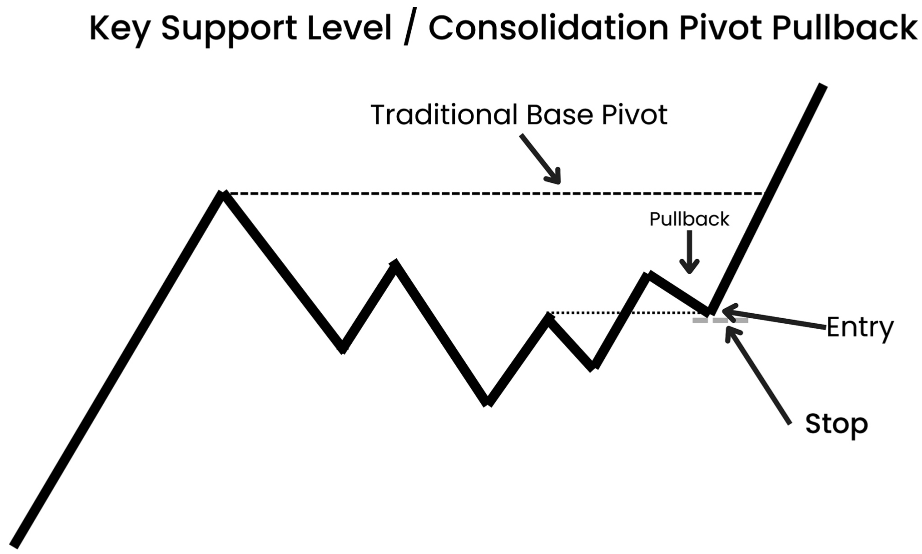
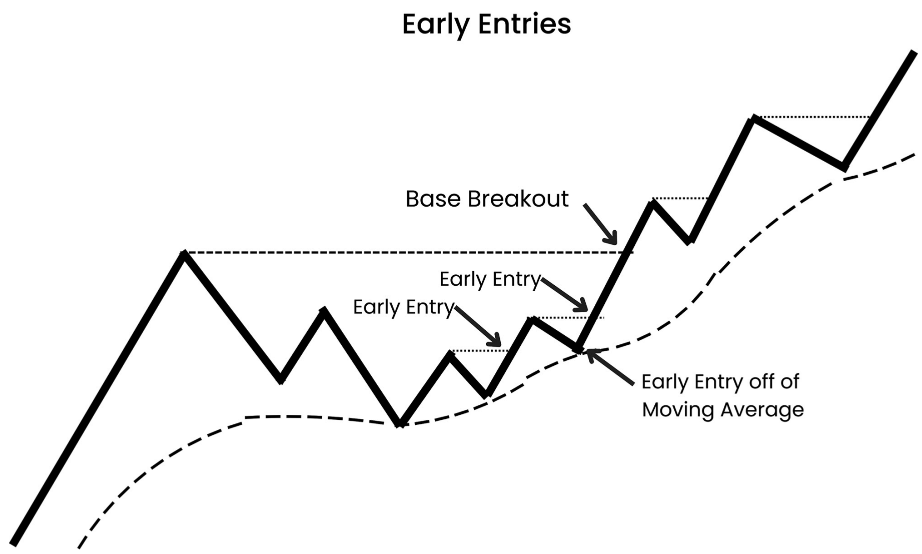


Ideally the pullback to the pivot is gradual and on lower than average volume. The risk management level is just below the pivot and higher low that is forming.

AFTER THE BREAKOUT

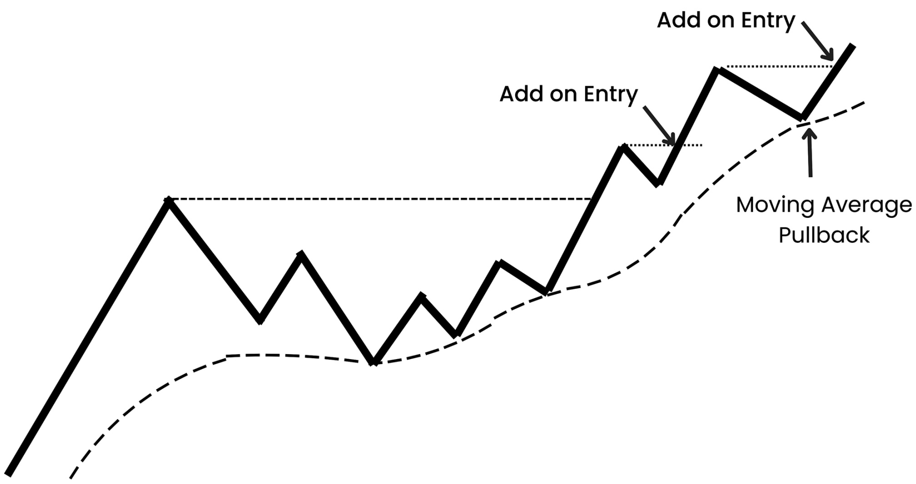
The entry tactics we've covered so far ideally will have you positioned in a stock before the traditional base breakout.



After a stock has broken out, especially if the base is one of the first in the longer-term uptrend, you can look to add to your position, or start swing trades, or add on entries.

The main two we use are moving average pullbacks or shorter-term consolidation pivots.

Add On Entries



After a breakout, there is often a quick retest of the 10-day SMA. Then as the stock trends it will often rest for one to three weeks and let the 21 EMA catch up. These are both opportunities to either add to a position or start a new one if you missed other entries.

Finally, the stock may experience a longer-term pullback and test the 50-day SMA. The first touch of the 50-day SMA/10-week SMA after a longer-term base breakout is often an excellent entry point.

However, the more extended the stock gets from the base, the more likely it will need to form another one, so the second and third tests of the moving averages often are lower-quality opportunities.

ENTRY TACTICS FOR THE GAPPER SETUP

With the gapper setup, there are a few options for when you want to get involved:

Day 1 is the day of the gap up. There is often an opportunity on this day for intraday setups, although you would have to have been focused on the stock before the open, either by running screens for gaps or keeping an eye out for strong earnings reports/news events.

Day 2 is the following day. Waiting for this day gives you the ability to judge the power of the stock and there are clear levels to trade off, as we will discuss below.

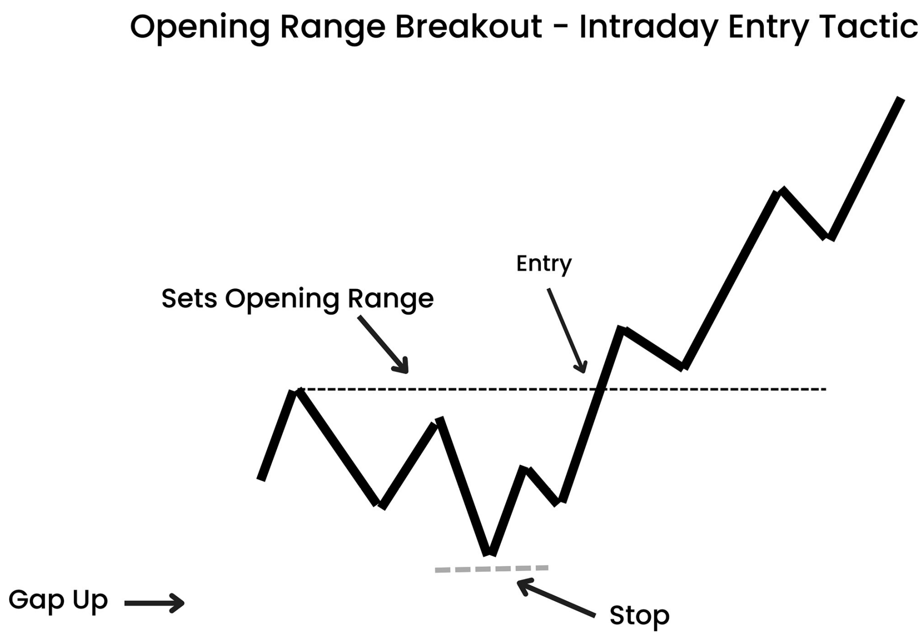
After day 2 you can wait for a short consolidation to form or a moving average pullback. This is more like a normal trade entry, so we will focus on the day 1 and day 2 entry tactics here.

Opening range breakout

This Entry Tactic occurs on the intraday time frame on day 1. In the opening prints, a stock will often form a short range. This range can be viewed as an intraday base and the entry tactic is completed when the stock breaks out of the range.

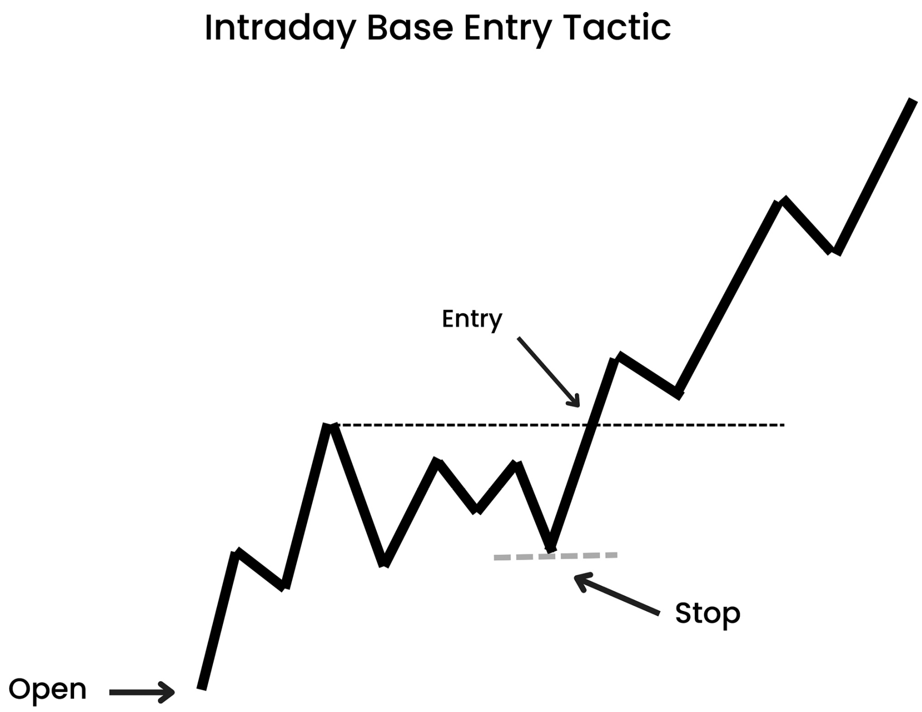
You can trade a 15-minute opening range breakout, but for many gappers, a faster five-minute opening range breakout or a three-minute one is required. The best gappers on day 1 open and take off, trending above the daily volume weighted average price all day.

Key reminder: The shorter term the entry tactic, the likelier there is to be more noise and failures. Manage risk and expectations accordingly.



The intraday base entry tactic

On day 1 of a strong gap up, the stock will often form intraday bases and pull back before continuing higher. These are opportunities to build your position. These will often coincide with a pullback to or compression beneath the intraday anchored volume weighted average price.

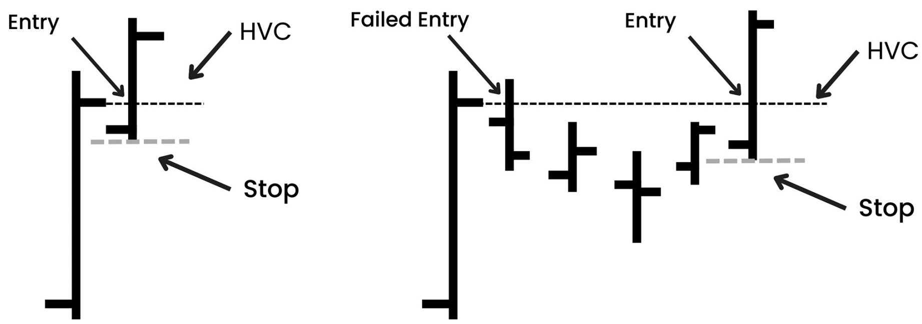


The entry point is a breakout from the intraday base. The risk management level is the recent higher low.

High volume close (HVC) pivot

The HVC entry tactic is a day 2 pattern where we are looking for a continuation move through the close of the gap up day. By waiting for the second day you get the benefit of being able to judge the quality of the gapper setup by looking at the amount of volume and the closing range.

High Volume Close Entry tactic



This pivot can be used as a day 2 entry or after some time if the stock pulls back and consolidates before forming a U-turn higher.

The risk management level should be kept tight, often using the low of the breakout day or relevant intraday higher low. We are shooting for stop losses of less than 3% with this entry tactic.

The HVC can also be used as the last addition as you build a position. You can use a combination of opening ranges, intraday bases, and the HVC to size up as the stock continues the momentum from the gap day.

Key reminder: Context matters.

Remember not to miss the forest for the trees. These entry tactics are best used in a strong stock showing institutional accumulation and as many edges as possible that we covered in Chapter 4. The stock must also be exhibiting a larger pattern and setup.

There will also be different market periods where certain setups and entry tactics work best. Keep an eye out during your routines for what types of patterns are acting well and following through.

Just like there can be a fundamental theme driving a group of stocks higher, there can also be a technical theme that is working at any moment in time.

TRADER’S HANDBOOK CHALLENGE 3

To apply what you have learned in this section, annotate in detail one base breakout setup and one gapper setup. Label the entry tactics you would use to build a position and where you would enter and set your stop loss. Be sure to share your work on twitter and tweet at us @TraderLion_ and #THChallenge

KEY TAKEAWAYS

Here are five key takeaways from this chapter:

1. Entry tactics are short-term processes and patterns that we use to build a position as a larger setup is being completed.
2. 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.
3. For each setup you have, you should have associated entry tactics that allow you to execute within that larger pattern.
4. Each entry tactic has a pivot point and a risk management level.
5. Context matters: Setups and entry tactics have periods where they work well and periods where their performance declines.

BONUS RESOURCE

We recorded a webinar on our favorite entry tactics that we use to enter stocks while managing risk.

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

CHAPTER 6: RISK MANAGEMENT

"At the end of the day, the most important thing is how good are you at risk control. Ninety per cent of any great trader is going to be the risk control."

—Paul Tudor Jones

THIS CHAPTER IS likely the most important one in this book. Risk management is the skill that will allow you to protect both your principal as well as your profits. It will enable you to trade for decades, allowing you to fully take advantage of compounding.

But what does "managing risk" actually mean?

It's a phrase that is thrown around a lot but often with little substance. In contrast, in this chapter, we will fully define what it means to manage risk on both a position and portfolio level.

This includes a process for setting and managing stops, determining how to size positions, as well as when to lower your overall exposure.

WHAT IS RISK MANAGEMENT?

At its core, your risk is the amount of capital you have exposed in the markets at any given time. It's controlled by the number of positions you have on, the sizes of each of those positions, and where your stops are for each of those positions (where you will exit).

This resulting dollar value is the total amount you are currently risking and can lose if the market turns against you and stops you completely out of your positions.

However, as a trader, you need to put on risk to potentially profit from winning trades. The key is to develop a risk management system that keeps your losses small relative to your profits over time.

CALCULATING TOTAL OPEN RISK

In the previous chapter, we discussed different entry tactics and where we expect to cut our losses on a trade level. But it is also important to be able to track your risk at a portfolio level.

This data point is called total open risk or simply total risk for short.

As an example, if we are in a strong bull market, trading well, we may reach our highest total exposure, be completely invested and on 100% margin. With a 100k account in five hypothetical positions, our portfolio might look something like this:

- 40k in DEEP with our stop 5% below the current price.
- 40k in VUE with our stop 15% below the current price.
- 40k in TLDV with our stop 3% below the current price.
- 40k in WON with our stop 8% below the current price.
- 40k in TH with our stop 10% below the current price.

You’ll notice that a few of these positions have tight stops. These represent stocks that potentially were just put on. With the others the stop is a bit wider, representing stocks that are trending with open profits. For these, we have trailing stops at a moving average further from the current price.

Let’s now calculate the total risk. To do this, for each position multiply the position size in dollars by the distance to the stop loss in percentages. For each position this gives you the dollars at risk. Then to calculate the total risk you would sum all of these together.

The formula is:

Total risk (dollars) = Position size 1 * Stop 1 + Position size 2 * Stop 2 + … Position size n * Stop n

Total risk (% of portfolio) = [Total risk (dollars)/Total portfolio value (dollars)] * 100

For the example above each position size is the same, so the calculation for total risk in dollars at the given moment is $40,000*(.05+.15+.03+.08+.10) = $16,400.

With an account of 100k the total risk in % is 16,400/100,000 or 16.4%.

So 16.4% of our principal is quite a high total risk amount. This may be suitable if the market is trending well and we have large profit cushions. However, if all our positions stopped out at once, it would be quite a drawdown from our peak equity.

For another example, here is another 100k portfolio that could be during a correction or very choppy environment where recent trades have not made any traction, volatility is high, and trends are short-lived. In this case all the trades are on a tight leash:

- 10k in AR with our stop 4% below the current price.
- 8k in NS with our stop 5% below the current price.
- 15k in RH with our stop 2% below the current price.

The total risk here is (10,000*.04) + (8000*.05) + (15,000*.02) = $1,100 or 1.1% total risk.

This is an example of perhaps three pilot trades with smaller position sizes which allow you to test the waters but would only draw your account down 1.1% if they all got stopped out.

You may notice that in this example, we have a 15% position size on one position, as well as a 10% size position, which may be considered very risky to investors who are used to diversification. However, despite relatively concentrated positions, the small stop size keeps the total risk in check.

In summary, the three factors that we use to calculate total open risk are: the number of positions we have open, the amount invested in each position, and the location of the stop loss on each position. All of these factors are completely within our control.

“Managing this risk” means adjusting at least one of the three factors described above to ensure that your total risk is acceptable given your risk tolerance, style, conditions of the market, extensions from moving averages, volatility, profits on the year… and any other factors.

Depending on your style you can focus on using one or more of the factors to manage risk. For instance, day traders may trade large positions but only one or two at a time with very tight stop losses.

Investors on the other hand often try to manage risk by increasing diversification (number of positions) and lowering positions sizes.

However, they often do not sell out of positions based on the market conditions or raise stop losses, and so risk is not necessarily managed. Additionally, they may find that stocks are not nearly as diversified as they thought.

In short, your total open risk allowance should fluctuate depending on the market conditions. Factors to consider are: the trend of the major indexes, health and breadth of market leadership, and the results from your past ten trades.

EXERCISE: CALCULATE TOTAL OPEN RISK

Using the figures below, calculate the total open risk in the portfolio. Assume a portfolio of 100k:

- 15k in Stock A with the stop 5% below the current price.

- 23k in Stock B with the stop 15% below the current price.
- 10k in Stock C with the stop 3% below the current price.
- 45k in Stock D with the stop 21% below the current price.
- 5k in Stock E with the stop 10% below the current price.
- 8k in Stock F with the stop 2% below the current price.

If the market were in an uptrend, would you be comfortable with this amount of risk? Why?

If the market were choppy, would you be comfortable with this amount of risk? Why?

How could you lower the total open risk?

LOWERING RISK

Say the market is starting to weaken or simply you haven't been trading well and have lost money on five out of the past six trades.

You have a few options to lower your risk in response to the trade feedback and changing market conditions.

Lowering the number of positions

Sort your existing positions by your profit or performance over the past month. Grade the positions from A to D taking this into account and your view on the potential of each stock going forward.

As you look to lower the number of positions, eliminate the Ds first and look to keep the As if possible.

Decreasing position sizes

You can also consider selling portions of your positions to bring position sizes back down to what feels comfortable for the moment.

Again, look to preserve your strongest stocks first, but if the market seems to be turning and a winner is extended from a base and is showing weakening signs, you can always sell half and look to re-enter when conditions firm up.

If you are looking to lower risk, starting position sizes can also be adjusted down. For example, with a 100k portfolio you could use 5k positions in weak markets, 10k positions in normal markets, and 15k positions for strong markets.

Adjusting stop losses

A strong market is forgiving; a weak market is the opposite. When conditions worsen consider tightening up initial stop losses and being quicker to raise them to your breakeven level.

Each stock you buy has to prove itself to you that it is worth the risk.

INCREASING RISK

Coming out of a correction it’s important that you test the waters and increase risk in response to positive feedback, such as new positions working well and other stocks on your watchlist moving higher.

As conditions improve, you build up a cushion and things are working, you can increase your total risk. As conditions worsen, size down, take fewer trades, and raise your stops to decrease your potential overall drawdown.

Trading is not an on-or-off business. Think of risk as a dial that you can turn in response to how things are going. As Mark Minervini says: “*You want to be trading your largest when you are trading your best and your smallest when conditions/your trading is at its worst*.” He coined the term progressive exposure, which describes this process of raising and lowering sizing in response to market feedback.

Managing risk in this way ensures your survival, allowing you to profit from uptrends and protecting yourself during corrections and bear markets.

Now that we have addressed the concept of risk management from a portfolio level, let's zoom into how you can manage it on individual positions using stop losses.

SETTING AND MANAGING STOP LOSSES

Stop losses are key to managing risk. Without a sound loss-cutting system, it is impossible to make consistent progress in the market over time.

Without a process for cutting losing positions, at best you will have some booms before you go bust.

Never forget, stop losses are what keeps you in the game to fight another day. Stop losses serve to protect and preserve your financial capital, as well as your mental/emotional capital.

It doesn't matter how good you are at picking stocks. At some point you are guaranteed to pick the wrong one and without a stop loss to protect you, it won't be long before your hard-earned money disappears, and your negative emotions come boiling to the surface.

Having a detailed plan to manage risk for the times when you are wrong is the only path to consistent success, as well as objective decision making when you are under pressure.

So let's dive into creating a detailed plan. We will cover setting an initial stop loss, common stop loss questions, adjusting your stop loss to breakeven, and trailing your stop loss when you are in a profit.

The initial stop loss

When we first enter a trade anything is possible. There is excitement, potential, uncertainty, this trade you just put on could double and make your year.

However, we need to remember to take a step back and think about the overall system and the long-term view. What do we need to do with this trade to ensure that we preserve our capital and continue to make progress?

The best growth stock traders are right in strong markets about 50% of the time. The rest of the time they are cutting their losses short to ensure that they preserve the majority of their capital and try again.

Some of the top traders from the past year who have competed in the US Investing Championship and achieved well over triple digit returns are only right 30–40% of the time.

This means that the six out of ten times they lose they must have strict risk control so that when they are right, it more than pays for all the losses.

And it all starts with the initial stop loss.

You should place this stop loss immediately after placing the buy order. And in fact, you should know your stop level before you even enter the stock as it should be one of your determining factors of whether you will place the trade at all.

Before placing an order, ask yourself, can I manage risk in this stock if I enter here? Is there both a logical place on the chart to place my stop under, and is it also tight enough to my potential entry price to be a small loss if triggered?

Tight means that your loss on the position if your stop is triggered should be limited to just a few per cent. For swing/position trading we consider 1–4% to be a tight stop for your average growth stock and up to 6% for a more volatile name.

However, using a tight stop alone is not enough. It must also be logical.

A tight stop loss set to 2% does no good if your entry was at a place where a normal price fluctuation can easily stop you out.

If you are unable to place a tight and logical stop loss, then you are likely not using a sound entry tactic and pivot point. Until this is the case, wait for your spot to set up.

A logical stop loss means that a violation of your stop level invalidates your thesis and suggests that your entry tactic has failed for the time being. The stock may reset and set up again, but for now your rules state that you should be out of the stock.

This logical stop is likely defined by a significant technical level. This could be a moving average that the stock has shown respect for, a low of the range, or the low of the day.

This concept of requiring a tight and logical stop is one of the most important lessons we wish to share with you. It does not matter if you are a day trader trading one-minute charts or a long-term position trader trading weeklies, placing tight and logical stops is crucial to your long-term performance.

For your time frame, and style, a general rule of thumb for the % stop to be considered “tight” is to look at your average gain over a period of six months and divide by three.

Day traders may average 3% returns and be shooting for less than 1% stops. Investors may average 30% returns and shoot for less than 10% stops. Swing traders may average 10% returns and look for sub 3% stops.

This rule of three is a guideline and the tighter the better.

COMMON STOP LOSS QUESTIONS

Should I set my stops right at key levels?

We typically set our stops a few cents below the key level. The “obvious” stop loss points sometimes get shaken out. That’s trading. We are always ready to re-enter.

Should I wait until the end of the day to honor my stops?

In a strong bull market you should look to give your stocks the benefit of the doubt. You can also have an “intraday stop” that is your worst case but gives the stock a bit more room to maneuver.

For example, your stop could be 4% but intraday could be 7%. This stop should be decided in advance, not when the stock is already falling.

In a choppy market we don’t wait to ask questions, we act in the moment and maybe cut a stock early if it does not act well.

We would rather be out of a stock wishing we were in than in a stock wishing we were out. This both protects your capital as well as your psyche.

Should I set hard stop losses with my broker?

It depends on your situation and your discipline. If you can watch the market and follow your rules you can use alerts. If not or if you work full time, hard stops may be the answer.

Should I avoid the stock after I have been stopped out?

Definitely not if the setup and story are still valid!

Sometimes the best trades take a few times to work. A shakeout that takes out the more obvious stop loss levels may even improve the setup!

However, if the bar that takes out your stop suggests significant distribution, you should be patient for the chart to heal itself.

What if I want to enter a stock but there is no place to put my stop loss?

Then you can’t place a tight and logical stop and are likely looking to enter in the middle of nowhere—have the discipline to wait.

What if I am constantly getting stopped out right before the stock moves higher without me?

If this is the case, analyze your entries. If normal fluctuations are stopping you out you may want to expand your typical stop loss slightly and lower your position size to balance the risk.

However, it may also be that your entries are not sound, so be sure to look at your entry tactics and setups as well to see if that is the issue.

What if a stock gaps down below my stop loss?

This actually happens a lot less than traders expect. For the most part, beginner traders would do best honoring their original stops until they are further into Stage 2 and then Stage 3.

Once you have more experience you can judge the severity of the gap and catalyst, and make an informed decision of whether to give your stock a chance to recover.

Remember, however, that the goal is to preserve capital at all costs. If a stock has a large gap down on, then something isn’t right and you are likely better off out of the stock and re-evaluating the situation.

ADJUSTING STOP LOSSES TO BREAKEVEN

Once a trade is on and makes progress for you, the next step in trade management is to raise your stop to protect your breakeven point, and then eventually backstop profits.

The faster your trading style—swing and day traders—the more quickly you want to move up your stops. This helps keep your losses as small as possible.

Investors and position traders can take a bit more time with this, although they still should have defined rules.

A good rule of thumb in a strong market is to move up your stop loss to your cost basis once you have a profit in the stock of two to three multiples of your initial stop loss.

This gives you some cushion to let the stock fluctuate while also capping your downside.

In a weak market you may want to move a lot quicker than this, maybe when you have even just a few % profit.

TRAILING YOUR STOP LOSS

Once your stop loss is at breakeven, the next step is to trail your stop loss behind the stock, leaving room for normal price action.

The higher your time frame the more room you should give your stock.

One of our favorite methods for trailing a stop loss is to use a moving average once it rises above our cost basis. For swing traders this could be the 21 EMA and for position traders this could be the 50 SMA.

Then we are waiting for two closes below the moving average to signal that our stop has been active. This works great in trending markets as stocks can make up to triple digit moves without breaking their key moving averages.

Another method would be to raise your stop loss once it has formed a new swing low and then continues higher. In this case you would back stop it just below the new swing low. Either way works—you just have to find the one that makes sense for you.

Stage 2 and 3 traders can look to adjust their trailing stops when they notice changes in character in a stock. For instance, if it starts an accelerated move upward after already being extended, you can switch to a shorter moving average or trailing at the low of two days ago.

Or on the flipside, if a stock looks to be breaking down with obvious downside reversals and failed breakouts, there is no need to wait by law for a drop to the 50 SMA if that is not your style. You could adjust your stop to the low of the week or the 21 EMA.

The more experienced you are, the more you can let your judgment of price action dictate things. Early stage traders should try to use clear and objective rules.

The key is to have a general system for stop losses and sell rules that allow you to capture the majority of the trend for your style and time frame. We won't buy the low or sell the high, but if we can consistently catch the meat of the move, we will outperform.

POSITION SIZING

Along with stop losses, position sizing is a key determining factor to how much you can lose on a position if the trade goes against you:

A 3% loss on a 10% position is a 0.3% loss in your total portfolio.

A 3% loss on a 20% position is a 0.6% loss in your total portfolio.

A 3% loss on a 40% position is a 1.2% loss in your total portfolio.

One of the biggest mistakes traders make is trading too large, too soon. They see experienced traders using margin and taking 50% positions, and think that is the pathway to success.

It's very similar to going to the gym for the first time and putting 250 pounds on the bench press because you saw another lifter rep it out easily. That's a recipe for injuries. Instead, you have to start at what you are comfortable with and slowly scale up as you learn the proper techniques and get stronger.

You have to earn the right to lift heavier weights.

It’s the same thing with trading—you have to earn the right to trade larger size. Larger positions can lead to bigger performance, but only if you can manage the risk correctly.

Many of the top traders don’t buy a large position all at once. They string together entry tactics and put on 20% of their portfolio then 10%, then the last 20% as the stock is working for them and triggers new pivots. They have techniques to put on size while keeping their overall risk very small.

For Stage 1 and 2 traders, we would say that a base position of 10% is a nice sweet spot. Stage 1 traders should stay consistent with that as they work on their process, while Stage 2 traders can adjust their size up depending on the market and number of edges present to a maximum of 20%.

This would lead to a portfolio of around eight to ten stocks if completely invested.

Stage 3 traders can adjust these parameters as they see fit, but only after they have proven that they can manage risk over multiple market cycles.

Even the most experienced traders can get themselves into trouble by sizing too large or taking on too much risk at the wrong time.

Many of the very best traders also significantly pull back on their sizing if they don’t feel in sync with the market or are trading badly.

The key is to take away your ego and adjust your sizing to the current situation and your skill level.

DETERMINING THE POSITION SIZE FOR INDIVIDUAL TRADES

For each trade you are considering, you should ask yourself these questions when determining the number of shares you will buy:

1. What is my current total risk and how much am I willing to add to that?
2. What is my expected stop loss level? What would be the % loss on the position?
3. What is my conviction in this stock and setup, and how many edges are present?
4. How is the health of the current market—are we in a weak, normal, or strong trending market?
5. How have my recent trades performed? Am I getting positive feedback?

In answering the first two questions, you will answer for yourself the maximum amount you could purchase in the stock.

In answering the last three questions, you can determine the final size you will put on relative to your normal starter position sizing.

Let’s do an example.

If we are in a normal market and have currently 7% total risk and are comfortable taking that up to 10%, this means we could potentially add 3%. This does not mean we have to, but it means that we could add up to 3% and still be within our risk parameters.

The setup we are looking at is a consolidation pivot with a higher low 3.5% below. This also lines up with the 21 EMA which is 4% below the pivot. A tight and logical stop loss would be just below the moving average at 4.1%.

This means that the maximum size we could take is the 3% equity divided by 0.041 = 73% position size.

However, your maximum position size as a Stage 2 trader is 20%. So although you won't be taking a 73% position, you've confirmed that you have space in your portfolio for this new trade.

Next up is analyzing the current context and setup. It's a decent market so normal sizing is alright, but this stock is showing a few edges and is a potential leader in a strong theme. You decide that this stock is a B+ and worthy of slightly higher position sizing.

Recent trading has resulted in a normal win percentage and average gain.

Taking this all into account, you decide to take your base position sizing of 10% and raise it by 5% for this trade to a 15% position size.

This fits within your total risk parameters and for the individual trade, so you can go ahead and enter.

TRADER'S HANDBOOK CHALLENGE 4

List out the steps you take to set initial stops and adjust them. Annotate and label them on a previous trend of a market leader of your choice from one of your bread and butter setups. Be sure to share your work on twitter and tweet at us @TraderLion_ and #THChallenge

KEY TAKEAWAYS

Here are four key takeaways from this chapter:

1. Risk management is the key to longevity in trading.
2. The three factors that control open risk are the number of positions, the size of the positions, and the stop loss levels.
3. Stop losses should be tight and logical.
4. You need to earn the right to size up positions.

BONUS RESOURCE

We recorded a webinar on risk management, setting stop losses, and position sizing.

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

A SMALL ASK THAT CAN HELP TRADERS JUST LIKE YOU

So far in this book we've covered key concepts that have hopefully helped guide you along your journey as a trader.

We strongly believe that the risk management chapter in and of itself can make a huge difference in helping you protect your hard-earned profits and capital.

It's part of our mission to educate as many traders and teach them the key principles that can keep them in the game for decades.

To help us achieve this goal, we need your help.

If this book has been helpful, can you take 30 seconds right now and leave us a quick review?

Because you picked up this book and have read this far, we know you are determined to improve your trading and care deeply about finding quality resources to expand your knowledge.

You may have read a review on Amazon or Goodreads that made you give *The Trader's Handbook* a chance.

Leave us a review to help other fellow traders out and let them know that it will be worth it.

On our website and in podcast comments, our favorite messages to receive are from past students or viewers a few years later where they mention how they had watched an interview, took a masterclass, or read an article, and it ended up being an inflection point in their trading.

This book could similarly impact a trader just like you. Someone who has dreams of turning profitable, managing their own accounts, or even having their first 50% year.

Your review means an immense amount to us *and* could make the difference in this book reaching fellow traders. The review is completely free and only takes 30 seconds.

You can visit the book's page on Amazon or whichever platform you purchased it on to leave a review. We read every one! And thank you in advance for sharing your thoughts with other traders.

Also, feel free to tell other traders about it in person or on X.

Cheers!

Richard, Rai, Nick, and Ross

Now back to the next chapters of the handbook.

CHAPTER 7: SELL RULES AND POSITION MANAGEMENT

"Buying a stock without knowing when or why you should sell it is like buying a car with no brakes, or being in a boat with no life preservers, or taking flying lessons that teach you how to take off but not how to land."

—William O'Neil, Market Wizard

SO FAR WE have covered the important topics of edges, setups, and entry tactics. We've discussed how to manage risk in order to keep losses and drawdowns small. However, this is only half of the trading equation.

We must also address sell rules and position management, which allows you to capture the trend for your time frame and yields strong winners. Although many traders focus on getting their entries perfect, position management is actually more crucial for achieving success over time.

In this chapter we will cover how we manage our positions and the clear steps of trade execution. After reading the next few pages, you should have a clear understanding of the last three letters in the S.N.I.P.E. framework: Identify, Plan, Execute.

KNOWING YOUR GOALS AND TIME FRAME

Before we discuss specific rules, you must define your personal style and time frame. There is a balance you must meet between holding a position for a larger move and the potential drawdown risk if that position moves against you over time.

Selling into strength allows you to sell at your equity peaks after a short duration. However, you will potentially lose out on profits if the stock continues higher.

Selling into weakness allows you to stay with a trend until it fully breaks down for your style. However, you will experience larger drawdowns in your equity curve, and may experience opportunity cost since your capital is locked into one idea.

Depending on your style and psychological make-up, one of these options, or a certain split between options, will give you the most peace of mind.

Swing traders will look to sell more into strength and then look for the next setup, focusing more on fast-moving stocks and quick trends.

Position traders will likely sell more into weakness as they look to play longer-term trends, even holding stocks throughout intermediate-term bases.

You will discover this balance through trial and error, many trades, and market cycles. Your preference may also shift over time as your account grows or your time constraints change.

GUIDELINES FOR DIFFERENT STAGE TRADERS

As we discussed in Chapter 2, depending on which stage you are in, your goals in the market should be different.

If you are a Stage 1 and early Stage 2 trader, your goal is to build consistency and look to gain experience in the market.

With this in mind, the sell rules for Stage 1 and 2 traders should be much more rigid, while Stage 3 traders can adapt to particular situations and use their experience and intuition to guide them more.

At late Stage 2 and once in Stage 3, you can then build off that foundation and tweak your rules to focus on performance.

Regardless of experience level, however, the goal of every trader when building sell and position management rules is the same: To ride a stock during the portion of the trend that is significant for their time frame.

SELL RULES FOR STAGE 1 AND 2 TRADERS

Let’s begin by focusing on early stage traders. The goal here is to build a consistent system that nails down profits while playing a portion of your position for an intermediate-term trend.

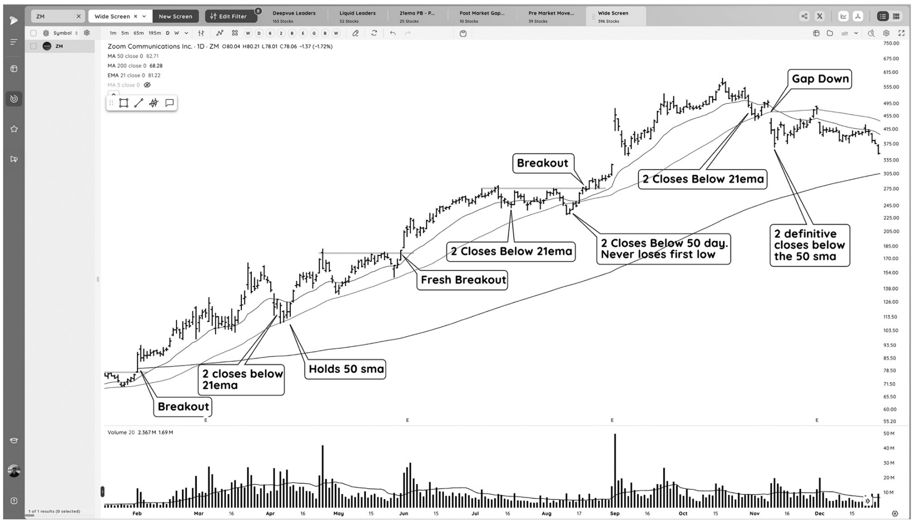
Once your stock reaches a profit of 5%, immediately sell half your position and raise the stop on the balance of your position to breakeven.

From this point, if your stock ever breaches your maximum stop loss, the position should immediately be sold at the market, no ifs, ands, or buts.

If your stock continues to make progress without hitting your sell stops from this point, your goal is to then begin to use its relevant key moving averages to trail your position along the way. In the event that there are two closes below a relevant key moving average, your position must be closed immediately.

For swing traders we recommend using the 21 EMA moving average. The 21 EMA or similar timeframe EMA/SMA does a great job of tracking trends from base to base. For beginner position traders, we recommend starting with the 50 SMA. The 50 SMA can help position trades still with the longer term intermediate trend and hold through constructive bases.

Sell Rules with Moving Averages



As you become comfortable with these sell rules, below are some progressions you can make. However, don't rush this process—make sure you are consistent in your process before adjusting:

1. Instead of selling half of your position at 5%, sell a third. Sell the next third at your average gain of the last 20 trades, and sell the last third on weakness using the moving averages.
2. Sell a third at 5%, a third into strength above your average gain when the stock gets visually extended from the moving average, and sell the last third on weakness using the moving averages.
3. Use the rule above but allow yourself to add back a third if the stock forms another low-risk entry tactic.
4. Sell a third at your average gain, a third into strength, and a third into weakness using the moving averages. Allow yourself to add back up to the two-thirds you sold previously if the stock forms another low-risk buy point.

Again, be very honest with yourself about where you are in your journey. Only move on to the next progressions if you feel like you are solidly in

Stage 2 and getting closer to Stage 3. The goal of this stage is not necessarily profits, but to build a consistent process and rule set.

SELL RULES FOR STAGE 3 TRADERS

The goal of this phase is to capture the largest gains possible. The idea behind it is to do less proactive selling early within each market cycle, and instead wait until later in the cycle to begin to sell more aggressively, into bouts of strength.

The Stage 3 performance phase does not have strict rules like the Stage 1 and Stage 2 consistency phases do.

In essence, once you have reached the performance phase, you should possess the skill, confidence, and experience necessary to do the tactical selling needed to really enhance your performance when it matters.

In some cases, you will ultimately get forced out of a profitable position when your stock weakens and breaks below its key moving averages. In the case where you have enough of a profit cushion, it often makes sense to divide your sale between two different key moving averages, in an attempt to hold on to at least part of your position for a larger move.

Alternatively, as we’ve discussed above, you can use sell rule of 2 closes below a moving average. For Stage 3 traders, they can also consider how the stock is acting with those 2 closes. Are they sharp and definitive, or is the stock merely drifting below the moving average area. Also, sometimes the stock may have 2 closes below a moving average, but the second close is higher than the first one.

In short, Stage 3 traders can make more of a judgment call if they want to sell or give the stock a bit more of a benefit of the doubt.

There are also the times when you will find yourself proactively selling into strength. This is typically toward the end of a cycle or in choppier markets. For example, as one of your stocks becomes clearly extended above its 10

SMA, like it’s done so many times before in the past, it may be prudent to sell a portion before it pulls back in hard.

A key part of Stage 3 position management is understanding your environment, as well as whether or not the stock you are trading is a true market leader worth trying to hold on to, or just a performance enhancer.

As a Stage 3 trader, if you get positioned with size early in a market cycle in a stock that you feel fits the template of a market leader in a leading theme, then your goal should be to let that position work for you, and to play for the larger move.

However, if a stock is more of a secondary name/performance enhancer, you can be quicker to sell into strength and use that cushion to feed your other positions or improve your confidence.

As a Stage 3 trader, pay attention to how your average winner over the past 20 to 30 trades has performed. If you find that your average winner is increasing, look to increase your holding periods. If it is declining, shorten things up and lean more into swing trading.

SELLING INTO STRENGTH

Between the two options, selling into strength is more nuanced. Psychologically, it can be difficult selling when a stock is moving up, fearing that it will continue on without you.

The most important thing, however, is that you do what is right for your equity curve. Selling into strength allows you to lock in profits and builds your confidence. And if you are selling a third or a half into strength, you still have the remainder of your position to ride the trend.

You are also able to move the freed-up capital into another fresh idea that may not be as extended.

When should you sell into strength?

You can look to sell into strength at fixed intervals based on your entry or the stock’s price structure, or on more fluid points such as when the stock becomes extended from a moving average or puts in a key reversal.

Selling into strength at your average gain and R multiples

The first logical spots to sell some of your position into strength are at your rolling average gain and at R multiples from your entry point. (An r multiple means a multiple of your initial stop loss. For example a profit of 9% when your original stop was 3% means you have a gain of 3 r multiples.)

By locking some in at your average gain you are ensuring a profitable trade with the potential for the remainder of your position to increase that average.

R multiples are also useful as they allow you to focus on your risk and reward, and ensure that your winners are paying for any stop loss hits along the way.

Selling into strength at base extensions

When stocks break out from a base, they typically progress strongly for a period before settling into a groove and trending. Often, there is a pause around 20–25% from the top of the base where the stock may pause, consolidate, and then continue higher.

As a stock approaches this level, it may increase in volatility, as different market participants take profits. For swing traders, you can also look to take some or all of your position off, having ridden a strong momentum move from the breakout.

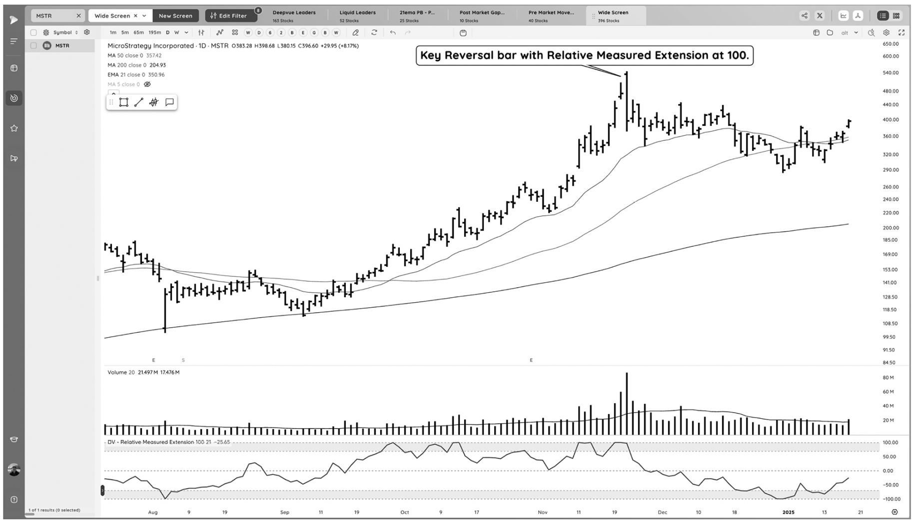
Selling into strength using moving averages

When a stock is trending, it will naturally pullback, gather strength, and then continue higher. You will start to notice that it will form a habit of how far stretched it can be from the moving averages before pulling back in.

You can note the % it typically becomes extended from the moving average, or measure it in average true range (ATR), or simply eyeball it. Regardless of your method, the stock will be likely to continue with this character.

In Deepvue we’ve also developed an indicator that is trained on prior stock extensions versus a moving average and identifies where the current extension rates versus historical ones. When the Relative Measured Extension indicator approaches 100, it means that based on historical values, it is becoming stretched from the moving average.

Relative Measured Extension Indicator In Deepvue

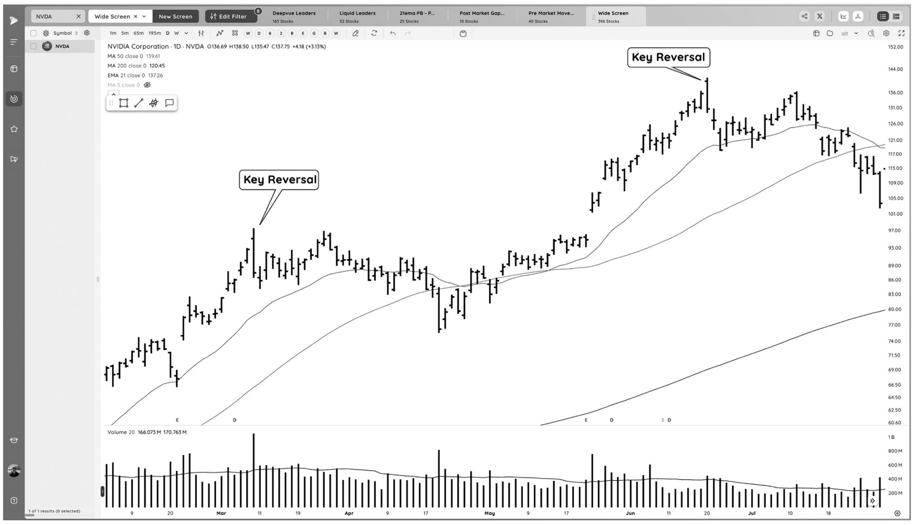


If it is already becoming stretched from the prior base, you may consider locking in a portion of your position when the stock approaches its extension level. This allows you to potentially get ahead of any key reversals or significant pullbacks to moving averages.

Selling into strength on key reversals

This technique is slightly a hybrid of selling into strength and weakness. There are moments in a stock's move where it becomes slightly extended and closes significantly down on the day.

Key Reversal Bar



Ideally, you are already watching to sell into strength because of an extension from a moving average and you notice some of the characteristics in real time.

Here are some criteria to look for when identifying key reversals:

- At the high the stock was visually extended from the moving averages.
- The stock gaps up but quickly fills the gap and reverses downwards.
- The stock breaches a trend line of highs.
- The volume is abnormally high or the highest since the breakout.
- The stock forms the widest range bar since the breakout.
- The stock reverses below the prior day's low and closes low in the range.

These reversals can mark a change in momentum and potentially the start of a new base. It may be prudent to use these reversals to lock in some profits so you can move the capital toward a fresh opportunity as the original stock consolidates.

Key reminder on selling into strength

If you are a position trader and have properly bought a stock up the right side of a base or near the breakout, it's likely you would want to avoid selling too much into strength if the stock becomes extended shortly thereafter.

Early in a cycle, extensions are a show of power, and it's likely that the stock will continue to trend after short-term pullbacks.

Extensions further from the base or into the move are more suited to selling into strength, as the stock likely has less potential and is more likely to pullback and form a longer base.

The key is to judge whether the extensions are a sign of significant accumulation or are more indicative of exhaustion.

TRADE EXECUTION

Now that we have covered the key aspects of setups, entry tactics, and risk management, let's bring it all together and discuss the overall process of executing a trade.

From your daily routine, which we will discuss in Chapter 9, each day you will have a focus list of the very top ideas to trade. This will be a handful of stocks that meet all of your criteria, are forming setups, and could complete entry tactics that day.

Your daily focus list should have a maximum of around five ideas and ideally just one to three. The tighter this list, the better your execution will be.

For each of these stocks you should have a plan prepared for a trade. You should know what your buy point or entry tactic will be, where your likely stop loss will be set, and how many shares you should buy.

The next step is to set alerts for each of these stocks. We like to set alerts, not only at the buy point but also potentially one or two alerts set slightly below that point. This allows us to be notified as the stock is approaching our level of action.

For each stock on your daily focus list, visualize what it will look like if it executes your entry tactic and how you will respond.

When the market opens, your job is to monitor your setups and alerts. As a stock hits your early alerts, prepare your order with your broker. If you are finding that there is still too much going on, limit the number of stocks on your daily focus list even more to just one or two.

As the stock is hitting your early alerts as well, double-check that it is fulfilling the requirements of your setup and entry tactic. Be very restrictive. If you require a certain amount of volume for instance, make sure that volume is running much more than average.

If the stock triggers your entry conditions, place your order with your broker. Also enter your stop loss that you had planned before.

Once you are in the trade, continue to monitor the stock, but there is no need to watch it constantly. Cheering it on won’t help it push higher. We like to place alerts just below our entry price as well as just above our stop loss to keep tabs on the stock.

The best trades often make immediate progress and push higher throughout the day. If a stock does not trigger alerts in the morning, there is often a period of opportunity later in the day after lunchtime or in the last hour of trading.

Near the close, check up on any executed trades. Ideally they are closing strong, and we already are at a few percentage points of profit. Determine how the stock is acting and if you will hold it at least until the next day. In choppier markets we may take a trade off if it has not shown much follow-through or if we are down on a position near the close.

Check in with your stop loss and position management rules to see if there are any actions or adjustments that you have to make.

Once the market closes, review your trades for the day and journal any thoughts or potential opportunities for improvement. We will dive deeper into this process in later chapters.

TRADER'S HANDBOOK CHALLENGE 5

Annotate a full trade of a market leader of your choice from a breakout to where you would sell into strength or weakness. Label key price and volume characteristics. Be sure to share your work on twitter and tweet at us @TraderLion_ and #THChallenge

KEY TAKEAWAYS

Here are five key takeaways from this chapter:

1. Your sell rules should match your goals and trading style.
2. Early stage traders should focus on building consistency with a set of sell rules.
3. Selling into weakness and selling into strength both have pros and cons.
4. The goal is to capture the majority of the trend that is relevant to your time frame.
5. You should have defined steps for trade execution and position management.

BONUS RESOURCE

We recorded a webinar on sell rules, selling into weakness, and selling into strength.

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

CHAPTER 8: MARKET CYCLES

"At least 50% of the whole game is the general market."

—William O'Neil, Market Wizard

When you look back at your trading results, are there periods where you have found tremendous success with your trading style?

Have there also been periods where you felt like even the most perfect setups failed and you couldn't seem to make a winning trade?

This all has to do with market cycles—the natural shifts in market environments that lead to uptrends, downtrends, and choppy sideways markets.

In this chapter we will show you how to develop a system to identify the current market environment so that you can know with clarity how aggressive you should be when trading.

The best traders can clearly identify when market factors align, and their system will be extremely profitable. Similarly, they have the awareness to scale back their trading when the opportunity period is over, and their style will not be as effective.

This is one of the keys to becoming a Stage 3 and Stage 4 trader, and being able to make progress and protect it, experiencing only minimal drawdowns.

In this chapter we will:

- Further define a market cycle.
- Cover how to pick the criteria to define yours.
- Create an example system designed for swing traders.

- Cover how you should trade during a cycle including coming from cash.
- Provide examples of long-term and short-term cycles for you to study.

This is one of the most important chapters. Being able to identify where you are in your market cycle will ensure that you are always able to trade with the wind at your back. This reduces stress, frustration, drawdowns, and better yet, helps you make and keep profits more easily.

Let’s dive in!

WHAT IS A MARKET CYCLE?

The patterns we see in the market are a reflection of human psychology. Based on this, the market and its leadership follow a template that is cyclical which, if you study history, occurs again and again.

These cycles, where we see uptrends and downtrends, can be identified using systems that allow us to maximize our profits and exposure in positive environments, and tailor back exposure and protect profits during negative environments.

The market cycle is composed of two different layers. The first is the technical layer, which involves the amount of liquidity available in the marketplace. This drives the longer-term cycles we see in the market, from bull to bear markets.

The second layer is the human psychology layer, which causes shorter-term fluctuations in the market. This layer is driven by fear and greed as market participants either accumulate or distribute stock.

After a strong short-term move up, some market participants will take profits, locking in gains and causing a pullback. These uptrends and downtrends within the longer-term cycle are important for traders to recognize in order to determine how aggressive and exposed they should be.

Throughout history, market cycles have played out over and over again. To trade sustainably, you need to develop a system that can identify and weather the market's movements.

WHAT CRITERIA DOES A MARKET CYCLE SYSTEM REQUIRE?

To create a market cycle system—which we will show you how to do in short order—you need to define specific criteria that combine to both start and end a market cycle.

These criteria should be based on factors that create a conducive environment for you to trade within. They should also be easy to interpret and provide a clear signal.

The criteria should also line up with your time frame. Long-term position traders should not create a market cycle system that provides them with signals every other week. Instead you should design one that captures the longer-term trends in the market. Swing traders, on the other hand, should design a system that is nimble enough to identify shorter-term uptrends and downtrends.

A market cycle system is a guide for your trading, letting you know when it is appropriate to become more aggressive, and when it would likely be best to pump the brakes and focus on capital protection.

When your cycle turns on, it does not mean that you should go 200% long immediately, but instead you should begin the process of testing the waters and then listening to market feedback.

Similarly, if your market cycle turns off, focus on each of your positions and how they are acting. You can listen to that feedback to decide if you would like to cut exposure.

Key reminder: Remember that like any trading system, your market cycle will not be perfect. It will provide false positives and false negatives. Treat it as confirmation or a sign to change your mindset and encourage you to take the appropriate action that the market is indicating.

HOW SHOULD I PICK THE CRITERIA TO INCORPORATE?

To pick the criteria you will use, study past environments where you felt that your style produced strong results.

With these environments selected, consider how to define it:

- Were key indexes trending above certain moving averages on different time frames?
- Which breadth indicators helped identify the start and end of this opportunistic environment?

As we will discuss below, you can also use key stocks—market gauges—that are representative of institutional appetite to serve as gauges of overall market health.

The bottom line for when you are creating your system is that the criteria should matter to *you*. Think about what factors you look at on a daily and weekly basis to analyze the market and incorporate those.

HOW DO MARKET GAUGES HELP US IDENTIFY MARKET CYCLES?

In addition to market indexes and breadth metrics, you may choose to add market gauges to your toolset for determining market cycles.

Market gauges are key stocks that institutions are currently supporting/accumulating. We choose these stocks by identifying key growth names as well as the best stocks in the current market leadership.

TSLA and GOOGL are good stalwarts because of their status as institutional favorites and also their weighting in the indexes. We also choose the top stocks in the current potential leadership groups. For instance, in 2023 and 2024, NVDA was very representative of the semiconductor group which was leading.

The process is somewhat subjective, but the key point is that these gauges are leading indicators of the risk appetite of institutions. If they are being supported and holding key psychological levels such as round numbers, the environment is positive and other trades will work well. However, if they are breaking below levels, that shows that the environment is deteriorating, and you have a reason to be more conscious.

To write a rule around your market gauges, you could add a point if they are above a moving average.

TRADING THE MARKET CYCLE

Let’s now go through the full cycle and the actions you should be taking during each part.

First, when the market is in a downcycle, you should be limiting exposure or taking select shorts. Keep an eye out for stocks that are showing Relative Strength and holding up well. However, especially for Stage 1 and 2 traders, you should primarily be sitting on your hands and in cash until an uptrend begins. Trying to trade these properly in downward or choppy markets is like trying to sail a boat upwind.

As a downtrend persists, start looking for signs that it is losing downside momentum. One of the first signs to look for is that the indexes will begin to hold support, and may start to turn up on daily charts with a rounded bottom look. Or they may show capitulatory action with a sharp drop that recovers quickly after the market has already become extended to the downside.

The second sign you should look for is decoupling between the market and key stocks/market gauges. Keep a close eye on your watchlists for an indication that they are beginning to ignore the actions of the general market.

When we are in a downcycle and the indexes make new lows or gap down severely into the red, be on alert for the watchlists to be performing significantly better. This shows that even though the market indexes are being pushed downward, institutions are stepping in and accumulating promising stocks.

CREATING A SWING TRADING MARKET CYCLE SYSTEM

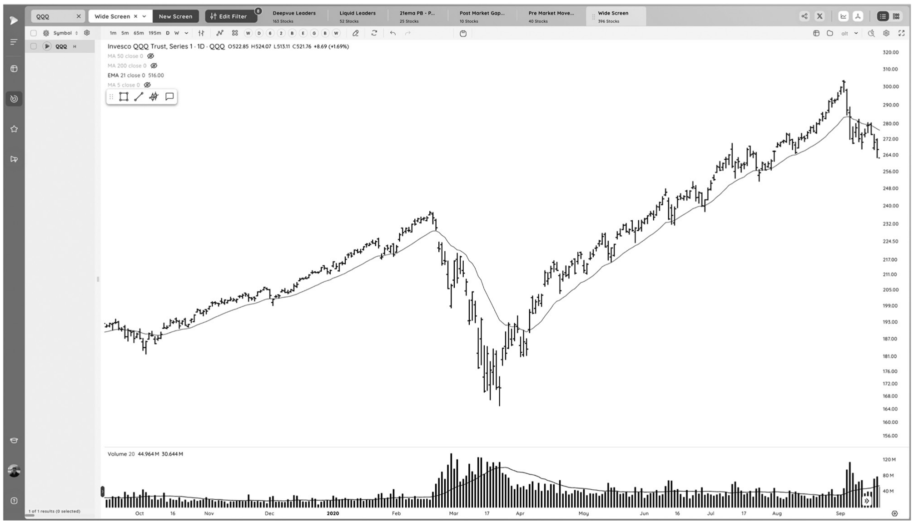
To bring these concepts to life, let’s build a simple market cycle system for swing traders where the goal is to capture intermediate-term trends. We will then discuss how to trade each part of the cycle.

Although our example is geared toward swing and position traders, you can use a similar method for each shorter-term or longer-term trading, just switch out the criteria to what is logical.

To create our system, we will use the 21 EMA and the QQQ as our reference. Looking back in history the 21 EMA does an excellent job of identifying strong upcycles lasting a few weeks to a few months.

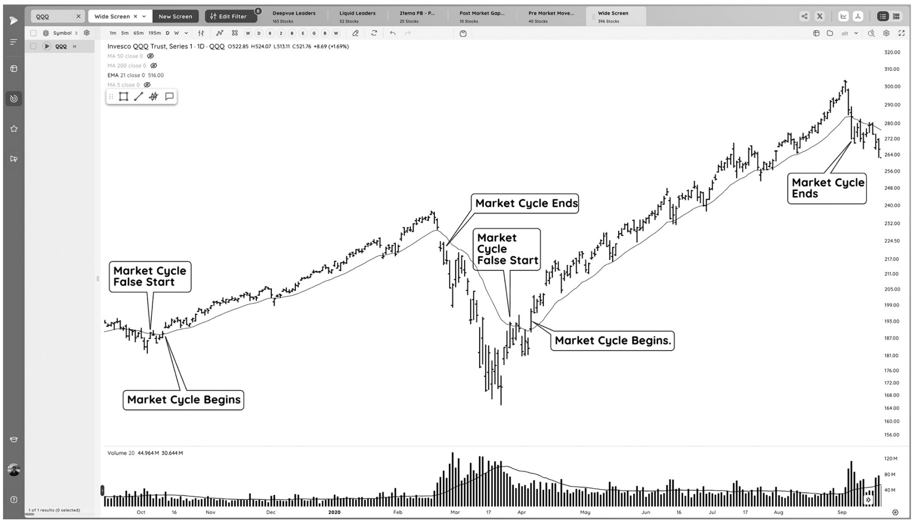
Here is a period from Fall 2019 to Fall 2020.

QQQ Fall 2019 – Fall 2020



To begin a market cycle, our criteria will be a close above the moving average. To end a cycle we will require two closes below the 21 EMA with the second close being below the prior day's low. Here is the same period marked with the start and end to the two cycles.

QQQ Fall 2019 – Fall 2020



You'll notice with these two simple rules you would have been encouraged to participate during strong uptrends and encouraged to be defensive during the worst of sharp pullbacks.

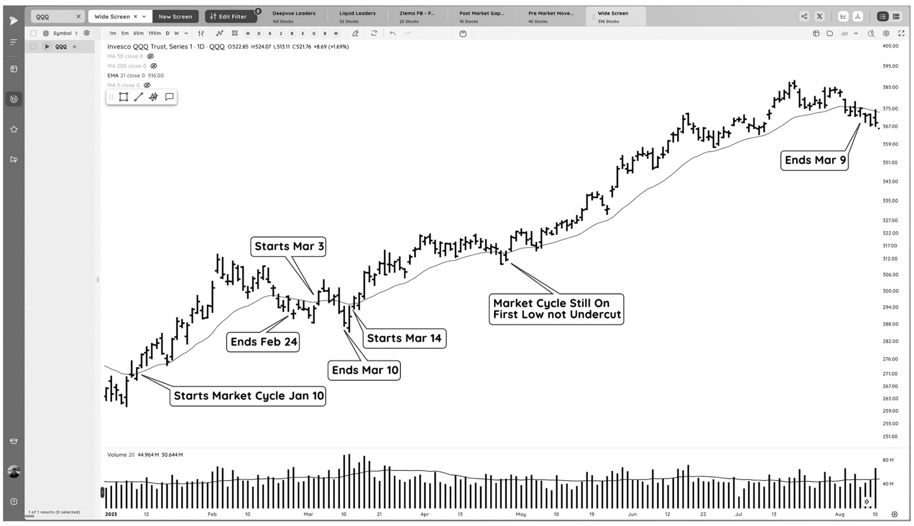
In both cases, and this will be true for most sensitive market cycle systems, there were a few false starts to the cycle. This will happen; what's key for when a market cycle begins is that we get follow through up, and that leading stocks are also signaling a change with strong action, gap ups, breakouts, and multiple mature bases.

Remember a market cycle turning on does not mean you should go pedal to the metal immediately, but it should be a mindset shift to start testing the waters.

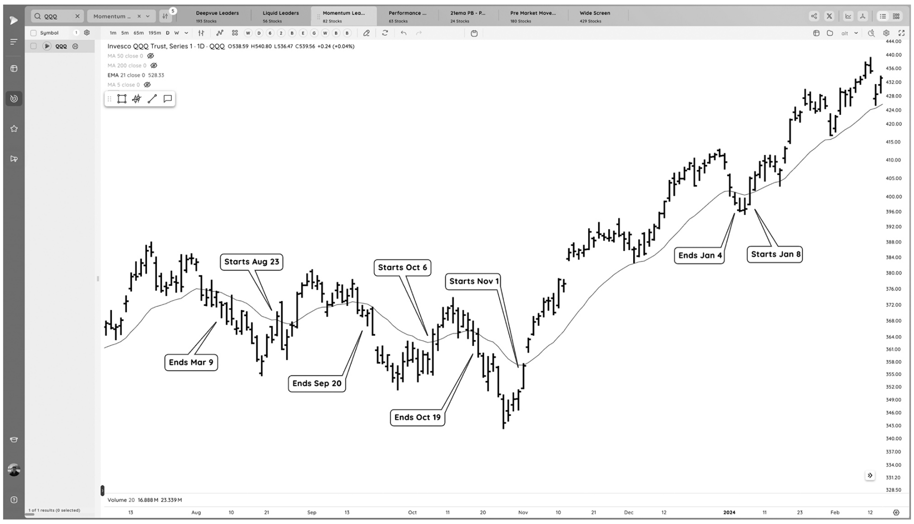
The strongest cycles occur after more significant corrections or extended bear markets. After such periods most will feel tentative about the market. However, these uptrends, when they take hold, can lead to the strongest performance and longest moves.

This criteria is designed to give QQQ the benefit of the doubt when it is in trend. Here are examples of this market cycle applied to 2023.

QQQ Jan 2023



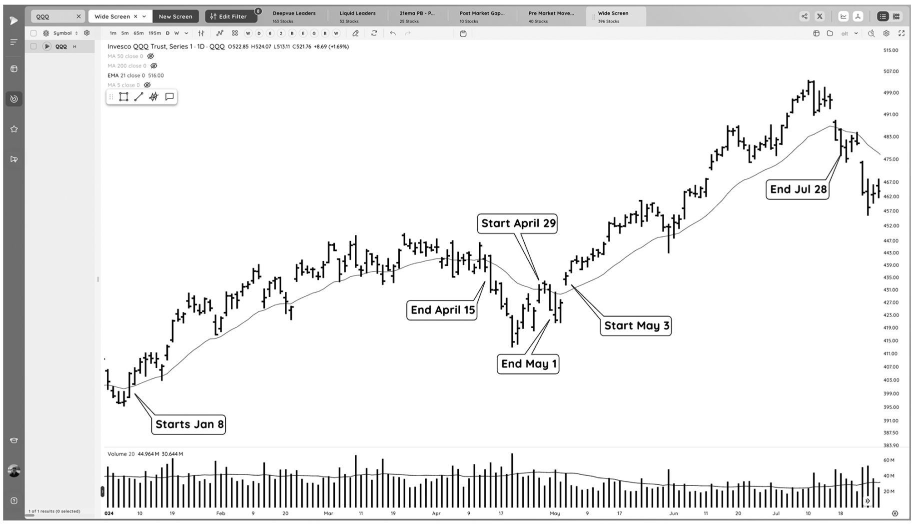
QQQ Fall 2023



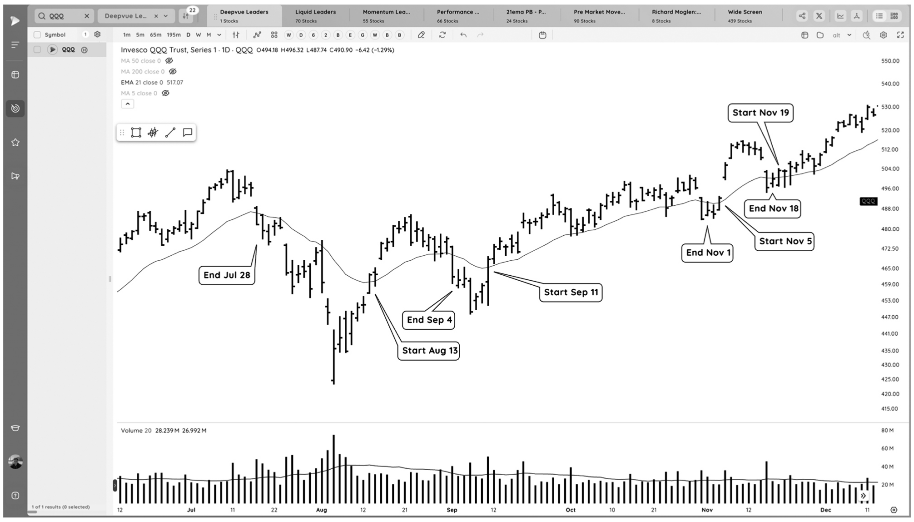
You can see that although there may be false starts during choppier periods, this system does an excellent job of capturing the meat of intermediate-term trends.

Here’s 2024:

QQQ Spring 2024



QQQ Summer 2024



So now that we’ve defined our system, how do we actually trade it?

THE CYCLE BEGINS

The cycle begins when we close above the 21 EMA. At this point liquidity is improving and we are at the very beginning of a promising period.

The first one to three days of a new cycle are the best risk/reward opportunities for taking advantage of the move. You should look to add exposure using ETFs or by taking trades in the most promising stocks in the market that are setup and leading the market.

You should quickly get feedback on whether these trades are working or not. If they are, increase your exposure. Stage 1 and 2 traders can start with half their normal position size, building up to full size after positive traction in their first few trades. Stage 3 and 4 traders can work more quickly based on intuition as well as how much traction they are getting.

If the feedback is negative and you get stopped out, regroup and wait for another start to the cycle. There is a balance between putting on exposure quickly enough to make progress, but deliberately enough to protect your downside if the market reverses.

STRESS TESTS

Stress tests are when we see a sudden negative day within the start of a new uptrend. These are a natural part of the cycle where profit taking takes hold and we see the market test the strength of the rally.

The first stress test generally occurs on days four to six of the cycle. How your portfolio, watchlists, the leaders, and the market as a whole respond to this bout of selling provides valuable information about the strength of the rally.

If the market holds firm and recovers from the initial weakness, we should expect the rally to extend further.

When days four to six roll around, you want to be ready for the stress test and be in a winning position risk and stops wise.

Even if all your positions at that point are stopped out, you want to ensure that you will be making a higher low on your equity curve.

In general, traders in Stage 1 and 2 should focus on interpretation of the cycle, while Stage 3 and 4 traders should look to anticipate this.

TRADER’S HANDBOOK CHALLENGE 6

Bring up a chart of QQQ in your trading software and go to 2019. Label the market cycles through using the 21 EMA system we covered in the chapter. Be sure to share your work on twitter and tweet at us @TraderLion_ and #THChallenge.

TRADING LATER IN THE CYCLE

After the first stress test your portfolio should continue to progress, and you can continue to take fresh trades.

There will be continuation stress tests every so often, so never get complacent in managing your risk and listen to the market for feedback.

After a few weeks, keep an eye out for longer consolidation periods or even the end of the cycle. Trends last longer than we think, but stay focused on the best stocks and low-risk entry points, becoming stricter as the trend progresses.

The risk/reward is not as good so you should adjust accordingly. You can think about this in the same way that you don't want to add too heavy a position far above the proper pivot point. Keep your portfolio cost basis low and add less size later in the trend.

Stocks that are just now breaking out multiple months into a cycle are laggards and more prone to failure. Stick with the leaders and remember that the goal is to have enough of a profit cushion that the moving average rises above your cost basis.

When this is the case you can let the trend work for you and let the stock fluctuate naturally. In strong cycles this allows your swing trades to transition into position trades to maximize profit.

KEY TAKEAWAYS

Correctly identifying the current market cycle is one of the most important aspects of trading. It will help you trade with the market at your back and position in promising stocks as the market becomes conducive to your style.

Look back on your trades and determine certain periods where you made a lot of progress. What did the market look like during these times? Distill criteria that define a good trading environment for you and create a system that will turn on during these periods.

Remember that this cycle is a guide, and that you should ultimately listen to trade feedback to determine how to regulate exposure.

The goal is to get from a state of interpretation to anticipation. Stage 1 and 2 traders should focus on identifying cycles, while more advanced traders can look to anticipate and position earlier as they notice the environment changing.

Market cycles will help you become more fluid in your interpretation of the market health. Instead of labels like bull or bear market, you will develop for yourself a more refined way to identify when there is easy money to be made, or if you would be better off going fishing.

Identifying the market cycle should be a part of your routine as a trader. We'll help you create this routine in the next chapter.

See you there!

BONUS RESOURCE

We recorded a webinar on market cycles and how to trade during different parts of them.

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

CHAPTER 9: STOCK SELECTION, SCREENING, AND TRADING ROUTINES

"A good company doesn't always mean it's a good stock. The first rule to superperformance is… all stocks are bad unless they are going up."

—Mark Minervini, 2x US Investing Champion

EVERYONE WANTS TO own a stock that can double or triple in a short amount of time. But how do you find them? And more importantly, how do you set up a system so that you can do it consistently each market cycle?

This is what we will cover in this chapter—stock selection, screens, and routines that save you time and help you find and focus on high-potential stocks.

We've already discussed the edges and price/volume characteristics in previous chapters. Now we will talk about how to make use of technology to find stocks easily that fit those criteria.

We will share the screens that we use daily and weekly to stay in tune with the market and find high-potential stocks, as well as how you can design your own screens that are tailored to your specific approach.

THE THEORY OF STOCK SELECTION

We want to be focused on in demand names that have the potential to double or more in the right market environment.

How do we find these? The answer is to follow the template that the market has created for us. If you study history, many of the strongest performing stocks shared both fundamental and technical characteristics.

Many of the characteristics we look for are neatly described in William O'Neil's CANSLIM methodology, which we encourage all our readers to study in his book *How to Make Money in Stocks*.

However, we do have our own spin on things. Our own acronym that summarizes what we are looking for is TIGERS:

- **Theme**—The stock is riding a strong growth theme.
- **Innovation**—The company has a standout product, service, or element that separates it from its peers.
- **Growth**—The company is currently growing its earnings and sales rapidly, or is projected to in upcoming quarters. Quarterly triple-digit growth year over year and acceleration are preferred.
- **Edges**—The chart is displaying at least one of the chart edges we described in Chapter 3.
- **Relative strength**—The stock is displaying unusual strength, outperformance, momentum, and trend.
- **Setup**—The stock is forming an actionable setup.

Theme

Each market cycle (and year) there are distinct themes created by the driving forces of the world and technology.

Within these themes there will be specific companies that ride their waves and grow extremely fast. This growth leads institutions to build positions, driving prices higher, and creating extraordinary moves that we can join as retail traders.

There are two main types of themes: transformative and cyclical.

Transformative themes are largely created by the development of new technology that significantly changes how we live. Some examples of driving factors would be locomotives, steel, electricity, radio, television, rockets, semiconductors, the internet, smartphones, and, currently, artificial intelligence. These themes can be long lasting, and multiple waves of innovation can continue to create fantastic opportunities for new companies to grow.

Cyclical themes are more driven by the economic cycle and macro conditions. Examples are energy, construction, banks, and airlines. These themes may have their day when conditions line up, but often these themes are shorter lived and produce less meaningful opportunities.

During each market cycle, there will be a handful of themes that propel the best stocks higher. If you can track these themes, and notice group moves, you will be well on your way to identifying the top stocks of the cycle.

Think of it this way. When the market is healthy it creates a strong wave that lifts stocks and creates trends. When a larger disruptive theme is emerging and thriving, institutions will look to accumulate positions in the stocks from that theme. This creates another wave.

And if a particular company is extremely well poised to profit from a larger theme, for example if they have the best product, then they will create their own personal tailwind.

When these three waves combine and are all working together, that is when you can find a special stock that can rapidly appreciate in price. Although all the stocks in the theme may do very well, and even laggards within the group may do better than the best stocks outside of the theme, the leader will be head and shoulders above the others.

Your goal should be to identify the top one to three stocks within the current transformative theme of the cycle. We can’t predict what they will be, but they will be standing out in terms of momentum, Relative Strength, orderly price action, and edges.

Innovation

The leaders of a theme will often have a unique value proposition that is leading them to rapidly grow and take up market share. This could be a new product that leverages a proprietary technology, or a unique approach to solving the most important problems of their customers.

When you discover a theme, try to get a feel for which companies are really on the edge and bringing forward the technology. Read articles, listen to podcasts, but remember to try to avoid sensationalist perspectives.

Everyone will try to say that their product will change the world. Try to take a step back and see what the majority of subject matter experts are agreeing upon.

If possible, try to experience the company and product for yourself, which can give you a unique insight into what sets it apart.

One thing to remember is that even a supposedly great theme, technology, or product does not matter if the market does not care about it. It should be obvious based on the price action that institutions are taking notice and are believers.

So remember, however in-depth your research is, if the price action does not fit your thesis, don't fight it. Look elsewhere and maybe return once the market has started taking notice.

Growth

We look for strong and significant earnings and revenue growth. Revenue growth in particular is extremely promising since, in today's markets, more companies seem to be focused on growth at all cost and may forgo profits momentarily.

However, there should be a sense that profits are on the near horizon, and occasionally markets, especially during tighter monetary cycles, may focus almost solely on companies that are making money. Stay fluid and look for growth.

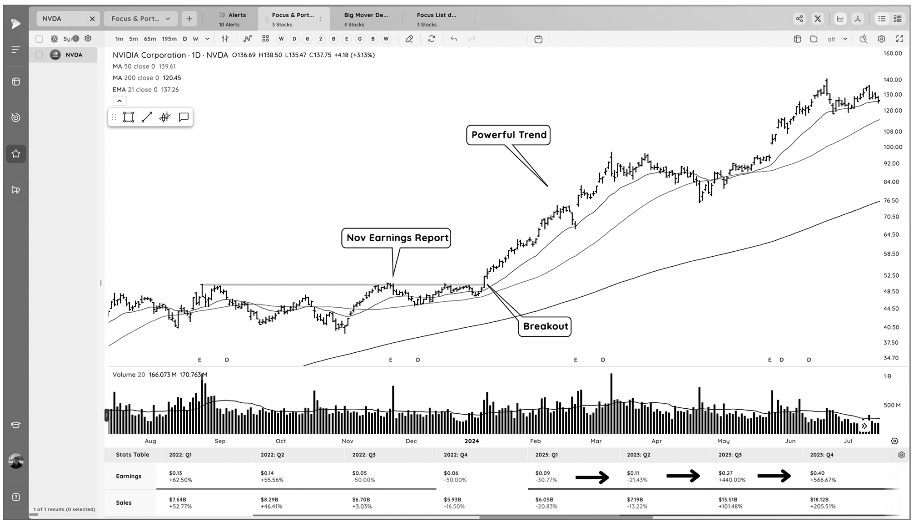
You’ll see in the screens we share later a few ways that we incorporate these criteria. In short, however, we like to see at least quarterly growth in earnings or sales of 25% when compared to the same quarter a year prior. The higher the better, with triple digits preferred.

Additionally, we like to see acceleration in growth, meaning we like to see growth trend for instance from 25% EPS growth to 40% to 80% in sequential quarters.

In November 2023 NVDA reported earnings growth of 566%. The previous quarter it also showed strong growth of +440%. The prior quarters were negative but were becoming less so, and NVDA was posting earnings and sales surprises with each report. This showed rapid demand and growth in market share as the leader in the semiconductor/AI theme.

In Deepvue, we highlight growth trends like this by underlining the earnings data in the table with a blue bar.

NVDA Accelerating Earnings Growth Trend



Edges

Although the fundamentals of a stock are important, the accumulation of the company must ultimately show up in the charts in the form of edges and unique technical characteristics.

We discussed these previously in Chapter 4, but as a reminder we are looking for clear signs that the stock is in high demand by large players.

The stock will show the ability to trend in an orderly fashion when the market is strong. It will seem to fight downtrends and/or bounce quickly up after market corrections end. It will gap up on earnings and breakout and trend from base patterns.

We are not looking for a beaten down stock that nobody wants. We are looking for a rising leader that has already caught the eye of institutions and is already showing outperformance. We are looking for a stock near the beginning of its move, but don't feel the need to "guess" that a stock is under accumulation.

Relative strength

The Relative Strength should jump out at you. It should be close to the top of the leaderboards in terms of three-month Relative Strength, and should continue to trend and obey moving averages.

Large gap ups, respect for moving averages, leading the market in the market cycle, are all signs we look for that a stock is showing Relative Strength.

Setup

In terms of stock selection, this is the last piece of the puzzle. Once you've identified a potential leader in a theme, keep track of it on your watchlists and wait until it develops a setup that you have studied and can trade effectively.

This will look different for each trader, but we’ve covered many options in Chapters 4 and 5.

COMMON STOCK SELECTION QUESTIONS

Do you only trade leaders?

Not necessarily, there are times when secondary stocks in the theme may be outperforming for even weeks on end as the leader’s base. These stocks, which may not quite have the fundamental story or liquidity, can still make great trades, but they may be more volatile and better suited for swing trades and treated as “performance enhancers.”

Do you trade stocks outside of themes?

Yes! Some stocks may lack a larger group theme but still in their own right be forming great trends and growing fast. However, the odds are more in your favor if an idea is part of a larger wave.

Do you buy and hold leaders?

Although leadership stocks may make fantastic moves over a span of a few years of several hundred % or more, nothing is known for certain ahead of time, and therein lies the opportunity. You never know if a leader is about to break down for good as it forms a base.

However, leaders can be traded multiple ways with different time frames. Because of their extended outperformance, day traders, swing traders, position traders, and active investors can all look to enter the trends and ride them during the periods that match their strategy.

The advantage is that these leaders have an underlying institutional bid that makes them respect support and key levels which helps traders of all styles manage a trade more effectively and sit with the trends.

Eventually, all great stocks will lose their momentum and either start a longer-term downtrend or base for an extended period of time. Many leaders decline significantly off their peak and are best avoided until they reset and start a new Stage 2 uptrend.

What if a stock has a stellar chart but does not have earnings or sales growth?

This can still be traded to great effect but may be treated more as a secondary name. However, investigate the stock and see if it is part of a different type of theme, or if EPS and sales growth is expected in the near future.

For instance, a recent theme has emerged where heavily shorted stocks can go on tremendous moves, led by social media interest. The best recent example is GameStop (GME).

These moves have a different type of underlying driving factor and are often more short-lived, albeit spectacular. You can trade them, but you just have to be aware of the dynamics at play and maybe recognize it’s more of a swing trade type situation.

BUILDING SCREENS

Now that we have discussed the high-level frameworks of what we look for, let’s discuss specifically how to find these types of stocks.

We will walk through our process for creating screens (including a lot of examples) and we will also discuss a weekly and daily routine that you can use to apply them.

General versus specific screens

Let's cover on a high level what we as traders are looking to accomplish with screening.

Then to close, we'll build a high-quality screen that in seconds can help you find top growth stock trading ideas.

The goals of screening

What are we actually trying to accomplish when it comes to screening? Well, there are two main objectives:

1. Consistently find high-quality and actionable trade ideas.
2. Gain a feel for the health and breadth of market action.

Let's dive into each one.

Objective 1: Consistently find high-quality ideas

When it comes to point number 1, it is extremely important to remember that although screens can be very helpful in narrowing your focus, as a final step, you will have to review charts manually to find the best ideas.

However, screening can save you quite a bit of time and allow you to review dozens or only a few hundred high-potential charts instead of painstakingly going through thousands.

Think of screening as a funnel. You start with all the potential stocks in the market and then add restrictions and filters.

This squeezes down the pool of potential stocks until you are left with only the best that meet your trading style's criteria.

Objective 2: Gain a feel for the health and breadth of market action

This is the second objective of screening and is very underrated in our opinion.

By screening and reviewing charts regularly, you will get a sense of what to expect from the stocks that pass through your filters, and you will also build intuition around the total number of results and setups.

This will help inform you about whether there are a lot of trade ideas working, or if you are seeing a lot less than usual as the market weakens.

Say you are a trend follower and have a general screen that looks for stocks trending over the 21 EMA, 50 SMA, and 200 SMA.

Typically, this particular screen returns about 200 names in a healthy market. Then, one week, you notice that only about 77 names are showing up and looking around you see a lot of stocks breaking down.

This is valuable information that you've gained through your routine that tells you that a negative change is starting in the market.

Similarly, if a screen like this provides a lot more results than normal, it can be a sign of a broadening market with many great opportunities developing.

STRUCTURING A SCREEN

Creating screens is an art form, and often many tweaks and updates are required to get them right.

However, we do have a framework that we use consistently to speed up the process. We'll talk through the major steps and also create a live example here with you.

Here are the major steps we will cover:

1. Planning and analysis:

   a. Define the purpose of the screen
   b. Identify your model stock (the textbook result for your desired screen).
   c. Define its characteristics:
      - Break down the fundamental data points
      - Break down the technical data points.
2. Screen development:
   a. Create a prototype
   b. Analyze the results
   c. Update the criteria
   d. Repeat until satisfied.

These steps can be used to design any screen for any style. They create a loop that you can repeat to create new screens or tweak existing ones.

Now let's put them to work.

Define the purpose of the screen

One key point to remember as you are designing the purpose of your screen is that you should decide upfront whether this screen will cast a wide net or look for very specific situations.

General screens are great for general idea sourcing and building situational awareness, while specialist screens look for unique opportunities or patterns that appear only every so often.

With general screens your goal should be to come up with around 75–400 strong candidates. With specialist screens the results should ideally be less than 50 and fit a very specific situation and setup.

Let's create a screen that identifies strong, liquid stocks that are in uptrends and have strong earnings growth in the most recent quarter.

Identify your model stock

With this purpose and scope in mind, NVDA in early 2023 is a good avatar to think of when designing this screen.

Define the characteristics

Fundamental

We want the stock to have strong earnings growth last quarter and be liquid, so let's choose these data points:

- Average dollar volume (Price of the stock * Average daily volume)
- EPS growth last quarter.

Technical

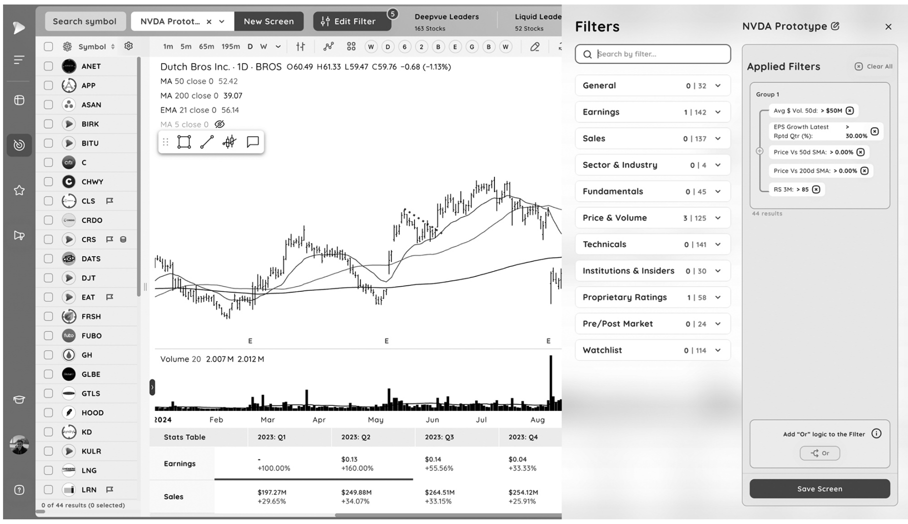
We want the stock to be in an uptrend and have strong Relative Strength. With this in mind let's use these technical data points:

- Relative strength rating three-month (ranks the price performance in the last three months of all stocks on a percentile scale)
- Above the 50 SMA
- Above the 200 SMA.

Create the first iteration

With these data points in mind, here is the first iteration of the screen in Deepvue.

NVDA Prototype Screen - 1st Iteration

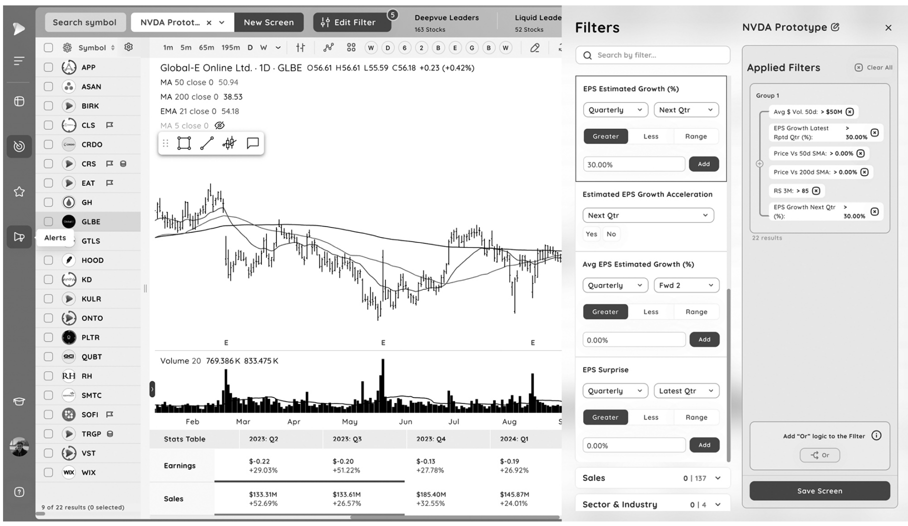


Analyze the results

Looking at these results we realize that we also want strong EPS growth estimates for the next quarter, so let's add this data point.

Updated screen

NVDA Prototype Screen - 2nd Iteration



There we go, that looks a lot better. These are liquid stocks that are growing rapidly and have a good runway for the next quarter.

We can also note the number of results we see and keep an eye on how that fluctuates based on market conditions.

We hope you have a good sense of these steps, but remember, we will revisit them until you have mastered this process and become a pro at designing and analyzing screens.

This is a crucial part of becoming a top trader.

TRADING ROUTINES

In trading, we may not be able to control the outcome after we place our order, but we can control the quality of our decision making with thorough preparation.

Routines are crucial in order to help us create trading plans and stay on top of the markets. If you often feel like you are missing obvious setups, or are out of sync with the market, your routines should be on the top of your list to review and improve.

For stock trading, there are two main routines that you will have to define for yourself:

- The first is the daily routine, the steps you take each trading day to prepare for the open, execute during trading hours, and then build your plan for the next day once the market closes.
- The second is the weekly routine where you analyze the markets, your own trading, and find ideas for the next week.

In the following pages we will share the outlines of our personal routines. As always, take what works for you and make it your own. Remember also to keep it simple. The best routine is the one you can be consistent with. Start with as few steps as possible and iterate as you go.

THE DAILY TRADING ROUTINE

A daily routine, coupled with weekly analysis, allows you to stay in tune with developing themes and jump on trends early.

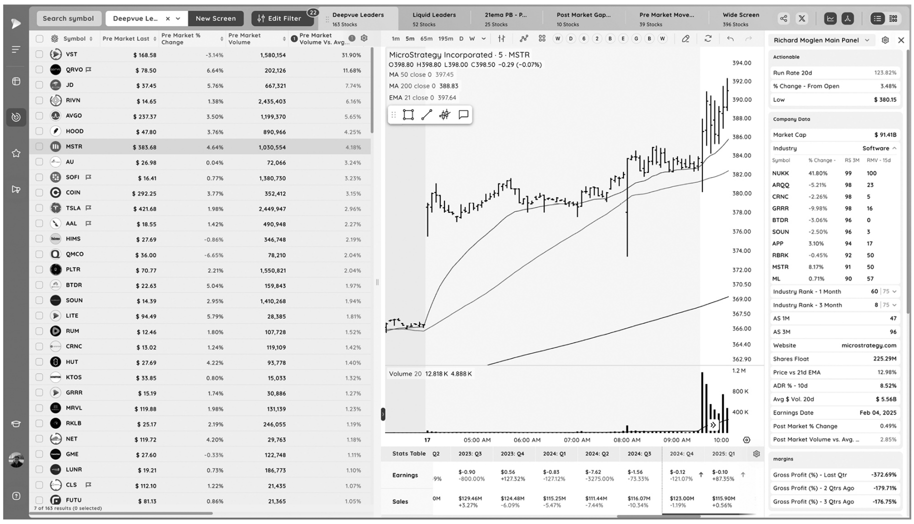
Here's a framework that you can use as your foundation.

One hour before market open

Review premarket price action and finalize your daily focus list of one to five names. Add alerts on your positions, market gauges, focus list stocks, and other key names that you want to monitor. For focus list stocks we like to set early alerts as well that will let us know to watch the stock as it is approaching our buy area.

If it's within your style, screen or sort for premarket high % movers, high volume, gaps… as you can do in Deepvue or similar software.

Pre Market Chart Setup



Also be sure to review your existing positions and see if any maintenance will be required.

Visualize possibilities for how the day may resolve and prepare a game plan for each possibility.

Market open

Track the price action of your positions and top ideas. Sort your main watchlists looking for:

- High relative volume movers
- High closing ranges
- Strong % movers
- Strong moves from the open.

Make any planned entries or sales. Be sure to monitor and reset alerts as they go off.

Quick tip: If the market open feels very hectic to you, consider only setting alerts on your positions and top one-to-three focus list names. This limits the noise and allows you to focus on proper execution.

During market hours

Continue to monitor price action and take notes. Research promising stocks and themes. If you are more on the position trading end, remember to not micromanage your positions.

One hour to market close

Monitor the closes of your positions and top ideas. Note any standout names from your lists and screens.

Stocks may surge upward or downward in the last hour, so be ready for any actions you may have to take. For any newly opened positions check on your profit cushion and make a decision on whether you will hold it overnight.

After market hours

1. Review your actions and complete a daily trade journal.
2. Monitor any earnings reports if applicable.
3. Run your daily screens and prepare your watchlist for the next day.

With this high-level framework in mind, let's dive deeper into how you can sort and screen intraday.

SORTING SCREENS AND WATCHLISTS INTRADAY

During the day, you should be monitoring your stocks, ideas, and taking notes about rotation, strong groups, weak groups, and any other trends you see.

Here are a few helpful data points that you can use to sort your screens and watchlists:

- Volume run rate
- Price % gain
- Daily closing range
- Above volume weighted average price (VWAP).

Volume run rate

Volume run rate is a representation of how volume is tracking versus normal at that instant in time. In Deepvue, we have both a 20-day and 50-day variation.

Our volume run rate data points will let you see how abnormal volume is at any moment in time, even right at 9.30 am after the market opens.

In the first hour, relative volume will let you know which stocks are moving on significant volume, a key indicator that institutions are behind a move and that breakouts may be more likely to hold, as well as breakdowns may be more detrimental.

This will give you a step up versus traders who have to guess by just looking at the raw volume to see if it looks abnormal.

Price % change

Price % change is an obvious but powerful data point that can point you toward the top and worst performing stocks of the day.

In Deepvue, you can sort by this (or price % change from the open) to quickly see the strongest stocks in your watchlists and screens.

On an upside reversal day, where the market and most stocks are rallying strongly from lows, it may also be helpful to sort lists and screens by price % change from lows to see which ones are bouncing the strongest.

Daily closing range (DCR)

DCR is what top traders use to identify Relative Strengths and strong stocks. It represents the location of the close relative to the range from high to low.

On a negative day in the markets, the strongest stocks that day will have high DCRs near 100, even if they may be red on the day.

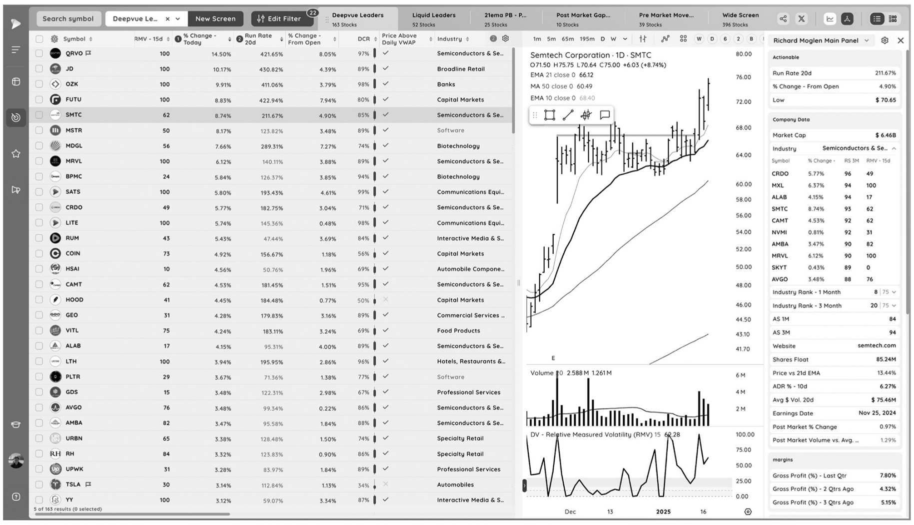
Above VWAP

VWAP is commonly used by institutions to enter and manage positions. Stocks under accumulation will consistently trend above this level.

HOW TO USE THESE DATA POINTS

By adding these data points as columns in Deepvue, you can quickly sort your watchlists and screen results throughout the day to monitor leading names and analyze rotation.

Intraday Data Points

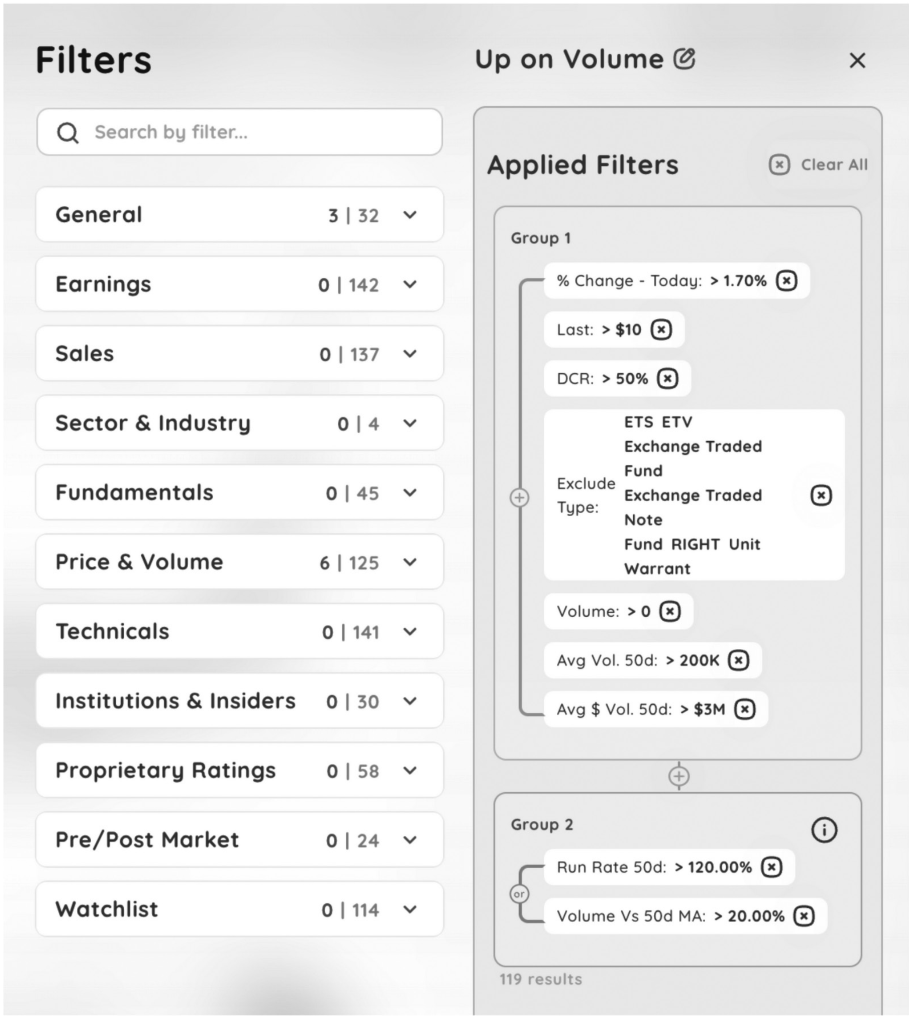


INTRADAY SCREENS

Let’s cover three screens that you can run during the trading day to help fund new ideas and track rotation.

Up on volume

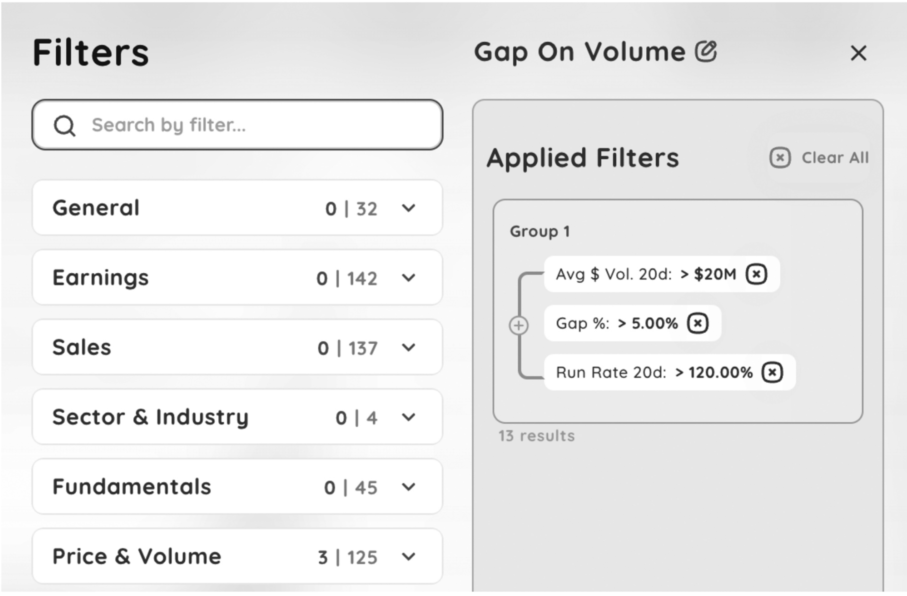
Up on Volume



This is Ross Haber's go-to scan. Simply sorting through stocks that are acting well will enable you to read the pulse of the market.

Gap ups

Gap on Volume

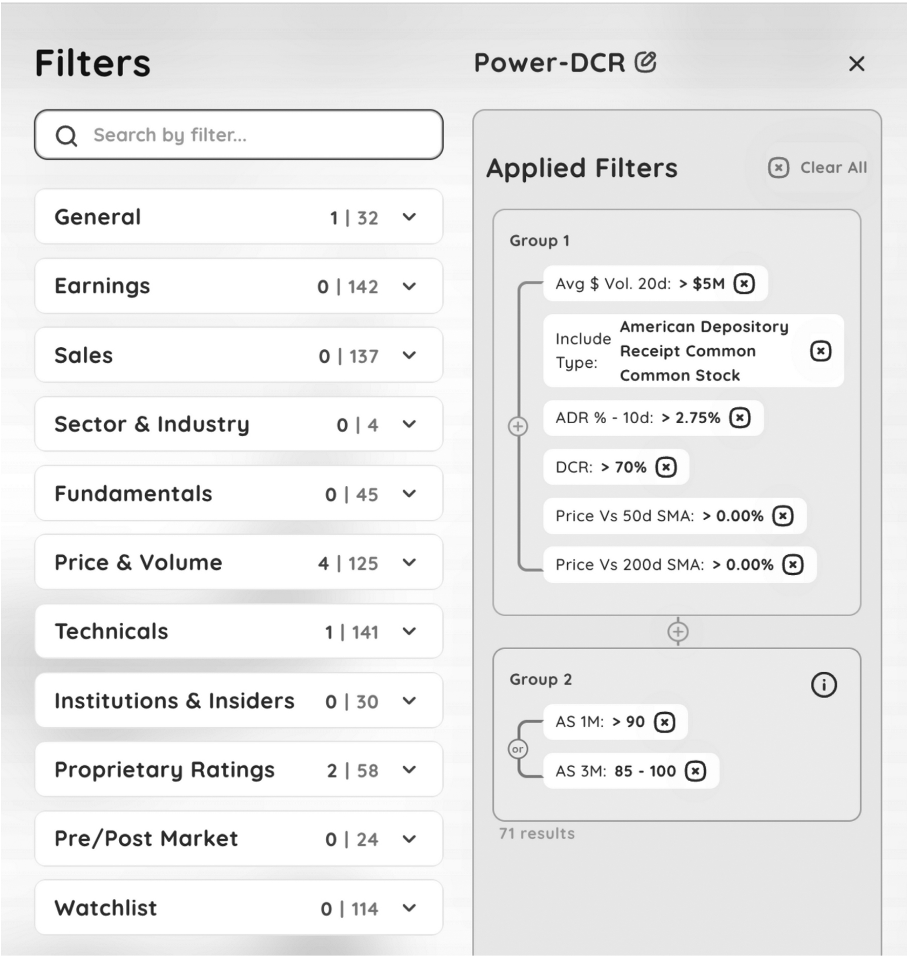


This screen looks for stock with a gap of at least 5% on at least 25% above average volume run rate.

Each day you should track gap ups, especially on earnings. These may or may not be directly actionable, but having them on your radar will allow you to watch for the next setup.

Power DCR

Power DCR



This screen is especially good on down days. It looks for strong stocks in a trend with high closing ranges. Tracking high DCR stocks points you toward the Relative Strength, especially if a whole group is standing out.

POST-MARKET SCREENS

After the market has closed, you should run a subset of your weekly screens that will find any big movers to include on your watchlists.

Then, you should run through your weekly and wide watchlists and build your daily focus list for the next day, jotting down any trends or situational awareness thoughts.

The key thing is that you develop a solid plan for the day surrounding your positions and top ideas.

Remember, even if you work full time and are unable to watch the market, you can do unbelievably well. In fact, in many ways, it is extremely helpful to be away from the noise of intraday price action as it can suck you in and swing your emotions.

THE WEEKLY TRADING ROUTINE

In addition to a daily routine, we also recommend defining a routine that you complete each weekend. It's useful to take a step back and reflect on how you have been trading and any new market developments.

Here is the general framework for a weekly routine:

1. Analyze your actions from the past week. Write down any lessons and mistakes.
2. Analyze the general market indexes.
3. Go through your universe screens:
    a. Save any ideas to your watchlists.
    b. Note any trends and themes developing.
4. Refine your watchlists.
5. Build your weekly focus list.
6. Go enjoy your weekend.

There are many ways to tweak this template to suit your style, but we hope that this general framework serves as a good foundation for you.

We will be discussing post analysis and step 1 in the next chapter and in step 2 you want to apply your market cycle rules to determine the health and breadth of the current market.

With those covered let's go into more detail on how to screen the market and refine your watchlists, which is a common pain point among the traders we've mentored.

BUILDING YOUR STOCK UNIVERSE

What is a stock universe? Well it is generally a list of all the stocks that meet your widest criteria for a potential trade.

You should look to have around 400–500 names that form your universe.

Much more than that and the work becomes tedious, and you are likely looking at many subpar charts. Much less than that and you will be eliminating promising charts.

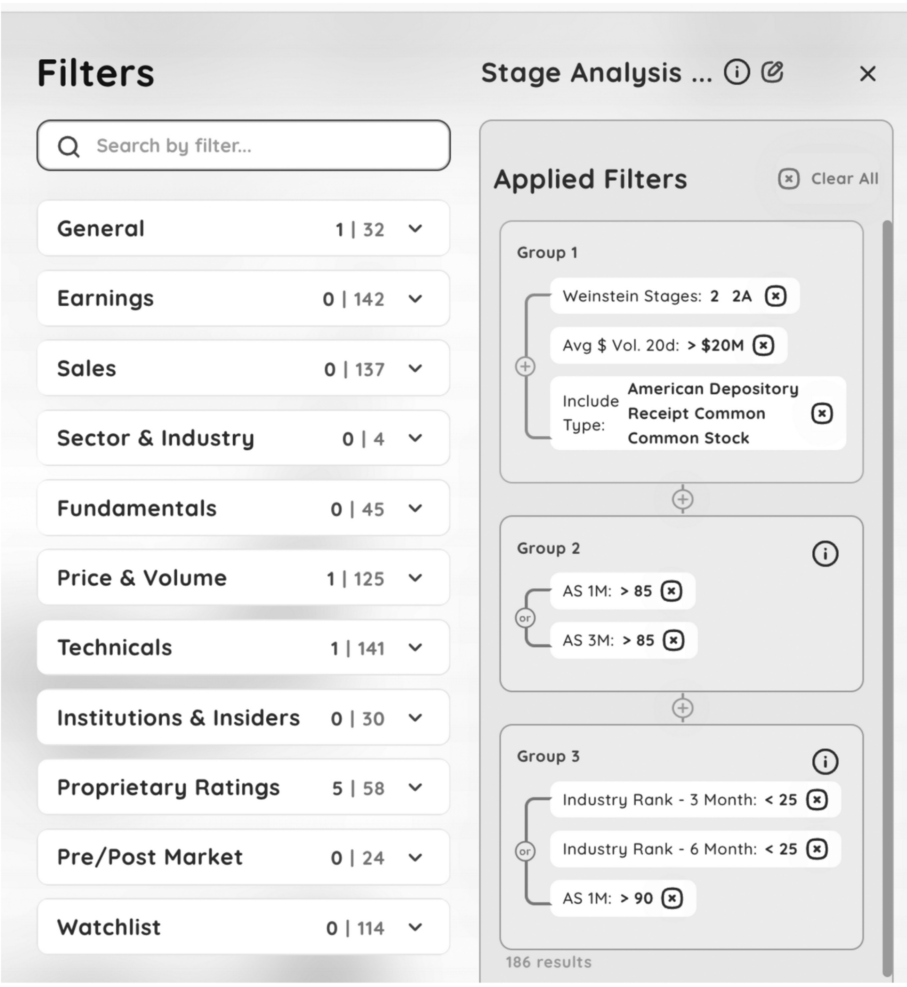
Once you have this universe, you want to either spacebar through each of the charts or run tighter screens on this list.

USING SCREENS TO BUILD YOUR UNIVERSE

Let's now cover some excellent universe screens that you can use for growth style trading. We'll share the specific criteria we use and why.

Stage analysis leaders’ screen

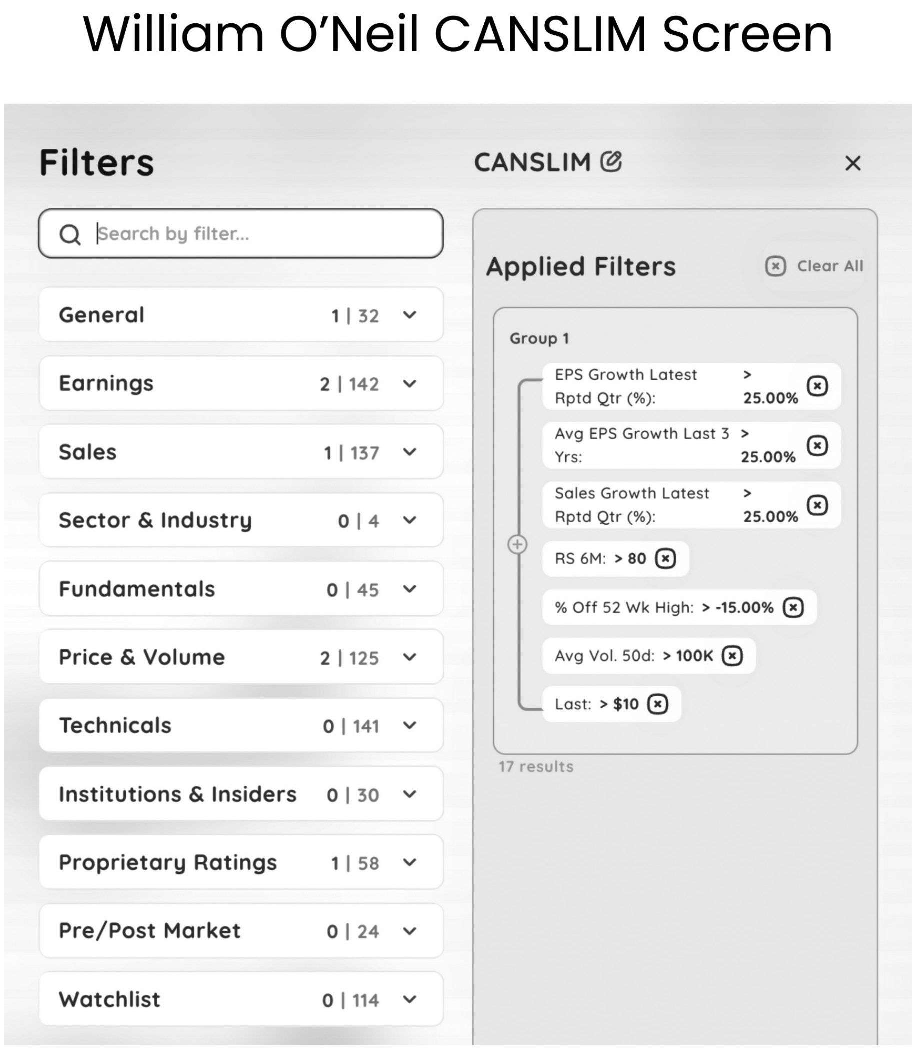
Stage Analysis Leaders



This screen looks for stocks in early Stage 2 uptrends that are in leading groups and either among the strongest stocks this month or over the past three months.

The idea is to incorporate Stan Weinstein’s Stage Analysis methodology and look for leading stocks in leading groups. It typically returns around 100 stocks.

William O’Neil CANSLIM growth screen

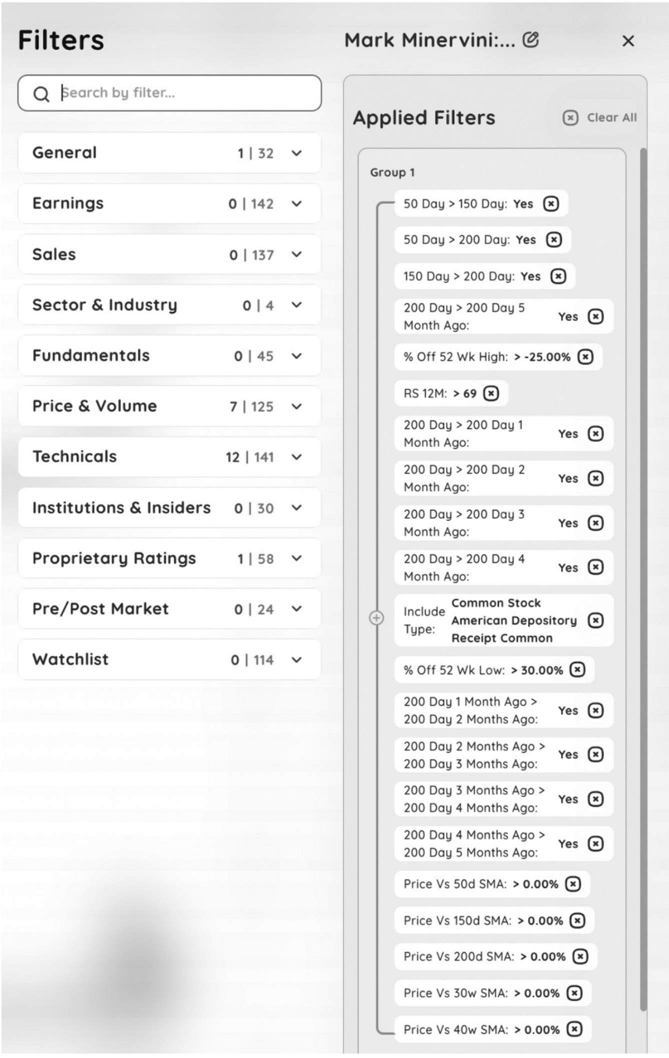


This screen incorporates the criteria that William O’Neil used to find true market leaders. It looks for stocks with strong earnings growth, Relative Strength, and near highs.

It typically returns less than 50 stocks to go through. This is a built-in preset in Deepvue.

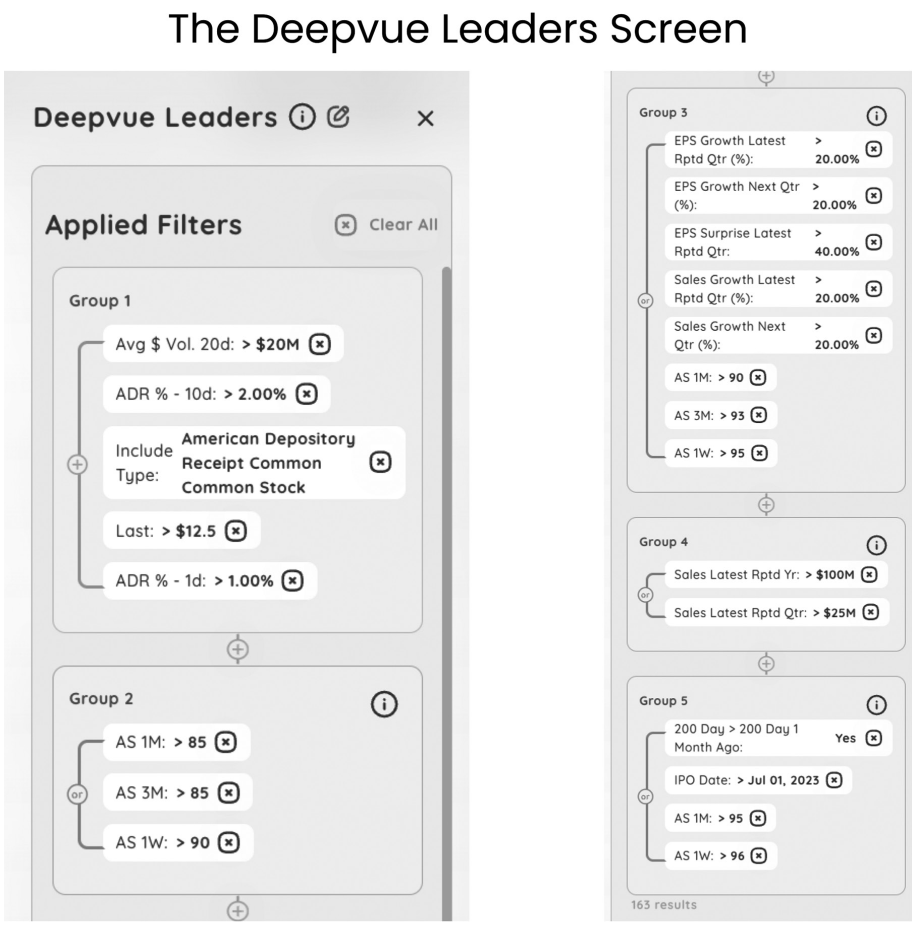
Minervini trend template screen

Mark Minervini Inspired Trend Screen



This screen is inspired by Mark Minervini’s Trend Template criteria. It looks for strong stocks that are in trend. There are preset variations that look for early-to-established trends.

The Deepvue LEADERS screen



This is the first screen that we review on the weekends. It looks for reasonably liquid stocks that are in strong trends and/or in top industry groups.

This screen makes use of the and/or filters in Deepvue. These allow for added flexibility when screening since you can add “or” conditions where only one criterion needs to be true for a stock to pass through.

CREATING AND REFINING YOUR WATCHLISTS

As you go through your screen results, select stocks that look promising for the next week and are close to completing a setup and are showing your edges.

This first pass should yield about 75 stocks to your weekly universe list.

Next, combine this list with a watchlist where you are tracking the highest quality stocks of the cycle. These are the leaders of the market that are trending and riding larger themes.

Now you should go through this larger list and only select the most actionable and highest potential stocks to add to your weekly focus list. Existing leaders should be added if they are setting up again.

Be very selective here. At the end of the process you should have a maximum of around 15 names on this weekly focus list.

Many traders initially have difficulty arriving at a final list. Our recommendation would be to prioritize stocks that are:

- In the strongest theme of the market cycle
- Have shown the most edges and Relative Strength
- Are most actionable and closest to completing a setup.

With your focus list set don't forget step number 6!

Time away from the screens is extremely valuable, not only for your life but to reset your mind, increase energy and focus, and to trade effectively the next week.

TRADER’S HANDBOOK CHALLENGE 7

List out the key steps of your trading routines. Be specific and describe the screens and processes you will use. Be sure to share your work on twitter and tweet at us @TraderLion_ and #THChallenge.

KEY TAKEAWAYS

Here are two key takeaways from this chapter:

1. Use the TIGERS acronym to remember what to look for in a stock.

    1. **Theme**—The stock is riding a strong growth theme.
    2. **Innovation**—The company has a standout product, service, or element that separates it from its peers.
    3. **Growth**—The company is currently growing its earnings and sales rapidly, or is projected to in upcoming quarters. Quarterly triple digit growth year over year and acceleration are preferred.
    4. **Edges**—The chart is displaying at least one of the chart edges we described in Chapter 3.
    5. **Relative strength**—The stock is displaying unusual strength, outperformance, momentum, and trend.
    6. **Setup**—The stock is forming an actionable setup.

2. The two goals of screening are:

    - Consistently find high-quality and actionable trade ideas.
    - Gain a feel for the health and breadth of market action.

BONUS RESOURCE

We recorded a webinar about stock selection and how to create a trading routine.

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

CHAPTER 10: POST ANALYSIS AND TRADING RULES

"The single most important advice I can give anybody is: Learn from your mistakes. That is the only way to become a successful trader."

—David Ryan, 3x US Investing Champion

So far in this handbook we've focused on building your trading system. However, like with any system, it needs maintenance and a feedback loop to stay up to date with the times and increase its performance.

This will be the focal point of this chapter—how to analyze your system and trading performance on both a single trade and portfolio level, as well as how to analyze that information, draw conclusions, and make updates and improvements.

This chapter will show you how to build a clear picture of your trading and allow you to identify both your strengths and weaknesses.

There is a reason that professional athletes watch film of their previous performances, especially in games where they made crucial mistakes. It's because although that particular game may be over, they can learn from it and improve for the next match, series, or tournament. The athletes don't dwell that they had maybe a bad game or embarrassing moment. Instead they recognize that they will likely experience that same situation again and can improve how they handle it.

It is the same for trading. By analyzing past trades, you will notice patterns of mistakes as well as common strengths.

Trading is excellent for this type of post analysis because you will likely have a large sample size of data each month and year. Although it may be painful to look back on your past trades, especially the losses, it is likely the single most impactful exercise that you can do to improve your performance.

Approach it from a mindset that if you had a winner, then great, you can study what you did right and do more of that. And if you are analyzing a loser, then it’s more likely you will be able to identify a mistake that you can avoid in the future.

On my high-school baseball team, before each game our coach would emphasize that we had to minimize the amount of “free bases” that we gave the other team. To count the number of free bases, he would add up the number of walks our pitchers gave up, the number of fielding errors, extra bases that runners took on us after bad throws… any action by us that gave the other team a bonus base.

After each game was over, we would go over each free base and discuss how we could avoid it next time. Some would be unavoidable, but in a game of inches where the difference in scoring could just be one run, free bases became the key metric for us as a team that we worked to improve.

Over the course of the season we gradually gave up fewer and fewer free bases, and ended up playing some of our best baseball and winning the league. Simply by focusing on and trying to improve the fundamental mistakes that we were making, we naturally performed quite a bit better.

Even though it hurt sometimes to discuss overthrows or communication mistakes that led to free bases, we recognized as a team how important it was.

In this chapter we will discuss the equivalent of “free bases” for your trading—key metrics that will help you identify your common weaknesses. In addition to this higher-level view, we will share our frameworks for analyzing single trades as well as how to complete a daily journal to stay in touch with your trading.

Finally, we will cover how you should create trading rules based off your experience and what you have learned from this book in order to codify your trading system.

For Stage 2 traders who feel they are right on the edge of achieving Stage 3, this post-analysis chapter can provide you with just the breakthroughs you need. Take the past six months of your trading data and complete the processes that we will cover, and you will no doubt identify exactly what you need to fix to improve your equity curve.

Now let's dive in!

HOW TO ANALYZE YOUR TRADES

A crucial part of post analysis is analyzing your best and worst trades over a period. This helps you identify not only your biggest trading issues but also the strengths and aspects that you should lean into more.

Picking trades to analyze

In an ideal world you would analyze every single trade that you take. However, this can take quite a lot of time, so we want to make sure we prioritize trades that will likely provide the best insights.

Over a trading period, sort your trades by the % return. To start with, pick your five top-performing trades as well as your bottom ten. If you have more time, analyze the next top five and next ten worst performing trades.

Likely in just this small sample size you will notice tendencies that you make. With these post analyses, depth is more important than the total number of trades that you look at.

Analyzing a single trade

To analyze a specific trade, the first step is to collect information about the trade that is relevant to your process.

This includes a stock chart, the screen/routine you used to find the stock, any journal entries about your trading actions, fundamental information, key news events… whatever you used in the moment to make decisions about the trade.

You can create a trade log sheet to help systematize this process. Once you've created one that you like, it's best practice to fill out as much information as you can in real time.

We have a sample trade log that you can use here.

Sample questions that you can use:

Symbol:

Date:

Why did you take this trade? Be specific. What edges was this stock showing?

What setup and entry tactic did you use?

What position sizing are you using? How did you arrive at that amount? How did you manage initial risk?

How did you manage your position after your entry?

How would you rate your trade execution out of ten? Why? What are your key takeaways from this trade?

This log's goal is to capture the most important information in the shortest amount of time. If you find yourself forgetting to fill it out, eliminate as many questions as you can until it takes under two minutes to complete.

Analyzing your trade on the chart

The first step to analyzing a trade is to go back to your entry point.

In your charting software, go back in time to what the stock looked like at the moment in time that you decided to buy.

Label the chart and analyze the quality of the setup/chart. Note any relevant price and volume characteristics.

Here are some sample questions that you can ask yourself:

What was the template setup/entry tactic I was using with this trade? How would I grade this example of the setup/entry tactic?

Were there clear signs of accumulation before my entry?

Was there a lower-risk buy point prior to my actual entry? Why did I not look to enter there?

What was the trend of the stock on multiple time frames? Was I trading with the longer-term context of the setup?

How was the market/sector/group performing at the time of entry into the stock? Where in the market cycle did you take this trade?

When looking at your trading execution, judge your actual entry point and where ideally you would have wanted to buy for the best perceived risk/reward.

How different was your entry point compared to the ideal? Why was that the case? What would you change going forward?

For each stock case study, after reviewing all your actions, think about what you did well, what you did poorly, and anything else of note about the trade that could help you improve going forward.

It can be difficult looking back on your trades, especially the losers, but remember that the past has already happened and the best thing you can do is study it so that you can trade better in the future.

Consistent 1% improvements over time can lead to dramatic changes in your performance and process.

These improvements are only possible after post analysis that leads you to rule changes and routine tweaks.

EXAMPLE TRADE REVIEW

To walk through this process, let’s examine an example trade in RDDT. The example trader in mind here is a swing trader who looks to hold from base to base for weeks to months. When a position is trending, they like to use 2 closes below the 21 EMA as their final sell rule.

They are looking to risk maximum about 0.75% of their portfolio on a given trade. This trade was one of their best of 2024, but they felt like they left some on the table. The trader made 2 trades of RDDT.

The first was a 10% size trade entering at 61.93, exiting the next day at 58.20 for around 6% loss on the position or .6% of their total portfolio. The second was a 10% size position entering at 66.87 and exiting at 134.77 for around a 100% gain or 10% of their total portfolio.

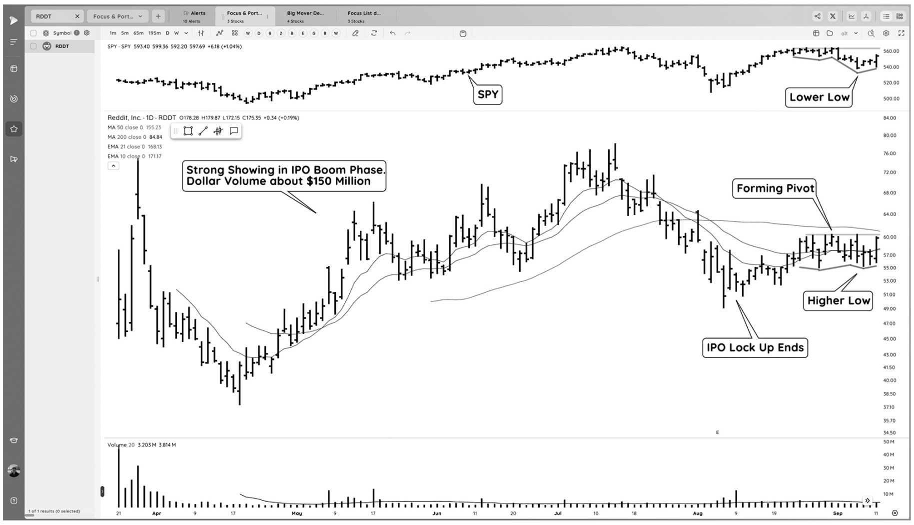
Step 1: Gather Trade Log information on the trades

The trader checked his notes and found the information he gathered on the trades. It’s also good practice to grab any screenshots you have of the chart at key actions like buys and sells.

Here is what the trader noted before Trade 1.

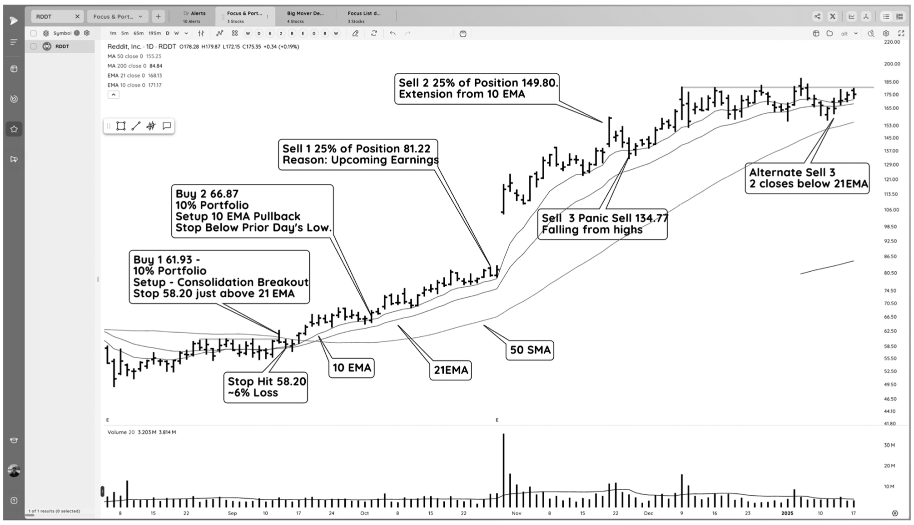
The reason for focusing on RDDT was that it was a liquid recent ipo that had been consolidating for a while and had recently made higher lows in a consolidation while the market was making lower lows.

Reddit Before Trade 1



Step 2: Mark up the chart with buys and sells

Reddit Post Analysis Example



Step 3: Go action by action and grade your plan and execution of that plan

Remember that in the moment you only have the information available to you at the time. It's important to be as intellectually honest with yourself about what you did, why, and what you could do better next time.

For the first trade the reason for purchasing was that it was breaking above the two-week consolidation and the 50 day moving average.

Entry Buy 1:

The plan was to enter on a break above the consolidation pivot of 60.

Looking at his entry the trader noted that he entered late, about 3% above the pivot of the consolidation. He had not placed alerts below the pivot and entered only after noticing it later in the session and not wanting to miss out on the move.

Grading: 6/10

The plan was solid, however the trader noted that he did not follow his routine to set alerts to properly execute, and therefore he entered too late after it had already passed his entry area.

The closer you can buy to your planned entry the better you can manage risk. We typically focus on breakouts of getting in within 1.5% of the pivot.

Position Management and Exit

The planned stop was at the 21 EMA which was at 57.80 the day before. With a 60 pivot this would have been around a 4% position loss or with a 10% position that would be a 0.4% portfolio loss, well within the trader's parameters but also giving the stock a bit of leeway to get going at the pivot.

The next day the 21 EMA had risen to around 58, however, with the poor entry execution the updated stop loss was closer to a 6% loss.

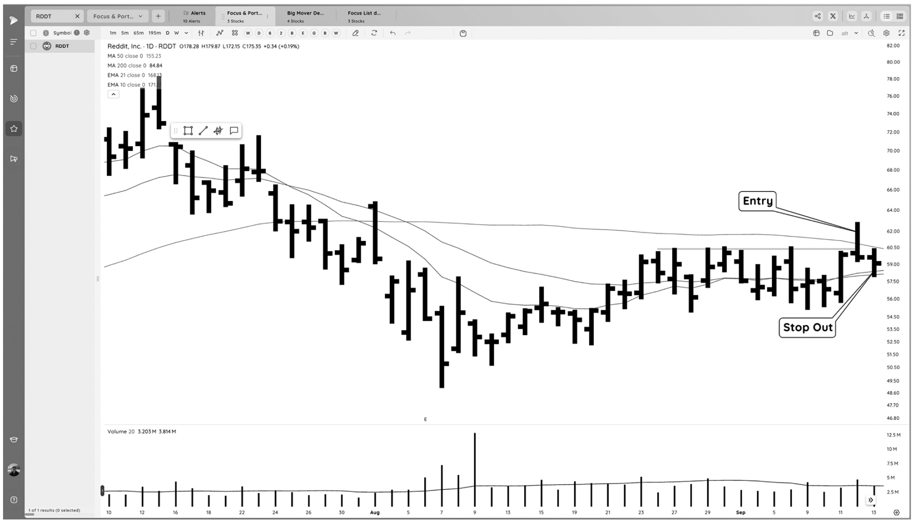
The stock faded sharply right after the trader's entry and closed near the low of the day. The trader adjusted his stop slightly higher to try to manage his risk a bit tighter.

The next day it followed through down and stopped him out, but ultimately closed off of the 21 EMA.

Grading: 8/10

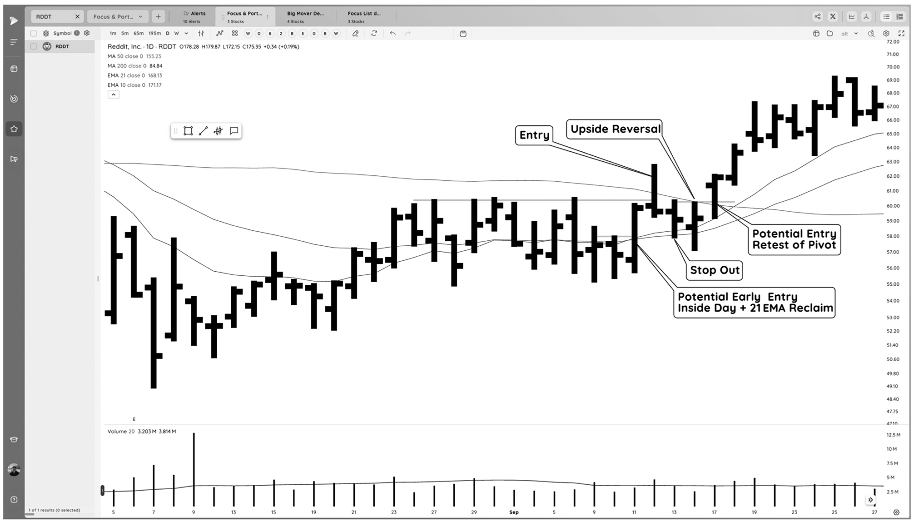
Risk was managed at the original planned spot of the 21 EMA but the trader moved up their stop early.

Reddit Trade 1



Step 4: Overall Trade Observations

Reddit Trade 1 Observations



After analyzing this trade the trader made the following observations:

- The poor entry execution led to a larger than expected loss.
- The day of entry with the poor close broke expectations, he could have cut half his position or taken it off entirely and waited for a re-breakout.
- The poor entry execution led to a defensive mindset, leading him to adjust his stop higher early versus letting the stock attempt to work above the 21 EMA. This saved him a few cents in this case but may choke off trades in the future.
- There was a potential earlier entry the day before his buy where he could have entered on the reclaim of the 21 EMA/ inside day highs.
- After he was stopped out the stock still acted well and it set up again with an upside reversal, then on the gap up RDDT retested the pivot and closed well, another good entry where risk could have been managed at the low of the day.

Key Point – when analyzing a trade always look out into the future a few weeks past your exit and see if the stock set up again. Often the stock will be right, just the initial timing or even the market cycle held it back momentarily.

Entry Buy 2:

The plan was to enter on a push higher off the 10 EMA, following through from the prior day's upside reversal.

The stock gapped down in the morning then pushed higher, and the trader entered at 66.87 after the stock advanced over the prior day's high of 66.61.

Grading: 9.5/10

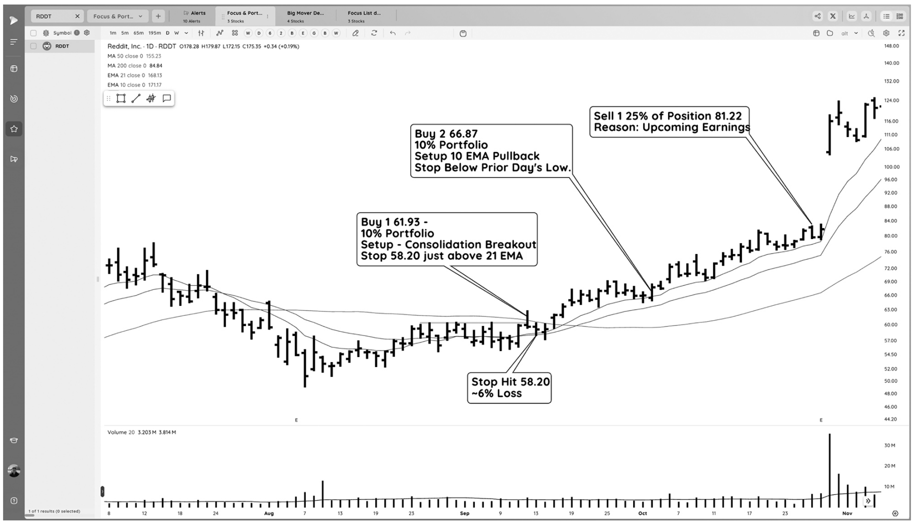
The plan was solid, and the execution was also strong, entering close to the pivot. Advanced traders could have looked to enter a bit sooner after the opening weakness as it formed up.

Position Management and Exit

From this entry RDDT trended cleanly above the moving averages.

Sell 1 was due to upcoming earnings and was 25% of the position. This is prudent to lock in solid profits while holding a core for a larger move. Earnings are binary events, you always want to make sure you are accepting a large gap either way and have adequate cushion.

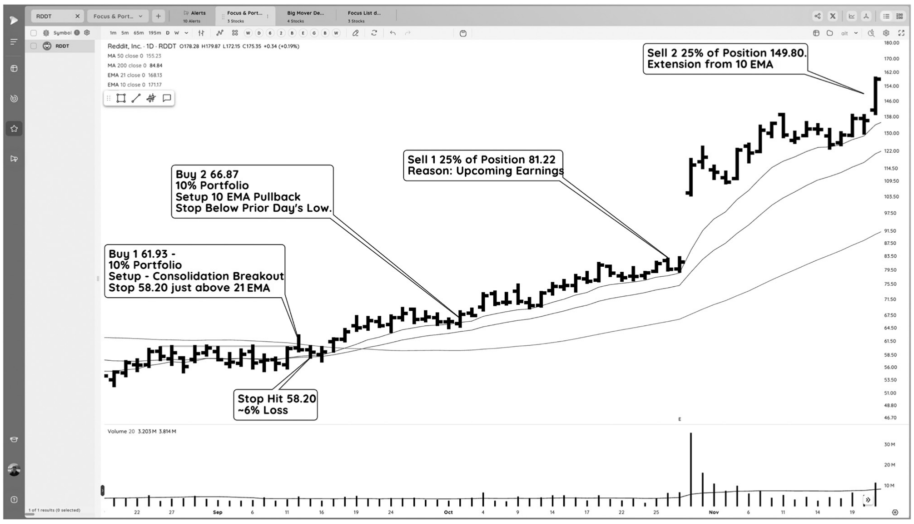
Reddit Trade 2: Sell 1 Ahead of Earnings



Grading on this sell was a 10/10. Often top traders like to wait for the week prior to earnings to sell a portion if they are planning to. Exactly when or how much is up to the individual.

Sell 2 was into strength as RDDT got stretched from the 10 EMA. Selling into strength on extensions and when to do so is a learned tactic that requires feel. More advanced traders can look to trade around their positions and add back sold portions at the next entry area.

Reddit Trade 2: Sell 2 Extension

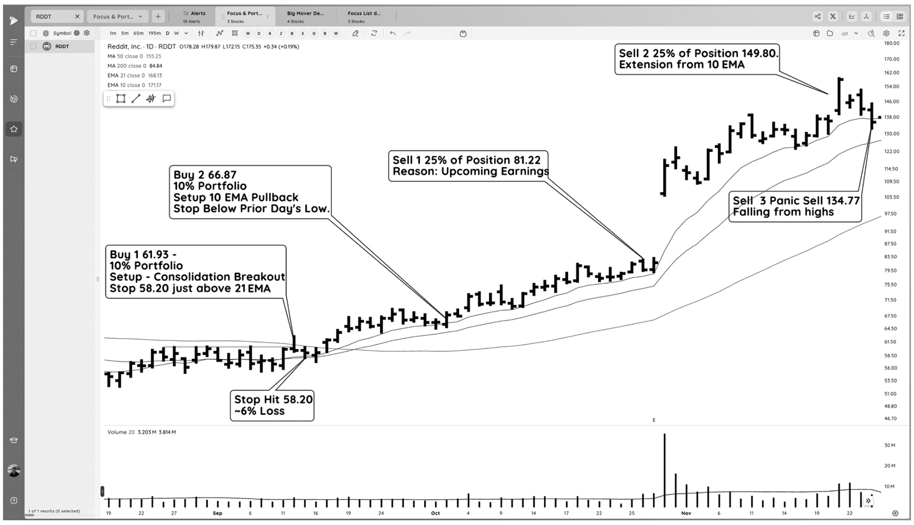


Grading on this sell was a 9/10. It was a 16% up day with a gap from a shorter consolidation. The trader left a little on the table here although you’ll never know in the moment that the stock will push higher that day.

One thing to consider is that RDDT was still early in its lifecycle and had just shown extreme power with the earnings gap. This type of stock can double or triple and more experienced traders would want to recognize this and look to hold as much of their core for as long as they can.

Sell 3 was the key one, the trader sold after the stock had pulled back sharply from the extension but still above the 21 EMA. This was a sell based on emotion as the trader had gone from excited and near euphoric on the strong gap and go move up to now, panicked as RDDT had gapped lower and was following through down.

Reddit Trade 2: Sell 3 Panic Sell

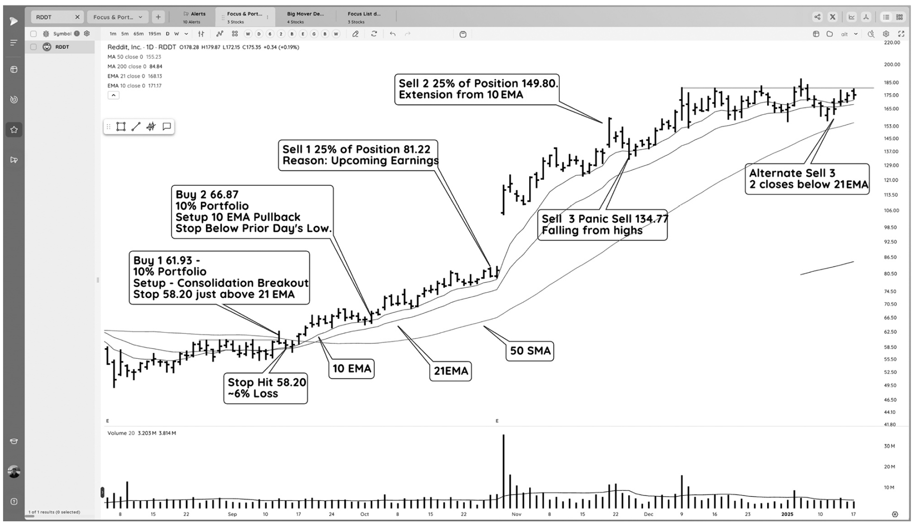


This type of day is why traders need to have rules and be vulnerable to their system.

Grading for Sell 3 is a 2/10. The stock had not triggered the 2 closes below the 21 EMA. At this point the stock was making higher highs and higher lows.

Overall Trade Observations

Reddit Post Analysis Example



After analyzing Trade 2 the traders made the following observations:

- A strong entry helped build a cushion right away, allowing them to hold a core position through earnings.
- The final sell was due to emotion, if they can't stomach a 15% drawdown above the 21 EMA they need to be more proactive with selling into strength, **or** they need to accept the wiggles and jiggles that will happen above uptrending moving averages.
- RDDT respected the 10 EMA after the entry, the trader could have switched to 2 closes below that moving average after the respect was clear.
- The sell signal if the trader had followed his rules would have been weeks later and 20% higher. However, an advanced trader especially with that type of cushion may have decided to wait another day before selling here, as the second close was higher than the low of the first and RDDT was simply consolidating in a base.

Key Points when analyzing a single trade:

First, analyzing your trades will be the most effective way of determining your weaknesses and areas of improvement as a trader. They will help you refine your entries, exits, and position management. However, remember to be stern but forgiving of yourself. We are human and will make errors. The goal is to incrementally improve over time and post analysis is the path to do so.

Analyze your trades objectively and try to come up with system level action/rules to improve your trading. Instead of saying I need to just buy closer to the pivot, implement a rule and change to your routine so that you are aware of the stock even before it breaks through.

Also, each series of trades will be impacted by the market. Some markets reward fast sells into strength while others reward holding for long moves.

Remember to take this into account and don't change your rules too fast simply because of the data of one market cycle.

CREATING A TRADING JOURNAL

Why is journaling important?

Journaling is the process of taking notes on your actions in the market and your thoughts, feelings, and analysis.

Just like a stock chart is a record of a company's price action history and contains important clues signaling accumulation or the starts and ends of trends, a trade journal contains clues about the strengths and weaknesses of your trading.

Trading is also a personal journey.

A journal can help you reflect on successes, or problems you are experiencing. If you can be truly honest with yourself, by reading your trading journal in retrospect, you can diagnose and solve many of your faults.

It can also serve as a time capsule—you'll be able to look back on past years' notes and see how far you've come.

Daily trade journal sections

Your daily journal should not feel like a huge task to complete each day. Around 15 minutes should be plenty of time to fill out the sections. You can set up a Google form that you can fill out each day which stores your data in a spreadsheet.

Overall trading performance check-in

It can be helpful to include an overall trading performance check-in at the start of your journal. Out of ten, how do you rank your execution and trading?

Market trend and thoughts

Include a chart of the market indexes. What are your current thoughts on the trend? How does it fit into your market cycle?

New positions with charts and thoughts

List out any new positions you took, and thoughts on their performance and your execution. Include your setup, rationale for each trade, and how well you followed your plan.

Active trades and thoughts

Also include your thoughts on your existing positions. Are any of them close to needing management? Which are your strongest positions?

Key notes

Include any additional notes or thoughts in this section. Check in on how you are feeling currently about your trading performance and psychology.

That’s it!

This should be a quick check-in that you can consistently complete. This allows you to reference how you were thinking and feeling in different moments of the market cycle and trades during post analysis.

TRADE ANALYTICS

The next step of post analysis is to analyze your performance and trade analytics. This should be completed regularly, ideally every few months.

You can do this manually or there are different journaling services out there that can automate calculating the statistics.

This process allows you to objectively step back and analyze your edge. The following is inspired by Mark Minervini as well as Dr. Eric Wish.

The key metrics that we suggest you track are:

- Batting average—the % of trades which are winners
- Average gain $, %, equity contribution—your average gain on winners in terms of dollars, % gain per position, and equity contribution
- Average loss $, %, equity contribution—your average loss on losers in terms of dollars, % loss per position, and equity contribution
- Your risk/reward ratio—the ratio of your average gain/average loss
- Max gain $, %, equity contribution—your maximum gain in terms of dollars, % gain per position, and equity contribution
- Max loss $, %, equity contribution—your largest loss in terms of dollars, % loss per position, and equity contribution
- Average trade length for winners—the number of days on average of winning trades
- Average trade length for losers—the number of days on average of losing trades.

Let's walk through each metric and how you can use it to draw conclusions about your trading.

Batting average

The batting average is calculated by dividing the number of winners by the total number of trades losers. If you want to take this a step further, you can eliminate trades near 0% return say −1% to 1%. These are scratched trades and may skew the perception of the final number.

Your batting average is important to track personally but is a lot less important as a performance indicator than traders believe.

Many market wizards and traders we've met actually have win rates of around 40% on average. This may seem low, but in reality what this means is that they are excellent at cutting the losers short. They have a lot of small losses but make up for all of them with large gains when they do have winners.

However, the batting average or win % is helpful to track on a personal level to see how it fluctuates in different market environments. If you notice your average dipping, it's a sign to take the foot off the gas and pump the brakes. The market could be weakening, or your style simply could not be working as effectively as usual.

Average gain

Your average gain is calculated by taking the average of all your winning trades. You should calculate it three ways: dollar amount, % gain on the position, and equity contribution. This is because you could have a trade that was a huge winner, but it was also a tiny position. That will skew the % gain calculation but not the equity contribution. To calculate the equity contribution, multiply the % gain on the position by the position size. A 30% gain on a trade that was 20% of your portfolio was a 6% equity contribution.

Tracking this over time gives a similar view to the batting average. It can help you identify the best trading periods as you see it trending upwards, and then in choppier periods it will contract.

Average loss

Your average loss is calculated by taking the average of all your losing trades. Like the average gain you should calculate it three ways: dollar