TraderLion

THE TRADER'S HANDBOOK

WINNING HABITS AND ROUTINES OF SUCCESSFUL TRADERS

RICHARD MOGLEN / NICK SCHMIDT
ROSS HABER / AMEET RAI

Hh

THE TRADER’S HANDBOOK

Winning Habits and Routines of Successful Traders

Richard Moglen, Nick Schmidt, Ross Haber, Ameet Rai

Harriman House

CONTENTS

FOREWORD BY DR. ERIC WISH

I wish I had been able to read this book when I started trading around 1964.

Richard Moglen took my undergraduate Honors course, Introduction to the Stock Market and Technical Analysis, at the University of Maryland in 2019. That course introduced young students to what I had learned about trading by studying the great traders, including Nicolas Darvas, William O'Neil, Stan Weinstein and Mark Minervini.

I first began teaching the course in 2006, after placing 5th in the 2005 Barron's Stock Challenge for business professors (which I was not), where I returned 30.8% during the 2.5-month contest. I convinced the University of Maryland Honors program to allow me, a Research Psychologist and Director of the Center for Substance Abuse Research, to offer a trading course, where my aim was to teach young students what I wish someone had taught me at their ages.

What links my two passions? Well, I reasoned that drugs and the stock market are both addictions!

Since then, I have offered the course each year and have published a free blog www.WishingWealthblog.com in which I tell people what I am doing in the market. I successfully avoided the steep market declines in 2000, 2008 and 2021-22 and in addition to protecting my university retirement accounts from huge declines, I have been able to increase my IRA trading account about 20x since the 1990s.

I tell my students to study the works of people who have "walked the talk" and have made fortunes in the stock market. Richard found his passion for trading in my class and upon graduating, went on to produce YouTube interviews with Weinstein, Minervini and a host of other market wizards. His growing reputation in the trading field led to his joining TraderLion and partnering with Ross Haber, a protégé of William O'Neil and prior Portfolio Manager at William O'Neil + Co.

Richard and his co-authors have pooled their 60+ years of extraordinary market experience to produce this book, and it shows. The book is filled with specific details about how to apply the actions they describe. And as an instruction manual, each chapter ends with a Trader's Handbook Challenge, really homework, that induces the reader to apply the concepts described in the chapter. The chapter on risk management is, perhaps, the most valuable, as it provides an excruciatingly detailed description of how to define and manage risk. Examples are given to show how to calculate each measure of risk. Many authors talk philosophically about managing risk. These authors show how they do it.

The TraderLion team has launched a new trading software, called Deepvue. It was Richard's goal to create an all-in-one tool that merges technical analysis with fundamental analysis and that would be priced much lower than competitors' programs. The book is infused with examples of how he uses Deepvue to create practical stock charts and scan for stocks worthy of purchase. This book is to Deepvue what William O'Neil's first book was to the *Investors Business Daily* newspaper and the CANSLIM strategy.

I hesitate to talk about any one chapter because all of them are essential. Discussions of the analysis of market trends, setups, setting stops, creating watchlists, preparing to trade, and post-trade evaluation of results are all invaluable. The book ends with examples of model stocks the authors have identified, but does not stop there. Readers are urged to compile their own collection of model stocks because of the knowledge gained by doing so.

The explicit details provided about the steps and challenges involved in trading reflect the fact that these authors are seasoned traders. I especially enjoyed Ross's descriptions of his experiences working with Bill O'Neil. My only advice for gaining the most from this book is that the reader first prepare by familiarizing himself with Nicolas Darvas' classic book, "How I made $2,000,000," and Stan Weinstein's concept of Stage Analysis, which guides my trades to this day.

If I had been able to read a book like this when I started trading, I believe I would have been able to trade profitably long before I did. Study this book and enjoy the journey!

Eric D. Wish, Ph.D.
WishingWealthblog.com and on X, @wishingwealth

PREFACE

WHAT THIS BOOK IS ABOUT

THIS BOOK IS about the key steps of developing a trading system and how you can practically go about executing an effective strategy.

This is not a book about the glam or glory of trading, but the hard work and processes necessary to perform it over the long term.

The principles we will cover are derived from the market itself and what has worked in the past and will continue to work in the future. We combine ideas from legendary traders such as William O'Neil, Nicolas Darvas, Jesse Livermore, and Stan Weinstein with current top traders such as Oliver Kell and Mark Minervini.

WHO THIS BOOK IS FOR

This book is for traders of all skill levels who want to keep improving and learning. While we build up the concepts from the ground up, there is no shortage of advanced techniques for more experienced readers.

We are primarily long-focused growth stock traders, and the specific examples and methods we share reflect that. This is not to say that the larger principles are not useful for traders who like to short, but that is not a focus of this book.

HOW THIS BOOK IS STRUCTURED

Each chapter of this book covers a key aspect of a trading system, from technical analysis to entries to exits, from risk management to post analysis, it is all discussed here. Not only do we present critical components of a trading system but we show how you apply them using real-world rules and techniques from our own combined 60+ years of trading.

With each chapter we have included challenges that help you apply the material. To get the most out of this book we highly encourage you to complete them and ideally exchange ideas with other traders.

We’ve designed this book to serve as a reference guide with each chapter covering a key aspect of trading.

Chapter 1 sets the stage and introduces five overarching principles to keep in mind as you read the book and refine your trading system.

Chapter 2 introduces the trader’s journey and helps you identify your current stage.

Chapter 3 presents the key technical and fundamental foundations that form the basis of this book.

Chapter 4 dives into edges and setups in the market. We share our thought processes and the specific ones we use.

Chapter 5 discusses the entry tactics we use to enter positions, and briefly looks at how we manage risk along the way.

Chapter 6 dives deeper into risk management from both a portfolio and individual trade level. It also lays out a clear process for how to set position sizes.

Chapter 7 focuses on how to manage a trade once you have entered. This includes sell rules for swing and position traders.

Chapter 8 covers how to analyze the market to determine its trends and cycles. This is your guiding light that will inform you on how aggressive you should be with your trading.

Chapter 9 is where we share our screening process for finding new ideas and the repeatable routines we use to consistently perform.

Chapter 10 covers post analysis, journaling, and continuous improvement. We walk through how we analyze our own trading in order to improve with time.

Chapter 11 is for traders looking to find new edges, setups, and entry tactics. We discuss how to build model books of winners and how to perform a trading study on a trading concept or pattern.

Chapter 12 is a bonus chapter that shares many charts of top performers from the past few years to help speed up your learning curve.

We hope you enjoy this book, find it useful, and consider it a valuable reference as you progress as a trader.

Happy trading

—Richard, Rai, Nick, and Ross

CHAPTER 1: A LOOK IN THE MIRROR

IT WAS THE second week of April 1999, right during the peak of the internet bubble. I remember the feeling of delight as I hopped up and down cheering while CNBC covered Charles Schwab's standout stock performance. At that moment, SCHW, the ticker Charles Schwab traded under, was one of the largest positions in my portfolio at William O'Neil + Company.

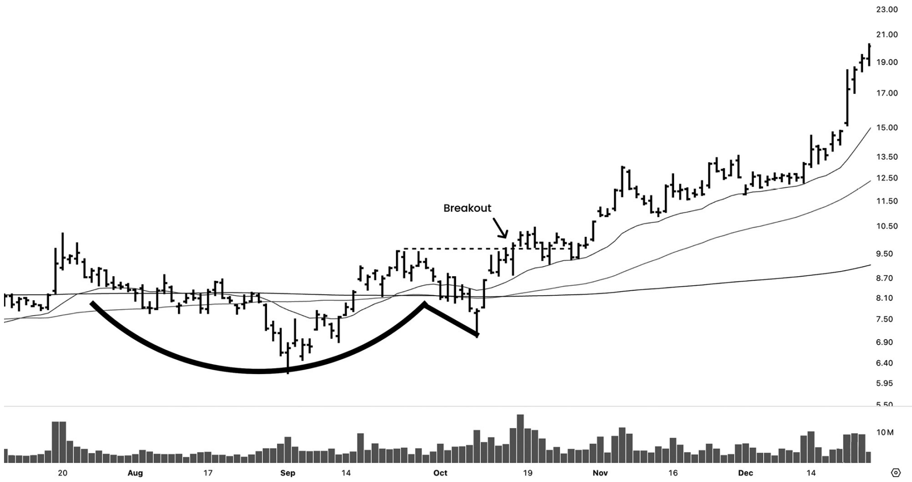
The late 90s was a superb trading environment, and it felt like you could do no wrong buying breakouts in technology companies. The internet revolution was under way, and it was an amazing time to be a growth stock trader. A company could change their name, adding .com to the end, and double in value in a few days for no other reason.

I had started building a position in SCHW after it broke out from a 12-week cup and handle pattern in October of 1998. From the breakout it had acted perfectly, and proceeded to advance from $30 a share pre-split to well over 100% in just a matter of weeks.

In terms of fundamentals, Schwab seemed perfectly poised, taking market share and growing earnings at an accelerated rate each quarter. Schwab had doubled down on the internet and was riding the wave of more and more clients looking to move their brokerage services online.

During this incredible run Charles Schwab never broke the 10-week moving average, which is a quality shared by many of the most impressive stocks in history. This sustained trend was likely due to accumulation by large institutions wanting to grab their pieces of the pie.

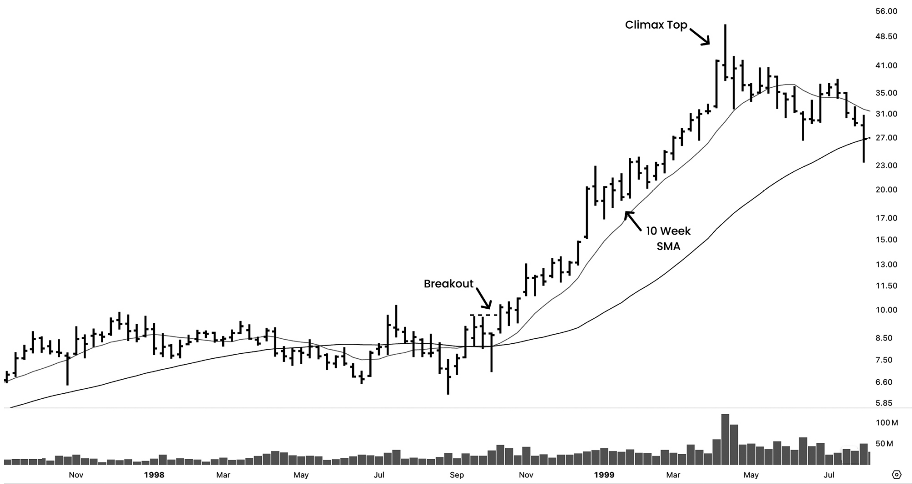
SCHW 1998- Daily



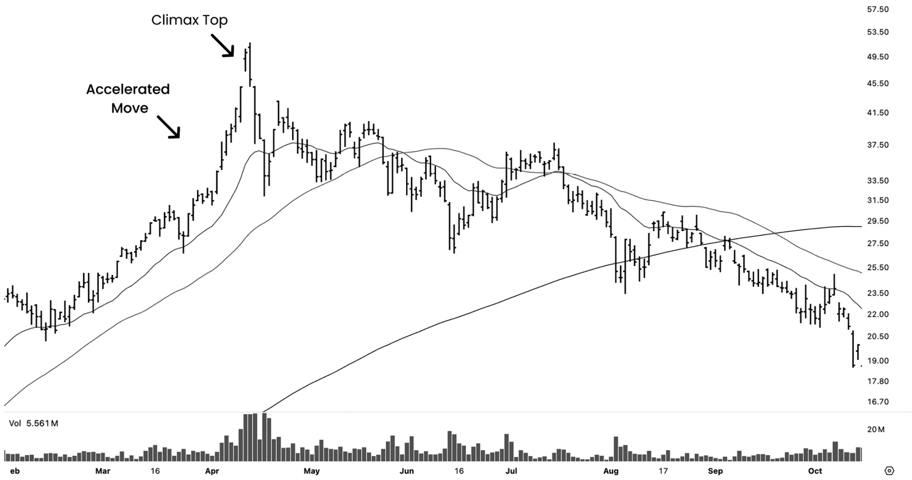
Standing in front of the TV on that day in April as CNBC highlighted Charles Schwab and what a tremendous stock it had been, I paused for a moment and some self-awareness pushed through the giddiness.

Bringing up a chart, I took one glance, and it confirmed my suspicions. SCHW was forming a climax top after a 400% increase in just 24 weeks. I sobered up quickly, objectivity taking hold.

SCHW Weekly



SCHW Daily



Climax tops occur after a stock has already made a major move and accelerates upward in a euphoric last push. This move, driven by greed, often marks the end of the rise of a model stock.

Realizing this, I immediately called my trader on the William O’Neil trading desk and told him to sell my entire position. By the time I sold, Schwab had fallen well off its highs for the day and had actually gone red. Looking back, this ended up being the top day in SCHW, which would fall over 65% in the next six months and lose 87% of its value during the 2000–2003 bear market.

Reflecting on this trade, I can only be grateful for the lessons I had learned working with Bill (William O’Neil) as a portfolio manager. For those who may not know, O’Neil was one of the most impressive stock traders in history. Through careful study of historical top stocks, he developed the CANSLIM methodology for trading, which pairs technical and fundamental analysis. Using this style, he achieved extraordinary results including becoming the youngest ever individual to purchase a seat on the NYSE at age 30, capitalized on game-changing stocks like Syntex, Cisco, Yahoo, Amgen, as well as Costco, and most profoundly educated millions of traders around the world.

I first joined O’Neil and company in 1998 in the institutional sales department, working with large funds and institutions who O’Neil consulted for. I was able to learn directly from him and, because we traded through the O’Neil broker, he was aware of our personal results. In 1999 I was lucky enough for O’Neil to invite me to become a portfolio manager and also work on research projects for the firm, including proprietary model books, with Mike Webster and Charles Harris.

O’Neil also entrusted me with helping him teach the CANSLIM methodology around the country at workshops and events. My time at William O’Neil & Company was invaluable, and I was able to lean on William O’Neil’s experience during tough decisions and see first-hand how he traded and approached the markets.

During portfolio manager meetings, he reminded us consistently that although we buy based on both technicals and fundamentals, we must look to the charts to determine exactly when we should sell.

Despite Charles Schwab’s great story and seemingly glowing future, the technicals revealed the raw truth. The large institutional investors were now net selling their shares to the general crowd, leading to the inevitable end of the stock’s move.

My trade of SCHW remains one of my best executed, but it also serves as an important reminder to never let emotions get in the way of making the correct decisions while trading. When a stock is going up it feels amazing; it seems like we are able to print money at will. However, nothing is more important than managing risk and protecting the profits we gain during bull market runs.

Many new traders have felt the incredible potential of stock trading first-hand, but unless they also learn to respect risk and learn when to sell those stocks that had previously made them money when they change character and start downtrends, they will be hard pressed to keep what they have earned.

At TraderLion we've seen this many times with each bull market. Traders try to hold on to previously great stocks, unable to understand that, now, the prevailing trend is down.

We've learned to never fall in love with a stock, no matter how innovative the company seems or how charismatic the CEO may be. We've seen too many previously great stocks that rose tenfold, then lose momentum, and tumble 75% or more during downtrends. Often the fundamentals only seemed to deteriorate well after the stock had fallen from highs.

These hard-won lessons often take multiple market cycles of bear and bull markets to fully understand, and most people who start trading will become frustrated and quit long before they make the necessary breakthroughs.

This is one of our main motivations for writing this book—to pass on our learnings from our collective decades of market experience so that you can learn from both our triumphs and, ideally even more so, from the many mistakes we've made.

We hope we can help you learn the right approach and mentality that will enable you to create a successful trading system for yourself, so that you can protect your profits and compound your capital over a long career as a trader.

The barriers to entry for stock trading have never been lower. With commission-free trading, mobile apps, and online resources at your fingertips, anyone can open and fund an account in minutes and place their first trade.

You hear stories out there about million-dollar trades, new traders doubling and tripling their accounts in a matter of months, and otherwise fantastic feats which rightly show the incredible opportunity that exists in the markets. With the ease of access, more and more individuals are stepping into the arena with the professionals, with the hopes of obtaining *easy and fast money*.

Many of these new traders begin their journeys in the strongest bull markets when everyone seems to be making fortunes. The 90s were a perfect example, and more recently we saw many people start getting involved during the 2020 bull market. (You in fact may have picked up this book for the first time during the next great trading period.)

However, the reality of trading is that it is anything but easy. After the strong bull markets come bear markets and choppy periods which wipe out any progress from inexperienced traders, leaving them discouraged and likely to give up. To successfully navigate changing environments over decades it takes years of commitment, hard work, discipline, and the development of a time-tested process.

Newcomers to the markets hear about the headline trades, which are only the tip of the iceberg when it comes to real trading. In truth, every trader must go through a journey and evolution where they gradually learn the key lessons necessary to develop a personal, sustainable process.

Often, these lessons are learned at the cost of bumps and bruises, which, in the trading world, translates into losing trades and making significant mistakes. However, the most famous traders you have heard of—Stan Druckenmiller, George Soros, Paul Tudor Jones, and Mark Minervini—all had one thing in common: They persevered through early struggles until they found their style and gradually achieved super-performance.

Thinking you can jump into trading and be successful immediately is as misguided as believing you can pick up a baseball bat and produce the crucial game-winning hit in the bottom of the ninth in the World Series against an All-Star closer. Sure, it may look simple on TV to slap a fastball past the pitcher and into centerfield, but what is often forgotten by fans is all the hard work and preparation behind every single at bat.

This is the truth for any discipline, whether it’s becoming a doctor, engineer, or musician. Each profession requires years of experience and hundreds of mistakes to turn a novice into a pro. It is the same story with stock trading, except from day one you are competing in the same market as hedge fund managers with decades of experience. What we hope to pass on in this book is a road map, a guide, and a resource that will allow you to progress as quickly as possible.

In this book we will present multiple edges and frameworks that are precisely relevant to the current markets. These edges come from our collective studies of setups and our analysis of the best-performing stocks over the past few decades. Even better, in Chapter 11, we will walk you through our process of performing a study to show you how you can find your own edges in the future.

You may ask yourself why, if we use these edges and setups, are we willing to share them?

The answer is that these edges are the result of market structure and human psychology, factors that have gone unchanged since the 1920s.

The methods we will share are the result of trend orders of magnitude bigger than us individuals and instead they are created by the actions of the largest funds and institutions on Wall Street.

These institutions manage billions upon billions of dollars and create the sustained trends we see in the market. Even collectively, individual retail investors cannot change the direction of a liquid stock for more than a few moments. And it is actually our relatively small size that allows us to capitalize on many of the setups and edges we will share.

Our general tactics may change over time, but the core strategy, riding the waves created by institutions, will remain the same. This is what O’Neil found when he first developed his system decades ago, and it will be true for the next market wizards years in the future.

Keep this in mind: Whenever you come across a saying taken as truth or a common trading method, test it out for yourself. By putting in the work and challenging the norms, you just might find a new edge that you can consistently use to take income from the market. We will show you how to do your own studies on the market and trading techniques, following the exact process that we have used to build our systems from the ground up.

In this handbook we will share what has worked and continues to work for us and the many thousands of traders we have worked with. Take what you find helpful, iterate to make it your own, and ignore the rest.

FIVE KEY PRINCIPLES OF TRADING

As you read this book, we want you to keep in mind the following five key principles that we have found successful traders fully embrace:

1. Keep it simple.
2. Stay focused.
3. Plan for failure.
4. Manage risk tightly.
5. Think in cycles.

1. Keep it simple

The best trading systems, routines, rules, etc., are remarkably simple. With simplicity comes robustness, as there are fewer cogs in the chain to jam, as well as polish and improve.

With your charts, focus on price action above all else, and potentially supplement with only a few key indicators. Make sure any indicator you use helps you analyze and manage a trade and does not add noise.

With your rules, be specific and clear about exactly what you mean. With your routines, make them easy to complete so that you will actually follow them consistently.

Complexity adds in randomness and confusion. Keep your trading as simple and clear as possible.

2. Stay focused

In trading, becoming a specialist is the path to success. This means one style—day trading, swing trading, position trading, investing. Pick one and master it.

Within your strategy, you also want to focus your attention on just a handful of stocks and a handful of chosen setups. We will show you how to build strict criteria for your stock selection so that you are focused on the top 1% of stocks for your strategy.

This focus and specialization allows you to build confidence in yourself, and become great at key processes that allow you to perform.

3. Plan for failure

As you create your system, you want to make sure that you are setting realistic expectations as well as building in failure. Planning for failure ensures that you can protect your capital even when you are trading at your worst.

There will be market environments where your setups are ineffective, or even simply just periods where you are not on your A game. Even just bad luck can lead to many losing trades in a row, gap downs, stop loss hits, etc. Your system and psyche must be resilient enough to handle these periods as well as drawdowns.

With this expectation in mind, building in failure is truly the key to success. If you can hold your own even when things are not going well and the wind is in your face, think of what you can achieve in periods when the wind is with you.

4. Manage risk tightly

This follows closely with building in failure. Everyone says, “You have to manage risk.” But what does that mean? We’ve dedicated the entirety of Chapter 6 to answering that question and it is likely the most important concept of this book. This is especially important for very new traders who are boom and busters.

Very simply, you will take losses, sometimes many in a row, while trading. You want to make sure that your losses are papercuts, and just one trade that performs well can pay for many of them. To do this you need to select and design setups and entry tactics that allow you to know quickly when a trade is not performing and allow you to exit with a minimal drawdown to your account.

If you can master this skill—the ability to always enter with both a tight and logical stop loss in a high potential stock and setup—you will succeed in the market.

5. Think in cycles

Both the market and individual stocks rise and fall in overall cycles created by supply and demand, fear, and greed.

You want to ensure that you are trading in the right direction relative to the current market trend and becoming aggressive at the right points. We will teach you in Chapter 8 how to identify market cycles and build a system for yourself that tells you how exposed you should be at any given point.

In addition, as a trader, you will go through cycles of learning and then testing. It’s a process of continuous improvement. You will always be refining your system and slowly raising the bar. Chapters 10 and 11 are dedicated to frameworks that will help you study yourself and the markets.

There will be frustrating periods and drawdowns where it feels like you can’t do anything right. Dig in and remember that just like with the market during a correction, a new uptrend is just around the corner.

When you feel yourself struggling, take a step away and review your system.

A LOOK IN THE MIRROR

Before we progress any further, we want to emphasize that the single most important factor that will determine how successful you will be at trading is your commitment to learning.

Passion and determination will sustain you through the early stages of your journey and help you persevere through any obstacle you experience.

To achieve outsized returns and consistently beat the market, you must be willing to put in the work that most traders shy away from. Each of the following chapters will focus on a key element of a trading system. We will share our processes and lay out a specific blueprint for you to follow.

However, reading is one thing; applying the material is another. You need to study and work hard to become a successful trader; no one is going to give it to you.

So right now take a minute and get out a piece of paper and a pen. Once you have that ready, list all the reasons you have for learning to trade.

Finally, write a personal commitment to yourself (example below) declaring that you will put in the work to learn and improve your trading. You should also tweet this out or otherwise proclaim it to the world. You may find it a bit ridiculous, but written down goals have an interesting way of becoming true.

Remember, your choices and habits will over time form your reality. If you want to become a fantastic trader, it is fully within your power to do so. Read this book, perform studies, do your homework, and you will be well on your way to progressing along your trading journey.

It all starts with a look in the mirror and a commitment to yourself:

I will do my utmost to make incremental improvements and put in the work that will allow me to learn and improve as a trader. I will establish routines, read books, conduct studies, and otherwise look for ways to extend my knowledge base and perform at my best.

My reasons for learning to trade are:

Sign here:

With that commitment made, let’s get started.

CHAPTER 2: THE TRADER'S JOURNEY

> "The secret to being successful from a trading perspective is to have an indefatigable and an undying and unquenchable thirst for information and knowledge."
>
> ***—Paul Tudor Jones, Market Wizard***

EVERY TRADER GOES through the trader's journey: A meandering path full of setbacks, breakthroughs, side quests, triumphs, pitfalls, and continuous learning. It often starts with early success that gets you hooked, that feeling that this is so easy, of limitless opportunity.

You may have even plotted performance on a spreadsheet and calculated how much your portfolio will grow in five years, ten years, 30 years from now.

Unfortunately, all traders soon learn that you must pay your dues to the market, learn to respect it, and that the only way forward is through hard work.

The journey is non-negotiable. Some traders may progress faster than others, other traders may have to double back and travel parts of the journey multiple times, but every trader must go its length before they can develop a consistent and successful trading system.

Even after this, top traders know all too well that there are always ways to improve and further paths to walk. The challenge of trading is unique in life. It always seems to come up with new obstacles and problems for you to tackle.

This book is focused on the *how* and *what* of trading, and the four stages that every trader must pass through to reach consistent profitability. We will strive to give you a blueprint, a guide, to help you along your path and hopefully help you avoid the many hazards that new traders face.

We will share what actually has worked, and continues to work, for us, and the hard lessons won over the years, not theoretical or academic hindsight observations.

You will find that it's much less about finding the perfect indicator or memorizing candlestick patterns and that true trading is much more about mindset, probabilities, execution, routines, and discipline. Doing the boring but effective and necessary work consistently.

Anyone can become a successful stock trader, but they must first make a commitment to themselves; a promise that they will approach trading like a business, instead of a hobby. To progress as a trader, whatever your current starting point, your *why* must be powerful enough to drive you to work hard, continue to learn, and apply yourself to this endeavor.

Real money is on the line and fortunes can be made, but until you respect the process and learn to manage risk, you will likely lose money over time instead of compounding.

Now let's dive into the four stages of trading, to help you identify where you are on your path and the steps you need to take to reach the next stage.

This chapter lays the groundwork for the rest of the book. If you are more experienced feel free to breeze through. However, if you are in your first few years of trading, or new to trend-following and momentum strategies, we urge you to read closely and study this chapter before moving on to the rest of the book.

THE STAGES OF TRADING

Along your trading journey you will go through four distinct stages. We've developed these categories through our work teaching thousands of traders over the past few years.

The stages are as follows:

- Stage 1: Unprofitable Stage
- Stage 2: Boom and Bust Stage
- Stage 3: Consistency Stage
- Stage 4: Performance Stage

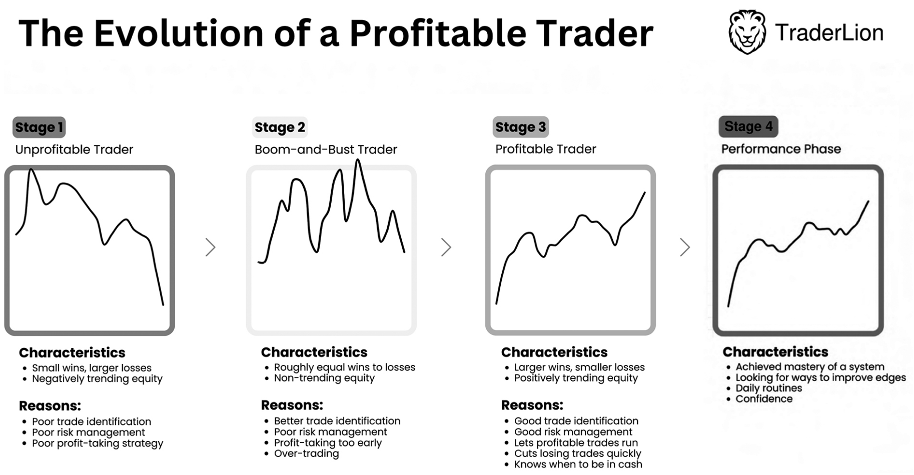
Our goal with this book is to lay out the knowledge you need to move forward from whichever stage you are currently in. We will carefully describe commonalities between the stages as well as steps to take to continue your development.

As you are reading this section, be brutally honest with yourself about which stage you are currently in. Armed with this knowledge, focus on our recommendations for how you can progress to the next stage.

One key aspect of determining your stage is to plot your performance or portfolio value on a time series chart (many brokers show this natively). Scan out to a wide view, at least one year long.

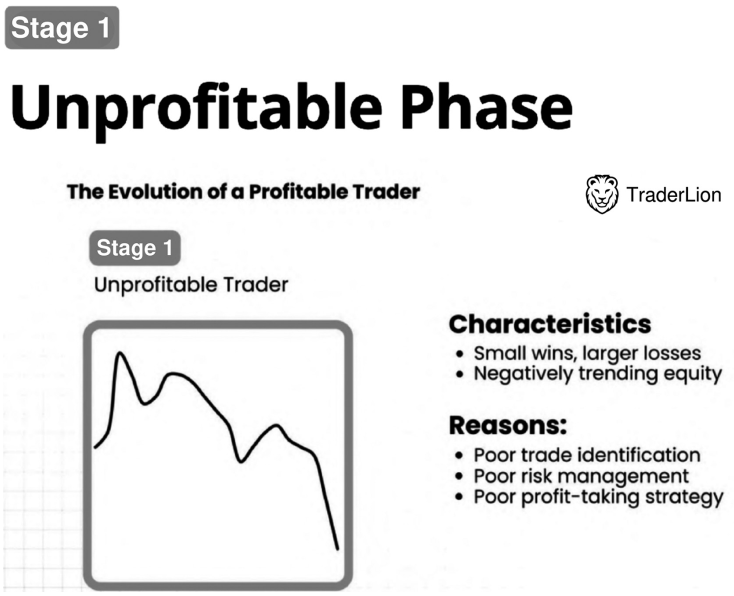
This plot is called your Equity Curve. It represents the truth about your trading. Each of the four stages has a very particular look to the trader’s equity curve. Have this plot ready for comparison as you continue to read.

Take a look at this graphic of the four stages.



We will now cover the stages in turn.

STAGE 1: UNPROFITABLE STAGE



Every trader, no matter how experienced they are now, initially started in Stage 1. This stage is characterized by a volatile, downtrending equity curve. Traders in Stage 1 act randomly without a system and act on tips and impulses.

There is very little rhyme or reason when it comes to buys and sells, and often traders in this stage have not received any trading education outside of social media posts. Traders in this stage often begin trading during strong bull markets and achieve a few wins before the tides change and random entries are no longer as effective.

Traders in Stage 1 often use a wide variety of trading styles. They may swing trade, day trade, buy deep value, short, use options, trade futures… flitting from one thing to the next to try to chase the easy money.

They will often have no risk management process and likely do not use stop losses. They size their positions extremely large to try to capitalize on the next great opportunity. They are chasing the quick double, triple, or quadruple of their account.

Traders in this stage appear in every bull market. When the market changes, however, they will likely give back any gains they made and then some.

However, a fraction of these traders will have caught the trading bug and will become committed to improving. If this stage resonated with you, know that you only have to make the decision to treat trading seriously in order to progress.

The key elements of Stage 1 traders are:

- Lack of a system for buys/sells.
- Random entries and exits, and stock selection—all based on emotion and tips.
- Trying a variety of styles and trading instruments all at once.
- Lack of risk management such as using stop losses or a position sizing system.
- Interest is completely driven by the search for quick money.

How Stage 1 traders can progress to Stage 2

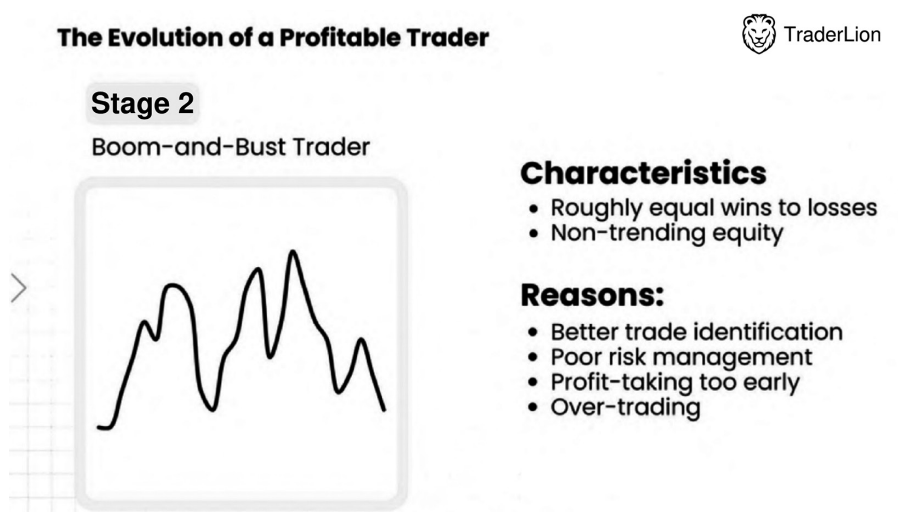
Stage 1 traders can very quickly progress to Stage 2 by seeking out resources and beginning to create their first trading system.

Their goals should be to:

- Commit to learning.
- Write their first set of trading rules (covered in Chapter 10).
- Build a consistent system for stock selection and entry setups (Chapters 4, 5, 9).
- Implement risk management systems through stop losses (Chapter 6).
- Adopt sell rules (Chapter 7).

In this stage there is so much to learn and improve on. Motivation is high and the traders who succeed dive into the work headfirst. What's great is that improvements come quickly and can keep you going.

STAGE 2: BOOM AND BUST STAGE



In this stage traders have often gotten more serious about trading and have done some research and even read a few books on strategies and setups.

However, they may struggle with consistently implementing a system and often lack proper risk management. Traders in Stage 2 have a volatile equity curve with upswings when the market is good and then they often give all their profits back when the market turns.

The key elements of Stage 2 traders are:

- Equity curve trends with the market.
- Risk management skills are still developing.
- Obsession with trying every indicator and strategy, albeit with more capability than Stage 1 traders.
- Lack of awareness of market cycles—long term and shorter term.

How Stage 2 traders can progress to Stage 3

Stage 2 traders' largest problem is that they are trying to focus on too much all at once. They are aware of all the resources and choices they can make and try to master all of them.

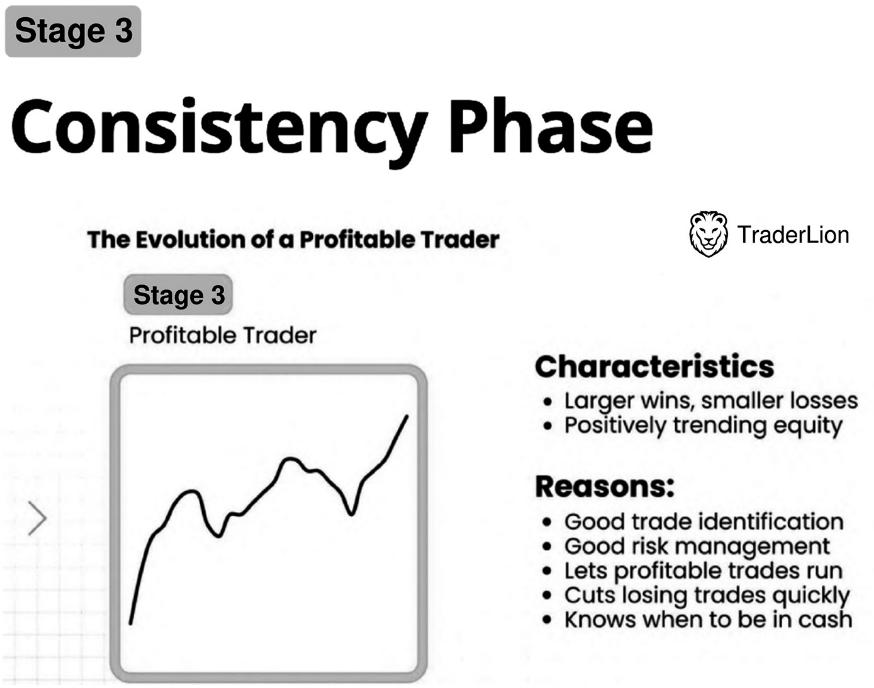
Their goals should be to:

- Focus on one time frame and one overall strategy.
- Study winning stocks and study traders who use their chosen strategy.
- Refine their rules and have rigid systems for entries, setting stop losses, position sizing, and selling.
- Gain more trading experience and knowledge.

This stage can be a turning point. The trader is now aware of the work ahead of them and it may feel very daunting and frustrating. Even with more knowledge and a starter system, Stage 2 traders may feel like they are not improving at all.

However, they should realize, and you should realize if you feel you are a Stage 2 trader, that Stage 3 is just around the corner after a few tweaks and refinements. Keep at it!

STAGE 3: THE PROFITABLE AND CONSISTENT STAGE



In this stage, traders have fully committed to learning and have often read multiple trading books and found a sound strategy that makes sense for them and their situation.

They may have also received mentorship from a more experienced trader using a similar style. At this point, they follow their system nearly all the time, they have improved risk management skills, and they also have awareness of the trends of the market and react accordingly.

The transition from Stage 2 to Stage 3 generally occurs when traders limit noise and focus on mastering one strategy and even just one setup. Proper risk management through position sizing and repeatable sell rules is also crucial to progressing to this stage.

In Stage 3, a trader’s equity curve will generally be upward trending from left to right and will be forming higher lows as they protect their profits from one market cycle to the next. At this point they have started to build confidence, but still require many improvements and tweaks to start truly performing.

The key elements of Stage 3 traders are:

- Higher highs and higher lows in their equity curves.
- A strong focus on one strategy, a handful of setups, and position management rules.
- A basic understanding of market cycles.

How Stage 3 traders can progress to Stage 4

At Stage 3, traders are profitable, although they still may not be performing as well as they would like. However, the transition to Stage 4 is more nuanced.

Their goals should be to:

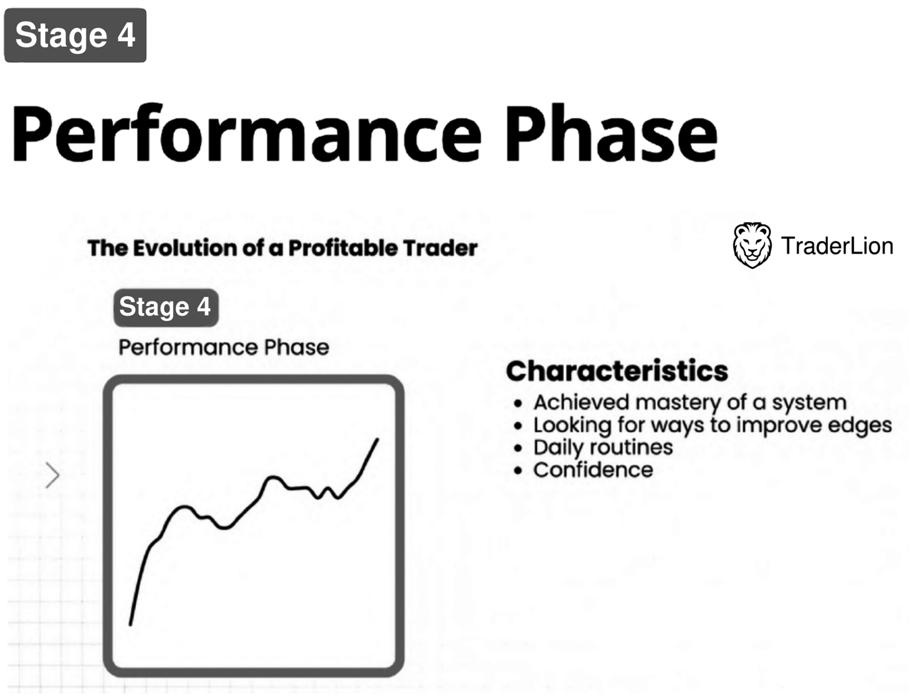
- Master and do deep dives into a small handful of edges, setups, and entry tactics.
- Trade in sync with medium-term market cycles.
- Continue to refine their rules to suit their own developing style.
- Double down on focusing on setups/tactics that produce tight and logical entries.

- With tighter entries, they can begin to position size higher, while keeping risk in check.
- Focus on the highest potential stocks of each cycle.

In Stage 3, traders are starting to see their work pay off and that will feel rewarding and motivate them to keep working. Performance is the end goal and at this point it’s about refinements, working hard, and individual breakthroughs.

For Stage 3 traders working to progress, Chapters 10 and 11 should be a focus, as you work to develop your own system.

STAGE 4: THE PERFORMANCE STAGE



Stage 4 may be the last stage, but it by no means signifies that the learning or hard work is done. Traders in this stage have achieved mastery of their trading system, but they are continuously looking for ways to improve edges and their performance.

Performance stage traders have nailed down routines that keep them focused on the highest potential stocks for their system and aware of the current market conditions. They know when to press on the gas as well as when to take a step back and limit their involvement in the markets.

This does not mean that they do not go through drawdowns or experience setbacks. However, they have confidence in their process and method, and know that when the environment is right they can perform vastly better than the indexes.

This confidence allows them to be patient and selective when their style is not well suited for the market environment. They wait, stalk, and pounce when the time is right.

In Stage 4, your equity curve will have a sharp upward trend with higher lows. What differentiates it from Stage 3 is the steepness during uptrends and the shallowness of any drawdown.

The key elements of Stage 4 traders are:

- Higher highs and higher lows in their equity curves.
- Strong performance during opportunity periods and limited drawdowns.
- Strong confidence in themselves as traders, even with occasional setbacks and mistakes.

How Stage 4 traders can progress

Stage 4 is a continuation of Stage 3. The trader’s goals should be to:

- Fully master a small handful of entry setups, defining their nuances.
- Anticipate and trade in sync with shorter-term market cycles.
- Size into the highest quality opportunities of their system at the correct moments.

- Limit drawdowns as cycles end.

Once a trader has reached Stage 4 they have a clear and consistent process that is unique to them. They have mastered particular setups and know intimately their nuances and what environments they work best in.

At this stage their goal is capital, time, and performance efficiency—to be concentrated on only the best opportunities coming out of the right setups in the right market environment.

DETERMINE YOUR STAGE

Think about your current trading ability and take a close look at your equity curve over the past year. It may be helpful to plot it against an index so you can have a visual representation of how the market was performing during different periods of time.

Look at how you have performed compared to the index. Is your curve trending upward or are you more of a boom and buster?

It may be hard to see the truth of your performance, but remember that no matter where you are now, with just a few tweaks and added experience, you will quickly progress to the next stage.

Likely if you are reading this book you are in the Stage 1+ to Stage 3+. This is an exciting time for a trader as you are committing to master this very difficult art and skill. Kudos to you for putting in the work.

THE MINDSET OF A WINNING TRADER

Once you have determined your stage, it is up to you to identify your strengths and weaknesses, and work hard to progress. The best part of trading is that your potential is unlimited.

Once you have developed your process and acquired the knowledge, no one can take that from you. It may take you years to progress from Stage 1 to

Stage 3, but thereafter you will be able to benefit from every future market cycle and opportunity. Don't feel like there is a rush to perform; you need to build your foundation through studying price action, studying leaders, and studying yourself.

Then, from this strong foundation, you can build your system and success.

Most top traders take around two full bull-to-bear cycles to progress to Stage 3. It takes real experience trading, making mistakes, and learning from them to fully work out the kinks and to develop your own psyche. Approach trading like a student. Every loss is a learning opportunity that can help you improve.

The progression from Stage 3 to Stage 4 is about incremental improvements and mastery of yourself outside of trading.

It will take time to achieve, but once again if you refuse to quit then there is no doubt you can reach the performance stage and consistently see a rapid trend of higher lows within your equity curve.

KEY TAKEAWAYS

In this chapter we have discussed the stages of trading from unprofitable to boom and buster, to consistency, to performance.

We described each of the stages and how you can identify your current stage using your equity curve, and also how you can continue to progress.

BONUS RESOURCE

We recorded a webinar about common trading problems and the stages of trading. We discuss at length how you can work towards progressing along your journey.

You can watch it today at traderlion.com/handbook.

CHAPTER 3: FOUNDATIONS

BEFORE WE DIVE into building a system and more complex concepts such as setups, we wanted to emphasize some key technical and fundamental foundations that form the basis of this book. In this chapter we will focus on the most important aspects of reading price action, winning characteristics of high potential stocks, and what drives market trends.

More experienced traders can skim this, or skip to later chapters, but if you are in your first few years of trading, we highly encourage you to read this attentively. We will be sharing key observations about top-performing stocks that we have gathered from over 60 years of combined trading experience.

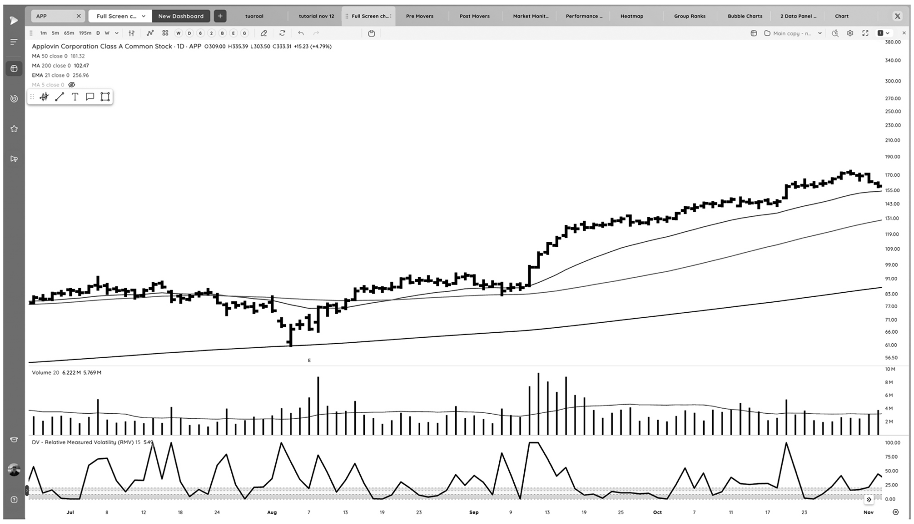
READING PRICE ACTION

Let’s start from the very basics and quickly accelerate to the key price and volume characteristics that we look for.

First we encourage you to keep your charts as clean and simple as possible. Stick to a few key indicators, such as moving averages, to help you identify trends.

You can also choose to master a few indicators that help you identify edges, setups, or entry tactics that you use. However, we want to emphasize that the simpler you make your charts, the easier you will be able to focus on what truly matters: price and volume.

Here is the primary chart template that Richard Moglen uses in Deepvue.



He is using three moving averages to judge trends over different periods, volume with a moving average to judge supply, and relative measured volatility to help identify tight price contraction areas.

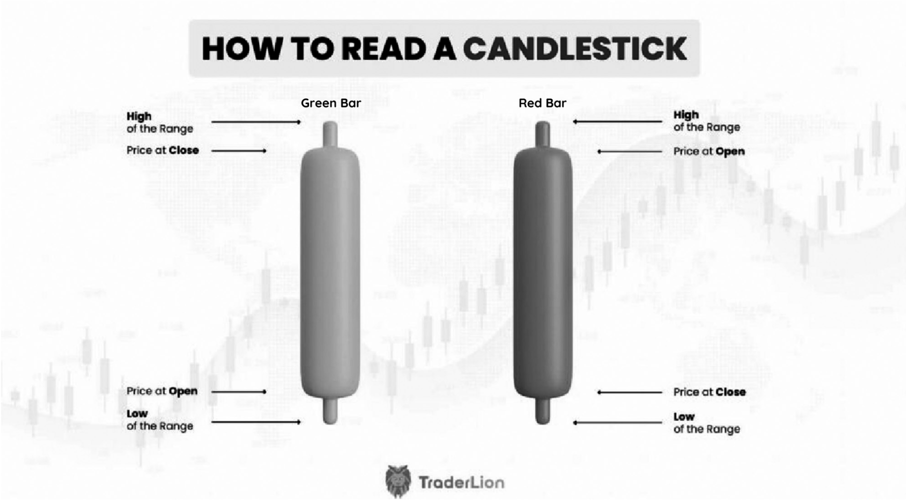
Quick Tip! You can differentiate between the moving averages by how quickly they react to price movements – the 21ema is the most sensitive and the 200sma the least reactive.

Key moving averages and volume are a must, and you can decide for yourself if you'd like additional indicators that may help you analyze a stock, such as a Relative Strength line or other indicator.

The key point here is that there is no magic indicator combination—there is only what is most helpful to you and helps you quickly analyze charts. A common mistake of newer traders is to add many different indicators in a search for *the perfect signal*.

Less is more. You want to avoid analysis paralysis.

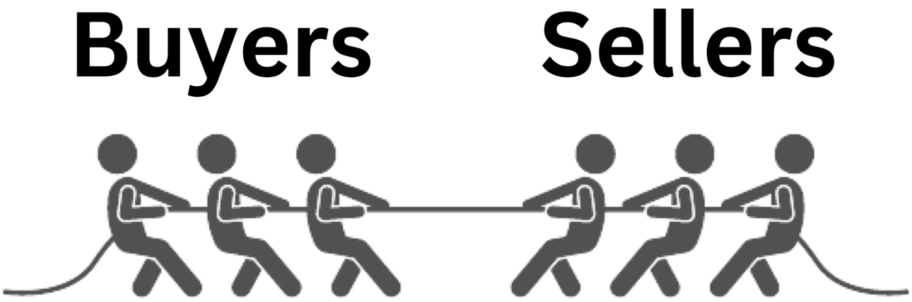
READING A SINGLE PRICE BAR



Charts are built from single bars or candlesticks. They can represent a minute's, a day's, or a week's worth of price action depending on the time frame.

How they are shaped and how they close relative to the price bars around them provides valuable clues about the forces of supply and demand. Larger patterns and higher time frames provide the context, the overall story, while individual bars write the new plot twists in words and sentences.

Instead of trying to memorize individual patterns and dozens of names, you should think of a price bar as a tug of war between buyers and sellers.



Buyers are trying to push the stock higher, closer to the top of the bar's range, while sellers are trying to pull the stock down toward the lows.

On any given bar we can determine who is stronger based on the closing range: A percentile representation of where the close is within the range from high to low.

To calculate the closing range you take the high, low, and close, and substitute it into the following quick formula and multiply by 100 to get the percentage value:

Closing range = (Close − Low / High − Low) * 100

A closing range at the midpoint of a trading range would be a 50% closing range. A close at the highs would be 100%, at the lows 0%.

$$\text{CLOSING RANGE} = \frac{\text{CLOSE - LOW}}{\text{HIGH - LOW}}$$

If a daily bar has a high of 100, a low of 90, and a current price of 98, then the daily closing range (DCR) is 80%.

A closing range of greater than 50% suggests that for that bar, buying pressure was stronger. The closer to the highs, the stronger the buyers; the closer to the lows, the stronger the sellers. A closing range of 50% suggests indecision and a balance.

By looking at the closing range of a single bar, you will start to be able to build an expectation of what can happen next and be able to differentiate between a constructive and non-constructive bar.

Here’s a handy guide that combines the closing range with volume, which adds weight to what price is doing.

Constructive vs Non-Constructive Price Action

Type	Up Day / Down Day	Closing Range	Volume
Constructive	Up Day	>50%	Below Average/Average/Above Average
Constructive	Down Day	Any	Below Average
Non-Constructive	Up Day	<50%	Average/Above Average
Non-Constructive	Down Day	<50%	Above Average

It's important to remember that a single bar's price action should always be taken in the context of the larger pattern and price formation around it. Additionally, remember that higher time frames supersede lower ones.

Just because the stock is closing poorly on a five-minute bar near the end of the day on Friday, does not mean that the stock is doomed. Especially if the stock on a weekly time frame has a closing range of 95%, just broke out of a large base, and is making new highs.

VOLUME ANALYSIS

While reading price action at the end of the day is the most important aspect of analyzing a chart, volume provides helpful clues you can use to judge the conviction of buyers and sellers.

With volume, the first thing you want to be able to do is determine if a particular bar's volume was abnormally high or low. You would then pair that data point with analysis of the price action of the bar.

To judge if volume is high or low, you can use a moving average on the volume. For swing traders a 20-day period simple moving average is helpful, for position traders you can use a 50-day simple moving average. They will provide similar reference points in most cases.

Once the moving average is plotted, keep an eye out for bars where volume is around 25% more than average or 25% less. These are above or below average volume days.

You can also simply compare a bar’s volume with the previous five-to-ten bars to see if in general it is high or low. We typically use a combination of the two methods.

High volume or low volume is most significant when it occurs in areas of similar action and when the stock is experiencing significant price expansions or contractions.

During contractions, low volume areas indicate a dry up in supply coming to market, which can make the eventual expansion more explosive.

High volume during expansions such as base breakouts indicates high demand, likely leading to a more powerful trend.

During a base you will often see a gradual decline in volume as an equilibrium is reached and there is less supply coming to the marketplace.

Because high volume is often helpful to recognize in real time, we recommend using a data point like volume run rate in Deepvue, which compares the current volume to the average at that time of day.

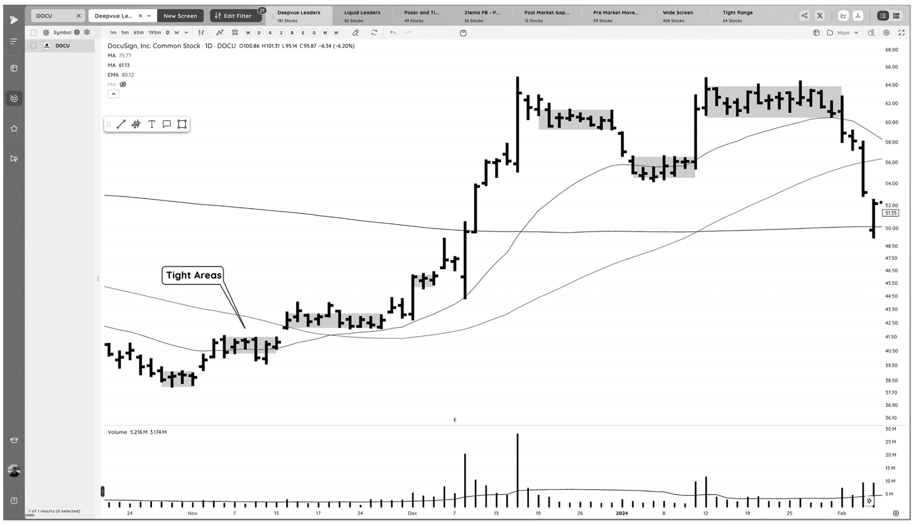
This data point will let you know if volume is above or below the average even after just a few minutes of trading.

PRICE TIGHTNESS AND VOLATILITY CONTRACTION

The overall range relative to recent price action is also important to note. If the stock normally trades with an average daily range of 5% from high to low and forms an inside day with only a range of 2%, then it is compressing in volatility. From these types of bars we can see expansion to the upside or downside. A tight open and close where they are similar in value is also a sign of contraction.

Looking at a series of bars we can also see ranges being built, then expansions upwards or downwards.

On the chart below, we've highlighted periods where bars were forming a range and tightening.



You can see how from these areas DOCU expanded and trended to the upside or downside.

In the markets, stocks on all time frames alternate between consolidation periods and trends upwards and downwards. From bases, consolidations, contractions, ranges—whatever you want to call them—come momentum moves and trends that we can take advantage of as traders.

This is a characteristic of markets where supply and demand control the prices as market participants buy and sell depending on their views of a stock's value on different time frames.

You can think of price tightness as the coiling of a spring. The tighter a stock gets relative to recent price action, the more explosive a momentum move is likely to be, once the stock emerges from the pattern.

This occurs intraday, on the daily time frame, and on even higher time frames setting up multi-month moves.

For instance, here is NVDA going back to 2015 on a monthly chart.

Notice how it continued to move from bases to expansions, upwards and downwards.

DEFINING TRENDS

Between consolidation periods, stocks move in trends. These sustained price increases or decreases are opportunities for traders to hold positions and profit.

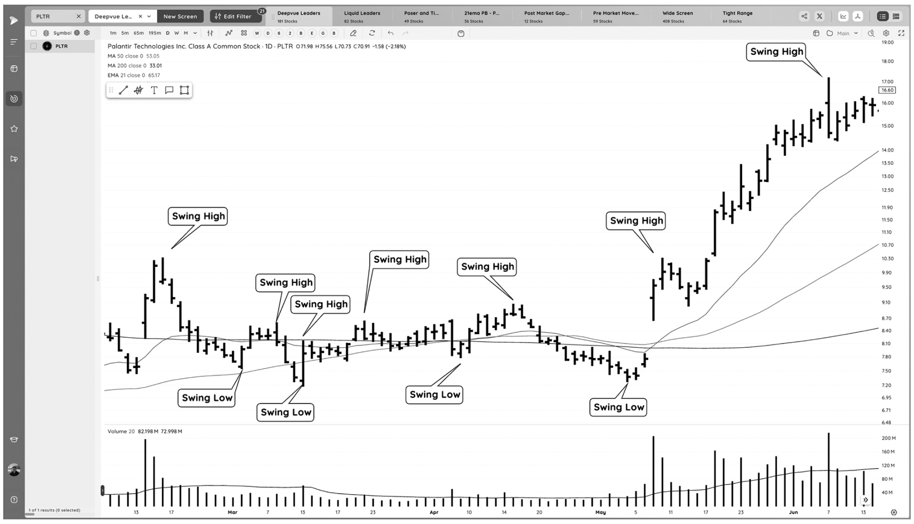
It's important to recognize that even if a stock is in a sustained trend, there will be basing and counter trends along the way. Not every stock gives you an easy ride.

There are two simple but powerful ways that we want to teach you to define trends. The first is using market structure, and the second is by using moving averages.

Using market structure to define trends

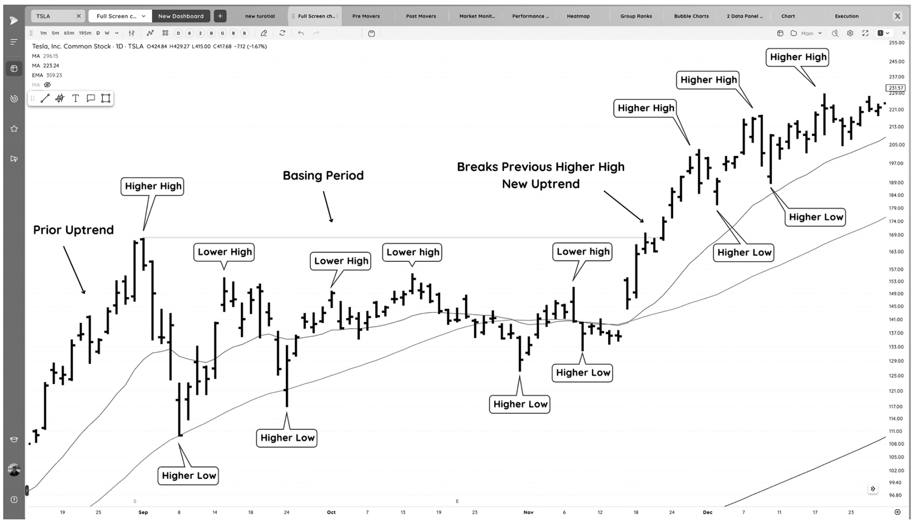
The first way that you can define a trend is through simple market structure. You want to define local swing highs and swing lows. These turning points are when the stock changes direction meaningfully.

A simple way to do this is to define a turning point when a high or low is not overtaken for at least three bars.

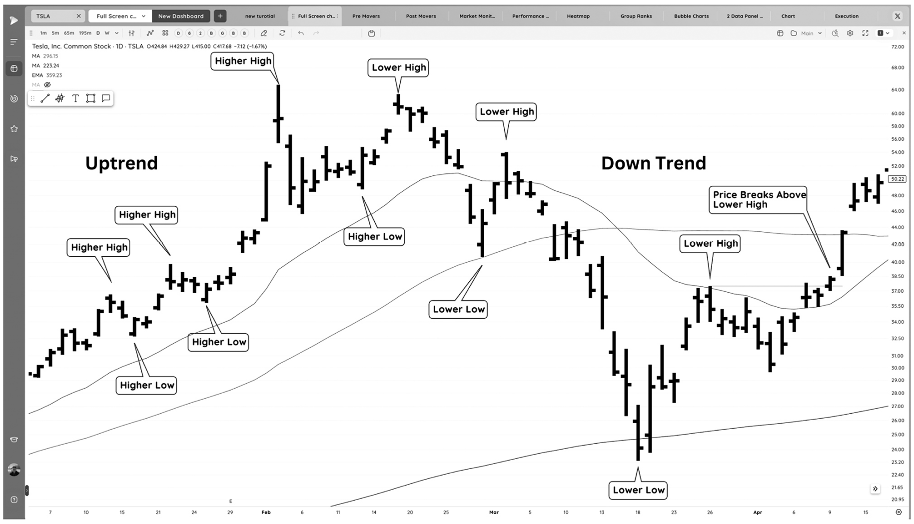


With these swing highs and lows set, an uptrend is defined as a period where the stock continues to make higher swing highs and higher swing lows.

During an uptrend there may be periods of basing in the short term where the stock may put in a lower high or lower low, but for the most part until the stock truly changes character and breaks structure, the uptrend is intact.



Then finally, once the stock transitions from higher highs and higher lows to lower highs and lower lows, a downtrend is set into place.



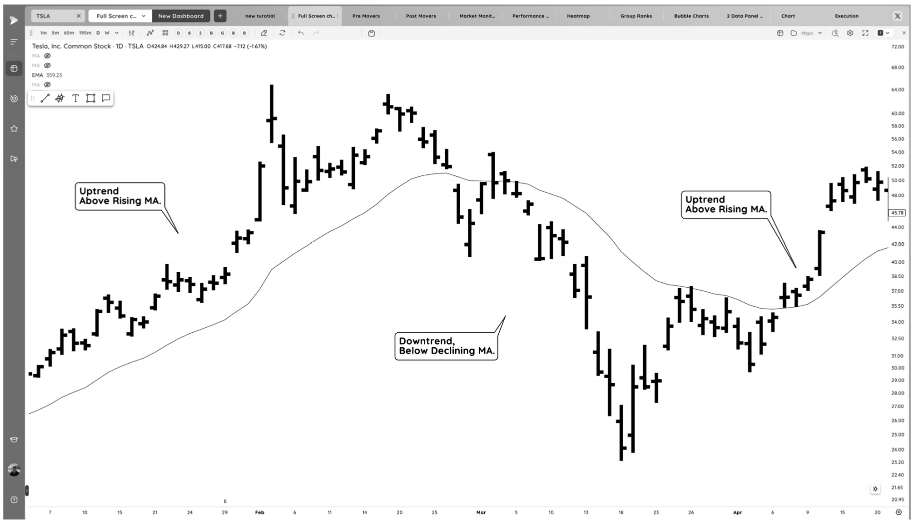
This continues until buying pressure once again overcomes supply and another break of structure occurs, resulting in a new uptrend.

This is a simple way to define uptrends and downtrends using price action.

Using moving averages to define trends

Another way to define trends is through using a moving average.

If the stock is moving higher above a rising moving average, by definition it is in an uptrend for that period.



If it then undercuts the moving average and begins declining below the same moving average, it has transitioned into a downtrend.

Key question: Which moving average should you use?

You should pick the moving average that makes sense for your trading time frame. If you are a day trader you will likely want to focus on shorter term moving averages such as the 5-day simple moving average (SMA) and ensure you are focusing on stocks in an uptrend for that period. Then you may even want to use intraday moving averages to define uptrends and downtrends.

Swing traders may prefer a 10-day SMA or 21-day EMA (exponential moving average), to focus on trends that last multiple weeks.

Position Traders and investors can focus on the 50-day SMA or even 200-day SMA to help identify the longer-term market cycle of the stock.

To decide on the moving average, you should also look to the left on the chart and identify previous sustained moves in the stock.

Which moving averages did the stock respect previously? Stocks have characters and you should use the moving averages that will keep you in the trade for your relevant time frame.

In the chart below, you can see that during both uptrends and downtrends NVDA tends to respect the 21-day EMA area.

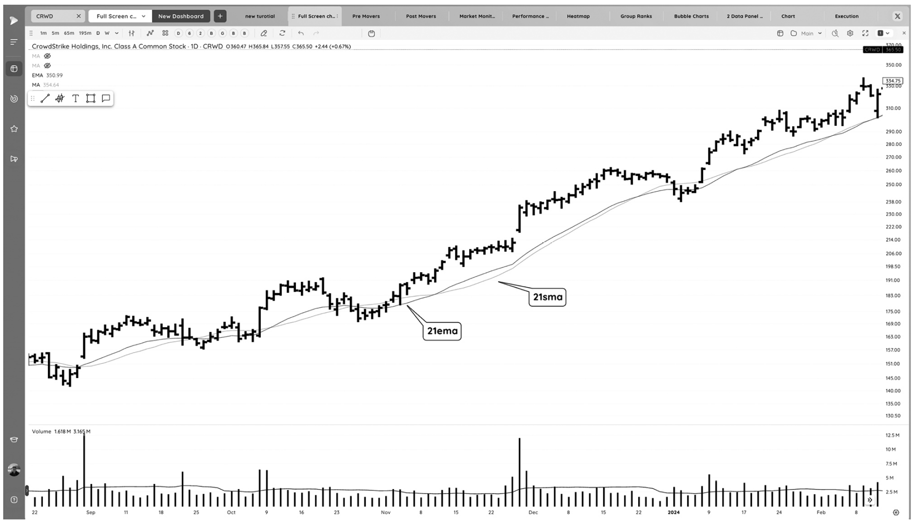
The 50-day SMA/10-week SMA, 200-day SMA/40-week SMA are often areas where institutions look to accumulate or add to positions. It's worth keeping an eye on those general levels since many market participants are watching them.

Should you use simple moving averages or exponential moving averages?

The true answer is that it does not matter. Moving averages are simply reference points.

The precise value is not as important as the overall trend and general area that surrounds the moving average. Stocks will often slightly undercut moving averages, even ones they have respected in the past, before finding support and continuing to trend.

Look at the chart below of CRWD. The light color is the 21-day simple moving average and the dark color is the 21-day exponential moving average.



For all intents and purposes, they are providing the same information.

Therefore, find what fits your trading the best and helps you stay in trades over a large sample size.

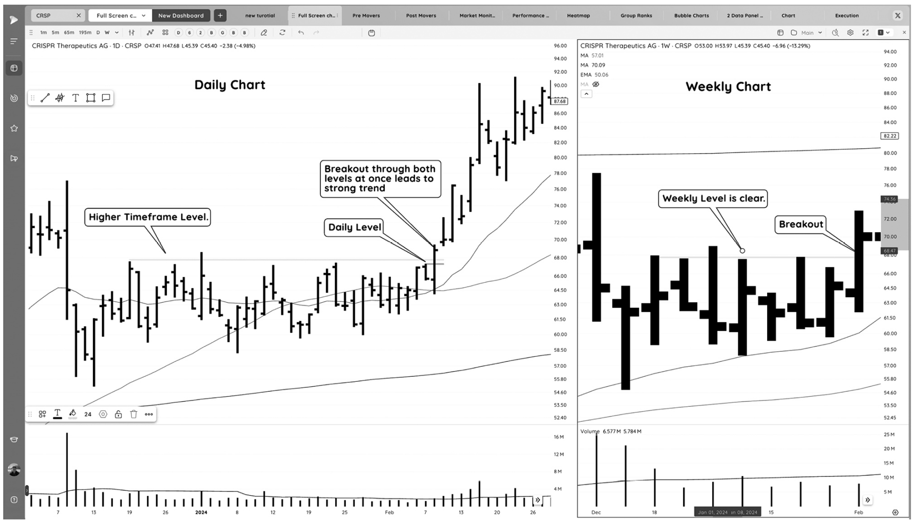
USING MULTIPLE TIME FRAME ANALYSIS

The market is fractal, which means that trends and patterns occur on all time frames. The benefit of this is that by learning how to analyze price and volume action on one time frame, you can artfully determine supply and demand dynamics on any chart and time frame with the same process.

In addition, trends and levels become more powerful when they are aligned on multiple time frames.

If a stock on a daily chart is breaking out through yesterday's high and that high lines up with a key level on a weekly or monthly chart, then the breakout will involve participants of both the weekly and daily time frames. This adds fuel to the fire and increases the likelihood of the expansion holding and beginning a trend.

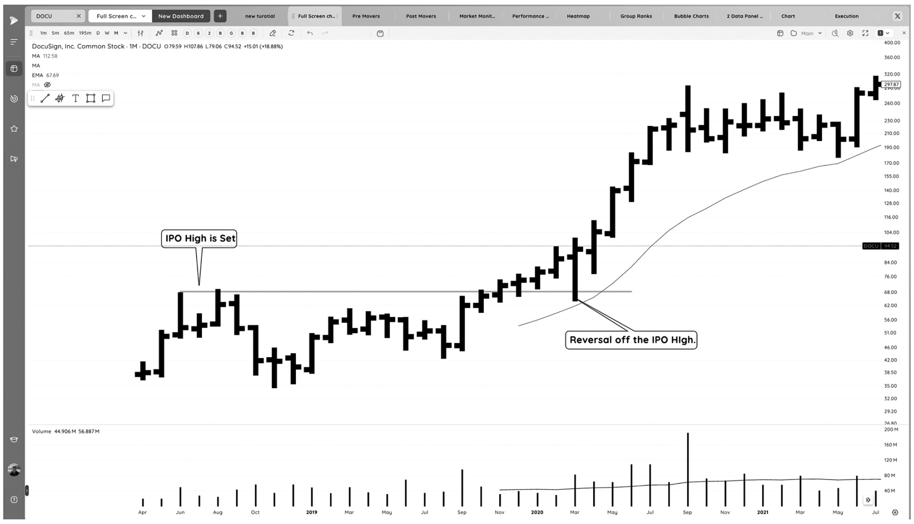
For instance, with CRSP we see a breakout through a daily high that coincides with a key level that had been resistant multiple times in the past few weeks. This led to a powerful expansion.



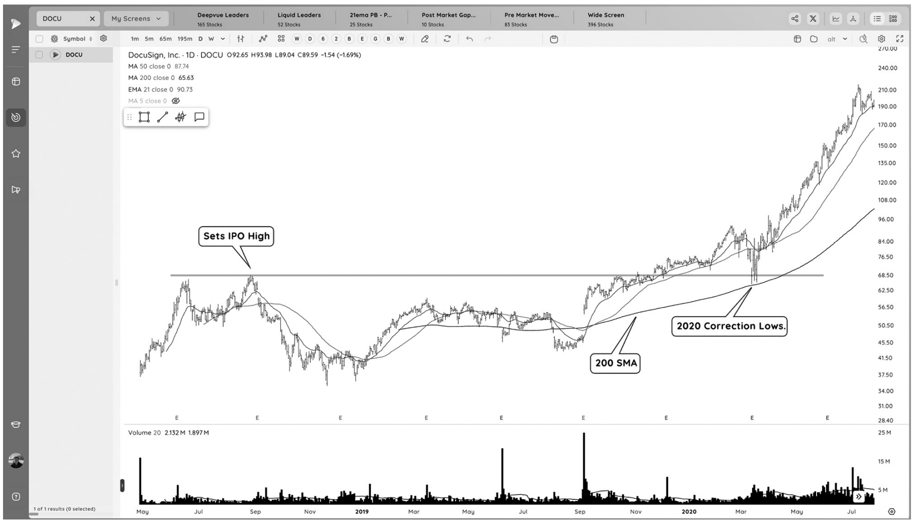
Another key thing to remember is that important levels from higher time frames are areas where trend changes can occur on lower time frames.

A prior swing low from a monthly chart is a spot where on a daily chart a trend of lower highs and lower lows may find support, start forming higher lows, and ultimately break structure and start a new daily uptrend.

Another example can be seen below with DOCU. First on the monthly chart you can see how the reversal in 2020 occurred right at the higher time frame IPO high that it set in 2018.



Zooming into a daily chart of the 2020 reversal we can see how DOCU was accumulated and supported right at that level.



Even better, we have the confluence of the 200-day simple moving average in that same area.

When multiple key levels line up together, there is a stronger likelihood of an actionable pattern developing. Always keep an eye out for confluence.

Like with moving averages, price may undershoot or overshoot a level slightly. Think of them more as areas to be aware of—areas of interest.

WINNING CHARACTERISTICS

Now that we have covered the basics of reading price action, we wanted to share some key price and volume characteristics that the highest potential stocks share. These winning characteristics are based on observations and studies of the top-performing stocks from the mid-1990s onwards. They are shared by almost all stocks that double and triple.

The characteristics are:

- Increase in average volume

- Huge volume spikes
- Tight areas on low volume
- Respect for moving averages
- Powerful prior moves
- Gap Ups
- Relative Strength.

We’ll now look at these in turn.

Increase in average volume

As a stock is being accumulated, it will become more liquid as more institutions become involved. You will see a distinct step up in average volume. The start of this increase often occurs at the beginning of a new uptrend or after an earnings report.

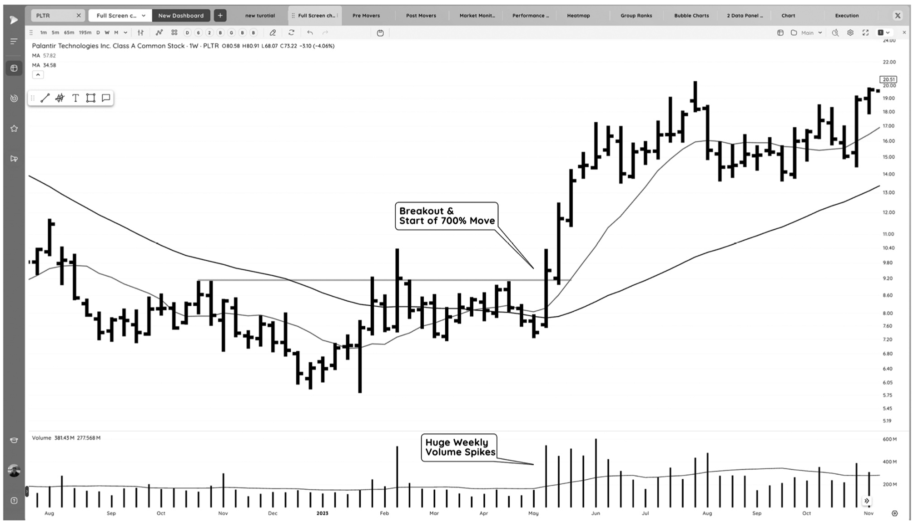
Huge volume spikes

Oliver Kell, the US Investing Championship record holder, has a saying: Volume = Price, Cause = Effect.

Big volume is a signal of big accumulation. Along with the average increase in volume, you will often see large spikes of volume as trends get underway and at key moments such as on base breakouts and earnings reports.

Large volume is a sign of institutions stepping in and accumulating shares. On a daily chart look for the highest volume in a year or more and on a weekly look for large blue weeks during trends.

Here is an example of PLTR in 2023 which showed huge weeks of volume as it quickly doubled following an earnings report.



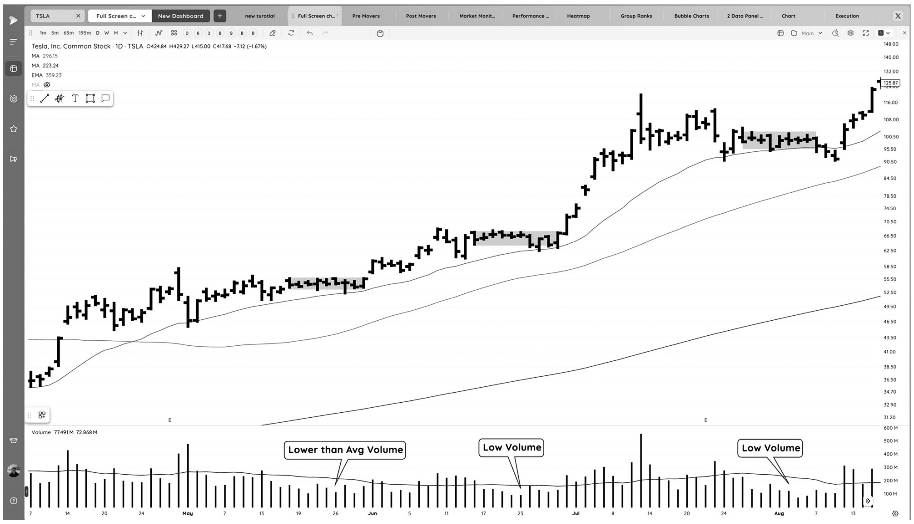
Tight areas on low volume

During both trends and consolidation periods, there will be moments where the stock pauses and forms tight areas, both in terms of overall ranges as well as closes.

Volume should decrease noticeably as, for a moment, there is an equilibrium reached in supply and demand. The key here is that these tight areas signify a lack of sellers and subtle accumulation by institutions as they support the stock and keep it within the range.

During a trend, these tight areas and pauses will often occur after a sharp increase in price. The stock should stair step higher in a very orderly and consistent manner above the moving averages.

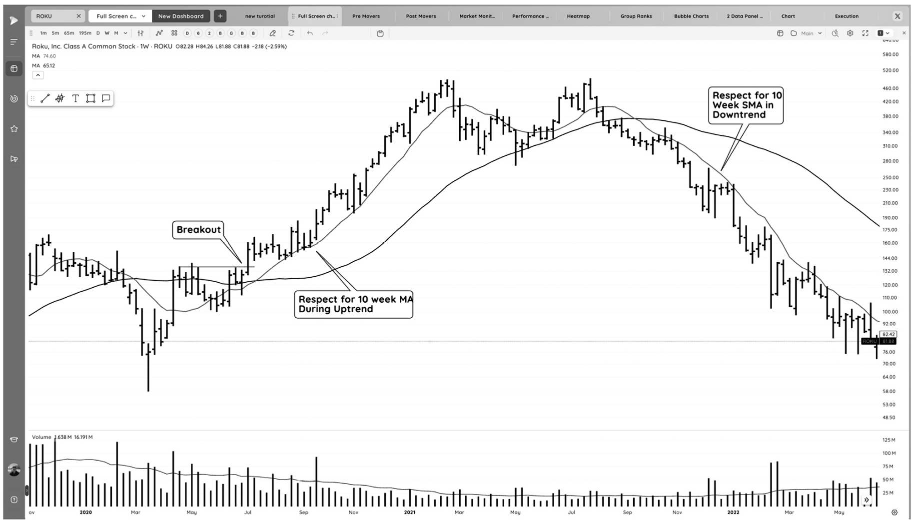
It should expand up, go tight, expand up, go tight, and repeat as it trends. This is a clear sign that demand is continuing to support the stock even as it moves higher.



Respect for moving averages

Strong leaders during their moves will hold specific key moving averages for extended periods. This is a signal that the stock is still being accumulated during the trend.

During its 2020 250% move, ROKU showed clear respect for the 10-week simple moving average,



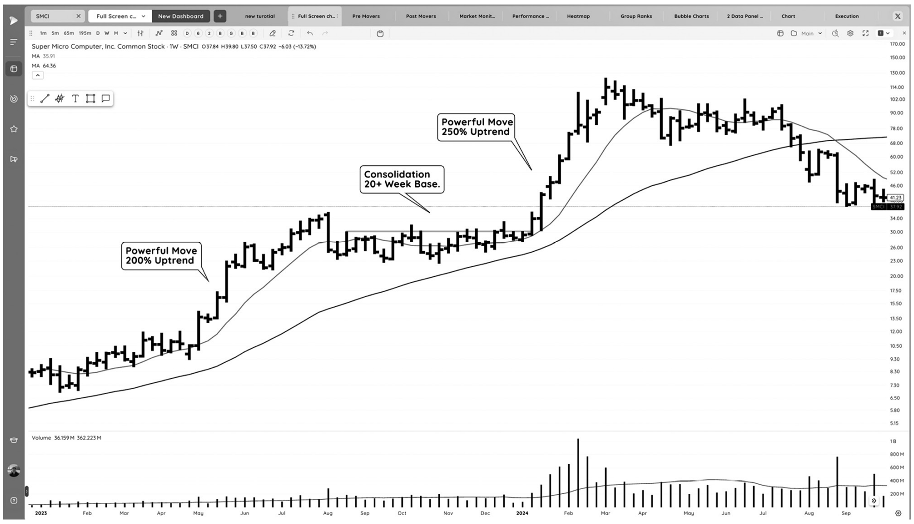
During its decline in 2021 it respected the 10-week to the downside as well.

The moving averages stocks respect become part of their character. Take note of when a stock finally seems to lose that respect because that could be a sign that the move is near the end or that the stock needs to build a longer base.

Powerful prior moves

Winning stocks often continue to win. Stocks that have shown the ability to trend strongly in the recent past can perform once again after a base or longer corrective period.

SMCI in 2024 is shown in the graphic below.

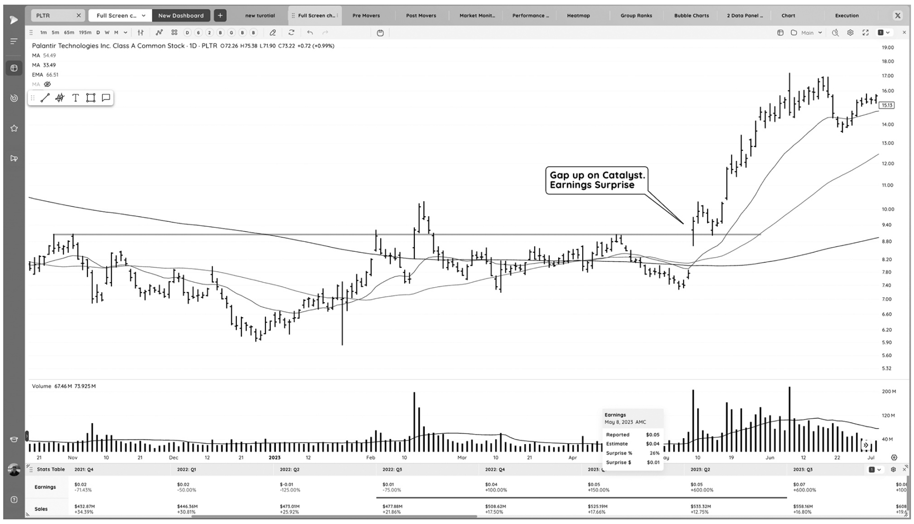


On the flip side, if you look to the left in the chart and a stock trades weakly, does not progress well from proper bases, and trades choppy, then do not expect a nice clean trend unless you see a full change in character.

Gap ups

Gap ups, often coinciding with earnings reports, are a key signature of market leaders. Stocks that make moves of 200%, 300%, 500%+ will often have multiple gap ups during their moves.

This price signature is a pattern that we will take advantage of later with our high volume edge and gapper setup.



As we will mention later, the early gaps in a move have a higher probability of maturing into a trend as institutions are still accumulating shares aggressively due to changes in fundamentals, key news events, or other catalysts.

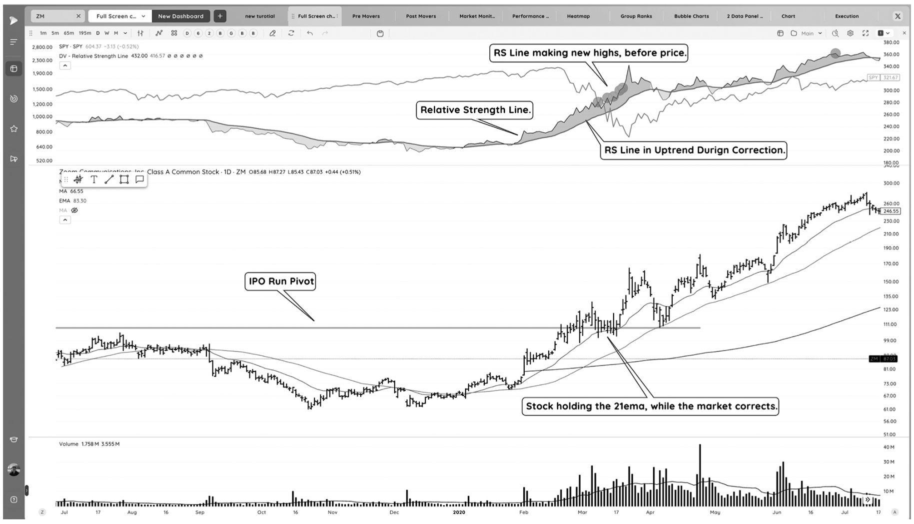
Relative strength

The key leaders will always have periods where they stand out due to their Relative Strength. During a market correction they may be going sideways or advancing, even as the market is still pulling in.

This Relative Strength can be shown clearly in a Relative Strength line or screened for using the Relative Strength rating or absolute strength rating.

For instance, if a market correction is around three months long, you could use the 3-Month Absolute Strength Rating in Deepvue to find the top-performing stocks during that period.

A classic example of Relative Strength is Zoom (ZM) in 2020. Even as the market was correcting, institutions were accumulating this stock and it actually increased in value during the 2020 correction. This preceded its 350% gain once the general market began an uptrend in April 2020.



When the market weakens or consolidates, look for stocks that are standing out and diverging, fighting any drawdowns. These are potential leaders when the general market pressure is relieved.

LEARNING THE CHARACTER OF A STOCK

Along with recognizing winning characteristics, another key concept is learning the character of a stock. This will help you recognize how you should enter, manage, and exit a trade.

As you analyze thousands of charts, you will start to realize how each stock has its own patterns of movement.

Some are steady trenders, others are jumpy and volatile. Some stocks gap from base to base, others will go on strong momentum moves consistently. Some stocks respect the 21-day EMA, some the 50-day SMA.

These behaviors are a function of the particular supply and demand dynamics of that stock and the major participants who trade it.

There are a few key components that play a part:

- Liquidity, dollar volume, and institutional involvement
- Float

- Life cycle of the stock

As a general rule of thumb, the more liquid a stock is, the cleaner its trends will be and the more it will respect key levels and moving averages.

This is because when a stock has high dollar volume, which is defined by the average shares traded over a period multiplied by the current price, larger institutions can safely take positions. With larger players involved, bid and ask spreads tighten and a stock becomes less jumpy and trades smoother.

Does this mean the stock can’t make extraordinary moves? Not at all!

In fact, many of the biggest moves in history occur as a young stock is becoming more liquid and larger institutions can take up stakes. This leads to the increase in average volume signature that we covered earlier.

Institutions also help dampen drawdowns by accumulating shares on weakness during a long-term uptrend. They tend to buy on pullbacks to key levels such as the 10-week or 40-week moving averages, creating bases.

Along with liquidity, the float of the stock can also impact how volatile a stock trades. Typically stocks with a lower float are more volatile, while stocks with more shares available to trade usually have gentler moves.

This goes hand in hand with where the stock is in its life cycle. Recent IPOs are often more volatile pre lock up because part of their float is restricted from trading. Post lock up, and after secondary offerings, stocks mature and become more liquid, leading to less volatility over time.

One of the most useful ways to express the volatility of a stock, and a parameter that we use frequently in screens, is average daily range (ADR). This can be expressed either as a dollar range or a % range. We prefer using the % version so it can be used to compare stocks of different share prices.

ADR is a measure of how much a stock typically moves during a trading day. There is a trade-off to be made since we want a stock that has strong movements but also trades tight enough that we can manage risk.

A good rule of thumb for growth and momentum trading is to focus on stocks with an ADR % of at least around 3–5%. At this level stocks can make powerful moves in just a few weeks.

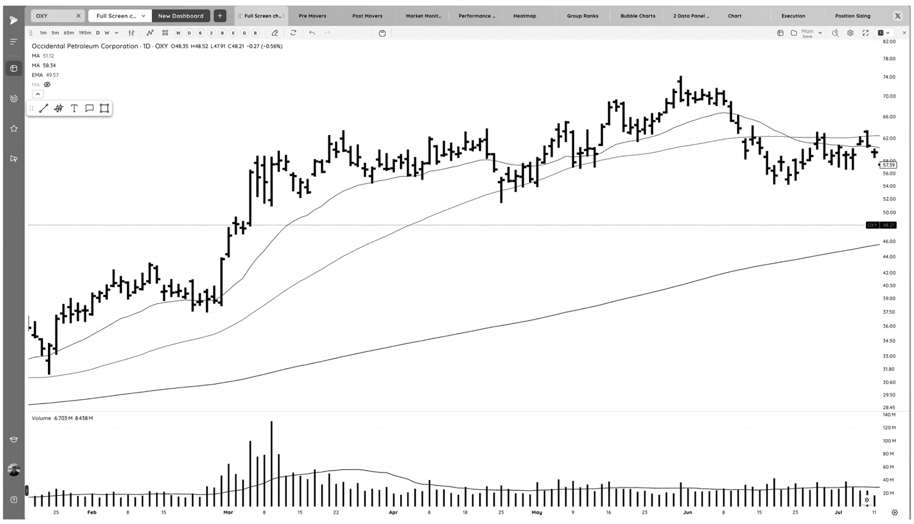
CLEAN TRENDERS VERSUS CHOPPY TRADERS

One thing you will notice in charts is that some stocks trade cleanly, transitioning from uptrends to downtrends in an orderly fashion, respecting trend lines and moving averages, and also with few gap downs.

On the other side of the spectrum are what we call choppy traders. These are stocks that gap up and down frequently, lack tight areas on charts, and have little respect for key moving averages.

A good example of these stocks are oil and gas companies or other stocks that are influenced by an underlying commodity.

For instance, we have OXY. Even during an uptrend, it has the habit of gapping up and down with many false breakouts.



Both clean trenders and choppy traders can go on fantastic moves and double and triple, but we as a whole prefer the clean trenders. They are easier to manage, easier to position in, and respect key reference points along the way like the 50 SMA. A great trend only makes you money if you are able to stay in it.

CAN A STOCK'S CHARACTER CHANGE?

A stock's character can certainly change. This can occur when there is a catalyst that fundamentally changes a company or entire industry.

When this occurs, institutions have to recalibrate their models and allocate capital accordingly. This changes the supply and demand dynamic and can turn a once stagnant stock into a momentum mover.

Character changes show up in the charts often with a large increase in volume and powerful price moves. After this occurs stocks may have newfound respect for moving averages, trade more cleanly, and otherwise change their behavior.

WHAT DRIVES STOCK MARKET MOVES?

This is an important question that can help you determine which stocks have high potential and could produce meaningful trends.

To answer the *what*, we must first address the *who*. In the markets, the vast majority of trading volume—about 90%—is attributed to institutional investors, from hedge funds to pension funds to banks.

Only about 10% of trading volume can be attributed to retail and independent investors, according to research from Morgan Stanley.

So what are institutional investors looking for?

In short, they are looking to invest in companies which have increasing expectations for future earnings. They are looking for companies that will grow their value, develop new products, increase revenue, and improve margins.

How do we find companies like this? We've adapted the CANSLIM criteria, which was developed by William O'Neil, to suit the current markets.

CANSLIM is a trading and investing framework that consolidates the seven key criteria that defined the greatest performing stocks of all time. For an in-depth walkthrough of the system, we highly recommend you read *How To Make Money in Stocks* by William O'Neil.

Here is a brief overview of the seven CANSLIM criteria.

1. Current quarterly earnings

Look for stocks with increases in quarterly earnings of at least 25% for the last two quarters. Ideally you will see strong earnings, sales, and profit margins growth in recent quarters. The faster the growth, the better.

2. Annual earnings growth

On top of quarterly earnings, you want to be sure stocks are showing strong long-term growth.

This can be done by looking for stocks that have increased their earnings at least 25% for the past three to five years. In the case of unprofitability, you want to see a trend toward profitability. Also, take special note of significant annual earnings estimates over 25%, although the higher the better, for the current and successive year.

3. New product/service/CEO/price high

All the studies of the greatest stock market winners have a new product or service in common. Look for the companies with the most innovative products/services. Ideally, these are companies that are changing the way we work, live, and play.

CEO changes can also lead to incredible turnaround stories, with Dr. Lisa Su of AMD being an excellent example. Since Dr. Su took the helm of AMD, the stock has risen from under $5 a share to well over $100 in under six years—greater than a 5,000% increase. Finally, many leadership stocks will be making new 52-week price highs over and over again during strong market trends.

4. Supply and demand

This metric is where charts and technical analysis come into play. A stock's price goes up because more investors demand a limited supply of stock. You want to look for accumulation signs by institutions to gauge demand. We will teach you how to analyze a chart and be able to identify specific entry points where supply is limited and demand is exceptional.

5. Leader or laggard

We want to focus on the best of the best stocks—these are the leaders. Leaders generally have a stronger chart and have superior earnings and sales growth versus similar companies. True market leaders will most likely be in top-performing industry groups and sectors as they are often innovative companies riding a disruptive theme.

6. Institutional sponsorship

We want to be focusing on young companies with rapidly growing fund ownership as well as high-quality funds establishing new positions in the stock. This institutional sponsorship will lead to clean trends and buy points during bull markets as funds accumulate shares.

7. Market direction

Finally, the most important factor in CANSLIM is the market direction, since three out of four stocks follow the trend of the general market. We always want to be aware of the overall trend and be trading when the deck is hot and the probabilities are with us. We want to be involved in uptrends, and conversely we want to be lightly exposed when conditions change and the market corrects.

We will never catch the low and never sell the high, but the goal when the market begins correcting is to step aside as a downtrend starts. Then we let institutions create the bases and join in ourselves after a new uptrend has been established.

How we've adapted CANSLIM

In current markets, CANSLIM still continues to point to many of the strongest institutional quality stocks in the market.

However, we have a few tweaks that we have made. First, we focus more on technicals than fundamentals. Fundamentals are important and are the driving factor in multi-year moves of a stock. But, for swing trades and even position trades, momentum and Relative Strength in technical screens will lead you to the strongest names.

In addition, although earnings growth is important, in recent times with more companies focusing on growth at all cost, revenue growth is often just as or more important for judging the potential of a stock.

The other key difference is that many stocks trade on catalysts even before growth shows up in earnings or sales data. These stocks can be found by looking for large gap ups and volume surges. We will discuss this in more depth in subsequent chapters.

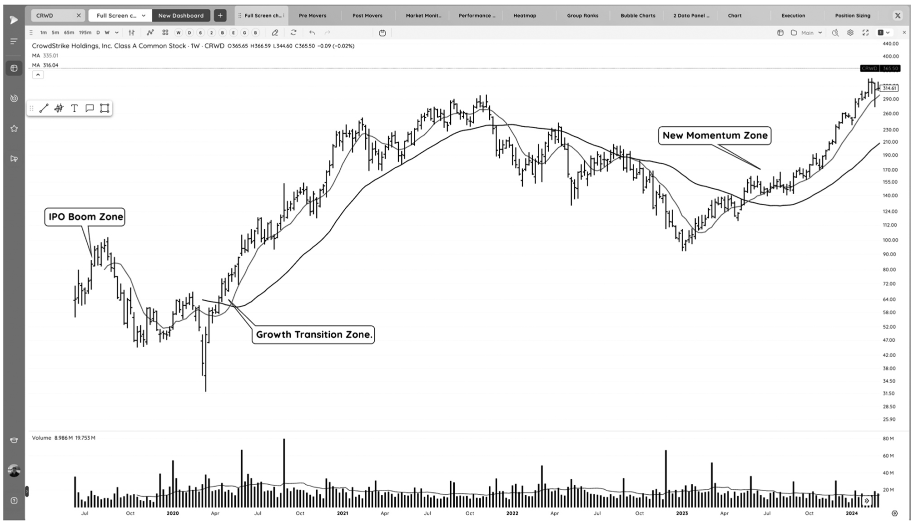
In short, the key tenets of CANSLIM still hold true, although we personally focus more on price and volume signatures on the chart than on longer-term fundamental drivers. We also focus on the current strong themes in the market.

OPPORTUNITY ZONES

The final concept that we want to cover in the foundations chapter is that of the three opportunity zones. These are larger areas within a stock's trading history where we often see trends where stocks double and triple.

The three zones are:

- IPO Boom Zone
- Growth Transition Zone
- New Momentum Zone

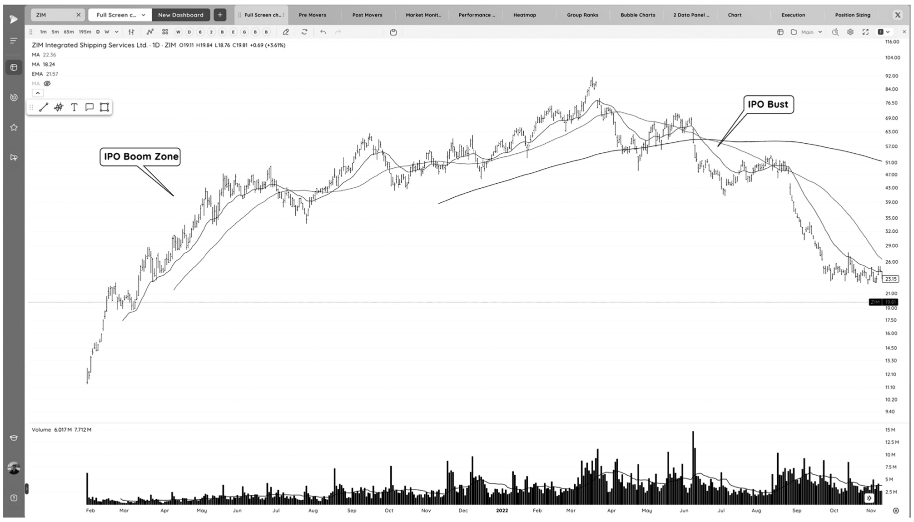


When a promising stock has entered one of these zones, you can zero in for further analysis, looking for price and volume signatures, entry setups, and finally entry tactics if a stock meets your criteria.

These zones build off the work of Mike Webster, Stan Weinstein, as well as the Lifecycle Trade team: Eve Boboch, Kurt Daill, Kathy Donnelly, and Eric Krull.

IPO Boom Zone

This is the first opportunity zone of a stock's life cycle. It occurs right after a stock IPO and often begins with an IPO base, a short consolidation of a few days to a few weeks. A recent IPO can make high momentum moves, especially if the stock is part of a current leadership group and theme.



The main drawback of this zone is that it is short-lived and volatile. Still, traders can look for early entry points.

The supply and demand dynamics at play here are that because of a lock-up period, many of the stock's holders are unable to sell, leading to high potential for a trend if there is strong demand that comes in.

However, once the lock-up period ends, insiders are able to sell and there are often secondary offerings, leading to increased supply and the typical drawdown and basing period that the Lifecycle Trade authors coined the institutional due diligence phase.

Growth transition zone

This is the next opportunity that a stock will exhibit. This occurs as a stock establishes a trading range after the initial drawdown from its IPO and begins a new longer-term uptrend up the right side of the institutional due diligence stage.

Within this zone you can look for base breakouts off the bottom or along the trend closer to its previous IPO highs.

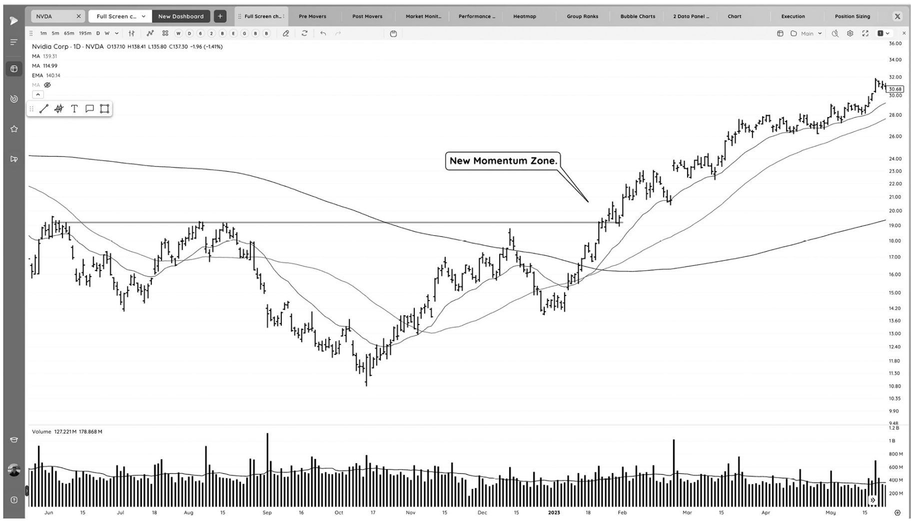
This zone is created because institutions have researched the company and begun to accumulate positions. Often the stock has continued to innovate and grow, and may be showing the first signs of profitability as it emerges into this zone.

Keep an eye out for IPOs which have gone public six months to a year ago, are part of a leading theme, and are just turning profitable/posting strong growth in earnings and revenue.

Quick tip! This zone can often line up with the appearance of the 200-day SMA.

New momentum zone

The final zone can occur multiple times during a stock's lifetime. The new momentum zone occurs anytime the stock has been declining or basing for some time, and then forms a base and begins a new strong Stage 2 uptrend.



These zones often occur after the market has experienced a longer-term basing or correctional period.

The best stocks emerging into these zones will have a catalyst and leading theme associated with them, creating strong growth potential.

KEY FOUNDATIONAL TOPICS

There, we’ve done it! We’ve now covered the key building blocks that the rest of this book will be based upon.

Now let’s quickly review before we move on to an exciting chapter on entry tactics.

We pivoted toward important technical analysis concepts that will form the basis for the edges, setups, entry tactics, and position management frameworks that we will discuss in the next few chapters.

Finally, we discussed winning characteristics, learning the character of a stock, and what drives market moves.

TRADER'S HANDBOOK CHALLENGE 1

Annotate the following chart of CRWD using the technical analysis concepts you learned in the chapter. Feel free to use your own charts. Be sure to share your work on X (formerly Twitter) and post at us @TraderLion_ and #THChallenge

KEY TAKEAWAYS

Here are five key takeaways from this chapter:

1. Price action gives clues to the potential and trend of a stock. We can learn to recognize winning characteristics and build a template of what high potential stocks look like before and during their big moves.
2. Each stock has a particular character. This is due to its catalysts, institutional involvement, float, life cycle, and Average Daily Range (ADR). By learning these characteristics we can recognize when a stock is under accumulation and learn to manage a position relative to this character.

3. Institutions drive stock market moves. They are responsible for the vast majority of trading volume, and they look to accumulate positions in stocks with strong growth and earnings potential. This accumulation creates trends that we can ride as retail traders.
4. There are certain opportunity zones that appear in stocks. The first is the IPO Boom Zone, the first potential momentum move in a stock's lifetime that starts shortly after a stock comes to market. The second is the Growth Transition Zone, which occurs after institutions have done their research and have started accumulating positions in force. The last zone is more cyclical, occurring after major bases or general market corrections. The new momentum zone occurs when a new Stage 2 uptrend begins, driven by a catalyst and often when the stock is part of an emerging theme.

BONUS RESOURCE

We recorded a webinar about reading price action and the foundations of technical analysis.

You can watch it today at traderlion.com/handbook.

CHAPTER 4: EDGES AND SETUPS

> "Wall Street never changes, the pockets change, the suckers change, the stocks change, but Wall Street never changes, because human nature never changes."
>
> ***—Jesse Livermore***

EDGES AND SETUPS tactics are some of the most talked about aspects of trading. Newer traders strive to learn the secret patterns that lead to near 100% win rates and have the magical predictive ability to always lead to 1,000% moves in short order.

The reality of trading, however, is that the market is uncertain. We can focus on setups with higher probabilities of producing a strong return, but there is always a chance of a loss.

Therefore a proper setup is not necessarily special because of its ability to always produce strong returns consistently, but rather because it allows traders to manage risk tightly and logically.

The goal with edges and setups is to define frameworks for identifying and entering high potential stocks at a point where if you are right, you will quickly be at a profit, and where if you are wrong, you will quickly be stopped out for a negligible loss.

How does this work?

The setup in question must have a clearly defined entry level and a corresponding level where if the stock reverses, it would signal a current failure of the setup. The closer the failure level is to your entry point, the tighter your stop can be on the trade.

However, the stop level must also be logical—meaning that it reflects an important technical level that the stock should not violate given its current momentum if the trade is to be successful. This means that with normal trading of the stock, the level should not be breached. We will go much further into setting tight and logical stops in the risk management chapter.

How you define your setup will depend on your time frame and style of trading. Some traders reading this may be day traders, shorting artists, mean-reversion buyers… strategies that are very different from our approach. This is perfectly normal and each trader should study their own trades and develop their own unique styles that fit their method. However, the principles we will be discussing can apply to setups for all different styles.

A key point that we will emphasize again and again is that you do not need ten different strategies. Some of the best traders in history focused on only one setup that they mastered, then they waited and waited until the conditions were perfect. Specialization pays in trading.

If you can define just one to three repeatable setups that allow you to manage risk and show up during every market cycle in high-quality opportunities, you will excel as a trader.

So, as we go through the next two chapters, think about what your own unique edges, setups, and entry tactics are. Describe each of them in detail and include examples that you can refer back to.

Here’s what we will cover in this chapter:

1. The S.N.I.P.E. framework
2. The high volume edges
3. The Relative Strength edge
4. The N-factor edge
5. The launch-pad setup

6. The gapper setup
7. The base breakout setup.

WHERE DO EDGES, SETUPS, AND TACTICS FIT INTO A TRADING SYSTEM?

Although entries are important, they are only one part of an overall trading system. Position management, among other concepts, is just as important, if not more so, and each of the chapters of this book plays a critical role.

We say this because often many beginning traders get obsessed with finding ‘perfect’ entries. In the reality of trading there is no such thing; there are only entries that fit a template for a high potential return to risk.

So how and where do entries fit into your trading system?

You can break down a trading system into five key processes. It may help you to remember them using the S.N.I.P.E. acronym, which in and of itself is a great reminder to focus, trade with discipline, and to specialize.

S.N.I.P.E. stands for:

1. **Search and scan**—Look for current opportunities.
2. **Narrow**—Focus your attention only on the stocks that fit your system and have strong potential.
3. **Identify**—Finalize your watchlists and analyze each opportunity looking for edges and setups.
4. **Plan**—For actionable names plan the setup and entry tactic that you will use to enter.
5. **Execute**—Enter your trade while managing risk and then manage the position.

Search and scan

This is your process for getting stocks that meet your most general criteria across your desk for further examination. This is the largest part of your funnel. We will explore this more in Chapter 5. This step could be requiring certain liquidity and dollar volume levels, or basic fundamental growth numbers.

Narrow

Focus your attention only on the stocks that are exhibiting edges and fit tighter criteria for a trade. This could be looking for necessary fundamentals, theme, story, momentum, trend, or price and volume signatures.

Identify

In this step you further restrict the flow of ideas and focus only on stocks that show edges and a specific setup that you have studied, and thrives in the current environment.

Plan

For the names you are focused on, you will plan out the entry tactic you will use, how you will manage risk using stop losses and position sizing, and any other relevant criteria when making the trade.

Execute

The final step of the process is to execute your plan, enter the position, and then manage the position using your position management rules. This includes both rules to sell into strength and rules to sell into weakness.

Now that we have the full context in mind, let's zoom in and explore trading edges and how they can help you identify high potential stocks.

WHAT IS AN EDGE?

In trading, the phrase "you need an edge" gets thrown around quite a bit, but what does that exactly mean?

Well, having an edge simply means that your process and its components allow you to have a winning expectation over time. The last two words "over time" are important because the markets are probabilistic. An edge or setup might be very successful over the long haul but may fail spectacularly the next time you use it. This is why risk management is a key part of successful trading as it allows you to protect yourself from large losses.

Edges come in all shapes and sizes. It can be Warren Buffett's ability to analyze a company's financials to find deals, Jim Simons' algorithms, or a news-based trader's ability to analyze information the fastest. In addition, the effectiveness of certain edges may fade over time due to changing market dynamics. This is why it's important to be fluid and bend with the market—to listen to what is working.

Position sizing based on edges

Position sizing is an extremely important part of trading. It is what ultimately contributes to performance by increasing the impact of a trending and well-performing position on your equity curve. However, you do have to balance this positive with the downside risk associated with any position if it goes against you.

As we've already discussed, edges are winning characteristics that indicate that a stock has high potential. It follows that the more edges a stock exhibits, the more evidence there is that it could be a top performer.

With this in mind, it stands to reason that when a stock shows more edges, we should increase our focus on that stock in order to execute and capitalize on a strong potential reward/risk opportunity. In this same vein, we should also commit more capital to that position, managing risk along the way.

Using a hypothetical portfolio of 100k, here is a breakdown of an example position sizing system based on the number of edges. The starter position here is 10k, or 10% of the total portfolio.

Base position	1 edge present	2 edges present	3 edges present	4 edges present
10% or 10k	12.5% or 12.5k	15% or 15k	17.5% or 17.5k	20% or 20k

This simplified system can serve as the base position sizing methodology that you should then tailor to your own trading while taking into account your own experience, skill level, and risk tolerance. Maybe you are more comfortable setting your base sizing at 5%. That is perfectly fine.

What's important is that when your system has identified that a stock has many edges present and better fits your ideal template, you accordingly allocate more focus and capital to that opportunity.

You should also focus more on edges that are working in that current market cycle. It does not make sense to increase capital allocation based on an edge that is not working currently. Instead focus on recent edges that have proven themselves and focus on stocks in your universe that are exhibiting those criteria.

WHAT IS A SETUP?

If edges are repeatable winning characteristics that signify that an opportunity is developing, a setup is a repeatable larger pattern that signifies that there is a strong reward-to-risk ratio. It combines both the edges in play as well as the entry tactic that completes the larger pattern.

WHAT IS AN ENTRY TACTIC?

The last piece of this puzzle is entry tactics. Entry tactics are shorter-term patterns and methods that traders and investors use to establish positions within overall setups. Entry tactics allow you to manage risk tightly and logically while putting on enough size.

Entry tactics and trade execution will be the focus of the next chapter.

OUR PLAYBOOK

With the definitions set for edges, setups, and entry tactics, let's now dive into the specific ones that we use to position in the market leaders of each market cycle.

Reminder: These are the methods that we use. You may have your own setups. Organizing your own "playbook" with the characteristics you look for is an excellent exercise and may even be the challenge for this chapter (hint hint).

EDGES

The high volume edges: HVE HVIPO HV1

The High Volume (HV) edges are a key part of our process. These volume signatures indicate that the stock is undergoing a potential significant character change.

A gap up on extremely large volume can lead to a strong momentum move and/or a long-term new trend in the stock.

HVE = Highest volume ever

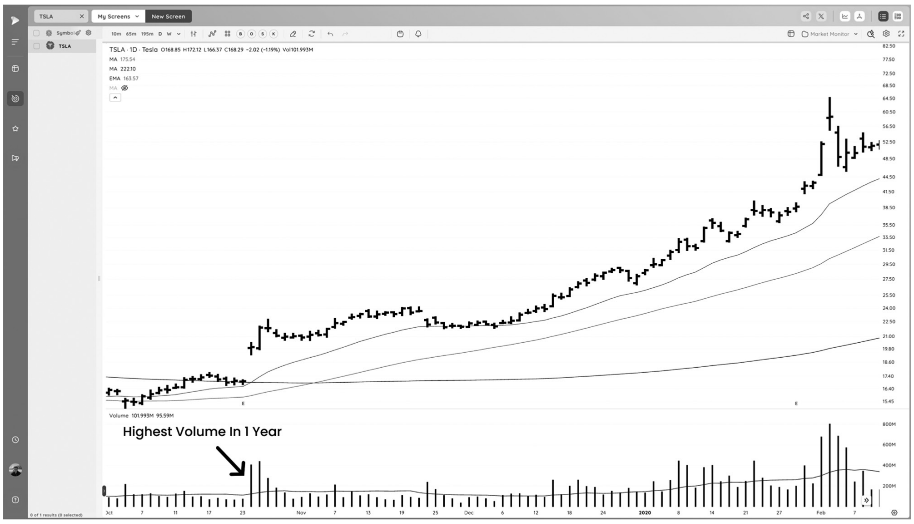
HVIPO = Highest volume since the IPO week

HV1 = Highest volume in 1 year

The most promising HV edges occur when they are associated with a game-changing catalyst. This could be an earnings report where they announce profitability for the first time, a development and launch of a new product, or an industry-level change created by new legislation.

The larger the volume the better, and we want to see the stock change character and start a new uptrend; refer to the TSLA chart.

High Volume Edge



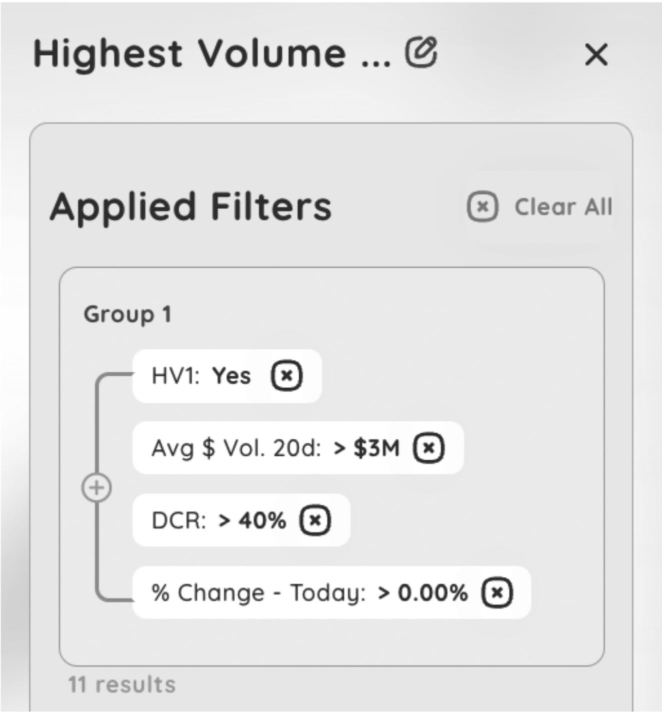
A great example of an HV1 is 24 April 2019 in TSLA. The company had reported earnings the previous day and announced a surprise profit, new over the air autopilot updates, and that a new factory was ahead of schedule.

This showed a dramatic change in the near-term future prospects of the company and changed how institutions viewed Tesla. The stock gapped up on the highest volume in a year and then rose the next day on *even higher volume*.

In this case the HV edge identified the character change that led to a 200% move in a few months.

You can easily create a screen for this edge using the logic that volume today is greater than the maximum volume of the past 250 days. We also have the logic built in as a data point in Deepvue.

We also like to specify that the closing range for the day was over 40%, the stock was up on the day, and the stock has at a bare minimum 3 million in dollar volume, but the key is the HV edge; refer to screen criteria.



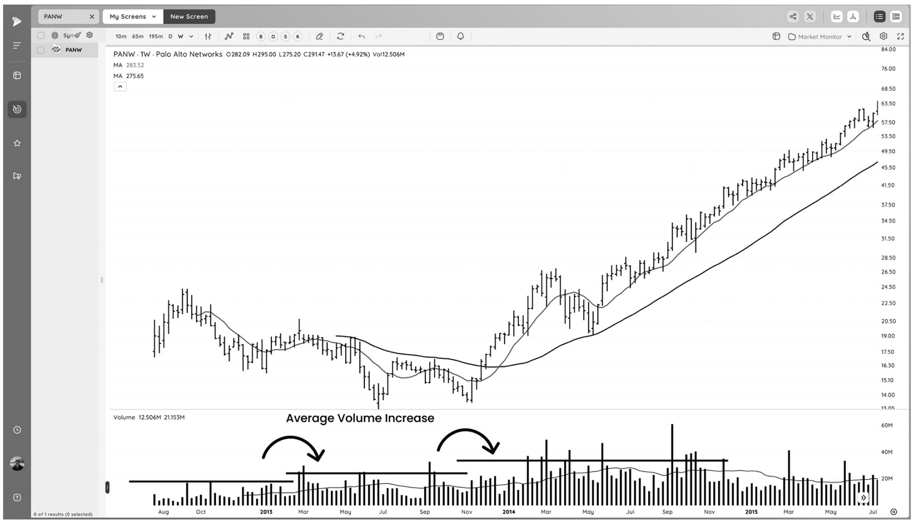
You will often see Biotech stocks on this screen. Although they can work, they often gap up on drug trial news which typically goes nowhere. We prefer stocks in other industries that again have a game-changing catalyst.

The high volume edge

When looking at market leaders of the past you may notice that the average volume of a stock often significantly increases just as the move is getting underway.

This often indicates that the stock is becoming more liquid and is being traded more by more institutions. This change in supply/demand dynamics often contributes positively to the performance of the stock as larger institutions can get involved; refer to chart.

Increasing Average Volume Edge



In 2013 we can see how PANW’s average volume increases during the base and we see a further increase as the stock begins an uptrend in 2014.

Liquidity is key for institutions. They need to be able to build deca-million-dollar positions. As more institutions become involved in a stock, you’ll see the daily average volume increase and often large weekly volume spikes.

The Relative Strength edge

If you want to find a strong stock with the potential to make a powerful move, you often want to focus on stocks which have already shown outperformance.

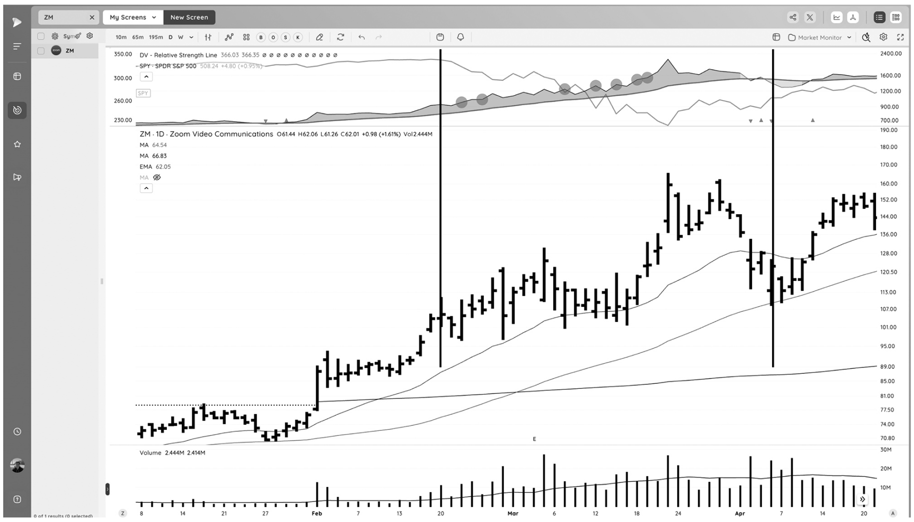
Outperformance means that a stock was holding up better or rising faster than its peers over a certain time frame. It is often most apparent when the general market is undergoing a correction or pulling back. Institutions use these periods to add capital to their highest conviction ideas.

This demand supports the stock, so even though they may pull back with the rest of the market, they can stand out in various ways such as:

1. The Relative Strength Line in an uptrend and ideally making new highs.
2. On over 60% of days during a correction, the stock outperforms the market (a Relative Strength [RS] day).
3. The stock holds above key moving averages as the market undercuts them.
4. During a later part of a correction, the stock ignores market pullbacks and may form higher lows as the market forms lower lows.
5. As the market moves up the right side after consolidating, the stock “jumps up” and recovers faster, as if pressure on a spring has been released.

Once a new uptrend begins, it is often the stocks that showed Relative Strength, especially during the last third of the correction, that become leaders. Leaders will also often lead the market higher, meaning they will reclaim moving averages and make new highs ahead of the indexes; refer to the chart.

ZM during 2020 is an excellent example of RS. We’ve highlighted in the chart with vertical bars the period where the market was correcting. During this period ZM outperformed on 61% of the days as its RS line increased. It also held the 21 EMA as the market undercut and the RS line stayed in an uptrend and showed multiple new highs throughout the correction.



After the market correction ended, ZM led the work from home theme and increased a further 350%.

The RS line is an indicator that plots the ratio of the stock's price divided by an index ETF, typically the SPY. It is very different from the commonly used RSI or Relative Strength Index. An uptrend indicates outperformance versus the index; a downtrend indicates underperformance. The value itself is not meaningful—the trend is what matters.

During a normal uptrend you can use three-month absolute strength rankings to find the strongest stocks. You can also scan for stocks that are gapping up, or moving higher on volume. Essentially, you are watching for standout price action.

The N-factor edge

The next edge we will be discussing is more fundamental in nature. We are looking for a game-changing catalyst that can provide the story which leads to a significant advance in a stock. A common example is an EPS or revenue surprise where a company dramatically beats expectations and raises their guidance for upcoming quarters.

Surprises force large funds and institutions to accumulate or add to positions over time based on changing factors in their analysis and spreadsheets. This may result in a large gap up and potential trend which we as retail traders can take advantage of.

A game-changing catalyst can also appear at the industry level where perhaps regulation changes allow for significant development and growth. These changes can impact all stocks in that industry, but we like to focus on the strongest in the group.

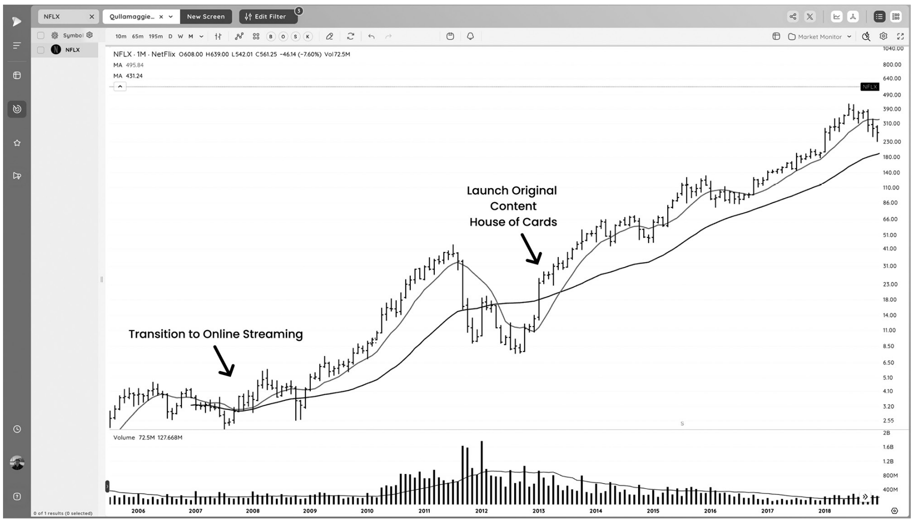
Advances in technology can also lead to new industries being formed. For instance, the recent theme of AI has emerged after advances in computer hardware and software made it much more accessible and powerful.

Finally a company could introduce a revolutionary product/service and reinvent themselves. This “N-factor” can lead to new growth, and a great example is Netflix.

NFLX has undergone multiple reinventions starting first with mail-order DVDs and later introducing and becoming the market leader in both streaming and original content. These new areas of its business disrupted the industry and led to fantastic earnings and sales growth.

Each of these catalysts led to multi-month uptrends in the stock; refer to chart.

The N Factor Edge - A Game Changing Catalyst



The N-factor is most effective when it is directly leading to growth in earnings and sales. We are always looking for companies with strong quarterly growth of over 25% at least and ideally triple digits and/or accelerating.

To use TSLA as a negative example, there has been talk for many years of how autopilot and robotaxis will be a dramatic growth driver. So far it has not yet materialized and TSLA has stagnated since late 2021. It may yet become another N-factor, but so far institutions are not buying it as of this writing in mid-2024.

Once they do it will be apparent in the price and volume action, and TSLA will again start an uptrend. Maybe by the time you are reading this book this next N-factor will be in play.

Group/theme/market strength

Stocks move in groups, with often a few groups making up the current leadership of the market cycle. These potential leadership groups (PLGs) are the result of outside factors such as game-changing catalysts for an industry as a whole.

When a stock is part of a PLG, the strength of the group contributes to its performance. This can have a significant impact and even average stocks in strong groups can outperform the strongest stocks in mediocre ones.

Market conditions add another level to this. Even strong stocks in strong groups may make little progress if the overall market is negative. This is why for the most part we want to always trade with the trend of the general market, group, and the stock. By aligning these forces, we have the strongest chance of success.

We will discuss more about the importance of group moves and themes in Chapter 9.

Edges exercise

Now that we have discussed the edges that we look for, it is time to apply what you have learned.

List out and describe the edges that you look for when analyzing and screening for ideas. For each edge, include an historical example.

Once you are done, remember to snap a picture and tweet us your work. We'd love to provide any feedback we can!

SETUPS

Edges help get promising stocks on our radar, but now it's about waiting for an applicable setup. Remember that the goal for a setup is to give us an opportunity to enter a high potential stock at a point where we are expecting a strong trend to begin.

Another key is that for each setup we want to be able to quickly know if we were wrong and be able to exit with a small loss.

An important reminder is that you can be stopped out of a trade once, even multiple times, and the overall setup can still be intact. This is where our entry tactics come into play, as we will discuss in the next chapter. So as long as the overall setup is still valid, keep watching stocks that stop you out.

Setups are larger chart patterns that take weeks to form but yield trends that can last months.

The launch-pad setup

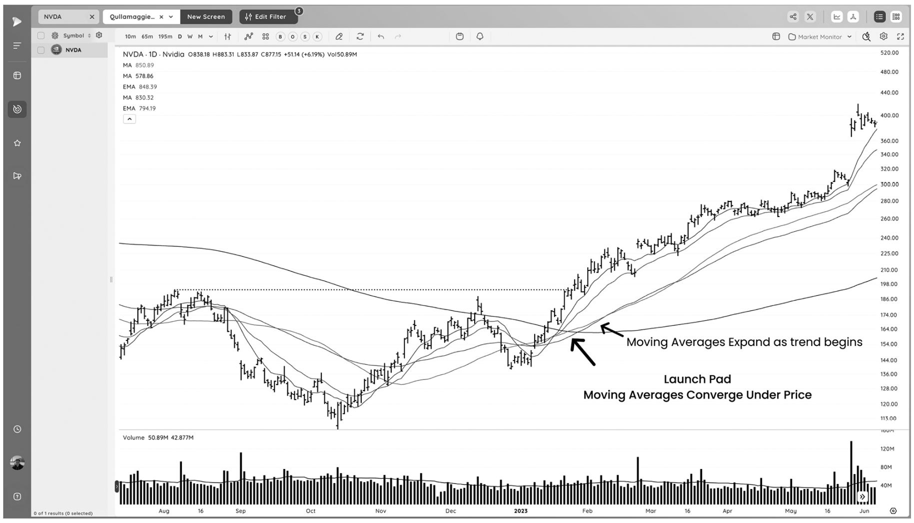
The Launch Pad is one of our bread and butter setups of the TraderLion methodology, taught to Ross by Andre Neidich, his very first hedge fund client, when he worked in institutional sales at William O'Neil + Co. It is formed when all of our key moving averages converge and the stock begins to shape up within a consolidation.

With this type of setup, the focus is on stocks where the group as a whole is shaping up together and has the potential to lead. We typically use the 10-day SMA, 21-day EMA, 50-day SMA, 65-day EMA, and 200-day SMA.

This pattern often emerges after significant market corrections and bear markets as stocks form bottoms.

For instance, NVDA in 2023 formed a launch pad on January before advancing 400%; refer to chart.

The Launch Pad Setup



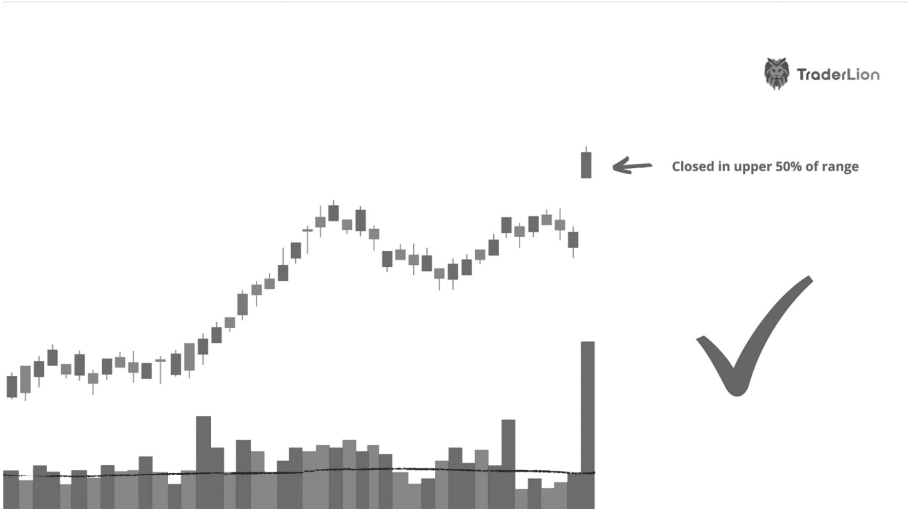
This pattern is particularly significant when a whole group sets up launch pads together. This is an indication that a group move is beginning to start.

Once a launch pad forms, we look to find clear consolidation pivots and other entry tactics that we can use to enter and manage risk.

The gapper setup

The gapper setup relates closely to the HV edges. We want to see gap ups on large volume with a catalyst. Then we can look for entry areas using the tactics we will discuss shortly; refer to chart.

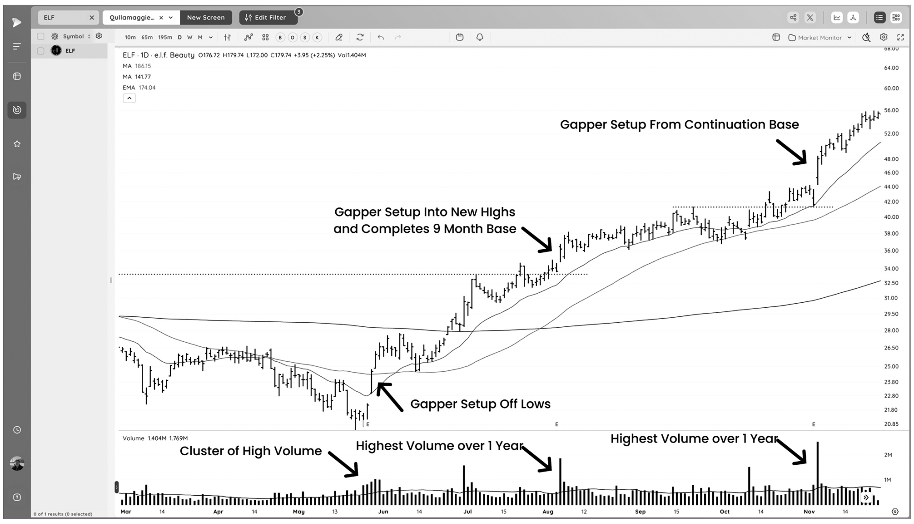
The Gapper Setup



A stock may form multiple gappers during a strong uptrend. We want to focus on the first one or two to ensure that the stock still has a significant runway.

The later in the trend the more likely the momentum will deteriorate and gaps may be sold into as institutions take profit; refer to chart.

ELF 2022 - Gapper Setup



In 2022, ELF started its model book move with a gapper off the lows on earnings. It then formed another gapper setup on earnings as it emerged from the nine-month base to new highs and then another one on earnings in November. In this case the third gapper is actionable given the size of the base ELF had just emerged from and because the first gap was so low in the base.

These three gappers occurred as ELF accelerated EPS growth from −18% to +44% to +71%, and showed EPS surprises of +106%, +65%, and +126%, respectively.

From the closing price of the third gap shown, ELF has since advanced another 350% in 2023 to April 2024.

Base breakout setup

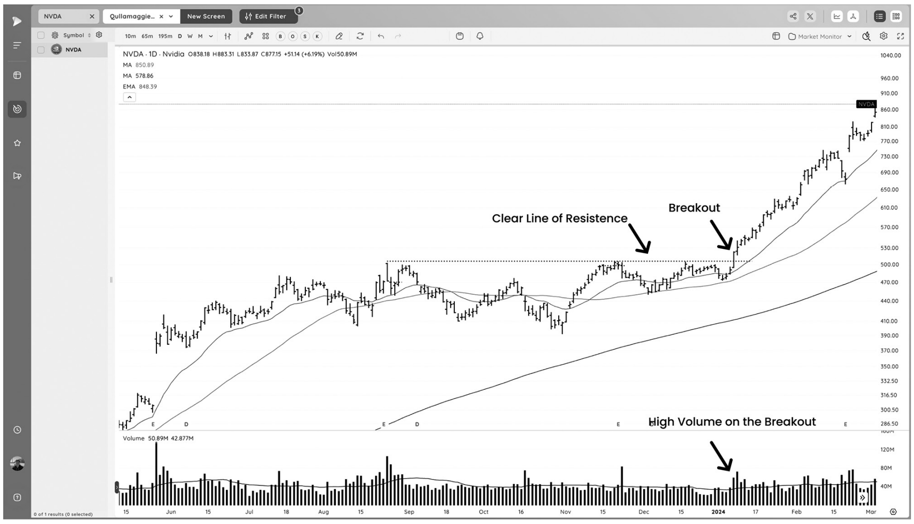
This is a classic William O'Neil setup. We are looking for a multi-week consolidation within the context of a longer-term uptrend. The minimum we are typically looking for is five weeks.

While the launch-pad setup forms a bottom and starts a trend, these base breakouts are continuation setups as the longer-term trend resumes.

The healthiest bases tighten in price and volume from left to right, although shakeouts can form double bottoms which are certainly actionable.

On the breakout we are looking for a clean move through the line of resistance and a pick up in volume. These are the elephant tracks of the big institutions; refer to chart.

Base Breakout Setup



Like with the gapper setup, we want to focus on the first few bases in a stock's longer-term move. This is to ensure that the stock still has room to run.

One thing we have noticed in recent markets is that there are more breakout failures than there used to be in the 90s. This is why we usually look to enter earlier as a stock is moving up toward the breakout rather than waiting for it to be breached and potentially reverse. Another alternate entry point we use is when a stock stalls after a breakout and falls back to a key moving average like the 21 EMA, and resets.

We'll discuss how to do this using various entry tactics in the next chapter.

SPECIALIZATION

In this chapter we've covered many different examples of both edges and setups.

To start with, you should pick one that fits your style and study it carefully, looking up as many historical examples as possible. This will allow you to build intuition about when the setup will work and what should happen shortly after.

Then, only after applying that setup and entry tactic successfully can you look to build your repertoire of skills and master the next one. A common mistake that newer traders make is to try to master everything all at once. This leads to confusion, frustration, and often inferior execution.

Take the gapper setup or breakout setup and make it yours. Or pick a different setup such as a pullback to a key support level or moving average. The point is to master one blueprint and become an expert on when it works well, when it works alright, and when it does not work at all.

TRADER'S HANDBOOK CHALLENGE 2

With this in mind, pick one setup that we have covered and find five strong examples from the past five years.

Annotate them and label your buy point as well as any key price and volume characteristics that you notice.

Remember to tag us in your work by sharing it on X (formerly Twitter). Have fun with this! You are building your personal playbook that will help you catch future model book stocks. #THChallenge

KEY TAKEAWAYS

Here are four key takeaways from this chapter:

1. The S.N.I.P.E. framework can help you find and manage trading ideas:
    - Search and scan—Look for current opportunities.
    - Narrow—Focus your attention only on the stocks that fit your system and have strong potential.
    - Identify—Finalize your watchlists and analyze each opportunity looking for edges and setups.
    - Plan—For actionable names plan the setup and entry tactics

that you will use to enter.

- Execute—Enter your trade while managing risk and then manage the position.

2. Edges are repeatable winning characteristics that signify that an opportunity is developing.
3. A setup is a repeatable larger pattern that signifies that there is a strong reward-to-risk ratio.
4. Focusing on just a handful of edges and setups allows you to master them.

BONUS RESOURCE

We recorded a webinar about the top edges and setups we use in our trading and how we find them.

You can watch it today at traderlion.com/handbook.

CHAPTER 5: ENTRY TACTICS AND TRADE EXECUTION

"Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat."

—Sun Tzu

In the previous chapter we covered the key steps of trading and how we identify promising stocks. These edges and setups define the larger context of a trade, the *why*.

Now it's time to define the *how*, meaning the process by which we will enter a position while managing risk tightly and logically—namely, entry tactics. We spend more time on risk in Chapter 6.

Entry tactics are short-term processes and patterns that we use to build a position as a larger setup is being completed.

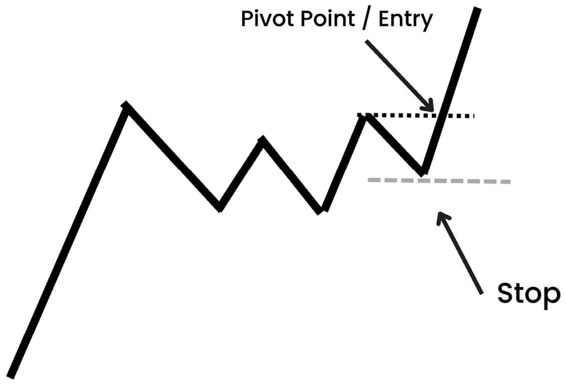
The benefit of entry tactics is that they allow us to size a position enough to make a difference if the trade moves in our favor, while also managing risk tightly enough if the trade fails.

Always thinking about the downside, we want to preserve the vast majority of our capital on any losing trade. This gives us both the confidence and flexibility to try a set up multiple times.

In this chapter we will cover the entry tactics we use as they correspond to each setup and also the key steps in the process of trade execution.

KEY COMPONENTS OF AN ENTRY TACTIC

An entry tactic has two main components. First is a well-defined level that becomes the pivot point, or the price that triggers the entry. The second component is the risk management level, where you are managing your risk against, exiting if the entry tactic fails.



Remember that your risk management should be both tight and logical, allowing the stock to oscillate normally while keeping a loss small if the trade definitely resolves to the downside.

PAIRING ENTRY TACTICS WITH YOUR TRADE SETUPS

For the setups that you specialize in, you should have specific entry tactics that you use to execute that setup.

Not every setup will resolve in the same way, but your entry tactics should allow you to creatively enter the stock on the setup while managing risk.

Here are the entry tactics that we use in conjunction with each of our setups. For a particular trade we might use a subset of each of these entry tactics to establish our position.

Launch-pad setup and base breakout:

- Key Support Level Reclaim
- Consolidation Pivot Breakout
- Key Moving Average Pullback

- Oops Reversal
- Key Support Level Pullback.

Gapper Setup:

- Opening Range Breakout
- The Intraday Base Entry Tactic
- High-Volume Close Pivot.

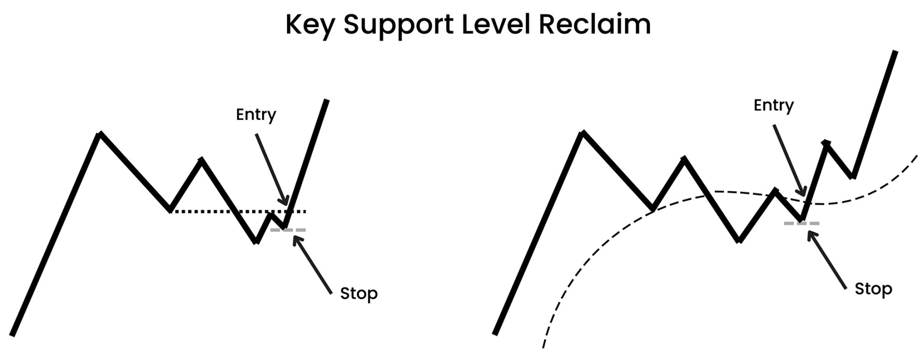
We will now walk through each of these tactics and show them in action.

ENTRY TACTICS

Key support level reclaim

A key support level reclaim occurs when a stock has undercut a prior level of support such as a base low or 50-day moving average, and then surges back up through that level.

This entry tactic occurs in stocks that have already been basing and consolidating for a few weeks.



For this entry tactic the pivot point is the key level, and you want to use a relevant higher low or other key technical area as your stop loss point. Typically, we look to keep our stop losses for this tactic at less than 5% and ideally less than 3% on the position.

Once a stock has reclaimed the key level, this entry tactic fails if it loses that level. A key level reclaim can occur on different time frames. A stock may undercut that level for a few days or as little as a few minutes. The more powerful a stock is on the reclaim, the more likely the stock will continue its momentum and rise further in the base, toward the consolidation highs.

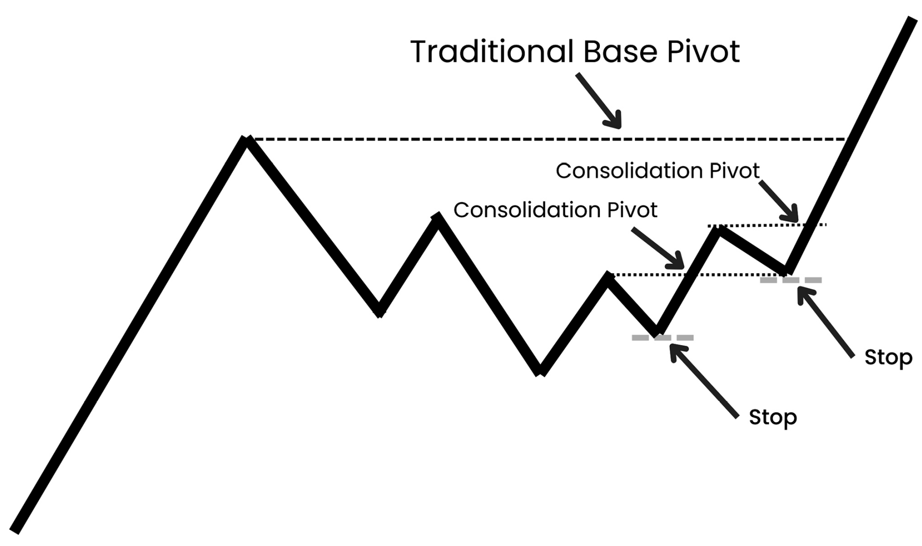
This entry tactic is often one of the first tradable spots in a stock's base.

Consolidation pivot breakout

The consolidation pivot was developed by Ross Haber when he started his hedge fund. With the higher amount of capital, he was unable to buy base breakouts in the traditional way and he had to find other methods to build positions.

He identified early entries where the stock would tighten and form pivots before the traditional breakout from a base.

Consolidation Pivot Breakout



These consolidation pivot breakouts often present strong risk/reward opportunities and allow you to build a position up the right-hand side of a consolidation. To identify these consolidation pivots, you want to look for defined shorter-term resistance areas and swing highs. These become your pivot points.

To manage risk, we look for the nearest relevant technical area. Most commonly, we use the nearest higher low or key moving average. If you are using a moving average, you want to ensure that the stock has previously respected that moving average while in an uptrend.

Like with the key level reclaim, we are looking to keep our stop losses for this tactic at less than 5% and ideally less than 3% on the position.

The idea here is to build a full position and have a profit cushion before a stock breaches the traditional base pivot.

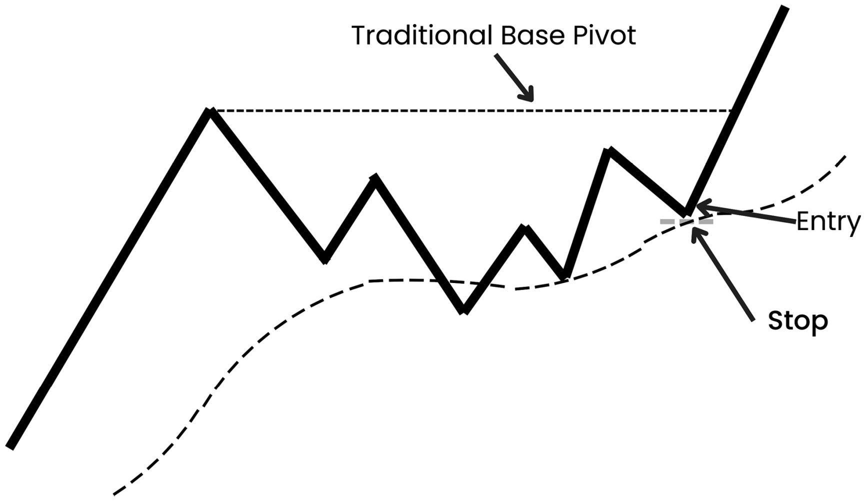
Key moving average pullback

Just as the consolidation pivot breakout is a buy on strength, you can also use a pullback to a key moving average or prior consolidation pivot within a consolidation as an entry point. Ideally the pullback occurs gradually on below-average volume, and we always want to see signs of Relative Strength before entering.

For instance, the market could be pulling back and forming a lower low as the stock you are focused on simply forms a higher low.

We are not blindly buying a stock as it drops, but instead reading the strength of the overall pattern and managing risk tightly.

Key Moving Average Pullback



With a key moving average pullback the pivot is the moving average that the stock has respected previously. The stock may undercut the moving average slightly or even for a day or two, but we want to see demand come in and push the stock back higher.

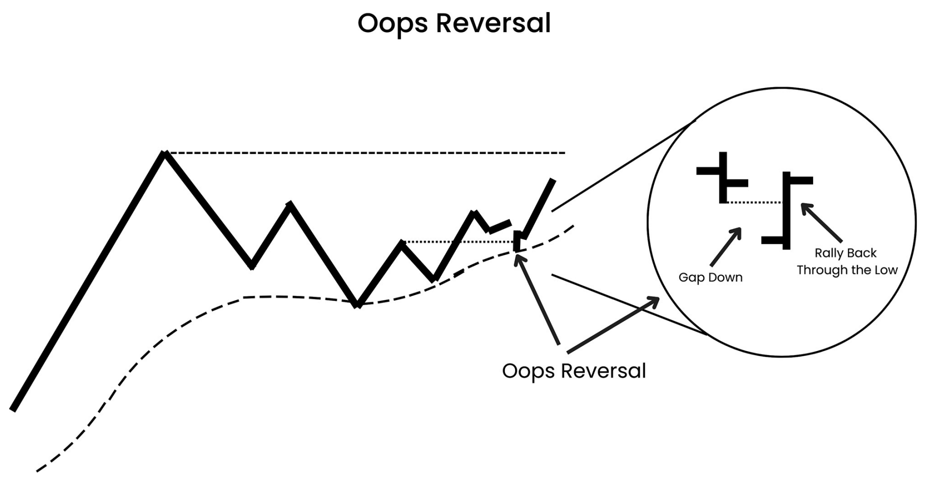
Similarly, during the base-building process, there may be a sudden gap down to the moving average. If the stock responds to the level and closes strong off the moving average, that is often an excellent entry point.

The risk management level with this entry tactic is just below the moving average. If the stock pushes up from the moving average but then turns around and undercuts that level, the entry tactic has failed.

With this entry tactic we want to build the position as close to the moving average as possible. Our risk on the position can be very small, even below 1–2% if you are ready and able to give the stock multiple shots at working.

Oops reversal

The oops reversal is a very short-term pattern that can be within the other entry tactics we have mentioned.



It was developed by Larry Williams and occurs when a stock gaps down below the prior day's low and then pushes back up through that low.

The *oops* is when all the market participants who sold out on the gap down have to buy their shares back, driving it higher.

The best oops reversals tend to occur up the right side of the base and when the gap down is right into a potential area of support, such as a moving average or consolidation pivot.

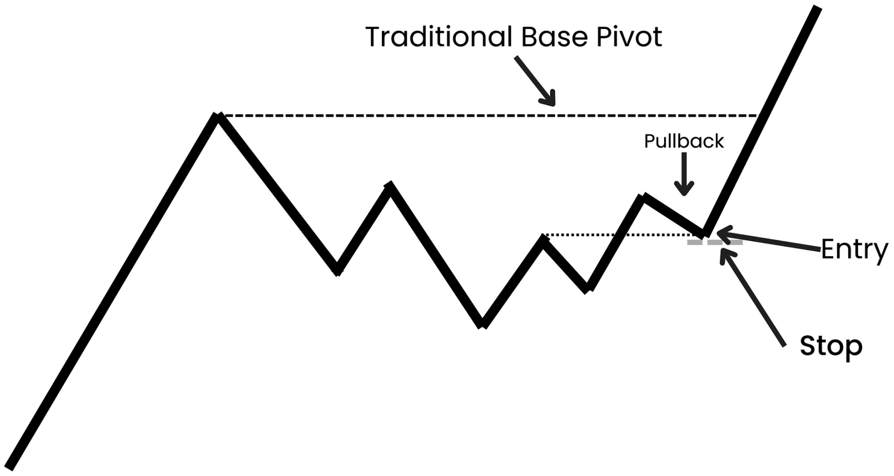
The strongest oops reversals immediately rebound and often finish with high daily closing ranges and ideally with an outside day.

The pivot for the oops reversal is the low of the prior day, and the risk management level is often the low of the day or a key support level if that is nearby.

Key support level pullback

This is the same idea as the moving average pullback entry tactic, except the key level and pivot are the prior consolidation pivot or a base pivot. We are looking to enter as the stock rebounds from and shows respect for that level.

Key Support Level / Consolidation Pivot Pullback



Ideally the pullback to the pivot is gradual and on lower than average volume. The risk management level is just below the pivot and higher low that is forming.

AFTER THE BREAKOUT

The entry tactics we’ve covered so far ideally will have you positioned in a stock before the traditional base breakout.

Early Entries