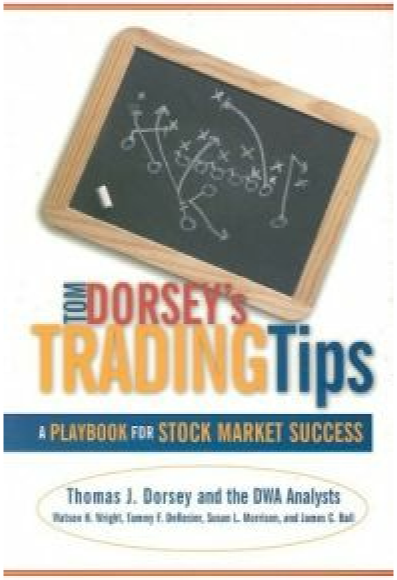

Book Tom Dorsey's Trading Tips

A Playbook for Stock Market Success

Thomas J. Dorsey, Watson H. Wright, Tommy F. DeRosier, Susan L. Morrison and James C. Ball
Bloomberg Press, 2001

Recommendation

Honestly, there are not too many books in the personal investing genre that we'd recommend for serious investment advice. But if you're a serious investor considering a venture into short-term trading (formerly known as day-trading), you'll benefit from the wisdom, mind-boggling detail and dizzying array of charts presented here. Tom Dorsey likens good investment advice to a sports playbook that a coach can follow through the twists and turns of the game. The plays and strategies that they outline will be valuable for novices, but *BooksInShort* figures that they will challenge trading veterans as well. You need to do some homework (like following the indices and making charts) to work with this book. Dorsey and crew urge you to learn stock-market basics, govern your emotions, understand the psychology that drives investors and avoid common mistakes, like investing based on trends and hot tips. And, don't mind their sports jargon; it's just a framework to make the uninitiated feel comfortable.

Take-Aways

- Emotions influence every investor's stock decisions.
- To make money, you must understand market psychology.
- Invest using research methodologies, including point and figure charts.
- Point and figure charts can help you determine when to buy and sell.
- These charts record the relationship between supply and demand.
- Base your strategies on the fundamental laws of supply and demand, not on emotions or superficial market trends.
- Combine technical and fundamental analysis to determine what and when to buy.
- Avoid common investor mistakes.
- Risk-reward principles help identify a stock's potential return.
- Short-term trading is unlike any other kind of trading and has its own rules.

Summary

Market Technology

Your emotions inevitably influence your decisions as an investor. Not only are the simple acts of buying and selling inseparable from emotion, your choice of stocks and your strategies are, too. So, it’s important to understand market psychology. Do you find the newest stock on the block irresistible? Do you buy stocks that are down in the dumps, feeling that you’re automatically getting a bargain? Are you influenced by market trends?

> “Remember that the person who is wildly promoting or recommending a particular stock more than likely already owns it.”

You can develop confidence in your stock market decisions by using investment research methodologies, including point and figure charting. This proven, objective strategy is based on the fundamental laws of supply and demand, not on superficial market trends. When you learn basic strategies - such as how to evaluate technical pros and cons or accurately compare your stocks to market leaders - as well as more advanced strategies regarding short-term trading, options and indices, then the terms and the processes of stock market trading will be demystified. You will be in a better position to make profitable decisions.

Charting

Learn to combine technical and fundamental analysis, so you can decide not just what to buy, but when to buy. Using point and figure charts helps you determine when to buy stocks. Charting stocks lets you see the movement that determines whether supply or demand is in control of the stock. If supply is in control, then the probability is high that the stock will decline. If demand is in control, then the odds favor an increase in the price of stock.

> "The one thing all winners of a Nascar race will tell you is that they drove a straighter line than anybody else. Investing is the same way. Try to make as few lane changes as possible.

Point and figure charts are superior to other kinds of charts because:

- Formations are easier to recognize and interpret. The patterns tend to repeat themselves.
- Trends are easily identified, and trend lines can be drawn easily.
- You can establish valid targets using the vertical and horizontal counts.
- You can see both the near-term and long-term position of stock.
- You can follow more stocks because this is the easiest kind of chart to keep.
- Charting by hand every day gives you a good feel for the stock, something you would otherwise not get.
- The chart enables you to stay with a winner while it is winning and get rid of a loser quickly.
- You can make the pricing interval fit whatever you want to chart, including stocks, bonds, commodities, speculation, investment and even volatility.

> “Volatility is the price you pay for higher returns.”

The point and figure methodology has been around for more than 100 years. One of its first proponents was Charles Dow, The Wall Street Journal’s first editor. This kind of chart is simply a logical, organized way to record the relationship between supply and demand.

As the methodology has developed over the years, it has been refined for even easier use. Prices are put on the chart’s vertical axis. Xs and Os are used to signify changes: Xs stand for demand and are always moving up the chart; Os stand for supply and are always moving down the chart. Numbers in the chart record the time and identify months. Just as master chess players excel at pattern recognition on the chessboard, accomplished stock market technicians are highly skilled at chart pattern recognition. If you can understand and remember chart patterns, you can become a better investor.

Common Investor Mistakes

Because you - like all investors - are always at risk of letting emotions influence investing decisions, it's important to avoid common investor mistakes. Be sure that you:

- Don't fall in love - Don't hold on to a stock that has deteriorated just because you're still in love with your original reasons for buying.
- You bought the right stock, don't forget to sell it right - Once you buy a stock you must review it on a regular basis; don't forget about it.
- Have a game plan for investing - Remember that stocks are governed by risk-reward principles. Investors often haphazardly pick stocks to buy in a strong market, thinking that the stock market is easy to beat. They fail to realize that risk is as prominent as reward. Have a game plan that helps dictate what stocks to buy and when, and also tells you when to sell or "play defense."
- Don't buy stocks that are extended - They lessen your potential reward.
- Be willing to take small losses as well as small gains - Avoiding large losses will keep you in the game. You won't be right on every trade, so you must be willing to bail out and take the small loss when it's time.
- Don't act on poor advice, tips and financial media hype - Many investors try to get rich quick without doing any homework. They simply rely on TV or the financial media to tell them what to buy. This is a prescription for disaster. Educate yourself, create a game plan, do your own research. Only then can you be in a position to make sound, informed decisions. Never rely on schemes and rumors.
- Don't buy a stock just because it is a "good value" - Value is in the eye of the holder, and is subjective at best. If a stock has become a good value, find out why. The true value of a stock is determined by its capital appreciation potential, not by numbers on a balance sheet. The basis for capital appreciation lies in the supply and demand relationship of the stock.
- Don't hold on to losing stocks in hopes that they'll come back - While hope is eternal, your portfolio isn't. Holding on to a losing stock will sink your portfolio.
- Don't pursue perfection - If you are constantly pursuing the perfect "system" to play the stock market, or waiting for the perfect trade, you will be disappointed and broke.
- Don't do anything based on a magazine cover - Following the hot news and trends on magazine covers is a shortcut to the poorhouse.

Stock Selection

Knowing what stadium you're playing in and what time the game starts is just as important as having a game plan and a playbook for investing. A football player wouldn't show up at a swimming pool, and a golfer wouldn't tee up on a baseball field. Each sport has its own playing field, and the same goes for investing. Learn the intricacies of market index composition and weighting, sector timing and sector-relative strength. Those factors will let you know what stadium your game is in and if the playing field is level.

> "When to sell is probably the hardest part of investing."

When you know the essentials of individual stock selection, you can be confident that you're putting the right player on the field. This four-step process will help you do just that:

- Step One: Market - Use the NYSE Bullish Percent, Option Bullish Percent, OTC Bullish Percent, High-Low Index, Ten Week and other indicators to determine if you should play offense or defense.
- Step Two: Sector - Use your charting to determine which sectors suggest offense (those that are bullish).
- Step Three: Fundamentals - Create and maintain an inventory of stocks. Any number of sources can help you determine which stocks are fundamentally sound. At this point, you want to choose which specific stock to buy.
- Step Four: Technicals - Review these sound stocks on a technical basis to pick those controlled by demand, those that demonstrate the best technical picture. Then you can narrow your fundamental inventory down to those stocks with the best probability of moving higher. This is the step in which you determine when to buy a specific stock.

Risk-Reward Principles

Risk-reward analysis is an extremely important part of stock selection since it helps you identify the potential return in a particular stock compared to the amount of risk you take in buying it. Ideally, you want at least a two-to-one ratio: two points of profit for every one point of risk. To calculate the amount of risk versus reward, focus on:

- Determine where significant resistance lies ahead, or where the stock would be overbought on its trading band.
- Determine where significant support resides below.
- Calculate the price objective for the stock, using either the vertical or horizontal count in your point and figure chart.
- Determine your stop-loss point, the point at which you no longer want to own the stock.

Short-Term Trading Techniques

Short-term trading is unlike any other kind of investment activity. Becoming a good short-term trader takes a lot of work, experience and money. It's not only difficult, but it can be very dangerous. However, adhering to a strict risk-reward strategy can help you make good profits. Most people don't understand the nature of the risk in short-term trading. As a trader, you're not risking your entire investment on a particular transaction since the odds are high that you will get out of the stock as soon as it looks even the tiniest bit weak. The real risk lies in the fact that while short-term traders can cut their losses, they also automatically cut their profits. To be a successful short-term trader, you have to pick stocks that are going up right now. Otherwise, you'll spend all your money and most of your time, chasing your tail. Here are a few guidelines:

- Consider buying after a stock pulls back - This will give you a better risk-reward ratio and a tighter stop loss.
- Sell immediately if the stock drops - Sell if it drops below its support line.
- Have in mind a precise short-term target - The vertical count used in your point and figure chart is an effective target. If the stock moves up, move the stop loss up below it until you are finally stopped out.
- Consult a trendline - This is an alternative to the first three procedures. If the trendline is violated, sell the stock. One main trendline always dominates, but the short-term trader may want to redraw shorter trendlines. Studying trendlines can help short-term traders another way, also. A stock in an uptrend can be purchased as it hits the bottom of the trendline. If the stock does not rally off that trendline and continues its decline, then you have a close stop loss.

Managing Your Investment

It's the fourth quarter and your football team is winning by a touchdown. Then, suddenly, your quarterback hits the ground injured. Now, you have to adapt. The stock market can cause similar injuries. When you manage a portfolio, the market is an opponent that never stops playing the game (no time outs!) and will constantly challenge your ability to adapt. You must form alternative strategies to conquer potential setbacks consistently, including:

- Over time, manage your money so that you have consistent returns each year - This garners better results than having huge gains one year and terrible losses the next year.
- Make as few moves as possible to get to your goal - If everything looks good from a technical standpoint, let your strong horse keep running the race. Don't sell a successful stock to generate money to buy today's hot tip. Stay with your winner.
- Let the profits run - Really strong stocks tend to remain the strongest. They typically continue to outperform the market for an extended period of time.

About the Authors

Thomas J. Dorsey conducts risk-management seminars for brokers throughout the world at major stock exchanges and investment firms. He is the author of two prior books, *Thriving as a Broker in the 21st Century* and *Point & Figure Charting: The Essential Application for Forecasting and Tracking Market Prices.* He has also written articles for such publications as *The Wall Street Journal, Barron's Fortune* and *Bloomberg Personal Finance.* He is president of Dorsey, Wright & Associates, Inc., an investment advisory firm in Richmond, Virginia. The other authors are associated with Dorsey, Wright & Associates, Inc.