



3RD EDITION

# MASTERING THE TRADE

PROVEN TECHNIQUES  
FOR PROFITING FROM  
INTRADAY AND SWING  
TRADING SETUPS

JOHN F. CARTER

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— THIRD EDITION —

**PROVEN TECHNIQUES FOR PROFITING FROM  
INTRADAY AND SWING TRADING SETUPS**

JOHN F. CARTER

FOREWORD BY PETER BORISH



NEW YORK CHICAGO SAN FRANCISCO  
LISBON LONDON MADRID MEXICO CITY MILAN  
NEW DELHI SAN JUAN SEOUL SINGAPORE  
SYDNEY TORONTO



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*To everyone out there who is giving trading for a living a shot.  
And here's to courage. Have the courage to take a loss so that you will have a chance at keeping some of your profits.*

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# Acknowledgments

Writing and trading have a lot in common in that they are essentially solitary professions that are made much more enjoyable by having people who are willing to lend a helping hand. A lot has changed since the First Edition of *Mastering the Trade* was released in January 2006 and the Second Edition was released in 2012. And yet, a lot has stayed the same. We've had flash crashes, credit bubbles, the great deleveraging process, the real estate crash, the real estate boom, and cryptocurrency mania. Throughout this process, I've enjoyed sharing this journey with the team at Simpler Trading, along with my wife, Maria, and my children, James, Avery, and Dylan. It's an adventure I wouldn't "trade" for anything.

# Foreword

In early 2003, I was attending an online trading conference to educate active traders on a new class of products called “security futures.” After having been in the managed money business for more than 20 years I joined OneChicago because I believed that these products would enhance equity trading in the cash, futures, and options markets. Having avoided these conferences for many years, I was surprised when I had the pleasure of listening to someone who was incredibly articulate and thoughtful. I said to myself, “He really gets it.”

John Carter was not speaking about security futures; rather, he was presenting his intellectual framework and approach to trading. It was a method to which I could relate strongly, so I introduced myself. We spoke at length on many subjects, including the idea that his methodology could be applied to security futures and that successful trading is one long journey, not a destination. John became an early supporter of and trader on OneChicago, another indication of his innovativeness. We have continued to exchange ideas, and therefore, I was honored when John asked me to review *Mastering the Trade*.

I judge a book on trading according to one simple criterion: Have I learned something new? *Mastering the Trade* not only introduces new concepts; it is insightful and easy to read. This is indeed a rare combination in the trading literature. In addition, John stresses that there is neither a single approach nor a single answer to successful trading. In fact, he emphasizes that before one can be a profitable trader, one must fully understand one’s own personality. Every decision, from the holding period of a trade to the amount of one’s capital to risk per trade, reflects the trader’s inherent preference curves. In fact, *Mastering the Trade* begins by emphasizing the importance of the proper approach to trading prior to discussing methodology.

Once the book turns its attention to the process of trading, it sparkles once again. Regardless of how long one has been in the markets, there are new approaches or enhancements to existing ones that I find quite beneficial. For example, from an active participant in the stock index futures markets, John’s unique application of extreme tick readings is very insightful. I can then decide whether to apply it to my own trading, test it further, or ignore it entirely. The beauty of trading is that there is not one size that fits all, and John does not try to force his ideas on anyone. They are presented, discussed, and then demonstrated. Amazingly enough, not every trade is always a winner. The setup is a probability outcome that, if followed over time, should lead to trading success. This is the essential message that John drills repeatedly. Bad trades happen all the time; it is how one reacts to them that determines one’s future success.

Another point that *Mastering the Trade* makes is that there is no single answer to the question: Should one be short or long a market? There are always valid reasons to be both ways. The markets provide some clues, but one’s trading style needs to provide the rest. That is why John shows how to use everything from monthly charts to one-minute pivots. A full-time trader should have different volatility and risk parameters from one who only examines the market before the open and after the close.

Trading is an emotionally debilitating business. One can always explain yesterday perfectly. The weekly



trader says: “If I had only followed the one-minute chart, I would not have gotten caught in that position.” The one-minute, intraday trader says: “If I had only leaned against that weekly pivot point, I wouldn’t have gotten stopped out, and I would have had a huge winner.” John doesn’t play this game. He applies an intellectually honest process to trading, suggests risk/reward setups, and then lets the markets do the rest. Remember, the market is always right. It is the analysis or setup that is wrong.

*Mastering the Trade* reinforces what successful traders intuitively do every time, they place a position: trade small, stay in the game, and try to let time be your ally. Losing streaks are bound to occur. But knowing that they will occur and living through them are two different things. Diversify across markets. Some setups will be working well in a market and then stop. The market hasn’t changed or the setup failed; the more opportunities, the greater the chance of success. But if one is trading too large, then one may not be able to initiate the next trade after a series of losses. John is very helpful in outlining what unit sizes to trade.

I would suggest studying the list of markets recommended and being prepared to participate in many of them. We all tend to pick and choose the setups in those markets for which we have a predefined bias. The message of *Mastering the Trade* is that the setups are objective and can help eliminate the emotional battles that are constantly being fought. Today a single-stock future may look great on a chart, but the setup may indicate that it is time to sell. If you are looking for excuses not to follow the signal, then don’t buy *Mastering the Trade*. However, if you are tired of saying, “I knew this would happen,” but you do not have anything to show for that knowledge, then John Carter’s book is an outstanding place to start—a realistic, grounded approach to mastering the trade!

PETER BORISH

Chairman, OneChicago

Former Head of Research for Paul Tudor Jones

# Introduction

The best lesson I've ever learned about short-term trading happened while I was on a white-water rafting trip. Eight of us were in the raft when it hit a rock and flipped, launching us into the air like a catapult and sending everyone headfirst into the icy water. Half of us remembered that in the event of a spill we needed to stay calm and position ourselves on our back, feet facing downstream. We zipped around rocks and through cascades of water, eventually dragging ourselves safely ashore. An hour passed before we learned what had happened to the rest of the group. For them, a rescue operation went into effect. The end result was a gashed leg, a concussion, and a near drowning. Later, when speaking to the other group, I learned that all of them had experienced a type of brain freeze. They could see the danger around them. They knew they were in trouble. They even knew that they needed to act, to do something. But they literally could not decide about what action they should take. So, they took the one option left to them: they froze like the proverbial "deer in the headlights" and did nothing. In the absence of a decisive path of action, the river grabbed them by their lapels and, like an angry pimp with bills to pay, slapped them senseless.

I remember one member of the group saying, "That river was out to get me!" Extreme paranoia and self-centeredness aside, the river was not out to get anyone. It did what it was supposed to do: move quickly and rapidly through a canyon in order to get to the ocean. The riders who understood the nature of the river were prepared and took the roller-coaster journey in stride. The riders who fought this trend got thrashed.

The similarities between this event and a typical trading day are nearly identical. The unprepared trader (newbie) is in the same situation as the unprepared white-water rafter. In the event of extreme conditions, both will freeze, and both will be lucky to survive the experience. One bad trade can wipe out months or years of profits.

Professional traders make money not because they are right more often than not, but because they know how to take advantage of all the "fresh meat" that is sitting out there in the form of amateur, unprepared traders. "Fresh meat" refers to anyone who has been trading for less than 10 years. That said, many traders never make the leap, and remain in this victim-like state all of their trading lives. The minority who endure and join the ranks of consistently winning traders are the ones who have learned the following truths:

- The financial markets are naturally set up to take advantage of, and prey upon, human nature. As a result, markets initiate major intraday and swing moves with as few traders participating as possible. A trader who does not understand how this works is destined to lose money.
- Traders can know more about a market than anyone else in the world. But if they apply the wrong methodology to their trading setups, they will lose money.
- Traders can know more about an indicator or group of indicators than anyone else in the world. But if they apply the wrong methodology to those indicators, they will lose money.

- Traders can know exactly what they're doing. But if they're trading the wrong market for their personality, they will lose money.
- Traders can know exactly what they're doing. But if they apply the same strategies that they used to make themselves successful in other areas of their life, they'll lose money.

Without this knowledge, a trader is like a wounded antelope in the center of a pride of lions: it is not a question of "if" the antelope is going to get torn to shreds and swallowed, but rather of "when." For a trader without this knowledge, the possibility of ruin is not a question of "if." It's only a matter of "when."

Nevertheless, even with the odds stacked against them, each year tens of thousands of unprepared traders flock to the markets like lemmings to the sea, their heads filled with visions of easy cash and first-class tickets, and dreams of telling their boss to go pound sand. By the time most of them sense the spark of an idea that would've allowed them to understand how trading really works, they've already flung themselves over the cliff and are plunging toward the rocks below. All they have to show for their hard work is ample amounts of frustration and despair, perhaps a furious spouse, and a trading account that has been ravished and ripped off by a professional.

This has all recently hit a fever pitch with the growth of the cryptocurrency market, where a lot of fortunes were made by the early adopters. But once markets like Bitcoin popped up and settled in, they started trading just like all the other markets out there. Remember, you're not trading cryptocurrency or Netflix, you're trading against another person or institution who thinks you're wrong and they're right.

Trading is not about everyone holding hands, belting out the lyrics to John Lennon's "Imagine," and making money together. The financial markets are truly the most democratic places on Earth. It doesn't matter if a trader is male or female, white or black, American or Iraqi, Republican or Democrat. It's all based on skill.

The only way to become a professional trader is to obtain an edge, a weapon that can separate you from the rest of the migrating sheep. That edge is gained by utilizing specific chart setups and trading methodologies that take into account the five key points listed previously, as well as the psychology of the trader taking the other side of the trade. Without this, as you enter the revolving door to the financial markets, filled with excitement and anticipation, the predators are merely licking their lips because what they see is a slab of freshly cured meat, ripe for the eating. And feast they will.

### **Who Should Read This Book?**

This book discusses a unique approach to the markets that focuses on the underlying reasons that really cause market prices to move; it is applicable to trading stocks, stock options, futures, Forex, and cryptocurrencies. In reality, markets don't move because they want to, they move because they have to. Margin calls, stop runs, and psychological capitulation all force a series of rapid-fire market orders in a very short period of time. These generate sharp intraday moves that last from a few minutes to a few hours, and, on a bigger scale, swing moves that last for a few days to a few weeks. These moves inflict pain on a lot of traders who do not understand how this process works. Yet, there's always a group of traders who profit from these moves. This book discusses specific ways to get positioned "on the other side of the trade" in order to take advantage of these

moves, relying on a unique interpretation of many classical technical analyses and chart patterns.

More specifically, in discussing strategies, this book gives exact entry, exit, and stop-loss levels for the intraday trading of stocks, options, ETFs (exchange-traded funds), various futures and commodity markets, and the Forex currency markets, with trade updates on cryptocurrencies and more recent strategies found via online links provided throughout the book. Strategies focus on day trading, swing trading, and position trading various markets and asset classes.

It's my hope that traders at all levels of experience will welcome this book's broad market overview and specific trading strategies. Beginner traders will be treated to a no-hype reality check on how the markets really work, will be introduced to clear concepts and trade setups, and will come to understand why newer traders are destined to lose money until they grasp the basic market mechanics that are constantly happening behind the scenes. Beginner traders will also understand how they're repeatedly taken advantage of.

It's my goal that intermediate traders will appreciate the knowledge included in this book, which is designed to take them to the next level of trading. In addition, I hope that professional traders and other market insiders will find that this book is able to clarify some of the truths that they have instinctively found to be true, in addition to providing fresh ideas to improve their bottom line.

Day traders will learn why relying on indicators alone is a losing game, discover specific strategies for getting into a trade early, and learn the differences that will let them know when to bail and when to hang on for the ride. Swing traders and pure stock pickers will learn how to read the ebbs and flows of the market, and know whether they should be focusing on the long or the short side. Investors who are overseeing their retirement accounts will discover specific ideas for timing their investments on a monthly and quarterly basis in order to improve their returns. While this book is aimed at full-time traders, there are special sections throughout the book that focus on individuals who are working full time and are able to trade only part time. This does have advantages if it's done correctly.

While I feel that this book will be a welcome addition for anyone who is interested in the financial markets, it's important to realize that this book assumes that you have a working knowledge of the basics, though I do cover entry-level market concepts in [Chapter 3](#). While I spend a chapter on option plays and I dig into some basic option strategies, it's not my intention to cover all the different ways in which options can be utilized. In other words, if the subject has already been written about, or if it can be Googled, then it won't be rehashed here. This book focuses on *new* concepts that have not been written about before. I'll also discuss websites and other books that are great for getting up to speed.

In addition to specific trading setups, this book discusses practical aspects of trading, such as the type of hardware and software to use, money management allocation, and developing a game plan that fits the trader's personality. Finally, there's a strong focus on specific information that can be used during the next trading day.

## **A Few Notes on This Updated Edition**

I first wrote this book during 2005, with an update in 2012. While I still utilize many of the techniques described in the original book, I've updated some of them, thrown out others, and added techniques, chapters, and examples that are completely new. I'm the first to admit that I had mixed feelings about updating this

book. A common question I receive is something along the lines of: “If these trading strategies are working for you, why in hell would you want to share them, and aren’t you worried that once everyone starts using them, they’ll become less effective?” These are fair questions.

One of the casualties of writing *Mastering the Trade* was “the 3:52 trade,” which was one of my favorite setups for a long time. As more people read the book and started doing that trade, it became less and less effective. The main issue was that it was a low-volume setup at a specific time of day, so it didn’t take a lot of additional volume pouring into the trade to make it less effective. I’ve had to toss that one out and replace it with an “end-of-day trade,” which is based more on market internals. However, I left this chapter in the book because it illustrates very clearly who is on the opposite side of a trade. Understanding this will lead you to find similar situations in other markets into the closing bell. The rest of the setups haven’t been affected. Much of this has to do with the markets I’m trading, which are highly liquid. Hedge funds are too big to do these setups on an intraday basis, and there aren’t enough retail traders out there to move these markets and offset what the hedge funds are doing. In addition, in working with traders over the years, I’ve learned that even if you do show traders a winning setup, about seven trades into that setup, they’ll start tweaking the parameters to fit their own personality—especially if the setup loses money two times in a row. (Hey I can tweak that, so it doesn’t happen again!) The net result is that there isn’t a massive button being pushed every time one of my setups fires off.

In terms of, “Why in hell would I want to share them?” I’m not totally sure. Although I enjoy writing, putting together a book is a huge ordeal and requires a lot of time, focus, and commitment. I meet a lot of people who tell me that one day they, too, would like to write a book, although most of them have yet to get started. I don’t blame them a bit—it’s a huge time commitment, even with outside help. From talking to other writers who have published books in multiple areas of interest, I’ve discovered a trend: the only way a book will get written by your own hand is if you feel obsessed to push it out of your body. For whatever reasons, I had to get *Mastering the Trade* out of my head the first time around, and the same feeling emerged six years later when I realized that I had to get these updates for the Second Edition, and again for the Third Edition. It’s like these bubbles of information in my head emerge and I just have to get them out there so I can clear my head and move on. In the short term, it’s practical. This way, when people ask, “What’s your favorite setup?,” I can just hand them this book and it saves me a lot of time.

Longer term, I fully realize that one day, a day that’s going to sneak up on me much sooner than I’d like (hey, it doesn’t seem like that long ago that I was a teenager), I’m going to die. Maybe this is a way to have a part of me still live on long after I’ve passed on to the next adventure. I don’t know anything about my great-grandfather. Maybe this is a way for my great-great-grandkids to get to know me a little bit. If they do decide to trade, hopefully my book can share with them enough information so that they can cut their learning curve way down. Trading evokes painful lessons. If my great-great-grandkids can read this book and pick up a few things that help them navigate the path toward being successful traders (with a minimal amount of screaming at their computers in frustration), then I’ve accomplished what I’ve set out to do.

I’m grateful for everyone who has read this book and truly gotten something out of the material and my own lessons along the way. I meet a lot of people—at Traders Expos and other events—who have read the book, and I’ve signed copies and heard the stories. This book isn’t for people who are looking for the Holy

Grail of trading, or for some simple system that they can trade mechanically for the rest of their lives. It's for people who are going down the path of testing their trading skills and personality against the market. It's a day-to-day process, which is what makes trading for a living so damn interesting, as no two days are ever the same. In the end, I'm flattered and grateful that anyone would deem this work important enough to read, learn from, or critique. It's truly an honor.

Trading and life are tightly intertwined. The better you understand yourself, the more likely it is that you'll be able to find a market, a strategy, and an overall trading philosophy that best fit your personality. Let's dive in.

PART I

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# TRADER'S BOOT CAMP

How Do the Markets Work and What Are the Best Ways to Get Mentally Prepared for Successful Trading and Investing?

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I don't want the cheese; I just want to get out of the trap.

SPANISH PROVERB

*Some of us think holding on makes us strong; but sometimes it's letting go.*

HERMANN HESSE



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## What *Really* Causes the Markets to Move?

### Did You Know That Most People Who Lose Money in the Markets Do So Because of These Four Things?

Individual traders live in a state of constant flux, stuck between two worlds that combine both the best and the worst that trading has to offer. On the one hand, they can move into and out of markets with an ease and efficiency that large funds can only dream of. Have you ever wondered what it would be like to have to dump 200 million shares of AAPL (Apple) stock—without drawing attention to what you’re doing? Well, like trying to hide a pregnancy from your parents, it’s not easy. It’s a process, not a mouse click. On the other hand, you can get into and out of 1,000 shares of AAPL or 10 E-mini S&P 500 futures contracts instantaneously, and it won’t even register as a minor blip on the day’s trading activity. In other words, a smaller trader can move about undetected—a huge advantage. Funds need days, and sometimes weeks or months, to move into and out of sizable positions without showing their hand. If they do show their hand, then other funds will front-run them (jump in front of their orders) and bury them if possible. That is how money is made in the markets—by taking it from other traders. If you think this sounds ruthless, you’re right. It’s. This isn’t a holistic coming together of like-minded souls to light incense and a celebration of the meaning of life. This is trading.

Then why are so many people attracted to this profession? It’s exciting, yes. It’s engaging, definitely. It’s a chance to make a lot of money. In a word, though, it’s freedom. In every area of our lives, we’re told what to do. Some people don’t like that. Traders have the freedom to carve out specific niches for themselves that other people on the planet can never achieve or duplicate. Most millionaires don’t have freedom, especially if they’re running a business. They have obligations, demands, and multiple fires to put out daily. Is that sacrifice of freedom worth being able to fly first class? Retirees have a sort of freedom, but at what price? Dan Sullivan, an engaging and energetic 75-year-old owner of Strategic Coach, has a different view on retirement: “Retirement is a GPS signal for death to come and find you. It’s important to always be engaged with an interesting future.” Stay-at-home moms? That’s the hardest job on the planet (as is marrying rich).

The only paid professions I’ve seen that offer a large degree of freedom are independent contract-type jobs like driving for Uber or hanging a shingle on Upwork. That said, the pay isn’t great, so a lot of hours still have to be worked to meet the monthly nut. Trading, when done right, offers substantial income for a small amount of work. Traders, at least traders who learn the art of being consistent, have the opportunity to create an independent life free from the hassles of the average Joe. These perks are extremely appealing and impossible to duplicate in many other professions.

Reasons for trading full- or part-time are many. They can include: the desire for a career change, a wish to be more independent, the desire to escape the responsibilities of running a large corporate division or individual business, or the choice to be a stay-at-home parent. A lot of would-be traders I meet are already successful in other areas of their lives—they're simply bored. I call these folks "doctors seeking excitement," although this can include anyone in a high-paying career. They like the income and the prestige, but they don't like the bubble in which they're now trapped. Others have been burned by the financial markets and are now interested in taking control of their financial future. And many have put together a small stake and want to give it a go and pursue their dreams of becoming a trader. I see this firsthand in my office, watching guys like Henry go through the painful cycle from "the excitement of discovering trading" to "wow, I can't believe that option expired worthless." However, after a couple of years of ups and downs and getting into a rhythm, it's been fun to see Henry step into the role of a consistent trader. It's the hardest easy thing to do on the planet.

This is a "job" that provides the chance to make a very nice living, and it's a lot more interesting and fun than any other profession, except being a rock star, of course. But if sharing the stage alongside U2 seems slightly out of reach, then trading is a good alternative.

It can be done from anywhere that has reliable Internet access, and as I'm writing this update in 2018, that means just about anywhere. I've even made trades on airplanes. As a plus, there are many perks to becoming a full-time trader. There are no manic-depressive bosses spewing forth inane, ever-changing, contradictory orders as they struggle within a system that has promoted them right up to, and through, their level of competence. For some people, working for a corporation is a way to gain power, which is more important to them than financial independence. Working for one of these clowns is enough to drive anyone to question the meaning of life while raiding the corporate bar.

In addition, in trading, employees aren't necessary, although at some point they can be very helpful if you decide to trade many markets and watch many different time frames. (I'd love to trade the European session, but I have to sleep sometime. However, I can hire someone to do that for me.) Those of us who have survived the corporate world can find nothing on this Earth that's equal to the freedom and beauty that come from no longer having to manage a large group of dispassionate human beings: "I'll pretend to praise you, and you'll pretend to love your job." The good news is that if you hire someone to help you with your trading, they will generally be as passionate and excited as you are about the adventure.

Start-up costs are minimal thanks to falling computer prices and the leasing programs from companies like Dell. Trading in your robe or nothing at all is perfectly fine. Best of all, a trader can choose their own working hours. Some examples of schedules from successful traders I work with include trading actively from October through April, and then taking the remaining five months off; trading only the first two hours of the market open and taking the rest of the day off; and trading until they make 50 percent on their capital, and then taking the rest of the year off. The list goes on and on. By the way, one of the common fallacies of trading is the idea that, "to make more money, I need to trade more." Nothing could be further from the truth. Trading smarter and less frequently is one of the hidden secrets of doing this for a living. There's no need to catch every move. When traders discover that they can make a living with two well-thought-out, well-planned trades per week, it makes me happy, as I know they've hit upon true freedom.

Since trading has so much to offer, it's no wonder that tens of thousands of people toss their hats into the ring, trying to make a go at this most appealing of professions. It truly represents the proverbial American dream, and traders from all over the world are giving it a shot. Since this book first hit the shelves in 2005, I've had the opportunity to speak to traders all over the United States, as well as in China, Taiwan, India, Sweden, Australia, England, France, Singapore, Argentina, and many other countries. The bottom line is that traders sweep aside political and philosophical differences when speaking to other traders. Traders around the world are linked together by a single idea—to generate cash with their mind and to reap the benefit that this cash creates: freedom. It's a beautiful thing. I love traders and all the craziness they represent.

I'm not kidding when I say, "craziness." The University of St. Gallen, Switzerland, has come out with a study that compares traders with psychopaths. The study reviewed the results from an existing study comparing 24 psychopaths in German high-security hospitals with a control group of 27 "normal" people. The funny thing is, this control group of "normal" people turned out to be traders. Stock guys, currency and commodity traders, and derivative types happened to be the *normal* control group stacked up against the high-security, barbed-wire-enclosed psychopaths. In the end, the performance of the trading group was actually worse than that of the psychopaths. The study indicated that traders, "Have a penchant for immense destruction," and that their mind-set would lead them to the logical conclusion of "beating one of the neighbor's expensive cars with a baseball bat with the sole objective of owning the most beautiful car in the neighborhood."

In other words, traders have to constantly battle their desire to be right and prove their worldview, as it in no way, shape, or form helps them to make consistent money. Indeed if you look up the textbook definition of a psychopath, here are some of the tidbits you'll uncover: antisocial behavior, poor judgment and failure to learn from experience, inability to see oneself as others do, and inexplicable impulsiveness. This sounds like a typical trader struggling against the market and can't figure out why.

So it's the freedom (and excitement) that attracts traders. And it's the freedom that's the undoing of many traders because with so much freedom comes a cruel price. Simply put, the markets cannot protect traders from themselves. Individual traders, unlike fund managers (most of them, anyway), are unsupervised and have the freedom to act unchecked in any way they choose. And for many traders, this means they live a life where they're one mouse click away from disaster. The markets lull them, encourage, and even reinforce bad habits. Have you ever removed your stop and had the trade then go on to hit your target? Well, the market just taught you that it's perfectly okay to do that, at least once in a while. That can work 999 times in a row. It's the one time where it doesn't work that wipes out the profits from all your previous trades and can potentially wipe out your entire account. It's the day you buy gold on a dip, remove your stop, and it falls \$80 an ounce. "Wow," you think, "I can't believe it fell that far!"

Exactly. It's what we don't see coming at us like a runaway freight train that destroys us. It's the classic bad habits—chasing a market higher or lower, trading too large for your account size, not having a firm idea of your loss limits, and so on—that create a market that moves and thrives in such a way as to prevent as many people as possible from consistently making money. Remember the psychopath trait, "Failure to learn from experience"? Why is this? Why are traders so good at sabotaging themselves? After all, nobody, and I mean nobody, enters a trade with the idea of losing money. In a nutshell, it has to do with traders being the best

salespeople in the world. Introverted, yes, but salespeople nonetheless.

Although used-car salespeople are saddled with the reputation of being pushy and dishonest, they don't hold a candle to the average trader. A trader, once in a position, can deceive him- or herself into believing anything that helps to reinforce the notion that he or she is right, or at least "not wrong" on this trading idea. Nobody likes to be wrong. In a job, a person who is wrong can typically blame it on someone else. "It was those stupid delivery people," he says. "They screwed it up." In trading, there's nobody to blame but yourself. And human beings have a very difficult time accepting that they might, in fact, be wrong. "If a husband expresses a thought alone in the middle of the woods," so the joke goes, "is he still wrong?" Probably so.

When faced with a loss, Joe Trader will look at a chart and tell whoever is nearby, "See that spike? That's the hedge funds running stops." He then says with a knowing grin, "As soon as they're done, just watch; this market is going to rip higher." Net result: he doesn't exit the position, and his losses mount. When faced with a profit, Joanne Trader hesitates to pull the trigger, telling her cat, "The market is acting fantastic here. There's a ton of good news on CNBC. I bet it goes a lot higher." Net result: she doesn't exit the trade, and it turns into a loser. The mistake these traders are making is a common, yet fatal affliction that most traders suffer from: *they're unaware that the market naturally programs their reactions into a losing trader's mind-set*. And they're unaware of the key factors that really move the markets. The net result is a trader who "eats like a sparrow and defecates like an elephant." This is a situation, of course, that no account can withstand. Worse, this cycle of emotional slavery won't end until it's met head on, until a trader can "pull his head out" and realize that trading is unlike any other activity on Earth. Trading has a lot more to do with repeatedly admitting that you're wrong (and being okay with it) than with trying to make a lot of money. Unfortunately, professional traders understand this all too well, and they set up automated trading systems (algos) to take advantage of these situations, specifically preying on the traders who haven't figured out why they lose. One trader's disaster is another trader's bread and butter.

Here are the four things that cause traders to lose money:

1. Anyone who's attracted to trading shares has the same characteristics as a psychopath.
2. The inherent freedom is destructive. After all, we spent our first 18 years of life learning that it's better to follow the rules and do what we're told.
3. The markets actually encourage and reinforce bad habits.
4. Traders are seduced into taking every opportunity to sell themselves on the idea that they're right.

There's always someone on the other side of your trade. Start being that trader. Not the one who chases, but the one who knows that other people are chasing. Not the one who removes stops, but the one who knows that traders tend to remove stops. Not the one who trades too big for his or her account size, but the one who trades just the right size, or smaller, for his or her account size. Not the one who frantically feels that he or she has to be in every move, but the one who's content to wait patiently for the one setup that falls within his or her trading plan, even if it means not having a trade that day. Over the long haul, a trader can make a lot more money trading small and consistent versus trading large and haphazard. Be the trader that wants to make money over time, not the one that *needs* to be right, right now.

## How Do Our Odds for Success Increase Once We Understand the Pain and Suffering of Individual Market Participants?

The problem is simple and twofold. First, although traders certainly know that not all their trades are going to work out, they do get a distinct feeling right after placing every trade that *this trade is going to work out*. A study done by a pair of Canadian psychologists documented this fascinating aspect of human behavior. Just after placing a bet at the racetrack, people are much more confident about their horse's chances of winning than they were immediately before laying down the bet. Obviously, there's nothing about the horse that has changed; but in the minds of those bettors, the horse's prospects improved significantly once they placed their bet and got their ticket.

Without getting into a large psychological treatise on why humans behave like this, it has to do with a strong, underlying social influence to appear consistent with our choices. Once we make a choice, we respond to external and internal pressures in such a way as to justify our earlier decisions. If we made a good choice, then this process works out very well for us, and we'll continue to build upon our good choice.

However, if we made a bad choice, whether it's regarding a trade, a job, a significant other, or a business deal, then this process will take this bad choice and make it emphatically worse as we dig in to justify our initial decision. We'll simply refuse to let go and move on, as we're more concerned about trying to act consistent with our earlier decision.

People can waste an entire lifetime living within the justifications of a bad choice: trying to make it work, trying to be nice and look good and not hurt anyone's feelings, and trying to make it seem as if they were right. It's a painful journey that can lead a person to be a shadow of his or her former self.

Doing and saying things simply to prove to others that your choice was right leads down a slippery slope of not being true to yourself. And if you're not true to yourself, it automatically leads to frustrations, some of them popping up like zits all over your face for no apparent reason. Did you ever get ticked off at your mom when she simply told you to eat more veggies? Bingo. There's some stuff going on there, and, believe it or not, it will affect your performance as a trader. You aren't mad at mom; you're mad at yourself.

By the way, your personal life is a good place to test this out, and it's a lot cheaper than working it all out in your trading account. Just start paying attention to what annoys you and what sets off an emotional trigger.

I worked with Rosa, my awesome sister-in-law, for a while on our website back in 2005. We're very close, like brother and sister. I've known her since she was seven years old. While we were working together, we would get into arguments, and essentially I'd calmly try to show her why I was right and she was wrong. I didn't think much about it (because, hell, I was right!), but eventually our working relationship became very frustrating for both of us, to the point where she moved on to "explore other opportunities."

I had no idea what was going on. I only knew that I simply couldn't work with her, even though we got along great outside of work. I discussed this issue with some friends. They pointed out to me that "my having to look like I knew what I was doing at all times" was the real issue, and that if I wanted to learn more about this, I should go to a workshop called the Landmark Forum. I Googled it and initially decided to pass—after all, it looked like a damn cult. Then I read that it made a top 10 list of weekend adventures, and that piqued my interest. An adventure? And I could see the positive change in my buddies, Michael Palmieri and Tom Tuohy. They were becoming more effective in their chosen fields of work, and they were happier and more

engaging. They pointed out that my frustrations with Rosa were really a reflection of something that was going on with me. If I wanted to find out what it was, then I should man up and take the course. Fine. I didn't go in kicking and screaming, but let's just say I was very skeptical.

I attended, and I can honestly say I'm glad I did. Up until then, I'd never really understood how married we are to the stories we tell ourselves, and how easy it is to break free from that narrative once we know how. The net result? Freedom from that giant anchor, known as our past, is the best freedom of all.

A year later, my wife also attended, and our lives are the better for it. She's empowered. Our communication is better, and we're more open and honest with each other and not worried about "hurting each other's feelings" or anything. If she's pissed at me, she just lets me know, instead of holding it in for days. Straight talk. In other words, we can be authentic with each other, which is a much easier and more pleasant way to live. For my own trading, it led me to move toward being unemotional with my losing trades, and more aggressive about cutting them loose "early" without even wondering if I should give them more room or time to work out. It made my discretionary trading easier, creating the ability to make quicker decisions and move on without any self-judgment.

Like developing a solid trading plan, I took from the Landmark Forum what was helpful to me and discarded the rest. I also sent Rosa to the course, and it changed her life as well. We now have a much more open and honest relationship, and we can have discussions without trying to be right. We just say what needs to be said without worrying about hurting the other person's feelings. It's great. And that's what the trading journey is all about—taking bits and pieces here and there that make sense to you, and then turning those bits and pieces into a trading plan that works for you and your personality. I see a lot of traders wrestling with personal issues that they try to "take out or work out" in the markets. Doing the Landmark Forum is one way to experiment with working those issues out of your system before you take them out on your account.

I think there are a lot of parallels between being a good trader and living a good life. The market truly is the ultimate psychologist. To be a happy trader, you must cut off bad trades at the knees and throw them in the trash heap. Clinging to a bad trade like a limpet in order to be right is like, as the Chinese saying goes, "cutting off your stalk to spite a jade gate."

Second, many traders feel that they can rely on their judgment *while in a trade*. On paper, this makes a lot of sense. After all, before a trade is placed, traders are at their most objective. However, once the trade is on, the degree of objectivity diminishes immediately and in direct proportion to the number of shares or contracts being traded relative to the account size. Think of it this way: if one trader is long 10 E-mini S&P500 futures in a \$10,000 account using day-trading margin, and another trader is long 1 E-mini S&P 500 futures in a \$100,000 account, who's going to be sweating bullets over each tick? Not only does the first trader already have the feeling that, "this trade is going to work out," but now the trader trapped with the additional pressure of having to manage a position that causes huge equity percentage swings with every tick. Traders who rely on their judgment when they're in a position that is churning their brain with extreme emotions is like trying to row a boat upstream with a piece of Swiss cheese—it simply doesn't work. Ever. And, believe it or not, studies show that the intensity with which you stare at the price charts on your computer screen actually has zero correlation with what the markets are going to do next. There is no willing the market to do your bidding.

These factors perpetuate a vicious cycle, with the end result being traders who, like bad used-car

salespeople, are consistently selling themselves a faulty collection of beliefs that set them up for slaughter. Instead of following a game plan with which to exit a position, traders in this situation spend their time justifying *why they're right* (if you're married, you'll know why this is a waste of time) and will end up closing a position only for one of two reasons.

First, the pain of holding becomes so great that traders cannot “take it” any longer. Once they reach this “uncle” point, they start frantically banging their keyboard to sell (or cover) “at-the-market” (ATM) price to relieve the pain.

Second, their broker politely offers to help them out by giving them a phone call, gently letting them know that they should exit their position. This is also called “getting a margin call.” This trade is also placed “at-the-market” price. In these situations, there's no plan, no thought, and no objectivity. There's just a batch of forced sell orders or, in the case of someone who's short, a batch of forced buy orders, or covering. This act of capitulation—traders exiting a position because they have to, not because they want to—is emotions-based trading at its finest, and this is what creates the best market swings to trade. Whether it's a sustained multi-month move to the downside because of continuous capitulation selling or a quick 10-minute rally because of shorts being forced to cover, these acts are responsible for the major moves in all markets, in all time frames. In the end, markets don't move because they want to. They move because they *have* to move.

The pressure from traders trying to act “consistent with their original choice,” combined with traders who are trading way too big for their account, leads to more disasters in trading than anything else. However, right on the other side of disaster is opportunity. For 20 traders who are blowing up their accounts, there's another trader out there on the opposite side of that blowup. After all, the money doesn't just disappear. It simply flows into another account—an account that utilizes setups that specifically take advantage of human nature. One person's panic-induced margin call is another trader's profit objective being reached. Don't let the markets seduce you into having to be right.

### **The Case Study You'll Never Read About at Harvard Business School, or, Has This Ever Happened to You or Your Spouse?**

I thought about updating this example for this new edition, but this really is a classic case that would apply equally well to trading today's hot stocks such as NFLX (Netflix) or TSLA (Tesla) or anything else that's volatile and actively traded today. I did go through and update and expand the text. Let's take a look.

Figure 1.1 is a chart of an actively traded stock with the name deliberately removed for now. During 2004, it was vigorously bought by one side of the trading community and energetically shorted by the other side. Both parties had plenty of opportunities to make money. On December 29, 2004, this stock made a new 52-week high, hitting \$33.45 the next trading day. Over the next five sessions, it pulled back to support at point 3, at \$27.62, which represented a solid buying opportunity, replicating the buying opportunity that had taken place at point 1, with the same oversold stochastic reading as point 2.

**Figure 1.1**



This chart represents a classic case of an inflection point at which a group of traders has to make a decision. A trader who bought the stock as it broke out to new highs will be feeling pain, while a trader who shorted the highs will be feeling euphoria. Traders who are long the stock way back from \$10.00 will feel excited and wonder whether they should add to their positions on this pullback. A trader who is flat the stock is anxious, not wanting to miss the next move, and will be looking to buy the stock here at this pullback to support. Take a moment to look at this chart. What would you do here? Would you short the stock or buy it? What would you be willing to risk? These are questions all traders need to know before they actually place the trade.

Let's work with someone I'll call Joe Trader. Joe has been trading for a while and has learned a lot about risk/reward levels and about being patient and waiting for high-probability setups. He looks at this chart and sees a decent buying opportunity in this stock. He has a \$100,000 account. Near the close, he buys 2,000 shares at \$27.80, using about half his cash buying power and not even getting close to using any margin. He places a stop limit order at \$26.20 and also places a GTC (good till canceled) sell order at \$32.60, which is just below the recent highs. He's risking \$1.60 (\$3,200) to make \$4.80 (\$9,600), a very comfortable 3:1 risk/reward ratio. If he's stopped out, he'll lose 3.2 percent of his account's value, which he deems an acceptable risk against making a potential 9.6 percent return on the trade.

The next day, January 7, 2005, the stock gaps lower, opening at \$23.78, well below Joe's stop-limit order. (See [Figure 1.2](#).) This leaves Joe in the stock, as his stop-limit order won't fire unless the stock rallies back to \$26.20. (A stop-market order at \$26.20 would have been liquidated at the open at-the-market price, incurring a larger loss.)

Figure 1.2





Joe doesn't panic. He's been down this road before. He's negative on his trade, but it's not the end of the world. He gets that he's going to lose money on this trade, and he's not going to do anything stupid like triple down to bring down his average cost. He's going to follow his plan and take his stop-loss like a man. He's trying to exit gracefully. "Do I dump the stock here," he wonders, "or do I wait for a small retracement?" He understands that when stocks break down, they'll almost always retrace a portion of the move before ultimately moving lower. He might even be able to get out at his original stop-loss price. He checks the daily chart and sees that the stochastic is oversold, setting the stock up for a bounce, even if only of the dead cat variety. He decides to leave his stop-order limit in for this eventual retrace, and he plans to see where the stock ends up near the close.

Fifteen minutes before the closing bell, he checks the stock and notices that it never reached his stop-order limit, but it also bounced off its lows on the day. He thinks there's a good chance that the stock will start to retrace a portion of the move the next trading day. He's calm. He's objective. He decides to hang on. He's simply dealing with a bump in the road of what is a logical plan.

Unfortunately, the next trading day isn't until Monday, and he spends most of the weekend thinking about his stock, not really reacting to the environment around him. On Sunday, his wife notices that he's been quiet, almost listless, all weekend and keeps staring at charts on his computer screen. She flips through her latest issue of *Cosmopolitan* magazine to see if she can get any tips on how to cheer him up, and perhaps invigorate their sex life, but by the time she's done reading the insightful articles, she wonders what her life would had been like had she accepted the marriage proposal from Gary. By the time she goes to bed Sunday night, she's annoyed. She calls out, "Are you coming to bed, honey?"

Joe, oblivious, is still up looking at a chart. "Still doing research, babe," he tells her.

Monday morning finally arrives. Joe jumps out of bed early after a restless sleep, just in time to see that the

stock is trading lower premarket. It gaps down by almost \$3.00 at the open of the regular session. Joe looks at this and shakes his head. Now he knows he's in trouble. How could this have happened? (See [Figure 1.3](#).)

**Figure 1.3**



As Joe numbly sips his coffee, he looks at the chart “objectively” and sees all the reasons why the stock should bounce. It’s now down by more than 40 percent from its all-time highs in only seven days. It’s near major support on the daily charts. The daily stochastic is now deeply oversold. He’s realistic. He knows this stock is done for, and he knows he’s going to lose money on this trade, but he also knows that at some point the stock will at least retrace, and he’ll be able to exit gracefully and keep his losses to a minimum. He watches the stock all day, chewing his dirty nails, slurping cold coffee and warm Red Bull, ignoring everything else in his life. The stock closes at more than \$6.00 below his stop. Aghast, he goes into a near-catatonic state. This is not a situation he remotely believed could happen with this trade. He simply can’t sell this stock now. The loss is just too big. He decides to hang on for another day, as the stock is way, way overdue for a bounce.

It’s not until he hears the garage door opening downstairs that he remembers that he was supposed to drop off his wife’s pile of clothes at the cleaners. He grabs them, pauses in the entryway, and races out the front door, timing it perfectly so that she doesn’t see him.

On Tuesday, January 11, the stock (okay, it’s TASR) gaps down yet another 3 points, opening at \$17.01. (See [Figure 1.4](#).) Joe takes a deep breath and grits his teeth. A part of him seems to die a small death. Yet there is also an odd sense of relief. After all, this couldn’t be his fault. It’s the markets that did this to him, so he’s really not to blame.

**Figure 1.4**

TASR - Daily NASDAQ



He's dead-tired from not being able to sleep last night, and to top it off, his wife has suddenly been acting downright hostile. He wonders if she saw his profit & loss (P&L) statement on the computer screen, but he's confident that he's kept that covered up, always minimizing his execution platform when he leaves the room. And he's been acting normal. There's no way she can tell something is wrong. He knows he should talk to her, and he will, as soon as he exits this position and goes flat. After all, she's the one holding down a real job so that he can pursue his dream of becoming a trader. He doesn't want to feel the shame and embarrassment of letting her down.

He focuses on the chart. He tells himself not to panic like a stupid newbie and to react like a professional trader. He knows he'll never let himself get into a situation like this again, ever, ever, ever. But in the meantime, he has to keep a cool head and get out of this mess. He asks God for help, though from past experience he suspects that He doesn't pay too much attention to the financial markets.

Joe reflects that over the past four months, he has been able to generate an income averaging \$5,000 per month from his trading account. If he closes out his TASR position here at \$17.00, he'll be down \$21,600 on just this one trade. It would take him more than four months simply to rebuild his capital. He says to himself, "Okay, forget about your original order. Let's say you just entered the trade here. What would be a reasonable target?" He quickly sets up a series of Fibonacci retracement lines on his chart to see where the 50 percent retracement level of the entire move down is located. That level is \$22.79, well below his original stop, but if the stock rallies to that level, it means \$11,580 in recovered open losses, leaving him with just a \$10,020 "hard loss" to make back instead of \$21,600. Okay, that makes some sense. He starts to feel better and places his new sell order, confident that this is going to work. He sits back to watch the action. He contemplates doubling down, and almost does it. But he has learned the hard way that it's not the right thing to do. He holds back. He waits.

Amazingly, the stock continues to drift lower during the day. Joe stares at the chart, getting quite close to his screens. He's blinking about once every 30 minutes. He now has it on seven different time frames, continually reminding himself to keep a cool head, that the stock is desperately oversold and that it will soon bounce. *Be patient; wait for the retracement; don't be an idiot and sell at the dead lows.*

As the markets near the close, TAsR breaks new intraday lows yet again, cracking \$14.00 a share. Joe pushes back from his desk and yells in disgust, "This is freaking impossible!" TAsR is down by nearly 60 percent in eight days. About to explode with rage, he realizes he simply cannot deal with this any longer. His nervous system is a wreck, and his neck muscles feel like plywood. He sells near the close for \$14.02, a mind-numbing loss of \$27,560. He still cannot believe how far and how fast TAsR has fallen. How much lower can it go? Is this company going bankrupt? Is it going to be the next Enron?

On impulse, he looks at the weekly chart and notices that there isn't any support until \$10.00 a share. He immediately reverses and goes short 4,000 shares at \$14.04, just minutes before the closing bell. Although disgusted with himself, he feels better now that he has taken action, and at least he won't miss out on the remaining down move for this stock. He's eager to see where TAsR opens the next day. Maybe they'll announce a financial scandal? In that case, he could make back all of his lost profits in one day!

He decides not to tell his wife about any of this, but he does leave a Post-it note on his computer screen reminding himself to pick up the clothes from the cleaners the next day. After a moment's hesitation, he also scribbles the words, "Buy flowers."

TAsR opens flat the next day, and then steadily starts to rally. (See [Figure 1.5](#).) Joe's confident that the rally will be short-lived. However, he does place a stop just above yesterday's highs. This time he places a stop-market order, as it was the stop-limit order that got him in trouble in the first place. He feels very confident that this trade is going to work out. This is a good horse!

**Figure 1.5**



TASR closes near its highs on January 12, but it doesn't exceed the previous day's highs, so Joe's stop isn't hit. He can't believe his bad luck, although he's still optimistic that this trade will work out. He certainly hopes the stock will gap down the next day. His wife calls to say that she's going out with the girls. He grabs a bottle of Grey Goose from the freezer and turns on HBO to see how Tony Soprano is dealing with the problems in his life.

Well, the next day comes around, and the stock gaps up by almost \$4.00. Joe's stop-market order gets him out at the open, as this turns into a market order when the price is above his stop, which is \$20.83. He lost \$6.79 on the play. On 4,000 shares, that is \$27,160, nearly identical to the loss on his first trade. His \$100,000 trading account is now down to \$45,280. He needs to make 121 percent just to get back to breakeven. He's so angry that he doesn't know what to do, and eventually he picks up his keyboard and slams it against the wall. About an hour later, his wife calls to say that they should seek counseling. Joe pours himself a large shot of Jack Daniels (since he's now out of Grey Goose) and contemplates the meaning of life. He mutters out loud, "What the hell happened to me?"

Joe didn't have a bad plan. He treated this trade as well as he could have, with one minor, but very important, exception. He got the stock long based on a credible entry method. He used a low-risk entry point, had a great risk/reward ratio, and was risking only 3 percent of his portfolio. He didn't even get a margin call like many traders did in this same situation. The bottom line is, it was a great plan, but it turned into a disaster. This is something that could happen to any trader. It's not the fault of Joe Trader that the stock gapped through his stop. However, once it happened, *he stopped focusing on the risk and instead focused only on the gain*—in this case, how much of his loss he could make back. It was this small detail that derailed an otherwise solid trading plan and blinded him to the possibility of ruin. "Live to fight another day" is the mantra of all traders who have survived their first 10 years dancing with the markets. The right answer? When

a stop gaps below your stop, and you have a stop-limit order in place, suck it up and get out immediately at the market.

I'll never forget what one of my many mentors told me about losses, in response to my not wanting to take a loss, because I thought I could get out for a scratch if I waited. "John," he said, "Learn to manage your trades based on your account balance. An unrealized loss and a realized loss are the same damn thing."

## **A Note from My Wife: How Have I Dealt with Being Married to John Carter the Trader?**

### Living with a Trader

BY MARIA M. CARTER

For those of you who are beginning or well on your way in your trading journey with a significant other or loved one in the wings, I suggest you share this chapter with them.

John and I have been married for 20 years, and we've shared a life together for 25 years. I can almost map my dating and married life to John's level of trading experience. For many years, I was waiting to be issued a medal for "standing by my man" during the rough patches of his trading. Now I realize that sticking through those learning experiences has created the life and freedom we have today through his trading career. May you learn from our collective experience and be sensitive to the journey of a novice trader trying to make a living at trading.

### **The Couple's Trading Litmus Test**

Every trader will have bad trades, and in most cases, they'll have at least one or two *really* bad losses. If you're involved with a trader who's on a consistent losing streak, it would be unrealistic and frankly irresponsible for you to just ignore it. These are some areas of discussion you can have together to help you navigate those rough spots and see if your partner is still going down the trading path for the right reasons. Use these "three Ps" before you get to the big P, Pissed Off, that leads to a whole lot of pain.

**PASSION.** To become a professional at anything, you have to love what you do. If you're looking for trading to get you out of debt or give you a quick cash fix, you're going to get burned. John has been intrigued with the markets since the day I met him, when I was 19 years old and in college. In fact, even back then, he taught me how I could invest some of my financial aid money in a little stock called Iomega. (He had me hooked at Iomega.)

Aspiring traders should be intrigued by the markets, enjoy the process of learning about them, and recognize whether the lifestyle of market traders and the markets they're trading fit their nature. I've met many potential clients and friends who probably shouldn't be trading—it doesn't suit their personality or the type of life they want to create. If you're dreading your trading day or becoming secretive, or if your gut or your health is nagging at you, these are all probably pretty good indicators that something isn't right, or that you're not pursuing something you may be passionate about for many years to come.

**PERSPECTIVE.** Emotional management is critical to traders. Having activities and interests outside of trading allows the traders to gain perspective and de-stress. Does your trading partner have other outlets outside of trading? How does he or she decompress or blow off steam? For John, that includes spending

time with our kids, working out and running, traveling to exotic locations, staying involved with business networking groups where not all the members are traders, and, of course, hanging out with his awesome wife. Allow time for vacation days and days off, just as you would in any other career. Sometimes it will take the non-trader to rip the trader away from the monitor and push him or her in this direction. In our house, I like to call this “the Gollum.” If your partner begins to look like Gollum from *Lord of the Rings*, hunched over his computer and stroking the keys lovingly like “his precious,” it’s time to help him unplug. All the successful traders I’ve met who have made the leap to becoming professional traders have found a way to bring perspective to their trading. Finding a passion outside of trading and having a bigger-picture vision of what’s important to you that keeps your trading in check is the only way to make it work for the long term.

PLAN. I may not know much about the technical aspects of the market, but one thing I’ve learned from hearing all the blowout stories over the years is that traders are only as good as their trading plan. Everybody deviates from a plan occasionally, but without one, you’re toast. John has boxes and boxes filled with trading journals logging not only his trading plans, but also his emotional state when those plans did or didn’t work. By retrospectively looking at his actions and behaviors, he can reset his course and avoid repeating the same mistakes. I believe this also helped him find the niche in the markets that best suited his own personality. A loss on the day doesn’t get me worried now; it’s when I don’t see John writing in his trading journal that does.

## **Rules of the Road**

Living with a trader is much like riding the ups and downs of the markets. In fact, the way the markets behave is often the barometer for the trader’s emotional state at the dinner table. If you’re living with a trader, here are a few rules of the road to make the ride a little more pleasant for you and for him.

### *Here’s a Quarter, Call Someone Who Cares*

Traders, if there are times when you come home or come downstairs, as the case may be, from your trading cocoon, itching to talk to a human about your trading adventures, remember this: your deep passion for the markets may not be shared by your significant other, and that can be a very good thing. Balance is a blessing in a relationship. Don’t always expect your partner to hang on your every word as you talk ad nauseam about the details of your trading day. Just as John doesn’t want to hear me talk about the 20 fabric samples I want him to look at for our new drapes, my eyes might roll back in my head if I hear about option strikes and E-minis and Fibonacci clusters while I’m trying to sip on my Pinot Noir on date night. In fact, we have a code word we use to cease diarrhea of the mouth related to our obsessive interests: “Drapes.” Hearing about one another’s day is lovely, but hashing out the nitty-gritty should be reserved for your trading buddies. So, cut your partner some slack; she may not be the next Maria Bartiromo, but that doesn’t mean she doesn’t care.

### *The Pain Principle*

There’s a pain scale that is inversely proportional to your trader’s level of experience. It seems that the less

experienced the trader, the more intense are his or her feelings of pain at the full realization of a poor trading day. In those early days of trading in our marriage, I wish I'd had a Hallmark card that said, "Sorry for your loss. Thinking of you." There's not much you can say in words to make someone feel better after losing \$500 or \$5,000 in a day. But creating a relationship in which your partner can come to you even when he or she is feeling the pain of a huge loss without total fear of hellfire and damnation judgment at each drawdown is critical in building character and confidence as a trader. Being able to keep trading successes and failures somewhat transparent will force traders to go back to the drawing board because they realize that they're not going at this alone. If you attack at each loss, that's when the rash decisions happen causing traders to take stupid trades to quickly recover their losses to appease themselves or those around them. It's better to digest and go back with a plan.

### *The Do Not Enter Zone*

A trader's work day can be volatile, filled with ups and downs. But certain times of day are critical, and the most critical are probably market open and market close. During these hours, treat a trader's trading space like Harry Potter's Chamber of Secrets. Do not enter. I learned this the hard way. John's business partner actually has installed a soundproof, bolted locked room in his home specifically for trading. While this is a little extreme, it can give you an inkling of how serious the level of focus of some traders can be.

If you want to see pissed-off traders or, worse yet, passive-aggressive pissed-off traders, call them repeatedly until they pick up or burst into their trading office during critical trading hours. Do this day after day, and not only is it a recipe for frustration, but it becomes downright disrespectful. Imagine that your partner is an open-heart surgeon and you burst into his or her open-heart surgery procedure midstream. No bueno. During opening bell and closing bell, a trader's level of concentration is probably as intense, and like the patient on the table, the trader's heart and soul are splayed out there, just waiting to get stomped on by the markets.

### **Taming Your Trading Beast**

"Raising" a trader in your household is a little like birthing a trading beast. In those early days of his or her trading life, he or she is raw and rough around the edges and foaming at the mouth occasionally at a losing trade. Periods of poor hygiene may even occur on those long trading jags.

Have faith; if your trader is consistently abiding by the three P's mentioned earlier, he or she will begin to mature. My beloved trading beast John evolved something like this:

#### *Years 1–5: The Novice Trader*

DEVELOPMENTAL MILESTONES. Novice traders may devour and regurgitate every trading strategy they can get their hands on. You will hear frequently about "the next new thing" that they discovered. Sleep patterns are highly irregular at this stage. Irritability and tantrums mixed with periods of jubilant elation and lots of high-fiving is common. Onset of delusions of grandeur may occur.



SPOUSAL SKILL DEVELOPED. Tolerance.

#### *Years 5–10: The Intermediate Trader*

DEVELOPMENTAL MILESTONES. Sleep patterns become more regulated, with short periods of fitfulness. New interests may develop. Intermediate traders may experience the need for social interaction with other traders. Displays of emotional bipolar disorder at wins and losses are less pronounced. Writing habits and homework skills improve.

SPOUSAL SKILL DEVELOPED. Acceptance.

#### *Years 10–15: The Successful Professional Trader*

DEVELOPMENTAL MILESTONES. Successful professional traders regain humanlike countenance once again. They can be taken out in public and social situations. They take losses like a champ. Body is functioning optimally. Bank account is functioning optimally.

SPOUSAL SKILL DEVELOPED. Elation.

### **Take Stock**

Taking risks and managing risk is a huge percentage of what trading boils down to. In our case, John took the huge risks and the big hits very early in our relationship. It was definitely a test for our relationship, and a testament to his character. John took risks when the things we had to lose were truly only monetary. In my twenties, I could live on ramen noodles for a couple of weeks if I had to. I could wait on having our first starter home if I had to.

However, if you have three children, have a job that's barely paying the rent, and are in debt to high heaven, you're playing a game with very high stakes. If you're making trades that eat away at your life and the lives of those around you without being honest with yourself about following your passion, keeping perspective, and having a plan, it's not going to be pretty. If you and your partner have highly different values concerning lifestyle, material goods, and timing of your life plan, that's something you need to look at closely before you begin pursuing life as a trader (or begin pursuing a marriage, for that matter).

There are many ways to make a go at this life, and trading is a great one. But take stock and figure out whether trading is the right path and whether it's coming at the right time for you. Determine the level of risk you're willing to take and manage a plan accordingly.

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### **How Do I Top That?**

Okay, it's John again. I didn't know my lovely wife, Maria, had been paying attention over all these years! It truly goes to show that this is a team effort, and being a team has nothing to do with actually trading together. It's about working together in this game called life.

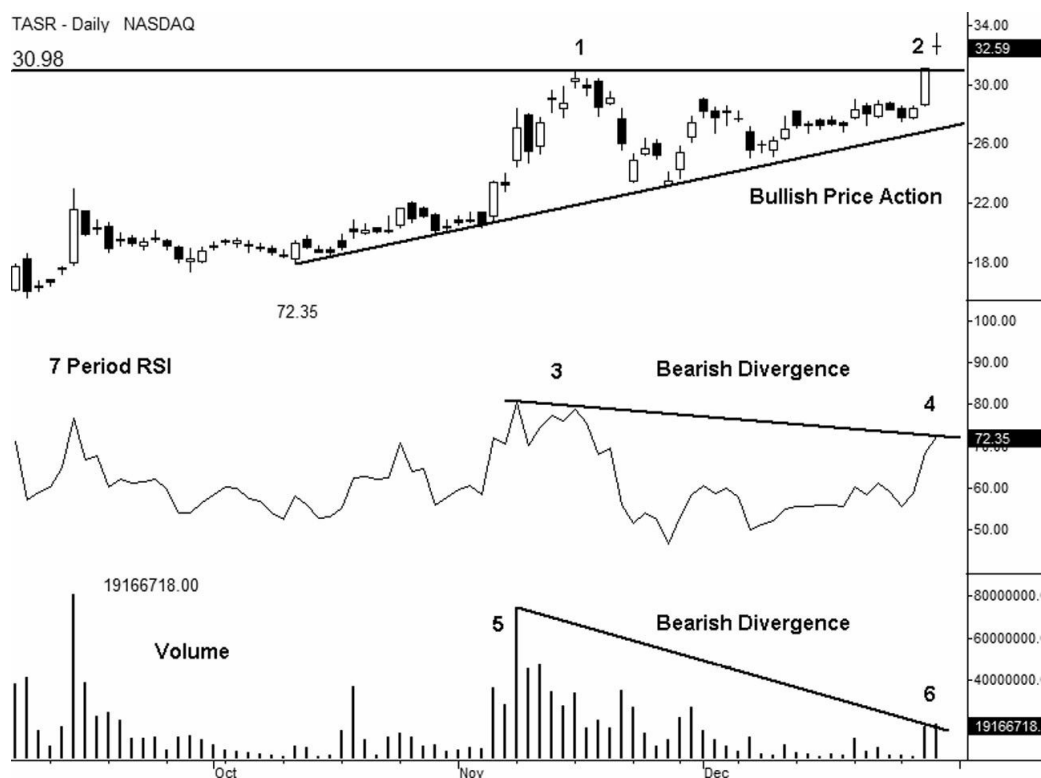
That was great information, and reading it made my life as a trader flash before my eyes. I think I choked

back both vomit and a tear. Maria doesn't trade or have any interest in trading, just as I have zero interest in fabric colors, and it works and brings a healthy balance to our relationship, and we have many shared interests in our travel, reading, exploring, children, and life philosophies. That said, I did learn early on to simply "get it out there" and let her know when I had had a crappy trading day. And by crappy I don't just mean a normal loss. I mean a situation that got out of control, like a big gap against me on an options play. That way, she'd know I wasn't upset at her. I was just retreating inside my head to dust myself off and get back in the saddle again. Trading truly is an adventure. If you liked Maria's insights, you can see more of them at her blog, [www.thisonelifelife.com](http://www.thisonelifelife.com), which covers some interesting ground on a variety of subjects.

One thing that clicked into place when I reached, as Maria would say, "intermediate trader status" was that whenever I had a situation that went horribly wrong, it struck me that someone else was having a joyous occasion taking all that money away from me. Was there a setup in there somewhere that I'd completely missed?

We saw in detail how the trading disaster unraveled for Joe Trader. And yet for someone else, this was simply a great trading opportunity. This chart of TADR represents a different view. (See Figure 1.6.) This is a common setup that's created when large funds want to get out of a stock. They push the stock to new highs, sucking in the retail crowd, and then they start unloading. They know that the retail crowd will buy the new highs, and they also know that the retail crowd will feel comfortable buying all the way down to support. This gives the institutions ample time to sell their holdings. By making the stock look great, even though it actually isn't, institutions fool the masses. I call this setup the "fake orgasm." It certainly sounds good, but there really isn't anything to get excited about.

Figure 1.6



I use it as a fade play for swing trades on stocks. (To *fade a market* means to take a trade in the opposite direction from the move.) In other words, if a stock is rallying with this setup, then I'm looking to short it.

### *How Does a Person Make Money from a "Fake Orgasm" Setup?*

These are the rules I use in trading with the fake orgasm setup. I use this setup on individual stocks.

#### TRADING RULES FOR SELLS/SHORTS (BUYS ARE REVERSED)

- *Look at stocks that are making new 52-week highs.* On December 30, having made new 52-week highs the day before at point 1, TAsR gapped up and hit a new all-time high of \$33.45 (point 2).
- *For stocks making new highs, look for a bearish divergence using a seven-period RSI (relative-strength index).* When TAsR made new highs on December 30, the RSI hit 72.35 (point 4), well below the level it had hit on November 15 when the stock made its last 52-week high (point 3). When prices make higher highs and, at the same time, the RSI makes lower highs, this is called a *bearish divergence*. The RSI measures the power of the move, and this is telling the trader that the stock is losing power.
- *For stocks that are making new highs, look for a significant decrease in volume.* When TAsR made new 52-week highs, it was on one-fourth of the volume of the last thrust to new highs. This is the equivalent of a car running out of gas. There's no sustained price movement without volume.
- *Short the stock the day after it closes below the previous 52-week high.* On January 3, TAsR closed back below \$30.98, the previous 52-week high established on November 15. Utilizing this setup, the trader, let's call her Joanne Trader, goes short 2,000 shares at the open on January 4, getting filled at \$30.27. She places a stop at 25 cents above the all-time highs. Since the all-time highs are \$33.45, the stop is placed at \$33.70. This is a stop-market order, not the stop-limit order that Joe Trader used.
- *To exit, use a close above the high of the low day while above key support. If key support is broken, stay in the trade until there's a close above the high of the low hour on a 60-minute chart.* We take a look at this briefly here, but this is a concept I talk about in much detail later in the book.
- *Don't trail stops.* The exit is the price reversal signal.

Let's now look at the trading of Joanne Trader, who was on the opposite side of Joe's trade. After she entered TAsR short, the stock never rallied enough to close above the previous day's highs. Joanne was still in the stock short once it broke key support on the daily charts in the form of the key uptrend line. Once it broke this key support level, the selling got ugly.

Figure 1.7 is a 60-minute chart that shows the increase in volume once TAsR broke key support on the daily charts, at point 1.

Figure 1.7



During the three large sell-off days, at points 2, 3, and 4, at no time did the market rally enough to close above the high of the low 60-minute bar. The next day, at point 5, TASR rallied enough to close above the previous 60-minute bar, which was the low bar of the entire move down. This close was the signal to cover, and once the next bar opened, Joanne covered her 2,000 shares of TASR at \$16.17, pocketing \$28,200. She also reversed and went long 4,000 shares at this same level, using the lows of the move as a stop.

She stayed in the move until the 60-minute price action created a close below the low of the high 60-minute bar. This happened the next day at point 6, and Joanne closed out her long at \$20.54 for a profit of \$17,480. As Joe was berating himself for being such a stupid fool and sitting through his first day of marriage counseling, Joanne was counting her profits, totaling \$45,680, and wiring a portion of them out of her account to pay for a one-week vacation to Maui.

When a trader loses money, it hasn't vanished into a black hole. It has just been moved into another trader's account. This is true even of the great financial crisis of 2008. The money lost by AIG (American International Group) was simply a trading gain on Goldman Sachs's books. When AIG couldn't pay the loss, the government was nice enough to step in and lend it taxpayer money so that it could, in turn, pay Goldman Sachs. Nice work if you can get it!

### What Is the Only Economic Principle That Matters in the Markets?

TASR didn't lose 60 percent of its value in eight trading days because it wanted to. Desperate traders and mutual funds that had loaded up on this stock to sell covered calls were the main victims. *Covered call writing* was one of the most reliable forms of income generation for most of 2004. This was because the market was choppy and didn't go anywhere. Because this method was doing so well, Wall Street announced plans to start a couple of mutual funds that specialized in covered calls.

Although there are no guarantees in the markets, here is one "almost" guarantee: as soon as Wall Street

announces a special vehicle for trading a market or strategy, then that market or strategy is either at the tail end of being effective, or it is positioned for a bubble-type implosion. Once the covered call funds got started, the markets roared higher during the last two months of 2004, invalidating this strategy as the best way to take advantage of current market conditions.

Here's another example. When Wall Street's pushing of home-loan-backed CMOs (collateralized mortgage obligations) morphed into subprime to feed the demand, it was a clear signal that the housing market was about to go in the toilet. The moral of the story? When Wall Street decides to package something up, put a bow on it, and sell it to the public, that move is nearing its end. But I digress.

TASR lost 60 percent of its value because a lot of people were caught on the long side, like Joe Trader, and froze. Many of them didn't make a conscious decision to sell the stock. They held on until they couldn't take the pain any longer, or their brokers got them out because of margin calls. It was the margin calls that caused the worst of the selling when TASR closed near \$14.00 a share. These forced market orders caused ripple movements in the stock that resulted in even worse fills for traders, like Joe, who were trying to use their skills to finesse their way out of the trade.

Disgusted with themselves and red-faced as beet roots, the victims of these trades stalked off to contemplate the insanity of the universe. Meanwhile, as we saw, another group of traders took the opposite side of this "capitulation trade" and made great profits. How does a trader get on the winning side of these trades? To fully understand how to do this, we must first step back and understand how the markets really work, and why traders continually and instinctively sabotage themselves in the first place.

Well, the first part is easy. The markets are not that complex, and they work very simply. Markets rise on a day-to-day basis because current demand exceeds current supply. Period. It has nothing to do with being in a secular bear market or a cyclical bull market, high price/earnings ratios (P/Es), or Maria Bartiromo's choice of a necklace. (For anyone who actively traded during the [dot.com](#) bubble, traders would look for a rally when Maria wore pearls. Very rational, of course.) It has everything to do with what traders are willing to pay for a particular market or an individual stock *today*.

It doesn't matter whether the demand is falsely created by a hedge fund "taking the street" (buying large amounts of a single stock to drain a market maker of its inventory, forcing it to buy the stock back at a higher price), a squeeze that whacks shorts and forces them to cover, or a rumor that a hedge fund kingpin is buying a stock that has fallen out of favor. Demand is demand, and that's what drives markets higher.

The inverse is equally true: if there's too much supply in the market, prices will fall. The best source of "too much supply" hitting the markets is generally margin calls, too many trailing stops in the market (which causes a cascade effect) and other means of forced selling all hitting the markets at once, such as the Joe Traders of the world throwing in the towel and dumping their positions. This is why markets can erase gains so quickly; they take the stairs up, but they ride the elevator down. It's very important for a trader to remember this. Yes, the stock may be acting great and its prospects may be bright, but if there are 1.5 million shares offered for sale all at the same instant and only 50,000 shares are sought by buyers, then that stock is going to crash. It isn't rocket science. It's supply and demand at its finest.

Trading the long or the short side is very easy, once a trader learns to ignore his or her own personal opinions, quits trying to be right, and quits trying to make money. And by the way, that's the hard part. This

means pushing aside any, and all, prejudices about the market and focusing on the current supply-and-demand situation. When you're dancing with the market, it's best to let the market lead. Once traders understand this, the next thing they need to work on is their own mental trading outlook and how they process this information, and to fully understand how the human brain naturally and emphatically causes traders to do things that make them lose money in the markets. It could be a whopper of a bad trade like Joe Trader's or a series of smaller bad trades that grind down an account—death by a thousand cuts. Either way, it's the human brain that's letting it happen. To succeed in trading, you have to get your arms wrapped around the idea that your brain is naturally wired to sabotage your dreams of becoming a trader. And ironically, it's doing this because it thinks it's protecting you. Understand this and you have an edge. And that's what we discuss in the next chapter.

*Lose as if you like it; win as if you were used to it.*

TOMMY HITCHCOCK, POLO PLAYER

*When you have got an elephant by the hind legs and he is trying to run away, it's best to let him run.*

ABRAHAM LINCOLN

*Man suffers only because he takes seriously what the gods made for fun.*

ALAN WATTS

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## Psychology 101: What Didn't They Teach About Trading and Investing in School?

*Only a fool tests the depth of the water with both feet.*

AFRICAN PROVERB

*Respect your limitations; your limitations will not respect you.*

SWEDISH PROVERB

### Emotions Are Fine at Weddings and Funerals; Why Aren't They Fine When It Comes to Trading and Investing?

Trading is the most deceptive profession in the world. Do you know anyone who has recently walked into an airport, jumped into the cockpit of a jumbo jet loaded with passengers, and taken off down the runway without any prior training? Yet people will routinely open an account and start trading without any guidance whatsoever. And that is equally insane. Little do they know that their emotions and the natural functions of their brain are against them right from the opening bell. They're the freshest of meat.

Just as a chatty masseur is the enemy of a relaxing spa treatment, emotion is the enemy of successful trading. Remember, the markets are set up naturally to take advantage of and prey upon human nature, moving sharply only when enough people get trapped on the wrong side of a trade. This sweeps a burst of fear, frustration, and rage into the markets—and creates fabulous trading opportunities for the prepared trader. To head into this adventure called *trading* (note that it is called “trading,” not “guaranteed income”) without having a firm grasp of how human emotions move markets and how human emotions can sabotage your own trading is like trying to hail a taxi in Manhattan during a thunderstorm. In other words, the odds are overwhelmingly against you.

The whole idea of this chapter is to lay the groundwork for the setups we discuss later in the book. With this foundation, traders will be able to understand how to control their “inner demon” with respect to trading. This is the creature that mentally blocks them from following the parameters of a particular setup once they are in the trade. It is very similar to the brain freeze that occurred during the river-rafting incident discussed in the Introduction and to Joe Trader in the TASR trading example in [Chapter 1](#). It is also important to remember that every trader has different dominant personality traits that he or she uses to absorb information and relate to the world around him or her. Some traders are more *visual*, others are more *auditory*, and still others are more *kinesthetic*—they relate to the world based on how events make them feel on the inside. These three traits can have a big impact on a person's trading.

Traders who are dominantly kinesthetic are doomed from the outset—until they realize that this is how they relate to the world and the impact that it has on their trading. If you buy a stock only when you feel good about it, you are a kinesthetic trader. Your best entries will be the ones that are scary and make you feel nervous. If you buy only when you feel good, the stock is probably near the top of a move. Think about it.

Near the end of this book, there is a chapter on tips for when trading “isn’t working for you.” In this chapter there is a personality test that can help you determine what type of personality you are and the pros and cons for each personality trait. The cons will work against a trader without his or her even knowing it—until he or she learns about them and realizes what’s going on.

In addition, the trader needs to realize the importance of utilizing a specific methodology for each setup, because each setup takes advantage of a different aspect of human emotions.

A trader cannot apply the same trading rules to all setups across the board.

This is one of the biggest mistakes I see newer traders make. A two-point stop in the E-mini S&Ps can work well with one setup but for another, 10 points works better. In fact, one of the quickest ways to fix most win ratios is to double your stop loss and cut your position size in half. You’re still risking the same amount of money, but you’re giving the trade enough room to work itself out. Putting 20 percent of your capital into one option trade can work well with one setup and strategy, but can be devastating with another. By understanding the psychology behind the trade, the individual will also then understand the right parameters and the right allocation to use for each setup. Each setup really is unique, and it has to be treated that way.

The purpose of this chapter is for you to develop what I call a *professional trading mind-set*. Although we discuss setups for most of this book, traders have got to have the trading psychology nailed down or their trading experience will be short-lived and painful. The other option, of course, is to go to a purely mechanical system and have your computer trade for you. Although this sounds like a good idea, I’ve found that traders who don’t understand the psychology start tweaking the system every time there is a losing trade, which negates the whole idea of having an automated system. The bottom line is that if you understand the trading brain, you have a distinct advantage over (1) those individuals who don’t and (2) those large funds that are trapped in larger positions, which will take them days or even weeks to liquidate.

### **Why Is a Guy with a System Always Welcome in a Casino?**

This is an old Las Vegas saying that applies equally well to the financial markets. Having a system gives people a sense of security—nothing can go wrong. Every time I walk into Mandalay Bay or Bellagio in Las Vegas, I am reminded that all these fabulous structures were paid for by people who thought they could beat the blackjack tables. The owners of the Luxor borrowed \$550 million over 20 years to build their place. They were able to pay it off in less than three years. Tell them at the front desk that you have a system, and you’ll most likely get a presidential suite and a private table.

Why don’t systems work in Las Vegas? The reason for this is twofold: the house has an edge with percentages, and as soon as the system falters a couple of times, the human mind gets to work trying to tweak it to make it perfect. This eventually screws up the entire process. In casinos, as in trading, it takes only one stupid bet to blow your whole wad. Casino owners know this, and this is why they sell the strategy books right there on the property, prominently displayed in their own gift shops. This elevates the concept of the fox



guarding the henhouse to a whole new level.

Craps is a great game for studying the trading mind-set. The board is set up to encourage more of the “stupid bets” as the game goes on. Instead of just focusing on the higher-probability pass and no pass bets, participants get sucked in and start betting the hard ways and all the other exciting, low-probability bets. It’s a crowd mentality case study right before your eyes. Guess who wins consistently in the end? And that’s why the drinks are free.

It’s the same process with the markets. The odds are against the trader surviving because the market has an edge: it doesn’t have any emotions. Like the river making its way to the ocean, the markets ebb and flow with total disregard for the objectives of the people who are hanging on for the ride. Humans have a tendency to try to imprint their will on the markets. This is like trying to get a tornado to shift course by yelling at it, or trying to convince your wife that making returns to the department store is not the same as saving money.

## What Is the Right Mental Outlook for the Markets, and Why Shouldn’t I Turn On My Computer Without It?

*He who conceals his disease cannot expect to be cured.*

ETHIOPIAN PROVERB

*I will not allow yesterday’s success to lull me into today’s complacency, for this is the great foundation of failure.*

OG MANDINO

First, traders must understand the psychology, and then they can learn about the setup. Initially newer traders don’t care about the psychology. “Just show me the setup,” they say eagerly. Then, after the market has its way with them, they come back and start digging into the psychology, if they have the financial and mental capacity to give it another go. It’s like two pieces of a puzzle, and these two pieces have to snap together snugly in place before a trader can expect to trade for a living without repeating the same mistakes over and over again. I’ve shown many traders setups that work. The ones who don’t get the psychology part always screw it up eventually. Remember, the process is deceiving because it doesn’t mean every trade is screwed up. Far from it. It just takes one nasty psychological downward spiral to throw it all away. Usually this takes place right after the first time they have three losing trades in a row. “I wonder what would happen if I added a MACD (moving average convergence divergence) filter and changed the settings of this moving average. I bet if I’d done that, I wouldn’t have been stopped out.” And a good setup dies an early death as the trader heads down the path most traveled—that of the never-ending tweak, the search for the magic potion that doesn’t exist.

I’ve spent a lot of my career focused on trader psychology—not only working on myself, but working with hundreds of other traders in person, and thousands of them online and through webinars. I’ve spent a lot of time in large trading rooms with hedge funds and proprietary traders, executing orders right alongside hundreds of other traders. I’ve watched the fear, the elation, and the greed permeate a room of a group of traders like a disease. I’ve literally seen money from accounts on one side of a room flow into the accounts on the other side of the room as each group of traders focused on different setups and parameters.

In addition, I’ve worked with hundreds of traders who have come up to my office to sit beside me and watch me trade, and to have me look over their shoulder while they trade. I’m the first to say that I’m not a

psychiatrist, but let's just say that my experiences have left me with a clear road map of the process most traders go through when they first start to trade. Every person is unique, but when it comes to money, the differences are quickly stripped away. Doctor, lawyer, surfer, or engineer—it doesn't matter. A herd of thirsty cattle will quickly drop all pretenses and stampede to get to water.

In addition to my experiences in working with other traders, it shouldn't be surprising to hear that I learned a lot of this firsthand from the best teacher that the market has to offer: extensive personal pain and suffering. By the time I was a senior in high school, I'd saved \$1,000 working a \$4 an hour job slinging cookie dough and sodas at the local mall and running my own very small mail-order business, buying rolls of wheat pennies in bulk and selling them individually through newspaper ads.

My stepfather, Lance, noticed my stash of cash and my entrepreneurial spirit. He said, "Have you thought about putting your capital to work?"

I had no idea what he meant, but he was a Morgan Stanley broker, and I watched him meet with his friends every Sunday night as they visited and mapped out their Monday morning buying-and-selling strategies. When they told me they were going to buy Intel call options and asked me if I wanted in, I said, "Sure," even though I had no idea what in the hell a "call option" was. But I was and always have been a risk taker, so, shortly thereafter, I spent my entire \$1,000 savings on 10 Intel calls for a buck each. Four days later, my stepfather told me to sell, and I did . . . at \$1.80 per option, earning an 80 percent profit of \$800, less commissions. I never went back to that cookie store again, at least not as a boy flipping cookie dough for \$32 a day, less taxes. I was hooked on putting my capital to work.

For the next eight years, through college and through my first corporate job, I maintained a routine of staking myself with \$10,000 in order to buy and sell low-priced stocks and options until I increased my portfolio to the \$120,000 to \$130,000 range. During those eight years, I repeatedly did a smart thing, followed by a stupid thing, whenever I ran my account up that much. The smart thing I did was when I had built up my account to over six figures, I would withdraw \$20,000 to \$30,000 of profits to invest in single family homes and duplexes that I would rent out.

## Minnesota Stupid

The stupid thing I did was sit back and say, "Gee, I managed to take \$10,000 and turn it into a little over \$100,000. Now I'm going to try to take this remaining \$100,000 and turn it into \$1,000,000. Let's do this!"

The first time I tried this, the experiment ended quickly, much like taking a Band-Aid and ripping it off with a flick of the wrist. It took all of six weeks to grind my capital down from \$100,000 back toward the neighborhood of \$10,000. Sure, it surprised me, but I chalked it up to bad luck. I rolled up my sleeves and went back to work. About a year later, I had built up my account to just over six figures, and then I paused and did the same thing. First, I took money out to buy real estate. Next, I decided to try turning \$100,000 into a million dollars yet again. This time I lasted four months, but the result was the same: back to \$10,000 and change. Hmmm. Third time's the charm?

A few years after graduating from college, I was engaged to be married. I was in a nice swing trading rhythm. I had built up my small stake back into a \$150,000 trading account. This time I decided to "chill out" and just trade for income, as opposed to going for a million dollars, as that didn't seem to be working out too

well. I took modest profits out of the account at the end of the month as income, proving to myself that I could be consistent, and I was getting closer to my goal of quitting my job as a financial analyst to become a full-time trader. At the time, my fiancée and I were living in Austin, Texas, but we were contemplating a move to Korea to teach English and just to try something different. We thought it'd be a bonding experience.

Then the company I was working for offered me a promotion and a transfer to Minneapolis, Minnesota. We thought about it, and in our youthful "wisdom" decided that Minnesota was probably a lot like Korea—cold. We moved to Minneapolis in the mid-1990s, during two of the coldest winters in the history of the city. Outside our apartment, the wind chill hit 40 degrees below zero, and our cars wouldn't start. Inside our apartment, my fiancée, who had never seen snow before, sat. She was miserable.

I took taxis to and from work and came home to find her in the living room with a mask over her nose, sanding the apartment walls for the second time. Even I could see that she was going stir crazy. Then she issued an ultimatum: "Get us a house with a garage so that our cars will start; we're getting the hell out of here."

It took a few months, but by May, just as the snow had melted, we found a house with a heated garage. I'd never heard of such a thing, but it sounded like the right thing to have. I planned to put down \$30,000 at closing. About a week before closing, I sat and stared at my \$150,000 trading account and wondered how it was going to affect me—psychologically—to take my account down to \$120,000. I was in a comfortable rhythm. The money I was pulling out of my account I mostly put into rare coins that I planned to hold for years, so I didn't have a lot of liquid assets other than my trading account. I liked my account size. I didn't want to change it. I had only a week before the closing to decide what to do.

As I thought about it more, I chose to make just one big trade, enough to earn \$30,000 so that I could take out the down payment and still maintain my \$150,000 trading account. It was so logical that I truly thought it was a genius idea. I would do one of my normal setups—just with a much bigger size. And I would watch it like a hawk. I started flipping through the charts, and there it was. The OEX S&P 100 Index Options was knocking up against a serious downtrend line on the daily charts.

The next day at the office, I set up my laptop, poured myself a cup of coffee, and watched the charts. (By this time I'd been promoted into my own office, so it wasn't difficult to do some swing trading while I worked.) The market started to rally, and it hit right into that mega-downtrend line. My heart rate quickened. I phoned my broker and bought 100 OEX puts at \$8.00. Immediately, the market came down, and in 20 minutes I was up \$10,000.

I thought, wow, this is going to work out faster than I'd hoped! The next thing I saw was a small kickback rally that brought new highs, and the options dropped to \$7.00. I believed this was the deal of the century. I mean, I loved them at \$8.00! I called my broker and bought 100 more puts at \$7.00, which put my entire \$150,000 into the trade. I skipped meetings and didn't go to lunch. I did not take my eyes off the screen. By the end of the day, the market had edged down off its highs and I went home with an open position that was up around \$12,000. I wasn't going to take home a loser, so this fit into my plan of taking a "green" position home overnight. In fact, my thought was that I could close out this trade at the open, hit my goal, and live happily ever after.

But when I woke the next morning and turned on CNBC, I saw a green arrow indicating that the Dow

futures were up +130 points. I turned off the TV, shook the remote, and turned it back on. The green arrow was still there. Ouch. I was hosed. I'd been trading long enough at this point to realize a couple of things:

1. I wasn't going to make \$30,000 on this trade.
2. My main goal now was to contain my losses.

I knew that this opening gap had a high probability of retracing half its opening range (to where the Dow was only up +65). I calculated that if I sold my puts at that level, I'd be out with about a \$20,000 loss on the trade.

I got to my office. I turned on the charts. I watched and watched, and I waited and waited, but the retracement never came. Dazed, I stared at my account. The next day the markets gapped up again and rallied. For good measure, they did that for the following two days as well. I don't remember this time at all. I do remember at some point that it was the day before we were supposed to close on the house, and I needed to sell out my position so that I could have money to buy the house. I had no idea what the options were even trading for. (I couldn't look.) I just told my broker to sell. By the time the dust settled, I was able to check my account balance. I noticed that my \$150,000 trading account had evaporated into the tidy sum of \$8,000 and change. At this point I did what any man in his right mind would do—which means that I sure as hell did not tell my fiancée. For good measure, I stared at the charts a little longer. Maybe I was only dreaming this and I would wake up at any moment.

Finally I got up, went to the bank, and maxed out my credit cards in order to get the down payment. I went to the closing and handed over the \$30,000 check, at which point the mortgage officer said, "Wait. I thought this was coming from an investment account. We need to see where this money came from."

I acted ignorant. "Uh, what are you talking about? There's the money right there. Right in front of you." My real estate broker started to get angry at the closing agent (he didn't know what was going on). An hour later, the agent finally allowed us to close on the house. I kissed my fiancée good-bye (she had no clue what was going on), drove to the par 3 golf course down the road, and attempted to play a round of nine holes. I drove. I chipped. I putted. And I threw up. I did that for five holes. My nerves were shot, and I felt horrible. After I'd calmed down, I asked myself, "What do I want?" I knew I could raise another trading stake. All I had to do was sell one of my real estate holdings. But did I want to continue to go down this road of uncertainty? How could I quit my job and rely on a trading income if I did stupid crap like this?

I loved—and still love—analyzing the markets. I love placing and managing the trade. It's an intellectual challenge. And it's an emotional challenge—not letting your emotions actually zip down your arm and into your fingertips and onto the keyboard. But most of all, it's where my passion lies, and where it has lain since I placed my first trade.

Still, I decided that I wouldn't trade again until I figured out what I'd been doing right and wrong up to this point. I knew I could make money trading—why couldn't I keep it? For the next year, I thought, studied, talked to other successful traders, and read.

During this time I came across a book by Mark Douglas called *The Disciplined Trader*. This book was a real eye-opener in that Mark showed how to turn everyday stressful trading situations into "normal" trading behavior. His follow-up book, *Trading in the Zone*, is also excellent. His books have had a huge impact on me,

and they are required reading for anyone I'm working with. Mark's insights, as well as my long discovery period, finally gave me the answer: whenever I focused on the setups and not the results, I did fine. *But whenever I focused on the results and not the setups, I got killed.* Why is this? Once I got my hands on a decent-sized trading account, I would start to think: "I want to turn this account into a million dollars." Or even better, "I just need to make a quick 30 grand for the down payment on the house."

Instead of focusing on the setups, I was focusing on making a million dollars or, in the case of the house, a \$30,000 down payment. This caused me to jump into the trading habits that ruin all traders: betting it all on one trade, not using a stop because the trade "had to work out," and focusing on making a million dollars instead of waiting patiently for a high-probability trade setup. All of these habits guarantee trading failure in the long run. Yes, it would have been easier to just blame it on my mother for hitting me with a wooden spoon once when I was a kid, but at some point we have to step up and take responsibility for our own actions. By focusing on "making money," a trader will see a lot of opportunity where there is none.

Once this revelation sank in, I started to do two things differently:

First, I started wiring any profits out of my trading account at the end of each week. This kept me focused on producing a smaller, steady income, as opposed to making a grand killing. I later refined this and today call it "cash flow trading," and I'll talk more about this specific trading methodology shortly. (In trading, there is trading for cash flow and trading to create wealth; they are very different.)

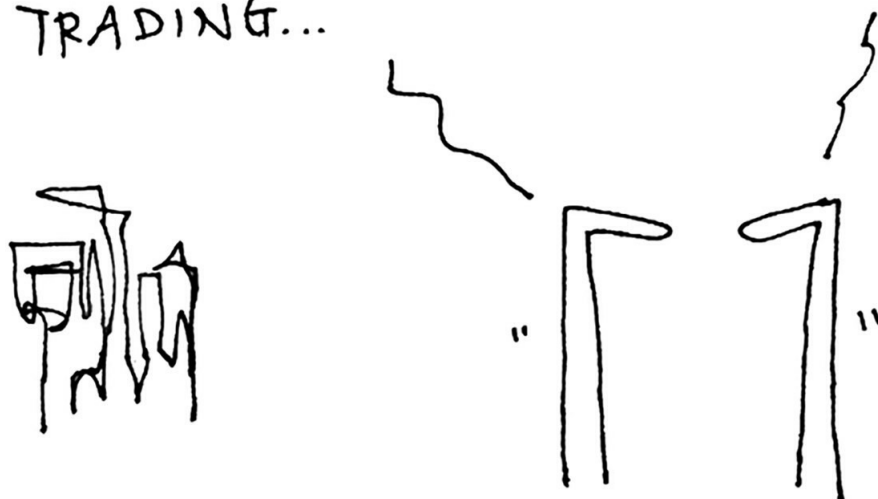
I also discovered that wiring money out was a great way to protect profits. The market can't have them if they're safely tucked away out of reach. I use these profits mostly for longer-term investments like land and gold. But I also set aside some of the money for fun and interesting experiences—after all, we're only here once, as far as I know, and at the end of the day, it's the memories that stick with us, not the things we buy. And one important thing I realized from another successful trader is that there is no need to trade every day. I started to notice that there were days when I didn't take a trade—not because I didn't want to, but simply because the setup I was waiting for didn't occur. This turned me into a more relaxed trader as I no longer experienced FOMO: Fear of Missing Out.

Second, I started a competition among the various setups I used. This way, I could measure the performance of every one of my setups at the end of each month. The setups that made money I kept using. The setups that lost money I dumped. This was incredibly important to my trading. The only way I could keep my competition going was to execute my trade setups the same way every time. I did this in blocks of 25 trades. This had the added benefit of removing much of the importance from any trade I happened to be in at the time. It was just "trade 13 out of a series of 25"—no big deal. Any time I deviated from a standard setup, I marked this down in my trading journal as an "impulse trade." I kept track of my performance on these, too. After about six months of tracking my impulse trades (wow, this market is going higher; I must get in), I realized that they weren't making me any money and were in fact preventing me from making a living as a trader. Yes, they were fun. But they weren't helping. (See [Figure 2.1](#).)

Figure 2.1

THE BEST CURE  
FOR WHIPSAW LOSSES  
IS TO STOP  
TRADING...

BUT THAT  
WOULD BE  
TOO EASY...



@gapingvoid

In working with other traders, I see impulse trading as one of the most common reasons for people getting their heads handed to them. They don't have a plan. They just get long when that feels right, and they get short when that feels right. Or they just get bored. I've literally had traders in my office who have visited to work specifically on their impulse trades—only to sneak in orders when I wasn't looking. The urge to jump in and be a part of the action is that powerful. It's like a drug addiction, and like most addictions, it never works in the long run.

My method for dealing with them is to simply sit next to them and watch them trade—and to do exactly the opposite of what they're doing. At the end of the day or the week, we compare our profit-and-loss (P&L) statements, and that usually tells the story. This is a win/win situation because it is a great lesson for the impulse traders—there are actually people out there doing the exact opposite of what they're doing and making money—and it is a mostly profitable exercise for me.

The cure for impulse trading is patience and understanding integrity—a topic that we're sneaking up to shortly. Patience is such an important quality for a trader—both in learning what setups best work for you, and in waiting for those setups to occur. Impulse traders who cannot own up to this bad habit need to stop trading and go to Las Vegas. The end result will be identical—they will lose all their money. But at least in Las Vegas the drinks are free.

If people are stuck in a relationship with an individual who berates their best efforts and undermines their dreams, then it's time to leave this individual and move on. It was in this vein that I “broke up” with my impulse trading. I liked my impulse trading. It was fun. It made me feel good, feel alive. It was exciting. But the bottom line was that my impulse trading was undermining my potential and preventing me from realizing my dreams of being a full-time trader. Once this realization took hold, I took immediate steps to cut that cancer out of my life. This included a reward-and-punishment system that I discuss later in this book, in the

chapter on formulating a business plan.

In the end, I stuck with my friends who believed in me—the setups that worked when I gave them half a chance. Once I was able to follow my setups consistently, exactly the same way every time, I was able to make the transition to trading full time. A large part of my transition was mental and developing what I call a “professional state of mind.”

Oh, and by the way, it wasn't until years later, when I was doing a talk at a Traders Expo in Las Vegas and telling the story about the “Minnesota Stupid House” that my wife actually learned of the event. She was sitting in the audience, and I'd totally forgotten that I'd never told her. Everyone around her started asking, “Wow, how did you handle that?!” Afterwards she came up to me with a sweet smile and a few blinks of the eyes and said, “So what *else* haven't you told me?”

### **Why Do Most Traders Have to Blow Out an Account Before It All Sinks In?**

Trader psychology is one of those subjects that doesn't seem to matter until it really matters. You think the issue will never arise, or it won't apply to you, or you'll figure it out before the moment of truth. However, that moment of truth tends to happen at the least convenient moment, typically when things are about to go from bad to much, much worse, like when you're changing a flat tire or when your three-year-old daughter yells out in the middle of traffic, “No, Dad, I have to go poop *now!*” It's one thing for your daughter to *say* she has to poop in the car, but it's a whole new ballgame when she actually cuts one loose.

The term itself, *trader psychology*, inevitably gets thrown around with greater and greater frequency as a trader nears the goal of trading the markets successfully, because the closer a trader gets to being consistent, the more apparent it becomes that his or her greatest enemy is rarely the individual on the opposite side of the trade. Far more often—as is the case in so many aspects of life—our worst enemy is the person looking back at us in the mirror each morning. Unfortunately, most traders, myself included, never realize this until they blow out an account. “Wow,” they say, “I didn't think that would ever happen to me.” Seasoned traders call this the price of tuition.

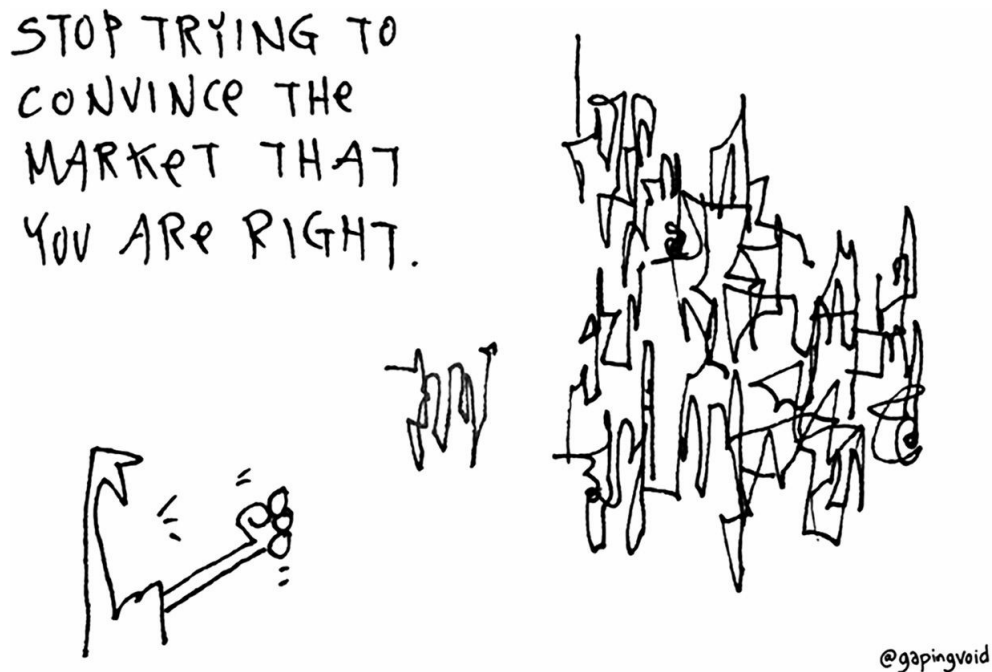
### ***Addiction***

The first psychological issue that traders find themselves butting up against is addiction. When people hear traders talking about addiction, they often think about gambling. *Addiction* in a trader refers to the rush of placing the trade, and the anticipatory thrill as a trader establishes a position and hopes that it goes his or her way and brings in tons of cash. Yet that all pales in comparison to the addiction to being right or, worse, not being wrong. It drives human behavior into the realm of absurdity. When we dive deeper, addiction, any type of addiction, whether it is to alcohol or work, is just a way to numb painful emotions we don't want to face. I think it is important we realize this and own up to it for our own sake.

For example, placing a trade that will make money, as long as that market doesn't crash overnight, is a reasonable setup and a reasonable assumption. Stops can be used. Risk can be assessed. In the early morning of January 17, 1995, an earthquake hit in Japan, causing its stock market to take a nosedive. One particular trader saw this unfolding, watched his losses mount, and started doubling and tripling up in order to recoup his position and make money on the trade by bringing down his average cost. When the bounce failed to

materialize, the trader, Nick Leeson, bolted out the door, leaving a note that said, “I’m sorry.” This trade lost \$1.3 billion and bankrupted Barings Bank. Although this is an extreme example, it happens every day around the world with much smaller accounts. Maybe \$5,000 doesn’t seem like much in comparison, but if that is your entire trading stake, losing that amount can be just as devastating as losing \$1.3 billion. Okay, maybe not quite as devastating, as you could get another \$5,000 with a credit card advance, but you get the idea. (See [Figure 2.2.](#))

Figure 2.2



I’ll mention this book a few times as it is one I’ve found very helpful in my own life. It’s called *Letting Go: The Pathway of Surrender* by David R. Hawkins. It’s one of those books where I feel lighter, and experience more freedom, every time I read the first few chapters or listen to it on Audible.

In many facets of life having to do with careers, an addiction to being right is a strength. It forces us to work harder to meet our goals and to prove to ourselves and to others that we can, in fact, accomplish what we’ve set out to do. It can cause us to view a potentially devastating setback as a mere learning experience, and onward we go, dusting ourselves off and getting back on the horse for another ride. It’s like the movie *Rocky* every trading day. No one thought an uneducated but kind-hearted debt collector for a loan shark could get a shot at the world heavyweight championship. But he did, and he proved that everyone was wrong and showed everyone that he was right, and it made a great movie. It’s a fantastic life lesson in persistence and in following your dreams.

But if you try that in trading—try holding on to a losing trade until it turns back into a winner, just so you can prove to everyone that you aren’t wrong—you’ll get your ass handed to you. Maybe it won’t happen on this current trade and maybe not on the next one, but it will happen, and it will lead to a blown-up account. True, not many of us will ever bring down a bank, but wiping out your life savings is a close second. Trading is the only profession that punishes tenacity by taking your money. Be tenacious in learning how to become a



better trader, not in proving that you're right on this current trade.

### *Rationalization*

But it's not just the human need to be right that makes trader psychology such a complex battle, it's that other great power of the human mind—the power of *rationalization*. This is a topic I've already touched upon, but it's worth another quick look from a slightly different angle.

In the film *The Big Chill*, Jeff Goldblum's character discusses this subject in a particularly salient manner.

**Michael:** Don't knock rationalization. Where would we be without it? I don't know anyone who'd get through the day without two or three juicy rationalizations. They're more important than sex.

**Sam:** Ah, come on. Nothing's more important than sex.

**Michael:** Oh yeah? Have you ever gone a week without a rationalization?

Rationalizing the events on your screen means rewriting the story of what's really happening in a way that feels comfortable to you, that makes your position seem like the correct one. "This trade isn't going to go against me for long," thinks Joe Trader. "They aren't going to shake me out!" And if it works out, Joe Trader compliments himself for being the genius that he is. He just knew it would work out, especially this particular trade. Call it a gut feeling. And, of course, since it did work out, it just proves that his analysis was spot on. "You know," he muses, "I think it's time for me to up my trading size on this next one."

People can gloss over reality in nearly all areas of their lives, reshaping their interpretations of events to put themselves in a favorable light and keep their pristine image intact. After all, it's okay to ignore your kids when you're on the computer if you've got VITTD (very important things to do)—or so goes the rationalization. None of us wants to admit when we're being a shitty parent.

In trading, however, at the end of the day, the result is right there on your profit-and-loss (P&L) statement. No matter how "right" you persuaded yourself you were, a loss that was incurred when you were trying to prove yourself right is still a loss, and your story doesn't mean a thing to a neutral-minded market. The P&L statement is the great equalizer. It reveals you for who you really are, and in many instances the picture isn't pretty. Unfortunately, most people would rather do anything other than confront themselves or their ideal image of who they are. It's not fun. Believe me, I thought I had much better qualities as a person before I got into analyzing my trading personality. And this is why trading has such a high failure rate. Flaws explode onto the P&L statement. They must be addressed—not just in theory, not just through a few notes in a trading journal, but in practice, on every trade. The game changed for me when I committed to becoming a better trader on every trade, as opposed to rationalizing why I was right on every trade or getting caught up in my own idea of the hero's journey by hanging onto a loser for the sake of the drama and chasing the feeling of victory I craved.

### **The Trader Mind-Set: What Is the Best Way for Getting, and Keeping, Your Head in the Game?**

Great trading, like greatness in any profession or art, is a kind of balancing act. Each trade requires us to split ourselves into two parts: caution and boldness. We need the caution to be patient, the courage to get in, the

confidence to stay in a winning trade, and the caution to protect our gains once we have them—but not too aggressively, so that we don't get stopped out on a mere wiggle. Most important is the courage to admit that our trade is wrong and to get the hell out. Great trading is all of these things, which is why great traders are so rare. This balancing act is the reason so many type A personalities perform so badly in the markets. While they may possess boldness, courage, and decisiveness, they frequently lack the caution, patience, and ability to accept that their first impression was the wrong one. Or, more simply, they lack the ability to concede that, while their setup might have been as attractive as a Swedish au pair, it just didn't go the way they expected it to go. The market doesn't care if the setup was a good one. It's still going to do whatever it wants to do.

Something happens at the beginning of a trade, a psychological battle. It's that classic scene of a devil on one shoulder and an angel on the other. One tells you to hang in there with all your might, that things are going to go your way eventually, no matter what the evidence suggests. The other screams in your ear to preserve your capital, to get out, to take a tiny profit or a tiny loss. Just get out! It's a powerful sensation, especially for the beginning trader, which is why a clear trading strategy is critical. A trading plan in which you can place your faith is like a pair of mufflers, blocking out the sound of that noisy chorus. Trading without a game plan is like swimming in the Amazon River with a couple of raw steaks strapped to your waist. You might get some good exercise, but the longer you're in the water, the greater your chance of a violent end.

It's when you're not trading your plan that fear takes hold, and when fear takes hold, it's easy for you to lose perspective and exit too early, cutting your opportunity for profitability off at the knees. Yet fear can also cause traders to do something that seems the total opposite of fear. It can cause traders to ratchet up their nerve and stay in the trade long after signs of danger have presented themselves. That is, fear triggers an irrational boldness. It takes courage to stay in a trade; that much is certain. But the lesson that too many traders learn too late is that it takes just as much courage, if not more, to get out of a trade that's clearly not working. The greater a trader's nerve, the greater his or her chances of ruin.

I often think of the words of a great general who said, "Retreat is a perfectly legitimate military tactic." Of all the parallels between war and trading, none may be truer than this one. There is no shame in taking a small loss. In fact, when taking a small loss prevents you from taking a big one, it should be considered a victory. If things aren't going the way you hoped, preserve your capital and live to fight another day. And always remember, reentry is only a commission away. Go flat, take a walk, and clear your head. The market isn't going anywhere.

It sounds simple enough, as if you could simply resolve at the start of every trade that you will exit neither too early nor too late, and you'll have courage in the right measure at the right times, but it's actually a tremendous shift in perspective for most traders. We're all geniuses when we're looking at the charts in hindsight. It's making decisions in real time, clearly not knowing what exactly is going to happen next, that makes or breaks a trader. Anyone can tell you what you should have done.

Great flexibility is required when you're looking at the markets. There is a certain Zen attitude that is reached by the greatest of traders. In fact, this is one of the terrific, sometimes hilarious, paradoxes of the trading world: meeting serious traders in their seriously expensive suits, who amidst their talk about the hard-core daily battle between the bears and the bulls sprinkle in Zen proverbs. "There's no meaning to a flower unless it blooms." Or, perhaps more relevant, "No ego, no pain." The people who have learned these lessons

are the ones who make money in the market, because they have learned that when you're forming an opinion of the market, that's all you're doing: forming an opinion. You must leave room for chance. And when you see that your opinion was the wrong one, you must have the courage to get out and the faith to accept another difficult truth: the opportunity will always come around one more time. Again, the markets aren't going anywhere.

Once the trader accepts the constant flow of the market and that endless renewal of opportunity, then the trader will understand that there's no need to enter the market on half-convictions. Just sit back and wait until a setup has laid itself out with clarity. Not a maybe or an almost—it's simply there, period. What if it doesn't work? It doesn't matter. When the setup presents itself, your only job is to take it, not care if it works out or not. That's what stops are for.

In the meantime, the main job of traders is to fight off their boredom and stay flat. Traders who take on a position out of boredom then spend their time managing that mediocre trade while good ones pass them by. There is a huge opportunity cost in taking mediocre setups, as it causes traders to miss the great ones. Getting in too late and getting stopped out on a normal pullback just means that someone else is eating your lunch that day. When you don't follow your plan, you help other traders who are following their plan, as your stop loss becomes their well-thought-out, well-planned entry point.

The markets change daily. Literally there is never the exact same combination of orders and trader actions from one day to the next. The gravity of that fact can be hard to grasp when you read about the same kinds of setups or anticipate the same kinds of moves day after day. But the market truly is continually changing and forming new combinations. There is an infinite number of possibilities on any given day, at any given minute. Did you know that each time you shuffle a deck of cards, the odds are that no deck of cards in history has ever been in that precise order? In fact, the odds against it are staggeringly astronomical. Imagine what that suggests about the markets, in which the variables are tremendous by comparison. For that reason, it is critical that you take a fresh look every day to consider the possibilities, not merely in relation to what you saw yesterday or the day before, but in terms solely of this moment, today. Bringing to the table no preconceptions or intentions of your own, you must always ask yourself: "What is the market showing me now?"

### **What Is the Easiest Way to Establish a Consistently Winning Outlook?**

Just as professional gamblers are unfazed by their winning and losing streaks, great traders learn to roll with the punches (because they are so used to taking them). They manage their money in such a way that no one session leaves them broke.

One strategy in establishing the proper outlook is to stop thinking of your money as money. Anyone who had a job as a teenager will surely remember the way in which every hour of work could be translated into a real-life desire. An hour of work might have been a bit of gas for the car, a night out at the movies, or dinner with a girlfriend. In trading, there is the temptation to do precisely the same thing: to say, "I just won my car payment," or, "I could have bought a new home entertainment center with that loss." Don't think of it as money. In the world of trading, remember that money is only a tool of the game; it's a means to keep score.

Though this removal from the literal value of money could certainly be a hazard in real life, it is an excellent habit for removing an emotional element from the trading day. The moment you lose sight of money

as a tool of the game and revert to thinking of it in terms of its purchasing power, you have sentenced yourself to playing less skillfully and more emotionally, which is poison to any trader.

### **What Does Personal Integrity Have to Do with Successful Trading?**

In the game of life, everything is in play: your time, your money, your relationships, your social position. Every element of your day-to-day existence is in your hands, and you protect each part of your life by investing wisely in each category. In fact, your quality of life is entirely determined by the way you handle those investments. You invest in your health by treating your body in a certain way and asking only reasonable things of it. You invest in your relationships by fostering them, treating them respectfully and with care. The way in which you invest in your life for a positive outcome can be boiled down to a single word: integrity.

*Integrity* is often thought of as doing what you say you're going to do with other people. When you say you'll be at a meeting, you show up at the appointed time. When you promise to take out the trash, you get it to the curb before the trash man cometh. Other people's faith in you grows each and every time you keep your word. People who don't keep their word aren't treated seriously. If you have an opportunity for a new business venture and you need to find a partner, whom are you going to choose? Not someone who can't even keep his or her word on the little things. Integrity is its own type of currency in the world. It's how we show others that we deserve their respect, their love, and their compensation for our hard work.

The problem comes when we don't treat ourselves with the same integrity. We do have a sense of self that we come to rely on when the chips are down. We have varying degrees of faith in ourselves in various situations, based on how we've handled those situations in the past. In trading, it's critical that we're able to trust ourselves to follow our plan, preserve our capital, and not freeze when the going suddenly gets very rough.

How do we build integrity with ourselves? Simple: we keep our word. If we write down that we're going to go to the gym at 3:00 p.m., then come hell or high water, we get to the gym at 3:00 p.m. And if we also tell ourselves, "Today I'm not eating any dessert," then we stick to the plan, honor our word, and pass on the dessert. With each missed workout, with each slice of cheesecake, another shred of integrity is lost. This chips away at our own sense of self, creating a growing sense of unreliability. What is the result? For traders, it's being scared to take a trade because you don't know if you can trust yourself to follow your plan once you're in it. And not trusting yourself as a trader is a guaranteed route to disaster.

How do you build up this sense of self, this sense of trust in yourself? It's very simple: keep your word with others and with yourself starting today. More important, learn to say no so that you don't overcommit. But when you agree to do something, whether it's meeting someone for a drink or going to the gym at a certain time, then fight like hell to make it happen. Be unreasonable if you need to. After all, you're building up your most important trading tool—faith in yourself that you'll follow your trading plan, which is keeping your word. There's no one else there to hold you to it. You need to rely on yourself, and you need to believe with absolute conviction that you're someone who can be counted on.

As traders, we're confronted each moment with opportunities to violate our plans. Every new bar or candlestick is a chance to let just one of our rules slip. Whether the outcome is a win or a loss, toying with your rules in the heat of the moment is more than merely a bad idea; it's a message to yourself that you aren't

reliable and that you don't play with integrity. Eventually your integrity erodes to the point where you don't even trust yourself. "Man, I hope I don't screw this up again," thinks Joe Trader.

Integrity in trading is the most critical component of your trading plan. Building up that integrity is easy to do. Start with the next trade. Follow your plan and follow your word, and your trading skills will increase.

## **Where Are You Now in Your Trading Journey?**

It is critical that traders understand this process and recognize where they are on their journey. This is obviously important for a trader's own development, but there is a more subtle reason why it's essential to grasp this concept—so that a trader can understand what mistakes other traders are making and how to profit from those mistakes. This is the biggest poker game on the planet, and the money that's flowing into your account isn't appearing as if by magic. It's coming from someone who is still learning how the markets work, and who most likely followed his or her gut and got suckered into taking the wrong side of the trade.

Believe it or not, everyone who is trading today has about the same odds of making money on the very next trade. There is simply not a lot of skill involved in making money on one trade. The difference is over the course of 60 trades, 100 trades, or 1,000 trades . . . who is going to be able to generate an up-trending equity curve over the course of that many trades? It's the traders who have graduated from the four basic phases of trading:

- Phase I: Destined to lose—six months to a year
- Phase II: Fear-based trading—two to six months
- Phase III: Search for the Holy Grail—six months to death
- Phase IV: Learning how not to lose

I've found that most traders go through these phases in one fashion or another. Unfortunately, by the time they get through Phase III, they are typically out of money and can't even move on to—or grasp—learning how not to lose.

Phase V, of course, represents the time when a trader has become consistently profitable. This doesn't mean on every trade—it means creating an equity curve that has an overall upward slope. It means having the ability to be strict enough in your discipline to be able to make a consistent income from the markets. This means trusting yourself that you won't break down and screw it up yet again. Remember, the moment a trader wavers from his or her plan, the market is ready to attack. The market is waiting ever so patiently, ready to suckle those emotions, ready to lure traders back into their old habits . . . just one more time! And the trade might even work. If it does, it doesn't matter. That's not the point. If you break your rules once and win, you'll break them again. At some point, this will come back to haunt both you and your trading account. This discipline and patience has to be utilized on every trade, period. Are you starting to see that this is 90 percent of the battle here?

## **Phase I Trading: Destined to Lose—What Are the Traits That Make People a Success in Life but Routinely Get Them Killed in the Markets?**

*He that lives on hope will die fasting.*

It has been said that “the road to hell is paved with good intentions,” and nowhere is this more apparent than in the world of trading. (It also becomes very apparent when you start hiring relatives to help you with your business, but that story is for another book.) I have yet to meet one individual who went into trading with the goal of losing money. Everybody’s intentions are quite the opposite. The first thing that people do when they enter the world of trading is to tap into what has worked for them successfully in the past. While good judgment is critical for an individual who wants to climb the corporate ladder or start a business, we have already seen why “good judgment” didn’t work in the middle of the TASR trade. This leads us to the most painful lesson ever inflicted on the optimistic nature of the human species:

The tactics that individuals use to achieve their dreams and goals in everyday life do not work in trading; in fact, they are one of the main reasons for traders’ failures.

The determination, courage, positive thinking, and resoluteness that have made people successful in one area of their life simply set them up for slaughter in the markets. It is these types of traders who obstinately hold on to a losing position, adding to it on the way down, and using positive-thinking techniques to visualize this fiasco eventually turning into a winning trade. I don’t care how many Tony Robbins tapes the employees of Enron listened to; it wasn’t going to get their stock back up to \$90 a share. The trader who is unaware of this phenomenon is set up for failure from the very beginning.

This doesn’t mean that a person shouldn’t be positive about his or her ability to eventually become a successful trader. Far from it. However, traders will be much better off assuming every trade they take will fail. This way, they’ll learn to focus on protecting their downside and minimizing their risk. The upside can take care of itself, thank you very much. It’s the downside that can easily get out of hand. Be positive on life, positive that you can develop your trading skills, but pessimistic on your next trade.

Traders who “play the markets” with a mental framework oriented toward how external society rewards and punishes “good” and “bad” behavior are set up to lose from day one. For example, “cutting one’s losses short” is difficult when there’s the possibility of the market coming back to the break-even point. At the break-even point, the trader is not a “loser.” Thus, according to the benchmarks of society, if traders can exit a position with a gain, they’re “successful.” This leads to the removal of stops “once in a while” in the hopes of getting out at the break-even point in order to be a winner in the eyes of society. This can work 10 times in a row, even 100 times in a row, but it is the one time when it doesn’t work that knocks traders flat on their back. On this day, these traders will be among the many who cause a “rip-like movement” in the markets, as they pound their keys in disgust to get out of a trade that is killing their account.

The habit of removing stops, even if it’s done once in a while, is reinforced by the societal belief of what defines a winner versus a loser. This habit will destroy a trader’s account faster than anything else—and the smaller the account, the more quickly it will be destroyed. By using hard stops and sticking to them, a smaller trader at least has a fighting chance of being able to do this for a living. If he or she can’t at least do that, he or she will not make it as a trader. Period.

What happens to traders in the beginning is that they naturally end up on a cycle in which they label themselves as good traders on days when they make money and as bad traders on days when they lose money.

This is an ordinary reaction instilled in them based on the principles that apply to general society. After all, straight A's mean that a student is a success, while F's mean that a student is a failure, right?

If there's anything I can emphasize in this book, it would be this: *trading has nothing to do with general society*. In fact, the markets are set up in such a way as to use what most people hold near and dear to their hearts as a means of taking advantage of them. The markets thrive on taking the rules and ideals that govern general society, wadding them up into a ball, setting them on fire, and then shoving them down a new trader's throat. Any trader who is unaware of this phenomenon is being played like a fish right from the opening bell.

General society tells us that losing money equates with failure and making money equates with success. After a losing day, the trader unconsciously thinks: "I've lost money. I can't do this. If I had just removed my stop, the market would have come back and got me out at breakeven, and then I'd still be a contender." What happens next is that the trader starts looking for opportunities to remove his or her stops in order to not end up with a losing trade. Not on every trade, of course. Just on some trades. And how do traders determine when to do this? It's easy enough; they just use their "judgment" while they're in a trade. And this is exactly when professional traders step in for the kill.

This society's focus on money traps traders into the very habits that cause their ruination. Removing a stop in the hopes of getting out at breakeven is one of the worst habits a trader can develop. Sure, it will work some of the time, but it has to turn into a disaster only once to wipe out half or more of an account. While the rest of the world views losing as a bad thing, in trading, small losses are the best sign of success. Nobody outside of trading will ever understand this, so don't waste a lot of time telling your in-laws how losing only \$2,000 yesterday is part of your success plan. Yes, this means you're doing your job. But as long as the sun continues to rise in the east, other people will never get it. The only people who understand traders are other traders. Personally, when I'm at a cocktail party and people ask me what I do for a living, I've found it's easier to say that I do charity work. People at least understand that and can empathize. Or, if I don't want to talk to them, I just say I'm an accountant.

The biggest issue for newer traders is to reprogram their brains into realizing that in trading, losing is winning. A professional trader's job is to take small losses. Period. Most traders don't realize that there are only a few days each month where big profits can be made. The rest of the time, traders are doing their job if they're keeping their heads above water. The idea is to keep the trading account intact for when the big moves come along. If on Monday some traders take three small losses in a row and end up down on the day, they're doing their job and have the chance to be successful professional traders, because they will have maintained the bulk of their account to use on one of the few days when the markets really move. That is what trading is about. It's about traders sticking to the parameters that they have set for themselves and sticking to the setups that they've decided to follow. It's not about gut reactions and chasing the latest sound bite mentioned on CNBC. That is the path to trading annihilation.

I remember getting a call in mid-2003 from a guy who was running a \$10 million hedge fund for his family. It was never made clear to me how he qualified for this role, although I think he mentioned something about knowing how to use the Internet. He sent me an e-mail about YHOO (Yahoo Finance), asking me for my thoughts. I looked at the chart. The stock was trending higher on nice volume, and I told him about a couple of different setups I would use to get long the stock. Apparently that wasn't the answer he was looking

for because he called me the next day and told me that I was reading the chart wrong. As I listened to him rant on about page views and price/earnings (P/E) ratios, a light went on. I interrupted him and asked, “Where did you short this stock?” After a moment of silence followed by a cough, the story emerged. He had shorted it at \$12.00 based on a newsletter recommendation. As the stock rallied, the newsletter had shorted more, and so did he. By the time I talked to him, he had shorted 400,000 shares at an average price of \$16.25, for a total outlay of \$6.5 million.

I asked if the newsletter was still short, and he said no. I checked my quote screen and saw that YHOO was trading at \$22.50 and had just cracked out new 52-week highs. He asked me if he should short some more to raise his average cost, “so it won’t have to go down as much for me to get back to breakeven.”

Here he was down \$2.5 million on the trade, his family hadn’t seen the statements, and he was trying to salvage his career as the family financial guru. There was zero rationality in his thinking. I told him he needed to get out of the trade, or at least buy call options for a hedge. I even said that YHOO was going to keep on rallying until all the people who were short cried uncle and covered. Apparently, that wasn’t the advice he was looking for either. He ended up shorting another 100,000 shares. He finally caved when YHOO hit \$30, for a loss of \$6.25 million. It’s an excruciating story, but this happens all the time with all types of different account sizes. This guy didn’t want to take a small loss because he didn’t want to look like a loser to his family. His motto became, “As long as I hold on to this position, it’s not really a loss.” This is like having blood pour out of your bowels and choosing not to go to the doctor. “As long as I don’t go to the doctor, no one will know I’m dying.” Trust me, once you’re dead, people will figure it out.

Averaging down on a losing position is like a sinking ship taking on more water. When the family fund manager kept shorting YHOO as it made new highs on increasing volume, he might as well have been driving nails into the *Mona Lisa*. Both are deliberate acts of destruction. Financial planners always talk about *dollar-cost averaging*. I call it “*dollar-loss averaging*.” Adding to a winning trade is okay, but adding to a losing trade is insane (unless scaling into a full-sized position is part of your trading plan). If you caught some of your employees stealing from you, would you give them a raise or fire them and find somebody else? This guy trading YHOO would have given them a raise, a housing allowance, and a comfortable pension.

As traders approach the end of Phase I, assuming that they still have any capital left, they have some solid experience under their belt. However, they haven’t quite figured out why they’re getting hammered by the markets. It’s not as if they’ve lost money on every trade. In fact, they’ve had some great trades. Unfortunately, they’ve also been knocked down very hard on many occasions and their account is underwater. They started off optimistically, but now they just want to be a little more careful. And the bottom line is that they don’t want to lose any more money. Welcome to Phase II.

## **Phase II Trading: Fear-Based Trading or “Why Does Everything I Touch Turn to Crap?”**

Many traders think that once they become more cautious, their trading will improve. They’re wrong. When traders decide that they don’t want to lose any more money, they unwittingly turn themselves into the “late-entry” champions of the trading world. They wait, and they wait, and they make doubly sure that a trade looks good before they take it. In this scenario, the markets start to rally. But by the time these traders are absolutely convinced that this rally is for real, they’ve jumped in near the dead highs of the move. These traders and the



rest of the traders who did this just gave the markets the fuel they needed to start moving down. Why? Because suddenly the market has a lot of stops being placed beneath it, and like wind on a forest fire, these stops will ignite a sell-off. This safe, cautious entry quickly turns into a loss.

The difference this time is that prudent traders religiously stick to their stops. The problem is that this overcautious behavior gives them terrible entries, and their odds of getting stopped out are extremely high. Yes, small losses are good, but if nearly every trade results in a small loss the account will eventually be worn down.

Phase II usually doesn't last very long. Traders in this phase generally don't lose a lot of money, but they lose enough. Once traders figure out that they can stick to their stops, but that their entries are suffering, they reach what alcoholics refer to as a "moment of clarity." If their entries are bad, then obviously their indicators are bad. So they go looking for some better ones. And thus begins the search for the Holy Grail.

### **Phase III Trading: Why Is the Search for the Holy Grail Guaranteed to Limit Your Success as a Trader and an Investor?**

The search for that fail-safe indicator that's going to work nearly every time takes traders down a path that's littered with corpses, broken dreams, and stuttering fools. Many traders stay in this search for the rest of their lives. The irony is that individuals in this phase think they're developing as traders. In reality their development as traders is dead in the water. Traders in Phase III are stuck in quicksand, entrenched in a losing game that can last for years, decades, or longer. The result are traders who spend their time repeating the same mistakes over and over or happily discovering new ones.

The cycle that takes place is one of always looking for the next best thing. It's the search for that oh-so-special indicator or system that's going to give the traders their lodestone reward. In a typical scenario, this means diving headlong into a couple of different trading programs or ideas and tweaking them endlessly until they reveal their magic. One typical scenario involves traders who develop a simple set of mechanical rules, which are kept secret, of course, that will help them attain a substantial profit each year with virtually no risk and using only a small amount of capital. They get especially excited when they see that these methods, when carefully applied to selected historical data, work amazingly well. The ones that didn't work out could easily have been "filtered out." This type of trader typically dies with a one-page summary of how well the trade works and a stack of 68 pages that explain when not to take the trade.

Other traders who are stuck in Phase III will go to seminars and learn about trends, and learn the importance of never fighting the trend. They discover the magic of moving averages and how they cross over when the trend changes. Oh, the power! When the market is trending, these methods work beautifully. Eventually, though, these traders get discouraged when they figure out that 75 percent of the time, markets are trading sideways, as professionals chop the Holy Grail seekers into mincemeat.

This may lead traders to the world of options, where they start looking at spreads to contain risk and writing premiums to generate monthly income. This works great when the markets are chopping around, but then when the markets start trending again, these positions can, and often do, get killed, if they are positioned against the trend or for a neutral market.

The list goes on and on. At various stages throughout this journey, after traders have studied a number of

systems, strategies, and indicators, one day they sit down and create what they think is the perfect chart with the perfect indicators. Then they start to use it. It may work well for the first couple of days, or even the first couple of weeks, but then the traders get burned on what they thought was a perfect setup. So, instead of using a MACD (moving average convergence divergence) with a setting of 12, 26, 9, they read somewhere that a setting of 12, 17, 10 is faster. They go in and reformat all their charts with the new setting and eagerly await the next trading day. Their setups work for a couple of days or a couple of weeks, and then a couple of trade setups don't work out. Back into cyberspace the traders go. They are determined. They are focused. They neglect their family, miss their daughter's softball game, and lose track of time. But it's all worth it, because seven days later, at 3:45 in the morning, they discover what they've been looking for. On their stochastic (simple momentum oscillator), they've been using the settings 14, 3, 3 when they should have been using 15, 3, 1! They put it on a chart and apply it to historical data. It works much better! The traders once again reformat all their charts and, once again, eagerly await the next trading day.

And when this doesn't work, they go from a 15-minute chart to a 13-minute chart. And when that doesn't work, they switch from trading the E-mini S&Ps to trading options on SPY. And when that doesn't work, they learn that selling premium is the place to be. And when that doesn't work, they become gold bugs, because, don't you know, it's the only real money? It's always, always, always the next best thing. This cycle repeats itself forever until the trader gets sick of this roller-coaster and jumps off at the next stop. Most never figure this out and remain stuck here for the rest of their trading lives. Their kids go from diapers to dormitories, and they barely notice because they're still lost, tweaking the next best thing, never realizing that they're the chump with the strategy who would be welcomed with open arms in any casino. Like Duluth, Minnesota, in February, it's a terrible place to be.

This whole situation is summed up succinctly by one of the hedge fund characters in Ben Mezrich's entertaining book *Ugly Americans: The True Story of the Ivy League Cowboys Who Raided the Asian Markets for Millions*. He says: "The whole game of arbitrage is spotting who the asshole is. If you can't spot the asshole—well, then *you're* the asshole."

## What Are the Signs That a Trader Is Stuck in Phase I, II, or III?

Here are a few additional anecdotes and situations that let traders know that they're still stuck in these beginning stages of trading.

### *Good Till Close*

A popular order type for swing traders is called a GTC order, or "good till canceled." This means just what it says: "Keep my order in place until my target is hit or until I cancel the order." My partners and I, as well as many brokers, refer to GTC orders as "good till close." This is because many traders will keep their "good till canceled" order in place right up until price action gets "close" to their order. What happens is that the stock they're in is rallying hard and approaching their GTC sell order. They start looking at the stock and think: "Wow, this stock is acting great! I don't want to get out of it because it's going to keep heading higher." So they call their broker and cancel their GTC sell order. The stock rallies, pushes up through that order level, and then eventually starts to sell off. The trader has no exit strategy, and the stock continues to fall and turns

into a losing trade. This starts off as a greed play and turns into a fear play. When this happens to traders often enough, they start to get really fearful about losing money.

### *Size Really Does Matter*

When traders get scared and start to put most of their focus on not being wrong, a variety of bad things start to happen. The most common is that the traders get into a new position, and as soon as they see a small profit, they take it. They buy the mini-sized Dow at 10,100, and it goes to 10,104. Even though there are screaming buy signals in place and there are zero sell signals, they, miracle of miracles, have a profit, and they'll be damned if they're going to let the market take it away from them. So they pocket the four Dow points, which amount to \$20 per contract, or about \$14.00 after commissions. Never mind that the Dow goes on to rally another 40 points before it gives an exit signal.

What happens is that these traders are taking a four-point profit, a three-point profit, and a six-point profit, and then the last trade of the day goes 30 points against them. The traders have three winners out of four, which makes them feel good, but they're down on the day. And this is kind of a typical thing that'll happen to traders who are in the frame of mind of not wanting to have to go through the pain of watching a profitable position go all the way back into the red.

Many Forex brokers analyze their clients' accounts to predict when they're going to blow up. This way they can hedge the traders before the losses actually start to occur, essentially trading against their clients. I'm not saying this is a good practice, but it doesn't actually cause the traders to lose money faster. It's just that the signs of a trader about to blow up are that clean and clear. The number one indicator that a trading account is going to blow up is a 20 percent drawdown followed by an increase in the frequency of trading combined with an increased use of market orders instead of limit orders. Firms that hedge see this situation develop, begin to lick their chops, and fade their customer's account, taking the opposite side of every trade.

Pro Tip: When you have a bad loss, it pays to do exactly the opposite of this. Take a break, get away from the markets, and come back in trading small, with limit orders and well-planned-out trades. Don't be the trader who comes up on the broker's radar screen as a hedging candidate.

Yes, size does matter. Bigger losses are a lot worse than smaller profits. However, a trader who takes small profits because of fear is not following a plan. A trader who is not following a plan and is reacting only to internal emotions is going to get beaten. Not maybe. Not probably. *Going to.*

### *Greed Is Bad Nourishment for the Brain*

There are limitless ways in which traders can sabotage their accounts, but this is a particularly good one. What happens is that traders get into a comfortable routine. Maybe they're averaging \$250 a day trading the mini-sized Dow on a \$50,000 account. This, for them, is a reasonable goal with the capital they're trading. One night such a trader is at dinner with his spouse, who asks how the trading is going. The trader responds that all is going great. The spouse is pleased and says something like, "Well, since your trading is going so well, I've been thinking that I'd really like to get a BMW. Can we go ahead and get one?"

The next day the trader wakes up and thinks, "Okay, if I'm going to get this BMW, I've got to step up my trading and start making \$750 a day. This way I can set aside a large down payment, and I can get the car in

the next six to eight weeks.” *The very second a trader utters those words, a trigger clicks in the remote recesses of his mind, and he has unknowingly entered a period in which he will not be able to do anything right.* Instead of sticking to his original parameters, he’s going to start reaching for more. He’s going to start seeing things that aren’t really there. What used to look like a perfectly good 20-point profit in the mini-sized Dow now looks puny—it certainly won’t have much of an impact on the BMW purchase. So the position doesn’t get sold, and the trader sits back and waits for the market to give him more money. The market inevitably turns, and the trader ends up getting stopped out for a loss. In this mind-set, what once used to look like a reasonable profit becomes too small, and this throws the entire trading plan out the window.

I remember working with one trader who was in almost exactly this situation. He was a good trader, but he had recently entered a losing streak, and he couldn’t figure out why. I asked him if he suddenly was trying to trade his way into any big, specific purchases. Yes. Aha. Something for his wife. We talked about this phenomenon for a while, including the story about the fur coat, which is described in *Reminiscences of a Stock Operator*, by Edwin Lefèvre, a book that is a must-read for all traders. My friend paused for a moment and rubbed his chin. “Well, I think I know how to fix this problem,” he said. “I’ll just tell my wife she’s not getting the new kitchen.” I never asked him how that conversation went, but the point is, don’t project future purchases on your current trading account. Let the market give you what it is going to give you. Be detached from the outcome. Once you have the money and have wired it out of your account, then and only then can you decide what to use it for.

Hoping to make a big purchase with as of yet unearned trading profits? This is the home-run mentality, and it’s a pitfall for all traders. It’s important for the trader to remember that the market is not going anywhere. Like an all-you-can-eat buffet in Las Vegas, it’s going to be there all the time. There’s no reason to try to load up your plate to the max on your first trip through the buffet line. You can grab your plate, mosey on over to the buffet, pick up a couple of pieces of shrimp, and saunter back over to your table and enjoy them. Then, when that’s done, you can go back and pick out a few slices of brie. There is no need to be a hog and load up your plate. The buffet is always going to be there. A person can sit there all day and take little nibbles from the buffet all day long. Remember, in the markets, bulls can win and bears can win, but pigs get slaughtered.

### *Speaking of Jesse Livermore*

Many traders know that *Reminiscences of a Stock Operator* by Edwin Lefèvre is a book about Jesse Livermore, the famed trader who made approximately \$100 million in 1929 dollars in the stock market crash (about a billion dollars in today’s dollars). What many people do not know is that on March 5, 1934, he filed for bankruptcy, and on November 28, 1940, he blew his brains out in the bathroom stall of a hotel. Although this may not sound like a strong endorsement for the book, it is a must-read for any serious trader. While this book talks about the trading strategies that made him his fortune, the book *Jesse Livermore, World’s Greatest Stock Trader* by Richard Smitten, also goes into detail about the years and days leading up to Livermore’s suicide.

I majored in history and I was trained to take pieces of historical data and form an opinion, based on facts, about what really happened in the past. From what I’ve read about Jesse Livermore’s life and eventual demise,

my opinion is that he suffered a bout of euphoria after the 1929 crash. This euphoria caused him to trade recklessly and with huge size, and this caused him to lose his fortune in less than five years. Although he had gone broke and made a fortune three times before, the size of this loss did permanent psychological damage, and the pressing weight of “trying to make it all back” is what eventually did him in. Let’s take a look at what euphoria can do to a trader.

### *Euphoria: Redefining Stupid*

Euphoria is the worst emotion for a trader to succumb to, even worse than greed. What happens with *euphoria* is that traders have such a great day in the markets that they proclaim themselves kings and queens of the trading world. Let’s say they normally trade 10 contracts or 1,000 shares. Well, now since they’re “kings and queens,” they’re going to start off with 50 contracts or 5,000 shares and go up from there if they feel like it. After all, they’re now “the world’s greatest traders” and can do no wrong.

This happens to traders frequently, and the resulting act of insanity is just like doubling each bet on a roulette wheel. People can sit on red and keep doubling up on each bet until they win. This works great right up until the time that they have maxed out their capital on red, and the color comes up black. Doubling and tripling up on positions just because a trader is feeling confident is yet another sucker’s game. What’s worse is that this strategy always leads to traders giving back all the fantastic gains that made them euphoric in the first place. This places added pressure on them—now they have to trade in order to get back to where they were. This, of course, causes a multitude of bad habits.

Increasing trading size just because you’re feeling awesome about your trading is like being in a marriage that’s going fantastically well. The conversations are sparkling, the mutual adulation is adoring, and life under the covers is grand. Happiness abounds in spades. How can you make this better? Double up! Have an affair. It may seem like a good idea in theory, but this is going to turn out only one way—very, very badly.

### **Paper Trading—Why Is It More Worthless Than an Iraqi Dinar?**

When I wrote the title of this section in 2005, I never imagined that there would be a growing popularity of advertisements from firms pushing paper Iraqi dinars (IQDs) as an investment. Admittedly, the advertisements sound very appealing. For just a few thousand dollars, you can buy a million dollars’ worth of Iraqi dinars, and “when the dinar goes to parity with the US dollar,” it will then be worth a million US dollars. And of course the firm that is selling these dinars is also the only place where a market is being made. Never mind that this exchange rate is a hoax and that the black market for dollars in Iraq is many multiples of what is being shown in the advertisements (that is, the Iraqi dinar is even more worthless than advertised because people prefer having US dollars). Hopefully I’m not the first person to give the heads-up that this is one of those scenarios where “if it sounds too good to be true, then pull your head out of the sand, because it is too good to be true.” Yes, at some point the Iraqi dinar may be pegged to the US dollar, but that is not even in the ballpark of going “to parity” with the US dollar. And if it does go to parity with the US dollar, guess how that will happen? It will be revalued. Iraqi dinars can be printed at will. That does not constitute rarity and value. The few thousand dollars you’re tempted to throw at this in the hopes of turning it into millions would be better served by putting them toward a vacation or something tangible like silver. Even if you want to sell

Iraqi dinar, who is going to buy it? There is no market for it. Ah, but there is! Go on eBay and sell it to someone who thinks it's going to parity with the US dollar. But hurry before the jig is up. If you have any doubts, then think of it this way—if this were a legitimate opportunity, then George Soros would already have cornered this market. He knows a little more about currencies than you and I do.

This reminds me of the “ostrich scam” that hit Texas a decade or so ago. Breeder ostriches were going for \$50,000 each because of the high nutritional value of the meat. Unfortunately, no one bought the meat, so the breeders just kept selling their stock to other people who wanted to breed ostriches, and so on, until everyone who wanted to breed ostriches had them. After that, you literally couldn't give the large birds away, and to this day there are some ostriches roaming free on the Texas plains. Which brings us back to paper trading.

There are a few good reasons for people to paper trade. Paper trading can help traders learn a new execution platform. They can figure out how to use the software through a demonstration account and save themselves the costly errors that can arise when people try to place orders on an unfamiliar system. Also, paper trading is good for forward-testing a system or strategy to see how it works before committing real money, or to understand how complicated option strategies play out with the ups and downs of the market.

However, paper trading does have one distinct disadvantage. Paper trading can be worthless because it does not consider how traders will act when there is real money on the line. That is what makes or breaks traders. It's okay to paper trade smaller amounts, but without real money on the line, traders won't understand how they hold up under pressure. This is also a good way for traders to test how far apart they are mentally from “paper trading versus real trading.” Traders should feel the same, or at least as close as possible, when trading paper as they do when they're trading with real money. To the extent that they feel extreme emotions when they're trading with money rather than paper trading, it will give them a clue as to where they're on the psychological trading scale. In other words, how screwed up are they psychologically when they're trading with real money? When traders freak out on a real trade, it's a red flag that they're trading too big for their account size. Their judgment goes to zero, and financial ruin is just around the corner. In this case, traders should keep trading smaller sizes until they feel the same emotionally as when they are in a paper trade.

Building up trading size is very similar to building up muscle with weights. The first time a person goes into the gym, he may only be able to bench-press 135 pounds for 10 repetitions. A month later, he is able to knock out 160 pounds for 10 reps, as the muscles build up and adapt to the heavier workload. This continues over the course of a year, at the end of which he is cranking out 225 pounds for 10 reps. Yet had he tried benching 225 pounds at the outset, he could literally have killed himself.

It's the same in money trading. The first time I lost \$1,000, I threw up. The next time, I merely choked on my own bile. By the tenth time, it became something that my intestines could handle. At that point, I realized it was time to up my trade size to where I could risk \$1,500 on a trade without getting “too intense” emotionally. As the years went by, I was able to increase that to larger and larger amounts as mentally and emotionally I got used to the dollar swings on my scoreboard. And it has to be treated as such—a scoreboard. The moment you start thinking in terms of purchasing power, of something that you could buy with your winnings or could have bought with the current losing trade, all is lost. Emotions at that point rule the day, and that strategy only works to the trader's detriment. One thing I've studied over the years, and we've come out with irrefutable proof—staring harder at the screen does not make the market do what you want it to do.

If you find yourself staring intently at the screen, it's a heads-up that you're trading too big for your account size.

The most dramatic instance I've seen of this is in working with traders in Asia, specifically in Taipei, Hong Kong, Tokyo, and Shanghai. Asians are fantastic gamblers, willing to risk huge sums. This can be a problem with trading, and it takes only one bad trade to ruin an account. One guy I worked with was trading 100 lots at a time in a \$100,000 account (obviously using the maximum day-trading margin). Each 1-point move in the S&Ps represented \$5,000. The first day he made 5 points (\$25,000), and the next day he lost 7 points (\$35,000). These were normal fluctuations for him, and it showed. He'd get so excited and animated that I thought he was going to implode. I had him cut his size down to 10 lots. At first he was bored, but then a strange thing happened. He wasn't excited, so he traded objectively . . . and he made money. We got him to trade in the same mental state he was in when he was paper trading, and he gradually built up from there, like lifting weights in the gym. It made all the difference.

Being able to work with traders overseas is a great win/win for me, as I get to learn how other people view the U.S. markets, as well as see how U.S. news is filtered through their local news channels. Being able to put yourself in another person's shoes brings more understanding of how the world really works. That may not help you decide whether or not to take the next trading setup that comes your way, but it does help you form a macro view of the world—and it does make life more interesting.

### **But What About Phase IV—How Does a Person Learn How Not to Lose Money?**

This is the trickiest part for traders to get their arms around. Learning how not to lose? In trading, first you lose, then you learn how not to lose, and then, and only then, can you get on the road to generating a consistent income. "Learning how not to lose" is a simple way of summing up everything we've talked about up to this point. It's about having the patience to wait, the courage to get out, and the integrity to follow your plan—all of that leads to learning how not to lose. It's about focusing on limiting risk, not having to be right, and limiting the downside so that the upside can take care of itself. And once this starts to sink in and you get comfortable with "learning how not to lose," then and only then can you make the transition to generating a consistent income from trading. Ironically, though we all think we're different and unique human beings, people who lose consistently in the markets over time all do the same things. These traders:

1. Overtrade, or trade way too frequently.
2. Use too tight stops (their fear of loss is so strong that they don't even give the trade a chance to work out).
3. Trade with too much leverage; they would be far better off trading smaller size.
4. Have one big loss that wipes out a big chunk of their account.

Losing traders consistently do at least one—if not all—of these four things. I've looked at hundreds of brokerage accounts, and they all tell the same story. In fact, I know traders who fixed their trading simply by doing the opposite of this.

These traders:

1. Under-trade, or trade one or two solid setups each day or each week.
2. Use too wide stops, staying outside of the market noise.
3. Trade with appropriate leverage, which is why they're able to use wider stops.
4. Never have a big losing trade; it really can be that simple.

### **Why Does the Plateau Money Management Method Work?**

Up to this point, I haven't talked about a specific money management method, but there is one method I'd like to talk about now. It's something I've been surprised to find that not many traders think much about. The usual mind-set is, "Get some setups, follow them, and make some money." Yet once a trader has his or her psychology in check, the next issue that needs to be resolved is money management. There are innumerable methodologies and schools of thought where money management is concerned. And plenty of them work, at least up to a point.

What many money management systems fail to acknowledge is that as traders inch up the ladder of profitability, they frequently hit mental plateaus. Maybe a trader can start with a \$25,000 account and run it up to \$40,000, but then, instead of climbing still further and taking the account to the next level, the trader plateaus and things begin to fall apart. This \$40,000 plateau becomes *an invisible barrier* that holds the trader down and prevents him or her from moving to the next level.

Plateaus can easily turn into very real stumbling blocks. Plateaus can trigger bad habits, usually based on the idea that the trader now has a "comfortable cushion of cash" to work with in his or her account. This makes the trader lax and more prone to break his or her rules. This amount will be different for everyone. Maybe you have a \$5,000 account and you do a great job running it up to \$7,500, but when you reach that, you hit a big losing streak. Or maybe you have \$75,000, and every time you hit \$100,000, you start trading with "house money" and getting more aggressive, and soon you find yourself back at \$75,000.

I've struggled with this problem myself over the course of my trading life, although my plateaus have grown over time. It's almost like lifting weights. You must reach new levels all the time, not just in terms of your trading skills, but in terms of figuring out how to wrap your mind around specific amounts of money. You need to get comfortable with progressively larger and larger sums of money.

I have solved this problem by employing a strategy that I call the "plateau money management method" of managing my day-trading and swing-trading accounts. Specifically, this is for trading shorter-term, highly leveraged accounts such as futures, Forex, and options. I don't use this methodology for longer-term investments.

Let's use a \$10,000 hypothetical starting account. Your initial goal is to run the account up to 2.5 times your starting capital, which is \$25,000. (This is an example; your amount to reach may be different.) Under this methodology, when you reach your desired target (\$25,000, in this case), you withdraw your original \$10,000, plus a profit of \$2,500, leaving you with a balance of \$12,500 in your trading account.

Now you tweak your goal. Instead of \$25,000, your aim is to run your account up to 2.5 times your new starting capital, which equals \$31,250 ( $\$12,500 \times 2.5$ ).

Once you reach your target of \$31,250, withdraw half of the account (\$15,625) and reset your goal.



Now your goal is to take the \$15,625 and increase it 2.5 times yet again, making your goal \$39,062.50. When you reach that target, take out half, and continue.

The time it takes to do this isn't critical. You aren't focused on achieving your target in a week, a month, or a quarter. You're simply following your plan and taking your setups, and when you hit the plateau, you'll take money out and establish a new goal. Sometimes it will happen quickly. Other times it may take longer than you thought it would. When you're trading leveraged instruments, one solid runner can make a big impact on your account. This is why it is so critical to keep your losses small.

Here's the key: you aren't trading your whole stake. If you have \$50,000 with which to trade, then use only \$10,000 as your stake to get started. This allows you the freedom to take bigger risks, because it's only \$10,000 of your \$50,000. And if your \$10,000 gets wiped out, then you have another \$10,000 to put in and try again until you've got the hang of it.

Naturally, not everyone is going to have \$50,000 in starting capital. If \$5,000 or \$10,000 is all you can manage, that's fine. Just be careful not to piss away your capital on undeserved risks, trades that are typically taken out of boredom. Wait for the "Porsche setups" and pass on the "Pinto setups," which I talk about later, and establish a trading plan that insists on only the highest-probability trades. And now you know you'll keep your word and follow your plan, because you're committed to trading with integrity, remember?

The "plateau money management method" works because it assumes that you have passed the first few phases of the trading journey and are now content to simply wait for the best setups that work with your plan. As with any trade, you'll want to consider the market within more than a one-time frame, always "zooming out" to see the bigger picture, which helps you maximize runners (more on this later).

Remember that there will be days when nothing is setting up for you. When those days come and go, review your charts at the end of the session and take a good, hard look at all the crappy trades that some poor bastards stuck in Phase II took. Then pat yourself on the back as you think about all the money they lost that you held on to (because you've learned how not to lose). Some of the best trades are the ones *not* taken. People who overtrade or trade without money management plans are trading an incomplete system. They fall into that category we're all so eager to avoid—the 90 percent of traders who are going to lose their accounts to those of us who have trading plans in place that include quantifiable and specific money management plans.

Trading with small sums—ideally just a part of your trading capital, not all of it—on a limited number of reliable, proven setups opens up the opportunity for extraordinary results. When you use the "plateau money management method" to manage your gains, you have the added benefit of holding on to the capital you worked so hard to acquire. When you have a working methodology to focus on, you're not just looking for the next winning trade. Though individual trades are obviously critical, when viewed through the lens of your grander plans, each trade becomes just a brick in the wall of wealth you're building. Yes, some of those bricks will fall off the wall, but you're building tools to replace those bricks and continue building.

### **When Trading and Investing, What Are the Best Ideas to Keep in Mind?**

A trader's relationship with the market is really like a dance, and it's best to let the market lead. It's important not to come into the market with an overly bullish or overly bearish outlook. The more strongly a trader believes in an idea, the easier it will be for him or her to get suckered into taking the wrong side of a trade. In

an upcoming chapter, I talk about how to read market internals, and this is a great way to get a reading on what's happening in the markets. Instead of coming into the day as a raging bull or as a roaring bear, I just come in as an interested observer. The “radar screen” that I watch keeps me in the loop and gives me odds on the path of least resistance. As long as we're dancing together, I'd like to know when my partner is going to try to dip me.

The reality is that the markets do move in cycles. My studies in history had a huge impact here. I could clearly see that since the beginning of modern civilization, the world had gone through a number of repetitions of similar events, all driven by human decisions. This insight really changed my focus and how I looked for opportunities in the markets. I stopped looking for the next great indicator and started looking for repeatable market patterns based on human nature.

A great book that falls within this theme is *The Secret Life of Real Estate and Banking* by Phillip J. Anderson. The dry title does not do this book justice. It's a great and fascinating read, and the author is incredibly passionate about his subject matter. With great stories and examples, he documents how a real estate price cycle that has repeated every 18 years since the United States was formed peaked right on schedule in 2008, with the next one looming in 2026. More fascinating is how the actions of speculators, bankers, and politicians—all of whom are reacting to the price movement of real estate—were all nearly exactly the same during each one of these 22 cycles. In other words, none of the stuff you're seeing on TV today is new, not even President Trump. Politicians, banks, and speculators have been reliving their lives and policies right on cue in predictable, 18-year cycles. This knowledge is priceless when it comes to financial planning and real-estate investing—not to mention keeping the latest headlines in perspective.

There's a little saying that I always like to remember; it's called “discipline before vision,” which is something I first heard from Peter Borish, the former head of research for Paul Tudor Jones. I may think that the market is going to crash today, but I'm still going to have a stop in place in case I'm wrong. The vision of being short during a crash is a pleasant one, and the thought of a big move leads traders to do stupid things, like doubling up and adding to losing positions. Disciplined traders live to fight another day. Through most of 2004 and 2005, I heard many traders who were “staying positioned for the next, inevitable terrorist attack.” After the events of September 11, 2001, they saw how that had affected the markets, and they wanted to get positioned for the next attack. (Yes, this is a terrible way to look at a disaster, but this is how traders think. If there's a hurricane in Florida, then it's time to go long lumber because they'll have to rebuild a lot of houses.) The funny thing is that this vision of being positioned for a crash totally clouded their judgment.

The only thing the market hates is uncertainty. The events of September 11, 2001, were unexpected, and the market got crushed. However, terrorist activity is now a certainty. It is no longer an unexpected event, and therefore the market has already priced in future terrorist attacks. Sound insane? On July 7, 2005, America woke up to the news of the London bombings. At one point, the Dow was down more than 200 points before the market open. All of these people got heavily short. The markets rallied and closed positive on the day, and those “waiting- for-the-next-disaster traders” got crushed. Rely on discipline before vision.

This also ties in with one of the main themes of this chapter: Do you want to be right, or Do you want to make money? Just think if you'd kept buying the dip on the day of the flash crash. You would've been wiped out. It's okay to miss “out-of-the-blue” moves like that. Just be disciplined and don't get hurt by them by

trading appropriate size with appropriate risk parameters in place.

Another reason to rely on discipline before vision is that a stock or a market can move for *any* reason. It doesn't have to be logical or rational. It could be world events: war in the Middle East, a fragile European economy, or politicians who refuse to work together. But it could be something completely different—something that Maria Bartiromo can't tell you, can't predict, and can't figure out.

For example, one day when I logged in to my trading account to set up some buy orders, I was told that my buying power had been exhausted. I keep solid mental track of my stock and option positions, and I knew that I should have plenty of buying power. I checked my records, knowing that I'd be flat. But what I saw on my computer was that I'd depleted my buying power on 60,000 shares of IAG, a gold stock from IAMGOLD Corporation in Canada. I called to confirm that and was told that, yes, I'd made that trade. But I knew I hadn't.

Then I got an instant message from a new employee named Henry Gambell. Henry, who'd recently set up a demo trading account, told me that his "demo" account had come up nicely on 60,000 shares of IAG he'd purchased.

*Really?* I started looking at all gold stocks. Everyone was down except for IAG, which was up by 50 cents.

I looked at the markets, and I couldn't figure out why IAG was up. Was there news? No. So I went back to a one-minute chart and found a huge volume spike—right at the open—in IAG. Henry, having thought that he'd logged in to my demo account but in fact had actually logged in to my real account, had purchased 60,000 shares of IAG at the open, at the market price. To this day, I'm convinced that other black box systems saw this "volume spike" and started buying the stock based on "unusual activity." Singlehandedly and inadvertently, Henry, a demo-account trader for all of two weeks, had driven up the price of IAG, while all other gold stocks were going down. I brought Henry into my office and explained what had happened. He turned white as a sheet and got very nervous, very quickly. I told him he needed to manage the trade now and get out of the position. He started to sell all 60,000 shares at market, but I stopped him. I explained the need to scale out of the trade 1,000 shares at a time, waiting a few minutes in between sell orders. He did that for the next hour and eventually closed out the entire position for a nice profit. It covered his salary for a year.

It was a good lesson for me—watch those demonstration account logins. It was a good lesson for Henry as well—market movements are not rational, so control your risk on each and every trade. Keep this story in mind the next time you see a stock move that doesn't make any sense. In trading, there are mistakes like this being made every day.

Toward the end of the day, Henry did ask, "So do I get to keep any of the profits?" My response? "If it had lost that much money, would you have been able to help cover any of the losses?" We called it even. It's been fun watching Henry grow as a trader over the years, and that was a great lesson to learn early on.

Since market moves can be irrational, one needs to focus on limiting one's risk on every trade, not obsessing over why the stock price is going up or down. It is also important to remember that there's no need to spend wasted years looking for complicated setups or the next Holy Grail. There are very simple setups out there to use. Some of the best traders I know have been trading the same setup, on the same time frame, on the same market for 20 years. They don't care about anything else, and they don't want to learn about anything else. This works for them, and they are the masters of this setup. They have nothing else coming in

to interfere with their focus. If a setup doesn't happen that day, then they don't take a trade.

Other successful traders I know have learned to discipline themselves whenever they break their stop-loss rules. One trader I know would jump into his Chicago outside swimming pool . . . in January. It took two times, but he hasn't broken his stop-loss rule since. Another trader writes a check to a charity he doesn't support, in this case the ACLU. (That's going to be different for everyone.)

When Jesse Livermore was in the process of making his fortune, one of his favorite quotes was, "If I bought a stock and it went against me, I would sell it immediately. You can't stop and try to figure out why a stock is going in the wrong direction. The fact is that it *is* going in the wrong direction, and that is enough evidence for an experienced speculator to close the trade." Small losses make all the difference, and traders must learn to reward themselves for doing their job in this regard.

It is important to remember that traders are not trading stocks, or futures, or options. Traders are trading other traders. There is another person or system out there that is taking the opposite side of the trade. One side is going to be right, and the other side is going to be wrong. Whoever has the better psychological perspective and money management system in place on the trade is going to win. Is the trader on the other side of the trade an amateur or a professional? That trader should be wondering the same thing about you. The next time you succumb to greed and chase a trade, remember that there is a professional somewhere else in the world who has been waiting patiently for this setup and is doing just the opposite.

I have found that the most important step in becoming a successful trader is just learning how to accept a loss without any anger or frustration or shame. It's just part of trading. It's not a big deal. I take losses every day, and I do it live in front of people all the time. It's just part of the process. Okay, this trade just hit its stop. Next. It's like Tom Hanks's character in the movie *A League of Their Own*, who screams at his female player and makes her cry. "Are you crying?" he asks, shocked. "There's no crying in baseball!"

There's also no crying in trading, no throwing your coffee cup against the wall, and no screaming at your monitor. Losses and missed trades are just part of the deal. On some days, things are just not going to come together. If I'm using a setup and I'm stopped out two times in a row, then I just stop using that setup for the rest of the day. For whatever reason, it is out of sync with the markets on that particular day. It's no big deal. There is no need to reformat the MACD. It's just part of trading.

The key is to have two specific sets of rules:

1. *There needs to be a trading methodology.* For this setup, do the traders go all in or scale in? Do they scale out or get all out at a specific target? Do they trail a stop or leave it? Where is the stop placement in relation to the target? These are all things that must be set in stone before the trade is placed. Once the trade is placed, there's no room for rational thought. The setup must be followed the same way every time, or the traders will never be able to gauge whether the setup is going to help them or hurt them in their trading. Without that information, they're just making impulse trades, and those are the sucker trades.
2. *There needs to be a money management rule.* How many shares or contracts does a trader allocate toward this setup? How much equity is a trader willing to risk on this setup over the course of a day, a week, a month, or a year? After traders do this for a while, what happens is that they develop the habit of

following their rules and they eventually learn to trust themselves. Once traders learn to trust themselves, they can then free their minds to focus on the market opportunities that present themselves, instead of being wrapped up tight in a ball of fear, frustration, and doubt.

This is where traders make the transition out of the first three phases and begin to really have an opportunity to do this for a living. The transition involves focusing on developing their own trading skills instead of focusing on the money. And the skills are easy—keep your emotions in check and have the discipline to follow the setups. Don't focus on making \$1,000. That is what the amateurs do. Focus on developing your skills and executing the setups the same way every time. It sounds simple enough, but I've worked with enough traders to know that most of them can't do it over the long haul. They get impatient and don't want to miss out on the action, so they jump in and chase without a clear setup. Once they do this, they go back into the barrel with all the amateurs.

Most of trading involves waiting. First, it involves waiting for a setup. Once the setup occurs, then the professional trader takes it without hesitation. The skill comes in waiting for it to set up and not succumbing to an impulse trade. Then, once he or she is in a setup, a trader needs to have the discipline to wait for the exit parameters to be hit, and not cave and bail out too early. Waiting is the hardest thing for many traders to do, but it's the waiting that separates the winners from the losers. Even for a day trade, it can be hours before a setup happens or a parameter is hit. That's the whole key: just be patient and wait. The person who chases four rabbits catches none.

Also, it's important to realize that professional traders are not in every move. It's okay to have the market leave the station without you. Catching every move is impossible, but chasing every move is the mark of an amateur. This is why it's imperative for traders to have a set of rules to follow for both entries and exits, as opposed to relying on their own gut feelings to manage a position. Develop a set of rules and have the discipline to follow them; they exist for your protection.

For me, the biggest difference in my trading occurred when I learned to ignore my brain and just focus on a handful of good setups. Once I learned the setups, the next challenge was to have the discipline to follow them the same way every time. No thinking, no hemming and hawing. I did this by recording my trading activity and grading myself on how well I executed each setup, instead of on how much money I was making or losing. Whereas focusing on the profit and loss (P&L) automatically encourages the bad habits that plague many traders, a setup-based approach encourages habits that can push a trader into the realm of consistent profitability.

My two best practical tips for turning into a profitable trader? First, try cutting your position size in half and doubling your stop. This usually fixes most problems. Next, focus on executing two well-thought-out, well-planned trades per week, instead of cranking out five trades per day. Easy peasy.

In the end, professional traders focus on limiting risk and protecting capital. Amateur traders focus on how much money they can make on each trade. Professional traders always take money away from amateurs. Amateur traders start to turn into professional traders once they stop looking for the next great technical indicator and start controlling their risk on each trade.

For additional information on trading psychology, visit [www.simplertrading.com/traderpsychology](http://www.simplertrading.com/traderpsychology) for updated articles and free videos on the business of getting into the right frame of mind for trading.

*You cannot be disciplined in great things and undisciplined in small things. Brave undisciplined men have no chance against the discipline and valor of other men. Have you ever seen a few policemen handle a crowd?*

GENERAL GEORGE S. PATTON

### *Quotes by Paul Tudor Jones*

*Every day I assume every position I have is wrong.*

*Losers average losers.*

*There is no training, classroom or otherwise, that can prepare for trading the last third of a move, whether it's the end of a bull market or the end of a bear market.*

*You adapt, evolve, compete, or die.*

*Trading is very competitive, and you have to be able to handle getting your butt kicked.*

*Failure was a key element to my life's journey.*

*Where you want to be is always in control, never wishing, always trading, and always, first and foremost protecting your butt.*

*At the end of the day, the most important thing is how good are you at risk control.*

*Don't be a hero. Don't have an ego. Always question yourself and your ability. Don't ever feel that you are very good. The second you do, you are dead.*

*Markets trend only about 15 percent of the time; the rest of the time they move sideways.*

*Always think of your entry point as last night's close.*

*The whole world is simply nothing more than a flow chart for capital.*

*I spend my day trying to make myself as happy and relaxed as I can be. If I have positions going against me, I get right out; if they are going for me, I keep them. If you have a losing position that is making you uncomfortable, the solution is very simple: Get out, because you can always get back in.*

### **Other Books I've Found Useful for Getting My Trading Mind-Set Right**

- *Letting Go: The Pathway of Surrender* by David R. Hawkins. This is one of the best books I've found to quickly recognize and remove mental obstacles that are holding you back. It's very helpful to understand his technique when you're in the middle of a trade that is freaking you out.
- *The Four Agreements: A Practical Guide to Personal Freedom* by Don Miguel Ruiz. This book is simple and eye opening on many levels, and it shows you how to create an amazing amount of personal freedom in your life as it relates to how you interact both with other people and yourself. Our self-talk as traders can destroy us if we aren't careful. This book shows you how to deal with that in a very practical and positive way and turn it around into something that can accelerate your life forward on many levels.
- *The Surrender Experiment: My Journey into Life's Perfection* by Michael A. Singer. This is a great book on going with the flow of life instead of fighting it. What I loved about this book is Michael plunged into the world of business, building up a huge company from his cabin in the woods, so there's lots of real-world practical experience and wisdom shared in this story.
- *Trading in the Zone: Master the Market with Confidence, Discipline, and a Winning Attitude* by Mark Douglas. This is a must-read for traders to understand how the human mind reacts to the markets.
- *What I Learned Losing A Million Dollars* by Brendan Moynihan. This is a surprisingly good read on

the psychological factors behind bad financial decisions and how to prevent them from happening to you.

- *Turning Pro: Tap Your Inner Power and Create Your Life's Work* by Steven Pressfield. This is a short book and a follow-up to his work, *The War of Art*, which is also excellent. This book is the best and most positive kick in the ass I've ever had.

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## Is There Rhyme or Reason to How the Markets Move?

*With enough mental gymnastics, just about any fact can become misshapen in favor to one's confirmation bias, which is the most effective way to go on living a lie.*

CRISS JAMI, HEALOLOGY

### The Markets Are Moving—Are You Fighting the Tide or Flowing with It?

We've spent two full chapters discussing the psychology of the trader—the ebbs and flows of mental turmoil and how they impact a trading account. What about the markets themselves? Is there a rhythm as to how they move? Or is it totally random? This is where we will tie in and transition from *trader psychology* into *market psychology*.

As a trader, and as a human, it's easy to be a pessimist and not trust anyone or anything. After all, who didn't love the movie *The Big Short*? But that doesn't mean the only trades worth doing are the ones betting on the end of the world. I've worked with individuals who know a lot more about the obscure corners of the markets than I do, and many end up talking themselves into betting a healthy portion of their net worth and their kid's inheritance on bunkers, bullets, gold coins, and cans of Spam, figuratively, and in some cases, literally. This fear-based outlook takes up a lot of mental capital, drowning out other points of view. Once fear of the future takes hold, it becomes the filter through which we view the world. Fear-based decisions reinforce a fear-based outlook, creating an infinite loop that can define an entire life. We also tend to be attracted to themes that fit our inner perspective of the world. This is known as *confirmation bias*. As a trader, and as a human, it is useful to be open to the idea that our conviction of what we "know" to be true can have absolutely nothing in common with actual reality.

In trading, confirmation bias can create an immense amount of frustration. It causes us to automatically filter out any information that disproves our outlook and accept only the information that validates our beliefs. This is obviously dangerous when we consider our relationships with things like politics, advertising, and consumerism. As the saying goes, "Lies are only as strong as the suckers that believe them." In trading, it makes us easy prey for the machines, which are trading without the burden of beliefs.

With the markets, whether it is an individual stock, cryptocurrency, or an entire asset class, there are thousands of data points that a trader can study, but the reality is that only a handful of them will make an impact when it comes to results. More importantly confirmation bias ensures that people's viewpoints are skewed toward projections of their own inner worlds rather than any form of reality. John Maynard Keynes



experienced this phenomenon firsthand. Although at the top of his game in economic circles, he speculated huge sums in currency trades and lost a lot of money by having the right idea at the wrong time. This led to his famous quote: “The market can stay irrational longer than you can stay solvent.” The need to be right does not sway the markets.

In reality, the market is not truly as “irrational” as Keynes would have us believe. The markets move based on thousands of different confirmation biases coming together, as well as different entry levels, account sizes, and emotions. This creates patterns and “flows” that can make trading and investing much less frustrating, when and if we get in synch with them. The markets aren’t irrational; we are. Irrationality is holding on to a trade that isn’t working. Because of our inherent fondness for confirmation bias, we are often ignorant of our motivations and create fictional narratives to explain our decisions, emotions, and history without realizing it . . . all to stay true to our perceptions about ourselves and the world.

In trading, you can discard this made-up narrative about yourself. A trade is either working or it is not working, regardless of the story you tell yourself about who you are and what you believe to be true. If it’s not working, the trade is wrong; so get out. By basing your trading behavior on what reality is, instead of your perception of what reality *should* be, no narrative confirmation is necessary. It’s a much easier way to live and a much smarter way to trade. As a discretionary trader, your main job is to override the fictional narrative of your life and not let it interfere with your next signal.

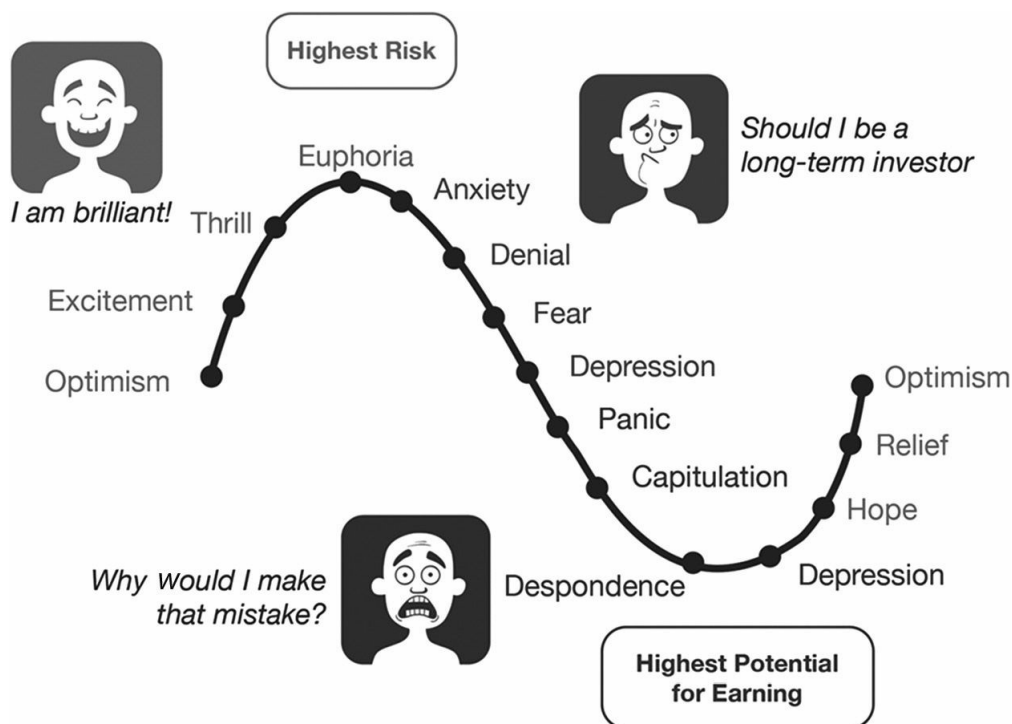
Reality and theory are often at opposition with each other. For every flash crash, there is a seven-year bull market. For every housing crisis, there is new technology that changes the way we drill for oil or introduces an unseen game changer, like the blockchain. Fiat currency is fiction and we should only own gold? Yes, I get it, but Walmart won’t exchange your gold for toilet paper. It only accepts fake money. Facebook’s earnings are up 79 percent but the stock drops the next day? In theory, it doesn’t make sense. In reality, markets are very efficient at pricing in news well before that news is known. Trying to make sense of the markets based on “what is known” versus “all the bad things that could happen” is like trying to predict how the person you are dating will turn out as a spouse based on how he or she holds a fork while eating a pork chop. With the markets, most data points, and most theories, that are available to the retail trader are just as irrelevant when it comes down to understanding what is really happening. Not only are they irrelevant to what is going on, we are also filtering them based on our own confirmation bias. In other words, the information is doubly useless. The potential for bad decisions in this situation is mind-boggling.

With the markets, we don’t know what exactly is going to happen next, but we can understand the foundation of how and why they move. Without this foundation, all trading attempts will eventually dissolve into a pool of frustration and disappointment. “What did I do wrong?” the trader thinks. “I read all the books and plotted all of the moving averages.” The trader didn’t do anything wrong. He or she just didn’t understand the basic foundations of how markets naturally ebb and flow in all market conditions. The key is to understand these movements and trade with these natural currents. We will never beat the Ray Dalios of the world in terms of market information, but we can wade into the surf, catch a wave, and hang on for the ride. And we can exploit our edge as retail traders, which is *liquidity*. We can get in and out of anything fairly quickly. Which brings me to how the markets move regardless of the news, regardless of our inner beliefs, and regardless of the latest doom-and-gloom newsletter you just read in your inbox.

## How Do the Markets Naturally Move?

Just as the moon's gravitational pull affects the ocean's tides, there is a constant pull on the markets. Human emotions and algorithmic-based buying-and-selling programs impact the rising and falling of all markets, as well as individual stocks. The more intense the human emotion, the more crowded the trade and the larger the market swings. In the markets, just like the ocean, there are periods of normal movement and there are storms. Like an ocean, a stock chart has ebbs and flows, peaks and valleys. As prices reach new highs, some people take profits, while others finally jump in, tired of missing out on the movement. The next series of movements will reflect this constantly changing dynamic. Eventually, however, all water returns to sea level. All prices revert back to the *mean*, the average price over a specific period of time. (See [Figure 3.1](#).) This is an important concept we will come back to shortly, as well as in a later chapter.

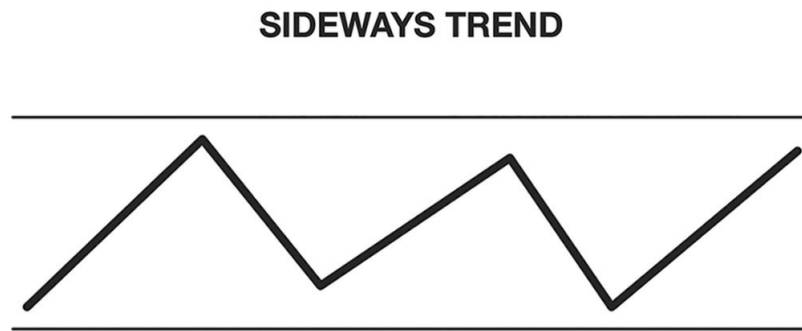
Figure 3.1



In a sideways trend, stocks rise and fall in a narrow, flat range. There are calm seas. Think of a boat rising and falling gently with the waves. This is telling the story that the market is currently fairly valued in the eyes of investors. In this type of market, inexperienced traders often buy the highs (because it feels safer) and get stopped out on normal pullbacks, only to see the markets rally yet again. In this environment, buying the highs and shorting the lows is like trying to lose weight by eating more Twinkies. It's fun but the results will be frustrating.

In sideways markets, emotion plays a big role in these seemingly small movements. There will always be a group of traders who are not in sync. They get in at the highs and out at the lows based purely on emotion, in a roller coaster that looks like [Figure 3.2](#). Oddly enough, many retail investors do well in sideways markets. They like the short-term action and they love to short rallies to resistance and buy declines into support.

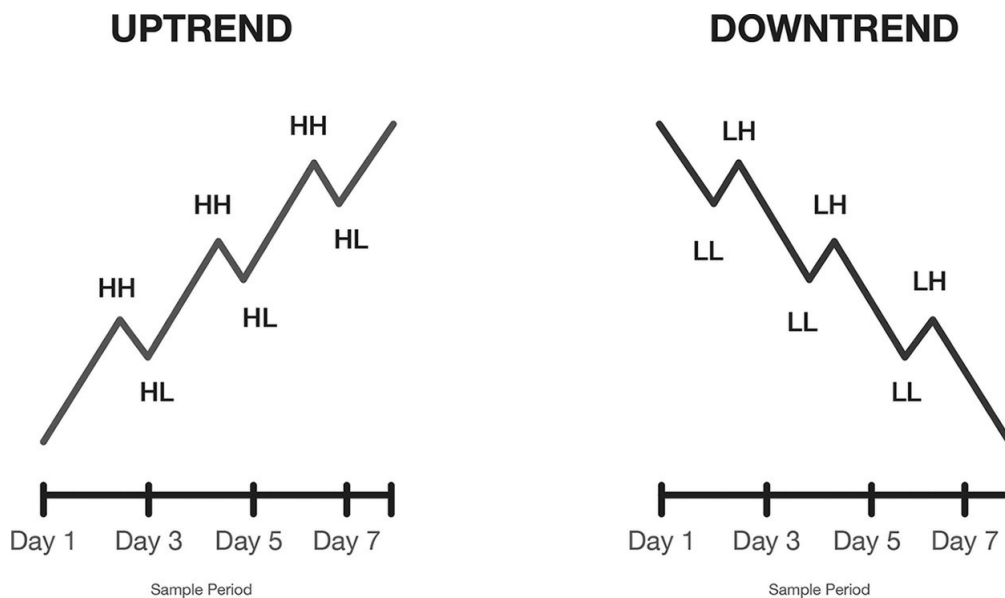
Figure 3.2



While it is easy to see these ebbs and flows in a sideways market, it is critical to understand that these same ebbs and flows also occur during strong uptrends and strong downtrends. They move exactly like sideways markets in terms of the ebbs and flows, they just do it at a different angle. Think of it as an ocean slowly rising and climbing up a hill due to global warming. The ebbs and flows are still the same, but because the volume of water is increasing, the ocean itself is moving higher at the same time. To look at it another way, if we entered another mini ice age and the polar caps started to freeze over, the ocean levels would recede, but the waves would still ebb and flow and pound against the shore as they fell back gradually over hundreds of yards and eventually miles.

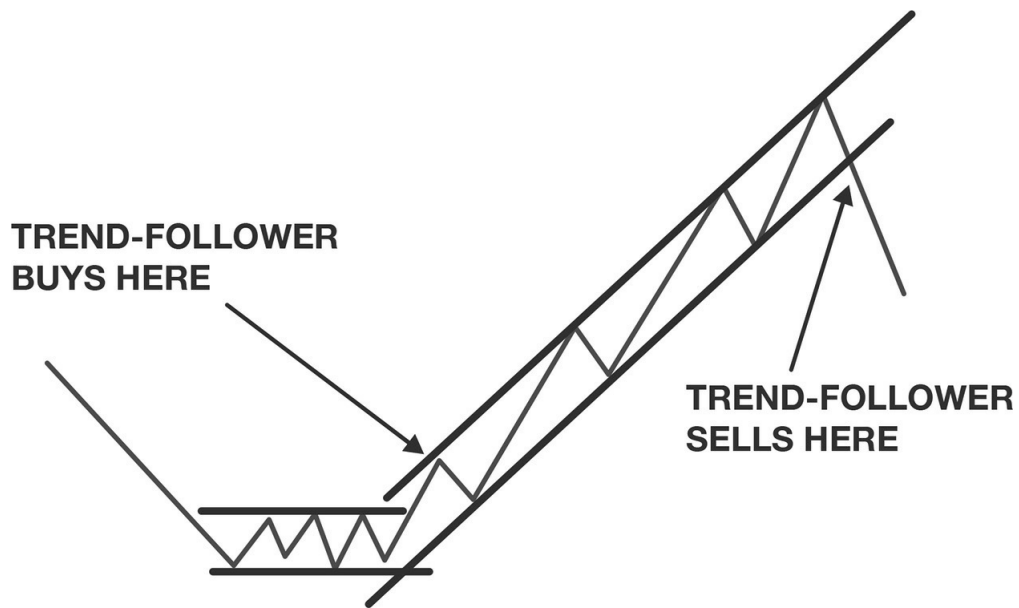
That is how uptrends and downtrends work. You get the same ebbs and flows as a sideways market, but the overall value of the stock is either surging forward (uptrend) or receding (downtrend). (See [Figure 3.3](#).)

Figure 3.3



The key is that in an uptrend, we are seeing a series of higher highs (HHs) and a series of lower lows (LLs). In a downtrend, we are seeing lower lows (LLs) and lower highs (LHs) on each consecutive ebb and flow of the current. Strict trend traders will look to buy the first higher high (HH) out of a consolidation period; they will hold on until that trend of higher highs (HHs) and lower lows (LLs) is ultimately broken. (See [Figure 3.4](#).)

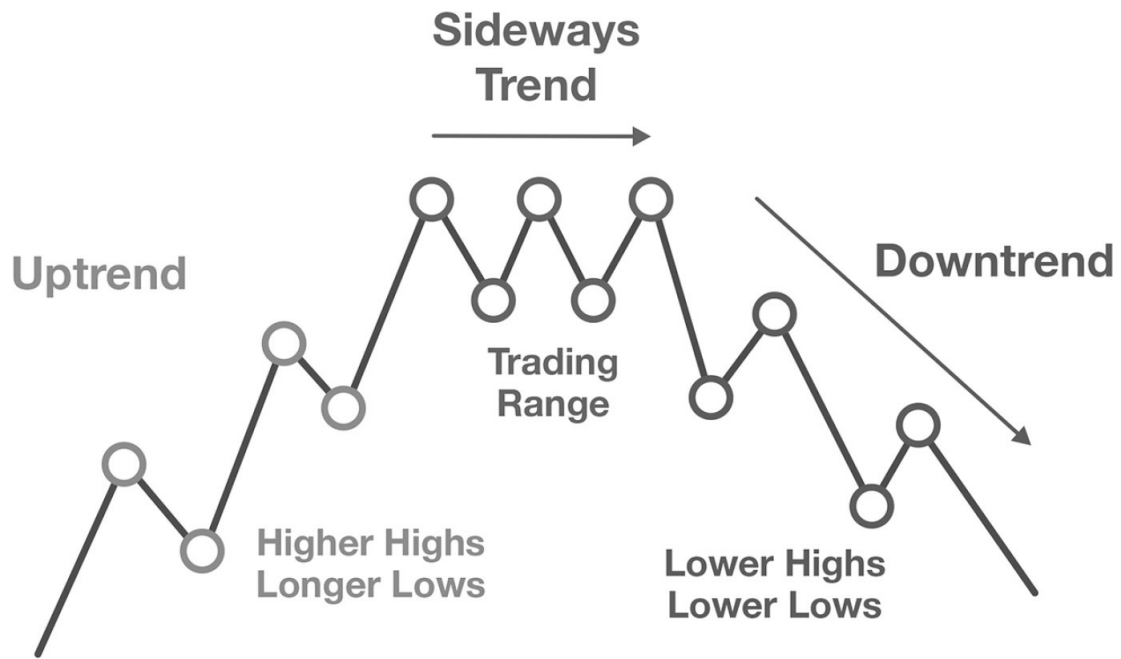
Figure 3.4



With the algorithms and their constant hunt for liquidity, typically found in the piling up of trailing stops, there are more false bull and false bear moves than there used to be. But before we can discuss that, let's understand the basic foundations.

As previously mentioned, the markets are always ebbing and flowing in one of three patterns: sideways, uptrend, or downtrend. All three patterns have different sets of emotional intensity, which is why down moves are always faster than sideways or up moves. In a down market, fear drives decisions, and fear of loss will override nearly all arguments for calm and logic. In an up market, there is fear of missing a move combined with the euphoria of making money. In a sideways market, conviction is at low levels all around and boredom is often an overriding emotion. (See [Figure 3.5](#).)

Figure 3.5



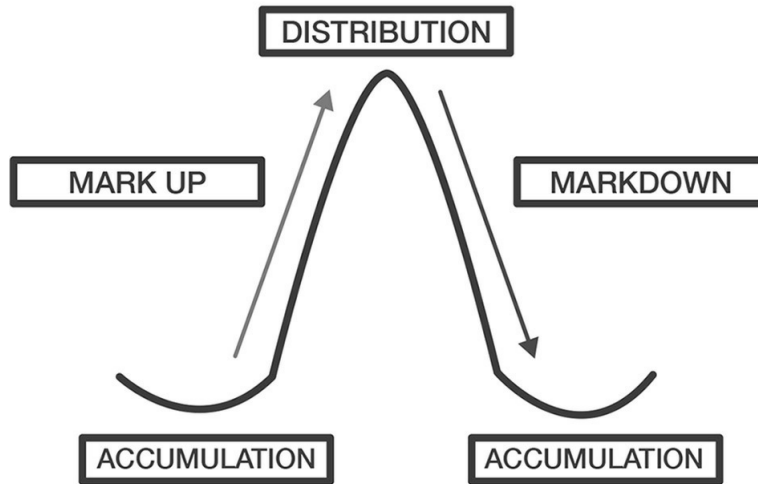
Think of this as the trading cycle, and this trading cycle is happening all the time, whether it is an uptrend, downtrend, or sideways market. The only difference in each is the level of intensity and conviction.

For uninitiated traders without a well-thought-out plan, [Figure 3.6](#) is the cycle they will naturally fall into. It might not be true for the first few trades, but the more active they are, the sooner and harder they typically fall into this unwitting rhythm. They start buying at the highs, getting stopped out and, even worse, reversing and going short at the lows. Think of these as price thrusts followed by emotional reactions. The *thrust* is the initial move after the smart money has taken its positions. The emotional market slaves come in and start buying the stop of this thrust right when the smart money is cashing out. The position starts to go against them and the *reaction phase* is essentially a map of how they handle this move against them.

Figure 3.6

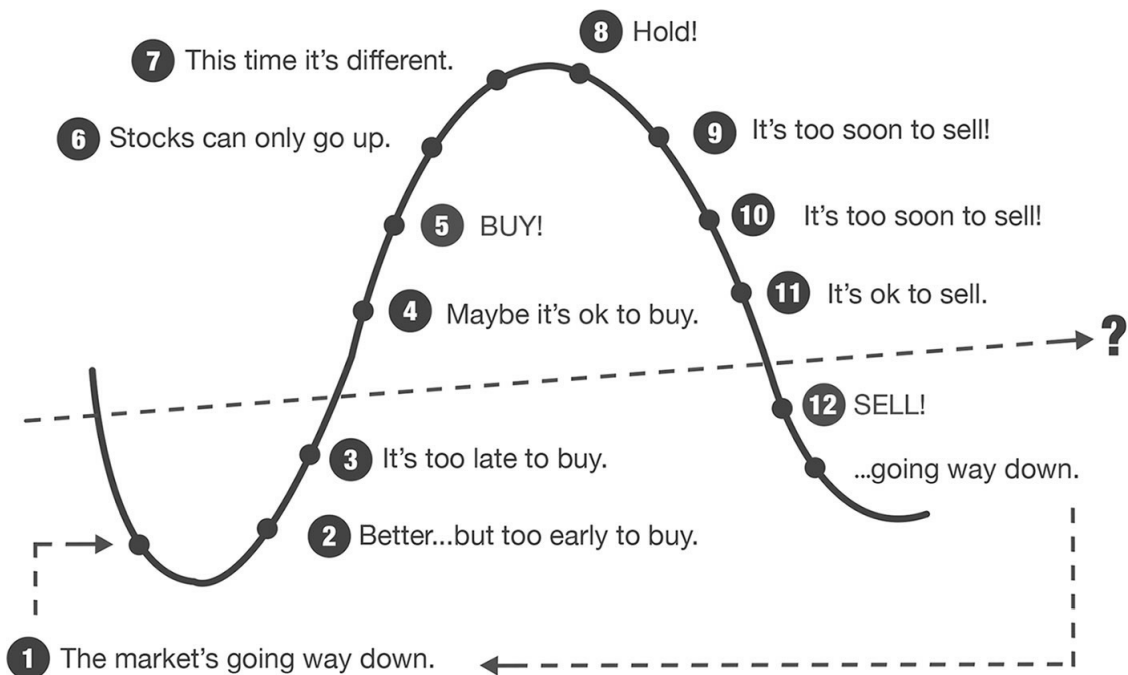
# THE TRADING CYCLE

- ✓ Strong, Smart, and Dumb Money
- ✓ The Marketing Model



If they had a good entry and have been trailing a stop, they get out fast with a profit. If they took a modest position near the highs, they get stopped out at a normal level for an acceptable (though preventable) loss. If they took the trade at the dead highs on impulse and didn't place a stop or really think it through, then they typically get out only when they can't take the pain of being wrong any longer. That typically marks the low, which is usually a great entry level if you are watching and are in sync with this natural market rhythm. These buy-and-sell points are mapped out in [Figure 3.7](#).

Figure 3.7



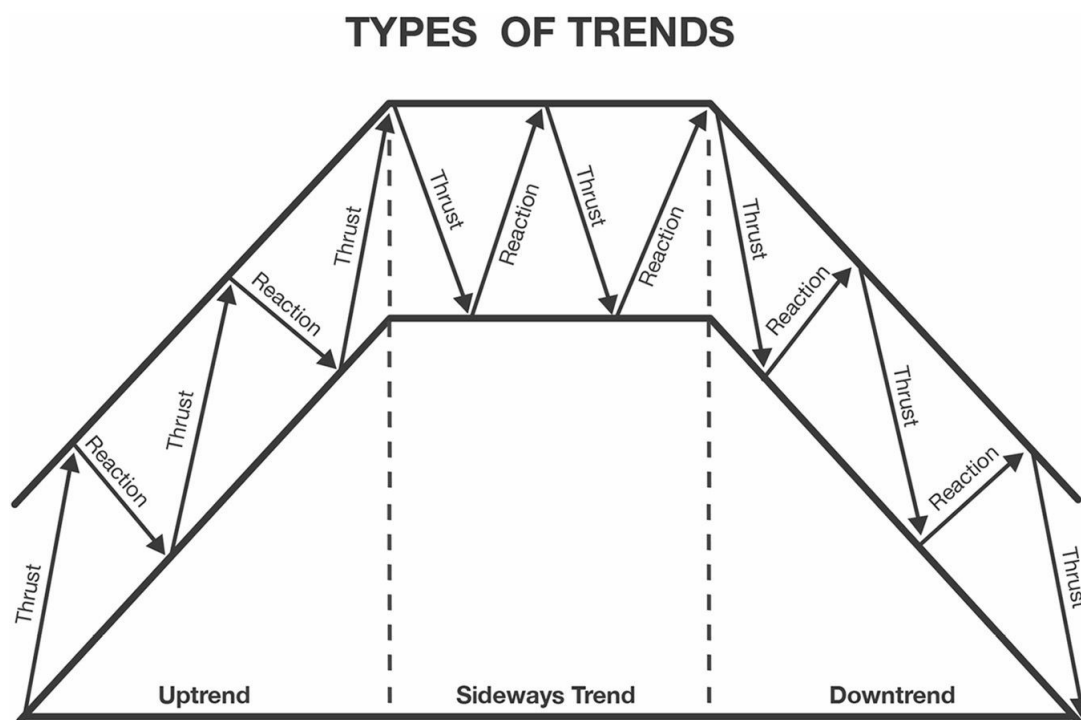
Who is taking the opposite side of this trade when these emotional whip horses are getting stopped out?

Hopefully, after reading this chapter, it's you. Let other people's stop losses be your new entry points.

These money-making thrusts and emotional reactions create support and resistance levels. Whenever I see resistance I think, "Who bought that high and why?" Whenever I see support I think, "Who got stopped out at the dead lows and why?" Every thrust and reaction could be its own movie filled with heroes and victims. Which role are you going to play?

It is important to keep in mind that this general ebb and flow applies to all timelines, whether it is a monthly chart, a daily chart, or a five-minute chart. A steep downtrend with lower lows and lower highs on a five-minute chart can be part of an ongoing sideways pattern on a daily chart. As a rule of thumb, I defer to trading the pattern on the larger time frame. That is, if the daily chart is in an uptrend, I'm not going to get too excited about a short signal on a 30-minute chart. I'd rather wait for the next signal on the 30-minute chart that is aligned with the daily chart. This way I'm swimming with both the tide and the larger currents that are driving the tide. In [Figure 3.8](#), we can see how these emotional reactions create solid moves whether the trend is up, down, or sideways.

Figure 3.8



For option traders that focus on time frames that last a few days to a few weeks for their trading positions, it is critical to understand these ebbs and flows and stay on the right side of them. While traders can get away with buying a stock at new highs and holding through the reaction, that is very difficult to do if you are buying calls (in an uptrend) or buying puts (in a downtrend). With a stock, there isn't any premium decay, so the price is the price. If I buy Facebook (FB) at \$180, and hold through a decline to \$175, and it goes back to \$180, I'm now "back to even" on my trade. Had I bought 30-day-out calls, however, the story would be much different. If I'd bought the \$175 calls at \$8 with a 30-day expiration, with the stock at \$180, and then I held through two weeks of chop and a pullback to \$175, and then FB finally makes it back to \$180 with two weeks

left on the option, they would be trading around \$6. So, even though I'm back to breakeven on the stock, I'm down 25 percent on my option position and the stock will have to get back to about \$182 before I break even on the option.

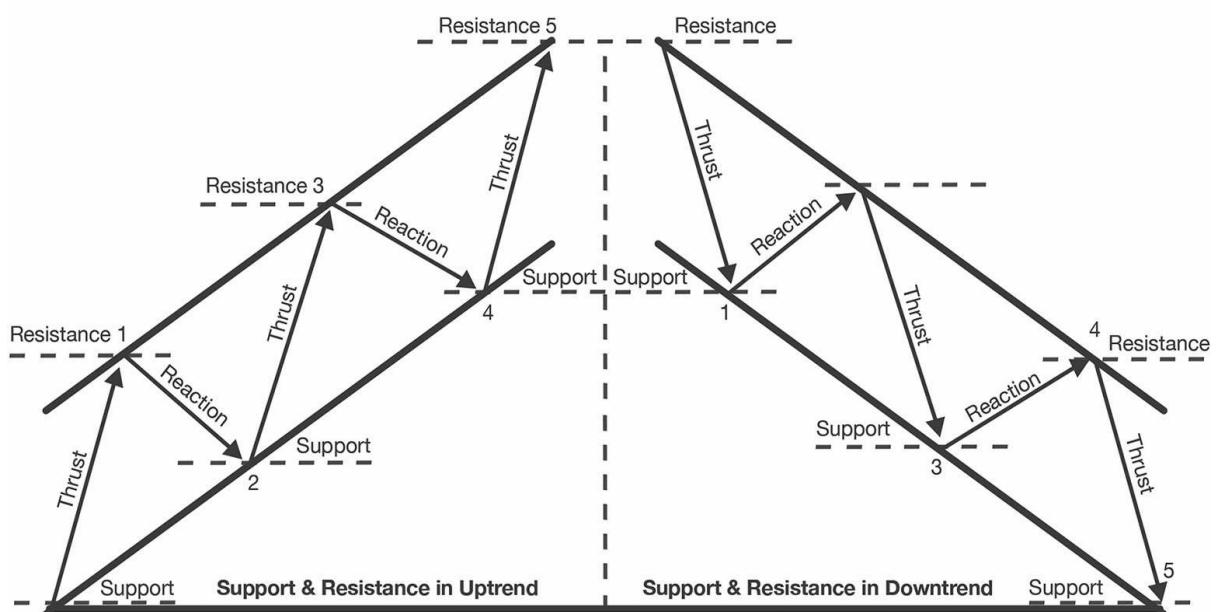
When trading directional options, it is critical to be "in flow" with these thrusts and reactions. Another tip that will save an exponential amount of frustration: even if you plan to hold the option for two days, buy one that expires in 60 or 90 days, the premium decay will be negligible, and it will be much more forgiving if you time it wrong. Of course, for more advanced option traders that understand premium selling and constructing a theta-positive position, there are tons of advantages to selling options against these natural ebbs and flows, something I'll discuss in more detail in a later chapter.

Option traders hop over to the expert side when, on a pullback within an uptrend, instead of buying call options, they are selling puts, either naked or as a spread. First, think of the other person who is taking the other side of this trade. The newbie option trader who, upon seeing the market fall, uptrend or no, jumps on the bandwagon by buying puts at the current market price. Who is taking the opposite side of this trade? You are. Not only are you selling puts on a decline into support, but, should the market stall out and "just trade sideways," you can still make money—potentially even your max target on the trade. Selling puts instead of buying calls on a pullback to support gives the trader a huge edge.

In [Figure 3.9](#), we can see how these thrusts and reactions naturally create support and resistance levels. Many times, these levels line up with Fibonacci extensions such as the 1.272 percent extension (resistance) on thrusts, with .382 percent to .618 percent levels holding as a general zone on reactions. More on these Fibonacci levels later. Just keep in mind these all naturally work together in the context of this natural ebbing and flowing of the markets—and how far they move past the prior levels on thrusts, and what levels hold on the reactions.

Figure 3.9

## SUPPORT & RESISTANCE UPTREND & DOWNTREND





As it relates to option strategies, the biggest complaint I hear in a situation like this—and it used to be my own complaint as well—is that, on a pullback to support, by selling puts instead of buying calls you are limiting gains. It's a valid point but it can be addressed by position size. If you are planning to buy 10 call options at \$6 and sell them near the expected move of the stock during the next week at \$9, that is a profit of \$3,000. But if you sold an at-the-money lot of 10 put credit spreads, \$5 wide put credit spread at \$2, and you bought it back at a reasonable 80 percent of max profit (0.40), your profit would only be \$1,600. The easy answer? Up your put credit size. If I sold 19 of the same put credit spreads, and my target was hit at 0.40, then my profit would be \$3,040, the same as my long call position, and just enough extra profit to cover the additional commission generated with the increased number of contracts.

Usually if I'm teaching a class and explaining this concept, a "Professor Hindsight" in the back of the room will raise his or her hand and proclaim, "But what if the put credit spread play loses money?" Lord almighty. As if the long call has no chance of losing money. But while we're on the subject, let's look at the risk involved.

Ten lots at \$6 gives us a maximum risk of \$6,000 if it goes to zero. "But," the 'professor' says, "I would have gotten out well before it went to zero." Yeah, sure you would have. Let's go with the maximum risk anyway, in case you get caught up in confirmation bias and the need to be right.

Nineteen lots of an at-the-money (ATM), \$5 wide put credit spread at \$2 has a maximum risk of \$3 X 19 lots, or \$5,700. In other words, the risk involved is the same, and the logical reward, based on the expected move, is also the same. The main difference? With the long call, the stock must move substantially higher, very quickly, for us to meet our profit objective. With the put credit spread, the stock could trade sideways and even slightly down, and we could still meet our same profit objective. Once a trader grasps this concept, the light bulb comes on and never turns off again. By selling premium, you can be wrong and still make money.

Except for Professor Hindsight. His light bulb is shining its own, special light that nobody else can see. Usually the next argument from this individual is, "Well, with the put credit spread I'm risking \$5,700 to make \$3,040, which is lopsided, but with my long call my reward is unlimited." It's a fair theoretical point. But while I've yet to see a long call go to "infinity," I've seen plenty stay within their expected moves and lose lots of premium. Add this to the fact that the hardest part of trading is holding onto a big winner. If this is a problem for you, and it probably is, do yourself a favor and focus on capturing the "expected move" and get out and on to the next setup. You can make a great living doing just that. Remember, with trading, we want to play the odds, not smoke the "hopium" pipe.

At the end of the day, selling puts at support instead of buying calls is always the smarter choice. The consistency you will see in your profit and loss (P&L) curve will more than make up for the rare times you miss a huge run-up (greater than expected move) by holding short puts instead of buying long calls. And, with that 19 lot put credit spread, you could still buy a couple of calls just in case it really takes off.

If you have a pullback to support an already existing uptrend, you can buy an in-the-money (ITM) call or sell an at-the-money (ATM) put (or make it a spread to reduce risk). You can, of course, also sell one standard deviation or higher puts and put credit spreads. While the probabilities here are higher, there isn't much meat on the bone. Of course, you can also do all the above. Just get some of that premium decay working in your favor.

If you have a rally into resistance within an already existing downtrend, then you can look to buy in-the-money (ITM) puts and/or sell at-the-money (ATM) call credit spreads. The principles are the same in both uptrends and downtrends.

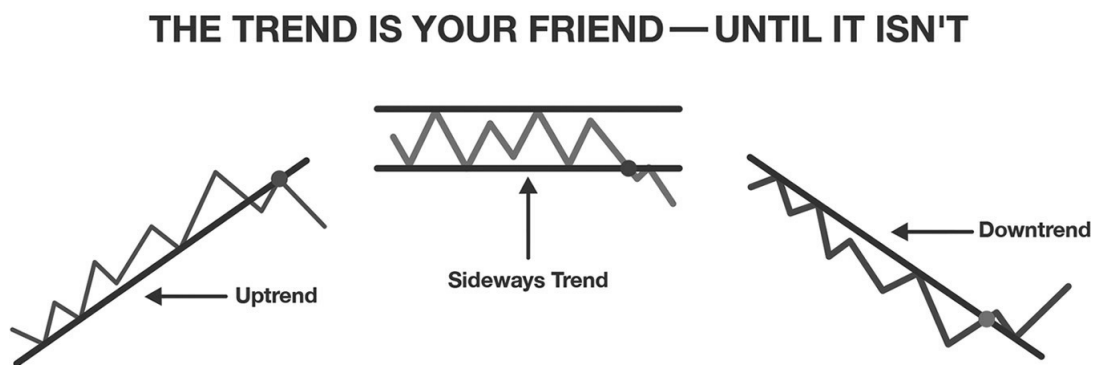
If it's a sideways market, you can sell call credit spreads on rallies to resistance and sell put credit spreads on declines to support. I often prefer to leg into iron condors like this rather than doing it all at once.

Last, but not least, if traders want to save themselves a lot of frustration, just assume the trend is going keep on going until it breaks its current trading cycle. The trend is your friend, until it isn't.

We essentially play the trend until it ends. We don't want to assume that it is about to end unless there are clear signals on the internals, such as a high SKEW reading or a low 10-day put call ratio average. There are also signs that a trend is about to end, which we want to pay attention to.

The first sign is that we go from a trending market to a sideways market. The next thrust higher fails, but it hasn't turned into a downward trend. This is where a buildup in volatility pressure can happen (as measured by a squeeze, discussed in a later chapter) and this energy can be released to the upside or the downside. In [Figure 3.10](#), there are many instances where it looked like a trend "might" fail, but in trading, the easiest path to stay on is the "path of least resistance." Just assume the trend is your friend until it betrays you. Then switch to playing the new trend.

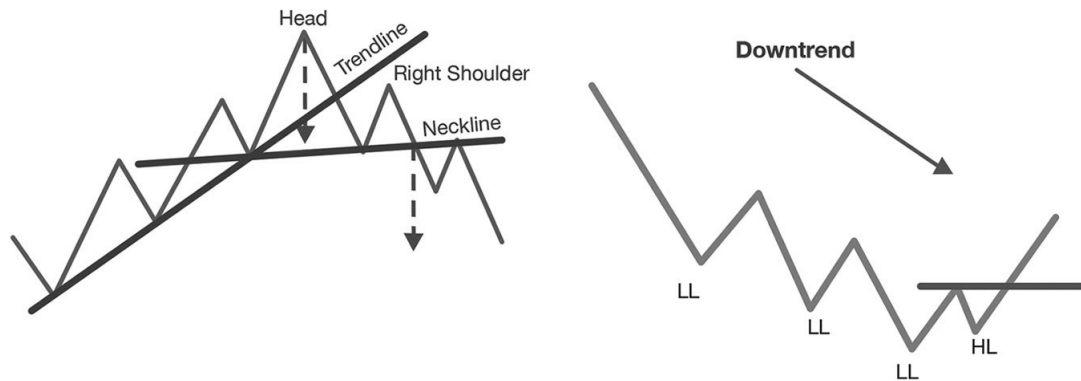
Figure 3.10



In addition, patterns start to form at trend change points; these patterns also take into account the thrust and reaction moves we are now on the lookout for. There isn't always a squeeze, but when there is, the corresponding move up or move down is usually very powerful and creates a "greater-than-expected" move. The ultimate decision is whether the market trend continues or reverses and starts a new downward trajectory. It is helpful to spot the signs that this is in the process of happening. In [Figure 3.11](#), we see how an upward trend morphs into a head and shoulders topping pattern, all with natural thrusts and reactions. Right next to that, we see how a downtrend can form a reversal by having a thrust move fail, creating a higher low (HL) and a subsequent reversal pattern.

Figure 3.11

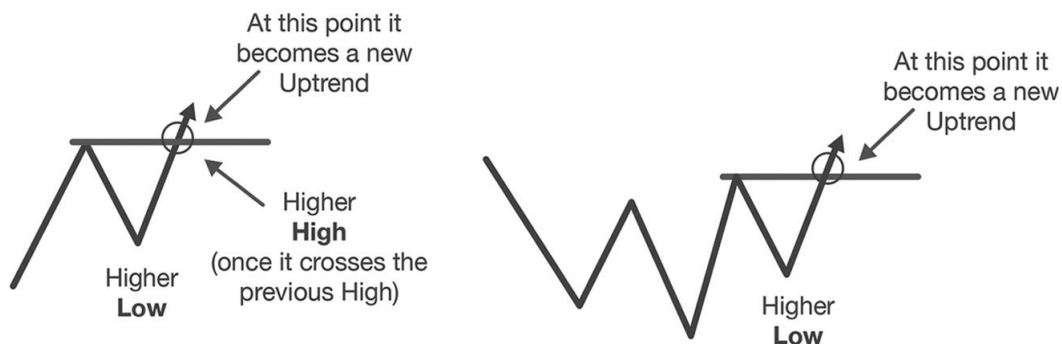
## THRUSTS AND REACTIONS MORPH INTO PATTERNS



When we zoom into these moves, we can see the precise price action we are looking for to confirm a trend change. In [Figure 3.12](#), we zoomed in on the higher low (HL) to see at what point the trend change is confirmed.

Figure 3.12

## TREND CHANGE MOMENTS IN TIME



Of course, there can be fake-out moves, but these usually happen on the smaller intraday time frames. The larger the time frame, the more solid the pattern.

### Which Newsletter Is Right?

This section isn't about recommending good financial market subscription services that are available. It's about how to treat them. There are many market-related services, newsletters, and Internet chat rooms that are operating today. These services typically offer opinions on the markets, and they usually charge a fee for accessing their information. They offer thoughts on market direction and sometimes specific market picks. I used to be a newsletter junkie, and I'm still to some extent.

However, these days I'm much less interested in individual opinions and more interested in websites that offer a quick synopsis of the current state of the markets through a variety of technical data. "Help me save time," is my watchword. For this reason, I'm a big fan of scanners and filters that can help me dig through mountains of data quickly and point out what I am searching for. What used to take me hours now takes me minutes with tools such as Investor's Business Daily, as well as our own scanner found at

[www.simplertrading.com/scanner](http://www.simplertrading.com/scanner).

I also find it useful to read and balance the views of the people who think the Dow Jones Industrial Average (DJIA) is going to 3,000 with the views of the people who think the Dow is going to 80,000. There are both rational and ridiculous arguments for both cases, but it is easier to create fear than hope. Keep that in mind the next time you read an e-mail calling for the next market crash. There are times I get finished reading through someone's point of view on the next five years, and I feel like we need to sell everything, convert all our assets to gold, and move to the country where we can grow our own food when the apocalypse happens. Then I'll go balance this with a forecast that is overly optimistic. The reality is usually somewhere in the middle.

I've also heard stories about people blowing out their accounts because "they put it all on a newsletter recommendation." This was true recently with the cryptocurrency craze, with people taking out mortgages to buy Bitcoin when it was at 18,000. There is a tendency for traders to feel more confident in a trade because it is being recommended by somebody else, which in reality, is just a trading setup like any other. It is important that traders not get lured in with a false sense of security that a particular trade is going to work out exactly as planned. Remember, it's always just about probabilities and risk control. Don't get overconfident just because you read about something online.

### **How to Establish Priorities: If You Are Getting Interrupted During the First Two Hours of the Trading Day, Why Is It Your Fault?**

I talk more about this at the end of the book when I discuss the business plan, but it does touch a little on technology here. The bottom line is that a trader needs to focus and concentrate to be successful in this business. The most critical hours in the stock market are generally the first two hours of the trading day. This is where most of the setups occur. It is up to traders to communicate to their colleagues or, if they are trading from home, their spouses and children that they cannot be disturbed during this time. When I am trading, I am not checking e-mail, I am not answering the phone, and I am not accepting uninvited visitors. If my wife wants to be dropped off at the gym before the trading day starts, she knows the deadline. If she lets me know after the deadline, my answer is always the same: "Honey, you know I love you, but I am in the middle of trading." Communicate clearly every time and it will make it easier for everyone involved. In life, you get exactly what you tolerate.

It can be hard to communicate things like this directly, especially if you start operating on assumptions that other people "should" know your priorities and schedule. You'll find it is helpful to write out a fully-developed trading plan and then share it with the people in your life. Once they understand that this is important to you and that you are serious, they will generally respect any boundaries that are clearly outlined in what they are reading. Think of it from their perspective. I know that when my wife visits me at my office, it doesn't look as if I'm working very hard. I'm just kicking back, looking at charts. Of course, I'm actually very focused, and I'm watching and waiting for the market events to unfold. "Just because I'm not digging a ditch," I like to tell her, "doesn't mean I'm not working." If you are experiencing any frustrations in this area of your life, drop everything and read the book *The Four Agreements* by Don Miguel Ruiz, which I referenced in the last chapter or listen to the book on Audible. There's a lot of "aha" moments in that short book.

In terms of communicating with people throughout the day, for anyone who doesn't utilize instant

messaging software, this is an incredibly efficient way to stay in touch. People can call at exactly the wrong moments during a trade. With instant messaging, people can type in a question and traders can get back to them at their leisure. Instant messaging was built for traders. The services change over the years. These days I'm mostly using Skype, Google Talk or "Gchat," or Slack.

The key with instant messaging software, however, is for the trader to block everybody except for people who the trader has specifically permitted to be on his or her list. If everyone knows you are online, then everyone will bug you. For traders, instant messaging between their brokers and other traders is appropriate. It is inappropriate from anyone else who could interrupt a trader's workday, and this includes family members. My wife did make the cut, however, and it has proved to be a useful way to stay in touch when the markets are moving—way easier than going back and forth on phone calls, at least for me. It is your life. Life is short. Put a stake in the ground and own your time.

### **Why Is Watching *Harry Potter* on DVD After 12:00 EST Better Than Watching CNBC?**

I am bringing this up because I've seen too many traders who quit their jobs and follow what I call the "CNBC setup." They are excited because they are finally able to trade full-time. They feel they've been at a disadvantage all these years, getting quotes from their iPhone and sneaking in trades in between meetings, and hearing about key news events only after the markets have already closed. What do they do once they start trading full time? They plop a TV down right next to their computers, turn on CNBC, and glue themselves to the screen, looking for trading opportunities.

CNBC has a very specific job: to provide viewers with enough entertainment so that they tune in and stick around for as long as possible. When a lot of people are watching, the network makes more money from the commercials. It's as simple as that.

CNBC is fun to watch, and when things get serious, it does a great job of reporting. I found out about 9/11 as it unfolded live before my eyes from Mark Haines. I flipped to some of the other channels, but I ended up parking it on CNBC that day because it did, hands down, the best job of reporting about it. Who can forget Maria Bartiromo reporting about the event, covered in ash and soot just after the first building collapsed? It was a gut-wrenching experience to watch, and the reporters and the network did a great job.

That said, traders must realize that they cannot make a living "trading the news" off any financial news channel. By the time something appears on TV, it is way too late to react. Trading floors have already heard the news, and by the time it makes it to the public, the floor traders are closing their positions, ideally to suckers who just saw the headlines. If anything, CNBC can be used as a "fading tool"—taking the opposite side of the news. Once it runs out of stories and starts repeating the same things over and over, I turn down the volume and either turn on a commercial-free music radio station, or some "brain focus" music like the Mind Amend channel on YouTube or [www.focusatwill.com](http://www.focusatwill.com). Sometimes I'll put on previously viewed movies on Netflix or Amazon Prime as background noise. Who can get tired of watching *Gladiator* or *Game of Thrones*?

Traders who do this for a living spend their days waiting for specific setups to take shape. Yet one of the biggest weaknesses of most traders is a need to be *in* every move. If the markets start running away, many traders just can't help but jump in, fearing that they may be missing something big. This is a fatal flaw that

will ruin any trader who can't control this habit. If there is anything I can hammer into your brain as you are reading this book, it is this: it is okay to miss moves. Professional traders miss moves; amateur traders try to chase every move. By listening to music or keeping a movie or series on in the background, traders have something they can use to pass the time while they wait for their specific setup to take shape. This makes them less prone to jump impulsively into trades just because they are bored or because they can't stand missing out on a move. The goal is not to catch every move in the market. The goal is to take the specific setups that you have outlined as a part of your business plan. Otherwise you are just a gunslinger, and sooner or later all gunslingers get killed.

We've set up [www.simplertrading.com/scanner](http://www.simplertrading.com/scanner) to sort through the noise and find specific, actionable setups on underlying stocks. These can be used to trade the stock itself, or, my preference, options on those stocks.

Now that we have a picture of what can impact the markets and how they tend to move, it brings up a logical question. What to trade? Stocks, Options, Futures, Forex, Cryptocurrencies—or trade all of the above?

*You can judge a leader by the size of the problem he tackles. Other people can cope with the waves, it's his job to watch the tide.*

ANTONY JAY

Jesse Livermore On His Best Trades:

*Money is made by sitting, not trading.*

*It takes time to make money.*

*It was never my thinking that made the big money for me, it always was sitting.*

*Nobody can catch all the fluctuations.*

*Men who can both be right and sit tight are uncommon.*

*The desire for constant action irrespective of underlying conditions is responsible for many losses in Wall Street even among the professionals, who feel that they must take home some money every day, as though they were working for regular wages.*

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## Now That I Understand The Markets—What Do I Trade?

*No wife can endure a gambling husband, unless he is a steady winner.*

THOMAS DEWAR

### Tell Me Straight—What Markets Will Give Me the Best Chance of Success?

Alright. Now you've got an idea of the psychology involved in trading, and how the markets generally ebb and flow, and it's time to trade. What to trade? Stocks? Forex? Cryptocurrencies? Futures? Options? I know cryptocurrencies are all the rage, but they are a trading instrument just like any other, and if you don't know what you're doing, you will get your head ripped off. I've owned Bitcoin, Ethereum, and Litecoin for a while, and the only complaint I have is I didn't buy more when they first came out. It was amazing to watch \$5,000 turn into \$300,000. But now that they have made their amazing bubble move, they are trading the same ebb-and-flow patterns just like the other markets. Remember—these markets are all made up of people filled with all kinds of emotions, whether they are trading Netflix or Bitcoin. I trade futures and Forex (the foreign exchange market), as well as stocks. What I'm talking about here is trading the instrument that is going to give you the best odds of creating a consistent income in all market conditions, right out of the starting gate. This is based on my own market experience, as well as watching thousands of other traders coming into the markets and giving this a shot. At the end of the day, I want you to have the best chance of success.

If I had to pick one and only one instrument? That's easy. Options. You get great leverage for directional moves. Unlike futures and Forex, you have a fixed amount of risk if you're buying a call or a put. That is, your account can't "go negative," like it can when something crazy happens like the Swiss Franc decoupling from the Euro. This caused a surprise 23 percent overnight move. Not only did this create huge losses for people on the wrong side of this, many accounts went negative. This means you suddenly owe your broker money. Not fun. Also, I can say without a doubt that day trading futures, for the newer trader, has the highest rate of failure. The commissions eat you alive if you trade too much, and it's easy to let just one trade get away from you if you stop following your plan. Cut your teeth in the options market first. It's way more forgiving.

The only real danger in trading options is if you decide to sell them "naked." Well, guess what. You never have to do that. A *spread* is just selling a naked option with a fixed amount of risk in place. What happens if you get assigned when you sell a spread? Your risk doesn't change; only the margin requirements of the trade change. If you can handle the margin, keep the trade. If you can't, then just close it out. By the way, getting assigned doesn't happen very much. I've often held on to stock I was assigned after the spread expired and

turned the trade into greater profitability. Again, your risk doesn't change in this situation, while the spread is on, as the movement in the stock is offset by the other option in the spread.

In addition, option trades can be set up for any account size, even if you're trading options on a \$1,000-stock in an account with only a few thousand dollars in it. Options are available on nearly everything—individual stocks, sectors, indexes, currencies, and just about anything you can think of. I'm on the lookout for options on cryptocurrencies in the future. Do you want to benefit from rising interest rates? Instead of shorting bond futures and holding all that risk, buy long-term puts on TLT (iShares Barclays 20+ Yr. Treasury Bond ETF). Think NFLX (Netflix) is going to trade sideways for a while? Sell premium. A trader with options knowledge can take advantage of any market situation, up, down, or sideways, and meet any of their trading goals—from creating monthly income to multiplying their wealth, with the appropriate option strategy. It's like being a kid in a candy store. Best of all? If you learn about selling premium the right way (because, yes, there is a wrong way) you can be in situations where you get the direction wrong on the underlying stock but still make money. The main trick with options? It's learning what *not* to do. Let's take a look.

Options trading is the most fascinating type of trading, simply because there are so many different things you can do with them. When it comes to options, there are generally two types of retail traders. The first trader doesn't know anything about them, or did a few trades that didn't work out, so the trader moved on. The second trader tried buying an option (most likely an out-of-the-money call), lost money, and then discovered that a person could also sell options and collect the premium. This sent the trader down the rabbit hole, and now he or she knows all the possible ways to sell premium and becomes obsessed with doing so without incurring any risk. This trader spends a lot of time legging in to and out of option positions, making a little money each month. This tends to work for many months—until it doesn't, and then it gets very ugly very quickly. In other words, even though this type of trader knows everything there is to know about options, he or she still can't make a consistent income trading them. With options, too much knowledge isn't necessarily a good thing. Keep it simple.

I utilize a few basic strategies when it comes to options trading. I like to keep things straightforward. My rule of thumb is: "If I can't explain it to my 12-year-old, it's too complicated." I focus both on directional plays and on collecting premium. I'm going to explain options quickly for newbies, focus on the few key things you need to know, and then discuss my favorite strategies.

This chapter will also lay the foundation for the option strategies that I discuss about setups in [Part 2](#) of this book. Did you forget what a Delta is? Or an implied volatility (IV) crush? Then you can come back to this chapter for a quick reference. Also, don't worry, you don't have to be a master of "the Greeks" to do options. It doesn't hurt, of course, but there are simple strategies that work great without having a clue as to what Gamma or Vega are or what they do.

## **What Would You Pay for a First-Class Plane Ticket to Singapore?**

Imagine that you are on a flight from Chicago to Singapore. It's a mind-numbing 17-hour oxygen-depleted journey. By a stroke of luck, you get upgraded to first class. Score! You sit down, get comfortable, and get ready to enjoy this 17-hour flight in style. Just before takeoff, a hedge fund manager walks up to you and



whispers, “Hey, I got stuck back in coach. I’d like to give you money to switch seats with me. How much do you want?” Well, this is a new twist. You love your seat. You don’t want to leave your seat—but how much is this guy willing to give you for it? You go back and forth, and he says he is willing to give you no more than \$1,500.00 for the seat. You tell him it would have cost him \$20,000.00 if he had booked it online. “True,” he says. “But you got it for free. The question here is how much do you want for it.” You think about it and tell him that \$1,500.00 is too low—but if he lets you sit there for the first 5 hours, he can have it for the last 12 hours. “Deal,” he says.

Five hours go by, and he comes back to your seat, ready to switch. He hands you \$1,200.00. “Wait a second,” you say. “I thought we agreed on \$1,500.00.” He gives you a funny look and says, “Well, yeah, that was when there was a 17-hour flight in front of us; now it’s only 12 hours. Time is running out.” You tell him you want to think about it. Disgruntled, he walks off. You unwittingly pass out in your seat. Later, after 9 hours of glorious sleep, you wake up. “Hey buddy,” he says, looking as if he’s been stuck in coach for 14 hours, “Are you ready to switch seats yet?” Sure, you say. He hands over \$300. “Where’s the rest of it?” you ask. He explains, annoyingly, that you slept for 9 hours, and there are only 3 hours left in the flight. At this point, he might as well sit in coach, but he’s still willing to give you \$300 to have possession of your seat for the last few hours. You think about it, realize that in 3 hours your seat will be worthless (this guy isn’t going to pay anything after the plane lands), and you take the \$300 to switch seats. That is essentially *premium decay* in action on an “at-the-money” call. The closer you get to the end of the flight (the expiration date) the lower the price you could get for your first-class seat (the premium).

In my first options trade that I made in high school, I bought call options on INTC (Intel), and I hadn’t the foggiest notion what they were or what that meant. Later I found out that a call option increases in value if the underlying stock moves higher, and a put option increases in value if the underlying stock moves lower. So, buying a call is like going long, and buying a put is like going short.

One option represents 100 shares of stock. When you see a stock option priced at \$4.30, that is per share of stock. Since each option represents 100 shares of stock, one option at \$4.30 costs \$430.00. Easy enough?

Then I learned about *strike prices*, and how options were either in-the-money, at-the-money, or out-of-the-money. Great. If AAPL (Apple) is trading at \$399.26 per share, and I’m looking at call options, then the \$390 call is in-the-money (trading below the current stock price, also called ITM for short), the \$400 call is at-the-money (trading at or near the current price, also called ATM for short), and the \$410 call is out-of-the-money (trading above the current price, also called OTM for short).

The \$390 call is “in-the-money” because it gives the option buyer the right to buy the stock for \$390. Simple math shows that if the stock is trading at \$399.26, then the \$390 call option is worth \$9.26. It works like this. If that option gives me the right to buy the stock at \$390.00, and the stock is trading at \$399.26, then I can immediately go out into the open market and sell the stock I acquired for \$390.00 for \$399.26, thus making a \$9.26 profit. This portion of the option price is known as the *real* or *intrinsic* value of the option. But if it were this simple, then wouldn’t both the \$400 and the \$410 strike be worth nothing, since the stock is trading at \$399.26, below both of those levels?

That is where premium comes in. [Figure 4.1](#) shows the actual prices of these options. These options have 24 days of life left, at which point they will expire. When an option expires, it is literally worth only the *real*

value that a person would get if he or she exchanged it for stock. That is, if it was *expiration day* and AAPL was at \$400.00 a share, then any call options above that price would be worth zero (expire worthless, since they have no intrinsic value), and any call options below that price would be worth the price of the actual stock less the strike price. So, in this case, the \$390 calls would be worth \$10 (if AAPL closed at exactly \$400.00). The \$400 and \$410 calls, which give the option holder the right to buy AAPL at those strike prices, would be worth zero. After all, you can go out in the open market and get it for \$400.00, so why would you pay anybody for the “right” to buy it at \$400.00, let alone \$410.00? Note that when you’re trading options, you’re never really exchanging the options for stock. It’s something you can do, but most of the time traders are just buying and selling the options themselves.

Figure 4.1

AAPL APPLE INC COM ETB NASDAQ B: 399.40 A: 399.45 399.26 -3.91 -0.97%											
UNDERLYING											
Last X	Net Chng	Bid X	Ask X	Size	Volume	Open	High	Low			
399.26 D	-3.91	399.40 P	399.45 P	1 x 2	22,589,1...	408.73	409.25	398.06			
TRADE GRID											
OPTIONS											
Layout: Volume, Open Interest Exchange: Composite											
CALLS											
Volume	Open Int	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Volume	Open Int		
SEP5 11 (3) 100 (Quarterlys) 37.67% (±125.844)											
OCT 11 (24) 100 44.06% (±149.804)											
1,767	6,158	25.45 N	25.95 I	OC...	385	10.80 X	11.00 Z	3,132	47,774		
2,274	11,701	22.25 N	22.75 A	OC...	390	12.65 N	13.00 A	5,278	48,851		
3,148	9,469	19.25 N	19.60 N	OC...	395	14.70 N	15.05 A	2,250	6,878		
11,523	42,510	16.60 N	17.00 Q	OC...	400	16.95 N	17.30 I	5,479	12,207		
6,377	51,395	14.15 N	14.45 Z	OC...	405	19.50 Z	19.90 A	3,312	5,598		
14,716	57,174	12.00 X	12.30 A	OC...	410	22.25 Q	22.65 A	3,361	10,561		

And yet when we look at the prices of these options 24 days out from the expiration day, we notice a very strange thing. The \$390.00 calls are not trading at just the intrinsic value of about \$10.00; they are trading at a whopping \$22.75, well above the \$10.00 they would be worth if this were expiration day. The \$410 calls, which would be worth zero in this example if it were the close of options expiration day, are trading for \$12.30 (\$1,230.00 per option contract). The \$400 calls, which would also be worth zero in this example if it were the close of expiration day, are trading at \$17.00 (\$1,700.00 per options contract). What gives?

Just as with that first-class seat, there are people out there who will pay a premium to buy the option, even if it’s trading out-of-the-money. Why? The stock could have a huge rally, and the option could be worth a lot more in the future. And the further out the expiration date (that is, the longer the flight), the more premium they are willing to pay. Why not just buy the stock? Because they don’t want to shell out a lot of money to buy the actual stock. Thus, they are willing to pay a premium to own *the right to buy* the stock and to take advantage of the limited risk and leverage involved in buying the option. Note that while the \$390.00 option has some real value priced in, the \$400.00 and \$410.00 options are pure premium. The in-the-money call is a mixture of intrinsic value and premium.

On the flip side, someone who owns the stock must make a similar decision. Does the owner sell an option against it and collect the premium? The owner wants to keep the stock, so the goal is to sell an option against it that will expire worthless. That is, the owner hopes that the stock price doesn't close above the strike price by the expiration date.

As a buyer of an option, just like the guy who wanted to buy the right to sit in your first-class seat, you are buying with the expectation of a better experience. Instead of shelling out \$40,000.00 to buy 100 shares of AAPL at \$400, you could pay \$1,700.00 to buy a \$400.00 call option. With each passing day, the premium on that option erodes a little bit. And the closer that option gets to expiration (that is, the closer the plane gets to the airport), the faster that premium starts to lose value. Your bet in this case is that AAPL has a fantastic move higher, perhaps to \$450.00. If it does, at expiration, your \$400 option will be trading at \$50.00, and your profit on the trade will be \$3,300.00 (the \$5,000.00 sale price less the \$1,700.00 purchase price). In other words, you were able to participate in AAPL's rally without having to shell out all the money required to buy the stock. In fact, in trading, owning the stock is sort of like sitting in coach.

On the flip side, the owner who sold you the option does not want to see AAPL go to \$450. The owner is hoping that the stock stays near \$400 and that the option you bought for \$1,700.00 expires worthless. Where did your \$1,700.00 go? To the person who sold you the option. That goes right into his or her pocket. It's like the AAPL stock he or she owns is a piece of property, and you were just charged \$1,700.00 for a month's rent, thank you very much.

Everything that we've just talked about has focused on the "call" side of the options world, but the same story holds true for the put side. In [Figure 4.1](#), where AAPL is trading at \$399.26, we can see that the out-of-the-money put at \$390.00 is trading at \$12.65, the at-the-money put at \$400.00 is trading at \$16.95, and the in-the-money put at \$410.00 is trading at \$22.25.

### **Why Wouldn't I Buy These Particular Options with My Mother-in-Law's Trading Account?**

Okay, up to this point, I've been talking about what options are and how they work. Now let's talk about the main reason that people lose money trading options. It's very simple: it's because they focus mainly on buying cheap out-of-the-money call options. In [Figure 4.1](#), the \$410.00 AAPL call options are trading at \$12.30. This is 100 percent premium. There is zero intrinsic value here. In this case, the trader looked at the \$390.00 call options, but found them to be "too expensive" at \$22.75. AAPL is currently at \$399.26. Let's say it had a nice steady move into expiration, rallying just over \$10.00 per share, and closed at \$409.75. A trader bought the \$410.00 call option because he or she thought AAPL would go up. The trader was right. It did. How much money is the option worth at expiration? A big goose egg. The trader lost every dime. In fact, AAPL would have had to close above \$422.30 for the trader to make a profit on this trade. At \$422.30, the \$410.00 call option at expiration is worth \$12.30—the exact price paid for the option. Although the trader didn't lose money on the trade, he or she didn't make anything either. In other words, when buying out-of-the-money call options, not only does a trader have to be right, but the trader has to be right in a big way. A steady move higher won't do. The move has to be explosive.

In this same scenario, had the trader bought the "expensive" \$390.00 call option at \$22.75, a move to \$422.30 would price the call, at expiration, at \$32.30, resulting in a profit of \$9.55 (\$955.00) on the trade.

Would you rather buy an option for \$2,275 and make \$955 or buy an option for \$1,230 and make \$0.00? Buying an option “just because it’s cheap” is a ridiculous trading strategy. In the options world, a common scenario is: (1) retail traders buy out-of-the-money calls (without paying attention to fair value or implied volatility; more on that later), and (2) professional traders gladly sell them these calls all day long. “Hey, you want some more?” they ask eagerly. “Because we’ve got more to sell you.”

I’ve known guys who have traded options on the floor for more than 20 years. They have never bought an out-of-the-money call. Not one. To them, there could be nothing worse on this planet than buying an out-of-the-money call.

That’s not to say that out-of-the-money options don’t have their place. Believe it or not, there are scenarios where it can make sense to buy them, but these are the exception rather than the rule. This brings me to my first options strategy.

### **Directional Plays: Why Is Delta 0.70 or Better Superior?**

Buying a cheap out-of-the-money option is enticing because if it works out, the trade could win in a big way. Everyone wants to be able to buy an option for \$1.00 and sell it for \$15.00. That’s the “quit your job and travel the world” trade if it’s done right. Yes, this *could* happen with an out-of-the-money option, just like you *could* get a royal flush when you’re playing poker. The odds aren’t great, but the chance is there, however remote. Personally, I’m more interested in increasing the odds for creating a consistent income stream than crossing my fingers and swinging for the fence.

Figure 4.2 lays out an option diagram with “the Greeks,” known as Delta, Gamma, Theta, and Vega. The good news is that for what I like to do a trader doesn’t need to know too much about these. The only one I want to talk about here is Delta. This is important. *Delta* simply tells us how far the option price will move in relation to each \$1.00 move in the underlying stock. A Delta of 1.00 means that the option price will move right along with the stock, dollar for dollar. If the stock moves up \$1.00, then the option will move up \$1.00. A Delta of 0.10 means that if the stock moves up \$1.00, then the option will move up only 10 cents. As a side note, a Delta of 10 is also telling us that the market makers think there is only a 10-percent chance this stock will get to (let alone through) that strike price. The deeper in-the-money the call option is, the higher the Delta. The further out-of-the-money it is, the lower the Delta.

**Figure 4.2**

AAPL APPLE INC COM ETB NASDAQ											
UNDERLYING											
Last X	Net Chng	Bid X	Ask X	Size	Volume	Open					
400.27 P	+1.01	400.27 P	400.40 J	1 x 3	12,902,404	400.19					
TRADE GRID											
OPTIONS Spread: Single Layout: Delta, Gamma, Theta, Vega											
CALLS						PUTS					
Delta	Gamma	Theta	Vega	Bid X	Ask X	Exp	Strike	Bid X	Ask X	Delta	Gamma
SEP 5 11 (2) 100 (Weeklys)											
.95	.01	-.25	.03	25.40 A	25.75 B	SEP ...	375	20 X	24 N	-.04	
.93	.01	-.32	.05	20.55 I	20.90 A	SEP ...	380	33 X	37 X	-.06	
<b>1</b> .89	.01	-.41	.07	15.80 C	16.15 B	SEP ...	<b>2</b> 385	59 Z	63 X	-.10	
.81	.02	-.53	.10	11.40 X	11.60 Z	SEP ...	390	1.15 Z	1.19 C	-.18	
.69	.03	-.66	.13	7.50 W	7.65 Z	SEP ...	395	2.24 A	2.28 X	-.31	
.52	.04	-.72	.14	4.40 X	4.55 A	SEP ...	400	4.10 Z	4.15 X	-.48	
.39	.03	-.84	.13	2.25 X	2.33 A	SEP ...	405	8.90 N	7.00 X	-.87	
<b>3</b> .18	.03	-.45	.10	.97 X	1.02 Q	SEP ...	410	10.65 Q	10.75 X	-.82	
.08	.01	-.26	.06	.37 Z	.40 Z	SEP ...	415	14.85 B	15.20 A	<b>5</b> -.92	
.04	.01	-.15	.03	.15 N	.18 Q	SEP ...	420	19.70 Q	20.00 X	-.94	
.02	.00	-.09	.02	.06 Q	.11 X	SEP ...	425	24.55 X	24.80 X	-1.00	
.01	.00	-.08	.01	.04 C	.05 A	SEP ...	430	29.50 A	29.85 X	-1.00	
OCT 11 (23) 100											
.73	.01	-.32	.34	33.15 A	33.30 A	OCT ...	375	7.75 N	7.80 N	-.26	
<b>4</b> .70	.01	-.33	.36	29.50 I	29.65 Z	OCT ...	380	9.10 A	9.20 X	-.30	
.68	.01	-.34	.38	26.10 A	26.25 Z	OCT ...	385	10.70 N	10.80 X	-.34	
.62	.01	-.35	.39	22.90 N	23.05 N	OCT ...	390	12.45 A	12.55 X	-.38	
.57	.01	-.36	.40	19.90 Q	20.00 Q	OCT ...	395	14.45 A	14.55 C	-.43	
.52	.01	-.36	.41	17.10 X	17.25 A	OCT ...	400	16.70 N	16.80 N	-.48	

There is a flaw in this options pricing model that can be exploited. The market makers are all pricing these out-of-the-money options based on the idea that the volatility will remain constant. That is a false assumption. We do look for setups, like squeezes, where a sharp, bigger-than-expected move has a greater percentage of happening than is being priced into the options market. These situations are gold. In other words, most of the time, the out-of-the-money options will expire worthless. Some of the time, they'll explode in value. I like to identify setups that pinpoint moments in time where the odds have increased that the underlying stock will explode in value. Then and only then will I utilize a few out-of-the-money calls in that trade "basket" of option strategies. For example, I might buy in-the-money calls, sell put credit spreads, and buy out-of-the-money calls all on the same stock, based on the setup. This gives me an edge in terms of capitalizing on premium decay as well as the possibility of an explosive move, all on the same trade.

For purely directional plays, I simply view the option as a cheaper way to participate in the price movement of the underlying stock. One of the plays I'll talk about later in the book (the squeeze play) is a favorite of mine for option plays. This setup indicates a high probability that the stock is ready to make a larger-than-expected move. In this case, I simply want to participate in the movement of the stock, without having to fork over all the money required to buy the actual stock. For these trades, I simply buy an in-the-money option with a Delta of 0.70 or higher. This means that as the stock price moves in my favor, the option will move right along with it at the rate of 70 cents for every dollar the stock moves. As a bonus, as the stock moves my way, placing my option even deeper in-the-money, the Delta also increases. For the first 2 points of

a move, my option might move \$1.40 (70 cents per dollar). For the next 2 points, it might move \$1.60, as the Delta increases from 0.70 to 0.80. A far-out-of-the-money option, on the other hand, will stay at a low Delta for quite some time. Buying far-out-of-the-money options is a lose/lose, unless you have identified a high probability setup for an explosive move, or unless you have some inside information, such as Bear Stearns being about to collapse. Someone bought \$1.4 million in far-out-of-the-money put options a few weeks before Bear Stearns went bankrupt. He knew what was coming down the pipeline, and he made a fortune.

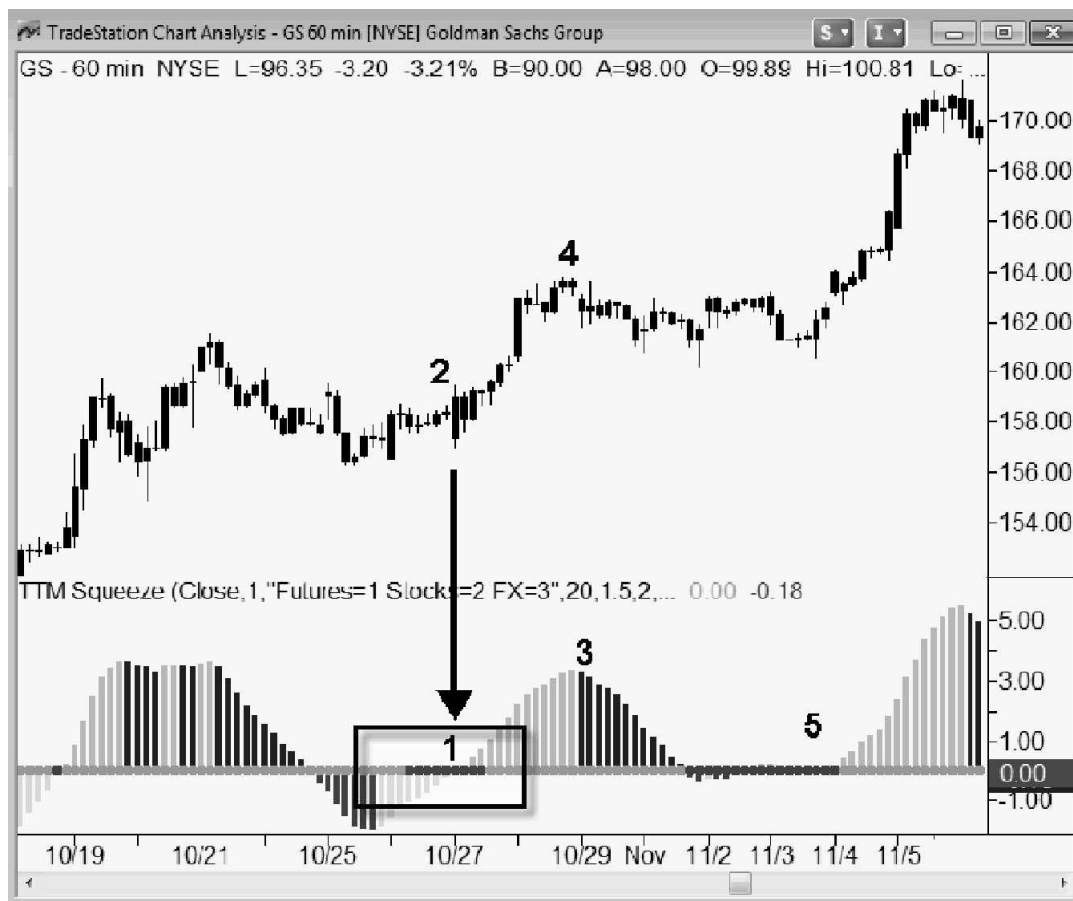
In [Figure 4.2](#), on the left-hand side, we can see the corresponding Delta values for the AAPL call option strike prices from \$375.00 up to \$430.00. At point #1, we see the strike prices with a Delta of 0.70 or higher (the \$395.00 call has a Delta of 0.69, which is close enough). These are for the recently introduced September weekly option series, which have 2 days left until expiration.

As a side note, up until recently, all stock options traded monthly, expiring the third Friday of every month. Now we also have “weekly options” that started out on some of the bigger names, but are now found on many actively traded stocks, which has been great, especially around earnings. These options have a very high premium because—you guessed it—retail traders are clamoring to buy these “cheap” options. I would never buy one, ever, ever, ever. But I’m happy to sell them to anyone who thinks she’s getting a bargain. This is one of the great things about options. If you would never buy one because you think it will expire worthless, you can always sell it and take the opposite side of that trade. Just do it as a spread so your risk is limited. There is no reason to ever sell a naked call.

A glance at point #4 shows the Deltas for the monthly options, which expire in 23 days. Note that the Delta levels are not the same for each strike price. The further out the expiration, the deeper in-the-money a trader needs to go to achieve a Delta of 0.70. At point #3, we see the Delta levels for the out-of-the-money options, which fall precipitously the further away from the current price we move. That is, a trader could buy the \$430.00 call option for a nickel, and if AAPL moved \$10.00 a share the next day, the option price would barely budge. For put options, the story is the same, just in reverse. The Delta levels we want for puts are –0.70 or greater, as highlighted at point #5.

I’m the first to admit that purely directional plays aren’t sexy. They are just simple, and they work, as long as they are combined with a high-probability technical setup on the underlying stock. Let’s take a look at [Figure 4.3](#), which details one of my favorite “short term swing-trading strategies” in options. By short-term, I mean a trade that I’m generally in for one to three days. For these types of trades, I look at hourly charts, and one of my favorite setups on the hourly charts is a *squeeze*.

**Figure 4.3**



1. At point #1, a squeeze sets up on the hourly chart of GS (Goldman Sachs), as indicated by the darker-colored dots within the square. When the dots turn back to lighter-colored dots, the trade is a buy if the histogram is above zero and a sell (short) if the histogram is below zero. (Note: There is more about the squeeze in a later chapter.) In this case, it's a buy.
2. At point #2, GS is trading near \$159.00. I want to buy calls, as the squeeze has generated a buy signal. Of course, I want to go for a Delta 0.70 call, which in this case turns out to be the strike price of 155. I buy over the course of the next hour at prices of \$7.25, \$7.35, and \$7.40. I'm willing to risk a move of \$2.00 against me on the underlying stock, at which point I would close out the options at their current price. With a Delta of 0.70, I already know that means that the option would drop about \$1.40 if the stock dropped \$2.00.
3. At point #3, the squeeze indicator has issued a sell signal, as the move has started to lose momentum. This is indicated by the darker-colored histogram. As a result, I start closing out this position at point #4.
4. For this trade, as seen in [Figure 4.4](#), I scaled into 300 contracts at prices of \$7.25, \$7.35, and \$7.40. I then scaled out of these 300 contracts at prices of \$9.05 and \$9.25, for an average profit of \$1.85 (+\$185.00) per contract. (See [Figure 4.4](#).) I did this trade during one of our quarterly live trading mentorships, so I was able to take screenshots of it as the trade unfolded.

Figure 4.4

The screenshot shows the TradeStation TradeManager - Orders window. At the top, there are fields for Symbol Filter, Account No, Status (set to Filed Orders), From (10/27/2010), and To (Today). Below these is a 'Retrieve Orders' button. The main area contains a table with the following columns: Entered, Filled/Cancelled, Symbol, Spread, Type, Quantity, Qty Filled, Qty Left, Stop, Limit, and Filled Price. The table lists six orders for GS 101120C155. A summary box in the center of the window displays the following text:

Buy 300 GS Nov 155 Calls on October 27 at 7.25, 7.35 and 7.40.  
 Sell 300 GS Nov 155 Calls on October 28 at 9.05, 9.25, 9.25.  
 Total time in the trade: 1 day  
 Total Profit: \$55,965.00

At the bottom of the window, there is a navigation bar with buttons for Orders, Average Price, Staged Orders, Positions, Strategy Orders, Strategy Positions, Balances, Allocations, and Messages.

Entered	Filled/Cancelled	Symbol	Spread	Type	Quantity	Qty Filled	Qty Left	Stop	Limit	Filled Price
10/28/10 09:28:21 AM	10/28/10 09:29:30 AM	GS 101120C155		Sell to Close	100	100	0		9.05	9.09
10/28/10 09:22:45 AM	10/28/10 09:22:58 AM	GS 101120C155		Sell to Close	100	100	0		9.25	9.25
10/28/10 09:45:42 AM	10/28/10 09:57:40 AM	GS 101120C155		Sell to Close	100	100	0		9.25	9.25
10/27/10 02:05:56 PM	10/27/10 02:06:03 PM	GS 101120C155		Buy to Open	100	100	0		7.40	7.40
10/27/10 01:56:28 PM	10/27/10 01:58:28 PM	GS 101120C155		Buy to Open	100	100	0		7.35	7.32
10/27/10 01:56:02 PM	10/27/10 01:56:10 PM	GS 101120C155		Buy to Open	100	100	0		7.25	7.25

The main idea here is that when I'm looking for a stock to move a few dollars, I want my option to move up as much in lockstep with that price movement as possible. With a Delta of 0.70, a \$2.60 move in GS resulted in a \$1.85 move in the price of the option. I'm more than happy to buy an option for \$7.30 on Thursday (GS October 155 call) and sell it for \$9.20 on Friday. There is no need to hold it to expiration to "see what happens" or hope that the option will quadruple in value. I buy based on an underlying signal in the stock, and then close out the option based on an underlying signal in the stock.

That's the last point on this trade. Most of the literature on options talks about buying or selling an option and "holding it until expiration." I rarely do that. As traders, it's perfectly okay to make a living practicing what I call BASAARP: buying and selling at a reasonable price.

For more advanced options traders, there are, of course, a couple of ways to play this GS trading signal. The signal gives a high probability that the "stock will move up a point or two." Traders who are more familiar with option strategies could also initiate a variety of spreads on this position, some of which I'll talk about shortly.

This list could go on and on, but hopefully you get the idea. The key is first having a clean signal on the underlying stock and then stepping in with option strategies to leverage that move. For the most part, I'm fine with a pure directional move, where I just buy a Delta 0.70 option and exit that same option based on the underlying movement of the stock. It's simple and clean. It's, of course, even better to sell put credit spreads in that situation as you get premium decay in your favor. I'll often do both.

### The Importance of Implied Volatility Crush, or "Look, Ma, They're Panicking!"

The biggest mistake newer option traders make is not understanding the role of implied volatility (IV) and how it affects the price of an option. Although a portion of the option price is calculated based on the underlying stock, another significant portion of the price is based on its implied volatility. Have you ever



bought a call option on AAPL the day before earnings, watched AAPL trade \$20.00 higher overnight, and then been unable to sleep because you were mentally counting all the money you were about to make at the open? Then the next day, you looked in horror as your option actually opened lower in price than where you bought it, and you ended up *losing* money on the trade instead? WTF? Welcome to the world of implied volatility.

In this case, the market makers know that the earnings report is going to be a high-volatility event, so they price the options much higher to account for this anticipated volatility. In other words, they are *pricing in* the expected stock movement. If a trader bought AAPL calls the day before earnings, then the earnings report came and went, and AAPL opened the next day at about the same price where it had closed, the options price would open much lower, even though the stock didn't move from the day before. The reason for this is that the event that caused the price gouge has now disappeared. Once that happens, the options price gets crushed—hence the term *IV crush*.

Implied volatility increases with panic, uncertainty, or a looming big event. Implied volatility decreases right after those events, and remains low when there is nothing on the horizon to be worried about. For example, implied volatility on AAPL options is currently around 35 percent (this is a number that is available on most option-trading platforms). Right before earnings, this can jump to 100 percent, which essentially triples the premium portion of the options price. In general, a trader wants to buy options only when implied volatility is low. If implied volatility gets too high, it's really a losing proposition to buy the option, though it does become attractive to sell (more on that in a bit).

Just how important is implied volatility? During the 1987 crash, when the stock market dropped 20 percent (that is like the Dow dropping more than 5,000 points in one day in 2018, a total and utter panic), some of the floor traders who owned call options on the market actually made money. Uh, say that again? Aren't calls supposed to make money only when the markets go up? Yes, but if the implied volatility explodes, it increases the price of all options. On that day, it exploded to an unprecedented level . . . to the point that even the call options, the very options that should have collapsed in value, made money.

Here is one way a trader can utilize this knowledge to his or her advantage. [Figure 4.5](#) shows an hourly chart of GS (Goldman Sachs). On August 18, 2011, the stock gapped down more than \$3.00 per share. A “*gap down*” event is a situation where some panic ensues at the open. People who own GS panic to buy puts to protect themselves, and the gap itself creates uncertainty in the market. There is a window of about 5 to 10 minutes at the open when the put option prices are artificially high because of all this—in other words, the implied volatility increases. It pops at the open, and the premium price of the option expands accordingly.

**Figure 4.5**



The thing about gap downs is that most of the news is already in the price once the stock opens. After the gap down and the initial flurry of activity, a stock will often spend the rest of the day trading in a choppy, quiet range. As things quiet down, the implied volatility drops . . . and so does the price of the options. This is called an *implied volatility (IV) crush*. There is a way to take advantage of this.

In this trade, we aren't looking to buy puts; we are looking to sell them to someone who is panicking. Since this trader is panicking, he or she will pay up to buy the puts. We will gladly sell those puts to the trader, and then buy them back when the market quiets down. The trade goes like this:

1. About half an hour before the cash open at 9:30 p.m. EST, I scan for stocks that are gapping down of their own accord. This is mostly due to a news event specific to that stock. In [Figure 4.5](#), we can see at point #1 that we have a nice gap down in GS from the previous day's close.
2. Within a few minutes after the open, I sell puts that are one strike out-of-the-money. (Remember, we want to buy in-the-money options but sell out-of-the-money options.) In this case, GS opened at \$114.07 and quickly traded lower. The first out-of-the-money puts are the \$110.00 strike, and I sell these at current market prices at point #2.
3. The goal with this trade is to then close it out that day. As we near the close at point #3, GS rallies back toward the \$114.00 level. At this point, the uncertainty is no longer there, and the implied volatility gets "crushed" back to what it had been the day before. The option that I sold for \$1.20 drops back down to \$0.60 by the close, even though the stock hasn't really moved since the open.
4. For stop losses, I'm looking at a 1:1 risk/reward ratio. That is, if I'm looking to make \$1.00, then I am willing to risk \$1.00. It's important to figure out a stop, because there will be instances where the stock could just keep falling. Selling a naked option is risky in this regard. In this case, if GS kept selling off and ended up down \$10.00, the option I sold for \$1.50 could be trading for \$5.00 or even

higher. (Of course, I could also buy the next strike out-of-the-money put as protection against this situation.) As a seller in this case, any price over \$1.50 represents a loss, and it's wise not to let that loss get carried away.

Selling naked calls and holding them overnight is inherently dangerous; it is the riskiest option strategy alive. If a trader sells 20 naked call options at \$5.00 (collecting \$10,000.00) on a stock, and then wakes up the next morning to see that the stock is up \$80.00 a share on a takeover, then that trader is hosed. That option is now worth \$160,000.00, and the guy who sold it has just lost \$150,000.00. This is where "verticals" and "credit spreads" come into play, because they protect an option seller against this kind of surprise nastiness.

To summarize, if I'm buying options, I try to avoid buying them when IV is high. This is typically right after a huge move (wow, AAPL is up \$10.00 today—I'd better buy some out-of-the-money calls!) and right before earnings, unless I'm doing a strategy specially geared towards a stock that tends to rally into earnings. I'd rather wait for a "quiet period" to buy options, such as a squeeze play, which forms when a market is consolidating and lackluster. However, high IV does give a trader the opportunity to sell options. For example, back in the day, there was a period of several years when every time IBM approached \$280.00, it would then sell off. Thus, every time IBM approached this level, the floor traders would sell naked the \$280.00 call options on IBM and collect the extremely high premium. Of course, the retail traders who bought these call options (hoping that IBM would blast through \$280.00) got hosed. The saying for years was, "Sell the 80s and buy a Mercedes." This party ended the day IBM finally broke through \$280.00 and kept on going.

In the GS example, I sold naked puts (they weren't backed by underlying stock) at a high IV and bought them back when the IV normalized. Of course, you can also sell those puts as a spread to further limit your risk. If I'm selling naked, I'm selling small size.

## **How Do You Know When to Hold 'Em and When to Spread 'Em?**

When you're trading options, you have two choices: buy an in-the-money option or sell a credit spread during a quiet IV period for a directional play, or sell options during high-IV periods, looking for a collapse in the value of the IV. As we have already seen, selling naked options is riskier than buying options, even though they have a higher probability of working in our favor. We normalize this risk by selling naked options with a fixed amount of risk by doing it as a spread. When buying an option, we are limited to losing only the amount we paid for the option. If we sell a naked call, our loss is theoretically unlimited, as the stock could go to infinity. Of course, I have yet to see a stock do that. But a big gap on an upgrade or takeover is still a risk not worth taking when all you must do is turn that naked call into a fixed risk spread.

Other than an IV crush situation, the main reason to sell options, especially out-of-the-money options, is that they're literally losing premium value every day. Think of the premium portion of the option as a bright, juicy peach . . . covered with ants. Every day those ants are going to work on that peach, little by little, stripping away the flesh, until at some point there is nothing left but the seed in the middle. This happens all the way to options expiration until the premium portion of the option price is zero, and all that's left is the real or intrinsic value of the option. If that option is out-of-the-money, then it expires worthless.

By the way, one mistake option sellers make is hoping their option will expire worthless. I admit, it's very

satisfying. But if you sold a \$5.00 spread for \$1.00, and the week of expiration you can get out for 20 cents, the safe trade is to take the profit and move on. After all, you're now risking \$4.80 to make that last 20 cents. So many things can, and do, go wrong that last week of expiration. When selling a spread, once you get to 80 percent of your maximum available profit potential, there is little reason to hold on to that trade any longer. Get out, move on, and find another fat, juicy credit to sell.

This premium decay is measured by Theta, which is one of the "Greeks" that is readily available on most option platforms. If a call option is trading at \$11.50 (total value is \$1,150.00) and the Theta is 53.80, then this option is losing \$53.80 in premium every day. That is, the \$11.50 option is losing more than 50 cents per day just in premium. To put this in perspective, if the underlying stock traded sideways for three days and didn't budge in price, this option price would plummet to \$10.00, a loss of \$150.00 per contract, even though the stock hasn't budged. If this option had a Delta of 0.50, then the stock would have to move up \$1.00 a day just to keep this option at the same price. Even more brutal, if the stock drops \$2.00 today, but has a fierce \$3.00 rally the next day, your option is back at . . . merely breakeven. The closer an option gets to expiration, the higher the Theta—that is, the faster the premium erodes. This is critical to keep in mind, and it's why buying far-out-of-the-money call options a few weeks out from expiration is such a low-probability event.

That is also why selling options is so attractive. They literally lose value every day, and that value goes to you. The only problem in selling options is that the risk of loss is great should the stock have a big move against you. You could literally have 15 winning trades in a row and then get wiped out on the very next trade if you're doing this wrong. The way around this risk is to initiate what is called a *vertical spread* closer to the money. Yes, one and two standard deviation spreads have a greater chance of working out, but in many situations, you're are risking 10 to make 1 or even 20 to make 1. It works great right up until it doesn't. When you are at-the-money, you're generally risking 1.5 to make 1, with the same premium decay benefits. Spreads are attractive because a trader doesn't have to be "dead right" to make money on the trade. I'm not going to spend a lot of time on this concept because there are entire books written on the subject, but we can learn enough here to be dangerous. Let's take a quick look.

If we revisit the GS trade from [Figure 4.3](#), I could have initiated a bullish vertical spread on this trade to lessen the risk. I could have still purchased the \$155 calls at \$7.30, but instead of having a \$2.00 stop based on the underlying movement of the stock, I could at the same time have sold the same amount of \$160 calls at the then-current price of \$3.80. Remember, this out-of-the-money call is all premium, and the ants are eating away daily at that juicy peach. It is losing value each day. Because of this, had the GS position traded sideways for a few days, I could still have closed out the position for a small profit, making money on the premium erosion. I could also have done the following:

1. Legged in to the same spread as described earlier, instead of initiating it all at once. That is, I could have bought in-the-money calls initially, and then, when the squeeze signal finished the next day, stepped in and sold out-of-the-money calls against it, creating a fixed-risk debit spread. Once the signal finishes, a stock will generally trade sideways for a few days. The small price spurt gooses the IV, thereby increasing the pricing on the out-of-the-money calls. In other words, it's a good time to sell them. Ideally, the stock then trades sideways for a few days, and I'm able to close out both legs of the trade for a profit.

2. Sold a naked at-the-money or one strike out-of-the-money put, buying it back when the squeeze signal was done. The risk with this is if GS receives bad news (for example, an SEC investigation) and drops \$20.00 a share quickly, this trade can get very ugly very fast. When in doubt, just do this same trade as a spread and you can sleep better at night. In fact, let's discuss that next.
3. Initiated a vertical bull put credit spread. Once the squeeze signaled a long trade, I could have sold an at-the-money put and then bought an out-of-the-money put. This is like strategy 2, except that now I have downside protection in the event of a disaster.

This list could go on and on. The more a trader knows about option strategies, the more he or she can do with this, but I want to emphasize that it's not necessary to make this that complicated.

With the advent of weekly options on most of the actively traded stocks, a unique opportunity has been created. I personally like to buy an in-the-money monthly option, and then each week initiate a vertical spread by selling an out-of-the-money weekly option against it. This is called a *diagonal*. There are times when a trader can sell a weekly option each week for three or four weeks and have it expire worthless each week. During this entire time, the trader can still hold on to the monthly option and end up closing it out for a gain as well. It's the best of both worlds. Holding a deep-in-the-money option is like owning a piece of real estate. Selling the weekly options against it is like collecting rent on your property every week. It beats working for a living. When buying options, even if you plan to be in the trade for a few days, always give yourself the gift of time. Most of my two- and three-day trades are done on options that expire in 30 days or more. Why? The premium decay is minimal.

A final note for those of you who are interested in commodity options: these take a while to get your arms wrapped around if you aren't used to them. Whereas one stock option represents 100 shares of stock, one commodity option represents just one futures contract.

For pricing, just take the current price and multiply it by the multiplier of the underlying futures contract. For example, if you see that an at-the-money call option on the E-mini S&P 500 is trading at 52.25, multiply 52.25 by \$50.00 (the per point price), and you get a price of \$2,612.50. This means it would cost you that much to buy the call option, which represents one futures contract. Of course, you could buy the actual futures contract for about the same price. This is why I'm not crazy about futures options. You might as well just buy the actual futures contract.

Commodity options do have their place. They are good for hedging a futures position, and for anticipated bigger moves (like a weekly squeeze, as discussed in [Chapter 11](#)), where it makes sense to buy an out-of-the-money option. Otherwise I'll tend to stick to the actual futures contract.

Now that you understand how all these different futures and options markets work and the trading opportunities that they represent, it's time to move on to market internals. Let's jump in and review what I start looking at with the opening bell of the regular stock market session.

For more information on options, visit [www.simplertrading.com/options](http://www.simplertrading.com/options) 101 for free access to a class that covers the basics and will help you build a foundation. We have lots of free tutorials on difference concepts and strategies, free nightly market recap videos, as well as premium services that provide ongoing, real-time market commentary. In addition, you can sign up for market and trade alerts that go right to your cell phone through our Simpler Trading app. Many of our clients listen to our market commentary during the day while

they're at work, right through their cell phone and a headset. They also enable notifications so that any new trade pops up on their cell phone. The trades are for educational purposes only, so you can get a sense of what we're seeing and what we're doing. Any trading decisions you make are still your own.

It's what I wish I had when I was working full time in corporate America, trying to manage the markets and my job at the same time. What are other traders seeing and doing right now while I'm stuck in this meeting? Is this sell-off buyable or are other traders bailing and going short? It's helpful not to be alone in those situations and to have somewhere you can get an alert or some feedback from your fellow traders.

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*May the odds be ever in your favor.*

SUZANNE COLLINS, THE HUNGER GAMES

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## The Stock Market Is Now Open— What Tools Best Predict the Market’s Next Move?

*Unless you enter the tiger’s den, you cannot take the cubs.*

JAPANESE PROVERB

### Musicians Know How to Read Music; Can Traders Learn How to Read the Markets?

Although I originally wrote this chapter for people who focused on day trading stock index futures or exchange-traded funds (ETFs), these tools have become an indispensable part of my swing stock and option trading as well. They help keep me in positions when my brain is telling me to bail and to get me out early when I’m dead wrong. They protect me from further losses and, in some cases, from being momentarily overtaken by my ego. “It’ll turn around, just hang on,” is the trader equivalent to, “hold my beer and watch this.”

For traders who truly want to get a feel of the markets and understand the ebbs and flows and what “should” happen next, this chapter is for you. Is this sell-off something to be concerned about? Do I need to bail on longs here or add to my position? Is the market about to crash? Is a violent short-covering rally about to take off? Is it going to be a “chop-fest” all day? These are the kind of questions that the internals can guide the trader through. Are these important if you’re an end-of-day trader or a longer-term investor? For the daily ebbs and flows, no, since they won’t factor into a longer-term approach. However, it’s still helpful to be aware of extreme readings, what they look like, and their resulting implications. As I’m writing this in February 2018, we just experienced a series of extreme readings as a couple of leveraged short-volatility funds blew up. The internals helped us get out well before the meltdown and then catch some of the resulting volatile moves, both to the upside and the downside. We’ll look at examples from this week shortly.

The internals are the language of the market. In 2005, I took my first trip to Asia, acting as a consultant with the Chicago Board of Trade (CBOT). After visiting Taipei and Hong Kong, we landed in Tokyo. I discovered that I loved Asia and couldn’t wait to explore this amazing city. One morning, I woke up at 5:00 a.m. to check out the Tsukiji fish market, where they auction off tuna, offer 480 different types of seafood, and sell an average of \$15 million worth of seafood each day. I had to see this for myself. I hopped in a taxi from the hotel, and spent a few hours touring the market. I grabbed some amazing sushi in a nearby stall before flagging a taxi to head back to the hotel, where I had to get ready for a conference in which I was due to speak before a large audience in a few hours.

Once in the taxi, I said, “Imperial Hotel, please.” The driver shook his head and replied in Japanese. This

went back and forth a few times before I realized he had no idea what I was saying. Worse, beyond a few words like “thank you” and “hello,” I didn’t know any of his language. We stared at each other for a few minutes like a pair of rams about to butt heads. Remember, this was before iPhones and Google maps, let alone Uber. Was I going to miss the conference? Anxiety seized me. I could already feel the embarrassment sizzling my skin like a nasty sunburn. I’d certainly never be invited back.

The driver motioned for me to get out of his taxi. I realized that wasn’t going to help my situation in any way, shape, or form, so I stayed put and started to think. Luckily, I’d read the book *Shogun* by James Clavell a few years earlier, and remembered the story referred to the imperial ruler of Japan as the Taiko. I tried, “Taiko Hoteru?” The driver immediately smiled and off we went, back to the hotel.

I learned two things from this incident, besides wishing I’d taken Japanese in high school and questioning the wisdom of touring a fish market in a foreign country immediately before an important talk with the knowledge of only two words in their language:

- *First, if you don’t understand the language, you’ll be able to get by, but you’ll be at a disadvantage.* In trading, this means not fully understanding the moves that are taking place on your screen and getting whipsawed. While in Hong Kong and Taipei many of the taxi drivers spoke at least some English, but this wasn’t the case in Japan.
- *Second, never venture out without a homing beacon.* In trading, this means having a pre-planned exit strategy. When wandering around a foreign land where you don’t speak the language, this means grabbing a hotel business card with the address printed in the local language. With this knowledge, my subsequent visits to Asia fared much better.

It’s the same with trading and investing. By taking the time to understand the language of the markets, it will be much easier to navigate your way through the maze and find your way home.

With the internals, the only drawback is that there are a lot of them and it’s easy to get analysis paralysis or get caught up in the noise. There are two things to remember here:

- *First, more data does not equate to better decisions.* This has been proven in numerous studies. What happens is that as we get more data, our mind latches onto the data that confirms our bias and discards the data that refutes it. In other words, more data causes our performance to suffer as it unwittingly gives us permission to impose our worldview on the markets. If you’ve ever shaken your head and said, “These markets make no sense,” then you’ve been a victim of this phenomenon. *The markets always make sense.* It’s our worldview that isn’t in sync. It’s a blow to the ego, for sure. The realization that the markets are always right—and that we have no idea what’s going to happen next—is the winning formula for trading consistently.
- *Second, the markets spend a lot of time meandering back and forth.* As traders, we’re interested in knowing when conviction is in the air, as that’s what kicks off the bigger, sustained moves. The internals represent the frontline of this knowledge, giving us the heads up as well as measuring the strength of that conviction. The trick is to look at just a few of the key internals, recognize the patterns, and track the extremes.



Not understanding the material in this chapter and then going on to trade the stock indexes intraday is like not knowing how to swim and then trying to qualify for the 100-meter backstroke at the Summer Olympics. Although I'll swing-trade almost anything, a large percentage of my intraday trading is confined to instruments that reflect the underlying readings of the internals. There's a good reason for this. There's a ton of data available during the trading day that will show a trader what's happening behind the scenes in the stock markets.

The Euro? Not so much, as there are no internals that measure other asset classes in this way. By understanding how to read and interpret these data, a trader will have a better feel of whether the pressure in the markets is on the buy side or on the sell side; this helps the trader make trading decisions accordingly. There are plenty of traders out there who only have the vaguest idea of how to interpret these tools, and an even larger group of newbies who has no clue that the tools even exist. This represents a large pool of cash that's ripe for the plucking, and knowledge of this information gets traders closer to the front of the handout line.

There's another critical reason for thoroughly understanding this material. Every single trading day is going to present both setups on the long side and setups on the short side. By understanding how to interpret these internals accurately, a trader will know the following:

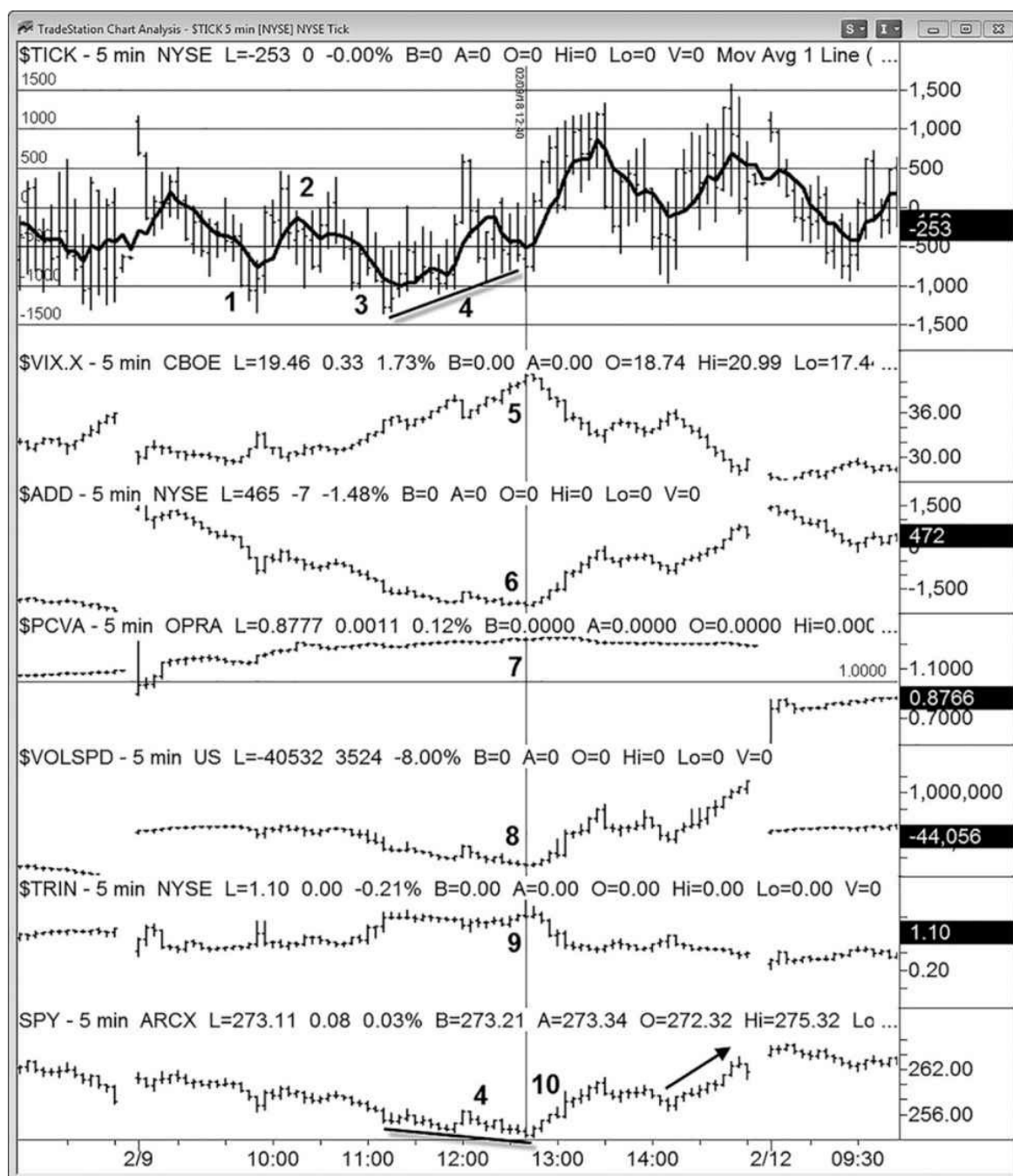
- Which days to ignore all short setups
- Which days to ignore all long setups
- Which days to focus on setups that do best in choppy markets
- Which days to focus on potential huge reversals, either up or down

This knowledge is critical and has a big impact on whether a trader is going to have a winning day or a losing day and, as the weeks and months progress, an upward-trending equity curve or something that's, well, less amusing to your spouse. Let's get started.

Before we dive into the individual components, let's look at what a big reversal looks like. Once we understand what can trigger an extreme move, it helps us better understand normal days and normal readings. Some of my best trading days happen after my first trade or two get stopped out. I may start the day focusing on the short side, get stopped out, and, because of the strength of the internals, just reverse and "go with the flow."

Figure 5.1 shows an example of an extreme short-covering rally in the middle of the day on Friday, February 9, 2018. These are my favorite trading days, as short-covering rallies are the best kind of up move to catch. When shorts get spooked, they're willing to get out at any price. This, combined with traders trying to establish new long positions, drives the market up very quickly, all against the backdrop of "bad news." Although it's difficult to see the extent of the rally on this small chart with all the internals, here are some stats on a move that started at 12:40 p.m. CST and lasted 55 minutes before a meaningful pause: S&P 500, +79 points; the Nasdaq, +230 points; Dow Jones, +736 points; and AMZN, +77 points. In a quiet market, these are moves that take months, not minutes. Being able to identify that this type of move is setting up and is going to last is a huge advantage to the full-time trader. Let's look at the day's activity.

Figure 5.1



1. The markets started the day with strong selling, with the markets down 30 S&P points early in the session, and the \$TICK hitting -1,336, an extreme reading.
2. The markets try to bounce. The tick readings test the +500 level, with the 5-period simple-moving average staying below zero. This is bearish, showing a lack of enthusiasm on the buy side.
3. Here the \$TICK makes new lows on the day, but this time it hangs out at these levels, which means the selling pressure is intensifying. Note that the 5-period moving average makes new lows and even gets to -1,000, which is rare. The markets continue to sell off, with the S&Ps now down nearly 60 points on the day.

4. While the markets are making new lows, something interesting takes place at point #4. While the S&P is making a lower low, the \$TICK is making a higher low. This is a huge bullish divergence, and a heads up that the market may be getting ready to turn around.
5. I added a vertical line on the chart to mark the key turning point. At point #5, the \$VIX (CBOE Volatility Index) rolls over and starts to fall, while the \$TICK makes new highs on the day, tagging the +1,000 levels. Is it a quick flash in the pan? Each time the \$TICK tests the zero line, it pops back up to new highs. This only happens when there is huge, sustained buying pressure. This is what scares shorts, and this is where we start buying in earnest. Anyone waiting for a pullback will get left behind.
6. At point #6 the \$ADD (the number of advancing stocks less the number of declining stocks), which had been dropping all day, starts to turn and push higher.
7. The \$PCVA (the combined equity and index put/call ratio) at point #7 has been well over 1.0 all day, setting the stage for a short-covering rally. I'll talk more about this indicator shortly; but when it is well over 1.0, it means there are a lot of people short, which sets the stage for a trap.
8. The \$VOLSPD (S&P 500 Up-Down Volume Difference), which is similar to the \$ADD, also starts to push higher in a big way.
9. The \$TRIN (Short-Term TR INdex or Arms Index) starts to drop rapidly.
10. The SPY (Spider) rallies hard, catches its breath, and then pushes new highs into the close.

Although this compressed chart doesn't do the move justice, this is a textbook example of what to look for in terms of a major upside reversal on the day. Typically, the news will only be negative, so any rally would seem "out of the blue." As a bonus, short-covering rallies, after their initial pause, will typically see another push higher into the close, and this day did not disappoint, with the \$TICK making a higher high and the \$VIX continuing to push lower. Hanging on to trades like this is one of the hardest parts of trading. Learn to recognize the winners. Then just ride them until the screaming stops.

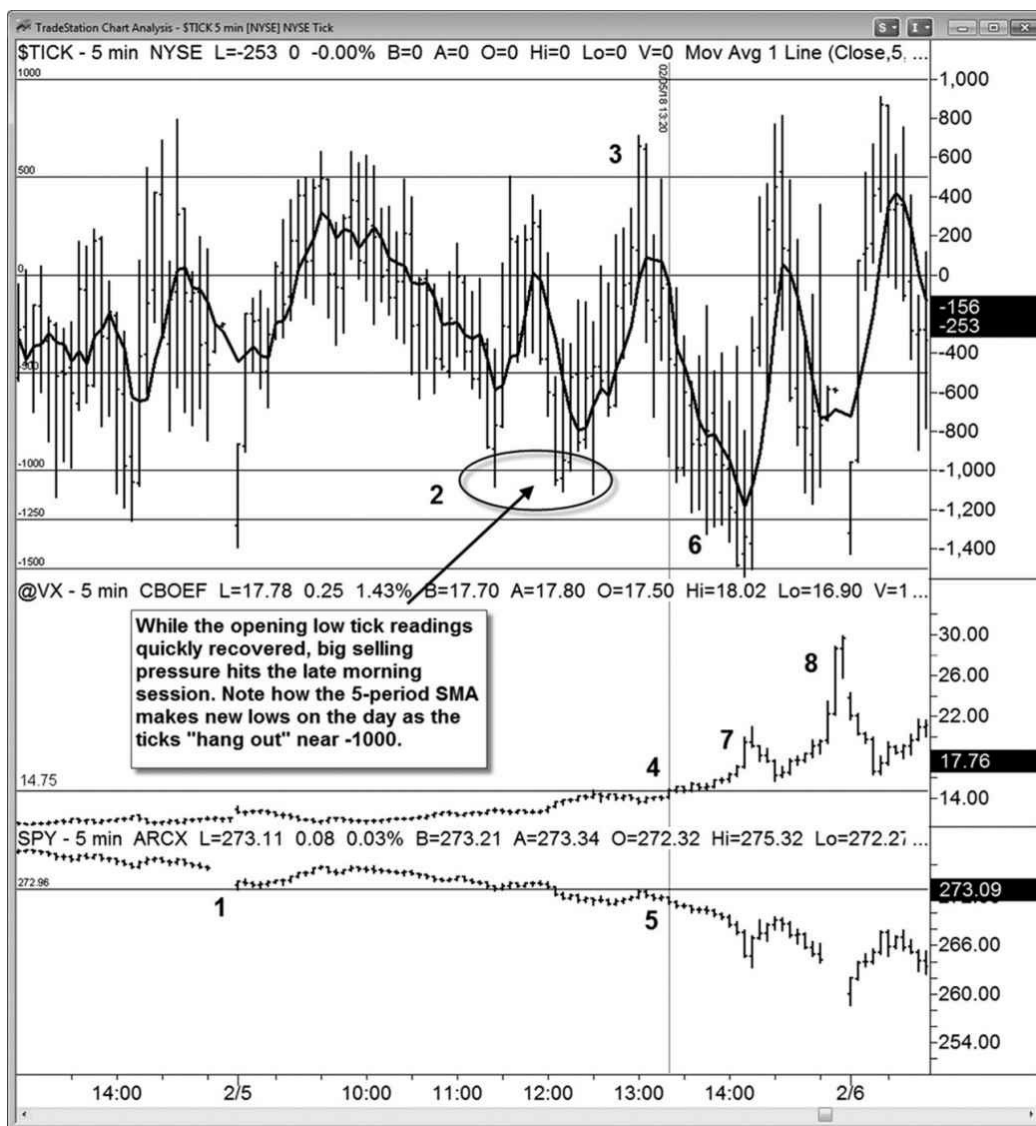
The moving average on the five-minute \$TICK chart is a 5-period simple-moving average. I don't always use it, but it can be helpful for newer traders as well as on days where the action is fast and furious. This helps to provide a visual of where the tick is "hanging out." There's a big difference between a quick spike up to over +1,000 ticks versus staying up around these levels. It's rare for this moving average to cross the +500 or -500 levels. When it does, it means there's sustained pressure in the markets. For example, at point #2, the ticks spike up to +600, but the moving average stays below zero. Whereas to the right of the vertical line, the moving average crosses +500 and stays there for 30 minutes. This is a very rare occurrence and shows incredible conviction on the buy side, most of it in the form of panic from shorts scrambling to get out of their positions. To the left of the vertical line, the sell-side conviction was high, and the moving average spent plenty of time below the -500 level. In this situation, I never buy the dip.

These are the moments that define a trader's job, which I equate to, "Sitting under a tree with a fully-loaded gun, waiting for your next meal to walk by." When we chase mediocre opportunities out of boredom, we squander our bullets—both our real and psychological capital. By the time our unsuspecting prey comes walking past the tree, we're out of ammunition and miss the opportunity. This means we're out-of-the-money

to trade, or, more likely, we're mentally spent and unfocused, so we miss the signs and miss the move, realizing what happened only when it's over.

In Figure 5.2, we have the opposite extreme, with the markets selling off hard a few days earlier on February 5, 2018. In this chart, I've removed some internals so we can better zoom in on the two I find most important, the \$TICK and the \$VIX. With this one-day move, measuring the day's high-to-low levels, we had the following stats: S&P 500, -168 points; the Nasdaq, -426 points; Dow Jones, -1,786 points; and AMZN, -139 points. These were big moves to be sure, and something the market hadn't seen since the late-August 2015 mini-flash crash.

Figure 5.2



1. This chart has all the classic elements of a panic day. First, it's a Monday, a favorite day for extreme moves. Second, the markets fell apart on Friday, with the S&P 500 closing down 65 points, breaking multiple key support levels, and closing at their dead lows of the session. This left a lot of traders nervous over the weekend. The day kicked off with a large gap down, as seen at point #1, with the

S&P 500, as represented by the SPY, down 25 points.

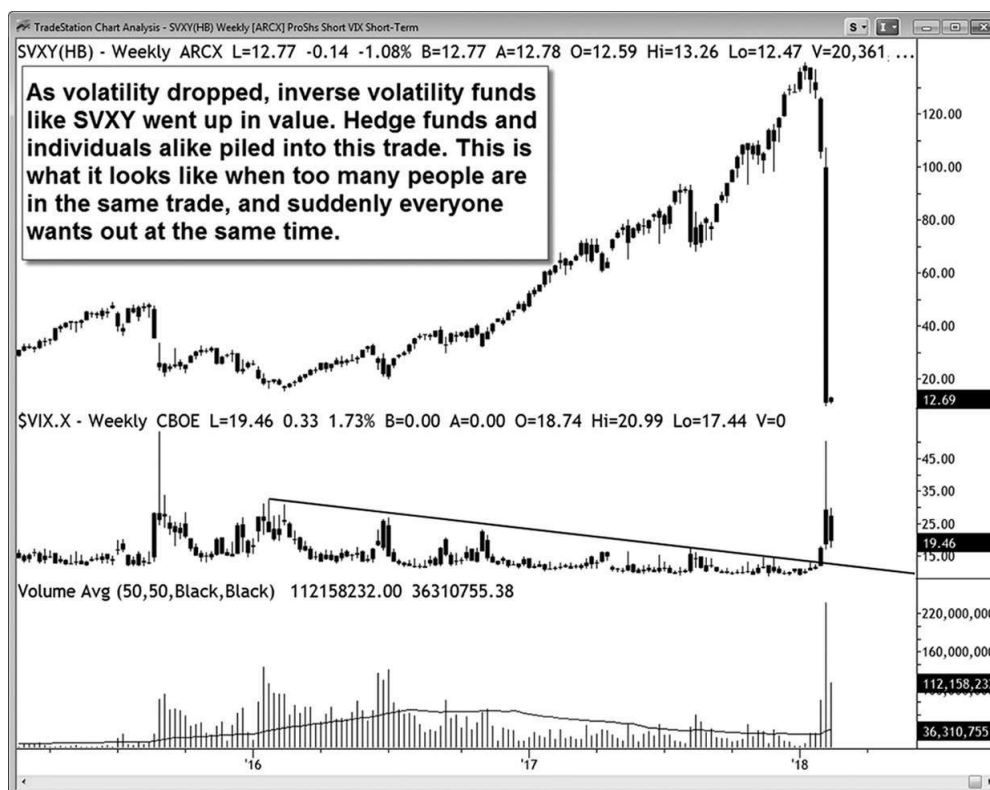
2. The markets quickly recovered, filling their opening gaps. This head-faked the people who held short over the weekend, flushing them out of their positions. (Remember, the markets are an equal opportunity dream killer.) However, the \$TICK quickly lost steam. Not only couldn't it get above the +500 level to indicate real buying, it gradually rolled over, hitting -1,000 levels at point #2. Although the ticks pushed back up to +500 quickly, the 5-period moving average couldn't get above zero, and the next rollover revealed the intense selling pressure taking place behind the scenes. Note here how the ticks hung out at these lower levels, with the 5-period SMA (separately managed account) hitting new lows on the day.
3. At point #3, the ticks tried one more time, pushing past +500 again, but the markets languished.
4. When there's real panic in the market, the \$VIX moves first as traders buy these contracts to hedge. At point #4, the \$VIX futures make new highs on the day. This is a huge red flag that all is most certainly not well in candy land. When I saw this, I cut the rest of my longs loose and focused on the short side.
5. With the \$VIX making new highs, the markets roll over, making new lows on the day. There are no bullish divergences between the tick readings and the SPY prices. This is an indication that things are about to get much worse.
6. Shortly thereafter, at point #6, the ticks made new lows, and stayed there. The only time I've seen the \$TICK hang out around -1,250 and push to -1,500 for an extended length of time is when a panic or a crash is *about* to hit the market. I say, "about" because although the markets were already down a considerable amount by that point, the real selling hadn't even started yet. This is why you never buy the dip on days like this. The internals are practically screaming, "This is not a normal day. Something big is about to go down."
7. Panic is starting to set in here as the \$VIX pops higher.
8. The selling pressure in the \$TICK and spike in the \$VIX lead to a mini-flash-type crash in the markets, where, in a matter of minutes, we saw AMZN drop \$80, and many other stocks had similar percentage plunges. The markets closed near their lows of the day and experienced a large gap down the next morning.

On this day the \$VIX futures started off around 12, which was on the high side, since it had spent most of January trading between 10 and 11 in a record low-volatility environment. By 12:00 p.m. CST it had pushed through 15, and then started to accelerate. When the \$VIX is making continued higher highs in a consistently negative \$TICK environment, something's blowing up. Don't bother looking to the news, because they have no idea what is going on.

As it turns out, everyone that had been making money shorting volatility (betting that the \$VIX would stay low) was getting squeezed. Inverse ETFs (exchange-traded funds) such as SVXY (ProShares Short VIX

Short-Term Futures ETFs) and XIV (VelocityShares Daily Inverse VIX Short-Term ETN) blew up overnight, losing 95 percent of their value and bankrupting traders and hedge funds who'd been minting money shorting volatility for the past year. One thing that doesn't stand out in Figure 5.3 is the extent of how trapped these traders were. SVXY sold off hard on Monday, dropping from 105.60 to 71.82. If that weren't tough enough, the next day its opening trade was at 11.70. This is the kind of overnight gap-down move that stop losses can't fight, and it destroyed everyone following this strategy. (See Figure 5.3.)

Figure 5.3



The key point here is that none of this was evident during the trading day to most traders. What had happened didn't become clear until well after the market closed. The internals tell us what's happening now and what's about to happen next from a factual standpoint. It doesn't care what the reasons are; it just recognizes behavior and calls it out. "Something really bad is happening here. No clue what it is, but someone is blowing up." Meanwhile, the news is there to entertain us as the *Titanic* slides into the Atlantic.

### Great, Now How Do I Learn to Read the Internals?

While it's critical to understand the signs of an extreme day, which results in extreme moves, the internals are also useful on days where the action is quiet. These are the ones I like to watch:

1. \$TICK: Measures the cumulative buying and selling pressure and conviction for the NYSE (New York Stock Exchange) and other equity markets. I'll also cover a few more tick-related tools, but this is the main one I watch.
2. \$ADD: The number of advancing stocks less the number of declining stocks.

3. \$VIX: It's meant to track the market's expectation of 30-day volatility and is often called "the fear index."
4. \$PCVA: The combined index and equity put/call ratio.
5. \$VOLSPD: The difference between the amount of volume trading above or below yesterday's closing prices.
6. \$TRIN: Also known as "the Arms Index," it tracks the number of advancing stocks and divides that by the number of declining stocks.

Of all the internals I watch, the NYSE \$TICK is my favorite. If the markets are a party, this is the disk jockey (DJ), reflecting most accurately the immediate mood of the market participants. It summarizes the number of stocks on the NYSE that are increasing in price versus the number that are decreasing in price from the previous price quote. Yes, there are also \$TICK readings for the Nasdaq, S&P 500, Russell 2000, and so forth, and I've spent time watching them all. What I discovered is that they all basically move the same, and watching one is much easier than watching six. Using the DJ analogy, this indicator tells us if the party is a rave, if everyone is chilling over cocktails, or if there's a fire in the building. Alerts on this indicator work great, so there's no need to stare.

This brings us to the first rule I follow when watching the ticks:

Any tick reading in between -400 and +400 is noise and should be ignored.

This means that there's no conviction in the market. This can happen during specific times, like the lunch hour, or the day before a large economic report, where everyone's sitting on the sidelines, waiting for the event to take place. For stocks to move, we need conviction from either buyers or sellers. I start paying attention to the ticks whenever readings are over +600 or under -600. If the readings exceed these levels and hang out above or below those zones, conviction is in the air. The larger the number, the more intense the pressure being applied to the markets. These types of readings indicate that a sustained move is underway. If we get sustained readings of +800 and I'm already long, I'm comfortable. If I'm short, on the other hand, I start to realize I might be on the wrong side of the market, and, assuming these readings are sustained, can get out before my stop-loss is hit.

How I handle these readings depends on the trades I'm in and those I'm looking to setup. If I have longer-term trades based on the weekly charts, then I'm not going to let one day's worth of activity impact those positions. However, if I have shorter-term swing trades in place that typically last a couple of days, I pay attention to this indicator. The real key here is to recognize a spike versus conviction. A spike is usually what happens. The markets are quiet and, boom, we get an extreme reading that lasts for a few minutes, and then it heads back to the zero line. Not a big deal. However, if I get a spike that lasts a few minutes, eases back a bit, and then hits a new, higher level, then conviction is in the markets.

For example, let's say I own call options on Facebook (FB) and the ticks hit -1,000, hangs there for a few minutes, eases back to -500, and then rolls over to hit -1,200. In this case, I'll look to close out my position, even if it hasn't approached my predetermined stop. The DJ is telling me the mood of the party has turned sour, and it's time to leave.

This indicator is also useful for day trading the stock indexes, whether it's a futures contract or an option on instruments like the SPY and the QQQ ETF, as well as their individual components. This brings us to my second rule in using the ticks for day trading:

If I'm long intraday and my stop hasn't been hit and the markets generate a tick reading of -1,000, bounces back to -500, then rolls over and makes a new low, I'll close out my position at the market.

Similarly, if I'm short and the markets generate a tick reading of +1,000, pulls back to +500, then pushes up to new highs, and my stop hasn't been hit, I'll close out my position at the market.

Readings this high with minimal retracements are telling the traders loud and clear that, on an intraday basis, they're either right or wrong, depending on their position. If I'm short, and the market is telling me that I'm wrong through continued tick readings of +1,000, I take the hint and close out my trade. This used to be an emotional occurrence. "Damn this market," I'd yell, taking the move against me like a knee in the groin. I remember days where I would continue to follow my conviction, shorting the whole way up. "There's no way the market can keep going. This is a bubble." Over time, I've learned to let my convictions go. It is what it is, and the ticks helped me to learn and understand that by helping me cut things loose well before my ego had a chance to step in and destroy my account, all for the sake of possibly being right. Don't fight the mood of the party. If everyone's dancing, it's ok to jump on the table and let out a primal scream and a shout. If, on the other hand, they're holding a seance and the candles are snuffing out, that would be inappropriate and might get you hurt. This also has the additional benefit of increasing a trader's risk/reward ratio, as it's possible in many instances to get out of trades early that would otherwise have been stopped out for the maximum loss.

I want to make one thing perfectly clear before I move on: *I never exit a trade early just because "I think I'm wrong."* I've learned the hard way over many years of trading to stick to my original parameters—what I think has absolutely nothing to do with what might happen next. With the tick readings, I've designated a specific, measurable event that alerts me to get out of the trade early. A sustained tick reading of +1,000 or -1,000 is one of these specific events. My decision to get out of a trade early has nothing to do with gut feel or interpretation—I've already discussed in [Chapter 2](#) how woefully inadequate human beings are at making objective decisions while they're in a trade. Luckily, there's no way around a sustained tick reading of +1,000 or -1,000. Either the markets are hanging out at that level or they're not. Either we're on the right side of this, or we're not. If we're not, shut up, reverse, and try not to back over the curb. There's no emotion involved.

I'm emphasizing this point because I've had the opportunity to sit next to many traders who come to visit me at my trading office. We trade next to each other, side by side, for one week. For the first two days, it's straightforward and low key. I do my trades; they do their trades. It may seem relaxed and laid back, but there's a very specific reason I do this—I can learn more about people in one day by watching them trade live, with their own money, than I can learn about them through normal conversations over the course of five years. By merely talking, people put their best face forward—the image that they think they are or should be. However, when their money is on the line, this façade lasts about 12 minutes, and then the underlying, dominant personality springs forth. Sometimes I meet Mr. Hyde.

Working like this with many other traders, I've seen firsthand the reason that most people never make it in this business. In the final analysis, most traders are atrocious at managing their exits. This isn't entirely



their fault. Their minds are consumed by emotions that have been repressed for years. Repressed emotions always seek an outlet. Trading is often the only time they get a chance to be heard, and they'll interfere with your results. I'll probably mention this book a few times. I highly recommend *Letting Go: The Pathway to Surrender* by David R. Hawkins. The first few chapters are eye opening and potentially life changing.

This is indisputably the one thing that prevents most people from making a living as a trader. To put it simply, many traders manage their exits based on how they feel about the trade. Worse, if they're down on the day, they'll manage trades differently from the way they do when they're up on the day (because, of course, they want to be "right" and make money on the day), and they don't even realize this. To illustrate this point, there are many times when I'll take a trade, and they'll take it with me. We'll get into the same trade at exactly the same time and five minutes later, I'll see them selling out half their position. Of course, I'm perplexed by this because they said, "JC, I'm going with you on this next trade." The ensuing conversation goes something like this:

**Me:** Steve, I thought you said you were going to follow me on this one. Did you just sell some of your position?

**Steve:** Uh, well, no, I . . .

**Me:** I heard the software execution platform say, "Sell."

**Steve:** Oh, that, yeah, well, I'm selling some here to book gains.

**Me:** Why? The stock has only moved up 20 cents and our target is two dollars.

**Steve:** (accusingly) Didn't you say it was an excellent idea to scale out of your position as it goes your way?

**Me:** Yes, and two dollars from where we are right now is our first target where, if we get there, we'll scale out of half our position and trail up our stop. Remember when we discussed that like 15 minutes ago?

**Steve:** Uh, yeah, but the ticks dropped, telling me I was on the wrong side of the trade.

**Me:** The ticks are only at -350. Remember, to exit early we are looking for -1,000, an extreme reading, then a bounce, and then a push back to lower levels.

**Steve:** But they fell to -650 and I didn't want to lose that gain.

**Me:** No soup for you.

As a matter of faith, I let these traders try to convince me that they're justified in their actions, but my eventual goal is to get them to admit to what they're doing. They're selling because they're nervous, scared, excited, or whatever, and that surge of emotion is what made them push the button. In other words, there were no rational reasons for them to take the action that they did. But there were certainly plenty of repressed emotions screaming to be heard.

Trading is an extremely private world for most people, with friends and spouses kept totally in the dark about the emotional ups and downs that traders feel and experience every trading day. Getting a trader to admit what's really going on internally is like trying to pry open a walnut with your fingers. It's challenging because most traders are masters at masking their true emotions. Whether a trader is up \$25,000 or down

\$25,000, many times the outside world will never know. I've been there, and I know the feeling.

Armed with this knowledge, I go on the “friendly attack” and eventually get most of them to fess up. I don't pull any punches. I tell them that no one's ever going to understand their trading journey like another trader. Speak now or be stuck in your rut forever. Usually this works, and it gets traders to talk about and confront their trading demons; this is Trading Therapy 101. In addition to repressed emotions, a lot of feelings traders experience stem from focusing on the *fear* of the unknown, rather than focusing on the *risk* of the unknown. Fear destroys. Risk can be controlled.

The next thing I'm looking for in the ticks is if they hit levels beyond +1,000 or -1,000. This is the most important level of the day for two reasons:

1. *This level usually represents the maximum amount of sustained buying or selling pressure that the market can handle.* It's like a sprinter getting to the end of a 100-yard dash and having to stop and gasp for breath.
2. *This level represents a specific new trading opportunity.* When these extreme readings are first hit, they set up a “fade” play that I follow. If we get a tick reading of +1,000 ticks, I'll set up a day-trading short. If we get a tick reading of -1,000 ticks, I'll set up a day-trading long. I discuss this play in detail in [Chapter 9](#), and it's intended as a quick scalp-type play.

Often, especially if the market is quiet, an out-of-the-blue buy or sell program will hit, causing the tick to hit these extreme levels and then quickly retreat, which creates a great shorter-term trade. However, keep in mind that if the tick goes over these extreme levels, and then hangs out there for more than a few minutes, this is a sign that something much bigger could be in the works.

This brings me to the third rule I use with the ticks:

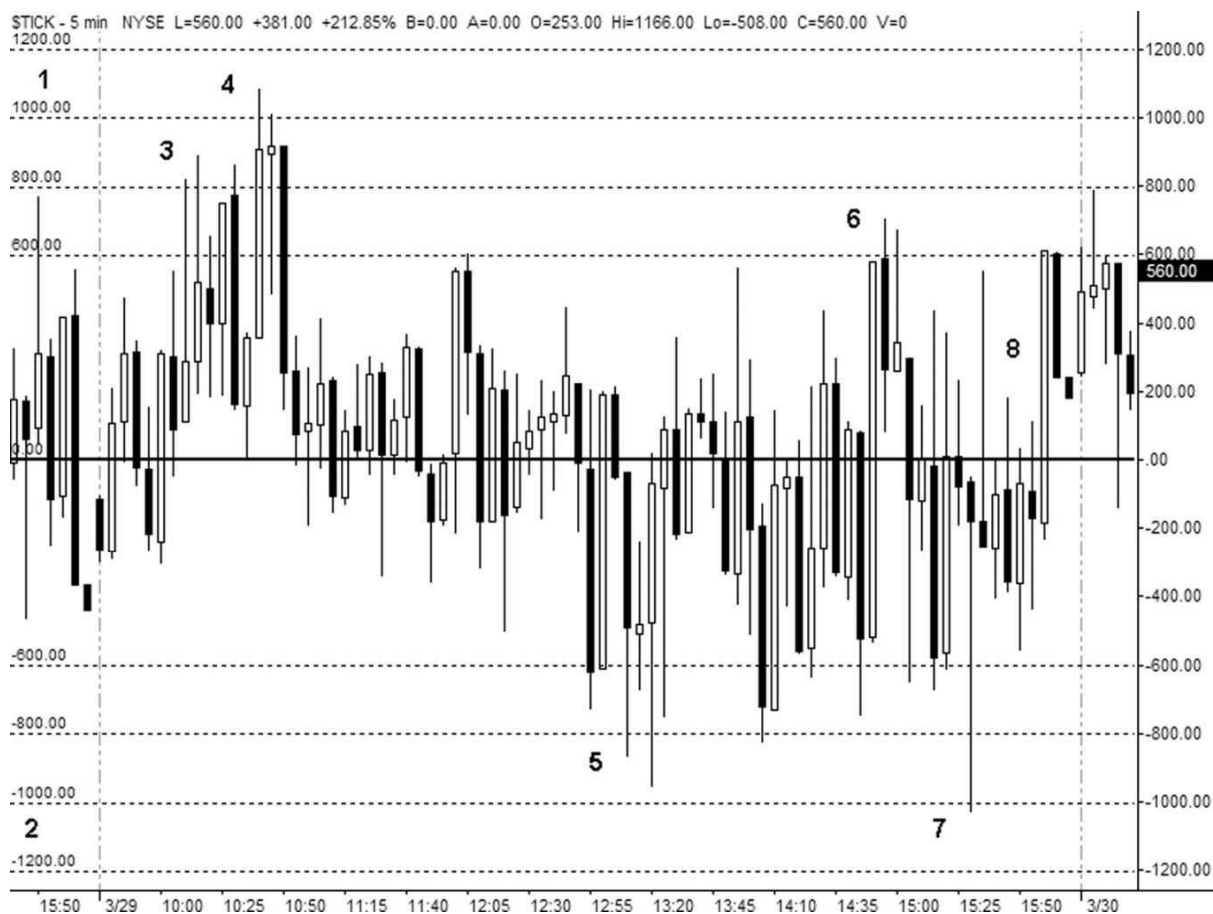
If the markets are quiet and we suddenly hit +1,000 ticks, I'll use that as a signal to fade (short) the market move.

Under the same circumstances, if we suddenly hit -1,000 ticks, I'll use that as a signal to fade (buy) the market move. The first test of these levels is often a head fake.

This may seem contradictory to what we just talked about. “I thought you said you'll close out your longs if we get sustained tick readings below -1,000 ticks?” Most of the time, a high tick reading is short-lived and presents a trading opportunity. The key is to recognize the times when it's turning into something bigger, with shallow retracements and higher readings that “hang out” at those levels, with the 5-period SMA crossing the 500 levels.

[Figure 5.4](#) is a snapshot of the ticks from March 29, 2005. Although this book is a new edition, some of these examples are timeless, and the ones that made the cut. This is how I have them set up on my TradeStation charts. I use a five-minute chart, but the interval isn't important. The key for me is that I want to be able to see a full trading day worth of data.

**Figure 5.4**



All the charts you see in this book have a white background. This is for printing purposes. When I'm watching these on the screen, I set the background to black, and the chart colors are usually green for up moves and red for down moves. Some of the charts in the electronic versions of this book have been converted to color.

In this chart, we can see at points 1 and 2 that there are horizontal lines placed at +1,200, +1,000, +800, and +600 ticks, and at -1,200, -1,000, -800, and -600 ticks. These horizontal lines serve a very specific purpose, which brings me to my fourth rule in using ticks:

- I set up audio alerts at all the key tick levels. This way I don't have to stare at the chart, and I never miss a move.

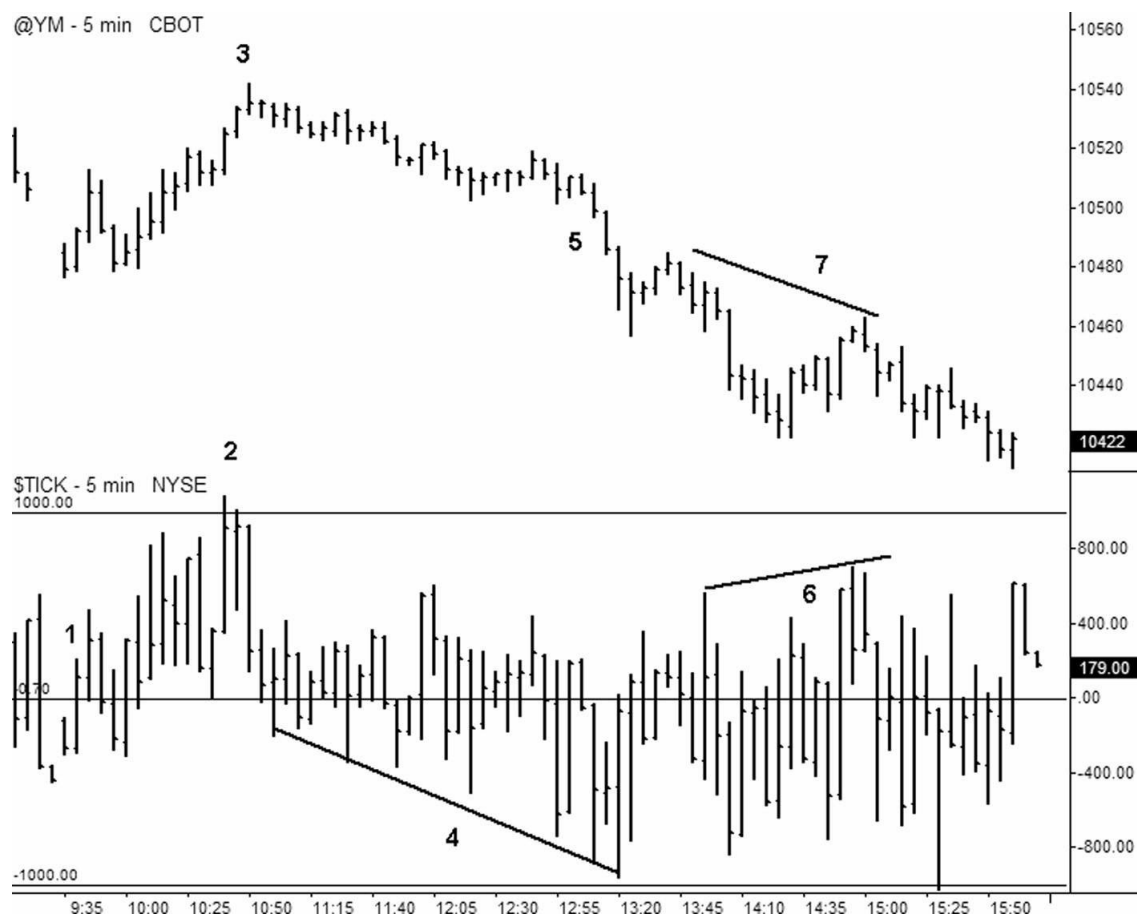
These audio alerts are a key part of my trading plan. I used to have them starting at the 600 levels, but that turned into too many alerts, so now I start them at the 1,000 level. I can be on the phone, down the hall, or in the bathroom, and I'll hear if the ticks make a move. Remember that at the 1,000 level, I take action; so I don't want to miss it. Yes, there have been times when I've had to initiate a new trade with my pants around my ankles, modesty be damned, as I'm stumbling out of the bathroom. These days I've worked toward a more automated approach, though in the past I've made these alerts halfway entertaining. For a while, when the ticks hit +1,000, I heard Daffy Duck screaming, "I'm rich! I'm rich!" and when the ticks hit -1,000, I heard the Wicked Witch from the *Wizard of Oz* crying, "I'm melting! I'm melting!" The alerts today are currently just beeps. Alas, the adolescent has become a man.

I want to point out that I specifically use a bar chart or a candlestick chart for anything related to audio alerts. Another popular chart, the “line on close,” is also good when watching the ticks, because it helps to show traders when they’re rolling over or “hooking.” However, these types of charts can, and do, miss many audio alerts because the line is literally created on the close of the bar and misses the high and low fluctuations, which is what sets off the audio alerts.

In this chart, we can see what I would call a typical, sloppy, and choppy day. The readings spent most of their time between +400 and -400. At point #3, we get a quick move up to +800, followed by a retest of the zero line, followed by a quick thrust towards +1,000. This is a very typical pattern that leads to false breakouts and a quick move back to the chop zone. As traders, we want to recognize what’s going on and not chase the non-conviction-type price action.

Between about 10:30 a.m. EST and 12:30 p.m. EST, nothing happened. The ticks were twitching back and forth like a freshly caught tuna on a boat deck. At around 1:30 p.m. EST, the action picked up enough to the point where the ticks registered a reading of -800, and they even hit -1,000 later in the day. This replicated almost exactly to the downside what happened earlier to the upside. Let’s look at this same chart with the actual market action overlaid on top of it. (See [Figure 5.5](#).)

**Figure 5.5**



1. The ticks are quiet at the open, showing a lack of conviction either way. At point #1 we can see that the ticks just flopped back and forth for the better part of an hour. The markets did a whole lot of

nothing during this time.

2. By 10:25 a.m. EST, we get the first notable tick reading at +800, and this drives the markets higher, with the ticks eventually hitting +1,000. (Remember, this is a shorting opportunity discussed later in the book.) At this point, had the ticks pulled back, and then made a higher high at +1,200, then that would signal the start of a possibly much bigger move. Instead, they quickly moved back to the zero line and stayed there, showing the lack of willingness to follow through. This is what a probe looks like.
3. The mini-sized Dow futures hit 10,542 when the ticks moved over +1,000, and this ended up being their dead highs of the day. Once the ticks quiet back down, the market moves toward the path of least resistance, as stop-loss orders are hit from everyone who got long chasing the move higher.
4. I like to watch how the markets react when the ticks start stair-stepping and making higher highs or higher lows. The ticks shot up to +600 at around 12:00 p.m. EST, but the markets didn't move higher. Yet when the ticks started making lower lows, so did the market. This is key information. If high ticks of over +600 can't move the markets higher, then that's a tip-off that the selling pressure is predominant.
5. This series of lower lows in the ticks leads to an eventual steep sell-off. The market generally works up to "abrupt" rallies or sell-offs, and the ticks can clue a trader as to which way the "out-of-the-blue" move is likely to be. It's almost like a pressure cooker, because the steam eventually needs to be released before the lid explodes.
6. Here we see the ticks make higher highs, forming an uptrend.
7. Yet when the ticks made higher highs, the YM (mini-sized Dow futures) made lower highs. This is a bearish divergence and a signal that the rally can be sold because there isn't enough "juice" to get things rolling.

There are rare days when the markets rocket higher and keep on going, or gap down and keep on selling. On these days, consistent extreme tick readings are generated, usually in the neighborhood of 1,200 to 1,400. These consistent high readings are rare, but when they happen, I don't fight them. This brings me to my last rule regarding the ticks, which I take into account after 10:30 a.m. EST and watch throughout the day:

- When the ticks spend 90 percent of their time above zero with repeated extreme high tick readings, I ignore trading short setups all day and focus on longs.
- When the ticks spend 90 percent of their time below zero with repeated extreme low tick readings, I ignore trading long setups all day and focus on shorts.

The ticks are a great way to see what's going on "underneath" the price action. The charts can tell you if prices are going higher or lower, but they can't tell you if the buying or selling pressure is merely fleeting or unrelenting. Leave that job to the ticks. As an update to this chapter, I've found that I've been increasingly using this indicator in more and more of my swing trading. On days when the ticks are repeatedly hitting +1,000, I'll use any pullbacks to the 0.00 line as buy entry opportunities, either for new longs or to add to

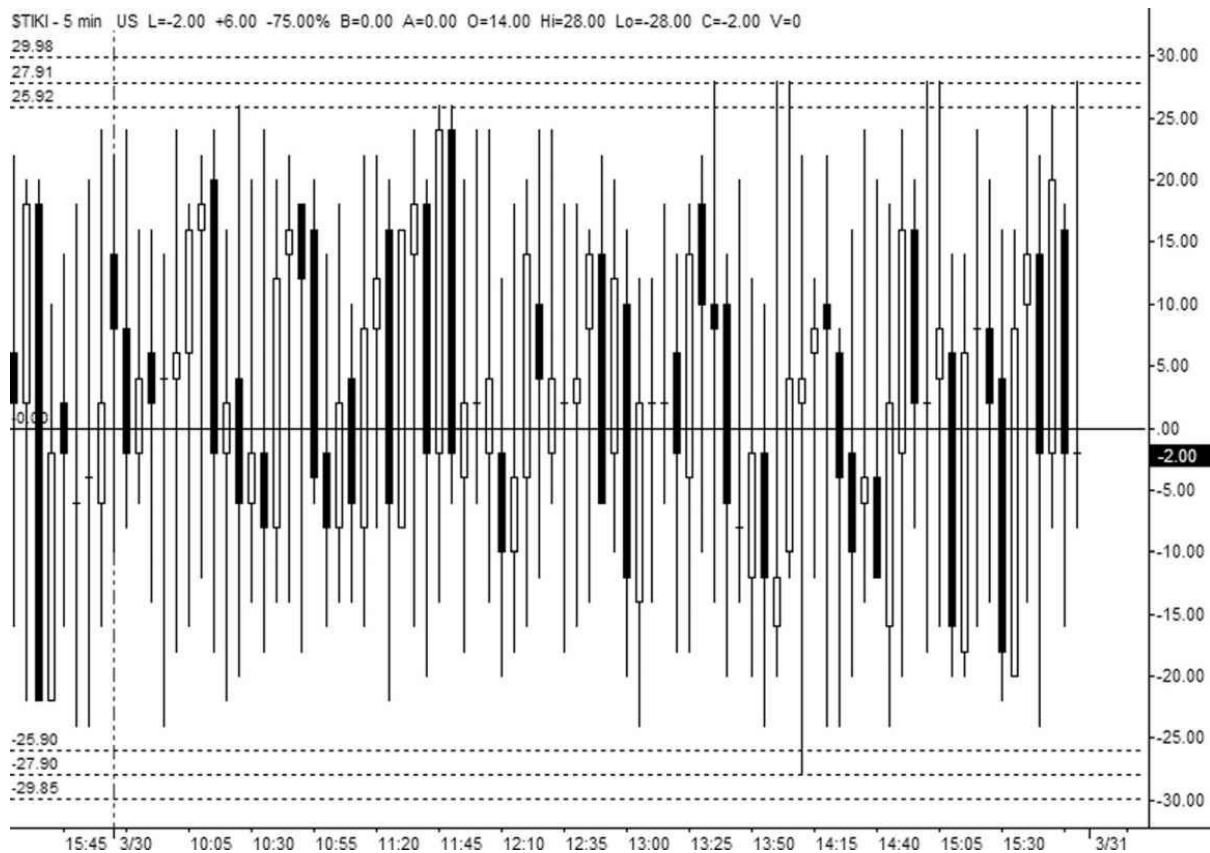
longs I already have. For example, I might have call options in Alibaba (BABA) and I'm looking to add more at specific levels. However, this tick action tells me the markets are about to take off, so I go ahead and pick up the rest of my long calls when the ticks pullback to the 0.00 line, instead of waiting for the specific price level I'm watching.

The opposite is also true. On any days when selling is brisk and we are getting repeated -1,000 tick readings, I'll use any rallies in the ticks back to the 0.00 line as shorting opportunities. Even better, these tick readings help a trader to stay in a trend. For example, if I'm short, and each time the ticks rally back to 0.00 they get pushed back down, I'll just stay short until we get a +600 reading. The opposite, of course, is also true. This is imperative on those occasional runaway days where the S&Ps are up or down 30 or more points. These kinds of days don't happen often. The tick helps us to identify and maximize these opportunities.

### What Is the Fastest Heads-Up That Stocks Are About to Make a Move?

The tiki (TradeStation symbol \$TIKI) is similar to the tick, but it measures the net upticks versus downticks on the 30 Dow Jones Industrial Average (DJIA) stocks instead of the entire New York Stock Exchange (NYSE). Because this reading follows only 30 stocks, it's the first thing that fires off when a buy or sell program hits the markets. (See [Figure 5.6](#).)

Figure 5.6



Tiki charts are filled with noise, and at first glance they look useless to watch. The key with them, however, is to set up alerts the same way as for the ticks. On the tiki, I set up alerts to fire off at +26, +28, and

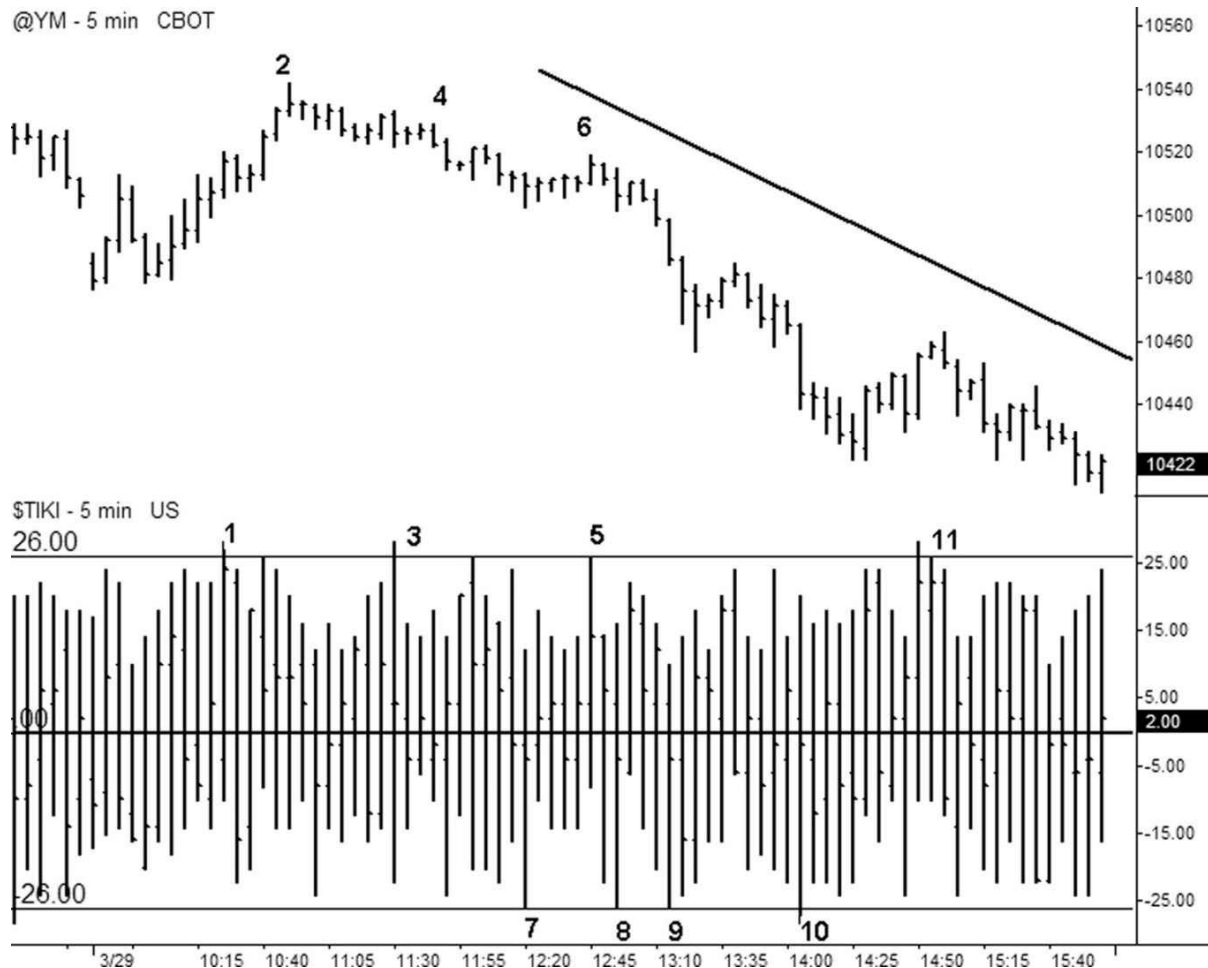
+30 on the upside, and -26, -28, and -30 on the downside. When buy or sell programs hit the markets, these alerts fire off instantly. In general, small programs generate the 26 level, medium programs hit the 28 level, and massive programs hit the 30 level; this means that all 30 Dow stocks are moving in the same direction. These readings are rare and highlight significant and sustained periods of buying or selling.

Surprisingly, I don't use these signals for any actionable exit strategies. If I'm short, and a tiki level of +28 is generated, I'm probably wrong on the move, but I'll wait until the ticks get to +800 before I exit. This is because a buy or sell program can be swift and over in a blink, causing the tiki movement to be erratic. This brings me to my first rule with the tiki:

For exits, tiki readings are only the heads-up; ticks are the confirmation.

Figure 5.7 shows the tikis on March 29, 2005. When comparing this to the ticks, the first thing that's evident is that the tiki looks like it's all over the place and hard to read. However, upon closer inspection, immense value can be found.

Figure 5.7



1. I always like to see what type of program hits the market first—a buy or a sell program. This represents the first real “try” of the day, and I want to see how it pans out. In this chart, the first program of the day is a buy program that hits at 10:25 a.m. EST.

2. This sends the Dow to new highs.
3. The next program is also a buy, and it hits at 11:30 a.m. EST.
4. However, this time the Dow does not make new highs, but in fact continues to drift lower. This is a heads-up that “even a buy program” can’t move the market higher.
5. There’s another buy program at 12:45 p.m. EST, and this one is after the first sell program hit the markets.
6. This buy program causes a small pop in the markets; but this buying dries up quickly.
7. At points #7, #8, #9, and #10, a series of sell programs hits the market, and each time a sell program hits, the markets make new lows. When this happens, the next opposing signal is a fading opportunity.
8. At point #11, there’s an opposing signal with a buy program—an opportunity to go short.

This brings me to the second and third rules I use in following the tiki:

If buy programs are driving the markets to new highs, then the occasional sell program is a buying opportunity.

If sell programs are driving the markets to new lows, then the occasional buy program is a shorting opportunity.

I like to see where most of the programs are hitting. Are they mostly buy or mostly sell programs? This is important, because most of the time markets are doing nothing. They’re chopping back and forth. If most of the programs on the day are buy programs and these programs are pushing the markets up to new highs, then I want to use the quiet selling opportunities to get long. This way I’m getting into the market when it’s quiet, *before the next move higher*, instead of chasing it higher. A good example of a setup that works well in this situation is the pivot plays that I discuss in [Chapter 8](#).

### What Is the Best Tool for Reading Buying Versus Selling Pressure?

The trin (TradeStation symbol \$TRIN), also known as “the Arms Index” after its creator, Richard W. Arms, measures the relative rate at which volume is flowing into advancing or declining stocks on the New York Stock Exchange. To calculate the trin, the following formula is utilized: (advancing issues/declining issues) / (advancing volume/declining volume).

If more volume goes into advancing issues than into declining issues, the Arms Index falls below 1.0.

If more volume goes into declining stocks than into advancing stocks, the Arms Index rises above 1.0.

Most educational material on “how to use the trin” tells traders that “over 1.0 is bearish, so consider shorting, and under 1.0 is bullish, so consider buying.” That statement is annoying and misleading, and it brings me to my first rule when using the trin:

I don’t care what the current reading is.

I care about the current reading only in relation to where it has been.



In other words, what I care about is not the trin reading itself, but the *trend* of the trin. A reading of 1.50 might seem bearish, but if the reading started the day at 2.00 and we're now an hour into the trading day and 1.50 is the low, this is bullish. This means that volume is flowing into advancing issues and that there's sustained buying pressure in the markets. Conversely, a reading of 0.85 might seem bullish, but if the reading started the day at 0.45 and we're now two hours into the trading day and 0.85 is the high, this is bearish. This means that volume is flowing into declining issues and that there's sustained selling pressure in the markets. Let's look at [Figure 5.8](#).

Figure 5.8



1. [Figure 5.8](#) is a shot of the mini-sized Dow on March 29, 2005, the same day we used for the tick and the tiki. At point #1, we can see that the trin started the day near 1.40. The first 15 to 20 minutes are volatile, as listed issues open on a delayed basis on the NYSE. Because of this, I dismiss the first five-minute bar, but I like to note the opening levels based on the start of the second five-minute bar.
2. The trin settles in, and by 10:40 a.m. EST it's trading near its lows of the day at 0.81.
3. The YM hits its highs of the day in correlation with the low trin reading.
4. By 12:00 p.m. EST, the trin has been in a steady uptrend, making new highs on the day (after discounting the first five-minute bar).

5. The YM is quiet and choppy, and it's trading in the middle of the day's range. However, even though the markets are quiet, the trin continues to rally. This is the key action I'm looking for—which way is the trin trending? A trend higher indicates that volume is flowing into declining issues, and this means that when the market actually breaks, the odds are strong that it will be to the downside. As we can see on the chart, a little later in the day, the market breaks down.
6. The YM tries to rally here, but it's in vain, as the trin is staying in a nice uptrend. The YM soon rolls over and drifts down into the close.

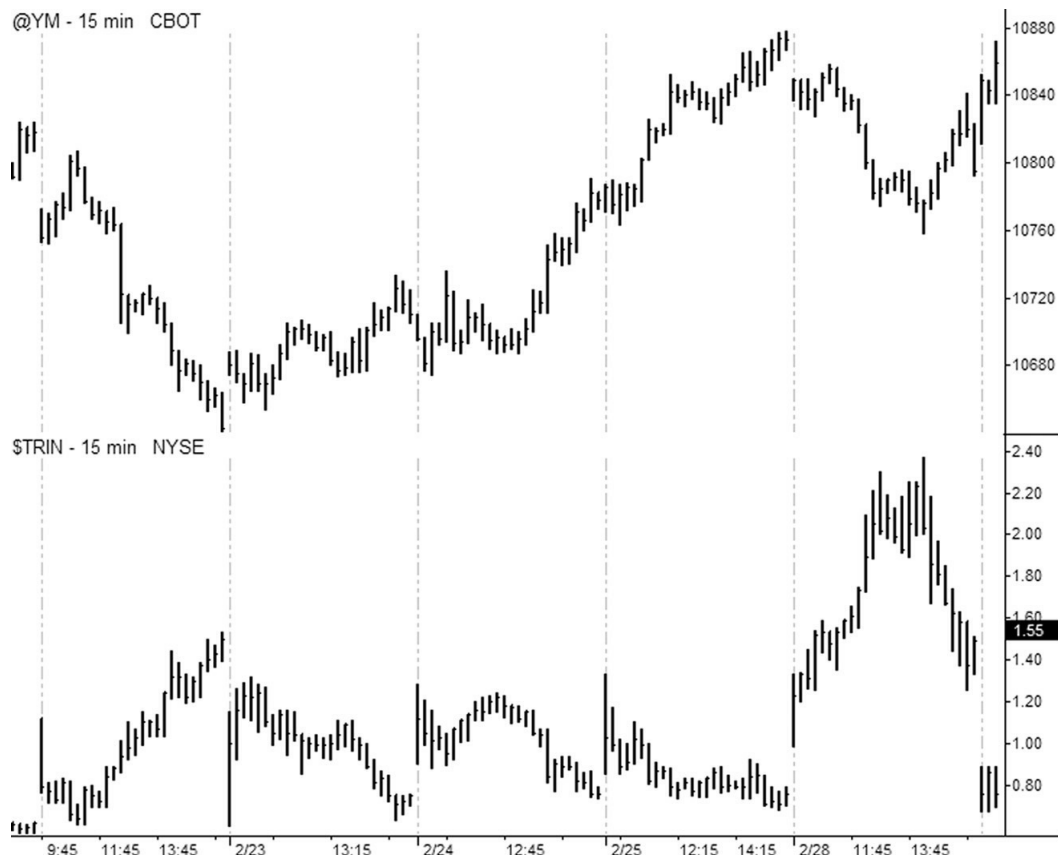
This brings me to my second rule for the trin:

If the trin is trending higher and making higher highs on the day, I'll ignore all long setups.

If the trin is trending lower and making lower lows on the day, I'll ignore all short setups.

Let's look at another multi-day chart and the trin action. (See [Figure 5.9](#)).

**Figure 5.9**



[Figure 5.9](#) shows a good overall representation of what various trin patterns mean. On the first day, February 22, 2005, the trin started off low. Some would call this bullish. Yet the trin then proceeded to rally all day long, and the Dow fell more than 120 points. The rule of “no longs on this type of day” serves a trader well. Conversely, if I'm in a short and the trin is making new highs, I realize that there's no reason to cover, as the eventual market break has a high probability of being in my favor.

On February 23, 2005, the trin started off high, but then proceeded to trend lower all day long. Although

many traders will get caught up in the previous day's selling and use this initial strength as a shorting opportunity, they'd realize the folly of this idea if they knew that they should follow the trend of the trin. With the trin heading lower, the markets stabilized early in the session, and a modest rally ensued. Because the trin continued to make lower lows on the day, I just focused on long setups.

On February 24, 2005, the trin started off high once again, then proceeded to spend the rest of the day grinding lower. Based on this, I ignored short setups on the day. The YM broke nicely higher later in the day. On February 25, 2005, the trin once again started off high and spent the day working lower.

Finally, on February 28, 2005, the trin started off high but moved higher. While it was making new highs on the day, I ignored long setups and focused only on short setups. During the last two hours of the trading day, the trin reversed, and the markets rallied into the close. The most bullish days are gap ups where the trin starts off low, say around 0.50, and stays at that level all day long. On such a day, it doesn't trend lower because it can go only so low and it won't make it to a zero reading. The sustained lower reading looks like a consolidation pattern on a chart, and it's extremely bullish. On these types of days, I ignore all short setups, and a breakout to new highs is a buying opportunity.

The key with the trin is to watch to see if it's making new highs on the day or new lows on the day. Whenever this is happening, I just ignore the opposing setups. I've read that some people recommend using levels such as 1.50 as "oversold" and start looking for a bounce, or 0.50 as "overbought" and start looking for a sell-off. I'm not a fan of oversold or overbought, and I generally ignore this with most indicators. The trin intraday is no exception. The biggest rallies take place when the trin hovers under 0.50 all day long. Just because something is overbought doesn't mean that it's going to reverse. For reversals, I'll look only at price action. I discuss these types of setups in later chapters.

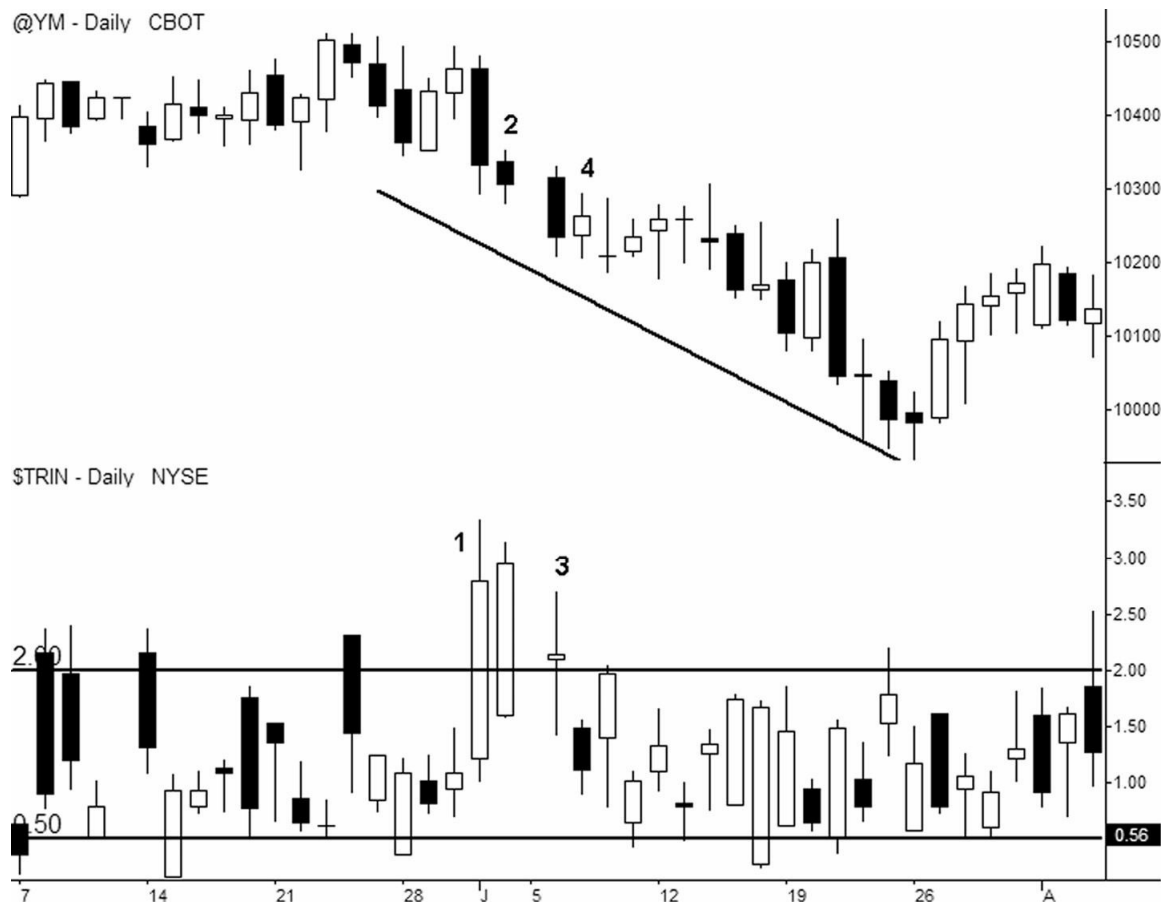
Although I'm not a big fan of overbought and oversold in general and I don't worry about overbought or oversold readings intraday on the trin, I'll pay attention to where it closes on the day. This closing number is valuable when it comes to gauging an extreme overbought or oversold reading. These readings are rare and happen about a dozen times a year. This brings me to my third rule when using the trin:

If the trin closes above 2.0, the market has an 80 percent chance of rallying the next day.

If the trin closes below 0.60, the market has an 80 percent chance of selling off the next day.

The moves the next day won't necessarily be big moves, but they'll generally be opposing moves. I'll keep this in mind as I'm viewing my setups the next trading day. If the previous day's close was over 2.0, then the next day I'm going to focus more on long setups and ignore short setups. Here's where it gets interesting. If after a 2.0 reading, the markets can't rally on the next trading day, then the markets are in deep trouble and are setting up for a major slide. This happened during the first week of July 2004. (See [Figure 5.10](#).)

**Figure 5.10**



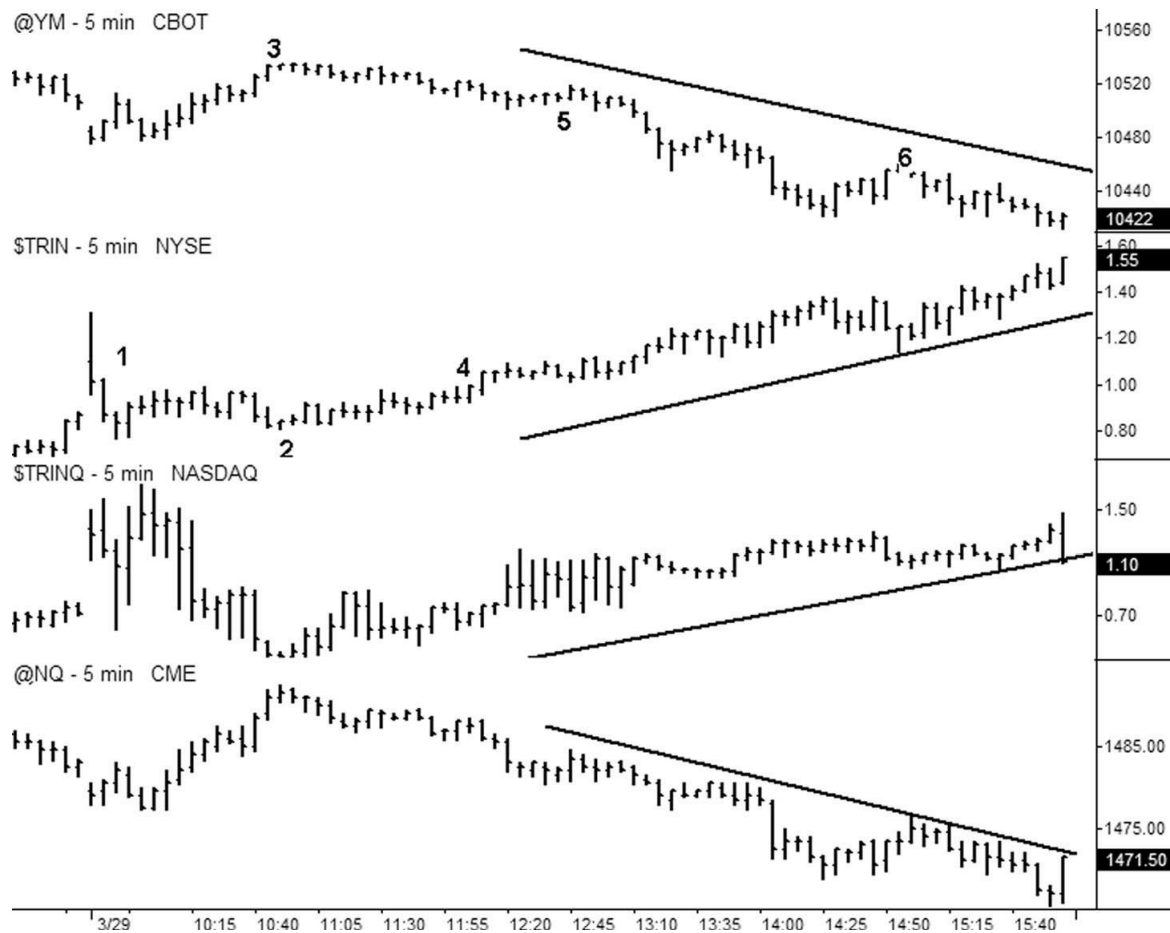
On this daily chart of the trin and the mini-sized Dow, the trin closed on July 1, 2004, with a reading of 2.80 (point #1). The next day, the markets tried to rally early in the session, but ultimately collapsed and ended lower on the day. This is always an ominous sign, and the Dow went on to lose 673 points before bottoming out on August 6, 2004. On July 6, 2004, the trin closed at 2.12 (point #3) and the Dow managed to rally the next day (point #4), but the bulls' moment of glory was short-lived. This same scenario unfolded during the second trading day of 2005, January 4, when the trin closed at 2.53. The next day, the markets couldn't rally, and they ended up selling off 410 points through the rest of the month.

### Is There a Similar Tool Just for Nasdaq Stocks?

The trinq (TradeStation symbol \$TRINQ) is just like the trin, except that it's for the Nasdaq. The same rules apply here—all I'm interested in is the trend of the trinq.

Figure 5.11 is the same chart we were looking at on March 29, 2005, but I've added the trinq and the Nasdaq. With the trinq going higher, the Nasdaq is going lower. In general, I place more weight on the trin, but I like to see what's happening in the Nasdaq as well. There are times when the trinq will be the leading mover, making new highs or new lows before the trin. On days where the trinq is mixed and the trin is trending, I'll pay more attention to the trin. The strongest moves in the market occur when both the trin and the trinq are moving more or less in alignment.

Figure 5.11



### Put/Call Ratio—Is This the Key to the Kingdom?

As a trader, what would you give to be able to know what the rest of the market participants are doing at any given time? If a broker told me that he could provide me with that information every day, I'd be so appreciative that I might even let him charge me \$25 a round turn for an E-mini futures contract. While a secret report isn't going to magically appear in your inbox, the put/call ratio (TradeStation symbol \$PCVA and referred to during the rest of this section as PC) is as close to having this information as a trader is going to get.

The *PC ratio* measures how many put options are bought relative to call options. The formula is very simple to calculate: take the volume for puts and divide by the volume for calls. (For anyone unfamiliar with options, *buying a put* is making a bet that the market is going to fall, and *buying a call* is making a bet that the market is going to rise). If there are 50,000 puts sold and 100,000 calls, the ratio is 50,000/100,000, or 0.5. If there are 125,000 puts sold and 85,000 calls, the ratio is 1.47.

There are three main PC ratios that are generated throughout the day: the equity PC ratio, the index PC ratio, and the combined equity/index PC ratio. The *equity PC ratio* is generally very low, which reflects a retail crowd that tends to favor the long side (more call buying). The *index PC ratio* is usually very high (more put buying), which reflects an institutional mind-set that wants to stay hedged against any unexpected lower moves. The *combined equity/index PC ratio* reflects the behavior of both of the above groups, and gives a trader the best gauge of what the overall market participants are thinking and, more importantly, where they're placing their bets. It's this combined equity/index PC ratio that I watch during the trading day.

To illustrate how I use this indicator, let's assume that the market is made up of exactly 100 participants. Let's further assume that all 100 of these people are bearish on the markets, and that because of this prevalent feeling, they have established short positions in stocks, ETFs (exchange-traded funds), and index futures, as well as through the buying of puts. With all 100 market participants bearish and now short, a very interesting turn of events takes place. There's nobody left to sell. With nobody left to sell, the markets don't have any downward pressure, and they start to drift higher. This drifting eventually hits the first set of stop orders placed in the market by the 100 market participants who are short. Within any given group of traders, some will be using tight stops, some medium stops, and some wide stops. The group of tight stops gets hit first, and this generates fresh buying pressure in the form of short covering that drives the markets higher, right into the next range of stops. This next series of stops kicks off yet another short-covering spree, which, once triggered, drives the markets even higher into the next range of stops, and so on until all the stops are taken out.

At this point, the 100 market participants get bullish, and they start buying stocks and index futures, as well as call options. Once they have all scrambled to establish their positions, a very curious thing takes place. There's nobody left to buy. With nobody left to buy, the markets begin to drift lower and take out the first set of tight stops, which in turn creates enough selling pressure to drive the markets down to the next set of stops, and so forth. It's a vicious cycle.

Obviously, this is a simplified scenario, and in the real world, not every single market participant is going to be bullish or bearish at the exact same time. However, the amount and intensity of bullish bias and bearish bias do fluctuate regularly, and this shift in attitude causes markets to move in a fashion related to the oversimplified scenario just described. This brings me to my first rule regarding the PC ratio:

If the combined equity/index PC ratio reaches over 1.0 intraday, I'll ignore all short setups and start looking at long setups.

A PC ratio of over 1.0 represents extreme bearishness and put buying, and, as a result of the scenario just described, places a floor in the markets. It's not an immediate floor. When the ratio goes to 1.0, the markets don't suddenly stop declining and then immediately rally. It's a process, and a visible support level does take shape because of the simple fact that there are too many bears in the market, and lots of buy stops sitting overhead just waiting to be taken out. These 1.0 readings usually happen when the markets have fallen for many days in a row, or when bad earnings or economic data hit the tape, suddenly infecting many market participants with a bearish outlook. In fact, many times a market will continue falling until the PC ratio gets over 1.0. The opposite extreme is also true, which brings me to my second rule regarding the PC ratio:

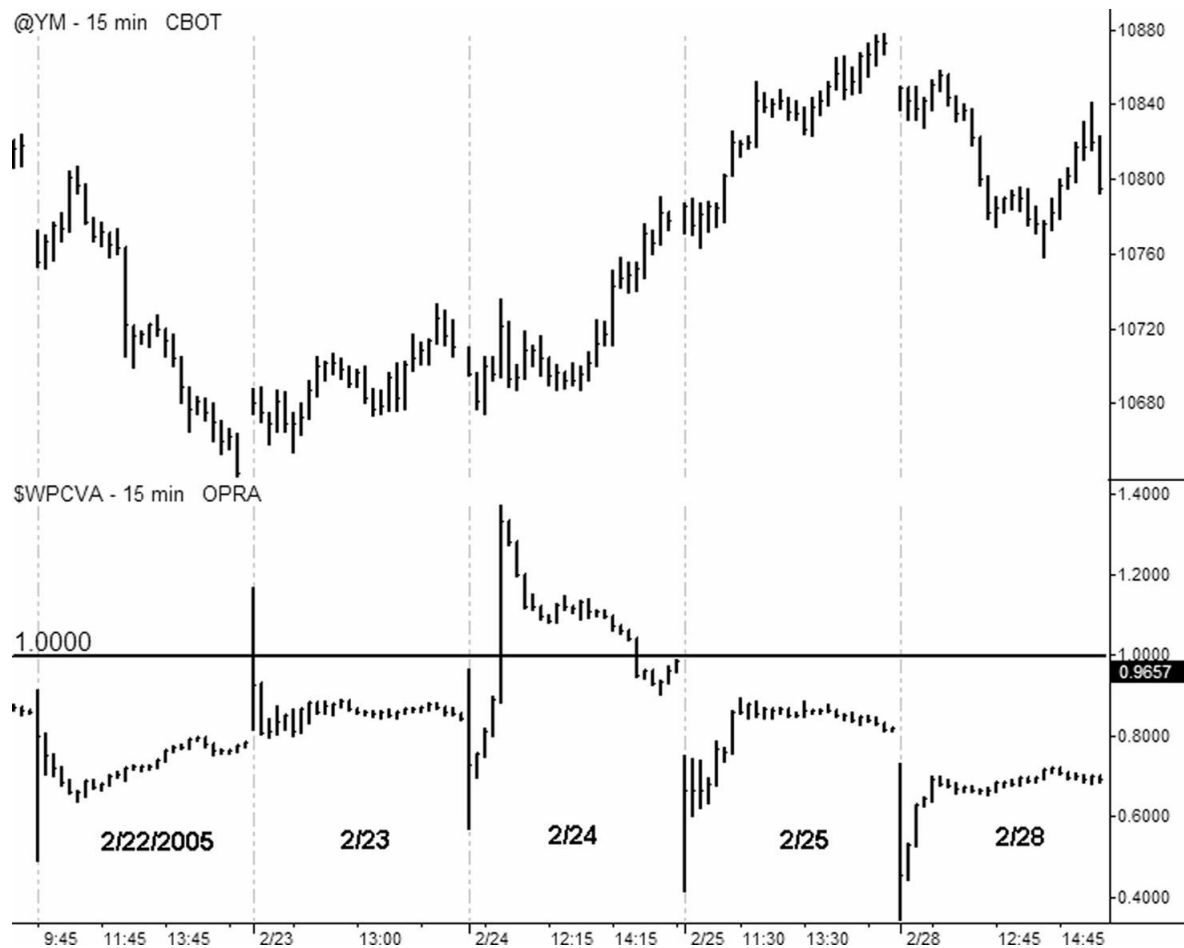
If the combined PC ratio falls under 0.60 intraday, I'll ignore all long setups and start looking at short setups.

A PC ratio of under 0.60 represents extreme call buying and puts a ceiling on the markets. This represents a scenario in which there are too many bulls and very few people left to buy. Now there are lots of sell stops sitting beneath the current levels, just waiting to be hit. This usually happens after the markets have rallied for many days in a row, or after seemingly great earnings or economic news hits the tape. Also, people who have missed the move start chasing it for fear of being left behind. In fact, many times a market will continue rallying until the PC ratio gets under 0.60.

Figure 5.12 is a 15-minute chart that shows the mini-sized Dow overlaid on top of the equity/index PC ratio. On February 22, 2005, the PC ratio stayed low most of the day, dipping below 0.60. This represents a

bullish outlook and the buying of stocks, index futures, and calls. This placed a lot of stops below the markets, and the Dow subsequently sold off over 120 points to clear them out.

Figure 5.12



On February 23, 2005, the PC ratio spent a little time over 1.0. This represents a bearish outlook, the establishment of short positions, the buying of puts, and the placing of many stops above the market. This was enough to kick-start a modest rally into the close, as the overhead stops provided the fuel for the market rally.

On February 24, 2005, the PC worked itself to an extreme high reading, while the markets gapped down and stayed under pressure early in the session. However, with so many people bearish and with so many buy stops sitting above the markets, the market had little choice but to rally. On February 25, 2005, the PC started the day low but quickly rallied and stayed near 0.80 for most of the day.

On February 28, 2005, the PC started off low and spent nearly an hour under 0.60. This meant that everyone was excited and was buying calls because of the rally on February 25, 2005. Now, with so many sell stops in the market resulting from all the fresh long positions, the markets drifted lower and took them out. (See [Figure 5.12](#).)

To reiterate, the main thing I'm looking for in the PC ratio is if it's at an extreme range. This indicator doesn't spend a lot of time in the extreme ranges, but they're hit often enough to have an impact on the markets. What about when the PC isn't generating an extreme reading?

The PC actually spends a lot of time in what I call “neutral” territory. This is between 0.70 and 0.90. During these periods, the PC is generally not a factor in my trading decisions. However, there’s another aspect of the PC that I’ll watch during the day, and that’s the “trend” of the PC. This brings me to my third rule regarding using the PC ratio:

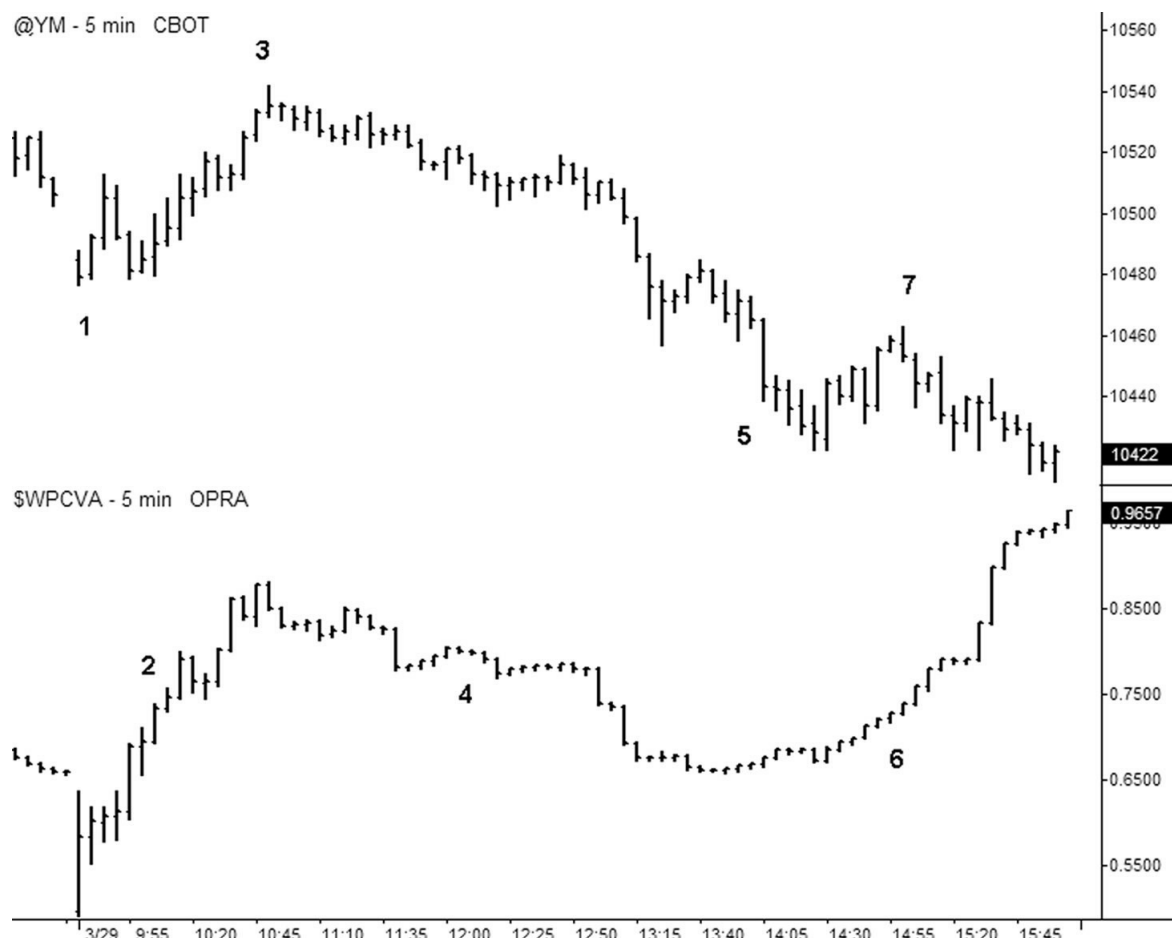
If the market is rallying, I want to see the PC rallying to confirm the move.

If the market is falling, I want to see the PC falling to confirm the move.

If the PC is rallying, this means that more people are getting bearish, and they’re shorting stock, shorting indexes, and buying puts. This means that people don’t believe in the rally, and they’re using the strength to establish short positions. Little do they know that their act of shorting merely adds fuel to the next leg higher, as the market now has a series of stop orders sitting overhead, just waiting to be ripped through.

If, however, the market is rallying and the PC is falling, this is because people believe in the rally and are chasing it; this is a sign that it has run its course. Naturally, the opposite is also true. If the market is falling and the PC is falling, this means that more people are bullish, and they’re using the market weakness to buy stocks and buy calls. They’re merely providing fuel for the market to continue on its downward path in the form of new sell orders placed below the market. If the market is falling and the PC is rallying, this means that people are getting scared and are chasing the market lower; this is a sign that the decline is about to end. (See [Figure 5.13](#).)

**Figure 5.13**

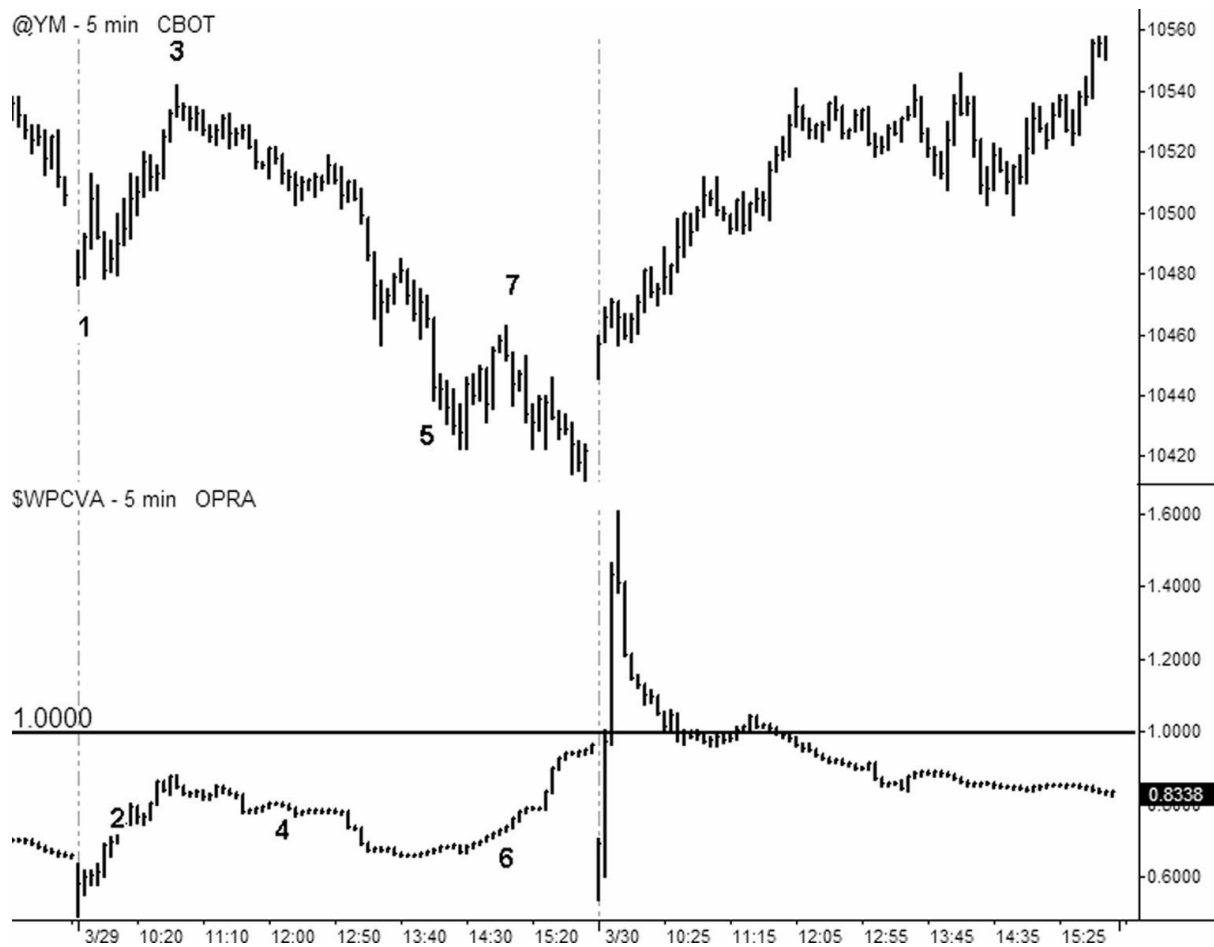




1. On March 29, 2005, the mini-sized Dow futures gap down and try to push lower.
2. The PC rallies as people scramble to establish short positions and buy puts.
3. This causes increased put buying. Even though it doesn't push the PC above 1.0, it's enough to get the markets to reverse course and take out the overhead stop orders.
4. Traders view this rally in the YM as a positive thing, and they start buying calls as the market pulls back. This call buying intensifies, driving the PC ratio to under 0.65.
5. With the aggressive call buying, the YM drifts lower for a few hours and then cracks, falling more than 120 points.
6. With the decline, traders start to worry that they're going to miss the down move, and they start shorting stock and buying puts. This drives the PC ratio to its highs on the day.
7. Although the markets don't rally into the close, they stabilize, as a high PC ratio starts to establish a floor in the markets.

Figure 5.14 shows the markets the next day. With the markets closing near their lows on March 29, 2005, people get bearish the next morning, and on the gap up, they start shorting aggressively and buying puts for the “inevitable” move lower. The PC ratio gets very high as traders race to get positioned on the short side. How does the market respond? By closing more than 140 points higher than the previous day's close.

Figure 5.14



I do want to point out that I largely discount the PC ratio until after 10:00 a.m. EST. There are a lot of listed stocks that take time to get opened, and a lot of overnight option orders that take time to get executed. This causes a lot of erratic movement in the PC ratio. Also, I ignore the reading on options expiration day, as it tends to get out of whack because of all the specific options-related activity.

The PC ratio is a valuable intraday trading tool. As of this writing, there are many data feeds that don't carry this indicator. On TradeStation, you must be permissioned for "opra" in order to receive the PC ratio. For example, while it's available on TradeStation, it's currently not available on eSignal. More quote vendors will supply this information if their customers ask for it. Also, this information is available for free at [www.cboe.com](http://www.cboe.com) in its "Market Data" section. These numbers are updated every half-hour.

### What Is the Most Effective Way to See What's Really Going on in the Stock Market During the Day?

The sector sorter list (SSL) is a simple tool that I use to gauge what's going on "beneath the indexes." I list all the key sectors and have them sorted automatically every few seconds throughout the trading day based on their net percent change. This tells me at a glance which sectors are leading the markets higher or lower, and this brings me to my first rule regarding the sector sorter list:

Any move without the banks (BKX), brokers (XBD), and semiconductors (SOX) is suspect and most likely won't last.

On April 1, 2005, the only sectors up on the day, for the most part, were energy, housing, and gold. (See

Figure 5.15.) One of the worst sectors of the day was the semiconductors, and not far behind it were brokers and banks. I like knowing where these sectors are in the mix for three reasons:

Figure 5.15

	Symbol	Last	Net Chg	Net %Chg	Description
1	\$OSX.X	142.28	2.97	2.13%	Phlx Oil Service Sector Index
2	\$XNG.X	333.76	6.86	2.10%	Amex Natural Gas Index
3	\$XOI.X	870.23	17.75	2.08%	Amex Oil Index
4	\$HGX.X	481.75	3.21	0.67%	Phlx Housing Sector Index
5	\$UTY.X	393.85	1.86	0.47%	PHLX Utility Sector Index
6	\$GSO.X	157.45	0.61	0.39%	Gsti Software Index
7	\$XAU.X	94.01	0.26	0.28%	PHLX Gold And Silver Sector In
8	\$GIN.X	155.94	0.01	0.01%	Gsti Internet Index
9	\$BMX.X	111.79	0.00	-0.00%	Phlx Computer Box Maker Sector
10	\$HMO.X	1357.03	-0.81	-0.06%	Morgan Stanley Healthcare Payo
11	\$DFX.X	261.06	-0.24	-0.09%	Phlx Defense Sector Index
12	\$INX.X	183.89	-0.82	-0.44%	CBOE Internet Index
13	\$XCI.X	672.76	-4.10	-0.61%	Amex Computer Technology Index
14	\$GSV.X	132.64	-0.84	-0.63%	Gsti Services Index
15	\$IIX.X	146.07	-1.01	-0.69%	Amex Interactive Week Internet
16	\$CYC.X	741.75	-5.15	-0.69%	Morgan Stanley Cyclical Index
17	\$MSH.X	452.24	-3.19	-0.70%	Morgan Stanley High-Technology
18	\$BKX.X	95.84	-0.71	-0.74%	PHLX KBW Bank Sector Index
19	\$STRN	3686.61	-29.36	-0.79%	Dow Jones Transportation Index
20	\$DRG.X	312.31	-2.53	-0.80%	AMEX Pharmaceutical Index
21	\$IXF.X	2634.55	-22.28	-0.84%	Nasdaq Financial-100 Index
22	\$GHA.X	301.12	-2.69	-0.89%	Gsti Hardware Index
23	\$CMR.X	572.08	-5.73	-0.99%	Morgan Stanley Consumer Index
24	\$XBD.X	144.12	-1.52	-1.04%	Amex Securities Broker/dealer
25	\$NVX.X	202.80	-2.18	-1.06%	AMEX Networking Index
26	\$BTK.X	486.83	-6.02	-1.22%	AMEX Biotechnology Index
27	\$GSM.X	203.35	-2.82	-1.37%	Gsti Semiconductor Index
28	\$SOX.X	411.22	-5.77	-1.38%	Phlx Semiconductor Sector Inde
29	\$RLX.X	424.02	-6.16	-1.43%	S&p Retail Index
30	\$XAL.X	47.96	-0.99	-2.02%	AMEX Airline Index

- First, the giant money-center banks represent the biggest (or almost biggest, depending on current prices) market capitalization sector in the market. The markets need participation from this index if they hope to make any headway.
- Second, brokers are a great market proxy. As go the brokers, so go the markets.
- Third, everyone participates in the semiconductor stocks. They have a strong following among retail and institutional investors alike. If I see a decline with these three sectors leading the way lower, I'm confident that the decline is going to last. The reverse is also true.

The other way I like to use this list is when the markets are quiet and choppy. Often there are stealth moves in the markets. This happens when the overall indexes are restricted in a tight range, but below the surface, a couple of key sectors are deteriorating or firming. This often isn't picked up in the index itself. This brings me to my second rule regarding the sector sorter list:

During these quiet periods in the market, the more sectors that go red, the greater the odds are that, when the market finally does break, it will be to the downside. Conversely, the more sectors that go green, the greater the odds are that, when the market finally does break, it will be to the upside.

Like a doctor's relationship to a patient's medical chart, the sector sorter list helps a trader gauge the overall health of the current market environment. ETFs can also be utilized for this. The nine sectors I like to follow are XLY (Consumer Discretionary), XLF (Financial), XLB (Materials), XLP (Consumer Staples), XLV (Health Care), XLK (Technology), XLE (Energy), XKI (Industrial), and XLU (Utilities).

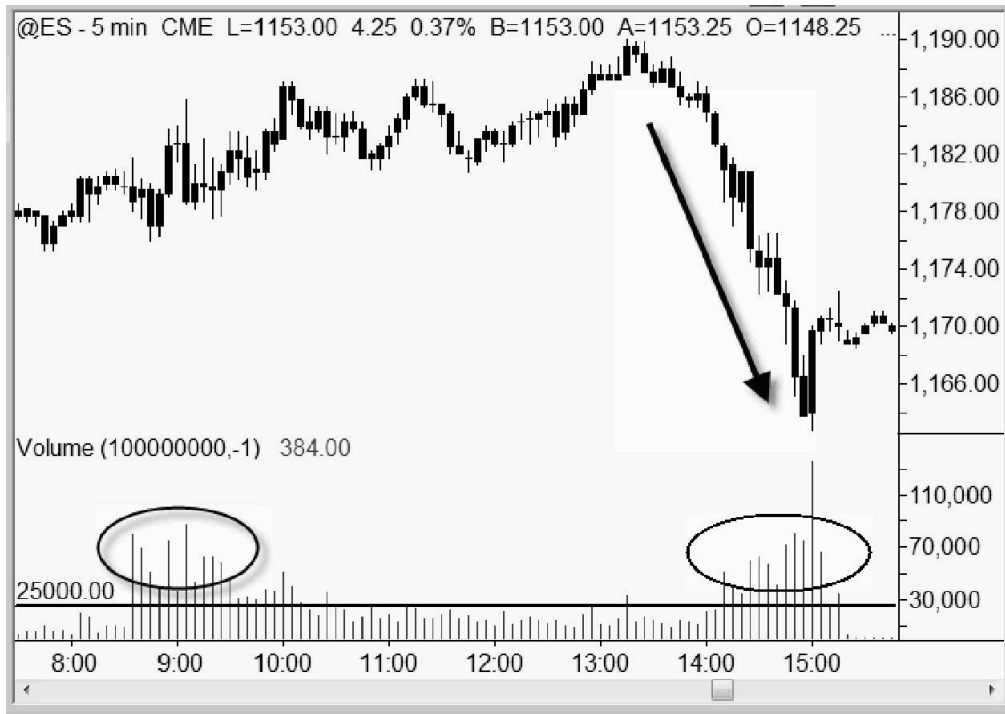
### How Do You Know When It's Going to Be a Choppy Day?

One of the most frustrating things for traders is dealing with a tight-range, choppy day in the stock indexes. Choppy days occur when the stock indexes spend most of the day trading in a slow, narrow range, providing minimal volatility. Most traders don't realize that the trading is choppy until about halfway through the day. They can tell by looking at the chart, and they can tell by the amount of losing trades that they've taken. In addition, there are specific trade setups that work great in choppy markets. If a trader relentlessly pursues a setup that works best in trending markets, he or she is going to get killed. Two of my favorite choppy market strategies are described in [Chapters 8 and 9](#) (Pivots Points and Tick Fades).

My goal is to identify what type of market it is going to be as early as possible in the trading day. To do this, I set up a five-minute chart of the E-mini S&P 500 futures, and the only indicator I place on this chart is volume. Once this is done, I place a horizontal line at the 25,000 level on the volume chart (or as close to 25,000 as I can place it).

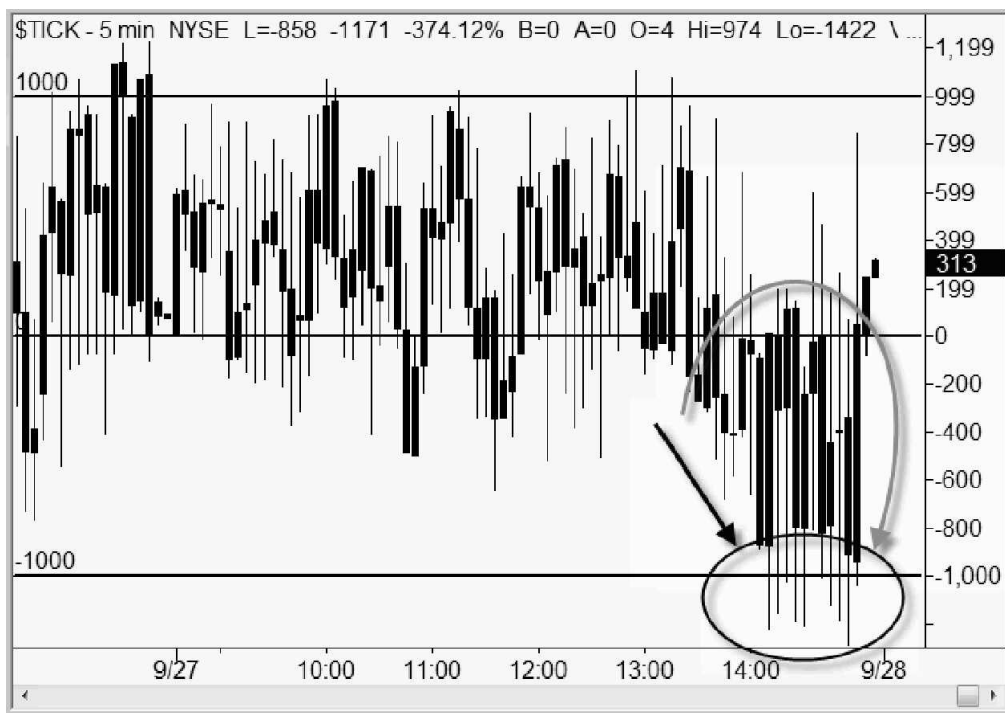
In [Figure 5.16](#), we can see that the trading during the first hour on September 27, 2011, had the majority of the volume bars going over 25,000. This is typical, as the first hour of trading is typically hectic. This means that more than 25,000 contracts were traded every five minutes. The markets traded quietly higher for most of the day, and then started to ease back into the final hour. Once volume spiked above 25,000 contracts and then stayed above that level, it indicated that bears were swooping in for the kill. And slaughter they did, sending the S&Ps 30 points lower into the close.

**Figure 5.16**



Volume is extremely helpful in measuring the conviction of the move. Had the market started to sell off on light volume, I would have known that there wasn't much conviction in the move. It was just a probe that would most likely fail, and it would indicate a buying opportunity for a continuation rally into the close. However, once the volume backs the move, it's continuation at its best, and there's no reason to fight it, just go with it. In [Figure 5.17](#), we can see the \$TICK from that same day.

Figure 5.17



For much of the day, the \$TICK spent quality time above zero, frequently hitting the +1,000 level. During this time, any pullbacks to the zero lines were buying opportunities, with moves back up to +1,000 an opportunity to sell that position. However, once volume spiked higher and the \$TICK hit its first -1,000 reading into the close, the nature of the market changed. As you can see, all rallies back to the zero line were rejected (offering shorting opportunities) as the bears kept pounding the bulls into submission. In fact, the \$TICK got as low as -1,200, which indicates extreme selling taking shape. Watching both the volume and the \$TICK together offers a great map of what's going on underneath the surface on any given day. This brings me to my rule for watching this volume chart:

If the first six bars on a five-minute ES chart have most of the volume at or well under 25,000 contracts, expect a choppy, tight-range session.

If the first six bars on a five-minute ES chart have most of the volume at or well above 25,000 contracts, expect a more volatile session with better trends.

This is a simple way to determine early on if the markets are going to be choppy or more volatile on the day. This allows traders to choose the setups that are more appropriate for these types of markets early in the day. To put it simply, on choppy days, it's best to fade extreme \$TICK readings. On trending days, it's better to go with extreme \$TICK readings by fading moves back to the 0.00 line. (See [Chapter 9](#) for more information on \$TICK plays.)

### **Putting It All Together—How Can You Size Up the Trading Day from the Opening Bell?**

It's easy to get overwhelmed by too much data, and the key for reading these data is to do it in such a way that your brain can take in the information as quickly and as efficiently as possible. I do this by looking at these data in a certain order, in two columns, top to bottom, left to right.

[Figure 5.18](#) shows how I tie all this information into a single screen. The trin and the trinq are in the upper left, and these are what I look at first. Then my eyes go below this to the PC ratio, which is what I look at second (note that the symbol for this is now \$PCVA instead of \$WPCVA). After this, I look at the ticks, which are at the bottom left of the screen. From here my eyes jump to the upper right and to the sector sorter list (SSL). Finally, I look at the tiki. I don't even have to look at a chart to know that the market has been selling off steadily all day.

**Figure 5.18**



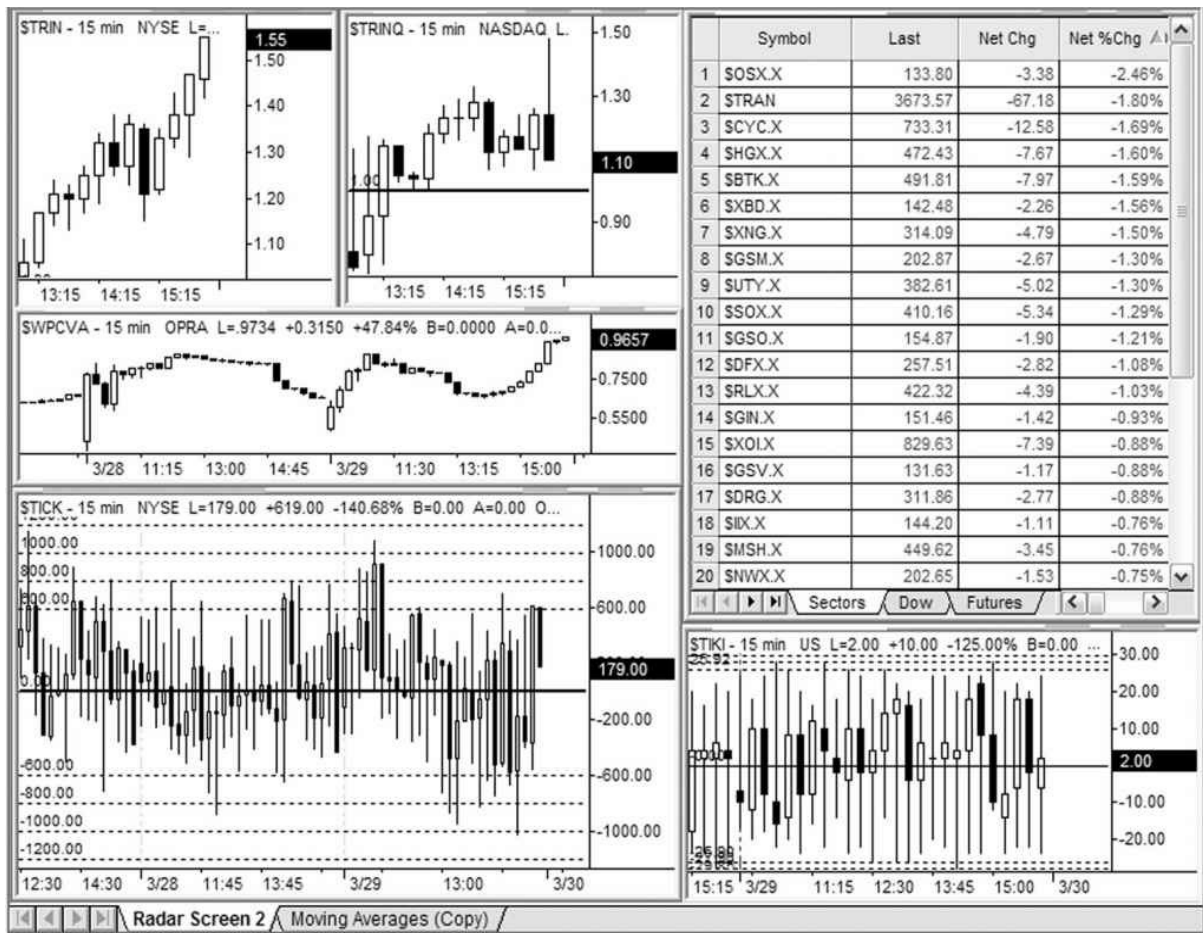
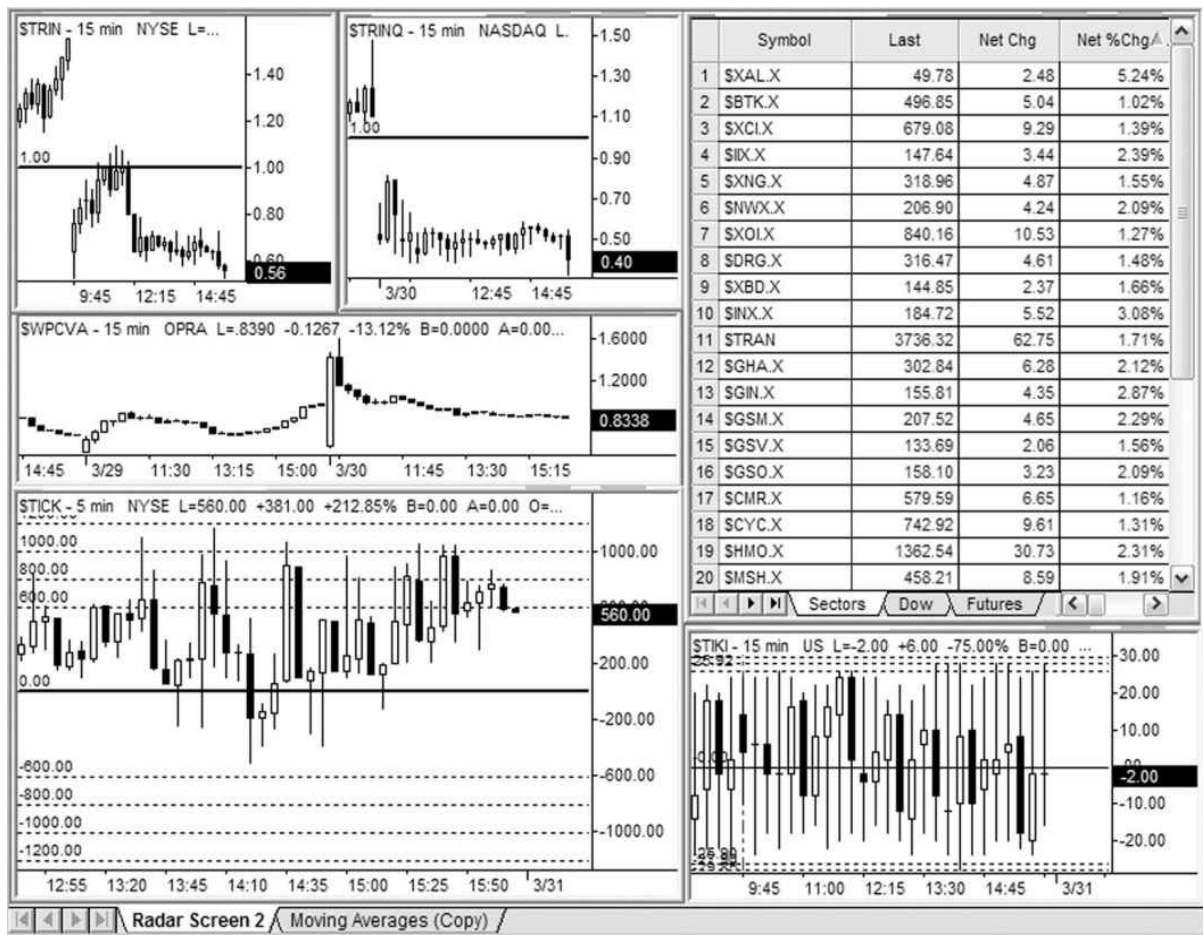


Figure 5.19 shows these key indicators against the backdrop of a strong market. At a glance, I can see that the trin and trinq are trending lower, and that the PC ratio started off well at over 1.0 on the day. I can see that the ticks are spending a lot of quality time above zero, and that most of the sectors are in positive territory. I can also see, with the tiki, that there have been a lot more buy programs than sell programs. On this type of day, I want to focus on long setups and ignore short setups.

Figure 5.19



In addition to getting a solid feeling for whether the market has upside or downside pressure, this will also help a trader understand when the markets are in “chop mode”. This will happen when these different indicators conflict with one another. For example, the trin is making new highs (bearish) but the ticks are spending all their time above zero (bullish).

One of my favorite ways to see if we have a choppy market is also the simplest. I look at the sector sorter list, and if about half the sectors are green and half the sectors are red, well, it can’t get more neutral than that.

I don’t include the ES five-minute volume chart on this layout simply because there isn’t enough room. I watch this on another screen.

### What Are the Other Main Things to Keep Track Of?

Not a whole lot has changed since I wrote this chapter back in 2005. In fact, my updates to this chapter have been minimal, except for the volume numbers on the ES from [Figure 5.19](#), which have grown to 25,000 from 10,000. I’ve also been using the \$TICK a little differently, utilizing the 0.00 line as an entry opportunity on those strong days, of which we’ve had so many in August 2011 and September 2011.

The \$TRIN is still good, although its impact has been muted a bit with the reverse ETFs that are on the market now, which are trading good volume and skewing the \$TRIN numbers. Not a lot, but they’re skewed a touch.

To make up for this, there are two “new” internals that I also watch these days. I say “new” intervals, but



they aren't really new. I just watch them a lot more intently now than I did a few years ago. These indicators are the \$VOLSPD (S&P 500 Up-Down Volume Difference) and the \$VIX, which is of course the CBOE Volatility Index.

The \$VOLSPD is worthless at the beginning of the day, but it's priceless into the last hour of trading. When I look at this indicator, I think of selling pressure and buying pressure. If selling pressure is sustained into the final hour, then look for a sell-off into the close. If buying pressure is sustained, then look for a rally. This may seem overly simplistic, but there are a lot of fake-outs during the last half-hour of trading. If the stock market sells off seemingly hard, but the \$VOLSPD continues to grind higher, guess what? The stock market is going to reverse and rally into the close. The opposite is also true.

In [Figure 5.20](#), we see a chart of both the \$VOLSPD and the SPY on a five-minute chart. Around 1:45 p.m. CST at point #1, the stock market begins to rally, and the rally is persistent for nearly half an hour. Is this real buying, or is it a fake-out? By looking at the \$VOLSPD, we can tell not only that it is a fake-out, but that the market has a high probability of selling off into the close. Not only does the \$VOLSPD not confirm the rally, but it actually starts to make new lows on the day, which in this case is the death knell for bulls. The markets crater into the close.

**Figure 5.20**

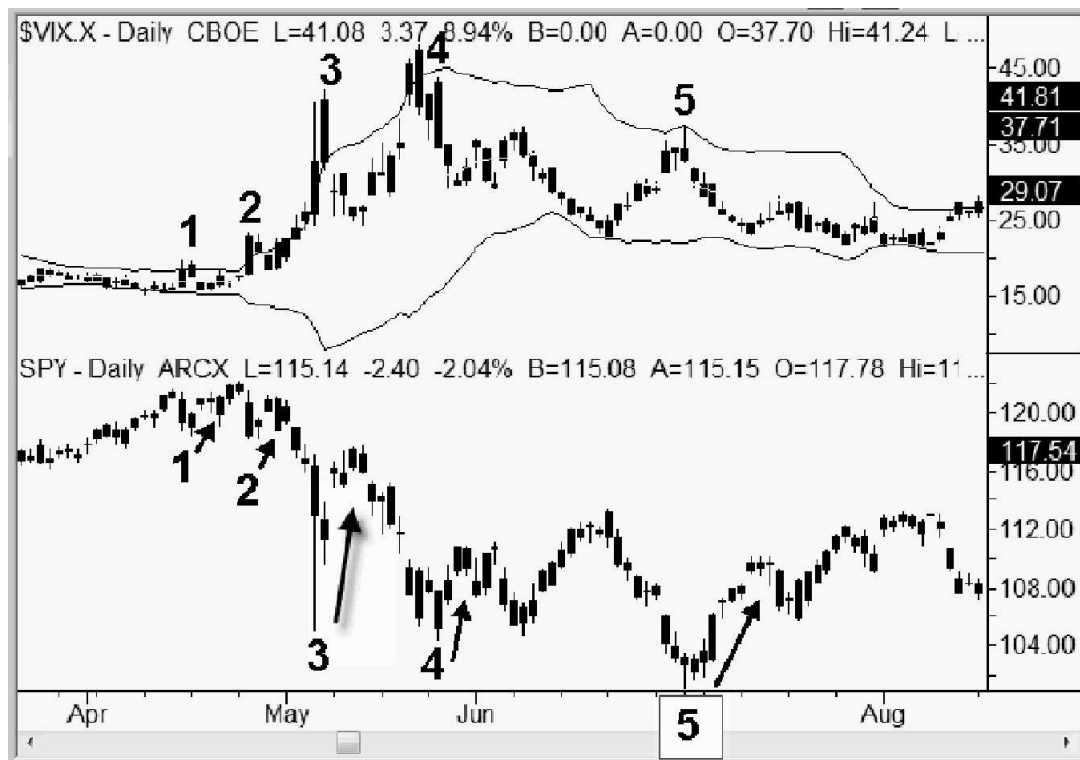


The \$VIX has, of course, been around forever, and its importance increases as market volatility increases. This is also known as the “fear indicator,” as it does a good job of measuring panic. Panic, of course, can go overboard, and too much panic is a buy signal.

In [Figure 5.21](#), we see a daily chart of the \$VIX on the upper half with a set of standard Bollinger Bands with the settings at 20 and 2. The bottom half of the chart is the SPY. Note that anytime the \$VIX rallies up to the top of the Bollinger Bands, and especially when it closes above the Bollinger Bands, not only is a

market bottom in the making, but a potentially violent rally is as well.

Figure 5.21



At point #3, see what happened on the day of the infamous “flash crash,” where the market went nuts to the downside for part of the day. The \$VIX spiked higher. People were freaking out. And what happened? The market had a violent multi-day rally that exceeded the highs just prior to the flash crash. Going along the chart, you can clearly see that any extremes in the \$VIX reading, indicating extreme fear in the markets, indicated that the selling had exhausted itself. The lesson? Don’t get too excited on the downside if the \$VIX is extended.

I’ll also watch the \$VIX on a five-minute chart intraday, as seen in [Figure 5.22](#). With this, I’m just looking for the \$VIX to make any breakout or breakdown moves. The \$VIX is fast and will typically break before the market.

Figure 5.22



At point #1, the \$VIX popped higher, and shortly thereafter the markets broke down. As long as the \$VIX is trending higher in this case, the market will continue to sell off.

For the \$VIX, I utilize the five-minute chart to measure the “immediate fear” in the market. For the daily chart, I utilize the daily chart to see when the fear has gotten out of hand and it’s time for a relief rally.

### **And, Oh Yes, Did You Know That If You Ignore This One Thing, You Don’t Stand a Chance?**

There has been a lot in the press over the past few years about the “carry trade,” but most traders and investors don’t give it much thought. “That’s some weird thing the hedge funds are doing,” they think. “It doesn’t apply to me.” That’s where the traders are wrong. Dead wrong.

The carry trade affects the markets today more than nearly anything else. Stripping it down to its simplest measure, it works as follows. Hedge funds borrow a low-interest currency, like the yen or US dollar, and then put those funds into a higher-yielding currency, like the Australian dollar. Then they borrow against these Australian dollars and go out and buy appreciating assets such as stocks, gold, silver, grains, oil . . . you name it. Why do they go to all this trouble? Simple—to make big returns so that they can collect big fees.

Why is this important? Because when funds are putting on the carry trade, also known as “putting risk on,” then most asset classes rise in value; the funds are buying them hand over fist. More important, however, is when funds are “taking risk off.” When they do this, it means that they’re winding down portions of their carry trade. To do this, they need to: (1) sell off the assets they bought, (2) dump the high-yielding currency they own, and (3) pay back the cheap currency they borrowed. These three steps all happen very close to simultaneously.

Why is this important to know? Because when hedge funds are “taking risk off,” nearly all asset classes will sell off, regardless of what’s going on in the news.

That's great, but how does a trader know when hedge funds are "putting risk on" or when they are "taking risk off"? By watching CNBC? No. They aren't sure what happened until way after the fact. If hedge funds could hide their footsteps and their actions, believe me, they would. Surprisingly, this information on whether hedge funds are "putting risk on" or "taking risk off" is very easy to obtain. All you need is a data feed.

Figure 5.23 is a chart of the AUDJPY cross, where the current price is 73.739. This just means that 1 Australian dollar is equal to 73.74 Japanese yen. Believe it or not, this chart represents what hedge funds are doing in real time. The price of AUDJPY isn't critical. What is critical is whether the chart is moving higher or lower.

Figure 5.23



It's not that AUDJPY represents all carry-trade activity. However, it does represent one very common carry trade, which is to borrow Japanese yen and then put that money into Australian dollars. The more yen that are being borrowed, the more the Australian dollar is being bought, and thus the higher AUDJPY goes (that is, as risk is being put on, 1 Australian dollar can buy more and more yen). Thus, when the carry trade is on, AUDJPY will rise. When the carry trade is being taken off, AUDJPY will fall as Australian dollars are sold to pay back the yen loans. If that seems a little complicated, this is all you should remember:

AUDJPY moving higher = risk on = assets rise

AUDJPY moving lower = risk off = assets fall

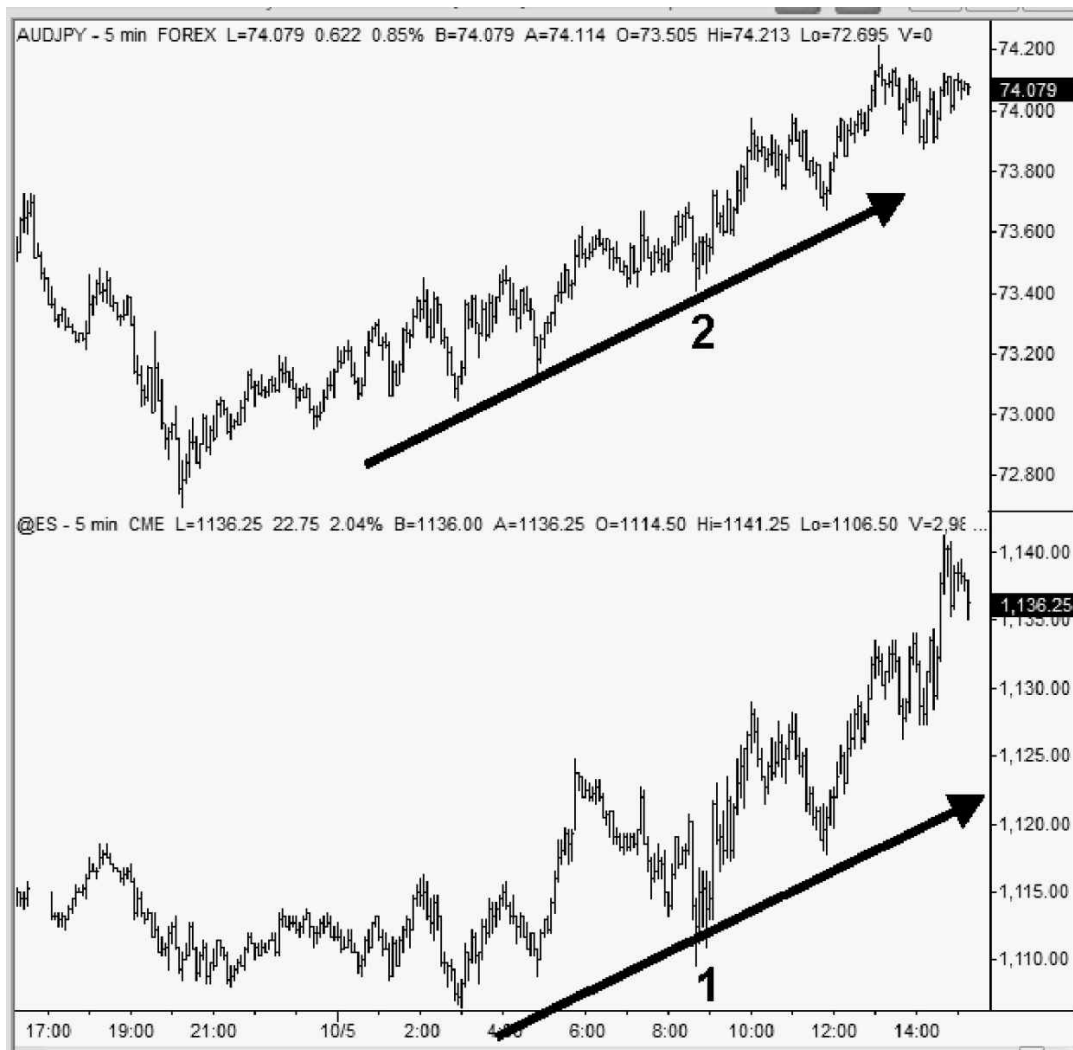
Figure 5.23 shows a chart of AUDJPY with the stock market (SPY) plotted below it. The dates represented are from October 2010 through October 5, 2011. Points #1 and #2 show both a rising AUDJPY and a rising stock market. Points #3 and #4 show both a falling AUDJPY and a falling stock market. That's easy enough.

Where this gets interesting is when AUDJPY acts as a leading indicator, which it did at point #5. On this date, March 29, 2011, AUDJPY broke out and made new highs. What did the stock market do? Nothing. It was in turmoil over yet another European country being on the brink of insolvency. And yet AUDJPY kept moving higher and higher, indicating that funds were aggressively putting risk on.

Lo and behold, about a month later, on April 26, 2011, the stock market broke out and made new highs. A trader who was listening to every word of the financial press got short stocks because of the continuing coverage and worry over the European debt crisis. Traders who understood the importance of the carry trade bought stocks, or call options on stocks, to await the inevitable catching up of the stock market to the *actual* risk being put on by hedge funds. Long story short, the money that the funds are borrowing has to be put back to work.

In Figure 5.24, we have an intraday five-minute chart of AUDJPY and the E-mini S&Ps. I like watching this during the day and gauging the intensity of a sell-off in the ES. Point #1 shows a big sell-off in the ES midday on October 5, 2011. If, during this sell-off, AUDJPY has a mere "mild pullback" (as it does at point #2), then the chances of the ES turning around and rallying are very strong (as it does here). If the ES sells off and the AUDJPY also takes a nosedive, then you know that the selling in the stock market is for real.

Figure 5.24



Finally, the last reason it is important to understand the carry trade is because it explains what many people find unexplainable. For example, during the 2008 financial crisis, everyone and his mother was talking about how the US dollar was dead, and how it was critical to put all available funds into gold and gold stocks. What happened during the heat of the financial crisis in October 2008? Gold got annihilated, selling off from \$1,080 an ounce down to \$707 an ounce. Gold stocks fared far worse. Goldcorp Inc. (GG), a very solid and popular gold stock, fell from \$52.65 to \$13.84. This was a typical move for gold stocks during the heat of the financial crisis from July to October 2008. Everyone who thought they were smart and did “the wise thing” got taken out back and shot. What happened?

Figure 5.25 shows exactly what happened. The top chart is AUDJPY, and we can see that risk was coming off in a big way, as AUDJPY plummeted from just over 100.00 to below 60.00. Remember when I said that markets move because they *have to*, not because they want to? Bingo. This was essentially the largest margin call in the world. Funds were forced to sell everything that counted as an asset, and that included gold. It didn’t matter what the asset was or if it had intrinsic value. All the assets that they had bought with borrowed money had to be sold so that they could pay back their loans. This is also why the US dollar rallied during this time. The US dollar is also used in the carry trade, along with the yen, because it’s such a low-interest currency (at least it has been over the past few years). As the carry trade was “taken off” and yen and US

dollars got “paid back,” guess what happened? The US dollar rallied. Why? Borrowing money is the equivalent of selling it; paying money back is the equivalent of buying it. Therefore, paying back US dollars applies upward pressure on the US dollar chart. This is the reason why the US dollar didn’t collapse as many pundits had predicted. The US dollar may collapse someday, but not while it’s a low-interest currency and hedge funds are taking risk off.

Figure 5.25



Where does the leftover cash go once all the assets are sold? Into US Treasury bonds, which is why the 10-year note futures and other bond futures rocket higher during these times.

The carry trade is on? Great, buy everything.

The carry trade is off? Get out of the way.

### Summing Up

It’s important to realize that the markets spend most of the day—even most weeks—consolidating, resting, backing, filling, and pretty much doing nothing. Traders who wait for a move, and then must chase it will always be at a disadvantage to traders who get in *before* the move takes place. The way to do this is to watch

these internals and look for clues concerning the path of least resistance. When the markets are quiet, get positioned for the next move in this direction. Once the move takes place, the amateurs will chase it, and you can sell your position to them.

I've set up [www.simplertrading.com/marketinternals](http://www.simplertrading.com/marketinternals) where we can post updates to this chapter, including videos of live market conditions to show how internals work as the market is unfolding, as well as updated internals and moving averages we use to make sense of these readings. Sometimes it's easier to "show how I use it live" rather than to copy and paste a chart in a book.

We are almost to the end of [Part 1](#). Before I dive into [Part 2](#)—actual trading setups—I'd like to review the winding and amazing path of a recent newer trader and the twists and turns that led her to trading and, eventually, profitability. Whether or not you are familiar with Danielle Shay (soon to be Danielle Gum), I think you'll find her trading journey both interesting and entertaining. I'll hand the next chapter over to her.



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## A Beginner's Journey

BY DANIELLE SHAY GUM

*Note from John Carter:* I remember Danielle just kept showing up to our live events, and after she went through the normal and overwhelming trading learning curve, she started to ask inciteful—and sometimes tough—questions. It was great. “Who is this girl?” I wondered. She’s smart, funny, strongly analytical, and not afraid to voice her opinion. She’s also very persistent. Very. At some point we were talking at an event and I said, “Why don’t you just move to Austin and work for us, helping newer traders get up to speed?” From there, she took the ball and ran with it, not waiting for anyone’s permission, and created her new future. It’s been fun to watch. Here’s Danielle.

### And So, It Began

If you told me when I was in college—or really, at any point in my life—that I would have a successful career in the financial markets, I would have walked away laughing, and hard. The path that I have followed to get here has been one with many surprises, but at the end of the day, I am doing exactly what I love—making money my own way and teaching others how to do it themselves.

Why didn’t I suspect that I’d end up in financial education? I grew up wanting to be a lawyer, studying language and writing. But even then, I was never the type of person who fit into a box. I have always wanted to take control of my own destiny and create a path for myself that was unlike anyone else’s journey. I considered human rights law, entrepreneurship, or becoming an inventor. I could never land on any one thing. By the time I dove into something, my interest would wane, and I’d be on to the next great big idea. My independence was unforgiving and did not allow me to settle on anything less than what made me feel truly passionate and alive. This never-ending wanderlust took me abroad after college, where I ended up teaching elementary school in Central America. I wanted to do something unique, I wanted to teach, and I wanted to go to sleep at the end of the night knowing that I did some good in the world.

That is how I ended up teaching sixth grade in a little town right on the beach. I loved the kids, putting together lessons, and breaking down large concepts into something they could understand. I taught English, Math, and Science. After teaching English as a second language in college to refugees, teaching kids seemed like the next step. Not only could I teach, which I loved, I could also immerse myself in another country and culture. While I taught these kids, they too, taught me something every day. It was always a new adventure. And boy, do I love my adventures.

So, how did I get from there to teaching aspiring options traders? I have always felt that I was the type of

person who would die if I worked in corporate America. The rules and the hours, and please, don't even get me started about the dress codes. You can call it the millennial in me, but it has always been a distinct part of my personality.

Becoming an options trader wasn't a lightbulb moment in my mind. I wish I could say I had a moment of genius where I realized how awesome this career path would be, but that simply isn't how it happened. I suppose you could say I had gotten myself into a bit of a pickle. At this point, I had spent three years building what I thought was a future in Costa Rica. I loved my teaching job, my house, and the family I believed I was building. I had fallen in love, gotten engaged to the man I thought I would spend the rest of my life with, and ultimately pregnant. Soon into the pregnancy, I realized the truth behind the façade that my then fiancé had built. I won't get into the dirty details, but the important part of this story is that the life I envisioned, the one I was promised, wasn't the one that was playing out. There was no evidence to prove anything would change. I felt young, stupid, and betrayed. I had two choices: stay and be trapped in despair or leave, and get out while I still could. I chose to leave.

*"You're always one decision away from a completely different life."*

Leaving my fiancé meant leaving my entire life. My teaching career ended abruptly, along with all my possessions up until that point. With a very pregnant belly and two suitcases packed with as much as I could carry, I left. Where else could I go at this point but back to my parents. I had a combined total of \$800 in my checking and savings accounts (intended for my now, never-happening wedding). Within two months, I went from having my entire life mapped out to becoming the black sheep of the family. I was about to give birth as a 25-year-old single mother, living at home with my parents. I felt I had completely failed at life.

I was always smart and excelled in school, attending one of the most widely respected universities in the state. Still, I struggled to understand how I allowed myself to get in this position. As I have come to find so many times in life, some of the worst things that happen to a person can blossom into some of the best outcomes.

At this point, my options in life were incredibly slim. Unfortunately, teaching elementary school in the United States really doesn't come with a paycheck that can sustain a single mother paying for childcare and all the costs that come with having an infant. I was incredibly lost, and I had no idea where to turn.

In September 2013, I gave birth to my son, Leo. His arrival gave me drive like nothing I have ever experienced. I didn't have it all figured out, but I knew that I loved my son. I wanted to provide him with the best possible life. I did not want to struggle financially, while raising him, living paycheck to paycheck. I was willing to do whatever work it took to break free from financial bondage. As I cried to my dad, I lamented that I did not think I would ever make it out of my mess. I thought I had done right in the world. I just could not accept this situation where I could not even afford to take care of my own child. As I continued to cry about my failed life plan, my dad told me, "I have an answer for you: John Carter."

## **A New Idea**

My dad actively invested and traded for over 20 years, though, I can say up until that point, I had never discussed trading with him. "John Carter?" I asked. How could a guy named John Carter possibly get me out

of this mess? This was the moment that forever changed my life.

It was then that my dad introduced me to options trading. At this point, I had no idea what an options contract was, let alone how I could possibly make money off one. Even simple terms such as “bullish” and “bearish” were completely Greek to me. But my dad told me that in all his years of investing and trading options, he had never seen a guy multiply money like John could. He told me that John was a teacher, and we could take his classes together. I could learn how to make my own money and support Leo and myself, all from home, so that I wouldn’t have to leave my son. To say I was skeptical was a huge understatement.

So, I went through my decision tree. Applying for a new job with a one-month-old baby didn’t seem like a viable option. If you saw me as a first-time mom with a newborn, you’d realize I would rather play in traffic than leave this baby’s side. Even if I *did* decide to get into teaching in the United States, a teacher’s salary as a single mother in Seattle (one of the most expensive real-estate markets in the country) just wasn’t going to cut it. I would literally be working to pay for daycare. Don’t even get me started with rent and food, not to mention baby items! The only thing I envisioned for my future at this point was living in poverty, which was a place I never imagined I would be.

Backed into a corner I said, “Okay, Dad, tell me about this John Carter guy,” even though my prevailing thoughts were:

Math?! Ugh, I hate math. Numbers? Finance?! This was not my thing. I narrowly avoided taking math classes in college. Economy 101 was the worst grade I received in four years. How could I possibly do this?

I continued searching for job options that would let me work from home. Working outside of the home wasn’t an option thanks to the cost of childcare alone. I looked through writing careers, teaching English online, transcription, and translation jobs. All I wanted was to be able to take care of my son on my own. My dad reminded me again. “I’m taking one of John’s classes this weekend. Just sit here and watch.” And so, I sat, with my newborn baby in my arms, listening to this guy John explain how he multiplies his money with his options strategies. I had no clue what was on his charts, how to use a platform, and barely understood about 10 percent of what John talked about. But, there was something about his charisma as a teacher, and my dad’s continued insistence that this was a viable plan, that made me want to stick with it. It was at that point that I decided to give it a shot. What did I have to lose? I opened up a Paper trading account (a virtual trading account) with TD Ameritrade and started my journey into options trading.

## **Fast-Forward Five Years**

*The harder you work, the luckier you get.*

BEN FRANKLIN

Fast-forward to the present day, and I’m now one of the primary technical analysts, traders, and content creators for John’s company, Simpler Trading. I present my analysis in our Live Trading Chatroom, coupled with trade ideas I’m placing in my personal accounts. My episodes are called “Trading it Simpler,” where I focus primarily on directional strategies for small accounts. My main job at the company is to work with new traders who come to us and break down ideas the way I once needed. I help them on their path to financial freedom.

In addition to my trading-room analysis, I also teach weekly after-hour member webinars called the “What Just Happened” series. These webinars focus on ensuring our new members can learn, understand, and (most importantly) apply our Simpler Strategies—and help them realize, “What Just Happened.” I thoroughly enjoy authoring a variety of blogs that include both market analysis, and trade and strategy breakdowns to help our members better understand our traders and strategies. Though my strategies work for any level of trader, I primarily focus on new and intermediate traders, helping others with the same issues that I once faced myself.

Just like my mentor, John, I love nothing more than an amazing mix of technical patterns where I can really leverage my account to gain the aggressive growth I seek. My trading plan is truly a mix of options and futures strategies that I’ve learned from varying members of our team. Though John was my initial mentor, I soon began studying the works of Henry Gambell and Carolyn Boroden. During this time, I tested, tested, and then tested some more, honing my strategies into something that worked for *me*. It is my goal to help traders through that same process.

## **My Trading Persona**

So, you ask, “Who are you as a trader?” Well, really, I’m a mix of everything I’ve learned in five years of studying and trading under John and the rest of the Simpler Trading team. I’ve taken John’s directional, top-down approach, starting with the overall index markets and various sectors to identify the highest probability directional trades. Then, I added in some of what I learned from Carolyn’s Fibonacci analysis training and sprinkled in Henry’s technical analysis techniques to make all this work for my small account. The result has been a unique, risk-averse trading strategy that I’m proud to truly call my own. It’s something I never would’ve believed possible five short years ago.

I don’t think I could ever fully show my gratitude for everything that I’ve learned under Simpler Trading. This opportunity has given me not only the ability to make money on the money that I already have, but the ability to make money at any point in time, no matter where I am. But more than that, the immense gratitude that I have to my dad for getting me started in the first place cannot be put into words.

Trading has been one of the most difficult things I have ever attempted, but with my personality, difficulty in any aspect of life just makes me want to push that much harder. “If the door won’t open, just break a window!” has been a huge part of my mind-set. The frustration, the gains, and the setbacks that I’ve experienced have only made me push harder.

So many people want to know, “How’d you do it? How did you achieve profitability in such a short time span?” Well, it’s simple. I decided that I was going to become a trader, and I did everything in my power to make that happen. That however, does not mean it was easy.

Though life has changed dramatically from the fall of 2013, I always appreciate looking back on the rough times that brought me to where I am today. How did I get from there to here? If I could pinpoint the biggest factor in my success, it would all come down to the amount of effort that I’ve put in during that time frame. Let me take you back to where, and how, it all began.

## **The Beginning of a New Life**

To say that I started learning to trade as a “beginner” is an understatement. What kind of knowledge did I have when I started? Well, not much. I didn’t even know what options *were* when I started following John. Technical analysis? Hah! I couldn’t even tell the difference between the colors and lines I saw on the screen. I was completely green when I began.

I have always gone all-in with everything in life. If I’m going to do something, you best bet I’m going to do it as well as I possibly can (another something I picked up from my dad). If you’re going to do something, do it with everything you’ve got.

Crazily enough, these are some of the main reasons why John ended up hiring me to help teach new traders. I could remember clearly what seemed so complicated to me, therefore, I worked toward teaching that to new traders who came to us.

### *September 2013*

I dove right in. I started listening to John’s classes and trading room sessions. I remember how, at first, it was too much to try and listen to multiple traders. They each had their own styles and terminology, and it was all I could do to keep *one* of them straight in my mind! I looked at learning about trading from John like college. I printed out all his slides, took meticulous notes, and asked lots of questions. Most importantly, I asked for help when I needed it.

It took me a long time to figure out even the most basic terminology and how to work a platform. I copied trades directly from John, noted how (and why) they worked, and how much money I made or lost at the end. I practiced a variety of different trading strategies, but there was still no way I could locate and place a trade on my own without the help of the chatroom. However, I knew what I wanted to achieve. I wanted financial freedom, so I kept going, full-steam ahead.

My dad helped me learn the basic concepts. John’s teachings were just so advanced. I always needed someone to fill in the blanks. Those times are still fresh in my mind. It’s crazy that now, that is my job here at Simpler Trading—filling in the blanks for our new traders.

### *From Green to Full-Time Trader*

As time went by, I started to slowly understand the basic concepts behind the varying options strategies and different trade setups. It still blew my mind how a specific chart pattern meant a certain event had a high probability of occurring.

I never knew that you could actually “read” the markets. But, that is exactly what John was teaching me to do. I learned to read price action. I used the tools that were recommended through John’s classes, and I wrote out how they worked. Learning how to read price action was kind of like learning a new language (a very strange one). But, as I got better, I started to recognize that similar patterns would pop up, and then I would know (probably) what to do.

I think it was after about a year and half that I really felt like I got it. Little did I know that my trading journey was just beginning. It was at this point that I finally abandoned paper trading and set off to finally trade some real cash.

### *Finally Seeing Results*

I distinctly remember being two years into my trading career. I was really struggling. At that point, I had only been trading with real money for about six months. The first few months went great! I was making money left and right. Of course, that didn't last (at least initially).

When I look back on it now, I think that doing so well during those first few months really kept my fighting spirit alive. After studying trading for a year and a half, and paper trading the entire time, I felt like I was finally ready to put my real cash to work. I'd been saving it, waiting until I honed my craft and I was *sure* I wouldn't lose my real capital. Well, as they say, you can never be sure about anything in this life!

I traded primarily credit spreads for my first several years of trading. To me, it was ideal because I could control my risk much better—the width of the spread was all I could lose. It was only now and then that I would venture out into what I saw as the more *risky* way of trading and buy long calls and puts.

Then, one July afternoon, I saw Henry placing orders in the Simpler Options Chatroom. He was buying long calls that were about \$4.00 per contract. I wish I could remember which company. Anyhow, it wasn't even a day or two later that my call doubled. My 26-year-old mind was blown. At this point, I was working 9- to 10-hour days, away from my nine-month-old son for \$12 an hour doing contract photography work. But with options, I literally made money while I slept. The \$400 I placed in this trade became \$800 almost overnight. I cashed it out and bought myself a new iPhone, so that I could keep trading on the go.

Those first two months of trading real money were wild. I thought I was going to be rich overnight. Following John's and Henry's recommendations, I made about 5 percent of my account in both July and August of 2015. By the time the end of August rolled around, John started talking about shorting the indexes. At that time in my trading, I still didn't really know how to recognize trading setups. I could understand about 70 percent of what the traders said, and I could copy their orders. But as far as voicing my own opinion . . . well, my opinion was just, "Follow John and Henry!"

It was still that way when I decided to buy some SPY puts (at John's recommendation) right before the "flash crash" of August 24 and August 25, 2015. I still didn't really know what he was talking about. Did he know there was going to be a flash crash? I still don't know for sure, but he loaded up on SPY puts because of the varying market internals. He kept talking about these "internals." The VIX? The SKEW? I mean what is that? I swear, I learned something new every day from this guy.

Well, I can tell you that my birthday is August 25<sup>th</sup>, and man did I get an amazing birthday present that year! That trade alone got me enough money to buy my own laptop. Before that moment, I took the classes and I listened to the Chatroom. I was trading. I gave it maybe 20 hours a week. But *after* that trade I was officially hooked. I made it my ultimate goal to learn everything there was to know about trading and master it for myself.

My first few months of trading with real money were amazing. I was shocked at the amount of money I could make trading. It was like the beginner's luck that strikes gamblers in Las Vegas. Looking back, I think it was a sign that the universe just wanted me to succeed.

### **What Goes Up, Must Come Down—or Must It?**

I'd like to tell you that after my wild success during my first two months of trading real money, I never looked back and immediately became a pro. That, however, is very far from the truth. Between the "flash crash of

2015” and now, there was a lot more blood, sweat, and tears than I ever imagined coming my way.

It wasn't long after my summer of winners that I had a very dark winter of losers.

It was during this time, in November 2015, that I met John and company at an event they were hosting in Las Vegas. Before I met the team, I felt like they were superstars behind the microphone. It was as if what they were doing (trading professionally full-time) was an unattainable goal. I admired the trading team so much that to say I was intimidated to meet them didn't fully express my feelings.

People always ask me when the shift in my thinking happened. When did I go from feeling that “I sort of want to trade, but I'm losing money and don't know if I can make it” to believing that “this is what I am going to do for a living.” When my paycheck started looking like scraps compared to my trading winnings (that bought me both a new iPhone *and* laptop) was a start. But meeting the trading team in person and recognizing that they were real people who actually do this for a living was when things really clicked for me. Once I met the team and realized that they truly were just normal people who made this their career, I decided to go all in, and never give up.

### **If Only It Was Sunshine and Roses from There**

You'd think from that point it was all sunshine and rainbows, but it wasn't. Meeting the trading team was great, but between September and January of 2016, I either lost or spent about 35 percent of my account. I was completely distraught. Around December, I noticed that their next live trading event was coming up in January. I've always been the type who learns better in person, when I can talk to someone face-to-face and ask all the questions I've been dying to ask. I knew that I couldn't afford it, especially after such a terrible string of losses. But my justification was that this was the Hail Mary, the final attempt before I'd have to call it quits and hold onto the money I still had left and look for a new career. And so, I headed to Austin, Texas, in January 2016.

I wish I could explain all the trials and tribulations I went through between September 2015 and the present day. But I think it's best if I describe the most important lessons I learned during this period from each of my mentors. Up until this time, I had only focused on John and Henry's work. I had my options strategies and setups mostly down. However, I was still consistently losing money, and I couldn't figure out how to stop the bleeding.

Looking back, it's no wonder that I was bleeding dry. I didn't have a trading plan, I didn't have a trading journal, and I just followed random trades from the trading room without understanding the how's or the why's. What I really needed was a swift kick in the butt and a major dose of discipline. It's so obvious to me now. When I speak to our traders who aren't doing well I know exactly what to ask them and where to lead them. However, I remember the struggle, and it was very, very real.

January 2016 was such a key moment for me in my trading career. After pouring my heart out to Carolyn at the bar at the event that month (and telling her that I racked up credit card debt to be there), she told me that what I needed was *her* work. She told me it would help me identify and create my own trades, as well as specific entry-and-exit points that I could identify on my own. I remember how crazy it seemed at the time. “Measuring swings?” I thought. “I can't even figure out which movement is “a swing.” “Is there a squeeze? How am I going to combine this with John's setups? She goes so fast; how could I ever do that?” The doubt

clouded my mind, but it was either throw the towel in and declare my two years of trading a total failure and loss, go back to square one and find a completely different career, or try out this whole Fibonacci thing. Fibonacci won. I bought Carolyn's book and began studying her work with Fibonacci analysis.

This book was a huge turning point for me, as far as understanding the waves in which the market flows and truly learning how to read and analyze a chart. It was after I added Fibonacci analysis to my work that I stopped losing money on a regular basis. Within months, I went from consistently losing money to consistently breaking even. It was incredibly enlightening, while frustrating at the same time. What was I to do next?

Right around this point in my trading career, I added overall futures index analysis that I primarily got from our futures day trading analyst, Neil Yeager. After I added this analysis to my work, it became clear to me why many of my trades failed. It was because I had failed to analyze the market conditions in relation to my options trades. For so long, as a new trader, I ignored the analysis the traders gave on the S&P 500, the Nasdaq, and Dow futures. I would tune out John or Henry when they would talk about the Nasdaq or the S&P 500. "I can't trade futures," I would think to myself. "Why are they wasting so much time talking about the Nasdaq?! I am trading MSFT (Microsoft). Who cares about the NQ?!"

This is one of the most embarrassing trading mistakes I made as a newbie, and I really hate to even admit it. But, if it can help others learn, I will gladly do so. It was Neil who taught me how important this component was to my options trading, and not only why and how it was important, but how to read and analyze the S&Ps, and how to trade them. When I finally incorporated this analysis, then meshed this with my options setups, I knew at this point, my recipe for success was almost complete.

John encouraged me, telling me:

All traders go through these three stages. First, you lose money. There is no way around this. Then, you learn how to stop losing money. The amount of time in the first and second stages are completely up to you, and how hard you work. The third stage is where you finally begin making money. This is called sweet victory, and it'll make all the suffering worth it.

And so, I kept at it. I dedicated all my time and effort to being in the trading room, listening to those who knew far more than me, working on my skills, and striving to be the best trader I could be.

## **Big Changes**

This tiny section of advice is so critical, yet at the same time, such a small blip on my path to figuring out what I was doing wrong. Every non-successful trader wants a magic answer as to why he or she is losing money. Usually, there isn't just one answer. But, I can tell you, what *I* changed that turned me into a winning trader.

First, I would have to say overall discipline. It sounds like a lot, but in reality most of this came from learning Fibonacci, creating a trading plan, and using a trading journal. I had heard John speak about it in every single one of his classes, but of course, thinking about how much work it would be, I never actually made one. Only until I got to the depths of despair when I thought I had to quit, did I sit down and work on my psychology, trading plan, and trading journal. If only I would have done that much sooner.

Along with my trading journal, I focused on learning chart patterns—trading the same way every time, narrowing down my focus, and figuring out what I was good at. The trading journal allowed me to narrow my



focus and identify the reasons I was losing money, so that I could work to eliminate them. Of course, you'll never eliminate all your losing trades. But even if you can figure out how to cut a percentage of them, you've now (ideally) shifted the edge in your favor.

By examining my work and looking at the red staring me in the face, I had to figure out how to shift the outcome so that each loser was (percentage wise) smaller. Then I had to eliminate some of them, ensuring that the winners would outpace the losers. Without a trading journal, I really don't see how that would have been possible.

## Lessons from the Masters

*The amateur believes she must have all her ducks in a row before she can succeed.*

*The professional knows better, and keeps on trucking.*

STEVEN PRESSFIELD, *Turning Pro*

From January 2016 to the present day, is easily the time when I've gone through my greatest period of growth as a trader. Suddenly, I just got it. Along the path to consistency, there is no one secret or lesson to take you from struggle to success. Instead, it's a combination of insights, put together to create your own trading plan and lesson-filled journey. I learned this the hard way, and if you're reading this, just know that it's okay to start by failing. Just fail forward. That's how I got to where I am today, allowing me to combine my favorite insights from my favorite mentors and pass them along to other beginning traders.

Here are some of my favorite lessons I've learned over the years, from some of my favorite mentors (and, more importantly, my favorite people).

### *John Carter*

*You don't need to know everything there is to know about the markets in order to make money." You only need one high probability setup that works.*

JOHN F. CARTER

It's hard for me to narrow down just one lesson to highlight from John. The closest I can get is describing the impact that his overall mind-set has had on my ability to learn how to trade. When I first started, it was all so overwhelming. I think most people believe that you must be a financial master to learn how to trade options. This was something that John spoke about over and over.

*The key is to understand the game, and then work continually to put the odds in your favor. Trading is a skill set. It's not the person who knows the most who wins.*

All this advice allowed me to have confidence that trading was something that I—a former teacher—could learn.

Of course, John *is* the creator of the squeeze, and the master of trading directionally aggressive options. There is no way in which I could adequately emphasize this factor. I learned most of my trading strategies from him. The foundation of my trading plan is a compilation of John's setups that he has taught in classes over the last five years. This is the ultimate base, and everything else I do, grew from there.

What are some of my favorite setups? The Squeeze, the Nested Squeeze, the Pop Squeeze, and the Triple Squeeze—these form the entire basis of my trading. My entire goal as a directional trader is to identify the

strongest, high-probability moments in time where the market is going to make a move, and then jump on it where I have an edge. These setups do just that. While John did it in a bit more aggressive way than I was able, I learned how to combine these setups with additional advice from other mentors to create my own, unique style, while also risking less capital on more *boring* stocks. I found myself using John's exact same setups, on slower-moving stocks than what he would normally trade. For me, this was the perfect mix.

I can say for certain that without his initial encouragement over the air, continued talk of breaking through the barriers of trading from a psychological perspective, teaching of specific setups, and continued shared wisdom, I most definitely would not be where I am today. Often I wonder if I had a different mentor, how my trading would be today, or if I would even trade period. The main reason options interested me to begin with was because of the way John made them seem possible for anyone. I, of course, also loved the aggressive growth potential and the excitement factor. That is something that John simply exudes, and I caught on.

### *Henry Gambell*

While John was my initial and primary trading mentor, Henry is number two on the list of my key mentors. As John's protégé, Henry has gone through the same steps as I have in learning to take John's wisdom and make it his own. Henry is a methodical technical analyst, and his infusion of directional trading, plus heavy use of Fibonacci analysis, is something that's resonated strongly with me. Henry is also much more conservative than John, and his tips and tricks for mitigating losses as well as staying in trades have been key in my trading. He has taught me how to time my entries and my exits in a way that limits my risk, something that is key for a small account.

The strict, technical aspect of my trading comes from Henry. Waking up and listening to the trading room every morning, and having Henry repeat the same rules and setups day in and day out, with distinct rules and a conservative eye, taught me the methodical procedures I use today. John has such an amazing intuition, but I sometimes found it incredibly difficult to glean "what I should do" from his intuition-based moves. Genius, yes. But as a beginner, it was hard for me to follow.

That's where Henry came in. He was able to constantly break down these setups, entries, and exits, and follow through on them with discipline and explanations that made sense to me.

Henry is also a Zen master. Staying calm is something I've always struggled with, but his continual patience in the face of any type of market condition is something that has helped me immensely. I always strive to stay calm in the face of the complete uncertainty we face every day. And thanks to Henry's training, I can do exactly that.

From John, I learned the setups and strategies. But it was Henry who really taught me how to apply those strategies in a way that made sense to me, and that I could replicate and make money from.

### *Carolyn Boroden*

I think one of the most frustrating parts of my trading journey was deciding when and where to take profits and cut losses. It took me two years before I started to incorporate Fibonacci price analysis into my work. I try and shorten that learning curve for anybody who'll listen!

I always had trouble controlling my emotions—and I still do, at times—but using Fibonacci analysis has enabled me to take profits and cut losses in a methodical manner that gets results. As Carolyn always says, “*Moves tend to terminate at extensions of prior swings.*” This was a key addition to my trading plan. I always say a special thank-you to both Henry and Carolyn for continuing to encourage me on my path to Fibonacci analysis.

To this day, Fibonacci analysis is still one of the *most important* parts of my work. I simply cannot trade a chart without running the levels first. So many times, my long setups that failed were simply a matter of a move being already extended, or a profit that turned into a loss because of I didn’t pay attention to the extension targets. Learning how to draw symmetry, and recognize the *personality* of a market, has been key to my trading success.

### *Neil Yeager*

It was Neil who taught me how to read futures indexes, or rather, the market personality. This was something I never considered particularly important as an options trader in my early days. Wow, was I wrong!

After following Neil’s methods and learning how to align my swing options setups with what the overall market was doing, my trading vastly improved. Neil also taught me how to trade futures. The ability to trade futures gave me another tool in my toolbox, especially on volatile days or days that I needed a hedge on. I currently love to day trade futures using a combined trade setup from different things I learned from John, Neil, and Carolyn, and then I created something that is my own.

In addition to the overall market view he gave me, I’ve also been able to hone my swing options strategies through tips I’ve learned from Neil’s trend-following approach. Neil’s method of strict technical analysis allowed me to perfect my swing trades, especially using his candlestick patterns and market observations. He is not only methodical, but also risk-averse, and works hard to find his edge. He will pass on anything outside of his risk-tolerance arena; this is a very important skill for a growing trader to learn.

### *Raghee Horner*

As I continue to dive more into futures trading, it is Raghee who is teaching me how to master it. Her work focuses on a wide, macro view of the markets, which is something that I have struggled with. I am primarily a technical trader, but this wide view that she has is teaching me to continue learning about the broad scope of the global markets. It is Raghee who has given me the wider view.

Additionally, her teachings on the differences between trending, “whippy chop,” and consolidating markets has been a key new addition to my trading plan. As primarily a trend follower, it is key to recognize when the trend is solid, when the trend has changed, and when there really is no trend to speak of. This work has immensely helped both my options swing plays, as well as my intraday futures trades. As I advance in my career, it is my goal to expand my futures trading from where it is right now. Currently, my primary focus is on intraday index futures setups, but I’d like to get to a point where I’m swing trading a variety of futures contracts at ease. It is Raghee who is continuing to help me down this path.

## **Key Advice on the Path to Consistency**

The following notes are my favorite pieces of advice I got from each trader. With these, I made changes to my trading that got me to a point of profitability. Here is a list of the top changes I made to get me on the path to consistency:

1. *Never risk more than you're willing to lose.* Understand that anything can, and will, happen.
2. *Select your entry point carefully.* With every trade you enter, recognize where your stop is BEFORE you place the trade. If your entry point is too far from your stop, pass on the trade. Do not get in at extensions.
3. *Understand the probability behind your setups.* Learn to recognize the higher probability setups, and the ones that you trade best. Do what makes you money. Have at least three reasons for getting into each trade.
4. *Don't put the same amount of money into every trade.* Pick the best setups and load up on those, while using lower probability setups for singles and doubles.
5. *Stop taking small profits.* Wait until your target extension is hit, or close to it. Otherwise, you're just capping your own profits. And why would you do that?
6. *Stop getting shaken out.* Relax and trust the setup. Most people get shaken out by watching charts on too small of a time frame and get anxious about their position. If that's you, try to determine a target and stop level when you enter the trade. Then set alerts on your platform at these levels. Then STOP watching the trade. Go do something else and let the trade play out. You will learn to trust your exit points.
7. *Scale both into and out of your positions.* It hurts less when you're wrong. Taking profits off at predetermined levels is a good thing.
8. *Read psychology-based books.* They will help you improve your trading, and also your life. John has several recommendations, and these helped me immensely. I especially love *Trading in the Zone* by Mark Douglas and *Turning Pro* by Steven Pressfield.
9. *Learn to use the right strategy at the right time.* A strategy that works great in a strong directional market may fall apart when the market begins chopping around. Know how to identify the market environment.

## **In Conclusion**

It is these lessons, along with many more, that brought me from a newbie trader to a consistently losing trader to a successful trader who was able to double my small trading account from the previous year's low. I'm also proud to say that I've never even gotten close to blowing out my account. During both the good and the bad days, it has always been risk first and profits second. And let me tell you, there have been more than a few bad days!

In five years, I went from somebody who knew nothing about trading to somebody who is fortunate enough to talk to you today. It wasn't without blood, sweat, and tears, but there is nothing I love more than being able to teach this subject I now know and love, day in and day out. I certainly never imagined as an

elementary school teacher that I would be teaching options and futures trading to adults by the hundreds at a time, online, at home! I am so grateful to be here today, and I owe it all to my dad, first and foremost, and all my mentors mentioned in this chapter, most notably John.

I think it's equally important to mention that while I have come this far, and I get to teach others my craft, I still consider myself a student. Every day my goal is to continue learning from this vast array of mentors in our trading team and continue to hone my skills as a trader.

Later in the book, I'll show you the strategies I use in my day-to-day trading. But first, it is time to dive into the basic setups to build a foundation. Then you can see how I combine some of these basic setups to find the best trades that work for me.



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# WHAT ARE THE BEST INTRADAY AND SWING-TRADING SETUPS FOR FUTURES, STOCKS, OPTIONS, FOREX, AND CRYPTOCURRENCIES?

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*Be not afraid of going slowly; be afraid only of standing still.*

CHINESE PROVERB

*Some long for the glories of this world; and some sigh for the Prophet's Paradise to come. Ah, take the cash and let the promise go. . . .*

OMAR KHAYYÁM: *The Rubaiyat*

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## The Opening Gap: Why Is This the First and Highest-Probability Play of the Day?

### A Note on the 3<sup>rd</sup> Edition

**Part II** of the 3<sup>rd</sup> Edition is very similar to the 2<sup>nd</sup> Edition. The setups are described in great detail, with updated links at the end of each chapter where you can access free videos and tutorials with newer examples and techniques, including cryptocurrencies where applicable. The purpose of **Part II** is to lay a foundation that you can start to use immediately in your own trading, and build upon from there. While many of the setups use futures contracts as examples, these signals can be applied to individual stocks as well as cryptocurrencies. If you are an options trader, and you see an example of a signal to buy a stock at point #1, keep in mind that you could also buy calls or sell a put credit spread at point #1 as well. The video tutorials at the end of the chapters include discussions of more advanced strategies that are difficult to explain in book format. An example is when using multiple time frames to confirm a buy signal and having to flip back and forth between the pages to reference each of the charts. This is just much easier to explain in a video where I can point out the specifics on my computer screen. For a free summary of newer setups I'm using not discussed in this book, go to [www.simplertrading.com/newsetups](http://www.simplertrading.com/newsetups). These setups build on the ones that are discussed in Part II. For Part III, this has been largely redone and updated with feedback and examples of "how we use this stuff" from myself, Henry, and Danielle.

### How Is Trading Without a Specific Setup in Mind Like Hiking in the Amazon Without a Compass?

If I had a dollar for every time someone asked me, "Of all the setups you have, what's the one setup that works best all of the time?" I'd have my kids' college already paid for, as well as their graduate school and their weddings. And I'd probably be able to take care of my in-laws, too, and their numbers are considerable. There is no easy way around it: different setups work better in different market conditions. Another question I get asked a lot is, "What's the win ratio on that setup?" I've never been asked that question by an experienced trader. It's always a newbie. Win/loss ratios have very little to do with the setup and everything to do with the parameters that are being applied to that setup. Are you interested in a setup that has a win ratio of 99 percent? Great. Every time the \$TICK goes to -1,000, buy one ES contract and use a 1-point target and a 100-point stop. This setup will win 99 percent of the time. "Fantastic," you might think. But, alas, when it is stopped, you'll wipe out all of the profit of the previous incredible string of winning trades. To put it in



perspective, I know many traders who have a 50 percent win ratio and make a lot of money trading. How? Their winners are, on average, three times bigger than their losers. Yes, it all comes back to trading psychology and letting your winners run and cutting your losers off at the knees.

Before we jump into the first of the setups, the opening gap play, I want to quickly review one absolute truth about this business. That truth is as follows—when it comes to trading for a living, all investors fall into one of three categories:

1. Those who have a system that they follow each and every day
2. Those who are developing a system and are on the lookout for the Holy Grail
3. Those who have never believed in utilizing a specific system and just trade on instinct—and are still explaining to their spouse how they lost all their trading capital

The point of this, of course, is to emphasize the importance of facing each trading day with a game plan and of establishing a trade setup with a three-pronged approach. In addition to the actual setup, there also needs to be a foundation from which to operate the setup. This foundation consists of the following: the trading methodology, the money management technique, and the knowledge of the best markets to trade for that particular setup. In other words, it's a lot more than just "What's the entry?" Do traders scale into a trade or go all in? Do they scale out or go all out? Is it better to use a tight stop and bigger size, or a wider stop and smaller size? Does this trade work better on the mini-sized Dow or the euro currency or an individual stock like FB (Facebook)? Each market is unique. Each setup is unique. Each time frame is unique. Without these additional data, traders are destined to fail, and they are only kidding themselves if they think they can do this for a living. They may have a lot of fun for a few months or a year, and they may get an incredible high out of a great trade, but it won't last over the long haul. These are the traders that act quickly when trying to make money and that act too slowly when trying to protect what they have. The idea is to create a situation that allows a person to do this for a living—each and every day.

This section focuses on a series of setups for the active trader and provides a collection of strategies that I currently use in my own trading. Specific markets are highlighted, with exact entry, exit, and stop loss levels, focusing mostly on intraday setups. Swing-trading setups are also discussed, and these are noted as such. In general, any setup that is used on the stock index futures can also be used on individual stocks. 500 SPY (SPDR S&P 500 ETF Trust) shares is the equivalent of 1 E-mini S&P 500 futures contract. If buying options on the SPY to mimic a futures trade in one of these chapters, then using 7 Delta 70 SPY calls is about the same as buying 1 E-mini S&P 500 futures contract, from a P&L fluctuation perspective. Exceptions to this guideline are noted. I like to use day-trading strategies in one account and swing-trading strategies in another account. This keeps everything separate and easy to track. I chose to show setups that had a successful resolution in order to demonstrate how to manage the exits on these setups. In instances where these setups get stopped out, and that does of course happen, sometimes frequently, that is an easy exit to manage—the stop was hit. As a trader, it is important that you realize that not every trade will work out. It is quite possible to get stopped out two or three times in a row before you catch a successful move. This is a normal part of trading, and it is important that a trader not get frustrated. This is why it's important to "keep losses small and let winners run." Even with an 80 percent win ratio, it doesn't mean you will only lose one out of every five at

bats, as the groupings of outcomes are random. This means you could have 5 losing trades in a row over the course of 100 trades. This is why it is important to keep track of “batches” of trades. How did that block of 25 trades work out? The block of 100? If the blocks are profitable, then you are on the path to creating a consistent income.

A typical scenario I’ve witnessed with traders is that they get stopped out of a setup and then hesitate to take the next one, which of course turns out to be a winner. Or they get stopped out of a setup, so the next time that setup occurs, they take profits too fast. Or if the last one was a winner (or a loser), then they double up on the next one. The point of this is that a trader needs to become like a machine and just do the setups, not operate based on “how he feels about the last trade.” On any given day, I will take five intraday setups. One of these will get stopped out, two will be scratched, and two will be winners. On days where my first three trades are winners, I will usually stop for the rest of the day and book my gains. If I hit a day where my first three trades are stopped out, I take the hint and go to the gym.

I utilize a variety of specific setups in my daily trading routine. I started off trading stocks and stock options, so most of the setups focus on some aspect of the stock market, whether it’s through individual stocks or through the mini-stock index futures. There are also setups in other markets that I discuss, particularly in gold, silver, and some of the currencies. Some of these I developed myself, and some of them were developed by other people whom I trade with. The purpose of this section is to give you specific setups that you can utilize on the next trading day. It should also give you a blueprint for developing and tweaking your own setups. For me, the biggest difference in my trading occurred when I learned to ignore my brain and just focus on a handful of good setups. Once I learned the setups, the next challenge was to have the discipline to follow them the same way, each and every time. I did this by recording my trading activity for more than a year and focusing on the results *for each setup*. If I deviated from the setup, if I tried to outthink it and got out too early or in too late, I noted this in my data and marked it as an “impulse play.” After a while, I noticed that these impulse plays didn’t make me any money. I saw the light, so to speak, and suddenly my trading focus took a dramatic shift. Instead of focusing on the potential gains of a trade or worrying about missing a move, I focused on executing a flawless setup. That is the key difference between a trader who can do this for a living and a trader who lives a life of quiet frustration. I’m not going to beat around the bush on this: following setups without letting the day’s or week’s or month’s P&L affect your thinking is very, very hard to do. But it’s the difference between life and death.

It’s like quitting smoking. Either people choose to light up another cigarette or they do not. They take it one day at a time. For each day they don’t light up, the better the odds that they will never smoke again. It is no different in trading. For each day traders can actually be totally disciplined and follow their setups exactly as planned—even if it means standing aside when the market is racing away without them—the better the odds that they will make it in this business. If you want thrills, go to Disneyland.

Although I can’t stand over your shoulder and help you with your discipline, I can show you the setups that I use to trade for a living. I have loosely organized these in the order in which I look at them throughout the trading day. As you try these out on your own, you will find that you naturally gravitate toward some rather than others. Key in on this, as a trader will tend to move toward setups and markets that seem to fit her personality. Let’s jump right in with the first setup and one of my favorites—the opening gap play.

## Why Aren't All Gaps Created Equal?

With regard to gaps, very little has changed since this book first came out. I still find gap plays to be the best way to start off my trading day. Not only are they the first trades of the stock market session, but, more important, they can also tell a person a lot about the upcoming market action for the day. Because of this, I spend more time talking about this setup than the others.

Gaps are contrarian plays, or “fade plays,” as I like to call them. Opening gaps create a lot of excitement and emotion in the market participants, and I like to step in and take the opposite side of this emotion. The play is completely against the crowd, which I like, and it is one of the lowest-risk trades available. What exactly is a gap? A *gap* occurs when the opening price of the next day's regular cash session is greater or lower than the closing price of the previous day's regular cash session, creating a “gap” in price levels on the charts, similar to that space we used to see each night between David Letterman's two front teeth. It is important to note that traders will not see this gap on their charts unless they specifically set up a “gap” chart. With a 24-hour chart, traders will not see the gaps. This is discussed in more detail shortly.

When it comes to gaps, not all markets are created equal. Gaps in “single-item” markets do not act the same way as gaps in “multi-item” markets. Examples of single-item markets include bonds, currencies, grains, and individual stocks. These gaps typically fill at some point, but not necessarily on the same day. For this play, I'm specifically interested in gaps that have a high probability of filling on the same day they are created. For single-item markets, a news item controls the entire order flow for that day, instead of affecting just a small portion of an entire index.

This is especially true of individual stocks. Individual stocks are like politicians, in that each day they can produce a fresh skeleton from the proverbial closet. Earnings announcements, corporate scandals, and insider deals can create gaps in price that never get filled. Ken Lay and Bernie Ebbers certainly wished that their Enron and WorldCom stock would fill their overhead gaps. Unfortunately, the odds of this happening are about the same as that of Republican and Democratic senators working together for the good of the country. In other words, it's never going to happen. Because of the unpredictable nature of individual stocks, they make poor candidates for gap fills. The exception to this is gaps on individual stocks that are gapping with the market and not on any particular news. How does a person tell this? If a stock is gapping about the same percentage as the overall market, and there isn't any news on that stock, then that stock can be played as a gap play. For example, if AAPL gaps up 1.00 percent, the overall S&P 500 is also gapping up 1.00 percent, and there isn't any specific news on AAPL, then it can be played as a gap play. It's just moving with the overall market.

As compared with single-item markets, multi-item markets such as the E-mini S&Ps and the mini-sized Dow futures, as well as their equivalent ETFs (exchange-traded funds) via the Spiders (SPY) and Diamonds (DIA), make great candidates for gap plays. This is because there are individual components of these indexes that will respond differently to various news items. Good news for oil companies is bad news for transportation companies. Good news for defense stocks can be bad news for travel-related stocks, and so on. This means that, although the market may gap up on a news item, there will be individual stocks within the index that will either ignore the news or sell off on the news. This, coupled with an initial pullback in the strong issues that are gapping up, weighs down the entire index, creating an opportunity for the market to fill

its gap. In addition, many fund managers watch the open gaps. They've been doing this for a long time, and they know that the markets hate to leave "messy charts" in the form of open gaps. If the markets gap up, they will generally wait to start committing to the long side until the market has pulled back and filled its gap. In this way, it is also like a self-fulfilling prophecy.

What about the Nasdaq and the Russell? I've watched these markets as well, and although they do fill their gaps a large percentage of the time, that percentage is lower than those for the Dow and the S&Ps. In the end, my favorite gap plays are in the mini-futures and ETFs representing the Dow and the S&P 500.

### *What Is So Magical About Premarket Volume?*

The great thing about gaps is that they are like an open window, and, like all windows, at some point they are going to be closed. The key, then, is to be able to accurately predict when the day's gap (window) is going to be filled (closed). What is as important as analyzing the gap itself is analyzing the *market conditions* that produce the gap. The reason for the gap is immaterial. Upside earnings surprises, terrorist threats, takeover announcements, economic reports—each morning the markets are bombarded with news. It's not the actual news, but how the markets respond to that news that is important. To understand how the markets are really reacting to the news, all a person has to do is look at the premarket volume. In addition to news gaps, which are more or less fishing expeditions, there are also professional gaps. Professional gaps are designed to keep the retail investor out of the market. These occur when the Dow gaps up 100 points and then trades in a tight range for the rest of the day. The move essentially happened before the market opened. The professionals who were positioned for the move benefit, while the average retail investor is left with nothing and no opportunity to participate in the move. Again, premarket volume can tell a trader if the gap is going to be a professional breakaway event or is going to lead to price action that has a high probability of filling the gap on the very same day it was created. A professional gap with high premarket volume can take weeks to get filled. Much more common are gaps that are news reactions or fishing expeditions. These are smaller in nature, are highlighted with low to moderate premarket volume, fill quickly, and can be faded regularly.

The question, then, is, if I ignore the reason for the gap, what is it that I'm looking for that determines whether or not I will take the setup? Premarket volume in what, exactly? The key action I am watching is the premarket volume in a specific set of cash stocks, typically the big names of the day. When I first wrote this in 2005, I liked to watch KLAC (KLA-Tencor Corp.), MXIM (Maxim Integrated Products Inc.), NVLS (Novellus Systems Inc.), and AMAT (Applied Materials Inc.). I liked these stocks because they were traded actively in the premarket session and were traded aggressively by both individual traders and fund managers. Today, I've replaced these stocks with AAPL (Apple), GOOGL (Google), FB (Facebook), BIDU (Baidu), AMZN (Amazon), and NFLX (Netflix). These are the movers and shakers today. Ten years from today, the set of stocks may be different, though it's hard to imagine AAPL and AMZN leaving this list.

Even though these stocks have different weightings in the indexes they represent, they still provide a clear map as to how the market is handling any particular news that is out on the day. If the volume on these stocks is heavy, then it is obvious that the market is taking this news very seriously. If the volume on these stocks is light, which is more common, then the market either is not interested in the news or, more likely, has already priced it in. It is on these days that the gaps have a very high probability of filling on the same day in which

they were created.

What I'm looking for is the premarket volume in these stocks as of 9:20 a.m. eastern, 10 minutes before the regular cash session opens. The premarket session opens at 8:00 a.m. eastern, so these are data on 1 hour and 20 minutes' worth of trading. If these stocks are trading less than 30,000 shares each at this time, the gap (up or down) has an approximately 85 percent chance of filling that same day. However, if the volume jumps up to 50,000 shares each, the gap has only about a 60 percent chance of filling that same day. On these particular days, however, the midpoint of the gap has an 85 percent chance of being hit, so I do take this into account and adjust my target accordingly. For example, if the gap is 50 points on the Dow and the premarket volume is moderate, then my target is going to be 25 points from my entry instead of the full 50 points, which would constitute a gap fill. Finally, if the premarket volume jumps to more than 70,000 shares each, the chances of the gap filling that same day drop to 30 percent. These are typically the days that involve a professional breakaway gap. On these days, I don't fade it. I typically stand aside and wait for one of my other setups to unfold.

These figures are for "normal" market conditions. When I wrote this in September 2011, the markets have been extremely volatile, and I've had to double these numbers, especially for AAPL. One way to get an idea of these levels is to look at the \$VIX. A few months ago, the \$VIX was trading at around 20.00, which is essentially "normal" and is what the volume numbers given here are based upon. It's currently trading at 40.00, which indicates much higher volatility—double, in fact. Hence the volume levels have also had to be doubled. Take a look at where the \$VIX is trading and you'll be able to get the approximate volume numbers you'll need. If it's trading at 60.00, you'll need to triple the numbers given here; if it's trading at 10.00, you'll need to cut them in half; and so forth.

Why does this premarket volume indicator work? Think about it as driving a car uphill on an empty tank of gas versus a full tank of gas. If the market is really set up to move, then there will be real volume coming into the cash market to propel that car "up and over" the hill. If the market is just setting up a head fake, then the volume in the cash market will be low, as there won't be any real conviction in the move. Ignore the news and follow the money. [Table 7.1](#) shows how I use this information to manage my trades.

**Table 7.1**

<b>Pre-Market Volume in Key Stocks</b>	<b>Position Size</b>	<b>Trade Target</b>
Less than 30,000	Full size	Exit entire position at gap fill
Between 30,000 and 70,000	$\frac{2}{3}$ size	Exit half at 50 percent of gap fill, half at gap fill
Above 70,000	No fade trade	No fade trade

There are many days when three of the stocks are trading under 30,000 shares and another stock will be trading 95,000 shares. In these cases, I will first check to see whether there is specific news on that stock. If there is, I will throw it out. If there isn't, I will then take an average, call this a "moderate" gap, and play it

accordingly—meaning that my target on the first half will be 50 percent of the gap fill instead of holding on to the entire position for a full gap fill. For moderate gap plays, I do not trail down the original stop, even when I get out of half my position.

### *What Are the Best Days of the Week to Take This Trade?*

We keep a tab on raw gap data, meaning the percentage of the time that a gap fills, regardless of how big the gap was or how much premarket volume traded. Just the clean, raw, “it is what it is” data. In [Table 7.2](#), these data are sorted by day of the week and show what percentage of the time the markets filled their opening gaps on the same day in which they were created.

**Table 7.2**

<b>Day</b>	<b>Percentage of Gaps Filled</b>
Monday	65%
Tuesday	77%
Wednesday	79%
Thursday	82%
Friday	78%

As is evidenced by these data, gaps in and of themselves have a very high probability of being filled on the same day on which they are created. If a person could get these same odds at a blackjack table, Las Vegas would be put out of business in three months. That said, it is important to note that Mondays are the days with the lowest percentage of filled gaps. The main reason for this is that most breakaway gaps happen on Mondays—there are a lot of developments that can happen over the weekend. On Mondays, I typically pass on the gaps; in fact, I typically just let the markets open without me, in order to give them a chance to “settle in” before I start looking for setups.

Finally, I’ve noticed that expiration day (the third Friday of every month) and the first trading day of the month have low probabilities, in the range of 55 to 60 percent. I generally pass on fading the gaps on these two days. The only exception is if the premarket volume is very low. The bottom line is that if the premarket volume gets confusing and a trader doesn’t understand the reading on any given day, the odds are still there, and the trade is worth taking.

### **What Are the Trading Rules for Gaps?**

#### *Trading Rules for Gap Down Buys (Gap Up Sells Are Reversed)*

This set of rules for gap down buys is based on a gap with low premarket volume. If the volume is moderate, then I will do exactly the same thing, except that I will take off half my position when the markets reach the price level that represents 50 percent of the gap fill. If the premarket volume is high, then I pass on this trade

setup. Remember, this is a fade play. I will buy a gap down and short a gap up. The following set of rules is for a gap down:

1. I first set up a special intraday gap chart that starts collecting data at 9:30 a.m. eastern and stops at 4:15 p.m. eastern. This is so that I can view the gaps. These gaps won't appear on charts that carry 24 hours' worth of data or as "regular session" data on the futures markets.
2. A gap must be at least 10 YM points or 1 ES point—otherwise I will pass.
3. If a gap is more than 70 YM points or 7 ES points, I pay careful attention to the premarket volume. Most breakaway gaps are big gaps. However, if the premarket volume is low to moderate, I will still take these.
4. With a gap down, when the regular cash market opens at 9:30 a.m. eastern, I buy the YM or ES at the market. The DIA and SPY can also be used. It doesn't really matter which market is utilized, with two exceptions. First, if one of the stocks in the Dow is "out of whack," then I will play the gap in the S&Ps. By this I mean that if a stock like IBM is up 10 points on earnings, then this index is going to be out of whack with the rest of the markets. The other exception is if I am specifically using the Dow in another setup, say a squeeze or a pivot play (these are discussed in upcoming chapters). Then I will take the gap in the S&Ps. This way, if I am still in the gap play when this next setup fires off, I can just take it in the Dow and leave my gap trade on.
5. Once filled, I set up a protective sell stop with the following parameters:
  - For gaps that are under 40 YM or 4 ES points, I use a 1½:1 risk/reward ratio. (For example, for a 20-point gap, I use a 30-point stop.)
  - For gaps that are over 40 YM or 4 ES points, I use a 1:1 risk/reward ratio. (For example, for a 45-point gap, I use a 45-point stop.)
6. My target is the gap fill itself. If yesterday's closing price was 1058.50 on the S&Ps, then that is my target for the gap fill. For a moderate-volume gap, I will split this order up, having half my target at 50 percent of the gap fill and leaving on the remaining half for a potential full gap fill.
7. I don't trail stops for this setup.
8. If I'm stopped out, then the gap play is over for the day.
9. If neither the target nor the stop is hit by the closing bell, I exit my position at the market.
10. For the gap play, there is only one potential setup per trading day.

### **Who Is Getting Hurt on This Trade?**

One of the most important steps for traders is to understand why they are making money in a particular trade—which also means understanding who exactly is losing money on the other side of the trade. Who is getting hurt and why?

When markets gap down, there are generally two groups that are going to get hurt. First, there are the people who are long from the day before. When the markets gap down, these people are either getting

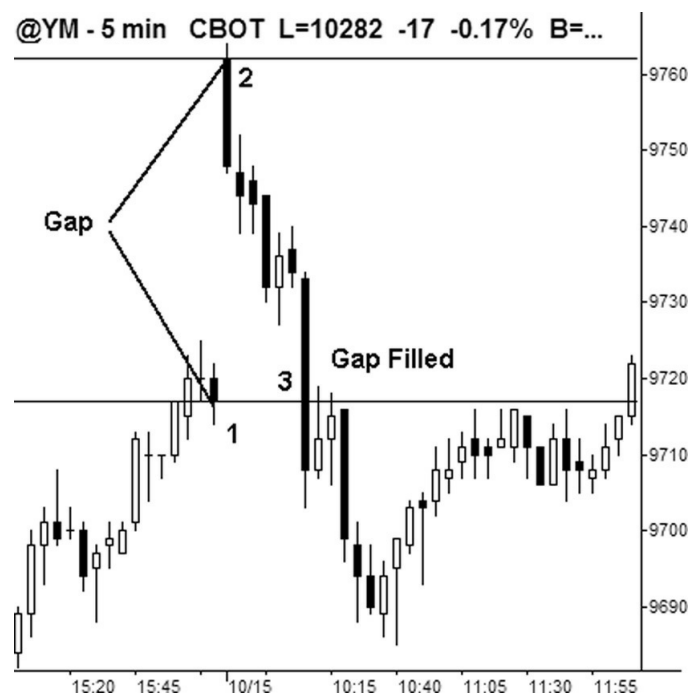
stopped out or panicking and selling. Second, there are people who are flat, see the gap down, think it is the end of the world, and start shorting. In this setup, I want to be on the opposite side of the trade from both these groups, because both of them are having a strong emotional reaction to the market, and this emotion is causing them to get into a trade. Therefore, when they are selling, I am buying. These same groups will provide the fuel for the rally through, in the case of the first group, panic buying in trying to make back their early losses and, in the case of the second group, short covering via the stops they placed when they put on their short trade. Let's take a look. The charts that follow are numbered in specific places where price action is taking shape. Each of the lists that refer to the chart is numbered so that the text following "2" describes point 2 in the chart to which the text is referring.

### What Are Some Specific Examples of Trading the Gap?

#### *Mini-Sized Dow—December 2003 Contract, October 15, 2003*

1. The mini-sized Dow contract closes at 9717 on October 14 (see [Figure 7.1](#)).

Figure 7.1



2. On October 15, the opening trade at 9:30 a.m. eastern is 9762, producing an opening gap of +45 points. I "fade the gap" right at the open and short the YM at the market. My protective stop is 45 points away from my entry, at 9807, and my target is the gap fill, which is the previous day's close at 9717.
3. The gap fill is complete once the price levels reach the previous day's close. This occurs 35 minutes after the opening bell. This is a relatively smooth trade. I refer to these quick fill gaps as "Bahamas gaps" because they are relatively smooth, quick, and stress-free. This trade nets a profit of \$225 per contract.



*Mini-Sized Dow—December 2003 Contract, October 16, 2003*

1. The market closes at 9704 on October 15 (see [Figure 7.2](#)).

Figure 7.2



2. The opening trade at 9:30 a.m. eastern on October 16 is 9645, creating a 59-point gap down. I buy at these levels and place a stop at 9586.
3. Many people who play gaps would get stopped out right here at point 3, as they would trail up their stop to breakeven to protect their gains. For these people, the gap play is now over.
4. Yet by holding on to this play with parameters that were made especially for gaps, I end up staying in profitable trades that shake many other traders out (see [Figure 7.3](#)). The reason for this is that the other traders are using blanket types of parameters for every play, instead of utilizing specific parameters that are tailored for specific plays. Although many gaps are filled within the first hour, many can take a couple of hours or more. I like to set the parameters and focus on something else while the market “does its thing.” I refer to gaps of this type as “Somalia gaps.” Unlike Bahamas gaps, they tend to cause a lot of stress in the people who are watching them. It’s okay to feel stress; professional traders simply don’t act on it, maintaining the parameters they have set for themselves. This trade nets out a profit of \$295 per contract.

Figure 7.3



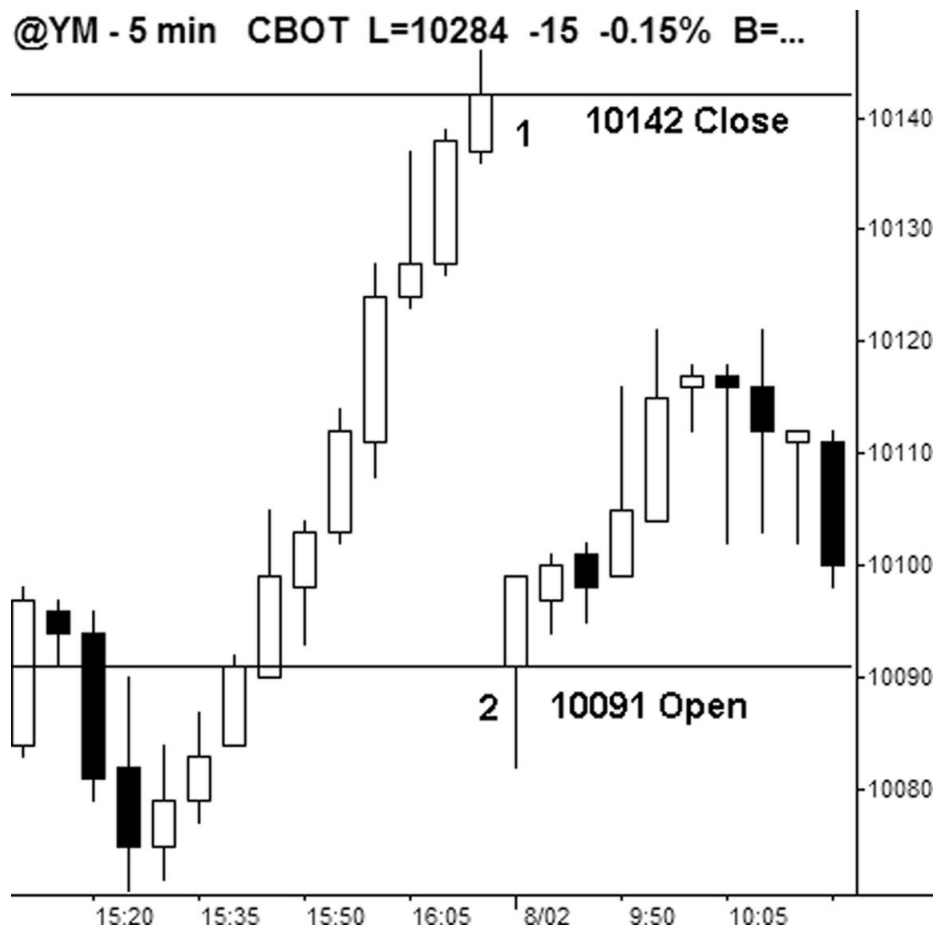
Note that one of the best signs of an amateur trader is a person who uses only tight stops or a 3:1 risk/reward ratio on every trade. Most beginning traders are taught by their brokers to use this tight stop formula, risking 1 point to get 3 points. As the traders wonder why they always get stopped out just before the market turns, their broker is tallying up the commissions generated on the day. In general, wider stops produce more winning trades. The key with wider stops, of course, is to play only setups that have a greater than 80 percent chance of winning. The gap play I'm describing, with the parameters that I use, has a greater than 80 percent chance of winning with the risk/reward ratios that I utilize. When you use a tight stop on a gap play, the probabilities of the trade's working out fall dramatically—to less than 30 percent. In essence, one of the reasons many traders fail to make it in this business is that they are using stops that are too tight. This might seem like a contradiction, but if almost every trade is stopped out, it's tough to make any money.

What is also important to remember for gap plays is that an active program of trailing stops will negatively affect your win/loss ratio. Once the parameters are set in place, the best thing a trader can do is to walk away and let the orders do their job. Although tweaking is a good thing to do when giving a car a tune-up, tweaking the parameters of a gap trade won't work.

### *Mini-Sized Dow—September 2004 Contract, August 2, 2004*

I've found that most traders get too caught up in the reasons for the gap. In reality, the reason is meaningless. Gaps happen because a flurry of emotion hits the tape at the opening bell. However, the reason for the gap has little significance with regard to whether or not the gap fills. On Sunday, August 1, 2004, the US government issued a terrorist warning claiming that there was chatter on the airwaves about a plan to blow up a large financial institution. The markets got nervous, and the markets gapped down in a big way on Monday morning, August 2 (see [Figure 7.4](#)).

Figure 7.4



1. On Friday, July 30, 2004, the mini-sized Dow futures closes at 10,142.
2. On Monday, August 2, 2004, the markets open for trade at 10,091, down 51 points. I buy here right at the 9:30 a.m. eastern open. I place a stop at 10,040. The markets spend a good part of the day chopping around, and I talk with other traders who are nervous about the terrorist threat news. Do I let this “nervousness” get into my own trading? Should I listen to the reasons for the gap?
2. Later that same day, the markets grind higher, and I am out at the gap fill (see [Figure 7.5](#)). Gaps are the ultimate contrarian play; don't get caught up with the crowd. This trade nets a profit of \$255 per contract.

Figure 7.5



*E-mini S&P—September 2004 Contract, August 24, 2004*

1. On August 23, the ES closes at 1097.00 (see [Figure 7.6](#)).

Figure 7.6



2. The next morning, the 9:30 a.m. opening trade prints at 1101.00, 4 points above its close. I short at

the open, placing a stop at 1105.00.

3. A little over an hour later, my target is hit as the E-mini S&Ps fill their gap, for a total gain of \$200 per contract.

*E-mini S&P—September 2004 Contract, August 4, 2004*

1. On August 3, the ES closes at 1097.50 (see [Figure 7.7](#)).

Figure 7.7



2. The next morning, the market gaps down and opens at 1094.25. This gap is 3.25 points, so I use a 1½:1 risk/reward ratio and place my stop at 1089.25.
3. I buy at the open. The market chops up, then pushes down to new lows. A little over an hour later, the market has firmed, and I'm out of my position at the gap fill. The markets spend a good portion of the day in a tight, choppy range, rallying only in the final half-hour of trading. On many days, the gap play is not only the safest, but really the only trade to take. We call the market *choppy* when it trades in a narrow, low-volume range because it chops up newer traders to death. This trade nets a total of \$162.50 per contract.

*E-mini S&P—September 2004 Contract, July 14, 2004*

1. On July 13, the E-mini S&Ps closes at 1114.75 (see [Figure 7.8](#)).

Figure 7.8

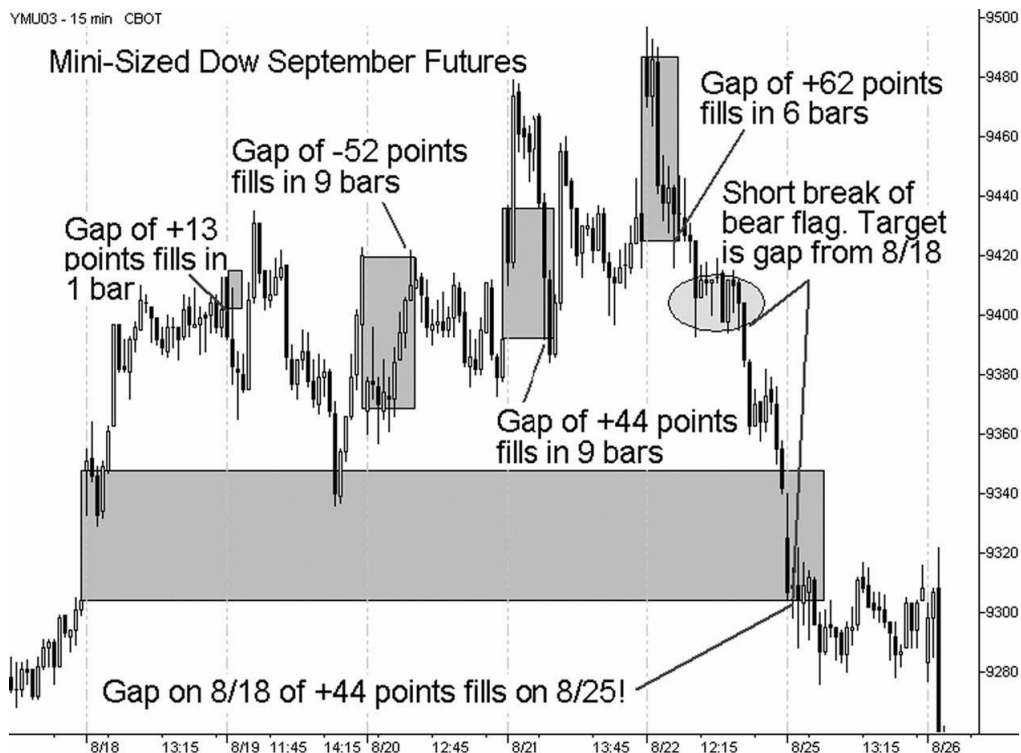


2. The next morning, the market opens down 5.75 points at 1109.00.
3. I buy at the open and place a stop at 1103.25.
4. The gap fills in a little under an hour. This is another example of a Bahamas gap, as it is very relaxing to trade with a minimum of false moves. This trade nets a total profit of \$287.50 per contract.

### What's the Secret to Unfilled Gaps?

One important thing to remember: if 80 percent of these plays win, that means that 20 percent of them lose. I actually like losing trades for one main reason: this leaves an “open gap” in the markets. An open gap is like a black hole or a tractor beam, eventually sucking prices back to their opening gap levels. Whenever the markets leave an open gap, I mark that level on a Post-it note and place it on my computer. Let's look at an example (see [Figure 7.9](#)).

Figure 7.9



Let's get a little more specific on how to play this, using a \$100,000 account and utilizing nine contracts for a full position, or approximately one contract for every \$11,100 in the account. Yes, a person can trade a lot more contracts than that in a \$100,000 account, and many brokers will encourage a person to trade more than that. With some brokers, a trader can get enough leverage to trade 100 contracts on a \$100,000 account. This is purely and simply insane. Just because people can do something doesn't mean they should. The leverage here is far too much. Traders who are using a modest 2-point stop on the S&Ps could get stopped out four times in a row. Where does this leave them?  $2 \text{ points} \times \$50 \times 100 \text{ contracts} = \$10,000$ . Four stops in a row = \$40,000. I've seen more than my fair share of people do this, and it is just inexcusable. There are many things people can do in life. They can drink one glass of wine or the whole bottle. They can drink one cup of coffee or the whole pot. They can go to the gym each day or sit and watch TV. It all comes down to choice. Just because people can do something doesn't mean that it's a good idea. Choose with your best interests in mind. Let's go back to the example.

On August 18, we gapped up a modest 44 points in the Dow prior to some economic numbers. I shorted at the open. We rallied, sold off into the economic numbers, and then shot higher once the numbers were released. I had a 44-point stop, and the markets rallied just through that level, producing a loss of \$220 per contract, or \$1,980.

I headed into the next trading day knowing that there was now a "black hole" gap below. I could actually hear the sucking sound. The next day we had a modest low-volume 13-point gap higher that worked out quickly for \$65 per contract (\$585). The day after, we got a nice 52-point gap lower that took a few hours to fill, but created few headaches, for \$260 per contract (\$2,340). The next day we got a 44-point gap higher that was on moderate volume. It came close to our stop, but eventually filled the gap for \$255 per contract on four contracts. I covered the first five contracts when we got to 50 percent of the gap fill level, which was 22 points.  $4 \text{ contracts} \times 44 \text{ points} \times \$5 = \$880$ , and  $5 \text{ contracts} \times 22 \text{ points} \times \$5 = \$550$ , for a total of \$1,430 on the play.

Finally, on August 22, we got the “sucker gap” when Intel announced “cautious upside earnings revisions.” The market exploded and gapped up 62 points, right into key resistance—on low premarket volume.

I shorted the gap. Six bars later, my target was hit for 62 points, or \$310 per contract (\$2,790). *The sucking sound of the black hole below was getting louder.* During the afternoon session, we got a bear flag consolidation. I set up a sell stop at 9392 to let the market take me into a breakdown of that flag formation. I got the fill and set my stop above intraday resistance at 9455. My target was the August 18 black hole open gap at 9304. The market spent the rest of the day on its hands and knees, dry heaving, trying to hold back the internal pressure. This pressure proved to be too much, and, like a freshman college student during his first year away from home, the market eventually fell over and vomited. The gap filled for an 88-point gain, or \$440 per contract (\$3,960).

When there are open gaps left in the market, I always write them down and mark them on my chart. The markets will take them out eventually, usually within 5 to 10 trading days.

### **What Are the Best Strategies for People Who Can't Trade Full Time?**

Gaps are one of the best strategies for people who are holding down a full-time job. On the West Coast, this is particularly easy, as the markets are open well before most people have to head to the office. The main consideration to keep in mind is that a person will want a trading platform that will automatically cancel a stop once the target is hit. Another, often overlooked alternative is to have a broker who can be called with the parameters. Typically these brokers will cost a little more in commissions, but it is worth it to have someone watching out for the trade. The biggest advantage of doing this trade as a part-time trader is that you won't be prone to making the very mistakes most full-time traders make while watching the trade progress. They get antsy, they get fidgety, and they end up bailing out too soon. Someone who is at the office and doesn't have time to watch the trade actually has a big edge over most of the traders who haven't learned to control their emotions.

### **How Does a Trader Position Size for This Setup?**

One frequent question I get is, “How many contracts or shares are you trading with this strategy?” These same plays can be executed in five different markets. There are the mini-sized Dow and E-mini S&P futures, the SPY and DIA ETF shares, and also futures on the DIA available through One Chicago. [Table 7.3](#) shows the different instruments and the number of shares or contracts I would trade on a \$100,000 account using this setup. The DIA futures are nice if a trader is using a smaller account. They are a happy medium between having a lot of leverage with the mini-sized Dow and E-mini S&P futures and having no leverage with the DIA and SPY stock. The example shown in [Table 7.3](#) is with a gap that occurred on July 24.

**Table 7.3**



Quantity	Market	7/23 Close	7/24 Open	Gap: Points	Stop	Profit
9	mini Dow	9,169.00	9,233.00	64	9,329	\$2,700
9	E-mini S&P	987.00	993.50	6.50	1,003.25	\$2,925
20	DIA futures	91.96	92.58	0.62	93.51	\$1,240
500	DIA	91.91	92.50	0.59	93.38	\$295
500	SPY	99.29	99.99	0.70	101.04	\$350

### Summing Up the Gaps

Gaps are the one moment of the trading day where all the players have to show their poker hand, and this creates the single biggest advantage for the short-term trader. Understanding the psychology behind the gaps is paramount for playing them successfully on a daily basis. The gaps are so powerful that many traders make a nice living playing these setups alone. The key is to know how they work and to develop a solid methodology and set of rules to trade them. One consideration to keep in mind while playing gaps is the 50 percent retracement level. At the beginning of this chapter, I mentioned that I would take half of my position off when there is moderate premarket volume. The reality is, the 50 percent retracement level is the highest-probability exit on any gap. It is okay to modify your trading plan to take off half your profits on any gap that reaches the 50 percent retracement level, regardless of whether premarket volume was moderate or low.

After reading about this setup and understanding the specifics behind it, the serious trader will have a better foundation for a plan to trade the markets successfully on a full-time basis: a proven setup to play, markets that best fit that setup, and a plan of action to maximize the play. That is pretty much all a trader needs in order to survive and thrive in this greatest of professions.

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## Pivot Points: Why Are These Good Pausing Points for Trending Days and Great Fading Points for Chippy Days?

### What Is the Best Way to Beat Indicator-Based Traders?

One of the simplest and most effective position entry and exit techniques that I use is based on what I call the multipivot levels, which consist of the daily, weekly, and monthly pivot points, along with the midpoints between the daily levels. This is a setup I use primarily on the stock index futures, although they can also be utilized on some individual stocks (the big names), as well as the corresponding stock index ETFs via the DIA, SPY, QQQ, and IWM. In addition, I like to use the weekly pivots on most other futures contracts, such as gold, currencies, oil, and so forth. These are also proving useful for the actively trading crypto currencies like Bitcoin and Ethereum. The daily pivots on these are okay, but I've found that the weekly levels hold much better on these other commodities. Like the gap play, the pivot play hasn't changed much since this book first came out, and I've left the examples here intact that still ring true today.

The main advantage of this system is that it is price-based rather than indicator-based. By the time most indicators generate a buy or a sell signal, the move is already well under way. By following this price-based methodology, I will get into a trade before the indicator-based traders, and I usually end up handing off my position soon after a buy or sell signal is being generated on a stochastic or other oscillator type of system. This is especially true on chippy days. Just as the Johnny-come-latelies are jumping in, I'm closing out my position and looking for the next setup. On chippy days, it's the indicator-based traders who get taken out back and shot. Their buy signals get them in at the top of the move, and their sell signals get them in at the dead lows, leading to a frustrating day with a negative P&L. Pivots are set up to naturally take advantage of their mistakes, essentially siphoning money from these trading accounts into your own.

This is also a good system for traders who don't have time to stare at the charts all day long or, not surprisingly, for traders who have a bad habit of chasing the market higher and lower. Playing the pivots automatically creates trader discipline, because the entries and exits are determined before the trading day even starts.

The other thing I like about the pivots is that they can be used as a tool to quickly determine what kind of trading day it's going to be. On a trending day, markets will move to a pivot level, consolidate for 15 to 20 minutes, and then continue to march in the direction of the trend. On these days, I wait for the move through the pivot level and then buy the first pullback to that level. On chippy days, however, the markets will move

up to a pivot level, hang around for a short time, and then drift back in the direction whence they came. Many traders get “chopped up” during these types of trading days, losing money and making their brokers rich in the process. The pivots are naturally set up to be faded on these days and are one of the few profitable ways to trade the low-volume, narrow-range chop.

There are two very easy ways to tell whether the market is trending or chopping. The first is to look at how the market reacts to the pivot levels once it reaches them. The second is to set up a five-minute chart of the E-mini S&Ps and see what kind of volume is coming into the market after 10:00 a.m. eastern (see [Chapter 5](#)). If the volume is more than 25,000 contracts on each bar, then the market has power and volatility behind it. These types of days usually have wide ranges and strong trends. However, if the volume after 10:00 a.m. eastern is consistently below 25,000 contracts on a five-minute chart, then there is little power to move the beast, and the end result will be a slow, choppy day. On the first type of day, I wait for the markets to move through pivot levels, and then I set up an order to get in on the first retracement. On the choppy days, I place open buy and sell orders against the pivots and have standing orders to fade these moves throughout the day. There is nothing to watch on these types of days, so I generally let my orders do the work for me while I spend some quality time at the driving range. Is there a bonus play? On a choppy day, a high or low \$TICK reading (+1,000 or -1,000) right into a pivot level. That is, the market rallies right into a key pivot, and during that rally, a +1,000 \$TICK reading is reached, exhausting all of the buying pressure. Bingo. That is the short setup of the day.

### Why Aren't All Pivots Created Equal?

So what exactly are the pivots? There is no big mystery or secret to them, and many readers will have heard about them and have used them in their own trading on a regular basis. For the uninitiated, I explain how I set them up and why they work, and then we can jump into the setups that I use with them.

Pivots are readily available and have been around for a long time. They are support and resistance levels calculated by floor traders using a simple mathematical formula. These levels became widely known and have moved off the floor. Today many traders are aware of them and try to use them, but in my experience, they are using them incorrectly. To add to the confusion, there are different formula versions and different time frames that are used when calculating pivots. So, to get started, let's look at what I use, which is one of the standard pivot formulas:

$$\text{R3: } R1 + (\text{High} - \text{Low})$$

$$\text{R2: } \text{Pivot} + (\text{High} - \text{Low})$$

$$\text{R1: } 2 \times \text{Pivot} - \text{Low}$$

$$\text{PIVOT: } (\text{High} + \text{Low} + \text{Close})/3$$

$$\text{S1: } 2 \times \text{Pivot} - \text{High}$$

$$\text{S2: } \text{Pivot} - (\text{High} - \text{Low})$$

$$\text{S3: } S1 - (\text{High} - \text{Low})$$

Once a trader has this formula, then the key data needed are the high, low, and close of the previous session. For my own trading, I like to utilize 24 hours' worth of data to capture the highs and lows. However,

it is absolutely imperative to use the settlement price for the close, as this is the only closing price that matters. Often a 24-hour setting on a chart means “midnight to midnight,” and that will destroy the validity of the data. We will go over this in more detail shortly.

Once I get this high, low, and close, I plug them into an Excel spreadsheet with the formulas listed previously. This information generates seven important levels for the next trading day: a central pivot, then three levels above (R1, R2, and R3) and three levels below (S1, S2, and S3). The central pivot has the most weight of the seven levels. In addition to these daily levels, I also utilize the midpoints between these levels. Finally, I like to know where the weekly and monthly levels are located. These are calculated by taking the high, low, and close of the previous weekly or monthly bar. While the daily pivots change each day, the weekly pivots change only once a week, and the monthly pivots only once a month. As a side note, indicators can also be programmed with these formulas so that the pivots are set up automatically on your charts without the need for you to do it all manually each morning—though doing it all manually does make you remember where those pivots are located.

It is important to note that it is rare for a stock index to hit its daily R3 or S3 level. This is important to know because if a market rallies to R2 or sells off to S2, that usually ends up being the dead high or the dead low for the day. This knowledge will help temper a trader’s emotions and keep him on track to follow this system. This is, of course, under normal market conditions. When I wrote this in September 2011, the \$VIX is at 40.00 and the markets are incredibly volatile, regularly testing the R3 and S3 levels. The lower the \$VIX, the tighter the ranges.

### **How Exactly Should I Set Up the Pivots on My Charts?**

I’m going to go through the process of how I update the pivots on my charts each day. This is based on updated exchange trading hours as of September 29, 2017. To calculate the daily pivot numbers, I use the following data to generate my high, low, and close numbers:

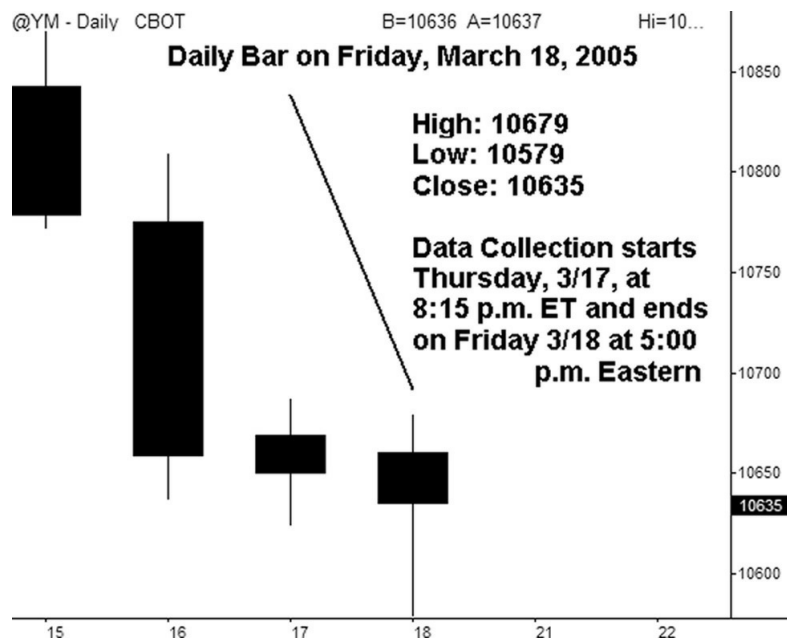
- YM: Start Wednesday at 4:30 p.m. eastern; end 4:15 p.m. on Thursday
- ES: Start Wednesday at 4:30 p.m. eastern; end 4:15 p.m. on Thursday
- NQ: Start Wednesday at 4:30 p.m. eastern; end 4:15 p.m. on Thursday
- TF: Start Wednesday at 8:00 p.m. eastern; 6:00 p.m. on Thursday

This range of data gives me all the price action for when these markets are trading, allowing both pre- and postmarket price action to be factored into the next trading day’s numbers. The times are slightly different on the different contracts because of the times they are traded on the exchange. The settlement price is the key. If traders are ever unsure about the settlement price, they can check it for the YM, ES, and NQ at [www.cmegroup.com](http://www.cmegroup.com). For the TF, go to [www.theice.com](http://www.theice.com). Note that the CME recently re-acquired the rights to this contract, and it will trade with them as RTY.

The easiest way to get an accurate high, low, and close is to just set up a daily chart with the time frames listed for each contract. In TradeStation, this is very easy to do. Just enter the continuous symbol, such as @YM or @ES, and set it on a daily chart. The data will default to the “regular session,” which refers to the

times listed earlier. With many other charting programs, a trader has to go in and set this up manually, as many of them default to the regular stock market session from 9:30 a.m. to 4:00 p.m. eastern. Once the chart is set up, just wait for the 4:15 p.m. eastern close on the ES, NQ, and YM and wait until after 6:00 p.m. eastern on the TF. After these times, the markets will then reopen shortly with a new daily bar. Just take the high, low, and close reading on the daily bar generated for that trading day to get the correct numbers. This closing price will almost always match the settlement price, although I like to check to make sure. For Monday, then, I want the high, low, and close for Friday. Let's take a look (see [Figure 8.1](#)).

Figure 8.1



On Friday, March 18, 2005, we have a daily bar on the YM that started after the 4:15 p.m. eastern close (it starts again when the market reopens at 4:30 p.m. eastern) on Thursday, March 17, and ended at 4:15 p.m. eastern on Friday, March 18. This range gives us the following numbers:

- High: 10,679
- Low: 10,579
- Close: 10,635

By changing the chart to a weekly time frame, I can also take the high, low, and close of the completed weekly bar and get the numbers I will use for the weekly pivots.

- High: 10,870
- Low: 10,579
- Close: 10,635

On Monday, the daily and weekly close will be identical, since they are both based on Friday's close. In this instance, the lows are also identical because the lows on Friday were also the lows of the week. The

process can be repeated with the monthly levels, but I won't need new monthly inputs until the first trading day in April.

Now that I have my key levels, I want to figure out the key pivot points that I'll be using for Monday, March 21, 2005. The first thing I do is take these high, low, and close figures and plug them into the formula. To figure out the daily pivot, I take the high + low + close and divide by 3:  $10,679 + 10,579 + 10,635 = 31,893/3 = 10,631$ . We now have our pivot point for the day. To figure out R1, which is the next level above the pivot, I multiply the pivot by 2, and then subtract the low. So we take  $10,631 \times 2 = 21,262 -$  the low at  $10,579 = 10,683$ .

We continue this process until we are done, and we come up with the following levels:

- R3: 10,783
- R2: 10,731
- R1: 10,683
- Pivot: 10,631
- S1: 10,583
- S2: 10,531
- S3: 10,483

Once I have these levels, I place them on my chart. I also like to note the midpoints between the daily pivot levels. These are calculated very simply, as they are literally the midpoint. The pivot is 10,631, and R1 is 10,683, 52 points away. Half of 52 is 26. I add that to the pivot, and I get a midpoint of 10,657. These are all formulas that can be set up in Excel, making this a very quick and easy process. I don't calculate the midpoints for the weekly and monthly levels.

Once I have created the chart and added the appropriate pivot levels, the first thing I will note is where the daily pivot is in relation to where the market closed. The daily pivot is at 10,631, and the market closed at 10,635. The second thing I will be watching for is where the markets are trading at 9:30 a.m. eastern on Monday. How far away are they from the daily pivot? This will work in relation to the gap play. The markets test their daily pivot level at some point during the day 90 percent of the time. I will always fade the first move to the daily pivot. For example, if the markets are trading above the central daily pivot, and they sell off to this level, I will fade the move by buying it when it reaches the pivot. I will talk about specific entry methods in a moment.

By setting up these formulas in an Excel template, I can quickly obtain all the key levels for the YM, ES, NQ, and TF. I did that, and all I do today is just enter the high, low, and close. Once this is done, the spreadsheet fills in the rest of the numbers for me automatically. It takes me just a few minutes to look up the high, low, and close and then plug them into this spreadsheet. I then instantly have my levels for the next trading day. Of course, I have to update the weekly pivots only once a week, and the monthly pivots once a month. The spreadsheet for the chart we are working on is shown in [Figure 8.2](#).

**Figure 8.2**

Daily Futures Pivots & Midpoints					
	S&P	DOW	NASDAQ	RUSSELL	
High	1197.00	10679	1503.50	626.60	High
Low	1186.50	10579	1483.00	619.90	Low
Close	1190.75	10635	1491.00	622.00	Close
R3	1206.83	10783.00	1522.50	632.47	R3
Mid	1204.38	10757.00	1517.75	631.00	Mid
R2	1201.92	10731.00	1513.00	629.53	R2
Mid	1199.13	10707.00	1507.50	627.65	Mid
R1	1196.33	10683.00	1502.00	625.77	R1
Mid	1193.88	10657.00	1497.25	624.30	Mid
Pivot	1191.42	10631.00	1492.50	622.83	Pivot
Mid	1188.63	10607.00	1487.00	620.95	Mid
S1	1185.83	10583.00	1481.50	619.07	S1
Mid	1183.38	10557.00	1476.75	617.60	Mid
S2	1180.92	10531.00	1472.00	616.13	S2
Mid	1178.13	10507.00	1466.50	614.25	Mid
S3	1175.33	10483.00	1461.00	612.37	S3

Weekly Pivots					
	S&P	DOW	NASDAQ	RUSSELL	
High	1216.25	10870	1532.00	637.70	High
Low	1186.50	10579	1483.00	619.90	Low
Close	1190.75	10635	1491.00	622.00	Close
R3	1238.92	11101.33	1570.00	650.97	R3
R2	1227.58	10985.67	1551.00	644.33	R2
R1	1209.17	10810.33	1521.00	633.17	R1
Pivot	1197.83	10694.67	1502.00	626.53	Pivot
S1	1179.42	10519.33	1472.00	615.37	S1
S2	1168.08	10403.67	1453.00	608.73	S2
S3	1149.67	10228.33	1423.00	597.57	S3

Monthly Pivots					
	S&P	DOW	NASDAQ	RUSSELL	
High	1214.75	10864	1565.00	641.50	High
Low	1179.50	10467	1490.50	615.90	Low
Close	1204.00	10778	1513.00	634.70	Close
R3	1254.58	11336.00	1629.67	671.10	R3
R2	1234.67	11100.00	1597.33	656.30	R2
R1	1219.33	10939.00	1555.17	645.50	R1
Pivot	1199.42	10703.00	1522.83	630.70	Pivot
S1	1184.08	10542.00	1480.67	619.90	S1
S2	1164.17	10306.00	1448.33	605.10	S2
S3	1148.83	10145.00	1406.17	594.30	S3

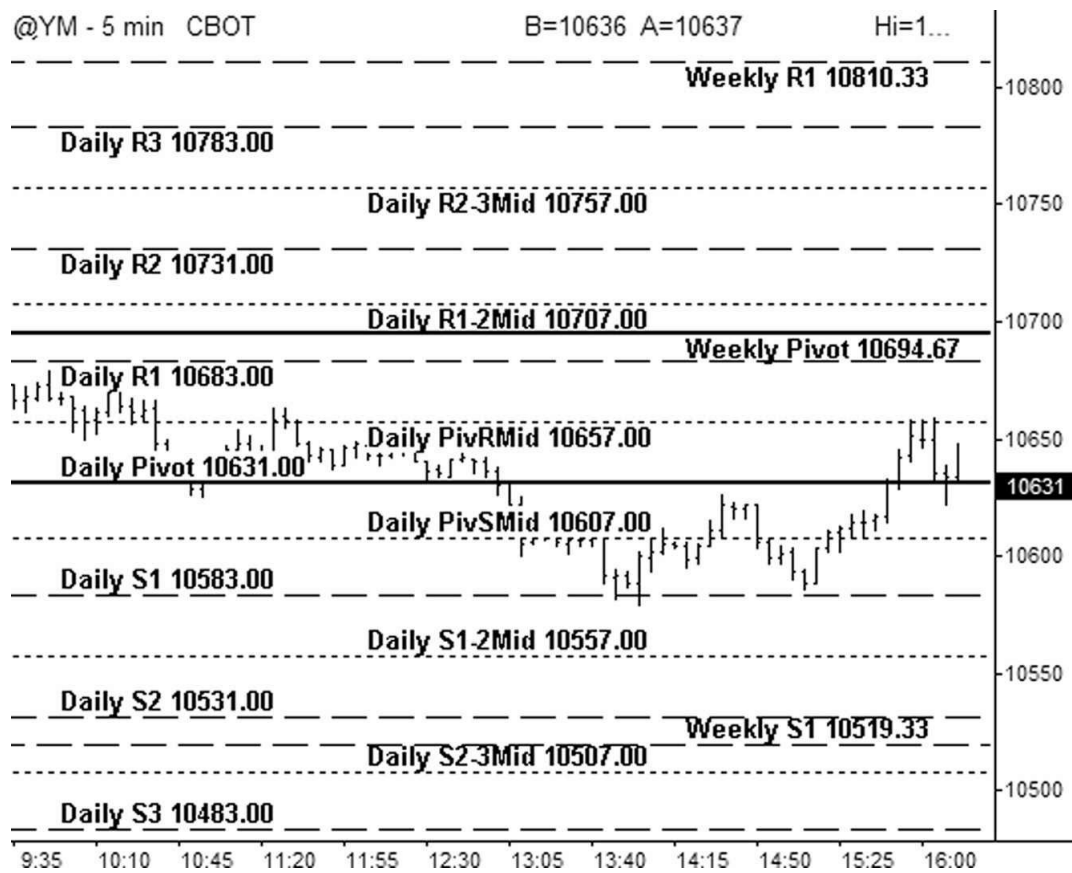
I also like to note where the extreme levels are, because it is very rare for the stock indexes to hit their R3 or S3 level. This is important to know because if the markets rally to R2 or sell off to S2, that usually ends up being the dead high or the dead low of the day. This knowledge will help temper a trader's emotions. When a market is going up, it is easy to think that it will go up forever. On this same note, when the market is heading down quickly, it is easy to assume that it's the end of the world. The emotion of greed is, of course, a disaster for anyone who succumbs to it because of the surge of adrenaline that runs through the body. By understanding the odds of a move above and beyond these outer levels, a trader will be able to stay more objective and take the money away from the people who are panicking.

The pivots help to keep a trader grounded. Instead of getting overexcited and hoping for a market crash, the pivot trader knows that there is a 90 percent chance that the markets will not close above R2 or below S2 on any given day. A move to that level signals a time for the trader to take profits instead of pyramiding into a bigger position that will lead to disaster.

Let's take a look at the pivot levels that we calculated for Monday, March 21, 2005, on a five-minute chart

(see Figure 8.3).

Figure 8.3



This chart looks very busy, with the daily pivot levels labeled on the left, the midpoints of the daily levels in the middle, and the weekly pivot levels on the right. For the sake of space, I left the monthly levels off. I like to take a look at this wide view first in order to see where the extreme levels are located for Monday's trading. Once I've done that, I will then reduce the chart to a more manageable level (see Figure 8.4).

Figure 8.4





In this chart, I've zoomed in so that I can see where the key close levels are for Monday's trading.

### The Psychology Behind the Pivots—Who Is Getting Burned?

Before I jump into the rules and specific setups that I use to trade the pivots, I want to cover briefly why they work. The first, and most obvious, reason is that a lot of traders watch these daily levels, so there is a self-fulfilling prophecy involved. However, the same can be said for Fibonacci levels, but they do not hold nearly as well as the pivots. Why? I elaborate on this in the next two points.

On the floor, it is generally a trader's goal to grab smaller moves, typically 2 points in the S&P 500, which is about 20 points in the Dow, or smaller depending on what is going on in the pit. The floor traders all operate in a big circle, with the brokers standing on the first step that surrounds the pit. This gives them the best view of all the locals so that they can get the best price for their customers. Since it is easier to trade with someone who is right in front of you, the prime space for locals to stand is just inside the top rail that separates the top-step brokers from the locals. Experience, politics (whom you know), and the ability to take orders of all sizes (not just single lots) can get a local a prime position near the top-step brokers. Usually this space is determined by how long the local has "held the spot" and his ability to continue to make markets. New traders must find space where available. This is usually at the farthest point from the brokers, which is the center of the pit. Because of this layout, there are several different scenarios being traded at one time. The locals on one side of the pit are making markets based on order flow coming from the brokers on their side of the pit. If a broker in one corner is selling size (a very large position) while a broker on the other side of the pit is buying, the two brokers don't always hear each other or even know what the other side is doing. It would be very easy for them to do their trade together if they knew that they could meet each other's needs. Instead,

locals near the broker who is buying start “racing” the broker by buying from other nearby brokers and then turning around and selling their contracts to him. This causes many price fluctuations throughout the day and often results in the public’s getting stopped out before the action settles down again. In its purest form, the traders on the outside will get in on a trade, let’s say it’s a long, and then sell their position to the guys on the inside of the circle who can’t really see what is happening way out on the top steps. What happens is that the traders on the inside, by the time they see the market moving, are the last ones in the pit to get in on the move. If they are lucky, they will then be able to turn around and sell it to the public. As the guys on the inside are selling to the public and closing their positions, the guys on the outside are also selling to the public, but they are opening new short positions, essentially fading a public that is chasing the up move. And the cycle renews itself like this throughout the day. This causes a specific dynamic in the markets, generating specific cycles of speed and rest on an intraday basis. The traders focus on the pivot levels to base their entries and to also gauge market action. The pivots play on this in that they are spaced out to catch these “patches of momentum.” Dow pivots are usually 30 to 50 points apart, and this is the type of movement that perpetuates the cycle I just described. The floor traders in the center of the circle are catching half this move, dumping it, and waiting for the next level to be hit. The key is to get in when the market is quiet and get positioned for the next round of activity.

One of the main reasons that these pivots work has to do with the inexperience of the vast majority of traders out there. The floor traders start a trade, and the inexperience of most traders causes the momentum that finishes a trade. How? Because average traders rely on a lot of different “indicators.” They are getting into and out of their positions far too late, which causes losing trades and leads to a specific cycle of market movement as their stop placement slowly and steadily increases the velocity of market movement in the direction of their stops. Indicators are just that, an “indication.” This is like your significant other slapping you across the face, and you taking it as an “indication” that this person might be angry with you. If it takes a slap across the face for you to realize this, then you are following the wrong indicators. By the way, all market indicators are the wrong indicators, because they are all lagging. Price action is pure. This overreliance on indicators by the majority of traders is what helps this system to work. By the time the average trader gets a buy signal, the pivot play is almost over, and users of this system will be selling their position to the indicator-based traders. Then the subsequent reversal that takes place results from all the stop losses sitting out there, like trout sunning themselves at the top of a lake—easy targets for the hawks who come swooping down from overhead. The market pauses, drifts down, then picks up steam and rips through all the stop losses, pausing when the run is over. This pause generally happens at a pivot level. It’s where the floor traders are beginning to accumulate their next position for the next cycle of play.

Let’s jump into the trading rules and look at some setups.

### **What Are the Trading Rules for Pivot Buys on Trending Days?**

Sells, of course, are reversed.

1. Unlike with the gap charts, I want to see 24 hours’ worth of data, so that I can view any overnight highs and lows. Each day I update the appropriate pivot levels on the charts to reflect the previous day’s action. On Mondays, I also update the weekly pivots, and on the first trading day of a new

month, I update the monthly pivots.

2. The first pivot play is done in conjunction with the gap, if there is one. If there is a gap down, then I buy a decline into the closest pivot level. If there isn't a playable gap (more than 10 YM points or 1 ES point), then I will wait until 9:45 a.m. eastern to initiate the first play.
3. If the volume on the five-minute ES chart is more than 25,000 contracts, then I'll wait for the markets to penetrate a pivot level and move up at least a quarter of the way to the next pivot level. Once this happens, I will then set up a bid to buy the first retracement back to the violated pivot level.
4. I enter my trades with limit orders only. I place orders "just in front of" the pivot. For the YM, I use 3 points; for the ES, 0.25 point; for the NQ, 0.50 point; for the TF, 0.20 point; and for individual stocks, 5 cents. For example, if I'm trading the YM and the pivot level is 10,000, then I would buy a decline to 10,003 and short a rally to 9997. Sometimes the pivot will be an odd number, such as 1117.38 on the ES. In this case, I always round in the direction of the trade. So, if I'm bidding for a long, I will round 1117.38 to 1117.50, and my bid will be 1117.75. If I'm offering a short, I will round 1117.38 down to 1117.25 and place my offer at 1117.00. My stops and targets, then, would be "just in front of" these appropriate long and short levels.
5. Once filled, I place an order to close the first half at the next pivot level and the second half at the pivot level after that, using the same "just in front of" parameters.
6. I place a stop at 20 points for the YM, 2 points for the ES, 4 points for the NQ, and 1.50 points for the Russell. For stocks, I will use a stop based roughly on the price of the stock. If the stock is under \$10 a share, I will use a stop of 20 cents. If it is between \$10 and \$20, I will use a stop of 30 cents; if it is between \$20 and \$30, I will use a stop of 40 cents, and so on, adding another 10 cents for each \$10 increment in price. (A \$75 stock would have an 80-cent stop, for example.)
7. If the first target is hit, I will then move up the stop to my entry-level pivot, minus the "just in front of" fractions discussed in rule 3. For example, if I get in a YM long at 10,003 and the pivot is at 10,000, then my new stop would be 9997 once the first target is hit.
8. If I am in a trade at the market close and neither my stop nor my target has been hit, I will close out my position "at the market" at 4:10 p.m. eastern for futures, and at 3:58 p.m. eastern for stocks.
9. I don't initiate any new positions after 3:30 p.m. eastern, but I will manage existing positions into the close.
10. The markets rarely have a sustained move above R3 or below S3. If I trade to those levels, I will always fade the move.
11. After two losers in a row, I'm done with pivots for the day.

### **What Are the Trading Rules for Pivot Buys on Choppy Days?**

Once again, sells are the same, just reversed. The rules for choppy days are identical except for the targets. On choppy days, I just focus on the YM and the ES. My first target is mechanical: 10 points for the YM and 1 point for the ES on half of my position. Once this is hit, I will trail up my stop in the same way I would for a

trending trade. The second target becomes the “just in front of” level for the actual next pivot level. In working with other traders, I’ve found that they grasp the concept of the “choppy day” setup easily, but they struggle with the “trending day” setup. Therefore, I focus most of the examples on the trending day setups, and we go through those first.

## What Are Some Specific Examples of Trading the Pivots?

### *E-mini S&P—September 2004 Contract, September 10, 2004*

1. The S&Ps gap down into daily S1 (see [Figure 8.5](#)). I have a limit order to buy placed at 1114.00, just above daily S1. The market comes very close to this level, but not close enough. I am not filled, and the market rallies away without me. Once the market pushes up through the midpoint, I move my bid to buy the next pullback to the midpoint. The midpoint is at 1115.88, so I get a little in front by placing an order to buy at 1116.25. I am filled quickly at this level. I place an initial 2-point stop at 1114.25, and my first target is just in front of the next pivot. The pivot is 1118.00, so my first target is 1117.75.

Figure 8.5



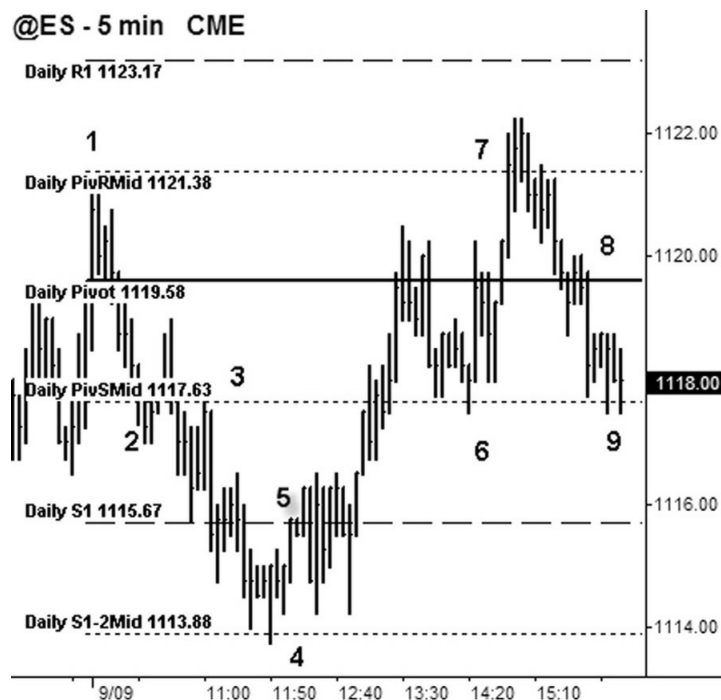
2. My first target is hit, and I move my stop up to 1115.50 (just below the midpoint where I entered the trade). Shortly thereafter, my second target is hit at 1119.75, and I am out of the trade.
3. I place an order to buy a pullback to the pivot at 1118.25. I am filled, and I place a 2-point stop at 1116.25. My stop is hit. The market rallies back through the pivot, and I place another order to buy a pullback to 1118.25. I am filled, and I place the same 2-point stop at 1116.25.
4. My first target is hit just in front of the next pivot level, at 1119.75.

5. I move my stop on the second half of my position up to 1117.75, which is just below the pivot where I entered my trade.
6. I exit the second half of my position at 1122.00, just in front of the next pivot level. Once the market pushes decisively through this pivot level, I place a bid to buy at 1122.50, just above R1. I am not filled, and the market goes on to make new highs. At this point it is past 3:30 p.m. eastern, and I am done with my pivot plays for the day.

*E-mini S&P—September 2004 Contract, September 9, 2004*

1. The S&Ps gap open, and I place an order to short just below the midpoint at 1121.00 (see [Figure 8.6](#)). I am filled, and I place a 2-point stop at 1123.00. My first target is just in front of the next pivot level at 1120.00. This target is hit, and I move my stop down to 1121.75, which is just above the pivot level I used for my entry. My second target is just in front of the next pivot level at 1118.00.

Figure 8.6



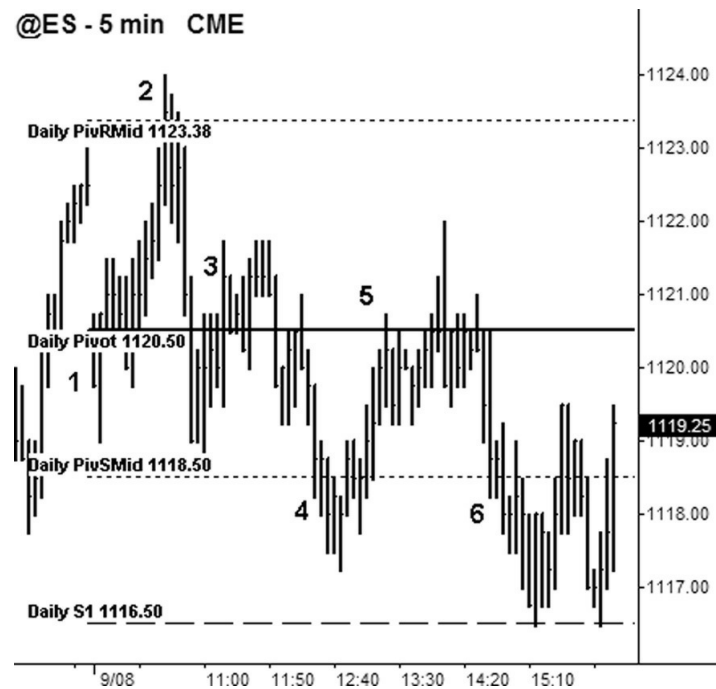
2. My target is hit on the second half of my position. The market bounces and starts to move up to the daily pivot, and I place an order to short at 1119.25. I am not filled, and the market rolls over and moves quickly into daily S1.
3. I move my order to short down to the next pivot level, and my order is now at 1117.25. I am filled, and I place a stop at 1119.25. My first target is 1116.00. This target is hit, and I move my stop to 1118.00.
4. My second target is hit at 1114.25, and I place an order to short a rally back to S1 at 1115.25.
5. I am filled, and I place a 2-point stop at 1117.25. I get stopped out as the market rallies hard.

6. I'm filled at 1118.00. I place a stop at 1116.00.
7. The market rallies to the next pivot level, and I'm out half at 1119.25. I move my stop up to 1117.25. My next target is quickly hit at 1121.00.
8. Normally I would place an order to buy the next pullback here at 1120.00. But I don't. Why? Because I'm following the rules. It is now past 3:30 p.m. eastern, and I'm not initiating any new trades!
9. This trade would have been stopped out.

*E-mini S&P—September 2004 Contract, September 8, 2004*

1. The markets gap down, and I place an order to buy at 1118.75 (see Figure 8.7). This order is not filled. When the markets rally through the daily pivot, I raise my bid to 1120.75. I am filled, and I place a stop at 1118.75. My first target is 1123.00.

Figure 8.7

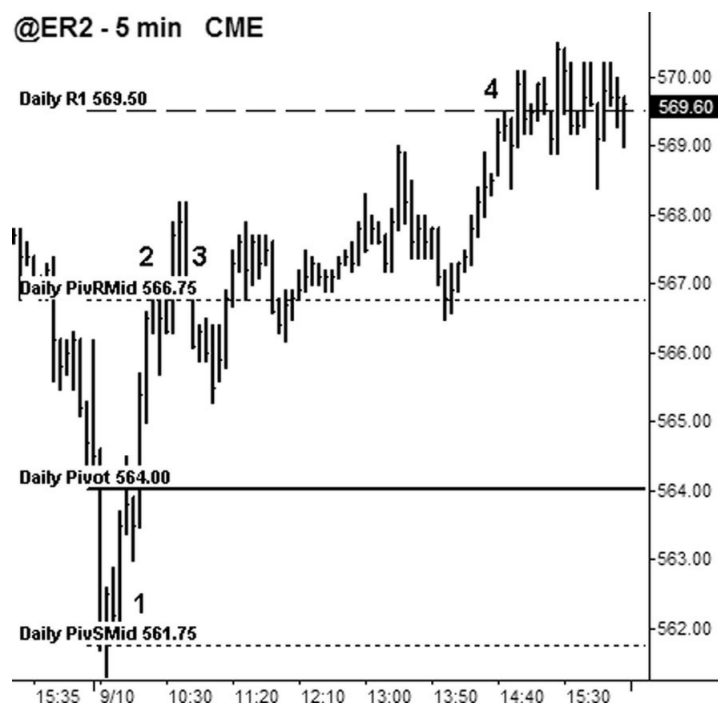


2. My first target is hit. I move my stop up to 1120.25.
3. I am stopped out of my second half, and I wait for the next setup.
4. The market continues to trend down, so I want to short the next move to the overhead pivot.
5. The market rallies, and I get short at 1120.25. I place a stop at 1122.25, and my first target is 1118.75.
6. My first target is hit, and I move my stop to 1120.75. Shortly thereafter, my second target is hit at 1116.75. I place an order to short the next rally to an overhead pivot, and I am filled at 1118.25. I place a stop at 1120.25. My first target is hit at 1116.75, and I move my stop down to 1118.75. The market rallies into the close, and I am stopped on the second half.

*E-mini Russell—September 2004 Contract, September 10, 2004*

1. The Russell 2000 futures gap down, and I place a bid at 561.90 (see Figure 8.8). I am filled, and I place a stop at 560.40. My first target is 563.80, and this is filled quickly. I move up my stop to 561.50.

Figure 8.8

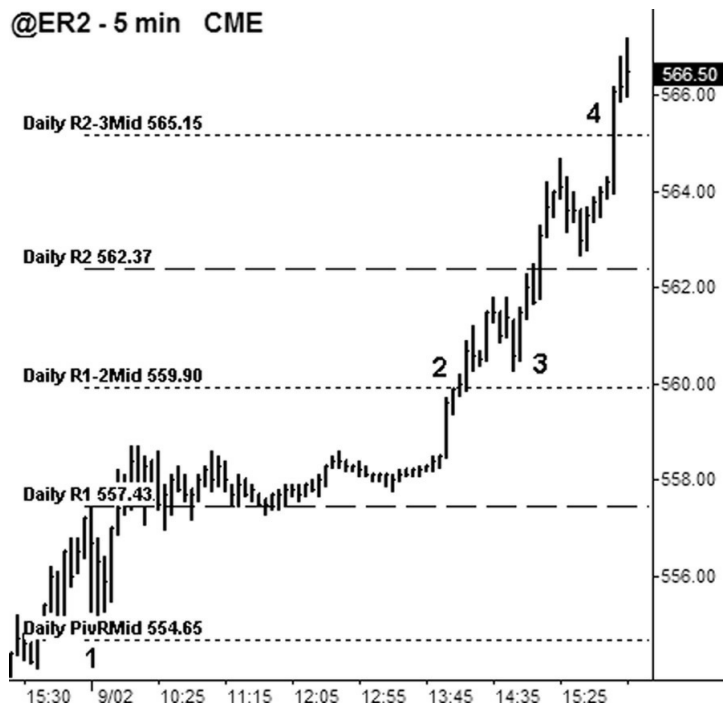


2. My second target is hit at 566.50, and the market continues to rally through this midpoint.
3. Once the market pushes through the midpoint, I place a bid at the pivot below at 564.20. The market never comes down to this level, but in fact makes new highs. Once this happens, I move my bid up to the next pivot level, and my new bid is 566.90. I am filled close to 2:00 p.m. eastern. I have been bidding long for 3½ hours. With pivots, patience is a virtue!
4. I place a stop at 566.40, and my first target is 569.30. My first target is hit, and I move my stop up to 566.50. The market hangs around this same level into the close. Since neither my stop nor my target is hit, I exit “at the market” at 4:10 p.m. eastern and get out at 569.40.

*E-mini Russell—September 2004 Contract, September 2, 2004*

1. The Russell 2000 opens flat and pushes higher, right into daily R1 (see Figure 8.9). I set up a bid to buy the next pullback to the midpoint at 554.90. I am filled, and I place a stop at 543.40. My first target is the next pivot level at 557.20. This level is hit, and I move my stop up to 554.40.

Figure 8.9



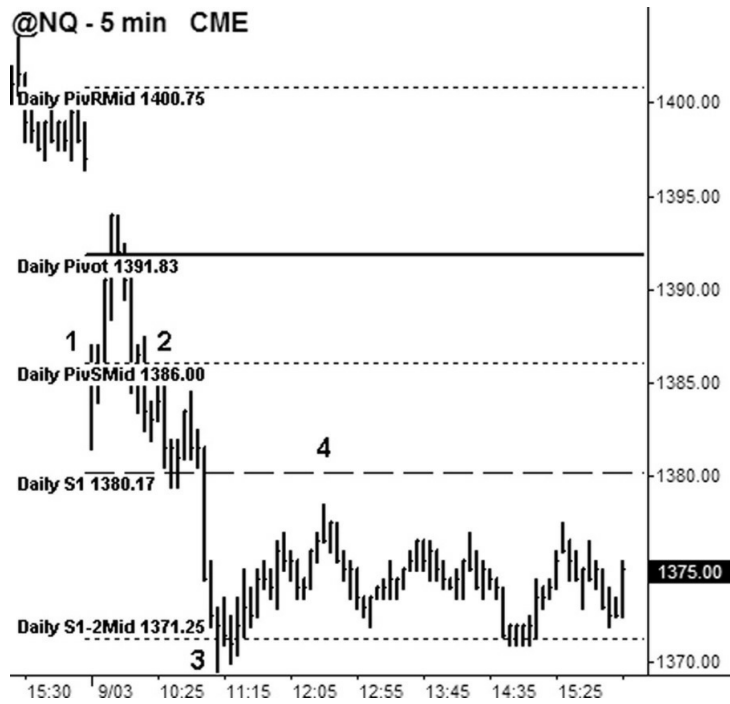
2. The markets spend the next four hours consolidating, then finally push up and hit my second target, once again showing that patience with the pivots pays off.
3. The market pushes through the midpoint and starts to pull back. I place a bid at 560.10. The market comes close, but I am not filled. The Russell pushes through daily R2, and I move my bid up to 562.60. I get filled here and place a stop at 561.10. My first target is 564.90.
4. My first target is hit. I move my stop up to 562.10. The market approaches the close without hitting either my stop or my second target. I exit at the market at 4:10 p.m. eastern and get out at 566.30 on the second half of my position.

*E-mini Nasdaq—September 2004 Contract, September 3, 2004*

1. The Nasdaq gaps down, and I place a bid at daily S1 at 1380.50 (see [Figure 8.10](#)). This isn't filled, and when it moves up through the midpoint, I raise my bid to 1386.50. I get filled, and I place a stop at 1382.50, with my first target at 1391.00. The first target is hit, and I raise my stop to 1385.50.

Figure 8.10





2. I'm stopped on the second half. The market goes on to make new lows, and I place a short at 1385.50. I don't get filled.
3. The market continues to fall and slams into the next pivot level.
4. I move my short bid down to the next level at 1379.50. I don't get filled, and nothing else sets up for the day. A good day to rearrange the sock drawer.

*E-mini Nasdaq—September 2004 Contract, August 5, 2004*

1. The Nasdaq has a slight gap up into the midpoint, and I short at 1383.50 (see [Figure 8.11](#)). I place a stop at 1387.50, and my first target is at 1379.50.

Figure 8.11



2. My first target is hit, and I move my stop down to 1384.50. The market rallies, and I am stopped out on my second half.
3. The Nasdaq sells off through the next pivot level.
4. Once it is through this level, I place an order to short a rally back up to this level at 1373.50. I get filled, and I place a stop at 1377.50, with my first target at 1369.50. The first target is hit quickly, and I move my stop down to 1369.50. My target on the second half is 1364.50.
5. My target on the second half is hit, and I am now flat.
6. I place an order to short a rally to the above pivot level at 1368.50. I am filled, and I place a stop at 1372.50. My first target is the pivot below at 1364.50. This gets hit, and I move my stop down to 1369.50.
7. My second target is hit at 1359.50. I place an order to short a rally to the next overhead pivot level at 1364.00. I come right up to this level but am not filled, and that is the last pivot play that sets up for the day.

*Mini-Sized Dow—September 2004 Contract, August 5, 2004*

1. The mini-sized Dow futures open mixed and begin selling off early in the session (see [Figure 8.12](#)). I place an order to short the next rally to the midpoint at 10,118, but I don't get filled. Once it breaks down through the daily pivot, I move my order to short down to 10,091. This time I get filled, and I place a stop at 10,111 and an order to cover half my position at 10,069. I'm filled on the first half of my order, and I then move my stop down to 10,097. My next target is 10,041.

Figure 8.12

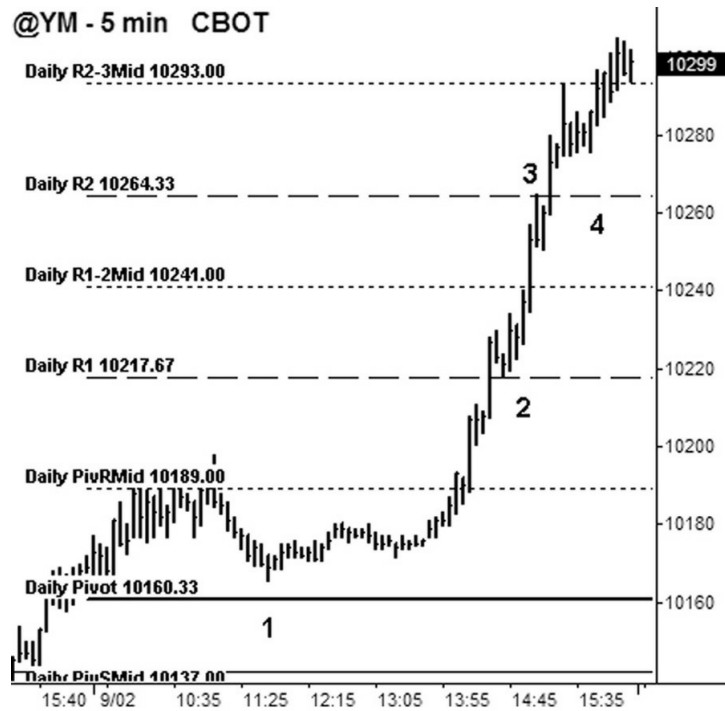


2. My next target is hit, and I'm now flat.
3. The market continues to move lower and tests the next pivot level. I place an order to short at the pivot level above, right at 10,035. The market is acting really slowly. I put my orders in place and go grab some lunch. By the time I get back, I'm still not filled, which is why I absolutely love the low-volume August trading. It takes a couple of hours, but I end up getting filled later in the afternoon. I place a stop at 10,055, and my first target is 10,015. This target is hit quickly, and I move my stop down to 10,041.
4. My second target is hit at 9988, and I'm now flat. Since the market continues to trend lower, I place a bid to short at the next overhead pivot level, and I place an offer at 10,008.
5. The market trades right up to this level, but I don't get filled. When the market collapses, I move my offer down to 9982, but this doesn't get filled either.

*Mini-Sized Dow—September 2004 Contract, September 2, 2004*

1. The markets open mixed and rally into the midpoint at 10,189 (see Figure 8.13). I set up to buy the first pullback, and I place an order at 10,163. It comes very close to this level, but not quite, and I don't get filled. The market rallies through the next pivot level, and I move my bid up to 10,192. The market doesn't even look back and keeps on going, moving up through yet the next pivot level.

Figure 8.13

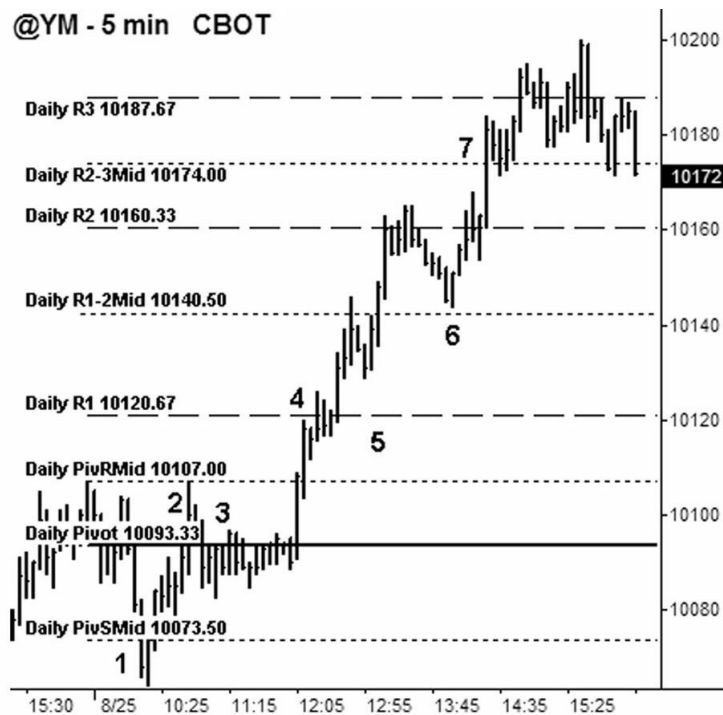


2. I move up my bid again, to 10,221. This time I get filled and place a stop at 10,201, and my first target is 10,238. The first target is hit quickly, and I move up my stop to 10,215.
3. My second target is hit at 10,261, and I am now flat.
4. The market rallies, and I place an order to buy at 10,267. I don't get filled, and the market closes near its highs.

*Mini-Sized Dow—September 2004 Contract, August 25, 2004*

1. The Dow gaps down, and I place a bid at 10,077 (see [Figure 8.14](#)). I get filled, and I place a stop at 10,057, with my first target at 10,090. My first target is hit, and I move up my stop to 10,071.

Figure 8.14



2. The Dow continues to rally, and my second target is hit at 10,104.
3. I place an order at 10,096 in order to buy the next pullback. I get filled, and I place a stop at 10,076. The market slows to a crawl for the next hour, and nothing happens. Then momentum begins to pick up, and I'm out of my first half at 10,104. I raise my stop to 10,090.
4. My second target is hit at 10,118.
5. The Dow continues to rally to the next pivot level. I place an order to buy a pullback at 10,124. I don't get filled.
6. The market pushes higher to the next level, and I raise my bid to 10,144. I get filled, and I place a stop order at 10,124, with my first target at 10,157. My first target is hit quickly, and I raise my stop to 10,138.
7. My second target is hit at 10,171, and I am now flat. The market continues to rally to daily R3. This is a rare event. The markets hardly ever get through R3, and I always fade initial moves to these levels. I place an order to short at 10,185. I am filled, and I place a stop at 10,205. The market pushes up to 10,200 and fades into the close. Since neither of my parameters is hit, I cover at 4:10 p.m. eastern at 10,176.

***KLAC (KLA-Tencor Corp), September 10, 2004***

1. KLAC gaps down on this day, and I place an order to buy at 38.48 (see [Figure 8.15](#)). I am filled, and I place a stop at 37.93. My first target is hit at 38.89, and I raise my stop to 38.38.

Figure 8.15



2. The stock continues to rally, and my second target is hit at 39.39.
3. I place an order to buy the first pullback at 38.99. This order doesn't get filled, and the stock runs away.
4. When it breaks the next pivot level, I raise my bid to 39.49. It takes a while, but I get filled, and I place a stop at 38.99.
5. My first target is hit at 39.72, and I raise my stop to 39.39.
6. By the time the market approaches the close, neither of my parameters has been hit, and I close out at the market right at 4:00 p.m. eastern at 39.78.

### *Trending versus Choppy Markets*

For the most part, the setups we just went through cover trending markets. I also wanted to take a look at choppy markets to show how the pivots work under those circumstances. Figure 8.16 shows the mini-sized Dow on a day when it stayed locked in a confined, narrow trading range through the majority of the day. In fact, most of the initial move down happened before the 9:30 a.m. eastern open for the cash markets. I also inserted some basic indicators onto this chart to show how far they can lag behind on a choppy day compared with a setup that is based purely on price. The indicators I'm looking at are basic exponential moving averages as well as an RSI index. This doesn't mean that these indicators don't have any value—it's just important to keep in mind that for the most part, an indicator-only-based trading approach is a lagging approach, and this fact is heightened on a choppy trading day.

Figure 8.16



1. As the markets chop along and the volume on the ES chart continues to run under 25,000 contracts, this becomes the appropriate time to set up the pivot plays in the following “chop-enhanced” manner (see [Figure 8.17](#)). At point 1, the YM is quiet, and I am looking to fade a move to the nearest pivot level. I don’t want to sit and stare at the markets while this mind-numbing action unfolds. Therefore, I place a buy limit order at the nearest pivot level below the current price action, plus 3 points, so I’m just in front of the pivot. I also place a sell limit order at the next level above current price action.

Figure 8.17



2. The sell limit order is hit first. I came close to the buy limit order, but I didn't quite make it. Once the sell limit order is hit, I place a 20-point stop. My first target is a mechanical 10 points away from my entry, and my second target is the next pivot level below. It is a weekly pivot level at 10,532, so I would set up a buy limit order at 10,535 to cover the second half of my short.
3. Both of my targets are hit, and I am taken out of the trade. Note that when the moving averages finally crossed over, the markets were almost at our final target. Indicators like moving averages work amazingly well on trending days, but they are a killer on choppy days. Price rules on the choppy days.

This example shows something that traders will notice quite often when they trade this system: they will be trading exactly the same levels multiple times during a given day. The level at which a trader would get long on a decline is also the level at which the trader would close out a short, and vice versa.

Let's take another look at the same chart (Figure 8.17), but we'll look at all the setups that occurred that day.

1. At point 1, the YM falls to one of the weekly levels, but doesn't quite touch it. I manage to get into the market long because my limit buy order is the weekly level + 3 points. The weekly level is 10,532, so my limit buy order is placed at 10,535. I'm out for +10 points quickly on the first half, and then I bring my stop up to "pivot - 3," which is breakeven - 6.
2. At point 2, we come up and ease just through the daily midpoint. I am out of the second half of my long on a limit order to this level. Note that the moving averages have barely crossed higher when the markets have reached the target. I try to reverse and short, but the market moves too quickly, and I miss the short. One way around this is to keep a resting order in for the stop and also for a new position. If traders are long 10 contracts and want to reverse and go short when they exit, then they



just set a sell limit order for 20 contracts. This way, they will exit their long and establish a short position simultaneously.

3. For point 3, I am bidding long for a decline back at the weekly level + 3 points. The weekly level is 10,532, so my bid is that plus 3 points, which is 10,535. When two levels are close together like this (by at least 10 points—in this case a weekly level and the daily pivot), I will place my bid based on the level closest to the price action. I am filled on my long. The market eases through and trades around this level for half an hour. My stop is not hit, although it comes close. My initial target for “half at 10 points” is hit quickly, and I trail my stop. It is not until a couple of hours later that my second target is hit at the midpoint. This is an important note: some of these trades will last a few hours in duration, while others can last 10 minutes. The key is to wait for the levels to be reached and not try to hurry things along or get out because of anxiety or boredom. Although human emotions are a good idea in building relationships with other people, in trading, they have to be ignored.
4. I am out of the second half of my long more than three hours later, at a daily midpoint level. Since this is a choppy day, I just reverse and go short, placing the target on the first half of my position 10 points away from my entry. My second target is the next level below + 3 points.
5. The market actually moves quickly, and I’m out of the first half in 15 minutes, and the second half another 15 minutes after that. I reverse and go long and set up the same parameters: +10 points on the first half, and back to the other pivot on the second half.
6. I’m out of the first half quickly for +10, and the market continues to trek higher into the close. The market doesn’t quite reach my second target, and I end up getting out at the market at 4:10 p.m. eastern, a few points below my target. Note again that by the time the moving averages crossed higher, I was already out of half my position.

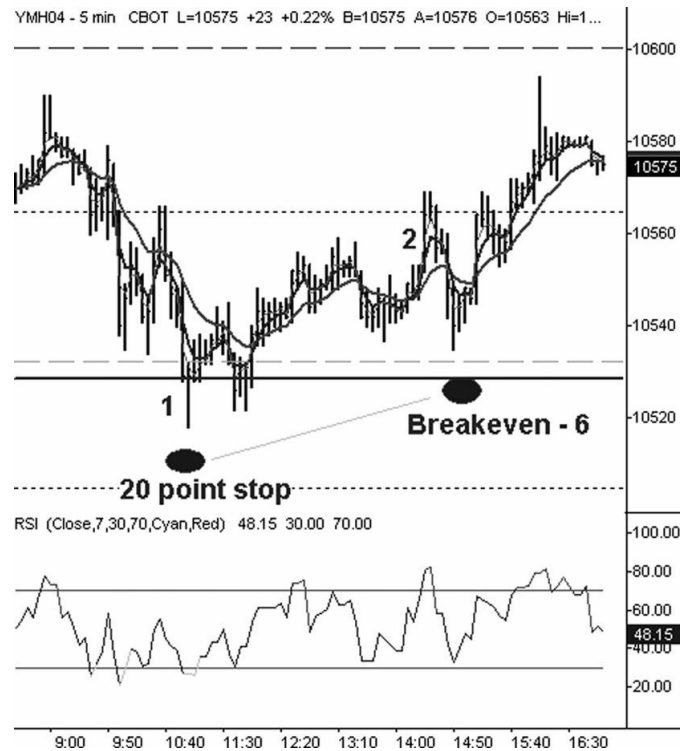
### **Trailing Stops in This Fashion Is the Key**

I’m not a big fan of aggressively trailing stops. By this I mean that if the market moves in my favor by 1 YM point, I will keep my stop static instead of trailing it up by 1 point. This auto-trailing stop strategy generally will stop a trader out on the first normal retracement, and these are moves I’m willing to sit through.

However, if I’ve established multiple targets and my first target is hit, then and only then will I generally move up my stop to protect gains on the entire trade. For pivot plays, I treat stop movement the same way on both trending and choppy days. I’m just waiting for my first target to get hit. Once that happens, then and only then will I move up my stop.

1. Here we have our original 20 stop from our long entry on a decline to the weekly pivot + 3 points (see [Figure 8.18](#)).

**Figure 8.18**



2. If this was a trending day, then I would wait until my first target—the next pivot level—is hit. At that point, I would trail up my stop. On a choppy day, my first target would be +10 points on the YM, so in this example, that would mean that my stop would have been moved up sooner, right after my first lower target was hit.

### Tips and Tricks for Using the Pivots

The key with this setup and all the setups I use is that the trader gets everything prepared on her charts in advance of the opening. Once everything is set up, all the trader has to do is watch and wait, or, better yet, utilize audio alerts to give her a heads-up that a setup is either forming or firing off. With pivots, traders can place orders in advance, as the exact targets, entries, and stops are known before the trade is entered. This way, the traders can also focus on other things if they come up. When the traders hear the alerts going off, they know that it is time to go back to their charts and see what is going on. There is no chasing. Either the orders will get hit or they will not. This system, like all the systems I use, is constructed in such a way as to naturally enforce the mindset of a professional trader, which is the only consistent way to make money in the financial markets.

The important thing to know about midpoints is that you don't need to use them all the time. I use them on days when the distance between two YM daily pivot levels is greater than 40 points. This is a general rule, and it is okay to use them if the pivot level is only 30 points. If the pivots are closer together than 30 points, the midpoints don't play as much of a role, as the markets will move straight to the next pivot, since the pivots are so close together.

On my charts, I typically use a black background, which can't be shown in the context of this book. I then make the daily pivots yellow, the weekly pivots light blue (cyan), the monthly pivots purple, and the midpoints white. I also make the central pivots solid lines and the rest of the pivots dotted or dashed lines. This way it is

very easy to pick out what the markets are butting up against.

The use of pivots has gotten a lot easier over the years. I used to calculate these manually, using a calculator, but I eventually switched to an Excel spreadsheet where all I had to do was enter the high, low, and close, and the spreadsheet did the rest. However, I still had to draw the horizontal lines manually on my charts each day, and this took a good part of half an hour. There is software that will calculate the pivots for a person automatically, but it generally uses the wrong time frames and can create errors because of bad ticks. I'm anal-retentive when it comes to this, and I have to enter my pivots manually each day—I want to make sure they are correct. I finally found a programmer who could help me out on this, and the end result is a piece of software that automatically calculates the correct daily, weekly, and monthly pivot levels and automatically draws them on the various charts I watch. Manually is fine too, but this does save time, something that I have less of now that I have kids!

### **What About Fibonacci Numbers?**

One question I frequently receive with regard to the pivots is how they relate to Fibonacci retracement levels. For the uninitiated, Fibonacci numbers are used by traders to determine support and resistance levels, with the most commonly used retracement levels being 0.382, 0.50, and 0.618. In my experience, sometimes these work great, and sometimes the market doesn't even know they exist and blows right through them. However, I do like to see where the Fibonacci cluster numbers are on any given trading day. These are more accurate than regular Fibonacci numbers because of the use of more data points and the way the Fibonacci ratios are calculated. Getting these numbers takes a lot of work, and for a while I calculated them myself. Then I discovered Carolyn Boroden's work at [www.fibonacciqueen.com](http://www.fibonacciqueen.com), and from then on I just subscribed to her service, as this is her area of expertise. She works on both the time and price axes of the markets, using the confluence of Fibonacci ratios. For price, she runs retracements of prior swings using the ratios 0.382, 0.50, 0.618, and 0.786. She also runs price extensions of prior swings, which are essentially retracements beyond 100 percent. For extensions, she uses the ratios 1.272 and 1.618. Carolyn also runs price projections comparing swings in the same direction. For projections, she uses 100 percent and 1.618. In doing this, she runs all possible levels from the key swing highs and lows in a chart and looks for the confluences. When she sees a confluence, these become the key levels in the markets to buy and sell against.

Personally, I'm interested in the bigger levels found on 60-minute and daily charts, and I use these mostly for swing trading. However, there will be days when these clusters line up with some of the daily pivot levels, and of course on these days those particular levels become that much stronger. I also like to look at these Fibonacci cluster levels on other markets, as they provide key levels across all markets. Let's look at a few examples from Carolyn Boroden's work.

#### *Mini-Sized Dow—June 2005 Contract, April 6, 2005*

**Figure 8.19** is on the 15-minute mini-sized Dow futures contract. You can see the obvious uptrend that developed from the April 4 swing low. For this reason, we wanted to focus on setting up clusters on the buy side of the market. We saw a nice zone develop between 10,489 and 10,492. This zone included the coincidence of a 1.618 price extension, a 0.50 percent retracement, a 0.382 retracement of another swing, and

a 100 percent price projection of a prior corrective decline. The initial low was made directly within this cluster zone at the 10,489 level. From there, we saw a rally to 10,578, or 89 points.

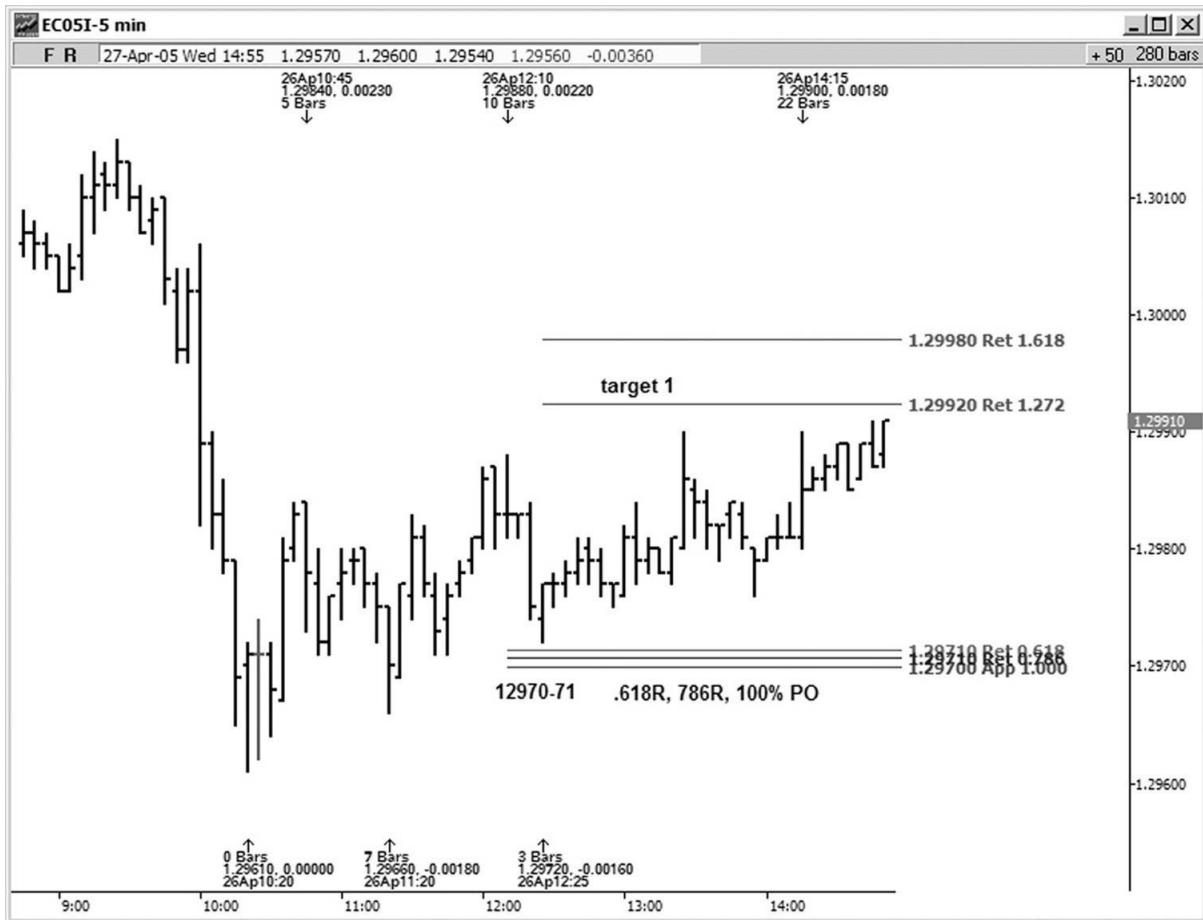
Figure 8.19



*Euro FX—June 2005 Contract, April 27, 2005*

In the five-minute euro currency example in Figure 8.20, we found a confluence of three key Fibonacci price relationships between 1.2970 and 1.2971. This included a 0.618 retracement of the 1.2961 low to the 1.2988 high, a 0.786 retracement of the 1.2966 low to the 1.2988 high, and a 100 percent price projection of the 1.2984 high to the 1.2966 (swing) low. The actual low was made at 1.2972. The initial rally took you to 1.2990.

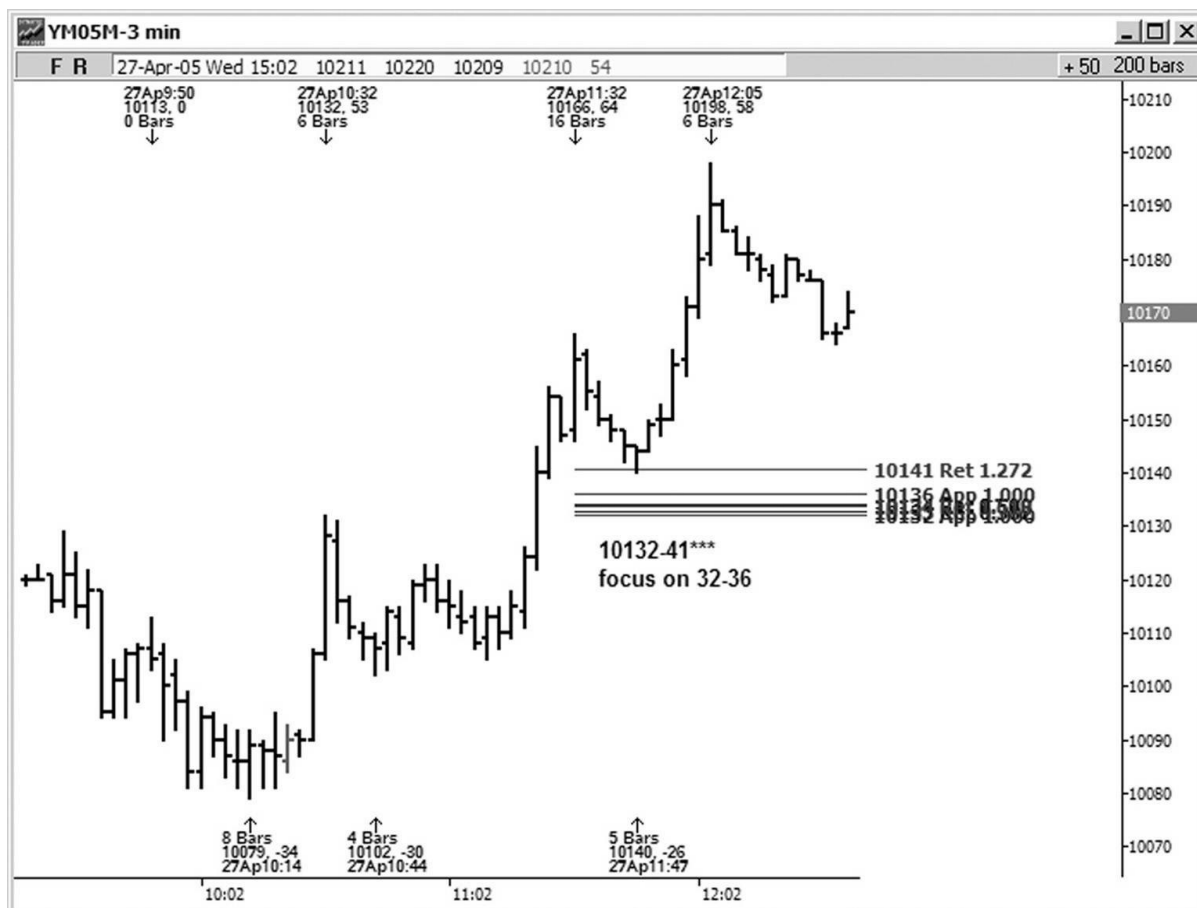
Figure 8.20



*Mini-Sized Dow—June 2005 Contract, April 4, 2005*

For entries into the market, we ideally want to set up “price clusters” in the direction of the trend in the time frame we are trading. We sometimes use “countertrend” clusters for exits or to tighten up stops on a position. The example in [Figure 8.21](#) in the mini-sized Dow futures contract shows a confluence (clustering) of at least five Fibonacci price relationships in the 10,132–10,141 area. The focus of these levels came in the 10,132–10,136 area. In this case, the actual low was made at 10,140. A “trigger” for an entry against this zone could be as simple as taking out a prior bar high. At that point, your initial stop could be placed either below the low made prior to the trigger (10,140) or below the low end of the cluster zone (10,135). The initial move off this cluster was 58 points.

**Figure 8.21**



These examples of Carolyn’s work show how these Fibonacci clusters act as support and resistance levels in the markets, and I use them intraday just as I use the pivot levels. They can also be used to initiate swing trades on larger time frames, as these can be used on any time frame, from a three-minute chart to a weekly or even a monthly chart.

Carolyn also has a great book out on the subject entitled *Fibonacci Trading: How to Master the Time and Price Advantage*. It’s available on Amazon.

### What’s the Best Way to Trade Commodity Markets with Pivots?

I mentioned at the beginning of this chapter that I prefer to utilize only weekly pivot levels on the other commodity charts. This includes anything other than stock indexes, and could be currencies, gold, oil . . . literally anything other than stock indexes. There are two reasons for this. The first is that while I don’t mind trading the stock indexes for smaller moves, I generally like to trade the other commodities for larger moves, trades that last a few hours or more as opposed to a few minutes. In that respect, I look at hourly charts on the rest of the commodities, and I utilize the weekly pivots on these charts so that I can see these key levels in relation to the current price action.

In [Figure 8.22](#), there is a chart of the euro currency futures contract from September 29, 2011. My main focus on this chart, as well as for other hourly commodity contracts, is the location of the main central pivot. On this chart, that is represented by the 1.3542 price point. Over the course of this week, the euro has been attracted to this level like a magnet, and this is typical. This weekly “central pivot” is a key area for both

initiating positions and taking profits.

Figure 8.22



### Summing Up the Pivots

The pivot levels work mainly because of the psychology pain/pleasure cycle that perpetuates the markets each day. Traders who follow only indicators will chase a position when it is already half to three-quarters of the way off its pivot, and it is these traders who provide the stop losses to perpetuate the next cycle of market movement. If you rely only on indicators for your entries, instead of using the price action of the pivots, you will get in and out of these cycles too late, and you won't make any money trading.

What is nice about this system is that traders don't have to watch it very closely once they are in a position. I'm not an aggressive trailer of stops. I like to get in a position, set my parameters, and then focus on other things. Depending on a trader's work situation, he could do this at the office, especially on the West Coast, and especially if he had an order system that automatically bracketed trades. This way he can place the parameters and then go to the next meeting or appointment. *Let the parameters babysit the position.* This is much better as well because it takes human emotion out of the equation.

I've created a video at [www.simplertrading.com/pivots](http://www.simplertrading.com/pivots) that gives additional, updated examples of pivot plays as well as live trading examples of the pivots in action.

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## Tick Fades: Are They Really the Best Way to Take Money Away from Newbies?

### What Is the Number One Action Alert Available to Traders Today?

The stock markets spend the majority of their time backing and filling. That is, they drift up to a resistance level, then turn around and drift back to a level of support, not really doing much of anything. For most of this time, there isn't much for a trader to do except wait, and that usually requires extreme patience. Many traders fail in this regard. After all, they are traders, right? They should be taking a trade or managing a trade, not just sitting around doing nothing. This is and will always be one of the biggest misconceptions about trading—the idea that a trader has to be in a trade nearly every minute or every hour of the day. In reality, there are always three positions traders can be in at any given time: they can be long, short, or flat. For day trading, being flat, meaning not having any trades on, is the best course of action 60 percent of the time. Cats don't chase the first bird they see. They crouch and wait, sometimes for hours, for the right time to pounce. And that's what the active trader should do. When something interesting actually does happen, such as a buy or sell program hitting the markets, this creates a great scalping opportunity for the alert trader. The key for traders is to be patient, sit on their hands, and wait for these moments to occur. Actively trading really means actively waiting. Overtrading is the number one reason most day traders fail.

There is no easier way to do this than by watching the \$TICK, or, I should say, “listening” for the \$TICK. When the \$TICK gets over +1,000 or under -1,000, this represents extreme buying or selling, and at this stage of the move, most of the bullets have already been fired. Many amateur traders get caught up in the froth and excitement, get scared that they are missing out on a big move, and jump onboard in the direction of the move—just as it is starting to peter out. These are the bag holders that will get shaken out on the reversal. Rather than join the move, I like to wait until an extreme tick reading is registered and then fade the move. Earlier I mentioned that I liked to listen for the \$TICK. By this I mean that I have set up audio signals to alert me when these levels are hit. This way, I don't have to stare at the charts and potentially miss a move because I'm not paying attention. I can be down the hall, but if I hear the alert, I know exactly what is going on.

Getting down to specifics, whenever I see or hear readings of over +1,000 or -1,000 \$TICK, I fade the move by placing a market order. If we get a +1,000 tick reading and I am flat, I short the move at current levels. If I am already long based on another signal, I start exiting that move and initiating a short position. The reverse is also true. If the markets are selling off and traders are jumping in on the move down to the point where a tick reading of -1,000 is registered, I want to step in and buy. There isn't any cleaner way to get



on the opposite side of amateur traders who are chasing the market. I've been shown a couple of different renditions of this setup by other traders. The \$TICK has been around for a long time, and many people who have been doing this for decades have a portion of their trading tied into the \$TICK movement.

In this chapter, I'm going to first cover the fading strategies. Toward the end of this chapter is new information on how and when to "go with" extreme tick readings, meaning that when a +1,000 reading is hit, how to know when to wait for a pullback to the 0.00 line to actually buy and "go with" that extreme \$TICK reading. Note that I use the terms *\$TICK*, *tick*, and *ticks* interchangeably, and they all mean the same thing. When I'm trading, I'll tell someone, "The ticks are high here." I don't say, "The dollar sign tick is high here."

### What Are the Trading Rules for Sell Fades (Buys Are Reversed)?

1. I have studied three different setups that I have learned from other traders and have modified to fit my own trading plan and style. Let's look at the parameters I use for this "extreme emotion" play. I take trades only between 10:00 a.m. and 3:30 p.m. eastern. A lot of sporadic action can happen during the first and last half-hour of trading. I like to let the markets settle in before I take trades.
2. I play tick fades in two markets, the E-mini S&Ps (ES) and the mini-sized Dow (YM). These can also be played in the SPY, DIA, E-mini Russell, E-mini Nasdaq, and any stocks that are mirroring the action of these indexes. For option traders, it is perfectly okay to use options on the SPY to do this trade. Of course, you should choose slightly in-the-money options when doing this. My preference, of course, is options with a delta of at least 0.70.
3. When the ticks reach +1,000, I short at the market. I like to set audio alerts for +1,000 and -1,000 readings. That way, I don't have to stare at the chart. If the ticks get to +988 and fall back, I don't take the trade because I won't hear my audio alert. This keeps the setup clean and very specific, and not subject to trader interpretation.
4. For the YM, I use a 30-point stop and a 20-point target. I also set a time limit of 35 minutes on this trade. If my stop or target isn't hit within the 35-minute time span, then I exit my position at the market. I like to use a timer with a beep so that I'm aware of when the 35-minute time limit has passed. Most traders have very little sense of time when they're in a trade.
5. For the ES, I use a 3-point stop and a 2-point target, as well as the same time limit.
6. If I am stopped out twice in a row on this trade, I am done with tick fades for the day. By "stopped out," I mean that my physical hard stop is hit, as opposed to the time stop. Note that it is on these days that I will switch to a "go with" strategy, which I will talk about later in this chapter.
7. If by 12:00 noon eastern the ticks have spent more than 85 percent of their time above zero, I will pass on all other tick fade plays for the day. This shows an extreme level of buying in the market, indicating that funds are accumulating stocks. These "power days" are rare, but they do happen about once every four to six weeks. They are accompanied by many extreme tick readings above 1,000, typically between 1,200 and 1,400 ticks. In addition, if it is past 10:00 a.m. eastern and the ticks have all been one-sided, for example, all positive on the day, I will wait until the ticks have spent some time in negative territory before setting up the first tick fade play. On these days, this is a sign to "go with"

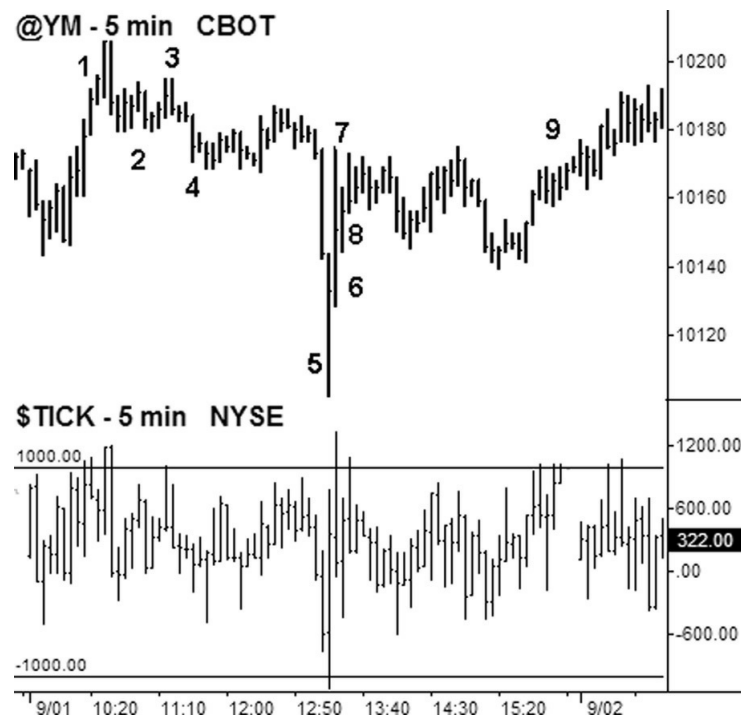
the ticks.

## What Are Specific Examples of Tick Fade Setups?

### *Mini-Sized Dow—September 2004 Contract, September 1, 2004*

1. Shortly after 10:00 a.m. eastern on September 1, 2004, the ticks move up through +1,000 (see [Figure 9.1](#)). I short the mini-sized Dow at the market and am filled at 10,192. I place a stop at 10,222 and a target at 10,172. I also set my timer for 35 minutes.

Figure 9.1

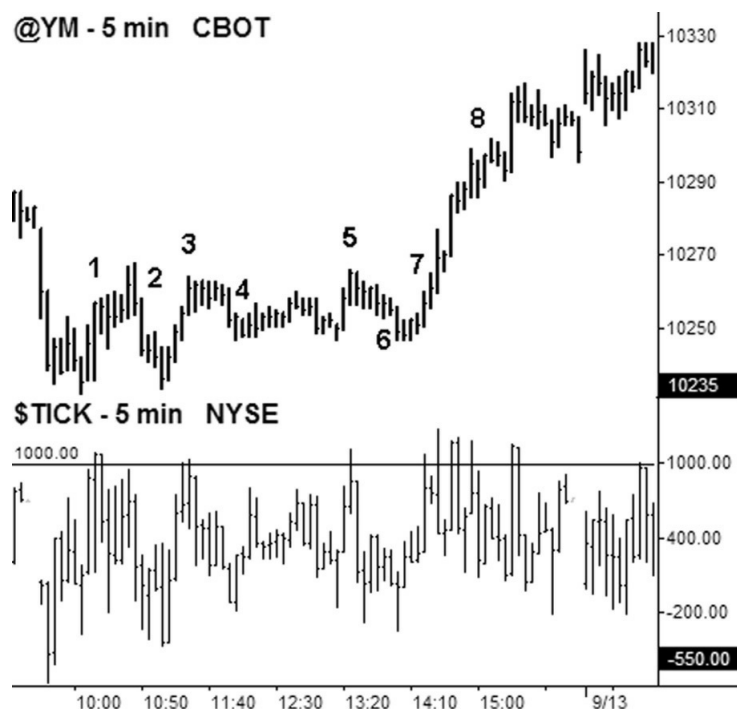


2. The markets drift lower, but after 35 minutes, neither my target nor my stop has been hit, so I exit at the market. I am filled at 10,182 for +10 points.
3. The ticks hit +1,000 again at point 3, and I short at the market. I am filled at 10,194. I place a 30-point stop and a 20-point target.
4. The markets roll over, and my target is hit 20 minutes later at 10,174, for +20 points on the trade.
5. The markets sell off hard, and the ticks get down to -1,000. I buy at the market and am filled at 10,118. I place a stop at 10,088, 30 points below my entry, and a target at 10,138, 20 points above it.
6. My target is hit within eight minutes, and I am out for +20 points.
7. The ticks reverse and quickly hit +1,000, and I short at the market. I am filled at 10,168.
8. The markets roll over quickly, and I am out at 10,148 for +20 points.
9. The ticks hit +1,000, but it is 3:50 p.m. eastern, so I don't take the trade. Remember, according to my trading rules, I don't take any new tick fade trades after 3:30 p.m. eastern.

*Mini-Sized Dow—September 2004 Contract, September 10, 2004*

1. On September 10, 2004, the ticks hit +1,000 shortly after 10:00 a.m. eastern (see Figure 9.2). I short at the market and am filled at 10,252. I place a 30-point stop and a 20-point target from my entry level, and I set my timer.

Figure 9.2

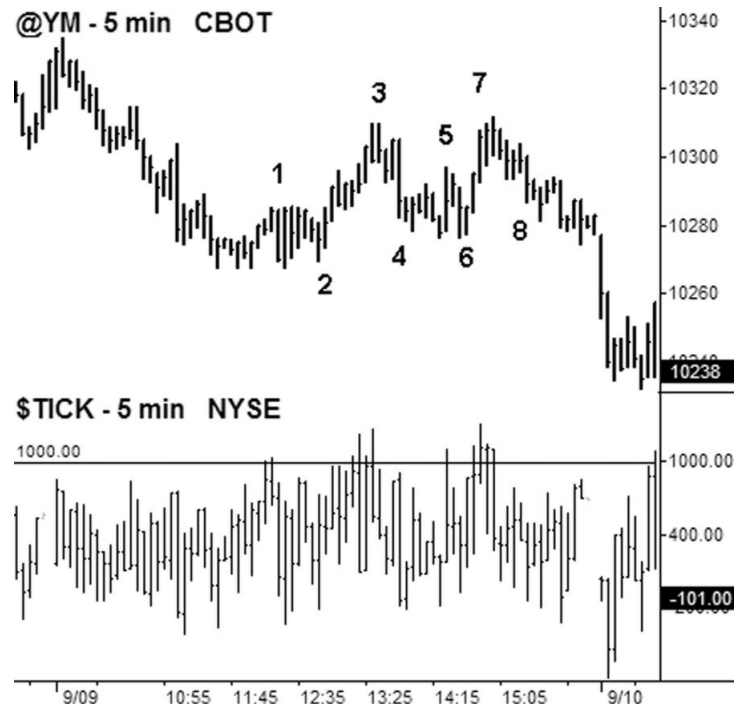


2. Thirty-five minutes pass, and my timer goes off, so I exit at the market and am out at 10,257, a loss of 5 points.
3. The ticks ramp up again and hit +1,000, so I short at the market and am filled at 10,262.
4. Time flies when you are having fun. My timer goes off after 35 minutes, and I exit at the market. I'm out at 10,252 for a gain of 10 points.
5. The ticks head north of +1,000 in the middle of the day. The only reason I'm aware of this is that my audio alert goes off. At the time, I was on the phone. I drop it and run over to the computer, short at the market, and am filled at 10,264. I set my parameters, set my timer, and go back to my phone call.
6. I hear my timer go off again, and I come back to my computer and see that I am still in the trade (that is, neither my stop nor my target has been hit), and I exit at the market. I get out at 10,255 for +9 points. I don't try to finesse these timer exits—I just get out.
7. The ticks push past +1,000, and I short at the market. I'm in at 10,257. I place my stop and place my target.
8. The ticks continue to push higher, and the market rallies. My hard stop is hit for a loss of 30 points.

*Mini-Sized Dow—September 2004 Contract, September 9, 2004*

1. Around noon on September 9, 2004, the ticks hit +1,000, and I short at the market (see [Figure 9.3](#)). I am filled at 10,283. I place my stop and my target, and I set the timer.

Figure 9.3

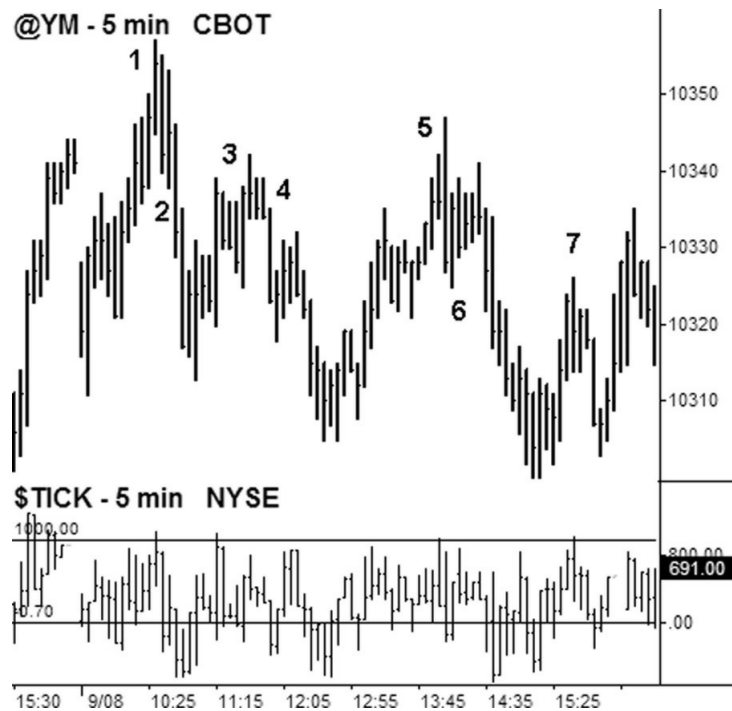


2. After 35 minutes pass, I exit at the market at 10,272 for a gain of 11 points.
3. The ticks again push up past +1,000, and I short at the market. I get in at 10,306, and I place my parameters.
4. The market drifts down, and after 25 minutes my target is hit at 10,386, and I am out for +20 points.
5. The ticks pop up again, and I short at the market. I am in at 10,297.
6. Fifteen minutes later, my target is hit at 10,277, and I am out for +20 points.
7. The markets shoot higher on ticks of +1,000, and I short at the market. I'm filled at 10,308.
8. The markets roll over, and my target of 10,288 is hit, for a gain of 20 points. In the end, this beats working for a living.

*Mini-Sized Dow—September 2004 Contract, September 8, 2004*

1. On September 8, 2004, the ticks register a +1,000 reading shortly after 10:00 a.m. eastern, and I short the YM at the market, getting filled at 10,355 (see [Figure 9.4](#)). I place my stops and targets and kick back. Once I get into these trades, there is nothing to do but wait.

Figure 9.4

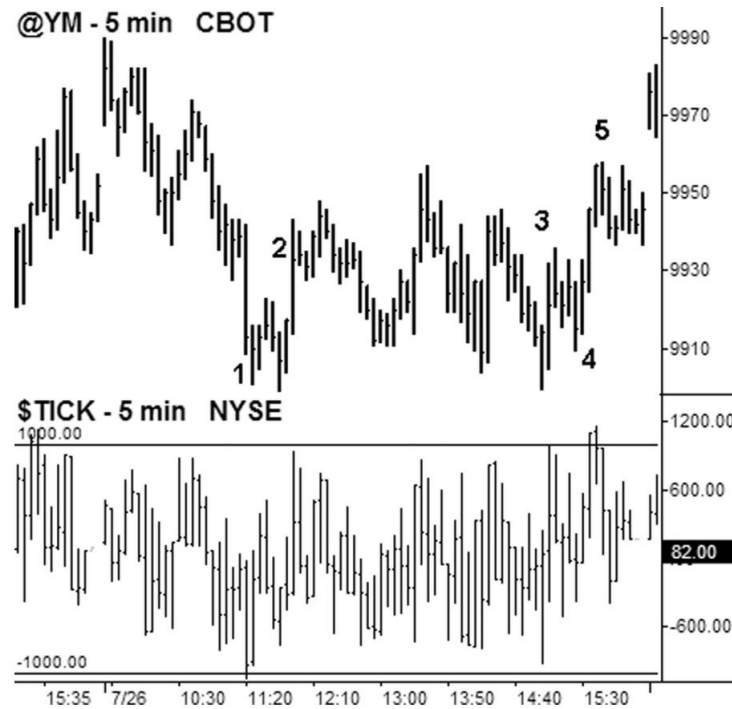


2. The market rolls over quickly, and my target at 10,335 is hit in 10 minutes for +20 points.
3. About 40 minutes later, the ticks act up again, and I short at the market, getting in at 10,337.
4. The markets go into chop mode, and 35 minutes later my timer goes off and I exit at the market, getting a fill at 10,335 for a whopping +2 points.
5. A few hours later, the ticks start getting “jiggy with it,” and I short and get filled at 10,346.
6. About 15 minutes later, my target is hit at 10,226, and I’m out for +20 points.
7. The ticks ramp up again, but I pass on this trade because it is now past 3:30 p.m. eastern. The trade would have worked out at a +20-point trade, but I have found that tick plays in the last half-hour tend to be less reliable.

*Mini-Sized Dow—September 2004 Contract, July 26, 2004*

1. On July 26, 2004, the market action starts off weak, but there aren’t any extreme tick readings until just after 11:00 a.m. eastern (see [Figure 9.5](#)). At this time, I get a –1,000 tick reading, and I buy the YM at the market, getting a fill at 9912. I place my orders for my stop and target, and I set my timer.

Figure 9.5

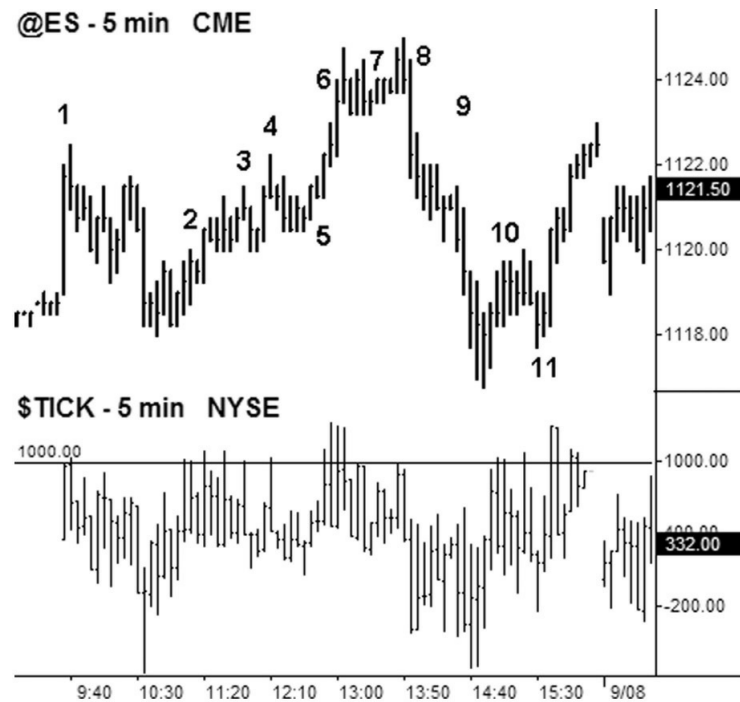


2. After about 30 minutes in the trade, the market firms, and I get out at my target of 9932 for +20 points.
3. The market is quiet for most of the day, and then as it approaches 3:00 p.m. eastern, we get a +1,000 tick reading. I short at the market and get filled at 9932.
4. About 20 minutes later, my target is hit at 9912, and I am out for +20 points.
5. There is another extreme reading in the markets, but it is past 3:30 p.m. eastern, so I sit on my hands and do nothing.

*E-mini S&P—September 2004 Contract, September 7, 2004*

1. On September 7, 2004, I get an early +1,000 tick reading (see [Figure 9.6](#)). I'm watching the E-mini S&Ps, and I'm tempted to short, but I look at the time, and it is near 9:50 a.m. eastern. This is before my parameter of 10:00 a.m. eastern, so I pass on the trade. Although this trade would have worked out in my favor, I have found that tick trades in the first 30 minutes of trade are haphazard at best.

Figure 9.6



2. I wait for the next setup, and it hits the tape near 11:30 a.m. eastern with a +1,000 tick reading. I place an order to short the E-mini S&Ps at the market, and I get a fill at 1119.75. I place a 3-point stop at 1122.75, and I place a target at 1117.75. Of course, I also set my timer to buzz me when 35 minutes have elapsed.
3. The 35 minutes pass by rather quickly, and the only interesting thing that has happened is that my two-foot-long arrowana (a tropical fish from the Amazon that looks like a tarpon) tried to jump out of its tank, causing me to jump like I'd been hit with a cattle prod. Regardless of this distraction, I hear my alarm go off, and since neither my target nor my stop has been hit, I execute an order to get out of my position at the market. I am out at 1121.25 for a loss of 1.50 points.
4. Soon thereafter, an episode of "ticks gone wild" hits the tape, and they move back up to +1,000. I short at the market and am filled at 1122.00. I place my stop and target and set my timer.
5. My timer goes off while I'm enjoying a smoked turkey breast sandwich from Panera Bread Company. I exit at the market at 1121.50 for -0.50 point.
6. The markets pop higher on a +1,000 tick reading, and I short at the market. I'm filled at 1123.50. I set my parameters, kick my feet up, and watch the action.
7. The next 35 minutes pass by swiftly, and at the sound of my buzzer, I execute an order to cover at the market. I'm out at 1123.50 for a scratch trade.
8. The ticks hit +1,000 again, and I short at the market. I am filled at 1124.75.
9. This time the markets roll over, and my target is hit at 1122.75 for +2.00 ES points.

10. As we move into the last hour, the ticks dare to hit +1,000 yet again. I short at the market and am filled at 1119.75.
11. The market rolls over, and I am out at my target at 1117.75 for +2.00 points.

*E-mini S&P—September 2004 Contract, September 3, 2004*

1. On September 3, 2004, the pickings are slim. The ticks get close to +1,000 and close to -1,000, but they never actually hit these levels (see [Figure 9.7](#)). I don't mess around with these kinds of plays. Either the ticks hit 1,000 or they don't. We don't get an extreme reading on this day until the final hour, when the markets register a +1,000 reading. I leap at this opportunity to do something, and I short at the market. I am filled at 1117.25. I set my stop and my target, and I turn on my timer. I kick back and watch the action.

Figure 9.7



2. About 30 minutes after my entry, my target is hit at 1115.25, and I am out for +2.00 points. Conveniently, the market is approaching its close for the day, and I can now do something more exciting, such as arrange the soup cans in the pantry alphabetically. This is a good example of why it is so important to have a specific setup to wait for. Without one, a trader can spend a day like September 3 overtrading and chopping himself up. It is tempting at times to take a trade just to alleviate the boredom. But this begs the question—is the goal of trading “not to be bored” or to make money?

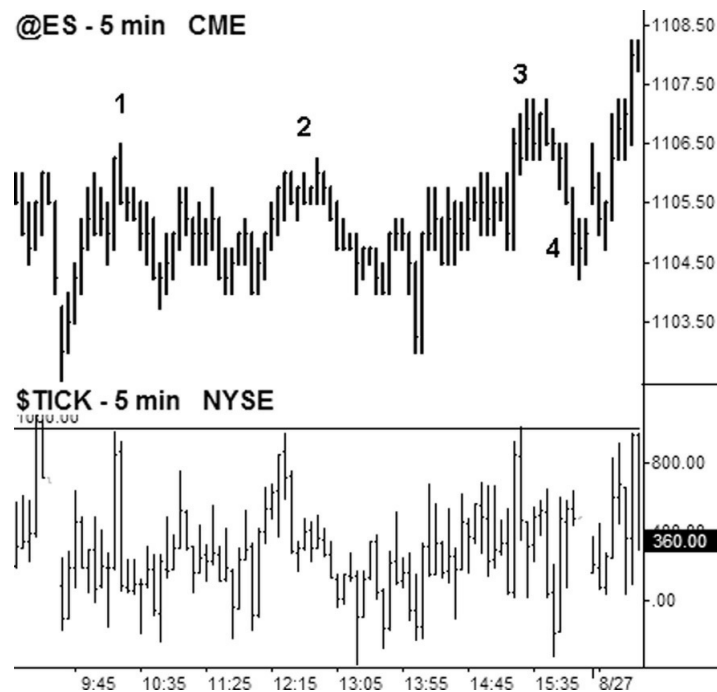
*E-mini S&P—September 2004 Contract, August 26, 2004*

1. The ticks approach an extreme reading early in the day, but they don't quite get there, registering a high of +978 (see [Figure 9.8](#)). Since this is not a game of grenades or horseshoes, I stand aside and



wait until we get an actual reading of over +1,000.

Figure 9.8



2. Again, we come close to 1,000 ticks, but we don't quite cut the mustard. I stand aside and do nothing. This actually isn't as hard as it may seem. I don't stare at the tick chart; I'm taking action only if I hear the audio alert.
3. Finally, we get a reading of over +1,000. I short at the market, and I'm filled at 1106.75. I set my parameters and await the action—having done nothing all day at this point with regard to this setup.
4. About 30 minutes later, my target is hit at 1104.75, and I'm out for +2.00 ES points.

*E-mini S&P—June 2004 Contract, May 24, 2004*

1. On May 24, 2004, the markets gap higher and register a +1,000 tick reading early in the session (see [Figure 9.9](#)). This is before 10:00 a.m. eastern, so I treat it just like a phone call that pops up as “out of area” on caller ID—I ignore it. Closer to 10:30 a.m., we get another +1,000 reading, and I short this action with a market order. I am filled at 1098.50, and I set my parameters.

Figure 9.9

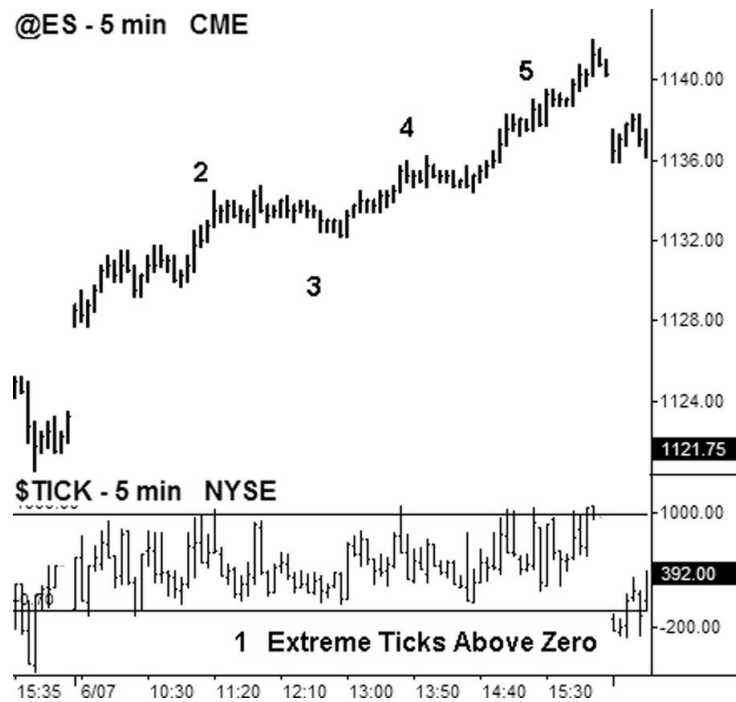


2. About 20 minutes later, my target is hit, and I'm out at 1096.50 for +2.00 ES points.
3. Most of the rest of the day is quiet, but as we approach the last few hours, we get an extreme tick reading, and I take a short at 1096.50.
4. About 25 minutes later, my target is hit, and I'm out for +2.00 ES points.
5. The ticks get wild and crazy again, hitting +1,000, so I short, and I'm filled at 1096.00.
6. The markets remain choppy, and my time buzzer goes off. I cover at the market, and I'm out at 1095.50 for a gain of 0.50 ES point.
7. The markets pop higher again and register an extreme tick reading. However, it's past 3:30 p.m. eastern, so I don't take any action on this signal.

*E-mini S&P—June 2004 Contract, June 7, 2004*

1. The markets gap up, and the ticks spend the vast majority of their time over the zero level (see [Figure 9.10](#)). If at 12:00 noon eastern the ticks have spent more than 85 percent of their time above zero, then I pass on any further tick fades on the day. Remember, it is on these days that there is serious buying taking place. Only consistent and steady fund buying can keep the ticks above zero all day long. That hasn't happened yet, but it's in the back of my mind.

**Figure 9.10**



2. At around 11:00 a.m. eastern, the ticks register an extreme reading, and I short at the market. I'm filled at 1134.25, and I set my parameters. I take this short because at this point we haven't passed the 12:00 noon eastern deadline. Also, in the rules, I mentioned that if the ticks have spent all of their time above zero by 10:00 a.m. eastern, I'd like to see at least one move below zero before taking a trade. In this case, we did get some moves just below zero. These aren't ideal conditions, but they do pass the test.
3. Time passes by quickly, and my time stop expires. I exit at the market, and I'm out at 1133.00 for +1.25 ES.
4. A little after 1:00 p.m. eastern, the ticks register another +1,000 reading. I ignore this reading because the ticks have spent more than 85 percent of their time above zero, indicating massive fund buying.
5. This happens again near 3:30 p.m. eastern, and I ignore this signal for the same reason. The markets are "on fire" today, as is evidenced by the consistent high tick readings, with hardly anything dipping below the zero level. I therefore pass on fading these extreme tick readings. Although these days are rare, it is important to know what they look like so that they can be avoided in terms of a "tick fade" day.

### Summing Up the Tick Fades

As I state in the introduction, the financial markets are naturally set up to take advantage of and prey upon human nature. When traders see a market running away without them, their natural instinct is to jump onboard and participate in the run. Although this makes sense on paper, this feeling of "missing the move" causes more trading errors than almost anything else. This blinding urge forces amateur traders to jump into markets based solely on the fear that they are missing out on a lot of profits—as opposed to entering the market as a result of a specific setup that they have mapped out and are patiently waiting to set up. This

extreme panic buying and selling is measured accurately by the ticks, and extreme tick readings provide traders with the opportunity to jump into the markets and teach the amateurs a valuable lesson.

### **How Do You Know When Fading Ticks Won't Work?**

In the first edition of this book, I focused exclusively on the “fade” setup. During most of 2004 and 2005 (when I wrote the first edition), the stock indexes were extremely quiet, and most of the big momentum moves were found in the currency markets. And that's one great thing about becoming a trader of setups—the market you end up trading is irrelevant. In truth, I don't trade markets; I trade setups and patterns. I couldn't care less whether a setup takes place in the stock market, oil, or gold. Just give me something that is ready to make a move.

Since the 2008 financial crisis, however, big stock market moves have become the new normal—big moves to the upside and big moves to the downside. Either is fine with me, and the ticks play a crucial role in these types of markets as well. The bottom line is this: if the markets are crashing today, then we aren't going to try to buy a -1,000 tick reading. We are, in fact, going to use modest tick strength (instead of extreme tick strength) as an opportunity to go short.

The question comes down to this: how do we know whether we should be fading the move or going with the move? And, if we are going to go with the move, how do we play that move?

Let's jump in and take a look.

### **How Do We Trade “Going with” the Ticks Instead of Fading Them?**

This chapter ties in a lot with the chapter on internals. The first half-hour of trading is typically very telling concerning what kind of day it's going to be. It's like when I wake up in the morning and try to gauge my wife's mood. I've learned that if she's had dreams of happy things and happy places, then the day will start off positive and trend that way well into the evening. If, on the other hand, she had a dream about me and our Swedish au pair, then I know the first half-hour of the day is going to be dicey at best, and the rest of the day will depend on how I navigate that early session. During those shaky times, I try to reassure her that I'm a trader at heart, and that swapping out half my net worth for a quickie with the au pair is, at best, a bad trade. Sometimes that logic seems to help. Sometimes.

Quite simply, the ticks are a road map to what the elephants are doing and where they are going. In July 2010, I traveled to South Africa for two weeks to see the World Cup. It was an amazing trip. The first week I stayed at Ulusaba, which is Richard Branson's game reserve, located in Kruger National Park. Although the terrain looked a lot like Texas, it was amazing to see the “Big 5” in their natural habitat, up close and personal. Of the Big 5 animals, the easiest to find were the elephants. Not only could you see their tracks, but you couldn't help seeing the knocked-over trees and their huge piles of dung. For them, hiding was impossible. (As opposed to the jaguar, which was extremely difficult to find. In trading, just be the jaguar quietly following the elephant.)

Large-scale coordinated institutional buying and selling is the same. It is impossible for them to hide if you know where to look. The \$TICK marks their trail through the bush, along with their steaming piles of dung. As traders, all we have to do is follow along for the ride.

In [Figure 9.11](#), we have a snapshot of the \$TICK and SPY from Friday, September 30, 2011. On this particular day, the first few hours of trading are on the quiet side. The market gaps down big, about 15 ES points (150 Dow points), which is \$1.50 on the SPY. It takes time for traders to digest this move, and the first few hours see choppy action. The first extreme \$TICK reading occurs at 11:20 a.m. eastern, when the ticks hit the +1,000 level. The first extreme \$TICK reading of the day is a good one to fade. It's the first probe, and probes generally fail. In this case, the markets chop around for about 20 minutes and then promptly sell off.

Figure 9.11



The \$TICK goes back into quiet mode, and then about an hour later we get the first extreme \$TICK reading to the downside. At this point, even though the market has gapped down more than 15 ES points, it is still choppy. There isn't any real trend in place. This might seem like a scary \$TICK reading to buy because the market is down so much, but in reality it's the first real probe to the downside during the cash session (the rest of the selling occurred during the overnight session). It's worth a shot. After the extreme \$TICK reading, the market did indeed set up a nice rally, so fading the first extreme \$TICK reading of the day is working nicely.

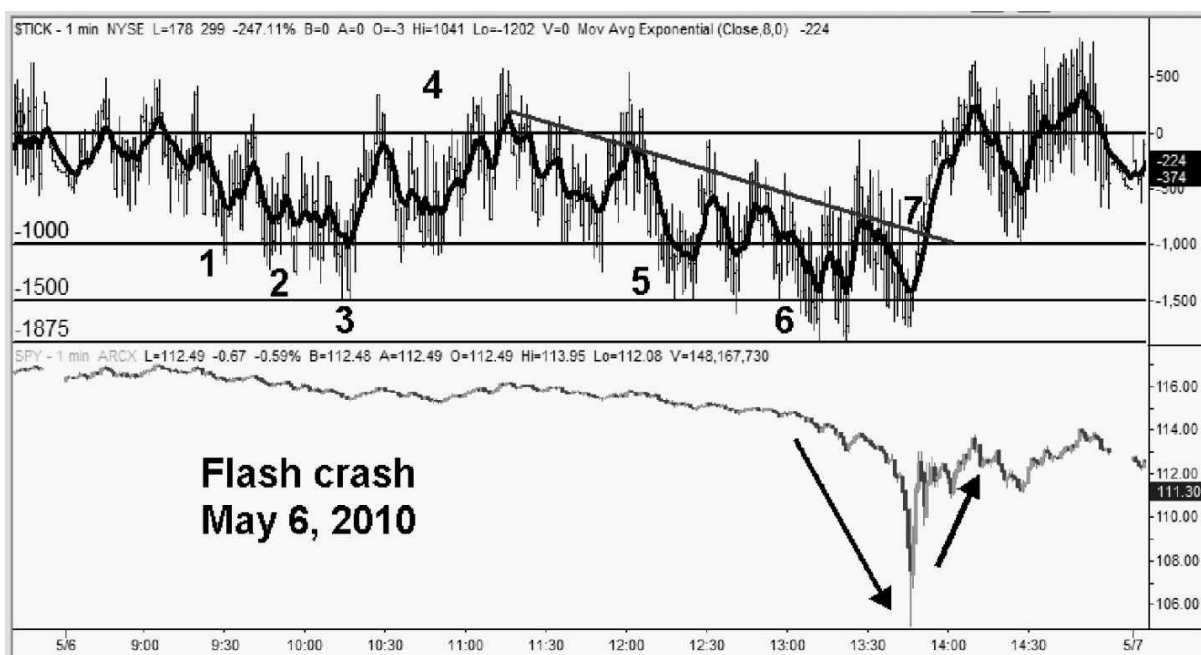
At point 3, the dynamics change. First and foremost, the market is no longer choppy. It's making new lows on the day. That's not chop; that's trend. It is after this point, however, that things get interesting. Try as they might, the ticks cannot push much above the +200 level, and when they do, they are rejected handily. Not only are they now spending most of their time below zero, but they continue to probe the -1,000 level and beyond. And that's the real key here. If a market tests -1,000 and bounces back, that's a probe. If, on the

other hand, a market tests  $-1,000$  and then keeps hanging around at that level, even testing lower \$TICK levels, then there is some real selling coming into the markets. The final stake in the coffin here is when any move back toward the 0.00 line is quickly rejected. Then we know that the elephants are selling, and they are selling hard.

In situations of this type, there are two strategies. First, any move to the 0.00 line is a shorting opportunity. The stop loss is a market that stays above  $+600$  for more than a minute or 4 to 6 ES points, whichever comes first. The target is another move to  $-1,000$ . Into this ferocious selling, it's okay to cover your short, and then reload at the next retracement \$TICK move to the 0.00 line.

Let's look at an extreme example. Sometimes, as in all areas of life, it helps to look at an extreme situation in order to get a better reading on how to handle something that's "normal." In Figure 9.12, we see the \$TICK and how it behaved on the day of the infamous "flash crash," May 6, 2010. This is a one-minute chart, on which I've placed an eight-period exponential moving average (EMA). The moving average is helpful for watching the "trend of the \$TICK" intraday. As I've mentioned already, moving averages are a lagging indicator, and they aren't useful for spotting "immediate" changes in trend. However, they are useful for clarifying that a trend "has now changed." Many traders blow out their accounts trying to prove they are right. Moving averages are glaring road signs that indicate when it's time to throw in the towel and change tactics. Still shorting when the moving averages have crossed and turned higher? Good luck with that.

Figure 9.12



This day starts out normally enough. We can see that at point 1, we get the first extreme \$TICK reading of the day at  $-1,000$ . This is a normal reading. At point 2, we start to get consistently extreme readings, which is the first heads-up that this is going to be a "go with" day. At this point, however, there is nothing telling us what is about to unfold. At point 3, we get the first  $-1,500$  \$TICK reading of the day. This is unusual and shows that there is extreme downside pressure in this market. At this point, we are looking at all rallies in the

\$TICK as an opportunity to get short.

For a few hours, the market then goes into chop mode. Rallies to the 0.00 line (point 4) can be shorted and then covered when the \$TICK heads down to -1,000. Easy enough?

And then something very unusual happens. At point 5, we start to get consistent readings at the -1,500 level, which shows an incredible amount of selling pressure. This is a rare reading, and it shows that there is some “ugliness” going on out there and that this day might, in fact, be a “crash day.” Crashes can occur only when there are consistent \$TICK readings in the -1,200 to -1,500 range. If the \$TICK hangs out at these levels, the selling eventually cracks the markets. And then things get even more intense at point 6, when the \$TICK hits -1,875 and in fact tests the -1,700 to -1,800 level multiple times. The markets start selling off steadily for about 15 minutes, to the point where the Dow is down just over 300 points. And then all hell breaks loose, and the Dow drops another 600 points over the course of five minutes . . . only to then recover that move in the next five minutes. “The world is coming to an end,” I hear a few people say. “Never mind, it’s not.”

Was there any way to tell that the “flash crash” was going to happen this day? Of course not. Were there telltale signs that intense selling pressure was hitting this market, and that there wasn’t any reason to be long? Yes, absolutely. Finally, was there a way to recognize that the selling pressure had come to an end? Yes.

At point 7, we can see that the downward trendline of the eight-period moving average has been broken. Moments like this represent key areas of “mentality shift” in the herd of elephants that we are trying to follow. For a while, they were heading south, and we followed them south. Now they’ve changed direction and are headed north, and there is nothing to do but follow them north. This doesn’t mean that we are able to catch the dead bottom of a move; it just means that once we are able to see that the herd has shifted, we can then also shift our focus. Once the \$TICK shifted, it became time to focus on long setups, although every ounce of rational thought fought against that idea.

In [Figure 9.13](#), I’ve zoomed in on the flash crash portion of the day. Points 1 and 2 show the extreme -1,500 \$TICK readings and the even more extreme -1,800 \$TICK readings. These are very hard for the market to “shake off.” They indicate persistent selling, with more to come. Anytime I see something like this, I expect any rallies to continue to be sold and for new lows to continue to be made on the day. The underlying intensity of this type of selling cannot be underestimated.

**Figure 9.13**



Shortly after point 2, the eight-period EMA turns higher and a small bounce ensues. However, remember from the previous chart that what we are looking for here is a change in trend. That doesn't happen until point 3, when we break the trendline shown in Figure 9.12 at point 7. It's all about going with the flow and not fighting the action unfolding on the computer screen.

With Figure 9.14, we have slightly more "normal" conditions. This is from Monday, October 3, 2011. The market shows some choppy strength early in the session, then rolls over into steady selling. One thing I've found helpful in "watching the flow of the \$TICK" is to place an 8- and 21-period EMA on the one-minute chart. On this chart, the 8-period EMA is the thick line, and the 21-period EMA is the thin line. Although I spend more time watching the actual \$TICK, these moving averages are helpful in gauging the "trend of the \$TICK," which drives the price action throughout the day. If I see these moving averages above the zero line, then I'm inclined to focus on the long side, and if they are below the zero line, then I'm going to focus more on the short side. The crosses on these moving averages are also helpful. If the ticks are below zero, a cross of the 8-period EMA below the 21-period EMA indicates massive selling pressure. A cross of the 8-period EMA above the 21-period EMA (while below zero) indicates a pause in the selling pressure, and the reverse is also true when the ticks are above zero.

Figure 9.14



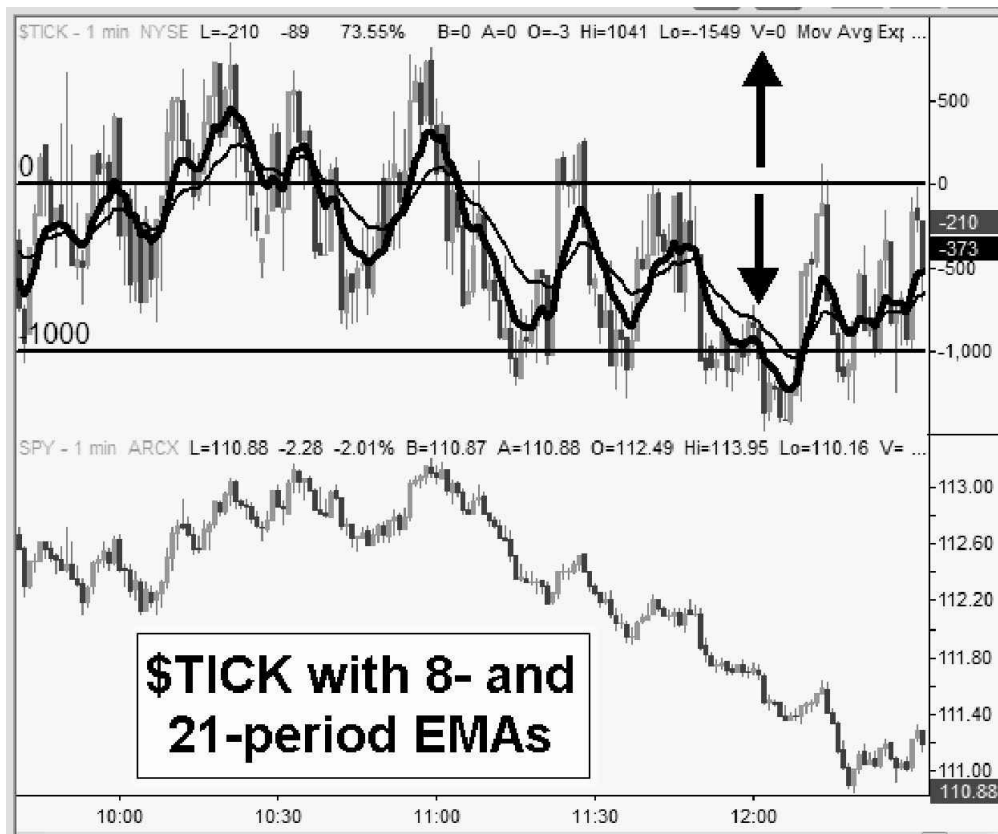
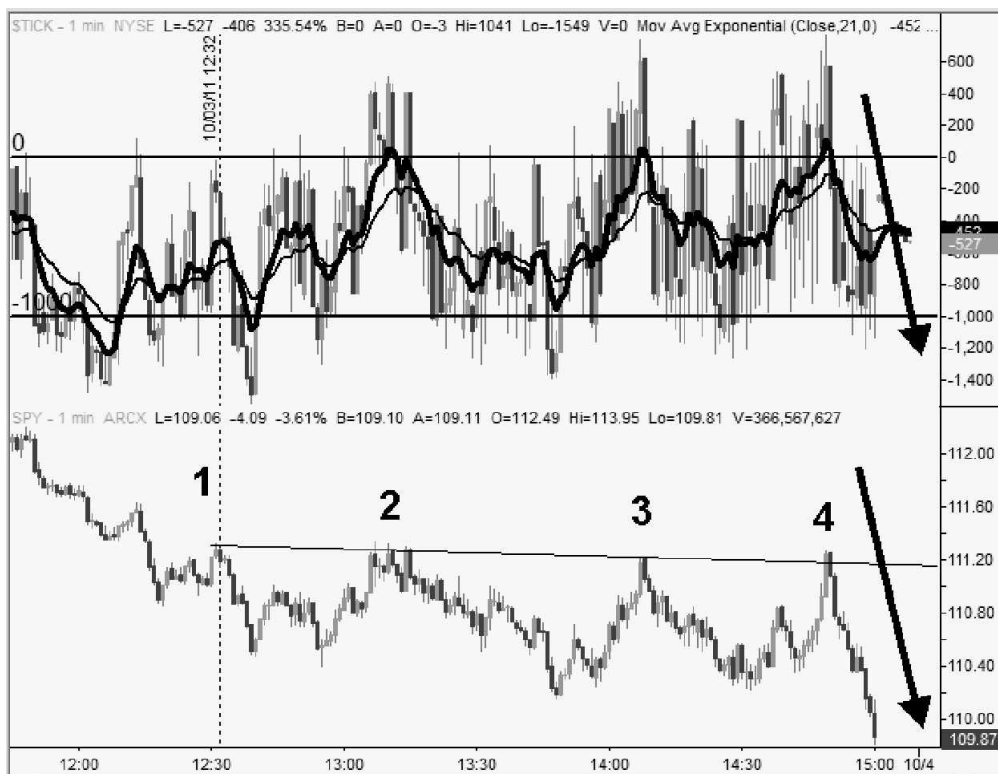


Figure 9.15 shows the remainder of October 3, 2011, with the vertical line at point 1 representing the cutoff point on Figure 9.14.

Figure 9.15



On this chart, the \$TICK rallies and the SPY rallies into point 2, only to be rejected, forming an intraday swing high, a key level that will need to get broken for there to be a significant short-covering rally into the close. At point 3, the \$TICK goes positive and the markets rally hard, only to get rejected again. Finally, at point 4, a time of day when a reversal is most likely to happen, the \$TICK rallies above zero and the SPY rallies hard, only to get handily rejected at this level once again. This time the markets plummet into the close. What do all of these key rallies have in common? Although the \$TICK went positive and a market rally looked promising, the 8- and 21-period EMAs could not both cross above zero. As long as they are staying below zero, the pressure is to the downside.

In quiet markets, fading \$TICK moves and the occasional wayward high \$TICK reading is a solid way to make a living. Watch it, though, when the elephants are moving. During those times, it's best to follow the herd.

I can't imagine day trading stocks or stock indexes without using the information provided by the \$TICK indicator. The best way to learn about how to use this indicator is simply to start using it. I've logged over 20,000 hours watching how the \$TICK interacts with the market. I've created a page at [www.simplertrading.com/ticks](http://www.simplertrading.com/ticks) with additional updates to this setup as well as live trading examples. Watching this with live examples is really the only way to learn how to maximize this trading asset.



# Reverting Back to the Mean, or, “When Is the Best Time to Take a Profit?”

## Where Do Markets Stop Their Current Trend and Run Out of Gas?

If you were walking down the street, minding your own business, and suddenly found yourself in the middle of a mugging or an assault, and you survived, you would possibly decide to take some sort of action going forward such as: (1) notifying the police. (2) buying some mace or a taser. (3) avoiding that street in the future or, (4) choosing to no longer walk alone. All reasonable decisions to prevent that bad experience from happening again. By not understanding the natural ebbs and flows of the market, however, it is like choosing to walk down that same scary street repeatedly, alone, without a taser. “He’s back again?” the muggers ask incredulously. “I guess he just likes losing money.”

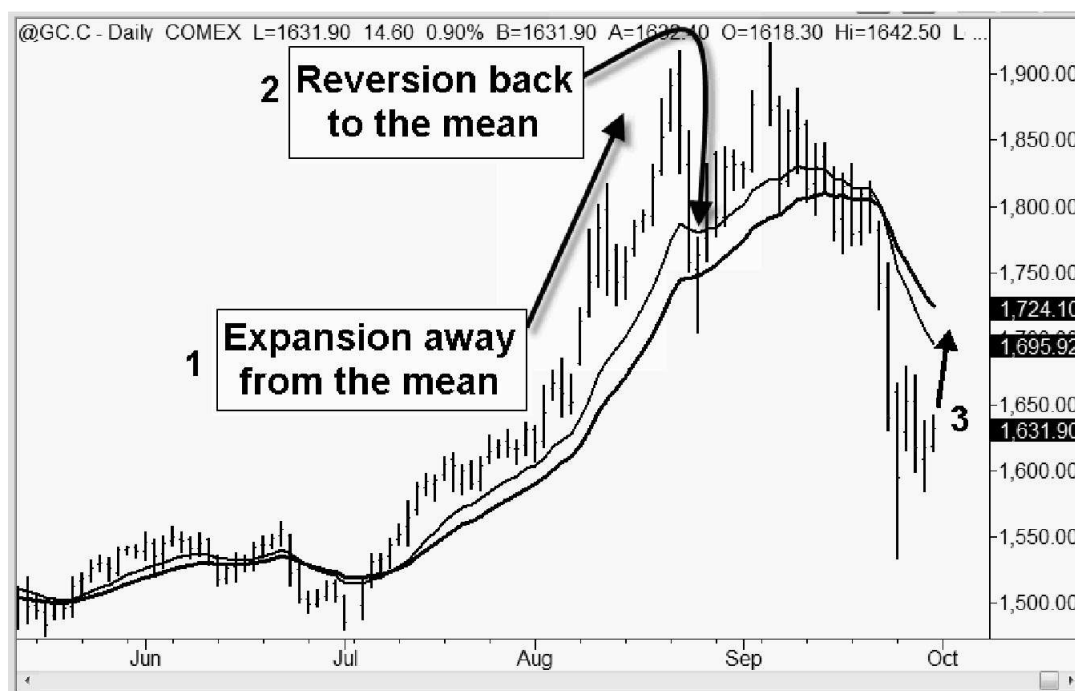
On a five-minute chart, like a dark alley, all kinds of atrocities take place on a regular basis, and traders keep coming back for more. “I’ll avoid those muggers next time,” they think. Computer-generated trading programs (algorithms) are like terminators on a relentless quest for your cash, sucking the joy out of all humans who dare to compete with them. The good news? A lot of these computer programs focus on moves within a stock’s Average True Range (ATR). Whether a stock or a market is in an uptrend or a downtrend or is just trading sideways, it stays true to its ATR the vast majority of the time. What is this elusive measurement?

This is a tool developed by J. Welles Wilder for daily charts and the commodities markets. Turns out, it works great with daily charts and individual stocks as well. Thought—how far away does a stock have to get from the 21 EMA before the odds increase of a return to the 21? The pivots are great for establishing ranges in markets on an intraday basis. But what about for larger time frames, such as daily and weekly charts? Is there a way to establish extension levels to buy and sell against on a swing basis—positions that can be held for days or weeks instead of minutes or hours? Although this chapter has nothing to do with pivots, the general idea is the same. A daily pivot level represents an “average price” from the prior day’s trading, which is one of the reasons price is attracted to that level on the next trading day. It just needs to test it out and see if it will hold.

The concept of *average price* is an important one. Any particular market at any given time is either expanding away from its average price or reverting back to its average price—also known as “reverting to the mean.”

In [Figure 10.1](#), we see a daily chart of gold with a set of exponential moving averages, the 13-period EMA and the 21-period EMA. These levels, which represent the average prices over the past 13 days and 21 days, respectively, are also a continually adapting representation of a market’s key average price levels. These are the specific levels that the market is either expanding away from or reverting back to. The key question is, then, “How far away from its average price zone does a market need to get before it needs to start reverting back to that level?”

Figure 10.1

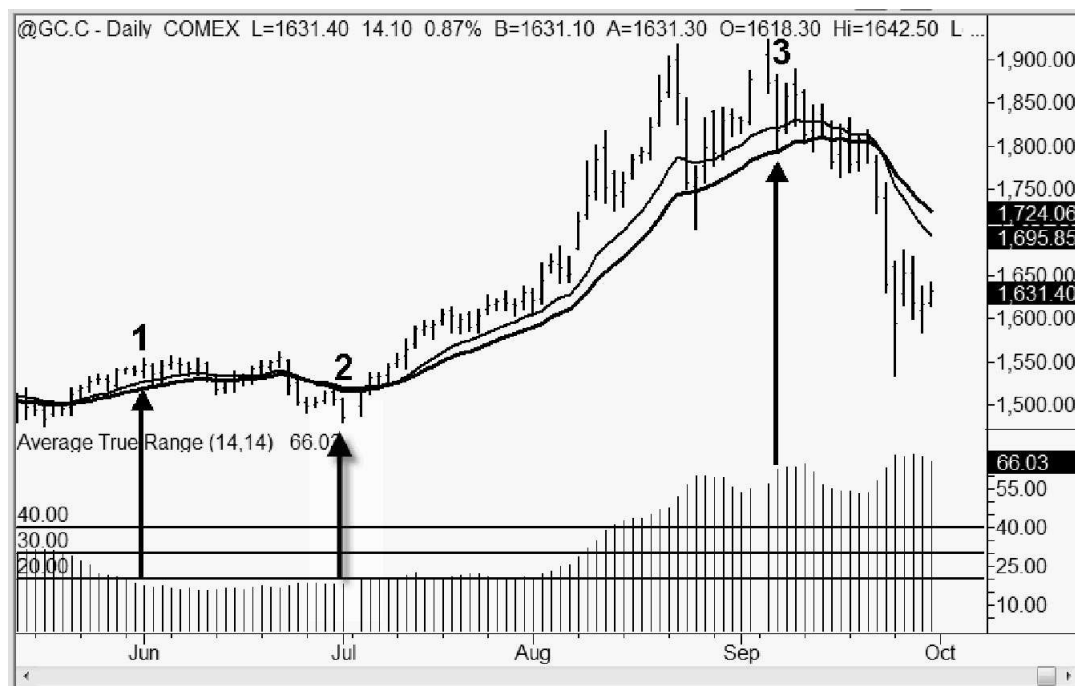


That's a great question.

This is where the concept of average true range comes into play. The average true range, referred to as ATR throughout the rest of this chapter, literally represents the average price range of the prior 14 periods of trading.

In Figure 10.2, we see the same gold chart with its ATR inserted at the bottom of the chart. At point 1, the ATR is around 20, which in this case means \$20.00 an ounce on the price of gold. Why is this important? It means that most of the time, if the price action moves about \$20.00 away from the mean (the zone represented by the 13- and 21-period EMAs), then it's going to have to start reverting back to the mean. At point 1, prices extended above these moving averages by \$20.00 an ounce, and then started making their way back. At point 2, prices extended about \$20.00 an ounce below these levels, and then promptly made their way back to the mean. Later in the year, we can see that the ATR increases to \$60.00 an ounce, at point 3, which means that the price action could move this far away before it needed to start working its way back.

Figure 10.2



In [Figure 10.3](#), we have a daily chart of the Swiss franc (SF). On this chart, I've placed a modified version of the Keltner Channels, which plot the average true range as outer-range bands. I have the "mean" price (the middle dotted band) set to 13, and I set the bands to be 1.5 times that average true range. This means that at any given time, both the upper and lower bands will be 1.5 times the current ATR reading away from the middle band. For example, at point 1, we have an ATR reading of 0.0100, which translates into 100 ticks. Multiply this by 1.5, and you get 150 ticks. At point 2, we see that the lower band is 150 ticks away from the middle band, and at point 3, the upper band is also 150 ticks away from the middle band. Why multiply it by 1.5? The ATR is a lagging indicator, and by multiplying it by 1.5, we give a little more room to accommodate the most current price action.

**Figure 10.3**



There are now a couple of key concepts we need to understand in order to trade this setup on this chart.

1. The bands are sloping upward, indicating, surprise, an uptrend. Because of this, I'm interested in initiating only long trades. I could initiate short trades at the upper bands, but since the upper bands are continually rising, this is an inherently lower-probability strategy than going long. For example, if we initiated a short at point A, the market would just keep moving higher and stop us out. The market is still trading within its ATR, just on a steep uprising slope.
2. At point 4, we get a pullback to the mean. I initiate a long. When SF moves back to the outer band at point 5, I close out the position. Then when SF pulls back to the mean again at point 6, I go long, and I sell at point 7. I then buy the pullback at point 8 and close it out at point 9. Wash, rinse, repeat.
3. *Tip:* There is no need to try to capture every tick of these moves. Remember that I said that the bands were set to 1.5 times the ATR? Well, I'm really interested in capturing only 1 ATR worth of movement, or even slightly less than that. So I'm getting out of the trade at point 7, even though it hasn't hit the band. This is because I'm trying to get only 1 ATR (about 100 ticks) instead of 1.5 ATR (about 150 ticks). In other words, I'm constantly selling too soon. There's no need to be a pig at the trough.
4. What about stops? For best results, have stop losses, in this case, just outside the lower bands. This keeps a trader completely out of the wiggle room, and a stop out usually occurs only when there's a change in trend. This is one of those setups where stops that are too tight will have a bad impact. Trade smaller size and let the trade work itself out.
5. *Bonus:* If the move gets too near the lower band, indicating a potential change in trend, as happened at point B, the trader has the option of bailing out on the trade on a move back to the mean, closing out the trade at a "scratch" or small loss. Double bonus: A trader can also start out with half size,

double up to full size on a move toward the lower band, then get out on a move back to the mean for a profit. This is one of my favorite ways to turn losing trades into small winners. The key, of course, is money management and fully understanding what a full-sized position means for your account. It does not mean “doubling up” to position sizes that are too large for your account. It is critical to still keep a hard stop in place during these types of trades.

6. *Another tip:* One of the most common questions I get is something along the lines of, “What kind of stop would you use on the Swiss franc on the hourly chart?” or, “What kind of stop would you use on Amazon on a daily chart?” or even, “What kind of stop would you use on crude oil on a 512-tick chart?” or, perhaps, something like, “What kind of stop would you use on the ES on a 15-minute chart?” or, quite possibly, something along the lines of, “What kind of stop would you use on the euro on a five-minute chart?” (After about the 10th time in a matter of minutes, I start to get a nervous tick in my left eye.) Here’s the answer: no matter what market you are looking at and no matter what your time frame, you can put a 14-period average true range indicator on your chart. Whatever that value is, double it, and you have your stop. Voilà!
7. Also note that at point A, the market just runs away, and during a move like this, it’s typical not to get filled on a reversion to the mean for days, sometimes weeks at a time. This setup is geared to catch bits and pieces of a market that is in a quiet trend or quietly trading sideways. It’s not meant to capture momentum.
8. *Key point:* The one major flaw with this setup is that it can miss entire big moves, as big moves will push beyond the ATR bands. This is where the squeeze comes into play, which we will look at next.

### **This Sounds Awesome—Why Isn’t Everybody Doing This?**

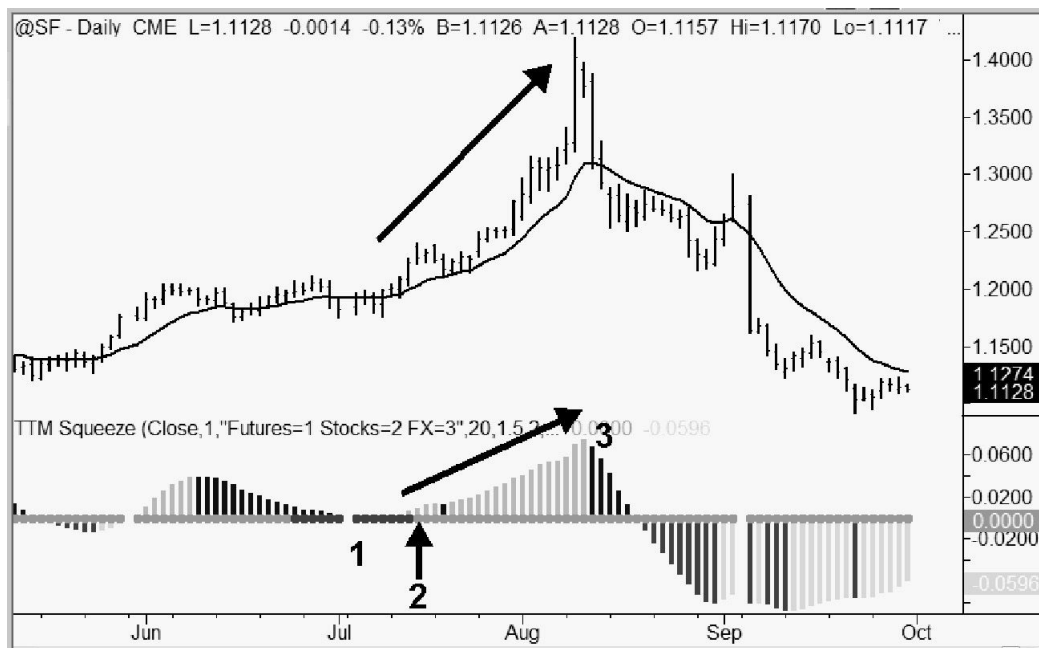
Okay, at this point, you are probably thinking, “If it’s that easy, why isn’t everybody doing this setup?” Alas, a lot of people have tried. The concept of reversion to the mean is not original by any stretch of the imagination. There are two things that I’ve seen that throw traders for a loop on this setup. The first is the temptation, in referring to the same SF chart, for traders to short moves to the upper band in a clearly defined uptrend. Yes, it will work at times, but it’s inherently dangerous, as we saw at point A. Just go with the trend, don’t fight it. This also holds true for downtrending markets—there is little need to pursue a strategy of buying the lower bands when you can just short retracements back to the mean. That’s rule 1. (Advanced traders with large accounts and a scale in methodology can pull this off—shorting uptrends to the upper bands and buying downtrends to the lower bands. Newer traders with smaller accounts get chewed up and spit out trying to do this. However, using options, vertical credit spreads can safely be initiated at these levels, which I’ll discuss shortly.) The second rule is that this trade becomes irrelevant once a squeeze fires off.

Figure 10.4 shows the SF daily chart with a squeeze at the bottom of the chart. I’ll explain the squeeze setup and mechanics in more detail in the next chapter. For now, here’s the short version. The darker-colored dots at point 1 indicate a tight compression of volatility that is about to be released. This compression lasts, in this case, for 13 bars. The first lighter-colored dot after the series of darker dots (as indicated at point 2) signifies that this energy is ready to be released. At this point in time, a trade is triggered. If the histogram is above zero at this time (as it is here), it indicates a long trade. If the histogram had been below zero, then it



would have indicated a short trade.

Figure 10.4



This squeeze is valid as long as the histogram continues moving higher. When the histogram finally loses momentum (as indicated by the darker-colored bars) the squeeze is no longer “in play.”

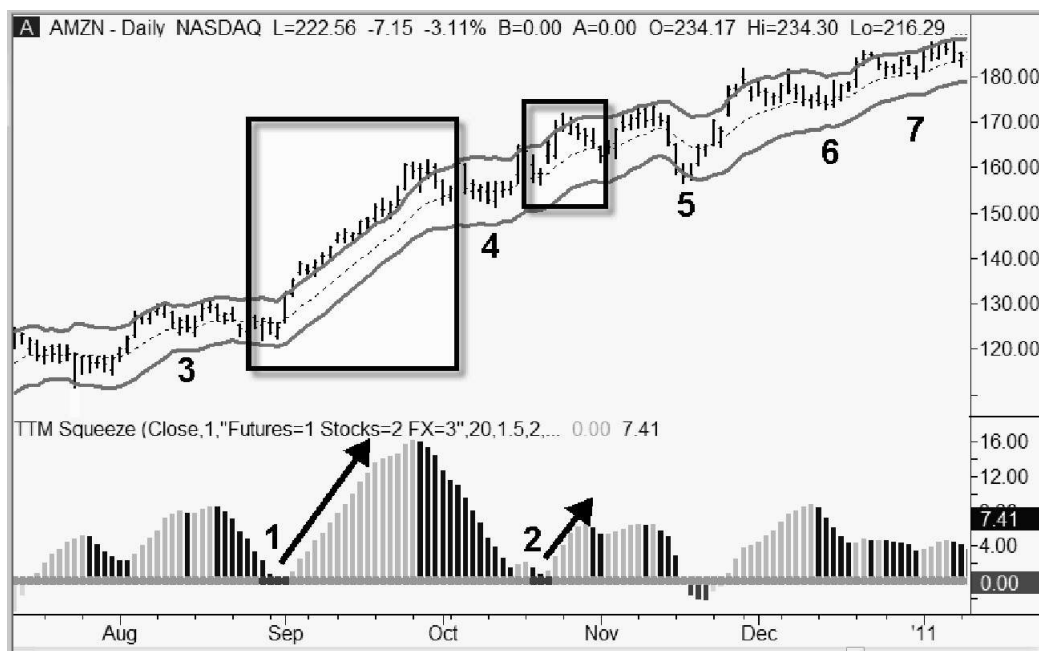
There are a few key things to know about the squeeze in relation to the reversion to the mean trades, as well as some general tips on how I utilize this setup.

1. I typically focus on reversion to the mean (RTM) plays on daily charts only. I don't use them on intraday charts. I will sometimes utilize weekly charts for longer-term plays.
2. I look at various commodities, including stock index futures, and also individual stocks with this setup. For individual stocks, I'm utilizing these RTM setups to do option strategies, such as buying delta 0.70 options to capture the move back to the upper band (in the case of an uptrending stock).
3. The RTM trade is valid all the time . . . except when a squeeze has fired off.
4. Once a squeeze fires off, disregard the bands completely. They are now utterly worthless. The bands will not hold prices in check when a squeeze has fired off. In fact, once a squeeze has fired off (that's what I call the first lighter-colored dot, such as point 2 in Figure 10.4), I just take the bands off the chart. Once the squeeze is over, I'll put the bands back on the chart.
5. For the squeeze, I'll enter a trade for a directional momentum play. Here's where it gets interesting.
6. A squeeze actually expands the average true range of a market. This is why doing reversion to the mean trades during a squeeze is an exercise in futility. Imagine all the people out there trying to do these trades that don't know about or understand the squeeze. This trade works out great for them 70 percent of the time, but then they give back all their profits and then some the remaining 30 percent of the time. This is typically when a squeeze is in play and they have no idea about the concept.

7. For a squeeze, I generally like to scale out based on the concept of expanding average true range levels. For example, if and when the trade is up 1 average true range (in the case of the Swiss franc, 120 ticks), I'll take off a quarter of the position. Then I'm looking to see if we can move to 2 ATR, or 240 ticks. If we get there, I'll take off another quarter and tighten my stop to my entry. Then if we get to 3 ATR, I'll take off another quarter. For the last piece, I'll hold on until the momentum rolls over, as indicated by point 3 in Figure 10.4. Of course, if the squeeze loses momentum at any time during the trade, it means that the squeeze is over and it's time to bail on the position, even if the first ATR target hasn't been hit yet.

In Figure 10.5, we have a daily chart of AMZN with the RTM bands and the squeeze. At points 1 and 2, a squeeze fires off long. During this time, I buy in-the-money calls (delta of 0.70 or better) on AMZN, and my plan is to scale out of the first part as we hit the various ATR levels, and then hang on to a chunk of it for the entire ride, which in the case of the first squeeze is considerable. This is the type of move where an option can go up 500 percent or more. AMZN moves steadily higher from \$125.00 a share to \$160.00 a share in about one month. Note: with option plays on daily squeezes, plan on being in the trade for one to three weeks. Therefore, if you are one week out from expiration, go ahead and buy the options on the next month out. Of course, during this squeeze, the RTM bands are to be completely ignored until the squeeze loses momentum, as indicated by the two darker-colored momentum bars. Once this takes place, the squeeze is officially over, and we can go back to RTM trading. We did get another squeeze at point 2. This resulted in a nice pop in the stock, but the move was short-lived.

Figure 10.5



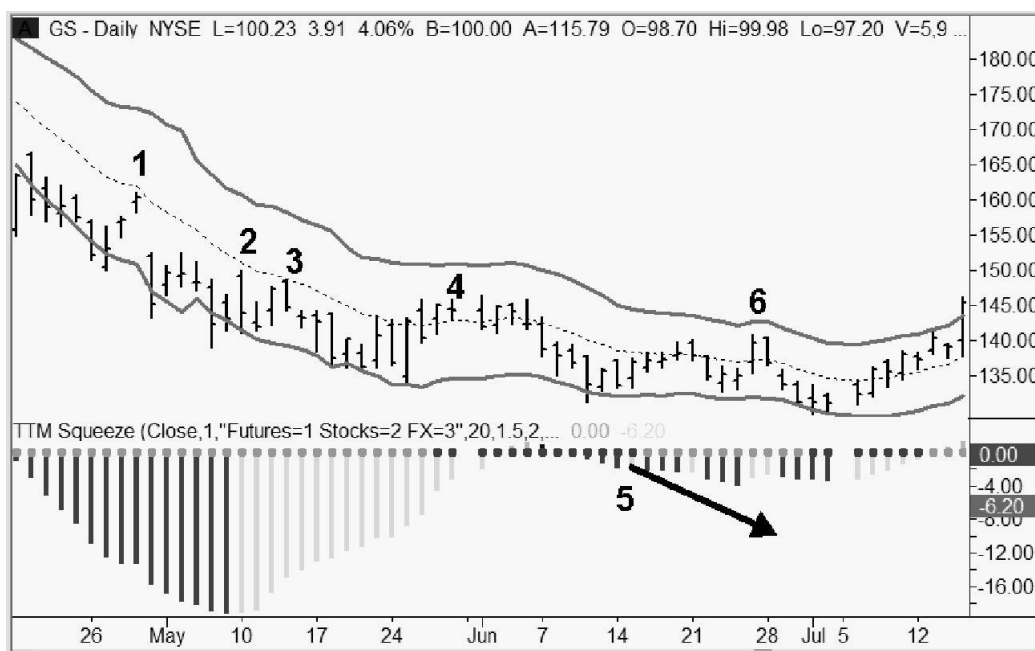
For the reversion to the mean trades, there are examples at points 3, 4, 5, 6, and 7. The distance between the middle band and the upper band is about \$6.00. In these cases, I'm buying in-the-money calls on pullbacks to the band, then closing them out when AMZN moves up about \$4.50. Remember, the bands are

1.5 times the ATR, and I'm interested in capturing only 1 ATR. With a delta 0.70 option, this means that I'm capturing \$3.15 in the option. A typical scenario here would be buying a call option at \$9.00 and then selling it a few days later for \$12.15. One thing that is nice about RTM trades that go with the trend is that they are typically quick. This is great for option trading, as we already know how fast the clock is ticking on the premium decay from reading [Chapter 4](#).

At point 5, this trade gets stopped out. I bought the calls on the pullback to the mean, then the stock plummeted. Of course, a few days later it was back to its upper band again. This is why they call it "trading" and not "how to know exactly what's going to happen next in the markets."

We've looked at plenty of uptrending examples, so let's look at a downtrending example. [Figure 10.6](#) is a daily chart of GS (Goldman Sachs), which on principle is a stock that I will only short. Now that we are familiar with this setup, I'll start moving more quickly. At points 1, 2, 3, and 4, I'm able to buy in-the-money puts (yep, delta of 0.70) and close them out on a move back to the lower band. Trade 4 took nine days to hit its target, while the other trades all hit their targets in one to three days. At point 5, a squeeze fired off short, and it turned out to be a very quiet trade, in essence a normal reversion to the mean trade. That happens sometimes with a squeeze. Not every squeeze trade is a big trade, but a lot of big trades are the result of a squeeze. At point 6, I initiate another RTM trade, as the squeeze has lost momentum.

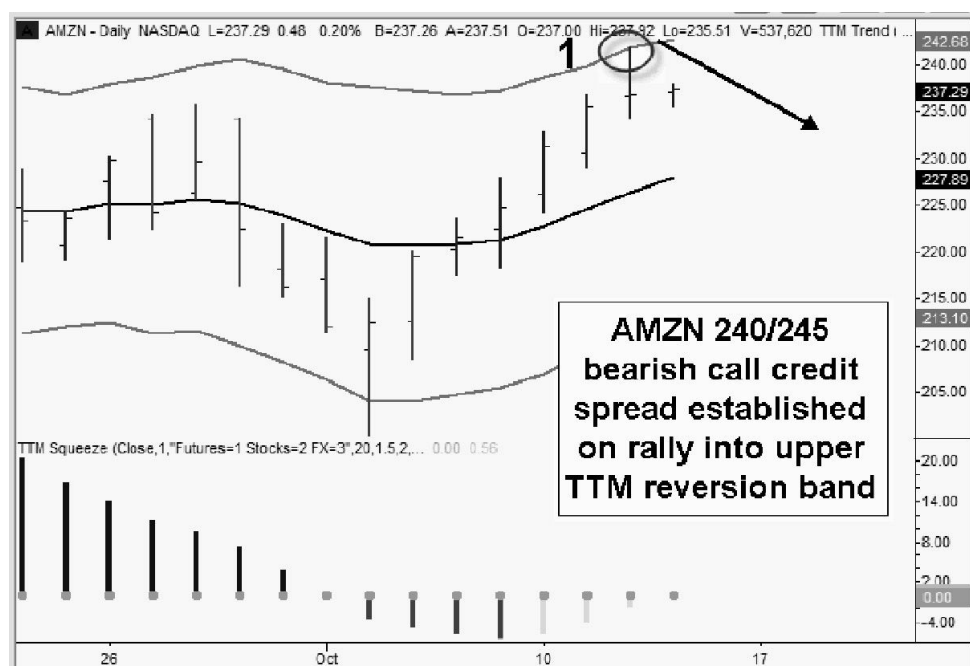
**Figure 10.6**



I will use this setup on just about anything, although to reiterate, I do not follow it on intraday time frames. The daily chart is my first choice, although I will also check the weekly chart for longer-term plays. Are there other ways to utilize this setup with options? Absolutely.

[Figure 10.7](#) is a screen shot of AMZN on a daily chart, rallying right into its upper band on October 12, 2011, as it hit a high of \$241.84. On October 11, via our [www.SimplerOptions.com](http://www.SimplerOptions.com) options trading alert service, we placed an order to sell a vertical credit spread at \$2.30 on the weekly options, which was the price that this spread would hit should AMZN actually rally into that level. It did rally, and we got filled.

Figure 10.7



For those who aren't sure what "selling a vertical credit spread" means, I'll do a quick walk-through. The goal with this trade is to sell premium and take advantage of the rapid premium decay into expiration. This is especially attractive when a stock gets extended (up or down) right into its TTM reversion bands. *It's even more attractive if this happens with only a few days until options expiration.* With the advent of weekly options, these types of setups happen with increased frequency. The goal is to sell an at-the-money option (the higher-priced option), and then hedge your risk by buying the next strike out (the cheaper option).

Figure 10.8 shows the actual position. At point 1, I'm short 100 of the 240 call options (shown as -100 on the TD Ameritrade thinkorswim platform). This means that I sold them to someone else, and I hope they expire worthless so that I can collect the entire premium. However, I didn't want to have completely open exposure, either. What if AMZN gapped up \$50.00 the next day on some crazy news? I'd be hosed. That's just not worth the risk, however unlikely the event. To protect myself and limit my losses, I also bought 100 of the 245 calls, as seen at point 2. This way, if AMZN does skyrocket higher, my loss is limited, as the 245 calls would increase in value, and my loss would be limited to the spread between the two strikes. In this screen shot, you can see that I'm making money on the options I sold. They are up \$31,300.00. I'm losing money on the options I bought; they are down \$17,150.00. My net profit on the trade is +\$14,150.00. Since I sold this spread for \$2.30, my maximum profit (should AMZN close under \$240) is \$230 per contract, or \$23,000 on 100 contracts. My maximum loss is the spread difference ( $245 - 240 = \$5.00$ ), which is  $5.00 - 2.30 = \$2.70$ , or \$270 per contract. Of course, there is no need to hold the trade into expiration. If the spread is "in the money" there is a risk of being assigned the stock before expiration. This happens rarely but it happens, and isn't a big deal. Once assigned the stock, you just close out the stock position. This is why I started [www.SimplerOptions.com](http://www.SimplerOptions.com). There are a lot of ways to make option trading more complicated. This site is designed for both newer and advanced traders to "trade along" with our trades on a step-by-step basis and be able to ask questions and learn as you go.

Figure 10.8

POSITION STATEMENT											
Group: Type		Arrange Positions: INSTRUMENT		Watch spreads		Click → to setup group		Reset Groups		Return To Old Layout	
Equities and Equity Options											
Instrument	Qty	Days	Mark	Mrk Chng	Delta	Gamma	Theta	Vega	P/L Open	P/L Day	
AMZN					-1800.18	-222.62	2570.04	-264.37	\$14,150.00	\$2,700.00	
AMAZON.COM INC COM	0	1	238.07	-74	.00	.00	.00	.00	\$0.00	\$0.00	
100 (Weeklys) OCT2 11 240 C...	-100	1	1.28	-53	-2944.21	-491.60	6047.92	-602.19	\$31,300.00	\$5,300.00	
100 (Weeklys) OCT2 11 245 C...	+100	1	.395	-26	1144.04	268.97	-3477.88	337.82	(\$17,150.00)	(\$2,600.00)	
Selected Totals											
Subtotals					-1800.18	-222.62	2570.04	-264.37	\$14,150.00	\$2,700.00	
Overall Totals									\$14,150.00	\$2,700.00	

This “difference” between the two option prices is calculated continually, so it’s easy to track. Figure 10.9 shows the actual vertical price of the “240/245.” Since I sold it for 2.30, and it’s currently trading at 1.39 bid/1.56 ask, I’m up on the spread. My stop loss on the spread was 3.50, and if the vertical combination had reached that level, I would have been stopped out. Once you understand the power of this concept, it then becomes a matter of just being patient and waiting for a nice extended entry, such as a slam into the one of the bands right before expiration.

Figure 10.9

AMZN AMAZON.COM INC COM										
UNDERLYING										
	Last X	Net Chng	Bid X	Ask X	Size					
	238.36 P	+1.55	238.28 P	238.53 C	5 x 1					
TRADE GRID										
OPTIONS										
CALLS										
	Delta	Gamma	Theta	Vega	Bid X	Ask X	Strike			
								Strikes: 12		
OCT2 11 (1) 100 (Weeklys) POS										
	.01	.00	.04	.00	4.45	5.45	210 / 215			
	.01	.00	.01	.00	4.55	5.40	215 / 220			
	.03	-.01	.09	-.01	4.45	5.25	220 / 225			
	.08	-.01	.16	-.02	4.20	5.00	225 / 230			
	.16	-.02	.16	-.02	3.70	4.40	230 / 235			
	.25	-.01	.00	-.01	2.71	3.13	235 / 240			
POS	.23	.02	-.24	.02	1.39	1.56	240 / 245			
POS	.12	.02	-.24	.02	.45	.56	245 / 250			
	.05	.01	-.15	.01	.09	.21	250 / 255			
	.01	.00	-.01	.00	-.05	.08	255 / 260			
	.00	.00	.02	.00	-.10	.07	260 / 265			
	-.01	.00	.12	.00	-.26	.10	265 / 270			

Now that we have covered reversion to the mean, it’s time to dive into the squeeze. For more examples, visit [www.simplertrading.com/meanreversion](http://www.simplertrading.com/meanreversion) to see how this works across different markets.





# The Squeeze: What Is the Best Way to Get Positioned for the Big Market Moves?

## Is It Better to Trade for Cash Flow or to Create Wealth?

In the previous chapter, we discussed reversion to the mean (RTM) trading, and how it's the best type of trading to do "unless there is a squeeze." And that really is trading in a nutshell—playing the reversion back to the mean via something like a pivot, an extreme \$TICK reading, or an outer reversion band test, and looking for price to go "back" to the mean. Or, looking for a stock or market that is trading near the mean (key moving average like the 21 EMA) and is building up a squeeze, which is an indication that it is likely to explode "away" from the mean. Reversion to the mean trades are higher probability, slower to pan out, and have a great chance of blowing up in your face. Squeeze trades "away from the mean" are slightly lower probability, pan out much more quickly, and have a much lower chance of continually moving against you. Be patient and pick your poison. My preference? I'll do both, but the squeezes "away from the mean" make the top of my list.

The squeeze is a setup that I use for everything: day trading, swing trading, and position trading. It's the best indicator I've found for setting up longer-term moves, especially on the larger daily, weekly, and monthly time frames. In fact, I find it very difficult to look at a chart without this indicator. It's been working great on new markets like Bitcoin and Ethereum. It gives me a lot of information about the nature of the current market and time frame with a quick glance. We aren't talking about "overbought or oversold," which, like most Twitter updates, doesn't really mean much. We are talking about seeing where the market is in its natural cycle, like we discussed in [Chapter 3](#). Is the market away from the mean and near the top of its cycle? Great, then let's focus on RTM trading. Or is it trading near the mean and building up energy, that is, under accumulation or distribution, and is getting ready to release that energy to the upside or the downside? Great, let's focus on a big move away from the mean, also known as a squeeze.

This is very useful information for deciding when and where to allocate trading capital, as well as deciding what type of trading strategy to utilize with that capital. Want one quick example of how this information is useful? You might think that when a trade is "about to run out of energy," it is merely a signal to exit a current position. It is that, yes, but it is also so much more. When a squeeze is running out of energy, it's also one of the best times to start selling options premium such as an iron condor and incorporate a host of other option strategies that benefit from when a market runs out of energy and goes back to trading sideways. But I digress. We still need to discuss what a squeeze is, what it represents, and how to time it and manage the move.

In a nutshell, I like to use RTM trading for the creation of income (taking profits out of an account) and squeeze-type momentum trades on larger time frames for the creation of wealth (gradually building up the value of an account over time). Can a trader utilize squeezes on smaller time frames, though, for day trading? Like a five-minute chart? Absolutely, and I'll cover specific examples that utilize smaller time frames for day



trading. But where this setup really shines is on the bigger time frames. Hourly charts, two-hour, daily, weekly, monthly . . . there is never any reason to not understand what is going on with the bigger time frames, and, should a squeeze be firing off on one of these larger time frames, there is never any reason to fight it on the lower time frames. For example, if a 60-minute chart has fired off a long squeeze on the S&P 500, then only the uninformed are pulling their hair out entering short signals on the five-minute chart during that time. “Jeez,” they say, “this thing just keeps going higher!” Yep. That’s the idea.

Even if a weekly squeeze is too long a time frame for your own trading plan, at the very least it pays to be aware of it so that you are not “fighting against it” on the smaller time frames. That is, if the weekly squeeze on AAPL has fired off a short signal, then why waste time buying the dips on the daily chart? This is clearly telling you that the path of least resistance, for the time being, is lower. Why fight it? Any long trades in this scenario are very likely going to be stopped out until that weekly squeeze short signal is over. It’s as if one person offered you \$8.00 an hour to flip burgers, and another guy offered you \$100.00 an hour to do the exact same job. Which offer would you take? Fighting the weekly squeeze is like taking the \$8.00-an-hour job, when you could just “go with the squeeze” and get the \$100.00-per-hour job. By following the larger time frames, a trader is always moving along the path of least resistance—trading in alignment with the larger time frames. Knowledge is power.

On average, a squeeze signal lasts about 6 bars, sometimes 8 to 10 bars. This means that a signal on a monthly chart can last for six months, while a signal on a one-minute chart can last for six minutes. The signal is the same no matter what the time frame; it’s just the duration of “being in the trade” that changes.

Why bother with swing trades and overnight exposure? I know that some traders freak out when they have overnight exposure, and that’s fine. I, for one, have trouble sleeping if I don’t have a position on. The benefit of these types of swing trades is that a person is “in” the market and already positioned for the move. While day traders can catch a few points here and there, it’s the swing traders that catch big multiday and even multiweek moves. True, if you are flat overnight you avoid getting whacked on bad news the next morning—but if you are position sizing correctly and using limited risk option strategies, then when this happens once in a while it is not a big deal. The offset of this is all of the big overnight moves you get to participate in. It’s okay to prefer one type of trading over the other. The key with trading is to find the niche where you are both happy and profitable.

The markets spend a lot of time in trading ranges, building up energy for their next major move. By the time the move fires off, it is usually out of the blue and violent, leaving many day traders behind. This includes the times when a market will gap open and then spend the rest of the day stuck in a narrow range, totally bypassing the day traders. That’s why we call this move a “gap and go.” By keeping some exposure in positions on a swing-type basis, I will frequently participate in larger moves that leapfrog over many of the day traders. The secret to swing trading is realizing that “being positioned” is half the battle, and not stressing out over a trade that is not working out right away. The markets never break when they are expected to, and they will do so only when they are good and ready, usually when the greatest number of people are unprepared. Sometimes being positioned means waiting weeks for the move to finally unfold. This requires patience and the ability to step aside and not obsessively stare at the charts all day. This is a huge problem for many traders. They sit back, they watch the charts, they get emotional, and they get faked out and close the trade. Typically, once

that process has completed itself—faking out as many traders as possible—the markets will make their move. If everybody is expecting a move, then everybody will already be positioned for it. If everybody is positioned for a big down move, then everybody is already short and there is no one left to sell. It's a great system. It's also how the markets always have worked and always will work. Stick to your setup and let it play out.

One of the best trading books I've ever read on managing "swing trader anxiety" is called *How I Made Two Million Dollars in the Stock Market*, by Nicolas Darvas. This book was written a few decades ago and remains one of my favorites. It's a quick, easy read and very entertaining. For anyone who has trouble hanging on to swing positions and jumps out too early, this book is a must read.

It is important to position size correctly for swing trades. In general, if traders cannot sleep because they are worrying about their overnight positions, then they are trading too large in relation to their account size. Swing trades have larger stops, and their position size must be reduced accordingly. There is a very easy way to manage this—establish a monetary stop and work backward from there. For example, if traders are not willing to lose more than \$500 on a trade, then all they have to do is look at the parameters for the setup and do the math to figure out the position size. Using \$500 as a benchmark, a day trade that requires a 20-point stop in the mini-sized Dow futures would equate to a position size of five contracts. However, if a swing trade in the mini-sized Dow called for a 100-point stop, then these same traders are going to use one lot. Monetarily, these stops are identical because of the reduced position size on the swing trade.

### **How Does a Trader Redefine Volatility and Use It to His Advantage?**

The squeeze takes advantage of quiet periods in the market, when the volatility has decreased significantly and the market is building up energy for its next major move higher or lower. My wife and I have three young children, and recently she deemed me responsible enough to watch them by myself on a Saturday at the house. After she left, I made sure all the doors that led outside and into the bedrooms were closed and locked so that I wouldn't lose track of them. I discovered very quickly that if they were making noise, they were fine. But if things suddenly got very, very quiet, then something bad was fixin' to happen. This is when I would come around the corner and see the two older ones trying to stuff the younger one into the refrigerator. Energy, having been built up, was being released.

For students of Bollinger Bands, periods of low volatility are identified as the times when the bands "move closer together." This is the equivalent of "the kids being quiet around the corner." That is, this particular market has gotten "too quiet" and is about to release a truckload of energy.

This is always great in hindsight, but in real time, how does a trader know that the current narrowness of the Bollinger Bands is really narrow enough to qualify as low volatility and is about to trigger a release of a lot of energy? This setup answers that question by adding the Keltner Channels as well as a momentum index oscillator.

For readers who are unaware of how these indicators work, I'll take a few moments to explain them here. *Bollinger Bands* are a type of envelope that is plotted at standard deviation levels above and below a moving average. This produces an effect of having the bands widen during periods of higher volatility and contract during less volatile periods. During periods of lower volatility, in sideways-moving markets, the bands contract toward the moving average. *Keltner Channels* are based on a moving average and the average true range (ATR)

readings of the underlying stock or market. The actual band lines are offset from the central moving average value by a positive and negative value, based on the ATR, to provide upper and lower bands. While the Bollinger Bands expand and contract as the markets alter between periods of high and low volatility, the Keltner Channels stay in more of a steady range. The momentum index oscillator is used to estimate the direction, velocity, and turning points of market movements. Does this make sense? If not, that's fine. I don't understand how electricity works, but I know when I plug my computer into an electric outlet, it will turn on. Now let's look at how I use all this for a setup.

The quiet periods I'm looking for are identified when the Bollinger Bands narrow in width to the point where they are actually inside of the Keltner Channels. This marks a period of reduced volatility and signals that the market is taking a significant breather, building up steam for its next move. The trade signal occurs when the Bollinger Bands then move back outside the Keltner Channels. I use a 12-period momentum index oscillator to determine whether to go long or short. If the oscillator is above zero when this happens, I go long; if it is below zero, I go short. These are all canned studies that come with most charting packages. For the parameters, I just use the default settings on TradeStation. These readings are 20 and 1.5 for the Keltner Channels and 20 and 2 for the Bollinger Bands. We also took an extra step and turned all these into an indicator that makes them easier to read on the chart; I'll explain this in a moment.

### **What Is the Best Way to Get in Right Before a Big Move?**

I use the squeeze signal on various time frames, as I like it for both day trading and swing trading. On the mini-sized Dow, for example, a squeeze can move the market 10 to 20 YM points on a 2-minute chart or a 377 tick chart, 30 to 50 points on a 15-minute chart, and several hundred points on a daily chart. The kicker, of course, is that the smaller the time frame, the more frequent the signals. A two-minute chart may fire off three to five signals in a day, while the daily chart will fire off six to seven signals over the course of an entire year.

Although I spend a large amount of my trading day focused on the stock indexes, squeezes work on all markets. On days when the indexes are trading in a range that is narrower than Donald Trump's political ambitions (note—I wrote that sentence in 2012, fairly amusing in hindsight), I look to the currencies, gold, bonds, oil, and individual stocks for my next setup. And, of course, new instruments such as Bitcoin, Ethereum and Litecoin. For currencies, if you see an example with a futures or Forex chart, keep in mind these days I'm just as likely, if not more likely, to buy in the money options on a currency ETF such as FXE or FXY, which are ETFs on the euro and yen, respectively. Holding onto option trades like that are just easier than holding onto futures or Forex trades.

### **What Are the Trading Rules for Buys (Sells Are Reversed)?**

1. Set up a 24-hour chart so that the overnight activity can be accounted for in this indicator setup.
2. The "heads-up" on this indicator is the first black dot. This is not a trade signal, but rather a heads-up that a trade signal is setting up. This indicates when the Bollinger Bands are trading inside the Keltner Channels.
3. The signal on the indicator is the first gray dot after a series of black dots. This indicates that the

Bollinger Bands have come back outside of the Keltner Channels. This is shown in detail in the charts that follow.

4. Once the first gray dot appears after a series of black dots, I go long if the histogram is above zero. Once the signal fires, I just place a market order. This is a momentum play, and I don't want to be messing around with limit orders that may not get filled. Note: though unusual, there are also instances in which, when the signal fires, momentum is below zero, yet it is ascending. This also constitutes a long signal.
5. For day trades (five-minute charts or smaller), I place the following minimum money management stops. If the stop is also near a key price support level, I will take that into consideration and adjust accordingly. For example, if my entry is 1104.00 on the S&Ps and the daily pivot is at 1101.75, I would move my stop to just below that pivot level, or 1101.50, for a stop of 2.50 instead of 2.00. I find that nine times out of ten, I just use the default stop. Remember, too, that if you are unsure of what stop to use, then you can place the 14-period average true range (ATR) on your chart, double the current value, and use that as your stop.
  - YM: 20 points
  - ES: 2 points
  - NQ: 4 points
  - TF: 1.50 points
  - EC: 20 ticks
  - EURUSD: 20 pips
  - US: 7 ticks
  - Gold: 1.50
  - Stocks: 50 cents
6. For swing plays and position trades (taken off the daily charts), I place the following stops. I take into consideration the same key levels as discussed in item 4, and of course it is very beneficial to look at a 14-period ATR on the daily charts, as the range on this time frame can expand and contract dramatically with increases and decreases in volatility. The main point here is that if you are trying to catch a bigger move in the ES, there is no point in using a 2-point ES stop because the probability of being stopped out is too high.
  - YM: 150 points
  - ES: 15 points
  - NQ: 25 points
  - TF: 8 points
  - EC: 100 ticks

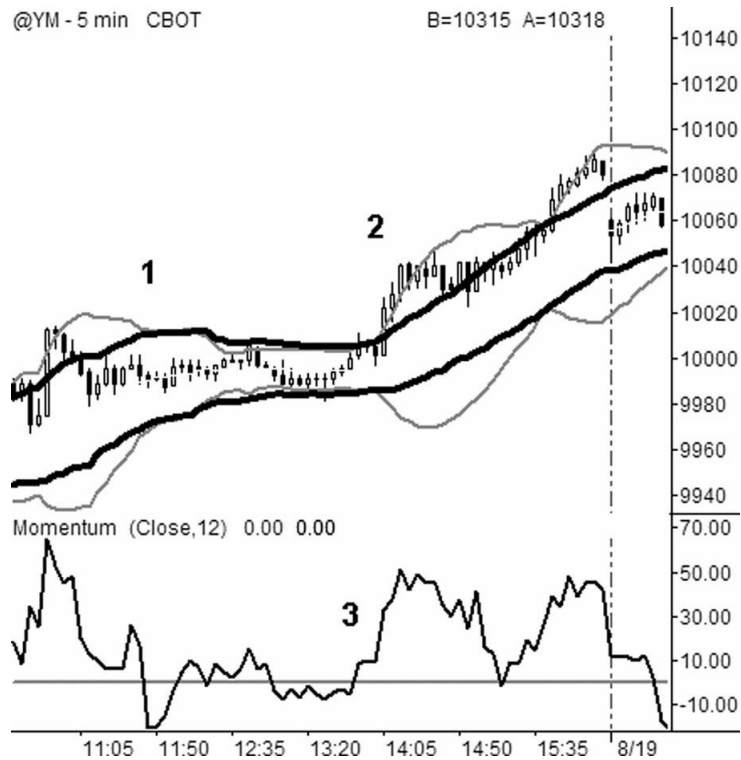
- EURUSD: 100 pips
  - US: 35 ticks
  - Gold: 20.00
  - Stocks: \$2.50
7. My target is based purely on the momentum of the trade. Once the momentum index signal starts to weaken, I get out of the trade at the market.
  8. I don't trail stops.

Let's first look at examples from the first edition of this book, and then we will take a look at some updated examples.

*Mini-Sized Dow—September 2004 Contract, August 18, 2004*

1. [Figure 11.1](#) shows how to set up the elements of this play in whatever time frame a trader wishes to view. For intraday trading, I like to watch the five-minute chart. The one- and two-minute charts are good for scalping, but these signals are not as powerful as those of the five-minute chart, though they are tradable. The Keltner Channels are the pair of thick black lines and are set at the default parameters of 20 and 1.5 on TradeStation. The Bollinger Bands are the thinner gray lines and are set at the default settings of 20 and 2.0. At the bottom is a 12-period (on the close) momentum index oscillator. At point 1, the Bollinger Bands have gone inside the Keltner Channels. This indicates that the market is going into a quiet period, and it is a heads-up. This is not a signal—it is just a heads-up that when the Bollinger Bands pop back out, it will be time to take a trade.

**Figure 11.1**

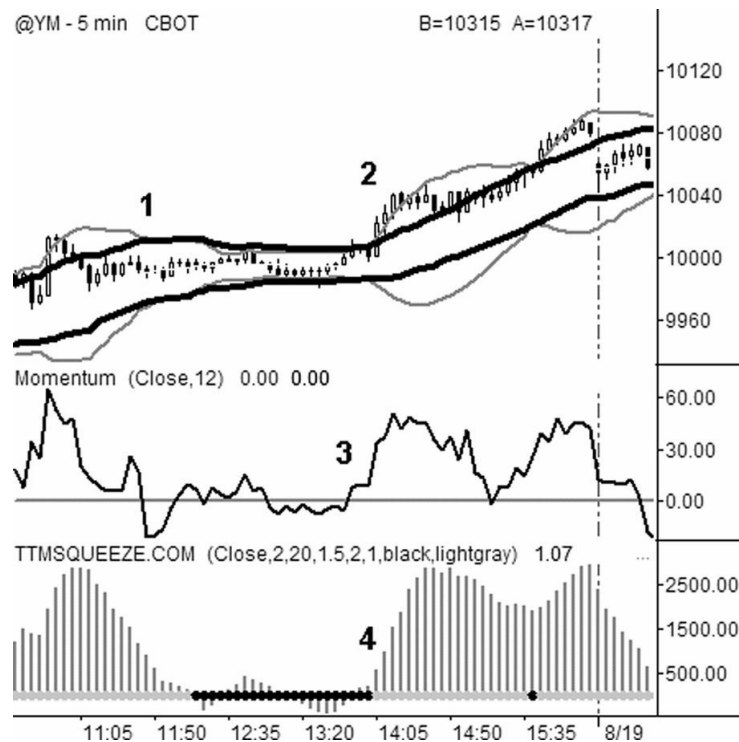


2. At point 2, the Bollinger Bands have come back outside the Keltner Channels. It is time to take a trade.
3. If the momentum index oscillator is above zero at the time of point 2, I go long. If it is below zero at this point, I go short. I don't mess around with limit orders. I just jump it at the market, hitting the current offers. This is just an example of what triggers the entry and exits. I look at specific plays in a moment.

*Mini-Sized Dow—September 2004 Contract, August 18, 2004*

1. One of the things we did was turn all the things in [Figure 11.1](#) into an easy-to-read indicator, which is what I now use on my own charts, as seen in [Figure 11.2](#). We have developed this for TradeStation, eSignal, thinkorswim, Infinity Futures, Ninja Trader, and other platforms as well. When the Bollinger Bands go inside the Keltner Channels, the dots turn black. This is a heads-up that the markets have entered a quiet period.

Figure 11.2



2. At point 2, the Bollinger Bands come back out of the Keltner Channels.
3. Since the momentum index oscillator is above zero at point 3, this is a long signal.
4. On the indicator itself at the bottom of the chart, this is all measured by when the dots turn back to gray after being black. This occurs at point 4. The black dots are the heads-up that the market has “gone quiet” and is about to release a truckload of energy. When I see that first gray dot after the series of black dots, I know it is time to take a trade. If the histogram is above the zero line, I go long, and if it is below the zero line, I go short. Again, this is just to show you how the indicator works. In the next examples, I go over some actual plays. I prefer to take off all the “clutter” that is on the price chart and just use the indicator. But now you know how the indicator works.

*Mini-Sized Dow—September 2004 Contract, August 20, 2004*

1. On this two-minute chart of the mini-sized Dow, we get a black dot a little after 10:00 a.m. eastern (see [Figure 11.3](#)). This is a signal that the Bollinger Bands have narrowed and are now trading inside the Keltner Channels. I know that when I get the next gray dot, I will have a trade signal. In this case, the gray dot happens right away. Usually there is more than one black dot, but once in a while it will have just the single instance, and that’s okay. Common sense dictates that the more black dots there are, the more powerful the potential move will be. In my experience, this is not true, as I have seen one-dot signals that have bigger moves than twenty-dot signals on numerous occasions. I find it is best to just take the signal when it comes. Humans tend to mess up their trading when they try to outthink their positions. When the next gray dot appears, the histogram is above zero, so I place an order to buy the YM at the market. I am filled at 10,164. I place a 20-point stop at 10,144. My target is open, as I’ll be waiting for the momentum index to falter as my exit signal.

Figure 11.3



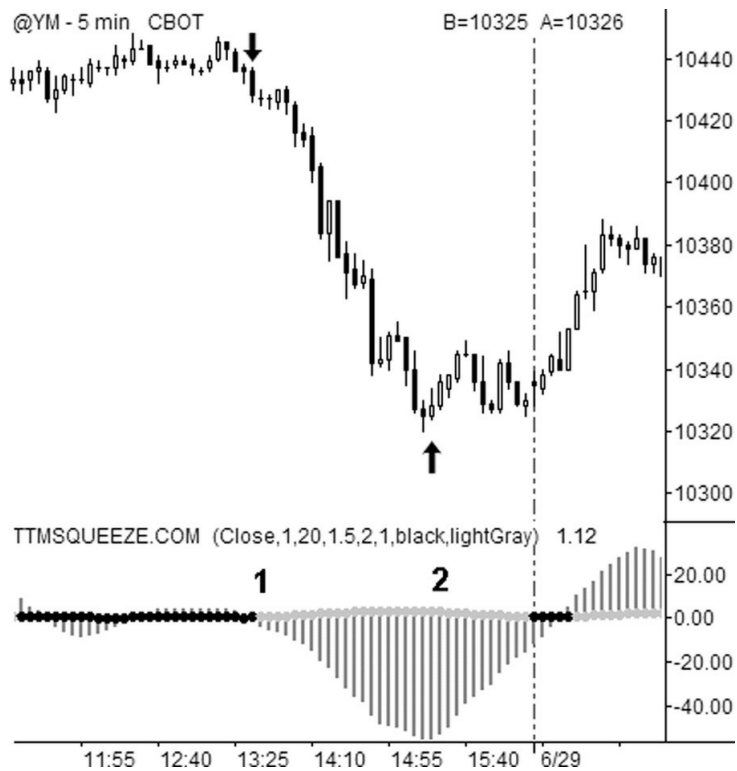
2. The market pushes higher, and I'm watching the histogram. As long as it makes higher highs, I stay in the trade. When it makes its first lower high, I will get out. At 10:30 a.m. eastern we get a lower high on the histogram, and I exit at the market. I'm out at 10,198 for a gain of 34 points.

*Mini-Sized Dow—September 2004 Contract, June 28, 2004*

1. On June 28, 2004, the markets trade in a tight range all morning, creating a long series of black dots on the five-minute YM chart (see [Figure 11.4](#)). Remember, the black dots indicate that during this time frame, the Bollinger Bands are trading inside of the Keltner Channels, marking a period of very low volatility. A little after 1:30 p.m. eastern, the first gray dot appears in the sequence. The histogram is below zero, so I take a short at the market. I'm filled at 10,426, and I place a 20-point stop at 10,446.

Figure 11.4



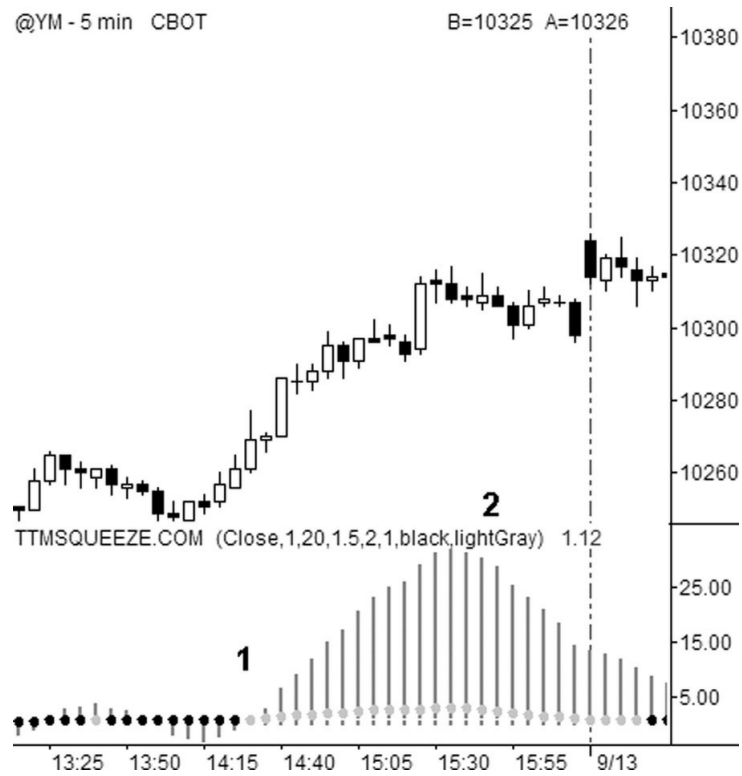


2. The goal is to stay in the trade as long as the histogram is making lower lows (or in the case of a long, higher highs). It makes its first higher low nearly two hours later, and I exit at the market. (If you were just watching the momentum index oscillator, you would exit as it starts to turn higher.) I'm out at 10,325 for a gain of 101 points, or \$505 per contract—a very smooth, low-stress, and profitable trade. This is a great example of a trade where it pays to sit on your hands until you are given a clear exit signal. In fact, part of my reward system isn't focused on profits—it's focused on my ability to follow a setup from entry to exit. Every trader should have a reward system like this: not for making money, but for hanging in there and following the setup—staying in the trade until you get a specific exit signal. Taking tiny profits is easy, which is what most traders do. And that is why most traders fail; they always succumb to the easy way out, the bad habits that the markets naturally encourage and reinforce. When a trade is going your way, stick your hands underneath your butt cheeks.

*Mini-Sized Dow—September 2004 Contract, September 10, 2004*

1. On September 10, 2004, the five-minute squeeze on the YM fires off (see [Figure 11.5](#)). About an hour earlier, there was a single gray dot, and I went long here. However, the very next dot went back to black. This means that the Bollinger Bands came out of the Keltner Channels, but then went right back in. This is a rare occurrence, but when it happens, I just get out and wait for a solid signal. In that case, I was in and out and lost 6 YM points. About 50 minutes later, we get the setup again, and the dots turn gray. For this next trade, with the histogram above zero, I go long and place a 20-point stop. I am in at 10,263, and I place a stop at 10,243.

Figure 11.5

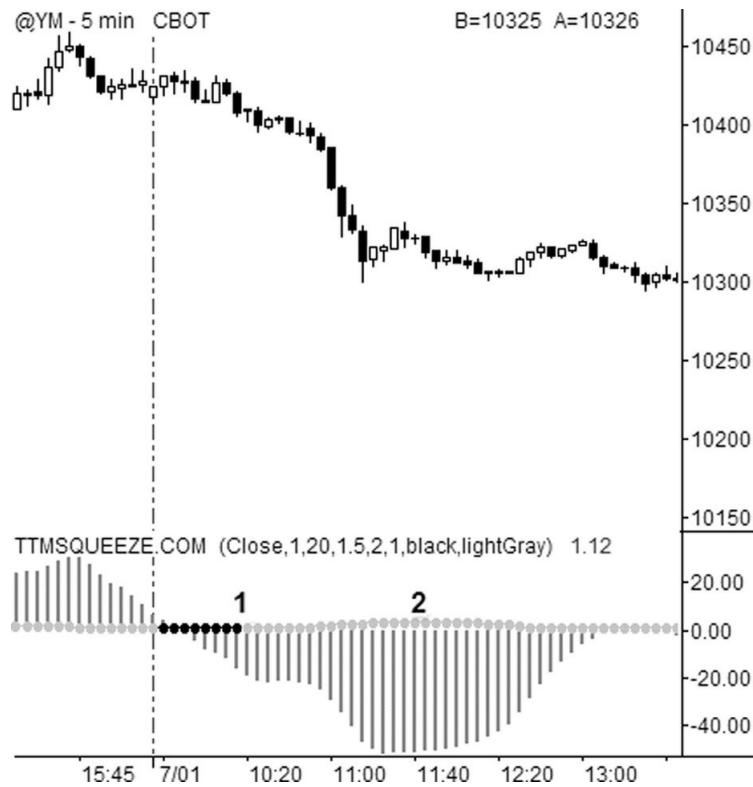


2. The histogram continues to move higher until 1:30 p.m. eastern, at which point it starts to lose momentum. I cut the position loose at 10,309 for a gain of 46 points.

*Mini-Sized Dow—September 2004 Contract, July 1, 2004*

1. A little after 10:00 a.m. eastern on July 1, 2004, the first gray dot appears on the five-minute YM chart (see Figure 11.6). The histogram is below zero, so I go short at the market. My entry is at 10,402.

Figure 11.6

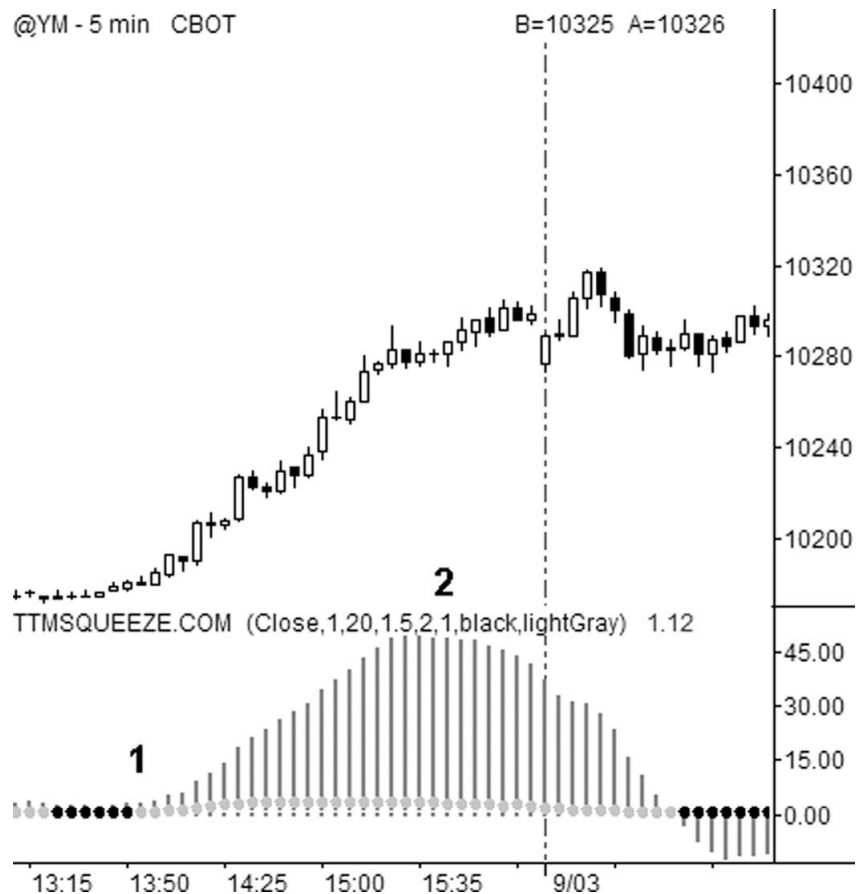


2. The markets drift down, and the histogram begins to level off. The markets continue to make lower lows, and suddenly the selling accelerates, pushing the histograms down deep into their range. They begin to bottom out at around 11:20 a.m. eastern, and I cover at the market. I'm out at 10,312 for a gain of 90 points.

*Mini-Sized Dow—September 2004 Contract, September 2, 2004*

1. On September 2, 2004, the five-minute YM chart goes into alert status at around 1:15 p.m. eastern (see [Figure 11.7](#)). Six black dots appear, showing that the Bollinger Bands are trading inside the Keltner Channels. When the next gray dot appears at 1:50 p.m., the histogram is above zero, so I go long at the market. I am filled at 10,183. I place a 20-point stop at 10,163.

Figure 11.7

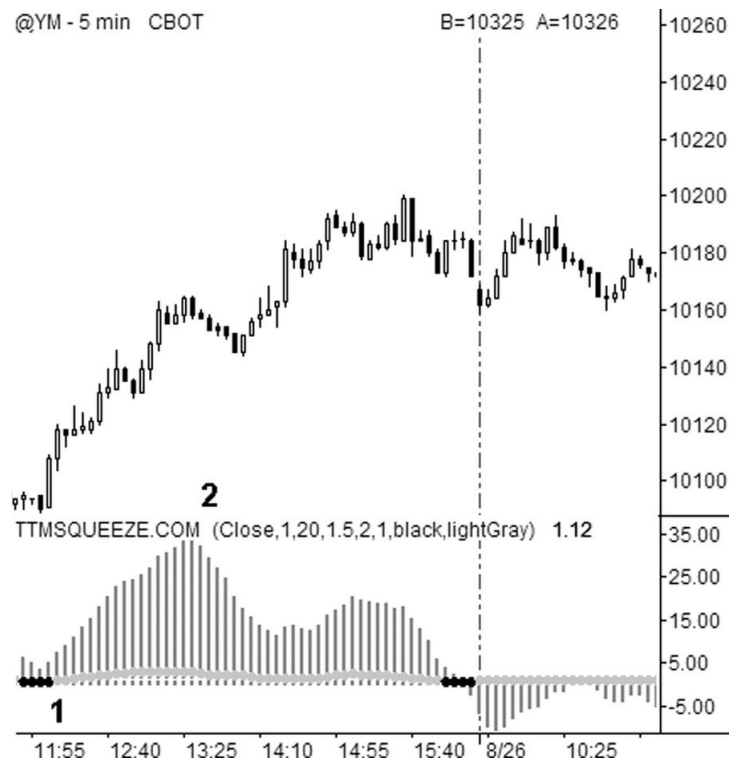


2. The market cruises higher, and the histogram begins to start making lower lows at 3:30 p.m. eastern. I exit at the market and am out at 10,278, for a gain of 95 points. Not every five-minute squeeze ends up with a big move like this, but I've found that when there is a big move, it is generally kicked off by a squeeze on the five-minute chart. I have a rule in trading that says, "Never fight the direction of the five-minute squeeze!" It supersedes all my other intraday trading rules and setups. Remember when I talked about all these plays working in conjunction with one another? If there is a five-minute long squeeze in place and we are rallying up to a pivot level, then I'm not going to place a short at that pivot level. Never fight the five-minute squeeze.

*Mini-Sized Dow—September 2004 Contract, August 25, 2004*

1. On August 25, 2004, the five-minute squeeze goes into alert status at around 11:45 a.m. eastern, as evidenced by the first black dot (see Figure 11.8). About 20 minutes later, the dots change back to gray. The histogram is above zero, so I take a long at the market. I was filled at 10,113, and I immediately place a stop at 10,093 and leave my target as open.

Figure 11.8

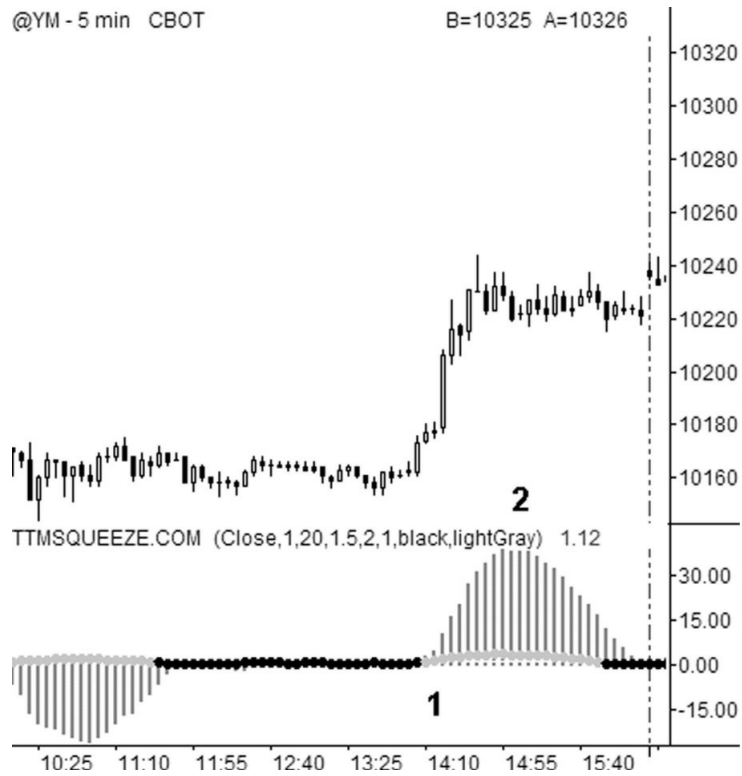


2. About an hour and a half later, the histogram starts to make lower highs, and I get out at the market. I'm out at 10,149 for a gain of 36 points.

*Mini-Sized Dow—September 2004 Contract, August 20, 2004*

1. I like this example because it clearly shows the power of an intraday consolidation move (see [Figure 11.9](#)). It's like a chart of the young wife's life played by Geena Davis in *Thelma and Louise*. There is the narrow consolidation of life energy for a while, and then Thelma busts out and nothing can hold her back. Her personality explodes, and she finally experiences life—just like the squeeze. The first gray dot appears just after 2:00 p.m. eastern, and the histogram is above zero, so I go long at the market. I'm filled at 10,172, and I place a 20-point stop.

Figure 11.9

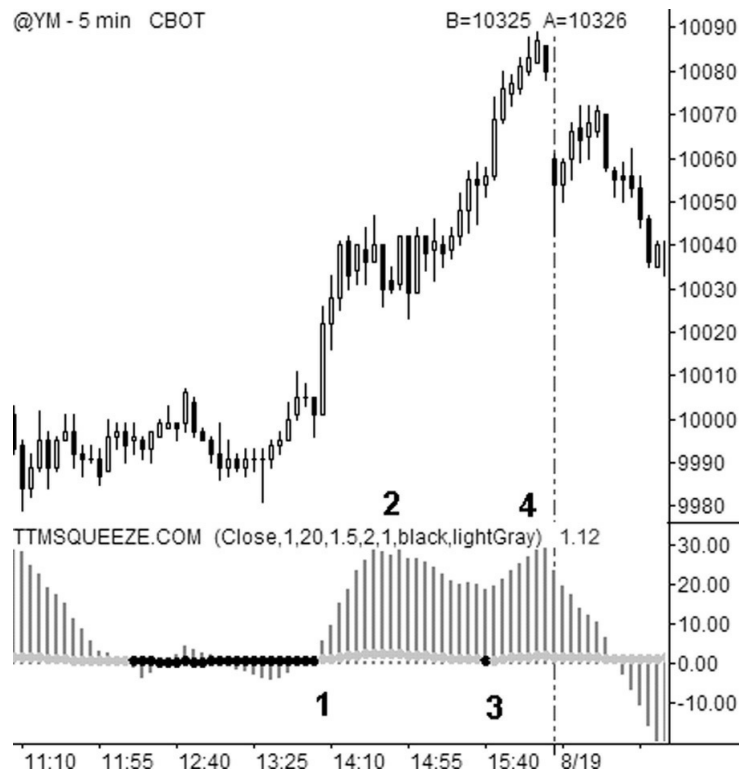


2. The market pops higher, and a little less than an hour later, the momentum starts to slide. I exit at 10,221 for a gain of 49 points.

*Mini-Sized Dow—September 2004 Contract, August 18, 2004*

1. On August 18, 2004, the market spends most of the morning consolidating, and, as the volatility comes out of the market, the Bollinger Bands contract and start to trade inside the Keltner Channels (see [Figure 11.10](#)). This shows

Figure 11.10



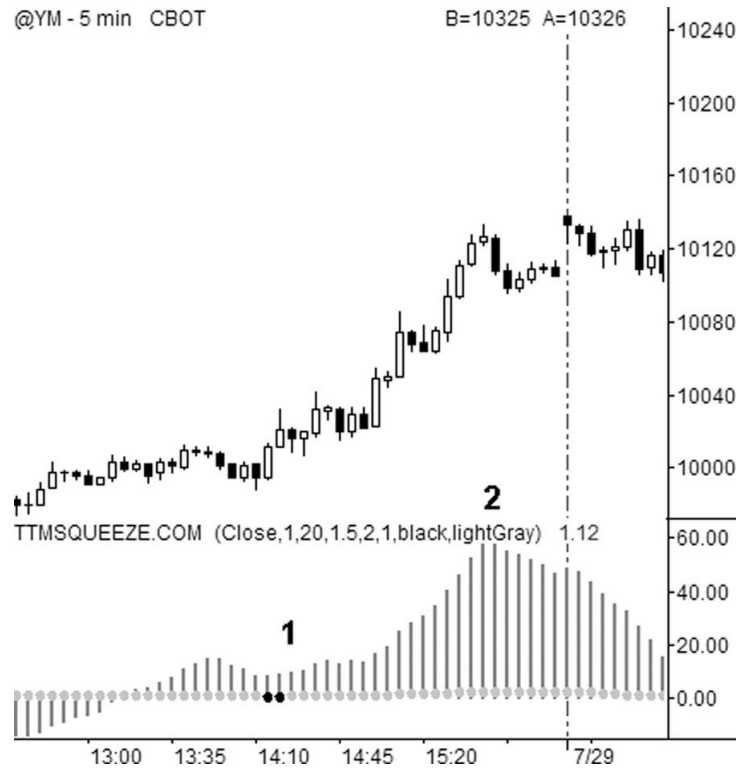
up in the form of black dots. When I get the first gray dot, the histogram is above zero, and I go long at the market. I'm filled at 10,003, and I immediately place a 20-point stop at 9983.

2. The markets push higher and start to lose momentum. I exit at 10,034 for a gain of 31 points.
3. A few hours later, we get a single black dot that is quickly followed by another gray dot. I take the signal. Since the histogram is above zero, I go long at the market, and I'm filled at 10,056. I place a 20-point stop.
4. The histogram is strong right into the close. I stay in the trade until 4:10 p.m. eastern and exit at the market. I'm out at 10,082 for a gain of 26 points.

#### *Mini-Sized Dow—September 2004 Contract, July 28, 2004*

1. On July 28, 2004, the YM creeps higher for most of the day, and then a little after 2:00 p.m. eastern, I get a black dot (see [Figure 11.11](#)). Shortly thereafter, we go back to gray, and since the histogram is above zero, I go long. I'm filled at 10,028, and I place a 20-point stop at 10,008 and leave my target as open.

**Figure 11.11**



2. A little more than an hour later, the histogram makes a lower high. I exit at the market, and I'm filled at 10,103 for a gain of 75 points.

*30-Year Bond—September 2004 Contract, August 18, 2004*

1. I love using the five-minute squeeze on the YM, but it works on other markets as well. [Figure 11.12](#) is a chart of the 30-year bonds. At around 11:30 a.m. eastern, the dots turn black, signaling that we are entering into a period of very low volatility. About 90 minutes later, we get a gray dot at point 1, and since the histogram is above zero, I go long at the market.

Figure 11.12





I'm filled at  $111 \frac{9}{32}$ . I place a 7-tick stop at  $111 \frac{2}{32}$ . (If you aren't familiar with bonds, 1 tick is \$31.25. So if you lose 7 ticks, that equates to \$218.75, or approximately 44 YM points.)

2. The momentum starts to peter out about 40 minutes later, and when the histogram makes a lower high at point 2, I exit at the market. I'm out at  $111 \frac{11}{32}$  for a gain of 2 ticks. At one point I was up 10 ticks on the trade (the equivalent of 63 YM points), but the market rolled over quickly, which can happen. That's why it's called fishing, and it's not guaranteed to catch a fish. The key to successful trading is to stay in the signal until it ends. This way, when a big move does take place, a trader will be able to stay in the trade and let the profits run. Work on developing successful habits, not staring at the P&L.

### *30-Year Bond—September 2004 Contract, August 10, 2004*

1. On this five-minute chart of the bonds, we go into black dot territory at around 10:45 a.m. eastern, and I sit back and wait for the next gray dot to appear (see [Figure 11.13](#)). This happens a little after 12 noon at point 1, and since the histogram is below zero, I short at the market. I'm filled at  $110 \frac{30}{32}$ . I place a stop at  $111 \frac{5}{32}$ . Remember, one full point in the bonds is composed of 32 ticks. When it goes to  $\frac{32}{32}$ , it becomes a new point. For example, when bonds are at  $110 \frac{31}{32}$  and they move up one tick to  $110 \frac{32}{32}$ , this reads as 111, and so on.

**Figure 11.13**

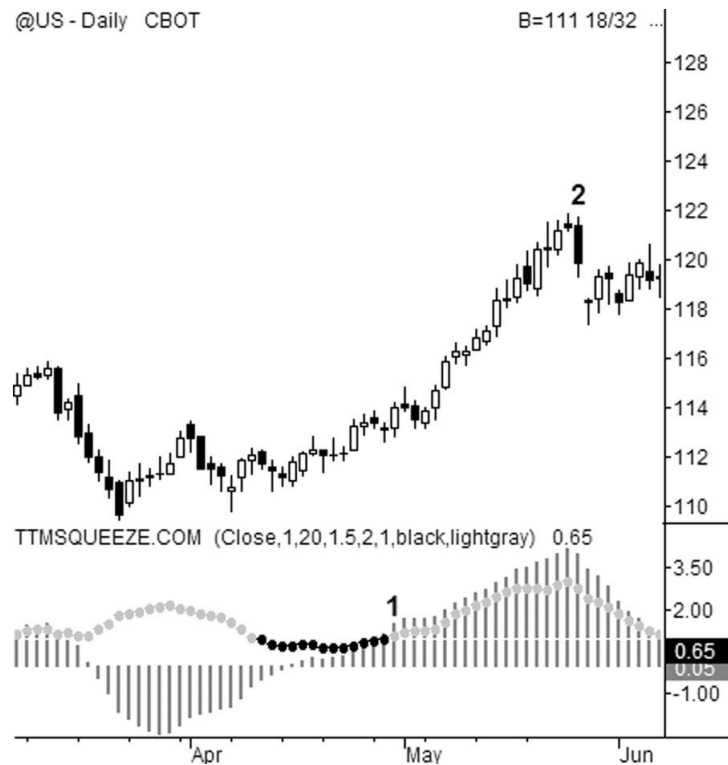


2. The momentum to the downside builds, and bonds sell off. Once the histogram makes a higher low at point 2, I cover my short at the market, and I'm out at  $110 \frac{26}{32}$  for a gain of 4 ticks.
3. At around 1:30 p.m. eastern, we go back into black dot mode, and I prepare for my next trade. About 45 minutes later, we get our first gray dot at point 3, and since the histogram is below zero, I short at the market. I'm in at  $110 \frac{21}{32}$ . I place a stop at  $110 \frac{28}{32}$ .
4. Bonds sell off and move lower into the close. I cover at the first higher low at point 4, and I'm out at  $110 \frac{16}{32}$  for a gain of 5 ticks. The market rolls over again quickly thereafter and closes on its lows.

### *30-Year Bond—June 2003 Contract, April 30, 2003*

1. On this daily chart of the bonds, we can see that these markets consolidated heavily for nearly a month during most of April 2003 (see [Figure 11.14](#)). When the first gray dot appears after this consolidation at point 1, I go long and am filled at  $113 \frac{13}{32}$ . Because this is a daily chart, I give the trade more room and use a 35-tick stop at  $112 \frac{10}{32}$ . Bonds rally through the entire month of May, finally losing momentum in June.

**Figure 11.14**

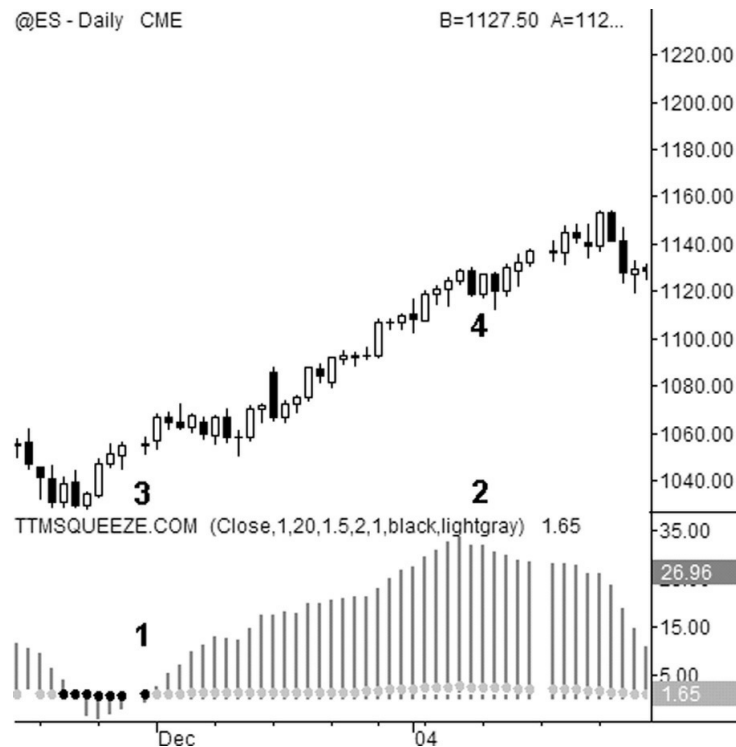


2. Bonds get nearly as high as 122 before crashing on economic news at point 2. This kicks off a lower histogram reading, and I exit at the market at the end of that day, getting out at  $119 \frac{3}{4}$  for a gain of  $6 \frac{1}{4}$ , or \$6,562.50 per contract. This is the same as catching a 1,312-point move in the YM.

*E-mini S&P—December 2003 Contract, December 2, 2003*

1. On this daily chart of the E-mini S&Ps, the markets start to consolidate near the end of November 2004 (see Figure 11.15). On December 1, we get a gray dot. The histogram is above zero, so I go long the next day. There is no magic on the entry formula. I wake up and look at the chart, and if it tells me to take action, I take action. I just get in at the market, very near the open. I'm in at 1062.50 (point 3). I place a 15-point stop at 1047.50.

Figure 11.15



2. The histograms peak out and start making lower lows during the first week in January. I get out on January 9 at 1129.50 (point 4) for a gain of 67 points, or \$3,350 per contract. The market continues to move another 30 points higher. This is all about “being positioned” in the market when it’s setting up to make a big move. Note that this contract expired in the third week of December, so I closed out my position in the December contract and reopened it in the March 2004 contract, which was the next front month. I literally sold the December futures, then turned around and, because the signal was still valid, bought the March futures in order to stay in this play. This is called “rolling over” your position.

*E-mini S&P—September 2004 Contract, July 8, 2004*

1. On this daily chart of the ES, we go into a period of consolidation at the end of June 2004 that lasts into the first few trading days of July (see [Figure 11.16](#)). On July 8, we get a gray dot, and since the histogram is below zero, I go short about 15 minutes after the open of the regular session. I am filled at 1118.25 (two bars to the right of point 3). I place a 15-point stop at 1133.25.

**Figure 11.16**

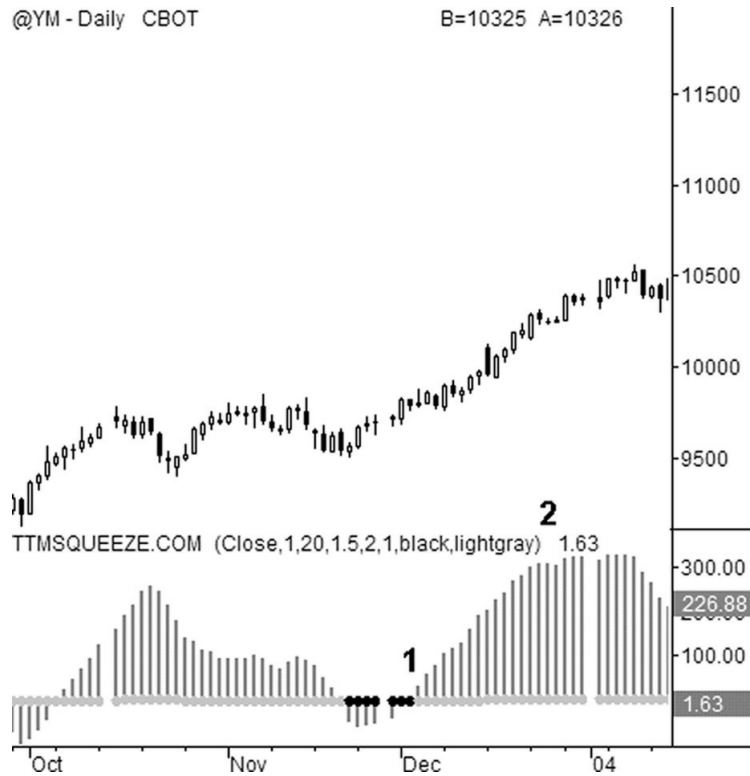


2. The markets move lower, and toward the end of July they start to run out of momentum. At point 2, I exit near the open at 1092.25 for a gain of 26 points (point 4).

*Mini-Sized Dow—December 2003 Contract, December 1, 2003*

1. We've looked at a lot of five-minute squeezes on the YM, so I want to look at a daily squeeze on this contract as well. At the end of November 2003, the daily YM goes into black dot mode, and I await the next gray dot (see [Figure 11.17](#)). We get it on December 1, and since the histogram is above zero, I go long shortly after the open and get filled at 9804. I place a stop at 9654, 150 points below.

Figure 11.17

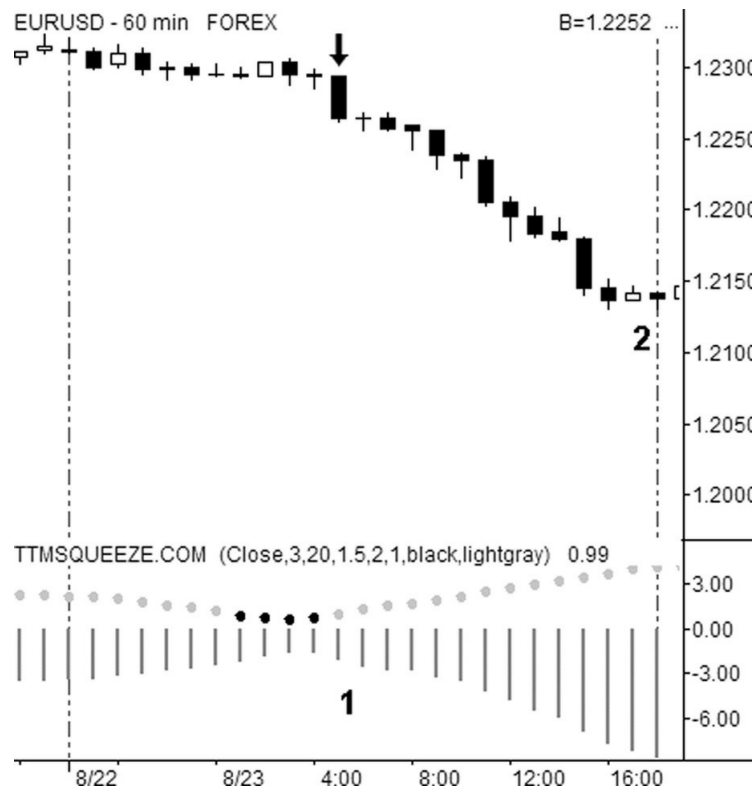


2. The YM rallies into early January and starts losing momentum during the second week of the new year. I exit on January 9 soon after the open at 10,506 for a gain of 702 points, or \$3,510 per contract.

*Forex Markets—EURUSD, August 23, 2004*

1. I like to use the squeeze on the various currency pairs in the Forex markets as well. I normally like to use the 60-minute charts and 5-minute charts, but it also works on the daily charts. On August 23, 2004, I wake up to see that the euro has just fired off a short squeeze on the 60-minute chart (see [Figure 11.18](#)). I go in and short at the market, getting filled at 1.2252. I place a 20-pip stop at 1.2272. (Remember, 1 pip in this currency pair equals 1/100 of a cent and equates to \$10 on your P&L.)

Figure 11.18

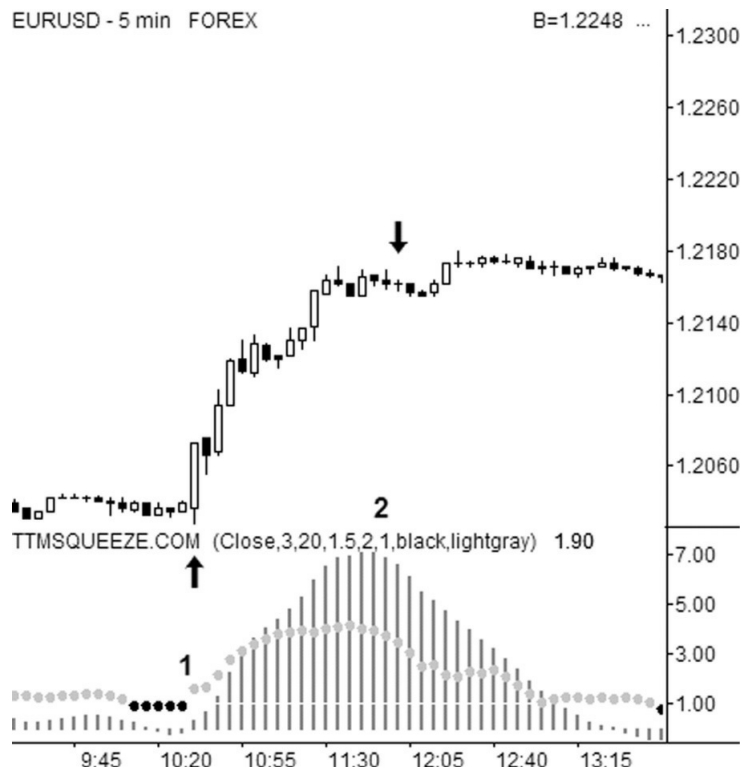


2. The market sells off considerably, and the momentum on the histogram never lets up. I stay in the trade all day, exiting at 4:00 p.m. eastern at point 2, when the US stock markets close. The main reason I do this is that this started off as an intraday play, and I generally get out of the office after the stock markets close to go clear my head. I exit at the market and am filled at 1.2146 for a gain of 106 pips, or \$1,060 per contract. This is like making 212 points on the YM.

*Forex Markets—EURUSD, September 8, 2004*

1. On this five-minute chart of the euro currency, we go into black dot territory a little before 10:00 a.m. eastern on September 8, 2004, and 25 minutes later we get our first gray dot at point 1 (see [Figure 11.19](#)). The histogram is above zero, so I go long at the market, and I'm filled at 1.2054. I place a stop at 1.2034.

Figure 11.19



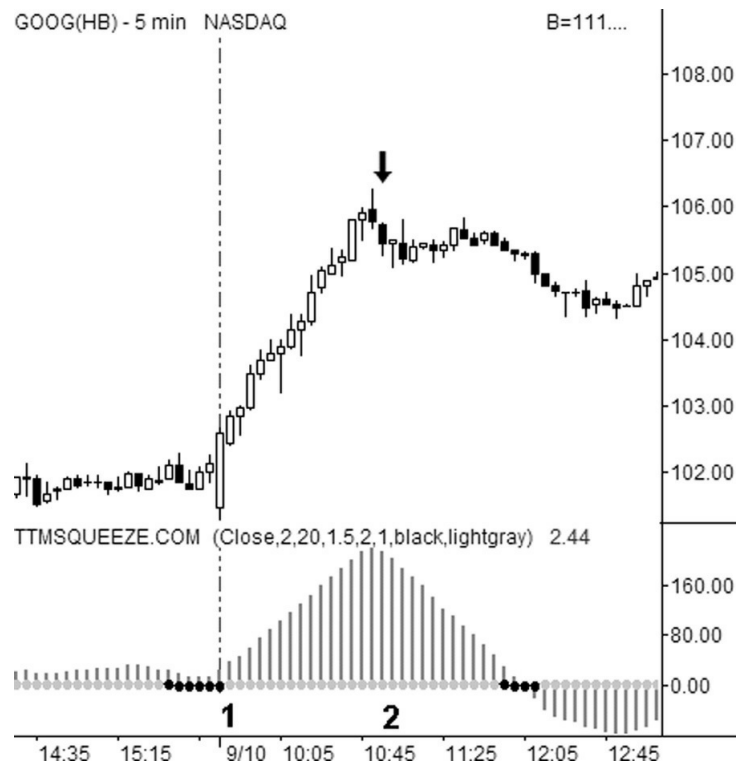
2. The market rallies steadily for the next 90 minutes and starts to lose momentum just before 12:00 noon, at point 2. I exit at the market and am filled at 1.2153 for a gain of 119 pips.

*GOOG (Google Inc.), September 9, 2004*

1. I like to watch the squeeze on various stocks as well, especially on daily time frames, since most of my stock trading involves swing trading. I also use the daily squeeze on individual stocks for in-the-money option plays. I talk more about how I play options in the chapter on the “8/21 EMA for Swings” setup. That said, I will use the five-minute squeeze on volatile stocks for potential intraday trading setups. Figure 11.20 shows a five-minute chart of Google (GOOG), where we can see the price action shortly after its IPO (initial public offering). On September 9, 2004, the stock goes into a squeeze setup at the end of the day, and this carries into the beginning of the next day. Very soon after the open, we get our first gray dot, and, since the histogram is above zero, I take a long at the market. I’m filled at 102.33, and I place a stop at 101.83.

Figure 11.20





2. The momentum builds quickly and begins to fade near 11:00 a.m. eastern. I get out at 105.45 for a gain of 3.12. Another squeeze play sets up later in the afternoon and fires off right after 12 noon. On this play, the histogram is negative, and I would normally short, but since it was an IPO, shares were not available to the general public to short at this time, so I obviously passed on this trade.

### What Is the Biggest Mistake New Traders Make?

Squeezes show me when the markets go into quiet mode. The only reason markets go into quiet mode is that they are building up energy for their next major move. Many new traders make the classic mistake of waking up in the morning and “looking for which markets are on the move.” They see that AAPL is up 5 points and buy the stock, or, worse, they buy out-of-the-money calls. Or they see that the euro is down 40 ticks and they stumble over themselves to short it. They are chasing the action. Well, they are late to the party, and they are most likely going to be buying positions from people like me who are exiting squeeze trades on losses of momentum. Traders who chase markets, like dogs that chase cars, eventually get run over.

I like to sneak into the markets when they are quiet, before everyone else knows what is going on. With the squeeze, I have a clear indication of when to take the trade. And once I’m in, I just don’t mess with the trade. When it starts to lose momentum, it is pretty clear, and that is the signal I use to get out.

Many day traders I talk to ask about the wisdom of swing trading. The biggest question I get involves the risk in being exposed to an overnight position. “What if there is another terrorist attack?” After trading the markets for nearly 20 years, there is one thing I am absolutely convinced of—there is always somebody who knows about the upcoming market move, and this person is in the process of getting positioned for it. After the crash on 9/11, one of the ways the government tracked down terrorist cells was to look at all the brokerage accounts that showed heavy short selling in the weeks before the attack, especially of insurance and airline

stocks. This led to multiple arrests, as people who knew about the upcoming attacks had been shorting these stocks aggressively. Out of the blue? Let's look at a few market crashes and just see how "out of the blue" they really were.

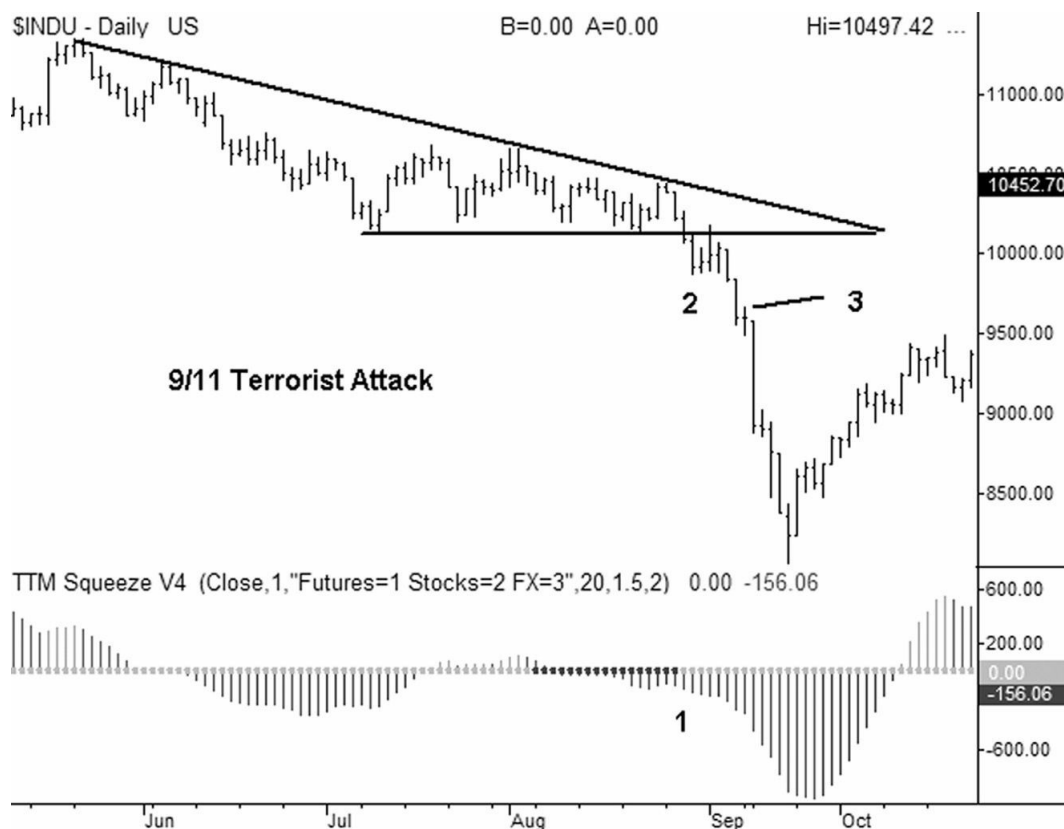
### Is It Possible to Get Positioned Before a Market Crash?

I don't mean to belittle the events of 9/11 by viewing them as merely a "trade setup." I lost friends, and I know many people who lost friends and loved ones in that attack. The point of this is that the event should not scare us and make us cower in the corner. It should not keep us from taking risks, whether it involves getting on a plane, visiting another country, embracing people from other cultures, or having exposure to overnight positions. Living scared can hardly be called living.

#### *Dow Cash Index—September 11, 2001*

1. This is a daily chart of the Dow Jones Industrials leading up to the terrorist attack on the World Trade Center on September 11, 2001 (see [Figure 11.21](#)). At point 1, we can see that the daily squeeze fired off a short on August 30. This is the first sign that there is a lot of steady, quiet selling going on in this market. There is no reason to be long this market. If you have a retirement account or 401(k) that is invested in stocks, this is the time to switch to 100 percent cash or bonds, even though when you call in to do it, your "advisor" will try to talk you out of it. Why would she do that? She makes more in fees if you are invested in stocks. You can get back into stocks once the squeeze has lost its downside momentum.

Figure 11.21



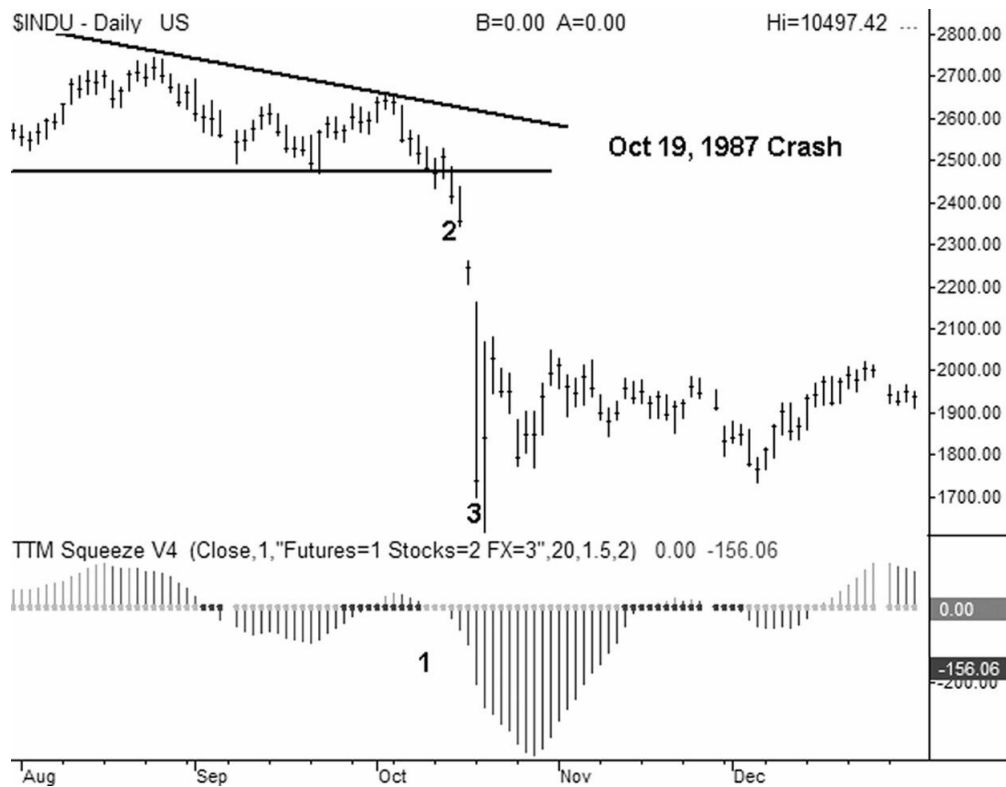
2. The very next day, the markets break through support on a descending wedge pattern. There are now two solid short signals in place.
3. Six trading days later, it is September 10. The markets make new intraday lows, and the momentum on the squeeze is still strong. Did we know about the looming terrorist attacks and that the market was going to crash? No. I didn't, anyway, and 99.99 percent of the population on the planet didn't know either. However, as a trader and investor, I did know that there was (1) no reason to be long the current market, in which case I have the option to sell all my stocks and sit in cash in my retirement accounts, and (2) as a trader, there were numerous sell signals here and plenty of time to get short. On a play like this, I like to buy slightly in-the-money put options on SPY and DIA at least six weeks out, and then I can just sit on those options while the squeeze unfolds.

After 9/11, the markets were closed and didn't reopen until September 17. The Dow closed at 9605 on September 10, and after the next trading day, closed at 8920.70, down nearly 700 points. Again, leading into this, there was no reason to be long in this market. Even though we didn't know what was about to happen, somebody did. The charts do not lie. This is why listening to the news is so worthless—all it does is tell you what has already happened, as it has no idea what's going to happen next, and in between doing this, it lets people try to sell you stuff via commercials. Thank you, sir, may I have another!

#### *Dow Cash Index—October 19, 1987*

1. There was another big crash on October 19, 1987 (see [Figure 11.22](#)). This was the year I graduated from high school, and one of my fondest trading memories is having owned a put on IBM during the crash. I wish I could say that I had seen the crash coming, but it was pure luck. I had a bunch of calls, read something about hedging, and bought a put on IBM. The put saved my bacon and then some, although my calls didn't fare too badly because of the increase in implied volatility—again, at the time, I had no clue what that was either (see [Chapter 4](#)). If I'd had the squeeze at this time, I would have noted that the daily squeeze fired off a short signal on October 9, ten full days before the crash, and I wouldn't have owned any calls. I'd have played the move for what it was; instead of hedging my longs, I'd have just gotten short. We are, of course, all geniuses in hindsight!

**Figure 11.22**



- Then on October 14, the markets broke down from a descending wedge pattern. There were now two reasons not to be long in the markets. There are times to buy the dip, and there are times to shun the dip. When the squeeze is firing off short, shun the dip.

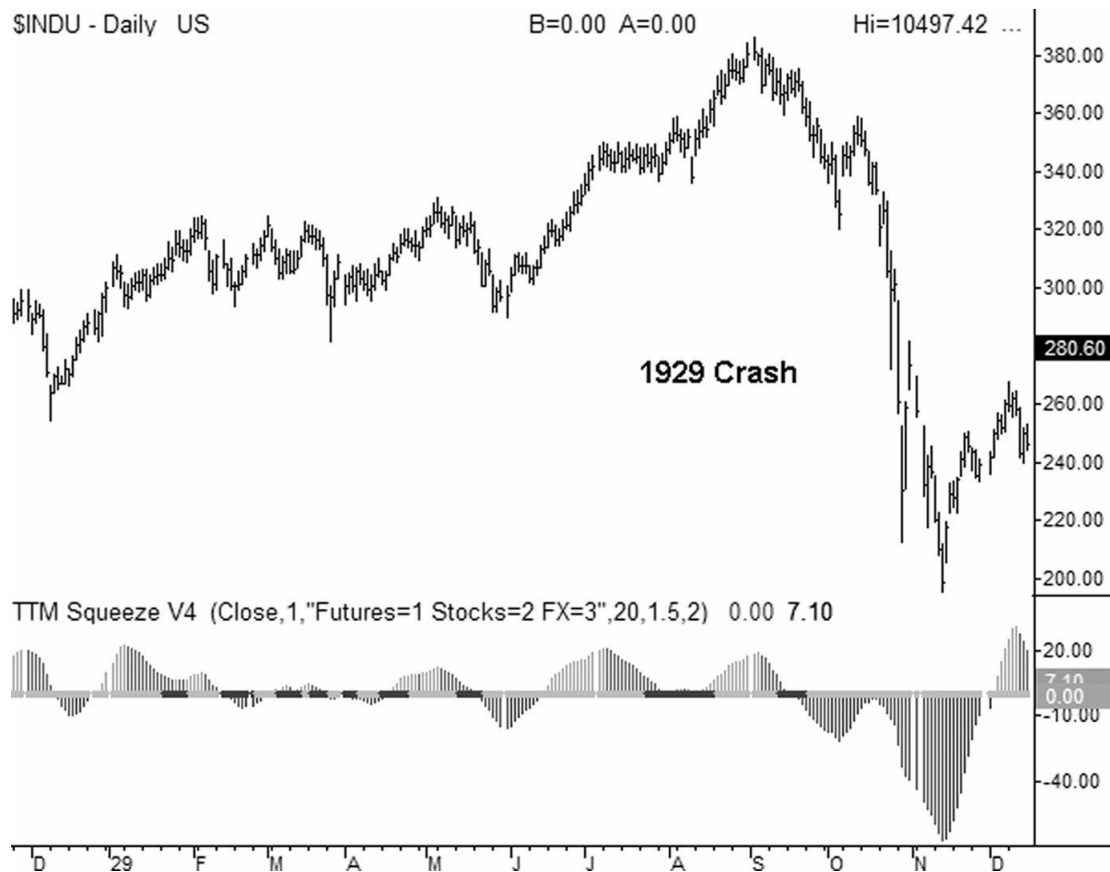
On October 19, the markets crashed. Those who were already positioned for the move had a nice trading day. Those who didn't have the squeeze to guide them experienced new variations of the meaning of pain.

### *Dow Cash Index—the Crash of 1929*

The crash in 1929 was no picnic, either. I once talked to a trader who was there when it happened. He traded right up until he passed at the ripe old age of 94. To him, nothing had ever changed, and it was always the same game. Remember that in the first chapter, I talk about markets moving not because they want to, but because they have to? We talk about TASR in that example. Along these same lines, here is the quick narrative of the crash of 1929.

On the night of Monday, October 21, 1929, margin calls were heavy, and Dutch and German calls came in from overseas to sell overnight for the Tuesday morning opening (see [Figure 11.23](#)). On Tuesday morning, out-of-town banks and corporations sent in \$150 million of call loans, and Wall Street was in a panic before the New York Stock Exchange opened. The selling was heavy, but the influx of cash staved off a crash.

Figure 11.23



Unfortunately, on Thursday, October 24, 1929, more margin calls hit, and people began to sell their stocks as fast as they could. Sell orders flooded the market exchanges, the ticker was running more than an hour behind on price quotes, and the markets sold off hard, but not enough to be considered a crash. The exchange directed all employees to be on the floor, since there were numerous margin calls and sell orders placed overnight for the next trading day. Extra telephone staff was also arranged at the members' boxes around the floor. The Dow Jones average closed at 299 that day.

On Tuesday, October 29, 1929, the crash began. Within the first few hours, the prices fell so far that they wiped out all gains that had been made in the entire previous year. This day, the Dow Jones average closed at 230. This is like the Dow losing 2,400 points in one day today. Between October 29 and November 13, more than \$30 billion disappeared from the American economy—and these were 1929 dollars. It took nearly 25 years for many of the stocks to recover.

The Dow finally bottomed out in July 1932 at near 40. That is like the Dow going from 10,000 to 1,100 in the year 2005.

Coming back full circle, it is important to note that a short squeeze fired off on the daily chart before the 1929 crash. Yes, terrorist attacks and crashes are scary things, but the squeeze is designed to give traders a heads-up on which way the markets are going to break, so that they aren't caught with their pants down.

### What Is the Best Trading Strategy for Those of Us Who Have a Job and Can't Trade Full Time?

The squeeze on a daily or weekly chart is one of the best ways I know to trade part time. It can be used on individual stocks, and there is no reason to scan thousands of charts. *Investor's Business Daily* is a good

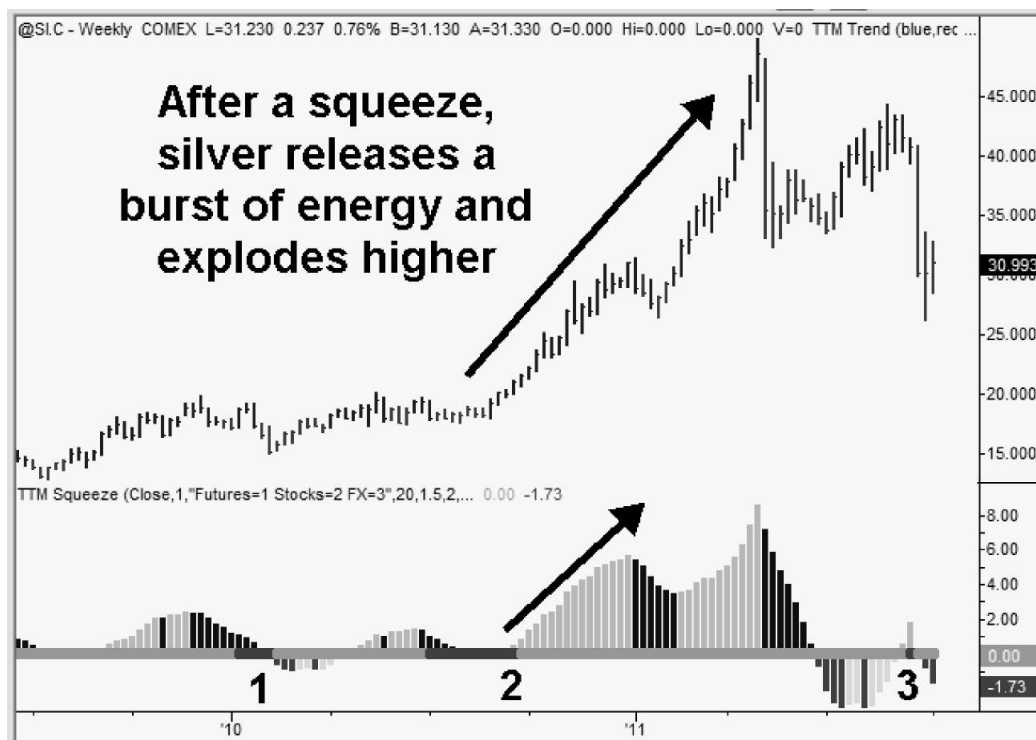
resource for actively traded “healthy stocks” via the IBD 50. I just sort through these stocks, and once I see a squeeze fire off on one of them, I will place an order for the trade, via either the actual stock or a delta 0.70 option. These types of trades do not need to be managed intraday. Even though I watch the markets full time, I do not watch my swing trades intra day. There is no point. My parameters are in place, and the only thing I’m going to do if I watch my position is try to outsmart it, which never works in the long run. In addition to individual stocks, this can be used for sectors and ETFs, and for commodities as well. As an added benefit, if you are working a full-time job and can’t watch the markets intraday, you are actually at an advantage. In that type of situation, a lot of the psychological stuff that I discussed in [Chapter 2](#) doesn’t even have a chance to come up. Place the trade, set your parameters, go to work, and log in later to see what happened. There is a lot of wisdom to that approach.

### Updated Examples for the 2008 Financial Crisis and Beyond

During times of great uncertainty, which we’ve had ever since the financial crisis of 2008 hit the world, indicators like the squeeze take on added importance. They allow a trader and investor to stay calm, make decisions, and not get sucked into all the misinformation that’s being spread around like so much cow manure. Let’s take a look at a few examples of how this all played out. Also remember my discussion of the AUDJPY currency cross from [Chapter 5](#). This plays strongly into understanding “what the hell is going on” in today’s financial markets. It’s always good to know when hedge funds are buying and when they start selling. This way, you can sidestep the freight train when it comes your way.

In [Figure 11.24](#), we have a weekly chart of silver. This is a classic example of a squeeze. At point 2, the silver market had been consolidating between \$15.00 and \$20.00 for over a year. People who had bought at \$20.00 were anxious, while people who had bought at \$15.00 felt slightly more comfortable. For long-term bullion holders who want to own silver forever, this isn’t too much of a concern. But for traders, part of the key is knowing “when to put capital where.” It would have been possible to buy silver at \$20.00 a year and a half too early. That money would have been essentially “dead money” from a trading perspective, as it could have been put to work elsewhere.

**Figure 11.24**



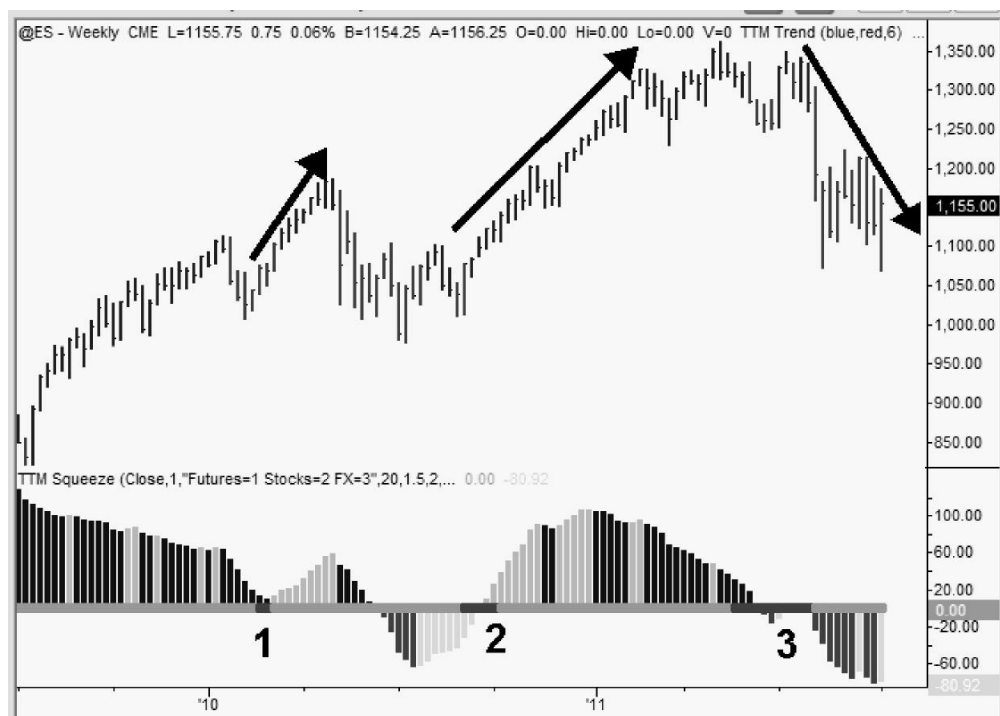
At point 2, we can see that a squeeze has been setting up for several weeks. This means, of course, that the silver market is getting ready to potentially release a truckload of energy. In this case, it initiated the move that eventually saw silver soar to \$50.00 an ounce. It is during this time, during the “squeeze period,” that a trader wants to look at taking a position in silver. This could be done in many ways: buying the silver ETF (SLV), buying call options on SLV, buying silver futures, buying call options on silver futures, buying silver mining stocks, or even buying silver bullion. And a trader could take this a step further and initiate option positions in SLV that would benefit from a rise in SLV—selling naked puts and so forth. The key is having and understanding the signal (in this case, seeing that silver was potentially about to go higher) and then choosing the variety of trading strategies around this signal that best fit your personality and trading goals.

At point 1, there is a squeeze that fires off a short signal in silver. As you can see from the chart, this move did not last long, though silver did fall from \$20.00 back toward the \$15.00 level. In the next chapter, I’m going to talk about a filter for the squeeze that filters out setups like that—setups that may not have a whole lot of conviction.

Figure 11.25 shows a weekly chart of the S&P 500 futures. Point 1 shows a squeeze that results in a multimonth 20 percent spurt higher at a time when there was extreme bearish sentiment about the markets as a result of the European bailouts. And yet, the market ignored the news and rallied anyway. At point 2, the European situation had continued to get worse, and the stock market had had some serious selling, falling from 1200 all the way back to 950. People were getting jittery. At point 2, a squeeze took shape and fired off long, and the S&P 500 started one of its most ferocious 35 percent rallies in recent memory. Day after day, week after week, shorts got clobbered on this rally as they fought the advance every step of the way. And why not? The news was negative every day! Traders who were following the squeeze didn’t fight it. They just got long and waited for the exit signal to get out, no matter how negative the commentary spewing forth from the financial press. At point 3, in July 2011, the S&Ps started setting up another squeeze, and this one fired off

short. Again, once this happens, there is no reason to be long on stocks, no matter what the news is saying, and aggressive traders can go one step further and get short. Isn't this a lot easier than scanning the news every day for hours, trying to figure out what is going to happen next? Of course, if the S&P 500 is firing off a squeeze, individual stocks will also follow. If I see the S&P 500 set up a signal, I will also look at taking positions in key stocks like AAPL, BIDU, PCLN, and so on that will benefit from a move in the S&P 500.

Figure 11.25



The king of the squeeze charts is the monthly chart. Although squeezes don't set up on these charts very often, once every few years, they are hugely powerful. Figure 11.26 shows a monthly chart of gold. Gold tends to have a solid move, then consolidate for 12 to 18 months, and then have another solid move. This can all be mapped out and timed with the squeeze. Point 1 shows a long squeeze from the middle of 2002. Point 2 shows a long squeeze from the end of 2005. The next squeeze took place two years later at point 3 near the end of 2007. Then, two years later, near the end of 2009, yet another monthly squeeze fired off that launched gold from \$900 an ounce to over \$1,800 an ounce. As of this writing in October 2011, it's time for gold to "go quiet" again for another 12- to 18-month period until its next major monthly squeeze signal. As with the trade in silver, there are many ways to utilize this information, implementing strategies with stocks, options, and futures.

Figure 11.26





Another critical chart to watch is a weekly chart of the US dollar index, symbol DXY (also referred to as Dixie). The fundamentals on the US dollar are well known and always point to lower prices for our beloved currency (he says, tongue in cheek). That said, no market moves straight up or straight down, and while the Dixie has a fundamental sob story, there are moments when it shines and will continue to shine. Back in the good old days, the US dollar would rally because our economy was so strong when compared to other major economies. These days, the US dollar will rally during periods of global economic unrest. This is important to realize because the price of the US dollar affects nearly every other asset around the world to some extent. The dollar goes up? Guess what, oil, gold, grains, and many other commodities, and even many stocks, go down in price, as they are priced in US dollars (as US dollars get more valuable, it takes less of them to buy the same amount of gold, oil, and so forth).

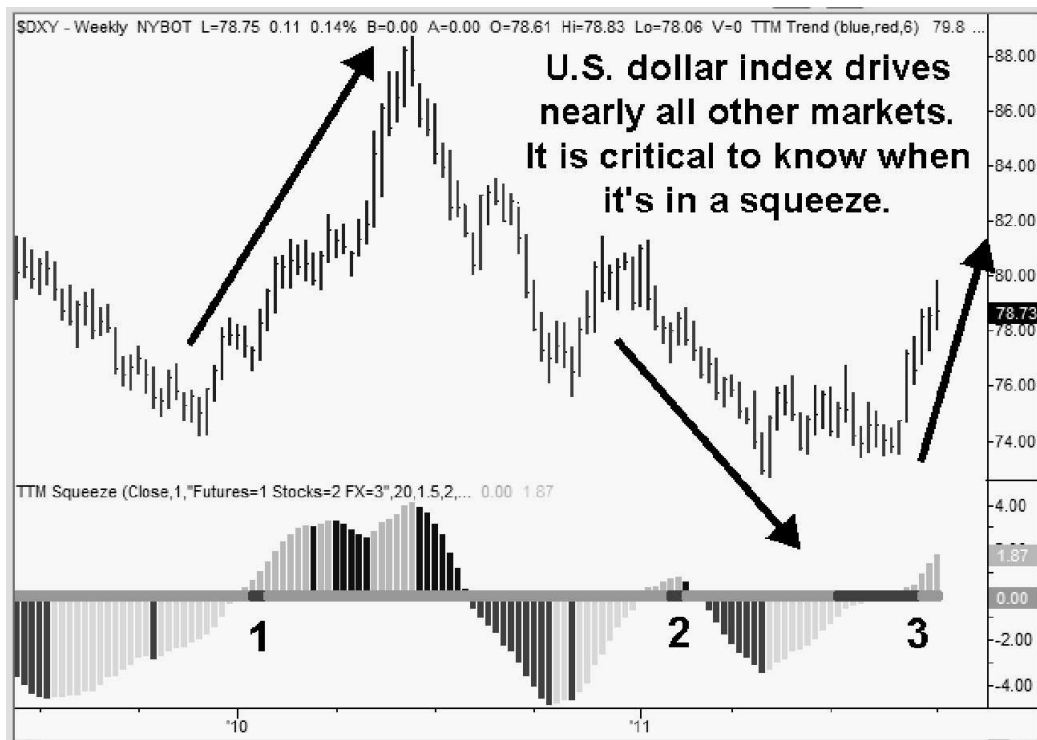
What about quantitative easing? Yes, this creates a lot of new currency at the push of a button, and in theory this should push the dollar lower. This would be true if so many dollars weren't being destroyed by deflationary real estate pressures. For example, in 2009, there was \$1.1 trillion in new dollars created by quantitative easing. There was also \$1.6 trillion in debt destroyed by falling real estate prices. This means that in 2009, despite quantitative easing, the supply of US dollars actually decreased by \$500 billion, making the fewer dollars that were left more valuable. Luckily, a person doesn't have to understand or even know about this. Just look at the chart and follow the squeeze signals.

The two big factors that drive this currency higher these days are (1) the unwinding of the carry trade (see the [Chapter 5](#) discussion of AUDJPY) and (2) global economic recessions. In a global recession, when *everything* is slowing down, the US dollar starts to look pretty good in comparison to other fiat currencies. Think of it as "the least stinky piece of crap" floating to the surface.

In [Figure 11.27](#), we have a weekly chart of the \$DXY. At the start of 2010, a long squeeze fired off, and the Dixie had a fantastic rally. During this time, gold fell from 1200 to 1000, the S&P 500 fell from 1215 to

1000, the euro got clobbered from 1.50 to 1.19—the list goes on and on. Even strong markets like oil could only manage to trade sideways during this time. A strong dollar truly affects everything, just as a weak dollar also affects everything. The key is not to stick your head in the sand and trust that the US dollar will continue weakening in a straight line down. At point 2, there is a short squeeze, and during this time, as the US dollar sold off, nearly everything else rallied. Stocks, gold, oil, euros—you name it, it rallied. As I'm writing this on October 8, 2011, the US dollar has recently fired off another long squeeze (on fears of a global recession—but of course the reasoning doesn't really matter; just follow the signal), sending the dollar higher. This has been a powerful signal, as prices of gold, silver, stocks, and so forth continue to fall apart.

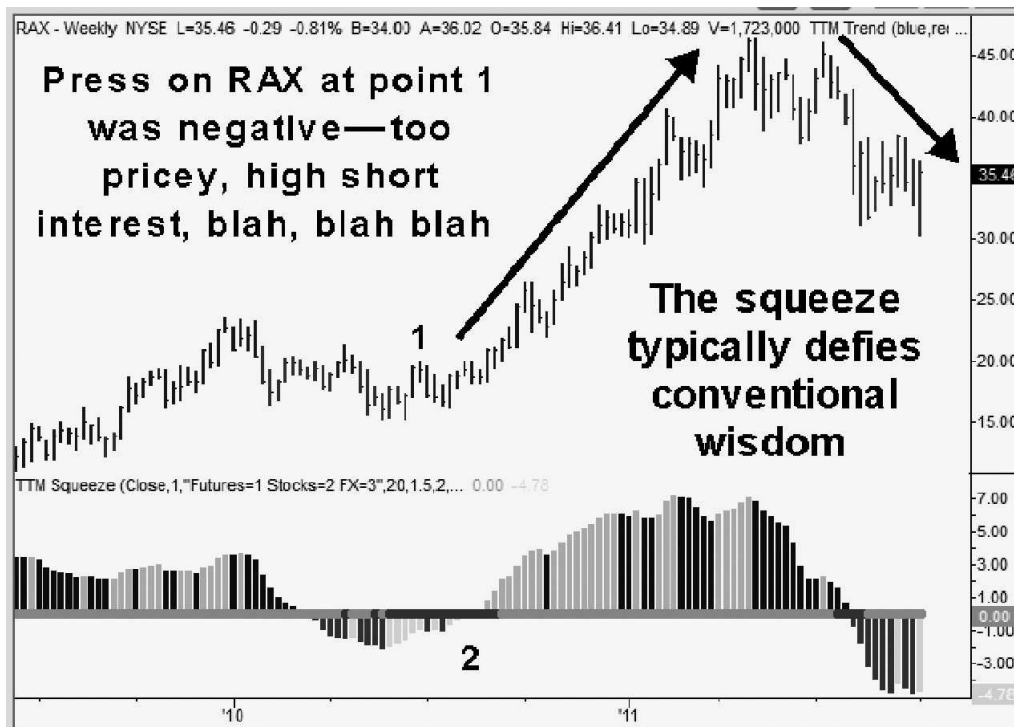
Figure 11.27



The weekly squeeze is also very useful for cutting through the noise, which is often confusing and contradictory. In September 2010, RAX (Rackspace), a web hosting company, was getting a lot of negative press. The stock was too expensive, the P/E ratio was too high, and the short interest continued to climb as hedge funds shorted the stock in anticipation of a great fall.

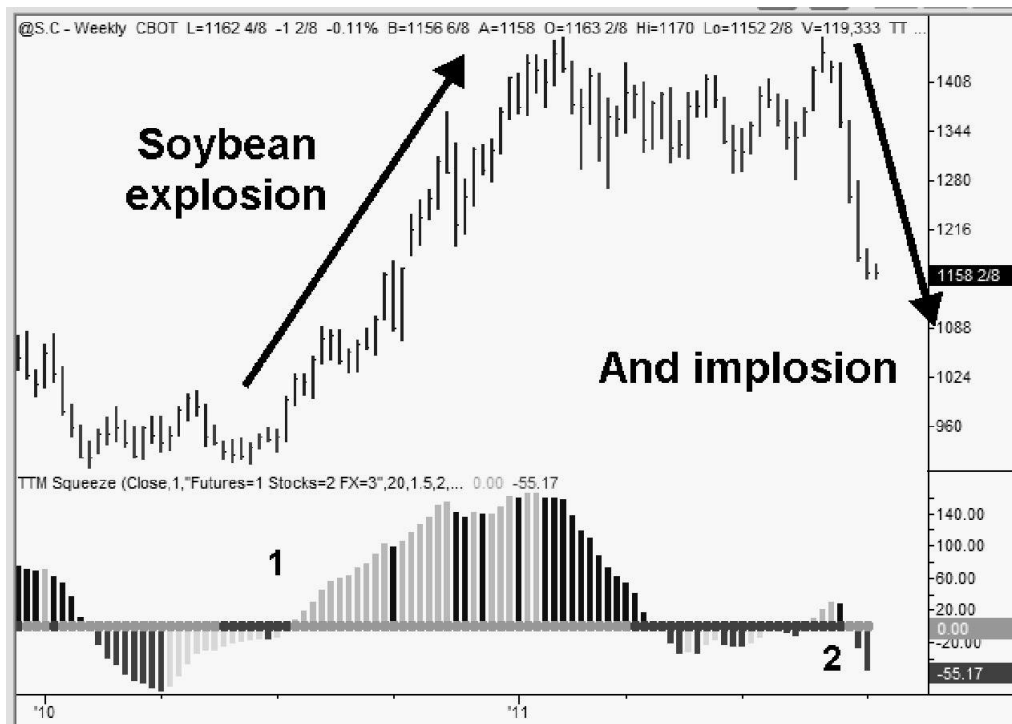
Figure 11.28 shows a weekly chart of RAX. During this time of negative “this stock is way overvalued” press, a weekly squeeze slowly and quietly started to develop. By the time it fired off at point 2, it launched the stock into a move that would more than double the price of the stock. For weekly squeezes, a trader can buy the stock outright or buy in-the-money call options a few months out. For RAX, those who listened to the negative press sold the stock or, worse, shorted the stock. Those who watched the weekly squeeze and brainlessly followed the signal enjoyed an awesome run higher in the price.

Figure 11.28



One thing about the squeeze is that it doesn't really care what market you watch. [Figure 11.29](#) is a weekly chart of soybeans. As a trader, getting long soybean futures at point 1 turned into an incredibly profitable trade. And there are other uses for this type of information. For a farmer who is trying to decide whether to hedge his crop at \$10.00 (by shorting soybean futures), this squeeze proves to be very useful information. "Don't hedge yet," it screams. "At least wait till the squeeze is done." When it's done, soybeans are closer to \$13.50. The farmer can hedge his cash crop here and lock in that profit. This can also be done with gold and silver bullion. Selling physical gold and bullion can be a huge pain. However, hedging physical holdings is super easy if you know how to read the squeeze.

Figure 11.29



### What Is the Best Way to Filter Out Squeezes That Might Not Work Out?

On the weekly chart of silver in [Figure 11.24](#), we saw a squeeze signal at point 1 that was tepid at best. It worked, but it didn't work great. There are also squeezes that just plain don't work. This is not common on weekly and monthly charts, but it can be a factor on intraday charts, such as a five-minute chart, or something a little longer, like a 39-minute chart (I like 39-minute charts on individual stocks, since the chart shows 10 equal-sized bars, as the cash stock session has 390 minutes of trading activity). What is the best way to filter out the potentially bad trades?

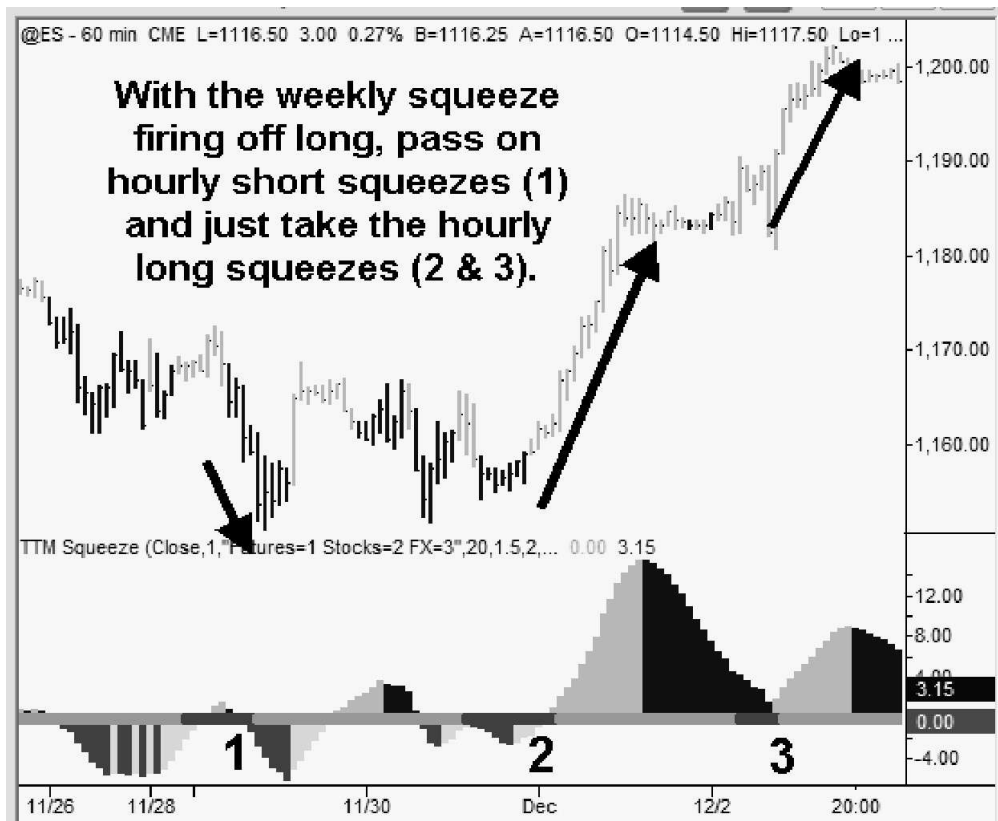
As I said earlier in the chapter, it really is important to know what is going on in the larger time frames, even if your trading plan doesn't have you actually trading these time frames. [Figure 11.30](#) shows a weekly chart of the e-mini S&P 500 futures. This squeeze signal fired off long at the end of September, 2010, pushing the index nearly straight up for 300 plus points. The move was ferocious, and fighting this move proved disastrous to many a trader's health.

Figure 11.30



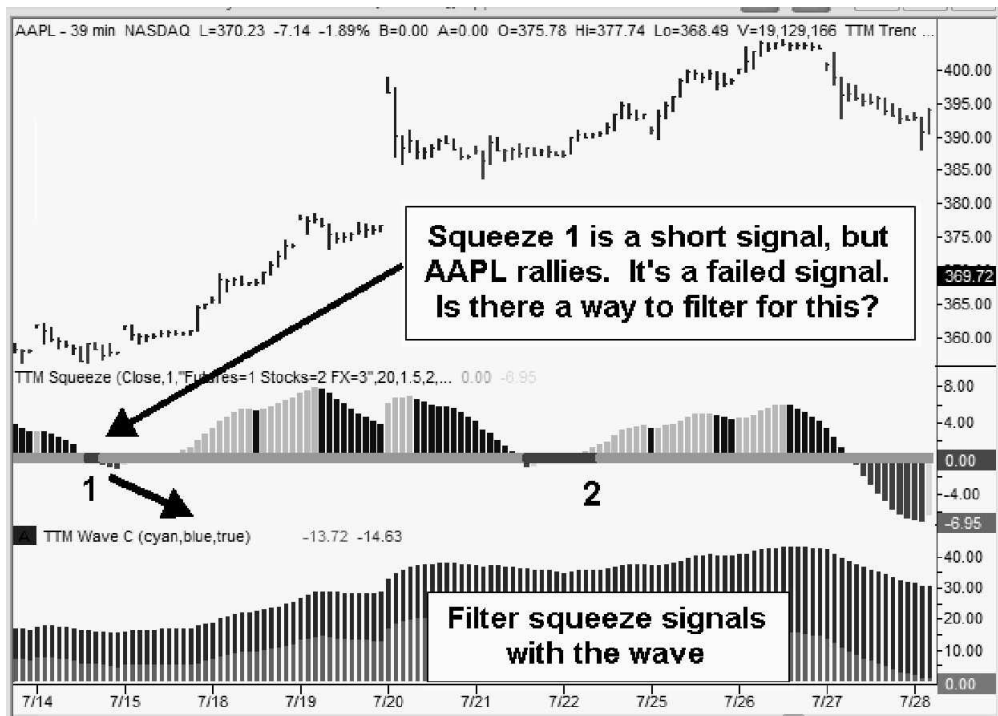
In [Figure 11.31](#), we drill down to an hourly chart of the e-mini S&P 500 futures toward the end of November 2010, while the weekly chart in [Figure 11.30](#) remained in the strong upward squeeze. The trading process now becomes extremely simple. Is the hourly chart firing off a short squeeze, in the opposite direction of the weekly chart? Like at point 1? Yes? Pass on this trade. It's a low-probability trade that is fighting the predominant larger trend. On the other hand, is the next squeeze that is setting up firing off long? In the direction of the weekly squeeze? Like at points 2 and 3? Yes? Then take those trades because they are great signals aligned with the weekly trend. This is why it's always important to understand what the larger time frames are doing. These act as great filters for the smaller time frames.

Figure 11.31



There is also another filter that can be used. [Figure 11.32](#) shows a 39-minute chart of AAPL. At point 1, a short squeeze fires off, indicating that shorting AAPL here would be a good idea. AAPL does not sell off and in fact starts to rally . . . hard. Although the next signal at point 2 did great, that first signal at point 1 failed utterly. If we weren't looking at the larger times frames such as a daily or weekly chart, is there a way to filter out these potentially false signals?

Figure 11.32



Yes. At the bottom of the chart is something called the “TTM Wave C,” which works as a directional filter. TTM stands for “Trade The Markets.” The key is that if it is above zero, as it is on this entire chart, then you ignore short squeezes. The opposite is also true. If, on this chart, the TTM Wave C were below zero, then you would ignore all long squeeze signals. This is a handy tool if you are looking at a lot of charts and find it hard to keep track of all the larger time frames for the instruments you are trading. We’ll dive into this tool in the next chapter.

For updated information and examples on the squeeze setup, including crypto currencies, go to [www.simplertrading.com/squeeze](http://www.simplertrading.com/squeeze) for a series of videos and charts.





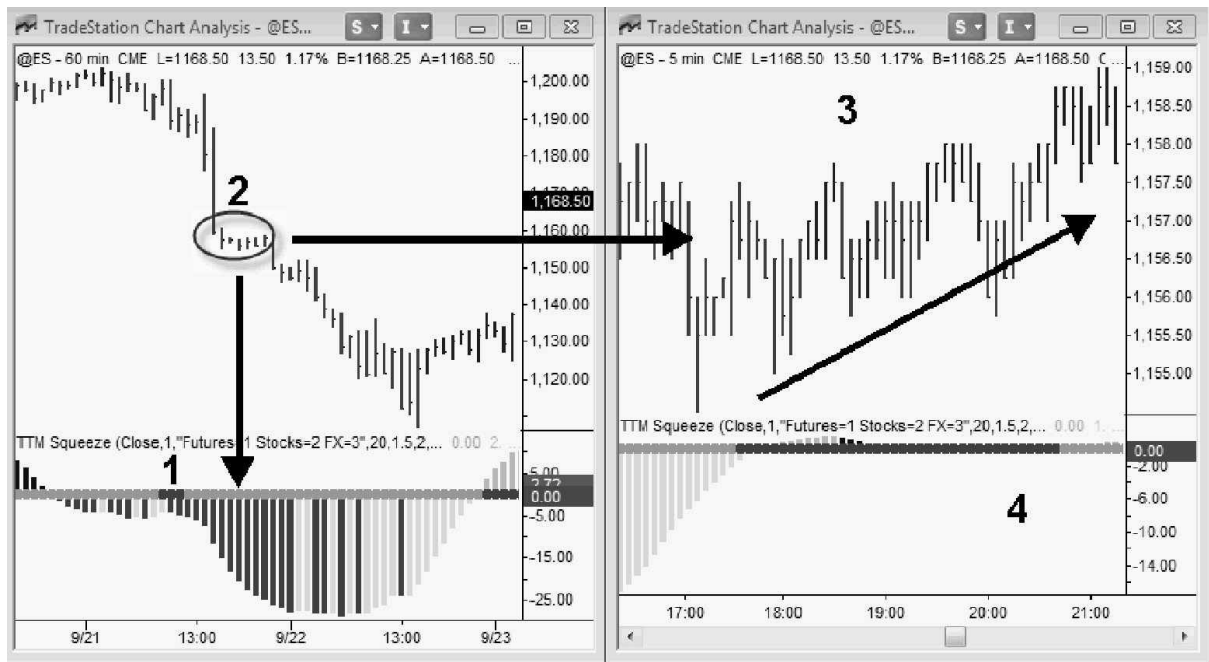
# Catching the Wave: What Is the Easiest Way to Stay on the Right Side of the Trend on Any Market, on Any Time Frame?

## Why Is It Critical to Understand the Concept of Anchor Charts?

I watched the squeeze for a long time without any hard-core filters. I felt comfortable with the risk/reward ratio, and I knew that not all signals would work out. I did notice, however, that there were times, especially on intraday charts, when the squeeze wasn't consistent. And it didn't seem random. It happened in blocks of trades, sometimes two or three in a row before a really good one fired off again. What was going on? How could I pinpoint the common denominator? Looking at "anchor charts" helped. This is the process of looking at a larger time frame and referring to that larger time frame before taking a trade on a smaller time frame. For example, if I'm using an hourly chart as my anchor, and it's bearish and everything is pointed lower, why would I take a long signal on a five-minute chart? In this case, by looking at the hourly "anchor," I can see that it would be better to be patient and wait for a short signal on the five-minute chart, in the direction of the larger "anchor."

Figure 12.1 shows two charts. The one on the left is an hourly chart of the ES, while the one on the right is a five-minute chart of the ES. At point 1 on the hourly chart, a squeeze fires off short. During this signal, the market goes into consolidation mode at point 2. If we zoom in on this consolidation on a five-minute chart at point 3, we can see that this action is slightly bullish. And, look, a squeeze is setting up . . . maybe it is worth a shot on the long side? Grab a couple of ticks? During the heat of the moment, that might seem like a great idea. Why not try to make a little extra money?

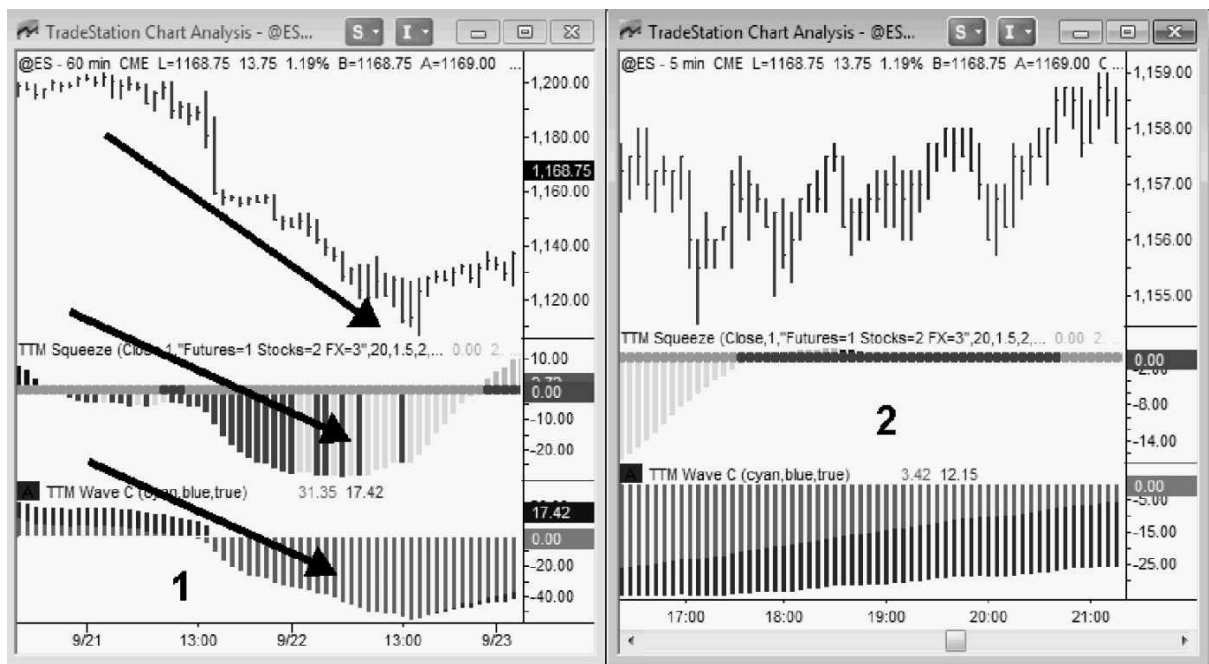
Figure 12.1



This rally failed miserably starting on the next bar, falling 50 ES points (\$2,500 per contract) in rapid succession. Looking at the hourly chart, there was clearly no reason to get long, as the squeeze to the downside was still unfolding. Zoom in on that five-minute chart, however, and it looked as if a real rally was taking shape. This is why anchor charts are so important. They keep the overall market movement in perspective. More important, they prevent a trader from getting tied up in a bad trade and then completely missing the good trade that was unfolding before her eyes. That is one of the main dangers of hanging on to a losing trade—it closes your eyes to all of the wonderful opportunities that are setting up around you, as all your concentration is diverted to watching the disintegrating P&L on your screen. As one of my former trading mentors told me numerous times, “Why dick around with ticks when you can tally up the points?” Indeed. Some of the best trades are the ones in which we decide to pass.

Figure 12.2 shows the same charts with the “TTM Wave C” (I just call it the “C wave” and will refer to it as that throughout the rest of the chapter) added to the bottom of the chart. On the hourly chart, we already know from Figure 12.1 that the signals are to the downside. The added C wave reinforces this by crossing below zero while the squeeze is firing off short. The downside of the anchor chart is that there are times when it is easy to forget to refer to it, especially if a trader is looking at many markets, and especially in the heat of the moment. This is where the TTM Wave C comes in handy. At point 2 on the five-minute chart, we can see that the C wave is clearly below zero. This means, in essence, that the longer-term trend on this market, on this time frame, is bearish. In other words, there is no reason to get long. This is known as “riding the waves.”

Figure 12.2



## What Exactly Are the Waves, and How Do They Work?

The waves were introduced to me by a fellow trader, Rodney Julian. I had spent a few hours explaining to him my concept of anchor charts, and after I was through, he just looked at me and said, “John, this is a simple math problem. You should just be using these.” He showed me “these,” which was a series of indicators he had developed over the last decade. There are three of them, which he calls waves. They are as follows:

- Short-term trend: A wave
- Medium-term trend: B wave
- Long-term trend: C wave

The waves essentially measure various trends on whatever market and whatever time frame a trader is observing. An A wave measures the trend of the prior 6 or so bars, the B wave measures the trend of the prior 15 or so bars, and the C wave measures the trend of the prior 30 or so bars (this is my best guess, as Rodney won’t tell me the specifics).

Figure 12.3 shows a daily chart of GS (Goldman Sachs) with a C wave. Although Rodney likes to watch the ebbs and flows of the waves, I really just focus on whether they are above zero or below zero, and how that all lines up with the current squeeze.

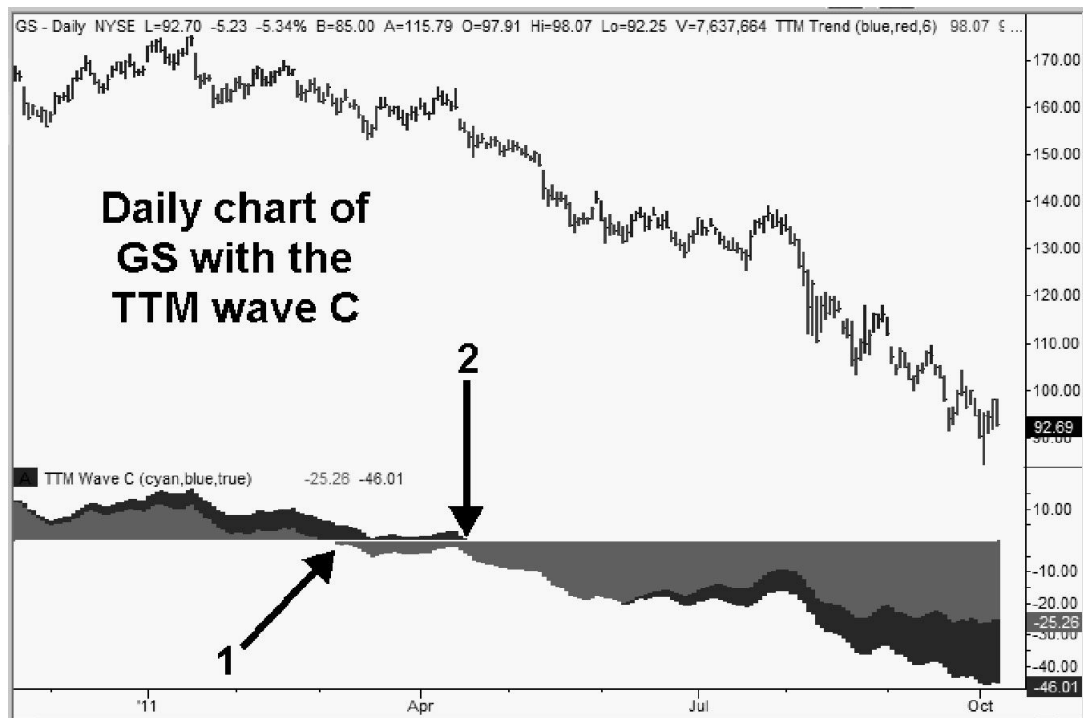


Figure 12.3

At point 1, the C wave starts to edge below zero. This is a “heads-up” for me that the uptrend in GS might be coming to an end. When the C wave goes fully below zero at point 2, then the longer-term trend on GS has officially rolled over to the downside.

Figure 12.4 goes one step further and adds the A and B waves to the chart, as well as the squeeze. At point 1, a squeeze fires off a short signal. The A, B, and C waves all cross below zero at this time, which is a great sign for the short side. The squeeze, as is typical, runs out of gas shortly after six bars. It would be possible at this point for a trader to take his profit and move on to the next trade. Another strategy would be to take off half his position, move his stop loss to the entry point, and hold on for as long as the C wave (the bottom wave) is trading below zero. This is, after all, measuring the longer-term trend of this market. Why fight it?

Figure 12.4

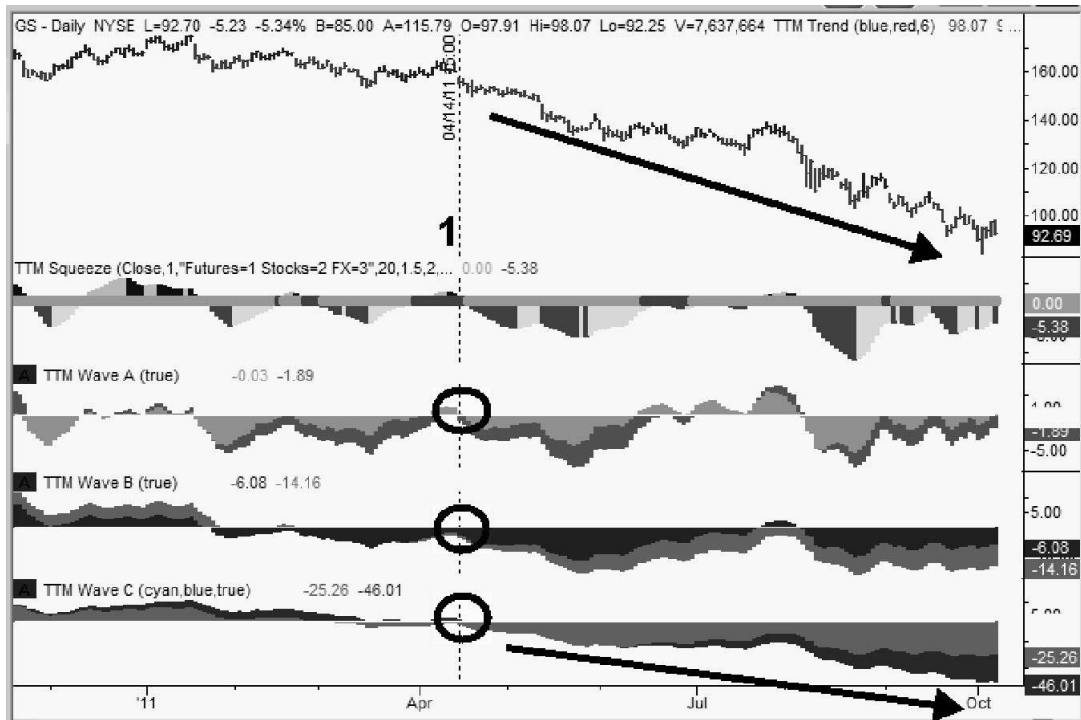
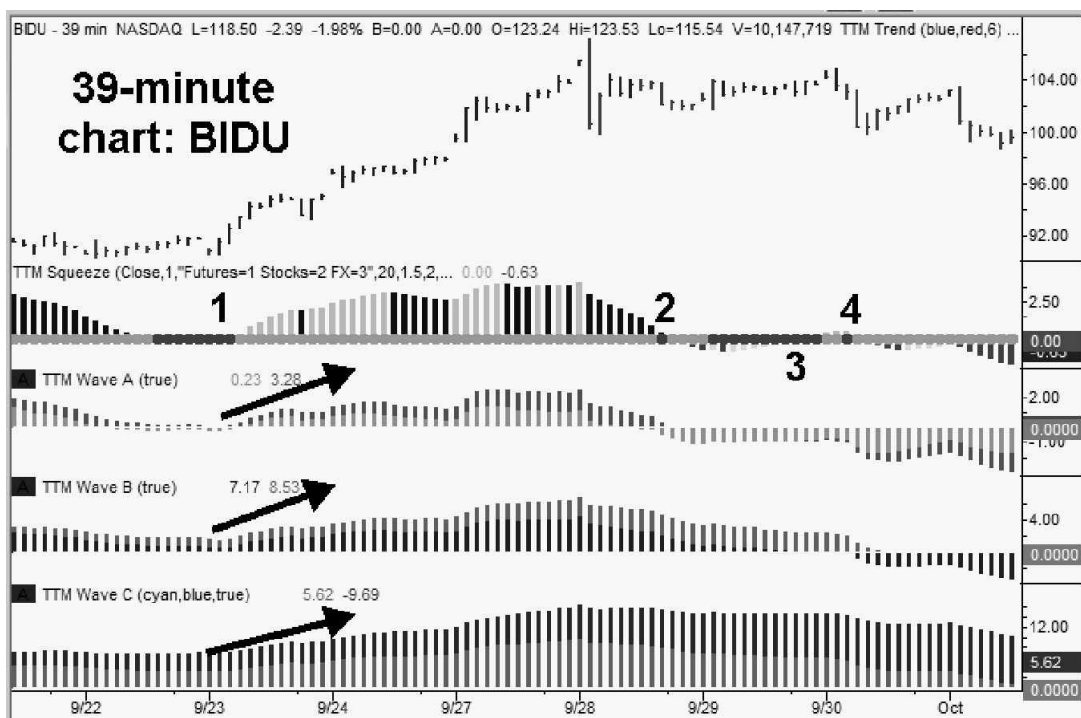


Figure 12.5 shows a 39-minute chart of BIDU. Point 1 represents what I call a “Porsche setup,” as everything has come together for a nice trade. The squeeze fires off long. The C wave is well above zero, as is the B wave. The A wave has dipped below zero, but immediately is back up above zero. In other words, the short-, medium-, and longer-term trends on this chart are all in alignment for this signal. And the signal works great, as BIDU kicks off a 10-point plus move.

Figure 12.5

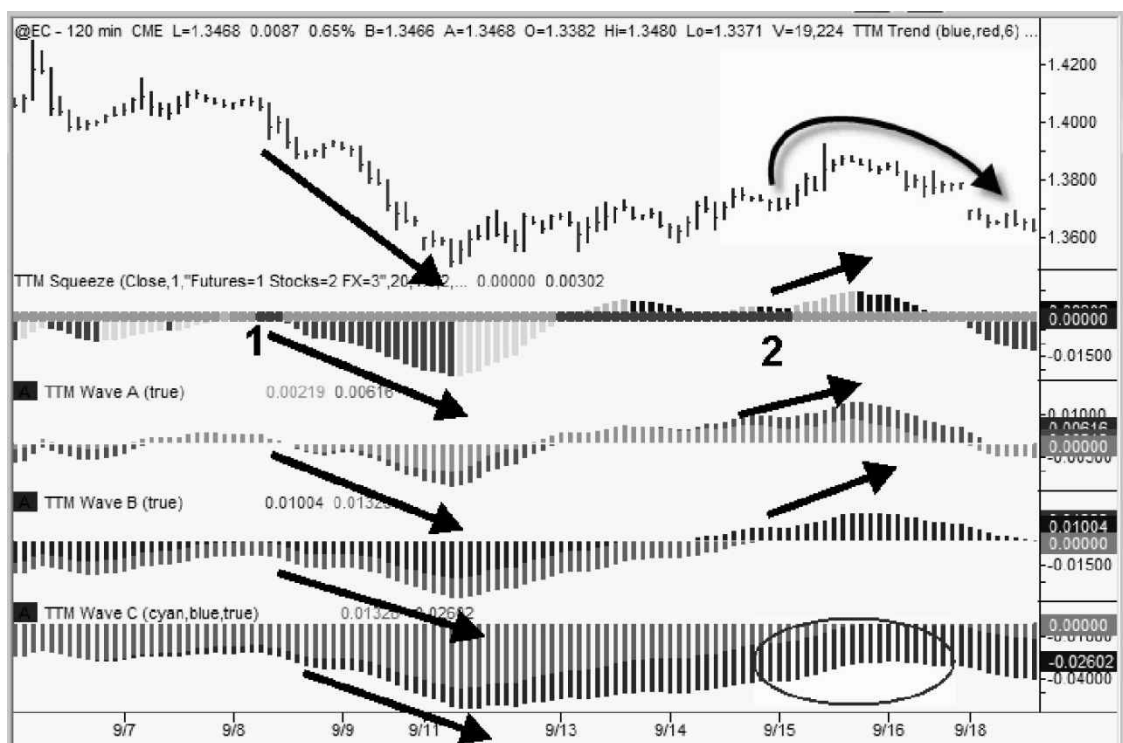


At point 2, a one-dot squeeze sets up to the short side. Do we take this signal? No. The C wave is still well above zero, so there is no point in fighting that longer-term trend higher by trying to make a quick buck on the short side. Point 3 sets up a squeeze, and this one has the C wave above zero. Is it a good signal? This is where understanding the waves can become very helpful. In this instance, the A wave is below zero and just can't cross above zero. This is a flag that the short-term momentum on this market isn't ready to move higher. This squeeze fires off long, and BIDU fizzles quickly. Point 4 sets up another one-dot short squeeze, which of course we pass on because the C wave is clearly above zero.

This chart is a great example of having the patience to wait for a setup where "it all comes together." I also call these Porsche setups. The remaining three setups are all Pintos. If you had a choice, would you rather drive a Porsche or a car that could catch fire?

Figure 12.6 shows a two-hour chart of the euro. Point 1 shows a squeeze that fires off short. The A, B, and C waves are all in alignment. Point 2 shows a squeeze that fires off long. While the A and B waves are in agreement, the C wave is not. The trade pops higher, but the rally is short-lived. And this is one of the biggest benefits I've found with using the waves. They tend to distinguish signals that will trend well from those that are the quicker countertrend moves. If I see a squeeze like the one at point 2 and I decide to take it, then I'm looking to get a movement of 1 ATR (average true range) and then get the hell out. It's a countertrend trade. I know this in advance. I won't be looking for a runner or a big move. With point 1, on the other hand, I'm looking for a longer-lasting trend movement, and I'll know that I can sit on my hands and let the trade unfold.

Figure 12.6



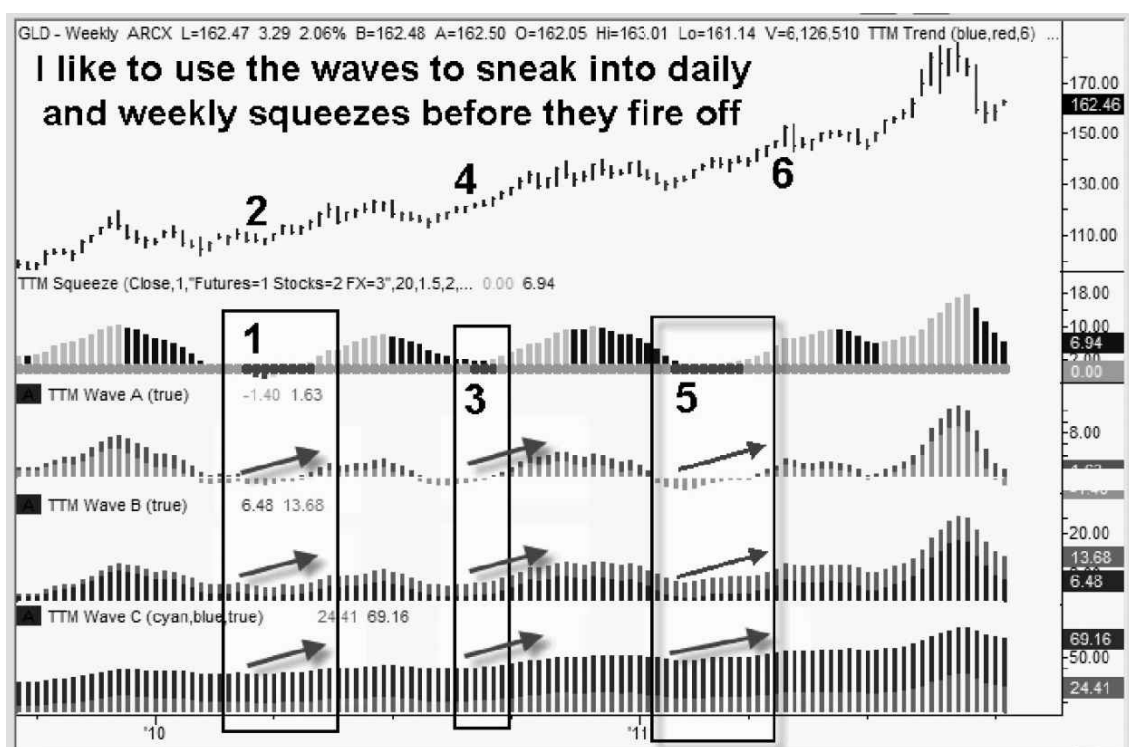
How Can I Use the Waves to Sneak into a Squeeze Before It Fires Off?



What I've found in watching the squeeze over the years is that it is very consistent on longer time frames, such as daily, weekly, and monthly charts, and that a trader doesn't really need the wave filters on these longer time frames. The filters are, however, extremely helpful and necessary for any intraday trading on shorter time frames where it is critical to be on the right side of the trend, right now. That said, one of my favorite ways to use the waves is to sneak into squeezes on the bigger time frames.

Figure 12.7 is a weekly chart of the gold ETF, GLD. This chart shows three clear squeezes, and they all fire off and push GLD nicely higher with each signal. Prior to the waves, I would patiently wait for the squeeze to fire off, and then duly pile in. With the waves, I found that I could sneak into the squeeze before it actually fired off. How so?

Figure 12.7



Once I see the first black dots at points 1, 3, and 5, I know that a squeeze is setting up. I don't know how long it will take to unfold and "fire off," but I do know that this market has entered that special time of setting up for a potentially large move. But which way is it going to move? Is the squeeze going to fire off a long signal or a short signal?

What I've found is the following. If, at the time the first black dot appears on the squeeze (at points 1, 3, and 5), the waves are above zero and trending higher, then this squeeze has a 90 percent chance of firing off long. The opposite, of course, is also true for a downside move.

Knowing this, when this scenario sets up, I'll start scaling into these positions early, and I will often have built up a full position before the squeeze even fires off. For example, at point 5, I see that a squeeze has started and that the A, B, and C waves are all trending higher. (Note: It is important that the B and C waves are also above zero. The A wave can be below zero, but it should be trending higher.) I see that this setup meets the criteria for sneaking in early, and I set about doing just that. At the time for the first black dot,

GLD is trading at \$131.00. My goal is to build up to a full position of 20 call options on GLD. Note that if the setup for sneaking in early isn't there, then I just wait for the squeeze to fire off as I normally would.

The first black dot occurs on February 4, 2011, at point 5. Since this is a weekly chart, I realize that this play could last for many months. Therefore, I want to get options that have a few months still left before expiration. In this case, I look at the May calls, which will expire on May 20, 2011, the third Friday of the month. As discussed in [Chapter 4](#), when it comes to options, I prefer to buy them in the money. In this case, I look at the May 128 call options. I buy one-fifth of my position, or four contracts, at current prices. At the end of the next week, GLD has moved up to \$132, and I buy another four contracts. The next week, GLD pops higher, to \$135, and I pick up four more contracts. The next week, GLD pops again, up to \$137, and I buy four more contracts. The next week, GLD edges up toward \$139, and I pick up the rest of my position. It is okay to buy different option strike prices. In this case, since GLD kept moving higher, I also kept buying slightly higher strike prices, though they were all in the money.

I'm now five dots into the squeeze, and I have a full position. GLD pulls back a few dollars while the squeeze continues to form, and it eventually has eight dots, meaning that this signal developed over eight weeks. When it does finally fire off, GLD is near \$139. My average price is well below this, and I'm locked and loaded with a nice position. GLD proceeds to rally to \$150 before it starts to lose momentum, at which point I take off half the position. But because the C wave is still trending higher, I decide to hold on to the second half, and I scale out as GLD continues moving higher.

What is nice about this entry method is it allows scaling in and typically ends up with a better average price than if a trader had waited for the squeeze to fire off. In this case, by the time the squeeze had fired off, GLD was trading at \$139, well above the price level when the squeeze first started to form. I also utilize this strategy for daily charts.

There are other ways to use the waves, and Rodney does like to watch the ebbs and flows of the waves on various time frames, initiating trades when they roll over. We've set up a free video at [www.simplertrading.com/waves](http://www.simplertrading.com/waves) to give additional examples and tips on using them.



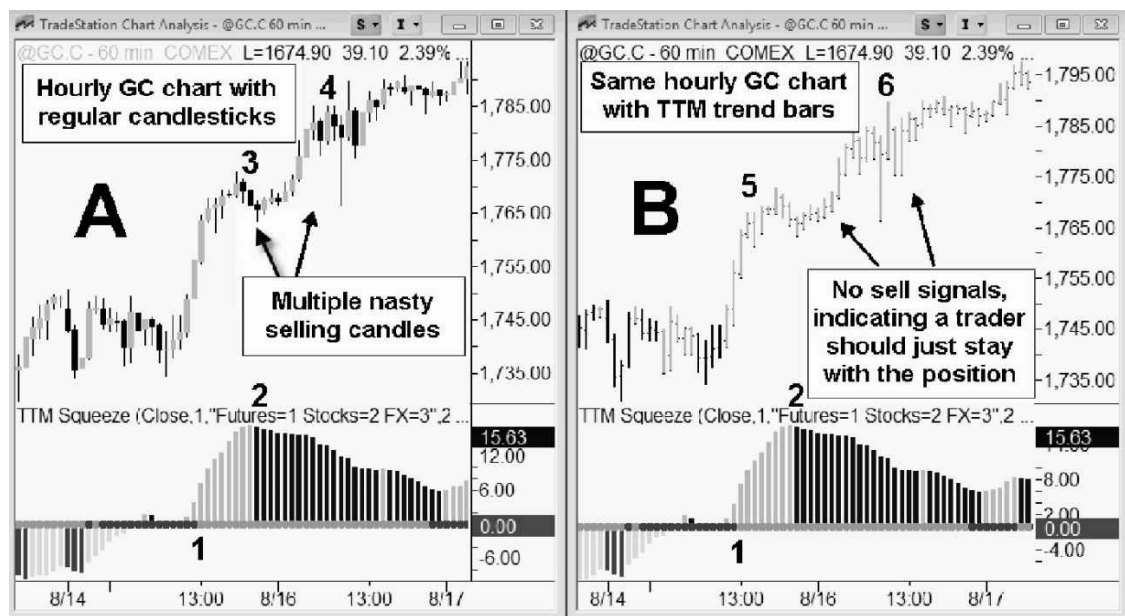


# What Is the Best Tool for Staying in a Trade and Not Jumping Out Too Early?

## Entries Are a Dime a Dozen; It's the Exits That Make You Money

This is going to be a short and simple chapter, and we are going to kick it off by looking at [Figure 13.1](#). This shows two identical hourly charts of GC, the gold futures contract. The chart on the left (Chart A) has regular candlestick bars, while the chart on the right (Chart B) has TTM trend bars. Otherwise, these two charts are exactly the same, showing exactly the same price action over the three days from August 14 through August 17, 2011.

Figure 13.1



One of the biggest problems I hear from traders is, “How do I learn to hang on to a winning position? I always end up taking profits way too fast. I just can’t help myself, and nothing I do seems to help.” The temptation to take profits too soon is great—remember, the market lures us into thinking that this is a good idea, when in actuality it is one of the main reasons traders struggle to make a consistent living from the markets. This is, simply put, a very bad habit. So how does a trader hang on to a winner?

A lot of traders I know start their careers looking at candlestick bars, which are good for evaluating price action. The only thing I don’t like about them is that it is easy, especially for newer traders, to get too caught up in the action on the current bar. It is easy to get tunnel vision and to place too much importance on what is happening “right now” as opposed to looking at that action in the context of the prior six bars. One nasty-looking bearish engulfing candlestick is enough to drive most traders out of a long position, or vice versa with

a bullish engulfing candlestick while they're in a short position. Those candlesticks are nerve-racking, to be sure. Yet many times, the market continues moving in the intended direction shortly thereafter. Worse, many traders then "chase the market" in order to reestablish their position, since it is still moving. "Oh, man," they think. "It's not done!" And that is yet another bad habit that will prevent a person from being able to do this for a living. It truly is a vicious cycle. What happened in this instance is that a trader got "shaken out" of a perfectly good trade because she placed too much emphasis on the action of a single bar. This is the issue that needs to be addressed.

I prefer to look at TTM trend bars (similar to Heikin-Ashi bars), which take the action of the prior six bars into account before rendering a verdict of bullish or bearish. This technique literally takes in the average price of the prior six bars. If the average price of the prior six bars is in the upper half of that trading range, then it will paint the current bar blue, representing a bullish bias and solid buying pressure. However, if the average price of the prior six bars is in the lower half of that trading range, then it will paint the current bar red, representing a bearish bias and steady selling pressure. On the right-hand chart (Chart B) in [Figure 13.1](#), this "bullish blue" is shown as light gray bars, and "bearish red" is shown as black bars. Let's take a look. This is where it all starts coming together.

[Figure 13.1](#) shows a squeeze that fired off long. As we learned in the squeeze chapter, these moves are considered to be over once there is a loss of momentum, which occurs at point 2. This is a valid exit strategy. However, I've noticed that many times, a market will keep moving higher after this exit signal. What do I do? I will take off half my position at the loss of momentum at point 2, and I will move my stop to my entry point. I will then wait for the TTM trend bar to change color for two bars in a row before I get out of the rest of the position.

### **How Do I Protect Myself When They Are Trying to Shake Me Out of My Position?**

[Figure 13.1](#) shows "nasty candles" on the left-hand side (Chart A) at points 3 and 4. These look scary, as if real selling is coming into the market. It's a sign to bail out, right—to get out frantically before the market can take away any more of our profit? Or . . . is it meant to be a fake-out? After all, the market continues moving nicely higher right after these two "short and nasty" selling sprees. To be blunt, it's meant to be a fake-out. It's meant to shake traders out of their positions. Not that anyone at Goldman Sachs would try to shake us out of our position so that he could get back in at a cheaper price. . . .

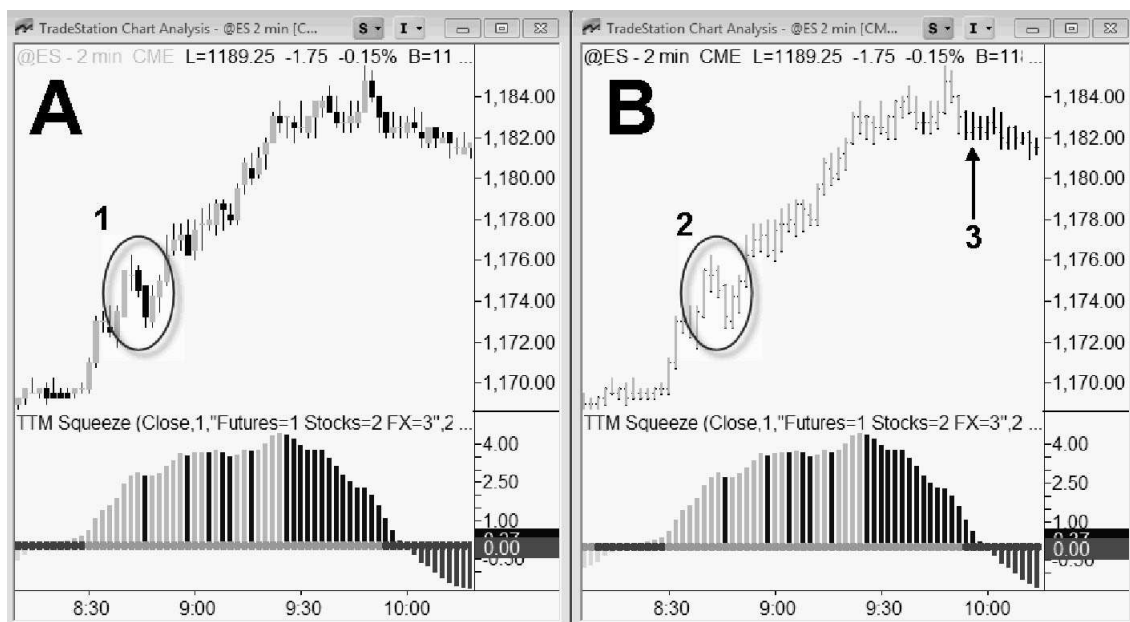
How do we fight this? Take a look at Chart B in [Figure 13.1](#). It's the same trade. The same points are marked on the chart at 5 and 6. And yet what looked like nasty selling candles on Chart A show up as "merely nothing" on Chart B. There is no sell signal on Chart B. Remember, since we are long, we are looking for two black bars (which, on a color chart, would show up as red) before we bail. These two black bars would represent real selling and a potential trend change coming into this market on this time frame. On Chart B, there is no exit signal. We are still long at the top of the chart, with gold trading at \$1,795.00, while many newbie candlestick traders got shaken out at points 3 and 4 on Chart A.

Trading is not meant to be easy. It is meant to trick most of the people most of the time. No one is going to make it easy for you to stay in a position. Others will try to scare you out so that they can take your position from you at a cheaper price. Where do you think liquidity and volume come from? If you sell too soon and get

panicked out of a trade too fast, well, that liquidity comes from you. Whereas it is easy to get faked out of a trade by a scary candlestick, a trader who takes the current price action's behavior into consideration will be able to withstand the small countertrend shocks that are meant to shake traders out of their position.

Let's take a look at another trade. Figure 13.2 shows the devious ES contract on a two-minute chart. The ES is famous for shaking traders out of their positions right before they make their next move. A squeeze fires off at 8:30 a.m., allowing traders to get in on the long side at 1171.00. Prices grind higher for about 10 minutes, and then, *wham*, prices get knocked down from 1176.25 to 1172.75 quickly, as indicated by point 1 on Chart A. Many traders would get knocked out here on a trailing stop that they are trailing too closely. Others would see the nasty candles and just get the hell out, probably near the lows. Did they still make money on the trade? Yes, there is nothing wrong with making 1.75 points (7 ticks) on the ES, or \$87.50 per contract. But take a look at Chart B. The nasty selling at point 2 never materialized into "two black selling bars," so there was nothing to do here but hold on to the position until that event took place on the chart. This eventually did happen, about an hour and a half later, at point 3. At this point, a trader could get out near 1182.50, a gain of 11.50 (46 ticks), or \$575.00 per contract. That is the difference between getting suckered into selling too soon and staying in a trade until it is truly over.

Figure 13.2

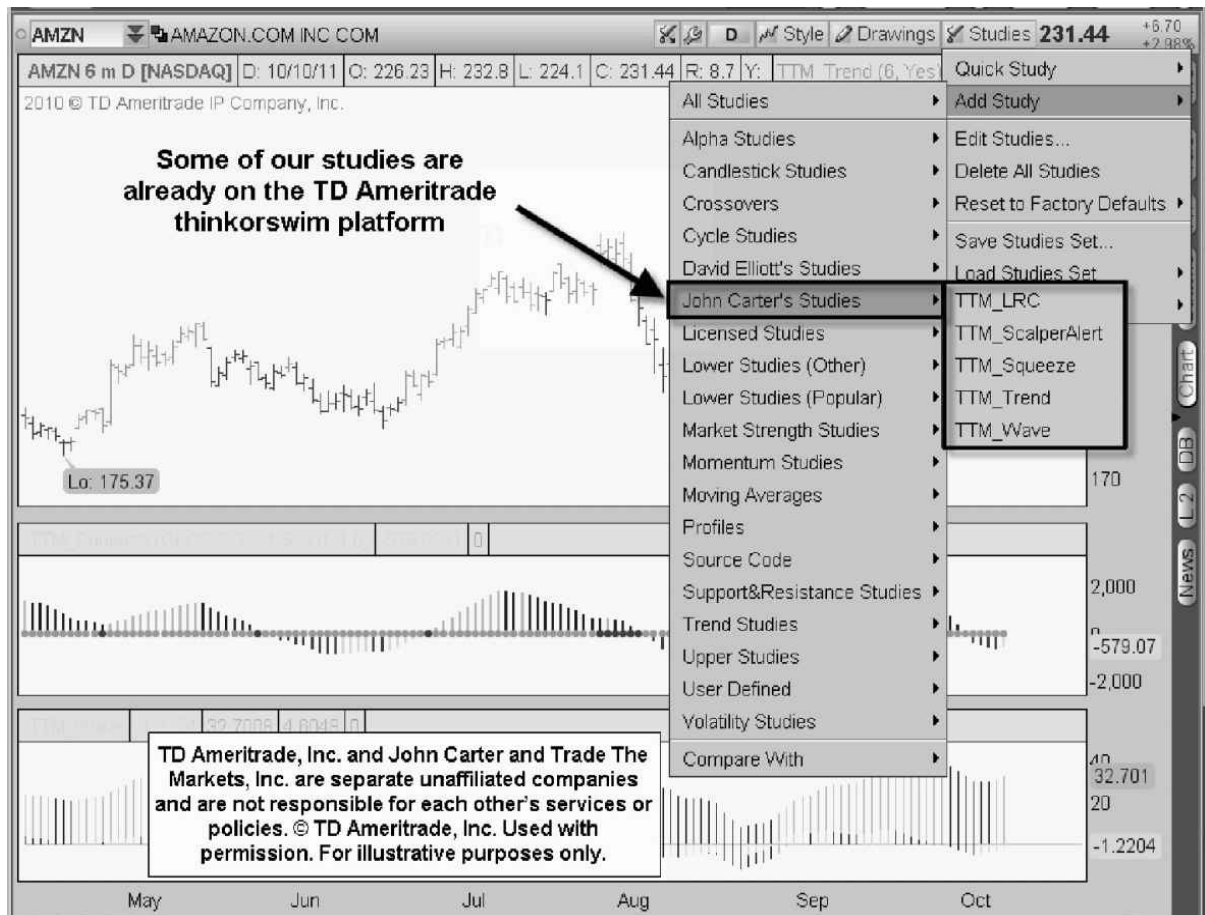


I utilize the TTM trend bars for exit management. I typically don't use them for entry signals, as I'd rather wait for something like a squeeze to get into a position, or even use other entry techniques discussed in this book. I have found, however, that this is one of the better tools for managing exits.

The indicators I've discussed so far are "ideas" that can be programmed, downloaded from our website at [www.simplertrading.com](http://www.simplertrading.com), or found on other platforms. Figure 13.3 shows the TD Ameritrade/thinkorswim platform, which has some of our indicators already built into its platform. For other platforms, like TradeStation, eSignal, Ninja Trader, or Infinity Futures, and others, we have these indicators available for download from our website. Some are free, and others have a fee that we split with the programmers who put

them together. If you are handy with the programming part of things, these are fairly easy to recreate on your own.

Figure 13.3



For additional videos on the TTM trend, as well as other “bar-based” trade management tools that have been developed over the past several years, visit [www.simplertrading.com/trendbars](http://www.simplertrading.com/trendbars) for the most up-to-date ways in which I’m utilizing this indicator.



# Scalper Alerts: Is This the Best Tool for Quick Price Trend Change Confirmation?

## How Do You Identify and Profit from Changes in Trend Without Catching a Falling Knife or Stepping in Front of a Freight Train?

In watching the markets over the years, I've observed that most reversals take place after three consecutive higher closes or three consecutive lower closes, and this tendency is valid for all time frames. The key to this setup is that it is based on consecutive closes and not just on intraday or daily high and low price action for an individual price bar on a chart. In other words, the highs and lows are not important. I'm not interested in three higher price highs or three lower price lows. I want to see where the action settles or closes, because that is where the rubber meets the road.

The hard way to follow this play, especially intraday, is to stare at the charts and keep track of consecutive lower or higher closes until you get three in a row. This can cause a person to go bug-eyed, not to mention insane, and is recommended only for those who get a thrill from "the little things in life." I'm not a big fan of staring at charts, and I would be a prime candidate for the mental hospital if I did this with the naked eye. Instead, I've developed a simple indicator that will "paint" the first bar in the sequence after the third bar has met the criteria for a signal. Once I see the painted bar, I just place a market order, and I'm in the trade. Even better, I set up an audio alert so that if I'm down the hall, I'll hear the signal and come back to my computer to place the trade. This works when I'm on the phone with my wife as well, although she has yet to appreciate the importance of the signal and my urgent need to hang up in the middle of our conversation. Such is the life of a trader.

For the indicator, I did add one key filter. I found that at times I could get shaken out of a play that was consolidating (that is, a bull flag) when prices made a series of lower closes within that consolidation. So, if there are three lower closes, but this price action does not go below the signal bar's low, then I ignore the signal. For this indicator on a long signal, then, the trigger bar would be the first bar that has a higher low than the previous bar. The next bar that closes above the high of this trigger bar paints this previous low bar, which now becomes the swing low point. In most cases, all of this happens with "three higher closes," but there are times when it is not as clean, and these instances are taken into account with the one confirmation that really matters—price.

I use this signal in various time frames. For scalping the E-mini S&Ps, I like to use a 233-tick chart, because the signals are very fast. On the mini-sized Dow, I will use a 144-tick chart for scalping and a five-minute chart to catch the one or two reversals that set up on any given day. For swing trades, I will use both 60-minute and daily charts. I like to use this primarily on the stock index futures and the major currency pairs, but it works just the same in any market, in any time frame. It is simple, and it is based solely on the price action. I will also use this signal for individual stocks that I am following.

## Why Are Tick Charts Best for Scalping?

For tick charts (not to be confused with the NYSE \$TICK play I discussed earlier), I like to use Fibonacci sequencing numbers. If you Google that phrase, it will bring up a list of numbers that looks like this: 5, 8, 13, 21, 34, 55, 89, 144, 233, 377, 610, 987, 1,597, 2,584, and 4,181 (and so on). Of course, the list keeps going, but we don't need them all. There is no need to test the 144-tick chart vs. the 143-tick chart to see which is better. Why tick charts? A 377-tick chart forms a new bar every 377 trades. When the volume is slow (especially in the overnight session), this chart crawls along. When the volume and trading are fast and furious, this chart will develop at a much faster rate. In sum, when the market is slow, so is the chart. It's not pressured to form a new bar every two minutes (as is the case with a two-minute chart), regardless of the volume, thus firing off false signals when low-volume conditions exist. When the trading is fast, so are the signals. Tick charts adapt to the market, and I find them especially useful for day trading. How do we know which tick chart to use? There isn't an exact science, but the rule of thumb is this: the higher the volume, the higher the tick chart. While I use a 987-tick chart for the ES, I'll use a 144-tick chart for the YM. The only difference is volume. As a general rule of thumb, the 377-tick chart is good for day-trading most commodities, as well as individual, high-volume stocks.

Let's quickly review what a 233-tick chart is for anyone who hasn't used one before. Remember, this type of chart forms a new bar every time there are 233 trades executed. It doesn't matter what the size of any of the trades is, just that 233 trades have crossed the tape. I like to use these charts when I'm scalping for two reasons. First, they are faster than regular time charts when it really matters—when the trade frequency accelerates. In comparison, a two-minute chart is going to form a bar every two minutes, regardless of how fast or slow the trading is. With a tick chart, when the trade frequency slows down, so do the signals that are firing off in this time frame; thus, these charts naturally keep a trader out of the market when there is nothing going on. Second, traders in the pit have no concept of time with respect to a two-minute or a five-minute chart. They are focusing on the actual frequency of trades, and a breakout on a two-minute chart means nothing to them. Although I prefer the 987-tick chart on the ES for intraday swing trades, meaning trades that I could be in for half an hour or more, I will at times use the 233-tick chart for faster scalping. A couple of example plays with tick charts are shown here.

## What Are the Trading Rules for Buys (Sells Are Reversed)?

1. Set up a 24-hour chart on intraday charts so that the overnight activity can be accounted for in this indicator setup. This can be used in all time frames. The larger the time frame, the larger the parameters and the potential move. For daily charts, I will use the regular session hours.
2. After three consecutive higher closes, I go long at the market at the close of the third bar in the sequence.
3. The trade is valid until three consecutive lower closes occur, at which point I exit the trade. If the market is still open for an intraday trade, I will simultaneously exit a long and establish a new short position. I don't use a stop loss on this for intraday chart trades because the reversal signal is my exit strategy, whether it is a loss or a gain. For daily charts, I will place a stop at the low of the bar that



caused the signal to fire off, which is the first of three in the sequence of closes.

4. If I'm in an intraday trade (a 15-minute chart or smaller) and the market closes before giving an exit signal, I will exit at the market at 4:10 p.m. eastern.
5. For time frames that are 60 minutes or longer, I will stay in them overnight and exit at the next signal. This could be the next day for a 60-minute chart, and it could be a month later for a daily chart.

### Specific Examples of Scalper Alert Buy and Sell Setups

*E-mini S&P—December 2004 Contract, October 3, 2004*

1. Figure 14.1 is a 233-tick chart of the E-mini S&Ps, which is one of my favorite time frames for taking quick scalp trades in the market. The spot marked 1 on the chart is a little to the right of the painted bar in question. The “paint” is added by TradeStation, and it is the thick black mark that covers the bar. This bar is painted because it is the first bar in a series of three with consecutive higher closes.

Figure 14.1



2. When I see the painted bar signal, I go long at the market. I am filled at 1133.25, which is where we closed at point 2, which is the close of the third bar of this series of higher closes. (This will get easier, I swear.)
3. I am now in the trade until I get a signal that a reversal has developed. Later in the trading session, I get the next painted bar signal, which indicates that a series of three lower closes in a row has taken place. I place an order to sell my long position at the market. Note that the next signal will not show unless it is a reversal. There is a series of many higher closes during this rally, but none of them

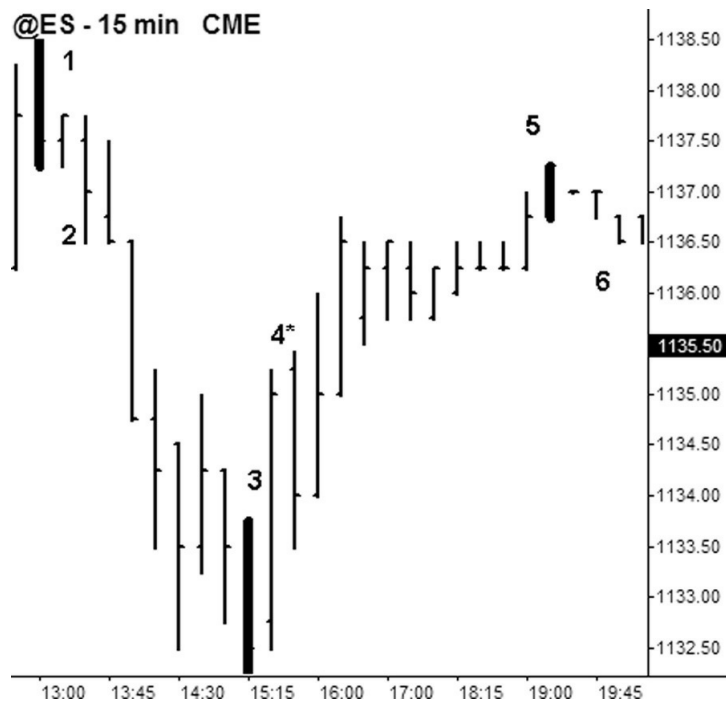
constitutes a reversal, so they are ignored because the original signal has already fired off.

- I am out at 1138.50, which is the close of the third bar in the series of lower lows at point 4 on the chart. The gain on the trade was +5.25 S&P points, or \$262 per contract. It is interesting to note that during this trade, all the oscillators were measuring overbought near the 1135.00 level, which would have gotten some traders out and caused other traders to start going short. Using this setup, the only thing that matters is the price, which, in reality, is the only thing that matters.

*E-mini S&P—December 2004 Contract, October 5, 2004*

- On October 5, 2004, I get a short reversal signal near 1:00 p.m. eastern on the 15-minute ES chart, and I enter at the market right after the signal fires off (see Figure 14.2).

Figure 14.2



- I am filled at 1137.00. I'm now waiting for the next reversal signal to cover my short and go long.
- As we approach 3:00 p.m. eastern, we get a signal, and I cover my short and also go long at the same time.
- My fill is 1134.00. I'm out for +3.00 points on the S&P play, and I have established a new long position.
- There isn't another reversal signal until near 8:00 p.m. eastern. However, because this is off an intraday chart (15 minutes or less), I exited this position at the market at 4:10 p.m. eastern, and I was filled at 1133.75 for a loss of 0.25 point.
- Some traders I know like to watch the action 24 hours a day, and they would stay in the trade until point 6. They would have gotten out at 1136.50 for a gain of 2.50. I don't recommend this. The

market action in the stock index futures after hours is slow and irritating, and there are many other things I'd rather do with my time. If you want to trade actively after 4:00 p.m. eastern, then by far the best liquidity and opportunities are in the currency markets. I prefer the Forex cash markets in this regard because there is more liquidity in the various currency pairs during this post-4:00 p.m. time frame. When markets are active and liquid, they are tradable. When they are quiet, let them be.

*E-mini S&P—December 2004 Contract, September 30, 2004*

1. At 12:30 p.m. on September 30, 2004, I get a signal on the 60-minute ES chart, indicating that a reversal is in place (see Figure 14.3). The bar that is painted is the 10:30 a.m. bar. Remember, even though the 10:30 a.m. bar is painted, the signal didn't actually fire off until the close of the third bar at 12:30 p.m. (the 10:30 bar is the first bar, the 11:30 bar is the second bar, and the 12:30 bar is the third bar).

Figure 14.3

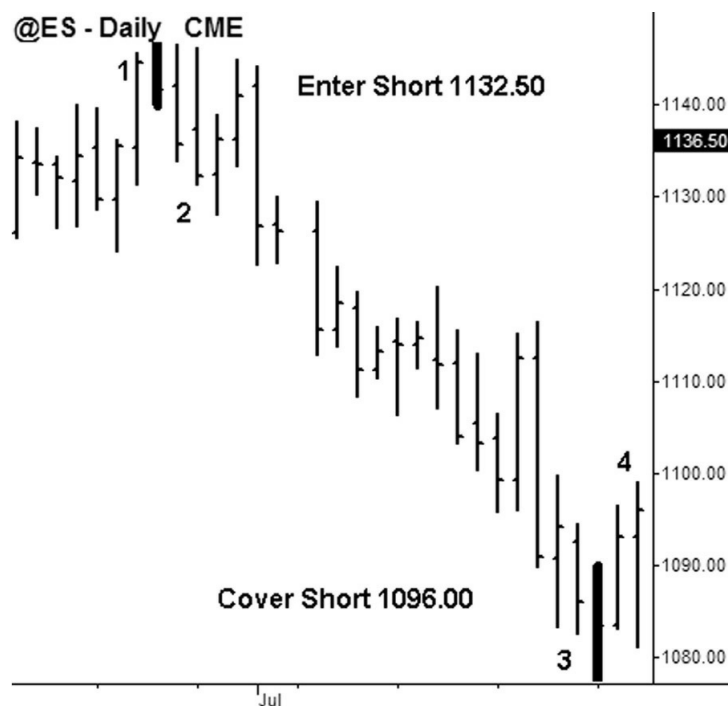


2. At 12:30 p.m., I go long at the market, and I'm filled at 1114.75. I am now awaiting the next reversal signal in order to exit my position.
3. I get my next signal a few days later, on October 4.
4. I exit at 1136.50, for a gain of 21.75 S&P points, or \$1,087.50 per contract. The 60-minute chart is great for catching swings that last anywhere from two to five days. This is a great setup for people who are holding down a full-time job and don't have time to stare at the markets all day. In addition, this is a great setup for people who are day trading and are currently losing money. This 60-minute setup forces discipline and prevents a trader from overtrading, which is by far the number one reason why most traders fail to make money in this profession.

*E-mini S&P—September 2004 Contract, June 28, 2004*

1. On this daily chart of the S&Ps, a signal fires off on June 28, 2004, which paints the June 24 daily bar (see Figure 14.4). (June 26 and 27 were the weekend.)

Figure 14.4

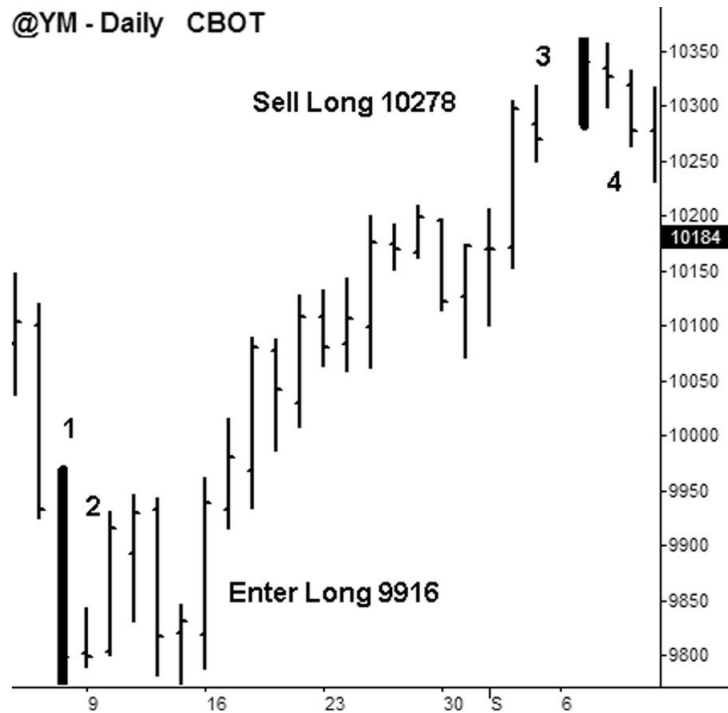


2. I go short at the close of the third day, which is what triggered the signal. I'm in the trade at 1132.50. I will now stay in the trade until I get a reversal signal. For a stop, I use 1136.50, which is the high of the June 24 bar. In my experience, the actual stop is rarely hit because a reversal signal will fire off before the markets reach that level.
3. On July 28, a month later, I get a reversal signal that paints the July 24 bar.
4. I exit at the market on July 28 at the close. I'm out at 1096.00, for a gain of 36.50 S&P points, or \$1,825 per contract. Again, this setup is great for people who are working and don't have time to stare at the markets all day. I also think it is important for full-time traders to have two accounts, one for day trading and one for swing trading. During a period when a trader's day trading isn't going well, it is possible to catch a good move in the swing-trading account using setups like this.

*Mini-Sized Dow—September 2004 Contract, August 10, 2004*

1. On this daily chart of the mini-sized Dow futures, a long signal occurs on August 10, 2004, which paints the August 6 bar (see Figure 14.5).

Figure 14.5



2. I go long at the close of August 10, and I'm filled at 9916. I'm now waiting for the next reversal signal in order to exit the trade. The low of August 6 is 9809, which is where I place my stop.
3. The next signal hits on September 7, nearly a month later.
4. I'm out at 10,278, for a gain of 362 YM points, or \$1,810 per contract. One of the things I like about these swing trades is that they tend to take care of themselves. Compared to the active and sometimes frantic pace of intraday trading, it's almost like buying a rental property and turning the maintenance over to a management company. The type of trading a person chooses to do is really a reflection of her personality. Someone who is inherently a swing trader will have a tough time at day trading.

*KLAC (KLA-Tencor Corp.), April 5, 2004*

1. On this daily chart of KLAC, a reversal signal sets up on April 5, 2004 (see [Figure 14.6](#)).

Figure 14.6

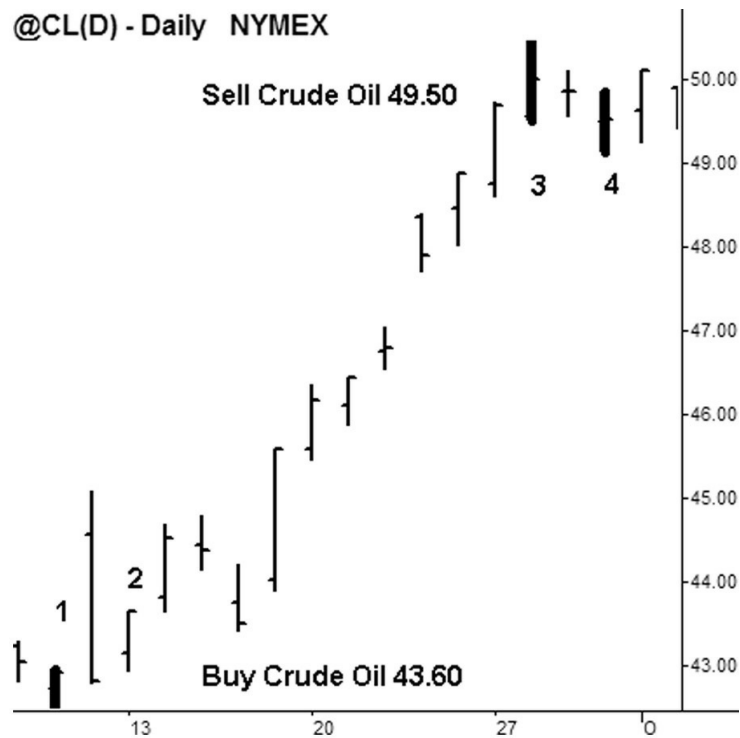


2. I take a short at the close and get in at 52.51. My plan is to stay in the trade until I get the next reversal signal. My stop is the high of the signal bar, which is 53.97.
3. About a month later, on May 3, I get a reversal signal.
4. I cover my short at 42.96 for a gain of 9.55. For traders who just focus on stocks, this is a great setup to use on the daily charts to catch reversals.

*Light, Sweet Crude Oil—September 2004 Contract, September 9, 2004*

1. It is important to note that this setup is based purely on price action, and therefore works in all markets (see [Figure 14.7](#)). On September 9, 2004, a reversal signal is painted on crude oil.

Figure 14.7

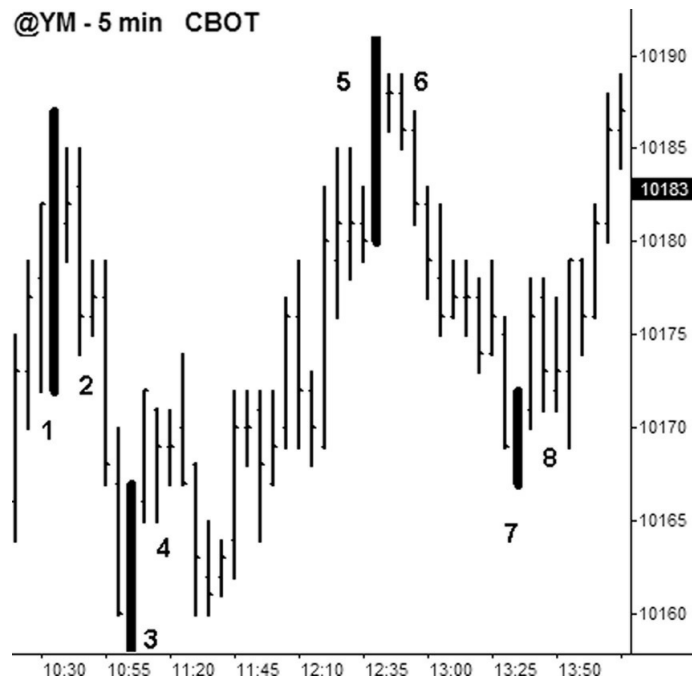


2. The resulting long is entered at 43.60.
3. On September 28, the reversal painted bar is in.
4. I'm out of the trade at 49.50, for a gain of 5.90. Note that this exit bar also became an entry signal to get back into the trade long, as the market reversed right away and made three higher closes. If you are not familiar with crude oil, a one-dollar move is worth \$1,000 on the big contract and \$500 on the mini-contract, so a move of 5.90 equates to \$5,900 per contract on the big contract (symbol = CL) and \$2,950 per contract on the mini-contract (symbol = QM). The quote feed a person needs to get live crude oil prices is NYMEX. There is an option for this in eSignal and TradeStation, and it's also available through most of the other robust quote vendors.

*Mini-Sized Dow—December 2004 Contract, October 6, 2004*

1. I wanted to use this example to show how I flow into and out of positions intraday, going both long and short (see [Figure 14.8](#)). This is best done on lower-value intraday charts, such as five-minute charts or a tick chart like 233. The first signal on October 6, 2004, in the YM is painted at 10:35 a.m. eastern.

Figure 14.8



2. This means, of course, that I am going short at the close of the last bar in the sequence of three bars, which is 10,176.
3. The next reversal is noted on the chart at point 3.
4. I cover at 10,169 and simultaneously go long. The easy way to do this is to double the number of contracts you are trading on your exit order. So, if you are long 10 contracts, then you place an order to sell 20 contracts in order to exit your 10 long contracts, and at the same time establish a new position that is short 10 contracts.
5. The next signal occurs at point 5.
6. I go long at 10,186 and simultaneously go short at this same level.
7. The next signal occurs at point 7.
8. I cover my short at 10,173 and go long at the same level.

I'd like to share some examples of this same setup in the Forex currency markets and continue to add commentary regarding the trading of these instruments. Let's start with a market that most traders are familiar with, the euro currency as it trades against the US dollar.

#### *Forex Markets—EURUSD, October 15, 2004*

1. On the daily chart of EURUSD (see [Figure 14.9](#)), a long signal fires off on October 15, 2004. I go long near point 1 at 1.2469. Remember, the stop is the lows of the signal bar.

**Figure 14.9**





2. The market has a steady move higher off this level, pausing to consolidate for a week in early November. However, there aren't any reversal signals given during this time, so there is nothing to do but sit on my hands and stay in the trade. EURUSD resumes its rally and shoots up hard into the end of December. At this point, the market rolls over, and many people in this trade start taking profits. Again, however, there are no sell signals using this setup. Finally, on January 3, 2005, nearly 2½ months after the initial buy signal, a sell signal is generated at point 2. I exit at 1.3467, for a gain of 998 pips. At \$10 per pip, that is \$9,980 per individual lot that is being traded. For each lot, a trader needs to have \$1,000 in his account. This is part of the large attraction of the Forex markets—the ability to establish specific stops while using leverage to ride out a potential trend until it turns. Forex traders often talk in terms of the dollar value of the contract they are trading: one lot (contract) represents \$100,000 worth of currency, 10 lots represent \$1,000,000 worth of currency, and so on. Being long 10 lots is referred to as having a “buck” (that is, a dollar). If I'm long 35 lots of EURUSD and I need to call my broker to change my order, she will refer to my position as “3½ bucks.” Also, catching 1 full cent, or 100 pips, is referred to as catching “one large.” So on this play, we caught almost “10 large,” which is, of course, a huge play. In the interbank market, which is where all the institutions and large funds trade currencies, the smallest trade size is \$1,000,000, or the equivalent of trading 10 lots through your retail Forex broker.

*Forex Markets—GBPUSD, May 9, 2005*

1. On this daily chart of GBPUSD (see [Figure 14.10](#)), a short signal sets up on May 9, 2005, at point 1, and I go short at 1.8837.

**Figure 14.10**



2. The market sells off steadily, and on June 3, 2005, it fires off a reversal signal at point 2. I cover my position at 1.8148, for a gain of 689 pips or \$6,890 per contract. Or, in Forex trader speak, almost seven large.

*Forex Markets—GBPUSD, August 2, 2005*

1. While this signal works well on daily charts for the Forex markets, it also works well on intraday charts for day trading. On this five-minute chart (see [Figure 14.11](#)) of GBPUSD, a long signal sets up on August 2, 2005, at point 1. The entry is 1.7696.

**Figure 14.11**



2. About an hour later, the corresponding reversal signal fires off at point 2. This is the heads-up to close out this position. The price level is 1.7724, a gain of 28 pips, or \$280 per contract.

*Forex Markets—AUDUSD, July 31, 2005*

1. On July 31, 2005 (see [Figure 14.12](#)), AUDUSD sets up a long signal on the 60-minute chart at point 1. The long entry is at 0.7560.

**Figure 14.12**



2. The next day, on August 1, 2005, a reversal signal is given at point 2, and we exit the play at 0.7604, for a gain of 44 pips. Remember, any currency pair that ends in “USD” is worth \$10 per pip, so the gain on this trade is \$440 per lot being traded. The three main currencies I trade that end in “USD” are the euro (EURUSD), the pound (GBPUSD), and the Aussie (AUDUSD). If a currency ends in “USD,” this means that it will generally move in the opposite direction from the US dollar index. If the dollar is moving higher, then the euro, the pound, and the Aussie are selling off. Of these three currencies, the euro and the pound are most closely correlated with the dollar. The Australian dollar is also tied closely to commodity prices, as Australia is a huge exporter of various commodities. Because of this, the Aussie at times doesn’t move in direct correlation with the US dollar. Let’s take a look at the other main currency pairs.

*Forex Markets—USDCHF, July 21, 2005*

1. On July 21, 2005 (see [Figure 14.13](#)), USDCHF sets up a long signal on the 60-minute chart at point 1. The long entry is at 1.2855.

**Figure 14.13**



2. A few days later, on July 24, a reversal signal is given at point 2, and we exit at 1.2971, for a gain of 116 pips. Since this currency pair does not end in “USD,” the valuation of the pip will be slightly different from that in the previous examples. When this play was taken, the value of a pip was around \$7. So, in this case, 116 pips equates to a gain of \$812 per lot being traded. This currency, the Swiss franc, trades very closely with the US dollar. If the dollar is going higher, so is the Swissy.

*Forex Markets—USDJPY, July 20, 2005*

1. On July 20, 2005 (see [Figure 14.14](#)), USDJPY fires off a short at point 1 on the 120-minute chart. The short entry is at 112.85.

**Figure 14.14**



2. The next day, on July 21, the market gives a reversal signal for an exit at 110.40 at point 2, a gain of 245 pips. Pip value on the USDJPY at the time of this writing was around \$8, so this translates into a gain of \$1,960 per lot being traded, or 2½ large. The Japanese yen also moves very closely with the dollar.

*Forex Markets—USDJPY, July 22, 2005*

1. On July 22, 2005 (see [Figure 14.15](#)), USDJPY fires off a long signal at 111.12. The market quiets down shortly thereafter, but has a steady grind higher.

**Figure 14.15**



2. About a week later, on July 28, a reversal signal shows up on the chart at point 2, signaling an exit at 112.10. This is a gain of 95 pips or \$784 per retail lot. All “lots” discussed in these Forex trades are based on the retail “standard” lot, which is worth \$100,000. This is as opposed to the “mini,” which is worth \$10,000.

*Forex Markets—USDCAD, July 21, 2005*

1. On July 21, 2005 (see [Figure 14.16](#)), USDCAD fires off a long signal at point 1. The entry is 1.2169. The market consolidates for a few days and almost stops the play out, but a sell signal is never given. In this situation, there is nothing to do but wait for a signal to exit the trade. We’ve already established why human emotion makes a poor “exit signal.”

**Figure 14.16**



2. Nearly a week later, on July 27, a reversal signal is given at point 2, and we are out of the long at 1.2360, a gain of 191 pips—almost two large. The rate for pips on this currency pair during this play was about \$6, which translates into a gain of \$1,146 per lot being traded.

After reviewing this play, we’ve now covered the six major currency pairs that most traders focus on. However, there are other currency pairs that are also good to trade, and I will focus on two of my favorites next.

*Forex Markets—EURJPY, August 2, 2005*

1. On August 2, 2005 (see [Figure 14.17](#)), EURJPY—euro/yen—fires off a short signal at point 1 at 136.66 on the 15-minute chart. The market chops around for about an hour before breaking down and selling off.

Figure 14.17

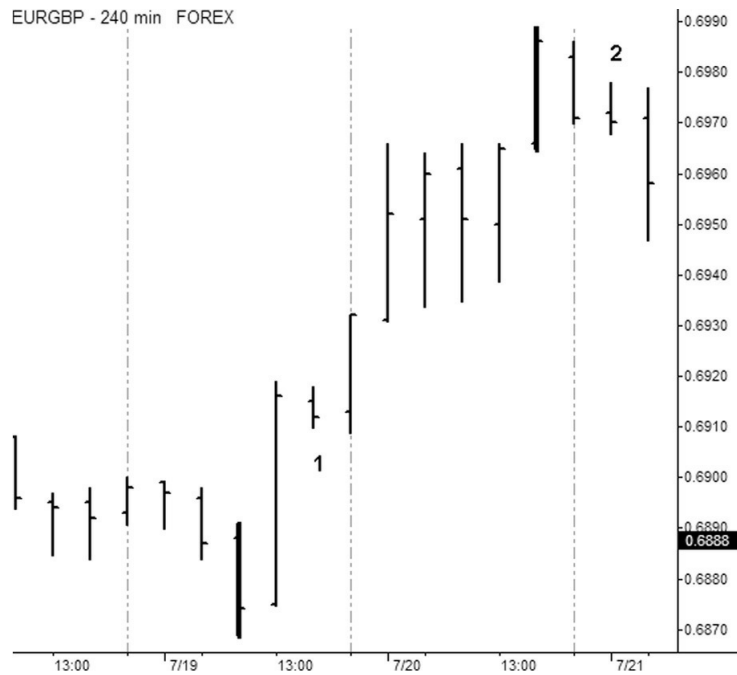


2. Nearly two hours later, a corresponding reversal signal is given at point 2, and I exit the trade at 136.18, for a gain of 48 pips. The pip value on this currency pair was around \$8 at the time of this play, which translates into a gain of \$384 per lot being traded.

*Forex Markets—EURGBP, July 19, 2005*

1. On July 19, 2005 (see [Figure 14.18](#)), EURGBP—euro/pound—fires off a long signal at 0.6912 on the 240-minute chart. The market grinds higher.

Figure 14.18



2. Two days later, we get three lower closes in a row, and the signal fires off at point 2. The exit on the long is 0.6970, or 58 pips. On this currency cross, each pip is worth about \$18, which makes the payout on this play \$1,044 per lot. This is actually a very quiet currency pair, but when it does move, it is very steady, and it tends to act like nothing can stand in its way. Because of this trait, we have nicknamed this currency pair “the tank.”

### Summing Up the Scalper Alerts

Scalper alerts are especially useful for traders who like to try to buy bottoms or short tops. While it is foolish to short a market just because it’s “too high” or buy a market because it’s “too low,” it’s fine to short that high flyer or buy that all-out loser once you get a reversal confirmation with this signal. It doesn’t mean that the dead highs or the dead lows are in place, but it does mean that there has been a temporary shift in power, and it is a valid signal to step in and establish a position. Whether this is an intraday reversal on a five-minute chart or a total market reversal off a daily chart, the concept is exactly the same. In addition, this play is based on pure price action, and I appreciate its simple and effective nature.

### Increase the Probabilities of Success Through Multisetup Combinations

One theme that a trader will find in my setups is that they all work well together. When I’m scalping (which is admittedly less frequent the older I get), I particularly like to combine the pivots with the scalper alerts on a 233-tick chart for the ES and a 144-tick chart for the YM. On days when I’m not sure what the market is going to do, I can wait for a scalper confirmation against a pivot level, as this is a trade that has a very high probability of success. Even better, I will get into a pivot trade, and shortly thereafter I will get a scalper confirmation in the direction of the trade. I can also use the scalper sell reversal to get out of my long pivot trade. I talk about this more in the chapter on developing a business plan, but the idea is to find what makes sense to you and your personality and mix and match accordingly.



There are other tools you can use with this indicator, such as price channels, that work really well in terms of pinpointing high probability turns. We've set up [www.simplertrading.com/scalper](http://www.simplertrading.com/scalper) for updated information on this indicator, other free tools that work well with it, as well as additional examples.



# Brick Plays: How Can I Tell When a Market Is Going to Reverse Its Trend in the Middle of the Day?

## Using Bricks to Capture Intraday Reversals in the Mini-Sized Dow

The best intraday trades take place when a trader can catch the major portion of an intraday reversal. One of the best ways to do this is with a specific price pattern that we call *bricks*. We call them bricks because the price pattern that is formed looks like a bunch of building blocks that have been placed on top of a regular bar chart. These building blocks are formed on the chart because of specific price action. A series of three consecutive higher closes will form an “up” brick, and a series of three consecutive lower closes will form a “down” brick.

If you have a hard time pulling the trigger, this is a good play to use with buy stop and sell stop orders, as you will see in a moment. If you don't have a hard time pulling the trigger, then you can just wait for the signal and go in at the market. This is one of those plays that are difficult to explain, but easy to show. In this case, a picture is worth at least 1,000 words, if not more, so let's go through the trading rules and then go over a couple of actual plays.

## Trading Rules for Buys (Sells Are Reversed)

This is a momentum reversal confirmation play.

1. Set up a 24-hour time frame on an intraday chart so that the overnight activity can be accounted for in this indicator setup. This is best used on smaller time frames, typically less than five minutes, although it can also be used for swing plays on daily charts.
2. Once a market shifts direction, which is denoted by the bricks changing color, count backward to the third brick in the formation.
3. Then draw a horizontal line across the top of this third brick back.
4. Once the price action breaks above this horizontal line, go long.
5. For scalp trades on smaller time frame charts, I use this setup on the mini-sized Dow, starting off with a 10-point stop from the entry. Then when I'm up 10 points, I sell half the position and move the stop to breakeven -3. (So, if the entry was 10,545, then the new stop is 10,542.) If the market goes up another 10 points, then sell a quarter of the position and then moves up the stop 6 points to breakeven +3. (If the original entry was 10,545, the new stop after the second target is hit is 10,548.) Then hang on to the last quarter of the position to exit at your discretion, or through an exit signal like the TTM Trend or Scalper Alert. Or, to keep it easy, hold on to this last part of the position until the bricks signal an opposing sell signal.

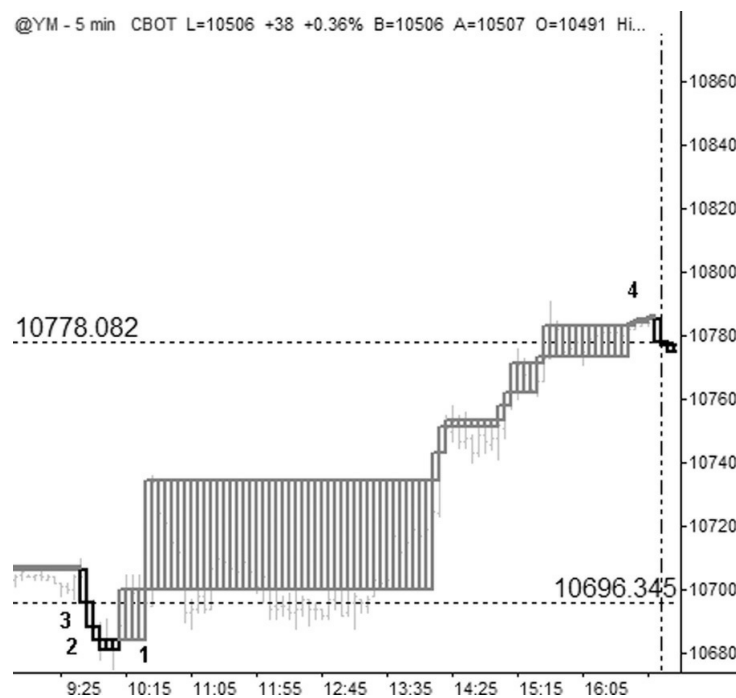
- I will get into the same trade and use a 20-point stop. I will exit half my position at +15 points and then stay in the trade until there is a brick that has formed in the opposite direction—an opposing sell signal. I don't trail the stops. Both methods work well, and this is a good example of how different exit strategies can be utilized on the same setup, based on whatever fits your personality best.

Let's take a look at some actual plays.

*Mini-Sized Dow—March 2005 Contract, February 25, 2005*

- On this five-minute chart of the mini-sized Dow futures on February 25, 2005, a long signal occurs at around 10:00 a.m. eastern (see Figure 15.1). This takes place when the price action reverses and crosses above the horizontal line created by the third brick back in the series. The first brick in the series is the black brick labeled as point 1, the second is that labeled as point 2, and the third is that labeled as point 3. The entry price is 10,696. This horizontal line is drawn in manually. Originally it started on the brick above where the line is currently drawn at point 3. This horizontal line was sitting near 10,710. However, as the market continued to push lower, additional down bricks were formed, and the horizontal line was trailed three bricks back accordingly. This line, representing the entry point for a long, continues to be trailed down as long as new down bricks are being formed. It is only when the markets can cross back above the third brick back in the series that a trade signal occurs. On a color chart, the up bricks are blue, and the down bricks are red. On these charts, the up bricks are light gray and the down bricks are black.

Figure 15.1



- In this instance, once the trade is entered, the YM rallies to almost 10,790 before rolling over. A reversal signal is generated shortly thereafter at point 4 at a price of 10,778, for a total move of 82

points.

I want to also discuss three different ways in which this setup could be played. The first and most straightforward way would be to stay in the entire trade from entry to exit, capturing the entire move. In this type of play, I start off with a 20-point stop and then stay in the trade until the reversal signal occurs. The downside of this is that the market could rally 18 points, then roll over and stop out the trade.

Another way to play this is to exit half the position at a purely mechanical price target. This is how I play this. By exiting half of your position at a predetermined mechanical level for the first half of the trade, some profits will already have been taken. This can mean the difference between a losing trade and a scratch trade. So, the second way to play this is to start off with a 20-point stop, exit the first half of the position at a mechanical level, such as 15 points, and then exit the second half upon a reversal. This is typically how I play the bricks.

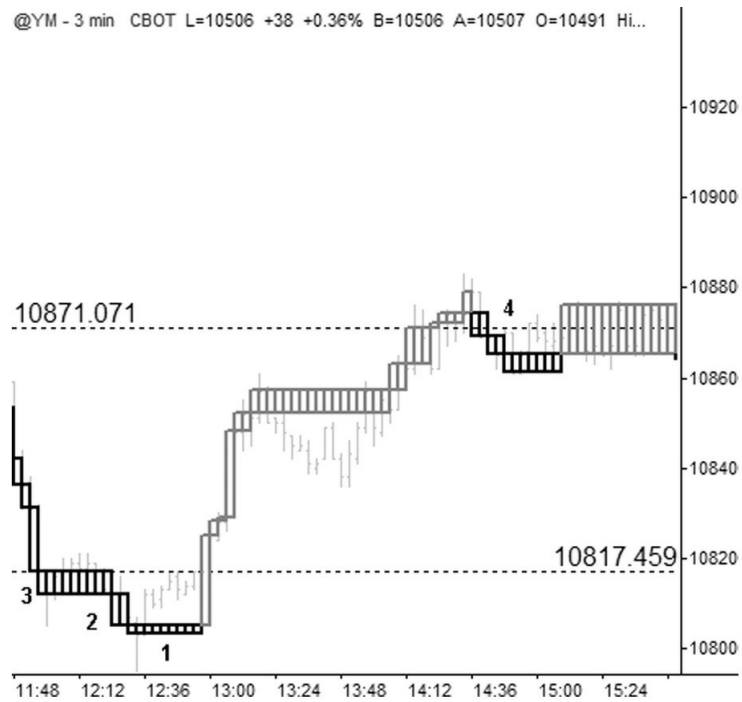
The third way to play this is to use a 10-point stop and then start peeling out of the position almost immediately. In this case, sell half of the position when the trade is up 10 points, sell another quarter when it's up 20 points, and hold on to the rest until the reversal. Note that these exit strategies can be used on all the intraday plays discussed in this book.

These are all valid exit methodologies for this setup. It is important for a trader to recognize that every setup can be played in different ways and to find the way that best suits her own personality. For the rest of the examples, I focus on the actual reversal points as entries and exits.

#### *Mini-Sized Dow—March 2005 Contract, March 3, 2005*

1. On this three-minute chart of the mini-sized Dow on March 3, 2005, a long reversal signal fires right around 1:00 p.m. eastern, as the third brick back in the series is penetrated (see [Figure 15.2](#)). The entry on a buy stop order is 10,817.

**Figure 15.2**

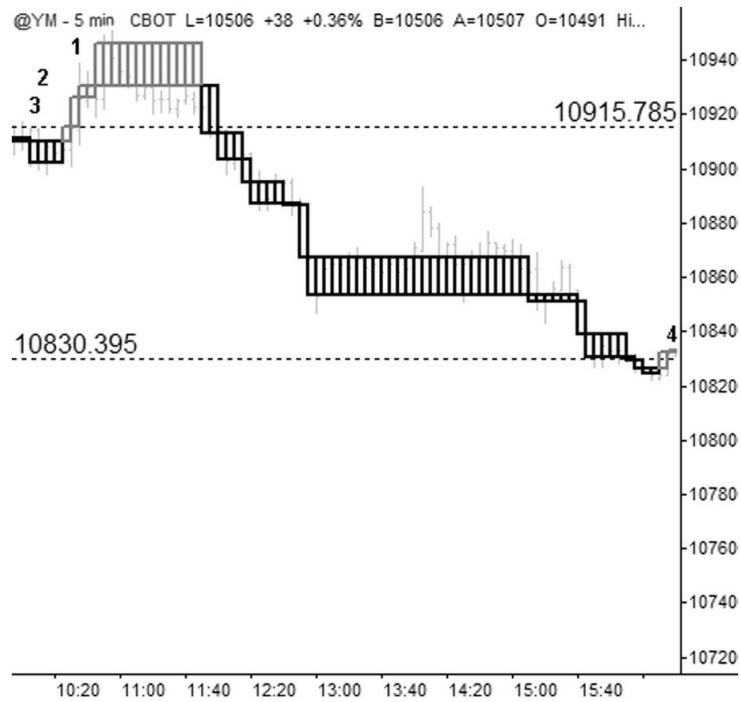


2. For the exit, we are now waiting for a down (black) brick to form, and once that happens, we will use a trailing three-brick stop utilizing the up bricks. By doing this, we exit the trade at 10,871, for a gain of 54 points.

*Mini-Sized Dow—March 2005 Contract, March 9, 2005*

1. On March 9, 2005, this five-minute chart of the YM fires off a brick short just before noon eastern (see [Figure 15.3](#)). The entry takes place using a sell stop order at 10,916.

Figure 15.3

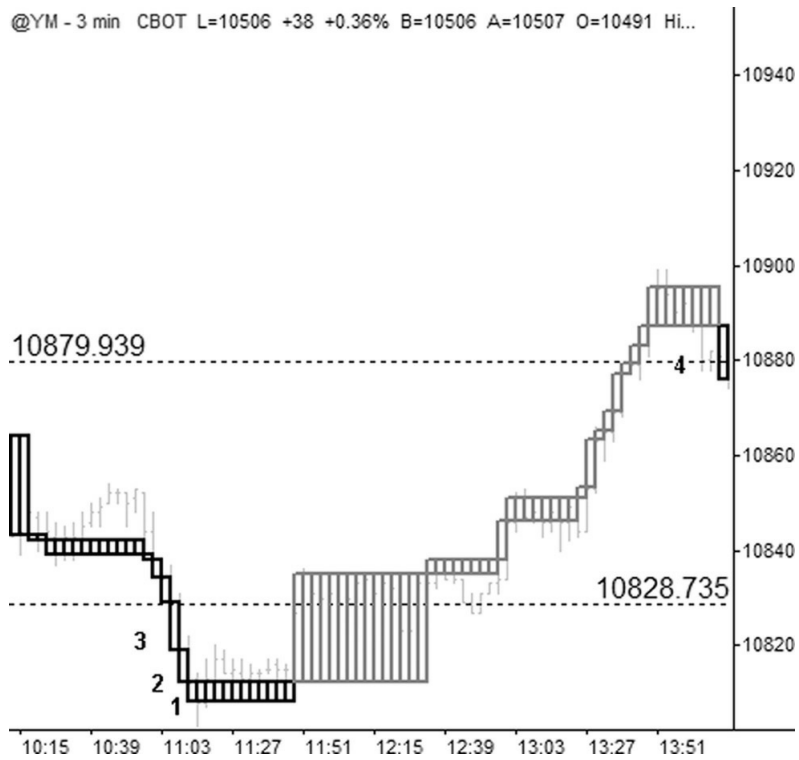


2. For the exit, the goal is to wait for an up brick, and, once that occurs, to trail a stop three bricks back. The stop is hit at 10,830 for a gain of 86 points. What I like about this is that the setup keeps a person in the trade all through the choppy noise and false rallies that occur between 1:00 p.m. and 3:00 p.m. eastern. This goes back to the importance of having a specific exit strategy—and only a specific exit strategy—to get out of a trade.

*Mini-Sized Dow—March 2005 Contract, March 10, 2005*

1. On March 10, 2005, the YM three-minute chart fires off a brick long just before noon at 10,829 (see [Figure 15.4](#)).

Figure 15.4



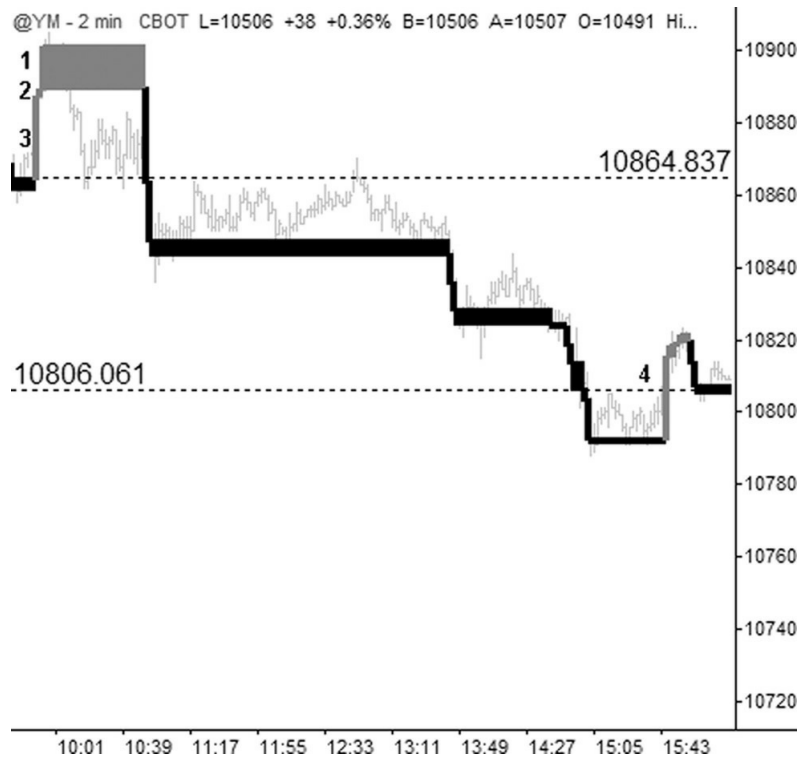
2. The setup reverses a few hours later, setting up an exit signal at 10,880 for a gain of 51 points.

*Mini-Sized Dow—March 2005 Contract, March 11, 2005*

1. On this two-minute chart of the YM on March 11, 2005, a reversal short brick signal fires off at 10,864 at around 11:00 a.m. eastern (see [Figure 15.5](#)).

Figure 15.5



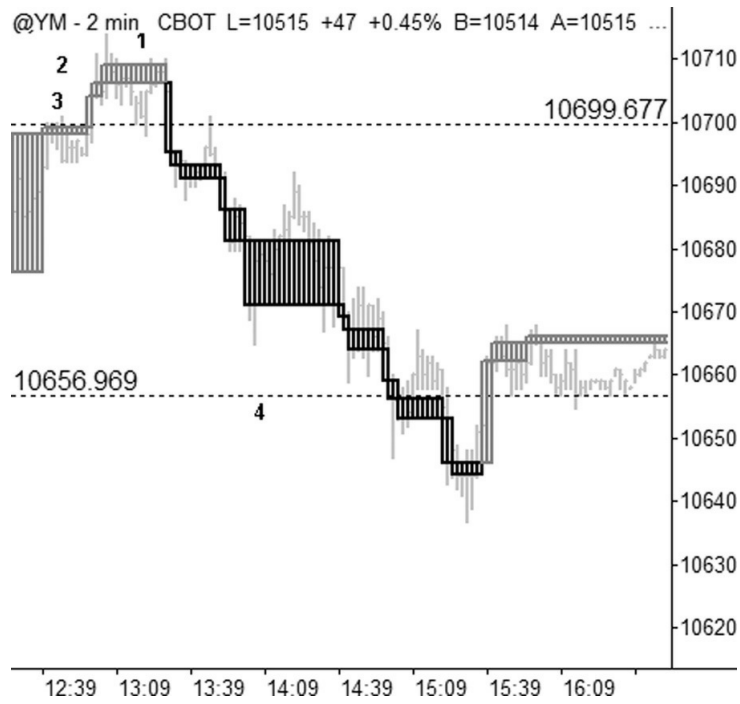


2. The play continues to work lower until the last hour of trading, generating an exit signal at 10,806 for a gain of 58 points. Again, I would like to point out all the noise in this chart that occurred between 11:30 a.m. and nearly 2:00 p.m. How many traders got chopped up in this? How many chased it higher? How many shorts panicked and covered? A trader who follows a specific setup, with a specific set of parameters, is at a huge advantage over all the people out there who are “trying to rely on their judgment while in a trade.”

*Mini-Sized Dow—March 2005 Contract, March 16, 2005*

1. On this two-minute chart of the YM on March 16, 2005, a reversal short brick signal fires off at 10,699 in the latter part of the trading day a little after 1:00 p.m. eastern (see [Figure 15.6](#)).

Figure 15.6

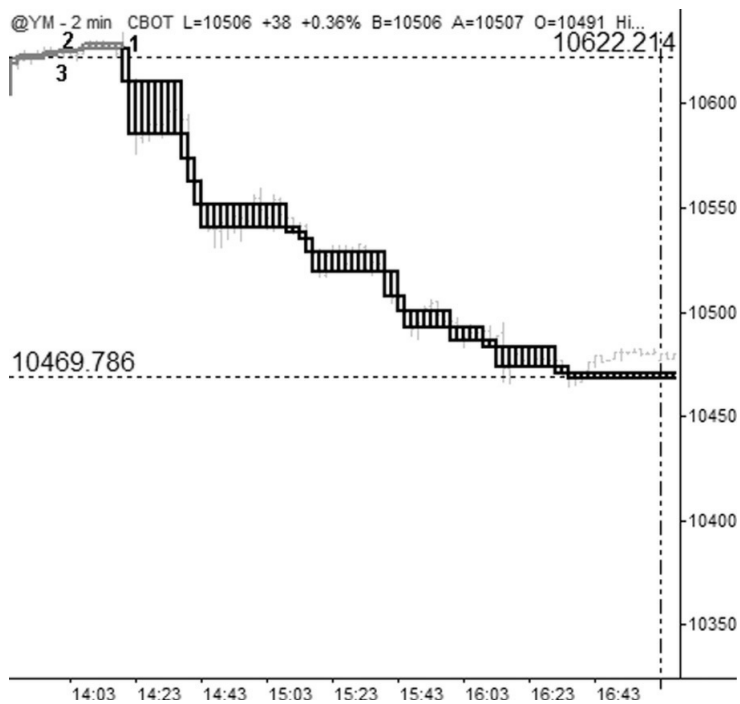


2. The markets continue to sell off, and the bricks stay in sell mode until about 20 minutes before the close, when a reversal signal hits, stopping the trade out at 10,657 for a gain of 42 points.

*Mini-Sized Dow—March 2005 Contract, March 22, 2005*

1. On this two-minute chart of the YM on March 22, 2005, the YM fires off a short signal late in the trading day, and a sell stop order is hit at 10,622 (see [Figure 15.7](#)).

Figure 15.7



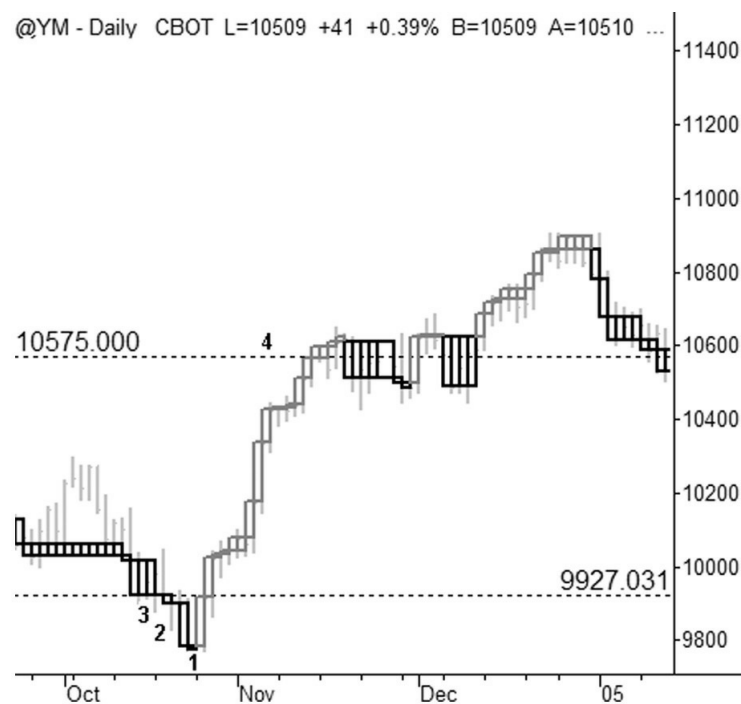
2. The markets drift lower into the close, and there actually is not a reversal signal given to exit this trade. In this case, we just use the 4:15 p.m. eastern close on the ES to get out of the trade. Although the YM continues to trade until 5:00 p.m., the liquidity really dries up after the ES market closes. In this case, exiting on the close generates an exit at 10,469 for a gain of 153 points. Why the big sell-off?

This was FOMC (Federal Open Market Committee) day, and the markets sold off after the news hit about another quarter-point rate increase. This ties into one of my biggest beliefs about trading the markets—economic reports mean very little in the overall scheme of things. The market is going to do what the market is going to do. The key is to focus on the setup and ignore the rest of the noise.

*Mini-Sized Dow—December 2004 Contract, October 27, 2004*

1. On this daily chart of the YM, a swing play is generated on the bricks near the end of October 2004 (see Figure 15.8). The entry on this play is 9927.

Figure 15.8



2. The daily bricks stay in buy mode until the end of November, when a sell signal is generated at 10,575, for a gain of 648 points. When the market reversed in late October, there were a lot of bears. This again points to the fact that it doesn't really matter what people think about the market and what they feel it *might* do. What matters is what the market is doing. Trade setups like the bricks remove all the emotion.

## Summing Up the Bricks

The brick setup is great when you're trying to catch an intraday reversal. Too many traders try to do this, but end up getting burned. They short the market, but it just keeps going higher. Or they buy the market, and it gets flattened. There is no reason to try to catch the exact high or the exact low in a market move. That involves too much risk and has a low probability of success. With this confirmation signal, a trader will be made aware of when the move has petered out and started its reversal, and although she won't be able to catch the exact highs or the exact lows, she will still be able to catch the "meat of the move."

We've set up [www.simplertrading.com/reversals](http://www.simplertrading.com/reversals) with free videos that update this play for current market conditions, as well as other methods for picking up market reversals.



# The 3:52 Play: Capping Off the Day with a Fine Cigar

## This Is Where the Other People Start to Panic

The 3:52 play is a setup I discovered while working in a trading room observing more than 100 other traders going through their daily gyrations with the market. It is commonly known among traders that 3:30 p.m. eastern is a key reversal point in the markets. What was fascinating was that I would watch this room full of traders stare at the bounce (or sell-off) that would start at 3:30, and then they would wait, wait, and wait some more. They would wait for confirmation, wait for an indicator-based buy or sell signal, wait for their mother to call and tell them it was okay to take the trade, or whatever. The point is that they would *wait* to jump in on the move. Finally, they would succumb to the pressure to get in, and they would jump in on the move just as it was running out of steam. I would spend the rest of the session watching in fascination as they pointed, gyrated, and yelled at their computer screens as the markets drifted against them. Often they would wait until the last possible minute to get out of their S&P futures trades, which is 4:15 p.m. eastern. They would wait in the hope that the markets would come back to them, and they spent this brief session praying that their position would work out. Sometimes it did, but often it did not because there were too many of them who were trapped and hoping for the same move. As the markets neared 4:15 p.m., they had no choice. They could not wait any longer, and they were forced to close out their positions. Like rats on a sinking ship, these traders would all head for the exits at once. If they were long, they would all be selling at once. If they were short, they would all be buying at once.

The interesting part of this is that the liquidity dries up after 4:00 p.m. eastern. With the decreased liquidity that exists from 4:00 p.m. to 4:15 p.m., these groups of traders can easily cause exaggerated movements in the markets in the final minutes before the closing bell. This causes the markets to move hard against them. I watched them do this day after day, assuming that one day they would catch on. They never did, and after a while I would just sit there and do the opposite of what they were doing, so that while they were crying, I was cashing in. This same setup continues to work today, and it is something that I do nearly every trading day. Like a single-malt Scotch after a filet mignon, it's a great way to cap off a trading session.

## Trading Rules for Buys (Sells Are Reversed)

This is a fade play. I let the 3:30 p.m. eastern reversal happen, and then 22 minutes later, at 3:52, I take the opposite side of the move.

1. I use this setup for the E-mini S&Ps and the mini-sized Dow futures.
2. I set up a one-minute bar chart without any other indicators or interference.

3. At 3:30 p.m. eastern, I mark where the futures are trading. In the case of this example, the futures would have started rallying at 3:30 p.m. eastern.
4. At 3:52 p.m., I take a short using a market order. I short at the opening of the 3:52 one-minute bar. This is assuming that the ES is at least 1 point away and that the YM is at least 10 points away from where it was trading at 3:30. On days when this does not occur, I don't take the trade.
5. My stop for the ES is 2 points, and my stop for the YM is 20 points. I do not trail stops for this play.
6. I hold on to the trade until 4:13 p.m. eastern, at which point I close out at the market. Technically I could hold on until 4:15, but I don't want to get stuck in this trade overnight, which is why I give it two minutes of elbow room. If I discover that my PC has locked up, that gives me enough time to call my broker and get out of my trade. (I use a broker who actually answers the phone and doesn't put me on hold.)
7. Even though the mini-sized Dow doesn't close until 5:00 p.m., I still use 4:13 p.m. to mirror the E-mini S&P futures markets. By 4:15, I'm ready to take a break from trading for the day.

*E-mini S&P—December 2004 Contract, October 14, 2004*

1. At 3:30 p.m. eastern on October 14, 2004, the S&Ps start to rally, and since they are rallying off of 3:30, I will be looking to short this market at 3:52 (see [Figure 16.1](#)). By watching a one-minute bar, I can see that the 3:51 p.m. bar closes at 1104.75. Then at 3:52 p.m., the bar opens at 1104.50, and I take the opposite side of this move. I short at the market, and I am filled at 1104.50. I place a two-point stop at 1106.50.

**Figure 16.1**



2. The traders who jumped on this 3:30 p.m. “pop” late are now starting to watch their trade go under water. The longer they hang on, the more nervous they get, and they start getting their stops hit or just dumping their position using market orders. This pushes the market down even further. At 4:13 p.m., the one-minute bar opens at 1103.00. This is my time signal to get out, and I cover at the market for a gain of 1.50 E-mini S&P points. One of the things I like about this play is that there is a time limit. I know that when I get in, I will be getting out 21 minutes later. I also like the fact that I’m not looking for a big move. I’m mentally prepped to take a small scalp, and when this trade does move against me, it is typically for a very small loss, since my actual stop is rarely hit.

*E-mini S&P—December 2004 Contract, October 4, 2004*

1. At 3.30 p.m. eastern on October 4, 2004, the market sells off into the 3:52 p.m. time frame (see [Figure 16.2](#)). Since the market is selling off from this time reversal point, I am looking to take the opposite side of this move, so I go long. All I am waiting for now is 3:52 p.m., which is my time trigger to get into the trade. At 3:52 p.m., I buy at 1136.00 and place a stop at 1134.00. Why do I wait for exactly 3:52 p.m. to fade this move? This is just the time I settled on after doing this on a trial-and-error basis for a long period of time. I cannot mathematically prove that getting in at 3:52 is better than getting in at 3:50. It’s almost like asking whether people prefer blondes or brunettes. They may have a preference, but in the end all that matters is that they are able to get along with their choice and make a go of it.

Figure 16.2



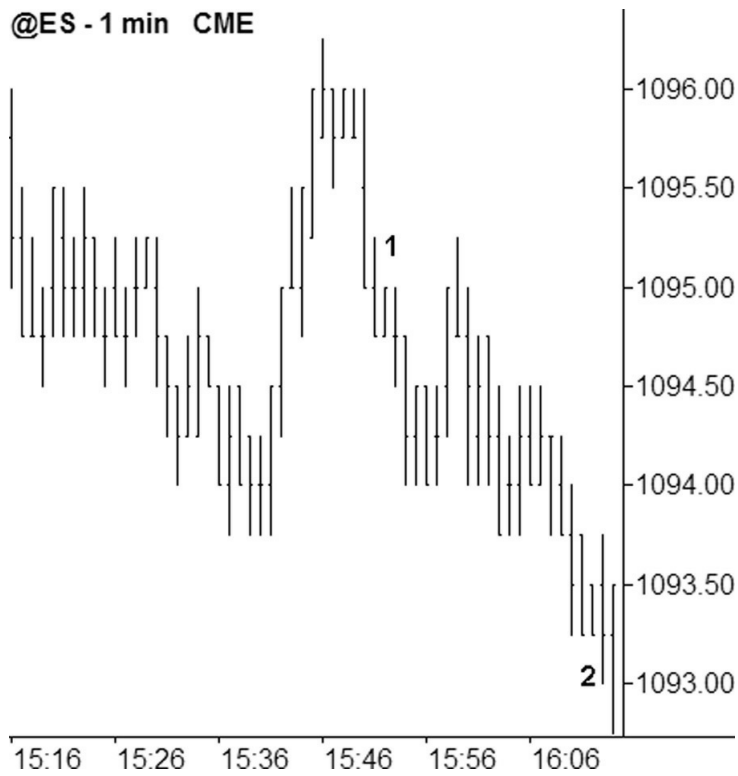


2. The market chops back and forth, and at 4:13 p.m., I am out at 1135.50 for  $-0.50$ . It is interesting to note that I am rarely stopped out on this play. Though I do take losses with this setup, they are typically very small.

*E-mini S&P—September 2004 Contract, July 27, 2004*

1. From 3:30 p.m. eastern on July 27, 2004, the market rallies into the 3:52 p.m. time frame (see [Figure 16.3](#)). At 3:51, the one-minute bar closes at 1094.75. I short at the open of the next bar, and I'm in at 1094.75. I place a 2-point stop at 1096.75.

Figure 16.3



2. The market drifts down, and when the 4:13 p.m. bar starts, the S&Ps are being offered at 1093.25. I cover at the market, and I'm out for +1.50.

*E-mini S&P—September 2004 Contract, July 28, 2004*

1. On July 28, 2004, the market rallies off of 3:30 p.m. eastern, and at 3:52 p.m., I short at 1096.75 (see [Figure 16.4](#)). I place a 2-point stop at 1098.75.

Figure 16.4



2. The market drifts down, gets as low as 1094.75, and then starts drifting back up. At 4:13 p.m., I cover at 1096.50 for a gain of 0.25.

*E-mini S&P—September 2004 Contract, July 29, 2004*

1. On July 29, 2004, the market sells off from 3:30 p.m. eastern to 3:52 p.m. (see [Figure 16.5](#)). At 3:52 p.m., I buy in using a market order, and I'm filled at 1099.00. I place a stop at 1097.00.

**Figure 16.5**



2. The market starts moving higher after 4:00 p.m., and at 4:13 p.m., I sell using a market order. I'm out at 1100.50 for a gain of 2.50.

*Mini-Sized Dow—September 2004 Contract, July 1, 2004*

1. This trade also works well with the mini-sized Dow. I don't really have a preference for one market over the other for this play. Since the volume in the mini-sized Dow is less than that in the E-mini S&Ps, the movements in this market can sometimes get a little more exaggerated from 4:00 p.m. to 4:15 p.m., which is a positive for this trade setup. On September 8, 2004, the mini-sized Dow sells off into 3:52 p.m., so I take a long and am filled at 10,311 (see [Figure 16.6](#)). I place a 20-point stop at 10,291.

**Figure 16.6**



2. After 4:00 p.m., the markets start to rally on short covering, and at 4:13 p.m., I sell at 10,322 for a gain of 21 points.

*Mini-Sized Dow—December 2004 Contract, September 13, 2004*

1. On September 13, 2004, the mini-sized Dow sells off at 3:30 p.m. eastern, so at 3:52 p.m. I go long using a market order, and I'm filled at 10,309 (see Figure 16.7). I place a stop at 10,289. This is a good example because the market stabilizes and starts to drift higher at around 3:40 p.m. Shouldn't I then be shorting this rally into 3:52 p.m.? No! The key element to look for is the predominant move after 3:30 p.m. Remember our friends in the trading room? They see the move off 3:30 p.m., and then they wait, wait, wait to get in. So in this example, they are shorting the dead lows of the move, and they will spend the rest of the session covering their shorts for a loss. My basic rule of thumb on this trade is as follows: if it is not crystal clear, then I just don't take the trade. For example, if the market is dead quiet into the final hour of trading and there isn't any reaction at 3:30 p.m., then I don't have a trade to take. Either this setup is very obvious, or there isn't a setup. There is usually a clear setup four days out of five.

Figure 16.7



2. The short covering continues right into the close, and at 4:13 p.m., I am out at 10,321 for a 12-point gain. Note: this trade could also have been done in the September 2004 contract, which was still active, though it was set to expire on Friday, September 17. Remember, during rollover week, the next front month becomes the most active contract the Thursday of the week before expiration. Expiration during this time was set up for Friday, September 17, so the December contract became the official front month on Thursday, September 9. During rollover week, both contracts will trade actively, but volume starts pouring into the next contract out, and a trader will want to begin trading that next contract on the Thursday of the week before expiration.

*Mini-Sized Dow—December 2004 Contract, September 14, 2004*

1. On September 14, 2004, the market starts to sell off near the 3:30 p.m. eastern time frame (see [Figure 16.8](#)). Since it is selling off, I'm waiting for my time entry to go long. My time entry at 3:52 p.m. appears, and I go long at the market. I'm filled at 10,318, and I place my 20-point stop at 10,298.

Figure 16.8



2. At 4:13 p.m., I cover at 10,324, for a gain of 6 points. This brings to light the vast differences between scalping and swing trading. A trade like this won't pay the mortgage, but it does allow me to pick up an extra shot of espresso the next time I'm at Starbucks. Of course, the idea here is that scalp trades are used to generate monthly income, and swing trades are used to create wealth.

*Mini-Sized Dow—December 2004 Contract, September 24, 2004*

1. On September 24, 2004, the mini-sized Dow starts selling off at 3:30 p.m. eastern (see [Figure 16.9](#)). I wait until 3:52 p.m., at which point I fire off a market order to buy. I'm filled at 10,037, and I place a stop at 10,017.

Figure 16.9



2. The market chops higher, and at 4:13 p.m. I close out my long at 10,044, a gain of 7 points.

*Mini-Sized Dow—December 2004 Contract, September 27, 2004*

1. On September 27, 2004, the markets start selling off at 3:30 p.m. eastern (see [Figure 16.10](#)). I sit back, imagining all the traders who are now chasing the market, trying to get short. At 3:52 p.m., I place a market order to go long, and I'm filled at 9988. The market continues to sell off, coming close to my 20-point stop at 9968.

Figure 16.10





2. I can now watch as the same traders who chased the market short start to take some heat and start to cover. The market rallies hard, but the main part of this rally just gets me back to even. At 4:13 p.m., I offer my contracts out for sale, and I'm filled at 9990 for +2 points. Well, I won't even be able to do much at Starbucks with this trade, but I of course appreciate that I can still wear flip-flops to the office.

*Mini-Sized Dow—December 2004 Contract, October 6, 2004*

1. On October 6, 2004, the market starts to sell off at 3:30 p.m. eastern, stabilizes about 10 minutes later, and then starts to edge higher (see [Figure 16.11](#)). Because the initial move off of 3:30 p.m. was a down move, I am looking to do the opposite and go long. At 3:52 p.m., I go long with a market order, and I'm filled at 10,220. I place a 20-point stop at 10,200.

Figure 16.11



2. All the traders who chased that 3:30 p.m. short start getting smacked around. Their plight turns into my profit, and at 4:13 p.m., I offer out my contracts. I'm filled at 10,239 for a gain of 19 points. Today I can buy everyone in the office Starbucks with my last trade. No joke. When we walk into Starbucks on these days, the Starbucks employees whisper, "Here comes the ringleader." Where else can five people walk into a coffee shop and get a round of flavored water for \$20? On principle, I had to buy stock in the company. This way I don't feel like I'm getting ripped off; I'm just helping to increase the value of my investment. What's the phrase? Denial ain't just a river in Egypt. (Of course, these days I walk in and buy an herbal tea, which is just wrong on so many levels.)

*Mini-Sized Dow—December 2004 Contract, October 8, 2004*

1. On October 8, 2004, the market rallies from 3:30 p.m. eastern right into 3:52 p.m., at which point I go short at the market, and I'm filled at 10,049 (see [Figure 16.12](#)). I place a stop at 10,069. We come within 8 points of my stop and then start to reverse.

Figure 16.12



2. At 4:13 p.m., I cover my short, and I'm filled at 10,037 for a gain of 12 points.

*Mini-Sized Dow—December 2004 Contract, October 13, 2004*

1. On October 13, 2004, the market rallies nicely off of 3:30 p.m. eastern, and as we hit 3:52 p.m., I short faster than a Boston Red Sox fan drinking a beer after his team won game 7 against the Yankees after being down 3–0 (see [Figure 16.13](#)). (I had to put that in. On October 18, I was at game 4, six seats behind home plate. The game lasted 14 innings and was the most memorable sports experience of my life.) I'm filled at 9994, and I place a stop at 10,014.

Figure 16.13



2. The market drifts down immediately, and at 4:13 p.m., I cover at 9984 for a gain of 10 points.

### Summing Up the 3:52 Play

I like this trade because it is simple and effective, and it clearly goes against the masses who chase this move off the 3:30 p.m. reversal time frame. Like it or not, futures trading is a zero-sum game. For someone to win, someone else has to lose. This trade clearly takes advantage of traders' emotions and cleanly separates the winners from the losers.

Have there been any updates to this chapter since it first came out? This chapter is one that is near and dear to my heart, as this setup really hits on the reality of trading—and that is that to make money trading, you have to take it from someone else. This setup clearly lays out who is getting her money taken away from her and why. There is no use denying this. As traders, we aren't saints. We are just pitting our skills in the arena against those of the other gladiators.

I have had to make a few modifications to this setup since this book was first released. I refer to this now in my daily newsletter videos as the "end-of-day play," and while the theory is still the same, there are a few tweaks that take internals into account. Why the tweaks? In reality, this is the one setup that I should not have had published in book form. It's a low-volume setup, and when too many people dive into a low-volume setup, it dilutes the effectiveness of that setup. The other setups in this book aren't like that. They all occur in markets and time frames that can handle lots of volume. This particular setup, however, takes advantage of low volume to panic traders out of their positions. It's truly a beautiful thing. Even when I find myself on the losing end of a trade like this, I still appreciate its simplicity. One person's gain is another person's pain.

There is updated information on this play at [www.simpletrading.com](http://www.simpletrading.com). I've set up a series of free videos at

[www.simplertrading.com/tradingtheclose](http://www.simplertrading.com/tradingtheclose) that shows the updates I've been utilizing for this particular play.



# HOLP and LOHP—Catching Trend Reversals Without Getting Smashed

## Buying a Market Just Because It's Cheap or Shorting a Market Just Because It's Expensive Is Dangerous—Unless It's Done Like This

When it comes to the financial markets, the bottom line is that the current action is going to be determined by one thing and one thing only: the price that people are willing to pay right now. A stochastic can be overbought, a MACD (moving average convergence divergence) can be rolling over as a potential short, and moving averages can be violated to the extreme. Whatever the indicator, it doesn't mean that price action is going to reverse. There is a high probability, to be sure, but that doesn't mean that it's going to happen. On the contrary, in these cases of extreme overbought or oversold readings, prices can still keep trending higher or lower for a long, long time. In 1999, overbought stayed overbought for months and months. In 2000 and 2001, oversold stayed oversold almost continuously. During the 2008 financial crisis, some stocks (like Lehman Brothers) got so oversold that they disappeared. Everyone who screamed, "It's a bargain" on the way down learned the meaning of pain many times over.

I hear stories nearly every day from people who bought a stock "because it looked cheap," only to have it continue to crater on a daily basis. Some of these stocks, like EXDS (Exodus Communications, Inc.) and WCOM (WorldCom, Inc.), got real cheap, real fast. Eventually, the people who bought these stocks on the way down either got frustrated and couldn't take the pain anymore, so they sold, or, in many instances, they got out using one of the best tried-and-true sell signals on the planet—the company declared bankruptcy, and the stock went to zero. The opposite is also true, in that I've heard plenty of war stories about traders shorting a stock "because it looked too high." They were soon experiencing shell shock as the stock continued to race higher and destroy their account.

Speaking of shorting, I always find it amusing that brokers talk about how dangerous shorting a stock is, because the potential losses are "infinite." Well, I have yet to see a stock rise to infinity, but I've seen plenty of stocks go to zero. Never mind the fact that brokers and trading firms make a huge living taking the opposite side of the retail public's trades.

In trading, it is never a good idea to try to catch a falling knife (buy a steep sell-off) or step in front of a freight train (short a frantic rally) just because prices "look too low" or "look too high." How, then, does a trader catch a reversal without risking life and limb?

That is where this setup comes into play. This method for catching market tops and bottoms is based on the one solitary thing that matters most in trading: price.

### Trading Rules for Sells (Buys Are Reversed)

This is a reversal play. I will short tops and buy bottoms only upon confirmation of this setup. I generally use

this for swing plays, but it is valid on all time frames, including smaller time frames for intraday plays. HOLP and LOHP are acronyms for “high of the low period” and “low of the high period.” We pronounce them “HOPE” and “LOPE.”

1. Identify a trending market, or an individual stock, that is ideally making new 20-day (or period) highs. This is a rule of thumb; markets that are making only 17- or 18-day (or period) highs are also fine. The point is that you want to see a definitive trend and be ready to step in when that trend reverses.
2. Identify the high bar in the uptrend. This is typically the current bar, but it could be a few bars back. By “high bar,” I mean the bar with the highest intraday price prints in the entire move higher.
3. Once I identify the high bar, I will then go short once price action closes below the low of this high bar. (Say that really fast three times.)
4. The initial stop is the high of the high bar. If I am still in the trade on the third day, or period, I will start to use a two-bar trailing stop. I will exit this trade when the current bar closes above the price level represented by the two-bar trailing stop.
5. Because of retracement price patterns while in a play, the two-bar trailing stop will sometimes have to be held on the current “stop bar” until the trend resumes. Once the trend resumes, the two-bar trailing stop can also be resumed. This doesn’t happen very often, and I realize that it makes no sense while reading this text. Don’t worry, it is not subject to interpretation, and it will become clear when you see a specific example. I will focus specifically on this in [Figure 17.13](#).

**Figure 17.13**



GBPUSD - Weekly FOREX



This setup works in all markets, in all time frames. I usually use this play on individual stocks and their corresponding stock options, stock index futures, and the Forex currencies on the 60-minute and daily charts.

*E-mini S&P—December 2004 Contract, October 7, 2004*

1. [Figure 17.1](#) is an example of the entry method. This particular chart is a daily representation of the E-mini S&P futures. Once I've gone over this entry method, we will jump into the exit strategy. It is important to understand how to enter this trade. The white bar labeled point 1 represents the "high bar" in the uptrend. The low of this high bar is 1133.50. The high of this bar represents the highest prices seen in at least 20 days. In fact, the last time the S&Ps were at this price level was back on July 1, 2004.

Figure 17.1



2. Since the black bar labeled point 2 broke the low of the high day, we enter this position at the close of this day. My entry is 1131.50. This trade does not have an exit at the time this snapshot was taken because an exit signal has not fired off. I usually get a few questions here when I discuss this trade. The first is, “Can I enter the trade intraday as soon as it breaks the low of the high day instead of waiting for the close?” My answer to this is that you can, but I really want to see a close to show that the market means business. Often I would take this trade intraday, only to have it close back up above the low of the high day, which invalidates the trade. By waiting for the close, you are getting extra insurance that this reversal is valid. The other question I get usually has to do with entry points and knowing which bar is actually going to be the high bar. Of course, you don’t know which bar is going to be the high bar that kicks off the reversal until the price break actually occurs. Is it going to be this bar? Or are we going to get another, higher bar first? All you can do is continue to watch the new bars develop. When I identify a high bar, I keep an eye out to see whether price action closes below the low of that high bar. If the next bar goes even higher, then this new, higher bar becomes the high bar. In essence, I’m trailing an imaginary sell stop order. As prices advance higher, so will my entry until we finally get a break of the low of the high bar. Although this is a simple concept, I have found that it takes a few examples for people who are new to this setup to get the hang of it. That said, let’s look at some more examples.

*E-mini S&P—December 2004 Contract, October 7, 2004*

1. This daily chart of the E-mini S&Ps (Figure 17.2) is the same as Figure 17.1. However, this chart focuses on the initial reversal trade off the lows. The bar labeled point 1 takes place at the end of the September, marking the lows of this particular move, which aren’t quite 20-day lows, but they are 18-day lows, which is fine. I want to buy a close above the high of the low day. The high on this day

registered at 1112.50.

Figure 17.2



2. The next day, we close above this bar, and I enter this trade right after the 4:00 p.m. eastern close of the regular cash session. I am filled at 1115.25. My initial stop is the lows of bar 1 just above 1100.00.
3. I'm in this trade for seven days. In the bar labeled 3, the S&P's close below the low of the previous two bars. Once this happens, I exit right after 4:00 p.m. and get out at 1132.25, for a gain of 17.00 points, or \$850 per contract. Note that the exit of this long also coincides with the initialization of the new short position in [Figure 17.1](#). This doesn't always happen, but it does once in a while.

*Mini-Sized Dow—September 2004 Contract, August 6, 2004*

1. On August 6, 2004, the mini-sized Dow establishes a new low within its current trend, and then starts to rally (see [Figure 17.3](#)). This bar marks the low day, so I'm looking to buy a break of the high of this low day.

Figure 17.3



2. It takes seven trading days to close above the high of the low day. When this finally happens on August 17, I get in after the close, and my entry is 9974. My initial stop is the low of the bar that triggered this trade, near 9770. Once I'm in the trade for two days, I start using a two-bar trailing stop.
3. On August 26, this bar closes below the close of the two-bar trailing stop. I'm out at 10,121 for a gain of 147 points, or \$735 per contract.

*Mini-Sized Dow—September 2004 Contract, June 23, 2004*

1. On June 23, 2004, the mini-sized Dow futures put in a nice high bar (see [Figure 17.4](#)). The low of this high day is 10,343.

Figure 17.4



2. On June 28, the YM closes below the low of the high day at point 2. I enter this position short at the close of this day at 10,329. I start off with a stop at the highs of the high day, and once I'm in the trade for two days, I start to use a two-bar trailing stop. Remember, I'm looking for a *close* above these levels as a signal to exit the trade.
3. On July 27, I exit at the close of bar 3 at 10,061 for a gain of 268 points, or \$1,340 per contract.

*E-mini Nasdaq—September 2004 Contract, August 13, 2004*

1. On August 13, 2004, the high of the low day on the E-mini Nasdaq is 1317.50 (see [Figure 17.5](#)).

Figure 17.5



2. On August 16, since the bar labeled 2 broke the high of the low day, I enter this position at the close of this day at 1322.00.
3. On August 30, I exit at the close of bar 3 at 1367.00, for a gain of 45 points, or \$900 per contract.

*E-mini Nasdaq—September 2004 Contract, June 30, 2004*

1. On June 30, 2004, the low of the high day is 1506.00 on the daily NQ chart (see [Figure 17.6](#)).

Figure 17.6

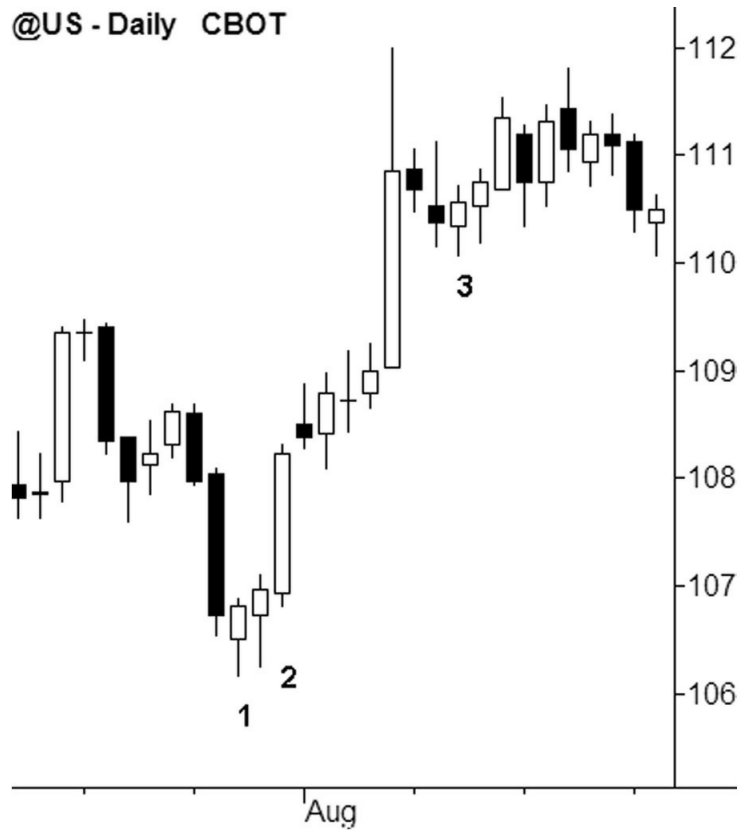


2. On July 1, since the bar labeled 2 broke the low of the high day, we enter this position at the close of this day at 1494.00.
3. As the NQ sells off, we start using the two-bar trailing stop. On July 29, prices close above our trailing stop, and we exit at the close of the bar labeled point 3 at 1401.50, for a gain of 92.50 points, or \$1,850 per contract.

*30-Year Bond—September 2004 Contract, July 28, 2004*

1. On July 28, 2004, the high of the low day is  $106 \frac{26}{32}$  for the 30-year bonds, which can be seen on the bar labeled point 1 (see [Figure 17.7](#)).

Figure 17.7



2. On July 29, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at  $106 \frac{31}{32}$ .
3. We start trailing our stop, and on August 23, we exit at the close of the bar labeled point 3 at  $110 \frac{16}{32}$ . Bonds are worth \$1000.00 for a full point move. This move of  $3 \frac{17}{32}$  is worth \$3, 531.25 per contract.

*Forex Markets—EURUSD, December 31, 2004*

1. On December 31, 2004, the EURUSD breaks and closes below the low of the high day (see [Figure 17.8](#)). The entry on the short side is 1.3553.

Figure 17.8





2. The market continues to drop lower for five days in a row before bottoming out. On January 12, the stop is triggered, and we are out at 1.3254 for a gain of 299 pips, or \$2,990 per lot.
3. On February 4, the EURUSD makes new nearly 20-day lows and is now a candidate for this setup. The entry signal fires off on February 9 with a close above the high of the low day. The entry is taken at 1.2803.
4. The markets work higher until the two-bar trailing stop is hit on March 1 at 1.3186, for a gain of 383 pips, or \$3,830 per lot being traded.

*GOOG (Google Inc.)—September 2, 2004*

1. On September 2, 2004, the high of the low day is 102.37 on the bar labeled point 1 on GOOG (see [Figure 17.9](#)). The low here isn't a 20-day low, but GOOG had just gone public on August 19, 2004, 11 days prior.

Figure 17.9



2. On September 10, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 105.33.
3. We start trailing the stop, and on October 12, we exit at the close of bar 3 at 136.55, for a gain of just over 30 points.

*TZOO (Travelzoo Inc.)—August 30, 2004*

1. On August 30, 2004, the high of the low day is 42.37 on the bar labeled 1 on TZOO (see [Figure 17.10](#)).

Figure 17.10



2. On August 31, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 45.00.
3. On September 28, we exit at the close of bar 3 at 56.42. This is one of those trades where, in hindsight, it would have been “genius” to exit at the intraday break of the two-bar trailing stop. That exit would have been around \$70. However, I have done this play both ways, and I’ve found that the intraday stop will frequently get a trader out of a position that still has a lot of room to move. In any event we still netted nearly 12 points on this trade.

*EXM (Excel Maritime Carriers Ltd.)—September 2, 2004*

1. On September 2, 2004, the high of the low day is 23.50 at the bar labeled 1 on EXM (see [Figure 17.11](#)).

Figure 17.11



2. On September 3, since the bar labeled 2 broke the high of the low day, we enter this position at the close of this day at 24.21.
3. On September 15, our trailing stop is hit, and we exit at the close of bar 3 at 38.00, for a gain of nearly 14 points. On this play, we got stopped out just before the stock rocketed higher another 30 points in just three trading days. This goes back to being a “genius in hindsight.”

*Forex Markets—EURGBP, June 16, 2005*

1. I like this particular example because it demonstrates how important it is for a trader to stick to his setups. On June 16, the EURGBP makes new lows, and the next day prices reverse and close above the high of this low day, firing off a long signal (see [Figure 17.12](#)).

Figure 17.12

EURGBP - Daily FOREX



2. I go long, and a group of other traders I work with also goes long. Our entry was 0.6709.
3. EURGBP rolls over and closes below our two-bar trailing stop. Our exit is 0.6632, at point 3 on June 23, for a loss of 77 pips. This bar also marks a fresh low and becomes the new signal bar in this setup.
4. On June 29, at point 4, we get another close above the high of the low day, and I take the entry at 0.6680. Other Forex traders I work with pass on this setup, having felt the sting of the first loss.
5. EURGBP rallies nicely, and the two-bar trailing stop gets hit on July 13 at point 5, at 0.6851, for a gain of 171 pips. The point of this example is to show the importance of not filtering out a particular setup because of how you feel about it. If the previous setup was a loss, many newer traders will hold off on taking the next setup because of the feelings associated with the last time they took the play. In reality, our feelings have nothing to do with how the next trade will work out. We never really know what the market is going to do next, but we can plod along, follow our setups, and try to make a living.

*Forex Markets—GBPUSD, August 29, 2003*

1. In this example, I will also focus on rule 5, which talked about holding a stop in place until the trend

resumes (see [Figure 17.13](#)). As I said, this doesn't happen very often, but it does happen once in a while, and it will make sense once I show it to you. This is a weekly chart of GBPUSD. I like to use the weekly chart to catch macro trend reversals, as these can result in big plays. The stops are also wider, so it is important to determine position size correctly on this larger time frame. In this weekly chart, a new low bar is created during the week of August 29, 2003, with a low of 1.5620. The very next week, prices dip below this level to 1.5612, creating a new low bar. Because this is a weekly bar, the only time action is taken is at the end of the week. These plays require a lot of patience.

2. There is a close above the high of the low week during the week ending September 12, at point 2. The entry is 1.6037.
3. GBPUSD rallies strongly the following week and then edges up for the next several weeks. During the week of November 9, labeled at point 3, prices fall below the two-bar trailing stop intraweek, but then rally and close above the lows by 30 pips. At this point, if we move the two-bar trailing stop up to the next bar, we will be stopped out because prices are already trading below that new stop. This is what I talked about in rule 5. Because of this, I just leave my closing stop in place, which is designated by the longer line reaching out from point 3. I will just leave my stop here until I am stopped out or until prices make new trend highs.
4. At point 4, prices make new trend highs, and I go ahead and resume my two-bar trailing stop.
5. GBPUSD rallies strongly until my two-bar trailing stop is hit during the week ending March 5, 2004, about six months after the entry, for a gain of 2,424 pips, or \$24,240 per contract. This is the type of trade that makes the Forex markets interesting, because a trader could take a \$50,000 account in this example and make a million dollars on the trade. Needless to say, there is also the obvious risk of losing the entire \$50,000. It wouldn't be fun if it were easy.

### **Summing Up the HOLP and LOHP Plays**

There are two ways to try to catch tops and bottoms: the wrong way and the only way. Shorting a stock or a market just because it is too high is the trader's version of committing suicide. Just as a dog will generally let you know when it's about to attack, a market will let you know that it is about to reverse. All you have to do is pay attention and be alert to the appropriate entry signal.

For updates to this play, and other ways to get confirmation of moves before getting into a trade, visit [www.simplertrading.com/timing](http://www.simplertrading.com/timing) for a series of free downloads.



# Propulsion Plays—Swing Plays Using Stocks, Single-Stock Futures, and Stock Options

## Setting Up for the Bigger Moves in Individual Stocks

To me, some of the greatest risk takers on Wall Street are long-term investors. They will stubbornly hold on to a stock that they bought three years ago because they have a “long-term view.” It doesn’t matter that the company is beating off its creditors with a lead pipe. It doesn’t matter that the stock is down more than 80 percent from the entry price. It doesn’t even matter if the CFO was recently seen sharing an 8 × 8 cell with Martha Stewart. What matters is that, come hell or high water, they have blind faith that if they step back and take the long-term view, all will be well in the end. All’s well that ends well, right? Of course.

Unfortunately, this ain’t Shakespeare’s play; this is Wall Street.

This came to me in glaring full color in early 2000. First, there was the Super Bowl. I don’t even remember who played in that game, but I do remember the 18 commercials that played advertising various dot-com companies that were blowing their whole annual marketing wad on this one 30-second spot. I also remember that this was the time the first ever “day-trading expo” took place in southern California. Finally, I remember my refrigerator breaking down. It wasn’t the actual breaking down that was significant, but the man I called out of the Yellow Pages who came to fix it for me was. The job took him exactly 84 minutes. The first 12 minutes were spent fixing the refrigerator. The rest of the time he spent preaching to me about his favorite stocks in the Nasdaq and why Cisco was worth \$500 a share. I tried to stop him halfway through his lecture to let him know that a fleck of saliva was hanging off his chin, but he wouldn’t let up. As he preached the gospel of the Internet, I realized that there was so much excitement in this current market that it really didn’t matter how far down it went when the crash finally came—people were now believers, and they would hold on until they got their margin call. By the time he left, I started looking at my charts for any breaks of the low of the high day. There weren’t any that day, but a month later there were plenty.

I do focus some of my efforts on finding newer companies that have the potential to make a big splash with a new product. I look at *Investor’s Business Daily* to find these candidates. It’s the new companies that have the potential for big gains. There are many long-term trend-following opportunities in the markets, on both the long and the short side. However, finding the next Microsoft is not my trading niche. If I do find it, great, but in the meantime, I’m going to keep looking for setups. Therefore, most of my “long-term” efforts in the stock market involve swing trading, and one of my favorite setups is what I call propulsion plays. This is a systematic approach to getting positioned in stocks over a few days to a few weeks. Some 70 percent of the time, individual stocks spend their days backing and filling in a tight range, building up steam for their next major move. This approach looks for stocks that are done with their “resting period” and are getting ready to spurt higher (or lower) once again.

The idea is to already be in the stock when it makes a push higher (for longs) or lower (for shorts), instead



of trying to chase it intraday. The reason I like to do this is that there are many times in the market when very few intraday trading opportunities in the stock indexes set up. Some of the sectors are up and some are down, resulting in a very choppy and quiet overall market. However, during these times, there are always going to be individual stocks that are making a move. When I am positioned in these stocks over the course of a few days to a few weeks, I don't feel forced to get into intraday trades in the stock index futures when nothing is really setting up. This is because I already have positions on that are set up to take advantage of the next "mini-move."

For this setup, I'm focusing mostly on individual stocks. However, on individual stocks that also trade single-stock futures (SSFs) and stock options, I will consider plays in those instruments as well. Because SSFs are new and because most people play options incorrectly, I'm going to spend a little time reviewing how they work and how I use them. Let's review.

## The Trader's Guide to Single-Stock Futures

Single-stock futures (SSFs) are futures contracts on individual stocks. There are currently around 130 well-known stocks, such as GOOGL, AMZN, PYPL, COP, MSFT and MA, that have futures on them. This is a recent development that hasn't quite caught on as of yet. It was only in late 2000 that Congress passed legislation lifting the ban on these products, which were already trading in Europe and other countries. There are also futures contracts available on many exchange-traded funds (ETFs). To get a complete listing of all these futures contracts, a trader can visit [www.onechicago.com](http://www.onechicago.com). One Chicago is an electronic exchange that is a joint venture of the Chicago Board Options Exchange (CBOE), the Chicago Mercantile Exchange Inc. (CME), and the Chicago Board of Trade (CBOT). Of course, the CBOT and CME are now part of the same company, CME Group. Now, how do SSFs work and how does a trader use them?

Many brokers have been slow to adapt to these new trading instruments, but they are starting to catch on. Because they are futures contracts, traders need to have a futures account in order to trade them. On top of that, they also need to be trading with a broker that is set up to trade them, as not every broker is equipped to handle these trading instruments. Once that is completed, these are traded just like a normal futures contract, and they are available through eCBOT and Globex, just like the mini-stock index futures.

Whereas mini-stock index futures contracts like the YM and ES trade quarterly, the SSFs trade monthly. Traders who aren't familiar with the letter codes for the various months should write this down and tape it to their wall as a reference guide. These are applicable to all futures contracts:

F = January

G = February

H = March

J = April

K = May

M = June

N = July

Q = August

U = September

V = October

X = November

Z = December

To get a quote on an EBAY (eBay Inc.) single-stock futures contract in Trade-Station, a trader would type in EBAY (underlying stock symbol) 1C (One Chicago) V (Month Code) 05 (Year). So the final quote for the EBAY October 2005 SSFs would look like this: EBAY1CV05.

There are a few nice features of SSFs that I find attractive. First, the “\$25,000 day-trading rule” does not apply. Active traders who have a \$50,000 account and tie up \$26,000 of that in options trades will suddenly find themselves out of luck. They will not be able to execute any new stock or options trades because the broker won’t count the option value toward the traders’ equity. This situation would draw their “countable” account balance below \$25,000, and traders would be locked out of initiating any new trades. An annoying situation, to be sure. SSFs provide the leverage of “just-in-the-money” options without the restrictions constraining “pattern day traders” and their account size. Here are a few additional key points:

- On stock accounts, a trader can get a 2:1 overnight margin, and the interest charged is the same amount a person would pay for a mediocre deal on a credit card. For SSFs, the equivalent of a 5:1 margin is available, and there are no interest fees.
- 5:1 leverage equates to having to put up 20 percent of the purchase price of the underlying stock. A trader who buys \$10,000 worth of IBM (100 shares at \$100) by using one IBM SSF contract would have to put up only \$2,000. A trader who buys 10 contracts of IBM1C at \$95 (\$95,000 worth of IBM) would put up \$19,000, and so on.
- When shorting stocks, a trader has to wait for an uptick in order to get filled (although this rule should be changed soon). There isn’t any uptick rule for short selling an SSF contract. This is becoming less important as more and more actual stocks are becoming shortable on downticks.
- One SSF contract equals 100 shares of stock.
- A 1-point move equals \$100 per contract.
- These are monthly contracts that expire the third Friday of each month, just like options. If traders own a February contract on the day it is expiring, they will need to sell the February contract and buy the March contract. This is also known as “rolling over” into the next month. If traders hold on to the contract through expiration, they will have the stock “delivered” into their account. Don’t worry about forgetting, however, because brokers don’t want to deal with this, and they will call and pester you to close out your position days before expiration.

The biggest question I get about SSFs has to do with their volume. For many of these contracts, there is not a lot of volume traded at this time, and this is an obvious concern for traders. However, it is important to note that the “real volume” of an SSF contract is in the underlying stock itself. The LMMs (lead market

makers) and MMs (market makers) for SSF products make their living buying and selling SSF contracts and immediately hedging or arbitraging that position with the underlying cash stock. Because of this, they will fill any order that is in line with the underlying volume of the stock. Since most of these stocks trade millions of shares, getting a fill is not an issue. There have been days when I've been the only one trading the SSF, and yet I have had no problem getting into and out of the position. On those days, which rarely happen anymore because volume is steadily growing, it's fun knowing that I'm the only person in the entire world who made money on that trade.

The other question I get from traders involves the spreads. If there aren't any orders coming in, then the LMMs and MMs will keep the spreads wide. This is so that they don't end up trading against each other. However, once a real order comes in, they will close the bid and ask to be in line with those on the underlying stock and snap it up. Because of this, I never use market orders when I'm getting into an SSF trade. I just look to see where the underlying stock is trading and place a limit order based on the price of the underlying stock.

The other thing to remember about SSFs is that their charts are pretty much worthless at this time. The volume is sporadic, so the charts aren't very clean. The best thing to do is to chart the underlying cash stock and then base all decisions to get into and out of the SSFs on the underlying stock. What I will do is set up the chart of an underlying cash stock and then put the quotes for both the cash stock and the SSF contract below it so that I can see where the current bid/ask is located. However, because most of my trades in the SSFs are swing trades, I don't even watch the charts intraday. I just set up my limit orders the night before based on the cash chart and then wait until the end of the day to see if I'm filled.

We'll look at a couple of sample plays on EBAY and QCOM in a moment. First I want to discuss options quickly.

## **The Only Way to Play Individual Stock Options**

I'm writing this section based on the premise that the reader knows at least a little about what options are and how they work. If not, that's okay. There are plenty of websites out there that explain them in detail, and I would recommend reading more about what options are and how they work if you plan on using them. I'm just going to give you a quick rundown and share how I incorporate them into my trading plan. (Of course, this new edition of the book has a new chapter on options, [Chapter 5](#).)

There are many complicated option strategies available, and many people spend hundreds of hours looking for the perfect strategies to generate "guaranteed income." Most of these strategies work great when the markets are range-bound—which they are most of the time. Then along comes the inevitable big rally or watershed decline, and all these people get thrashed. For a period of years in the mid-1990s, a lot of traders and funds made a nice living selling naked puts. These are put options whose writers do not have a short position in the stock on which they have written the put. The goal here is to have the options expire worthless, so that the put writers collect the premium. Many books started popping up on the shelves about "taxi-driver millionaires" who discovered this "amazing get-rich-quick" trading strategy. Then along came October 27, 1997.

The markets had been drifting down through October, and many of the taxi drivers, as well as several large funds with a few hundred million in assets, were busy selling naked puts. The brokers who worked with

the funds started getting nervous because the positions had gone against the funds to the point where it wouldn't take much of a further decline to start forcing margin calls. The brokers, who didn't quite understand the strategy that the funds were using, started to place discreet calls to other traders asking what would happen "if the Dow dropped a couple of hundred more points" over the next week or so. The answer was easy—these funds would be forced to dump their positions because of margin calls, and this would create tremendous downward selling pressure in the overall markets. The S&P 500 floor traders at the CME got wind of this and started prepping for the slaughter.

On October 16, 1997, the Dow broke through its most recent uptrend line, as seen at point 1 in [Figure 18.1](#). The Dow then rallied and closed at 8034.65 on October 22, just below its broken trend line, at point 2. This is a common occurrence in all markets—once a trend line is broken, the markets will come up and test it one last time before rolling over. I call this "kissing the trend line goodbye." On October 24, at point 3, the Dow closed at 7715.41, down 319.24 points. This started the round of forced margin calls after the close, which was on a Friday. The margin call selling would take place on Monday. The Dow opened Monday at 7633.14, down 82.27. Then the forced selling via the margin calls began—and the S&P pit traders, who knew what was happening, simply stepped back and walked away from the bids. With no support in the markets, the Dow dropped quickly and closed at 7161.39, down 554.02 points on the day, as seen at point 4. By the time the closing bell rang on Monday, everyone who was selling naked puts for a living had lost a substantial amount of money. The funds that were involved not only lost all the money under their management, but ended up owing money to the brokers. Well, more correctly, the people who had invested in the fund lost all their money, and ended up owing more than they had put into the fund. Many metaphors come to mind here, but I will pass, as most of them are quite graphic in nature. Once all these people were cleaned out, the markets were set to rally. The very next day, the markets pushed down to new lows, touching 6927 at point 5, having shed just over 1,000 points in three trading days, before putting in a hard bottom. The Dow then closed at 7498.32, up 336.93 points on the day, and went on to rally steadily from there. Once all of the naked put sellers were cleaned out, there was nothing to do but resume the uptrend.

**Figure 18.1**



Okay, so how do I use options? The main way I use options is as a means for owning a stock at a cheaper price. Because of the premium and time decay, I am very specific about the options I buy. For example, I won't buy out-of-the-money options, as they are all premium and a sucker's game. Therefore, I want to look at options that are trading in the money ("in the money" means that the option's strike price is below the current market price of the stock for call options, and that the strike price is above the current market price of the stock for put options), if not more, in order to buy an option where the premium constitutes less than 30 percent of the overall purchase price. In early 2005, the premium of options was generally low, so I could usually buy options just one strike in the money to meet this criterion. In 1999 and 2000, however, option premiums had been at extremes, and I often had to go 5 to 10 strikes in the money to buy options that met my criteria. I remember when QCOM was at \$250 before its infamous "run to a thousand" at the end of 1999. At-the-money call options were \$45. In order to buy calls that were only 30 percent premium, I had to go nearly 15 strikes in the money.

The option table represented in [Figure 18.2](#) shows different strike prices and expiration months for GOOG. At the time this was created, in early November 2004, GOOG was trading at \$191.67. If I am interested in buying a call on this stock, I'll start looking at the near-month contracts that are in the money. Because GOOG is a higher-priced, volatile stock, the option premiums are going to be high—the higher the volatility, the higher the premium. In this case, I look at the November 180 calls, which are two strikes in the money. The premium on these is still excessive, and I need to go down one more strike price, to the November 175 calls, to meet my criterion of the premium being less than 30 percent of the overall purchase price. The amateur option trader in this case is going to buy the November 220 calls because they are so "cheap" at \$2.55. Never mind that they will expire worthless. For puts, I first look at the November 200 puts, but they are too expensive. I look at the 210s, and they are close, but the 220s are better with respect to the amount of premium I want to pay. Remember, all I'm trying to do is buy (or short) the actual stock at a

cheaper price. This means that I don't want a lot of premium. Looking at the next month out in December, these same strike prices jump up excessively in price, so I want to stay with the near-month contracts and wait until expiration to roll over into December if I have to. I'll explain more about how to figure out premium shortly. (As I discussed in [Chapter 5](#), an easy way to do this is just to buy an option with a delta of 0.70 or higher.)

Figure 18.2

GOOG														
GOOGLE INC														
191.67	GALLS		Bid: 118.39	Ask: 264.69	BSize: 1	ASize: 1	Vol: 13.9M	Volatility: 64.96	Nov03	18:40	Today's Date: 11/3/2004			PUTS
Oplnt	Vol	Bid	Ask	Change	Last	ymbol(shot)	Symbol	ymbol(shot)	Last	Change	Ask	Bid	Vol	Oplnt
4.17K	106	37.70	38.00	-5.20	36.90	GOO KZ	NOV04 155.00	GOO WZ	0.95	+ 0.10	1.05	0.90	1.85K	8.97K
4.48K	569	33.20	33.40	-2.70	33.10	GOO KY	NOV04 160.00	GOO WY	1.35	-0.10	1.50	1.30	936	7.00K
3.90K	108	28.80	29.10	-3.10	28.50	GOO KX	NOV04 165.00	GOO WX	2.15	+ 0.15	2.10	2.00	1.25K	6.64K
4.94K	206	24.60	25.00	-3.40	24.40	GOO KW	NOV04 170.00	GOO WW	2.95	+ 0.25	3.00	2.80	2.33K	6.60K
3.77K	447	20.80	21.20	-2.70	20.50	GOU KO	NOV04 175.00	GOU WO	4.20	+ 0.40	4.10	4.00	1.44K	8.16K
7.35K	1.63K	17.40	17.70	-2.60	17.40	GOU KP	NOV04 180.00	GOU WP	5.80	+ 0.70	5.80	5.50	2.47K	8.09K
6.26K	1.73K	14.30	14.60	-1.70	14.60	GOU KO	NOV04 185.00	GOU WO	7.60	+ 0.40	7.50	7.40	1.86K	4.22K
5.53K	2.54K	11.50	11.80	-2.20	11.50	GOU KR	NOV04 190.00	GOU WR	10.00	+ 1.00	9.90	9.60	2.10K	5.10K
4.27K	3.43K	9.20	9.30	-2.00	9.10	GOU KS	NOV04 195.00	GOU WS	12.60	+ 1.10	12.30	12.20	1.46K	1.85K
9.55K	5.52K	7.10	7.30	-1.80	7.20	GOU KT	NOV04 200.00	GOU WT	15.80	+ 1.70	15.60	15.20	1.38K	3.52K
8.48K	4.37K	4.30	4.30	-1.50	4.30	GOU KB	NOV04 210.00	GOU WB	22.10	+ 0.60	22.70	22.30	279	253
7.00K	3.08K	2.50	2.55	-0.85	2.55	GOU KD	NOV04 220.00	GOU WD	31.00	+ 1.60	30.80	30.50	102	197
4.38K	2.58K	1.40	1.55	-0.65	1.45	GOU KF	NOV04 230.00	GOU WF	39.90	+ 2.50	39.70	39.30	17	90
3.78K		41.10	41.50	+ 1.60	44.90	GOO LZ	DEC04 155.00	GOO XZ	4.50	-0.10	4.60	4.30	118	2.75K
1.69K	20	37.30	37.70	-1.80	40.40	GOO LY	DEC04 160.00	GOO XY	5.50	+ 0.20	5.70	5.40	390	2.51K
1.21K	1	33.50	33.90	+ 2.70	39.50	GOO LX	DEC04 165.00	GOO XX	6.90	+ 0.10	7.00	6.70	130	5.53K
4.49K	103	30.10	30.50	-2.40	30.50	GOO LW	DEC04 170.00	GOO XW	8.50	0.00	8.60	8.30	617	2.36K
966	162	26.70	27.10	-3.00	26.80	GOU LO	DEC04 175.00	GOU XO	10.40	+ 0.60	10.20	9.90	132	1.57K
2.79K	173	23.80	24.20	-1.90	23.80	GOU LP	DEC04 180.00	GOU XP	12.00	+ 0.70	12.20	11.90	308	2.46K
5.59K	132	21.00	21.40	-2.70	20.80	GOU LO	DEC04 185.00	GOU XO	14.30	+ 0.30	14.40	14.10	339	1.55K
2.44K	420	18.50	18.90	-2.60	18.30	GOU LR	DEC04 190.00	GOU XR	17.20	+ 1.20	17.00	16.60	483	1.62K
1.85K	481	16.20	16.60	-2.50	15.80	GOU LS	DEC04 195.00	GOU XS	19.80	+ 0.80	19.70	19.30	132	974
4.34K	1.80K	14.40	14.50	-2.20	14.10	GOU LT	DEC04 200.00	GOU XT	22.70	+ 1.30	22.60	22.20	194	797
5.20K	600	10.70	11.00	-1.90	10.50	GOU LB	DEC04 210.00	GOU XB	28.90	+ 3.00	29.20	28.80	161	336
3.31K	454	8.00	8.30	-1.70	7.80	GOU LD	DEC04 220.00	GOU XD	36.10	+ 2.50	36.40	36.00	67	223
929	751	5.90	6.20	-1.30	6.00	GOU LF	DEC04 230.00	GOU XF	41.90	+ 0.10	44.30	43.90	70	201
492	20	49.90	50.40	-1.10	52.80	GOO CZ	MAR05 155.00	GOO OZ	11.50	-1.30	13.30	12.90	44	3.04K
1.22K	13	46.60	47.10	-0.70	49.40	GOO CY	MAR05 160.00	GOO OY	14.00	-0.90	14.80	14.40	34	674
705	23	43.40	43.90	-2.60	45.70	GOO CX	MAR05 165.00	GOO OX	15.60	-1.10	16.70	16.20	67	1.70K

In contrast to GOOG, IBM is a more stable stock, and the premiums here aren't that high. With the stock trading at \$91.20, I first look at the November 90 calls, but they have too much premium (see [Figure 18.3](#)). The 85s fit the bill nicely. On the put side, the first strike in the money, the 95s, works fine. Note that I could even go out to the next month, the December 95s, and pay only a little extra in premium. I like to focus on the near-month contract in order to reduce premium. However, if the option is set to expire in less than two weeks, then I will go ahead and buy the next month out, though I may have to go even deeper in the money. Following are a few more notes of interest on options contracts:

Figure 18.3



Options1														
IBM														
INTERNATIONAL BUSINESS MACH: Bid: 90.65 BSize: 4 Vol: 6.55M Nov03														
91.20 c Ask: 91.07 ASize: 2 Volatility: 15.78 20:09 Puts														
OpInt	Vol	Bid	Ask	Change	Last	Symbol/sho	Symbol	Symbol/sho	Last	Change	Ask	Bid	Vol	OpInt
320		16.10	16.30	+ 0.10	15.40	IBM KO	NOV04 75.00	IBM WO	0.05	0.00	0.05	0.00		3.32K
2.06K	107	11.10	11.30	+ 0.70	11.10	IBM KP	NOV04 80.00	IBM WP	0.05	0.00	0.05	0.00	5	18.5K
12.9K	906	6.10	6.40	+ 1.00	6.40	IBM KO	NOV04 85.00	IBM WO	0.10	-0.15	0.10	0.05	98	18.1K
29.5K	9.45K	1.80	1.90	+ 0.30	1.85	IBM KR	NOV04 90.00	IBM WR	0.80	-0.50	0.80	0.75	1.29K	6.13K
7.33K	993	0.10	0.20	+ 0.02	0.17	IBM KS	NOV04 95.00	IBM WS	4.00	-1.00	4.10	4.00	352	660
261		0.00	0.05	0.00	0.05	IBM KT	NOV04 100.00	IBM WT	8.80	-0.80	9.10	8.80	12	245
		0.00	0.05	0.00	0.00	IBM KA	NOV04 105.00	IBM WA	13.40	-1.00	14.10	13.80	35	120
81	10	16.10	16.40	+ 0.80	16.20	IBM LO	DEC04 75.00	IBM XO	0.10	0.00	0.10	0.00		517
960	14	11.20	11.40	+ 0.80	11.40	IBM LP	DEC04 80.00	IBM XP	0.10	-0.05	0.15	0.05	125	2.75K
5.15K	210	6.50	6.70	+ 0.60	6.60	IBM LO	DEC04 85.00	IBM XO	0.40	-0.20	0.40	0.35	192	4.55K
6.86K	1.53K	2.60	2.75	+ 0.50	2.75	IBM LR	DEC04 90.00	IBM XR	1.45	-0.55	1.55	1.40	271	1.67K
7.91K	2.55K	0.60	0.70	+ 0.06	0.61	IBM LS	DEC04 95.00	IBM XS	4.20	-1.10	4.50	4.30	39	304
1.21K	10	0.05	0.15	+ 0.10	0.20	IBM LT	DEC04 100.00	IBM XT	9.60	+ 0.40	9.10	8.90		54
4		0.00	0.05	0.00	0.05	IBM LA	DEC04 105.00	IBM XA	14.80	+ 0.10	14.10	13.80		50
296	42	16.40	16.60	+ 0.60	16.70	IBM AO	JAN05 75.00	IBM MO	0.20	0.00	0.20	0.10		5.17K
13.2K	80	11.60	11.80	+ 0.90	12.30	IBM AP	JAN05 80.00	IBM MP	0.30	-0.10	0.35	0.30	179	25.6K
13.2K	1.60K	7.00	7.20	+ 0.20	7.20	IBM AO	JAN05 85.00	IBM MO	0.80	-0.25	0.80	0.70	367	22.8K
39.7K	732	3.30	3.50	+ 0.30	3.40	IBM AR	JAN05 90.00	IBM MR	2.00	-0.55	2.10	1.95	4.50K	27.6K
26.6K	1.51K	1.15	1.25	+ 0.10	1.20	IBM AS	JAN05 95.00	IBM MS	4.90	-0.40	4.90	4.70	127	10.9K
36.1K	383	0.30	0.40	+ 0.05	0.35	IBM AT	JAN05 100.00	IBM MT	9.10	-0.70	9.20	8.90	2	9.12K
4.06K	338	0.05	0.15	-0.02	0.13	IBM AA	JAN05 105.00	IBM MA	13.90	+ 0.50	14.10	13.80	19	1.04K
93		16.90	17.20	+ 0.47	16.90	IBM DO	APR05 75.00	IBM PO	0.50	-0.05	0.55	0.45	80	2.88K
430	23	12.40	12.60	+ 0.40	12.40	IBM DP	APR05 80.00	IBM PP	0.85	-0.15	0.90	0.85	230	4.87K
2.30K	18	8.20	8.40	+ 0.20	8.50	IBM DO	APR05 85.00	IBM PO	1.60	-0.30	1.70	1.60	215	5.59K
19.0K	380	4.70	4.90	+ 0.40	4.70	IBM DR	APR05 90.00	IBM PR	3.10	-0.41	3.20	3.00	410	12.2K
5.79K	400	2.25	2.30	+ 0.30	2.40	IBM DS	APR05 95.00	IBM PS	5.30	-0.70	5.80	5.60	313	1.72K
3.11K	1.47K	0.95	1.00	+ 0.10	1.00	IBM DT	APR05 100.00	IBM PT	8.90	-1.30	9.50	9.30	80	1.44K
742		0.30	0.40	+ 0.05	0.40	IBM DA	APR05 105.00	IBM PA	13.40	-1.40	14.10	13.90	81	614

- One option contract equals 100 shares of stock.
- If you buy 10 GOOG November 190 calls at \$12, that will cost \$12,000.
- To buy an equivalent 1,000 shares of the stock at \$190 would cost \$190,000.
- If GOOG rallies by 10 points, these options will move about 6 points. This depends on how far in the money they are. The further they are in the money, the more they will move “dollar for dollar” with the underlying stock.
- If you sell the 10 GOOG calls at \$18 (\$18,000), you will pocket \$6,000.
- The maximum loss on this trade is the option’s cost, \$12,000.

By contrast to this last bullet point, if a trader bought 1,000 shares of GOOG at \$190 and it gapped down 30 points on an earnings report, the trader would be out \$30,000. Options do limit risk if they are purchased correctly. Now that we’ve reviewed SSFs and stock options, let’s get down to the play itself.

### Trading Rules for Buy Fades (Sells Are Reversed)

This is a fade play that focuses on swing positions that last a few days to a few weeks. I am looking to sell strength and buy weakness.

1. For these plays, I am utilizing a daily chart. Because these plays are meant to last a few days to a few weeks, I’m not interested in what is happening on a 5- or 15-minute chart. I want to be able to step back and look at a slightly bigger picture without all the noise found in intraday charts.

2. The only indicators I place on the daily chart are an 8- and a 21-period exponential moving average (EMA).
3. For longs, I want to see the 8-period EMA trading above the 21-period EMA. Once this upward cross happens, then I can start looking for a setup to occur.
4. The specific setup I'm looking for, once the 8-period EMA has crossed above the 21-period EMA, is a pullback to the 8-period EMA.
5. The initial stop is the 21-period EMA or 4 percent of the stock price, whichever is greater. Typically the initial stop turns out to be this 4 percent level. Note that this 4 percent level is based on the price of the stock, not my equity level. That is, I'm not risking 4 percent of my equity on one trade; I'm risking 4 percent of the price of the stock. I could have 10 stocks going at one time.
6. Once I'm up 4 percent on the position (I call this my *watermark level*), I will move up my stop to the 21-period EMA. I will then use this 21-period EMA as a trailing stop until my target or trailing stop is hit.
7. My target is an 8 percent move in the price of the stock from my entry price. Although I focus mostly on stocks when I'm using this play, it can also be used on the stock index futures. However, the percentages will be different. On a daily chart, instead of an 8 percent target, I just use a 1 percent target and a 0.5 percent stop to start. If the mini-sized Dow is at 10,604, then my target is 106 points, and my initial stop is 53 points or the 21-period EMA, whichever is greater. On a 60-minute chart, I cut this in half, using a target of  $\frac{1}{2}$  of 1 percent and a stop of  $\frac{1}{4}$  of 1 percent or the 21-period EMA, whichever is greater. To get these, I just multiply the price of the index by 0.005 for the target and by 0.0025 for the stop. A sample play of this nature is discussed in [Chapter 23](#).
8. The easiest way to figure out all these levels is to quickly set up an Excel spreadsheet with the formulas already in place (see [Figure 18.3](#)).
9. One way to slightly increase the odds of success on long setups is to trade only stocks where the 8-period EMA is higher than the 21-period EMA on the weekly charts. This condition can last on a weekly chart for months and even years. If this setup exists on the weekly charts, then it's just a matter of waiting for an entry on the daily chart as per this setup. This process is discussed in more detail in [Chapter 23](#).

[Figure 18.4](#) is a snapshot of the exact Excel spreadsheet I use to calculate my key stop and target levels. All I do is enter my entry price in the highlighted box. If I'm long on the stock, then I use the "long" box, and vice versa. Once the price is in, the Excel spreadsheet calculates all the levels for me automatically. The formulas are very simple. For example, the target is calculated by taking the entry price and multiplying it by 0.08 (8 percent). The initial stop is calculated by taking the entry price, multiplying it by 0.04 (4 percent), and subtracting it from the entry. The 4 percent watermark level is calculated by taking the entry price, multiplying it by 0.04 (4 percent), and adding it to the entry price. I used to do all this manually, and it was a



real buzz killer.

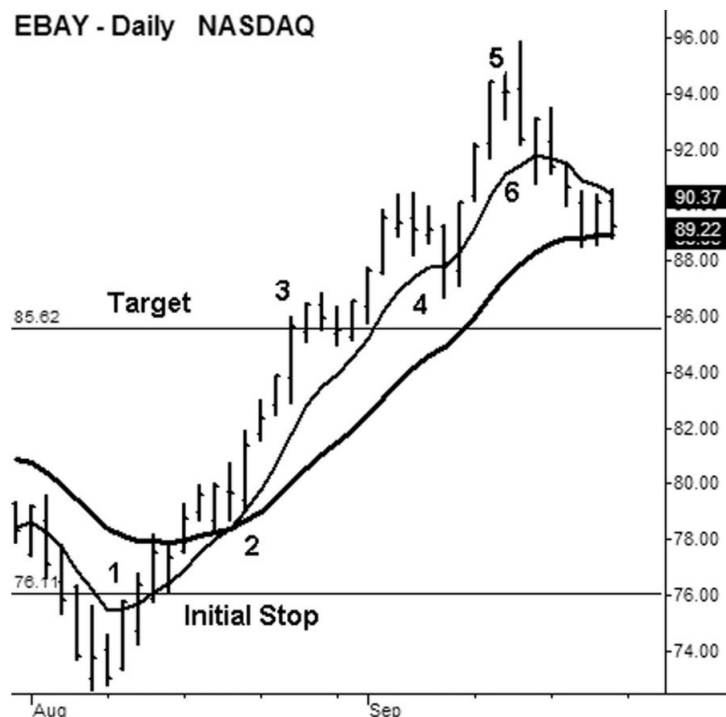
Figure 18.4

LONG				
Enter Price	\$ 88.45			
		Points	Price	
	Target	7.08	95.53	
	Initial Stop	3.54	84.91	
	Up 4%	3.54	91.99	
SHORT				
Enter Price	\$ 25.10			
		Points	Price	
	Target	2.01	23.09	
	Initial Stop	1.00	26.10	
	Up 4%	1.00	24.10	

*EBAY (eBay, Inc.)—August 19, 2004*

1. On August 10, 2004, EBAY crosses above its 8-period EMA (see Figure 18.5). However, since the 8-period EMA is still trading below the 21-period EMA, I am not interested in setting up a buy order just yet. I need to wait for the 8-period EMA to cross up through the 21-period EMA before I set up my first buy order. Note: on all these charts, the 8-period EMA is the skinny moving average line, and the 21-period EMA is the thicker moving average line.

Figure 18.5



2. On August 19, the 8-period EMA crosses up above the 21-period EMA. I'm now ready to start

bidding for a long, and my entry point will be a pullback to the 8-period EMA. The next day I am filled at 79.28 when the market pulls back to the 8-period EMA. Now that I'm in the trade, I need to check where to place my stop. The 21-period EMA is at 79.08, which is not very far below my entry level. A 4 percent stop would be placed at 76.11. Since the 4 percent stop is greater, this is the stop I will use to start out with. My target is 8 percent up from my entry, which is 85.62. Remember, once I'm up 4 percent in the position, I will move my stop up to the 21-period EMA. The initial stop and target for this play are highlighted on the chart with the horizontal lines.

3. On August 25, EBAY pushes higher and hits my target, and I'm out for just over \$6 per share (\$6.34). Now that I'm out, it's time to start looking for the next pullback to the 8-period EMA. A trader could also have followed this same play using single-stock futures or in-the-money call options. I will review those possibilities for this play in a moment.
4. On September 9, 10 trading days later, EBAY pulls back to its 8-period EMA, and I am filled at 87.95. I do a quick calculation, and I see that my target is going to be 95.78 and my stop is 84.43. I set my parameters and let my orders babysit my position.
5. Four trading days later my target is hit, and I'm out of the trade.
6. On September 17, the market pulls back to the 8-period EMA once again. I take the trade, and I get in at 91.74 and set my parameters. This would be a stop of 88.07 and a target of 99.08. At the time I did this chart, I was still in the trade, so it was "active."

I'd like to take a moment to examine the first EBAY play detailed in [Figure 18.5](#) more closely. This play could also have been executed using single-stock futures or in-the-money call options. It is useful to compare these trades to the actual stock trade to get an idea of how this setup could have been followed on these various trading instruments. This will also give a trader an idea of the risk/reward parameters for each scenario. Although it's the exact same play across all three instruments, the amount risked versus the amount gained is different for each of the three scenarios. Let's take a look:

- Buy 1,000 shares of EBAY stock at \$79.28. Total cost is \$79,280.
- Buy 10 EBAY1C September single-stock futures (SSF) contracts at \$79.28. Total cost is \$15,856 (20 percent of \$79,280).
- Buy 10 EBAY September 75 call options at \$6.10. Total cost is \$6,100.

To figure out the premium on an options contract, people can look at the delta, or, if they aren't familiar with that, just use a calculator: with the stock at \$79.28, a \$75 call option costs \$6.10.  $\$75.00 + \$6.10 = \$81.10$ , and  $\$81.10 - \$79.28$  (the actual price of the stock) = \$1.82. The option, then, has \$4.28 of intrinsic (real) value and \$1.82 of premium. The ratio is 29.84 percent ( $1.82/6.10$ ).

Now that we've looked at the total costs for each entry, let's take a look at the exits:

- Sell 1,000 shares of EBAY stock at \$85.62, a gain of \$6,340, or 8.00 percent (or 16.00 percent if

bought on margin).

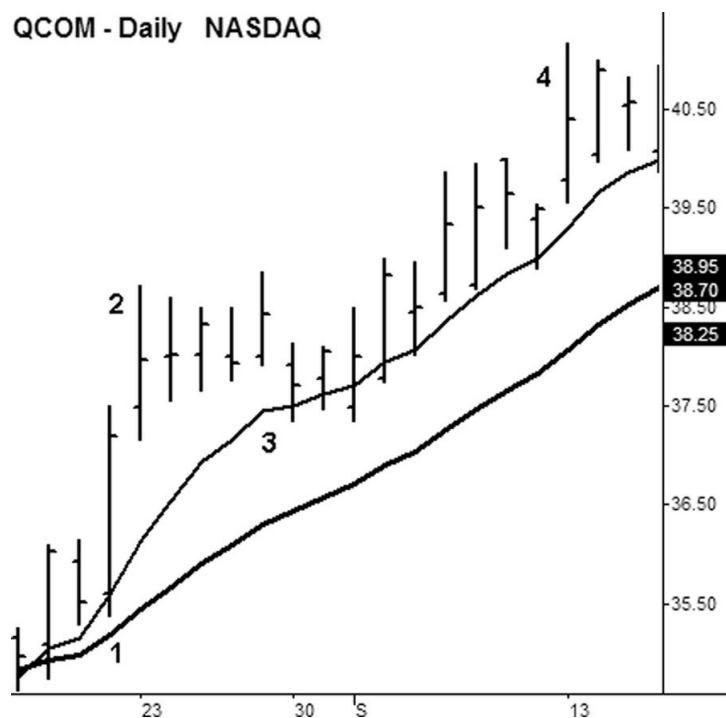
- Sell 10 EBAY1C September SSF contracts at \$85.62, a gain of \$6,340, or 40 percent.
- Sell 10 EBAY September 75 calls at \$12.20, a gain of \$6,100, or 100 percent.

As you can see, using this exact same setup, a trader could put up \$79,280 in cash to buy the stock (or \$39,640 if he is using margin), \$15,856 to buy the single-stock futures, or \$6,100 to buy the options. The dollar outcome of the trade is very close across all three scenarios—a little over \$6,000. By using SSFs or the correct in-the-money option strike prices, a trader can risk less capital for the same potential monetary gain of the stock play. It is up to the trader to decide whether she wants to focus on stocks, SSFs, options, or a combination of the three.

### *QCOM (Qualcomm, Inc.)—August 19, 2004*

1. The 8-period EMA pushes above the 21-period EMA, and I place my bid (see Figure 18.6). Two days later, on August 20, 2004, I am filled at 35.47. I place a stop at 34.05 and a target at 38.31. By the time trading is done this day, the stock is already up by 4 percent from my entry, so I move my stop up to the 21-period EMA, which is 35.34.

Figure 18.6



2. On Monday, August 23, QCOM continues to push higher, and my target is hit. I immediately set up a bid to buy the next pullback to the 8-period EMA.
3. On August 30, my trailing bid is hit, and I'm in at 37.51. I place a stop at 36.01 and a target at 40.51.
4. About two weeks later, on September 13, my target is hit. Note that when the stock is up by 4 percent

from my entry on September 7, I raise my stop to the 21-period EMA at 37.42, and I trail this stop until my target is hit.

As I did with EBAY, let's take a look at executing this same QCOM play across all three trading instruments. Here is how the entries would break down:

- Buy 1,000 shares of QCOM at \$37.51. Total cost is \$37,510.
- Buy 10 QCOM1C September SSF contracts at \$37.51. Total cost is \$7,502 (20 percent of \$37,510).
- Buy 10 QCOM September 35 calls at \$3.10. Total cost is \$3,100.

To figure out the premium on the QCOM options, just take  $\$35.00 + \$3.10 = 38.10$ . There is \$2.51 of real value ( $\$37.51 - \$35.00$ ) and 0.59 cents of premium ( $3.10 - 2.51 = 0.59$ ). The ratio is 19.03 percent ( $0.59/3.10$ ).

We've looked at the total costs for each entry, so now let's take a look at the exits:

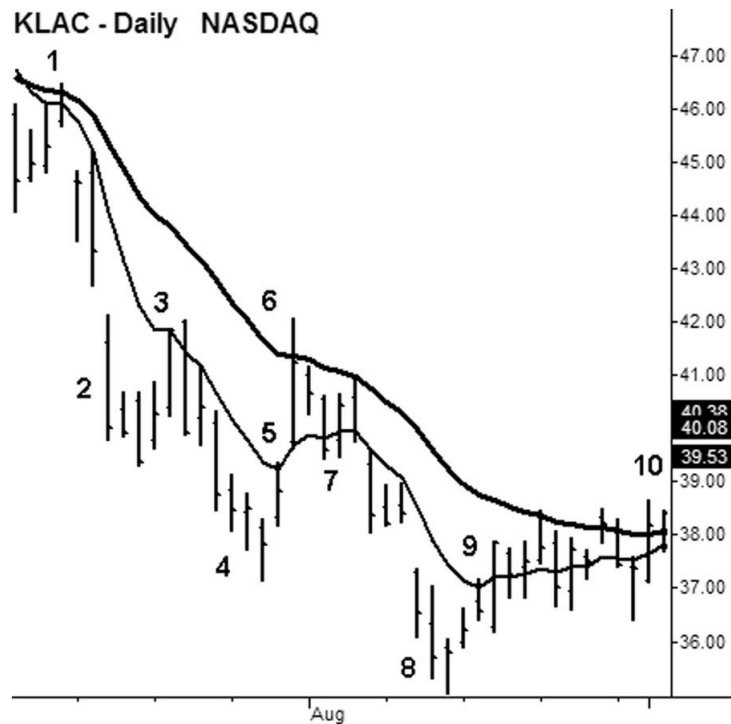
- Sell 1,000 shares of QCOM at \$40.51, a gain of \$3,000, or 8 percent, or 16 percent if using margin.
- Sell 10 QCOM1C September SSF contracts at \$40.51, a gain of \$3,000, or 40 percent.
- Sell 10 QCOM September 35 calls at \$5.90, a gain of \$2,800, or 90.32 percent.

Once again, using this exact same setup, a trader could put up \$37,510 in cash to buy the stock (or \$18,755 if she is using margin), \$7,502 to buy the single-stock futures, or \$3,100 to buy the options. The dollar outcome of the trade is very close across all three scenarios—about \$3,000. Now that you have the idea, I'm just going to focus on the actual stock plays for the rest of this chapter. Of course, not all stocks have options and single-stock futures available on them, so some of these plays can be executed only on the actual stock.

#### *KLAC (KLA-Tencor Corp.)—July 9, 2004*

1. When the 8-period EMA crosses below the 21-period EMA and the price action moves below both these levels on KLAC, I start looking for the next shorting opportunity (see [Figure 18.7](#)). I want to short a rally back to the 8-period EMA, and on July 9, 2004, I am filled at 46.19. I place a stop at 48.04 and a target of 42.49. On July 13, my position is up by 4 percent, so I move my stop up to the 21-period EMA, which is 46.84.

**Figure 18.7**



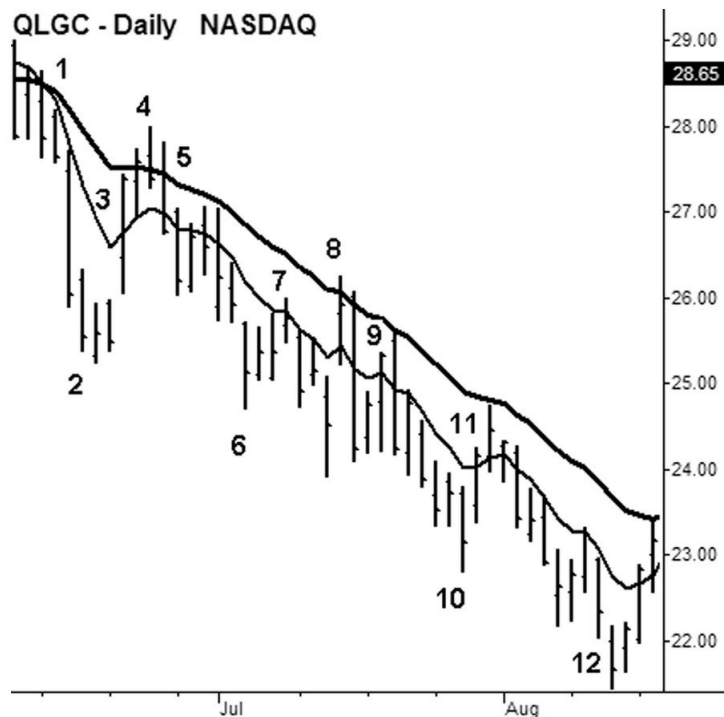
2. On July 14, KLAC gaps down and opens through my target. I'm filled at the open at 41.61, 88 cents better than my target, for a nice gain. KLAC is still trading below its 8- and 21-period EMAs, so I set up my next short, which would be a rally back to its 8-period EMA.
3. On July 20, the market rallies back to the 8-period EMA, and I'm filled at 41.81. My stop is 43.48, and my target is 38.47. On July 22, the stock is up by 4 percent from my entry, so I move my stop down to the 21-period EMA, which is 42.84.
4. On July 26, my target is hit, and I'm out for an 8 percent gain. I start looking to short again at the next rally back to the 8-period EMA.
5. On July 29, I'm back in short at 39.33. I place a stop at 40.90, and my target is 36.18.
6. The next day, KLAC gaps up on positive news and rallies to my stop. I'm out for a 4 percent loss. I note that the 8-period EMA has not crossed above the 21-period EMA. I sit back and wait, because if KLAC trades and closes back below its 8-period EMA, I will set up an order to short the next rally back to its 8-period EMA.
7. A few days later, on August 3, KLAC closes below its 8-period EMA. I set up an order to short a rally back to its 8-period EMA, and on August 4, I am filled at 39.93. I place a stop at 41.53 and a target at 36.74. The stock pushes higher, and on August 5 it comes within spitting distance of my stop, but it doesn't make it and closes well off its highs.
8. On August 10, I have a 4 percent gain registered, so I move my stop down to the 21-period EMA, which is 40.29. On August 11, KLAC gaps lower and pushes lower all day, hitting my target.

9. KLAC is still trending lower according to the 8- and 21-period EMAs, so I set up another order to short a rally to the 8-period EMA. On August 17, KLAC rallies, and I am filled at 37.15. I place a target at 34.18 and a stop at 38.64.
10. The market chops back and forth for a while, and on September 1, I am stopped out for a 4 percent loss.

*QLGC (QLogic Corp)—June 14, 2004*

1. On June 14, 2004, the 8-period EMA on QLGC crosses below the 21-period EMA, setting up a situation in which I can start taking new plays (see Figure 18.8). I place an order the next day to short a rally back up to the 8-period EMA, and I'm filled at 28.14. I place a stop at 29.27 and a target at 25.89.

Figure 18.8



2. On June 16, QLGC dry heaves and pukes for a nice down day. It gets close to my target, but not quite. Since I'm up more than 4 percent on the play, I move down my stop to the 21-period EMA, which is 28.22. The very next day, my target is hit at 25.89. I'm now flat on QLGC, and I begin looking at new entries. A new entry, of course, would mean a rally back to the 8-period EMA.
3. I place my order and am filled on June 22 at 26.68. I place a target at 24.55 and a stop at 27.75.
4. QLGC continues to rally, and on June 25, I'm stopped out for a 4 percent loss.
5. The day after I'm stopped, QLGC moves back below its 8-period EMA and closes below it. This is the trigger I'm looking for before I set up my next trade. I need to see a close back below the 8-period

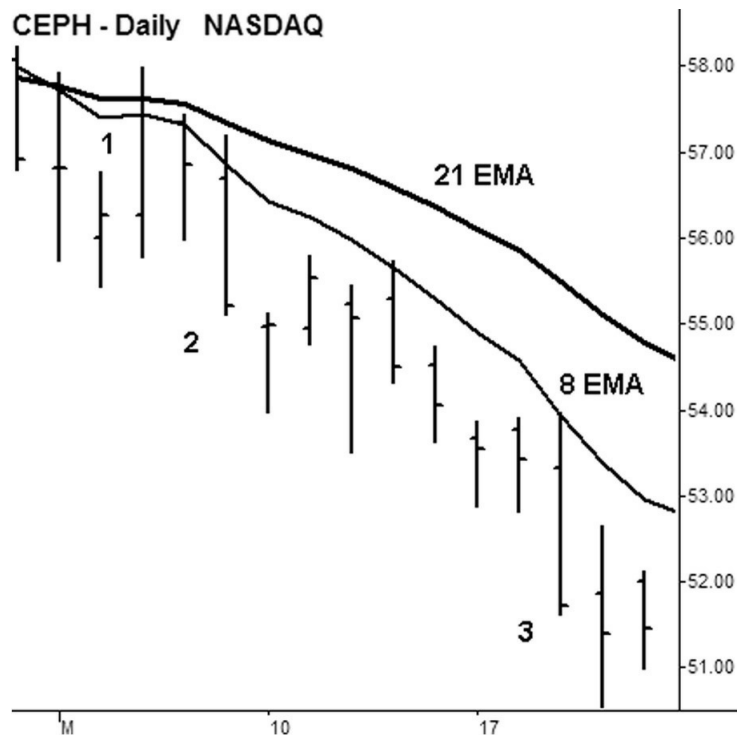
EMA in order to start setting up orders for a new short position. The next day I set up an order to short a rally back to the 8-period EMA, and I'm filled on June 28 at 26.86. My stop is 27.93, and my target is 24.71. QLGC starts moving my way, and on July 1 I am up by more than 4 percent on this position. At this point, I move up my stop and start using the 21-period EMA as a trailing stop, starting with 27.12.

6. QLGC continues to bleed like a stuck pig, and on July 6, I am out at my target. I set up an order to short a rally back to the 8-period EMA.
7. On July 9, my order is hit, and I'm short at 25.85. I place a stop at 26.88 and a target at 23.78. On July 14, QLGC comes close to my target, but "close" works only when you are throwing a grenade. My target isn't hit, but I do move my stop down to the 21-period EMA, which is 26.03.
8. The next day QLGC moves higher, and I'm stopped out for a loss of 18 cents. One question I usually get in a situation like this is, "Hey, since the stock was so close to your target, why didn't you just take the profit?" The main reason I don't is that if I bring that "human judgment" into the equation, two things happen. First, instead of this being a relaxed system to trade, it now becomes an intense system because you have to watch the moves closely on an intraday basis in order to decide when to get out. Second, I've found that most traders, when they are in a trade, lose all objectivity. By actively managing this trade, many people will close it out as soon as it starts to go against them, or they'll start taking profits too soon. In this respect, you might as well be day trading without a plan, which is the most common reason traders lose money. Choose your setup, choose your parameters, and stick to them! How can you measure the effectiveness of a system unless you stick with the parameters?
9. On July 16, QLGC closes back below its 8-period EMA, so I set up another order to short. I'm filled on July 20 at 25.10. My stop is 26.10, and my target is 23.09.
10. QLGC bleeds lower, and my target is filled on July 28. Remember, once I am up by 4 percent in the position, I start using the 21-period EMA as a trailing stop.
11. On July 29, QLGC bounces back up to its 8-period EMA, and I'm filled on a short at 24.09. My target is 22.16, and my stop is 25.05. On August 5, I am up by 4 percent in the position, so I move my stop down to the 21-period EMA, which is 24.23.
12. On August 12, my target is hit, and I'm out for an 8 percent gain.

#### *CEPH (Cephalon, Inc.)—May 3, 2004*

1. On May 3, 2004, the 8-period EMA on CEPH crosses below the 21-period EMA (see [Figure 18.9](#)). I set up an order to short the next rally back up to the 8-period EMA. On May 5, my entry is hit at 57.42. My target is 52.83, and my stop is 59.72.

**Figure 18.9**



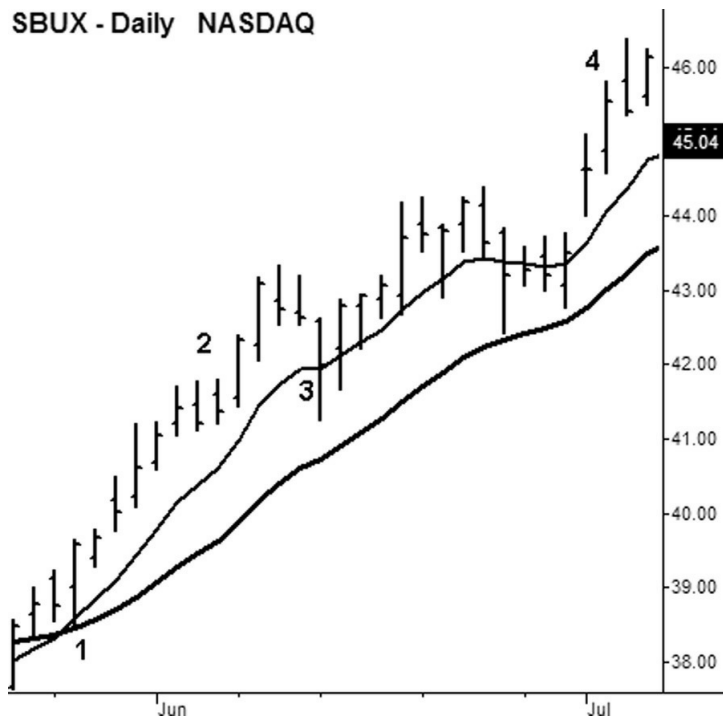
2. On May 7, in addition to celebrating my birthday (after you turn 21, what's the point?), CEPH moves down by more than 4 percent, so I adjust my stop to the 21-period EMA, which is 57.30. This now becomes a trailing stop that I update at the end of each trading day.
3. On May 19, my target is hit. This is a pretty typical swing trade, where I'm in the position for a little more than two weeks, and my daily management of the trade is at the absolute minimum so that I can focus on other things. A pure day trader who was flipping into and out of CEPH during this time could have easily done 30 trades and had nothing to show for it except a pile of commission costs.

***SBUX (Starbucks Corp.)—May 24, 2004***

1. As long as there are day traders, Starbucks will be able to charge as much as it wants for a cup of coffee. There is no bid and ask when it comes to a Grande Latte. Traders will take that one "at the market." On May 24, 2004, SBUX has its 8-period EMA cross up above its 21-period EMA (see [Figure 18.10](#)). This is my signal to set up a bid to buy the next pullback to the 8-period EMA. On May 25, my order is hit, and I'm filled at 38.64. I place a stop at 37.09, and my target is 41.73.

**Figure 18.10**



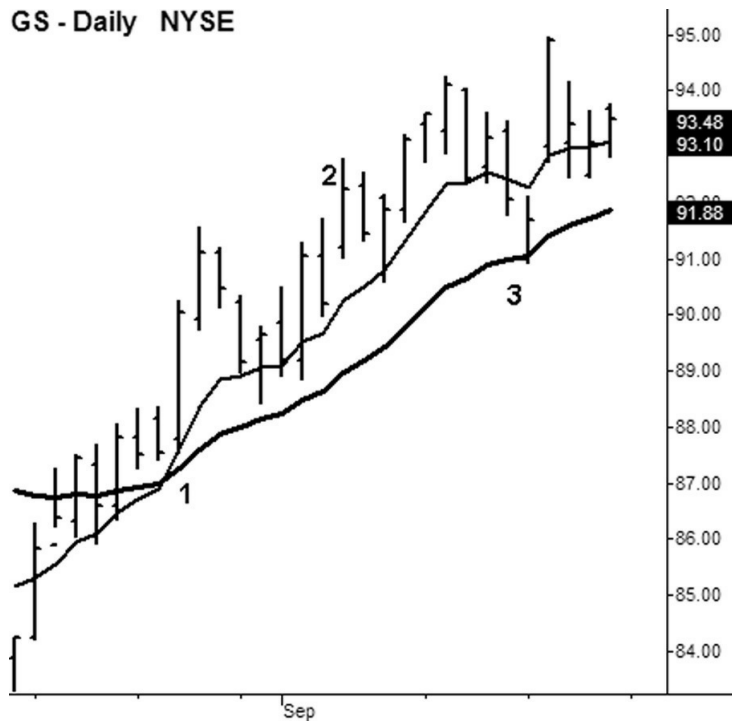


2. On May 27, SBUX moves up by 4 percent from my entry, so I move my stop up, using a trailing 21-period EMA. My stop on this day is moved up to 38.71. The stock continues to push higher, and on June 3 my target is hit. I start to set up my next bid on a pullback to the 8-period EMA.
3. On June 14, SBUX pulls back, and I am filled at 41.96. My stop is 40.28, and my target is 45.32. The stock grinds higher from this point, and on June 18 it hits my 4 percent watermark. I tighten my stop, using the 21-period EMA as my guideline. My new stop is 41.51. On June 25 and June 30, the stock pulls back very close to the 21-period EMA, and obviously very close to my stop. However, it doesn't hit, and I'm still in the trade.
4. On July 2, SBUX firms, and my target is hit for a gain of \$3.36, or 8 percent.

*GS (The Goldman Sachs Group, Inc.)—August 24, 2004*

1. On August 24, 2004, the 8-period EMA on GS crosses up above the 21-period EMA (see [Figure 18.11](#)). I start setting up bids to buy the next pullback to the 8-period EMA. On August 25, I am filled at 87.75. I place a stop at 84.24, and my target is 94.77.

Figure 18.11

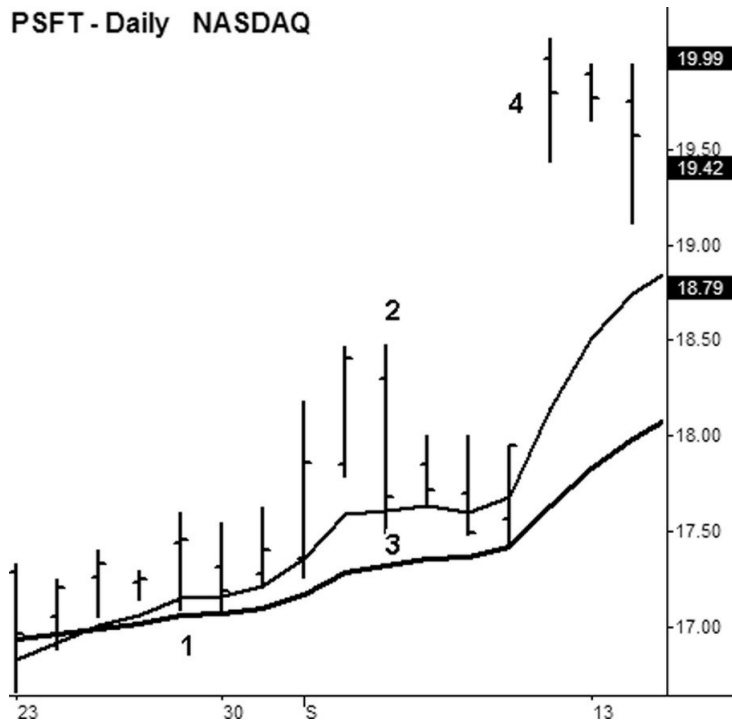


2. On September 7, this position is up by 4 percent from my entry, and I adjust my stop to reflect the current position of the 21-period EMA, in this case 89.06.
3. I update and change my stop at the end of each day, reflecting the movement in the 21-period EMA. GS pulls back and hits its 21-period EMA nine trading days after I start using the trailing stop. I am out at 91.05 for a gain of 3.30, or 3.76 percent. This is another good example of a low-maintenance trade that lasts the better part of a month. This is a very manageable type of trade for people who work full time. I should know, because these are the main types of trades I did when I was doing my stint in the corporate world.

*PSFT (PeopleSoft, Inc.)—August 27, 2004*

1. I like this example because this does tend to happen more often than you would think. This setup keeps you in the direction of the most recent order flow. Typically, when stocks come out with really good news or really bad news, there are always people “in the know” who get positioned for these moves before the news is released. This pushes the stock higher (for good news) or lower (for bad news) before the story hits the wire, since these insiders load up or dump shares. When the news hits, they get out—and often I can too, because I’m following these setups. With PSFT, the 8-period EMA crosses the 21-period EMA on August 25, 2004 (see [Figure 18.12](#)). I set up an order to buy the first pullback to the 8-period EMA.

Figure 18.12



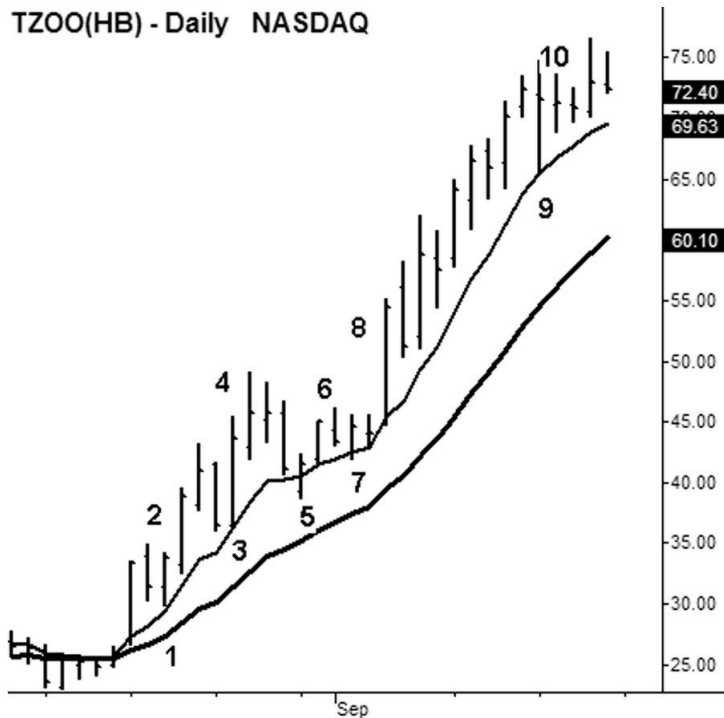
On August 27, PSFT pulls back, and I am filled at 17.11. My stop is 16.43, and my target is 18.47. On September 1, I'm up by 4 percent, so I start to trail my stop using the 21-period EMA.

2. On September 3, my target is hit, and I set up an order to buy the first pullback to the 8-period EMA.
3. The pullback actually occurs on this very same day, and I'm filled at 17.62. I place a stop at 16.92, and my target is 19.03.
4. The stock doesn't do a whole lot for the next three trading days, but on the fourth day it gaps higher on the ORCL (Oracle Corp.) takeover news and opens at 19.97, 94 cents above my target. I'm out for a 13.34 percent gain. Although I had no clue that this would be announced, I did know that the order flow on the stock was positive based on this particular setup, so the odds were in my favor that the path of least resistance would be higher.

*TZOO (Travelzoo, Inc.)—August 13, 2004*

1. TZOO was one of the hyped stocks of 2004, and using this setup, I was able to catch a few of the moves. On August 13, 2004, the 8-period EMA crosses up and through the 21-period EMA (see [Figure 18.13](#)). Once this happens, I set up an order to buy the next pullback to the 8-period EMA. A few days later, on August 18, I am filled at 30.29. I place a stop at 29.08 and a target at 32.71.

Figure 18.13



2. TZOO ramps higher soon after I enter the stock, and my target is hit later that same day. Once I am out, I place another order to buy a pullback to the 8-period EMA.
3. On August 24, the pullback occurs, and I am filled at 37.03. I set my target at 39.99 and my stop at 35.55.
4. Similar to my last trade, TZOO ramps up, and my target is hit the very same day. Like a robot, I set up an order to buy the next pullback to the 8-period EMA.
5. On August 30, I had a bid set at 40.81. The stock gapped below this level and opened at 39.24, where I was filled. This is a good example of what I do in this type of situation, because I place my orders before the market opens and don't wait and try to finesse my entry after the market opens. When you have a limit order in place and the stock opens below that level, then your order becomes a market order because it is "at this price or better." However, I will update my stop and my target based on my actual entry price. In this case, my entry price was 39.24, so I use a stop that is 4 percent lower than this price, which is 37.67, and a target that is 8 percent higher than this price, which is 42.38.
6. On August 31, the very next trading day, my target is hit. I know what I'm going to do now—I'm going to bid for the next pullback to the 8-period EMA. It's like kissing your spouse goodbye when you leave for work in the morning; after a while it's automatic and you don't have to think about it.
7. On September 2, I'm filled at 42.36, and I set my stop at 40.67 and my target at 45.75.
8. A few days later, my target is hit. It's time to buy the next pullback.
9. The market pulls back many times, but never quite to the 8-period EMA until September 20, where

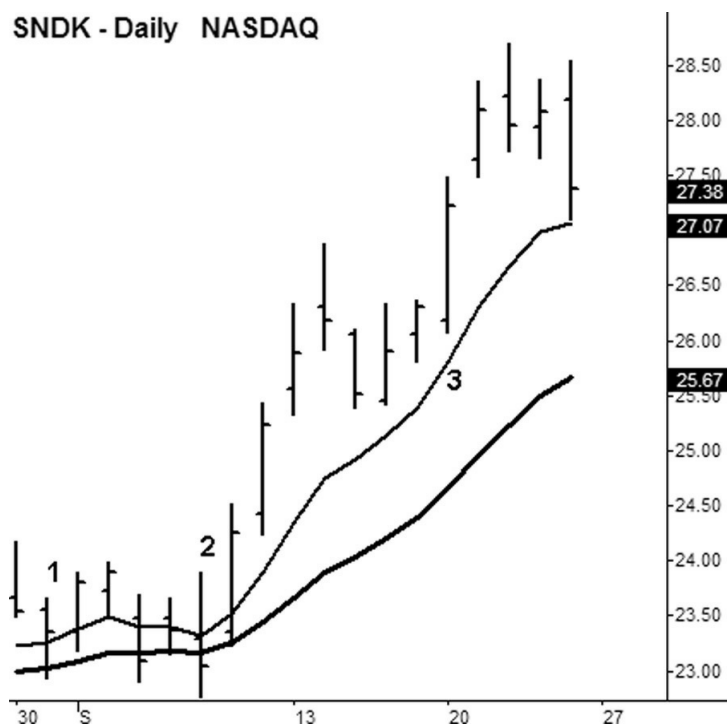
I'm filled at 66.34. I place a stop at 63.69, and my target is 71.65.

10. My target is hit the very same day.

### *SNDK (Sandisk Corp)—August 31, 2004*

1. On August 31, 2004, I buy a pullback to the 8-period EMA on SNDK, and I'm filled at 23.30 (see [Figure 18.14](#)). I place a stop at 22.37 and a target of 25.16. On September 8, SNDK gets close to my stop and closes near the lows. After I see this, I assume that I'm going to get stopped out the next day, but the important thing is that I do not alter my parameters. It doesn't matter what I think, as long as I don't touch the parameters!

Figure 18.14



2. Two days later, the stock has reversed, and I'm out at my target on September 10. It's time to set up my next bid to buy SNDK on a pullback to the 8-period EMA.
3. I trail up my bid, and it's almost hit on September 20 and again on September 24, but close enough doesn't cut it. I don't get filled again on this play during this time frame.

### Updates to the Propulsion Plays

This chapter hasn't changed much since I wrote it for the first edition. However, I did want to include a few updated charts that tie in a couple of things that I introduced earlier in the book. [Figure 18.15](#) shows a chart of the E-mini S&P 500 during the first half of 2011. At point 1, we get a clean 8/21-period EMA cross to the upside, and we have a great opportunity to buy a pullback, just as the setup indicates. However, this chart also has the TTM trend. As long as the bars stay light gray in color, it indicates buying pressure, and there is no reason to exit the trade until there are two black bars in a row. This is great because it can keep a trader in

a trend “as long as it is willing to trend.” Then, at point 2, as the 8/21-period EMA cross is crossing to the downside, a squeeze is also forming at point 3. Bonus! Here a trader can use the concepts discussed in [Chapter 11](#) to get into this trade early and be positioned for the potentially explosive move.

Figure 18.15

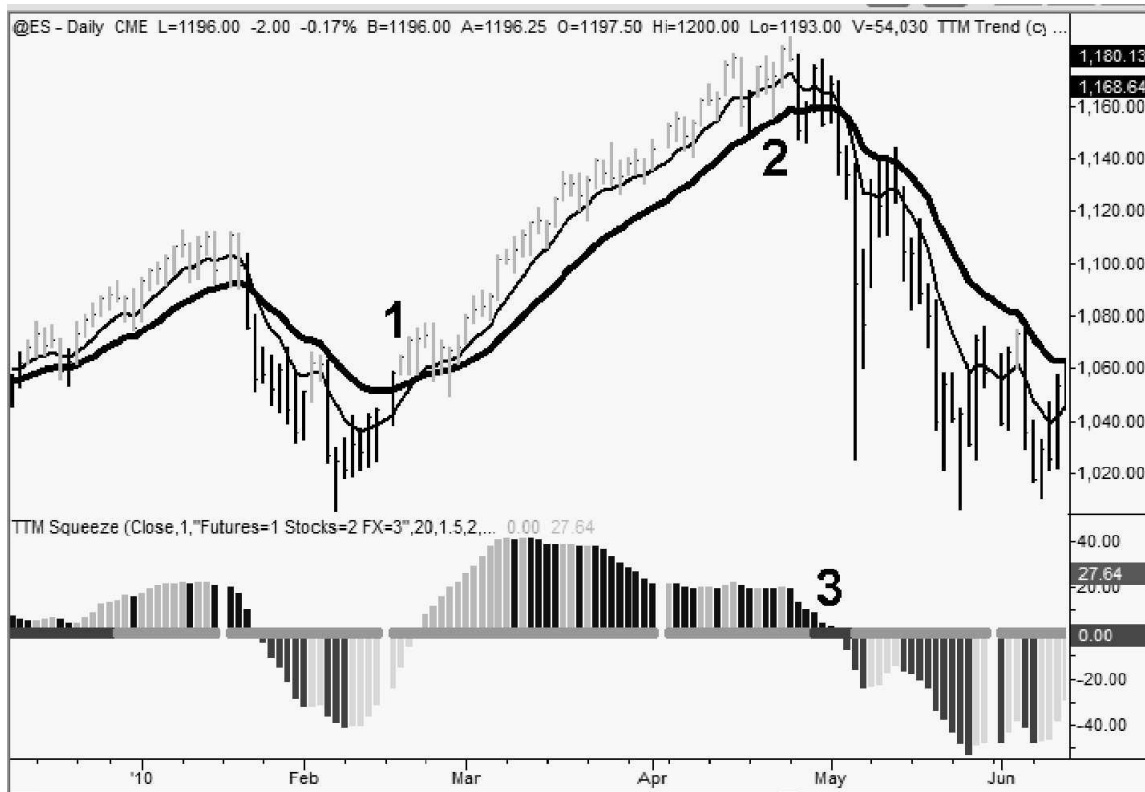
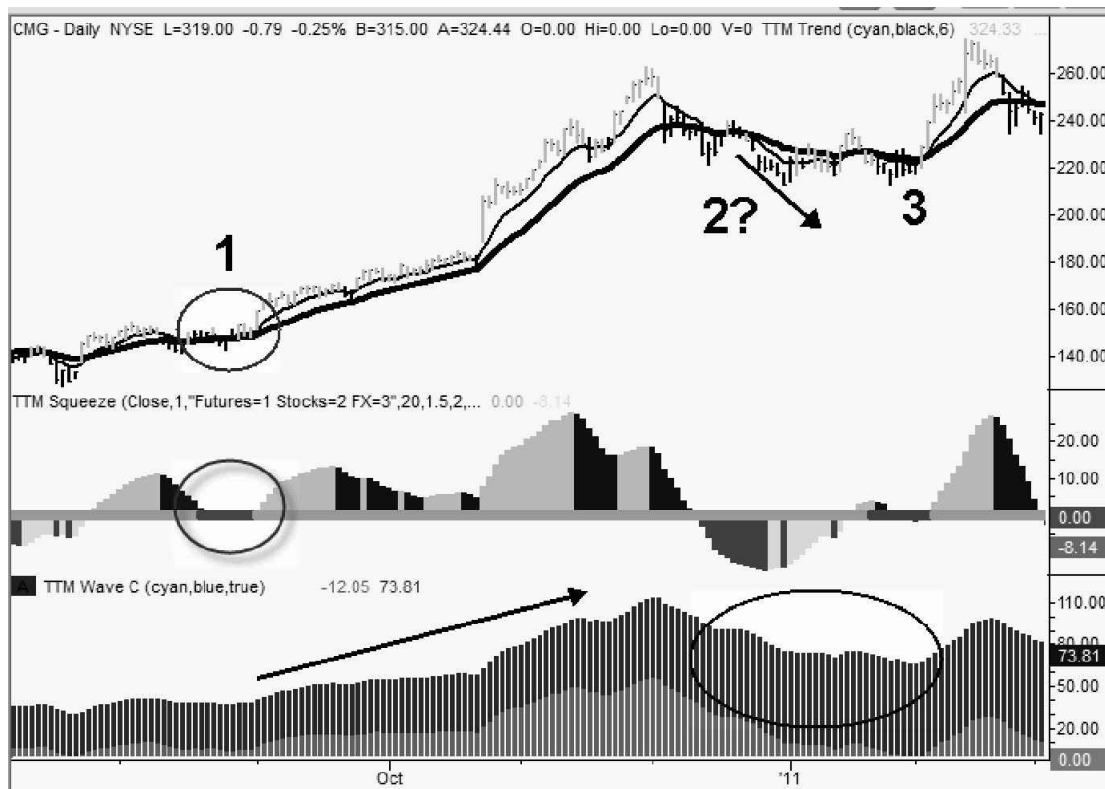


Figure 18.16 is a daily chart of CMG (Chipotle Mexican Grill Inc.), a stock that has confounded shorts for much of its run. In this chart, I’ve also added the C wave from [Chapter 12](#). At point 1, we have a squeeze combined with an 8/21-period EMA cross. As the stock starts moving higher, we can take off a portion of the trade, and then trail the 21-period EMA as a stop. Depending on a trader’s intestinal fortitude, a trader could have enjoyed a massive run on this move, until CMG pushed below its 21-period EMA. What gets interesting is at point 2, where the 8/21-period EMA crosses to the downside. Is this a trade that’s worth taking? Well, if we look at the C wave, we can clearly see that it is above zero, indicating that the longer-term trend on this stock is higher. We can certainly take a short trade here, but at least the C wave is giving us a heads-up that the easier money is on the long side. In this case, it pays to just wait for the next long signal, and a squeeze with an 8/21-period EMA cross sets up at point 3.

Figure 18.16



Although all of the concepts in this book can be used individually, what's fun is working out combinations that enhance your skills as a trader and fit your personality best.

### Summing Up the Propulsion Plays

There are two main things that I like about the propulsion play. First, I don't have to watch the markets all day in order to get my entry. I can set up the orders the night before and then check at the end of the day to see which of my orders got filled. Second, these plays have specific targets. I've tried this method by just using trailing stops, but the results were not as good. Sure, once in a while I would catch a stock that would have a parabolic move, but more often than not, a perfectly nice profit would roll back over into a breakeven trade. Through trial and error, I have found that by setting a firm 8 percent target using a GTC (good till canceled) order, my profitability improved. (Note: If you are using this with a squeeze and a TTM trend, you can also use 8 percent on the first half of your position, then move your stop to breakeven and utilize the TTM trend to manage the rest of your position.) Remember, you don't want to become one of the many brokerage clients that the staff people poke fun at. They call GTC orders "good till close," because any time the stock gets close to the client's target, the client calls up and cancels the order "because it looks like it will go even higher." Of course, most of these stocks end up heading back lower and getting sold for a loss. Establish the parameters, then treat your parameters like good employees and let them do their job. Have a plan and follow it. Want to get out of half at 8 percent? Great. Don't change your plan once you've decided on your course of action.

In terms of actual execution of these plays through your broker, here are two additional tips. First, it helps to "drill down" and watch the daily EMAs update in real time throughout the day. You can do this by overlaying the daily EMAs on a 15-minute chart. To do this in TradeStation, set up a 15-minute chart and then do the math. Take the 6.5 hours in the regular stock session, which equates to twenty-six 15-minute

bars.  $26 \text{ periods} \times 8 \text{ EMA} = 208$ , and  $26 \text{ periods} \times 21 \text{ EMA} = 546$ . These 208-period and 546-period EMAs on a 15-minute chart mimic the 8-period and 21-period EMAs on a daily chart. You can adjust this to include the pre- and postmarket sessions if you like. By watching the intraday charts with the daily EMAs overlaid, a trader can really keep an eye on when the cross is taking place and where to place the orders. Second, as with the pivots, I think it is helpful to get “just in front of” the moving averages. For example, if the 8-period EMA is at 43.40 and you are trying to buy a pullback, then place a limit order 10 to 15 cents higher, say 43.52, in order to get filled. When the setup is there, don’t make the mistake of tripping over pennies when your aim is to be picking up dollars.

For updates to this trade setup, visit [www.simplertrading.com/movingaveragecrossover](http://www.simplertrading.com/movingaveragecrossover) to see how I’m using it today and what other indicators I’m combining it with.

We’ve reached the end of [Part 2](#). It’s time to head out into the real world, and that’s what I talk about in [Part 3](#). What setups work the best? What kind of trading plan should I have? What kind of computer do I need for trading? In [Part 3](#), we’ll look at real work case studies and address the practical aspect of trading. Grab a cup of coffee, stretch your legs, and dive in.

Hope in reality is the worst of all evils because it prolongs the torments of man.

FRIEDRICH NIETZSCHE

Vision without action is a daydream; Action without vision is a nightmare.

JAPANESE PROVERB

Spoon feeding in the long run teaches us nothing but the shape of the spoon.

E. M. FORSTER



PART

III

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## HEADING BACK INTO THE REAL WORLD OF TRADING



# My Trading Journey and Strategy

BY HENRY GAMBELL

*This is the real secret to life—to be completely engaged with what you are doing in the here and now. And instead of calling it work, realize it is play.*

ALAN WATTS

Any sufficiently advanced technology is indistinguishable from magic.

ARTHUR C. CLARKE

*Note from John Carter:* It's been my honor to have a front-row seat to watch Henry's journey in becoming a professional trader. I've learned a lot from him in return, and it's been great watching him grow as a human being as he continues down this path. It was Henry who introduced me to Alan Watts, which has helped me to balance out everything going on in my life. Unofficially, we keep each other grounded and sane.

## So You Want to Be a Trader?

When you decide you're ready to become a trader there are two unique disciplines that need to be mastered. These two areas include the mental / psychological side and the technical / fundamental side. Depending on whom you talk to you may hear that trading is anywhere from 50 percent to 90 percent mental. I tend to lean toward the 90 percent. You need a solid grasp on both, and you need to be proficient with both, but you can have excellent setups and still lose money if you're not mentally prepared to manage life as a trader.

I found myself beginning the pilgrimage of trading through the pursuit of technical analysis. Having been employed by the Geek Squad for several years and having a technical background, I figured this was a better path for me as opposed to studying P/E (price/earnings) ratios. Not to mention, I found technicals much more interesting than fundamentals. I began by reading the first edition of *Mastering the Trade* and applying the trade setups shared on what I thought was a purely mechanical basis. It wasn't until several years and hundreds of trades later that I began to realize the importance of a sound mental approach.

After having gone through these hundreds of trades, and not getting the results I was looking for, I had to ask myself some introspective questions about my trading and decide what I was going to change. For me this meant several things. First, I had to stop trading futures. Please let me be clear, trading futures can be a wonderful thing, and I encourage traders to learn everything they can about every market available. However, this is how I approached trading when I first began working with John. I thought to myself, "I've found the mecca of trading knowledge. I'm going to learn and trade *all* of it." Having pursued a technical career up to this point, I felt comfortable sitting down with a book, running through the material a few times, and then being able to look forward to an early retirement. If only that were true.

The quest to learn everything there was to know about trading started off modestly enough. I used three books that I would reference several times over the following years: *Futures and Options for Dummies* by Joe

Duarte, *Mastering the Trade* (First Edition) by John F. Carter, and *Fibonacci Trading: How to Master the Time and Price Advantage* by Carolyn Boroden. Expanding your trading knowledge past these books is something we'll all pursue. While these books do not provide you with everything there is to know about trading, they do provide you with a foundation that can help you put together a profitable trading plan.

I started with the *Futures and Options for Dummies*, as I was very green and needed to understand the fundamental nature of how these products worked before I began trading them. When I met John I had been focused on buying shares of companies that I thought had bullish potential through my Scottrade account. I had never even heard of options. Branching off into the world of leveraged products I needed something basic to lay the groundwork for me. Then I could get into the more technical aspects of John's and Carolyn's writing.

Knowing that these books have been so helpful to me, *Mastering the Trade* and *Fibonacci Trading* especially, my purpose in these additions is to help traders avoid the mistakes I made. I feel I've always learned more from my setups that didn't work—the ones where everything looked perfect on the chart. Learning from these points will accelerate your learning curve and help you avoid the mistakes I made when I began trading.

## No Stops

I hope the idea of “only trade with money you can afford to lose” is common knowledge to everyone reading by this point. It's also my belief that not only do you trade with money you can afford to lose, but you organize your life in a way that promotes peace and simplicity, as opposed to living a life run with debt. I was fortunate to grow up in a home where both of my parents were adamant about saving money and not buying things on credit (with the exception of a home and car, where I think you can have some flexibility). I was exposed to this lifestyle early on, and it's a way of thinking that's been extremely helpful in cultivating a relaxed state of mind when trading. I'm not going to panic over a trade going against me because I'm not going to be able to make a car payment. There is no payment on “Little Red,” my 2005 Ford Ranger, so I can approach the markets thinking about the markets.

Working with the idea of only trading with what you're willing to lose brings me to one of the most critical aspects of my trading, especially if you're still looking to generate a profitable equity curve, and that's to risk 100 percent of the cash that you allocate to a trade. If I buy a call for \$12.85, that's \$1,285 US Dollars I stand to lose. If I sell a \$10-wide put credit spread for \$3.45 then I have \$655 of risk in that trade. There is no stop. I trade small enough so that my stop-loss equals the risk I'm willing to take on the trade. Before, I would trade bigger and use a tight stop, and it seemed to always get hit. Stops were never useful in my humble opinion and like any steadfast belief, it can usually be traced back to a particular experience.

I remember the day, during the previous session I had taken a bullish position on AMZN (Amazon). I was managing an account somewhere around \$5,000 and had purchased 3 long calls that we're about \$1,300 each. AMZN was much cheaper back then, and I was playing these short-term, in-the-money, and looking for a few points to the upside while risking the same. The next day the stock gapped down some \$25.00 and my stops, mental at the time, were toast. The \$4 I had been willing to risk for each of these contracts was now looking closer to \$10, and this was my first “deer in the headlights” moment. After a brief period of coaching, where John assured me that “I'd figure it out,” I told myself that I would never let that happen again. From

that point forward I began thinking of \$13.00 options as \$1,300 of risk, and I've never found myself in a situation I couldn't handle, at least as far as trading is concerned!

Another reason why I've never been an advocate of setting stops on options positions, especially spreads, is because you're effectively *becoming the liquidity* at those prices. When you see a market go against you, you get stopped out right at the lows and then watch the move go on without you. You created the liquidity for that move by setting your stop at what was a favorable level to buy. By risking 100 percent of the debit you pay (or the difference of the credit in spreads), you'll have better odds of making money by letting your strategy play out.

This kind of a gap situation, like we're discussing with AMZN, is always one of the most painful lessons to learn—when you think you can only lose \$500 and end up losing \$1,500. These are sharp stepping-stones, and making sure you never have a position on that you can't handle, is the first step in being emotionally stable when trading. If you know there's absolutely no way you can lose more than \$X amount of money on a trade, you can begin to think about the setup, not where your P/L (profit and loss) is on the day.

Another reason I find this method so helpful is because you can begin to truly let your swing setups play out. When traders are buying calls and thinking, "I'll pay \$16.00 for this long option and use a stop at \$11.00," they're not taking intraday swings into consideration. It's always frustrating to have a stock come down and trigger the monetary stop you've set on the option, only to have prices recover and the stock close at the highs on the day. This is where the concept of the *daily close* below the 21 EMA (the 21-period exponential moving average) must be clearly understood. You can't use a stop of any kind if you're using a plan that requires you to see the trade through the end of the day. And if you're going to base the trade off a daily close, you'll have to stomach whatever the day may bring to see where we close at 3:00 p.m. CST. Maybe at the end of the day you do end up taking the trade off based on a close below your level, but quite often you'll be able to hold the position through the noise and see the trade through.

There are more reasons I could go on about why I enjoy this way of thinking. Granted it can't be applied to strategies like ratio spreads and calendars, but if you'll at least let yourself become successful using this method of thinking, it will be helpful years down the line when you begin to use strategies involving undefined risk.

## Seeking Success

This is a way of thinking that hit me in an epiphany kind of way, and I wish I could recall the exact place I heard it from as it was worded so well. But it's an important concept to understand when learning from others, especially when it comes to financial advice.

You won't be successful until *you know* you deserve it.

To illustrate my point and to promote radical transparency, I'll tell you that there was a part of me that thought when I met John I had found the Holy Grail to consistent financial success in the markets. "I am so thankful I've found someone that clearly understands the markets. All I have to do now is follow his trades, and I'm set!" It took me a couple of years to realize just how flawed this logic really was. Not only was I taking on a vocation I didn't understand, but I was a novice taking on the most skilled professionals in the world. There aren't many occupations you can approach as a complete newbie and compete against the best in the

world. There is poker, which may be part of why I love Texas Hold 'Em so much, but we'll look at more of those comparisons in a moment.

As the story goes I came to find that John had some great trades, but his drawdowns, which were normal for the account size he was trading, could cover my entire account. I was simply trading too big for my account size. There's this underlying feeling that since I'm following someone else, someone that knows more than I do, then this must be the correct action to take. In reality a losing trade for John was just the thirteenth trade in a series of 25 trades; he had little to no emotional attachment to it, while my entire world hinged on this single decision on this one trade.

As time moves on, you learn that each trade is in fact just one in a series of many. I was pursuing this lifestyle because I wanted to learn how to provide for myself, and not to be spoon-fed for the rest of my life. With that I did the work:

- I ran the Fibonacci levels.
- I broke down an index to find which components were getting ready to move.
- I studied the historical data so that I knew the odds for an earnings run were in my favor.

Once I had done the work, then I knew I deserved to be successful with it. With that I turned a pivotal page in my trading career.

## **Mindfulness and Flexibility**

Another page in my career that I think many traders find themselves going through, and maybe not knowing how to handle, are moments when things aren't going your way and you find yourself discouraged. I use the word *discouraged*, but this could also include depressed, worried, angry, furious, and/or miserable. There's a long list of emotions that trading will inevitably drive you to feel, but it's important that you don't give into them. Don't let yourself fall into a downward spiral. This is a term that can take on several different forms. Alcohol was the one I found myself working through simply because of its convenience and acceptance. Like so many things, alcohol is wonderful in moderation, but I found a point in my life where I knew it wasn't doing anything to help me solve my problems. Something had to change.

I'm not going to tell you that I've got this particular paragraph of advice entirely figured out. I still enjoy drinking, but meditation really helped me turn my life around during a period where I was probably pushing my limits a little further than I should have. You reach points in life when you know it's time to do something different. That was right about the time I was fortunate enough to discover Alan Watts. His "Out of Your Mind" lecture series was exactly what I needed and it made me realize that meditation might be helpful. The stress levels working at the Geek Squad and options trading weren't really comparable, and if I really was about to lose my mind, I thought the lecture series title might be meant for me. I don't have a perfect practice, but the medical benefits of meditation are well documented. You could even consider it like a massage for your brain. Turning off your mind for even just a few minutes a day can be extremely beneficial and can change the way you find yourself reacting to stressful situations.

Along similar lines, after reading Michael A. Singer's *The Surrender Experiment*, I became more dedicated to practicing yoga. John recommended the book to me and I would encourage everyone to read it. Michael

narrates the audiobook as well, and it makes for great listening during commutes. Through stories he told in the book I became convinced that yoga might be helpful, and I started with basic videos on YouTube. You can really find some great content out there these days. I've found the "Sarah Beth Yoga" YouTube channel to be extremely helpful for me, and a good place to get started if any of this resonates with you.

In addition to the documented benefits of yoga, like flexibility, I've found yoga to be helpful for my trading in two ways. First, there are several poses that you take in yoga, "asanas," that have no movement but can be extremely uncomfortable. There are moments exactly like that in trading where the position you're in is uncomfortable, but you know the right thing to do is to continue to hold the position. Of course, there's a difference between uncomfortable and acute pain. That is no different than taking heat versus triggering your stop, but if you can follow a plan and breathe through the discomfort you have a much better chance of success. Yoga teaches you to breathe through these moments, and I don't think anyone would argue that learning to handle pain is a part of a successful trading career.

The other aspect of this that I think all traders would find helpful is flexibility. Just because you become flexible physically doesn't mean you'll instantly become flexible mentally, but the two are very much connected. John has told me, and I've always found it to be true personally, that your own life will echo in your trading. If you can be flexible and mindful as you go about your trading not only will your results be better, but your life will be better as a result of better trading.

## **Trading as Gambling**

I always get a kick out of people who defend the idea that trading is not gambling. They always seem to tell you in a matter-of-fact way. It's as if they're having to defend themselves against some overbearing judgment. I would have you look at trading and say this is absolutely gambling. Once you agree that trading is gambling, several points of the game become common knowledge. These include things like: "I have no idea what's going to happen next" and "I can never risk more than I'm truly willing to lose." When a trader has totally acknowledged that there are factors that are 100 percent out of his or her control, then the focus is no longer on finding that one bet that's a sure thing, but instead it becomes controlling risk.

Once you've got your risk under control you can start thinking about number of occurrences. This is another way of saying that if you've got a strategy that's going to work 65 percent of the time, you need to apply it several times to get those numbers to come through. If you're using a strategy that has a 65 percent chance of working, but only apply it three times, you may not see two winners. All three may lose. but that's not an accurate reflection of the strategy over time. This is akin to poker where you may have pocket aces (the best possible hand pre-flop) but if they end up getting beat, you're not going to stop playing pocket aces. You'll be in these high-probability situations hundreds of times. Not all of them will work, but you also can't second guess which times it will work and which times it will fail. The longer you trade, the more confidence you will gain in the percentages working in your favor over time.

The top 10 hands is another place traders and poker players can find symmetry among each other. There are 169 different two-card starting hands in Texas Hold 'Em. That's how I feel some mornings going through a long list of scans. "There are 169 setups I have to look at; how can I pare this down to 10?" In Texas Hold 'Em the answer is easy enough. You start with pocket pairs (Ace Ace, King King) and work your way down



through Ace King suited, etc. With trading it can be a little more complicated as there are an infinite number of criteria and variables. But as we step into technical analysis you'll see the criteria I've used to look for something that might resemble a "Top 10 hands setup" and begin to narrow down the trades you like to take.

## Technical Analysis

There are an infinite number of ways to approach technical analysis. There are methods dating back to the 1800s, as well as new methods being created every day. Some say understanding chart patterns isn't necessary and you only need an options chain to trade. Others argue that an options chain doesn't add any information to your decision. You buy a company based on its fundamental merits and stay patient through the ebb and flow.

What I have found is that both sides of this argument are true. To approach trading and only trade from the options chain leaves a good deal of information ignored. There is merit to technical analysis and it's worth spending the time to learn it. To approach trading and only trade from a chart leaves you overpaying for your options, ultimately, giving yourself a lower probability of success. Could you make money without it? Sure. However, it doesn't maximize your opportunity, and if there was ever a Holy Grail in trading, maximizing opportunity would be it.

At the end of the day, your best trades will come from situations where all of these factors come into confluence with each other. Be careful to not fall into the trap of *analysis paralysis*, as that is easy to do. But if you can combine the best technical indicators with the best fundamental indicators, and trade them in a disciplined way, you may just have a shot at making money trading.

When I begin going through my analysis some of the first watchlists I'll reference include:

- The IBD 50 Index (from Investor's Business Daily)
- Anything mentioned in the batch of charts I download from Carolyn Boroden at [www.FibonacciQueen.com](http://www.FibonacciQueen.com)
- Recommendations through Chaikin Analytics
- Names found in the Simpler Trading web-based scanner (We've built it out and are continuing to improve it over the years.)

In the following paragraphs we'll begin to discuss the layout of my swing trading charts. This is the culmination of the analysis I've adopted up to this point, and the foundation of what I base my decisions on. While this is my complete, recommended swing-based layout, it's not necessarily all-inclusive. I do add new indicators to my charts (slowly) and after having observed them for a few months, begin considering them for my swing-based decisions.

## Time Frames

The first point to define when we start thinking about our swing trading analysis is what time frames we're going to trade. With anything classified as a "swing trade," we're going to hold overnight at a minimum. This doesn't mean we won't use charts smaller than a daily. I like using time frames John shared years ago that

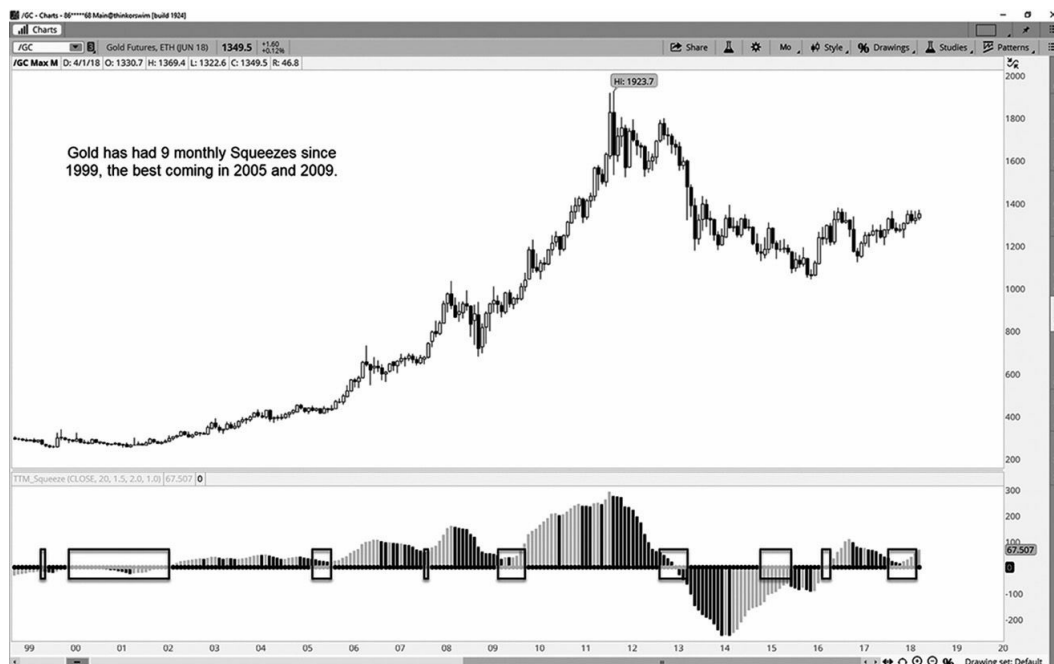
evenly divide the cash session into intraday bars.

For example, there are 390 minutes in the cash session. If you divide the daily 390-minute cash session by 2, you get 195. Divide by 3 and you get 130-minute bars. This pattern repeats for each even division down into three-minute charts. For my swing-based analysis I won't go down to anything smaller than a 15-minute chart, showing me 26 bars for each day of trading. Below you'll find a list of time frames that revolve around this concept.

390 minutes = 1 daily bar
195 minutes (or 3 hours 15 minutes) = 2 bars per daily cash session
130 minutes (or 2 hours 10 minutes) = 3 bars per daily cash session
78 minutes (or 1 hour 18 minutes) = 5 bars per daily cash session
65 minutes (or 1 hour 5 minutes) = 6 bars per daily cash session
39 minutes = 10 bars per daily cash session
15 minutes = 26 bars per daily cash session
10 minutes = 39 bars per daily cash session
6 minutes = 65 bars per daily cash session
3 minutes = 130 bars per daily cash session

The first time frame I use is a monthly chart with as much back data as I can get. Typically 20 years is plenty, but I use a large amount of data to see if there are any major retracements or extensions I should be aware of that may not show up on the daily or weekly charts. The other thing I look for in monthly charts is *the Squeeze*. If the Squeeze provides 7 to 10 bars of momentum, that means catching a monthly Squeeze, which can keep you in a trade for 7 to 10 months and can be a very effective signal from a trend-following perspective. At the time of this writing there's a monthly Squeeze in gold that's trying to fire long. In the image shown we can see gold has had nine monthly Squeezes since 1999. The Squeezes in 2005 and 2009 were two of the more effective, so how can we go about narrowing down these powerful monthly signals against those that don't perform as well? The next chart I'll look to for assistance with that decision is the weekly chart. (See [Figure 19.1](#).)

**Figure 19.1**



## Weekly Charts

As we begin discussing the weekly chart, it's worth noting that my entire trend-following concept for this time frame revolves around the idea of "reversion to the mean" or daily price being attracted to the 21 EMA (the 21-day exponential moving average). The 21 EMA is a good level to look for trends to pullback to then advance from. The problem I found when using only the 21 EMA and exiting when price closes below these levels (assuming a bullish position) was that you're often closing the trade out only to see the trend recover and the idea go in your favor as you had initially planned.

To trade this concept in a more lenient way, I adopted the 10 SMA (10-day simple moving average) and the 34 EMA (the 34-day exponential moving average) on my weekly charts. In [Figure 19.2](#), you can see the moving averages being used in the header, their corresponding values on the far right (as well as in the header), and the last price traded just to the right of the ticker symbol. This is helpful when trying to determine what indicators and levels a trader may be referencing on their charts. As far as how to use each level, first you want to start with the direction you're trading. Since I'm focused on the long side of gold because of the monthly Squeeze, I'd like to find a similar signal on the weekly chart. Since I don't have a Squeeze on the weekly chart, I'll look to my moving averages and see what they're telling me about the trend. (See [Figure 19.2](#).)

Figure 19.2



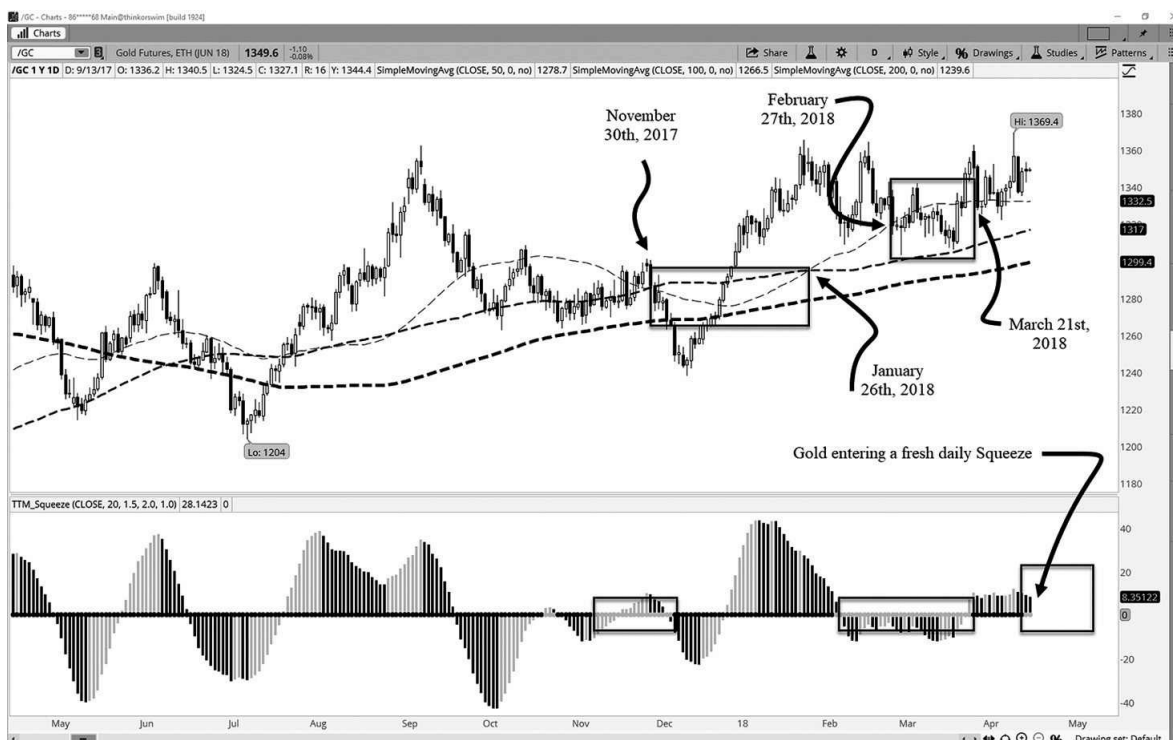
The basic concept of these two moving averages is that I want to be buying when the 10 SMA is trading above the 34 EMA, and I want to be selling when the 10 SMA is below the 34 EMA. This gives me the overall direction of the pattern and tells me whether I should focus on being bullish or bearish. From the moment the 10 SMA crossed above the 34 EMA back in April 2017, this pattern would suggest that I should only focus on the long side. However, I can see that this wasn't a straight path higher. In order to stay out when I'm being bullish but choppy and pursue positions when I'm being bullish with momentum, I want to enter my long trades when the 10 is above the 34, and the price closes above the 10 on a weekly basis. This lets me know I'm trading with the wind to my back (in favor of the trend), and at a point where I should see momentum start to kick in (above the 10 SMA).

## Daily Charts

No different than taking the monthly chart down to a weekly chart, when I'm looking for clarity on a weekly chart, I'll drop down to a daily chart. Daily charts are where I start to add a few more technical indicators, but most of my decisions can be made from a small set of signals. The first of those signals is the Squeeze. Do I have a reason to think the daily chart might start moving like the monthly chart? Has this particular time frame consolidated for long enough, and is it finally ready to make a directional move? In the case of gold, the answer is yes.

Figure 19.3 shows where gold is entering a daily Squeeze. The signal is two bars into consolidation, and is in alignment with the monthly chart. I determine this alignment by a bullish relationship to the 50-, 100-, and 200-day simple moving average (SMA). I like thinking of these moving averages as a set, and that's why you'll find them all shown as dashed lines, increasing in thickness as the indicator looks further back in time. (The 50 SMA is the skinny dotted line, while the 200 SMA is the wide dotted line. The thickness of the 100 SMA is between the two.) When price is trading above the 50 SMA, the 50 SMA above the 100 SMA, and all of them above the 200 SMA, this is where you'll find your best bullish setups. (See Figure 19.3.)

Figure 19.3



Another way of sharing this is to look at the points in time that I wouldn't have wanted to be long gold. The first period was November 30, 2017, to January 26, 2018. During this time the 50 SMA was trading below the 100. The second period was from February 27, 2018, to March 21, 2018. I would be avoiding gold here as price is trading below the 50 SMA. Since I'm trying to buy this market based off the monthly chart, I'll allow the price to rally above the 50 SMA on the daily, and then look to buy the next pullback.

### Why Use Simple Moving Averages?

Why use simple moving averages here? In my experience, these are the most commonly followed long-term moving averages among funds and other common places that index levels are quoted. Simple moving averages give equal balance to all past data giving me a balanced, long-term view of however much data I'm looking at.

It's what I grew up watching Carolyn use. It's what you'll see commented on for levels on CNBC. Everyone is watching these simple moving averages. I find them helpful enough to include them in my daily analysis. Can you use the 55 EMA (the 55-day exponential moving average) instead of the 50 SMA (the 50-day simple moving average)? Sure. Just remember that we're looking at something akin to waves in the ocean. We're looking at a pattern of higher highs and higher lows (or lower highs and lower lows) and trying to get in at opportune times on the path of least resistance. These moving averages can be thought of like the troughs in a wave, and the degree of your aggression can be measured by the moving averages you use to enter your position at. In this case the 50 SMA would be the most aggressive, and the 200 SMA would be the most conservative.

### Chart Coloring

When I set the color adjustments that I've used for this book, they're more than my humble attempt at meeting the publisher's specifications. I set my colors to accommodate my vision. I've been colorblind ever since I knew such a thing existed. That discovery, and my first eye exam were the same day. There's no point getting into that discussion here, but it's worth knowing so you can see how my color schemes are an effort to avoid the red/green color issues that many colorblind people may have, but also to set a color scheme that may be helpful for anyone reading this text, printed or via a color tablet. I look at my candlesticks in a very basic way too: the white candlesticks are bullish and the black candlesticks are bearish.

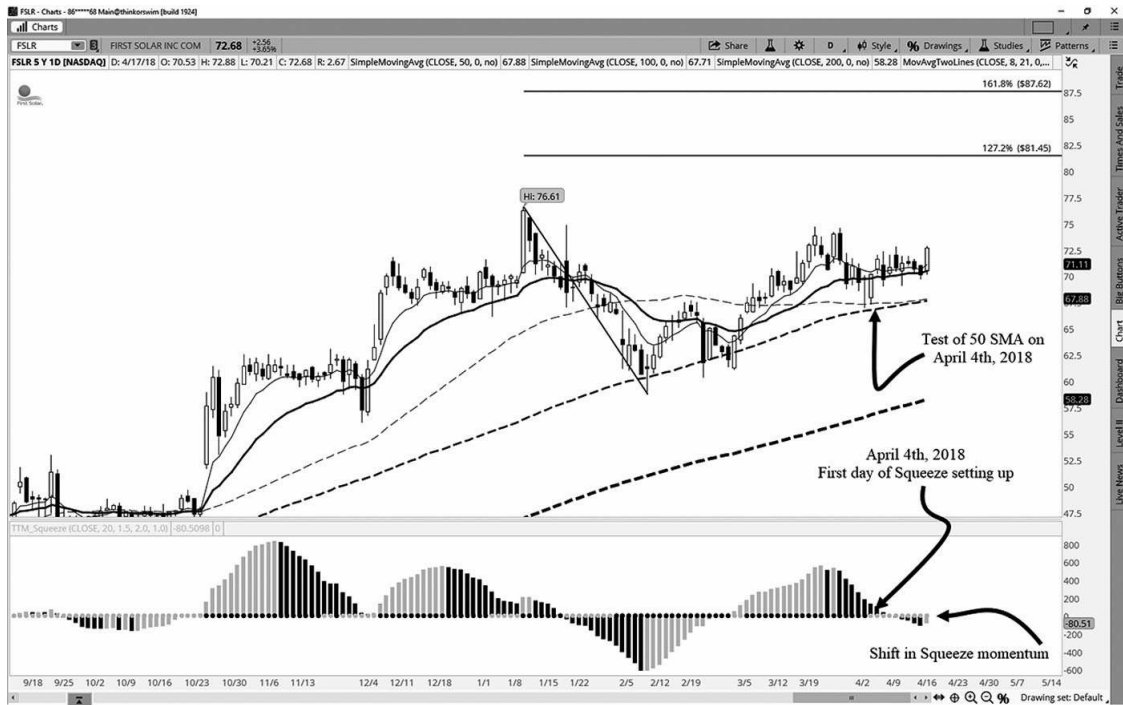
When I approach the Squeeze, I cover it in two similar methods. The light dots are the most important. They're "white hot" and remind me of periods in time when volatility is contracting, and price is telling me we're getting ready to have a significant move. The transition from light to dark dots in the Squeeze (red to green if you use the default colors) is the move we're trying to capture. When the signal fires, we would like to already be in the trade and catch the majority of the expansive move in price. These signals can take some time to fire. Most of the time stocks aren't having big radical moves, but trading in a range. That's another concept I wish I would've given more credit to earlier in my trading career. Catching a big intraday move can be rewarding, but most of the time stocks spend their time consolidating. It's important to keep that in mind when managing a swing-based portfolio.

### **The 8 EMA and 21 EMA**

As we continue our progression with the daily chart analysis the next thing we do is add our exponential moving averages. Exponential moving averages will put more emphasis on the most recent price action and tends to follow short-term trends more closely than simple moving averages. This allows us to participate in more aggressive trends rather than always having to wait to buy at the 50 SMA.

I chose the 8 EMA and the 21 EMA for my trading. These numbers are part of a number sequence known as the *Fibonacci series* and they fit my directional, momentum-based approach well. This is another place where we can look at these moving averages as waves of the market. The Fibonacci series begins 0,1, 2, 3, 5, 8, 13, 21, 34, 55, 89, and so on—each number adding to the one prior, into infinity. I don't use anything from 1 to 5, as that strikes me as being too close to the current price. But if I know the 8 EMA and the 21 EMA I can get a basic idea of where the 13 EMA is, and I don't use any values above that for my exponential moving averages. Past that, my simple moving averages would come into play and I would look for support at the 50-, 100-, and 200-day levels. (See [Figure 19.4](#).)

### **Figure 19.4**



Let's look at this idea with a trade example in FSLR (First Solar, Inc.). On April 4th, FSLR began developing the first bar, or day, of a daily Squeeze. At the same time, it was selling off down into the 50-day SMA. If you didn't have your order sitting there waiting to buy the 50-day SMA in FSLR, you will not get that opportunity again. The next several sessions spend time consolidating well above this 50 SMA level. This is where the 8 EMA and 21 EMA come into play. Over the course of the next seven sessions price trades between these two moving averages and I add 200 shares each day near these levels until I have 1,000 shares, my maximum risk for a trade like this. On April 17th, the shares close up 3.5 percent on the day, and our daily Squeeze is now underway. The momentum of the Squeeze has shifted, and the only other thing we need to see is the signal actually fire, which is what triggers when the Bollinger Bands pop outside of the Keltner Channels, ideally giving us a run into the primary 1.272 percent extension of \$81.45. The daily Squeeze fires long on April 19th, giving us a nice move higher, but the high on the day is only \$78.95, \$2.50 shy of our target. This is where the same *reversion to the mean concept* we use to enter the trade comes back into play. As long as the price holds the 8 EMA and the 21 EMA on a daily closing basis after the Squeeze fires, I will hold the position in an attempt to eventually make the target at the 1.272 extension. In this case FSLR pulls back exactly to the 21 EMA, resumes with the strength of our daily signal, and makes targets three days later on the back of their earnings report. If there was ever an example of how I've been able to put together the concepts I've learned from John and Carolyn, this would be it. (See [Figure 19.5](#).)

**Figure 19.5**





One common mistake you might see traders new to the Squeeze make is thinking the Squeeze is a bearish signal as the momentum moves from higher to lower through the histogram (the period from April 4th to April 16th). It's important to remember the overall prevailing trend of the market comes first. Then the shift of momentum allows the bigger part of the actual move to occur with the trend. That's not to say the Squeeze can't fire short. It can. But I would either have to manage my position or take a stop. I would never initially trade a setup like this as a bearish position.

This is what I use for my everyday swing trades. I would encourage anyone wanting to learn how to swing trade to start here. I've always enjoyed the idea of mastering weekly and daily charts, and this is the most basic and helpful way I've found to go about it.

## More Swing Setups

Once you've got the basic idea of what I'm looking for in my chart setups, we can start stepping into how to best trade them with options. As the name implies, options give you several different ways to do things. If we assume an underlying price is going to go higher we can buy a call, we could sell a put credit spread, or we could look at a bullish butterfly. So much of this will depend on your personality and trading goals, and it's important to establish that before choosing your strategies.

One of the more aggressive ways to trade a daily Squeeze is through directional options. Most of the time I'm focused on the long side of markets, so buying long calls is a common strategy for me. Buying long calls is usually looked at as a low-probability strategy, and with good reason, as you really do need to have good timing and be right on direction, due to the premium decay. However, pursuing these trades two to four weeks prior to a company releasing earnings can be an extremely effective way to trade. During this time Theta or time decay will still work against your position, but if you're buying the calls in the same week as the earnings report, the steady increase in volatility leading up to the actual earnings release date will help inflate the price of your option. If you can time your entry, get the direction right, and have the added boost of a rise



in implied volatility, you can really find the trifecta that creates great trades.

This may seem like several variables that need to line up to create these trades, but they're more common than you may think. With this in mind, I would like to thank Ophir Gottlieb for his work at CML TradeMachine. This web-based options analysis tool has been especially helpful in confirming technical signals that I'd been trading prior to having this information and providing new ideas that also lined up with my charts. For example, in the past year MSFT (Microsoft) has had four earnings reports. Three of them were preceded by a daily Squeeze and as we approach the April 26, 2018, report, once again we see a daily Squeeze. We could buy MSFT simply off those signals, but when I compare that technical setup with the information from CML TradeMachine that the "bullish momentum pattern in MSFT seven calendar days before earnings has outperformed every other stock in North America over the last three and a half years" . . . this is powerful information. This is a trade where I'll consider a "core position," something that I'll have on with the full amount of risk I'll allow myself to take, and try to capture a nice swing trade. To check out the CML tool, visit [www.simplertrading.com/cml](http://www.simplertrading.com/cml) for a discounted link.

## Symmetry

Symmetry is another concept that I couldn't trade without. Fibonacci analysis and symmetry typically go hand in hand, but for the sake of simplicity, I'm just going to focus on symmetry here. (See [Figure 19.6](#).)

Figure 19.6



*Symmetry* is defined as “the quality of being made up of exactly similar parts facing each other or around an axis.” We find this concept in butterflies with bilateral symmetry. We find it in architecture and nature in similar ways. In the market we want to look for this relationship along the  $x$ -axis and the  $y$ -axis, each independently. I've always enjoyed using symmetry not only because it can help me find good trades, but it really helped me to see markets in a new way and stop chasing extended moves.

GS (Goldman Sachs) gives us a great example of this where the daily chart was looking especially bearish

when the cash session opened on May 3, 2018. Shares were trading below \$230 while they had been trading above \$260 just a few weeks prior. This is usually when I'd start hearing that voice in my head telling me, "Goldman Sachs is going to zero." Of course, this is a mild exaggeration. I didn't really think Goldman Sachs was going to go out of business, but I'd come up with some reason that allowed me to go short. With the new insight of symmetry in time however, not only do we know not to chase, but we can sell puts to people that do.

When we look at the decline that took place from March 12, 2018, to April 2, 2018, we see that this move took 15 trading days to complete. Then we rallied for the next nine sessions. If the stock can fall straight down for a certain amount of time, then get a healthy bounce, what's to say that's not what shares were going through on the morning of May 3rd? This was the fifteenth trading session from the high put in on April 13th, and a spot to consider the idea of rallying for the next several sessions. (See [Figure 19.7](#).)

Figure 19.7



Of course, there's always the potential to have a setup like this and price continue to fall below it. But if we know that on a certain day we might find a low in a stock, then it makes sense to consider a trigger *against* that moment in time. A trigger is just a way of confirming your initial idea. Instead of just blindly buying, you try to make sure you have the right idea before getting involved. As GS continued to sell off down below \$230, but knowing we were looking for reasons to buy, we drop down into a 15-minute chart to look for confirmation that buyers are coming into the stock. The low finally prints at \$227.40, but we don't know to call that the low until 30 minutes after trading that price. It took two 15-minute bars (30 minutes) to see the price rally above the high of the low bar and trigger us into a long trade. This ended up being the low for GS up into the time of this writing, May 14, 2018. I'm sure it'll be interesting to see how the level held up and where GS is trading when you read this. At the end of the day, symmetry in both price and time can be a helpful way to sell rich premium, and way to look at a chart that helps you think strategically instead of reacting to your emotions. (See [Figure 19.8](#).)

Figure 19.8



## Closing Thoughts

Trading is hard. It will push your buttons, test your limits, and at the end of the day really give you an honest glimpse of who you are. I can't see myself pursuing any other vocation and I'm eternally grateful that trading came into my life when it did. Find balance in the highs and lows and rest each night knowing you dared greatly.

*It is not the critic who counts: not the man who points out how the strong man stumbles or where the doer of deeds could have done better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood, who strives valiantly, who errs and comes up short again and again, because there is no effort without error or shortcoming, but who knows the great enthusiasms, the great devotions, who spends himself for a worthy cause; who, at the best, knows, in the end, the triumph of high achievement, and who, at the worst, if he fails, at least he fails while daring greatly, so that his place shall never be with those cold and timid souls who knew neither victory nor defeat.*

—THEODORE ROOSEVELT



# What Setups Work Best for Me?

BY DANIELLE SHAY GUM

*Note from John Carter:* I introduced Danielle in [Chapter 6](#) of this book. This is where you get to see her tenacity and persistence come to life.

## The Five-Star Setup

At this point in my trading career, I am a technical analyst with a focus on directional options trades for aggressive account growth. I also have additional trade setups for situations such as monthly options expiration, earnings, and choppy markets. By and large my overall focus is directional trading. My goal, every day, is to pick out the strongest charts to trade. How do I do this? It's all about the combination of setups that I've been taught, many of which are discussed in [Part II](#), coupled with my in-depth research process and chart pattern analysis, and the creation of my strict rule set to identify trades that I call my *Five-Star Setup*. To me, chart patterns are simply another language to be deciphered, which is where it all begins. I use the same formula to analyze each chart.

## Rating Your Setups

John has always talked about rating your setups on a five-point scale, and then putting different levels of capital at risk depending on how strong your setup is. He explained many times that there will always be setups that are better than others. The key, he said, is to understand why some are better than others, and look to trade them differently. When it comes to trading them differently, that can mean trading them with varying options strategies, different risk tolerance levels, or simply passing on the setup all together because it doesn't fit the parameters for a *Five-Star Setup*.

The analogy he used made a lot of sense to me, so I set out to create a set of rules to identify the best plays. For me, it all came down to the strength of technical analysis. The way I saw it, there was no reason to even trade setups that would earn less than four stars. Also, I wanted to know a Five-Star Setup when I saw it. Then I could position myself accordingly to best take advantage of the move. Just to be clear, I would never consider pinning plays or earnings trades to fit the criteria of the Five-Star Setup. This is a different category of trade.

When I say that I'm looking for a *Five-Star Setup*, I mean I am working to identify the most solid chart that I can trade in an aggressive, directional manner.

## Where Does the Criteria Come From?

My criteria for strength is based on the knowledge that I have gleaned from the strengths of the trading team. When I first came to Simpler Trading, as a student, I noticed something in particular—each of the traders,

except for John and Henry, did not follow each other's work. And for the most part, why would they? They're all professionals. They're focused on their own trades and their own content creation. However, for me, as a student something became abundantly clear. Each of the traders had his or her own "high probability setup." So, what did I do? I took my favorite piece of each of their setups and used a combination of those to create my own Five-Star Setup.

## My Favorite Setups

I like, and trade, a somewhat wide array of directional setups. There are some setups that we call "trend-continuation" setups, where we are merely looking to play the trend as it continues stair-stepping higher or lower, which is great. They can be a great opportunity to use conservative options strategies, such as selling credit spreads on a slow, trending move. I also like Fibonacci clusters and symmetry setups that give me a directional bias and overall expectation on a certain chart.

However, the best directional setup for me, is anchored in the *squeeze*. I am looking for the calm before the storm, or the compression before the explosion. The entire purpose and glory of the squeeze is that it allows you to trade directionally and enter in front of an explosive move, not just a stair-stepping higher move. Identifying the best squeeze trades is my primary goal.

Traders may think they can throw the squeeze onto their charts and they will be set. However, this couldn't be further from the truth. Sure, you'll be further along than somebody without the squeeze but, it takes a lot of time and care to learn how to properly add it to your trading plan. Once you combine the squeeze with additional analysis criteria—such as chart patterns, time frames, Fibonacci, fundamentals, market environment, and just overall sentiment to consider—there's a lot more to consider than just a simple squeeze.

It's important to remember that not all squeezes are created equal. Therefore, I combine my knowledge of the squeeze, with additional factors to pick out the ones with the highest probability of working out. It's all about giving yourself the best edge you can. Of course, you'll never eliminate your losses 100 percent of the time and that's fine. That's trading. But, you can work to eliminate as many of them as possible.

## My Favorite Squeezes

As a swing options trader, I prefer squeezes on technically strong stocks within strong sectors, on the weekly, daily, and 195-minute time-frame charts. I will trade multi-time-frame squeezes, where I have squeezes across time frames on the same chart. I will also trade triple squeezes, where I have squeezes on the indexes, sectors, and the individual stock. Additionally, I like squeezes that appear on stocks with high short interest. If I find a nice Fibonacci cluster or a symmetry setup, coupled with the squeeze, you guessed it, I'll trade that as well. Basically, it's all about the squeeze coupled with the highest confluence of criteria.

## The Research Formula: How I Find Them

*A practice implies engagement in a ritual. The dedication, daily exercise of commitment, will and focused intention.*

STEVEN PRESSFIELD, *TURNING PRO*

My day (or night) starts with analyzing the overall market conditions, looking primarily at the S&P 500, the

Nasdaq, and the Dow futures. This is where my top-down analysis begins. I apply this formula to pick out my favorite indexes, and within those indexes, I pick my favorite sectors. At this point, I look to stocks within that basket. I apply my same technical analysis formula to these chart patterns. After analyzing the charts, I then narrow my selections down. I focus on identifying the highest probability directional chart patterns.

Carrying out an immense amount of research is the most important activity to do in selecting directional trades. Traders have so many options today. Thanks to the Internet, the world is our oyster. My research includes searches through: custom scans, Simpler Trading Scanner, Sector SPDRs, *Investor's Business Daily* Top 50 list, the Nasdaq, S&P 500 and Dow futures, Fibonacci setups through our colleague Carolyn Boroden, and lastly and almost as important, tickers suggested by both members and my fellow traders in our trading room. Each of these sources have their own benefits and are important to find quality trades.

I enjoy doing my trading research at night. This way I can focus on the markets without the distraction of the trading day and the emotion that comes along with market hours.

All this legwork takes me about an hour, but it's the only way to be prepared for what the next trading day brings. After filtering through hundreds of thousands of charts, I create a short list that prepares me for the trading day ahead. I use specific criteria to narrow my list, which I will discuss in the next section.

John has always said, "Have a 10-year-old look at the chart. Is it going up, down, or sideways? You should know within three seconds what the answer is. If you don't, that's probably a clue it's one you should skip." One of the biggest signs of improvement in my trading was when I could look at a chart and immediately know if I would trade it or not.

How does that really look? For example, let's say after looking at the overall markets, I determine that the S&Ps have relative strength to the Nasdaq and the Dow, or maybe they are just setting up for a big move at that moment in time. I then look to the S&P sectors to see which I favor. At this point, I typically have three sectors that look favorable to the long side. Perhaps the Industrials and Healthcare sector are both setting up for a move, but Industrials has an entry point with an edge because Healthcare has already taken off. Next, I'll look toward Industrial stocks that are setting up. After analyzing the top-10 weighted stocks within this sector, I conclude that BA (Boeing) and HON (Honeywell) have the strongest technical charts, coupled with strong buy setups. An hour into my analysis, I decide to trade BA and HON to the long side because I've narrowed them down to be my best options.

I consider setups that fit this specific rule set to be a Five-Star Setup, due to the process I used to find them and the criteria they fit. But, what is that exact criteria, you ask?

## **Filtering My Selections**

This checklist is the filter for the order in which I narrow down my selections. I analyze the following, in relation to each ticker I'm considering, in this order:

### **Filter Checklist**

1. Market Environment
2. Sector Analysis
3. The Squeeze

4. The Strength of the Trend
5. Entry with an Edge
6. Fibonacci Analysis
  - a. Symmetry
  - b. Cluster Decisions
7. Fundamental Backing
8. The Confluence of Setups

After analyzing the above checklist I make the decision to trade or not to trade. What does each piece of analysis entail? Read the following sections for more insight on how I analyze each component of the Filter Checklist.

### *Market Environment*

First and foremost, I want to know which (if any) indexes are in buy mode, so that I can pile in to additional longs (or shorts) in that index. What tells me if the index is in buy mode? Ideally, I'll see the following:

1. A squeeze on the daily and/or 195-minute charts
2. A strong bullish trend, as defined by stacked moving averages with price above the 50 SMA
3. A chart maintaining a bullish trend via Fibonacci analysis

That's the ideal situation, but I'll accept a little less than perfect as well. A single 195-minute squeeze in the direction of the trend in the S&P futures can give me enough movement to ride.

The key here is the ability to identify when the overall markets are setting up to make a big move. This movement is critical when you're trading directionally. Eighty-five percent of stocks move *with* the broader market. When the overall market is moving, it's time to jump on board.

Conversely, it's important to note when a certain index (or the overall market) is looking shaky. It's best to either remain conservative or sit on your hands. The perfect situation is alignment—something you must know how to recognize. Beyond that, there are “good but not great” times to be long and “terrible” times to be long. You must know how to recognize each situation with the backdrop of the overall market environment before making any trades on any products. Analysis of the overall market environment is always the first step.

### *Sector Analysis*

After market analysis comes sector analysis. Like a major index, a major sector can also be in buy mode. That movement trickles down to the highest-weighted products within that sector and the remaining stocks in that basket as well.

What do I need to see to consider the sector to be in buy mode? This is the same criteria that I listed for index analysis. Buy mode in a specific sector can last a couple of weeks or a couple of months. It doesn't really matter how long it lasts because when energy rotates out of a sector, another one is just shaping up for a long ride. Either way, you must know how to recognize this trend.



When you pick a sector that is newly in buy mode plus a stock that is in buy mode, you have probabilities on your side. This is where you find your edge, and a high probability bet.

What's even better than just a stock aligned with its sector? When you have an index, sector, *and* a stock in buy mode all at the same time. It doesn't happen as often as when the stock and sectors line up, but when it does, I'll aggressively ride that wave until it's complete.

### *Strength of the Trend*

A breakthrough in my trading came when I decided to only play solid, trending charts. Of course, a chart that is choppy in nature or in a downtrend can have a squeeze that fires long. However, this isn't where I focus. I focus on charts that have proven themselves to have a high probability of continuing in the direction that I'm betting on, either up or down. Before ever deciding which squeeze I'll play, I must consider the trend. Here are my rules to define a solid trend.

### **Trend Checklist (for bullish bets; inverse is true for bearish bets)**

1. Overall chart pattern of higher highs and higher lows (the Stair Step)
2. Chart has pattern of steady retracements to the moving averages without experiencing violent pullbacks (I like to see it hold the 50 SMA on pullbacks.)
3. Price's current relation to the moving averages (above 50 SMA is critical)
4. Stacked moving averages (shortest moving averages on top, descending in numerical order)
5. This chart pattern must be valid for at least the last six months, but preferably longer.

As a bonus, I like to look at charts that are nearing their lifetime highs, and/or that have high short interest. These two components aren't critical, but I love the addition.

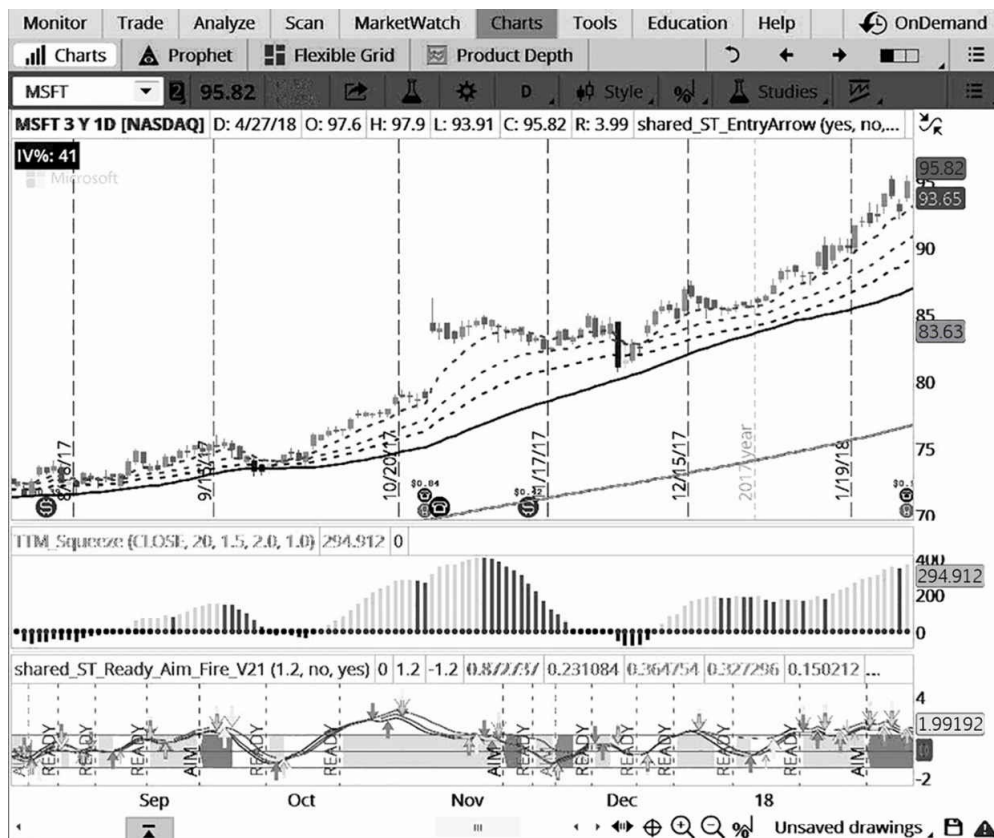
In a perfect world, on a bullish trending chart, I like to see the moving averages neatly stacked on top of each other in this order and price holding above the 34 EMA (the exponential moving average). The chart shows nice, clean retracements to the moving averages before pushing higher each time. I love a nice squeeze in the context of this pattern, with a steady pullback to buy into it.

While this is the ideal situation, I'll trade a chart that doesn't fit these exact parameters. I know that when I do see this situation align perfectly, I'll max out my appropriate risk.

### **TREND EXAMPLE: MICROSOFT CORPORATION (MSFT)**

This MSFT daily chart displays a solid trend. You can see price hugging the short moving average, the 8 EMA, along with neatly stacked moving averages on a chart that exhibits gentle pullbacks instead of violent selloffs. Price also holds the 50 SMA on pullbacks, but this is a rarer situation versus a frequent occurrence. This pattern has been in effect for more than six months, and in fact, much longer. (See [Figure 20.1](#).)

**Figure 20.1**



### *Fibonacci Analysis*

The importance of the addition of Fibonacci in my trading can't be overstated. Fibonacci analysis on its own produces high-probability setups. By using it to trade one decision to the next, you already have an edge. However, couple that with the explosive setup of the squeeze, and you've got something even better.

I use Fibonacci cluster, symmetry, or timing setups to identify high-probability moments in time where I have an edge in a directional trade. When combined with additional long setups, the technical setup becomes that much stronger. I also use symmetry to help me stay in a trade that is going south, or better yet, alert me when it's gone farther than I should hold. Simplest of all are the Fibonacci extension targets, which I use to determine both resistance levels and profit targets.

### SYMMETRY

*Symmetry* is a simple concept; it measures previous swings to identify where a current swing could end or begin. As simple as it is, symmetry is a powerful tool. Not only is it powerful, it just makes logical sense. Symmetry is used to quantify the "personality" of the chart. Each chart moves in waves. You're looking to measure those waves to see if they match up with similar movements in the past. By measuring how a chart typically moves, you can identify entry and exit points that have an edge.

Just looking at a chart, any chart, you can see that tickers move in a similar fashion. It works on a five-minute S&P Futures chart just like it'll work on a daily chart in Microsoft. I use symmetrical projections combined with squeeze setups to give myself an ideal entry point in a directional trade.

I find it particularly useful in the futures markets. Trading on an intraday basis, it's fascinating to see how (again and again) the S&P futures holding simple symmetry can give a trader an edge in buy setups. Especially

on days where the market seems to be falling apart, watching for a break in symmetry can give me a huge heads-up.

### SYMMETRY EXAMPLE: ADOBE SYSTEMS INCORPORATED (ADBE)

As you can see on this Adobe daily chart, while price action ebbs and flows higher, the pullbacks it experiences are symmetrical. As such, each time ADBE makes a new high, symmetrical projections can be drawn. This gives the trader an idea for a solid pullback zone for re-entry on the long. (See [Figure 20.2](#).)

Figure 20.2



### RETRACEMENTS

Watching for retracement levels are key in my directional trading. I can see where the market may pause, and anticipate that. There is nothing more frustrating than having a great directional trade take off, and then have it stop moving, seemingly out of nowhere. Very often I have found that there is a simple Fibonacci retracement level in this spot. At this point, I anticipate these levels and recognize that a pause here isn't anything out of the ordinary.

#### *Extension Targets*

The next step beyond Fibonacci retracements is the Fibonacci extension targets. Profit targets are a critical part of my trading plan, and they couple perfectly with directional setups like the squeeze. I use these in conjunction with my overall setup to decide when to exit.

### RETRACEMENTS AND EXTENSIONS EXAMPLE: WINGSTOP INC (WING)

1. The retracements are listed under point #1. These include the 0.50, 0.618, and 0.786 retracement levels. These typically provide resistance, but strong charts will break through these levels. (See [Figure 20.3](#).)

Figure 20.3



2. Point #2 demonstrates extension targets. The first “low-hanging fruit” target is listed at the 127.2 percent extension with the second target at the 161.8 percent extension. These are my two primary targets that I will use in a trade.

### CLUSTER ZONES

I’m a huge fan of *Fibonacci cluster zones*—support or resistance zones that are made up of a combination of at least three levels, which can be any combination of Fibonacci retracements, extensions, or symmetry levels. When using clear cluster zones in your trading, combined with triggers, you can give yourself an edge. That edge is even stronger in the presence of a squeeze.

### *Squeeze: An Entry with an Edge*

Where would I be without the squeeze? The *Squeeze indicator* attempts to identify periods of consolidation in a market. In general, the market is either in a period of quiet consolidation or vertical price discovery. By identifying these calm periods, we have a better opportunity of getting into trades with the potential for larger moves. Once a market enters into a *squeeze*, we watch the overall market momentum to help forecast the market direction and await a release of market energy. I love playing this release in the market with long calls.

However, as I stated before, not all squeezes are created equal. Here are some important considerations with the squeeze:

1. Momentum: Does it look to fire in the direction of the trend?
2. In what time frame does it appear?
3. Is there an entry with an edge?
4. How much confluence do you have with other setups?

I also want to see it on a chart that fits the rest of my Filter Checklist criteria.

## MOMENTUM

A big aspect of the Squeeze indicator is the *momentum*. I want to see momentum either climbing higher, or shifting higher, in what I call a “slingshot squeeze.” A “flat squeeze” that isn’t doing much and is still consolidating isn’t the same as a squeeze that is showing rising momentum and is about to go. I like getting in on these right when they are about to move.

## SQUEEZE TIME FRAMES

As an options swing trader, I focus on 78-minute, 195-minute, daily, and weekly charts. This is where I look for my setups. While a squeeze can last 8 to 10 bars on the time frame chart you’re trading, each chart setup can give you a differing length of trade. For me, the sweet spot is the 195-minute and daily charts, particularly when they’re both in a squeeze. I enjoy trades that last a few days to about a maximum of two weeks. This time frame allows me to trade at that pace.

When day trading futures, I also use the squeeze, however, I use it on smaller time frames. For example, when trading S&P futures, I will look for squeezes on 5-minute, 15-minute, 30-minute, and 78-minute charts for a nice intraday trend. These trades will normally last me anywhere from 20 minutes to a few hours.

Regardless of whether this is a swing options setup or an intraday futures setup, I like to see multiple squeezes across multiple time frames, instead of one squeeze on a single time frame. This is because these moves are stronger. One squeeze will fire off, leading to the next time frame to fire off, and so forth, until you have a beautiful move on your hands.

## MULTIPLE TIME FRAME SQUEEZE EXAMPLE: YUM! BRANDS, INC. (YUM)

YUM has squeezes across multiple time frames. This could potentially be a squeeze with more power than just a single time frame squeeze alone. (See [Figure 20.4](#).)

**Figure 20.4**



1. Point #1 shows the squeeze on the 195-minute chart.
2. Point #2 shows the squeeze on the daily chart.

Typically, when the lower time-frame squeeze fires, it will cause the higher time-frame squeeze to fire as well, creating an exponential move.

## ENTRY WITH AN EDGE

Entering before the squeeze fires is key. Identifying a squeeze doesn't help you if the squeeze has already taken off. There is no reason to chase it. With so many tickers to trade, you can always find another one that you don't have to chase. I absolutely *must* have a solid entry point.

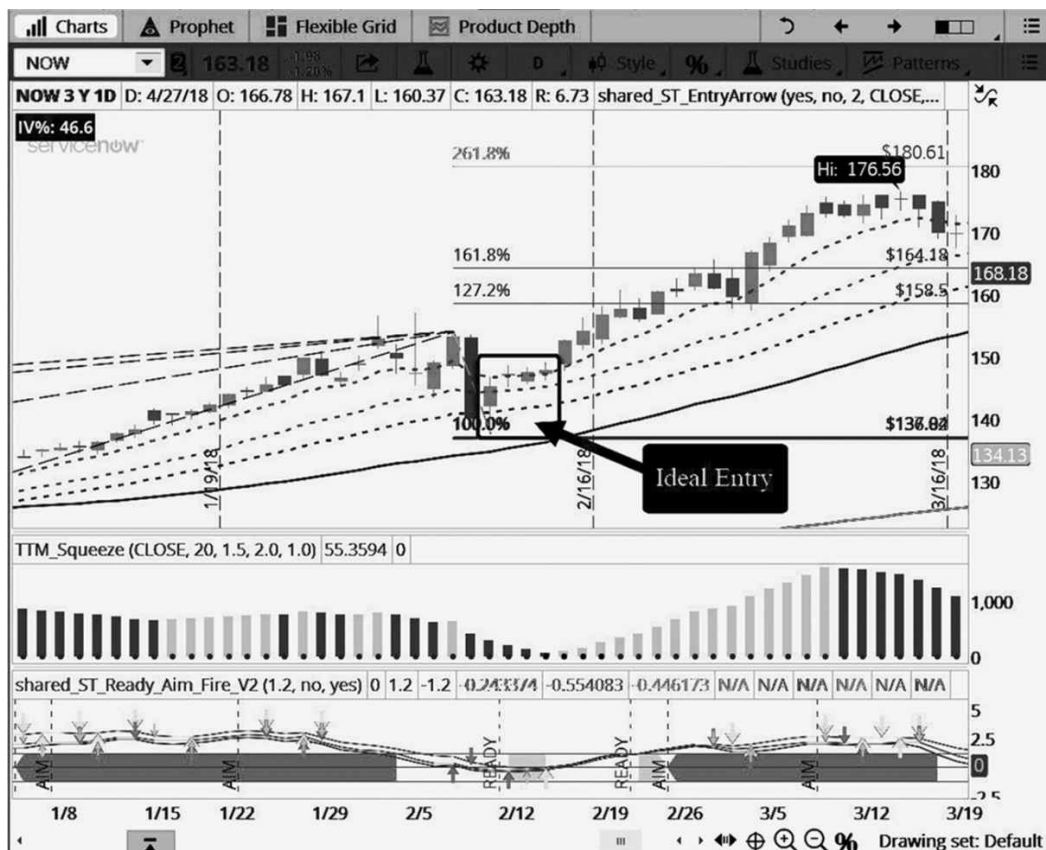
For me, the best entry with a squeeze is the price's relation to the moving averages. Typically, I want to see that the squeeze is still in consolidation, on a chart that is trading near the 21 EMA (the exponential moving average) on the daily chart. You must check the distance between the 21 EMA and your Fibonacci extension target to make sure your chart isn't too extended when you enter. There are so many options available that you never need to chase one specific trade. Ideally, an entry between the 8 EMA and the 21 EMA is the best spot.

## ENTRY WITH AN EDGE EXAMPLE: SERVICENOW INC (NOW)

In this example, you can see how price pulled back into the moving averages right as the squeeze was consolidating. This created a great edge for an entry because it was above symmetry support as well as the 50 SMA (which is my stop-loss point). (See [Figure 20.5](#).)

Figure 20.5





## CONFLUENCE

Sure, you can trade just one squeeze on a single time frame. However, the more confluence, the better. I like to see as much confluence as possible within the seven different categories listed in my Filter Checklist. The goal here is to identify where the most strength lies, which is always in the setup with the highest amount of confluence.

### *Fundamental Ranking*

While I'm primarily a technical analyst, I have begun adding a fundamental backing to my directional setups. Thus, I began using Chaikin Analytics. I like to look for stocks that have bullish or very bullish Power Gauge Rankings and combine that with my setup criteria. Thus, I end up with a strong, fundamentally backed stock with a strong technical setup.

I also use *Investor's Business Daily* quite frequently. Their IBD 50 stock list is a flagship screen of leading growth stocks that gives you 50 companies showing relative price strength and top-notch fundamentals. I love picking stocks off this list, and then combining them with my Five-Star Setup criteria. These are stocks that are already outperforming the market. When you take that, and couple it with an explosive, directional setup, the results are powerful.

Additionally, I keep my eye out for sectors or companies in the news due to the strength or growth they're experiencing. I apply my analysis across the major indexes and sectors, and then focus on the highest-weighted products within those strong sectors. Focusing on strong sectors, and then focusing on those individual stocks looking for explosive setups is key here.

## The Highest Confluence of Setups

A huge part of my trading plan is identifying the largest confluence of setups and only trading those. Of course, not every trade will work out. That's just part of the game. However, you can stack the odds in your favor by working to identify the highest-probability setups and going from there.

The squeeze in and of itself is a high-probability directional bet. Fibonacci analysis identifies high-probability moments in time where you have an edge in directional trading. On top of that, trading with the trend, versus countertrend trading, is higher probability. The icing on the cake is the alignment of individual stock names with either the directional movement in the indexes or their individual sector. In my opinion, the highest-probability way to trade directionally is when a specific sector is moving higher, playing individual names within that sector that also exhibit either squeezes and/or solid Fibonacci analysis.

### TDAMERITRADE (AMTD): FEBRUARY 2018

The daily chart of AMTD (TDAmeritrade) exhibited the following technical analysis traits during a time when the overall market had just experienced a violent pullback during the early February correction. However, AMTD remained strong. (See [Figure 20.6](#).)

Figure 20.6



1. *Sold Trend.* Up until the point I entered the trade, AMTD had maintained a very solid trend since September 2017. This is defined by stacked moving averages, steady pattern of higher highs and



higher lows, with an absence of violent pullbacks.

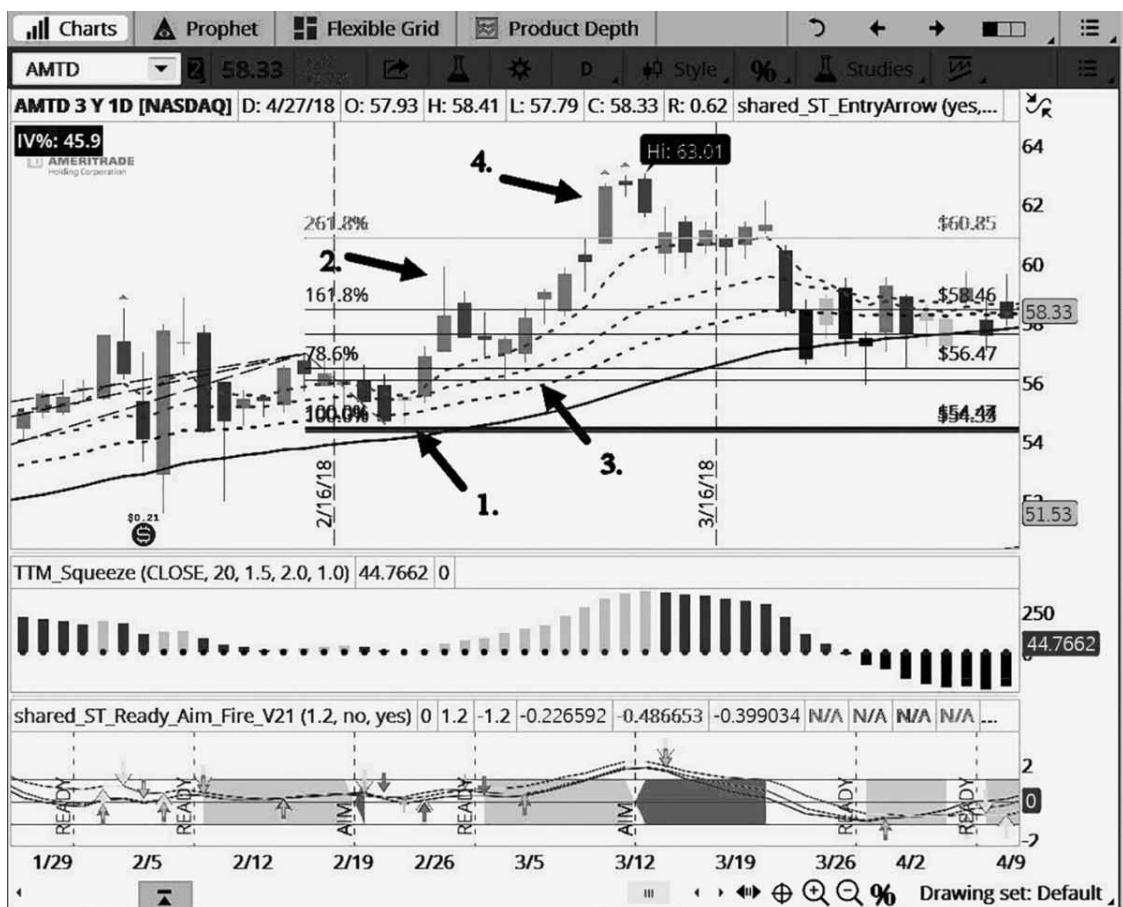
2. *Symmetry*. The pullback that occurred around February 12, 2018, was exactly symmetrical with three prior pullbacks. This symmetrical pullback held, and then triggered for a long.
3. *Squeeze*. There was a nice squeeze on the daily chart, which was exhibiting positive momentum in a moment in time where the chart was holding steady.
4. *Entry with an Edge*. The pullback to the 34 EMA that overlapped with symmetry was a great entry on February 12, 2018.

AMTD also had significant fundamental backing, appearing on the IBD Top 50 list. The confluence of setups was incredibly strong on this chart, showing a trend, symmetry, a solid squeeze, and a great pullback for an entry. All these points qualified AMTD as a Five-Star Setup.

## TRADING AMTD

With such a perfect confluence of factors, I like to trade these setups aggressively. I do this by buying calls with a Delta of 0.70, about a month until expiration. With this trade I also scaled in, as well as scaled out, of this trade to limit risk and maximize profits. (See [Figure 20.7](#).)

Figure 20.7



## KEY POINTS

1. First entry at the symmetrical pullback
2. First area of profit targets at the 161.8 percent extension
3. Second entry on the pullback
4. Final exit of all contracts at the 261.8 percent extension

## Summary

My entry on this trade came after symmetry held, and the momentum began to shift to the buy side. I like to use the 8 EMA and 34 EMA cross trigger on the 30-minute chart, as well as a Ready Aim Fire trigger on the daily chart. This gave me a tight stop, which was under symmetry support at the \$54.00 level and coincided with the 50 SMA.

I managed this trade initially by watching my Fibonacci retracements, which were quickly broken, giving me further confidence in the trade. Once the market broke through the \$56 level, my eyes were set on the first 127.2 percent Fibonacci extension target at \$58. My secondary target was at \$58.46, the 161.8 percent extension target. The third and most unlikely target, which as you can see was met, was at \$60.85. The 261.8 percent target is a rare target. But I have found in the case of IBD 50 stocks that this target can be met fairly often when there is a Five-Star Setup in play.

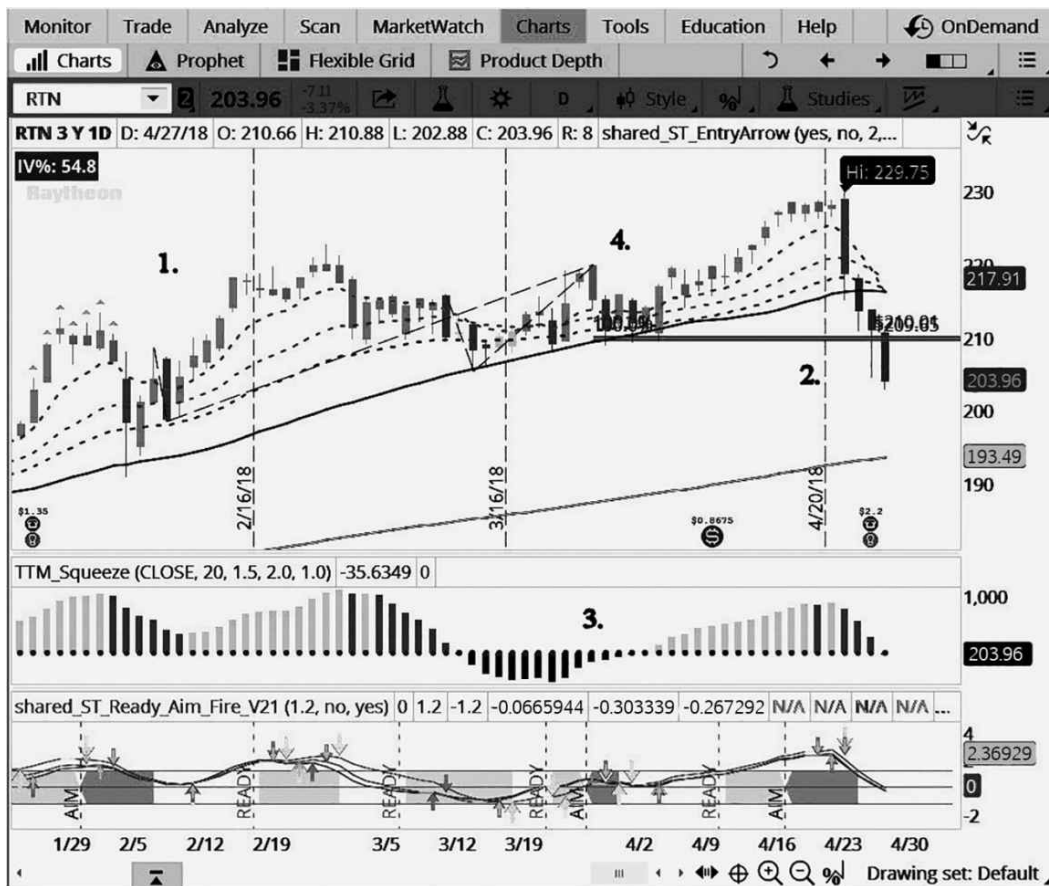
I typically manage these trades by scaling out at the first extension target, while adding more contracts on additional pullbacks if the setup hasn't completed itself. In the case of this trade, I was able to take profits at the first 161.8 percent extension, and then reload on the pullback to the 21 EMA, in order to take the ride a second time.

## *Raytheon Company (RTN)*

The daily chart of RTN exhibited the following technical analysis traits during a time when the industrials, particularly defense stocks, were incredibly strong:

1. *Solid Trend.* RTN had maintained a very solid trend for the last 2.5 years. This is defined by stacked moving averages, steady pattern of higher highs and higher lows, with an absence of violent pullbacks (for the most part).
2. *Symmetry.* The pullback that was experienced around April 4, 2018, was exactly symmetrical with two prior pullbacks. This symmetrical pullback held and then triggered for a long.
3. *Squeeze.* There was a nice squeeze on the daily chart, coupled with a squeeze on the 195-minute chart. These squeezes were exhibiting positive momentum in a moment in time where the chart was holding steady.
4. *Entry with an Edge.* The pullback to the 50 SMA that overlapped with symmetry was a great entry on April 4, 2018. (See [Figure 20.8](#).)

## Figure 20.8



RTN also had “the wind behind it’s back,” with the market seeing a rise in the defense sector. Overall, companion stocks such as Lockheed Martin Corporation (LMT) and Northrop Grumman (NOC) were also seeing a rise in price action. In addition, this stock was within the range of a “run into earnings.” This meant that historically, I could look for a bid going into earnings. This ultimately came through. The confluence of setups was incredibly strong on this chart, showing a trend, symmetry, a solid squeeze, and a great pullback for an entry. All these points qualified RTN as a Five-Star Setup.

## In Conclusion

*If you are not willing to learn, no one can help you. If you are determined to learn, no one can stop you.*

SOURCE UNKNOWN

Though I am five years into my journey and I’ve made an immense amount of progress during that time, I always remind myself that the journey is truly just beginning. This is a life-long path for me. I’m in it for the long haul. My goal is to continue honing my craft and studying the work of those who have been trading far longer than me. For anyone who is new at this, or for those of you who are still struggling, just remember a few things for me. Success doesn’t come from what you do occasionally. It comes from what you do consistently—with heart, will, and passion.

Trading is a business, and just like any other business, you’re going to lose money. It will probably take longer than you think. Risk always comes first and profits come second. After a while, you’ll start to figure it out, but how long that takes is all up to you. Practice makes perfect, but you must track what you do. Focus on

what works and cut out what doesn't work. Live to trade another day by making sure you don't run out of money. If you need help, ask for it. That's why our community exists. It's not much more complicated than that!



# How I Look at the Markets, Think About Them, and How I Handled My Emotions While in an Options Position Where I Made \$1.4 million on a Single Trade

What follows is a cleaned-up transcript of a podcast interview I did with *Chat with Traders*, hosted by Aaron Fifield. He asked insightful questions and it turned into a solid review of how I look at the markets, think about them, and we discuss how to handle emotions while in an options position where I made \$1.4 million on a single trade, my largest “day trade” to date. Let’s dive in.

## In the Beginning

**Aaron Fifield (AF):** You said something interesting right at the start about how the market sort of took off and you were upset that you weren’t in it. How do you deal with that? Do you just realize that you’ve just potentially missed the move and you’ve got to sit on your hands now or do you jump into it with a smaller position size? How do you manage those sorts of situations, because I know it can be very frustrating when you see a move which you were kind of anticipating, but it just takes off without you and you’re not in on it. How do you deal with that?

**John Carter (JC):** You know, I’ve been trading actively now for almost 25 years—which is crazy, because it seems like it was just yesterday—but with experience comes patience. After about six years of trading, one of my mentors sat me down and said, “Look, the difference between traders who can do this for a living and those who can’t is patience—patience to wait for the right opportunity, patience to sit in a winning trade . . . otherwise it’s game over.” My dad said something similar. When I first started trading, I’d say “God, I can’t believe I missed this move!” and my dad laughed. He said: “Look, I promise you the markets are going to be open tomorrow and there’s going to be another opportunity.” And it would be frustrating to sit there for a week doing nothing. There was a time when the Dow was down 300 points a day, and had I been positioned correctly, I could have made a lot of money. It’s frustrating, but what I’ve learned in doing this over time is that when you get emotional and you chase, you get yourself in a mind-set where you miss what’s going on. And when a real opportunity comes along, you’re just not ready because you’re chasing; you’re emotionally invested in something that wasn’t really a setup. You just felt like you were being left out. Recognizing that is just something that comes with experience. I mean, at some point you can kind of snap your fingers and say: “Okay, I’m not going to chase stuff anymore,” but after a while, what happens is you just learn the opportunity cost of doing that. First, you’re usually the last one to get in. And then second, your brain is all messed up, because it’s a purely emotional trade, and emotional trades over the long run just aren’t consistent. That’s how I’ve learned to deal with it.

**AF:** There's a lot of great insight in that answer. You've mentioned that there's some market blood that runs in the family. Tell us about how you first got into trading.

**JC:** When I was 18, I was working at a cookie store in the mall, which was a thankless job. I was making \$4 an hour, making cookie dough and then selling cookies to kids that came up with their moms. Over the course of a summer I'd say that I made about \$1,000. One Sunday night toward the end of summer, I came home from work to my dad and his friends sitting around the table. They had copies of *Investor's Business Daily*, and as I'm walking by I hear someone say, "Well, you know, I'd probably make \$1,000 on that trade." In my mind I thought: "Well I've got \$1,000 in my bank account now." So I asked: "What are you guys talking about?" They explained that they were going to buy some call options on Intel that week. I didn't know what Intel was, I didn't know what a call option was, but I thought: I'm 18, I've got nothing to lose. I asked, "Can I open an account and do this trade?" They told me that I wouldn't have time to open an account and do all the paperwork, but they said they'd spot me. They said: "Give us the \$1,000, we'll buy 10 contracts for you, and if it loses money, you're S.O.L., but if it makes money, we'll give it to you." And I'm like: "Done!" These options that they bought at \$1.00 sold at \$1.80. So . . . I had worked for three months, eight hours a day, five days a week to make \$1,000 and now, in five days, doing absolutely nothing, I made \$800. At that point I was hooked. I realized the power of having your own money work for you instead of doing physical labor. I mean, not that there's anything wrong with physical labor. It's good to get out and work, but the bottom line is that we're worth so much more than what somebody's willing to pay us per hour.

**AF:** I think that's what a lot of traders realize, and what's got them pursuing this, so I totally understand where you're coming from. Now, in past interviews, I've heard you talk about when you started getting into trading, you went through several boom-and-bust cycles. I'd love to ask you: What did those boom-and-bust cycles look like?

**JC:** I've always been a pretty decent risk taker for whatever reason. I think it's how I'm naturally wired. When I started trading, I was very good at making a lot of money, and then I'd lose it. There were three times over the course of my early trading career where I'd have \$10,000 and then over the course of about a year, I would run it up to about \$100,000. I took crazy risks in terms of position sizing. I'd decide to put my entire account into a trade, and if it worked, great, and if it didn't work, oh well. What would typically happen is I'd have \$10,000, it would jump to \$20,000, drop back to \$13,000, jump up to \$27,000, drop back to \$18,000 . . . but when I'd get to about \$110,000 or \$120,000, I'd step back and say, "Wow! I just went from \$10,000 to \$100,000, so now, I'm going to go from \$100,000 to \$1,000,000!" But what I was doing—and it took me forever to figure this out—was over-focusing on the million dollars. Before, I was just trading. I didn't have a goal. I was just like: here's a trade, let's take it, I want to make some money. But when I started focusing on making a million dollars, I changed my trading approach. Now, if I had a losing trade, whereas before I would just get out, I would now say, "Gosh, you know, I'm trying to make a million dollars, so I can't take this loss. I've got to at least break even." So, I started doing stupid things. That happened to me three times where I'd make this money, blow it up, and after the third time, I went through a gut-wrenching learning cycle and conversation with myself—you know, do I want to keep putting myself through this? And at the time, I was just about to get married, and I thought if I'm going

to get married and have kids, am I going to put my family through this? I just had to come to terms with what I was doing. I ran across Mark Douglas's book *The Disciplined Trader* at that point and then *Trading in the Zone*; those helped a lot. Then I talked to some traders, and I just said, alright, if I'm going to do this, I've got to act like a professional. I learned not to try to "make a million dollars," and that changed things. It obviously didn't mean that I never had losing trades or drawdowns, but I never blew up an account after that.

## How Much Risk Is Needed to Become a Successful Trader?

**Aaron Fifield (AF):** You obviously by nature have quite a big appetite for risk. You're very comfortable in many ways taking large amounts of risk. Do you think that's a necessary trait to be a successful trader?

**John Carter (JC):** There's a fine line. You can take too much risk, but I don't know what is worse: if you have an appetite for too much risk or if you're too conservative. And I've seen both. Obviously too much risk leads to scenarios where you're going to make a lot of money and then you're just going to blow up. If you have too much fear, though, the good news is that you're not going to lose a lot, but you're not going to make a living as a trader, either. I think that's one of the things that people get confused about. I think that one of the goals a lot of people have, and this was certainly my goal for a while, is to be able to *immediately* make a living from trading. When I was in the corporate world, I was making right around \$100,000 a year. I mapped it out and thought, "Alright if I'm going to quit my job, I need to make \$8,500 a month trading!" If you're too aggressive in that situation, your account is making swings that don't make sense with your goals. But if you're too fearful, you're not going to make nearly enough money to meet your goals. The biggest problem with being too fearful is that you wait for confirmation. The problem with waiting for confirmation in trading is that by the time something is confirmed, and all the indicators are aligned that this is a buy signal, that's usually the time that you should be taking profits. Everybody's looking at the same charts; if everybody thinks that something looks good and everybody's long, no one is left to buy, and at that point, it rolls over on the weight of all the automated trailing stops people use these days. That's why sometimes it feels like if you're in a pattern where you're buying something and as soon as you buy something it goes down, well, usually it's because there are 27 indicators that people have been watching, and now they're finally all lined up. You feel "safe" to take the trade, but at that point, now it's obvious that the pros are getting out.

**AF:** I hear you mention Mark Douglas's book *Trading in the Zone*. What was it about this book that was such a huge help in getting you to the point where you could achieve consistency? What was it about this book that really clicked with you?

**JC:** When I first read the books, I didn't know Mark. I eventually got to know him, and we became friends. He recently passed away, which was a complete surprise and it knocked the wind out of me. His knowledge of (1) the markets, (2) the human mind, and (3) how the two interact is unparalleled. People who are making their own trade decisions—not just turning it over to a computer—without having read Mark Douglas's books are at a disadvantage, because he had an intuitive sense of how the markets prey on people, and it does—it sucks people in at the wrong time. The main thing that you learn from reading Mark's books is that to trade successfully, you've got to understand how your mind should be thinking



while you're in a trade. The key is probabilities. You need to have a probabilistic mind-set, meaning that you must accept that anything can happen. Just because I'm long doesn't mean the stock is going to go up. Anything can happen. And if you realize that anything can happen, then you get a little bit more relaxed. You focus more on risk and you don't take small profits, because if anything can happen and I have my risk covered, it could turn into a big winner. When I got my mind wrapped around that, my trading just changed. My winners got bigger and my losses got smaller. It was amazing. He also hit on things like how unresolved emotional issues can create "hidden agendas" in our trading that we aren't fully aware of. Those hidden agendas like "I'll show them I'm a winner" are never good.

## What Did Your Learning Curve Look Like?

**Aaron Fifield (AF):** Okay. Just so we can put this into perspective—from the point where you got started trading, you went through the boom-and-bust cycles three times over, until the point where you achieved some sort of consistency. How long was that time frame?

**John Carter (JC):** Gosh, that's a good question. I would say that my learning curve for trading was probably longer than most people's. And the reason for that is that I stuck with it longer than I should have. A lot of people I know tried trading for like two years; it didn't work out and they gave up. So, the reason I was able to last longer is that when I had those three boom-and-bust cycles, I would take \$10,000 and turn it into \$130,000 and then think: "Okay, I'm going to make a million!" The one smart thing I would do is that I would take \$30,000 out and put it into real estate. I put down payments on a couple of duplexes and rented them out. By the time I busted my third account, I had a decent real estate portfolio. So, when I finally decided to "get real" about trading, I was able to sell some of that real estate and raise another stake.

**AF:** About how long was it between the time you took your first trade to the time you got to this point?

**JC:** At this point, when I had finally read Mark Douglas's book and I had been through all that, it had been eight years, and I had put my fiancée through a few tough moments. There was a time where I blew up the last account right when we were trying to buy a house, which is a story I tell in my book. That was incredibly painful. We're still married to this day and have three kids, and I'm thankful to have such an awesome wife. I don't think it needs to be eight years of frustration to learn how to trade for anybody else. I think you've got to put in the time, I mean nobody's going to learn on day one, but I like to compress the learning curve with other folks. For me it took eight years. I think for the average trader who has the right tools it could be two years. People have to see the different market conditions and they have to believe that the market can take away all of their money if they're not focusing on risk control. The one thing that's unknown is how people react. If you've got money on the line and the market starts going against you or it gaps against you, how are you going to react? Are you going to freak out? Are you going to be a "deer in the headlights"? Or are you going to be able to calmly take action? That's a little different for everyone. The sooner that you can get to the point where you just focus on probabilities and you let go of any emotional attachment to the outcome, the sooner you're going to be consistent.

## How Do You Trade Today?

**Aaron Fifield (AF):** Okay. Let's focus in a little more on how you trade today. How would you describe your method and your overall approach to markets?

**John Carter (JC):** I find it's good for every trader to find his or her sweet spot. You need to match your trading to your personality. To me, there are four types of trading: there's scalping/day trading, there's swing trading, there's position trading, and there's investing. My sweet spot is swing trading, which are positions that last a few days to a few weeks. I have no interest in scalping off a one-minute chart, buying something, and then selling it three minutes later. It's too much work for too little reward. Now it seems like that's safe and it does create a lot of adrenaline, but what a lot of people don't realize is that you generate so many commissions that it's almost impossible to make money. If you have a \$20,000 account and you're a day trader, it's very likely that you're spending \$20,000 a year in commissions. So you have to make 100 percent a year just to pay your broker. People just don't realize that until you start tracking it. So, to me the sweet spot is the larger time frames, 30-minute charts and above. Track down trades that you expect to last a few days to a few weeks, where the reward is worth the effort of finding the trade as well as hanging onto the trade. I'm not looking at five-minute charts during the day—and by the way, one of the best things I ever did was just take my five-minute charts and throw them away. I look at 30-minute charts, hourly charts, then daily and weekly charts. I'm just looking for setups; I want to be in something that is going to make a decent-sized move. If I'm buying something on Tuesday, the earliest I would sell it is Thursday, unless I'm stopped out, and that to me is a nice sweet spot. You can get aggressive, you can catch nice little pops, and the markets tend to do that. They tend to move in little pops and then consolidate. That's kind of what I look for and it works for me really well.

**AF:** Okay, and what markets or products are you most actively trading?

**JC:** I cut my teeth on the stock index futures, so I like the stock indexes in the United States: the E-mini S&P 500 (ES) futures, the E-mini NASDAQ futures, but I'm also a big options trader on individual stocks. The two are very complementary, so I'm bullish on the ES. Then great, what are the strongest stocks? Tesla (TSLA), Google (GOOGL), Amazon (AMZN), or whatever is setting up. Then I can buy some call options on those, so to me, those all work together. I'm also big on correlation, so if the yen futures are going higher, is that going to mean weakness for stocks? Great, which stocks will be impacted the most and where can I buy puts? I do like to look at those leverage instruments.

I watch the Australian dollar too. Speaking of which, here's a funny story. In 2008 I flew out to Australia to give a talk. I make it a practice to buy a country's currency before I go there, just in case my credit cards aren't working or I'm in a taxi that only takes local currency. I bought Australian dollars about a month before I went; I bought it when the ratio of the Aussie dollar to the US dollar was 1:1. By the time I got to Australia in October 2008 it had fallen in half. So that was a really bad trade because I bought them for a dollar and they were worth only half that by the time I got there.

The world economies are all tied in together and I got to watch firsthand as the paper currency in my hands imploded in value. But here's the thing: you don't need to know that. You do not need to know that if the yen goes higher, stocks might go lower; all you must do is have a handful of good setups. The traders who have mentored me and have been doing this for 30+ years all say, "I've got three setups and I

watch four markets and that's it." They don't care what's going on in other stocks or other markets. They don't watch the news. They're not looking for the latest tips. They just have their niche and they grind it out and make some money, and I'm a big believer in that. I think that the less news-related information you have, the better you'll do, because otherwise you'll just get distracted. Remember, the guys on TV just want you to stick around to watch the commercials.

**AF:** I think that's a great point you raise. You said a little earlier that traders might see some sort of consistency after putting in two years of good work, and the reason for that was because over that time they experienced different market conditions and would go through different regimes. How did your trading change depending on what type of market we were going through at the time?

**JC:** That's a good question, because one of the things it took me a long time to learn is that you don't do the same trades all the time. Is it a bullish market? Is it a bearish market? The art of trading has come down to a couple of things. One of them is knowing that there are three positions you can have: you can be long, you can be short, or you can be flat. The longer I do this, the more I realize that flat is one of the best positions, because when you're flat, your mind is neutral. There's a saying that I heard from a friend of mine, a trader in London. He said: "Don't piddle away your chips." In the United States, we'd say "Don't piss away your capital." If there's nothing to do and you're bored, just go do something else. Wait. Be patient.

Right now, the markets are kind of interesting because we had this super-bearish sentiment in January, and then in February, 2018. All of the signals that I've gotten have been long, but my brain was screaming to be short, which was interesting. I've learned to just trust the signals, instead of my opinion: this is a bullish signal, buy it. And the main thing that I've learned is that no two trading days are alike, but there *are* cycles. If it's a bullish cycle, great. If you're in at the beginning of a bullish cycle and you've got some signals that are going on there, load the boat and ride it out.

Right now, we've had this fantastic rally from the beginning of February 2016 to where we are now in April 2018. This is not the time to load the boat on longs, but it's not the time to load the boat on shorts either, because there are no short signals. I'm playing it pretty light. I'm staying flat and neutral, biding my time. I'm just kind of in a hurry-up-and-wait mode. What I've found in trading is that if you can be patient over the course of a trading year, there's going to be one or two days a month where if you're focused and you have a neutral state of mind, you can dive in, have a larger-than-normal position, make a killing, and then get out and go flat again. That's really what it's all about. As a trader, it's hard to do that because you think you should always be trading. When people get bored and trade to alleviate their boredom, they just piss away their capital. So when a big trading opportunity comes along, they're just kind of getting back to where they were. Just learn to wait. I think that's one of the toughest things to do, but I think it's one of the most important things to do. If you're looking at the markets and there's nothing to do, don't do anything. If you look back on your trades and say that trade worked out really well, go back and look at it. What came together? Wait for that to happen again. Go for a larger-than-average position if you are confident with your risk controls; otherwise, stop and wait. Don't piss away your capital on mediocre setups. It's something you don't know at the beginning, but over time you'll learn, and it's just a huge lesson.

## What's Your Thought Process for Deciding When to Get Out of a Trade?

**Aaron Fifield (AF):** Absolutely. Now just going to the other end of the trade, what's your thought process for deciding when or where to get out of a trade? How do you form an exit plan?

**John Carter (JC):** It's a good question. At the end of the day, entries are a dime a dozen. To become a good trader, you've got to become a master of exits. And that means, of course, stop-losses, but also targets. This is kind of easy in the options world because options are priced with what's called an expected move. Of course, with spreads your targets are fairly simple to figure out since the total gains on the trade are limited. For directional trades, I'm always looking at the expected move. What I mean by *an expected move* is that market makers and computers study a stock, and with implied volatility and a few other readings, price the options based on the range they think the stock will trade in during the life of that option. For example, if NFLX (Netflix) is a \$300 stock and the market makers have priced it a \$20 move over the next two weeks, well, guess what? If you're in this trade, and it goes up (or down if you're long puts) the expected move of \$20 . . . get out! The odds of it going much higher than that are not very high. If anything, it will meet resistance at that level and start coming back toward your entry. When you're long options, retracements like that suck out all the premium.

The other thing I'm a huge fan of is Fibonacci extensions. Whether it's a 30-minute chart, a daily chart, or a weekly chart, if a stock makes a new swing high and it gets up to the 1.272 percent extension of that move, from the swing low, you have reached a high-probability target. The odds of it going higher than that amount in the near future, like the 1.618 percent extension, without a major retracement, drop dramatically. Take the easy money and get out. You want to know where the low-hanging fruit is.

I might see a great setup and decide that I'm going to get 10 contracts. Let's say it's futures. I'm going to get 10 S&P futures contracts, and if we get to the 1.272 percent extension of the swing move, I'm going to sell seven of them. Let's take the bulk of the risk off the table here. And if we get to the 1.618 percent extension, great, but I'm going to move my stop on the remaining three contracts to break even here, so at that point my risk in the trade has been cut drastically. Not only have I taken chips off the table, I've reduced my risk on the remaining chips I'm still playing with. I'm not going to hope that the things are just going to keep moving magically in my favor forever.

**AF:** I like that, the low-hanging fruit. So, let's talk a little more about options now that you bring it up. I know options are one of your main focuses right now, but over your 25 trading years you've traded in pretty much every market at some point during your career. What is it about options trading that you find really attractive?

**JC:** Well, if I look at something like gold, I might say: Okay, I'm bullish on gold, what do I do? Do I go out and buy some gold futures or buy physical gold bullion, or do I buy call options on an ETF like GLD that follows the price of gold? Well, if I'm looking to diversify my assets, I'll buy some gold bullion and tuck it away. However, if it is a trade where I'm just looking to participate in the price movement and have it benefit my trading account, then I need to decide on the best way to participate in that move. Here's the thing: it is much harder to hold on to a futures contract than it is an options contract. Futures move all the time, are notorious for hunting stops, and oftentimes have a lot of slippage, especially in the overnight

sessions on crazy moves. Or, I could buy call options on GLD 60 days out and just forget about it. I know what my maximum risk is. I don't need to stare at the chart. A spike move that would have stopped me out in the futures market is not a problem to hold through with options on an ETF. What I like about the options is you can say: I just want to risk \$5,000 and I'm done. And the other thing is that options are depreciating assets, which are kind of fun, so you can also sell them. Here's an example: a popular stock in the US markets is APPL (Apple). If Apple is at \$250, you could buy a \$270 out-of-the-money call option for like a dollar. You're making a bet that Apple is an amazing stock and it's going to rally up to \$290 and you'll be a big winner. Well, it's probably not going to work out like you thought.

However, you can take the opposite side of that trade and just sell it. You sell it for a dollar, it expires worthless, and then you keep all the money. So, with options there are a lot of fun things you can do in terms of selling them or keeping the money that a lot of other traders are losing on the premium decay side of things. You're taking the opposite side of other people who are buying options that expire worthless. There's just a lot of flexibility when it comes to options.

**AF:** You were recently on the *Option Alpha* podcast with Kirk Du Plessis. One of the things you were speaking to him about is that with options you find that they've helped you see more consistency in your results, kind of minimizing the drawdowns and lessen volatility in your actual account. Is that something relevant to your choice of trade options?

**JC:** Well, it depends on your goals. If you're looking for a steadier equity curve, meaning you don't want the crazy ups and downs, you can structure trades in a way with options that makes it really consistent. Now, consistency also means that you're limiting profit potential, but that's not a bad thing for most people. For example, you could buy a call option on TSLA (Tesla) at \$8 and it's either going to go to \$16 or go to \$0, or you could sell a put-credit spread on Tesla that's out-of-the-money and the odds of you making a profit on that trade are 90 percent.

The nice thing about options is that you can decide what kind of risk you want to take. What kind of equity curve do you want? The job of the trader is to have an equity curve that goes from the lower left of the screen to the upper right. It's going higher. It's not about being right; it's about managing that equity curve. I'm an aggressive trader, so my equity curve is going to have a little bit more zigzag to it, but some people don't like that. They want it to be more consistent. What's nice about options is that you can construct your trades in such a way so that you're never going to have any big blow-up surprises, but you're not going to have any upside excitement either. You're just steadily cranking out the money and that's great. The great thing about options is that you can structure your trades in a way that matches your personality and your own trading goals. Obviously at the end of the day, all that matters here is that everybody's able to figure out their trading goals and then find the right instrument to execute those trading goals.

**AF:** Another thing you mentioned on that podcast was the term "financing a trade." Now I didn't quite understand this, but I think it's somewhat interesting. Would you mind expanding on what you mean when you refer to financing a trade using options?

**JC:** Sure, and there are a couple of ways to do it. Since we were talking about gold earlier, I'll use it again

in this example. Let's say I think GLD is going to go higher over the next three months, I'm going to buy a call option three months out. Well, let's say it's at \$120. What I could do is that even though my call option is three months out, I could sell the \$125 options that are 30 days out against those, and in a perfect world, they expire worthless, kind of like having a rental property. That trade is called a *diagonal*: you buy something that's longer term and you sell shorter term options against it. If the stock moves up methodically (or down methodically, if it's a bearish play), you can do it in such a way that you end up selling enough options against it that it pays for itself, which is kind of fun.

The other thing in that scenario is that you can structure the trade so that you're collecting premium but also leaving yourself open to a bigger move. To do this on a bullish play, you could buy 10 call options, and then sell a 30-contract put-credit spread that ends up expiring worthless and ends up paying for the entire call-option trade, so now you've got a free trade. The nice thing with options is that there *are* things like that that you can do. Obviously on anything like that, there's a risk, but the fun thing is that you can finance a trade, and once it's financed, you can just let it go and see what it can do.

### What Advice Do You Have for Novice Option Traders?

**Aaron Fifield (AF):** Okay, so that sounds like something which is a little bit more advanced, but very interesting. Just before we move off the topic of options, is there any advice you'd like to give to novice options traders that would be really helpful? Maybe some advice that would have been helpful for you when you started getting into options.

**John Carter (JC):** I'd say the first thing is that if you're a novice and you're getting into options, usually if you think that the stock is going to go higher, you're going to buy a call. If you think it's going to go lower, you're going to buy a put. That's just kind of the basics. The mistake that most novice traders make is they look for cheap options. If you're looking at a stock, let's use APPL (Apple) as an example, and say it's a \$100 stock. You'll look at it and say, "Wow, it's a \$100 stock, the \$95 calls are \$7, but the \$110 calls are only \$1, so I'm going to buy the \$110 calls because they're cheaper." That's the biggest mistake you can make. Essentially with options, those out-of-the-money options are designed to expire worthless. They're designed to suck people into them. So if you buy an in-the-money option, even though it's "more expensive," all you've got to think of is this: instead of buying Apple for \$100, you're buying an option for \$7, so for a much cheaper price than actually owning Apple, you're going to be able to participate in the price movement of Apple and do it that way. I would just stay focus on in-the-money options if you're buying them and if you graduate from that, start considering spreads and selling put-credit spreads or call-credit spreads.

I remember the first time I went to an options seminar and I started hearing about butterflies and all this kind of stuff and it went right over my head. But if you can grasp the next step—that if a stock rallies, the puts will lose value—then on the next pullback to support, instead of buying a call, just sell a put. And create it as a spread so your risk is fixed. Now you're on the same side as the professionals, who prefer to sell options since they can take advantage of premium decay.

When you're long options, premium decay takes money out of your pocket. When you're short options,

premium decay puts money into your pocket. I like to do both, to take advantage of both the premium decay and the potential for a greater than expected move. If you're bullish on something, buy an in-the-money call, and sell an at-the-money put-credit spread. You're done. If you're bearish on something, buy an in-the-money put, sell an at-the-money call-credit spread. You're done. And that's all you need to do.

**AF:** And when you say you don't need to go down that road, are you talking about sort of in the early days, or is it not necessary at any point? Is that something you get into these days?

**JC:** No, I don't think it's necessary at any point. Don't get me wrong, as I've grown to really appreciate buying butterflies. The thing about options is that it can be easy to get overwhelmed by the Greeks. Theta, Delta, Gamma, Vegas. If it's confusing then don't worry about it as long as you understand the basics we just talked about. If it's intriguing and you want to go down that road, that's great. Their importance really depends on your style of trading. If you're looking at charts and taking buy-and-sell signals on stocks, the Greeks aren't as important. I'm not knocking the Greeks, because they're important for other types of trades. But I look at a chart, and I get an opinion based on a setup that this stock is going higher. Well, that's very simple. If I think it's going higher, then I need to buy the right call (in-the-money, at least 30 days out), and I should add the extra kicker of selling a put-credit spread to minimize Theta decay and ideally offset the premium I'm losing on the long call. That's a win/win.

### What Is Your Favorite Setup?

**Aaron Fifield (AF):** Okay, good advice. Let's talk a little bit about technical analysis and indicators. Starting with technical analysis: how do you use technical analysis in your trading? Is there anything key that you look for on a chart?

**John Carter (JC):** Well, my favorite setup is something called *the Squeeze*. That is when the Bollinger Bands are trading inside the Keltner Channels. It just means that the standard deviation of a stock or market is now trading inside of its Average True Range (ATR). It may sound kind of complicated, but think of it this way: if Olympic athletes just ran a 100-yard dash, they're not going to go run another 100-yard dash immediately after that. They're going to rest, they're going to drink some electrolytes, and they're going to get ready for the next event. It's the same thing with the stock. It's going to have a move, and then it's got to rest and relax and kind of get ready for the next move.

What I've found is that when the Bollinger Bands contract to the point where they're trading inside the Keltner Channels—and by the way, these are all default settings that are available on most platforms—that's telling you hey, heads-up, this is getting ready to go again. It's almost done resting. We've got an indicator we've created called the Squeeze that makes the setup something that can be scanned or searched for, and that's the first thing I look for on a stock I'm interested in. Is it building up a Squeeze or not? If not, I'll keep looking for one that is. When I see a Squeeze, I know the odds have increased significantly that some movement is about to happen; that it is ready to do something. If it's in an uptrend, this is saying that there's an 87 percent chance that this uptrend is going to continue. I can work with that, and vice versa, if it's in a downtrend. I keep it fairly simple. There's a lot of other indicators I use, but I always start with that as a foundation.

**AF:** Now I don't mean to keep going back to the interview with the *Option Alpha* podcast, but one of the things you said which really struck me was that you don't look at a chart for more than a split second. I'd love it if you could share your reasoning for this.

**JC:** Yeah, this is another hard lesson I've learned. The good setups are right there in front of your face, and if you're looking at a chart for more than a split second, it means that you're trying to force something onto that chart that isn't there. You can identify the best setups just like that, and if you can't, move on to the next chart. You might read something in the news that suggests a stock is bullish, but then you look at the chart and the chart looks like crap. But in your mind, it's like it should be bullish, so you keep looking at it and trying to force it into that scenario. If you're determined, you're going to find something on that chart that says it's bullish to justify your opinion, even if it has nothing to do with whatever you've looked at in the past. Bottom line: if you're looking at a chart and in a split second you don't see anything, you don't have anything. Move on.

**AF:** Do you think that you can identify setups that quickly because you have 25+ years of market experience and years looking at charts? Or is that something you would say that newer traders should also try to apply to their own trading?

**JC:** I think it's a little combination of both. After doing this for 25+ years, you start learning the setups, something I call "high-probability moments in time," that give you the best results. Any time that happens I definitely will take a position. As a newer trader, there's a natural inclination to search for that Holy Grail, and continue tweaking a chart, adding more indicators, all that fun stuff. A newer trader wants to get long a certain stock, so you'll keep looking at this stock until you find a reason to go long. Even if it's the most bearish setup on the planet, you can find a reason to go long if you really want to, so the moral of the story is, have a setup that you like and keep it simple.

Don't get married to a stock, get married to a setup. If it's not happening on NTFX (Netflix), then see if the setup is happening somewhere else. Then have an alert that pops up when it is happening on Netflix. Then and only then trade Netflix. Not because of something you read on Twitter.

I have found that if you have a setup that you can't explain to a 12-year-old, it's too complicated. You don't need a lot of indicators; in fact, you really shouldn't have more than like three to five. Besides price and volume, I like to look at tools like the Squeeze that measure volatility, as well as tools that measure logical price targets, momentum, and turning points. If you've got more than that, you've got too many indicators on your chart. Identify that setup. You can use something like a Squeeze or a Moving Average (MA) crossover—it really doesn't matter, just identify what the setup is and then track it. Whenever you find a setup, just do 25 trades in a row, and at the end of 25 trades, see if you made money or lost money after that batch of 25 trades. Wins and losses are going to be randomly distributed even on a 75 percent probability setup. Just because you do four trades does not mean that three of them are going to be winners. You might have four losers in a row. But at the end of 25 trades you're going to have a good sample set, and if you made money on that, you're going to have more confidence in your ability to keep taking that setup. You'll be able to say "Okay, every time I see that setup, I'm going to take a trade." That's what you do and that's what you get into the habit of doing. In a split second, you say, "That's it, that's the



setup I'm looking for. I'm taking it." Otherwise, keep looking. It's much better to have a couple of well-thought-out, well-planned trades during the week as opposed to a dozen mediocre trades placed out of boredom.

**AF:** That's really a great point that you've made. You have mentioned indicators a few times. When do indicators serve a purpose and when are they unnecessary noise?

**JC:** I know traders who only look at price action. There are times when that makes sense, when you're looking at price action and volume. A great example of this is one I remember from when I was a newer trader. The market was rallying, but it was overbought, according to the Stochastic or Relative Strength Index (RSI), or whatever it was that I was watching. I'm like, "Well, I guess I can't buy it." And I watch the market go up like what felt like forever from that point—that point where I thought I couldn't buy it because I thought the move was over. At the end of the day, it's the price action that matters. Indicators are just a derivative in interpretation of price action. There's no magic involved in indicators; it's just math. You don't want to let the indicators get in the way of what's really happening on the screen. The first thing that's most important is price. After that, you look at a couple of indicators and see what's going on. But it's easy to get lost in a bunch of different indicators when all that matters is if the market is going up or it's going down. What is the path of least resistance? Price is the most important thing; the indicators are merely an interpretation of that.

### **Can You Please Share the Story of the \$1.4 Million TSLA Options Trade?**

**Aaron Fifield (AF):** That's well said. I like that. Now one of the things I'm keen to ask you about is the time you banked about \$1.4 million on a trade. I'm not sure exactly when it was, but could you please share the story with us? Walk us through it step-by-step. I think the story would be really interesting to hear. I watched the video of you doing this trade on your website, where you are scaling out of the trade and trying to stay calm.

**John Carter (JC):** Sure. I remember that trade. I've had a couple of big trades before, but not in one day like that. This was in January 2014. I remember on that day that I woke up and I had two trades that weren't doing well. I got stopped out of both. One account I was trading was about a \$1.5 million account, so it was a pretty decent-sized account. I'd lost about \$100,000, so I thought, that's not what I wanted, but I've been doing this a long time, so I wasn't flustered. I'm sitting there and I'm now flat. I got stopped out of my positions. But I had noticed that earlier in the day TSLA (Tesla) was down \$10, and then I suddenly noticed that it was up \$5. I was like, what is going on? Tesla was down \$10, now it's up \$5. So, I check on Twitter, and Elon Musk had made an announcement that spooked shorts. I knew that the short interest on this stock was high, like 45 percent, so if shorts are spooked, that is a lot of stock that is stuck on the wrong side of the trade. This is something I do look for. If there's a lot of people who are short, typically over 20 percent, then you get some kind of surprise announcement to the upside, they're forced to cover. Plus there's going to be new buyers, so you can generally get these huge moves on the day, bigger than almost anything else that could happen, even earnings. So, I'm looking at that thinking that Tesla was down \$10, up \$5, I'm looking at the chart. There's no real resistance and the prices were at maybe like \$150 at this point. There's no resistance to \$170, and the volume has exploded to 500 percent above

normal at this time of day. This is the real deal. Pure panic on the part of shorts, and they're going to be taking a beating all day long. I buy 100 call options, and it continues to do well. I'm buying them at \$6, and in a \$1.5 million account, that's a small position. I keep adding as it goes in my favor, and I get to a point where I have 1,000 call options, which is a pretty sizeable position. I even bought a bunch of stock. About an hour into the trade, I was up about \$300,000, after being down \$100,000 to start the day. I thought this was an amazing trade and I was starting to think about getting out and calling it a fantastic day. But I'm looking at this thinking that it's not showing any signs of stopping. The volume is pouring into this. But obviously no stock goes up or down in a straight line, and it started to pull back. I'm watching my profit that was up \$300,000 over the course of 10 minutes drop to being up \$200,000.

Now we're at that moment in time where every trader is worried that it's turning into a losing trade, but I think I see a lot of potential here, so I stepped away from the computer and took a shower. I just had to get away. I had stopped thinking objectively. When I came back, Tesla had gone a little bit lower. Then it stabilized, so I was back to where I was, up \$300,000. I had started the day trading at home. I packed up and headed to the office, which was about 20 minutes away. By the time I was at the office, I was up \$600,000. Wow. And it was showing no signs of slowing down.

At this point I'm also in our trading room and fielding questions, which was also an exercise in multitasking. The stock consolidated during the last hour into the close, which is a good sign that it will: (1) rally into the close and (2) gap higher the next morning. As it started to rally into the close, with 10 minutes left, I'm up just over \$1 million on the trade. It was crazy. I want to hold some overnight, but I can't hold it all or I would have a panic attack, so I close out about half my position. Of course, sleeping was nearly impossible that night. I got out of bed three hours before the market opened and saw that Tesla was trading \$10 higher pre-market. That's great, of course, but when you're trading options, you can't sell them until the cash session opens. I try to distract myself to pass the time by checking my Facebook feed and catching up on e-mails, all the while looking at pre-market price action. The gap holds into the cash open and it's up around 10 points and I'm immediately up another \$500,000. It starts to sell off and I drag my orders down to exit some of the options, and then it reverses and pops higher and I get solid prices on my next sale. After that I ease out of the rest. This is probably the video you saw as I did this live in our room and recorded it. It was an amazing trade and very difficult to hold on to. It's interesting because looking back at it I would analyze and say, "Why didn't I buy it when it was down 10?" And so on. In a perfect world, I would have done a lot better on the trade. But the point is, you can make a lot of money on a trade and not be anywhere near perfect. The explosion in volume, combined with the high short interest, was the key signal.

The ability to sit on a winner like that? That is hard and that is the result of training yourself how to behave when you're in a trade and your emotions are working overtime. That's just something that you learn to recognize: this thing is moving. There's volume pouring in. Traders are trapped. Every pullback is being bought. Where is this going to end? Just hold on. There are moments in trading where all your training comes together, and that was one of those times. I haven't had another million-dollar day trade since then, mostly because I think I went a little overboard on my position size on that trade. A few other moves I've caught like that since then I've done with a few hundred contracts instead of a thousand. Much

easier to manage after that Tesla experience! But also, those other setups weren't quite the same as what happened to Tesla. The short interest wasn't as high, and the reversal wasn't as abrupt. This was just one of those special times where you recognize what's happening, step up to the plate, and just hold on.

**AF:** The [part I](#) find really fascinating about that trade is that you almost knew to push harder on that trade. You said when the trade started working out you just kept adding to your position. How did you know how to push harder on this particular trade?

**JC:** A big part of that is just recognizing what I would call "a special situation." We've seen those days where a stock starts off down 5 and then suddenly it's down 30. A lot of it is volume; that's just an easy thing to monitor. If volume is several hundred percent above normal for that time of day, something unusual is going on. The volume signals that something interesting is going on—something out of the ordinary. The easiest way I can describe it is that it's a special situation. When a stock breaks, especially when something that everyone thinks should happen isn't happening, things can get interesting. Tesla had fallen, fallen, fallen. Everybody thought it was overvalued. The news was negative. Hedge funds were shorting it. People had written articles that it was dead. Then suddenly it started having this huge reversal. The biggest moves happen when a lot of people are wrong and are stuck on the wrong side of the reversal. Big moves don't happen when a lot of people are right. In that situation, things just kind of plod along. When a lot of people are wrong, and they must get out of that position, that's what causes big moves. So, with Tesla you had this reversal; you had a lot of people who were wrong, who were forced to get out of that position. When you recognize that, you can take advantage of it. You know, people are stubborn. They're going to keep holding on and holding on, and then they panic and must get out. That's how the markets work. When there are a lot of people on the wrong side of a position and they all realize they need to get out, that's when big moves happen. That's what happened with Tesla. And you learn to recognize those opportunities.

### **What Changes Did You Make as a Result of This Trade?**

**Aaron Fifield (AF):** Was there anything about this particular trade that changed the way you traded moving forward? Or is there anything about it that you specifically tried to replicate?

**John Carter (JC):** The main thing that probably changed in how I traded going forward was that it's very rare these days that I'll have 18 different positions on. I prefer to wait for a larger potential trade to come along. I would rather have three or four larger positions on than 18 smaller ones. Conventional wisdom will say well, if you've got 18 smaller positions, you're diversified. I forgot who said this, and maybe it was even Warren Buffett, but essentially diversification is for people who don't know what they're doing. If you're diversified, then your account is not going to change. You've got some bullish positions, you've got some bearish positions. If you see something that you like, then get in and focus on it. Have a few eggs in the basket and then watch that basket. It really changed my outlook to one of focus, instead of shotgunning a lot of different positions and trying to keep track of all of them, which is also distracting and exhausting. Watching three kids is much easier than watching 18. With fewer positions it's more about, "Let's be patient, let's miss out on things that aren't stellar, but when things come together, let's press it and focus." It doesn't mean buying 1,000 contracts every time there is a great setup. Far from it. I just

closed out a Facebook trade where we had 300 contracts on it. It was a nice trade, good for \$80,000. Great! That's not a Tesla trade, but it's not having 18 different positions either. Just focusing on a few trades at a time. Narrow your focus. I think that's the key.

**AF:** That's a great point. One last question. After 25+ years, how have your goals and outlook on trading changed, as opposed to your early years?

**JC:** In the early years, I felt a big pressure to make a big trade. Like, I've got to make a big trade, that's freedom. I can quit my job. The main difference now after I've been doing this for a while is that you start getting confidence in your skills, so it's not like, "Well I didn't make money today, I'd better throw in the towel." It's more about realizing it is part of the process. That it's fine. The markets will be there tomorrow. Focus on your next trade. Act like a professional. There is more confidence that I will know when to pull back and do nothing instead of trying to force something.

At some point also I realized that it's not all about making big trades. If it came down to it, I'd be happy waiting tables in the Cayman Islands at night and trading during the day, with a goal of making \$10,000 a month. It's important to realize that more isn't necessarily better. I think traders, including myself, get into trading because the idea of money is attractive and it can fill a hole inside us. We probably don't even understand how it relates to self-worth or whatever. And that just comes from skill set. Trading, like golf, is a skill. And like with golf, you have to focus on every swing or you'll hit it into the rough. It's the same with trading. Focus on the trade in front of you. Hone your skill. Zen out and take the shot. I admire anybody who wants to do trading for a living because it's one of the professions where you need to develop confidence in a situation where the result is always uncertain and often negative. You need to get to the point where you master being able to deal with that, and feel comfortable being uncomfortable. That's a good life lesson too. Trading is obviously primarily a monetary thing, but I think to really get it, you also need a philosophical approach, and that is the one that works for me.



# How Important Is the Right Technology When It Comes to Trading?

BY DARRELL GUM

## Introduction

We're engulfed by technology in all walks of life. We carry battery-powered supercomputers connected to the aggregated and indexed wealth of all human knowledge in our pockets. With a few keystrokes we can talk with our favorite celebrities, send birthday wishes to a distant relative, or place trades in the markets of our choosing across the globe. Never in history have we been so connected, and it can be downright confusing to figure it all out. In this chapter we're going to dive in and tackle some of the most important things you need to know as a trader so you can get the technology you need optimized for trading. We'll cover everything from the computer you need for trading, how to configure your network, how to optimize your trading platforms, and how to stay safe in this increasingly dangerous online world. Trading is a business. As in business technology, trading can be seen as a cost center. But it's crucial to not cut corners and ignore this basic pillar of your trading journey. A \$50 cost-cutting measure, like getting a power strip instead of a battery backup, has the immediate potential to cost you a significant real-money loss in your trading account. Take care of your technology, and in turn it will take care of you.

## Desktop versus Mobile versus Laptop

There are three main ways to access your trading account, either with a desktop computer, through your mobile device (smartphone or tablet), or with a laptop computer. All three have distinct advantages and drawbacks.

The preferred traders' workstation is still the venerable desktop computer. Large, powerful, and extremely customizable, it offers the best bang for your buck, and is far and away the most popular choice for traders, from beginner to professional. A desktop computer will run the most powerful versions of your trading platform across multiple monitors; this will allow you to scan for setups in your trading plan, chart them, and execute trades all at the same time. However, more and more these days traders are going to mobile solutions using either their smartphones or tablets to place orders.

With the increasing number of alerts available and the "always in your pocket" factor of these devices, it's no surprise that we're all using mobile trading platforms more than ever before. However at the time of this writing, mobile platforms fall behind desktop computers with their charting tools. Mobile devices often lack support for third-party indicators (like the ones discussed in this book) and have less screen space to identify setups (requiring multiple tab changes or viewing the same chart multiple times to see the time frames or indicators you need).

The laptop computer is the happy medium. Capable of being shoved in a backpack and taken with you

across the country, yet still able to connect multiple monitors and give you the full desktop trading platform experience, a laptop computer can be a traveling trader's best choice. However, a laptop computer powerful enough for trading can be quite heavy to carry, and you may need to add in a couple of external monitors to boot. It's not uncommon for a trading laptop with external monitors and accessories to take up a full carry-on case just by themselves.

Most traders will use all three types of computing devices at different points in their trading journey, and it's important to try and keep things synchronized as much as possible. Using the sharing/saving functions of many popular platforms (we'll dive into those details in the coming paragraphs), it's now easier than ever to get the setups you need for your trading plan across all your devices.

### *Computer Hardware*

For a desktop trading computer, you'll want a few things. First, you'll want something powerful enough to run your trading platforms and brokerage accounts. You'll also want something that supports multiple monitors (we've tried everything from 2 to 16, but it's a personal preference). You'll want to get something powerful (remember, the goal isn't to cut costs here). Most computer brands will have a "gaming" model; this is a good place to start. For desktop monitors, get something with a good resolution (1920 X 1200 or higher recommended). The higher the resolution the more charts you'll be able to fit on the screen at once.

For a laptop trading computer, you'll want to decide if you want something very portable if you travel often, or something semi-portable if you just want to move it around occasionally. Two main things affect portability in a laptop, screen size and weight. A good screen size for a portable trading computer would be 14 inches to 15 inches. You can find some laptops with smaller screens, but for trading, screen real estate is king. If you're going to mainly leave your laptop on a desk and only take it when necessary, I'd go for a 17-inch model. They're big and heavy, but also more powerful and usually cheaper for similar specs than a smaller laptop. You also may want to consider external monitors. For a laptop, you can find USB 3.0 (and recently USB-C) travel monitors that get their power and data all in one cable from the monitor to the laptop.

One thing you may have noticed is that I haven't discussed any specific computer brands. There are quite a few to choose from: Dell, Falcon, EZ, Apple, HP, Lenovo, Acer, Asus, Samsung, MSI, etc. From my experience, the brand doesn't matter nearly as much as the quality and support. Nearly all big-name manufacturers score decently in the quality department, the main difference is in support and warranty options. Check online reviews to see how particular models stack up.

As for exact specifications, I could give you a list of them, but depending on when you're reading this book, it might not be relevant. Instead, we'll stick to generalizations instead of hard model numbers.

### CENTRAL PROCESSING UNIT (CPU)

For a central processing unit (CPU), get one of the latest generations from Intel or AMD. These two main CPU manufacturers use a tiered naming structure for their chips (i3, i5, i7, i9 or Ryzen 3, Ryzen 5, Ryzen 7, etc.). Get something within the top two tiers, and the more cores the better. A higher core count means there are more lanes in the CPU highway, so you won't get bogged down when you have six charts open across four monitors while you're placing a trade and multitasking.

## GRAPHICS PROCESSING UNIT (GPU) OR GRAPHICS CARD

For a graphics processing unit (GPU) or graphics card, get something that will offer the number of monitor outputs you desire. GPUs from the two major manufacturers (AMD and Nvidia) can range from \$50 for a decent two-monitor solution to about \$600 for a graphics card that will support eight outputs. Make sure the connections work for what your monitors need (same type of plug, like HDMI or Display Port) and resolution (1080p, 4K, etc.).

## STORAGE DRIVE

For your storage drive, get a solid-state drive (SSD) instead of a hard-disk drive (HDD). A SSD is faster and much more reliable than a HDD. A SSD has no moving parts (so it's much less likely to break if the TSA (Transportation Security Administration) drops your laptop at security). A SSD also uses less power. If your computer locks up in the middle of a trade and your computer reboots, every second counts. Skimping out here can cause your computer to take over a minute longer to boot up. How much can an option move in a minute?

The amount of space you'll need as a trader isn't substantial, and even if you're planning on using your computer for more than just trading, even a smaller-sized SSD now, around 256 gigabytes (GB), can still store all your trading platforms, indicators, workspaces, operating system, updates, and still have a couple of hundred GB of space to spare for your photos, music, etc. If you have a need for more storage the cost isn't substantial, and I'd recommend getting more storage than you think you'll need.

## RANDOM-ACCESS MEMORY (RAM)

For random-access memory (RAM), get the most you can reasonably afford. One statement I have never heard in my IT career is "I have too much memory." There are two types of storage in your computer, a large storage device for your files, and a smaller, faster storage device for active processes. Think of your computer like your office. RAM is the space on top of your desk—all the papers and files you're working on and need quick access to are at your fingertips and can be quickly shuffled around and used.

The storage drive—hard-disk drive (HDD) or the solid-state drive (SSD)—is like the big filing cabinet in the back room of your office. It holds so much more than your desktop, but every time you need a file you must get up, walk across the office, get the file, and then walk back to your desk before you can use it. That is what your computer will be doing every time you ask it to perform a task for you. As more programs on the computer run and take up more memory, the computer may run low on memory, and slow down over time.

## BATTERY BACKUP AND SURGE PROTECTION

Battery backup and surge protection are also very important to a trading computer setup. You'll also want to connect your modem and router to it if you can. If they're not close to your desktop then get another one for them, trust me. For the average trading computer, a battery backup will give you 15 to 20 minutes of runtime after your power goes out. This might not seem like much, but it's enough to safely close out of your intraday positions or set alerts that you can receive on your mobile device. You'll also want to shut the computer down as soon as you can when it's on battery power to prevent a hard crash when the battery dies. This will prevent any serious corruption or stability issues that might cause your computer to need serious repair. A decent 1500VA UPS (uninterruptible power supply) will run you around \$150. It could save you much more than



that.

## Computer Security

*Computer security can simply be protecting your equipment and files from disgruntled employees, spies, and anything that goes bump in the night, but there is much more. Computer security helps ensure that your computers, networks, and peripherals work as expected all the time, and that your data is safe in the event of hard-disk crash or a power failure resulting from an electrical storm. Computer security also makes sure no damage is done to your data and that no one is able to read it unless you want them to.*

BRUCE SCHNEIER

There are five main parts to securing your technology. They are the hardware layer, the network layer, the information layer, anti-malware layer, and data backup.

### *The Hardware Layer*

The first part of your computer security and technology protection is *the hardware layer*. This can be as simple as locking your door, using a good password to log in to your computer (more on this later), and making sure you log off when you aren't using it. There's honestly no good way of securing your hardware from others who have access to it. If someone has physical access to your machine, and wants to get in, he or she can. There are ways of making it more difficult, like enabling Bitlocker on Windows or FileVault on Macs, but they can slow your systems down and can be complicated to set up. Protecting your computer from someone with physical access should be considered the same as locking your front door at night; it won't prevent anyone from entering if they really want to, but if you can make it sufficiently difficult enough that their time is better served going after an easier target, then you'll be safe.

### *The Network Layer*

The second part of your computer security and technology protection is *the network layer*. There was a recent survey performed which showed that over 60 percent of users did not change their default usernames or passwords on their wireless routers. This is something that sounds complicated (encryption keys and IP addresses, oh my!), but it isn't. You can find any number of guides online, and most routers will even include a manual that walks you through the process step-by-step. Make sure only trusted devices are connected to your network.

Don't open any guest networks or leave anything without a password. If you want to make sure you're protected, and don't want to go through the process yourself, there are companies that will come secure your network (like my previous employer from about a decade ago, the Geek Squad) for typically around \$100 for a simple configuration (wireless router and a few devices) or more if you want extra features like printer and file sharing between devices.

### *The Information Layer*

The third part of your computer security and technology protection is *the information layer*. The first line of defense for your information is to use strong passwords. When you think of a strong password, you're probably thinking of something like 10 characters, including upper- and lower-case letters, numbers, and symbols. This is not necessarily the best way to create strong passwords as it leads people to memorize one or

two passwords, which they re-use over and over on every site they use.

Here is a quick, secure, and very easy way to create extremely strong passwords: Use a sentence. “I really like blueberries” is a stronger password than \$DqfQ4}2. There are 457,163,239,653,376 possible combinations of an 8-character password with upper- and lower-case letters, numbers, and symbols. It would take a reasonably fast computer a couple of days to brute-force crack it. There are 29,098,125,988,731,506,183,153,025,616,435,306,561,536 possible combinations of the password sentence given above (and that’s not including capitalization or punctuation). Unless quantum computing becomes commonplace in the near future no computer will be able to perform a brute-force attack on a password like it.

A step above passwords alone is also recommended. By using an additional device, you can ensure that you and you alone are the one accessing your accounts. Two-Factor Authentication (or 2FA for short) has been around for quite some time, but it is only recently becoming ubiquitous. The most common method is receiving a text message with a code that you then enter when you log in to verify it’s you. That method is okay, however, you can do better.

Check out FIDO 2FA devices. They’re as small as a flash drive, and very easy to set up and use. When you want to sign in somewhere online, you can just plug them in and click a button on the device after you enter your password. By using a separate hardware device, you’re preventing a possible attack on your smartphone (if someone else receives your texts they could get into accounts if that’s the only method). Almost all services offer 2FA now. It’s quick and easy to set up. If you only do one thing out of everything I’ve written about computer security, please set up 2FA!

### *Anti-Malware Protection*

The fourth part of your computer security and technology protection is anti-malware protection. Malware comes in all shapes and sizes now; it’s not simply a “virus” or “worm” (though those do still exist). There are many programs out there that will help you protect, defend, and remedy your system from a malware attack. Some are better than others, and it seems to be somewhat cyclical: The software I loved years ago is now lower-rated than the software I hated. I can’t tell you what to use right now, because depending on when you’re reading this book a certain software might be awesome or it might be terrible.

I can however tell you where to go to find out which is the “best” anti-malware protection right now. As with almost any question these days, you just need to ask the oracle (aka Google). Do a quick search for “Antivirus Reviews 2018” (or whatever year it happens to be) and look for reviews from well-known publishers like *PC Magazine*, *Tech Radar*, *Tom’s Guide*, *Consumer Reports*, etc. Most of these will have an extensive list of all the pros and cons, and an editor’s choice, which is a good place to start.

### *Data Backup*

The fifth and last pillar of your computer security and technology protection is backing up your data. If you don’t have your data fully backed up in multiple versions in “the cloud,” you don’t have your data backed up. Most people think that having an external hard drive next to their computer system that they back up once a month is enough protection. I’ll tell you why it isn’t:

1. It doesn't protect against fire, theft, water damage, or anything else physically happening to your computer.
2. It's not redundant at all; you only have one copy (which may or may not have everything you need depending on when you last backed up).
3. It's too easy to forget to back up.

We all get complacent at times, especially when everything is working fine. What I like to do for my files is use a multi-tier approach. I use Dropbox (free for personal use) for my most important files. It will save two versions of each file automatically (in case one gets encrypted from a ransomware attack or you accidentally save over your word document). It also works across all your devices—Mac, Windows, Linux, iOS, Android—making file sharing very fast and easy. I also have an online backup that takes everything on my local drive and stores it online. The initial backup after you sign up can take a while (sometimes a month even if you're like me and have a lot of data to upload) but once it's there, the program just moves files that have changed, making it very efficient. Having a backup like this is also great for transitioning between computers. When I get a new computer all I need to do is install the backup software and click restore, and all my data is put back in its place. The software I use for this is Carbonite, but there are other ones out there. Ask the oracle (Google) which the best one is right now.

## Trading Platforms

Your trading platform is another critical piece of your trading technology. Having an up-to-date and fast platform can help you avoid slippage and missed trades. There are always new bug fixes and security patches released in any software, and if you don't update because "it's working" you could be missing out on new features or more importantly subjecting yourself to increased risk. Some platforms—like thinkorswim and tastyworks—will automatically update you and only allow you to log in when you're using the latest update. Some other platforms—like TradeStation, Infinity, or Ninja Trader—will prompt you to update, but you need to physically click the "yes" button to allow the update to run. If you get a notice that an update is pending, and you have a few minutes, run it! If you are in the middle of a trade or need to do something on the platform immediately, then leave yourself a Post-it note to update after the close. Most platforms that require manual updates have the option listed in the Help menu on the top of the main platform window.

Now when I say keep your platform up-to-date, I'm not talking about always running the latest version. TradeStation currently offers versions 9.1, 9.5, and 10. Ninja Trader currently offers versions 7 and 8. The latest versions of the platform can sometimes be a bit buggy, or not compatible with your indicators or strategies. I usually stay one version back, and make sure that version has the latest updates.

If you're using an online platform—like TradingView, Schwab, or Fidelity—they'll take care of the update and versioning for you. I like online platforms, with the main exception that they're almost universally uncustomizable. If you use a simple strategy that only involves the most basic of technical indicators, then they'll do fine, but if you really want to dive into the world of technical analysis you'll be reaching for a more powerful platform.

Most platforms now offer mobile versions as well so that you can place trades on your smartphone or

tablet. Like online platforms, they're very limited in charting options (specifically advanced indicators). Because of this they're not very well-suited for identifying trade entries, but they are amazingly good at allowing you to modify or exit a position when you aren't in front of your computer. If you want the full desktop platform experience on your smartphone or tablet, there is a neat workaround that I use daily. There's a program called TeamViewer, which is available free for personal use that will allow you to log in to your desktop computer from your smartphone or tablet and use any programs as if you were in front of the computer yourself.

No matter which platform you're using, you should also assume you will have a problem with it someday. Whether the problem is a software bug, crashed computer, Internet outage, power outage, account issue, etc., you need a backup. Get a Post-it note, write down your broker's trade desk phone number on it, and stick it somewhere near your trading office. While you're at it, enter your broker's number into your smartphone as well. This will take you about five minutes and could save you big time if you have a technical issue and need to exit or modify a position.



# Tips and Tricks for When It's Not Working for You, No Matter What You Do

*Do not blame God for having created the tiger, but thank him for not having given it wings.*

—INDIAN PROVERB

*There is an island of opportunity in the middle of every difficulty. Miss that, though, and you're pretty much doomed.*

—DESPAIR.COM

## Will Cry for Food—Using Your Emotions to Make Money

The biggest problem traders have is controlling their emotions. I see it all the time. Traders know the setup they are supposed to follow, but they get swept up in their emotions and blow the trade. By stepping back and examining this process in more detail, traders can learn to use their emotional reactions as indicators. Properly tuned, these emotional indicators, instead of leading to mistakes, can create great triggers to enter and exit a market. This is part of the transition from amateur to professional—instead of getting sucked into a trade because of your emotions, use the emotional triggers to fight back and do exactly the opposite of what they are signaling you to do.

## The Four Seasons Hotel Trade

When I am in a trade that is going my way and I start to feel overly excited and have the urge to add to my position, I instead use this as my trigger to set up a “double stop order.” As an example, let's say I'm long 10 E-mini S&P contracts. The market is screaming higher. I find myself thinking of how many nights I could live at the Four Seasons on Maui with the day's profits. I recognize this feeling and immediately take the “Four Seasons trigger”: I place a trailing 2-point stop for 20 contracts, double the size of my current position.

What happens is that I will stay in the trade as long as it is moving higher, but once the market turns, not only am I out of my position for a nice profit, but I also simultaneously get short 10 contracts. This process takes advantage of the market dynamics of human emotion in a very clean fashion. The sell-off that occurs will be driven by other traders who succumbed to their emotions and bought at the top, because of either fear of missing a move or the euphoria of having a current winning position. Once the market does reverse, it will be these traders who will provide the fuel for the move down as they start dumping their positions once they can't take the pain of losing any longer. This is one example of how to get your emotions working for you instead of against you.

## Thank You, Sir, May I Have Another?

When I'm in a trade, I visualize what a newer trader would be doing—or what I would have been doing when I first started out. “If I entered here, where would my pain point be?” I've found that on the S&Ps, a move of

6 points without any meaningful retracements is the maximum “uncle point” for most traders. When I see a 6-point move without a retracement, I picture new traders and try to imagine the pain they are feeling. After about 6 points, I know they won’t be able to take the pain any longer, and I step in and take the opposite side of this move, just as they are bailing out of their position and throwing cabbage at their screen. One person’s stop run is another person’s entry point.

As a professional trader, you will always be using a stop, so you will no longer find yourself in this very real, very frequent, and very unfortunate position. Use your emotions to feel other traders’ pain and figure out when they are going to throw in the towel.

### **When I Tick, You Tick, We Tick**

A more technical way to measure emotion is to watch the ticks. This is the same setup we talked about in [Chapter 9](#). This time, however, if you are sitting there and the market is running away from you, instead of blindly jumping in, look at the ticks. Are they approaching +1,000? They are probably getting close, as pools of amateur traders continue to buy at the market and tempt the goddess of good luck. The ticks are a great emotional balancing mechanism. A frequent surge of adrenaline that comes from watching a market that’s moving without you can be quickly tempered by a quick look at the ticks.

### **Dive, Captain, Dive**

My trading partners and I run an Internet-based trading room where people log in from around the world. One of the things we all like to do is watch how the newer traders react to the market action. There are “noises” that the people in the room can use. One of the classic actions is that when the market is falling, falling, falling, one of the free trial users in the room posts that she is going short and initiates the “submarine dive, dive, dive” noise. Immediately upon hearing this, I know it is time to cover my shorts and go long. The experienced traders in the room also know this, and we all jump in and take the trade. The market usually reverses quickly, and once the newbie traders say that they are stopped out of the short trade, we cover our longs. It’s emotion-based trading at its finest. Of course, we then share this information with the newbie traders. Once they catch on, we just have to wait for the next free trial to show up.

As a trader, if you find that you are constantly shorting the lows and buying the highs, picture newbie traders getting so excited that they are about to literally “push the dive, dive, dive button.” Do you want to be trading with or against these people?

### **High Five, Baby**

Whenever traders I work with—or myself, for that matter—start slapping one another on the back as the result of a good open trade that is racking up profits, I immediately snap alert and close out my position. This is the result of extreme emotion, and extreme emotion is not sustainable. I call this the “high five sell signal.”

Any time you actually utter a noise or pound on something as the result of a trade that is going really well, it’s a wake-up call for you to turn back into a professional trader.

### **Discover Your Personality Type and Find Out If It’s Holding You Back**

One of the themes I've discussed in this book is the importance of finding the right markets and the right setups that best fit a trader's personality. People view the trades they are taking through one of the three dominant personality traits that all human beings share. Some of these personality types are naturally better suited to the world of trading than others. Unfortunately, there are also personality types that will not win at trading no matter what they do. However, there is a silver lining here. The reason these personality types lose is that they are unaware that their personality is the very thing that is responsible for their mounting losses and continued frustration. Once a trader learns about this, he can then use this information to turn his trading around.

The following 20-question quiz will help you determine your dominant personality type. There is no right answer, and it may seem to you that there are two right answers to some of the questions. Just pick the one that makes the most sense in terms of how it relates to you. Don't think about these too long. The faster you can move through this, the more accurate the readings will be, and the better the information you will have to improve your trading. This is one of the personality profiles I have traders take when they come and work with me, so I can get a better idea of who they are and which markets and setups are best suited to their personality. Here we go:

1. When you think back to one of the best vacations you've had, what part of the vacation do you first remember?
  - A. The sights and how the place looked.
  - B. The different sounds you experienced.
  - C. The way you felt while on vacation there.
2. When you think back to a person who captivated your interest, what is the first thing that really attracted you to him or her?
  - A. The person's appearance and looks.
  - B. What the person said to you.
  - C. How you felt being around the person.
3. When you are driving, how do you get around?
  - A. I look for road signs or follow a map.
  - B. I listen for familiar sounds that point me in the right direction.
  - C. I follow my gut and get a sense of where I am.
4. When I play my favorite sport, I really enjoy:
  - A. The way the sport looks, and the way I look playing it.
  - B. The way it sounds, like the bang of the bat hitting the ball or the cheering fans.
  - C. The way the game feels, like holding on to a tennis racket or the feeling of running around the court.
5. Making a decision is easier when:



- A. I can see all the choices in my mind's eye.
  - B. I can hear discussions from both sides in my head.
  - C. I can sense how I would feel if either option came to fruition.
6. From the following list, I would say my favorite activities are:
- A. Photography, painting, reading, sketching, and films.
  - B. Music, musical instruments, the sound of the sea, wind chimes, concerts.
  - C. Ball games, woodworking, massage, introspection, touching.
7. When I am shopping for clothes, after seeing the item for the first time, the very next thing that I do is:
- A. Take another really good look at it or picture myself wearing it.
  - B. Listen closely to the salesperson and/or have a dialogue with myself about the pros and cons of buying it.
  - C. Get a feeling about it and/or touch it to see if it's something I'd enjoy wearing.
8. During the times I find myself thinking of a former lover, the first thing that happens is that I:
- A. Visualize the person clearly in my mind.
  - B. Hear the sound of the person's voice in my mind.
  - C. Start feeling a certain way about the person.
9. When I am at the gym or working out, my feeling of contentment comes from:
- A. Seeing my reflection in the mirror improving.
  - B. Hearing compliments from people around me about how good I look.
  - C. Feeling my body get stronger and sensing that it's more in shape.
10. When I'm doing math, I check my answer by:
- A. Viewing the answers to see if the numbers look correct.
  - B. Counting the numbers in my mind.
  - C. Using my hands and fingers to get a sense of whether or not I am right.
11. When I write out words, I verify the correct spelling by:
- A. Seeing the word in my mind's eye to see if it looks right.
  - B. Pronouncing the word out loud or hearing it in my mind.
  - C. Getting a gut feeling about the way the word is spelled.
12. When I love someone, I get an immediate experience of:
- A. The way we appear with each other through the eyes of love.
  - B. Hearing or saying "I love you."

- C. A warm feeling toward that person.
13. When I do not like someone, I immediately experience dislike:
- A. When I see that person coming toward me.
  - B. When that person starts talking to me.
  - C. When I know that person is around.
14. When I am at the beach, the initial thing that makes me happy to be there is:
- A. The look of the golden sand and the beautiful sun and placid water.
  - B. The sound of the thrashing waves, the howling winds, and whispers from afar.
  - C. The touch of the sand, the salty air at my lips, and the feeling of calmness.
15. With regard to my career, I know I'm on the right path when:
- A. I see myself clearly in one of the executive offices.
  - B. I hear the president say, "You are one of the company's stars."
  - C. I feel satisfaction in getting a promotion.
16. In order for me to get a good night's sleep, it is critical that:
- A. The room is dark, with little or no light coming in from outside.
  - B. The room is quiet, without any distracting noises.
  - C. The bed feels incredibly soft and comfortable.
17. When I get anxious, the first thing I notice is:
- A. The world seems slightly different to me.
  - B. Various sounds and noises start to irritate me.
  - C. I no longer feel a sense of ease and calm.
18. When I get focused and motivated, I immediately:
- A. View things from a brand new and positive perspective.
  - B. Tell myself that this new state of being is going to open up new doors.
  - C. Feel my body and mind getting excited.
19. When someone tells me, "I love you," my first reaction is:
- A. To form an image of the two of us being together or of that person loving me.
  - B. To hear my soul saying something like, "This is amazing."
  - C. A feeling of great satisfaction and contentment.
20. Dying, for me, is closest to:
- A. Seeing no more or seeing things in a brand new fashion.

- B. Hearing nothing ever again or hearing things in a brand new fashion.
- C. Feeling nothing ever again or feeling things in a brand new fashion.

Once you have completed this test, add up how many times you answered A, B, or C. For example, you might have A: 6, B: 4, C: 10. These results will give you an idea about your dominant personality type. People generally react to and interpret the world around them through this filter. Get your scores together and we'll move on—you'll want to have taken the test before we proceed so that your answers aren't influenced by what you read next. The goal here is to get an honest assessment of your personality traits and then learn how to best utilize those traits in your trading.

### **Personality Types and Trading—What You Don't Know About Yourself Can Hurt Your Trading**

Nearly 60 percent of the population will have "A" as their highest-scoring trait. This indicates that a person's dominant way of viewing the world is visual. It's not really known why this is so, but experts feel that it has to do with sight being our strongest sense, and that the majority of us were taught from birth to depend on our eyes in order to make our way through life. Also, in today's world, our input is largely through television, movies, computer screens, and printed copy—all of which are heavily dependent on the eyes.

Visual people like daylight and are extremely mobile, and it's easy to find them in professions that allow them visual expression. Nowhere is this more observable than in the entertainment industry. Visual people are generally "movers and shakers" and like to move fast. They are drawn to this industry and its related fields as a natural expression of who they are. These types of people naturally gravitate to professions such as painting, photography, and design. They also make great marksmen, firefighters, and pilots.

In terms of trading, visual people adapt most quickly to this profession, as they depend largely on what is happening visually in front of them on the computer screen to make decisions. This doesn't mean that they will make the right decisions, but they are most naturally adapted to the world of trading. If they are untrained in how the markets work, they will make the same mistakes as everyone else. Once they get some experience, however, they tend to be good at waiting for the charts to set up before taking their entries. Yet, only experience teaches them how to manage their exits. A visual's biggest weakness is watching the P&L fluctuate throughout the trading day. It would be better for her to cover that up (a business card taped to the corner of the computer screen works well) and just focus on the setups. Also, visuals tend to laser in on a price chart and ignore everything else, which can be a detriment to their trading. This is why it is helpful to have auditory alerts on things like high tick readings and to listen to pit noise in the background so that visuals don't get sucked into the extreme price action they are seeing on the charts.

If your highest score was "B," then your dominant personality trait is auditory. My accountant is highly auditory, and I've noticed that the sounds around the office occupy most of his attention. Auditory personality types relate to the world through the way things sound and in many respects are more sensitive to sounds than visual people are to sight. Auditory people can be easily distracted by the most inoffensive sound, which can make it seem as if they are not paying attention to you during a conversation. In reality, though, they are strong verbal communicators—it's just that they hear every sound coming their way, and sometimes it distracts them. They enjoy both talking with others and just talking out loud to themselves. Because of their

innate internal ability to put thoughts into dialogue, experts believe that most loners have this dominant personality type. Because of their heightened sensitivity to sound, auditorys don't tolerate harsh or disharmonic noise as well as others do. Fire or ambulance sirens are major offenders, and you can spot an auditory easily by observing who on a street corner is holding his ears as an ambulance screams past. Also, they have an incredible ability to listen so thoroughly and with such intent that data are absorbed and processed in their minds very quickly, without needing to be translated into pictures. Because of this enhanced ability, auditorys tend to gravitate to areas in life that permit the use of such superb listening and communicative talents.

With regard to trading, this personality type has one strong advantage—the ability to sit alone in front of a computer for days at a time without going crazy. That is an important part of trading, and this ability to be patient and wait and not feel isolated is a necessary trait to have. The downside of this personality type and trading is that a chart isn't really much use to an auditory, and such a person will frequently miss setups simply through not paying attention. Whereas a visual can stare at a chart for hours because the red and green lights are fascinating, an auditory personality needs additional input. Audio alerts and pit noise are important tools for auditorys, and I know some of these personality types who don't even look at price charts. They just listen for audio alerts and then place their trades.

If your highest score was "C," then you relate to the world around you by how you feel. People with this dominant personality trait long to be understood and respected for being so in touch with their feelings. They tend to like a person because of how they feel when they are around that person, or they like a movie because of how it made them feel when they were watching it. When they laugh, they let themselves go and really feel the laughter, giving the person they are talking to a sense that they totally understand and agree with what was so funny. Type C personalities are able to translate visual images and acoustical data into feelings that are pertinent to them and those around them. Type Cs enjoy conversations, but not for the same reason that visuals or auditorys do. They use dialogue to translate words, sounds, and images into feelings. While visuals and auditorys are busy communicating with pictures and sounds, the type C personality is busily running through her vast storehouse of feelings and attaching sensory meaning to what the other person has just said.

Because of their heightened ability to feel, you would assume that type Cs are introverts. However, the opposite is true. Moreover, because of their superior sense of touch, type Cs make superior athletes. Any occupation that requires manual tasks is just plain easier for people with this personality type. Typical occupations that are tailor-made for them usually have hands-on or feeling parameters. Psychologists, woodworkers, potters, surgeons, actors, all types of mechanics, and other feeling- or sensory-based occupations are common among them.

For traders, people with this type of personality have the biggest struggle, and they usually don't make it until they figure out how their personality is working against them. A trader with a type C personality will wait until he senses that things are good or bad, or wait until he gets a sense about whether what he is doing or is about to do is good or bad. Such a trader will literally get into trades when it feels good to do so, and get out when it feels bad. This almost always puts them in just as a move is ending, and gets them out just as it is turning. For people with a type C personality, it feels bad to buy a market that is selling off into a pivot level. They would rather wait to see a bounce so that they can "feel good" that the trade is going to work out. Of

course, by the time this happens, they should actually be closing out a position instead of initiating a new one. The solution to this is hard yet simple. If you are a type C, then just acknowledge that your feelings need to be faded. If you are excited and feel good about going long, then you should be looking at the short side, and vice versa. If you are a type C, don't despair. A type C who masters this will have a distinct advantage over other traders. A type C who is unaware of this will always face an uphill battle when it comes to trading.

In terms of personality, no one is going to be 100 percent anything. I am primarily visual, then "feeling" is not far behind, and finally auditory makes up a small portion of my overall personality profile. I've learned to set up my charts to take the best advantage of my dominant visual personality, listen to my feelings to get an idea of what the amateur traders are doing and thus "fade my feelings," and set up audio alerts to make sure my eyes aren't the only thing that are responsible for my trading decisions. Learning this about myself made me a better trader.

### **Trading Really Isn't That Easy—Alternatives to Consider for Jump-Starting Progress**

The harsh truth is that trading isn't for everyone, but the problem is, you won't know whether it's for you or not until you give it a shot. It takes guts, courage, and years to become good enough to do it for a living. My advice is to start out small. Whatever amount you start with is your tuition money—you are going to lose it, and that is your educational fee for entrance into this world. Do yourself a favor and trade small until you start getting consistent with your setups. If it still isn't working out after a few years and you are getting ulcers, or if you figure out that you'd rather be playing golf, there are other options.

First off, learning about trading by reading a book is about like learning about golfing by reading a book. Both require what are called complex execution skills. Reading will help in the understanding, but not the doing. Other examples of this are:

- Learning a native language or a second language
- Driving a car
- Playing a sport (baseball, football, hockey, and so on)
- Snow skiing or water skiing
- Playing a musical instrument
- Math
- Morality
- Computer programming
- Playing poker or bridge
- Flying a plane and getting a pilot's license
- Trading and investing
- Tuning a piano or working on a car engine
- Being a doctor or a lawyer

Activities that require complex execution skills are learned by 99 percent of the population in exactly the same way. How is that? They have to have at least one other human being physically beside them teaching them for an extended period of time.

For trading, this often isn't practical. It's easy to practice in isolation. It's hard to find someone who (1) can really trade and (2) will let you sit next to her for an extended period of time. This need to have someone with you is why the Stockholm syndrome happens. Physical contact with kidnappers changes the perspective of those who are held in captivity because the captured feel what their kidnappers feel and end up mimicking their kidnappers' rules, sentiments, actions, and so forth. It's the way human beings learn and operate. Humans see others around them and discover what, why, and how they do things, and this is how humans learn and start to mimic. Those who don't have physical contact with kidnappers may read and understand what the cause of the capture is, but that pales in comparison to the changes that are taking place in the minds of the victims who are being held hostage.

For me, I had to spend time and sit side by side with other traders before I turned the corner to consistency. In sitting beside these traders, it was helpful to hear them talk about what they were doing and why, but that was only about 40 percent of what I learned. The rest of it had to do with what they *weren't* saying or doing. They weren't getting upset if they missed a move. They weren't answering the phone when it rang. Also, there were many things they did and habits they had that they weren't even aware of until I pointed it out to them. It was these unconscious trading habits that I picked up that really helped me out as well—just observing and absorbing how a professional trader spent his day. To that end, if you really want to do this, I would encourage you to find an experienced trader and just spend a week sitting next to him. That was what turned the corner for me. If you can't find anyone, there are a few times a year when we will hold live events, in addition to our online based classes. At the live events, traders can hang out with our team and other traders and immerse themselves for a few days into the practical side of this endeavor.

I'm also a big fan of taking screenshots of each trade that I do—once when I enter the trade, and once again when I exit. I'll use software like Snagit or the free screen capture that comes with most computers. I'll write out a few sentences about the setup I see, what I'm thinking, and, of course, what happened. This way I have a running visual of the trading decisions I've made over time. This keeps me in check and moving forward, plus it helps imprint my memory with patterns that work, so I recognize them faster the next time around. I encourage everyone to do this. It allows you to go back and review your trade "live" as it unfolded. This is like a quarterback watching the game films, trying to better understand what he and his players did and how the other team tried to work against them. This is great information to have as a trader: to be able to go back, look objectively at your own mistakes, and see ways to improve. Be more patient? Don't chase? It's a great way to get to the next level.

*Practice does not make perfect. Only perfect practice makes perfect.*

—VINCE LOMBARDI

*No one ever won a war by dying for his country. He won it by making the other poor dumb bastard die for his country.*

—GENERAL GEORGE S. PATTON

*One thing is certain. Praying for luck in the getting of money is futile. If Lady Luck exists, she is highly perverse, choosing to visit those who have little apparent need of her and ignoring others desperate to worship at her shrine. I've found the best thing is to ignore her. To "treat her mean and keep her*

*keen."*

—FELIX DENIS, BILLIONAIRE PUBLISHER





# Mastering the Trade

## Amateurs Hope; Professionals Steal

Professionals steal money from amateurs because amateurs hope, close their eyes, and unwittingly allow professionals to drain their accounts.

The sum of my trading experience is this: I've learned that being a professional is all about maintaining a specific state of mind while trading, and traders are never going to make consistent money until they achieve that frame of reference from which to operate. All the successful traders I know blew out their account at least once before they became consistently profitable. Along these lines, I've composed a list of 40 "trading tips" for staying in this professional state of mind. These "tips" are not meant to make a trader conservative or hesitant. On the contrary, trading takes guts, and by following these tips, traders will be given the key that will allow them to embrace risk and take the necessary chances required in the pursuit of capital gain. That is, traders will feel more compelled to take a chance because they know they are also going to fight to protect their capital. They won't freeze and lie helpless as it is whittled away.

This is a list I've developed specifically for myself. When I use the term *you*, I'm referring to "me." Feel free to add to these tips or modify them to fit your own personality and trading style.

At home, we have a llama named Shim. (We called the animal "Shim" because when we got it, the beast had so much hair that we couldn't tell whether it was a "she" or a "him." We later discovered that Shim was a she.) I have a photo of myself with Shim up in my office as a reminder about the markets. Shim may seem nice and docile, but if you stare in her eyes too long or make any sudden movements, she will spit up the nastiest, most vile liquid right into your face. Her aim is deadly accurate. In the markets, never let your guard down. Otherwise Shim (is the market a he or a she?) will get you right between the eyes.

## 40 Trading Tips for Maintaining a Professional State of Mind

1. Trading is simple, but it's not easy. If you want to stay in this business, leave hope at the door, focus on specific setups, and stick to your stops.
2. When you get into a day trade, watch for an 800 reading in the opposite direction from your trade for signs that you are wrong. This might allow you to get out of your trade before your stop is hit.
3. Trading should be boring, like factory work. If there is one guarantee in trading, it is that thrill seekers and impulse traders get their accounts ground into parking meter money.
4. Amateur traders turn into professional traders once they stop looking for the "next great technical indicator" and start controlling their risk on each trade.
5. You are trading other traders, not the actual stock or futures contract. Who is taking the other side of

your trade? Is it an amateur who is chasing or a professional who has been patiently waiting for this entry all day? You have to be aware of the psychology and emotions on both sides of the trade.

6. Be very aware of your own emotions. Irrational behavior is every trader's downfall. If you are yelling at your computer screen, imploring your stocks to move in your direction, you have to ask yourself, "Is this rational?" Ease in. Ease out. Keep your stops. No yelling. The person who is screaming should be the one on the other side of your trade.
7. Watch yourself if you get too excited—excitement increases risk because it clouds judgment. If you are feeling peak excitement, it probably means that the move is just about over. Tighten your stop and look to reverse.
8. Don't overtrade—be patient and wait for three to five good trades.
9. If you come into trading with the idea of making big money, you are doomed. When accounts are blown out, this mindset is responsible most of the time.
10. Don't focus on the money. Focus on executing trades well. If you are getting into and out of trades rationally, the money will take care of itself.
11. If you focus on the money, you will start trying to impose your will upon the market in order to meet your financial needs. There is only one outcome for this scenario: you will hand over all your money to traders who are focused on protecting their risk and letting their winners run.
12. The best way to minimize risk is not to trade. This is especially true during the doldrums, between 11:30 a.m. and 2:30 p.m. eastern. If your stocks or other markets aren't acting right, then don't trade them. Just sit and watch them and try to learn something. By doing this, you are being proactive in reducing your risk and protecting your capital. The most common problem with losing traders is that they feel that they always have to be in a trade.
13. There is no need to trade five days a week. Trade four days a week, and you will be sharper during the actual time you are trading.
14. Refuse to damage your capital. This means sticking to your stops and sometimes staying out of the market.
15. Stay relaxed. Place a trade and set a stop. If you get stopped out, that means that you are doing your job. You are actively protecting your capital. Professional traders actively take small losses. Amateurs resort to hope and sometimes prayer to save their trade. In life, hope is a powerful and positive thing. In trading, resorting to hope is like placing acid on your skin—the longer you leave it there, the worse the situation will get.
16. Never let a day trade turn into an overnight trade. An overnight trade should be planned as an overnight trade before the trade is ever entered.

17. Keep winners as long as they are moving your way. Let the market take you out at your target or with a trailing stop. Don't use impulse exits. Every exit is taken for a specific reason based on parameters that have been clearly defined.
18. Don't overweight your trades. The more you overweight a trade, the more hope comes into play when the trade goes against you. Remember, hope in trading is like acid on skin.
19. There is no logical reason to hesitate in taking a stop. Reentry is only a commission away.
20. Professional traders take losses. Being wrong and not taking a loss damages your own belief in yourself and your abilities. If you can't trust yourself to stick to your stops, whom can you trust?
21. Once you take a loss, you naturally forget about the trade and move on. Do yourself a favor and take advantage of any opportunity to clear your head by taking a small loss.
22. In general, you should never let one position go against you by more than 2 percent of your account equity. Many setups work out better if you can use a larger stop. Instead of trading 20 E-mini contracts with a 1-point stop, trade 10 contracts with a 2-point stop or 5 contracts with a 4-point stop. The monetary loss is exactly the same, but one set of these parameters will work better on a particular setup than all the others. Find out what works best for your setup and adjust your parameters accordingly.
23. Get a feel for market direction by "drilling down." Look at the monthly charts, then the weekly, daily, 60-minute, 15-minute, and 5-minute charts to get the best idea of what the market is going to do in the short term. Always start with the larger time frames and drill down to the smaller.
24. If you are hesitating to get into a position when you have a clear signal, that indicates that you don't trust yourself, and that deep inside, you feel that you may let this trade get away from you. Just get into the position and set your parameters. Traders lose money in positions every day. Keep them small. The confidence you need is not in whether or not you are right; the confidence you need comes from knowing that you execute your setups the same way each and every time and do not deviate from your plan. The more you stick to your parameters, the more confidence you will have as a trader.
25. Averaging down on a position is like a sinking ship deliberately taking on more water. This is ridiculous and stupid. Don't be ridiculous and stupid.
26. Try to enter in full size right away. If you pick up a half position first, don't add to it and create a full-sized position unless the trade is going your way.
27. Ring the register and scale out of your position. Have modest, mechanical targets for the first half of your position. Give the second half more room to run.
28. Adrenaline is a sign that your ego and your emotions have reached a point where they are clouding your judgment. If you are not in a trade, do not enter a new trade when you are in this state of mind.

If you are in a trade, stick to your parameters and walk away. If you are in a losing trade that has gone through your stop, exit your trade immediately and walk away from the markets.

29. You want to own the stock before it breaks out, then sell it to the momentum players after it breaks out. If you buy breakouts, realize that professional traders are handing off their positions to you in order to test the strength of the trend. They will typically buy them back below the breakout point—which is typically where you will set your stop when you buy a breakout. Use this information to make money off of amateur traders who buy breakouts.
30. Embracing your opinion leads to financial ruin. When you find yourself rationalizing or justifying a decline by saying things like, “They are just shaking out weak hands here,” or, “The market makers are just dropping the bid here,” then you are embracing your opinion. Don’t hang on to a loser. You can always get back in.
31. Unfortunately, you will not learn discipline until you have wiped out a trading account. Until you have wiped out an account, you typically think that it cannot happen to you. It is precisely that attitude that makes you hold on to losers and rationalize them all the way into the ground. If you find yourself saying things like, “My stock in EXDS is still a good investment,” then it is time to rethink your trading career.
32. Siphon off your trading profits each month and stick them into a money market account. This action helps you to focus your attitude and reminds you that this is a business, not a place to seek thrills. If you want thrills, go to Disneyland.
33. Professional traders risk a small amount of their equity on one trade. Amateurs typically risk a large amount of equity on one trade. This type of situation creates emotions that ruin amateurs’ accounts.
34. Professional traders focus on limiting their risk and protecting their capital. Amateur traders focus on how much money they can make on each trade. Professionals always take money away from amateurs.
35. In the financial markets, heroes get crushed. Averaging down on a losing position is a “heroic move” that is akin to Superman taking a spoonful of Kryptonite to prove his manhood. The stock market is not about blind courage. Nobody hands out any awards to traders who picked the dead high or the dead low. Wait for a setup. This is about finesse. Don’t be a hero.
36. Traders never believe that they will blow out their account. Always realize that you will become a candidate for this if you don’t stick to your trading rules.
37. The market reinforces bad habits. If early on you held on to a loser that went against you by 20 percent, but you were able to get out at breakeven, you are doomed. The market has reinforced a bad habit. The next time you let a stock go against you by 20 percent, you will hang on because you have been taught that you can get out at breakeven if you are patient and hang on long enough.
38. The true mark of an amateur trader who is never going to make it in this business is continually

blaming everything but himself for the outcome of a bad trade. This includes, but is not limited to, saying things like:

- The analysts are crooks.
- The market makers were fishing for stops.
- I was on the phone, and it collapsed on me.
- My neighbor gave me a bad tip.
- The message boards caused this one to pump and dump.
- The specialists are playing games.

The mark of a professional, however, sounds like this:

- It is my fault. I traded this position too large for my account size.
- It is my fault. I didn't stick to my own risk parameters.
- It is my fault. I allowed my emotions to dictate my trades.
- It is my fault. I was not disciplined in my trades.
- It is my fault. I knew there was a risk in holding this trade into earnings, but I didn't fully comprehend it when I took the trade.

The obvious difference here is accountability. For amateurs, everything having to do with the market is "outside their control." That is not reasonable thinking and really just points to individuals who have, probably for the first time, had to confront their "real self" as opposed to the perfect self or idealized self that they have constructed in their mind. This is also known as "living in a fog." People can drift through life in their own private world, where they are pretty special and can do no wrong. Unfortunately, trading rips off this mask, because you cannot dispute what has happened to your account. This is also known as "confronting reality." For many people, when they start trading, they are suddenly confronting reality for the first time in their lives. Just to see the world as it really is requires a lifetime of training, and for many people, trading the stock market is their first real step on this journey. Some people say that traders are born, not made. Not so. If you choose to see the world as it is, then you can start trading successfully tomorrow.

39. Amateur traders always think, "How much money can I make on this trade?" Professional traders always think, "How much money can I lose on this trade?" Traders who control their risk take money from the traders who are thinking about the red BMW they are going to buy.
40. At some point traders realize that no one can tell them exactly what is going to happen next in the market, and that they can never know how much they are going to make on a trade. Thus the only thing left to do is to determine how much risk they are willing to take in order to find out if they are right or not. The key to trading success is to focus on how much money is at risk, not on how much you can make.

The longer I do this, the more protective I get of my trading capital, and the more surprised I am when things actually work out exactly as planned. And that is what keeps it so interesting each and every day.

### **Surviving the Trader's Journey**

Strategies fail because traders have to have only a couple of losing trades in a row before they throw out the whole system and go back to relying on their gut. Once traders are in this situation, they head into a downward spiral very quickly. Human emotions get people in at the dead highs, and then human emotions get people out at the dead lows, as they continually buy at the top out of greed and then sell the lows out of fear. Or, in the case of shorts, they sell at the lows out of greed and cover at the highs because of fear. And this is a cycle that happens over and over and over again. And it's never going to stop.

The financial markets naturally take advantage of and prey upon human nature, especially when it comes to greed, hope, and fear. The key is to remember that the biggest movements in the markets do not occur when traders in general "feel like buying." They occur because groups of traders are all getting skewered at the same time and are being forced out of a position. In reality, traders are not trading stocks, futures, or options. They are trading other traders. The profitable traders learn to be aware of the psychology and emotions behind the person who is taking the opposite side of their trade. Average traders understand only their side of the trade. Superior traders understand what's happening on both sides of a trade and know how to take advantage of situations that will hurt most traders. They know how to take advantage of human weakness, and, therefore, they are able to grind most traders into the ground like so much raw meat. In essence, winning traders steal money from losing traders.

My partners and I jokingly refer to the financial markets as the "electronic heroin." The goal, of course, is for traders to develop a professional trading mindset that prevents them from succumbing to these temptations as if they were a drug addict. Instead of being the *cause* of the ebbs and flows of the markets, traders need to jump the chasm that allows them to ride out these ebbs and flows on a course toward profitability.

Good skiers rarely worry about a route. They just go, confident that they'll react to changes in the trail as they come upon them. It's the same thing in trading: traders have to have confidence in their technique. That is the beauty of mustering the right mindset before a trader starts the day—it enables the trader to feel like a good skier, nice and relaxed for the next unexpected turn.

### **Before the Trade**

Traders live hectic lives, with outside influences jerking their senses around on a daily basis. These external forces can drive traders to distraction, and once that happens, the traders start adding to losing positions and start pulling stops. This takes a trader down the dark path where she sets herself up for a catastrophic loss. There are few guarantees in life, but I guarantee this: if traders allow outside circumstances to influence their level of discipline, they will get whacked with a catastrophic loss. Maybe not today and maybe not next week, but it only has to happen once. And it will occur much more quickly with leveraged instruments such as futures and options, where gun-slinging traders can rack up a monster loss in the time it takes them to return from the bathroom. Once this disaster hits a trader's account, a new reality emerges that is even more horrible

to imagine—having to go out and get a job.

### *Block Out Distractions*

To succeed as a trader, the daily distractions have to be managed. Life marches on, despite a trader's need for quiet and solitude. To be able to make a consistent living at this incredible occupation, a trader must maintain discipline no matter what is going on around him.

### *You Just Never Know . . .*

The longer I trade, the more I have come to understand that no matter what a trader does—no matter how many indicators or time frames she meticulously studies—a trader can never, never, never predict with 100 percent certainty what the market is going to do next.

Once I realized that, a funny thing happened to me during the trading day. I stopped getting stressed out. Instead of being tired and exhausted at the end of the day, I was relaxed enough to enjoy time with my kids and generally hang out. This is in contrast to the stressed-out days when I would painstakingly watch every tick, willing the market to go my way. Afterwards, I was so tired that I had to grab a few beers and look for escape in movies and one-person shooter games to unwind.

The market is going to do what it damn well pleases, regardless of any hopes and dreams the trader has pinned to a particular trade, and completely regardless of how much confirmation a trader has on a particular trade that may normally have a high probability of working out.

The only thing a trader can do is control his risk—on each and every trade. Stay disciplined. Be patient. Remind yourself of this before every trade. If there is a secret to trading, it is this: take the next trade not to make money, but to improve one's skills as a trader. This is how a trader is able to make a living at the game. This is how a trader is able to avoid a catastrophic loss.

### **Conclusion and Final Thoughts**

Finishing a book must be similar to sending a child off to college, except that in this case, I'm not sad to see it go. It's a great process, and it even helped me to clarify some of my own trading ideas . . . but it's a lot of hard work. If it helps you to become a better trader, then the time was well spent. This book really discusses everything I know about trading up to this point in time. If you are interested in additional resources outside of this book, you can pay us a visit at our main website, [www.simplertrading.com](http://www.simplertrading.com). We use this site to post our research on stocks, options, futures, Forex and cryptocurrencies.

When I kicked this off about 400 pages ago, I mentioned that intermediate traders generally fall into the following three categories:

- Those who know the setup like the back of their hand, but fail to make money because of a flawed trading methodology
- Those who know the setup better than their spouse's bad habits, but fail to make money because the setup is being used in the wrong market
- Those who know the setup better than the varied plot lines on *Game of Thrones*, but fail to make money

because they can't stick to their rules.

The point of this, of course, is to emphasize the importance of establishing a trade setup from a multifaceted approach. Successful trading is a lot more than just, "What's my entry, and what's my stop?" In addition to the actual setup, there also needs to be a foundation from which to operate the setup. This foundation consists of the following: the right setup, in the right market, in the right time frame, all of which tie into the trader's personality—and all this ultimately ties into how the trade is managed. How will you know when this all comes together for you? The first clue is that it will have nothing to do with how you feel about it. It will have everything to do with the results. I've shared with you some of the setups that work for me. Find two setups out of this book that you can follow in a particular market in a particular time frame, stick to your rules, and make them your own. Once you have two setups that work for you consistently, start looking at adding a third. There is no reason to rush into this. Take your time and master each step as you go. And remember, making a living on one simple setup, on one market, on one time frame is just fine too.

As I state in the Introduction, without rules, a trader is like a wounded antelope in the center of a pride of lions. It is not a question of "if" the antelope is going to get whacked faster than a newly discovered FBI informant within the Mafia, but rather of "when." For traders without the discipline to follow their rules, the possibility of financial ruin is not a question of "if." It's only a matter of "when."

I work with traders all the time. The ones who turn the corner and eventually start making a living at this profession learn to stick to their rules. This is typically a painful process. There is only one guarantee I can give you in this business, and it is this: *if you can't stick to the rules you develop, and if you are always finding some excuse to enter or exit a trade earlier or later than your rules state, you will never, never make it as a trader.*

As a history major, I have to say that this is the most exciting time to be alive in the history of the world. Change used to occur over the course of centuries, and then decades, then years, and now change is taking place every day. One of my favorite fiction books of all time is James Clavell's *Taiipan*. This book is based on historical facts and tells the tale of rival China traders Dirk Straun and Tyler Brock in the newly formed British colony of Hong Kong in the 1840s. They had to make their buying and selling decisions for vast quantities of spices, cotton, and tea using price quotes from London that had been printed three months before. Can you imagine trading with quotes delayed three months? That is what people had to do less than 150 years ago. Today, when I'm in Hong Kong on business, I can type in real time and get responses in real time from a counterpart in London through WhatsApp. Don't get caught up in any "wishing for the good old days" or any of that nonsense. As I'm writing this on May 27, 2018, the news is unusually negative. But remember, this is just the news and what they are *choosing* to focus on. Bad news sells. Fear sells. There are plenty of other information sources out there that talk about all of the amazing things going on in the world. Change is life; life is change. For traders, whether the markets go up, down, or sideways, whether the economy is growing or we are in the midst of a great depression, there will always be opportunities to trade.

It is my hope that, after reading this book, you will have a better foundation for a plan to trade the markets successfully on a full-time basis: proven setups to play, markets that best fit those particular setups, and a set of rules to apply to those setups. That is pretty much all a trader needs in order to survive and thrive in this greatest of professions.

For a list of all the different links and videos we put together especially for this book, visit



[www.simplertrading.com/masteringthetrade](http://www.simplertrading.com/masteringthetrade) and you'll be able to click on and access all of the free videos developed specifically for this book from this one page.

I hope these pages help you take your trading to the next level, and I wish you well on your trading journey. It's not for the faint of heart, but it sure builds character.

*The benefit of death is you know not to waste life living someone else's choices.*

—STEVE JOBS

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John is a member of the non-profit organizations Entrepreneurs' Organization (EO) and Young Presidents' Organization (YPO). When not trading, he enjoys spending time with his wife and three children, and tending to the goats and cattle at his ranch in the Texas Hill Country.

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