contract, August 18, 2004

1. I love using the five-minute squeeze on the YM, but it works on other markets as well. [Figure 11.12](#) is a chart of the 30-year bonds. At around 11:30 a.m. eastern, the dots turn black, signaling that we are entering into a period of very low volatility. About 90 minutes later, we get a gray dot at point 1, and since the histogram is above zero, I go long at the market. I'm filled at $111 \frac{9}{32}$. I place a 7-tick stop at $111 \frac{2}{32}$. (If you aren't familiar with bonds, 1 tick is \$31.25. So if you lose 7 ticks, that equates to \$218.75, or approximately 44 YM points.)

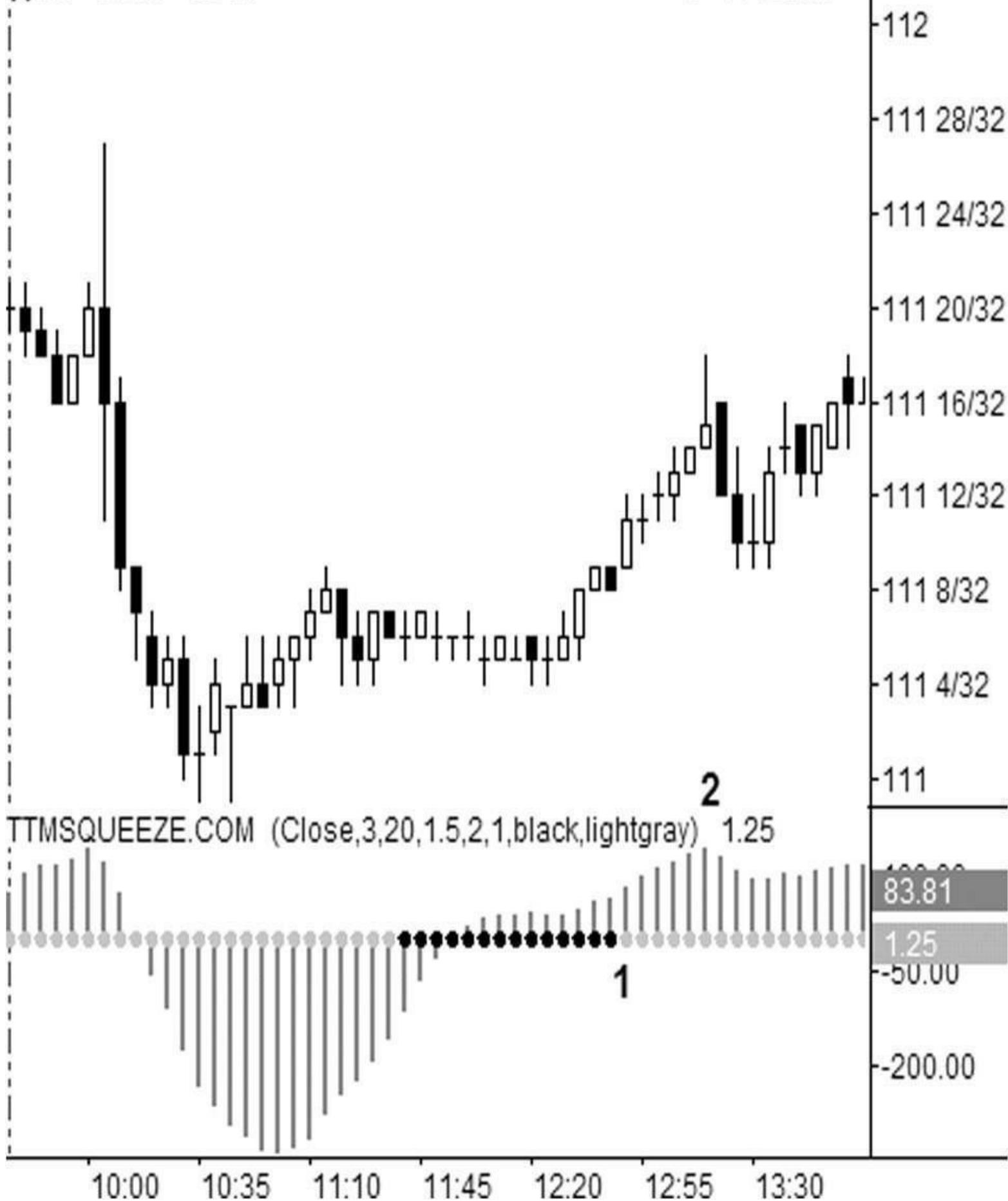


Figure 11.12

2. The momentum starts to peter out about 40 minutes later, and when the histogram makes a lower high at point 2, I exit at the market. I'm out at 111 $\frac{11}{32}$ for a gain of 2 ticks. At one point I was up 10 ticks on the trade (the equivalent of 63 YM points), but the market rolled over quickly, which can happen. That's why it's called fishing, and it's not guaranteed to catch a fish. The key to successful trading is to stay in the signal until it ends. This way, when a big move does take place, a trader will be able to stay in the trade and let the profits run. Work on developing successful habits, not staring at the P&L.

30-Year Bond—September 2004 Contract, August 10, 2004

1. On this five-minute chart of the bonds, we go into black dot territory at around 10:45 a.m. eastern, and I sit back and wait for the next gray dot to appear (see [Figure 11.13](#)). This happens a little after 12 noon at point 1, and since the histogram is below zero, I short at the market. I'm filled at 110 $\frac{30}{32}$. I place a stop at 111 $\frac{5}{32}$. Remember, one full point in the bonds is composed of 32 ticks. When it goes to $\frac{32}{32}$, it becomes a new point. For example, when bonds are at 110 $\frac{31}{32}$ and they move up one tick to 110 $\frac{32}{32}$, this reads as 111, and so on.

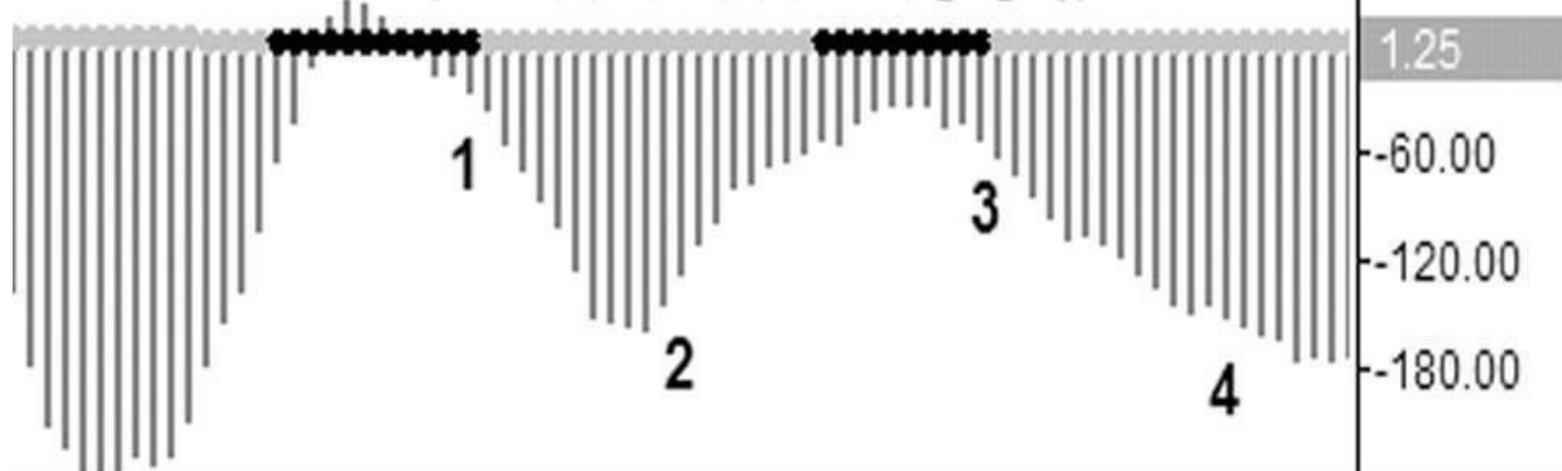
@US - 5 min CBOT

B=111 23/...

-111 8/32



TTMSQUEEZE.COM (Close,3,20,1.5,2,1,black,lightgray) 1.25



10:25 11:10 11:55 12:40 13:25 14:10 14:55 15:40

Figure 11.13

2. The momentum to the downside builds, and bonds sell off. Once the histogram makes a higher low at point 2, I cover my short at the market, and I'm out at 110 $\frac{26}{32}$ for a gain of 4 ticks.
3. At around 1:30 p.m. eastern, we go back into black dot mode, and I prepare for my next trade. About 45 minutes later, we get our first gray dot at point 3, and since the histogram is below zero, I short at the market. I'm in at 110 $\frac{21}{32}$. I place a stop at 110 $\frac{28}{32}$.
4. Bonds sell off and move lower into the close. I cover at the first higher low at point 4, and I'm out at 110 $\frac{16}{32}$ for a gain of 5 ticks. The market rolls over again quickly thereafter and closes on its lows.

30-Year Bond—June 2003 Contract, April 30, 2003

1. On this daily chart of the bonds, we can see that these markets consolidated heavily for nearly a month during most of April 2003 (see [Figure 11.14](#)). When the first gray dot appears after this consolidation at point 1, I go long and am filled at 113 $\frac{19}{32}$. Because this is a daily chart, I give the trade more room and use a 35-tick stop at 112 $\frac{10}{32}$. Bonds rally through the entire month of May, finally losing momentum in June.



Figure 11.14

2. Bonds get nearly as high as 122 before crashing on economic news at point 2. This kicks off a lower histogram reading, and I exit at the market at the end of that day, getting out at $119 \frac{31}{32}$ for a gain of $6 \frac{18}{32}$, or \$6,562.50 per contract. This is the same as catching a 1,312-point move in the YM.

E-mini S&P—December 2003 Contract, December 2, 2003

1. On this daily chart of the E-mini S&Ps, the markets start to consolidate near the end of November 2004 (see [Figure 11.15](#)). On December 1, we get a gray dot. The histogram is above zero, so I go long the next day. There is no magic on the entry formula. I wake up and look at the chart, and if it tells me to take action, I take action. I just get in at the market, very near the open. I'm in at 1062.50 (point 3). I place a 15-point stop at 1047.50.



Figure 11.15

2. The histograms peak out and start making lower lows during the first week in January. I get out on January 9 at 1129.50 (point 4) for a gain of 67 points, or \$3,350 per contract. The market continues to move another 30 points higher. This is all about “being positioned” in the market when it’s setting up to make a big move. Note that this contract expired in the third week of December, so I closed out my position in the December contract and reopened it in the March 2004 contract, which was the next front month. I literally sold the December futures, then turned around and, because the signal was still valid, bought the March futures in order to stay in this play. This is called “rolling over” your position.

E-mini S&P—September 2004 Contract, July 8, 2004

1. On this daily chart of the ES, we go into a period of consolidation at the end of June 2004 that lasts into the first few trading days of July (see [Figure 11.16](#)). On July 8, we get a gray dot, and since the histogram is below zero, I go short about 15 minutes after the open of the regular session. I am filled at 1118.25 (two bars to the right of point 3). I place a 15-point stop at 1133.25.



Figure 11.16

2. The markets move lower, and toward the end of July they start to run out of momentum. At point 2, I exit near the open at 1092.25 for a gain of 26 points (point 4).

Mini-Sized Dow—December 2003 Contract, December 1, 2003

1. We've looked at a lot of five-minute squeezes on the YM, so I want to look at a daily squeeze on this contract as well. At the end of November 2003, the daily YM goes into black dot mode, and I await the next gray dot (see [Figure 11.17](#)). We get it on December 1, and since the histogram is above zero, I go long shortly after the open and get filled at 9804. I place a stop at 9654, 150 points below.

@YM - Daily CBOT

B=10325 A=10326

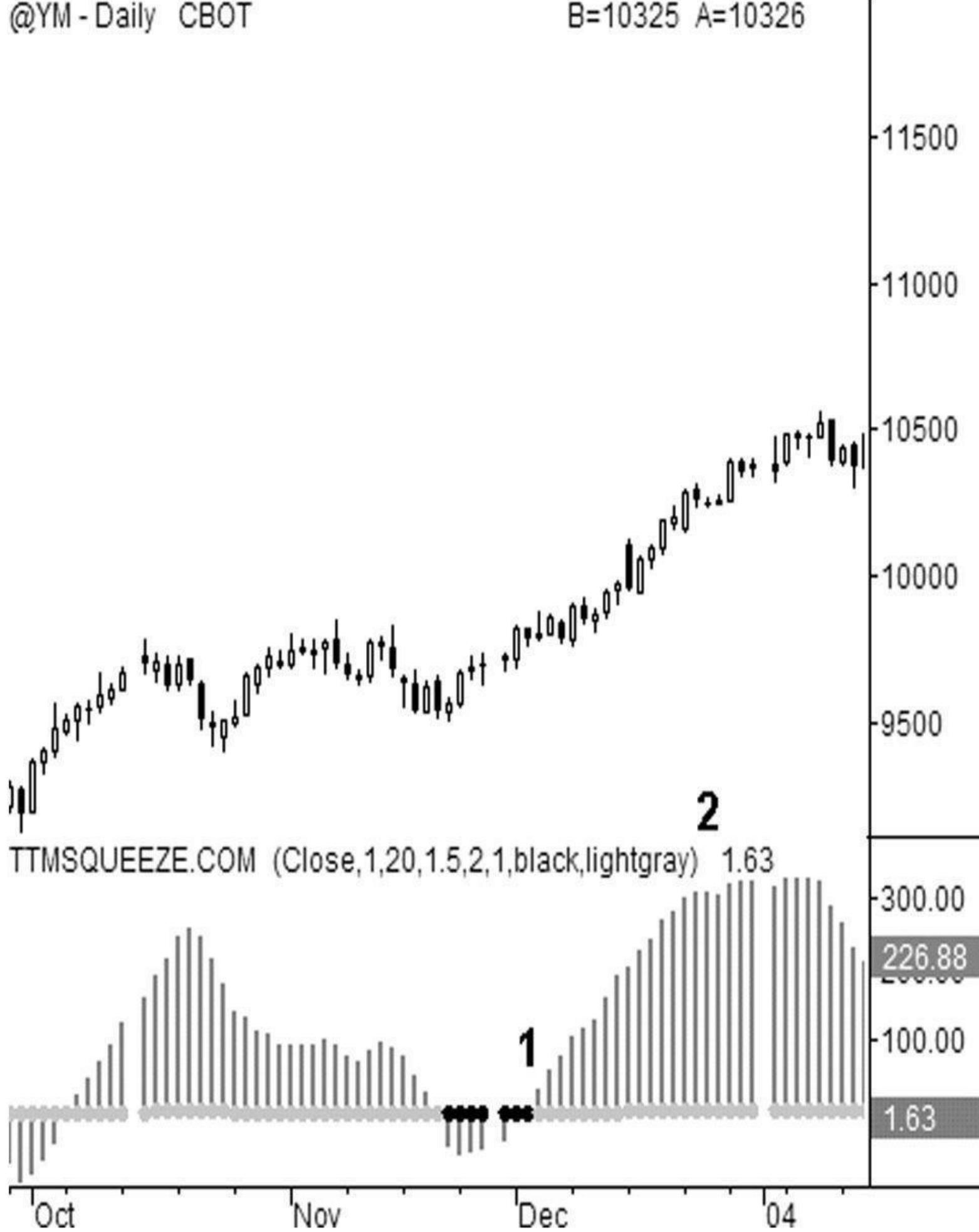


Figure 11.17

2. The YM rallies into early January and starts losing momentum during the second week of the new year. I exit on January 9 soon after the open at 10,506 for a gain of 702 points, or \$3,510 per contract.

Forex Markets—EURUSD, August 23, 2004

1. I like to use the squeeze on the various currency pairs in the forex markets as well. I normally like to use the 60-minute charts and 5-minute charts, but it also works on the daily charts. On August 23, 2004, I wake up to see that the euro has just fired off a short squeeze on the 60-minute chart (see [Figure 11.18](#)). I go in and short at the market, getting filled at 1.2252. I place a 20-pip stop at 1.2272. (Remember, 1 pip in this currency pair equals $\frac{1}{100}$ of a cent and equates to \$10 on your P&L.)

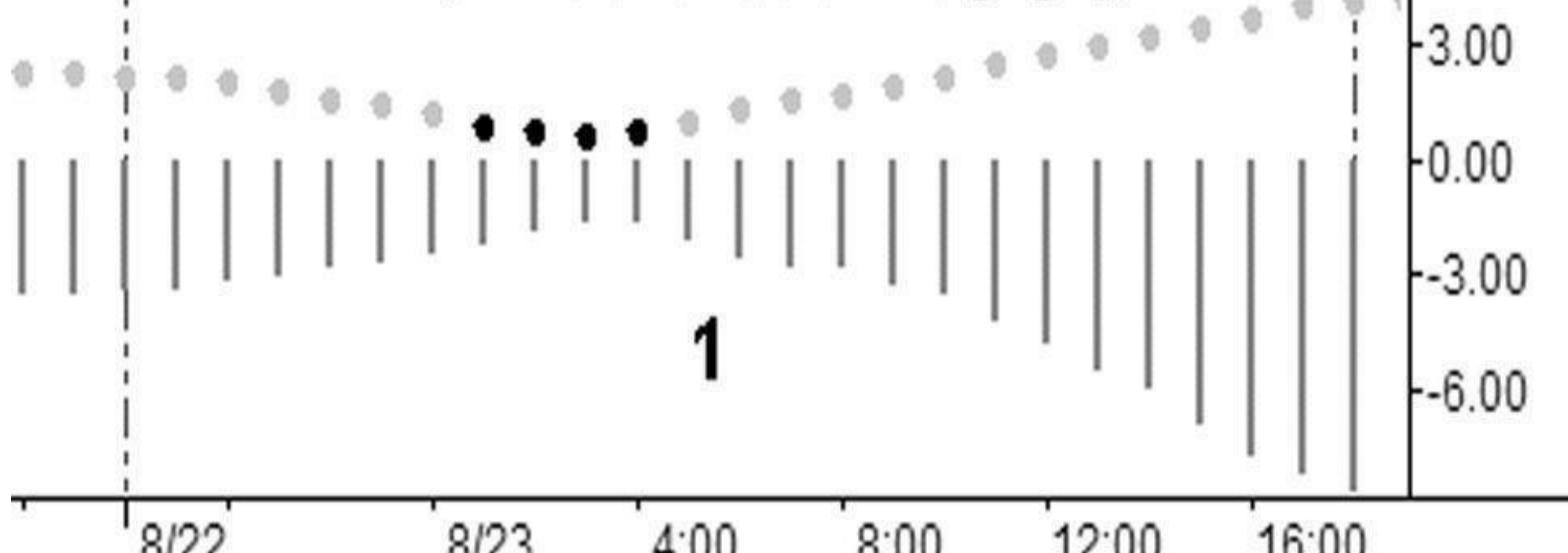
EURUSD - 60 min FOREX

B=1.2252 ...



2

TTMSQUEEZE.COM (Close,3,20,1.5,2,1,black,lightgray) 0.99



1

8/22

8/23

4:00

8:00

12:00

16:00

Figure 11.18

2. The market sells off considerably, and the momentum on the histogram never lets up. I stay in the trade all day, exiting at 4:00 p.m. eastern at point 2, when the U.S. stock markets close. The main reason I do this is that this started off as an intraday play, and I generally get out of the office after the stock markets close to go clear my head. I exit at the market and am filled at 1.2146 for a gain of 106 pips, or \$1,060 per contract. This is like making 212 points on the YM.

Forex Markets—EURUSD, September 8, 2004

1. On this five-minute chart of the euro currency, we go into black dot territory a little before 10:00 a.m. eastern on September 8, 2004, and 25 minutes later we get our first gray dot at point 1 (see [Figure 11.19](#)). The histogram is above zero, so I go long at the market, and I'm filled at 1.2054. I place a stop at 1.2034.

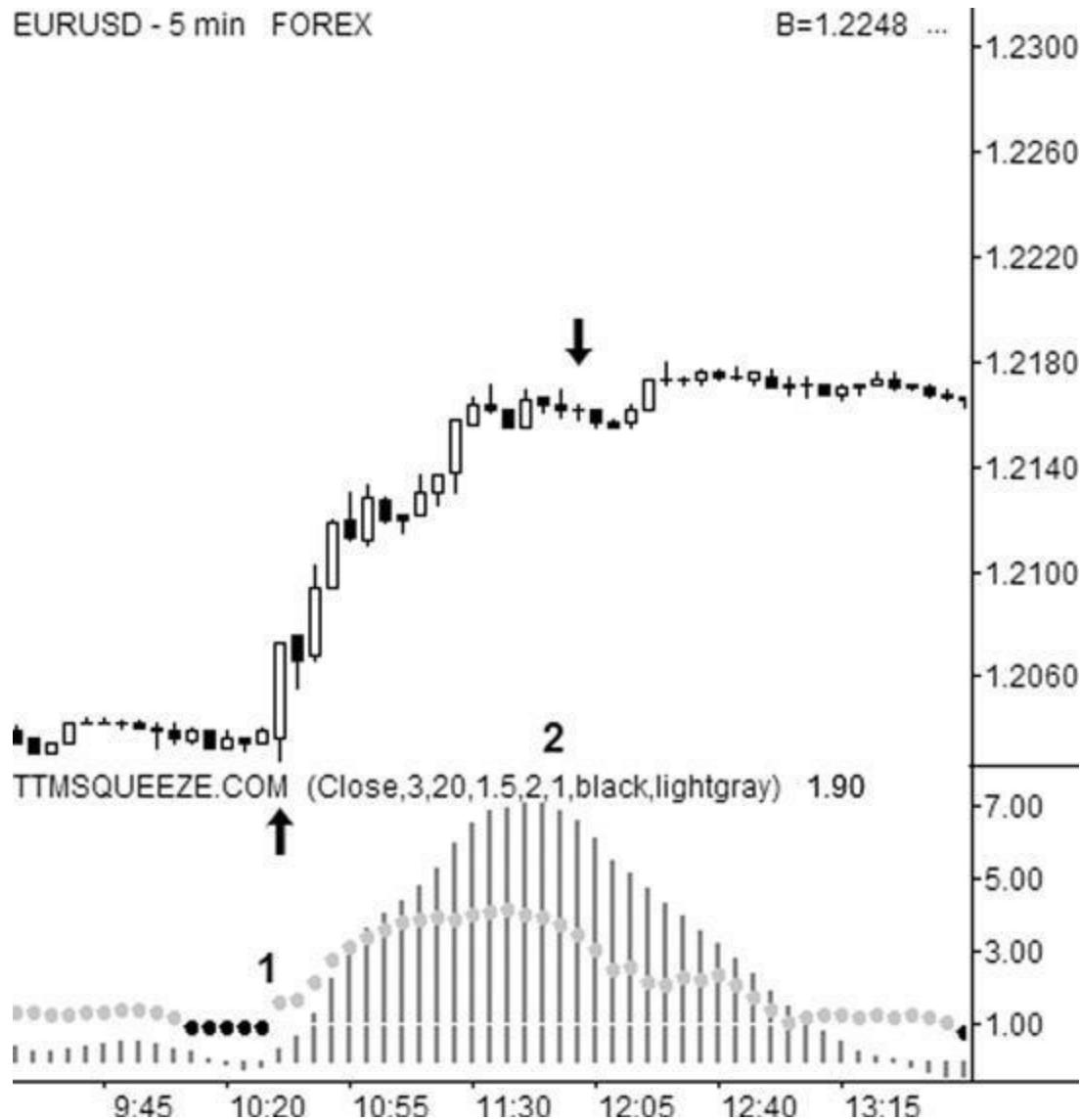


Figure 11.19

2. The market rallies steadily for the next 90 minutes and starts to lose momentum just before 12:00 noon, at point 2. I exit at the market and am filled at 1.2153 for a gain of 119 pips.

GOOG (Google Inc.), September 9, 2004

1. I like to watch the squeeze on various stocks as well, especially on daily time frames, since most of my stock trading involves swing trading. I also use the daily squeeze on individual stocks for in-the-money option plays. I talk more about how I play options in the chapter on the “8/21 EMA for Swings” setup. That said, I will use the five-minute squeeze on volatile stocks for potential intraday trading setups. [Figure 11.20](#) shows a five-minute chart of Google (GOOG), where we can see the price action shortly after its IPO (initial public offering). On September 9, 2004, the stock goes into a squeeze setup at the end of the day, and this

carries into the beginning of the next day. Very soon after the open, we get our first gray dot, and, since the histogram is above zero, I take a long at the market. I'm filled at 102.33, and I place a stop at 101.83.

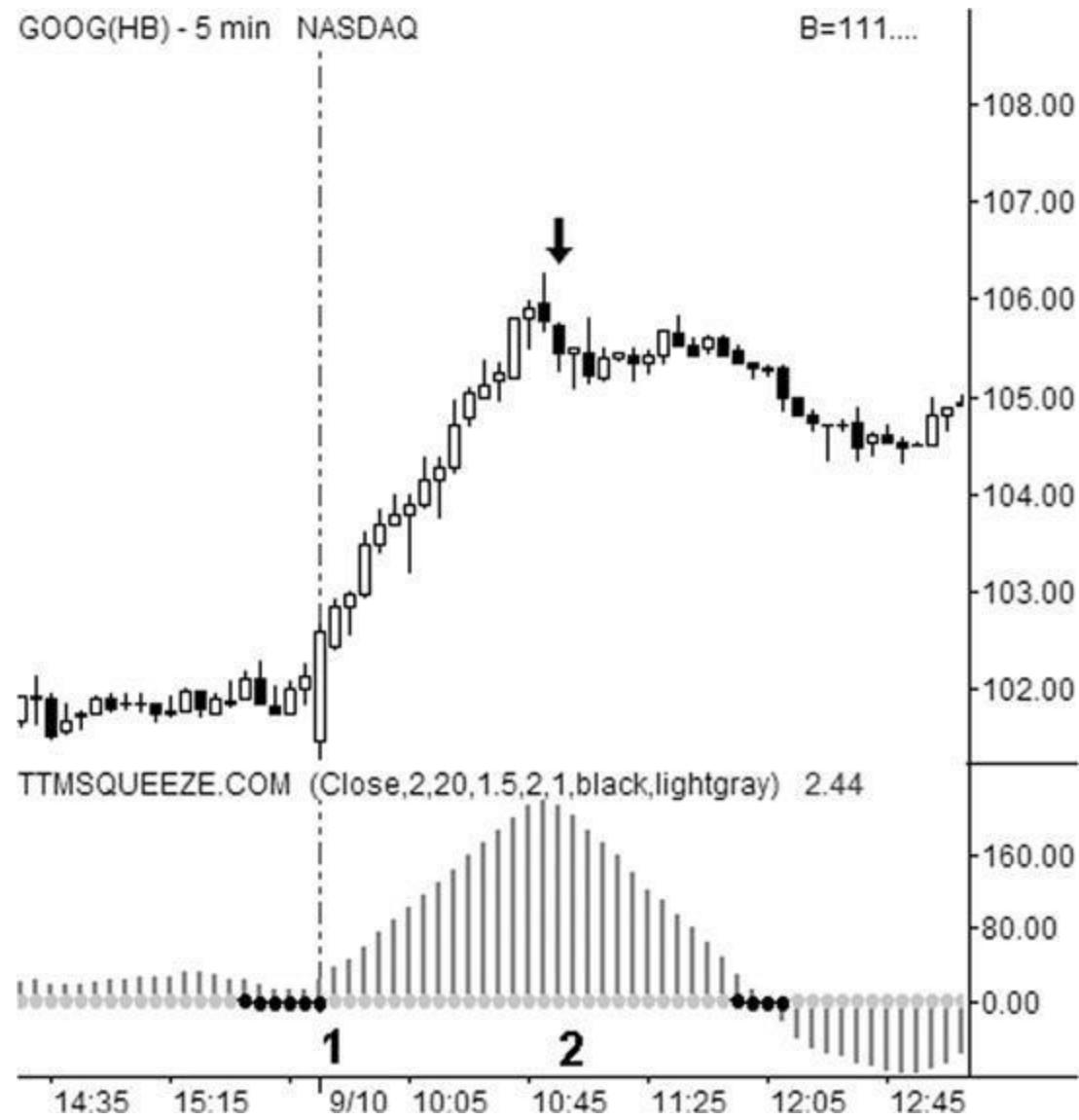


Figure 11.20

2. The momentum builds quickly and begins to fade near 11:00 a.m. eastern. I get out at 105.45 for a gain of 3.12. Another squeeze play sets up later in the afternoon and fires off right after 12 noon. On this play, the histogram is negative, and I would normally short, but since it was an IPO, shares were not available to the general public to short at this time, so I obviously passed on this trade.

What Is the Biggest Mistake New Traders Make?

Squeezes show me when the markets go into quiet mode. The only reason markets go into quiet mode is that they are building up energy for their next major move. Many new traders make the classic mistake of waking up in the morning and "looking for which markets are on the move." They see that AAPL is up 5 points and buy the stock, or, worse, they buy out-of-the-money calls. Or they see that the euro is down 40 ticks and they stumble over themselves to short it. They are chasing the action. Well, they are late to the party, and they are most likely going to be buying positions from people like me who are exiting squeeze trades on losses of momentum. Traders who chase markets, like dogs that chase cars, eventually get run over.

I like to sneak into the markets when they are quiet, before everyone else knows what is going on. With the squeeze, I have a clear indication of when to take the trade. And once I'm in, I just don't mess with the trade. When it starts to lose momentum, it is pretty clear, and that is the signal I use to get out.

Many day traders I talk to ask about the wisdom of swing trading. The biggest question I get involves the risk in being exposed to an overnight position. "What if there is another terrorist attack?" After trading the markets for nearly 20 years, there is one thing I am absolutely convinced of—there is always somebody who knows about the upcoming market move, and this person is in the process of getting positioned for it. After the crash on 9/11, one of the ways the government tracked down terrorist cells was to look at all the brokerage accounts that showed heavy short selling in the weeks before the attack, especially of insurance and airline stocks. This led to multiple arrests, as people who knew about the upcoming attacks had been shorting these stocks aggressively. Out of the blue? Let's look at a few market crashes and just see how "out of the blue" they really were.

Is It Possible to Get Positioned Before a Market Crash?

I don't mean to belittle the events of 9/11 by viewing them as merely a "trade setup." I lost friends, and I know many people who lost friends and loved ones in that attack. The point of this is that the event should not scare us and make us cower in the corner. It should not keep us from taking risks, whether it involves getting on a plane, visiting another country, embracing people from other cultures, or having exposure to overnight positions. Living scared can hardly be called living.

Dow Cash Index—September 11, 2001

1. This is a daily chart of the Dow Jones Industrials leading up to the terrorist attack on the World Trade Center on September 11, 2001 (see [Figure 11.21](#)). At point 1, we can see that the daily squeeze fired off a short on August 30. This is the first sign that there is a lot of steady, quiet selling going on in this market. There is no reason to be long this market. If you have a retirement account or 401(k) that is invested in stocks, this is the time to switch to 100 percent cash or bonds, even though when you call in to do it, your "advisor" will try to talk you out of it. Why would she do that? She makes more in fees if you are invested in stocks. You can get back into stocks once the squeeze has lost its downside momentum.

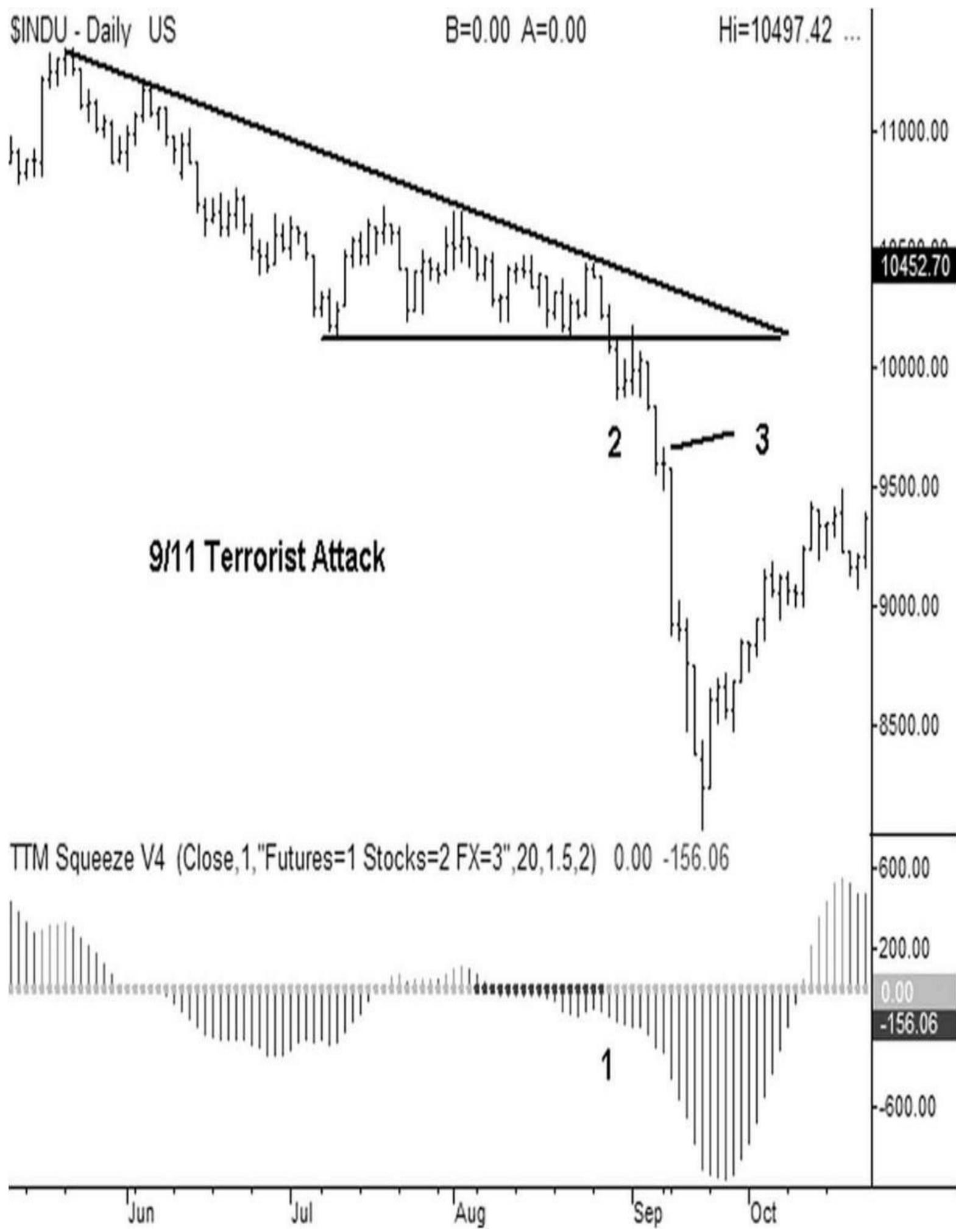


Figure 11.21

2. The very next day, the markets break through support on a descending wedge pattern. There are now two solid short signals in place.
3. Six trading days later, it is September 10. The markets make new intraday lows, and the momentum on the squeeze is still strong. Did we know about the looming terrorist attacks and that the market was going to crash? No. I didn't, anyway, and 99.99 percent of the population on the planet didn't know either. However, as a trader and investor, I did know that there was (1) no reason to be long the current market, in which case I have the option to sell all my stocks and sit in cash in my retirement accounts, and (2) as a trader, there were numerous sell signals here and plenty of time to get short. On a play like this, I like to buy slightly in-the-money put options on SPY and DIA at least six weeks out, and then I can just sit on those options while the squeeze unfolds.

After 9/11, the markets were closed and didn't reopen until September 17. The Dow closed at 9605 on September 10, and after the next trading day, closed at 8920.70, down nearly 700 points. Again, leading into this, there was no reason to be long in this market. Even though we didn't know what was about to happen, somebody did. The charts do not lie. This is why listening to the news is so worthless—all it does is tell you what has already happened, as it has no idea what's going to happen next, and in between doing this, it lets people try to sell you stuff via commercials. Thank you, sir, may I have another!

Dow Cash Index—October 19, 1987

1. There was another big crash on October 19, 1987 (see [Figure 11.22](#)). This was the year I graduated from high school, and one of my fondest trading memories is having owned a put on IBM during the crash. I wish I could say that I had seen the crash coming, but it was pure luck. I had a bunch of calls, read something about hedging, and bought a put on IBM. The put saved my bacon and then some, although my calls didn't fare too badly because of the increase in implied volatility—again, at the time, I had no clue what that was either (see [Chapter 5](#)). If I'd had the squeeze at this time, I would have noted that the daily squeeze fired off a short signal on October 9, ten full days before the crash, and I wouldn't have owned any calls. I'd have played the move for what it was; instead of hedging my longs, I'd have just gotten short. We are, of course, all geniuses in hindsight!

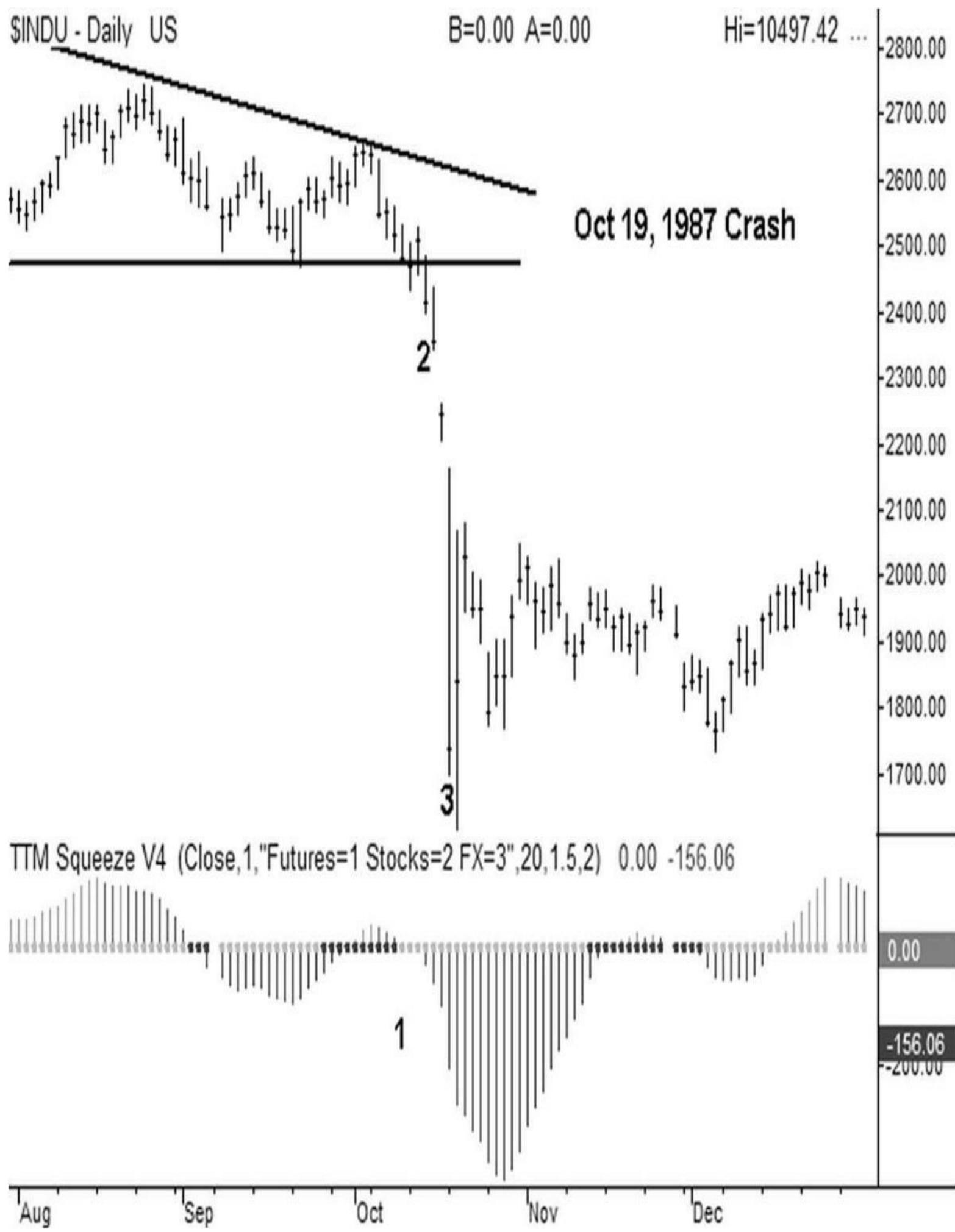


Figure 11.22

2. Then on October 14, the markets broke down from a descending wedge pattern. There were now two reasons not to be long in the markets. There are times to buy the dip, and there are times to shun the dip. When the squeeze is firing off short, shun the dip.

On October 19, the markets crashed. Those who were already positioned for the move had a nice trading day. Those who didn't have the squeeze to guide them experienced new variations of the meaning of pain.

Dow Cash Index—the Crash of 1929

The crash in 1929 was no picnic, either. I talked to one trader who was there when it happened. He is over 90 years old now and still actively trades. To him, nothing has changed, and it's all the same game. Remember that in the first chapter, I talk about markets moving not because they want to, but because they have to? We talk about TASR in that example. Along these same lines, here is the quick narrative of the crash of 1929.

On the night of Monday, October 21, 1929, margin calls were heavy, and Dutch and German calls came in from overseas to sell overnight for the Tuesday morning opening (see [Figure 11.23](#)). On Tuesday morning, out-of-town banks and corporations sent in \$150 million of call loans, and Wall Street was in a panic before the New York Stock Exchange opened. The selling was heavy, but the influx of cash staved off a crash.



Figure 11.23

Unfortunately, on Thursday, October 24, 1929, more margin calls hit, and people began to sell their stocks as fast as they could. Sell orders flooded the market exchanges, the ticker was running more than an hour behind on price quotes, and the markets sold off hard, but not enough to be considered a crash. The exchange directed all employees to be on the floor, since there were numerous margin calls and sell orders placed overnight for the next trading day. Extra telephone staff was also arranged at the members' boxes around the floor. The Dow Jones average closed at 299 that day.

On Tuesday, October 29, 1929, the crash began. Within the first few hours, the prices fell so far that they wiped out all gains that had been made in the entire previous year. This day, the Dow Jones average closed at 230. This is like the Dow losing 2,400 points in one day today. Between October 29 and November 13, more than \$30 billion disappeared from the American economy—and these were 1929 dollars. It took nearly 25 years for many of the stocks to recover.

The Dow finally bottomed out in July 1932 at near 40. That is like the Dow going from 10,000 to 1,100 in the year 2005.

Coming back full circle, it is important to note that a short squeeze fired off on the daily chart before the 1929 crash. Yes, terrorist attacks and crashes are scary things, but the squeeze is designed to give traders a heads-up on which way the markets are going to break, so that they aren't caught with their pants down.

What Is the Best Trading Strategy for Those of Us Who Have a Job and Can't Trade Full Time?

The squeeze on a daily or weekly chart is one of the best ways I know to trade part time. It can be used on individual stocks, and there is no reason to scan thousands of charts. *Investor's Business Daily* is a good resource for actively traded "healthy stocks" via the IBD 50. I just sort through these stocks, and once I see a squeeze fire off on one of them, I will place an order for the trade, via either the actual stock or a delta 0.70 option. These types of trades do not need to be managed intraday. Even though I watch the markets full time, I do not watch my swing trades intraday. There is no point. My parameters are in place, and the only thing I'm going to do if I watch my position is try to outsmart it, which never works in the long run. In addition to individual stocks, this can be used for sectors and ETFs, and for commodities as well. As an added benefit, if you are working a full-time job and can't watch the markets intraday, you are actually at an advantage. In that type of situation, a lot of the psychological stuff that I discussed in [Chapter 2](#) doesn't even have a chance to come up. Place the trade, set your parameters, go to work, and log in later to see what happened. There is a lot of wisdom to that approach.

Updated Examples for the 2008 Financial Crisis and Beyond

During times of great uncertainty, which we've had ever since the financial crisis of 2008 hit the world, indicators like the squeeze take on added importance. They allow a trader and investor to stay calm, make decisions, and not get sucked into all the misinformation that's being spread around like so much cow manure. Let's take a look at a few examples of how this all played out. Also remember my discussion of the AUDJPY currency cross from [Chapter 6](#). This plays strongly into understanding "what the hell is going on" in today's financial markets. It's always good to know when hedge funds are buying and when they start selling. This way, you can sidestep the freight train when it comes your way.

In [Figure 11.24](#), we have a weekly chart of silver. This is a classic example of a squeeze. At point 2, the silver market had been consolidating between \$15.00 and \$20.00 for over a year. People who had bought at \$20.00 were anxious, while people who had bought at \$15.00 felt slightly more comfortable. For long-term bullion holders who want to own silver forever, this isn't too much of a concern. But for traders, part of the key is knowing "when to put capital where." It would have been possible to buy silver at \$20.00 a year and a half too early. That money would have been essentially "dead money" from a trading perspective, as it could have been put to work elsewhere.

At point 2, we can see that a squeeze has been setting up for several weeks. This means, of course, that the silver market is getting ready to potentially release a truckload of energy. In this case, it initiated the move that eventually saw silver soar to \$50.00 an ounce. It is during this time, during the "squeeze period," that a trader wants to look at taking a position in silver. This could be done in many ways: buying the silver ETF (SLV), buying call options on SLV, buying silver futures, buying call options on silver futures, buying silver mining stocks, or even buying silver bullion. And a trader could take this a step further and initiate option positions in SLV that would benefit from a rise in SLV—selling naked puts and so forth. The key is having and understanding the signal (in this case, seeing that silver was potentially about to go higher) and then choosing the variety of trading strategies around this signal that best fit your personality and trading goals.

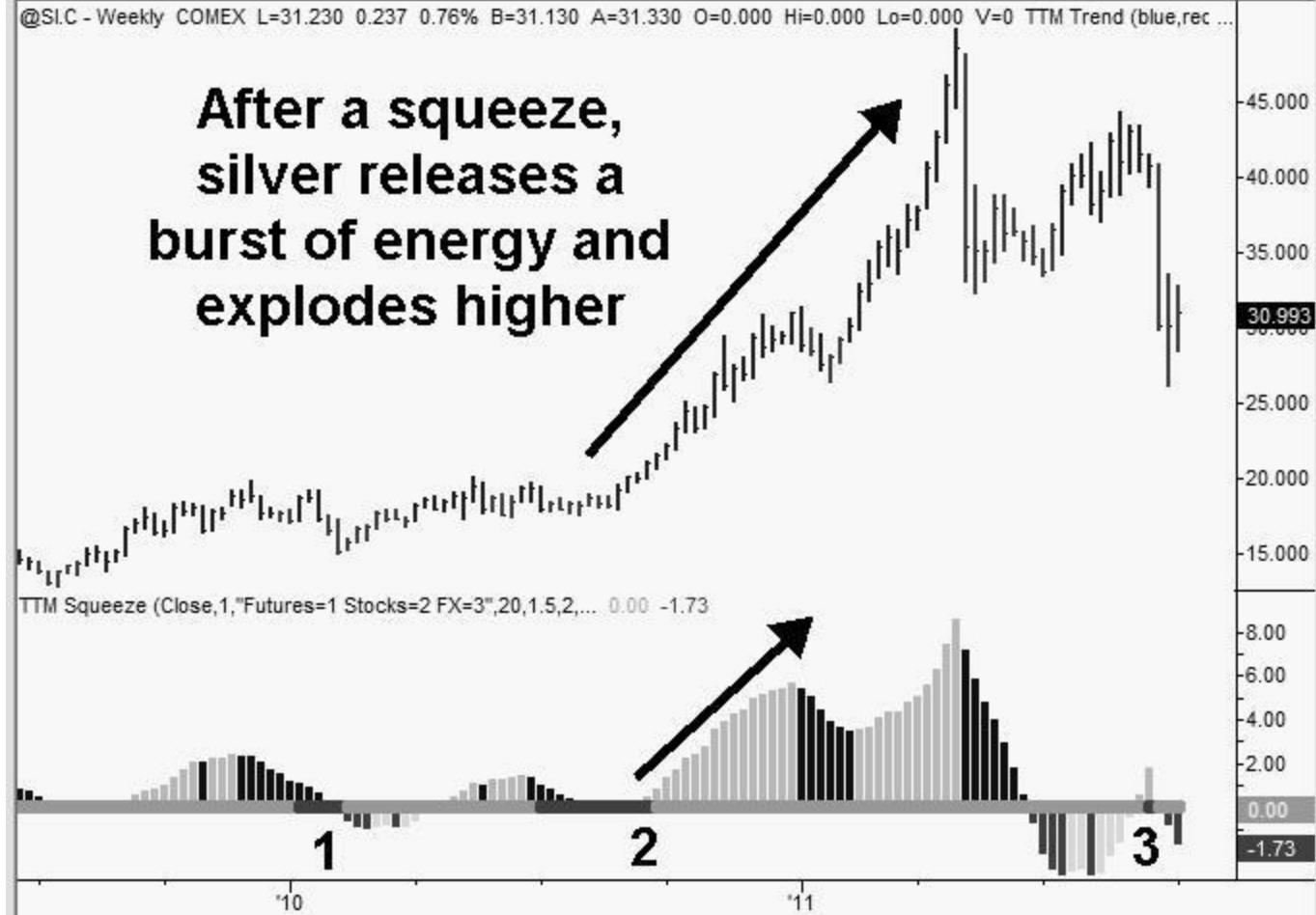


Figure 11.24

At point 1, there is a squeeze that fires off a short signal in silver. As you can see from the chart, this move did not last long, though silver did fall from \$20.00 back toward the \$15.00 level. In the next chapter, I'm going to talk about a filter for the squeeze that filters out setups like that—setups that may not have a whole lot of conviction.

[Figure 11.25](#) shows a weekly chart of the S&P 500 futures. Point 1 shows a squeeze that results in a multimonth 20 percent spurt higher at a time when there was extreme bearish sentiment about the markets as a result of the European bailouts. And yet, the market ignored the news and rallied anyway. At point 2, the European situation had continued to get worse, and the stock market had had some serious selling, falling from 1200 all the way back to 950. People were getting jittery. At point 2, a squeeze took shape and fired off long, and the S&P 500 started one of its most ferocious 35 percent rallies in recent memory. Day after day, week after week, shorts got clobbered on this rally as they fought the advance every step of the way. And why not? The news was negative every day! Traders who were following the squeeze didn't fight it. They just got long and waited for the exit signal to get out, no matter how negative the commentary spewing forth from the financial press. At point 3, in July 2011, the S&Ps started setting up another squeeze, and this one fired off short. Again, once this happens, there is no reason to be long on stocks, no matter what the news is saying, and aggressive traders can go one step further and get short. Isn't this a lot easier than scanning the news every day for hours, trying to figure out what is going to happen next? Of course, if the S&P 500 is firing off a squeeze, individual stocks will also follow. If I see the S&P 500 set up a signal, I will also look at taking positions in key stocks like AAPL, BIDU, PCLN, and so on that will benefit from a move in the S&P 500.

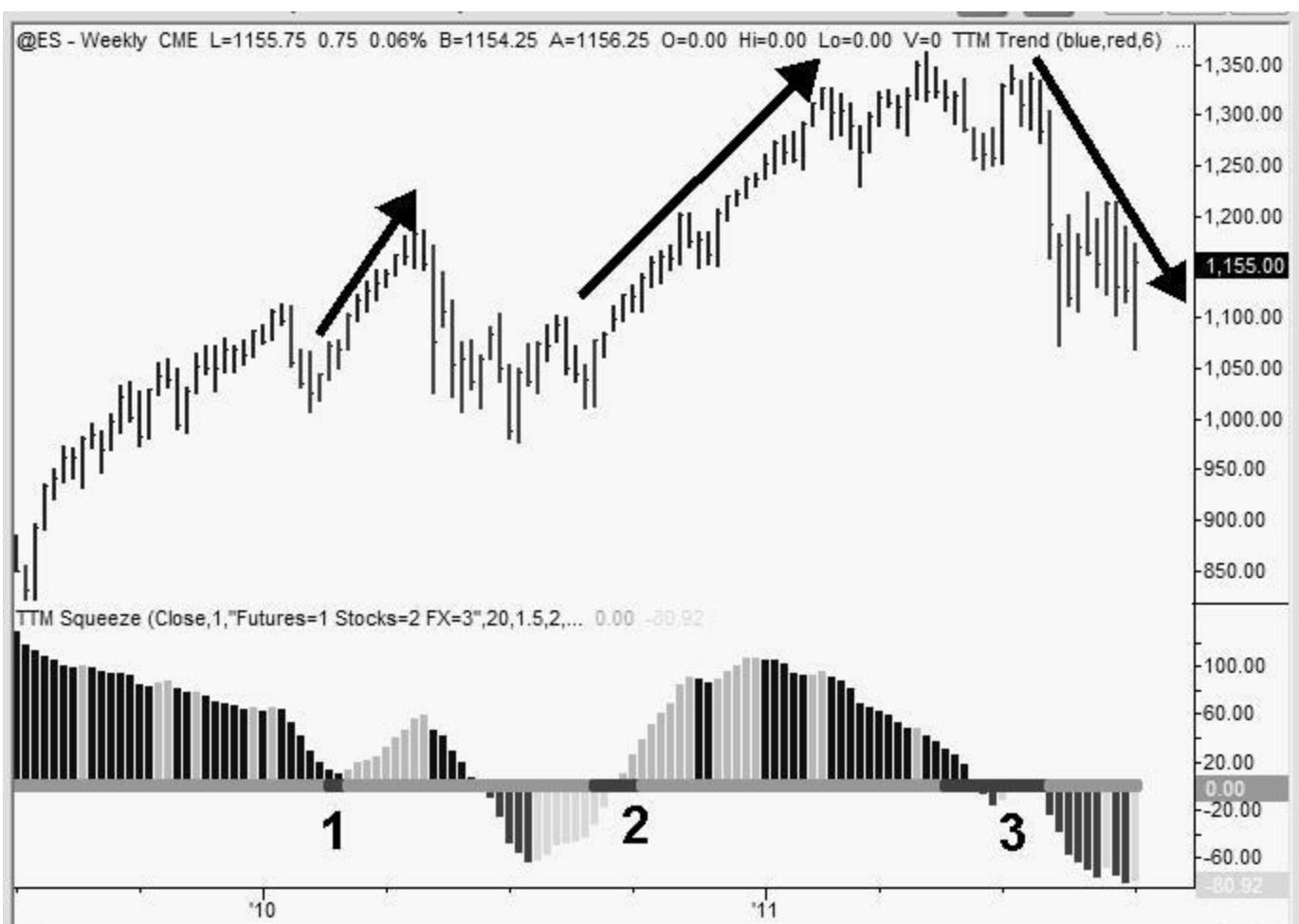


Figure 11.25

The king of the squeeze charts is the monthly chart. Although squeezes don't set up on these charts very often, once every few years, they are hugely powerful. [Figure 11.26](#) shows a monthly chart of gold. Gold tends to have a solid move, then consolidate for 12 to 18 months, and then have another solid move. This can all be mapped out and timed with the squeeze. Point 1 shows a long squeeze from the middle of 2002. Point 2 shows a long squeeze from the end of 2005. The next squeeze took place two years later at point 3 near the end of 2007. Then, two years later, near the end of 2009, yet another monthly squeeze fired off that launched gold from \$900 an ounce to over \$1,800 an ounce. As of this writing in October 2011, it's time for gold to "go quiet" again for another 12- to 18-month period until its next major monthly squeeze signal. As with the trade in silver, there are many ways to utilize this information, implementing strategies with stocks, options, and futures.

Another critical chart to watch is a weekly chart of the U.S. dollar index, symbol DXY (also referred to as Dixie). The fundamentals on the U.S. dollar are well known and always point to lower prices for our beloved currency (he says, tongue in cheek). That said, no market moves straight up or straight down, and while the Dixie has a fundamental sob story, there are moments when it shines and will continue to shine. Back in the good old days, the U.S. dollar would rally because our economy was so strong when compared to other major economies. These days, the U.S. dollar will rally during periods of global economic unrest. This is important to realize because the price of the U.S. dollar affects nearly every other asset around the world to some extent. The dollar goes up? Guess what, oil, gold, grains, and many other commodities, and even many stocks, go down in price, as they are priced in U.S. dollars (as U.S. dollars get more valuable, it takes less of them to buy the same amount of gold, oil, and so forth).

Squeezes on the monthly gold chart dominate the trading action



Figure 11.26

What about quantitative easing? Yes, this creates a lot of new currency at the push of a button, and in theory this should push the dollar lower. This would be true if so many dollars weren't being destroyed by deflationary real estate pressures. For example, in 2009, there was \$1.1 trillion in new dollars created by quantitative easing. There was also \$1.6 trillion in debt destroyed by falling real estate prices. This means that in 2009, despite quantitative easing, the supply of U.S. dollars actually decreased by \$500 billion, making the fewer dollars that were left more valuable. Luckily, a person doesn't have to understand or even know about this. Just look at the chart and follow the squeeze signals.

The two big factors that drive this currency higher these days are (1) the unwinding of the carry trade (see the [Chapter 6](#) discussion of AUDJPY) and (2) global economic recessions. In a global recession, when *everything* is slowing down, the U.S. dollar starts to look pretty good in comparison to other fiat currencies. Think of it as "the least stinky piece of crap" floating to the surface.

In [Figure 11.27](#), we have a weekly chart of the \$DXY. At the start of 2010, a long squeeze fired off, and the Dixie had a fantastic rally. During this time, gold fell from 1200 to 1000, the S&P 500 fell from 1215 to 1000, the euro got clobbered from 1.50 to 1.19—the list goes on and on. Even strong markets like oil could only manage to trade sideways during this time. A strong dollar truly affects everything, just as a weak dollar also affects everything. The key is not to stick your head in the sand and trust that the U.S. dollar will continue weakening in a straight line down. At point 2, there is a short squeeze, and during this time, as the U.S. dollar sold off, nearly everything else rallied. Stocks, gold, oil, euros—you name it, it rallied. As I'm writing this on October 8, 2011, the U.S. dollar has recently fired off another long squeeze (on fears of a global recession—but of course the reasoning doesn't really matter; just follow the signal), sending the dollar higher. This has been a powerful signal, as prices of gold, silver, stocks, and so forth continue to fall apart.

The weekly squeeze is also very useful for cutting through the noise, which is often confusing and contradictory. In September 2010, RAX (Rackspace), a web hosting company, was getting a lot of negative press. The stock was too expensive, the P/E ratio was too high, and the short interest continued to climb as hedge funds shorted the stock in anticipation of a great fall.

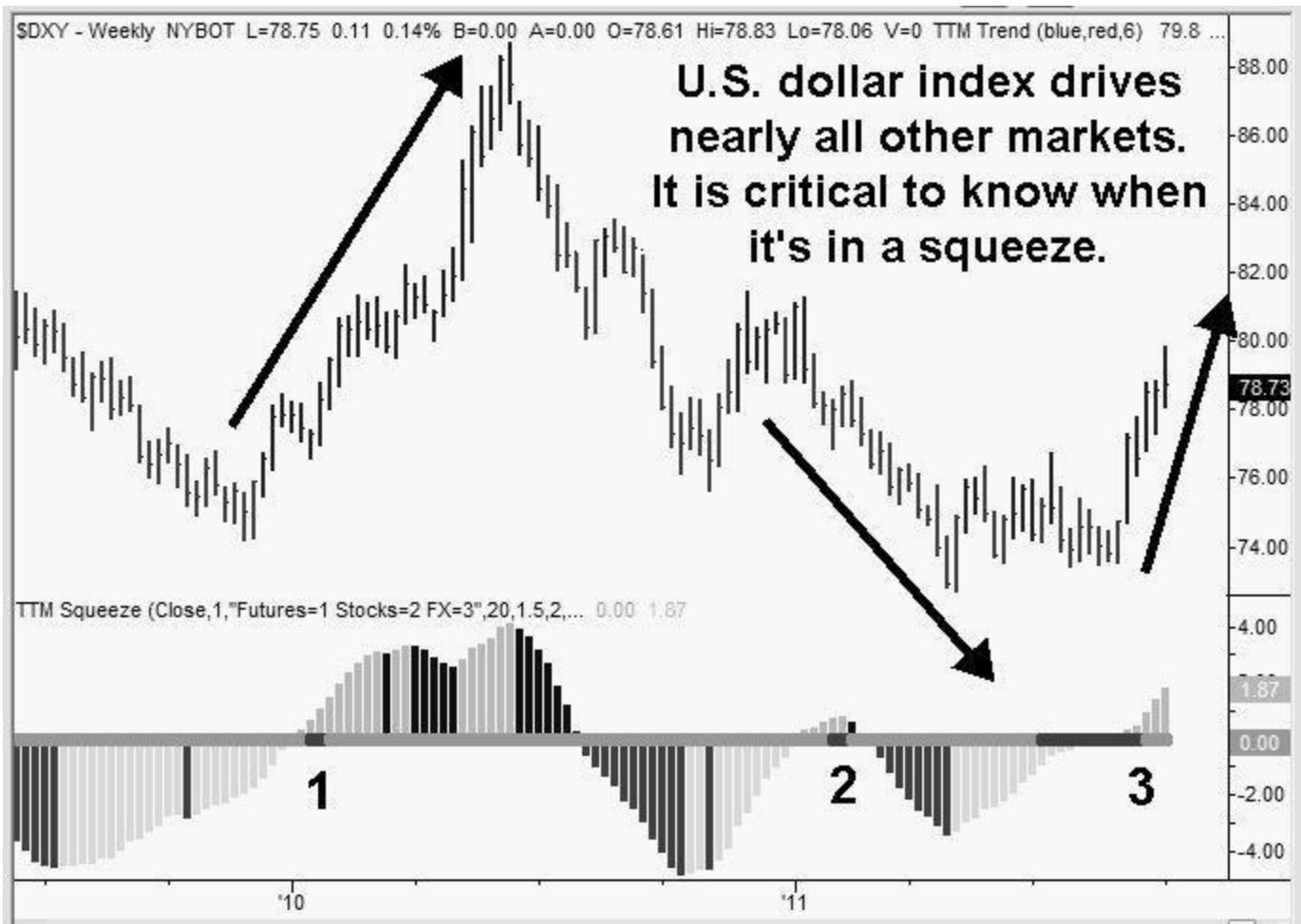


Figure 11.27

[Figure 11.28](#) shows a weekly chart of RAX. During this time of negative “this stock is way overvalued” press, a weekly squeeze slowly and quietly started to develop. By the time it fired off at point 2, it launched the stock into a move that would more than double the price of the stock. For weekly squeezes, a trader can buy the stock outright or buy in-the-money call options a few months out. For RAX, those who listened to the negative press sold the stock or, worse, shorted the stock. Those who watched the weekly squeeze and brainlessly followed the signal enjoyed an awesome run higher in the price.

RAX - Weekly NYSE L=35.46 -0.29 -0.81% B=34.00 A=36.02 O=35.84 Hi=36.41 Lo=34.89 V=1,723,000 TTM Trend (blue,red)

Press on RAX at point 1
was negative—too
pricey, high short
interest, blah, blah blah

The squeeze
typically defies
conventional
wisdom

TTM Squeeze (Close,1,"Futures=1 Stocks=2 FX=3",20,1.5,2,... 0.00 -4.78

2

Figure 11.28

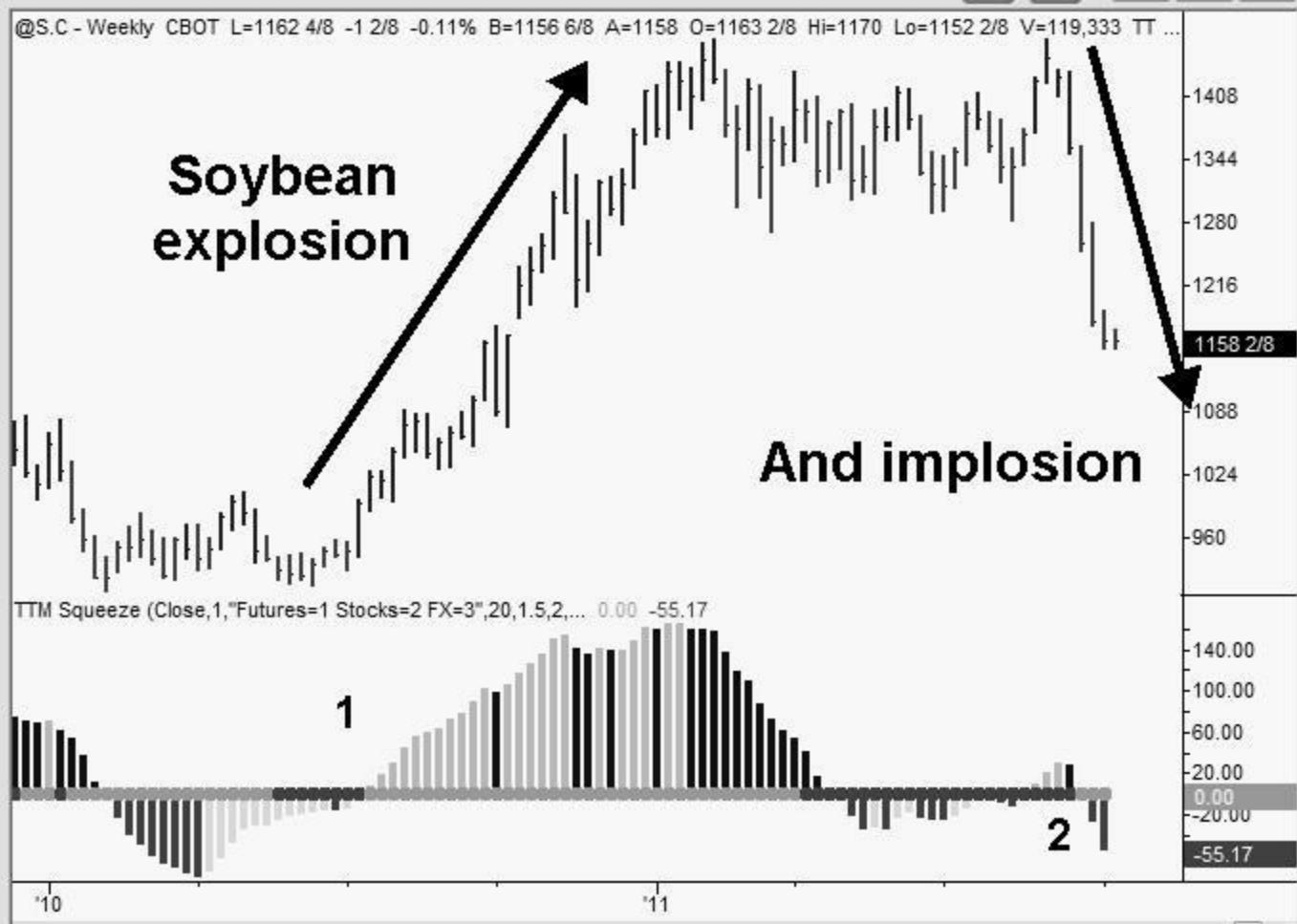


Figure 11.29

One thing about the squeeze is that it doesn't really care what market you watch. [Figure 11.29](#) is a weekly chart of soybeans. As a trader, getting long soybean futures at point 1 turned into an incredibly profitable trade. And there are other uses for this type of information. For a farmer who is trying to decide whether to hedge his crop at \$10.00 (by shorting soybean futures), this squeeze proves to be very useful information. "Don't hedge yet," it screams. "At least wait till the squeeze is done." When it's done, soybeans are closer to \$13.50. The farmer can hedge his cash crop here and lock in that profit. This can also be done with gold and silver bullion. Selling physical gold and bullion can be a huge pain. However, hedging physical holdings is super easy if you know how to read the squeeze.

What Is the Best Way to Filter Out Squeezes That Might Not Work Out?

On the weekly chart of silver in [Figure 11.24](#), we saw a squeeze signal at point 1 that was tepid at best. It worked, but it didn't work great. There are also squeezes that just plain don't work. This is not common on weekly and monthly charts, but it can be a factor on intraday charts, such as a five-minute chart, or something a little longer, like a 39-minute chart (I like 39-minute charts on individual stocks, since the chart shows 10 equal-sized bars, as the cash stock session has 390 minutes of trading activity). What is the best way to filter out the potentially bad trades?

As I said earlier in the chapter, it really is important to know what is going on in the larger time frames, even if your trading plan doesn't have you actually trading these time frames. [Figure 11.30](#) shows a weekly chart of the e-mini S&P 500 futures. This squeeze signal fired off long at the end of September, 2010, pushing the index nearly straight up for 300 plus points. The move was ferocious, and fighting this move proved disastrous to many a trader's health.

In [Figure 11.31](#), we drill down to an hourly chart of the e-mini S&P 500 futures toward the end of November 2010, while the weekly chart in [Figure 11.30](#) remained in the strong upward squeeze. The trading process now becomes extremely simple. Is the hourly chart firing off a short squeeze, in the opposite direction of the weekly chart? Like at point 1? Yes? Pass on this trade. It's a low-probability trade that is fighting the predominant larger trend. On the other hand, is the next squeeze that is setting up firing off long? In the direction of the weekly squeeze? Like at points 2 and 3? Yes? Then take those trades because they are great signals aligned with the weekly trend. This is why it's always important to understand what the larger time frames are doing. These act as great filters for the smaller time frames.



Figure 11.30

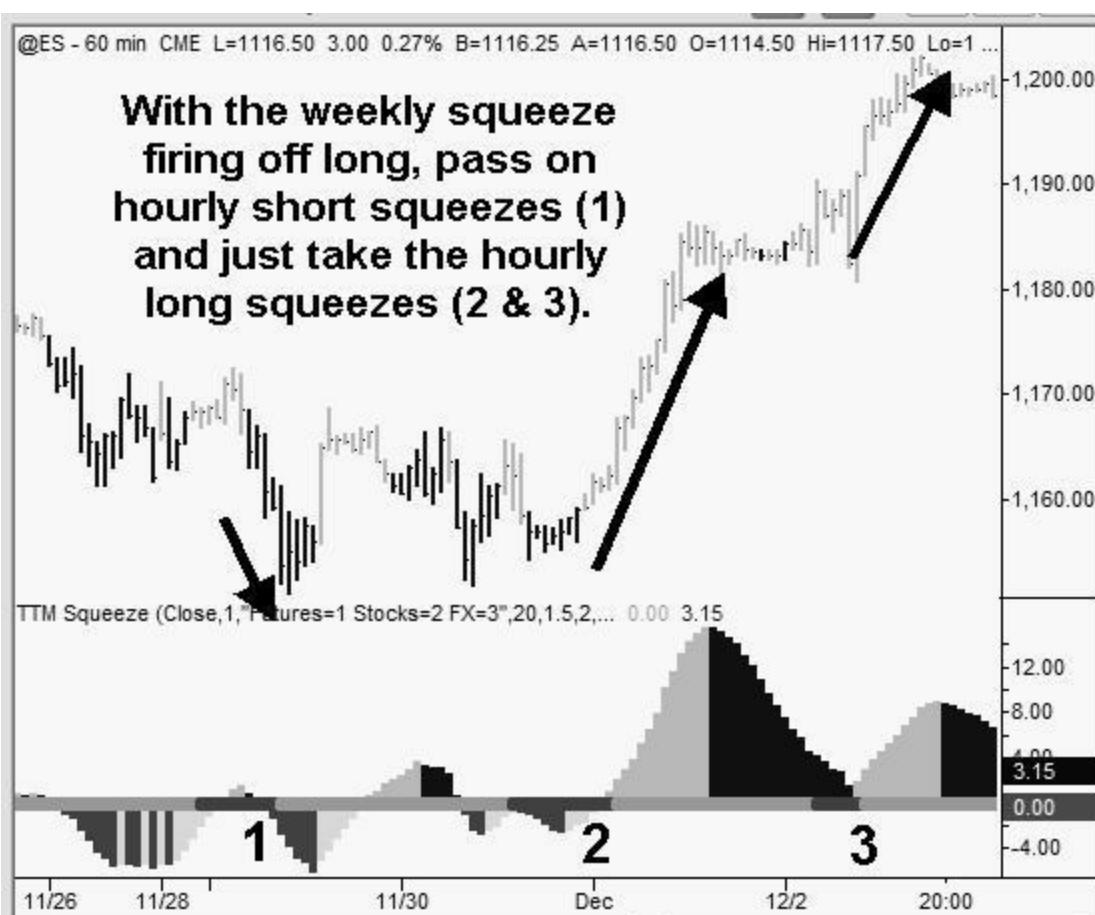


Figure 11.31

There is also another filter that can be used. [Figure 11.32](#) shows a 39-minute chart of AAPL. At point 1, a short squeeze fires off, indicating that shorting AAPL here would be a good idea. AAPL does not sell off and in fact starts to rally ... hard. Although the next signal at point 2 did great, that first signal at point 1 failed utterly. If we weren't looking at the larger times frames such as a daily or weekly chart, is there a way to filter out these potentially false signals?

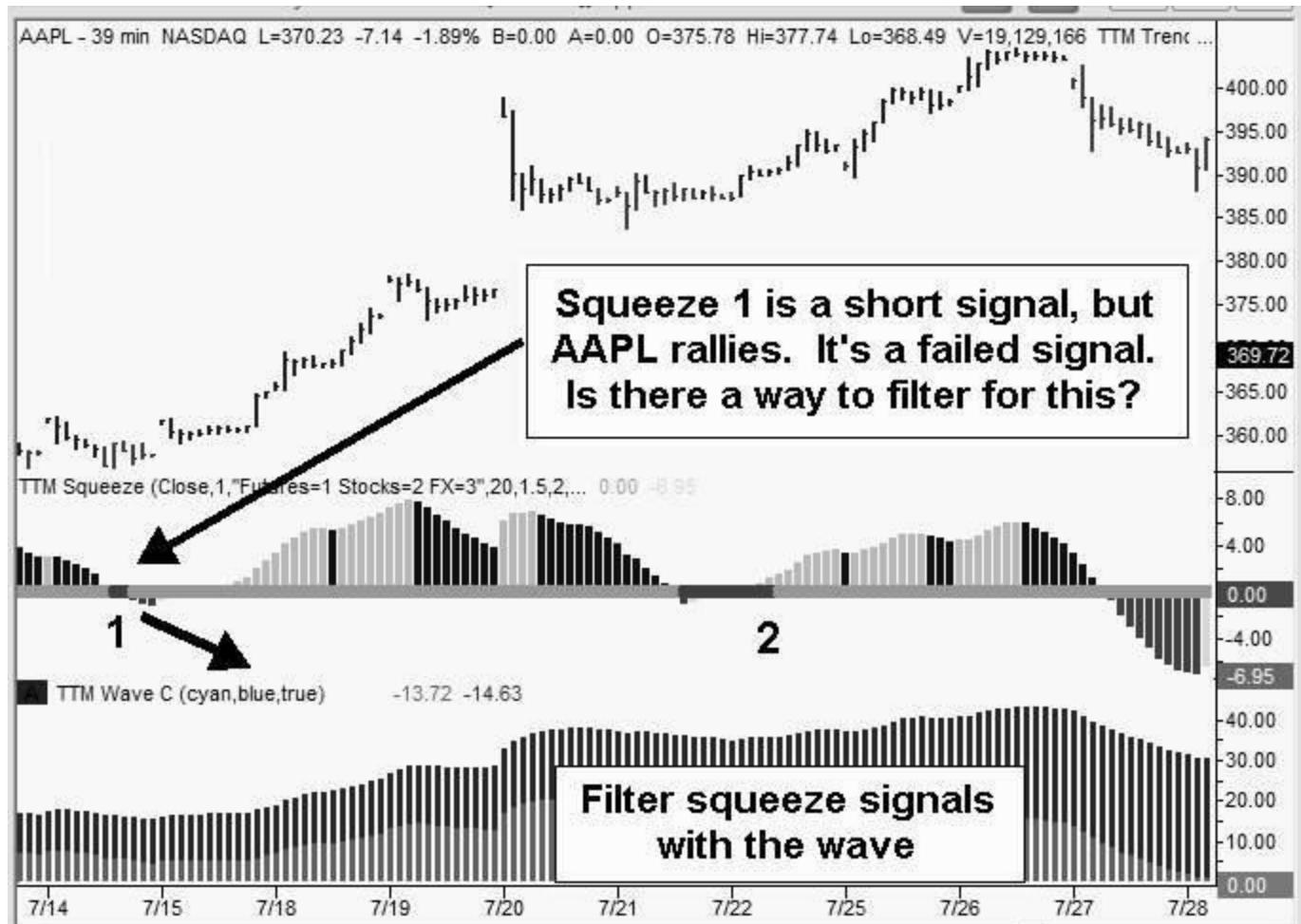


Figure 11.32

Yes. At the bottom of the chart is something called the “TTM Wave C,” which works as a directional filter. The key is that if it is above zero, as it is on this entire chart, then you ignore short squeezes. The opposite is also true. If, on this chart, the TTM Wave C were below zero, then you would ignore all long squeeze signals. This is a handy tool if you are looking at a lot of charts and find it hard to keep track of all the larger time frames for the instruments you are trading. We’ll dive into this tool in the next chapter.

For updated information and examples on the TTM squeeze setup, including live trades, go to www.tradethemarkets.com/squeeze to see it in action.

Catching the Wave: What Is the easiest Way to Stay on the right side of the Trend on any Market, on any time frame?

Why Is It Critical to Understand the Concept of Anchor Charts?

I watched the squeeze for a long time without any hard-core filters. I felt comfortable with the risk/reward ratio, and I knew that not all signals would work out. I did notice, however, that there were times, especially on intraday charts, when the squeeze wasn't consistent. And it didn't seem random. It happened in blocks of trades, sometimes two or three in a row before a really good one fired off again. What was going on? How could I pinpoint the common denominator? Looking at "anchor charts" helped. This is the process of looking at a larger time frame and referring to that larger time frame before taking a trade on a smaller time frame. For example, if I'm using an hourly chart as my anchor, and it's bearish and everything is pointed lower, why would I take a long signal on a five-minute chart? In this case, by looking at the hourly "anchor," I can see that it would be better to be patient and wait for a short signal on the five-minute chart, in the direction of the larger "anchor."

[Figure 12.1](#) shows two charts. The one on the left is an hourly chart of the ES, while the one on the right is a five-minute chart of the ES. At point 1 on the hourly chart, a squeeze fires off short. During this signal, the market goes into consolidation mode at point 2. If we zoom in on this consolidation on a five-minute chart at point 3, we can see that this action is slightly bullish. And, look, a squeeze is setting up ... maybe it is worth a shot on the long side? Grab a couple of ticks? During the heat of the moment, that might seem like a great idea. Why not try to make a little extra money?

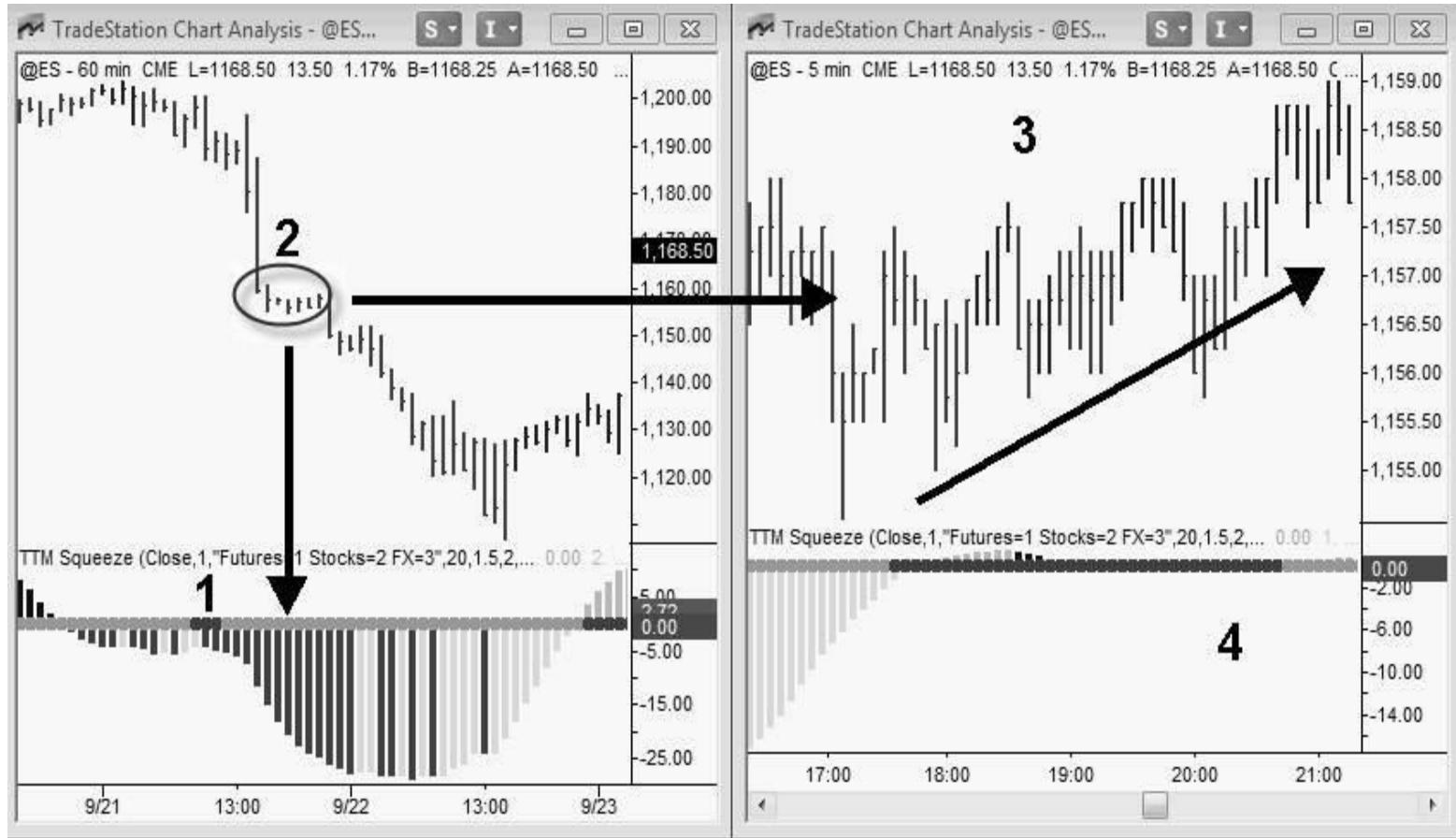


Figure 12.1

This rally failed miserably starting on the next bar, falling 50 ES points (\$2,500 per contract) in rapid succession. Looking at the hourly chart, there was clearly no reason to get long, as the squeeze to the downside was still unfolding. Zoom in on that five-minute chart, however, and it looked as if a real rally was taking shape. This is why anchor charts are so important. They keep the overall market movement in perspective. More important, they prevent a trader from getting tied up in a bad trade and then completely missing the good trade that was unfolding before her eyes. That is one of the main dangers of hanging on to a losing trade—it closes your eyes to all of the wonderful opportunities that are setting up around you, as all your concentration is diverted to watching the disintegrating P&L on your screen. As one of my former trading mentors told me numerous times, "Why dick around with ticks when you can tally up the points?" Indeed. Some of the best trades are the ones in which we decide to pass.

[Figure 12.2](#) shows the same charts with the "TTM Wave C" (I just call it the "C wave" and will refer to it as that throughout the rest of the chapter) added to the

bottom of the chart. On the hourly chart, we already know from [Figure 12.1](#) that the signals are to the downside. The added C wave reinforces this by crossing below zero while the squeeze is firing off short. The downside of the anchor chart is that there are times when it is easy to forget to refer to it, especially if a trader is looking at many markets, and especially in the heat of the moment. This is where the TTM Wave C comes in handy. At point 2 on the five-minute chart, we can see that the C wave is clearly below zero. This means, in essence, that the longer-term trend on this market, on this time frame, in bearish. In other words, there is no reason to get long. This is known as “riding the waves.”

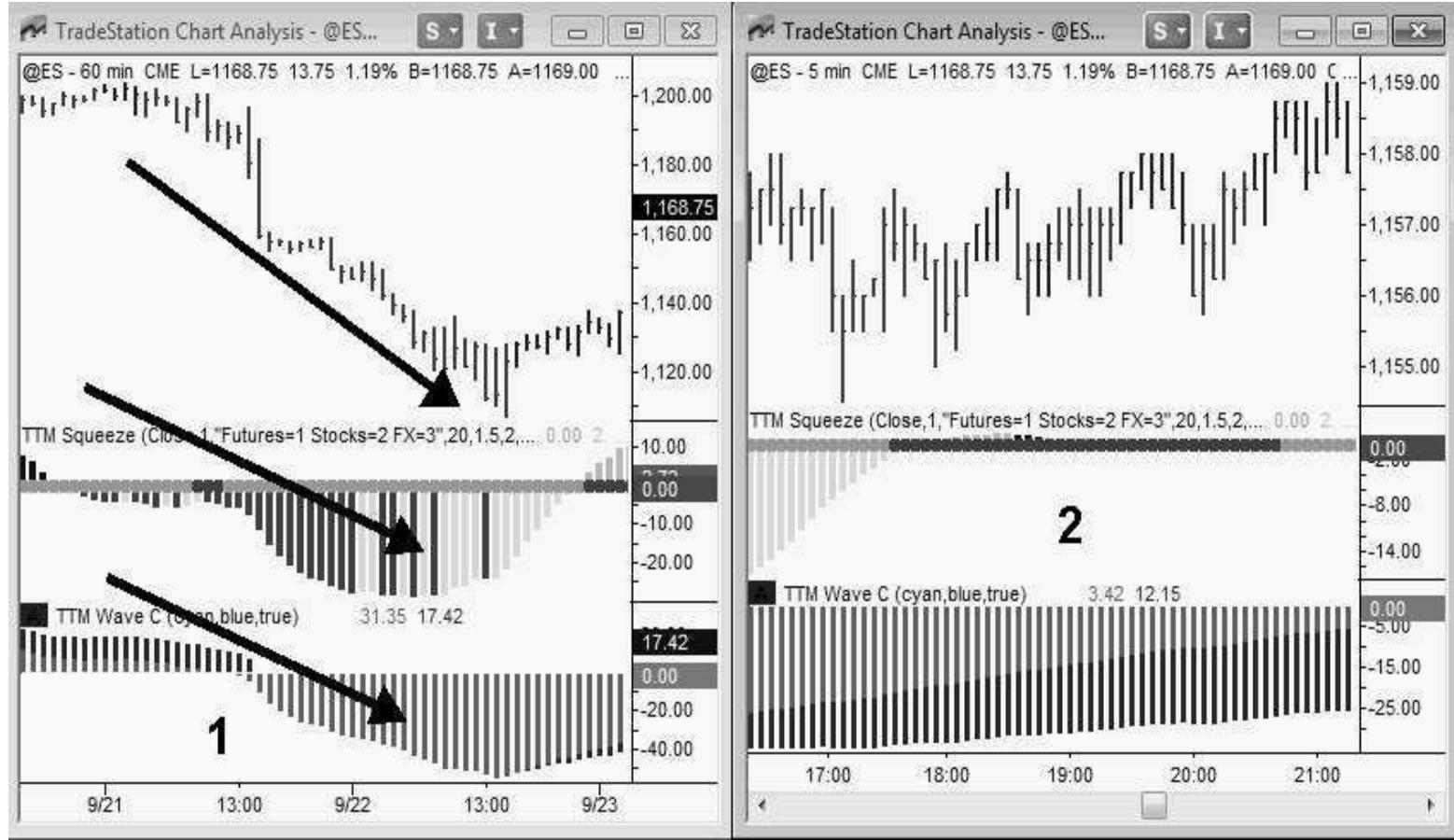


Figure 12.2

What Exactly Are the Waves, and How Do They Work?

The waves were introduced to me by a fellow trader, Rodney Julian. I had spent a few hours explaining to him my concept of anchor charts, and after I was through, he just looked at me and said, “John, this is a simple math problem. You should just be using these.” He showed me “these,” which was a series of indicators he had developed over the last decade. There are three of them, which he calls waves. They are as follows:

- Short-term trend: A wave
- Medium-term trend: B wave
- Long-term trend: C wave

The waves essentially measure various trends on whatever market and whatever time frame a trader is observing. An A wave measures the trend of the prior six or so bars, the B wave measures the trend of the prior 15 or so bars, and the C wave measures the trend of the prior 30 or so bars (this is my best guess, as Rodney won’t tell me the specifics).

[Figure 12.3](#) shows a daily chart of GS (Goldman Sachs) with a C wave. Although Rodney likes to watch the ebbs and flows of the waves, I really just focus on whether they are above zero or below zero, and how that all lines up with the current squeeze.

At point 1, the C wave starts to edge below zero. This is a “heads-up” for me that the uptrend in GS might be coming to an end. When the C wave goes fully below zero at point 2, then the longer-term trend on GS has officially rolled over to the downside.

[Figure 12.4](#) goes one step further and adds the A and B waves to the chart, as well as the squeeze. At point 1, a squeeze fires off a short signal. The A, B, and C waves all cross below zero at this time, which is a great sign for the short side. The squeeze, as is typical, runs out of gas shortly after six bars. It would be possible at this point for a trader to take his profit and move on to the next trade. Another strategy would be to take off half his position, move his stop loss to the entry point, and hold on for as long as the C wave (the bottom wave) is trading below zero. This is, after all, measuring the longer-term trend of this market. Why fight it?

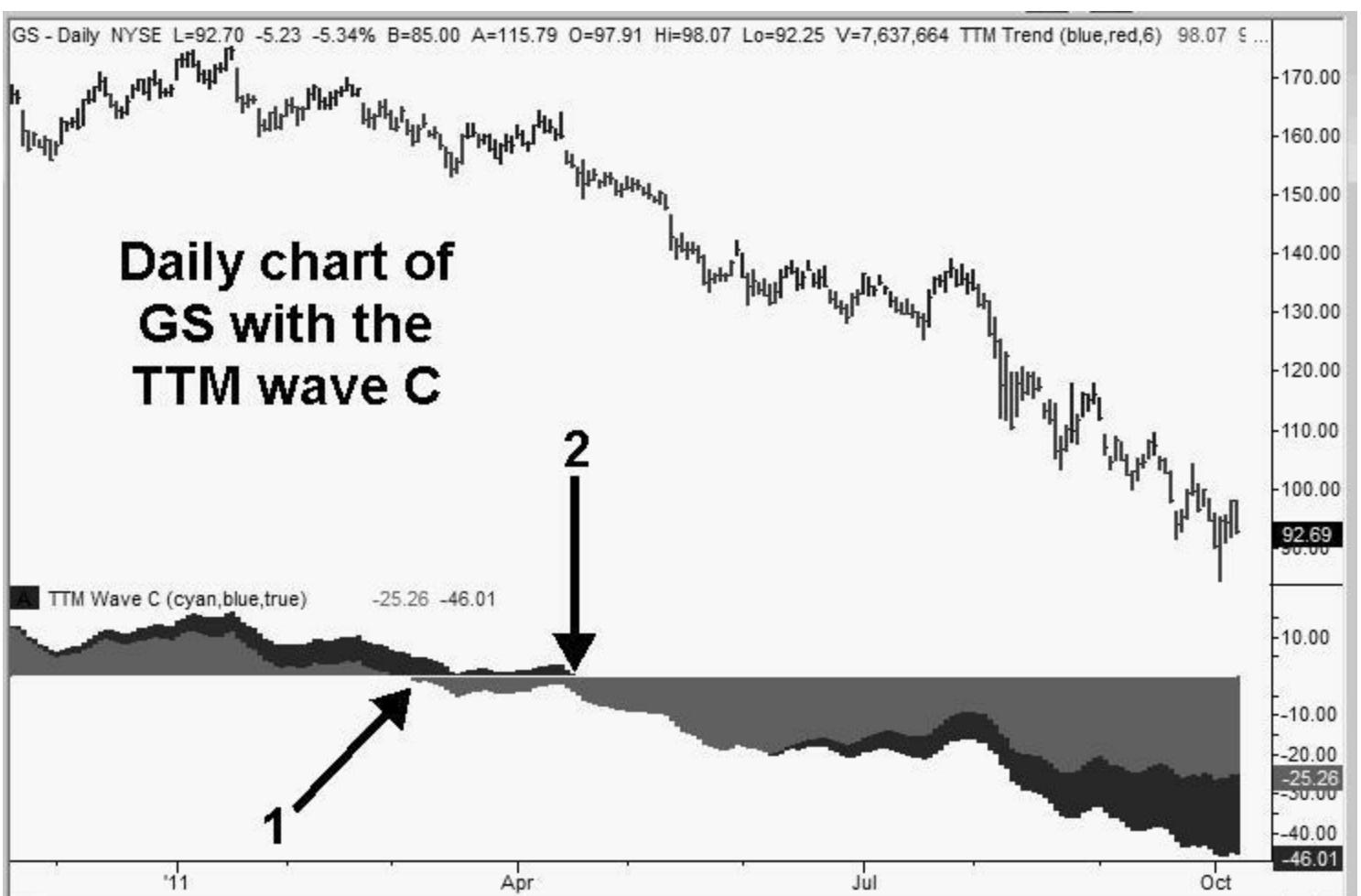


Figure 12.3

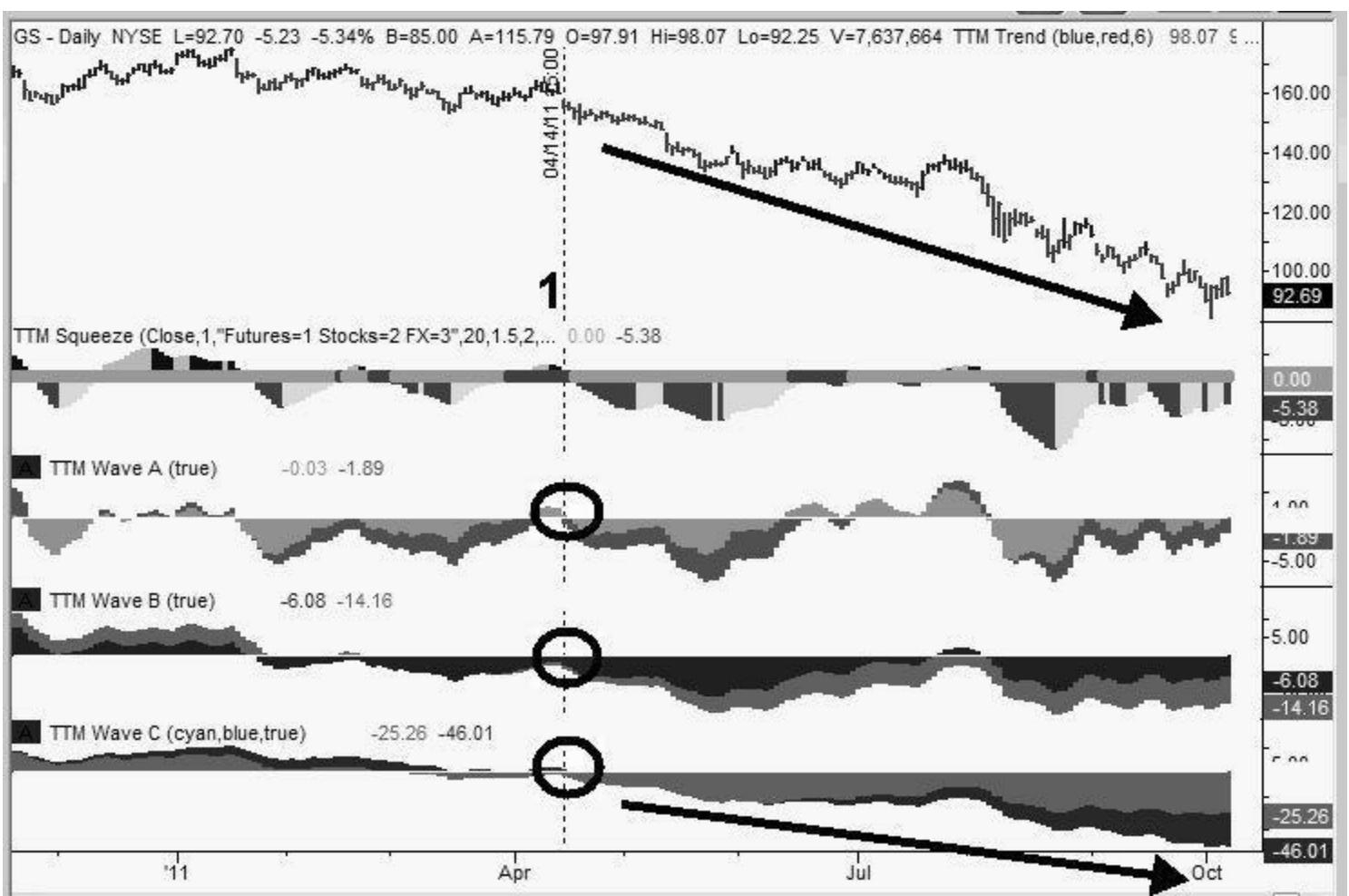


Figure 12.4

[Figure 12.5](#) shows a 39-minute chart of BIDU. Point 1 represents what I call a “Porsche setup,” as everything has come together for a nice trade. The squeeze fires off long. The C wave is well above zero, as is the B wave. The A wave has dipped below zero, but immediately is back up above zero. In other words, the short-, medium-, and longer-term trends on this chart are all in alignment for this signal. And the signal works great, as BIDU kicks off a 10 point plus move.

39-minute chart: BIDU

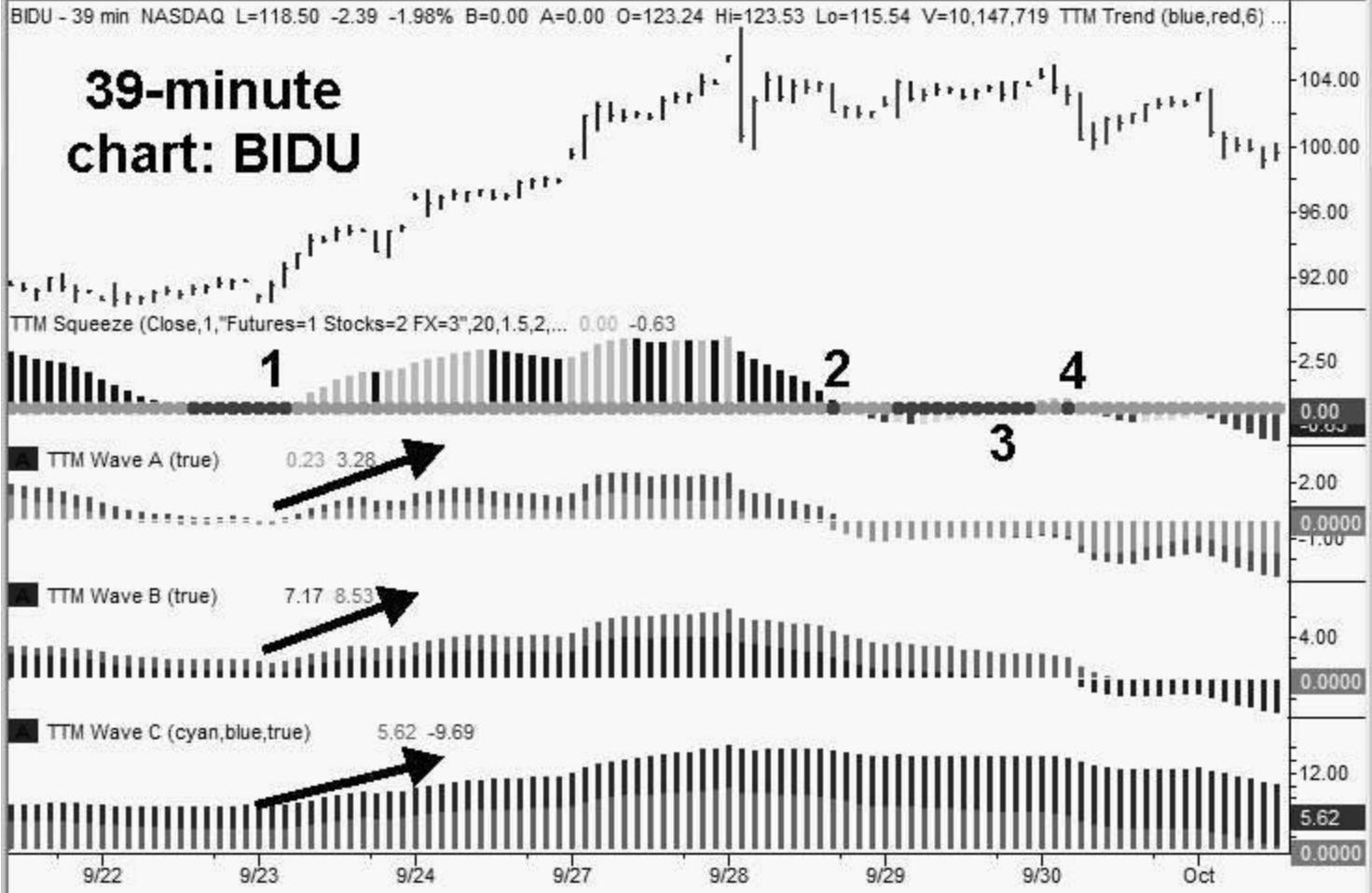


Figure 12.5

At point 2, a one-dot squeeze sets up to the short side. Do we take this signal? No. The C wave is still well above zero, so there is no point in fighting that longer-term trend higher by trying to make a quick buck on the short side. Point 3 sets up a squeeze, and this one has the C wave above zero. Is it a good signal? This is where understanding the waves can become very helpful. In this instance, the A wave is below zero and just can't cross above zero. This is a flag that the short-term momentum on this market isn't ready to move higher. This squeeze fires off long, and BIDU fizzles quickly. Point 4 sets up another one-dot short squeeze, which of course we pass on because the C wave is clearly above zero.

This chart is a great example of having the patience to wait for a setup where “it all comes together.” I also call these Porsche setups. The remaining three setups are all Pintos. If you had a choice, would you rather drive a Porsche or a car that could catch fire?

[Figure 12.6](#) shows a two-hour chart of the euro. Point 1 shows a squeeze that fires off short. The A, B and C waves are all in alignment. Point 2 shows a squeeze that fires off long. While the A and B waves are in agreement, the C wave is not. The trade pops higher, but the rally is short-lived. And this is one of the biggest benefits I've found with using the waves. They tend to distinguish signals that will trend well from those that are the quicker countertrend moves. If I see a squeeze like the one at point 2 and I decide to take it, then I'm looking to get a movement of 1 ATR (average true range) and then get the hell out. It's a countertrend trade. I know this in advance. I won't be looking for a runner or a big move. With point 1, on the other hand, I'm looking for a longer-lasting trend movement, and I'll know that I can sit on my hands and let the trade unfold.

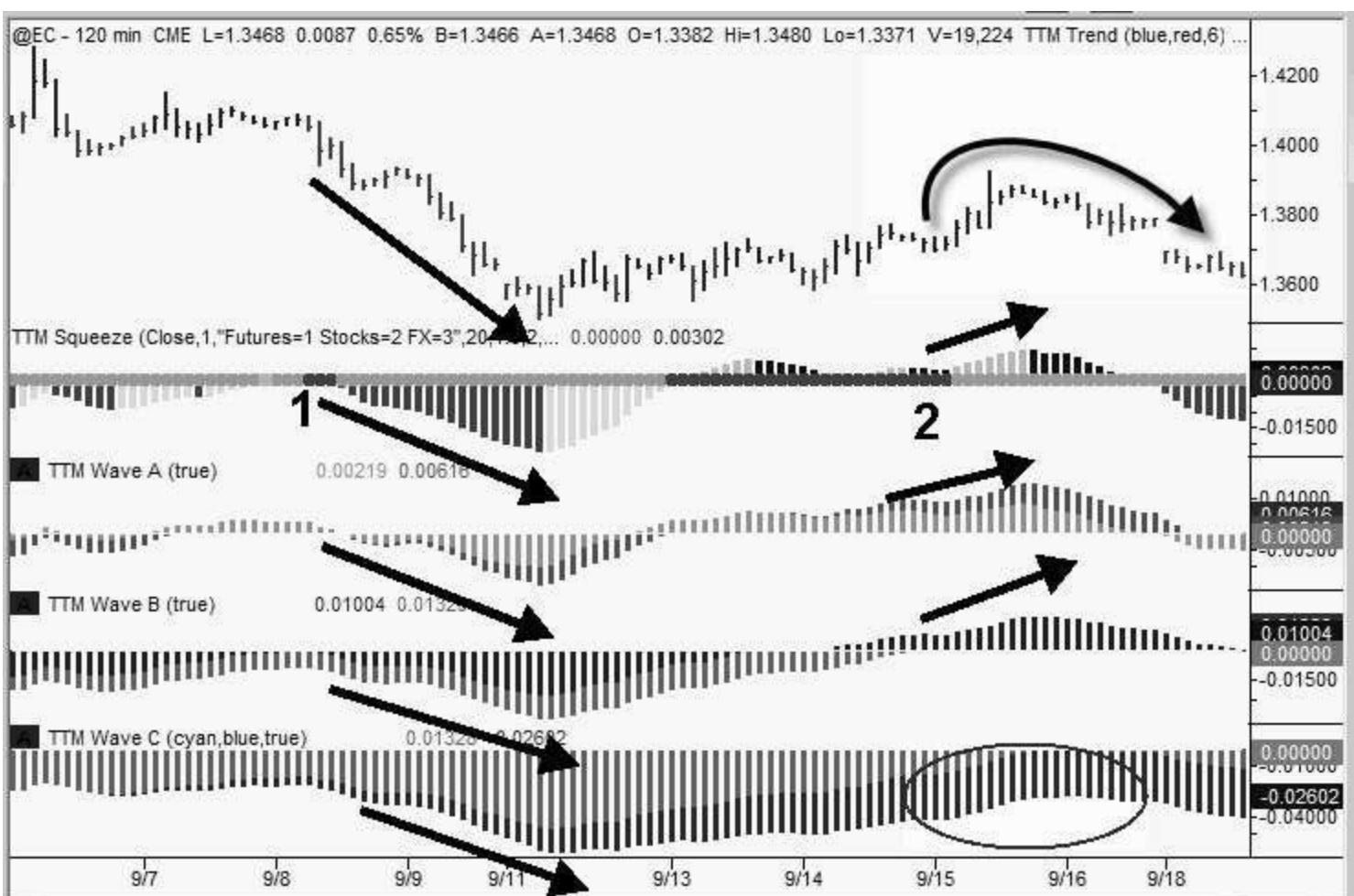


Figure 12.6

How Can I Use the Waves to Sneak into a Squeeze Before It Fires Off?

What I've found in watching the squeeze over the years is that it is very consistent on longer time frames, such as daily, weekly, and monthly charts, and that a trader doesn't really need the wave filters on these longer time frames. The filters are, however, extremely helpful and necessary for any intraday trading on shorter time frames where it is critical to be on the right side of the trend, right now. That said, one of my favorite ways to use the waves is to sneak into squeezes on the bigger time frames.

[Figure 12.7](#) is a weekly chart of the gold ETF, GLD. This chart shows three clear squeezes, and they all fire off and push GLD nicely higher with each signal. Prior to the waves, I would patiently wait for the squeeze to fire off, and then duly pile in. With the waves, I found that I could sneak into the squeeze before it actually fired off. How so?

Once I see the first black dots at points 1, 3 and 5, I know that a squeeze is setting up. I don't know how long it will take to unfold and "fire off," but I do know that this market has entered that special time of setting up for a potentially large move. But which way is it going to move? Is the squeeze going to fire off a long signal or a short signal?

What I've found is the following. If, at the time the first black dot appears on the squeeze (at points 1, 3, and 5), the saves are above zero and trending higher, then this squeeze has a 90 percent chance of firing off long. The opposite, of course, is also true for a downside move.

Knowing this, when this scenario sets up, I'll start scaling into these positions early, and I will often have built up a full position before the squeeze even fires off. For example, at point 5, I see that a squeeze has started and that the A, B, and C waves are all trending higher. (Note: it is important that the B and C waves are also above zero. The A wave can be below zero, but it should be trending higher.) I see that this setup meets the criteria for sneaking in early, and I set about doing just that. At the time for the first black dot, GLD is trading at \$131.00. My goal is to build up to a full position of 20 call options on GLD. Note that if the setup for sneaking in early isn't there, then I just wait for the squeeze to fire off as I normally would.

I like to use the waves to sneak into daily and weekly squeezes before they fire off

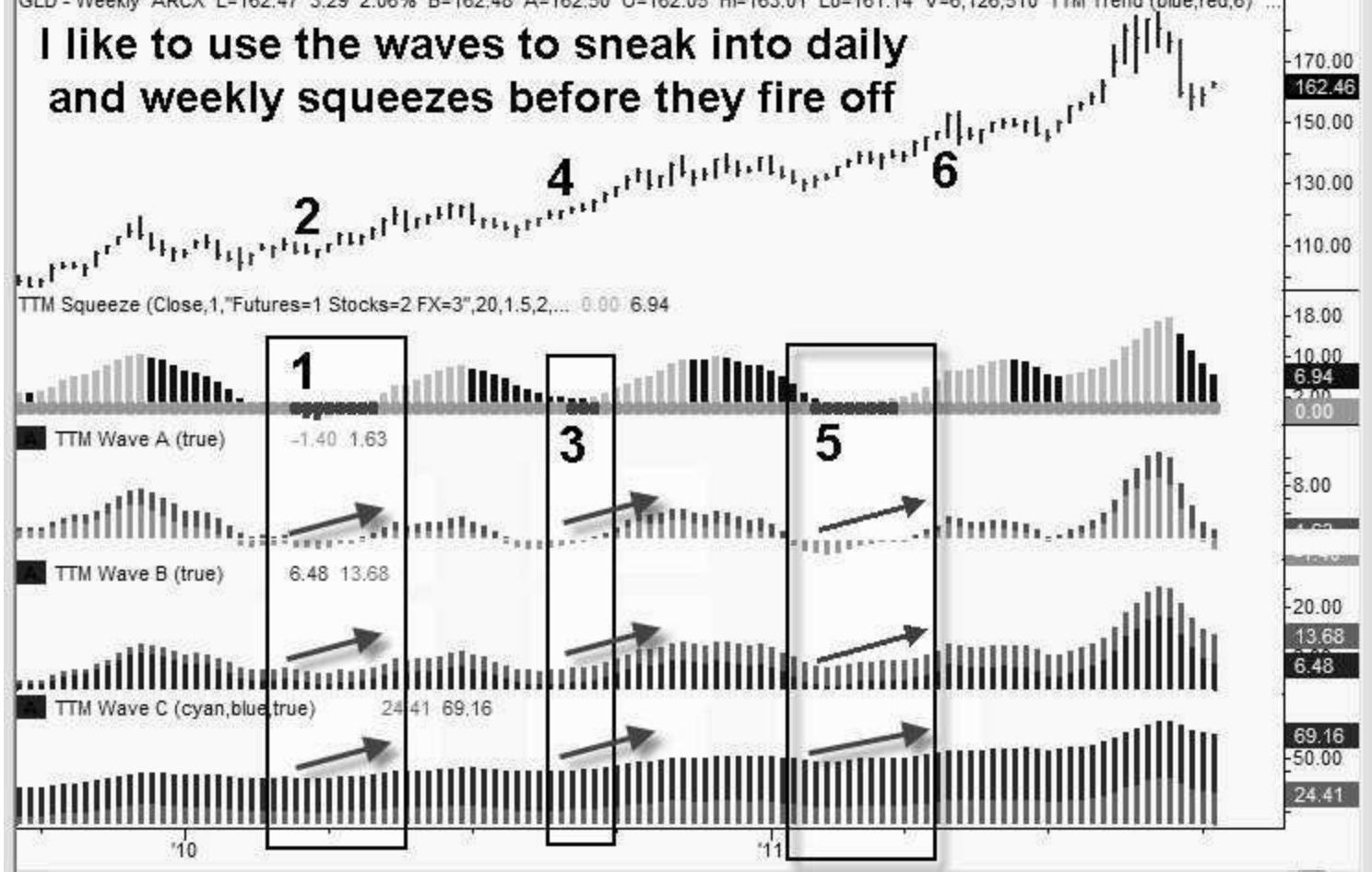


Figure 12.7

The first black dot occurs on February 4, 2011, at point 5. Since this is a weekly chart, I realize that this play could last for many months. Therefore, I want to get options that have a few months still left before expiration. In this case, I look at the May calls, which will expire on May 20, 2011, the third Friday of the month. As discussed in Chapter 5, when it comes to options, I prefer to buy them in the money. In this case, I look at the May 128 call options. I buy one-fifth of my position, or four contracts, at current prices. At the end of the next week, GLD has moved up to \$132, and I buy another four contracts. The next week, GLD pops higher, to \$135, and I pick up four more contracts. The next week, GLD pops again, up to \$137, and I buy four more contracts. The next week, GLD edges up toward \$139, and I pick up the rest of my position. It is okay to buy different option strike prices. In this case, since GLD kept moving higher, I also kept buying slightly higher strike prices, though they were all in the money.

I'm now five dots into the squeeze, and I have a full position. GLD pulls back a few dollars while the squeeze continues to form, and it eventually has eight dots, meaning that this signal developed over eight weeks. When it does finally fire off, GLD is near \$139. My average price is well below this, and I'm locked and loaded with a nice position. GLD proceeds to rally to \$150 before it starts to lose momentum, at which point I take off half the position. But because the C wave is still trending higher, I decide to hold on to the second half, and I scale out as GLD continues moving higher.

What is nice about this entry method is it allows scaling in and typically ends up with a better average price than if a trader had waited for the squeeze to fire off. In this case, by the time the squeeze had fired off, GLD was trading at \$139, well above the price level when the squeeze first started to form. I also utilize this strategy for daily charts.

There are other ways to use the waves, and Rodney does like to watch the ebbs and flows of the waves on various time frames, initiating trades when they roll over. His strategy is a little complicated to explain in a book, and it would sound better in his own words, although he does tend to get a tad esoteric. We've set up a free video at www.tradethemarkets.com/waves to give you Rodney's perspective on the waves as well as additional examples of how I use them.

What Is the Best Tool for Staying in a Trade and Not Jumping Out Too Early?

Entries Are a Dime a Dozen; It's the Exits That Make You Money

This is going to be a short and simple chapter, and we are going to kick it off by looking at [Figure 13.1](#). This shows two identical hourly charts of GC, the gold futures contract. The chart on the left (Chart A) has regular candlestick bars, while the chart on the right (Chart B) has TTM trend bars. Otherwise, these two charts are exactly the same, showing exactly the same price action over the three days from August 14 through August 17, 2011.

One of the biggest problems I hear from traders is, “How do I learn to hang on to a winning position? I always end up taking profits way too fast. I just can’t help myself, and nothing I do seems to help.” The temptation to take profits too soon is great—remember, the market lures us into thinking that this is a good idea, when in actuality it is one of the main reason traders struggle to make a consistent living from the markets. This is, simply put, a very bad habit. So how does a trader hang on to a winner?

A lot of traders I know start their careers looking at candlestick bars, which are good for evaluating price action. The only thing I don’t like about them is that it is easy, especially for newer traders, to get too caught up in the action on the current bar. It is easy to get tunnel vision and to place too much importance on what is happening “right now” as opposed to looking at that action in the context of the prior six bars. One nasty-looking bearish engulfing candlestick is enough to drive most traders out of a long position, or vice versa with a bullish engulfing candlestick while they’re in a short position. Those candlesticks are nerve-racking, to be sure. Yet many times, the market continues moving in the intended direction shortly thereafter. Worse, many traders then “chase the market” in order to reestablish their position, since it is still moving. “Oh, man,” they think. “It’s not done!” And that is yet another bad habit that will prevent a person from being able to do this for a living. It truly is a vicious cycle. What happened in this instance is that a trader got “shaken out” of a perfectly good trade because she placed too much emphasis on the action of a single bar. This is the issue that needs to be addressed.

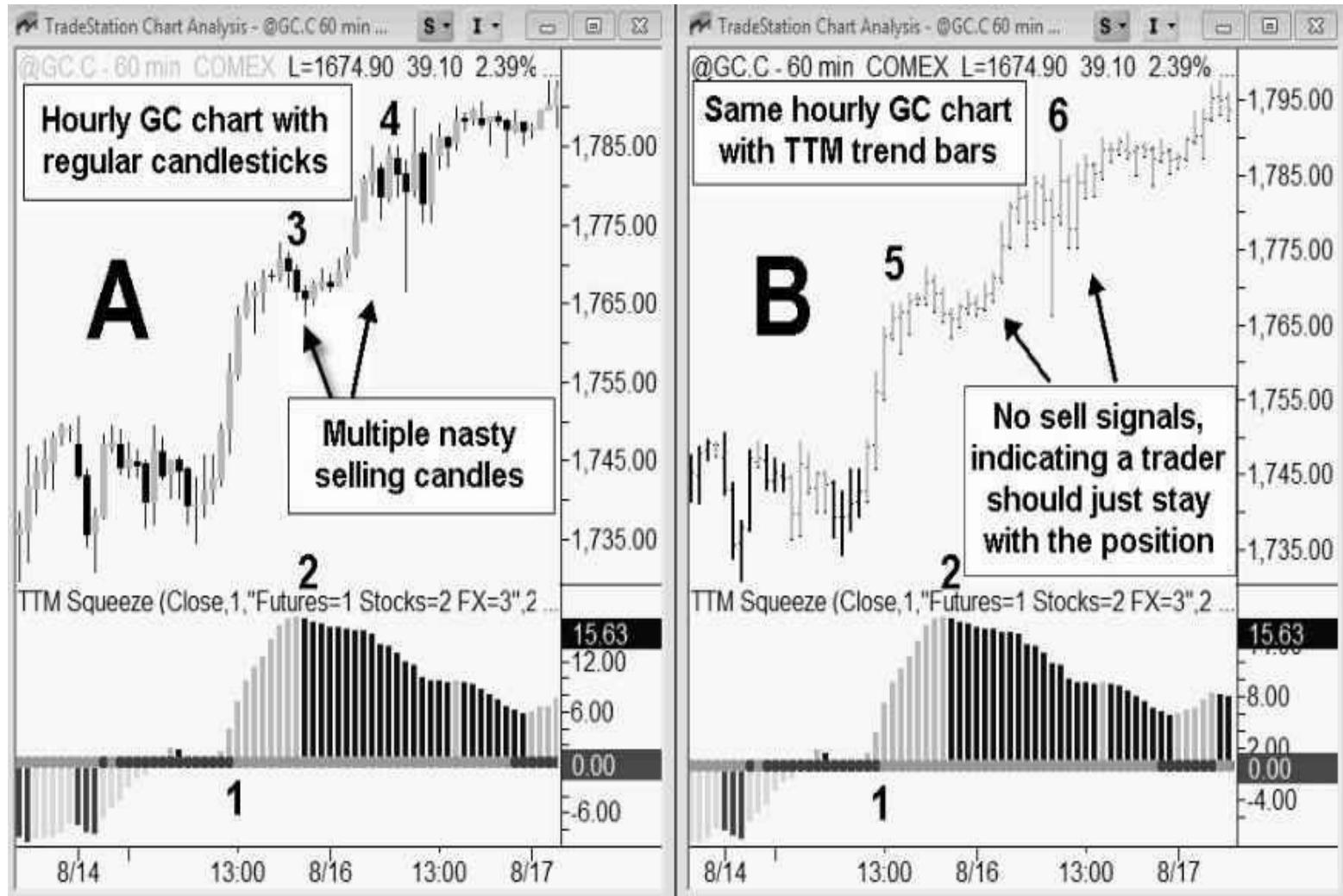


Figure 13.1

I prefer to look at TTM trend bars (similar to Heikin-Ashi bars), which take the action of the prior six bars into account before rendering a verdict of bullish or

bearish. This technique literally takes in the average price of the prior six bars. If the average price of the prior six bars is in the upper half of that trading range, then it will paint the current bar blue, representing a bullish bias and solid buying pressure. However, if the average price of the prior six bars is in the lower half of that trading range, then it will paint the current bar red, representing a bearish bias and steady selling pressure. On the right-hand chart (Chart B) in [Figure 13.1](#), this “bullish blue” is shown as light gray bars, and “bearish red” is shown as black bars. Let’s take a look. This is where it all starts coming together.

[Figure 13.1](#) shows a squeeze that fired off long. As we learned in the squeeze chapter, these moves are considered to be over once there is a loss of momentum, which occurs at point 2. This is a valid exit strategy. However, I’ve noticed that many times, a market will keep moving higher after this exit signal. What do I do? I will take off half my position at the loss of momentum at point 2, and I will move my stop to my entry point. I will then wait for the TTM trend bar to change color for two bars in a row before I get out of the rest of the position.

How Do I Protect Myself When They Are Trying to Shake Me Out of My Position?

[Figure 13.1](#) shows “nasty candles” on the left-hand side (Chart A) at points 3 and 4. These look scary, as if real selling is coming into the market. It’s a sign to bail out, right—to get out frantically before the market can take away any more of our profit? Or ... is it meant to be a fake-out? After all, the market continues moving nicely higher right after these two “short and nasty” selling sprees. To be blunt, it’s meant to be a fake-out. It’s meant to shake traders out of their positions. Not that anyone at Goldman Sachs would try to shake us out of our position so that he could get back in at a cheaper price ...

How do we fight this? Take a look at Chart B in [Figure 13.1](#). It’s the same trade. The same points are marked on the chart at 5 and 6. And yet what looked like nasty selling candles on Chart A show up as “merely nothing” on Chart B. There is no sell signal on Chart B. Remember, since we are long, we are looking for two black bars (which, on a color chart, would show up as red) before we bail. These two black bars would represent real selling and a potential trend change coming into this market on this time frame. On Chart B, there is no exit signal. We are still long at the top of the chart, with gold trading at \$1,795.00, while many newbie candlestick traders got shaken out at points 3 and 4 on Chart A.

Trading is not meant to be easy. It is meant to trick most of the people most of the time. No one is going to make it easy for you to stay in a position. Others will try to scare you out so that they can take your position from you at a cheaper price. Where do you think liquidity and volume come from? If you sell too soon and get panicked out of a trade too fast, well, that liquidity comes from you. Whereas it is easy to get faked out of a trade by a scary candlestick, a trader who takes the current price action’s behavior into consideration will be able to withstand the small countertrend shocks that are meant to shake traders out of their position.

Let’s take a look at another trade. [Figure 13.2](#) shows the devious ES contract on a two-minute chart. The ES is famous for shaking traders out of their positions right before they make their next move. A squeeze fires off at 8:30 a.m., allowing traders to get in on the long side at 1171.00. Prices grind higher for about 10 minutes, and then, *wham*, prices get knocked down from 1176.25 to 1172.75 quickly, as indicated by point 1 on Chart A. Many traders would get knocked out here on a trailing stop that they are trailing too closely. Others would see the nasty candles and just get the hell out, probably near the lows. Did they still make money on the trade? Yes, there is nothing wrong with making 1.75 points (7 ticks) on the ES, or \$87.50 per contract. But take a look at Chart B. The nasty selling at point 2 never materialized into “two black selling bars,” so there was nothing to do here but hold on to the position until that event took place on the chart. This eventually did happen, about an hour and a half later, at point 3. At this point, a trader could get out near 1182.50, a gain of 11.50 (46 ticks), or \$575.00 per contract. That is the difference between getting suckered into selling too soon and staying in a trade until it is truly over.

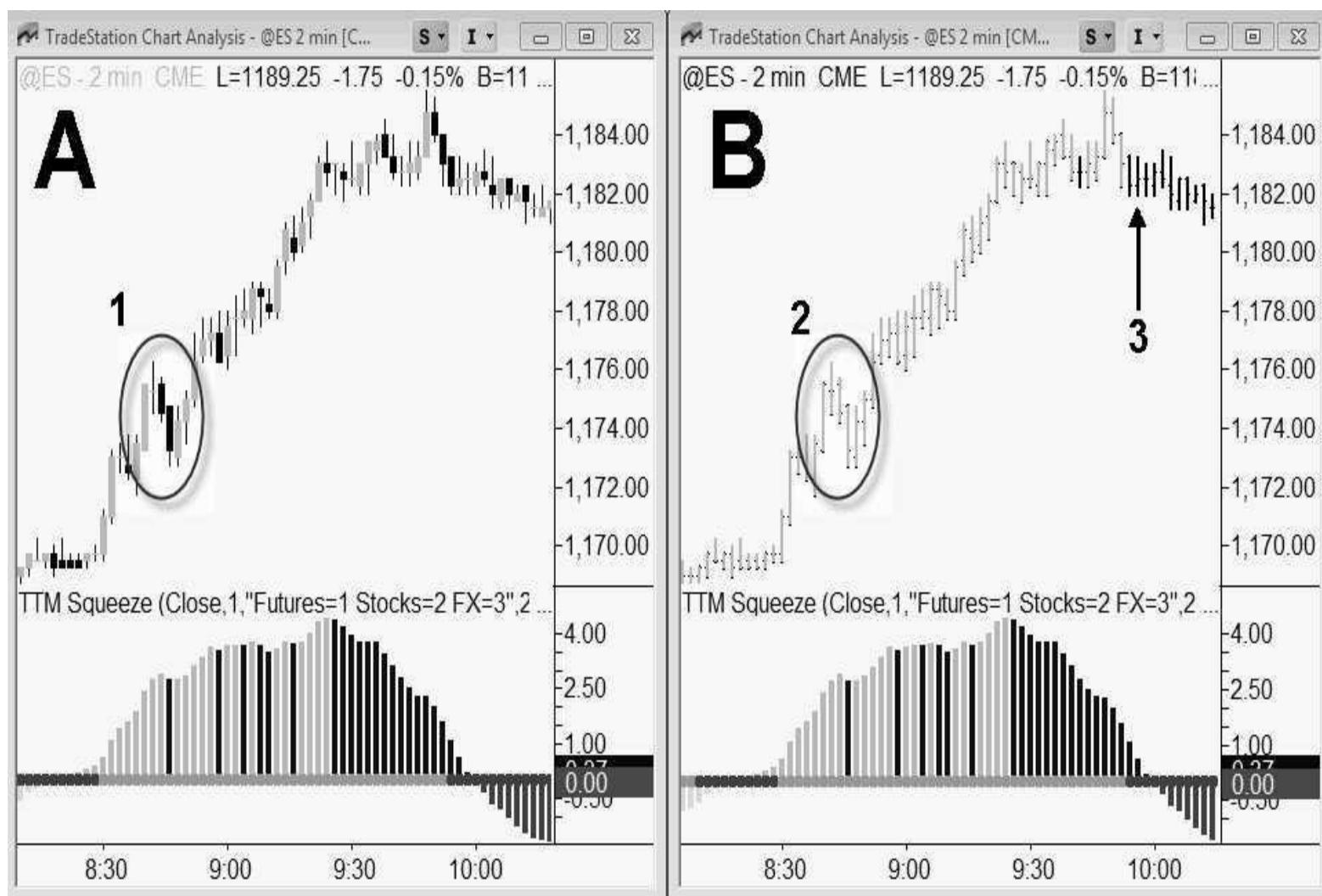


Figure 13.2

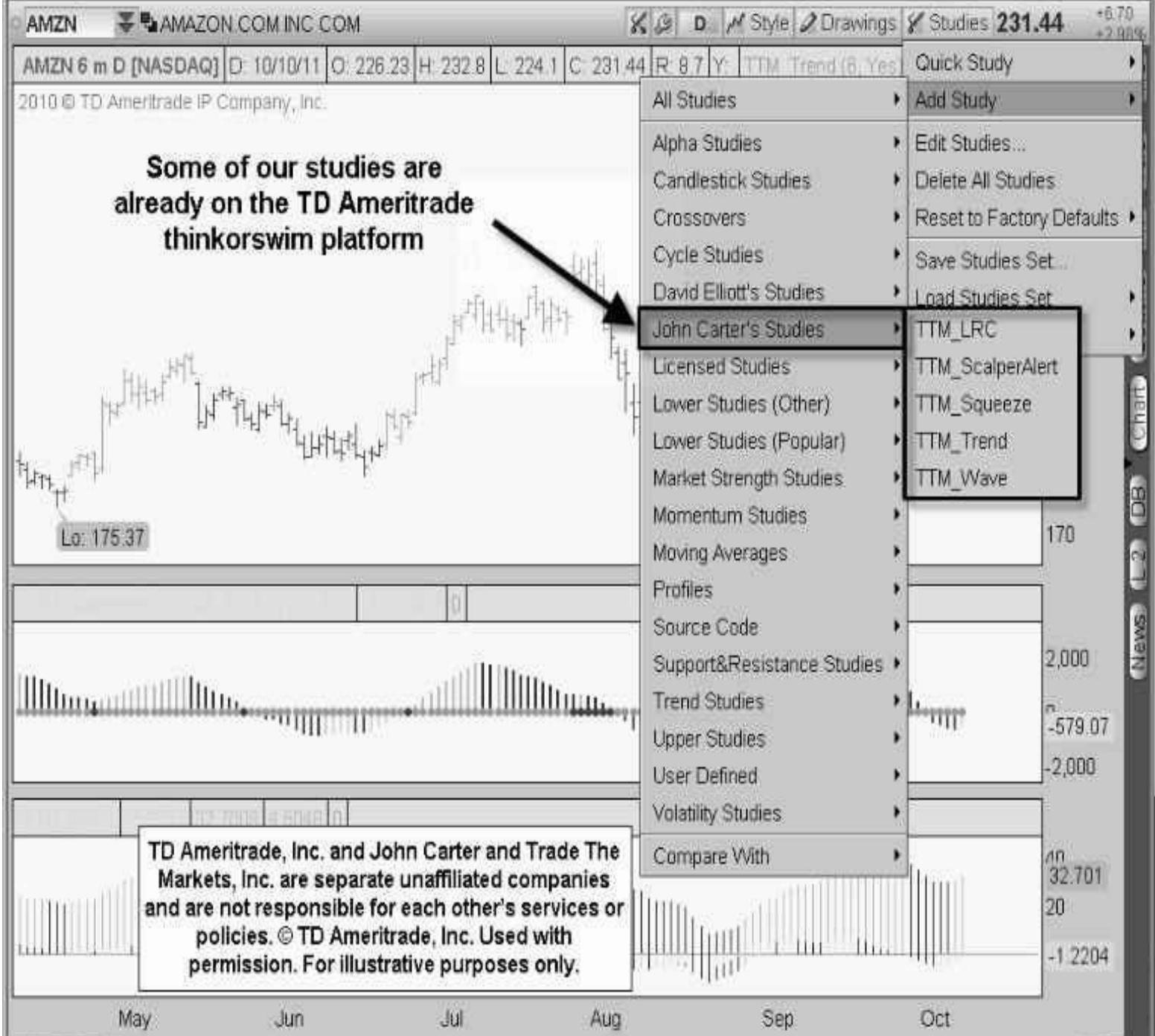


Figure 13.3

I utilize the TTM trend bars for exit management. I typically don't use them for entry signals, as I'd rather wait for something like a squeeze to get into a position, or even use other entry techniques discussed in this book. I have found, however, that this is one of the better tools for managing exits.

The indicators I've discussed so far are mostly proprietary. They can be programmed, found on some platforms, or downloaded from our website. [Figure 13.3](#) shows the TD Ameritrade/thinkorswim platform, which has some of our indicators already built into its platform. For other platforms, like TradeStation, eSignal, Ninja Trader, or Infinity Futures, and others, we have these indicators available for download from our website. Some are free, and others have a fee that we split with the programmers who put them together.

For additional videos on the TTM trend, visit www.tradethemarkets.com/trend for the most up-to-date ways in which I'm utilizing this indicator.

Scalper Alerts:

Is This the Best Tool for Quick Price Trend Change Confirmation?

How Do You Identify and Profit from Changes in Trend Without Catching a Falling Knife or Stepping in Front of a Freight Train?

In watching the markets over the years, I've observed that most reversals take place after three consecutive higher closes or three consecutive lower closes, and this tendency is valid for all time frames. The key to this setup is that it is based on consecutive closes and not just on intraday or daily high and low price action for an individual price bar on a chart. In other words, the highs and lows are not important. I'm not interested in three higher price highs or three lower price lows. I want to see where the action settles or closes, because that is where the rubber meets the road.

The hard way to follow this play, especially intraday, is to stare at the charts and keep track of consecutive lower or higher closes until you get three in a row. This can cause a person to go bug-eyed, not to mention insane, and is recommended only for those who get a thrill from "the little things in life." I'm not a big fan of staring at charts, and I would be a prime candidate for the mental hospital if I did this with the naked eye. Instead, I've developed a simple indicator that will "paint" the first bar in the sequence after the third bar has met the criteria for a signal. Once I see the painted bar, I just place a market order, and I'm in the trade. Even better, I set up an audio alert so that if I'm down the hall, I'll hear the signal and come back to my computer to place the trade. This works when I'm on the phone with my wife as well, although she has yet to appreciate the importance of the signal and my urgent need to hang up in the middle of our conversation. Such is the life of a trader.

For the indicator, I did add one key filter. I found that at times I could get shaken out of a play that was consolidating (that is, a bull flag) when prices made a series of lower closes within that consolidation. So, if there are three lower closes, but this price action does not go below the signal bar's low, then I ignore the signal. For this indicator on a long signal, then, the trigger bar would be the first bar that has a higher low than the previous bar. The next bar that closes above the high of this trigger bar paints this previous low bar, which now becomes the swing low point. In most cases, all of this happens with "three higher closes," but there are times when it is not as clean, and these instances are taken into account with the one confirmation that really matters—price.

I use this signal in various time frames. For scalping the E-mini S&Ps, I like to use a 233-tick chart, because the signals are very fast. On the mini-sized Dow, I will use a 144-tick chart for scalping and a five-minute chart to catch the one or two reversals that set up on any given day. For swing trades, I will use both 60-minute and daily charts. I like to use this primarily on the stock index futures and the major currency pairs, but it works just the same in any market, in any time frame. It is simple, and it is based solely on the price action. I will also use this signal for individual stocks that I am following.

Why Are Tick Charts Best for Scalping?

For tick charts (not to be confused with the NYSE \$TICK play I discussed earlier), I like to use Fibonacci sequencing numbers. If you Google that phrase, it will bring up a list of numbers that looks like this: 5, 8, 13, 21, 34, 55, 89, 144, 233, 377, 610, 987, 1,597, 2,584, and 4,181 (and so on). Of course, the list keeps going, but we don't need them all. There is no need to test the 144-tick chart vs. the 143-tick chart to see which is better. Why tick charts? A 377-tick chart forms a new bar every 377 trades. When the volume is slow (especially in the overnight session), this chart crawls along. When the volume and trading are fast and furious, this chart will develop at a much faster rate. In sum, when the market is slow, so is the chart. It's not pressured to form a new bar every two minutes (as is the case with a two-minute chart), regardless of the volume, thus firing off false signals when low-volume conditions exist. When the trading is fast, so are the signals. Tick charts adapt to the market, and I find them especially useful for day trading. How do we know which tick chart to use? There isn't an exact science, but the rule of thumb is this: the higher the volume, the higher the tick chart. While I use a 987-tick chart for the ES, I'll use a 144-tick chart for the YM. The only difference is volume. As a general rule of thumb, the 377-tick chart is good for day-trading most commodities, as well as individual, high-volume stocks.

Let's quickly review what a 233-tick chart is for anyone who hasn't used one before. Remember, this type of chart forms a new bar every time there are 233 trades executed. It doesn't matter what the size of any of the trades is, just that 233 trades have crossed the tape. I like to use these charts when I'm scalping for two reasons. First, they are faster than regular time charts when it really matters—when the trade frequency accelerates. In comparison, a two-minute chart is going to form a bar every two minutes, regardless of how fast or slow the trading is. With a tick chart, when the trade frequency slows down, so do the signals that are firing off in this time frame; thus, these charts naturally keep a trader out of the market when there is nothing going on. Second, traders in the pit have no concept of time with respect to a two-minute or a five-minute chart. They are focusing on the actual frequency of trades, and a breakout on a two-minute chart means nothing to them. Although I prefer the 987-tick chart on the ES for intraday swing trades, meaning trades that I could be in for half an hour or more, I will at times use the 233-tick chart for faster scalping. A couple of example plays with tick charts are shown here.

What Are the Trading Rules for Buys (Sells Are Reversed)?

1. Set up a 24-hour chart on intraday charts so that the overnight activity can be accounted for in this indicator setup. This can be used in all time frames. The larger the time frame, the larger the parameters and the potential move. For daily charts, I will use the regular session hours.
2. After three consecutive higher closes, I go long at the market at the close of the third bar in the sequence.
3. The trade is valid until three consecutive lower closes occur, at which point I exit the trade. If the market is still open for an intraday trade, I will simultaneously exit a long and establish a new short position. I don't use a stop loss on this for intraday chart trades because the reversal signal is my exit strategy, whether it is a loss or a gain. For daily charts, I will place a stop at the low of the bar that caused the signal to fire off, which is the first of three in the sequence of closes.
4. If I'm in an intraday trade (a 15-minute chart or smaller) and the market closes before giving an exit signal, I will exit at the market at 4:10 p.m. eastern.

5. For time frames that are 60 minutes or longer, I will stay in them overnight and exit at the next signal. This could be the next day for a 60-minute chart, and it could be a month later for a daily chart.

Specific Examples of Scalper Alert Buy and Sell Setups

E-mini S&P—December 2004 Contract, October 3, 2004

1. [Figure 14.1](#) is a 233-tick chart of the E-mini S&Ps, which is one of my favorite time frames for taking quick scalp trades in the market. The spot marked 1 on the chart is a little to the right of the painted bar in question. The “paint” is added by TradeStation, and it is the thick black mark that covers the bar. This bar is painted because it is the first bar in a series of three with consecutive higher closes.
2. When I see the painted bar signal, I go long at the market. I am filled at 1133.25, which is where we closed at point 2, which is the close of the third bar of this series of higher closes. (This will get easier, I swear.)



Figure 14.1

3. I am now in the trade until I get a signal that a reversal has developed. Later in the trading session, I get the next painted bar signal, which indicates that a series of three lower closes in a row has taken place. I place an order to sell my long position at the market. Note that the next signal will not show unless it is a reversal. There is a series of many higher closes during this rally, but none of them constitutes a reversal, so they are ignored because the original signal has already fired off.
4. I am out at 1138.50, which is the close of the third bar in the series of lower lows at point 4 on the chart. The gain on the trade was +5.25 S&P points, or \$262 per contract. It is interesting to note that during this trade, all the oscillators were measuring overbought near the 1135.00 level, which would have gotten some traders out and caused other traders to start going short. Using this setup, the only thing that matters is the price, which, in reality, is the only thing that matters.

E-mini S&P—December 2004 Contract, October 5, 2004

1. On October 5, 2004, I get a short reversal signal near 1:00 p.m. eastern on the 15-minute ES chart, and I enter at the market right after the signal fires off (see [Figure 14.2](#)).

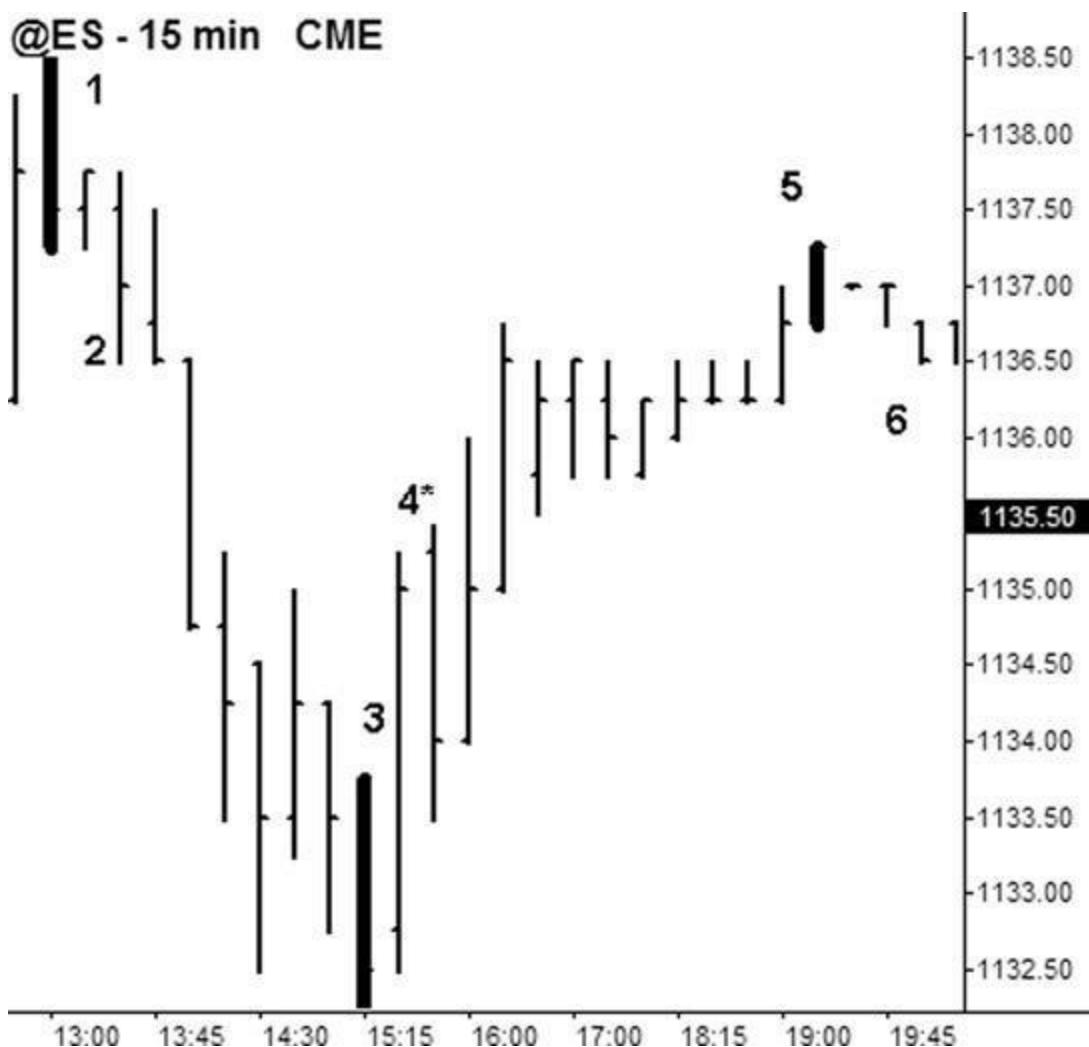


Figure 14.2

2. I am filled at 1137.00. I'm now waiting for the next reversal signal to cover my short and go long.
3. As we approach 3:00 p.m. eastern, we get a signal, and I cover my short and also go long at the same time.
4. My fill is 1134.00. I'm out for +3.00 points on the S&P play, and I have established a new long position.
5. There isn't another reversal signal until near 8:00 p.m. eastern. However, because this is off an intraday chart (15 minutes or less), I exited this position at the market at 4:10 p.m. eastern, and I was filled at 1133.75 for a loss of 0.25 point.
6. Some traders I know like to watch the action 24 hours a day, and they would stay in the trade until point 6. They would have gotten out at 1136.50 for a gain of 2.50. I don't recommend this. The market action in the stock index futures after hours is slow and irritating, and there are many other things I'd rather do with my time. If you want to trade actively after 4:00 p.m. eastern, then by far the best liquidity and opportunities are in the currency markets. I prefer the forex cash markets in this regard because there is more liquidity in the various currency pairs during this post-4:00 p.m. time frame. When markets are active and liquid, they are tradable. When they are quiet, let them be.

E-mini S&P—December 2004 Contract, September 30, 2004

1. At 12:30 p.m. on September 30, 2004, I get a signal on the 60-minute ES chart, indicating that a reversal is in place (see [Figure 14.3](#)). The bar that is painted is the 10:30 a.m. bar. Remember, even though the 10:30 a.m. bar is painted, the signal didn't actually fire off until the close of the third bar at 12:30 p.m. (the 10:30 bar is the first bar, the 11:30 bar is the second bar, and the 12:30 bar is the third bar).



Figure 14.3

2. At 12:30 p.m., I go long at the market, and I'm filled at 1114.75. I am now awaiting the next reversal signal in order to exit my position.
3. I get my next signal a few days later, on October 4.
4. I exit at 1136.50, for a gain of 21.75 S&P points, or \$1,087.50 per contract. The 60-minute chart is great for catching swings that last anywhere from two to five days. This is a great setup for people who are holding down a full-time job and don't have time to stare at the markets all day. In addition, this is a great setup for people who are day trading and are currently losing money. This 60-minute setup forces discipline and prevents a trader from overtrading, which is by far the number one reason why most traders fail to make money in this profession.

E-mini S&P—September 2004 Contract, June 28, 2004

1. On this daily chart of the S&Ps, a signal fires off on June 28, 2004, which paints the June 24 daily bar (see [Figure 14.4](#)). (June 26 and 27 were the weekend.)
2. I go short at the close of the third day, which is what triggered the signal. I'm in the trade at 1132.50. I will now stay in the trade until I get a reversal signal. For a stop, I use 1153.50, which is the high of the June 24 bar. In my experience, the actual stop is rarely hit because a reversal signal will fire off before the markets reach that level.

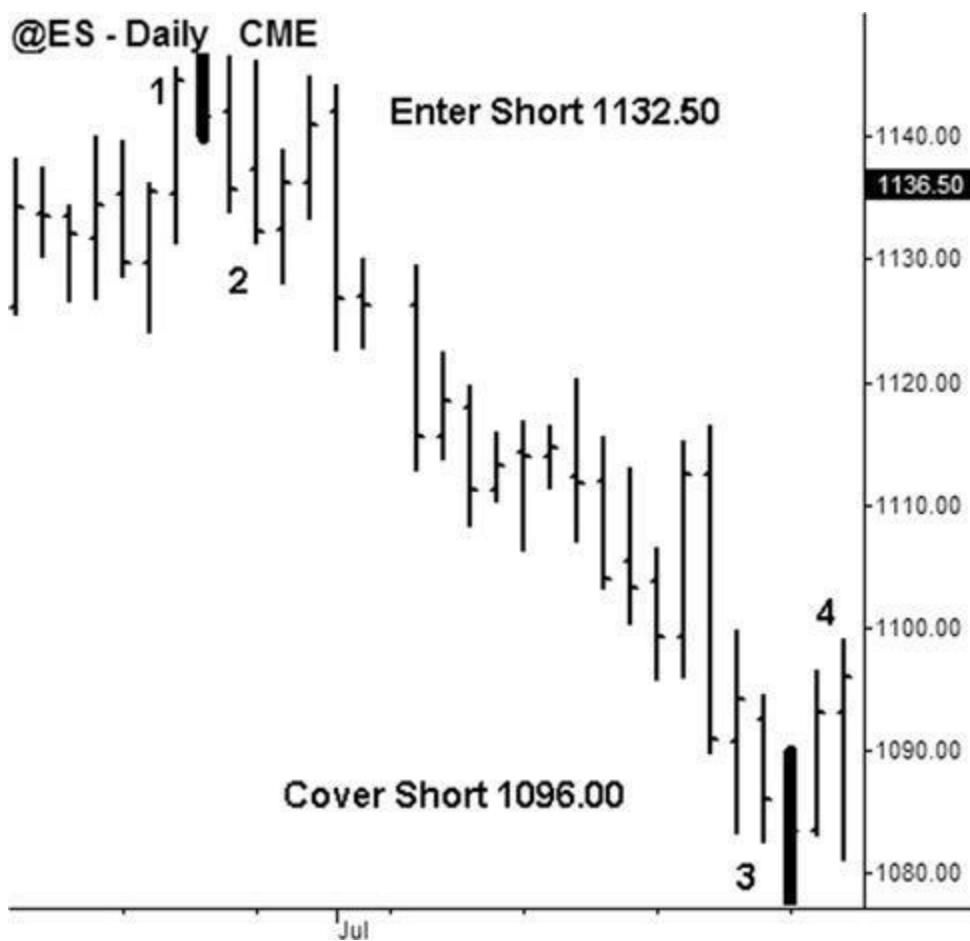


Figure 14.4

3. On July 28, a month later, I get a reversal signal that paints the July 24 bar.
4. I exit at the market on July 28 at the close. I'm out at 1096.00, for a gain of 36.50 S&P points, or \$1,825 per contract. Again, this setup is great for people who are working and don't have time to stare at the markets all day. I also think it is important for full-time traders to have two accounts, one for day trading and one for swing trading. During a period when a trader's day trading isn't going well, it is possible to catch a good move in the swing-trading account using setups like this.

Mini-Sized Dow—September 2004 Contract, August 10, 2004

1. On this daily chart of the mini-sized Dow futures, a long signal occurs on August 10, 2004, which paints the August 6 bar (see [Figure 14.5](#)).

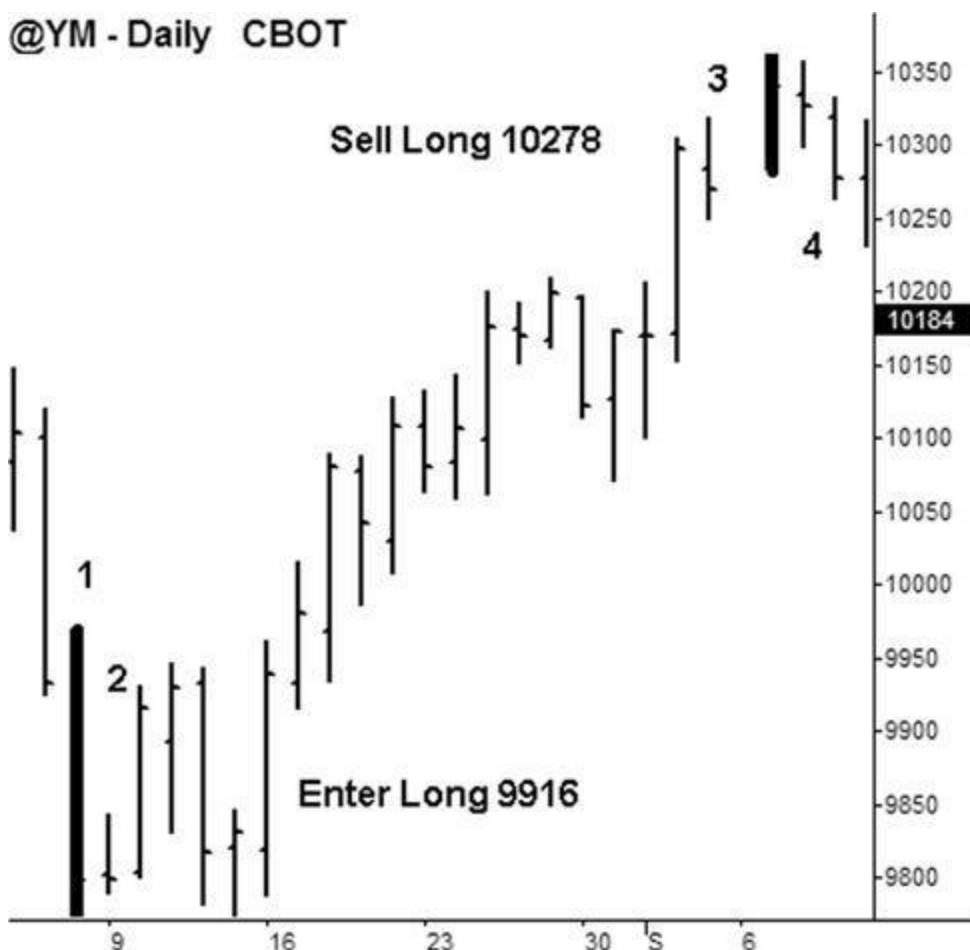


Figure 14.5

- I go long at the close of August 10, and I'm filled at 9916. I'm now waiting for the next reversal signal in order to exit the trade. The low of August 6 is 9809, which is where I place my stop.
- The next signal hits on September 7, nearly a month later.
- I'm out at 10,278, for a gain of 362 YM points, or \$1,810 per contract. One of the things I like about these swing trades is that they tend to take care of themselves. Compared to the active and sometimes frantic pace of intraday trading, it's almost like buying a rental property and turning the maintenance over to a management company. The type of trading a person chooses to do is really a reflection of her personality. Someone who is inherently a swing trader will have a tough time at day trading.

KLAC (KLA-Tencor Corp.), April 5, 2004

- On this daily chart of KLAC, a reversal signal sets up on April 5, 2004 (see [Figure 14.6](#)).
- I take a short at the close and get in at 52.51. My plan is to stay in the trade until I get the next reversal signal. My stop is the high of the signal bar, which is 53.97.



Figure 14.6

3. About a month later, on May 3, I get a reversal signal.
4. I cover my short at 42.96 for a gain of 9.55. For traders who just focus on stocks, this is a great setup to use on the daily charts to catch reversals.

Light, Sweet Crude Oil—September 2004 Contract, September 9, 2004

1. It is important to note that this setup is based purely on price action, and therefore works in all markets (see [Figure 14.7](#)). On September 9, 2004, a reversal signal is painted on crude oil.

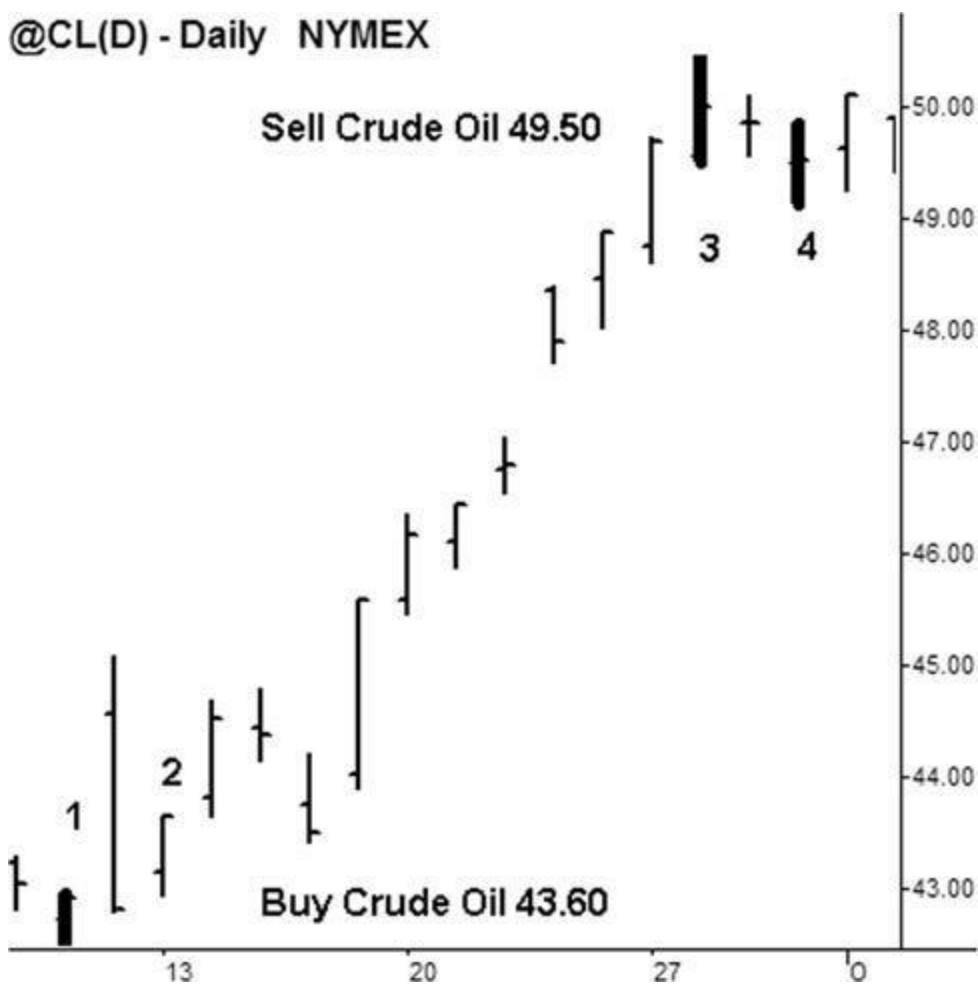


Figure 14.7

2. The resulting long is entered at 43.60.
3. On September 28, the reversal painted bar is in.
4. I'm out of the trade at 49.50, for a gain of 5.90. Note that this exit bar also became an entry signal to get back into the trade long as the market reversed right away and made three higher closes. If you are not familiar with crude oil, a one-dollar move is worth \$1,000 on the big contract and \$500 on the mini-contract, so a move of 5.90 equates to \$5,900 per contract on the big contract (symbol = CL) and \$2,950 per contract on the mini-contract (symbol = QM). The quote feed a person needs to get live crude oil prices is NYMEX. There is an option for this in eSignal and TradeStation, and it's also available through most of the other robust quote vendors.

Mini-Sized Dow—December 2004 Contract, October 6, 2004

1. I wanted to use this example to show how I flow into and out of positions intraday, going both long and short (see [Figure 14.8](#)). This is best done on lower-value intraday charts, such as five-minute charts or a tick chart like 233. The first signal on October 6, 2004, in the YM is painted at 10:35 a.m. eastern.



Figure 14.8

2. This means, of course, that I am going short at the close of the last bar in the sequence of three bars, which is 10,176.
3. The next reversal is noted on the chart at point 3.
4. I cover at 10,169 and simultaneously go long. The easy way to do this is to double the number of contracts you are trading on your exit order. So, if you are long 10 contracts, then you place an order to sell 20 contracts in order to exit your 10 long contracts, and at the same time establish a new position that is short 10 contracts.
5. The next signal occurs at point 5.
6. I go long at 10,186 and simultaneously go short at this same level.
7. The next signal occurs at point 7.
8. I cover my short at 10,173 and go long at the same level.

I'd like to share some examples of this same setup in the forex currency markets and continue to add commentary regarding the trading of these instruments. Let's start with a market that most traders are familiar with, the euro currency as it trades against the U.S. dollar.

Forex Markets—EURUSD, October 15, 2004

1. On the daily chart of EURUSD (see [Figure 14.9](#)), a long signal fires off on October 15, 2004. I go long near point 1 at 1.2469. Remember, the stop is the lows of the signal bar.



Figure 14.9

2. The market has a steady move higher off this level, pausing to consolidate for a week in early November. However, there aren't any reversal signals given during this time, so there is nothing to do but sit on my hands and stay in the trade. EURUSD resumes its rally and shoots up hard into the end of December. At this point, the market rolls over, and many people in this trade start taking profits. Again, however, there are no sell signals using this setup. Finally, on January 3, 2005, nearly $2\frac{1}{2}$ months after the initial buy signal, a sell signal is generated at point 2. I exit at 1.3467, for a gain of 998 pips. At \$10 per pip, that is \$9,980 per individual lot that is being traded. For each lot, a trader needs to have \$1,000 in his account. This is part of the large attraction of the forex markets—the ability to establish specific stops while using leverage to ride out a potential trend until it turns. Forex traders often talk in terms of the dollar value of the contract they are trading: one lot (contract) represents \$100,000 worth of currency, 10 lots represent \$1,000,000 worth of currency, and so on. Being long 10 lots is referred to as having a “buck” (that is, a dollar). If I'm long 35 lots of EURUSD and I need to call my broker to change my order, she will refer to my position as “ $3\frac{1}{2}$ bucks.” Also, catching 1 full cent, or 100 pips, is referred to as catching “one large.” So on this play, we caught almost “10 large,” which is, of course, a huge play. In the interbank market, which is where all the institutions and large funds trade currencies, the smallest trade size is \$1,000,000, or the equivalent of trading 10 lots through your retail forex broker.

Forex Markets—GBPUSD, May 9, 2005

1. On this daily chart of GBPUSD (see [Figure 14.10](#)), a short signal sets up on May 9, 2005, at point 1, and I go short at 1.8837.



Figure 14.10

2. The market sells off steadily, and on June 3, 2005, it fires off a reversal signal at point 2. I cover my position at 1.8148, for a gain of 689 pips or \$6,890 per contract. Or, in forex trader speak, almost seven large.

Forex Markets—GBPUSD, August 2, 2005

1. While this signal works well on daily charts for the forex markets, it also works well on intraday charts for day trading. On this five-minute chart (see [Figure 14.11](#)) of GBPUSD, a long signal sets up on August 2, 2005, at point 1. The entry is 1.7696.

**Figure 14.11**

2. About an hour later, the corresponding reversal signal fires off at point 2. This is the heads-up to close out this position. The price level is 1.7724, a gain of 28 pips, or \$280 per contract.

Forex Markets—AUDUSD, July 31, 2005

1. On July 31, 2005 (see [Figure 14.12](#)), AUDUSD sets up a long signal on the 60-minute chart at point 1. The long entry is at 0.7560.

**Figure 14.12**

2. The next day, on August 1, 2005, a reversal signal is given at point 2, and we exit the play at 0.7604, for a gain of 44 pips. Remember, any currency pair that ends in “USD” is worth \$10 per pip, so the gain on this trade is \$440 per lot being traded. The three main currencies I trade that end in “USD” are the euro (EURUSD), the pound (GBPUSD), and the Aussie (AUDUSD). If a currency ends in “USD,” this means that it will generally move in the opposite direction from the U.S. dollar index. If the dollar is moving higher, then the euro, the pound, and the Aussie are selling off. Of these three currencies, the euro and the pound are most closely correlated with the dollar. The Australian dollar is also tied closely to commodity prices, as Australia is a huge exporter of various commodities. Because of this, the Aussie at times doesn’t move in direct correlation with the U.S. dollar. Let’s take a look at the other main currency pairs.

Forex Markets—USDCHF, July 21, 2005

1. On July 21, 2005 (see [Figure 14.13](#)), USDCHF sets up a long signal on the 60-minute chart at point 1. The long entry is at 1.2855.



Figure 14.13

2. A few days later, on July 24, a reversal signal is given at point 2, and we exit at 1.2971, for a gain of 116 pips. Since this currency pair does not end in "USD," the valuation of the pip will be slightly different from that in the previous examples. When this play was taken, the value of a pip was around \$7. So, in this case, 116

pips equates to a gain of \$812 per lot being traded. This currency, the Swiss franc, trades very closely with the U.S. dollar. If the dollar is going higher, so is the Swissy.

Forex Markets—USDJPY, July 20, 2005

1. On July 20, 2005 (see [Figure 14.14](#)), USDJPY fires off a short at point 1 on the 120-minute chart. The short entry is at 112.85.



Figure 14.14

2. The next day, on July 21, the market gives a reversal signal for an exit at 110.40 at point 2, a gain of 245 pips. Pip value on the USDJPY at the time of this writing was around \$8, so this translates into a gain of \$1,960 per lot being traded, or $2\frac{1}{2}$ large. The Japanese yen also moves very closely with the dollar.

Forex Markets—USDJPY, July 22, 2005

1. On July 22, 2005 (see [Figure 14.15](#)), USDJPY fires off a long signal at 111.12. The market quiets down shortly thereafter, but has a steady grind higher.



Figure 14.15

2. About a week later, on July 28, a reversal signal shows up on the chart at point 2, signaling an exit at 112.10. This is a gain of 95 pips or \$784 per retail lot. All "lots" discussed in these forex trades are based on the retail "standard" lot, which is worth \$100,000. This is as opposed to the "mini," which is worth \$10,000.

Forex Markets—USDCAD, July 21, 2005

1. On July 21, 2005 (see [Figure 14.16](#)), USDCAD fires off a long signal at point 1. The entry is 1.2169. The market consolidates for a few days and almost stops the play out, but a sell signal is never given. In this situation, there is nothing to do but wait for a signal to exit the trade. We've already established why human emotion makes a poor "exit signal."
2. Nearly a week later, on July 27, a reversal signal is given at point 2, and we are out of the long at 1.2360, a gain of 191 pips—almost two large. The rate for pips on this currency pair during this play was about \$6, which translates into a gain of \$1,146 per lot being traded.



Figure 14.16

After reviewing this play, we've now covered the six major currency pairs that most traders focus on. However, there are other currency pairs that are also good to trade, and I will focus on two of my favorites next.

Forex Markets—EURJPY, August 2, 2005

1. On August 2, 2005 (see [Figure 14.17](#)), EURJPY—euro/yen—fires off a short signal at point 1 at 136.66 on the 15-minute chart. The market chops around for about an hour before breaking down and selling off.



Figure 14.17

2. Nearly two hours later, a corresponding reversal signal is given at point 2, and I exit the trade at 136.18, for a gain of 48 pips. The pip value on this currency pair was around \$8 at the time of this play, which translates into a gain of \$384 per lot being traded.

Forex Markets—EURGBP, July 19, 2005

1. On July 19, 2005 (see [Figure 14.18](#)), EURGBP—euro/pound—fires off a long signal at 0.6912 on the 240-minute chart. The market grinds higher.
2. Two days later, we get three lower closes in a row, and the signal fires off at point 2. The exit on the long is 0.6970, or 58 pips. On this currency cross, each pip is worth about \$18, which makes the payout on this play \$1,044 per lot. This is actually a very quiet currency pair, but when it does move, it is very steady, and it tends to act like nothing can stand in its way. Because of this trait, we have nicknamed this currency pair “the tank.”

Summing Up the Scalper Alerts

Scalper alerts are especially useful for traders who like to try to buy bottoms or short tops. While it is foolish to short a market just because it’s “too high” or buy a market because it’s “too low,” it’s fine to short that high flyer or buy that all-out loser once you get a reversal confirmation with this signal. It doesn’t mean that the dead highs or the dead lows are in place, but it does mean that there has been a temporary shift in power, and it is a valid signal to step in and establish a position. Whether this is an intraday reversal on a five-minute chart or a total market reversal off a daily chart, the concept is exactly the same. In addition, this play is based on pure price action, and I appreciate its simple and effective nature.

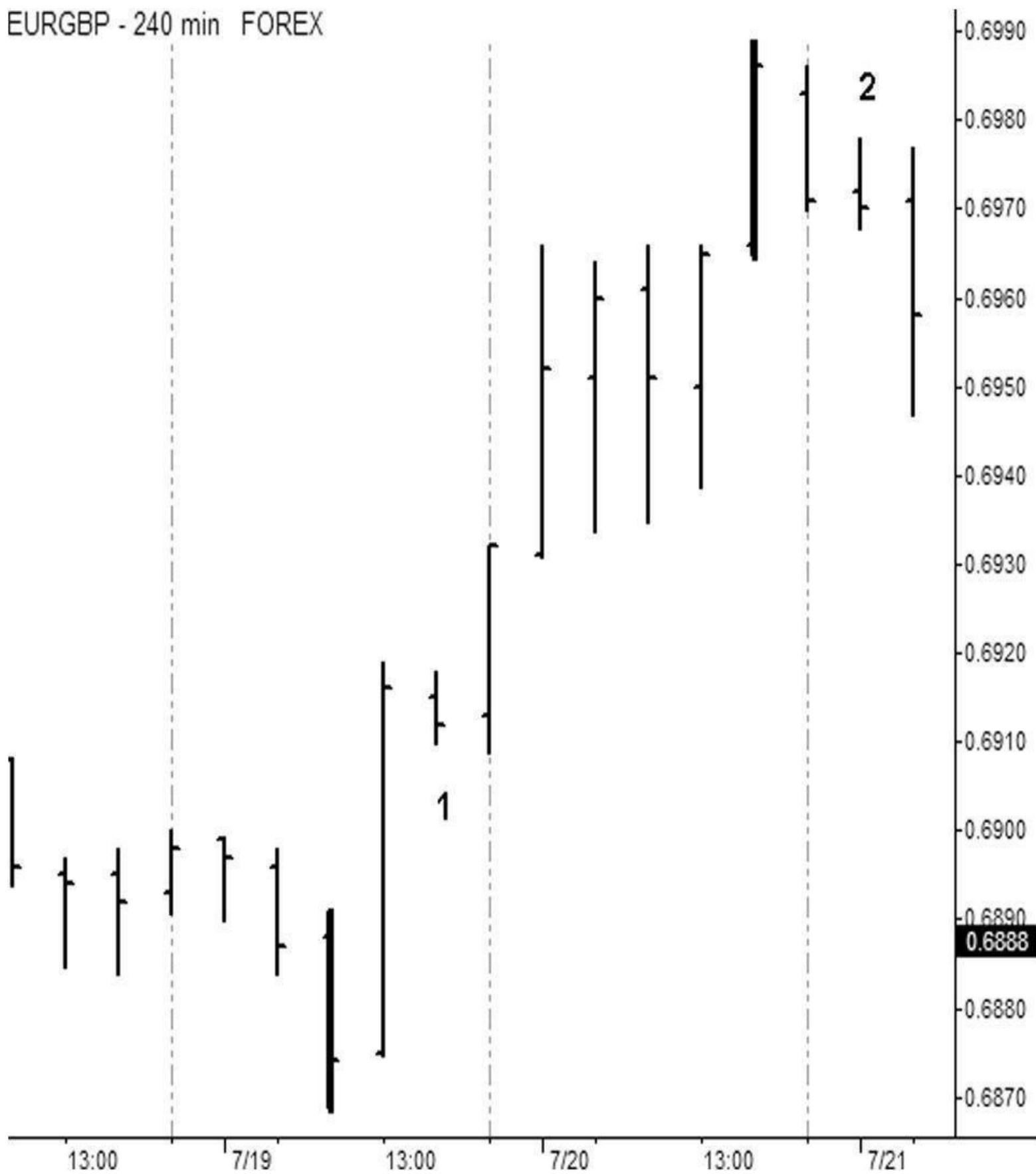


Figure 14.18

Increase the Probabilities of Success Through Multisetup Combinations

One theme that a trader will find in my setups is that they all work well together. When I'm scalping (which is admittedly less frequent the older I get), I particularly

like to combine the pivots with the scalper alerts on a 233-tick chart for the ES and a 144-tick chart for the YM. On days when I'm not sure what the market is going to do, I can wait for a scalper confirmation against a pivot level, as this is a trade that has a very high probability of success. Even better, I will get into a pivot trade, and shortly thereafter I will get a scalper confirmation in the direction of the trade. I can also use the scalper sell reversal to get out of my long pivot trade. I talk about this more in the chapter on developing a business plan, but the idea is to find what makes sense to you and your personality and mix and match accordingly.

And of course, we've set up www.tradethemarkets.com/scalper for updated information on this indicator and this setup.

**Brick Plays:
How Can I Tell
When a Market Is Going
to Reverse Its Trend in the
Middle of the Day?**

Using Bricks to Capture Intraday Reversals in the Mini-Sized Dow

The best intraday trades take place when a trader is able to catch the major portion of an intraday reversal. One of the best ways to do this is with a specific price pattern that we call *bricks*. We call them bricks because the price pattern that is formed looks like a bunch of building blocks that have been placed on top of a regular bar chart. These building blocks are formed on the chart because of specific price action. A series of three consecutive higher closes will form an “up” brick, and a series of three consecutive lower closes will form a “down” brick.

If you have a hard time pulling the trigger, this is a good play to use with buy stop and sell stop orders, as you will see in a moment. If you don’t have a hard time pulling the trigger, then you can just wait for the signal and go in at the market. This is one of those plays that are difficult to explain, but easy to show. In this case, a picture is worth at least 1,000 words, if not more, so let’s go through the trading rules and then go over a couple of actual plays.

Trading Rules for Buys (Sells Are Reversed)

This is a momentum reversal confirmation play.

1. Set up a 24-hour time frame on an intraday chart so that the overnight activity can be accounted for in this indicator setup. This is best used on smaller time frames, typically less than five minutes, although it can also be used for swing plays on daily charts.
2. Once a market shifts direction, which is denoted by the bricks changing color, count backward to the third brick in the formation.
3. Then draw a horizontal line across the top of this third brick back.
4. Once the price action breaks above this horizontal line, go long.
5. Hubert Senters (cofounder of www.tradethemarkets.com) and I use this setup on the mini-sized Dow, and we each manage this trade differently, so I will go over both of our methods. Hubert places a 10-point stop from the entry. Then when he is up 10 points, he sells half his position and moves his stop to breakeven – 3. (So if his entry was 10,545, then his new stop is 10,542.) If the market goes up another 10 points, he sells a quarter of his position and then moves up his stop 6 points to breakeven + 3. (So if his original entry was 10,545, his new stop is 10,548.) He then hangs on to the last quarter of the position to exit at his discretion. This typically means that he will hold on to this last part of his position until the bricks signal an opposing sell signal.
6. I will get into the same trade and use a 20-point stop. I will exit half my position at +15 points and then stay in the trade until there is a brick that has formed in the opposite direction—an opposing sell signal. I don’t trail the stops. Both methods have worked well for us, and this is a good example of how different traders can take the same setup and modify the trading methodology to fit their own particular personality.

Let’s take a look at some actual plays.

Mini-Sized Dow—March 2005 Contract, February 25, 2005

1. On this five-minute chart of the minisized Dow futures on February 25, 2005, a long signal occurs at around 10:00 a.m. eastern (see [Figure 15.1](#)). This takes place when the price action reverses and crosses above the horizontal line created by the third brick back in the series. The first brick in the series is the black brick labeled as point 1, the second is that labeled as point 2, and the third is that labeled as point 3. The entry price is 10,696. This horizontal line is drawn in manually. Originally it started on the brick above where the line is currently drawn at point 3. This horizontal line was sitting near 10,710. However, as the market continued to push lower, additional down bricks were formed, and the horizontal line was trailed three bricks back accordingly. This line, representing the entry point for a long, continues to be trailed down as long as new down bricks are being formed. It is only when the markets can cross back above the third brick back in the series that a trade signal occurs. On a color chart, the up bricks are blue, and the down bricks are red. On these charts, the up bricks are light gray and the down bricks are black.

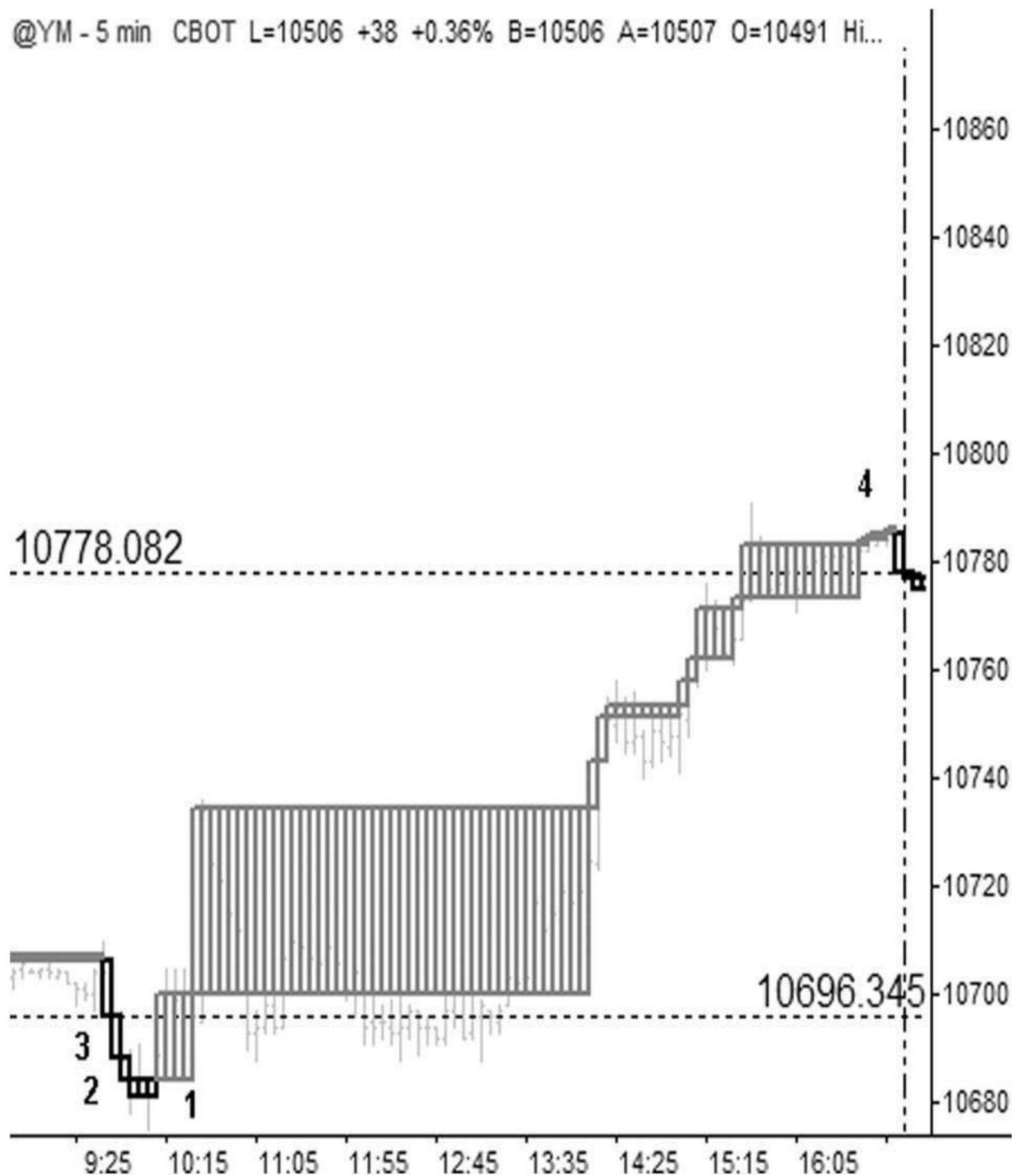


Figure 15.1

2. In this instance, once the trade is entered, the YM rallies to almost 10,790 before rolling over. A reversal signal is generated shortly thereafter at point 4 at a price of

10,778, for a total move of 82 points.

I want to also discuss three different ways in which this setup could be played. The first and most straightforward way would be to stay in the entire trade from entry to exit, capturing the entire move. In this type of play, I start off with a 20-point stop and then stay in the trade until the reversal signal occurs. The downside of this is that the market could rally 18 points, then roll over and stop out the trade.

Another way to play this is to exit half the position at a purely mechanical price target. This is how Hubert and I play this. We each execute this trade slightly differently, and the mechanics of each of our styles will be explained shortly. By exiting half of your position at my or Hubert's predetermined mechanical levels for the first half of the trade, some profits will already have been taken. This can mean the difference between a losing trade and a scratch trade. So the second way to play this is to start off with a 20-point stop, exit the first half of the position at a mechanical level, such as 15 points, and then exit the second half upon a reversal. This is typically how I play the bricks.

The third way to play this is the way Hubert plays it, where he uses a 10-point stop and then starts peeling out of the position almost immediately. In this case, he sold half of his position when he was up 10 points, sold another quarter when he was up 20 points, and held on to the rest until the reversal. Note that these exit strategies can be used on all the intraday plays discussed in this book.

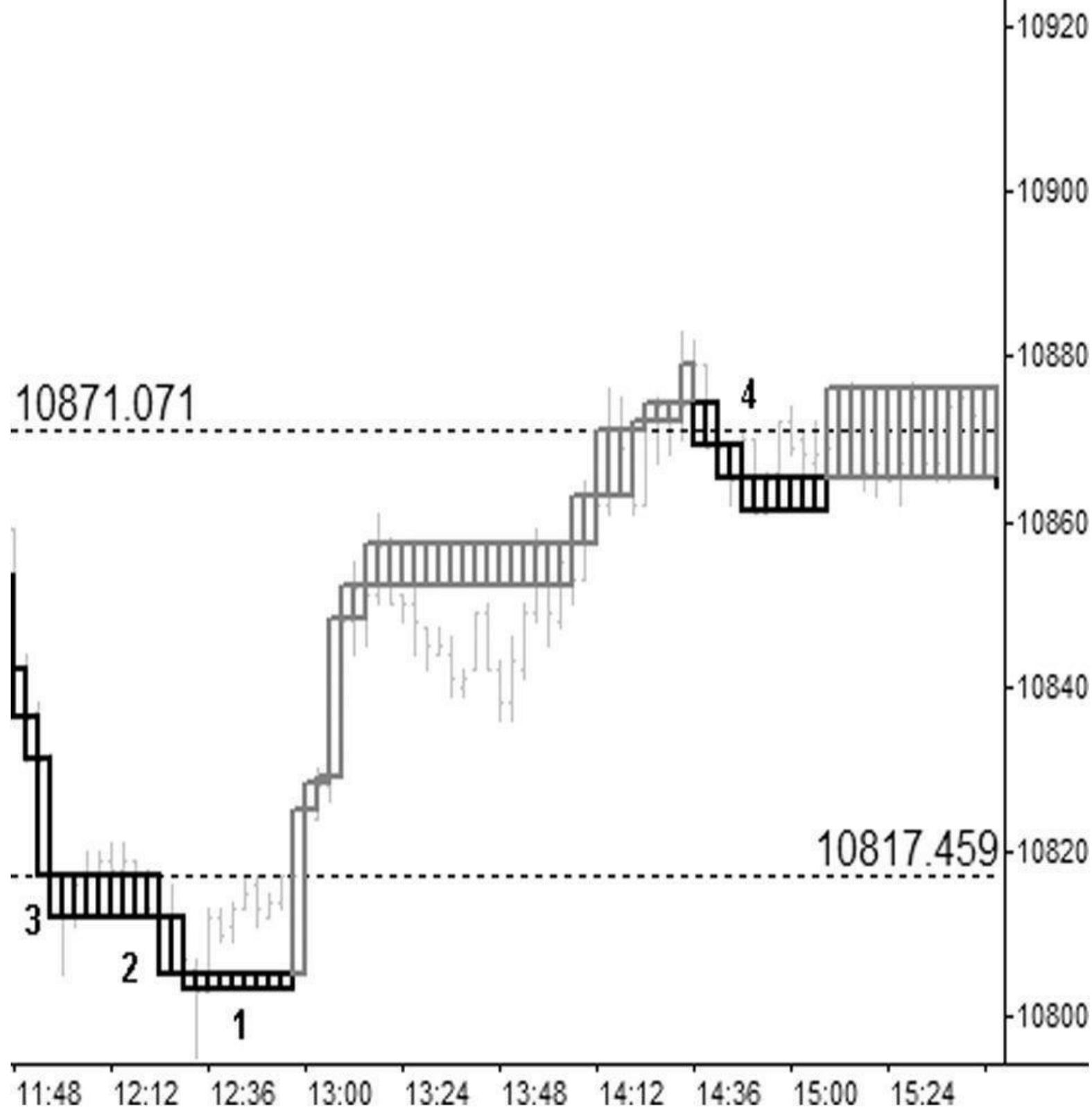


Figure 15.2

These are all valid exit methodologies for this setup. It is important for a trader to recognize that every setup can be played in different ways and to find the way

that best suits her own personality. For the rest of the examples, I focus on the actual reversal points as entries and exits.

Mini-Sized Dow—March 2005 Contract, March 3, 2005

1. On this three-minute chart of the mini-sized Dow on March 3, 2005, a long reversal signal fires right around 1:00 p.m. eastern, as the third brick back in the series is penetrated (see [Figure 15.2](#)). The entry on a buy stop order is 10,817.
2. For the exit, we are now waiting for a down (black) brick to form, and once that happens, we will use a trailing three-brick stop utilizing the up bricks. By doing this, we exit the trade at 10,871, for a gain of 54 points.

Mini-Sized Dow—March 2005 Contract, March 9, 2005

1. On March 9, 2005, this five-minute chart of the YM fires off a brick short just before noon eastern (see [Figure 15.3](#)). The entry takes place using a sell stop order at 10,916.

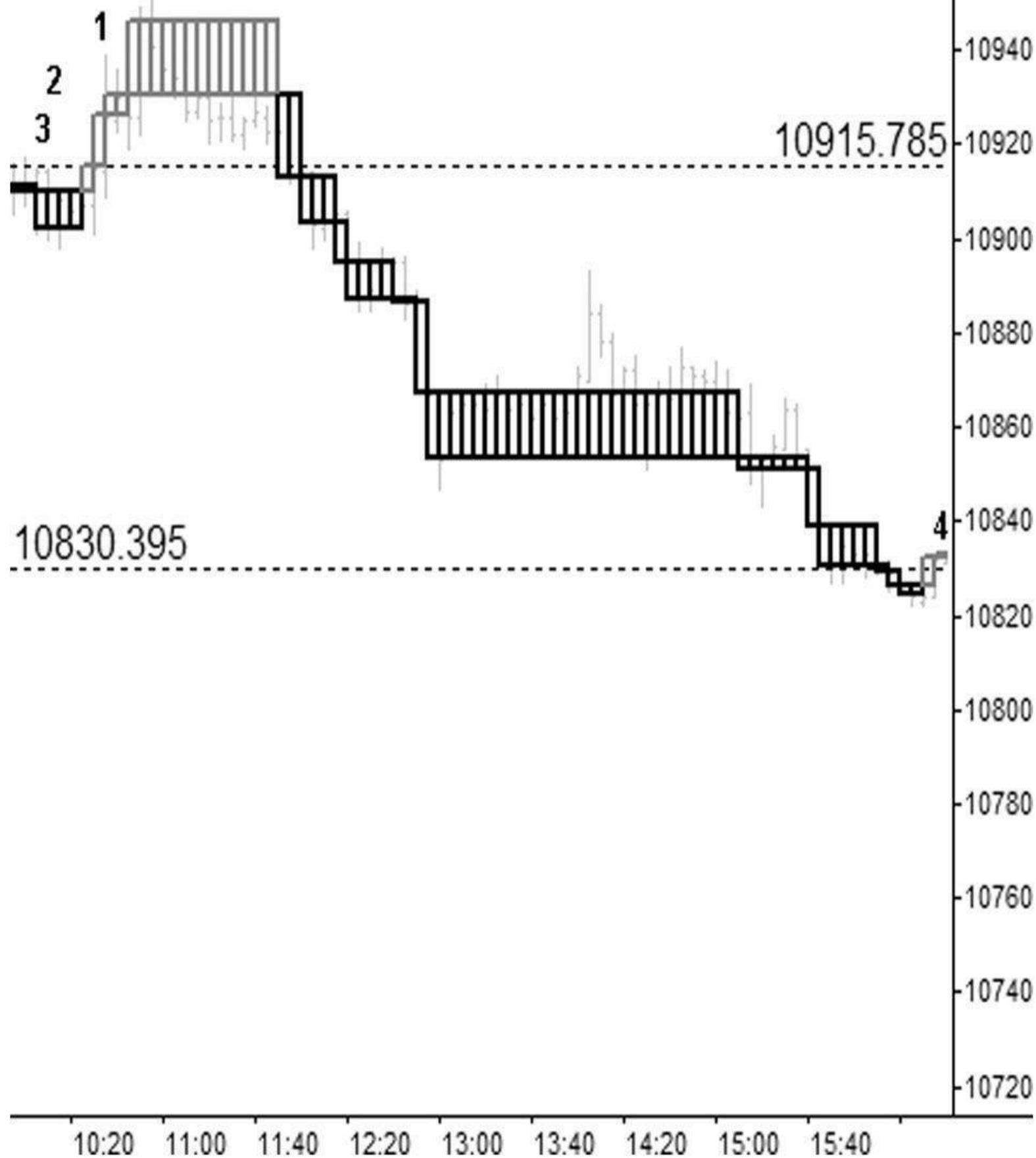


Figure 15.3

2. For the exit, the goal is to wait for an up brick, and, once that occurs, to trail a stop three bricks back. The stop is hit at 10,830 for a gain of 86 points. What I like

about this is that the setup keeps a person in the trade all through the choppy noise and false rallies that occur between 1:00 p.m. and 3:00 p.m. eastern. This goes back to the importance of having a specific exit strategy—and only a specific exit strategy—to get out of a trade.

Mini-Sized Dow—March 2005 Contract, March 10, 2005

1. On March 10, 2005, the YM three-minute chart fires off a brick long just before noon at 10,829 (see [Figure 15.4](#)).

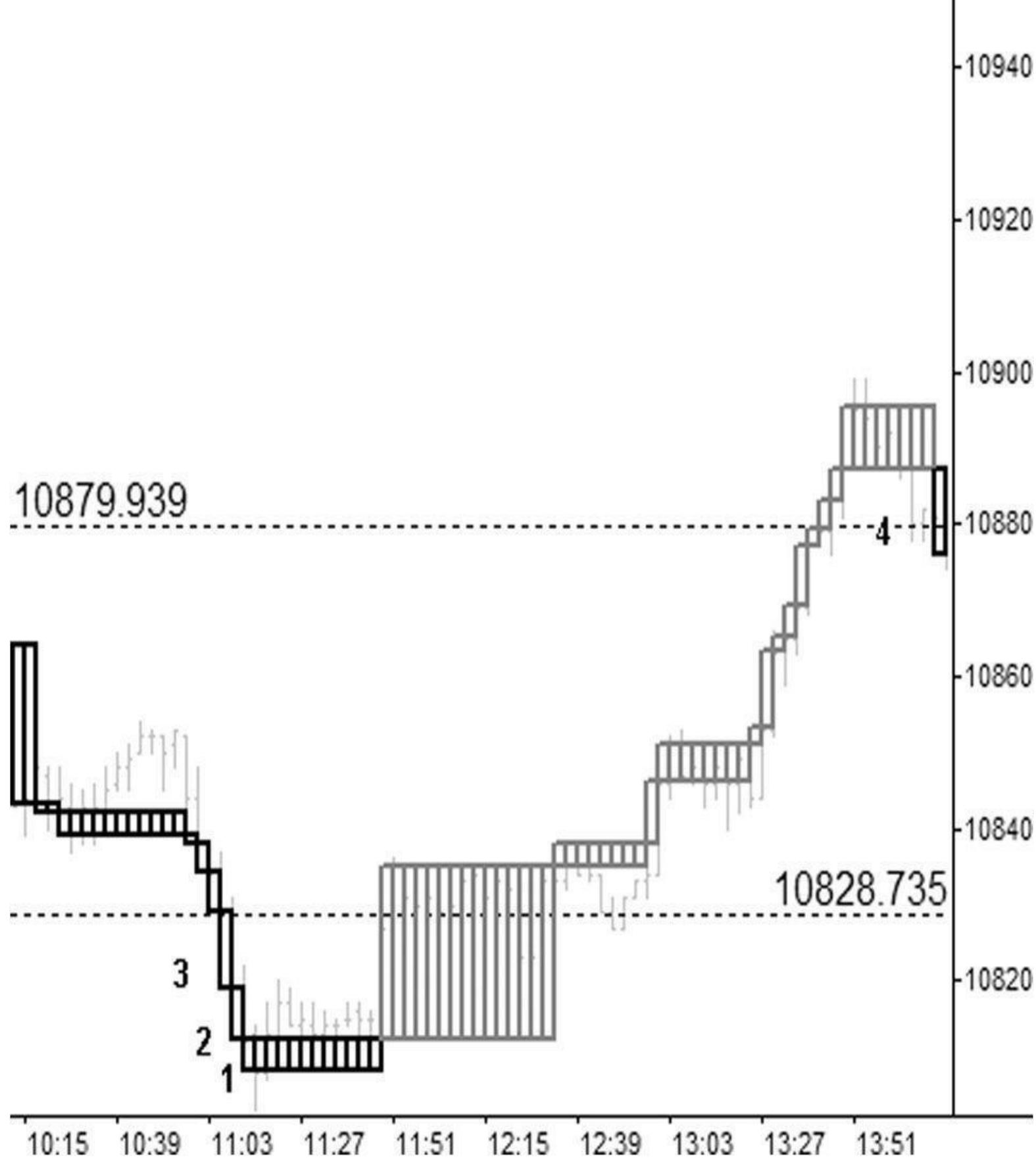


Figure 15.4

2. The setup reverses a few hours later, setting up an exit signal at 10,880 for a gain of 51 points.

Mini-Sized Dow—March 2005 Contract, March 11, 2005

1. On this two-minute chart of the YM on March 11, 2005, a reversal short brick signal fires off at 10,864 at around 11:00 a.m. eastern (see [Figure 15.5](#)).

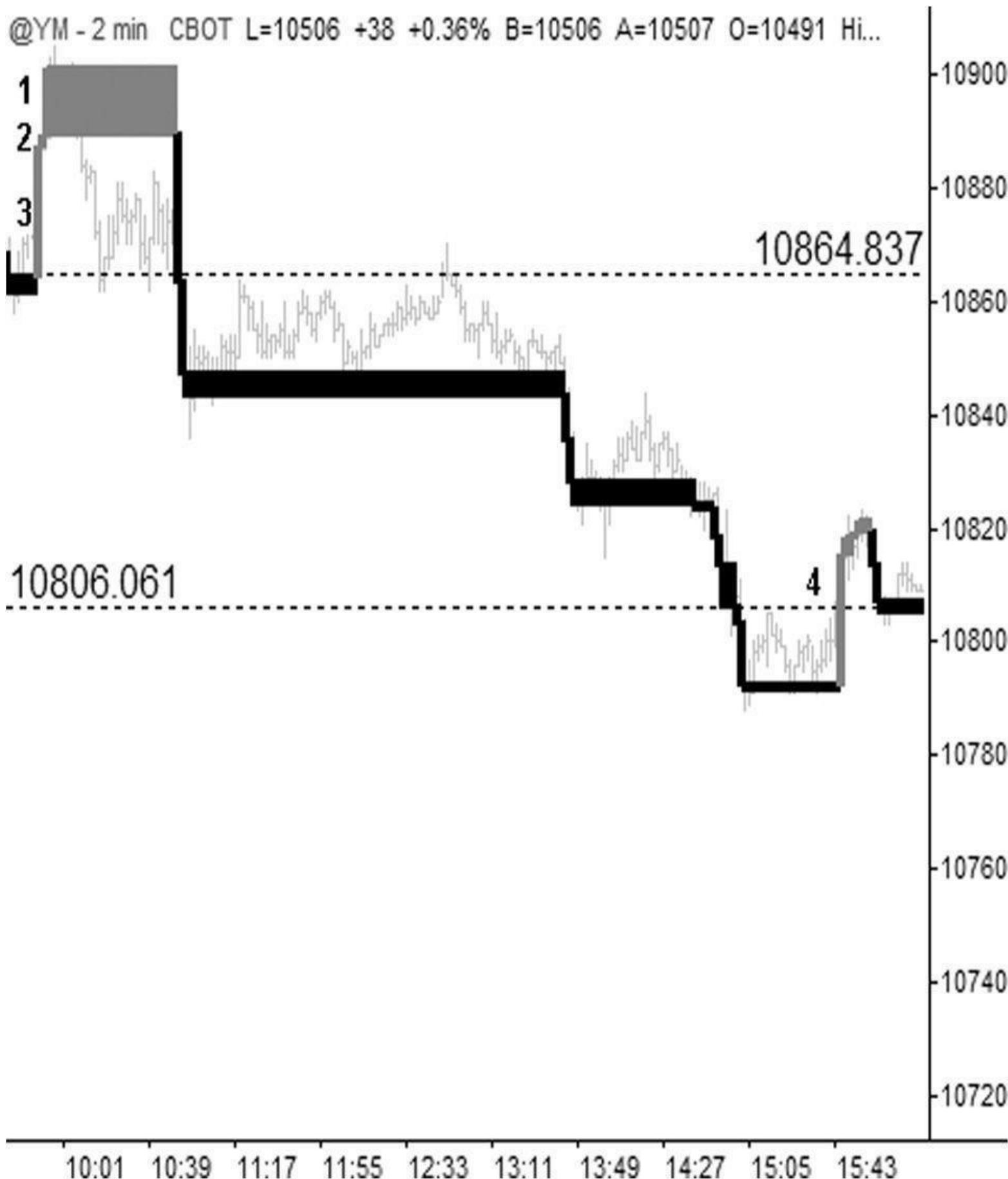


Figure 15.5

2. The play continues to work lower until the last hour of trading, generating an exit signal at 10,806 for a gain of 58 points. Again, I would like to point out all the noise in this chart that occurred between 11:30 a.m. and nearly 2:00 p.m. How many traders got chopped up in this? How many chased it higher? How many shorts panicked and covered? A trader who follows a specific setup, with a specific set of parameters, is at a huge advantage over all the people out there who are “trying to rely on their judgment while in a trade.”

Mini-Sized Dow—March 2005 Contract, March 16, 2005

1. On this two-minute chart of the YM on March 16, 2005, a reversal short brick signal fires off at 10,699 in the latter part of the trading day a little after 1:00 p.m. eastern (see [Figure 15.6](#)).

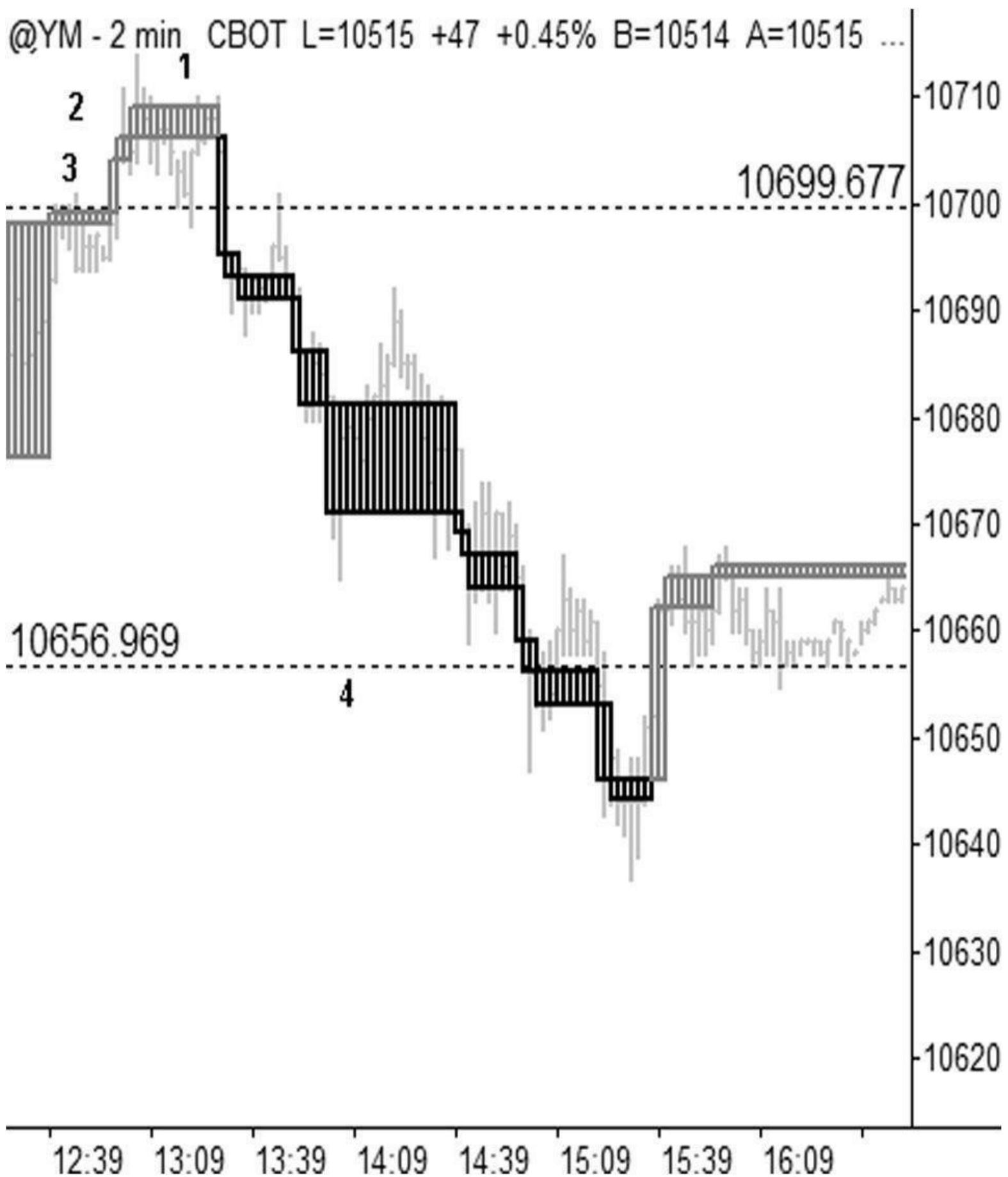


Figure 15.6

2. The markets continue to sell off, and the bricks stay in sell mode until about 20 minutes before the close, when a reversal signal hits, stopping the trade out at 10,657

for a gain of 42 points.

Mini-Sized Dow—March 2005 Contract, March 22, 2005

1. On this two-minute chart of the YM on March 22, 2005, the YM fires off a short signal late in the trading day, and a sell stop order is hit at 10,622 (see [Figure 15.7](#)).
2. The markets drift lower into the close, and there actually is not a reversal signal given to exit this trade. In this case, we just use the 4:15 p.m. eastern close on the ES to get out of the trade. Although the YM continues to trade until 5:00 p.m., the liquidity really dries up after the ES market closes. In this case, exiting on the close generates an exit at 10,469 for a gain of 153 points. Why the big sell-off? This was FOMC (Federal Open Market Committee) day, and the markets sold off after the news hit about another quarter-point rate increase. This ties into one of my biggest beliefs about trading the markets—economic reports mean very little in the overall scheme of things. The market is going to do what the market is going to do. The key is to focus on the setup and ignore the rest of the noise.

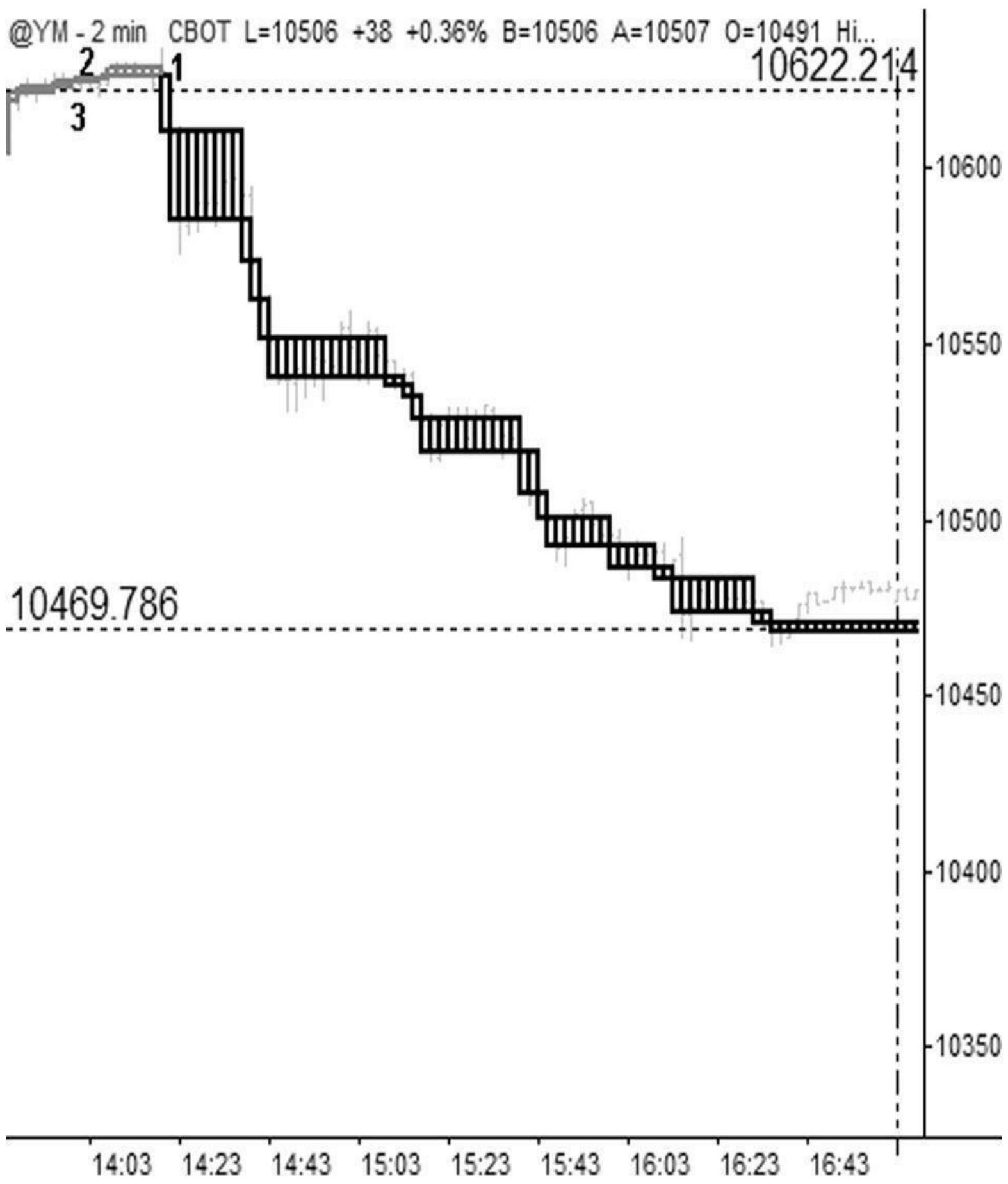


Figure 15.7

1. On this daily chart of the YM, a swing play is generated on the bricks near the end of October 2004 (see [Figure 15.8](#)). The entry on this play is 9927.

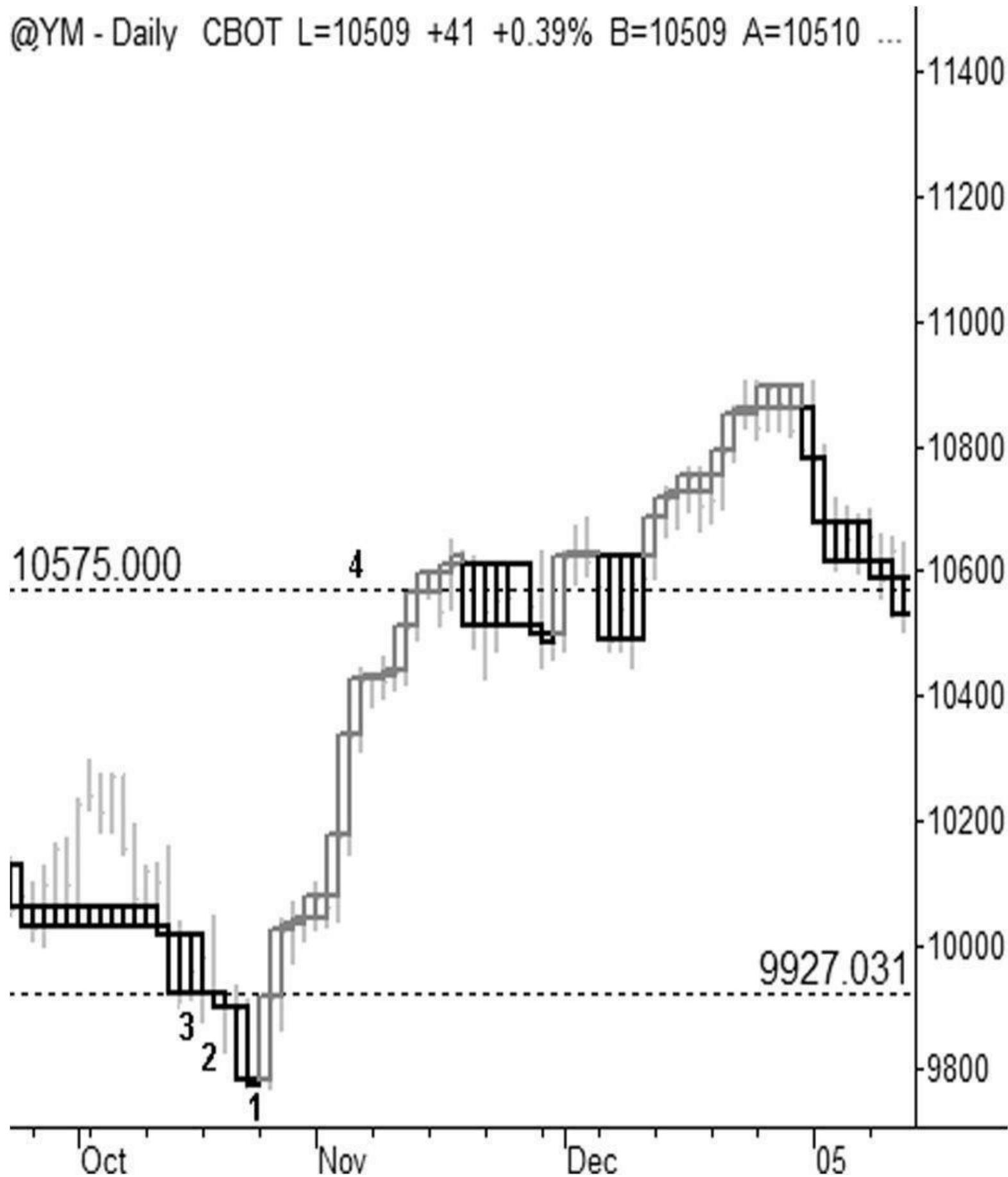


Figure 15.8

2. The daily bricks stay in buy mode until the end of November, when a sell signal is generated at 10,575, for a gain of 648 points. When the market reversed in late October, there were a lot of bears. This again points to the fact that it doesn't really matter what people think about the market and what they feel it *might* do. What matters is what the market is actually doing. Trade setups like the bricks remove all the emotion.

Summing Up the Bricks

The brick setup is great when you're trying to catch an intraday reversal. Too many traders try to do this, but end up getting burned. They short the market, but it just keeps going higher. Or they buy the market, and it gets flattened. There is no reason to try to catch the exact high or the exact low in a market move. That involves too much risk and has a low probability of success. With this confirmation signal, a trader will be made aware of when the move has petered out and started its reversal, and although she won't be able to catch the exact highs or the exact lows, she will still be able to catch the "meat of the move."

We've set up www.tradethemarkets.com/ bricks with free videos that update this play for current market conditions.

The Ping-Pong Play: Batting the Markets Back and Forth ... All Day Long

A Trading Channel That Moves and Adapts to the Markets in Real Time

The Ping-Pong play is a channel play with a twist: this channel is always present and is continually adjusting itself to the market action. There isn't any need to draw a couple of parallel lines and wait for two tests of the highs and two tests of the lows to confirm that a channel is in place. This channel is always hanging around, waiting for a trade to set up.

This setup was discovered by accident by Hubert Sinters, my business partner and friend for going on more than 10 years now. He spent a couple of years watching KLAC (KLA-Tencor Corp.) on a two-minute chart and a five-minute chart. He noticed that when KLAC broke up through the 200-period simple moving average (SMA) on a two-minute chart, it would head right up to the 200-period SMA on a five-minute chart. To make life easier, he eventually figured out that he could do this all on one chart by setting up a new two-minute chart that had both a 200-period SMA and a 500-period SMA. The 500-period SMA on a two-minute chart plots just the same way as a 200-period SMA on a five-minute chart. Once this play was converted to one chart, it was easy to see that a live, moving channel was in place, as the 200-period SMA and the 500-period SMA moved together in an almost graceful dance.

Hubert uses this setup almost exclusively on the stock KLAC. We've also found that it works well for other high-volatility, high-volume stocks that tend to attract a lot of the day-trading crowd; examples include GOOG, PCLN, AAPL, AMZN, and others of that type. Although the examples in this chapter focus on KLAC, they apply equally to these other stocks as well. For the higher-priced stocks, stop prices are calculated at 50 cents per \$50. So with a stock like AMZN trading at \$200, a stop of \$2.00 would need to be utilized. Let's take a look.

Trading Rules for Buys (Sells Are Reversed)

The Ping-Pong play can be both a momentum play and a fade play, depending on the initial move against one of the moving averages. When prices are trading inside the channel, this is a fade play. When prices break into the channel, this turns into a momentum play.

1. I set up a two-minute chart on a 24-hour time setting. I want the pre- and postmarket activity to be taken into account for the moving average calculations.
2. I like to use candlestick price charts on this play, but this is not critical because I'm not looking for any specific candlestick patterns, such as dojis, hammers, shooting stars, and so forth. If you are unfamiliar with candlestick patterns, an excellent book is *Japanese Candlestick Charting*, by Steve Nison. I personally don't use candlestick patterns for intraday trading, but I do like to see what the daily candlestick bars are doing to get a better feel of who is in control of the market—buyers or sellers.
3. I place a 200-period SMA (represented by the thick line in the chart examples) and a 500-period SMA (represented by the thin line in the chart examples) on the two-minute chart.
4. When the market is trading below both moving averages, I go long after the first two-minute bar closes inside the moving average channel.
5. When the market is trading inside the moving averages, I go long on a bounce off the bottom of the channel. I will wait for a two-minute bar to close on a bounce off the channel before placing a market order to go long.
6. I use a 50-cent stop. If the moving averages are trading wider than 50 cents, then when I am up 50 cents on the trade, I will move my stop to the moving average that triggered my entry. If the moving averages are trading narrower than 50 cents, then I will leave my original stop in place, and I won't trail it.
7. My target is the "other moving average."
8. I typically use this trade on KLAC, as does Hubert. However, it works with other volatile stocks as well.

KLAC (KLA-Tencor Corp.), October 4, 2004

1. On October 4, 2004, KLAC breaks down through the 200-period SMA (see [Figure 12.1](#)). After the first closing candlestick, I go short at the market and am filled at 43.83. I place a 50-cent stop at 44.33, and my target is the 500-period SMA below. About 45 minutes later, I am up 50 cents on the trade, so I move my stop down to the 200-period SMA, which is trading at 43.91.



Figure 16.1

2. KLAC rallies and comes within 10 cents of my stop. It eventually rolls over and hits my target at 43.11 at point 2, and I am out of the trade for a gain of 72 cents. KLAC is liquid and will support a large number of shares on this trade. For 1,000 shares, that is a profit of \$720; for 10,000 shares, that is a gain of \$7,200. There will be a little slippage when going into and out of 10,000 shares at the market. When this happens, I just take the average price, and I use that to determine where I will place my 50-cent stop. I will also trade KLAC single-stock futures on this trade (KLAC1C). For those of you who aren't familiar with single-stock futures, they are nice because the leverage is 5 to 1 without any margin interest costs. And these can be traded in an IRA through a trust account (meaning that you can short them in your IRA), and you can do these day trades with only a few thousand dollars in your account, instead of the \$25,000 minimum you need to day-trade stocks. One single-stock futures (SSF) contract represents 100 shares of stock. With single-stock futures, I will use limit orders instead of market orders because they are not as liquid as the underlying stock. However, the low volume that is currently present in SSFs is misleading. The liquidity is based more on the volume of the underlying stock. This is something that I talk more about later in [Chapter 22](#), "Propulsion Plays," using the 8/21 EMAs for entries and trade management. My experience with single-stock futures has been very positive, and I continue to add more of these contracts to my trading program.

KLAC (KLA-Tencor Corp.), September 23, 2004

1. On September 23, 2004, KLAC pushes up through its 200-period SMA (see [Figure 16.2](#)). After the first two-minute bar closes above this level, I take a long at the market, and I'm filled at 40.76. I place a 50-cent stop at 40.26. My target is the 500-period moving average trading overhead. For this particular trade, the moving averages are not 50 cents apart, so I won't be trailing my stop.



Figure 16.2

2. KLAC edges higher, and my target in the form of the 500-period SMA is hit, and I'm out at 41.07 for a gain of 31 cents.

KLAC (KLA-Tencor Corp.), August 30, 2004

1. On August 30, 2004, KLAC rallies into the 200-period SMA (see [Figure 16.3](#)). When the first bar closes back below this moving average, I go short at the market. I'm filled at 38.24, and I place a 50-cent stop at 38.74. The moving averages are less than 50 cents apart, so I won't be trailing my stop on this trade.



Figure 16.3

2. KLAC goes pretty much straight down, and a little over 40 minutes later, I am out of my short at the 500-period SMA. I'm filled at 37.82 for a gain of 42 cents.

KLAC (KLA-Tencor Corp.), August 25, 2004

1. On August 25, 2004, KLAC comes down and tests the 200-period SMA while trading inside this moving average channel (see [Figure 16.4](#)). Once the first two-minute bar closes above the 200-period SMA after the test, I go long at the market. I'm filled at 37.10, and I place a 50-cent stop at 36.60. The moving averages in this case are less than 50 cents apart, so I won't be trailing any stops on this trade.

**Figure 16.4**

2. KLAC rallies to the 500-period SMA, and I'm out at 37.58 for a gain of 48 cents. This is scalping at its finest, and although these aren't huge plays, some would argue that it beats flipping burgers for a living.

KLAC (KLA-Tencor Corp.), August 23, 2004

1. On August 23, 2004, KLAC sells off and breaks hard through the 200-period SMA (see [Figure 16.5](#)). It closes pretty deep within the channel, but as soon as this first bar closes, I go short. I'm filled at 37.94. I place a 50-cent stop at 38.44. The 500 SMA is not very far away, so I won't have the opportunity to trail my stop at all.



Figure 16.5

2. It takes longer than I thought it would, but the 500-period SMA is eventually hit, and I'm out at 37.61 for a gain of 33 cents.

KLAC (KLA-Tencor Corp.), August 19, 2004

1. On August 19, 2004, KLAC slams through the 200-period SMA (see [Figure 16.6](#)). Once the first bar through closes below this level, I go short at the market. I'm filled at an average price of 37.44. I place a 50-cent stop at 37.94. The two moving averages are less than 50 cents apart, so there won't be any trailing on this trade.

**Figure 16.6**

2. The market chops around for a while, and KLAC doesn't so much fall to its 500-period SMA as the 500-period SMA rallies to the current price levels. Once this happens, I get out at the market. I'm filled at 37.15 for a gain of 29 cents. This is a good example of the "living, breathing, moving horizontal channels" in action. There are no stationary straight lines on these setups. These babies move and ebb and flow with the market.

KLAC (KLA-Tencor Corp.), August 18, 2004

1. On August 18, 2004, KLAC gaps down into the 500-period SMA (see [Figure 16.7](#)). Once I see a two-minute candlestick that closes back above the 500-period SMA (the third candlestick over from point 1), I go long at the market and am filled at 36.32. Once again, the two moving averages are less than 50 cents apart, so I won't be trailing any stops.

**Figure 16.7**

2. KLAC pushes higher quickly, and eight minutes later I'm out at 36.76 for a gain of 44 cents.

KLAC (KLA-Tencor Corp.), August 10, 2004

1. On August 10, 2004, KLAC sells off and hits the bottom of its 200-period SMA (see [Figure 16.8](#)). KLAC pushes through this level, and I'm poised to go long after the first two-minute bar closes back inside the channel. This takes place shortly thereafter, and I go long at the market. My fill is 38.53. Once again, the moving averages are less than 50 cents apart, so I won't have to worry about trailing my stop.



Figure 16.8

- KLAC grinds higher, and after a while the 500-period SMA is touched. When this happens, I exit and take my profits at 38.80, for a gain of 27 cents. It is okay to place limit orders for targets, but because the two-minute charts move fast, the price of the moving average is going to fluctuate and change every couple of bars, so you have to either keep an eye on it or have the exits adjust automatically via a trading system.

KLAC (KLA-Tencor Corp.), July 21, 2004

- On July 21, 2004, KLAC drops back into its channel and through the 200-period SMA, and I short once the first bar closes within the channel (see [Figure 16.9](#)). I'm filled at 41.23, and I place a 50-cent stop. I do a quick check and see that the moving averages are less than 50 cents apart, and that, of course, means I won't be trailing any stops.



Figure 16.9

2. KLAC drifts down, and the 500-period SMA is tagged. I cover at 40.81, and I'm out for a gain of 42 cents.

KLAC (KLA-Tencor Corp.), July 12, 2004

1. On July 12, 2004, KLAC pushes back up into its channel via the 200-period SMA (see [Figure 16.10](#)). Once the first two-minute bar closes inside this channel, I go long, and I'm filled at 44.39. I place a 50-cent stop at 43.89. I duly note that the moving averages are more than 50 cents apart. So, if I get to the point where I'm up 50 cents on this trade, I will move my stop up to the 200-period SMA.



Figure 16.10

2. KLAC pushes higher, and once it trades through 44.89, I move up my stop to the 200-period SMA, which is at 44.23. KLAC continues to rally straight up, and it runs right into the 500-period SMA. When this happens, I close out my long at the market. I'm filled at 45.23, for a gain of 84 cents.

KLAC (KLA-Tencor Corp.), July 1, 2004

1. On July 1, 2004, KLAC gaps down and hits its 200-period SMA (see [Figure 16.11](#)). Once it closes through this level, I go short, and I'm filled at 49.01. I immediately place a stop 50 cents away, at 49.51. The moving averages are greater than 50 cents apart, so I will look to trail my stop down to the 200-period SMA once I'm up 50 cents in the trade. KLAC ends up selling off quickly, and once it trades through 48.51, I move my stop down to 48.99, which is where the 200-period SMA is trading at this time.

2. KLAC continues to sell off; once it touches the 500-period SMA, I start to cover, and I'm out at 48.44 for a gain of 57 cents.

KLAC (KLA-Tencor Corp.), May 19, 2004

1. On May 19, 2004, KLAC sells off and enters its moving average channel (see [Figure 16.12](#)). I go short when the first two-minute bar closes inside this channel. I'm filled at 45.78, and I place a 50-cent stop at 46.28. Since the moving averages are more than 50 cents apart, I will be looking to trail my stop once I'm up 50 cents. KLAC drifts down, and once the price action falls through 45.28, I move my stop down to 45.89.

2. KLAC continues to sell off, and once it hits the 500-period SMA, I'm out at 44.94 for a gain of 84 cents.



Figure 16.11



Figure 16.12

When You're Dancing with the Market, It's a Good Idea to Let It Lead

One of the things I like about this play is that it catches the ebbs and flows of the market nicely. All I have to do is sit back and “let the market lead.” There really isn’t any good time to try to force the market to do what you want it to do. This setup is a nice reminder of that, and all I have to do is sit back, relax, and follow my dance partner.

Check out www.tradethemarkets.com/ pingpong for updates to this play.

The 3:52 Play: Capping Off the Day with a Fine Cigar

This Is Where the Other People Start to Panic

The 3:52 play is a setup I discovered while working in a trading room observing more than 100 other traders going through their daily gyrations with the market. It is commonly known among traders that 3:30 p.m. eastern is a key reversal point in the markets. What was fascinating was that I would watch this room full of traders stare at the bounce (or sell-off) that would start at 3:30, and then they would wait, wait, and wait some more. They would wait for confirmation, wait for an indicator-based buy or sell signal, wait for their mother to call and tell them it was okay to take the trade, or whatever. The point is that they would *wait* to jump in on the move. Finally, they would succumb to the pressure to get in, and they would jump in on the move just as it was running out of steam. I would spend the rest of the session watching in fascination as they pointed, gyrated, and yelled at their computer screens as the markets drifted against them. Often they would wait until the last possible minute to get out of their S&P futures trades, which is 4:15 p.m. eastern. They would wait in the hope that the markets would come back to them, and they spent this brief session praying that their position would work out. Sometimes it did, but often it did not because there were too many of them who were trapped and hoping for the same move. As the markets neared 4:15 p.m., they had no choice. They could not wait any longer, and they were forced to close out their positions. Like rats on a sinking ship, these traders would all head for the exits at once. If they were long, they would all be selling at once. If they were short, they would all be buying at once.

The interesting part of this is that the liquidity dries up after 4:00 p.m. eastern. With the decreased liquidity that exists from 4:00 p.m. to 4:15 p.m., these groups of traders can easily cause exaggerated movements in the markets in the final minutes before the closing bell. This causes the markets to move hard against them. I watched them do this day after day, assuming that one day they would catch on. They never did, and after a while I would just sit there and do the opposite of what they were doing, so that while they were crying, I was cashing in. This same setup continues to work today, and it is something that I do nearly every trading day. Like a single-malt Scotch after a filet mignon, it's a great way to cap off a trading session.

Trading Rules for Buys (Sells Are Reversed)

This is a fade play. I let the 3:30 p.m. eastern reversal happen, and then 22 minutes later, at 3:52, I take the opposite side of the move.

1. I use this setup for the E-mini S&Ps and the mini-sized Dow futures.
2. I set up a one-minute bar chart without any other indicators or interference.
3. At 3:30 p.m. eastern, I mark where the futures are trading. In the case of this example, the futures would have started rallying at 3:30 p.m. eastern.
4. At 3:52 p.m., I take a short using a market order. I short at the opening of the 3:52 one-minute bar. This is assuming that the ES is at least 1 point away and that the YM is at least 10 points away from where it was trading at 3:30. On days when this does not occur, I don't take the trade.
5. My stop for the ES is 2 points, and my stop for the YM is 20 points. I do not trail stops for this play.
6. I hold on to the trade until 4:13 p.m. eastern, at which point I close out at the market. Technically I could hold on until 4:15, but I don't want to get stuck in this trade overnight, which is why I give it two minutes of elbow room. If I discover that my PC has locked up, that gives me enough time to call my broker and get out of my trade. (I use a broker who actually answers the phone and doesn't put me on hold.)
7. Even though the mini-sized Dow doesn't close until 5:00 p.m., I still use 4:13 p.m. to mirror the E-mini S&P futures markets. By 4:15, I'm ready to take a break from trading for the day.

E-mini S&P—December 2004 Contract, October 14, 2004

1. At 3:30 p.m. eastern on October 14, 2004, the S&Ps start to rally, and since they are rallying off of 3:30, I will be looking to short this market at 3:52 (see [Figure 17.1](#)). By watching a one-minute bar, I can see that the 3:51 p.m. bar closes at 1104.75. Then at 3:52 p.m., the bar opens at 1104.50, and I take the opposite side of this move. I short at the market, and I am filled at 1104.50. I place a two-point stop at 1106.50.



Figure 17.1

2. The traders who jumped on this 3:30 p.m. “pop” late are now starting to watch their trade go under water. The longer they hang on, the more nervous they get, and they start getting their stops hit or just dumping their position using market orders. This pushes the market down even further. At 4:13 p.m., the one-minute bar opens at 1103.00. This is my time signal to get out, and I cover at the market for a gain of 1.50 E-mini S&P points. One of the things I like about this play is that there is a time limit. I know that when I get in, I will be getting out 21 minutes later. I also like the fact that I’m not looking for a big move. I’m mentally prepped to take a small scalp, and when this trade does move against me, it is typically for a very small loss, since my actual stop is rarely hit.

E-mini S&P—December 2004 Contract, October 4, 2004

1. At 3.30 p.m. eastern on October 4, 2004, the market sells off into the 3:52 p.m. time frame (see [Figure 17.2](#)). Since the market is selling off from this time reversal point, I am looking to take the opposite side of this move, so I go long. All I am waiting for now is 3:52 p.m., which is my time trigger to get into the trade. At 3:52 p.m., I buy at 1136.00 and place a stop at 1134.00. Why do I wait for exactly 3:52 p.m. to fade this move? This is just the time I settled on after doing this on a trial-and-error basis for a long period of time. I cannot mathematically prove that getting in at 3:52 is better than getting in at 3:50. It’s almost like asking whether people prefer blondes or brunettes. They may have a preference, but in the end all that matters is that they are able to get along with their choice and make a go of it.



Figure 17.2

2. The market chops back and forth, and at 4:13 p.m., I am out at 1135.50 for -0.50. It is interesting to note that I am rarely stopped out on this play. Though I do take losses with this setup, they are typically very small.

E-mini S&P—September 2004 Contract, July 27, 2004

1. From 3:30 p.m. eastern on July 27, 2004, the market rallies into the 3:52 p.m. time frame (see [Figure 17.3](#)). At 3:51, the one-minute bar closes at 1094.75. I short at the open of the next bar, and I'm in at 1094.75. I place a 2-point stop at 1096.75.



Figure 17.3

2. The market drifts down, and when the 4:13 p.m. bar starts, the S&Ps are being offered at 1093.25. I cover at the market, and I'm out for +1.50.

E-mini S&P—September 2004 Contract, July 28, 2004

1. On July 28, 2004, the market rallies off of 3:30 p.m. eastern, and at 3:52 p.m., I short at 1096.75 (see [Figure 17.4](#)). I place a 2-point stop at 1098.75.



Figure 17.4

2. The market drifts down, gets as low as 1094.75, and then starts drifting back up. At 4:13 p.m., I cover at 1096.50 for a gain of 0.25.

E-mini S&P—September 2004 Contract, July 29, 2004

1. On July 29, 2004, the market sells off from 3:30 p.m. eastern to 3:52 p.m. (see [Figure 17.5](#)). At 3:52 p.m., I buy in using a market order, and I'm filled at 1099.00. I place a stop at 1097.00.
2. The market starts moving higher after 4:00 p.m., and at 4:13 p.m., I sell using a market order. I'm out at 1100.50 for a gain of 2.50.



Figure 17.5

Mini-Sized Dow—September 2004 Contract, July 1, 2004

1. This trade also works well with the minisized Dow. I don't really have a preference for one market over the other for this play. Since the volume in the mini-sized Dow is less than that in the E-mini S&Ps, the movements in this market can sometimes get a little more exaggerated from 4:00 p.m. to 4:15 p.m., which is a positive for this trade setup. On September 8, 2004, the mini-sized Dow sells off into 3:52 p.m., so I take a long and am filled at 10,311 (see [Figure 17.6](#)). I place a 20-point stop at 10,291.

**Figure 17.6**

2. After 4:00 p.m., the markets start to rally on short covering, and at 4:13 p.m., I sell at 10,322 for a gain of 21 points.

Mini-Sized Dow—December 2004 Contract, September 13, 2004

1. On September 13, 2004, the mini-sized Dow sells off at 3:30 p.m. eastern, so at 3:52 p.m. I go long using a market order, and I'm filled at 10,309 (see [Figure 17.7](#)). I place a stop at 10,289. This is a good example because the market stabilizes and starts to drift higher at around 3:40 p.m. Shouldn't I then be shorting this rally into 3:52 p.m.? No! The key element to look for is the predominant move after 3:30 p.m. Remember our friends in the trading room? They see the move off 3:30 p.m., and then they wait, wait, wait to get in. So in this example, they are shorting the dead lows of the move, and they will spend the rest of the session covering their shorts for a loss. My basic rule of thumb on this trade is as follows: if it is not crystal clear, then I just don't take the trade. For example, if the market is dead quiet into the final hour of trading and there isn't any reaction at 3:30 p.m., then I don't have a trade to take. Either this setup is very obvious, or there isn't a setup. There is usually a clear setup four days out of five.



Figure 17.7

2. The short covering continues right into the close, and at 4:13 p.m., I am out at 10,321 for a 12-point gain. Note: this trade could also have been done in the September 2004 contract, which was still active, though it was set to expire on Friday, September 17. Remember, during rollover week, the next front month becomes the most active contract the Thursday of the week before expiration. Expiration during this time was set up for Friday, September 17, so the December contract became the official front month on Thursday, September 9. During rollover week, both contracts will trade actively, but volume starts pouring into the next contract out, and a trader will want to begin trading that next contract on the Thursday of the week before expiration.

Mini-Sized Dow—December 2004 Contract, September 14, 2004

1. On September 14, 2004, the market starts to sell off near the 3:30 p.m. eastern time frame (see [Figure 17.8](#)). Since it is selling off, I'm waiting for my time entry to go long. My time entry at 3:52 p.m. appears, and I go long at the market. I'm filled at 10,318, and I place my 20-point stop at 10,298.



Figure 17.8

2. At 4:13 p.m., I cover at 10,324, for a gain of 6 points. This brings to light the vast differences between scalping and swing trading. A trade like this won't pay the mortgage, but it does allow me to pick up an extra shot of espresso the next time I'm at Star-bucks. Of course, the idea here is that scalp trades are used to generate monthly income, and swing trades are used to create wealth.

Mini-Sized Dow—December 2004 Contract, September 24, 2004

1. On September 24, 2004, the mini-sized Dow starts selling off at 3:30 p.m. eastern (see [Figure 17.9](#)). I wait until 3:52 p.m., at which point I fire off a market order to buy. I'm filled at 10,037, and I place a stop at 10,017.



Figure 17.9

2. The market chops higher, and at 4:13 p.m. I close out my long at 10,044, a gain of 7 points.

Mini-Sized Dow—December 2004 Contract, September 27, 2004

1. On September 27, 2004, the markets start selling off at 3:30 p.m. eastern (see [Figure 17.10](#)). I sit back, imagining all the traders who are now chasing the market, trying to get short. At 3:52 p.m., I place a market order to go long, and I'm filled at 9988. The market continues to sell off, coming close to my 20-point stop at 9968.



Figure 17.10

2. I can now watch as the same traders who chased the market short start to take some heat and start to cover. The market rallies hard, but the main part of this rally just gets me back to even. At 4:13 p.m., I offer my contracts out for sale, and I'm filled at 9990 for +2 points. Well, I won't even be able to do much at Starbucks with this trade, but I of course appreciate that I can still wear flip-flops to the office.

Mini-Sized Dow—December 2004 Contract, October 6, 2004

1. On October 6, 2004, the market starts to sell off at 3:30 p.m. eastern, stabilizes about 10 minutes later, and then starts to edge higher (see [Figure 17.11](#)). Because the initial move off of 3:30 p.m. was a down move, I am looking to do the opposite and go long. At 3:52 p.m., I go long with a market order, and I'm filled at 10,220. I place a 20-point stop at 10,200.

**Figure 17.11**

1. All the traders who chased that 3:30 p.m. short start getting smacked around. Their plight turns into my profit, and at 4:13 p.m., I offer out my contracts. I'm filled at 10,239 for a gain of 19 points. Today I can buy everyone in the office Starbucks with my last trade. No joke. When we walk into Starbucks on these days, the Starbucks employees whisper, "Here comes the ringleader." Where else can five people walk into a coffee shop and get a round of flavored water for \$20? On principle, I had to buy stock in the company. This way I don't feel like I'm getting ripped off; I'm just helping to increase the value of my investment. What's the phrase? Denial ain't just a river in Egypt. (Of course, these days I walk in and buy an herbal tea, which is just wrong on so many levels).

Mini-Sized Dow—December 2004 Contract, October 8, 2004

1. On October 8, 2004, the market rallies from 3:30 p.m. eastern right into 3:52 p.m., at which point I go short at the market, and I'm filled at 10,049 (see [Figure 17.12](#)). I place a stop at 10,069. We come within 8 points of my stop and then start to reverse.



Figure 17.12

2. At 4:13 p.m., I cover my short, and I'm filled at 10,037 for a gain of 12 points.

Mini-Sized Dow—December 2004 Contract, October 13, 2004

1. On October 13, 2004, the market rallies nicely off of 3:30 p.m. eastern, and as we hit 3:52 p.m., I short faster than a Boston Red Sox fan drinking a beer after his team won game 7 against the Yankees after being down 3–0 (see [Figure 17.13](#)). (I had to put that in. On October 18, I was at game 4, six seats behind home plate. The game lasted 14 innings and was the most memorable sports experience of my life.) I'm filled at 9994, and I place a stop at 10,014.



Figure 17.13

2. The market drifts down immediately, and at 4:13 p.m., I cover at 9984 for a gain of 10 points.

Summing Up the 3:52 Play

I like this trade because it is simple and effective, and it clearly goes against the masses who chase this move off the 3:30 p.m. reversal time frame. Like it or not, futures trading is a zero-sum game. For someone to win, someone else has to lose. This trade clearly takes advantage of traders' emotions and cleanly separates the winners from the losers.

Have there been any updates to this chapter since it first came out? This chapter is one that is near and dear to my heart, as this setup really hits on the reality of trading—and that is that to make money trading, you have to take it from someone else. This setup clearly lays out who is getting her money taken away from her and why. There is no use denying this. As traders, we aren't saints. We are just pitting our skills in the arena against those of the other gladiators.

I have had to make a few modifications to this setup since this book was first released. I refer to this now in my daily newsletter videos as the "end-of-day play," and while the theory is still the same, there are a few tweaks that take internals into account. Why the tweaks? In reality, this is the one setup that I should not have had published in book form. It's a low-volume setup, and when too many people dive into a low-volume setup, it dilutes the effectiveness of that setup. The other setups in this book aren't like that. They all occur in markets and time frames that can handle lots of volume. This particular setup, however, takes advantage of low volume to panic traders out of their positions. It's truly a beautiful thing. Even when I find myself on the losing end of a trade like this, I still appreciate its simplicity. One person's gain is another person's pain.

I've set up a series of free videos at www.tradethemarkets.com/352 that shows the updates I've been utilizing for this particular play.

Box plays— On Days When the Stock Market Is Dead in the Water, Look to the Currencies

Measuring the Length of the Move Before It Occurs

The one thing I can say for certain about the markets is that they will never move straight up or straight down forever. A market can definitely rip higher for a long time, but at some point it will have to rest and consolidate, and sometimes it will even come back down to earth and reverse all those spectacular gains. Just as a runner can sprint for only a limited amount of time before his body gives out, a market can move only so far before it needs to pause, take a rest, and build up its energy reserves for the next major move.

Box plays are used to discover situations in which a market is taking a break before getting ready for its next major thrust, whether it is the next spurt higher or the next spurt lower. My favorite markets in which to use this play are the currency markets. These plays work well on both the currency futures and the cash forex markets.

The most popular currency to trade is the euro. This is not to be confused with the Eurodollar contract that trades on the CME, symbol ED. Eurodollars are U.S. dollars on deposit in commercial banks outside of the United States. Eurodollars are an interest-rate product that portfolio managers can use to hedge short-term interest-rate risk with all kinds of complicated strategies. This is the most liquid contract in the world, but it doesn't move, and I don't trade it. To clarify, I'm talking about the euro/dollar currency cross, which is the actual currency I get in my hands when I go to Europe and exchange my U.S. dollars for euros. On the CME, this is called Euro FX, symbol EC. In the forex markets, it is called the euro/dollar cross, symbol EURUSD.

To review, on the CME and in the forex markets, the euro moves in increments of 1/100 of a cent. On the CME, this move is called a *tick*, and it is worth \$12.50 per contract, making a full 1-cent move worth \$1,250 per contract. In the forex markets, this move is called a *pip* (price interest point), and it is worth \$10, making a full 1-cent move worth \$1,000 per contract. There are also a mini-forex and a micro-futures contract available, in which each pip is worth \$1, and a full 1-cent move here would be worth \$125. It is important to keep in mind, however, that there are many other trading opportunities out there in the currency world besides the euro. Often the other currency pairs move and trend better for the simple reason that there are not a lot of retail traders jumping into and out of these other markets. Trades in the euro make up only about 10 percent of my currency trading.

There are arguments on both sides concerning which market is better for currencies—futures or the cash forex markets. With the futures, the spreads are a little tighter, and the commission is the same as trading regular futures contracts, but there are no guaranteed fills, and slippage can be a real issue. With forex, the spreads are a little wider, fills are guaranteed in all but extreme market conditions, and the advertising says there aren't any commissions to pay. Really? This works out as follows: if a trader buys one contract on the CME, she will pay roughly \$5 in commission plus the \$12.50 spread, for a total outlay of \$17.50. In forex, a trader will pay a 3-pip spread at \$30 and no commission. The difference between the two in this case is \$12.50, meaning that you can save \$12.50 per contact by trading futures. This does add up. I am a redundancy freak, so I am set up to trade both. If for some reason I have a problem with the futures contract, then I can hedge my position in the forex market. In general, however, I like to keep my stock index futures trades separate from my currency trades. By having separate accounts, I can easily measure my performance in trading these various markets. One area where I utilize the forex cash market is in the exotic crosses, such as the EURJPY, GBPJPY, and so on. All of these currencies trade very technically, and the more charts that a trader has available to watch, the more opportunities that will set up. Overall, I continue to favor the futures markets for trading futures, as it is a regulated entity. However, being able to trade the exotic crosses as well as trade in various position sizes (micos, minis) with liquidity is a nice feature of the cash market.

Okay, back to the box play. I'm looking for a period of horizontal consolidation with at least two tests of the highs and two tests of the lows. Once I get these two tests, then I'm looking to buy a breakout of the box or sell a breakdown of the box. My target on these trades is the width of the box. These plays can be done on all time frames. An individual who is primarily a day trader can execute this setup utilizing 1-, 2-, 3-, 5-, and even 15-minute charts. An individual who also likes to swing trade can look for these setups on the 60-minute, 120-minute, 240-minute, and daily charts. I trade these as both swing and intraday plays, with each time frame being independent of the other time frames. This means that I could have a 60-minute box play going on with one set of parameters, and a 5-minute box play going on with a totally different set of parameters. Also, since the forex markets actively trade 24 hours, these box plays can be set up at any time. It is important to remember that there are multiple major openings each day. Tokyo, London, Australia, New York—and other markets—all open around 8:00 a.m. in their local time. There isn't a bell or anything that rings. Traders waltz into their offices, and when they get to their desks, they start placing orders for their clients. Because of this, these consolidation patterns tend to break quickly, and once they do, they tend to trend really well.

I like to try to get some sleep each night, but on those nights when I get shafted by the wait staff (that is, I order decaf coffee after dinner, but they give me caffeinated, so I end up lying in bed staring at the ceiling), I can at least get up and check whether a box play is forming overnight. Although I will look for box plays throughout the trading day, I also like to scan through the charts before I go to bed. If there are any box plays setting up, I will place my orders, hit the sack, and see how my trades worked out in the morning. This works out great—my friends joke with me because I can't sleep very well unless I have a position on.

Trading Rules for Buys (Sells Are Reversed)

Box plays are momentum plays. I will buy a breakout and short a breakdown.

1. I like to set up a simple bar chart on the time frame I want to play. I will search through various time frames to see where box plays are currently setting up. For this example, I use a 15-minute chart.
2. As the market action progresses, I take a horizontal line and start marking highs and lows. I usually have to adjust this horizontal line a few times as the market

action develops. Once I get two tests of one of the lines, I have a potential box play developing.

3. At this point, I am watching to see if I get another test on the opposite side of the box. Let's assume in this example that I do, and that I now have two tests of the highs and two tests of the lows. The width of the box is 20 ticks. Now, a trader isn't going to know that a box is in place until the prices hold the fourth test and move back into the center of the box. Once prices have moved back up into the box by about 25 percent, my box is complete. For example, if the width of the box is 20 ticks, then I would want to see prices move back into the box by at least 5 pips after the fourth price test.
4. Now that I have my box, I place two orders. I place a buy stop order one tick above the high end of the box, and I place a sell stop order one tick below the low end of the box. Whichever way the market breaks, I am sitting there with my order waiting to get filled.
5. My buy stop is hit. For my stop, I just leave my sell stop in place, as this now becomes my stop loss order on this trade. This represents a risk/reward ratio of a little over 1:1.
6. I stay in my play until my stop or my target is hit. I do not trail stops.

Euro FX—December 2004 Contract, October 5, 2004

1. This is a 15-minute chart of the euro currency futures contract that trades on the CME (see [Figure 18.1](#)). On October 5, 2004, there is a high point marked at 1.2319. I draw a horizontal line over this level to see if this will hold and become the top of a new box.



Figure 18.1

2. A few hours later, the markets make a low and bounce, and this is where I draw the horizontal line for the bottom of the channel. Now that I have my first high and low, I need secondary tests of both these levels in order to have a box.
3. About five hours later, a test of the upper end of the range occurs.

4. And about two hours after that, another downward test occurs. I now have a box, and I can set up my orders. I place a buy stop order one tick above the high of the box. The high of the box is 1.2319, so I place my order at 1.2320. The low end of the box is at 1.2306, so I place a sell stop order at 1.2305. It is important to note that boxes do not always set up in a “picture perfect” way. In this chart, there is a wayward tick at point 4 that pushes through the horizontal line. I’m more concerned about the two levels that were tested, which is why I keep the line of the first test at point 2. The basic rule of thumb for boxes is this: if you have to sit back and wonder whether there really is a box on the chart, then there isn’t a box on the chart. Once boxes form, they are very obvious. It is not critical that you include the wayward ticks in your box if they are only a few ticks away. This is a trade in which a few ticks usually won’t make or break the trade.

5. At point 5, my sell stop is hit, and I’m now short at 1.2305. My target is the width of the box. Since the width of the box is 13 ticks, I subtract 0.0013 from 1.2305, and I get 1.2292. I place a limit buy at this level to cover my position. I leave my original buy stop in at 1.2320, as this will be my stop. Note that even though I am getting into the trade a little “outside the box,” I still use the exact width of the box as my target.

6. My target is hit at 1.2292, and I’m out for a gain of 13 ticks, or a gain of \$162.50 per contract.

Euro FX—December 2004 Contract, September 27, 2004

1. This is an example of another box play on the CME euro currency futures contract, although this is on a 60-minute chart (see [Figure 18.2](#)). This box takes a period of two days to develop, over September 27 and 28, 2004. At point 1, a high is established at 1.2305, and I draw a horizontal line. Two bars later, the market pushes higher to 1.2310, and I move my horizontal line up to this level (see [Figure 18.3](#)).



Figure 18.2

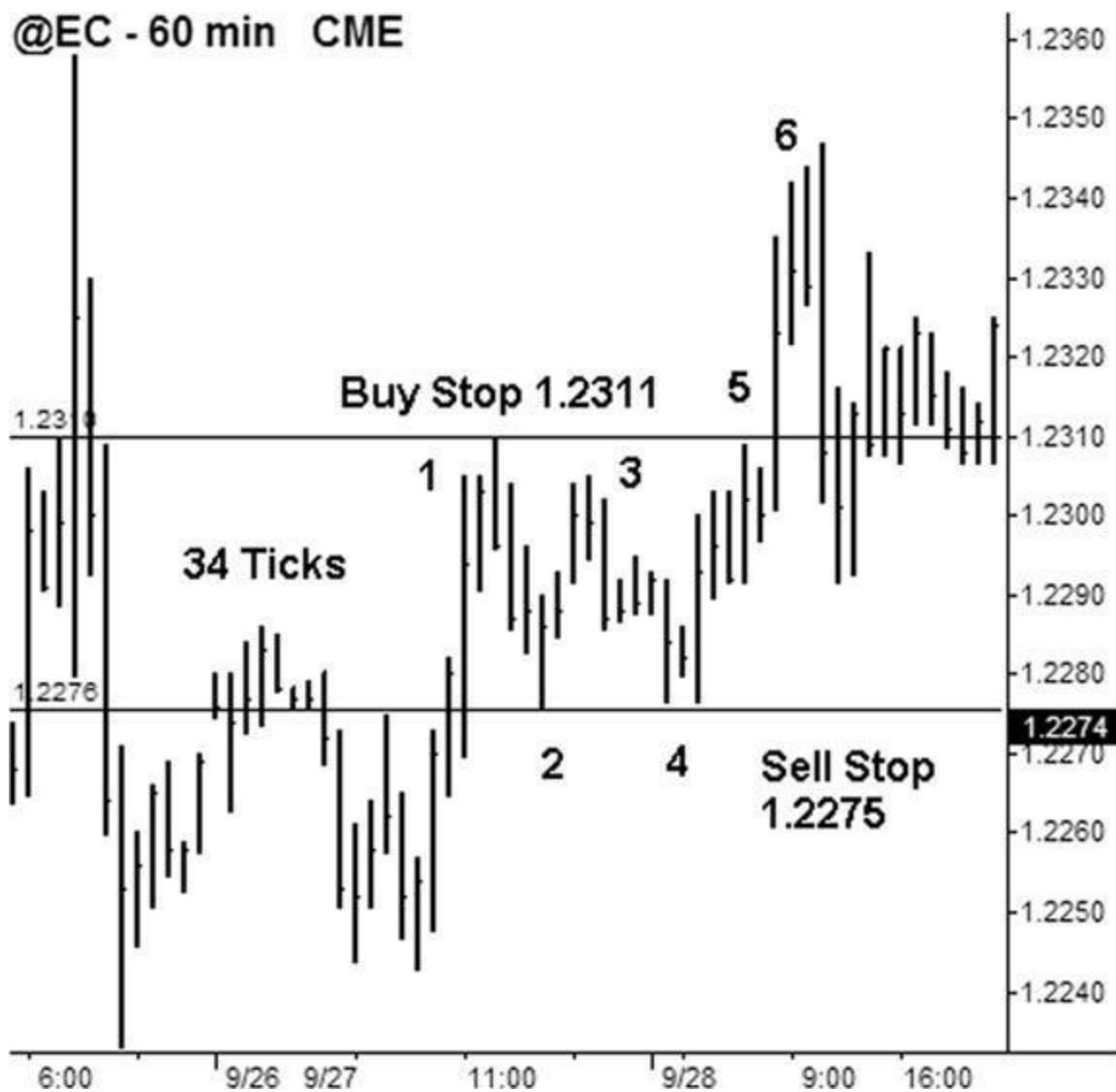


Figure 18.3

2. The market sells off for six hours and bottoms out. I draw a line at this point, 1.2276, and I have a potential bottom to my box. I now need another test of the highs and another test of the lows.
3. The euro rallies for four hours and tests the upper end of the box. It makes a high of 1.2305 before turning back and heading lower.
4. Five hours later, there is another test of the lows, at 1.2276, and we now have a box. Let's look at [Figure 18.3](#) to see where I placed my orders.

Euro FX—December 2004 Contract, September 27, 2004 (Continued)

1. As prices continue to fluctuate, I move my horizontal line up to 1.2310, which is the new top of the box. Could I have left this at 1.2305? Yes. Remember, when it comes to wayward ticks that are a few ticks away, it generally does not have any impact on the trade. I place a buy stop order 1 tick above this level at 1.2311 at point 5. I also place a sell stop order 1 tick below the low of the box, at 1.2275. I note that this box is 34 ticks wide, so my target will be 34 ticks, whether I'm taken into the market long or short. Later, it turns out that my buy stop is hit. I place a limit sell order for my target 34 ticks above my entry, which is 1.2345. My stop is my original sell stop order at 1.2275.
2. My target is hit, and I'm out for 34 ticks, a gain of \$425 per contract. If you aren't using OCO (order cancels order) orders, be sure to remember to cancel your open sell stop order at 1.2275. If you don't, you will be leaving a live order in the market, and if this level is hit, you will get filled with an unwanted trade. Leaving an open order in the markets is like leaving your food out overnight when you're camping near bears. Sure, nothing may happen, but there is also a decent chance that disaster will strike.

Forex Markets—EURUSD, October 15, 2004

1. This is a 15-minute chart of the euro currency on the forex market (see [Figure 18.4](#)). The reason it says "EURUSD" is that this is the indication that this is the euro as it is trading in relation to the U.S. dollar, as opposed to the euro as it is trading against the pound, the yen, or some other currency. By now this drill should be

familiar. We get two tests of the highs and two tests of the lows, and we get our box via the levels marked 1, 2, 3, and 4 in [Figure 14.4](#). I adjust my lines so that the high of the box and the low of the box are represented, and I place my orders. I have a buy stop in at 1.2402 and a sell stop at 1.2375.



Figure 18.4

2. This box stays in place for a long time. It's a relatively tight box at 24 pips. Typically, the longer the box is in place, the more energy it is building up, and the more forceful the move will be when it eventually breaks.
3. At 7:30 a.m. eastern, the market breaks the box and hits the buy stop, labeled point 5. I'm filled, and the target is hit shortly thereafter, for a gain of 24 pips, or \$240 per contract. This particular move keeps right on going. Some traders I work with will take half their position off once the initial target is hit, and then trail the other half. This all comes back to formulating a business plan that best fits a trader's personality—something that I talk about in great detail at the end of the book. For me, the box play is a high-probability play in and of itself, and I stick with the original stops I have laid out in this chapter. However, I will scale out of multiple-lot positions when they are going my way, and I'll show an example of that at the end of this chapter.

Forex Markets—EURUSD, May through June, 2004

1. This is a daily chart of the euro on the forex markets (see [Figure 18.5](#)). This is an example of a swing trade and a bigger example of the “power of the box.” On May 20 and May 21, 2004, we form the lows at 1.1620.

EURUSD - Daily FOREX



Figure 18.5

2. On May 27, the market loses steam from its vault higher and sells off, forming the highs of the box 312 pips later (a little over 3 cents).
3. On June 4 and June 5, the market retests the lows of the box.
4. And on June 16, there is a retest of the highs of the box. Once this happens, I place my orders. I use a buy stop at 1.1933 and a sell stop at 1.1619.
5. My sell stop is hit at 1.1619 at point 5. Since the width of the box is 312 pips, I calculate my target accordingly, and I place a buy limit order at 1.1307. My stop is my original buy stop order at 1.1933.
6. The market moves down nicely and then shoots back higher. Anyone who was using a trailing stop for this trade would have been stopped out for a small gain. The reason I keep my stop wider, and the reason I do not trail it, is that I know that this is a high-probability play, and I want to give this setup “room to move” in order to give it a chance to work out. My target is hit nearly two weeks later for a gain of 312 pips, just over three large in trader speak, or \$3,120 per contract. Next.

Forex Markets—EURUSD, August 3, 2004

1. On August 3, 2004, the euro forms a box on the 15-minute charts (see [Figure 18.6](#)). The first high is marked here at point 1.

EURUSD - 15 min FOREX



Figure 18.6

2. A few hours later, we get a potential low for the box, and I draw a horizontal line at the lows here.
3. The market bounces, and we get a retest of the highs.
4. Then the euro sells off nicely, and we get a retest of the lows. Since this low pushed a little lower than the low at point 2, I go ahead and move my horizontal line down to reflect this low. Once I have these lines set up, I place my orders. I use a buy stop at 1.2062 (1 pip above the highs) and a sell stop at 1.2042 (1 pip below the lows).
5. My sell stop is hit at 1.2042. Since the width of the box is 18 pips, I calculate my target, and I place a limit buy order at 1.2024. My stop is my original buy stop order at 1.2062.
6. My target is hit, and I'm out for a gain of 18 pips, or \$180 per contract. I don't have to remember to cancel my open buy stop because my execution software does it for me automatically.

Forex Markets—EURUSD, August 19, 2004

1. On this 15-minute chart of the EURUSD, we get a first test of the highs at 1.2347 (see [Figure 18.7](#)). Once the market sells off from this level, I draw a horizontal line across the high.



Figure 18.7

2. The market sells off and pushes as low as 1.2323. I start off drawing a line at this level. Later I move this line back up to 1.2331 because the rest of the price support tests are much closer to this level than the “wayward tick.”
3. Here we get another test near the highs.
4. And here we get another test near the lows. Once the four price tests are complete, I place a buy stop order at 1.2348 and a sell stop order at 1.2330. Although this box isn’t perfect, there is no doubt that we have a nice horizontal channel in place.
5. My buy stop order is hit. Since the width of the box is 16 pips, I place a sell limit order for my target at 1.2364. My sell stop remains in place as my stop on this play.
6. My target is hit, and I’m out for 16 pips, a gain of \$160 per contract. as you can see, I could have also used the low of the “wayward tick” in my calculations, and this would have been a more profitable trade. The bottom line is that when it comes down to a few ticks, where you place your horizontal line is not a big deal, as long as it is crystal clear that a box is in place. This applies to nearly all setups. If you have a setup, and you miss the trade because you were trying to get the perfect entry, then you are the chump that just got played by the market. Good setups take time to develop and shouldn’t be squandered. Generally, traders who miss their “perfect entry” usually end up chasing the markets as prices run away from them. Afraid of missing the move, they frantically jump on board. Unfortunately, this action shifts them into the group of traders who just bought the top or sold the bottom. What was a great setup suddenly turns into a losing trade. As with most of the scenarios in this book, I’m speaking directly from the painful and frustrating experiences all newer traders have. This particular scenario is where the following often-quoted trader saying comes into play: *don’t be a dick for a tick*. I keep this somewhat crude phrase handy so that when I see a setup, I just get into the trade and don’t try to finesse my entry. Entries are a dime a dozen. It’s the exits that make you money.

1. On this 120-minute chart of AUDUSD, we get a first test of the highs at 0.7638 (see [Figure 18.8](#)). Once the market sells off from this level, I draw a horizontal line across the high.

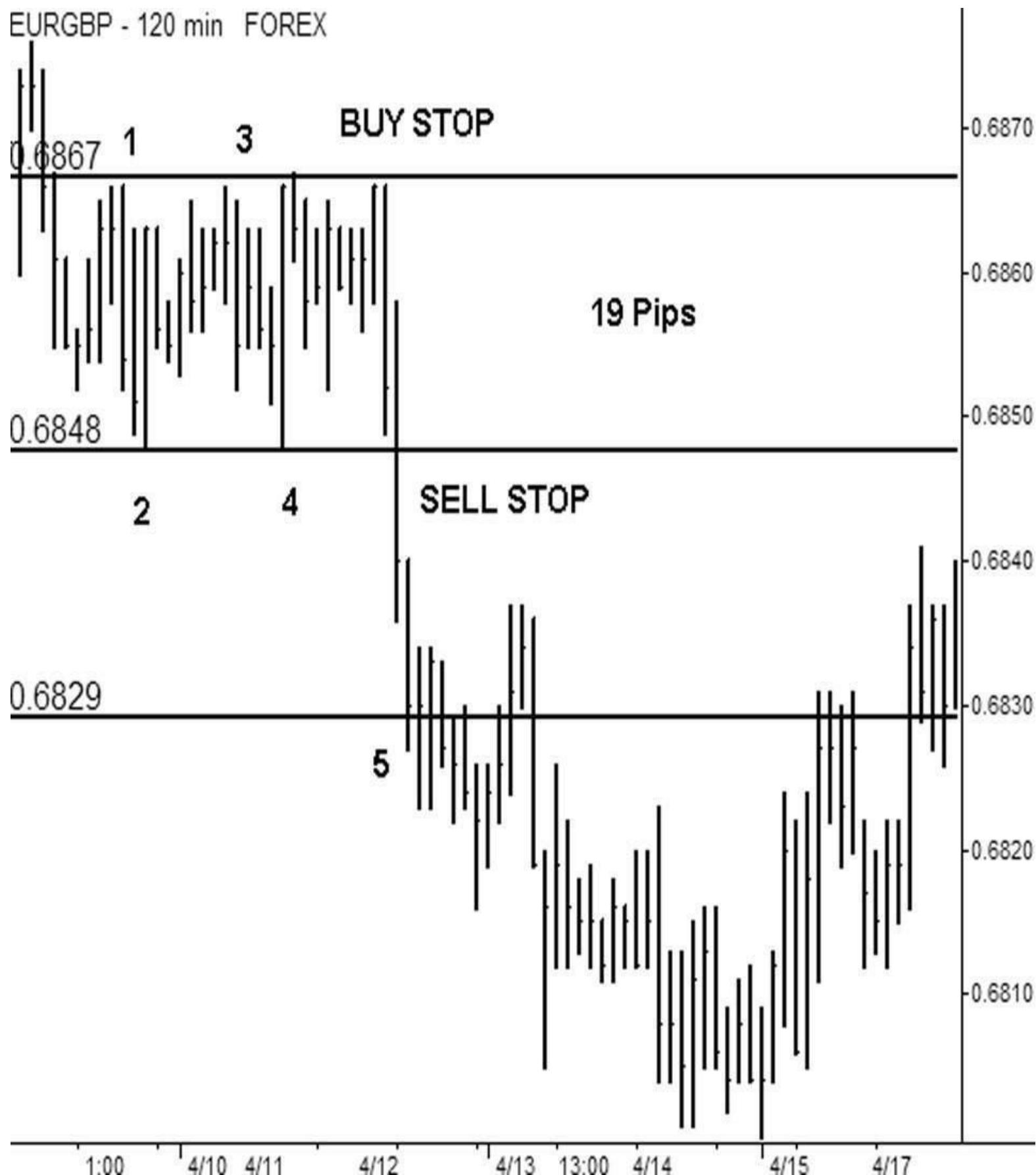


Figure 18.8

2. The market sells off and pushes as low as 0.7584. I start off drawing a line at this level. The market bounces and retests this level again before moving higher.
3. At point 3, we get another test of the highs, pushing up a little bit above the previous highs.
4. Once this high is tested, the markets stair-step their way back to the lows at point 4. After the four price tests are complete, and prices rally about 25 percent back into the box (the width of the box is 54 pips, so 25 percent of this is about 14 pips), I place a buy stop order at 0.7639 and a sell stop order at 0.7583. Prices rally almost all the way to the top of the channel before rolling over and heading lower. Finally, on May 30, 2005, my sell stop is hit. It is important to remember that I had to wait patiently for this setup to execute. After I placed my buy and sell stops, I had to wait 44 hours before one of them was hit.
5. After my sell stop is hit, my original buy stop becomes my stop loss on this trade. My target is the width of the box, which is 54 pips away at 0.7530. The markets move quickly down to this level, but don't quite make it. Then they bounce all the way back to my entry, pause, and then reverse back lower, plunging violently into my buy limit order. I'm out for 54 pips, a gain of \$540 per lot being traded. I want to emphasize again how important it is to be patient in trading and waiting for the right setup. This trade took 76 hours to set up. Then, once I placed my orders, it took another 44 hours for one of them to be hit. And after I was filled, it took another 34 hours for my target to get hit. This one trade spanned 154 hours. In trading, patience is a virtue, and impatience triggers devastation.

Forex Markets—EURGBP, April 12, 2005

1. On this 120-minute chart of EURGBP, we get a first test of the highs at 0.6867 (see [Figure 18.9](#)). Once the market sells off from this level, I draw a horizontal line across the high.

**Figure 18.9**

2. The market sells off and prints a low of 0.6848 before bouncing higher. I draw another line beneath this level.
3. Prices firm and rally back up to the highs. Once this level tests and prices roll over, I wait to see if a retest of the lows will hold.

4. And we get another test near the lows. Once the four price tests are complete, I wait to see if the markets can rally at least 25 percent back into the box. Since the width of the box is 19 pips, 25 percent would be about 5 pips. Once this happens, I place a buy stop order at 0.6868 and a sell stop order at 0.6847. This box is pretty clean.
5. Prices come back up to retest the highs, sell off to the middle of the box, come back up yet again to test the highs, and then finally roll over and go through the lows, filling my sell stop order. My buy stop order stays in place as my stop. EURGBP sells off quickly, and my target is hit on the second bar at point 5. (Of course, quickly is a relative term, as these are 120-minute bars.) This currency pair is worth around \$18 a pip, so the 19-pip target yields a gain of \$342 per lot.

Forex Markets—USDCHF, June 10, 2005

1. On this 60-minute chart of USDCHF, there is an initial test of the highs at 1.2577 (see [Figure 18.10](#)). Prices quickly fall from this level, and I draw a horizontal line across the high.

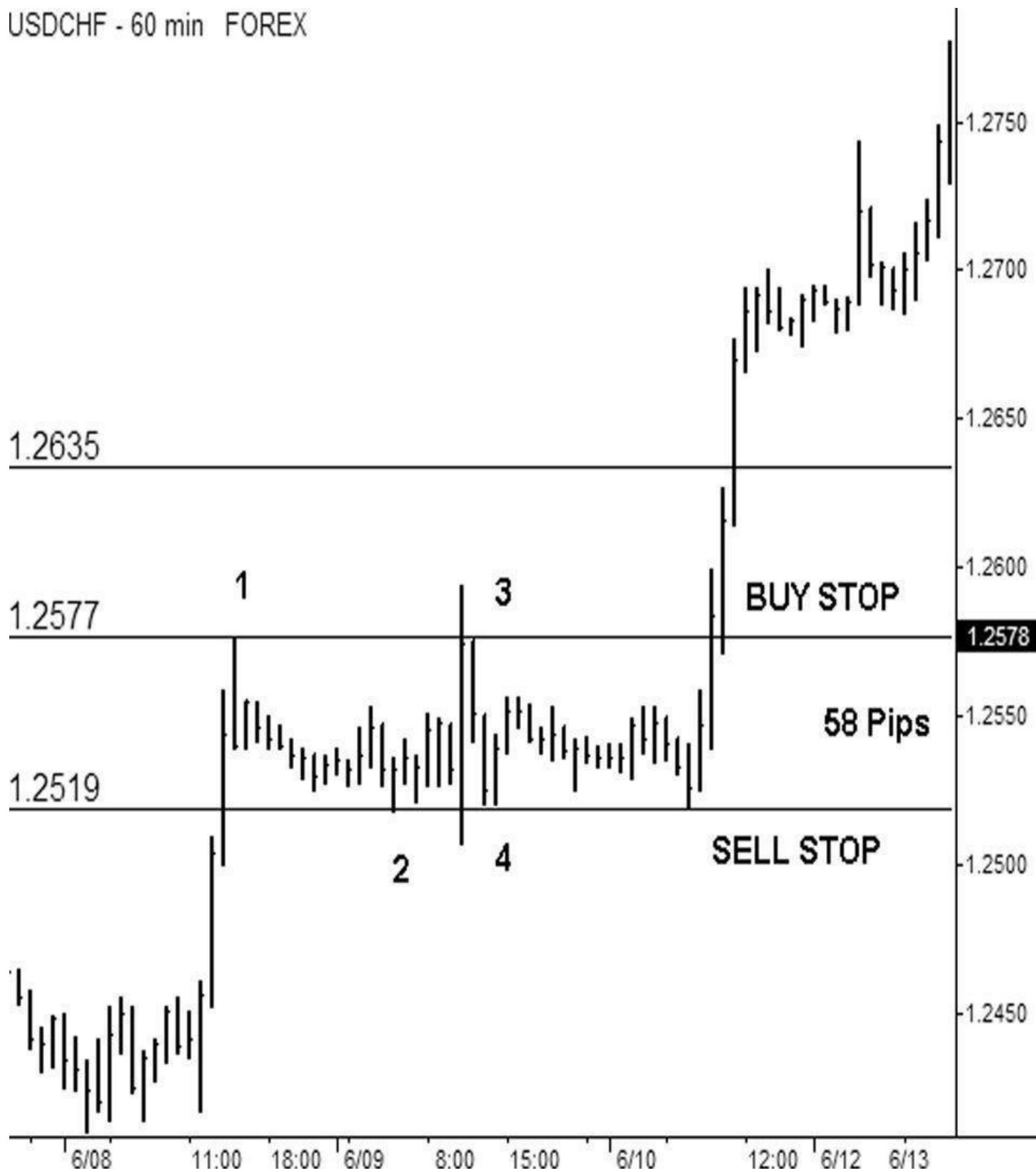


Figure 18.10

2. USDCHF sells off to 1.2519 at point 2. Once prices start to rally off this level, I place a horizontal line across the lows.
3. Prices shoot up and retest the highs at point 3.

4. This is quickly followed by another test of the lows at point 4. Once prices rally about 25 percent back up into the box, I place my orders, with a buy stop at 1.2578 and a sell stop at 1.2518. After retesting the lows yet again, prices firm 20 hours later and bust out through the highs, triggering my buy stop order. My sell stop remains in place as my stop loss on the trade. Prices plow forward, and it doesn't take long for my target to get hit. The gain is good for 58 pips, or roughly \$464 per lot.

Forex Markets—EURJPY, April 7, 2005

1. On this 60-minute chart of EURJPY, we get a first test of the highs at 140.03 (see [Figure 18.11](#)). Once the market sells off from this level, I draw a horizontal line across the high.

140.03

1 3

BUY STOP

139.66

2 4

36 Pips

SELL STOP

139.30

5

9:00 16:00 4/06 6:00 13:00 4/07 10:00 16:58 4/08 7:00

Figure 18.11

2. The market sells off to point 2 at 139.66 and bounces. I draw a line underneath this level.

3. We rally quickly back up to the highs for the third test.
4. Once prices test the highs, they quickly roll over and test the lows, and we now have the fourth test of the box in place. Once prices rally back 25 percent into the box, I place my orders, a buy stop at 140.04 and a sell stop at 139.65.
5. Prices rally to just beneath my buy stop, then roll over and trigger my sell stop. My buy stop stays in place as my stop loss order. Prices consolidate near the lows for about five hours before breaking lower and hitting my target at 139.30, for a gain of 36 pips, or about \$288 per lot.

Forex Markets—GBPJPY, May 16, 2005

1. On this 240-minute chart of GBPJPY, we get a first test of the lows at point 1 at 197.86 (see [Figure 18.12](#)). Once the market rallies off of this level, I draw a horizontal line across the lows.

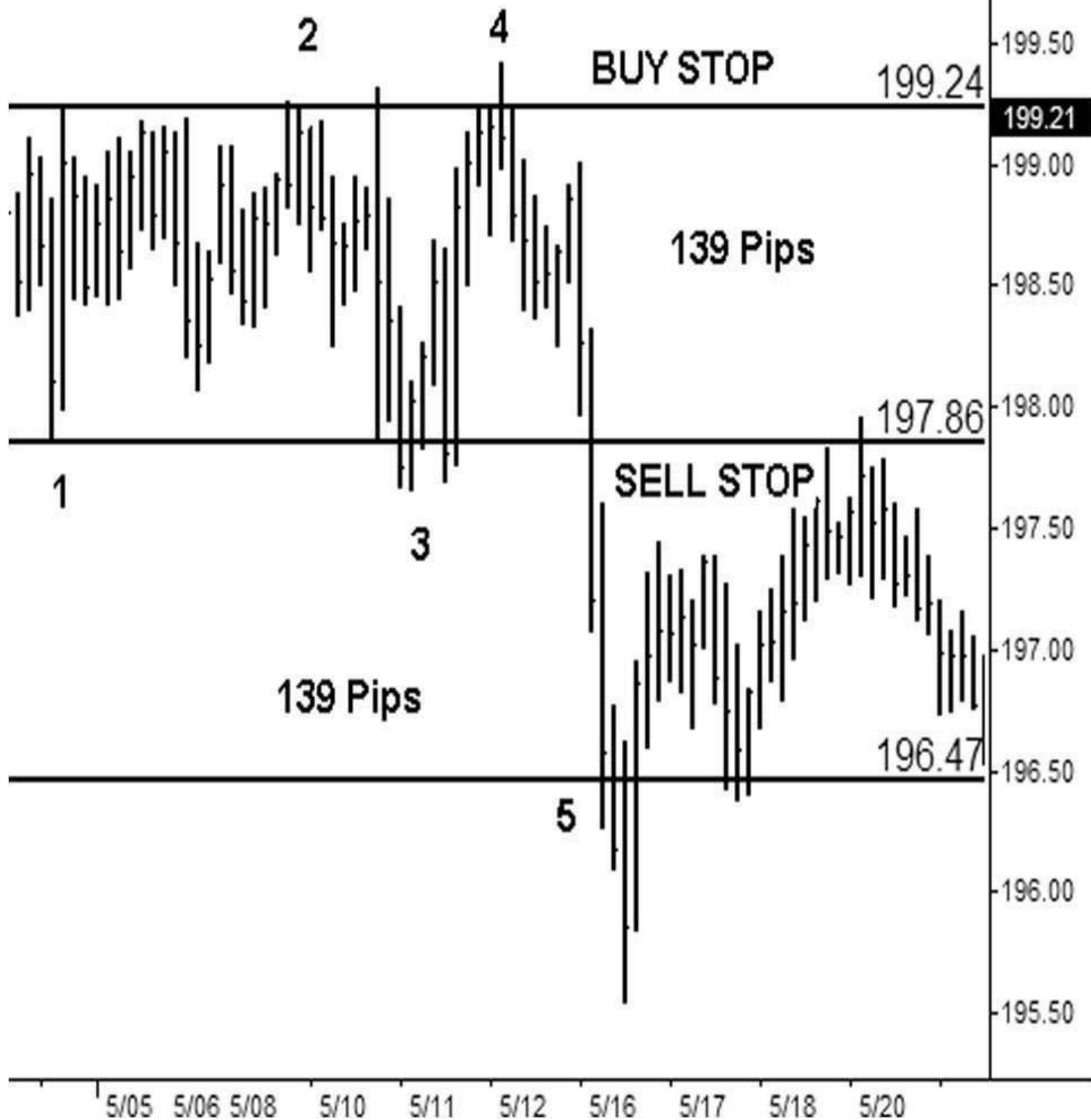


Figure 18.12

2. The market rallies and stays in the upper part of its range for a long time. We test the highs three times before selling off to test the lows again. Even though we test the highs three times, this counts as only test 2 of the box. For this upper part of the range to become an official part of the box, it has to be offset with another

corresponding test of the lows. (For example, three tests of the highs and one test of the lows do not make a box.) I keep my line across the highs at 199.24 and wait to see if we will get another test of the lows.

3. At point 3, the market finally sells off and retests the lows.
4. It doesn't take long for the market to rally back up and test the highs of the box at point 4, and once prices fall back to within 25 percent of the box's range, I set up my buy stop order at 199.25 and my sell stop order at 197.85.
5. Prices continue lower and hit my sell stop order. My buy stop order stays in place, as it is now my stop loss. Prices proceed quickly and without pause down to my target, and I'm out for a gain of 139 pips, or about \$1,112 per contract.

Forex Markets—EURJPY, August 4, 2005

1. This play was particularly fun, as it occurred while I was finishing the rewrites on this chapter, and I was able to capture it live on my execution platform. On this 15-minute chart of EURJPY, we get a first test of the highs at 1.3784 (see [Figure 18.13](#)). Once the market sells off from this level, I draw a horizontal line across the high.

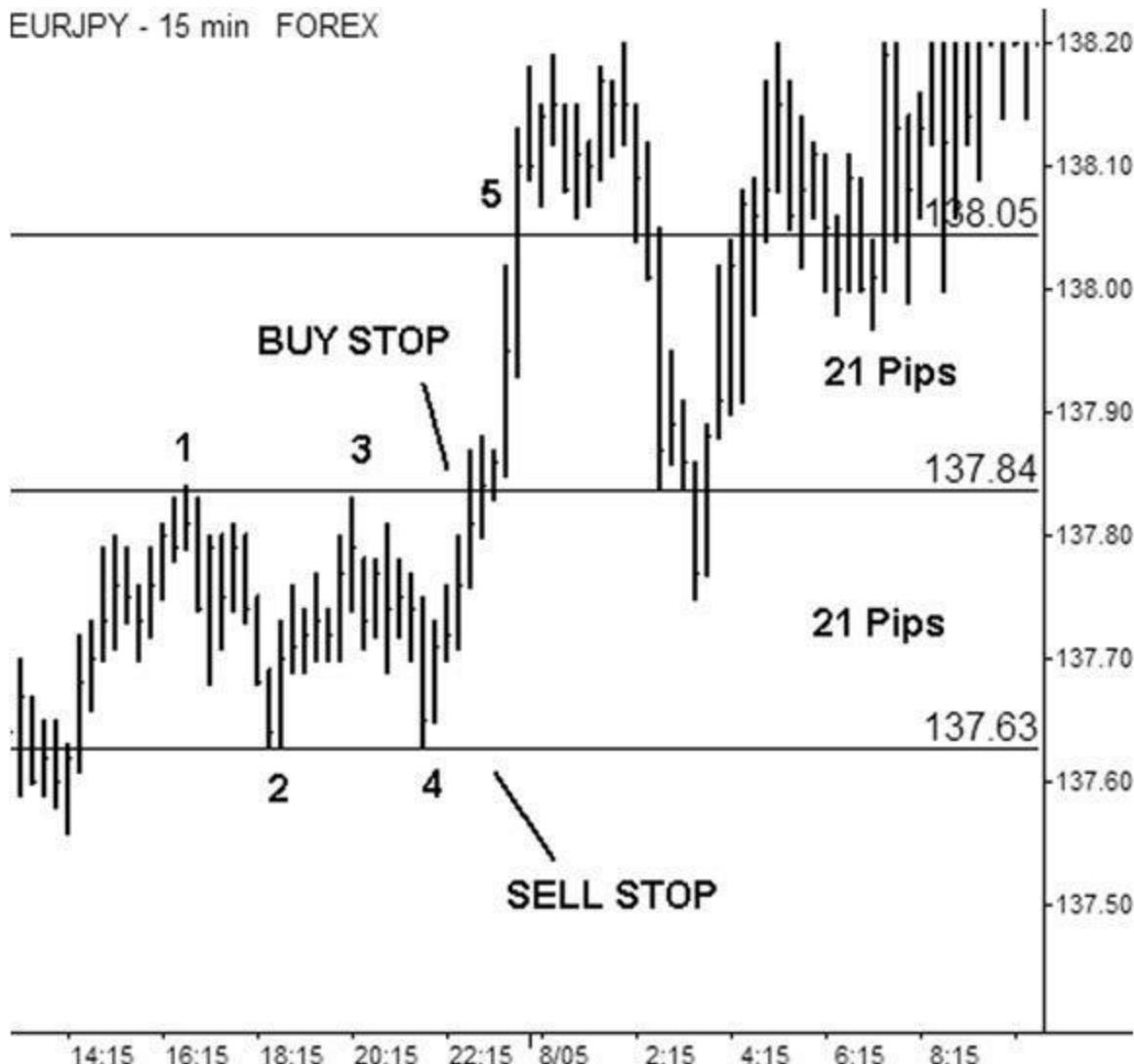


Figure 18.13

2. The market sells off and pushes as low as 137.63. Once prices rally off of this level, I draw a horizontal line across the lows.
3. Here we get another test near the highs at point 3.
4. The markets drift back down and retest the lows. Once prices rally back about 25 percent into the box, I place a buy stop order at 137.85 and a sell stop order at 137.62.
5. The market rallies right off the lows to and through the highs. My buy stop order is triggered, and shortly thereafter my target is hit, for a gain of 21 pips, or \$168.

per contract.

Ringing the Cash Register—Scaling Out of a Position as It Goes Your Way

My style within a strategy is to get into the trade all at once and then scale out as the trade goes my way. My goal is to still have one-third to one-half of my position left if and when the strategy hits my target. This is one big advantage of trading multiple lots. With one lot, I would just stay in the trade from start to finish. With multiple lots, a trader can start peeling off contracts so that if the trade does reverse and gets stopped out, the overall loss will be offset by any gains already booked, thus increasing the trader's risk/reward ratio. On this particular play, my buy stop order was for 75 lots. Once the markets triggered my buy stop, I scaled out in thirds all the way up to my target (see [Figure 18.14](#)). This snapshot of my execution platform shows that I sold 25 lots at 137.93, another 25 lots at 138.05, and the final 25 lots at 138.07, for a total gain on the play of \$14,957.62. Because I literally executed this trade while scrambling to make the deadline for this chapter, it put into perspective how much writing a book really is a labor of love, albeit painful. This is my first book, but I'm guessing that my year of toil in trying to fill hundreds of blank pages with semิuseful material will probably net me about the same amount as this two-hour trade. (I'm sure there is a lesson in there somewhere.)

	EUR/JPY		Currency Pairs				
	138.19/24						
7	Buy GBP	Sell EUR	19	24	Buy EUR		
	Lots		EUR				
	0		0				

Gain | Capital - PRODUCTION

Minimize

Deal Analysis News Logon Reports Commentary Trading Tools

Margin Analysis

Account Balance	\$1,007,833.00
Realised Gain/Loss	\$14,957.62
Unrealised Gain/Loss	\$ 0.00
Margin Balance	\$1,022,790.62
Total Available Position	\$102,279,062
Open Position	\$ 0
Max Deal Available	\$102,279,062

Activity Log

Deal Blotter

Confirmation	Buy/Sell	Currency...	Amount	Deal Rate	USD Value	Dealt On
7546695	Sold	EUR/JPY	-2,500,000	138.0700	-2,500,000	8/4/05 11:34 PM
7546641	Sold	EUR/JPY	-2,500,000	138.0500	-2,500,000	8/4/05 11:33 PM
7546048	Sold	EUR/JPY	-2,500,000	137.9300	-2,500,000	8/4/05 11:15 PM

Figure 18.14

If you wish to drown, do not torture yourself with shallow water.

BULGARIAN PROVERB

Summing Up the Currency Box Play

I always enjoy the act of giving presents and opening them over the holidays. I find that I enjoy that feeling almost as much as discovering a new “box” to open up in the currency markets. With this play, Christmas seems to happen a few times each week instead of just once a year.

In parting, I can't emphasize enough how important it is for traders to find a market that fits their own personality if they hope to be successful. If you find that you are happy only if you are buying breakouts and selling breakdowns, then the currencies are probably your market of choice. Currencies break and trend well, while the E-mini S&Ps tend to suck in traders with false breakouts and breakdowns. In other words, if you are buying breakouts in the S&Ps and getting killed, then give the currencies a try. I particularly like to combine the box play and the squeeze play on the hourly charts for all of the major currencies, especially on the overnight session. I call this the “life is like a box of chocolates” play because when you wake up in the morning, you never know what you are going to get. This particular trade setup has controlled risk and open targets, so it's possible to really catch big moves during the overnight action. I've included examples of this hourly squeeze/box play in the link below.

Visit www.tradethemarkets.com/box for updates and additional examples on the box play.

HOLP and LOHP— Catching Trend Reversals Without Getting Smashed

Buying a Market Just Because It's Cheap or Shorting a Market Just Because It's Expensive Is Dangerous—Unless It's Done Like This

When it comes to the financial markets, the bottom line is that the current action is going to be determined by one thing and one thing only: the price that people are willing to pay right now. A stochastic can be overbought, a MACD (moving average convergence divergence) can be rolling over as a potential short, and moving averages can be violated to the extreme. Whatever the indicator, it doesn't mean that price action is going to reverse. There is a high probability, to be sure, but that doesn't mean that it's going to happen. On the contrary, in these cases of extreme overbought or oversold readings, prices can still keep trending higher or lower for a long, long time. In 1999, overbought stayed overbought for months and months. In 2000 and 2001, oversold stayed oversold almost continuously. During the 2008 financial crisis, some stocks (like Lehman Brothers) got so oversold that they disappeared. Everyone who screamed, "It's a bargain" on the way down learned the meaning of pain many times over.

I hear stories nearly every day from people who bought a stock "because it looked cheap," only to have it continue to crater on a daily basis. Some of these stocks, like EXDS (Exodus Communications, Inc.) and WCOM (WorldCom, Inc.), got real cheap, real fast. Eventually, the people who bought these stocks on the way down either got frustrated and couldn't take the pain anymore, so they sold, or, in many instances, they got out using one of the best tried-and-true sell signals on the planet—the company declared bankruptcy, and the stock went to zero. The opposite is also true, in that I've heard plenty of war stories about traders shorting a stock "because it looked too high." They were soon experiencing shell shock as the stock continued to race higher and destroy their account.

Speaking of shorting, I always find it amusing that brokers talk about how dangerous shorting a stock is, because the potential losses are "infinite." Well, I have yet to see a stock rise to infinity, but I've seen plenty of stocks go to zero. Never mind the fact that brokers and trading firms make a huge living shorting stock to the public.

In trading, it is never a good idea to try to catch a falling knife (buy a steep sell-off) or step in front of a freight train (short a frantic rally) just because prices "look too low" or "look too high." How, then, does a trader catch a reversal without risking life and limb?

That is where this setup comes into play. This method for catching market tops and bottoms is based on the one solitary thing that matters most in trading: price.

Trading Rules for Sells (Buys Are Reversed)

This is a reversal play. I will short tops and buy bottoms only upon confirmation of this setup. I generally use this for swing plays, but it is valid on all time frames, including smaller time frames for intraday plays. HOLP and LOHP are acronyms for "high of the low period" and "low of the high period." We pronounce them "HOPE" and "LOPE."

1. Identify a trending market, or an individual stock, that is ideally making new 20-day (or period) highs. This is a rule of thumb; markets that are making only 17- or 18-day (or period) highs are also fine. The point is that you want to see a definitive trend and be ready to step in when that trend reverses.
2. Identify the high bar in the uptrend. This is typically the current bar, but it could be a few bars back. By "high bar," I mean the bar with the highest intraday price prints in the entire move higher.
3. Once I identify the high bar, I will then go short once price action closes below the low of this high bar. (Say that really fast three times.)
4. The initial stop is the high of the high bar. If I am still in the trade on the third day, or period, I will start to use a two-bar trailing stop. I will exit this trade when the current bar closes above the price level represented by the two-bar trailing stop.
5. Because of retracement price patterns while in a play, the two-bar trailing stop will sometimes have to be held on the current "stop bar" until the trend resumes. Once the trend resumes, the two-bar trailing stop can also be resumed. This doesn't happen very often, and I realize that it makes no sense while reading this text. Don't worry, it is not subject to interpretation, and it will become clear when you see a specific example. I will focus specifically on this in [Figure 19.13](#).

This setup works in all markets, in all time frames. I usually use this play on individual stocks and their corresponding stock options, stock index futures, and the forex currencies on the 60-minute and daily charts.

E-mini S&P—December 2004 Contract, October 7, 2004

1. [Figure 19.1](#) is an example of the entry method. This particular chart is a daily representation of the E-mini S&P futures. Once I've gone over this entry method, we will jump into the exit strategy. It is important to understand how to enter this trade. The white bar labeled point 1 represents the "high bar" in the uptrend. The low of this high bar is 1133.50. The high of this bar represents the highest prices seen in at least 20 days. In fact, the last time the S&Ps were at this price level was back on July 1, 2004.



Figure 19.1

2. Since the black bar labeled point 2 broke the low of the high day, we enter this position at the close of this day. My entry is 1131.50. This trade does not have an exit at the time this snapshot was taken because an exit signal has not fired off. I usually get a few questions here when I discuss this trade. The first is, "Can I enter the trade intraday as soon as it breaks the low of the high day instead of waiting for the close?" My answer to this is that you can, but I really want to see a close to show that the market means business. Often I would take this trade intraday, only to have it close back up above the low of the high day, which invalidates the trade. By waiting for the close, you are getting extra insurance that this reversal is valid. The other question I get usually has to do with entry points and knowing which bar is actually going to be the high bar. Of course, you don't know which bar is going to be the high bar that kicks off the reversal until the price break actually occurs. Is it going to be this bar? Or are we going to get another, higher bar first? All you can do is continue to watch the new bars develop. When I identify a high bar, I keep an eye out to see whether price action closes below the low of that high bar. If the next bar goes even higher, then this new, higher bar becomes the high bar. In essence, I'm trailing an imaginary sell stop order. As prices advance higher, so will my entry until we finally get a break of the low of the high bar. Although this is a simple concept, I have found that it takes a few examples for people who are new to this setup to get the hang of it. That said, let's look at some more examples.

E-mini S&P—December 2004 Contract, October 7, 2004

1. This daily chart of the E-mini S&Ps ([Figure 19.2](#)) is the same as [Figure 19.1](#). However, this chart focuses on the initial reversal trade off the lows. The bar labeled point 1 takes place at the end of the September, marking the lows of this particular move, which aren't quite 20-day lows, but they are 18-day lows, which is fine. I want to buy a close above the high of the low day. The high on this day registered at 1112.50.

**Figure 19.2**

2. The next day, we close above this bar, and I enter this trade right after the 4:00 p.m. eastern close of the regular cash session. I am filled at 1115.25. My initial stop is the lows of bar 1 just above 1100.00.
3. I'm in this trade for seven days. In the bar labeled 3, the S&Ps close below the low of the previous two bars. Once this happens, I exit right after 4:00 p.m. and get out at 1132.25, for a gain of 17.00 points, or \$850 per contract. Note that the exit of this long also coincides with the initialization of the new short position in [Figure 19.1](#). This doesn't always happen, but it does once in a while.

Mini-Sized Dow—September 2004 Contract, August 6, 2004

1. On August 6, 2004, the mini-sized Dow establishes a new low within its current trend, and then starts to rally (see [Figure 19.3](#)). This bar marks the low day, so I'm looking to buy a break of the high of this low day.

**Figure 19.3**

2. It takes seven trading days to close above the high of the low day. When this finally happens on August 17, I get in after the close, and my entry is 9974. My initial stop is the low of the bar that triggered this trade, near 9770. Once I'm in the trade for two days, I start using a two-bar trailing stop.
3. On August 26, this bar closes below the close of the two-bar trailing stop. I'm out at 10,121 for a gain of 147 points, or \$735 per contract.

Mini-Sized Dow—September 2004 Contract, June 23, 2004

1. On June 23, 2004, the mini-sized Dow futures put in a nice high bar (see [Figure 19.4](#)). The low of this high day is 10,343.



Figure 19.4

2. On June 28, the YM closes below the low of the high day at point 2. I enter this position short at the close of this day at 10,329. I start off with a stop at the highs of the high day, and once I'm in the trade for two days, I start to use a two-bar trailing stop. Remember, I'm looking for a *close* above these levels as a signal to exit the trade.
3. On July 27, I exit at the close of bar 3 at 10,061 for a gain of 268 points, or \$1,340 per contract.

E-mini Nasdaq—September 2004 Contract, August 13, 2004

1. On August 13, 2004, the high of the low day on the E-mini Nasdaq is 1317.50 (see [Figure 19.5](#)).



Figure 19.5

2. On August 16, since the bar labeled 2 broke the high of the low day, I enter this position at the close of this day at 1322.00.
3. On August 30, I exit at the close of bar 3 at 1367.00, for a gain of 45 points, or \$900 per contract.

E-mini Nasdaq—September 2004 Contract, June 30, 2004

1. On June 30, 2004, the low of the high day is 1506.00 on the daily NQ chart (see [Figure 19.6](#)).
2. On July 1, since the bar labeled 2 broke the low of the high day, we enter this position at the close of this day at 1494.00.
3. As the NQ sells off, we start using the two-bar trailing stop. On July 29, prices close above our trailing stop, and we exit at the close of the bar labeled point 3 at 1401.50, for a gain of 92.50 points, or \$1,850 per contract.



Figure 19.6

30-Year Bond—September 2004 Contract, July 28, 2004

1. On July 28, 2004, the high of the low day is 106 $\frac{26}{32}$ for the 30-year bonds, which can be seen on the bar labeled point 1 (see [Figure 19.7](#)).



Figure 19.7

2. On July 29, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 106 $\frac{31}{32}$.
3. We start trailing our stop, and on August 23, we exit at the close of the bar labeled point 3 at 110 $\frac{16}{32}$. Bonds are worth \$1000.00 for a full point move. This move of 3 $\frac{17}{32}$ is worth \$3,531.25 per contract.

Forex Markets—EURUSD, December 31, 2004

1. On December 31, 2004, the EURUSD breaks and closes below the low of the high day (see [Figure 19.8](#)). The entry on the short side is 1.3553.
2. The market continues to drop lower for five days in a row before bottoming out. On January 12, the stop is triggered, and we are out at 1.3254 for a gain of 299 pips, or \$2,990 per lot.
3. On February 4, the EURUSD makes new nearly 20-day lows and is now a candidate for this setup. The entry signal fires off on February 9 with a close above the high of the low day. The entry is taken at 1.2803.
4. The markets work higher until the two-bar trailing stop is hit on March 1 at 1.3186, for a gain of 383 pips, or \$3,830 per lot being traded.

GOOG (Google Inc.)—September 2, 2004

1. On September 2, 2004, the high of the low day is 102.37 on the bar labeled point 1 on GOOG (see [Figure 19.9](#)). The low here isn't a 20-day low, but GOOG had just gone public on August 19, 2004, 11 days prior.



Figure 19.8

**Figure 19.9**

2. On September 10, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 105.33.
3. We start trailing the stop, and on October 12, we exit at the close of bar 3 at 136.55, for a gain of just over 30 points.

TZOO (Travelzoo Inc.)—August 30, 2004

1. On August 30, 2004, the high of the low day is 42.37 on the bar labeled 1 on TZOO (see [Figure 19.10](#)).
2. On August 31, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 45.00.
3. On September 28, we exit at the close of bar 3 at 56.42. This is one of those trades where, in hindsight, it would have been “genius” to exit at the intraday break of the two-bar trailing stop. That exit would have been around \$70. However, I have done this play both ways, and I’ve found that the intraday stop will frequently get a trader out of a position that still has a lot of room to move. In any event we still netted nearly 12 points on this trade.



Figure 19.10

EXM (Excel Maritime Carriers Ltd.)—September 2, 2004

1. On September 2, 2004, the high of the low day is 23.50 at the bar labeled 1 on EXM (see [Figure 19.11](#)).



Figure 19.11

2. On September 3, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 24.21.
3. On September 15, our trailing stop is hit, and we exit at the close of bar 3 at 38.00, for a gain of nearly 14 points. On this play, we got stopped out just before the stock rocketed higher another 30 points in just three trading days. This goes back to being a “genius in hindsight.”

Forex Markets—EURGBP, June 16, 2005

1. I like this particular example because it demonstrates how important it is for a trader to stick to his setups. On June 16, the EURGBP makes new lows, and the next day prices reverse and close above the high of this low day, firing off a long signal (see [Figure 19.12](#)).
2. I go long, and a group of other traders I work with also goes long. Our entry was 0.6709.
3. EURGBP rolls over and closes below our two-bar trailing stop. Our exit is 0.6632, at point 3 on June 23, for a loss of 77 pips. This bar also marks a fresh low and becomes the new signal bar in this setup.
4. On June 29, at point 4, we get another close above the high of the low day, and I take the entry at 0.6680. Other forex traders I work with pass on this setup, having felt the sting of the first loss.
5. EURGBP rallies nicely, and the two-bar trailing stop gets hit on July 13 at point 5, at 0.6851, for a gain of 171 pips. The point of this example is to show the importance of not filtering out a particular setup because of how you feel about it. If the previous setup was a loss, many newer traders will hold off on taking the next setup because of the feelings associated with the last time they took the play. In reality, our feelings have nothing to do with how the next trade will work out. We never really know what the market is going to do next, but we can plod along, follow our setups, and try to make a living.



Figure 19.12

1. In this example, I will also focus on rule 5, which talked about holding a stop in place until the trend resumes (see [Figure 19.13](#)). As I said, this doesn't happen very often, but it does happen once in a while, and it will make sense once I show it to you. This is a weekly chart of GBPUSD. I like to use the weekly chart to catch macro trend reversals, as these can result in big plays. The stops are also wider, so it is important to determine position size correctly on this larger time frame. In this weekly chart, a new low bar is created during the week of August 29, 2003, with a low of 1.5620. The very next week, prices dip below this level to 1.5612, creating a new low bar. Because this is a weekly bar, the only time action is taken is at the end of the week. These plays require a lot of patience.



Figure 19.13

2. There is a close above the high of the low week during the week ending September 12, at point 2. The entry is 1.6037.
3. GBPUSD rallies strongly the following week and then edges up for the next several weeks. During the week of November 9, labeled at point 3, prices fall below the two-bar trailing stop intraweek, but then rally and close above the lows by 30 pips. At this point, if we move the two-bar trailing stop up to the next bar, we will be stopped out because prices are already trading below that new stop. This is what I talked about in rule 5. Because of this, I just leave my closing stop in place, which is designated by the longer line reaching out from point 3. I will just leave my stop here until I am stopped out or until prices make new trend highs.
4. At point 4, prices make new trend highs, and I go ahead and resume my two-bar trailing stop.
5. GBPUSD rallies strongly until my two-bar trailing stop is hit during the week ending March 5, 2004, about six months after the entry, for a gain of 2,424 pips, or \$24,240 per contract. This is the type of trade that makes the forex markets interesting, because a trader could take a \$50,000 account in this example and make a million dollars on the trade. Needless to say, there is also the obvious risk of losing the entire \$50,000. It wouldn't be fun if it were easy.

Summing Up the HOLP and LOHP Plays

There are two ways to try to catch tops and bottoms: the wrong way and the only way. Shorting a stock or a market just because it is too high is the trader's version of committing suicide. Just as a dog will generally let you know when it's about to attack, a market will let you know that it is about to reverse. All you have to do is pay attention and be alert to the appropriate entry signal.

For updates to this play, visit www.tradethemarkets.com/holp to see a list of current markets that I'm using this strategy with.

Gold Trades and the Darvas Box

This Is How I Like to Trade Gold

Hi, my name is Hubert Senters, and I'm a cofounder of www.tradethemarkets.com. I have a Series 3 and 30, and I hold a seat on the CME Group/CBOT via an IDEM. I am also John's business partner in many other ventures.

Welcome to the chapter from a guy who *hates* to write. There are only a few things I'm good at, and writing isn't one of them. You have been warned; continue reading at your own risk. John said that he would read over my text and attempt to clean up what he could. I wish him the best of luck.

I don't think I have a natural talent for anything, but there are skills that I've developed and refined over time. Trading is in my blood, and I'm also an excellent entrepreneur, which is a form of trading. I understand how business and marketing work, and I'm great at taking complicated subjects and breaking them down so that they're easy to understand.

In John's first version of this book, I had it easy. All I had to do was give John several screen shots showing a few of my trading setups, such as the Ping-Pong play on KLAC. Then all John had to do was "write all the content for the chapter." I actually thought that writing the content was the easy part. Hell, I had to find those charts, didn't I? I was horribly wrong. This time, John suggested that I write an entire chapter from scratch. That sounded good. I asked, "How long does the chapter need to be, and when do you need it?"

He said, "It needs to be about 20 pages. I know how much you hate to write. That's why I'm telling you three months in advance. And don't worry too much about the text. Just take some screen shots, with detailed explanations of how your trade setups work." He gave me three months' notice. I got this to him about 30 minutes before his deadline to the publisher.

My Pain, Your Gain

Because I hate writing so much, I'll include a link for a video update at the end of this chapter. I love doing videos. I hate to write. Why? There are a few reasons.

REASON 1

I'm dyslexic. That's a broad defining term for a learning disability that impairs a person's ability to read and spell. Many dyslexics switch letters and numbers. What you see as an E, I might see as a 3.

If you suffer from dyslexia, or if you think your child has dyslexia, don't worry too much about it. It's not a *bad* thing. I've never seen my dyslexia as a learning disability. People with dyslexia process information differently, and I see that as a gift and an advantage. One of the big advantages of being dyslexic is that we learn and process information in a different way from most people. Hell, who wants to be like everyone else anyway? Different is good. Dyslexia helps me process an extremely complicated subject and break it down into its simplest parts. There is a great book on the subject, *The Gift of Dyslexia: Why Some of the Smartest People Can't Read and How They Can Learn*, revised and expanded, by Ronald D. Davis and Eldon M. Braun.

What kind of a sick joke, or twisted mind, came up with the name *dyslexia* anyway? They must have known how difficult it would be to spell dyslexia without spell check or Google. It's almost impossible, but it does make me laugh.

REASON 2

I'm still a hunt-and-peck typist, and I need to fix it. I know I have a Mavis Beacon Teaches Typing program in my office somewhere.

REASON 3

It's far easier for me to do video than to write copy. I know I learned much more easily and a lot faster by watching videos myself. You will learn faster by watching someone do whatever you want to learn, too.

Since I'm not a professional writer, I'm going to talk to you as if we are friends at a bar having drinks, and you ask me how to trade. I'll let the editors clean up the grammar and spelling! Here's what I'm going to do. I have an outline of some of my favorite trading setups, working right now in the markets. I'm going to create screen shots, then label them with numbers. The corresponding numbers will give you directions and descriptions of what to look for and how to trade them, with entries, stops, and targets. If you can follow simple directions, you should be able to follow along easily. Let's jump into the world of trading.

Welcome to Trading. Are You Ready for the Bad News?

Okay, which do you want first, good news or bad news? Let's start with the bad. You have less than a 9 percent chance of ever making any money day-trading the markets over the long haul. Ouch! That stung a little, didn't it? The good news is, your account's destruction will happen quickly, so you won't be in pain that long. It will be like ripping off a Band-Aid. Has anyone ever told you that if you rip it off fast, it won't hurt as much? You've been lied to there, too. It still hurts like crazy, and I actually think it hurts worse. Many people who try to do it that way lose most, if not all, of their money within the first three months. Another stat you need to know is that most people blow out three accounts before they figure out how to do this. Fun, fun, fun.

Or are all successful traders just a little crazy? I actually think all successful traders are abnormal, for what it's worth. If you think you are a little odd, or strange, or different, the good news is that you might have what it takes to become a successful trader. Welcome to the Land of Weirdos. I'm not pointing fingers; I'm right there with you. We are an odd lot. Where else in the world can you go to a room and see grown men and women staring at price action charts like they're porn, for hours at a time? When a group of traders get together, it's a little like an AA meeting. For those who do figure out how to do this, the cash flow can be addictive. But that's a topic for a later discussion. First, let's see if I can share some good trade setups with you. Then you can go out and start making some consistent income.

It's Not Your Fault

If you are losing money trading, it might not be your fault. Oddly enough, most people trade the first market they come to, whether it matches their trading personality or not. Most people don't know that markets have individual trading personalities.

For example, if you're trading the index e-minis, which are made up of the mini-sized Dow, the E-mini S&P, the E-mini Nasdaq, and the E-mini Russell, and you're losing money, that market might not match your particular style of trading. So index futures may not be the best place to start, but that is where most people cut their teeth in futures trading. This is not a good thing or a bad thing. You just have to understand that there are other markets out there that may suit your personality better.

Food for Thought

For example, the index futures trading personality is like a sprinter, moving quickly in one direction, then stopping, reversing, and running back in the other direction. If you're getting stopped out a lot, which happens quite often in the E-minis, it's because they are a great countertrend trading market. You may want to consider trading in a different market.

Now let's compare gold to the e-minis. Gold tends to have the trading personality of a marathon runner or the Energizer Bunny because it just keeps going and going and going and going, until you eventually get a minor pullback, then it will start again and keep on going and going and going. So gold would be a better trend trading market than the E-minis if you buy breakouts.

The setups I'm about to share with you are working right now in the markets, but you and I both know that not all trading setups last forever. You must be willing to adjust, adapt, and evolve with the markets. I cannot promise you that these trading setups will always work with these parameters. They can and will change over time, so make sure you go to www.tradethemarkets.com and get our free daily trading videos so that you can stay on top of the current parameter changes for these setups.

RAW Trading Rules

This section of the book is like a trader's handbook where you're going to get RAW trading rules. In RAW, R = Real, as these rules have been tested in the real world, not just back-tested. There's only testing with real money in my real trading account. A = Actionable, as in the steps you need to take in order for them to work for you. W = Working right now in the markets.

The first trades I want to share with you are my gold trading setups. I have seven gold trades that I use on a consistent basis, but I am only going to be able to share three. The three that I'm sharing with you are the good night gold (GNG) trade, the gold rush (GR) trade, and the gold spike (GS) trade.

Why Should You Consider Trading Gold?

By now you know that John and I teach people how to trade for a living at our site, www.tradethemarkets.com. At one of our monthly live trading webinars, I asked attendees the following question: *what are you having the hardest time with when it comes to your trading?* The traders on the monthly live trading webinar were mostly day traders trading the E-minis. Guess what their answer was.

As you probably guessed, most of them were having issues with consistent cash flow or income generation. The number one answer was, "I'm getting chopped up in the E-minis, and I can't seem to get enough consistent winners or runners to make up for all the small losses." This is pretty common with E-minis. They just don't trend well on an intraday basis.

My follow-up question was asking what style, strategies, and tactics they were using to trade the E-minis. Not all of them were using a breakout strategy. I'm not saying that a breakout strategy will never work on the E-minis, but let's face it, the odds of that working consistently are rare. You can occasionally buy breakouts and trend trade the E-minis intraday, but it has to be at just the right time and place. It's like hitting yourself in the head with a hammer—it feels great once you stop. Let's face it, trading is hard enough, so why make it harder? Your job as a professional trader isn't to work harder, it's to work smarter. Don't get me wrong, I like hard work as much as the next guy. I know from personal experience that the harder I work, the luckier I get.

I came to the conclusion that most traders were in the wrong markets for their trading personality and style. If you are always chasing at the wrong time, or always getting stopped at the worst possible time, you are probably in the wrong markets for your trading personality and style.

If you ever find yourself in this type of situation, there are only two things you can do to fix it. One is hard, and the other is easy.

The hard way is to learn to trade that market, even if it goes against your style. Basically, you will be changing your natural habits into forced habits. It can be done, but it's hard, and people tend to relapse to their old true self. You've probably heard the line, *fake it till you make it*, but it's not a good idea in the markets that will break you.

The easy way to figure out your natural style is to gravitate toward the market that looks, sounds, and feels right to you. It will take work, but it won't be nearly as hard as forcing your style on a market that won't work for you.

The market is a ruthless bitch, and she will try to trip you up every chance she gets. She will slit your throat and watch you bleed. She doesn't care about you, so why should you play her game by her rules when you can slant the odds in your favor and play by your rules, where you have the edge or advantage? I can think of no better way than figuring out your natural trading style, then finding a market to match it. Do you want to be right, or would you rather be wealthy?

So back to the story. I wanted to help out everyone on the monthly live trading webinar, so the first thing I did was look for something with a wider average true range. Oddly enough, it was gold. I set out to figure a way in which people with smaller accounts trading one to five lots could make about \$300 to \$2,000 a day. Obviously, you won't do that every day. Some days are better than others. There is no guarantee of performance. These were trades I was doing in my own live trading account with smaller size, so I could figure out whether or not I could teach them to others to enhance their chances of trading success. I found a few methodologies that I could share with them that would work.

So You Want to Be a Rainmaker

Rainmaker is a term that is used broadly across many different niches. It basically means either that you get paid to make money, or that you're really good at making

money "rain."

There are two main schools of thought when it comes to becoming a rainmaker. Number one, you can put in a ton of time, sweat, and energy to learn everything and anything there is about trading so that you can make as much money as possible with your newfound skills. For long-term, consistent cash flow, I believe this is the best way. Unfortunately, most people don't have the time, energy, and dedication. And if the stress doesn't get you, the vodka and tequila will. Sorry, liver, I will try to be nicer to you in the future. Heads up: if you do have the occasional drink from time to time, take some milk thistle to help protect your liver.

The second school of thought is that you don't have to become a total package rainmaker if you're willing to figure out where it's raining, then head there and set up tarps and buckets so that you can sit and collect it. Now we're talking.

I have tried both, but I believe the best mix of the two is to gather some basic knowledge on how the markets work, just enough to keep you from hurting yourself, then figure out where it's raining and go there, set up some tarps and buckets, and collect the rain. Let everyone else work harder so that you can work smarter.

Let's take the S&P E-minis, for example. Pretend that the average true range (ATR) for the S&P is 10 points and you want to take out 2 of those 10 points every day. Sounds easy, right?

It sounds easier than it actually is. The average true range is really just the average daily range of that market from its low to its high or from its high to its low.

Now let's assume, for example, that during that same time, gold's average true range is, say, 40. Which one do you think it's going to be easier to grab 2 points out of?

Your common sense tells you that it should be easier to make 2 points from a 40-point move than to make 2 points from a 10-point move.

Which one would you rather try? Would it be easier to land a plane on a large runway, or would it be easier to land a plane on an aircraft carrier? Obviously, the longer runway is going to be more forgiving of any errors you make in the process than the aircraft carrier.

Shawshank Redemption

One of my favorite movies is *Shawshank Redemption*. In the movie, Andy Dufresne is wrongly convicted of a murder he didn't commit. He is in the process of escaping from prison, but in order to escape, he must burst a two-foot-diameter sewer pipe, then crawl 500 yards through feces to escape and claim his freedom. This is a line from the movie:

Andy crawled to freedom through five hundred yards of shit smelling foulness I can't even imagine, or maybe I just don't want to. Five hundred yards ... that's the length of five football fields, just shy of half a mile.

You're probably wondering why I'm telling you this, and where it's going. Great question. It's a great analogy for trading. I have no clue how you make money without first risking it. In order to find the profitable trades, you must get dirty, crawl around in some feces, get stopped out on some trades, and lose some money. There is no way I know of to tweak out the bad trades so that you only get the good ones.

If there were a field full of diamonds covered in feces, and it was a race to find as many as you could in the shortest amount of time, what would you do? If you were smart, you would roll up your sleeves and get to work, stink and all. Again, there are no perfect trade setups and no perfect traders. Try not to make trade setups too complicated. Don't look for a confirmation of a confirmation of a confirmation, for example, because you are too afraid of being stopped out and losing money. Stop losses are a large part of what we do; they're how we manage our risk.

You must learn to be comfortable with your discomfort.

Don't Worry, Be Happy

That's a catchy little tune, one you could never get out of your head, just like when you take your kids to Disneyland and go on It's a Small World After All.

Don't worry if you don't know how to trade gold futures; I'm going to teach you everything you need to know so that you can get up and running as quickly as possible. We've already discussed the trading personality of the gold market, so we can skip that and move right into the contract specs.

Any time you look at trading a new market, or adding a new market to your trading toolbox, you must figure out the contract specifications. The contract for gold that we will be trading is the biggie (not the mini or micro contract). The symbol is GC, and it is currently traded on COMEX/NYMEX, which is owned by the CME Group.

The minimum tick move for gold (GC) is 10 cents. Each 10-cent move is worth \$10. For example, if gold goes from 1880 to 1880.10, that is 1 tick, and that 1 tick is worth \$10. There are 10 ticks in every point of gold, so every point of gold is worth \$100 per contract. If you're using more contracts, multiply by that number accordingly.

You must know how much it will cost you to trade gold. There are two different factors you need to know; one is the intraday margin for gold, and the other is the overnight margin. The exchange sets the minimum intraday margins and the minimum overnight margins, but your broker can, and in most cases will, increase those minimums. It does this to protect both itself and you.

Margins also change when a market grows volatile. The exchange will increase them in an attempt to limit volatility. Sometimes it works, and sometimes it makes things worse. The easiest way for you to find out what the intraday and overnight margins are is to pick up your phone and call your broker or clearing firm. It should be more than glad to help you. If it isn't, switch to someone else.

The Famous Good Night Gold Trade

The first gold trade I'm going to share with you is the famous good night gold trade. This is a simple trade setup, but don't let that fool you. It is extremely powerful. I've found over the years that the simple stuff usually kicks the shit out of the complicated stuff. For some reason, I get the most questions on this simple setup. I think the reason I get the most questions on this setup is that it's so simple and easy that most people try to make it more complicated. If you find yourself wanting to add more stuff to this trade, I caution you not to. Here is a famous quote. I'm not sure who said it, but it's great!

The system wasn't designed so that most people could beat it. Most traders take a good system and destroy it by trying to make it into a perfect system.

What I have found over the years is that most people don't like losing money. Successful traders don't like it either. But it is a risk thing, and I would rather lose a little than a lot, and live to fight another day.

Gold Settlement Price

The first thing you must know about the good night gold trade is that you have to be able to figure out the settled price of gold, or at least be able to find it easily. The settlement price is very important for this setup. If you don't know what the gold settlement price is, you won't be able to make this trade.

The gold settlement price is determined at 1:30 p.m. EST. There is a close price and a settlement price. You want the settlement price, not the close price. It doesn't really matter what it means; all you need to know is that you want to know the settlement price of gold, or at least where to find it.

Notice that at point 1 in [Figure 20.1](#), it is 1:30 p.m. EST on a one-minute chart. If you can't find the settlement price, this will do in a pinch. Sometimes the close price and the settlement price will be close; sometimes they will be further apart.



Figure 20.1

If you are a TradeStation or thinkorswim user, they actually calculate it correctly and display it as the net change in gold price. Tada! It's like magic, but not all brokers calculate their net from the settlement at 1:30 p.m. EST; some use the close, and others use the electronic close. No worry here; there is still another easy way to find out the settlement price of gold. Google the CME Group website and look for "gold settlement price," then do a quick search and you will find the URL. [Figure 20.2](#) shows how you do it.

Google

cme gold quotes

1

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www.cmegroup.com/trading/metals/precious/gold.html

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www.cmegroup.com › Market Data Services › Real-Time Quotes
CME CORE: **CME** Clearing Online Risk Engine. Trading Practices .

Figure 20.2

1. Type in the words “CME Gold Quotes.”
2. Click on the first link that you find at the top of the page in Google from the CME.
3. It should lead you to this URL: http://www.cmegroup.com/trading/metals/precious/gold_quotes_settlements_futures.html.

When you get there, it will look like [Figure 20.3](#).

Gold Futures

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Month	Charts	Last	Change	Prior Settle	Open	High	Low	Volume	Lo
Oct 2011 <input checked="" type="button"/> OPT		-	-	1615.5	-	-	-	0	No
Nov 2011 <input checked="" type="button"/> OPT		-	-	1616.6	-	-	-	0	No
Dec 2011 <input checked="" type="button"/> OPT		1616.3	-1.0	3 1617.3	1618.3	1619.2	1615.7	2 75	No
Feb 2012 <input checked="" type="button"/> OPT		1619.7 b	+0.5	1619.2	-	1619.7 b	-	0	No
Apr 2012 <input checked="" type="button"/> OPT		-	-	1620.7	-	-	-	0	No

Figure 20.3

- Find the Volume column at point 1.
- Find the month that is showing the most volume. In this case, it is 75 (point 2). This is so low because I took this screen shot as soon as gold opened at 6:00 p.m. Gold is thin when it opens up. I actually have a trade that I love to do at 6:00 p.m. EST. I call it a gold wiggle trade, where I pick the pockets of retail traders by playing mental masturbation games in the DOME, or Depth of Market, Level 2 if you're a stock trader. But that is for the next book if John can con me into writing one more time.
- Now just line up the month that has the most volume with the column headed Prior Settle, and there you have the settlement price. All you have to do is write this number down. In this case, it's 1617.30, as seen at point 3.

You now know how to find the settlement price of gold. Congratulations! I told you that I would walk you through the steps and that they'd be pretty easy to understand.

How to Turn \$600 into \$6,000

Here are the good night gold trading rules:

- Find the settlement price of gold at 1:30 p.m. EST.
- Look at the Gold ADX (average directional index; this is an indicator that's available on most platforms) reading on a daily chart. If it's above 20, then yes, it's trending, and it is worth trading. If it isn't, don't trade.
- Look at the daily chart: is gold in an uptrend or a downtrend on the daily chart?
- If it's in an uptrend, go long at 11:30 p.m. EST if gold is up more than 3, but not more than 20, from the settlement price.
- If it's in a downtrend, go short at 11:30 p.m. EST if gold is down more than 3, but not more than 20, from the settlement price.

6. Use a 6-point stop loss and a 60-point target.

7. Stay in the trade until either the target or the stop is hit.

8. You can also have decision points or targets at +20 and +40 to decide whether you are going to keep the trade or cut it loose if the stop hasn't been hit.

This is a real sweet setup. It works only about 30 or 40 percent of the time, but in reality it needs to work only about 1 out of 10 times because you are risking 6 to make 60. To break this down to its simplest terms, the smallest possible size that you can trade on a gold futures contract is one contract. You are going to risk \$600 to potentially make \$6,000. I will take that trade every day, all day long, and twice on Sunday.

Frequently Asked Questions

Why do you enter the trade at 11:30 p.m. EST?

Because you have the Asian markets opening and the European markets about to open, so you're getting in front of a potential move that will take you into the market, and we are trying to take advantage of potential volatility.

Why do you think this trade works so well?

This setup works so well because you can't mess with it. You will be in bed, so you will not be able to move your stop or jump out early. It forces you to hold on to a winner, while also forcing you to cut your losses quickly. Let's face it, most of the time, when you place the trade with your target and your stop, you will wake in the morning with either a 6-point stop loss or a target that has been hit, or you will have a working trade that's going in your direction first thing in the morning.

It removes the human factor from the equation. I will let you in on a little secret: I'm never smarter once I'm in a trade. I almost always make a bad decision the second I start messing with a predetermined plan. Plan your trades and trade your plan.

How can you get over the fear of trading?

There are a lot of people who will tell you that your job is to be an unemotional robot while trading, but I think that's a load of BS. I believe your job is to manage being a bumble of nervous emotion, and not allow your voice or head talk to interfere with your best course of action.

It's true that the longer you trade, the less emotional you get about it. But it takes years and years and years of experience to get there, so you will have to learn how to become comfortable with being uncomfortable.

Does this trade work on the gold mini?

No, it's too thin.

Do you do this trade every night?

No, I trade it only when it meets the checklist rules for this setup.

What if you are already in the trade from the night before, and you targeted a stop, but it hasn't been hit. If it meets the criteria again tonight, should you add to your position?

No. I let the trade play itself out before I do another one.

Do you move your stop to breakeven once you're up a little?

No, I don't. I'm in bed. If it's the next day, I still don't even know that the target hasn't been hit. I can decide to cut it loose at +20 or +40 the next day, but I never move the stop. I have to give it enough room to run. It's a double-edged sword, but I believe there are more advantages than disadvantages.

For the rest of the chapter, I'm going to take you through some trade setups that are working for me right now. It's going to look like a step-by-step instruction manual with tons of details, so there will be a lot of screen shots with numbers on them. Simply follow the steps in order: 1, 2, 3. And don't worry, these are not like the instructions you got with the cheap furniture you had when you were in college or when you first got married, which were clearly written by someone who had never attempted to put it together himself.

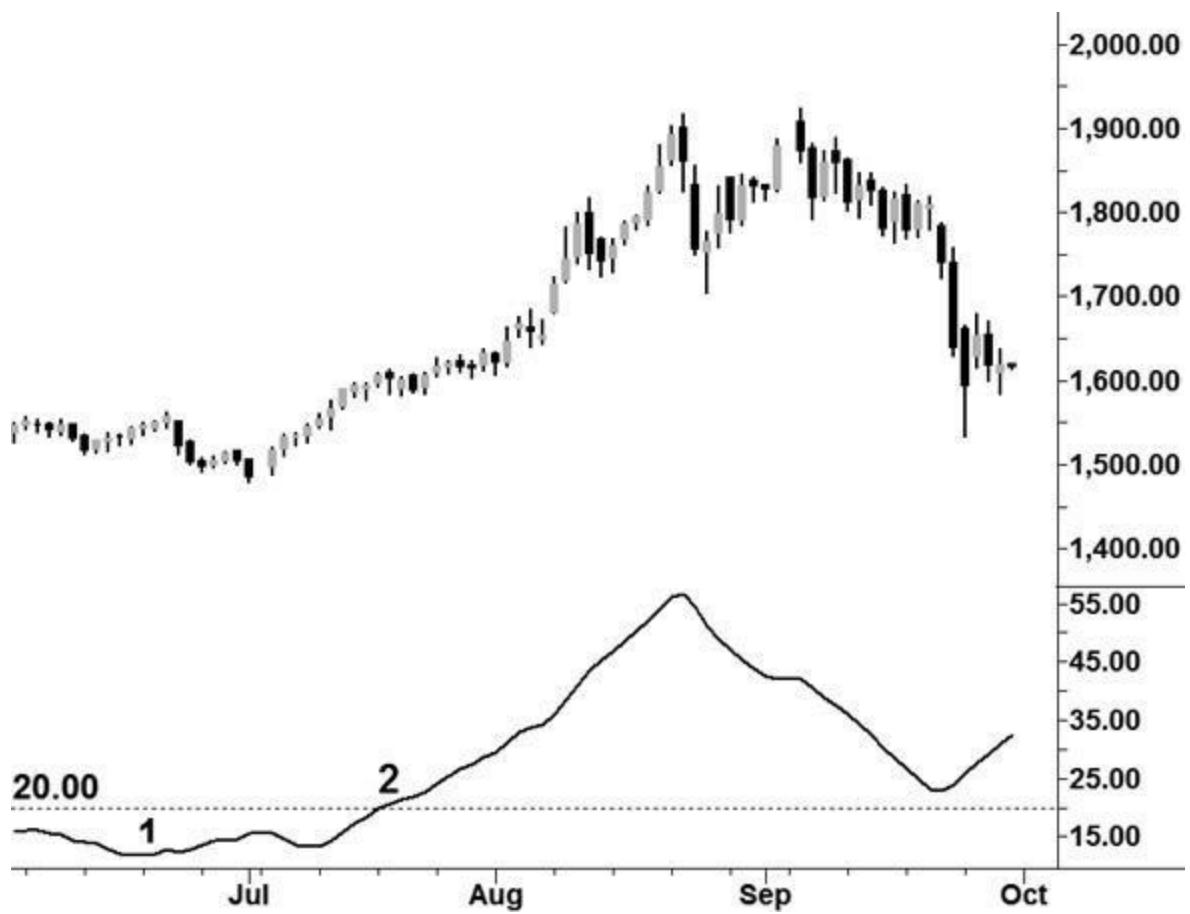


Figure 20.4

Good Night Gold Step by Step

GOOD NIGHT GOLD LONG EXAMPLE

1. If the 14-period ADX is below 20, don't trade it. It's not worth it because the market is too choppy (see point 1 in [Figure 20.4](#)).
2. If the 14-period ADX is above 20, the markets are trending and you can trade (see point 2 in [Figure 20.4](#)).

You don't care which way the market is going; you just want to know that it's trending. You can look at the chart and tell which way it's going fairly easily.

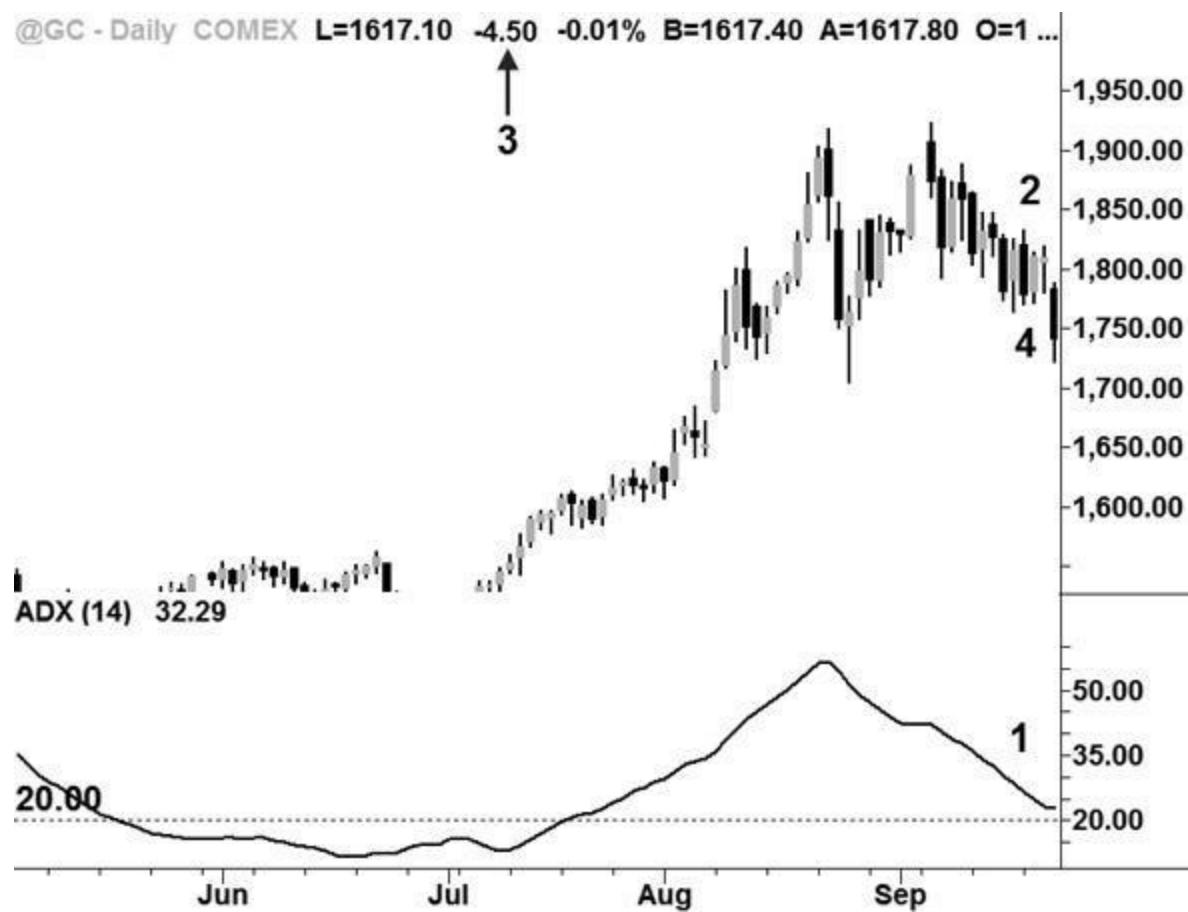


Figure 20.5

1. In [Figure 20.5](#), is the 14-period ADX above 20? Answer: yes!
2. Is the daily gold chart in an uptrend? Answer: yes!
3. Is gold up more than 3 points, but not more than 20, at 11:30 p.m. EST from the 1:30 p.m. EST settlement price? Answer: yes!

All you have to do is place a long trade and use a 6-point stop loss and a 60-point target. You can also have decision points at +20 and +40 where you decide whether you are going to keep the trade or cut it loose. Now just rinse and repeat.

GOOD NIGHT GOLD SHORT EXAMPLE

**Figure 20.6**

1. In [Figure 20.6](#), is the 14-period ADX above 20? Answer: yes!
2. Is the daily gold chart in a downtrend? Answer: yes!
3. Is gold down more than 3, but not more than 20, at 11:30 p.m. EST from the 1:30 p.m. EST settlement price? Answer: yes!
4. Now all you have to do is place a short trade and use a 6-point stop loss and a 60-point target. You can also have decision points at +20 and +40 where you decide whether you are going to keep the trade or cut it loose. Now, rinse later and repeat.

What happened next with this trade (see [Figure 20.7](#))?

1. The short trade is filled at 1,750 with a 6-point stop loss and a 60-point target.
2. Notice the drop in gold. I'm warning you right now that this trade can be extremely addicting.

The hardest part about this trade is following the rules and not jumping right back in as soon as your target is hit. My advice to you is to make sure you have your mind right for the massive moves.



Figure 20.7

You should pass on the trade in [Figure 20.8](#), as it does not meet the filter criteria for the trade.



Figure 20.8

1. Is the 14-period ADX above 20? Answer: yes!
2. Is the daily gold chart in a downtrend? Answer: yes!
3. Is gold down more than 3, but not more than 20, at 11:30 p.m. EST from the 1:30 p.m. EST settlement price? Answer: no! It is up 3.70, not down, so there is no trade.
4. You can enter a sell stop at 1,614.30, which would be when gold would be down 3.00 points. I am testing this right now; sometimes it works and sometimes it doesn't, but I figured I would tell you the good with the bad.

GOOD NIGHT GOLD CHECKLIST RECAP

- Is gold trending on the daily chart? To answer that question, we will use the 14-period ADX.
- If the ADX is above 20, you can trade it.
- If the ADX is below 20, you cannot trade it.
- What direction is the daily trend of gold?
- If it is up, focus on long.
- If it is down, focus on short.
- If gold is trending up on a daily chart, place a long trade at 11:30 p.m. EST, as long as gold is up at least 3, but no more than 20, from the settlement price at 1:30 p.m. EST.
- The stop is 6 points, and the target is 60 points. But we also have decision points at +20 points and +40 points.
- *Warning:* The big moves are addictive, and this trade will fool you into thinking that you have more trading skills than you actually do, because gold is trending well and has a good wide ATR. Plus, you cheated a little bit, didn't you? You figured out where it was raining and set up tarps and buckets. You're a little crazy, crazy like a fox! Now laugh all the way to the bank.

The Gold Rush Trade

The gold rush trades off the advantage of the breakout moves that gold produces much of the time. On the surface, it will look a little like the good night gold trade, but it's not. Although the filter criteria for this trade are the same, it's a different setup. The reason you are going to use these filter criteria is to make sure that you keep yourself on the right side of the market, and that you keep yourself out of trouble by making sure that you are not overaggressively pursuing or chasing the market.

You know what happens to all dogs that chase cars, don't you? They eventually get hit. If they survive, they either learn their lesson the hard way or lose more legs.

This works on intraday and/or overnight. It's a basic scalp trade that can turn into a runner if you catch it right. For this trade, you do not care what the daily trend is; you just want it to be moving.

Gold Rush Rules

1. Is the gold ADX on a one- or two-minute chart above 20? If yes, go to step 2. If no, *stop!*
2. Is gold up or down at least 3 points on the day, and no more than 60 percent of its daily ATR (average true range)?
3. Place a buy stop at new highs or a sell stop at new lows.
4. Use a 3- to 6-point stop loss, and use a target that is double your stop.

The reason you are looking for gold to be up at least 3 and no more than 60 percent of its daily ATR is that it's a safer trade. If gold is already up one full ATR range on the day, you don't have a lot to work with. I'm not saying that it will never break from the daily ATR range. Actually, it does this quite often, but we want to play it safe. Plus, if you trade multiple contracts on this trade, you can always scale out and keep the last quarter of your trade for a runner when it happens.

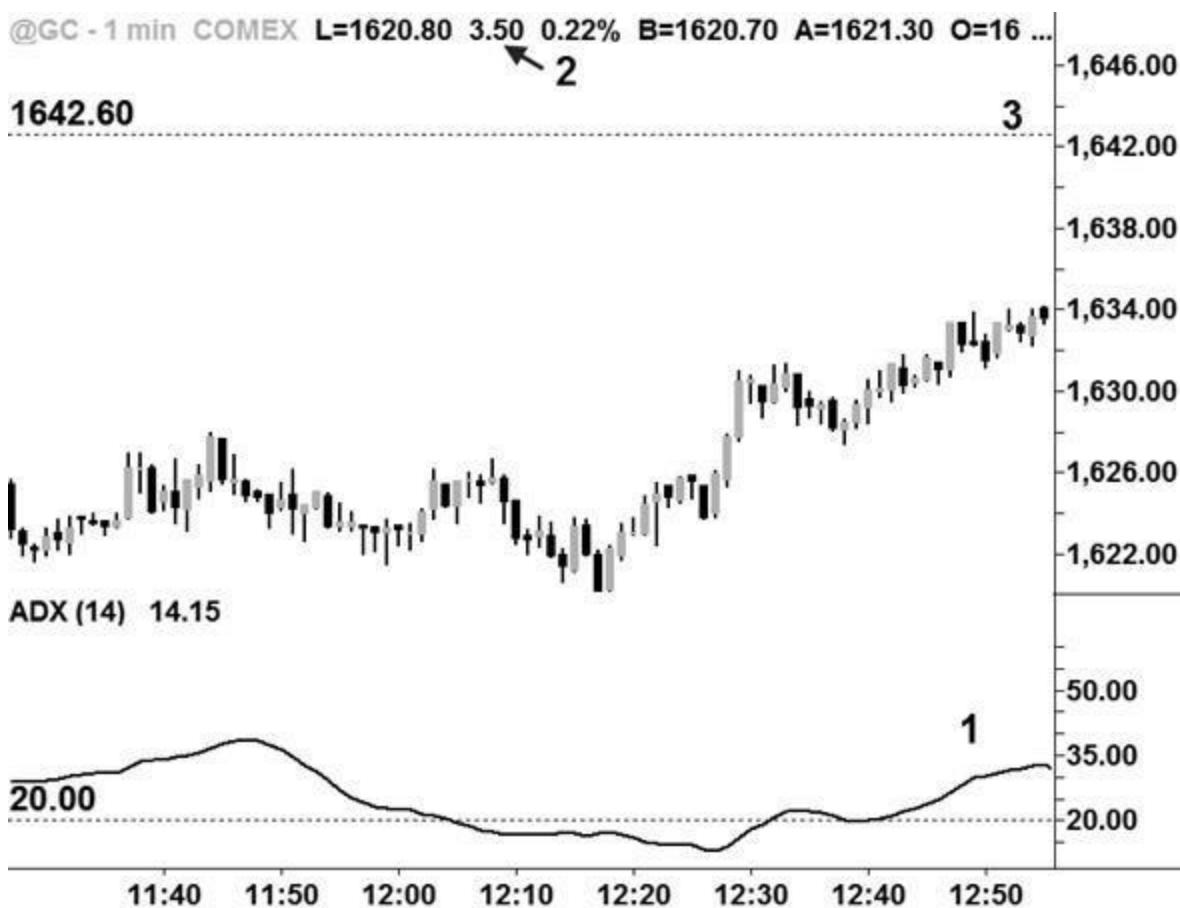


Figure 20.9

1. In [Figure 20.9](#), the ADX is above 20 on a one- or two-minute chart.
 2. Gold is up at least 3 but no more than 60 percent of its daily ATR.
 3. The high of this day is where you place your buy stop. Then use a 3- to 6-point stop and double your stop for the target.
-
1. In [Figure 20.10](#), is gold up more than 3 but less than 60 percent of a daily ATR? Answer: yes!
 2. Place a buy stop 1 tick above the current high of the day. Use a 3- to 6-point stop loss and a target of twice the stop.
-
1. In [Figure 20.11](#), is gold up more than 3 and less than 60 percent of its daily ATR? Answer: yes!

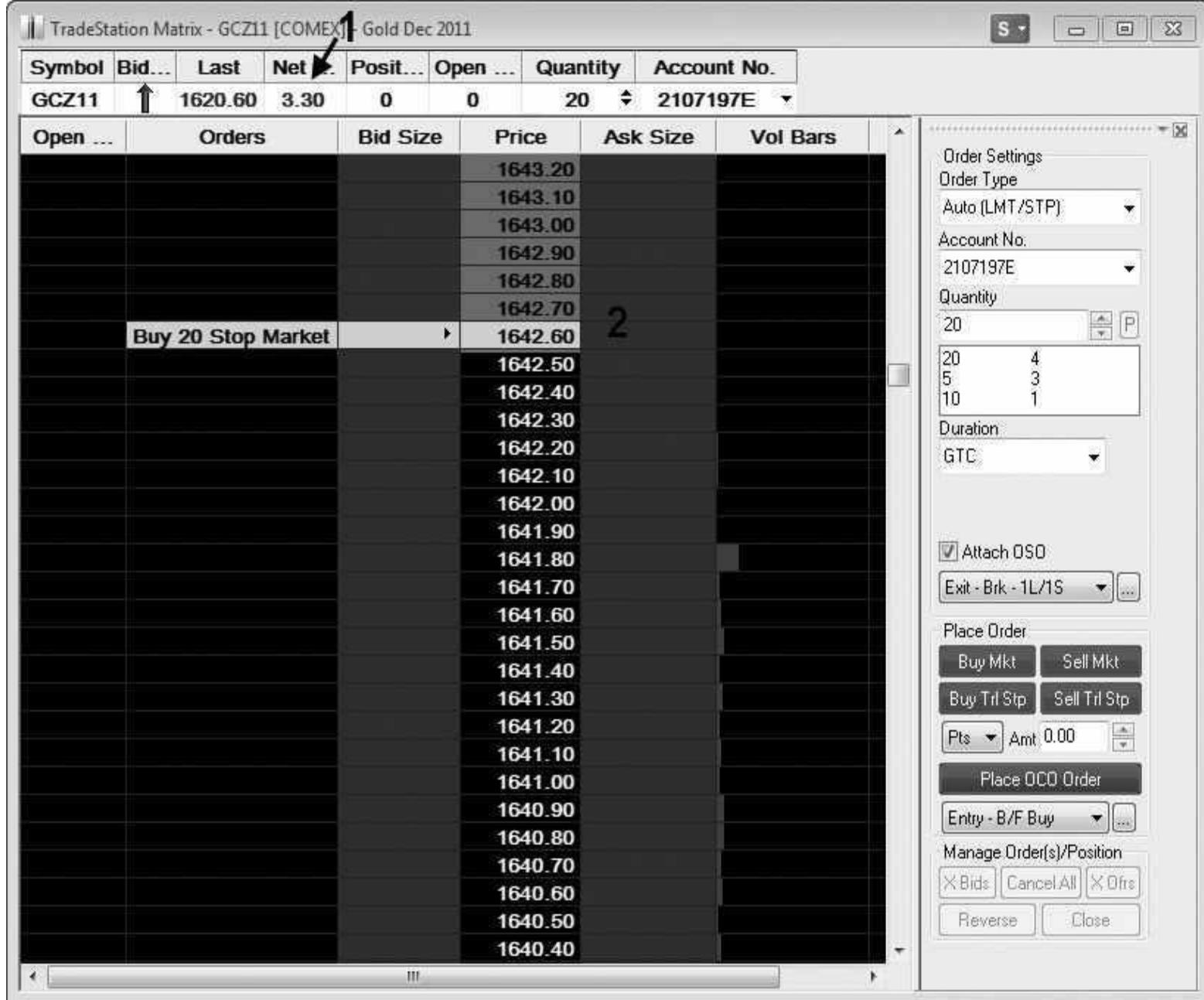


Figure 20.10



Figure 20.11

2. Is the ATR on a one- or two-minute chart above 20? Answer: no! Pass; do not do the trade until the ATR is above 20.

The Gold Spike Trade

These are rules and a checklist for the gold spike trade.

Long Trade Rules

1. Identify the trend in gold on the daily chart as up.
2. Wait for a sell-off in the daily uptrend.
3. The sell-off must be at least 15 points or 1 ATR on the daily chart.
4. Use a one-minute chart to find the volume spike to get long gold.
5. Use a stop of 3 to 6 points.
6. Exit 1 is a quick scalp of 3 to 6 points.
7. Exit 2 is to hold for a 60-point target.



Figure 20.12

1. In [Figure 20.12](#), gold is down 15 points, but the daily chart is in an uptrend.
2. A sell-off happens.
3. There is a volume spike on the one- or two-minute chart.
4. Get long around 1610 and place a 3- to 6-point stop.
5. Scale out at twice the stop and keep a runner for +60 points.

Short Trade Rules

1. Identify the trend in gold on the daily chart as down.
2. Wait for a retracement of the daily downtrend.
3. The retracement must be at least 15 points or 1 ATR on the daily chart.
4. Use a one-minute chart to find the volume spike to get short gold.
5. Use a 6-point stop and a 60-point target.
6. Exit 1 is a quick scalp of 3 to 6 points.
7. Exit 2 is to hold for the 60-point target.



Figure 20.13

1. In [Figure 20.13](#), gold is down 18 to 20 points, but the daily chart is in a downtrend.
2. The retracement happens.
3. There is a volume spike on the one- or two-minute chart.
4. Get short around 1630–1636 and place a 3- to 6-point stop.
5. Scale out at twice the stop and keep a runner for +60 points.

Now you're armed with three extremely simple but powerful gold-trading setups. I hope they serve you as well as they have served me.

How Do I Buy Bottoms and Sell Tops?

This is a great strategy, and it will work on any market with volume. That means it will work on everything except for the spot forex markets. Now, it does work better in some markets than it does in others. It starts out as a scalp trade, and it can signal key turning points for tops and bottoms. What if you could look inside a price bar or candle and find out quickly which side was more aggressive right now, the buyers or the sellers?

What this indicator does is calculate the difference between the volume traded at or above the ask price and the volume traded at or below the bid. Then it represents this in a histogram form. It is very simple to tell whether the current high or low is more likely to hold or not. The country-boy commonsense definition of this thing is this: it tells you if there are aggressive buyers at the low or if there are aggressive sellers at the high. The only bad thing about this indicator is that it is real-time only (you won't be able to see how it did in the past, only how it does in real time going forward), so you have to turn it on and let it run so that it can calculate the bid/ask relationship.

Delta Divergence

Let's take a closer look at what this thing is actually doing and how it works. The indicator looks for a current low or a new tick low and calculates whether the buyers are more aggressive than the sellers. If they are, then that gives you the edge when you're trying to buy lows. I don't know if you have ever tried to catch a falling knife, but it's no fun, to say the least.

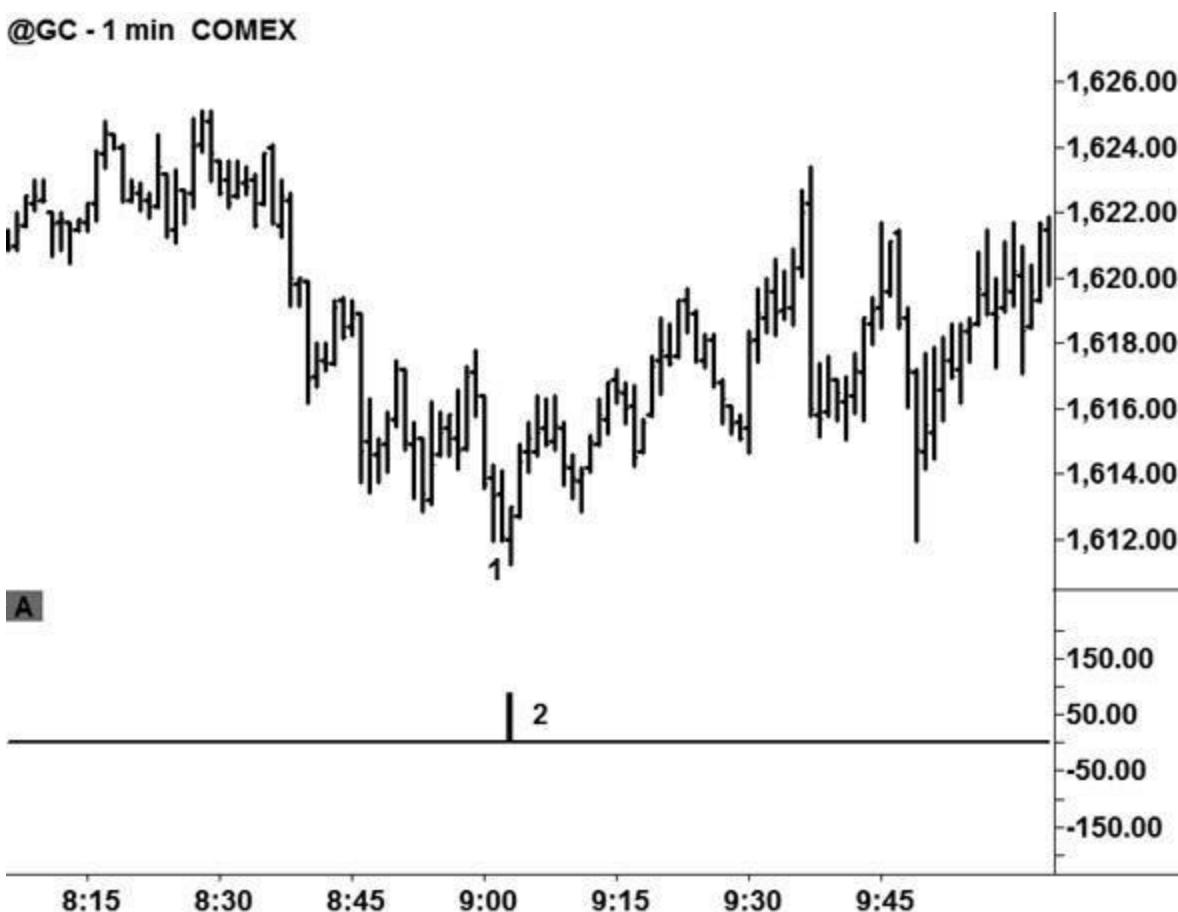


Figure 20.14

1. In [Figure 20.14](#), is a current low or a new low being made? Yes.
2. Is the indicator telling you that buyers are aggressive? Yes. Whenever the indicator spikes higher with a blue bar like at point 2, it indicates that buyers are being aggressive. *Special note:* The indicator is blue, not black, in real life. The publishers make you use black-and-white in all the charts.

1. In [Figure 20.15](#), is a current high or a new high being made? Yes.
2. Is the indicator telling you that sellers are aggressive? Yes. Whenever the indicator spikes lower with a purple bar, it indicates that sellers are aggressive. *Special note:* The indicator is purple, not black, in real life. The publishers make you use black-and-white in all the charts.

Darvas: How to Make 2 Million Dollars in the Stock Market

This is the strategy made famous by the book, *How I Made 2 Million Dollars in the Stock Market*, by Nicolas Darvas. His stair-stepping strategy, the Darvas Box Trading Method, is discussed here with a modern twist.

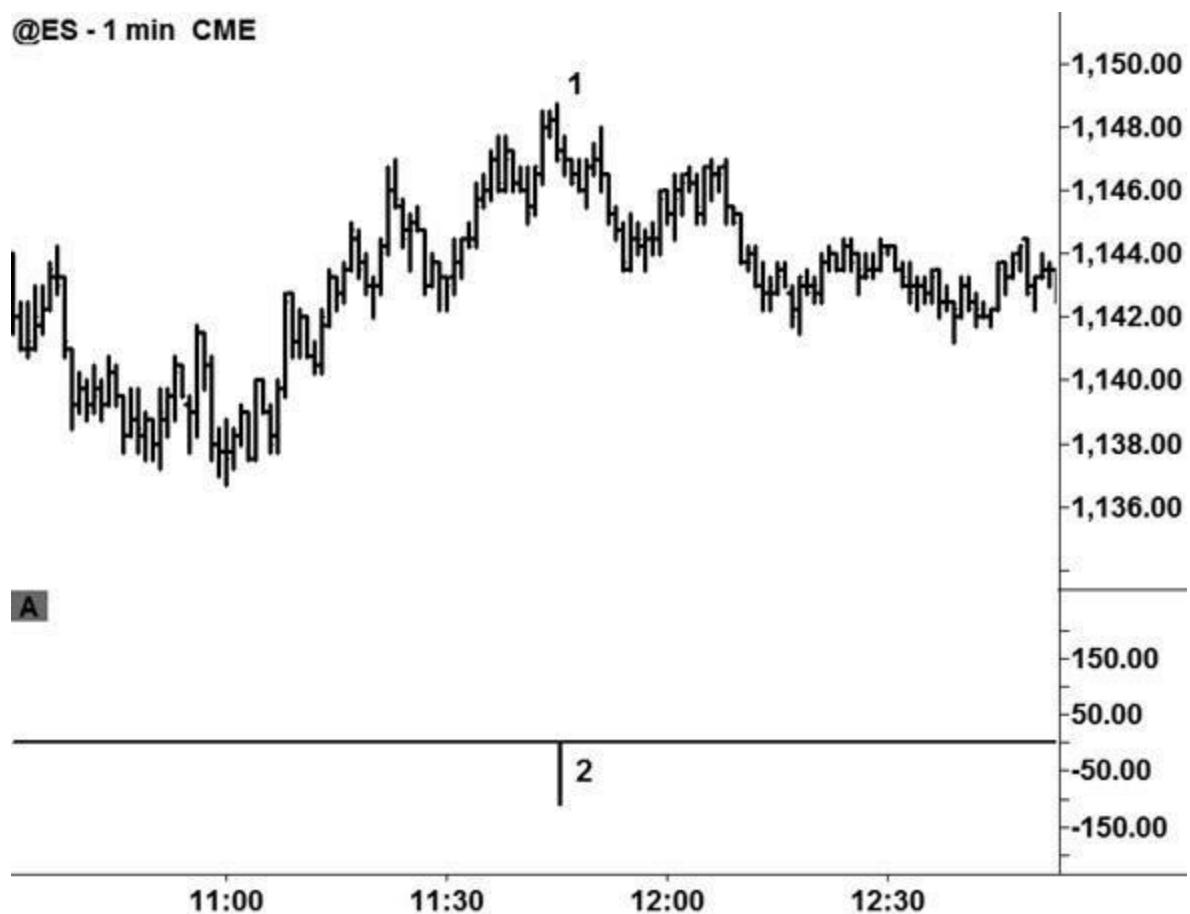


Figure 20.15



Figure 20.16

1. [Figure 20.16](#) shows a price break below the Darvas box, which means to get short.
2. Place a stop at or above the top of the box.
3. Calculate the distance or height of the box.
4. Use the height of the box as your target.

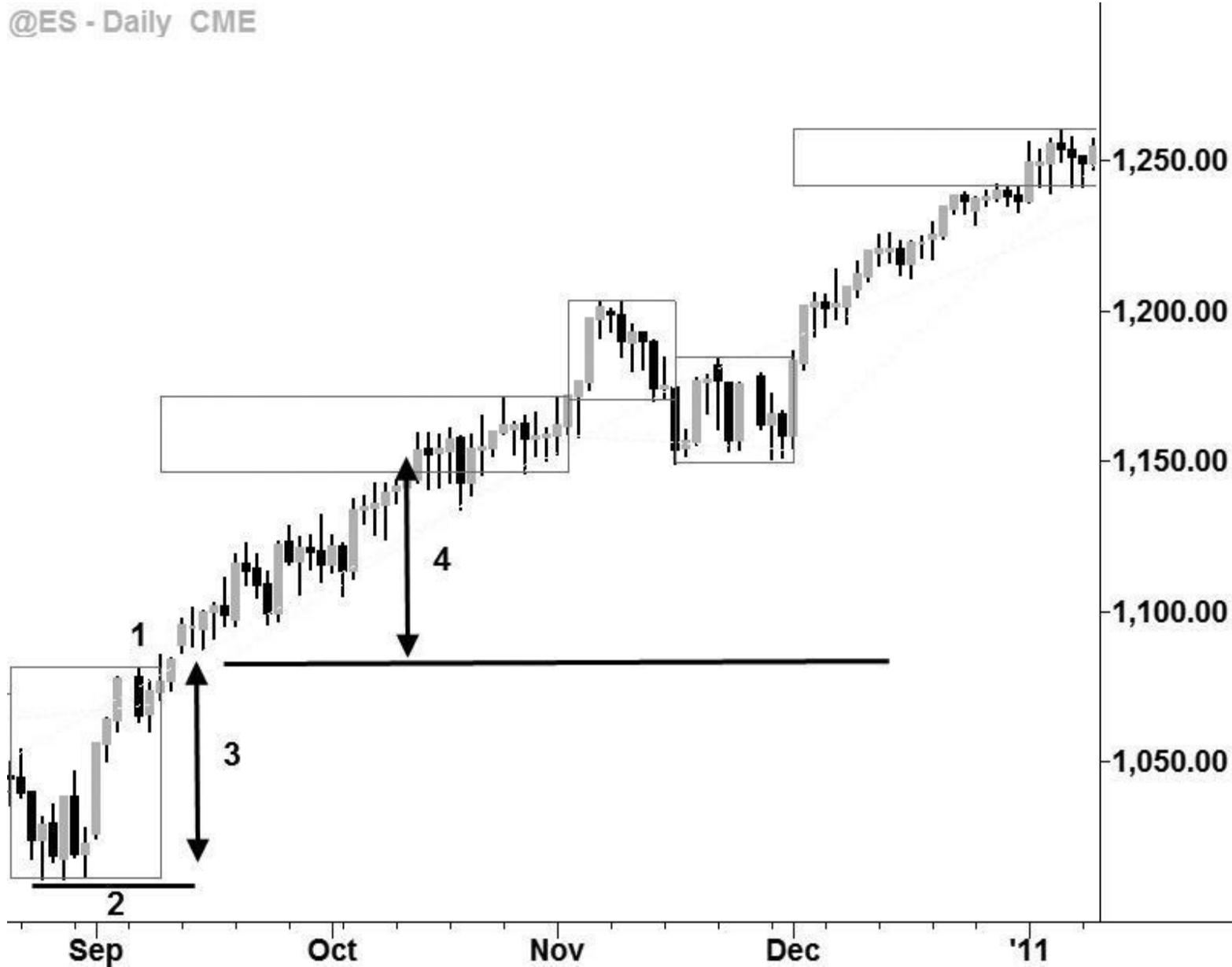


Figure 20.17

1. [Figure 20.17](#) shows a price break above the Darvas box, which means get long.
2. Place a stop at or below the bottom of the box.
3. Calculate the distance or height of the box.
4. Use the height of the box as your target.

That's a wrap for me. I hope you enjoyed it, and I hope you get a ton of value from it. Remember, the best way to learn how to trade is to trade. Good luck on your journey, and I really hope this helps. Never ever, ever quit, and make the commitment to being a lifetime learner who is always in pursuit of excellence. For updates for my setups, you can visit www.tradethemarkets.com/gold, where I've placed a free video for you.

Our Live Trading Room and Streaming Real Time Analysis

It's All About the Timing

One of our favorite things we like to do at www.tradethemarkets.com is run a live Internet-based virtual trading room. This is where a group of us takes turns throughout the day and week sharing our charts and our execution platforms ... live. There is no “genius in hindsight” trading here. It’s a chance for people to see how a group of trading room moderators does under live market conditions, trading their real accounts. Why do this? Why subject ourselves to the scrutiny? The badgering? Well, if you think trading in private is fun, trading on a stage gets even more intense. Why waste precious time berating yourself for making a mistake when hundreds of people can do it for you?

I’ve already discussed the use of “anchor charts” as a significant way to filter out the weak setups. This statement should not be taken lightly. As full-time professional traders one of our greatest trading tools includes using the power of multitime-frame analysis (MTFA) to significantly increase our probabilities for success. In our day-trading room, in addition to the TTM squeeze, TTM wave, TTM trend, pivots, gaps, and market internals, two important tools in our day-trading arsenal are the TTM momentum and TTM trigger, which were introduced into our room by Rob Hoffman. As a trader, no two days and no two trades are ever alike, and the market is always there to remind us not to get too comfortable, no matter how long we have been doing this for a living. This is why it’s key to have adaptive tools at your disposal to handle today’s ever-changing market conditions.

The MTFA concept is fairly straightforward. We’re looking for alignment of buy- and sell-side opportunities on not only the time frame we’re looking to trade, but also the longer time frames. We want to identify areas of agreement between larger players moving bigger positions over hours or days and generally smaller traders moving in and out quickly on shorter time frames. The more in alignment we are with institutional money flows, the more successful we are likely to be. For interval charts, we typically use 5-, 15-, 30-, and 60-minute charts, as well as a daily chart, for intraday and overnight short-term trading analysis. We also use various tick charts, such as the 987 tick chart, for intraday analysis.

Let's Dig into the Setups

There are many ways a trader can utilize the TTM momentum and TTM trigger. For the sake of space, I’ll discuss two in this chapter and then provide a link to a free video at the end of this chapter where you can watch the remaining setups and get a deeper exploration of this versatile tool set as well as other setups we use in the live trading room. The primary setup we’re looking for with the TTM momentum and TTM trigger indicators are to have them fire off in the same direction on any individual chart that we’re looking to trade off of. To significantly increase our probability of success, we’ll want to have the next higher time frames firing off in the same direction as well.

Getting Familiar with the TTM Momentum and TTM Trigger

The TTM momentum can be found as two bars (slow and fast) at the top and the bottom of the price chart, and the TTM trigger is found as a histogram down below price. See [Figure 21.1](#).

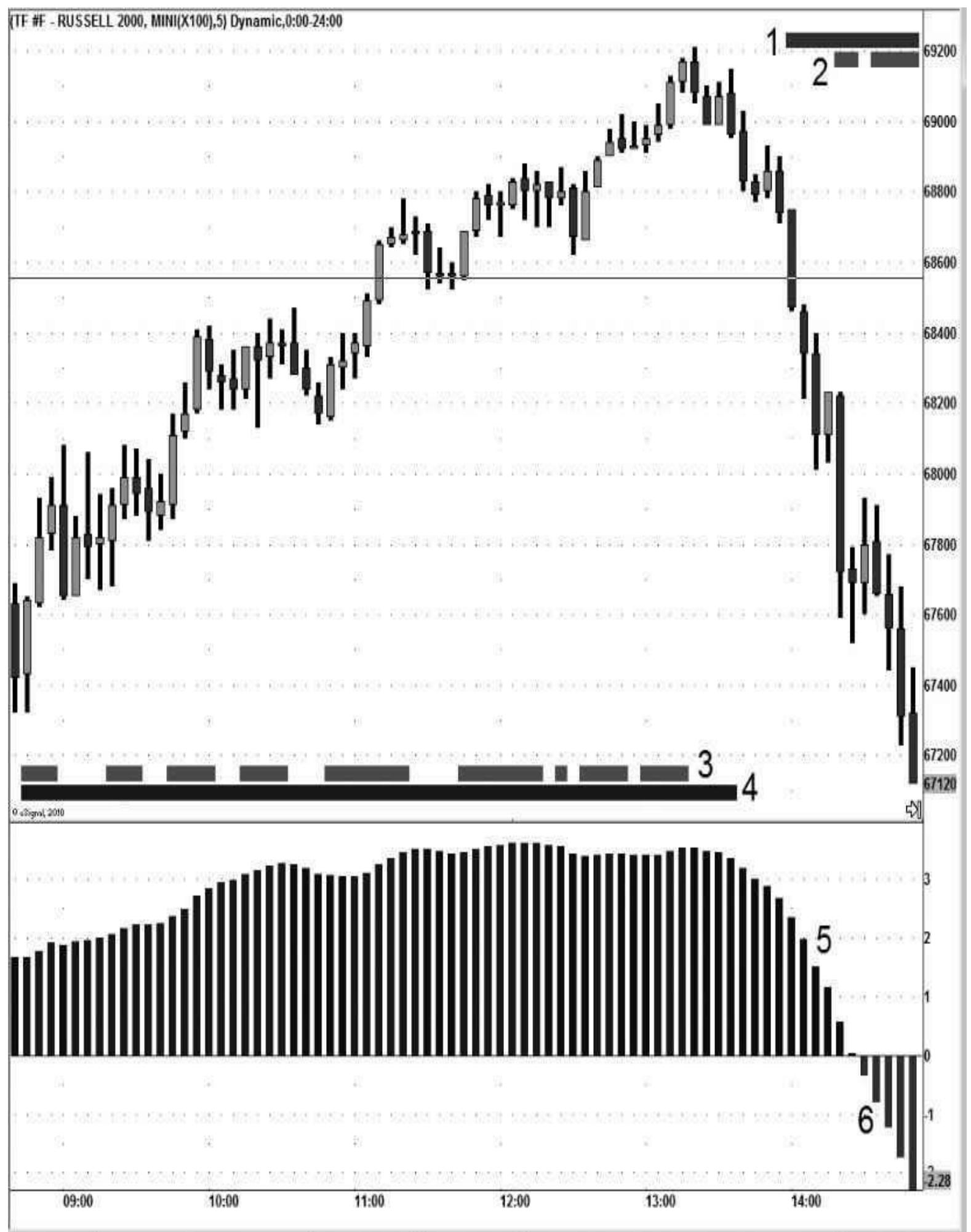


Figure 21.1

1. The slow sell momentum bar can be found at the very top of the price section of the chart.
2. The fast sell momentum bar can be found toward the top of the price section of the chart at point 2, right below the slow sell momentum bar.
3. The fast buy momentum bar can be found toward the bottom of the price section of the chart, at point 3.
4. The slow buy momentum bar can be found at the very bottom of the price section of the chart at point 4, right below the fast buy momentum bar.
5. The buy-side trigger appears as vertical bars above the center line of the histogram below the price chart, as seen at point 5.
6. The sell-side trigger appears as vertical bars below the center line of the histogram below the price chart. This takes place at point 6, turning a buy-side trigger into a sell-side trigger.

These Are the TTM Momentum and TTM Trigger “Crossover” Play Trading Rules for Sells/Shorts on Single-Chart Analysis (Buys Are Reversed)

1. For all futures markets, this is set up as a 24-hour time chart (equity and ETF charts use regular trading hours).
2. The slow sell momentum bar should be firing off sell signals, and the TTM trigger should be crossing over from the buy side to the sell side.
3. Entry takes place at the close of the bar where the TTM trigger closed below the zero line.
4. Initial stop losses are currently set to those outlined in [Chapter 10](#). However, make sure to assess the current volatility and average true range of the instrument you’re trading. For instance, as of this writing, several instruments are experiencing 100 to 200 percent increases in their average true ranges. Therefore, using stops associated with “normal” market conditions will lead to “death by a thousand cuts” in more volatile environments. When in doubt, cut position size in half and double your stop. This way you are risking the same amount of money while also giving your setup a chance to survive the normal back and forth price action.
5. We prefer profit targets set to exit on a close back above the 13-period simple moving average (SMA); another favorite for this is a trailing stop.

Mini-Sized S&P—December 2011 Contract, September 13, 2011

1. The slow sell momentum bar has kicked in (see [Figure 21.2](#)).
2. The TTM trigger crosses over to the sell side.
3. Entry takes place at the close of the bar at 1161.75.
4. Exit takes place at the close of the first bar above the 13-period SMA at 1153.25.

Mini-Sized Russell—December 2011 Contract, September 23, 2011

1. The slow sell momentum bar has kicked in (see [Figure 21.3](#)).
2. The TTM trigger crosses over to the sell side.
3. Entry takes place at the close of the bar at 644.80.
4. Exit takes place at the close of the first bar above the 13-period SMA at 632.60.

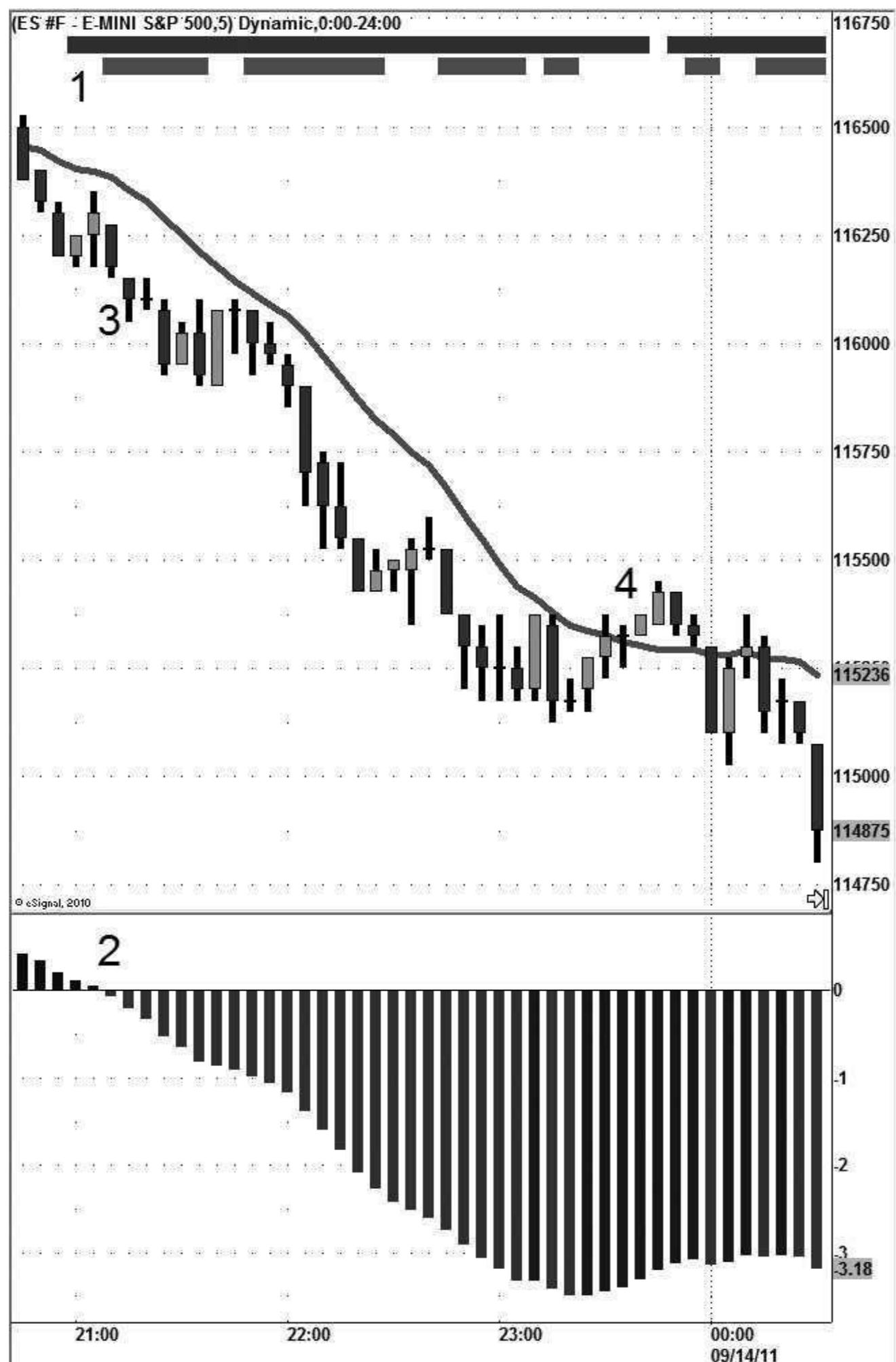


Figure 21.2

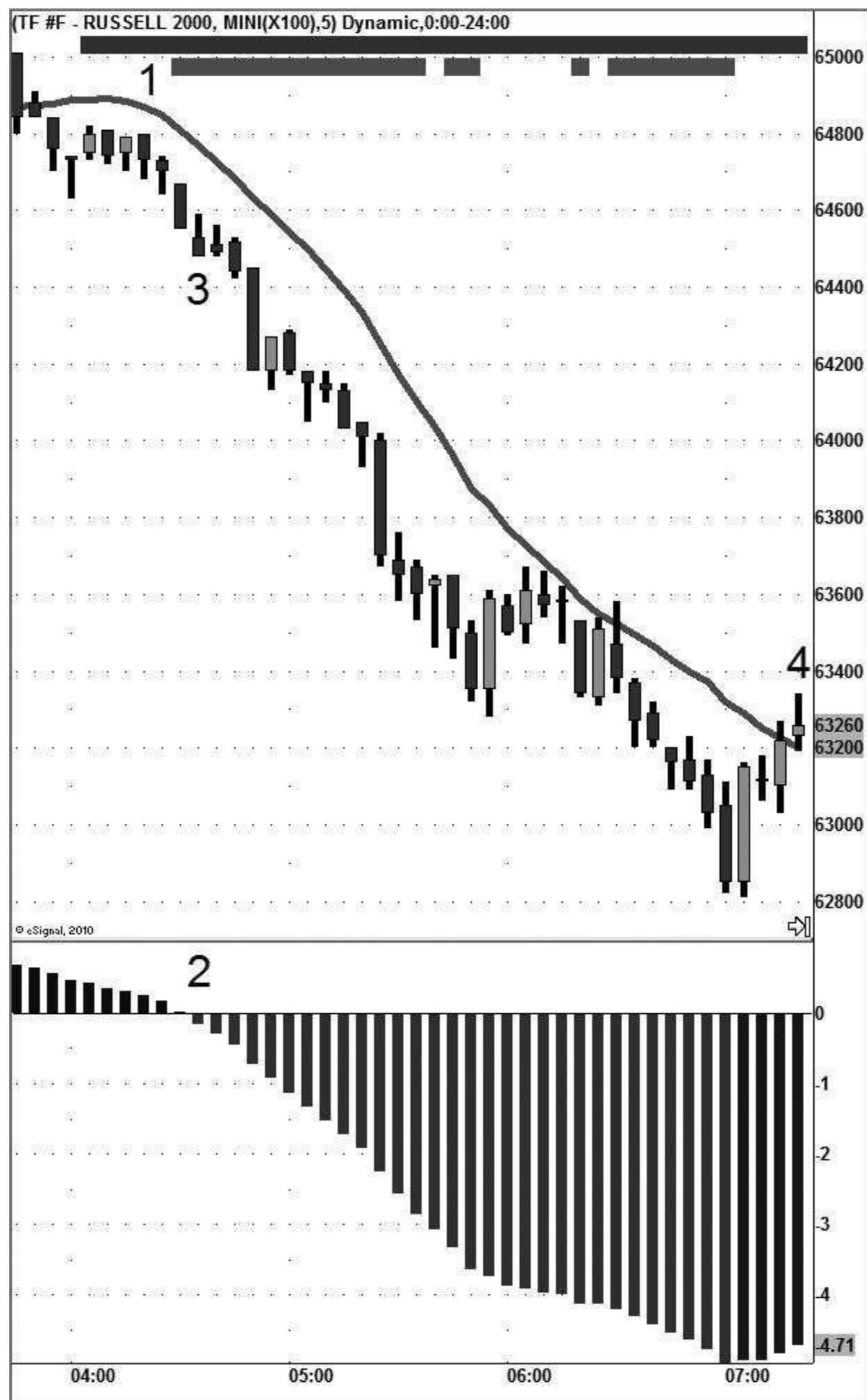


Figure 21.3

Mini-Sized Dow—September 2011 Contract, August 4, 2011

1. The slow sell momentum bar has kicked in (see [Figure 21.4](#)).
2. The TTM trigger crosses over to the sell side.
3. Entry takes place at the close of the bar at 11,761.

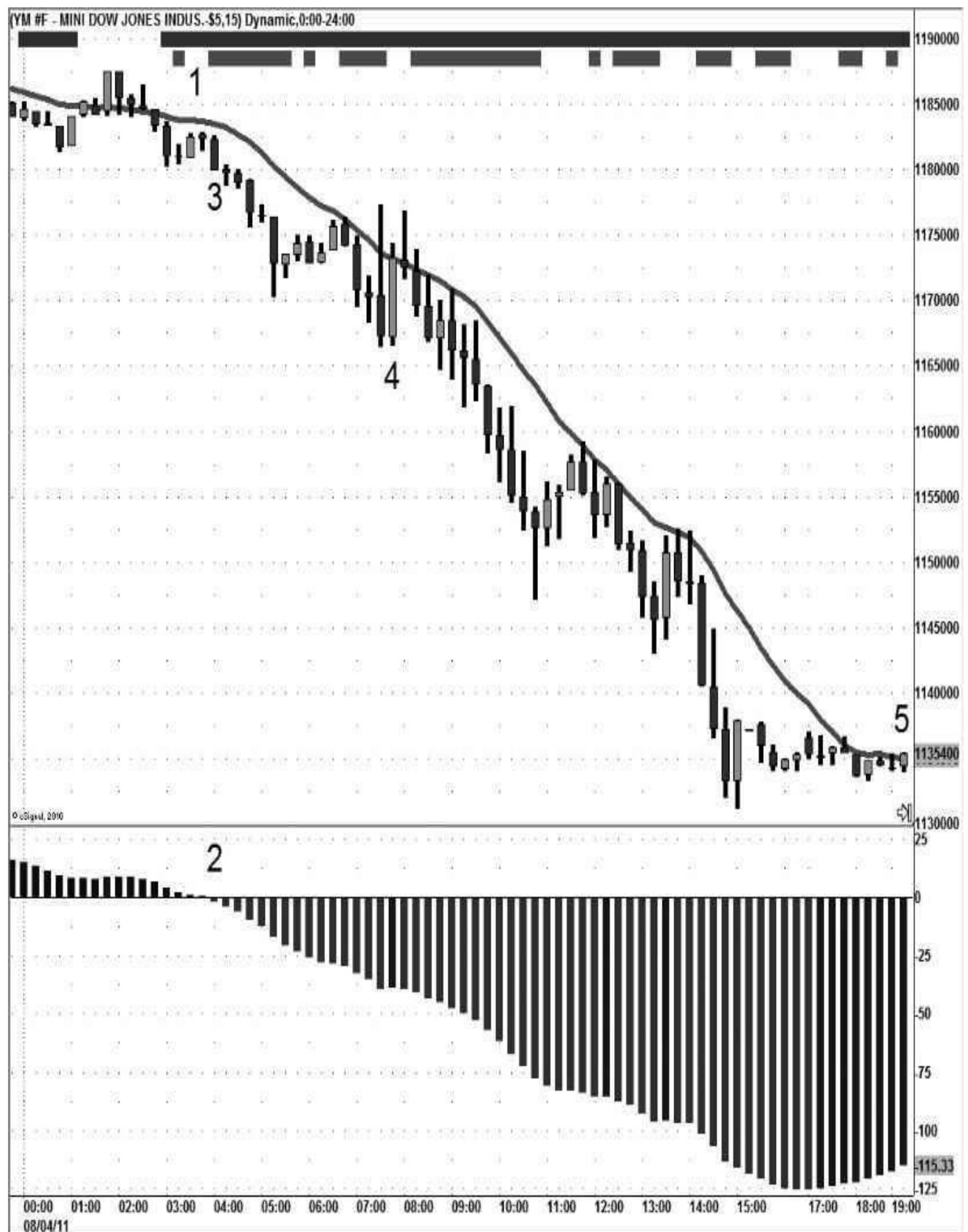


Figure 21.4

4. The trade was almost stopped out at 11,733, but it continues until it closes fully above the 13-period SMA.
5. Exit takes place at the close of the first bar above the 13-period SMA at 11,354.

These Are the TTM Momentum and TTM Trigger “Crossover” Play Trading Rules for Buys/Longs using Multi-Time-Frame Analysis (Sells Are Reversed)

1. For all futures markets, this is set up as a 24-hour time chart (equity and ETF charts use regular trading hours).
2. On the time frame you're looking to trade, the slow buy momentum bar should be firing off buy signals, and the TTM trigger should be crossing over from the sell side to the buy side.
3. In the background, for the next two higher time frames you monitor, the TTM triggers should both be showing buy-side signals. Note: if the slow buy momentum bar is also appearing, that strengthens the probability of success for the trade.
4. Entry takes place at the close of the bar where the TTM trigger closes above the zero line.
5. Initial stop losses are currently set to those outlined in [Chapter 10](#). However, see the earlier note about using the ATR.

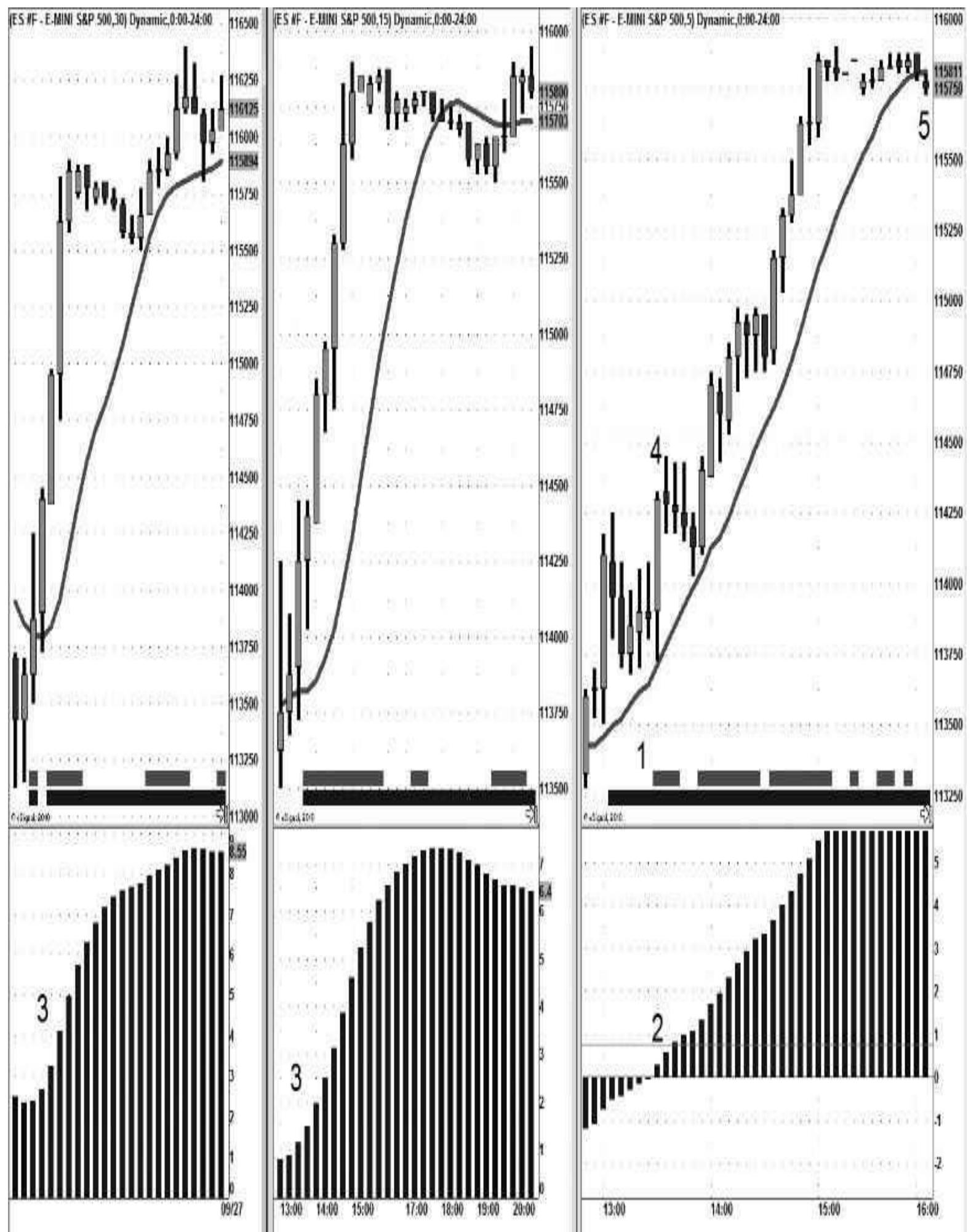


Figure 21.5

6. We prefer profit targets set to exit on either a close back below the 13-period SMA or a trailing stop.

Mini-Sized S&P—December 2011 Contract, September 26, 2011

1. The slow buy momentum bar has kicked in on the chart we're looking to trade in the example (five minutes; see [Figure 21.5](#)).
2. The TTM trigger crosses over to the buy side.
3. The 15-minute and 30-minute chart TTM triggers are rising, as shown at point 3 on these charts.
4. Entry takes place at the close of the bar at 1143.00.
5. Exit takes place at the close of the first bar below the 13-period SMA at 1157.50.

Mini-Sized Russell—September 2011 Contract, August 23, 2011

1. The slow buy momentum bar has kicked in on the chart we're looking to trade in the example (five minutes; see [Figure 21.6](#)).

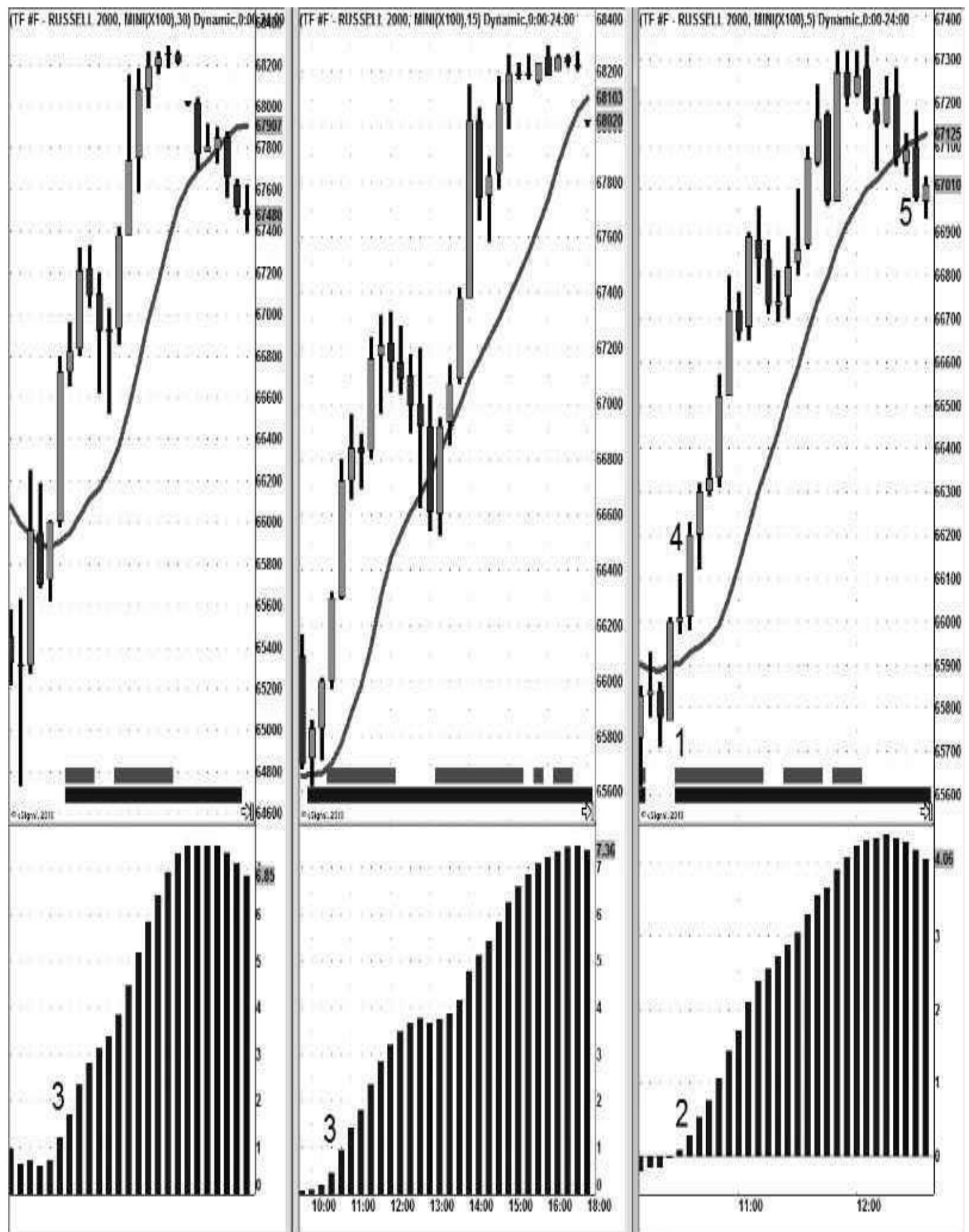


Figure 21.6

2. The TTM trigger crosses over to the buy side.
3. The 15-minute and 30-minute chart TTM triggers are rising, as shown at point 3 on these charts.
4. Entry takes place at the close of the bar at 660.10.
5. Exit takes place at the close of the first bar below the 13-period SMA (at 671.00) at 670.90, so 1 tick lower.

Mini-Sized Dow—September 2011 Contract, August 15, 2011

1. The slow buy momentum bar has kicked in on the chart we're looking to trade in the example (five minutes; see [Figure 21.7](#)).
2. The TTM trigger crosses over to the buy side.
3. The 15-minute and 30-minute chart TTM triggers are rising, as shown at point 3 on these charts
4. Entry takes place at the close of the bar at 11,311.

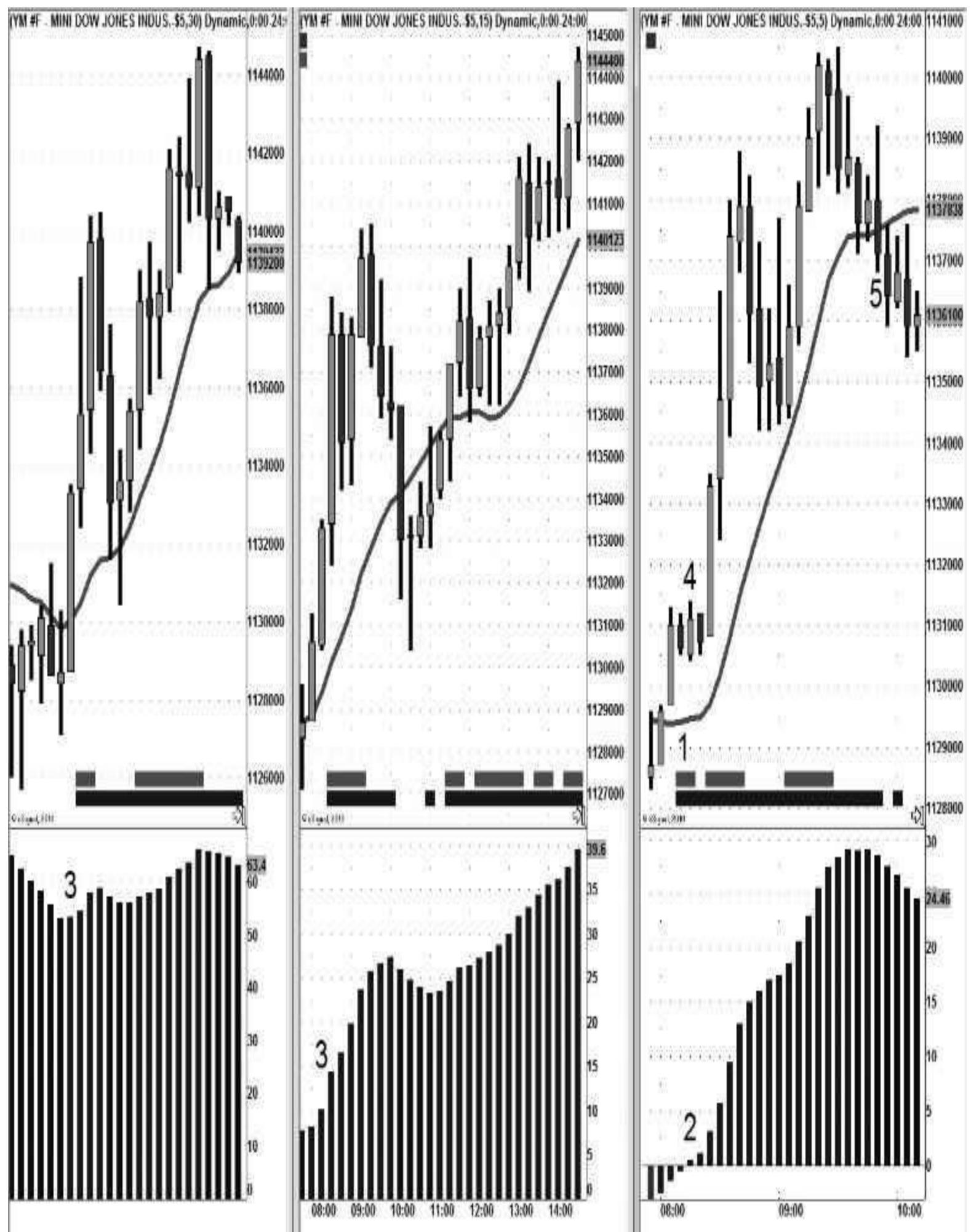


Figure 21.7

5. Exit takes place at the close of the first bar below the 13-period SMA at 11,371.

These Are the TTM Momentum and TTM Trigger “Trigger-Reversal” Play Trading Rules for Sells/Shorts on Single-Chart Analysis (Buys Are Reversed)

1. For all futures markets, this is set up as a 24-hour time chart (equity and ETF charts use regular trading hours).
2. The slow sell momentum bar should be firing off sell signals, and the TTM trigger should be reversing from a rising buy-side trigger to a falling buy-side trigger.
3. Entry takes place at the close of the bar where the TTM trigger closed lower than the previous bar and where the slow sell momentum bar has appeared.
4. Initial stop losses are currently set to those outlined in [Chapter 10](#). However, see the previous note about using the ATR.
5. We prefer profit targets set to exit on either a close back above the 13-period SMA or a trailing stop.

Mini-Sized S&P—September 2011 Contract, August 10, 2011

1. The slow sell momentum bar is firing off sell signals (see [Figure 21.8](#)).

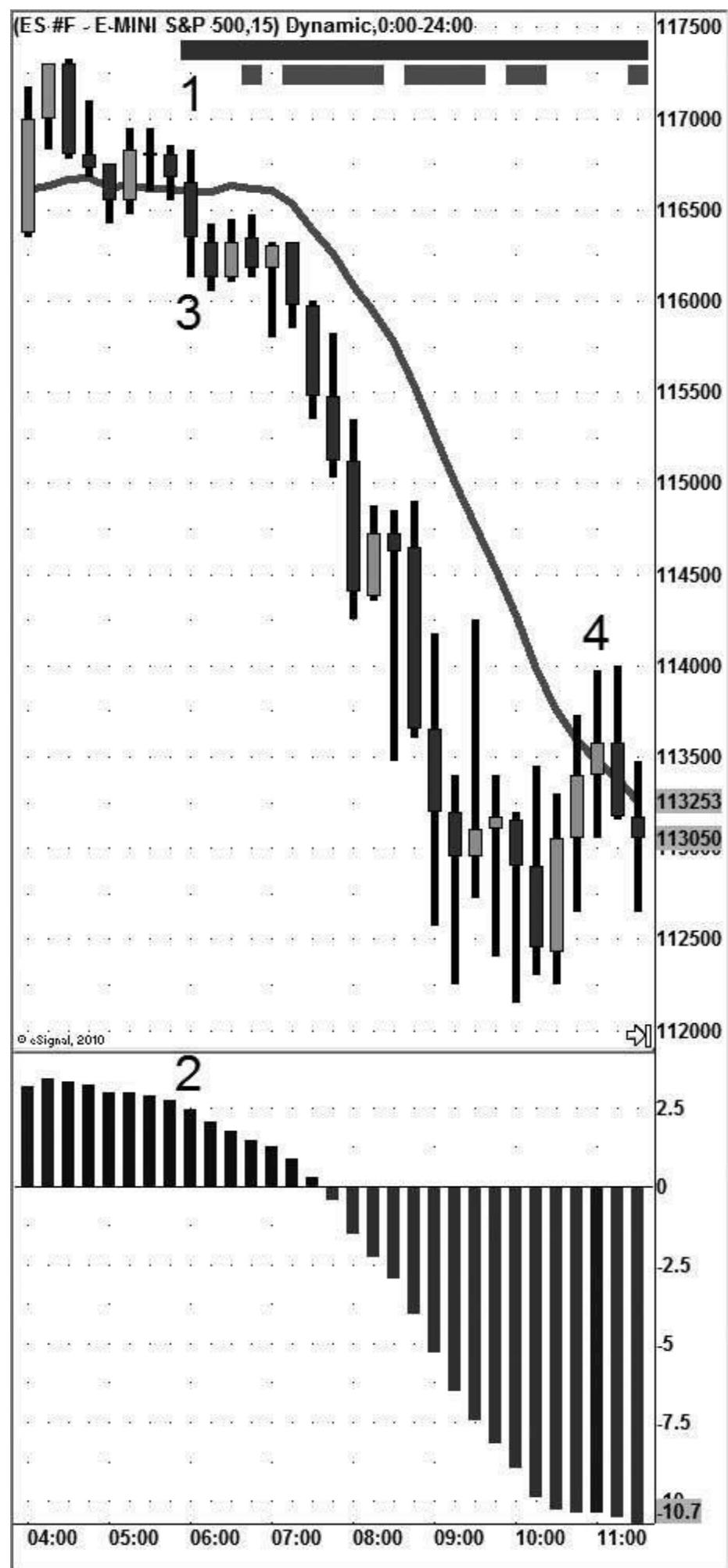


Figure 21.8

2. The TTM trigger is reversing from a rising buy-side trigger to a falling buy-side trigger.
3. Entry takes place at 1163.50 with the close of the bar where the TTM trigger closed lower than the previous bar and where the slow sell momentum bar has appeared.
4. Exit takes place at the close of the first bar above the 13-period SMA at 1135.75.

Mini-Sized Russell—December 2011 Contract, September 20, 2011

1. The slow sell momentum bar is firing off sell signals (see [Figure 21.9](#)).
2. The TTM trigger is reversing from a rising buy-side trigger to a falling buy-side trigger.
3. Entry takes place at 701.40 with the close of the bar where the TTM trigger closed lower than the previous bar and where the slow sell momentum bar has appeared.
4. Exit takes place at the close of the first bar above the 13-period SMA at 687.10.

Mini-Sized Dow—September 2011 Contract, August 19, 2011

1. The slow sell momentum bar is firing off sell signals (see [Figure 21.10](#)).
2. The TTM trigger is reversing from a rising buy-side trigger to a falling buy-side trigger.
3. Entry takes place at 10,882 with the close of the bar where the TTM trigger closed lower than the previous bar and where the slow sell momentum bar has appeared.
4. Exit takes place at the close of the first bar above the 13-period SMA at 10,780.



Figure 21.9

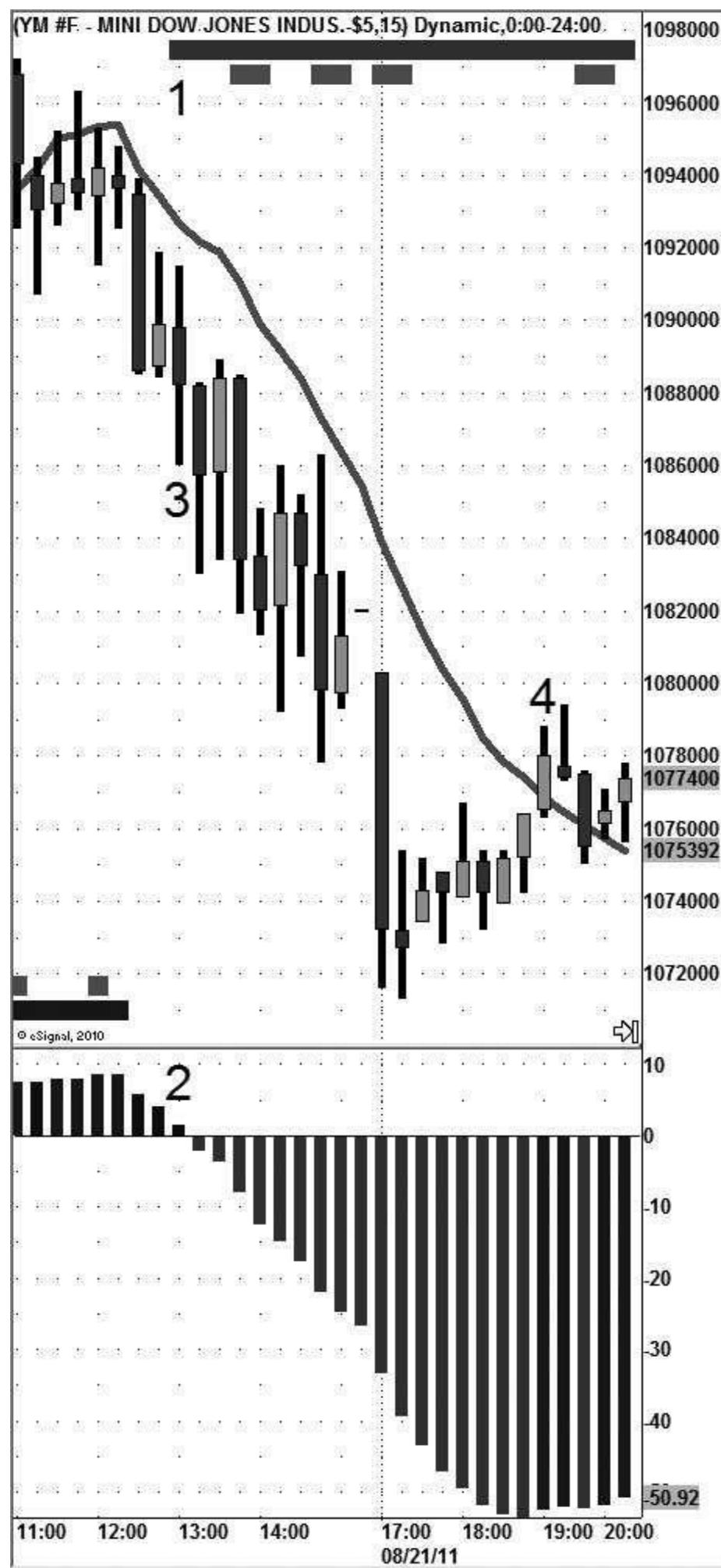


Figure 21.10

These Are the TTM Momentum and TTM Trigger “Trigger-Reversal” Play Trading Rules for Buys/Longs Using Multi-Time-Frame Analysis (Sells Are Reversed)

1. For all futures markets, this is set up as a 24-hour time chart (equity and ETF charts use regular trading hours).

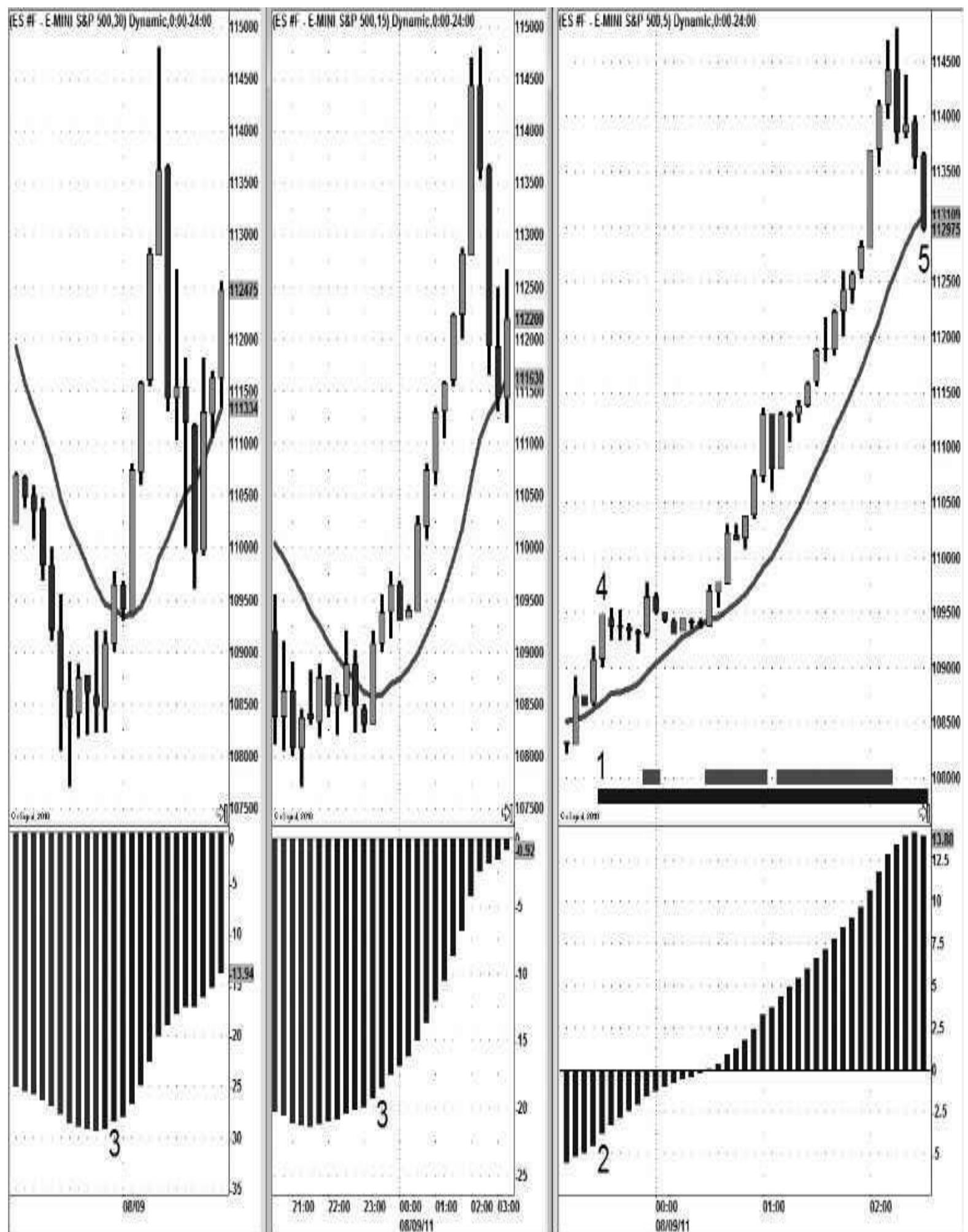


Figure 21.11

2. On the time frame you're looking to trade, the slow buy momentum bar should be firing off buy signals, and the TTM trigger should be reversing from a falling sell-side trigger to a rising sell-side trigger.
3. In the background, for the next two higher time frames you monitor, either both the TTM triggers should be firing off buy signals or the sell-side trigger should be rising toward the center line.
4. Entry takes place at the close of the bar where the TTM trigger closed higher than the previous bar and where the slow buy momentum bar has appeared.
5. Initial stop losses are currently set to those outlined in [Chapter 10](#). However, see the previous note about using the ATR.
6. We prefer profit targets set to exit on a close back below the 13-period SMA; another favorite for this is a trailing stop.

Mini-Sized S&P—September 2011 Contract, August 8, 2011

1. The slow buy momentum bar is firing off buy signals on the five-minute chart we're looking to trade (see [Figure 21.11](#)).

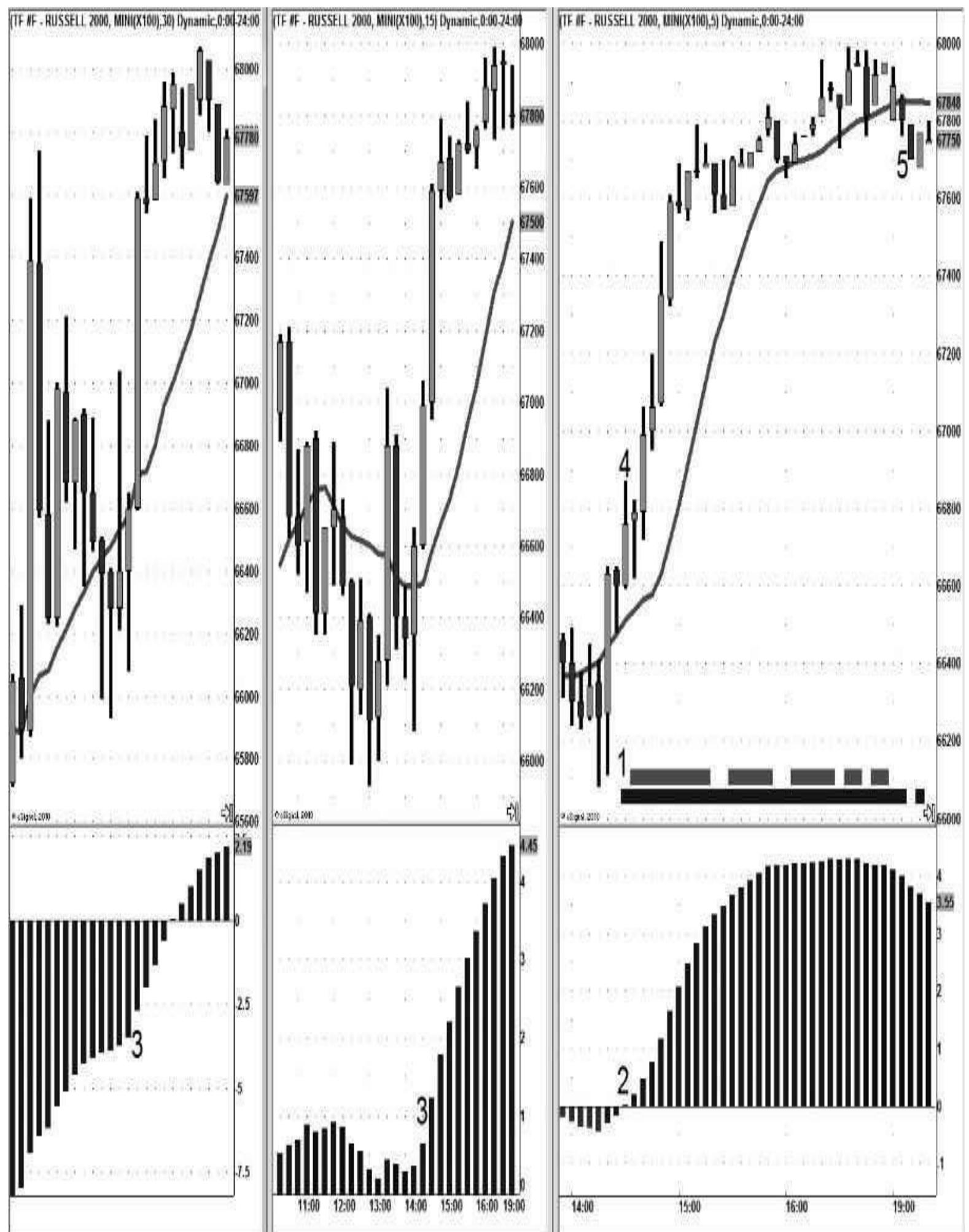


Figure 21.12

2. The TTM trigger is reversing from a falling sell-side trigger to a rising sell-side trigger on the five-minute chart.
3. The 15-minute and 30-minute chart TTM triggers are both rising bar over bar higher toward the centerline from the sell side, as shown at point 3 on these charts.
4. Entry takes place at 1094.75 with the close of the bar where the TTM trigger closed higher than the previous bar and where the slow buy momentum bar has appeared.
5. Exit takes place at the close of the first bar below the 13-period SMA at 1129.75.

Mini-Sized Russell—September 2011 Contract, September 12, 2011

1. The slow buy momentum bar is firing off buy signals on the five-minute chart we're looking to trade (see [Figure 21.12](#)).
2. The TTM trigger is reversing from a falling sell-side trigger to a rising buy-side trigger on the five-minute chart.

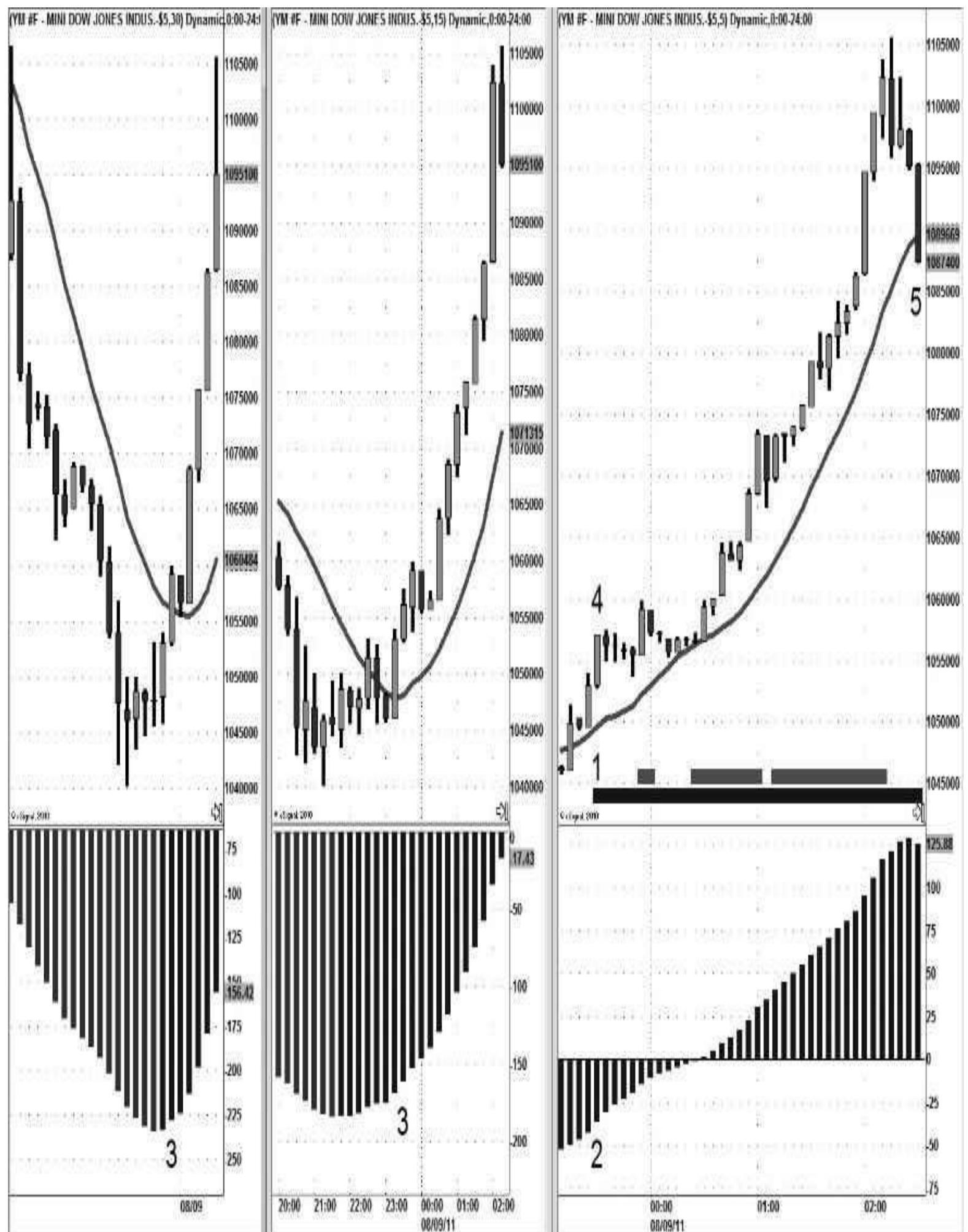


Figure 21.13

3. The 15-minute and 30-minute chart TTM triggers are already above the buy-side centerline and rising from the sell side, respectively, as shown at point 3 on these charts.
4. Entry takes place at 667.60 with the close of the bar where the TTM trigger closed higher than the previous bar and where the slow buy momentum bar has appeared.
5. Exit takes place at the close of the first bar below the 13-period SMA at 678.00.

Mini-Sized Dow—September 2011 Contract, August 8, 2011

1. The slow buy momentum bar is firing off buy signals on the five-minute chart we're looking to trade (see [Figure 21.13](#)).
2. The TTM trigger is reversing from a falling sell-side trigger to a rising sell-side trigger on the five-minute chart.
3. The 15-minute and 30-minute chart TTM triggers are both rising bar over bar higher toward the centerline from the sell side, as shown at point 3 on these charts.
4. Entry takes place at 10,571 with the close of the bar where the TTM trigger closed higher than the previous bar and where the slow buy momentum bar has appeared.
5. Exit takes place at the close of the first bar below the 13-period SMA at 10,874.

Strategies for Those Who Can't Trade Full-Time

In the current economy, it can be tough to find a great job with a great boss, a quick commute, and a salary that makes us happy. This is one of the reasons that many budding traders want to enter trading. But to achieve a sufficient level of proficiency to do this full time takes time and effort. We personally know what it's like to have first and even second careers ahead of trading, but with trading and independence being our primary dream and goal. This is one of the reasons we've made our Live Trading Room available through various portable media, such as iPads and iPhones: to allow you to take the room on the road and to work with you so that you can learn while you earn at your other career. In the meantime, until you can make the full transition to professional trader status, one option that can be available to you in your off-hours is swing trading. The good news is that all of the TTM momentum and TTM trigger concepts just covered can be very effective for swing trades. The only difference is that for swing trading, we're focusing on daily and weekly charts for our analysis. See the following examples.

PCLN, July 12, 2010

1. The slow buy momentum bar is firing off buy signals on the daily chart we're looking to trade (see [Figure 21.14](#)).
2. The TTM trigger is reversing from a falling sell-side trigger to a rising sell-side trigger on the daily chart.
3. The weekly TTM trigger is already on the buy side, as shown at point 3.
4. Since this is a daily chart, entry takes place at 207.10 with the open of the next bar after the TTM trigger closes higher than the previous bar and where the slow buy momentum bar has appeared.
5. Exit takes place at the close of the first bar below the 13-period SMA at 291.80.

AAPL, June 29, 2011

1. The slow buy momentum bar is firing off buy signals on the daily chart we're looking to trade (see [Figure 21.15](#)).
2. The TTM trigger is reversing from a falling sell-side trigger to a rising sell-side trigger on the daily chart.
3. The weekly TTM trigger is already on the buy side, as shown at point 3.

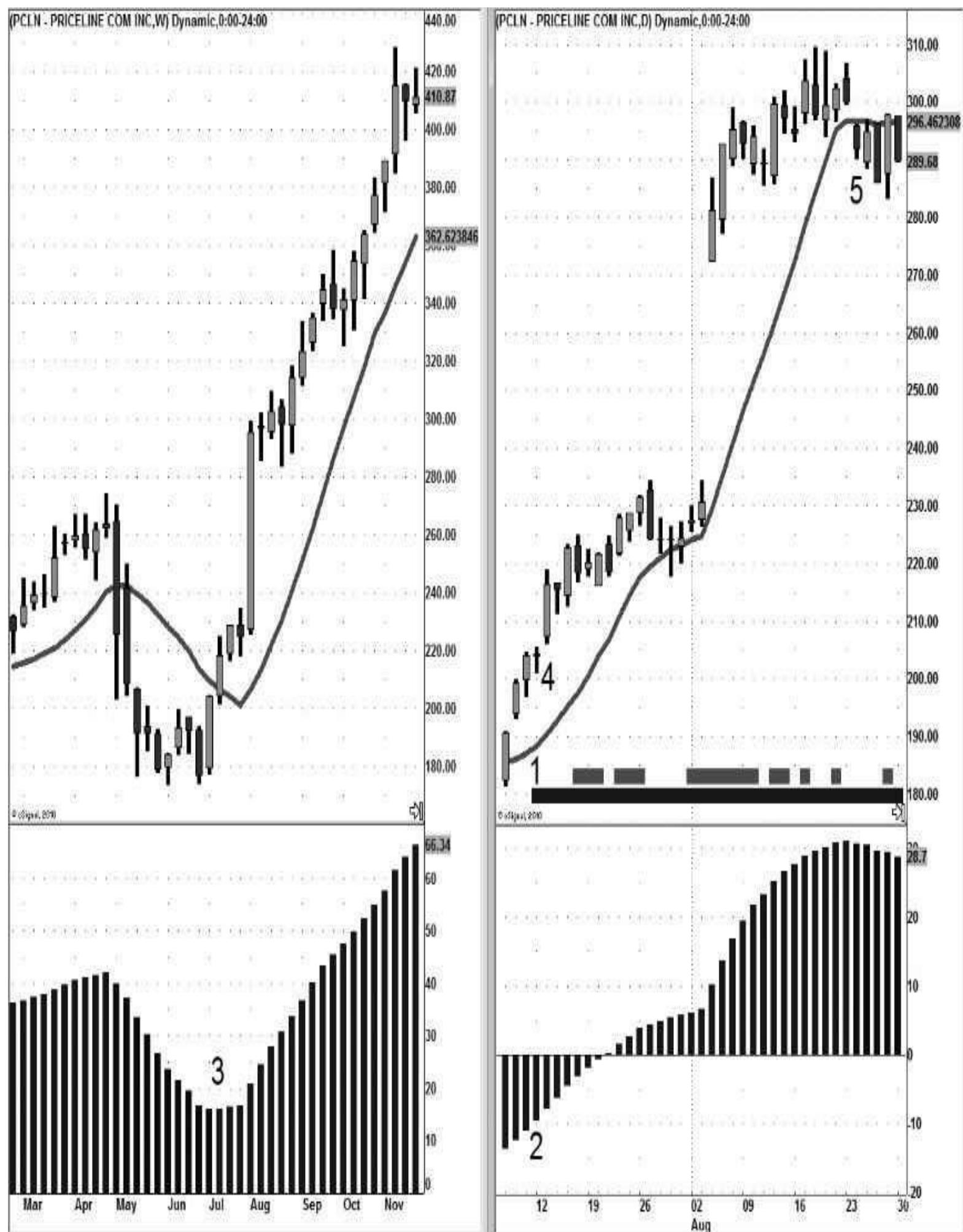


Figure 21.14

4. Since this is a daily chart, entry takes place at 334.70 with the open of the next bar after the TTM trigger closes higher than the previous bar and where the slow buy momentum bar has appeared.
5. Exit takes place at the close of the first bar below the 13-period SMA at 377.37.

Summing Up the Trades

The TTM momentum/trigger setup is designed to detect and validate a trend as early as possible and to keep traders on the right side of the market for the primary piece of the trend and pullbacks within the trend. It was not designed to be a more risky top-catching and bottom-catching tool. It was developed many years ago, and it has stood the test of time through many market cycles.

We have set up a free video at www.tradethemarkets.com/tradingroom that discusses additional setups utilized with these indicators as well as examples of the types of trades taken in our live trading room.

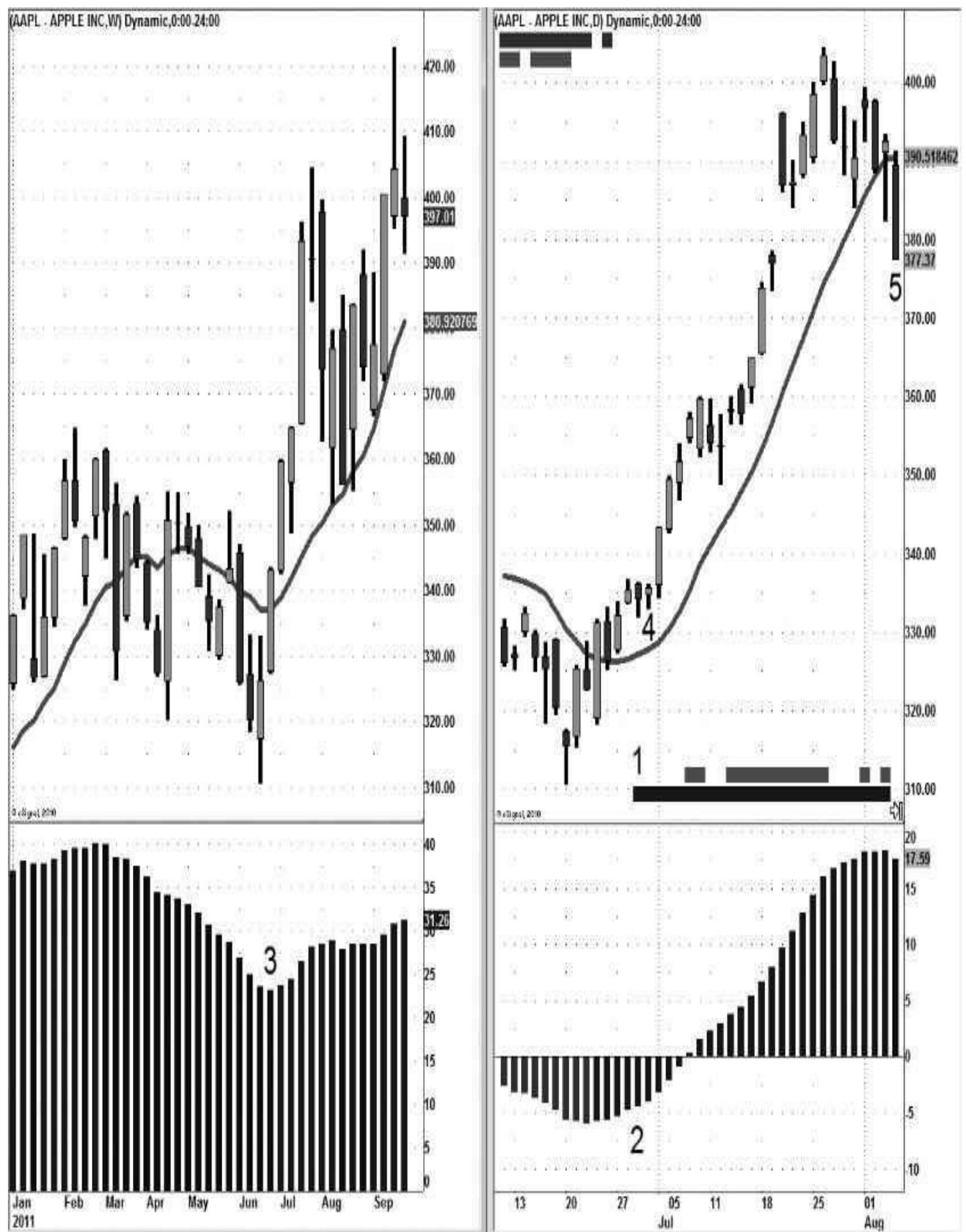


Figure 21.15

Propulsion Plays— Swing Plays Using Stocks, Single-Stock Futures, and Stock Options

Setting Up for the Bigger Moves in Individual Stocks

To me, some of the greatest risk takers on Wall Street are long-term investors. They will stubbornly hold on to a stock that they bought three years ago because they have a “long-term view.” It doesn’t matter that the company is beating off its creditors with a lead pipe. It doesn’t matter that the stock is down more than 80 percent from the entry price. It doesn’t even matter if the CFO was recently seen sharing an 8 × 8 cell with Martha Stewart. What matters is that, come hell or high water, they have blind faith that if they step back and take the long-term view, all will be well in the end. All’s well that ends well, right? Of course. Unfortunately, this ain’t Shakespeare’s play; this is Wall Street.

This came to me in glaring full color in early 2000. First, there was the Super Bowl. I don’t even remember who played in that game, but I do remember the 18 commercials that played advertising various dot-com companies that were blowing their whole annual marketing wad on this one 30-second spot. I also remember that this was the time the first ever “day-trading expo” took place in southern California. Finally, I remember my refrigerator breaking down. It wasn’t the actual breaking down that was significant, but the man I called out of the Yellow Pages who came to fix it for me was. The job took him exactly 84 minutes. The first 12 minutes were spent fixing the refrigerator. The rest of the time he spent preaching to me about his favorite stocks in the Nasdaq and why Cisco was worth \$500 a share. I tried to stop him halfway through his lecture to let him know that a fleck of saliva was hanging off his chin, but he wouldn’t let up. As he preached the gospel of the Internet, I realized that there was so much excitement in this current market that it really didn’t matter how far down it went when the crash finally came—people were now believers, and they would hold on until they got their margin call. By the time he left, I started looking at my charts for any breaks of the low of the high day. There weren’t any that day, but a month later there were plenty.

I do focus some of my efforts on finding newer companies that have the potential to make a big splash with a new product. I look at *Investor’s Business Daily* to find these candidates. It’s the new companies that have the potential for big gains. There are many long-term trend-following opportunities in the markets, on both the long and the short side. However, finding the next Microsoft is not my trading niche. If I do find it, great, but in the meantime, I’m going to keep looking for setups. Therefore, most of my “long-term” efforts in the stock market involve swing trading, and one of my favorite setups is what I call propulsion plays. This is a systematic approach to getting positioned in stocks over a few days to a few weeks. Some 70 percent of the time, individual stocks spend their days backing and filling in a tight range, building up steam for their next major move. This approach looks for stocks that are done with their “resting period” and are getting ready to spurt higher (or lower) once again.

The idea is to already be in the stock when it makes a push higher (for longs) or lower (for shorts), instead of trying to chase it intraday. The reason I like to do this is that there are many times in the market when very few intraday trading opportunities in the stock indexes set up. Some of the sectors are up and some are down, resulting in a very choppy and quiet overall market. However, during these times, there are always going to be individual stocks that are making a move. When I am positioned in these stocks over the course of a few days to a few weeks, I don’t feel forced to get into intraday trades in the stock index futures when nothing is really setting up. This is because I already have positions on that are set up to take advantage of the next “mini-move.”

For this setup, I’m focusing mostly on individual stocks. However, on individual stocks that also trade single-stock futures (SSFs) and stock options, I will consider plays in those instruments as well. Because SSFs are new and because most people play options incorrectly, I’m going to spend a little time reviewing how they work and how I use them. Let’s review.

The Trader’s Guide to Single-Stock Futures

Single-stock futures (SSFs) are futures contracts on individual stocks. There are currently around 130 well-known stocks, such as IBM, QCOM, EBAY, GOOG, RIMM, and MSFT, that have futures on them. This is a recent development, since it was only in late 2000 that Congress passed legislation lifting the ban on these products, which were already trading in Europe and other countries. There are also futures contracts available on many exchange-traded funds (ETFs). To get a complete listing of all these futures contracts, a trader can visit www.onechicago.com. One Chicago is an electronic exchange that is a joint venture of the Chicago Board Options Exchange (CBOE), the Chicago Mercantile Exchange Inc. (CME), and the Chicago Board of Trade (CBOT). Of course, the CBOT and CME are now part of the same company, CME Group. Now, how do SSFs work and how does a trader use them?

Many brokers have been slow to adapt to these new trading instruments, but they are starting to catch on. Because they are futures contracts, traders need to have a futures account in order to trade them. On top of that, they also need to be trading with a broker that is set up to trade them, as not every broker is equipped to handle these trading instruments. Once that is completed, these are traded just like a normal futures contract, and they are available through eCBOT and Globex, just like the mini-stock index futures.

Whereas mini-stock index futures contracts like the YM and ES trade quarterly, the SSFs trade monthly. Traders who aren’t familiar with the letter codes for the various months should write this down and tape it to their wall as a reference guide. These are applicable to all futures contracts:

F	=	January
G	=	February
H	=	March
J	=	April
K	=	May
M	=	June
N	=	July
Q	=	August
U	=	September
V	=	October
X	=	November
Z	=	December

To get a quote on an EBAY (eBay Inc.) single-stock futures contract in Trade-Station, a trader would type in EBAY (underlying stock symbol) 1C (One Chicago) V (Month Code) 05 (Year). So the final quote for the EBAY October 2005 SSFs would look like this: EBAY1CV05.

There are a few nice features of SSFs that I find attractive. First, the “\$25,000 day-trading rule” does not apply. Active traders who have a \$50,000 account and tie up \$26,000 of that in options trades will suddenly find themselves out of luck. They will not be able to execute any new stock or options trades because the broker won’t count the option value toward the traders’ equity. This situation would draw their “countable” account balance below \$25,000, and traders would be locked out of initiating any new trades. An annoying situation, to be sure. SSFs provide the leverage of “just-in-the-money” options without the restrictions constraining “pattern day traders” and their account size. Here are a few additional key points:

- On stock accounts, a trader can get a 2:1 overnight margin, and the interest charged is the same amount a person would pay for a mediocre deal on a credit card. For SSFs, the equivalent of a 5:1 margin is available, and there are no interest fees.
- 5:1 leverage equates to having to put up 20 percent of the purchase price of the underlying stock. A trader who buys \$10,000 worth of IBM (100 shares at \$100) by using one IBM SSF contract would have to put up only \$2,000. A trader who buys 10 contracts of IBM 1C at \$95 (\$95,000 worth of IBM) would put up \$19,000, and so on.
- When shorting stocks, a trader has to wait for an uptick in order to get filled (although this rule should be changed soon). There isn’t any uptick rule for short selling an SSF contract. This is becoming less important as more and more actual stocks are becoming shortable on downticks.
- One SSF contract equals 100 shares of stock.
- A 1-point move equals \$100 per contract.
- These are monthly contracts that expire the third Friday of each month, just like options. If traders own a February contract on the day it is expiring, they will need to sell the February contract and buy the March contract. This is also known as “rolling over” into the next month. If traders hold on to the contract through expiration, they will have the stock “delivered” into their account. Don’t worry about forgetting, however, because brokers don’t want to deal with this, and they will call and pester you to close out your position days before expiration.

The biggest question I get about SSFs has to do with their volume. For many of these contracts, there is not a lot of volume traded at this time, and this is an obvious concern for traders. However, it is important to note that the “real volume” of an SSF contract is in the underlying stock itself. The LMMs (lead market makers) and MMs (market makers) for SSF products make their living buying and selling SSF contracts and immediately hedging or arbitraging that position with the underlying cash stock. Because of this, they will fill any order that is in line with the underlying volume of the stock. Since most of these stocks trade millions of shares, getting a fill is not an issue. There have been days when I’ve been the only one trading the SSF, and yet I have had no problem getting into and out of the position. On those days, which rarely happen anymore because volume is steadily growing, it’s fun knowing that I’m the only person in the entire world who made money on that trade.

The other question I get from traders involves the spreads. If there aren’t any orders coming in, then the LMMs and MMs will keep the spreads wide. This is so that they don’t end up trading against each other. However, once a real order comes in, they will close the bid and ask to be in line with those on the underlying stock and snap it up. Because of this, I never use market orders when I’m getting into an SSF trade. I just look to see where the underlying stock is trading and place a limit order based on the price of the underlying stock.

The other thing to remember about SSFs is that their charts are pretty much worthless at this time. The volume is sporadic, so the charts aren’t very clean. The best thing to do is to chart the underlying cash stock and then base all decisions to get into and out of the SSFs on the underlying stock. What I will do is set up the chart of an underlying cash stock and then put the quotes for both the cash stock and the SSF contract below it so that I can see where the current bid/ask is located. However,

because most of my trades in the SSFs are swing trades, I don't even watch the charts intraday. I just set up my limit orders the night before based on the cash chart and then wait until the end of the day to see if I'm filled.

We'll look at a couple of sample plays on EBAY and QCOM in a moment. First I want to discuss options quickly.

The Only Way to Play Individual Stock Options

I'm writing this section based on the premise that the reader knows at least a little about what options are and how they work. If not, that's okay. There are plenty of websites out there that explain them in detail, and I would recommend reading more about what options are and how they work if you plan on using them. I'm just going to give you a quick rundown and share how I incorporate them into my trading plan. (Of course, this new edition of the book has a new chapter on options, [Chapter 5](#).)

There are many complicated option strategies available, and many people spend hundreds of hours looking for the perfect strategies to generate "guaranteed income." Most of these strategies work great when the markets are range-bound—which they are most of the time. Then along comes the inevitable big rally or watershed decline, and all these people get thrashed. For a period of years in the mid-1990s, a lot of traders and funds made a nice living selling naked puts. These are put options whose writers do not have a short position in the stock on which they have written the put. The goal here is to have the options expire worthless, so that the put writers collect the premium. Many books started popping up on the shelves about "taxi-driver millionaires" who discovered this "amazing get-rich-quick" trading strategy. Then along came October 27, 1997.

The markets had been drifting down through October, and many of the taxi drivers, as well as several large funds with a few hundred million in assets, were busy selling naked puts. The brokers who worked with the funds started getting nervous because the positions had gone against the funds to the point where it wouldn't take much of a further decline to start forcing margin calls. The brokers, who didn't quite understand the strategy that the funds were using, started to place discreet calls to other traders asking what would happen "if the Dow dropped a couple of hundred more points" over the next week or so. The answer was easy—these funds would be forced to dump their positions because of margin calls, and this would create tremendous downward selling pressure in the overall markets. The S&P 500 floor traders at the CME got wind of this and started prepping for the slaughter.

On October 16, 1997, the Dow broke through its most recent uptrend line, as seen at point 1 in [Figure 22.1](#). The Dow then rallied and closed at 8034.65 on October 22, just below its broken trend line, at point 2. This is a common occurrence in all markets—once a trend line is broken, the markets will come up and test it one last time before rolling over. I call this "kissing the trend line goodbye." On October 24, at point 3, the Dow closed at 7715.41, down 319.24 points. This started the round of forced margin calls after the close, which was on a Friday. The margin call selling would take place on Monday. The Dow opened Monday at 7633.14, down 82.27. Then the forced selling via the margin calls began—and the S&P pit traders, who knew what was happening, simply stepped back and walked away from the bids. With no support in the markets, the Dow dropped quickly and closed at 7161.39, down 554.02 points on the day, as seen at point 4. By the time the closing bell rang on Monday, everyone who was selling naked puts for a living had lost a substantial amount of money. The funds that were involved not only lost all the money under their management, but ended up owing money to the brokers. Well, more correctly, the people who had invested in the fund lost all their money, and ended up owing more than they had put into the fund. Many metaphors come to mind here, but I will pass, as most of them are quite graphic in nature. Once all these people were cleaned out, the markets were set to rally. The very next day, the markets pushed down to new lows, touching 6927 at point 5, having shed just over 1,000 points in three trading days, before putting in a hard bottom. The Dow then closed at 7498.32, up 336.93 points on the day, and went on to rally steadily from there. Once all of the naked put sellers were cleaned out, there was nothing to do but resume the uptrend.



Figure 22.1

Okay, so how do I use options? The main way I use options is as a means for owning a stock at a cheaper price. Because of the premium and time decay, I am very specific about the options I buy. For example, I won't buy out-of-the-money options, as they are all premium and a sucker's game. Therefore, I want to look at options that are trading in the money ("in the money" means that the option's strike price is below the current market price of the stock for call options, and that the strike price is above the current market price of the stock for put options), if not more, in order to buy an option where the premium constitutes less than 30 percent of the overall purchase price. In early 2005, the premium of options was generally low, so I could usually buy options just one strike in the money to meet this criterion. In 1999 and 2000, however, option premiums had been at extremes, and I often had to go 5 to 10 strikes in the money to buy options that met my criteria. I remember when QCOM was at \$250 before its infamous "run to a thousand" at the end of 1999. At-the-money call options were \$45. In order to buy calls that were only 30 percent premium, I had to go nearly 15 strikes in the money.

The option table represented in [Figure 22.2](#) shows different strike prices and expiration months for GOOG. At the time this was created, in early November 2004, GOOG was trading at \$191.67. If I am interested in buying a call on this stock, I'll start looking at the near-month contracts that are in the money. Because GOOG is a higher-priced, volatile stock, the option premiums are going to be high—the higher the volatility, the higher the premium. In this case, I look at the November 180 calls, which are two strikes in the money. The premium on these is still excessive, and I need to go down one more strike price, to the November 175 calls, to meet my criterion of the premium being less than 30 percent of the overall purchase price. The amateur option trader in this case is going to buy the November 220 calls because they are so "cheap" at \$2.55. Never mind that they will expire worthless. For puts, I first look at the November 200 puts, but they are too expensive. I look at the 210s, and they are close, but the 220s are better with respect to the amount of premium I want to pay. Remember, all I'm trying to do is buy (or short) the actual stock at a cheaper price. This means that I don't want a lot of premium. Looking at the next month out in December, these same strike prices jump up excessively in price, so I want to stay with the near-month contracts and wait until expiration to roll over into December if I have to. I'll explain more about how to figure out premium shortly. (As I discussed in [Chapter 5](#), an easy way to do this is just to buy an option with a delta of 0.70 or higher.)

Options1



GOOG  M Q % 9 ok

GOOGLE INC Bid: 118.39 BSize: 1 Vol: 13.9M Nov04
191.57 GALLS Ask: 264.69 ASize: 1 Volatility: 64.9% 18:40 Today's Date: 11/3/2004 PUTS

Oplt	Vol	Bid	Ask	Change	Last	Symbol	Symbol	Last	Change	Ask	Bid	Vol	Oplt	
4.17K	106	37.70	38.00	-5.20	36.90	GOO KZ	NOV04 155.00	GOO WZ	-0.10	1.05	0.90	1.85K	8.97K	
4.48K	569	33.20	33.40	-2.70	33.10	GOO KY	NOV04 160.00	GOO WY	-1.35	-0.10	1.50	1.30	936	7.00K
3.90K	103	28.80	29.10	-3.10	28.50	GOO KX	NOV04 165.00	GOO WX	-2.15	-0.15	2.10	2.00	1.25K	6.64K
4.94K	706	24.60	25.00	-3.40	24.40	GOO KW	NOV04 170.00	GOO WW	-2.95	-0.25	3.00	2.80	2.33K	6.60K
3.77K	447	20.80	21.20	-2.70	20.50	GOO KO	NOV04 175.00	GOO WO	-4.20	-0.40	4.10	4.00	1.44K	8.16K
7.35K	1,63K	17.40	17.70	-2.60	17.40	GOO KP	NOV04 180.00	GOO WP	-5.80	-0.70	5.80	5.50	2.47K	8.09K
6.26K	1,73K	14.30	14.60	-1.20	14.60	GOO KO	NOV04 185.00	GOO WO	-7.60	-0.40	7.50	7.40	1.86K	4.22K
5.53K	2,54K	11.50	11.80	-2.20	11.50	GOO KR	NOV04 190.00	GOO WR	-10.00	-1.00	9.90	9.60	2.10K	5.10K
4.27K	3,43K	9.20	9.30	-2.00	9.10	GOO KS	NOV04 195.00	GOO WS	-12.60	-1.10	12.30	12.20	1.46K	1.85K
9.55K	5,52K	7.10	7.30	-1.80	7.20	GOO KT	NOV04 200.00	GOO WT	-15.00	-1.70	15.60	15.20	1.38K	1.52K
8.40K	4,37K	4.30	4.30	-1.50	4.30	GOO KB	NOV04 210.00	GOO WB	-22.10	-0.60	22.70	22.30	779	251
7.00K	3,08K	2.50	2.55	-0.85	2.55	GOO KD	NOV04 220.00	GOO WD	-31.00	-1.60	30.80	30.50	102	197
4.38K	2,58K	1.40	1.55	-0.65	1.45	GOO KE	NOV04 230.00	GOO WF	-39.90	-2.50	39.70	39.30	17	90
3.78K	—	41.10	41.50	-1.60	41.90	GOO LZ	DEC04 155.00	GOO XZ	-4.50	-0.10	4.60	4.30	118	2.75K
1.69K	20	37.30	37.70	-1.80	40.40	GOO LY	DEC04 160.00	GOO XY	-5.50	-0.20	5.70	5.40	390	2.51K
1.21K	1	33.50	33.90	-2.70	39.50	GOO LX	DEC04 165.00	GOO XX	-6.90	-0.10	7.00	6.70	130	5.53K
4.19K	103	30.10	30.50	-2.40	30.50	GOO LW	DEC04 170.00	GOO XW	-8.50	0.00	8.60	8.30	617	2.36K
96	162	26.70	27.10	-3.00	26.80	GOO LO	DEC04 175.00	GOO XO	-10.10	-0.50	10.20	9.90	132	1.57K
2.79K	173	23.80	24.20	-1.90	23.80	GOO LP	DEC04 180.00	GOO XP	-12.00	-0.70	12.20	11.90	308	2.46K
5.59K	132	21.00	21.40	-2.70	20.80	GOO LQ	DEC04 185.00	GOO XQ	-14.30	-0.30	14.40	14.10	339	1.55K
2.44K	420	18.50	18.90	-2.60	18.30	GOO LR	DEC04 190.00	GOO XR	-17.20	-1.20	17.00	16.60	483	1.62K
1.85K	481	16.20	16.60	-2.50	15.80	GOO LS	DEC04 195.00	GOO XS	-19.80	-0.80	19.70	19.30	132	974
4.34K	1,80K	14.40	14.50	-2.20	14.10	GOO LT	DEC04 200.00	GOO XT	-22.70	-1.30	22.60	22.20	194	797
5.20K	600	10.70	11.00	-1.90	10.50	GOO LB	DEC04 210.00	GOO XB	-28.90	-1.00	29.20	28.80	161	336
3.31K	454	8.00	8.30	-1.70	7.80	GOO LD	DEC04 220.00	GOO XD	-36.10	-2.50	36.40	36.00	67	223
929	751	5.90	6.20	-1.30	6.00	GOO LF	DEC04 230.00	GOO XF	-41.90	-0.10	41.30	41.90	70	201
492	20	49.90	50.40	-1.10	52.80	GOO CZ	MAR05 155.00	GOO OZ	-11.50	-1.30	13.30	12.90	44	3.04K
1.22K	13	46.60	47.10	-0.70	49.40	GOO CY	MAR05 160.00	GOO OY	-14.00	-0.90	14.80	14.40	34	674
705	23	43.40	43.90	-2.60	45.70	GOO CX	MAR05 165.00	GOO OX	-15.60	-1.10	16.70	16.20	67	1.70K

Figure 22.2

In contrast to GOOG, IBM is a more stable stock, and the premiums here aren't that high. With the stock trading at \$91.20, I first look at the November 90 calls,

but they have too much premium (see [Figure 22.3](#)). The 85s fit the bill nicely. On the put side, the first strike in the money, the 95s, works fine. Note that I could even go out to the next month, the December 95s, and pay only a little extra in premium. I like to focus on the near-month contract in order to reduce premium. However, if the option is set to expire in less than two weeks, then I will go ahead and buy the next month out, though I may have to go even deeper in the money. Following are a few more notes of interest on options contracts:

- One option contract equals 100 shares of stock.
- If you buy 10 GOOG November 190 calls at \$12, that will cost \$12,000.
- To buy an equivalent 1,000 shares of the stock at \$190 would cost \$190,000.
- If GOOG rallies by 10 points, these options will move about 6 points. This depends on how far in the money they are. The further they are in the money, the more they will move “dollar for dollar” with the underlying stock.

MM		M		Q		%		B		C			
INTERNATIONAL BUSINESS MACH		Bid: 90.65		DSize: 4		Vol: 6.55M		Nov03		Puts			
P120		c		Ask: 91.07		ASize: 2		Volatility: 15.78		2099			
Oput	Vol	Bid	Ask	Change	Last	Symbol	Symbol	Last	Change	Ask	Bid	Vol	Oput
320		16.10	16.30	+ 0.10	15.40	IBM KO	NOV04 75.00	IBM WO	-0.05	0.00	0.05	0.00	3.32K
7.06K	107	11.10	11.30	+ 0.70	11.10	IBM KP	NOV04 80.00	IBM WP	-0.05	0.00	0.05	0.00	5 18.5K
12.9K	906	6.10	6.40	+ 1.00	6.40	IBM KO	NOV04 85.00	IBM WO	-0.10	-0.15	0.10	0.05	98 18.1K
29.5K	9.15K	1.30	1.30	+ 0.30	1.85	IBM KR	NOV04 90.00	IBM WR	-0.20	-0.50	0.30	0.75	1.29K 6.13K
7.11K	993	0.10	0.20	+ 0.02	0.17	IBM KS	NOV04 95.00	IBM WS	-1.00	-1.00	1.10	1.00	152 660
261		0.00	0.05	0.00	0.05	IBM KT	NOV04 100.00	IBM WT	8.80	-0.80	9.10	8.80	12 245
		0.00	0.05	0.00	0.00	IBM KA	NOV04 105.00	IBM WA	13.40	-1.00	14.10	13.80	35 120
81	10	16.10	16.40	+ 0.30	16.20	IBM LO	DEC04 75.00	IBM XO	0.10	0.00	0.10	0.00	517
960	14	11.20	11.40	+ 0.80	11.40	IBM LP	DEC04 80.00	IBM XP	0.10	-0.05	0.15	0.05	125 2.75K
5.15K	210	6.50	6.70	+ 0.60	6.60	IBM LO	DEC04 85.00	IBM XO	0.40	-0.20	0.40	0.35	192 4.55K
6.86K	1.53K	2.60	2.75	+ 0.50	2.75	IBM LR	DEC04 90.00	IBM XR	1.45	-0.55	1.55	1.40	271 1.67K
7.91K	7.55K	0.60	0.70	+ 0.06	0.61	IBM LS	DEC04 95.00	IBM XS	1.20	-1.10	1.50	1.30	39 304
1.21K	10	0.05	0.15	+ 0.10	0.20	IBM LT	DEC04 100.00	IBM XT	9.60	+ 0.10	9.10	8.90	54
4		0.00	0.05	0.00	0.05	IBM LA	DEC04 105.00	IBM XA	14.00	+ 0.10	14.10	13.80	50
2%	42	16.40	16.60	+ 0.60	16.70	IBM AO	JAN05 75.00	IBM MO	0.20	0.00	0.20	0.10	5.17K
13.2K	80	11.60	11.80	+ 0.90	12.30	IBM AP	JAN05 80.00	IBM MP	0.30	-0.10	0.35	0.30	179 25.6K
13.2K	1.66K	7.00	7.20	+ 0.20	7.20	IBM AO	JAN05 85.00	IBM MO	0.80	-0.25	0.80	0.70	367 22.8K
39.7K	732	3.30	3.50	+ 0.30	3.40	IBM AR	JAN05 90.00	IBM MR	2.00	-0.55	2.10	1.95	1.50K 27.6K
26.6K	1.51K	1.15	1.25	+ 0.10	1.20	IBM AS	JAN05 95.00	IBM MS	4.90	-0.40	4.90	4.70	127 10.9K
36.1K	383	0.30	0.40	+ 0.05	0.35	IBM AT	JAN05 100.00	IBM MT	9.10	-0.70	9.20	8.90	2 9.12K
4.06K	338	0.05	0.15	-0.02	0.13	IBM AA	JAN05 105.00	IBM MA	13.90	+ 0.50	14.10	13.80	19 1.04K
93		16.90	17.20	+ 0.37	16.90	IBM DO	APR05 75.00	IBM PO	0.50	-0.05	0.55	0.45	80 2.88K
430	23	12.40	12.60	+ 0.40	12.40	IBM DP	APR05 80.00	IBM PP	0.85	-0.15	0.90	0.85	230 4.87K
2.30K	18	8.20	8.40	+ 0.20	8.50	IBM DO	APR05 85.00	IBM PQ	1.60	-0.30	1.70	1.60	215 5.59K
19.0K	380	4.70	4.90	+ 0.40	4.70	IBM DR	APR05 90.00	IBM PR	3.10	-0.11	3.20	3.00	410 12.2K
5.79K	400	2.25	2.30	+ 0.30	2.40	IBM DS	APR05 95.00	IBM PS	5.30	-0.70	5.80	5.60	313 1.72K
3.11K	1.37K	0.95	1.00	+ 0.10	1.00	IBM DT	APR05 100.00	IBM PT	8.90	-1.30	9.50	9.30	80 1.44K
742		0.30	0.40	+ 0.05	0.40	IBM DA	APR05 105.00	IBM PA	13.40	-1.40	14.10	13.90	81 614

Figure 22.3

- If you sell the 10 GOOG calls at \$18 (\$18,000), you will pocket \$6,000.

- The maximum loss on this trade is the option's cost, \$12,000.

By contrast to this last bullet point, if a trader bought 1,000 shares of GOOG at \$190 and it gapped down 30 points on an earnings report, the trader would be out \$30,000. Options do limit risk if they are purchased correctly. Now that we've reviewed SSFs and stock options, let's get down to the play itself.

Trading Rules for Buy Fades (Sells Are Reversed)

This is a fade play that focuses on swing positions that last a few days to a few weeks. I am looking to sell strength and buy weakness.

1. For these plays, I am utilizing a daily chart. Because these plays are meant to last a few days to a few weeks, I'm not interested in what is happening on a 5- or 15-minute chart. I want to be able to step back and look at a slightly bigger picture without all the noise found in intraday charts.
2. The only indicators I place on the daily chart are an 8- and a 21-period exponential moving average (EMA).
3. For longs, I want to see the 8-period EMA trading above the 21-period EMA. Once this upward cross happens, then I can start looking for a setup to occur.
4. The specific setup I'm looking for, once the 8-period EMA has crossed above the 21-period EMA, is a pullback to the 8-period EMA.
5. The initial stop is the 21-period EMA or 4 percent of the stock price, whichever is greater. Typically the initial stop turns out to be this 4 percent level. Note that this 4 percent level is based on the price of the stock, not my equity level. That is, I'm not risking 4 percent of my equity on one trade; I'm risking 4 percent of the price of the stock. I could have 10 stocks going at one time.
6. Once I'm up 4 percent on the position (I call this my *watermark level*), I will move up my stop to the 21-period EMA. I will then use this 21-period EMA as a trailing stop until my target or trailing stop is hit.
7. My target is an 8 percent move in the price of the stock from my entry price. Although I focus mostly on stocks when I'm using this play, it can also be used on the stock index futures. However, the percentages will be different. On a daily chart, instead of an 8 percent target, I just use a 1 percent target and a 0.5 percent stop to start. If the mini-sized Dow is at 10,604, then my target is 106 points, and my initial stop is 53 points or the 21-period EMA, whichever is greater. On a 60-minute chart, I cut this in half, using a target of $\frac{1}{2}$ of 1 percent and a stop of $\frac{1}{4}$ of 1 percent or the 21-period EMA, whichever is greater. To get these, I just multiply the price of the index by 0.005 for the target and by 0.0025 for the stop. A sample play of this nature is discussed in [Chapter 23](#).
8. The easiest way to figure out all these levels is to quickly set up an Excel spreadsheet with the formulas already in place (see [Figure 22.3](#)).
9. One way to slightly increase the odds of success on long setups is to trade only stocks where the 8-period EMA is higher than the 21-period EMA on the weekly charts. This condition can last on a weekly chart for months and even years. If this setup exists on the weekly charts, then it's just a matter of waiting for an entry on the daily chart as per this setup. This process is discussed in more detail in [Chapter 23](#).

[Figure 22.4](#) is a snapshot of the exact Excel spreadsheet I use to calculate my key stop and target levels. All I do is enter my entry price in the highlighted box. If I'm long on the stock, then I use the "long" box, and vice versa. Once the price is in, the Excel spreadsheet calculates all the levels for me automatically. The formulas are very simple. For example, the target is calculated by taking the entry price and multiplying it by 0.08 (8 percent). The initial stop is calculated by taking the entry price, multiplying it by 0.04 (4 percent), and subtracting it from the entry. The 4 percent watermark level is calculated by taking the entry price, multiplying it by 0.04 (4 percent), and adding it to the entry price. I used to do all this manually, and it was a real buzz killer.

LONG		
Enter Price	\$ 88.45	
	Points	Price
Target	7.08	95.53
Initial Stop	3.54	84.91
Up 4%	3.54	91.99

SHORT		
Enter Price	\$ 25.10	
	Points	Price
Target	2.01	23.09
Initial Stop	1.00	26.10
Up 4%	1.00	24.10

Figure 22.4

- On August 10, 2004, EBAY crosses above its 8-period EMA (see [Figure 22.5](#)). However, since the 8-period EMA is still trading below the 21-period EMA, I am not interested in setting up a buy order just yet. I need to wait for the 8-period EMA to cross up through the 21-period EMA before I set up my first buy order. Note: on all these charts, the 8-period EMA is the skinny moving average line, and the 21-period EMA is the thicker moving average line.



Figure 22.5

- On August 19, the 8-period EMA crosses up above the 21-period EMA. I'm now ready to start bidding for a long, and my entry point will be a pull-back to the 8-period EMA. The next day I am filled at 79.28 when the market pulls back to the 8-period EMA. Now that I'm in the trade, I need to check where to place my stop. The 21-period EMA is at 79.08, which is not very far below my entry level. A 4 percent stop would be placed at 76.11. Since the 4 percent stop is greater, this is the stop I will use to start out with. My target is 8 percent up from my entry, which is 85.62. Remember, once I'm up 4 percent in the position, I will move my stop up to the 21-period EMA. The initial stop and target for this play are highlighted on the chart with the horizontal lines.
- On August 25, EBAY pushes higher and hits my target, and I'm out for just over \$6 per share (\$6.34). Now that I'm out, it's time to start looking for the next pullback to the 8-period EMA. A trader could also have followed this same play using single-stock futures or in-the-money call options. I will review those possibilities for this play in a moment.
- On September 9, 10 trading days later, EBAY pulls back to its 8-period EMA, and I am filled at 87.95. I do a quick calculation, and I see that my target is going to be 95.78 and my stop is 84.43. I set my parameters and let my orders babysit my position.
- Four trading days later my target is hit, and I'm out of the trade.
- On September 17, the market pulls back to the 8-period EMA once again. I take the trade, and I get in at 91.74 and set my parameters. This would be a stop of 88.07 and a target of 99.08. At the time I did this chart, I was still in the trade, so it was "active."

I'd like to take a moment to examine the first EBAY play detailed in [Figure 22.5](#) more closely. This play could also have been executed using single-stock futures or in-the-money call options. It is useful to compare these trades to the actual stock trade to get an idea of how this setup could have been followed on these various trading instruments. This will also give a trader an idea of the risk/reward parameters for each scenario. Although it's the exact same play across all three instruments, the amount risked versus the amount gained is different for each of the three scenarios. Let's take a look:

- Buy 1,000 shares of EBAY stock at \$79.28. Total cost is \$79,280.
- Buy 10 EBAY1C September single-stock futures (SSF) contracts at \$79.28. Total cost is \$15,856 (20 percent of \$79,280).

- Buy 10 EBAY September 75 call options at \$6.10. Total cost is \$6,100.

To figure out the premium on an options contract, people can look at the delta, or, if they aren't familiar with that, just use a calculator: with the stock at \$79.28, a \$75 call option costs $\$6.10 + \$75.00 = \$81.10$, and $\$81.10 - \79.28 (the actual price of the stock) = \$1.82. The option, then, has \$4.28 of intrinsic (real) value and \$1.82 of premium. The ratio is 29.84 percent ($1.82/6.10$).

Now that we've looked at the total costs for each entry, let's take a look at the exits:

- Sell 1,000 shares of EBAY stock at \$85.62, a gain of \$6,340, or 8.00 percent (or 16.00 percent if bought on margin).
- Sell 10 EBAY1C September SSF contracts at \$85.62, a gain of \$6,340, or 40 percent.
- Sell 10 EBAY September 75 calls at \$12.20, a gain of \$6,100, or 100 percent.

As you can see, using this exact same setup, a trader could put up \$79,280 in cash to buy the stock (or \$39,640 if he is using margin), \$15,856 to buy the single-stock futures, or \$6,100 to buy the options. The dollar outcome of the trade is very close across all three scenarios—a little over \$6,000. By using SSFs or the correct in-the-money option strike prices, a trader can risk less capital for the same potential monetary gain of the stock play. It is up to the trader to decide whether she wants to focus on stocks, SSFs, options, or a combination of the three.

QCOM (Qualcomm, Inc.)—August 19, 2004

1. The 8-period EMA pushes above the 21-period EMA, and I place my bid (see [Figure 22.6](#)). Two days later, on August 20, 2004, I am filled at 35.47. I place a stop at 34.05 and a target at 38.31. By the time trading is done this day, the stock is already up by 4 percent from my entry, so I move my stop up to the 21-period EMA, which is 35.34.

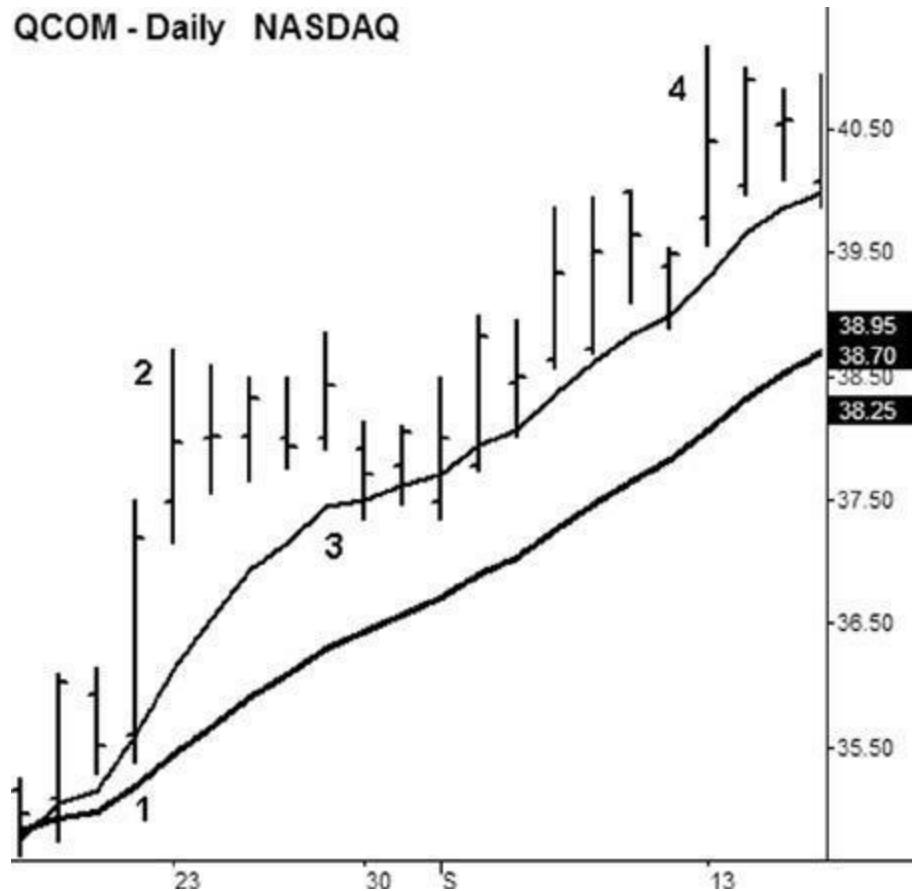


Figure 22.6

2. On Monday, August 23, QCOM continues to push higher, and my target is hit. I immediately set up a bid to buy the next pullback to the 8-period EMA.
3. On August 30, my trailing bid is hit, and I'm in at 37.51. I place a stop at 36.01 and a target at 40.51.
4. About two weeks later, on September 13, my target is hit. Note that when the stock is up by 4 percent from my entry on September 7, I raise my stop to the 21-period EMA at 37.42, and I trail this stop until my target is hit.

As I did with EBAY, let's take a look at executing this same QCOM play across all three trading instruments. Here is how the entries would break down:

- Buy 1,000 shares of QCOM at \$37.51. Total cost is \$37,510.
- Buy 10 QCOM 1C September SSF contracts at \$37.51. Total cost is \$7,502 (20 percent of \$37,510).
- Buy 10 QCOM September 35 calls at \$3.10. Total cost is \$3,100.

To figure out the premium on the QCOM options, just take $\$35.00 + \$3.10 = \$38.10$. There is $\$2.51$ of real value ($\$37.51 - \35.00) and 0.59 cents of premium ($\$3.10 - \$2.51 = \$0.59$). The ratio is 19.03 percent ($0.59/3.10$).

We've looked at the total costs for each entry, so now let's take a look at the exits:

- Sell 1,000 shares of QCOM at \$40.51, a gain of \$3,000, or 8 percent, or 16 percent if using margin.
- Sell 10 QCOM 1C September SSF contracts at \$40.51, a gain of \$3,000, or 40 percent.
- Sell 10 QCOM September 35 calls at \$5.90, a gain of \$2,800, or 90.32 percent.

Once again, using this exact same setup, a trader could put up \$37,510 in cash to buy the stock (or \$18,755 if she is using margin), \$7,502 to buy the single-stock futures, or \$3,100 to buy the options. The dollar outcome of the trade is very close across all three scenarios—about \$3,000. Now that you have the idea, I'm just going to focus on the actual stock plays for the rest of this chapter. Of course, not all stocks have options and single-stock futures available on them, so some of these plays can be executed only on the actual stock.

KLAC (KLA-Tencor Corp.)—July 9, 2004

- When the 8-period EMA crosses below the 21-period EMA and the price action moves below both these levels on KLAC, I start looking for the next shorting opportunity (see [Figure 22.7](#)). I want to short a rally back to the 8-period EMA, and on July 9, 2004, I am filled at 46.19. I place a stop at 48.04 and a target of 42.49. On July 13, my position is up by 4 percent, so I move my stop up to the 21-period EMA, which is 46.84.



Figure 22.7

- On July 14, KLAC gaps down and opens through my target. I'm filled at the open at 41.61, 88 cents better than my target, for a nice gain. KLAC is still trading below its 8- and 21-period EMAs, so I set up my next short, which would be a rally back to its 8-period EMA.
- On July 20, the market rallies back to the 8-period EMA, and I'm filled at 41.81. My stop is 43.48, and my target is 38.47. On July 22, the stock is up by 4 percent from my entry, so I move my stop down to the 21-period EMA, which is 42.84.

4. On July 26, my target is hit, and I'm out for an 8 percent gain. I start looking to short again at the next rally back to the 8-period EMA.
5. On July 29, I'm back in short at 39.33. I place a stop at 40.90, and my target is 36.18.
6. The next day, KLAC gaps up on positive news and rallies to my stop. I'm out for a 4 percent loss. I note that the 8-period EMA has not crossed above the 21-period EMA. I sit back and wait, because if KLAC trades and closes back below its 8-period EMA, I will set up an order to short the next rally back to its 8-period EMA.
7. A few days later, on August 3, KLAC closes below its 8-period EMA. I set up an order to short a rally back to its 8-period EMA, and on August 4, I am filled at 39.93. I place a stop at 41.53 and a target at 36.74. The stock pushes higher, and on August 5 it comes within spitting distance of my stop, but it doesn't make it and closes well off its highs.
8. On August 10, I have a 4 percent gain registered, so I move my stop down to the 21-period EMA, which is 40.29. On August 11, KLAC gaps lower and pushes lower all day, hitting my target.
9. KLAC is still trending lower according to the 8- and 21-period EMAs, so I set up another order to short a rally to the 8-period EMA. On August 17, KLAC rallies, and I am filled at 37.15. I place a target at 34.18 and a stop at 38.64.
10. The market chops back and forth for a while, and on September 1, I am stopped out for a 4 percent loss.

QLGC (QLogic Corp)—June 14, 2004

1. On June 14, 2004, the 8-period EMA on QLGC crosses below the 21-period EMA, setting up a situation in which I can start taking new plays (see [Figure 22.8](#)). I place an order the next day to short a rally back up to the 8-period EMA, and I'm filled at 28.14. I place a stop at 29.27 and a target at 25.89.



Figure 22.8

2. On June 16, QLGC dry heaves and pukes for a nice down day. It gets close to my target, but not quite. Since I'm up more than 4 percent on the play, I move down my stop to the 21-period EMA, which is 28.22. The very next day, my target is hit at 25.89. I'm now flat on QLGC, and I begin looking at new entries. A new entry, of course, would mean a rally back to the 8-period EMA.
3. I place my order and am filled on June 22 at 26.68. I place a target at 24.55 and a stop at 27.75.
4. QLGC continues to rally, and on June 25, I'm stopped out for a 4 percent loss.

5. The day after I'm stopped, QLGC moves back below its 8-period EMA and closes below it. This is the trigger I'm looking for before I set up my next trade. I need to see a close back below the 8-period EMA in order to start setting up orders for a new short position. The next day I set up an order to short a rally back to the 8-period EMA, and I'm filled on June 28 at 26.86. My stop is 27.93, and my target is 24.71. QLGC starts moving my way, and on July 1 I am up by more than 4 percent on this position. At this point, I move up my stop and start using the 21-period EMA as a trailing stop, starting with 27.12.
6. QLGC continues to bleed like a stuck pig, and on July 6, I am out at my target. I set up an order to short a rally back to the 8-period EMA.
7. On July 9, my order is hit, and I'm short at 25.85. I place a stop at 26.88 and a target at 23.78. On July 14, QLGC comes close to my target, but "close" works only when you are throwing a grenade. My target isn't hit, but I do move my stop down to the 21-period EMA, which is 26.03.
8. The next day QLGC moves higher, and I'm stopped out for a loss of 18 cents. One question I usually get in a situation like this is, "Hey, since the stock was so close to your target, why didn't you just take the profit?" The main reason I don't is that if I bring that "human judgment" into the equation, two things happen. First, instead of this being a relaxed system to trade, it now becomes an intense system because you have to watch the moves closely on an intraday basis in order to decide when to get out. Second, I've found that most traders, when they are in a trade, lose all objectivity. By actively managing this trade, many people will close it out as soon as it starts to go against them, or they'll start taking profits too soon. In this respect, you might as well be day trading without a plan, which is the most common reason traders lose money. Choose your setup, choose your parameters, and stick to them! How can you measure the effectiveness of a system unless you stick with the parameters?
9. On July 16, QLGC closes back below its 8-period EMA, so I set up another order to short. I'm filled on July 20 at 25.10. My stop is 26.10, and my target is 23.09.
10. QLGC bleeds lower, and my target is filled on July 28. Remember, once I am up by 4 percent in the position, I start using the 21-period EMA as a trailing stop.
11. On July 29, QLGC bounces back up to its 8-period EMA, and I'm filled on a short at 24.09. My target is 22.16, and my stop is 25.05. On August 5, I am up by 4 percent in the position, so I move my stop down to the 21-period EMA, which is 24.23.
12. On August 12, my target is hit, and I'm out for an 8 percent gain.

CEPH (Cephalon, Inc.)—May 3, 2004

1. On May 3, 2004, the 8-period EMA on CEPH crosses below the 21-period EMA (see [Figure 22.9](#)). I set up an order to short the next rally back up to the 8-period EMA. On May 5, my entry is hit at 57.42. My target is 52.83, and my stop is 59.72.

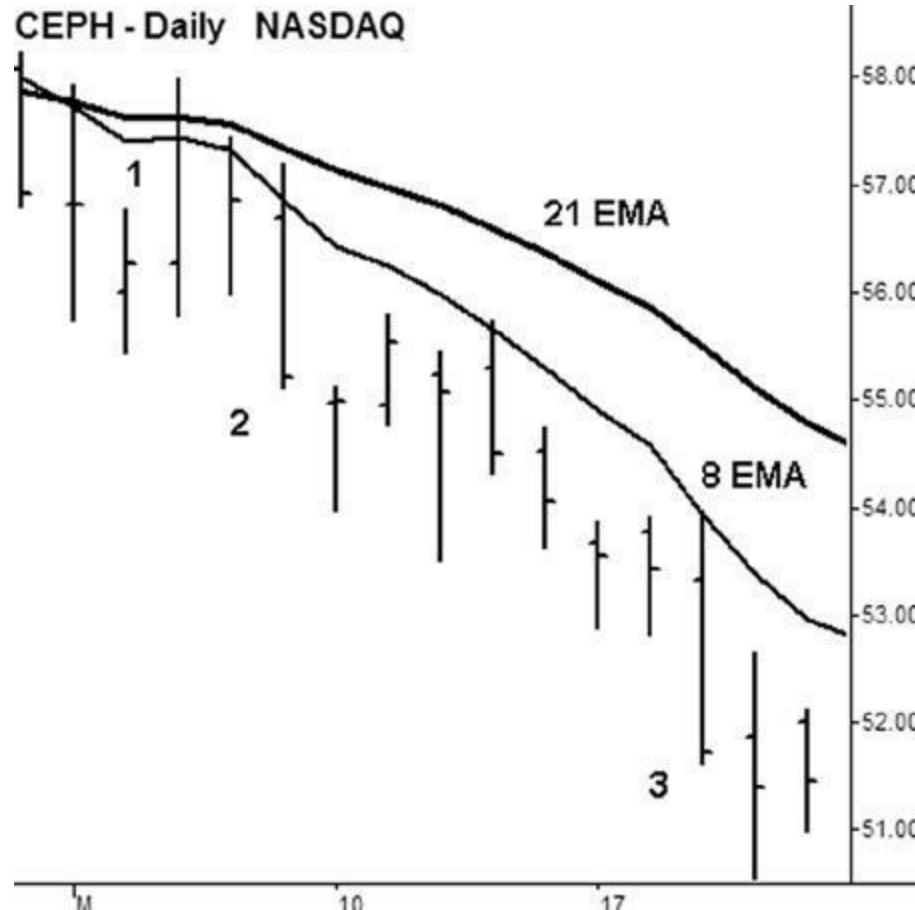


Figure 22.9

- On May 7, in addition to celebrating my birthday (after you turn 21, what's the point?), CEPH moves down by more than 4 percent, so I adjust my stop to the 21-period EMA, which is 57.30. This now becomes a trailing stop that I update at the end of each trading day.
- On May 19, my target is hit. This is a pretty typical swing trade, where I'm in the position for a little more than two weeks, and my daily management of the trade is at the absolute minimum so that I can focus on other things. A pure day trader who was flipping into and out of CEPH during this time could have easily done 30 trades and had nothing to show for it except a pile of commission costs.

SBUX (Starbucks Corp.)—May 24, 2004

- As long as there are day traders, Starbucks will be able to charge as much as it wants for a cup of coffee. There is no bid and ask when it comes to a Grande Latte. Traders will take that one “at the market.” On May 24, 2004, SBUX has its 8-period EMA cross up above its 21-period EMA (see [Figure 22.10](#)). This is my signal to set up a bid to buy the next pullback to the 8-period EMA. On May 25, my order is hit, and I’m filled at 38.64. I place a stop at 37.09, and my target is 41.73.
- On May 27, SBUX moves up by 4 percent from my entry, so I move my stop up, using a trailing 21-period EMA. My stop on this day is moved up to 38.71. The stock continues to push higher, and on June 3 my target is hit. I start to set up my next bid on a pullback to the 8-period EMA.

SBUX - Daily NASDAQ



Figure 22.10

- On June 14, SBUX pulls back, and I am filled at 41.96. My stop is 40.28, and my target is 45.32. The stock grinds higher from this point, and on June 18 it hits my 4 percent watermark. I tighten my stop, using the 21-period EMA as my guideline. My new stop is 41.51. On June 25 and June 30, the stock pulls back very close to the 21-period EMA, and obviously very close to my stop. However, it doesn’t hit, and I’m still in the trade.
- On July 2, SBUX firms, and my target is hit for a gain of \$3.36, or 8 percent.

GS (The Goldman Sachs Group, Inc.)—August 24, 2004

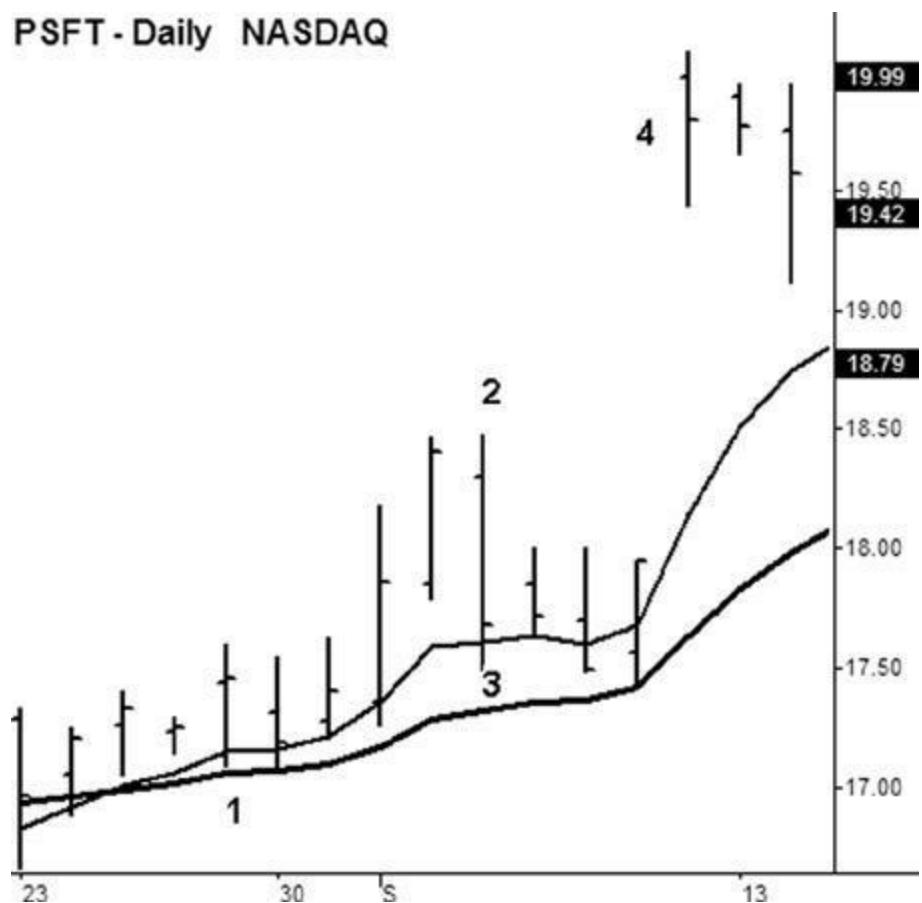
- On August 24, 2004, the 8-period EMA on GS crosses up above the 21-period EMA (see [Figure 22.11](#)). I start setting up bids to buy the next pullback to the 8-period EMA. On August 25, I am filled at 87.75. I place a stop at 84.24, and my target is 94.77.

**Figure 22.11**

2. On September 7, this position is up by 4 percent from my entry, and I adjust my stop to reflect the current position of the 21-period EMA, in this case 89.06.
3. I update and change my stop at the end of each day, reflecting the movement in the 21-period EMA. GS pulls back and hits its 21-period EMA nine trading days after I start using the trailing stop. I am out at 91.05 for a gain of 3.30, or 3.76 percent. This is another good example of a low-maintenance trade that lasts the better part of a month. This is a very manageable type of trade for people who work full time. I should know, because these are the main types of trades I did when I was doing my stint in the corporate world.

PSFT (PeopleSoft, Inc.)—August 27, 2004

1. I like this example because this does tend to happen more often than you would think. This setup keeps you in the direction of the most recent order flow. Typically, when stocks come out with really good news or really bad news, there are always people “in the know” who get positioned for these moves before the news is released. This pushes the stock higher (for good news) or lower (for bad news) before the story hits the wire, since these insiders load up or dump shares. When the news hits, they get out—and often I can too, because I’m following these setups. With PSFT, the 8-period EMA crosses the 21-period EMA on August 25, 2004 (see [Figure 22.12](#)). I set up an order to buy the first pullback to the 8-period EMA. On August 27, PSFT pulls back, and I am filled at 17.11. My stop is 16.43, and my target is 18.47. On September 1, I’m up by 4 percent, so I start to trail my stop using the 21-period EMA.

**Figure 22.12**

2. On September 3, my target is hit, and I set up an order to buy the first pullback to the 8-period EMA.
3. The pullback actually occurs on this very same day, and I'm filled at 17.62. I place a stop at 16.92, and my target is 19.03.
4. The stock doesn't do a whole lot for the next three trading days, but on the fourth day it gaps higher on the ORCL (Oracle Corp.) takeover news and opens at 19.97, 94 cents above my target. I'm out for a 13.34 percent gain. Although I had no clue that this would be announced, I did know that the order flow on the stock was positive based on this particular setup, so the odds were in my favor that the path of least resistance would be higher.

TZOO (Travelzoo, Inc.)—August 13, 2004

1. TZOO was one of the hyped stocks of 2004, and using this setup, I was able to catch a few of the moves. On August 13, 2004, the 8-period EMA crosses up and through the 21-period EMA (see [Figure 22.13](#)). Once this happens, I set up an order to buy the next pullback to the 8-period EMA. A few days later, on August 18, I am filled at 30.29. I place a stop at 29.08 and a target at 32.71.

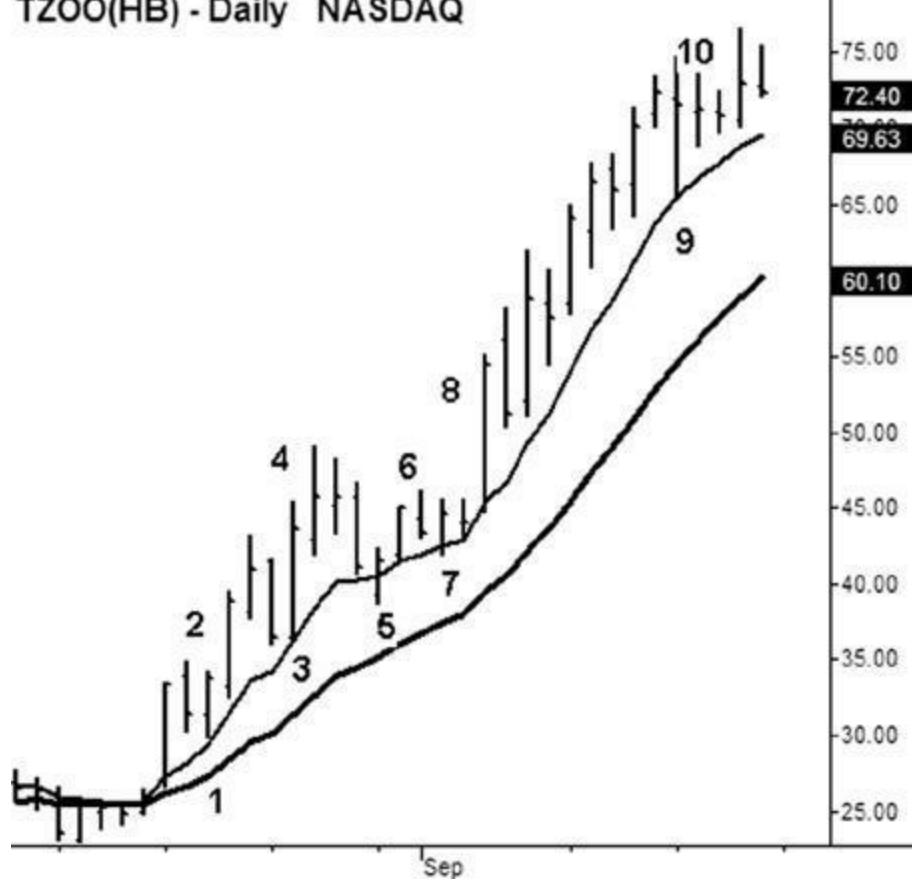


Figure 22.13

2. TZOO ramps higher soon after I enter the stock, and my target is hit later that same day. Once I am out, I place another order to buy a pullback to the 8-period EMA.
3. On August 24, the pullback occurs, and I am filled at 37.03. I set my target at 39.99 and my stop at 35.55.
4. Similar to my last trade, TZOO ramps up, and my target is hit the very same day. Like a robot, I set up an order to buy the next pullback to the 8-period EMA.
5. On August 30, I had a bid set at 40.81. The stock gapped below this level and opened at 39.24, where I was filled. This is a good example of what I do in this type of situation, because I place my orders before the market opens and don't wait and try to finesse my entry after the market opens. When you have a limit order in place and the stock opens below that level, then your order becomes a market order because it is "at this price or better." However, I will update my stop and my target based on my actual entry price. In this case, my entry price was 39.24, so I use a stop that is 4 percent lower than this price, which is 37.67, and a target that is 8 percent higher than this price, which is 42.38.
6. On August 31, the very next trading day, my target is hit. I know what I'm going to do now—I'm going to bid for the next pullback to the 8-period EMA. It's like kissing your spouse goodbye when you leave for work in the morning; after a while it's automatic and you don't have to think about it.
7. On September 2, I'm filled at 42.36, and I set my stop at 40.67 and my target at 45.75.
8. A few days later, my target is hit. It's time to buy the next pullback.
9. The market pulls back many times, but never quite to the 8-period EMA until September 20, where I'm filled at 66.34. I place a stop at 63.69, and my target is 71.65.
10. My target is hit the very same day.

SNDK (Sandisk Corp)—August 31, 2004

1. On August 31, 2004, I buy a pullback to the 8-period EMA on SNDK, and I'm filled at 23.30 (see [Figure 22.14](#)). I place a stop at 22.37 and a target of 25.16. On September 8, SNDK gets close to my stop and closes near the lows. After I see this, I assume that I'm going to get stopped out the next day, but the important thing is that I do not alter my parameters. It doesn't matter what I think, as long as I don't touch the parameters!



Figure 22.14

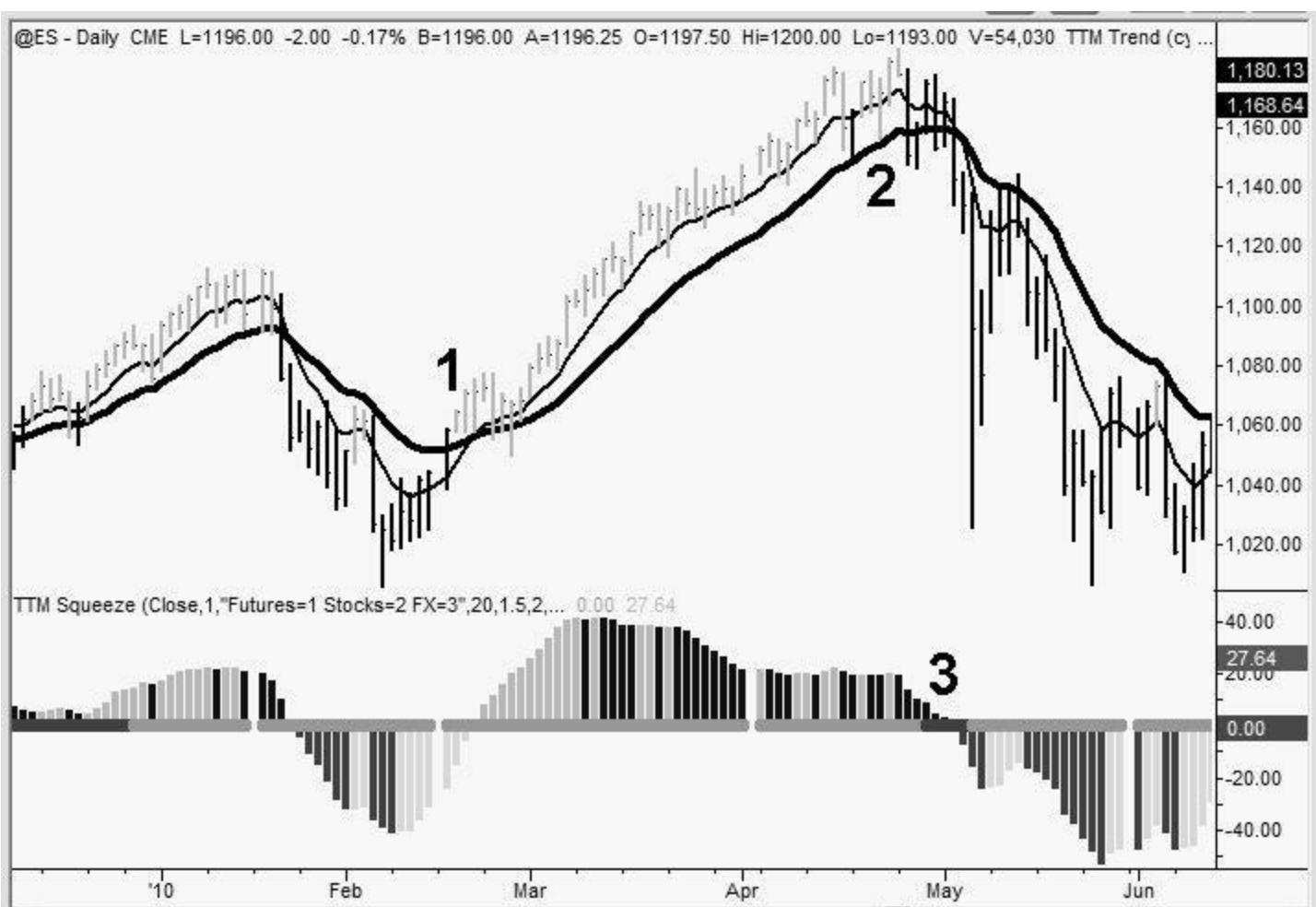


Figure 22.15

2. Two days later, the stock has reversed, and I'm out at my target on September 10. It's time to set up my next bid to buy SNDK on a pullback to the 8-period EMA.
3. I trail up my bid, and it's almost hit on September 20 and again on September 24, but close enough doesn't cut it. I don't get filled again on this play during this time frame.

Updates to the Propulsion Plays

This chapter hasn't changed much since I wrote it for the first edition. However, I did want to include a few updated charts that tie in a couple of things that I introduced earlier in the book. [Figure 22.15](#) shows a chart of the E-mini S&P 500 during the first half of 2011. At point 1, we get a clean 8/21-period EMA cross to the upside, and we have a great opportunity to buy a pullback, just as the setup indicates. However, this chart also has the TTM trend. As long as the bars stay light gray in color, it indicates buying pressure, and there is no reason to exit the trade until there are two black bars in a row. This is great because it can keep a trader in a trend "as long as it is willing to trend." Then, at point 2, as the 8/21-period EMA cross is crossing to the downside, a squeeze is also forming at point 3. Bonus! Here a trader can use the concepts discussed in [Chapter 11](#) to get into this trade early and be positioned for the potentially explosive move.

[Figure 22.16](#) is a daily chart of CMG (Chipotle Mexican Grill Inc.), a stock that has confounded shorts for much of its run. In this chart, I've also added the C wave from [Chapter 12](#). At point 1, we have a squeeze combined with an 8/21-period EMA cross. As the stock starts moving higher, we can take off a portion of the trade, and then trail the 21-period EMA as a stop. Depending on a trader's intestinal fortitude, a trader could have enjoyed a massive run on this move, until CMG pushed below its 21-period EMA. What gets interesting is at point 2, where the 8/21-period EMA crosses to the downside. Is this a trade that's worth taking? Well, if we look at the C wave, we can clearly see that it is above zero, indicating that the longer-term trend on this stock is higher. We can certainly take a short trade here, but at least the C wave is giving us a heads-up that the easier money is on the long side. In this case, it pays to just wait for the next long signal, and a squeeze with an 8/21-period EMA cross sets up at point 3.

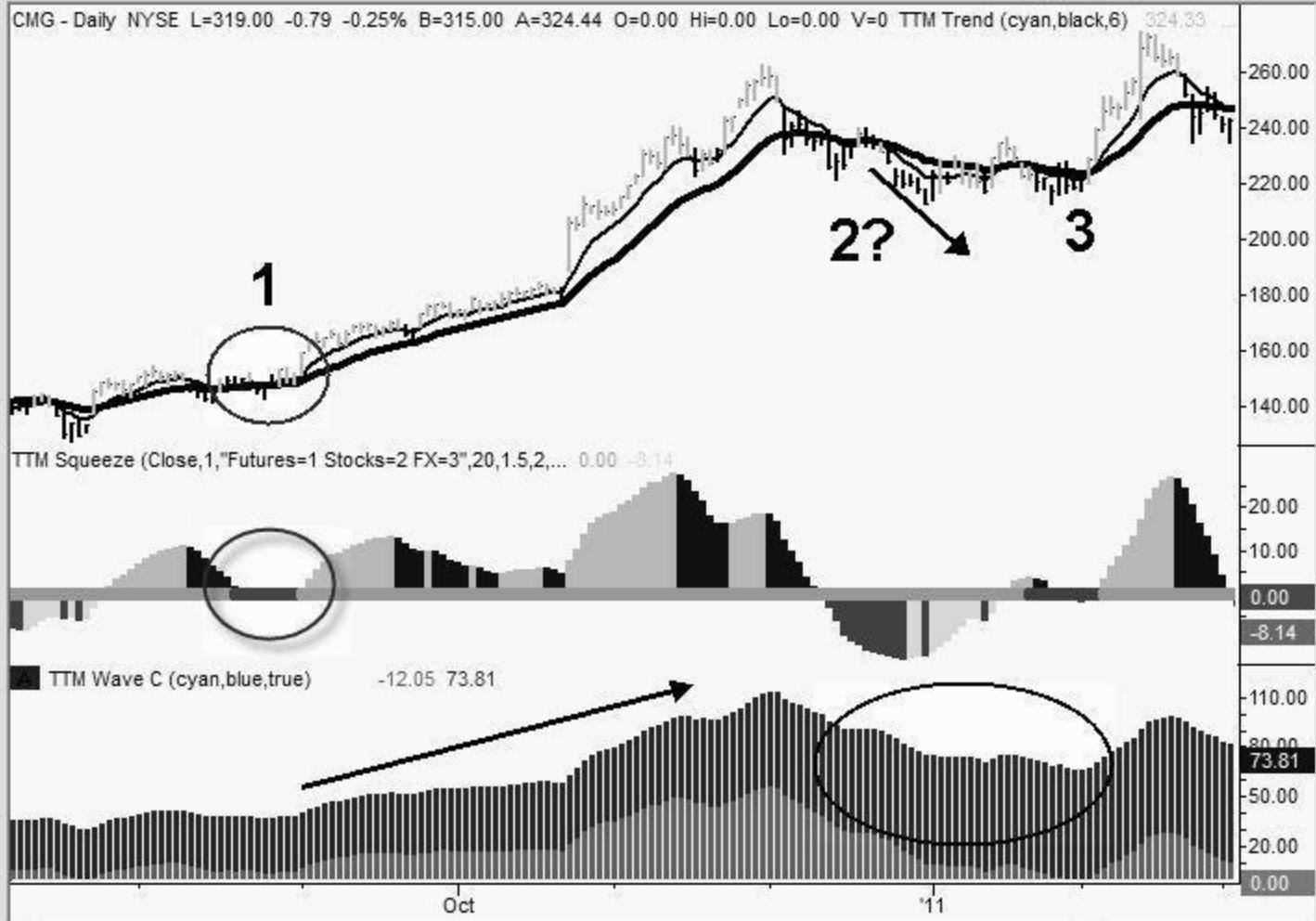


Figure 22.16

Although all of the concepts in this book can be used individually, what's fun is working out combinations that enhance your skills as a trader and fit your personality best.

Summing Up the Propulsion Plays

There are two main things that I like about the propulsion play. First, I don't have to watch the markets all day in order to get my entry. I can set up the orders the night before and then check at the end of the day to see which of my orders got filled. Second, these plays have specific targets. I've tried this method by just using trailing stops, but the results were not as good. Sure, once in a while I would catch a stock that would have a parabolic move, but more often than not, a perfectly nice profit would roll back over into a breakeven trade. Through trial and error, I have found that by setting a firm 8 percent target using a GTC (good till canceled) order, my profitability improved. (Note: if you are using this with a squeeze and a TTM trend, you can also use 8 percent on the first half of your position, then move your stop to breakeven and utilize the TTM trend to manage the rest of your position.) Remember, you don't want to become one of the many brokerage clients that the staff people poke fun at. They call GTC orders "good till close," because any time the stock gets close to the client's target, the client calls up and cancels the order "because it looks like it will go even higher." Of course, most of these stocks end up heading back lower and getting sold for a loss. Establish the parameters, then treat your parameters like good employees and let them do their job. Have a plan and follow it. Want to get out of half at 8 percent? Great. Don't change your plan once you've decided on your course of action.

In terms of actual execution of these plays through your broker, here are two additional tips. First, it helps to "drill down" and watch the daily EMAs update in real time throughout the day. You can do this by overlaying the daily EMAs on a 15-minute chart. To do this in TradeStation, set up a 15-minute chart and then do the math. Take the 6.5 hours in the regular stock session, which equates to twenty-six 15-minute bars. $26 \text{ periods} \times 8 \text{ EMA} = 208$, and $26 \text{ periods} \times 21 \text{ EMA} = 546$. These 208-period and 546-period EMAs on a 15-minute chart mimic the 8-period and 21-period EMAs on a daily chart. You can adjust this to include the pre- and postmarket sessions if you like. By watching the intraday charts with the daily EMAs overlaid, a trader can really keep an eye on when the cross is taking place and where to place the orders. Second, as with the pivots, I think it is helpful to get "just in front" of the moving averages. For example, if the 8-period EMA is at 43.40 and you are trying to buy a pullback, then place a limit order 10 to 15 cents higher, say 43.52, in order to get filled. When the setup is there, don't make the mistake of tripping over pennies when your aim is to be picking up dollars.

For updates to this trade setup, visit www.tradethemarkets.com/propulsion to see how I'm using it today and what other indicators I'm combining it with.

We've reached the end of Part 2. It's time to head out into the real world, and that's what I talk about in Part 3. Grab a cup of coffee, stretch your legs, and dive in.

Hope in reality is the worst of all evils because it prolongs the torments of man.

Vision without action is a daydream; Action without vision is a nightmare.

JAPANESE PROVERB

Spoon feeding in the long run teaches us nothing but the shape of the spoon.

E. M. FORSTER

PART III

HEADING BACK INTO THE REAL WORLD OF TRADING

The Premarket Checklist— Creating a Game Plan for the Next Trading Day

In a calm sea, every man is a pilot.

SPANISH PROVERB

Moh ching, moh meng (no money, no life).

IAN DUNROSS, FROM THE BOOK *Noble House*,

WRITTEN BY JAMES CLAVELL

Like Running a Credit Check, to Understand What the Market Is Going to Do in the Future, It Helps to Understand Its Past

Although I base many of my daily trading decisions on specific setups, I also like to analyze how the market has recently been behaving. My goal in doing this is to be constantly aware of the path of least resistance, since I want to set up the bulk of my trades directly along that path. To that end, I have developed a quick daily checklist and, for Sundays, a more detailed and thorough checklist. The purpose of this is to prepare myself mentally for the trading day ahead. There will be times when my analysis is totally off, but I've found that the act of mentally reviewing potential scenarios before the opening bell prepares me for just about anything. The market can be easy to trade when the going is smooth, but there are plenty of times when the market will throw a curve ball. In these situations, it's the prepared traders who consistently come out on top.

The first thing I do in this regard is to look at the markets I'm trading from a top-down approach, starting with the monthly charts and working my way down to the 60-minute charts. In this example, I analyze the S&P 500, but I do this with every market that I'm following. I like to do this with the main indicators that I like to watch, including the squeeze, reversion bands, waves, key moving averages, and so on. For purposes of illustration, all the charts I'm looking at here have the following indicators placed on them:

1. The 8-, 21-, and 200-period exponential moving averages (EMA). In the charts shown in the pages that follow, the 8-period EMA is the thinnest line, and the 200-period EMA is the thickest line. I will also look at the 50- and 100-period EMAs, but they aren't as important to me.
2. A slow stochastic with the default TradeStation settings of 14, 3, 3.
3. A MACD with the default TradeStation settings of 12, 26, 9.
4. A TTM squeeze indicator—this is the same indicator discussed in [Chapter 11](#). Of course, you can also include waves, reversion bands, and other indicators on these charts. To keep this discussion simple, I'm going to keep the charts simple.

Monthly Chart Analysis

I always like to start off with the monthly charts. Even though I'm going to be doing most of my trading in the futures market, for the stock indexes, I will look at the monthly charts of the cash index. This is because there is much more history here to view, as the cash index has been around a lot longer than the stock index futures contracts.

The first things I look at are the stochastic and MACD readings. These represent “pressures” on the market. Is the pressure more to the upside (buying pressure) or to the downside (selling pressure)? In general, I want to establish positions that are on the same side as the current dominant pressures in the market I am trading. My rule of thumb for this is as follows:

The stochastic is the heads-up, and the MACD is the confirmation.

This brings me to why I place little value on whether a stochastic is overbought or oversold. According to the stochastics in [Figure 23.1](#), the S&P was overbought starting in the middle of 1995, and it stayed overbought until the middle of 1998—three long years. During that time this “overbought” market rallied by more than 100 percent. To me, an overbought stochastic is actually a bullish sign—if the MACD is also in a buy. This brings me to my next guideline:

What I'm looking for is MACD crossovers.

The stochastics are valuable in that they will turn first, and therefore they can give me a heads-up that a MACD cross might occur. That said, I don't act on this information unless and until a MACD crossover actually does occur.

At point 1 in [Figure 23.1](#), the monthly MACD crossed over into a sell signal in May 2000, about two months after the stochastics crossed into a sell. Once this happened, the path of least resistance on the monthly S&P chart officially switched from higher to lower. This means that, for longer-term swing and position trades, I would start spending more time focusing on short setups and generally ignore long setups. I would do this until the monthly MACD went back into a crossover buy, and that happened at point 2, nearly three years later. Once this occurred, I started focusing more on long swing-trading setups and generally ignored most short trading setups. Remember, I'm talking about swing and position trades here, not day trades.

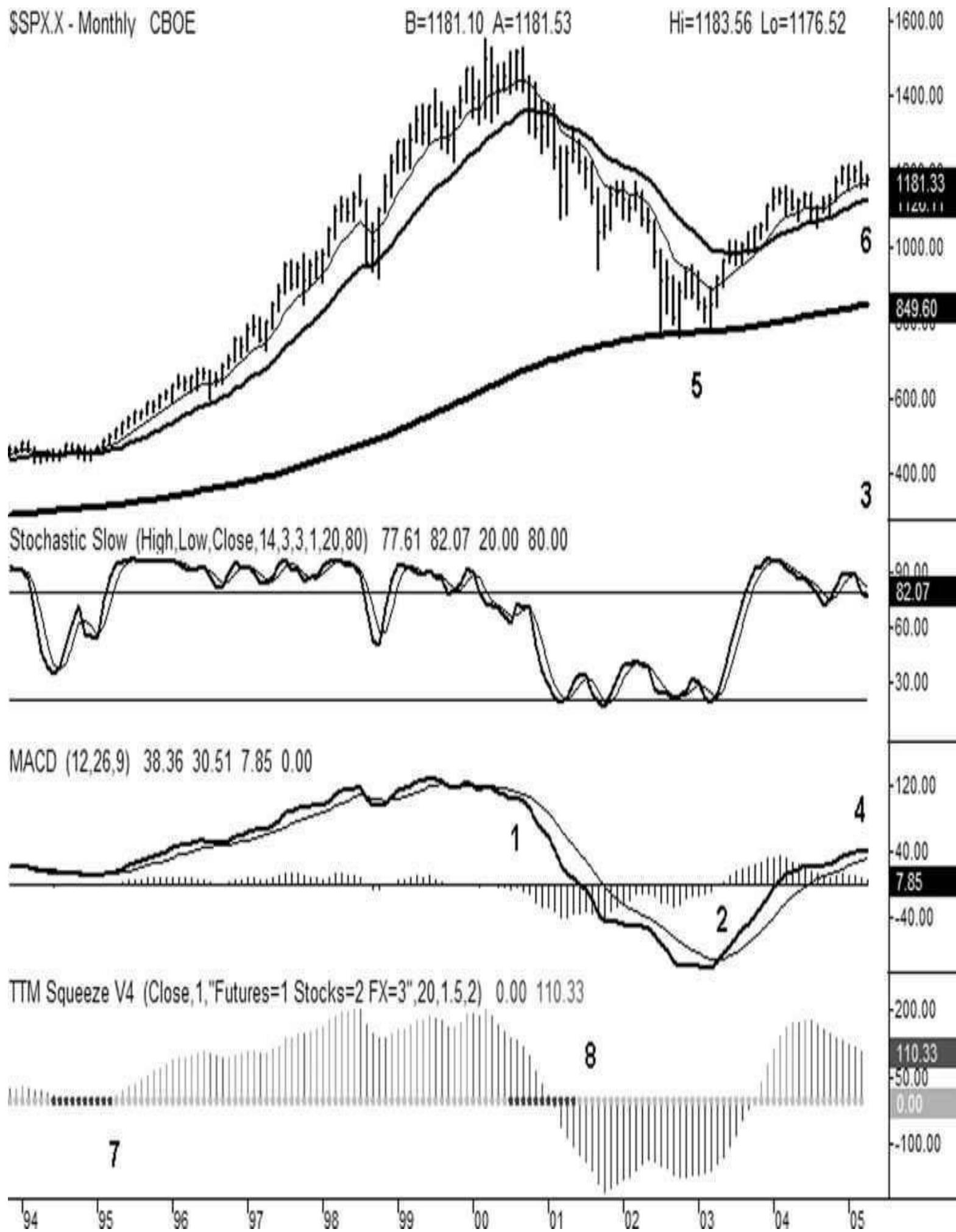


Figure 23.1

The snapshot of this chart was taken on April 5, 2005. At point 3, I can see that the stochastics are trying to roll over into a sell. What does this mean to me? It means that, potentially, the MACD *could* roll over into a sell. However, at point 4 we can see that the MACD is still in a buy. For me, this means that, for longer-term swing and position plays, I will still continue to focus on the long side *until the monthly MACD rolls over into a sell*.

The next thing I like to look at is the key moving averages. First, I will look at the 200-period EMA just to see where it is in relation to the current market prices. This is the strongest moving average, and it represents serious support or resistance—it was enough to stop the crash of 2000, as seen at point 5. In this current snapshot of the S&P, the 200-period EMA is way down at 849.60 and isn't much of a factor in the current market conditions. However, the fact that the market is trading above this level is bullish.

What is more relevant in the short term is the relationship between the 8- and 21-period EMAs. The first thing I'm looking for is to see which moving average is on top of the other. If the 8-period EMA is on top of the 21-period EMA, this shows that the path of least resistance is higher. If the 8-period EMA is trading below the 21-period EMA, this shows that the path of least resistance is lower. This crossover is a confirming indicator for the MACD, as the MACD will fire off faster. I like to use these moving averages in my entries. In this regard, I will use these moving averages on the monthly charts in the same way as I described for the daily charts in [Chapter 22](#), where I will buy pullbacks or short rallies to the 8-period EMA. In this current chart, at point 6, I can see that the S&Ps are trading right at their 8-period EMA. Since the 8-period EMA is trading above the 21-period EMA, this is a buy zone.

I also like to look at where the 50- and 100-period EMAs are located, but I don't place as much importance on them in terms of establishing a trade. I will use these more as targets than as entry points.

The last thing I look at is the squeeze. Most of the time, the squeeze is not doing anything, so I just glance at it to see if it is in the process of setting up a move. However, when it does fire off, as it did at point 8, this takes precedence over everything else. When the squeeze is on, then I'm in this trade until the squeeze is no longer valid. At point 7, you can see that a long squeeze occurred in early 1995. This signal fired off at the beginning stages of one of the strongest and most enduring rallies the S&P has ever seen. To that end, I like to know when a squeeze is in play. I never fight the squeeze.

For this current chart, there isn't a squeeze play that has fired off or is even developing. Monthly squeezes are a rare occurrence, with only two of them in the last 10 years.

Weekly Chart Analysis

Once I am done with the monthly chart, I take a quick glance at the weekly chart (see [Figure 23.2](#)). Note that here I have switched back to the ES futures contract, because with the weekly ES chart, there is enough data to get accurate information going back a few years. All the same guidelines apply. What I'm most interested in here is what is happening as of today.



Figure 23.2

We can see at this point that the weekly chart has been in a MACD sell for about a month, and during this time, the S&P has fallen by about 60 points. The stochastics at point 3 have taken it on the chin and are oversold. Remember, however, that I couldn't care less about that. What I'm interested in is the weekly MACD at point 2. Is it turning higher? No, it is still in a sell. In addition, the squeeze at point 3 has three black dots. This is not a signal, but it is a heads-up that a squeeze is in progress, and I want to pay attention to the direction in which this eventually fires off. Finally, I look at the moving averages at point 4, and I can see that the 8-period EMA has crossed below the 21-period EMA, a bearish development. We are right at the 21-period EMA.

What to do here? This is what I call a *mixed market*. The monthly chart is bullish, and the weekly chart is bearish. In this situation, the sell signals on the weekly chart will create buying opportunities on the monthly chart. This is an important distinction to understand. Just because the weekly chart is in a sell doesn't mean that the world is coming to an end. Yes, it absolutely creates shorting opportunities, but the monthly charts are still indicating a buy, and this means that the longer-term path of least resistance is higher. I want to point this out because this type of situation typically creates many bears and many negative attitudes, since a weekly sell signal can generate a devastating beating for bulls. But, in the bigger scope of things, I'm looking for the weekly chart to turn higher and move back in line with the monthly chart. The best trading opportunities occur when the weekly charts line back up with the monthly charts.

For setups, the weekly chart is still in a sell, meaning that short setups are appropriate. However, before I set anything up, I would want to first look at the daily charts to see if the pressures on this time frame are lower or higher.

Daily Chart Analysis

Although I will use the monthly and weekly charts to help me determine the path of least resistance for swing and position trades, it is the daily chart that I drill down to in order to get my specific entry levels. [Figure 23.3](#) shows the daily chart of the S&Ps, and now it is time for me to set up a trade. The first thing I notice is that the stochastics at point 1 are turning higher. I then, of course, look to the MACD at point 2 to see what it is doing, and it is also trying to turn higher, although it hasn't quite done it yet. At point 3, I see that the S&Ps have held a test of support at the 200-period EMA. However, at point 4, the 8-period EMA is trading below the 21-period EMA, which is negative. The squeeze also doesn't help me out because there aren't any signals on it at this time.

Okay, so now I have a bullish monthly chart, a bearish weekly chart, and a bearish daily chart that is trying to turn bullish. Can I do anything with this? There really isn't a clear answer here. It's time to keep on drilling down. Let's visit the 60-minute chart.

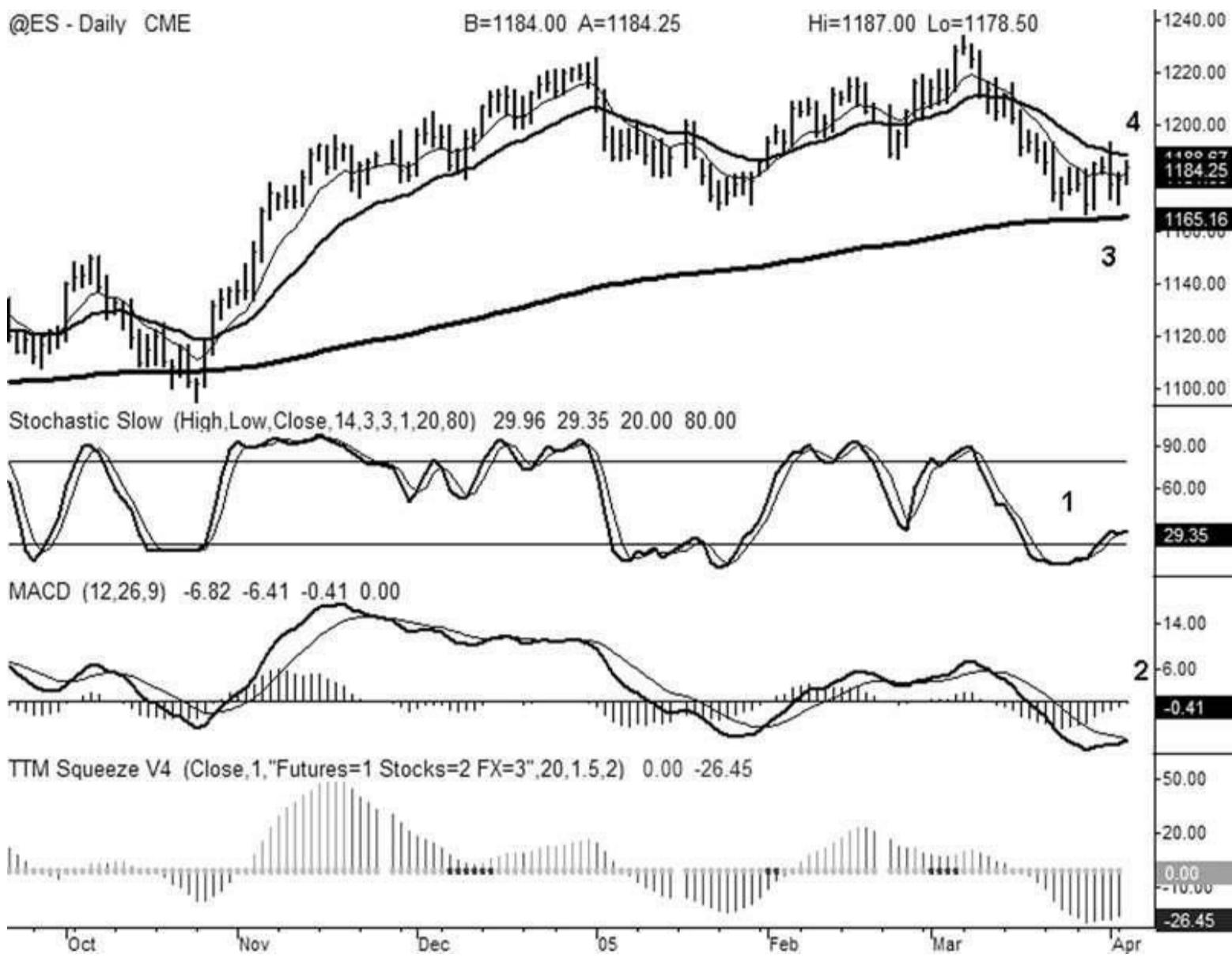


Figure 23.3

60-Minute Chart Analysis

The 60-minute chart reveals a bullish stochastic at point 1, and when I check the MACD at point 2, I can see that the MACD is also pointing higher, which is bullish (see [Figure 23.4](#)). In looking at the moving averages at point 3, I can see that the 8-period EMA is trading above the 21-period EMA, which is bullish, but the market is below its 200-period EMA, which is bearish. Is there a trade here? Take a moment before reading on and figure out what you would do in this situation. I want you to take a trade based on what we've just talked about. Would you go long or short? What's your entry level? What's your stop? What's your target? Spend a few minutes on this before moving on to the next paragraph.

Today is Tuesday, April 5, 2005. Here is what I'm going to set up for tomorrow, Wednesday, April 6, 2005. I'm going to set up a buy order at 1183.50, right above the 8-period EMA. Since this is a 60-minute chart, I'm going to use a target of $\frac{1}{2}$ of 1 percent, which is 5.9175. I will round this up to 6.00, which would make the target 1189.50. This is right below the 200-period EMA, which is a good place for a target. If the 200-period EMA had been below my target, then I would not take the trade. My stop will be 2.95875 ($\frac{1}{4}$ of 1 percent), which I will round up to 3.00. This makes my stop 1180.50. This is just below the 21-period EMA. If we get up $\frac{1}{4}$ of 1 percent in the play (three points to 1186.50), I will move my stop up to the 21-period EMA and trail it from there. If this looks familiar, this is the propulsion play described in [Chapter 22](#).

For my swing plays, I want to play them in the direction of the path of least resistance according to the MACD. The monthly charts are higher, and the daily chart is about to turn higher. Two of the three time frames are pointing higher. Then when I drill down to the 60-minute chart, I see one of the setups that I utilize staring me right in the face, so I set it up. It's as simple as that.



Figure 23.4

However, before we get too excited about a potential play, let's double-check the path of least resistance by looking at two more charts.

Daily RSI Chart Analysis

While the previous charts give me an idea of the overall buying or selling pressure and give me an indication of key levels that I need to be watching out for during the next trading day, there is still a piece missing. What I want to see next is whether there are any bullish or bearish divergences in the seven-period relative strength index (RSI). These are heads-up for a pending market reversal.

In [Figure 23.5](#), we can see that at point 1 at the top of the chart, the S&P made a nice rally into the end of 2004. However, if we look at point 1 at the bottom of the chart, we can see that the seven-period RSI was making lower lows, while the S&P was making higher highs. This is a massive bearish divergence; essentially, it is a heads-up that the current rally is not going to last.

That's great, but how does a person enter that trade? That is a great question. Think a minute before you go on to the next paragraph and decide what you would do in this situation with the tools you've learned so far in this book. The market is rallying, but there is a bearish divergence. I'm looking for the market to fall—how do I enter?

There are a couple of different ways to enter. Plays described in this book that have worked well in this situation are discussed in Chapters 14 (Scalper Buys and Sells), 15 (Bricks), 19 (HOLP and LOHP), and 22 (Propulsion Plays). This comes back to the fundamental basis of my whole trading plan: *even if I feel 100 percent sure that the market is going to roll over, I will not establish a short position until one of my setups generates a short signal.*



Figure 23.5

Now if we go to point 2 in the upper right-hand portion of the chart, we can see that prices made lower lows. Then if we look at point 2 in the lower right-hand portion of the chart, we can see that the RSI made higher lows, creating a bullish divergence. This sets up a potential reversal in the markets, meaning that I want to

focus on the long side. This confirms that the play we just set up in the last section with the 60-minute charts is the right way to go.

60-Minute RSI Chart Analysis

On this 60-minute chart (see [Figure 23.6](#)), there are two bullish divergences in place within the current market action. I've marked one of them—can you find the other one?

The one I've marked shows the RSI making higher highs, yet prices have not made higher highs. This is bullish. The RSI is essentially leading the market higher. The second divergence takes place when the ES made lower lows on April 1, yet the RSI made higher lows. This is a bullish divergence and is also positive. After looking at both these RSI charts, we can clearly see that the long side is the path of least resistance in the short term.

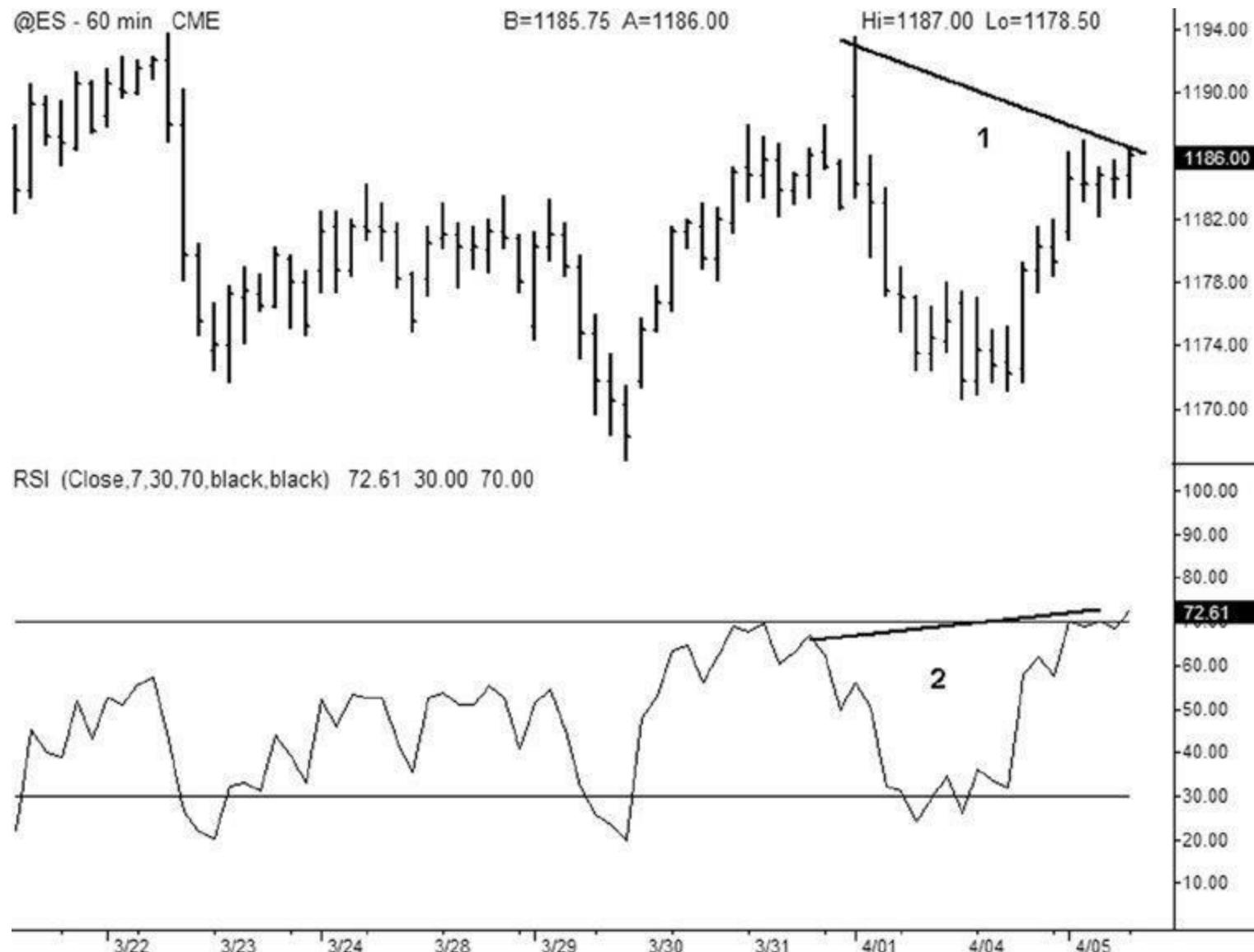


Figure 23.6

What if I'm wrong? What if news about oil hits tomorrow, driving it higher by \$5 a barrel, and that kills the stock market? Then I'm stopped out. Next trade. This is about getting the odds in your favor, not about getting guarantees.

Index Radar Screen Alert

Looking at one index in a couple of different time frames can be a handful to track. But what happens if you are looking at all these different charts and time frames for three or four different indexes, a couple of sectors, and a handful of stocks? It can get confusing. However, knowing what's going on across multiple trading instruments and multiple time frames gives a trader a much better feel for the overall markets. To that end, I've put together the following table to help me keep it all straight (see [Figure 23.7](#)).

This table gives me the opportunity to write down my chart interpretations in an easy-to-read, take-it-all-in-at-a-glance worksheet. With the key indexes that I'm viewing on the far left, I can then go through the stochastics, MACD, RSI, and the squeeze on all the different indexes in all the different time frames. For stochastics and MACD, I have M, W, and D as headings for the monthly chart, the weekly chart, and the daily chart. For the RSI and the squeeze I have W, D, and S as headings for the weekly chart, the daily chart, and the sixty-minute chart. I can then go through and see at a glance that the monthly and daily MACDs are in buys across the board, and that the 60-minute RSIs are also in buys (as they are showing bullish divergences), as are some of the daily RSIs. For the squeezes, I have N, R, S, and B,

representing *neutral*, *red dot*, *sell*, and *buy*. *Neutral* just means that there currently isn't a signal in place, nor is a squeeze even in a heads-up. The red dot (which is the black dot in this book because the charts are black and white) means that a squeeze play is setting up, but it hasn't yet fired. Whenever I see a market that is in R mode, I start paying close attention because I want to see when it fires off. Finally, after it does fire off, if it's a long squeeze, that is a B for buy, and if it is a short squeeze, that is an S for sell.

Index	Close	Change	STOCH			MACD			RSI (7)			Squeeze		
			M	W	D	M	W	D	W	D	S	W	D	S
DOW	10421.14	+16.84	S	S	B	B	S	B	S	B	B	N	N	N
S&P 500	1176.12	+3.20	S	S	B	B	S	B	S	B	B	R	N	N
OEX 100	559.49	+2.00	S	S	B	B	S	B	S	B	B	R	N	R
NDX 100	1476.72	+7.37	S	S	B	B	S	B	S	S	B	N	S	R
Naz Comp	1991.07	+6.26	S	S	B	B	S	B	S	S	B	N	N	R
Rus 2000	613.76	+2.21	B	S	B	B	S	B	S	S	B	N	N	S

Figure 23.7

This may seem like a lot of work, but it doesn't take long to do. The monthly and weekly charts do not change very often—most of the attention is spent on the daily and 60-minute charts. I update this table each evening after the stock markets are closed, and I post the results in my daily newsletters. One of the reasons I started sending out newsletters in 1999 was that it forced me to keep these tables updated each and every day, no matter what else was going on in my life.

By having everything in place, I can see when one index is breaking down before all the others, as the Nasdaq did in early 2005. When one index starts to buck an overall trend, that is a heads-up that the rest are setting up to roll over as well.

Sectors and Key Stocks Radar Screen Alert

This radar screen alert is the same as that for the indexes, except that it will have key sectors and key stocks that I'm watching (see [Figure 23.8](#)). It is set up in just the same way and works in just the same way. When markets turn, you can see it first in the key sectors and stocks that make up the index. Also, if I'm looking for trading ideas and I see that the semiconductors, for example, have just fired off a short squeeze, it is fairly easy to figure out where I should go looking for short plays.

Sector	Close	Change	STOCH			MACD			RSI (7)			Squeeze		
			M	W	D	M	W	D	W	D	S	W	D	S
Banks	95.91	+0.07	S	S	B	B	S	B	S	B	S	N	N	N
Brokers	145.17	-1.05	B	S	B	S	S	B	B	B	S	N	N	N
Semis	409.42	-1.80	S	S	B	S	S	B	B	S	B	N	N	R
PC Tech	674.78	+2.02	B	S	B	B	S	B	B	S	S	N	N	N
Retail	428.64	+4.82	B	S	B	B	S	B	B	B	B	N	N	R
IBM	90.32	-0.12	B	S	B	B	S	B	B	B	B	R	N	N
GE	35.29	-0.18	B	S	B	B	S	B	S	B	B	R	R	R
MER	56.29	+0.34	B	S	B	S	S	B	B	B	S	N	N	R

Figure 23.8

Both these radar screens are included in the daily newsletter I write. Traders who want to prepare themselves will benefit from the exercise. Traders who simply don't have time or who like to have a second opinion can get these daily readings from my research.

The Key to Reading Daily Volume

I like to watch the daily volume in the cash indexes to see how much activity there is going on behind the moves. Each day I take the volume and key it into an Excel spreadsheet like the one shown in [Figure 23.9](#).

Volume	NYSE Market Reading			Nasdaq Market Reading		
	NYSE	Day Before	Percent	Nasdaq	Day Before	Percent
UP	1,223,832,000	944,072,000	29.63%	1,405,734,000	1,147,448,000	22.51%
DOWN	252,459,000	494,847,000	-48.98%	238,069,000	808,448,000	-70.55%
Unchanged	12,077,000	33,701,000	-64.16%	20,243,000	26,933,000	-24.84%
Total	1,488,368,000	1,472,620,000	1.07%	1,664,046,000	1,982,829,000	-16.08%
50 Day Avg*	1,502,598,000	1,502,598,000	-0.95%	2,010,802,050	2,023,950,200	-17.24%

Figure 23.9

What I'm looking for is the strength or lack of strength behind the move. If the markets push higher, I've got to see two things in order to validate the move: first, the volume has to be greater than it was the day before, and second, the volume has to be greater than the 50-day average volume. The bigger the difference in these numbers, the better the odds that the move is the real deal and the start of something big. Conversely, if the markets have a big day to the upside, but the volume is lighter than that of the previous day and lighter than the 50-day average volume, then I have more trouble believing in the move. The lower the actual volume in relation to these other numbers, the greater the chance that the move was a mere probe and is going to reverse violently at the drop of a hat.

Think of it this way—a car that is going uphill on a full tank of gas has a much better shot at making it than a car that is running on fumes. High-volume days show the markets riding on a full tank of gas, while low-volume days show the markets riding on fumes.

The Key Price Levels to Know Each and Every Trading Day

There is a specific set of numbers that I want to be aware of every day, because these are critical in helping me to establish trades and stay on the right side of the market (see [Figure 23.10](#)).

I like to follow most of these price levels in the S&P futures, just because it is the biggest and broadest index and tells me a lot about what is going on in the market. However, I also like to do the same for the Dow, Nasdaq, and Russell futures. For the sake of this example, we focus mostly on the S&Ps, but we bring in the other indexes for part of it as well.

The first thing I want to look at is today's close in relation to the prior three days' highs and lows. Did today's price eclipse either of these levels, or was it contained within these levels? If it eclipsed either of these levels, then we have a trending market. If it stayed contained within these levels, then we have a trading range. It is very important that you always understand what type of market environment you're currently in, and this is one of the easiest and most accurate ways to tell. If today is Thursday and the close is 1050.50, then you just look at a daily chart and review the highs and lows for Wednesday, Tuesday, and Monday. Did Thursday's close make it past these levels, or was it contained within these levels?

S&P Futures Prior Three Days Highs/Lows + Monthly & Weekly Levels

TODAY'S CLOSE	1050.50
Prior 3 Days HIGH	1058.75
Prior 3 Days LOW	1043.25
Break and hold these levels today?	Broke highs intraday, failed
Close: Upper/Middle/Lower 3 rd Today?	Lower
Prior Week High/Low + Current Level?	1064.50/1043.25 Mid: Neutral
Prior Month High/Low + Current Level?	1055.75/995.00 Mid: Neutral
Low of High Week (week ending 10/17)	1043.25 Above: Bullish
Low of High Month (mo ending 10/31)	995.00 Above: Bullish
Number of days in current trend	1 day down
Key Gaps on the S&P Futures: 9:30 a.m. - 4:15 p.m. Eastern	1049.50 on 11/3 1030.75 on 10/28 994.00 on 9/30
Key Gaps on the DOW Futures: 9:30 a.m. - 4:15 p.m. Eastern	No Gap on 11/3 9587 on 10/28 9258 on 9/30
Key Gaps on the Nasdaq Futures: 9:30 a.m. - 4:15 p.m. Eastern	1418.00 on 11/3 1377.50 on 10/28 1338.50 on 10/2 No Gap on 9/30

Figure 23.10

I also like to note where the close was in relation to the day's range. Did the market close at the top of its range? If so, there is a good chance for upward continuation tomorrow. Did it close near the bottom of its range? Or did it close in the middle—indicating massive indecision.

Next, I want to see where the highs and lows for the prior day, prior week, and prior month are located. These are all important support and resistance levels, and I want to know where they are sitting in relation to current market prices. I like to note whether we are trading above any of these levels, which is bullish, or below any of these levels, which is bearish. If we are stuck in the middle, then I call that neutral.

After this, I look at the HOLP and LOHP levels (as discussed in [Chapter 19](#)). Any moves above or below these key levels are a major opportunity. I also like to note whether we are trading above or below these key levels, because that is also bullish or bearish.

The next number I want to know is the number of days in the current trend. The reason for this is that many trends reverse after three days, so if we are in the third day of a trend, I want to be aware of it. Also, after six to seven consecutive days, markets just lose their gas and fail to move any further. I want to know about this so that I'm not the last one jumping on the bandwagon.

Finally, I want to know where all the open gaps are sitting. Remember in [Chapter 7](#) when we talked about open gaps filling within 5 to 10 trading days? It's important to know where those gaps are located.

Pivot Numbers, of Course

We talked extensively about pivots in [Chapter 8](#), so I'm not going to explain again why I look at them. However, I do like to have them handy so that I can look at them before the trading day. By placing them in this easy-to-use Excel spreadsheet (see [Figure 23.11](#)), I can quickly glance at these levels and see if any of them line up with the key price levels we just talked about. Is the daily pivot also lined up with an open gap? That is important because that level will be particularly strong on that trading day.

In addition to the daily pivots, I'm looking for confluence with my list of key numbers among the weekly and monthly pivots (see [Figure 23.12](#)).

Daily Pivots & Midpoints

	S&P Futures	DOW Futures	Nasdaq Futures	
High	1125.00	10315	1435.50	High
Low	1109.50	10153	1408.50	Low
Close	1122.50	10278	1431.50	Close
R3	1144.00	10506.33	1468.83	R3
Mid	1139.25	10458.50	1460.50	Mid
R2	1134.50	10410.67	1452.17	R2
Mid	1131.50	10377.50	1447.00	Mid
R1	1128.50	10344.33	1441.83	R1
Mid	1123.75	10296.50	1433.50	Mid
Pivot	1119.00	10248.67	1425.17	Pivot
Mid	1116.00	10215.50	1420.00	Mid
S1	1113.00	10182.33	1414.83	S1
Mid	1108.25	10134.50	1406.50	Mid
S2	1103.50	10086.67	1398.17	S2
Mid	1100.50	10053.50	1393.00	Mid
S3	1097.50	10020.33	1387.83	S3

Figure 23.11

Weekly Pivots

	S&P Futures	DOW Futures	Nasdaq Futures	
High	1159.00	10634	1485.00	High
Low	1101.00	10070	1398.00	Low
Close	1118.00	10205	1431.50	Close
R3	1209.00	11100.00	1565.33	R3
R2	1184.00	10867.00	1525.17	R2
R1	1151.00	10536.00	1478.33	R1
Pivot	1126.00	10303.00	1438.17	Pivot
S1	1093.00	9972.00	1391.33	S1
S2	1068.00	9739.00	1351.17	S2
S3	1035.00	9408.00	1304.33	S3

Monthly Pivots

	S&P Futures	DOW Futures	Nasdaq Futures	
High	1158.75	10750	1525.50	High
Low	1122.00	10417	1452.00	Low
Close	1144.50	10582	1471.50	Close
R3	1198.25	11082.00	1587.50	R3
R2	1178.50	10916.00	1556.50	R2
R1	1161.50	10749.00	1514.00	R1
Pivot	1141.75	10583.00	1483.00	Pivot
S1	1124.75	10416.00	1440.50	S1
S2	1105.00	10250.00	1409.50	S2
S3	1088.00	10083.00	1367.00	S3

Figure 23.12

Key Sentiment Readings

We talk about the put/call ratios in [Chapter 6](#). I like to record where the put/call ratio closes on the day, and also note where the 10-day moving average of the put/call ratio is trading. While the daily number is good for gauging market direction on that particular trading day, the 10-day moving average pinpoints major market turns. The following chart ([Figure 23.13](#)) from Decision Point shows the key turning points in the markets based on the reading of the 10-day moving average on the put/call ratio. You can get these data from TradeStation, but I just subscribe to www.decisionpoint.com and get it there. It's \$20 a month, it provides nearly every key historical technical study on the planet, and it's where I spend a lot of quality time each weekend.

Key Sentiment Readings	Reading	Rating
Today's Put/Call Close	0.78	Neutral
10 Day MA of CBOE Put/Call Ratio	0.74	Neutral
10 Day MA of OEX Put/Call Ratio	0.97	Neutral
Investors Intelligence Advisor Sentiment	Bulls 56.30%	Bears 21.40%
AAII Investor Sentiment	Bulls 58.00%	Bears 17.00%
Daily Arms Index	1.20	Neutral

Figure 23.13

[Figure 23.14](#) shows that whenever the put/call ratio gets near 1.00, this excessive bearishness in the form of put buying creates a bottom in the market. All these shorts then spend the next several weeks frantically covering their positions. The opposite is also true. When the crowd gets frothy and overly bullish, driving the PC ratio to 0.70, the market is overloaded with bulls and either halts its advance or rolls over.

10 Day Moving Average of Put/Call Ratios

(c) 2005 DecisionPoint.com

S&P 100 Index

562.11 +2.62 +0.5% 4/5/05

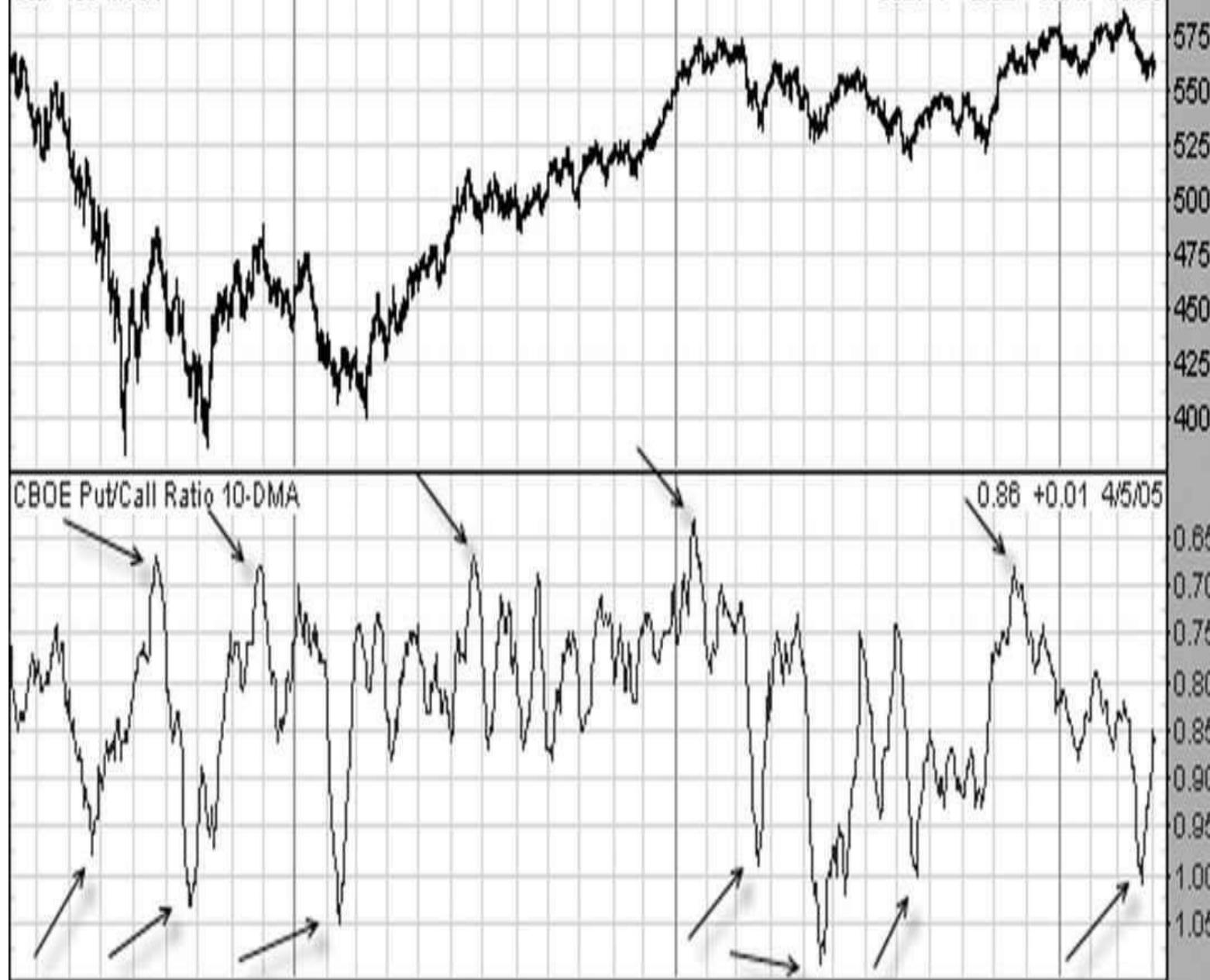


Figure 23.14

I also like to look at AAII investor sentiment, because this is a good gauge of how traders are feeling about the current market. This is also a contrarian indicator. When there are too many bears, look for the markets to bottom out and reverse. When there are too many bulls, look for markets to take a breather or roll over.

AAll Investor Sentiment

(c) 2005 DecisionPoint.com

S&P 500 Large Cap Index (Weekly)

1181.39 +8.47 +0.7% 4/5/05



Figure 23.15

[Figure 23.15](#) is a chart from April 5, 2005, the day I'm writing this. You can see that we are at excessive bearish levels. This tells me that the market is looking to

bottom out and is starting to beat up on all the shorts.

The other item I have listed in [Figure 23.13](#) is the daily Arms Index reading, which is shown in [Figure 23.15](#). This is the indicator we discuss in [Chapter 6](#), and I'm looking for readings of over 2.0 or under 0.50 as key action signals.

It's a Good Idea to Know What These People Are Doing

The last key number in this series is the NYSE member net buy/sell numbers, which I get from www.decisionpoint.com. This shows whether NYSE members are net long or short. If they are net long, it is because they have very strong reasons to believe that they will be able to distribute their holdings to the public at a higher price. If they are net short, they have strong reasons to believe that they will be able to buy back their inventory at a cheaper price. These people make a lot of money, and I like to follow what they are doing.

[Figure 23.16](#) shows a couple of huge readings that came into play over the past few years. The first was during the March 2003 bottom. These people loaded the boat with a record amount of longs. Lo and behold, the markets moved significantly higher shortly thereafter. They sold their inventory all the way up and then reloaded the boat in October 2003, just before the next leg higher. Finally, in September 2004, they loaded the boat again with a record number of long positions. The markets chopped around for six weeks and then rocketed into 2005. If these people are loading the boat one way or the other, I want to know about it.

NYSE Member Net Buy/Sell (Weekly)

(c) 2005 DecisionPoint.com

NYSE Composite Index (Weekly)

7170.90 +34.54 +0.5% 4/5/05



Figure 23.16

Miscellaneous Items

The final things I want to know about are any key economic and earnings reports that are coming out on the day. I'm not concerned with every company that is reporting, but I want to know if a big company like MSFT or IBM is going to be coming out with numbers after the close. I also want to know when key economic

reports are going to be hitting the tape. There are two main reasons for this. First, if traders are waiting for a key earnings number or an economic report, they will generally stand aside to see how the market reacts. This means that the markets are going to be choppy, and I don't want to be trying to catch trends intraday if the markets are going to be choppy. On these days, I will focus on fading pivot levels and fading extreme tick readings—these are the best plays I've found for days where the trading is light and choppy. The second thing I'm looking for isn't the actual number itself, *but how the markets react to it*. The number, whether it is earnings or economic, has no importance. What is important is whether the market sells off on the news, rallies on the news, or ignores the news.

The market is efficient at pricing in information before it ever comes out. In addition, large firms have access to the same research as the government, and they hire an army of economists to figure out what the numbers are going to be before they are announced. These reports mean little in the grand scheme of things because they get priced into the market well before the actual number is released.

The moral of the story? Find a couple of setups and stick to them, and don't get sucked into the “waiting for the next report” game. Just because a report is hyped on CNBC doesn't mean that it's a good idea to place a lot of importance on it.

What Does Your Mother Think?

My final piece of research has to do with random comments that I hear from people who are not in the industry. A classic example is a recent conversation I had with my mother, who mentioned that she had read about eBay in *Business Week*. Was it a good time to buy? In situations like this, I normally just run out and look for a short setup on the stock, but, because it was my mother, I told her I would hold off on buying it for now. Then I shorted it. A few weeks later, it got killed on earnings.

Anything that is just now hitting the ears of the nontrading public is a major signal. This typically means that the people who are usually the last to know are thinking about finally getting in. I can't think of a better topping signal in my arsenal of trading tools.

As I'm writing this, there is this same flurry of activity going on in real estate. More and more random people are talking about things like buying parcels of land sight unseen from out of the back of magazines because “real estate is doing so well.” It's almost at the same ferocity as when Beanie Babies topped out and crashed back to earth. Pretty soon we are going to start seeing major magazine covers talking about how everyone is making money in real estate. Shortly thereafter, prices will start to soften. And no, it's not different this time.

Summing Up the Premarket Checklist

I've got a quote on my wall that says, “Fortune favors the prepared mind.” There is a big difference between getting lucky on one trade and being able to make money in the markets consistently. There is also a delicate balance between being prepared and overanalyzing, but the basic set of tools and numbers discussed in this chapter will give traders a huge leg up without drowning them in barrels of information.

All these data are available to every trader. It's a good practice to take the time to go through and line up this information each day. If you don't have the time, or if you would like supplemental information, this is the same routine I go through each evening. I post the same daily checklist I've reviewed in this chapter in a newsletter that comes out five evenings per week (each night the stock market is open). In addition to this information, I also post the swing trades I'm setting up the next trading day, with the exact entry, exit, target, and stop loss levels. I typically focus on stock options, futures, and currencies, as well as some individual stocks.

In addition to these key levels, I also include a nightly video that's embedded in the newsletter and records my computer screen. With this technology, I'm able to flip through my charts and make comments, discussing the way the various markets are setting up and talking about what I think is going to happen during the next trading day—and the orders that I am placing. This technology is great, as it allows a person to look over my shoulder as I'm doing my research each night. I don't rehearse—it's all recorded live, so you get my first impressions, along with the coughs and telephone interruptions. A trader can just click on the video link, turn up the speakers on her computer, and watch and listen.

For information on the newsletters, you can visit the following websites:

- www.tradethemarkets.com/freetrial
- www.simpleroptions.com/freetrial

Trade The Markets focuses on futures and currencies along with the bigger-picture outlooks, while Simpler Options focuses on, of course, stocks and stock options.

The Trader's Business Plan

No one ever won a war by dying for his country. He won it by making the other poor dumb bastard die for his country.

—GENERAL GEORGE S. PATTON

One thing is certain. Praying for luck in the getting of money is futile. If Lady Luck exists, she is highly perverse, choosing to visit those who have little apparent need of her and ignoring others desperate to worship at her shrine. I've found the best thing is to ignore her. To "treat her mean and keep her keen."

—FELIX DENIS, BILLIONAIRE PUBLISHER

Who Gets to the World Series—the Team with a Plan or the Team That Decides to Wing It?

A two-foot-long arrowana is a voracious predator fish. A single-minded creature, it has one basic rule of thumb that it follows each and every day: if it thinks something will fit into its mouth, it will eat it. When traders visit my office to watch me trade, they are often surprised to learn that their first assignment is to feed Martha, my two-foot-long pet arrowana. They have to take the net, dip it into the feeder tank filled with goldfish, and choose a victim. Martha is used to this routine by now, and she begins to shimmer with excitement and anticipation. The goldfish is released. The water boils and churns as the predator lunges, and a few seconds later, all that remains of Nemo is a few scales and a bit of fin. Steve Patrow, a visiting trader, summed it up succinctly when he said, “That just seems really cruel.”

“Yep,” I replied. “Almost as cruel as sending a trader out into the markets without a fully developed trading plan.” A trader who is trying to make a living in the markets without a fully developed trading plan is in exactly the same position as the goldfish. Whereas one is merely a meal for an arrowana, the other is routinely preyed upon by professional traders. At least for the goldfish, the pain is over quickly. Traders without a plan can stretch out their torment for years.

My first trading plan was created in 1993, eight years after I started trading. It was a one-page document that has evolved over the years into the 15-page plan that I use today. This plan evolved out of experience and from having other traders share their plans with me. I update this plan annually. My plan expanded over the years as I realized the following truths:

- A superior per-trade tracking system had to be set in place.
- A specific day-to-day money management system had to be set in place.
- A methodology for holding specific trading setups accountable for performance had to be set in place.
- A reward and punishment system for myself had to be set in place.
- My plan had to evolve and take into account the setups and markets that best fit my personality.
- Not only did I have to incorporate trading into my plan, but I had to incorporate it into my whole life to really make the plan work. One reality of trading is that this is a profession that can take over a person and dominate his life. It is important that you recognize this and bring a more holistic approach to your overall trading plan. This keeps a trader in the game for the longer term, helping to prevent burnout—a common occurrence in the trading world.

Every trader I’ve worked with has mentioned that the comprehensive business plan that I make him write has been the deciding factor in his own performance. “It was when I turned the corner,” is a common phrase I’ve heard used to describe the results of writing out such a detailed plan. What’s in the plan? I’ll show you the questions I make myself answer every year and take you through them step by step. After I’m done with this, I’ll share a plan that was developed by one of the traders I’ve worked with. What follows are the questions and excerpts from the answers in my actual trading plan for 2005.

Why Am I Trading Again This Year?

The first question I ask myself each year is, why am I trading again this year? Although this might seem obvious, it is important to deliberately choose this occupation over everything else that’s available out there. This applies whether you are trading part time while you’re holding down another job or are trading full time. Here is my answer:

The main reason I’m going to continue trading in 2012 is that I enjoy the financial independence and freedom that trading has to offer. I also love the fact that I can do this from anywhere, because I don’t like to be tied down to any one location. I’ve never been good at taking orders, so I appreciate that I don’t have a boss whom I have to placate. I enjoy meeting other traders because they are the most random, eclectic, crazy, and interesting people on the planet. I enjoy the mental challenge and stimulation that come from trading, and I know that if I stopped, I would miss it. As long as I’ve been doing this, I’ve yet to encounter two trading days that have been the same. Just as I get comfortable, the market reminds me who is running the show. There truly is never a dull moment.

Happy Wife, Happy Life

This is where I take stock of everything else that is going on in my life and how it might affect my trading. By doing this, I figured out when I needed to hire my first assistant, when I needed to bring in another partner, and whatever else needed to be done in order to streamline my life for trading. Here’s what I wrote down for 2005:

I have a lot of activities going on in my life besides trading. I’m actively involved in real estate investing, coin collecting, and traveling, and I have a lot of stuff going on with my website and other financial market-related programs. I also have a lovely wife who expects me to notice that she is a living and breathing human being, and I’ve realized how important it is to include her in my plans and keep her involved in the process, as well as being able to “leave trading at the door” and spend quality

time with her. It's good for her, it's good for me, and it's good for us. Happy wife, happy life.

My wife and I are expecting our first child, and we are considering moving from Boston to Austin, Texas, where most of our family is located. I know that trading is my main occupation, and that the only way I can continue with these other things is if I'm making profits from my trading. It is possible that I will drop some of these other activities if they become a distraction. I will compartmentalize and focus on trading during trading hours. To help with this, I have someone who runs the day-to-day operations of the website, I have a cook and a maid to handle all routine daily chores around the house and the office, and I have someone else who helps manage my other investments. I will focus on writing newsletters that pertain only to my own trading, instead of writing about what I think other people want to know about. These newsletters are mostly for me to help force myself to clarify my own research and continue to find new trading ideas. I will not try to please all the people all the time.

I won't try to day-trade if I am traveling or on vacation. It's okay to have swing trades on and manage existing positions, as long as I have a stop and a target in place and I don't try to "outthink" the position intraday. If I have distractions going on, I will not trade. I will get rid of the distractions first. Examples include having uninvited guests over, morning phone calls, people instant messaging me in the morning asking about a trade, and so forth. I will take care of the distractions. I will ignore phone calls and instant messages until after 11:00 a.m. eastern or, better yet, turn them off. I will not be accommodating just to be nice. The path to hell is paved with good intentions.

Fast-forward to 2012, and things are busier, with three kids in the mix and a growing website business and trading operation. This year has been particularly busy, and I'm consciously trying to get things in place to "simplify." This means getting key people in place to help out, and focusing on what is important. The truth is, I could always check out and just trade, but the business aspect is also interesting. The key is setting things up so that I don't have to work a 16-hour day to get everything done. This means asking for help, and recharging. And saying no, which isn't easy. For me, I've found that being able to get away on the weekends has been invaluable in terms of being able to spend quality time with my family and rejuvenate. We have a place in the country where we can head out on Friday, hang out with our goats and llama (in no particular order), and unplug for 48 hours. To me, this was an important enough goal to find a way to make it work. As an added bonus, the place is crawling with scorpions, which makes walking through the house barefoot an adventure.

What Markets Am I Going to Trade?

This is where I lay out all the markets I'm going to trade. Beginning traders should be focusing on only a few markets. Once a trader decides on the markets she wants to trade, she should stick with those markets for a year instead of looking for the "next great thing."

For day trades, I'm going to trade the mini-sized Dow (YM), the E-mini S&Ps (ES), the E-mini Russell (TF), 30-year bonds (US), and the major currency pairs. For swing trades, I will trade the E-mini Nasdaq (NQ), 10-year notes (TY), corn (C), wheat (W), soybeans (S), crude oil (CL), gold (GC), silver (SI), single-stock futures, individual stocks, and stock options, in addition to taking swing trades in the major currency pairs in the forex markets. I will allocate my total trading funds as follows:

- 25 percent intraday trades (ES, YM, TF, US, forex markets)
- 25 percent swing trades on futures (NQ, TY, C, W, S, CL, GC, SI, single-stock futures, forex markets)
- 25 percent swing trades on stocks
- 25 percent swing trades on stock options

Why These Markets? What Specific Trading Strategies Am I Going to Use?

This is a really important part of the plan. Traders should have a specific setup for each market they are trading. This way, the setup can be tracked for performance. Each setup should be independent in itself. This means that a trader could have a short on the YM for a gap play and a long on the ES for a pivot play simultaneously, and then track the performance of each setup separately.

For intraday trades, I will use the following plays:

- YM: gap plays, tick fades, and pivot plays
- ES: squeeze plays, waves, and market internals
- TF: squeeze plays and pivot plays
- US: break of the high/low 15-minute bar, squeeze plays
- Forex markets: box plays, squeeze plays, break of the high/low 15-minute bar

For swing trades, I will use the following plays:

- All futures and forex plays: daily squeeze plays, box plays, break of the high/low day, 8/21-period EMA for swings (for single-stock futures)
- All stock plays: daily squeeze plays, box plays, break of the high/low day, 8/21-period EMA for swings
- All stock options plays: daily squeeze plays, break of the high/low day, 8/21-period EMA for swings

The key with this is that if I don't have a specific setup in one of these markets, then I'm not taking a trade. I just wait until something sets up.

How Much Money Am I Going to Allocate to Each Trading Strategy and Setup?

Determining how much money to allocate to each trading strategy and setup is, of course, critical. The key is to find an allocation that doesn't cause any stress, allows the chance for a trade to do its work, and won't violate any daily drawdown rules. One of the biggest problems I see with newer traders is that they are trading way too big in relation to their account size. Trading 10 lots on a \$10,000 account is like introducing your mistress to your wife. Yes, you can do it, but that doesn't make it a good idea. (Luckily, my wife has a great sense of humor.)

The following allocations are based on a per \$100,000 basis. The number of contracts or the position size to be used is as follows:

Trading Vehicle	Intraday Futures/Forex Each \$100,000	Swing Futures/ Forex Each	Stocks Each \$100,000	Stock Options Each \$100,000
YM, ES, US	10 contracts			
TF	5 contracts			
NQ, TY, C, W		5 contracts		
S, GC, SI, QM		3 contracts		
Forex	8 contracts	2 contracts		
SSFs		10 contracts		
Stocks			15% of account toward each position	
Options				15% of account toward each position

These numbers will seem conservative to some of you and aggressive to others. I've seen traders take a \$100,000 account and start trading 60 ES contracts at a time. Pretty soon they are trading six contracts, because that's all the money they have left to trade. The goal with this plan is to make a living, not a killing.

What Execution Methods Will I Be Using? What Parameters?

This is where I decide my primary execution method. Am I scaling in? Am I scaling out? Am I getting all in and all out? What is my risk/reward ratio? This is a lengthy part of the plan, as I will write down sample plays for all my categories. I'm not going to do that with all my plays here, but I will spell out my parameters for gap plays.

For all of my intraday plays, I will get in all at once and scale out as the position goes my way. The target on the first half of my play will be small, the equivalent of 1 to 2 ES points or 10 to 20 YM points. Once I have this initial profit, I will give the second half more room to play out. For my swing plays, I will get in all at once and get out all at once, trailing my stop to protect any gains.

For five-minute squeeze plays on YM, I will get in all at once, using 10 contracts per \$100,000. I will use a mechanical target of 10 points on the first half for choppy days, and 20 points on the first half for more volatile days, as determined by the volume on the ES on a five-minute chart ([Chapter 6](#)). If the target on the first half is hit, I will move my stop up to breakeven. I will stay in the trade until one of four things happens:

- My stop is hit.
- I get a reading of 800 ticks in the opposite direction from my trade.
- There is a reading of 1,000 ticks in the direction of my trade.
- The squeeze loses momentum.

I do this for each of my plays, so that there is no question as to how they should be executed. This is crucial because it ties in directly with the next portion of the plan.

How Am I Going to Track and Rank My Trades?

This is where I detail how I am going to track each of the setups I trade and how they are working. I track this information in Excel, which calculates a running average.

I will track all my trades and rate them as follows:

5. Target hit
4. Out at a different price from target, but profitable
3. Out at breakeven
2. Out at a different price from stop, but a losing trade
1. Stop hit

I will add up my daily score and divide by the number of trades to get an average. This provides a "grade point average" on the different setups and how they are doing. I separate the trades based on the specific setup that is being used. At the end of the month, I will have an average for each setup and an overall cumulative average. This will help me to weed out the setups that aren't working. For example, I may have something at the end of the month that reads, "Gap plays: 4.24; squeeze plays: 3.57; pivot plays: 3.87." By looking at this, I can see trends in these setups and potentially drop setups that aren't working or allocate more funds to setups that are working. It is imperative that traders do two things well in order to do this. First, they have to spend 10 minutes a day keying their trades into an Excel spreadsheet or into a journal. Second, they have to follow their setups the same way each and every time. This brings me to an important rule regarding my trading plan:

Any trade I take that does not fall into a specific setup or chart pattern that I have outlined, I will label as an "impulse play."

This includes plays in which I took a specific signal to get in, but I got out of the trade too late or too early because I wasn't paying attention or because I was feeling hopeful or scared or whatever. This is a weakness, and if I succumb to this temptation, I must track it and see the impact it has on my trading. I know from past experience that the results of my "impulse plays" over time are poor, and this reminder keeps me from taking these trades. However, I do not want to get lax, and I will continue to write down these trades and track them if I do take them. I will make notes on these trades. Did I jump in too soon? Did I miss a fill? Did I chase? I have found that by tracking these things, I'm also holding myself accountable. The more I keep tracking my trades, the fewer impulsive trades I take and the fewer overall amateur mistakes I make.

To this end, I also grade my trades on how well I followed the setup. I will give a trade a 5 if I followed the setup to the letter—whether or not it makes money. Any trade that is not a 5 is an impulse play. You have to be brutally honest with yourself here. If you aren't, you're only hurting yourself and anyone who depends on your trading income.

I will also note any overall trends in my trading. How many days did I start off losing but ended up on the plus side? How many days did I start off strong, only to give it all back? What was going on that day in terms of interruptions, phone calls, family stuff, and the like? I know from past experience that I get in trouble when I start off strong and start to go for "bigger trades with house money." I will keep track of any days in which I let greed get the best of me, then work on reducing the number of those days.

What Are My Drawdown Rules?

If I am down by 15 percent for the month, I will cut my position size in half for the rest of the month. If I am down by 20 percent for the month, I will stop trading for the rest of the month. If I hit a 30 percent total drawdown, it is time for a six-week break from trading. My daily drawdown maximum for intraday trading is \$3,000 per \$100,000. If at the end of the day I have exceeded this level, I am on probation the next day. If I exceed \$3,000 per \$100,000 again that week, I am done for the rest of the week. This is my punishment for breaking my trading rules.

I have to point out that many hedge funds and money managers are much more conservative than this when it comes to drawdowns and annual targets. A monthly drawdown of more than 5 percent can be devastating for a hedge fund's business, and an annual gain of 20 percent, year after year, opens the floodgates to billions and billions of dollars for any fund. I have a couple of comments on that.

First off, the day-trading strategies discussed in this book are not going to work for a \$400 million fund. There is nowhere near enough liquidity to enable a fund to get into and out of the markets with that much money in that short a time frame. Many funds, however, will allocate a portion of their \$400 million to take advantage of the intraday trading opportunities I describe in this book. Out of \$400 million, how much would they allocate? Maybe a million. That is $\frac{1}{4}$ of 1 percent of the entire fund.

I bring this up because people need to treat their trading account for what it is—a high-risk way to make a living. Most of a trader's funds should be kept in conservative vehicles—things like bonds or funds run by conservative money managers. Only a portion of total funds should be allocated to an aggressive trading account designed to generate monthly income.

What Are My Profit Rules?

My target daily average goal for intraday trading is \$500 per day per \$100,000. This is conservative and achievable, and it adds up quickly. I will focus on generating five \$2,000 per \$100,000 days per month. This means that I don't have to trade every day. I know from past experience that my best trading days are Tuesday, Wednesday, and Thursday. Therefore, I will focus more on trading on these days. If I am up more than \$2,000 per \$100,000 before noon, I will continue to trade until I have a losing trade, at which point I will stop for the day. If I have a day in which I make \$5,000 per \$100,000, I will take the next day off to escape those feelings of euphoria that cause traders to do stupid things like double up on positions or trade without a stop. I will stop trading for the rest of the month at \$20,000 per \$100,000. I will track my daily equity curve through using an Excel spreadsheet.

I will withdraw 50 percent of my trading profits at the end of each quarter. I will never add money to an account that is down, and I will never meet a margin call. I will add money to an account that has proved itself with positive returns. The reason I will withdraw profits is because this is the best way to protect them. It is with these profits that I get to invest in more real estate, buy more gold coins, pay for a family vacation, and fund my projects. It also is a reminder that the numbers on the screen are real and represent real cash.

What Is My Office Setup Going to Be Like?

I have a separate apartment a few miles from my house that I have set up specifically for trading. My computer setup is in the living room. One of the bedrooms has a computer in it, and I can go in there and shut the door if I need privacy (as when I'm trying to write a book). The privacy is not only from people, but from the markets. It's good to take a break. The other bedroom is set up for an office for my assistant. The apartment next door houses the TTM team, and we recently added another apartment because we needed the space. I'm sure the apartment complex manager is wondering why I need three apartments. We may need to get "real office space" soon. I have AT&T U-Verse (fiber), which is an awesome broadband connection, and I have cable broadband as a backup. My goal this year is to get two people to help me with my actual trading as I continue to expand the markets I watch, and to program more of my trading setups to generate mechanical signals. I have had my trading office located in "regular" office space, but I found the solicitors and the general banter too distracting for trading. Also, when other people in the office building found out that I had quote screens all over the place, they started stopping by to check out what the markets were doing. This was fine the first few times, but then it got real annoying, real quick. In contrast, in the apartment, I've got a full kitchen, and it's still okay to work in a robe. And best of all, there are no unwanted interruptions.

What Are My Rewards If My Trading Is Going Well?

This is where I establish goals that motivate me to stick to my plan. I know that if I stick to my plan, my trading has a better chance of succeeding. And if I succeed, I get to reward myself.

If I hit 60 percent for the year, I will take the next four weeks off. If this occurs in the fourth quarter, I will take the rest of the year off. I could go for more money, but it's enough. For 2005, I want to spend two weeks in northern Italy and Switzerland. I want to take four long weekends where I go to a beach and do nothing. I want to visit Australia, Hong Kong, Taipei, and Tokyo this year, whether on business or for pleasure. I like to watch movies, and I would like to upgrade my home theater system. I have a farm in southwest Nebraska, and I would like to buy another section of farmland in that area. I realize that I need to focus on the setups and not focus on the money needed for the rewards. If I focus on the money, I will lose. If I focus on the setups, I will win.

Updating this in 2011, I did visit all of those areas and bought some more farmland. Going forward, I'm not interested as much in "buying stuff" as I am in "saving time."

Are There Any Groups, People, or Organizations I'd Like to Help Out This Year?

I used to send money to the Salvation Army, but I don't really feel any impact when I donate money to big charities. I would rather help out individuals. I also do a lot of work with www.DreamsForKids.org, which is doing amazing work with children. There is a school in Austin that I would like to help out so they can expand.

What Are My Specific Plans for Staying "On Plan" Throughout the Year?

This is where I add any notes I have gained from my own experiences to help me stay profitable in my trading.

After you have a \$5,000 per \$100,000 day, escape any feelings of euphoria by taking the next day off and doing something that humbles you, like playing golf or flying a plane or sparring with a black belt in tai kwon do. Do not trade the S&Ps between 12:00 noon and 2:00 p.m. unless you are managing an existing position (do not initiate any new trades). Between 8:30 a.m. eastern and 10:30 a.m. eastern, leave your instant messaging service off, do not check e-mail, and do not answer phones. In the trading room, let people know that you will not answer questions during this time. Minimize the trading room window so that you do not read what is going on in the room. You can talk about what you are looking at and what you are doing over the microphone. If people have questions, they will have to wait. If they don't like that, they can leave. Do not trade anything during the overnight S&P session. Better yet, don't watch it, either. If you quit early because you had a 20 percent month, get away physically so that you cannot trade. Go to Cape Cod if it is summer or go skiing if it is winter. Do not trade after 12 noon on Fridays. Focus on trading lighter or not trading at all during the last three days of options expiration. Review your performance during this time and consider this as your time off during the month. For the past year, the market has seemed to do absolutely nothing during this time. Focus heavily on the first two trading weeks of the month. After the first two trading weeks are over, take the next two trading days off and get away from the markets. Give your brain a rest. Take off the entire week of Thanksgiving. Take off the last two weeks of the year. Plan your vacations in August so that you won't be missing anything.

What Am I Doing About My Physical Health?

This portion of the book deserves a thorough update, not because I need to change any of the information, but because I want to expand it. The comments and reactions to this portion of the book have been remarkable. It's a topic that people don't think about until it's thrown in their face. Since I wrote this, I've found a few additional useful pieces of information that I've incorporated into my life. I've had some issues I've had to deal with regarding health, and that led me onto a path of being a guinea pig and talking to all kinds of doctors and trying all kinds of different things in order to be as highly functioning as possible. As one of my doctor-clients recently told me, "Look, you can be average or you can be great. The difference is 300 minutes per week." That 300 minutes refers to vigorous cardio activity. It's the difference between a body that is functioning at optimum levels versus one that is just getting by. That is direct from a 68-year-old surgeon who practices what he preaches (he walks for an hour a day on a treadmill at an incline, 5 days per week). He sees the results day in and day out of his many patients who don't follow that advice. For him, it's both sad and motivating. Something so simple to do, yet so hard to maintain. Let's take a look.

Your ability to trade effectively and consistently is directly related to your physical well-being. You sharpen your mind through physical activity and plenty of exercise, as well as healthy eating. I'm going to share with you my recent health experiences. I debated whether to include this or not, as this is a book on trading, not on health kicks. And, of course, I'm certainly not a doctor. However, I do feel strongly that optimum health is important for a trader, so I'll talk about my recent experiences and you can take the information for what it's worth.

I've always been health-conscious, though I certainly go through "less healthy" periods of time. I try to work out regularly, watch what I'm eating, not drink too much alcohol or caffeine, and take vitamins. When I was 34, I took a couple of physical fitness tests and detailed exams, and was surprised by the results. First off, my cardiovascular health and flexibility were rated as excellent. This means that my running and aerobic activity over the years were keeping me in good shape. That was where the good news ended. I then discovered that my body fat percent was much higher than I thought, and I would need to lose 20 pounds of fat. This was a total surprise. Second, I discovered that I had an extremely low pH level, which means that my body was highly acidic. I then went on to find out the many pleasant things that are associated with having a continuous low pH/high acidic reading in the human body. Some of you will know what this means, while others of you won't. I'm going to condense this as much as possible and share it, so that people who are interested can research this for themselves, form their own opinions, and make their own decisions regarding their health. I swear on my unborn child that this is not going to lead into a multilevel marketing pitch.

In a nutshell, a low pH level (high acidity) is the root cause of more than 50 percent of all diseases leading to hospitalization, including all the killers like heart disease and cancer, and of psychological diseases as well. More specifically, it causes plaque to form on artery walls, and it causes imbalances in the brain that lead to insomnia, anxiety, and impairment of memory. It also leads to calcium deficiencies, as calcium is pulled from the bones to fight the high acidic levels in the body, and these lead to weakened or collapsed vertebrae, poor posture, and back pain. A high acidic reading in the body leads to dysfunction of the digestive system causing indigestion, gaseousness, bloating, and abdominal cramping. Because of this, not enough nutrients get absorbed from the food we eat, and the entire body can experience malnutrition. This also causes undigested foods to ferment in the intestines, causing toxicity. High acidity also interferes with the basic functions of the colon, causing constipation and many other unpleasant side effects. The list goes on and on, with the immune system, the respiratory system, the urinary system, and the glandular system all being affected by a low pH level (high acidity) in the body.

I had no idea about any of this until I was told about it, and I was admittedly obstinate with the doctor when he was telling me about this. Did I have cancer? No. Were my bones weak? No. He assured me that in time this would become a problem, but he did pinpoint an immediate problem, and that was with my digestive system. He asked me if I had to take antacids frequently because of heartburn. "Yep," I answered. He also asked, rather delicately, I might add, if, upon emerging from the bathroom after "doing my business," I noticed a strong, almost embarrassing odor. This applied equally to any gas I might be passing into the atmosphere. "Uh, yeah, that happens sometimes," I said. He smiled and told me that this was due to the high acidity in my system, which caused the digestive system to falter and not fully digest the food I was eating—which also was the cause of my extra 20 pounds of fat.

Before I embarrass myself further, let's jump into the next obvious question. What causes high acidity? Not surprisingly, it's the foods we eat—mostly the ones that are manufactured and come in cans or boxes. Even more so, it is based on what we drink. Sodas, regular or diet, are the worst culprit. I used to suck down three or four Diet Cokes a day. I love sodas. Unfortunately, the more doctors I've talked to, the more convincing the argument has been that sodas are killers, just like cigarettes. Believe me, that is something I never thought would be coming out of my mouth. I stopped cold turkey and haven't had one since.

With respect to diet, I found it amusing that many of the things I thought were healthy were responsible for my current condition. In the mornings, I would pour soy milk on my cereal. Well, while soy is good for you, processed soy is like drinking soda, and most cereals are highly acidic because of the high proportion of refined flour in them. For lunch, I would have a sliced turkey sandwich, soup, and a diet soda. Well, the turkey is bad because packaged lunch meats carry nitrates that ruin a person's stomach. The bread was bad because of the refined flour, and of course the soda was bad. For dinner I would have something similar to what I had for lunch.

To top it off, I also found out that all of the vitamins I took were worthless because they were synthetic. This applies to every vitamin a person takes that lists ascorbic acid for vitamin C, which is pretty much every vitamin. What about all the health benefits that you read about and hear in the media? It's called marketing.

Anyway, here is the list of foods by category, regarding overall health for the body. Foods that promote a healthy pH level are listed first, and the "killers" are listed at the bottom.

1. Eat all you want

- Raw fruits
- Raw vegetables (or lightly steamed)
- Brown rice
- Selected herbs
- Unprocessed fruit and vegetable juices
- Whole grains
- Ezekiel bread (also referred to as flourless)
- Drink one ounce of water for every two pounds of body weight each day.

2. Eat with some moderation—one part for every three parts from item 1

- Clean meats, cooked rare
- Roast fish
- Eggs
- Raw dairy
- Unrefined molasses
- Raw nuts and seeds

3. Occasionally

- Processed cheese
- Commercial pizza
- Commercial butter
- Real ice cream (no gum)
- Canned foods
- Alcohol
- Coffee
- Pasteurized dairy

4. Not in this lifetime

- Soft drinks
- French fries
- Doughnuts
- Potato chips
- Refined protein powders
- Margarine
- Mayonnaise
- Hydrogenated oil snacks (salty snacks)

- Diet soft drinks
- NutraSweet/aspartame
- Processed soy (soy milk, soy cheese, soy protein isolate, soy lecithin)
- White bread

Things like fast food aren't just "fattening" they wreak havoc on your system. They're toxic, in fact. How does one mass-produce a food product like meat that can be served fast in under a minute? Very disgustingly. If you aren't convinced, watch the documentary *Food, Inc.* I haven't set foot in a fast-food place since, and I won't let my kids eat that crap either. There is a great saying I heard from a doctor that went something like, "If you won't feed it to your dog, then don't feed it to your kid." Calm children are the result of healthy foods. Of course, this applies to us adults as well.

Admittedly, eating the foods from the first group on a regular basis took some getting used to—that is, until I discovered a Vitamix blender. One of the best pieces of advice I received from a nutritionist was to have a "green shake" every day. Take one cup of fresh fruit, one cup of water, and one large handful of green leaves (spinach, kale, lettuce, or something similar), throw it in the blender, then drink it. Okay, it doesn't taste very good at first, but I got used to it, and I eventually added other things like goji berries and cacao nibs. This drink is amazingly simple and amazingly healthy. It keeps the brain alert, flushes toxins from your body, and keeps your pH levels high. And best of all, I don't have to endlessly chew salads. Instead of using a juicer, which makes a mess of all the pulp, I'll just take my Vitamix, throw in a whole apple, a carrot, some frozen peas, a large handful of spinach, pour in some fresh, clean water, and just mix it together. Again, we aren't going for a best-tasting-drink contest here. We are going for awesome health. And to top it off, this drink is very high in fiber. As you will notice soon after you start drinking it. Why is fiber important? Fiber absorbs waste and pushes it out of your body. If you aren't getting enough fiber to push the waste out through your colon, then the waste will try to get out of your body in other ways. Through sweat. Mucus. Zits. All very pleasant. Eating a large bunch of green leaves every day is about the best thing you can do for yourself.

I love cereal, but now in the mornings I eat oatmeal with fruit, and later in the day I'll have a green shake, sometimes with whey or even pea-based protein powder. I love deli sandwiches and sodas, but now for lunch I eat a Greek salad with grilled chicken and water. For dinner I'll have vegetables, salad, and either chicken or fish. For snacks throughout the day, instead of grabbing something from the vending machine, I'll have an apple with almond butter or a handful of raw almonds that have been soaking in water. And, believe it or not, cooking eggs (local if you can get them) in real butter is a lot better for you than cooking them in oil. Most oils turn rancid when they are heated. Avoiding rancid oils is one of the keys to health. These oils are also found in many favorite foods, such as chips, crackers, and so on. Essentially, anything that needs to be preserved on a shelf in a box needs to be doused in oils, which then turn rancid. What about stink? Don't worry, the rancid smell is covered up with perfumes. Nice. If you want a cookie, then make them at home.

My challenges today aren't food-based, and this stems more from my travel schedule. I still drink alcohol, but only on Fridays and Saturdays, and then only two drinks (except when I'm working on a book—sorry, liver!). Every once in a while, I will do a cleanse and not drink any alcohol for 60 days. I can say without a doubt that I always feel much better when I'm off the weekend juice.

The biggest challenge for me is caffeine, and I go through periods where I cut back on it slowly and then wean myself off it, reducing my consumption over the course of a couple of weeks. When I do this and adjust, I always notice that I have more energy because I start drinking so much water. The biggest change during the trading day is that instead of sucking on sodas and coffee and having my energy move up and down like a stochastic on a five-minute chart, I drink six bottles of water (16.9 ounces each) a day, and my energy level stays high and constant. The transition was difficult, but after four weeks of doing it, I couldn't imagine going back to my old habits—that is, until I got on a plane for a two-week trip to Asia with the CME Group. The jet lag knocked me over and I needed a caffeine IV before a talk, and it was all over.

I found that caffeine helped prevent "brain fog" during the day and also helped me out when I felt general fatigue. I asked my doctor about this, and he did some blood tests. He discovered that my adrenals were shot and my thyroid function was on the low side. This is a common thing among people who just feel "fatigued" throughout the day. For my particular blood test results, he said that I needed an adrenal rebuilder to help repair the adrenal glands. Adding some bile salts and milk thistle for a healthy liver got me on the road to feeling better and more alert. Your adrenals get worn out when you eat sugar, refined carbohydrates, caffeine, and alcohol, all of which put stress on these glands. Sound familiar? These are also acidic foods. It's a big circle. When you eat and drink healthy, it really makes an impact. Although I don't eat sugar or refined carbs, those beverages snuck back in and didn't help. It was time to go back to the heavy water diet. As I'm writing this, I've been off caffeine for about 2 months. I find that if I start eating processed foods like bread, I get tired and crave caffeine. But when I eat foods that are healthy and alive, then I have more energy than I know what to do with.

I'm including this information because it was a real eye-opener for me, and a big key to my improved health. One side benefit to all this, besides feeling better and sleeping better, was that I lost the extra 20 pounds I was carrying in five months, without increasing the amount of exercising I was doing. It was just a matter of eating foods that helped the functions in my body instead of harming them.

One thing our doctor did to jump-start my wife and me was put us on a 21-day cleanse. There are many of these available. The one we did was called the "Standard Process Purification Product Kit," which is available on Amazon. It flushes out toxins, cleans out the liver, and, over the course of eating extremely healthy foods for 21 days, erases cravings for the crap food. The first few days are tough (I nearly licked smeared egg off my kid's face), but the body adapts quickly. My wife dropped 15 pounds and her skin started glowing.

Finally, as a trader, I spend an inordinate amount of time in front of computers, and this isn't the best thing for posture. I never thought much about it until I started tweaking my lower back on a regular basis at the gym. One of my older and wiser friends told me to "go see my chiropractor." I said, "What? I don't see chiropractors. They're whack jobs." He just shook his head in disgust. To make a long story short, I started doing regular adjustments at a chiropractor who uses the "Gonstead system," and my lower back tweaks disappeared quickly. After that I kept going (and keep going) in for regular adjustments and tune-ups. My mom sat in front of a desk for years at her job, and she never saw a chiropractor. I had her visit mine and he took an x-ray, but at this point her spine has fused together and there is nothing he can do, and she has to live with the pain. Mine was approaching being fused, but it has now been adjusted so that it's closer to "normal." I feel a lot better, and since I started the adjustments more than two years ago, I haven't been sick. Somehow it is also supposed to be good for your immune system.

There is one last thing I recently had done, and again this came about as a result of consulting with a nutritionist. I had my three amalgamated fillings that I've had in my mouth for 20 years removed. The main component of dental amalgam is mercury, which is released from the filling into the body. Mercury in dental fillings is a source of environmental exposure in humans, and mercury is incredibly toxic to the human body. The big dental associations continue to support amalgam because,

frankly, they don't want to appear like they've been wrong all these years, despite all the well-documented risks. This also means that most dentists are not equipped to remove these fillings and in fact will try to talk you out of it (mine did). Removing mercury is dangerous. It is critical to find a dentist who knows what he or she is doing and is equipped to handle this procedure. There are new dentists sprouting up that can be found by doing an Internet search for "biological dentist." These are the ones specifically set up to do this. Ask and make sure they know what they are doing. They should have a specific system in place for extracting mercury safely. I switched dentists. My process took a few hours and my fillings were replaced with ceramics.

Anyway, that's the health story. I'm stepping up my game in 2012 and doing more longer runs, biking, and yoga, and I'm going to start signing up for races to stay motivated. After all, my kids are still young, and I'm going to have to be able to outrun them when they are teenagers.

For anyone who is interested in more information, a good place to start is a book called *Alkalize or Die*, by Theodore A. Baroody. Also, you can go on Google and search for "acid and alkaline foods" or "high-pH foods," and you will get all the information you need. If you are interested in the tests I took, feel free to contact me and I can give you more information. My own research has convinced me that by eliminating refined sugars and refined flours from our diet, significantly increasing our intake of clean water, and doing some general exercise (300 minutes of vigorous exercise a week!), we are preventing more health issues than just about anything else we could do. Good health and good trading go hand in hand. Bad health sneaks up on people; it's under the hood and may not show up for 20 years. But when it does show up, it can be very ugly.

Concluding Thoughts on My Plan

This is the plan. For me, the key here is complete and accurate daily records so that I can assess my trading, review my progress on a month-to-month basis, and make changes in my strategies based on my performance. I also want to incorporate other areas of my life into my trading plan, since trading is a very central and important part of my life.

I've shared my actual plan with a number of traders who have come up to the office to trade with me for a week. One of my goals in working with traders is to help them identify the markets, setups, and time frames that best suit their personality, and then from there help them to put together a game plan. Once they leave, they then e-mail their business plan to me, and I critique it for them and send it back. One of the traders who went through this process is Eric Grywalski. I've asked Eric if he would be willing to share the plan he created, because it is very specific to the beginning trader.

In spending time with him, I could see right away that he was highly intelligent and highly perceptive. Unfortunately, after the first few hours of trading, I could also see that he overanalyzed everything. Instead of jumping into a trade on a predetermined signal, Eric would continue to analyze the market to make sure that the trade setup was really a winner. When he finally did get into a trade and was stopped out, his first statement was, "What am I doing wrong?" This tendency to overanalyze the markets is a problem for a specific group of traders, especially analytical and logical thinkers who are looking to make sense out of the "chaos and randomness" of the markets. To combat this, I had him focus on simple setups that required minimal analytics, and to formulate an exit plan with the same idea in mind—exits that were mechanical or that met a specific set of simple criteria. Eric had had some trading experience on a swing basis before he came to visit me, so he'd already had some experience with the market under his belt. However, he was very new to intraday trading, and this is what he wanted to focus on. His plan follows, and I'll turn this over to him. Items in italics in his plan are my notes from the initial feedback I gave him on his first draft.

A Sample Plan from a Beginning Trader

My name is Erik Grywalski, and my trading plan was developed with the new trader in mind, using John's plan as a model. Defining a handful of solid setups, creating rules to govern my behavior in a limitless environment, and integrating proper trader psychology are key themes in my plan. As a beginning trader, I also wanted to focus on keeping my expectations realistic by not focusing on "making a killing in the market." Forming good habits early on and learning from my mistakes will be critical for staying in the markets long term, which is every aspiring trader's ultimate objective.

Overall, my plan lays out three high-probability setups that I learned from John Carter and Hubert Senters during the week I spent trading with them. Gap, pivot, and squeeze plays allow traders to take advantage of market behavior that occurs on a fairly consistent basis throughout the trading day. Gap plays position a trader for the contra move that often follows morning gaps, while pivot plays anticipate potential turning points in the markets that are identified before the trading day. Squeeze plays allow traders to capitalize on the market's tendency to fluctuate between low- and high-volatility states.

Last, more important than the actual trade setup is trader psychology. Without establishing and maintaining a proper trader's mindset, consistent success in the markets will be unachievable. I strongly believe that this is an area that new traders often overlook because of their obsession with instant profits and is therefore briefly included in my plan. I would like to acknowledge Mark Douglas for his superb book, *Trading in the Zone*. All the core attitudes listed in my plan were taken from Mark's book, and all traders should put this book at the top of their reading list. Comments in italics are notes from John Carter that he inserted after reading the first draft of my plan.

2005 Trading Plan, Eric Grywalski

WHY AM I TRADING?

I am trading because of my passion for the financial markets and my long-lived aspiration to become a profitable, full-time trader. Trading will allow me to actively manage my money in all market situations, while having the freedom to work for myself in an area in which I have great interest. Being a student of the markets, I have gained an appreciation for some of the things that are critical for success as a trader. Proper mindset, strict money management, and trading with a predefined plan are just some of the more important areas to focus on when trading the markets.

Since I have limited intraday trading experience, I realize that the road ahead will be extremely challenging, and I have set expectations for my first year accordingly. The most important, often overlooked area that will be critical for me will be to *establish and maintain* a trader's mindset. The ability to internalize and master the psychological aspects of trading is one of the most crucial skills that determine success. Indicators, charts, and the myriad other tools are helpful, but I must be careful not to overanalyze the market, and I must realize that trading is 90 percent mental. In general, proper attitude will produce better overall results than analysis or technique. With that said, my main goals during this first year are to learn how to execute trades well while achieving modest profitability. This means taking signals when they occur and managing my positions to maximize profitability.

WHAT MARKETS WILL I TRADE?

- Main contract: mini-sized Dow futures contract (YM)
- Hedging contract: E-mini S&P 500 futures contract (ES)

Eric, the YM is a great contract to trade for newer traders. However, you need to have a backup plan. In situations where the eCBOT goes down or you have any computer problems, you will want to be able to hedge any “trapped” YM positions with the ES using one of the following options:

1. *Take an opposite position in the ES market to offset a YM position. As an example, if I am long two YM contracts, I will sell two ES contracts to hedge.*
2. *Use buy/sell stops in the ES market to hedge a YM position. As an example, if I am long two YM contracts and the eCBOT goes down, I will place a sell stop for two ES contracts at a price level that is equivalent to my initial YM stop. This way, if the YM hits my stop and I can't get out of my position, I am hedged at my stop in the ES. However, if the market actually moves my way, I will still be able to participate in the move and liquidate my position once I am physically able to. —JC*

WHY THIS MARKET? TRADING STRATEGIES

The mini-sized Dow will be used for the following intraday trading setups:

- Gap fades
- Pivot plays
- Volatility expansion/five-minute squeeze plays

The mini-sized Dow has a better spread than the S&P and Nasdaq futures, which gives the beginning trader more room (levels) to allow trades to play out. Additionally, it is easier to track all 30 Dow stocks than the 500 that exist in the S&P.

ACCOUNT SIZE AND NUMBER OF CONTRACTS TO TRADE

An amount of \$90,000 in start-up capital should be allocated in the following manner:

- \$40,000 for trading capital
- \$40,000 savings account
- \$10,000 for first-year business expenses (home office, software, etc.)

GENERAL ACCOUNT RULES

- Withdraw 100 percent of any trading profits at the end of each month and place into savings account.
- Never add money to the trading account if the balance is below \$40,000.

NUMBER OF CONTRACTS TO TRADE

- One YM contract per \$20,000
- Equal number of ES for hedging purposes

TRADING STRATEGIES

Three strategies will be used for intraday trading of the YM contract. I will follow only one setup at a time:

- Gap fades
- Pivot trades
- Squeeze trades

Eric, if this is comfortable for you, simultaneous trades in the YM and ES markets may be considered. For example, if I am in a gap trade in the YM that hasn't filled and a five-minute squeeze play sets up in the ES, I will take the trade signal in ES using my standard squeeze execution procedure. This scenario is likely in a market that gaps up in the morning and consolidates all day before selling off into the close. In this instance, it is okay to take both positions; just make sure you play them

Each trading day will be broken down into two 2-hour trading periods:

- 6:30–8:30 a.m. Pacific
- 11:00 a.m.–1:00 p.m. Pacific

All trades must be initiated only during these two time frames with the following exceptions:

- Management of an existing trade that is still on from the morning
- Five-minute squeeze

A. **GAP FADES** The gap trade will be the first trade of the day that I will look for during the morning session. Gap trades are high-probability trades that often fill on the same day. Intraday charts for this trade should be set with a 1:15 p.m. Pacific close and a 6:30 a.m. Pacific opening to account for any overnight/morning gaps in price.

Gap Trade Guidelines

1. Using two-year raw gap data, take gap trades only from *Tuesday through Friday* and take only those gaps that occur at or between R1 and S1 pivot levels. Exceptions to this rule can be made if price opens near another significant level that has a high probability of providing support or resistance. As an example, the market gaps down below S1, but prices open right on the weekly pivot, which also coincides with key daily chart support and/or a moving average (or fib level).
2. YM gaps should be at least 20 points and not more than 60 points.
3. Risk a maximum of 1.5 percent of total trading capital per trade.
4. Around 6:20 a.m. Pacific time, evaluate premarket volume in key institutional stocks to gauge the power of the gap. Specifically, review volume for MXIM, NVLS, KLAC, and AMAT along with other stocks tracked in One Chicago's single-stock futures listing. Use the underlying volume of the cash market, not the futures market.

Volume Guidelines

- Light = < 30,000 shares
- Moderate = 30,000 to 80,000 shares
- Heavy = 80,000+ shares

Note: As a new trader, use a full position (two contracts) only on those gaps where there are less than 30,000 shares in premarket volume for the key stocks. These trades have the highest probability of filling the same day. With moderate-volume openings, trade only one contract and use $\frac{1}{2}$ gap fill as the target. Heavy-volume openings are not to be faded.

1. Premarket volume takes precedence, but be alert during the gap trade if most of the sectors are moving in the direction of the gap. Ideally, look for at least five sectors moving in the opposite direction from the gap. Consider closing the position before stop is hit if the five sectors reverse and start to trade in the direction of the gap.

Eric, I would throw this idea about the sectors out—this will end up being an excuse to overanalyze the play, and you will end up getting out of the trades that you should have stayed in. Just focus on the premarket volume, set your parameters, and leave it alone.—JC

2. If gap occurs with premarket volume over 80,000 shares and does not fill, look for the first buy/sell signal in the direction of the gap. This may be a pullback to a pivot or squeeze play after a consolidation of the morning's gap.

3. When the daily pivot precedes the prior day's close, look to lock in any gap trade profits at the daily pivot.

4. Record unfilled gaps and keep price level handy, as the market will often fill open gaps within 5–10 days.

Avoid gaps on the following days:

- Options expiration Friday
- Rollover Thursday and the day after
- First trading day of a new month
- If after a narrow range day, the next day's gap is larger than the previous day's range
- Gaps where the opening price is outside the previous session's high/low

Gap Trade Execution Procedure:

1. When taking gaps, enter opposite the market using an “all-in” market order and place stop from fill price.

2. Stop price will be determined from the gap’s size, as follows:

Gap Size	Stop*	Potential Loss	% of Capital
0	30	\$300	0.75
25	38	\$380	0.95
30	45	\$450	1.13
35	53	\$530	1.33
40	60	\$600	1.50
45	45	\$450	1.13
50	50	\$500	1.25
55	55	\$550	1.38
60	60	\$600	1.50

*Gaps 20-40 pts: use 1.5-to-1 risk/reward; gaps >40 pts: use 1-to-1 risk/reward.

3. After setting parameters, stay in trade until the gap fills or stop is hit, but do not hold overnight and **do not trail stops**.

4. For two contracts and light volume gaps, the target is a complete gap fill. This price level should match the 1:15 p.m. Pacific closing price level from the previous day and should be set upon entry of trade. Use $\frac{1}{2}$ gap fill as a target for moderate volume gaps.

B. PIVOT LEVEL TRADES Daily, weekly, and monthly floor trader pivots will be a second strategy used for intraday trading of the YM market. Pivots are leading price-

based indicators that help anticipate market turns/points of consolidation and can be valuable entry points for both trending and choppy days. The basic strategy utilizes preplanned (“anti-impulsive”) trades to either fade pivot levels on choppy days or buy/sell pullbacks to pivots on strong trend days. Daily pivots will be calculated using the 24-hour time period, while weekly and monthly pivots will use the high, low, and close from each of the previous week/month’s trading range of the continuous contract (@YM).

Pivot Level Calculations

R3: $R1 + (\text{high} - \text{low})$

R2: $\text{pivot} + (\text{high} - \text{low})$

R1: $2 \times \text{pivot} - \text{low}$

Pivot: $(\text{high} + \text{low} + \text{close})/3$

S1: $2 \times \text{pivot} - \text{high}$

S2: $\text{pivot} - (\text{high} - \text{low})$

S3: $S1 - (\text{high} - \text{low})$

Daily, weekly, and monthly price levels will be drawn on the intraday chart each trading day.

Pivot Trade Guidelines

1. Use 144-tick chart for pivot strategy. Experimenting with other time frames (89- or 233-tick) is okay to see what works best.
2. Add in 8- and 21-period EMAs for confirmation (after entry) and seven-period RSI to spot bullish/bearish divergences. *This is fine, but make sure you are using this for confirmation after the entry, and don't use these to wait to get into the trade.* —JC
3. Consider using pivot strategy as the first trade of the day if an opening gap is a runaway gap where the gap does not fill because of strong buy/sell interest. On these days, look for price to pull back to a pivot level where an entry can take place before the market resumes in the direction of the opening gap.
4. Look to fade the first move to the daily pivot and stay in the trade until a scalper buy/sell signal is generated.
5. If the market opens above the daily pivot, look for short entries for a move down to test the pivot and vice versa for openings below the pivot. If the pivot isn’t tested during the morning session, look for a test in the afternoon.
6. For levels that have multiple pivots, such as a daily and weekly, defer entry point to daily price level.
7. In general, for trend days, look to buy/sell pullbacks to pivot levels, and look to scale out at pivot levels above/below. *How are you determining whether a day is choppy or a potential trend day? This is another area where overanalysis can hurt a trader. For choppy days, it is okay to trade pivots, but remember you are fading the initial move to the pivot on these days. Remember to look at the ES volume and see if it is greater than 10,000 contracts per five-minute bar over the first six bars, which indicates a trend day, whereas volume of less than 10,000 contracts during the first six bars sets up a choppy day.* —JC
8. Utilize market internals to decide what action to take at pivots. For example, if the trin is falling and most sectors are green, focus on buying pull-backs to pivots and ignoring sell signals against pivots. In a choppy market, the internals are less critical, so look to fade rallies and declines to pivots.
9. Use midpoint pivots if the range between the seven daily pivots exceeds 40 points. Midpoints are not used with weekly and monthly price levels.
10. Moves to R3 or S3 are extreme, so keep emotions in check at these extended levels.
11. Daily R2/S2 will contain the market 90 percent of time, so be aware of these levels when trading intraday.
12. Look for convergence of daily, weekly, and monthly pivots (and fib clusters). These levels are strong support/resistance areas to be aware of when trading.
13. If five-minute squeeze fires off in conjunction with pivot, stay in trade until momentum runs out.
14. After two losses in a row, quit using pivot strategy for that day.

Pivot Trade Execution Procedure

1. Use “all-in” limit orders to enter the market. Limit orders should be placed at the targeted pivot level ± 3 pts. If buying at daily midpoints, just use nominal value for entry. *If trading more than 10 lots, use MIT orders (market if touched) to eliminate partial fills for both entries and targets.* —JC
2. Place an initial stop 20 points from the fill price. This represents a maximum drawdown of \$100/contract or 0.25 percent of total equity.

3. Sell/buy one contract after a 10-point profit and use the next pivot level as the target for the final contract.

4. After closing out the first contract, move the stop to breakeven \pm 6 points.

5. Consider using scalper buy/sell signals on 233-tick chart of ES to confirm the trade in YM at pivot levels. Confirmation should occur within 15–20 minutes. If confirmation doesn't happen, close out your position.

C. **FIVE-MINUTE SQUEEZE TRADE** Squeeze trades rely on the premise that stocks and indexes fluctuate between periods of high volatility followed by low volatility. The squeeze indicator captures the moment when the market goes from a low-volatility to a high-volatility state. The squeeze trade is the only trade acceptable to take during the 8:30–11:00 a.m. Pacific doldrums.

Squeeze Trade Guidelines

- Use the continuous contract (@YM) symbol when charting. Focus on signals in the five-minute time frame for intraday trades.
- Red dots signify the contract is in a squeeze (Bollinger Bands are inside Keltner Channels).
- Blue dots signify that the Bollinger Bands have moved outside the Keltner Channels and volatility is increasing.
- Histogram measures move's momentum. Green bars on blue dots are long signals, and red bars on blue dots are short signals.

Squeeze Trade Execution Procedure

1. Monitor a continuous five-minute YM chart for red dots. You should have at least two red dots before considering a potential squeeze.
2. Once a dot turns blue and closes blue for one five-minute period, use an “all-in” market order to go long (two contracts) if the histogram is green and short if the histogram is red. Histogram appears above/below dots.
3. Set an initial stop of 20 points.
4. Scale out of one contract at a 10-point profit and move the stop to break-even minus 10 for the second contract.
5. For the second contract, stay in the trade until momentum runs out on the histogram. This is indicated by the histogram’s failure to make consecutive higher highs if long or consecutive lower lows if short. Wait for two consecutive higher/lower bars before exiting at the market on the second contract.

PSYCHOLOGY

Psychology plays a very important role in trading, and the development of a proper trader’s mindset should not be taken for granted. The unsuccessful trader has firm beliefs and expectations that are often not met by the market. When the outcome doesn’t match the expectation, the trader feels pain and often views the market in a threatening way. Once this occurs, traders are doomed to fail unless they can recognize what is wrong and develop the proper winning attitude of a successful trader.

Adopt the following for trading success:

- **Every Moment Is Unique:** Either the trade works or it doesn’t.
- **Anything Can Happen:** Develop a resolute, unshakable belief in uncertainty. The market has no responsibility to give us anything or do anything that would benefit us.
- **Markets Are Neutral:** The market does not generate happy or painful information; therefore, no threat exists. Our expectations formed from our original beliefs are the sole source of any happiness or pain.
- **Losses Are Okay:** Losing and being wrong are inevitable realities of trading, since anything can happen. Taking small losses is part of a successful trader’s job.
- **Accept Risk:** Fully acknowledge the risks inherent in trading and accept complete responsibility for each trade (not the market). When a loss occurs, do not suffer emotional discomfort or fear.
- **Monitor Emotions:** Learn how to monitor and control the negative effects of euphoria and the potential for self-sabotage.
- **Abandon Search for Holy Grail:** Attitude produces better overall results than analysis or technique.
- **Rigid Rules, Flexible Expectations:** Adopt rigidity in your trading rules and flexibility in your expectations.

PROFIT GOALS

Income Goal = \$20,000 full-time trading profits using two YM contracts (June–December).

$\$20,000 \div 7 \text{ months} = \$2,857/\text{month}$

$\$2,857 \div 4 \text{ weeks} = \$715/\text{week}$

$\$715 \div 5 \text{ days} = \$143/\text{day}$

$\$143 \div \$5/\text{contract} = 29\text{--}30 \text{ points/day}$

$30 \text{ points} \div 2 \text{ contracts} = 15 \text{ points/contract}$

PROFIT RULES

- \$143/day profit objective.
- Once my daily profit goal is obtained, stop trading for the day. *Eric, remember you will have losing days too. You will want \$143 to be an average, not a stopping point for the day. If you make \$300 one day, and lose \$100 the next, then your average over the past two days is \$100 per day.*—JC
- If I have a day in which I am up double my daily goal and the next trade is a loser, I will stop trading for the day.
- If I triple my daily profit goal before 9:00 a.m. Pacific, I will stop trading for the day and will take the next day off.
- If I meet or exceed my weekly profit goal (\$780) before the end of the week, I will take the rest of the week off.
- Track daily P&L and convert to percent returns per day.

DRAWDOWN RULES

- *Daily drawdown maximum is 2 percent.* If I exceed this level by the end of the day, I cannot trade the next day. If I exceed 2 percent again that week, I will stop trading for the rest of the week.
- If I am down by 10 percent for the month, I cut my position size in half for the rest of the month.
- If I am down by 15 percent for the month, I will stop trading for the rest of the month.
- If I am down to a 20 percent total drawdown, it is time for at least a four-week break from trading until I can figure out and correct what I am doing wrong.

GRADE CARD

Track and rate the performance of all trades as follows:

PERFORMANCE SCORING

5. Target hit
4. Out at a different price from target, but profitable (time stop)
3. Out at even (scratch, time stop)
2. Out at a different price from stop, but a losing trade (time stop hit)
1. Stop hit

Eric, this is good, but you will also want to grade how well you follow the setups you have chosen—in other words, how well you execute your plan. This is particularly important given your tendency to overanalyze what you are doing. You also tend to blame yourself when you lose money, i.e., “What am I doing wrong?” If you follow the setup the same way each time, then the focus of what is “wrong” becomes the setup, not you personally. This way you focus on tweaking the setup, not blaming yourself. I would adopt the following scale to use to grade how well you actually executed the trade:

EXECUTION SCORING

5. Followed trade as dictated in your plan.
4. Followed trade entry, but closed out position before predetermined target was hit.
3. Followed trade entry, but removed stop and let position run past original target.

2. Entered setup late and didn't set target.

1. Impulse trade.—JC

Add up daily scores and divide by the total number of trades to get an *average for both categories*. This will keep a grade point average of the number of trades made that are profitable *and those that are executed as originally planned*. Track by trading method used (gaps, pivots, and squeeze) so I am able to rate each method and tweak as needed. Review the score at end of each month to see what needs to be modified.

Note: Any trade that does not fall into one of the three strategies outlined in this plan will be labeled an “impulse play.” Impulse plays are a weakness because they violate the trading plan, so I must track them to see what impact they have on my trading. I will write down notes on each trade and recognize if I jumped in too soon, missed a fill, or chased at an extended price.

I will also track various trends in my trading journal:

- How many days did I start off losing, only to come back by the end of the day?
- How many days did I start off strong, only to give it back?
- Were there interruptions during trading hours that may have affected my results?
- Did I decide not to trade because it was a narrow range day?
- Did I get too confident because of a good morning and trade outside my parameters?

OFFICE SETUP

I will use one room in my house as my office, and it will be strictly for trading. The office will be set up with the following:

- Trading computer with three monitors using broadband Internet access.
- Day-to-day computer with separate broadband connection used for nightly research, e-mail, and as a backup to the primary trading computer.
- All computers will run with a battery backup and have Maxtor external hard drive.
- Antivirus and firewall protection.
- Spyware software.
- Printer.
- Separate phone line and cell phone.

Eric, this is good. You and your wife also just had your first child (congratulations). How does this fit into your trading? Who is going to watch the baby during the day? Are you going to get a nanny, etc.? My wife and I are expecting our first child, and I'm in the process of hiring a live-in nanny to help with the daily tasks of raising children. This is so that Daddy can sleep at night and be ready to trade the next day.—JC

GENERAL TRADING RULES

- Do not hold any intraday positions overnight.
- As a day trader, I am limited by time and range, so I need to be keen to where the market is trading and avoid shorting/buying dead lows/highs of day.
- Parameters of trades are not to be changed once entered. I will define my profit target and stop *before* the trade is executed. After execution, I will let the trade play out to see what happens.
- Do not rush into a trade unless parameters are defined before the trade is placed. There will always be another opportunity down the road, and there is no reason to chase the market.
- Trade on the path of least resistance. For intraday trading, use moving averages on 5-, 15-, and 60-minute charts to confirm the market's short-term trend. If market dynamics are strong and moving averages are rising on all time frames, do not take short signals. For mixed markets, take long and short setups in line with buying/selling pressure on that particular day. Also, use a squeeze indicator to help with determining short-term market bias. If a daily squeeze exists on YM, focus on long setups and pass on shorts.
- Be aware of monthly and weekly pressures to be on the right side of the market.
- Focus on executing trades efficiently and not on P&L.
- Do not trade during lunchtime doldrums (8:30 a.m.–11:00 a.m. Pacific).
- Minimize trading on Fed days. Maybe look at the first ½ hour and the last hour for any opportunities.
- During options expiration week, reduce your position size to one contract and consider trading only Monday to Wednesday of that week. Do not trade on Thursday

and Friday.

- Trade light during the month of August, especially the last two weeks, as volume dries up and the trading gets choppy. Focus on preparing for September trading when volume and players return to the markets.
- Consider taking time off during Thanksgiving week and during the last two weeks of December.

WHAT TO TRACK

On a daily basis, keep track of the following:

- Market dynamics spreadsheet: tracks sector performance, advance/decline, breadth, and so on, of the major markets. This should be done in both intraday and end-of-day formats. For intraday, data will be logged every $\frac{1}{2}$ hour.
- Pending economic data and when it is being released, key earnings reports, and any upcoming Fed meetings.
- Review major markets and key sectors on 15-minute, 60-minute, and daily time frames. Note position of moving averages to gauge supply/demand dynamics, oscillators, and key price levels on daily and 60-minute charts. Use monthly and weekly charts to help confirm support/resistance on shorter time frames. Look for confluence at price levels. From this information, a bias should be developed for the next day.
- Keep a trading journal that documents each trading day's action.

This is the end of Eric's trading plan.

Summing Up the Trading Plan

Eric put a lot of thought into his plan, and, as a result, he will not be staring at the markets each day wondering what he should be doing. This mental flailing around is what initiates most of the mistakes all amateurs tend to make. If you are a new trader without a plan, remember that you are going to be trading directly against Eric and other people like him who have put a lot of thought into their trading plan. For every hundred traders who are out there, fewer than five have a plan as detailed as this. Who do you think stands a better chance of winning more consistently over the long run? You can visit www.tradethemarkets.com/plan to download an updated copy of my trading plan.

The fun in trading comes from the thrill of the hunt, the anticipation of the kill. All the research, all the work culminates into a single moment in time when a trader makes a decision to pull the trigger and is shortly thereafter presented with the results. A trader who can string together enough consistent winners opens the door to a whole new life of independence. The lure of this challenge draws people of all ages and from all walks of life into the markets. Those who can face up to the challenge of drawing up a plan to pave the way will have the odds of success in their favor.

Tips and Tricks for When It's Not Working for You, No Matter What You Do

Do not blame God for having created the tiger, but thank him for not having given it wings.

—INDIAN PROVERB

There is an island of opportunity in the middle of every difficulty. Miss that, though, and you're pretty much doomed.

—DESPAIR.COM

Will Cry for Food—Using Your Emotions to Make Money

The biggest problem traders have is controlling their emotions. I see it all the time. Traders know the setup they are supposed to follow, but they get swept up in their emotions and blow the trade. By stepping back and examining this process in more detail, traders can learn to use their emotional reactions as indicators. Properly tuned, these emotional indicators, instead of leading to mistakes, can create great triggers to enter and exit a market. This is part of the transition from amateur to professional—instead of getting sucked into a trade because of your emotions, use the emotional triggers to fight back and do exactly the opposite of what they are signaling you to do.

The Four Seasons Hotel Trade

When I am in a trade that is going my way and I start to feel overly excited and have the urge to add to my position, I instead use this as my trigger to set up a “double stop order.” As an example, let’s say I’m long 10 E-mini S&P contracts. The market is screaming higher. I find myself thinking of how many nights I could live at the Four Seasons on Maui with the day’s profits. I recognize this feeling and immediately take the “Four Seasons trigger”: I place a trailing 2-point stop for 20 contracts, double the size of my current position.

What happens is that I will stay in the trade as long as it is moving higher, but once the market turns, not only am I out of my position for a nice profit, but I also simultaneously get short 10 contracts. This process takes advantage of the market dynamics of human emotion in a very clean fashion. The sell-off that occurs will be driven by other traders who succumbed to their emotions and bought at the top, because of either fear of missing a move or the euphoria of having a current winning position. Once the market does reverse, it will be these traders who will provide the fuel for the move down as they start dumping their positions once they can’t take the pain of losing any longer. This is one example of how to get your emotions working for you instead of against you.

Thank You, Sir, May I Have Another?

When I’m in a trade, I visualize what a newer trader would be doing—or what I would have been doing when I first started out. “If I entered here, where would my pain point be?” I’ve found that on the S&Ps, a move of 6 points without any meaningful retracements is the maximum “uncle point” for most traders. When I see a 6-point move without a retracement, I picture new traders and try to imagine the pain they are feeling. After about 6 points, I know they won’t be able to take the pain any longer, and I step in and take the opposite side of this move, just as they are bailing out of their position and throwing cabbage at their screen. One person’s stop run is another person’s entry point.

As a professional trader, you will always be using a stop, so you will no longer find yourself in this very real, very frequent, and very unfortunate position. Use your emotions to feel other traders’ pain and figure out when they are going to throw in the towel.

When I Tick, You Tick, We Tick

A more technical way to measure emotion is to watch the ticks. This is the same setup we talked about in [Chapter 9](#). This time, however, if you are sitting there and the market is running away from you, instead of blindly jumping in, look at the ticks. Are they approaching +1,000? They are probably getting close, as pools of amateur traders continue to buy at the market and tempt the goddess of good luck. The ticks are a great emotional balancing mechanism. A frequent surge of adrenaline that comes from watching a market that’s moving without you can be quickly tempered by a quick look at the ticks.

Dive, Captain, Dive

My trading partners and I run an Internet-based trading room where people log in from around the world. One of the things we all like to do is watch how the newer traders react to the market action. There are “noises” that the people in the room can use. One of the classic actions is that when the market is falling, falling, falling, one of the free trial users in the room posts that she is going short and initiates the “submarine dive, dive, dive” noise. Immediately upon hearing this, I know it is time to cover my shorts and go long. The experienced traders in the room also know this, and we all jump in and take the trade. The market usually reverses quickly, and once the newbie traders say that they are stopped out of the short trade, we cover our longs. It’s emotion-based trading at its finest. Of course, we then share this information with the newbie traders. Once they catch on, we just have to wait for the next free trial to show up.

As a trader, if you find that you are constantly shorting the lows and buying the highs, picture newbie traders getting so excited that they are about to literally “push the dive, dive, dive button.” Do you want to be trading with or against these people?

High Five, Baby

Whenever traders I work with—or myself, for that matter—start slapping one another on the back as the result of a good open trade that is racking up profits, I immediately snap alert and close out my position. This is the result of extreme emotion, and extreme emotion is not sustainable. I call this the “high five sell signal.”

Any time you actually utter a noise or pound on something as the result of a trade that is going really well, it’s a wake-up call for you to turn back into a professional trader.

Discover Your Personality Type and Find Out If It’s Holding You Back

One of the themes I’ve discussed in this book is the importance of finding the right markets and the right setups that best fit a trader’s personality. People view the trades they are taking through one of the three dominant personality traits that all human beings share. Some of these personality types are naturally better suited to the world of trading than others. Unfortunately, there are also personality types that will not win at trading no matter what they do. However, there is a silver lining here. The reason these personality types lose is that they are unaware that their personality is the very thing that is responsible for their mounting losses and continued frustration. Once a trader learns about this, he can then use this information to turn his trading around.

The following 20-question quiz will help you determine your dominant personality type. There is no right answer, and it may seem to you that there are two right answers to some of the questions. Just pick the one that makes the most sense in terms of how it relates to you. Don’t think about these too long. The faster you can move through this, the more accurate the readings will be, and the better the information you will have to improve your trading. This is one of the personality profiles I have traders take when they come and work with me, so I can get a better idea of who they are and which markets and setups are best suited to their personality. Here we go:

1. When you think back to one of the best vacations you’ve had, what part of the vacation do you first remember?

- A. The sights and how the place looked.
- B. The different sounds you experienced.
- C. The way you felt while on vacation there.

2. When you think back to a person who captivated your interest, what is the first thing that really attracted you to him or her?

- A. The person’s appearance and looks.
- B. What the person said to you.
- C. How you felt being around the person.

3. When you are driving, how do you get around?

- A. I look for road signs or follow a map.
- B. I listen for familiar sounds that point me in the right direction.
- C. I follow my gut and get a sense of where I am.

4. When I play my favorite sport, I really enjoy:

- A. The way the sport looks, and the way I look playing it.
- B. The way it sounds, like the bang of the bat hitting the ball or the cheering fans.
- C. The way the game feels, like holding on to a tennis racket or the feeling of running around the court.

5. Making a decision is easier when:

- A. I can see all the choices in my mind’s eye.
- B. I can hear discussions from both sides in my head.
- C. I can sense how I would feel if either option came to fruition.

6. From the following list, I would say my favorite activities are:

- A. Photography, painting, reading, sketching, and films.
- B. Music, musical instruments, the sound of the sea, wind chimes, concerts.
- C. Ball games, woodworking, massage, introspection, touching.

7. When I am shopping for clothes, after seeing the item for the first time, the very next thing that I do is:

- A. Take another really good look at it or picture myself wearing it.
- B. Listen closely to the salesperson and/or have a dialogue with myself about the pros and cons of buying it.
- C. Get a feeling about it and/or touch it to see if it’s something I’d enjoy wearing.

8. During the times I find myself thinking of a former lover, the first thing that happens is that I:

- A. Visualize the person clearly in my mind.
- B. Hear the sound of the person’s voice in my mind.
- C. Start feeling a certain way about the person.

9. When I am at the gym or working out, my feeling of contentment comes from:

- A. Seeing my reflection in the mirror improving.
- B. Hearing compliments from people around me about how good I look.
- C. Feeling my body get stronger and sensing that it’s more in shape.

10. When I’m doing math, I check my answer by:

- A. Viewing the answers to see if the numbers look correct.

B. Counting the numbers in my mind.

C. Using my hands and fingers to get a sense of whether or not I am right.

11. When I write out words, I verify the correct spelling by:

- A. Seeing the word in my mind's eye to see if it looks right.
- B. Pronouncing the word out loud or hearing it in my mind.
- C. Getting a gut feeling about the way the word is spelled.

12. When I love someone, I get an immediate experience of:

- A. The way we appear with each other through the eyes of love.
- B. Hearing or saying "I love you."
- C. A warm feeling toward that person.

13. When I do not like someone, I immediately experience dislike:

- A. When I see that person coming toward me.
- B. When that person starts talking to me.
- C. When I know that person is around.

14. When I am at the beach, the initial thing that makes me happy to be there is:

- A. The look of the golden sand and the beautiful sun and placid water.
- B. The sound of the thrashing waves, the howling winds, and whispers from afar.
- C. The touch of the sand, the salty air at my lips, and the feeling of calmness.

15. With regard to my career, I know I'm on the right path when:

- A. I see myself clearly in one of the executive offices.
- B. I hear the president say, "You are one of the company's stars."
- C. I feel satisfaction in getting a promotion.

16. In order for me to get a good night's sleep, it is critical that:

- A. The room is dark, with little or no light coming in from outside.
- B. The room is quiet, without any distracting noises.
- C. The bed feels incredibly soft and comfortable.

17. When I get anxious, the first thing I notice is:

- A. The world seems slightly different to me.
- B. Various sounds and noises start to irritate me.
- C. I no longer feel a sense of ease and calm.

18. When I get focused and motivated, I immediately:

- A. View things from a brand new and positive perspective.
- B. Tell myself that this new state of being is going to open up new doors.
- C. Feel my body and mind getting excited.

19. When someone tells me, "I love you," my first reaction is:

- A. To form an image of the two of us being together or of that person loving me.
- B. To hear my soul saying something like, "This is amazing."
- C. A feeling of great satisfaction and contentment.

20. Dying, for me, is closest to:

- A. Seeing no more or seeing things in a brand new fashion.
- B. Hearing nothing ever again or hearing things in a brand new fashion.
- C. Feeling nothing ever again or feeling things in a brand new fashion.

Once you have completed this test, add up how many times you answered A, B, or C. For example, you might have A: 6, B: 4, C: 10. These results will give you an idea about your dominant personality type. People generally react to and interpret the world around them through this filter. Get your scores together and we'll move on—you'll want to have taken the test before we proceed so that your answers aren't influenced by what you read next. The goal here is to get an honest assessment of your personality traits and then learn how to best utilize those traits in your trading.

Personality Types and Trading—What You Don't Know About Yourself Can Hurt Your Trading

Nearly 60 percent of the population will have "A" as their highest-scoring trait. This indicates that a person's dominant way of viewing the world is visual. It's not really known why this is so, but experts feel that it has to do with sight being our strongest sense, and that the majority of us were taught from birth to depend on our eyes in order to make our way through life. Also, in today's world, our input is largely through television, movies, computer screens, and printed copy—all of which are heavily dependent on the eyes.

Visual people like daylight and are extremely mobile, and it's easy to find them in professions that allow them visual expression. Nowhere is this more observable than in the entertainment industry. Visual people are generally "movers and shakers" and like to move fast. They are drawn to this industry and its related fields as a natural expression of who they are. These types of people naturally gravitate to professions such as painting, photography, and design. They also make great marksmen, firefighters, and pilots.

In terms of trading, visual people adapt most quickly to this profession, as they depend largely on what is happening visually in front of them on the computer screen to make decisions. This doesn't mean that they will make the right decisions, but they are most naturally adapted to the world of trading. If they are untrained in how the markets work, they will make the same mistakes as everyone else. Once they get some experience, however, they tend to be good at waiting for the charts to set up before taking their entries. Yet, only experience teaches them how to manage their exits. A visual's biggest weakness is watching the P&L fluctuate throughout the trading day. It would be better for her to cover that up (a business card taped to the corner of the computer screen works well) and just focus on the setups. Also, visuals tend to laser in on a price chart and ignore everything else, which can be a detriment to their trading. This is why it is helpful to have auditory alerts on things like high tick readings and to listen to pit noise in the background so that visuals don't get sucked into the extreme price action they are seeing on the charts.

If your highest score was "B," then your dominant personality trait is auditory. My accountant is highly auditory, and I've noticed that the sounds around the office occupy most of his attention. Auditory personality types relate to the world through the way things sound and in many respects are more sensitive to sounds than visual people are to sight. Auditory people can be easily distracted by the most inoffensive sound, which can make it seem as if they are not paying attention to you during a conversation. In reality, though, they are strong verbal communicators—it's just that they hear every sound coming their way, and sometimes it distracts them. They enjoy both talking with others and just talking out loud to themselves. Because of their innate internal ability to put thoughts into dialogue, experts believe that most loners have this dominant personality type. Because of their heightened sensitivity to sound, auditories don't tolerate harsh or disharmonic noise as well as others do. Fire or ambulance sirens are major offenders, and you can spot an auditory easily by observing who on a street corner is holding his ears as an ambulance screams past. Also, they have an incredible ability to listen so thoroughly and with such intent that data are absorbed and processed in their minds very quickly, without needing to be translated into pictures. Because of this enhanced ability, auditories tend to gravitate to areas in life that permit the use of such superb listening and communicative talents.

With regard to trading, this personality type has one strong advantage—the ability to sit alone in front of a computer for days at a time without going crazy. That is an important part of trading, and this ability to be patient and wait and not feel isolated is a necessary trait to have. The downside of this personality type and trading is that a chart isn't really much use to an auditory, and such a person will frequently miss setups simply through not paying attention. Whereas a visual can stare at a chart for hours because the red and green lights are fascinating, an auditory personality needs additional input. Audio alerts and pit noise are important tools for auditories, and I know some of these personality types who don't even look at price charts. They just listen for audio alerts and then place their trades.

If your highest score was "C," then you relate to the world around you by how you feel. People with this dominant personality trait long to be understood and respected for being so in touch with their feelings. They tend to like a person because of how they feel when they are around that person, or they like a movie because of how it made them feel when they were watching it. When they laugh, they let themselves go and really feel the laughter, giving the person they are talking to a sense that they totally understand and agree with what was so funny. Type C personalities are able to translate visual images and acoustical data into feelings that are pertinent to them and those around them. Type Cs enjoy conversations, but not for the same reason that visuals or auditories do. They use dialogue to translate words, sounds, and images into feelings. While visuals and auditories are busy communicating with pictures and sounds, the type C personality is busily running through her vast storehouse of feelings and attaching sensory meaning to what the other person has just said.

Because of their heightened ability to feel, you would assume that type Cs are introverts. However, the opposite is true. Moreover, because of their superior sense of touch, type Cs make superior athletes. Any occupation that requires manual tasks is just plain easier for people with this personality type. Typical occupations that are tailor-made for them usually have hands-on or feeling parameters. Psychologists, woodworkers, potters, surgeons, actors, all types of mechanics, and other feeling- or sensory-based occupations are common among them.

For traders, people with this type of personality have the biggest struggle, and they usually don't make it until they figure out how their personality is working against them. A trader with a type C personality will wait until he senses that things are good or bad, or wait until he gets a sense about whether what he is doing or is about to do is good or bad. Such a trader will literally get into trades when it feels good to do so, and get out when it feels bad. This almost always puts them in just as a move is ending and gets them out just as it is turning. For people with a type C personality, it feels bad to buy a market that is selling off into a pivot level. They would rather wait to see a bounce so that they can "feel good" that the trade is going to work out. Of course, by the time this happens, they should actually be closing out a position instead of initiating a new one. The solution to this is hard yet simple. If you are a type C, then just acknowledge that your feelings need to be faded. If you are excited and feel good about going long, then you should be looking at the short side, and vice versa. If you are a type C, don't despair. A type C who masters this will have a distinct advantage over other traders. A type C who is unaware of this will always face an uphill battle when it comes to trading.

In terms of personality, no one is going to be 100 percent anything. I am primarily visual, then "feeling" is not far behind, and finally auditory makes up a small portion of my overall personality profile. I've learned to set up my charts to take the best advantage of my dominant visual personality, listen to my feelings to get an idea of what the amateur traders are doing and thus "fade my feelings," and set up audio alerts to make sure my eyes aren't the only thing that are responsible for my trading decisions. Learning this about myself made me a better trader.

Trading Really Isn't That Easy—Alternatives to Consider for Jump-Starting Progress

The harsh truth is that trading isn't for everyone, but the problem is, you won't know whether it's for you or not until you give it a shot. It takes guts, courage, and years to become good enough to do it for a living. My advice is to start out small. Whatever amount you start with is your tuition money—you are going to lose it, and that is your educational fee for entrance into this world. Do yourself a favor and trade small until you start getting consistent with your setups. If it still isn't working out after a few years and you are getting ulcers, or if you figure out that you'd rather be playing golf, there are other options.

First off, learning about trading by reading a book is about like learning about golfing by reading a book. Both require what are called complex execution skills. Reading will help in the understanding but not the doing. Other examples of this are:

- Learning a native language or a second language

- Driving a car
- Playing a sport (baseball, football, hockey, and so on)
- Snow skiing or water skiing
- Playing a musical instrument
- Math
- Morality
- Computer programming
- Playing poker or bridge
- Flying a plane and getting a pilot's license
- Trading and investing
- Tuning a piano or working on a car engine
- Being a doctor or a lawyer

Activities that require complex execution skills are learned by 99 percent of the population in exactly the same way. How is that? They have to have at least one other human being physically beside them teaching them for an extended period of time.

For trading, this often isn't practical. It's easy to practice in isolation. It's hard to find someone who (1) can really trade and (2) will let you sit next to her for an extended period of time. This need to have someone with you is why the Stockholm syndrome happens. Physical contact with kidnappers changes the perspective of those who are held in captivity because the captured feel what their kidnappers feel and end up mimicking their kidnappers' rules, sentiments, actions, and so forth. It's the way human beings learn and operate. Humans see others around them and discover what, why, and how they do things, and this is how humans learn and start to mimic. Those who don't have physical contact with kidnappers may read and understand what the cause of the capture is, but that pales in comparison to the changes that are taking place in the minds of the victims who are being held hostage.

For me, I had to spend time and sit side by side with other traders before I turned the corner to consistency. In sitting beside these traders, it was helpful to hear them talk about what they were doing and why, but that was only about 40 percent of what I learned. The rest of it had to do with what they *weren't* saying or doing. They weren't getting upset if they missed a move. They weren't answering the phone when it rang. Also, there were many things they did and habits they had that they weren't even aware of until I pointed it out to them. It was these unconscious trading habits that I picked up that really helped me out as well—just observing and absorbing how a professional trader spent his day. To that end, if you really want to do this, I would encourage you to find an experienced trader and just spend a week sitting next to him. That was what turned the corner for me. If you can't find anyone, there are a few times a year when we will hold weeklong "mentorships" at my trading office (see [Figure 25.1](#)). Traders can sign up to come and spend time side by side with me and some of the other traders I work with and just watch what we do. After a few days, we will then have the visiting traders start making trades while we observe and make comments. If they do a good job following their own rules, we'll let them make some trades in one of the various funds that we run. Part of their homework while they are with us is to develop a full trading plan like the one I shared earlier. The goal is that when they leave, they will never again have to wonder what they should be doing when they are staring at the charts. They will have a plan to follow, and they will just wait for specific things to happen "according to plan."



Figure 25.1

John Carter (outset) and Hubert Senter (closest in) showing Bill Shugg (center) how they trade.

If that's not an option? Then one thing you can do is record your trades while you do them in a program like Camtasia. This allows you to go back and review your trade "live" as it unfolded. This is like a quarterback watching the game films, trying to better understand what he and his players did and how the other team tried to work against them. This is great information to have as a trader: to be able to go back, look objectively at your own mistakes, and see ways to improve. Be more patient? Don't chase? It's a great way to get to the next level.

There are also programs available in which specific setups can be auto-traded by a number of brokers. There are brokers who do this with my own setups and newsletter plays. However, the setups I use are shorter-term in nature, volatile, and not appropriate for everyone.

There is no shame in throwing in the towel when it comes to trading. For many, quitting trading is the best trade they ever made. They are not stressed out, they let someone else manage their accounts, and best of all, they understand what is going on because they have already been there themselves. Visit www.tradethemarkets.com/tips for updates and ideas on how to work through this journey called trading.

Practice does not make perfect. Only perfect practice makes perfect.

—VINCE LOMBARDI

Mastering the Trade

Amateurs Hope; Professionals Steal

Professionals steal money from amateurs because amateurs hope, close their eyes, and unwittingly allow professionals to drain their accounts.

The sum of my trading experience is this: I've learned that being a professional is all about maintaining a specific state of mind while trading, and traders are never going to make consistent money until they achieve that frame of reference from which to operate. All the successful traders I know blew out their account at least once before they became consistently profitable. Along these lines, I've composed a list of 40 "trading tips" for staying in this professional state of mind. These "tips" are not meant to make a trader conservative or hesitant. On the contrary, trading takes guts, and by following these tips, traders will be given the key that will allow them to embrace risk and take the necessary chances required in the pursuit of capital gain. That is, traders will feel more compelled to take a chance because they know they are also going to fight to protect their capital. They won't freeze and lie helpless as it is whittled away.

This is a list I've developed specifically for myself. When I use the term *you*, I'm referring to "me." Feel free to add to these tips or modify them to fit your own personality and trading style.

At home, we have a llama named Shim. (We called the animal "Shim" because when we got it, the beast had so much hair that we couldn't tell whether it was a "she" or a "him." We later discovered that Shim was a she.) I have a photo of myself with Shim up in my office as a reminder about the markets. Shim may seem nice and docile, but if you stare in her eyes too long or make any sudden movements, she will spit up the nastiest, most vile liquid right into your face. Her aim is deadly accurate. In the markets, never let your guard down. Otherwise Shim (is the market a he or a she?) will get you right between the eyes.

40 Trading Tips for Maintaining a Professional State of Mind

1. Trading is simple, but it's not easy. If you want to stay in this business, leave hope at the door, focus on specific setups, and stick to your stops.
2. When you get into a day trade, watch for an 800 reading in the opposite direction from your trade for signs that you are wrong. This might allow you to get out of your trade before your stop is hit.
3. Trading should be boring, like factory work. If there is one guarantee in trading, it is that thrill seekers and impulse traders get their accounts ground into parking meter money.
4. Amateur traders turn into professional traders once they stop looking for the "next great technical indicator" and start controlling their risk on each trade.
5. You are trading other traders, not the actual stock or futures contract. Who is taking the other side of your trade? Is it an amateur who is chasing or a professional who has been patiently waiting for this entry all day? You have to be aware of the psychology and emotions on both sides of the trade.
6. Be very aware of your own emotions. Irrational behavior is every trader's downfall. If you are yelling at your computer screen, imploring your stocks to move in your direction, you have to ask yourself, "Is this rational?" Ease in. Ease out. Keep your stops. No yelling. The person who is screaming should be the one on the other side of your trade.
7. Watch yourself if you get too excited—excitement increases risk because it clouds judgment. If you are feeling peak excitement, it probably means that the move is just about over. Tighten your stop and look to reverse.
8. Don't overtrade—be patient and wait for three to five good trades.
9. If you come into trading with the idea of making big money, you are doomed. When accounts are blown out, this mindset is responsible most of the time.
10. Don't focus on the money. Focus on executing trades well. If you are getting into and out of trades rationally, the money will take care of itself.
11. If you focus on the money, you will start trying to impose your will upon the market in order to meet your financial needs. There is only one outcome for this scenario: you will hand over all your money to traders who are focused on protecting their risk and letting their winners run.
12. The best way to minimize risk is not to trade. This is especially true during the doldrums, between 11:30 a.m. and 2:30 p.m. eastern. If your stocks or other markets aren't acting right, then don't trade them. Just sit and watch them and try to learn something. By doing this, you are being proactive in reducing your risk and protecting your capital. The most common problem with losing traders is that they feel that they always have to be in a trade.
13. There is no need to trade five days a week. Trade four days a week, and you will be sharper during the actual time you are trading.
14. Refuse to damage your capital. This means sticking to your stops and sometimes staying out of the market.
15. Stay relaxed. Place a trade and set a stop. If you get stopped out, that means that you are doing your job. You are actively protecting your capital. Professional traders actively take small losses. Amateurs resort to hope and sometimes prayer to save their trade. In life, hope is a powerful and positive thing. In trading, resorting to hope is like placing acid on your skin—the longer you leave it there, the worse the situation will get.
16. Never let a day trade turn into an overnight trade. An overnight trade should be planned as an overnight trade before the trade is ever entered.

17. Keep winners as long as they are moving your way. Let the market take you out at your target or with a trailing stop. Don't use impulse exits. Every exit is taken for a specific reason based on parameters that have been clearly defined.
18. Don't overweight your trades. The more you overweight a trade, the more hope comes into play when the trade goes against you. Remember, hope in trading is like acid on skin.
19. There is no logical reason to hesitate in taking a stop. Reentry is only a commission away.
20. Professional traders take losses. Being wrong and not taking a loss damages your own belief in yourself and your abilities. If you can't trust yourself to stick to your stops, whom can you trust?
21. Once you take a loss, you naturally forget about the trade and move on. Do yourself a favor and take advantage of any opportunity to clear your head by taking a small loss.
22. In general, you should never let one position go against you by more than 2 percent of your account equity. Many setups work out better if you can use a larger stop. Instead of trading 20 E-mini contracts with a 1-point stop, trade 10 contracts with a 2-point stop or 5 contracts with a 4-point stop. The monetary loss is exactly the same, but one set of these parameters will work better on a particular setup than all the others. Find out what works best for your setup and adjust your parameters accordingly.
23. Get a feel for market direction by "drilling down." Look at the monthly charts, then the weekly, daily, 60-minute, 15-minute, and 5-minute charts to get the best idea of what the market is going to do in the short term. Always start with the larger time frames and drill down to the smaller.
24. If you are hesitating to get into a position when you have a clear signal, that indicates that you don't trust yourself, and that deep inside, you feel that you may let this trade get away from you. Just get into the position and set your parameters. Traders lose money in positions every day. Keep them small. The confidence you need is not in whether or not you are right; the confidence you need comes from knowing that you execute your setups the same way each and every time and do not deviate from your plan. The more you stick to your parameters, the more confidence you will have as a trader.
25. Averaging down on a position is like a sinking ship deliberately taking on more water. This is ridiculous and stupid. Don't be ridiculous and stupid.
26. Try to enter in full size right away. If you pick up a half position first, don't add to it and create a full-sized position unless the trade is going your way.
27. Ring the register and scale out of your position. Have modest, mechanical targets for the first half of your position. Give the second half more room to run.
28. Adrenaline is a sign that your ego and your emotions have reached a point where they are clouding your judgment. If you are not in a trade, do not enter a new trade when you are in this state of mind. If you are in a trade, stick to your parameters and walk away. If you are in a losing trade that has gone through your stop, exit your trade immediately and walk away from the markets.
29. You want to own the stock before it breaks out, then sell it to the momentum players after it breaks out. If you buy breakouts, realize that professional traders are handing off their positions to you in order to test the strength of the trend. They will typically buy them back below the breakout point—which is typically where you will set your stop when you buy a breakout. Use this information to make money off of amateur traders who buy breakouts.
30. Embracing your opinion leads to financial ruin. When you find yourself rationalizing or justifying a decline by saying things like, "They are just shaking out weak hands here," or, "The market makers are just dropping the bid here," then you are embracing your opinion. Don't hang on to a loser. You can always get back in.
31. Unfortunately, you will not learn discipline until you have wiped out a trading account. Until you have wiped out an account, you typically think that it cannot happen to you. It is precisely that attitude that makes you hold on to losers and rationalize them all the way into the ground. If you find yourself saying things like, "My stock in EXDS is still a good investment," then it is time to rethink your trading career.
32. Siphon off your trading profits each month and stick them into a money market account. This action helps you to focus your attitude and reminds you that this is a business, not a place to seek thrills. If you want thrills, go to Disneyland.
33. Professional traders risk a small amount of their equity on one trade. Amateurs typically risk a large amount of equity on one trade. This type of situation creates emotions that ruin amateurs' accounts.
34. Professional traders focus on limiting their risk and protecting their capital. Amateur traders focus on how much money they can make on each trade. Professionals always take money away from amateurs.
35. In the financial markets, heroes get crushed. Averaging down on a losing position is a "heroic move" that is akin to Superman taking a spoonful of Kryptonite to prove his manhood. The stock market is not about blind courage. Nobody hands out any awards to traders who picked the dead high or the dead low. Wait for a setup. This is about finesse. Don't be a hero.
36. Traders never believe that they will blow out their account. Always realize that you will become a candidate for this if you don't stick to your trading rules.
37. The market reinforces bad habits. If early on you held on to a loser that went against you by 20 percent, but you were able to get out at breakeven, you are doomed. The market has reinforced a bad habit. The next time you let a stock go against you by 20 percent, you will hang on because you have been taught that you can get out at breakeven if you are patient and hang on long enough.

38. The true mark of an amateur trader who is never going to make it in this business is continually blaming everything but himself for the outcome of a bad trade. This includes, but is not limited to, saying things like:

- The analysts are crooks.
- The market makers were fishing for stops.
- I was on the phone, and it collapsed on me.
- My neighbor gave me a bad tip.
- The message boards caused this one to pump and dump.
- The specialists are playing games.

The mark of a professional, however, sounds like this:

- It is my fault. I traded this position too large for my account size.
- It is my fault. I didn't stick to my own risk parameters.
- It is my fault. I allowed my emotions to dictate my trades.
- It is my fault. I was not disciplined in my trades.
- It is my fault. I knew there was a risk in holding this trade into earnings, but I didn't fully comprehend it when I took the trade.

The obvious difference here is accountability. For amateurs, everything having to do with the market is "outside their control." That is not reasonable thinking and really just points to individuals who have, probably for the first time, had to confront their "real self" as opposed to the perfect self or idealized self that they have constructed in their mind. This is also known as "living in a fog." People can drift through life in their own private world, where they are pretty special and can do no wrong. Unfortunately, trading rips off this mask, because you cannot dispute what has happened to your account. This is also known as "confronting reality." For many people, when they start trading, they are suddenly confronting reality for the first time in their lives. Just to see the world as it really is requires a lifetime of training, and for many people, trading the stock market is their first real step on this journey. Some people say that traders are born, not made. Not so. If you choose to see the world as it is, then you can start trading successfully tomorrow.

39. Amateur traders always think, "How much money can I make on this trade?" Professional traders always think, "How much money can I lose on this trade?" Traders who control their risk take money from the traders who are thinking about the red BMW they are going to buy.

40. At some point traders realize that no one can tell them exactly what is going to happen next in the market, and that they can never know how much they are going to make on a trade. Thus the only thing left to do is to determine how much risk they are willing to take in order to find out if they are right or not. The key to trading success is to focus on how much money is at risk, not on how much you can make.

The longer I do this, the more protective I get of my trading capital, and the more surprised I am when things actually work out exactly as planned. And that is what keeps it so interesting each and every day.

Surviving the Trader's Journey

Strategies fail because traders have to have only a couple of losing trades in a row before they throw out the whole system and go back to relying on their gut. Once traders are in this situation, they head into a downward spiral very quickly. Human emotions get people in at the dead highs, and then human emotions get people out at the dead lows, as they continually buy at the top out of greed and then sell the lows out of fear. Or, in the case of shorts, they sell at the lows out of greed and cover at the highs because of fear. And this is a cycle that happens over and over and over again. And it's never going to stop.

The financial markets naturally take advantage of and prey upon human nature, especially when it comes to greed, hope, and fear. The key is to remember that the biggest movements in the markets do not occur when traders in general "feel like buying." They occur because groups of traders are all getting skewered at the same time and are being forced out of a position. In reality, traders are not trading stocks, futures, or options. They are trading other traders. The profitable traders learn to be aware of the psychology and emotions behind the person who is taking the opposite side of their trade. Average traders understand only their side of the trade. Superior traders understand what's happening on both sides of a trade and know how to take advantage of situations that will hurt most traders. They know how to take advantage of human weakness, and, therefore, they are able to grind most traders into the ground like so much raw meat. In essence, winning traders steal money from losing traders.

My partners and I jokingly refer to the financial markets as the "Goddess of Temptation." The goal, of course, is for traders to develop a professional trading mindset that prevents them from succumbing to these temptations. Instead of being the *cause* of the ebbs and flows of the markets, traders need to jump the chasm that allows them to ride out these ebbs and flows on a course toward profitability.

Good skiers rarely worry about a route. They just go, confident that they'll react to changes in the trail as they come upon them. It's the same thing in trading: traders have to have confidence in their technique. That is the beauty of mustering the right mindset before a trader starts the day—it enables the trader to feel like a good skier, nice and relaxed for the next unexpected turn.

Before He Trades

In some marriages, a wife might get upset when her husband stumbles home drunk at 4 in the morning after going to a rock concert with another woman. My marriage would qualify as falling into that category. Although this mishap can partly be blamed on the false sense of energy and confidence one gets from combining too much Tito's Vodka with Red Bull, I did have what I thought was a valid trading-related excuse for this behavior. The excuse: "I want to help other traders." I'll discuss this knowingly dubious statement in more detail shortly. More pressing is the question, "Why in the world am I sharing this story?" After all, there is a reason it's called a personal life—it's personal.

Traders live hectic lives, with outside influences jerking their senses around on a daily basis. These external forces can drive traders to distraction, and once that happens, the traders start adding to losing positions and start pulling stops. This takes a trader down the dark path where she sets herself up for a catastrophic loss. There are few guarantees in life, but I guarantee this: if traders allow outside circumstances to influence their level of discipline, they will get whacked with a catastrophic loss. Maybe not today and maybe not next week, but it only has to happen once. And it will occur much more quickly with leveraged instruments such as futures and options, where gun-slinging traders can rack up a monster loss in the time it takes them to return from the bathroom. Once this disaster hits a trader's account, a new reality emerges that is even more horrible to imagine—having to go out and get a job.

Block Out Distractions

To succeed as a trader, the daily distractions have to be managed. Life marches on, despite a trader's need for quiet and solitude. To be able to make a consistent living at this incredible occupation, a trader must maintain discipline no matter what is going on around him. And that's why I'm sharing this story.

Today is the first trading day after my 4-in-the-morning escapade. I did have the weekend to recover, so I'm feeling semi-human again. On this day, with figurative plates being thrown against the wall, I still have to focus on my setups. I have been doing this long enough to know that a catastrophic loss can happen to anyone. The market could not care less that I wrote a book on trading—it's certainly not going to show me any courtesy (or mercy, for that matter). Since I truly do not want to go out and get a real job, I take a deep breath and start the "hurry-up-and-wait" process that I have done thousands of times before, where I kill time waiting for a specific setup to take shape. This is despite my strong inclination this morning to just throw on a trade to give my mind something else to occupy itself with.

While I'm lingering, I do have a few song lyrics to rewrite, so I work on that while waiting for one of my alerts to fire off. Yes, I did say song lyrics, and that's part of the reason I was out so late.

Trading the Squeeze

The S&P futures were down more than 20 points yesterday, and this morning they are trading in a volatile, yet narrow range. On the 377-tick chart I'm watching (see [Figure 26.1](#)), I see that a squeeze sets up at point 1, but the C wave at this point was wishy-washy, with part of it still below zero. I pass on the trade, though I really want to pull the trigger. Half an hour later, another squeeze sets up at point 2. This time the C wave is clearly above zero, and I take a long trade. I get in at 1193.50. For this small a time frame, I'm willing to risk no more than 10 ticks, so I set my stop at 1191.00. Once I'm up 8 ticks (at point 4), I sell half my position, and move my stop to my entry level at 1193.50. Now I'll just wait for the TTM trend to turn black two bars in a row, or I'll get stopped out. The ES pushes as high as 1198.50. By the time the bars turn black at point 5 and I'm able to sell, I'm out at 1196.50.

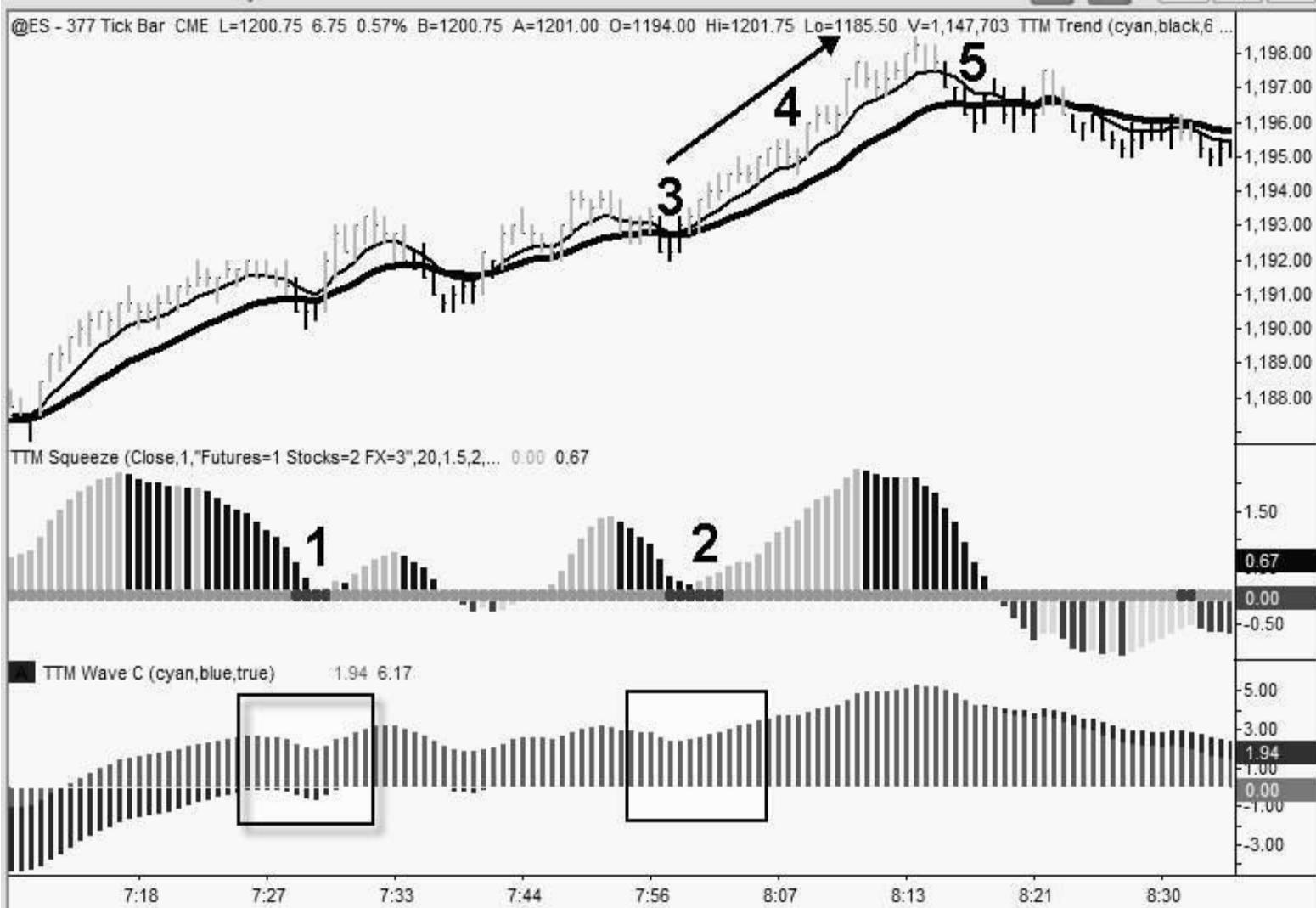


Figure 26.1

The Subtleties

Trading truly is an art form, with the canvas being not the screen but the profit and loss (P&L). The art of trading comes into play once a predefined setup has occurred. At this point, it is time to finesse an entry. And once that entry is finessed, it is then time to manage the position in such a way as to continually reduce one's risk while allowing the trade, if it so desires, to stretch its legs and run. Surprisingly, trailing stops on a full position are some of the worst ways to do this. With this style, traders set themselves up for getting stopped out of the entire position on a wiggle, while the market then resumes its original move.

For a finessed entry, my main goal is to avoid going into a position using a market order. That opens the door to too many bad habits; I prefer to keep that door closed. In looking at [Figure 26.1](#), I see that the ES pulled back into moving average support at point 3, just as the squeeze had started to form. I placed a bid at 1191.50 to try to pick up any additional slight weakness. I couldn't get filled. Once the TTM trend turned back to gray and popped back up above its moving averages (also at point 3), I got more aggressive and moved my bid to 1193.50. This time the market eased back and I got filled, and a few moments later the squeeze fired off long and we were off and running.

This is where the rubber meets the road—any trader can get into a position, and frankly entries are a dime a dozen. It's the exits that make or break a trader, and this is where one has to stay focused and not do anything stupid. I'm not going to add to this position and load the boat because the market looks like it is going to take off. Part of me is thinking, “Maybe I should make a big trade, generate some quick cash, and buy something for my wife to make her happy.” That thought passes quickly—I am lucky enough to have already experienced how brainless a trading idea that would be.

Keep Those Stops in Place

I'm also not going to hold on to this position without a stop in place. That's the tough part about outside distractions—in a normal situation, professional traders don't worry about getting stopped out of a trade. Small losses are simply a part of the trading lifestyle. However, if there are crazy events swirling around a trader's life, getting stopped out can be frustrating and can instigate foolish behavior—such as removing the stop so as not to have to deal with the annoyance of getting stopped out. All traders have done it, and it makes as much sense as not going to the hospital after getting a gunshot wound to the abdomen so as not to increase one's insurance premiums.

In this case, I start with an initial stop at 2.5 ES points (10 ticks). If and when the trade goes my way, I like to start reducing risk as soon as possible. Once I'm up 2

full ES points (8 ticks), I cover one-half of my position and move my stop from 2.5 points to breakeven. My next target is essentially “open,” and I’m willing to hang on as long as the TTM trend stays in my direction. This could mean that it runs out of gas quickly and I get stopped out at my new breakeven stop, or it could mean that economic data are released, the market rallies 15 handles, and I catch every point. You just never know what is going to happen next.

Once I see the two black bars, it’s the signal for me to close out the rest of the position. I do this and net 3.00 points on the last half of the trade.

The whole idea of this exit strategy is to reduce risk on the trade to the point where a trader has a breakeven stop, and then to be patient and sit on one’s hands for a potential runner. When I’m sitting on my last half, I do not trail my stop—I just wait for an exit signal. I’m either going to get stopped at breakeven on my last half or get a runner. For the ES, typical runners are 2 to 5 points, with an occasional 10-point (or more) run thrown into the mix. In other markets, such as soybeans, oil, and gold, typical runners can be much more sustained. Soybeans can easily run 15 to 20 cents, which P&L-wise is identical to 15 to 20 ES points or \$750 to \$1,000 per contract.

The Other Woman

We are now at a logical place to revisit my 4-in-the-morning juvenile adventure, and how that event unfolded. To make a long story short, I had been trying to think of an entertaining way to remind traders of the critical importance of following their trading plans. It is just so crucial to follow the basic rules of trading each and every day and on each and every trade. Deviation is not an option—not even for one trade. And for some reason I thought, “Why not a music video?”

Carrie Underwood’s song “Before He Cheats” kept playing in my mind. It’s a song about a guy who is cheating on his girlfriend. The girlfriend finds out and proceeds to destroy his car with a baseball bat. I thought, “Why not rewrite the song? Have a girl who gave her man all her money to trade. He, of course, doesn’t follow the trading rules and loses all her money. She finds out and proceeds to destroy his computers and monitors with a baseball bat. And I could call it ‘Before He Trades.’” (In case you are wondering, it’s considered a parody and is 100 percent legal.)

Of course, if one writes a song, one has to have a singer. I found one—a gospel singer. We agreed to meet up at a My Chemical Romance concert at Stubb’s Barbecue in Austin, Texas. I had to hear her sing, and I needed to see if she would be right for the video. (For the record, I did invite my wife along, but at the last minute she declined because she had a cold.)

If you have never seen My Chemical Romance live, it is a great band with a ton of energy and presence. Many Tito’s with Red Bull later, we followed the crowd out to Sixth Street, drifted into a bar, and before I knew it, the hours flew by, and—bam!—I got home late. I was in B-I-G trouble. (Any readers who have been to Sixth Street in Austin might understand how that could happen.)

In the end, my wife saw that I really did just want to shoot a music video—I wasn’t going through a midlife crisis or anything. She got enthusiastic about the project and even helped me rewrite some of the lyrics. We interviewed a couple of production companies and felt that Ray Schlogel at Underground Planet would be a good fit. The singer, Gloria Cadena, recorded the song. I played the trader in the video, of course. Schlogel shot and edited the footage, and presto, I had a music video.

You Just Never Know ...

The longer I trade, the more I have come to understand that no matter what a trader does—no matter how many indicators or time frames she meticulously studies—a trader can never, never, never predict with 100 percent certainty what the market is going to do next. As someone who trades during the day and who is also involved in running other trading-related businesses, I realize that this is a statement some people would call blasphemous. Surely, through all my years of trading, I have found a way to wait patiently for the perfect setup that works nearly all the time. But really one never knows what’s going to happen—that’s the plain and simple truth.

Once I realized that, a funny thing happened to me during the trading day. I stopped getting stressed out. Instead of being tired and exhausted at the end of the day, I was relaxed enough to enjoy time with my kids and generally hang out. This is in contrast to the stressed-out days when I would painstakingly watch every tick, willing the market to go my way. Afterwards, I was so tired that I had to grab a few beers and look for escape in movies and one-person shooter games to unwind.

The market is going to do what it damn well pleases, regardless of any hopes and dreams the trader has pinned to a particular trade, and completely regardless of how much confirmation a trader has on a particular trade that may normally have a high probability of working out.

The only thing a trader can do is control his risk—on each and every trade. Stay disciplined. Be patient. Remind yourself of this before every trade. If there is a secret to trading, it is this: take the next trade not to make money, but to improve one’s skills as a trader. This is how a trader is able to make a living at the game. This is how a trader is able to avoid a catastrophic loss.

And did I learn any additional lessons about the trading lifestyle while shooting the video? Yes—the next time I’m out until 4 a.m. with another woman, I’m taking my wife along. To see the video, go to www.youtube.com/user/tradethemarkets and click play.

The Easier Path: Swing Trading

One thing that I have learned during years of trading is that it is often easier to make money swing and position trading. Day trading still has its place—but overtrading is a guaranteed path to losing money, as is overreacting and over-staring-at-the-charts. For me, day trading is about being patient for a few select setups each day, with the aim of creating monthly cash flow to pay the bills. Swing and position trading, on the other hand, are about creating wealth.

I will swing and position trade just about anything, and I trade the same patterns whether what I’m trading is soybeans, oil, or an individual stock. In this case, PotashCorp (POT) (see [Figure 26.2](#)) caught my eye back in April 2008 as it set up a textbook swing trade. At point 1, POT reaches a new 52-week high, which is one of my favorite things to see in a stock, because at some point it will try to make another 52-week high ... until it doesn’t. On June 3, 2008, a squeeze setup indicates a contraction in volatility at point 2. I check the C wave, and it’s well above zero. It’s just a matter of waiting for the toothpaste to shoot out of the tube and being there to catch it before it hits the floor.

Potash stock is consolidating directly under new all-time high levels. This is important because it indicates a persistent type of momentum. The goal of the trade is to wait for a signal that shows it’s ready to break out, jump in, and then scale out using Fibonacci extension targets. My favorites for this are the 1.272 percent and 1.618 percent extensions, which are shown at point 4 and point 5. To get these in most platforms, you have to edit the parameters and add these in as new default levels on top of the regular 0.382, 0.50, and 0.618 retracement levels.

Okay, let’s look at the current signal setting up at point 2. Unlike day trading, which requires a precise and patient entry methodology because of the small stops used, with swing trades, the signal firing off means that it is time to take a position immediately. I still use limit orders, but I don’t try to get too cute. I don’t want to

miss the trade—I don't want to "be a dick for a tick," where I get a great signal but miss a huge move because I was trying to save a few pennies on the purchase price.

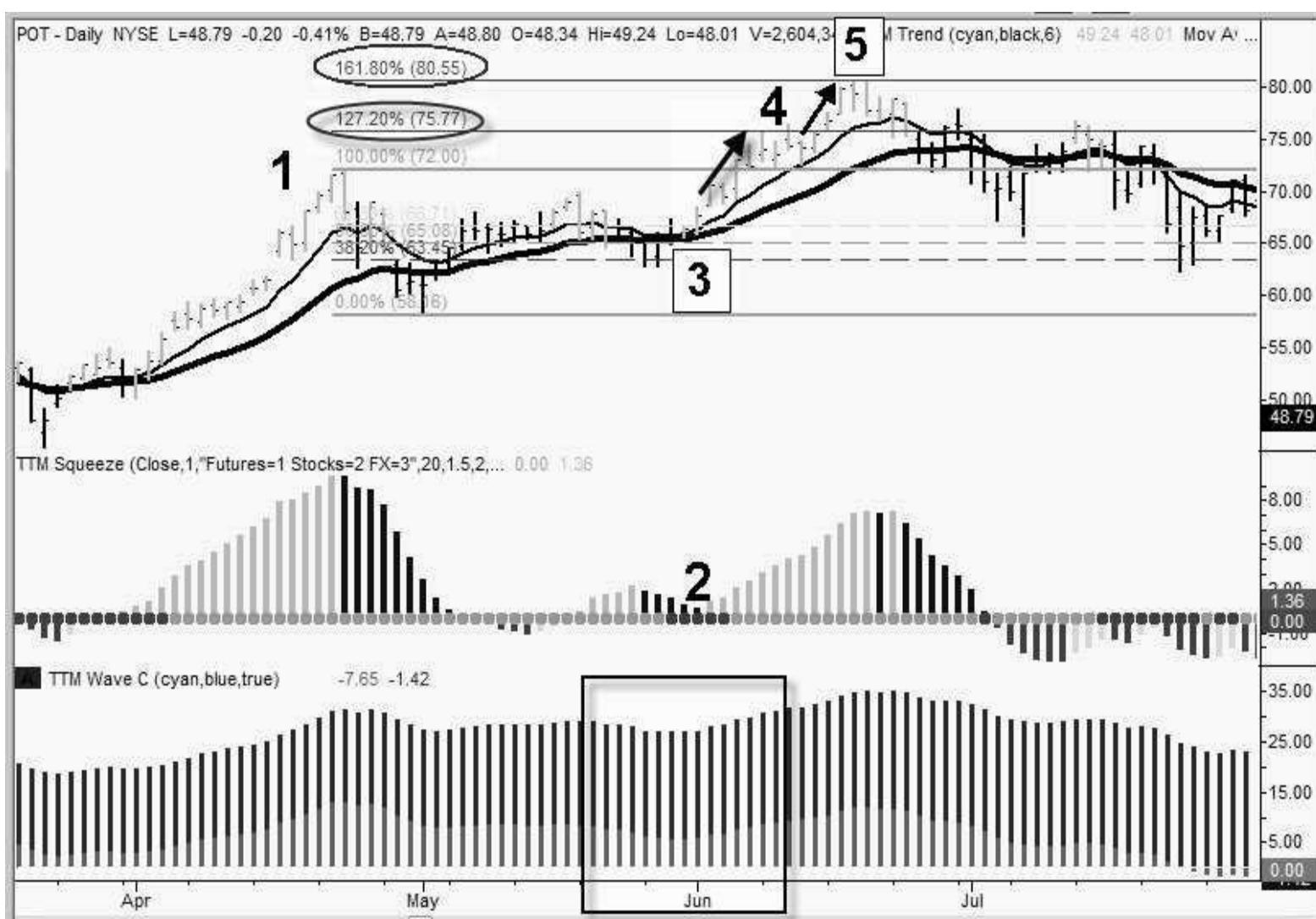


Figure 26.2

The squeeze on POT fires off, with a gray dot appearing after a series of black ones. I use a simple five-minute chart and place limit orders at intraday support levels, my goal being to get a full position that day. My trading instrument of choice is to buy in-the-money calls (delta 0.70) that have at least two weeks of life before expiration. The nice thing about options is if you are ever in doubt, just go out to the next month to buy more time. It's like an insurance policy.

In this case, POT was actually trading at \$210 when I took this play. Since that time, the stock has split 3 for 1 in February 2011, so this chart shows the lower "split" price closer to the \$70 level. Of course, the signals are still the same. I bought the June and July 190 and 195 calls, which would be the equivalent of buying the June and July 65 calls post-stock split. I split my order in half across June and July to give myself extra time on a runner should the occasion arise.

Many traders like the idea of buying 100 out-of-the-money options at \$1 (\$10,000 total investment), thinking that if the stock were to really take off, they would make a fortune. I would rather take that \$10,000 and buy 10 in-the-money calls at \$10 apiece. This way, when the stock moves even a little, I'm making money. There is nothing worse than being dead right on a stock but losing money because one bought the wrong options contract. That's why it's called trading, not praying.

The targets on this trade are \$227 and \$242 (\$75.66 and \$80.66 post-split). Once a stock exceeds a prior 52-week high, it has an 85 percent probability of testing its 1.272 Fibonacci extension. When this level is hit at point 4, I move my stop up to breakeven. There is then about a 65 percent chance that the stock will then hit its 1.618 Fibonacci extension. At this point, one of three things is going to happen. First, my new stop will get hit. Second, my 1.618 Fibonacci target will get hit. Third, the TTM trend will change colors, and I will use that signal to exit. In this case, we hit the 1.618 level at point 5. We were able to get a nice high from POT. (I'm glad the stock symbol wasn't LSD.)

Conclusion and Final Thoughts

Finishing a book must be similar to sending a child off to college, except that in this case, I'm not sad to see it go. It's a great process, and it even helped me to clarify some of my own trading ideas ... but it's a lot of hard work. If it helps you to become a better trader, then the time was well spent. This book really discusses everything I know about trading up to this point in time. If you are interested in additional resources outside of this book, you can pay us a visit at our main website, www.tradethemarkets.com. We use this site to post our research on currencies, futures, and stocks. For stock options, because they are so specialized, we've set up a site called www.simpleroptions.com. For anyone interested in managed accounts, we also have a website called www.razortrading.com where you can get more information on the managed account programs we offer. We also have additional tutorials at the site, and once a year we do a seminar up in Chicago, as well as a few

live trading “webinars” (online seminars) every year. The live event is great because we also get to tour the trading floors at the CME Group, which is always awesome to see. Free trials for our premium services, as well as general information, can be found at:

- www.tradethemarkets.com/freetrial
- www.simpleroptions.com/freetrial
- www.razortrading.com/info

When I kicked this off about 400 pages ago, I mentioned that intermediate traders generally fall into the following three categories:

- Those who know the setup like the back of their hand, but fail to make money because of a flawed trading methodology
- Those who know the setup better than their spouse’s bad habits, but fail to make money because the setup is being used in the wrong market
- Those who know the setup better than the varied plot lines on *Alias*, but fail to make money because they can’t stick to their rules.

The point of this, of course, is to emphasize the importance of establishing a trade setup from a multifaceted approach. Successful trading is a lot more than just, “What’s my entry, and what’s my stop?” In addition to the actual setup, there also needs to be a foundation from which to operate the setup. This foundation consists of the following: the right setup, in the right market, in the right time frame, all of which tie into the trader’s personality—and all this ultimately ties into how the trade is managed. How will you know when this all comes together for you? The first clue is that it will have nothing to do with how you feel about it. It will have everything to do with the results. I’ve shared with you some of the setups that work for me. Find two setups out of this book that you can follow in a particular market in a particular time frame, stick to your rules, and make them your own. Once you have two setups that work for you consistently, start looking at adding a third. There is no reason to rush into this. Take your time and master each step as you go. And remember, making a living on one simple setup, on one market, on one time frame is just fine too.

As I state in the Introduction, without rules, a trader is like a wounded antelope in the center of a pride of lions. It is not a question of “if” the antelope is going to get whacked faster than a newly discovered FBI informant within the Mafia, but rather of “when.” For traders without the discipline to follow their rules, the possibility of financial ruin is not a question of “if.” It’s only a matter of “when.”

I work with traders all the time. The ones who turn the corner and eventually start making a living at this profession learn to stick to their rules. This is typically a painful process. There is only one guarantee I can give you in this business, and it is this: *if you can’t stick to the rules you develop, and if you are always finding some excuse to enter or exit a trade earlier or later than your rules state, you will never, never make it as a trader.*

As a history major, I have to say that this is the most exciting time to be alive in the history of the world. Change used to occur over the course of centuries, and then decades, then years, and now change is taking place every day. One of my favorite fiction books of all time is James Clavell’s *Taipan*. This book is based on historical facts and tells the tale of rival China traders Dirk Straun and Tyler Brock in the newly formed British colony of Hong Kong in the 1840s. They had to make their buying and selling decisions for vast quantities of spices, cotton, and tea using price quotes from London that had been printed three months before. Can you imagine trading with quotes delayed three months? That is what people had to do less than 150 years ago. Today, when I’m in Hong Kong on business, I can type in real time and get responses in real time from a counterpart in London through instant messaging. Don’t get caught up in any “wishing for the good old days” or any of that nonsense. As I’m writing this on October 18, 2011, the world is undergoing a lot of economic uncertainty, and things are going to get worse before they get better. But they will get better. Change is life; life is change. For traders, whether the markets go up, down, or sideways, whether the economy is growing or we are in the midst of a great depression, there will always be opportunities to trade.

It is my hope that, after reading this book, you will have a better foundation for a plan to trade the markets successfully on a full-time basis: proven setups to play, markets that best fit those particular setups, and a set of rules to apply to those setups. That is pretty much all a trader needs in order to survive and thrive in this greatest of professions.

For a list of all the different links and videos we put together especially for this book, visit www.tradethemarkets.com/book and you’ll be able to click on and access all of the free videos developed specifically for this book from this one page. If you would like to get free videos each night that recap what we are doing in the markets right now, go to www.tradethemarkets.com/videos and sign up there.

I hope this book helps you take your trading to the next level, and I wish you well on your trading journey. It’s not for the faint of heart, but it sure builds character.

The benefit of death is you know not to waste life living someone else’s choices.

—STEVE JOBS

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About the Author

John F. Carter grew up as the son of a Morgan Stanley stockbroker, and was introduced into trading as a sophomore in high school. He's been trading actively ever since. He studied international finance at Cambridge, England, before graduating from the University of Texas at Austin. In 1999, he launched the website www.TradeTheMarkets.com to post his daily trade setups in futures and equities markets. More recently he started www.SimplerOptions.com to focus on the equity options markets. Today, his "free nightly trading videos" reach hundreds of thousands of people each day. He's a Commodity Trading Advisor (CTA) with Razor Trading, and while he focuses on only a handful of markets for day trading, he will swing trade "just about anything." He clears his head running, traveling, and taking Tae Kwon Do. Carter appears regularly on CNBC and Bloomberg, speaks often at Money Shows and other trading industry events in the USA, Asia and Europe, and is a regular contributor to SFO Magazine, MSN Money and CME Group Publications.

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