Professional Trading Techniques

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Introduction

The mastery of trading is a never-ending pursuit. Knowledge of and confidence in a workable methodology is just a departure point. Consistency in the approach and application of a particular technique will be the real key to a trader's success. So, though initial market and trading theory is important, it is not until a trader attempts to put actual technique into actual practice that the real learning begins. All methods begin with the laying down of structure and rules – however, these are ultimately meant to serve as guidelines. A newer trader will do best to follow these guidelines as closely as possible and in doing so, should meet with a modicum of success. As a trader develops more expertise, they will be better able to recognize when certain market conditions are changing and when "rules" can be given more flexibility. If a trader's bottom line starts to suffer, though, they will do best to go back and follow the guidelines and rules as possible.

Self-study is just as important to successful trading as is the study of price behavior or technical analysis. A trader must maintain an even temperament, an orderly composure and a calm mind. They must have the confidence to believe in their own trading decisions without looking to outside sources for validation or confirmation. Dedication, persistence and patience are required for success and ultimately, mastery.

This in-depth manual is designed to provide you with techniques and tools to give you an edge in trading. However, those who crave success must ultimately still do their own research in order to develop their own trading process. Study the ideas presented here but then prove to yourself that they work. Keep what makes sense to you and find ways to make the material your "own", for this is how it will have of most value to you. Doing your own analysis, study and research is the fastest way to build confidence in a trading process.

Though all the tools necessary to design your own trading program are contained in this manual, the time necessary to gain in experience is always the most underestimated part of the equation. Experience is applying the trading process in a consistent fashion until it becomes ingrained in your trading personality and is part of your routine. Understanding the next most "probable play" needs to become second nature. The ability to then act on this information is the goal. Cumulative successful results are achieved by following this process on a daily basis. As with any performance-oriented discipline, you must enjoy the day to day process that makes up the journey if you are to be successful.

Read this manual several times and review the concepts on a regular basis. The ideas presented here will take on more meaning as your experience grows. And as you gain in experience, your confidence and success will also grow.

I wish you success in your quest to improve your trading performance and excel in your niche in the markets. There is no substitute for hard work, patience and perseverance. In my own case, my initial failures provided the foundation for an eventual climb to success in trading. In fact, we are all ever climbing and would like for you to join in experiencing the satisfaction of a job well done. Trade well and prosper!

The Nature of The Game

The markets are a personal journey and every trader is destined to learn market truths for themselves. The learning curve is as much about figuring out what doesn't work as it is discovering which things work best for you. Each individual has a different personality and thus a slightly different approach to the market. However, a trader is less apt to experience a setback if he accepts some basic fundamental truths as to the nature of the game.

First, though principles of price behavior remain the same, the game is always changing in subtle ways. Relationships that we take for granted can change. New technology has speeded up information flows and changed the execution process. New market products continue to be created. So, it is important to maintain an open mind to the fact that there are a myriad of possibilities that we may not be able to see at the time

Second, the key to longevity in this business is first and foremost capital preservation. Have the patience to wait for clear, well-defined trade setups. The majority of trades result in small wins and small losses. Stay in the game until the deck is loaded, and then strike when iron is hot. Unfortunately, these times don't come around as often as we would like. There is never much advance notice when the markets are going to get hot. Thus – be prepared to trade every day and when the action is good, do not take it for granted that it is going to continue to be good.

Third, a large percentage of trading profits will come from a small percentage of the trades. A trader can't predict in advance that the market is ready to give a better then expected gain. More often than not, a consistent increase in the bottom line comes from a combination of two factors: numerous small winning trades, and not letting any one loss get too large.

The majority of professional traders nickel and dime the market week in and week out and can make a consistent living in the process. Still, the trader is always staying alert yet patient, waiting for the market to give that one opening where a larger gain can be made.

Much of trading is learning how not to beat yourself. Oddly, the majority of traders know when they're making mistakes. In this respect, traders beat themselves. The best defense against making trades out of an emotional state, frustration or boredom, is to be prepared and have a game plan. You must be in a prepared state *before* the market opens, and then by being patient, calm, cool, and collected, you will be better able to capitalize on the choicer opportunities when the market tips its hand.

Successful trading is about minimizing mistakes or "unforced errors", to use a sports analogy. It's not about brilliant analysis or out-smarting the market. It's about perseverance, consistency and confidence. Professionals can and do occasionally make big mistakes. But the ability to get right back in the game and fight to make back losses is what makes them a professional. The ability to get back on track and start following a well thought out trading program keeps them playing the game. They don't quit because they are determined to succeed.

In order to be profitable, you must learn how to win the real game: the mental side of the business. This includes recognizing the importance of having a **game plan**, the incredible role that **patience** plays (waiting for conditions to be just right before entering a trade), and the tremendous amount of **mental fortitude** it takes to endure the slow times.

Trading is not an intellectual game. You can't "out-think" the market. Analyzing and predicting the markets is not nearly as important as learning how to react to what the markets actually do. Stay involved in the process of making the right decisions at each moment, and let go of worrying about the outcome. Take each trade one at a time and manage it to the best of your ability at that moment. Trust your judgment.

Hard work is required to win. It is hard work preparing your game plan each and every day and putting in the necessary time to study the markets' actions. Determine the overall market environment and whether it favors your play. Then make your forecasts based off the current price swings, not what you think the market ought to do.

It is hard work to stay focused and push aside all the distractions that try to come between you and success. Concentration, routine, and ritual are the most powerful tools at your disposal to help ward off distractions and eliminate the emotions and anxieties that hinder good performance. To win and win consistently is hard work. Otherwise, everyone would be a winner in the markets and that's obviously not the case.

The nature of the game is to understand the constant changing nature of market relationships. There are numerous aberrations and "outlier" events, (abnormal behavior), that create both opportunity and risk. Though it is important to follow a trading process in a consistent manner, there is no guarantee of consistent profits. The professional knows that just two or three good months can make his whole year. It takes a lot of patience to step back and view one's business with such a long-term perspective. It takes a lot of tolerance to accept the fact that our timing will never be perfect, and that we'll always leave profits on the table. We'll miss dozens of "big ones." For the great trades that we do catch, we are often never as heavily committed in terms of size as we would like.

Trading is the ultimate lesson in attitude. Every day we can choose to criticize all the things we didn't do right, or we can marvel at the abundance of opportunity the market provides for us. We can accept our losses as necessary lessons and steps to future successes or we can blame a myriad of external causes for those failures and become discouraged.

Ultimately, the best traders don't try to figure out all of the market's peculiarities. They follow their methodology and find great mental freedom in following their rules and structure. They've created their own playing board, their own mental market world. They are absorbed in it and find pleasure in marveling at all the subtle nuances they have discovered.

I can share with you the mental world I have created, the game board that I play on. I can give you tools to build your own playing field. I can inspire you to be a better trader, and I can help you to believe that you can achieve your dreams and dream even bigger. But you must apply the necessary energy yourself. There is no substitute for the hard work it takes to organize yourself and your trading plan or system. Being prepared will be the key to your success.

Trading With The Edge

Successful traders who have demonstrated longevity in this business have one thing in common: a consistent methodology with a demonstrable edge. You cannot trade profitably over the long run without an edge. What is your edge? How are you going to have an advantage over everyone else? Your edge will come from following a methodology that has a proven, quantifiable positive expectation. Your edge will come from recognizing the type of market environment that favors your particular methodology. Your edge also comes from avoiding certain market environments that you know are not suitable to your trading style or skills. You must know what works and doesn't work for you. Your edge is in your ability to quickly admit when you are wrong and revise your game plan. You may also have an individual edge such as having fast reflexes, exceptional execution skills, or perhaps an ability to recognize and react right away to a trade that isn't working. To KEEP your edge, be prepared in all ways for each trading day. Lastly, you must BELIEVE that you have an edge. This belief comes from doing your own research and preparation. It is this belief that will motivate you to achieve superior performance.

There is no such thing as a wrong methodology if it can be proven to have an edge over time. Many successful traders employ many different styles of trading, execution and money management. The ideas presented in this manual are 100% technical. It is a basic tenet of technical analysis that the most important fundamentals have already been discounted in the market's price. Fundamentals may affect the longer-term trend. However, a professional trader is concerned with capitalizing on the short and intermediate price swings, and these are often caused by human emotions, such as fear and greed, in addition to fluctuations in supply/demand.

Once you can apply a trading process consistently, your profitability will all come down to simply executing trades. You won't make money if you don't pull the trigger. Confidence is what will keep you consistently placing the proper trades on a regular basis. Confidence comes from doing your own research, staying involved in the process and taking each moment one at a time, observing a pattern repeat itself numerous times, and gaining experience in execution and organizational skills.

If you pick one style and stick with it, you will not only gain confidence in that style, but you will begin to learn its subtle nuances (giving you a further edge). If you continually trade with an edge, you will make money. Stick with one methodology and take all the trades.

To summarize the key points:

- Develop a consistent framework for following the market's action.
- Develop your own process (routines, rituals, research) to take advantage of the price action within this framework.
- Believe in your process.
- Trades made must come from this process, rather than "randomly."
- Stay involved in the process and emotionally detached from the outcome.

Principles of Price Behavior

There are four basic principles of price behavior which have held up over time. Confidence that a type of price action is a true principle is what allows a trader to develop a systematic approach. The following four principles can be modeled and quantified and hold true for all time frames, all markets. The majority of patterns or systems that have a demonstrable edge are based on one of these four enduring principles of price behavior. Charles Dow was one of the first to touch on them in his writings.

Principle One: A Trend Has a Higher Probability of Continuation than Reversal

This is one of the basic tenets of Dow theory. An up trend is defined as BOTH a higher high and a higher low, and vice versa for a downtrend. For example, in order to reverse from an up-trend to a down-trend, the market must make a lower low and a lower high and then turn DOWN from there. If the market is in a well-defined trend, the largest price swings tend to occur in the direction of the trend. When the price is moving in a clearly defined trend, there are numerous strategies for entry based on the small retracements that occur along the way. These reactions allow the trader to find a tight risk point while still playing for a new leg in the direction of the trend.

A few notes on trends:

- Once a trend is established, it takes considerable power and time to turn it.
- A major trend seldom reverses without warning, such as a pronounced loss of momentum followed by a period of accumulation or distribution, or a buying or selling climax.
- In strong trends, reactions become shallower as the trend progresses.
- The absence of any pattern or swing in the price implies a continuation of the prevailing trend. The strongest trending action tends to be accompanied by a decrease in volatility. This could be describes as a methodical eating away of overhead supply, or a slow, steady price deterioration in the case of a downtrend.
- Trends tend to begin after the market has wound down to an equilibrium level. Just as volatility collapses in the middle part of a trend, price action can become more parabolic in the later stages of a trend. In some extreme cases, 75% of the gains can come in the last 20% of the move.

Principle Two: Momentum Precedes Price

If momentum makes a new high or low, the price high or low is most likely yet to come. Momentum is one of the few “leading” indicators. Elliot used the term “impulse” to refer to an increase in the market’s momentum. Impulse indicates an imbalance in the supply demand equation and most often occurs in the direction of the prevailing trend. A trader should look to enter in the direction of the market’s initial impulse. New momentum highs can be made in both a trending environment, or on a breakout of a trading range. New momentum highs or lows should correspond with a new price high or low as well.

Momentum can be defined using a number of different types of calculations or oscillators. A simple rate of change, such as a 2 or 10-period rate of change is a momentum indicator. Moving average oscillators or an RSI will make new highs or lows when momentum makes new highs or lows. Range is highly correlated with momentum. New highs or lows in a momentum oscillator accompanied by range expansion also confirms new momentum highs or lows. An increase in range is a sign of “impulse”.

A trader should look to establish new positions in the market on the first reaction following a new momentum high or low. The only exception to this rule is after a market makes a buying or selling climax. This is not a new momentum high or low, but an exhaustion point that creates a vacuum in the opposite direction.

A trader can enter a trade “at the market” when new momentum highs or lows are made following a breakout from a trading range. In an already established trend, a mild pullback or consolidation will be more likely then new momentum highs or lows following a breakout.

Principle Three: Trends End in a Climax

A trend will continue until it reaches a “buying or selling climax.” This tends to be marked by an increase in volatility and volume. Ideally, there should also be a marked increase in the range. A buying or selling climax indicates that the last buyer or seller has been satisfied. The market then usually begins a process of backing and filling, testing and retracing, and in some cases, has a greater reaction in the opposite direction.

Trends tend to go further then we think they will and often, the price “overshoots” on the extremes. Price is at a new level and nobody has had a chance to get comfortable with the new levels. The market will tend to begin a testing process in both directions until it reaches a new equilibrium level. It is rare that a market immediately begins a sustained downtrend after it has been in an up trend. Thus, a trader should be prepared to trade in both directions for a while after a trend has ended and not be too eager to set positions in the opposite direction. The process of consolidating back to a new equilibrium point can be a long and drawn out process.

There are a smaller percentage of times where a market makes a “V” spike reversal following a buying or selling climax. This is the most powerful pattern in technical analysis as it creates a vacuum to the other side. In these situations, the market sharply reverses its direction without the normal consolidation period. This type of pattern does not happen very often, but has powerful forecasting implications when it does.

Principle Four: The Market Alternates between Range Expansion and Range Contraction!

Price action tends to alternate between two different states. The market is either in a trading range environment trying to wind back down to an equilibrium level, or it is expanding in range with impulse, indicating a persistence supply demand imbalance. This mark up or mark down phase persists until it reaches a new level. One a new level is reached; the testing process will begin all over again as the market winds back down to an equilibrium level. And, once again, when a market has narrowed in range and found an equilibrium level, it is difficult to predict the direction of a breakout. On occasion, the market will move first in one direction and then move sharply in the opposite direction. Volume is a useful confirmation took that the range expansion is for real.

BASIC MARKET STRUCTURE

The market moves in up and down waves that form “swings”. The pattern made by these swings is what is used to define an uptrend or a downtrend. The highs and lows of the waves are used to define “support’ and “resistance” levels. A trader or technician does not care about the fundamental reasons that are behind an up wave or down wave. The main concern is which waves offer the greatest trading opportunities.

An up-trend is defined by a pattern of higher highs and higher lows. When a market reverses the trend from up to down, it must first make a lower high <u>and</u> a lower low, or, a lower low and a lower high, and THEN turn down from there (meaning take out the last swing low for confirmation

Any method used to define the trend will have spots of ambiguity as well as signals that fail to generate follow-through. Any method used to define a trend, will also be confirming a trend reversal well after the high or low of the prior trend has been made.

There are 5 types of trading signals generated by the patterns formed by the waves.

1) Buying a down wave in an established up trend or selling an up wave in an established down trend. This is a simple retracement entry in the direction of the prevailing trend.

2) Buying a corrective A-B-C down wave in an up trend (Power Buy) or selling a corrective X-Y-Z up wave in an overall downtrend (Power Sell). This is a complex retracement formation in the direction of an established trend as opposed to the simple reaction noted in point 1. It should appear as a simple retracement on a higher time frame.

3) Entering at the point of a trend reversal from down to up or up to down. Note: A trend reversal can be seen as occurring when a power buy or power sell has failed to lead to a new high or new low. When the market makes a new lows after a failed power buy – this is the point of confirmation of a trend reversal as well as a breakout point. The “sideways line” that forms when a market is going through the trend reversal process is what gives the market power for a larger move in the opposite direction.

4) Shorting a failure test at the end of an up trend or buying a failure test at the end of a downtrend. A failure test is a lower high or higher low at the end of a swing. This is a more aggressive type of trade since it is against the prevailing trend and thus a stop right beyond the most immediate swing must be kept in place. isk but also, but lower

5) Entering on a breakout from a formation in which the waves have had considerable overlap as well as a shortening in either amplitude or duration. The corresponding chart formation often appears as a long rectangle, triangle or wedge. A period where the waves overlap each other for an extended period forms a "sideways line" and can also be called a coil. Breakouts are especially powerful when converging trendlines can be drawn around the chart formation.

Market technicians have used an assortment of ways to define a "wave". Percentage up or down from the most recent swing high or low, a price swing low or high that is bordered on both sides by two bars with lower highs or higher lows, range functions, and simple visual inspection are just a few of the methods that can be used. William Dunnigan originally explored percent swings versus range function back in the 1930's. Arthur Merrill expanded on this in his Filtered Waves book published in 1977. We prefer Average True Range functions similar to those published by Welles Wilder in his 1978 book, *New Technical Concepts*. Keep in mind that there are no "right" or "wrong" parameters when quantifying Waves. There are both pros and cons to varying the "sensitivity" levels for what turns a wave up or down.

The following are the parameters that are used in LBRGroup's back-testing and charting software applications.

Lowest low of last 14 bars + 2.5 ATR (Average True Range over 15 bar look back period) = Up-wave.

Highest high of last 14 bars – 2.5 ATR – point at which down wave begins.

A trader wishing to modify parameters can start by varying the ATR function or use the lowest close instead of the lowest low as the point by wish to measure a reversing swing.

Defining the Trend – summary:

All information used to define the waves that form reversal patterns comes from the raw price data.

Definition of an up trend: The market must make BOTH a higher high and a higher low, and then turn up from there. The up trend is confirmed when the last swing high is then taken out.

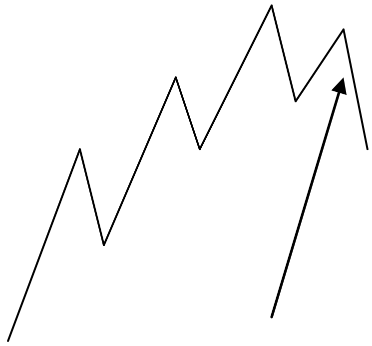
Definition of a downtrend: The market must make BOTH a lower low and lower high and then turn back down. The downtrend is confirmed when the last swing low is then taken out.

This classic method of defining a trend from the pattern of the swing highs and swing lows has occasional whipsaws as well as lack of follow-through, but it is the truest means and works just as well if not better, than complicated formulas or moving averages.

There can be a downtrend on the short-term time frame and an up-trend on a higher time frame at the same time.

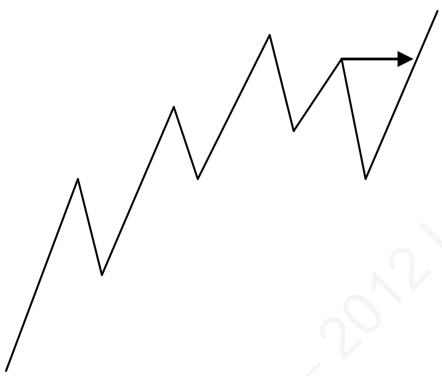
There will be periods where the true trend may appear to be ambiguous.

Trend analysis on multiple time frames is used to improve risk/reward ratios as well as determining leverage. If there is an established trend on multiple time frames, more leverage should be used. If two time frames are in opposing trends, the market is in a consolidation period and lower leverage should be used. Concentrate on the particular time frame you choose to trade on, but look at higher time frames to determine if a small or large target should be played for as well. The number one determining factor for which time frame to trade on should be the amount a trader can afford to risk.

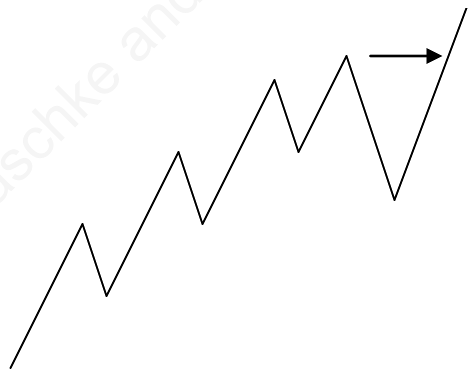


Lower High, Lower Low = Alert

Lower Low = Alert



Alert turns into Power Buy, new leg up



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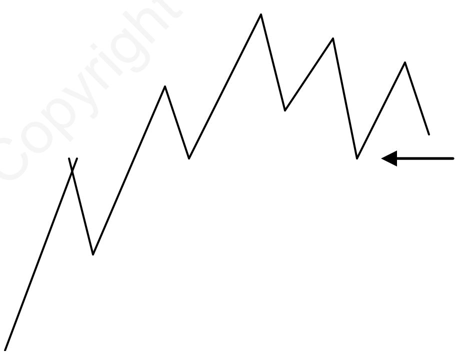
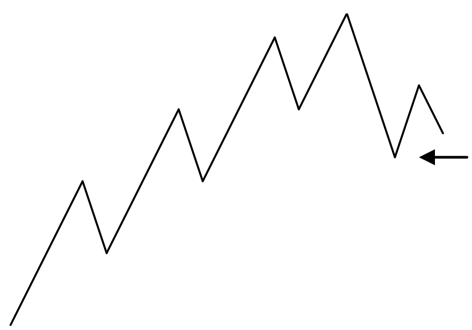


Alert turns into Downtrend which will be confirmed when it takes out the low



Alert turns into Downtrend which will be confirmed when it takes out the low

Classic Chart Formations as defined by Waves

All chart formations are comprised of variations of the patterns in the waves on some time frame. They represent areas where buyers and sellers come into temporary balance and the moves out of these balance periods can occur in the direction of the trend, or, in the opposite direction indicating a trend reversal. It is still the patterns in the waves that hold the forecasting value, though.

The danger in looking at chart formations without respect for analysis of the waves is that a trader will often “see” what he wants to see. The other trap traders fall into when looking at chart formations is looking for reversal or continuation patterns without analysis of the wave structure on a higher time frame, thus failing to pu a formation into a “context”.

Let’s examine how the waves form classic well-known chart formations, keeping in mind that all chart formations must be considered in relation to the structure on the higher time frames, or, the longer-term trend.

Bar Chart Patterns – Breakout Formations

The bigger the chart formation, the more potential for a trend move. The larger the chart formation, the higher the odds that it will prove to be a reversal formation as opposed to a continuation pattern. Head and shoulders chart formations are one of the most reliable formations when viewed in context of the pattern in the waves. Triangles, rectangles, wedges, and saucers or rounding bottoms or tops are some other more common classic chart formations. The most important considerations for chart formations is that the waves fluctuate on both sides of a central price level for an extended period, and trendlines can be drawn around the price action.

Continuation Patterns - Bull and Bear Flags

Bull or Bear flags occur when there is a well-defined trend. It occurs in the direction of the trend and is preceded by “impulse”, which is also what forms the “pole” for the flag.

When the market is in a trading range, there can often be the appearance of a bull or bear flag, but more often than not the pattern will fail to have any follow-through. It is also a trap to look for a bull or bear flags after a buy or sell climax. Trends end in a climax and too many times a trader will look to “fade” the first reaction after a climax. The best flag formations have significant “price bar overlap

Complex flag formations appear as a three part A-B-C retracements in a trend. These are often a bit longer in duration than a traditional flag or pennant pattern. According to Elliott Wave theory, about every third retracement pattern will be “complex” instead of a simple bull or bear flag.

V-Spike Climax Reversal Patterns

A “V” spike reversal is a climax pattern in which a push to new highs or lows leads to a sharp and dramatic price rejection. Though this pattern does not occur very frequently, it is one of the more powerful chart formations, as it tends to lead to a sharp swing in the opposite direction. There must be both range expansion and an increase in volume followed by a sharp reaction in the opposite direction that forms what is commonly called a “tail”. Noe: A well defined bull or bear flag will not leave a “tail”.

V-Spike reversals do not happen very often, but a trader must recognize the sharp reversal in momentum to the opposite direction and be ready to switch gears.

More Reading Material

There is much to be said for studying classic chart patterns, and there are plenty of books written on them. The best one of these is Schabacker’s original book called Technical Analysis and Stock Market Profits. The main points from this section to remember are:

1) Reversal patterns can take a long time to form.

2) The longer the chart formation, the greater the odds that it will be a reversal pattern.

3) The best short term trading patterns are the brief “continuation” patterns such as bull and bear flags.

Technical Indicators

A well-trained eye will be able to see the wave structure as well as chart formations without the use of technical indicators. However, there are many times when indicators can serve as a crutch for the eye and aid in picking out patterns or adding overall structure to the price data. Looking at the patterns that the waves form is an OBJECTIVE technique with which hard and fast rule-sets can be applied. Bar Chart formations are SUBECTIVE, in that it is easier for the human eye to see what it wants to see or erringly note a bull flag when the market is still in the middle of a trading range. It is difficult for scanning software to apply analytics to either waves or bar charts, but it is very easy to process technical indicators that help narrow the numbers of setups or markets from a large data base.

There is no such thing as a right or wrong technical indicator or parameter setting for an oscillator or moving average. Understand that there is little statistical edge in any of these tools as their main purpose is to highlight patterns. As a rule of thumb, it is better to use fewer rather than more indicators.

20-PERIOD EXPONENTIAL MOVING AVERAGE

Moving averages are of most use in a trending market are most often used to define the upper and lower end of a channel. Just as continuation patterns have little value while price is in a trading range, moving averages have little value for providing support or resistance in a trading range. The longer the moving average, the fewer times the market will retrace back to it and is best used to highlight the trend on the highest time frame. A shorter period for the moving averages will contain the many small jiggles along the way. A 20-

period EMA contains the intermediate trend and will contain numerous small continuation /consolidation patterns.

It is preferable to keep the same parameter settings for all time frames and all markets since the eye gets conditioned to see the charts a certain way. Keeping the settings constant will keep your analysis consistent. Once your eye gets comfortable looking at things a certain way, don't make too many changes.

To summarize, moving averages are shortcuts to assessing the degree of trend and are used for "eyeballing" support and resistance quickly.

KELTNER CHANNELS

Keltner Channels are based on an Average True Range[1] function centered around a moving average. We use parameter settings 2.5 times the Average True Range (smoothed by 20 periods) centered on the 20-period EMA. This contains between 90 – 95% of the price action.

A strong impulse move or thrust is needed to push the price through the Keltner Channels. The market must move greater than 2.5 times its average true range, which implies a large imbalance between the buyers and the sellers. A penetration of the Keltner Channels is an indication of momentum and leads to continuation of the trend about 66% of the time. (Momentum precedes Price).

A number of well-known mechanical trend following systems rely on a large standard deviation move to signal market entries. Our testing shows that average true range functions are preferable to standard deviation functions, and thus we have found more value in Keltner Channels than in standard deviation bands.

OSCILLATORS

Oscillators are calculated using a derivative of price and thus most oscillators will appear very similar in shape. Stochastics, RSI, Moving Averages oscillators and MACD are some of the more widely used oscillators. They are most useful in active swinging markets and will have less value in a flat, sideways market. When volatility is low and there are smaller and fewer price oscillations to measure, a turn up or down in an oscillator will be less meaningful. Oscillators are most commonly used to highlight retracements after price impulse, as well as to indicate a loss of momentum (which appears as a divergence). They can also be used to indicate an overbought or oversold condition when the market is still in a trading range. On the flip side of the coin, they can be used for confirmation of a

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[1] Average True Daily Range is the highest high minus the lowest low for the bar plus any unfilled gap area if the range is outside that of the previous bar.

Chester Keltner was a commodity trader and analyst for over thirty years. He was one of the first to pioneer systems using trend following rules. One of the systems he originally created was called the "Ten Day Moving Average Rule". A ten-day moving average of the daily trading range was added and subtracted to a simple 10-period moving average, thus forming "bands". These bands functioned as buy and sell levels by which to enter a position. His original system was traded on a stop and reverse basis, which was mildly profitable to the degree that any trend following system would be.

price breakout if they make a new momentum high or low along with new highs or lows in price.

Since oscillators are a derivative of the price, they highlight information already present in a simple bar chart. They are useful in helping to assess a small amount of data in a brief period of time. There are no “right or wrong” oscillators, nor are there any optimal parameters for an oscillator. Pick one oscillator and stick with it.

The 3/10 OSCILLATOR

The “3/10 oscillator” is created by subtracting a 10-period simple moving average from a 3-period simple moving average, and then creating a 16-period simple moving average of the 3/10 oscillator. These two lines are useful in confirming wave structure or highlighting chart formations. We call the 3/10 line as the “fast” line, and the 16-period SMA the “slow” line or trend line.

THE PRICE PULSE – THE MAIN PRINCIPLE BEHIND THE 3/10 OSCILLATOR

The 3/10 is a relatively sensitive oscillator and often highlights the “pulse” in the market’s action. Tony Plummer best describes this “pulse” in his book, “Forecasting Financial Markets”. It describes a “negative feedback” conditions that is present in the market about 80% of the time.

The theory behind the Price Pulse goes as follows:

The market is considered to be a “dynamic system” due to crowd behavior, (which is often non-rational, compulsive, and emotional). The two opposing forces of demand and supply are wrestling to find an equilibrium price level as new information is constantly entering the system. The majority of the time, new information leads to a push in price. As the information is digested the market reacts back in the opposite direction. The market moves in one direction until it receives new information. Then it reacts back in the other direction as traders digest the new information. This reaction casts doubt into the crowd’s mind about the market’s original direction, creating a movement in the opposite direction. The principle of a dynamic system is that new information is always coming in and influencing the action/reaction sequence.

A complete pulse is comprised of an A-B-C wave up followed by an X-Y-Z wave down. These waves are sometimes easier to see in the shape of the 3/10 oscillator than in the price charts themselves.

The most reliable oscillator signals tend to occur when the market is in a negative feedback mode, and this is when there is an identifiable “price pulse”, or wave pattern. When the market is in a negative feedback mode, there should be active trading and reasonable length of swings in both directions. This is a healthy volatility environment for the short-term trader.

In a “positive” feedback environment, new information received reinforces the move already underway. Each new price level serves as a catalyst to advance the price even further in the direction of the prevailing movement. Often, a vicious cycle is formed as stops are triggered, one side of the market is squeezed, trend following systems add to existing positions, and the cycle repeats forming a runaway price movement.

Avoid using oscillators after a volatility extreme such as a buy or sell climax. Avoid using oscillators when the trading range is too narrow and volatility is low.

TRADING PATTERNS USING THE 3/10 OSCILLATOR

Following are the patterns that I like to look for with the 3/10 oscillator:

FIRST CROSS BUY/SELL

The “First Cross” is analogous to the first higher low or lower high that occurs on a bar chart as a trend is beginning to reverse. The First Cross occurs when the “trend” line first crosses from below to above the zero line, and the 3/10 oscillator then pulls back below the zero line. This indicates an initial buy condition. A sell setup would occur the first time the 3/10 oscillator retraces above the zero line after the “trend” line has crossed from above zero to below zero. A chart pattern showing a lower high should always confirm the initial oscillator pattern.

The First Cross pattern is intended to highlight a potential “failure test” or the first retracement after a trend reversal.

Always remember that an oscillator pattern indicates an initial condition only. Price must serve as the trigger for entry and a stop should always be placed once a trade has been established.

INTERMEDIATE BUY/SELL

This setup highlights a classic price retracement in an already established trend. Price has been trading above the 20-period EMA and the “slow” line or “trend” has been above the zero line for multiple bars. Price retraces and finds support/resistance around the 20-period EMA at the same time the 3/10 oscillator retraces below the zero line. There may be times where the oscillator retraces all the way back to the zero line but price does not retrace all the way back to the EMA. This is a sign of strength (or weakness in the case of a downtrend). A shallow bull or bear flag will accompany the best setups on the bar chart.

There is a strong correlation between price being above the 20-period EMA and the trend line staying above zero.

Always remember that oscillator patterns drop off in reliability when there is a narrow sideways trading range. A low ADX reading can be used to filter out potentially false oscillator signals. An Intermediate Buy or Sell signal is not valid if it is accompanied by a low ADX reading.

The Grail trade that was popularized in the Street Smarts book will have this pattern on the 3/10 oscillator. A Grail setups is distinguished by times when the ADX reached an unusually high level, showing the trend has stronger then average momentum.

3/10 ANTI

The “Anti” pattern captures a bull or bear flag type of formation that actually occurs in a trading range environment as opposed to a truly trending market. This is one of the few patterns that indicates a good entry in the middle of a range. The “Anti” will fall in the middle part of the Price Pulse on the 3/10 oscillator (A-B-C reaction up or X-Y-Z reaction down).

The Anti occurs when the slope of the “trend” line has just turned positive. It does not matter whether it is above or below zero, but more often then not it will still be below zero in the case of a buy set up. The 3/10 or “fast” line pulls down towards the trend line but the price does not give up any ground. The pattern should resolve itself with a move out of the small chart formation equal to the move leading into it. In other words, the initial objective is for equal length swings.

The Anti should be preceded by Impulse or momentum, much as a flag formation has a pole. Ideally, the previous upswing must be greater then the previous downswing in the case of a long set up. (Demand should be overcoming supply).

Anti setups are also recognizable using a stochastic indicator. The trick here is to set the length of the %D to a longer period than the %K. The parameters I use are a 7-period %K (smoothed by 3 or 4) and a 12-period %D. Different software packages calculate the stochastic in slightly different ways, so a stochastic might appear different from one charting application to the next.

10-BAR DIVERGENCE SIGNAL

Oscillator momentum divergences occur against the direction of the prevailing trend. The best buy or sell divergences form when the “slow line” on the 3/10 oscillator is already at a high or low level. The ideal divergences in the “fast line”, or 3/10 oscillator, tend to form within a 9 – 13 bar window. This means that price makes a higher high but the oscillator makes a lower high. The best trading divergences will come when the price is near the upper or lower Keltner Channel. This indicates that there has been a good price swing and prices may be short-term overextended.

Do not look for buy and sell divergences in a flat, range-bound market. False signals will appear when the market is just breaking from a triangle formation. Also, do not look at buy or sell divergences in a market where all time frames are making new highs or new lows.

Divergences occur naturally in strongly trending markets. Recognize that this is a countertrend trade. An absolute stop must be used at the time of entry. In the strongest of trend, price will fail to react back in the opposite direction when there is a divergence. Thus, a “failed” divergence will indicate a stronger move yet to come in the direction of the already established trend. Markets that are making new price highs or new price lows usually show multiple failed divergences.

Divergences do not imply an imminent trend reversal, merely a price correction. The best divergence setup will be a loss of momentum to the downside when the higher time frame is still in an up trend (or vice versa). In a trading range, a retracement back to the 20-period exponential moving average is the initial objective

A tradable divergences has more of a “W” or “M” shape instead of a “stair step” pattern which indicates continued impulse. Good divergences form after a momentum extreme, and this will occur if price has pushed to the Keltner Channels first. The move or break from a divergence formation should unfold within a few bars at most. If the market starts to trade sideways for a few bars, the trend is most likely still too strong, and the market can continue on sharply in the direction of the trend. To repeat, an absolute stop must be entered after initiating a countertrend trade based on a divergence.

ADX

ADX stands for Average Directional Index. It measures the degree of trend over a given period of time and is a “non directional” indicator. It is based off comparing the highs and lows of bars and does not use the close of the bar. The stronger the trend, the larger the reading regardless of whether it is an up trend or downtrend. A standard default of 14 is used.

When the ADX is low, it highlights periods where there is lots of price bar overlap (also called a sideways line or trading range). There is almost always a corresponding classical chart formation highlighted by a low ADX. This is because chart formations represent consolidation or areas of distribution/ accumulation. Large moves often occur once the market breaks out from these areas.

When the ADX has risen above 30, this indicates that the market has picked up enough momentum that any reaction should be followed by a retest. We like to call this the “Holy Grail” trade (as originally described in the Street Smarts book).

The initial condition for a Holy Grail setup is that the ADX rises above 30. Price must then retrace back to the 20-period EMA. Sometimes price can run a bit through the 20-period EMA, but it is expected to find support or resistance around this level. By the time that the price has retraced towards the EMA, the ADX will have turned down. This is OK. The objective for the trade is a retest of the previous high or low area.

Usually there is only one Grail trade in a market per time frame. However, occasionally a second grail set up if a strong trend resumes. The second grail setup is good only if the ADX has risen to a higher level on the second setup than on the first setup. Very often, divergences in the ADX and the market will precede a trend reversal (meaning price makes a higher high but the ADX makes a lower peak).

When looking at intraday charts for grail setups, you will increase your odds of a successful trade if you use multiple time frames. The best trades occur in situations where the ADX level is high on several time frames. The market should always retrace first to the shortest time frame’s moving average. For example, in a strong up trend the S&P should retrace to the 30-minute EMA first, find support and rally back up. The next retracement will be a bit deeper and pullback to the hourly EMA. After the hourly grail gets its objective, if there is still a rising ADX on the 120-minute chart, then it too tends to get its objective before the trend starts to lose power.

A failed Grail signal is an ominous sign and can lead to a greater move in the opposite direction. Failed grails will occur more frequently when a trader has failed to note that there is not a true trend and in fact, the market is still in an overall trading range environment. Failed grails can also occur if there are momentum divergences on the higher time frame.

It also pays to be aware if there is an OPPOSITE trend on the higher time frame. For example, if a small 5-minute grail Sale setup occurs when the hourlies are in a very strong up trend with a rising ADX (this has occasionally happened), it is best not to take the 5-minute grail sell.

The last thing to keep in mind is that though this pattern is one of the highest probability trades that can be made, it tends to come late in a trend Thus, play for a smaller objective level and use a tight stop.

Charts for Section 1 – Basic Market Analysis

Chart 1 - Trends have greater odds of continuation than reversal.

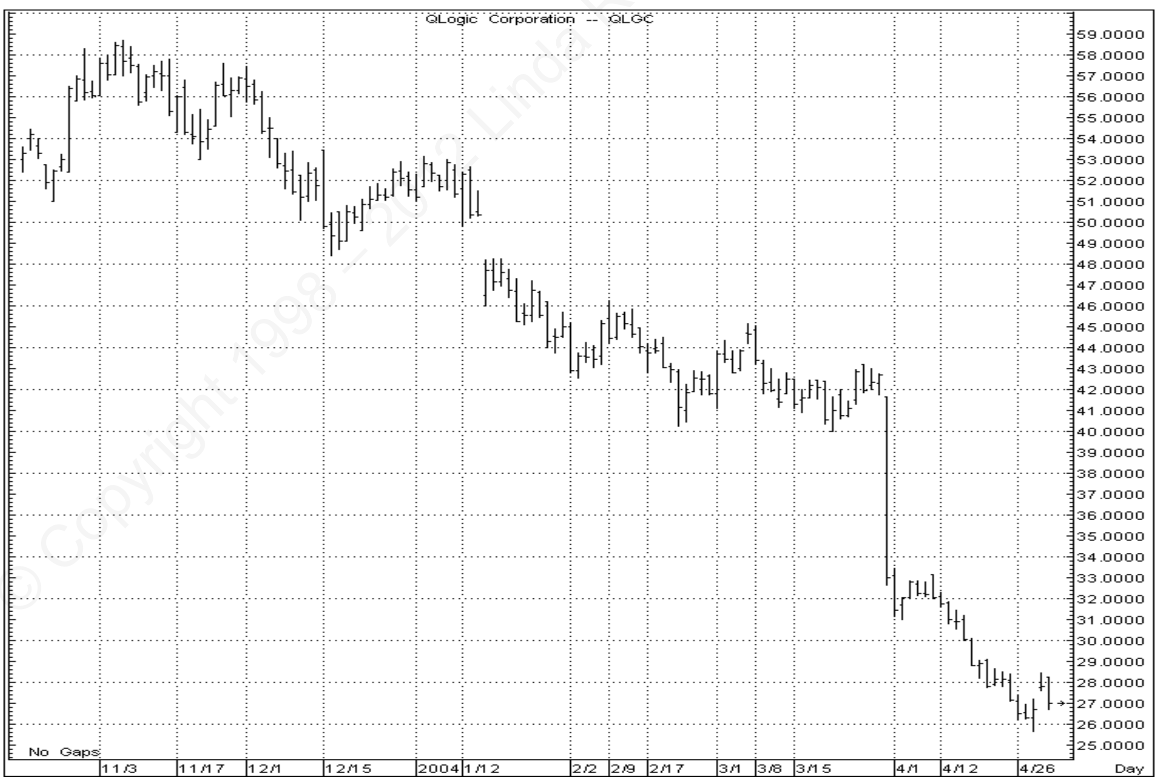

Chart 2 - A Trend seldom reverses without warning.

Chart 3 - Trends begin out of a low volatility environment.

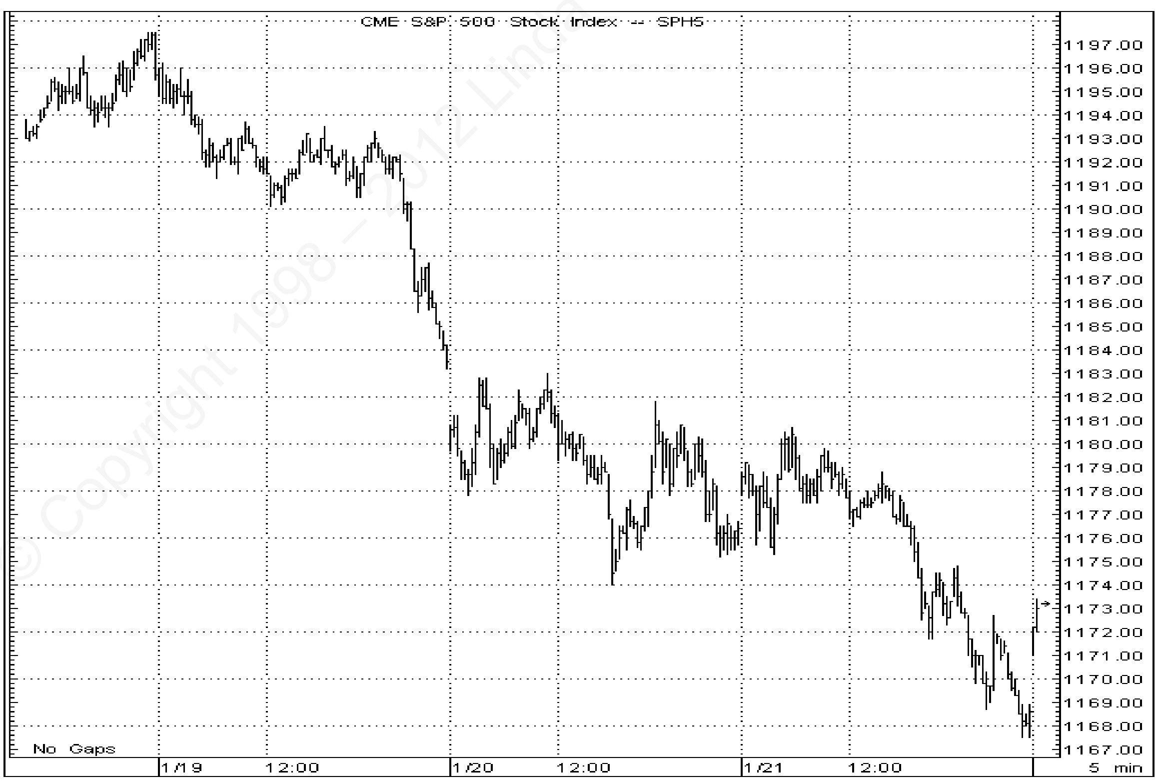

Chart 4 - Momentum Precedes Price! Impulse tends to occur in the direction of the trend.

Chart 5 - A trader should look to establish a position after a new momentum high or low.

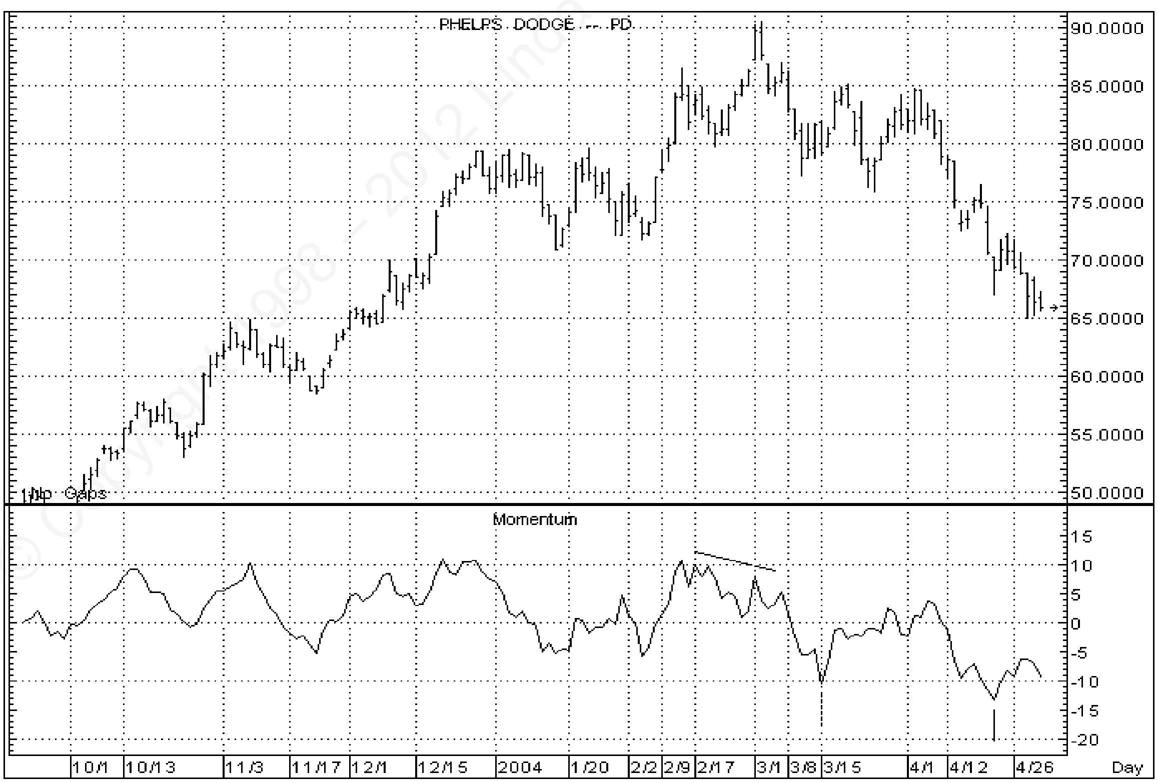

Chart 6 - A 10-period ROC is one type of momentum oscillator. As long as momentum makes new highs, continue to buy pullbacks.

Chart 7 - Trends end in a climax!

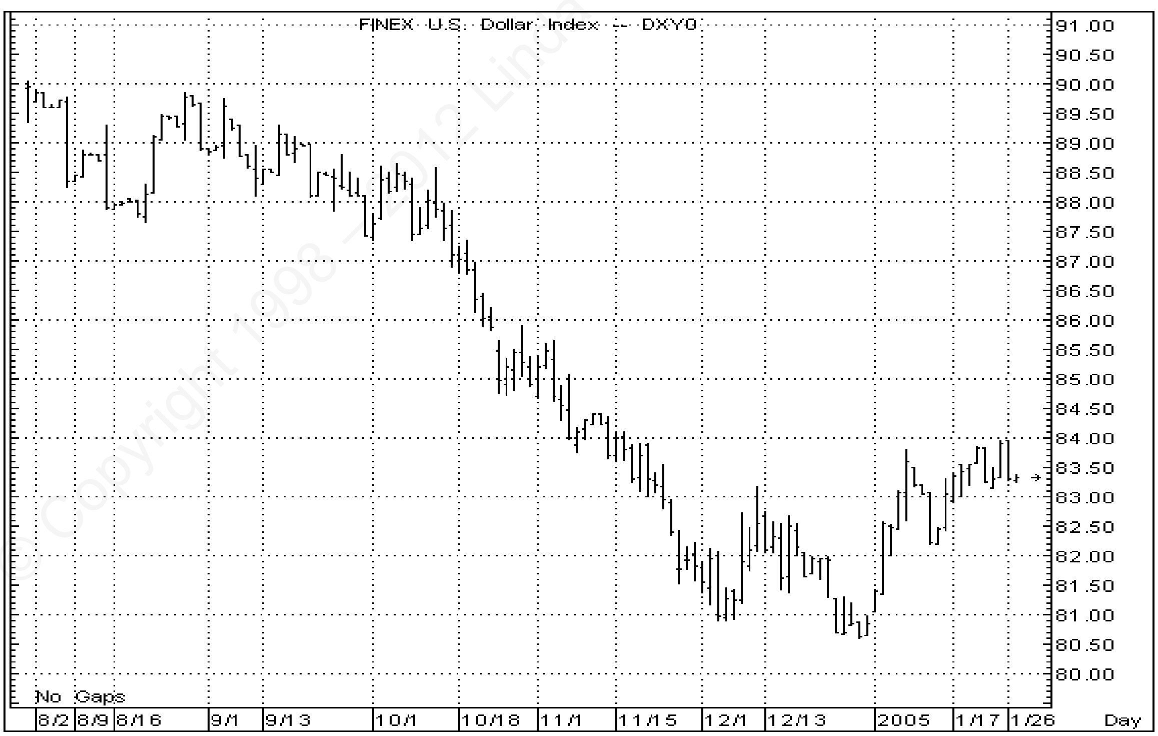

Chart 8 - A Trend Climax does not necessarily imply a trend reversal.

Chart 9 - The market alternates between range expansion and range contraction.

Chart 10 - On this intraday chart, it is easy to see how the market alternates between consolidation periods, and mark-up or mark-down period.

Chart 11 - Trends form after a breakout from an equilibrium level.

Chart 12 - The longer the sideways line, the greater the potential move. Note the breakout from the perfect "equilibrium point". This chart formation also had classic converging trendlines.

Chart 13 - Down waves in a well-defined uptrend are buying opportunities. A Failure Test at the top set up a short sale. The uptrend in still intact after a correction down, and a power buy sets up a long trade.

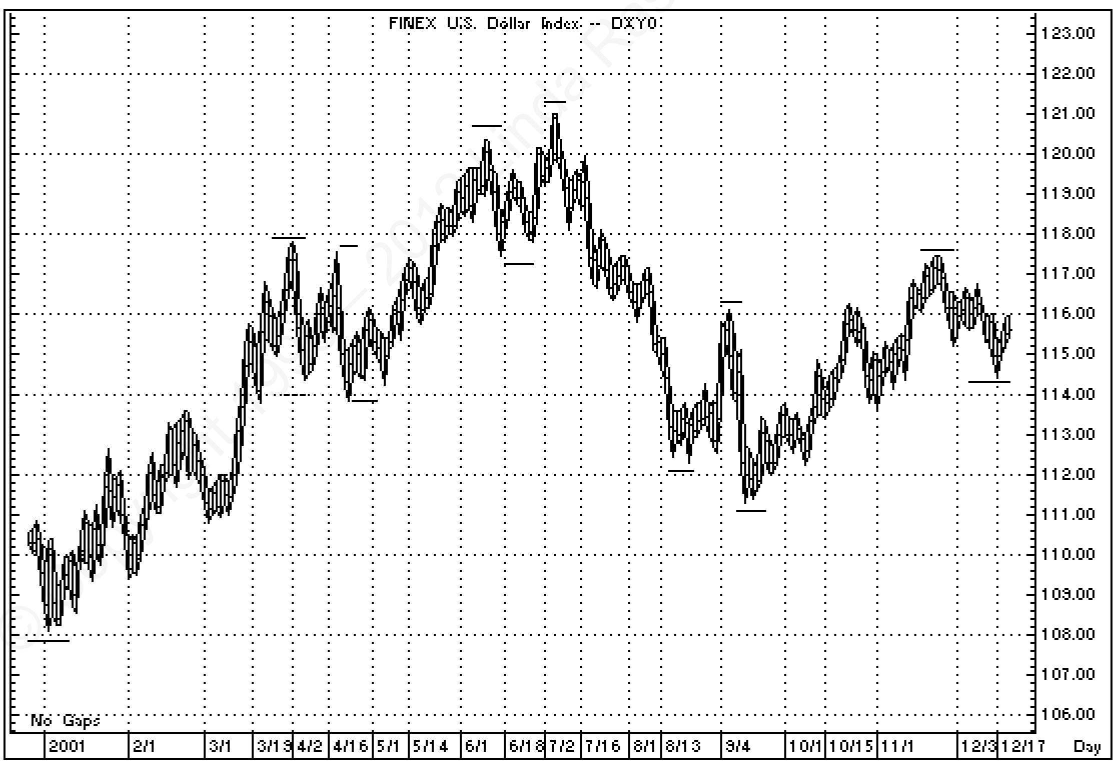

Chart 14 - The Power Buy led to a push to new highs. The downswings are still buying opportunitties. The right hand side of the chart could still be interpreted as a Power Buy (A_B_C dow off new hgihs). Note the sideways line that has formed though!

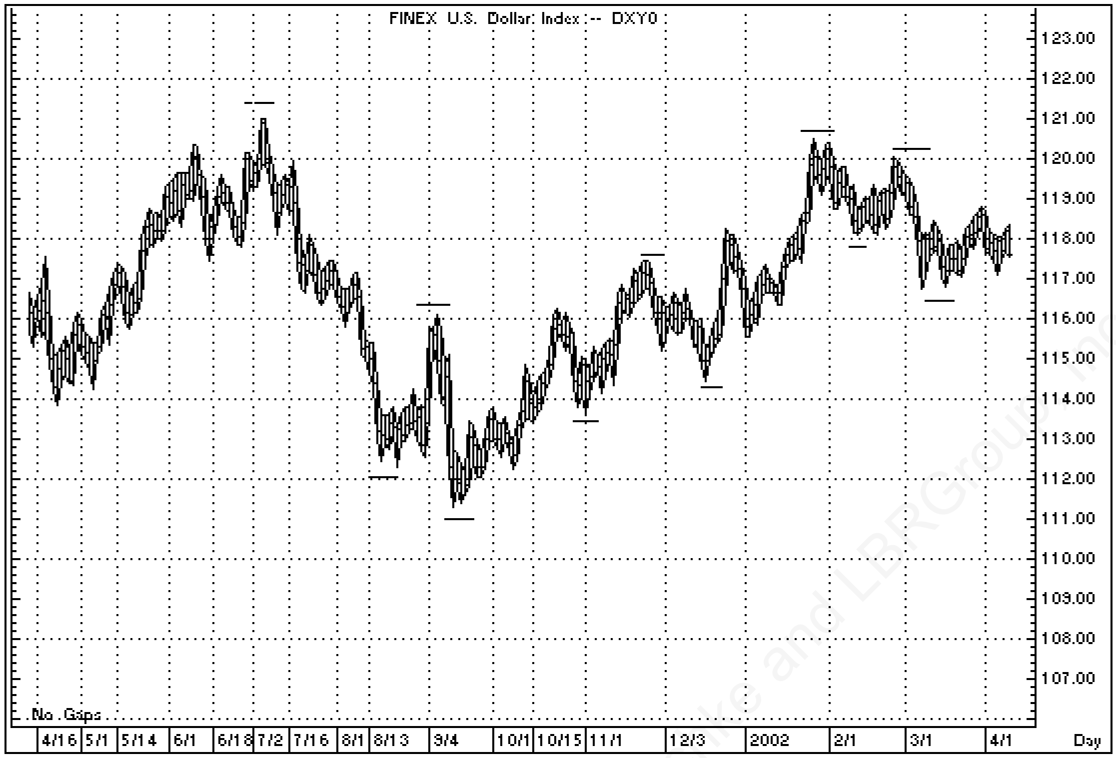

Chart 15 - The next push up fails to lead to new highs. Volatility is contracting as the swings are becoming shorter in length and duration. The uptrend is still intact.

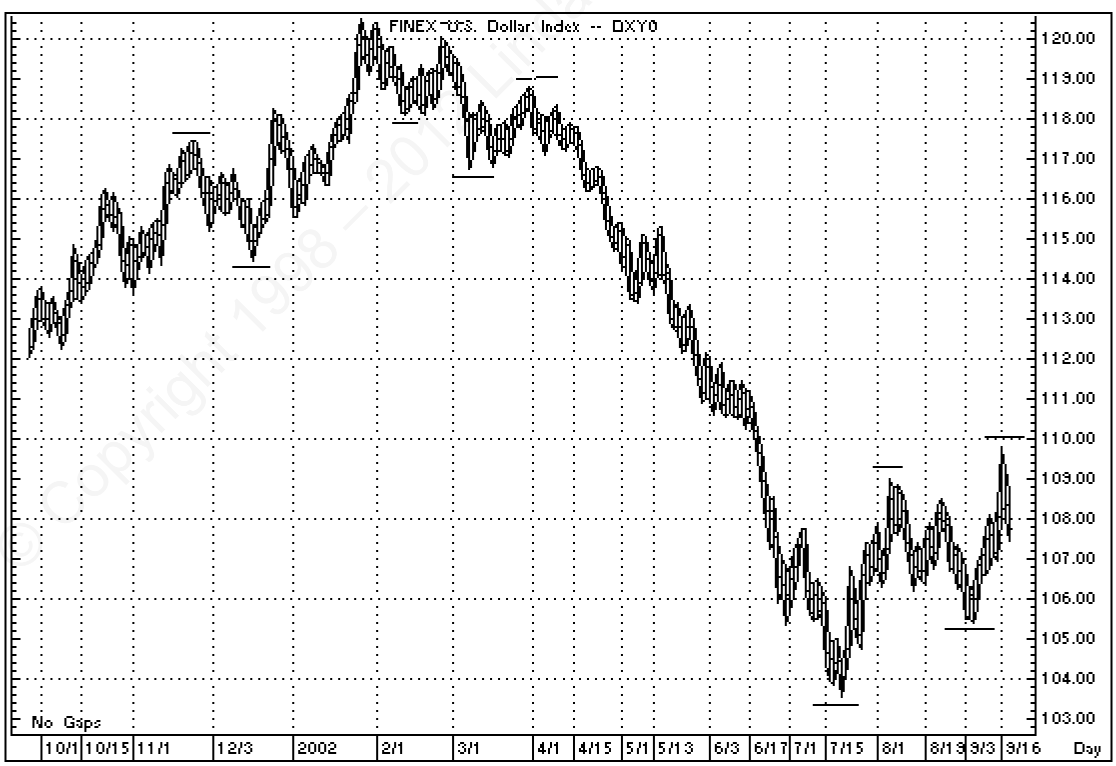

Chart 16 - The "failed Power Buy" sets the framework for a trend reversal. Upwaves are how shorting opportuntiites. A Power Sell leads to an eventual push to new lows.

Chart 17 – The Power Sell setup in the middle of the chart gave warning of potential for trend reversal - however, the warning was not confirmed and the break of the last swing low led to a new leg down. Shorting the next reaction up in July did not lead to any satisfaction, but the overall trend was still down. Yet another Power Sell setup formed, leading to a push to new lows

Chart 18 – The failure test at the lows set up a buying opportunity. Note how the lows of the swings were relatively close together. A failure Test plays for a small target. The push up still set up a shorting opportunity (Power Sell). The failed power sell led to a trend reversal BUY which was confirmed where the trendine is drawn in.

Chart 19 – The new up trend failed to carry very far. A Failed Power Buy led to a trend reversal signal. The downtrend was confirmed where the middle trend line is drawn. Even though the market then traded sideways for the next few months, technically the trend is down.

Chart 20 – The trend has once again reversed from down to up. The potential for trend reversal gave early warning in April. The uptrend was just recently confirmed. This time the swing to the upside is greater then the prior up trend's efforts.

Chart 21 – Where is the first sign of short term trend reversal and where is the point that new trend down was confirmed?

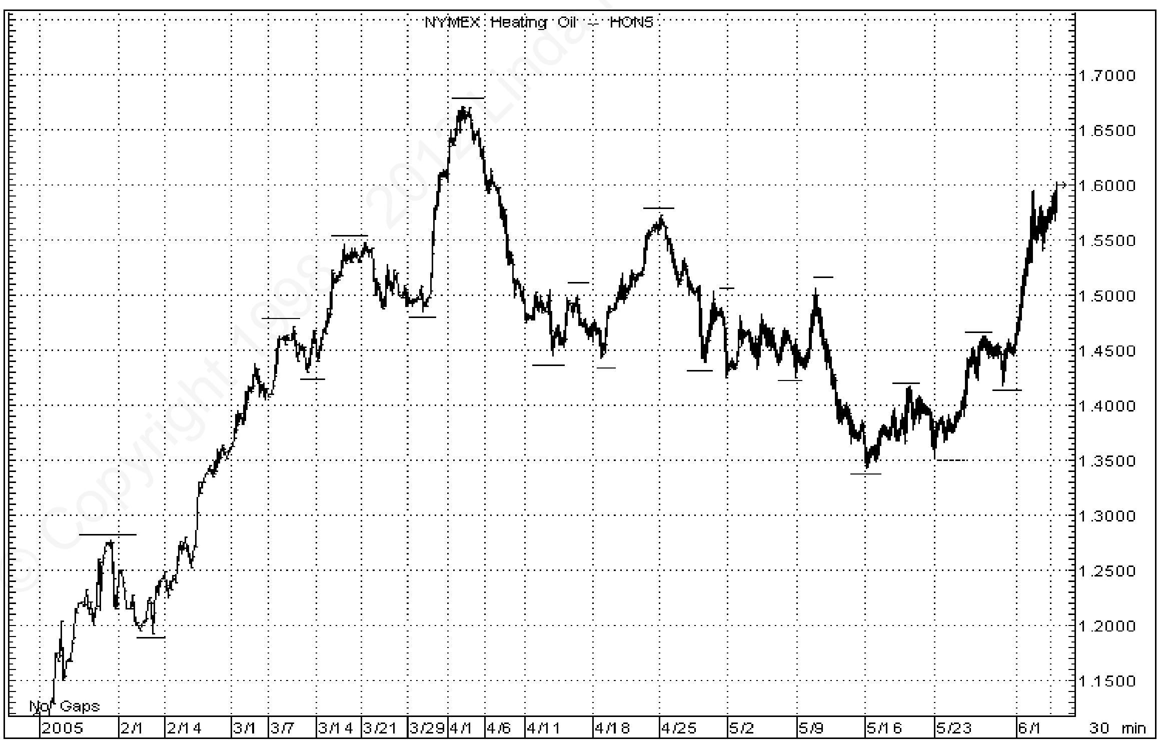

Chart 22 – Heating oil - interesting study - Did the break below support lead to continuation? At what point would the case for a downtrend be questioned? Where was the "Sweet Spot" on this chart?

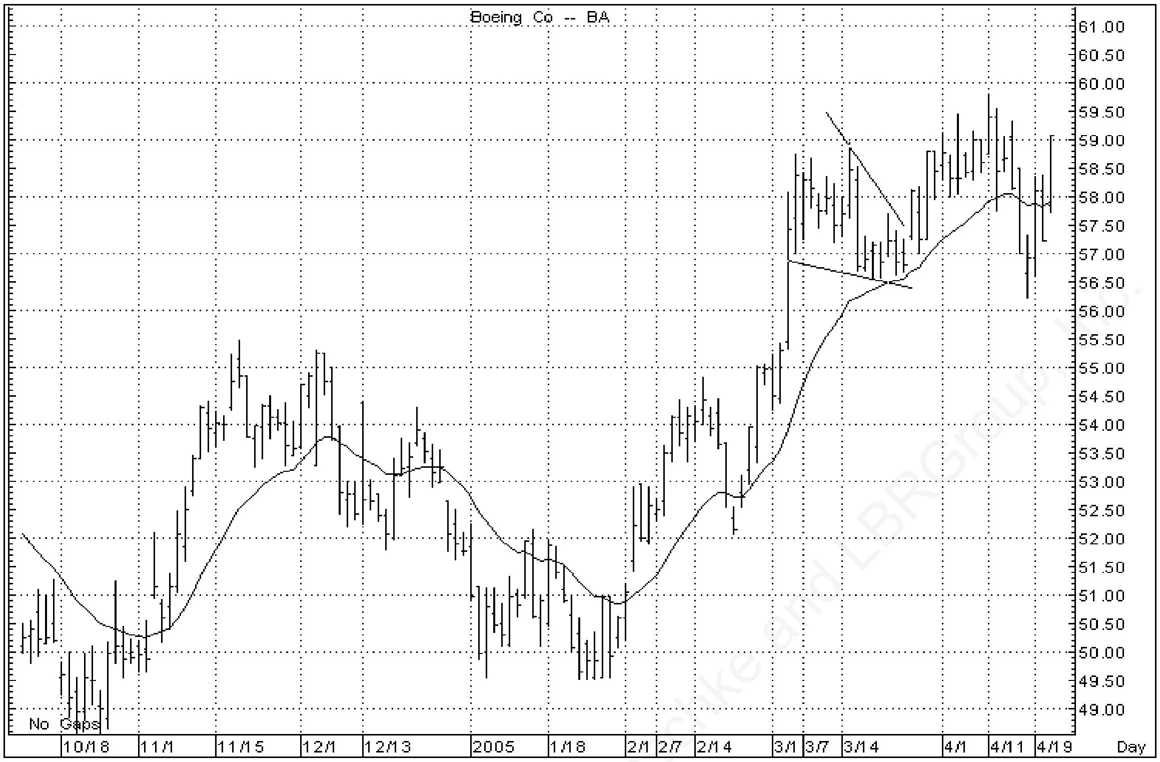

Chart 23 - A Classic flag formation in an uptrend. The pattern is preceded by a pole or momentum thrust and leads to a retest back up.

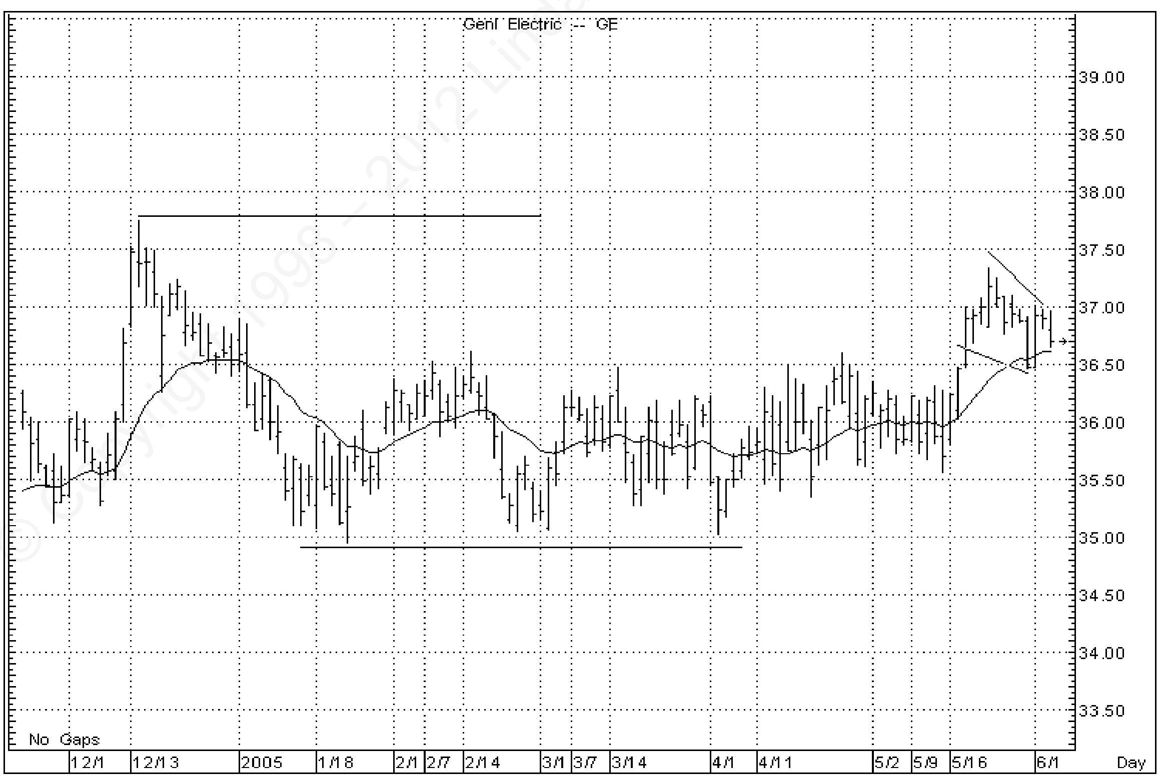

Chart 24 - This "flag" formation is suspect. The market is still in a broader trading range.

Chart 25 - A failed bear flag setup a U Turn buy, indicating a giant bear trap.

Chart 26 – U turn sell after three pushes up.

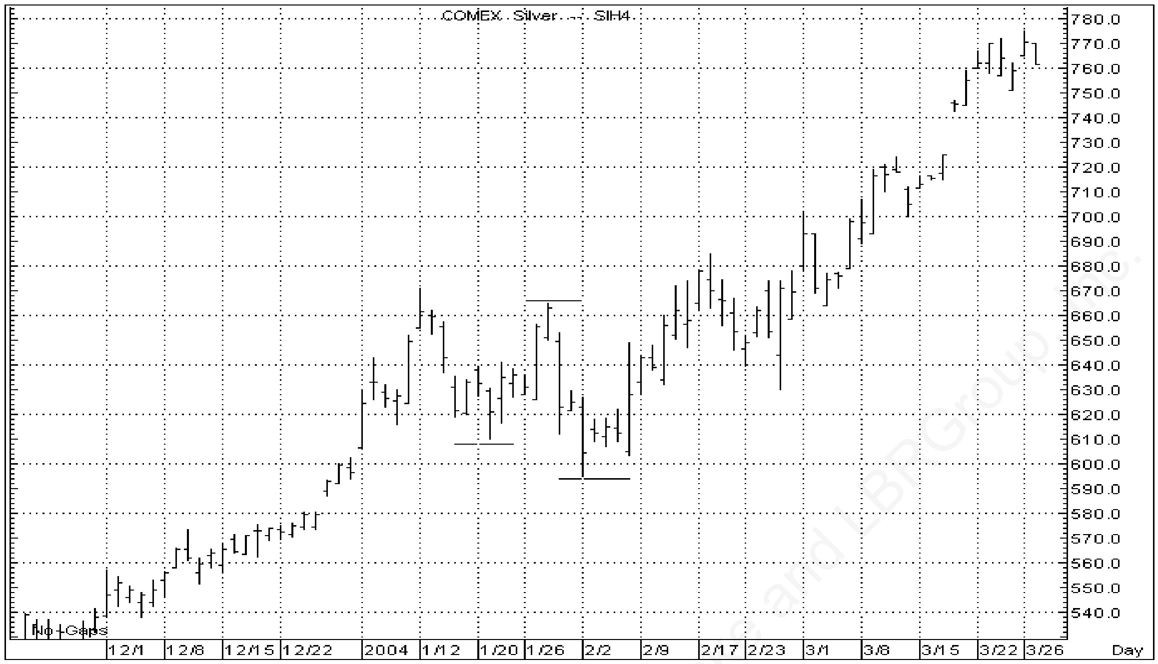

Chart 27 - An A-B-C continuation pattern in a trending market.

Chart 28 - Three pushes up on the hourly hogs.

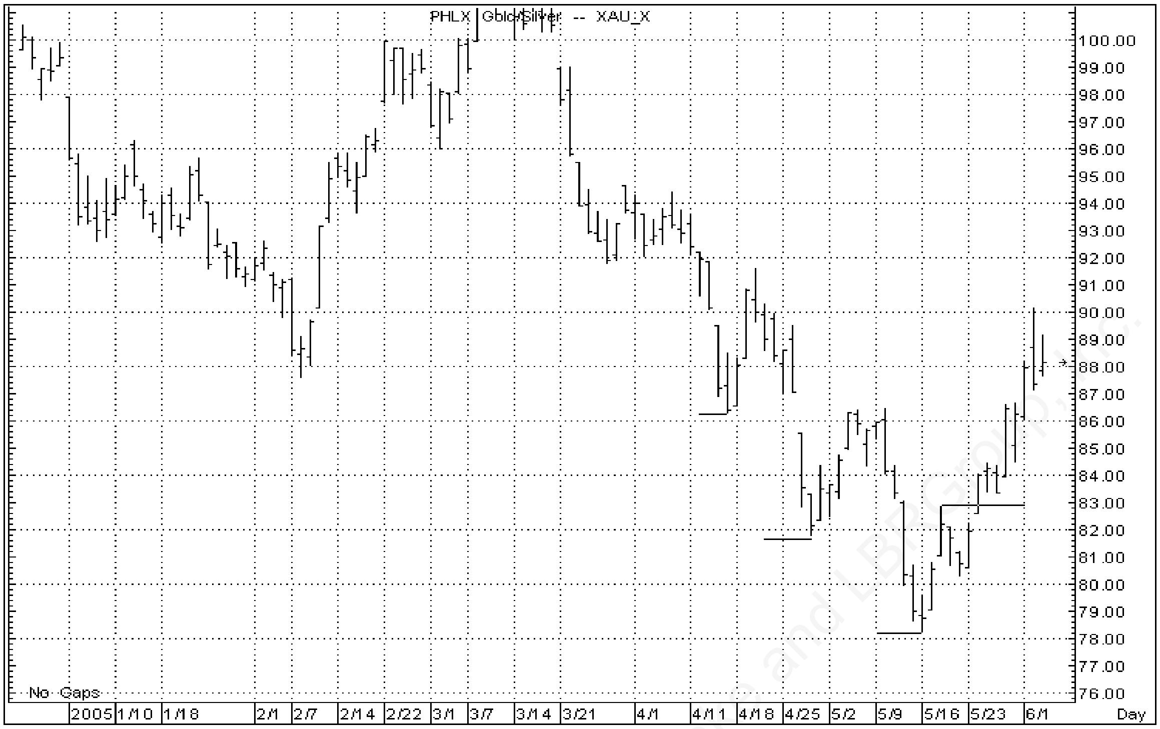

Chart 29 - Three pushes down on the XAU (followed by U turn BUY)

Charts for Section 1 – Indicators

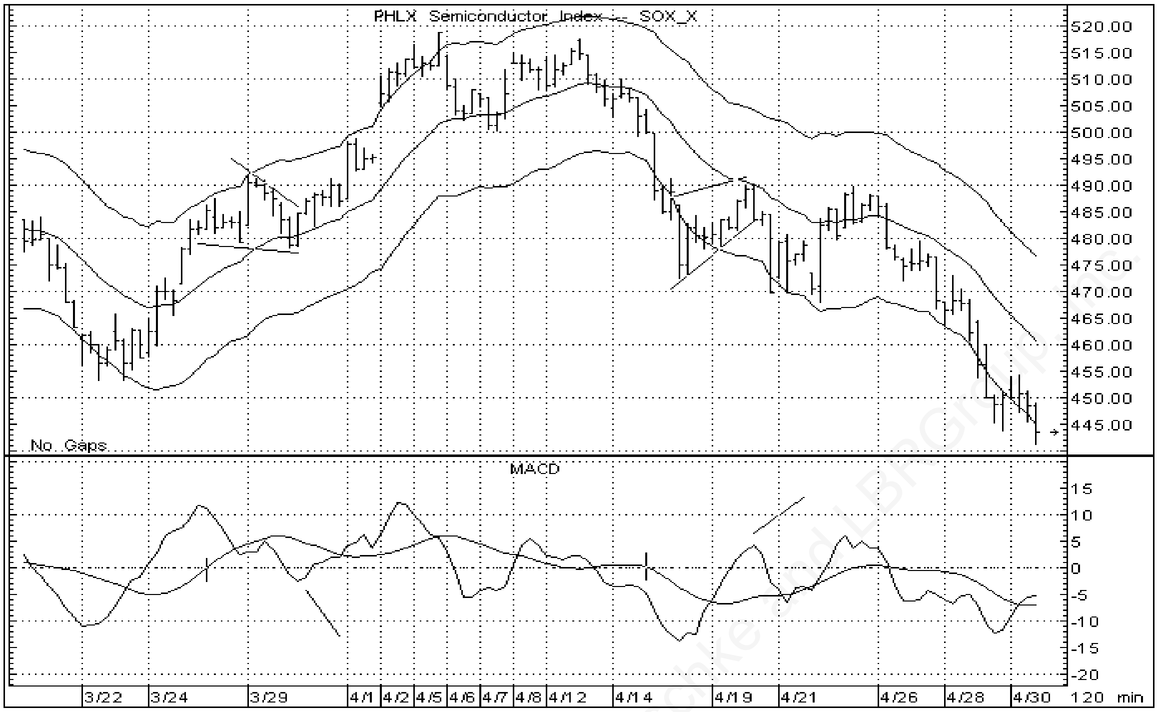

Chart 30 - First Cross Buy and Sell. Buy the first pullback after the "slow" line crosses above zero. The price should be making a higher low. The opposite occurs for Sell Setups.

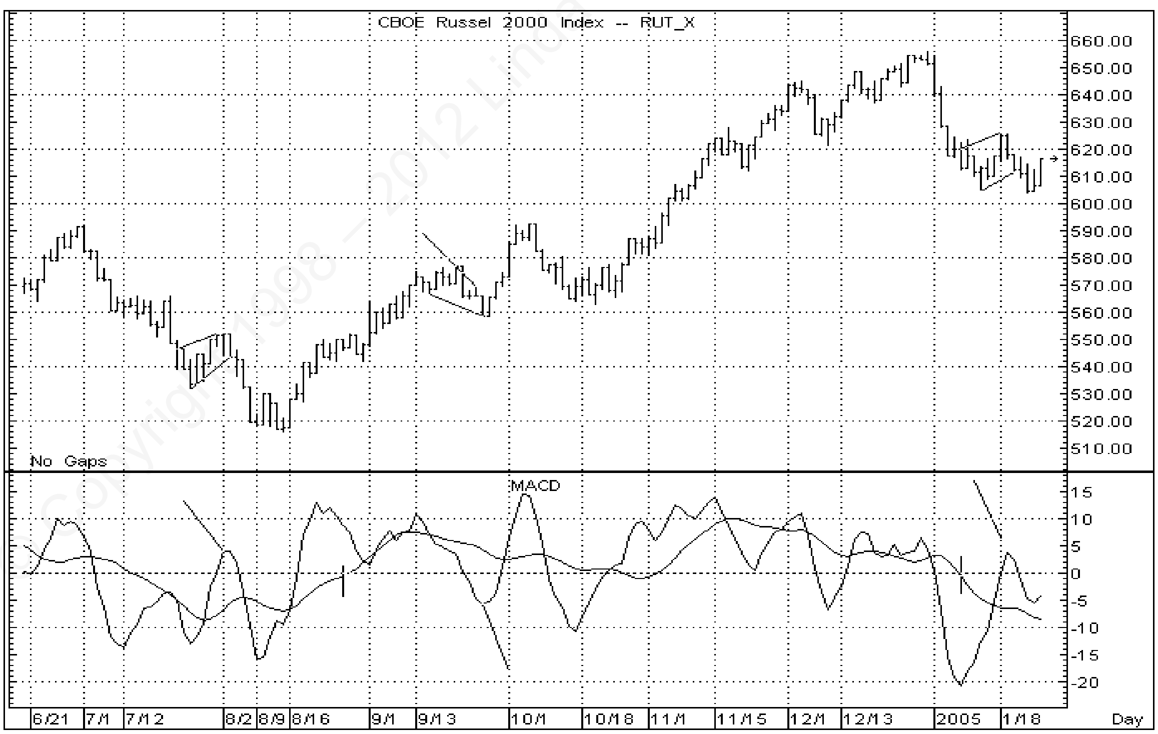

Chart 31 - More first cross Buy and Sell setups. Buy the first pullback after the slow" line crosses above zero. The price should be making a higher low.

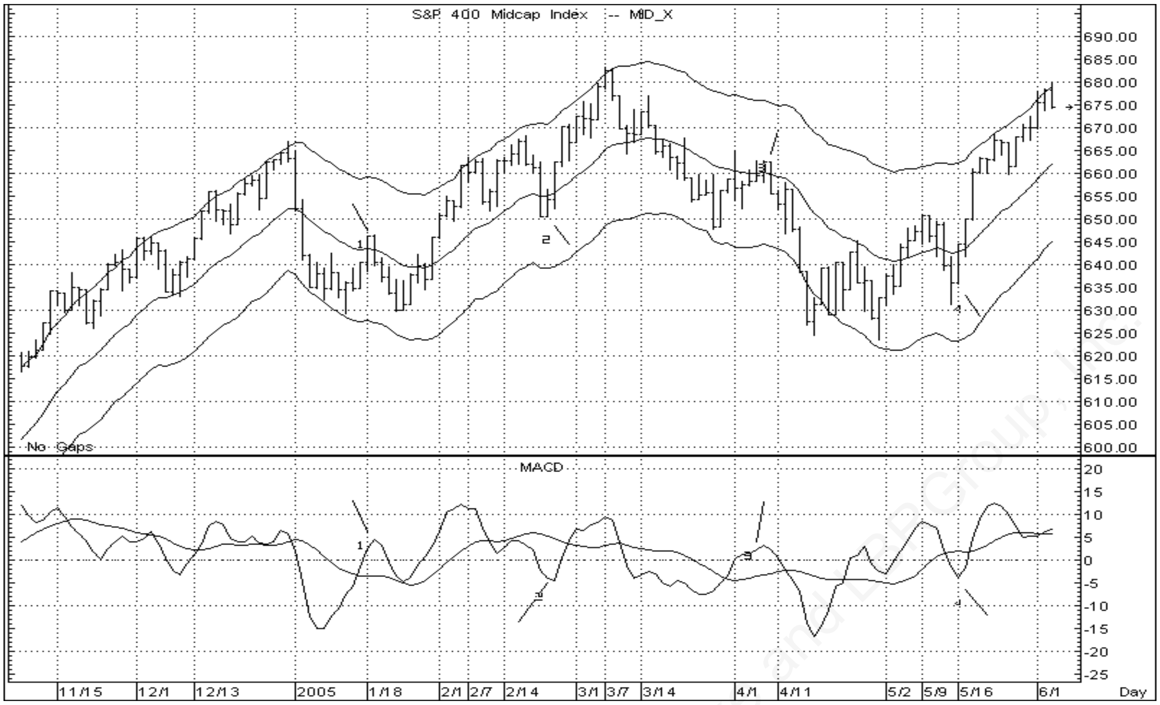

Chart 32 - First Cross is similar to the first retracement after the price crosses back over the 20-period EMA

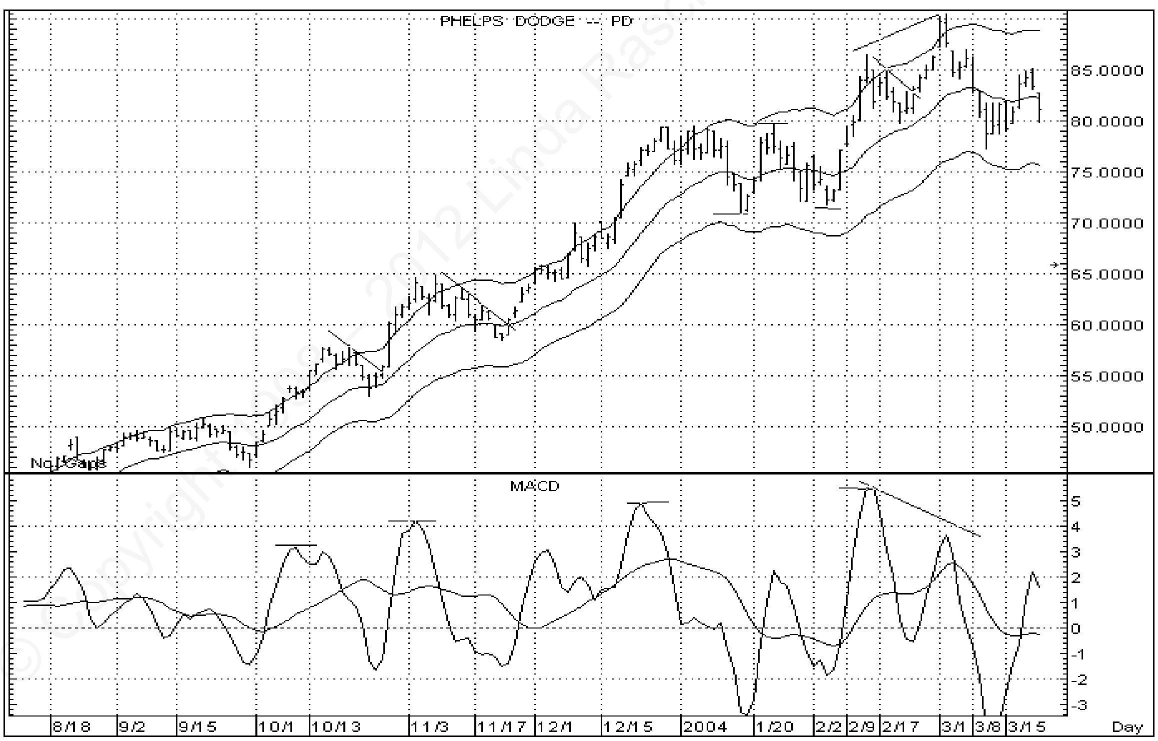

Chart 33 - 3/10 pullbacks after new momentum highs

Chart 34 – New Momentum highs or lows in the 3/10 oscillator need to be accompanied by new price highs or lows, and highs or lows in the price should be confirmed by the oscillator. This sets up a high probability short term SCALP.

Chart 35 – The 3/10 oscillator makes new momentum lows along with the price. Shorting the first reaction up is an extremely high probability trade. Note: this is a swing trade only – cover on a push to new lows.

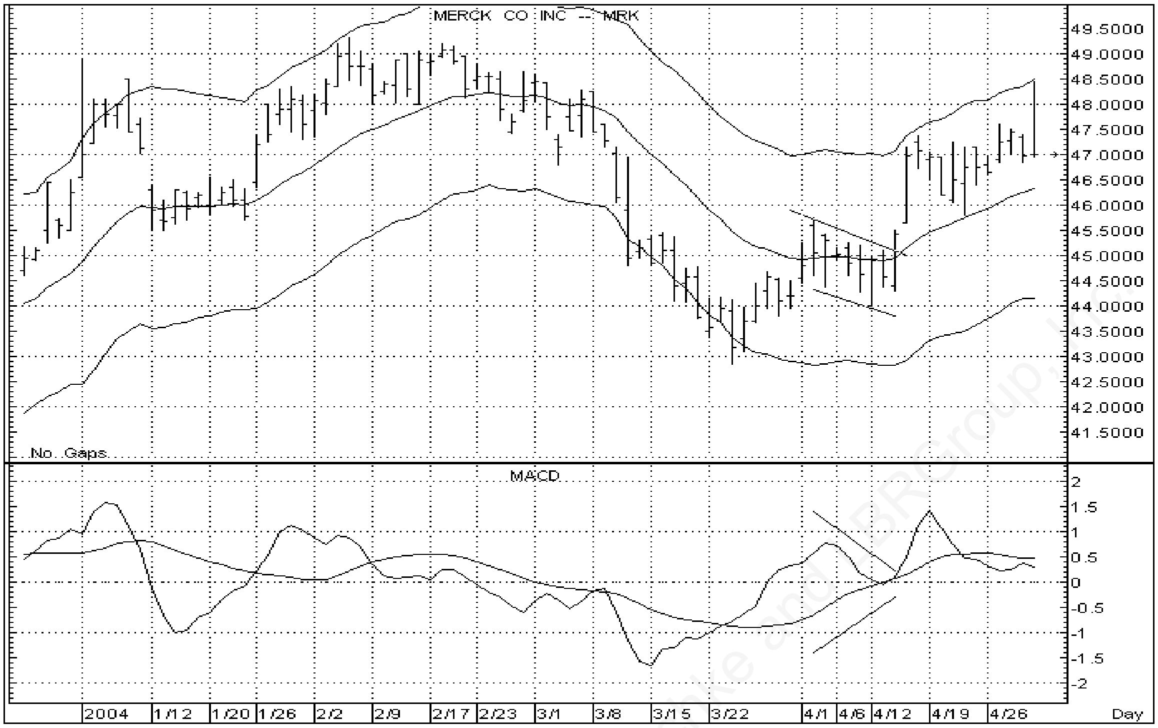

Chart 36 - Buy Anti – The slow line just turns up and the fast line pulls back to meet it. The chart pattern has the appearance of a Bull Flag.

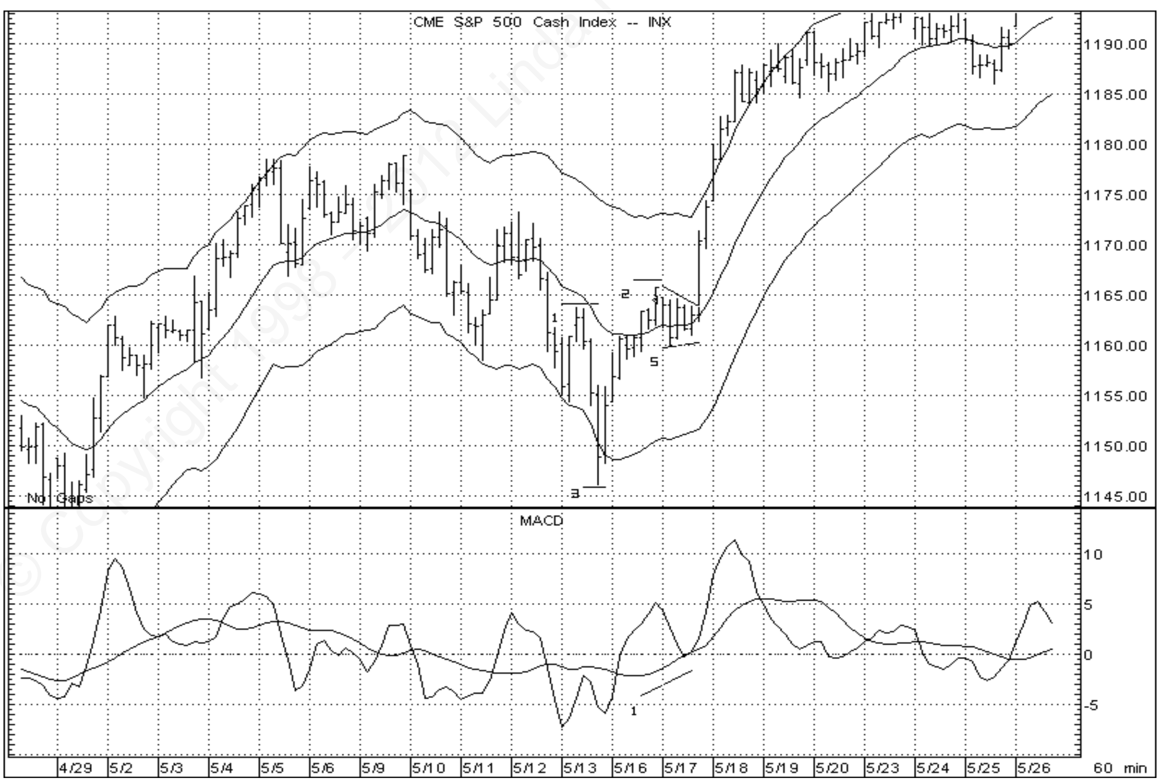

Chart 37 – Buy Anti - hourly SP. Last upswing greater then previous downswing followed by pause consolidation that has the appearance of a bull flag.

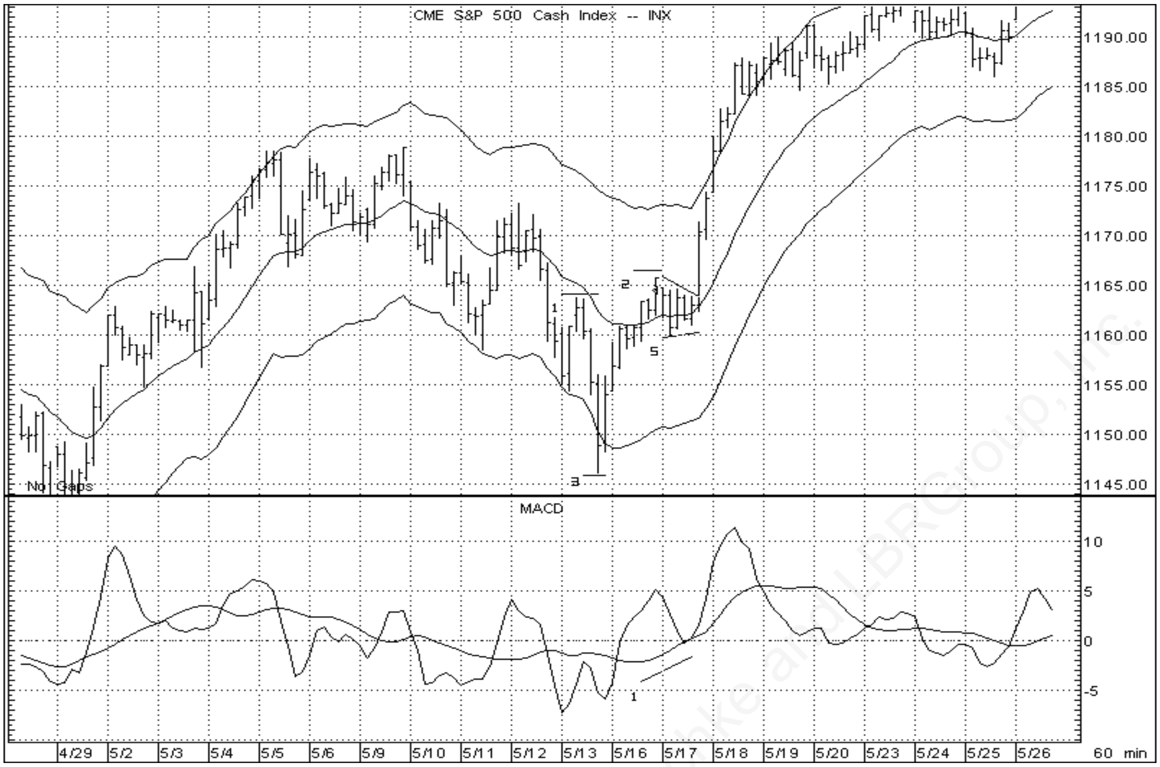

Chart 38 – Buy Anti - hourly SP. Last upswing greater then previous downswing followed by pause consolidation that has the appearance of a bull flag.

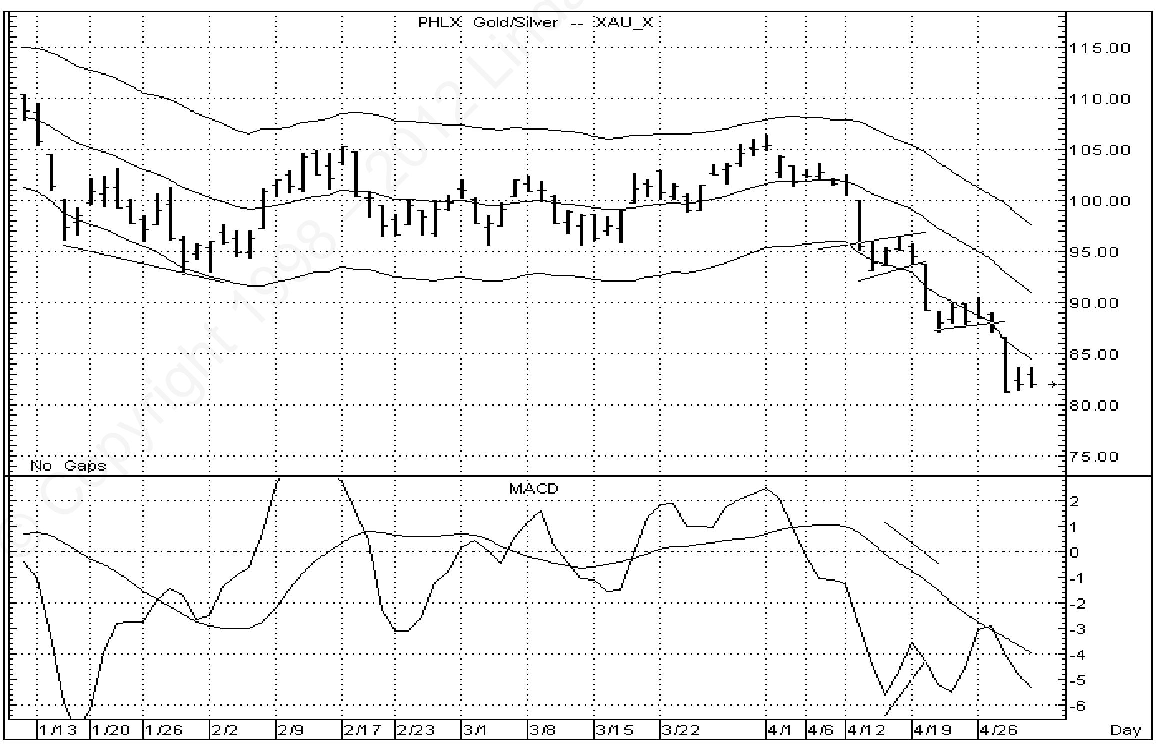

Chart 39 - Sell Antis occur after the "slow" line just turns down from plus territory. They tend to be smaller chart formations then Buy Antis and are not as common.

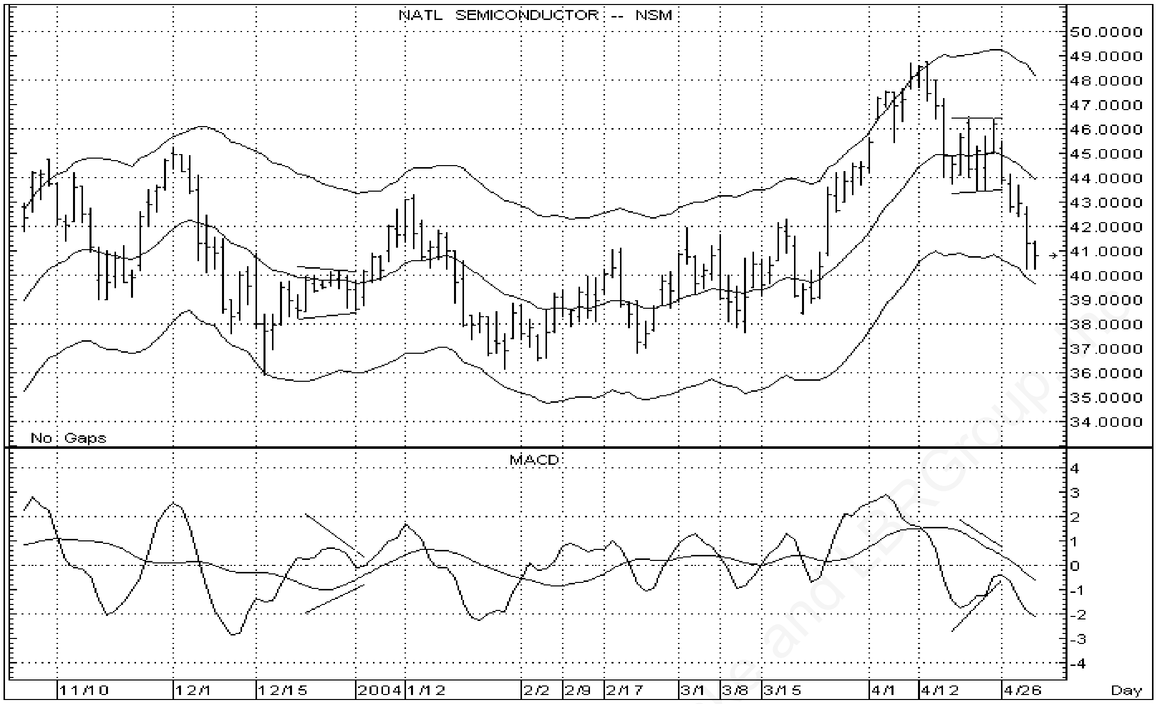

Chart 40 - Buy and Sell Antis tend to occur when a market is still in a trading range.

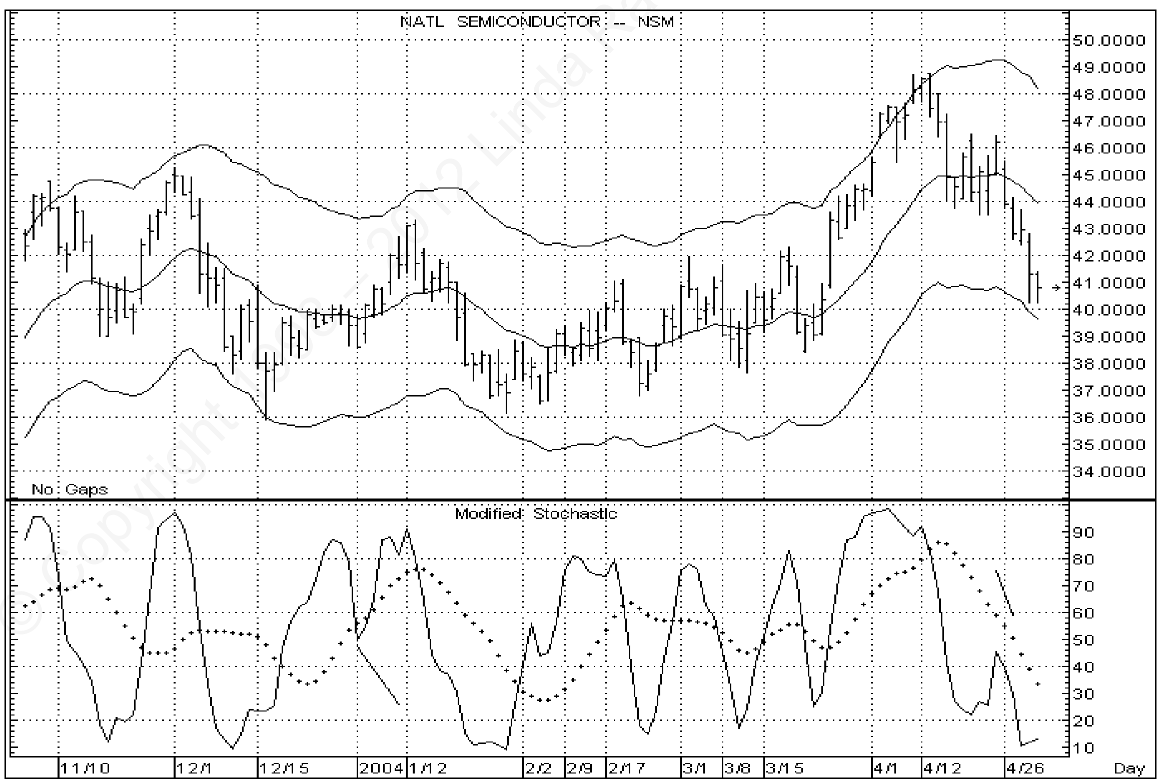

Chart 41 - Antis on a stochastic (%K = 7, %D = 14)

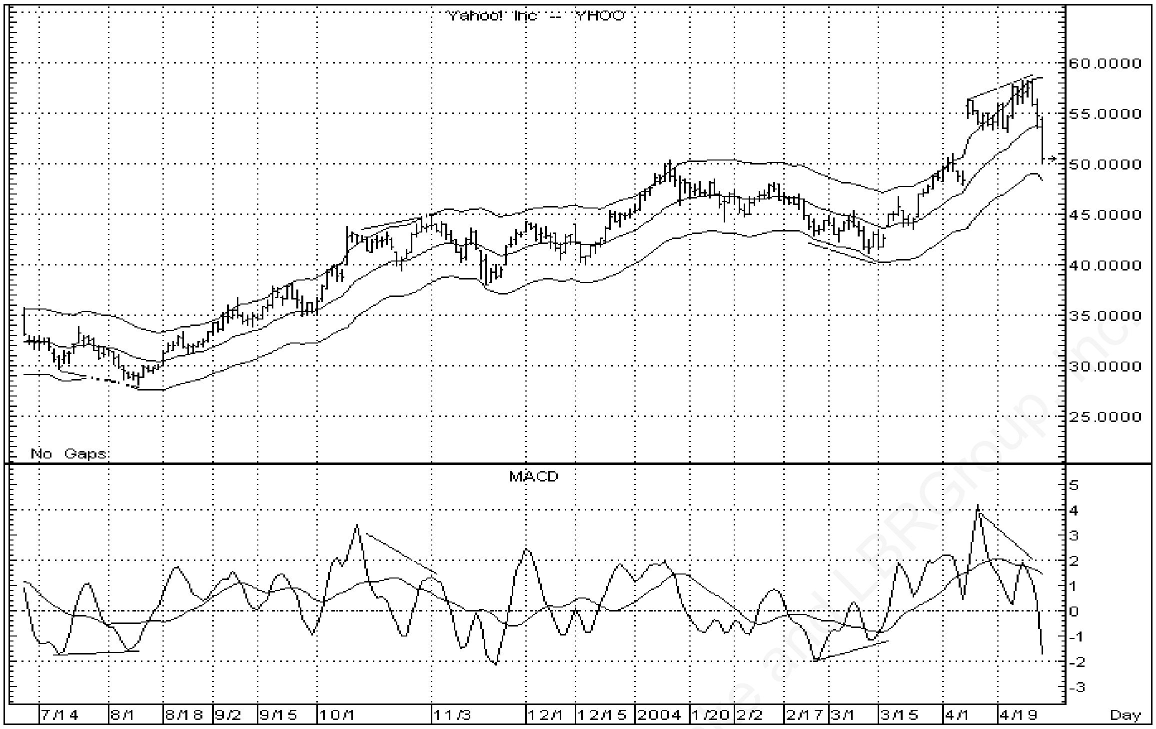

Chart 42 - The ideal divergences occur when price is at the upper and Lower Keltner Channels and tend to form a 9 – 13 bar window. Note how the “slow” line is just turning up or down.

Chart 43 – Crude - intraday chart. Note buy divergences in both the fast line and the slow line> The buy divergences on the slow line will show when there are buy divergences on the higher time frame as well (such as the daily chart in this case).

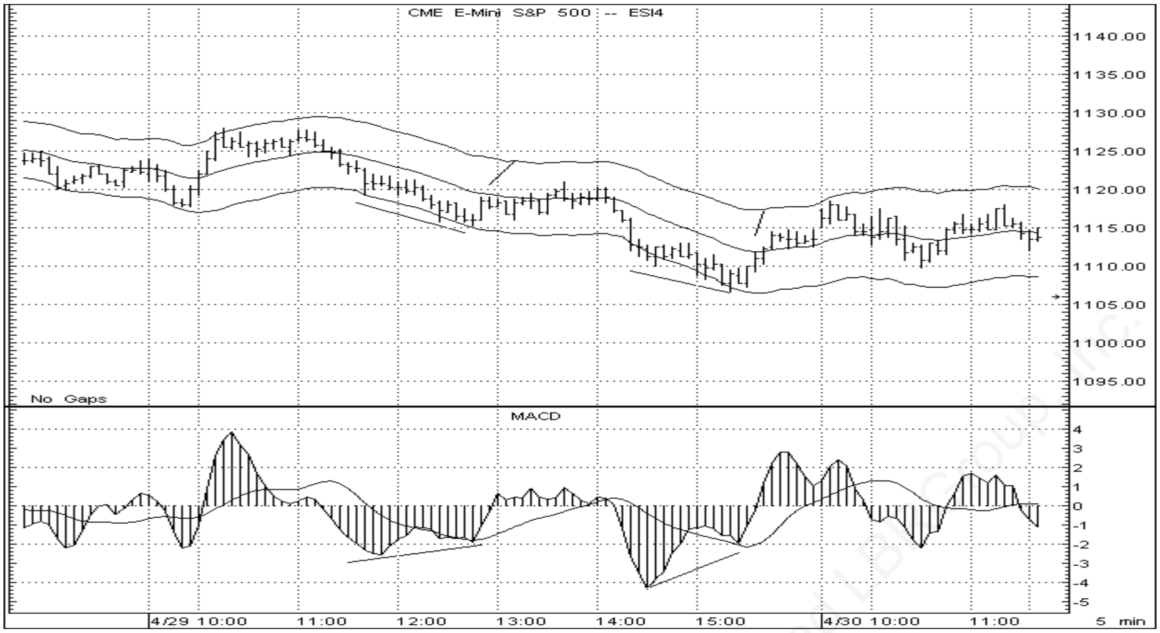

Chart 44 - 3/10 divergences on short time frame: Play for a retracement back to the EMA. A divergence does not imply a trend reversal.

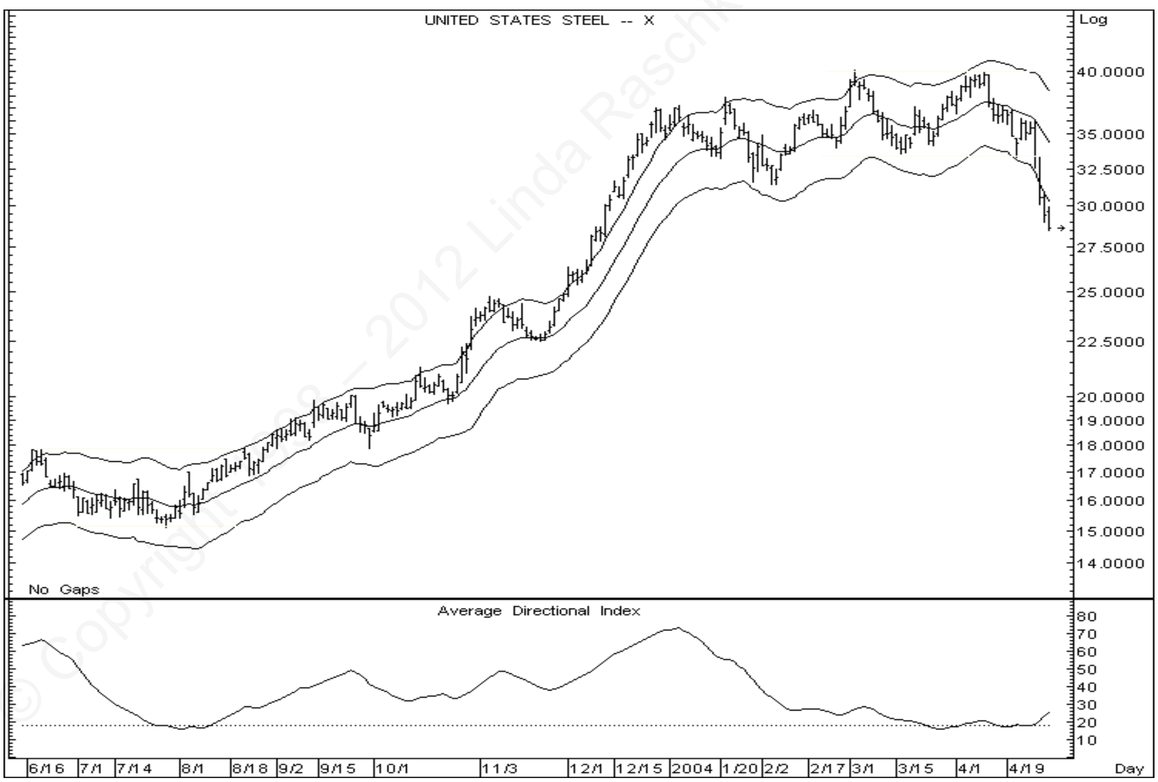

Chart 45 - A low ADX highlights accumulation or distribution. Most traders tend to underestimate the potential magnitude of a move upon a break of the established range.

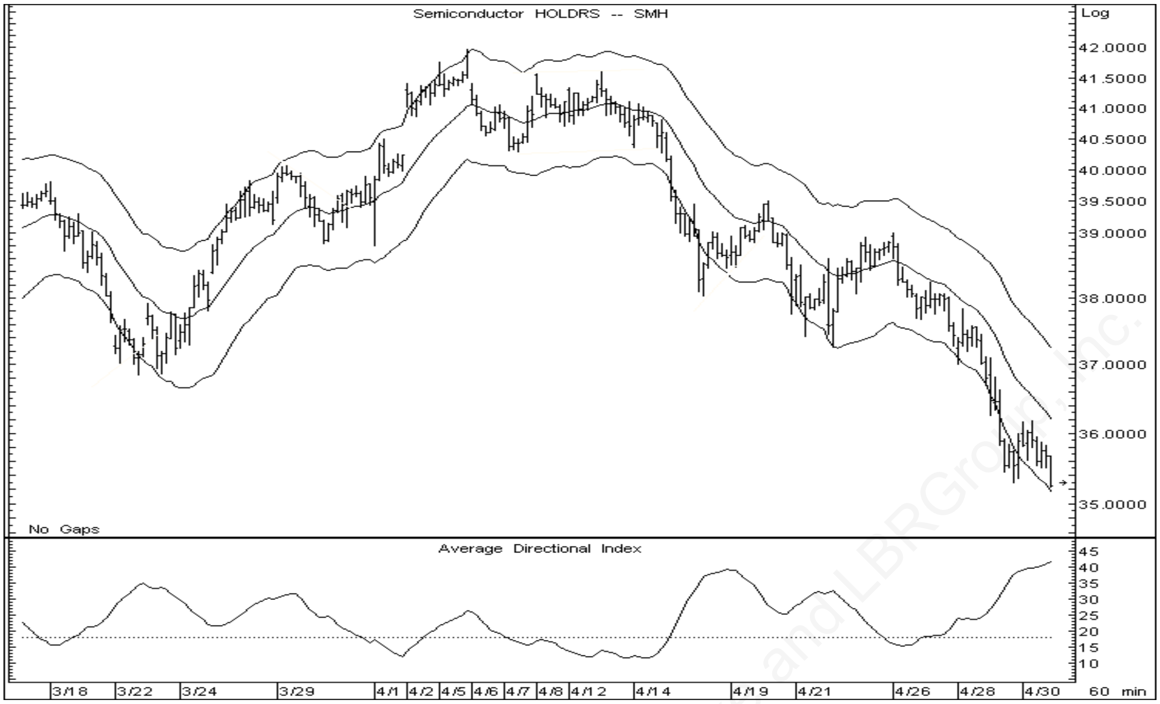

Chart 46 - Grail trades: After a high ADX reading, the retracement back to the 20-period EMA tends to lead to a retest of the previous swing high or low. Note the sideways line at the top.

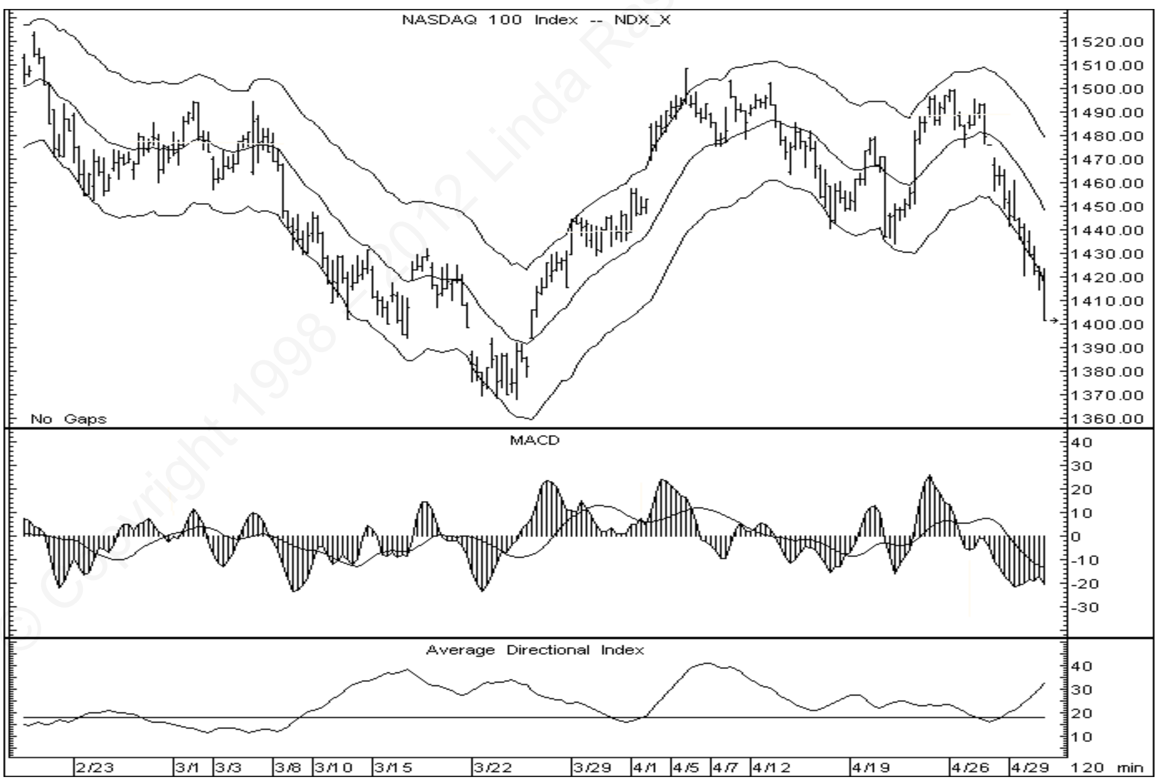

Chart 47 - Be careful using oscillators when there is a low ADX. Note the “price bar overlap” when the ADX is low.

Chart 48 - A low ADX is a sign that the market has reached an equilibrium point. Time to draw in trendlines and play for a breakout.

Tape Reading – monitoring markets for confirmation and aberrations

Professional traders watch the price on a discretionary basis for several key reasons. Tape reading can enable a trader to get a slightly better entry or exit price, as well as provide confirmation a trade is working after initial entry. Tape reading, or monitoring price action, can also impart information as to how fast a market is moving or if it is losing momentum in a manner that is a different feel from watching a chart. It also is a useful way to monitor relationships, such as those between two markets, as well as information about potential aberrations in the price behavior.

If a trader who knows what to look for when monitoring price, will always be one step ahead of the crowd. It is useful to review the basics of tape reading before moving on and study price pivots such as the opening, high and low for the day. Tape reading is something that improves with experience, but a newer trader still needs to know where to begin!

The basic premise of tape reading involves nothing more than watching the current price action to determine whether buyers or sellers are in control. Which is greater: supply or demand? This is of course, reflected by patterns of higher highs and higher lows, or vice versa, as well action indicating impulse. So, in addition to noting if the price is moving up or down, a trader is monitoring the overall activity level, which can show up in volume as well.

First, it is most useful to watch the current price relative to another price point. Where is the current price relative to the most recent swing high and swing low? Is the market moving closer or further away from these levels? Is it struggling to rally back towards the most recent swing high, making little headway over a large period of time, or is it rallying sharply and holding its gains, not giving up any ground in the process? Highs and lows are one type of pivot point and price must be watched relative to a pivot point.

Many traders comment on how much easier it is to sense if the market is moving higher or lower once they have established a position. This is because there is they now have a reference point and it is easiest to gauge momentum when it is measured against a reference point or pivot point. How fast is a market moving away from or closer to these points?

The most recently formed pivot points will always be the most significant in terms of determining structure. Note whether price action is contained by these levels and forming a trading range, or if it is trending and making higher highs and higher lows. Lastly, is the market moving with energy and volume? Or, is it creeping methodically higher or steadily oozing down lower? Both of these last two conditions can be signs of a trend, but each will call for a different trading strategy.

By watching the price relative to another pivot point, a good trader can start to anticipate different trade setups. For example, if the price is just falling short of testing a previous swing high and starts to react down from that level in a sharp, quick manner, the natural assumption would be to look for the market to then test the support levels below. If it is observed that the price takes out a previous swing high with impulse and activity, a trader can have confidence the up trend is intact and anticipates buying the first pause or retracement, or finding a spot to jump on board if a momentum move is under way and they are not already in a position.

The market is always probing for levels where the volume will come in. That is its job. If it probes up but no buyers come in to support a further advance, it will test back down to see if buyers reappear at lower levels. If selling brings in volume to the downside, the market will continue lower until the selling dries up or has exhausted itself. The tape reader monitors price to see if activity and volume increases or decreases in the direction the market is moving.

There are many ways to watch the price action for relative strength or weakness. Monitoring the length and duration of a price swing relative to the previous swing sets the basic foundation for swing trading.

Price can also be watched relative to a specific technical indicator. Momentum oscillators or stochastics are a useful tool for highlighting the market's swings. If an oscillator pulls back to the lower end of its range, but the price gives up very little ground, that is a sign of strength and the next swing up can be expected to be strong. If price makes a higher high, but a technical momentum indicator makes a lower high, that is a sign of non-confirmation and market weakness is expected to develop.

Another way to judge the market's relative strength or weakness is by observing the price relative to another market or indicator and watching for confirmation or non-confirmation. For example, if the DOW appears weak, and makes a new low, but the S&P futures are holding firm and making a higher low, this would be a sign of non-confirmation. Since the SPs failed to make a low at a time when other markets were weak, it is likely due to rally.

This same principle can be used in conjunction with watching the bond market. Let's say the bonds and the SPs have been trading in a similar directional fashion throughout the day, as they did for most of the 90's. In the last hour, the bonds close weak at the lower end of their range but the SPs start making higher highs and higher lows. The market is telling you that the SP futures are strong enough to ignore the poor bond close and are going to mount a rally.

The SP futures can also be watched relative to the underlying cash index. There have been times where the cash index made a new intraday price low but the futures did not. This, too, would forecast a rally.

Market internal indicators such as "Ticks" (the net reading of stocks on an up tick versus stocks on a downtick) can be used as a gauge to measure price strength or weakness. For example, if price makes a higher high but Ticks make a lower high, this "non-confirmation can signal a short term reversal. A later section of this manual will be devoted to intraday market timing based on relationships with market internals.

Another subtlety of tape reading is watching the market's response to news. If the news is bad, or the economic environment negative, yet the price holds firm and shrugs the bad news off, this is a sign of hidden strength. It is also a sign that the market is sold out…there are no more sellers left. At some point shorts will need to cover. The market is a discounting mechanism. There is much to be said for the old adage, "buy the rumor, sell the news".

Lastly, there is always a group of market leaders that tends to govern the market's overall psychology. These stocks have a high beta and are momentum leaders. They can very often lead the market indexes by anywhere from 1 to 10 minutes. They can also lead up or down on a daily time frame. An astute tape reader will watch the market leaders and note when they turn first, and also, when they appear to be tiring or running out of fuel on the upside.

There are many ways to watch price relative to another market, indicator or pivot point. Monitoring changes in relationships involves discretion and judgment and much of tape reading is observing relationships and watching for aberrations or changes in the relationships as a way of forecasting future price action.

Observe what a market is doing and forget about why it is doing it. The price always tells the most immediate supply and demand story and this is the only thing pertinent to short term trading. Thinking and analyzing too deeply get in the way of a trader’s objectivity. The market is either moving as expected or it is not. If a trader establishes a position and feels the market should be moving higher but it is not, he should not overstay his welcome. Do not give trades the benefit of the doubt when the tape action does not confirm in a timely manner. Never ‘hope” that the market will do what you think it should do. There is a fine line where hope turns into fighting the tape. The price action should tell you right away whether your play is correct or not and the best trades tend to work right away.

To summarize so far:

Tape reading helps fine-tune initial trade location when there is a trade setup based on the market structure.

Tape reading can be used to increase confidence that a trade is working out when volume or impulse occurs in the direction of the newly established position, as well as alerting to non-confirmations when the relationship between two markets or an indicator starts to change.

Tape reading detects market aberrations in either range or changes in relationships faster then any traditional indicator can.

Tape reading involves a trader’s ability to put the short-term price action within some type of conceptual framework irrespective of the price charts. This is something that continues to improve with experience and study.

PIVOT POINTS

OPENING PRICE

The opening price is the most important pivot for the short-term trader. This is what is used to determine the trend of the day. For example, a day may have an up close but have been in a downtrend for the day if the close is well below the opening price (implying there was a large gap up). The moves off the opening are also where an early imbalance in demand or supply will show up. There is much we can learn by observing how a market opens and first trades off the opening price. The most immediate goal of the short-term trader is to capture a piece of the main trend for the day.

An aberration in volume or range off the opening price increases the likelihood of a trend day. A greater percentage of the day's range occurs in the first hour then was the case in the past, and thus it has become increasingly important to trade aggressively if there are early signs of a strong trend for the day. If the first 15-minute bar of the day is greater than the previous first 15-minute bar of the past 7 days, there are high odds for continuation in the direction of the initial move. Early range indicates strong supply demand imbalances. Heavy volume on the opening or during the first 15 minutes of the day can also indicate early supply/demand imbalances and thus an increased probability of a trend day.

A large gap in the opening price creates a different set of patterns. If price gaps outside of the previous day's range, the first move should be for the market to make a push back into the gap area. If the push into the gap area is minimal or nonexistent in the first 30 minutes, this indicates potential for a strong move IN the direction of the initial gap. If the move back down into the gap area is moderate, watch to see if support or resistance comes in around the previous day's high or low. If the price is unable to show continuation in the direction of the gap in the first hour, the gap may likely have been a bull or bear trap and set up a trend day in the opposite direction of the gap. Either way, there is increased likelihood of range expansion after a large opening gap.

If there is no price action below the opening price after the first 30 minutes of trading, the odds increase that the market will close on its high for the day. If there is no price action above the opening price for the first 30 minutes of trading, there are high odds the market will close on its low for the day.

PREVIOUS DAY'S HIGH AND LOW

The previous day's high and low are two very important "pivot" points, for this was the definitive point where buyers or sellers came in the day before. Look for the market to either test and reverse off these points, or push through and show signs of continuation. Many times a market will bump up against these support and resistance points several times throughout the trading day. If support is taken out, does it then become resistance on the next reaction up? The way the market trades around the previous day's high or low is a good indicator of the market's technical strength or weakness. If a price rallies up to the previous days high, and then consolidates or trades around that level for a period of time, there are good odds that the price is going to eventually trade higher. The available supply at that level is being absorbed, and if the price breaks through, expect it to run a bit. Many times, the first play of the day will be for the market to test the previous day's high or low, and this then gives information about how the rest of the day should unfold.

When the market is in an overall trading range or a congestion area, look to exit positions around the previous day's high or low. Sometimes the price will fall just a bit short and sometimes it will just penetrate. A test of this level should be considered an opportunity to take profits. When the market is trending, look for the previous day's high or low to be broken early in the morning.

In a normal trading environment, we would expect the market to initially test the previous days high (if the first play is a test to the upside) and find a bit of trading around this level or even react back in the opposite direction. If there is a stronger trend in the price and the market is in a mark up phase, expect the price to run a ways through the previous high, providing a better exit level for longs, or before having a reaction in the opposite direction.

LAST HOUR HIGH AND LOW

If the previous day has had range expansion in which price was marked up to a new levels, and there has been an above average degree of trendiness, the previous day's high or low will not be as significant. For example, in the case of a trend day UP, the previous day's low is not likely to come into play. Instead, the last hour's low becomes the significant support level. This support level is most important in the morning session of trading. After a trend day down, expect that last hour high to provide initial resistance.

FIRST HOUR HIGH AND LOW

The first hour's range establishes the framework for the rest of the trading day. Half the time a push outside the first hour's range will lead to a close in the upper or lower extreme of the day's range, and about half the time, price will fail to follow-through, setting up a countertrend trade back into the first hour's range. If the market has just made a large move the day before, the first trade outside of the first hour's range the next day will often set up a countertrend trade for a move back into the first hour's range. Of even more importance, though, are the times that a move outside the first hour's range indicates the trend for the day.

There are clues in the early price action that will tell us which scenario to expect.

Conditions that lead to a strong close outside the first hour's range:

- Strong drive off opening price (first 15 minute bar has big range expansion)
- Opening price is at the extreme of the early range (price can't trade above (or below) the opening level in the first 30 minutes.
- There is unusually heavy volume in the first 15 minutes of trading.
- Opening gap outside of the previous day's range; market fails to retrace into the gap area off opening price level.
- Large opening gap outside previous day's range; market makes immediate move back into previous day's range.
- Breakout from an extremely narrow first 30-minute bar.

Conditions that lead to a lack of follow-through if breakout of first hour's range:

- Breakout in the morning session but volume is running lighter then normal or lighter then the previous day's pace.
- Breakout in the morning session following a trend day with significant range expansion (do not fade a breakout in the afternoon session).
- Mid-Morning breakouts following outside range days.
- Market opens in the middle of the previous day's last hour range following a normal day. Morning session will most likely be "testing session. (Do not fade an afternoon breakout).

- Friday afternoon breakouts are suspect.

Opening price versus opening call or “pre-opening” range. How does the market open relative to initial expectations? This indicates strength or weakness. As with racetrack betting, the smart money will often come near the “start.” For example, if the beans are called to open up 10 cents and they only open up 3 cents, this is a sign of weakness and the market will most likely fail.

THE CLOSING HOUR

The last hour often tells the truth about how strong a trend truly is. “Smart” money shows their hand in the last hour, continuing to mark positions in their favor. As long as a market is having consecutive strong closes, look for up-trend to continue. The up trend is most likely to end when there is a morning rally first, followed by a weak close. A downtrend tends to end when there is morning weakness first, followed by a strong close.

Morning reversals are much more likely then an afternoon reversal. Do not look for late day price reversals. However, they are significant when they do happen. (The least likely scenario has strong forecast value when it does occur).

High volume on the close implies continuation the next morning in the direction of the last half-hour. In a strongly trending market, look for resumption of the trend in the last hour. This tendency will be more pronounced as the weekend approaches. In general, the afternoon session tends to have a higher degree of trendiness then the morning session. However, on a light volume day, it is rare that the afternoon trend will be able to sustain itself into the close.

If the market makes a dramatic move in the last hour of a relatively lifeless day, be positioned in the direction of that move by the close. Hold this trade overnight, as there are very high odds of an opening gap in your favor the next morning. Anytime the market closes near its lows or highs after what appears to be a “normal” trading day, expect continuation in the direction of that close the next day. The close of a narrow range bar tends not to significant.

Charts for Section 2 – Tape Reading and Pivot Points

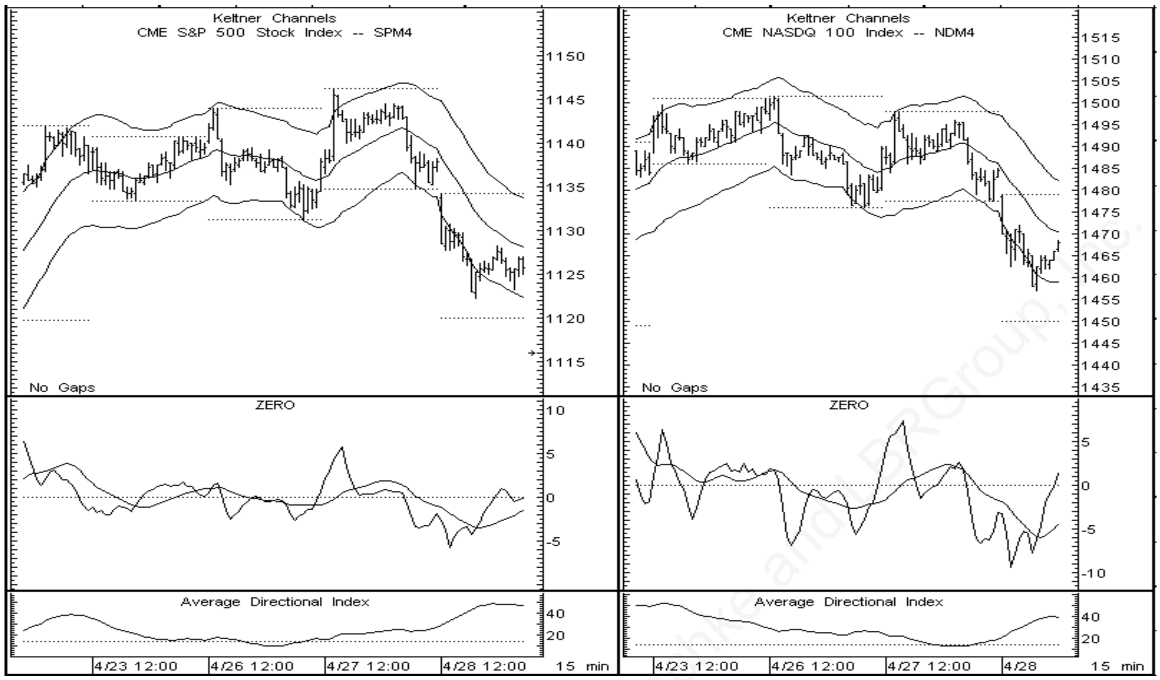

Chart 49 - Watch for non-confirmation between the indexes at tops and bottoms. The SPs make a higher high but the NASDAQ fails to confirm.

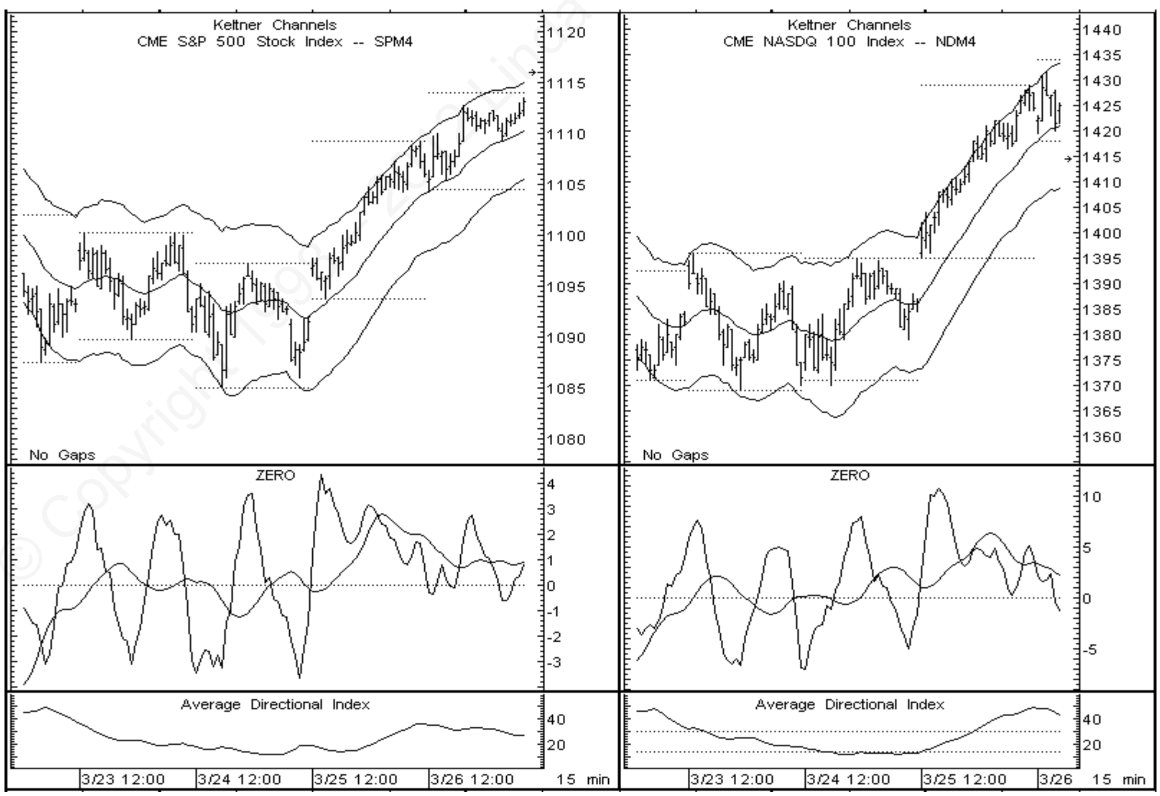

Chart 50 - The SPs make a lower low on 3/24 but the NASDAQ fails to confirm the push down.

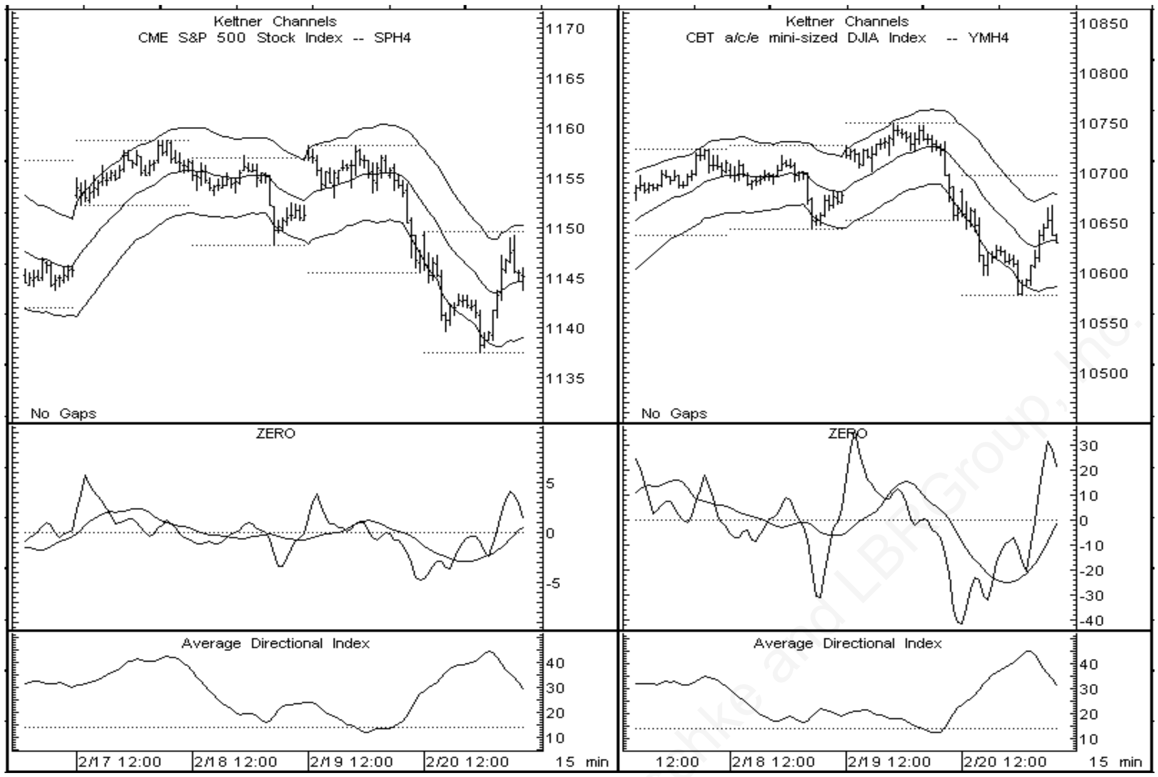

Chart 51 - The DOW made new 2-day highs, but the SPs failed to confirm. All indexes then made new momentum lows, which led to a severe decline.

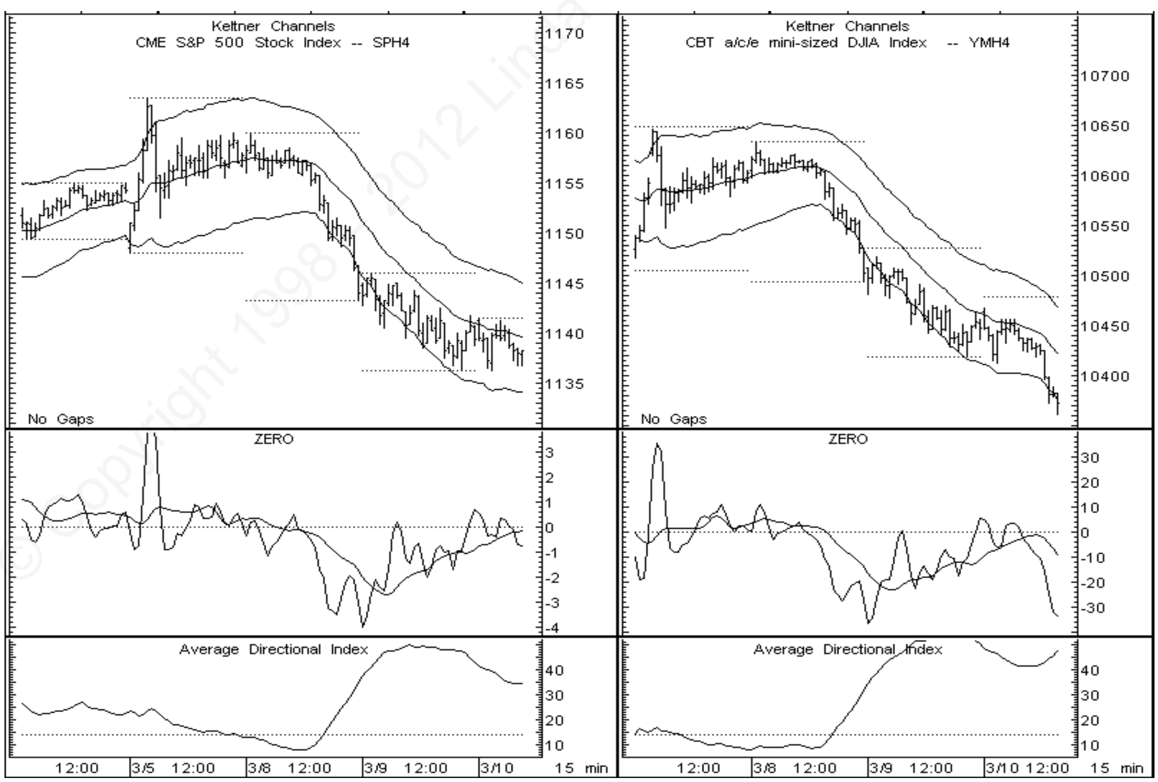

Chart 52 - Stay with an existing position as long as there is continued confirmation on multiple indexes.

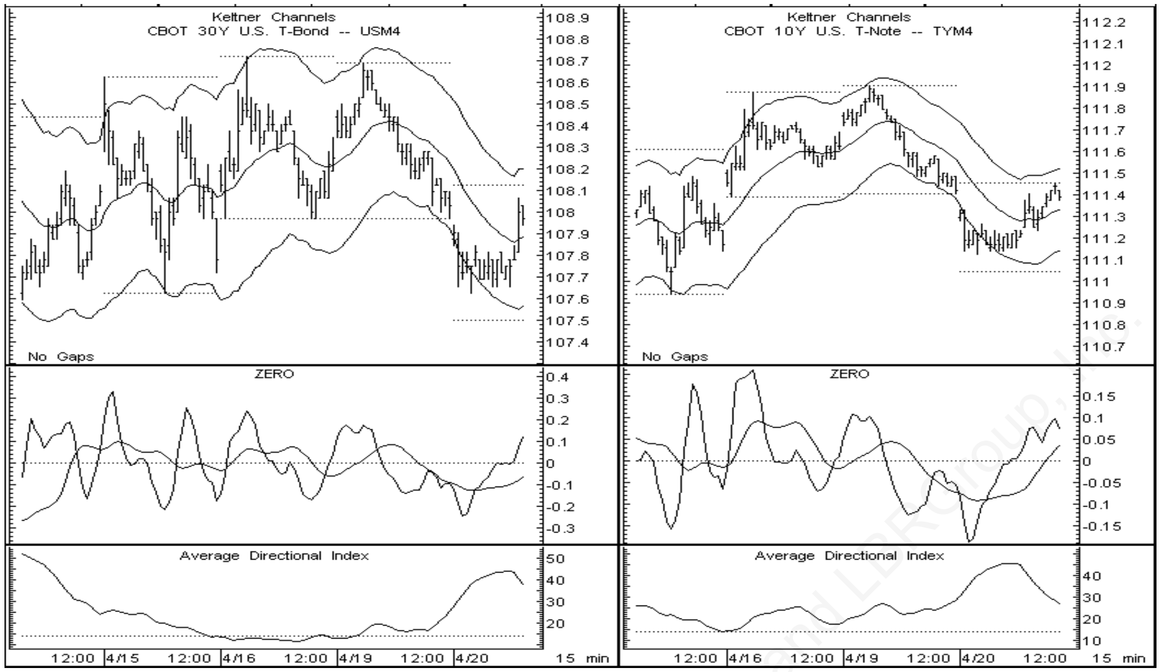

Chart 53 - Non-confirmation between the 10-year notes and the 30-year bonds indicates market reversals.

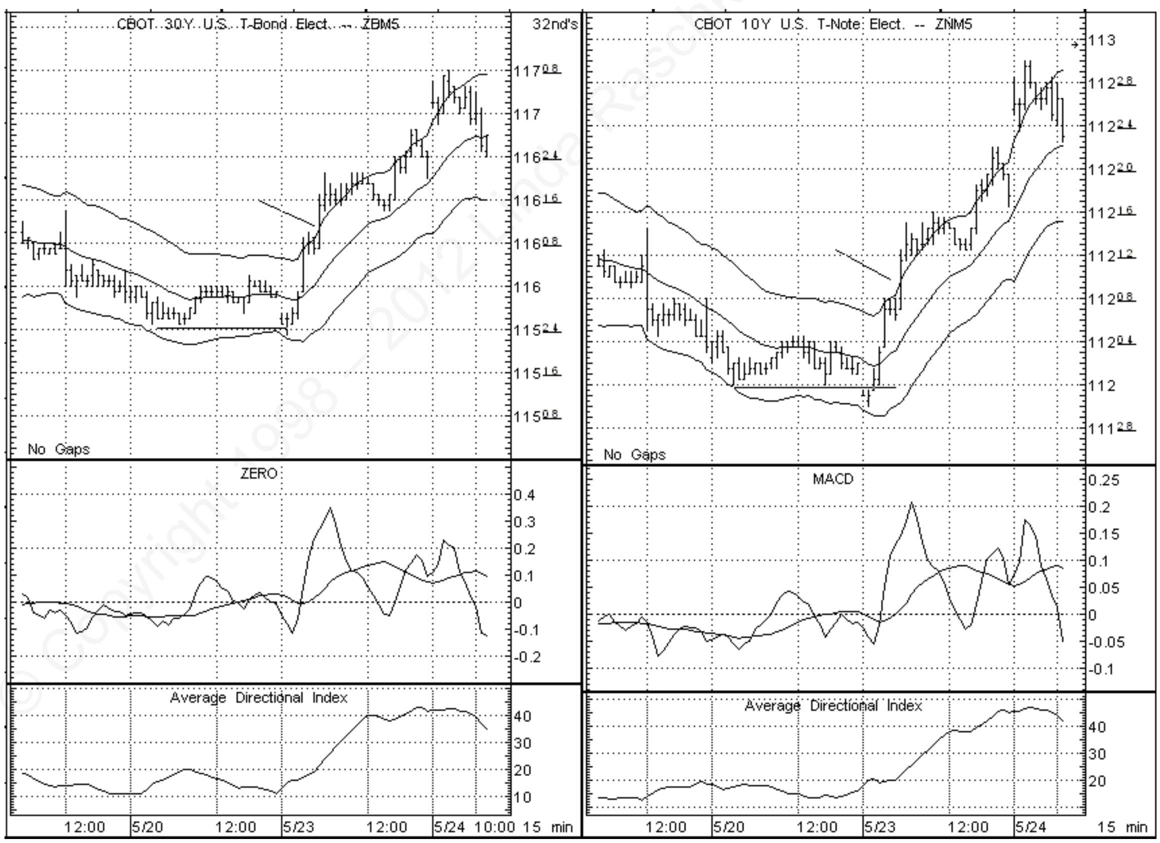

Chart 54 - Even though the bonds made new highs before the 10 years, the upside was confirmed by new momentum highs on the 3/10 oscillator in both markets.

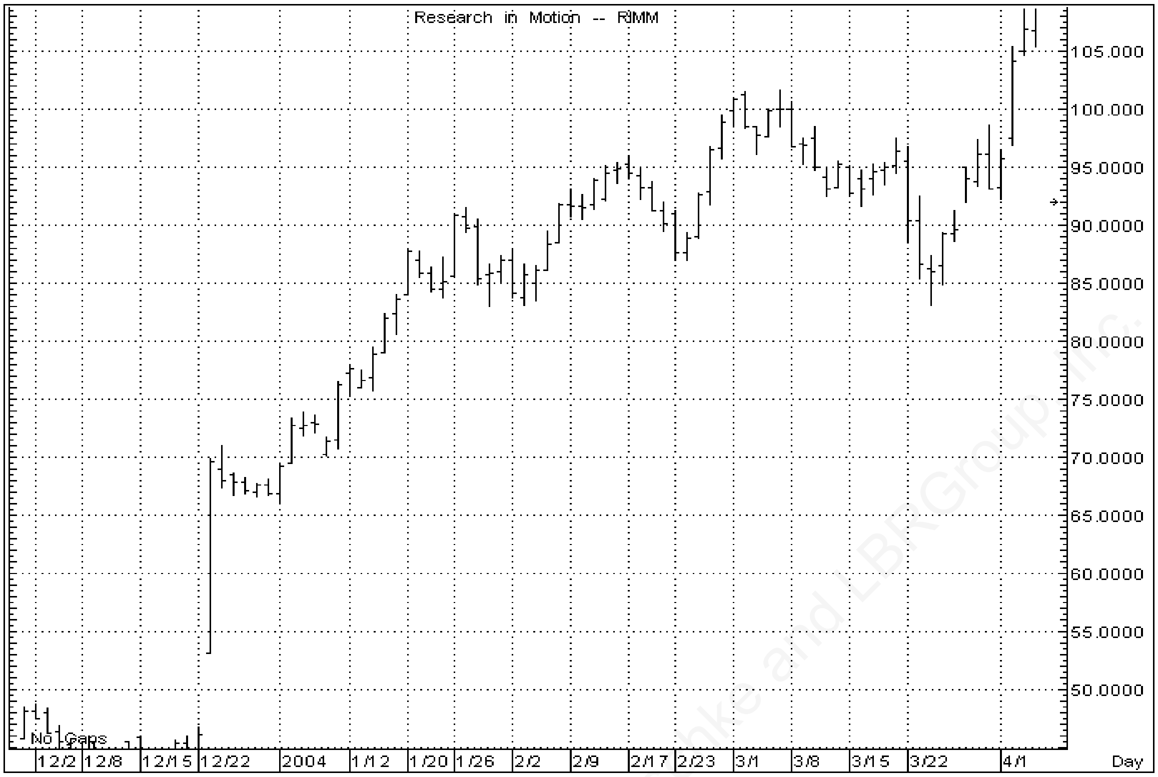

Chart 55 - Any unusually large gap or price movement is ALWAYS the market's way of telling us that there is an UNSUAL imbalance in the supply/demand equation that will lead to a stronger trend move.

Chart 56 - Unfilled gaps indicate a stronger trend move.

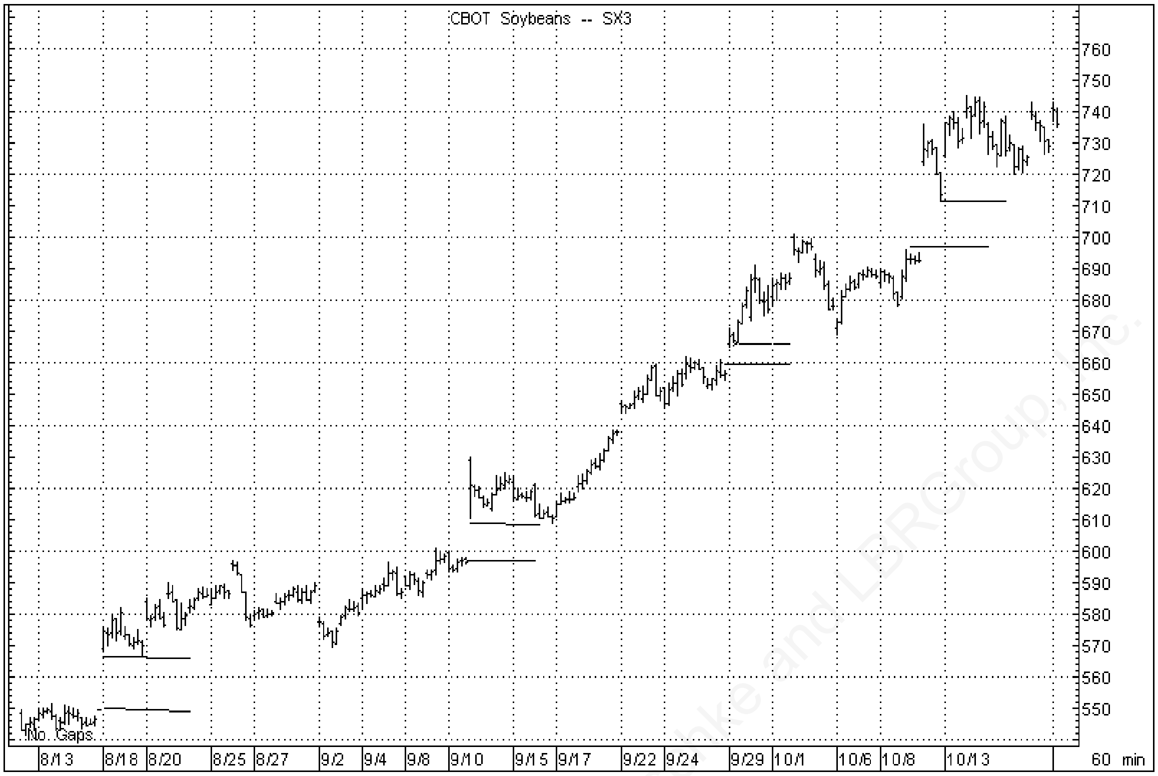

Chart 57 - There were many unfilled gaps at the beginning of this trend move in the beans.

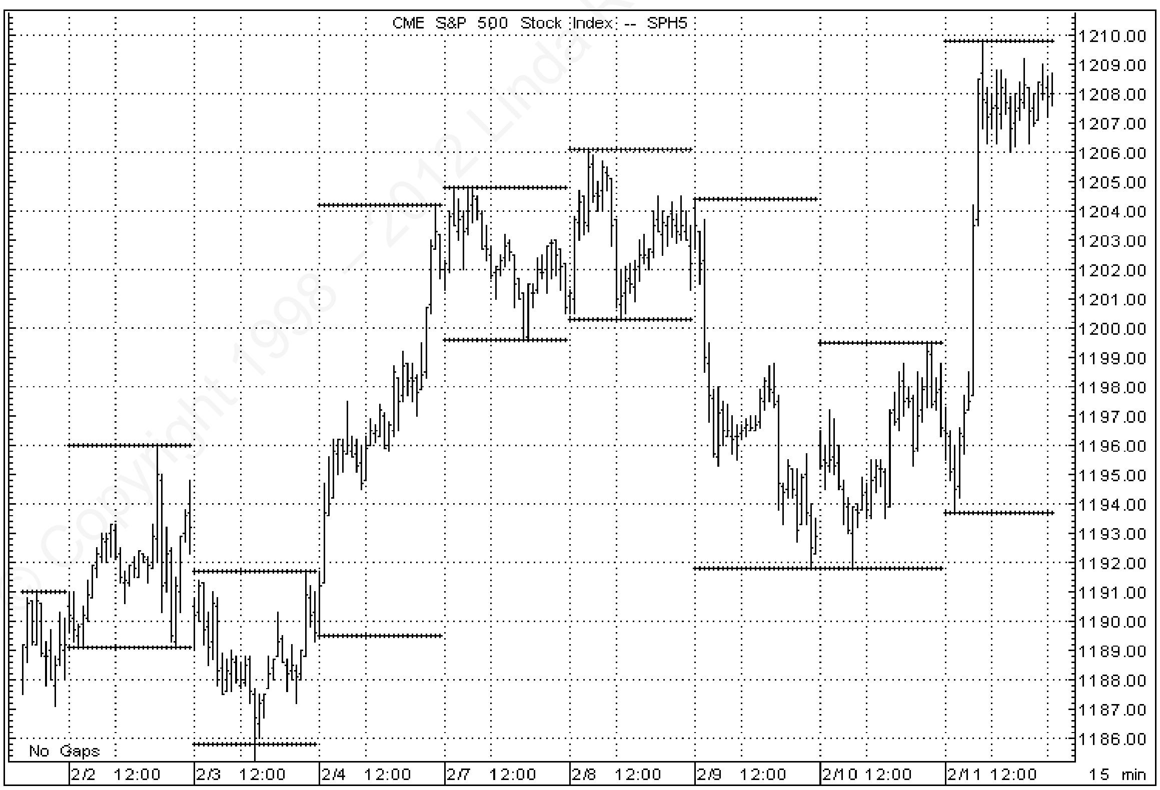

Chart 58 - The previous day's high and low are the most visable pivots and set up morning "tests".

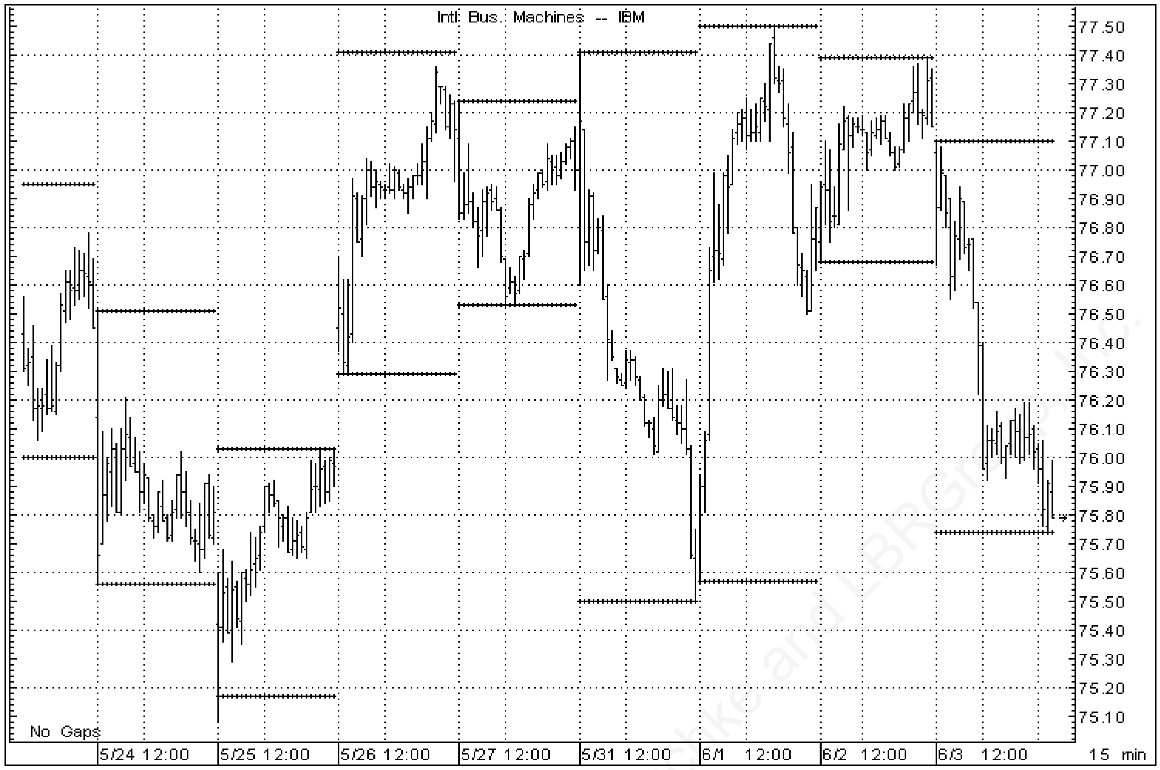

Chart 59 - Traders watch the prevous swing highs and lows for resistance or support.

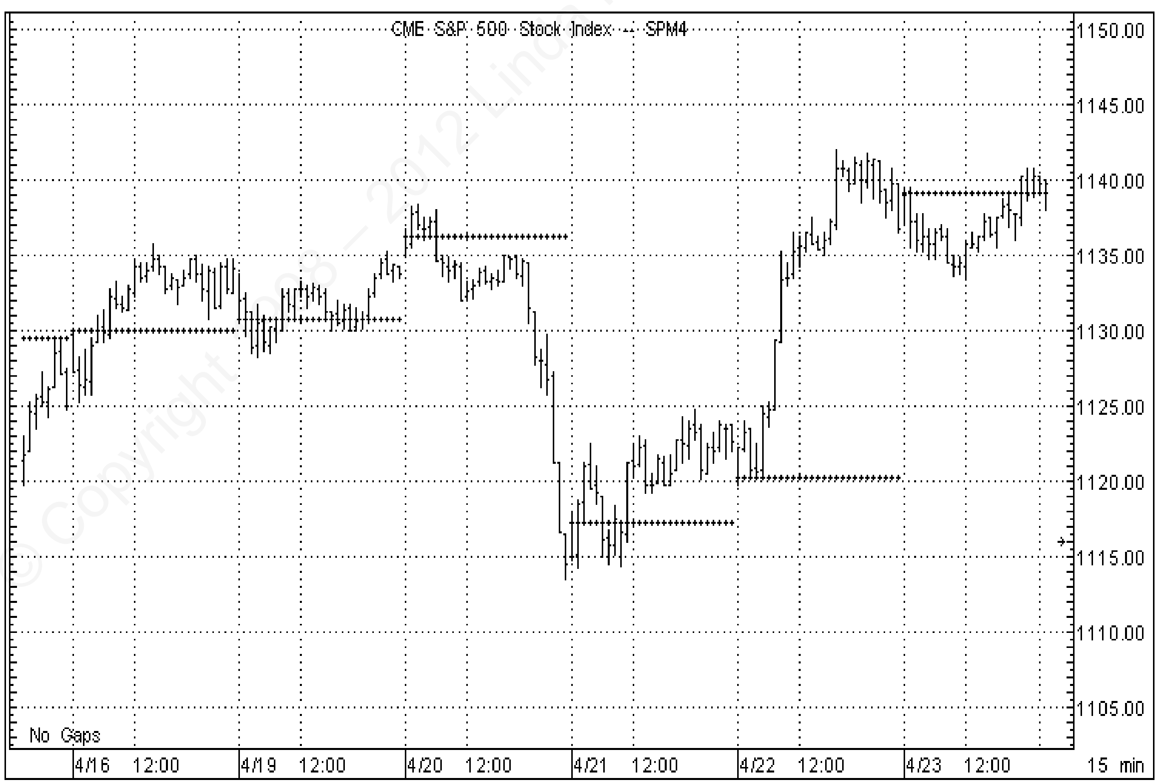

Chart 60 - The market alternates between trend off the opening price and rotation around the opening price.

Chart 61 - Neutral Day, Trend Day, Z-Day (consolidation day)

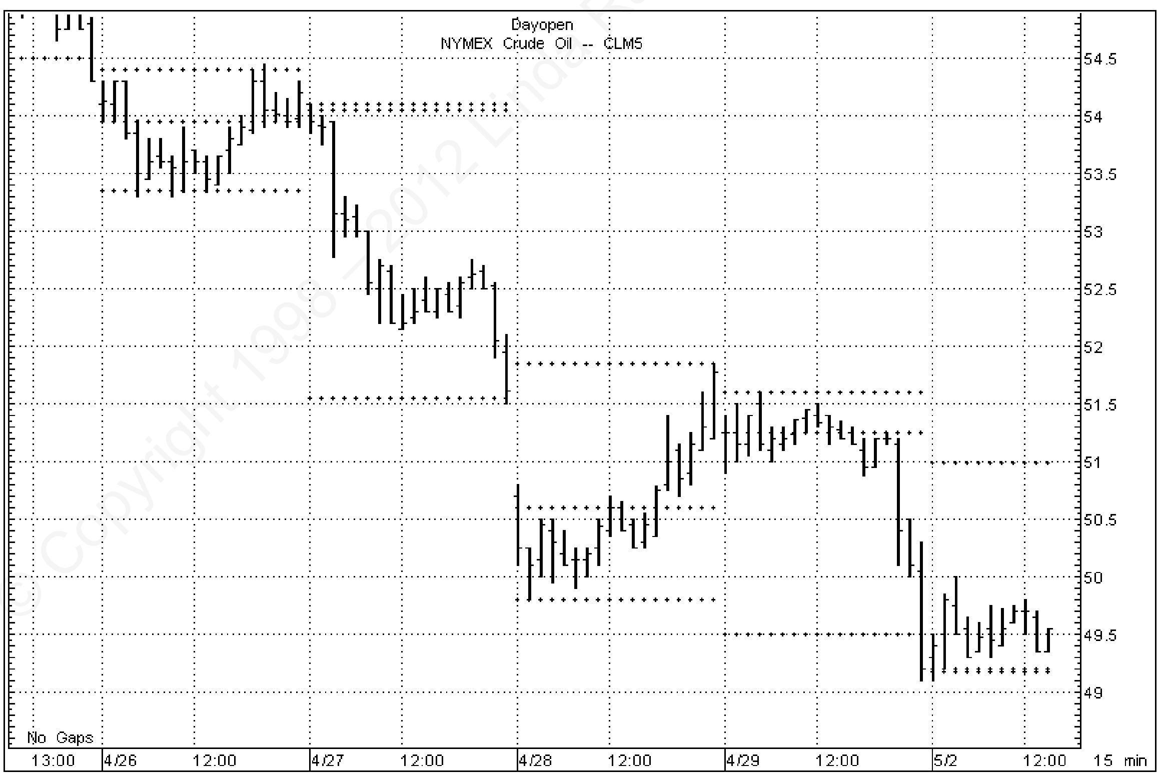

Chart 62 - Crude - Neutral Day, Trend Day, Z-Day. The Z day can still have good trading volatility, and often has a wider range then a neutral day. A Z-day forms a morning coil around the opening price but can have a higher degree of afternoon trendiness.

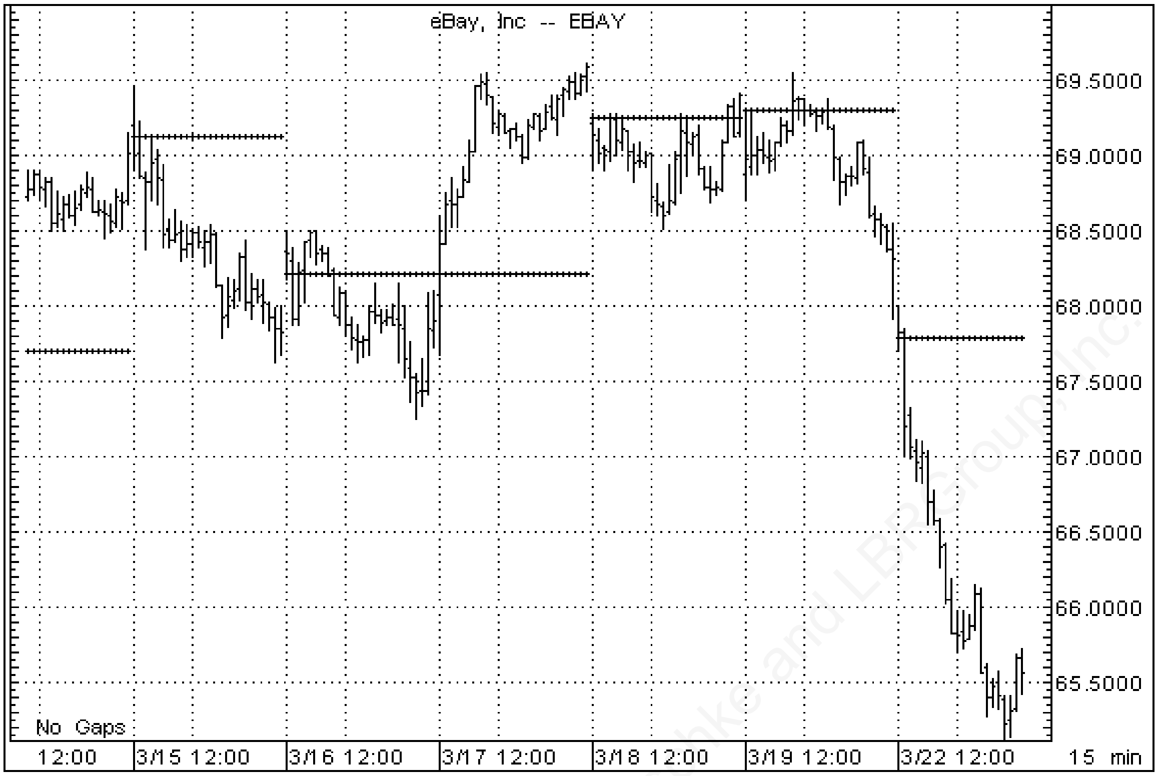

Chart 63 - An unusually large 15 minute bar off the opening indicates trend for the day.

Chart 64 – Here, the open and high and low are overlaid on each days action. Note how one day, the market will open at one end of its range and close at the other. The next day, it will trade through the opening price several times.

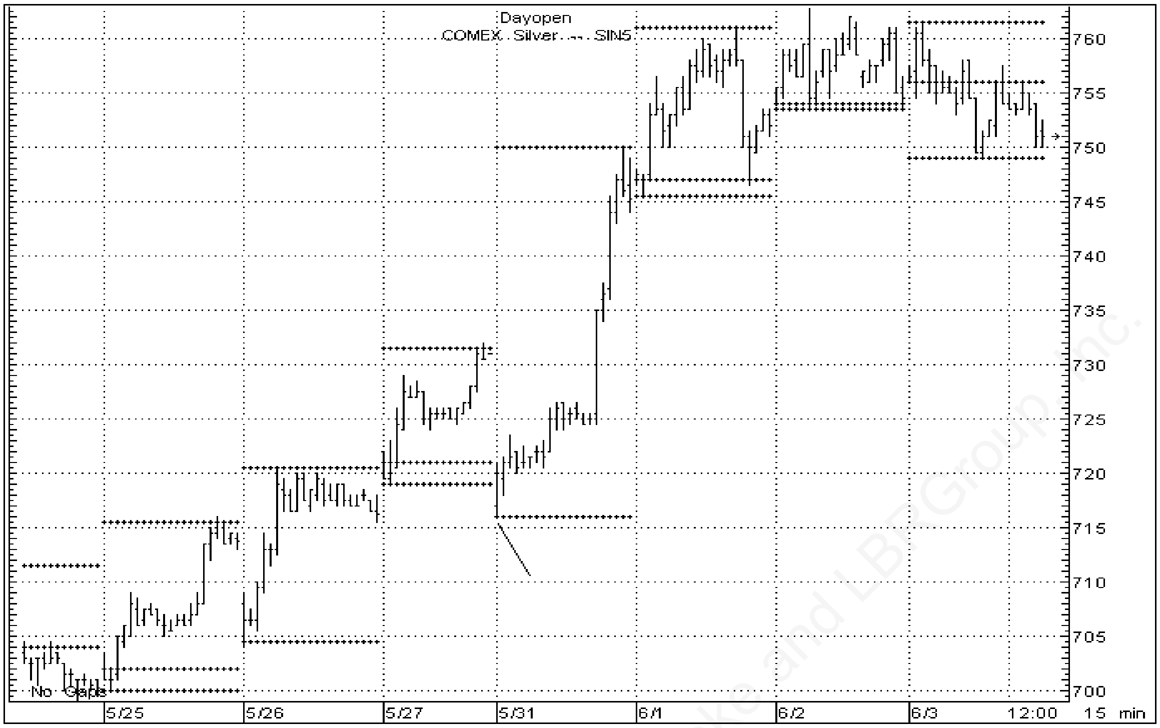

Chart 65 – Silver - Trend Day up after large opening gap where the opening price was the extreme of the first hour's range. Market closes on its high.

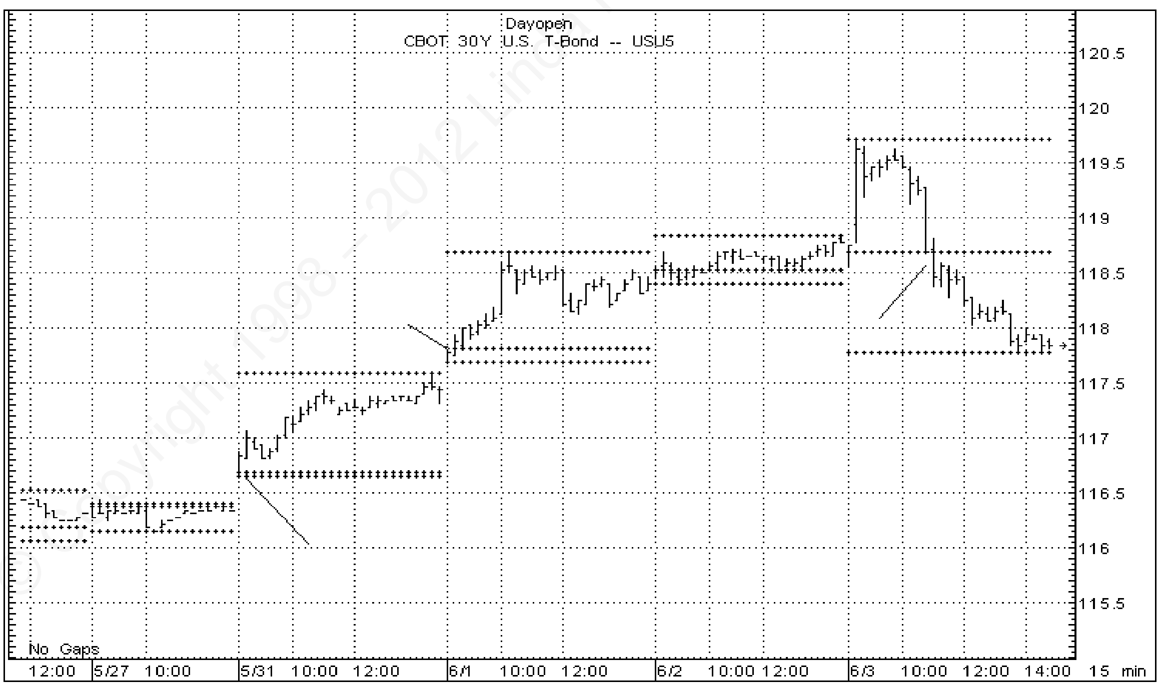

Chart 66 – Bonds - Trend Day up after Narrow/Inside range day. Another trend day up followed after market held its opening gap for the first hour.

Chart 67 – Trend days and Z-days (consolidation days) are two of the more easily identifiable patterns.

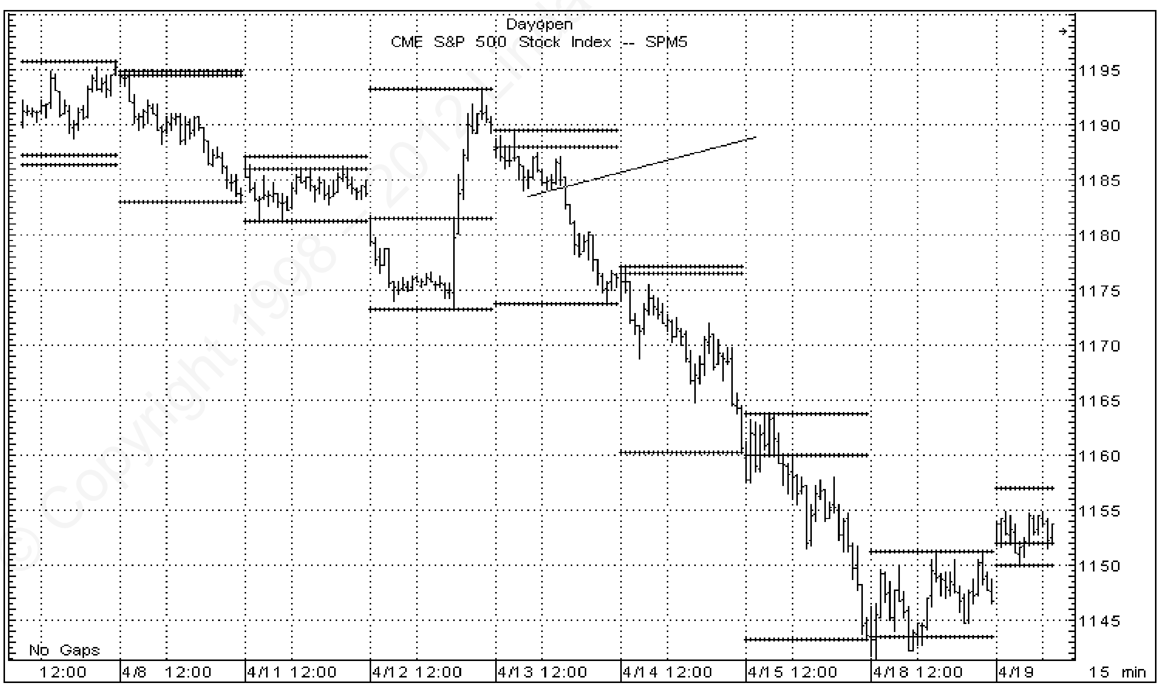

Chart 68 – Erasing the Impulse - The least likely scenario leads to a greater move in the opposite direction. Impulse should normally create short term support or resistance. When the previous day's impulse up was traded through, there was no support underneath. Note: the last hour's lows after the impulse move did not hold early on.

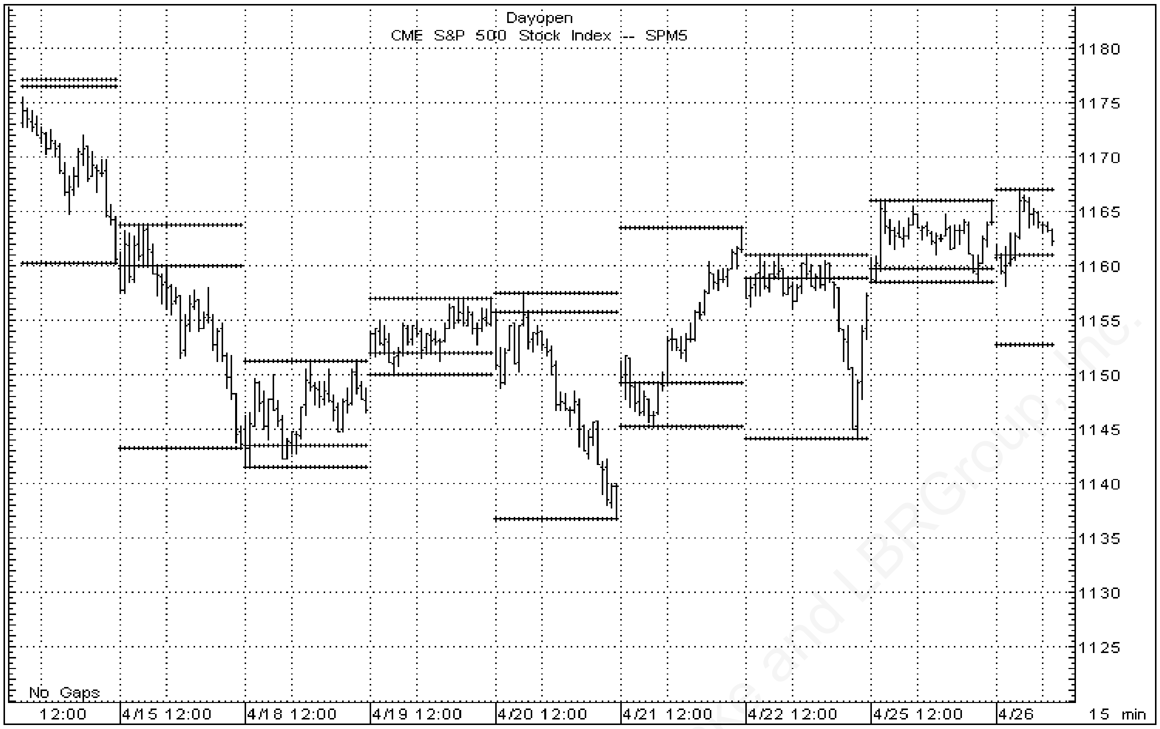

Chart 69 – Two more instances of "Erasing Impulse". Again, this type of price action does not happen very frequently but has strong forecasting implications when it does. They could be perceived as short-term Bear Traps.

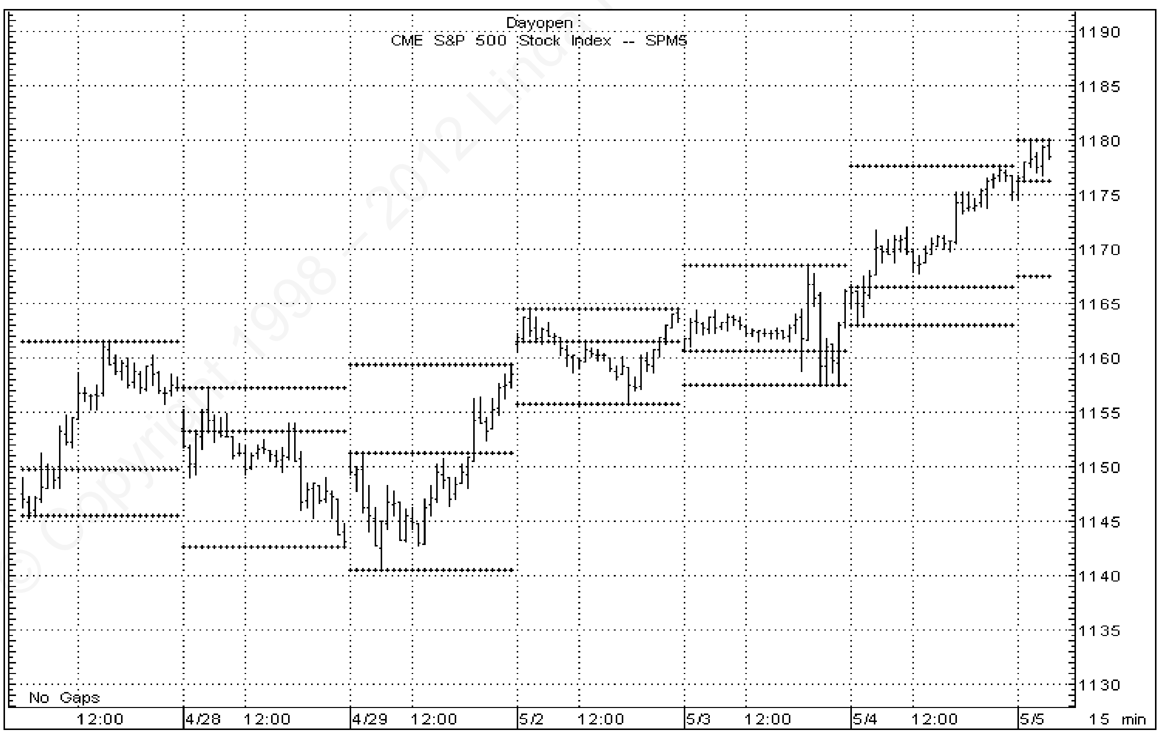

Chart 70 – Morning weakness is followed by afternoon strength. The Outside Up day was followed by two coil days, establishing an equilibrium level at a higher value.

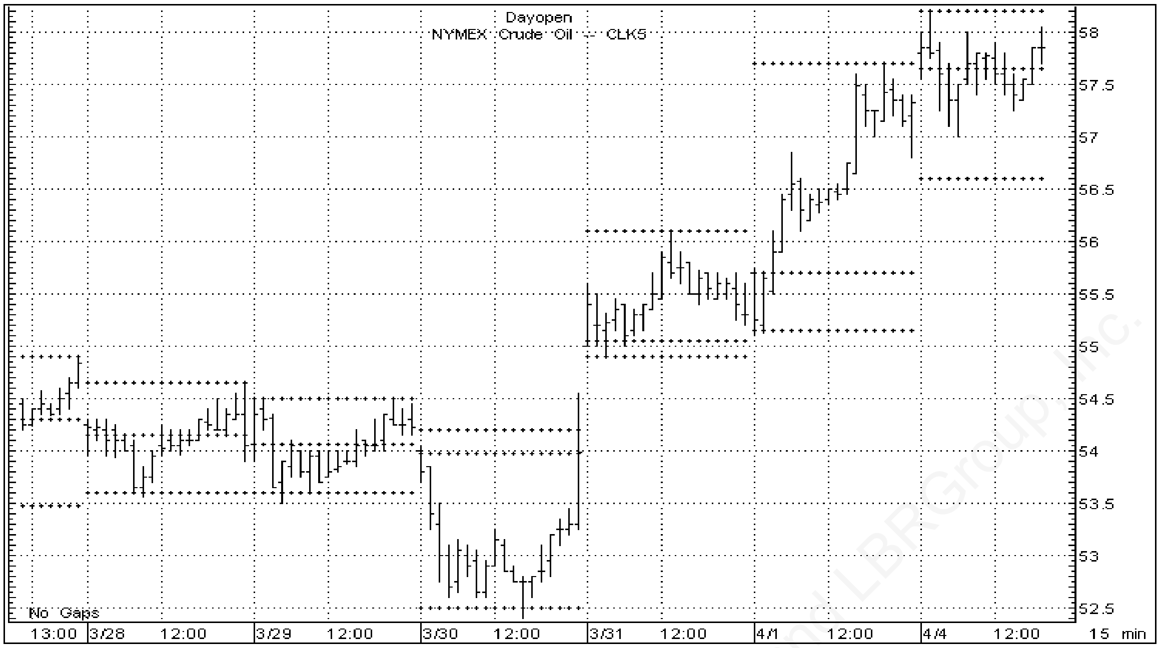

Chart 71 – Crude - the breakout from the first hour's range following 2 narrow range days set up a bear trap. The afternoon session confirmed a sharp price rejection and the market came back up through its opening price level. This is a rare pattern. As with most unusual patterns, there is strong forecasting value for a more extreme move in the opposite direction. When the least likely scenario happens, it is due to a radical shift in the supply/demand functions.

SWING TRADING CONCEPTS AND TRADING STRATEGIES

The earliest technical analysis, such as Dow, Schabacker, Wyckoff and Gann, as well as many great traders of the first half of this century, wrote about or practiced swing trading to some degree. Swing trading is nothing more than forecasting a market's move one "leg" or "swing" at a time. The market's technical strength or weakness is assessed by its position relative to the previous leg or market action.

Technical Wave structure was already presented earlier in this manual. But to generalize, a good rule of thumb is: If the previous "up-leg" was greater than the previous "down-leg" and the subsequent reaction down was shallow, a trader would look to go long. This process would continue until there was a "failure" test and the up-leg failed to show continuation. Experienced traders could play this "failure" test, but the most conservative play would be to wait until the down-leg was greater than the previous upswing and then short the first reaction up. Stops are always placed just beyond the previous support or resistance level and tightened as the market reverses its swing.

Swing trading is easier in theory than practice, as is the case with all trading methodologies. The benefit of hindsight when studying chart examples is deceptive. When decisions must be made when markets are open and moving, doubt invariably creeps in to the decision making process. So let's look at the practical realities of following one swing at a time.

First off, a swing trading strategy will, in general, show more winners than losers. There are frequent trades but only a limited amount of time spent in each trade. Swing trading is more work in exchange for more control and less risk.

Most professional traders are "bean counters". Steady profitable trades add up quickly. A trader must accept that the main things that count are the small trades that build up your equity. It's not your analysis that counts; it's your daily equity curve. So, recognize that the initial analysis is just a departure point to get pointed in the right direction. From there, it is truly a matter of seeing what the market is willing to give. There is nothing more true then the level that the actual price is trading at in the particular moment, despite the level we might wish to see.

The following concepts will keep the trader focused on the current price action and will reinforce the process of taking one step at a time.

1) Approach the market with a directional bias. This does not mean that you have an opinion – only that you have determined whether there are higher probabilities of an advance or decline. Are you looking to be a buyer or a seller?

2) Concentrate only on making one well-executed entry or exit at a time. Do not put pressure on yourself to day-trade or overtrade when markets are dull.

3) The majority of the time, there is a key “play” for the day. For example, a market might open, go down and test the previous day’s low, and then trend upwards for the course of the day, the “play” being to buy the morning test. Always keep in mind what you are “playing for” at the time you make a trade.

4) The market tends to trade from low to high or high to low. If you catch a morning reversal or find yourself in sync with the opening, don’t be too eager to take profits. Holding a winning trade throughout the day and overnight usually makes the largest gains.

A SUMMARY OF SHORT-TERM TENDENCIES WHEN FOLLOWING A 2-3 DAY RHYTHMN

- The best trading reversals occur in the morning, not the afternoon.
- Afternoon strength or weakness should have follow through the next day.
- Lower closes forecast lower prices the following morning approximately 80% of the time.
- The exceptions to the above are large range climax days!
- Prices tend to reverse every 2-½ days.
- The exception to this is a breakout from a chart formation, such as a triangle. Then expect the market to run at least 5 days.
- Following a day of range contraction, the market tends to trend in one direction for the day.
- Buy the first pullback after a new high. Sell the first rally after a new low.
- The larger the market gaps, the greater the odds of continuation and a trend.

TRADE EXECUTION

JESSE LIVERMORE: "I never could trade with a limit, I must take my chances with the market. That is what I'm trying to beat – the market, not a particular price. When I think sell, I sell. When I think stock will go up, I buy."

GEORGE DOUGLASS TAYLOR: "A trader must do his trading "at the market" never limit an order nor use stops and he must not expect to get tops or bottoms but it is surprising how many times he will get them after a little experience."

RICHARD DENNIS: "It is better to place limit orders than market orders. This is because limit orders offer a chance for better fills and less slippage than do market orders."

Each trader will develop his or her own style for execution. There are many different philosophies on which type of orders to use and why. Part of it will depend on if you are making a countertrend trade or entering on a small pause or breakout in the direction of the trend. It will also depend on which market you are trading in.

The three main ways of entering a trade are: placing limit orders to buy or sell, entering an order "at the market", and placing a resting buy or sell stop to initiate a trade in the direction a market is moving if the market trades beyond a certain level.

A trader who is trading a breakout pattern or continuation pattern in a trending market will very often price themselves out of the trade using limit orders. However, when making countertrend trades, or initiating in trading ranges, trade location can be more critical. Limit orders are more appropriate.

Two separate philosophies:

- "I do not want the trade unless it comes to my price. I place limits just beneath round numbers for sells and just above them for buys. I also place limit orders around where the market is trading when I call the floor."

- "I can't afford to miss that one good trade which might make my month. When the market reaches the price where I want to buy it, I buy it at the market. When it is time to sell, I sell at the market. "

Of course, one of the best ways is to work a limit order and give it a certain amount of time to be filled. If it is not filled within the time period you are monitoring, take the order "to the market".

In fast markets, put in a limit order. Allow for a few ticks slippage, but no more. Do not use market orders in an unstable market. Wait until the price stabilizes. If you price a trade and do not get filled, follow up and take it to the market.

Working size

When working large order size, get half on and then work the other half for an average price. Ask the broker to try to get an average price over a specific time frame – i.e., 10 minutes. (For large positions only).

The first rule is, get the position on!

Gap Openings

This is a bad spot to initiate a position. Better to use a buy or sell stop and force the market to move beyond the gap if you are looking to enter in the direction of the gap. Time can also be used as a qualifier to enter positions after a gap. If the market is still above your initial entry signal after an hour, this is a better spot on which to enter. (This applies to longer-term positions only).

If you have a position on and are looking to exit, always get an opening call. Place resting orders in the market in case the market gaps up or down big. Always take profits on a large opening gap in your favor.

Exiting profitable positions: First place a limit order in the market. See if the market will come to you. If a certain amount of time goes by and you still are not filled, take your original order "to the market". Or, if you feel the time has already expired for the trade, exit at the market.

Exiting losers - two schools of thought: 1) Exit at the market. The sooner you can get the bad trade off your sheet, the sooner you can start making the money back! 2) Bracket the market. Place a stop order on one side of the price and work a limit order on the other side to exit on a reaction. Remember, "O-C-O" – "One Order Cancels the Other" if filled.

TRADE MANAGEMENT and EXITING A POSITION

Trade management is ACTIVE management! Always monitor the market for new information. Always be looking for signs of strength and weakness. Exit immediately on any adverse development.

Prove it or lose it! Exit a trade if it is not profitable within a certain amount of time. Good trades move in your favor right away. TIME is a function that can kill a positive expectation.

If you ADD to a position, you must move your stop up to the average point of entry.

When in doubt, reduce the position size.

Day-traders must become masters at taking quick losses. You must learn to recognize as quickly as possible when you are in error. You must be on the lookout for a sign that you are wrong. The minute you realize that you are wrong in a trade, take action to get out. Place an order immediately. It does not have to be a market order but start to use a pivot or use a market bracketing strategy.

You must also recognize when you are in a good trade. PRESS your luck on a trade that immediately takes off!

The biggest mistake is a botched profit. Don't close a profitable trade without good reason. Always follow good trades up with a protective stop order to protect your profits.

Technical analysis has no place in money management. If you are in a bad position, throw the technical indicators out the window. Technical analysis only forecasts PROBABILITIES. You can't afford to deal with probabilities when you are in a losing trade! There is always the possibility of a disastrous loss. Thus, of first importance should be to exit a bad position ASAP.

The absolute best rule is NEVER GO HOME WITH A LOSS!

STOPS

Fixed money management stops have no relationship to market activity. But they are necessary. The advantage of a fixed money management stop is that its relationship to price action is random. It is unlikely to be placed around a cluster of stops or significant chart point. Stops should fall into two camps. The first type is the Worst Case scenario. This means that you want to use as WIDE a fixed money management stop as possible. The market has to be able to move in quite a broad range without hitting your stop. The second type of stop is a technical one. It is placed where the market shouldn't go. In other words, at the point that your original analysis would be proven wrong.

Money management decisions should be automatic and mechanical. Don't subject yourself to making risk judgments when under pressure. A person performs differently when under pressure.

I prefer to "turn the trade over to the market gods". Once I have a resting stop in the market, it relieves the anxiety and I do not feel compelled to watch every tick…I can let the trade do its thing. When I am stopped out, I am usually very glad I was stopped out. I have found that 90% of the time I am able to reenter at a better price if I still like the trade. When I don't use a stop, I find I let losses run a bit deeper than originally intended. Sometimes I find that by placing a stop in the market it allows me to stay with a trade a little longer.

Another type of stop is to use a time stop. Give the trade a certain amount of time to do its thing. If it is not working after a limited period of time, start taking the position off. Limited time exposure in the market equates to limited risk. And of course, the best trades start working right away!

EXECUTION PROBLEMS

Pulling the trigger

A common beginner's problem is the inability to pull the trigger. This comes from either a lack of confidence or a lack of preparedness. You must accept that your comfort level in making trades will improve with time, experience and practice.

Go back to the basics. Study the charts, study the set ups, and write out your orders or game plan the next day. Do more research until you have truly made that pattern or system your own.

The second solution is to use a system or pattern where you can place resting stop orders in the market. The market will then pull you into the trade when your orders are hit. Any time you use a stop order to enter the market, the odds are quite remote that the market will fill your order and immediately reverse. A novice trader can enlist the aid of his broker to help place resting orders in the market by which to initiate a trade.

Lastly, resting limit orders can be placed to enter the market on retracements. This works best when there is a well-defined support or resistance area, or when buying or selling at the moving averages in the direction of the trend. The main point is, start thinking about where you are going to place your orders BEFORE the market gets to your price. Good execution comes from anticipating the market's move.

Freezing up

Every professional has frozen at one point in time. This happens when a trader is blindsided by an adverse price movement. If you find yourself "hung out to dry" or caught with your pants down in an illiquid market, do the following:

Pick up the phone!

Place an order to get the ball rolling. Your immediate job is to start managing your position. Do not start looking at charts or trying to analyze the market. The mere fact that you are frozen indicates that you are on the wrong side of the market. Speed is of the essence. Place a resting stop order away from where the price is trading to limit further losses against you. Place an order on the other side of the price to exit the trade on the first reaction. Now you have the market “bracketed.” And you are in control again, even though you may still have 100% of your original position on.

If you are uncertain how to deal with a bad trade at a particular moment, at the very least place an order to exit the market MOC.

Once the price begins to stabilize or has a brief “pause”, exit your bad trade at the market.

If you freeze up, you must take some type of action, any action to get the ball rolling again. Close out the mistake and forget about it. GO ON TO THE NEXT TRADE!

RISK and MONEY MANAGEMENT

Traders differ in their appetite for risk.

Many times, the greater the risk point, the better the trade. This statement is made in the context of volatility. An active, swinging market has more to offer than a quiet market. Usually, the stops will be placed further away than they would be in a quiet market. Always assume risk if there is a positive expectation involved.

You can only know if a you have a PE (positive expectation) if you have also quantified the risk. A PE is not based on a win/loss ration. You could risk 3 ATRs (Average True Ranges) to make 1 ATR and win 66% of the time but still come out a loser. Once you have quantified risk, all you have to do is become consistent in your approach.

There are more “outlier” events, or price aberrations, than most traders and most mechanical systems take into account. These unexpected, unpredictable events are what make up a large portion of market risk. Much risk-taking rests on opportunities that develop from deviations from the norm or market inefficiencies.

Risk can be controlled by the amount of time spent in the market place. The shorter the time spent in the market, the less the risk.

Try to maximize the areas where you have control over risk and minimize the areas where you don’t. We can control leverage, time exposure, and fixed stops.

We cannot control factors such as volatility, overnight events, liquidity factors and execution risk.

One of the keys to good money management is the degree of leverage used. The majority of “big problems” come from using too much leverage. Risk management also encompasses watching the degree of correlation between positions.

When managing your trades, a good rule is to take half off and “push” the other half. Always think about putting yourself in a win-win situation. A stronger case can be made for scaling out of positions for trades made on a longer time frame. For short-term scalps, it is always best to exit the whole position at one time as apposed to trying to scale out.

Early risk management techniques were formed for the commercial concepts of insurance and diversification. A trader should think of a stop as a form of insurance.

ACCOUNT MANAGEMENT

Trade your equity curve; manage your position size.

Take profits out of your account and "put them in a cookie jar". If excess profits are allowed to stay in the account, it is too easy to give them back.

If there is an offsetting profit, one is tempted to fight the market in a losing trade. Constantly weed your garden of the losers.

No single trade is ever important. Never think about getting "even" with a market.

Mark to market every day and keep losses in perspective.

Remember, in account management, you cannot afford to play around with probabilities. You must have hard and fast rules to protect your capital.

Have a firm threshold level in your mind that you protect against for your account. If your account equity approaches this level, cut and run. Close the account down and then build it back up to this level.

Better to lose $1,000 per contract than $2,000.

Better to lose $10,000 than $30,000.

BASIC BUSINESS PLAN

Do you have a business plan? Have you written down goals? Make sure your plan and goals are thought out in bite-size pieces so you won't overwhelm yourself. Enclosed in the appendix of this manual is an outline for a basic business plan. Your business plan is a pact you make with yourself. It is your personal blueprint for success. It must include not only your goals but also a detailed plan of how you intend to get there.

The first thing your business plan must include is a detailed outline of your trading program. But this is just a small component to your overall business plan. It must also include everything from how you structure your trading environment to how you structure your life. Your mind and psyche are your main trading assets. How do you plan to protect them throughout the year? Do you have provisions included in your plan for time off? Do you have a safety net to protect yourself from sabotaging yourself if you get stuck in a rut? Don't laugh. Many traders have sabotaged their account when they have a momentary relapse and go over the deep end. A trader can be his own worst enemy. Anxiety and stress are the two biggest factors that can derail a trader. How have you structured your daily habits, your personal relationships, and your financial planning to protect yourself from these?

Your business plan should be structured to motivate you to make higher highs in your account equity. This sounds like a given, but you must truly fight to come back from each draw down. You must have allowances in your plan to not give back more than a minimal percentage of profits. You must always know what your "high water" mark is. This high point is always your next goal. Just as you swing trade the market's price action by using short-term pivots, so must you be aware of these pivot points in your account. Monitoring the draw down levels should be at the heart of your money management. As long as your draw downs are making higher lows as reflected in your account equity curve, you are doing OK!

Lastly, what type of business would you like to build over the course of a year? Do you have a three-year goal? Have you considered eventually managing money or creating your own fund? What type of research do you plan to do over the course of the year? What type of additional resources, computers, and software applications would you like to add to your ideal office setup? Many factors can be included in a business plan but it will mean nothing unless you write them down! Included in your plan should be a quarterly review to re-read your plan and see if your business is on track or if you need to modify it.

Emotional decisions are the most destructive factor to the bottom line. Your business plan is your protection to guard against these!

YOUR TRADING PROGRAM

Jesse Livermore "What beat me was not having brains to stick to my own game – that is, to play the market only when I was satisfied that the precedents that favored my play."

A trader must have a plan, methodology, system, or program! Without a program, the market already has you beat. The decision-making process can be so overwhelming you will either over-trade or be too conservative (hesitate), and sloppy mistakes will be made. Consistency is the only way to win. Having a trading program is the only way to achieve this.

Technical analysis can help provide a framework, but a program must go way beyond this. A program must have well defined rules. This is what makes trading a business.

- Which markets will be traded?
- Which time frames will be traded?
- Which patterns on each time frame will be traded?

I divide my trading program into separate “games”. Here is brief outline of how I structure my trading:

- Game 1 = intraday short-term scalping on the SPs. These are supplemental trades, but make up the bulk of my activity

- Game 2 = longer intraday trades based on 5 and 15 minute chart formations.

- Game 3 = overnight swing trades in futures markets. Trades can last anywhere from 1 – 5 days in duration.

- Game 4 = long term positions based on the daily/weekly structure.

- Game 5 = 2 – 4 times a year, put on longer-term stock positions at market turning points.

This is a lot of activity for most traders. It is not necessary to have this extensive of a plan in order to make a good living. A trader can make an exceptional living by concentrating on just one “game”. If you have more than one game, you may find it useful to keep separate accounts for each program. I have expanded my program over the years, but it is a compilation of trading full time for 23 years. Learn to play one “game” exceptionally well, before adding to your program. Too many markets and too many patterns only invite sloppiness. I know of one trader who does exceptionally well just day-trading one particular NASDAQ stock. I know another trader who only does short term breakouts in the SPs and never carries a position home overnight. This trader makes 7 figures a year. Find the mix and style that works for you. The single most important component to your program is to have a basic “bread and butter” trade. You must have the highest confidence in one trade pattern. This is the trade that you can count on to pull you out of a slump. For me, this is taking short-term scalps in the SPs.

A plan keeps one from making impulsive or irrational trading decisions during market hours. In part, a trader’s profitability depends on not making these types of trading errors. Having a plan also frees the trader from the mental angst of indecisiveness. Lastly, it is the key factor in maintaining trading consistency. (I can’t repeat this point often enough.)

The market is an incredibly complex system. The only way you can turn it into a game is to create your own set of rules. These rules don’t have to be mechanical as in having a system generates specific orders. But they are rules for governing your behavior. They are rules that distinguish when the odds are favorable enough to play and when you should stand aside. They are money management rules designed to preserve your capital and longevity in the game.

You must accept that the rules to your program can never be perfect! If there was an optimal set of rules, everyone would play by them and there would be no game. But the winners in this business have found a set of rules that work for them, and they follow their rules because they know this is the only way to achieve consistent profitability.

COMPONENTS OF A PROGRAM

A program has two components. The first is a theme, strategy, or arbitrage opportunity that can be exploited. Examples of this are a trend following program; a short-term swing-trading program based on a specific methodology, intra-day S&P trading strategies, or exploitation of a group of patterns (such as the Holy Grail ADX Trade), on different time frames and markets. You are defining your business objective and selecting your playing field. Thus, all the rules for initial entry conditions should be defined by the theme.

The second component of your program defines the actual mechanics. These include entry and exit techniques, a trade management system, an overall strategy to manage risk, and account or portfolio management rules.

To give you an idea of what a "specific technique" is, here are three examples of three trade exit strategies:

- Exit half of a position held overnight on the opening and half on an intra-day swing in your favor.
- Trail a stop and let the market take you out.
- Place an order at a profit objective. If the market does not hit your objective within a certain time frame, take your order to the market.

These strategies can be broken down even further. For example, there are several ways one can go about trailing stops. The better you are able to define these types of variables, the fewer decisions you will have to make during the trading day. You can then concentrate on "opportunities" instead of mundane details and mechanics.

These three exit strategies are good ones, but they will only work for you if you choose one and use it consistently. A trader can't tell which strategy will work best each time. Thus he must have confidence that his technique will do as well as any other on average, rather than constantly switch techniques.

Trade entry, exit and management must be automatic. The amount of leverage used should be predetermined. I use the same unit size for each market. If I am making short-term trades or am in "scalp mode only", I will trade just one unit. If the market is in a trending environment and is increasing in momentum, I will trade multiple units. The degree of leverage you use is one of the best money management tools available. Above all, you must have a program and follow it!

Use your account equity curve at the core of your money management strategy!

Stick with short-term scalps if you are starting out with a nominal amount of capital. Build up "house" capital so that you can assume a bit more risk in volatile conditions.

Many traders like to put a bit of money "on the line" in hopes of hitting a home run. However, the odds of hitting a home run are much smaller than you think. Trying to capture that glorious trend that your eye naturally gravitates to on the chart is not a realistic way to pay the month's rent. Instead, it will more likely lead you to develop bad habits by staying in marginal positions too long, hoping that they turn out to be something more than they are. Trading conservatively is definitely a grind. Bust it is the surest path to consistent profits. By designing your own trading plan and determining which patterns to trade, you will be in control by knowing when the trade setup is not working, since your risk for that trade will be predetermined and you will have chosen the support or resistance levels to trade against. Only by having a trading plan will you be able to avoid emotional trading decisions.

PUTTING TOGETHER YOUR GAME PLAN EACH DAY

It is essential to have a plan prepared before the opening each day. It frees one you up to implement the plan and manage the trades during the day. Do NOT do analysis or research during the trading day if you are planning on trading.

The first part of putting together your game plan for the next trading day should be to assess the volatility environment. Is volatility contracting as the market is beginning to consolidate after a large standard deviation move? If so, than look to trade off the short-term support and resistance levels as the market begins to form a trading range. On the other hand, if the price action has already contracted, there might be the potential for a breakout or a trend day.

Next, is there a directional bias to the next day? For example, if the market has been in an up trend, and has had a 1-2 day retracement, there would most likely be a positive directional bias the next day. Are there any bull or bear flags forming on the intraday charts? Do the daily and weekly charts support a strong directional bias?

Is the next day a Triples Expiration? End of quarter? Pre-holiday environment? Is the market in the middle of a runaway momentum move? These initial questions help determine the strategy you choose to employ the next day.

Decide the night before whether you are looking to be a buyer or a seller for your first trade. Are there any important levels that should be watched? Are there important swing highs or lows the market may gun for? Do you have positions on that you should exit? Will it be helpful to get an opening call?

These are all questions to be addressed in your daily game plan! Lastly, be aware of whether or not there are key reports or events that may lead to abnormal trading conditions. For example, FOMC meetings, or G7 meetings.

I have a worksheet I print out each night that has the previous day's high and low for each market on it. It also has space where I can note if I want to exit a position or put on a position in that market. At the bottom of the sheet is an area where I can write down the orders and fills for each market during the day. There is also a space where I write the opening price for each market that I am trading. Create your own worksheets to write out your game plan each day. You will find that if it is written down, your plans will have the best odds of actually being executed.

DAILY ROUTINE

First, it is important to have a separate office or private space designated to studying the markets where you will not be interrupted. Your analysis or preparation of the next day's trading plan must be done free from outside influence or opinions. Your trading environment should ideally be the same way.

Do your nightly homework! It is best if you can do it at the same time in the same place **every** day. The way you go about your work must be well thought out in order to strive for **consistency** in every detail.

Decide upon the important price levels ahead of time. Decide whether you want to be a buyer or a seller at those levels. Be prepared to trade on the opening! Concentrate on what you are going to do if the market acts a certain way. Ask yourself what will be the first play of the morning.

Sometimes, it's not what you DO before the markets open, but rather what you DON'T do. Do not take distracting phone calls in the morning. Don't get caught up in administrative details. Be relaxed and ready to focus on the first 15 minutes of price action. This first period gives you the most clues about the type of day ahead.

The first two hours of the trading day should be sacred. This is when some of the best opportunities occur. The pits are full and the volume should be at its best levels for the day. Don't take care of external problems during the first two hours. If there are problems (computer, phone, out-trades, distractions,) don't trade!

Every day has it's own trading rhythm. Put only well-planned positions on in the last hour. Many traders get tired at the end of the day and give back trading profits. Again, know yourself and what time of day the majority of your profits are made.

Do not do research and analysis during the trading day. These activities should be saved for after the close. The trading day should be reserved for implementing your plan, monitoring your positions, and managing your trades.

Keep a notebook of your observations and market impressions. Catalog your readings, thoughts, and notes. Sometimes the mere act of writing something down imprints it into the brain.

Sometimes you will find patterns in your own trading that will improve your profitability. For example, do the majority of your losers occur in the morning or the afternoon? Are you tired at the end of the week? See if a pattern develops with your own bottom line. Many traders run into trouble at the end of the month or the quarter. Perhaps BURNOUT might have something to do with this.

Every successful trader has his or her own rituals and routines. On the trading floor, some traders wear the same tie every single day. They take lunch at exactly the same time everyday. They follow the same path to pick up their confirmation slips, get their cup of coffee, grab a donut, and weave their way back to their trading space. Develop your own daily rituals. Ultimately, there is freedom to be found in routine and rituals. They help free the mind from "self-talk" and doubt. They keep one focused on the present and on the process. They add structure in an otherwise abstract environment. Rituals provide comfort, security, and help bring peace of the mind.

RECORD KEEPING - ADDING STRUCTURE TO THE PLAN

Write down your daily game plan! Do not put yourself in a position where you are reacting to the market's movement. You want to be prepared to take ADVANTAGE of the movement. The process of writing things down can be critical to your success as a trader. Keep a daily trading worksheet. Write down orders or trades for the next day. List any open positions and stop levels. Keep a record of your ticket numbers.

Log your trades at the end of the day. This is a discipline. It finishes off the day with a routine. Remember that routines free our mind from self-talk and give the day some type of closure. Markets are abstract. Finish the day off with something tangible.

Know where your account is at all times. Are you plus or minus on the day? How are you on the month? Recap your trades at the end of the day. Treat the markets like a business. Have routines at the end of the day to update your charts or crunch your daily numbers. The majority of successful professional traders have daily rituals that they do by hand.

MANAGING YOUR TRADING

The following points are more important than any method, technique or system we could ever show you.

If you are not in a proper frame of mind, don't trade! If you do not feel prepared for any reason, don't trade. How many millions of dollars have been needlessly lost because a trader is moving, having personal problems, having health problems, or is stressed out from an IRS audit! You are not going to perform in the market if you are not prepared to concentrate 100%.

Guard against BURNOUT! When you are burned out, you must close out your trading positions. Your judgment will become impaired and you risk losing your self-confidence. Step back, and regain your perspective and focus.

Keep your emotions in check. Try to stay on an even keel after both losing streaks and big winning trades. Your emotions need to stay steady regardless of what your equity curve is doing. Concentrate on playing a steady game. Do not think about profits.

Rely on yourself. Do not seek out other people's opinions or advice. Learn to think and trade independently.

Draw money out of your account after you make it. Do not let it build up in the account. This leads to complacency and overconfidence. You will trade differently if you know you have money you can afford to lose. Keep in your account only what you need to operate plus a small cushion.

After a long period of success or string of profitable trades, decrease your trading activity and take a rest. It is natural for a trader to get complacent or over confidant after a good winning streak. One of the worst mistakes a trader can make is to increase position size after a long string of gains. Money made should stay as money in the bank. Don't give it back!

PSYCHOLOGY

Jesse Livermore - "A stock operator has to fight a lot of expensive enemies within himself."

Humphrey Neill - "the biggest handicap of all is ourselves."

You can master technical analysis and learn dozens of trading techniques, but if you can't act in accordance with your own opinions, you will lose money.

All the personal emotions of fear, hope, greed, and our own ego will serve to distort your decision-making process and market timing. A trader's ego is a double-edged sword. There must be a strong enough ego to motivate the trader to initiate a trade in the first place. Yet, on the other hand, many times this ego can keep a trader from taking losses when he knows in his heart, as well as his head, that he is wrong.

A trader must be able to continue to pull the trigger on trades and avoid making impulsive or sloppy trades where there is no edge. Much of trading is about knowing yourself. The market is a very expensive place to learn who you are. Learn the patterns and times when you get into trouble. Know the situations that are going to draw you into making spontaneous or marginal trades.

Never dig yourself so deep into a mental hole that you can't claw your way back out. Never do so much damage to your account that you have to stop trading for a while. Once you have made back a loss, you know you can do it again. Only by closing your losing trades can you start to heal again. It is very hard to trade well with losses on your sheets. Bad positions will be a noose around your neck and will keep you from putting on the good trades.

If you are frustrated, don't think about the markets - find a distraction. If you get mad or frustrated, you are apt to make a poor decision.

Concentrate on getting experience. Intuition is just a sum of your experiences.

To become consistent, you must control your emotions. The trading game is best played in the abstract. Segregate the "real world" finances from your trading account. Have some money set aside to live on as well as to "buy" into the game.

If possible, do not stop trading on a losing trade. Try to make a "feel good" trade.

Never think about real dollars!

Get the self-talk out of your head. (How do you cut out the "head talk"? - Have a structure, a plan, and a routine).

People feel most comfortable in a congestion area, but this is the most dangerous place to play.

Recognize that sometimes the correct trade is the uncomfortable one.

If you can't pull the trigger or are fighting a losing position, you will finally take action when you get angry enough about it.

Don't force trades when nothing's happening. Instead, write things down. Doodle, draw, jot down patterns and thoughts, and keep a notebook. Writing with a pen or pencil frees up the mind from too much "self-chatter".

Also, know when you are getting burned out. This is the one of the few reasons why a trader should stop making trades for a while. If you are burned out, get out and stay out for a bit.

Take a break. Change the scenery. Walk out of the office. Keep yourself fresh!

CONCENTRATION

This can be the "make or break" point to your success as a trader. You can't allow interruptions or distractions during periods where you are making trading decisions or monitoring markets. When there is money on the line, you must give it your undivided attention and stay focused.

Lack of concentration causes sloppy trading and mistakes. This then undermines your self-confidence. Concentration means giving the task on hand your full attention. If you cannot do this, you should not trade until you get your concentration back.

Once a trade is placed and there are resting stops in the market to protect yourself, only THEN would it be OK to divert your attention to another matter.

Concentration is focusing on the process or the moment at hand. Take each moment one step at a time. Force yourself to stay in the present. Do not dwell on the past and do not project into the future.

PSYCHOLOGY OF WINNING

Your mind is the most powerful tool you have.

- Be loyal to yourself. Never be down on yourself for making a bad decision.
- Keep a positive attitude, especially when you are losing.
- Believe you can accomplish your goals eventually, no matter how long it takes.
- Don't worry about perfection.
- Don't be afraid to make mistakes.
- Do what the "correct action" calls for.
- Believe you can win the game before you sit down to play.
- Don't second-guess yourself.
- Trading is not an intellectual exercise. If you are very smart and disciplined, it might work against you. Give me someone with street smarts any day.

- Read you goals everyday!
- Fight against yourself and you will beat everybody. Fight against everyone else and you'll always play catch-up.
- Learn to use anger and make it WORK for you. You can channel it into a positive thing or you can self-destruct by it.
- Steady as she goes.... That's where all the money's going.
- There's a different dance-to-dance everyday.
- If you find an indicator that works, beat it to death.
- Everyday – appreciate the successes you've had.

IF THERE IS A WILL, THERE IS A WAY!

THE WINNING FORMULA

People who are masters or winners in their chosen field share common traits:

1) **Passion** - You must have a driving force that motivates you to succeed.

2) **Belief** - You must believe that you can achieve your goal. You must believe that you have the ability to overcome any obstacle.

3) **Game Plan** - Have a strategy or business plan by which to attack your goal. Lack of organization and preparation are the main reasons people fail.

4) **Integrity** - Have a personal value system. Your personal code of ethics is the strongest statement you can make about who you are.

5) **Commitment** - Commitment taps the unlimited source of energy reserve inside you. It provides the strength to keep moving forward each day, even when there is no visible progress. It allows one to focus on the small tasks at hand while keeping the end goal in sight. Commitment doesn't end once the initial goal is reached. It is a process of striving for constant improvement.

SLUMP BUSTING

There are two kinds of traders...those who have had a slump and those who will! Think about this...the most successful traders are the ones who have lost the most money. The majority of great traders have gone through long flat periods at some point in their career. Winning and losing periods can seem to come in streaks. But just about all extended slumps have a psychological reason behind them.

Why is it that nobody thought it was possible to run a 4-minute mile, yet when it was broken, within a few weeks 7 other runners also broke this barrier? The human species did not change…a psychological barrier was broken. Your belief system is always going to be your main weapon in pulling yourself out of a slump.

Let's review a few things. Let's say you have decided upon your trading method. You also have the second part of the equation – money management rules. You go back to your screens, monitor the markets, yet find you still aren't pulling the trigger. You still don't feel comfortable following your rules and you still have a difficult time exiting big losing trades. What's missing? The psychological part of trading is obviously very important yet that is the side that people spend the least time examining.

How many people are willing to admit that the battleground isn't the markets but what's within you? Well, the more you talk with other traders, the more you will learn that we all got through various common experiences. Most traders have run the gamut through all the classic mistakes. But what distinguishes the ones who can ultimately overcome them? Are there any psychological tricks we can use?

The markets are an interesting, stimulating game, but they are also emotionally and, at times, physically challenging. Just like boxing, you have to learn to take the punches. The mental side can be summed up real quickly…one-third beliefs, one-third concentration, and one third managing the stress.

Learn how to deal with distractions. They will be present almost every day. One of the top traders in the business has dealt with every distraction in the book…health problems, detached retinas, a divorce, his dad has Parkinson's disease, he owns other businesses and has brought companies public. Oh, and…he has minimal computer knowledge. He is, though the consummate tape reader, which demands a lot of concentration. He is also a countertrend trader, which is a style that inherently carries a high degree of risk. But this trader is the ultimate risk manager. When he is in a trade, he either has RESTING stops in place or he is giving it his FULL attention.

You will have more confidence if you are following a defined methodology. You must feel that you are making the "right play" and not worrying about the eventual outcome. It is OK to make the correct play and not have the trade work out. Don't worry if the price goes a little bit higher after you sell it – if you made the "right play," the odds will be on your side that it will soon pull back lower again.

Follow your game plan. Learn to put mistakes out of your head quickly. Let them go. There is nothing you can do when a mistake has been made except to correct it immediately. There is nothing you can do to undo the damage that has been done. It is like cheating on a diet. Once you have eaten that chocolate cake, all you can do is get back to exercising to work it off. So it is with trading and making back losses. Get back to making trades. The sooner you can clear your mind and start trading again, the faster you will make up your losses. Many traders actually trade their best when they are under the gun, so to speak. Making back a big loss is the most empowering feeling in the world! Once you have pulled back up to even, you are ready to make new account highs.

Stress impairs your judgment. Learn to recognize when you are under duress. Your mental state outside the markets will affect your decision-making ability during market hours.

A person can have knowledge, but if he doesn't have the presence of mind to handle a stressful situation, all that knowledge goes out the window. It takes confidence to be flexible. It is easier to change your mind when you are relaxed. When you are tense, it blocks the energy and this blocks the mental flow.

You must have confidence that you are going to win. Know your game. Find a way to frame the situation to be a positive one. Trust yourself to let your best judgment shine through. You must have the mental confidence in your own decision making process. Go into the markets confident but not cocky.

You have to recognize that we are all creatures of emotion. Intelligence is using that emotion at the right time in the right way. Intelligence is not being a rocket scientist; it is reacting in the right way under pressure, or using good judgment. It's making the right decisions when they need to be made.

Why can a C student be a more financially successful person than an A student? It might come down to who has better common sense and good judgment. Experience is learning to recognize your mistakes when you make them. However, experience doesn't always keep you from making the same mistakes!

The best traders learn to trust their best judgment at the time. You must train yourself over and over as to what that judgment must be. Become a high probability judgment machine. The price model in your head must become second nature.

Capitalize on short-term opportunities for quick profits. Study the longer-term opportunities. In other words, scalp the easy profits and lie in wait for the bigger trades.

Learn to concentrate your focus on MAKING money and quit thinking about the ways you can lose money. It is better to make the trade and assume some risk than it is not to try at all.

The way to increase trading profits is to continue to do the same thing but do it on bigger size. Once you make back the first draw down on bigger size (which may invariably happen right off the bat), your confidence will triple.

Great traders have learned how to take a loss. Know when a loss is going to get worse and act defensively.

Strive to always be at your high water mark. This is all time highs in your trading account. When you have a draw down, there is no better satisfaction than making it back up. Think all the time about succeeding.

You will have your best feel for the market when you have a position on. You never have a better feel of the pulse of the market than when you experience it first hand.

STAYING IN THE GAME MENTALLY

You must always believe that there is a way to make your monetary goals – even if it takes you an eternity to do it. You must believe it is possible.

You must believe that there is a strategy you can use and fall back on. You must have a game plan for every day.

Focus on the numbers, patterns, and tendencies to get an edge. Knowledge will give you an edge. So will understanding your own game. Preparation will give you your final edge.

The following comments were inspired from Brad Gilbert's book, Winning Ugly, which was written about tennis. There are many parallels between tennis and trading, both being individual performance disciplines.

- The most successful players are the ones who have a burning desire to win.
- Don't check out of the game. Never give up! DEFY FAILURE!
- Improve your consistency. Stay active, stay involved, and keep your feet moving.
- Be patient. Do not force a trade that isn't there. Wait for the play to set up.
- When you get a good trade, go for it. Manage it. Trail a stop. Don't be too eager to get out.
- Be flexible if what you're doing isn't working, change.
- When down, get a little rhythm and confidence going. Don't worry about being too ambitious.
- Stay with your game. Don't let outside distractions bother you. They take energy and break your concentration.
- Match your particular strengths to the type of market conditions.
- Hate making stupid mistakes and unforced errors. This includes not getting out of a bad trade when you know you are wrong.
- Many players will play their best game when they are coming from behind.

MENTAL TOUGHNESS

Monitor your very first trade or instincts to see if you are reactive or not. If you are emotional, why? No game plan? Not prepared? Too many positions? Have you just had a big winner or big loser? Once again, know yourself and your style. Do you fight back when you have losers, or do you hold back on pulling the trigger?

Jesse Livermore knew the markets and how to read the tape as well as anyone in his time. He made many great trades and knew exactly how to trade to make money. He had a well-defined methodology that had proven itself many times over. But, he blew out many times and ultimately wiped out in total in the cotton market. He died penniless. Why? He was a compulsive gambler. Even though he knew exactly how he should be trading, he could not act in accordance with this. His greatest enemy was not lack of knowledge or preparedness. It was truly himself.

Every great trader will have periods where they are not in the right space to trade. Evaluate yourself after a losing spell and see if you can identify if there were external factors that got in the way. Learn to re-center and regroup. Where do you get yourself into predicaments? Avoid situations that get you into trouble.

Which is worse...seeing the trade but not acting on it, or over-trading and not distinguishing between the high versus the low probability trades?

You can't look back at the trade you have just blown. You can only look forward. You must stay in the here and the now. Only look forward and do whatever it takes you to keep going.

Stay in the present, the here and now. Do not look on a horizon too far. What do you see now? Stay in the market down to the minute. What is the market doing right now?

Discard losing trades. Learn to take the loss the best way you can do it. If you perceive that the loss is going to get worse, get rid of it right away.

Put on the biggest positions when you are at the sharpest point in the game. Is that the first part of the month when you are fresh or the last part when you already have profits to play with?

What is the personality of the market for the day? Some traders use a model of a market manipulator, a "composite operator", or a "pool operator". Are the big players present on the day? It is like assessing the weather conditions for the day. Is it the type of day that you can make hay on?

The first trade is often a test trade not only to judge your emotional state but also to test the liquidity.

You must not allow any outside influence into your trading space. Your belief in your indicators must supercede everything.

Battle to see the Price objectively as opposed to what you feel or believe it is.

Have an initial plan. Adjust the plan after the opening. Even if you are just a scalper, you need a daily road map. Every trade should be made for a reason.

It is easier to have studied the chart patterns the night before and then just focus on a few key pivot points.

Always be on guard against getting casual. If you let a loss go too far, you are still going to have to get out eventually.

Hardships, setbacks and deprivation make a person tougher. People who have experienced adversity before do well because they know that failures and setbacks are part of the process.

WHEN THINGS GO BAD

- Talk about your fears or problems. Acknowledge them. This is the first step in learning how to deal with it.
- Make sure you do not sink into an investment mentality. The market has a different personality every day and can be traded in both directions.
- Go back to basics. Do some research. Study the simple trading patterns.
- Manage your lifestyle. Keep a balance and perspective and guard against burnout.
- Do your homework. Ask yourself, are you a trader today? Then follow your plan.
- Jumpstart some other part of your life such as an exercise program or hobby.
- Keep your mind occupied. Do not dwell on damage done that can't be undone.
- Learn how to channel your stress. A physical outlet is an excellent way.
- Build a support network. Have a friend or family member you can confide in. Develop other trader friendships.
- Don't forget to remind yourself about the things that you have done right in the past.
- Make sure to note the patterns within yourself so the negative ones do not repeat themselves.

Putting it all together

Here is a sample discretionary trading strategy that utilizes many of the concepts that been presented in this manual. The approach uses trend identification, multiple time frames, relative strength and tape reading skills. This might be a sample routine for a trader who trades a basket of futures or a basket of stocks.

Trading approach for Trader X

Nightly Preparation

Each evening, Trader X's goal is to figure out which markets are trending, which markets have pulled back within the trend, which markets are in a range, which markets have breakout set ups for the next day, which markets are too ambiguous to make trading decisions on.

Weekly charts are examined first in order to determine if the market is in an uptrend, a downtrend or a sideways line/range. Daily charts are then used to look for either retracement patterns in the direction of the trend, or momentum divergences that signal a correction is due. Broader daily consolidations, such as triangle formations or low ADX readings are also noted. For situations where there is a clean chart pattern, such as a bull flag or a triangle, potential breakout levels are written down.

For markets that are in a steady up-trend, the trader must wait for a day where the market corrects high to low. Pinball buys, short-term continuation patterns such as inside days, and 1-2 day flag formations are noted. “Buy Day’ or “Sell Short” day is written down on the trading sheet for the next day. Either the previous day’s high and low or short term support and resistance levels are written down on the trade sheet.

If the market is range bound and price has most recently touched the lower end of the range, is now moving up, she prepares to be a BUYER the next day.

If the market is range bound and price has most recently touched the upper end of the range, is now moving down, she prepares to be a SELLER the next day.

Short term reversal patterns such as buy and sell divergences or momentum divergences on the hourly charts are also noted and written down for each market traded.

At the end of the evening, the trader has a list of markets that can be traded the next day.

The Trading Day

Before the market’s opening, the trader checks the opening call and makes notes where the market is expected to open relative to the previous day’s high and low. The support and resistance levels written down on the trade sheet are reviewed, along with any breakout points. Once a market opens, short term charts such as a 3, 5 or 15 minute time frame can be used to frame out trades. For long trades, “tests” (such as short term buy divergences), intraday bull flags, or buy stops above resistance levels can be used to initiate trades in the markets listed as “Buy Days”. The reverse holds true for markets with the notation “Sell Short Day”.

Once a trade is made, the time and fill price are written down on a separate order sheet. Resting protective stop orders that have been placed are also written down. The trade is now monitored for confirmation that the market is moving as anticipated. Confirmation should appear as movement in the direction that the trade was placed. The ideal trade shows short-term impulse or momentum in the trader’s favor. If the market moves off as expected, the stop is then tightened to minimize risk. If the market shows no confirmation, the trader starts to reduce the position size or exit for a small scalp only. If the market moves against the trader’s position, the trader then exits on the first reaction unless the stop is hit.

At the end of the day, existing positions are reviewed for potential objective levels the following day. It is noted whether a stop is to be trailed, a position is to be exited, or if there are add on points the following day. The process of a more complete review of all the markets is then done at night.

This might be a one sample routine that allows a trader to follow multiple markets the next day. For stock traders, it is useful to have a "watch list" as well. This is a list of markets with either breakout setups or retracement patterns that could be triggered the next day. If a trader just specializes in a single market, such as the index futures, obviously the more levels that are noted the night before, such as swing highs and lows, unfilled gaps, previous day's highs and low, etc., the better prepared a trader will be for whatever may unfold the following session.

Using Relative Strength to augment the Trading Day

On certain days, markets that weren't on the watch list the night before may demonstrate a strong trend off the opening price. If a trader has charting software that has scanning or ranking features, studies such as percent up or down, or percent up or down off the opening price can be useful. Markets that are the relative strength leaders after the first hour should be traded from the long side for short term augmentation trades. The shares that are weakest tend to have 1-2 scalping opportunities for short sales.

Summary

The things to note about this strategy are:

1. Nightly preparation
2. The use of higher timeframes to determine the trend
3. The use of relative strength
4. Note how many days the market just traded high to low or low to high.
5. The discipline to NOT trade issues that are not on the daily trade plan (with one notable exception)

Appendices

Appendix A - CONCENTRATION – excerpt from “Tubbs’ Stock Market Correspondence Lessons”[2]

“Concentration is bringing to focal point, intensifying action. Our objective is successful trading; having objective is concentration; within that is focusing on the objective. Every specialist concentrates on his objective, not the objective of a dozen stocks. Market trading and all uses of the market is business warfare. In every struggle (fight), concentration wins. Centralize thought, idea, and force. Market trading becomes a one-man business through concentration.

Certain philosophies speak of the “monkey-mind” because thought runs from branch to branch with no activity or purpose, objective or aim. Every trade in stocks that is aimless, goes “wild”; that’s inevitable. Thought –of which one has tens of thousands each day - must be curbed and centered ere good result can come…Curb of thought is first step in concentration. Instead of thinking ten thousand thoughts condense them into a hundred. How? By thinking of one thing to the exclusion of others till that thing (or thought) magnifies so as to fill the mind. Thought is under command. One may think good as well as evil; right, as readily as wrong. Choose. The lesson of the moment is on concentration of thought; for now, keep that dominant. THAT is concentration”.

Determination + Attitude = Success!

A race is never won unless you finish it. It is never started unless you believe you can do it. To begin and end any endeavor, you must have the attitude that you can do it and be determined to finish what you start.

The field of trading is no different. Finish what you start! But to do so, you must have the attitude that it is possible to win. You must be determined to prove yourself right. The facts are: If you believe you can do it, you can do it!

I once heard words from a man who was paralyzed from the chest down and told he would not be able to get around on his own, but now moves freely in his wheelchair, as well as drives, “If it is difficult, you can overcome it. If it is impossible, it just means it will take a little more time.”

How true those words are!

Do you allow others to tell you that you cannot succeed?

Do you tell yourself that you are not good enough?

Do you put off taking action although you know you really should?

Do you find yourself giving up before completing what you started?

[2] Courtesy of a successful fellow trader.

If so, you need to readjust your attitude and become determined to finish what you start.

All people are unique with different gifts. Yet, with a positive mental attitude, and a belief that you are just as capable of succeeding as anyone else, you will have a foundation to build upon.

Let me tell you a story I found interesting:

There were these two eggs that were soon to come alive. They were discussing what they wanted to be in life. The one egg says to the other, “I would like to be like an oyster. An oyster only has to lie at the bottom of the ocean and just lets the water move him about. I will eat the food that comes between my shells as the water moves past me. I will eat only what the water passes by me, no more and no less.   I will go where the water moves me. As an oyster, I won’t have to do anything at all.” The other egg said, “That’s not the life for me. I want to be an eagle. Sure, I will have to hunt for my food. But I will be able to go where I want to go. Sure, life as an eagle will be harder, but I will be able to soar above the mountains or into the valleys below. I will control where I will go, not be controlled. Yes, it will be harder to be an eagle, yet I will be free to choose where I will go.”

This is exactly what life is all about, and also trading. The water is like the masses of traders who inevitably lose. Instead of choosing a direction for themselves in the direction in which to travel, they let the masses do the choosing for them. The results are usually disastrous and they soon drop out of the race.

I suggest making a daily affirmation. This technique has shown great results for many people.

Each day, on a clean sheet of paper, write the following line 20 times. Do this each morning for 21 days.   Your determination to succeed will improve daily. It is up to you to stick to this for 21 days to be effective.

This is the affirmation:

“All my thoughts and actions draw success towards me more and more each day.”

In almost any worthwhile endeavor, it takes climbing some major obstacles to get there. Too many people actually quit right when they are on the 1-yard line! Don’t let this be you. Believe in yourself, as you are just as capable as anyone else who has succeeded before you.

If you hear yourself saying to yourself, “I can’t do this”, it will take at least three positive affirmations to correct these negative thoughts. Positive thinking has allowed many to rise from the ashes of mediocrity to the height of greatness. Step out of your bubble and do something you might have been afraid to do before, no matter how small.

Small steps will eventually get you to the finish line. Time is not relevant if you start now. You WILL finish. Be determined to do so regardless. Avoid those who talk the negative talk, as they have given up and do not wish for anyone around them to be successful. Surround yourself with positive people, people motivated to improve, always encouraging you to continue your dream, your goals.

As the Bible says at 1 Corinthians 15:33, “Bad associations spoil useful habits.” This fact is as ancient as man! Keep yourself deep in positive material; avoid the negative of the newspapers. Read more entrepreneurial material such as Success magazine and other encouraging press.

What you feed your mind is what will motor your mind and actions. Make sure you feed it the food of positive thinking. Be determined to succeed in your dreams to be a successful trader, no matter how long it takes.

Be like the eagle. You are in control. Fly the heights in whichever direction you choose. It doesn’t matter, as long as you are the one making the choices.

Be determined to succeed. Have the positive attitude that you will succeed.

YOU WILL THEN SUCCEED!

Appendix B - DAYTRADING S&P FUTURES - Linda Bradford Raschke

The S&P market is a trading arena unto itself, which can accommodate many different trading styles. Not only does this market display a different daily profile than the other futures markets, but also it has a much longer "length of line" (intraday swings), and thus offers more trading opportunities. Additionally, there is a wealth of information provided by internal indicators on the equities market. In this article, I would like to share some observations, pointers, and favorite trading patterns. However, let me also say that the majority of the professional S&P daytraders I know tend to specialize in just one pattern or trade just one style. This is definitely a market where Over-trading can be a temptation

Swing Trading Concepts

The principles of "swing-trading" are nothing more than applying basic technical analysis to the secondary fluctuations that occur in a market. We can apply these principles to all time frames and all markets, but they work particularly well with the S&P's, so a brief summary is first in order.

Swing trading is following the price action and learning to anticipate the market's most probable course of action. We learn to determine the immediate trend by observing whether upswings are greater or lesser than downswings. In a simplified model, we look to enter on retracements in the direction of the trend. An early sign of a trend reversal is a "test" of a most recent extreme price level, which usually forms a higher low (or lower high). A trend reversal is confirmed when the upswing leg exceeds the length of the downswing (or vice versa). If a trader enters a position on a "test" looking for a trend reversal, but does not get this confirmation, he should exit the trade or pull his stop up close to his entry price.

There are also periods of market rest, consolidation, or low volatility range contractions. These patterns provide an opportunity for traders who like to trade "volatility breakouts" - a methodology in which one waits for the market to tip its hand with a powerful thrust and then jumps on board in the direction of the movement. This too, can be a form of swing trading, as we are playing only for the market's next immediate move and not making any longer-term judgments.

When a trader practices the principles of swing trading, he learns to develop a conceptual roadmap in his head. In the S&P market, it is particularly important to learn to think in terms of concepts because there can be so much distracting intraday "noise". Other concepts include: mid-morning trends tend to carry into 12:00(EDT) +/- 15 minutes. The best average intraday trends tend to last 45 to 90 minutes before having a countertrend reaction. The earlier a trend starts, the earlier it peters out. There is often an opportunity to play off a reversal of the move into 10:00 (EDT) +/- 15 minutes. The markets tend to be more emotional at the beginning of the day when a good move counter to the initial opening swing can occur. If you learn to think in terms of concepts, you can master the markets instead of becoming a slave to the charts.

Time-of-Day Tips

On average there are only 2-3 great S&P intraday "legs" or swings. Most professionals catch only 3-4 really great trades a week, if that! (Most trades will often be very small wins and losses). So don't be too harsh on yourself if you feel that you are missing the majority of the movement. Overtrading suckers one into seeing only the trees and missing the forest.

Traders tend to be creatures of habit, and thus it is easy to compile market tendency charts. There are several key patterns that have held constant over time. One common pattern might be: the market rallies or sells off into noontime. At this point, a large percentage of the floor traders and brokers in New York go to lunch and a countertrend correction begins. When the late stragglers get back from lunch, the morning direction tries to reassert itself again. If the afternoon rally or sell off starts too soon, it won't be able to sustain itself through the end of the day. It will die out around the bond close. However, if there is an afternoon "shakeout", (usually between 2:00-2:30), then the market can finish in a trend mode into the close.

Do not fade a move into the last hour of the day, for there is no time to exit gracefully if wrong. The odds suggest a better entry price the next day on the probable morning follow through. Moves on Friday tend to end at 3:00, not 4:00, too many traders prefer to flatten out or even up before the weekend.

On many days there occurs what I call the 3 o'clock jiggle. Right around the time the bonds close, there is a great 10-15 minute scalp trade. I believe it occurs as an emotional reaction to how the bonds go out. The trade usually lasts for no more than 10 to 20 minutes, but is fun to anticipate.

Sometimes a good selling opportunity occurs around 2:00. In fact, it is amazing how many good turning points occur on hourly readings, for example, 10:00, 12:00, and 1:00. I think this is because people are more conscious of time at these moments, creating a slightly sobering effect.

Divergences

Many clues can be gained by watching the S&P market in relationship to other markets or indexes. There is very often a leading/lagging relationship with the following: the NASDAQ, the Dow Jones Industrial Average, the Transportation Index, the bond market, and even the OEX's. These types of observations are another form of tape reading. How is the market acting? Is it holding together as the bonds are making new lows? What does this tell you? Is the S&P failing to confirm a new afternoon low made by another index? This may be a sign of relative strength.

Divergences with other indicators based on market internals make fabulous trading signals. My favorite one is when the S&P makes a higher high but the "Ticks" fail to make a higher high, indicating a potential non-confirmation or sell divergence. "Ticks" also indicate how much buying or selling power there is... in other words, fuel for the fire. Technically, the Tick represents the net number of stocks on the NYSE trading on an up price change or a down price change from the previous transaction. If Ticks are minus 500, there is lots of fuel for an upside rally. If Ticks are plus 500, buying power is running out. In general, pay attention when the Ticks stop going up or down. From here the market may often reverse. I don't necessarily initiate a trade by fading these extremes, but I may use this point to take profits on an existing position. It is much easier to sense the loss of momentum in a move when watching the Ticks because there is not as much "noise" compared to the price of the S&P.

The divergence pattern can also be used with the S&P premium level. For example, if the S&P contract makes a new low but the premium level makes a higher low, this indicates relative strength in the underlying cash index.

Another intraday indicator I would like to mention is the Trin (the concentration of volume in advancing and declining stocks.) Trin represents the market's "gas pedal". The absolute value of the Trin is not really as important as the direction it is trending. If the Trin is dropping from 80...76...74...72... it indicates buying coming into the market. Someone is stepping on the gas pedal. If the Trin holds at a constant level from here, you can say that there is no selling coming into the market. In other words, there is no deterioration. In general, follow the trend of the Trin. A change in its direction confirms market turning points. (In the first 1/2 hour of trading, the Trin will tend to jump around a lot. Don't pay too much attention to this indicator until the majority of stocks have opened and had a chance to stabilize).

Exits

Many traders can get good entry points but don't exit very gracefully. In fact, this is a common problem for the very reason that exit signals are never as strong as entry signals. If they were, we would constantly be stopping and reversing - a tiring prospect.

I have always found it psychologically easier to exit too early rather than too late in the S&P's. I get my best prices by selling longs into strength and covering shorts as the market falls - not after it turns. These days I usually pick up the phone and go in "at the market". I am happy to take a profit and don't want it to slip away by worrying about a few extra ticks in a fast market.

Trend Days

Good trend days occur 2-3 times a month. On these days, the market will open at one end of the range and close at the opposite extreme. Trend days most often occur after 2-3 small range days or a period of dull, listless trading. These are the types of days that systematic volatility breakout traders like to capture. Trend days are usually accompanied by heavy volume, extreme advance/decline ratios, and extreme Trin readings that do not back off much during the day.

Do not get anxious if you missed the morning move or tried unsuccessfully to fight it; trend days tend to have a parabolic move in the afternoon. Again, think of the concept: the market will close much further away from whatever the current price is. Pick up the phone and enter in the direction of the trend. Use the previous hours opposite extreme price as a protective stop and plan to hold the trade until the end of the day.

Trend days also often occur when there is a big price gap on the opening. It is generally difficult to predict with any statistical accuracy whether or not the market will trend up or down. However, the best entry signal is to buy if the market starts trading higher than the first hour's trading range and sell if it breaks below it. (Aggressive traders like to "cheat" on this parameter and try and enter a bit earlier). This is also an excellent way to enter breakout traders where the previous day's range has been relatively narrow.

How to Limit Losses

Any experienced trader can tell you that his greatest losses have been taken on those rare occasions where he substituted stubbornness for a proper stop loss technique. The proper way to trade is to establish where a stop loss will be taken before the trade is made. I recommend risking an initial fixed amount because it simplifies calculations and order entry. (In other words, you don't have to think about it too much!). You can then pull the stop up tighter if the trade does start working in your favor. If a trader waits until he has a loss before making that initial decision, his judgment is almost certain to be affected.

The best trades will tend to work right away if the trader has correctly anticipated a pullback or spotted a divergence. The market's response should be swift and certain. However, no trader is infallible, and thus a stop loss should be considered an invaluable form of "business" insurance.

I suggest keeping a daily journal to note your own observations. Also note which types of trades seem to work out best for you. I know one market professional who trades best by waiting for a strong afternoon thrust. He then enters on the first pullback in the direction of the thrust. He gets "chopped up" in the morning's crosscurrents and therefore avoids trading in the mornings. However, another good friend can only trade in the morning and only from the short side. He waits for an initial morning surge, places his shorts, and never risks more than 2 points. This professional has consistently made a most enviable living for the past 15 years. The moral of the story is: he knows himself and what style works best for him, and he always has a resting stop loss order in the marketplace.

Paper trading can never substitute the psychological lessons accompanying putting a real trade "in your gut". Don't worry about the exact prices you are getting in or out at, but instead remember to always think in terms of concepts - it is far more important to get the main idea right! Time and practice will then improve upon your execution skills and allow you to build up your confidence level.

Best Wishes for Happy Trading!

Appendix C - The Forefathers of Swing Trading – Linda Raschke

Traditionally, there have been two major methods of forecasting market movements – the fundamental method and the technical method. Fundamental factors include analysis of long-term business cycles and identifying extremes in security prices and public sentiment. An investor who looks to establish a line of securities after a long term business cycle low was said to be playing for the "long-swing". Short-swing trading (also referred to as "swing trading"), seeks to capitalize on the short and intermediate waves or price fluctuations that occur inside the longer major trends.

The market's short-term swings are caused by temporary imbalances in supply and demand. This causes the price action to move in "waves". A combination of up waves and down waves form a trend. Once the technical study of these imbalances in supply and demand is understood, the principles of swing trading can be applied to any time frame in any market.

Swing trading is based on the study of price behavior, as well as relative strength or weakness. In other words, the length and amplitude of the current swing is compared to prior swings. A trader attempts to forecast the probabilities of the next most immediate swing in terms of the probabilities of reasonable risk/reward ratios for the next leg up or down. A swing trading strategy should show more winners than losers. There will be frequent trades but limited time spent in those trades. Short-term swing trading is more work in exchange for more control and less risk.

The earliest fathers of traditional technical analysis as well as many great traders in the first half of this century examined both longer-term cycles and short-term price fluctuations. Most of them practiced swing trading to some degree. If we study their work, we will find the origin of the three basic types of swing trading patterns today.

Perhaps the best-known "father" of technical analysis was Charles Dow. From 1900 to 1902, he wrote a series of editorials on the markets. His theories were intended to serve as a barometer of general business activity. It was later that his principles were actually developed into what we know today as technical analysis.

Sam Nelson, another author and market technician, had tried unsuccessfully to convince Dow to set forth his ideas in a book. Nelson ultimately collected Dow's editorials and developed Dow's ideas into principles of market behavior. Nelson was the one who coined the phrase Dow Theory. Two other technicians also developed Dow's ideas into a more formalized structure. The first was William Hamilton, who became the editor of the Wall Street Journal after Dow died, and the second was Robert Rhea.

Dow set forth that there are three different market movements going on simultaneously. They are called the Primary, Secondary, and Minor or Day-to-Day trends. Though Dow Theory concentrates on forecasting the primary trend, which can last three to six years, the theorems and observations as to the nature of the secondary trends, which can last anywhere from three weeks to a few months, form the basis for swing trading. The first principle that Dow pointed out is that of Action – Reaction. It states that the market moves in waves, or up-legs and down-legs. In a bull market the swings upwards are called Primary Swings and the down swings are called secondary reactions. The greater the swing in one direction, the greater the eventual reaction will be when it does come. One important thing to note is that each market movement represents a different time frame and different time frames can be in opposite trends at the same time. For example, the Primary trend could be up, yet the Minor trend could be down.

Dow gave us the classic definition of a trend based on the movement of the secondary reactions. For an up-trend to be established, the price action must display both a higher high AND a higher low. For an up-trend to reverse, a lower high AND lower low must occur. A trend will remain intact until it changes according to the above definitions, and a trend has greater odds of continuation than it does of reversal. In a strongly trending environment, a swing trader looks to trade only in the direction of the trend for this is the true path of least resistance.

The idea that Dow is best known for is, "the Averages discount everything." The markets represent a composite of all known information and prevailingly emotions. This is the underlying assumption of technical analysis - all known variables have already been discounted by the current price action. Swing trading is purely priced based. A trader will do best having no opinions or preconceived ideas. Ideally, all he has to do is identify the trend and wait for a low risk entry in the direction of the trend.

Dow also gave us the concept of confirmation/non-confirmation. He stated that a change in the primary trend must be confirmed by two other indexes - the Dow Industrials and the Transportation Averages. Today, this principle of confirmation/ non-confirmation (also known as "divergence") is used in comparing one market to another market or index on both a short and a long-term basis. It can also be used to compare the price action to a variety of technical indicators. A non-confirmation is one of the tools used to warn of a "failure test" or potential for a swing reversal. (chart example – INDUS versus TRAN)

Lastly, Dow looked at the importance of volume in confirming the movement of the secondary reactions. For example, a market that is oversold will display light volume on sell-offs and increasing volume on rallies. Upswings can often start on light volume and end with excessive activity. Analysis of the volume can be used in conjunction with swing trading, but is not essential. More importantly, volume can also be used to confirm a breakout from a "line" or consolidation area. Breakouts are the third type of swing trading pattern to be aware of (retracements and "tests" or failure swings are the first and second types of swing trading patterns).

This concept of a "sideways line," was originally defined as a sideways movement extending for a few weeks within a 5% price fluctuation. This represents a period of accumulation or distribution. Lines often occur in the middle of secondary swings. However, small "lines" or periods of consolidation occur in just about any chart in any market on any time frame. The concept of a breakout from a line includes a different set of factors than just analyzing price direction. It touches upon cycles in volatility or the principle that contraction in range is followed by range expansion.

Robert Rhea studied Dow's work and spent much time compiling market statistics and adding to Dow's observations. He noted that indexes will be more inclined to form horizontal lines or extended chart formations than an individual stock will. He was also one of the first technicians to specify that a price movement must have a minimum amplitude in order to be considered a legitimate secondary swing. In the second half of this chapter, we will look at different criteria that can be used to categorize a market's swing, including percentage filters for the amplitude of a wave. This is particularly important when it comes to building your own swing charts.

Analyzing the market's swings is much easier when the market has good volatility and range. It is much trickier when the price starts trading sideways and the range narrows. The amplitude or length of a swing, in addition to its length or duration, are two of the main criteria used to assess the relative strength or weakness of the market's technical position. The third criteria would be the volume on each swing. In a trending environment, the amplitude of the market's reactions tends to be similar in nature. A swing trader can look for equal length swings as a measuring method for a market's expected move.

While Dow set forth some basic principles of price behavior, including the theory that market movements are comprised of a series of swings and reactions, Richard Schabacker could be called the father of the "science" of technical analysis. Schabacker categorized concrete tools that help the technician not only to forecast a move, but also to recognize signs that a swing might end. He was the first to classify common chart formations, develop "gap" theory, formalize the use of trend lines, and emphasize the importance of support and resistance levels. Few people are aware that Schabacker was R.D. Edwards' uncle, and much of Edwards and Magee's "Technical Analysis of Stock Trend" is an expose of Schabacker's work.

Richard Schabacker was the youngest financial editor of Forbes magazine. He was a prolific writer and managed to pen three huge volumes before his untimely death at age 36. The bulk of his writings were published in the early thirties. In addition to being a consummate technician, he was also a renowned forecaster and an astute trader. No one has written with more insight than Schabacker on the differences between short-term swing trading and long-swing investing. He said, in general, a long-swing investor has less worry, fewer chances of making mistakes, smaller commissions, and most likely, smaller profits. Trading for the short-swing movements, a person will have more work, more worry, higher commissions, but chances for much larger profit.

Some of Schabacker's greatest insights are on the psychological aspects of trading. Regarding the difficulty in holding positions for the long run, he stated, "You'll start out with the best of intentions, but you probably won't be able to buck human nature. And even if you do succeed in holding conscientiously to your long-swing basis all the way through, it will be so difficult that you won't have much fun in doing it." Short-term swing trading is more in line with human nature, with a desire for fairly rapid action.

Schabacker's most popular tool was using bar charts, which record the market's price action. When studying the market's technical position, the practice of chart reading is devoted to studying certain patterns in order to forecast future price movement. Schabacker grouped these patterns into two classes – continuation patterns and reversal formations. He noted that the chart patterns with the most forecasting significance do not occur very frequently, but they're quite important when they do show up. It is important for a swing trader to remember that they do not need to be in the market all the time, and that it requires a great deal of patience to wait for the high probability trades to set up.

Continuation patterns include triangles, small rectangles, pennants and flags. Usually, these formations occur because the preceding movement has been too rapid. Aggressive swing traders understand that continuation patterns are one of the best methods for isolating the most favorable risk reward setups. The more time a trader spends in the market, the more risk exposure there is. The object of trading on the short-term swings is to try and capture the most amount of gain in the least amount of time. (chart example of bull flag)

Reversal formations take a much longer time to form, and are prone to a larger number of false breakouts than continuation patterns. As a general rule of thumb, the longer the duration of the particular chart pattern, the greater the odds that it will be a reversal pattern.

Schabacker pioneered work with price gaps and categorized them into common gaps, breakaway gaps, continuation gaps, an exhaustion gaps. He considered gap phenomena to have great forecasting value regarding the potential for the next immediate price swing. He was also one of the first to write extensively on both trend lines, and support and resistance levels. Trend lines serve two main purposes. They help define the probable limits of immediate declines and recoveries within established trends. When a market finds support or resistance at these levels, it forecasts continuation of the trend. Trend lines can also warn of an impending reversal when they are broken. The more times the price touches the trend line, the more significant that trend line becomes.

The general study of support and resistance levels is one of the most practical tools for both the market student and swing trader.

Trend lines forecast future support and resistance levels in a trending market. However, in a trading range environment, key swing highs and lows serve as basic support and resistance. Once the market moves out of its trading range, previous resistance levels become future support levels and old bottoms become future tops.

Much of the study of chart formations, trend lines, gaps, and support and resistance levels seem so basic that the average market student glosses over it. What is most important, though, is not mere knowledge of these phenomena, but the practical application of them in a trader's nightly analysis. Much forecasting information is revealed by price, and price will always be faster than a derivative of price. Some of the best swing traders in history have been master tape readers.

When studying the charts or price, the market's technical strength or weakness is assessed by its position relative to the previous leg or market action. For example, if the previous up leg was greater than the previous down leg, and the subsequent reaction was shallow, forming a continuation pattern, the odds would favor that only the long side should be traded. This process would continue until there was a "failure" test and the up leg failed to show continuation. Experienced traders can play this "failure" test, but the most conservative play would be to wait until the down leg was greater than the previous upswing and then sell the next reaction.

Schabacker understood intimately the importance of tape action. "If the market or individual stock does not act according to one's primary analysis, the market itself is trying to tell the trader to change that analysis, or at least cut losses short and get out until confidence can be resumed in new analysis." Price should always be the primary factor for a swing trader, and the number one rule is: Don't argue with the tape! If a trader is long, expecting an upswing, but the market goes sideways instead, the probabilities are that the trade is not working and the trader should look to exit as quickly as possible.

Another consummate tape reader was Richard Wyckoff. While Schabacker's work concentrated on organizing price data and classifying chart patterns, his approach tended to be considered more mechanical in its orientation of observing formations. Wyckoff took the process of analyzing market swings one step further. He used volume and tape reading to analyze whether the patterns represented accumulation or distribution, and then organized the market activity into an overall sequence.

Wyckoff started working as a runner on Wall Street in 1888. In the early 1900s, he began to publish an advisory letter. He first published his method of technical analysis in 1908, and later in 1931, published a correspondence course. His technique used a combination of bar, point and figure, and wave charts to analyze the market swings. His ideas are based on the simple approach of monitoring the forces of supply and demand for a directional bias, and learning to select the markets which have the most immediate potential, thus making most effective use of a trader's capital.

The basics of analyzing supply and demand come from studying the individual bar charts and monitoring the market's action in relationship to volume. Trend lines, or "supply" and "support" lines, are also used to follow the market's movement. Wyckoff also outlines a specific bottoming and topping process comprised of "selling climaxes" and "secondary reactions."

In the case of a down-trending market (the sequence is essentially reversed for a topping process), assume that the market has been moving down and a decline is mature. The first attempt at finding a bottom is called "preliminary support". On this day, there will be a definite increase in volume and the market will find some type of support, or make a short-term low. This point cannot be anticipated, only observed as it is happening or after the fact. The ensuing rally should still be contained within the channels of the downtrend.

After this first swing low is made and market reacts up, the downtrend resumes and flushes out the last longs with a "selling climax". There is extremely heavy volume on this day and range should expand. If prices rally towards the end of the day, it indicates that the last longs have been flushed out.

Next, there is an "automatic rally" which is due primarily to the short covering. In general, volume is much lighter on this rally. Institutions have not yet established large long commitments at this point. A "secondary test" then follows the "automatic rally". This is a retest of the low of the selling climax, which tends to take place on lighter volume. Also the range will not be as wide as the range on the day of the selling climax. Usually the market will make a higher low on this test.

Once the secondary test takes place, a trading range has been established. The market will finally indicate that it is ready to break out from this trading range by showing a "sign of strength". This is a strong thrust up indicating an increase in upside momentum, accompanied by an expansion in volume. The reaction that follows this "sign of strength" is often just a sideways pause, but it is marked by a contraction in daily range and a drop-off in the volume. This is called the "last point of support" and is the last chance to get on board before a trend begins. (chart example of Wyckoff sequence)

"Springs" and "Upthrusts" are two more patterns that Wyckoff described which also setup key pivot points. "Springs" and "Upthrusts" describe the tests or false breakouts that can occur in a trading range. A spring occurs when the market breaks below support and then quickly reverses itself. There is little volume on the breakout and the market manages to shake out weak longs. Upthrusts occur when the market tests the upper band of trading range but is quickly met by overhead supply. Each of these patterns represents "price rejection" and provides a setup for a short-term trade in the opposite direction. The false breakout sets up a well-defined risk point, and in general, the market should then move to test the other end of the trading range. (chart example of springs and upthrusts)

Wyckoff also created an index comprised of five leading stocks. The stocks can be rotated to include the most active leaders at the time. He used a line chart, (also called a wave chart), to detect early reversals at critical swing points. Wave charts help monitor the responsiveness of the market to buying and selling impulses. The theory is that the five leading stocks should be the most sensitive.

Wyckoff also incorporated point and figure charts in order to determine the probable length of the move once the market breaks out of its “sideways line” or chart formation. For a trader, it is useful to have a rough expectation of the swing’s potential.

Wyckoff’s main emphasis was on formulating a comprehensive approach to the whole business of trading. The ultimate goal is to make trades with a minimum of risk, using only the best markets when all conditions are favorable, and being conscientious about when to exiting trades at the right time. “Avoidance of a large loss” is the guiding principle in swing trading.

Wyckoff was the first to really make a study of the action within congestion areas to seek clues about potential reversal points. He also looked to enter on swing reactions instead of entering via a breakout from chart formations, as Schabacker often did. While Schabacker calculated measured move objectives from various chart formations, Wyckoff used point and figure charts to calculate a price objective. However, he strongly advised judging the market by its own action, following the tape action, and taking what it gives you.

While Schabacker classified chart patterns that preceded the market swings and Wyckoff looked for signs of accumulation and distribution within these patterns, a third dimension was added to the study of the market’s swings through the work Ralph N. Elliott. He saw patterns in the market’s waves or cycles and set forth some basic tenets classifying these waves.

Ralph N. Elliott started out as a devout student of Dow Theory. He believed that market timing was the key to successful investing, and WHEN to buy was far more important than WHAT to buy. When a long illness in the late 20s and early 30s kept him bedridden, he began an intensive study of market behavior that ultimately went into much greater detail than Dow’s work. He developed his first set of principles in 1934. These were later published as “The Wave Principal”, and his work eventually became known as “The Elliott Wave Principal.”

Elliott concentrated on the cyclical behavior of the market’s swings or waves as opposed to chart patterns. He noted that these waves had a tendency to repeat themselves. This price behavior forms a structure that can be predictable and used as the forecasting tool.

A full wave or “cycle” consists of five waves up followed by three waves down. The swings that occur in the direction of the trend are called “impulse” waves. Elliott observed that the laws of nature tend to unfold in an upward direction, and thus there is an upward bias to the cycle. Each wave or cycle can be divided into smaller degrees. The larger cycles are subject to the same principles as the smaller cycles. Recognizable swing trading patterns can occur on any time frame.

Waves are defined by measuring both price and time. The market alternates between "impulse" type waves, or those that occur in the direction the trend, and corrective waves. Elliott did not use closing prices but instead looked at ranges. The distance between a swing high and a swing low defines a wave over a given period of time. The range of the impulse wave in relation to the range of the corrective wave is used to forecast the next impulse wave. A technique called channeling is the easiest way to visualize this. (chart example)

In general, when analyzing market swings, the degree of correction indicates the strength of the next wave. Though Elliott did not analyze volume to the extent that Wyckoff did, both technicians noted that volume tends to dry up on corrections. Volume also tends to be lighter on fifth waves, which sometimes look similar to Wyckoff's description of a test of a buying or selling climax.

Elliott tried to characterize the different personalities of different waves. Each swing is analyzed in terms of volume and volatility. All of Elliott's rules on wave characteristics served to build a generalized model of market behavior that can be used as a forecasting tool. However, Elliott went to great lengths in his writings, as did Wyckoff and Schabacker, to reiterate that theory varies greatly from actual practice! It took Elliott several years of constant application before he himself felt comfortable in applying the swing principles he had observed.

Human emotions cause waves, and thus cycles are more visible when a market is broad and active with good commercial interest. Volume and liquidity makes swing trading patterns more readily visible to the eye. Don't trade in dead, quiet markets!

There was one more famous technician/trader in the first half of the 20th century who helped contribute to the foundation of technical analysis and swing trading. W.D.Gann was born in 1878, the same decade as Elliott and Wyckoff. He started trading in 1902 and thus developed his market theories by observing the same markets and Schabacker, Wyckoff and Elliott. He was an extremely creative technician who also traded and wrote extensively about his work.

One of Gann's main contributions was the importance of studying time. Gann felt that time was the most important factor because time governs when price extremes will occur. His most famous concept is that "Price equals Time." In other words, so much time must pass before prices reverse direction.

Gann was an adept student of the market. He had experience as a runner, a broker, a trader, and an author. He wrote on a variety of market aspects, including market psychology, practical trading tips, and more esoteric ideas touching upon astrology and geometry.

Gann counted the number of days from swing highs and swing lows in order to determine time cycles and time periods. Many technicians use the length of a price swing to determine the trend. For example if the length of the upswing exceeds the length of the prior downswing, it is a warning of a trend reversal. Gann applied the same concept to time. If the number of days a market has been moving higher exceeds the time duration of the last down leg, the trend has reversed.

Though time played a big role in his work, Gann still used traditional chart patterns and technical studies of price movement for confirmation. He noted the importance of gap and limit days, making the same observations as Schabacker and Wyckoff. He also used the same terminology that Wyckoff used in defining market swings, such as "secondary rallies or reactions."

Primary levels of support and resistance come in at previous swing highs and lows. Gann also calculated the percentage retracements of swings, and consider the 50 percent reaction to be one of the most important trading points. The wider the swing and longer the time period, the more important the halfway point becomes when it is reached. If the market has been in an up trend, look to buy around the 50 percent retracement level with a stop just underneath.

Even though Gann elaborated in his later works about geometric structures and use of numerology to determine support and resistance levels, he ultimately let the price action dictate his trading decisions. Gaps, limit days, reversal days and basic support and resistance levels were at the core of his toolkit for analyzing the markets action.

Swing highs and lows are always the most important points to watch. A swing-trading student is always looking for tests of the highs and lows that have been defined in the past. (chart example of test of key high)

Swing trading requires a great amount of time for preparation and study. Much emphasis is always given to the initial trade setup. But the fathers of technical analysis all also wrote about the habits and organization required to successfully swing trade. Gann felt that the following ingredients were essential for trader success: A trader must have a plan, and knowledge is key in putting together the plan. The more time you put in gaining knowledge, the more money you'll make later. Gann's extensive use of pivot points, time cycles, seasonal dates, and intricate charting methods were his way of "gaining knowledge." These methods keep a trader intimately involved with the market's price action. Many successful swing traders keep charts and logs by hand, and credit this process in aiding their market "feel".

On top of the technical knowledge, Gann also insisted that separate trading rules were essential for success. Always use stop orders. Never let a profit turn into a loss. When in doubt, get out, and don't get in when in doubt. Trade only in active markets. Never limit your orders – trade at the market. Don't close out trades without a good reason. Follow up with a stop loss order to protect your profits. Never average a loss. Avoid getting in and out of the market too often. And lastly, avoid increasing your trading after a long successful run.

Appendix D - Notes from a Swing Trader - Extract from a 1993 lecture by Linda Bradford Raschke

Swing trading seeks to take advantage of a very basic price pattern that sets up and can be traded in any market. Though I refer to a two- to three-day trading cycle, principles that I teach work on an intermediate time frame - weekly charts - as well as on five-minute charts.

Whether you trade short-term, from a mechanical system, or a methodology like what I teach, there is one thing I want to impress on you: **Be consistent!** You can't do a Fibonacci calculation on one trade, try something else the next day, and then jump into a seasonal trade the next. It just doesn't work because trading is just a numbers game, that's all it is, trying to get a little bit of an edge in your favor.

My personal rhythm consists of buying one day and selling the next, or the day after that. I carry a lot of trades overnight. I don't take many on an intraday basis, only the trades which don't work out. The ones that don't work out become intraday trades really fast. The exception, of course, is the S&P market...in which there is plenty of opportunity to day trade.

Money (and Risk) Management

Scale in and scale out of trades. That's one aspect of money management on which I concentrate. I'm always scaling out of trades. Put yourself in a win/win situation. Take some money off the board; take partial profits. That way you can't lose. If it then goes against you, at least you locked in something. If it goes your way, you still have bullets to play with. Don't get greedy.

Most floor traders tend to make money twenty days of the month. Then in the last two days they get blown out of the water on a big trend day during which other traders are buying breakouts and cleaning up. When swing trading, you truly don't want to fight a trend day - the market is going to tell you quickly if your play is right or wrong. And if you're wrong, don't fight it.

Always go in with a game plan. Anytime market action deviates from my road map, I'm out of there because the market is not doing what I expect it to be doing. If I don't know what it is doing, why am I in there?

Anytime that you're in a trade and you start to have questions like, "Well, what should I do now? Should I get out now? Should I take profits now? Should I stay in a little longer? Should I add to the position?" Anytime you have a question like that, you have no business being in that market. You have lost your edge because you don't have any control or game plan in that market. So, first, before you start swing trading, realize that you never want to put yourself in a position where you're going to be reacting to that market.

I find the best way to control my risk is to watch my equity curve. Every day I calculate how much money I made or lost. I don't care which positions made or lost it or how many winners or losers I had. When my equity curve starts to dip, I know something is wrong - perhaps I am stressed or getting careless.

I also believe in diversification. Something is always working. Don't get married to a position; don't get an opinion on a market. If I get an opinion on a specific market, I have to stop trading it.

Finally, when a market closes against me, the odds suggest that it will go even further against me. So I get out. I can always get back in the next day at a better price. That's my rule. I don't view it as taking a loss - I'm just playing for better position! And it works!

"Reading the Tape"

The most important points to me are the previous day's high and low. That's all I care about. Now some people like to do retracement numbers, some people like to do Fibonacci numbers. Any number is going to work because it focuses your attention on market action relative to another number. You can take any number and ask if the market is getting closer to or further away from it. That's all tape reading really is. Is the price making progress towards or away from that number?

You'll find that intraday cycle tops, cycle bottoms, intraday swings, lows, highs, are important support and resistance levels. Even on five-minute time frames, watch those lows and highs on the swings. If you're on a weekly chart watch the previous highs, watch the previous lows. What you're going to do is just focus in on the price action around that point.

It's either going to be a **test**, with the market finding support and forming a nice double bottom (a high-percentage trade because you can put in a really tight stop and the market should move in your favor right away), or else it's going to **break through** (if accompanied by volume and activity, there is no support but there probably is going to be a continuation. Perhaps 90% of my trading tends to be looking at previous lows and previous highs on daily charts.

A lot of people like to look for price divergences using oscillators, or the Elliot Wave fifth wave - which is either a failure top or a last little hook through. It's still the same concept - double top, double bottom, and tests. **That's what swing trading really is: Buying retracements, finding out where the market finds support, and getting out.**

You just have to define what works for yourself. There is nothing wrong with one time frame or another, or one style of trading or another. But build a road map in your head. It teaches you to anticipate, to have a plan, anticipate, watch it setup.

Overnight Positions

However, I do believe in holding contracts overnight. For those of you who trade an intraday time frame, if you have a profit in your contract coming into the end of the day, try holding it overnight. The odds are you will win. Sure, one or two times it is going to gap down against you. But who cares? You took it home with a little profit, a little cushion. But the odds are that 70% of the time, you're going to get more money holding it overnight.

How many times have you come in the morning and they're gapping that market open? And you have to sit there and wait till the dust settles, and wait until the first 40 minutes of trading is out of the way. Do you know how nice it is to be able to come in with the market called to open higher - a ball of fire - and you say, "All right, suckers, if you want to pay that much for something, fine, you can have it, on the opening, yours, sold!" And usually the price will back down some after they have finished squeezing everybody who was short, everybody who had to cover on the opening.

Setting Up "The Swing"

Here is what makes a market. You have a number of different players and time frames in these markets. You have institutions, commodity pools and funds, and all that kind of big money.

On the other side are all the locals on the floor. Half of them make their profits off one tick, just trading the market back and forth. The other half usually close their positions out by the end of the day anyway. These guys are just scalping, putting money in their pockets; there are really not that many position traders in the pits.

Because of the activities of all these different market players, a two- to three-day swing pattern sets up. The big guys can't take advantage of it and the little guys don't care; but it creates a perfect niche from which to make a living.

What happens? The big players, the commercials, know the fundamentals, which their analysts have priced into the market. They know where they have to deliver x number of barrels in x number of days - a really long-term game plan. They have really deep pockets. Those guys are right eventually; they have deeper pockets than anybody. They can sit and buy into one decline after another. Maybe three months later the thing will turn around and they'll sit on it, and then they will start selling out, selling out, selling out. When the big guys come in to start accumulating their line, it doesn't mean the price is going to hold there, merely that at some level they start buying. The locals standing in the pit see Merrill Lynch working an order to buy 1000. They know exactly what's going on, where the big guys are, so they'll start coming in and buying a little bit, supporting the market.

All of a sudden the price is holding. Because the price is holding, all the people that shorted it earlier are going to start taking it back. Well, the price stopped going down, so they better start taking it back, which might cause the price to lift a little bit. Then it starts to rally a little bit. It trickles up, and then some people feel maybe the price is going to go up, so they start buying.

Just about now, traders looking at charts notice it going up. However, by the time an outside order gets to the pit, everybody else is buying these "breakouts" and the price is already marked up - and all of a sudden outside orders are chasing it. And sure enough, like moths to a light, everybody has already bought? The locals bought their line; the commercials are only buying at this price down here. Who's left to buy? What happens when there is nobody left to buy? The price stops going up. It doesn't fall down immediately, but the price stops going up.

When pit traders sense that loss of acceleration, when the order flow starts to slow down, those that bought in the morning when nobody else wanted to buy, who knew that the price held there yesterday - start taking their profits. That puts a little selling pressure on the market and the guys who see weakness in the market come in and start shorting it.

There are always people buying the market and always people selling it. There is constant supply and demand. There is always support and resistance in every time frame, always someone taking profits. Every long is going to have to take a profit or loss, and every short is going to cover at some point. It's like a zero sum game! It's a two-sided market. There's always going to be longs getting trapped and shorts getting squeezed.

The Rhythm of "The Swing"

So I look for a swing low and count that as day one. Day two is going to be the second day up, and day three I'm going to sell and go short - short it and look to cover on a pullback the next day. Then I'm back to day one, looking to buy.

So my rhythm is to "buy," "exit," "sell short," "exit," "buy," "exit". You find that usually there is not enough of a case to stop and reverse. I just sell and take profits. I find that to be the highest percentage. I know that I can lock it in, put it in my pocket. I do 90% of my orders at the market; I want in or I want out, I don't dicker over a tick or two.

Higher Bottoms/Lower Tops

How does the market "test the water?" Prices decline one day and the locals cover their positions. The market finds support at some point, even if just a little. What I want to do is buy the test of that support, which the market usually gives you. The market makes a V-bottom only a minority of the time. Most of the time it makes a W-bottom, or multiple tests, sometimes with higher and sometimes with lower bottoms. Tops are very rarely an inverted V; rarely does a market go straight up and straight down. You get a test, or at least a sideways ledge or consolidation.

Don't be too anxious; think about what you want to buy, how much, where. Have a little patience; see what the market is going to do. You can make a living just buying higher bottoms and selling lower tops.

Appendix E - SWING TRADING: RULES AND PHILOSOPHY – Linda Raschke

My style is based on the "Taylor Trading Technique", a short-term method for trading daily price movements that relies entirely on **odds** and **percentages** . It is a **method** as opposed to a **system**. Very few people can blindly follow a system, though many find it easier to be discretionary in a systematic way.

Because this short-term swing technique generates frequent trades, it is important to know the "correct plays," to lock in profits, and to seek the "true trend." **Taking a loss is merely playing for better position.** One trades strictly for **probable** future results, not for what the market might do.

To know the "correct play" is to know whether to buy or sell first, to exit or hold. Trades are based on "objective points," which are simply the previous day's high and low. Movement between these two points determines the "true trend."

When swing trading, adjust your expectations. The lower your expectations, the happier you will be and, ironically, the more money you will probably make! Entries are a piece of cake, but you must also trust yourself to get out of bad situations and trades. It is important to use tighter stops when trading swings and wider stops when trading trends.

This method teaches you to **anticipate**! Never react! Know what you are going to do **before** the market opens. Always have a plan--but be flexible! "See" your stop (support or resistance) before initiating a trade. Know how to trade out of trouble situations and get off the hook with the smallest possible loss.

Finally, never trade in narrow, dead markets. The swings are too small. Never chase a market. Rather than worry that you've missed a move, think instead, "Oh, boy! I've got oscillations and volatility back..."

Basic Rules for Swing Traders

But first--the rules! Because of the short-term nature of this technique, swing traders must adhere to some very basic rules, including:

- If the trade moves in your favor, carry it overnight--the odds favor follow-through. Expect to exit the next day around the objective point. An overnight gap presents an excellent opportunity to take profits. Concentrating on only one entry or one exit per day relieves the pressure.

- If your entry is correct, the market should move favorably almost immediately. It may come back to test and/or exceed your entry point a little, but that's OK.

- Do not carry a losing position overnight. Exit and play for better position the next day.

- A strong close indicates a strong opening the following day.
- If the market doesn't perform as expected, exit on the first reaction.
- If the market offers you a windfall of big profits, take them to the bank on the close.
- If you are long and the market closes flat, indicating a lower opening the following day, scratch or exit the trade. Play for better position the next day.
- It is **always** OK to scratch a trade!
- Use tight stops when swing trading (wider stops when trading trend).
- The goal always is to minimize risk and create "Freebies."
- When in doubt--get out! You have lost your road map and your game plan!
- Place your orders **at the market**.
- When the trade isn't working, exit on the first reaction.
- **ANTICIPATE!**

"Trading the Swing"

How does one anticipate entry? The following may be indicators of a buy day or a sell day:

The Count

Start searching for a **buying day** 2 days after a swing high or, conversely, a **shorting day** 2 days after a swing low. Ideally, the market will move in complete 5-day cycles. (In a strong trend, the market will move 4 days in the primary direction and only 1 in reaction. Thus, one must seek entry 1 day earlier.)

"Check Mark" on the Test

The potential entry is sought opposite, or contrary to, the previous day's close. If looking to buy (sell), one first wants the market to "test" the previous day's low (high), preferably early in the day, and then form a trading pattern that looks like a **"check mark".**

This pattern sets up and establishes a "double stop point" or strong support. If entering a market with only a "single stop point" or support formed by today's low only, exit on the same day--the trade is clearly against the trend.

Close vs. Open

The close should indicate the following day's opening. When a market opens opposite what is expected or indicated by the trend, one may first look to "fade" it--but must take profits quickly. Then look to reverse!

Support (Resistance)

Is today's support (resistance) higher or lower than yesterday's?

Swing Measurements

Where is the market relative to the last swing high or low? Look for swings (up or down) of equal length, and for retracements of equal percentage.

Additional Considerations!

No matter in what time frame, always look for supply at tops and support at bottoms. Volume and activity should accompany penetrations. Expect trends, either up or down, to last for either 2 or 4 weeks.

The following conditions are fairly reliable indicators for the start of one of these trends (I personally skip the first buy or sell swing when one occurs because the move ensuing could be quite strong):

- Narrowest range in the last 7 days
- 3 consecutive days with small range
- The point of a wedge
- A breakaway gap
- A rising ADX (14-period) above 32

Practice

Because a certain amount of confidence in any technique is required to trade it consistently, paper trading can cultivate the faith necessary to recognize and trade pattern repetition. Although the temptation to try too many different styles and patterns always exists, one must strive ultimately to trade in just one consistent manner--or at least to integrate techniques into **your own** unique philosophy.

System Characteristics

Certain points about trading short-term swings deserve note. Understanding the nature of short-term systems can help you recognize the psychological aspect of trading.

When consistently following a short-term system, you should expect a very high win/loss ratio. Though the objectives with this style of swing trading appear conservative, you will almost always incur "positive slippage". In all systems, winners are skewed. Even though making steady profits, 3-4 really big trades may actually make the month. It is vitally important to always "lock in" your trades. Don't give back profits when short-term trading. You may be astonished at just how big some winners may be from catching the swings "just right!"

Decision-Making

I feel it is important to address this topic. Every time you make a trade, you make a decision. The more decisions you make, the more you increase your self-esteem.

You grow with each decision, yet each decision has a price--you must discard a choice, and you must commit. Conditions are **always** imperfect! You must allow yourself to fail. Allow for human limitations and incorrect choices. Reserve compassion for yourself and your limitations.

There is so much instantaneous information available to all market players today. It is OK to use intuition and to listen to that little voice inside your head, "Does the trade **feel** right?" If in doubt, get out...!

Golden Rules

Finally, I want to leave you with what I believe are two Golden Rules, applicable to all traders but, of essential importance to short-term swing traders:

- NEVER, ever, average a loss! Sell out if you think you are wrong. Buy back when you believe you are right.

- NEVER, NEVER, NEVER listen to anyone else's opinion! Only YOU know when your trade isn't working.

Recommended reading list:

- The TAYLOR Trading Technique, by George Douglass Taylor, 1950

- Trading is a Business, by Joe Ross

- Day Trading with Short-term Price Patterns & Opening Range Breakout, by Toby Crabel

- Forecasting Financial Markets (or Technical Analysis Explained), by Tony Plummer

- The ABC of Stock Speculation, by A. Nelson, 1903

Appendix F - THE MENTAL ASPECT OF TRADING – Linda Raschke

Many traders quickly come to acknowledge that despite being familiar with winning strategies, systems, and money management techniques, trading success is dependent on your psychological state of mind. If you're a trader just starting out, where do you find the initial confidence to pull the trigger? How do you deal with the down times without digging yourself deeper into the hole? If you are in a hole, how do you work your way back out? How do experienced traders push through the ceiling of profitability that caps their initial trading years and make a truly fabulous living?

Trading is a performance-oriented discipline. Stress and mental pressures can affect your ability to function and impact your bottom line. Much of what has been learned about achieving peak performance in both business and sports can be applied to trading. But let’s first examine the ways that trading differs from other businesses.

1) Intellect has nothing to do with your ability as a trader. Success is not a function of how smart you are or how much you have applied yourself academically. This is hard to accept in a society that puts a premium on intellect.

2) There is no “good will” built up each day in your business. Customer relationships, traditionally important in American businesses, have little to do with a trader's profitability. Each day is a clean slate.

3) The traditionally 8-5 work ethic doesn't apply in this business! A trader could sit in front of a screen all day waiting for a recognizable pattern to occur and have nothing happen. There is a temptation to take marginal trades just so a trader can feel like he's doing something. There's also the dilemma of putting in constant hours of research, having nothing to show for it, and not getting paid for the work done. Yet if a trader works too hard, he risks burn-out. And what about those months where 19 out of 20 days are profitable, but the trader gives it all back in one or two bad days? How can a trader account for his productivity in these situations?

4) If you were to invest time, energy, and emotion into developing a business venture and backed out at the last minute, it would be considered a failure. However, you should be able to invest time and energy into researching a trading idea, and yet still be able to change your mind at the last minute. Market conditions change, and we cannot be expected to predict all the variables with foresight. Getting out of a bad trade with only a small loss should be considered a big success!

What IS the definition of a successful trader? He should feel good about himself and enjoy playing the game. You can make a few small trades a year as a hobby, generate some very modest profits, and be quite successful because you had fun. There are also aggressive traders who have had big years, but ultimately blow-out, ruin their health or lead miserable lives from all the stress they put themselves under.

Principles of Peak Performance

The first principle of peak performance is to put fun and passion first. Get the performance pressures out of your head. Forget about statistics, percentage returns, win/loss ratios, etc. Floor-traders scratch dozens of trades during the course of a day, but all that matters is whether they're up at the end of the month.

Don't think about TRYING to win the game - that goes for any sport or performance-oriented discipline. Stay involved in the process, the technique, the moment, the proverbial here and now! A trader must concentrate on the present price action of the market. A good analogy is a professional tennis player who focuses only on the point at hand. He'll probably lose half the points he plays, but he doesn't allow himself to worry about whether or not he's down a set. He must have confidence that by concentrating on the techniques he's worked on in practice, the strengths in his game will prevail and he will be able to outlast his opponent.

The second principle of peak performance is confidence. in yourself, your methodology, and your ability to succeed. Some people are born naturally confident. Other people are able to translate success from another area in their life. Perhaps they were good in sports, music, or academics growing up. There's also the old-fashioned "hard work" way of getting confidence. Begin by researching and developing different systems or methodologies. Put in the hours of backtesting. Tweak and modify the systems so as to make them your own. Study the charts until you've memorized every significant swing high or low. Self-confidence comes from developing a methodology that YOU believe in. Concentrate on the technical conditions. Have a clear game plan. Don't listen to CNBC, your broker, or a friend. You must do your own analysis and have confidence in your game plan to be a successful trader.

Analyze the markets when they are closed. Your job during the day is to monitor markets, execute trades and manage positions. Traders should be like fighter pilots - make quick decisions and have quick reflexes. Their plan of attack is already predetermined, yet they must be ready to abort their mission at any stage of the game.

Just as you should put winning out of your mind, so should you put losing out of your mind - quickly. A bad trade doesn't mean you've blown your day. Get rid of the problem quickly and start making the money back. It's like cheating on a diet. You can't undo the damage that's been done. However, it doesn't mean you've blown your whole diet. Get back on track and you'll do fine.

For that matter, the better you are able to eliminate emotions from your day, the better off you will be. A certain amount of detachment adds a healthy dose of objectivity. Trading is a great business because the markets close at the end of the day (at least some of them). This gives you a zero point from which to begin the next day - a clean slate. Each day is a new day. Forget about how you did the week before. What counts is how you do today!

Sometimes what will happen during the day comes down to knowing yourself. Are you relaxed or distracted? Are you prepared or not? If you can't trade that day, don't! - and don't overanalyze the reasons why or why not. Is psychoanalyzing your childhood going to help your trading? No!

The third important ingredient for achieving peak performance is attitude. Attitude is how you deal with the inevitable adverse situations that occur in the markets. Attitude is also how you handle the daily grind, the constant 2 steps forward and 2 steps back. Every full-time trader has gone through long flat times. Slumps are inevitable. It's impossible to stay on top of your game 100% of the time. Once you've dug yourself out of a hole, no matter how long it takes, you know that you can do it again. If you've done something once, it is a repeatable act. That knowledge is a powerful weapon and can make you a much stronger trader.

Good trades don't always work out. A good trade is one that has the probabilities in its favor. But that doesn't mean that it will always work out. People who have a background in game theory understand this well. The statistics are only meaningful when looking at a string of numbers. For example, in professional football, not every play is going to gain yardage. What percentage of games do you need to win in order to make the playoffs? It's a number much smaller than most of us are willing to accept in our own win/loss ratios!

Here is an interesting question: should you look at a trade logically or psychologically? In other words, should every trade stand on its own merits? Theoretically, yes, but in real life it doesn't always work that way. A trader is likely to manage a position differently depending on whether the previous trade was a winner or a loser.

How does one know when to take profits on a good trade? Ask yourself first how greedy do you want to be, or, how much money do you want to make? And also, does your pattern have a "perceived profit" or objective level? Why is it that we hear successful winning traders complain far more about getting out of good trades too soon than not getting out of bad trades soon enough? There's an old expression: "Profits are like eels, they slip away."

Successful traders are very defensive of their capital. They are far more likely to exit a trade that doesn't work right away than to give it the benefit of the doubt. The best trades work right away!

OK. Realistically, every trader has made a stubborn, big losing trade. What do you do if you're really caught in a pickle? The first thing is to offer a "prayer to the Gods". This means, immediately get rid of half your position. Cut down the size. Right off the bat you are taking action instead of freezing up. You are reducing your risk, and you have shifted the psychological balance to a win-win situation. If the market turns around, you still have part of your position on. If it continues against you, your loss will be more manageable. Usually, you will find that you wished you exited the whole position on the first order, but not everyone is able to do this.

At an annual Market Technician's conference, a famous trader was speaking and someone in the audience asked him what he did when he had terrible losing trades. He replied that when his stomach began to hurt, he'd "puke them at the lows along with everyone else." The point is, everyone makes mistakes but sooner or later you're going to have to exit that nasty losing position.

"Feel good" trades help get one back in the game. It's nice to start the day with a winning scalp. It tends to give you more breathing room on the next trade. The day's psychology is shifted in your favor right away. This is also why it's so important to get rid of losing trades the day before… so you don't have to deal with them first thing in the morning. Some of the choicest opportunities occur in the morning. You want to be ready to take advantage of them.

A small profitable scalp is the easiest trade to make. The whole secret is to get in and get out of the market as quickly as possible. Enter in the direction of the market's last thrust or impulse. The shorter the period of time you are is the marketplace, the easier it is to make a winning trade. Of course, this strategy of making a small scalp is not substantial enough to make a living, but remember the object is to start the day out on the right foot.

If you are following a methodology consistently (key word), and making money, how do you make more money? You must build up the number of units traded without increasing the leverage. In other words, don't try going for the bigger trade, instead, trade more contracts. It just takes awhile to build up your account or the amount of capital under management. Proper leverage can be the key to your success and longevity in this business. Most traders who run into trouble have too big a trade on. Size influences your objectivity. Your main object should be to stay in the game.

People tend to be more emotional or reactive under stress. “Tensing up” is a common reaction. There are many talented athletes who never become successful because they choke when the pressure’s on. You could be a brilliant analyst but a lousy trader. Consistency is far more important than brilliance. Just strive for consistency in what you do and let go of the performance expectations.

Master the Game

The final key to achieving mental mastery over the trading game is to believe that you can actually do it. Everyone is capable of being a successful trader if they truly believe they can be. You must believe in the power of belief. If you're a recluse skeptic or self-doubter, begin by pretending to believe you can make it. Keep telling yourself that you'll make it even if it takes you five years. If a person's will is strong enough, they will always find a way.

If you admit to yourself that you truly don't have the will to win at this game, don't try to trade. It is too easy to lose too much money. Many people think that they'll enjoy trading when they really don't. It's boring at times, lonely during the day, mentally trying, with little structure or security. The markets are not a logical or fair playing ground. But there are numerous inefficiencies and patterns that can be exploited, and there always will be.

Appendix G - Tape Reading - Linda Bradford Raschke

During times of high volatility, sometimes it is nice to reexamine a simple concept. Mechanical systems and patterns are helpful and even necessary for the structure they impose in organizing data, but even Richard Dennis in his original course discussed ways to "anticipate" entry signals, exit trades early, and filter out "bad" trades.

Learn to follow the market's price action and read the signals it gives. This can become a strict discipline in itself and the result will be greater confidence that a trade is or is not working.

Tape Reading

"Trading technique is simply the ability, through study, observation, and experience, to recognize the signals in each of the several phases of market movement." - George Douglas Taylor

Tape reading long ago referred to the practice of studying an old-fashioned ticker tape and monitoring prices, volume, and fluctuations in order to predict the immediate trend. (It does not mean you have to have the ability to read the prices scrolling across the bottom of the screen on CNBC!) Tape reading is nothing more than monitoring the current price action and asking: Is the price going up or down **right now?** It has nothing to do with technical analysis and everything to do with keeping an open mind.

Even the most novice observer has the ability to see that prices are moving higher or lower at any particular moment or, for that matter, when prices seem to be going nowhere or sideways. (Markets do not always have to be **going** somewhere!) It is also fairly easy to watch a price go up and then tell when it stops going up - even if it turns out to be only a momentary pause.

I've known hundreds of professional traders throughout my career. I don't want to disappoint you, but I know of only two whom where able to make a steady living for themselves with a mechanical system. (I am not counting the well-capitalized CTA's who are running a money-management program with "OPM" - other people's money.) All those other traders used some type of discretion that invariably involved watching the price action at some moment - even if just to move a stop up or down.

If you can learn to follow the price action, you will be two steps ahead of the game because price is faster than any derivative. You may have heard the saying, "The only truth is the current PRICE." Your job as a trader will become ten times easier once you accept this. This means ignoring news, opinions, and personal biases.

Watching price action can actually be very confusing if you go about it like a ship without her sails up in an ocean squall. You will get tossed back and forth with no sense of direction and no sense of purpose. There are two main tricks to monitoring price action. The first is to watch the price relative to another "reference point." This is why many traders use a "pivot point" - and it works! It is the easiest way to tell if the market is moving closer to or further away from a particular point. This is also why it is often easier to get a "feel" for the market once you put a position on - your "reference" point tends to be your entry price.

Some reference points, such as a swing high or the day's opening price, will have much more significance than those points involving some type of calculation. (Some numbers might have special meaning for those who calculate them, and who am I to argue if they work.) I like to concentrate on pivot points that the whole market can see. To sum up so far, when watching price, we want to know the following: how fast, how far, and in which direction. It takes two points to measure these things. One will always be the current price, the other a **pivot point.**

** Do not watch price for the sake of watching price. Watch price with the intent to do something or to anticipate a certain response!*

Responses

"The study of responses ... is an almost unerring guide to the technical position of the market."- Rollo Tape (Richard Wyckoff), 1910

The second main trick to monitoring price action is to watch for the market's response to a particular condition ... in other words, anticipating a particular behavior. For example, if the market has been at a very low volatility point and just begins breaking out of it's particular trading range, one might anticipate that the price would begin to accelerate in an impulsive manner and not run into immediate resistance. Or, on a directional play, if the price is moving in an impulsive manner in a trending market and then pauses to catch its breath on a mild reaction, one would expect it then to continue on in the direction of the trend. When there is a particular behavior to anticipate, it is easier to watch the price to see if it acts according to one's expectations.

Is the market failing to break on bad news? Is it finding support after a series of advances? Does it run into an invisible overhead wall and sharply back off, implying strong resistance? These are market responses to certain conditions. Tape reading is like playing a tennis game and watching to see how your opponent hits the ball back.

Part of studying price behavior and gaining experience as a trader is gradually learning what actions to anticipate. Then you must learn what the market's most probable response or outcome should be. It will always be easier to anticipate an event or response, which happens 70% of the time than to be looking for that which happens only 30% of the time.

However, it can also be a profitable strategy to recognize when a given signal or expected response is failing. Sometimes a failed signal can be more profitable than the normal expected response. For example, a classic failed response might be a scenario wherein price was consolidating in a pattern of higher lows and lower highs - a classic triangle pattern. One would expect a breakout from a chart formation to have some follow-through. However, if price only penetrates the lows by a small amount and then turns upward, picking up volume and momentum as it goes, and comes out the upside, a very significant reversal has probably occurred and there may be much more price advance to unfold.

One last trick to watching price action is to learn to think in terms of "handles," or levels. Think of the S&P's as reaching for the "1110" handle, or the "low 1060's" as a level. Each ten points is a defined level. Use big round numbers as reference points for levels. It doesn't mean that you are placing orders at those numbers. It is just a simple way of organizing data that professional traders practice subconsciously.

Pivot Points

An astute trader will always have the previous day's close in his head. He also knows the previous day's high and low (prices he would have liked to have bought and sold but probably didn't). He also knows the opening price, for that tells if the buyers or sellers are in control for the day.

The previous day's high and low and today's open have very strong psychological implications and are the most important "pivot points" to recognize. By concentrating on price action near these points, we can eliminate much of the hard work in tape reading. Many times the market will let us know right away if this is going to be an area of support or resistance.

The previous day's high and low tend to overlap in congestion areas. Look to exit profitable trades immediately at these points in sideways markets. In trending markets, the price will run through these points a bit before pausing. When the market is strongly trending, the opening price becomes the most important.

If we are watching a high, low, or opening price as a pivot point, we are watching to see whether there is any impulsive price action as the market approaches the point or moves further away from it. What is "impulsive action?" I like to call it a "whoosh." The market moves rapidly as if just coming to life for the first time. It is usually a series of ticks in one direction without a tick in the opposite direction. The market is tipping its hand. A sequence like this tends to consolidate or pause a bit before being followed by more impulsive action. This is quite easy to see in a market like the S&P's if you look on a short-term time frame. If we quantify these "whooshes," which we can do in several ways, we will see that the market tends to have continuation moves at least 2/3's of the time. Not bad for arriving at a "positive expectation" simply by following price action.

In conclusion, tape reading is not watching every trade that passes by (a monotonous task) but rather keeping an eye out for unusual impulsive action, unusual volume, or just observing the way the price trades at significant levels. Each price swing has forecasting value as to what the next most immediate move should be. We then follow the price action to see if that move plays out.

Tape reading is at the heart of swing trading. When looking for short-term moves, price-based derivative indicators will be too late to be of value. Ultimately, traders should feel a great sense of freedom when they can rely on simple charts to formulate a game plan or a conceptual roadmap in their heads - and the movement on the tape to tell them their game plan is correct.

Appendix H - TREND DAYS – Linda Raschke

A **trend day** occurs when there is a large expansion in the daily trading range, and the open and close occur at opposite extremes. The first half-hour of trading often comprises less than 10% of the day's total range; there is usually very little intraday price retracement. Typically, price action picks up momentum going into the last hour -- and the trend accelerates.

A trend day can occur in either the same or the opposite direction to the prevailing trend on daily charts. The critical point is that the increased spread between the high and low of the daily range offers a trading opportunity from which large profits can be made in a short time.

Traders must understand the characteristics of a trend day, even if interested only in intraday scalping. A trader anticipating a trend day should change strategies, from trading off support/resistance and looking at overbought/oversold indicators to using a breakout methodology and being flexible enough to buy strength or sell weakness. A trader caught off guard will often experience his largest losses on a trend day as he tries to sell strength or buy weakness prematurely. Because there are few intraday retracements, small losses can easily get out of hand. The worst catastrophes come from trying to average losing trades on trend days.

Fortunately, it is possible to identify specific conditions that tend to precede a trend day. Because this can easily be done at night when the markets are closed, a trader can adjust his game plan for the next day and be prepared to place resting buy or sell stops at appropriate levels.

The Principle of Range Contraction/Expansion

Several types of conditions lead to trend days, but most involve some type of contraction in volatility or daily range. In general, price expansion tends to follow periods of price contraction, the phenomenon being cyclical. The market alternates between periods of rest or consolidation and periods of movement, or markup/markdown. Volatility is actually more cyclical than is price.

When a market consolidates, buyers and sellers reach an equilibrium price level -- and the trading range tends to narrow. When new information enters the marketplace, the market moves away from this equilibrium point and tries to find a new price, or "value" area. Either longs or shorts will be "trapped" on the wrong side and eventually forced to cover, aggravating the existing supply/demand imbalance.

In turn, the increase in price momentum attracts new market participants, and pretty soon a vicious cycle is created. Local pit traders, recognizing the one-way order flow, scramble to cover contracts. Instead of price reacting back as in normally trading markets, "positive feedback" is created -- and no one can predict how far the price will go. The market tends to gain momentum rather than to check back and forth.

We can tell when the market is approaching the end of contraction or congestion because the average daily ranges narrows. We know a potential breakout is at hand. However, it is difficult to predict the **direction** of the breakout because buyers and sellers appear to be in perfect balance. All we **can** do is prepare for increased volatility or range expansion!

Most breakout trading strategies let the market tip its hand as to which way it wants to go before entering. This technique sacrifices initial trade location in exchange for greater confidence that the market will continue to move in the direction of trade entry.

Conditions Preceding a Trend Day

Several key price patterns can serve as alerts to the potential for significant range expansion:

- **NR7 --** the narrowest range of the last 7 days (Toby Crabel introduced this term in his classic book, **Day Trading With Short-term Price Patterns and Opening-range Breakout);**

- a cluster of 2 or 3 **small daily ranges**;

- the point of a **wedge**-type pattern (which usually exhibits contracting daily ranges);

- a **Hook Day** (wherein the open is above/below the previous day's high/low -- and then the price reverses direction; the range must also be narrower than the previous day's range; leads traders to believe that a trend reversal has occurred, whereas the market has instead only formed a small consolidation or intraday continuation pattern);

- **low volatility** readings, based on such statistical measures as standard deviations or historical volatility ratios or indexes;

- **large opening gaps** (caused by a large imbalance between buyers and sellers);

- **runaway momentum** (markets with no resistance above in an uptrend or no support below in a downtrend. This condition differs from the above setups in that volatility has already expanded. In a momentum market, however, the huge imbalance between buyers and sellers continues to expand the trading range!)

Trading Strategies

A breakout strategy, or intraday trend-following method, can best capture a trend day. Wait for the market to tip its hand first as to which direction it is going to trend for the day. Rarely can this be determined by the opening price alone. Thus, most breakout strategies enter only after the market has already begun to move in one direction or the other, usually by a predetermined amount.

Add the following techniques to your repertoire. All of them will ensure you participate in a trend day.

Breakout of the Early-morning Trading Range. The morning range is defined by the high and low made in the first 45-120 minutes. Different time parameters can be used, but the most popular one is the first hour's range. Wait for this initial range to be established and then place a (1) buy stop above the morning's high and a (2) sell stop below the morning's low. A protective stop-and-reverse should always be left in place at the opposite end of he range once entry has been established.

Early Entry. Toby Crabel defined this as a large price movement in one direction within the first 15 minutes of the opening. The probabilities of continuation are extremely high. Once one or two extremely large 5-minute bars appear within the first 15 minutes, a trader must be nimble enough to enter on the next "pause" that usually follows. With many of these strategies, the initial risk can appear to be high. However, a trader must recognize that as the trading volatility increases so too does the potential for good reward.

Range Expansion off the Opening Price. A predetermined amount is added or subtracted from the opening price. Though Toby Crabel also described this concept in his book, it was really popularized by Larry Williams. The amount can be fixed, or it can be a percentage of the previous 1-3 days' average true range. With resting buy and sell stops in place, the trader will be pulled into the market whichever way price starts to move. Entry, often made in the first hour, can be made earlier than the breakout from the first hour's range. In general, the further price moves away from a given point, the greater are the odds it will continue in that same direction. The ideal is continuation in the direction of the initial trend once the trade is entered.

Price Breakout from the Previous Day's Close. This strategy is similar to the above, with buy and sell stops based on a percentage of the previous 1-3 days' range added to the previous close. The advantage to using the closing price is that resting orders can be calculated and placed in the market before the opening. The disadvantage is the potential for whipsaw if the market moves to fill a large opening price gap. (Another version of a volatility breakout off the open or closing price is the use of a standard deviation or price-percentage function instead of a percentage of the average true range. All the above methods can be easily incorporated into a mechanical system.)

Channel Breakout. One of the more popular types of trend-following strategies in the nineties, Donchian originally popularized the channel breakout concept by employing a breakout of the 4-week high or low. Later, Richard Dennis modified this into the "Turtle System," which used the 20-day high/low. Most traders don't realize that simply entering on the breakout of the previous day's high or low can also be considered a form of channel breakout. (Another popular parameter is the 2-day high or low.)

Exit Strategies

One of the easiest and more popular ways to exit a breakout trade is simply to exit "Market-On-Close." The ideal trend day closes near the opposite extreme of the day's range from the opening. This strategy keeps the trader in the market throughout the day, yet requires no overnight risk. Most breakout strategies actually test out better for trades held overnight because the next opening will so often gap in a favorable direction. Thus, another simple strategy is to exit on the next morning's opening.

Instead of a strategy based on time, such as the close or the next day's open, one can also use a price objective. One popular method is to take profits near the previous day's high or low. One can also determine a target based on the average true range.

For the classic market technician, point-and-figure charts can provide a "count" which establishes a price target. This method is valid only if price breaks out of congestion or a well-defined chart formation.

Trade Management

In general when testing volatility breakout systems, the wider the initial money-management stop, the higher the win/loss ratio. With breakout strategies, the initial trade must be given room to breathe.

However, a discretionary day-trader will learn that the best trades move in his favor immediately. In this case, move the stop to breakeven once the trade shows enough profit. The stop can be trailed as the market continues to trend, but **not** too tightly. Because a great majority of the gains can occur in the last hour as the trend accelerates, try not to exit prematurely. When trading multiple contracts, scale out of some to ensure a small profit in the event of a reversal. However, do not add to a position: The later the trade is established, the more difficult it is to find a suitable risk point.

A Few Words on Volatility Breakout Systems

Trading a mechanical breakout system can provide invaluable experience. The average net profit for the majority of these systems is quite low, so they may not guarantee a road to riches; but they serve as a terrific vehicle to gain a wealth of experience in a very structured format.

If you are going to trade a mechanical system, you must be willing to enter **all** trades! It is impossible to know which trades will be winners and which ones losers. Most traders who "pick-and-choose" have a knack for picking the losing trades and missing the really big winners. The hardest trades to take tend to work out the best! With most systems, a majority of the profits come from less than 5% of the trades.

Though most breakout methods have a high initial risk point, their high win/loss ratio makes them easier to trade psychologically. You might get your teeth kicked in on the losers, but, fortunately, big losses do not happen very often. Also, if trading a basket of markets, as one should with a volatility breakout system, diversification should help smooth out the larger losses.

To summarize the main benefits of trading a breakout system:

- it teaches proper habits, there is always a well-defined stop;
- you get lots of practice executing trades;
- it teaches the importance of taking every trade;
- it teaches respect for the trend.

Additional Considerations when using Breakout Strategies

- overall average daily trading range (must be high enough to ensure wide "spread");
- volume and liquidity;
- seasonal tendencies (e.g., grains are better markets in spring and summer);
- relative strength;
- commercial composition.

Appendix I - Time Tested Classic Trading Rules for the Modern Trader to Live By – Linda Raschke

This is a list of classic trading rules that was given to me while on the trading floor in 1984. A senior trader collected these rules from classic trading literature throughout the twentieth century. They obviously withstand the age-old test of time. I'm sure most everybody knows these truisms in their hearts, but this list is nicely edited and makes a good read.

1) Plan your trades. Trade your plan.

2) Keep records of your trading results.

3) Keep a positive attitude, no matter how much you lose.

4) Don't take the market home.

5) Continually set higher trading goals.

6) Successful traders buy into bad news and sell into good news.

7) Successful traders are not afraid to buy high and sell low.

8) Have have a well-scheduled planned time for studying the markets.

9) Successful traders isolate themselves from the opinions of others.

10) Continually strive for patience, perseverance, determination, and rational action.

11) Limit your losses - use stops!

12) Never cancel a stop loss order after you have placed it!

13) Place the stop at the time you make your trade.

14) Never get into the market because you are anxious because of waiting.

15) Avoid getting in or out of the market too often.

16) Losses make the trader studious - not profits. Take advantage of every loss to improve your knowledge of market action.

17) The most difficult task in speculation is not prediction but self-control. Successful trading is difficult and frustrating. **You** are the most important element in the equation for success.

18) Always discipline yourself by following a pre-determined set of rules.

19) Remember that a bear market will give back in one month what a bull market has taken three months to build.

20) Don't ever allow a big winning trade to turn into a loser. Stop yourself out if the market moves against you 20% from your peak profit point.

21) You must have a program, you must know your program, and you must follow your program.

22) Expect and accept losses gracefully. Those who brood over losses always miss the next opportunity, which more than likely will be profitable.

23) Split your profits right down the middle and never risk more than 50% of them again in the market.

24) The key to successful trading is knowing yourself and your stress point.

25) The difference between winners and losers isn't so much native ability as it is discipline exercised in avoiding mistakes.

26) In trading as in fencing there are the quick and the dead.

27) Speech may be silver but silence is golden. Traders with the golden touch do not talk about their success.

28) Dream big dreams and think tall. Very few people set goals too high. A man becomes what he thinks about all day long.

29) Accept failure as a step towards victory.

30) Have you taken a loss? Forget it quickly. Have you taken a profit? Forget it even quicker! Don't let ego and greed inhibit clear thinking and hard work.

31) One cannot do anything about yesterday. When one door closes, another door opens. The greater opportunity always lies through the open door.

32) The deepest secret for the trader is to subordinate his will to the will of the market. The market is truth as it reflects all forces that bear upon it. As long as he recognizes this he is safe. When he ignores this, he is lost and doomed.

33) It's much easier to put on a trade than to take it off.

34) If a market doesn't do what you think it should do, get out.

35) Beware of large positions that can control your emotions. Don't be overly aggressive with the market. Treat it gently by allowing your equity to grow steadily rather than in bursts.

36) Never add to a losing position.

37) Beware of trying to pick tops or bottoms.

38) You must believe in yourself and your judgement if you expect to make a living at this game.

39) In a narrow market there is no sense in trying to anticipate what the next big movement is going to be - up or down.

40) A loss never bothers me after I take it. I forget it overnight. But being wrong and not taking the loss - that is what does the damage to the pocket book and to the soul.

41) Never volunteer advice and never brag of your winnings.

42) Of all speculative blunders, there are few greater than selling what shows a profit and keeping what shows a loss.

43) Standing aside is a position.

44) It is better to be more interested in the market's reaction to new information than in the piece of news itself.

45) If you don't know who you are, the markets are an expensive place to find out.

46) In the world of money, which is a world shaped by human behavior, nobody has the foggiest notion of what will happen in the future. Mark that word - Nobody! Thus the successful trader does not base moves on what supposedly will happen but reacts instead to what does happen.

47) Except in unusual circumstances, get in the habit of taking your profit too soon. Don't torment yourself if a trade continues winning without you. Chances are it won't continue long. If it does, console yourself by thinking of all the times when liquidating early reserved gains that you would have otherwise lost.

48) When the ship starts to sink, don't pray - jump!

49) Lose your opinion - not your money.

50) Assimilate into your very bones a set of trading rules that works for you.

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