3. Trade Management

Chapter 1: Trade Management Introduction

You have a market opinion and you are confident in it. Now it's time to find the best stocks and to devise a trading game plan for your entire portfolio and for each individual position. Market conditions change constantly and it's important to adjust your trading game plan. Sometimes, you will be thrown a curveball and we address that in this section.

Here is a sample of the topics we cover: when to take profits, how to hedge, how to nail the entry, how to size the position, and where to place your stops. A well-conceived game plan will keep your emotions in check as you try to stay one step ahead of the market.

In this section, we'll teach you how to raise your targets when everything is going right and we will teach you how to mitigate your losses when they are not.

Chapter 2: The Mental Game

Your mental and emotional state have a large impact on your trading. My experience is that this all boils down to confidence and you get it through experience and hard work.

Let me start by saying that my understanding of the human mind is limited to a Psych 101 class I took in college. There are many people who struggle with deep seated mental and emotional issues. I have not personally dealt with these challenges and I am not qualified to address them. If you are going to trade for a living, you need to be mentally and emotionally stable so, I urge all of you to get to that place before you start. Your fortitude is going to be tested constantly.

Stay sharp

I haven't traded "high", but I have traded with a massive hangover and I do not recommend it. You need to be mentally sharp and you need an acute sense of awareness. Drugs and alcohol impair your thinking. Studies have shown that exercise releases endorphins. I don't care about the scientific explanations, I just know that when I start my day with a workout or a walk, by the time I am finished, I am ready to trade. I feel good about myself and I've had time to wake up. I am alert! I also start preparing for the trading day hours before the open. I scour the news and I start game planning.

Limit your distractions

You can't focus when you have chaos around you. Find a quiet space and make it your own. "When "daddy" is in his office, we don't bother him." Many of you are trying to trade while you are working a full-time job and that is extremely difficult. At any moment you can be called into a meeting or you have to take an important call. When you hang up the phone, your position has gone to @#$% because you were not able to monitor it. This is extremely frustrating. Some of you are primary care providers for someone who is ill. That is physically and emotionally draining and there is nothing "left in the tank" for trading. You need to structure your life around trading and it needs to be your priority. Find your "space," hire a caregiver, work "second shift"… do whatever it takes to remove these distractions. Without complete focus, you will not get over the "emotional hump." Contrary to what you might have read or heard, trading is not a way to "make a little extra money." This is a profession and if you can't give it 100%, your chances of success are slim and your chances of losing money are high.

You are mentally alert, you are in your quiet space with more than an hour of time before the market opens and all of the potential distractions have been removed. For the rest of the article, we are going to talk about the emotional side of trading itself.

I've had the opportunity to observe thousands of traders over my career and I've been on the "emotional roller coaster" myself. Every person is different so I won't speak in absolutes. Here's what I've learned.

Like most traders, I've read books on the mental aspect of trading. Many people find them extremely useful, I have not. When I start reading about how we are all conditioned to "win" and how this dates back to cavemen needing to "win" for survival, I immediately tune out. It might be true, but that does not mean the information is useful to me. I already know I want to win and I know I need to make money to pay the bills. After reading these books I did not become a better trader and it did not reveal a missing element that was secretly sabotaging my trading. My self-awareness of the mental issues that were keeping me back did not come to light from a book and turn my win rate around. There is no harm in reading these books. They did not help me, but perhaps they will help you.

"Well la-di-da, I guess Pete didn't have any emotional issues when he was trading." Wrong! I've had plenty of them and I have recorded videos about the day trading journey I bared it all in a cover story for Active Trader Magazine in September 2006 called "All In." Here's what I've learned, observed and personally experienced. I'm not going to get into the theories about why we do the things we do. Instead, these tactics are actionable and you can incorporate them into your trading. They address a variety of emotional issues inherent to and you can incorporate them into your trading. They address a variety of emotional issues inherent to trading.

Let’s talk about some of the basic problems and then conclude with my solutions. The need to win is extremely important because it is positive reinforcement. That which gives us pleasure we tend to repeat and that which gives us pain we avoid. Trading is black and white. You either make money or you lose money. It has been my experience that your mind needs many more positive outcomes than negative ones and a ratio of 3:1 or higher (75% win rate) fosters a positive mental attitude. When my win rate is 50%, I am not as mentally fit because half of the trades don’t work out. Even if the winners are much bigger than the losers, there is a 50% chance that I am going to experience pain. This is such a basic concept that is seems silly to even write about it, but it shocks me how many people ignore the importance of a high win rate. By the way, even with a 75% win rate, your winners still have to be much bigger than your losers.

Confidence

The biggest mental block I had to deal with was confidence. When I started trading professionally in 2002, I didn’t know what I was doing. I had been involved in floor operations on the options exchanges for the previous 15 years. I was in the business, but those skills were not transferable. Would I be able to find a systematic trading approach that worked? How would I find it? Would I know how to refine it? What edge would this system provide? How long would it be before I was profitable? Could I support my family until I got to that point? If someone had provided me with a blueprint of how to do this and if I witnessed others having success with the system, I would have had very little doubt that I would be able to learn it and master it. If it took 80 hours a week for many years, no problem, I was determined. Unfortunately, such a system did not exist… at least not one that anyone would share with with me.

When people go to college or a trade school they are learning skills that should land a good paying job. Their education will often yield transferable knowledge that can be applied in various jobs. There are no guarantees, but the odds of the education paying off are fairly high. Aspiring professional athletes, artists and traders don’t get paid while they are training and there is no guarantee that the time and effort they put in is going to pay off. The skills they develop are not transferable. This is a large risk to take and there is no shortage of people who will discourage you from taking this path. For traders, failure means you will lose your hard earned money and when you “call it quits” you will have to admit defeat and face embarrassment. This adds to the pressure and all eyes are on you. There was a “dark period” when I started as a pro. I was struggling and my family and friends knew it. I couldn’t talk about my career or how it was going. I was isolated and I felt like I was on an island by myself. My capital was slipping away. I was learning and I felt like I was making progress, but I didn’t have anything to show for it.

I had to break the negative feedback loop I was trapped in. It was not a matter of will or mental fortitude, it was a matter of finding the right set-ups and the right system. Much like an athlete watches game film, I reviewed and studied my trade logs. I learned valuable lessons from each mistake and I devised ways to avoid those pitfalls in the future. I also learned the patterns that I had the greatest success with and I discovered the importance of market first and the advantages of trading stocks with relative strength. The course you the importance of market first and the advantages of trading stocks with relative strength. The course you are reading right now is the end result and I hope that this blueprint helps you avoid some of the mental anguish I went through.

It took years for all of the puzzle pieces to reveal themselves and I am still finding new pieces. Figuring out how to put those pieces together takes time. I started to develop a systematic decision making process and my confidence was growing. Once I reached this stage it was a matter of refining and repeating. At this point, you know the system and you know it works. Now it is just a matter of following it and not letting yourself stray. You also know that you will be able to pay your bills and that doing this professionally is viable. Instead of feeling like an idiot for pursuing your passion, you are proud of your decision. My emotions were raw until I got to this point, and now that I was getting positive results, it was no longer a matter of "will I figure this out," it was a matter of "stop doing stupid shit." To this point, mistakes were a matter of ignorance and they were not caused by my mental state. My confidence to this point was low because I still did not have all of the puzzle pieces and the odds of taking a loss on a trade were high.

Common Mistakes

This is a well documented trading system, but I still have to deal with the same day-to-day issues we all have. Take inventory and know your detrimental personality traits. Then, build safe guards into your decision making so that you can avoid common mistakes. Here are some examples.

Enter well

I am a stickler for good entries. That means I miss a lot of good trades, but it also means I avoid big losers. The pattern has to be perfect and ALL of the checkboxes have to be marked. I am not going into detail about those because they are in this course. For me, trading is all about control and awareness. The awareness comes from preparation and until you enter the trade, you are in control. If you are less confident in the trade, take a small starter position and add on confirmation. That means only adding to winners. This is critically important. When I add to a winner, my average cost is lower than the current price if (I am buying). That means I have cushion in the trade and in a worst case scenario I am able to exit at my average cost and scratch the trade. I don't place stops at my entry price, but knowing that I could gives me comfort. I have limited downside and unlimited upside. This is what we strive for in every trade. When I take a starter position and it is a loser, my losses are minor and I can contain my emotions. My entry is not ideal and I will let the stock move around until it proves me wrong. I am also looking for something that I might have missed. The bottom line is that I am not as confident in the trade as I was when I entered it. The last thing I want to do is to add to a losing position. When I do that I am losing control and my average cost is higher than the current price of the stock. My confidence is poor and my risk exposure (pain) is higher. When I enter well, the position performs right away. I have cushion in the trade, my confidence is high and I feel good that it is performing as I expected. When you become a seasoned trader, there will be times when you have to "size up" and your entry is critically important. The odds are very high and all of the checkboxes are marked. Your risk exposure is elevated and it is critically important that you enter well. That "cushion" when the trade is performing right away will give you the confidence you need to ride it higher. Some traders will ask, “How did you have the “guts” to trade that size?” The answer is… enter well. When the trade performs right away, you don’t need “guts.” Your mindset quickly shifts from risk management to profit management and your emotions are not a factor.

Be patient

This is something that many novice traders can’t master and it is not something I can teach. The market opens and they want to shoot at anything that moves. We don’t know what the market is going to do or what the stock is going to do in the first 45 minutes of trading and we don’t know what the market is going to do. If a stock is breakout through D1 resistance on heavy volume, how do we know the move is going to hold during the day? We don’t! The breakout could be a giant head fake and until we see how the stock closes that day, the breakout has not been confirmed. Even then, we need follow through. The breakout gets the stock on our radar, but the follow through is where we make money. Pretend that you are an archer and that there are a dozen hoops that are in constant motion. The goal is to shoot through all of the hoops with one arrow. The windows of opportunity don’t come along very often so you have to be patient. If the arrow passes through 11 of the hoops, you fail. That is how trading windows work. The market D1, the market M5, the stock D1, the stock M5, RS/RW D1, RS/RW M5, heavy volume, D1 technical breakout above resistance, M5 > VWAP. M5 > prior day high… All of the hoops have to be aligned. I call them checkboxes and there are many. Just before you click the buy button, ask yourself, “Why now?” What is it about this very moment that makes this the perfect entry? Can you wait 10 minutes? Often times you can wait and that slight delay prevented you from relinquishing control and the backdrop looks much different. If a stock you have been tracking for a swing trade gaps higher the next day, ask yourself, “Why is the company worth so much more overnight? Was there material news or is this just technically based? Remind yourself that there will always be another trade. Just because you missed one good entry, there will be other good entry points for the same stock or you might find other stocks you like even better.

Don’t look

Novice traders will always hawk their P&L. That is going to elevate your emotions. Watch the chart and the price action. That is all you need to watch. As long as the market and the stock are performing, you don’t have to worry about how much you are making or losing. Set alerts at key price points and you don’t have to watch the stock. When action is required, you will get an alert. A big winner will tempt you to take profits too early because you are worried that you will give it all back. There might still be plenty of upside to the trade. If the market and the stock are not behaving, know when it’s time to exit. The decision is part of your game plan before you enter the trade and it is black and white. If you are looking at your P&L, you might stay in the trade too long because you can’t stomach taking the loss and “hope” will enter the equation. By the way, “hope” is not a trading strategy.

“FOMO Joe”

These traders are impulsive and greedy. They can’t stand the thought of missing out on the next big winner. They don’t wait for all of the checkboxes to line up, they just fire and then they look for reasons to justify the trade. While they are conducting research to defend the trade, the bottom falls out and now they have a big trade. While they are conducting research to defend the trade, the bottom falls out and now they have a big loser on their hands. Greed has been replaced by fear and they are ashamed that… "they did it again." Here is the cure for these suffers. The next time you want to click the buy button, click the alert button instead. Never buy the high on what ever time frame you are trading. Set an alert at the low of a nearby candle. This is how you can monitor the stock without taking a position. You have no emotional attachment to it. "FOMO Joe" is not going to be chasing a flat stock, he is going to be in a stock that is stacking green candles. You will be shocked that the vast majority of stocks pullback. When you get the alert, you will find that the stock has lost its luster. I've created alerts that allow Option Stalker Pro users to easily buy dips. There are many variables that can be selected across any time frame. For instance, the stock will have relative strength M5 currently. When we select this variable and we assign a bullish value, our servers know the current state of the variable. If it is bearish, it just has to go bullish. If it is currently bullish, it has to go relatively weak and then relatively strong M5 for the alert to trigger. When the alert is triggered you evaluate the depth and duration of the dip. If it was brief and shallow without any long red candles and if VWAP was preserved, the stock is likely to go higher and we have an excellent entry point. Often, these "darlings" will turn into "dogs" and you will be happy you never took the trade. You have complete control and you are not chasing. That time gives you an opportunity to evaluate other stocks and general market conditions. "FOMO Joe" has visions of grandeur early in the day. At the end of the day he looks at bullish searches and he thinks about all of the money he could have made if he bought that stock at the start of the day. He won't miss that opportunity tomorrow. What he fails to understand is that bullish searches are going to show the best performers at the top. If he looks closely, he would notice that they all have dips. Missing from his evaluation are all the stocks that were at the top of the search early in the day and that are no longer on the search because they reversed. Most stocks did not stay on that search all day, but the best ones did. Don't be "FOMO Joe." Hasty decisions are rarely good.

Don't trade the open

I've already discussed this, but it is such an important concept that I am going to keep hammering it home. The open is for amateurs and the close is for pros. For those traders who swing overnight, you buy in the afternoon when you have technical confirmation for the stock and the market. The next morning the stock shoots higher, options IVs are elevated and the stock is stacking "greens." You are taking gains into strength and you are selling to "FOMO Joe." The stock is on his radar from the day before. It is stacking "greens" early and he can't resist temptation. The first 45 minutes are for data collection. You are going to evaluate the market and you are going to look for stocks that might be of interest. You will gather valuable information and you wait for the checkboxes to line up.

Overconfidence

The market doesn't go straight up or straight down. When you have a great run, take some money out of the account. That will make you feel good. I act as if I just took a loss. It will keep my ego in check and I will "reset." My biggest losses have come after my biggest gains because I am over-confident. The reality is that I caught the right conditions and I "sized up." The odds of those conditions continuing is slim and the market is likely to rest. This trap causes psychological damage because you just gave back a lot of what you made. My biggest gains have come after my biggest losses. I am mentally "grounded" because I was humbled and I have to get back to basics. It doesn't matter where you put that money, just act as though you lost it if you sense that you are over-confident. I like to set it aside for the taxes I will have to pay.

I can always get back in

This is one of the most important concepts when it comes to taking losses. No one wants to lose money so stop looking at a bad trade like it was a bad decision. You aren't a loser, your entry was off. From the time you enter the stock, you can see that it is not behaving as you expected. In time you have evidence that it is heading lower. Any fool can see the selling pressure, so get out. You can see that the stock might still have considerable downside. Are you really going to let it fall all that way and still feel good about it? What kind of mental strain is that going to put on you? If the stock does fall to that level, think of how much better your entry will be. Exit the stock and place an alert at your exit price so that you can get back in where you exited. You can also set alerts to buy dips and I mentioned how to do that earlier. You evaluate the depth and duration of the dip and you determine if the stock marks all of the checkboxes. Many of the stocks you took a loss on will rebound and you will have a great entry point. Some of them will never recover and you will be glad that you are out. While you were waiting for the stock to recover, you might have found other opportunities that were much better. You have alerts set and it is out of sight and out of mind. Hanging on to "dogs" that never come back does psychological damage and you are reminded of your poor decision(s) every time you look at your positions. Notice the positive spin that you have put on a losing trade. You are not a loser and you did not lose money… because you are going to enter at a lower price. Your analysis was not flawed and this is still a solid stock. When you re-enter, you will buy it back right where you got out. You will free up your capital and you will be properly managing risk. If you set alerts to buy dips, you can make even more money because it will be at a lower level. At the end of the day, you want to review the original entry to see if you missed something.

Time stops

Before you enter a trade, you should define a performance timeline. "I am expecting this bullish SPY 1OP cycle to produce in the next 20 minutes and when it does the stock will rally." If 20 minutes have passed and the market has performed, but the stock has not, consider scratching the trade. The relative strength you expected did not materialized and every minute you stay in the trade, your odds get closer to 50:50. That is not an attractive risk/reward profile. If the stock has performed, but the market has not, you have some cushion since the trade is making money. You are in profit management mode, but you are aware that you don't have the market tailwind that you were expecting so the trade is less attractive and you have to monitor it closely. This approach will "keep you honest." You expected an outcome in a specified period of time and it did not happen. You have an opportunity to exit and not lose money. Set alerts so that if the stock starts to perform you can consider re-entry. This will allow you to search for better opportunities and it will be one less position you have to monitor, You did not lose money so this is a neutral outcome. It does not help or hurt your psyche and I don't count scratches.

Anticipate LPTEs

We've talked about ¨inside days," pre-holiday trading conditions, pauses after big moves and pending news like the FOMC. As we are evaluating the action during the first 45 minutes, our expectations for a low probability trading environment (LPTE) are confirmed by mixed overlapping candles with long tails and wicks on light volume. You have worked hard to make money and if you don't adjust your trading, you will piss your gains away very quickly. Nice little breakouts will look great and the stock will be on your radar. You need follow through and as soon as you enter, the stock reverses. You will "leak oil" the entire day and you will be angry with yourself because you should have known better.

Junior Analyst

Stop thinking that you know more than the large institutions. If you ignore the news and if you ignore what others have to say, you will be much better off. Just follow price. Like most people, I consider myself to be fairly intelligent. My trading improved the moment I stopped conducting fundamental analysis. I've convinced myself that I don't know shit and that I just need to follow price. People with large egos have a very hard time with this concept. They are not as smart as they think they are and they are going to get humbled. Some of them will come around to just following price, but the vast majority of them will give up. They will take massive losses because they think that eventually the market will "get it right." Some will even add to losing positions. When they fail, they will conclude that the market is random and that no one can make sense of it.

Second chance

There will always be a second chance to enter a great trade that you missed initially. If the stock is as strong as you think it is, there will be a dip. That dip will be brief and shallow, and you will have additional confirmation that it is going higher.

Be the second mouse

We all know what happens to the first mouse. Don't anticipate how a candle is going to finish, let it complete. The current bar will often look very different when it completes. If there is a breakout, wait for confirmation. Don't expect that you are going to have follow through. Some of these breakouts will be head fakes to trigger buy stops. If the market looks like a top if forming, be aware of the patterns that are consistent with a trend reversal, but don't act until you see a lower high double top. That is the confirmation of resistance that you need. After a strong rally that went higher than anyone could have expected will attract short sellers. The first drop looks impressive and they are excited by the notion that they are going to make a killing on the way down. They load up on puts and then the market bounces. The buyers who fueled the rally are looking to buy dips. If they are aggressive, that dip could result in a bullish flag and the market is going to rocket to a new relative high. If the market does not make a new high, resistance is confirmed. Then and only then can you start considering shorts. So many traders try to pick bottoms and tops and they are squashed like little bugs.

Why now?

Can this day trade wait 10 minutes? Can this swing trade wait and extra day? Why is this the ideal moment to enter the trade? These are the questions you should be asking yourself for every trade. List your reasons and make sure they are valid. When possible, afford yourself the extra time.

Stay balanced

Often, traders will focus on a good outcome. When they enter a trade they are only focused on how much they will make and they are motivated by greed. The position does not "behave" and the focus shifts to fear. You should have seen "both sides of the coin" before you entered. The opposite is also true, but it is less common. Some traders suffer from "paralysis from analysis." They can't pull the trigger because they are afraid they will lose money. The stock takes off without them, fear turns into greed and they chase the move. If they would have entered with a starter position initially, they would have cushion and their fear would be minimal since they are in profit management mode.

Context

This is an important psychological concept and I am going to discuss it in great detail in another article. How we get from point A to point B matters. We analyze the price action and we develop our game plan around it. This is the source of our confidence. How can I be so sure this rally is going to continue? In that article I will explain how.

Motives

Why did you start trading? The answer to this question will often determine your mental state. There is only one right answer in my opinion. You've been introduced to trading and you have an insatiable appetite to learn more. This is your passion and you will spend every waking hour to master it. If you are learning how to trade because you want to make a lot of money or you just need "some extra cash", you are not going to put in the required time. Don't start trading because you hate your current job. When you start losing money, you will hate this profession even more. Trading is not as glamorous as it is made out to be. It requires an extreme amount of dedication and there is no easy path. Money is a strong motivator and most people have unrealistic expectations of how much they will make and how hard they will have to work.

Personality flaws

Some people are not well-suited for trading. The person who can't admit when they are wrong will struggle because they can't take losses. These people are intelligent and they are usually right. They will try to impose their will on the market and they will dollar cost average a losing position. All of their analysis can't be wrong, it's just not possible. The trade simply needs more time. This is a continual cleansing process and you need to admit when you are wrong. Then there is the compulsive liar. You can bullshit other people, but you can't bullshit the market. These are the folks who tout their winners and you never hear about their losers. In time, you won't hear about any of their trades because the trader won't be around. The thrill seeker who needs an adrenaline rush will take unnecessary risks. Trading should not be exciting. This is calculated risk needs an adrenaline rush will take unnecessary risks. Trading should not be exciting. This is calculated risk taking and we only trade when our odds of a positive outcome are greater than 75%. The margin of error is razor thin and you can't be impulsive. You can never compromise when it comes to checkboxes. If conditions don't line up, you don't take the trade. Some people feel entitled. If they "put the time in," they feel like they deserve a reward. There are no participation prizes for trading. These folks will complain that "the game is rigged" and that it's not fair. They will never take responsibility for their actions and their losses will always result from outside forces "beyond their control." I would argue that trading is extremely fair. Price is truth and we all have access to it. Your race, religion, sex, nationality, height, weight, social status or educational background won't prevent you from being successful. If you have these personality traits, you need to address them. They are obstacles that will prevent you from becoming a successful trader.

Conclusion

Let's conclude with a solution that removes the mental issues. Only a tiny fraction of traders will follow this advice. The first step is to gather information just like you are doing now. Once you learn how difficult this profession is, you will appreciate the education, the training and the dedication that are required. You will be properly grounded and you will be ready to take the next step. Regardless if it is my system or another, verify results before you take the next step. P&Ls can be photo shopped. Trust what you see real-time and not what you hear or read. When possible, talk to other traders who have learned the system and who are trading it. It is critically important that the system works and that it can be learned and replicated. The system needs to be well-documented and it needs to resonate with you. There is a lot of crap being peddled so do your due diligence. A trading system must have an edge and there is a decision making process that exploits that edge. You are going to spend the next 2-4 years learning this system and it is going to be like a 4-year degree. College students don't get paid when they are learning. You won't get paid either, but if you follow my suggestion, you will keep your tuition low and you will not be an emotional train wreck. You can start with paper trading, but I feel that trading 1 share of stock (no options) carries more weight because you actually have "skin in the game." You are also getting real fills. There will be many mistakes along the way, but your risk will be low since your trades are very small. This approach will take the emotions out of trading because you will be able to shoulder loses while you train. The goal is to have a 75% win rate for 3 consecutive months. If you are sloppy, you will never get your win rate up. For someone with very little trading experience, this could take 3-4 years. Aspiring traders that have some experience might be able to get to a 75% win rate in two years. Seasoned traders with previous marginal success can learn this system in a year or less. They have all of the technical skills and they are disciplined or they would not have lasted this long. A proven "edge" and a systematic decision making process gives them the structure they needed and they can pick this up quickly. The 75% win rate is hard to reach and it will take time. Along the way there will be set backs. Embrace them and learn from them, they are part of the process. If you are learning during a bear market, the journey will be harder, but you will learn valuable lessons. Don't get discouraged. There will be times when you feel like you are regressing. Know that when you look back at the end of the year you will be amazed by how much you have learned. When you start hitting the 75% win rate, all of the pieces will start to come together and you will have clarity. Each trade requires scrutiny and you need to learn from it. Keeping and reviewing trade logs is critically important. This is not the end of the journey, it is the starting point for your career as a professional trader. Now you are ready to gradually start increasing your trading size. You will hone your skills through repetition and you will refine, refine, refine. Your arms have encircled the beast we call trading and you will strengthen your grip on it. In time you will be ringing every drop of water out of it.

You keep your emotions in check through confidence and confidence comes with experience. Find a trading system that is proven and well-documented. Start slowly and trade small size while you are learning. Keep detailed trade logs and build in the safe guards I've mentioned. Get you win rate to 75% and gradually scale up. In time, chaos will turn into clarity. Then it's a matter of discipline (avoiding stupid mistakes) and refinement.

Chapter 3: The Right Swing Trading Mindset!

Your mental state is determined by your confidence and your confidence is driven by context. In this example we are going to look at the "best of the best." If your stocks don't look like this… they should!

Before we get started, let me set the context for this entire article. Most technical analysis books include annotated charts. They find picture-perfect setups and then they write about them: "Here is a classic example of buying a strong trend. The trend is your friend!" As expected, the stock soars and you think about all of the money you could have made buying calls. Hindsight is 20:20 and even a child can find those "perfect" historical examples. The decision to buy and to ride the trade is not as easy as they make it appear.

Let's say that you bought the stock in the chart below early in the move. Here's what your mind is telling you. All of the "words of wisdom" you've heard are casting doubt and you will be influenced by them. You have money on the line during the trend higher and you are emotional. You've made nice gains and you don't want to see them slip away. I understand… I've been there. "Don't be greedy, don't chase, be patient, pigs get slaughtered, buy dips…" If you are struggling to trade profitably, these voices will be very loud and you can't let these gains slip by.

Instead of listening to those "voices in your head," you need to mute them by conducting ongoing analysis. Along the way, you are picking up clues from the price action on how strong that trend is. The price action is very orderly and tight. There are more green candles than red candles. There are very few retracements and the dips are brief and shallow. The stock has great relative strength, good volume during the rally and it is above all of the major moving averages. These are all signs of aggressive buying and below are the "voices" you need to be listening to.

"Wait, are you telling me you should be buying more even after the stock has run up so much?" Yes! Do you see how your mental state is flipped? We look for signs that the trend might be weakening and there aren't any. In the first case, you are scared shitless because you don't want to be the dummy who pushed the trade too hard and who gave back all of the gains. Similar thoughts will keep most you out of the trade in the first place and you would never have taken it. "The stock has run too far." "I'm not going to chase." Some of you will wait for the dip that never comes. When the price action is this tight, a compression (pause) might be as good as it gets and that is a sign of incredible strength because all of the gains to that point have been preserved and buyers are still aggressive. When the stock finally does dip, you will convince yourself that the stock has "run too far" and this is the start of a trend reversal. You got the move you were looking for and you did not take action.

"OK Pete, you've picked a picture-perfect stock and now you are feeding us BS." Yes, I did pick a very strong stock to illustrate a point. These negative thoughts will run through your mind. No, I am not feeding you BS. This stock is the "poster child" for the pattern you should be looking for. I see stocks like this every day and if yours don't look like this, keep looking!! Many of the stock picks I see posted look like garbage. Your job is to predict price movement. Get it right and you will make money. Get it wrong and you will lose money. Do you want to try to predict the flight of a bat or a flock of geese in "V" formation? I know which one I am going to choose. During this course I have been teaching you the price action to look for. This price action gives us the context and the context gives us the confidence to add to a stock that has already moved a great distance.

Identify The "Best Of The Best"

The learning process happens in stages, so let me describe them. The first stage is that you've identified a stock with a really strong trend. If you are able to consistently identify the "best of the best," congratulations. Accept no substitutes! At first, you will take a position and you will scalp out of it when you have "enough profit." Surprisingly, some traders won't even consider it again. It's almost as if the stock is toxic and there is no way possible that the same stock can yield another winner. I don't get this mental block, but I see it all the time. It's almost as if they need a new challenge to find the next "star." As traders mature, they recognize this "honey hole" and they revisit it many times on each confirmation (breakout). They scalp in and out of it for small gains. They were nervous the entire way up and that is why they scalped it. By the time the move is over, they have nice gains, but they will realize that they could've made a lot more money with a lot less effort if they just held it. Now they will progress to the next stage. They buy the stock early in the move and they fight off the thoughts I've mentioned. They milk the move and they resist the temptation to take gains. This time they will wait for signs of selling pressure. They are not going to set predetermined price targets, they are going to ride the move. Congratulations, this is a major accomplishment! The next step of the learning process is to add to the position on the way up. This is a more challenging step and I'll explain why. It takes experience and your confidence will grow with each winner.

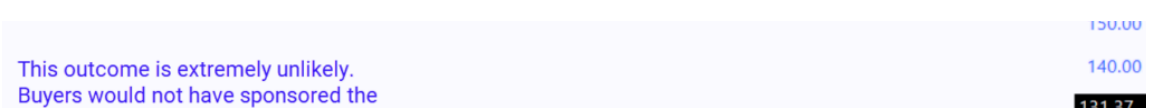
Not all of the charts you see are going to be as strong as the one I've selected. They will be excellent, but the dips could be a little more pronounced or the compressions might last longer. There might be more retracements and there might be mixed candles. That doesn't mean we can't trade these trends, it just means that we have to treat them with a little more caution, and I will go over some of those patterns in a future article. With regards to the stock I've highlighted, here are the prevailing thoughts that allow you to add to the position on the way up… even at the very top. "This is an incredibly strong trend and I know that from the price action. These set-ups are rare and this stock is going higher! If I get a dip, I want it to be brief and shallow. It is likely to turn into a bullish flag and if that happens, I will add."

Strong Stocks Typically Don't Reverse Sharply

Again, most stocks do not look like this. We know that and all of the checkboxes are marked. The second thought that allows us to add to the position is, "This level of strength does not typically reversed sharply." Buyers do not all of a sudden decide to pull the plug and bail on the stock. The trend usually ends with a compression. A normal bullish compression will be extremely tight and it won't last more than a week or two. Those would represent a pause and that is bullish. On a breakout, I will add. The compression that weakens the trend will have longer mixed green and red candles. Buyers and sellers are paired off and that is why we see these longer candles. When we start to see this, we take our gains and now it is time to celebrate a great trade and great trade management. We set alerts at the top and the bottom of the range. If the stock struggles to make a new relative high, it could be a lower high double top and I will take gains. The position is large at this stage because we have been adding on the way up. This compression is likely to take a while to be resolved. The stock could head higher so I will set an alert at the high. The trend could reverse so I will set alerts down below. Until an alert is triggered, I will look for the next prospect.

Lower Average Costs

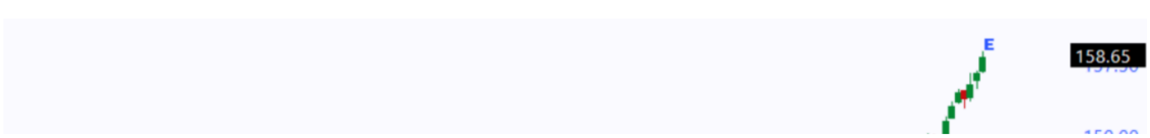
The next thought that allows us to add is, "Our average cost is much lower. If there is a nasty drop, I will be able to exit the trade for a nice gain. I don't have to panic if I see them. Even if there are a few stacked long red candles off of the high, the stock will bounce." This is a reassuring thought, but how can I be so sure? I know this from the previous price action. The stock is super, super, super strong. Buyers have been lined up for weeks/months and they have all been waiting for a dip. When they get one, they will buy aggressively. The stock will rally. If it makes a new relative high, that dip will result in a bullish flag. If the stock can't get through the high, it will form a double top lower high. That will be my sign to exit and that lower high will not be too far from the previous high. "No matter what… I will get that bounce off of the dip and I will get that opportunity to exit the trade at a great price. I do not have to worry about having the rug pulled out and I do not have to worry about all of my gains vaporizing." Those are your prevailing thoughts. You need to purge this thought. "I'm not going to be the idiot who buys the all-time high and then who has the rug pulled out."



I just know a handful of novices are going to be scratching their heads right now. “Pete, in the chat room you tell us not to buy the high of the day and you tell us not to chase. It sounds like you are telling us that’s OK.” To which I would respond… “Don’t make me come over there!” 1. We are talking about swing trading, not day trading. 2. I am not talking about buying stocks in the first hour of trading. 3. The D1 charts some of you are trading do not look like the stock I am showing you and the M5 does not look like the stock I am showing you. We are not chasing stacked “greens” that look like skyscrapers on volatile stocks. It is imperative that you understand the meaning of nice orderly price action. Now that I have that off of my chest, we can continue.

The context of the rally will indicate how strong the D1 trend is. It will give you the confidence to take a starter position. As the move unfolds, it will confirm strength and it will give you the confidence to stay in the position and to add to it. As the stock moves higher, you will look for signs of exhaustion. If there aren’t any, you will continue to add knowing that bull rallies of this nature “die hard” and that buyers will be looking to buy dips. If a dip is fairly deep (longer red candles than you have seen previously) and the stock can’t recapture the relative high (longer greens and reds), take gains. You won’t be leaving much on the table and you’ve seen signs of selling pressure. Moves with the level of strength of the highlighted stock very rarely reverse sharply. Buyers have been aggressive on the way up and if there was uncertainty surrounding the stock, the price action would not have been as orderly and steady on the way up. Remove any negative thoughts that the stock has run too far or that a big reversal is looming. Work on the process. Only trade stocks that have nice orderly price action and that have relative strength and heavy volume. Instead of scalping in and out, just hold the position and ride it as long as you can. Your next objective will be to add to the position as it confirms trend strength. The context of the move will give you the confidence to do so.

I will conclude on this note. Many traders will settle for inferior chart patterns. “Pete just found a great example, but those set-ups are rare.” That’s not true. In just a few minutes I found many examples and I could post 20 charts below. Do not settle for “sloppy moves.” They will #$%^ up your mental state. As soon as you buy, they retrace. Now you have a loser and you will wonder if this dip will be deeper and last longer than the one before. Once the dip is resolved you will have doubts on whether or not you should add to the position… so you don’t. If you are buying short-term calls, these dips will rob you of time premium. Nice, tight, orderly patterns with a nice trend higher on heavy volume are all that you should trade. Ideally, the stock does not dip, it compresses for a week or two before staging the next leg higher. If it does have dips, they are brief and shallow. The stock is consistently making higher highs and higher lows. I found these charts in two minutes and I even included a bearish one. Only pick stocks with this pattern and it will be much easier to manage the trade mentally.



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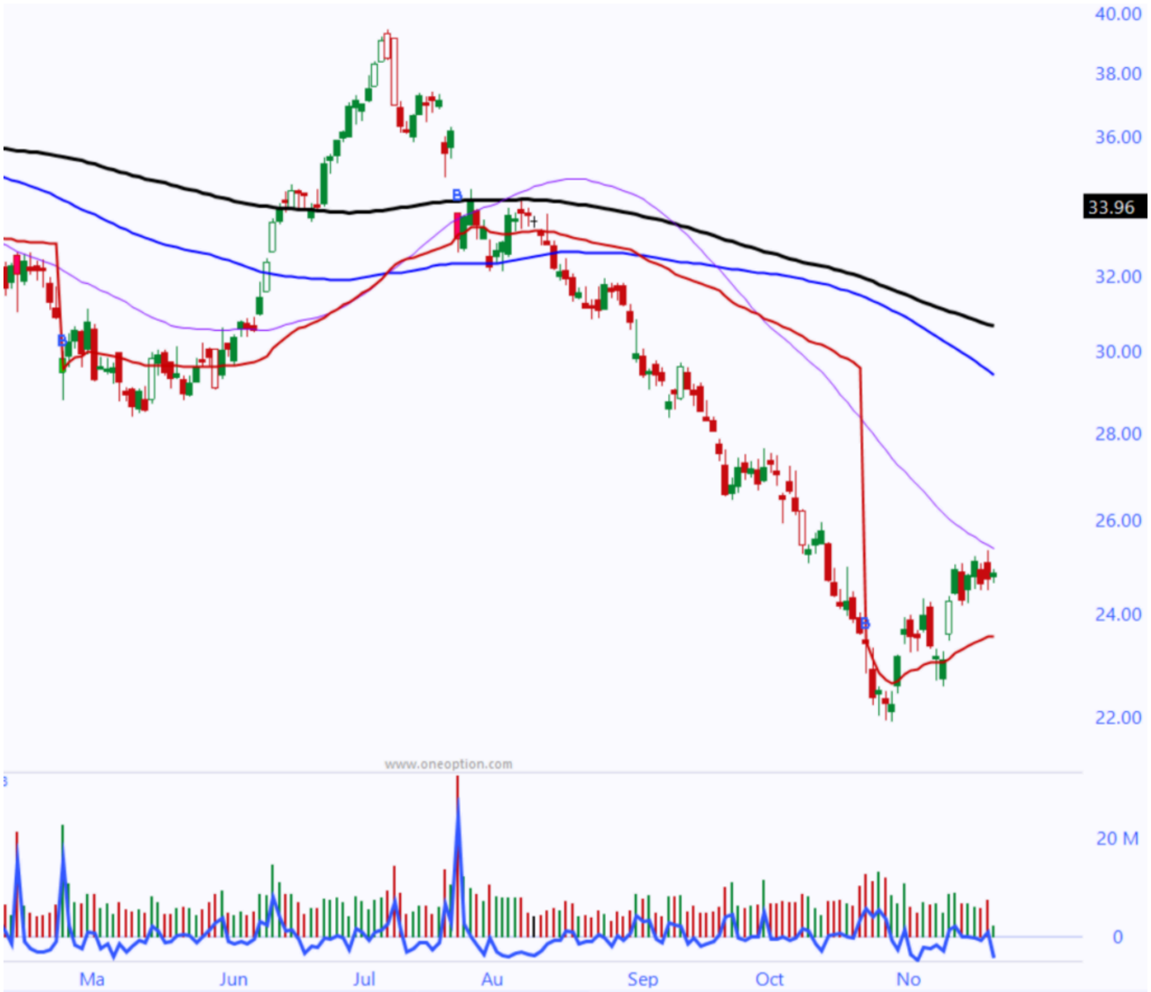


Chapter 4: The Right Day Trading Mindset

The longer-term market context determines our day trading mindset.

Market conditions have changed and this is the day trading mindset you need on 5/11/23**. The market is NOT going anywhere!** Here's how I know and here's how I will trade this information.

The 100 point /ES days of 2022 are gone and the market is settling into a tight range. Buyers and sellers are paired off, and I can make equally compelling arguments why the market could move higher or lower in the next few months. Traders are searching for information that could change the landscape one way or the other.

In the last two weeks, we had Q1 earnings, the FOMC statement, the jobs report and the CPI. This was a "window" where we might have seen sustained directional movement and a breakout. That moment passed and the market is still trapped in a tight range below major horizontal resistance and above the major moving averages.

The market is trapped. Your mind should be telling you that we are not going anywhere. Any decent intraday move is likely to reverse.

Light Volume "Inside Day"

There are 3 basic patterns that we will see. Unfortunately, the most common one is a light volume "Inside Day" where we are trapped between the high and low of the prior day. You should expect these after a big range (like yesterday) or ahead of a major news release. Monday and Tuesday this week were classic examples and traders were waiting for the CPI. On these days, you need to expect horrible market action and choppy mixed candles. The market is not going to help or hinder you so the stock will have to do all of the work. You MUST find stocks with heavy volume and D1 technical breakouts. The good news is that the market is not likely to hurt your positions either. That means you might try trading early in the day if you find the right stock. Look for that steady grind higher and that D1 breakout. Do not chase long green candles that can retrace. There is no market tailwind during an "Inside Day." Ahead of a major news release, if your intent is to day trade and NOT to take overnight risk into the news, you need to error on the side of not trading. Your entries need to be perfect (buy dips and pauses) and you need to wait for your opportunities to set up. Enter poorly and you will take a loss or hold overnight and increase your risk into an event. Look for stocks that are on a mission and that are oblivious to the market. Trim your size and your trade count and focus on a handful of stocks (the best of the best).

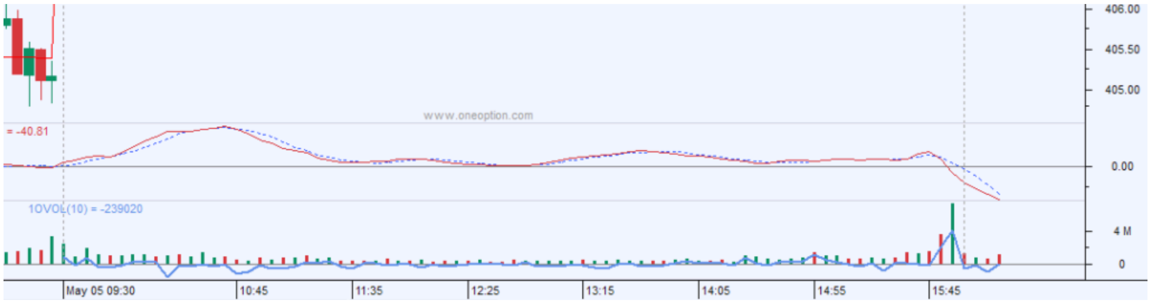
Light volume "Inside Days" mean that you have to focus on a handful of high volume stocks that are breaking through D1 technical levels and that have consistent price action.

Gradual Drift Higher/Lower

The second kind of day is the gradual drift higher/lower on light volume. The market is able to test the prior day's high or prior day's low and get through that level early in the day. The price action will be OK, but there will be mixed candles and retracement. On the initial breakout to a new high of the day, don't bite on the first candle through. Remember, your mindset is that the market is NOT going anywhere. You need proof. If you see a bearish engulfing candle after a new high of the day, you should be preparing for a reversal. If that breakout holds for a few bars and it starts gaining traction, the move is likely to hold. The volume is light, so your mind is going to tell you to be cautious. These moves often have tiny bodied candles of a single color and much of this is program driven. On a bullish breakout, sellers will never be too far away and that keeps these candles tiny. As long as the retracements are minor (no long red candles) and the market stays near the high of the day, it will continue to float higher. When there are signs of selling and it looks like the market is going to roll over, you can expect a bear trap. Short sellers will recognize the light volume wimpy rally and they will be looking for an opportunity to short. A move down to the VWAP would be a classic trap. That dip attracts short sellers and a bounce forces them to cover. When they do so, the shorts cover and the market stages the next leg higher. At some point late in the day, sellers will get more aggressive and they will keep a lid on the move. Day traders who are long will take gains. The chart below is from last week and it provides a good example. The early gap up is going to attract sellers. Remember, no one expects the market to do anything and buyers and sellers are paired off. A big gap up is going to be faded. In this instance, the overnight catalyst was good enough to fend off sellers. When the market was able to advance in an orderly fashion and when sellers were not able to knock it down, it was a sign that buyers were in control. The retracement was minor and eventually a bear trap surfaced mid-day when the VWAP was tested. Notice how that test gave the appearance that the market could roll over? That is what attracts short sellers, and it makes the trap more effective. As long as you do not see long red candles or a bearish engulf/bearish hammer off of the high of the day, there is no threat to your positions. You should be in the strongest of the strong stocks anyway and they will hold up well.

Gap and Go vs Gap Reversals

Very quick note on "Gap and Go" vs "Gap Reversals." Gap Reversals provide much better odds. In a gap up during a sideways market sellers will be anxious. When the open of the first M5 bar fails, that is the first crack in the dam. That reversal has plenty of room to gain momentum and programs feed on momentum. On the other hand, the initial gap up consumes most of the upside potential. Any advance from that point on will be limited. We also run the risk of having the rug pulled out in the first hour and that increases the risk profile for buying a bullish Gap and Go . Know that Gap Reversals are preferred over Gap and Go's for this reason. That means on a Gap Up, your searches should start with bearish candidates. That is where you stand to make the most money. It doesn't mean you will get a reversal, but why not prepare for your most lucrative scenario? If the gap up gains traction, you need proof and that time will give you an opportunity to find the best longs. The reversals happen quickly so you need to be ready. Weak stocks that are tanking during a gap up will also be easier to spot because they have relative weakness.

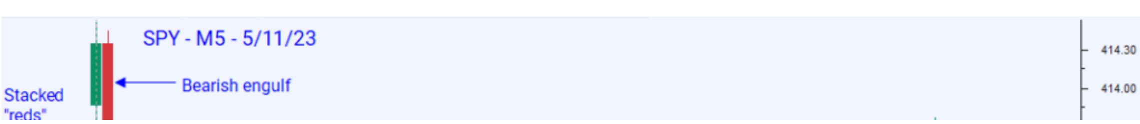


Most gaps will try to fill during the first hour especially if there was not much overnight news. Gap Reversals provide much higher odds for us than Gap N Go's.

Heavy Volume With Long Mixed Candles

The third pattern to watch for is heavy volume with long mixed candles. This is a sign of volatility and both sides are active. There is overnight news and both sides view the release differently. As good as the move in either direction looks during a high volume day, know that it is temporary. The heavy volume bullish and bearish trend days of old are gone. When we do finally get that big move, the news driving the market will be undeniable. It will be unexpected and it will result in a massive directional move with very little retracement and a breakout above horizontal resistance or below the major MAs. Anything less is going to reverse. This article will help you identify the prevailing patterns to look for, but there is a more important message. Your brain needs to know that THE MARKET IS NOT GOING ANYWHERE.

Yesterday the CPI came in at 4.9% vs 5%. Big deal. Inflation is still hot and that is inline with expectations. That was the news everyone was waiting for and it was a "nothing burger." The urge to pound the opening gap up was going to be strong. Why? Because the market is not going anywhere. The second bar was a giant bearish engulfing candle well into the gap and that was your cue to favor the short side. The gap filled quickly. The first bounce was big and it retraced substantially (buyers are still active). The volume was excellent, so we knew right away that both sides were going to be active and we would get movement. Bears took their shot and here is another moment where this lesson is going to pay off for you. The drop in the middle of the day looked very convincing. Nice organized red candles, and the low of the day failed easily, culminating with a long red candle. This is where your brain needed to kick in. This is NOT going to be like the bearish trend days of 2022. Why not? Because the market is NOT going anywhere! Was the CPI that good or bad? No. Have buyers been active? Yes, and we can tell that from the big bounces. Might the new low of the day attract short sellers? Yes. This was a selling climax and because you were in the right mindset you did not add to your shorts. You took gains and you looked for opportunities on the long side. If you do not understand the importance of the previous sentence, you will always be wondering, "How do I know when to take profits and when to add? How do I know when to pivot?" It is all about the context that has been set up by the D1 SPY chart.



We knew from the heavy volume and long mixed candles that buyers and sellers were going to be active. Eventually, buyers would take their shot and we should not expected a market melt-down and a bearish trend day.

This is a particularly tough market to trade because it is trapped in a range and the intraday price movement is compressed. Be very suspicious of gaps up or down and know that the tendency will be to reverse that move early (especially if the news is not that material). Trading in the direction of a Gap and Go is risky and you have to make sure that the gap is going to hold. Consecutive tiny bodied candles of a single color on light volume have a tendency to continue (programs). “Inside Days” are very challenging. The market won’t help of hinder and you need to focus on a few really strong stocks that have major D1 technical breakouts on heavy volume. When we get heavy volume and long mixed candles, expect nice movement. One side will dominate the early action and then there will be a nice reversal when the other side takes a shot.

The market is trapped in a D1 range and it is not going anywhere. The potential catalyst for a breakout has passed and we are likely to be right here until June. Watch for these days and set up your game plan accordingly. I wrote mainly using bullish price action, but know the same concepts apply to bearish price action. I am market neutral and it was easier to write from one market view point.

Chapter 5: A Cautious Swing Trading Mindset

Your confidence in the trade is determined by context. We've discussed the right mindset and the best context. Now let's take a look at situations that are marginally attractive so that we can set a minimal standard.

There will be times when the market is not in a strong trend and it is difficult to find stocks that have nice tight orderly price action with a strong trend higher. That is always the preferred swing trading pattern and I covered them in this previous article. Your search should be exhausted before you consider trading these "loser tier" stocks. Don't give up looking, those stocks are out there and they are leading the market higher. Often, traders won't look hard enough and they will settle for inferior price action. Sometimes they are in "love" with a stock and they will deem it to be "good enough." The issue at hand is that we are directional traders. We get paid when we properly forecast future price movement. If the price action is choppy, the context is not ideal and it is going to impact your confidence. It's imperative that you only trade "the best of the best." Here's why.

The chart below has a long-term uptrend. If it doesn't have a trend, why are you looking at it? Trends tell us that long-term money is active. The price action for the stock below is choppy. It has lots of "fits and starts" and the dips are fairly deep and frequent. The candles are mixed and overlapping. When you enter a swing position on a stock like this, you have to wait a long time for the move to progress and you will become impatient as you watch other stocks race by. On each pullback you are wondering if this is going to turn into a bigger drop. If you are long call options, these dips take weeks to play out and you are exposed to time decay. All of this is going to impact your confidence. The context below tells you that the stock is in a choppy up trend. It features two steps forward and one step backwards. It's easy to reconstruct charts like the one below. "Yes, this is an upward sloping trading channel!" That's not what you are thinking when you are in the trade. Those channels will not become apparent for a long time. When you are long a stock like this, your mind will cast doubt. These are big dips. On the left side of the chart, you can see a couple of bullish flags that you could have bought (dotted lines), but the channel did not reveal itself for quite a while so it was not something you could lean on. In the middle of the chart, you can see a downward sloping trading channel. The move lower was steady, but it featured mixed overlapping candles with lots of retracement. This was not a very strong move lower and we know that from our price action lessons. The trading channel was fairly tight, but the move lower was very choppy. This would try your patience and most traders won't be able to stick with the move. Every time you get a nice move in your direction, the stock retraces. This "toys" with you mentally and it's like Charlie Brown having the football yanked away just before he's ready to kick it.

Stocks can and do change the manner in which they trade. Material news that impacts future earnings will change the character of the stock. In the example below, you would buy the breakout above the downward sloping trading channel (green lines). It is above all of the major moving averages and AVWAPE. The breakout starts to stall. The previous context for the stock tells you it is choppy. You take gains and you evaluate the dip. Based on the price history, you are expecting a fairly deep drop. This time it is brief and shallow, and it bounces immediately off of AVWAPE. You buy that breakout and you watch it blow through horizontal resistance (blue dotted line). You are willing to hold the initial buy, but you are not ready to add to the position because you don't trust it. It tests horizontal support one more time and it confirms support. Buyers are supporting the breakout. This dip is also brief and shallow. Now you have the confidence to add to the position.

There is a huge difference between this chart and the stocks I highlighted in the other article where the price action was very steady and tight and where your confidence was high. In those instances, you know the dips will be brief and shallow because there aren't many. You also know that when the stock eventually hits resistance that you are going to have an opportunity to exit when it makes a double top lower high. You don't have that here. Any dip can gain traction. The above chart is "workable" if you are patient, but it would be the bare minimum I would consider trading. Between the two extremes there are much better stocks to trade. From a mental standpoint, you were never able to get behind the moves in the first part of the chart. As soon as the move was exhausted, we had to be ready to take gains because a reversal was coming. The trade duration was brief and we never had a chance to add. You are in more of a scalping mode for your swing trades. If you bought breakouts to a new relative high, the move was almost over and you had to be very careful because the dips were substantial. If you "whiffed" and missed the exit, you were going to be hanging on to a loser for a while before it turned around. You had to buy High- breakouts once support was established. These types of stocks are much more difficult to trade. Your confidence will be much lower and your odds of making money will be greatly reduced.

In almost every market environment, you can find stocks with strong trends and tight orderly price action. There are always companies with new products or changing business conditions that will lead to big future profits. Seek them out and be relentless. The same is true for bearish trends. Companies that are struggling will have very strong selling and the trend lower will be tight and orderly. Marginal patterns like the stock above will require greater position management and they will create more mental stress. You can find better! Look hard and don't compromise.

Chapter 6: An Aggressive Swing Trading Mindset

There will be moments when you are in an explosive move. You will be tempted to take early profits and you will be disappointed when you do.

These opportunities will represent less than 5% of your trades, but they have the potential to fund your retirement if you trade them properly. At some point you are going to take a starter position when a stock breaks out. Initially, the move looks pretty normal so I am not talking about trading big earnings related gaps. This is a normal breakout through resistance and the move is going to gain momentum and ultimately rocket higher. You will see D1 stacked candles with little overlap, immediate follow through and massive volume. When you get these super powerful moves, it is important to know what's fueling the stock. In order for the move to continue, it has to be a material event. Something has changed the long-term growth prospects for the company. The news could brew for months before the theme gains acceptance. The concept does not have to immediately produce profits, but the potential has to be so significant that it changes perception. These themes are transformational and they will change society. Let me give you a few examples of situations where stocks have gone parabolic.

Normally, I don't like to hold stocks over earnings, but if I deem this to be truly transformational, this is the exception. The news is so incredible and the strength in the stock is undeniable. Valuations no longer matter, it is all about perception and in the eyes of large institutions, the sky is the limit. The company could miss earnings estimates and it won't matter. They might not even make money or have a plan to monetize the model and it won't matter. It sounds incredible, but I've seen this movie many times.

First of all, the move starts out like a normal breakout. All resistance has been obliterated and the stock climbs straight up a wall. Once it goes parabolic, the move is easy to spot on a stock and that train has left the station. The key is to get in early. In the late 1990's, the internet was the big craze. Many companies just had to put .com into their press releases and discuss the growth potential for their online business. No one could gauge how profitable the internet was going to be or when those profits would be realized, they just "knew" the internet was going to be big (and it was). This unknown upside fuels the move and some of the projections are outrageous. Then the feeding frenzy sets in. During the ".com bubble," these analysts were deemed to be "visionaries" because of the returns they were generating. Some of them even went so far as to discredit Warren Buffet's "old" investing methods because he wasn't generating 50% annual returns like they were. His valuation models no longer worked in "the new online world."

Stories To Illustrate

Before I continue, I have a couple of fun stories. In 2000, I was speaking at a large conference and an attendee came up to ask me a question after my presentation. He asked me a "hypothetical" question. "What if I work for a company and I own stock in the company or if I will have stock options coming to me in the future. The stock has run up incredibly and I want to lock in those gains. How would I go about doing that? I told him he should buy LEAP puts and to select a strike price that matches the level of protection he would like to have. I mentioned that if he had inside information or if he was an officer of the company he needs to disclose his intentions internally. He said none of that applied, he just was happy with where the stock was and if he locked in those gains, he could retire. He was in his 30's. Two years later I was speaking at the same conference and he came up to me. He refreshed my memory and he thanked me profusely. I asked him how work was going and he said he had to leave the firm. It turns out that he returned to work and told his colleagues about the strategy to lock in the current stock price. They all scoffed at the idea. "The company was doing great and this stock was going to the moon!" He bought LEAP puts and no one else did. The stock fell from $160 down to $1 in the next two years. Everyone at work was so jealous that the work environment became toxic. He had to resign and he retired with the money he made. I didn't know it when we first spoke, but the company was Harmonic, Inc. (HLIT).

The second story was from the same time period and it also had a bittersweet ending. I had created a very large options order desk for retail customers. All orders had to be placed verbally back then. We would keep the customer on hold while we called down to the floor and got a fill. One of our customers loved trading. He had a small account ($10K) and he would make a little money and then give it back. This was more of a hobby for him and back then real-time quotes were hard to get so he would often call to get quotes. When it wasn't busy we would chat with customers so we got to know them. We hadn't heard from him in a while, but that was common since traders would come and go. One day we got a call from his wife. She told us that her husband had passed over a year ago after being ill and she needed to close the account. When we brought it up there was one position. It was worth over $1.2 million! We couldn't believe it so we double checked to make sure it wasn't an error. It was real!! Before he passed, he bought some way out of the money LEAP calls on QCOM. The stock ran up so much in two years that there were multiple stock splits along the way and these options were deep in the money. When we gave her the news, she cried. This was life changing for her. The only bitter part of the story is that he never got to witness the best trade of his life. To be fair, he also didn't have a chance to screw it up. We all would have done that by taking gains too early.

I hope you enjoyed these stories, but there is a point to them. When a stock goes parabolic, the gains will be much greater than you could have ever expected, and when the highs are in, the backside can be very nasty.

The key is being able to identify the reason for the move and then to ride it out until you see the first signs of a top. Stocks can go parabolic both ways (up and down).

Catalysts & Short Squeezes

I mentioned earlier that stocks that have parabolic rallies need a catalyst. If there isn't any material news, it could simply be a short squeeze. Game Stop (GME) would be one example and these trades are extremely dangerous because there is no substance behind the move. You can use the same method I am going to describe, but you should not be trading size when it is a short squeeze. Other stock examples and themes from the past include electric vehicles (TSLA), online social media (FB/META), search engines (GOOG), cell phones (AAPL), crypto currencies and new drugs (i.e. cancer vaccines). The current "disruptive technology" is artificial intelligence and I believe Nvidia (NVDA) is a stock to own.

The greater the perceived potential, the more likely the stock is to go parabolic. That's because there is no way to quantify how transformative it will be, how widely accepted it will be, what other possible uses there might be for it or how much people will be willing to pay for it. All investors know is that "This is going to be big!"

So let's talk about the pattern. In both cases (up or down), there will be an initial breakout. Just the way we like it, there will be long candles on heavy volume. There could be another long candle the next day or it might take a few days. There is very little retracement into the first breakout candle. That is a sign that the move is legitimate and that it is just starting.

It's time to take a deep breath. You are buying this breakout and you feel it is going to gain traction. Great, that is how we should feel about all breakouts. Realize that "disruptive technology" is rare and that parabolic moves are rare. A new whitening agent for a toothpaste manufacturer is NOT transformative. You know the potential for these moves so you will try to find them everywhere. Beware, they are not common!

Common Mistakes

This is where most traders/investors make the first mistake. They buy a breakout and the move gains immediate traction. They don't know the catalyst and this is just like every other trade. Instead of adding to the position, they are deciding where they should be taking gains. They've already made a lot of money. If the stock is climbing a wall and stacking green candles, it is going to go higher! How do I know? That price action is a sign of aggressive buying by institutions. There is little to no retracement and the volume is heavy. The news has these long-term investors excited and they are buying everything in sight. The price action is the "tell" and these buyers are looking years ahead. If the stock is not climbing a wall, it is not going to go parabolic. We are not playing Junior Analyst and we not are trying to predict that this new weight loss drug is going to dominate all others. That's not our job. We are trading the price action that is in front of us and it is telling us the move is real. We want to follow the smart money.

In the first chart, you can see a significant breakout through H- trendlines and the stock is above all of the major moving averages. It is also above AVWAPE and the volume is heavy. The candles are starting to stack and there is immediate follow through. The stock has broken horizontal resistance and it briefly pulled back to test the EMA 8. We want to add to the position, but we want to do it when the EMA 8 catches up. You can see how the test of the EMA 8 results in a bullish hammer.

This is where most traders and investors make the second mistake. Instead of adding to the position, they are in profit taking mode. At this stage, it's a monster winner. They are excited by the money they've made and they do not want it to slip through their fingers. They will take profits and they will feel fantastic… for a few days. The stock will stage the next leg of the rally and they will lament. There is no way that they can mentally re-enter the trade. "Only a fool would buy this stock at these levels. I will wait for a pullback." The dip never comes and the stock surges higher. They think about how much money they could have made if they had stuck with the original position. Later, I get one of the most common questions, "Pete, how do I know when to sell? I always seem to get out too early." My answer is always the same. We don't set predetermined targets. What in the price action told you it was time to exit the trade? The answer is… nothing. The problem was your mindset. Instead of having an aggressive mindset, you had a conservative mindset. Greed was replaced by the fear of giving your profits back. That's why you got out. You needed to recognize the pattern and you needed to realize the significance of the catalyst that was driving the stock higher.

This next chart is similar in nature so let's continue the lesson. There were a couple of missing thoughts that I need to cover. First of all, the trader is only thinking about what they could have made on the initial trade if they had held on. They are not even considering how much more they would have made if they had added to it. Next, there's the fool who decides that the stock is way too over-extended and that the valuations are outrageous. They short this move while the stock is still climbing. When they have taken a sufficient beating, they will cover and actually fuel the move higher.

Before I start sounding like an "all knowing" genius, I will tell you that this is a very hard lesson to learn and it is even more difficult to execute. Back in the late 1990's I traded, but passively. Every trade had to be pre-approved by a Compliance Officer. That took time a lot of time and longer-term swing trades were the only trades I could do. They were busy and so was I. When I had a trade on, it was a distraction. Sure I made great money in the late 1990's, but nothing close to what my customers made. I took gains too early and I was jealous. These people were blindly buying call options on stratospheric stocks and making a killing. Every time I would execute a buy order I felt like I was helping the lambs enter the slaughter house. Given my discipline, there was absolutely, positively no way for me to mentally do these trades and I knew it. I surmised that the only reason they were able to make that kind of money and to buy at those levels was because they had no idea of what they were doing. I knew stocks were over-extended and I knew they were over-valued. With every sell order and every giant gain they made, my envy grew. Everything I had learned during my MBA and everything I knew about trading was invalidated. I knew that eventually, the bottom would fall out and that they would take devastating losses. That moment did not come for a long-time and the move far exceeded everyone's expectations.

This was a great learning moment for me. The lesson was that I don't know shit about valuations and that there are times when they just don't matter. If there is "transformative technology" and "industry disruption," there is a chance for a parabolic move. The harder it is to quantify profits and future potential, the better. Find these situations and use price as your guide. Instead of having a normal trading mindset, have an aggressive one. Price is truth and it is telling me what the smart money is doing. Don't worry about playing the "greater fool." Instead of taking profits, add to the position. I have to admit that I still struggle with the "add to the position" part. I know these set-ups and my way of mentally handling these is to add very quickly when the move is just starting. If the move is a fad or I am uncertain about the potential (pot stocks), I will stay be more vigilant. If it is something I feel will change the future (AI right now) I will take a longer-term position. Instead of a D1 chart, I will pay more attention to the W1 chart.

Profit Taking

Let's get to the profit taking part of the lesson. You have a lot of money on the line and the gains are racking up quickly. As the move matures, it will accelerate with a buying climax. Long green candles resembling skyscrapers will form. There are no sellers, only buyers. Eventually the stock will hit resistance. Everyone is on "pins and needles" wondering how much higher the stock will run and at what price the warning signs will surface. Typically, the stock will gap up to a new all-time high. During that move, it will be smacked down on extreme volume and stacked red candles. This is an intraday gap reversal and the stock never looks back, not even remotely. There are very few bounces if any during the day. We don't make swing decisions based on an intraday price action, we wait for confirmation that the stock is going to finish weak. Late in the day, if the likely outcome is a bearish engulfing candle D1, I will take some gains. That will make me feel good and it will decrease my mental stress. I've already milked this trade for much more than I ever thought possible. In some cases, the stock might not have gapped up. It could have opened flat, but it surged to a new all-time high during the day and then got slapped down in a similar fashion leaving a bearish hammer on a D1 chart. In either case, this is a sign of heavy selling and it needs to be respected. Unlike a normal mindset where we have longer-term confidence that there will be a lower high double top and an attempt to get back to the previous high, we don't have that here. When we see selling pressure, we have to take our gains. Very aggressive traders can wait to see if there is follow through selling early the next day. If there is, then you would exit. If the stock bounces, you use the prior close as your stop. If the stock is able to recapture the all-time high in the next few days, you can ride the move. This is the approach I use for the remainder of the position. The hour is late and the profits are huge. Be in profit taking mode when you see this and don't worry about the upside until you do. Along the way, there will be plenty of little head fake dips that are instantly gobbled up. Those dips are great because they prove that buyers are still aggressive when they are erased. They are confirmation that the stock is going higher. The reason for the dip is that there are profit takers along the way who can't "take the heat." If your trading time frame is 6+ months out, use a D1 chart. If your time frame is greater than a year, you might opt for a W1 chart when you are looking for your exit. Realize that W1 parabolic moves are quite rare. Match the time frame for the bearish engulf or the bearish hammer to your trade duration.

Quick Recap

1. The breakout comes on a long green candle closing on its high. Major (if not all) resistance levels have been breached and there are "blue skies" ahead.
2. The volume is massive.
3. There is transformative news that will change the industry or society.
4. If this news is not unique to a company, find the best stock in the sector/group. If you are uncertain which stock will be the leader, spread out across a few of those stocks. Look for the stock with the best relative strength in the group or the largest market share.
5. There is instant follow through with more stacked candles.
6. Add early in the move and prepare mentally to ride the trade.
7. There are no early long red candles in the move. They don't exist because long-term buyers are gobbling up everything they can.
8. The potential for the company seems limitless. "How can anyone put a number on this?"
9. Don't play Junior Analyst. You don't know shit. Price is truth.

10. The move climbs like a hot air balloon. This is not your normal 45-degree chart.
11. Be aggressive and stay the course. Know that once you exit, your brain will not let you re-enter. Dispel the notion that you will re-enter on a dip, there won't be any. The future price will be much higher, not lower. You already hit the panic button once and you have no staying power if you re-enter. Once you hit the sell button, the trade is over.
12. Watch for a D1 bearish engulfing candle or a bearish hammer off of the all-time high. At minimum, take gains on half of the position. If the stock trades below the prior close the next day, exit the remainder. If the stock bounces, place a stop at the prior day low. You need the stock to recover the bearish candle in a few days. If it can't, take gains. If it does, use this same exit method described here for the remainder and watch for those bearish candles off of a new high.
13. Do not wait for a lower high double top. You were mentally aggressive on the way up and once you have the warning signs, you need to be mentally aggressive taking profits.

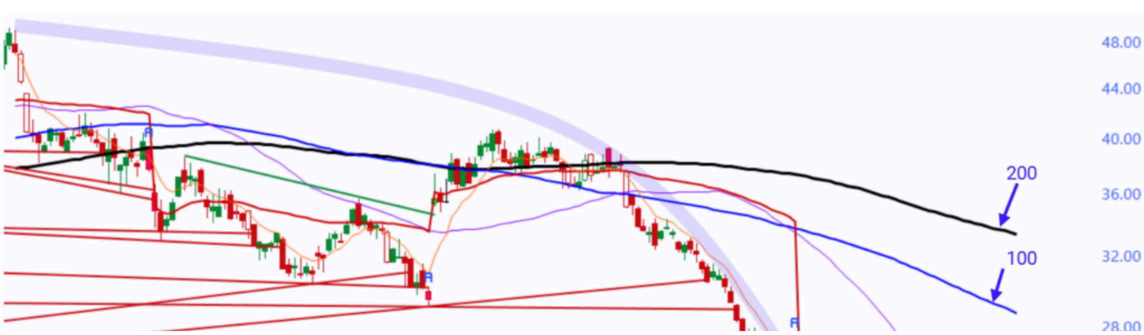
Parabolic Drops

Parabolic moves also happen on the downside. There's an old adage that "the market takes the stairs up and the elevator down." The same is true for stocks. Positive transformational themes take time to gain acceptance and we have time to monitor and watch the companies that will benefit. That is not the case with parabolic moves lower. They tend to happen much faster. When there's "blood in the water," institutions tend to "shoot first and ask questions later."

Parabolic drops are typically caused by changes in the macro business conditions. A new competitor or technology could disrupt an entire industry. New regulations could make it harder for the company to make money. Perhaps previous expectations (valuations) for the company were too high and the company is struggling to monetize this new technology (no one is willing to pay for it). There could also be fraud and the books were "cooked" (Enron). Perhaps there are civil lawsuits (tobacco). There could also be macro-economic conditions that spark investor fear (2008 Financial Crisis or Covid). Regardless of the reason, the bottom is falling out of the stock.

Given that the market is flat to higher more than 80% of the time, I tend to favor parabolic rallies over parabolic drops. That's because they take longer to play out and they are uplifting. When the bottom is falling out of a stock or a sector/group, I know that people's lives are impacted. During the financial crisis, there were some incredible shorts, but we were on the verge of a collapse. People were worried… I was worried. I was making money, but the future was very uncertain.

When the stock breaks technical support, it will do so with ease. There will be instant follow through with stacked consecutive red candles and you won't see any bounces. The volume will be extreme. Understand what's driving the stock down. Find out why institutions are selling the stock. Enter early and add early. This is more important for shorting because the move will accelerate quickly and put IVs will explode quickly. Then, stay the course and let the move play out. Don't exit until you see a bullish engulfing candle or a bullish hammer off of a new low. I am a more anxious profit taker on parabolic moves lower. The bounces tend to be just as violent as the drop and the market tends to go up more than it goes down. You are typically trading against the longer-term market trend. The company is going to calm investors and there might be share repurchases. Short squeezes are also common. If you are long puts, you will benefit from exploding option IVs so you want to take profits at the first sign of support. Once the stock stops going down, the option IVs will contract. If the stock bounces, the IVs will implode. You want to capture as much of those high IVs as you can.



Parabolic moves start out like a normal move. The theme is transformative and it could be a "disruptive technology" or a new discovery. It will take time for the idea to gain traction, but once it does, it will catch fire quickly. If the theme has the potential to change society or an industry well into the future, it has the key element. The company does not have to make money on the concept, it just has to be at the forefront and it needs to have an edge to exploit it before competitors enter. For instance, Facebook had critical mass (huge user base) well before it made money. We are not looking for companies that gap up or down after earnings. That's not what this is about. In fact, companies that fit this mold can miss earnings badly and it won't matter. All that matters is that the potential to make big profits in the future is there. The key is to identify the theme early and to get on board early. When you have price confirmation, add to the position quickly before it starts to "climb the wall." Mentally prepare to ride the stock higher until you see a bearish hammer or a bearish engulfing candle off of a new all-time high. Know that once you are out, you are out for good. Even if you don't catch the absolute high, this strategy will lock in gains beyond your wildest expectations.

If you only trade the best of the best that I outlined in The Right Swing Trading Mindset and you catch a few of these along the way, you won't need anything else. Stop trading choppy stocks.

Chapter 7: A Good Game Plan Increases Your Odds

You've conducted your research and you have the market context. Now it is time to devise a game plan.

It is critically important to gather information and to get your market bearings. That is going to frame your trading. There will be a number of possible outcomes and you can conduct scenario analysis. Some of the outcomes will be more likely than others. Some outcomes will have a greater probability for sustained movement. Some outcomes you can trade more aggressively and some outcomes you might not want to trade at all. I am going to provide a day trading example, but the same process can be applied to any time frame. When you have a game plan you are waiting to see which scenario plays out and you are ready to execute.

There is a huge advantage to being proactive instead of reactive. Just like in any game, you do not want to be surprised by an outcome. When that happens you are one step behind and you are trying to avoid a disaster. When you are proactive you are anticipating the next move. You are patiently waiting for an opportunity and you are in attack mode. This is the difference between entering a trade at a good price and having instant cushion or seeing a move once it is already well underway. The proactive trader can place a stop at the entry price and they have unlimited upside to the trade with little to no downside. The reactive trader enters later and the risk is elevated because the move is already underway. Will the stock retrace and stop them out for a loss? The proactive trader is waiting for technical confirmation so that they can add to the position. The reactive trader is still waiting for that next move so that they have some cushion in the trade. Professional athletes all have one thing in common, they anticipate what is going to happen and they are one step ahead. Planning and preparation keep them at the top of their game.

Trades posted in the chat room are real-time examples that you can dissect and study. Why did trader “X” decide to enter that trade at that time? How did it turn out? What made the trade so attractive? How can I find that trade when it is still forming? Are there Custom Search variables that will help me find it? Was there something they saw in the market that prompted that trade? The best traders game plan and consciously or subconsciously many “checkboxes” are marked before they do a trade. By the time you see the post and by the time you enter the order, the Pros might be ready to take profits. The point is to learn from the trades. You will not find success by following someone else. Often members ask, “Why did you buy “X” at that moment?” The response typically points out some of the current technicals. They are important and obvious, but in reality, the answer is probably more involved. The trade in question is the culmination of many different factors. Until I started writing these articles and dissecting all of the components, there were influences that I was not even aware of. Let me help you with scenario analysis and let’s work on devising a game plan. Here is an example from earlier this week that I highlighted in the chat room.

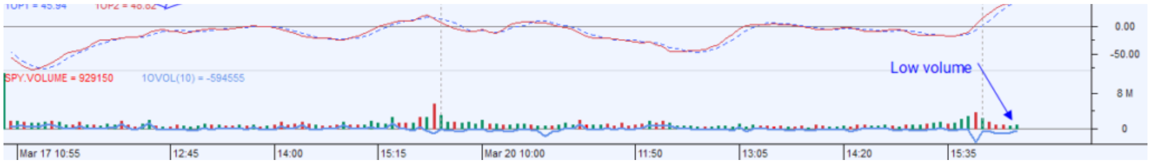
Market Long-Term

Everything starts with your long-term market outlook. It provides context for the current trading day. At this moment, SPY has been moving above and below the major moving averages frequently. The 100-day and the 200-day MAs are very close to each other (converging) and buyers and sellers are paired off. We know this because we are seeing big movements on heavy volume in both directions and the D1 candles are mixed. The SPY is right in the middle of its 60-day range and a it is neutral. The Fed will release its statement in two days and they are likely to be dovish. Recent bank failures have sparked credit concerns. This would be a shift from the Fed’s hawkish stance.

The market is right in the middle of its trading range. Long mixed candles on heavy volume are a sign of uncertainty

Market Short-Term

This morning the market is going to gap up 35 S&P 500 points. It will open above the major moving averages and this will be a new 5-day high. The FOMC meeting is tomorrow and the market is pricing in a “dovish” tone after the recent bank failures. 1OP is ending a bullish cycle and the volume is very light. The previous days have had movement both ways and one side has not been dominant.



Game Plan Scenario 1

The market is gapping higher. This could be a "Gap and Go" and we are above all of the major moving averages. Only stacked green candles would prompt me to take early action. That would be a sign that buyers are aggressive. That move would only last an hour and then the market would compress in a tight range. If this unfolds, I will only trade half size. The move is largely exhausted after a big overnight move higher so a "Gap and Go" is less attractive than a "Gap Reversals". This scenario is very unlikely. There was not any overnight news to fuel a move higher. The day before an FOMC statement we are not likely to see heavy volume and aggressive buying. This would be my least favorite scenario since I would have to take action early and since the upside is relatively limited after a big opening gap up. The downside risk is also higher because of a potential reversal. Imagine what the pattern I've just described might look like. The charts shown in each of the scenarios below are not real. I created them so that you can visualize each scenario.

This “Gap and Go” scenario forces us to take action early. It is our worst scenario because the upside is limited and the risk of a reversal is elevated. We would trade small size and the volume has to be very heavy. This is also the least likely scenario because sellers have recently been present.

Game Plan Scenario 2

A wimpy drift higher on light volume with mixed overlapping candles would be our best scenario and it coincides with the completion of a 1OP bullish cycle. That type of price action tells me that sellers are present (If sellers were not present, we would see long green candles stacked. The mixed overlapping candles tell us they are keeping a lid on the rally). That sluggish move would give me time to find stocks with relative weakness. If it happens in the first 45 minutes of the day it could set up a “Gap Reversal”. Bullish speculators will be flushed out and we could quickly take out the low of the day. Once that momentum is established we will start to fill in some of the overnight gap. Buyers and sellers have been present the last few weeks and there is no reason to think that the sellers have vanished. This is a likely scenario and it is the one that has the greatest profit potential. The volume is likely to be low ahead of the Fed and a Gap Reversal will provide us with some momentum. I will short a bearish hammer off of the high of the day knowing a bearish 1OP cross is pending. I will add on a new low of the day. This could be the only decent market move of the day. If I see long red candles and the volume picks up I can add to the short positions. That would be a sign that we are going to test the 100-day MA and that more of the gap could fill. If more than half of the gap is preserved on this dip, it is not likely to gain traction. In that case I have to start scaling out as the bearish cycle completes or if I start to see support forming.

A wimpy bounce serves many purposes and it is our best scenario. The nature of the move tells us that sellers are close. The bounce gives us time to find the weakest stocks and it also provides us with an excellent entry point.

Game Plan Scenario 3

The market opens with stacked red candles and decent volume. This would only happen if sellers are aggressive and if the volume is also heavy. They are so anxious to short that they smash every bid in sight. This would signal that most of the gap will fill and that a Gap Reversal is likely. Those often turn into bearish trend days and I can get aggressive with my shorts. Along the way I want to see the 100-day MA obliterated. As much as I would like to see this scenario, it is not likely. Traders are positioned for the FOMC and we are not likely to see aggressive buying or selling this close to the statement. If I get it, I will scale in quickly and I will keep adding on red candles if they stack consecutively. I will have a full position on early and then I will evaluate the price action around the 100-day MA.

Red stacked candles early in the session on heavy volume would indicate a trend reversal. In this scenario a gap fill is likely and this could turn into a bearish trend day scenario a gap fill is likely and this could turn into a bearish trend day.

Game Plan Scenario 4

The market has a choppy drift lower with mixed overlapping candles and light volume. This is a very likely scenario. Buyers and sellers have been active recently and this would be a sign that the early bounce is sparking profit taking by bulls. If half of the gap is preserved and I start to see support forming I have to take gains on shorts. These would be small starter positions and the lack of momentum would prevent me from adding. I will be in profit management mode and there might be a chance to trade from the long side. This scenario would demonstrate that the bid is fairly strong. The move lower was stubborn and more than half of the gap was preserved.

Game Plan Scenario 5

The market compresses near the high of the day and the opening price is preserved during the bearish 1OP cycle. That scenario would tell me that the gap up on the open was legitimate. Profit takers and short sellers were not able to knock the market down. The temptation early on is to test the bid and to "goose" a reversal. That effort failed and the market was able to tread water during an entire bearish cycle. The gains have been "digested" and sellers will be less aggressive because they feel they will be able to sell at a higher price. Buyers will be emboldened and they will start raising their bids. A bullish 1OP cross in this scenario would lead to a new high of the day and the market will float higher on light volume. Sellers are present and that is why the market compressed. If they were not present, we would have seen stacked green candles and follow through buying after the initial gap up.

Profit takers who are long and short sellers are going to take advantage of the gap up. That selling pressure will typically fill in some of the gap. If it does not, it is a sign that buyers are interested and that the next move is going to be higher. For this scenario, the market needs to stay close to the opening price. We do not want to fill much of the gap (if any) and no long red candles.

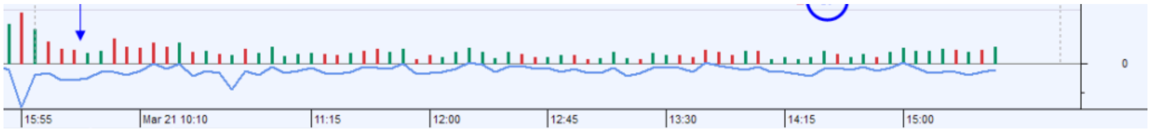
Executing the Game Plan

At this stage we have the different scenarios mapped out. By the way, this comes with experience. What took me hours to write and demonstrate happens in minutes after the opening bell. So what is the priority? Scenario 1 (stacked green candles) and Scenario 3 (stacked red candles) are the only ones that would deserve early action. Since the market action has been two-sided and since there is no D1 up trend, I would not be very interested in Scenario 1. A “Gap and Go” presents higher risk and lower reward. It would force me to take a long position early and I am vulnerable to a reversal if the move quickly runs out of steam. Consequently, I am not going to spend time looking for longs right away. Scenario 3 is a “Gap Reversal”. That move would indicate heavy selling and it has a chance to gain momentum since there is plenty of room to drop as the gap fills. I can stick with these positions longer, they present greater profit potential and this pattern has a good chance of turning into a trend day. Consequently, the best use of my time is to look for stocks with relative weakness. Scenario 2 is a wimpy rally and Scenario 4 is a gradual drift lower. Those also set up well for shorts. Scenario 5 will take an hour to unfold since we need proof that the opening gap up is going to be preserved. If the short scenarios don’t materialize in the first hour, there will be plenty of time to shift gears and to look for longs.

The day has started and we start looking for weak stocks. We need D1 breakdowns through technical support (trendlines, major SMAs or horizontal support). We want to see these levels breached with long red candles and heavy volume. We would also like to see relative weakness on a D1 basis.

The Outcome

The market was able to hold the opening bid for about 30 minutes and it compressed at the high of the day. 1OP was spiking and that was a sign of a potential reversal. The market had not been able to advance while the bullish cycle was completing. There was an attempt to breakout to a new high of the day, but that long green candle turned into a bearish hammer by the time it finished. Bullish speculators rushed in and they were going to have the door slammed in their face. The next bar took out the low of the day and it was time to short. At this stage it was too early to tell if the selling would gain momentum, but now that we are in the gap, we have plenty of room to the downside and we have a fresh 1OP bearish cycle to work with. On any additional weakness in the SPY and the stock, the plan was to add. Note that buyers did initially support the gap. On a Gap Reversal, the selling pressure would reveal itself immediately and the first few candles would be long and red and the volume would be heavy. We did not see that. Instead, the volume on the drop was light and the candle bodies were small. This told us to temper our bearishness. Add once, expect follow through and manage the gains. The market drifted lower, but a decent sized bounce happened well before half of the gap was filled. That was a sign of support. The market did make a new low of the day, but it was a marginal new low (barely got below the previous LOD). That was another sign of support. This was a sign to take gains on shorts that found support. The candle bodies remained tiny, the volume was light and 1OP was flat-lining around zero. The middle of the day was a time to lay low.



The market did fill in some of the gap, but the move lower found early support and that was a sign that buyers were still engaged.

During the first 30 minutes of trading, Digital Realty Trust (DLR) was coming up in the bearish searches. It had all of the characteristics we look for and it was highlighted in the chat room. It had broken a Low+ trendline, and horizontal support on a long red D1 candle. It was below all of the major MAs, it was relatively weak and the volume was heavy. It was an excellent candidate.

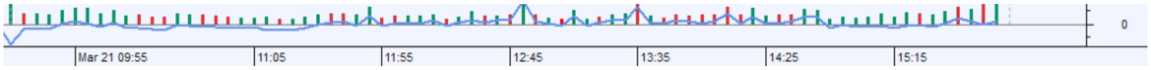
This stock had all of the qualities we look for in a short. Major technical support had been breached on heavy volume and the stock was weak relative to the SPY.

When the SPY made a new low of the day, DLR also made a new low of the day. In fact, when the SPY was treading water, the stock was ticking lower and that was a sign of relative weakness. This is worthy of a starter short position. The SPY volume was still light so it was important to wait for follow through. When the SPY continued to drift lower and the stock had a red Key Bar, the weakness was confirmed and this warranted adding to the position. The SPY price action was not extremely bearish so there would not be a reason to short aggressively. As it turned out, the SPY did bounce early and the next drop was a marginal new low. Support was starting to form. Fortunately, DLR was very weak and it continued to slip. There was no reason to exit the trade until it found relative strength later in the day. At that point, the market had also shown signs of strength.

Game planning is very important for day trading because some of the biggest moves happen early in the day. You have to know what might unfold and what your actions will be. As the day progresses, the price action becomes clear and we have a better sense of what might happen in the last few hours of the day. There is no urgency because we have had time to look for longs and shorts. On this particular day, the SPY made a higher low double bottom late in the day (Please reference the SPY 2 charts earlier). It rallied above the VWAP and there was a bullish 1OP cross. This was a good entry point for longs and I posted this chart of GOOG in the chat room.

GOOG was breaking through major trendlines and it was above the 200-day MA. The volume was heavy and the stock had been strong all day.

GOOG had been strong all day and you could have owned it at any point during the day and done well. The price action was very tight and the volume was heavy. The stock preserved its relative strength until late in the day. It pulled back slightly, but there was no reason to believe that the buyers who had been supporting the stock all day were going to abandon it when the market was showing signs of strength. Once the stock regained its relative strength it made it back to the high of the day.



GOOG had been strong all day. It got a little ahead of itself and it dipped late in the day. Once it found support it regained its relative strength and this time it had a market tailwind to push it back to the high of the day.

Conclusion

Once you do all of your analysis, you can draw conclusions and conduct scenario analysis. Some outcomes will be more likely, some will present greater profit potential and some will be less attractive (higher risk). Based on each of these scenarios you can develop a game plan. Try to visualize it. The game plan will include your position size, the conditions that would prompt you to add, the target position size if all goes as expected, when to exit the trade and how you will know if the position needs to be stopped out. This all sounds very complicated, but it’s not. It happens naturally for experienced traders in a matter of minutes. They can look at a trade, go through the mental checklist and know how they are going to proceed. They have a keen sense of awareness. It does take time and repetition to develop this skill.

The advantage to game planning is staying one step ahead. Wayne Gretzky was asked, “What makes you so great?” He replied, “I skate to where the puck is going to be, not where it has been.” Game planning will help you achieve that.

Chapter 8: When To Hedge

Hedging is another word for protection. Think of it as buying insurance. This can be a complicated process, so let me simplify it for you.

Institutions need to hedge because they have very large long-term positions that would be difficult and costly to “unwind.” There could be temporary uncertainty that they need to navigate so they buy that protection. This course was not written for large institutional traders. On occasion, retail investors might have long-term stock positions that require a hedge. They want to hold the original position to postpone capital gains taxes and that would be a legitimate reason to sell calls against the stock (covered call writing) or to buy protective puts (married put position) or to sell calls and buy puts (a collar). If this describes your situation, you can search for those topics and explore the strategy that best suits you. This course is written for traders and not investors, so we are not going to explore those hedges. Instead, we are going to explore why traders that have a relatively short-term trade duration (less than six months) might hedge.

Let’s start with the most basic scenario, the stock trader. Let’s suppose that the market is in a nice up trend and they have a basket of stock positions. They have nice gains and they want to lock them in. They only trade stock and they don't "mess with options." Their only recourse it to sell some of the stock positions, so they scale out. In doing so they reduce risk and they lock in profits. This approach is simple, effective and elegant. Trading is complicated and when I have the opportunity to simplify it, I do. That is why I use this method. I don't hedge. If I sense uncertainty in the stock, I reduce my position. If I sense uncertainty in the market, I reduce my positions.

The need to hedge stems from uncertainty. Sometimes it is real and sometimes it is perceived. So let's explore each of those. Our first concern is always the market. It drives all of our decision making. If the price action is extremely choppy with little to no direction, we should be focusing on very short-term trades and we should be keeping our trade size small and our trade count low. We don't have a clear sense of market direction so our odds are low. Since we are focusing on short-term trades and since we are keeping our positions small, we don't really have a need to hedge. We are in and out of positions and we will continue to use this approach until conditions change. On the other extreme, if the market is in a nice orderly trend higher with tight price action, we are aggressively long. We have large positions and a lot of risk exposure. As long as the orderly price action is preserved, we don't need the hedge. If we start to see more dips, we take notice that the upward momentum is starting to decelerate and we start reducing our position size. If the dips are deeper and they last longer, we reduce our position size even further. We recognize that market conditions are changing, so we adjust our risk based on our observations of price action.

We trade stocks with relative strength and relative weakness. That is our edge. We never compromise when it comes to trading stock. You should never, never, never be trading a choppy directionless stock. There are thousands of stocks to pick from and you can always find one that is trending higher or lower in a nice tight orderly fashion. If you can't find one, keep looking. They're out there.

Choppy & Directionless Markets

If market conditions are choppy and directionless, you are more likely to find both longs and shorts with relative strength and relative weakness respectively. You will take confidence in the nice tight stock trends and you will have a basket of longs and shorts. Your market risk is minimal because you have positions on both sides. Since the market is directionless, you keep your size relatively small. There are plenty of stocks in bullish and bearish searches and the candidates are fairly balanced. Sooner or later, the market is going to breakout in one direction or the other. When that happens, you are going to Identify that and you will be able to favor one side more than the other. If the market is starting to trend higher, you will have more long positions than short positions. Your searches will have more bullish prospects to choose from and your "mix" of longs and shorts will adjust naturally. As the market up trend is established and confirmed, it will become much more difficult to find good bearish patterns and the bullish patterns will be abundant. During the entire process, you are never compromising on the chart patterns. The D1 must have a nice, tight, orderly trend or we don't trade the stock. I've taught you the price patterns to look for that would indicate that the stock is losing its trend. When you see those signs, you start taking gains and eventually you are out of the position. You find new stocks to replace them. This is a very simple model and it adjusts naturally. The market dictates if we are bullish or bearish or neutral. It also dictates our position size and our trade duration. If the market is directionless and choppy, our trades are shorter in duration and our position size is smaller. When the market is trending, our position size is larger and we are adding to our positions when we have confirmation. Our trades are also much longer in duration because we want to ride the trend.

I've mentioned that retail investors might need to postpone capital tax gains and that is a legitimate reason to hedge. Day traders and short-term swing traders with a week or less holding period have no need to hedge – ever. They are trading the current price action and when the move is exhausted, they take gains. They have their finger on the pulse and they throttle risk based on the short-term price action through their position size and trade count.

Earnings & Scheduled Events

Longer-term swing traders who have a trade duration of 6 months or less could run into unexpected stock moves. I do not advocate holding over earnings announcements so there is no need to hedge. Get out of the stock before the announcement and trade it after the reaction. Predicting earnings reactions is a 50:50 proposition and this is a scheduled binary event. Our odds are much higher trading under normal conditions so we avoid holding over earnings releases. There will be moments when a stock makes an unexpected overnight move on surprise news. There is nothing we can do about that. Sometimes the news will hurt us, but it typically helps us. You will find that the news is "leaking" into the marketplace ahead of time and we are picking it up in the price action. We are on the "right" side of the news and this happens constantly. Evaluate the news and its impact on future earnings. Based on your findings, exit the position entirely, exit some of it or decide to hold all of it. The news will quickly be disseminated and it will find its new resting point. If you are in a stock and it is relatively flat, monitor the options implied volatilities (IVs) for the near term at the money strike price. If you notice that the option IVs are starting to rise, that is a sign that there is uncertainty ahead. This is a warning sign. It could be a clinical trial or litigation that will soon be released. These events tend to fly under the radar, but the Market Makers are aware of it so they reflect that in the price of the options. This scenario is avoidable and it is another example of a binary event that we want to avoid. By the way, you should never be camped out in a stock that is flat for more than a couple of weeks. We want stocks that are moving. The example below is Nvidia. The stock was flat and earnings would not be released for another two months. The option IVs were rising because it was hosting a huge AI conference and the chances of a "surprise announcement" were high.

New product launches and investor conferences are scheduled events. If you decide to hold through these periods, you are aware of them and you are willing to shoulder the risk. Instead of taking a larger position and then hedging it, simply take a smaller position. Again, I prefer to not have a position into these events. If the stock rallies ahead of it, we often see a negative reaction ("sell the news"). These situations don't require a hedge, you are either in the trade and willing to accept the risk... or not. Some news comes out of "left field" and it is something that no one could have predicted. Some stocks tend to be "newsier" than others and that is often reflected in the price action. A company might lower guidance or perhaps it has a factory recall on one of its products. It happens randomly and infrequently. Adjust your position and move on. The other events (earnings, product releases, litigation) can be avoided by checking the corporate schedule and by watching the option IVs relative to the stock's movement. If you are willing to accept the risk, hold the position. If not, get out.

Longer-term swing traders want to hedge in case there is a "large" "surprise'" "market drop." This is an odd statement with some key words. Many traders are worried about "large" drops of more than 10%. They can weather the small drops and adjust risk, but the big moves are very destructive. "Surprise" moves keep them up at night worrying that they might have missed something. As you will see, there are always warning signs and there are no "surprise" moves. Longer-term swing traders are worried about a "market drop." We already covered the stock component, but why do we only need a hedge against a market drop and not a market bounce? There are a few reasons. No one complains when the market screams higher, only when it tanks. That's because most traders favor the long side. If the market is falling and they are short, they are not thinking about hedging those shorts. We don't often see bear markets that last more than a year or two. When you are short, you are always walking on "thin ice." If you look at the 50-year chart of the S&P 500, you will see that it has an incredibly strong up trend. The bear markets are a tiny pimple on a long-term chart. This explains why long-term investors can "dollar cost average" without fear. They know that bear markets provide them with a better entry point and the market "always comes back." When you are trading from the short side, you are always nervous. The drops are huge, but you are trading against a 50+ year uptrend. When you get a big market drop, your shorts will perform incredibly well and you will have massive profits. Take your gains when you see those stomach wrenching moves lower that leave you feeling that the market will never rally again. The market will bounce and those moves will be equally violent. Traders who short during bear markets know that the Fed will do everything in its power to prevent a crash. They will have emergency rate cuts and they will "drop money from helicopters" (i.e. $3 trillion in Covid-19 relief) if needed. I have even seen the Fed announce a rate cut the morning of options expiration during the 2008-2009 financial crisis to inflict as much pain on shorts as possible. The market rocketed higher on the news. Your strategy in a bear market is to short bounces and take profits on massive drops. You are always nervous and you are always expecting bounces. Evaluate the height and duration of the bounce. If the bounce stalls at a resistance level that is lower than the high from the previous bounce (lower high), it might be time to reload your short positions. There is no need to hedge, you are in "hit and run" mode. We haven't talked about options as a hedge, but during big market drops, those hedges would be extremely expensive because option implied volatilities are spiking. This is why no one ever asks about hedging in a bear market. So let's talk about the need for hedging the other 80% of the time when the market is flat to higher.

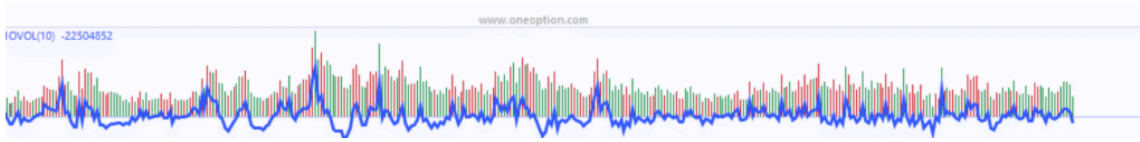
Horizontal Trading Ranges

There are periods where the market is trapped in a horizontal trading range for 60-days or more. The price action will be choppy, and buyers & sellers are generally in agreement (equilibrium). If the width of the range is greater than 10%, you might be able to favor the short side when the market is near the upper end of the range and the long side when it is near the lower end of the range. The market tends to keep on doing what it has been doing and if there is no material news that changes the economic backdrop, it will stay in the range. The market has no direction and that means we keep our trade size smaller. There will be strong stocks and there will be weak stocks so our portfolio will have a mix of longs and shorts. Regardless of the market backdrop, there will always be companies that do very well and those that do poorly. For instance, in a period of economic weakness, car manufacturers could be in a steady decline because people can't afford a new car, but auto supply stores could be in a strong up trend because people need parts for their older cars. The point is that there are always stocks with nice orderly tight trends in any market environment and we never compromise. Our positions are small and balanced (longs and shorts) and there is no need for a market hedge.

Upward Trending Markets & Trading Channels

The final condition we face is an upward trending market. We know these are common just by looking at a long-term chart. Some trends will be sloppy and there will be many dips and retracements. We recognize that the market is moving higher in a stair-step fashion. Longer-term swing traders understand that they will have to “weather” some bumps in the road and they are mentally prepared for that. Short-term traders will time those cycles. When the market dips, they will be watching for signs of support and they will buy. The market will stage the next leg of the rally and when it hits resistance, short-term traders will take gains. When this is the prevailing pattern, find an upward sloping trendline with at least 3 touches. It could connect the highs or the lows. If you draw through the body of an outlying candle or two, don’t worry about it. Then try to “fit” the other trendline so that it is roughly parallel to it. This will simply act as a visual aid. The choppy trend higher prevents us from getting overly aggressive with our trades. Every time the market stages a horizontal breakout to a new relative high, it quickly stalls out. Our guard is up so there is never any need to hedge. We buy dips and we take gains into strength.

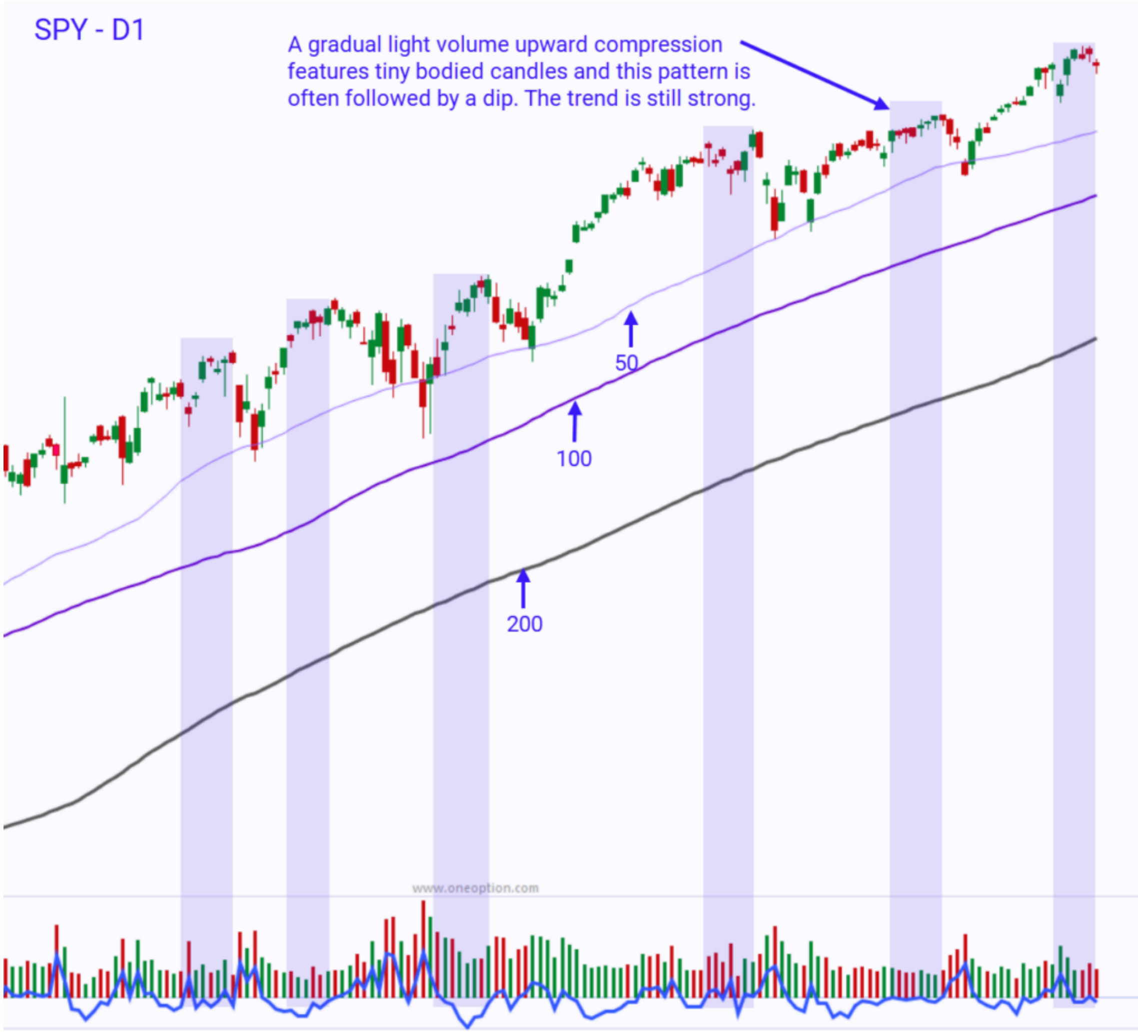
The chart below shows you how to draw a trading channel. In the early stages, you don’t even know if a channel is forming. You just see big drops and big bounces. We don’t have a lot of data, but the dotted lines provide us with an early indication of what we might expect. As the down trend matures, you would be able to draw the heavier lines. Again, these do not need to be perfect, they are a visual aid. The chart below is a downward sloping trading channel, but the price action will be very similar in an upward sloping channel. A sloppy trend higher or lower would not warrant hedging. We are in and out of positions based on the stair-step pattern and the trading channel. This is a common pattern and it can last for many months.



Nice, Tight, Orderly Trends Higher

The final market pattern we haven't discussed is our favorite one. It is a nice, tight, orderly trend higher. Buyers are so aggressive that there is very little retracement. Every little dip is gobbled up before it can get going. We recognize this strength and we are aggressively buying stocks. There is no need to suspect that these buyers are going to be deterred. They love the macro backdrop and they are putting long-term money to work. We are going to be doing the same. With each tiny dip that is instantly reversed, our confidence grows and we are adding to bullish positions. Now we have lots of downside risk exposure and this is the only time when we would even have to consider a hedge.

There are a few reasons why you might be considering a hedge. One is that you have big gains and you are "afraid" that you will give them all back. "Black Swan" events are very rare and we will get to those a little later in the article. This is not a legitimate reason to hedge. If you can't sleep at night because you are worried, your position is too large. Don't hedge, take some of the position off and reduce your risk. All arrows are pointing higher, but you don't have the confidence in your analysis to hold on even though that might be the right thing to do. In fact, you might be in a situation where you should be adding based on the price action, but you are running scared. It's OK. With experience, you will be able to replace fear with confidence and you will trust your analysis. Another reason traders hedge is because they see signs of strain. For some traders, all it will take is one red candle and they will freak out. We need those red candles, we just don't want too many of them consecutively. When the red candles reverse immediately, they actually confirm trend strength. The bigger issue for this trader is that the position is too large. Take some of the position off and scale out so that you can regain your clarity. The final reason traders want to hedge is because they see the trend strength starting to wane. The candle bodies are tiny and the price action is compressing near a relative high. If the compression is happening when the market is still heading higher on light volume, a dip is coming. Don't hedge. The decision is to weather a small dip and to hold the long positions or to reduce risk by selling some of your positions. Both decisions are fine. What often happens is that the trader who decides that they are going to stay the course loses their nerve when the dip comes. They are more likely to exit near the low of the dip which is actually where they should be buying. You know your personality so be true to yourself. "Are you really going to be able to stomach a dip?" "How much of a dip can you handle?" Quantify it. If you are a "nervous Nellie," take gains and reduce risk when the trend is starting to lose its momentum. A seasoned trader who is willing to ride out a dip knows that they have been buying on the way up and that their average cost is well below current levels. Instead of trading in and out of positions, they will hold the line and they will be ready to add on the dip. This pattern (a light volume float higher with tiny bodied candles) is a little more indicative that a dip is coming because the market has "fluffy gains" that can easily be taken back. Those moves result from a "sellers boycott" (very little supply) and bullish speculators are vulnerable. The light volume tells us the conviction is low and the tiny bodied candles tell us that sellers are nearby. The recent gains will eventually spark profit taking.

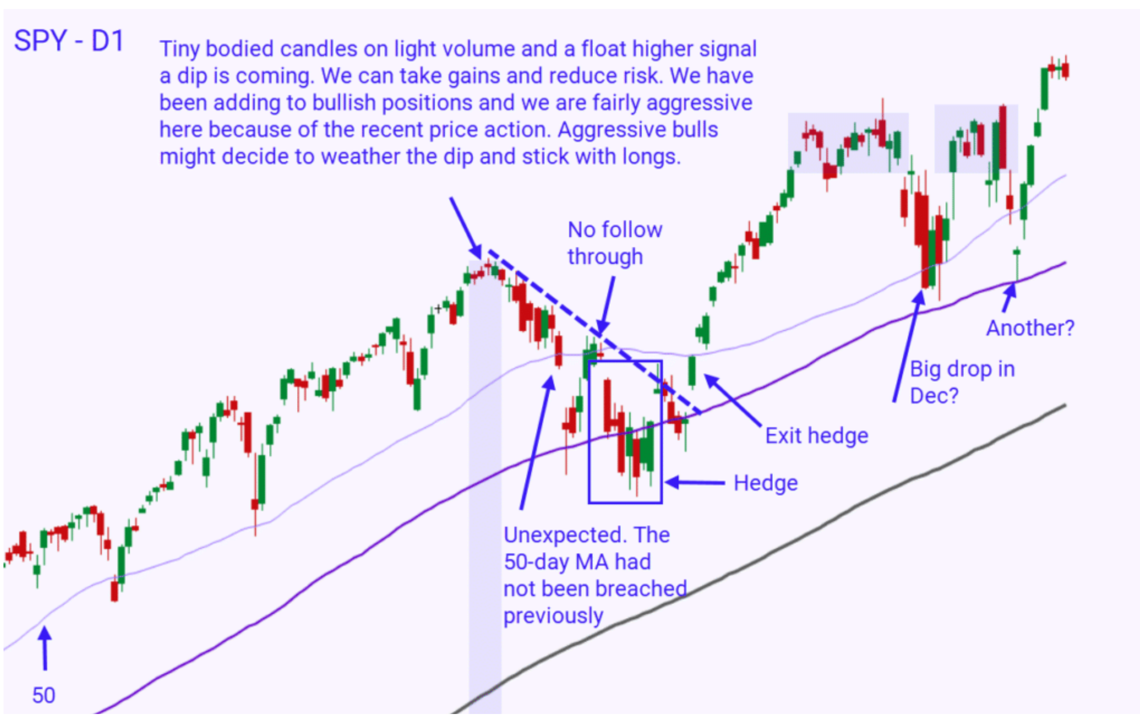


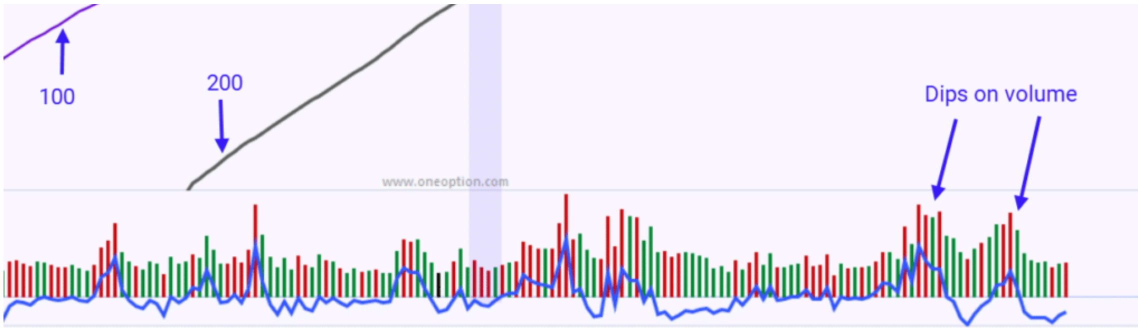
Horizontal Compressions

Sometimes we see horizontal compressions after a big move higher. This is different from the compression on a gradual move higher I just described. The candle bodies are also tiny and the momentum slows. In the chart below, you can see that we were coming out of a decline and the market was the early stages of a recovery (bearish trend reversal). There is plenty of upside so hold the line. These horizontal compressions are actually very bullish and the next leg higher will come soon. The compression won't last long. Profit takers are keeping a lid on the action and the market is simply digesting recent gains. The fact that there is no retracement tells us that all of those gains are being preserved. Buyers are aggressive and they are offsetting any supply. You should not be looking to hedge and you should not be exiting longs. On an upside breakout, you should be ready to add.

When the horizontal compressions last more than a month and when the trend has been established for more than a year, the momentum could start to wane. In the chart below, we can see that the market had been somewhat choppy with a stair-step pattern higher. Dips were common. As the market enters the shaded area of the chart, we start watching for a dip. In this case, the dip did not bounce right away, it retested support. That is fine, but it is a sign that there was a little more selling pressure that needed to be worked off. When the market bounced, it could not get through horizontal resistance. A marginal new high signaled that sellers were present. In this case, it looked like a longer-term horizontal trading range might result. This would still not be a time to hedge, it would be a time to lighten up on bullish stock positions. Eventually, the market does recover. Given the context of the move, you would proceed with caution and you would not aggressively add. On the right side of the chart, we can see that the price action has improved substantially. The second dip was brief and shallow relative to the previous dip and it made a higher low. It looks like this rally is improving and the price action gives us the confidence to be more aggressive with longs. In all this time, we have still not talked about hedging, but we will for the rest of the article.

At this stage, we have a market that had shown some signs of resistance, but it recovered and it was gathering strength. The dips were getting smaller and they weren't lasting as long. The price action was nice and tight, so we started to increase our position size. In the chart below you can see a tiny compression (first blue shaded area in the chart below), but that might not have been enough to prompt some traders to take gains. We are aware that September is seasonally weak so it's wise to use extra caution. [Here is a video from 9/13/21](). That video was right at the top of the compression and you can see what I was thinking at the time and how we traded. Let's say that you are willing to ride out what could be a soft patch. The market started to pullback. Nothing severe, just a normal dip in a bullish trend. It poked through the 50-day MA and it had not done that in many months. This was still not anything to get too worried about. The next day, the market gapped down and it touched the 100-day MA. This was a much bigger dip than we expected and we had seen a drop of this magnitude in the last year. The move was fairly sudden and it was a warning sign. The bounce barely got back to the 50-day MA and it found resistance. This was not the typical bounce we had seen previously. In the past, buyers were aggressive and the market shot right up to a new relative high after a period of weakness. If you had a lot of stock positions, you could have shorted the S&P 500 futures for a hedge at this moment. You would calculate your overall dollar allocation to stocks and divide that number by the dollar equivalent of one futures contract to calculate how many futures contracts you needed to short. The logic behind this is that the move is not going to last a long time. Instead of unwinding all of your stock positions, you can just short the futures in case the next leg lower is deeper. Your stocks have relative strength and they will hold up well relative to the S&P 500 so you don't want to sell your stocks. Something has changed the macro market backdrop and you are trying to determine what it is. There is uncertainty and your confidence has been shaken (that is why you are hedging). While you investigate, your position is protected. This happened in September and that is one of the weakest months of the year so this could simply be "seasonal weakness." You don't have to "perfectly hedge" the position. You can do fewer futures contracts if you are fairly confident the market will bounce. You can also reduce risk by selling some of the stocks you own that have become relatively weak. The point is that this drop is not like the others. It is deeper than the others and you need a little protection. The market tested the 100-day MA a second time and it bounces through the downward sloping High- (H-) trendline. You buy back your S&P 500 hedge and the market recovers. [Here is a video from 10/13/21] and you can see what I was thinking just before the bounce. You are still confident in the strength of the long-term trend and you are also confident that the market will try to get back to the previous high. Buyers have been buying dips for over a year, and they are likely to buy this one as well. When the market compresses at a new high, you take gains. That last drop was deeper than we had seen and it lasted longer than the others. This is a warning sign. We are in December and this is typically a strong month into year end. If we decided to hold some of the position, we are not expecting a dip at this time of year, but we got one. On the next bounce and compression, it's time to exit longs. The price action is getting very choppy. That is a sign that the selling pressure is building and that the trend is starting to weaken. We don't need to hedge, it is time to go to the sidelines. We rarely see selling in December and this is a warning sign. [Here is a video I recorded during the second dip on 12/20/21] and you can see what I was thinking. The market back drop had changed. Inflation was hitting levels that we had not seen in 40 years and the Fed was preparing to raise interest rates. Anyone can go back in time and analyze a chart. They know the outcome so they structure their comments to fit the outcome. That's why we have so many "gurus." I don't do that. These were my comments at the time and the price action was driving my decisions. It tells us when to be long, when to be balanced, when to be short, when to trade aggressively and when to trade passively. We throttle our risk to match the price action and there are not many times when we need to hedge. This is not simply "lip service," this is how we actually traded.





We’ve covered every market condition. If you are watching price action, you don’t need to hedge. When the market is in a down trend the price action is much more volatile. You are in hit and run move because huge drops don’t last long and there are violent snap back rallies. Don’t hedge your shorts, take gains! When the market is range bound, we don’t need to hedge. Our positions are smaller and we have a balance of longs (stocks with relative strength) and shorts (stocks with relative weakness). Our market risk is very low for that reason. When the market is in a normal stair-step rally, we expect dips along the way. We can choose to throttle our swing trades (buy dips and take gains into rips) or we can decide to hold the positions and ride out the dips. If the dips are deeper and if they start to last longer, we know the trend is weakening so we reduce our size. Our greatest risk comes when the market is in a very tight, orderly trend with heavy volume. There aren’t any dips because buyers are aggressive. For that reason, we know the bid is strong and we are aggressive as well. This is when you will be tempted to add a hedge. There is nothing in the price action to suggest that you need one. If you can’t trust what the price action is telling you, reduce your exposure, but don’t hedge. When that powerful move higher ends, we will see the warning signs in the price action. A gradual float higher on light volume with tiny compressed candle bodies will be a sign that a dip is coming. Take some risk off, wait for the dip and once support is confirmed, re-establish your longs. When we have very strong trends, we will typically see at least three dips with bullish flags before the momentum wanes completely.

Black Swans

What about “Black Swan” events? Apart from the “Flash Crash” in 2010 that lasted 35 minutes, I have not seen a crash that was not preceded by price action warning signs. The “2001 Tech Bubble,” the “2008 Financial Crisis” and even the “Covid-19 Crash” had warning signs. We had not seen global contagion in our lifetimes and this was the biggest and fastest market drop ever. The world stopped. The problems in China were well-publicized if you were paying attention. Here is a video from Friday (2/21/20) the day before the “Covid-19 Crash.” I also did a follow up video that Sunday night and you can find it on my YouTube channel. The warning signs were there and you can see how we had a few remaining options positions that were hedged with VXX calls. “VXX calls, what’s that?” To this point, I have not even talked about options so we might as well dig in.


SPY - D1
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Options & VXX Calls

If you listen to most "gurus," options are the answer to everything. Who knows, they might even cure cancer. They will tell you that with options "you can make money if the market goes up, stays flat or goes down." That is true if you know the direction, magnitude and duration of the move and if you get those components right. They don't teach you how to do that, but I do. They will teach you that if you are worried about your portfolio, you should buy some SPY/SPX put options or to buy some VIX/VXX calls. They will explain all sorts of risk/reward scenarios and then they will calculate the number of puts you need to buy and how long you need the protection. They might tell you how to create spreads to make the insurance cheaper. You might even create a position where you can more than offset portfolio losses if the market really tanks. "Worried about your stock? Buy some put options on the stock. Really worried about your stock? Let's sell some calls and use the proceeds to buy some puts (collar)." This is all a big steamy pile of @#$%. We are traders and we don't have to worry about capital gains taxes on long-term holdings. That is the only time when you need a hedge. This hedging exercise is gigantic waste of time and it complicates your trading. It makes these "gurus" sound authoritative and they spew this garbage to sell you their product. If you have reason to believe that conditions are changing and that you need a hedge, exit some of your holdings and reduce risk. Keep it simple.

So, in the video I mentioned that I was long VXX calls as a hedge. We had a few out of the money bullish put spreads that had a week until expiration on 2/28/20. They were way out of the money and I did not want to buy them back in. Option bid/ask spreads are often fairly wide and with a spread you have two legs to each trade, so they are a little harder to enter and exit (there is more slippage). They were very likely to expire and we would realize our maximum profit. Instead of buying them back, we bought calls on VXX. If the market tanked, option implied volatilities would explode and VXX would increase in value. VXX measures the option implied volatilities for farther out in time SPX options. There is a similar product called VIX that measures nearer term option implied volatilities. When there is uncertainty in the market, option premiums expand. That typically happens when there is a big market drop. At the time, option premiums were very cheap and if the market did drop, I viewed buying VXX calls as a nice trade with a great risk/reward profile and it would offset any possible loss on our spreads. I don't hedge so I'm not going to explain these instruments in any greater detail. They are an institutional product and you can visit the CBOE website to learn more.

When I Hedge

There are a couple of instances when I will hedge. If I have a large number of options positions that have a directional bias (long stock, long calls and/or short bullish put spreads) and I get blindsided, I will short S&P 500 futures on an intraday basis. It does not happen often, but I need some temporary protection and this provides it to me instantly. Unwinding a basket of positions is difficult and it takes time. When I get caught by a big contra market move, the option bid/ask spreads widen out and exiting can be very difficult and costly because of the slippage. It is much easier for me to just short S&P 500 futures and then to evaluate the news and the price action during the drop. If the news is damaging and it will have a longer-term impact on the market, I will hold the futures hedge overnight and I will start exiting my positions when the market settles down and the bid/ask spreads start to narrow. If the move was an over-reaction, I wait for the dust to settle and I remove the hedge the same day. An example of when I had to do this was when Donald Trump was

President. The market would be clipping along and then the bottom would fall out. “We’re going to increase tariffs on China to 100%! My red button is bigger than yours… and mine works!” We quickly learned that we needed to have a live Twitter feed and to watch for his press conferences. The other time I might hedge is if there is an adverse move related to a news release (i.e. FOMC or an economic number). I was aware of the news, but I did not expect a big reaction and it warranted a hedge. Again, these instances are rare and they might only happen a couple of times a year. I just need some temporary protection. If I feel that a major scheduled news event could result in a big market move, I reduce risk into the release. I am looking ahead and planning around these events. I wait for the reaction and then I resume trading.

Hedging Is Expensive & Complex

I don’t like hedging because the hedges are expensive. Hedges vary in cost depending on market conditions, option implied volatiles, and the desired amount of protection. When I was in the brokerage side of the business, I would run the calculations for large customers and explain that a hedge would cost 5-7% for six months of protection. They would ask for clarity, “If my portfolio goes up 5-7% in six months it would just cover the expense of the hedge?” Yes, and then you would make money above that. They never did the hedge. If you are nervous, take some risk off.

Another problem with hedges is that they don’t always work as expected. In the example above, if you used an index to hedge and you bought at the money SPX/SPY puts with 6 months of life and the index went up 7%, the hedge is not dynamic. It is not a safety net that moves higher with the index. It is still 7% lower. Those puts are exposed to time decay. When they expire, there is no hedge and you are unprotected. If you bought index puts to protect your portfolio, your stocks might drop by a greater percentage than the index. If you are hedging using VXX/VIX, the market might drop, but option implied volatilities might not spike. This is often the case during a slow drift lower. Your hedge is not working. Institutions are always eager to sell volatility and the move lower needs to be fast and sustained for option implied volatilities to spike. During a brief market drop, you might sustain losses on your portfolio and not realize any gains in the VXX/VIX position. VIX/VXX rises when there is sustained downward movement. As soon as the market finds support, the option implied volatilities contract.

Conclusion

In my experience hedging is a waste of time, energy and money. They often don’t work properly and they complicate your trading instead of simplifying it. You will constantly be adjusting the hedge and monitoring it to make sure it is working properly. There will be times when you take profits on your hedge too early and the market drop has not run its course. Now you are exposed. We are not giant institutions that need to hedge massive portfolios. We are traders who can read price action and we adjust our risk quickly. This is one of the few advantages we have so we had better take advantage of it. When you reduce risk, you have cash and you have flexibility. Instead of worrying about your hedge, you will be focused on new opportunities. You will not have a basket of “mush” to manage, you will have a clean slate to work with.

Ask yourself these questions: Why do you think you need a hedge? What is it about the price action that has you concerned? If you are seeing warning signs, reduce your risk. If you are nervous for no reason, your position is too large. Reduce your risk exposure. Scared money never wins and you have no staying power. Know that you don't have to sell all of the position at once, scale out.

Much of this article had to do with reading price action and adjusting risk. I tried to describe the market conditions and stock conditions you will encounter and how you should be trading them. The bottom line is to keep it simple. Don't complicate your trading by hedging. If you feel the need, reduce your risk. Cash is king and cash is a position.

Chapter 9: Your Trade Management Report Card

It's important to know how well you are managing your entries and exits. Daily logs will provide you with valuable information so that you can make steady progress.

Trading is a profession where we get constant feedback both positive and negative. From the moment we enter a position, it is either making money or it is losing money. Our emotions are running high and those early feelings are often misleading. Trades that are working out immediately often sour and trades that look ugly initially turn around quickly. That's why it is best not to look at your P&L when you are trading. Just look at the chart and focus on your game plan. When the dust settles and you exit the trade, you can calmly evaluate what you did well, what you did poorly and what you can improve on. Your trade log is the most valuable piece of information you have.

Unfortunately, our days are long and by the time the closing bell rings, we are tired. We put so much into our trading day that we are exhausted and hungry. Take a nice long walk, get some fresh air and grab a bite to eat. Your day is not done. Make sure you spend an hour reviewing your trades and writing your trade log. The information is still fresh in your mind and you won't be able to remember your thoughts and your game plan a few days later.

Trade logs can be handwritten, or trades can be downloaded and annotated in software programs. My career started at a time when people still drew trendlines by hand on a physical chart. I know this sounds crazy, but people used to also buy shares of stock and they would take physical delivery of the certificates and keep them in a safe. When I went Pro in 2002, I wrote trade logs and they were similar to a daily diary. I thought I knew what I was doing, but I had no clue. Little-by-little the pieces of the puzzle revealed themselves and they resulted in the trading system you are learning now. Handwritten trade logs are detailed and incredibly helpful. They are essential for beginning traders. You are in "hope and poke" mode when you start and you need all of the details that went into your decision. Written trade logs are also a must for intermediate traders who are testing new methods and developing new approaches. I still use them when I am developing and testing a new search, system or feature for my trading platform. You need this granularity and you just won't get that in a software program.

I could go through each of those lessons from the last 20 years one-by-one, but I've already done that in this course. At one point in my career my name was "FOMO Joe."I've chased my fair share of "hot stocks" on the open and I've been humbled. Now I know better and I am more likely to fade those moves than I am to join them. I have an MBA and I consider myself to have above average intelligence. Of course I've played "Jr. Analyst." In time, I came to realize that I don't know shit and neither do the "talking heads" on the financial news networks. That's when I realized that I don't need to analyze fundamentals; price is truth. I've bought a long green breakout bar to a new high of the day and I've had the door slammed in my face. Now I realize that I have to wait for follow through. If that move instantly reverses, I know it was an attempt to trigger buy stops and to lure in bullish speculators. Now I know the games institutions play and I use that knowledge to make money. My written trade logs revealed all of this information and none of it would have come to me if I just used a software program.

Your Trade Logs Have The Answers

If I've come across as a "know it all genius" that's never made a mistake, let me put that notion to rest. I hope you find the content in this course to be truly unique. These are not lessons I've read about. These are the lessons I've learned firsthand during my journey. They've cost me hundreds of thousands of dollars and I'm trying to help you avoid these mistakes. My daily written trade logs were the source of **ALL** of the information in this course. Do I think written trade logs are important? Heck yes! They are the most important thing you can do.

When you start trading, everything is random. You don't know where to start so you read a bunch of books. They show you some helpful technical patterns and it all seems so straight forward and easy. When you try to put these lessons into action, everything turns into garbage. Things that I read in a book were different in real-time. It was hard to find these picture-perfect setups I had read about and they never played out when I did find them. Reality was much different than theory and I quickly realized that anyone can go back and find the perfect pattern and then write about it. Many of these breakouts that looked just like the ones in the book "blew up."

Eventually, my trade logs revealed some of the big puzzle pieces. Market first, use technical analysis, don't rely on fundamental analysis, the characteristics of a strong trend… At this stage I was getting my arms around trading. In the next stage, I learned how to schedule my trading around major news events. This only came after getting blindsided a few times. By the way, lessons learned from mistakes are much more meaningful because you lose money. Get angry when you write your logs. Keep the wound fresh and rub some salt in it so that you don't repeat it. When you go back and read it you will relive the frustration and that's healthy. My logs were becoming more useful because I understood what I was doing right and what I was doing wrong. I came to realize that my stock trades where the stock was strong relative to the market performed better than my S&P 500 trades. There was a "cushion" or an "edge." Perhaps I should trade the performed better than my S&P 500 trades. There was a "cushion" or an "edge." Perhaps I should trade the stock instead and treat it as a surrogate market position. I also dedicated myself to reading price action. Every single indicator lag, but price action is real-time. How we get from point A to point B matters. At this stage, I had my hands around this monster. What seemed random a year or two earlier was starting to make sense. This process continued, and eventually, I had a tight grasp on trading, and I was ringing out the last drops of water from a wet towel. Those are the fine brush strokes where you are refining your systematic decision-making process. None of this would have been possible without written trade logs.

"Pete did you keep any of those original trade logs?" No, they pile up very quickly and I knew that I wouldn't take the time to go back and read them. When you give yourself a moment to reflect on an experience and then you take the time to write about it, you elevate your cognizance. What are you going to write about it? What lessons did you learn? Will you understand your notes when you read them in the future? It takes time to do this. I never threw out my old notes, they were single Word documents for an entire week. I would add to them each day and then create a new one for the next week. When I bought a new computer, I would just not transfer them over to the new computer. There were times when I would go back a few months and randomly look at my logs. "Oh yeah… #$%^ I remember that one. I won't do that again." The important lessons were never lost, they were etched in my memory. I still have notes from all of my failed attempts to create searches, systems and indicators. Sometimes I stumble across them and give them a glance. Most of them were trash, but some of them were the beginning of something special. There have been times when I used a component for something that I am working on currently.

"Pete do you still keep a trade log?" At this stage of my career, I don't write detailed notes like I used to. When I enter a trade, I know what I am expecting and what the odds of it happening are. I also know the margin of error I am willing to accept in any of my assumptions. The "tells" of a good trade or a bad trade are obvious to me now. This is an important point. I am not setting a mechanical stop of any kind. I am monitoring all of the influences/variables that got me into the trade and they need to keep "behaving." I've discussed this in my previous Trade Management articles. In time, this all becomes "second nature" and you are aware of all of the moving pieces in real-time. You won't get to that level of awareness without written trade logs. I still review all of my trades at the end of the day. I watch the last video that I posted to YouTube before I record a new one and I note what I was thinking and I evaluate how well I performed. I also review all of my posts in the chat room to see how well the stocks did and how well I predicted the market that day. I take pride in what I do and I am always looking for ways to improve. I am also very critical of myself.

Archived Market Comments

By the way, OneOption members have archived my market comments on the website and they have access to this. Click The Edge and select Daily Market Analysis from the menu. That will reveal each month. Select the month and you will see the SPY D1 chart. Then you can select the day you want to review. You will see my PRE-OPEN MARKET COMMENTS and my first post for the day on an M5 chart. When you click the dots along the bottom of the chart you can see my next comment and the chart will advance. This allows you to evaluate how accurate my forecast was based on the SPY chart and the price action since that previous post. [Here's one example] This entire feature is a giant trade log, and it drills down from the month, to the day, and to my intraday comments. Thank you members for updating this. I wish we had started doing this 5 years ago, but at least we have it now and you can learn from my log. It goes back to August 2022. It's really important for me to "walk the walk" and to lead by example. Otherwise, there's no substance behind anything I've written.

How To Analyze Your Trade Logs

Some members are writing out detailed trade analysis and they are posting it in the chat room and to social media. These are some of our top traders. Do you think this is a coincidence? Others are recording videos. They have had to verbalize everything they've learned and those lessons are cemented. You don't have to do this publicly, but you should at very least write daily logs.

Questions you should answer in your written trade log if you are buying:

1. Before the day starts, you should write a market game plan. What is the longer-term context? What is the shorter-term context? What news was released overnight? How did overseas markets perform? What is the opening market indication? How is the day playing out? What is the price action like? What needs to happen for a good window of opportunity to set up? What is our level of confidence? Market First!
2. Which stocks look attractive? Why is the D1 price action attractive? Is there D1 overhead resistance nearby? How much room does the stock have to run? Is the stock stacking M5 green candles on heavy volume? If it is, why is it worth so much more today? Was there news to justify the move? What industry is the stock in? Do stocks in this group typically make sustained directional moves? Has the stock been choppy intraday recently? Is it likely to dip and provide me with a better entry point? Is the stock in a nice steady grind higher? Does it have any dips? Is the stock above VWAP? Is the stock above the prior day's high? Is the price action orderly? Is the volume heavy? Why am I focusing on this stock? Is this the best stock I can find? Why is this the perfect entry point? If it is not the perfect entry point, what would be the perfect entry point? Does this stock have a pattern I am trading? What was the pattern D1 (bullish flag, compression breakout, trendline breach, SMA cross…)? What was the M5 pattern (gap up, gap reversal, post-earnings…)? When the market dipped, did the stock tread water or move higher? Is the stock strong relative to the market? Should I set an alert or should I buy it? If I buy it, how big should the position be? Is this a starter position? Is the volume heavy? Stock Second.
3. Once you are in the trade, you have no control and you are in trade management mode. If your analysis was good, the stock will move higher and you will know that you are in a good trade. Here is the information you should be collecting once you enter. What does the SPY M5 look like? Is it consistent with the trade? How much higher do I expect the market to go? Are we in the beginning of an SPY 1OP bullish cycle? Did the last SPY cycle produce? Are we in a SPY bullish trend day or an inside day? Is the SPY in a bullish divergence? When the SPY had a red M5 bar, did the stock have a green one? When the market dipped, did the stock preserve its relative strength? Is the stock oblivious to the market and in a strong grind higher? When the stock had a nice green candle did it retrace it or hug the high of the candle? Is the stock a little choppy? How much room should I give it? Am I getting the confirmation I need from the market to consider adding? Am I getting the confirmation from the stock to add to the

position? How much higher do I feel the market can go? What are the warning signs I should be watching for? Is the market trend strong enough to justify holding longs into a bearish cycle? Is the stock strong enough to weather a market dip? Is this a time to be passive and to take gains? Is this a time to be aggressive and to add to the position? What are the patterns for the SPY and the stock that are keeping me in the trade?

4. Once you exit the trade, you can complete your log. Here are some of the questions you should ask yourself. How well did I assess the market conditions? Was my forecast accurate? What did I miss? How can improve my analysis? What impact did the market have on the outcome of the trade? Did I select the best stock? Was there a better stock? What made that stock better? Can I quantify that trait so I can find these stocks easier? Did the pattern I was counting on produce? Was my entry good? How could I have improved my entry? Did I chase? If I set an alert instead of buying a breakout, could I have entered better? Would using a dip alert have kept me out of a bad trade? Was the price action what I expected after I entered? Should I have cut my losses earlier? What clues told me that I was on the wrong side? Why did I hang on to the position? Should I have held the position? What did the stock do after I exited? Would I have made money on the trade? How will I avoid bailing out of a losing trade that turns into a winner? Would a better entry point solve that? Should I have added to the position? What were the signs that the stock was going higher? Why did I exit the trade? Was it market related? What were those signs? Did the market drop? Was the stock starting to show signs of strain? What were those signs? Did I miss those signs and leave money on the table? Did I see the signs and ignore them? Why did I do that? Was my position size a factor in the decision to exit? Could I have scaled out? How would that have impacted the results? Did I bail out on one red candle? Why did I do that?
5. Did we trade options? Why? What was the bid/ask spread like? What were the option IVs like? Did the spread perform as expected? Did I buy the wrong options? Did I give the trade enough time? How would I have done if I didn't trade options and I traded stock? Would a different options strategy have worked better?

We are evaluating all of the decision-making elements before, during and after the trade. You won't get this granularity from the traditional trade log software on the market. These handwritten answers will be cemented in your mind if you take the time to do this. If you miss the opportunity to document everything after the close, it will be gone. The memory and the emotion attached to the moment will be lost and you will not go back to recreate it. Turn on some music, relax, reflect and learn. If this helps to motivate you, know that football teams watch game film the next day. They evaluate their previous game plan and they see how well they executed. They identify what they did well and they look for ways to avoid the mistakes they made. Then they watch game film for their next opponent. They develop a game plan and they make adjustments based on what they've learned. We are doing the same thing.

Trade Log Analysis Video

I have a very talented chat room member that I keep tabs on. I "checked in" to see how they were doing and they said that progress was very slow. I asked if they would share their most recent trades with me. I thought perhaps I could help them speed up the process so they agreed to share them with me. I spent the weekend recreating every moment for each trade. This video is almost two hours long. That member is cranking out fantastic trades now. Not because of me, I'm not going to take credit for that. I simply told them where to look for the answers. Here is the video. The answers are in your written trade logs.

Fine Tuning With Tags

There are many trade log software programs that you can use to track your trades. I'm not going to highlight any of them because they all have unique features and standard ones that you would expect. Some are expensive and some are free. They will import your trade data and then you can tag each trade with a category. This is useful information, but you do need to select categories that will be meaningful. Then you can run statistical analysis based on each category to see which ones performed the best. Make sure to create a field for the market D1 (rating 1-5) and M5 (1-5). You can use negative numbers for a bearish market. You could also do the same for the stock, but you don't need to. Why not? Because the stock D1 rating is 5 and the stock M5 rating is 4-5. Remember, we never compromise on the stock and we trade the "best of the best." Instead, your D1 stock categories might be compression breakout, trendline high- breakout, tight orderly grind, earnings breakout, SMA breakout… Your M5 stock categories could be greater than prior day high, greater than VWAP, dip alert, relative strength M5, gap up… Think of terms that are going to help you identify the trades that perform the best and then target those traits. You might find that there are months where you perform better (or worse), days of the week where you perform better (or worse) and times during the day where you perform better (or worse). When you are trading options, you will want to create categories as well and they could include weekly call debit spreads, out of the money put credit spreads, deep in the money calls and earnings calendar spreads. Determine which strategy performs best for you. These software programs are useful, especially for seasoned traders who are fine tuning.

I feel very strongly about keeping written trade logs. Most of you won't take the time to write them and your journey will take much longer than it has to. Find a nice relaxing moment to do this and create the right environment. It could be late at night after the kids are in bed. Take time to reflect on the day and write good notes that will make sense when you read them. Find an hour during the weekend to review your notes from the week and start planning for the next week. Everything in this entire course has resulted from my written trade logs. The last 15 years of my life have been a giant trade log from my blog posts to my YouTube videos, to my daily market comments to my posts in the chat room. You have not seen the logs that I have for my searches, systems and indicators. Committing your thoughts to paper reinforces them and you can review them. For novice and intermediate traders, this is a must. Trade log software programs can also provide useful information, but they are not nearly as valuable. I suggest using them to compliment your written trade logs, but they are not a substitute.

Chapter 10: How To Size Your Positions

This is one of the most common questions I get. This decision is the final brush stroke and it is critically important to get all of the other pieces of

brush stroke and it is critically important to get all of the other pieces of information right. That is where most traders should focus.

This is one of the most common questions I get. Novice traders believe that there is a secret formula that spits out the magic number. If they just had that formula their trading performance will reach new heights. Some books suggest to never put more than 5% of your capital at risk on any single trade and to use a constant dollar allocation. Other books suggest that you should leverage your account to the maximum because your stops will contain the risk per position and that to generate worthy returns you need to go full tilt. It's no wonder there is so much confusion on the topic. In this article, I will answer this question completely and the next time someone asks, I will point them here.

Dispelling Mechanical Solutions

Let's start with the two extremes I mentioned above. A constant dollar allocation per trade is not the way to go. That might work for portfolio managers who are looking to diversify based on sector correlation, but we're not investors, we are traders. Does a professional Black Jack player use the same dollar allocation when they bet? Of course not, they count cards and they increase their bet when the odds are in their favor. Market conditions are constantly changing and every minute of every day is different. Yesterday you might have had a trend day where you could ride your trades, size up and set high targets. Today you might have a light volume "inside day" with low probability conditions. Do you think you should be allocating the same amount of capital per trade in both situations? Trading an account "full tilt" might be the right thing to do in rare situations for some traders, but I'm not one of them. I will discuss this later.

Novice traders have been lead to believe that there is a mechanical answer to the position sizing question. "Never put more than 5% of your account into a trade and place your stop 2% below the current price and your target 4% above the current price." This is complete garbage and you'll find this canned solution in many books.

Novice traders have an unrealistic perception of trading and what it takes to be successful. "All I have to do is figure out how to read these wiggles and jiggles on a chart and I will make money." Trading is one of the toughest ways to make a living. To become a "professional" at anything takes years so let me draw a comparison.

An NFL quarterback has to assess risk and reward constantly. Mr. Brady, "Do you always throw 10 yard passes?" No. Mr. Brady, "Do you always throw bombs?" No. "Mr. Brady, at what point do you decide that it is best to throw the ball out of bounds or to squeeze the ball into tight coverage and risk an interception?" Before he answers the next question he is going to ask some of his own questions because he needs crucial information before he can respond. "Who are we playing? Are we winning? How much time is left? Is a defensive lineman in my face? Who is the receiver? Who is the corner? What are the field conditions? How well have I been throwing the ball? What down is it? Are we in field goal range? Are we backed up in our end zone?” The list goes on and on. The answer is dependent on the situation and the situation changes constantly. Tom Brady is aware of all of these factors and he processes them in an instant. At the very end, he weighs the risks and rewards and that is when he makes a decision. Come on Pete, “Are you comparing trading to being an NFL quarterback?” Yes! It took Tom Brady a hundred thousand snaps to get to that level and it is going to take you thousands of trades to answer the position sizing question.

But where can I read about this? You can’t find this in a book. Reading about Tom Brady is not going to make you a good QB. This you learn by doing. If you look at Hari’s trade log, some days he trades a lot, sometimes he does not, sometimes he trades ITM options, sometimes he trades CDS, sometimes he trades straddles, sometimes he trades stock. Sometimes he trades size, sometimes he pares back. Experience is what gets you to that level and it takes years. Each person is different and they have their own style. This is also where the mental part of trading comes into play. Should I click the buy button or should I wait?

The Real Issue

So my first goal in this article is to get you to think about position sizing in a different way. It is a continual assessment of risk and reward and size is dynamic (not static or mechanical). My answer is not going to be what you expected, so let’s get to it.

Most position sizing questions imply that everything would have been fine if they had just sized the trade properly. “I took the loss, but if I had correctly sized the trade, I could have taken the heat and it would have eventually turned into a winner. Pete, what is that magic number?”

The reality is that position sizing might not be the issue. If you are constantly getting stopped out, the issue is your trade selection. If you have to ask what your position size should be, the answer is 1 share. Work on every other aspect of trading, get your win rate above 75% and during that process you will develop the awareness you need. Your position sizing and risk management will become automatic in time. The best risk management/position sizing method in the world is not going to make any difference if you are making poor trading decisions.

Position sizing is way, way… way down on the decision making flow chart. What is the market doing D1? What is market doing M5? What is the stock doing D1? What is the stock doing M5? This is the decision making process and these are the priorities! Your opinion for each of these and your confidence in your analysis takes you to the next step. That is where you start determining your game plan. If you can consistently get to this stage of the process your win rate will be greater than 75%. If you get the market right and the stock right, your odds of success increase dramatically. What is the trade duration? Should I trade stock or options? How will I size this? What is the likelihood I will make money? How much am I willing to risk? At what point will I know if I am wrong? These decisions are at the end of the process. The pros have done it so often they don’t even think twice about it. They know based on the conditions what feels right and they know what has worked in the past.

This frustrates the hell out of novice traders and the pros who are trying to help them. The novice trader thinks that the pro is holding back. "There must be a method to their madness; they just don't want to share it." The pros get frustrated because this question comes up every @#$% day and the answer usually includes the phrase "it depends." The novice trader feels cheated out of an answer. "There's that old it depends answer again."

"Hari, why did you trade 100 OTM SPY put lottos?" The answer: He evaluated all of the inputs and based on the information at that time; the risk and reward for the trade were favorable.

Pre-snap, Tom Brady does not know what he is going to do. He knows what he would like to do, but the right circumstances have to present themselves. He is aware of the macro backdrop (score, weather, down and distance and field position…) and he evaluates the post-snap coverage. Then he weighs the risk and reward and he makes his decision. He does not step up to the line of scrimmage and decide that he is going to throw a 20-yard pass no matter what. A 20-yard pass is a position sizing risk/reward decision. Maybe a screen pass to the running back is the best decision.

Conclusion: Finding Your Own Path

Position sizing and risk management are the final brush strokes. Should you trade size? Should you scale in? Should you trade stock? Should you sell bullish put spreads? Should you buy OTM calls? They are game time decisions and the trader processes all of the other information and then they make a decision. The end result is personal. For every professional trader who is presented with an identical set of circumstances, the position sizing and risk management answer is different. This is where you make it your own. It is also where the mental/emotional aspect of trading comes into play. Consequently, we can't answer your position sizing question. Only you can answer it.

If you start out with 1 share and you focus on getting your win rate to 75%, you can focus on the really important aspects of trading. Reading the market correctly and finding the best stocks is critically important. Until you get to that point, you are not ready to take on the mental aspects of trading and with 1 share you won't have to. Getting your win rate to that 75% level is going to take time and there is no substitute for experience. You will be faced with many different situations and you will learn to identify changing conditions. You will learn when to adjust your positions and when to let them run. It might only be 1 share, but you are learning. These lessons will be very important when you start to increase your size. The lessons Tom Brady learned during High School football practices were important.

There is no way Hari would be able to flow in and out of all of positions the way he does if he did not have this skill. He would constantly be plugging in formulas to determine the "optimal size." He doesn't do this. He reads the market and the stock and he knows when to take a loss, when to enter a trade, when add to it and when to take profits.

Position sizing is the final brush stroke. Focus on everything that comes before it and when you get your win rate above 75% for a few consecutive months it will start to come naturally. You will experiment and you will define what feels right for you. This is when you start to define your trading personality.

Chapter 11: How To Size Your Position – Part 2

Position sizing is a dynamic process based on current information. This analysis determines if we should add to the position, take profits, or stop out.

Yesterday I posted an article on position sizing. Please read that article first. The lesson was that position sizing comes at the very end of the decision-making process. It is the final brush stroke, and this is the culmination of all of your trading skills right up to the point where you click the trade button. Your position sizing and strategic approach are dynamic and they adjust to changing market conditions. In this article, I will provide you with an example from a video I recorded Friday on the open and from my comments in the chat room Friday. I will breakdown all of the components to illustrate my point.

First of all, most novices never make it to the point where position sizing matters. I'm just being honest. They won't paper trade and they won't trade one share until they get their win rate up. They will just dive in, lose their money and blame someone/something else for their mistakes. Those who are trading with 1 share might not put the hours in "at the gym" or spend time "watching film" or "studying the playbook" like Tom Brady does. These are the thankless hours of preparation where you put everything you have into learning and training. Only faith and determination keep you engaged because there are no visible signs that all of this effort is going to pay off. Consequently, many aspiring traders quit before they ever reach the 75% win rate. This is a weeding out process and it is common to any high paying profession.

This article is for those of you who reach that 75% win rate for a few consecutive months. As much as I'd like to tell you that your learning has ended, it has not and it never will. The good news is that there is "light" and you are seeing progress. This is also the stage where you can actually start making a little money. It is like the years you put into a college degree and now you are going to get paid for that knowledge. This is where the mental aspect of trading comes into play and this is also where you define your trading personality. What I am about to describe is unique to me. It is how I processed all of the information and how it culminated with trades that suited my style. I gave the play-by-play in a video and in the chat room Friday, so these are NOT backwards engineered, "cherry picked" trades that I pulled out of thin air. This was my thought process from the beginning.

Market First (Long-Term Fundamental)

Credit concerns have surfaced with the SIVB failure. Credit Suisse and others are on the ropes. Asset Managers who might have been buying near the major MAs are going to hold off for a few months. The bid will soften until they are confident that banks are stable and that credit is not going to be an issue. Stock valuations are relatively high (forward P/E of 18) so there is no rush for them to buy aggressively. FOMC next week, swings are risky and the market could go either way. Stick to day trading and be in cash before the FOMC statement Wednesday.

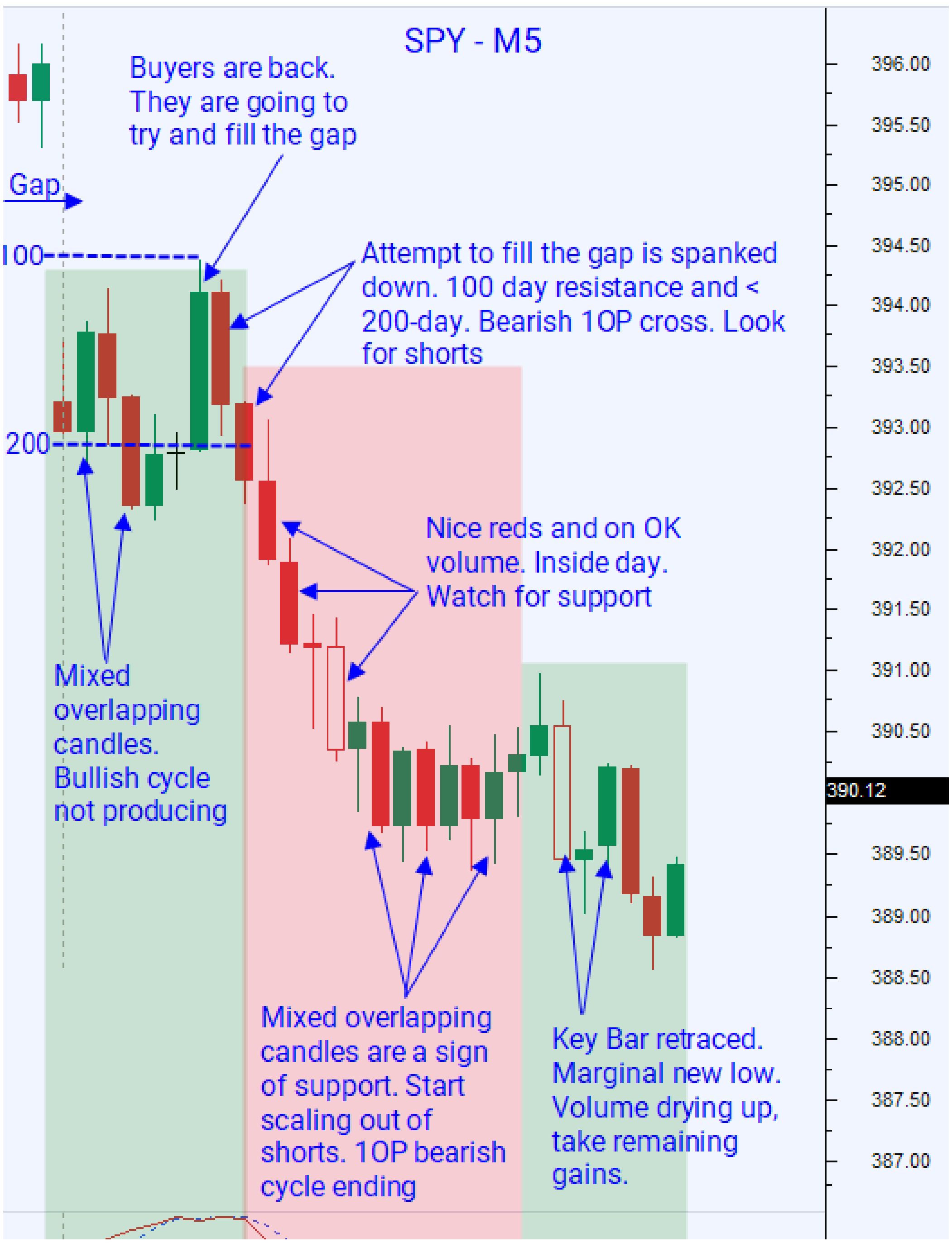
Market First (Long-Term Technical)

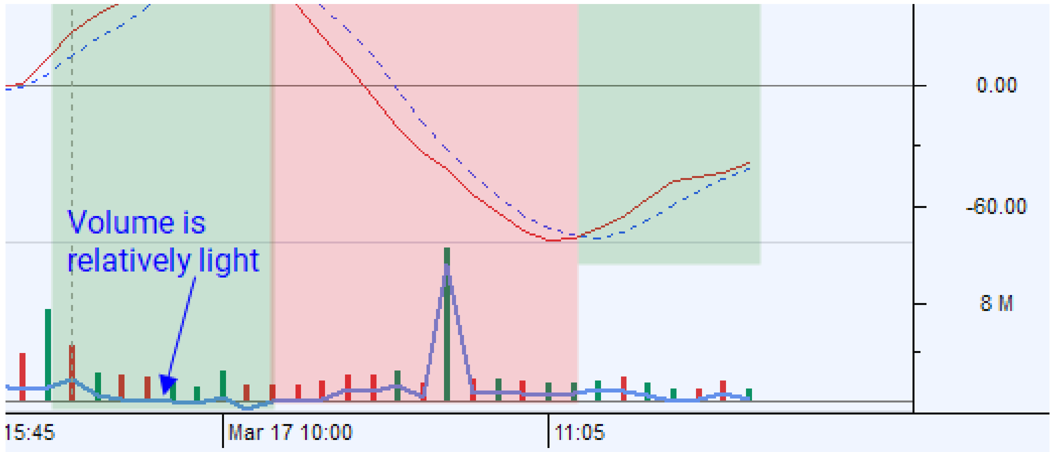
The intraday ranges are expanding and the major MAs have failed. The market has been making lower highs and lower lows the last few weeks and the down days have come on heavy volume. Two major D1 trendlines have been breached in the last two weeks on long red candles and heavy volume. This is neutral to bearish.

The market has breached major support levels, the volatility is increasing and the drops have come on heavy volume. The long-term technicals are neutral to slightly bearish.

Market First (Short-Term Technical)

The market staged a big rally Thursday. Stacked green candles on heavy volume and a close through the major MAs. Could have been short covering and triple witch related. Are buyers still there? The market gapped down below the 100-day MA. The 200-day is going to provide some support at $392.77. Mixed overlapping candles on lower volume to start the day – lack of direction early. Buyers are trying to push SPY into the gap. That attempt failed instantly and two red candles erased the move. 1OP bearish cross, look for shorts.

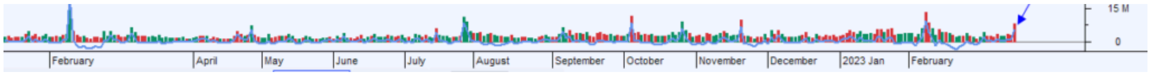




The buyers from Thursday are gone. They did not support the market early and the market easily fell back below the major MAs. This was going to set up a short. The tone is set and this is going to be an "inside day."

Stock Second (Long-Term Technical)

I want to find a stock that has relative weakness and long red candles through a major technical support level on heavy volume. Ideally, the stock has been down during the recent market bounce and it finished lower during the market bounce yesterday. ENPH is a short I mentioned Thursday and the alerts I set have been triggered this morning. It is also at the top of Heavy Selling search this morning. It breached a Low+ two days ago and today it is breaching multiple Low- lines. This video was recorded 50 minutes after the open and the link takes you right to that moment. [Click here to watch me do this analysis real-time in a video as it is unfolding](#).



This stock has been setting up for a breakdown and it is weak relative to the market.

ENPH easily breached the prior day's low. The D1 is weak and the volume is super heavy. It took out the prior day's low with ease and it did not retrace any of that first long red candle even though the market tried to bounce. The stock tried to get off the deck on the market hod, but it was instantly spanked down. This is a good short and I have a market tailwind.

This stock is weak and sellers are in control. This is the point where I need to game plan.

To this point, position sizing has not even remotely been considered. If you are trading 1 share, take the trade. It is going to be one that gets you closer to your 75% win rate. As the trade unfolds, you look for signs of confirmation and you imagine where you might have added and where you might take gains. What are the signs you will look for that tell you if it is a good trade or a bad one? What is the market doing? Is the stock preserving its relative weakness? When I decided to exit, how did I do? Record the trade in the log with your observations. Then review your trades after the close. You are going to get blindsided by market moves and wild stock bounces. At this stage of the learning process, you are going to make mistakes. It is critically important to keep them small. When you are trading 1 share, you are not worried about those mistakes because they are not going to impact you financially. Your complete focus is on reading the market and finding the best stocks. Your observations of what

Your complete focus is on reading the market and finding the best stocks. Your observations of what happened to the trade are going to be critical to your future growth.

So how would I have approached the trade? Again, this is my personality and this is my style. It is not going to be anyone else's style. Our experience level is different, our capital base is different, and our risk tolerance is different. Our long-term and short-term market bias is different, our long-term and short-term opinion of the stock is different and our confidence in our analysis is different. My approach is optimal for me at this exact time and for this specific stock and it will not be the same for anyone else.

The market is giving back the gains from yesterday, but the volume is lighter on a relative basis. We are still early in the day and this move should be decent because the range for the day is still being established. We are in the "sweet spot" (45 min after the open + 2 hours), the 1OP bearish cycle just started so I have the entire cycle to work with. The SPY low of the day failed easily and it is below the major MAs. ENPH is extremely weak. The ATR is $12 so it should be able to get to $185 with this market tailwind. I should be able to conservatively make $3 on this move with a 90% probability and a very small chance of losing money given the backdrop. Short shares, you don't need to mess with options. You do not plan on swing trading, so you need to be able to get in and out quickly. Start with a half position and add quickly if the SPY stacks another red. If it does, you will have a market tailwind for an hour and you should be able to make a few grand. If the SPY stalls quickly, don't add to ENPH. Stick with the original. That would be a sign of market support. We already know the SPY volume is not great and this is a triple witch. This is also likely to be and "inside day" so once the SPY low is in the price action will die down. OK. SPY stacked another red, short the other half of ENPH. The stock is weak and it can't get off the deck. It is leaking oil. This is a volatile stock so I am going to take partial gains if I see a long red candle. OK. Took partial gains on that long red candle and I did better than expected. The SPY bearish cycle is ending and the SPY is starting to find support. I've already taken partial gains so just watching to see what the SPY does here. 1OP bullish cross and mixed overlapping candles for SPY. The market is finding support here. The stock continues to drift lower so I can still ride the position. SPY made a marginal new low and the 1OP bullish cycle is starting to produce green candles. The stock is compressing at the lod. This is going to be an "inside day" and this was probably the move of the day. Take remaining gains on ENPH.

This is the thought process. The position size and trade management happened during the trade. Based on all of the information that was presented at that time, I made a decision to short ENPH. I set my expectations and the degree of certainty. That did not mean that the trade was going to unfold in the best possible manner, so I scaled in and waited for confirmation. My game plan included where I would add and under what conditions. It also included when I would take partial profits and when I would eventually exit the trade. If you showed me this exact same stock just a few hours later, my approach would have been (and was) completely different. In the spirit of the Tom Brady analogy, this is the first half of the game. We are constantly evaluating during the day and we are basing our decisions on the current information.

Another Example

Are we done? No, the trading day is not over so let's keep going. What have I learned to this point? The market is weak, support has been established, the heavier volume has come on the drops and the SPY is back below all of the major moving averages, this is going to be an "inside day" and we have probably seen the move of the day. I prefer trading from the short side given this back drop. I have too much shit to do so I don't have time to highlight longs in the chat room. If I did, they would be in the tech sector and they would only be scalps. For most members, the better lesson would be to teach them patience on a day like this. Highlighting longs will only encourage them to trade them. They should only focus on the short side and they should patiently wait for the next set-up. When the next window of opportunity surfaces, I will start to post again. These comments were all in the chat room on 3/17/23.

The market bounce was wimpy and sellers are keeping a lid on the action. We will get another shorting opportunity.

Two hours before the close our next window of opportunity surfaced. The SPY bounce hit resistance at the VWAP and the first attempt to get through it culminated with a bearish hammer. This told me that sellers were in control. During the next hour the price action dried up and the candles were tiny. 1OP had been grinding higher and it finally got back to zero. This was slightly bearish. We started to see more wicks on attempts to get the SPY above the VWAP. It was time to look for a weak stock. It was late in the day and this was going to be a small trade. There was no reason to get aggressive during compressed light volume price action. I have no intention of holding anything overnight, so I have to be extra selective and respect my stop. I am going to enter all at once with smaller size than the ENPH trade and I want a setup where I can make $1,000 without pressing too hard. The market lod should hold so I will take gains on signs of support. ENPH is dead, so I will check the RelWeak30 search for stocks that have been weak during the market bounce.

DG has broken trendlines on heavy volume. It is below all of the major moving averages and it has relative weakness. Let's see what the M5 looks like.

DG was a nice candidate. The D1 chart was weak. The stock was already below all of the major MAs. It was breaking major Low+ and Low- trendlines on heavy volume and it had a long red candle the previous day. So what? That was the day the SPY surged higher on heavy volume and the stock did not participate (sign of selling pressure and relative weakness). Upon closer inspection, DG had earnings before the open Thursday ("B" on the chart) and the reaction was negative. The M5 chart for DG was also weak. When the market bounced, the stock was barely able to get off of the low of the day. This was a sign that sellers were keeping a lid on it. Any market weakness and this stock should crumble. Now I just have to wait for confirmation that the market is going to roll over. Bearish 1OP cross for

SPY M5 and a couple of red candles. Stock dropped. Short the lod for DG. The ATR is $4.70 and we should still have a buck in this trade. The market has been compressing and the volume is light. There is no reason to think that there is enough fire power for the market to make a new low this late in the day. If the SPY stalls at the lod, I am going to take gains on DG and call it a week. SPY has tiny bodied candles at the lod, SPY bearish cycle ending and no SPY volume spike on the drop. The SPY lod is going to hold. DG is at its ATR, take gains on the DG short.

During the market bounce, DG was not able to distance itself from the lod. This is a good short, but I want confirmation. When the SPY drops, I want to see the stock drop. There it is. SPY dipped and the stock make a new lod – short.

Plan & Adapt

This is how position sizing and trade management work. They are dynamic and they happen in real-time. We don't have a machine that cranks out the optimal position size before the open and the perfect entry and exit points for any trade are not known. You are constantly evaluating the market and the stocks you might trade.

During the trade you are deciding if you should add or take profits. You are revising your expectations and your game plan as the action unfolds. Although I used day trades to illustrate the point, the same concepts apply to swing trading.

Belichick and Brady devised game plans ahead of time and they knew the matchups they wanted to exploit. However, the game does not always go according to plan. They watch and they gather information. Then they adapted during the game. Every game is different and so is every market day.

I was perfectly willing to go into Friday with a long mindset. The previous day was strong and the rally took place on heavy volume. The SPY closed above all of the major moving averages. After 30 minutes of trading, it was obvious that I needed to look for shorts. Would this turn into a bearish Gap and Go? I didn't know so I evaluated along the way. What took hours to write took me seconds to recognize. Click, click, click… there's a nice short. You know instantly from looking at the set up how much you can make and with what degree of likelihood. All of the inputs tell you how aggressive you can be or how passive you should be. Where to add, where to set targets and when to bail on the trade are determined by your analysis, your level of confidence in that analysis and the price action as the trade unfolds. Every trader has their own risk tolerance and this is where you will develop your trading personality. You will use various methods for scaling in or out and you will have your favorite options strategies. These are the final brush strokes to the trade. Before you start worrying about position sizing, get your win rate to 75% for a few months straight trading one share. Focus on getting the market right D1 and M5 and on finding the best stocks D1 and M5. This is going to take a couple of years and without even knowing it, you will be developing the skills you will need for trade management and position sizing.

Chapter 12: When To Enter and When To Exit

There's an old trading adage that says you can't go broke taking profits. That might be true, but you'll never make it as a Pro if you do that. You need to milk that trade for all its got.

I am a stickler for good entries. When your timing is right, the trade is much easier to manage. The same process we use on the way in is used to exit the trade. One of the most frequently asked questions I get is, "How do I know when to enter and exit?" This is an important topic, so let's dive in. I am likely to point to this article every time this question comes up.

Our mental state impacts our trading and we operate in an emotional spectrum that ranges from greed to fear. Our desire to make money is balanced by our need to protect what we have. Our confidence in the trade fear. Our desire to make money is balanced by our need to protect what we have. Our confidence in the trade determines where we are in that spectrum. The more checkboxes we mark, the higher our level of confidence. If we wait for the best windows of opportunity, our odds of success will increase. Ultimately, our desire to make money and our confidence in the set up allows us to enter the trade. If we enter the trade well, it will perform right away and we will have some cushion. We could place a stop at our entry price. Then we would have no downside risk and lots of upside. I don't do this, but for many traders this is a comforting thought. Entering well removes some of the emotion. Why was our confidence so high when we entered the trade?

In a previous article I discussed the importance of a Game Plan. We gather information and we set our expectations of what we believe is going to happen, what we would like to have happen and what we would not like to have happen. Based on all of the information we determine which scenarios are most likely. This entire process happens instantly and it determines our level of confidence. There is no substitute for experience and your skill improves over time. The market is dynamic and the more conditions you are exposed to, the better you'll get. This is not something that you can master instantly so be patient. Let's look at an example and let's start from the beginning.

Gather Your Market Bearings

Market First! As of this writing, the market has been in an incredible up trend. In the last two months of the year, it rallied almost 10%. There were no dips and every red candle was instantly gobbled up by buyers the next day. It is above all of the major moving averages and it is above AVWAPQ. It is also "one good day" from the all-time high. It has been able to digest the recent gains and earnings season is about to start. That could very well be the catalyst that sends us to a new all-time high. My D1 market confidence is VERY high and I am bullish (10 out of 10). Keep in mind I won't always have this level of confidence. I am adding to bullish swing trades and I am looking for bullish day trading opportunities. Let's focus on the bullish day trading opportunities and take the next step in this analysis.

Market First! I already know that I like the D1 chart, but what does the market look like today (1/12/24)? The first week of the year we saw a small round of profit taking. We were expecting that and we were also expecting the dip to be brief and shallow because of the D1 market strength. Buyers are still engaged. They came in with a vengeance Monday and they gobbled up everything in sight. The entire dip during the first week of the year was engulfed in one day (long green candle) and the market has drifted higher the rest of the week. The "hotter" than expected CPI Thursday could have sparked more profit taking, but the market finished near the high of the day and near the high from 2023. That was confirmation that buyers were not deterred by one "hot" reading yesterday.

This morning, bank stocks kicked off earnings season and financial stocks have been on an absolute tear the last two months. I am not expecting these stocks to move much one way or the other after earnings. Good news is priced in and banks will deliver good results. The backdrop for bank profits for Q1 is also intact. Interest rates will remain "higher for longer" and people have jobs so they can pay back loans. The early indication is that bank stocks will hold up well and they are mixed after posting results. The market is going to gap higher, but we are not going to chase the open. The SPY is testing the high from 2023 (resistance) and we have a bearish 1OP cross pending M5. The game plan is to evaluate the SPY during the bearish cycle and to look for the strongest stocks during that cycle. While the bearish cycle runs, we would like to see the gap hold. If it doesn't, it tells us the selling pressure is a little heavier and we will have to patiently wait for signs of support. We don't want the SPY to probe too much below the close from Thursday. A drop of that magnitude would be a sign of heavier selling. On the way down we want to see mixed overlapping candles. That will indicate that buyers are still active and that each move lower is challenged. Stacked consecutive red candles with little to no retracement would be a sign of heavy selling pressure especially if the volume is heavy. That would keep us sidelined for a couple of hours. We will also keep an eye on XLF since banks reported this morning. Do you see how we are setting our expectations? We know exactly what we are looking for and exactly how that will impact our decision making process.

As the trading day unfolds, we are constantly gathering and processing information on the market. The candles were mixed and overlapping and we are filling the gap. It would have been more bullish if the gap were preserved because it would have told us that buyers were fairly aggressive. The 1OP bearish cycle produced. Mixed overlapping candles on the way down were a sign that buyers were present. The volume was light and that was a sign that the market might not go far in either direction. It found support just below the prior close. The gap was filled and a bullish 1OP cross was pending. This is where we should see signs of support. Off of the low of the day we saw a green bullish engulfing candle. It had follow through so this was an entry point for long starter positions. The gap reversal was wimpy and it bought us time to find stocks with relative strength. Our M5 confidence in an SPY bounce was at a 5 at this stage. That means we will trade smaller size and only the strongest stocks will do. We won't have to worry about the market rug getting pulled out today, but we also won't have much of a tailwind. The stock will have to do all of the heavy lifting.

Find The Best Of The Best

META was the stock that I highlighted during the live event Wednesday. I love this D1 chart. The stock is above AVWAPE, through a High+ D1, it is above all of the major moving averages, it broke out to a new relative high, it has relative strength D1 and the volume is heavy. Yesterday the stock dropped with the market after the "hot" CPI, but it clawed its way back all day and it recovered all of the losses for the day and it closed near its high of the day. This was confirmation that buyers were still interested. They tested the bid and the stock roared back. That left a bullish hammer on the D1 chart. Our D1 confidence in the stock should be a 10. The stock confirmed support and it wants to move higher.

So, what did META do during the market pullback today? The stock had great relative strength and decent volume. During the market pullback it wanted to keep going higher and it was right at the high of the day when the market showed signs of support. This stock is poised to make a new high of the day if the market bounces. As far as the M5 for the stock our confidence should be a 10. We are still not that confident in the SPY M5 price action so this will be a starter position.

The market staged a nice bounce and we expected META to participate. It had been strong to this point and buyers were going to get more aggressive now that the market was moving higher. META did make a new high of the day and that was nice. However, the market probed for support once more. This was not a major concern since the SPY price action to this point had been bearish and the mixed candles told us that the selling pressure would not be very sustained. During this SPY bid check, the stock would have to pass another "test" and we would be able to observe how it handled this little market drop. META had been a little choppy so we should have expected a small pullback. Given the early price action in the stock, the VWAP will provide support and when the market finds support, the stock will lift off and make a new high for the day. The market retest was over and the SPY made a higher low double bottom M5. That was great and it confirmed support. Unfortunately, the stock traded below VWAP. That selling pressure was NOT what we expected. Furthermore, when the market bounced, the stock continued to drift lower. Now our M5 confidence in META would have dropped to a 5. There is no way we would be adding to this starter position. META needed to recover quickly during this market bounce and if it did not, we would be looking for a good exit.

As the action unfolded, the market did continue to grind higher. This was the moment we were waiting for and it was time for META buyers to flex their muscles. As the market moved higher, META did not participate. It compressed just above the VWAP and it was not able to advance. The volume had also dried up. We should still be willing to hold on to the position, but our confidence in META M5 would take a hit (2). 1OP for SPY had a bearish cross later in the day. The market price action had been choppy all day so there was a good chance that the bearish cycle would produce. This is a very important point. If the market price action had been bullish all day, we could have held the position on the notion that and dip would be minor and that META could still regain its footing. That was not the case here. The market was likely to dip. META did not participate in the market rally and the volume dried up. There was no reason to think that META was going to defy the market during this dip. It was time to exit the trade. The checkboxes that were marked earlier in the day are no longer valid. Our confidence in the stock moving higher was low and our desire to preserve capital was greater than our desire to make money.

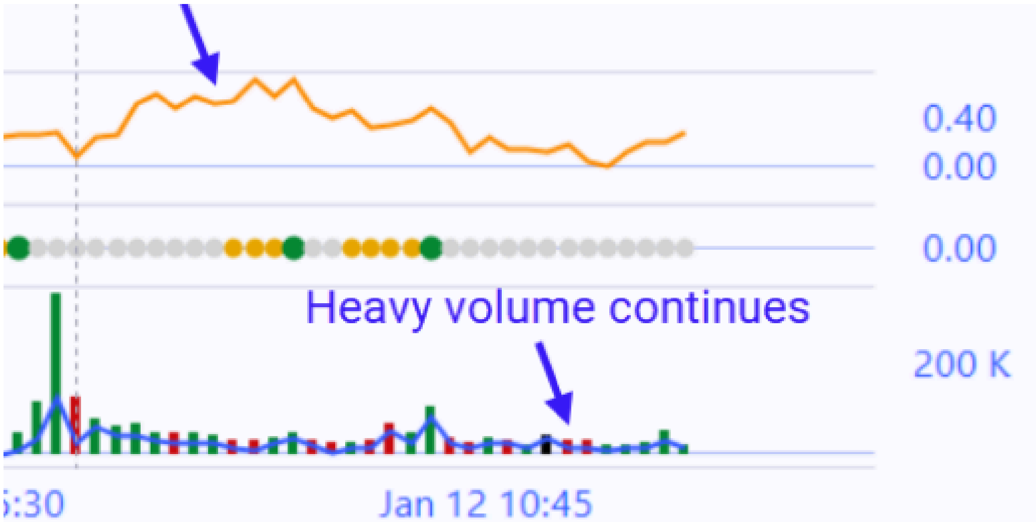
Notice how our expectations for the market and for the stock were determined before the trading day started. We knew the backdrop and we had a very high level of confidence in the market D1 and the stock D1. That did not mean that this was all going to transfer over to the M5 for either one of them.

We evaluated the price action for the market and we evaluated the price action for the stock during the day. Those observations set our expectations for what the market was going to do and what the stock was going to do intraday. We did not have pre-determined price levels where we would enter the trade and we did not have pre-determined levels where we were going to take profits or where we were going to set our stops. We were going to let the action unfold. If we got the market move we expected and the stock move we expected, we were going to stay in the trade and possibly add to it. If we did not get the market move we expected or the stock move we expected, we had to adjust our thinking and we had to consider exiting the trade. Let’s take a look at another stock during the same period of time.

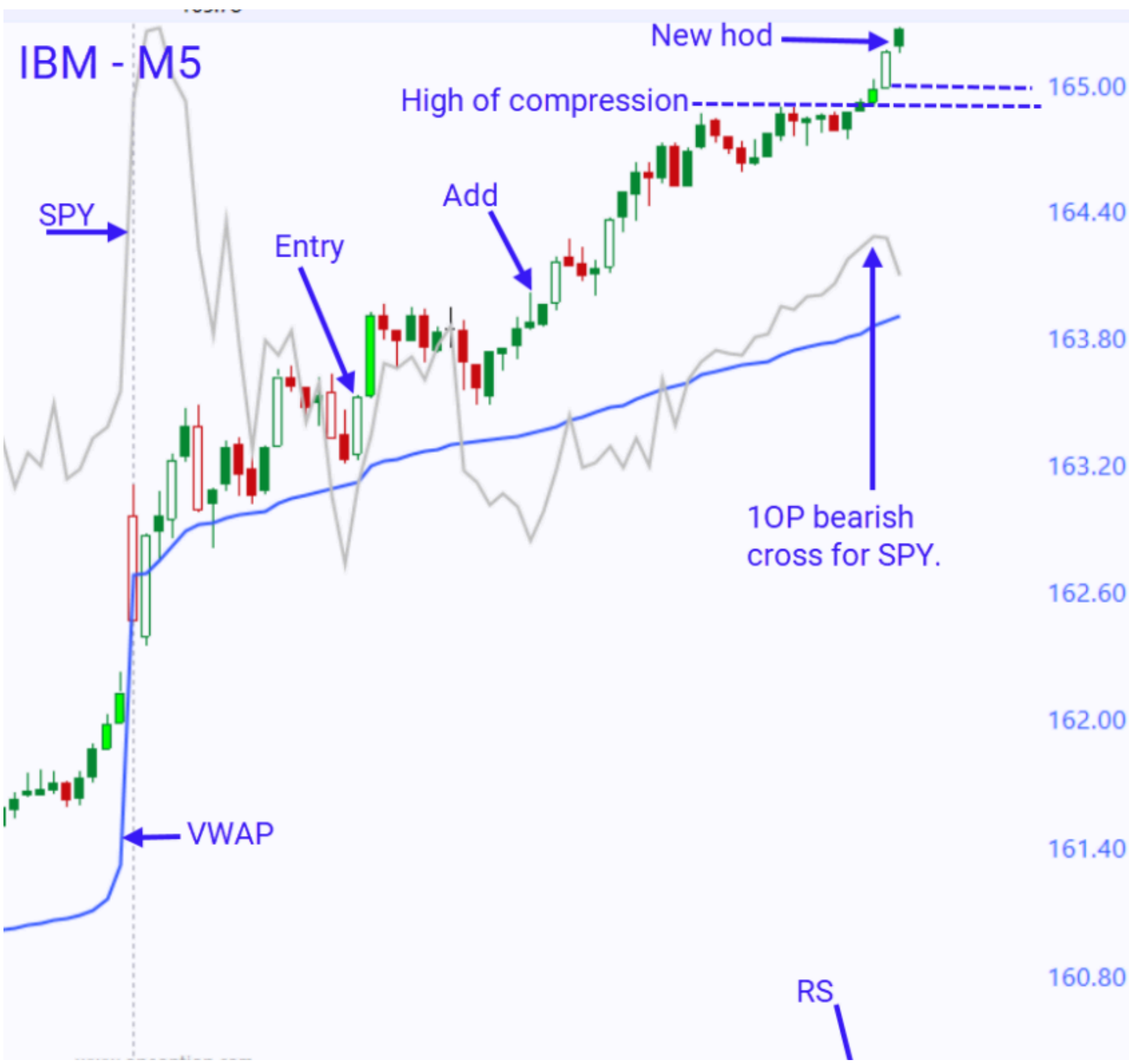
IBM had been popping up on our searches Friday morning. This stock was not on our radar prior to that, but the D1 was excellent. The stock was breaking out through a minor High- trendline and a bullish flag was forming. The stock had relative strength D1 and the volume was heavy today. It was above all of the major moving averages, it was above AVWAPE and the volume was heavy. As previously discussed, our market confidence D1 was at 10, our market confidence M5 was a 5 and for IBM our D1 confidence was also a 10. Now we just had to gauge the stock’s performance M5.

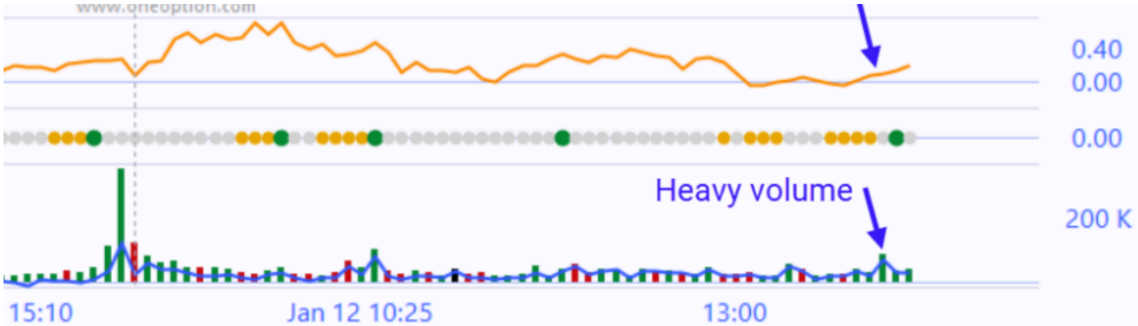
Entry
SPY
Gap up
163.60
163.20
162.80
162.40
162.00
161.60
161.20
160.80
160.40
0.40
0.00
0.00
200 K
Jan 12 09:50

IBM gapped up and it was above the prior day high. The volume was heavy and during the early market decline and the stock continued to drift higher. Our confidence for IBM on an M5 basis was at a 10. We just had to wait for the market to find support. As I discussed earlier, the SPY move lower was not that powerful. It featured mixed overlapping candles with lots of retracement. The bullish engulfing candle at the low of the day for SPY along with support at the prior close and a bullish 1OP cross was enough for us to take a starter long position. IBM had been defying gravity and with a market tailwind it should make a new high for the day.



The stock participated in the market bounce and it made a new high for the day. Unlike META, when the market probed for support once more, IBM did not retrace. The volume remained strong and it retained its relative strength. The market made a higher low double bottom so our market confidence was higher than when we entered the trade. The stock did exactly what we expected it to. IBM made a new high for the day and it was time to add to the position.





In the afternoon it was apparent that IBM was on a mission. It continued to make new highs for the day, the volume remained heavy, it retained its relative strength and it was oblivious to what the market was doing. Our confidence was high for the SPY D1, the Stock D1 and the Stock M5. The only weak point was our confidence in the market M5. We suspected that the pending bearish SPY 1OP cross might produce some selling, but the stock had been oblivious to the market all day. This was a sign that buyers were active. We did not want to give back our gains, so we should set a price level that we would like to see preserved. That price level could have been the open of the Key Bar or the high from the compression. Any technical support level would do. As long as that price level held, we were prepared to weather the market pullback.

During the market decline, IBM did not flinch. It preserved all of its gains and the volume remained heavy. The market found support at a higher low and IBM looked poised to advance. This is where we would add to the position.

Confidence Is Key

The key to trading is confidence. It is what allows us to enter the trade. The more checkboxes we mark, the higher our odds of success and the more confident we are in the trade. We determine our market confidence D1. This is a painstaking part of the process because we have a lot of information to gather and we need to be aware of the influences, scheduled events and the price action. We won’t always have a high level of confidence for the market D1. In 2022, we were seeing big moves in both directions. There will also be times when our D1 market confidence is high, but it might not be directional. We might be very confident that the market is going to remain in a trading range. That would keep us neutral (not bullish or bearish). The next step is to gather all of the overnight information and to conduct scenario analysis. We don’t know what the market will do, but often we can assess which outcomes are most likely and which ones we would favor. We also visualize the price action that would confirm which scenario is actually playing out. This preparation allows us to be proactive. Ultimately, we will determine an M5 level of confidence for the market. Our market forecast D1 and M5 and our confidence in that forecast drives all of our trading decisions. It determines our position sizing and our options strategies.

Once we get our market bearings, we find the best stocks. Our D1 confidence in the stock should always be a 10. There are thousands of fantastic stocks that have relative strength and there is no reason to ever compromise on the D1 chart. During the day the stock searches help us find the best stocks. Our custom column layouts are also very helpful and we can pin point the best of the best. We compare what the stock is doing M5 to what the SPY is doing M5. If the stock is strong relative to the SPY and if the volume is heavy and the price action is orderly, we have the right vehicle. We set up our expectations for the market and for the stock. As long as both are performing, we stay the course. If either changes we adjust. The same evaluation that got us in the trade is used to determine if we should add to the position, take gains or stop out. It is not static or mechanical, it is dynamic. We are trading the market, but we are riding the fastest horse. That is our edge.

Our confidence in our analysis and our desire to make money prompts us to take a trade. Our ongoing analysis once we enter the trade determines our confidence to stay in the trade. Eventually, our confidence will wane and our desire to preserve capital (take gains or cut losses) will prevail. That is when we exit the trade. It is not determined by how much money we made/lost, but by our confidence. Changing conditions impact our confidence. [In this video](), you can watch me go through the entire process with the stocks we used.

Let me conclude with an analogy. “Mr. Brady, how do you know when to attempt a pass and when to throw the ball out of bounds?" Think of all of the variables he would need to consider. Would you expect a simple answer? He processes information, he checks boxes, he assesses risk, he makes a decision and he acts. This decision is not determined before the snap. Every snap is unique and this is an ongoing process during the entire game. When it comes to football, people can appreciate how difficult it would be to answer this question. When it comes to trading, novices think that there is a simple "one size fits all" solution to entering and exiting a trade. That is simply not the case and your ability to process all of this information is what will determine your success as a trader.

Chapter 13: Why I No Longer Post Trades

The downside risks of posting a track record are too high and I am focusing my efforts on education and new features that will help us find the best stocks.

If you are a successful trader, you keep to yourself and you focus your efforts on trading. You don't need the headaches that come with posting trades. There is very little upside and lots of downside. 95% of the self-proclaimed "gurus" are fake. People are skeptical… and rightfully so. First you have to do cartwheels to prove that you are in the 5% who legitimately want to help others and who can actually trade. That means taking a bunch of crap from people who want to discredit you. This is the first hurdle and it is a tall one. We all have egos and it is hard to take unwarranted criticism. When you post trades, you have to answer constant questions about every trade. Why did you get in? Why did you get out? How did you size the trade? This consumes so much time and energy and that effort could be spent finding new trades. Next you have the "swing for the fence" follower who blows out and who threatens to sue you or worse. Again, you are having to defend yourself. These are enough reasons not to post trades publicly, but there is another issue. I've did this for 15 years and I no longer have the fortitude to do it.

This industry is highly regulated. The SEC wants to control everyone. If you are registered (licensed) with the SEC, every public statement you make that is trade related has to be approved by a Compliance Officer. That takes an extreme amount of time and effort and almost all Compliance Officers error on the side of not approving trade related statements. That means that the statements are not timely (for day trading or short-term swing trading). When I let all of my registrations lapse, I promised myself I would never be regulated again. I've been in this industry a very long time and you can't win against the regulators. **They will "hang you."** In 2002, I ran an advertisement for the brokerage firm I was the SVP for and I used that exact quote from the SEC Chairman (Arthur Levitt) in the ad. He said, "95% off all trades are not routed to the best price." The NASD still fined us for false advertising specifically for using that statement.

Newsletter writers are exempt from being registered. They do not know anyone's financial situation, they do not know anyone's suitability and they do not make recommendations to any individual. They simply make generic statements to the public. It is very important to keep all of these elements intact because the regulators will come sniffing and when they do, they will hang you on this. This exemption for publishers was fiercely defended in court by the WSJ and Barron's many years ago and it is why they can make statements about stocks to buy and sell. This bothers the hell out of regulators. They have a "bur under their saddle" for newsletter writers. They can't destroy you for posting "unapproved" trades, but they can find other ways to drag you through the courts and to financially/mentally destroy you. If you get big enough (followers), you are on their radar. Once that happens, they start digging. The first thing they will try to hang you on is false advertising or false statements on your website. I support this because 95% of the stuff you see is fake… so hang those bastards. I don't advertise. Next they will go over published track records. Warrior Trading posted actually brokerage statements and they still had an issue with it. They got sued for $3 million by the FTC because people who went through the course lost money and Warrior Trading needed to state that Ross was a pro and that people might not be able to achieve those results. If they can't get you there, they will get you for front running trades (pump and dump). You post your trades real-time and then followers enter. That pushes the price higher and you exit when they are getting in. If you are in an illiquid stock or almost any option, this would qualify.

I used to post trades, but I do not any longer. Part of that is because I am focused on completing The System and adding new features to Option Stalker Pro. Much of that decision is related to the risk of posting trades. If I look at what would destroy me personally, a lawsuit that questions my integrity is the greatest threat. Even if I win the suit, that would come at an extreme cost and it would exhaust me mentally. This is also why I recently beefed up my disclaimers on the website and the chat room.

I just don't need that in my life as I wind my career down. I've already proven my ability to trade to the most important person – myself. Those who want to believe that I can trade and that the system has merit will learn it and follow it. Those who don't choose to believe can find a "guru" and sue them when things go south. I believe that when someone learns The System their odds of success increase dramatically. That still does not guarantee success and I try to convey how difficult this is to master. I hope you understand why I no longer post trades. My goal at this stage is to simplify my life, not complicate it. I still want to help all of you. I am busy with projects that will help you learn The System and with new features that will help you find the best stocks and the downside risks of posting trades/track records is just too high.

Chapter 14: When To Take Profits

In this article, we are going to discuss exit strategies when the trade is working out.

You are in a nice trade and the market and the stock are behaving as you expected. The gains are mounting and you are nervous. You don't want to lose what you've made, but you don't want to exit too early and leave a lot of money "on the table." In this article, we will explore the decision-making process and some of the strategies you can use. For simplicity's sake, we are going to talk about a bullish market backdrop and a strong stock. The same concepts apply to the short side. This article focuses on winning trades. If you need help with stops, please read that article.

Every trade starts with a game plan. You've done your market analysis and your stock analysis. The checkboxes are marked and you have defined your level of confidence. It will determine your trade size and if you are trading options, your strategy. Your expectations are set. "If the market does this… and the stock does this… I will know that I am in a good trade. If the market does this… and the stock does this… I will know that I am in a bad trade." Those parameters (good and bad) are defined before you enter.

Market first! There will be times when your SPY confidence is high, but it might not be directional. For instance, the market has been trapped in a 60-day range and it is compressing. "I am confident that the market is NOT going to drop and if anything, it is going to breakout." In this example, you would reduce the size of your bullish positions because you do not have a market tailwind. The stock will have to do all of the work. You will need to watch the price action of the stock very carefully. When the momentum wanes, you won't get any help from the market. If your market confidence is high and the SPY is trending, you will trade larger size and your options strategies will favor call buying. You are expecting the market rally to fuel the move in the underlying stock. If the stock pauses, the strong market will provide a safety net so the pullbacks in the stock will be brief and shallow. Once recent gains have been digested, the buyers will return and the stock will stage the next leg of the rally. In the first scenario, you were not leaning very heavily on market strength because it was in a compression. That means you will be less sensitive to the market chopping around in the range and you will not be as dependent on major economic releases or "Fed speak." In the second scenario, you are leaning on the market momentum and you are expecting it to continue. You are trading larger size so you need confirmation that the market is holding up its end of the bargain. As long as the trend is intact, you stay the course. You are aware of major market moving news and you adjust risk ahead of those events.

The market is the top consideration for exiting trades and most traders don't even consider it. That's why I put it at the top of the list. If you are expecting the market to stay in a trading range and if you are trading average size and/or selling out of the money bullish put spreads, you are not as sensitive to market moves. If the market breaks below the lower end of the compression with a long red candle and heavy volume, you are aware of the move, but you do not have to be overly concerned until you see follow through selling. During this market move, you are watching your stocks. Did they hold strong during the market dip? If they did, you know they have relative strength. On any market bounce back into the range, the stock will also move higher. If the stock was very sensitive to the market move, it could be a sign that it is starting to lose its momentum. If the market continues to move lower, you are ready to exit the stock if it has become relatively weak.

If the market is in a strong uptrend and you are trading larger size, you are counting on that strength. You need to monitor the price action of SPY and you do not want to see any patterns that might suggest resistance. The stock might still look extremely strong, but the market is starting to falter. You are willing to "weather" a brief and small market pullback, but you do not want it to be organized (consecutive red candles). If the stock is easily shedding gains, you should take some of the position off. When the market regains its footing, a stock that weathered the soft patch beautifully confirms its strength and you might consider adding to the position. If there are major economic releases pending (i.e. jobs report), and the market has recently had bid reactions, reduce risk. You can always re-enter if the reaction is bullish. You are aggressively long because your confidence in the stock and the market is high. You can't afford to get blindsided. Remember, we are trading the market and we are riding the "fastest horse."

Let's start with a trade I highlighted in my [YouTube video](#) on 12/27.23. In that video, I went through my market analysis and, although I was bullish, I felt that we could see a small market dip to start the year after a huge market run up. My confidence was high and I felt that any dip would be brief and shallow. We were likely to see some profit taking so I did NOT want to buy calls. I was looking for a stock that had a nice technical breakout and that had high option IVs. SNOW fit the bill and I suggested selling the SNOW (Jan 19) $185/182.50 bullish put spread for $.50 Credit. If the market dipped, the stock was likely to dip. I could tell that from the previous price action. It had horizontal support at the breakout, support at AVWAPE and horizontal support at $185. This spread would expire in 3 weeks so I would have time decay working in my favor while the market digested gains.

So how did the trade turn out? As suspected, the market did dip during the first week of the year. The move featured tiny bodied candles with wicks and tails so the move was NOT organized or strong. SNOW dropped with the market and it tested support at $185. This was all part of the game plan so there was no need to panic out of the trade. I intentionally gave the trade room to move around and it was consistent with my market expectations and my expectations for the stock. In one day, the market recaptured all of the losses for the year and the stock shot higher. If the stock did not rebound, it would be a sign of weakness and I would have to consider stopping the trade out. The market regained its footing and so did the stock. The spread expired and generated a 25% return on margin.

In the above example, the stock did what we expected so we stayed with the position. In this next example, the market had broken through all of the major moving averages, AVWAPQ and a High-trendline. It had long green candles on heavy volume and gaps higher that never filled. There were barely any red candles, and this was an incredibly strong rebound off of a recent low. JPM had similar characteristics. My market confidence was extremely high and it was directional (up). My confidence in JPM was also very high and I expected it and the market to power higher. The strategy was to buy longer-term calls and you can see the original analysis from 11/19/23 in this YouTube video. We wanted at least 6 weeks until expiration and we selected the JPM Jan (19) $145 calls for $10.50. We wanted a high delta of .7 and we wanted the options to span earnings.

As the trade unfolded, the market kept marching higher as expected. Every red SPY candle along the way was erased immediately and buyers were aggressive. That is why we did not see any dips. Given this market price action, we expected JPM to perform well and it did. In the chart below, you can see the consecutive stacked green candles on heavy volume. The stock had incredible relative strength and even when the market dipped, JPM continued to grind higher. Those $145 calls were almost $30 in the money and there was no reason to exit the trade. The market and the stock continued to perform and you should have been adding to the position along the way.

Where would you add to the position? Every time the market had a red candle that was instantly reversed, you could have added because JPM never flinched. Those down days are very important because they give us an opportunity to gauge the strength of the stock relative to the market and they give us a chance to gauge the level of profit taking in the overall market. In this case, dips were instantly erased and that was a sign of strong buying pressure.

The market drives all of our decisions and it is the cornerstone for any trade. When it is volatile and directionless, we trade smaller size. When it is flat and trapped in a range, we trade smaller size and we lean more on the strength of the stock. When the market is trending, we are more aggressive and we have to watch for changes in momentum. Compressions are fine after a nice run and they are a sign of strength. Buyers were lined up and there was never a dip. We want the compression to last less than two weeks. Dips need to be brief (8-10 bars) and shallow (more than half of the move since the last dip is preserved). We look for confirmation along the way and we want to see red candles turn into bullish hammers during the move. We want to see red candles from the prior day erased immediately the next day. As long as we have these characteristics, we are confident that the market is going to fuel our trade and not work against it. If the market conditions change, we need to be ready to exit the trade.

There will be moments when the market has a temporary hiccup, but the stock remains extremely strong. Such was the case with the JPM trade above. You can stick with the trade, but you want the market to recover quickly. This is the “edge” and the relative strength in the stock allowed us to weather the “squall.” In fact, we like the stock position even more because it held firm during the market drop and that confirms the strength. The market rebounds and we are back on track.

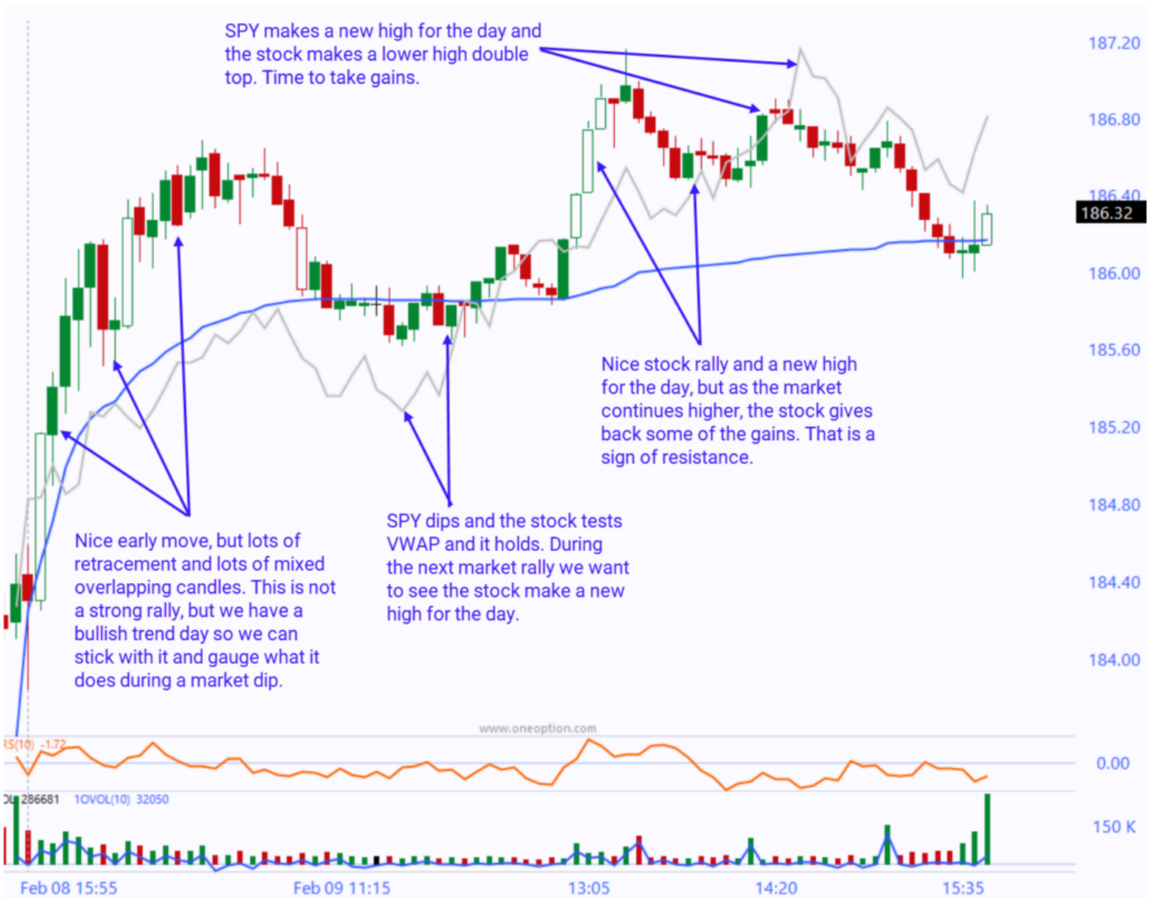
First let's take a look at a typical stock that is in a steady grind higher. It is strong, but it has plenty of retracements and dips along the way. On the left side of the chart below. you will see the letter 'B." That signifies earnings before the open and the stock gapped down. As it sold off, you can see the stair-step drop. That is important because it tells us the type of price action we can expect. It finds support and it rallies above the 200-day MA and AVWAPE. This is where we start watching for a trend reversal and an opportunity to buy. The stock hits resistance and at the arrow labeled 1. and it pulls back to the 100-day MA. The breakout above the 100-day MA would be a good entry point because the stock is also in the D1 gap referenced earlier. We know we can expect a bumpy ride because that is how the stock trades. At the arrow labeled 2. the stock pulls back, but it finds support above the 100-day MA. This is important because it tells us that buyers are eager and they never let it test that support. The red bearish engulfing candle is erased the next day and the stock is back on track. It continues to fill the gap and you can see how the stock closes strong before earnings at the very end of the chart. There really was no reason to exit the trade. The stock temporarily lost its relative strength along the way, but the selling pressure was contained to "solo" red bars that were immediately erased. This is not the strongest of set-ups, but that is how we would trade it.

In this next example, we will take a look at an intraday chart. Remember, the same technical concepts apply across any time frame M5 – D1. The market is trapped in a range and the volume is light. We've seen mixed overlapping candles and it is an ["Inside Day."](#) By now, you should know that this is a low probability trading environment for day trading, and you need to temper your expectations. You set passive targets and you take what you can get. In the example below, the market bounced off of support, and when it did so, the stock did not bounce. The selling pressure for the stock had been heavy earlier in the day and we can see that from the stacked red candles on heavy volume. It was compressing (shaded area) and on the next market dip, this would be a good short. When we have very steep drops, we should expect that support will be found earlier in the day because the selling has been extreme and the stock has taken a beating already. The bounces can be violent because buyers are interested at that low price. The point is that the stock might have one more leg lower, but we need to be ready to take gains because it has already dropped so far. Plus, we have a sideways market. In this case, the stock dropped as we expected. When we got the nice long red candle, it was time to take gains. In this instance, you do not wait around. Those were really nice gains on a dull day. What more can you expect? I often hear, "I can't make money in this sideways market." Yes you can, you just need to adjust your expectations. This is NOT a day where you can just let the stock run. If the stock had a less severe drop from the start of the day and if it was just drifting lower all day you could stick with it. I will provide an example.

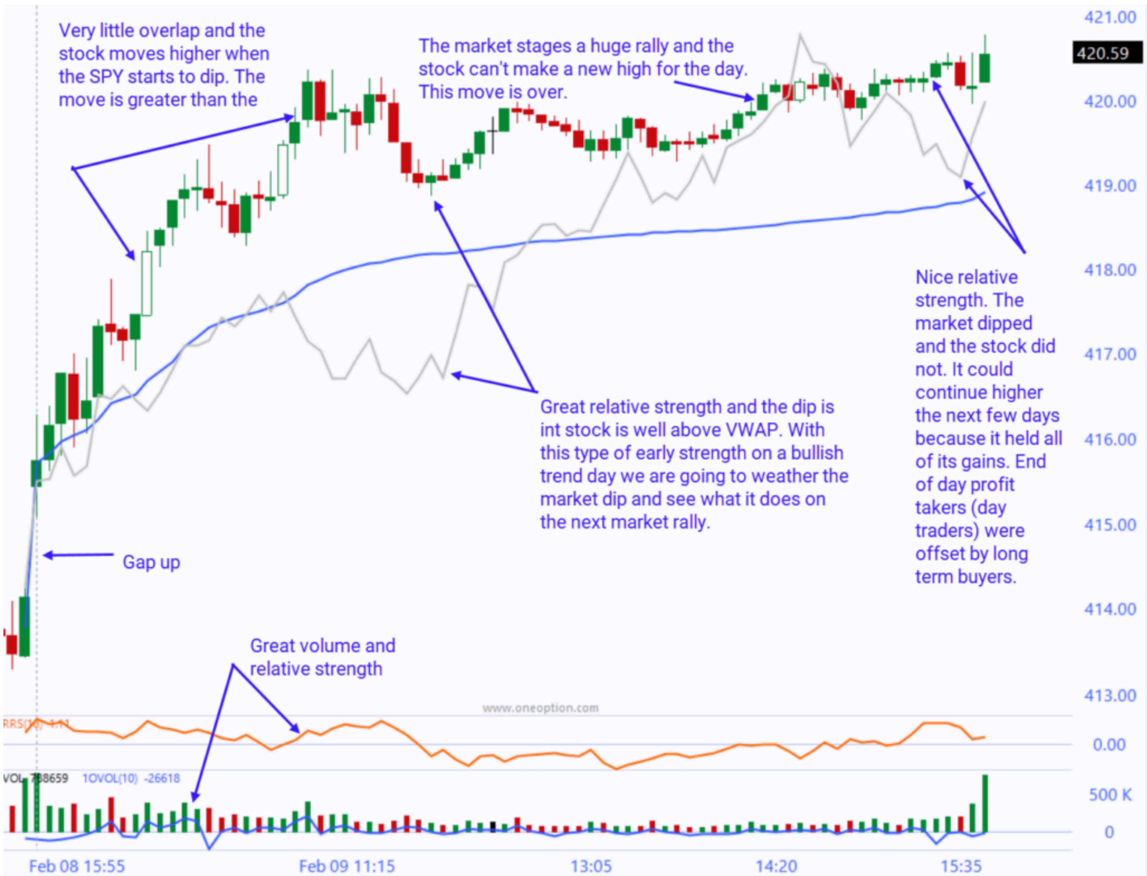
This next example is for the same day and it is an example of a stock that did not make a fast early move. The market is trapped in a range on this light volume day and it is chopping back and forth. After two hours of trading, we can see that the stock in the chart below has excellent volume and relative strength. It has been grinding higher and we notice that the stock made a new high for the day when the market dipped. This is an excellent entry point for a long and we know to temper our expectations given the market backdrop. The SPY bounces and the stock starts stacking green candles. On a day like this I know the "music" is going to stop so I am not worried about milking every last drop out of the trade. I just have to determine how much money I feel I can make on this move and I take gains into strength. In this article, I discuss a measured move and that is one technique you can use. As expected, the market bounce stalls and it tests the downside. The stock is on our radar, so we watch for relative strength. As the market continues to fall, the stock holds firm. When the market finds support, we will buy this stock again and we get another similar leg higher in the stock. As the stock starts to rally it stacks green key bars. A $1 gain on a $110 stock on a market day like this is great. Don't wait around for signs of resistance. When the sellers return, the drop will be quick. You have to take what you can get and you will rarely sell the high. On the exit you might lament for 10 minutes that you could have sold higher, but 20 minutes later, you are happy with your exit.

Now let's take a look at a few stocks during a trend day for the market. This concept applies to longer term charts as well. It takes time to identify trends and the initial move has to hold. If there is instant retracement and the entire move is erased, it was a head fake. If the move retraces, but half of it is intact, a series of higher lows will indicate that buyers are still interested and that the move up will be choppy. If all of the move is preserved and the market continues higher with very few red candles, it is a sign that a bullish trend is underway. Ideally, the move comes on heavy volume and technical resistance has been breached. This is an over-simplification, but it can be used as a rough guideline. Longer-term context plays an important role as well. How long does it take to confirm a trend is underway? For day trading, usually an hour. For D1 charts I would use 10-12 periods. The advantage to trading when you have a strong market trend is that you have staying power. You don't have to worry about dips because you know based on prior price action that they will be brief and shallow. When we have confirmation that the dips are brief and shallow, we know that buyers are engaged and that the next leg higher is about to begin. This is where we can add to the position. We continue to add and ride positions until the market shows signs of resistance (compression, bearish hammer or a bearish engulfing candle). This is where you take gains and reduce risk. We are trading the market and we are riding the fastest horse (stocks). Yes, this is where you start taking gains on stocks. Stocks that are still moving higher you can hold on to but have a support level in mind for a stop (or a time frame). Exit stocks that did not participate in the last leg of the market rally. Here are some examples.

As I just explained, it takes an hour of price action or more to identify when the market is in a trend day. Nice tight SPY price action with lots of green candles on good volume through technical resistance are the "tells" to watch for. We don't want long mixed candles or long wicks/tails. Those are signs of volatility. The next 3 charts use the same day. The market backdrop is strong and this is going to be a trend day and we know that after 90 minutes of trading. The stock below made a swift move higher right on the open. It had overlapping candles and long tails so that was a sign that the move was not that strong. As the market continues to move higher, the stock starts to crown (left side of chart). That is fine during a bullish trend day for the market, because we have staying power. On a normal "non-trending" day we would take profits here. The market dips and so does the stock. It pulled back pretty hard and it traded below VWAP. No worries, we are expecting the market to rally and when it does, the stock should make a new high for the day. During the initial stages of the market rally, the stock continued to compress. This is not ideal. The strongest of stocks will start to climb even before the market finds support. The stock surges higher and it makes a new high for the day (middle of chart). As the market continues to move higher, the stock pulls back. When the market makes a new high for the day, the stock makes a lower high double top. It is time to take gains. The exit is not determined by anything more than what the stock is doing relative to the market.

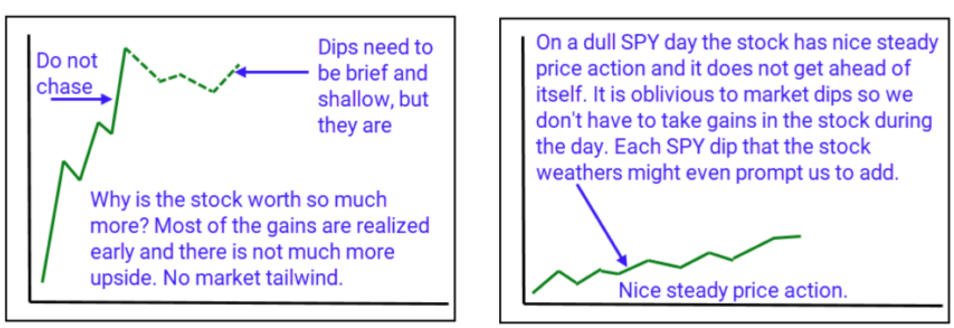


Using the same market day as a reference, the stock in this next example gaps higher on heavy volume. The relative strength is incredible and it even continues higher when the market starts to dip. We have no issues holding on to this stock on a bullish trend day. It has traveled more than the 20-day average true range (ATR), but sometimes stocks will move well beyond that. There is no harm in holding this stock and we will know what to do when the market bounces. As you can see, the stock "fired all of its bullets" in the first two hours of trading and there was no more gas left in the tank. As the market continued to move higher, the stock compressed and it was not able to get back to the high of the day. The issue with buying "hot" stocks that surge early in the day is that we don't know if the market is in a trend day, the risk of the stock giving back much of the gains is high and we never have time to add to the position. We don't want to chase so we are stuck with an initial position that does well, but we miss a great market move for the remainder of the day. If your capital is tight, take gains well, but we miss a great market move for the remainder of the day. If your capital is tight, take gains and find something else that is moving. If you have plenty of capital, you can hold the position and see if the stock gains momentum later in the day. In the last hour of trading, the stock did finish on the high of the day when the market pulled back. This is a sign that late day profit taking by short-term traders was soaked up by longer-term buyers and there is a good chance the stock will continue higher.



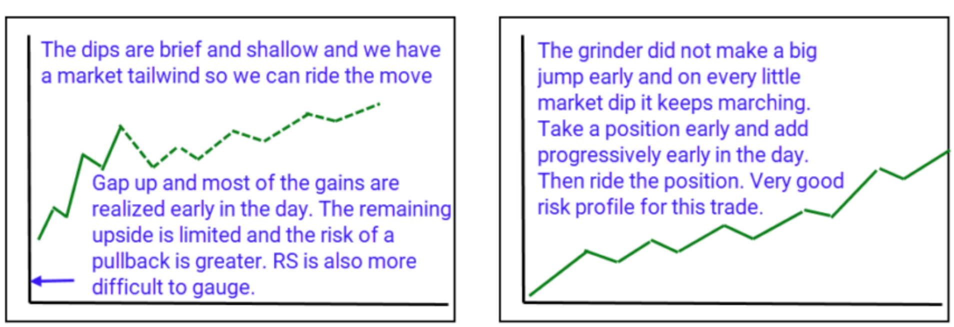
In this final example from the same bullish trend day, we have a boring old stock that opens flat and that gradually and consistently moves higher. It did not gap up so it is not over-extended. The retracements are very minor and as the market dips, it is oblivious to the selling and it continues to grind higher. You can add when the stock makes a new high for the day. It is not ahead of itself and we are not chasing. When the market finds support the stock is making a new high for the day. This is where you can buy more stock and as the market moves higher, we expect the stock to continue to grind higher. That is exactly what happened and we want to get our position on early so that we can ride the move up. This is a great situation because we are in complete control during the entire move. We have time to identify the market trend day and the stock is not surging higher so we have plenty of opportunities to add without feeling like we are chasing. Because the price action has been orderly, the dips should be minimal. Large spikes attract profit taking and that results in volatility. "Grinders" are great because you can get aggressive with this pattern on a bullish trend day. As the move unfolds you can see that the market continues higher and the stock compresses at the high of the day (middle of the chart). This is a sign that the stock is getting tired and that on the final market push higher, you should consider taking gains in the stock, especially if the stock only musters a marginal new high. Start scaling out into strength. You have a fairly large position at this stage. The red bearish engulfing candle is where you would exit the remaining position.

In general, this is how the market impacts our entry and exit. We don't want big market gaps up when the market is trending higher. Many of those gaps will reverse and taking early longs is risky for that reason. All stocks shoot higher and it is harder to identify relative strength. A "Gap and Go" is fairly rare and the real ones are typically news related. We are waiting for signs that the move is legitimate and the market surges higher before we have confirmation. Most of the gains are realized for the entire day during the first 90 minutes. If we wait for confirmation, we miss most of the move. If we chase, we run the risk of a reversal. This is not a good risk/reward set-up for us. A flat open is fine, it gives us time to evaluate stocks with relative strength. We watch for signs that the market might be trapped in a range "Inside Day" and we trade as if that is going to happen with starter positions. If the stock can get through the prior day high early in the day and if the volume is strong and other D1 resistance (MAs, trendlines…) has been breached, this has a chance to turn into a bullish trend day. The price action will be tight and orderly, and we can add to our starter positions. A gap down in an upward trending market is a gift. During the initial drop, relative strength will be easier to spot. Provided that the move lower is not too deep (< 20-day ATR) and that there are mixed overlapping candles (weak down trend) the market will find support and we will have a great entry. The market has the potential to fill much if not all of the gap. You take starter positions on support in the strongest stocks and you add when the market makes a new high for the day (it is in the gap). You continue to add to the positions as long as the stock is grinding higher and as long as the market continues to move higher in an orderly fashion. In the diagram below, you can see how stocks that surge higher (upper left corner) offer limited upside when the market is flat. They stage an initial surge higher and in a best case scenario, they tread water. They do not have a market tail wind to fuel the move. “FOMO Joe” will chase the heck out of these on the open and they will reverse sharply. Ask yourself, “Why is the stock worth so much more today?” If there was no material news, it is all technically based. There is limited upside and the move can easily reverse. This is a bad risk/reward set-up. If the stock grinds higher (upper right corner) in a flat market (or on a market that gaps down), this is a nice display of relative strength and we can take a starter position with a fairly high degree of confidence. The market won’t help or hinder. When the market starts to show signs of resistance below the prior high of the day, consider taking gains. Operate under the assumption early on that resistance is going to hold. If the market breaks out, you can always get back in. There will be days when the market does start to trend higher (lower right corner) and the “grinder” will continue. Those positions are easy to add to and you want to do so in the first half of the day. The remainder of the day, you are just going to ride the move and wait for signs of exhaustion in the stock or the market. Stocks that surge higher (lower left corner) might give us an early opportunity to enter, but we are on “pins and needles” wondering if the stock move is legitimate and if the market is going to trend. While we are waiting for market confirmation, the stock continues to move higher and we don’t have a chance to add because we are chasing. The stock has exhausted most of its upside. We can hold the position since the relative strength is good and we expect it to move higher when the market finds support. Most of the time, the stock does not have any gas left in the tank. In conclusion, nice orderly opens for the market and grinding stocks present the best opportunities for us.



Market inside day - Hot Stock

Market inside day - Grinder



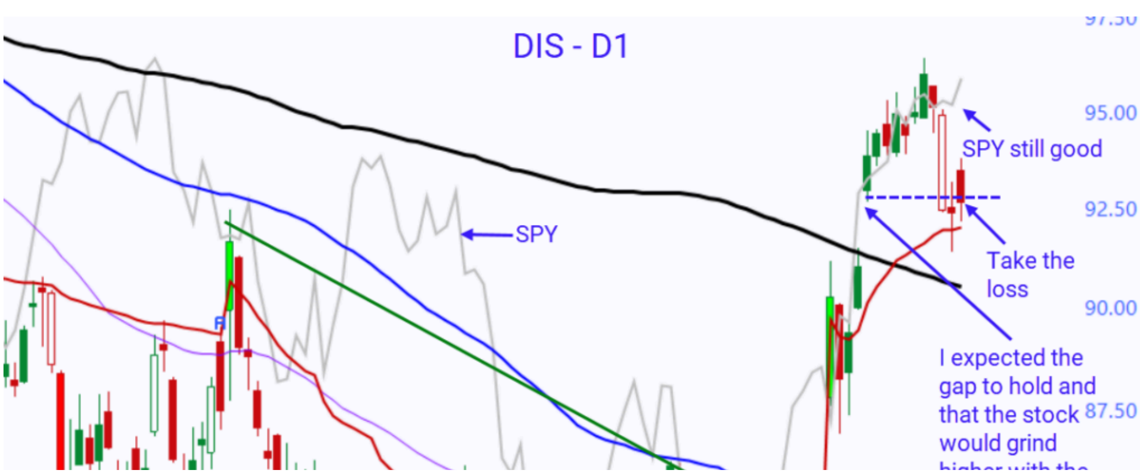
Market trend day - Hot Stock

Market trend day - Grinder

I could have broken out the impact the market has on our exits in a separate article, but then its importance would be diminished. You would focus on the other stock patterns and exit concepts below. Make no mistake… the market is the primary factor for deciding when to enter and when to exit the strongest stocks. Market first, market first, market first. For the rest of this article, we are only going to focus on the stock itself. The market is doing exactly what we expected, and we are going to take our clues from the stock.

“Problem Child”

Not every trade goes as expected and this was my only bad pick from Q4 2023. We can learn just as much from our bad trades as we can from the good ones, and I highlighted this one on YouTube (11/19/23). You can click here to watch my analysis. Before we enter a trade, we have to form a game plan that outlines what we expect the market to do and the stock to do. We also have to determine the conditions that would tell us when we are wrong. The market was very strong and my confidence was high that a D1 up trend was in place. Disney (DIS) also looked good. It had a nice breakout through a High- trendline, it gapped up after earnings, it was through all of the major moving averages, and it was above AVWAPE. I wanted the stock to hold the gap. It had run pretty far so I did not want to get super aggressive with it. The stock was choppy, so I sold an out of the money bullish put spread (92.50/90 for $.50 credit) to give it some room to move around. The stock had good relative strength and all of the checkboxes were marked. I expected the market to continue higher and I expected the stock to hold the gap and to possibly move higher. The market did as I expected, but the stock dropped below the gap. I was expecting that level to hold. Since this was a swing trade, I did not have to panic on the first long red candle. The stock was still close to that support and if it bounced, the position might still be alright. That outcome would also serve as confirmation of support. During the next few days, the market moved higher and the stock was not able to recover. This was a sign of selling pressure so I took my lumps. What did I miss? The box office receipts for two new Disney movies during Thanksgiving did not perform well. This is not news I would typically search for, but when it comes to Disney… I will in the future. The stock did not perform as I expected and that was why I exited the trade.



Measured Move

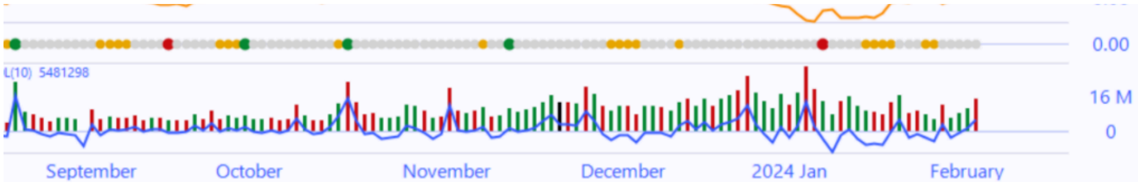
A method I sometimes use is called a measured move. It is a pretty basic concept where you take the range (high minus low) from a previous move and you add it to the high. That would represent how far the stock might travel before it hits resistance. If you see a compression or a bearish candle, you take gains, and it is a sign that the move will rest at that point. When you exit, set an alert line at the high. If there is a compression breakout, you might want to get back in. You can also set alerts in Option Stalker Pro for LRSI (or other indicators). Gauge which time frame would have triggered in the previous drop. When the indicator cycles (bullish to bearish to bullish) you will get an alert. Then you evaluate the dip. If it was brief and shallow, you might have a nice entry point for the next leg higher. As the stock moves up your alert at the previous high will also trigger and you can add to the position. How do I pick these boxes? Which one is the right one? Which one is the best one? **Stop.** Every stock behaves differently. If you can look at a chart and identify cycles like the ones below, use the method. If you can't, find another method you can use to set targets.

Grinder

These stocks are in a nice orderly grind higher. They have tiny dips, if any at all, and they are oblivious to market moves. They have relative strength and they do not have many stacked green candles. These moves can continue for a very long time and as I described earlier, you can add to the position every time the stock weathers a market dip because you have confirmation that buyers are still interested. These are moves you can ride higher and you do not want to be shaken out. Conventional methods like using the EMA 8 or a trailing stop will force you to exit the trade prematurely. Eventually, the candle bodies will become tiny and the momentum will wane. Typically, the volume will also dry up and the stock will start to lose its relative strength. When you see a compression, take gains and set a price alert at the top of the compression. The stock might just need time to digest gains and this way you will know when it is back on track.

High-Flier

As the old saying goes, “The bigger they are, the harder they fall.” These stocks are stacking green candles on volume and they have incredible relative strength. The move is fast and you feel like you are chasing. The rug can get pulled out from under you at any time, so you typically just get an initial position on and maybe one add if you act early. As the move unfolds, you are watching for any signs of weakness. You have big gains and that rightfully makes you nervous. First of all, good that you are not chasing the stock. If you missed the initial D1 move, you can always day trade the stock and catch some of the move. This is particularly true as the move extends and the risk of a reversal increases. Swing traders need to take comfort knowing that the pullbacks are brief and shallow and that the volume is still good. These moves typically end with a bang. When you see a bearish hammer with a long wick at a relative high or a bearish engulfing candle, take gains on the entire position. You did not add at higher levels and you did not chase. You kept your position size manageable, so your emotions did not cloud your judgement. You had monster gains and you did not take gains prematurely. Not all of these trades will reach the heights of the chart below, but some will. Wait for that red candle and hold the line. If you ride one of these the whole way, pat yourself on the back. Not many traders catch the entire move.



Channels

Some stocks have a random, choppy feel to them and you can’t even see a pattern to the price action. Every time the stock rallies to a new high, it pulls back. When you sense this, zoom out. Often the stock will be in a longer-term trend, but the bid is constantly tested. For upward sloping trends, I like to focus on the upper line first. If I can connect at least a few points I have a decent trendline. Then I will look for a lower line that is roughly parallel to the upper line. It does not have to be perfect and if there are a couple of “outliers,” that is OK as far as I am concerned. This is your trading channel and it gives you clarity. Now you can see the pattern. Before I go any further, this is not the type of stock I like to trade. I like the previous chart much better, and I seek nice steady price action. One approach to this type of stock is that you can sell out of the money bullish put spreads when the stock is near the low end of the trading channel. The black line is the 200-day MA and that would set up really well. I would not be more aggressive with a stock like this because I don’t know when it will take off and when it will pullback. If you are long a stock like this and if you notice a trading channel, you have to watch breakouts above the upper trendline very closely. These are often buying climaxes and the stock is ready to drop hard back into the channel. If there is no follow through, take gains before it falls back into the channel.

Dips

Some stocks are just choppier than others and that is something you need to be aware of if you are trading them. We want the dips to be brief and shallow. What does that mean? Personally, I want the dip to last less than 8-10 bars and I want half of the most recent move higher to be preserved. Each subsequent dip should end sooner and be less severe. That is a sign that buyers are getting more aggressive. In the chart below, you can see that this stock dips with frequency. That is its character and when you enter the trade, that needs to be a part of your game plan. It is not going to go straight up, and you are going to have to weather some of these. You can see how the dips were getting smaller (left side) before earnings and there was a nice trade on the breakout. After a big earnings jump (right side), you would not want to jump on that breakout. This stock has a history of dips and it will need a couple of weeks to prove that the gains are going to hold. It pulls back to the earnings announcement price and then it rallies above AVWAPE and a bullish flag forms. We know this is not going to be a straight shot higher and the stock retraces. This would flush most traders out, but you are expecting it. The stock quickly finds support. The dip is brief and shallow and the stock surges higher. There are “tells” that the dip is going to be brief and shallow. There are no long red candles and the red candles are fairly small in size. Ideally, the retracement features mixed overlapping candles and it is stubborn. Sometimes the dip will be influenced by a market dip and that is even better. If not for market weakness, the stock might not have dipped at all. You can use measured moves to exit or you can ride the move higher as long as horizontal support holds. The most recent breakout becomes your support. That was your entry and a drop below it would stop you out for close to a scratch. Each dip also creates a nice low point to anchor a trendline and you can use a breach below it for an exit as well. If the dips become more severe and they last longer, the stock could be getting ready for a trend reversal. Personally, if the dips are shorter and shallower, I will buy a bullish flag breakout and I will take gains at a measured move. I am more of a hit and run trader and I don’t like weathering dips/weakness. This is just a personal preference.

Double Top

A double top where both peaks are equal signal resistance, but an even more powerful pattern is a double top lower high. Before the stock can even challenge the previous high, sellers pound the stock down. They are aggressive and they don’t believe the stock will get back to that prior high. The bounce to get back to the prior high is weak with mixed overlapping candles and there are wicks. The wicks represent an attempt to get back to the high and that move is hammered down by sellers. This is an important topic so please take note. In the chart below, we can see a nice breakout (left side). The stock is choppy and we expect dips. If you bailed on each of these dips, you missed the move higher. They were brief and shallow. The price action before the high was not incredibly strong. We know that from the constant dips and the lack of stacked green candles. There are a few “stacked greens,” but nothing like we have seen in other charts. The price action tells us to expect dips. How do we know when the high has been reached? In any longer-term rally, there will be dips. The stock has not gone parabolic, so we are not over-extended. The first dip that does not recover and make a new high is where we have to exit. In the first two dips below, notice how they were followed by long green candles that obliterated the prior high. On the dip off of the high (right side), notice how the candles on the way down were more substantial and red. On the bounce, the candles were tiny and mixed. We also saw wicks above the candle. Every time the stock tried to challenge the high, the stock was pounded down. Almost every bull rally will have a double top lower high like this. There are clues everywhere. During the last leg of the rally, the moves higher will be marginal. There will be mixed overlapping candles and the gains will be hard fought. The drops during the dip will be more severe and they will last longer. The attempt to get back to the high will be squashed. You don't have to worry about the rug getting pulled out from a longer-term bull rally (SPY or a stock) until you see this lower high double top. During that drop from the high, don't bail. You will always get a bounce. Sometimes the rebound will feature stacked green candles and a new high and sometimes you will get a double top lower high. It is worth it to see which one you get. On the bounce, the stock (or SPY) will get fairly close to the prior high so your losses will not be that great.

Long Candles

A long candle has a body that is greater than the 20-day ATR by my definition. They stick out like a sore thumb on a chart. When the stock breaks out on a long green candle, we want at least half of it to hold. The same holds true during the middle of the move higher. Those long "greens" will attract profit taking. When the entire candle holds, it is more bullish than if only half of it holds. That is a sign of aggressive buying. Often, we will see a pause for a day or two after the long green candle before the move higher continues. We do NOT want to see those green candles "given back." If this happens, it is a sign that the long green candle was a buying climax and that the selling pressure is high. Long red candles are always a threat during a rally.

They will come near a relative high. In some cases, the red candle will be a head fake ("solo") to spark profit taking. If the red candle is erased immediately, it confirms that buyers are still in control and that the move higher is going to continue. You can see them in strong trends and the long "red" that came at a relative high is way back in the middle of the trend by the time the rally has ended. You can see that in the chart below. Each red candle that is reversed confirms the strength of the rally. If the red candle holds the low and the stock can't recapture it, sellers are aggressive. Any additional red candles need to be respected and it is time to exit the position.

Resistance Levels

Major moving averages, AVWAPE, horizontal resistance and trendlines are all overhead barriers for a stock that is trying to move higher. The fact that the stock is below these levels in the first place signals weakness. We do not want to buy weak stocks, we want to buy strong stocks that have minimal overhead resistance and that have "blue sky" ahead. If you are long a stock and it is approaching one of these resistance points, it needs to obliterate them with a long green candle. The harder it has to struggle to get through resistance, the more likely it is to hold. How the stock approaches those levels will often tell us if it has the strength to blow through them. A stock rally that has dips along the way and mixed overlapping candles is less likely to pass through these resistance levels. You can see that in the first chart below. The move higher is not very strong and it has difficulty passing through resistance. In the second chart below, you can see examples of great breakouts through resistance. The approach features stacked green candles on heavy volume and the stock passes quickly through all of these levels. This is a good breakout on the left side and on the right side of the same chart, you can see a nice breakdown. We can take action on these breakouts/breakdowns.


This trendline is provinding some resistance
and the stock can't break through.
Fairly big dips and lots of
resistance levels above limit
the upside. The move higher
is not strong and we know
that from the dips and mixed
www.oneoption.com
1OVOL(10) -595147
August
September
October
November
December
2024 Jan
February


Nice approach with stacked
greens on heavy volume
Obliteration
Nice approach
with stacked reds
on heavy volume
Obliteration
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1OVOL(10) -25479228
No
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Major Events

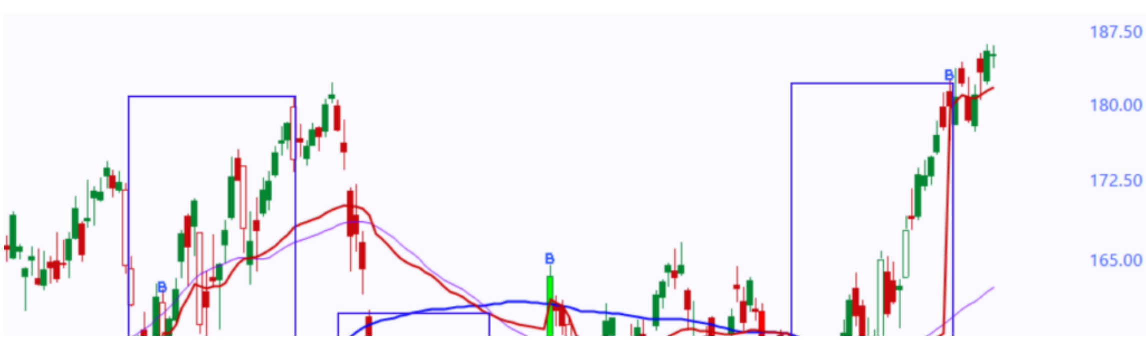
Stocks move on news and you need to be aware of earnings, earnings by peers, Investor Conferences, new product releases, clinical trials, legislature and pending litigation. If an event is approaching that could have a material impact on earnings, it is best to exit the trade and wait for the news and reaction. Earlier in this article, I mentioned that I missed the box office receipts for DIS. This is a good example of a loss that could have been avoided.

RS/RW

The stock needs to preserve its D1 relative strength. When that starts to wane, we lose our edge. It is a sign that buyers are not as aggressive as they once were. First you will see the shorter-time frames turn relatively weak and then you will see the longer time frames flip. When you are long a stock, you will see the market moving higher without the stock. This is a good time to exit and to find a "fresh horse."

Sectors & Groups

We often see sector rotation and when the entire group is in favor there will be a nice tailwind for all of the stocks. We don't trade sector or group ETFs because we want to trade the strongest stock within the sector or group. The other issue with leaning too heavily on sector and group analysis is that it is difficult to categorize companies. They have many divisions that can span various industries. Is Amazon a retailer or a tech company? If it is a retailer, does it really compare well with Macy's? The other issue with leaning heavily on sector and group analysis is that they all have different movement. Utility stocks and REITS move differently than the tech sector. With all of this in mind, it is good to know what the company does. Often we will see a big jump in a stock. You never need to chase stocks, especially if it is a stodgy old company like a food producer. They did not discover a new cure for cancer so there is no reason to chase the stock. Be patient and find your entry point. Basic material stocks and energy stocks trade based on the price of commodities. They are choppy and they will always pullback. If the stocks are in favor, wait for a dip. When you get a nice run, be ready to take gains. You know the stock dips, so exit when the momentum stalls. Companies that belong to a particular sector or group also tend to have similar dividend payments. When a company pays dividends, it tends not to be as volatile. That means you should not expect giant directional moves and it is more likely to be choppy. The chart below is Chevron. It is an Integrated Oil company. Even when it makes a decent move (blue boxes), there is plenty of retracement. We have to build that into our exit plan.



Mixed Overlapping Candles

By now you should know that mixed overlapping candles are a sign that the trend is not that strong. If we are long, we don't want to see this on the way up. If this starts to happen it is a sign that the momentum is starting to wane and we need to watch for a compression. That would signal to us that it is time to exit the trade. The only time we want to see mixed overlapping candles is on a dip when we are long. That would be a sign that the dip is not strong and that it is likely to be brief and shallow. It would serve as confirmation that buyers are close at hand and that support is nearby. The next leg higher will start soon.

This is one of the longest articles I've written and for good reason. It is a very complicated subject with many variables. The most important influence on when to enter and when to exit a trade is the market. Don't lose sight of the fact that we are trading the market using the strongest stock as a proxy. That is our edge. The long-term and short-term price action for the market determines our confidence and our position size. Stock selection is critically important and we want relative strength to the market and orderly price action. That relationship needs to be preserved. Our best risk/reward profile is to find grinders that consistently march higher. They are not over-extended, so we don't have to weather big dips or retracements. Each time that the market stumbles and the stock does not, we have confirmation and we can add to the position. When the price action for the market and/or the price action for the stock suggest resistance, we take our gains and we wait for the next opportunity.

Chapter 15: Where To Place Stops!

Traders seek a mechanical method that will keep them in good trades and minimize losses on bad trades.

“Where should I place my stops? If I keep them tight, I get stopped out and I miss big winners. If I keep them loose, my losses are huge.” This is a big dilemma for traders and I get this question daily. There are as many stop methods as there are traders and how risk is managed varies from person-to-person. Novices seek an optimal “one size fits all” mechanical solution that they can apply universally. If that’s you, there is no reason to read further. It doesn’t work and I will explain why. In this article I am going to get right to the heart of the matter. The stop is not the issue, there is something else you need to address first. At the end of the article, I will discuss some of the methods used for stopping a trade out and some of the special situations that arise.

What is a protective stop and why do we use them? Throughout this article it will be easier if I reference one side so we will be buyers (long stock). Once we enter the trade, we want to limit our downside risk exposure. It is critical to have a game plan when we are trading. A stop loss is the maximum risk that we are willing to take. If the stock drops to that level we exit the trade, we admit that our analysis was wrong and we move on.

According to an old sports adage, “the best defense is a great offense.” The rationale is that the offense stays on the field most of the game and it scores so much that the team’s defense is irrelevant. If you think about the nature of stop orders, they are our defense. If the stock drops to a certain level, they provide us with a safety net. If you are constantly getting stopped out, you need to improve your offense. Let’s focus on ways to improve your entries and minimize the need for stops.

Market First

Everything starts with the market and stops are no exception. The market is going to have a major impact on the underlying stock. If the S&P 500 is in a down trend and you are buying a stock, there is a good chance you are going to get stopped out. No matter how strong the stock is, sooner or later sellers will knock it down and you will get stopped out. If the market is not trending, you don’t have a tailwind and there is no urgency to buy a stock. Be patient and wait for your window of opportunity. Be aware of scheduled market moving events. The time to buy stocks is not before the FOMC statement. That news is going to have a major impact and if the reaction is negative, your stops are going to get triggered. Plan ahead and reduce your exposure ahead of time so that you can weather a temporary pullback. This is when you mentally prepare for how much of a pullback you believe could happen in a worst case scenario and how much of a pullback you are willing to “shoulder.” The market itself is a conditional stop for your long stock trades. “If the SPY drops below $XXX.XX that would be a major technical breach and I am going to exit my long stocks positions.” If the reaction to the news is positive, you can buy your stocks then. Stops are not a substitute for a good game plan. “Gee… I’m glad I had my stops in place or I would have lost a lot more money than I did!” Exiting trades for a loss is painful and there is not one trader who would be happy about this. If the potential losses were included in the game plan, they calculated the odds for that outcome and they were prepared to take that risk. If the trader missed the event, they would be fuming that they took losses that should have been avoided. In the first case the trader has incorporated the event into the game plan and in the second case the trader is blindsided.

Stock Second

Stock selection has been the second major focus of this course. We've covered all of the desirable characteristics that need to be present. The more checkboxes we've marked, the higher our odds of success. Nice orderly price action is critically important. We don't want to trade choppy stocks that do not historically

Nice orderly price action is critically important. We don't want to trade choppy stocks that do not historically trend well and that have big spikes and drops. Your odds of getting stopped out on Stock B (below) are high. Stocks that have sector strength/weakness are also less vulnerable to pullbacks because the entire sector is benefiting from asset rotation. We also look for stocks that have broken through technical resistance levels on heavy volume with follow through. The stock has demonstrated strength and that is a sign it is going to move higher. Institutions are buying the stock and they fueled the breakout. We want follow through on that breakout and no nearby overhead technical resistance. We call this "blue sky" and Stock A is a good example. It has fantastic relative strength, upward momentum, orderly price action and heavy volume breakouts. If you buy stocks that have overhead resistance, there is a good chance that the stock will not be able to breakout. Resistance is a sign of heavy selling pressure at that level. The stock could be rejected from that resistance level if sellers become more aggressive and you will be stopped out of the trade.

There is never a reason to compromise on your stock selection. If it does not look perfect, keep looking. There are thousands of stocks to pick from. You control the selection process. If you are constantly stopping out, chances are you are not picking good stocks.

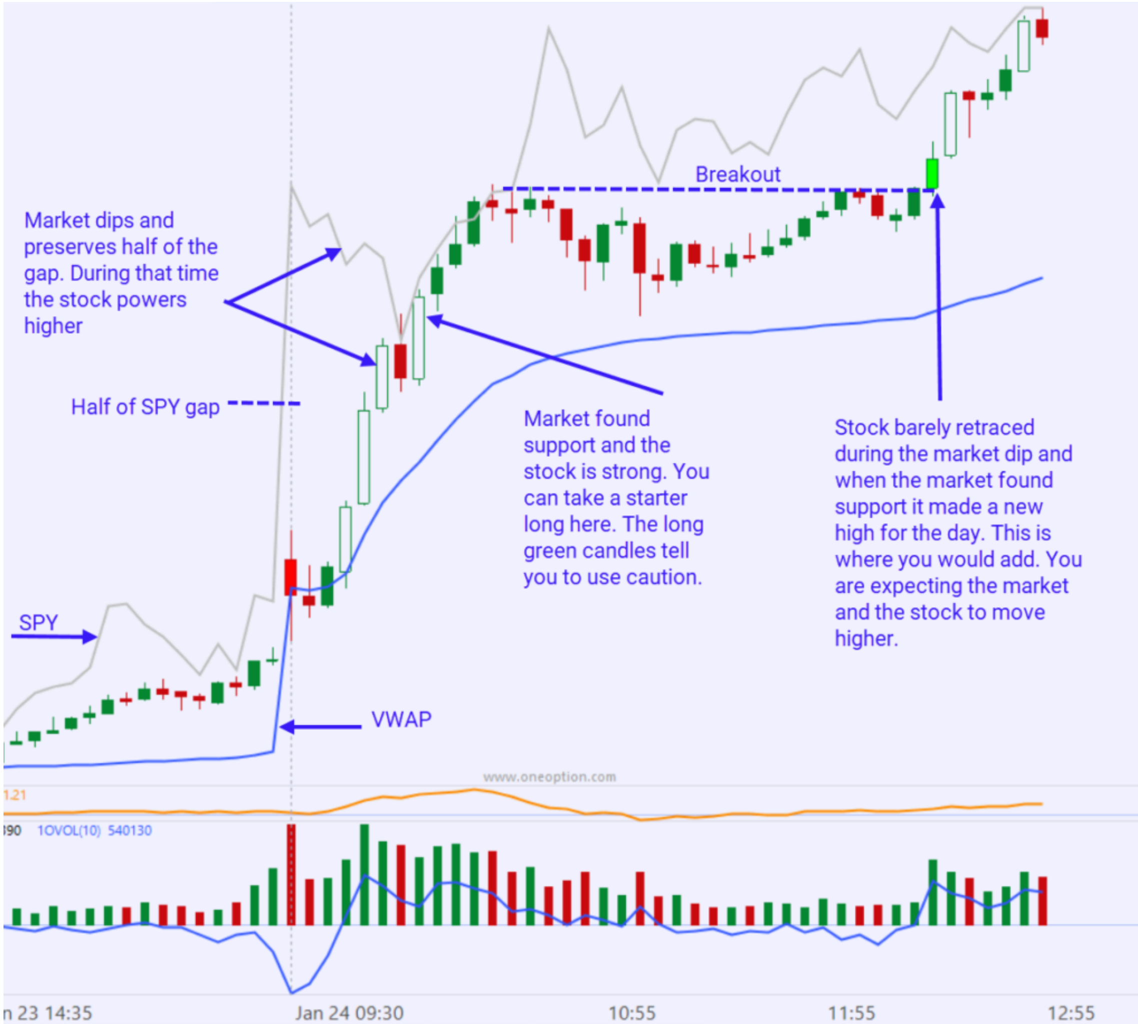
Let’s say that you have the right market conditions and you found a great stock with lots of checkboxes marked, there are still things that you can do to enter the trade well. A good entry will reduce the number of times you get stopped out. In the chart below, you will notice the first breakout (left hand side of the chart). This is exactly the type of breakout we want to see. It has a long green candle on heavy volume through horizontal resistance. The close above that resistance level and the close on the high of the day is bullish.

During that first breakout, short-term (2-3 days) swing traders can get long on and so can day traders (left side of the chart below). They will be looking for follow through buying and relative strength on an M5 basis for confirmation. As soon as the D1 momentum stalls and the stock starts to compress, they will exit and move on to another stock. Very long-term swing traders can also take a starter position on the first breakout with the understanding that the breakout is likely to get tested (confirmation). The stock could continue to power higher and that is why they want to at least take a small starter position. They will at least have some shares if the stock never looks back. More passive longer-term swing traders would prefer to wait for that retest before taking the trade. They know they will miss some moves and they understand that the stock might never dip or compress. By the way, Option Stalker Pro has alerts that you can set using many different variables across any time frame that trigger after a dip has run its course. It is fantastic for day trading and swing trading because you can evaluate the nature of the dip and it will provide a better entry point if it was brief and shallow. They take seconds to set and they don’t tie up any capital and you have no emotional attachment to the trade.

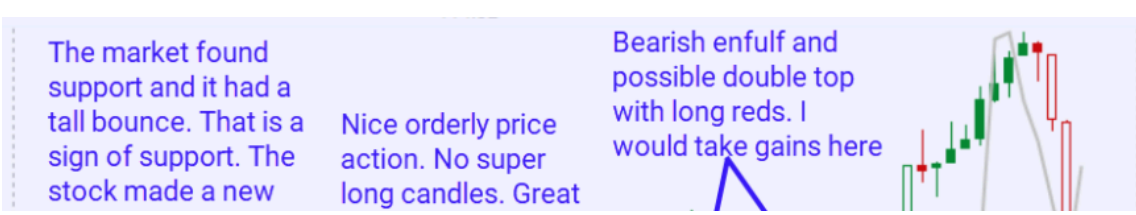
Novice traders have watched the first breakout below and they are “ready.” They buy the stock when it has moved considerably above the EMA 8. At this stage they have complete confirmation of follow through. They “know” this breakout is legitimate. The stock compresses and there is some profit taking. They did not expect this and when the stock drops below the horizontal breakout, they stop out. Don’t chase stocks that surged higher and that are far from the EMA 8. Wait for the stock to compress or dip. A compression that holds all of the recent gains is very bullish. It is a sign that buyers are supporting the move and that they are offsetting profit taking. The EMA 8 has a chance to catch up and eventually buyers will get more aggressive. Enter on that compression breakout. A dip that is brief (less than 8-12 bars) and shallow (most of the recent move up is preserved) is also bullish. Those dips are good entry points when support is confirmed and when the stock is back above the EMA 8. In the chart below you can see other good entry points to get long.

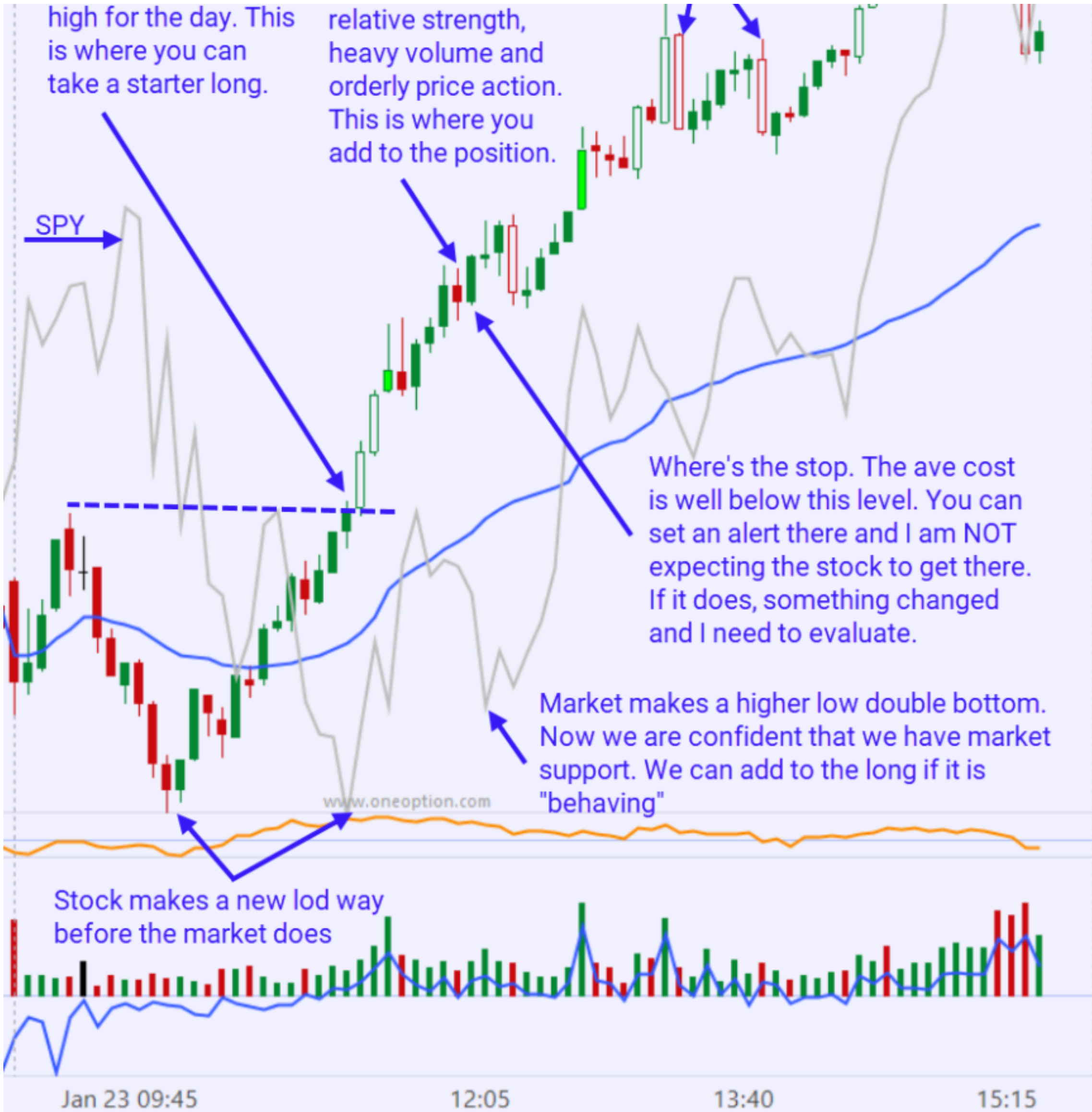
Let’s talk about entering day trades. The same principles apply to longer-term swing trades, but day trading is much more intense because the decisions happen much faster. First of all, you should rarely trade the first 45 minutes of the session. The volatility is higher and that means you are more likely to have adverse moves that will stop you out. Let the action settle down. If you are a buyer, gaps up present greater danger. We’ve already been through this in earlier sections. A market gap up could easily reverse and most of these moves higher are challenged. The bigger the gap up, the greater our risk if the move reverses. Tight stops will get triggered instantly for a loss because of the volatility. Wide stops (loose) would be much lower and the losses would be large. When the market gaps up, all stocks “rise with the tide” and it is difficult to identify relative strength. The chart below illustrates a couple of risks. First of all, the market gapped higher so it can reverse sharply. Secondly, it is more difficult to gauge relative strength because all stocks (even the fakes) have jumped. The “fakes” will look great for the first half and hour and then reverse sharply. The final risk is that the stock gapped higher followed by extremely long green candles. These candles have a tendency to reverse because of profit taking. “FOMO Joe” who rushed in to buy this stock is going to take a world of hurt. The stop will prevent disaster, but he is going to lose money because he is in a bad trade.

A market pullback after a gap up will tell us which stocks want to move higher. They will be the ones ticking higher or treading water when the market pulls back. On a gap up, we want the market and the stock to hold most of the gains. We do not want to see more than half of the gap filled. If more than half of the gap is filled, we have to wait for market support. The chart below is beautiful. The market gapped higher and it had a small pullback after the open. During that time, the stock held almost all of the gains and the VWAP. When the market found support, the stock made a new high for the day. You could place the stop/alert at VWAP, but why would you do that? This stock should not go anywhere close to that level and you should be out of the trade before it gets there. You are entering the trade because you expect the market to bounce and you expect the stock to lift off immediately when that happens. You should place an alert at your entry (breakout) once the stock moves higher. You are not expecting that level to be tested again and if it is, the trade is not working out and you need find out why. Is it the market or the stock? Based on your findings you will determine if you should stay in the stock. If everything is working as planned, you evaluate the stock and the market on an ongoing basis.



If the market has gapped down overnight, we have to wait for support. Stocks that have relative strength early in the day will tempt you. If you buy them and the market continues to drop, they will eventually decline. You need to make sure that the market is not in a bearish trend day. Under any market condition, when 1OP for SPY M5 is spiking, we know that a market dip is likely. Instead of chasing a stock that looks great, wait to see if the bearish 1OP cycle produces a market dip. If it does, the stock will show its “true colors.” If the stock pulls back hard during the market dip and it breaches VWAP, it is probably not that strong and you should look elsewhere. If the stock holds all of the gains during the market dip, you have confirmation that it is going to move higher when the market finds support. Don’t chase single or double long green candles. This applies to the SPY and to the stock. Those big candles are much more likely to retrace, and they could have resulted from a large order (stock). Wait to see if those long candles hold. We would prefer a series of 6-8 consecutive green candles that cover the same distance.

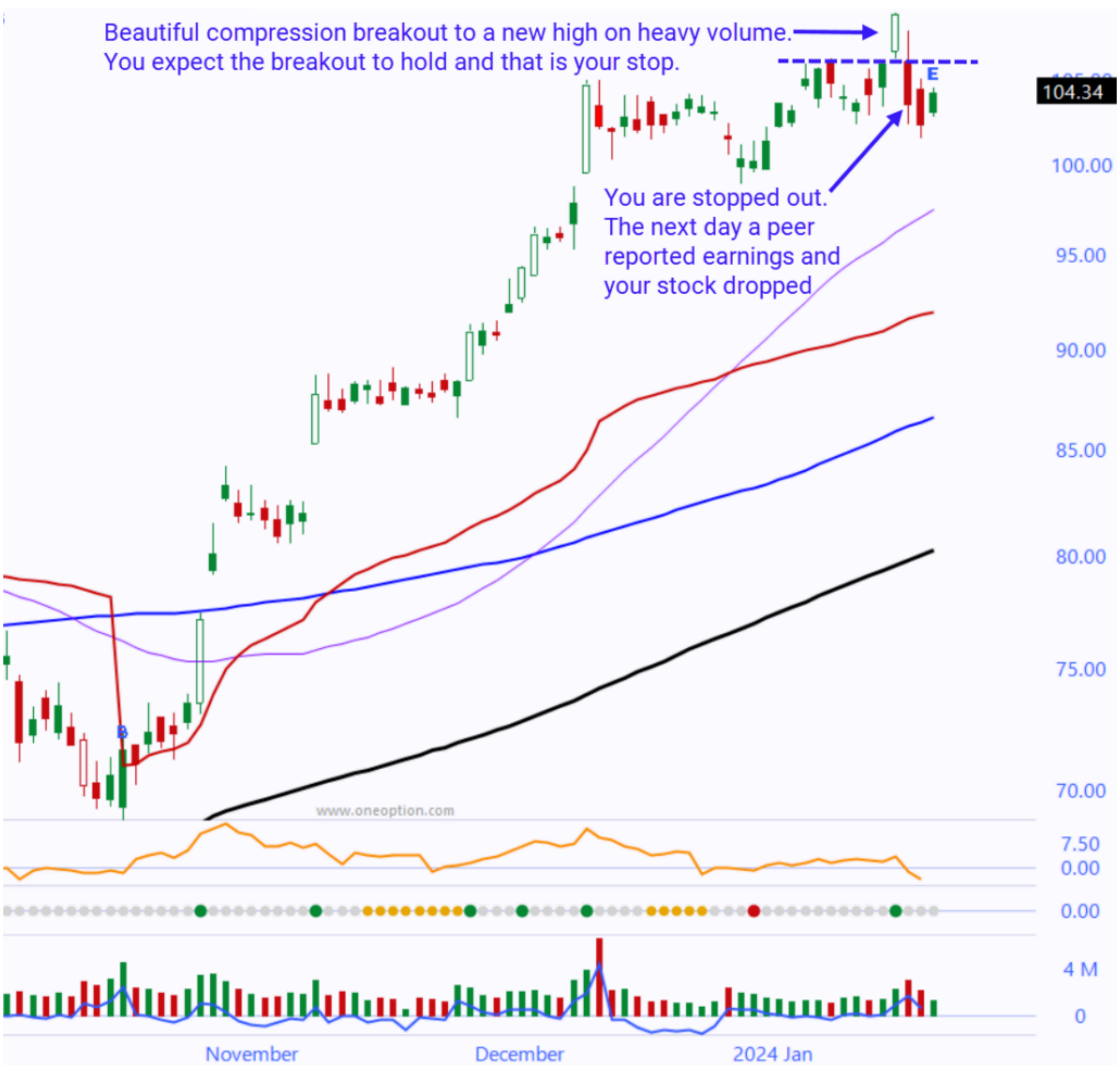




The nice orderly price action on heavy volume is a sign of persistent buying over time. Look back on the M5 chart of the stock for the last week. Does it typically make wild swings? Remember, we want nice orderly price action that we can predict. If a choppy stock is making a nice move, know that it typically retraces. Don't chase a new high for the day, buy dips. Is the stock above the prior day high? That is the first minor resistance, and I won't even consider buying a stock that can't move through it. Has the stock been above VWAP most of the day? That is a sign of strength and we want that if we are looking for longs. We want stocks with heavy volume because that legitimizes the move. These are ways that you can improve your entry for day trading and these tips will reduce your need for stops.

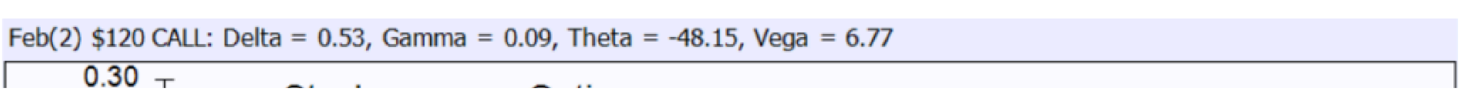
Traders who over-leverage rely heavily on stops because they are "scared shitless." One bad move can be disastrous, so they need to make sure that they contain the losses by placing stops. By nature, these traders don't give the trade enough breathing room because they can't shoulder the losses and they are always stopped out. These same traders are typically in the "take a shot, make a lot" mindset so they are in volatile stocks.

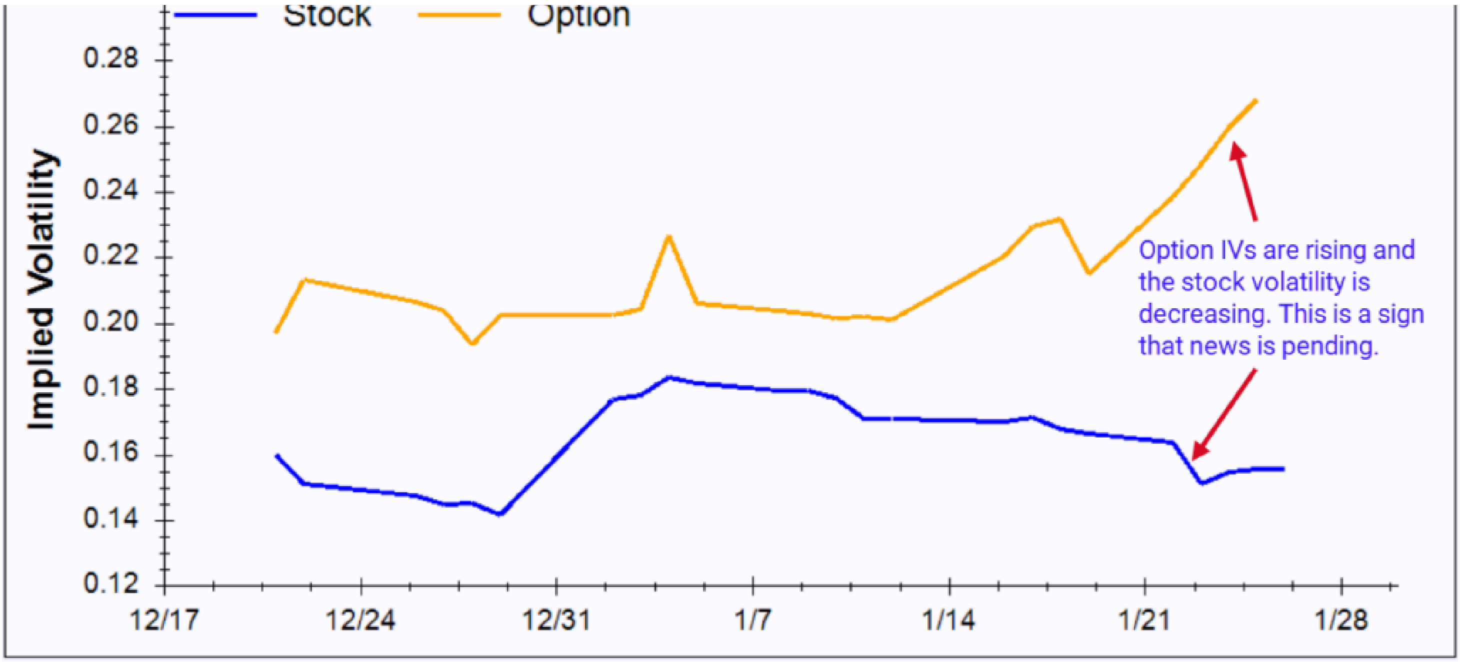
Planning around scheduled events is also very important. I mentioned this in the market section, but that also applies to the stock. Have you checked the earnings calendar? Do you know when the earnings are going to be announced? Do you know the competitors and when they will announce? Typically, earnings from peers will impact other stocks in the same group. If you are oblivious to this news, you will be blindsided and your stops will get hit. I never hold stocks over the earnings announcement. That is a binary event and the outcome is random. I won't accept a 50:50 outcome when I can have a much higher win rate trading under normal conditions. If you are aware of the pending earnings news for a competitor, you can buy the stock knowing that that risk or you can wait for the reaction and buy after the news. The point is that you are aware of the risks and you are incorporating that into the game plan.



There are many other events for the stock. "Investor days," analyst conferences and new product release dates are examples. Recently, crypto stocks were strong. They were moving higher because the SEC was likely to announce the approval of a crypto ETF. The charts looked great and there was money to be made. If you entered late and you were oblivious to the news, you were stopped out for a big loss once the ETF was approved. You chased the stock, so your entry was poor and this was a "sell the news” event (chart below).

There are also other pending announcements that could impact the stock. They include patent litigation, civil lawsuits, regulatory changes and clinical trials. These are more difficult to “root out,” but you can take a look at the stock’s historical volatility and you can compare it to the option implied volatilities (IV) for the stock. If the IVs have been rising and the stock has been dormant, news is pending. Market makers are aware of the event and they are reflecting that uncertainty in the price of the options.

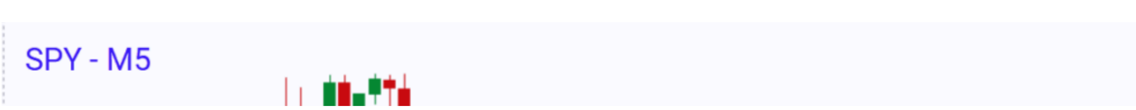




To this point I have not even talked about how or where to place stops. If you enter the trade well, the need for stops decreases substantially. If you are constantly getting stopped out, you need to improve your entry and your awareness. The time spent on stop placement should be less than 1% of the entire process. Stops should be an afterthought. You know what you are expecting the market to do D1 and M5. You know the scenarios that could play out and which ones are most likely. Your forecast is solid and you have handicapped the outcomes. You do the same thing for the stock D1 and M5. This analysis determines your overall confidence in the trade and the position size. During the trade you are monitoring the action, and you are deciding if you want to hold, exit or add. Novice traders have read that you must use stops. They feel like there is a secret stop formula or method that is going to vastly improve their success. If you pick shitty stocks and you enter poorly, you are going to get stopped out constantly and you are going to lose money. No stop method in the world is going to turn that around for you.

Let's cover some basics and then move on to some of the techniques you can use. First of all, stops have an element of danger. They lull traders into thinking that they have a "safety net." That "warm fuzzy" allows them to enter marginal trades because if the trade sours, they will minimize their losses. The other danger is that institutions will hunt for stops. They know where traders are likely to place them and they will try to flush you out. The stop is triggered, you establish the loss and then the stock runs higher. Sound familiar? Another risk is news related. There is a "knee jerk" reaction to a headline and the bottom falls out of the stock. You are stopped out at the worst possible price and once you've had a chance to read the news, you surmise that it was not going to have a material impact on the stock and that you would have held the position. The stock roars back and the stop leaves you with a big loss. For this reason, you should use alerts. They can come in the form of horizontal price alerts (same as a stop limit order), a trendline alert (similar to a trailing stop) or an indicator (exit when it flips from bullish to bearish). When the alert is triggered, you calmly evaluate the price action and the news if there was any. If the move was legitimate, you can exit on your own terms. If the move was temporary, you can reset the alert. I highly suggest you use alerts to enter and exit trades (stops losses and profit taking).

Below is an example of stop hunting on an intraday basis. You can see how the SPY found support many times at the same horizontal support level. Traders have been taught to buy near support and then to place their stops just below that level. This produces a low risk, high reward scenario if the SPY bounces. Institutions know how you think. They are going to push the SPY below that support to trigger those stops. Once those traders have been flushed out, the SPY rallies back into the range. They will use this same tactic around major technical levels (SMAs, trendlines and horizontal support/resistance). If the stop level is obvious to you, it is obvious to them.



Many books teach that trading is mechanical. “If you buy the stock your stop should be 5% lower and your target profit should be 10% higher.” I tried methods like this early in my career and they didn’t work. How likely was I to hit that 5% stop? How likely was I to hit the 10% target? What models were being used to determine the odds of those outcomes? The market doesn’t move in a mechanical fashion. Isn’t it common sense that you should look for opportunities that have greater upside than downside? At best these are basic guidelines. The moment I got rid of this rigid way of thinking, my trading improved. The 5% stop does not account for breakouts, momentum, relative strength or how far the stock has traveled. The target is arbitrary as well and you often miss the majority of the move because your exit was early. If there was a mechanical system that worked consistently, it would have been automated. If it was made public, institutions would have incorporated it into their models, and they would know exactly how to trade against you. The market is dynamic. There is no secret formula so stop looking for one. Gather information, process it and make decisions based on the price action that unfolds.

Remember to use alerts instead of stops. To determine that price point, ask yourself, “At what price do I know that the trade is not moving as I expected?” Since we are trading the market and “riding the fastest horse,” the exit is a function of the market and the stock. There will be times when you are long, but the market makes an unexpected big drop. If the price action suggests there is more selling to come, you should consider exiting some or all of the stock position even if the stock is holding up pretty well. If the price action for the market drop is not that daunting and the stock has had relative strength, you might consider holding it even though it has poked below a technical support level that you were leaning on. When the market recovers, the stock will rebound and then you will have a market tailwind to fuel the move. If the market has been stable and the stock falls below technical support, that was unexpected. The stock has become relatively weak. Determine if it was news related and if you need to exit.

What are the key technical levels where you might consider placing a stop? If you are swing trading and leaning on a D1 chart, the technical level should be visible on that time frame. You do not stop out of swing trades that drop through that price point intraday. We evaluate the position in the last 5-10 minutes of trading. As I mentioned before, institutions will be hunting for stops around key technical levels. Often a stock will move below that price point and then bounce right back. That support held as you expected. An intraday stop would have flushed you out of a good trade. Let the stock move around. You should not act based on the how a bar (D1 or M5) looks before it has finished. You wait for it to close and very often it looks different than you expected. The exception to this on a swing trade would be news related where the stock has a big gap down and it is stacking consecutive red candles with little to no overlap on heavy volume intraday. That is heavy selling, and it is likely to continue the rest of the day and perhaps for a few days. Big gaps down on news also put us on high alert. It happens to the best of us and you instantly go into loss management mode. As I mentioned earlier in this article, you exit as gracefully as you can and you gauge the price action during the day. You know you need to get out and move on. This news was unexpected and it sparked heavy selling. For swing traders these D1 technical support levels include; the major SMAs, trendlines, horizontal support/resistance, AVWAPE, and the EMA (8). If you are day trading a stock, you use shorter-term support levels based on an M5 chart. VWAP, key bars, the high/low of the day, the prior day high/low, and the open of a key bar are levels you can use. The trade duration determines the time frame we use for our stops.

One final tip. If you are trading options, never, never, never place stop orders based on the price of the option. The tail does not wag the dog. Option pricing is a function of the underlying stock and your exit needs to be based on the price of the stock. The bid/ask spread on an option is wide and you are always trading against a Market Maker. If the stock drops quickly, they will widen that bid/ask spread and they will drop the bid of those call options and lift the ask on put options. They don't want to trade against a big move unless they get a great price. That means you will get filled at a horrible price. If the stop for an option order resides at a specific exchange, what happens when it doesn't trade at that particular exchange? Is the stop triggered? What happens if your option does not trade during the drop? The stock keeps falling and your stop is not triggered. Know that you should never place a stop based on the price of the option. If the stock drops below your price an alert is triggered and then you can manage the exit and "work" the bid/ask.

Here are some stop methods that can be used to protect your position.

Stop Limit Order

If the underlying stock trades at that price, the stop is activated and a limit order to exit will be placed at that price. The benefit of a stop limit is that you will not get a horrible fill because it is a limit order. The issue is that the stock drops below your price and it never looks back. Your limit order is not filled and the safety net you were counting on had a big hole in it.

Stop Market Order

If the underlying stock trades at that price, the stop is activated and a market order is placed. The good news is that you will get out of the trade, the bad news is that it could be at a horrible price because you used a market order. If the stock has news during the day, the bottom could fall out of the stock. It could be a rumor or a "knee jerk" reaction and given time to evaluate the news, you could have managed the exit much better on your own.

Trailing Stops

The stock is going your way and you want your safety net to follow the stock higher. This is different from stopping a trade out because it is not performing well. The stop is based on a dollar amount that you specify. If you are long stock, the high is $100 and you place a $.50 trailing stop, it will exit if the stock trades at $99.50 or lower. If the stock trades up to $101.50 the stop will be raised to $101. The stop order trails the stock higher. This allows you to participate in the upside and to move the safety net higher along the way. You need to consider how volatile the stock is. If it is a nice tight orderly move, you can use a smaller dollar amount. If the stock makes choppy stair-step moves, you need to consider the depth or those moves and use that as a guide. Failure to do so will prematurely stop you out of a good trade. Keep in mind that upwards trending alert lines can be set instead of using a trailing stop. There is nothing more aggravating than getting stopped out of a good trade during a normal retracement. Use alerts. When the alert is triggered, you have an opportunity to evaluate the price action.

Conditional Stops

This stop is not based on the underlying asset. It based on another asset. In the case of a call option on stock XYZ, the exit could be based on the underlying stock. For example, contingent on stock XYZ trading below $100, sell the Jan $100 calls @ $2.00 (limit order). Instead of a limit order the trader can also exit using a market order and run the risk of getting a bad fill. The conditional order can also be based on the SPY (or any other stock/ETF). If the trader is leaning on a specific support level for the SPY and it is breached, the stop for the underlying stock (or option) would be triggered. If you absolutely must use stops for options trades, you should use a conditional order based on the price of the stock. I don't like using market orders for options for the reasons stated. To calculate where the option would be trading when the stock reaches that price, use the delta of the option as a guideline and use a stop limit order. There are also many options pricing tools you can use to calculate the approximate price of the option if the stock reaches that price.

Time Stops

This is something you should use. This is not an order that can be placed. Based on all of your analysis you are expecting the market and the stock to behave in a specific manner within a defined period of time. With each passing moment, you need confirmation that your analysis was correct. If the market is moving higher as expected and the stock is not moving higher as expected, you might exit the trade. You give the stock as much time as you feel is appropriate, but the trade is on "borrowed time." If the market is not moving higher as expected and the stock is not moving higher as expected, you might exit the trade. When you enter a trade you are timing the entry at what you believe is the best moment. For every M5 bar (day trades) and every day (swing trades) that passes without movement, your odds of success decline until they eventually reach 50%. You should not be in a trade with those odds so somewhere along the line you need to exit and realize that your original analysis was "off." There is no harm in taking a small loss, a scratch or a small gain. The trade did not perform as you expected. Everything was in place for the stock to move higher and it didn't. When you exit the trade, set alerts so that if the stock does start to move you can consider reentry. There are times when you have to enter at a higher price, but then you have confirmation that the move is underway and your odds are better. There have been many times when you will be glad that exited a position on a time stop. A surprise news event hits the stock or the market and you did not have the risk exposure associated with a

A surprise news event hits the stock or the market and you did not have the risk exposure associated with a stock that was not "behaving." This strategy also frees up your capital for other opportunities and it is one less position you have to monitor. So let's look at an example.

In the example, above the stock has incredible strength on the left side of the chart. It is stacking green candles and you want to ride the move as long as you can. You will be watching for any dips. They need to be brief and shallow. If each dip lasts longer and is a little deeper, that is a sign of resistance and you need to take gains. There weren't any dips. You will also be looking for a compression. If the relative strength wanes and the stock starts to compress, you should take gains and see what happens next. The powerful move has us expecting it to go higher and you believe you will be buying a compression breakout. The stock has a brief and shallow dip and a nice bounce. That forms a bullish flag in the middle of the chart and it is time to buy. You are expecting it to blow through the compression high immediately. That is how bullish flags work. The SPY staged another move higher the next two days, but the stock did not participate. It had a bullish flag formation, incredible strength over the last two months and a market tailwind. It doesn't get any better than this, but the stock was not able to get through horizontal resistance. Under the best conditions it did not do what we wanted – time stop. You exit the trade and you wait to see what happens. If the stock breakout through the D1 high, you will know it because you set an alert there. You need that confirmation. During the next week, the SPY dips and it makes a higher low. The stock dips and it makes a lower low. This is a sign of weakness. When the market surges through the previous high, the stock does not even challenge horizontal resistance and it is weak relative to the market. You could have placed a stop when you entered the bullish flag, but why would you wait to take a loss? Everything you needed for an immediate move higher was in place and it did not happen. Exit, set alerts and evaluate.

Indicators

Instead of using technical support/resistance levels to stop a trade out, some traders will exit long positions when an indicator flips from bullish to bearish. LRSI and SMI are two indicators that can be used. As long as they are bullish, you stay in the trade. When they turn bearish it is time to exit. I have not used this method because I feel that most indicators lag. Knowing how to read price action is more reliable and it is current.

Price Action

We've discussed the price action we are looking for to enter the trade properly. Be selective and your need for stops will decrease dramatically. We've also discussed the price action that would trigger our exit on a big drop through technical support. Price action can also be used to exit winning trades and I will cover that in another article.

Day Trading Stops

Intraday price movement can include the prior day high/low or the current day high/low. It can also use the open of a Key Bar. If you are long stock and you get a green Key Bar (or any oversized green bar) you want that open to hold. Buyers were there before and when that level is tested, you want to see that they are still there. The open for that bar would be where you place a stop. VWAP can also be used as a stop. Know that VWAP is like a magnet for the stock and that it is likely to be tested. Institutions are aware of all the price points that have been mentioned so they will often hunt for stops around them. This is another good reason to use alerts instead of stops. Instead of being head faked out of a position, you will get the alert and then you can determine if the move is legitimate or fabricated by programs.

Conclusion

Question: When should you stop a trade out?

Answer: When you know you were wrong.

The key to every trade is to have a game plan. The trade duration is defined and in that set period of time you are expecting the market to do “X” and you are expecting the stock to do “X.” Your analysis is based on the previous price action for both and you can assign a level of confidence. You are aware of scheduled events and you are picking the best stocks that have room to run with little to no overhead resistance. The game plan includes characteristics that will confirm that you are in a good trade, and it will include characteristics that tell you it is a bad trade. With regards to a bad swing trade, you might be expecting a technical support level like the 100-day SMA to hold. That level is not selected because it is X% below your entry price. It is selected because a normal sized retracement for the stock would put that support level within striking distance. You are not expecting it to be tested, but if it is, you are expecting it to hold. There could be a scheduled economic release that could cause the market to drop and if that happens, you are mentally prepared for how far it might drop and you are willing to take that risk. If the market surges higher for 3 days, the stock needs to move higher as well. If it is compressing or drifting lower, that is not what you expected. It is time to stop the trade out even if it is a scratch or a marginal winner. The stock is not doing what you expected. Go to the sidelines, set alerts in case the stock starts to perform and look for other opportunities.

Longer-term trades should have more room to move (wide stops), and they should be granted more time to perform. You should place wider stops on volatile stocks and tighter stops on orderly stocks. The stops for swing trades are evaluated at the end of the day. Short-term trades need to perform immediately and the stops need to be tighter. The evaluation is constant.

Here are two parting thoughts. If you are getting stopped out frequently, focus on improving your entry. If you are nailing your entries the stock will perform and you will be managing profits instead of worrying about risk. Secondly, don’t use stops, use alerts. Alerts will give you an opportunity to evaluate the situation and then you can decide if the move is legitimate or fake. If it is legitimate, you can use your trading skills to improve the exit vs bailing on the trade because it hit a specific price.