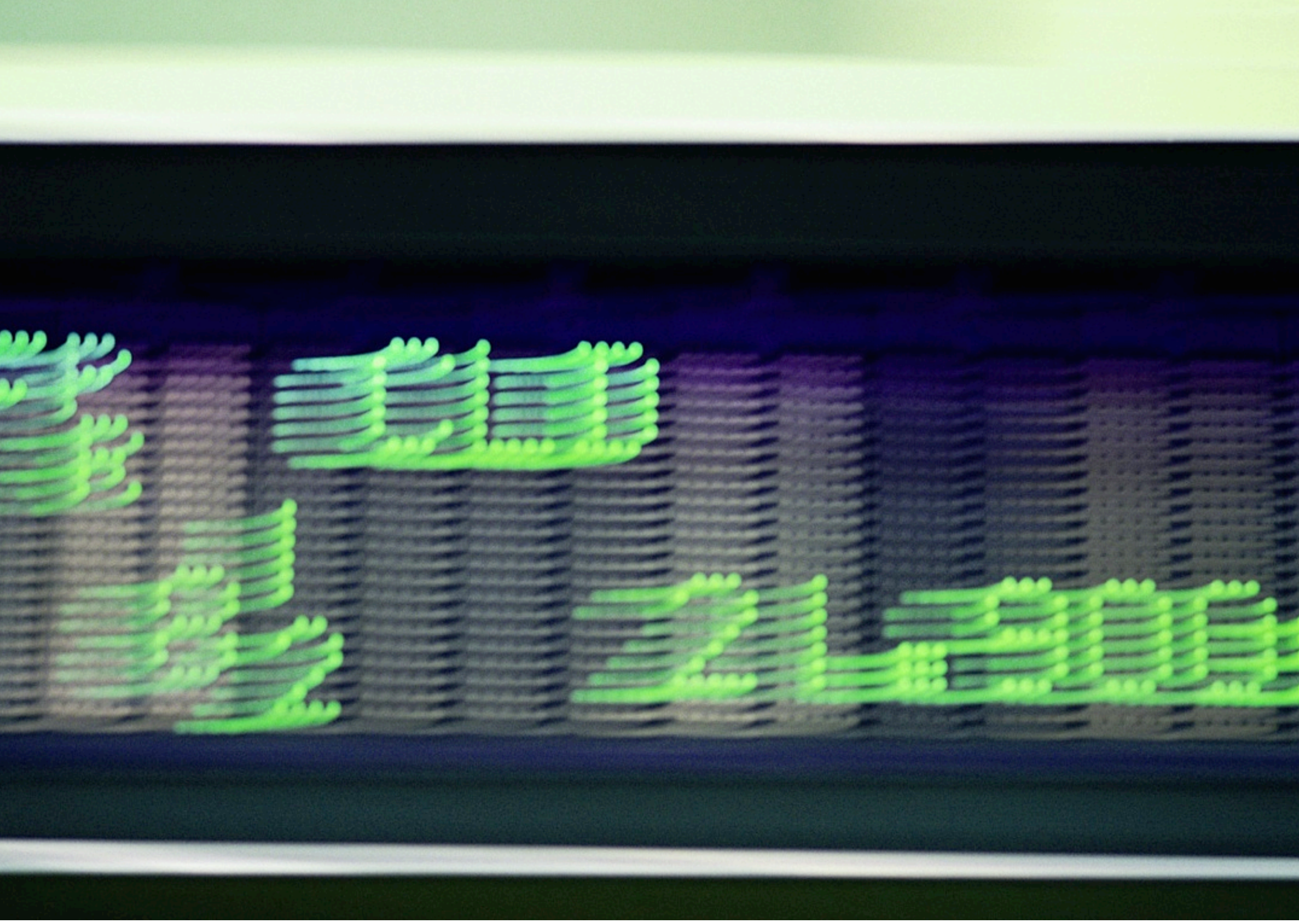

Master Trend Following

Basics & Tactics for the Rookie

John Palatine

Developer of Dynamic System
www.trendarchitect.com

Be advised that Trend Architect will not be held responsible for any investment actions that you take as a result of securities mentioned. Trend Architect is neither an investment advisor nor a financial advisor.

Trend Architect is strictly an informational publication and does not provide individual, customized investment or trading advice. It is intended for experienced investors who are familiar with the risks, costs and legal consequences of investing. Use or misuse of any information included in this book specifically exempts Trend Architect and anyone affiliated with Trend Architect from any liability whatsoever.

While every effort is made to continue performing well, all subscribers or users of Trend Architect agree to take full responsibility for their investment decisions and any losses. All performance figures are based on actual trades taken but past results are no guarantee of future performance.

The information given is intended to be an aid to your own investment process, and your investment actions should solely be based upon your own decisions and research. Trend Architect may or may not already own securities mentioned here. You agree to hold Trend Architect completely blameless in the event of financial losses you may incur by trading securities mentioned here.

"Genius is eternal patience."

Michelangelo

Table of Contents

Introduction

Facing Reality

When it comes to stock market trading, people entering the business have one thing in common. They all expect a high return on investment and are indeed fully confident about themselves being the one who will strike it big, despite the failures of many before them. To many, sadly, this remains a fantasy.

This book is not promising you to become the next millionaire if you follow my or anybody else's strategy. Instead, it will offer rich insights into trend following, greatly enhance your understanding of the movements of the market, and your odds of winning consistently over the long run. If you dreamed of making a few thousands per day, better forget about it for the beginning stage of your trading career. There is enough evidence—such as broker client's account statements—suggesting that the vast majority who enter the market will end up giving away money instead of making it. After all, the financial market is a zero-sum game because money merely changes the owner, it is swapped in exchange for equities and vice versa. The increase of wealth for an individual or a group of individuals occurs when equity prices fluctuate, which in turn results in a decrease of another individual's wealth. Only the very few who have somehow gained deeper insight about the never-ending fluctuation in prices are profiting seemingly easily from other people's losses.

This shady picture of financial markets should not hold you off from participating in them because when approached properly, it can be one of the most prosperous journeys in your financial life.

Welcome to the stock market.

Chapter 1

The Movements of the Market

How do markets move and why? When should I be in a trade and in which direction should I be trading? Trend following is a concept that requires only little effort coupled with big profits once the major trend or a trend reversal has been identified. Here is an excerpt from The Book of Five Rings by Miyamoto Musashi:

The way to do battle is the same whether it is a battle between one individual and another or a battle between one army and another. You should observe reflectively, with overall awareness of the large picture as well as precise attention to small details.

The large scale is easy to see; the small scale is hard to see. To be specific, it is impossible to reverse the direction of a large group of people all at once, while the small scale is hard to know because in the case of an individual there is just one will involved and changes can be made quickly. This should be given careful consideration.

Stock prices are never constant. Financial markets do not act like economic markets with an equilibrium point where everyone is satisfied with one price and where it does not fluctuate much anymore once reached. Relative valuations change throughout the day. You do not have a consumer and a retailer such as in the grocery store. There are only investors with the desire to make money. So they look around and see what other (potential) investors are thinking and compare financial statements or analyses. They move in a sphere with tremendous lack of knowledge which naturally it leads to a herding effect. That is why markets get so compulsive by getting way overvalued or undervalued and have trends along the way. Once a trend is in place it is very difficult to stop it.

Due to this high uncertainty environment, we are going to divide investors into two groups: one is bullish on a stock and the other bearish (the reason for their bias being neglected here). Basically, that is all we can do in response to our opinion: we either buy or sell. If you imagine the market as a place where two crowds gather to battle, the price action which we observe day by day can be understood in a much easier manner. It is very similar to a tug of war where two opposing parties pull on a rope with the aim to drag the competitor over a border line. Once a party has gained some degree of advantage, it will be very difficult for the opposing side to end it. The losing side eventually gives up fighting this influence.

For instance, if prices have been moving down in the broader picture, bearish investors must be possessing greater power while the bullish investors are countering against their influence. This explains the minor swings up while the price is overall falling and thus forming a downtrend. Buying becomes a more challenging proposition than simply going with the major trend—or ignoring the stock altogether if you do not like shorting. Having this concept in mind greatly enhances the probability of a successful trade. It is an everlasting way to participate in the market because the battle will never end as long as the market exists. It has served successful traders and investors well through many years of changing market conditions. In the next chapter we go into further detail on how to view price history.

Chapter 2

An Objective Approach

Beginners tend to take way too many opportunities by scalping the market up and down. Taking that many opportunities will result in many errors because the beginner is not proficient enough to maneuver through every movement. Trading off shorter intraday time frames is one of the seductions in believing the closer you look, the more control you have. The advice is to concentrate on what is really happening in a market, say a stock. If the share price has been rising recently, the only reaction that traders can think of is shorting “the top”. After countless of losses, they finally realize that bulls are too strong and decide to buy and hold for a while.

Now comes the moment when the stock really starts diving and they get out frustrated with another loss. To our surprise, this behavior is frequently observed in trading chat rooms. Experience has taught traders to be more passive because it is usually beneficial. Both trading and investing are about being objective and looking at the market from a neutral standpoint. A reliable indicator (or a combination thereof) does not exist, besides the price itself. After reading the first chapter you already know that there is a fight for control going on in the market between bullish and bearish investors. Support and resistance are areas where this control can be transferred to the opponent—be it temporarily or for good. In other words, here is where the pendulum slows to swing back.

Let us get straight into chart reading. Below you see a daily chart of AAPL and you are going to learn how a trend follower would approach and manage his position. Look at it and try to see which price levels stand out visibly. Find logic in the movements. Each stock offers only a few great opportunities in its lifetime, therefore do not attempt to join every little swing but look for a trade that would have yielded you handsome profits. Was there an early hint?

The first you do when looking at a chart is to find striking patterns which especially are support and resistance zones. These zones are not exact prices but approximate areas.[1] It is important not to fall for a misconception, though. If your only tool is the hammer, everything you look at will appear like a nail. The same applies for chart patterns. Rigorously searching for a pattern, makes it seem as if there was an opportunity coming up every moment which obviously is not true. See what the entire market sees and what is visible to any market participant. Now imagine yourself being in a position already. What would you be thinking and what would be your interest?

[1] Support and resistance areas develop with the battle between bulls and bears. At a certain price level there are more individuals of one party than the other, thus swinging the price back and forth. Once price penetrates above this range for whatever reason (be it news or general market sentiment), the bearish crowd betting on falling prices is in a losing position and has to find a way out. Most exit in panic, some remain patient enough to wait for price to retreat until they can get out with the least loss. This in turn causes more upside pressure and why former resistance is now becoming support. The longer resistance has persisted, the stronger the released pressure tends to be.

Chapter 3

Position and Risk Management

We want to continue with the actual entry and the subsequent position management. Let us assume you had a bullish bias on AAPL because you know the company well and believe in its prospects. Do not jump in right away because the "fundamentals" appear reasonable to you. Timing is an important factor when it comes to successful trading and investing. If you believe in a story, you want to be making money from the first day on, otherwise exit and admit being wrong.

You saw a pop out above the multi-month range in March 2009 and bought a few shares on that day. Where is a sensible price area to set the stop loss order at? A 10% distance? Five dollars below the entry price? Remember how we discussed, in the previous chapter, to be objective and see what the entire market sees. Accordingly, we are going to set the stop loss order to the most visible recent swing low. One that stands out sharply is 94.00 (see chart below). Once the order is set, our job is done.[2] All we have to do in the coming weeks, is to check back regularly and monitor our position. When the stock has broken *and* held a new high for a few days, you are ready to

[2] If your goal is to risk no more than a certain dollar amount, say $150, you need to do a little calculation. Given an entry price of 106.00 and the stop loss set to 94.00, you divide 150 by the difference between entry and stop loss price (150/12 = 12.5). You can buy 12 to 13 shares of AAPL without risking more than $150.

adjust the stop loss higher to a more recent low that was formed along the way.

By doing so, you are gradually reducing your initial risk and even securing increasingly more profits. Should the stock crash or retreat too much, you will be automatically flushed out of the position with a profit. This is exactly how you follow trends. You merely worry about limiting losses by setting a working order properly and let the rewards come to you on its own. To phrase it differently: You *want* to get stopped out if the original reason for your entry no longer exists.

Visualization	Correct Entry
	**Breakout** Upon breakout, best is to wait for an entry near the closing bell to avoid intraday failures unless it looks very convincing. Set the stop loss to the recent low.
	**Bounce** Resistance becomes support. Trade a bounce off support after it has gone up a good distance for confirmation. Place the stop loss to the recent low formed earlier.
	**Using a Moving Average** This indicator can be a helpful tool but it is only secondary to price action and therefore should not be taken too seriously. Entry is identical to a bounce.
	**Trends and Flags** You want to see a visible and decisive break of the trend before you enter. Setting a stop properly is key to a quick exit should the pattern fail.

Conclusion

Practice Makes Perfect

Stock price movements have logic. It is contrary to what many failed traders claim, who say the market is manipulated or that the “big guys” know where our stops are placed. Such nonsense. What we have learned so far surely may not work every time, as false breakouts do occur, or price rises a few days only to drop from there on. Many things happen on our journey, but we learn from mistakes and grow more experienced. Once we got into a trade, we want to follow the trend until the market exits for us, because this is where the really big money is made. Trends last weeks and months if there is fundamental backup, so trend following a stock means trading a story.

The tactics introduced here can be applied similarly to day trading where the focus is on intraday time frames and where fundamental criteria do not play such a role. Mind the battle between bulls and bears when looking at price action. Who is winning right now? What is the consequence of it?

What you learned from this book:

- You learned how to read price. Why it is moving the way it does and how we can decipher what the market is telling us.
- The nature of support and resistance and how to identify them. What they mean when we are bullish or bearish.
- Being objective on what is happening in the market to make a convinced entry and on how to manage our position. We know our maximum risk upfront and can turn off the profit & loss ticker.
- Always use a stop loss. It is equivalent to the brakes in a car. You would not drive a car without brakes, right? We learned how to use it to our advantage.

I'm glad if I was able to teach something even to a skilled trader or investor. Feel free to pass this book around and drop me an email if you want to go into more details on a subject.

For trading signals in trend following the S&P 500 stock index, visit our website at www.trendarchitect.com.

John Palatine
john@trendarchitect.com