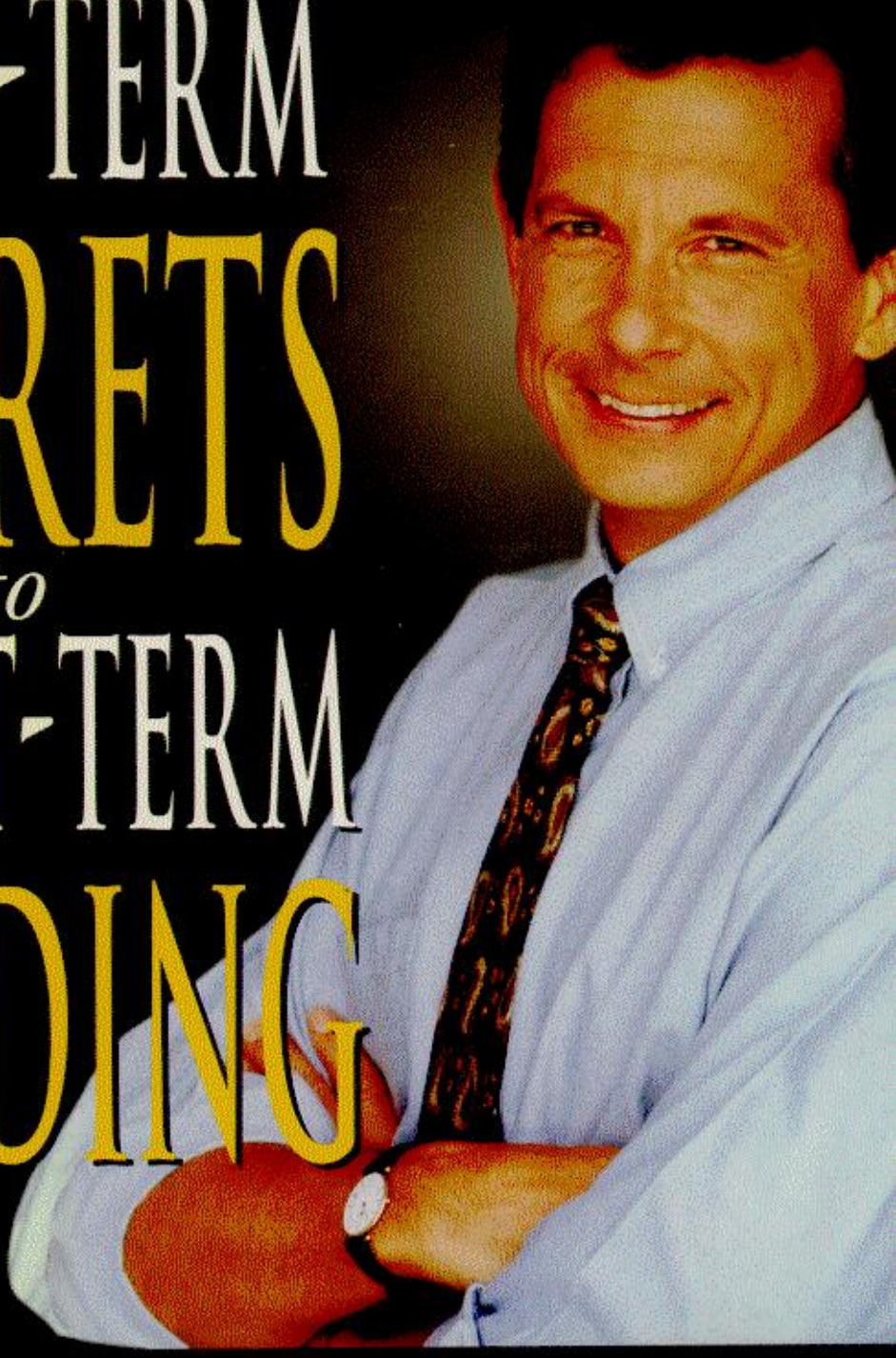
Wiley Trading Advantage

# LONG-TERM SECRETS *to* SHORT-TERM TRADING



ID

LARRY WILLIAMS

3 2022 17528341 1

# THE LONG-AWAITED NEW BOOK BY ONE OF TODAY'S MOST RESPECTED AND RECOGNIZED TRADERS

"Larry is the only person I know who can mix systems and rules with confessions of his soul. This book should have universal appeal to not only the trading world but to all who apply themselves to the laws of the universe. This is a study of the self, the markets, and the interfacing of the two."

—Linda Raschke, President,
LBR Group, Inc., CTA

"Larry Williams's contributions to the study of technical analysis are well documented and indisputable. I have learned more from Larry than all other traders combined. His techniques are original, clever, and fresh. The depth and breadth of his knowledge is mind-boggling. I highly recommend it."

—Tom DeMark, President,
Market Studies, Inc. Consultants;
author, *New Market Timing Techniques* and *The New Science of Technical Analysis*

"Having known Larry for 25 years, I can truly say that this is his 'magnum opus'; the culmination of a brilliant career; *must reading* for anyone who trades futures with success as their goal!"

—Jake Bernstein, President,
MBH Commodity Advisors, Northbrook, Illinois

ISBN 0-471-29722-4
56995
9 780471 297222

JOHN WILEY & SONS, INC.
Professional/Trade Division
605 Third Avenue, New York, N.Y. 10158-0012
New York • Chichester • Weinheim • Brisbane • Singapore • Toronto

$69.95 USA
$108.50 CAN

*"The public thinks speculation is a game of knowing the future, of knowing that which cannot be known. They are wrong. It is a game of developing strategies with winning advantages, of getting the odds on your side, and then working those odds. Here's how I've done just that for the past 35 years."*

—Larry Williams

Short-term trading is how most traders and would-be traders play the markets. While it offers the greatest financial payoffs, it also presents the greatest challenge, requiring constant attention and vigilance, as well as a very strict plan. Written by Larry Williams, the most recognized and popular technical analyst for the past three decades, this groundbreaking book—his first in almost a decade—provides the blueprint necessary for sound and profitable short-term trading, highlighting the advantages and disadvantages of what can be a fruitful, yet potentially dangerous venture.

Sharing his years of experience as a seasoned and successful trader, Williams offers his market wisdom on a wide range of topics, from chaos and speculation to volatility breakouts and profit patterns. With his expert guidance, you'll learn about such fundamentals as how the market moves, what are the three most dominant cycles, when to exit a trade, and how to hold on to winners until the end of your chosen time frame.

Along with in-depth analysis of the most effective short-term trading strategies and details on the best theory and implementation of money management, *Long-Term Secrets to Short-Term Trading* features Williams's winning technical indicators, as well as his thoughts on a broad range of topics. A sampling:

- **"A short-term trader has one objective; to catch the current trend of the market. That's it. That's all you should try to do!"**

- **"The shorter your time frame of trading the less money you'll make."**

*(continued on back flap)*

*(continued from front flap)*

- "You will never make big money until you learn to hold on to your winners, and the longer you hold the more potential you have for profiteering. . . . It takes time to make money regardless of the activity."

- "Wealth is not amassed with just good market calls. It also requires correct money management."

- "I think you need to fear the market and fear yourself. . . . Without fear there is no respect, if you do not respect the markets and fear yourself you will become one more dead body on the long trail of commodity market casualties scattered across the land."

Filled with invaluable insight, precise rules and formulas, and helpful advice from one of today's most respected market players, this comprehensive and practical resource will serve as the basis for, if not indeed become, your short-term trading "gospel."

LARRY WILLIAMS is a well-known trader, author, newsletter editor, and money manager. He is the all-time top winner of the Robbins World Cup Championship in Futures Trading, taking $10,000 to $1,100,000 in less than twelve months. He has served on the Board of the National Futures Association and twice ran for the U.S. Senate in Montana. Featured in such publications as *Barron's, The Wall Street Journal, Forbes,* and *Fortune,* Mr. Williams has been one of the most widely quoted and followed advisors over the past twenty-five years.

Jacket Photo: Jay Spence Photography

# Long-Term Secrets to Short-Term Trading

## WILEY TRADING ADVANTAGE

*Trading without Fear* / Richard W. Arms, Jr.
*Neural Network: Time Series Forecasting of Financial Markets* / E. Michael Azoff
*Option Market Making* / Alan J. Baird
*Money Management Strategies for Futures Traders* / Nauzer J. Balsara
*Genetic Algorithms and Investment Strategies* / Richard J. Bauer, Jr.
*Technical Market Indicators: Analysis and Performance* / Richard J. Bauer, Jr., and Julie R. Dahlquist
*Seasonality: Systems, Strategies, and Signals* / Jake Bernstein
*The Hedge Fund Edge* / Mark Boucher
*Managed Futures: An Investor's Guide* / Beverly Chandler
*Beyond Technical Analysis* / Tushar Chande
*The New Technical Trader* / Tushar Chande and Stanley S. Kroll
*Trading on the Edge* / Guido J. Deboeck
*Trading the Plan* / Robert Deel
*The New Science of Technical Analysis* / Thomas R. DeMark
*Point and Figure Charting* / Thomas J. Dorsey
*Trading for a Living* / Dr. Alexander Elder
*Study Guide for Trading for a Living* / Dr. Alexander Elder
*The Day Trader's Manual* / William F. Eng
*The Options Course: High Profit & Low Stress Trading Methods* / George A. Fontanills
*The Options Course Workbook* / George A. Fontanills
*Trading 101* / Sunny J. Harris
*Trading 102* / Sunny J. Harris
*Analyzing and Forecasting Futures Prices* / Anthony F. Herbst
*Technical Analysis of the Options Markets* / Richard Hexton
*Pattern, Price & Time: Using Gann Theory in Trading* Systems / James A. Hyerczyk
*Profits from Natural Resources: How to Make Big Money Investing in Metals, Food, and Energy* / Roland A. Jansen
*Trading Systems & Methods, Third Edition* / Perry Kaufman
*Trading to Win* / Ari Kiev, M.D.
*Understanding Options* / Robert Kolb
*The Intuitive Trader* / Robert Koppel
*Nonlinear Pricing: Theory & Applications* / Christopher T. May
*McMillan on Options* / Lawrence G. McMillan
*Trading on Expectations* / Brendan Moynihan
*Intermarket Technical Analysis* / John J. Murphy
*Forecasting Financial Markets, 3rd Edition* / Mark J. Powers and Mark G. Castelino
*Neural Networks in the Capital Markets* / Paul Refenes
*Cybernetic Trading Strategies* / Murray A. Ruggiero, Jr.
*The Option Advisor: Wealth-Building Techniques Using Equity and Index Options* / Bernie G. Schaeffer
*Gaming the Market* / Ronald B. Shelton
*Option Strategies, 2nd Edition* / Courtney Smith
*Trader Vic II: Principles of Professional Speculation* / Victor Sperandeo
*Campaign Trading* / John Sweeney
*The Trader's Tax Survival Guide, Revised* / Ted Tesser
*The Mathematics of Money Management* / Ralph Vince
*Portfolio Management Formulas* / Ralph Vince
*The New Money Management: A Framework for Asset Allocation* / Ralph Vince
*Trading Applications of Japanese Candlestick Charting* / Gary Wagner and Brad Matheny
*Trading Chaos: Applying Expert Techniques to Maximize Your Profits* / Bill Williams
*New Trading Dimensions: How to Profit from Chaos in Stocks, Bonds, and Commodities* / Bill Williams
*Long-Term Secrets to Short-Term Trading* / Larry Williams

# Long-Term Secrets to Short-Term Trading

Larry Williams



John Wiley & Sons, Inc.

New York • Chichester • Weinheim • Brisbane • Singapore • Toronto

Navigator charts were provided by
Genesis Financial Data Services: 800-808-3282.

This book is printed on acid-free paper. ♾

Copyright © 1999 by Larry Williams. All rights reserved.

Published by John Wiley & Sons, Inc.
Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4744. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 605 Third Avenue, New York, NY 10158-0012, (212) 850-6011, fax (212) 850-6008, E-Mail: PERMREQ @ WILEY.COM.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering professional services. If professional advice or other expert assistance is required, the services of a competent professional person should be sought.

***Library of Congress Cataloging-in-Publication Data:***

Williams, Larry R.
Long-term secrets to short-term trading / Larry Williams.
p. cm. — (Wiley trading advantage)
ISBN 0-471-29722-4 (cloth: alk. paper)
1. Commodity futures. 2. Speculation. I. Title. II. Series.
HG6046.W539 1999
332.63'28—dc21 98-44949

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

# Acknowledgments

This book is not the product of research—it is the culmination of a career that has included a great deal of research, personal introspection, and, along the way, some personal growth.

My career, and accordingly this book, would not have been the same without the help, support, and sharing of knowledge with others over the years. Prominent among these people are Don Sarno, who was the first one to invite me to speak for *Commodities Magazine*, and Bill Meehan and Tom DeMark—both brilliant analysts, yet poles apart—who were most instrumental to my understanding of the markets. Both these guys were always willing to swap ideas. I also owe a large debt of gratitude to Ken Hornbrook, who was always willing to help me program yet "one more" idea.

I want to thank Mike Stock for his programming and idea exchange; Jake Bernstien for his friendship for over a quarter of a century; the brokers, including Al and Greg Alesandra, who have put up with my constant questions and phone calls; Joel Robbins for his support and fine staff including Larry Herst and my daily contacts, the dynamic duo of "Rick and Gene." Thanks to Andy Daniels as well, and most of all to Ed Walter for taking my phone calls from all over the world and giving me quotes every day of the year for more years than we can remember.

So many fellow analysts have urged me on in one way or another, from Bob Prechter, probably the nicest person in the advisory business, to Bruce Babcock, my personal devil's advocate. Frank Taucher and Bob Prechter have been the only other big names to stand up for—and pay the lawyer bills of—newsletters trying to establish their first amendment right to publish without being registered with the U.S. government's Commodity Futures Trading Commission (CFTC). Marty Zweig and Ned Davis taught all of us what research should be about. And thanks to the many friends I have developed within the business: Joe DiNapoli; Welles Wilder; R. E. McMaster; Nick Van Nice (Joe and Willie's son, who is a real rising star and also battler against the CFTC); Linda Bradford-Raschke; George Angell; Brian Schad; Mark Benjamin; Sheldon Knight; Miles Dunbar; Glen Larsen, at Genesis Data; Stan and Gretchen Marzalk; John Hill; Bo Thunman, founder of "Club 3000"; Kim Henrie, and the entire staff at British American for their tremendous support and backup. I have been blessed to know all of you and am certain I have left others off this list who should be here.

My secretary and office manager, the very efficient Jennifer Wells, deserves special attention for her work, efforts, and support of my somewhat different lifestyle. Jennifer is a real gem.

My career and this book would never have been possible without people from all over the world subscribing to my newsletter, *Commodity Timing*. My subscribers, seminar attendees, and readers of my other books deserve personal thanks for being with me through the good times as well as some I would like to forget! You are a great group of people I have come to know and deeply appreciate.

Finally, thanks to my wife, Carla, and five unique and wonderful children—Kelley, Jason, Sara, Michelle, and Paige.

Larry Williams
*Rancho Santa Fe, California*

# Contents

**Introduction You Are Already a Commodity Trader** 1

**Chapter 1 Making Order Out of Short-Term Chaos** 9
- How I Learned about the Market 9
- Charting the Market 11
- The Nonrandom Market 14
- Understanding Market Structure 15

**Chapter 2 It's a Question of Price and Time** 23
- All You Will Ever Need to Know about Cycles 23
- The Natural Cycle of Range Change 27
- Where the Trend Is with You—The Second Power Play Price Pattern 36

**Chapter 3 The Real Secret to Short-Term Trading** 45
- It Is All about Time 46

**Chapter 4 Volatility Breakouts—The Momentum Breakthrough** 57
- Simple Daily Range Breakouts 61
- A Look at Volatility in the S&P 500 66
- Separating Buyers from Sellers to Find Volatility Using Market Swings to Follow Volatility 71
- Results 72
- One Step Further 73

**Chapter 5 The Theory of Short-Term Trading** 75
- What Is Wrong about the Information Age 78
- E. H. Harriman's Rule of Making Millions 79

**Chapter 6 Getting Closer to the Truth** 81
- The Market Is Not a Coin Flip 82
- Monthly Road Maps 89

**Chapter 7 Patterns to Profit** 93
The Common Element 94
The Questions to Ask 99
My Smash Day Patterns 101
How to Use Smash Day Patterns 104
Specialists' Trap 108
A Vital Note—This Works on Shorter Time Frames as Well 113
Oops! This Is Not a Mistake 113
S&P Oops! Trading 119

**Chapter 8 Separating the Buyers from the Sellers** 121
Greatest Swing Value 123
Stock Index Trading with Greatest Swing Value 124
Some Pointers 128

**Chapter 9 Short-Term Trading from a Quote Screen** 131
How a Quote-Screen Trader Makes Money 132
Swing Points as Trend Change Indication 134
The Three-Bar High/Low System 136
A New Indicator for Short-Term Traders . . . Will-Tell 138
Will-Spread and the S&P 500 Stock Index 141

**Chapter 10 Special Short-Term Situations** 147
Month-End Trading in Stock Indexes 147
Target Months 148
Making It Better 149
Month-End Trading in the Bond Market 149
Getting Specific 152
Better and Better 153
A Time to Sell as Well 154

**Chapter 11 When to Get Out of Your Trades** 157

**Chapter 12 Thoughts on the Business of Speculation** 159
What Speculation Is All About 160
It's about Time 161
Trade Management 161
Essential Points about Speculation 162

**Chapter 13 Money Management—The Keys to the Kingdom** 171
Most Traders Use a Hit-and-Miss Approach 172
Approaches to Money Management—One Is Right for You 173
The Good, the Bad, and the Ugly of Money Management 175
Looking in New Directions, Drawdown as an Asset 178
Back to Ryan and Ralph 183

**Chapter 14 Thoughts from the Past** 185

**Chapter 15 Just What Does Make the Stock Market Rally?** 233
Logic 101 234
These Words Are My Bond 234
A Look at Data A and Data B 235
Let's Break Some Bad Habits 237
How to Break Bad Habits 238
Comments on Setting Stops—Dollar Loss and Unpredictability 240

**Chapter 16 Closing Comments** 245
It Is Just Like Life 245

**Index** 249

# Long-Term Secrets to Short-Term Trading

# Introduction

# You Are Already a Commodity Trader

Whether you know it or not, you have been trading commodities all your life. Sure, you may have never traded a contract of Pork Bellies, but you have almost certainly traded a possession like a car, house, or antique for someone else's money or possession. If you have never done that, for sure you have traded time for money. You have traded your time as a teacher, lawyer, pipe fitter, or ditchdigger for someone else's money. So, you are halfway there, you just never knew it!

When we trade our time, we are actually trading our time plus our skills. That is why a brain surgeon gets more per hour than a knee surgeon. That is also why an outstanding quarterback gets more than a tackle and surgeon combined. He has a greater career risk. It is not that one skill is inherently more valuable than the other, it is that one is more difficult to come by and carries higher risk. This characteristic generates more dollars for the person selling his or her time and skills.

There is no intrinsic value to Michael Jordan's dribbling and shooting skills, but the owner of the Chicago Bulls saw an opportunity to make a great deal of money with those seemingly valueless skills by packing stadiums and getting television revenues. Thus, something of "no value" may have great value.

At a trading seminar, I once demonstrated this point by placing a personal check of mine in a sealed envelope and then added it to 14 similar envelopes in a clear plastic bag. The attendees each had the opportunity to reach in and draw out an envelope. The person who drew the one with the $5,000 check would be allowed to keep it.

The bag contained 14 worthless envelopes, but suddenly they had value! Although all but one were empty, there was a 1 in 15 chance of winning $5,000; thus each envelope, or opportunity to take out an envelope, was worth $333.33. Once the participants began taking envelopes out of the bag,

those empty, worthless envelopes gained in value. After all, once five empty envelopes were removed, there was now a 1 in 10 chance and the value had risen to $500. When just two envelopes were left in the bag, people in the audience were willing to pay $2,500 to dip their hand in and pull out an envelope! Suddenly, what was worthless had great value!

That is your first lesson in becoming a more aggressive commodity trader. Value, like beauty, is in the mind of the beholder. As a trader, the lesson is never to second-guess what value really is: it is what the market will pay. It (the market or collective judgment of other traders) may not pay that value for long, but price is King, it is what is. I learned long ago not to argue with what is.

In 1974, I reached a value judgment that the price of Cattle would skyrocket so I began loading up, taking my first position at 43 cents a pound. I "knew the value" of Cattle; at this price, it was way under value offering a sure trade. So, as price drifted to the 40-cent area, I bought more. After all, if 43 cents was cheap, 40 cents was even better.

At 38 cents, where price next went, I had a steal, and being no dummy, I stole some more, only to see price plummet to 35 cents, then 30 cents, and finally 28 cents—where, dear reader, I was tapped out. My resources were limited; this move cost me about $3 million, all in less than 30 days.

Two months later, the price of Cattle soared to over 60 cents a pound. But I was not there—a sure-thing trade had set me back dearly and helped contribute to rumors, afloat still today over a quarter of a century later, that I blew out trading, despite a few successes I will get to later in this book.

Reflecting on this experience over the years has enabled me to formulate two important rules. The first is that value is ephemeral: it can be anything, and anything can and will happen trading commodities, or stocks for that matter.

The second rule, which carries greater weight is that although market trend and direction are major concerns, knowing how to deal with your resources has the highest priority. After all, had I marshaled out my resources on the Cattle trade so I could have ridden through the bad times, I would have made a respectable killing.

You never know when the markets will do what you think they are supposed to do. Many times, like God, the market does not deny, it just delays. Serious traders weave protection against this delay into the fabric of their program. There is no greater rule to learn than that of money management. All the horror stories you have heard about commodity trading are true. Good people have been totally wiped out by doing the wrong thing. That wrong thing has never been the market, nor the fact the trader made a bad call. Indeed, every successful trader will have bad calls, losing trades. And lots of them.

The wipeouts you have heard about, every single one of them, have come from placing too large a bet on a trade or holding on to a losing position too long. The sooner you learn to master your defeats, the sooner you will be on your way to amass the wealth possible in this business. It is your failures, not your successes that kill you in this business. Failures do not build character, they destroy your bank account.

The foundation to all your success is in the preceding paragraph. Psychics may or may not be able to predict the market, value may or may not prevail. The world of speculation is about predicting the future and that is difficult at best. The fabled United States military complex, which had supposedly bankrolled the brightest of the bright, and thousands of intelligence officers, was not able to predict the fall of the Berlin wall! So how can you and I hope to do better?

Our inability to see the future very well is proven yearly by such august sports magazines as *Sports Illustrated.* In 1997, their oracles predicted Penn State would be the number one football team, ranking Michigan number 18. By the end of the season, Michigan was number one and Penn State floundering. Washington was supposed to be number three, but was beaten by lowly Washington State, a team not mentioned in any top 20 list, that went on to win the Pac 10 championship and almost upset Michigan in the Rose Bowl!

People who make their living looking into crystal balls are destined to eat a lot of broken glass.

But take heart: although neither you nor I can divine the future, especially price action, we can learn to control our losses. That is a certainty, based on math, that will provide the building blocks for your successes. Each and every one of them.

For years, I chased the prophets of profit, those financial soothsayers who claimed they, or their indicators, could reveal the future. Eventually, I realized that God does not want us to see the future. It is as simple as that.

If we could see "out there," we could all be millionaires many times over. We would bet the ponies, spin the roulette wheel, and roll dice, except of course, no casino would back the other side of an unwinnable wager. Besides, how thoroughly boring life would become if we could know today how every day of our future would be. Who would want to live that way? Where's the joy of discovery, the magic of the unknown, the thrill of victory, the challenge of overcoming limitations?

If we were all be rich from our powers of foresight, who would work for us, grow wheat, raise cattle? There would be no phone company, no movies, and no television, as no one would need to work. Worse yet, who would hire us?

Like I said, God with infinite wisdom, does not want us to know much about the future and for sure very little about the future of futures. Would-be

speculators think this is a game of knowing the future, of knowing that which cannot be known. It is not. This is a game of developing strategies with winning advantages, getting the odds on your side, working those odds, and staying alert to any potential changes in the game including new players or new ideas and concepts.

The word speculate comes from the Latin *specular*, meaning "to observe," as in spectacle (your glasses). We are not like gamblers, who enter a game they cannot win over time. All they can do is hope chance will run their way, not that of the house. We speculators observe how things should happen in the future, but because we know there are no guarantees, we protect our position with appropriate preservation of capital techniques, so we can win at our game.

The art of speculation requires one part observation tossed together with one rather large dose of preservation.

## My Most Important Market Belief

Based on my research and experience, I have developed a powerful and profitable belief system:

*I believe the current trade I am in will be a loser . . . a big loser at that.*

This may sound pretty negative to all you positive thinkers, but positive thinking can give way to thinking you will win—a surefire formula for buying and selling too many contracts and holding on too long. After all, if you are positive things will work out, you are certain to hold for a bounce or turn that never comes.

I look at it this way, if you get all pumped up and glossed over with positive beliefs about your market success, your conviction will lead you to mismanage losing trades. That is why belief systems are so important to a trader. If your belief system tells you the current trade will be a winner—and it isn't—the need to confirm that belief in your mind will literally force you to let losses run, to stay with losers, something no successful trader ever does. An outrageously positive belief that the next trade or two will turn your account around or make a small fortune for you is most dangerous.

Now let's look at my belief that the current trade I am in will be a loser, that I have no pact with God for success on this trade. Indeed, I genuinely believe the market is not precisely perfect. Keep in mind the data for this belief overwhelmingly supports it; 75 percent of mutual fund managers do not outperform the Dow, 80 percent of short-term traders lose their risk capital. On a personal note, many of my own trades do not make money, and I can positively guarantee many of yours will not succeed.

No major loss I have ever had, and I have had more than my fair share of them, has been the market's "fault." "They" were never out to get me. I got myself by believing my current trade would be a winner so I did not follow the rules of the game.

I agree with those who say you are only as powerful as your belief system because that belief will give you the power of taking an action with more certainty and less hesitation. We act out what we believe: those mental beliefs are the scriptwriters for our play of life.

Adopt my belief that the current trade will most likely not work out and you sure as heck will protect yourself with stops. You will control disasters, taking the first lifeboat possible instead of going down with a sinking ship.

Adopt my belief that the current trade will most likely not work out and you sure as heck will not load up on a trade, banking on it to bail out all your problems. A tiny loss can wipe you out when you have taken a very large position or number of shares or contracts.

Positive beliefs about future results cause us to take on undue risk. Doing that in a game where the odds are unfavorable to begin with is a sure invitation to disaster.

## The Beginning of My Career as a Speculator

*I ride rodeo because I'm too lazy to work and too honest to steal.*

—Freckles Brown, World Champion Bull rider

My career as a speculator began in the seventh grade when a kid named Paul Highland showed me how much money could be made flipping coins, matching quarters or odd man out for the shiny silver dollars we lugged around in our Levi's. Growing up in Billings, Montana, was an excellent precursor to speculation. Flipping quarters was my start; sure I lost some, but if there was anything I understood, other than my art classes and playing football, it was that there was plenty of real easy money to be made gambling for quarters and dollars.

It may well be that everything I needed to know about speculation I learned in jr. high. It took a while, but I finally figured out that Paul and Virgil Marcum were taking my money by teaming up. One would control his coin so a head came up, the other a tails so I could not win. Later they split the proceeds, and I had my first lesson on market manipulation.

I did not call the police or any authorities. I handled it in my own way, and to this day distrust the bureaucrats that are supposed to right such wrongs. They don't, at least not in time to help you or me.

Jack McAferty was the toughest kid in Billings. Fact is he was the toughest kid in the entire state of Montana and that's saying a lot considering

the number of cowboys, roughnecks, and miners we had in the Treasure State. When a big guy hits you on the arm it hurts. When Jack, who was not a big guy, socked you on the arm your bone ached. He had unbelievable power, which served him well in every single fight I ever saw him in. No one came close. Fighting became his way of life and Jack was killed by an L.A. policeman, supposedly on a freeway chase. The truth, however, is that Jack, a real ladies man, had been dating the cop's wife.

Most the guys who were coin-matching speculators would not play with Jack. Usually he would pay off, give you his quarter, but if he decided not to, what was your choice? Threaten him and get the living crap beat out of you? Ah, another lesson in speculation, choose your partners and business associates carefully.

Years later, we took a $5,000 account to over $40,000 trading a Cattle system Richard Ulmer developed. This happened at a brokerage firm owned by George Lane, a guy who claims he is the originator of the widely followed Stochastics Index. Well, George did not invent Stochastic, and I did not get my $40,000 from the brokerage. The regulators closed old George up and just before they did the funds were drained from my account!

Another thing I learned from Jack was that strong people do not respect weak ones. I had put up with enough of Jack's reneging on our coin flips so when he decided not to pay up and kept his quarter, I blasted him in the stomach as hard as I could. Astonished, he glared at me, asking, "Why the hell did you do that? You know I'm going to clean your clock now."

All I could say was, "Well go ahead and do it, I'm just tired of you not playing by the rules. I know you're going to break every bone in my body and you'll get a lot of pleasure out of that, but it won't compare to how I feel knowing I stood up to you."

Jack shot back, "I like that, I respect you," handed me the quarter I had just won, and walked away. We became pretty good friends after that, but we never matched coins again.

Everyone in Montana works hard. Certainly, my dad worked as hard as anyone, putting in over 40 hours a week at a refinery, then more hours on weekends at Doc Zinc's sulfur refinery. And as if that wasn't enough, he would stay up late at night reading books, taking courses on electronics so he would be more valuable to Conoco, his career employer. The gambit of hard work and loyalty paid off—he got promoted.

One of the advantages of having a father working at the refinery was that his kids could get summer jobs there if they were in college. I did that, too, and it reinforced my strong desire to not do what these guys did: work. They worked long hours, ever-changing shift work. One week, you went to work at 3:30 P.M., the next week at 11:30 P.M., and the following week you might pull the 3:30 shift or start at 7:30 A.M. There was neither rhyme nor reason to the schedules that I could see. All I saw was the unending hours of

voluntary servitude in a hot, stench-filled noisy refinery, a place where nothing made sense to me.

There must be a million valves in an oil refinery and I am certain they all turn on and off the same way. My problem was I could never figure out which way was the right way. That was frustrating, not only because it showed my ineptitude, but also because it also reflected on my father, who had all this mechanical stuff down pat. There really was nothing mechanical he could not fix. If I were to have a open-heart surgery, I would trust him more than a doctor.

Dad knew how to build things (our house, delicate cabinetry for mom) and knew how to fix things—in part, I am sure, because we did not have money to pay to get things fixed. Poor people develop more skills than rich people.

My ineptness also held me up to ridicule when people compared me with my older brother, who just naturally knew what to do at the refinery, and seemingly got along well with the older men. My general laziness coupled with a desire to be alone and a total inability to do anything well, but draw, caused me to feel inadequate. My initial response to find self-esteem came from sports. But that sense of approval only lasts through the game. I would lay awake in bed dreaming, scheming about a way to have a better life, wondering how the few people with really big houses achieved success. I was not content; what I wanted was a way out.

Flipping coins seemed reasonable; making fake driver's licenses (for $5 each, birth certificates for $20) paid a lot better. My limited artistic talents made more money and let me work by myself. It also included a healthy dose of risk. I liked knowing that I was doing something the average person couldn't or wouldn't; and for sure, I was not going to find that kind of satisfaction in what I saw at the time as my father's humdrum existence. My dad did everything by the book and followed all the rules—with one exception.

When deer season came, the rulebook went out the window. We killed enough deer, antelope, and elk to feed our family for the year. We used the same deer tag or license three or four times. When it comes to survival, I learned there are no rules: people must take risks, even my Pops. What did I like most about those hunting trips, bagging my deer or taking the chance of getting caught with too many deer, fish, or other game? I have often thought about that. In their own way, they are both thrilling—my speculative career began on a roll.

Really good speculators like thrill, indeed they seek it, as some sort of intellectual rush.

Maybe that is why I liked selling newspapers on the street corners after school or Christmas cards and garden seeds door to door to pick up spending money. I was at risk, never knowing if I would make a sale, but I also might make some decent money for just being there, talking, and showing some stuff.

I had seen enough hard work to know I did not covet it. Like rodeo riders, I was "too lazy to work" and had been raised "too honest to steal." Hence going to college or joining the Navy after high school seemed to be the right direction, and it was one my mom and dad encouraged. They always told us to do better, that there was an easier life, and college was the door to that life.

In 1962, I asked someone what the "most active" list of stocks in the newspaper meant. I was hooked when he replied, "Well, see that stock for General Motors was up 1½ for the day? Had you bought it yesterday, you would have made $150 today."

$150 in one day!

Wow, this sure beat flipping quarters! Back then, $150 was more than guys at the refinery made in a week. This looked easy, and the winnings were staggering. My only two questions were, how did one get started and where had I been all my life? There was an instant affinity between me and what looked like easy money!

That affinity led to the greatest challenge of my life, something I have worked hard at just about every day since 1962. Really, my only "time off" from the markets occurred when I ran for the United States Senate in 1978 and 1982. Other than those two interruptions I have spent every day of my life "working," much to my father's pleasure, I am certain, but it has never resembled work at the refinery or jobs in and after college.

From this experience, I believe three motivators are found in the heart of a successful speculator: an intense desire to make a lot of money, a longing or yearning to show somebody else up, and an internal discontent with how things are. Great big chunks of unrest seem to be an important asset for a speculator. Although most people seek balance in their life, I have never found that very healthy; no great achievements were ever made by perfectly normal people. Sometimes I think about living a more balanced life. That thought usually lasts a couple of seconds. I guess my unrest will never go away, but if my lifestyle tells us anything, it is that unrest fans the flames of a speculator's internal fires.

I would probably trade the markets without wanting profits if it "proved" my worth to the world, to an old girlfriend, to my parents, my brother, or even someone I cannot identify or dredge from the recesses of my mind. Saying I am ego-driven may be correct, but it is not about bragging, it is about showing them I can overcome.

It is about letting the world know I found a way out.

If these words have resonance for you, cinch up your seat belt, you are going on the ride of your life.

# Chapter 1

# Making Order Out of Short-Term Chaos

*There are two primary ways we make money trading; catching a big price move with a small position or having a large position and catching a small move.*

—Bill Meehan

If what I have written so far has meshed with your speculative goals, it is time to learn how markets operate. Speculation—stock and commodity trading—is not for everybody; it may not be for you. I have even wondered at times if it is for me!

## How I Learned about the Market

My career as a trader began in Portland, Oregon, where I had met a Merrill Lynch broker who thought we could make some money together. He was half right, we got lucky immediately. He made good money on his commissions and I lost money. Worse yet, the money wasn't mine; a fellow I had never met had asked me to invest it. In hindsight, the initial beating I took was more than fortunate, it was life changing.

That event hardened my desire to learn the business; after all, if it was that easy to lose, it had to be pretty easy to win, right? My broker was as new

to the game as I was and really had very little advice or suggestions. His market insight was to buy good stocks and hold on (a brilliant insight), but my aptitude or desire was to make money from catching short-term market swings. Thus began my education as a short-term trader.

I had no teacher and knew no other traders, so I naturally turned to books to help solve my problems, just as you have in buying this book. The authors all made it sound so easy. I read Joe Granville's classic work on technical analysis and began keeping daily open, high, low, and closing prices on stocks as well as indicators Joe said we should follow. Before I knew it, I was not only totally consumed by the markets but spending 5 to 6 hours a night and all my weekends on trying to beat Wall Street, gaining a fortune, and beginning to lose a marriage.

My first wife, Alice Fetridge, had become a "chartist's widow" yet still supported my habit. We eventually left Portland and moved to Monterey, California. We both had jobs, and I was also working on my law degree. I even sat for and passed the "Baby Bar Exam" (the test given to night school and correspondence students). By then, however, I had pretty much given up on becoming a lawyer, especially after working for one. I had thought being a lawyer meant being in court, saving people's lives; the reality was that it dealt with collecting money from judgments, finding deadbeats, and representing bums and outright criminals. It was not like trading.

Fortunately in Monterey, I met two brokers who, like me, kept charts. Joe Miller and Don Southard were soon swapping war stories with me, teaching what they knew about the markets. We were all big followers of Granville's On Balance Volume (OBV) work and kept OBV charts on the 30 to 50 stocks we followed. I also started to keep moving averages, another tool espoused in all the books back then, just as they are today.

My stock trading met with some success, but what accelerated my career was a book by Gil Haller, unabashedly called the *Haller Theory*. I learned a lot about stocks and speculation from the book, then got to know Gil and to this day appreciate the support and encouragement he provided. Gil's concept was to buy stocks that had already moved up a lot. This is now a methodology used by the funds to buy what they call "momentum stocks." Haller was doing it way back in 1964 and making a living. But, he didn't live the way I wanted to! His desk was an old door atop cinder blocks, stationery was the back of a letter someone else had written him. Gil was not cheap, just a frugal spender who precisely counted and saved every extra penny.

Eventually, I began to envision a theory of how markets work: In the short term, markets spurt in rallies and declines, moving above and below a balance point I could call the "average" price. My object was to determine when price was low and should move back to the average. That meant I needed to identify an overextension of price and then have something that would tell me when this move was over and the spring back to the average had

begun. Because it all seemed so easy, I was sure there must be some master theory or code to how all this was done. There must be some basic undeniable way the market—all markets—moved from point A to point B, I reasoned.

What I eventually found out is that this original thesis is true: there is a way markets move. The good news is that there is a structure in how prices move from point A to point B. The bad news is that the structure is imprecise. Nevertheless, there is a semblance of order to price action, and like a foreign language, it can be learned. It has taken most of my life to figure out the basics of this language that the market speaks, and I am more than happy to help you learn to use my magic decoding ring.

## Charting the Market

If you have begun your study of the markets, you already know it is a visual world, where charts prevail. As shown in Figure 1.1, the common charts represent each day's opening price with a horizontal slash mark to the left side of each bar and the closing price with a horizontal slash on the right side of the bar. The topmost point of the bar reflects the highest price reached by the stock or commodity during the day while the bottom of the bar represents just the opposite, the lowest price the commodity traded at on that day.

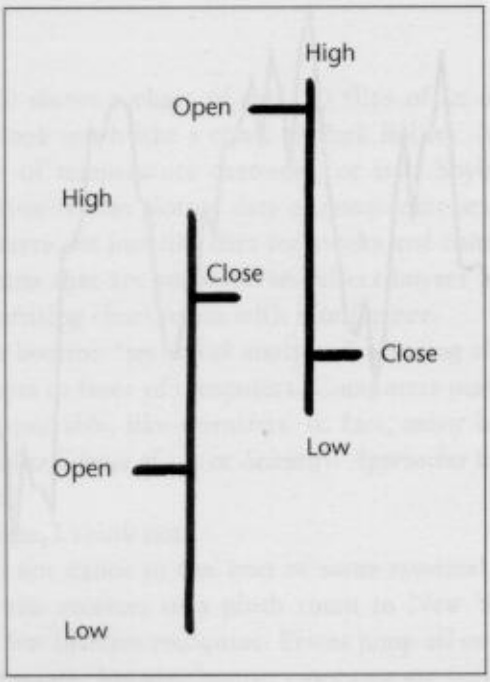



**Figure 1.1** Typical Chart showing openings, closings, highs, and lows.

The opening price, as you will see later on, is the most important price of the day. I developed this notion with Joe Miller, Don Southard, and Curt Hooper, a naval postgraduate student who—in 1966—was the first person I ever worked with using a computer for answers. While we were impressed with OBV, we wanted a more reliable formula; and once we learned that the original OBV work came from two guys from San Francisco, Woods and Vignolia, we thought we too could create a better approach.

Our chart reading problem begins and gives birth to chaos, when we start combining these daily bars of price action on a chart. These graphic representations of price action were "read" for years by folks calling themselves "chartists." By and large, chartists were about as welcome as your unemployed brother-in-law until the early 1980s.

This crowd gleaned over chart formations, found patterns, and gave them names like wedges, head and shoulders, pennants, flags, triangles, W bottoms and M tops, and 1-2-3 formations. These patterns were supposed to represent the battle of supply and demand. Some patterns indicated selling, others professional accumulation. Fascinating stuff, but wrong-headed. These same precise patterns can be found in charts of things that do not have a supply/demand factor.

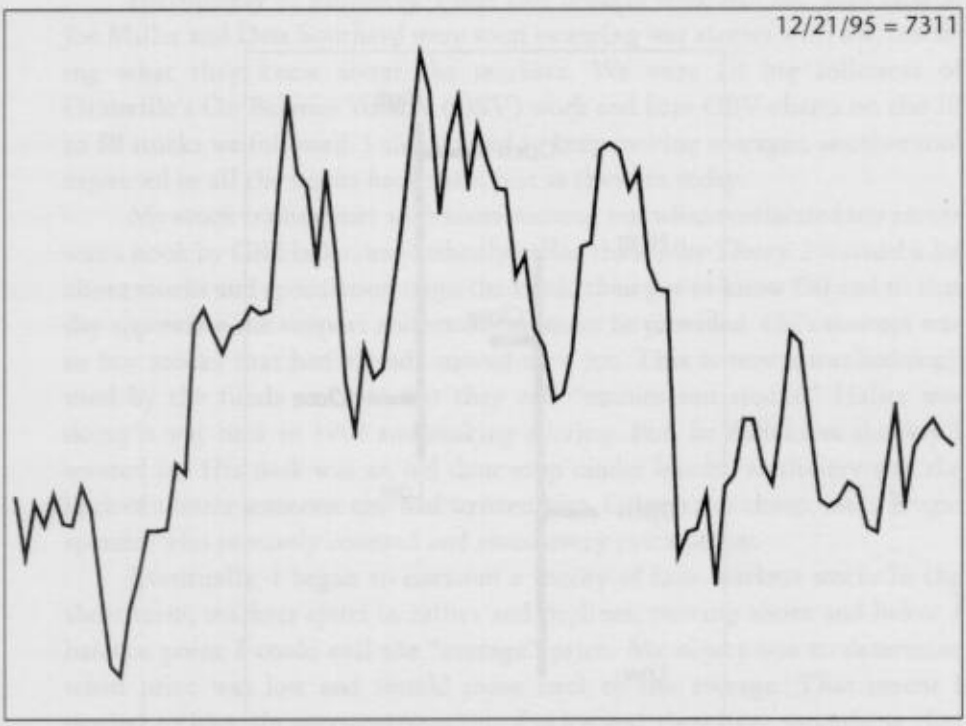



**Figure 1.2** A flip of the coin heads and tails on accumulative basis.




**Figure 1.3** A stock? No, daily temperature; high for the day; low for the day; last reading.

Figure 1.2 shows a chart of the 150 flips of an old silver dollar that graphs out to look much like a chart of Pork Bellies. Next, Figure 1.3 is a chart or graph of temperature extremes, or is it Soybeans? Who knows? What we do know is that plotted data of nonmarket or economically driven information charts out just like data for stocks and commodities, producing the same patterns that are supposed to reflect buyers and sellers. I caution you against confusing chart forms with intelligence.

Chartists became "technical analysts," severing their ties from Ouija boards and charts in favor of computers. Computers made chartists look and sound more respectable, like scientists. In fact, many books came out with titles like *The New Science of . . .* or *Scientific Approaches to . . .* Is there science to this madness?

By and large, I think not.

Prices do not dance to the beat of some mystical, magical drum that hides deep in the recesses of a plush room in New York City, and has a rhythm only a few insiders recognize. Prices jump all over the place, and our charts become erratic because human emotions are influenced by news and brokers' hot tips of immediate boom or gloom.

## The Nonrandom Market

For the most part, commodity prices are like a drunken sailor, wandering down the street without any knowledge of where he is going, or where he has been. Mathematicians would say there is *no correlation* between past price activity and future trends.

About that, they would be wrong: there is *some correlation.* Although that drunken sailor does swagger, stagger, and seemingly move in a nonrandom fashion, there is method to his madness. He is trying to go someplace, and we can usually find out where.

While price action involves a large degree of randomness, it is far from a totally random game. If I cannot prove that point, right now, early on in this book, the remaining chapters should be devoted to learning how to throw darts. In a random game, the dart thrower will outperform the experts.

Start with a given—if we flip a coin 100 times, it will come up heads 50 times and tails 50 times. Each time it comes up heads, on the next flip we will have 50 percent heads and 50 percent tails. If heads has now appeared two times in a row and we flip again, the results continue to be 50/50 that a head will appear on the next flip. As you have probably heard, the coin, dice, or roulette wheel has no memory. The odds are fixed, as this is a random game.

If that were true of the market and prices close higher 50 percent of the time, then after each up close we would expect to see another up close 50 percent of the time, and following that up close again 50 percent odds of another up close. The same thing should apply to a down close: 50 percent of the time following one down close, we should see a repeat; and again 50 percent of the time following two in a row, a third down close should appear. In our real world of trading, it does not turn out that way, which can only mean *price action is not totally random!*

**Table 1.1**
**Commodity Percent Time Close > Open**

| Commodity | % Time Close > Open |
|---|---|
| Bellies | 51 |
| Cotton | 53 |
| Beans | 51 |
| Wheat | 52 |
| British Pound | 56 |
| Gold | 52 |
| Nekii | 55 |
| Eurodollar | 57 |
| U.S. Bonds | 52 |
| Standard & Poor's 500 | 53 |
| Average % Higher | 53.2 |

Table 1.2
Commodity Number of Times after One-Down Close Percent;
Number of Times after Two-Down Close Percent

| Commodity | Number of Times after One Down Close Percent | % Up Next Day | Number of Times after Two Down Closes Percent | % Up Next Day |
|---|---|---|---|---|
| Bellies | 3,411 | 55 | 1,676 | 55 |
| Cotton | 1,414 | 53 | 666 | 55 |
| Beans | 3,619 | 56 | 1,612 | 56 |
| Wheat | 3,643 | 53 | 1,797 | 55 |
| British Pound | 2,672 | 57 | 1,254 | 56 |
| Gold | 2,903 | 58 | 1,315 | 55 |
| Nekii | 920 | 56 | 424 | 60 |
| Eurodollar | 1,598 | 59 | 708 | 56 |
| Bonds | 961 | 54 | 446 | 52 |
| Standard & Poor's 500 | 1,829 | 55 | 785 | 53 |
| Average + Close | | 55.8 | | 55.2 |

Table 1.1 shows the percentage of time that prices closed higher in a wide variety of markets. There were no criteria; the computer just bought on the open each day and exited on the close. Instead of having a 50/50 result we have a slight skewing in that 53.2 percent of the time price closed higher than the opening. This shouldn't be.

Well, if this "shouldn't be," how about buying on the opening following a down close? In theory, we should see the same percent of up closes shown in Table 1.1. The problem is (for college professors and other academics who are long on theory and short on market knowledge) that it does not turn out this way. Table 1.2 shows the number of times price closed higher following a number of down closes.

This is not earth-shaking news to a trader; we know market declines set up rallies. The exact percentages were not known in the past, and I would never use these tables to take or stay in a trade. That is not the point: the point is we should have seen an average up close of 53.2 percent following the one minus close as well as two consecutive minus closes. The fact we did not suggests the market is not random; patterns do "predict" and now we can proceed, sans darts.

## Understanding Market Structure

Whereas chartists have strange names for most every market wiggle and waggle, they have seemingly missed the major point of the market, which is that price (as represented by daily bars, where the top of the bar is the highest

point prices traded on that day and the bottom of the bar the lowest price traded) move in a well-defined and amazingly mechanical fashion. It is similar to learning to read a new alphabet—once you understand the characters, you can read the words, and once you know the words you can read the story.

The first letter to master tells you what market activity causes the formation of a short-term high or low. If you learn this basic point, the meaning of all market structure will begin to fall into place.

I can define a short-term market low with this simple formula: any time there is a daily low with higher lows on both sides of it, that low will be a short-term low. We know this because a study of market action will show that prices descended in the low day, then failed to make a new low, thus turned up, marking that ultimate low as a short-term point.

A short-term market high is just the opposite. Here we will see a high with lower highs on both sides of it. What this says is that prices rallied up to the zenith of that middle day, then began to move back down, and in the process formed a short-term high.

I initially called these short-term changes "ringed" highs and lows in deference to the work done in the 1930s by Henry Wheeler Chase. In the days before computers, we kept notebooks of prices, and to identify such termination of a move, we simply circled or "ringed" these points in our workbooks so we could see them more easily.

Figure 1.4 shows several short-term highs and lows. Take a minute now to see what this pattern is all about.

If you understand this concept, we can begin the building process of putting these elements together. You may have already figured out the sequence; the market swings from short-term highs to short-term lows. This is exciting; we can actually measure market movement in a mechanical and automatic way. There is no need for complex chartist talk, nor will we be as inclined to fall into the illusory world of the chartist or technician.

Two specific types of trading days can cause confusion with our basic definition. First, there is what we call an inside day. It is so named because all the trading on this day took place inside the previous day's range. These days are identified by having a lower daily high and a higher daily low. In a study of nine major commodities covering 50,692 trading sessions, I noted 3,892 inside days, suggesting we will see these days appear about 7.6 percent of the time.

For our purposes in identifying short-term swing points, we will simply ignore inside days and the possible short-term points they produce. An inside day means the market has entered congestion, the current swing did not go further, but then again it did not reverse, thus until this condition is resolved, we must wait and not use the inside day in our identification process.

Next we have outside days. These days are easy to spot because they have both a higher high than the prior day and a lower low! When these days

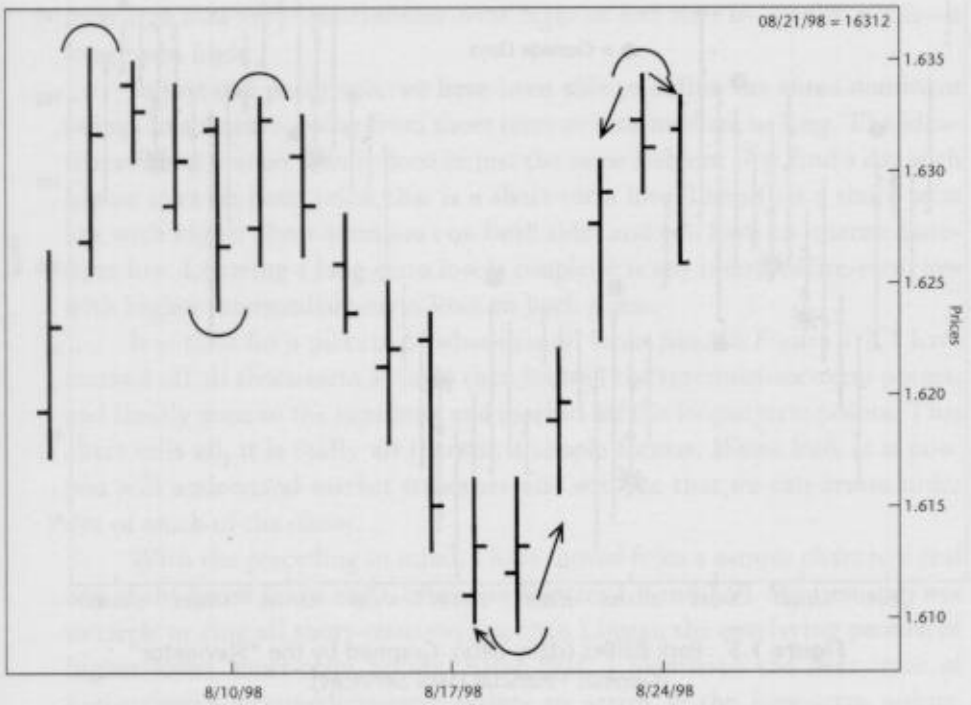



**Figure 1.4** British Pound (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services: 800-808-3282).

occur (and they do so about 3 percent of the time), we will have to study the flow of prices during that day by looking at the way price moved from the opening of the day to the close of that same day. In that study of 50,692 trading sessions cited earlier, there were 3,487 outside days, suggesting they are not as frequent as inside days, yet account for almost 7 percent of all days.

With the preceding information in mind, turn your attention to Figure 1.5, which illustrates these inside and outside days. Remember, what we are out to do is identify the short-term swings as traders move price from one terminus to another.

By now you should understand the basic concept, and be able to see how prices move in swings. On Figure 1.6 I have marked off these terminal points and connected a straight line from point to point to show the swing patterns.

## Defining Intermediate Highs and Lows

Now the fun begins! Consider this, if we can identify a short-term high as any day with lower highs (not counting inside days) on both sides, we can take a gigantic step forward and identify an intermediate term high as *any short-term high with lower short-term highs on both sides* of it. Hold on to your seat belts because we can take yet another step and say any *intermediate-*

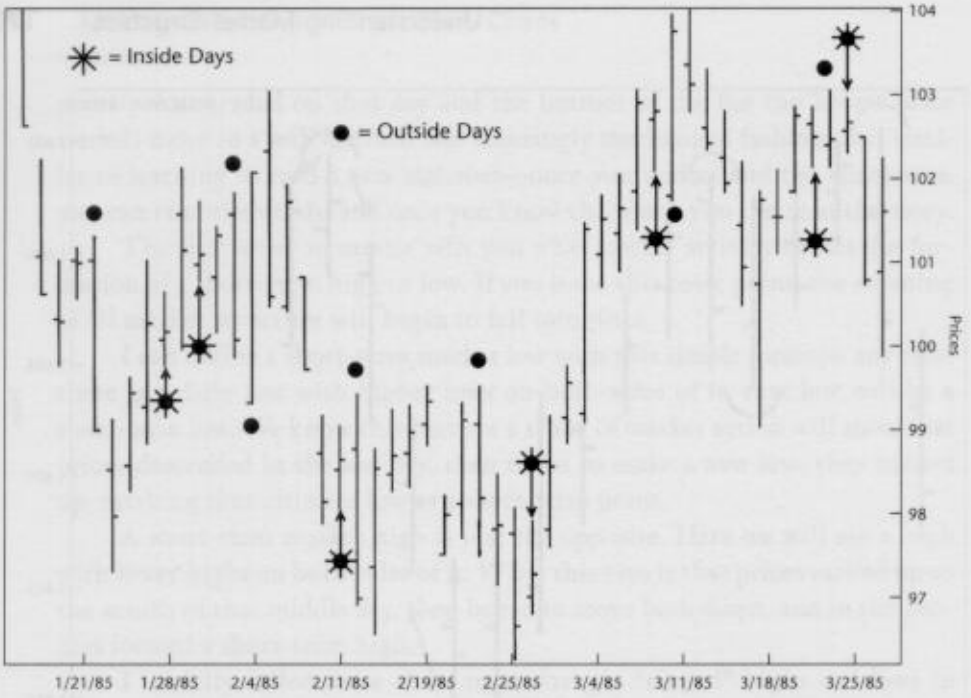



**Figure 1.5** Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

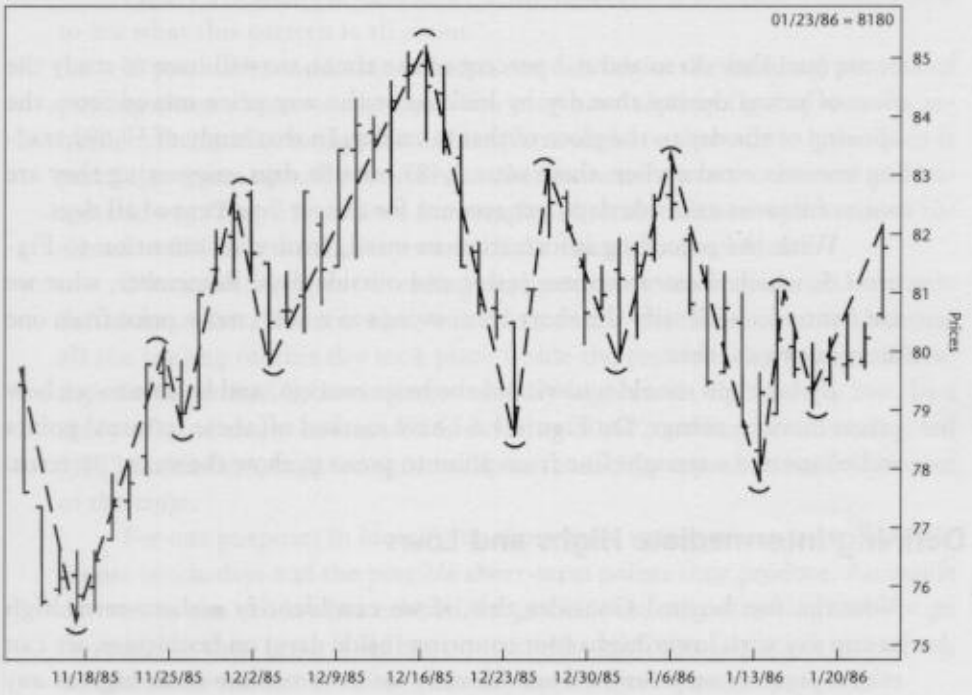



**Figure 1.6** Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

*term high with lower intermediate-term highs on both sides is*—you've got it—a long-term high.

In just one paragraph, we have been able to define the three dominant swings in a market, going from short term to intermediate to long. The identification of market lows is done in just the same fashion: first find a day with higher lows on both sides; that is a short-term low. Then find a short-term low with higher short-term lows on both sides and you have an intermediate-term low. Locating a long-term low is simple: it is any intermediate-term low with higher intermediate-term lows on both sides.

It is time for a picture of what this all looks like. In Figure 1.7, I have marked off all short-term swings, then located the intermediate-term points, and finally gone to the next level and marked off the longer term points. This chart tells all; it is really all there in a simple format. If you look at it now, you will understand market structure and will see that we can create order out of much of the chaos.

With the preceding in mind, I have moved from a sample chart to a real one of the Swiss Franc and Coffee (see Figures 1.8 and 1.9). My first step was to circle or ring all short-term swings; then I began the overlaying pattern of higher/lower short-term points. After that, I identified the next layer of higher/lower intermediate-term points to arrive at the long-term points. While words are great, until you study these charts, it will be difficult for you to get the picture. Go study.

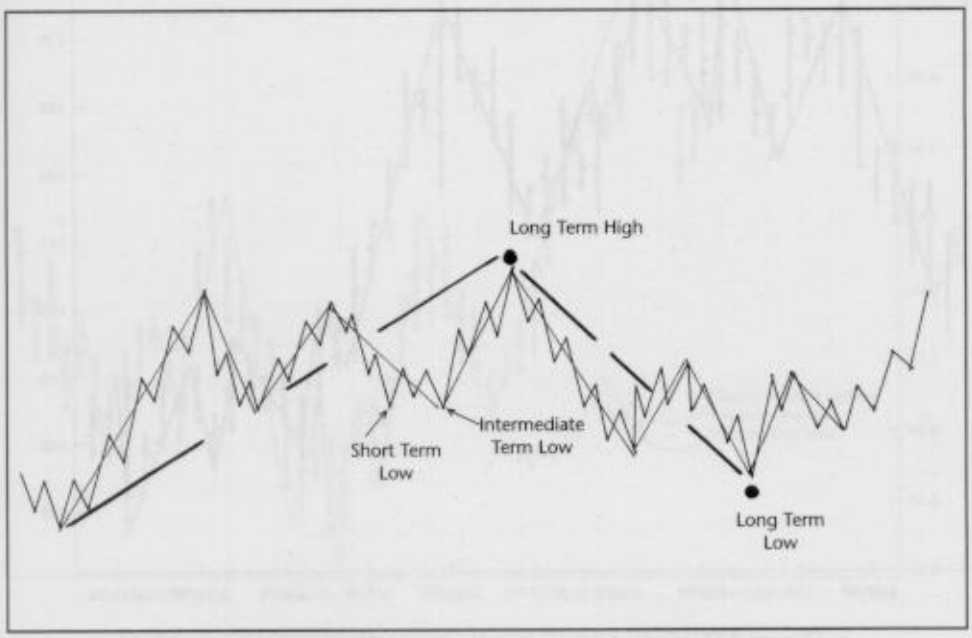



**Figure 1.7** Charting creates order out of chaos.

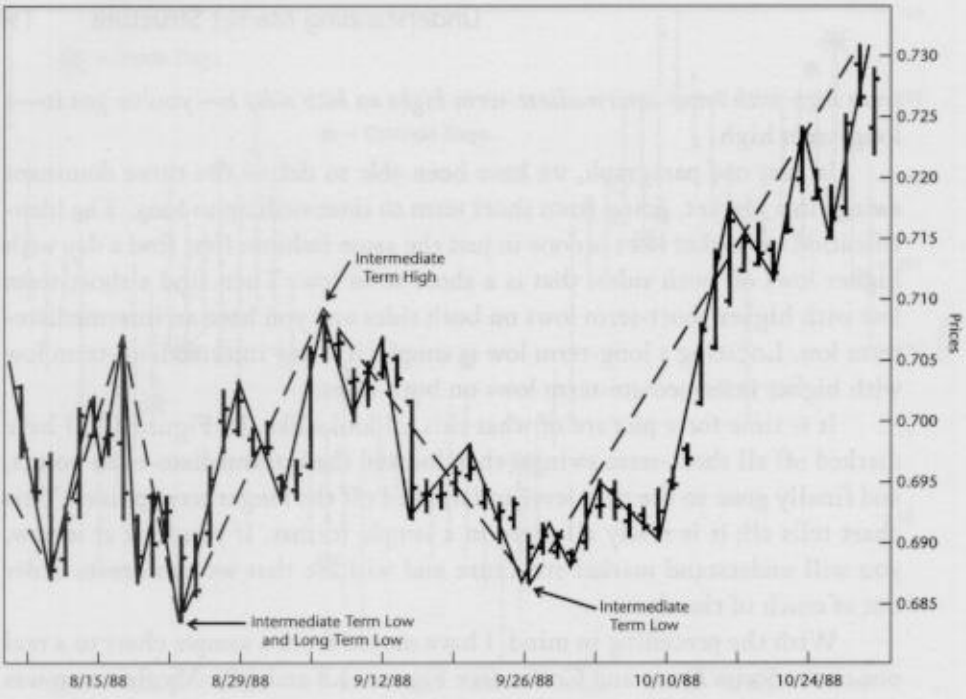



**Figure 1.8** Swiss Franc (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

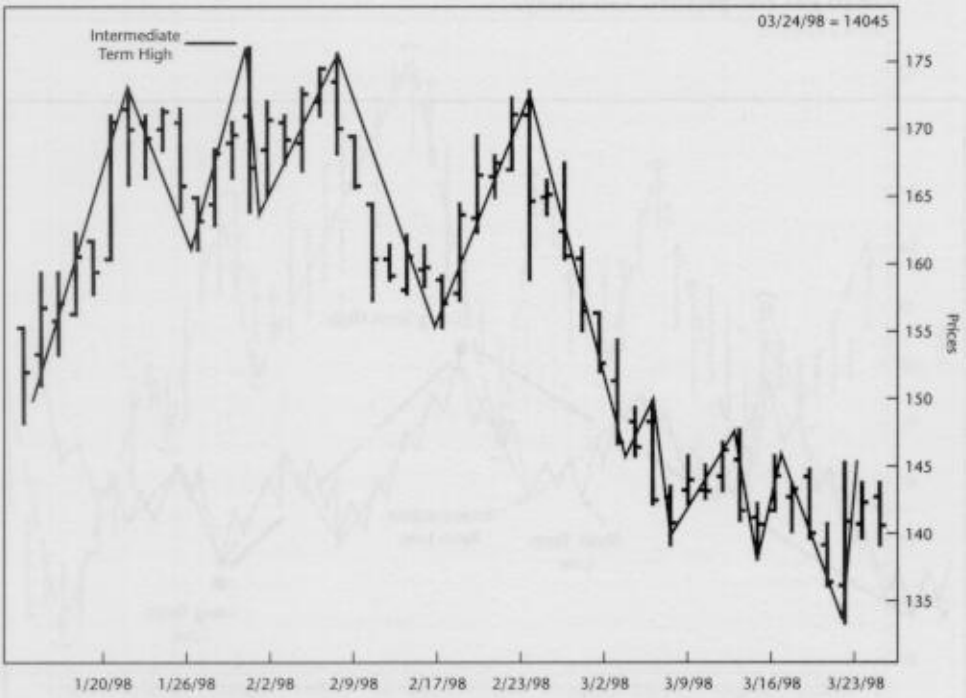



**Figure 1.9** Coffee (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

## Why This Is Important

Once you have this basic understanding of market structure you can identify, very early on, these market turns. You will always know that a short-term low has been made when you rally above the high of a day with a lower low than the prior day. By the very nature of this penetration, we know the short-term down swing has terminated. By the same token, whenever price declines below the low of a day with a higher high than the prior day, a short-term high has been formed. This means we can know, during the trading session, when these points are established.

As short-term traders, we also can tell when intermediate-term highs and lows are made. How? Simple, if the formation of a short-term high will confirm an intermediate-term high, which in turn confirms a long-term high, we can get in at some optimal turning points.

Figure 1.10 shows how this can all be combined. By going above the high of the day marked at (A), we have formed a short-term low that is in turn higher than the prior short-term low. This means the low at (B) is a long-term low and we can be buying at the start of an up leg in what is some type of long-term move.

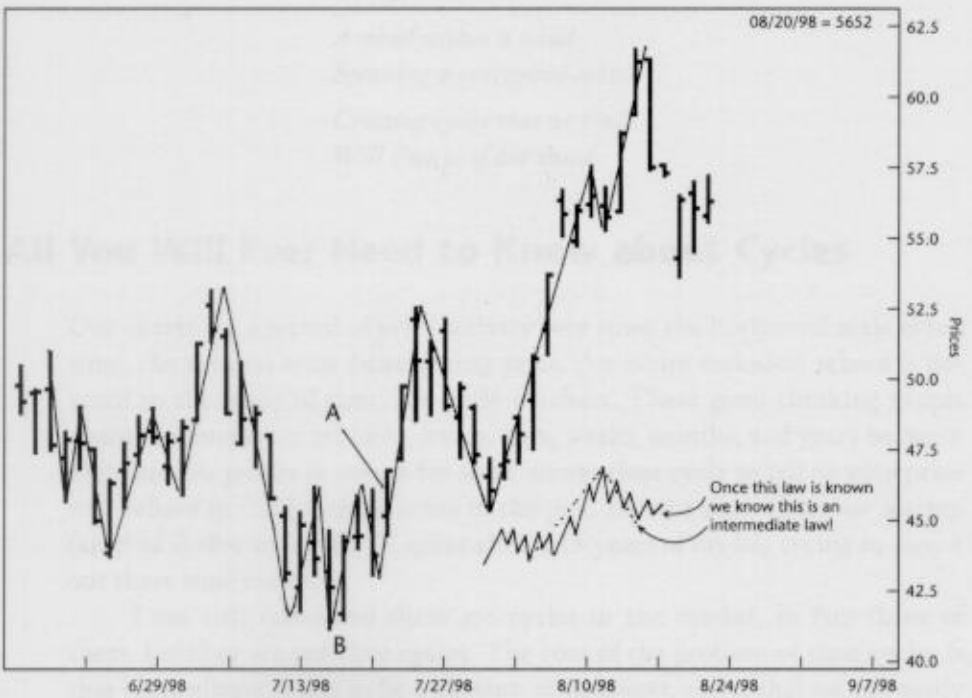



**Figure 1.10** Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

It is really all about nesting swings together, fitting the pieces of the puzzle into their proper place, to give us an understanding of the structure of market activity. The beauty is you can now identify, at all times and for all markets, whether the trend (based on price structure) is up or down and pick your points to get in and out.

For years, I made a pretty good living using just the formation of these points as buy and sell entries. These points are the only valid support and resistance levels I have ever found. They are highly significant and the violation of these price points provides important information of trend and trend change. Thus I can use them for my stop-loss protection and entry techniques.

# Chapter 2

# It's a Question of Price and Time

*Like a circle being squared,*
*Going round and round*
*A wheel within a wheel*
*Spinning a syncopated sound*
*Creating cycles that we find*
*Will o'wisps of our mind.*

## All You Will Ever Need to Know about Cycles

Our charts are a record of price activity over time, the horizontal scale being time, the vertical scale representing price. An entire technical school is devoted to the study of time, the cycle watchers. These good-thinking people count the number of minutes, hours, days, weeks, months, and years between high and low points in search for some master time cycle to tell us *when* price will behave in the future as it has in the past. Being a somewhat slow learner (an even slower unlearner), I spent almost 15 years of my life trying to figure out these time cycles.

I am still convinced there are cycles in the market, in fact three of them, but they are not time cycles. The root of the problem of time cycles is that there always seems to be a current, or *dominant*, cycle, that we can easily see on our chart right now. The rub is, another cycle is always about to become dominant, overpowering the one we have just located and invested in.

Although our first problem is cycle dominance, if there are such cycles, they change direction more often than a politician looking for votes. In the 1960s and early 1970s, the hope was that a combination of high-powered math and high-powered computers would solve this master cycle problem. It has yet to be done. Just what the heck cycle we should lay our bets down on at any given time is impossible to tell. But an even greater problem is the one of magnitude.

The cycle crowd deals exclusively with time. But I have yet to find a banker who allows me to deposit days, weeks, or months! By that, I mean that a cyclist might ferret out a market low, say an 18-year low, but price does not respond much to the upside, climbing up that vertical scale of dollars, the reward mechanism of the game. In theory, calling a major cycle low or high, if you could do it, would produce a move of some magnitude. But in the real world where I live and trade, that has seldom been the case; instead the cycle quickly faded. Sure, price stopped there—in time—and bobbled along for a few days or weeks, but there was not enough price magnitude for a profit.

I will prove my point with an actual study of past price activity. Figure 2.1 shows the result of a test of a timing system for Soybeans. I fired up my computer, asking it to buy when a short-term moving average of price crossed above a longer term moving average. This is standard technical stuff. The only variable was time, the number of days in the moving average. Thus it is cycle impacted. A moving average is simply the average closing price for the last "X" number of days. There are no other variables, only time.

Our first test was on Soybean prices from 4/29/75 through 1/1/87, and it looked at all possible combinations of short-term averages from 5 to 50 days against the longer term or second average from 10 to 60 days. The best result,

Data : SOYBEANS 67/99
Calc Dates : 04/29/75 - 01/01/87

| Num. | Conv. | P. Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---|---|---|---|---|---|---|---|
| 17 | -1 | $ 6.250 | $ 50 | $ 0 | $ 3,000 | CSI | C:\GD\BACK67\F051.DTA |

//////////////////////////// ALL TRADES - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $40,075.00 | | |
| Gross profit | $126,212.50 | Gross loss | $-86,137.50 |
| Total # of trades | 153 | Percent profitable | 35% |
| Number winning trades | 54 | Number losing trades | 99 |
| Largest winning trade | $13,000.00 | Largest losing trade | $-2,362.50 |
| Average winning trade | $2,337.27 | Average losing trade | $ -870.08 |
| Ratio avg win/avg loss | 2.68 | Avg trade (win & loss) | $261.93 |
| Max consecutive winners | 2 | Max consecutive losers | 8 |
| Avg # bars in winners | 35 | Avg # bars in losers | 10 |
| Max closed-out drawdown | $-13,625.00 | Max intra-day drawdown | $-13,687.50 |
| Profit factor | 1.46 | Max # of contracts held | 1 |
| Account size required | $16,687.50 | Return on account | 240% |

**Figure 2.1** Test of a timing system.

during this time period shown here used a 5-day average against a 25-day average. This time-based "system" made $40,075 with 54 profitable trades out of a total of 153. Wow, have we discovered a money machine?

Figure 2.2 shows what would have taken place had we traded this system from 1/1/87 through 4/23/98. The results are not promising. Whereas our accuracy at 31 percent winners on 163 trades has improved, we actually lost money, $9,100 to be specific and along the way suffered a drawdown (how much the system went against you before getting back in the black) of $28,612. Putting up $28,612 to lose $9,100 is hardly a good wager! The average profit per trade was $–55. What happened to the original cyclical or time influence? Beats me!

Reversing the process, I checked to see what two moving averages worked best in the second time period from 1/1/87 into April 23, 1998 (see Figure 2.3). The best combination was a 25-day moving average against a 30-day. This made $34,900 with a nice 59 percent accuracy. This system made $234 per trade and had a drawdown of $13,962. This too, is not a good bet.

Applying the best case results back on the earlier data, out of sample, produced a loss of $28,725, as shown in Figure 2.4. Forward, backward, the time or length or cycle of the moving average that worked in one time period does not work in another time period.

"Perhaps," you query, "The problem is not that time does not work but that Soybeans do not trend enough."

What appears next is the best case study of a moving average crossover system on the British Pound, a very trending market. From 1975 to 1987, the best such crossover system was a 5-day average versus a 45-day, making a most impressive $135,443.

```
Data              : SOYBEANS              67/99
Calc Dates        : 01/01/87 - 04/23/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   17  -1  $   6.250  $ 50   $  0   $  3,000  CSI     C:\GD\BACK67\F051.DTA

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $-9,100.00
Gross profit              $81,612.50    Gross loss                $-90,712.50

Total # of trades             163       Percent profitable             31%
Number winning trades          52       Number losing trades          111

Largest winning trade     $10,062.50    Largest losing trade      $-2,950.00
Average winning trade      $1,569.47    Average losing trade       $ -817.23
Ratio avg win/avg loss          1.92    Avg trade (win & loss)      $-55.83

Max consecutive winners            5    Max consecutive losers          9
Avg # bars in winners             30    Avg # bars in losers           11

Max closed-out drawdown   $-28,612.50   Max intra-day drawdown    $-29,412.50
Profit factor                   0.89    Max # of contracts held         1
Account size required     $32,412.50    Return on account             -28%
```

**Figure 2.2** What might have happened.

```
Data              : SOYBEANS                67/99
Calc Dates        : 01/01/87 - 04/23/98

 Num. Conv. P. Value   Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   17  -1  $   6.250  $ 50   $  0   $ 3,000  CSI     C:\GD\BACK67\F051.DTA

////////////////////////////// ALL TRADES  - Test 39 \\\\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $34,900.00
Gross profit             $101,262.50    Gross loss              $-66,362.50

Total # of trades            149         Percent profitable          59%
Number winning trades         89         Number losing trades        60

Largest winning trade     $3,812.50      Largest losing trade     $-7,237.50
Average winning trade     $1,137.78      Average losing trade     $-1,106.04
Ratio avg win/avg loss         1.02      Avg trade (win & loss)      $234.23

Max consecutive winners          8       Max consecutive losers         4
Avg # bars in winners           14       Avg # bars in losers          25

Max closed-out drawdown  $-13,962.50     Max intra-day drawdown   $-20,525.00
Profit factor                  1.52      Max # of contracts held        1
Account size required    $23,525.00      Return on account           148%
```

**Figure 2.3** Testing another time period.

The next time period, 1987 through 1997, the same system made money all right, $45,287 as Figure 2.5 shows, but suffered a $29,100 losing spell! Not such a hot bet. The best crossover to use on this current set of 10-year data was a 20/40, which cleaned up making $121,700, the problem is it only made $26,025 on the first time period and got tagged with a $30,000 drawdown. Sorry, the problem was not beans or the pound, the problem is that time based studies simply do not hold up. Using time exclusively as a consideration in speculation is one of the surer ways I know of getting a free pass to the poorhouse.

```
Data              : SOYBEANS                67/99
Calc Dates        : 04/29/75 - 01/01/87

 Num. Conv. P. Value   Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   17  -1  $   6.250  $ 50   $  0   $ 3,000  CSI     C:\GD\BACK67\F051.DTA

////////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $-28,725.00
Gross profit              $96,750.00     Gross loss              -125,475.00

Total # of trades            138         Percent profitable          56%
Number winning trades         78         Number losing trades        60

Largest winning trade     $4,600.00      Largest losing trade     $-12,750.00
Average winning trade     $1,240.38      Average losing trade      $-2,091.25
Ratio avg win/avg loss         0.59      Avg trade (win & loss)    $ -208.15

Max consecutive winners          8       Max consecutive losers         4
Avg # bars in winners           14       Avg # bars in losers          30

Max closed-out drawdown  $-43,775.00     Max intra-day drawdown   $-46,150.00
Profit factor                  0.77      Max # of contracts held        1
Account size required    $49,150.00      Return on account           -58%
```

**Figure 2.4** Applying best case results.

```
Data              : BRITISH POUND       67/99
Calc Dates        : 01/01/87 - 01/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   26   4  $   6.250  $ 50   $  0   $ 3,000  CSI     C:\GD\BACK67\F003.DTA

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $45,287.50
Gross profit             $134,175.00    Gross loss              $-88,887.50

Total # of trades            104         Percent profitable          31%
Number winning trades         33         Number losing trades        71

Largest winning trade     $17,262.50     Largest losing trade     $-4,575.00
Average winning trade      $4,065.91     Average losing trade     $-1,251.94
Ratio avg win/avg loss          3.24     Avg trade (win & loss)      $435.46

Max consecutive winners          3       Max consecutive losers        12
Avg # bars in winners           54       Avg # bars in losers          13

Max closed-out drawdown   $-29,100.00    Max intra-day drawdown   $-29,450.00
Profit factor                   1.50     Max # of contracts held         1
Account size required     $32,450.00     Return on account            139%
```

**Figure 2.5** Using this system on the next time period.

I have duplicated this study at various times, on wildly different sets of data and have yet to see the best cyclical-based approach to trading be even close to being the best in the next test on out-of-sample data.

My advice is to forget cycles of time, they are the will-o'-the-wisp of Wall Street.

There are cycles (maybe it is a pattern) to the way price moves that you can quickly see on any chart, any time frame, any market, any country in the world where I have traded. Once you understand these patterns, you will be better able to align yourself with where prices will most likely go.

Over the years, I have codified and identified three cycles and now refer to them as (1) small range/large range, (2) moving closes within ranges, and (3) closes opposite openings.

It is time for your first lesson in chart reading; we will begin with a study of changing ranges. When I refer to ranges what I am talking about is the total distance traveled by a stock or commodity in a day, week, month, year, it could even be in one minute. Think of range as the price distance traveled in whatever time period you are using. For all three cycles you will learn, the rules work equally well in any time frame. The rules I have uncovered are universal to markets as well as time frame references.

## The Natural Cycle of Range Change

On any given day, the range of price in a commodity can do anything. That is what causes so much chartist confusion. But over any time period you want to study, you will notice a clear-cut, precise cadence to range activity. At all

times, all markets, ranges fluctuate from—and this is critical—a series of small ranges to a cluster of large ranges.

*The cycle continues repeating itself year in and year out; small ranges are followed by large ranges, large ranges are followed by small ranges. This is clockwork, this is the basic key to profitable short-term trading.*

This seemingly obvious cycle is so powerful and important to us because speculators must have price change to make money. The greater the change, the greater the potential for profit. If there is no, or little, price change, a speculator is simply stuck in the mud as price fails to trend.

That is why short-term traders need explosive price moves over a few hours or days. Without this, we will wither on the vine. Got it? I hope so, because here comes the fascinating part. What usually attracts the public or uninformed to a market is large price change. They, usually incorrectly, think the current large change will continue.

You now know better.

Large ranges give way, most often, to small ranges. Your objective is to establish a position in advance of large price change. It is a classic sucker play to see a market that has been hot, with large ranges for a day or two, pull in the public just before a sideways or congestion move. Most short-term traders are losers. The reason they are is that they go from one hot market to the next because they have no understanding of how the drunken sailor swaggers, how prices move across the great wasteland of their chart books.

On the other hand, we who are the knowledgeable few, play just the opposite game. We look for markets that have been volatile in the past and are known for large daily ranges, but have recently produced small daily ranges because we know a large-range day is out there not too far away!

You can eliminate the madness of charts by laying low on the sidelines, carefully waiting until ranges have dwindled, dried up. Once that part of the natural cycle is about over, it is time for short-term fireworks.

By the same token, large-range days tell us we may soon get stuck in the mud of small ranges where we cannot make money. This is certainly no time to overstay our welcome. Let me prove this point with some charts. Figure 2.6 shows gold in the September 1997 to January 1998 time frame.

Do yourself a big favor. Mark off all the large-range days you see in this time period. Then study the size of the ranges just prior to these explosive up-and-down days. See what I see? We were given ample warning of virtually every large-range day by the shrinkage of ranges a few days earlier.

Voilà! We are on the edge of a major market discovery here. I know—I have not yet told you how to tell in which direction these ranges will take off, but don't get ahead of the teacher. For now study every chart you can so that you can imprint on your brain, your very speculative spirit, the first undeniable short-term truth of the market:

*Small ranges beget large ranges. Large ranges beget small ranges.*

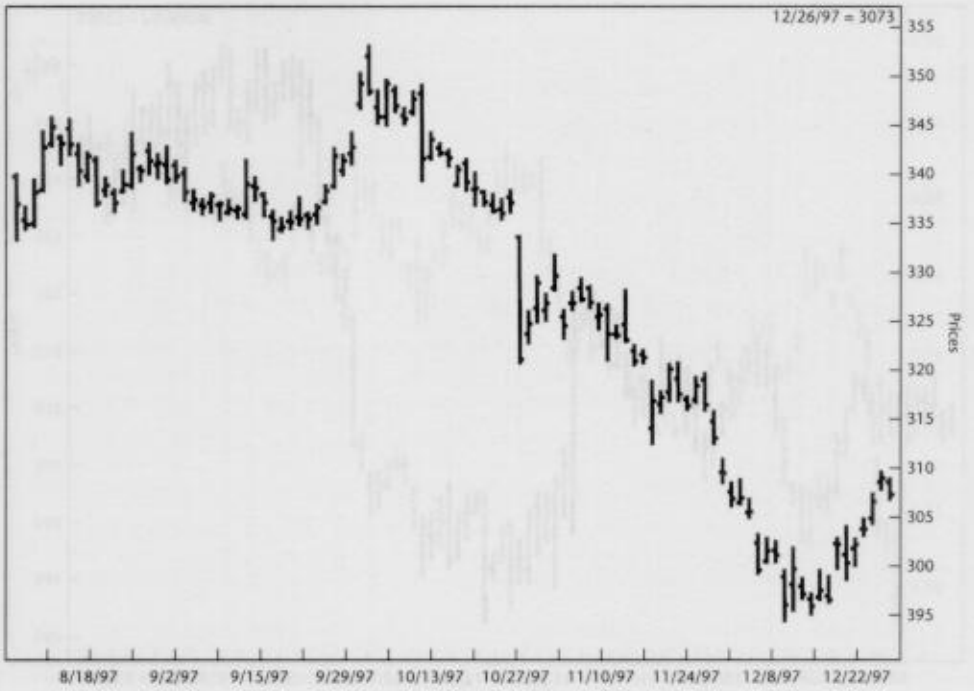



**Figure 2.6** Comex Gold (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

Look at Figure 2.7, which shows the always volatile S&P 500 from October 1991 through January 1992. Grab a pencil, mark off the days with smallest ranges on the chart and then note what happened shortly thereafter . . . a large-range day or two or even three, then a contraction of ranges, small to big, big to small—on and on it goes as it always has. Always will.

Our next study in speculative technique is that of Coffee (Figure 2.8), a fast-paced market, ripe with opportunity for the trader with an understanding of the truth. Again, mark off the small-range days, then observe what follows: large-range days when we can make money while the public gets all lathered up about these days hopping aboard only to lose patience as the ranges contract into decaffeinated days and the supposed opportunity evaporates. Just about the time most of the public has been bored out of their positions . . . zingo! . . . away go prices, switching gears back to large ranges.

Finally, I'd like you to take a close and hard look at Figures 2.9 and 2.10, which are for markets not traded in the United States, the Australian Dollar and the Nikkei (the Japanese answer to the Dow Jones Industrial average).

If you are still not convinced that we have uncovered a major cycle to price movement—a cycle without time—I am next presenting three charts of

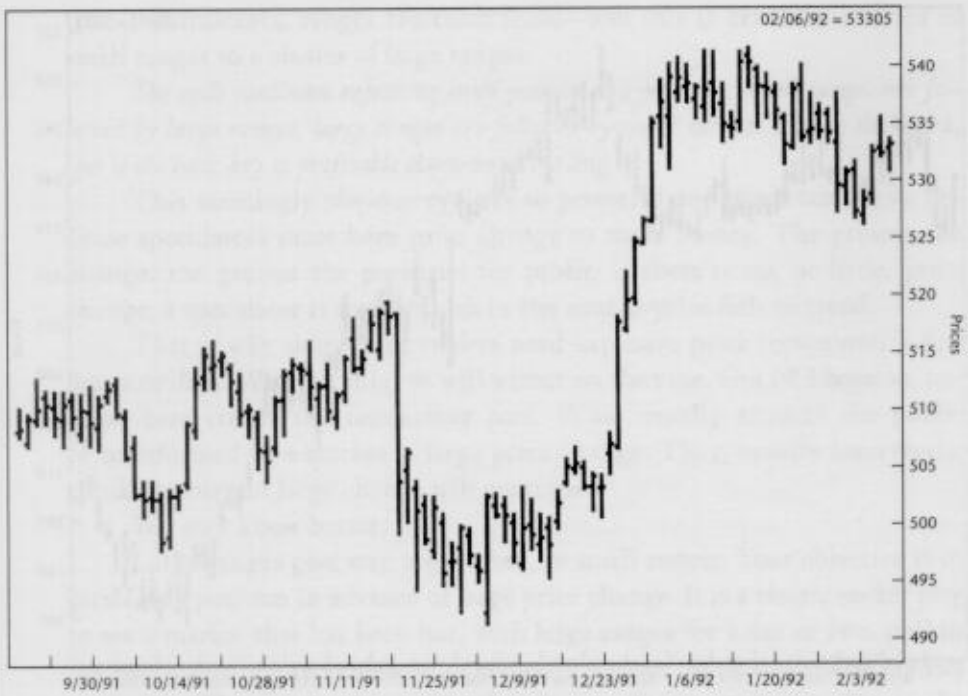



**Figure 2.7** S&P 500 Index (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

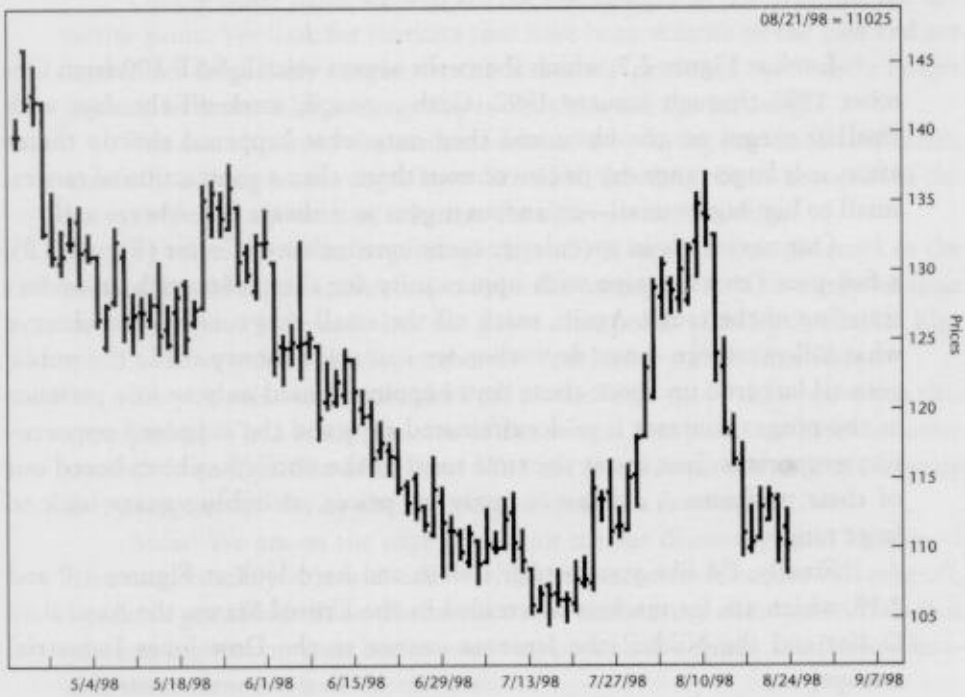



**Figure 2.8** Coffee (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

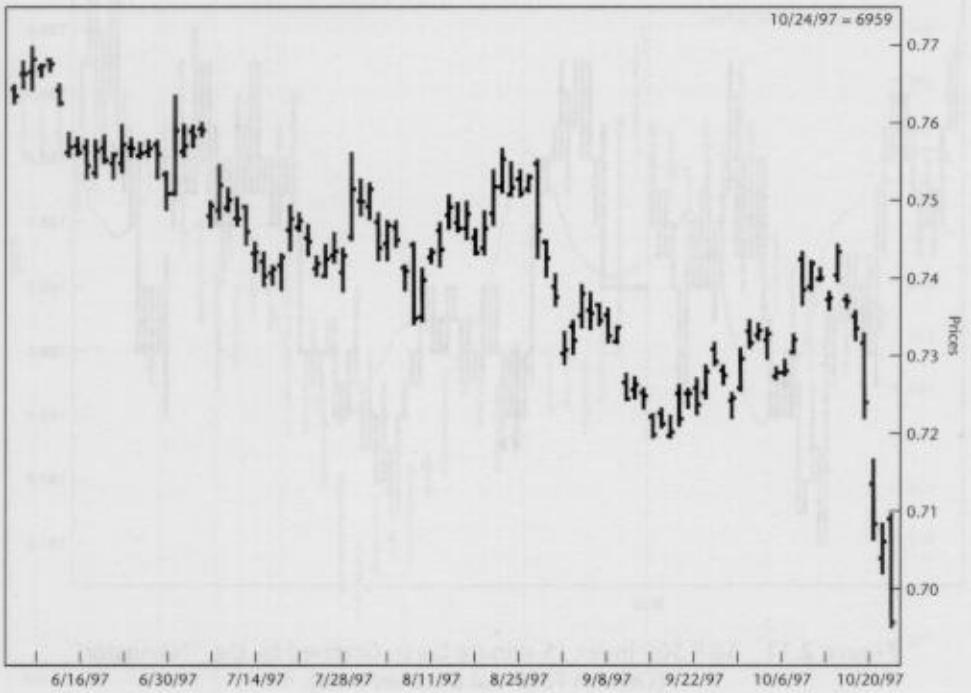



**Figure 2.9** Australian Dollar (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

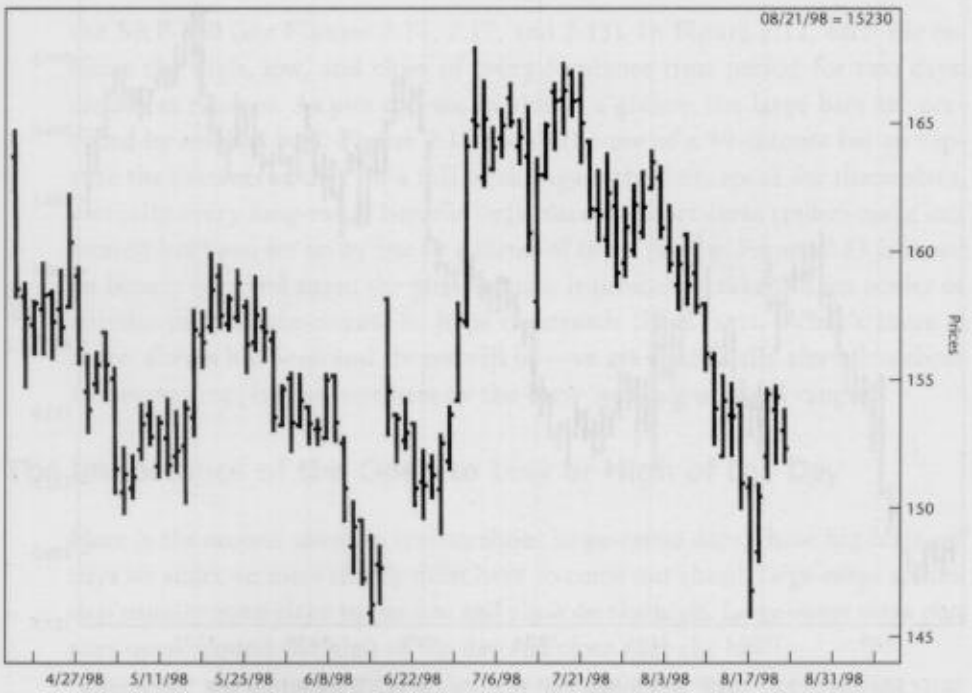



**Figure 2.10** Nikkei Stock Index (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

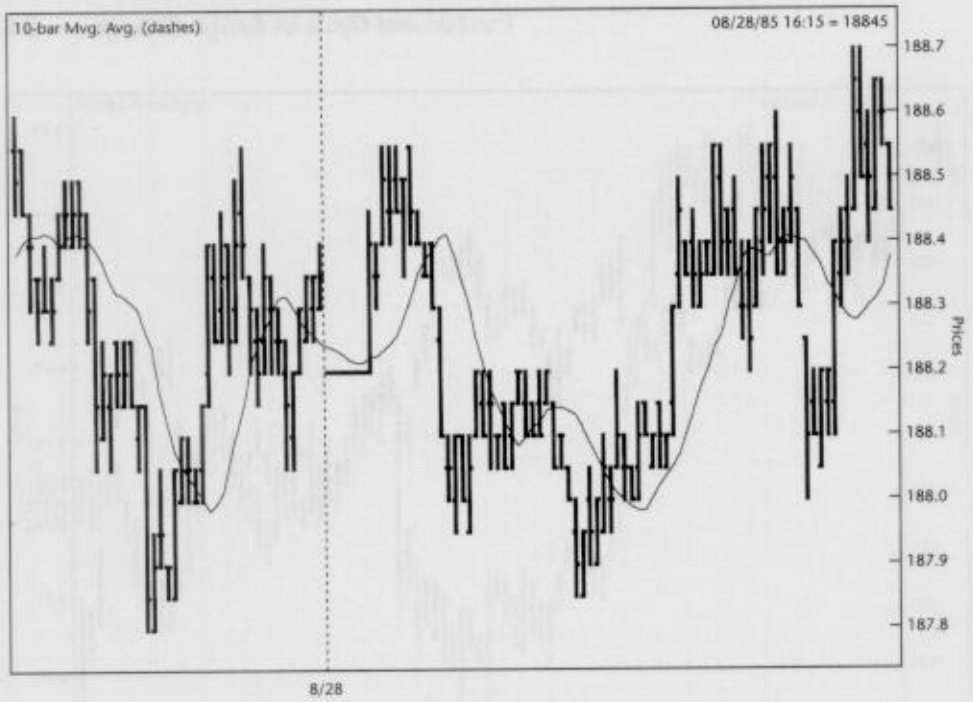



**Figure 2.11** S&P 500 Index (5-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

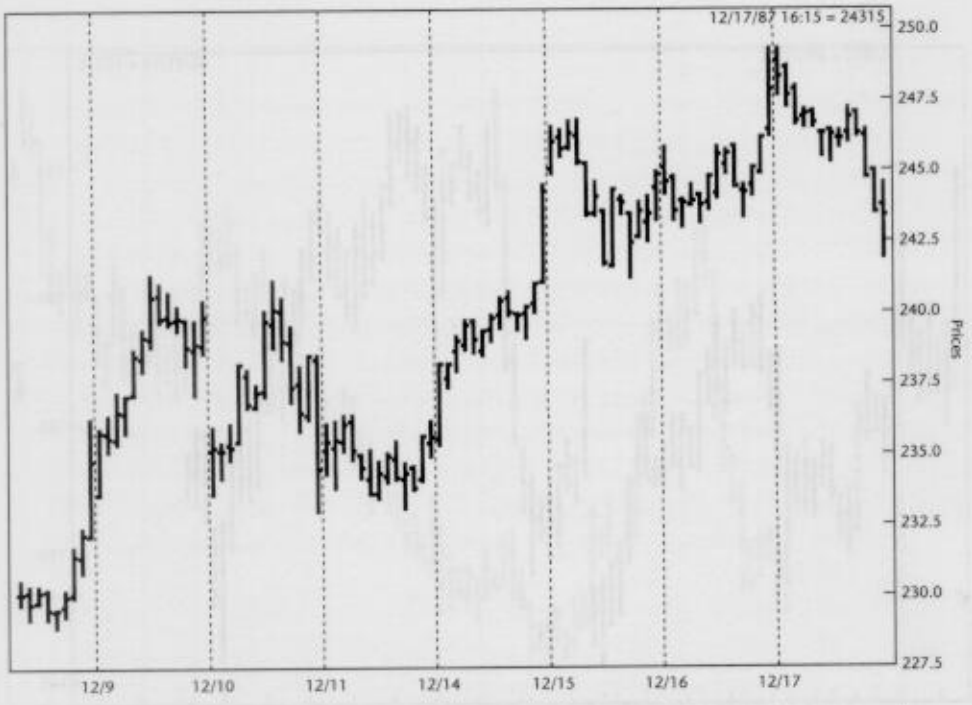



**Figure 2.12** S&P 500 Index (30-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

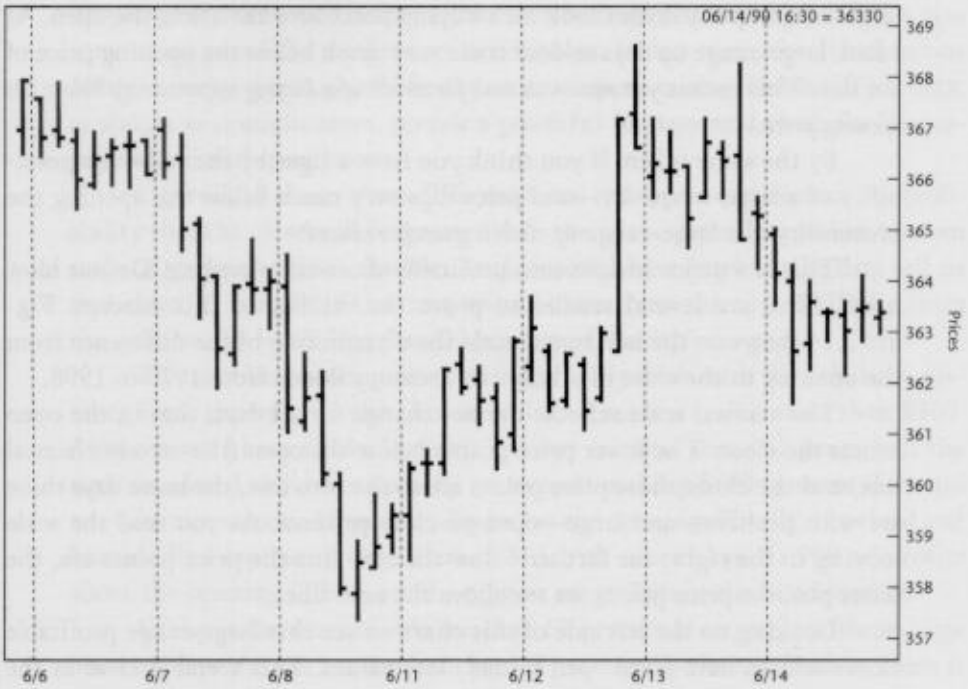



**Figure 2.13** S&P 500 Index (60-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

the S&P 500 (see Figures 2.11, 2.12, and 2.13). In Figure 2.11, each bar reflects the high, low, and close of every 5-minute time period for two days, chosen at random. As you can see in almost a glance, the large bars are preceded by smaller bars. Figure 2.12 shows the use of a 30-minute bar to capture the markets swings for a full week. Again the facts speak for themselves, virtually every long-range bar, the only place we short-term traders make our money, has been set up by one or a series of small ranges. Figure 2.13 is based on hourly bars and again the phenomenon is present. It takes no tea reader or mumbo jumbo spin-doctor to hype or stretch these facts. What's there is there, always has been and always will be—we are continually alerted to those moneymaking, large-range bars by the early warning of small ranges.

## The Importance of the Open to Low or High of the Day

Here is the second absolute truism about large-range days, those big blast-off days we short-termers simply must have to come out ahead; *large-range up close days* usually open close to the low and close on the high. *Large-range down close* days open around the high of the day and close near the low.

This means you must take two things into consideration in your trading. The first is that if we are "aboard" a day that we think will be a

large-range up day do not look for a buying point very far below the open. As I said, large-range up days seldom trade very much below the opening price of the day. This means *you must not look for much of a buying opportunity below the opening price.*

By the same token, if you think you have a tiger by the tail—the possibility of a large-range day—and price dips very much below the opening the probability of a large-range *up close is greatly reduced.*

This is a major insight into profitable short-term trading. Do not blow it off. Here are several studies to prove the validity of this concept. Figure 2.14 shows on the horizontal scale the distribution of the difference from the opening to the close of all days in Treasury Bonds from 1970 to 1998.

The vertical scale reflects the net change for all days, that is, the open minus the close. The fewer price points below the open (the zero horizontal line) and the closer those price points are to the zero line, the more days there are with positive—and large—open-to-close patterns. As you read the scale moving to the right, the farther below the zero line the price points are, the fewer positive price points we see above the zero line.

Looking on the left side of this chart we see that large-range profitable closes seldom have large open minus close values. This trend is clear as the mass of data slants from left to right, that is, the profitable side of trading.

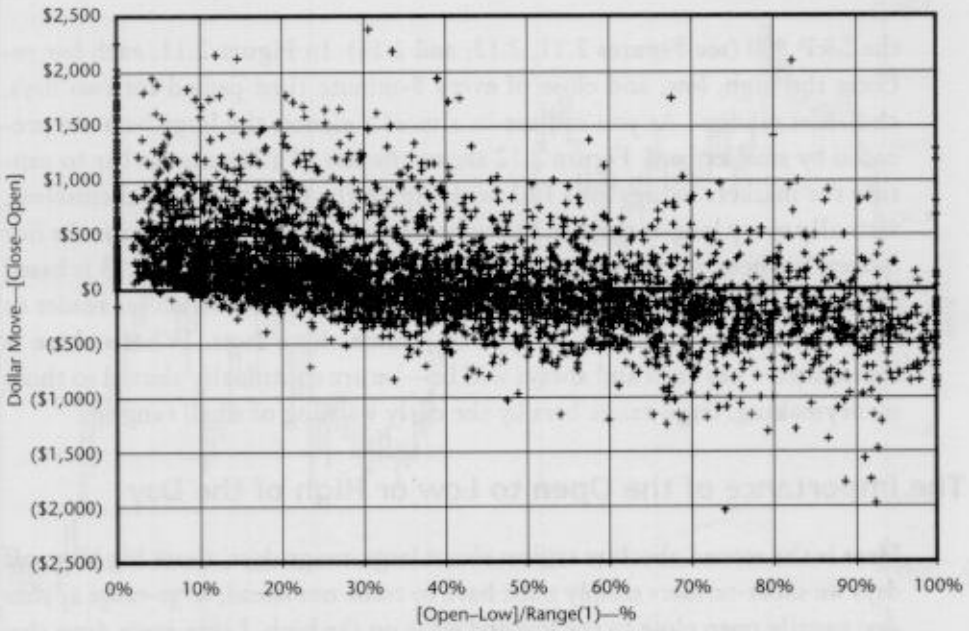



**Figure 2.14** Distribution of dollar value of open to close versus (open–low) as percentage of yesterday's range—T-Bonds.

The large opens to closes are pulled down by large opens to lows. This is also convincing proof the markets are not random. If they were, the distributions of highs minus opens, would be the same as opens minus the lows. This data, as simple as it might seem, reveals a powerful fundamental truth for becoming a successful speculator.

Figure 2.15 shows three different lines; the top one represents the probability that the close will be greater than the open, dependent on the bottom scale of the open minus the low. At the point I have marked, the data tell us that about 87 percent of the time we will close above the open *if* the dip from the open to the low is less than 20 percent of the day's range.

The next line coming down the chart only deals with days that the distance from the open to the close would have made a trader more than $500. At the point I have marked on this line, we see that about 42 percent of the time we closed above the open by an amount making $500 or more if we did not take more than a 10 percent dip below the opening. Finally, the third and bottom line represents days that closed with more than $1,000 of profits above the opening. These are the biggest range days in the bond market.

At the point marked, we see that 15 percent time, we get these huge blast-off days if there is a dip less than 10 percent. By the same token, there is

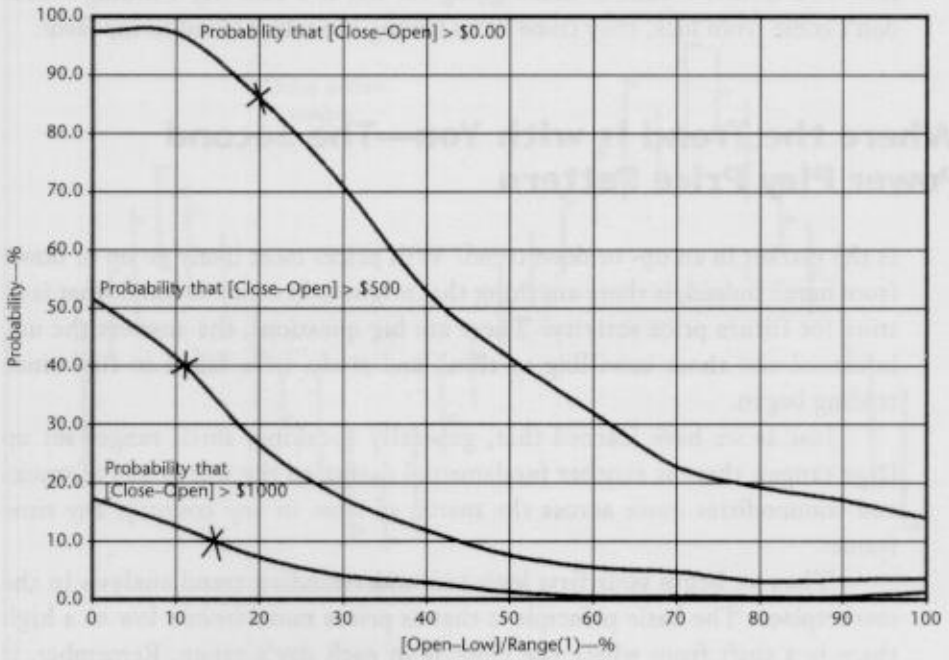



**Figure 2.15** Probability of dollar value of open to close versus (open–low) as percentage of yesterday's range—T-Bonds.

an almost zero chance of getting a large blast-off close above the opening if price has dipped 70 percent to 80 percent below the opening.

This is true of all three lines; again telling us the greater the price swings below the open, the less of a chance we have of a positive open to close. This proves my rules:

1. Don't try to buy big dips below the open on expected up close days.
2. If long and price fall much below the open on expected big up close days, "get out."
3. Don't try to sell big rallies above the opening on expected large down days.
4. If short and prices rally much above opening on expected large down days, "get out."

Don't try to argue with these statistics, they are the laws of gravity controlling how stock and commodity prices move. The tabulations shown here can be replicated in any freely traded market, thus representing a universal truth of how, on average, trading transpires during any given day. Yes, you will occasionally see large-range days that work both sides of the opening, but that is the exception, not the norm. The averages are against bucking this law. As a trader, I want as much going for me as I can. My winning trades don't come from luck, they come from having the tables tilted in my favor.

## Where the Trend Is with You—The Second Power Play Price Pattern

Is the market in an up- or downtrend? Will prices most likely go up or down from here? Indeed, is there anything that might help us understand what is in store for future price activity? These are big questions, the answers the uninformed and those unwilling to think and study, have failed to find since trading began.

Just as we have learned that, generally speaking, small ranges set up large ranges, there is another fundamental design to the way prices of stocks and commodities move across the march of time in any country, any time frame.

Thus we begin your first lesson in understanding trend analysis in the marketplace. The basic principle is that as prices move from a low to a high there is a shift from where the close is in each day's range. Remember, it makes no difference whether we are using 5-minute, hourly, or weekly charts. The same rule applies.

As a market low is made the close of the day, or time period, is right at or very close to the low of that day's range. Then seemingly out of nowhere, a rally begins, and as this rally unfolds, there is a marked relationship change. The change is that the further along this uptrend matures, the higher the close will be on the daily bars. Figure 2.16 presents a stylized view of this relationship change.

*Markets bottom with price closing on the low of the daily range, while they top out when closes are at or near the high of the daily range.*

The uninformed think "smart money" comes into the market with buying thus reversing the trend. Nothing could be further from the truth. As my long-time friend Tom DeMark says, "Markets don't bottom because of an influx of buyers, they bottom because there are no more sellers."

We can look at this relationship of buyers to sellers at work on virtually every day or bar that takes place. My operating rule, which I first wrote about in 1965, is that sellers in any time period are represented by the price swing from the high of the day to the close, while buying is represented by the close

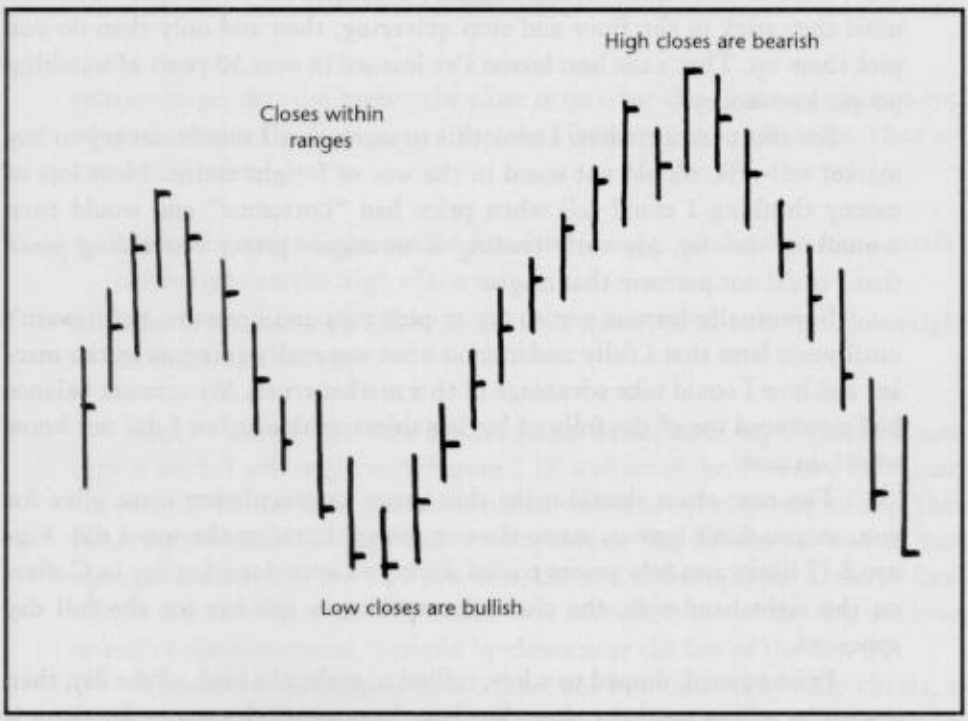



**Figure 2.16** The relationship changes as a rally occurs.

minus the low. My point is that the distance price closes off the low tells us the power of the buyers, the distance from the high to the close illustrates the impact sellers had on prices.

This understanding came from the work I did in trying to understand the OBV (On Balance Volume) charts Joe Miller and Don Southard were keeping at Dean Witter. Back then, traders, or just old duffers looking for a free cup of coffee and a place to chat, would sit around looking at the flow of prices on the ticker tape, a trade-by-trade display of each trade made during the day.

There were two noteworthy old codgers, Jack and Murray, who appeared daily to dispense their wisdom of the ages. Since they had been around longer than us, we hung on to their every word. Murray, the older of the two, had been a board room marker boy during the crash of 1929 and frequently recounted how he had marked down the price of the stock of Bank of America exactly 100 points on the first day of the crash! You could just see young Murray at the boards, writing down, in chalk the last price B of A traded at, then erasing to replace that value with a lower one. Murray said the biggest price mark down was 23 points from one trade to the next!

His story fit right in with the other oldsters' redundant favorite saying, which still rings in my ears. Jack would tell us at least once a day, "What you don't want to do is catch falling daggers," and then he would add, "You wait until they stick in the floor and stop quivering, then and only then do you pick them up. That's the best lesson I've learned in over 50 years of watching people lose money."

For short-term traders, I took this to mean that I should not try to buy market sell-offs, should not stand in the way of freight trains. I lost lots of money thinking I could tell when price had "bottomed" and would turn around for the day. My early trading accounts are pretty convincing proof that I could not perform that magic.

I eventually learned not to try to pick tops and bottoms, but it wasn't until years later that I fully understood what was really going on in the market and how I could take advantage of this market truth. My account balance had convinced me of the folly of buying abject weakness but I did not know why. I do now.

The next chart should make this lesson in speculation come alive for you, so you don't have to waste time or money learning the way I did. Figure 2.17 illustrates how prices traded during an actual market day in Coffee; on the right-hand side, the chart shows the way the bar for the full day appeared.

Price opened, dipped to a low, rallied to make the high of the day, then got hit by selling until the close. You have been aware that every day there is a battle between buyers and sellers; now you know how and where to look for the buyers and sellers. More importantly, you have learned about shifting

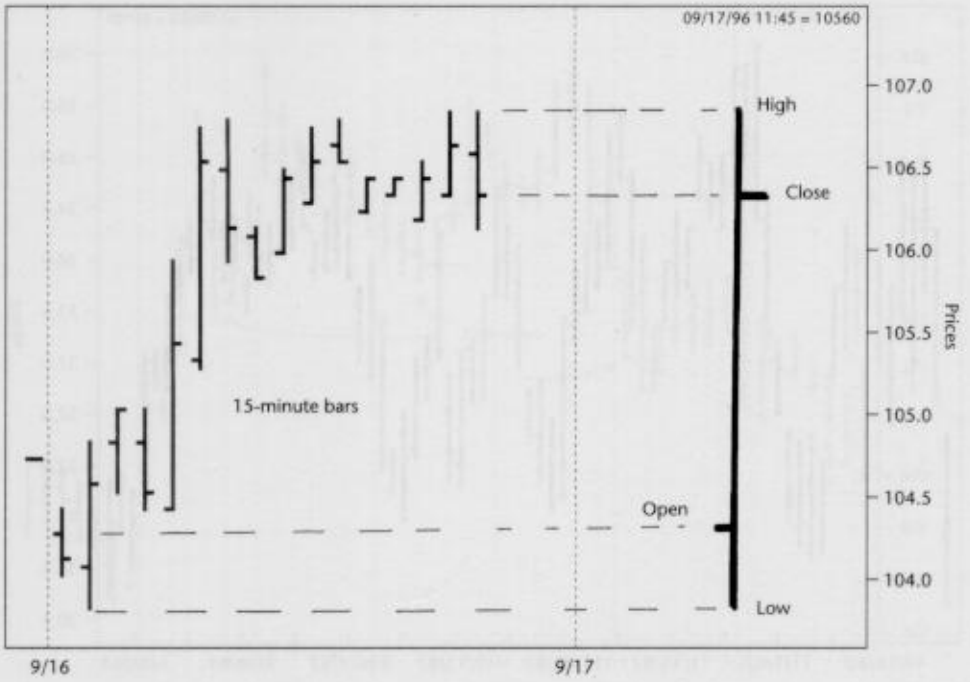



**Figure 2.17** Coffee (15-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

relationships: that the higher the close is on a bar the closer we are to a top, while the lower the close is on a bar, the closer we are to a bottom. Here are two of my rules:

1. Most all market highs can be found to occur at or shortly after a market closes right on the high of the day.
2. Most all market lows can be found at or shortly after a market closes right on the low of the day.

Got it? Good, now let's look at actual examples of my theoretical concept at work. I will begin with Figure 2.18, a chart of the Treasury Bond market from 1992. Look at the price turns, which are pretty easy to see, then focus on the terminal high and low days, at or just before, the end of each up- and downswing. See it? There it is, the end of the uptrend could be foretold by the mere fact the daily closes were near the highs of the day, the lows, or end of the downtrend, foretold by closes near the low of the day.

This is not an isolated occurrence, nor is it limited to daily charts, as the next few examples will show. Figures 2.19 through 2.23 show, in sequence, a 15-minute chart of the S&P 500, then an hourly chart, a daily chart, a weekly chart, and finally a monthly chart. In each instance, you

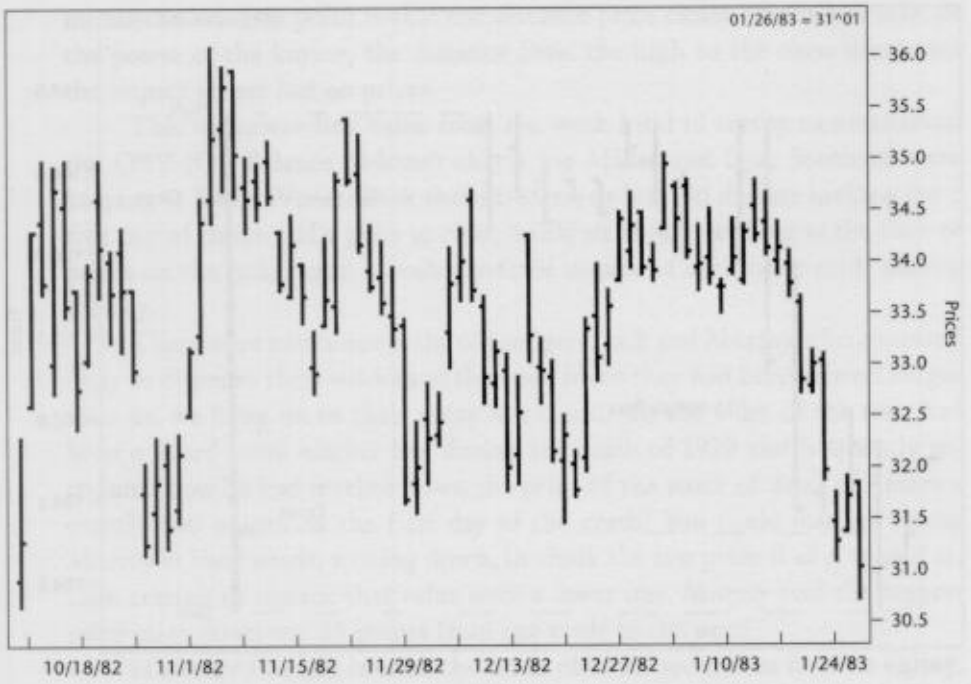



**Figure 2.18** Day T-Bonds (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

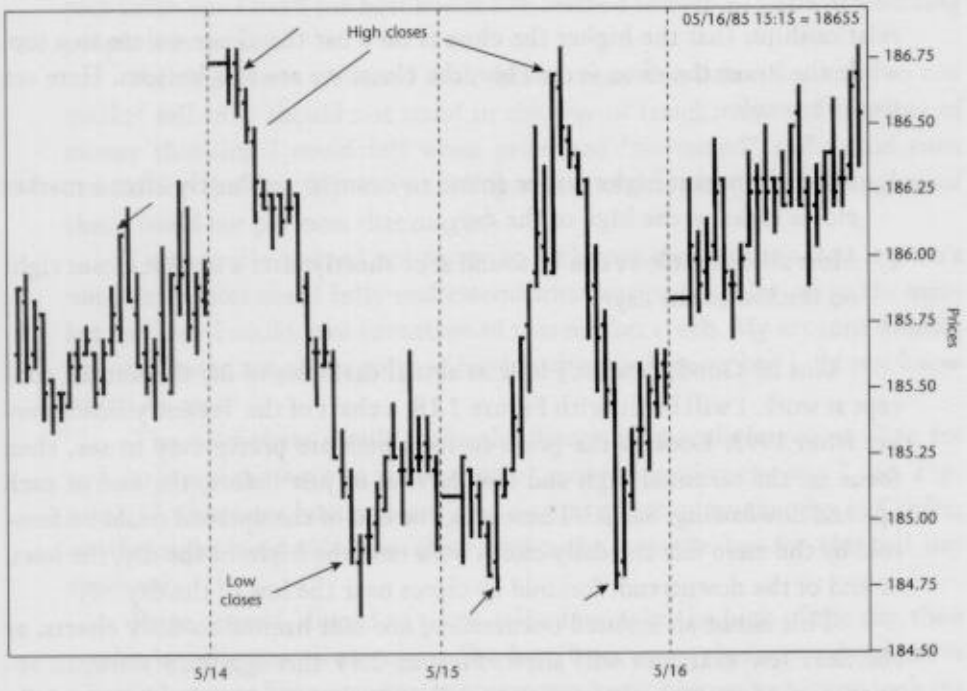



**Figure 2.19** S&P 500 Index (15-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

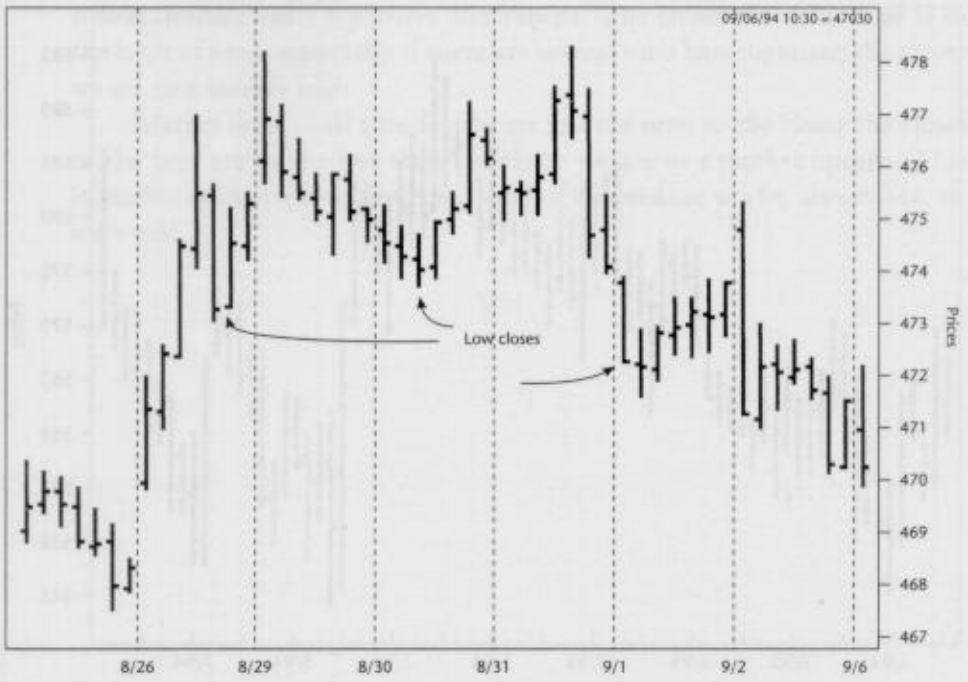



**Figure 2.20** S&P 500 Index (60-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).




**Figure 2.21** S&P 500 Index (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).




**Figure 2.22** S&P 500 Index (weekly bars). Graphed by the "Navigator" (Genesis Financial Data Services).

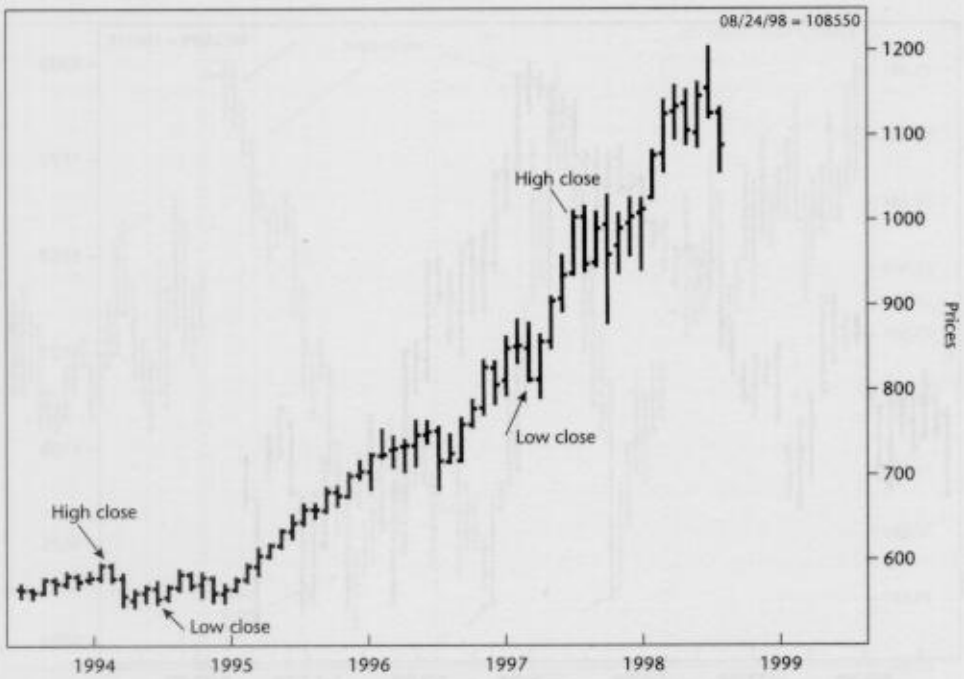



**Figure 2.23** S&P 500 Index (monthly bars). Graphed by the "Navigator" (Genesis Financial Data Services).

will note these same repetitive phenomena. The closer the daily close is to the high of a bar, especially if there are several such bars together, the closer we are to a market high.

Market lows, in all time frames are just the reverse: the closer the closes of the bars are to the low then the closer we are to a market upturn. This is market reality; this is how the world of speculation works, always has, always will.

# Chapter 3

# The Real Secret to Short-Term Trading

*The "secret" is the shorter your time frame of trading the less money you will make.*

Sad but true. Think about any investment you have ever been in. Did you make a killing in one day? And, if you were so lucky, how many times were you able to repeat it? Not many. That is because the universal rule of life, *of gain*, is the same as the universal rule of speculation:

*It takes time for profits to grow.*

Successful traders know that a market can only move so far in a minute, that a market can move further in 5 minutes, even more in 60 minutes, and a heck of a lot more in a day or a week. Losing traders want to trade in a very short time frame and thus automatically limit their profit potential.

By definition, they have limited their profits and kept an unlimited loss scenario. It is no wonder so many have done so poorly at this business of short-term trading. They have boxed themselves into a no-win situation under the guise, often promoted by brokers or system sellers, that scads of money can be made calling market highs and lows during the day. The argument is bolstered with the seemingly rational statement that by trading within just one day and never holding anything overnight, you cannot be exposed to news or major changes; thus you limit your risk.

That's flat-out wrong, for two reasons.

First, your risk is under your control. The only control we have in this business is to set a stop-loss point, a level at which we exit the trade, all trades. Yes, a market could gap beyond your stop the following morning, but that is a rare experience, and even then we are still able to limit our loss with our stop-loss and absolute willingness to get out of losing trades. Losers hold on to losses, winners don't.

Once you establish a position with stops, you can only lose about that much money. No matter when or how you got into the trade, your stop limits your risk. Your risk is the same if you buy at an all-time new market high, or low.

Not holding overnight limits the amount of time your investment has to grow. While sometimes the market will open against you, *if we are on the right track* even more of the time the market will open in our favor.

More importantly, by ending our trading at the end of the day, or worse yet at some artificial cutoff point such as a 5- or 10-minute chart, we have drastically limited the potential for profits. Remember I said the difference between losers and winners is losers hold on to their losses? Another difference is that winners hold onto their winning positions while losers get out "too early." It is almost as if losers can't stand being in a winning trade; they are so damn happy to get a winner, they bail out of it far too early (usually, by getting out during the day of entry).

You will never make big money until you learn to hold on to your winners, and the longer you hold the more potential you have for making a profit. Successful farmers don't plant a crop and then dig it up every few minutes to see how it is doing. They let it germinate, let it grow. We traders could learn a great deal from this natural process of growth. Our success as traders is no different; it takes time to create winners.

## It Is All about Time

What I have just told you is an absolute unequivocal investment truth. It takes time to make money regardless of the activity. Thus short-term traders, by very definition, are limiting their opportunities.

The fallacy of day traders is their belief that they can actually call the short-term swings of the market, tell where price is going the vast majority of the time, predict the highs and lows as well as the precise time markets will top and bottom. Sorry to tell you this, folks, but it cannot be done with any consistency. It is a day trader's dream, a pipe dream at that.

But don't give up hope, my years of market analysis and trading have revealed one fundamental truth about market structure, which is the secret to making "short term" trading profitable.

By now you understand that (1) short-term swings are very difficult to predict; (2) we must limit losses; (3) as short-term traders, we will only do well when there is an explosive move in our favor; (4) time is an ally because we need time to create profits.

To make significant money as short-term traders, we have to be able to sense how long the most profitable short-term swings usually last. This is not just a question of time, it is also one of price. Just as there are no straight paths to heaven, price can only go straight up, or down, to a certain point. The question I needed to answer was, What usually represents that balance of price and time? Note I said *usually;* many times, price swings will go further and take longer than you could ever imagine; and just as often, they falter and fizzle out just when you think you finally have outwitted the market.

Keeping all this in mind, I am now going to reveal my biggest short-term secret of trading to balance the trade-offs of price and time swings. This secret consists of two components:

1. We only make money on large-range days.
2. Large-range days usually close at or near the high, if an up day, the low if a down day.

I am willing to let the fancy dancing day traders figure out the machinations of interday swings. I doubt they can do it, but even if they can, it is very hard, frustrating, and demanding work. Despite the two old codgers' knowledge of tape reading and years of market wisdom, they had no more ability to correctly call market moves from tape watching than any of the rest of us. We have gone from tape reading to quote machines, but the game, or myth is the same, and so is the degree of difficulty. It is pressure city to sit in front of a quote machine for 7 hours a day battling, guessing, and being proven wrong more often than not.

About twice I year, I get talked into bankrolling some hotshot trader who thinks he or she can profit from these short-term swings. Let's see, two traders a year for 35 years, that's 70 times I should have learned the lesson I am teaching right here, right now. I just don't think it can be done. The only caveat I would put here is that it cannot be done with a system or mechanical approach. I have seen traders with a "feel" succeed at this, but that feel often deserts them and is something they cannot pass on to another person. Therein my work is different: you or anyone can repeat what I do.

I place my trade knowing only one of three types of days will develop: a small-range day that will produce a small loss or gain; a day that reverses against my position; or a large-range day that, if I am on the correct side, means I will finish the day very near the high of an up day or the low of a down day. Although no one can predict what will be the high or low of a

large-range day, I can predict that such days will most often close at their extreme—thus *there is no need to try to play any silly technical games* of wiggling and waggling buying and selling during the day.

I can prove my point about large-range days with the following charts. Figures 3.1 through 3.6 show different time periods of Copper, Cotton, Soybeans, Pork Bellies, Gold, and T-Bonds, a pretty wide diversity of markets. Carefully go through each chart, note the large-range days, and then notice where they opened and closed.

In the vast majority of the large-range, up close days you should have noted that price opened near the low of the day and closed near the high. The down close, large-range days reveal just the opposite trading pattern; openings near the highs and closes near the low of the day.

> *What this all means to short-term traders is that, to catch a winning trade, the most profitable strategy is to hold to the close.*

I cannot emphasize this enough. The most profitable short-term trading strategy I know and use is to enter the trade, place my protective stop, then shut my eyes, hold my breath, quit looking at the market, and wait to get out on the close. Or later! If I am lucky enough to get a large-range day I will




**Figure 3.1** High grade copper (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

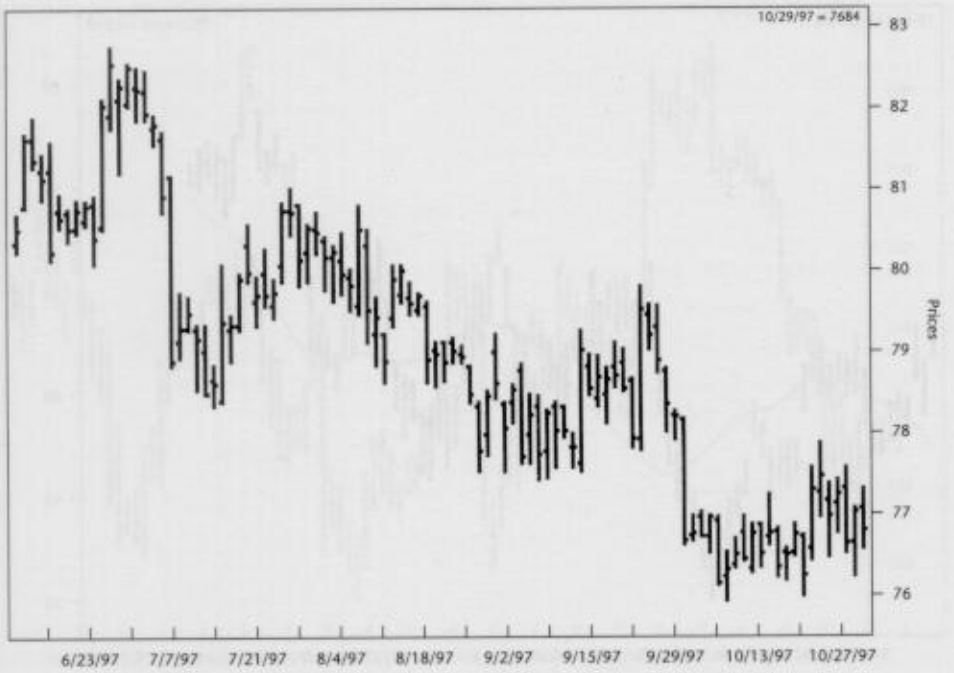



**Figure 3.2** Cotton #2 (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

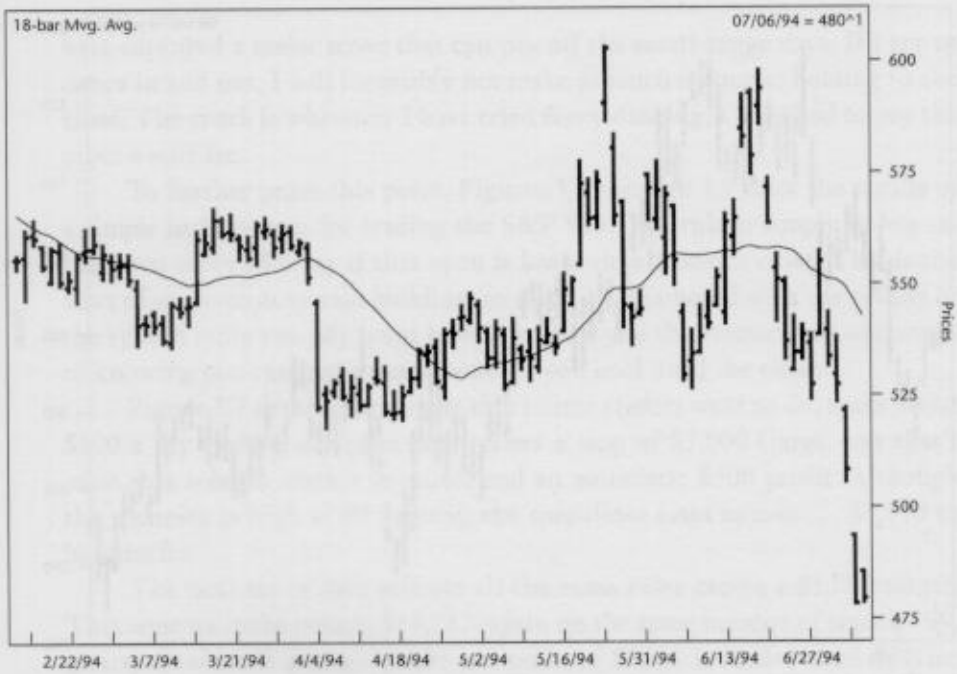



**Figure 3.3** Soybeans (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).




**Figure 3.4** Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

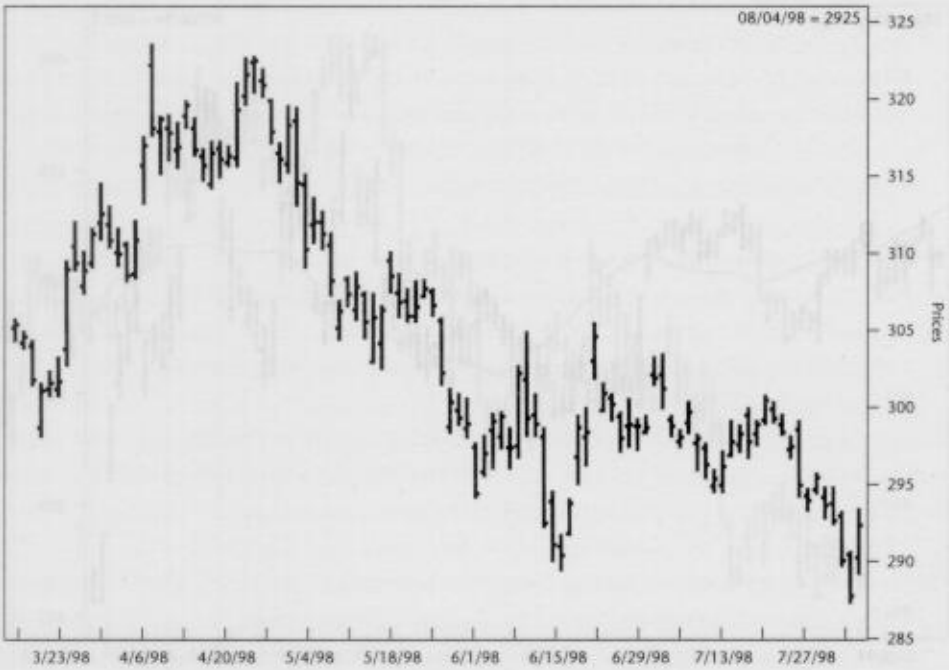



**Figure 3.5** Comex Gold (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

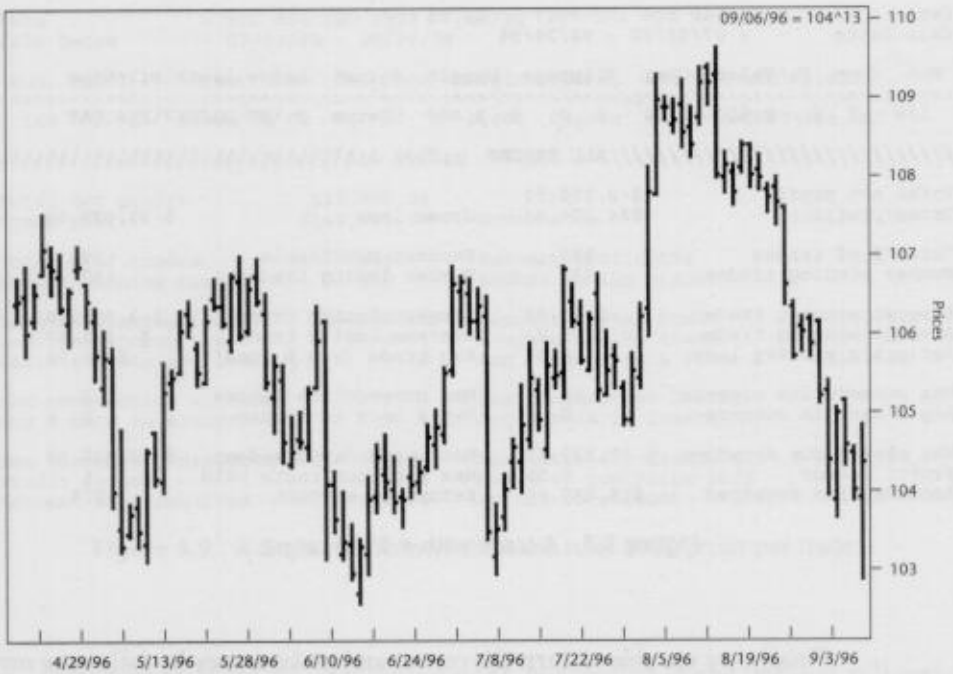



**Figure 3.6** Day T-Bonds (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

have captured a major move that can pay off the small-range days. If I try to dance in and out, I will invariably not make as much money as holding to the close. The truth is whenever I have tried fancy dancing, I have had to pay the piper a stiff fee.

To further prove this point, Figures 3.7 through 3.9 show the results of a simple little system for trading the S&P 500. The rule is simply to buy on the open every Monday if that open is lower than Friday's close. This is the start of short-term system building, so don't get enamored with the results or the system quite yet. My point here is to show you the tremendous advantage of knowing you can make more money if you hold until the close.

Figure 3.7 depicts what most short-term traders want to do, make about $500 a day trading so the results reflect a stop of $3,000 (large, but that's what this volatile market requires) and an automatic $500 profit. Although the accuracy is high at 59 percent, the speculator loses money . . . $8,150 to be specific.

The next set of data reflects all the same rules except a $1,000 target. This time we make money, $13,737, again on the same number of trades, 389, giving us a small average profit per trade of $35. I have deducted $50 for commissions (as all results shown in this book do). To make our $13,737, we were down $8,887 at one point, and had 55 percent winning trades.

```
Data              : S&P 500 IND-9967    06/98
Calc Dates        : 07/02/82 - 08/24/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 50   $  0   $ 3,000  CServe  C:\GD\BACK67\F58.DAT

////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $-8,150.00
Gross profit              $84,875.00    Gross loss              $-93,025.00

Total # of trades             389       Percent profitable           59%
Number winning trades         232       Number losing trades         157

Largest winning trade      $450.00      Largest losing trade     $-3,050.00
Average winning trade      $365.84      Average losing trade      $ -592.52
Ratio avg win/avg loss        0.61      Avg trade (win & loss)     $-20.95

Max consecutive winners        19       Max consecutive losers         7
Avg # bars in winners           0       Avg # bars in losers           0

Max closed-out drawdown  $-12,837.50    Max intra-day drawdown   $-12,837.50
Profit factor                 0.91      Max # of contracts held        1
Account size required    $15,837.50     Return on account            -51%
```

**Figure 3.7** A trade with a $500 target.

Finally, we are able to turn the corner and make money by following my basic rule of holding until the close and then exiting the position. What a difference, we actually clean up, banking $39,075 of profits, with a $100 average profit per trade, 3 times better than when taking an automatic $1,000 profit. Our drawdown, how much we had to lose during our worst run to make what we did, was less at $6,650; the $500 target trader had a $12,837 drawdown. The facts speak for themselves. Traders can argue all day long about what works and what does not work, but what you have just seen settles

```
Data              : S&P 500 IND-9967    06/98
Calc Dates        : 07/02/82 - 08/24/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 50   $  0   $ 3,000  CServe  C:\GD\BACK67\F58.DAT

////////////////////////// ALL TRADES  - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $13,737.50
Gross profit             $115,537.50    Gross loss             -101,800.00

Total # of trades             389       Percent profitable           55%
Number winning trades         217       Number losing trades         172

Largest winning trade      $950.00      Largest losing trade     $-3,050.00
Average winning trade      $532.43      Average losing trade      $ -591.86
Ratio avg win/avg loss        0.89      Avg trade (win & loss)      $35.31

Max consecutive winners         9       Max consecutive losers         7
Avg # bars in winners           0       Avg # bars in losers           0

Max closed-out drawdown   $-8,887.50    Max intra-day drawdown    $-8,887.50
Profit factor                 1.13      Max # of contracts held        1
Account size required    $11,887.50     Return on account            115%
```

**Figure 3.8** A trade with a $1,000 target.

```
Data              : S&P 500 IND-9967    06/98
Calc Dates        : 07/02/82 - 08/24/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $  2.500  $ 50   $  0   $ 3,000  CServe  C:\GD\BACK67\F58.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $39,075.00
Gross profit             $145,937.50    Gross loss              -106,862.50

Total # of trades             389       Percent profitable           53%
Number winning trades         210       Number losing trades         179

Largest winning trade      $6,575.00    Largest losing trade     $-3,050.00
Average winning trade        $694.94    Average losing trade      $ -597.00
Ratio avg win/avg loss          1.16     Avg trade (win & loss)     $100.45

Max consecutive winners            9    Max consecutive losers           7
Avg # bars in winners              0    Avg # bars in losers             0

Max closed-out drawdown   $-6,550.00    Max intra-day drawdown   $-6,550.00
Profit factor                   1.36    Max # of contracts held          1
Account size required      $9,550.00    Return on account             409%
```

**Figure 3.9** A trade that follows the basic rule: $100 profit per trade.

the argument for me. It is sitting tight, not trading in and out that will make for profits.

I hold to the close, at least, for an exit point. Until someone can do the impossible, call all short-term fluctuations, there will be no better strategy for a short-term trader, as you will capture the large-range days where serious money is to be made. The only difference in the preceding results was how long the trade was held: the shorter the holding period, the less opportunity for profits. Never forget that rule.

There is even more money to be made holding over, past the close, but that should be true if what I said earlier is valid, that it takes time for profits to accrue. As we discuss individual markets, I will give you more specific rules of how to further capitalize on this phenomenon of profitable trading.

As final proof for my thesis, Figure 3.10 shows the same system we just looked at, buying on Mondays when the market opens below Friday's close. But this time, we are going to hold the position in the first example until the next close; that is, the first close after our entry day or until we are stopped out, whichever comes first. The product of this strategy nets $68,312, making an additional $30,000 and increasing our net profit per trade by $71.

Finally, look at Figure 3.11, which depicts holding for the close 6 days after entry or being stopped out. Following this strategy proves my point and should cure you of the notion that big easy money can be made catching small swings. We now make $71,600, almost doubling the exit on close results boosting our average trade up to a now respectable $251. Remember, the only difference in these results is how long we stayed in the trade, all the other rules are the same.

```
Data              : S&P 500 IND-9967    06/98
Calc Dates        : 07/02/82 - 08/24/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 50   $  0   $ 3,000  CServe  C:\GD\BACK67\F58.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $68,312.50
Gross profit             $224,450.00    Gross loss              -156,137.50

Total # of trades             397       Percent profitable           55%
Number winning trades         222       Number losing trades         175

Largest winning trade      $7,025.00    Largest losing trade     $-3,500.00
Average winning trade      $1,011.04    Average losing trade      $ -892.21
Ratio avg win/avg loss          1.13    Avg trade (win & loss)     $172.07

Max consecutive winners          10     Max consecutive losers          5
Avg # bars in winners             0     Avg # bars in losers            0

Max closed-out drawdown  $-11,000.00    Max intra-day drawdown   $-11,000.00
Profit factor                   1.43    Max # of contracts held         1
Account size required    $14,000.00     Return on account            487%
```

**Figure 3.10** Using timing to increase our profits.

The legendary Jesse Livermore said it best, "It was never my thinking that did it for me, it was my sitting that made the big money. My sitting!"

He added, "Men who can be right and sit tight are uncommon."

What I am trying to get across to you is that catching the big swing (within the time frame you are trading) is the only way I have been able to make millions of dollars trading. I finally figured out that I had to let my profits run to be able to pay off the losses that are as natural to this game as breathing is to life. Losses will most absolutely come to you. That is a given,

```
Data              : S&P 500 IND-9967    06/98
Calc Dates        : 07/02/82 - 08/24/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 50   $  0   $ 3,000  CServe  C:\GD\BACK67\F58.DAT

//////////////////////////// ALL TRADES  - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $71,600.00
Gross profit             $298,400.00    Gross loss              -226,800.00

Total # of trades             285       Percent profitable           52%
Number winning trades         151       Number losing trades         134

Largest winning trade      $10,750.00   Largest losing trade     $-4,175.00
Average winning trade       $1,976.16   Average losing trade     $-1,692.54
Ratio avg win/avg loss          1.16    Avg trade (win & loss)     $251.23

Max consecutive winners           7     Max consecutive losers          6
Avg # bars in winners             5     Avg # bars in losers            4

Max closed-out drawdown  $-19,725.00    Max intra-day drawdown   $-19,725.00
Profit factor                   1.31    Max # of contracts held         1
Account size required    $22,725.00     Return on account            315%
```

**Figure 3.11** The timing makes all the difference.

it will happen, which gives rise to the obvious question, what can we do to offset these chunks out of our rear end? There are only two ways to overcome this negative, we must either have a very low percentage of losing trades and/or a substantially higher average profit than loss. Time, and time alone, will give you larger profits, not thinking, not fancy dancing, not trying to buy and sell every top and bottom. That is a fool's game. It is not a matter of opinion—it is provable, as the simple system presented in this chapter so clearly demonstrates.

By now, you should have learned how the market moves, the three most dominant time cycles, and be developing a sense, or feel, for the underlying order in what appears to be chaos. But most of all, you should have learned to hold on to winners to the end of the time frame you are trading for. In my case, I'm trading for 2- to 5-day swings. Whenever my greed factors have convinced me to take a quick profit—or overstay my time period—I have paid dearly.

# Chapter 4

# Volatility Breakouts—The Momentum Breakthrough

*Necessity may, or may not, be the mother of invention, but for sure it is the father of taking chances.*

Momentum is one of the five concepts that can bring us short-term trading profits. It is what Newton was talking about when he said an object once set in motion tends to stay in motion. So it is with stocks and commodities: once price starts to move, it will most likely keep going in that direction. There are almost as many ways to measure momentum as there are traders. I will not delve into all of them, just the ones I have found to work, and the concepts I trade with. There are other approaches; anyone with a fertile mind should be able to go past where I have. Mathematicians, this is the chapter where you can bring all your techniques, concepts, and formulas to play. This is where you have a distinct advantage over those of us limited to basic addition, multiplication, and subtraction.

I doubt that anyone fully understood how the markets work until the mid-1980s. Sure, we knew about trend; about overbought and oversold markets; about a few patterns, seasonal influences, fundamentals, and the like. But we really did not know what caused trend or, more correctly put, how it

began and ended. We do now and it is time for you to learn this fundamental truism of price structure and movement.

Trends are set in motion by what I call "explosions of price activity." Succinctly, if price, in one hour, day, week, month (pick your time frame for trend identification) has an explosive move up, or down, the market will continue in that direction until there is an equal or greater explosive move in the opposite direction. This has come to be known as an expansion in volatility and verbally captured by the phrase coined by Doug Brie "volatility breakout," based on my early 1980 work.

It gets down to this, price has an explosive breakout, up or down, from a center point. That is what sets or establishes the trend. Thus we have two problems; first, what do we mean by an explosive breakout (how much of an up or down move), and second, from what point do we measure this expansion in price?

Let's start with the beginning, what set of data should we use to measure the expansion?

Since my working thesis is that we need a very quick explosion of price change I like to use daily range values—the difference between the day's high and close. This value shows how volatile the market has been each and every day. It is when this volatility increases out of recent proportion that trends change.

There are several ways of taking this measure. You might use the average range for the last X number of days, various swing points, and the like. By and large though, I have found that using just yesterday's range as my comparison of volatility works wonders. Let's say yesterday's range was 12 cents in Wheat. If today's range exceeds that range by some percentage, the trend probably changed, at least that is the way to wager. This would be a clear indication price has had a new impetus driving it in a direction, and price, like any object once set in motion, tends to stay in the direction of that motion.

It is really as simple as that, a pickup in range, substantially greater than yesterday's range implies a change in the current market direction.

That also leads to the second problem: From what point do we measure the expansive move, up or down? Most traders think we should measure from today's closing price. That is typical thinking; we usually compare price change from close to close. But it is not the correct answer. I will get to that in a moment, but first let's consider points from which to measure this expansion: we could use the close, the average price of the current day, or perhaps today's high for a buy or today's low for a sell.

Let's look at the very best results of several nonrelated commodities using a variety of points for measuring the explosion. Table 4.1 shows buying tomorrow at a percentage of today's range added to today's close. The data, listed in order, shows the commodity, percentage of range, dollar profit, accuracy, and average profit per trade.

Table 4.1
Adding or Subtracting to the Close

| Commodity | Of Range % Buy/Sell Value | $ Profits | Number of Trades | Percent | Average Profit |
|---|---|---|---|---|---|
| Cattle | 70/50 | 24,556 | 265/117 | 44 | 92 |
| Bellies | 70/50 | 352,044 | 1,285/2,817 | 45 | 124 |
| Cotton | 50/150 | 54,485 | 200/465 | 43 | 117 |
| Coffee | 70/50 | 145,346 | 88/178 | 49 | 816 |
| Orange juice | 70/50 | 129,720 | 906/2,028 | 44 | 63 |
| Soybeans | 70/50 | 164,287 | 1,277/2,998 | 47 | 55 |
| British Pound | 70/50 | 228,631 | 981/2,358 | 41 | 96 |
| Gold | 190/70 | 64,740 | 289/717 | 40 | 90 |
| Heating oil | 50/130 | 66,397 | 182/418 | 43 | 158 |
| Bonds | 110/110 | 197,781 | 420/905 | 46 | 218 |
| Standard & Poor's 500 | 100/190 | 85,350 | 133/330 | 40 | 258 |

In this table I have even provided the best percent of the previous *day's range to add to the close* for a buy and to subtract for a sell. In this, and all data shown, no stop was used and you were always long short.

This table shows only the best percent volatility add-ons for buys and subtracts for sells; and again in the data for Table 4.1, we added the volatility factor or filter to the previous day's close. Using cattle as an example, if price rallied 70 percent of the previous day's range above the close, we bought and sold short at 50 percent of the day's range subtracted from the close.

Next, look at buying tomorrow at a percentage of yesterday's range added to yesterday's high or subtracting that same amount from yesterday's low for a sell signal (see Table 4.2).

Table 4.2
Adding or Subtracting to the High or Low

| Commodity | Percent Buy/Sell | $ Profits | Number of Trades | Percent | Average Profit |
|---|---|---|---|---|---|
| Cattle | 70 | 17,012 | 191/456 | 41 | 37 |
| Bellies | 110 | 141,288 | 278/608 | 45 | 232 |
| Cotton | 90 | 46,945 | 150/357 | 42 | 131 |
| Coffee | 60 | 120,573 | 36/86 | 41 | 1,402 |
| Orange juice | 110 | 60,825 | 261/582 | 44 | 104 |
| Soybeans | 80 | 99,568 | 444/1,022 | 43 | 97 |
| British Pound | 120 | 175,506 | 295/698 | 42 | 251 |
| Gold | 130 | 57,600 | 198/504 | 39 | 114 |
| Heating oil | 60 | 43,117 | 168/435 | 38 | 99 |
| Bonds | 90 | 154,968 | 290/605 | 47 | 256 |
| Standard & Poor's 500 | 100 | 80,787 | 569/225 | 40 | 141 |

Although this concept makes money, again on the best-fit basis, it does not do as well as adding or subtracting a value from the close. A simple way to compare the results is to determine the size of the average profit per trade. In the add-to-the-close method, it is $327 a trade and $313 for the add-to-the-high and subtract-from-the-low technique.

The next set of data adds a percentage of today's range to tomorrow's open and buys there for a long entry or subtracts a percentage of today's range from the opening for a sell. The results appear in Table 4.3.

A careful look at the data shows us the average profit per trade is higher at $389 and the accuracy is also higher; five commodities in this test showed an accuracy of 50 percent or higher while none of them did in the first two tests.

*My conclusion is that the best point to add or subtract a volatility expansion value to is tomorrow's open. I have always traded this technique with the open, but in preparation for this book, I did the preceding tests to see whether my judgment was right and was pleased to see facts fit my intuitive conclusion.*

As short-term traders, we can use this concept to tell us there is a high probability of a further extension of price we can capitalize on. I will not trade *just because of such an entry* but will use this as my entry technique when the time and conditions are correct.

Of all the trend entry approaches I am aware, from moving averages to trendlines, oscillators to Ouija boards, and fancy math to simple charts; I have never seen a more consistently profitable mechanical entry technique than volatility breakouts. It is the most consistent of all entries I have ever traded, researched or seen. Now let's look at some ways of using this basic concept.

**Table 4.3**
**Adding or Subtracting to Tomorrow's Open**

| Commodity | Percent Buy/Sell | $ Profits | Number of Trades | Percent + | Average Profit |
|---|---|---|---|---|---|
| Cattle | 140 | 37,992 | 124/230 | 53 | 163 |
| Bellies | 70 | 303,792 | 1,076/2,236 | 48 | 135 |
| Cotton | 60 | 71,895 | 988/454 | 45 | 73 |
| Coffee | 130 | 135,915 | 38/63 | 60 | 2,157 |
| Orange juice | 50 | 169,140 | 1,184/2,754 | 52 | 75 |
| Soybeans | 100 | 228,293 | 620/1,293 | 47 | 176 |
| British Pound | 130 | 242,062 | 300/600 | 50 | 403 |
| Gold | 130 | 95,070 | 290/634 | 45 | 149 |
| Heating oil | 140 | 42,163 | 87/196 | 44 | 215 |
| Bonds | 100 | 227,468 | 464/919 | 50 | 247 |
| Standard & Poor's 500 | 50 | 247,850 | 768/1,727 | 44 | 143 |

## Simple Daily Range Breakouts

From the preceding we have learned that we should *add our breakout value to tomorrow's opening.* Now the questions begin; What's the best value? There are several good ones, but the simplest is to take today's range adding a portion of it to tomorrow's opening. Just that simple approach has been a consistent moneymaker since I first discovered it almost 20 years ago.

It is now time to go a bit beyond these results and create a trading model that is actually tradable (i.e., it makes money in an acceptable fashion). Figure 4.1 shows the result of buying and selling bonds on the open every day at a distance of 100 percent of the previous day's range above the open for a buy and 100 percent below the open for a sell.

A protective stop of $1,500 or 50 percent of the previous day's range subtracted from our entry is used as our protective stop while our exit is the Bail Out or the first profitable opening after entry technique. This does make money, $73,468 with 80 percent accuracy on 651 trades. On average, the system makes $7,000 a year and would require a $13,000 bankroll to net the 70 percent a year gain. The drawdown of only $10,031 is quite good for such a basic system. A problem can be seen in that the average profit per trade is only $112.86; this needs to be higher. The data set is from 1990 through August 1998.

Any idea how we might accomplish such a lofty goal? For now, let's try our basic TDW (Trade Day of Week) strategy to see what happens if we only

```
Data              : DAY T-BONDS          67/99
Calc Dates        : 01/01/90 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  144  -3  $  31.250  $ 0   $ 0   $ 3,000  CSI     C:\GD\BACK67\P061.DTA

////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $73,468.75
Gross profit             $213,156.25    Gross loss                -139,687.50

Total # of trades             651       Percent profitable            80%
Number winning trades         523       Number losing trades          128

Largest winning trade      $3,968.75    Largest losing trade      $-1,812.50
Average winning trade        $407.56    Average losing trade      $-1,091.31
Ratio avg win/avg loss          0.37    Avg trade (win & loss)       $112.86

Max consecutive winners           20    Max consecutive losers           4
Avg # bars in winners              1    Avg # bars in losers             2

Max closed-out drawdown   $-10,031.25    Max intra-day drawdown    $-10,031.25
Profit factor                   1.52     Max # of contracts held          1
Account size required     $13,031.25     Return on account              563%
```

**Figure 4.1** A trading model that works.

//////////////////////////// ALL TRADES - Test 5 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Monday

| | | | |
|---|---|---|---|
| Total net profit | $9,500.00 | | |
| Gross profit | $22,968.75 | Gross loss | $-13,468.75 |
| Total # of trades | 77 | Percent profitable | 87% |
| Number winning trades | 67 | Number losing trades | 10 |
| Largest winning trade | $1,437.50 | Largest losing trade | $-1,500.00 |
| Average winning trade | $342.82 | Average losing trade | $-1,346.87 |
| Ratio avg win/avg loss | 0.25 | Avg trade (win & loss) | $123.38 |
| Max consecutive winners | 15 | Max consecutive losers | 1 |
| Avg # bars in winners | 1 | Avg # bars in losers | 4 |
| Max closed-out drawdown | $-2,843.75 | Max intra-day drawdown | $-2,968.75 |
| Profit factor | 1.70 | Max # of contracts held | 1 |
| Account size required | $5,968.75 | Return on account | 159% |

//////////////////////////// SHORT TRADES - Test 5 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $5,218.75 | | |
| Gross profit | $11,656.25 | Gross loss | $-6,437.50 |
| Total # of trades | 37 | Percent profitable | 86% |
| Number winning trades | 32 | Number losing trades | 5 |
| Largest winning trade | $1,437.50 | Largest losing trade | $-1,500.00 |
| Average winning trade | $364.26 | Average losing trade | $-1,287.50 |
| Ratio avg win/avg loss | 0.28 | Avg trade (win & loss) | $141.05 |
| Max consecutive winners | 15 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 5 |
| Max closed-out drawdown | $-3,406.25 | Max intra-day drawdown | $-3,406.25 |
| Profit factor | 1.81 | Max # of contracts held | 1 |
| Account size required | $6,406.25 | Return on account | 81% |

**Figure 4.2** Trade day of the week: Monday.

//////////////////////////// LONG TRADES - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Tuesday

| | | | |
|---|---|---|---|
| Total net profit | $21,718.75 | | |
| Gross profit | $38,062.50 | Gross loss | $-16,343.75 |
| Total # of trades | 108 | Percent profitable | 89% |
| Number winning trades | 97 | Number losing trades | 11 |
| Largest winning trade | $1,687.50 | Largest losing trade | $-1,500.00 |
| Average winning trade | $392.40 | Average losing trade | $-1,485.80 |
| Ratio avg win/avg loss | 0.26 | Avg trade (win & loss) | $201.10 |
| Max consecutive winners | 42 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |

//////////////////////////// SHORT TRADES - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $-6,375.00 | | |
| Gross profit | $21,625.00 | Gross loss | $-28,000.00 |
| Total # of trades | 79 | Percent profitable | 75% |
| Number winning trades | 60 | Number losing trades | 19 |
| Largest winning trade | $1,437.50 | Largest losing trade | $-1,687.50 |
| Average winning trade | $360.42 | Average losing trade | $-1,473.68 |
| Ratio avg win/avg loss | 0.24 | Avg trade (win & loss) | $-80.70 |
| Max consecutive winners | 14 | Max consecutive losers | 3 |
| Avg # bars in winners | 1 | Avg # bars in losers | 4 |
| Max closed-out drawdown | $-11,156.25 | Max intra-day drawdown | $-11,593.75 |
| Profit factor | 0.77 | Max # of contracts held | 1 |
| Account size required | $14,593.75 | Return on account | -43% |

**Figure 4.3** Trade day of the week: Tuesday.

//////////////////////////// LONG TRADES - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Wednesday

| | | | |
|---|---|---|---|
| Total net profit | $5,218.75 | | |
| Gross profit | $23,343.75 | Gross loss | $-18,125.00 |
| Total # of trades | 77 | Percent profitable | 84% |
| Number winning trades | 65 | Number losing trades | 12 |
| Largest winning trade | $1,406.25 | Largest losing trade | $-1,625.00 |
| Average winning trade | $359.13 | Average losing trade | $-1,510.42 |
| Ratio avg win/avg loss | 0.23 | Avg trade (win & loss) | $67.78 |
| Max consecutive winners | 17 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |

//////////////////////////// SHORT TRADES - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $12,250.00 | | |
| Gross profit | $27,500.00 | Gross loss | $-15,250.00 |
| Total # of trades | 68 | Percent profitable | 85% |
| Number winning trades | 58 | Number losing trades | 10 |
| Largest winning trade | $1,562.50 | Largest losing trade | $-1,718.75 |
| Average winning trade | $474.14 | Average losing trade | $-1,525.00 |
| Ratio avg win/avg loss | 0.31 | Avg trade (win & loss) | $180.15 |
| Max consecutive winners | 14 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |
| Max closed-out drawdown | $-3,000.00 | Max intra-day drawdown | $-3,000.00 |
| Profit factor | 1.80 | Max # of contracts held | 1 |
| Account size required | $6,000.00 | Return on account | 204% |

**Figure 4.4** Trade day of the week: Wednesday.

//////////////////////////// LONG TRADES - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Thursday

| | | | |
|---|---|---|---|
| Total net profit | $15,875.00 | | |
| Gross profit | $32,562.50 | Gross loss | $-16,687.50 |
| Total # of trades | 88 | Percent profitable | 87% |
| Number winning trades | 77 | Number losing trades | 11 |
| Largest winning trade | $1,687.50 | Largest losing trade | $-1,687.50 |
| Average winning trade | $422.89 | Average losing trade | $-1,517.05 |
| Ratio avg win/avg loss | 0.27 | Avg trade (win & loss) | $180.40 |
| Max consecutive winners | 17 | Max consecutive losers | 1 |
| Avg # bars in winners | 1 | Avg # bars in losers | 1 |

//////////////////////////// SHORT TRADES - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $15,937.50 | | |
| Gross profit | $33,937.50 | Gross loss | $-18,000.00 |
| Total # of trades | 81 | Percent profitable | 85% |
| Number winning trades | 69 | Number losing trades | 12 |
| Largest winning trade | $2,406.25 | Largest losing trade | $-1,500.00 |
| Average winning trade | $491.85 | Average losing trade | $-1,500.00 |
| Ratio avg win/avg loss | 0.32 | Avg trade (win & loss) | $196.76 |
| Max consecutive winners | 13 | Max consecutive losers | 1 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-3,343.75 | Max intra-day drawdown | $-3,937.50 |
| Profit factor | 1.88 | Max # of contracts held | 1 |
| Account size required | $6,937.50 | Return on account | 229% |

**Figure 4.5** Trade day of the week: Thursday.

////////////////////////// LONG TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

Friday

| | | | |
|---|---|---|---|
| Total net profit | $7,250.00 | | |
| Gross profit | $39,218.75 | Gross loss | $-31,968.75 |
| Total # of trades | 117 | Percent profitable | 82% |
| Number winning trades | 96 | Number losing trades | 21 |
| Largest winning trade | $1,656.25 | Largest losing trade | $-2,000.00 |
| Average winning trade | $408.53 | Average losing trade | $-1,522.32 |
| Ratio avg win/avg loss | 0.26 | Avg trade (win & loss) | $61.97 |
| Max consecutive winners | 17 | Max consecutive losers | 2 |
| Avg # bars in winners | 2 | Avg # bars in losers | 2 |

////////////////////////// SHORT TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $12,468.75 | | |
| Gross profit | $35,906.25 | Gross loss | $-23,437.50 |
| Total # of trades | 95 | Percent profitable | 82% |
| Number winning trades | 78 | Number losing trades | 17 |
| Largest winning trade | $3,968.75 | Largest losing trade | $-1,531.25 |
| Average winning trade | $460.34 | Average losing trade | $-1,378.68 |
| Ratio avg win/avg loss | 0.33 | Avg trade (win & loss) | $131.25 |
| Max consecutive winners | 12 | Max consecutive losers | 3 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-4,093.75 | Max intra-day drawdown | $-4,093.75 |
| Profit factor | 1.53 | Max # of contracts held | 1 |
| Account size required | $7,093.75 | Return on account | 175% |

**Figure 4.6** Trade day of the week: Friday.

take buy and sells on certain specific days. To get a sense of this, Figures 4.2 through 4.6 show the buys for each day of the week, then the sells for each day, and finally we put together the best buy/sell days for a working model we can actually trade.

The listings indicate the best days to buy have been Tuesdays and Thursdays, whereas the best sell days have been Wednesdays and Thursdays. Figure 4.7 shows that if we restrict trading to just these days, we don't make as much money, only $56,437, but just about cut the number of trades in half and boost our profits up to $173 on average, a number worth trading for. Your lesson here is that the Trade Day of Week (TDW) can make a big difference in your system's performance. Best yet, the drawdown plummets to only $3,500 from $10,031 and the accuracy jumps to 84 percent. This is a big improvement, as explained in the discussion of money management in Chapter 13.

```
Data              : DAY T-BONDS          67/99
Calc Dates        : 01/01/90 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
  144  -3  $ 31.250  $ 0   $ 0   $ 3,000  CSI     C:\GD\BACK67\F061.DTA

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $56,437.50
Gross profit             $122,375.00    Gross loss              $-65,937.50

Total # of trades            326        Percent profitable           84%
Number winning trades        277        Number losing trades          49

Largest winning trade      $2,406.25    Largest losing trade     $-1,718.75
Average winning trade        $441.79    Average losing trade     $-1,345.66
Ratio avg win/avg loss          0.32    Avg trade (win & loss)      $173.12

Max consecutive winners          23     Max consecutive losers           2
Avg # bars in winners             1     Avg # bars in losers             2

Max closed-out drawdown   $-3,500.00    Max intra-day drawdown   $-3,500.00
Profit factor                   1.85    Max # of contracts held          1
Account size required     $6,500.00     Return on account             868%

//////////////////////////// LONG TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $30,406.25
Gross profit              $64,406.25    Gross loss              $-34,000.00

Total # of trades            186        Percent profitable           86%
Number winning trades        161        Number losing trades          25

Largest winning trade      $1,687.50    Largest losing trade     $-1,687.50
Average winning trade        $400.04    Average losing trade     $-1,360.00
Ratio avg win/avg loss          0.29    Avg trade (win & loss)      $163.47

Max consecutive winners          16     Max consecutive losers           1
Avg # bars in winners             1     Avg # bars in losers             1


//////////////////////////// SHORT TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $26,031.25
Gross profit              $57,968.75    Gross loss              $-31,937.50

Total # of trades            140        Percent profitable           82%
Number winning trades        116        Number losing trades          24

Largest winning trade      $2,406.25    Largest losing trade     $-1,718.75
Average winning trade        $499.73    Average losing trade     $-1,330.73
Ratio avg win/avg loss          0.37    Avg trade (win & loss)      $185.94

Max consecutive winners          15     Max consecutive losers           3
Avg # bars in winners             1     Avg # bars in losers             3

Max closed-out drawdown   $-3,812.50    Max intra-day drawdown   $-3,812.50
Profit factor                   1.81    Max # of contracts held          1
Account size required     $6,812.50     Return on account             382%
```

**Figure 4.7** Restricting trade days makes a big difference.

## A Look at Volatility in the S&P 500

Does this concept have application for the S&P 500?

Although there can be no doubt about this technique working with a 50 percent volatility expansion, we can improve on it a great deal. How? By using something we already know about, the impact of TDW. The next set of data shows the volatility breakout performance by each day of the week for

Mondays

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 5 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $75,712.50
Gross profit             $167,200.00    Gross loss              $-91,487.50

Total # of trades             347       Percent profitable            85%
Number winning trades         298       Number losing trades           49

Largest winning trade     $4,975.00     Largest losing trade     $-4,400.00
Average winning trade       $561.07     Average losing trade     $-1,867.09
Ratio avg win/avg loss         0.30     Avg trade (win & loss)      $218.19

Max consecutive winners          26     Max consecutive losers           3
Avg # bars in winners             1     Avg # bars in losers             3

Max closed-out drawdown   $-9,150.00     Max intra-day drawdown   $-9,750.00
Profit factor                  1.82      Max # of contracts held          1
Account size required    $12,750.00     Return on account              593%
```

**Figure 4.8** Trading on Mondays.

Tuesdays

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $63,075.00
Gross profit             $150,725.00    Gross loss              $-87,650.00

Total # of trades             294       Percent profitable            83%
Number winning trades         246       Number losing trades           48

Largest winning trade     $8,512.50     Largest losing trade     $-3,962.50
Average winning trade       $612.70     Average losing trade     $-1,826.04
Ratio avg win/avg loss         0.33     Avg trade (win & loss)      $214.54

Max consecutive winners          24     Max consecutive losers           2
Avg # bars in winners             1     Avg # bars in losers             3

Max closed-out drawdown  $-10,800.00     Max intra-day drawdown  $-10,800.00
Profit factor                  1.71      Max # of contracts held          1
Account size required    $13,800.00     Return on account              457%
```

**Figure 4.9** Trading on Tuesdays.

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98                    Wednesdays

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

////////////////////////// ALL TRADES  - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $73,297.50
Gross profit             $163,372.50    Gross loss              $-90,075.00

Total # of trades            326        Percent profitable          85%
Number winning trades        278        Number losing trades         48

Largest winning trade     $4,462.50     Largest losing trade     $-3,912.50
Average winning trade       $587.67     Average losing trade     $-1,876.56
Ratio avg win/avg loss         0.31     Avg trade (win & loss)      $224.84

Max consecutive winners       28        Max consecutive losers        3
Avg # bars in winners          1        Avg # bars in losers          3

Max closed-out drawdown   $-6,762.50    Max intra-day drawdown   $-7,187.50
Profit factor                  1.81     Max # of contracts held       1
Account size required     $10,187.50    Return on account           719%
```

**Figure 4.10** Trading on Wednesdays.

the S&P 500. The exit is the same as with the bonds shown earlier. Clearly, some are days better than others to trade. Figures 4.8 through 4.12 show the buy signals by day of week; Figures 4.13 through 4.17 show sell signals by day of week.

Figure 4.18 shows trading on just the more influential days. The best days to be a buyer were all days except Thursday and Friday, while the best sell day was Thursday, with Friday a push, but it is used in the following listing. This is not a bad system, it "made" $227,822 with 75 percent accuracy on

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98                    Thursdays

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $56,400.00
Gross profit             $152,175.00    Gross loss              $-95,775.00

Total # of trades            307        Percent profitable          84%
Number winning trades        260        Number losing trades         47

Largest winning trade     $6,687.50     Largest losing trade     $-5,575.00
Average winning trade       $585.29     Average losing trade     $-2,037.77
Ratio avg win/avg loss         0.28     Avg trade (win & loss)      $183.71

Max consecutive winners       30        Max consecutive losers        2
Avg # bars in winners          2        Avg # bars in losers          3

Max closed-out drawdown   $-9,700.00    Max intra-day drawdown   $-12,537.50
Profit factor                  1.58     Max # of contracts held       1
Account size required     $15,537.50    Return on account           362%
```

**Figure 4.11** Trading on Thursdays.

Data : S&P 500 IND-9967 01/80
Calc Dates : 07/02/82 - 08/25/98

Fridays

| Num. | Conv. | P. Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---|---|---|---|---|---|---|---|
| 149 | 2 | $ 2.500 | $ 0 | $ 0 | $ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |

//////////////////////////// ALL TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $60,162.50 | | |
| Gross profit | $148,387.50 | Gross loss | $-88,225.00 |
| Total # of trades | 297 | Percent profitable | 86% |
| Number winning trades | 256 | Number losing trades | 41 |
| Largest winning trade | $4,387.50 | Largest losing trade | $-8,800.00 |
| Average winning trade | $579.64 | Average losing trade | $-2,151.83 |
| Ratio avg win/avg loss | 0.26 | Avg trade (win & loss) | $202.57 |
| Max consecutive winners | 21 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-13,125.00 | Max intra-day drawdown | $-13,125.00 |
| Profit factor | 1.68 | Max # of contracts held | 1 |
| Account size required | $16,125.00 | Return on account | 373% |

**Figure 4.12** Trading on Fridays.

//////////////////////////// SHORT TRADES - Test 5 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Monday

| | | | |
|---|---|---|---|
| Total net profit | $-4,812.50 | | |
| Gross profit | $135,525.00 | Gross loss | -140,337.50 |
| Total # of trades | 277 | Percent profitable | 73% |
| Number winning trades | 203 | Number losing trades | 74 |
| Largest winning trade | $16,712.50 | Largest losing trade | $-5,875.00 |
| Average winning trade | $667.61 | Average losing trade | $-1,896.45 |
| Ratio avg win/avg loss | 0.35 | Avg trade (win & loss) | $-17.37 |
| Max consecutive winners | 27 | Max consecutive losers | 5 |
| Avg # bars in winners | 2 | Avg # bars in losers | 4 |
| Max closed-out drawdown | $-26,225.00 | Max intra-day drawdown | $-26,900.00 |
| Profit factor | 0.96 | Max # of contracts held | 1 |
| Account size required | $29,900.00 | Return on account | -16% |

**Figure 4.13** Short trades test: Monday.

//////////////////////////// SHORT TRADES - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Tuesday

| | | | |
|---|---|---|---|
| Total net profit | $-21,400.00 | | |
| Gross profit | $142,825.00 | Gross loss | -164,225.00 |
| Total # of trades | 329 | Percent profitable | 75% |
| Number winning trades | 248 | Number losing trades | 81 |
| Largest winning trade | $9,987.50 | Largest losing trade | $-14,125.00 |
| Average winning trade | $575.91 | Average losing trade | $-2,027.47 |
| Ratio avg win/avg loss | 0.28 | Avg trade (win & loss) | $-65.05 |
| Max consecutive winners | 15 | Max consecutive losers | 4 |
| Avg # bars in winners | 2 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-37,275.00 | Max intra-day drawdown | $-37,975.00 |
| Profit factor | 0.86 | Max # of contracts held | 1 |
| Account size required | $40,975.00 | Return on account | -52% |

**Figure 4.14** Short trades test: Tuesday.

////////////////////////// SHORT TRADES - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\

Wednesday

| | | | |
|---|---|---|---|
| Total net profit | $-15,987.50 | | |
| Gross profit | $141,512.50 | Gross loss | -157,500.00 |
| Total # of trades | 312 | Percent profitable | 74% |
| Number winning trades | 232 | Number losing trades | 80 |
| Largest winning trade | $4,837.50 | Largest losing trade | $-4,975.00 |
| Average winning trade | $609.97 | Average losing trade | $-1,968.75 |
| Ratio avg win/avg loss | 0.30 | Avg trade (win & loss) | $-51.24 |
| Max consecutive winners | 22 | Max consecutive losers | 3 |
| Avg # bars in winners | 2 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-24,737.50 | Max intra-day drawdown | $-25,475.00 |
| Profit factor | 0.89 | Max # of contracts held | 1 |
| Account size required | $28,475.00 | Return on account | -56% |

**Figure 4.15** Short trades test: Wednesday.

////////////////////////// SHORT TRADES - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\

Thursday

| | | | |
|---|---|---|---|
| Total net profit | $36,250.00 | | |
| Gross profit | $183,775.00 | Gross loss | -147,525.00 |
| Total # of trades | 318 | Percent profitable | 75% |
| Number winning trades | 241 | Number losing trades | 77 |
| Largest winning trade | $8,737.50 | Largest losing trade | $-4,212.50 |
| Average winning trade | $762.55 | Average losing trade | $-1,915.91 |
| Ratio avg win/avg loss | 0.39 | Avg trade (win & loss) | $113.99 |
| Max consecutive winners | 19 | Max consecutive losers | 5 |
| Avg # bars in winners | 1 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-12,950.00 | Max intra-day drawdown | $-13,187.50 |
| Profit factor | 1.24 | Max # of contracts held | 1 |
| Account size required | $16,187.50 | Return on account | 223% |

**Figure 4.16** Short trades test: Thursday.

////////////////////////// SHORT TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

Friday

| | | | |
|---|---|---|---|
| Total net profit | $26,350.00 | | |
| Gross profit | $182,400.00 | Gross loss | -156,050.00 |
| Total # of trades | 347 | Percent profitable | 76% |
| Number winning trades | 267 | Number losing trades | 80 |
| Largest winning trade | $9,262.50 | Largest losing trade | $-4,250.00 |
| Average winning trade | $683.15 | Average losing trade | $-1,950.62 |
| Ratio avg win/avg loss | 0.35 | Avg trade (win & loss) | $75.94 |
| Max consecutive winners | 42 | Max consecutive losers | 4 |
| Avg # bars in winners | 1 | Avg # bars in losers | 2 |
| Max closed-out drawdown | $-32,812.50 | Max intra-day drawdown | $-32,812.50 |
| Profit factor | 1.16 | Max # of contracts held | 1 |
| Account size required | $35,812.50 | Return on account | 73% |

**Figure 4.17** Short trades test: Friday.

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $227,822.50
Gross profit              $642,447.50    Gross loss              -414,625.00

Total # of trades           1,333        Percent profitable           74%
Number winning trades         993        Number losing trades         340

Largest winning trade     $8,737.50      Largest losing trade     $-4,400.00
Average winning trade       $646.98      Average losing trade     $-1,219.49
Ratio avg win/avg loss         0.53      Avg trade (win & loss)     $170.91

Max consecutive winners          24      Max consecutive losers           4
Avg # bars in winners             1      Avg # bars in losers             1

Max closed-out drawdown  $-13,737.50     Max intra-day drawdown   $-13,737.50
Profit factor                  1.54      Max # of contracts held          1
Account size required    $16,737.50      Return on account            1,361%
```

**Figure 4.18** Trading on more influential days.

1,333 trades and had a very small drawdown of only $13,737. I would prefer a larger average profit per trade than the $170 shown here.

An astute, thinking trader should be asking questions like, "Could we use a closer volatility expansion number to be a buyer on the more bullish days and a farther away entry value on the days that don't work so well with the 50 percent value? And how about our exit, would it pay off to hold longer on the more bullish/bearish days?"

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 68 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $213,560.00
Gross profit              $473,110.00    Gross loss              -259,550.00

Total # of trades             850        Percent profitable           83%
Number winning trades         709        Number losing trades         141

Largest winning trade    $10,250.00      Largest losing trade     $-6,850.00
Average winning trade       $667.29      Average losing trade     $-1,840.78
Ratio avg win/avg loss         0.36      Avg trade (win & loss)     $251.25

Max consecutive winners          40      Max consecutive losers           3
Avg # bars in winners             1      Avg # bars in losers             2

Max closed-out drawdown   $-9,712.50     Max intra-day drawdown   $-10,087.50
Profit factor                  1.82      Max # of contracts held          1
Account size required    $13,087.50      Return on account            1,631%
```

**Figure 4.19** Research pays off!

These questions can continue indefinitely, but do need to be asked to optimize performance. Proof that research pays off is offered by Figure 4.19, which shows the use of the preceding rules, except that the buy entry comes at 40 percent of the previous day's range added to the open, the sell entry at 200 percent of the range subtracted from the open. There is a big difference here; while it actually makes a little less money ($14,000), the accuracy goes to 83 percent, the average profit per trade is escalated to $251, and our number of trades is reduced by 46 percent!

## Separating Buyers from Sellers to Find Volatility Using Market Swings

A third way to measure potential volatility expansions comes from looking at price swings over the past several days. Mike Chalek deserves credit for this concept with a system he designed and labeled, "Talon." The basic idea is to look at the various swings price has taken from one point to the next over the past few years. There are many such points to study.

The ones I have chosen for this next glimpse into market activity, measure the amount of price movement from the high 3 days ago to today's low. That is Step 1. Step 2 is to take the swing distance from the high 1 day ago minus the low 3 days ago. Finally, we will use the largest of these values as our basic volatility measurement to begin the process of designing a filter or price cushion to add to tomorrow's opening for buying or subtract for selling.

The system does okay; it makes money as the following results on the S&P 500 from 1982 to 1998 demonstrate (see Figure 4.20). The rules are to

```
Data              : S&P 500 IND-9967     01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $  0   $  3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $122,837.50
Gross profit              $264,937.50    Gross loss              -142,100.00

Total # of trades             538        Percent profitable          84%
Number winning trades         454        Number losing trades         84

Largest winning trade     $10,675.00     Largest losing trade     $-8,150.00
Average winning trade        $583.56     Average losing trade     $-1,691.67
Ratio avg win/avg loss          0.34     Avg trade (win & loss)      $228.32

Max consecutive winners         83       Max consecutive losers         5
Avg # bars in winners            1       Avg # bars in losers           2

Max closed-out drawdown   $-13,025.00    Max intra-day drawdown   $-13,112.50
Profit factor                   1.86     Max # of contracts held        1
Account size required     $16,112.50     Return on account            762%
```

**Figure 4.20** Using market swings.

buy at 80 percent of the swing value above the opening and sell at 120 percent of the swing value below the opening. Use a dollar stop of $1,750 and my bailout exit. This makes $122,837 from 1982 to 1998 with an average profit per trade of $228.

## Results

As always though, the question becomes, can we do better? Our last attempt at doing better was to use TDW as our filter to substantially improve performance. We will now go beyond this and bring in a fundamental consideration—the impact of bond prices on stock prices.

We will now try this concept as a filter (Figure 4.21). The rule is quite simple, we will only take buy signals if the closing price of bonds is greater today than 5 days ago, and only take sells if bonds are lower than 35 days ago. Our reasoning is well founded in the somewhat common knowledge that higher bond prices are bullish for stocks, lower bond prices bearish.

What a difference this makes! An average profit per trade goes from $228 to $281 while our drawdown plummets from $13,025 to only $5,250. Best of all though is that in the original "nonfiltered" trades we had a largest losing trade of $8,150, whereas with the bond filter the largest loss was only $2,075!

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 7 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $82,987.50
Gross profit             $148,350.00    Gross loss              $-65,362.50

Total # of trades            295         Percent profitable          87%
Number winning trades        258         Number losing trades         37

Largest winning trade     $10,675.00     Largest losing trade     $-2,075.00
Average winning trade        $575.00     Average losing trade     $-1,766.55
Ratio avg win/avg loss          0.32     Avg trade (win & loss)      $281.31

Max consecutive winners         59       Max consecutive losers         3
Avg # bars in winners            1       Avg # bars in losers           3

Max closed-out drawdown   $-5,250.00     Max intra-day drawdown   $-5,250.00
Profit factor                   2.26     Max # of contracts held        1
Account size required     $8,250.00      Return on account          1,005%
```

**Figure 4.21** The impact of bond prices on stock prices.

## One Step Further

Your education is nearing completion if you are wondering what happens in this model if we only take signals on the best TDWs while the trend of the Bond market is giving us bullish or bearish confirmation?

Again, the results speak for themselves: by combining all these ingredients we increase our chances or odds for short-term trading success. Notice the number of trades is substantially reduced, this means our exposure is less, but our average profit per trade increases. Our profits decline to "only" $76,400 but the average profit per trade jumps to $444, drawdown stays about the same at $5,912 but the percent of winning trades goes to 90 percent.

What we have done here is filter out trades that are not backed by all three of our conditions. Filtered trading for short-term swings will put you a light year—or two—ahead of all the rest of the short-term traders. There is an extra advantage here; by using filters you are placing demands on the market, demands that mean you will not trade every day, demands that naturally force you to trade less, not more. Active traders are usually losing traders. Those of us who pick and choose our spots to speculate are more inclined to come out winners as we have tipped the scales in our favor, which is what intelligent speculation is all about.

# Chapter 5

# The Theory of Short-Term Trading

*In the short term, theories work, but in the long term, give way to reality.*

Now that you have an understanding of how markets move from point to point and the basic strategy of how to best take advantage of these swings, it is time to examine the theory of what we are doing so I can then take you back to practical application.

Our basic concept or working theory is that something causes explosive market moves. These explosions put the market into a trend phase, and these trends, for our purpose, last from 1 to 5 days in most markets. Our object is to get aboard as close to the start of this explosion as possible.

Which gives rise to the questions, "What causes these explosions in market activity, when are they most apt to occur, and is there anything here we can use to pin down the time and place of these moves?"

Succinctly stated, those are the problems I have dealt with most of my life. Long ago, I recognized that if I could not identify a problem there was no way on earth I could find its solution. You now know the problems so let's look for some solutions. Let me hastily add that I do not have all the answers to this gigantic puzzle. There is nothing like losing to bring you to your senses, to teach you that you are not so damned smart, that you need more education. I still have losses, plenty of them, so I too, still need more education. And always will.

The biggest "cause" of these moves is probably news. But we have trouble trading on news because, first, the news can change as quickly and as unpredictably as the weather. News, or changes in world events and marketplaces, can be random; thus, the markets wobble around from one unknown news event to the next. The drunken sailor analogy mathematicians have used is most likely due to news knocking prices back and forth. Second, we may be the last guy on the food chain getting such news so we receive it too late. Third, there is nothing we can look at or observe that tells us what specific future news might be. Fourth, my years of trading strongly suggest that those who are close to the news usually position themselves prior to the announcement. (Note: There is not one group taking advantage of news; the group varies from source to source.) Bankers might have inside news about the T-Bond market, but not on Cattle, whereas feedlot operators might have that data, but nothing on Bonds. There is not an Illuminati controlling all news sources. While Mel Gibson's character Jerry Phillips was right on in the movie *Conspiracy Theory*, do not extend that theory to the markets.

While I was writing this book, a book about some of my archeological exploits, *The Gold of Exodus*, by Howard Blum (New York: Simon & Schuster), was discussed in several magazine and newspaper articles. In one of them, where I lived was stated incorrectly as was my occupation, my age, the type of car I drive, and my description of what the book is all about! In short, if I can't believe what I read about myself from a reporter who personally interviewed me, I suggest you probably can't trust much of what is written about Orange Juice, Oats, and Oil.

The supposedly prestigious *Wall Street Journal* is no exception. In early 1998, they told readers their source inside the Federal Reserve System was certain the Fed Open Market Committee was about to raise interest rates. Six weeks later when the Fed released their notes on the meeting, we learned the truth, they had voted 11 to 1 to not raise rates! On at least two occasions, reporters of the *Wall Street Journal* have been found to be touting stocks they, themselves, had already acquired a position in. Television is not exempt from this same problem; CNBC's lead "inside source" Dan Dorffman is no longer on air for the same allegations of misleading viewers. A few years back, even Ralph Nader was caught, or rather his mother was, by the Securities and Exchange Commission, selling short stocks in General Motors and a tire company just before Nader attacked them with his consumer complaint lawsuits.

So what else can we look at if we can't really examine news?

"Price action! Charts!" scream technicians and most short-term swing players. The nice thing about price action, as reflected on charts, is that there are plenty of things to look at and analyze, the most common being (1) price patterns, (2) indicators based on price action, and (3) the trend or momentum of price. Not so common, and the fourth one of my big tools, is the relationship one market may have on another. Remember the S&P 500

system and how much better it was when we required that bonds be in an uptrend? That is an example of market relationships that I discuss in detail a little later on.

Our final and fifth set of data to key off of comes from following the crowd most often found to be wrong. On a short-term basis, the great unwashed public trader is a net loser. Always has been, always will be. The figures I have heard bandied about over the years are that 80 percent of the public lose all their money, be they stock or commodity traders. Thus coppering their wagers should lead us to those short-term explosions and profits. There are various ways to measure the public; these are called *sentiment indicators.* The two best ones I know of are surveys of the public done by Jake Bernstein and Market Vane.

For short-term traders, I prefer Jake's because he actually calls 50 traders after the close each day to find out if they are bullish or bearish on any given market. Since these are short-term traders, and by definition usually wrong, we can use them as a guide of when not to be a buyer or seller. I will not use them exclusively as an indicator to buy or sell, but as a tool that should not be in agreement with my own hand-selected trade. If the public is excessive in their selling, I don't want to be a seller along with them. I may not always fade the public, but I sure don't want them on my side of the table.

Market Vane takes sentiment readings from newsletter writers as opposed to short-term traders; thus their index appears to be better suited for a longer-term view of things.

Well, there you have it, the five major elements I have found that can help with ferreting out short-term explosions. We will overlay these "tools" or events on market structure to enable us to hop aboard up and down moves. Since all these tools can be quantified, the logical procedure is to convert these observations and tools into mathematical models. The next leap of logic traders make is that since math is always perfect (two plus two always equals four), there must be a perfect solution to trading and mathematics can provide the answer.

Nothing could be more distant from the truth. There is not a 100 percent correct mechanical approach to trading. There are tools and techniques that based on observation usually work, but the reason we lose money is that we either reached an incorrect conclusion or did not have enough data to make a correct one. So math is not the answer, mechanics is not the answer. The truth of the market comes from ample observations, a dose of correct logic, and correct conclusions from the data at hand.

I am telling you this right up front so you do not get lulled into the idea that speculation is a game of blindly following the leader, a system, or absolute approach. If any one thing is certain about the markets it is that things change. In the early 1960s, an increase in money supply figures was considered very bullish and always put stock prices higher. For whatever reason, in

the late 1970s and early 1980s, an increase in money supply figures, as released from that largest of all privately held corporations the Federal Reserve, put stock prices down. In the 1990 time period money supply is barely looked at or felt in the marketplace. What was once sacred became apparently meaningless.

One of the markets I trade the most heavily in, Bonds, traded totally different after 1988 than prior to that date. Why? Prior to October of that year there was only one trading session, then we went into night sessions and eventually almost a 24-hour market. That changed trading patterns. What is more confusing to researchers is that "in the old days" the Fed released reports on Thursday that had huge impact on Friday's Bond prices. This effect was so great a popular novel used it as the central theme of a Wall Street swindle. As I write this, in 1998, there are no Thursday reports, hence Fridays look and trade differently now.

If you are to do me any favor as a reader of my work, you will not only learn my basic tools but also learn to stay awake and current to what is happening. Great traders, which I hope you become, are smart enough to note and respond to changes. They do not lock themselves into a "black box" unchangeable trading approach.

One of the truly great traders from 1960 to 1983 was a former professional baseball player, Frankie Joe. Frankie had a great wit and a deep understanding of his approach to trading. He was quite a guy, sharp as a tack and a delight to talk with. After we had developed a three-year friendship, he revealed to me his technique, it was to sell rallies and buy back on dips in the stock market. That is all there was to it; no more, no less. This was a great technique during that time period, it amassed a fortune for Frankie.

Then along came the most predictable, yet unpredictable, bull market of all time triggered by Ronald Reagan's tax and budgetary cuts. It was quite predictable that the bull market would come about. What no one realized was that there would be no pullbacks along the way as we had seen for the previous 18 years. Not even one of the greatest traders of all time, Frankie Joe. He kept selling rallies and was never able to cover on dips; there just weren't any. Eventually, he became so frustrated with losses and the lack of success (like all great traders, he was also compulsive about winning), that he apparently committed suicide.

What works, works in this business, but often not for long, which is why I so admire ballerinas, they stay on their toes.

## What Is Wrong about the Information Age

Fundamental principles do not change—that is why they are called fundamentals. "Do unto others as you would have others do unto you," was good

advice 2,000 years ago and will be good advice 2,000 years from now. The principles I'm laying out in this book are enduring; I have lived with them for close to 40 years and have literally made millions of dollars trading.

Yet, were I to fall into coma today and wake up 10 years from now I might not use the exact same rules with these fundamental principles. Whereas fundamentals are permanent, the application and specifics do change and will vary.

Technology has become king, speeding up every facet of life. We can now learn about anything faster, communicate faster, and find out about price changes faster. Indeed, we can buy and sell faster; get rich quicker; go broke faster; and lie, cheat, and steal at unbelievable speeds. We can even get sick or healed faster than ever before in the history of the world!

Traders have never had so much information and so much ability to process this information, thanks to computers and to Bill and Ralph Cruz, who invented the first and best workable software, System Writer, which evolved to Trade Station. Thanks to these products from Omega Research, average Joes like you and me can now test market ideas. For more than 10 years now, thanks to Bill's foresight, it has been possible to ask just about any question to find the "truth of the markets."

But guess what? This technical revolution in the age of information has brought no concomitant breakthrough to the world of speculation. We still have the same numbers of winners and losers. Guys and gals with state-of-the-art computers still get blown out on a regular basis. The difference between winners and losers is largely based on one simple turn of events, winners are willing to work, to notice changes, and to react. Losers want it all without effort; they fall for the pitch of a perfect system and an unchanging guru or indicator they are willing to follow blindly. Losers don't listen to others or to the market; they are unyielding in their minds and trades.

On top of that, they consistently fail to abide by the fundamental of successful business, which is to never plunge, to manage your money as well as your business by getting rid of bad deals and keeping the good ones. Me? I will stick to the fundamentals, as taught, with a healthy willingness to adapt to change. When I stay flexible, I do not get bent out of shape.

## E. H. Harriman's Rule of Making Millions

The Harriman family fortune, which endures to this day, was created in the early 1900s by "Old man Harriman," who had started his career as a floor runner and went on to become a major banking and brokerage power. He made a $15 million profit in 1905 from one play in Union Pacific. This speculator king focused on just railroad stocks, the hot issue of his era.

In 1912, an interviewer asked Harriman about his stock market skills and secrets. The trader replied, "If you want to know the secret of making money in the stock market, it is this: Kill your losses. Never let a stock run against you more than three-quarters of a point, but if it goes your way, let it run. Move your stops up behind it so that it will have room to fluctuate and move higher."

Harriman learned his cardinal rule from studying trading accounts of customers at a brokerage firm. What he discovered was that of the thousands upon thousands of trades in the public accounts, 5- and 10-point losses outnumbered 5- and 10-point gains. He said, "by fifty to one!" It has always amazed me that businesspeople who have tight control and accounting practices in their stores and offices lose all control when it comes to trading. I cannot think of a higher authority than E. H. Harriman, nor a more enduring rule of speculation than what this man gave us in 1912.

Like I said, fundamentals don't change.

# Chapter 6

# Getting Closer to the Truth

*Beginning proof the market is not random and our first "key" to market explosions.*

Losers of any game typically lament that either the game was rigged, or it is one no one can beat; thus, their failure is excusable. Well, the game of the market has been beaten by many people for many years. So while I have read the laments of the academicians such as Paul Cootner in his classic, *The Random Character of Stock Prices*, whose morose verdict is that prices cannot be predicted: past price activity has no bearing on what will happen tomorrow, or next week for that matter. This is true, he and a host of other apparently nontrading authors suggest, because the market is efficient. All that is to be known is known and thus already reflected in current prices. Therefore, today's price change can only be caused by new information (news) coming to the marketplace.

The bottom line of these authors is that returns from one day to the next are independent, thus price is impacted by random variables which accounts for the notion that prices move totally by random, thus defy prediction. Believing in this random walk means acknowledging that the market is efficient, that all is known. Obviously, you do not accept this concept; you spent hard-earned money on this book thinking that perhaps I know, and can teach you, something most other traders or investors do not know.

You are right! Cootner and his crowd apparently tested for dependence on future action of price in a one-dimensional approach. I suspect they may have tested future price change based on some sort of moving averages, thus while looking for the right direction, they used the wrong tools.

If there is no dependency on price action, over a long time period, 50 percent of the days a market should close higher and 50 percent of the time lower. It is supposed to be like flipping a coin—the coin has no memory. Each new toss is not biased by what went on in the past. If I were to flip such a fair coin on Tuesdays, I would get the same 50/50 heads and tails as I would by flipping on any other day of the week.

## The Market Is Not a Coin Flip

If the Cootner theory is correct and market activity is random, then a test of day-to-day price change should be easy to establish. We can start with a very simple question: "If market activity is random, should not the daily trading range, each day's high minus the close, be just about the same regardless of which day of the week it is?"

Also one should ask, "If all price action is random, would you not expect the daily change, regardless of being up or down, just the absolute value of daily changes to be about the same for each day of the week?"

And finally, "If price is random, is it not true that no one day of the week could or would show a strong bias up or down?" If the market has no memory, it surely should not matter which day you flip the coin or take your trades. The truth is it does matter, *a great deal.*

Instead of listening to the theorists, I went to the market to see what it had to say. I asked the preceding questions and many others to see whether there is dependency from one day to the next or one pattern or past certain price action that consistently influences tomorrow's price past the critical random walk point. The answer was clear; the market does not reflect Cootner's claim. Tables 6.1 and 6.2 prove my point. I have sampled two of the

**Table 6.1**
**S&P 500 1982–1998**

| | High-Low | Close-Open |
|---|---|---|
| Monday | 4.22 | .631 |
| Tuesday | 4.30 | .130 |
| Wednesday | 4.29 | .221 |
| Thursday | 4.19 | −.044 |
| Friday | 4.45 | −.1164 |

Table 6.2
Treasury Bonds 1988–1998

| | High-Low | Close-Open |
|---|---|---|
| Monday | .708 | –.001 |
| Tuesday | .781 | .064 |
| Wednesday | .767 | .010 |
| Thursday | .823 | –.017 |
| Friday | 1.05 | .022 |

biggest, and thus you would think the most efficient markets, the S&P 500, a measure of 500 stocks, and the United States Treasury Bonds.

My first question was, Is there a difference in the size of the range for different days of the week? Next, Does the distance change from the open to the close, depend on the day of the week? And finally, I looked at the net price change each day. In Cootner's world, all these questions should produce a homogeneous response; there should be no or little variance.

For the S&P 500 Tuesdays and Fridays consistently had daily ranges larger than any other time period. For the Bond market, Thursdays and Fridays had the largest daily ranges. Could it be that not all days are created equally?

You bet, or had better bet, because the second column for each market shows the absolute value of the price swing from the open to the close also varies widely. In the S&P 500 the largest open to close change takes place on Mondays at an average of .631 while the smallest takes place on Thursdays with –.044.

In the Bond market the difference is even larger Tuesdays saw the largest open to close change, .645 and the smallest on Mondays with –.001!

Finally, check out the last column to see that in both sets of data for the S&P 500 Fridays have a negative value and in Bonds, Monday and Thursday show negative changes for these days. Cootner should say this is impossible, in an efficient market one day should not be pre-disposed to rally or decline more than any other. The market tells us otherwise, some days of the week are in fact better for buying or selling than others!

I want to drive this point home: Cootner and his crowd apparently did not test for day of the week dependency. I conducted a study where we asked the computer to buy on the opening each day and exit on the close. I ran this test on all the grain markets (not shown). While not a trading system on its own, the data opens a door and gives us an advantage those who put this book back on the shelves don't have. The data makes clear:

*All the grain markets have a pronounced pattern of rallying more on Wednesdays than any other day of the week.*

Table 6.3
Day-to-Day Change in Price

| | Gold | | British Pound | | Bonds | | S&P 500 | |
|---|---|---|---|---|---|---|---|---|
| Monday | 50% | +$ 7 | 53% | +$13 | 54% | +$59 | 52% | +$ 91 |
| Tuesday | 48 | −2 | 54 | 15 | 49 | −18 | 52 | +59 |
| Wednesday | 49 | −3 | 49 | 0 | 54 | +16 | 52 | −27 |
| Thursday | 51 | 0 | 49 | −21 | 53 | +30 | 50 | −10 |
| Friday | 49 | −13 | 54 | 0 | 50 | −35 | 57 | +134 |

Go ahead, check it out, what happened to that random walk? Sure looks like it gets stuck on Wednesdays in the grains. What is evident here is an advantage to the game. Granted, it is small, but casinos work of an advantage of usually 1.5 percent to 4 percent in most of their games of random chances. It is that tiny percentage, played often enough, that builds all those hotels and subsidizes the buffet lines.

Although the grains, especially Soybeans, offer some short-term trading opportunities, this is being written at the turn of the twenty-first century, and there are more explosive short-term markets to focus on: the S&P, T-Bonds, the British Pound, and Gold. The first two are the best for us short-termers and short-timers.

Table 6.3 shows the impact the day of the week has on price changes in these markets. Again, traditionalists would argue there should be little if any differences assuming price change is random. What we find is that the trading day of the week does indeed produce a bias of future price activity, a bias we can turn into profitable trading.

One of my favorite short-term trading advantages is Trading Day of the Week (TDW). My focus here is the price change from the opening of the day to the close as opposed to just close to close. The reason should be clear to you, the day for a short-term trader begins on the open and, at least for a day trader, ends on the close.

Table 6.4 shows the results of such a study where the Bonds or S&P 500 were purchased on the open and exited on the close each TDW. Random

Table 6.4
Open-to-Close Change in Price by Day

| | Gold | | British Pound | | Bonds | | S&P 500 | |
|---|---|---|---|---|---|---|---|---|
| Monday | 53% | +$8 | 54% | +$10 | 55% | +$53 | 50% | +$45 |
| Tuesday | 52 | −3 | 58 | −12 | 47 | −35 | 55 | +56 |
| Wednesday | 53 | +4 | 55 | +18 | 52 | +4 | 51 | −27 |
| Thursday | 52 | +1 | 55 | +11 | 50 | +8 | 50 | −37 |
| Friday | 53 | −9 | 56 | +13 | 51 | −14 | 57 | +109 |

walk theorists should be gasping for their last breath about now. Here's a thumbnail sketch, the British Pound rallies off the open 55 percent of the time on Wednesdays and "makes" $18 per trade. "Makes" is in quotation marks because after commissions and slippage are taken into consideration not much is left, but the pattern sheds light on a market bias we can develop into tradable material.

Gold has rallied 52 percent of the time off of Tuesday's opening making –$3, while things are not much better with Tuesday buys on the Bond market; 47 percent winners and an average of –$35 per trade. The biggest display of this bias comes from the S&P 500 (Figure 6.1). This is where I first discovered the bias and have traded it since 1984. On Mondays, this kingpin of volatility has closed above the opening 57 percent of the time with an average profit of $109! Bond traders should note the open to close change on Mondays has been positive 55 percent of the time with an average gain of $53.

In case you are wondering about the close-to-close relationship, it is shown in and again the bias or advantage to the game becomes apparent. Study them for yourself.

Table 6.5 shows the results of buying on the opening and exiting 3 days later. Any remaining random walk enthusiasts will tell you we should not be able to find any differences between days of the week over a 3-day period. An efficient market should wipe that out. Yet when we look at just the best performing day of each week, based on the open-to-close change, we see a large bias and taste the sweetness of knowing markets are not totally random. The only random market was Gold; the rest of the markets I studied beat the random walk. Bonds and the S&P 500 led the way showing some decent profits.

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/25/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $76,400.00
Gross profit             $104,787.50    Gross loss              $-28,387.50

Total # of trades            172        Percent profitable           90%
Number winning trades        156        Number losing trades          16

Largest winning trade     $10,675.00    Largest losing trade     $-2,075.00
Average winning trade        $671.71    Average losing trade     $-1,774.22
Ratio avg win/avg loss          0.37    Avg trade (win & loss)       $444.19

Max consecutive winners          34     Max consecutive losers           2
Avg # bars in winners             1     Avg # bars in losers             4

Max closed-out drawdown   $-5,912.50    Max intra-day drawdown   $-5,912.50
Profit factor                    3.69   Max # of contracts held          1
Account size required     $8,912.50     Return on account             857%
```

**Figure 6.1** Trading on bias.

**Table 6.5**
**Best Trading Day of Week with a Three-Day Hold**

| Commodity | Day | Percentage Up | Average Profit |
|---|---|---|---|
| Gold | Tuesday | 50 | $ 0 |
| Pound | Friday | 54 | 36 |
| Bonds | Tuesday | 52 | 86 |
| Standard & Poor's 500 | Monday | 57 | 212 |

TDW does make a difference and can give us a workable bias to trade with. There are numerous ways to begin milking this cow, and you probably have already thought of some on your own. Certainly, it is a bias you want to understand, and consider, for any market you are going to trade on a short-term basis.

Earlier, I said the open is critical; if we start to expand or move away from the opening, price will probably continue in that direction. Now I will demonstrate one such approach. We will combine our day-of-the-week bias with one simple rule; buy on the opening of the bias day + X percent of the previous day's range. We target our bias day, and buy that day at an expansion off the opening price. Our exit is simple; we hold the trade to the close and take our profits/losses at that time. (There are better exit techniques, which I will get to later.)

The S&P 500 results of buying the opening Monday +.05 percent of Friday's range are pretty spectacular for trading just one day a week (see Figure 6.2)! This approach shows a net profit of $95,150 with 435 winning

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/26/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
  149   2  $  2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 6 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $95,150.00
Gross profit             $286,037.50    Gross loss              -190,887.50

Total # of trades            758        Percent profitable           57%
Number winning trades        435        Number losing trades         323

Largest winning trade      $6,950.00    Largest losing trade      $-3,000.00
Average winning trade        $657.56    Average losing trade      $ -590.98
Ratio avg win/avg loss          1.11    Avg trade (win & loss)      $125.53

Max consecutive winners          11     Max consecutive losers           7
Avg # bars in winners             0     Avg # bars in losers             0

Max closed-out drawdown  $-16,337.50    Max intra-day drawdown   $-16,337.50
Profit factor                   1.49    Max # of contracts held          1
Account size required    $19,337.50     Return on account              492%
```

**Figure 6.2** Buying on the opening Monday.

trades out of a total 758. Thus the average profit per trade is $125 with 57 percent accuracy. Bonds make money buying on Tuesday opening plus 70 percent of Monday's range with $28,812 profits and 53 percent accuracy netting $86 a trade which is a little small, but a better exit technique will radically change this number (see Figure 6.3). The long and short of all this data is that a simple filter, TDW, enables us to do what the professors say is impossible . . . beat the market.

To recap, stocks have a proven proclivity to rally on Mondays, Bonds on Tuesdays and virtually all the grains on Wednesday. To arrive at this opinion, we examined grain prices as far back as 1968 (30 years of data), Bonds to 1977 (21 years of data), and the S&P since they began trading in 1982 (17 years). In short, we rolled the dice enough to draw some reliable conclusions and observed enough data to determine there are biases; price is not solely motivated by a drunken sailor's random walk through the pages of the *Wall Street Journal.*

From this research, we have a leg up on other traders, an advantage in the game, and a window of opportunity to focus on when trading. It is not how often you trade that makes you a winner, after all any fool can trade every day of the week. Old punters like myself know it is how often you don't trade, how selective you are, that will lead to a successful career.

Astute traders are probably already asking the next question I will now answer, "If there is a bias to the TDW could there be a bias to the Trading Day of the Month?"

The answer is yes, and here comes the proof. The following results were arrived at by buying/selling on the opening of the trading day of the month

Data : DAY T-BONDS 67/99
Calc Dates : 12/02/77 - 08/26/98

| Num. | Conv. | P. Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---|---|---|---|---|---|---|---|
| 144 | -3 | $ 31.250 | $ 0 | $ 0 | $ 3,000 | CSI | C:\GD\BACK67\F061.DTA |

//////////////////////////// ALL TRADES - Test 8 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $28,812.50 | | |
| Gross profit | $66,781.25 | Gross loss | $-37,968.75 |
| Total # of trades | 334 | Percent profitable | 53% |
| Number winning trades | 180 | Number losing trades | 154 |
| Largest winning trade | $1,625.00 | Largest losing trade | $-1,750.00 |
| Average winning trade | $371.01 | Average losing trade | $ -246.55 |
| Ratio avg win/avg loss | 1.50 | Avg trade (win & loss) | $86.26 |
| Max consecutive winners | 10 | Max consecutive losers | 6 |
| Avg # bars in winners | 0 | Avg # bars in losers | 0 |
| Max closed-out drawdown | $-3,718.75 | Max intra-day drawdown | $-3,718.75 |
| Profit factor | 1.75 | Max # of contracts held | 1 |
| Account size required | $6,718.75 | Return on account | 428% |

**Figure 6.3** Using a better exit technique.

shown and exited with either a $2,500 stop in the S&P 500 or $1,500 in the Bonds or on the close the third day after entry.

The entry day *was not* the calendar date *but the* trading day of the month (TDM). A month can have 22 trading days, but because of holidays, weekends, and the like, we don't always get 22 days. Our entry rule is to buy or sell on the open of the TDM shown. This means you will have to count how many trading days have taken place so far this month to set up the trade.

This concept, TDM, is akin to seasonal influences. Most other authors and students of market activity have focused on calendar days but that approach has inherent problems; if the computer spits out that the 15th calendar day is the best for a buy, yet this year the 15th is a Saturday and the day before is a holiday, just when do we take action? On Wednesday, Thursday, or the following Monday? TDM eliminates this question, giving us focus on a specific tradable day.

I do not trade these days as exclusively, or should I say, inclusively, as TDWs. I use TDMs as setups, leading indicators of when to take what type of action. I may or may not take a TDM trade, I reserve judgment for that specific trade when that time rolls around. I will want to see what else is going on because this is a thinking person's game that deals in reality, not a robotic virtual reality experience. My research shows that all markets have TDM setup periods where the odds of a rally or decline are definitely tipped in our favor. If you trade markets other than the ones discussed in this book, you should get a computer, or programmer, to provide you with this information on your trading vehicles.

Indeed, there is a time to sow and a time to reap each week and each month of the year. Some times are better than others, but only a very inexperienced trader would blindly take such trades. My strategy is to find a bias such as TDW and TDM and then couple it with another bias to load or stack the deck in my favor. Should you and I play cards, for money, trust me to come with a marked and stacked deck, which is exactly how I want to trade; with as many odds in my favor as possible. If the scales are not heavily unbalanced in my favor, why trade? There are plenty of trades every year that are stacked deck trades, I will wait for them to materialize.

Enough said. Tables 6.6 and 6.7 show the best TDMs for Bonds and the S&P 500, respectively.

These results are actually staggering. By following some very simple rules, $211,910 of profits could be had from trading Bonds just 6 days a month, and $387,320 from trading the S&P a mere 7 days per month. The S&P results reflect no stop on entry day, but a $2,000 stop after entry day, whereas the Bonds used a $1,500 stop starting on entry day.

Although you may not want to blindly follow these trade dates, we certainly want to be awake and aware around these pivotal trading periods because we have a definite advantage in the game—we know when strong rallies are most likely to take place.

Table 6.6
Best TDMs for S&P 500 1982–1998

| TDM | $ Profit | Number of Trades | % Wins | Average Trade | Drawdown |
|---|---|---|---|---|---|
| 6 | 48,787 | 166/97 | 58 | 293 | 13,025 |
| 7 | 54,212 | 168/212 | 60 | 322 | 6,100 |
| 8 | 51,312 | 175/102 | 68 | 293 | 10,675 |
| 19 | 64,162 | 145/84 | 57 | 442 | 8,187 |
| 20 | 55,600 | 110/60 | 54 | 505 | 11,825 |
| 21 | 70,875 | 75/48 | 64 | 945 | 7,750 |
| 22 | 42,375 | 61/40 | 65 | 694 | 10,075 |

Table 6.7
Best TDM's for T-Bonds 1977–1998

| TDM | $ Profit | Number of Trades | % Wins | Average Trade | Drawdown |
|---|---|---|---|---|---|
| 8 | 38,375 | 230/128 | 55 | 166 | 7,125 |
| 18 | 46,562 | 231/132 | 57 | 201 | 12,656 |
| 19 | 43,593 | 195/116 | 59 | 223 | 12,343 |
| 20 | 30,131 | 148/84 | 56 | 292 | 7,093 |
| 21 | 31,562 | 106/59 | 55 | 297 | 7,406 |
| 22 | 21,687 | 76/49 | 64 | 285 | 7,250 |

## Monthly Road Maps

To give you a better feel of how prices usually move during *each month* of the year, Figure 6.4 shows a daily chart that reflects how price changes on each TDM. Again, these are general outlines of what price has done in the past. Like road maps, price may, or may not follow the same pattern this year and this month. Usually though, these price formats will be followed. Figure 6.4 charts T-Bonds for 1998; underneath the price activity is a line that reflects the daily movement during each month. No one should expect price to follow this index exactly, but, it generally follows the ups and downs. This index shown was created on data from the past and extended out into 1998. As you can see, the January peak came on schedule as did the May lows, June rally, and late July pullback.

Is this a fluke? Could be, so let's look at another TDM road map, this time for the S&P 500, again created on data ending in 1996, and then look at how prices moved in 1998 (see Figure 6.5). Although not a perfect representation, the similarity is remarkable and some excellent "stacked deck" trading time periods did appear in the future as the past suggested they might.

The best example is the major stock market slide that started in July 1998, right on schedule, congruent with the TDM road map. This index is

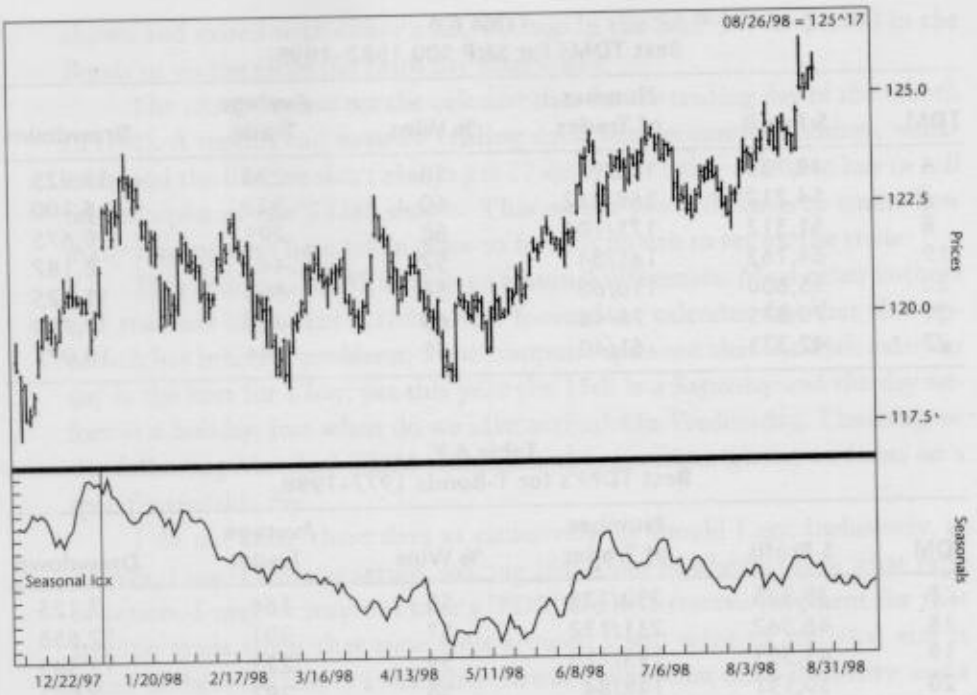



**Figure 6.4** Day T-Bonds (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

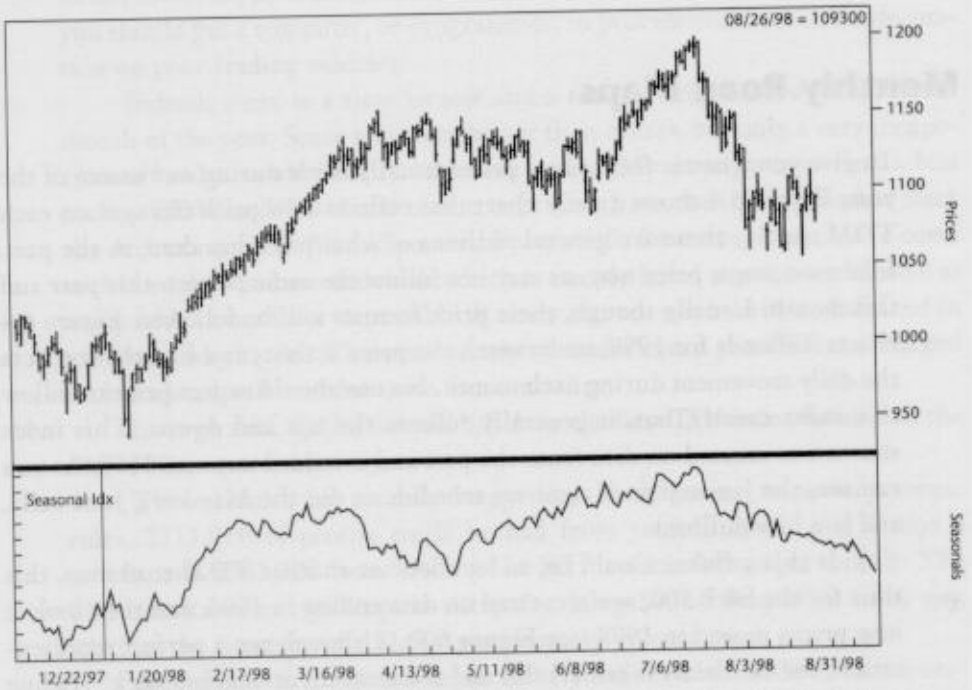



**Figure 6.5** S&P 500 Index (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

one of the tools I used to get all my stock subscribers out of the market in June 1998.

I do not believe the past precisely predicts the future. My view is that the past is an indication of what is likely to happen in the future, thus it is a general guideline, an outline or bias we can and should take into consideration. It is time to think about what we should be doing on this day, this month, this year.

I am closing this chapter with an actual example from my own trading in 1998. Based on a system I use for trading Bonds, I was short a little over 300 contracts of Bonds where the arrows are marked on Figure 6.6. This was not a very good place to be short; price moved against my position to the tune of almost $250,000. I was emotionally fraught as my automatic dollar stop was close at hand calling for me to exit and take my licking at 122 23/32nds.

Had I not known of this map or pattern I would have been stopped out. But, knowing of the pattern of weakness usually starting on the 12th TDM, I chose to not only raise my stop to the 122 23/32nd area but also went short on the 2/19 in hopes the TDM influence would come to play as it usually does. Fortunately, the market "knew what to do" and declined from that point until February 24 when my system called for going long. I still took a loss on

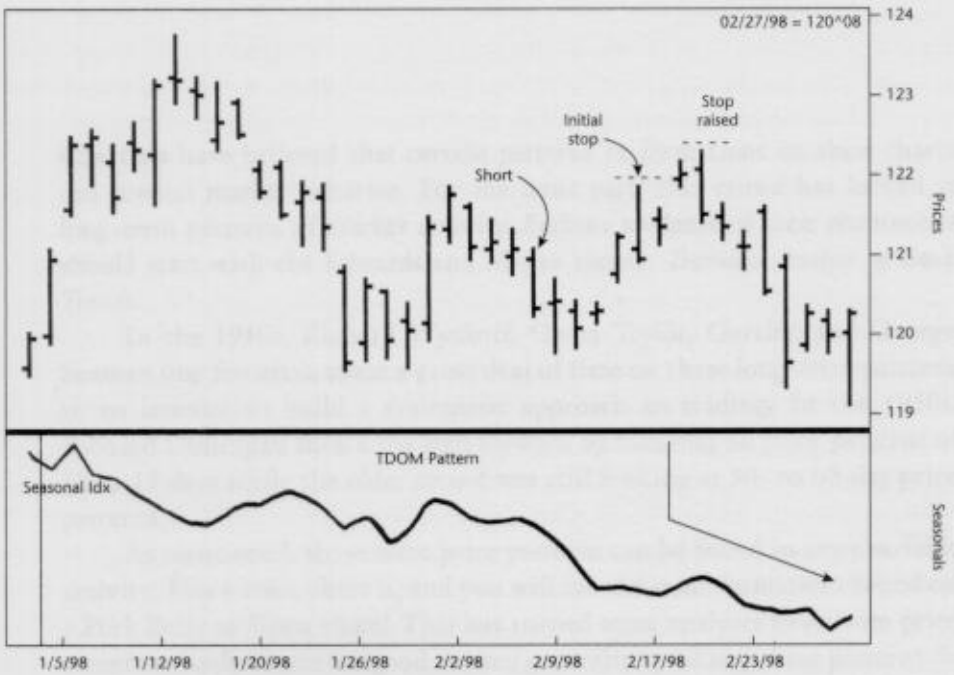



**Figure 6.6** Day T-Bonds (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

the initial trade, but far less than the one I would have taken had I not known of this market bias.

Admittedly, the market could have moved higher; the possibility of being wrong never takes a vacation, which is why I still used a stop. I just slightly altered it based on the information at hand. This is a thinking business. Always has been, always will be, which is why I am interested in teaching the elements that can lead to successful trading. One of the vital elements I have used with a good degree of success is the TDM/TDW concept. I am not really certain who first came up with this idea—Sheldon Knight, one of the nicest guys and best researchers in the commodities business, or myself. But I think I have relied the most on the technique.

Several of my trading friends reject the TDW concept and insist there is no difference from one day of the week to the other. I violently disagree; it is my first building block in determining what I will do tomorrow. The data in this chapter indicate the existence of bias on certain days of the week. It is my job as a trader to maximize this opportunity.

# Chapter 7

# Patterns to Profit

*My evidence that there is method to the madness of market movement.*

Chartists have believed that certain patterns or formations on their charts can predict market behavior. For the most part, this crowd has looked at long-term patterns of market activity. Serious students of such phenomena should start with the Edwards and Magee classic, *Technical Analysis of Stock Trends.*

In the 1930s, Richard Wyckoff, Owen Taylor, Gartley, and George Seaman (my favorite), spent a great deal of time on these long-term patterns in an attempt to build a systematic approach to trading. In the 1950s, Richard Dunnigan took a big step forward by focusing on price patterns of 10 to 15 days while the older crowd was still looking at 30- to 60-day price patterns.

As mentioned, these same price patterns can be found in any chartable activity. Flip a coin, chart it, and you will see the same formations found on a Pork Belly or Corn chart! This has turned some analysts away from price structure analysis and for good reason; generally speaking, these patterns do not forecast or tell us much about the future. This may be because there is no predictable ability in chart formations, or the time period studied is not

correct. W. L. Linden, writing in *Forbes* magazine, found that economic forecasts made by leading economists have consistently been incorrect at virtually every major turning point since the 1970s. A chilling thought here is that the study included forecasts done by Townsend-Greenspan—the latter name is that of the man who became head of the Federal Reserve System (the world's most powerful private corporation), Alan Greenspan.

The only ray of hope to be found in the article is the statement that these forecasts were correct in only a short time frame. This makes sense; it is far easier to forecast the next 5 minutes of your life than the next 5 years. As time progresses, more variables, more change, comes into play. Hence forecasts stumble in the unknown dark, black holes of the future altering what was once known or thought to be the path of righteousness.

I guess this may explain why I have actually made money (for many years I might add), trading off of patterns. The patterns I have used are for calling very short-term market fluctuations of from 1 to 5 days. There may be some grand scheme of things, some master pattern of all major market highs and lows. If so, it has never been revealed to me, but certainly there are many short-term market patterns that give you a big—in some cases, I would go so far as saying huge—advantage in the game.

## The Common Element

First, I need to prove that patterns can and do work or at least bring an advantage to the table, a cow for us to milk. Then I can tell you why I think these patterns do work, what the method to the madness is, what my working premise to these patterns to profits is all about.

Let's start with a basic pattern using the S&P 500, a broadly traded market. What we know is that 50 percent of the time this market should close up for the day, 50 percent of the time down for the day. What will happen tomorrow on any given day is supposed to be a coin flip, if we don't consider TDW.

Patterns can change all that rather dramatically.

We begin by establishing a basic parameter. What happens if we buy the S&P 500 every day and exit on the next close with a $3,250 stop? From July 1982 through February 1998, there were 2,064 trades with 52 percent accuracy and an average profit per trade of $134.

Now we add our first pattern, what if we only buy tomorrow if today closed down? In this case, there were 1,334 trades with the same 52 percent accuracy, but the average profit per trade escalated to $212. Finally, if our pattern consists of three consecutive down closes, the accuracy jumps to 58 percent to 248 trades and the average profit per trade skyrockets to $353! Could it be there is something to this pattern stuff?

Let's mock up a simple pattern to see what happens tomorrow if the following conditions exist: First, we want today's price to be greater than the close 30 days ago so we are in some sort of up trend. Next, we would like to have seen a slight pullback against the uptrend so we will want today's close lower than the close 9 days ago. If that condition exists, we will buy on the open tomorrow and exit on the next day's close. If the market is really random, 52 percent of such trades should make money (not 50% because during the time period of the study there had been an overall trend bias to rally best evidenced by the fact that the initial study showed higher closes 52% of the time).

The facts of the matter are far different. This meek little pattern produced 354 trades with 57 percent accuracy and an average profit of $421 a trade. Accuracy jumps from 52 percent to 57 percent and the average profit per trade increases almost fourfold! Hold on to your hat, it gets better.

If we combine a pattern with our trade-day-of-the-week concept and take these pattern trades on just Monday, the accuracy goes to 59 percent and average profit to $672. I rest my case; patterns and days of the week can be a helpful trading tool or advantage for the short-term trader.

*The best patterns I have found have a common element tying them together: patterns that represent extreme market emotions reliably set up trades for price swings in the opposite direction.*

In other words, what the public "sees" on their charts as being negative is most often apt to be positive for short-term market moves and vice versa. A case in point is an outside day with a down close. The day's high is greater than the previous day's high and the low is lower than the previous day's low and the close is below the previous day's low. This looks bad, like the sky is indeed falling in. In fact, the books I have read say this is an excellent sell signal, that such a wild swing is a sign of a market reversal in favor of the direction of the close, in this case down.

Whoever writes these books does not spend much time looking at price charts! As Figure 7.1 of the Dollar Index shows, this can be a very bullish pattern or market configuration.

Reality is far different than conjecture as a quick computer test shows and reveals the power of one of my favorite short-term patterns. It does not take much to prove the validity of patterns or to check to see what is really going on. Given this outside day pattern I have noticed, there is a final filter, or event that can happen to further influence the pattern tomorrow. This event is the direction of tomorrow's opening, as shown in Figure 7.2. If, in the S&P 500 index, tomorrow opens lower than the outside day's down close and we buy on the next day's opening, we find 109 occurrences with 85 percent accuracy making $52,062 and $477 a trade.

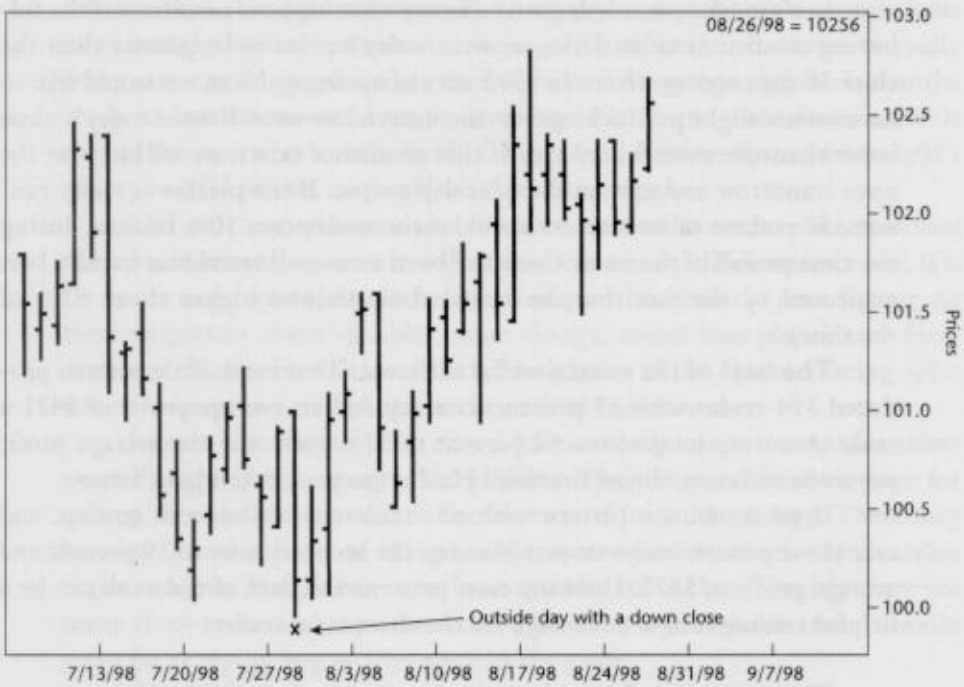



**Figure 7.1** U.S. Dollar (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/27/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $52,062.50
Gross profit              $84,062.50    Gross loss            $-32,000.00

Total # of trades             109       Percent profitable          85%
Number winning trades          93       Number losing trades        16

Largest winning trade     $4,887.50     Largest losing trade  $-2,000.00
Average winning trade       $903.90     Average losing trade  $-2,000.00
Ratio avg win/avg loss         0.45     Avg trade (win & loss)    $477.64

Max consecutive winners          44     Max consecutive losers       4
Avg # bars in winners             2     Avg # bars in losers         1

Max closed-out drawdown   $-8,000.00    Max intra-day drawdown $-8,000.00
Profit factor                  2.62     Max # of contracts held      1
Account size required     $11,000.00    Return on account          473%
```

**Figure 7.2** A bullish pattern.

If we buy on any day but Thursday, a day we know tends to see selling pressures spilling over into Friday, we make a little less, $50,037 but bump our average profit per trade up to $555 and increase accuracy to 86 percent with drawdown going from $8,000 to $6,000. These results use a $2,000 stop to exit or the first profitable opening exit rule.

We can use this same pattern for setting up trading opportunities in the Bond market as well. This pattern is so powerful that it can be used in all markets as a stand-alone trading formation, but stacked-deck Larry still prefers to have additional confirmation to make certain I use only the best of the best trades. Figure 7.4 shows the results of taking all outside day down closes followed by a lower opening the next day in Bonds. To get out of the trade, we will take a $1,500 loss or exit on the first profitable opening. Few traders realize that such a mechanical approach to trading can be so good, we score an 82 percent accuracy and $212 average profit per trade on the 57 occurrences since 1990.

Can we make this a better performing pattern? You bet. Got any ideas how? You should by now, in fact, you are probably wondering whether the pattern is better on some days of the week than others. It is. If we take the trade on any day but Thursday, just as in the previous S&P results, we skyrocket the accuracy to 90 percent and make $17,245 on 41 trades for an average profit per trade of $420 (see Figure 7.5). Folks, it doesn't get much better than this.

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/27/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $  2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $50,037.50
Gross profit              $74,187.50    Gross loss              $-24,150.00

Total # of trades             90        Percent profitable           86%
Number winning trades         78        Number losing trades         12

Largest winning trade     $4,887.50     Largest losing trade     $-2,150.00
Average winning trade       $951.12     Average losing trade     $-2,012.50
Ratio avg win/avg loss         0.47     Avg trade (win & loss)      $555.97

Max consecutive winners       39        Max consecutive losers        3
Avg # bars in winners          2        Avg # bars in losers          1

Max closed-out drawdown   $-6,000.00    Max intra-day drawdown   $-6,000.00
Profit factor                  3.07     Max # of contracts held       1
Account size required     $9,000.00     Return on account           555%
```

**Figure 7.3** Using the first profitable opening exit rule.

```
Data              : DAY T-BONDS          67/99
Calc Dates        : 06/10/90 - 08/27/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  144  -3  $ 31.250  $ 55   $  0   $ 3,000  CSI     C:\GD\BACK67\F061.DTA

////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $12,115.00
Gross profit              $27,665.00    Gross loss              $-15,550.00

Total # of trades             57        Percent profitable           82%
Number winning trades         47        Number losing trades         10

Largest winning trade     $2,101.25     Largest losing trade     $-1,555.00
Average winning trade       $588.62     Average losing trade     $-1,555.00
Ratio avg win/avg loss         0.37     Avg trade (win & loss)      $212.54

Max consecutive winners       11        Max consecutive losers        3
Avg # bars in winners          2        Avg # bars in losers          1

Max closed-out drawdown   $-5,416.25    Max intra-day drawdown   $-5,510.00
Profit factor                  1.77     Max # of contracts held       1
Account size required     $8,510.00     Return on account           142%
```

**Figure 7.4** All outside day down closes.

The problem is these outside day patterns do not occur as often as we would like! The next time you see an outside day with a down close lower than the previous day, don't get scared, get ready to buy!

Time for another bullish looking pattern in the S&P 500. We will now look for any day that closes above the previous day's high and is preceded by two consecutive up closes, making it the third up day in a row (see Figure 7.5). Such seemingly strong showings of strength have been known to lure the public into buying.

```
Data              : DAY T-BONDS          67/99
Calc Dates        : 06/10/90 - 08/27/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  144  -3  $ 31.250  $ 55   $  0   $ 3,000  CSI     C:\GD\BACK67\F061.DTA

////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $17,245.00
Gross profit              $23,465.00    Gross loss              $-6,220.00

Total # of trades             41        Percent profitable           90%
Number winning trades         37        Number losing trades          4

Largest winning trade     $2,101.25     Largest losing trade     $-1,555.00
Average winning trade       $634.19     Average losing trade     $-1,555.00
Ratio avg win/avg loss         0.40     Avg trade (win & loss)      $420.61

Max consecutive winners       11        Max consecutive losers        1
Avg # bars in winners          2        Avg # bars in losers          1

Max closed-out drawdown   $-1,555.00    Max intra-day drawdown   $-1,555.00
Profit factor                  3.77     Max # of contracts held       1
Account size required     $4,555.00     Return on account           378%
```

**Figure 7.5** Trade on any day but Thursday.

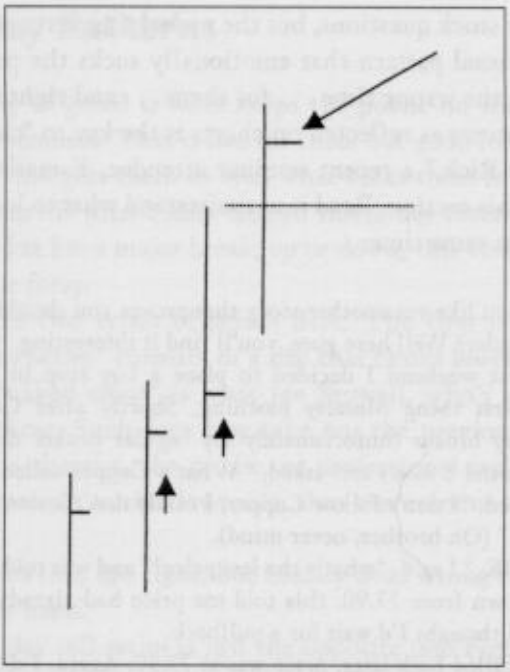


Figure 7.6 A close that is above the day's high.

For example, checking this pattern from 1986 to 1998 in the S&P 500, there were 25 occurrences of this pattern on Tuesday setting up sells for Wednesday. Of these, 19 were winners, netting $21,487. In the Bond market, the same pattern set up 28 trades on Thursday, to sell on Friday, making $13,303 which challenges the random walk professors with a thought-provoking 89 percent accuracy. The Bond test was on data from 1989 to August 1998! A $1,500 stop was used in Bonds, $2,000 in the S&P 500.

For both markets, we used the simple bailout exit I will teach later. There are several major short-term patterns like this that I take advantage of in my trading. The search is on each day to see what the current pattern foretells. I have some stock patterns that I have used for years, but am always on the lookout for new ones.

## The Questions to Ask

Patterns work. I know. I have cataloged hundreds of them over the years and suggest you do the same starting with the ones I am providing here. It is best to think about why these patterns work. What do they represent? Can I find the pattern at work in all markets? Does the trading day of the week matter?

Those are my stock questions, but the underlying germ of truth I am looking for is some visual pattern that emotionally sucks the public into buying or selling at just the wrong time . . . for them . . . and right time for me. Understanding emotions as reflected on charts is the key to "chart reading."

"Trader Rick," a recent seminar attendee, E-mailed me this note as I was writing this section. Read it to understand what to look for and reflect on yourself at the same time:

> Would you like yet another story that proves you should not be an emotional trader? Well here goes, you'll find it interesting.
>
> Last weekend I decided to place a buy stop in May Copper at 77.80, first thing Monday morning. Shortly after Copper opened I called my broker (unfortunately my regular broker does not come in until around 8 A.M.) and asked, "What's Copper called this morning?" He replied, "I don't follow Copper, I really don't know, I'd have to look it up . . ." (Oh brother, never mind).
>
> "OK," I said, "what's the last price?" and was told it was trading at 77.00 down from 77.90, this told me price had already gone above my stop so I thought I'd wait for a pullback.
>
> I called back later, price was at 77.30. Again, I did nothing. Why you ask? I really don't know, except I thought I'd "watch the market" to see what I should do. The funny thing is *I now know if it went higher I would have waited for a pullback, if it went lower I would have been afraid to buy.* Up or down would scare me out, and that's just what happened! What would I have "seen" anyway, handwriting from God?
>
> Later in the day I called back, now Copper was at 80.30. "Damn . . . OK, buy one at the market." Now I knew Copper was really hot, and buying it violated everything you had taught us that weekend. But something, almost a mysterious force, "pushed" me into the trade. I bought pretty much at the high of the day, *because I was upset I had not gotten in earlier.*
>
> The very next day Copper began a pullback, fortunately it eventually went higher, but it cost me $500. Dumb, dumb, dumb. Haven't I learned anything yet? Yeah, I have, it's simply this, Plan your trades and don't deviate, don't let emotions push your over the cliff at just the wrong time.

Rick's comments kind of reminded me of fishing, how I'll toss a worm in and wiggle it just a little, no bite, then a little more, still no bites, then just a little twitch and . . . *Blam!* I've hooked a nice fish. The market seems to hook us just like a fish with those little wiggles until we just can't resist and fall for it; hook, line, and sinker.

The problem is that this is not catch and release, it is bite and lose, no more "forced feeding frenzies" for me!

The next time old man greed taps you on the shoulder or your hear an emotional call luring you to the bait . . . don't bite!

## My Smash Day Patterns

The siren song of greed is what keeps the public on the losing side of the ledger in this business. That is bad for them but good for us if we can figure out what it is that gets them to bite, what sucks them into wrong decisions. One such "event" is what I have labeled smash day reversals. These are days where the market has a major break, up or down, this violent action pulls the public in to the foray.

There are two types of smash days. The first is pretty obvious. A "smash day buy setup" consists of a day that closes lower than the previous day's low, a "naked close" is what Joe Stowell, who's got a great eye for charts, calls these. Such days may take out the previous 3 to 8 days' lows as well. To the chartist, the public, or professional technical analyst, this looks like a breakout to the downside, thus the extreme selling brings them to the table.

Sometimes they are right, but usually dead wrong if the market immediately reverses itself.

A smash day sell setup is just the opposite (see Figure 7.7). Here what you will be looking for is a day that closes above the prior day's high and most likely "breaks" out to the upside to close above a trading range. This is the twitching worm that causes the public to leap before they look. The illustration shows how this usually looks. What you have here are the buy and sell setups.

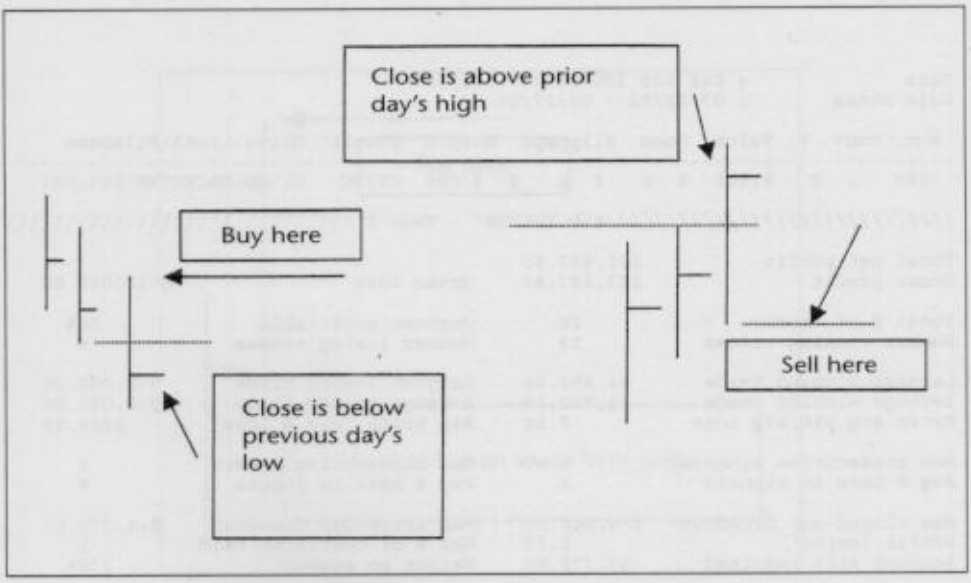



**Figure 7.7** A smash day sell setup.

As mentioned, sometimes this is a valid break. However, if *the very next day* price moves opposite the smash day and trades above the high of a down close smash day you have great buy signal. By the same token, a smash day up, one of those strong closes above the prior day's high, alerts us to sell signal if *the very next day* price trades to the smash day's low.

The phenomenon is that there is an immediate reversal the very next day, which means the public (sellers on the down close, buyers on the up close) are now in a world of hurt; their envisioned breakout has failed! They swallowed the hook, again, and now price responds with a reversal giving us an excellent entry. That is the pattern and the rationale, the reason it should work. I am a firm believer that when what "should happen in the market doesn't" we have powerful evidence to take a trade in alignment with the new information.

I have selected a few examples of this pattern at work (Figures 7.8 and 7.9). Once we review the other type of smash day reversal, I will explain how I use this pattern.

My second smash day reversal (Figure 7.10) is a bit more difficult to identify but works on the same principle of the market not following through on one day's action and reversing the very next day. The pattern you will be looking for, to establish a buy setup, will be a day that has an up close, *not a naked down close.* But, and this is the key or secret to the pattern, the day's close will be in the lower 25 percent of the up day's range and will also be closing below the opening of the day in the very best patterns. I call this a "hidden smash day" because of the up close.

```
Data              : S&P 500 IND-9967    01/80
Calc Dates        : 07/02/82 - 08/27/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $21,487.50
Gross profit              $33,487.50    Gross loss              $-12,000.00

Total # of trades             25        Percent profitable           76%
Number winning trades         19        Number losing trades          6

Largest winning trade     $4,850.00     Largest losing trade     $-2,000.00
Average winning trade     $1,762.50     Average losing trade     $-2,000.00
Ratio avg win/avg loss         0.88     Avg trade (win & loss)      $859.50

Max consecutive winners        6        Max consecutive losers        2
Avg # bars in winners          2        Avg # bars in losers          6

Max closed-out drawdown   $-4,000.00    Max intra-day drawdown   $-4,775.00
Profit factor                  2.79     Max # of contracts held       1
Account size required     $7,775.00     Return on account           276%
```

**Figure 7.8** Smash day pattern at work.

```
Data              : DAY T-BONDS          67/99
Calc Dates        : 01/26/89 - 08/27/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  144  -3  $  31.250  $ 55   $  0   $ 3,000  CSI     C:\GD\BACK67\F061.DTA

////////////////////////// ALL TRADES  - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $13,303.75
Gross profit              $18,000.00    Gross loss              $-4,696.25

Total # of trades             28        Percent profitable          89%
Number winning trades         25        Number losing trades         3

Largest winning trade     $2,413.75     Largest losing trade    $-1,586.25
Average winning trade       $720.00     Average losing trade    $-1,565.42
Ratio avg win/avg loss         0.45     Avg trade (win & loss)     $475.13

Max consecutive winners        9        Max consecutive losers       1
Avg # bars in winners          3        Avg # bars in losers         6

Max closed-out drawdown   $-1,586.25    Max intra-day drawdown  $-2,648.75
Profit factor                  3.83     Max # of contracts held      1
Account size required     $5,648.75     Return on account          235%
```

**Figure 7.9** Another smash day pattern example.

What has happened on these days is that price has either opened much higher and then closed up for the day but way off the highs, or opened a little higher, rallied way up and then failed to hold the day's gains. Sure, it closed up a little for the day but way below the high. The buyers got smashed, in either pattern, and chartists will now come in looking for the kill.

Only to be killed themselves—if the next day—price rallies back and takes out this smash day high. Again we see the pattern of a market failure immediately reversed *the very next day.* This is a most bullish set of events

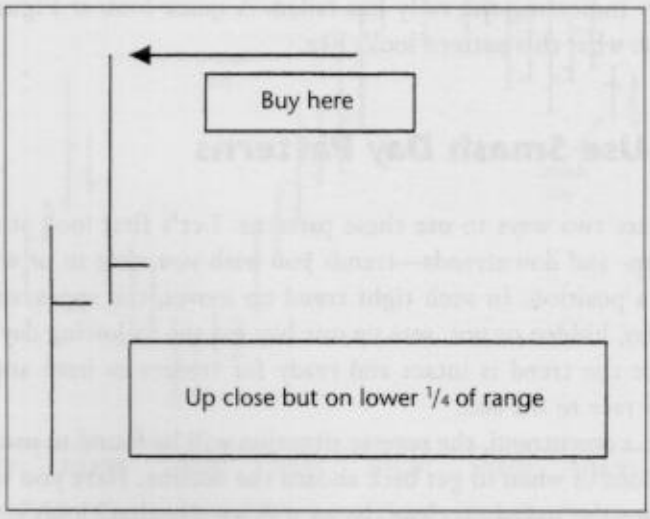



**Figure 7.10** A hidden smash day buy.

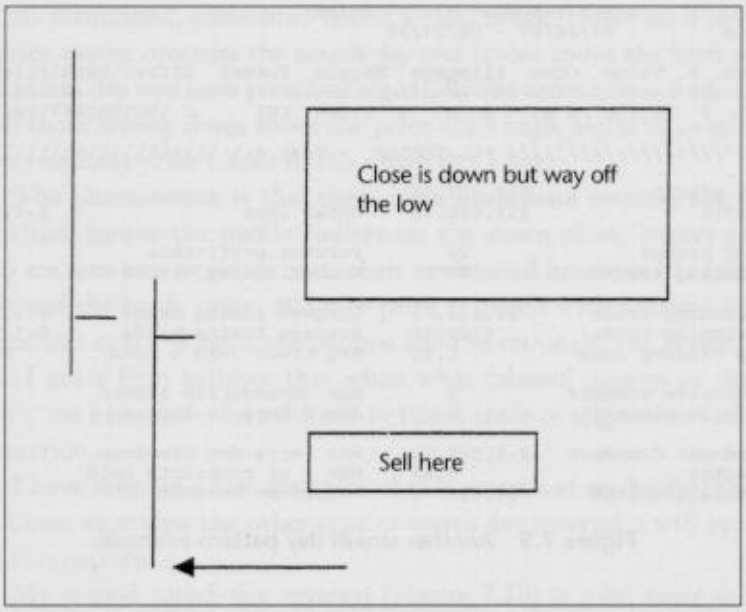



**Figure 7.11** A hidden smash day sell.

and calls for going long—if the stage has been set for a rally by our background tools such as TDW, TDM, market relationships, overbought/oversold, and trend.

A hidden smash day sell is just the opposite. Look for a down close that is in the upper 25 percent of the day's range and above the open of the day. Our entry comes when price falls below the hidden smash day's low *the very next day* indicating the rally has failed. A quick look at Figure 7.11 should establish what this pattern looks like.

## How to Use Smash Day Patterns

There are two ways to use these patterns. Let's first look at the pattern in sharp up- and downtrends—trends you wish you were in or where you want to add a position. In such tight trend up moves, the appearance of a smash down day, hidden or not, sets up our buy for the following day and is precise evidence the trend is intact and ready for traders to have another go at it, another race to the sun.

In a downtrend, the reverse situation will be found to produce excellent indications of when to get back aboard the decline. Here you will be looking for either the naked up close day or a down day that closes in the top of its range. If the very next day prices smash below that day's low, it is time to get

short. The examples shown here should help you understand the importance of this technique.

The other way I like to use these smash day setups is to look for a market that has been in a choppy trading range. I then note a smash day and act accordingly once the high or low of the smash day is penetrated. My thinking is that we will probably see a breakout of the congestion if the smash day is immediately reversed. Such action is suggestive of a market that moved to where all the stops were, and elected all the "breakout babies" who had orders there. The breakout is a magnet for the public to take action and they do. What kills them is the immediate reversal the very next day. They cannot believe their "luck" and decide to hold on despite the reversal; a few days later, they pitch their positions adding fuel to the move we hooked up with thanks to the smash day pattern.

Confucius must have been a chartist when he said that one picture (one chart) is worth a thousand words. I have marked off examples of the smash day pattern in trading ranges for your study. These appear as Figures 7.12 through 7.17.

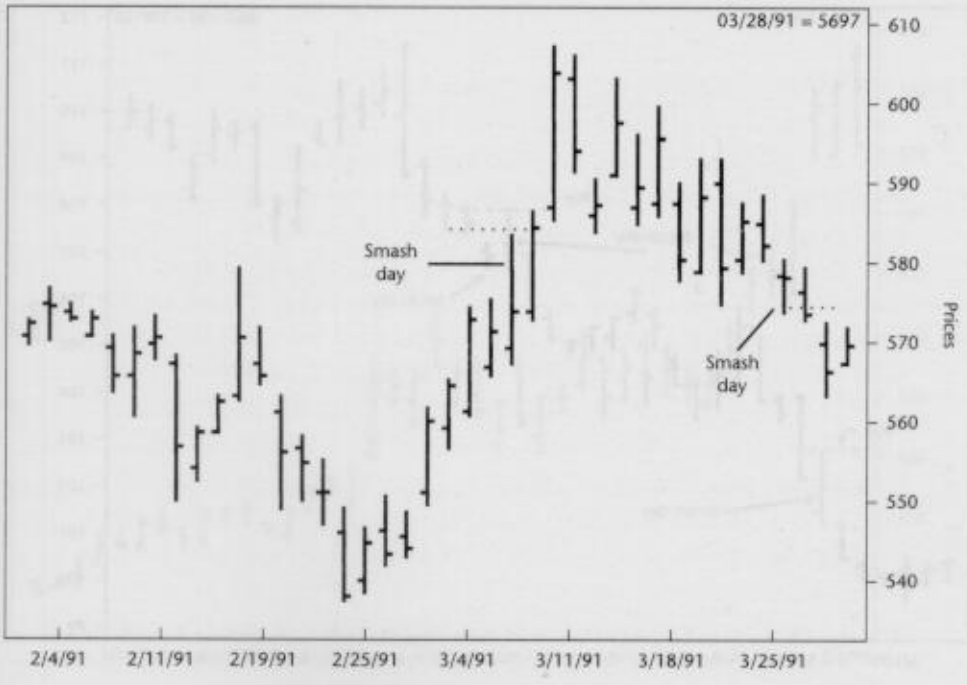



**Figure 7.12** Comex Silver (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

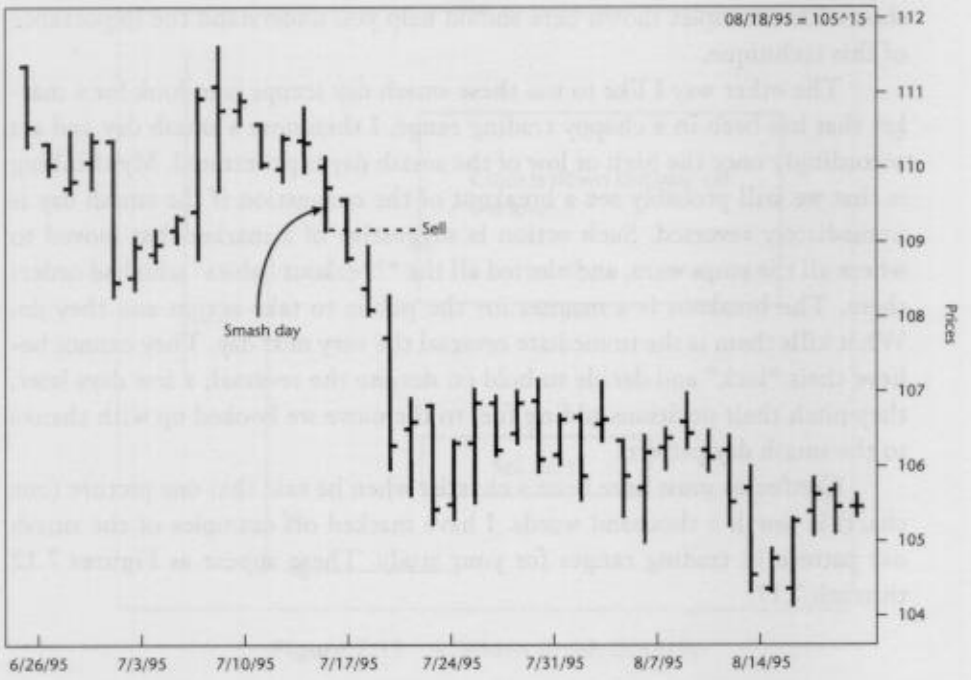



**Figure 7.13** Day T-Bonds (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

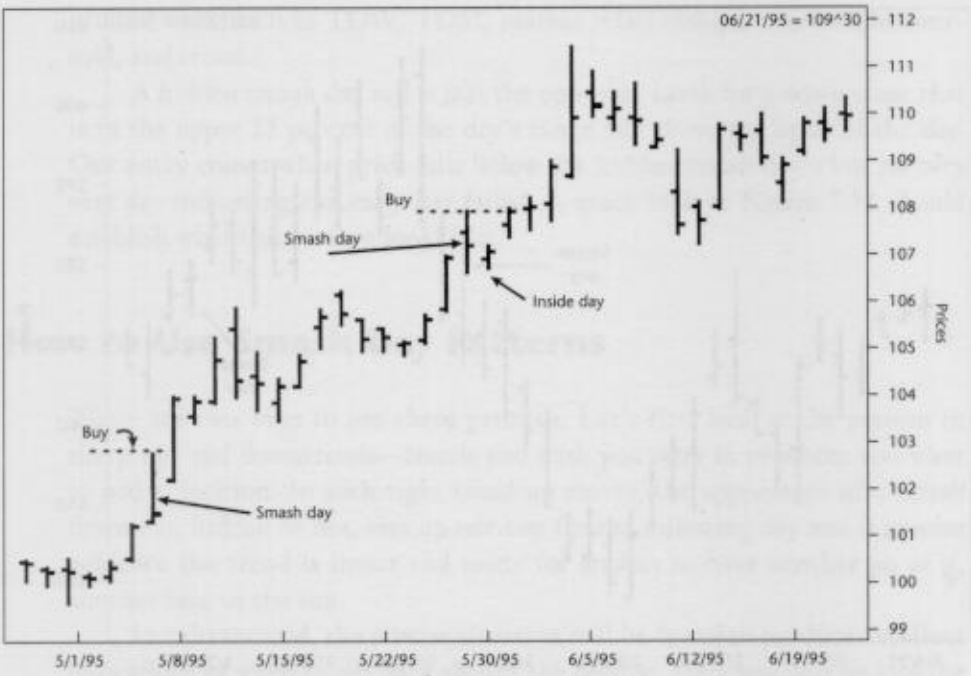



**Figure 7.14** Day T-Bonds (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

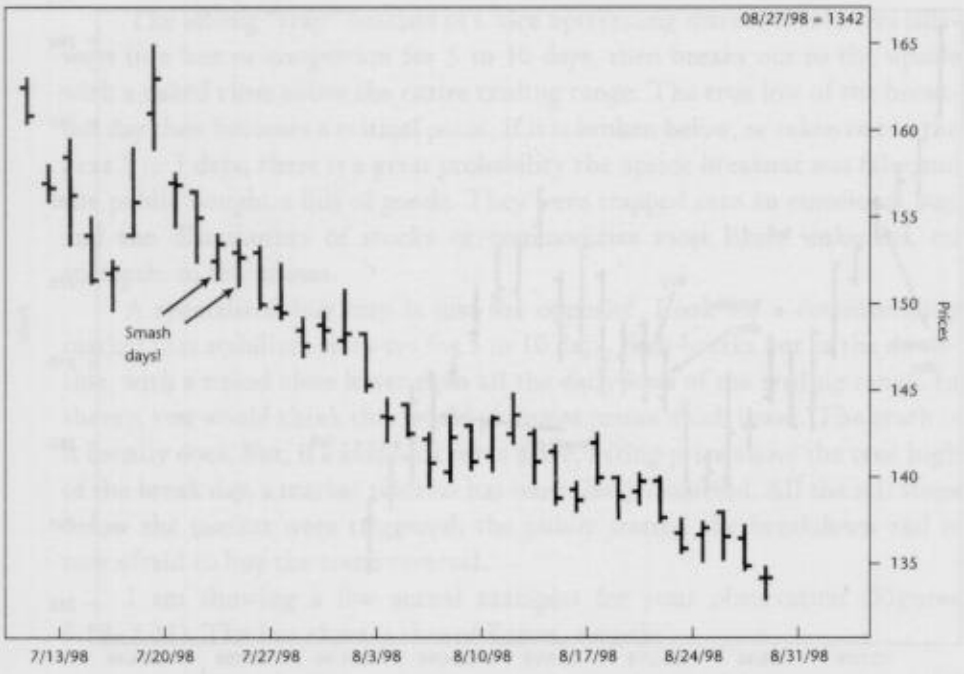



**Figure 7.15** Soybean Meal (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

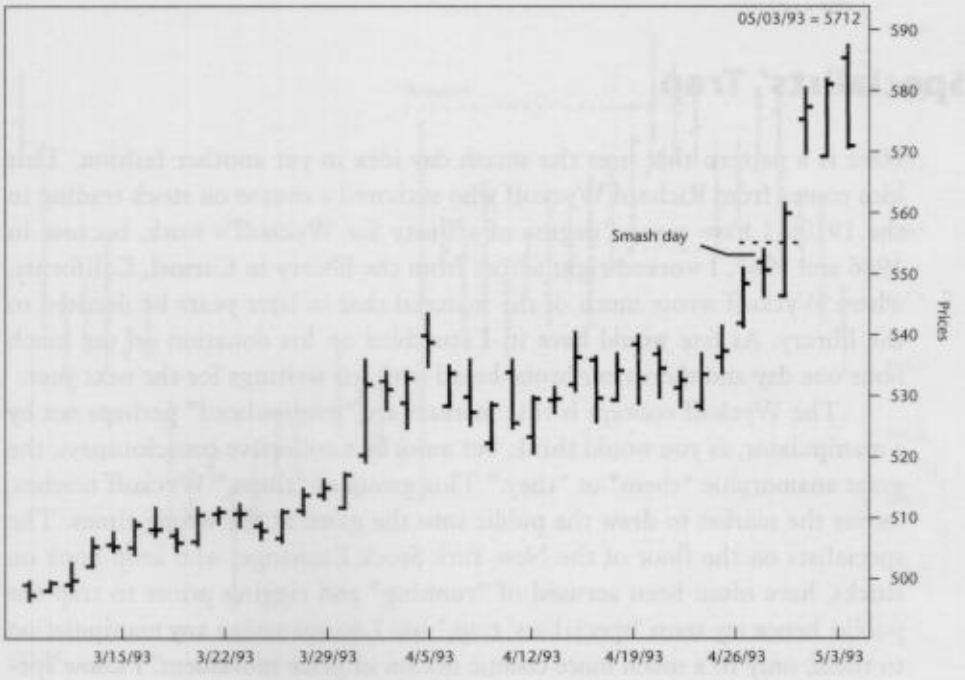



**Figure 7.16** Comex Silver (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

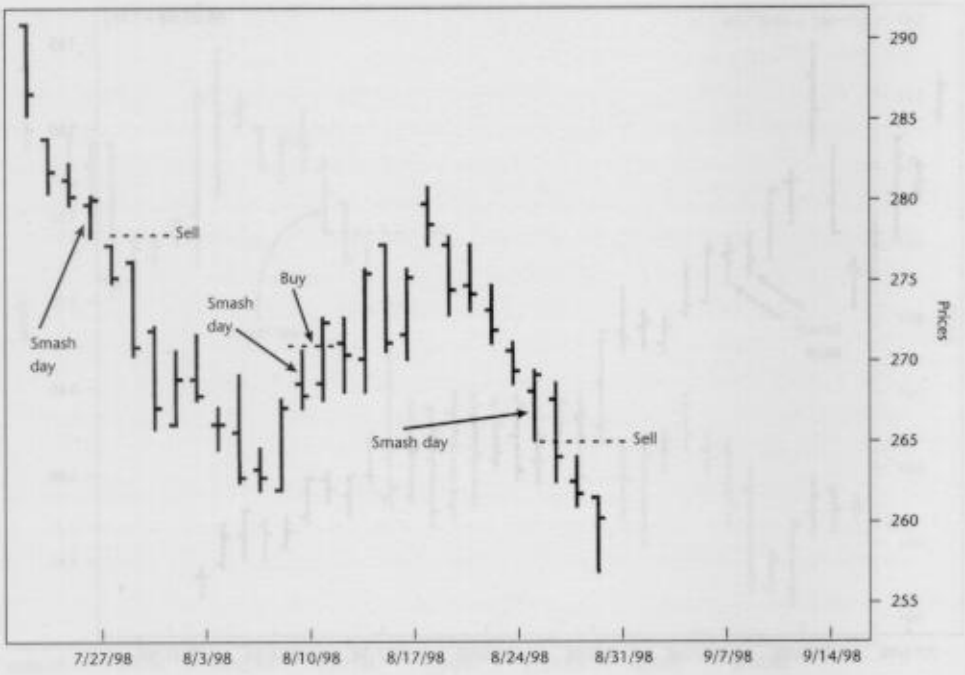



**Figure 7.17** CBT Wheat (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

## Specialists' Trap

Here is a pattern that uses the smash day idea in yet another fashion. This idea comes from Richard Wyckoff who authored a course on stock trading in the 1930s. I have a good degree of affinity for Wyckoff's work, because in 1966 and 1967, I worked right across from the library in Carmel, California, where Wyckoff wrote much of the material that in later years he donated to the library. As fate would have it, I stumbled on his donation on my lunch hour one day and thereafter broke bread with his writings for the next year.

The Wyckoff concept is that markets are "manipulated" perhaps not by a manipulator, as you would think, but more by a collective consciousness, the great anamorphic "them" or "they." This group of "them," Wyckoff teaches, moves the market to draw the public into the game at the wrong times. The specialists on the floor of the New York Stock Exchange, who keep book on stocks, have often been accused of "running" and rigging prices to trap the public, hence my term "specialists' trap," but I do not assign any manipulation to them, only to a much more cosmic notion of price movement. I know specialists: one, Bill Abhrams, has been a friend for 15 years and has convincingly proven to me they do not rig stock prices.

The selling "trap" consists of a nice uptrending market that moves sideways in a box or congestion for 5 to 10 days, then breaks out to the upside with a naked close above the entire trading range. The true low of the breakout day then becomes a critical point. If it is broken below, or taken out in the next 1 to 3 days, there is a great probability the upside breakout was false and the public bought a bill of goods. They were trapped into an emotional buy, and the distributors of stocks or commodities most likely unloaded, on strength, to the masses.

A specialists' buy trap is just the opposite. Look for a downtrending market that stabilizes sideways for 5 to 10 days, then breaks out to the downside, with a naked close lower than all the daily lows of the trading range. In theory, you would think this would plummet prices much lower. The truth is it usually does. But, if a snapback takes place, lifting price above the true high of the break day, a market reversal has most likely occurred. All the sell stops below the market were triggered; the public started the breakdown and is now afraid to buy the trend reversal.

I am showing a few actual examples for your observation (Figures 7.18–7.25). The last chart is that of Exxon, a stock.

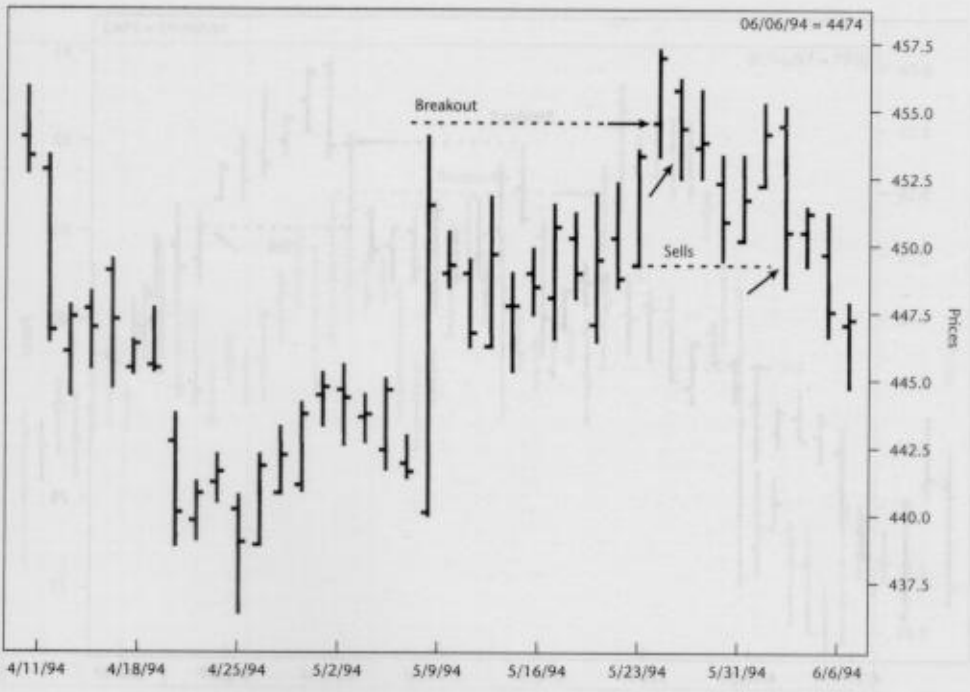



**Figure 7.18** Comex Gold (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

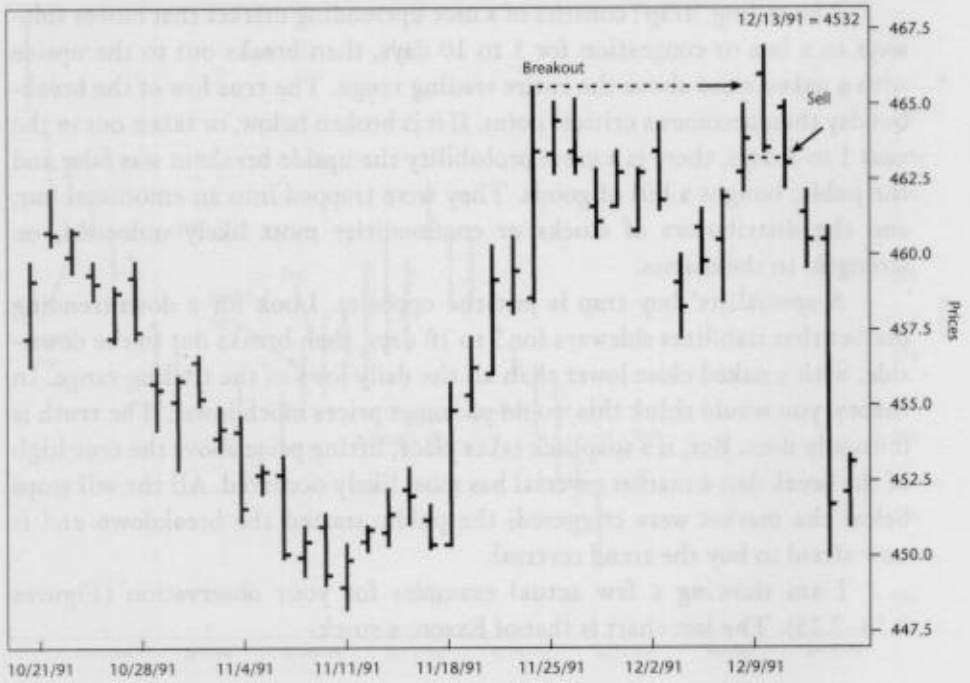



**Figure 7.19** Comex Gold (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

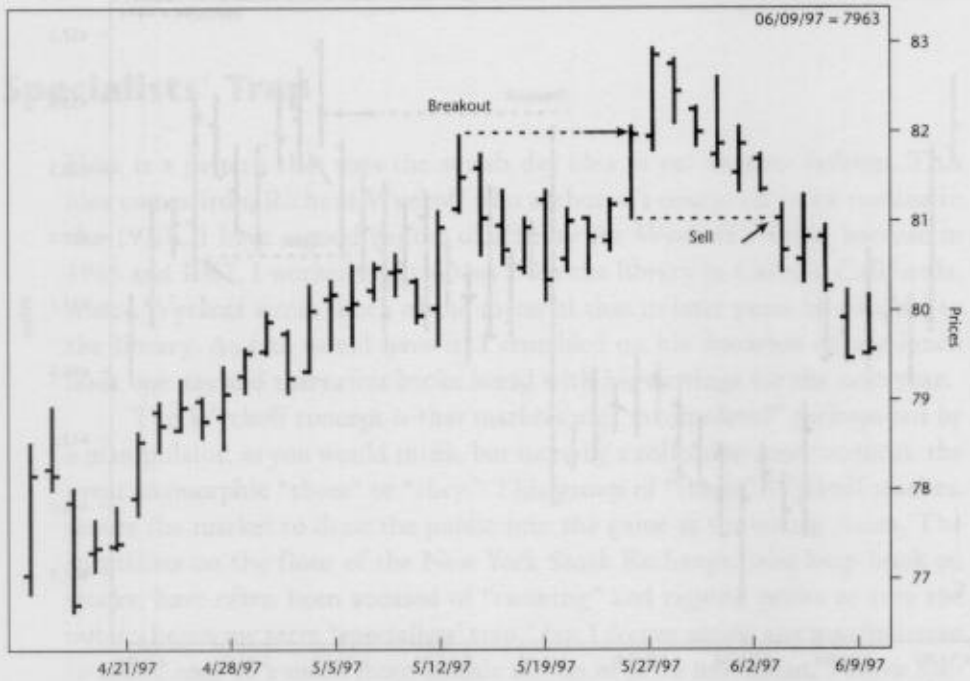



**Figure 7.20** Feeder Cattle (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

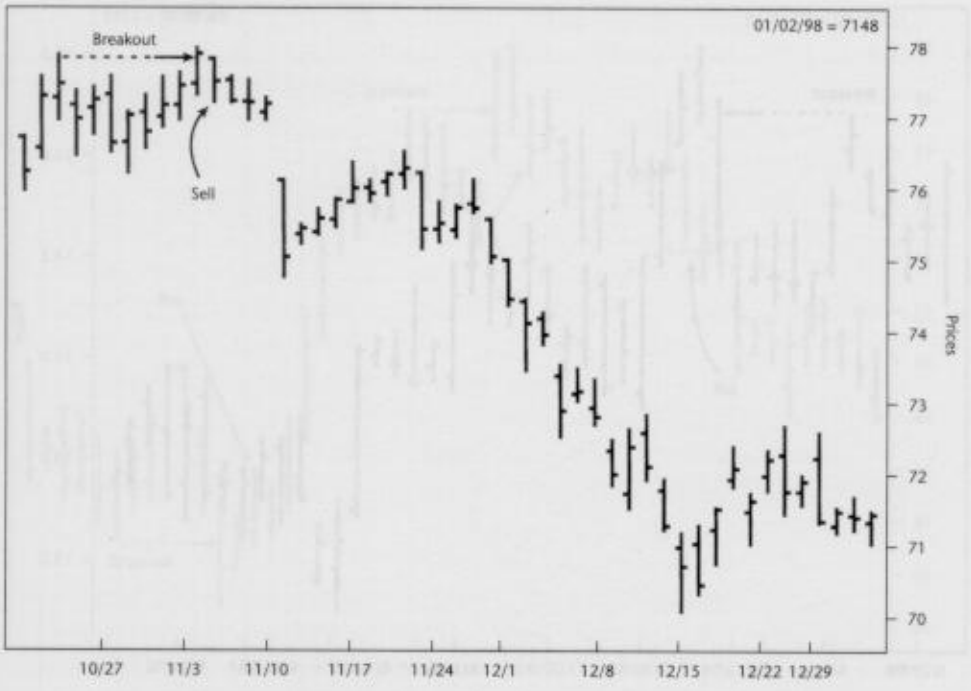



**Figure 7.21** Cotton #2 (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

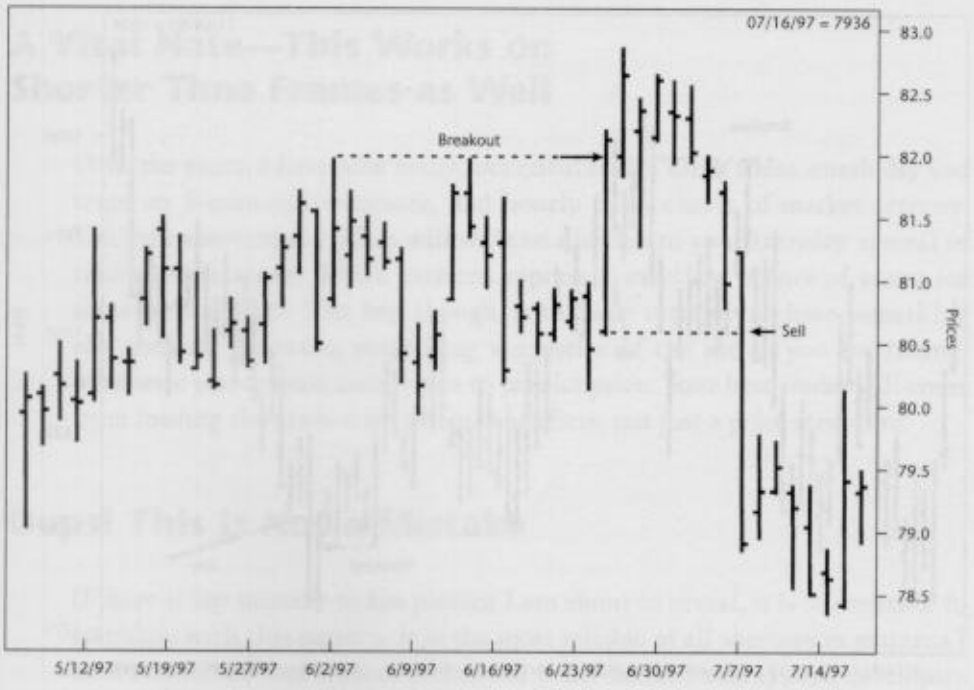



**Figure 7.22** Cotton #2 (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

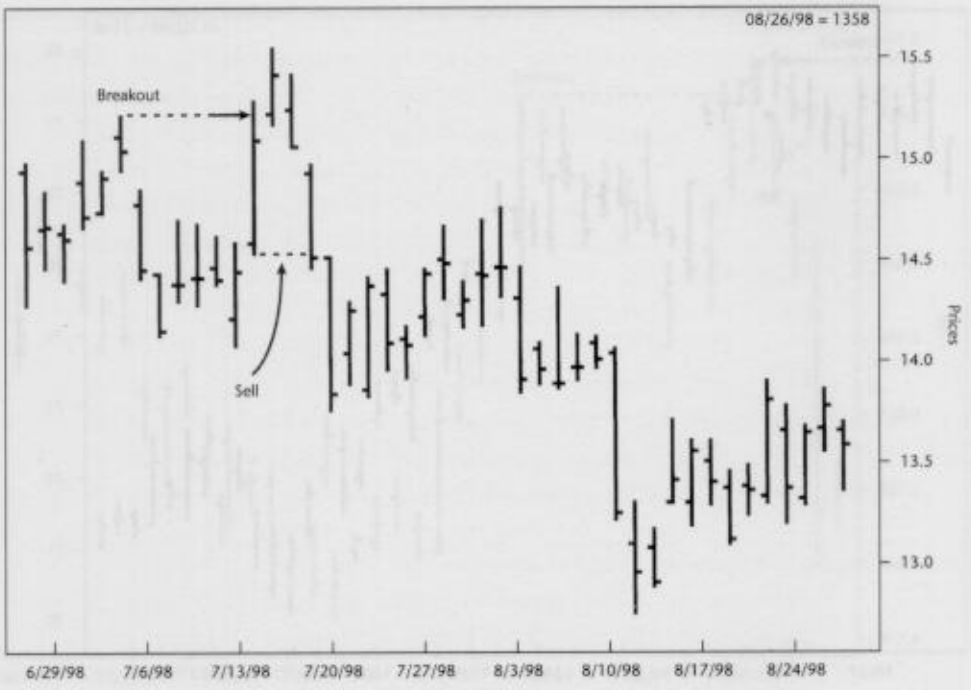



**Figure 7.23** New York Light (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

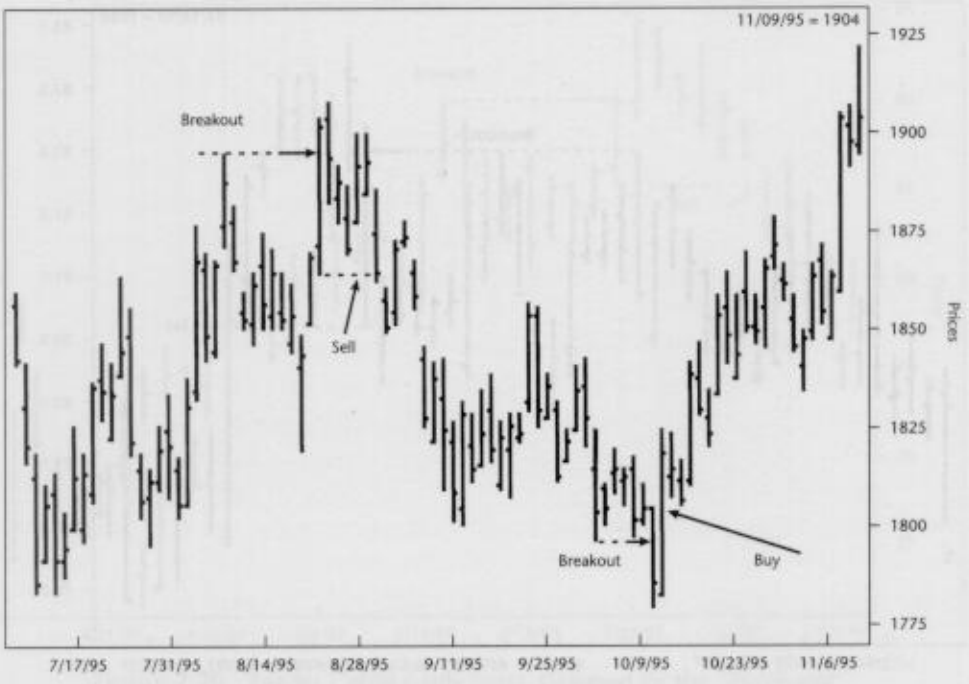



**Figure 7.24** Cocoa (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

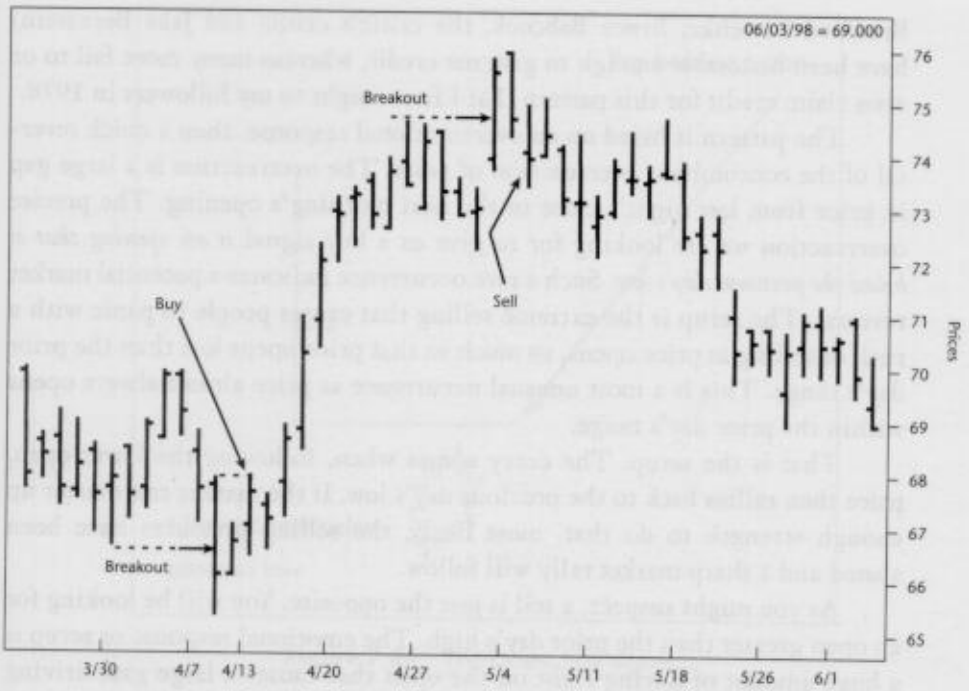



**Figure 7.25** Exxon Corporation (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

## A Vital Note—This Works on Shorter Time Frames as Well

Over the years, I have seen many successful trades using these smash day and traps on 5-minute, 30-minute, and hourly price charts of market activity. You very short-term traders will want to add this to your intraday arsenal of trading techniques. These patterns represent excellent points of entry for short-term traders. The key, though, is to make certain you have something else backing the trade, something suggestive of the action you are taking, otherwise you are just using price to predict price. Your best trades will come from loading the trade with several qualifiers, not just a price structure.

## Oops! This Is Not a Mistake

If there is any mistake to the pattern I am about to reveal, it is my mistake to go public with this pattern. It is the most reliable of all short-term patterns I have researched and traded. Numerous other authors and system developers have incorporated it in their work. A few (e.g., the highly talented Linda

Bradford Ratschke; Bruce Babcock, the critic's critic; and Jake Bernstein) have been honorable enough to give me credit, whereas many more fail to or even claim credit for this pattern that I first taught to my followers in 1978.

The pattern is based on an overemotional response, then a quick reversal of the concomitant overreaction of price. The overreaction is a large gap in price from last night's close to the next morning's opening. The precise overreaction we are looking for to give us a buy signal *is an opening that is below the previous day's low.* Such a rare occurrence indicates a potential market reversal. The setup is the extreme selling that causes people to panic with a rush of selling as price opens, so much so that price opens less than the prior day's range. This is a most unusual occurrence as price almost always opens within the prior day's range.

That is the setup. The entry comes when, following the lower open, price then rallies back to the previous day's low. If the market can muster up enough strength to do that, most likely, the selling pressures have been abated and a sharp market rally will follow.

As you might suspect, a sell is just the opposite. You will be looking for an open greater than the prior day's high. The emotional response or setup is a huge amount of buying right on the open that causes a large gap, driving price above the prior high. Our entry then comes from price falling back to the prior high, telling us the gap could not hold, giving us a strong short-term suggestion of lower prices to come.

The name Oops! comes from the price action as the public pitches their positions and sells short on the opening based on news, charts, and the like. For a moment, they appear to be on the right track; but about the time price rallies back to the prior day's low, their broker calls to tell them price is moving against them usually saying something like, "Oops! We may have done the wrong thing [again], price is coming back pretty strong. Do you want to stay short?"

By the time the collective public makes up their mind to now get out of the losing trade, price is above yesterday's low and their new buying or short covering adds momentum to the rally we positioned ourselves for. Figures 7.26 and 7.27 show how the Oops! signals will appear.

Okay, now let's see how we might use this pattern as short-term traders. We can start with taking buy signals in the S&P 500 on any day of the week except Wednesday or Thursday, the days of the week we know are most apt to lead to declines (see Figure 7.28). The results speak more loudly than anything I might say about this pattern: the 82 percent plus accuracy, $42,687 of profits, and a very large average profit per trade of $438 are quite remarkable considering the trade usually lasts 1½ days. That is, we buy today and are out on the opening tomorrow. The stop was a flat $2,000 loss. You may want to read about stops and exits (Chapter 11) to improve on what I am presenting here.

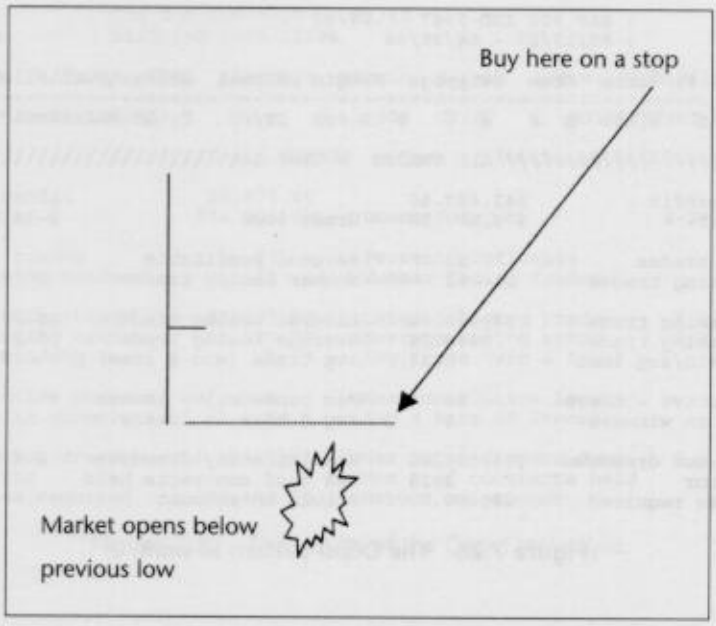



**Figure 7.26** The Oops! buy signal.

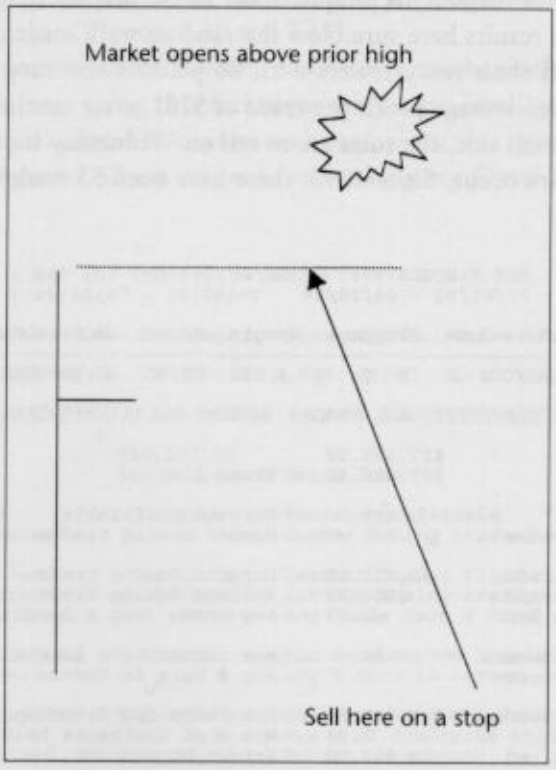



**Figure 7.27** The Oops! sell signal.

```
Data              : S&P 500 IND-9967    09/80
Calc Dates        : 09/15/87 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $  2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $42,687.50
Gross profit              $76,687.50    Gross loss              $-34,000.00

Total # of trades             98        Percent profitable           82%
Number winning trades         81        Number losing trades         17

Largest winning trade     $3,950.00     Largest losing trade     $-2,000.00
Average winning trade       $946.76     Average losing trade     $-2,000.00
Ratio avg win/avg loss         0.47     Avg trade (win & loss)      $435.59

Max consecutive winners       23        Max consecutive losers        3
Avg # bars in winners          1        Avg # bars in losers          1

Max closed-out drawdown   $-6,000.00    Max intra-day drawdown   $-6,000.00
Profit factor                  2.25     Max # of contracts held       1
Account size required     $9,000.00     Return on account           474%
```

**Figure 7.28** The Oops! pattern at work.

How about the Bond market? Here we will take long trades any day of the week except Wednesday and a stop-loss of $1,800 from the point of entry. Our exit is the bailout technique, soon to be discussed. As shown in Figure 7.29, the results here sure blow the random walk academicians out of the water and off their ivory towers with 86 percent accuracy, $27,875 profits, and a very nice average profit per trade of $201, after commissions of $50.

On the sell side, the rules are to sell on Wednesday if our Oops! opening gap and failure occur. Since 1990, there have been 55 trades with 31 winners

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/90 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $27,875.00
Gross profit              $60,812.50    Gross loss              $-32,937.50

Total # of trades            138        Percent profitable           86%
Number winning trades        120        Number losing trades         18

Largest winning trade     $2,031.25     Largest losing trade     $-2,125.00
Average winning trade       $506.77     Average losing trade     $-1,829.86
Ratio avg win/avg loss         0.27     Avg trade (win & loss)      $201.99

Max consecutive winners       24        Max consecutive losers        3
Avg # bars in winners          2        Avg # bars in losers          3

Max closed-out drawdown   $-5,812.50    Max intra-day drawdown   $-5,812.50
Profit factor                  1.84     Max # of contracts held       1
Account size required     $8,812.50     Return on account           316%
```

**Figure 7.29** Using Oops! on bond trades.

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/90 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $9,875.00
Gross profit             $34,031.25    Gross loss              $-24,156.25

Total # of trades            55         Percent profitable          56%
Number winning trades        31         Number losing trades        24

Largest winning trade     $2,687.50     Largest losing trade     $-1,093.75
Average winning trade     $1,097.78     Average losing trade     $-1,006.51
Ratio avg win/avg loss         1.09     Avg trade (win & loss)      $179.55

Max consecutive winners        5        Max consecutive losers        3
Avg # bars in winners          4        Avg # bars in losers          3

Max closed-out drawdown   $-4,437.50    Max intra-day drawdown   $-4,437.50
Profit factor                  1.40     Max # of contracts held       1
Account size required     $7,437.50     Return on account           132%
```

**Figure 7.30** The results of the Oops! technique.

netting $9,875 using a closer $1,000 stop and 4-day bailout exit. In the S&Ps, the best day to sell has been Thursday, which shows 78 percent winners and $14,200 of profits. Check out the results as shown here to solidify the value of this technique (Figures 7.30 and 7.31).

The most value will come, not from a mechanical rote approach to trading, but from using this technique with some intelligence or layered on top of a setup market. Here is one such example of this type of thinking. The results in Figure 7.32 are derived from taking my Oops! buy signals in the

```
Data              : S&P 500 IND-9967    09/80
Calc Dates        : 09/15/87 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $14,200.00
Gross profit              $40,200.00    Gross loss              $-26,000.00

Total # of trades            60         Percent profitable          78%
Number winning trades        47         Number losing trades        13

Largest winning trade     $4,612.50     Largest losing trade     $-2,000.00
Average winning trade       $855.32     Average losing trade     $-2,000.00
Ratio avg win/avg loss         0.42     Avg trade (win & loss)      $236.67

Max consecutive winners       14        Max consecutive losers        2
Avg # bars in winners          2        Avg # bars in losers          2

Max closed-out drawdown   $-6,725.00    Max intra-day drawdown   $-7,012.50
Profit factor                  1.54     Max # of contracts held       1
Account size required     $10,012.50    Return on account           141%
```

**Figure 7.31** More results with the Oops! technique.

```
Data              : DAY T-BONDS-9967     01/80
Calc Dates        : 01/01/90 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $24,625.00
Gross profit              $46,750.00    Gross loss              $-22,125.00

Total # of trades             66        Percent profitable           81%
Number winning trades         54        Number losing trades         12

Largest winning trade     $2,625.00     Largest losing trade     $-2,125.00
Average winning trade       $865.74     Average losing trade     $-1,843.75
Ratio avg win/avg loss         0.46     Avg trade (win & loss)     $373.11

Max consecutive winners       20        Max consecutive losers        2
Avg # bars in winners          3        Avg # bars in losers          6

Max closed-out drawdown   $-5,500.00    Max intra-day drawdown   $-5,500.00
Profit factor                  2.11     Max # of contracts held       1
Account size required     $8,500.00     Return on account            289%
```

**Figure 7.32** Buying on any day but Thursdays with the Oops! technique.

Bonds on any day but Thursday if Friday's 9-day moving average is less than Thursday's. The entry is Oops! as taught. The exit is the close on the first profitable opening after 3 days in the trade: 81 percent of these trades made money, $24,625, in fact. Check out the high average profit per trade of $373. On the sell side, the results reflect taking Oops! sell signals on Wednesday if the 9-day average is greater on Tuesday than Monday, which reflects an overbought market. These signals have been 79 percent accurate netting $13,406, and a surprising $394 profit per trade—not bad for a short-term trade, using the same rules as above for stop and exit as on the long trade (see Figure 7.33).

```
Data              : DAY T-BONDS-9967     01/80
Calc Dates        : 01/01/90 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

////////////////////////// ALL TRADES  - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $13,406.25
Gross profit              $25,281.25    Gross loss              $-11,875.00

Total # of trades             34        Percent profitable           79%
Number winning trades         27        Number losing trades          7

Largest winning trade     $2,375.00     Largest losing trade     $-1,812.50
Average winning trade       $936.34     Average losing trade     $-1,696.43
Ratio avg win/avg loss         0.55     Avg trade (win & loss)     $394.30

Max consecutive winners        8        Max consecutive losers        1
Avg # bars in winners          4        Avg # bars in losers          6

Max closed-out drawdown   $-2,781.25    Max intra-day drawdown   $-3,312.50
Profit factor                  2.12     Max # of contracts held       1
Account size required     $6,312.50     Return on account            212%
```

**Figure 7.33** Oops! sells on Wednesday.

## S&P Oops! Trading

The same idea meets with success in trading the S&P; here the best buy days, given the oversold criteria as established by the 9-day trend, are Tuesday, Wednesday, and Friday. This combination shows 81 percent accuracy and $22,650 of profits with an average profit, after losses, of $456, a remarkable feat for getting in and out the same day (see Figure 7.34). The idea of the 9-day moving average to set up the trade is based on work by Joe Krutsinger, a protégé of mine and avid system developer.

The best sell in this market, using the 9-day overbought technique is to take sells on Wednesday to make $18,962 with 89 percent accuracy on 35 trades (see Figure 7.35). The average profit of $486 per trade drives home the validity of the approach.

Now let's look at another way of using our Oops! entries in the S&P 500. For years, researchers have noted that stock prices tend to rally around the first of the month. This sets up a perfect Oops! trade. Should this pattern occur at the end of the month, and trading day after the 17th trading day of the month, our pattern and the monthly influence come together. These are good trades!

Knowing this end of the month rally spills into the next month, I tested taking all Oops! in Bonds after the first TDM through the 5th. The results are equally impressive. This combination setup is one of the most powerful short-term trades you will find to consistently appear, month in and month out.

Some observers may suggest we are curve-fitting things here by taking the Oops! signals only during a limited window of opportunity. That

Data : S&P 500 IND-9967 09/80
Calc Dates : 09/15/87 - 08/28/98

| Num. | Conv. | P. Value | Comm | Slippage | Margin | Format | Drive:\Path\FileName |
|---|---|---|---|---|---|---|---|
| 149 | 2 | $ 2.500 | $ 0 | $ 0 | $ 3,000 | CT/PC | C:\GD\BACK67MS\F59.DAT |

//////////////////////////// ALL TRADES - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $22,362.50 | | |
| Gross profit | $40,600.00 | Gross loss | $-18,237.50 |
| Total # of trades | 49 | Percent profitable | 81% |
| Number winning trades | 40 | Number losing trades | 9 |
| Largest winning trade | $3,875.00 | Largest losing trade | $-2,237.50 |
| Average winning trade | $1,015.00 | Average losing trade | $-2,026.39 |
| Ratio avg win/avg loss | 0.50 | Avg trade (win & loss) | $456.38 |
| Max consecutive winners | 28 | Max consecutive losers | 2 |
| Avg # bars in winners | 1 | Avg # bars in losers | 0 |
| Max closed-out drawdown | $-4,925.00 | Max intra-day drawdown | $-4,925.00 |
| Profit factor | 2.22 | Max # of contracts held | 1 |
| Account size required | $7,925.00 | Return on account | 282% |

**Figure 7.34** Oops! buys in a down trend on Tuesday, Wednesday, and Friday.

```
Data              : S&P 500 IND-9967    09/80
Calc Dates        : 09/15/87 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $  2.500  $  0   $  0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $18,962.50
Gross profit              $26,962.50    Gross loss              $-8,000.00

Total # of trades             39        Percent profitable          89%
Number winning trades         35        Number losing trades         4

Largest winning trade     $3,175.00     Largest losing trade    $-2,000.00
Average winning trade       $770.36     Average losing trade    $-2,000.00
Ratio avg win/avg loss         0.38     Avg trade (win & loss)     $486.22

Max consecutive winners       26        Max consecutive losers       2
Avg # bars in winners          1        Avg # bars in losers         2

Max closed-out drawdown   $-4,000.00    Max intra-day drawdown  $-4,000.00
Profit factor                  3.37     Max # of contracts held      1
Account size required     $7,000.00     Return on account          270%
```

**Figure 7.35** Oops! after the 17th trading day of the month.

could be, but let me hastily add I first became aware of this "window of opportunity" in 1962 when I read Art Merrill's classic, *The Behavior of Prices on Wall Street*. I believe Merrill, a delightful, white-haired grandfather figure, was the first to note the rally tendency at this time and fully discussed it in his works.

All I have done is add my Oops! entry, a reasonable stop and exit, to a known market bias. To the best of my knowledge, no one noticed this same pattern or tendency exists in Bonds until 1988 when I revealed it to my students; so again, we have lots of out-of-sample experience. This is not a conclusion looking for a promise. Merrill and others, notably Norm Fosback and Glen Parker, have suggested the end-of-the-month stock rally is due to mutual funds balancing and window-dressing their holdings. Once I discovered that Bonds rally at this time, I took the position that stocks rally not because of the funds but because of Bonds. As go Bonds, so go stocks. Always keep in mind Bonds (interest rates) are the dog that wag the tail, which is stocks.

Virtually any time you have a bullish outlook or bias in the market, Oops! buys are worth taking, just as Oops! sells are worth taking when you have a bearish outlook. This pattern works wonders, given an underlying reason. It is the single best pattern I have discovered; enjoy it, treat it with care, use it with wisdom.

# Chapter 8

# Separating the Buyers from the Sellers

*If it is true there is a buyer for every seller, how can prices move up and down?*

Which came first, the chicken or the egg, the buyer or the seller? I suppose this is the ultimate Zen koan that speculators must answer before attaining enlightenment. On the surface, it seems prices should never vary much if you must have a seller to give shares or contracts to a buyer. Shouldn't they balance each other out?

In a perfect world they would, but this is an imperfect world and an even more imperfect game of chance. Reality, as read in your daily newspaper or spoken in quotes from your broker, tells us prices do move, often wildly. The reason for price changes is not the amount of shares or contracts bought and sold; after all, they are matched. The reason price fluctuates is that one side, the buyer or the seller, blinks.

In other words, one side in this equation wants to establish a position and will pay up, or sell down. The imbalance that causes price change is not one of volume but of immediacy . . . the side that wants it and wants it now, is the side that pushes prices higher or lower.

As mentioned, we can break down the amount of buying and selling that took place in a given day by using the opening price. This chapter describes the elements of a trading system and approach I used to make more than $1,000,000 in 1987.

Consider this: each day the commodity opens for trading at a price established by an open outcry based on the buy and sell orders that have built up over night.

On March 27, 1998, May Bellies opened at 46.20, traded down to a low at 45.95 and up to a high at 48.60. Buyers were able to "push" prices 2.40 points above the open and .25 points below the opening. We have two swings here, the upswing of 2.40 points and a downswing of .25. Price closed for the day at 48.32 up from the previous day's close at 46.40.

The following charts show the greatest swing values marked off so you can visually see the actual workings in a real market. Figure 8.1 is of Soybeans in March 1990. Each day you have a buy swing and a sell swing. The direction of the close ± the open tells us which side won the battle. In this case, after the open, a selling wave was established and price went down that .25 in Bellies amount; we then closed higher. If the day after the up close, price moves more than .25 points below the opening, we have a new

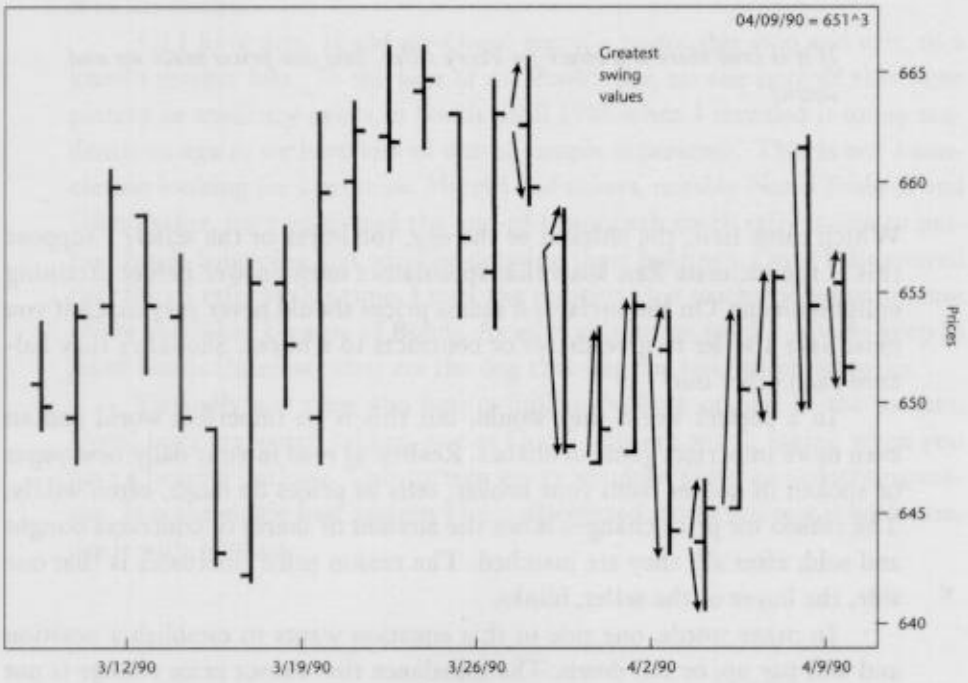



**Figure 8.1** Soybeans (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

"amount" of sellers in the marketplace. Thus a sell signal may be in effect as we have drawn more sellers in today than yesterday.

We can take this a little further. If I add up all the open to low swings for the past few days, I have an average of the amount of selling swings that have taken place and suspect that any swing from today's open that exceeds this average may be indicative of a sell signal.

But hold on, it is a bit more complicated. To really get a handle on the sellers, you need to take this measure on just days that closed above the opening, as this swing value is the amount price could decline *without* triggering a down close day.

By the same token, if you were to add up the swings from the open to the daily highs (on down close days), you would arrive at the swing values the market could rally without setting off a wave of buying resulting in an up close.

## Greatest Swing Value

I call this concept "greatest swing value (GSV)." It can be used in many profitable ways. The more work you do with the concept, the more you will appreciate the logic of finding the upswings on down days and downswings on up days. I categorize these swings as "failure swings": the market could swing that much, yet not hold it or follow through, and then closed in the opposite direction.

Let's look at some things you could do with these values. You could determine the average failure swings, say for the past few days, and use that as your entry added or subtracted to the next day's opening. Or how about taking all the failure swings for X number of days and then take one or two standard deviations of that value added to the value to trigger your entry?

I will start with a simple and profitable way of using these values for trading the Bond market. My first step is to create a setup for the trade, as I don't want to trade on just one technical goody all by itself. My setup will be an oversold market: prices have been declining so a rally of some sort should be in the future, and I am combining this with one of my prized possessions, the TDWs, as discussed earlier.

In this case, the first part of the setup is to have today's close lower than the close 5 days ago, suggesting Yin may turn into Yang. I also want to limit my buying to only one of 3 days of the week; they are Tuesday, Wednesday, and Friday.

Once that part of the setup exists, I will take the difference from open to the high for each of the past 4 days and divide that by 4 to get the average "buy swing." I want real proof the market is tracking in fresh ground, new territory, so I will be a buyer above the opening at an amount equal to 180 percent of the 4-day swing value average.

The *sell signal* is a mirror image in that I take the distance from the open to the low for each of the last 4 days and divide by 4 to get the average. This is also multiplied by 180 percent and subtracted from the opening *if the sell setup exits.*

The sell setup consists of Bonds closing greater than the close 6 days ago, and for even better performance, I would also like to see the price of Gold lower than the price of Gold 20 days ago.

Whether long or short, my stop is $1,600. I will take profits on the first profitable opening after being in the trade for 2 days. The results of this program from 1990 to 1998 are shown in Figure 8.2. As you can see, they are rather remarkable telling us the importance of setup criteria coupled with the greatest swing value concept. Frankly, I do not know of any Bond systems being sold by all the technical hot shots that can match these results.

## Stock Index Trading with Greatest Swing Value

The same basic formula works for trading the S&P 500. Again, we will take 180 percent of the 4-day average buy swing value (the highs minus the opens) and, for sell, the 4-day average swing sell value (closes minus the lows). As you might suspect, the results can be dramatically improved by demanding Bonds close higher than 15 days ago for a buy and lower than 15 days ago for a sell. Fundamentals do make a difference; don't let any frayed cuff chartist or fast-talking technician tell you otherwise. Our TDW filter will be to buy on Monday, Tuesday, or Wednesday. Shorts will be taken any day but Monday. The setup also consists of a close lower than 6 days ago for a buy, higher than six days ago for a sell, giving us an overextended market condition.

The results say it all, $105,675 of profits with 67 percent winning trades using a flat dollar stop of $2,500 and the bailout exit (Figure 8.3). Not as much money was made on the short side, but money was made; and considering the gargantuan bull market this took place within, the results are pretty good. Proof comes from the average profit per trade of $427.

### Better than It Looks

The results shown may also be considerably better than they appear. This is because my computer software does not allow us to bring into play a protective stop on the day of entry, that you can use in real-time trading. Thus our real time trading stop is most likely going to be closer to the market than what the computer shows. In real-time trading, I will use a stop at or slightly above or below the open, once I am filled on a long or short.

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/90 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $52,812.50
Gross profit             $105,000.00    Gross loss              $-52,187.50

Total # of trades            161         Percent profitable          75%
Number winning trades        122         Number losing trades         39

Largest winning trade     $3,437.50      Largest losing trade     $-1,718.75
Average winning trade       $860.66      Average losing trade     $-1,338.14
Ratio avg win/avg loss         0.64      Avg trade (win & loss)      $328.03

Max consecutive winners          13      Max consecutive losers          2
Avg # bars in winners             4      Avg # bars in losers            3

Max closed-out drawdown   $-6,343.75     Max intra-day drawdown   $-6,781.25
Profit factor                  2.01      Max # of contracts held          1
Account size required     $9,781.25      Return on account             539%

//////////////////////////// LONG TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $48,187.50
Gross profit              $88,281.25     Gross loss              $-40,093.75

Total # of trades            122         Percent profitable          77%
Number winning trades         94         Number losing trades         28

Largest winning trade     $3,437.50      Largest losing trade     $-1,687.50
Average winning trade       $939.16      Average losing trade     $-1,431.92
Ratio avg win/avg loss         0.65      Avg trade (win & loss)      $394.98

Max consecutive winners          13      Max consecutive losers          2
Avg # bars in winners             4      Avg # bars in losers            4

//////////////////////////// SHORT TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $4,625.00
Gross profit              $16,718.75     Gross loss              $-12,093.75

Total # of trades            39          Percent profitable          71%
Number winning trades        28          Number losing trades         11

Largest winning trade     $1,593.75      Largest losing trade     $-1,718.75
Average winning trade       $597.10      Average losing trade     $-1,099.43
Ratio avg win/avg loss         0.54      Avg trade (win & loss)      $118.59

Max consecutive winners           6      Max consecutive losers          2
Avg # bars in winners             2      Avg # bars in losers            2

Max closed-out drawdown   $-2,500.00     Max intra-day drawdown   $-2,500.00
Profit factor                  1.38      Max # of contracts held          1
Account size required     $5,500.00      Return on account              84%
```

**Figure 8.2** Greatest swing values in the bonds.

If price goes back there, after rallying the percentage of the swing value required to trigger a signal, the move we were playing for is questionable, we got a momentum run, but it didn't stick. In absence of this stop, you certainly must have one taking out the low of the day, this would be a sure sign of failure, thus resulting in less loss than illustrated by the computer printout.

////////////////////////// ALL TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $105,675.00 | | |
| Gross profit | $277,250.00 | Gross loss | -171,575.00 |
| Total # of trades | 247 | Percent profitable | 67% |
| Number winning trades | 167 | Number losing trades | 80 |
| Largest winning trade | $10,962.50 | Largest losing trade | $-3,587.50 |
| Average winning trade | $1,660.18 | Average losing trade | $-2,144.69 |
| Ratio avg win/avg loss | 0.77 | Avg trade (win & loss) | $427.83 |
| Max consecutive winners | 10 | Max consecutive losers | 5 |
| Avg # bars in winners | 4 | Avg # bars in losers | 4 |
| Max closed-out drawdown | $-12,500.00 | Max intra-day drawdown | $-13,462.50 |
| Profit factor | 1.61 | Max # of contracts held | 1 |
| Account size required | $16,462.50 | Return on account | 641% |

////////////////////////// LONG TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $51,575.00 | | |
| Gross profit | $148,437.50 | Gross loss | $-96,862.50 |
| Total # of trades | 123 | Percent profitable | 65% |
| Number winning trades | 81 | Number losing trades | 42 |
| Largest winning trade | $10,962.50 | Largest losing trade | $-3,587.50 |
| Average winning trade | $1,832.56 | Average losing trade | $-2,306.25 |
| Ratio avg win/avg loss | 0.79 | Avg trade (win & loss) | $419.31 |
| Max consecutive winners | 8 | Max consecutive losers | 4 |
| Avg # bars in winners | 4 | Avg # bars in losers | 3 |

////////////////////////// SHORT TRADES - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\

| | | | |
|---|---|---|---|
| Total net profit | $54,100.00 | | |
| Gross profit | $128,812.50 | Gross loss | $-74,712.50 |
| Total # of trades | 124 | Percent profitable | 69% |
| Number winning trades | 86 | Number losing trades | 38 |
| Largest winning trade | $9,125.00 | Largest losing trade | $-3,100.00 |
| Average winning trade | $1,497.82 | Average losing trade | $-1,966.12 |
| Ratio avg win/avg loss | 0.76 | Avg trade (win & loss) | $436.29 |
| Max consecutive winners | 9 | Max consecutive losers | 6 |
| Avg # bars in winners | 4 | Avg # bars in losers | 6 |
| Max closed-out drawdown | $-16,575.00 | Max intra-day drawdown | $-16,662.50 |
| Profit factor | 1.72 | Max # of contracts held | 1 |
| Account size required | $19,662.50 | Return on account | 275% |

**Figure 8.3** Greatest Swing value at .80 in the S&P 500.

## More Uses for the Concept

I have also used this idea to help me when I am confused. If I am in a position and looking for a place to exit, or maybe want to establish a position but do not have any clear-cut entry points, I will use the GSV to tell me when the current spate of buying/selling has been reversed. All I need to do is calculate the buy and sell swing values running the average as a tight stop or entry point.

Intraday traders can use this value a bit differently. What many of them want to do (not me, though) is sell what should be an overbought area and, buy an oversold area. In this case, the GSV will tell you about how far above the open you can sell, the largest failed value of the past few days, and then you would place a stop and reverse slightly above that value. You would buy below the open a distance of the largest failed down swing value, with a stop below that.

Here is a case in point. Table 8.1 shows the daily action of the S&P 500 in March 1998 along with the *sell swing values.* Once we arrive at the 4-day average on March 16 and multiply it by 180 percent we have a buy point (5.50 points) that much below the opening on the 17th with a fill at 1086.70. Table 8.1 shows how it looked.

Your stop on the long should be 225 percent of the 4-day average swing value of 3.57 or 8.00 – the 1092.20 open giving us a stop at 1084.20.

You can always determine the general area where a market should find support and resistance with the GSV concept. My work suggests contra trend moves of 180 percent with a 225 percent stop work quite well.

Yet another way I have traded and made money with this idea is to wait for a down close in the S&P 500 on Friday. I then buy Monday at the open plus Friday's high minus Friday's open swing value. I back this with Bonds closing on Friday greater than they did 15 days ago. The following results show simply using the bailout exit and a $2,500 stop. Practically speaking, I exit the trade at the open minus the swing value, unless the swing value is very large. In that case, I admit defeat if price trades below the lowest price seen in the day prior to going long. The time period here is from 1982 through March 1998. This is the most successful interday mechanical trading technique I know of.

It does not require a quote machine, any software, or constant phone calls to your broker. Once the setup is present (Bonds greater than 15 days ago, and Friday closes down), you buy at the next day's open plus the buying swing value from Friday. Certainly, this takes no great skill, only the

**Table 8.1**
**Daily Action of the S&P 500**

| | Open | High | Low | Close | GSV (Greatest Swing Value) |
|---|---|---|---|---|---|
| 3/11 | 1,078.00 | 1,082.40 | 1,077.20 | 1,080.80 | 0.80 |
| 3/12 | 1,080.00 | 1,085.20 | 1,075.50 | 1,084.00 | 4.50 |
| 3/13 | 1,087.00 | 1,088.60 | 1,078.40 | 1,080.90 | 8.60 |
| 3/16 | 1,085.00 | 1,092.40 | 1,084.60 | 1,091.70 | .40 |
| GSV 4 Day Average =14.30/4 or 3.57 *180 = 6.45 | | | | | |
| 3/17 Open is 1,092.20 – 6.45 Buy at 1,085.75 | | | | | |
| 3/17 | 1,092.20 | 1,094.50 | 1,086.00 | 1,094.20 | |

```
Data              : S&P 500 IND-9967    09/80
Calc Dates        : 09/15/87 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $  2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $57,087.50
Gross profit             $117,587.50    Gross loss              $-60,500.00

Total # of trades            161        Percent profitable           86%
Number winning trades        139        Number losing trades          22

Largest winning trade     $7,625.00     Largest losing trade     $-2,750.00
Average winning trade       $845.95     Average losing trade     $-2,750.00
Ratio avg win/avg loss         0.30     Avg trade (win & loss)      $354.58

Max consecutive winners         26      Max consecutive losers          2
Avg # bars in winners            1      Avg # bars in losers            2

Max closed-out drawdown   $-5,500.00    Max intra-day drawdown   $-5,500.00
Profit factor                  1.94     Max # of contracts held         1
Account size required     $8,500.00     Return on account             671%
```

**Figure 8.4** Greatest swing value buying on Mondays following a down close.

willingness to patiently wait for trades, then the gumption to put them on (see Figure 8.4).

Similar trading strategies can be developed for all markets using the GSV concept; just make certain you first define valid setups for the buys and sells. My favorite setups are days of the week, highly correlated data2 streams, seasonals, market patterns, and overbought/sold conditions.

## Some Pointers

Over the years, I have tried various time periods to see whether there is any ideal number of days to use in the calculation. My original thought was that one would want to use a 10-day period to arrive at the best average; after all, the more observations of swing value variance the more stable the answer should be, or so I thought. I was wrong on that. In almost all cases, the previous 1 to 4 days produce the best value in trading or developing systems.

The basics here involve volatility breakouts above or below the opening. The amount of breakout we are looking for is the amount that contained moves up to this point. Thus a critical element is to only take buy signals after down days, sells after up days.

Finally, keep in mind this is a "dumb" technique, it knows not when a big trade will come or even when a winning trade will be delivered on a silver platter. That is why you cannot pick and choose these trades, you must simply take them, one at a time, as they come out of the hopper. If you pick and choose, you will invariably pick the losers and walk away from the winners. It is nothing personal, we all do, and *the way to beat this devil is to take 'em all.*

To my way of thinking, the GSV concept is the most solid and logical approach to volatility breakouts. This failed swing measure has such great merit that I hope someone else, maybe you, will take it past the point I have reached. Perhaps the better answer lies in the standard deviation approach mentioned earlier, perhaps in using the GSV in relationship to the previous day's range. I am really not certain. What I am certain of is that this is one of the most powerful techniques in my bag of tricks and perhaps the most durable. It has served me well since I had the insight into the idea in 1977. Fancy math may improve the results, but it is not necessary to make this work.

# Chapter 9

# Short-Term Trading from a Quote Screen

*The markets can be understood looking backward but must be traded looking forward.*

What I have shared with you so far is the general way I trade. I use daily bar charts to set up patterns and relationships that usually spur short-term moves of 2 to 4 days. This is my style; it may not be yours.

People like the idea of day trading as there is no risk of anything "happening overnight." Their fear is a large adverse move may take place from today's close to tomorrow's opening. Their fear is news, change, and uncontrollable price action. They like the idea that at the end of the day it is all over, win, lose, or draw. There are no anguishing losses to take home and interrupt your sleep. Make no mistake about it, all this is true, but for everything you get in life you give up something in life. What you give up when day trading is any opportunity at all to catch a large and sustained move, as mentioned earlier.

To most people, the term "short-term trading" means being glued to a quote screen throughout the market trading day. They envision images of a high-pressure guy or gal with a phone in each ear, screaming something like

"Buy Chicago, sell New York." Certainly, this type of trading is hectic, and if you are going to trade this way, you had better make certain you have the temperament required for the job. I will tell you what I think that temperament is, then tell you what my quest for this Holy Grail of commodity trading has revealed.

Quote screen traders need three qualities; intensity, the ability to make intelligent choices, and the capacity to react without any more thinking to the conditions at hand.

If you are the type who *needs time* to make a decision, or freezes, refusing to take action once a decision has been made, this is not your game. Winning at this game requires making instant decisions and immediately reacting; there is no time for pontificating or reconsidering. If you cannot make decisions this way, you will be slaughtered in a matter of months. It is a game of the quick and the dead. If you are not quick, you will be dead. It is as simple as that. Short-term trading of this nature requires the physical ability to instantly pounce on a market and just as instantly reverse the decision you made just a few seconds ago, if that is what conditions dictate. It is a good thing the meek inherit the earth because they will never get rich as day traders.

Following the interday ebb and flow of prices on a screen, day after day after day, requires the ability to be focused and intense every hour of each trading session. This is not an occupation for daydreamers. If you cannot maintain concentration, you will get hurt; it is forgetting to do what you should do, not being there (physically or mentally) at that one critical minute, 60 seconds, that spells the difference between life and death in your trading. It is not easy work to stay this focused and intense, particularly when your spouse calls to ask you some mundane question about the garden or plumbing at home, or a close friend calls to chat. Do you have the guts to tell them you can't talk now, to hang up on a close friend, to refuse to take calls from your wife or husband? If so you are qualified for the job, if not, better rethink day trading.

I assure you the instant you get distracted by that phone call is the instant the market will have a major move, catching you off guard. Well, don't say I didn't warn you. Now let's look at the object of this game. You must also be able to change your view of the future in an instant. This is not a career for hardheaded people.

## How a Quote-Screen Trader Makes Money

A short-term trader has one objective: to catch the current trend of the market. That is it. That is all you should try to do!

It sounds easy, but trust me—it is far from simple, and for two reasons. The first is that trend identification is an art and science unto itself, and more

abstract art at that. It is a blend of Picasso and Cézanne with a splash of Chagall tossed in for fun. Second, even if you correctly spot the trend change, your reactive mind may screw things up and blow it for you. This is especially true if you are long with a loss or nominal profit and suddenly get a sell signal.

Do not confuse day trading with your long-term outlook; that is about something happening in the future. Day traders don't—can't—care about the future. Your only concern is being in phase with the current short-term trend. Your mission, should you accept this assignment, is to mimic what the market is doing. If it is up, you should be long, if down, short. Trying to forecast short-term tops and bottoms is a surefire way to rapidly deplete your bankroll. You want to be with the trend; it is your only friend.

Since greed is a stronger emotion than fear, your response will most often be to "hold and hope" which means you bypass the current new trend, holding on to the long position hoping the sell will be wrong when you should have spun on a dime. Dopes hope, winners are spinners.

My point is we are trying to do two very difficult things, beat the identification of trend changes and beat our "brains" by outsmarting ourselves. That is the challenge. My first technique for identifying trend changes comes from the short-term "ringed" high and low concept we went over in Chapter 1. This concept allows us to identify short-term swing points. A trend change from up to down occurs when a short-term high is exceeded on the upside, a short-term trend change from down to up is identified by price going below the most recent short-term low. Figure 9.1 depicts such trend changes in a classic manner, study it well because reality comes next!

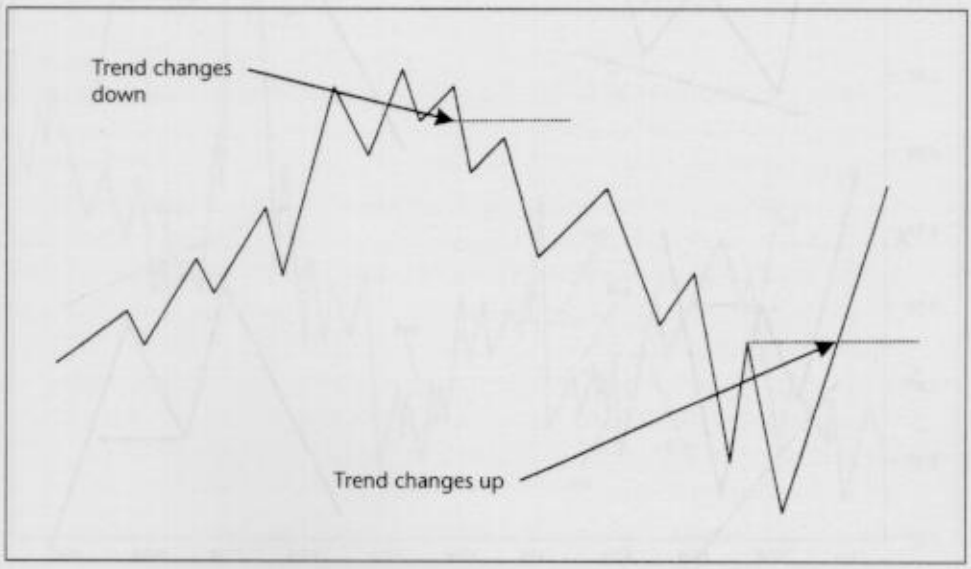



**Figure 9.1** Classic patterns of trend change.

## Swing Points as Trend Change Indication

Here are a couple of pointers on this technique. Although the penetration of one of these short-term highs, in a declining market, indicates a trend reversal to the upside, some penetrations are better than others.

There are only two ways a short-term high or low is broken. In an uptrending market, the low that is violated or fallen below will be either a low prior to making a new rally high, as shown at (A) in Figure 9.2, or a low that occurs after decline of a high that then rallies making a lower short-term high; it then declines below the low prior to the rally that failed to make a new high, as shown at (B).

The "better" indication of a real trend change is the violation of the low shown at (A).

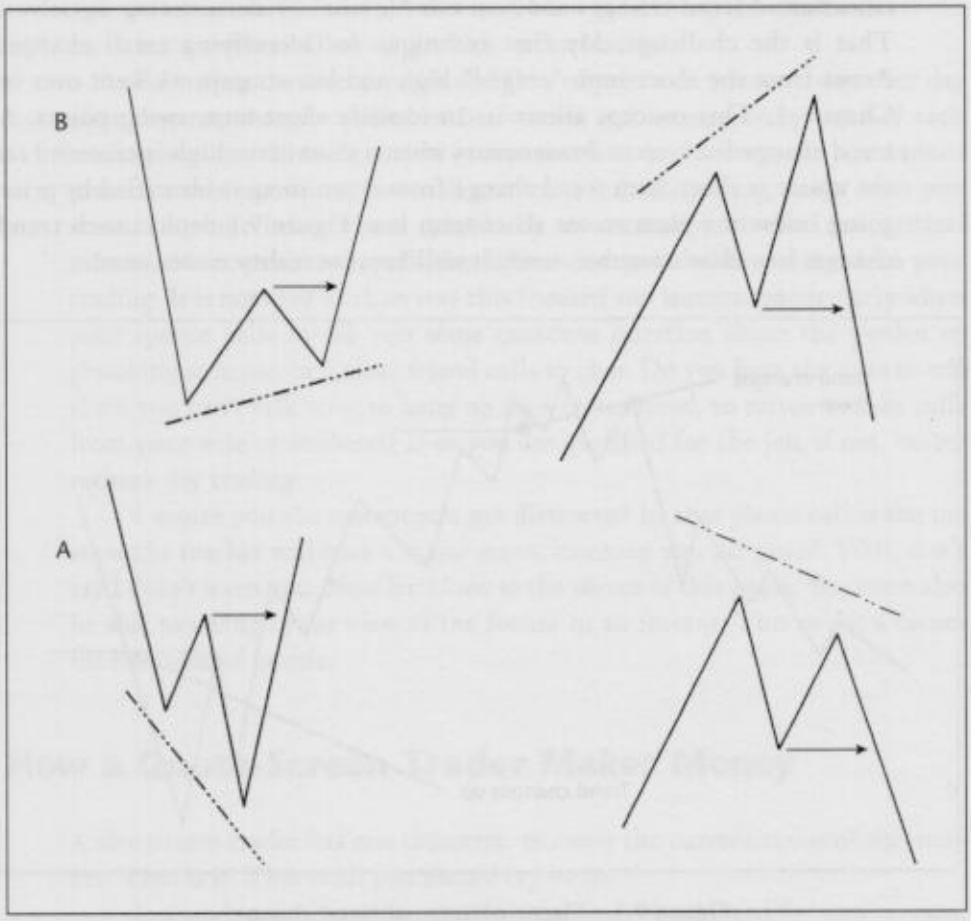



**Figure 9.2** Breaking a short-term high or low.

By the same token, a trend reversal to the upside will occur in one of the two following patterns: in (A) the rally peak prior to a new low is violated to the upside, or in (B) the market makes a higher low, then rallies above the short term high between those two lows. In this case, again, the (A) pattern is the "better" indication of a real trend reversal.

With that in mind, look at Figure 9.3, which shows a 15-minute bar chart of the September Bonds in 1989. The major trend moves were adequately captured by this technique.

Figure 9.4 again shows Bonds, this time in April 1998, and again you see how the penetration of short-term high and low points enables a trader to be in phase with most of the trend moves for a 10-day time period.

You can use this technique two ways. Some traders may simply buy long and sell short on these changes in trend. That's a basic simplistic way to use this technique. A more educated approach would be to take buy/sell signals when confirmed by TDW, TDM, secondary data, and so on, thus filtering our trades with something other than wiggles and waggles on a chart.

Finally, we may use this indication of trend to tell us we can buy on pullbacks, and sell on rallies in unison with the underlying trend. If our indication of trend is positive, and there has been a reversal to the upside, then we can take buy signals from short-term measures or techniques.

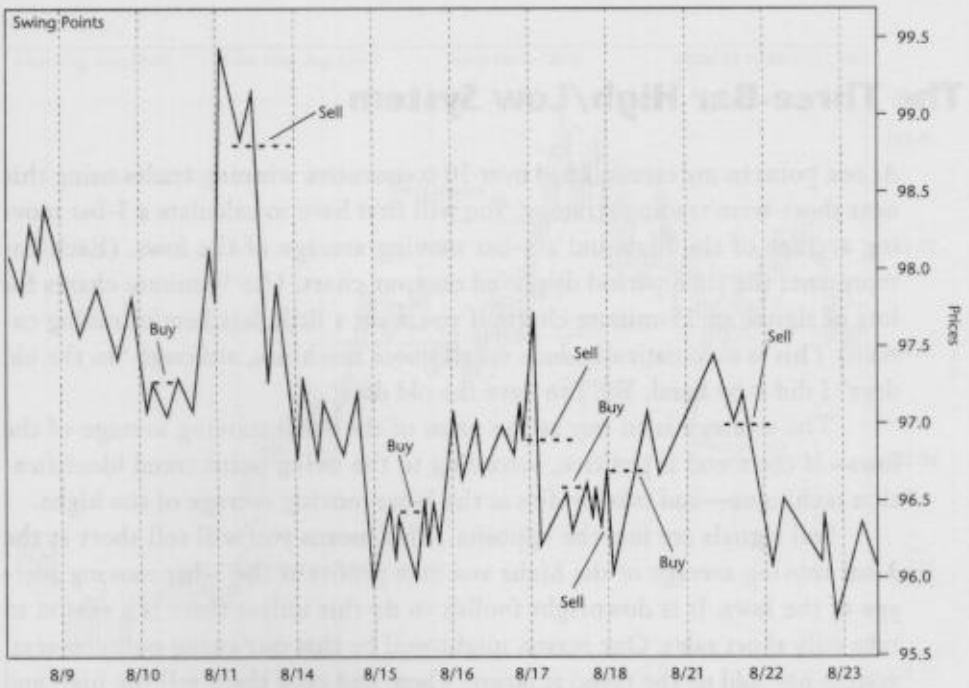



**Figure 9.3** T-Bonds (15-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

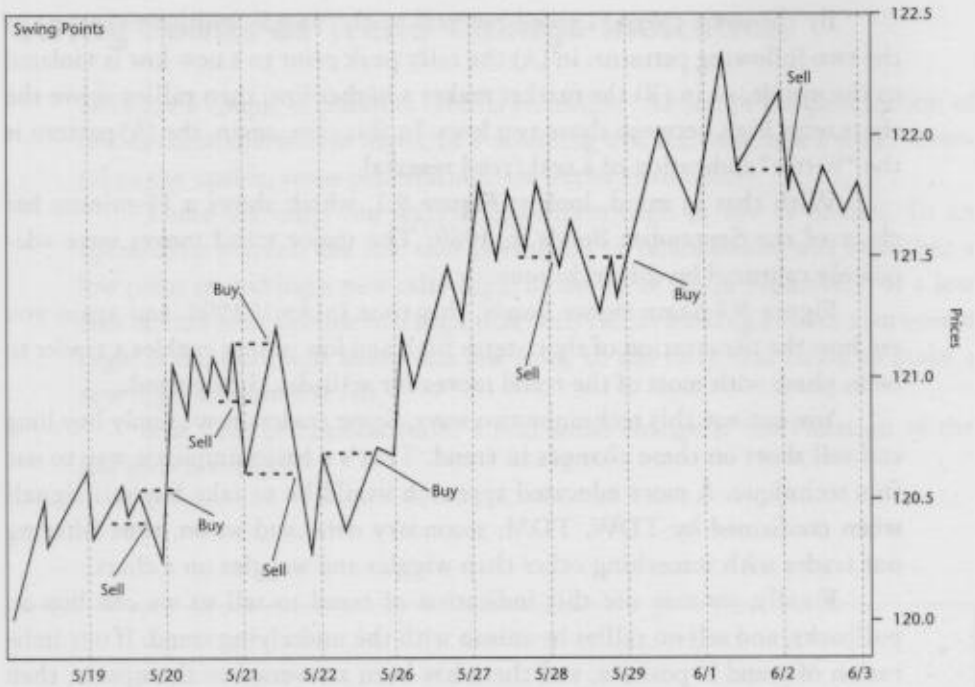



**Figure 9.4** T-Bonds (15-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

## The Three-Bar High/Low System

At one point in my career, I had over 30 consecutive winning trades using this next short-term trading strategy. You will first have to calculate a 3-bar moving average of the high and a 3-bar moving average of the lows. (Each bar represents the time period displayed on your chart. Use 5-minute charts for lots of signal, or 15-minute charts if you want a little less hectic trading career.) This is automatically done on all quote machines, although "in the old days" I did it by hand. You can have the old days!

The strategy is to buy at the price of the 3-bar moving average of the lows—if the trend is positive, according to the swing point trend identification technique—and take profits at the 3-bar moving average of the highs.

Sell signals are just the opposite. This means you will sell short at the 3-bar moving average of the highs and take profits at the 3-bar moving average of the lows. It is downright foolish to do this unless there is a reason to take only short sales. Our reason might well be that our swing point reversal system has told us the trend is down. Then, and only then, sell the high and cover at the lows.

Now let's try to make some order out of all this. Figure 9.5 shows the addition of the 3-bar moving averages and the swing lines. I have marked the

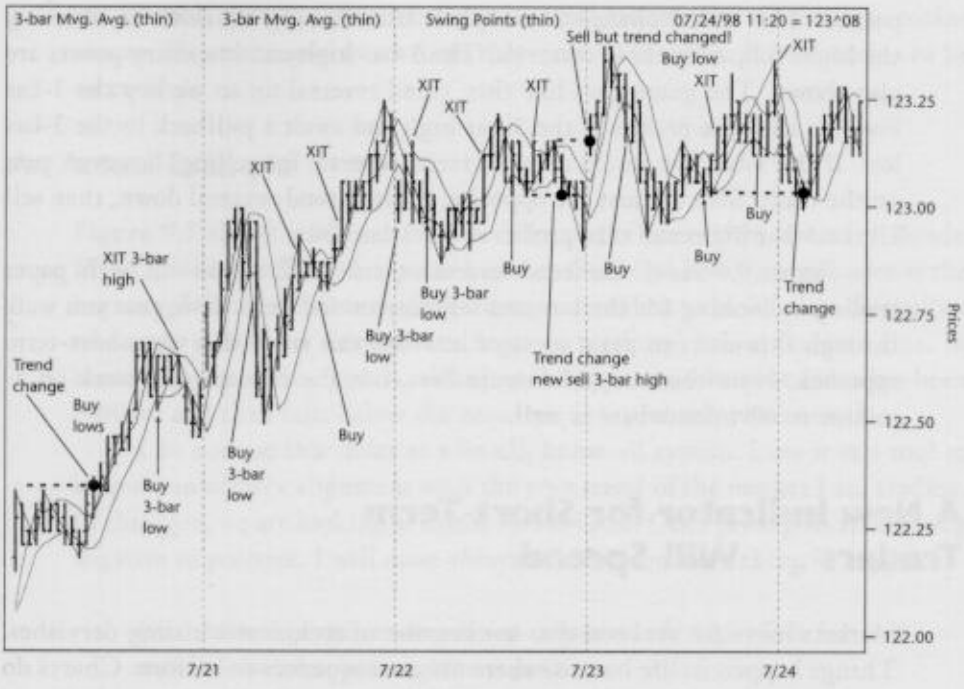



**Figure 9.5** T-Bonds (15-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).




**Figure 9.6** T-Bonds (15-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

points where trend changes; we switch from buying the lows to shorting the highs following these reversals. The 3-bar high and low entry points are also shown. The game goes like this; trend reversal up so we buy the 3-bar low line and take profits at the 3-bar high and await a pullback to the 3-bar low. If the 3-bar low would create a trend reversal for selling, however, pass on the trade. Sells are just the opposite; await a trend reversal down, then sell all the 3-bar highs and take profits at the 3-bar lows.

Figure 9.6 has all the trend reversals marked off, so you can begin paper trading by looking for the buy and sell entries and exits. I suggest you walk through this chart to get a sense of how one can trade this very short-term approach. Note these are 15-minute bars, but the concept will work on 5-minute to 60-minute bars as well.

## A New Indicator for Short-Term Traders . . . Will-Spread

Markets move for real reasons, not because of technical whirling dervishes. Things happen in life because there are consequences to actions. Charts do not move the markets. Markets move the charts. In keeping with that, I also think short-term swings occur because of some external factor. Price never rallies because it is rallying, the rally is the symptom of a cause. Detect that cause and we are several light years ahead of the average short-term or day trader.

One of my favorite causative indicators is my *Will-Spread* index, a measure of the flow of price between the primary market we are trading and a secondary market that influences the primary. As you know, Bonds influence stocks, and Gold influences Bonds; Will-Spread allows us to spot the inner workings of these market relationships. The index is constructed or calculated by first dividing the price of the market we are trading, the primary market, by the secondary market and multiplying by 100. This creates a spread between the two markets allowing a basic comparison of market interaction.

For short-term trading on 15-minute bar charts in particular, and most other time frames as well, I then create a 5-period exponential of the spread and subtract that from a 20-period exponential of the spread. By so doing, we can see when one market is heating up over another and get a better sense of these inner-market influences. Granted, this is not a perfect system, but the only perfect approach to day trading I have ever seen are those myriad of ads in commodity magazines and newspapers. You can absolutely trust me on this: those are 90 percent hype and 10 percent substance. If anyone really had such an outstanding system, he or she could make 100 times more money trading without the hassle of having to deal with the public. In addition, the tax advantages of trading are gargantuan compared with hawking systems. I have

yet to see a totally mechanical day trading system that consistently makes money. Day trading is an art form that must be based on good concepts to be successful.

## An Actual Example

Figure 9.7 shows a 30-minute bar chart of the June 1998 Treasury Bonds. Will-Spread, based on the spread between Gold and Bonds, is the index at the bottom of the chart. Our trading strategy should be to look for market rallies whenever this index moves from negative territory, below the zero line, to above it into positive land. A sell is just the opposite; when the index has been positive and then falls below the zero line, it is probably time to sell.

I do not use this index as a be-all, know-all system. I use it as a tool to keep me in correct alignment with the true trend of the market I am trading. In this case, we are looking at Bonds versus Gold. Once price goes from being negative to positive, I will most always wait for one more thing to happen.

*I want the very next trading bar to rally above the high of the bar that switched the index from negative to positive.*

*I am looking for final confirmation that the trend is still alive.*

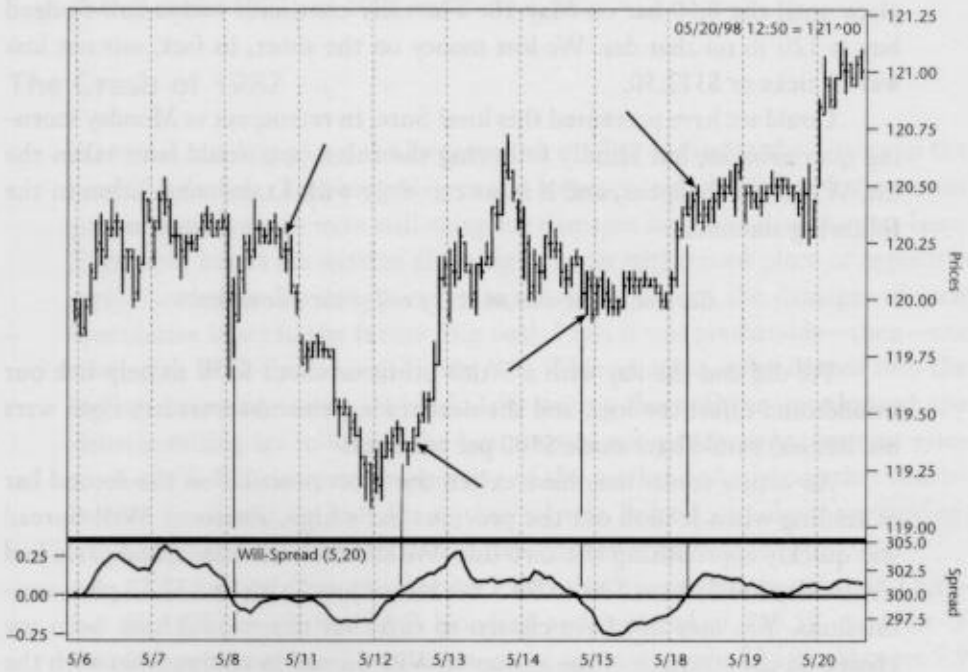



**Figure 9.7** T-Bonds (30-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

I am not nearly as comfortable without this confirmation taking place. An exception can be made if other technical gauges such as trendlines or positive oscillator readings are appearing on your chart or screen. You can take such trades, but there is no better proof of a market's ability to rally than taking out the high or falling below the low when a crossing from positive to negative has taken place.

Let's start with the May 8, 1998 chart. The first 30-minute bar saw a big down move resulting in a negative crossing, but the following bar did not fall below that bar's low so no entry. Finally on the 13:50 bar, we would have sold short as the index was negative and we traded below the prior bar's low. Our entry would have been 120$^{7}/_{32}$.

Will-Spread stays negative all that day as well as the next, finally turning positive on May 12 on the 9:50 bar. Now comes the acid test . . . will the rally continue? And it does as the 10:20 bar trades at 119$^{14}/_{32}$ netting us a gain of 25 ticks or $750 per contract.

We are now long at 119$^{14}/_{32}$ and looking for a negative crossing to go short. The first break below zero occurs on May 14 on the 12:50 bar. Again, we wait for confirmation, but none comes on the next bar. We now wait for that bar's low to be violated. Our "trailing" stop to exit and reverse is finally elected when the 14:20 bar trades down to 120$^{1}/_{32}$. Our net gain is 20 ticks or just a little over $600 per contract.

We steel our nerves for the short trade and await a new development, a penetration of Will-Spread back into the positive zone. This does not take place until the 8:50 bar on May 18. The rally continues with a full-fledged buy at 120$^{14}/_{32}$ on that day. We lost money on the short, in fact, our net loss was 10 ticks or $312.50.

Could we have prevented this loss? Sure, in retrospect as Monday morning quarterbacks, but blindly following the rules, you would have taken the hit. When this happens, and it most certainly will, I take consolation in the following statement:

*Casinos do not win on every roll of the dice either.*

We did end the day with a 5-tick profit or about $150 to help lick our wounds and offset the loss, and the next trade (remember, traders fight wars not battles) would have made $500 per contract.

An astute trader may have exited the short position on the second bar of trading when it took out the previous bar's high. Reasons? Will-Spread was quickly approaching the zero line. We should limit losses, and price had a volatility breakout at 120$^{5}/_{32}$ for a net loss of just 1 tick or $32.50 plus commissions. You may not have chosen to exit, but that would have been my choice on the strength of the action of Will-Spread in conjunction with the breakout of the trading range. As I said, this is a thinking person's business.

If you were in a quandary about what to do, you could have looked at a 5- or 15-minute chart on May 18. There you would have noticed both time frames giving a clear-cut penetration of Will-Spread to the upside suggesting the best course of action would have been—at the very least—to pitch your short position.

## Will-Spread and the S&P 500 Stock Index

This same idea works quite well in helping us catch short-term swings in the various stock index contracts such as the New York Stock Exchange, Dow Jones, Value Line, the Mini S&P as well as the S&P 500 full-size contract.

Although Gold makes the world of Bonds go around, it does not have as strong an impact on stocks. As you now know, however, interest rates do; so I suggest you use either T-Bills or Bonds in your Will-Spread setup. Using 30-minute bar charts, I am employing the difference between a 3-period and 15-period exponential average. Admittedly, this is a lot of work to do by hand, but the better quote software such as Omega's Trade Station and Genesis Data have now built my indicator into their programs.

Instead of just randomly choosing time periods to present to you to illustrate the value of Will-Spread I am first going to show you "The Anatomy of a Crash," by highlighting the biggest crash of all times, the 1987 debacle, as well as the 1997 and 1998 waterfall slides.

### The Crash of 1987

Here it is in all its glory; the largest stock market decline in the history of the world! A decline that changed lives and fortunes, a decline of such disastrous proportions lawyers were still suing for damages from the drop 5 years later. Even now, books are written claiming to know why it took place or explain it away. Academics have suggested many ways to prevent the damages of such speculative busts in the future. Big deal, I say; it was predictable—then—not now, with Will-Spread (see Figure 9.8). This amazing index dipped into the negative zone on October 14 at 311.50 staying short all the way through the debacle telling its followers the bottom was not yet in sight. Interest rates vis-à-vis T-Bills were not supportive of the market and without that confirmation we should not look for any buy signals. Indeed, just about any buying, other than the absolute low, would have proven costly.

The exit or first crossing back into positive territory came on October 20, 1987, with the S&P bloodied and battered at 219.50, a profit of $46,000 per contract. The margin at the time was only $2,500 (Figures 9.9 and 9.10).

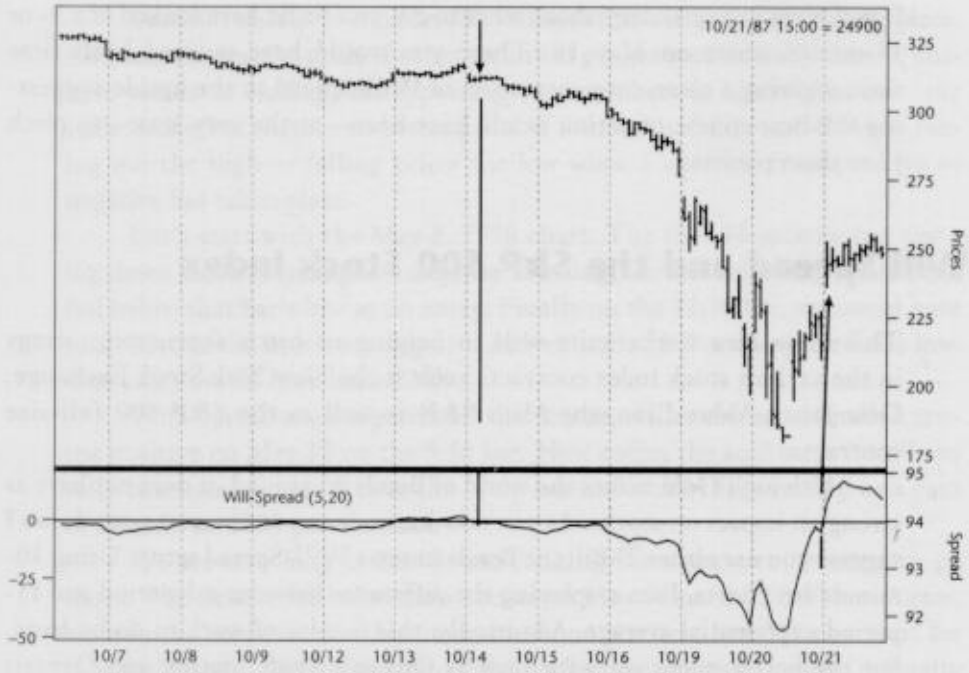



**Figure 9.8** S&P 500 Index (30-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

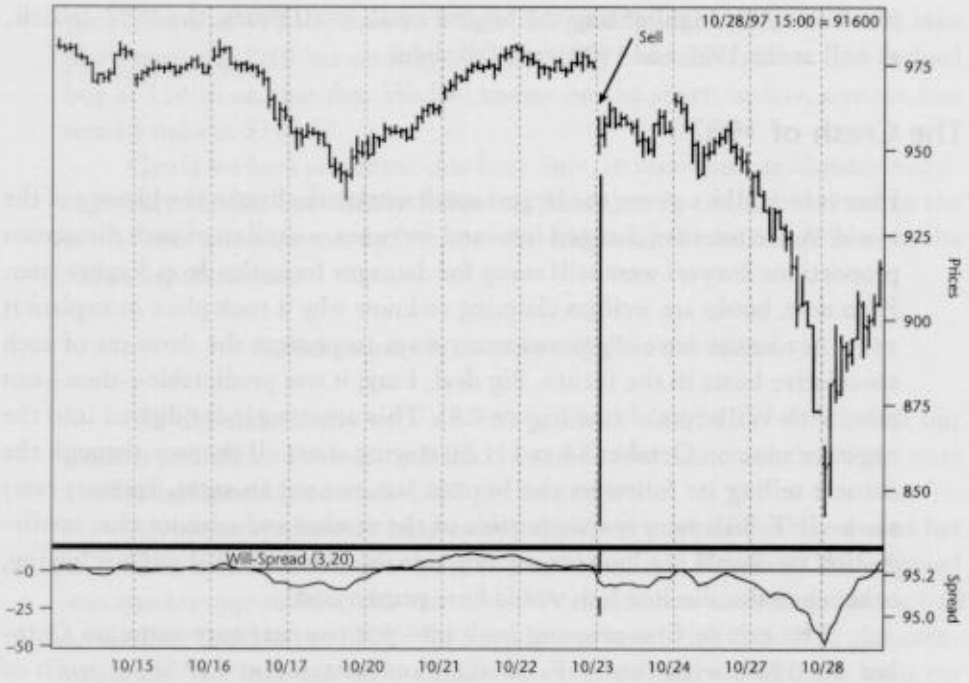



**Figure 9.9** S&P 500 Index (30-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

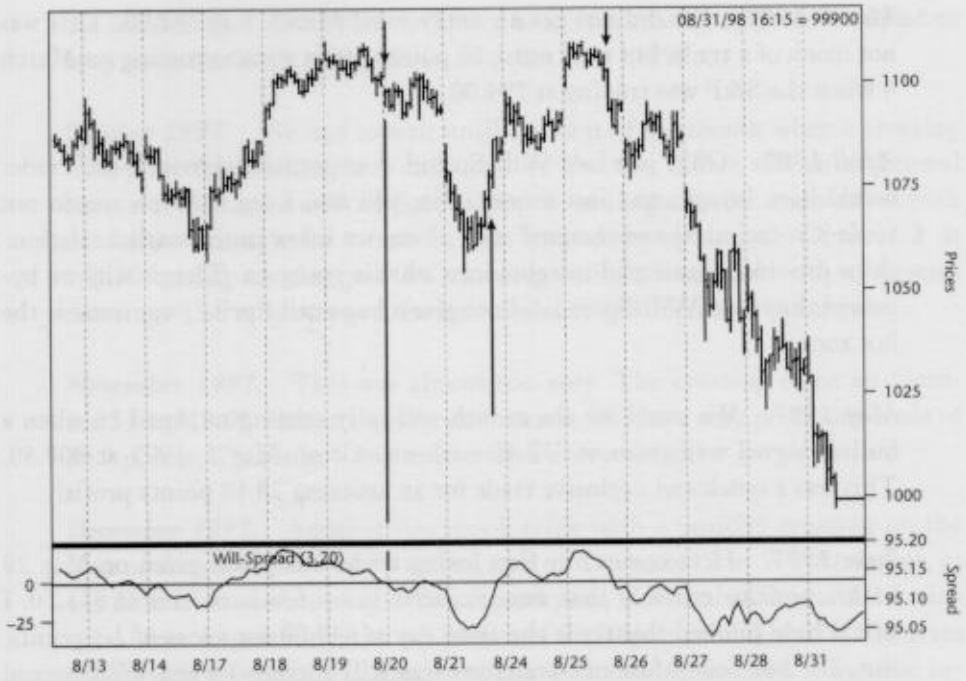



**Figure 9.10** S&P 500 Index (30-minute bars). Graphed by the "Navigator" (Genesis Financial Data Services).

Although Will-Spread can stand on its own, it can be used in conjunction with other known facts about the market. As just one example, you have read about a huge bias for stocks to rally at the first of every month, especially in February, March, May, July, September, October, and November. Thus one possible short-term strategy you could employ at the start of every month would be to take Will-Spread buy signals when the positive crossings occur, with special focus on the previously named months. Here is a recap of all such signals for 1997 starting with January. Stay with me as I "walk" and talk you through what happened and what you could realistically could have done using this combination of ingredients.

***January 1997.*** Will-Spread did its thing crossing on January 2, 1997, with an entry at 744.70, staying positive until the negative crossing on January 6; by then the S&P rallied to 752.00 with a profit of 7.30 points!

***February 1997.*** On January 29, the first-of-the-month rally was clearly indicated by a positive crossing at a price of 774.60 with an exit two days later on the close of January 31 as Will-Spread had begun to deteriorate. We know this is a 2- to 3-day bias, so let's take the 13.90 profit at the end of our time window unless the index is particularly bullish.

***March 1997.*** We did not get an entry until March 3 at 792.90. This was not much of a trade, but took out 1.10 points profit with a crossing on March 4 when the S&P was trading at 794.00.

***April 1997.*** Oh, I just love Will-Spread. A conventional month-end trader would have bought and lost money. But, you and I are smarter, we do not trade just technical and seasonal stuff alone, we know inner-market relationships provide meaningful insights into what is going on. That is why we bypassed the trade. Will-Spread did not give a buy until April 7, way outside the hot zone.

***May 1997.*** We could see the month-end rally coming on April 28 when a bullish signal was given at 772.40 with an exit on May 1, 1997 at 800.50. This was a quick and explosive trade for an amazing 28.10 points profit!

***June 1997.*** Here comes our first losing trade: a buy was given on May 28 with a positive crossing that went negative just a few bars later at 851.20. I would have pitched this trade the same day at 849.00 for a loss of 2.3 points. But, the hot zone of month-end/start was still there, so when Will-Spread turned positive on May 30, there was no reason not to take the trade; we were still in the time zone. Entry price was 844.70 with an exit on June 2 at 848.00 making up the loss on our first shot at the trade.

***July 1997.*** Well, we are given another lesson in humility, going long on a positive crossing on June 30 at 896 with an exit the same day, a 6.0 point loss at 890! Wow, that was quick and ugly. But just like the end of June, we see another positive crossing on July 1, so we go long at 898. Our strategy is simple, wait for a negative crossing or two days in the trade. We wait. Will-Spread crosses to the downside just a few hours later at 897.80 for a .20 loss. Another crossing comes late in the day on July 1, so we reenter at 900.25 and hold until our sell on July 7 at 927.55, netting 21.10 points in July.

***August 1997.*** Along comes the first of the month, but Will-Spread is tracking in the negative area so we have no trade. Again, our filter has kept us out of what appeared on the surface to be bullish. As the time approached, we could see the fundamentals were not there to justify the trade.

***September 1997.*** More humility. There is a clear-cut crossing on August 29 with an equally clear-cut exit and loss the same day at 902.55 for our biggest loss of the year of 3.20 points.

But we stick with it, taking the buy signal on September 2 at 912.50 and watch a very powerful rally unfold lasting until September 3 when we close out the trade at 928.90, again recouping our earlier loss. That was close, but

the combination of the time influence and inner market influence coupled to keep us in the black, with this 15.50 point gain +1295.

***October 1997.*** We had to wait until the first of the month when a crossing took place forewarning us a rally was on the way. There was an additional chance to buy again as Will-Spread dipped into negative for one bar, but with no follow-through for a sell and an immediate upturn on October 2 at 965.30, giving another positive crossing until time ran out with a negative crossing. The rally stopped, for us at least, at 968.75, a 3.45 point gain.

***November 1997.*** This was almost too easy. The crossing came on October 31 at 919.00 with an equally clear exit at 947 for a very profitable trade of 28.0 points. This is how I wish it worked every month!

***December 1997.*** Another storybook trade with a positive crossing on the first of the month at 962.50 and an exit on December 2 at 973.20. It was, as old Blue Eyes used to sing, a "very good year," 13 total trades with 10 winners. More importantly, the net profits of 99.70 points, or $24,925, illustrate the validity of combining fundamentals with time influences. The time influence is always there, but without a valid underpinning—the stage being set on a fundamental basis—I will pass, thank you. There are too many good trading opportunities where we can get such high odds that there is no reason to go slumming for trades just because there is one element "that may work."

The more the merrier, that is my adage!

# Chapter 10

# Special Short-Term Situations

*History does repeat itself, just not with precision.*

It is time to develop a checklist of possible short-term trading opportunities we can accept or reject each month. You can do this yourself by gleaning out of my work trading opportunities that appeal to you. To give you a feel for doing this, I devote this chapter to setting up specific trades you should be looking for each month. These trades are based on times of the month and holidays.

The time-of-the-month trade is hardly a new idea. As noted earlier, the concept has been known for years. Here are my improvements and adaptations to a long-standing market truism: stock prices rally around the first of the month. The light I shed on this play was to find out that Bond prices experience this same monthly uplift as demonstrated earlier. We will now develop a winning strategy based on these insights.

## Month-End Trading in Stock Indexes

There are now several vehicles speculators can use to catch these swings. The S&P 500 stock index has been the kingpin of trading stock market moves, but

```
Data              : S&P 500 IND-9967     09/80
Calc Dates        : 09/18/87 - 08/31/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F59.DAT

//////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $73,437.50
Gross profit             $103,250.00    Gross loss              $-29,812.50

Total # of trades            129        Percent profitable           85%
Number winning trades        110        Number losing trades          19

Largest winning trade      $6,700.00    Largest losing trade     $-2,437.50
Average winning trade        $938.64    Average losing trade     $-1,569.08
Ratio avg win/avg loss          0.59    Avg trade (win & loss)      $569.28

Max consecutive winners          20     Max consecutive losers          2
Avg # bars in winners             1     Avg # bars in losers            1

Max closed-out drawdown    $-3,325.00    Max intra-day drawdown   $-3,950.00
Profit factor                    3.46    Max # of contracts held         1
Account size required      $6,950.00     Return on account           1,056%
```

**Figure 10.1** S&P 500 buying first day of each month.

lately, the lower margin S&P minicontract has been grabbing smaller investors' attention. The newcomer in this group, though, is the Dow Jones 30 index, a futures contract that mimics the world-famous Dow Jones Average. I expect this to become an even more important index to trade in the future.

The strategies discussed here are based on the S&P 500 for one simple reason; we have more data because this stock index began trading in 1982, the Dow 30 in 1997. But, the strategies can be applied to all the stock indices; just alter your stop based on margin, contract size, and current volatility.

I went back to 1982 and tested buying the S&P 500 index on the open of the first trade day of every month with an exit on the first profitable opening. The stop I chose was only $1,500, but was not used on the day of entry; however, after the entry day it was in place at all times. There have been 129 trades making a net gain of $73,437, about $7,000 a year for trading only once a month. The numbers of this system are excellent; the accuracy is 85 percent, average profit per trade (that's net gain, winners minus losers, divided by total trades). Drawdown came in at $3,325, less than 5 percent of total gains. This is good stuff (see Figure 10.1).

## Target Months

If you are getting the hang of this game, you may have already asked yourself if some months do better than others. The answer is yes, as the following printouts show. The story they tell is that the worst months, in the past 16 years, have been January, February, and October. These should be your target months to avoid or be cautious of seasonal trading. I suggest you study the month-by-month recaps presented in Table 10.1.

Table 10.1
Profitable S&P Trades by Month

| Month | Net Profit | Number of Trades +/– Total |
|---|---|---|
| January | 2,325 | 9/11 |
| February | 3,437 | 8/11 |
| March | 5,650 | 9/10 |
| April | 5,437 | 10/11 |
| May | 6,075 | 9/10 |
| June | 6,500 | 10/11 |
| July | 5,875 | 9/11 |
| August | 12,500 | 9/10 |
| September | 5,557 | 9/10 |
| October | 1,150 | 8/11 |
| November | 10,500 | 11/11 |
| December | 8,150 | 9/11 |

## Making It Better

Although some of our speculative competitors are aware of this repetitive pattern, most do not consistently take advantage of it nor have they figured out about skipping some months. That is a big improvement, but we can do even better.

How? By only taking these first-of-the-month trades when Bonds are in an uptrend. As I demonstrated earlier, an uptrend in Bonds is conducive to stock market rallies. A pretty good rule, and easy to follow, is to only buy on the first of a month—any month—if Bonds have closed higher the day prior to our anticipated entry than 30 days ago. This is evidence Bonds should be supportive of a stock market rally.

## Month-End Trading in the Bond Market

Next, let's look at buying the first trading day of every month in the Bonds, as we did in the S&P 500. The results are quite profitable based on the rules of using an $1,100 stop and exiting on the first profitable opening. This approach to trading comes close to 70 percent accuracy and has a very large average profit per trade considering that we are in for only one day on average (see Figure 10.2).

We can dramatically improve these results by simply by-passing the poorer performing months which, as shown in Table 10.2, are January, February, April, and October, with December being a question mark.

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\P62.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $32,593.75
Gross profit              $83,531.25    Gross loss              $-50,937.50

Total # of trades             149       Percent profitable           69%
Number winning trades         104       Number losing trades          45

Largest winning trade     $2,593.75     Largest losing trade     $-1,375.00
Average winning trade       $803.19     Average losing trade     $-1,131.94
Ratio avg win/avg loss         0.70     Avg trade (win & loss)      $218.75

Max consecutive winners           8     Max consecutive losers           6
Avg # bars in winners             2     Avg # bars in losers             1

Max closed-out drawdown   $-6,812.50    Max intra-day drawdown   $-7,437.50
Profit factor                  1.63     Max # of contracts held          1
Account size required     $10,437.50    Return on account             312%
```

**Figure 10.2** Bonds buying first day of each month.

As mentioned, the month-end up move in stocks has been written about for years; all I have done is figure out how to better qualify trades for this time period. Until now, the tendency for Bonds to rally at this same time has been known by only a few of my students. My research and actual trading over the years show this is also an excellent time for short-term swing moves in Bonds and Bills.

Figures 10.3 and 10.4 should give you an overall view of this technique's strength. Figure 10.3 shows the growth in an account that would have

**Table 10.2**
**Profits in Bonds by Month**

| Month | Net Profit | Number of Trades +/– Total |
|---|---|---|
| January | –31 | 8/13 |
| February | –1,718 | 7/13 |
| March | 2,781 | 9/12 |
| April | –343 | 8/13 |
| May | 6,125 | 9/12 |
| June | 3,125 | 13/9 |
| July | 1,093 | 8/13 |
| August | 4,343 | 9/12 |
| September | 7,187 | 11/12 |
| October | –218 | 12/7 |
| November | 8,150 | 12/12 |
| December | 1,500 | 7/12 |

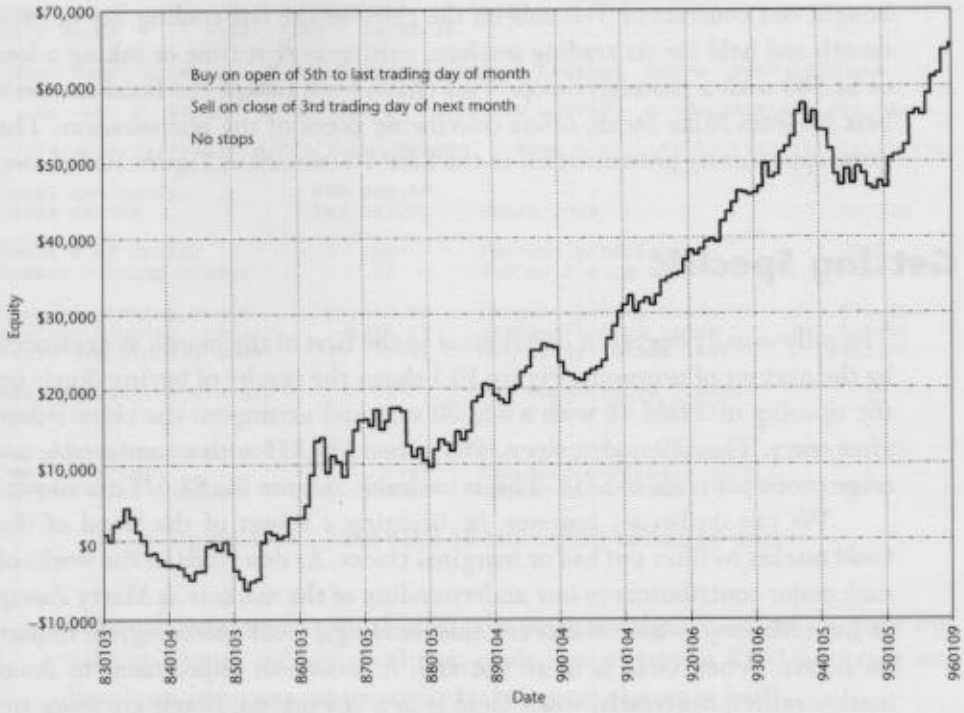



**Figure 10.3** End-of-month T-Bonds system (U.S. T-Bonds day session 1983–1996).

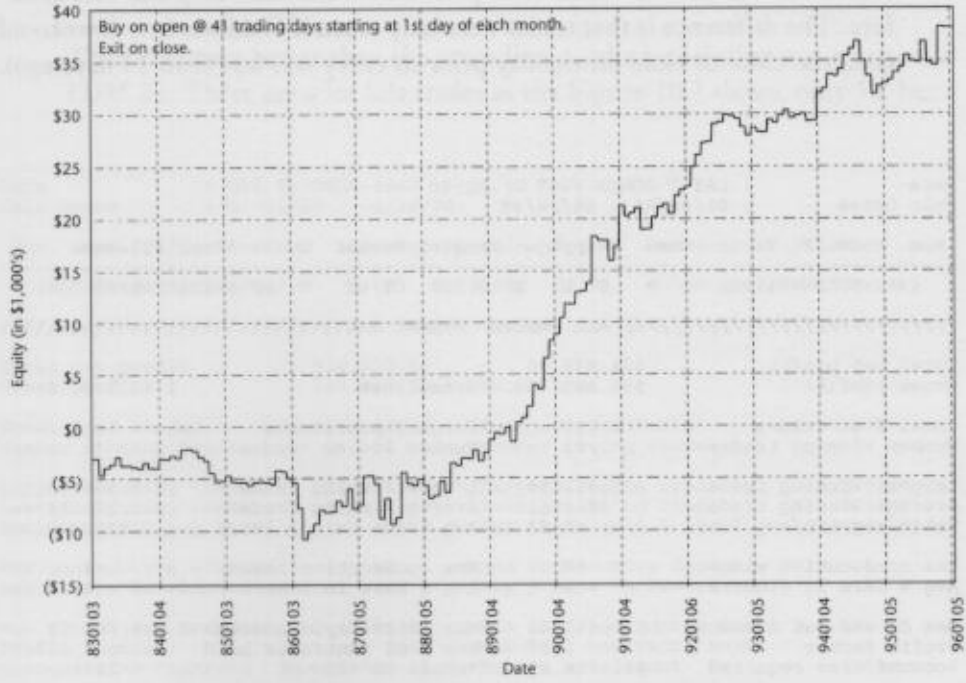



**Figure 10.4** End-of-month S&P 500 (1983–1996).

bought one contract of T-Bonds on the third to the last trading day of each month and held for six trading sessions, exiting at that time or taking a loss of $1,500 with a protective stop. This chart, from one of the Bond market's best students Mike Stock, offers convincing proof of the phenomenon. The same opportunity presents itself in the S&P 500 as well as Figure 10.4 shows.

## Getting Specific

The rally usually begins in Bonds prior to the first of the month as evidenced by the next set of printouts. Figure 10.5 shows the results of buying Bonds on the opening of TDM 18 with a $1,500 stop and exiting on the close 3 days after entry. The 139 trades, since 1986 netted $34,875 with a comfortable average profit per trade of $250. This is tradeable, despite the $8,625 drawdown.

We can do better, however, by bringing a subset of the trend of the Gold market to filter out bad or marginal trades. As described in the works of such major contributors to our understanding of the markets as Marty Zweig or John Murphy (whose books are must reading), Gold exerts a great impact on Bonds. When Gold is in an uptrend, it acts as an impediment to Bond market rallies, conversely, when Gold is in a downtrend, Bonds are more apt to rally.

Figure 10.6 reveals the power of filtering trades with Gold. In this case, trades were taken at the same time period with the same stop and exit as before. The difference is that trades were only taken if Gold was in a downtrend (i.e., the close of Gold on the day prior to entry was less than 24 days ago).

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $34,875.00
Gross profit              $95,843.75    Gross loss              $-60,968.75

Total # of trades             139       Percent profitable           71%
Number winning trades          99       Number losing trades          40

Largest winning trade     $2,812.50     Largest losing trade     $-1,906.25
Average winning trade       $968.12     Average losing trade     $-1,524.22
Ratio avg win/avg loss         0.63     Avg trade (win & loss)      $250.90

Max consecutive winners          17     Max consecutive losers          4
Avg # bars in winners             3     Avg # bars in losers            3

Max closed-out drawdown   $-8,625.00     Max intra-day drawdown   $-8,656.25
Profit factor                  1.57     Max # of contracts held         1
Account size required     $11,656.25     Return on account            299%
```

**Figure 10.5** Buying bonds on TDM 18.

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $32,062.50
Gross profit              $65,093.75    Gross loss              $-33,031.25

Total # of trades             90        Percent profitable           75%
Number winning trades         68        Number losing trades         22

Largest winning trade     $2,812.50     Largest losing trade     $-1,531.25
Average winning trade       $957.26     Average losing trade     $-1,501.42
Ratio avg win/avg loss         0.63     Avg trade (win & loss)      $356.25

Max consecutive winners       11        Max consecutive losers        3
Avg # bars in winners          3        Avg # bars in losers          3

Max closed-out drawdown   $-4,500.00    Max intra-day drawdown   $-4,500.00
Profit factor                  1.97     Max # of contracts held       1
Account size required     $7,500.00     Return on account            427%
```

**Figure 10.6** Bond TDM 18 buy signals backed by gold.

Although total profits dip $2,000, the accuracy slightly increases while our "all important" average profit per trade jumps up over $100 per trade and drawdown improves substantially by being cut almost in half!

## Better and Better

We can do even better than the preceding results by delaying our entry until TDM 22. There are a lot less trades as the Figure 10.7 shows, only 50, but a

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $24,812.50
Gross profit              $42,812.50    Gross loss              $-18,000.00

Total # of trades             50        Percent profitable           76%
Number winning trades         38        Number losing trades         12

Largest winning trade     $2,718.75     Largest losing trade     $-1,500.00
Average winning trade     $1,126.64     Average losing trade     $-1,500.00
Ratio avg win/avg loss         0.75     Avg trade (win & loss)      $496.25

Max consecutive winners        7        Max consecutive losers        3
Avg # bars in winners          3        Avg # bars in losers          2

Max closed-out drawdown   $-4,500.00    Max intra-day drawdown   $-4,593.75
Profit factor                  2.37     Max # of contracts held       1
Account size required     $7,593.75     Return on account            326%
```

**Figure 10.7** Bond TDM 22 buy signals.

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 2 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $20,156.25
Gross profit              $24,656.25    Gross loss                $-4,500.00

Total # of trades             28        Percent profitable            89%
Number winning trades         25        Number losing trades           3

Largest winning trade     $2,468.75     Largest losing trade      $-1,500.00
Average winning trade       $986.25     Average losing trade      $-1,500.00
Ratio avg win/avg loss         0.65     Avg trade (win & loss)      $719.87

Max consecutive winners       17        Max consecutive losers         1
Avg # bars in winners          2        Avg # bars in losers           1

Max closed-out drawdown   $-1,500.00    Max intra-day drawdown    $-2,093.75
Profit factor                  5.47     Max # of contracts held        1
Account size required     $5,093.75     Return on account            395%
```

**Figure 10.8** Bond TDM 22 buy signals backed by gold.

higher accuracy, 76 percent, an amazing $496 average profit per trade, and very livable drawdown of a little over $4,500.

I know, I know, you want to know what happens when we back this trading opportunity with the trend of Gold. Well, Figure 10.8 shows the answers and they are very impressive, $20,156 of profits. Again, the trend criteria is that Gold close lower than 24 days ago, same stop and exit as in the previous results. Although our drawdown has a major improvement, crashing all the way down to $1,500, the accuracy skyrockets to 89 percent and average profit literally zooms to $719 per trade.

This is an exceptional trading opportunity; the problem is not many months have a TDM 22, but when they do, I will be buying. Check out the string of winners with the Gold filter, 17 winners in a row, whereas without the filter, we only had 5 winners in a row.

## A Time to Sell as Well

Bonds have also dipped around mid-month most of the time, as Figure 10.9 reveals. The rules called for selling on the open of TDM 12 with our usual 3-day exit and $1,400 stop. From 1986 to the middle of 1998, this dip has been profitable to trade 76 percent of the time with an average profit per trade of $133 on the 152 trades. Drawdown is acceptable at $6,093, but larger than the ideal ratio of profits to drawdown. Ideally, drawdown should be no more than 15 percent of the profits of $20,281. In this case, the drawdown was 20 percent profits. So, although we are certainly onto something here, I would like a shot at making it better.

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $20,281.25
Gross profit              $73,375.00    Gross loss              $-53,093.75

Total # of trades             152       Percent profitable           76%
Number winning trades         117       Number losing trades          35

Largest winning trade     $3,000.00     Largest losing trade     $-2,000.00
Average winning trade       $627.14     Average losing trade     $-1,516.96
Ratio avg win/avg loss         0.41     Avg trade (win & loss)     $133.43

Max consecutive winners        13       Max consecutive losers         3
Avg # bars in winners           2       Avg # bars in losers           3

Max closed-out drawdown   $-6,093.75    Max intra-day drawdown   $-6,250.00
Profit factor                  1.38     Max # of contracts held        1
Account size required     $9,250.00     Return on account            219%
```

**Figure 10.9** Bond sells TDM 12.

Whereas traditional commodity market analysts would try to filter this trading opportunity with technical "junk" like the trend, oscillators, or momentum flows, I would rather go back to what matters; fundamental relationships, that of Gold to Bonds. After all, charts and oscillators do not move the market, underlying conditions do.

In addition to now having a real way to trade this mid-month dip, we are also able to again see the power of fundamentals in Figure 10.10. The trade entry and exit rules are exactly as in the previous clip, the only difference—and what a difference it makes—is that trades were only taken when

```
Data              : DAY T-BONDS-9967    01/80
Calc Dates        : 01/01/86 - 08/28/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
   44  -5  $ 31.250  $ 0   $ 0   $ 3,000  CT/PC   C:\GD\BACK67MS\F62.DAT

//////////////////////////// ALL TRADES  - Test 4 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $26,250.00
Gross profit              $50,250.00    Gross loss              $-24,000.00

Total # of trades             73        Percent profitable           78%
Number winning trades         57        Number losing trades          16

Largest winning trade     $2,656.25     Largest losing trade     $-1,500.00
Average winning trade       $881.58     Average losing trade     $-1,500.00
Ratio avg win/avg loss         0.58     Avg trade (win & loss)     $359.59

Max consecutive winners        14       Max consecutive losers         3
Avg # bars in winners           3       Avg # bars in losers           3

Max closed-out drawdown   $-4,500.00    Max intra-day drawdown   $-4,593.75
Profit factor                  2.09     Max # of contracts held        1
Account size required     $7,593.75     Return on account            345%
```

**Figure 10.10** Bond sells TDM backed by gold.

Gold had closed greater than the close 10 days ago. In other words, Gold was in an uptrend, which suggests to us that sell signals should be more effective in this monetary environment. The average profit per trade more than doubles, profits get bumped up $6,000, accuracy goes from 76 percent to 78 percent, no big deal, but our drawdown to profit percentage is just about halved from 20.9 percent to 11 percent. Perhaps best of all the average profit per trade jumps to $359 from $133.

Here we have a very tradable opportunity. All one need do is have the patience to wait for the mid-month time periods when Gold has been in an uptrend: that is the fundamental setup that created these results.

Patience seems to be the one commodity commodity traders have in short supply. Most people must like to trade for the heck of it, I guess. I want to wager or speculate only when I have a distinct advantage in the game. If it is not there you know where I will be . . . on the sidelines . . . where I belong. I hope you will be there with me!

# Chapter 11

# When to Get Out of Your Trades

*Never begin anything until you have reflected upon the end of it.*

I have three rules for you to follow to get out of your short-term trades:

1. Always use a dollar stop on all trades so in the event all else fails, you will have protection.
2. Use my "bailout" profit-taking technique developed with the help of Ralph Vince. The basic rule is to exit on the first profitable opening. If the profit is only one tick, take it.

   This works best for the S&P; for slower moving markets I will delay the bailout a day or two to give the market time to grow thus increasing my average profit per trade.
3. Exit and reverse if you get an opposite signal. If you are short and get a buy signal, don't wait for the stop or bailout exit, go with the most current signal.

That is all I have to tell you about exits. Don't get greedy, let the rules, not your emotions, take care of your trades.

# Chapter 11

# When to Get Out of Your Trades

# Chapter 12

# Thoughts on the Business of Speculation

*Speculation is not bad, but bad speculation is a disaster.*

It is one thing to correctly call the twists and turns of the markets, but that is not how long-term wealth is created, nor is that talent sufficient, in and of itself, for a career in this business.

Career success does not mean you have ferreted out a winning trade or two. Anyone can do that at any given time. That is not a career that is either getting lucky or getting good. The business end of speculation amounts to consistently doing the right thing—not getting off track, down in the dumps over the current losing trade or floating in the sky because you have had two winners in a row. I am much more interested in the career aspect of this art than I am in the last trade or two. Anyone can drive a nail or two into a board, but that is not what builds a house. To build a house you need not only the skills, but also a plan, the intentions to follow and complete the plan, and the ability to show up every day, rain or shine.

## What Speculation Is All About

The art of speculation is about figuring out the most probable direction the future will take. The future is seldom predictable to any precise level or event, yet all such investment predictions will entail three elements: *selection*, *timing*, and *management* of the prediction. Mastering one of these aspects is not adequate, you must understand and be proficient in all three of them, so let's take a look at each element.

There are two aspects of selection: one is selecting a market ready to move; the other is selecting so you can focus. Just because a market trades, don't expect your favorite commodity to suddenly have a rip-roaring move that will enrich your bank account. A study of any charted history of any stock or commodity will divulge an amazing secret that separates the would-be speculators from folks like you and me; price usually moves sideways in meandering back-and-forth pattern, perhaps with a slight trend direction. There are only three or four optimum times a year to take advantage of immediate and substantial changes in price. Go ahead, check some charts, see and learn for yourself that big price changes do not occur every day. In fact, they are less likely, rather than more likely, to take place . . . they are the exception, not the rule.

That is why trade selection is so important. You don't want to get stuck in the mud of a choppy, trendless market; it will wear you out or shake you out. In either event, you lose. If not money, time. It is imperative, then, that you learn to know when a market has been set up and is ready to roar.

I have given you numerous setup considerations in this book that include TDM, TDW, holidays, and intermarket correlations. There are others, such as the net long or short positions of the largest (and therefore smartest) traders, the invariably wrong positions of the public, even major news events that alter market activity. A successful speculator plays a waiting game. Most people can not wait, they would rather wager. The sooner the better. Speculator kings and queens have the patience to put off taking action until the tumblers have clicked into place, knowing profits are then more likely to prevail.

There is another reason selection can be paramount to profits. I have always done the best when I have traded just one or two markets. By eliminating all the others, the distractions, I have been able to thoroughly learn how my selected markets operate, what moves them, and perhaps of even greater importance, what does not move them. No great accomplishment has ever come about without focusing talent, intentions, and action. This business is no different. The more focused you are on what you are doing, the more successful you will become.

This thought fits well with the way business works. Heart specialists make more money than general practitioners. In this day and age of complexity, specialization has a large payoff. Years ago, I heard about a wise trader

who made millions in the stock market. He lived high in the Sierra Mountains and would call his broker about three times a year always to buy or sell the same stock. His broker told me the man had indeed amassed a fortune, all from this one stock, by using financial focus.

## It's about Time

If you are now focused on a specific commodity that your new tools, techniques, and dreams say should soon have a tradable move, it is still not time to rush in. Selection is about what should move; timing, the next element of speculation, is about precisely when that should happen. Timing is about narrowing down when price change should begin. Tools you can use here are simple trendlines, volatility breakouts, patterns, and the like. The essence of timing is to let the market prove to you that it is ready to explode in your selected direction.

Just what does that mean? In case of wanting to go long, I can tell you this; a decline in price sure as heck does not mean the upside explosion has begun. *Au contraire!* A price decline suggests further price decline: it is that simple Newtonian idea that an object once set in motion continues to stay in motion. Traders have a great conflict going at all times, we want to buy, thus conventional logic says to buy at the cheapest possible price. Yet trend analysis says don't buy what is going down! My advice is to forget buying cheap. Buy when the explosion has begun. Yes, you will miss catching the low, but that is far better than having new lows in price catch you!

## Trade Management

The third aspect of speculation has to deal with how you manage the trade itself as well as the money you are committing to the trade. Traditional wisdom is that you should not trade with money you cannot afford to lose.

Maybe.

But consider this, if your mind-set is that this is play money, I assure you that you will play with it. And probably lose. If it is real money—money *you cannot afford to lose*—the chances that you will pay close attention are much greater, and so are your chances of winning. Necessity is not only the mother of invention but also the control of speculation.

Trade management goes beyond money management as it relates to how long you will stay in the trade and how much profit to take. It directly concerns itself with your emotions: this means not getting carried away; it means not overtrading, not undertrading; it means doing the right thing and managing your emotional state during the trade.

Knowing how to trade is not the same as knowing how to win at trading. The art of trading combines selection and entry techniques with money management. That is the essence of what needs to be done, but the superior trader understands that it is the management—the control or the use of these techniques—that maximizes market profits.

## Essential Points about Speculation

### Rich People Don't Make Big Bets

Rich people, who are generally smart, have learned that you don't bet the farm on one spin of the wheel, investment deal, or trade. Wannabe speculators are consumed with the notion that they will amass tons of money very quickly by making a killing. They become the hapless victims, as in the process they have become plungers. Yes, you can plunge once or twice in your life, but if you consistently plunge, you will lose on one of these wagers, and since you are betting it all, you will lose it all. That is why rich people don't make big bets.

They are far too shrewd to risk all they have on an investment, as they know investment decisions can be random. In their wisdom, they know the future is somewhat unpredictable; hence they play the game that way. Years ago, I was on the board of directors of a small bank in Montana and in that position reviewed many loan requests. The business applications always included a pro forma, a projection of how the business would do, and how the loan could be repaid.

I don't think I ever saw any pro forma of what should happen become a reality! They were always off target, and as you might imagine, the reality of the business was not as prosperous as the pro forma would have led one to believe. An old-time banker had a great saying, "Nothing good ever comes in certified mail and pro formas are never right."

Rich people make more money by finding a good investment or two, and investing an optimal amount in those investments. There is no need to take the risk of being wiped out in exchange for the thrill of plunging; it simply is not worth it.

### To Make a Thousand, You've Got to Bet a Thousand

This is a favorite expression of pit bosses in Las Vegas and is a subset to the idea that rich people don't bet big.

*That's the favorite expression of Las Vegas pit bosses, and it's dead wrong. Here's the right way to "make a thousand."*

There is not that much difference between gambling and speculation. The big compelling contrast is that gamblers can never get a leg up on the game, the odds are against them all the time (unless they count cards and play blackjack). It has always amazed me that in a game where the odds are against us, we flock to the table to play.

Las Vegas stays open 24 hours a day for a simple reason; players won't quit and in any endeavor where you have an advantage, especially a slight one, the longer you play the more certain you are of winning. So they never stop. To casinos, the public is the bank account they tap every minute of every day.

***Weaknesses of the Pit Boss Adage.*** Pit bosses are supposed gurus of gambling knowledge; after all, they have seen it all. But the advice that to make a thousand you need to bet a thousand is "house talk" that will get you into serious trouble.

Last year, my daughter traded $10,000 to $110,000, while I took an account from $50,000 to over $1,000,000. At no time did we make "a big bet." It was quite the contrary, our bet size was small, never risking more than 20 percent of our stake and *that was larger than it should have been or needed to be.*

If you have an advantage in the game, as a speculator must before he decides to play, then play by the real rule that has kept Las Vegas building all those extravagant Meccas of money; risk little and play around the clock.

The problem with betting a thousand to make a thousand is you can lose that thousand just as quickly. So why not seek out a strategy that makes a thousand by the natural growth of the game, not by the luck or lack of it on the next trade. There is plenty of money to be made trading and the game is not going to get shut down anytime soon, so learn to harvest your winnings over time, not on one roll of the dice.

In my 36 years of following the markets, I have seen more people lose fortunes than make them. The losers—all of them—did the opposite of the winners, they bet big thinking they could make a killing on one or two trades. The winners made their fortunes by consistently doing the right thing. When you step out to make a killing, you are more likely to be killed than to survive.

***Rich People Don't Make Big Bets.*** Really rich—and smart—people don't make big bets. First they are not out to "prove" anything, they are out to make more money, and second, they know that risk control is as important as the other two legs of speculation, selection and timing. *That is all this business of commodity trading gets down to, selection, timing, and risk control.*

## Speculation Is for People Who Love Roller Coasters

Trust me on this. If you don't like the thrill and up-and-down gyrations of a roller coaster, put this book down, ask for your money back and go on with

your humdrum life. The life of a speculator is literally one roller coaster ride after another; it is a series of ups and downs, highs and lows where hopefully the lows are progressively higher, but the reality is often the lows are lower. Worse yet, so are the highs!

Although many are attracted to the life of speculation because of the thrill, they don't envision the ups and downs, they think it will be a steady stream of Rolls Royce limousines and lollipops. It is not; it's a steady stream of unknown, free-form verse that at times seemingly leads nowhere. In this business, thrill kills.

You must, at heart, be a thrill seeker. But you cannot let that take over your trading style; indeed, if you do not learn to corral or harness your thrill-seeking nature, you will never make it as a speculator. That is probably what makes this business so difficult; while it takes a thrill seeker to speculate, it takes a risk-aversive person to make a career out of speculation. What you must have to succeed in this business, you also must learn to regulate, to control. Clamp down on the roller coaster or it will jump the track. My advice to be a long-term winner in the game of speculation is this; kill thrill.

## If You Don't Have the Patience to Wait, There Will Be Nothing to Wait For

This is one of the elements of thrill you must learn to control. Thrill seekers, like you and me (I include you because you didn't put this book down and are still reading), enjoy the rush we get from the experience so much that we want it all the time; hence the neophyte speculator will trade, wager, at the drop of a hat. Set up a proposition and he or she will plunk down her money, simply because win or lose, there's a sure payoff—the rush.

The core problem new commodity traders have is what we call "over-trading." This comes about when traders look more for an adrenaline high than for market profits. They find this by either (a) trading more often than they should, or (b) trading more contracts than they should.

It is really a question of intensity: the more contracts you have on, the more thrill you will experience. The more often you trade, the more often you will get an injection of endorphins pumping through your brain. These, then, are *your mortal enemies:* too many trades or too many contracts. Rich people don't bet big and they don't bet every day.

Patience dictates that you trade for a reason beyond the rush, beyond the swashbuckling images we carry in our minds of what a speculator does and thinks. Frequency and intensity, in my world of speculation, are not bigger and better. I want to be selective, to wait for the ideal time to take my very best shot. This is certainly not a business of scattergun shooting; we are like hunters waiting in the bushes until our game is in full view and about three feet away. Then and only then should we fire away!

Impatient traders literally use up all their ammunition, money, and emotions, so when it is time to shoot, their guns are empty.

## If You Can't Follow It, What Good Is a System or Strategy?

Technicians and the like are forever developing trading systems to beat the pants off the market. They spend thousands of hours and dollars in pursuit of profits. That is good; I do the same thing almost every day of my life in an attempt to seek greater understanding of the markets.

The difference is once they have arrived at their "master system" they take a trade or two and then begin either tinkering with the system or overruling what it is telling them to do. Years ago, my long-time friend Lin Eldridge put it best, "Why keep a system and do all that work if you're not going to follow it?"

Be honest with yourself. If you are not going to abide by the rules you create, why create the rules? You should be spending your time doing something else. When it comes to speculation, rules are not made to be broken unless you want to end up broke. The rules of speculation exist to tell the ideal time to get in and out, but more importantly the rules exist to protect us from ourselves.

Maybe you think this is not your problem, that following a system is an easy thing to do. It isn't.

Last year in America almost 52,000 people were killed—about 1,000 a week—in car accidents because they failed to obey one of two very simple rules, don't speed and/or don't drive if you have been drinking. Those are easy rules, not complex, not chock-full of emotions like the rules of speculation. Yet families went through major turmoil and grief due to those unexpected wrecks caused by not following a very simple system. Should you choose to speculate in a swashbuckling fashion, trust me, the financial results will be the same. There most assuredly will be carnage and ruin on your speculative highways.

The law of gravity always prevails and the law of gravity in our business must be obeyed.

## Christmas Doesn't Come in December

Here is the real rub with this business of being a commodity trader or speculator; we never, ever, know when we will make our money for the year.

Jewelry storeowners know they will make most of their money around the holidays or at Christmas. That is true of most retail stores, they know when the money is going to roll in and can plan for that event.

We cannot. That's one reason why I have written books and published a newsletter, I wanted a sense of some steady income in my life, plus it is

profitable! I may make money hand over fist for 12 months running or make nothing, in fact lose money, for the first 6 or 7 months of the year then hit the jackpot. One never knows in this world of roller coasters what will happen.

That is why commodity fund managers take a flat percentage of the assets under management. That way, they have steady income to offset their costs, despite the typical 20 percent of the profits they charge. They, like anyone else, need to have a consistent income stream.

To my way of thinking, most of you should not quit your jobs and become traders. Your job, as bad as it might be, is your security, your source of income, the guaranteed Christmas. Yes, I know you don't like your job, but you know what? I don't like mine every day either. It is no piece of cake getting beat up in the markets for 2 to 3 months. It is no joy to have a series of bad market calls in a newsletter where everyone can see the errors of my way—errors my enemies love to magnify and my best friends chuckle over.

But, none of that matters. In my world, I know you don't have to like it, you just have to do it. That means I must continue following a system, even while it is in a drawdown losing money, I must use stops when I don't feel like it, and I must keep telling myself Christmas may be delayed this year. What is more, I had better budget and plan my personal life accordingly; I must have enough cash to get me through an extended Christmas drought. And finally, if I do get lucky and find Christmas comes this year in January or February, I sure as heck can't expect it will be Christmas every day until December 25. There are no straight paths to heaven, my account equity is not a straight-up line, it is a meandering backroad that encounters plenty of peaks and valleys. That is why I never know when Christmas will come. I just know if I do the right things, eventually Santa will find my chimney.

## If You Have an Advantage in the Game, the Longer You Play the Greater Your Chances Are of Winning

If you know you have an advantage in the game, you know that at some point you will be collecting the chips, that Christmas will come.

This is a vital concept for all speculators, it is a concept to build a belief system on, but the concept itself cannot be built on a belief. Casinos don't operate on a belief. They operate, run their business, on pure math; they know that eventually the laws of the wheel or dice will prevail. Thus they keep the wheels spinning. They don't mind waiting, they don't stop. They also play 24 hours for a reason; the longer you play their negative expectation game, the more certain they are of getting your money.

I guess that is why I have always been amused by people who think they can go to Las Vegas to tap the casino's bank. Casinos look at you and me as fodder for their bank accounts, and judging from the size of the megahotels as well as stock performance, they are on the right side of the ledger.

As traders, we must realize that time is our ally. Legal contracts say time is of the essence; that may be so when it comes to performance of obligations, but time is not of the essence when it comes to trading because, given an advantage in a game, the more time that elapses the more certain your eventual winnings.

Casinos don't close for another reason; the players won't quit. Players overtrade, in our vernacular.

We are not casinos but we can sure learn a great deal from them. We need to know for sure that our approach has a statistical advantage in the game. You need to test, to prove your strategy. You cannot just assume what you are doing will make money because you are so darn smart or good looking. Once you have proven through research that your approach works, it is then just a question of backing your convictions by following the system.

## Press Your Winners Not Your Losers

This is the most important underlying rule of speculation. Losers do the opposite: they increase the size of their bets when losing and decrease their bets when winning! Losers see a guy lose all his money at a slot machine and rush in to take his place!

Winners look for positive streaks and press their advantage. I vividly recall a string of 18 winning trades in a row in the S&P 500 on a hot line I used to do. After 3 winning trades in a row, 75 percent of the subscribers would not take the next trades; after 6 winners in a row, no one took any more trades!

What is going on here is that the human mind cannot stand success and seemingly loves failure. People fear that winnings will turn into failure, whereas they apparently have more hope that failure will turn into success, so they willingly invest or speculate following losses.

The truth is success is the result of strings of winning trades, and to succeed you must not stop because you have been successful. Press the winnings. Failure is the result of strings of losing trades; the most certain indication that a system is failing is that it is experiencing strings of losses greater than seen in the past, exactly what the typical speculator is seeking to take advantage of! Admittedly, there is wisdom in waiting for short-term failure to start investing in a long-term successful system, but there is no wisdom at all in stopping because something has been "too successful"!

Press your winnings, gang, not your losses.

## Success Kills—Affluence Is Dangerous

Although we must, and will, press our winnings, we cannot let success go to our heads because affluence leads to overconfidence, which in turn leads to not following the rules that led to our success.

I have heard countless stories from traders who started following my approach and did very well, in some cases making over $100,000, then gave it all back. When pressed on what happened, the bottom line is always the same, the speculator confused luck and consistent application of valid rules with ego and ego prevailed.

Their ego told them they had finally arrived, they had enough money to take chances and didn't need the basics anymore. They were in charge! Thus they got into a "damn the torpedoes—full steam ahead" mode. No longer were stops so important, and since they were now trading too many positions or too many markets, when the hits came they were big. Too big—it was wipeout time.

How is this cured? There is a simple concept that I keep telling myself: you dance with the person you brought to the dance. Don't change because you see some other beautiful system or trading approach. If you are making money, stay with it, same rules, same logic, don't tinker. It has never been me that has made the money trading, it has been my following of some well-tested and proven systems or methodology. On my own, on your own, flying by the seat of your pants, you are headed for a crack-up. The more ego you involve and the further you stray from the operating rules of speculation the sooner the crash, and the more spectacular.

## Confidence, Fear, and Aggressiveness

> The meek will never make it as speculators so they had better have an inheritance.

The three traits speculators must learn to manage within themselves are confidence, fear, and aggressiveness: I will discuss them in this order.

***Confidence.*** You need have some confidence but not too much. The confidence comes from your study of the market and not from your feelings about yourself. Forget that entire warm fuzzy inner-child good feeling about your self-confidence. What you need is confidence based on experience and research that allows you to take correct action without choking when it is time to place a trade. Losers choke. Winners feel nervous about the trade, but they have enough confidence in the approach they are using, not themselves, that they place the trade.

Without confidence, you will never be able to pull the trigger and take your trades, especially during tumultuous market times, which is usually when the best trades pop up out of nowhere.

The meek probably do inherit the earth because they sure as heck are not going to make any money on their own as speculators. The inner assurance I have seen in big-time commodity traders is inspirational. Its essence is

not pluck or conceit, nor a sense of self-possession. What is at the core of their confidence is trust or faith that things will work out.

Winning traders see or believe in the future, to that extent they are full of faith. I believe in God, and that good prevails, that all things do work out favorably. If I don't let God down, I will not be let down. My belief that God prevails gives me the trust in the future to have enough confidence to trade when others fail to take action. I know my life will work out okay, that I have never doubted for an instant. Fear can be limiting, to the point a trader does not believe in the future.

***We Have More to Fear than Fear Itself.*** President Roosevelt had it all wrong about fear. That should come as no surprise, he single-handedly screwed up this great country more than any other leader ever has with his New Deal socialism and welfare state programs. Worse yet, he persuaded the masses and the media that his programs got us out of the Great Depression. Sure, like America would not have recovered or grown without him? I will never forget campaigning for the United States Senate in the general election and knocking on doors in a heavily Democratic district. Behind one of those doors was a wizened lady of at least 80 whose vote I asked for only to have her tell me she didn't vote. When I asked why, she said, "I voted only once in my life, that was for FDR, and after seeing what he did, I told myself that if I was dumb enough to vote for that son of a bitch, I should never vote again!"

Fear is a powerful force to help speculators perform at their peak. The best example of the use of fear that I know was expressed by Royce Gracie. You may not know who Royce Gracie is so let me tell you a bit about him.

Gracie is a world-class athlete, he is the guy in those Ultimate Fight pay for view TV shows. In case you haven't seen one, they are for-real fights, no boxing gloves and just about anything is legal from kicking to gouging. This is for real violence. What is interesting about Gracie is that in over 100 fights he has never been beaten. That is never as in never, ever. By anyone, boxers, kickers, elbow punchers, Tai kickers. No one has been able to beat this guy.

Considering that most of these would-be tough guys weigh from 225 to 300 pounds, Gracie's accomplished victories are even more awesome when you find out he weighs about 180 pounds and looks better in a Mr. Rogers sweater than fighting attire. You would never know the guy is a giant killer. Since I am fascinated with fighters and winners (they have a lot in common with speculators), I have followed this guy's career and listened intently to his words of wisdom.

In one interview, these television thugs were asked if they felt any fear going onto these fights because, after all, they are real—guys have been maimed, lost their sight, broken bones, suffered numerous severe concussions,

and at least one fighter has died. All the tough guys machine-gunned out their male macho line about having no fear of anyone or anything.

That is all of them but Gracie. He freely admitted he is scared to death every time he enters the ring. He went on to say he uses that fear to his advantage as it enables him to respect his opponent and not take reckless action or deviate from his personal fighting style. "Without fear," he said, "you cannot win as fear pumps me up for the fight but also assures that I will not lose control. What we do is very dangerous; my best protection is to be afraid so I protect myself in all the ways of my craft."

Like Gracie, I have an immense fear of trading, I have seen people wiped out, losing all they owned from poor speculation. Some went bankrupt, some really did go crazy, and several killed themselves. I suspect all these people had one thing in common: they did not fear the markets.

I think you need to fear the markets and fear yourself.

Although the markets are frightening, the emotions you and I interject into trading are downright scary. Without fear, there is no respect; if you do not respect the markets and fear yourself, you will become one more dead body on the long trail of commodity market casualties scattered across the land.

***The Right Dosage of Fear and Confidence Create Aggressiveness.*** There comes a time in every trader's life, about once a week in fact, when you have to get aggressive, either in protecting yourself or asserting your market expectations. It is kind of like that eye of the Tiger thing in the old *Rocky* movie. Unless you have a killer instinct, you had better fold your tent and go home. This is not a business for passive people who seemingly don't care whether they win or lose, people who lack that cutting edge to pick up a challenge and proceed.

I don't mean hostility as most people usually envision aggressiveness. Winning traders have a certain boldness to their action, and that boldness is the culmination of confidence, fear, and aggressiveness. In this battle for speculative profits, a well-thought-out plan with boldness will go a long way toward carrying the day.

# Chapter 13

# Money Management—The Keys to the Kingdom

*The creation of a speculators' wealth comes from how they manage their money, not some magical, mysterious system or alchemist's secrets. Successful trading makes money, successful trading with proper money management can create immense wealth.*

Here it is, the most important chapter in this book, the most important chapter in my life, the most valuable thoughts I can transfer from me to you. I have nothing of more value that I could possibly give you than what you are about to learn. This is not an overstatement.

What I am going to explain, is the formula I have used to take small amounts of money like $2,000 to over $40,000, $10,000 to $110,000, and $10,000 to $1,100,000. These were not hypothetical victories; we are not talking Monday morning quarterbacking—we are talking real time, real money, real profits that you can spend to buy all the luxuries of life.

Until you use a money management approach, you will be a two-bit speculator, making some money here, losing some there, but never making a big score. The brass ring of commodity trading will always be out of your grasp as you sashay from one trade to another, picking up dollars but not amassing wealth.

The truly shocking thing about money management is how few people want to hear about it or learn the correct formulas. When I am at a dinner or cocktail party, invariably the conversation turns to the markets. People want hot tips, or to know how I have been able to make a living without working. They want my secret. As if there is one!

The public or noneducated speculator thinks there is magic to trading, that somewhere, someplace someone has a magic decoder ring that correctly signals market action.

Nothing could be further from the truth. Money is made in this business by getting an advantage in the game, working that advantage on a consistent basis, and coupling this with a consistent approach to how much of your bankroll you have behind each trade.

## Most Traders Use a Hit-and-Miss Approach

Most traders who are confident enough to risk large sums of money, are also confident enough to think they can figure out the future. That translates into two problem areas.

First, we think we can select the winning trades from the losers in our system or approach. Worst, though, is knowing we are smart enough to do that we than trade an unequal number of contracts or shares on our various trades.

Just as we must consistently follow our battle plan to succeed, we must also be consistent in the amount of money we marshal behind each trade. The instant you get the notion you can "for sure" spot the big winners and back those trades with more contracts than you have been trading, trouble will find you.

Every now and then, you will hit it right and score big, but eventually, you will have a loss on that large position. The loss is bad enough, but since you have overstepped good money management, you will then become emotional and probably hold onto the trade too long in hopes of recouping the big hit. Thus things don't get better, they get worse!

Let me turn to our well-worn Las Vegas casino analogy one more time. Casinos all over the world limit their losses by having a maximum amount the player can bet on any one decision in every game. A good commodity trader should limit losses in the same way. Can you imagine a pit boss suddenly allowing a high roller to bet more than the house limit because the boss "feels" the customer is going to lose on the next roll? Of course not; the pit boss would be fired on the spot for breaking a cardinal rule of money management, risking too much.

Trading too much, betting too much will cost you far more than bad market calls.

## Approaches to Money Management—One Is Right for You

There are many ways to go about this problem, many formulas to follow. But all the superior systems to manage your investment dollars have a common tenet; you will increase the number of units, contracts, or shares as you make money and decrease as you lose money. That is the essence of the sweet science of the correct marshaling of your funds. This basic truth can be worked several ways.

I am going to show you the major ones in hopes you find the shoe that fits you. No discussion on the subject could be complete without bringing up the name Ralph Vince. In 1986, I ran across a money management formula for playing blackjack originally developed in a 1956 paper, "A New Interpretation

**System Report** *9/11/98 11:54:44 AM*

**System Number:** 387 **Description:** bonds 7/98 no bail

**System Rules:**

**Market:** **Test Period:** 1/1/90 **to** 7/16/98

**Summary**

| | | | |
|---|---|---|---|
| Trades | 310 | Begin Balance | $ 20,000 |
| PL Ratio | 1.4 | Ending Balance | $251,813 |
| Drawdown TT | ($3,988) | Equity Peak | $251,813 |
| Drawdown PV | -18.3% | Return | 1159.1% |

| Profitable Trades | | Losing Trades | |
|---|---|---|---|
| Wins | 230 | Losses | 80 |
| Win Pct | 74.2% | Loss Pct | 25.8% |
| Win Avg | $1,350.68 | Loss Avg | $985.55 |
| Largest Win | $10,137.50 | Largest Loss | ($1,956.25) |
| Most Consec Wins | 31 | Most Consec Losses | 6 |
| Avg Consec Wins | 4.11 | Avg Consec Losses | 1.45 |

| | |
|---|---|
| Number of trades to reach the maximum units traded | 43 |
| Number of days to reach the maximum units traded | 370 |

**Base Unit Calculation Rules**

ONE CONTRACT ONLY

**Figure 13.1** Bond trading system without money management.

of Information Rate," regarding flow of information and now called the Kelly formula by commodity traders.

What I know about math, you could add up on your thumb and first finger, but I know "math works" so I began trading commodities using the Kelly formula (see Figure 13.1). Here it is with *F* representing the amount of your account you will back every trade with:

$$F = ((R + 1)*P - 1)/ R$$

P = Percentage Accuracy of the System Winning

R = Ratio of Winning Trade to Losing Trade

## System Report

*9/11/98 3:06:15 PM*

**System Number:** 387 **Description:** bonds 7/98 no bail

**System Rules:**

**Market:** **Test Period:** 1/1/90 **to** 7/16/98

**Summary**

| | | | |
|---|---|---|---|
| Trades | 310 | Begin Balance | $ 30,000 |
| PL Ratio | 1.4 | Ending Balance | $18,107,546 |
| Drawdown TT | ($3,988) | Equity Peak | $18,107,546 |
| Drawdown PV | -61.3% | Return | 60258.5% |

| Profitable Trades | | Losing Trades | |
|---|---|---|---|
| Wins | 230 | Losses | 80 |
| Win Pct | 74.2% | Loss Pct | 25.8% |
| Win Avg | $1,350.68 | Loss Avg | $985.55 |
| Largest Win | $10,137.50 | Largest Loss | ($1,956.25) |
| Most Consec Wins | 31 | Most Consec Losses | 6 |
| Avg Consec Wins | 4.11 | Avg Consec Losses | 1.45 |

| | |
|---|---|
| Number of trades to reach the maximum units traded | 310 |
| Number of days to reach the maximum units traded | 0 |

**Base Unit Calculation Rules**

BASE UNITS = account balance/(draw down*2)

If Account Balance Increases by: units last trade
INCREASE units on the next trade by: 1
If Account Balance Decreases by: units last trade
DECREASE units on the next trade by: 1

**Figure 13.2** Varied results based on risk % of account.

Let's look at an example using a system that is 65 percent accurate with wins 1.3 times the size of losses. The math is done as follows using $P$ as .65 and $R$ and 1.3:

$$1.3 + 1^{*}.65 - 1/1.3$$

$$2.3^{*}\ .65 = 1.495 - 1 = 0.495/1.3 = 38\% \text{ of account used to trade}$$

In this example, you would use 38 percent of your money behind every trade; if you had a $100,000 account you would use $38,000 and divide that by margin to arrive at the number of contracts (see Figure 13.2). If margin was $2,000, you would be trading 19 contracts.

## The Good, the Bad, and the Ugly of Money Management

What this formula did for my trading results was phenomenal. In a very short time, I became a real-life legend, as very small amounts of money skyrocketed. Using a percentage of the money in the account, based on Kelly divided by margin, was my approach. It was so good that I was kicked out of one trading contest because the promoter could not believe the results were accomplished without cheating. To this day, people on the Internet claim I used two accounts, one for winning trades and one for losers! They seem to forget, or not know, that in addition to being highly illegal, all trades must have an account number on them before the trade is entered, so how could the broker, or myself, know which trade should have the winning account number on it?

But, what would you expect, when no one to my knowledge, had turned in that type of performance ever before in the history of trading. To make matters "worse," I did it more than once. If it wasn't a fluke or luck, the losers lament is that it must have been done by pinching some numbers or trades along the way!

What I was doing was revolutionary. And, as with any good revolution, some blood flowed in the streets. The blood of disbelief was that first the National Futures Association and then the Commodity Futures Trading Commission commandeered all my account records, looking for fraud!

The CFTC went through the brokerage firm's records with a fine-tooth comb, then took all my records and kept them for over a year before giving them back. About a year after getting them back, guess what, they wanted them back again! Success kills.

All this was due to market performance that was unheard of. One of the accounts I managed went from $60,000 to close to $500,000 in about 18 months using this new form of money management. Then the client sued me, her lawyer saying she should have made $54,000,000 instead of half a million.

Now my believers were willing to put me on a pedestal, if they could collect some money. The revolution was more than anyone could handle.

What a story, huh?

But there are two sides to the edge of this money management sword.

My extraordinary performance attracted lots of money for me to manage. Lots of money, and then it began to happen: the other side of the sword flashed in the sun. Amidst trying now to be a business manager (i.e., running a money management firm) with precious few skills at doing something I am no good at anyway, my market system or approach hit the skids, with a cold streak that saw equally spectacular erosions of equity. Whereas I had been making money hand over fist, I was now losing money, hand over fist!

Brokers and clients screamed, and most took the off-ramps, they simply could not handle this type of volatility in their account balances. My own account, which had started the first of the year at $10,000 (yes, that is $10,000.00) and reached $2,100,000 . . . got hit along with everyone else's . . . it too was caught in the whirlpool, spiraling down to $700,000.

About then, everyone jumped ship but me. Hey, I am a commodity trader, I like roller coasters, is there another form of life? Not that I knew, so I stayed on, trading the account back to $1,100,000 by the end of 1987.

What a year!

Watching all this over my shoulder every day was Ralph Vince, when we were working together on systems and money management. Long before I could see it, he saw it, saw there was a fatal flaw in the Kelly formula. I was too blind; I kept trading it, while Ralph, math genius that he is, began intense research into money management, the culmination of which are three great books. His first was *The Mathematics of Money Management*, followed by *Portfolio Management Formulas*, and my favorite, *The New Money Management*. These are all published by John Wiley and Sons, New York, and are must-reads for any serious trader or money manager.

Ralph noticed the error of Kelly, which is that it was originally formulated to assist in implementing the flow of electronic bits, then used for blackjack. The rub comes from the simple fact that blackjack is not commodity or stock trading. In blackjack, your potential loss on each wager is limited to the chips you put up, whereas your potential gain will always be the same in relationship to the chips bet.

We speculators don't have such an easy life. The size of our wins and losses bounces all over the place. Sometimes we get big winners, sometimes miniscule ones. Our losses reflect the same pattern: they are random in size. Figure 13.3 shows a trade-by-trade recap on a system I use so you can see the irregularity of wins and losses.

As soon as Ralph realized this, he could explain the wild gyrations in my equity swings; they came about because we were using the wrong formula! This may seem pretty basic as we are about to enter a new century, but back

then we were in the midst of a revolution in money management and this stuff was not easy to see. We were tracking and trading where, to the best of my knowledge no one had gone before. What we saw were some phenomenal trading results, so we did not want to wander too far from whatever it was we were doing.

Ralph came up with an idea he calls Optimal F; it is similar to Kelly, but unlike Kelly can adapt to trading markets and gives you a fixed percentage of your account balance to bankroll all your trades. Let's look at what can happen with this general approach.

## On the End of a Limb and Sawing It Off

The problem with an optimal F approach or fixed fraction of your account is that, once you get on a roll, you roll too fast. Let me prove my point; if your average win/loss trade is $200 and you have 10 trades per month and you will increase on contract at every $10,000 of profits, it will take you 50 trades or 5 months to add that first additional contract. Then it will take only 2.5 months to go from 2 to 3; about 7 weeks to boost it up to 4 contracts; 5 weeks to jump to 5; one month to reach 6; 25 days, to 7; 21 days, to 8 contracts. Eighteen days later, you are at 9, and at 16.5 days, you trade a 10 lot.

Then disaster strikes, as it surely must. You have now scooted out on the end of a limb and are sitting there with lots of contracts on. Although the limb snaps when you have a large losing trade (3 times the average of $200 or $600 per contract times the 10 lot so you just dropped $6,000), you have not given back $10,000 yet. So you trade a 10 lot on the next trade and lose another $6,000. Now in two trades, you are down $12,000 from your equity high at $100,000.

The next trade is also a loser, three in a row, for the average of $200 times the 9 lot you are now trading and you get tagged for another $1,800 (let's call it $2,000). You are now down $14,000.

Meanwhile, a "smarter" trader decreases faster than you, cutting back two contracts for every $5,000 lost, so on the first hit he or she is back to 8 contracts, losing only $2,400, sidestepping another $6,000 hit, and on it goes.

## And It Can Get Worse by Far. . .

Let's take a winning system. It wins 55 percent of the time, and you decide to trade 25 percent of your bank roll, starting at $25,000 on each trade. Wins are equal to losses at $1,000 each. Table 13.1 shows the way the trades played out.

You made $1,000 yet had a 65 percent drawdown while a single contract trader would have dipped $16,000 with a 20 percent drawdown!

Let's look at another scenario where we hit it right from the get-go winning 5 of 8 trades (Table 13.2), a great deal, right?

**Table 13.1**
**Winning 55 Percent of the Time**

| | | |
|---|---|---|
| 1. | −6,000 | 15,000 |
| 2. | −3,000 | 12,000 |
| 3. | −3,000 | 9,000 |
| 4. | +2,000 | 11,000 |
| 5. | −2,000 | 9,000 |
| 6. | −2,000 | 7,000 |
| 7. | +2,000 | 9,000 |
| 8. | +2,000 | 11,000 |
| 9. | +3,000 | 14,000 |
| 10. | +3,000 | 17,000 |
| 11. | +4,000 | 21,000 |

**Table 13.2**
**A Winning Combination**

| | | | |
|---|---|---|---|
| 1. | +5,000 | 25,000 | |
| 2. | +6,000 | 31,000 | |
| 3. | +7,000 | 38,000 | |
| 4. | +9,000 | 47,000 | |
| 5. | +11,000 | 58,000 | (Wow) |
| 6. | −14,000 | 44,000 | |
| 7. | −11,000 | 33,000 | |
| 8. | −16,000 | 13,000 | What?? |

Look at this . . . 5 winners, 3 losers, and you are down. How can this be? Well, it is a combination of two things, one the money management that got you to the $58,000 also brought you down. Plus, I threw in a kicker, the last trade was just like trades the market gives us all the time, a loss 2 times greater than the average loss. Had it been the traditional loss, your account would be at $26,000. The smart trader who cut back twice the amount after the first loss would have lost $5,000 on trade 7, taking him to $29,000 and −$8,000 on the double hit on trade 8 to show a net of $31,000!

## Looking in New Directions, Drawdown as an Asset

My trading stumbled along with spectacular up-and-down swing, while we continued looking for an improvement, something, anything that would tame the beast. From this search came the basic idea that we needed a formula that would tell us how many contracts to take on the next trade.

One such thought was to divide our account balance by margin+ the largest drawdown the system had seen in the past. This sure makes a lot of sense. You are sure to get hit by a similar, if not larger, drawdown in the future, so you had better have enough money for that plus margin. Matter of fact it struck me that one would need an amount equal to margin + drawdown *1.5 just to be on the safe side.

Thus, if margin was $3,000 and the system's largest drawdown in the past had been $5,000, you would need $10,500 to trade one contract ($3,000 + $5,000*1.5). This is not a bad formula, but it does have some problems.

I am now going to show several money management schemes applied to the same system. The system is one of the best I have, so the results will look a little too good. You should also notice the almost unbelievable gains the system produces, millions of dollars of profits. Now the reality is this system may not hold up in the future exactly like this. Most of you will not want to trade up to 5,000 bonds, as this test allowed, which means one tick, the smallest price change bonds can have, will cost you $162,500 if that one tick is against you. Let me add, it is not unusual for bonds to open 10 ticks against you, on any given morning, that is $1,625,000! So, don't get carried away with the profits, focus on the impact money management can have on the results.

What you should focus on is the differences in performance produced by different approaches to managing your money. The system trades bonds, which have a $3,000 margin. Figure 13.1 shows no money management; it simply reflects the complete results of the system from January 1990 through July 1998, starting with a $20,000 account balance.

Now we will take this same system and apply a variety of money management strategies so you can see which one might best work for you. To arrive at the inputs, I ran the system for just the first 7 years, then traded forward with money management for the remaining time period so the drawdown, percent accuracy, risk/reward ratios, and the like were developed on sample data and run on out-of-sample data. I allowed the system to trade up to 5,000 bonds, which is a heck of a lot.

## Ryan Jones and Fixed Ratio Trading

Another friend, Ryan Jones, went at trying to solve money management like a man possessed. I met him when he was a student at one of my seminars; I later went to his seminar on my favorite subject, money management. Ryan has thought about the problem a great deal and spent thousands of dollars and research formulating his solution called Fixed Fractional Trading.

Like Ralph and me, Ryan wanted to avoid the blowup phenomenon inherent in the Kelly formula. His solution is to wander away from a fixed ratio approach of trading X contracts for every Y dollars in your account.

His reasoning is based largely on his dislike of increasing the number of contracts too rapidly. Consider an account with $100,000 that will trade one contract for every $10,000 in the account, meaning it will start trading 10 contracts or units. Let's assume the average profit per trade is $250, meaning we will make $2,500 (10 contracts times $250) and need 5 trades to increase to trading 11 contracts. All goes well, and we keep making money until we are up $50,000 with a net balance of $150,000 meaning we are now trading 15 contracts, which times $250 nets us $3,750 per win. Thus we increase an additional contract after only three trades. At $200,000 of profits, we make $5,000 per trade, thus needing only two winners to step up another contract.

Ryan's approach is to require a fixed ratio of money to be made to bump up one contract. If it takes $5,000 in profits to jump from one to two contracts, it will take $50,000 in profits on a $100,000 account to go from 10 to 11 units. The fixed ratio is that if it took 15 trades, on average, to go from one to two contracts it will always take 15 trades, on average, to bump on to that next level, unlike Ralph's fixed ratio that requires fewer trades to go to higher levels.

Ryan accomplishes this by using a variable input (one you can alter to suit your personality) as a ratio to drawdown. He seems to prefer using the largest drawdown times 2. We will now look at the same trading system for the bond market with the Ryan Jones formula.

As you can see, this approach also "creates wealth" in that it brings about an exponential growth of your account, in this case $18,107,546! However to achieve the same growth as with the other formulas you need to pony up a larger percent of your bankroll on each bet. This can result in a wipeout scenario as well, unless you use a very low percentage of your money, which in return guarantees a less rapid growth in your account.

## And Now My Solution to the Problem

In talks with Ralph and Ryan, I became aware that what was causing the wild gyrations was not the percent accuracy of the system, nor was it the win/loss ratio or drawdown. The hitch and glitch came from the largest losing trade and represents a critical concept.

In system development, it is easy to fool ourselves by creating a system that is 90 percent accurate, making scads of money, but will eventually kill us. Doesn't sound possible does it? Well it is, and here's how. Our 90 percent system makes $1,000 on each winning trade and has 9 winners in a row leaving us ahead by a cool 9 G's. Then comes a losing trade of $2,000, netting us $7,000, not bad. We get nine more winners and are sitting pretty with $16,000 of profits when we get another loss, but this one is a big one, a loss of

$10,000, the largest allowed by the system, setting us back on our fannies with only $6,000 in our pocket.

But, since we had been playing the game by increasing contracts after making money, we had two contracts on and thus lost $20,000! We were actually in the hole $4,000 despite 90 percent accuracy! I told you this money management stuff was important.

What ate us alive was that large losing trade. That is the demon we need to protect against and incorporate into our money management scheme.

The way I do this is to first determine how much of my money I want to risk on any one trade. I am a risk seeker so, for sake of argument and illustration, let's say I am willing to risk 40 percent of my account balance on one trade.

If my balance is $100,000 that means I have got $40,000 to risk and since I know the most I can lose is, say, $5,000 per contract, I divide $5,000 into $40,000 and discover I can trade 8 contracts. The problem is if I get two large losers in a row I am down 80 percent, so we know 40 percent is too much risk. Way too much.

Generally speaking, you will want to take 10 percent to 15 percent of your account balance, divide that by the largest loss in the system, or loss you are willing to take, to arrive at the number of contracts you will trade. A very risk-oriented trader might trade close to 20 percent of his or her account on one trade, but keep in mind, three max losers in a row and you have lost 60 percent of your money!

The final product of such a money management approach is shown in Figure 13.3. The $582,930,624 of "profits" came from determining a risk factor of 15 percent, taking that percentage of the account to arrive at a dollar amount which was then divided by the largest loss in the system.

As your account increases in value, you trade more contracts; as it declines, you trade fewer. This is what I do and this is the general area of risk I am willing to assume. It does not matter too much; a lower, and thus safer risk of 10 percent still makes millions of dollars.

What I find fascinating is that the Ryan Jones approach, which did very will, "made" only $18,107,546 while a one-contract trader would have made a mere $251,813, and my approach, at least on paper, makes a staggering $582,930,624. clearly, how you play the game does matter, it matters immensely.

Figure 13.4 shows the system with various risk percentages being used. The graph in Figure 13.5 depicts the increase in the account equity with the increase in percent risk drawdown directly next to it. As you can see, there is a point where the amount you make rises faster than the drawdown, then as the risk percent increases, drawdown increases faster than the increase on profits in your account. This usually takes place between 14 percent and 21

## System Report

*9/11/98 3:00:45 PM*

**System Number:** 387 **Description:** bonds 7/98 no bail

**System Rules:**

**Market:** **Test Period:** 1/1/90 **to** 7/16/98

**Summary**

| | | | |
|---|---|---|---|
| Trades | 310 | Begin Balance | $ 30,000 |
| PL Ratio | 1.4 | Ending Balance | $582,930,624 |
| Drawdown TT | ($3,988) | Equity Peak | $582,930,624 |
| Drawdown PV | -29.7% | Return | 1943002.1% |

| Profitable Trades | | Losing Trades | |
|---|---|---|---|
| Wins | 230 | Losses | 80 |
| Win Pct | 74.2% | Loss Pct | 25.8% |
| Win Avg | $1,350.68 | Loss Avg | $985.55 |
| Largest Win | $10,137.50 | Largest Loss | ($1,956.25) |
| Most Consec Wins | 31 | Most Consec Losses | 6 |
| Avg Consec Wins | 4.11 | Avg Consec Losses | 1.45 |

| | |
|---|---|
| Number of trades to reach the maximum units traded | 223 |
| Number of days to reach the maximum units traded | 2152 |

**Base Unit Calculation Rules**

BASE UNITS = account balance*.15/largest loss

**Figure 13.3** Varied results based on risk % of account.

System

**Begin Balance** $0.00

| Ending Balance | Peak/Valley Drawdown | Risk Pct | Max Units | Restart Pct | Min Profit | Trading Style | Recover Losses | Margin |
|---|---|---|---|---|---|---|---|---|
| $845,429,594 | -66.9% | 40% | 5000 | 100% | $0.00 | All Trades | No | $3,000.00 |
| 844,881,388 | -77.1 | 50 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 842,428,863 | -72.2 | 45 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 835,954,544 | -61.5 | 35 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 802,829,038 | -54.4 | 30 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 759,721,131 | -46.6 | 25 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 686,869,688 | -38.2 | 20 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 560,344,731 | -28.4 | 15 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |
| 18,606 | -7.0 | 10 | 5000 | 100 | $0.00 | All Trades | No | 3,000.00 |

**Figure 13.4** Top 10 optimization results.

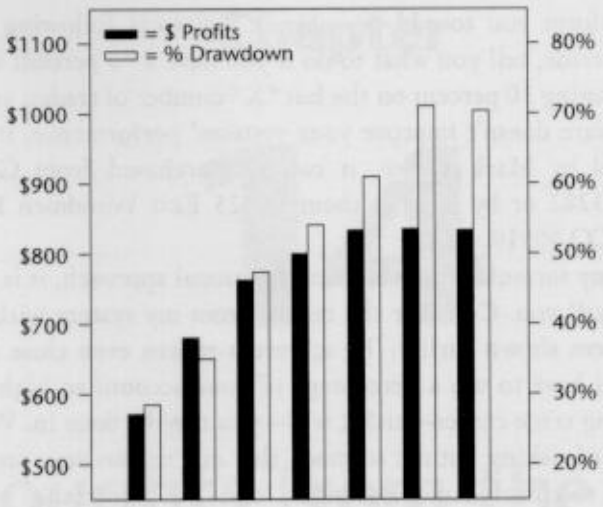



**Figure 13.5** Trading sugar.

percent; in most systems, any risk percent value greater than 25 percent will make more money but at a sharp increase in the drawdown.

> *So there it is, my money management formula: (account balance *risk percent)/largest loss = contracts or shares to trade.*

There are probably better and more sophisticated approaches, but for run-of-the-mill traders like us, not blessed with a deep understanding of math, this is the best I know of. The beauty of it is that you can tailor it to your risk/reward personality. If you are Tommy Timid, use 5 percent of your bank; should you think you are Normal Norma, use 10 percent to 12 percent; if you are Leveraged Larry, use from 15 percent to 18 percent; and if you are Swashbuckling Sam or Dangerous Danielle, use in excess of 20 percent of your account . . . and go to church regularly.

I have made millions of dollars with this approach. What more can I tell you—you have just been handed the keys to the kingdom of speculative wealth.

## Back to Ryan and Ralph

All equity runs and money management printouts in this chapter are from ULTIMANAGER a remarkable piece of software that allows you to test money management and trade selection techniques for any system. The software will teach you about your system or approach. For examples, it will tell you if you should add more contracts after "X" number of winning or losing

trades, inform you to add or subtract contracts following a big winning or losing trade, tell you what to do if you have a 70 percent accurate system that is running 30 percent on the last "X" number of trades, and on and on. If this software doesn't improve your systems' performance, it can't be done. Developed by Mark Thorn, it can be purchased from Genesis Data at 800-808-3282 or by writing them at 425 East Woodmen Road, Colorado Springs, CO 80919.

In any formula, even the fixed fractional approach, it is the largest loss that can kill you. Consider the results from my system with Ryan's money management shown earlier. To achieve a return even close to my formula, you would have to use a percentage of your account so high that when the large losing trade comes—and it will—you may be done in. What we need is a balance of risking but not so much that one or two very predictable events will cause too much damage. Longest losses are predictable.

# Chapter 14

# Thoughts from the Past

*Success in trading comes from knowing the markets well and knowing yourself better.*

Successful trading is based on a combination of using systems and the like tempered by thinking and controlling our emotions. To be successful, you need to know as much about yourself and market psychology as you do the markets. Until you get a handle on both these elements, your trading will not be at its best.

For that reason, I have selected what I think are some of my most useful writings from back issues of my newsletter, *Commodity Timing*. I hope they can help you, as they have helped me, become more balanced and controlled in trading.

*October 1995* *Volume 32, Issue 10*

### Lock-Up Time

*More comments on why traders "choke," freeze, or lock up, thus not trading, or worse yet, bypassing winning trades in favor of taking guaranteed losers.*

At least once a week someone calls, telling me they know what to do in the markets but just can't pull the trigger. They are afraid to do anything. Strangely, this is truer for traders with less to lose. The $10,000-and-under traders have more of this fear than the heavy capitalized traders.

#### Let's Take a Good Look at Fear Itself

We fear only two things. They are things we don't understand, hence there is no way to rationally deal with the situation, or similar things that have hurt us in the past.

It's no wonder then the markets stir up so much fear. No one really fully understands the markets . . . and are continually bitten by market alligators. So what's one to do for this self-inflicted catatonia?

Since fear is largely emotional, you need to reframe yourself with valid data to offset the fear. Here is some of that data.

First, if you use stops, you really can't get clobbered too badly. Ever. Sure, you will have losing trades. But wiped out, killed? That's not going to happen. Next, if you only trade with 30 percent of your bankroll at any one time, you can never get blown out. Again, never. Ever. The quickest way to bring sanity to trading is to use stops and only a fixed fraction of your bankroll.

> *By so doing, you have full understanding that you are trading with a huge safety net. You will survive, because you have controlled the seemingly uncontrollable game.*

At a more cosmic level, you need to check out if your deck of cards in life is one of blowouts, crashes, cycles of major success leading only to cycles of failure. For most, it isn't. You can trade (with stops and percentage of bankroll) knowing blowouts are just not your thing, not your spiritual calling. Speaking of spirituality, I'm a firm believer that God will not let us down. Knowing that gives me ample courage . . . sometimes too much, in fact . . . to trade, to pull the trigger.

*June 1995* *Volume 32, Issue 6*

### Enough on Greed . . . Now Let's Deal with Fear

*I've written at length about Greed being the dominant and most difficult emotion to deal with. Now it's time to walk through Fear.*

There are several things that distinguish winning traders from losers. Perhaps the least discussed is what I refer to as "locking up." I've seen it in countless traders, and experienced it myself many a time.

The repercussions of locking up are numerous, and all bad. A locked up trader doesn't get out of winners or losers . . . he/she is too frozen to act. Or, the lock up prevents you from pulling the trigger on getting into positions. This is the worst of all problems . . . a trader who can't trade! When this happens, know that fear is motivating you. The good news is that there are several things you can do to release the grasp old man fear has on your mind.

#### There Is a Lot More to Fear Than Fear Itself

Roosevelt was as poor at understanding emotions as he was at being a President. Have you ever noticed that sometimes it seems impossible to do something, maybe even something physical, like take action, step on the brakes, get out of harm's way, etc? You can be so locked up with fear that your attention is on the fear, not on taking the correct action. Yes, fear is the great immobilizer.

Proof? Okay, remember the last time you looked at a truly frightening person, some one either so ugly, so big, so dangerous, or of a different race that you "just knew" the guy was a killer? Okay, good, recall that. Then recall what you did . . . you turned away. You would not look into the object of fear. You froze, and not because you were hurt or because you were about to be harmed!

When you see fear, you MUST look directly into its ugly face before your fear will diminish. The vile villain we traders look at (the market), is that of being hurt. Hurt in our case means losing money and ego. There is no other harm that can become you in this business, ego and money, that's all there is to lose. So which is it for you?

The more you focus on losing, the better off you will be. Winners plan what to do if their trades don't work out. Losers have no plan for disaster; when it occurs, they don't know what to do . . . and are stuck in fear's grip.

Think about it. You, and you alone, have absolute and total control over what and how much you will lose. You control the number of contracts you trade, you control the stop or dollar risk (you set your fear level). Knowing that, what's there to be afraid of? That you might have another losing trade?

Let me tell you, O loyal follower, I have losing trades all the time. I had about 20 in a row a few years ago . . . losing trades are as much a part and parcel to this business as breathing is to living. It happens, always has, always will. Once you fully acknowledge that at a deep inner level (looking it in the face), and learn to only commit $$ up to your "Fear Level," fear will no longer have you in its ugly grasp.

*June 1996* *Volume 33, Issue 6*

### In an Information Age . . . Information Is Not Enough

*It takes more than data to be a winning trader . . . it also takes ability, attitude, and most importantly focus . . .*

#### What Dennis Rodman and You Should Have in Common

It's become increasingly clear to me, after all the seminars I've given, books and letters I've written, that just having winning approaches and strategies is not enough. To actualize my intentions to make more winning traders, I realized something was missing.

Years ago, I fell into the psycho-babble, mumbo-jumbo that psychological baggage kept us from maximizing our success. I no longer feel that is the main problem. The problem is one of focus. I'll explain:

McDonald's is not the largest purveyor of fast foods. They are big, about 14,000 restaurants worldwide. But the King of the business is, of all people, Pepsi Cola with over 24,000 stores including Taco Bell, Chevy's, Pizza Hut, California Pizza Kitchen, Kentucky Fried Chicken, Hot 'n Now, and numerous other food outlets. Pepsi's sales were recently 28.5 billion a year, Coca-Cola had 16.2 billion, and McDonald's 7.4 billion.

Yet the total market valuation (shares × market price) of Coke is 93 billion compared to Pepsi's 44 billion and McDonald's has a 31 billion valuation on 25 percent of the revenues of Pepsi!

Profitwise Pepsi earned 4 percent on sales compared to McDonald's 15 percent and Coke's 13 percent. The difference? Coke and McDonald's and more focused . . . more profitable.

Dennis Rodman is a great showman and basketball star. Why? Because early on in his college days his coach told him to focus exclusively on defense, forget being an offensive high scorer . . . and away his career skyrocketed. He has now become more profitable. Fellow teammate Michael Jordan unfocused to become a baseball player and became less profitable. Other unfocused sports stars Bo Jackson and Dion Sanders have also done less well than they could have by being one-sport athletes.

The year I turned $10,000 into $1,100,000 I was totally focused. Did nothing but trade, no marathons, no fishing, no family life, but, boy did I make money!

There are three levels of market focus. The first level is that of time and commitment. Most folks think that's all there is to it. It isn't. YOU must also focus on just a few markets and next focus on approach. Most traders follow too many markets with too many systems or approaches, becoming unfocused and unprofitable.

Like corporations that think they can grow by expanding into new areas, traders think they can make more money by following more markets with more systems. On paper, both strategies look good. In reality . . . they simply don't pan out thanks to the human element and Mr. Murphy's appearance and the least expected, and most costly, times.

Therefore, my bottom line is that while it helps to have winning strategies and valid data to base decisions upon, without focus—dedication—and single-mindedness—you will never maximize your ability to be a winning trader.

*May 1996* *Volume 33, Issue 5*

**Running, Trading, and Losing**

*Winning is easy to handle, but what about when all goes not quite so well?*

I know a little bit about losing. More than most, I suspect, because the truth is while I have had some spectacular wins and gains as a trader, I've also had my "fair" share of drubbings. Fact is, the last month or so have not been very pleasant around my house. A winning trade has been harder to find than a character witness for Mike Tyson.

In my case it's even worse than for you . . . I'm supposed to be an expert and not have this happen, plus I have several thousand people looking over my shoulder (at all times) seeing how positively poorly I am doing. Gads, that's enough to make one want to stop publishing.

So how does one handle these streaks of seemingly doomed failure?

My marathon running experience may have helped the most to answer this question. In every marathon I have ever run, 17 and counting, there has always been a spot where I ran better and faster than ever expected. And, by the same token, in every marathon I have run there's always been an "equity dip" a point of seemingly no return, no recovery. I'm not kidding here. At mile 23 in one run, I literally laid down in the street for about 5 minutes while runners I had passed earlier (my winning streak) sailed by.

What I learned about running was that the only way to snap out of those terrible, terrible letdowns was . . . to slow down . . . to walk a bit . . . even lie down in the street. In short, by stopping the pace and collecting myself, I was able to pick the pace back up and resume the race. Guess what, gang? It's the same with losing streaks. When they hit you, as they surely will, back off a bit, slow down, even stop trading, but stay in the race.

*November 1995* *Volume 32, Issue 11*

### Doing the Wrong Thing . . . It's So Easy, Isn't It?

*This business of trading commodities can get pretty funny.*

Pretty rough too. Take for example what I think is the *number one fault of all traders,* the love of a good debate.

It seems we are, or like to think we are, pretty smart cookies. Therefore "we know better," we argue our politics, religion and worst of all our markets. Thus when we can plainly see a market is in a downtrend, we become bottom pickers, trying to out argue the market itself.

Believing in some omnipotent power, we muster up all we have to argue with cold hard facts.

But that's not the half of it . . . the larger problem comes from us wanting to "beat" the system or the crowd. We attempt to do this by jumping the gun . . . by getting in ahead of time as we "know" the market, indicator or whatever will give a signal tomorrow and we want to be there first to prove we outsmarted everybody.

#### How to Prevent Jumping the Gun

We are a darned sight more concerned with showing off than we are with showing our winnings. That's costly in this business. Jumping the gun, arguing with the market (that means not doing what you know you should do) is just an immature attempt to prove our superiority. There are better, and far less expensive ways to establish such points. Trading is not a race, jumping the gun serves up no advantage. Speed without direction will never win a race.

The root problem is that we have probably defined intelligence incorrectly. We "smarty pants" perceive intelligence as an us versus them game and in that process use our supposed superior intellect to prove either (1) how big we are or (2) how small they are.

Intelligence is not about that, nor has it anything to do with IQ. *Intelligence is the ability to resolve problems.* Successful trading is the resolution of market direction, nothing more nor less. The more you focus on this, and the less on proving something—anything—the more money you will bank at the end of the year. Take action because it is correct, not because it might get you in quicker or prove how great of a trader you are. That's how one builds bank account in this business.

*April 1996* *Volume 33, Issue 4*

**Boston Marathon, 1996**

*Pain and agony are found on the streets of Boston as well as La Salle in Chicago . . . and give us an insight into trading commodities.*

I spent all of 1995 trying to qualify for the 100th, and greatest, running of the Boston Marathon. At my age, 53, one must run the 26.2 miles in less than 3 hours and 30 minutes. It took 12 marathons, one a month, before I squeaked in under the wire on the last day of 1995.

Pain and agony makes one's mind focus as well as wander during all those miles. Mine wanders and focuses on trading . . . what I discovered was the amazing similarities needed to succeed at both these callings.

No one has ever successfully traded or run these blasted races, on a consistent basis, without training. Training is the underlying key to running a marathon. For my money, literally anyone—that means you—could traverse those 26.2 miles. All you need to do is start slow, and keep extending your distances. Eventually, you catch yourself running 40–50 miles a week and . . . you are there . . . a marathoner. Ditto with trading. Spend that much time studying, paper or gingerly trading, and suddenly anyone, even you, are in the chips.

I've been passed by fat old ladies, little kids, and one guy smoking a cigar. Like I said, anyone can do it! You just learn to deal with pain and agony. It's there every day, in running or trading. Success comes from dedication, with a definite obsessive passion. There it is, what brings about success in either of these endeavors . . . passion, dedication, obsessiveness . . . it's what gets you through the pain . . . what brings you to the finish line.

*July 1996* *Volume 33, Issue 7*

### It's Not the Trade, It's the Battle

*Notes to myself on winning and losing.*

Traders are like gunfighters, we are only as good as our last trade. Or so we tell ourselves, thus committing one of the *major mental errors* in the game. The truth is there is little if any relationship to our current or last trade and how we will do overall. Jack Schwager makes the point that the best way to manage money between funds is to give some money to traders that are in large equity downswings.

It is no different with us.

But, we think the one battle (our current or last trade) is the entire war. In so doing, we get so bummed out, or elated, that we lose focus on the fact that trading is an ongoing war that never ends. It absolutely never ends. I will be trading until the day I die, that's a given. So, should I be concerned with the outcome of my current trade?

### Proud Ponies or Broken-Down Nag Syndrome

Well sure, to an extent, but it is not the be-all, end-all trade that will make or break my career. Yet we act like it is, prancing around like either a proud pony or roll over and play dead like an old nag. Which is also why I'm not betting the ranch on that one trade . . . there's more to my career than just the next spin of the wheel. The reason I am a short-term trader is that I don't have a long-term perspective (trust?). This then is my largest enemy; the inability to perceive that this is an ongoing process that will, hopefully, never end. Because of that we need to carefully marshal out our energies and capital to not scatter our talents across those multispecked charts.

*My battle plan is to wage a war, not a battle.*

*August 1996* *Volume 33, Issue 8*

### The Art of Fly-Fishing Revisited

*Fly-fishing and today's commodity traders have much in common that we can all learn from . . .*

While talking to a subscriber who owns a motel on one of the premier fishing streams back east, I stumbled onto an interesting analogy I'd like to share with you. My daddy taught me the fine art of catching trout long before the fly-fishing fad set in. Pops was never much of a fly-casting type, but could do an adequate double hall, carefully selected his tippets and knew the difference between a front-end weighted line and a double taper.

But he didn't use that stuff very much . . . fact is he looked down his nose on the L.L. Bean "fancy dancer fishermen" as much as they shook their heads at his beloved worms, grubs and grasshoppers. You'd never catch my dad at a Trout Unlimited meeting . . . but he could be seen after dark chasing night crawlers around our back yard with a flashlight.

I asked him once why he didn't fly-fish more often, to which he replied, "Son, I came out here to catch fish to take home to eat. Crawlers and Hoppers are the best thing I know of to catch fish with. Believe me, if those dainty little nymphs caught lots of fish I'd use them . . . but I sure as hell wouldn't get all dressed up in those fancy vests and pricey waders. This sport is about catching, not dressing."

Maybe that's why I don't have real-time quotes in my office, am pretty computer illiterate, don't read the *Wall Street Journal* and hobnob at Futures conferences decked out in Brooks Brothers suits. Invariably, successful traders tell me they became winners after they stopped keeping a jillion indicators, watching 3 or 4 monitors and following 5 hot lines every night. "It's the simple stuff that works" is the most common comment winning traders make.

*Sure, you can get all duded out to trade, but the truth is you'll catch more fish with worms and hoppers on a bent pin than any fly ever tied.*

*November 1996* *Volume 33, Issue 11*

## Fear and Greed, Looking Them in the Face Again

*Since they are the strongest emotions to screw up traders' psyches, I know we can never spend too much time dealing with these demons . . .*

### There's More to Fear Than Fear Itself

Obviously FDR was not only not a capitalist, he was also never a trader. There is a lot to fear about fear. But what it all gets down to is that fear is a blocking mechanism, a self-protection device, designed to keep us out of trouble.

While it's wise for fear to block or stop you from going into dark alleys after midnight, it's not wise to be afraid of taking trades.

My personal experience, plus that of talking to thousands of traders, is that the very best trades are the ones we fear the most. The greater your level of fear, the better the chances for a winning trade.

This makes absolute sense when you look at the opposite side of the coin, the trades we fear the least are the most dangerous. Why is this? Because in the world of speculation, the rules of investment profits are turned upside down; what looks good is bad, what looks bad is good. Trades that look like "sure things" seldom are, which is why trading is so difficult.

The point trades that make you tremble late at night are the ones you must take. But you can't. Wrong! You can take them once you have the realization that the risk on all trades is the same—the amount of your stop loss. A trade that looks like it's designed by Stephen King has no more risk than one from Mr. Rogers. AS LONG AS YOU USE AN ABSOLUTE DOLLAR STOP YOU WILL BLAST AWAY THE POTENTIAL RISK OF WHAT APPEARS TO BE A RISKY TRADE. In short, stops allow smart traders to take the trades everyone else passes by.

### Getting a Grip on Greed

Greed is a different breed of cat. The purpose of greed is to motivate, to cause us to excel, to strive for perfection . . . but since this never has been and never will be a perfect game or business . . . greed causes us to hold our losers, and winners, too long.

Plus, as I've learned the hard way, greed is the strongest of these two emotions. More money is lost due to overstaying positions (greed) than exiting due to the fear of losing money. Greed kills just as speed kills as we get out of control. The solution?

Systematic exit points.

The purpose of a system is to control your emotions of fear and greed, that's really why we have systems . . . to make it easy. So if you know where to take profits, you eliminate the power greed has over you . . . as long as you follow the system's rules. By getting a handle on fear (with stops) and greed (with known exit points or rules), we can trade free of emotional baggage.

*February 1997* *Volume 34, Issue 2*

## Pepsi Proves the Point

*Last year we wrote about the importance of focus using Pepsi Cola as an example, this year the market proves our point . . .*

### It's All About Focus

Last year we pointed out that Pepsi Cola was too broadly diversified . . . too unfocused . . . hence their market valuation on sales was far less than Coca-Cola.

Last week Pepsi announced they were getting rid of their restaurant business, Kentucky Fried Chicken, Taco Bell, and Pizza Hut and, lo and behold, the stock jumped up!

This is an all important life-lesson; You cannot do anything well without being totally focused.

Focus means you must first get rid of distractions, and annoyances to your goal or lifestyle. Then you need to continually define and redefine your purpose so that you can work on focus to and for that purpose.

As traders this means we need to identify what our personal market focus is. For some it means just short-term trading, for others it may mean just taking trades set up by Commercials and the Public, for others it may mean just following cycles, trendlines of W.D. Gann. . . . but it can never mean following all this stuff . . . which is exactly what most traders do. Defining your time frame of trading, one day, 3–6 days, 10–20 days, or longer, will give you trading perspective, plus enable you to use the indicators that work best for that time frame.

Most people seem to think they can affirm their way to market success with positive thinking, talking with their inner child or perhaps scheme with goals. That's devastatingly wrong. *Success in this business comes only from focus.* The more focused you are, the better of a trader you will be.

*April 1997* *Volume 34, Issue 4*

### Why Most Traders Lose Most of the Time

*I've spent years pondering why we are not more successful in our trading and think I may have the answer . . .*

It really gets down to this . . . markets can spin on a dime and most traders cannot.

That's why so many people fail at what looks like an easy game.

The scenario is that you get a signal to buy long. While you do that, your mind, being only human, affixes itself to the idea the markets will, should, and must go up. Damn the torpedoes, full speed ahead!

But a funny thing happens along the way; the market, being as fickle as it is, decides to head South. In that process, your technical bag of tricks clearly issues a warning if not an out and out sell signal. See . . . technical analysis "works."

Problem is, your reactive greed filled mind does not. It still wants that buy signal to be correct so it tells you to hang on; that what was, may yet become reality. Meanwhile reality is telling you that what was, was. Was, as in past tense. To compound the error, you have taken a few self-images or positive thinking classes or had a high school coach teach you the value of "hanging in there." So you do . . . to the chagrin of your real self-image.

We want to be right so badly that once our mind establishes a viewpoint (the market will rally), *it takes hell and high water (that translates into a margin call) to get us to face up to reality.*

Let me drive the point home. There's a bank robber (they've got about as much larceny in their hearts as traders) whose stakeout man tells him there's plenty of time to raid the vaults so he begins the chicanery, gleefully picking up the cash he's been hoping for. But, then the lookout beeps to say "the cops are coming." A bank robber would split, he'd change his plans. That's the difference between traders and bank robbers . . . traders would stay in the bank hoping the cop alert was a false signal!

The last signal, or indication in your work, is what you should be following, not the one before last that you are still hoping will work. Hope does not work in this business. Following the market does, that's reality. The instant you learn to trade reality, not wishes, you will break through the wall of fire to become a successful trader. Go for it!

*May 1997* *Volume 34, Issue 5*

### A Review of Losing Trades Showed That

*Subscribers sent me their trade recaps and I found that they are all doing pretty much the same thing.*

#### What Beginning Traders Have in Common

I'm spending a lot of time on losing this year, not because we are so inexperienced with it but because I figure that if you don't lose trading you should do pretty well in this game.

After a scrutiny of several subs' trades, a couple of things popped out, I'd like to share with you this month.

#### In Trading, the Weight of Evidence Does Not Prove the Point

The first thing I noticed is that these guys (which means all of us) were almost always buying at the end of a move. Why would that be? I suspect that's because novice traders wait and wait until it looks or feels like all the evidence is in . . . then they take action . . . buying at the high or selling the low.

This got me to thinking our problems are buying too soon—we are afraid of missing the move—or buying too late—we want proof the move is really underway.

The balance point to this, I think, is that we cannot buy until price has stopped going down, nor can we buy during the emotions of a strong rally. You need some indication from the market it will rally, but not too much, you can't wait until all the lights are green. The market will always try to scare you out/in or wear you out/in. It is these two extremes, you must stay away from. If you are getting in because of emotions, afraid the move has gotten away without you, pass on the trade . . . it's already too late.

Plus, once in a position we must give the market some room to move in our favor. That was the second most glaring error. These traders noticed many of their trades would have been correct if they used no stop. Well we do need stops, the problem was their stops were too close. Since they didn't want to lose much, they used close stops . . . and just lost more often! No one I know really has pinpoint precision timing, *UNTIL SOMEONE DOES,* stops need to be a good distance away from the market if we are to find success in trading.

*June 1997* *Volume 34, Issue 6*

### If You're Supposed to Quit When You Are Ahead, Shouldn't You Start When You Are Behind?

At the risk of breaking the Zurich Axiom to not seek order where there is none, I've been trying to determine if in fact it makes sense to start trading a system—or increase the number of contracts you are trading—when the system bangs out losers, not winners.

This viewpoint has long been debated by mathematicians and those who profess to understand money management. They are squarely of the opinion that YOU CANNOT AND MUST NOT increase or start trading when a system begins to falter. They are afraid it's just rain before a downpour.

Their point is that you may well be boarding a sinking ship, so it's best to stay ashore until you see the ship right herself with a few winning trades.

Traders, on the other hand, *or at least this trader,* have seen countless drawdowns turned around. Every year. For years. So we are inclined to think that even the worse storm is followed by brilliant sunshine. Always.

#### An Expert Speaks

In an attempt to get to the bottom of this, I first checked with the leading proponent of money management schemes, and long-time friend, Ralph Vince. His comments were illuminating; "First," he said, "The worse case is that all trades, winners or losers, are random. If that's the case, there is no difference between starting after a positive or negative streak. You will be doing yourself no service, or disservice by such an approach.

"The big question is if the system will continue working. I've done tons of research on that and have not found anything that predicts if a system or approach will continue to make money."

We agreed on this point. Even the fact a system has made money hand over fist—in real trading—for years—does not mean it will in the future. All we know about the future is that it will get here and that it will not be what we expected it to be. A system is based on some thing, if that thing or condition changes, out the window goes the system. To that extent, the past is meaningless to prove a point, of even a nonoptimized approach, to trading.

"If the future is at all close to the past," Ralph added, "Then, starting after losses will be to your advantage for the simple reason that you buy dips in bull markets—price goes higher. Like price, your equity curve will make a new high as well."

The bottom line then is that *IF YOU EXPECT A SYSTEM TO HOLD UP* you want a strategy for starting up or increasing contracts after losses. If you don't expect it to hold up, why are you trading it? The real bottom line bet is, "Will the system continue working?" That's unanswerable, but a choice we must make.

#### Simple Math

If you flip a fair coin 100 times, it should come up heads 50 times, tails 50, 25 times there will be two wins in a row, 12.5 times 3 in a row, and 4 in a row 6.25

times. Get it? A 50/50 system should always give 50 percent chance of next decision being repeated.

Or will it? In a Bond system I trade there has been 68 percent accuracy on 283 trades. In theory, if there has been a losing trade, there is a 68 percent chance of the next trade being a winner, two losers in a row, still a 68 percent win rate for the next trade.

But, that's not the reality of systems I use! In checking the systems I trade I found something truly amazing. In most of the systems the accuracy rate persisted after one losing trade, and in some for two losses in a row. But, after three losses in a row most of the systems (which were about 65 percent accurate) jumped up to over 80 percent winners.

Best yet, the average winning trade was about 130 percent greater than all average winning trades! Wow, we are on to something here . . . proof of what I have always done, increase my positions following enough losses that I got angry with myself!

I know . . . I know . . . you want some hard rules of how to implement such a strategy; I'll continue working on that, and hopefully guys like Ralph, Ryan Jones, and Mark Thorn will have some insight into all this. For now, my rule will be to increase one unit following three losing trades.

*July 1997* *Volume 34, Issue 7*

## Don't "Show Me the Money"

*Tom Cruise had it all wrong in* Jerry McGuire, *but what would you expect from Hollywood, brilliance?*

### It's Not About the Money

I've spent most of the last 30 days in hospitals with my mother's massive heart attack. Trust me, having all the money in the world could not offset being deprived of health. I have been broke and down and out in my life . . . and I'll take that to hospital living any day of the week.

You probably know that. But I'd like to think I picked up some wisdom while there. After all, you know me, the constant researcher, I was asking questions, checking out statistics and all to figure out how to prevent ending up there.

This quest really began years ago when Dr. Barney Meltzer told me I had two choices, to either be a fabulously wealthy commodity trader with all sorts of physical ailments or settle for making a lot of money, but living more fully and more functional than I was. Thanks to Barney, I got off the adrenaline lifestyle, changed a few things, and here I am a pretty happy person. Which I wasn't then even though it was not unusual to make $350,000 to $900,000 a month back then!

### In a Nutshell—How to Stay Healthy (The Wealth Will Follow)

I spent several nights with the emergency center crew. They said about 20 percent of their patients just let something go too long, a cold, sore throat, infection, so at 2 A.M., decided they "had" to do something about it. They estimated that 60 percent of their "customers" were there because of drugs or alcohol. Sure, the trauma may have been a car wreck, knife or gun fight (both such popular sports in Montana that there's a sign on the hospital door requesting all guns be checked in at the main desk), but the cause of the problem was rooted in too many and too much chemicals of one form or another.

So, that's 80 percent of the problems. Of the remaining 20 percent, I was told 10 percent were work related, and the remaining 10 percent were genuine accidents! There's a lesson here . . . don't do drugs, drink too much, or go to work!

### And Here's The Big One

As I snooped around I noticed something else . . . the one big thing that about 95 percent of the patients with major problems shared in common.

I had noticed this earlier when I took my mom to a doctor appointment. Virtually all the people coming in to see the sawbones had this one ingredient in common. Also noticed that of my mom's friends the healthiest and most vibrant one of the group did not share this in common. In short, whether they were smokers, drinkers, Mormons, Catholics, short or tall, old or very old, it came down to this:

*The more overweight they were, the more health problems they had.*

That is a powerful statement and I hope you will take a long hard look at your waistline—right now—to see if you are not headed for problems. *(I am personally convinced that being overweight is worse than smoking, some smokers don't seem to be fazed by it, but all overweight people suffer.)* The important thing, as Dr. Meltzer told me, is that once a person gets so out of shape or overweight, the trendline is too steep to correct. You just can't pull out of it, the bear market begins and thanks to old man age, it gets pretty ugly.

Well, enough of this wandering from the markets, but it's done with intent . . . I do want you to live life at its best and for a long time . . . after all it's hard getting good subscribers, I want those renewals!

*August 1997* *Volume 34, Issue 8*

### The Number One Reason We Lose Money Trading

*Let others talk about how much they make, I want to work on losing less!*

There are as many ways to lose big money trading as there are traders, yet there is a strong common denominator to each and every loss I have taken. If I can avoid this, I should be able to sidestep much of the pain usually associated with this business.

Here it is then, the biggest reason we have big losses . . .

*Large losses come about when we let our belief systems override reality.*

What I mean by this is that we pay more attention to our advisors, prejudices, hopes and aspirations than we do to what's really going on. That literally forces us to hold onto losing trades . . . and to keep holding on. The secret to winning in this business is to *get out of the losers as soon as possible and hold onto the winners.*

While I have a strong belief that I will make money trading, I have an equally strong belief that every possible trade I enter may well wipe out my account.

My belief system used to be that every trade would work out OK, and I had some very disastrous equity dips. I held onto what I should have pitched, which also *forced me* to pitch what I should have held onto! My positive approach to life, my belief system, was killing me, as I was not listening to reality: *Rocks are hard, water is wet, bad things happen, commodities are risky.* Believe that and you will sure as heck protect your hard-earned dollars. I trust my systems and trading techniques, but I don't believe for an instant that they will work on the next trade! That's a healthy, profitable attitude.

This is a universal truth. How many people do you have in your life that you should have "stopped out" of the relationship long ago? I know my life works best when I cut away from so-called friends that are really emotional drains and stay with those that enhance my enjoyment of life. If that works in living, it will work in trading!

*September 1997* *Volume 34, Issue 9*

### The Most Important Trading Belief You Have

*In this business a positive mental attitude and affirmations can kill you. Instead, try this.*

#### Belief Systems

While it is true that you are only as powerful as your belief system, the real advantage a belief system can bestow upon you is that a firmly held belief will give you more certainty to take action.

Traders have trouble taking correct action, as we lack certainty, thus the study of what we believe is critical to our success.

If you get all pumped up with positive beliefs about your market success you will believe so much (in that coming about) that you will mismanage losing trades. After all, if your belief system is that your current trade will be a winner—and it isn't—the certainty of that belief will have you holding onto losers, something no successful trader does. Ever. An outrageously positive belief about your success (on any one to two trades, not your total career as a trader) will have you rushing in where angels themselves fear to trade.

*My strange belief system is that the current trade I am in will be a loser . . . A big loser at that!*

Sounds negative, but it is most positive. If that is my belief, I will certainly be careful in taking the trade and for sure will manage the trade "by the books" that means my stops will be in—at all times—I will exit when my methodology says to, not my whims, wife, or broker. Every major loss I have had trading (and I've had more than my fair share) has come from believing my current trade would be a big winner, so I did not follow the rules of the game.

Adopt my belief system, that this trade will most likely be a loser, and you sure as heck will protect yourself!

#### A Note on Fear and Greed

Some years ago I postulated that greed is a greater motivating factor than fear. Recently a student, and psychologist, questioned that with convincing evidence that most people fail as fear (of failure or loss) keeps them from taking action.

My reply was that those of us who have decided to trade are not "most people" we have already broken the shackles of fear, evidenced by the fact we are trading. Back to his studies went the PhD and discovered this is true in animals as well. Rats when hungry (motivated by "greed") will take risky action to get food that they will not take when not hungry. We traders are like the hungry rats . . . motivated by greed.

*November 1997* *Volume 34, Issue 11*

### How to Buy a System/Newsletter . . . They Are All Making Money!

*That is all the system/software/newsletter seminar types were raking money in at the recent Futures West Symposium . . .*

#### Opening Up the Hornet's Nest

Let me first say I've sold as many books, seminars, maybe even systems, as anyone, so it's fair to ask is the pot calling the kettle black about this month's comments on "vendors" of commodity information.

The recent Futures West Symposium presented a great opportunity for traders to see new products, hear from speakers and mingle with one another. I certainly enjoyed seeing many of you there.

What I did not enjoy was the hawking of supposedly infallible systems and techniques by a host of vendors, many whom, from what I can tell, don't even trade. The claims of profits and "ease" of trading have gotten way out of hand. Accordingly, here are my comments on how to spot the good and bad apples.

#### How to Spot a Good Trading System/Program

All the vendors have fancy brochures, impressive track records, scads of testimonials, computer printouts and the like, making it very difficult to separate reality from hype. It gets even worse when you read *Investors Business Daily*, as you can see from the recent crop of ads.

All the computer printouts and fancy brochures are meaningless, so is the price (I recently monitored one of those $10,000 types of systems and saw it lose on just about every trade). Frankly, so it is having a "NAME" behind the system, mine or anyone else's. Yes, it tells about credibility but is still no assurance of future success.

#### Signs of a Bad System or System Seller

Anyone who tells you this is easy, implies little risk, and "almost" assures profits is a definite pass. T'aint so. Anyone who claims very high rates of return—without confirmation slips and account statements from a broker—is also a hustle in my opinion. The lack of a guarantee or a wishy-washy one is a red flag. Testimonials can be bogus. I know of several systems sellers that have shills professing how great the system is. Also, don't trust the "limited quantities to be sold" pitch. Most the sellers I know use this but have yet to turn away a single buyer. Finally, the more complicated and/or technically oriented the system is, the worse it will probably do. *There must be a reason or theory to why it should work; check the premise as much as you check out claimed results.*

#### The Sure Sign of a Good System

The proof is in the pudding and when it comes to tasting the pudding we're looking for brokerage firm confirmations. Little else matters. If a system is as great as the seller claims it is, he/she should sure as heck be trading it. Given most any

form of money management, the simplest of valid systems can make far more money trading than by being sold . . . and without the pressure of dealing with the public.

*Advisory Services* present a little different problem. There is only one that I know of that takes all their own trades, that's Russell Sands Turtle Talk. Without this, you need an independent measure of the letter's success. There's only one, *Commodity Traders Consumer Reports*. If a service is not monitored here it's probably because they don't want the warts to be exposed. Being under the microscope is not fun . . . just necessary. Also, I suggest you check several time periods to see if the letter is just currently on a hot or cold streak. Has their performance been dependable? That's the issue.

*April 1998* *Volume 35, Issue 4*

### Twitching Worms and Traders

A recent seminar attendee, "Trader Rick" E-mailed the following; it's good reading to understand what to look for and reflect on in yourself.

"Would you like yet another story that proves you should not be an emotional trader? Well here it goes; you'll find it interesting.

"Last weekend I decided to place a buy stop in May Copper at 77.80, first thing Monday morning. Shortly after Copper opened I called my broker (unfortunately my regular broker does not come in until around 8 A.M.) and asked, "What's Copper called this morning?" He replied, "I don't follow Copper, I really don't know, I'd have to look it up . . ." (Oh brother, never mind)

"OK," I said, "what's the last price" and was told it was trading at 77.00 down from 77.90, this told me price had already gone above my stop so I thought I'd wait for a pullback.

### Afraid to Buy, Afraid to Sell

"I called back later, price was at 77.30. Again, I did nothing. Why you ask? I really don't know, except I thought I'd "watch the market" to see what it would do. The funny thing is I now know if it went higher I would have waited for a pullback, if it went lower I would have been afraid to buy. *Up or down would scare me out,* and that's just what happened! What would I have "seen" anyway, handwriting from God?"

"Later in the day I called back, Copper was now at 80.30. "Damn . . . OK, buy one at the market." Now I knew that Copper was really hot, and I was violating everything you had taught us that weekend. But something, almost a mysterious force, "pushed" me into the trade. I bought pretty much at the high of the day, because I was *so upset* I had not gotten in earlier.

"The very next day Copper began a pullback, fortunately, it eventually went higher, but the cost would be $500. Dumb, dumb, and dumb. Haven't I learned anything yet? Yeah, I have, it's simply this, "Plan your trades and don't deviate, don't let emotions push you over the cliff at just the wrong time."

### It's Just Like Fishing

"It kind of reminded me of fishing, how I'll toss a worm in and wiggle it just a little, no bite, then a little more, still no bites, then just a little twitch and . . . BLAM! I've hooked a nice fish. The market seems to hook me just like I catch fish with those little wiggles until I just can't resist and I fall for it, hook line and sinker.

"Trouble is this is not catch and release, it's bite and lose, no more "forced feeding frenzies" for me!" The next time old man greed taps you on the shoulder or you hear its emotional call luring you to the bait . . . don't bite!

In fact when in "the old days" when I did very short-term trading off a quote machine, one of my best rules was to cancel any entry into a trade if there have been 18 rally bars. It didn't seem to matter if they were 5-minute bars, 30 minutes or hourly, but on a consistent basis I would say that 18 bars, worm twitches if you will, is about all the human mind can take before it snaps, and is then snapped in the pocketbook.

*May 1998* *Volume 35, Issue 5*

### The Worst Dog I Ever Had, Cost the Most

*It was the snippiest, most belligerent untrainable mutt you could imagine and it cost the most because it had been bred for a couple of hundred years to be the perfect dog. Instead it was a disaster.*

Commodity trading systems are a lot like that damned dog. The more you tweak and refine them, the more you optimize and try to improve the breed of trades the system kicks out the worse the dog performs.

So far this year my personal trading sucks. I've been up as much as 30 percent, down the same amount and sit today with about a 10 percent gain for the year, not much considering the risk and effort for all this. Naturally, I had to ask myself why.

The answer came pretty quick. Last year was a great year, the account I traded went from $50,000 to over $1,000,000. And guess what . . . that wasn't good enough for me so I kept breeding the system, tweaking it, thinking I was fixing it. Some fix! The peak of perfection in commodity trading is not attainable, yet we strive, and in my case, overstrive for it.

What works is to keep it simple, understanding perfection or anything close to it does not exist in this business. In short, forget the glitzy impossible, the show dogs, find a mongrel and take good care of it.

### More on What Works

Well, well, *Commodity Traders Consumers Reports* just came out and gives us an immense insight into how to make money in trading commodities. Let me explain. This service, started by Bruce Babcock and now aptly run by Courtney Smith (a for-real guy who actually trades, by the way) monitors 26 of the most popular market letters' REAL PERFORMANCE. It is a tedious task, to say the least, in the last 12 months they have had to follow each of the 3,590 trades we services had cranked out!

Here's some observations I've made about the services that make money; to begin the services with the greatest number of trades have been consistent losers. Guess, that old saw about over-trading is correct. By the same token, services that don't trade often seem to be consistent winners. But, the most consistent winnings have been picked up by services have about 200–300 trades in any given 12-month time period. Services with more trades than that perform poorly. Currently the best performing services are Futures Factors, up $92,761 on 252 trades in the last 12 months, Taurus up $94,307 on 355 trades in the last 12 months and Commodity Timing, up $119,716 on 290 trades in the last three months. The service with the most trades, 655, was down close to $50,000.

We can also break the newsletters into trading approaches. Generally speaking they are Seasonal, Trend following, Chartists and Gann/Elliot/Arcane, and here are the differences.

Here the performance figures are immensely more revealing. I went back the last three years and found that the poorest performers in 1995, 1996, and 1997 have consistently been the Gann/Elliott/Arcane group who, as a group, has averaged a loss of close to 100 percent a year. This from the crowd that claims all can be known, that you really can buy bottoms and sell exact tops.

Here's another interesting point, the most expensive service has lost money on balance the last three years (they charge $5,000 a year) while the cheapest service, $45 a year, is a net winner!

The seasonal letters did well a few years ago but in the last 12–18 months have not fared so well. The long-term trend followers led by Commodity Research Bureau and Commodity Trend Service have shown consistent profits. In the last three years no service has been in the top 5 performers each year. But, the following have been in the top performing group 2 of the last three, Commodity Trend Service, Commodity Timing, and Futures Factors. Hope all this helps you place performance, and the performers into some sort of viable and working understanding of this business.

*June 1998* *Volume 35, Issue 6*

*"The Most Important Athletic Ability Is the Talent to Comeback from Behind"*
*—Harmon Killebrew*

**Athletics Are Such a Parallel to Trading**

Maybe it's just my personal athletic background, but I think not. Over the years I've written about the similarities between winning on the court, track or field and the pits in Chicago. I don't think it's any fluke the most successful bond trader in the history of the world was also a High School All American football star, Paul Tudor Jones a pretty darn good boxer, and Frankie Joe an outstanding professional baseball player.

So, when I heard the above quotation from Harmon Killebrew, I was really rocked. Killebrew, Mantle, Jordan, Namath, Ali, were all born with and developed great athletic abilities, but, then so do many other individuals, who never become such superstars.

I've always wondered why that is. What are the differences between the SuperStars and the others? I used to think it was media flash, but then noticed guys like Brian Bosworth, Dion Sanders, or even Bo Jackson never attained superstar status though they had all the trappings of making it.

There are many brilliant market lecturers, authors, analysts and traders, but the really great ones have the same unique quality as Wilt Chamberlain . . . the ability to not blow up when the team started losing the ability to turn on scoring power when things looked pretty bleak. That's what makes a champion.

Not raw ability, not learned ability and not luck, which clearly wins some games but never establishes legendary champions. Luck is too infrequent and too easy to see when it does appear.

THE POINT THEN is that as traders we need to devote a great deal of time and energy into figuring out how we handle "getting behind" and what our response is. Do we give up, do we fold, get angry? Or do we take the emotions of the moment and turn the anger or frustration into not just scoring points, but winning the game?

*If we are to win at this game, we must develop the ability to score when we are behind; that's the key ingredient to develop in your psyche.*

*June 1991* *Volume 28, Issue 6*

## What Causes Stock and Commodity Market Trends

### Freight Train Theory Explained

The first 17 years of my market research revolved around trying to figure out when in the heck a trend was about to begin, had begun, or was in the process of reversing.

I read all the fancy math books, studied all the chart systems from Gann to Z charts, got totally lost in angles and confused by exponential. I had about resolved that the PhD crowd was correct in their assumption that it is impossible to know the trend of a stock or commodity.

### An Important Analogy

The problem, they said, is that the market is not a fixed energy vehicle, like, say a rocket. A rocket starts with a certain thrust and runs into a certain resistance. Hence, we can measure its speed, project where it will go and tell when it is spent.

The market, though, is more like a ship at sea . . . we see its wake . . . the chart book price pattern . . . and try to tell from the wake where the ship is going. That's fine . . . if the ship stays on course.

Our problem is that the ship does not stay on course very often, as external energy flows—new ship captains—are always trying to take over the helm and redirect the ship.

So, while we measure the wake, all we can learn is where the ship has been. The new captain, or even the old one, can and will change the course at will . . . seemingly without warning.

### From Boats to Trains

My biggest research breakthrough came in 1983, and then again in 1985, when I discovered what I loosely call the "FREIGHT TRAIN THEORY." My theory is that once a train gets rolling to a certain speed it is damn well impossible to bring it to an abrupt halt.

Sure, go ahead and pull the emergency brake . . . it will still take time for the train's forward force to grind to a halt.

Ditto, Pork Bellies and Bonds, S&P's or Soybeans. Once any market really picks up a head of steam, it will keep rolling, and in the process a trend will be established.

### Critical Mass

The last paragraph above explains it all . . .

Trend, I always thought (and so does the PhD crowd), was a function of slope, angle, slant, etc. It is not.

> *Trend is begun by an explosion in price. The resulting new trend stays in effect until there is a new explosion in the opposite direction.*

What happens between the explosion points is the construction or definition of trend, but not the creation of trend. Trend is begun with a big reversal and stays in effect until there is a new reversal.

This means all we have to worry about is catching the explosions and then letting the trend that follows take us along for the ride.

*August 1991* *Volume 28, Issue 8*

### The Farmer, the Gambler, and the Speculator

*It's an easy game, this business of making money trading.*

There are only three or four rules to follow. But . . . you and me . . . we overdo the game . . . and end up pouring money in, good after bad.

How come? What can we do about it? At last weekend's seminar in Florida, Jake Bernstein shared a very telling story. It goes like this:

Several years ago Jake was speaking to a brokerage firm gathering of farmers, ranchers and a few speculators. After his speech he was asked if he'd like to meet the one customer who made money. They said he wasn't very bright, but made money. Always.

The old farmer and Jake hit it off pretty well, so the gent asked Jake if he'd like to learn his system. "Sure," Jake replied. "I'd like to see what you do."

With that, the crusty, aged trader opened up his chart of Pork Bellies and brought out a pendulum on a string . . . held it over the belly chart and advised Jake, "If it swings up and down on the page, I buy 'em . . . if it swing cross ways, I sell 'em. There it is, Jake, now ya seen my system."

Jake stepped back, thought for a minute, and then asked, "That's all, there's nothing else to it?"

"Mmmm," mumbled the market wizard. "There is one other thing, but it don't mean much, I think. If I got a loss at the end of the day, I get out of them things."

I mulled over this wisdom on the delayed flight home (a bomb threat forced us to switch to another airline) and, while driving up I-5 listening to Country Western music at 1:15 A.M., heard—I mean really heard—Kenny Rogers' song "The Gambler." It struck me that everyone else has focused on his words, "Know when to hold them, know when to fold them" . . . but the real message I heard was in the refrain, "You gotta know what to throw away, know what to keep."

That dumb old farmer must have written Kenny's song. A gambler knows what to throw away . . . bad cards. Traders might want to listen to the farmer's and the gambler's work the next time they want to play speculator.

#### Proving the Point

To drive this point home I tried an interesting experiment . . . my thought was to develop a trading system for bonds that had three simple rules.

Rule one was to buy today's close if it was greater than the close 8 days ago. No magic here, just a demand the market is trending higher. The next step was to know when to throw them away . . . so I placed a stop of $850. Anything beyond that would be bad cards.

Finally, all cards . . . trades . . . would be held until a profit of about three times the stop was tested. The best was a profit of $3,500.

With just those rules, one could have made $36,500 trading one Bond since they began trading. The worst drawdown was a little large, but the average profit per trade, after $50 commissions and slippage, was an attractive $160.

This "system" was not based on magic or fancy math. The only strategy was that of money management. Kenny Rogers was right.

*October 1991* *Volume 28, Issue 10*

### How to Measure the Public vs. the Pros

*There is a big difference in the emotional state of the "public" and the "professionals" that I think one can measure through watching the entry and exit styles they are most apt to use.*

I'd like to explain this fascinating technique that will help you spot major divergences in the attitude of professional and amateur traders.

#### Let's Begin

Let's begin with an understanding of the typical "public" trader. Most likely he/she is short of cash either by having a small bankroll or, if fortunately possessed with a large bankroll, carries too many contracts, thus landing in the same fix as the small-time trader.

It is usually because of this pressure—which we bring on ourselves—that the trader becomes emotional and easily influenced by his broker, the *WSJ*, astrology or gracious who knows, maybe even charts that look like candles.

Think about it: When you are pressed for money, what is your natural reaction? Isn't it to run scared . . . to cut your losses very (too) quickly and to play catch-up . . . hopping aboard whatever looks like a good way to make money to balance out your losses?

That's the way it was for me, and I suspect pretty much the same for you.

#### What Does This All Mean?

What this means is that the "public" trader becomes emotional or irrational in style. In fact, pressure destroys style, so neither style nor a system are followed. It becomes a willy-nilly game of catch up and *the trader dances to the flow of the most current wind, even if it is a breeze.*

The key difference is the public (or almost always wrong) trader appears to be unduly influenced by opening prices. In fact, this relationship is so consistent that since 1969 I have advocated the use of opening prices for all market measures. In recent years, many analysts have finally gotten the message. For 22 years, this same powerful relationship has beat through all markets, stocks or commodities.

#### The Key

The key you need to understand is that the public action can be measured by taking the difference between last night's close and this morning's open.

Conversely, professional activity, or true underlying price direction, best shows up by taking the difference between the opening and the close of the same day.

*August 1992* *Volume 29, Issue 8*

### Folks, It Just Can't Be Done

Admittedly, our last market letter clearly explained and laid out a projected market high you to "focus on August 14th–17th for the high to appear." Beginning on the 17th a bear market attack was begun on stock prices, as we now know.

If we were like other services, we'd probably go out and buy a big ad in *Investor's Daily* you how great we are (were).

But, folks, 27 years of trading has proven to me that forecasting prices, politics and our lives is difficult if not damned near impossible. Please, let me explain . . . because as soon as you get this point you will become a successful trader.

### Gracious, What a Messy Drawer

I've used the top right-hand drawer of my desk now for the last 18 months as a vault to store predictions from a wide array of market letters (stocks and/or commodities) as well as other prognostications of what was to happen.

Last night I delved into this pile to rummage around with yesterday's news and possibilities. What I found was thrilling, enlightening, and most rewarding.

This culmination of hard work and multifaceted predictions of the future illustrates quite clearly that—it can't be done. Let's see, how do I prove it to you? Should I show you the chart from a leading computer type letter that used a Neuro-Net to scribe out that bonds would stage a big bull rally—in February? Nope, maybe I should quote from an *Investors Daily* interview with Guru Elaine Garzarelli, wherein she expected (as of March this year)that "Stocks should provide 20 percent returns over the next six to twelve months." Garzarelli follows fundamental indicators. Others follow astrology. Frankly, compared to the fancy fundamentalists, they have not done a bad job. What I mean is they are no worse than the better educated Wharton or Harvard forecasts.

I could belabor the point by showing you one of this country's major forecasters whose graphic forecast showed a continued bear market all the way down to a low in December . . . in Bonds. But, so what? Would that better prove the point I trust I have already made? If no . . . do what I did . . . collect all the forecasts that cross your desk. Store them up for a year and let the point prove itself.

*When I was younger* I had this silly notion that my personal future could be divined by some psychic means. Hence, I tried them all, palmistry, astrology, Tarot. The method did not matter, the outcome did. I learned a lot which all boils down to this, "There are better ways to spend your money."

After all, I began as an art major in college, switched to journalism and here I end up using math to trade the markets. None of those seers of what's to come, came remotely close to forecasting my future.

### Politics Too

Heard "Slick Willie" say the recent DJIA spill-off was Wall Street's reaction to the Bush acceptance speech. That's almost as bad a statement as to say our call for the August high predicted a bad Bush speech which would lead to the tumble. Speaking

of politics, where are the spin doctors today who so boldly predicted that it would be folly to run against Bush as he was unbeatable?

### OK—Let's Wrap This Up

It all gets down to this; in 27 years of trading I have yet to see anyone who can consistently forecast the future of anything. Every few years we have a Granville, Precheter, Inger or Williams that holds a hot hand, but not for long.

That's right—27 years—and not one of us have yet been right for long with prediction. Moral of the Month; "Just Say No" to anyone who claims such ability. God does not grant us that power it appears. But, he did give us the ability to have a better understanding of things so that we might develop a systematic way of driving, flying, living . . . even trading commodities.

### It Gets Down to This

You do not need to know the future of the world to make money trading (you'll never have that view anyway). What you need is a consistent advantage in the game. No more. No less. That's where commodity trading systems come into play, they, or any consistent approach, can give you and advantage in this game . . . and that, folks, is all you need.

*September 1992* *Volume 29, Issue 9*

## The Rush of Trading

Dostoyevsky, the Russian poet and gambling addict, said the greatest thrill in life is making money on a speculative wager.

The second greatest thrill was losing money. Perhaps that's what led to the title *Notes from the Underground* for his most famous writings. The point is well taken. Making money is a great rush, strangely enough so is getting out of a loss. Few things feel better than getting out of that much pain and anguish.

### The Dilemma

This sets up a mental conflict. Negative action, losing, creates a "rush" or feeling of exaltation that our minds scramble. Just maybe, the lot of men and women like us, is that we just like rush, thrill and excitement . . . to the point that we'll pay for the experience . . . with margin calls.

Think I'm kidding? In written interviews with almost 600 traders, when asked to list the three primary reasons they were trading not a one of them put down (as their first choice) to make money. That's right. They listed things like, thrill, challenge, excitement . . . but not one put to make money as their first choice.

Here's my next point; when people call wanting to learn a system, or subscribe to this letter, they seldom ask if we make money . . . instead they want to know how many trades we have a week and if we trade XYZ commodity, their current love. Many callers lose interest when they find we don't trade XYZ, because that is what they want to trade. Period. Even though they have been losing money doing it!

### This Leads to Psycho Babble

There has been a spate of books and seminars in the last few years claiming that all you had to do to make money was "get clear" to arrive at some sort of psychological understanding about you and the market. People have paid tens of thousands for this "enlightenment." Now it happens to be I know little bit about this.

First, let me give my qualifications about what I'm going to tell you. I have my minor in psychology, I'm as comfortable in front of a Skinner Box as a chart book, understand the subject matter from more than just a "pop" vantage point.

More importantly, though, there was a time in my life when I did indeed think it was our minds that screwed us up and kept us away from the unlimited wealth the markets seemingly offer. With that belief system operating at full speed, I dabbled in them all. Geez, I could never admit it before now, but turning 50 as this written, makes confession of the soul much easier.

I tried Scientology, rebirthing, ARICA, EST, Rolfing, Reichan, sat for countless hours in a Zen meditation center by Big Sur . . . listened to subliminal tapes for a message I could not hear, chanted, panted, prayed and pranced with the Sufis all to "get clear" so I could tap the market's till. In short, I went through more mental processes than coleslaw does in a Cuisinart.

It was fun, I learned a hell of a lot about myself, my body and rest of the people out there—like you. But, you know what? None of that stuff helped one iota in making money trading. Not a twit.

My experience had been to make big money—with splash as you all know—then give a little back, play some games and hit it big again. It seemed I was good, but haphazard.

### The Unvarnished Truth

Finally it hit me . . . all this time and money had been a waste.

My trading success had nothing to do with my mental state. The market did not care if I'd rather drink vinegar than kiss my mother. My mind-set about her, a Rorschach blot or my first-grade teacher . . . no not even my concept of God . . . made any difference.

The reason I lost money was not because I wanted to . . . or that I was retentive, possessive, etc. Nope, I lost because I did the wrong thing and losing was what screwed up my mental attitude or approach.

It is not the other way around.

So, for my money you can forget the psychobabble currently being offered. You don't need 6 hours in a flotation tank, mind-altering drugs, or hypnosis. All you need is . . .

### A Winning System and Patience

Frankly, I don't know which is the most important, the winning system or patience. It takes both. Why? Because even the best of systems does not make money every day. When you plant a crop, you don't dig it up every week to see how it's doing. Ditto systems, market letters, gurus etc. It always takes time to make money. Making money is about time, time is about patience. Moral of all this: Forget Freud; Shut down your Primal Scream; Activate your reactive mind if you want. It doesn't matter. Just find a reliable approach to trading and stick with it. And, for the record, of the 25 services monitored by Commodity Traders Consumers Reports, we are in the top 5 or so for profits for the year, one of the few that made money in 1991.

*December 1992* *Volume 29, Issue 12*

### Beating Them to the Punch

*In a matter of days, pundits will be telling you what 1993 has in store. All sorts of claims will be heard and sage, crystal ball, advice given based on these oracles. Will they be any good?*

### Sometimes You Can Judge the Future from the Past

Listen up here real good . . . people (analysts) tell you all the time that you can foretell the future from studying past events. That's true, but not as often as you might think. If that was totally true, all we market soothsayers would be multimillionaires. Few of the talking heads you see on CNBC, who judge from the past, have more than cab fare to get to the TV station.

But . . . there are some things you can judge from the past—one of these things is past predictions. I've been waiting 12 months to pull out last year's predictions, for this year to prove, that prognosticators' ability to see the future is no better, and probably worse, than yours.

### It Means Millions of Dollars

Say what you want, the *National Enquirer* is a multimillion-dollar operation that would just love to take bragging rights to being able to predict the future. Every year they have their psychics tell us what will unfold. If they could be right certainly the *NE* would shout it out to the world and make more $$. Ditto all market letters. Guess what? Sneaky me kept the *NE*'s 1992 forecast as well as the market letters that make yearly forecasts to see how their 1992 expectations came out. Here are the results:

**The National Enquirer** These journalists paid the top 10 psychics for their predictions and printed them last January. Here's the scorecard; of 41 forecasts for 1992 not a single cotton-picking one of them was correct. The closest was that "an AIDS epidemic will devastate prosports." Well, AIDS devastated Magic, but there was certainly no epidemic. Chicago psychic, Irene Hughes (who charges a pretty penny to forecast markets, and I've seen make major misses) saw that Vanna White would be "nearly killed" from a shock while turning the Wheel of Fortune . . . Angie Dickinson was to appear nude in *Playboy* at 60 years of age and Cybill Shepherd would renounce acting in favor of running a medical clinic for the poor. NONE of these hotshots predicted Bill Clinton's victory, most all gave the nod to Bush.

**Moving Right Along** Reading the *Enquirer*'s predictions is a stop far removed from reality . . . Donald Trump was to lose it all but become a successful late night talk show host . . . Michael Jackson was to have lost his voice . . . and Liz Taylor was to have children . . . maybe one would think that market forecasters would have a better grasp on reality.

The truth is they don't. Several of the more respected soothsayers were looking for a December 1992 (that's now) drop of 1,000 DJIA points. Another said

George Bush's New World Order troops would take the U.S. over on December 19th, complete with a bank holiday!

Some market analysts said we would be in a rip-roaring bull market, others, a devastating bear market. What became of the best-selling author of the 1992 depression book? And, what became of his depression and stock market crash? I hold in my hand an October 19th epistle which proclaims, "Have no doubt about it, a Crash will occur . . . there is a fast fortune to be made . . . $2,000 will become $20,000 . . . THE DECLINE WILL BEGIN NOW." Of course you are given the opportunity to call, with credit cards, for their recent update. The point is no crash came.

Like the *National Enquirer* crystal ball gazers, the markets pundits I kept book on also had a perfect record—of not being right. None of their "projected major turning points" were on the money. Several of them called for a major high in March with new lows for the year to be seen in October. Instead October was an excellent time to buy (it usually is).

### The Moral of All This

Avoid like the plague attaching any significance to any ones predications of the future. The future happens, certain laws come into play. But, the truth is good thinking and reasoning will get you much farther along than oracle reading. If you take correct action in your life, trading or investing, you will come out on top. Chasing guru forecasts is not right action. Prove my point—take 30 minutes right now to make your sensible notion of what will happen in 1993. Read it one year from now and you will see how accurate you are, compared to the headline mongers. Thinking and taking the correct action will always beat the crystal ball crowd. Sure, it's work, but it works.

In 30 years of this game I have tried hundreds of "magic" forecasts and crystal ball crap. I used to believe. But reality has taught me an important lesson I hope I can pass on to you—don't let forecasts get in the way of doing what needs to be done. Savvy??

### It's Just Over My Head

Mine too . . . .

I've had a flurry of phone calls and letters this past week that I found revealing about folks like you and me and the markets.

The call or letters generally go like this, "Gee, Larry, this stuff of trading commodities is hard, I don't understand it, it's just over my head. Would you please refund my subscription fee?"

We do.

But I don't want to . . . I want to grab them by the lapels and tell them this is not an easy business, that whoever told you this seriously misled you. After almost 30 years of trading most all of the market is still over my head. As trite as it sounds, I am still cobbling away, learning how very little I know about the market . . . it seems to me I will never be able to learn very much and some things I have to relearn. Over and over.

Yet despite all this, I've made millions of dollars trading . . . something few people can say . . . and I never would have made those hard-earned $$ had I let the notion of "stuff being over my head" thwart my intentions of making money. That's my first reaction. But upon some reflection what I should say is . . .

"Where did you ever get the idea that making money is easy—in this or any other business? Is it easy to make money in your business? If so, stay there. Refrain from trading.

"Money is made, in any endeavor, by an exchange of one thing of value for another. In this business the exchange a winning trader makes are his dollars at risk and his intelligence. He or she pays for his earnings with hours of study.

"There is just no way you can blindly follow some market guru and blissfully make money day after day, year after year. At some point you MUST go to work, figure this stuff out yourself, walk on your own. I'll help you, but bear in mind this is not an easy business, that to get money from any source requires an output of energy. There is no bliss or Nirvana in this business."

As my daddy used to tell me, and my children's father tells them, "There ain't no free lunches . . . we don't deserve anything. We earn it."

## I LOOKED FEAR AND GREED IN THE FACE

*And here's what I found . . .*

It's no secret that a trader's worst enemy is his/her emotions. Some have even gone on to identify that the emotions that kill us are the mutually entwined powers of fear and greed.

But's, so what, you ask. Is just knowing this enough to help a trader? The mumbo-jumbo crowd tells us that on that basis we can deal with the identified problem.

No way. I've known of these Gemini like emotional forces for years but it was not until recently that I fully understood (I think) how to avoid the negative downside of all this.

First, let me establish once and for all that Greed is the strongest of these two emotions.

Indeed, greed may be the strongest motivator, after sexual drive, that we all possess.

How do I know this, from watching my trading—and people like you—who hope to recoup losses. We do it in a host of ways. Why do you not use stops? Greed, pure and simple. You want to make money so you hang on too long. Alexander Pope said it best, "Hope springs eternal in the human breast." We all hope to make money, hope to get out of margin calls or bad marriages. We want to make money so badly that some of us cheat, steal, lie, even rob the local 7-11. Why, because of our greed to have more.

*The secret of winning as a trader* is simpler than most think. The operating rule is that if you lose, or can control your losses, who will probably become a winner.

What causes loss is greed. We get so greedy—crying for profits—that we get either; (1) sloppy in our money management or (2) fail to cut our losses as

our hopes are too high that every trade will turn into a winner at some point. The desire for profits is the killer. Just last week I held onto a long position, refusing to bail out taking my profit as I wanted to believe the market would move higher. I bucked the system. Why, because I wanted to make more. It is not my fear that screws me up, it is my greed. When looking these two emotions in the face I found that it is my greed that causes me to not follow my systems (do the right thing).

You can bet from now on I will be on alert when I "want" to make more money. I know my enemy, I have stared it in the face, it is not fear . . . it is my greed. And you know what? You are just like me.

*October 1993* *Volume 30, Issue 10*

### The Show Must Go On

*A loss I am not proud of and a reaction I am.*

Just because I've had the audacity to write several books about the market and publish a letter, some subscribers seem to think I never have the same problems trading they do.

That's wrong . . . real wrong. I go through the same emotions, and though I may harness them better, they still tug away at my heart and soul. Daily.

About a month ago I screwed up, big time. Oh, not enough to wipe me out, like maybe I would have done in the old days. But, enough to get my attention, my anger and raise those old questions of self-doubt I thought had been put to rest years ago.

Probably the first step to being a winning trader is getting rid of most of the self-doubt. When you "know that you know" you are on your way. Mentally, and physically, at that point you have become a professional. Why? Well, I thinks it's because you are no longer the effect of the market . . . you are the cause of what you are doing.

That's an important edge . . . my screw up had cut me like some giant pack rat slipped into my office to chew away at the fibers of my being. The self-doubt built as I went through several losing trades, until, naturally, the worst screw up of the year came.

I was humiliated by what I had done, felt as stupid as I'd felt in years, and just wanted to stop trading. "Forever," that voice in my head screamed. While I don't know much about the market, or trading, I do know there are no losers . . . only quitters. Professional people all have "off nights." Did that stop Joe Montana? I remember he had an off season just before elevating himself to the status of the greatest quarterback to ever play the game. Nor did similar poor performances end the careers of other greats.

Clearly, I'm not a "great," but I can sure learn from them. That's what I decided.

So, the morning after my screw up, there I was, at 5:10 A.M., placing an order to buy the S&P. The show would go on. Both trades won, not much, but they were my biggest wins of 1993.

*October 1997* *Volume 34, Issue 10*

**Broken Noses, Cauliflower Ears, and Bad Trades**

*Like boxing, trading is not only risky it is also a very difficult and dangerous business.*

AS I WRITE THIS . . . I'm angry. The last few days I haven't been able to find subscribers a winning trade for love nor money and my own trading, which was ablaze with glory and domination a few days ago, has lost quite a bit of its luster.

I'm angry about the markets. I'm angry with myself and I'm angry about this business where people advertise seemingly unlimited and easy wealth to be made trading commodities. So I reflect on my limited days as a boxer; I got beat up and quite a bit, yet still enjoyed the sport. Why? And how does this relate to trading. Why do I always turn to sports to find parallel or analogy to trading?

Fights, like the markets are not fixed. Guys really do get hit in the ring. They bleed, their eyes puff up and stay that way for days, and their facial cuts take weeks for the transformation to a scar. The differences between a true champion fighter and the wannabes is the champs climb back, continue fighting and after a loss still work at their craft (yes, it is a craft, no more brutal than trading) they stay in condition, they rethink strategy . . . but above all they continue. It is anger that propels them. When younger my anger was abated with drinking until I learned well channeled anger is a powerful force, so I now focus anger, using it to help push myself.

When I ask fighters how they can continue, I'm told, "This is what I love, this is really all I know, and getting beat up *is just the nature of the game.*" The ones that cannot *accept* the bloody noses and cauliflower ears never make it to the top. I have yet to see a champion without a marked up face, even Ali, up close, shows plenty of damage.

*Champions, just like traders get beat up. That's par for the course, the sooner you accept and constructively channel your anger behind the losses the sooner you will also rise to champion status.*

*May 1995* *Volume 32, Issue 5*

**Learning How To Lose Money**

Ha, bet you thought you didn't need help in learning how to drop your hard-earned dollars trading. My bet is that you have no idea how to lose; hence, you lose.

ANYONE CAN WIN . . . It takes no great feat to win in commodity trading, all you have to do is get in and out at the right places. Winning is a glorious feeling, hence something you can pretty well control, handle, or take care of in your own fashion. The world loves a winner, and a winner loves the world. Life is easy then . . . all green lights and blue skies.

But losing, man that's another story. Life's a bitch when you're down 30 percent to 40 percent of your money . . . even tougher when you are down 80 percent to 90 percent. I know: I've been there, only all too often. I took some nasty trips in my younger days I hope never to see the likes of again. However, they did teach me a few things I'd like to pass on to you.

Profits pretty well take care of themselves, losses don't. This means YOU must take care of the losses. Indeed, this is more a business of damage control than it is price exploitation. Control the losses, and you are probably going to come out a winner.

So, how do you control loss? There is only one correct answer. Are you ready? Do you really want to hear it? And will you follow it? (I doubt if you honestly answer "yes" to all of the above.)

The answer is not always use a stop. Always.

Before you continue reading, grab a dictionary. Check out what "always" means. It does not mean some of the time. Believe me, those "some of the times" you leave off stops will be the time losses wipe you out. At a younger age I traded with no stops, believed in my fiscal immortality, and ended up going deficit. Several times I had to sign notes to brokerage firms. That's a bitter reality. It's not fun and games being hounded by brokerage firms' lawyers. (Ah, the 60s . . . what a glorious time period.)

The only question left is where should one place his or her stops. There are two answers. (1) With your broker, not as "desk" stop. And again, that's always. (2) Since the purpose of a stop is damage control, it should be based, most often, on limiting risk. The best rule of thumb I have is that stops should be about $800 to $1,200 away, except in the S&P where I use stops of $1,750 to $2,500.

Sometimes I use what looks like a key market turning point as a stop, or perhaps an opposite signal, or even the end of the day. The end of the day (a time stop) may be coupled with a dollar stop. But in any event, NEVER FORGET that the closer your stop is the more often you will be stopped out.

Only a genuine masochist uses tight stops. NO ONE knows absolute highs, lows and turning points. We can only be generally correct, which is why stops must give the market some leeway . . . just not too much.

*Look, I don't like stops any better than you. I hate using them, but I use them. Always.*

*March 1995* *Volume 32, Issue 3*

*I know what evil I'm about to do, but my irrational self is stronger than my resolution.*

*—Medea*

MAYBE IT'S JUST ME AND MEDEA . . . but it probably isn't. The first lesson I ever learned in Psychology is that if I have frequent thoughts about something (sex, money, power, catching large rainbow trout), my peers are probably having the same thoughts and/or dreams.

No, don't think I've gone California Kooky on you. But I'll be the first to admit I have a constant dialogue with my inner selves (there are probably two of them) while trading. Some might say they hear voices . . . I would not be one of these. But these selves, or voices, exercise a tremendous power over my trading decisions. Therefore, I've been spending a lot of time listening to those voices or selves, and thinking about them. This is what I have learned:

First is the awesome power these selves seem to have over our judgment. Just to make certain I wasn't going batty (yet), I talked with a few other traders I respect. They too mentioned the voices or their inner-self dialogue . . . and how much an impact it has upon their decisions.

Like Medea, who uttered her classic statement just before killing her children, I confess I have taken trades I knew would lose, and actually felt helpless to do otherwise. Some compelling drive seems to lurk in the soul of we mortal traders.

**Greatest Trading Breakthrough of the Century?**

The breakthrough would be that of getting control of what can be very self-destructive behavior from this part of our mind. In a minute, I'll tell you some things you can do if you, like me, are under such an influence. For now, though, lets look at what's going on here.

The reason I really got turned on to all this is two weeks ago I did not take a buy signal in the Bond market that I sure as heck should of. Why? Real simple. One of those "voices" (me) talked me out of the trade. The mental chatter went something like, "Hey, Lar, you lost on the last trade, you better be careful here . . . this is pretty scary stuff . . . cool your heels here . . . wait for a better looking trade . . . at least wait for the signal then get a pull back or something . . ." Meanwhile, the other voice is saying something like, "Well, you've got to do what you've got do."

The striking difference is in the voice trying to protect me. In other words, that part of me that deals with survival has tossed up a bushel-basket full of fear. And make no mistake about it, the "voice" argued longer and harder than the second one. Hence, it carried the day and in the process I sidestepped what was a very good trade.

In short, the inner voice based on fear will talk you out of more good trades than bad trades you will ever talk yourself into.

I have focused on this problem a great deal the last few weeks. My observation are that you can get in touch with these sides of yourself. You can feel or hear which one is the fear, or survival-based one. That is the one you need to get to

know. Or, if you are not such a touchy-feely person, just realize that the inner message aimed at talking you out of doing something is the survival "voice," and the one you need to avoid.

By paying careful attention to these inner selves, you will be able to key off of them, as opposed to reaching to their negative dribble. Here's your exercise for the month: as you make your next 10 trades, write down what you are feeling or hearing on an emotional level. Let all the diatribe out, and really listen up so you can identify the two voices (I say two based only you my experience. But other traders I have interviewed to do this article also mention two crosscurrents going on inside their noggins). By doing this, you will be able to not only confront your emotions, but also catalog and codify them so you can deal with them in the future.

*April 1994* *Volume 31, Issue 4*

**Hillary, Highs Hopes, and Heartaches**

Over the last two weeks, I've carefully reviewed—at the request of the *New York Post*—all the commodity trading activity of our First Lady. What an entertaining account it is! Since much of Hillary's trading was not correctly covered by the media, I thought you might like to know what I unearthed.

Hillary (by the way, she used her maiden name, Rodham, and not Clinton, on the account) had a great introduction to trading; on her first trades she made right at $10,000. What looks particularly irregular, though, is that the trades required close to $8,000 in margin. Yet she pulled it off on only a $1,000 check, which may not have been placed in the account until after the first profitable trade had been recorded.

If there is a trading pattern to the account, it is one of day trades for winners, and holdovers for loser . . . as well as a real gutsy approach. As an example, on 2/12/80 she was long 10 Wheat which she exited on 2/21. The margin back then was about $1,000 per contract. Hillary had $3,911.20 in the account. While newspaper articles have largely focused on her Cattle trading, the records I was given also show numerous transactions in Copper, Wheat, Lumber, Sugar, and Bonds. She paid $41 for sugar commissions, $50 on everything else. So she paid a little high, but then look at what she got! On many occasions she had positions totaling over $45,000 in margin, while she actually had less than $10,000 in the account.

Like you and me, she did have margin calls. Unlike you and me, she never had to meet them. In one case, March 13, 1979, she had $53,478 worth of positions—with some $26,000 in the account. There are lots of 1 and 2 lot orders that did make money, but the vast majority of the profits come from huge positions on day trades, or huge positions where margin calls were never met. Here is another confounding sample of Hillary's trading style. In early June 1979, she carried a bewildering 45 cattle . . . on a mere $3,765.

Also a distinguishing characteristic in Hillary's trading is that the instant she made profits, she cashiered them out of the account. Even her famous first trade of $1,000 down on 10/11/78, with an immediate profit of $6,300 the next day, shows she siphoned $5,000 out of the account before any more trading transpired. I suppose this is a lesson we can all learn from. The long and short of it appears to me as this: Mrs. Rodham had a broker who did her some big-time favors.

*February 1995* *Volume 32, Issue 2*

### Nervous Nellies—Heaven Bound

*If money is only made by holding on, we'd better learn how to hold on!*

There is nothing easier than making money in commodities. It's a piece of cake. All you have to do is catch a move, and hold on until price mingles with the angels of speculation some place up in the clouds.

You're thinking to yourself, "easier said than done," right? And very easy to do in hindsight. Yet there are some lessons we can learn—from hindsight—that I would like to write about this month.

We currently have pretty nice trades going . . . long the Canadian Dollar, short Copper and Cotton. IF THESE ARE LONG-TERM PLAYS, our objective will be to hold them until they bottom/top out, or reach an area of major support. That's the game plan. Piece of cake.

Not really; following the game plan is very difficult. It's no wonder there are so few winners. So few people can sit tight and hold onto their positions long enough to allow time to maximize winnings.

As an aside, but a most important one, never, ever forget that it is time that creates large winnings. The longer a system's time frame, the greater the potential for a large profit. It takes time for redwood trees to grow. Seldom do huge profits come overnight. That's why short-term traders are doomed to small profits. They tighten down the hatches of their frame so much that profits are never given the time to "mature" or "grow."

The problem really is twofold. It is essential to develop a state of mind that allows you to sit through corrections on the way to the ultimate prize zone. The second problem is developing an indicator or system that tell us when to bail out, regardless of our mental conditioning. After all, even the tallest trees in the forest never quite reach heaven.

### "Preframing" Ourselves

Now there's a term I wish I would have bumped up against earlier in life. The idea is that if you preframe your belief system as to what the future will be like, you can better handle the future. It is one of the most valid psychological concepts I have ever used.

At the start of every trading year, I preframe myself to equity dips by telling myself that at some point during the year I will lose money . . . and a good amount of it at that. I reframe an equity dip, preframe that it may last a month or longer, and that to get through it I simply have to get through it.

When it comes to holding on to trades, it's the same thing . . . which I hope the following charts illustrate. Notice how in each example the ideal strategy was to hold. Also note that there were big pullbacks against the trend. These pullbacks took time and money away from you. Usually we mere mortals get shaken out by the flames of eternal damnation, just before the up move resumes.

However, if we preframed ourselves to realize that in all large trend moves there will be substantial any trend moves, I have found it easier to suffer through the brimstone.

*March 1991* *Volume 28, Issue 3*

**Secrets of System Developing and Trading**

Over 20 years ago I uncovered an amazing little secret that I have been trying to disprove ever since . . . and so have subscribers.

The "secret" is that effective commodity systems do better without a protective stop loss than with one—if they are not reversal systems.

It is strange but true. If you have a system that is always in the market . . . and does a decent job of it . . . you cannot improve its performance by tinkering around with tighter money management stops!

I will reiterate the point. If you have a decent system—forget about "improving" it with a protective dollar risk stop loss. The reason I have repeated this point is that I find myself, 20 years later, still trying to twist and improve systems with protection stops. They continue not making much difference, and usually hurt system performance.

Many subscribers have written, called or canceled their subscriptions because our stops "are so big." About that they are correct. Our stop and reverse points are a good distance away from the market . . . but . . . it works better that way.

As strange as is seems . . . for 20 years I have kept trying to improve good systems by using money management stops and they have yet to make much difference. What you gain in protection you lose in accuracy and profit per grade. Typically a $ stop will cut your percentage on winning trades by 10 percent to 15 percent and lop your average profit per trade by up to 1/3. What you get for what you lose, is not worth it.

Here's the proof: results of a system I have been working on this past week for short-term trading in Coffee (see Table 14.1). Notice that as the stop gets

**Table 14.1**
**Coffee Trading System with Different Stops Produces Drastically Different Results**

| Net Profits | % Wins | Average Profit | Worst Loss | Drawdown | Stop |
|---|---|---|---|---|---|
| 63,391 | 71 | 196 | 3,987 | 12,553 | 1,000 |
| 71,250 | 74 | 188 | 3,987 | 13,875 | 1,500 |
| 69,356 | 77 | 228 | 3,987 | 12,792 | 1,500 |
| 69,407 | 80 | 226 | 3,987 | 11,802 | 1,750 |
| 73,761 | 81 | 232 | 3,987 | 12,755 | 2,000 |
| 82,091 | 83 | 252 | 3,987 | 14,202 | 2,250 |
| 76,042 | 85 | 288 | 3,987 | 15,751 | 2,500 |
| 80,417 | 85 | 266 | 4,175 | 19,651 | 2,750 |
| 78,345 | 87 | 287 | 4,175 | 14,752 | 3,000 |
| 77,536 | 88 | 283 | 4,700 | 16,217 | 3,250 |
| 81,785 | 89 | 285 | 6,987 | 19,362 | 3,500 |
| 81,506 | 89 | 308 | 6,987 | 21,997 | 3,750 |
| 90,391 | 90 | 345 | 6,987 | 17,330 | 4,000 |
| 83,721 | 90 | 333 | 6,987 | 17,858 | 4,250 |
| 91,775 | 91 | 352 | 6,987 | 14,855 | 4,500 |

larger, the accuracy—net profits and total dollars won—all increase!! At the same time drawdown on the $1,000 stop of $12,553 gets bumped up to $14,855 with a $4,500 stop, but you make almost $30,000 more!

### The Second Secret

This one is even wilder . . . you cannot improve, appreciably, a good system by using targets.

Go ahead, reread what I just wrote just for you. The knack of a trend-following system's ability to make money is that it catches some really big trend moves. Those large wins pay off all the little losses.

We all know the rule—let your profits run—and it is proven when you try to add targets (cutting your profits short) with objectives. This also bothers new traders . . . they want to take profits or get out once price hits some magic number, a Gann line, Cyclical window, support/resistance or the like.

For 20 years my studies keep coming back with the same answer . . . you dampen the efficiency of a system by using fixed targets. I am certain that few, if any, subscribers will be able to ride our big winners all the way. The recent bases-loaded home run we scored in the currencies is a good case in point.

You would think our phones would be ringing off the hook with people talking about their profits. That, Red Ryder, is not the case. People are calling up wanting to know "where to get back in."

*February 1993* *Volume 30, Issue 2*

### The Difference between Winners and Losers

*The results of modeling over 20 winning and 30 losing traders.*

Most everything we learn to do well in life we have learned by studying those who do it well. I learned to throw a football by watching a kid named Russ Powers, learned to throw a handball by watching Paul Haber.

In hi-tech-talk this is called modeling; find someone good and scrutinize their every action AND beliefs to uncover what makes them good at what they do. You then imprint that winning form into your mind and body.

Tony Robbins is today's leading advocate of this technology and has probably spent as much time modeling people as anyone I know. Tony defines modeling as the process of discovering the sequence of internal representations and behaviors that allows someone to accomplish a task. The components of the strategy are beliefs, behavior, and language.

Belief systems are the bottom line to the difference between winning and losing commodity traders. First some facts: In a recent test, cancer patients were given chemotherapy, over 60 percent of them responded with the typical symptoms of this "cure"—vomiting, nausea, hair loss, and decreased energy.

However, they had all been given an inert placebo.

Their belief created their reality. So it is with us. I know. I've spent the last 2–3 years carefully recording conversations with losers and winners getting inside their heads to discover not only trading styles, but also their beliefs. You have read about some of the traders I modeled in books and magazines. Some of the winners are more private. But, what a discovery! There are major difference in how winners and losers play the game.

Perhaps my most fascinating discovery was that there are also major similarities between these sets of trader. Let's look at them first.

#### What They Share in Common . . .

Both winners and losers were found to be consumed by the idea of trading. It is their life. Winner or loser, it is their passion, and they are extremists. The biggest loser I know plays with the same intensity and energy as any of the winners. So, scratch off desire or motivation as the ingredient that makes the difference.

Another commonality I uncovered was that both camps had few close same-sex friends. The men had, at most, one strong male buddy, ditto the women. Win or lose, it looks like passionate commodity traders are not great social mixers.

The point of being extremists that I touched on earlier permeates their lives. Both groups seemed to go to extreme lifestyles and beliefs. They see the world as black and white in most categories with very few grays. I assume this is what gets the losers in so much trouble . . . they absolutely commit to trading, but since they are doing the wrong thing to begin with, their disasters have been pretty big—or steady.

### And Their Differences

First, let's look at the losers. This is what I found they share in common:

Most of all them are into the idea of turning $10,000 into $1,000,000, the quicker the better. Quick and substantial profits are a goal. All had internal dialogue "chatter" with themselves about their trades from before entering a position to days after exiting!

All losers spoke of having anxiety pushing them into a trade. They could not refrain from taking a trade . . . sitting on the sidelines with no position is apparently unbearable for these people. They are happier when they are in a trade, win or lose, than not being in a trade. They seemed addicted to having the rush of trading pumping thorough their blood stream.

Two other common points revolve around trading decisions and money management. Losers pay little attention to money management. One boldly told me, "This game is not about money management it is about being right and wrong." I also observed few of them would stomach a look at their equity . . . their account balance. They were amazed someone actually looked at it daily as they did not see what that had to do with getting into winning positions.

Finally, they all asked me if I knew of anyone that really made a living at this. They seemed very uncertain that anyone could. They lacked the belief . . . even face of the evidence from countless fund managers . . . that profits are made rather consistently.

### Now for the Winners

Where do I begin this? My surprise was that the winning traders asked me as many questions as I asked them! The losers asked very few questions. None of the winners traded options. They all had a form of money management and were all technical traders. To a man and woman, they could all recount one big loss that seems embedded in their mind that they will not let happen again . . . ever. So, they use stops and speak of "kicking out" trades just because they weren't doing anything. Thus, there is little internal "chatter" with themselves about their trades.

A big difference is that winners fix their attention on a very small number of key "favorite" markets. One winner has only traded Soybeans—nothing else—since 1956. The losers seemed to change markets, and gurus or newsletters about as often as I get slippage. While the winners do (or buy) a lot of research which they study the losers seemed to be looking for a personality to bail them out or make their money.

All the winners totally believe they will make money and simply refuse to let bad things happen to them. They have an aura of protection around them, they just don't do dumb things in the market. They are amazed more people don't do what they do, they realize it has lots of pressure, but believe anyone of reasonable intellect can do what they do.

# Chapter 15

# Just What Does Make the Stock Market Rally?

*Charts don't move the markets. The markets move the charts.*

I will answer that question. But first let me say that it is impossible to know at all times why the market does what it does. Unlike other aspects of our lives and occupations, the market deals us unstable data. Day after day.

Some say astrology is what really moves prices. Could be. Last week, every commodity on the board was down but Yen. Why should that be? It is not intellectually feasible to have Gold and the Bonds down at the same time or the meats and the grains. Yet it happens. Time after time, I have seen this phenomena.

Others say trend or speed resistance lines are what moves the market. The Gann crowd has their angles, origin points, and so on; now I for one don't believe in them. Yet time after time I have seen markets top the bottom right where these electric tools said they would.

Then, of course, there are fundamentals. Sometimes bullish news "makes" the market rally; just as often, though, the market declines following positive news and rallies after bad news!

It is no wonder that no one I have known in my 33 years of trading has consistently predicted what the market would do. Invariably, the hottest most

brilliant hands turn cold. I do not accept that this is a case of "them" getting "us." It is a case of dealing with unstable data.

Fortunately though, we can make money trading as there are a few indices, patterns, and techniques that will make money. Not always, but usually.

One of the better of these is the powerful impact that interest rates have on stock prices. This is not a new conclusion. In my 1969 book, *The Secret of Selecting Stocks*, I discussed Will Go, and index I created back then to give an idea of future stock trends based on yields (yields are impacted by interest rates).

An easier way of looking at the problem is to monitor the price of Treasury Bonds against the S&P 500. Not only is it easier, but thanks to the computer we can see what, if any, relationship exists between these markets.

## Logic 101

I had a great logic professor at the University of Oregon, Albury Castell. Many of you used his books in your logic and ethics classes. His class was the most stimulating one I took, outside my major, in four years of college. Looking back on it, I would also say it has been the most useful in life after college.

Have you ever thought about how much "stuff" we teach kids, or had taught us, that we never, ever use? All that math, and 90 percent of us actually only use about 10 percent of it. When's the last time you squared a circle or cuddled up with a copy of Beowulf? Or forgot and ended a sentence with a preposition? I suspect all this forced feeding of education is why we are not very "street smart" and fall prey to well-argued fallacious arguments and have been easily misled by market gurus.

## These Words Are My Bond

Back to Logic 101. One of the first rules of logic is that you cannot predict A with A. Yet day after day, we market analysts use price to predict price. Oh, we might cover it up and say we are predicting price with an oscillator or a moving average, or trendline. But the simple truth is we are using tools created from price to predict price. Dr. Castell would flunk 90 percent of technicians.

Here is something really wild . . . the tabulation displayed in Figure 15.1 showing $141,792.50 profits from trading the S&P 500 was accomplished without ever once using the price of the S&P! These buy signals were given in a fashion that said when conditions A in data A happens then and only then buy long in data B, the S&P. Given the average profit per trade of $1,750, which is 2.20 times greater than the average loss and a drawdown of less than 13 percent of monies earned, I think it is safe to conclude that data A is highly predictive of data B.

```
Data              : S&P 500 IND-9967    03/99
Calc Dates        : 08/09/82 - 03/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 45   $  0   $ 3,000  CT/PC   C:\GD\BACK67\FS9.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $141,792.50
Gross profit              $236,952.50    Gross loss              $-95,160.00

Total # of trades              81        Percent profitable           53%
Number winning trades          43        Number losing trades         38

Largest winning trade     $24,980.00     Largest losing trade    $-14,107.50
Average winning trade      $5,510.52     Average losing trade     $-2,504.21
Ratio avg win/avg loss          2.20     Avg trade (win & loss)    $1,750.52

Max consecutive winners         5        Max consecutive losers        4
Avg # bars in winners          46        Avg # bars in losers         12

Max closed-out drawdown  $-18,722.50     Max intra-day drawdown  $-19,880.00
Profit factor                   2.49     Max # of contracts held       1
Account size required     $22,880.00     Return on account           619%

                        Highlights - All trades
Description                             Date        Time       Amount
-------------------------------------------------------------------------
Largest Winning Trade                 02/25/98        -   $   24,980.00
Largest Losing Trade                  10/22/87        -   $  -14,107.50
Largest String of + Trades            08/15/89        -             5
Largest String of - Trades            06/24/94        -             4
Maximum Closed-Out Drawdown           10/26/87        -   $  -18,722.50
Maximum Intra-Day Drawdown            01/08/88        -   $  -19,880.00
```

**Figure 15.1** S&P 500 buy signals based exclusively on bonds.

## A Look at Data A and Data B

These results were attained by buying the S&P 500 (market on close) any day that the Bond market closed higher than the highest high of the last 14 days.

The trade was exited in one of two fashions; either a trailing stop of the lowest low of the last 17 days—in Bonds—or a 3,000 stop from the point of entry.

Thus, when Bonds break out of a 14-day channel, buy the S&P, exit at a dollar loss or a 17-day channel breakdown in Bonds. Here is an even more important point . . . channel breakouts in the S&P make for very poor systems. Yet, channel breakouts in Bonds obviously have a strong impact on stock prices.

Now here is what is really fascinating. A 14-day breakout of S&P prices on their own produces a miserable track record. In fact, there is little to offer a trader taking channel breakouts in this market. The "best" numbers are between a 15- and 20-day break. But even then, while money is made, the drawdown is insufferable and most the profit comes from one large winning trade.

```
Data              : S&P 500 IND-9967    03/99
Calc Dates        : 08/09/82 - 03/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 45   $  0   $  3,000  CT/PC   C:\GD\BACK67\F59.DAT

////////////////////////// ALL TRADES  - Test 8 \\\\\\\\\\\\\\\\\\\\\\\\\\
```

| | | | |
|---|---|---|---|
| Total net profit | $123,355.00 | | |
| Gross profit | $205,865.00 | Gross loss | $-82,510.00 |
| Total # of trades | 106 | Percent profitable | 45% |
| Number winning trades | 48 | Number losing trades | 58 |
| Largest winning trade | $37,892.50 | Largest losing trade | $-5,857.50 |
| Average winning trade | $4,288.85 | Average losing trade | $-1,422.59 |
| Ratio avg win/avg loss | 3.01 | Avg trade (win & loss) | $1,163.73 |
| Max consecutive winners | 5 | Max consecutive losers | 5 |
| Avg # bars in winners | 35 | Avg # bars in losers | 9 |
| Max closed-out drawdown | $-15,017.50 | Max intra-day drawdown | $-17,280.00 |
| Profit factor | 2.49 | Max # of contracts held | 1 |
| Account size required | $20,280.00 | Return on account | 608% |

Highlights - All trades

| Description | Date | Time | Amount |
|---|---|---|---|
| Largest Winning Trade | 08/08/97 | - | $ 37,892.50 |
| Largest Losing Trade | 11/20/87 | - | $ -5,857.50 |
| Largest String of + Trades | 08/31/87 | - | 5 |
| Largest String of - Trades | 07/06/93 | - | 5 |
| Maximum Closed-Out Drawdown | 10/11/90 | - | $ -15,017.50 |
| Maximum Intra-Day Drawdown | 10/29/90 | - | $ -17,280.00 |

**Figure 15.2** S&P 500 buy signals based bonds with stop from the S&P 500.

```
Data              : S&P 500 IND-9967    03/99
Calc Dates        : 08/09/82 - 03/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   2.500  $ 45   $  0   $  3,000  CT/PC   C:\GD\BACK67\F59.DAT

////////////////////////// ALL TRADES  - Test 7 \\\\\\\\\\\\\\\\\\\\\\\\\\
```

| | | | |
|---|---|---|---|
| Total net profit | $88,055.00 | | |
| Gross profit | $178,002.50 | Gross loss | $-89,947.50 |
| Total # of trades | 480 | Percent profitable | 82% |
| Number winning trades | 398 | Number losing trades | 82 |
| Largest winning trade | $6,392.50 | Largest losing trade | $-4,170.00 |
| Average winning trade | $447.24 | Average losing trade | $-1,096.92 |
| Ratio avg win/avg loss | 0.40 | Avg trade (win & loss) | $183.45 |
| Max consecutive winners | 22 | Max consecutive losers | 2 |
| Avg # bars in winners | 2 | Avg # bars in losers | 3 |
| Max closed-out drawdown | $-11,752.50 | Max intra-day drawdown | $-13,580.00 |
| Profit factor | 1.97 | Max # of contracts held | 1 |
| Account size required | $16,580.00 | Return on account | 531% |

Highlights - All trades

| Description | Date | Time | Amount |
|---|---|---|---|
| Largest Winning Trade | 10/21/87 | - | $ 6,392.50 |
| Largest Losing Trade | 07/05/96 | - | $ -4,170.00 |
| Largest String of + Trades | 08/25/88 | - | 22 |
| Largest String of - Trades | 10/30/97 | - | 2 |
| Maximum Closed-Out Drawdown | 11/22/94 | - | $ -11,752.50 |
| Maximum Intra-Day Drawdown | 12/08/94 | - | $ -13,580.00 |

**Figure 15.2A** S&P 500 buys based on bonds with 1–2 day hold.

On the other hand, it does not matter too much which channel breakout you use in Bonds to trigger an S&P entry . . . they all make money. Most rather nicely.

As an example, I offer the tabulations in Figure 15.2, the result of using a 14-day Bond market breakout for your entry and exiting at the lowest low of the last 12 days in the S&P. We will use the Bonds to get us long and protect ourselves with S&P price data.

Finally, those of you who have gone to my seminar will find that very short-term Bond channel breakouts (in conjunction with what we know as ½ bailout) produce outstanding results. In the last year, something like 42 out of 49 trades were winners with an average profit per trade of $527. Figure 15.2A shows this technique. While the profits are less at $88,055, you may be attracted to the high accuracy at 82 percent.

## Let's Break Some Bad Habits

Three things lead to the demise of commodity traders: a bad system, no money management, and . . . bad habits.

*Bad habits*—no, that's not the name of a rock group your kids listen to (it would probably sell a lot of records though). What do I mean by bad habits? Well on analysis, it breaks down into two areas.

The first area includes the bad habits you already know about. On the West Coast, the lackadaisical attitude we sometimes assume can mean not going to bed early enough to be alert at 5:10 A.M.—every single day of the year. On the East Coast, it may mean putting off your morning work until just before the opening bell.

Worse yet, we may not maintain our health and balance with the non-commodity world, the one we live in with our families and friends. But those bad habits are the ones we know of, deal with, and fight with all the time in our total sense of living as well.

The second area involves the *real bad habits.* In the business of trading, these are the habits, we have learned thinking they are right (or good habits) when nothing could be further from the truth.

Bad habits ingrained in this fashion become operating rules that are the very building blocks for what we think is success, but since the foundation is wrong we can never create profits. Aynn Rand was right: always check your premise.

The most common bad habit I have seen in traders—good and bad ones—is the inability to react correctly to market action. There is nothing outside market action, other than what we ascribe to it . . . that's the rub. When you input something "overlaid" on the market action, you are telling the market instead of listening.

The most common form of doing this is a very bad habit—you want to sell strength. Or, just as bad once you see a very strong market—say limit up—that little voice inside your head tells you to await a pullback—not to chase this move and that it must come back.

In short, it scares the hell out of you to buy new highs, sell new lows.

## How to Break Bad Habits

I know of only two ways to break bad habits. The first is to repeat, time and again, the correct action to build up a Pavlovian response that brings about the right action.

The other way is to have an intellectual understanding that the bad habit is wrong and replace the "knowledge" with correct data . . . the truth. So here are two doses of market truths.

### Truth 1

*Buy when a market closes on or near its high; sell when a market closes on or near its low (limit up/down moves see a continuation of surge).*

Yes, I know, it is really tough—intellectually and emotionally—to buy or sell up or down limit moves. But the truth is lots of money can be made in so doing. Here, let me show you: I went into System Writer and asked a simple question, "If price today closed in the upper 65% of the day's range, what would happen if I bought on that close and exited 5, 10, 15, and 20 days later?" The results are shown in Figure 15.3. With a stop for protection, this information is powerful. In all markets, this basic strategy made money as the following table depicts.

Even more staggering is that, as explained in an article I wrote for *Futures* magazine a year ago on candlestick charts, I took the "most bullish" candlestick formations and exited in the fashion described here. In the test,

| Exit Number of Days Later | Profits | Percent Wins | Number of Trades | Average Profit |
|---|---|---|---|---|
| 5 | $ 95,745 | 53 | 533 | $179 |
| 10 | 86,507 | 53 | 334 | 259 |
| 15 | 133,745 | 56 | 537 | 537 |
| 20 | 152,115 | 54 | 199 | 764 |
| 25 | 118,390 | 51 | 178 | 665 |

Figure 15.3 Buy S&P 500 market on close if close is above 65% of range for the day.

none of the patterns worked across all markets. Yet, here, one simple pattern, produces profits on all fronts? Egad, . . . buying incredibly strong markets is a good habit.

This is strange stuff. In our guts, we want to sell these strong days and buy the weak ones. You got it, we all like a discount. But, in this business of trading, discount leads to bankruptcy.

If any one good habit separates the pros I know from the public, it is their willingness to buy strength. Bill Meehan first tried to break me of my bad habit of buying pullbacks many years ago, and I can vouch it does not take a person that long to unlearn. Fix into your mind that strength is power and a market needs power to continue its trend.

To further get this point through our thick skulls, I will add that the best "chartist" buy signal I know of is when the price literally goes off the top of your chart, so you have to add chart paper. That is the ultimate buy.

## Truth 2

*Buy new highs/sell new lows.*

If I had to guess, my guess would be that more money has been made by buying new highs and selling new lows than with any other techniques known to traders. The converse is equally true; more has been lost (forever and ever) selling new highs, buying new lows.

Usually we see a new high and—if not long—decide to bypass the trade or await a pullback. That is wrong, real wrong as the following study reveals. This study only bought breakouts to new X day highs! It, the computer, did what the public and poorly "trained" trader can never do.

This truth is confirmed by the computer. The next set of data in Figure 15.4 shows what happens if today's high is less than the highest high of the last X days and price makes a new high tomorrow, which puts us long buying a new X day high.

| Number of Days of Breakout | Profits | Percent Wins | Number of Trades | Average Profit |
|---|---|---|---|---|
| 1 | $106,945 | 58 | 209 | $511 |
| 5 | 67,197 | 51 | 187 | 359 |
| 10 | 58,270 | 50 | 169 | 344 |
| 15 | 75,325 | 56 | 145 | 519 |
| 20 | 55,342 | 53 | 136 | 406 |

**Figure 15.4** Buy a S&P 500 breakout of the highest high last x days exit 13 days later $3,500 stop.

Again, we exit some days later. A $3,500 stop was used. We are chasing strength to buy. Buying new highs is a successful strategy. The preceding is not a system, rather an illustration to drive home the importance of letting strength lead the way. Most traders are frightened or intimidated by excessive strength. Thus they do not buy, or worse yet, sell short.

As it has been said, the race or the fight, may not always go to the biggest, the fastest, or the toughest. But, my friend, that is the way to bet.

## Comments on Setting Stops—Dollar Loss and Unpredictability

There are only two givens to this business, first, you *must* control loss; second, price is highly unpredictable. The goal of system development is to create the ultimate money-making machine that, like an oil well, just keeps pumping out profits. Although you may never attain that goal, you can acquire an amazing amount of insight into correct trading from system development.

### What Is the Purpose of a Stop?

Correct stop placement provides an example of what system development has taught us. We use stops for one and only one reason—to protect us when our system fails. Systems fail all the time; if that potential liability did not exist, stops would not be needed. Stops are our defensive shield and what they protect us from is the unpredictability of (1) our system and (2) the market itself.

The game of trading involves so much unpredictable behavior that stops can hurt you, if they are too close. Indeed, the closer your stop, the more times "they will have gunned for you," the more you will be stopped out, and the more paranoid you will become. Since no trader I have met can predict down to a gnat's eyelash (due to all the random activity of price), our stops must be beyond—or past—random fluctuations. They must be far enough away that if they are hit it will be because of real—not random—activity. That is Lesson 1.

### Now Comes Reality

Here's the next important thing about stops: since their purpose is to defend against ruin, they need to also be based on money management principles. As an example, here is the same S&P 500 Day Trading system but with three different stops.

Figure 15.5 uses a $500 stop, then a $1,500 stop and finally a $6,000 stop. There are some huge differences here we need to explore. Keep in mind

```
Data              : S&P 500 IND-9967    03/98
Calc Dates        : 01/01/86 - 01/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------
  149   2 $   5.000  $ 45   $  0   $ 3,000  CT/PC   C:\GD\BACK67\F59.DAT

//////////////////////////// ALL TRADES  - Test 1 \\\\\\\\\\\\\\\\\\\\\\\\\\\\

Total net profit          $-41,750.00
Gross profit              $165,665.00    Gross loss              -207,415.00

Total # of trades             510        Percent profitable          26%
Number winning trades         133        Number losing trades        377

Largest winning trade     $11,955.00     Largest losing trade     $-2,045.00
Average winning trade      $1,245.60     Average losing trade      $ -550.17
Ratio avg win/avg loss          2.26     Avg trade (win & loss)    $-81.86

Max consecutive winners           4      Max consecutive losers        14
Avg # bars in winners             0      Avg # bars in losers           0

Max closed-out drawdown   $-77,725.00    Max intra-day drawdown   $-77,725.00
Profit factor                   0.79     Max # of contracts held         1
Account size required     $80,725.00     Return on account             -51%

                        Highlights - All trades
Description                             Date       Time      Amount
-------------------------------------------------------------------
Largest Winning Trade                03/27/97       -   $   11,955.00
Largest Losing Trade                 03/17/97       -   $   -2,045.00
Largest String of + Trades           12/15/97       -           4
Largest String of - Trades           11/07/94       -          14
Maximum Closed-Out Drawdown          04/08/96       -   $  -77,725.00
Maximum Intra-Day Drawdown           04/08/96       -   $  -77,725.00
```

**Figure 15.5** S&P system with $500 stop.

this is the exact same system, all that's changed is the amount of risk we are willing to accept as determined by the stop.

With a $500 stop the system actually loses money, $41,750 to be specific! Our accuracy at 26 percent on the 510 trades suggests this is certainly not a very good system.

Or is it? The next tabulation shown in Figure 15.6 reflects the same system, that is the exact same buy and sell entry rules, but uses a stop loss of $1,500. What a difference the stop makes! The accuracy screams up to 56 percent and we turn a losing system into a winner taking profits from a negative $41,750 to a positive $116,880, close to a $160,000 change. Gee whillikers, could there be something to this stop loss stuff after all?

Our next test of the system is to use a $5,000 stop. Does this improve the performance? Well, yes and no. It does make more money netting $269,525 and the accuracy gets boosted up to 70 percent. But we pay for it. Notice in Figure 15.7 how the largest losing trade gets bumped up to $5,920 as opposed to $2,045 with a $1,500 stop. Worse yet, the average losing trade was $1,263 with a $1,500 stop and rises to $1,661 as the risk amount increases while the average winning trade at a $1,500 stop is $1,371 and only increases to $1,477 as the stop backs off.

```
Data              : S&P 500 IND-9967    03/98
Calc Dates        : 01/01/86 - 01/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   5.000  $ 45   $  0   $  3,000  CT/PC   C:\GD\BACK67\F59.DAT

////////////////////////// ALL TRADES  - Test 3 \\\\\\\\\\\\\\\\\\\\\\\\\\
```

| | | | |
|---|---|---|---|
| Total net profit | $116,880.00 | | |
| Gross profit | $393,560.00 | Gross loss | -276,680.00 |
| Total # of trades | 506 | Percent profitable | 56% |
| Number winning trades | 287 | Number losing trades | 219 |
| Largest winning trade | $14,205.00 | Largest losing trade | $-2,045.00 |
| Average winning trade | $1,371.29 | Average losing trade | $-1,263.38 |
| Ratio avg win/avg loss | 1.08 | Avg trade (win & loss) | $230.99 |
| Max consecutive winners | 11 | Max consecutive losers | 7 |
| Avg # bars in winners | 0 | Avg # bars in losers | 0 |
| Max closed-out drawdown | $-20,970.00 | Max intra-day drawdown | $-20,970.00 |
| Profit factor | 1.42 | Max # of contracts held | 1 |
| Account size required | $23,970.00 | Return on account | 487% |

Highlights - All trades

| Description | Date | Time | Amount |
|---|---|---|---|
| Largest Winning Trade | 10/13/89 | - | $ 14,205.00 |
| Largest Losing Trade | 03/17/97 | - | $ -2,045.00 |
| Largest String of + Trades | 05/25/93 | - | 11 |
| Largest String of - Trades | 03/07/86 | - | 7 |
| Maximum Closed-Out Drawdown | 01/08/88 | - | $ -20,970.00 |
| Maximum Intra-Day Drawdown | 01/08/88 | - | $ -20,970.00 |

**Figure 15.6** Same S&P system with $1,500 stop.

```
Data              : S&P 500 IND-9967    03/98
Calc Dates        : 01/01/86 - 01/01/98

 Num. Conv. P. Value  Comm  Slippage  Margin  Format  Drive:\Path\FileName
-------------------------------------------------------------------------------
  149   2  $   5.000  $ 45   $  0   $  3,000  CT/PC   C:\GD\BACK67\F59.DAT

////////////////////////// ALL TRADES  - Test 10 \\\\\\\\\\\\\\\\\\\\\\\\\\
```

| | | | |
|---|---|---|---|
| Total net profit | $269,525.00 | | |
| Gross profit | $508,730.00 | Gross loss | -239,205.00 |
| Total # of trades | 490 | Percent profitable | 70% |
| Number winning trades | 346 | Number losing trades | 144 |
| Largest winning trade | $14,205.00 | Largest losing trade | $-5,920.00 |
| Average winning trade | $1,470.32 | Average losing trade | $-1,661.15 |
| Ratio avg win/avg loss | 0.88 | Avg trade (win & loss) | $550.05 |
| Max consecutive winners | 16 | Max consecutive losers | 4 |
| Avg # bars in winners | 1 | Avg # bars in losers | 0 |
| Max closed-out drawdown | $-19,825.00 | Max intra-day drawdown | $-19,825.00 |
| Profit factor | 2.12 | Max # of contracts held | 1 |
| Account size required | $22,825.00 | Return on account | 1,180% |

Highlights - All trades

| Description | Date | Time | Amount |
|---|---|---|---|
| Largest Winning Trade | 10/13/89 | - | $ 14,205.00 |
| Largest Losing Trade | 10/10/95 | - | $ -5,920.00 |
| Largest String of + Trades | 09/14/88 | - | 16 |
| Largest String of - Trades | 07/27/95 | - | 4 |
| Maximum Closed-Out Drawdown | 01/15/87 | - | $ -19,825.00 |
| Maximum Intra-Day Drawdown | 01/15/87 | - | $ -19,825.00 |

**Figure 15.7** Same S&P system with $6,000 stop.

The problem is that when you get tagged with the larger stop you can drop too much of your bankroll, $6,045, on just one trade. This is a critical point. If you don't want to risk more than 5 percent of your account on any one trade on a $100,000 account you can trade only one contract with the $6,000 stop, while the $1,500 stop allows you to trade two contracts which effectively doubles the profits on your $100,000 account. This may not sound like much but when you use my money management formula the results are dramatically different.

The lesson you have learned, I hope, is that dollar stops are far more effective than the whirling dervishes of technical analysis.

# Chapter 16

# Closing Comments

I have shared a lot of my life with you in these pages and most all of what little I know about the markets. And, while this book is my gospel of trading, it should not be your gospel. You need to implement what I have that works for you, twist it around, come up with better ideas and new approaches, but the basis I have presented here is sound, workable trading material.

In this chapter, I wrap this all up with some comments on how to use my material, or anyone else's:

*This is not a black-and-white business.*

"But you said . . . Page 63 says to . . . This line crossed that one . . . It's trading day of the month 11, shouldn't I . . . ?" Those are typical comments I hear every day from readers of my books and illustrate an important part about being a winning trader.

## It Is Just Like Life

Not only is this business not black and white, neither is life. We all know that (I think), yet as traders we want absolutes so badly that we absolutely forget to think. For example, math is an absolute, but when applied to the imperfect world of stocks and commodities, it reverts to being a tool that

simply gives more clarity and definition to the imperfections. Please, never forget that above all else, speculation is a thinking business. If you are not good at thinking, or at least at getting correct answers, I suggest that you look for the off ramps.

This problem begins with a wish or hope that there is some be-all automatic/systematic approach to trading. The two greatest bits of bad information so-called advisers and authors such as myself foist on the great unwashed masses is either extreme and continual bearishness, or the belief that somewhere, someplace, there exists an absolutely perfect system—that there is precise cadence, order, and structure to the markets. These are the two great myths of speculation.

Yes, there are times to be bearish on stock and the economy, but there's an entire camp of newsletter writers making a pretty good living by deliberately pandering to fears of gloom and doom, of another 1929 . . . starting tomorrow. I know these folks; I have appeared at the same symposiums with them, and I have seen them consistently bearish, in one case, since 1962! One of these "Negative Nellies," in a private conversation told me there was a huge market of investors who feared the future, actually believed things were falling apart quickly and it was his business to flame these fires. He added, "It's easier to sell subscriptions to these people, they are an easy-to-target market, and if I'm wrong on stock picks, it doesn't matter, performance does not count, it's reaffirming their belief that they want to hear."

This crowd is full of pontificators, good people who have overanalyzed everything and concluded the future for the United States, and the world, is behind us. And yet, even the most cursory study of history will establish one dominant fact; *our condition and lot in life is constantly getting better.* Yes, there are some downs, but they are far outweighed by the ups.

There is another side to this coin, the "cosmic trader" who is convinced there is an explanation for every market high and low, that every up-and-down tick in price is fully explainable, and usually for a pretty stiff fee payable up front to them! When I was young and ignorant of the ways of the market, and my fellow traders, I fell for this pitch. After all, these people had a track record of success and could explain away all the market moves that had taken place in the past.

Usually the foundation for this belief is based on the legend of W.D. Gann, I have already written about the "legend" and that it was just a good dose of showmanship mixed with some winning trades, a bit a braggadocio and an aggressive public relations man. Again this is not my opinion, but facts as related to me by F.B. Thatcher, the advance man for old W.D.

The more time I spent in outer space with this crowd, the more losing trades I saw. Although their explanations of the past were brilliant, their forecasts of the future were right about one time out of twenty and, naturally, that's the one they talk (brag) about in all their advertisements. There is no

reality here; the fact they were dead wrong in the past did not prevent or harness them from again attempting to predict the future! Accuracy, making money, has nothing to do with their life—it is all about "proving" their mumbo-jumbo works. I have been on the speaking circuit with these folks as well, and have come to have little respect for this crowd, with some exceptions.

Of the thousands of traders applying this cosmic logic, I have only seen two do well, Arch Crawford and Jerry Favors. Two out of thousands is not a great batting average. In addition, Arch and Jerry are not only exceptionally smart people, but well-trained, experienced traders who use more than just one approach.

The bottom line problem with the "all can be known" thesis is that it causes you to throw away fear, to place your convictions, and money, on a thesis, not what is actually going on in the market. If your focus is the market, what is happening now, and not a belief that stock or commodity prices must do something, your chances for success will skyrocket:

*A perfect system or approach does not exist. Never has, never will.*

If there were such a thing as perfection in this business, then that would mean (1) the markets contain no random inputs and (2) someone else would have already found the magical solution and own most of the free world by now. Since we know the markets do have a high degree of random influence from ever-changing news, weather, traders' outlooks, and that even the best traders and funds tap out, we must realize that the markets are not to be traded with a 100 percent mechanical approach. Things change.

Does this sound strange coming from someone who has just about spent his entire adult life developing systematic approaches to trading? Probably so, and it should not be taken to mean all my work, or systems and such, don't work:

*Life is a judgment call, but that call is based on having data and systems to make life work better. So it is with trading. I need a systematic approach to get me into and out of trades, I need absolute stops, and I sure as heck need precise entry rules.*

But above all, I need to use some judgment of when to use this "stuff." Let's look at an example from real life.

If you are driving down the road and a truck is dead ahead of you in your lane, do you stay in that lane or swerve across to the empty lane where you are not supposed to be? The rules are clear, you are not supposed to be over there. The system says don't do it, but reality is an 18-wheeler coming toward you in your lane. Do we follow all the rules of safe driving, or do we adapt to the situation at hand? Survival is a function of adaptation.

Reality rules. On the road, in the markets:

*The first rule of life is to survive; the second rule is that all rules can be broken if that supports the first rule.*

Speculation follows the same rules we use for life; they are integrally the same. Successful trading is the art of using knowledge (systems) at the right time. This means when it is time to use the system or rule, you check for an oncoming 18-wheeler. That is what thinking is all about. We do need systems of living and systems for trading. But it is not mandatory that you follow *all systems exactly all the time*. The reason is that systems do not adapt to any new bits of reality. That is what our mind is for, to observe, to record, to note changes, and then to develop an optimum use of the system.

If you do not know what to do as you are trading, you must follow the rules because they will keep you alive. If you like market conditions and they fit what your rules suggest, go for it; if the rules don't fit conditions or conditions don't fit the rules . . . pass. You don't have to trade every day. The object of having systems and rules is to run them to your best advantage, and not to let them run you.

I wish you well, I wish you good luck and good trading, and most of all I remind you to remember those three little words:

*Always use stops.*

# Index


A

Accuracy, 199
Active traders, 73
Adams, Richard, 108
Adaptation, 247–248
Advisory services, 205
Aggressive trading, 2, 170
Amateur traders, 213
Athletics analogy, 209
Average profit per trade, 60

B

Babcock, Bruce, 114
Bad habits, 237–240
Balance, in price and time swings, 47–55
Bar charts, 11, 131. *See also specific types of trades*
Bearish markets, 37, 70, 72, 77
Bearish trades, 246
*Behavior of Prices on Wall Street, The* (Merrill), 120
Belief system, 4–5, 202–203, 228
Bernstein, Jake, 77, 114
Bias, trading on, 85–88
Bond market
  daily range breakouts, 61
  long-range days, 34–35
  Oops! pattern, 116–117, 120
  patterns, 97–99
  stock prices and, 72
Bottoms, 37–39, 55, 133
Breakouts:
  smash day patterns, 105
  specialists' trap, 109
  volatility (*see* Volatility breakouts)
Brie, Doug, 58
British Pound, 84
Bullish markets, 70, 77–78
Bullish patterns, 95–96, 98, 101
Buy setup, smash day, 101
Buy signals, 109, 115–117
Buy swing, 123

C

Casinos, 166–167, 172. *See also* Gambling; Games of chance
Castell, Albury, 234
Chalek, Mike, 71
Channel breakouts, 235
Chaos, 12, 19
Charting, generally, 11–13, 19, 43, 60
Chartists,12–13, 15, 93
Chase, Henry Wheeler, 16
Clinton, Hillary, 227
Close, holding strategies and, 51–52
Close-to-close relationship, 85
Closing, high/low, 39
Commodity Futures Trading Commission (CFTC), 175
Commodity Research Bureau, 208
Commodity Timing, 208
*Commodity Timing* articles:
  Art of Fly-Fishing Revisited, The, 193
  Athletics Are Such a Parallel to Trading, 209
  Beating Them to the Punch, 218–221
  Boston Marathon, 1996, 191
  Broken Nose, Cauliflower Ears, and Bad Trades, 223
  Difference Between Winners and Losers, The, 231–232

*Commodity Timing* articles *(Continued)*
Doing the Wrong Thing . . . It's So Easy, Isn't It?, 190
Don't "Show Me the Money," 200–201
Enough on Greed . . . Now Let's Deal with Fear, 187
Farmer, The Gambler, and the Speculator, The, 212
Fear and Greed, Looking Them in the Face Again, 194
Folks, It Just Can't Be Done, 214–215
Hillary, Highs Hopes, and Heartaches, 227
How to Buy a System/Newsletter . . . They Are All Making Money!, 204–205
How to Measure the Public vs. the Pros, 213
If You're Supposed to Quit When You Are Ahead, Shouldn't You Start When You Are Behind?, 198–199
In an Information Age . . . Information Is Not Enough, 188
It's Not the Trade, It's the Battle, 192
Learning How to Lose Money, 224
Lock-Up Time, 186
Medea, 225–226
Most Important Trading Belief You Have, The, 203
Nervous Nellies–Heaven Bound, 228
Number One Reason We Lose Money Trading, The, 202
Pepsi Proves the Point, 195
Review of Losing Trades Showed That, A, 197
Running, Trading, and Losing, 189
Rush of Trading, The, 216–217
Secrets of System Developing and Trading, 229–230
Show Must Go On, The, 222
Twitching Worms and Traders, 206
What Causes Stock and Commodity Market Trends, 210–211
Why Most Traders Lose Most of the Time, 196
Worst Dog I Ever Had, Cost the Most, The, 207–208
*Commodity Traders Consumer Reports*, 205, 207, 217
Commodity Trend Service, 208
Computer technology, impact of, 78–79
Confidence, in speculators, 168–169
Control:
risk and, 46
significance of, 225
Cootner, Paul, 81–83
Crawford, Arch, 247
Cycles:
moving average, 24–26
opening, high/low, 33–36
range change, 27–33
types of, generally, 23–24, 27

**D**

Daily range breakouts, 61–65
Daily range values, 58
Day traders, 47
Day trading, 133, 139
Day of week dependency, 83
DeMark, Tom, 37
Dependency, day of week, 83
Dominant cycle, 23
Dorffman, Dan, 76
Dow Jones Average, 148
Dow Jones 30 index, 148
Downtrends, 39, 104, 109
Drawdown, 52, 64, 154, 178–179
Dunnigan, Richard, 93

**E**

Efficient market, 81, 83
Emotional trades, 100, 114, 225–226
Entry techniques, generally:
Talon system, 71–72
TDW (trade day of week) strategy, 61–64, 66–70,72, 84–87

Exit rules, 157
Exit techniques, 87–88

F

Failures. *See* Losing trades
Failure swings, 123
Favors, Jerry, 247
Fear:
  dealing with, generally, 187, 194, 203, 206, 220–221
  in speculators, 169–170
Federal Reserve, 78
Fetridge, Alice, 10
Filtered trades, 72–73, 95, 152, 155
First-of-the-month trades, 149
Fixed ratio trading, 179–180
Flags, 12
Fly-fishing analogy, 193
Focus, importance of, 195
Forecasting, 94, 133, 214–215, 218–220
Fosback, Norm, 120
Freight train theory, 210
Futures Factors, 208

G

Gain, 45
Gambling, 162–163, 166, 212
Games of chance, 84
Gann, W. D., 195, 246
Gartley, 93
Genesis Data, 184
Gold, 84–85, 124, 138, 141, 152–156
Granville, Joe, 10
Greatest swing value (GSV):
  applications, generally, 126–128
  defined, 123–124
  stock index trading, 124–128
  volatility breakouts and, 128–129
Greed, 187, 194, 203, 220–221
Greenspan, Alan, 94

H

Haller, Gil, 10
*Haller Theory* (Haller), 10
Harriman, E. H., 79–80
Head and shoulders, 12
Hidden smash day, 102, 104
High, in short-term market:
  defined, 16
  intermediate, 17–20
High/low concept, 133
Holding strategies, 45–46, 51–53
Hooper, Curt, 12

I

Indicators, analysis of, 76
Information age, 78–79, 188
Inside day, 16–17
Intermediate highs, 17–20
Intermediate lows, 17–20
Intraday traders, 127

J

Joe, Frankie, 78
Jones, Ryan, 179–180, 199

K

Kelly formula, 174–177, 179

L

Lane, George, 6
Large-range days, 27–36, 47–48
Linden, W. L., 94
Livermore, Jesse, 54
Logic, 234
Long-term low, 19

Losing trades, dealing with, 45, 54–55, 73, 189–190, 197, 199, 202, 222–224, 231
Loss reduction strategies, 47
Low, in short-term market:
  defined, 16
  intermediate, 17–20

M

Market analysis, 46
Market belief, 4–5
Market psychology. *See Commodity Timing* articles
Market structure, 15–22, 46, 77
Market trends:
  impact of, generally, 2, 210–211
  price pattern and, 36–43
Market Vane, 77
Market volatility. *See* Volatility breakouts
Mathematical models, 77
McAferty, Jack, 5–6
Medea, 225
Meehan, Bill, 9
Mental errors, 192
Merrill, Art, 120
Miller, Joe, 10, 12, 38
Momentum stocks, 10
Money management:
  advantages/disadvantages of, 175–178
  computer software, ULTIMANAGER program, 183–184
  drawdown, 178–179
  fixed ratio trading, 179–180
  hit-and-miss approach, 172
  Kelly formula, 174–177, 179
  risk factor, 181, 183
  significance of, 2–3, 64
Month-end trading:
  bond market, 149–152
  stock indexes, 147–149
Monthly road maps, 89–92
Moving average:
  impact of, generally, 24–26, 60
  3-bar, 136
M tops, 12
Murphy, John, 152
Mutual funds, 4

N

Nader, Ralph, 76
Naked close, 101
National Futures Association, 175
Negative Nellies, 246
Newsletters, 204–205
Nonfiltered trades, 72
Nonrandom market, 14–15, 35, 81

O

Omega Research, 79
On Balance Volume (OBV) charts, 10, 12, 38
1-2-3 formations, 12
Oops! pattern:
  defined, 113–118
  S&P trading, 119–120
Open, volatility expansion value and, 60
Opening, high/low, 33–36
Opening exit rule, 96–97
Opening price, 12
Open-to-close patterns, 34
Optimal F, 177
Oscilllators, 60
Outside day, 16–17
Overbought/oversold markets, 57
Overconfidence, 196
Overtrading, 164

P

Parker, Glen, 120
Patience, significance of, 164–165
Patterns:
  common elements, 94–99

determination of, questions to ask, 99–100
Oops!, 113–120
price (*see* Price patterns)
smash day, 101–108
specialists' trap, 108–113
time frame and, 113
Pennants, 12
Perfect system, 247
Pit boss adage, 163
Pork Bellies, 13, 18, 21
Prediction:
chart formations and, 93
short-term market and, 47, 53
Price momentum, analysis of, 76
Price movement:
cycles, 28–33
implications of, generally, 10–11, 13
Price patterns:
analysis of, 76
types of, generally, 36–43
Primary market, 138
Probability, long-range days, 34–35
Professional traders, 213
Profitability, 47
Psychology, 216–217

Q

Quote screen traders:
characteristics of, 132
strategies, 132–133
three-bar high/low system, 136–138
trend changes (*see* Trend changes)
Will-Spread, 138–145

R

Rallies, 15, 233–234
*Random Character of Stock Prices, The* (Cootner), 81
Randomness, 14, 81–83
Random walk, 82, 84–85
Ratschke, Linda Bradford, 113–114
Real-time trading, 124
Resource allocation, 2
Reversals, 47, 102, 138
Risk-aversion, 164
Risk capital, 4
Risk reduction strategies., 45–46

S

S&P 500, 66–67, 76–77, 83–84, 86–89, 94, 119–120, 235–237
Seaman, George, 93
Secondary market, 138
*Secret of Selecting Stock, The* (Williams), 234
Selling strategies, 36
Sell setup, smash day, 101
Sell signals, 109, 115–117, 123–124, 154–156
Sell swing values, 127
Sentiment indicators, 77
Short-term market, defined, 16
Short-term trading theory:
defined, 75
illustration of, E. H. Harriman's rule, 79–80
information age and, 78–79
news and, 76
public traders and, 77
Small-range day, 27–33, 36, 47, 51
Smash day patterns:
applications, 104–105
defined, 101–104
illustrations, 105–108
Southard, Don, 10, 12, 38
Specialists, 108–113
Speculation:
defined, 160–161
gambling and, 162–163
implications of, generally, 3–4, 9–10, 26, 29, 43, 45, 73, 77, 80
rich people and, 162–163
risk-takers, 163–164
systems development and, 165

Speculation *(Continued)*
timing and, 161, 164–167
trade management, 161–162
winning trades and, 167–168
Speculators. *See* Speculation:
aggressiveness in, 170
characteristics of, 8, 35
confidence in, 168–169
ego, 167–168
fear in, 169–170
Stand-alone trade, 97
Stock, Mike, 152
Stock index trading, 124
Stock market crash of 1987, 141–145
Stop-loss protection, 46, 48
Stops, generally:
money management and, 240–243
purpose of, 240
Stowell, Joe, 101
Supply and demand, 12
System development, 204–205, 229–230

T

Talon system, 71–72
Tape reading, 47
Target months, 148
Taylor, Owen, 93
TDM (trading day of the month) strategy:
bias and, 88
road maps, 89–92
success of, 92
TDW (trade day of week) strategy:
bias in, 87–88
greatest swing value (GSV), 123–124
overview, 61–64, 66–70, 72
patterns, 94–97
random markets, 84–87
success of, 92
Technical analysis, 10, 13
*Technical Analysis of Stock Trends* (Edwards/Magee), 93
Thatcher, F. B., 246
Thorn, Mark, 184, 199
Three-bar high/low system, 136–138
Time frame, significance of, 46–55
Time-of-the-month trades, 147
Tops, 38–39, 55, 133
Townsend-Greenspan, 94
Trade Station, 79
Traders:
professionals distinguished from amateurs, 213
success factors, 45, 231–232
Training, importance of, 191
Traps, selling, 109
Treasury bonds, U.S., 83–85, 88, 139–141. *See also* Bond market
Trend(s)
analysis, 36–43
change (*see* Trend change)
defined, 58
price movement and, 14
Trend change:
classic pattern, 133
swing points as indicators, 134–135
Trendlines, 60
Triangles, 12

U

Ulmer, Riuchard, 6
ULTIMANAGER, 183–184
Uptrends, 38–39

V

Value, 1–2
Variable input, 180
Vince, Ralph, 173, 176–177, 179–180, 198
Volatility breakouts:
defined, 58
greatest swing value (GSV), 128–129
market swings and, 71–72

measurement, 58–60
S&P 500, 66–71
simple daily range breakouts, 61–65

## W

*Wall Street Journal*, 76
W bottoms, 12
Wealth creation, 171, 180, 200–201
Wedges, 12
Will-Sspread:
overview, 138–141
S&P 500 stock index, 141–145
Wyckoff, Richard, 93, 108

## Z

Zweig, Marty, 152