



# Trading Strategies of **TOP** Market Professionals

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## Part 1: The Deep Pullback

By James Chen, CTA, CMT

**WHEN TRADING IN THE FOREX MARKET**, traders who wish to maximize their probability of success should pay close heed to several key principles and practices. This article discusses some of these principles and then provides a specific, step-by-step strategic method for putting them into effective practice.

First and foremost, traders should always apply prudent risk management. Good risk management fosters longevity in trading, and traders should **ALWAYS** strive to target longevity. Only through surviving to trade another day can a trader truly have any chance of achieving consistent profitability. The proper practice of risk management primarily involves the active limiting of market risk, most often through the wise placement of stop losses.

The second key principle is to follow the prevailing trend. Though this principle is often over-eagerly touted by market gurus and educators, its importance cannot be emphasized enough. While there are successful counter-trend traders in all financial markets, trading with a strong, prevailing trend is one of the best ways to take advantage of existing market momentum. One of the most important primary factors of successful trading is simply making sure that one's directional bias is correct, and that one stays on the correct side of the market. By trading **ONLY WITH** the trend, this feat is more

readily accomplished. Trading with the trend is essentially taking the path of least resistance.

The third key principle is to exploit pullbacks within a trend (dips in an uptrend or rallies in a downtrend), wherever possible. Pullback trading epitomizes the sensible act of seeking optimal trade entries within trends. In an uptrend, entering a long trade on a downside pullback is ideal because the trader buys into the trade at a lower price, in anticipation of selling higher for a profit on a potential uptrend continuation. By the same token, in a downtrend, entering a short trade on an upside pullback is ideal because the trader sells short into the trade at a higher price, in anticipation of buying back (or covering) lower for a profit on a potential downtrend continuation. Pullback trading is common, but the intelligent trader should not just look for any pullback that occurs, as they can often quickly turn into reversals of the trend. Rather, the key event to look for is the pullback RECOVERY, where price begins to recover from the temporary pullback and starts to move back in the direction of the prevailing trend, thereby providing some indication of a potential trend continuation.

**Trading with the trend is essentially taking the path of least resistance.**

The fourth key principle to be discussed here involves ensuring a prudent reward-to-risk ratio. Generally speaking, this means that traders, and especially trend-following traders, should seek trades having potential reward (profit) significantly exceed potential risk (loss). Particularly when dealing with trend trades,

having a relatively high reward-to-risk ratio allows for less frequent (but substantially larger) winning trades to overshadow more frequent (but substantially smaller) losing trades, thereby targeting net profitability. There are many different ratios that different traders use for different purposes and strategies. Common ratios, depending on the trader and the circumstances, include 2:1, 3:1, and 4:1. A 3:1 reward:risk ratio, for example, simply means that one strives to make one's winning trades at least three times the size of one's losing trades.

With these prudent principles of high-probability Forex trading kept firmly in mind, the trader can then look to formulate a specific trading strategy that effectively puts these principles into practice. One solid strategy that fits these principles well is one that I have coined, the Deep Pullback.

The rationale for this trading strategy is straightforward – a cost-effective location to enter into a trend trade is where price begins to recover from a significant (hence, “deep”) pullback within a strong trend. In an uptrend where a trader is looking to buy, or go long, the most cost-effective location for entry is after substantial price dips, optimally getting the trader into the uptrend at a relatively low price. In a downtrend where a trader is looking to sell short, the most cost-effective location for entry is after substantial price rallies, optimally getting the trader into the downtrend at a relatively high price. If the correction does not turn into a trend reversal, a deep pullback is better than a shallow one simply because the entry on a deep pullback occurs at a more advantageous price than on a shallow pullback.

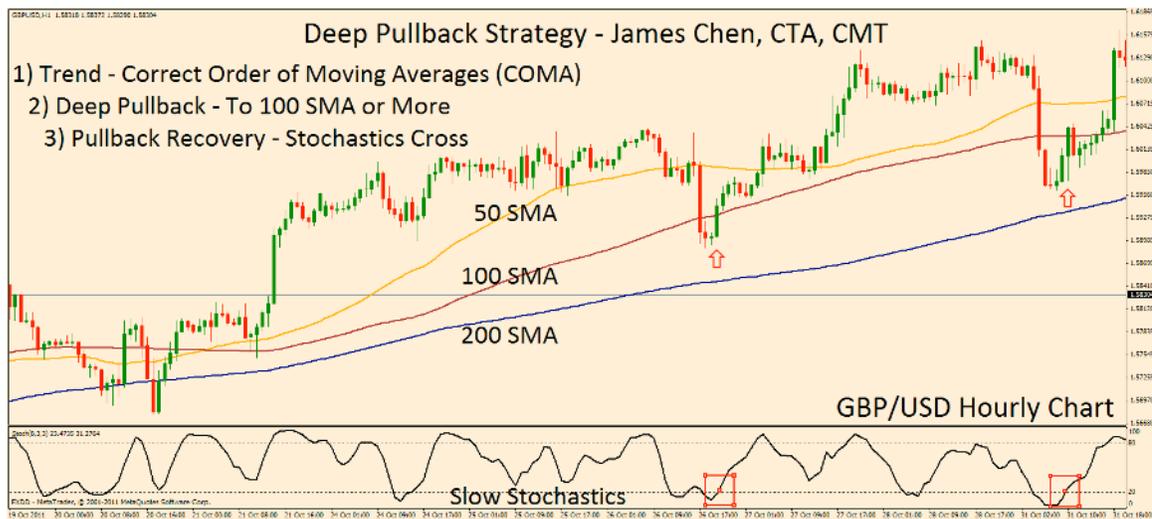
When a deep pullback occurs, trade entry should be considered only if price indicates a potential RECOVERY from the pullback by turning back in the direction of the prevailing trend. Once this occurs, a trade with the trend can be entered and risk control measures can then be set in place, along with a potential profit target according to the trader's desired reward-to-risk ratio.

The setup is simple. Hourly or other short-term charts of major currency pairs are scanned for the following criteria.

- 1) The first criterion is trend. A trend is in place only if there is separation and a Correct Order of Moving Averages (COMA) – in this case, three simple moving averages (SMA): 50, 100, and 200 periods. For an uptrend, the correct order of moving averages consists of the 200-period SMA on the bottom, followed above it by the 100, with the 50 on top. For a downtrend, the correct order of moving averages consists of the 200-period SMA on top, followed below it by the 100, with the 50 on the bottom. If this first criterion is fulfilled with a COMA, the second criterion should then be considered.
- 2) The second criterion is the deep pullback. Within a trend as defined by the first criterion, a trade is considered only if price moves deep enough – to the 100-period SMA or more. Therefore, in an uptrend, a pullback dip is considered deep enough only if price moves to the 100-period SMA or lower. In a downtrend, a pullback rally is considered deep enough only if price moves to the 100-

period SMA or higher. If this second criterion is fulfilled with a deep pullback that goes to the 100 SMA or more, the third criterion should then be considered.

- 3) The third criterion is a pullback recovery. This is indicated in an uptrend by the Slow Stochastics main line crossing and closing above the oversold (20) line after having been previously oversold, or on a downtrend by the Slow Stochastics main line crossing and closing below the overbought (80) line after having been previously overbought.



*The Deep Pullback on a GBP/USD hourly chart uptrend (chart courtesy of FXDD-MetaTrader)*

Once all three criteria are met, a trend trade may be entered immediately on the fulfillment of the third criterion. After entry, for a long entry in an uptrend the stop-loss can then be placed just a few pips below the low of the pullback dip. For a short entry in a downtrend the stop-loss can then be placed just a few pips above the high of the pullback rally.

With strictly-controlled, defined risk in place, attention can then be placed on targeting profits through the use of a predetermined reward-to-risk ratio. For example, if operating on a 3:1 reward-to-risk ratio (where reward is set at three times risk) in an uptrend, the trader would take the size of the defined risk (entry price minus stop-loss price), triple this risk amount, and then add that value to the entry price to derive the profit target price.

The Deep Pullback strategy can be employed as a robust trading method that fulfills some key principles of high-probability trading. The strategy's strict, built-in trading criteria filter out lower probability trades and present potentially higher probability trades which, when coupled with strong risk management, can contribute significantly to an effective overall trading approach.

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# 2

## Part 2: How to Profit from Market Retracements

By Tim Racette

**WHAT IS YOUR #1 JOB AS A TRADER?** A trader's main job is to organize market information into an identifiable sequence, providing an edge. This edge is the result of a statistical advantage from a given set of trades over time.

In this article we will look at how to...

- ★ Determine an edge in the context of the larger trend
- ★ Enter into a trade at a predetermined retracement level
- ★ Understand market behavior and avoid common challenges

The market is said to be continually retracing. At a quick glance of any basic chart it's pretty apparent. The market goes up, it pulls back, and it goes up again. Other times the market goes down, rallies, and goes down again. Time after time the process repeats itself.

So how then do we make sense of the market information? One method is to identify the larger trend and look to enter in the direction of that trend once a retracement has occurred.

### What is a Retracement?

A retracement is simply a short-term reversal in the trend, a pullback in an uptrend or a rally in a downtrend.

The market rarely moves higher or lower in a straight line. After a market has made an initial push, we often see a reversal, a retracement in price. Given the frequency of this occurrence we are able to get into the market at this retracement level and take part in the larger move.

## How to Think Like a Trader

It's time to train your brain to think like a trader and trade off what you *see*, not what you *think*. Traders think with their eyes, not with their brains. Said another way, traders do not try and predict what will happen; they trade off the data in front of them.

Remember the market is always right and anything can happen.

## The Psychology Behind the Market

Forget about Fibonacci, Moving Averages, or fancy indicators for a minute. Let's try and understand what is happening on a psychological level when price breaks out and pulls back.

*Example: A group of investors believe a market is going higher so they begin to buy in large size. This slowly pushes the market higher. Traders notice the movement and begin to jump on board.*

*After breaking highs the move higher becomes clear. The retail traders feel they will miss out if they don't get in now so they proceed to buy last, and at highs.*

*The professional traders and shorter-term hedge fund players close out their positions as we make new highs. And who do they sell to? Why to the retail traders that were chasing the move. It's at this point that the market begins to selloff.*

*Once we have pulled back say halfway, the original investors decide to add to their position just as the retail traders who were chasing the move are getting their stops hit and exiting for a loss. With investors adding to their already profitable position this sends the market higher once more, and the process repeats.*

## **When to Place Your Trade**

Buying pullbacks in an uptrend and selling rallies in a downtrend is a great strategy, but how do we know when the short-term reversal is over and the larger trend is ready to resume? We don't. What we do know, is that markets tend to retrace 50% of a given move, or come halfway back before resuming the larger trend.

To stay with the theme of simplicity, there are three steps to follow when placing a trade...

### **Step 1: Identify the Trend**

### **Step 2: Determine the Entry Point**

### **Step 3: Order Execution**

Simple, yes. Easy, not exactly. Let's take a look at each step individually with some examples. (I repeat this process for each market that I am trading).

## **Step 1: Identify the Trend**

The first thing to do is identify the larger trend. An uptrend is made up of higher highs and higher lows and a downtrend is made up of lower highs and lower lows (the time frame is irrelevant).

I prefer to start on a weekly chart and drill down to the smaller time frames. Whether you trade intraday or off daily levels, the process is the same. I use 4 time frames, a weekly, daily, 15-min, and 512 tick.

If you're unfamiliar with tick charts, each bar forms after X amount of ticks are traded (in this case 512). On a typical time based chart, each bar forms after a specified period of time has elapsed, such as 15-mins.

(More on tick charts and the screen setup that I use can be found on my blog, [EminiMind.com](http://EminiMind.com)).



Exercise: Print out a 5-min chart of any market and go through and identify the highs and lows that make up the trend. Use a pen to draw arrows in the direction of the trend (you will notice sometimes however, there is no trend as the market moves sideways).

I consider the larger trend one time frame higher than my entry time frame. So if I'm trading on a 512 tick chart I will look to the 15-min chart as the larger trend and if I'm trading off a 15-min chart I will look to the daily chart as the larger trend etc.

## Step 2: Determine Your Entry Point

Once you've identified the trend, watch for a retracement to occur. I look for a retracement of 50% of the initial move, also known as halfway back.



*Interesting Fact:* Some pit traders will use the first hours range as the initial push and look to enter in the direction of that trend once price retraces half of the move.

This halfway back level is the entry point. Sometimes the larger trend resumes before it makes it all the way halfway back, other times it trades through the halfway back level.

Here are two ways I handle the preceding issues which have shown to increase my winning % and profitability...

- ★ Place orders just in front of the halfway back level
- ★ Scale out a portion of the position at a small profit target

This brings us to the third step...

### Step 3: Order Execution

I only use limit orders. Since I have predetermined my entry price I let the market come to me. I will place my orders a few ticks/pips in front of the 50% retracement level in order to get filled. This is because most markets need to trade through your price to give you a fill.

Placing orders just in front of the 50% retracement ensures that if price stops and reverses at the 50% level exactly you will be filled and in the trade.

**Buying pullbacks in an uptrend and selling rallies in a downtrend is a great strategy...**

What if the market trades through the 50% retracement? This will certainly happen, however I've found that the markets will usually give some sort of bounce at these levels before breaking through or resuming the larger trend. For this reason I exit a portion of my position at a small profit target to reduce my risk on the trade. Over time, this method of reducing my risk helps eliminate full stop outs.

### 3 Challenges You May Face With This Strategy

No strategy is perfect, but I've found a lot of the mistakes and errors that occur are internal, they lie within us. Trading is mostly a mental game and these are some of the challenges I faced along the way.

*Making it more complicated than it needs to be.* With so many different methodologies out there, pick one and stick with it, I try to minimize my trading screen of all the clutter and only look at things that directly relate to my trading method. The addition of other indicators and news feeds just creates second guessing.

*Fear of Pulling the Trigger and Hesitating.* Use limit orders and place them in advance, then sit back and wait for your fill. If you have to physically sit on your hands or stand 3 feet away from the computer do so. Once you've identified the highs and lows of a move and draw up the halfway back you know where your entry is giving you plenty of time to place your limit order.

*Going against the trend.* In all cases when price is coming into your limit order it will be going against the larger trend. It's important to keep the bigger picture in mind and not lose sight of the larger time frame. I think in terms of groups of trades versus each individual trade individually. This is just another way to look at the data and stay objective.

### Conclusion: What to Do From Here

Now that you've familiarized yourself with the retracement strategy you will want to pick a market that has a good risk/reward ratio. I like the Euro (6E). It adheres to the setups well

and has very large price swings every day, providing great trading opportunities.

Begin with step 1 and pull up a simple candlestick chart with no indicators. Go back as far as you can and look to identify the trend and retracements within the larger trend.

In time the trend and retracements will become clearer and easier to identify. Reviewing the setups each night will help build confidence when it comes time to pull the trigger

You can find more details about the retracement method, and the specific setups I use on my blog [EminiMind.com](http://EminiMind.com) under the 'Trading Rules' tab.



## Part 3: Are You Trading with the Right Stuff?

### Successful Traders Possess Key Traits that Separate Them from the Herd

By Matt Blackman, CMT

**EVER WONDERED IF YOU HAVE WHAT IT TAKES** to be a really great trader? Your answer may be just around the corner.

Famous commodities trader Larry Williams and his son, Dr. Jason Williams, a psychiatrist at the John Hopkins School of Medicine have teamed up to document exactly what traits separate truly great traders from the rest of us. Due to be published in the fall of 2012 by McGraw Hill, the book focuses on the key psychological differences between extremely successful traders and the average trader. It identifies what factors are most important in determining our success or failure in this business.

Stock trader Dan Zanger, the host of ChartPattern.com and author of The Zanger Report newsletter, was invited to participate as part of the highly successful group of traders studied. Zanger holds the stock trading record with an annual audited return of more than 29,000%. Every year Dan holds his annual ChartPattern.com seminar where traders learn first hand how he does it.

In the detailed 270-question psychological test developed by the John Hopkins School of Medicine, Zanger was asked questions on a wide variety of topics. But the questions provided little

insight or guidance about what the test was attempting to achieve, according to Zanger.

“The questions were somewhat contradictory. For example, one question asked if I liked bright colors and flashy items. I like bright colors but don't like flashy items so how do you answer it? But it was certainly detailed and it will be interesting to see the results,” he said.

We talked to Zanger about the test and characteristics he feels are essential to trading success. His answers provided valuable insights into how he trades and what helped him become and stay successful in this business.

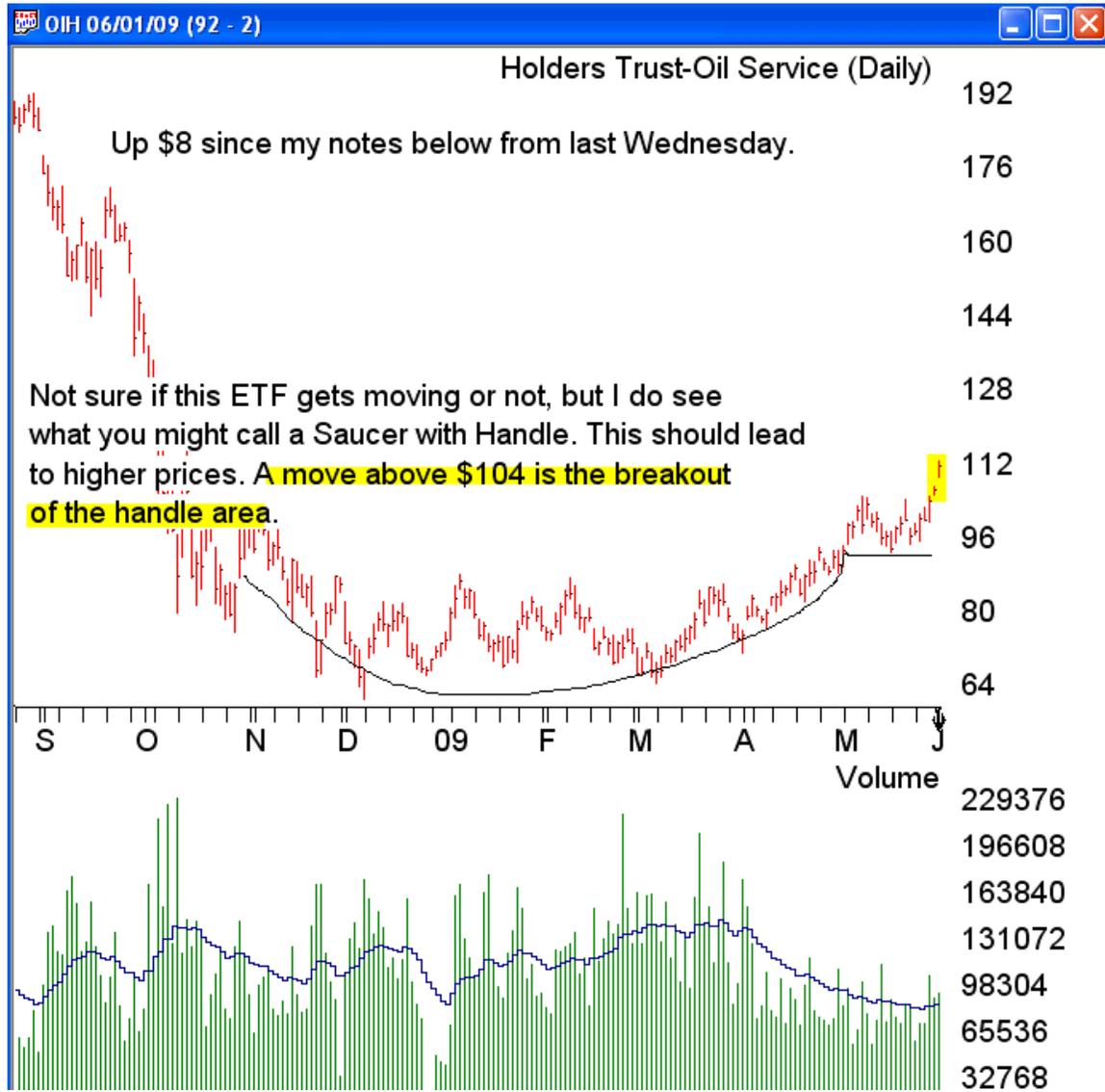


**Matt Blackman:** “Do you think it’s worth the time and money for traders to take a psychological test to learn what their strengths and weaknesses are before they start trading?”

**Dan Zanger:** “It is essential that traders understand the strengths and weaknesses that they bring to the trading table if they want to make money. Since the Williams’ book focuses on trader psychology, it provides a lot of insight about what the test will tell you.

In my experience, there are traders who are determined, focused, dedicated and passionate and there are those who want to be successful but don't want to do the homework, don't want to or can't focus and they just don't have the mental tools or

mental fortitude necessary. But even if you have the focus and determination, without the ability to see patterns, it's impossible to do what I do. So there are many different factors essential to being successful."



*Figure 1 – A chart from The Zanger Report newsletter showing the powerful basing Cup & Handle pattern in the Holders Trust Oil Services ETF (OIH) in what turned out to be the foundation of a move that eventually took this stock north of \$160. Chart courtesy of [ChartPattern.com](http://ChartPattern.com)*

**MB:** “One common theme Larry and Jason Williams found in their research was the fact that successful traders all shared a low level of anxiety under stress. Would you say this describes you?”

**DZ:** “You certainly get a sense of satisfaction from winning. There is a huge amount of winning gratification. Trading is a big game and you play the game to win. Other traders are trying to take your money every day. Knowing that you're going to take their money instead is very gratifying.

**MB:** “Would you say that you experience a low level of anxiety under stress?”

**DZ:** “I'm always leery that my trade will turn into a loss. You always need to know how much you can lose in a trade. What is the risk on this stock? If a stock goes down \$3 on a trade how will that affect me? If I can't handle a \$3 loss, then I've got too much stock.

“Do I have a high degree of anxiety? I don't believe in stocks, I don't believe that they can make big comebacks. I'm so focused that when the trade is on, I'm not feeling anxiety. That only comes after the trading day is over.”

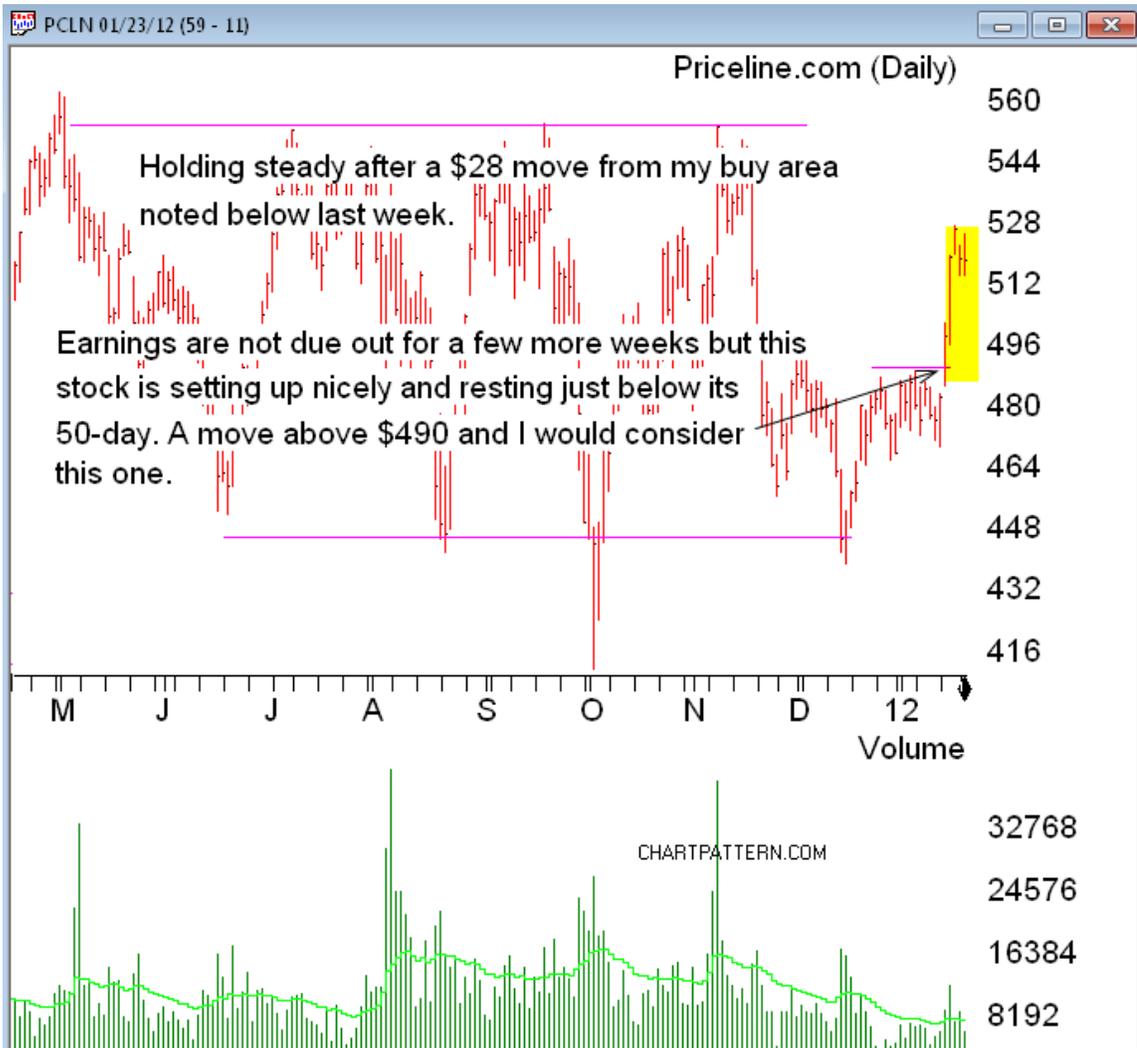


**Figure 2** – A great example from *The Zanger Report* newsletter showing the power of a bull flag pattern amid a parabolic run-up in Garmin in 2007. Note the narrowing channel through which momentum slowly increased followed by an explosive break out and \$20 run in just 2 months. But chasing a stock during a parabolic move is a bad idea. Chart courtesy of [ChartPattern.com](http://ChartPattern.com)

**MB:** “What do you believe are some of the most important traits successful traders need to possess?”

**DZ:** “First and foremost, you need a tremendous amount of focus. Next, you need a passion for the business and then it’s essential that you are very visible and are able to quickly pick out chart patterns in whatever time period you are using.”

**MB:** “In summary, what would you say are the five most important factors to becoming a successful trader?”



*Figure 3 – This chart shows the kind of sloppy sideways action that can decimate the account of the trader who tries to trade every move when markets are trendless. Chart courtesy of [ChartPattern.com](http://ChartPattern.com)*

**DZ:** “First, you need to do hours and hours of homework after market close on both winning and losing trades and to understand why you made them. You need to be fully aware both what you did right and when you made mistakes so will you do more of the former and less of the latter.

Second, as I mentioned above, a laser-beam focus on the trade during the trading day is absolutely essential. Distractions or mental lapses can be very expensive when you're in a trade.

Third, I enter every trade with healthy dose of pessimism and exit either when the trade goes against me or when it doesn't go as expected based on my reason for entering the trade in the first place.

Fourth, it is essential to keep you emotions in check so you trade logically based on what you've learned not how you

**I enter every trade with healthy dose of pessimism**

are feeling that day. You need to understand that anytime an emotion takes over, you lose control no matter what that emotion may be, whether its fear, elation, greed or hope.

Last, the ability to recognize patterns in a heartbeat is essential. You need to understand daily short-term patterns and longer term patterns and be able to put them together. Volume is also an important tool because it provides insight into the level of trader participation.”

[See Dan's excellent overview of the [11 most powerful chart patterns](#) ]

**MB:** “What is the single most common mistake traders including you make?”

**DZ:** “Continuing to trade a market that isn't following through on setups i.e. a choppy market with whipsaws, false breakouts, with no leadership (see Figure 3). That kind of market chop can kill you. For a lot of traders including me, one of the toughest lessons to learn is when to stay on the sidelines when markets aren't cooperating. It's tough because you never know when the choppy market has ended and the next rally has started till after the fact. It is a natural tendency to jump the gun but getting in too early can be a very costly and potentially destructive habit. So another essential key to trading success is patience.”

**MB:** “What are some of the other common mistakes traders make?”

**DZ:** “I've seen a lot of traders buying out of the money options and thinking that is the way to quick riches when in fact you get eaten alive by time decay. To a large degree people are outright gamblers, who are just throwing cash at the market with no rhyme, reason or a deep understanding of the market. That approach is what kills so many so fast.

Among stock traders there is the strong need to buy really cheap stocks and that can be equally devastating. They don't appreciate how the arithmetic is working against them. A one point drop in a \$10 stock is a 10% loss versus the same drop in a \$100 stock which is a more manageable 1% drop. Besides, cheap stocks are a lot more volatile which makes them riskier. But it's tough to overcome that desire to buy something that's cheap hoping that it'll go to the moon and you'll get rich. I learned that

lesson a long time ago and the sooner you learn it, the more money you'll make and keep.

Another common mistake traders make is the failure to use established rules. I have ten golden rules that I follow religiously in every trade." [ See Dan's [10 Golden Stock Trading Rules](#) ]

**MB:** "According to Larry and Jason Williams, one of the biggest surprises in their research was how consistent the personality traits between successful traders were. And the best traders were quite surprised to learn how their personality traits were working for them."

**DZ:** "A big part of their success is an understanding that you don't have to trade all the time, to wait for the right market and the right kind of setups to trade in the right kind of environment."

**MB:** "What can traders do to improve their trading? Larry Williams believes that you can't change your personality but you can adapt to it. Can traders eliminate destructive personality traits?"

**DZ:** "I would agree with him. You can't change your personality but you can reprogram yourself with regards to your discipline. It is important to understand when things are working well. But it takes years to understand the charts, the behavior of stocks, learning to read volume, and realizing when stocks get too extended and to learn not to chase a stock.

Traders need to learn to program themselves on how stocks behave so that they know how to overcome their emotions and trade with logic and common sense in various situations. You may not be able to change your personality but your behavior to stock situations can be programmed. And once you've programmed your reaction to situations and then fail to react properly to those situations, you'll realize you've had an emotional lapse. When you blow a trade you understand that your emotions have taken over. Then you work on not making that mistake again. Once you've programmed yourself this way, it takes constant attention and awareness to maintain logical control. One pivotal question every trader needs to ask him or herself before they enter this business is do I have the persistence, determination and discipline and am I prepared to dedicate the years it takes to develop these tools?"

**MB:** "In their research for the book, the Williams found that as well as having low levels of neuroticism especially anxiety, highly successful traders shared low levels of excitement seeking [gambler desire]. Would you say this describes you?"

**DZ:** "Some people, including me get anxious periodically because the stock is not behaving as expected so I'll trade out. Sometimes I trade out early but I'm looking for fast movers so when they aren't trading fast, I exit because that's not what I'm looking for. It's healthy to always have a deep mistrust of stocks. Traders who are eternal optimists get absolutely killed because they have a habit of staying in long after the trade has turned into a loser. If you can't learn to control that desire to gamble

and give in to that deadly compulsion to “roll the dice” in every trade, you won’t last very long.”

To attend Dan Zanger’s next annual seminar and learn from the master in person, go to [ChartPattern.com](http://ChartPattern.com) or go to the [direct link](#).

A big thanks to Larry Williams, Dr. Jason Williams and Dan Zanger for their time and input!



*Matt Blackman, CMT is the host of [TradeSystemGuru.com](http://TradeSystemGuru.com). Matt’s articles have appeared in publications such as **Technical Analysis of Stocks & Commodities** magazine, **SFO (Stocks, Futures & Options) Magazine**, **Trader Monthly Working Money**, **Physicians Money Digest**, **Laffer Economics**, **The Wellington Letter**, **Traders.com Advantage**, **Traders Mag (Europe)** and **Active Trader**. Matt is a member of the Market Technicians Association (MTA) and the Canadian Society of Technical Analysts (CSTA). He earned the Chartered Market Technician (CMT) designation and a B.Sc. (Honors) degree from Simon Fraser University.*

*Follow Matt's latest trading ideas and market comments on [Twitter](#).*



## Part 4: Forex – How to Trade News

By Kathy Lien, Director of Currency Research

**ONE OF THE MOST POPULAR WAYS TO TRADE FOREX** is to trade economic data and news releases. Most people may have heard of the saying News Moves Markets. In the forex market this is particularly true because currencies are essentially confidence indicators for countries. Since forex is traded on a leveraged basis, the impact of news is magnified, making a small reaction turn into a large one. News releases provide fresh information on how an economy is performing and if the data surprise is large enough, the market's reaction can last for a few minutes, hours and sometimes even days. Trading news through currencies can be exciting but also risky due to the volatility that can be triggered by the news event. Many forex traders love to trade news because of the potentially big reactions, but these same swings is what can also make news trading difficult.

Not all news releases are created equal. The key to trading news is knowing which releases matter and which don't. For example, there is no point in positioning ahead of U.S. wholesale inventories report because this piece of data is not a game changer for the U.S. economy and almost never affects the U.S. dollar. The non-farm payrolls report on the other hand is a very big market mover because the degree of job growth directly affects consumer spending which is key to the viability of any economy. However the non-farm payrolls report is also traditionally the most market-moving piece of economic data for the U.S. dollar and the foreign exchange market in general. For

this reason, it is better to avoid trading NFPs due to the volatility. The employment reports of other countries on the other hand are fair game. Many traders, particularly new ones will scratch their heads and wonder if they will be able to tell how impactful a particular news release will be. This comes with extensive experience but thankfully there are many experts out there who have do the work for you every day. A number of forex websites provide global economic calendars and rate the impact of each news events as High, Medium or Low. Generally speaking, the 3 most potentially market moving releases for currencies are the central bank's rate decision, the employment report and retail sales.

The following chart shows how USD/CAD reacted to the Canadian employment report which was released at 7:00 AM ET. Job growth that month was surprisingly weak with employment growing by only 2.3k compared to a 21.7k rise the prior month. The Canadian dollar fell immediately after the release, driving USD/CAD sharply higher the moment the data came out. An hour later, USD/CAD was trading 30 pips higher. If not for the U.S. non-farm payrolls release at 8:30 AM ET, USD/CAD would have probably extended its rise further.



Source: eSignal

Economic releases can be traded either proactively or reactively. Trading proactively involves taking an educated guess on whether a piece of data will surprise to the upside or downside and placing the trade before the number is released. This is not as mind boggling as it first sounds and a Masters Degree in Economics is certainly not needed but oftentimes traders find it too challenging and opt to trade reactively, which involves placing a trade after the economic data is released. This removes the need to “guess” the economic data but can also remove any initially advantageous knee-jerk reactions.

When trading news proactively, I generally like to place my trade 20 minutes before the data is released. I find 20 minutes the sweet spot because it is close enough to the data release that the market is usually quietly anticipating the report. It is also far away enough from the release time that spreads usually remain stable. The key to trading news reactively on the other hand is to wait 5 minutes after the number is released before taking the trade. This is extremely important because first we want to make sure the market cares about the number. Second, we want to make sure that the reaction is logical, meaning that a good number is followed by a rally in the currency and a soft number is followed by a sell-off. You always want to avoid trades where the number is good and the currency pair sells off because something else could be going on. In other words, either the market doesn't care about the release or there could be underlying weakness that is not immediately evident to new traders. We also don't want to see the reaction reverse in the first 5 minutes because that also suggests that the data surprise was not material enough for the currency to hold its gains. When a data surprise is significant, the initial move will oftentimes see continuation, as in the USD/CAD chart above. The continuation may not be long, but it could be meaningful enough to generate some short profits. However, news trading is not the same as swing trading because it aims to trade an initial burst of activity rather than a long trend. This makes it important to be nimble with profits and tight with

**Economic releases can be traded either proactively or reactively.**

stops. For news trading, I am typically satisfied with a 25 to 30 pip move depending on the currency pair and news release.

In Chart #2, which is the same USD/CAD chart shown above entry points for proactive and reactive trading. In both cases, the trade would have been profitable but profits are never guaranteed particularly when trading news, which is why using stops is very important. In the case of USD/CAD, had we been greedier and decided to ride the trade through the non-farm payrolls report, it would have been a disaster.



Source: eSignal

Here are some tips to predicting economic data for anyone interested in proactive trading.

## Employment Report

### ***Tip: To Forecast Employment, Look at Employment Component of PMI Reports***

The degree of job growth or lack thereof is very important to a country's economic outlook. If the labor market is doing well and jobs are plentiful, it is usually synonymous with a strong and improving economy. If companies are laying off workers in size, then there is a good chance that the economy is weakening. Forecasting the potential surprise in the labor market is not as difficult as it may seem. Nearly every major country releases purchasing managers' reports (PMI) for the service, manufacturing and construction sectors prior to the official employment report. In the U.S., it is called the ISM report. Within each of these reports is a subcomponent titled as employment. If the employment component of the 3 reports increased from the previous month, then there is also a good chance that the number of jobs created rose as well. However if the 3 reports show that the labor market has deteriorated, then there is a good chance that the official labor market report will show the same deterioration. A good jobs number is typically positive for the currency while a weak number will usually cause the currency to sell off. This information can usually be found through a simple Google news search using a clever combination of words.

## Retail Sales

### ***Tip: To Forecast Retail Sales, Look at Confidence and Sales Component of PMI Services***

The degree of consumer spending is just as important as the amount of job growth because it measures the contribution that consumers are making to the economy. If consumers are spending and retail sales are strong, then there is a good chance the economy is growing which is positive for the currency. If it is weak, then it is a cause for concern which usually translates into weakness for the currency. Forecasting the potential improvement or deterioration of retail sales is also not as difficult as one would expect. In Australia for example, most months, the performance of services index is released before retail sales and within the PSI report, there is a subcomponent titled sales. The PSI report is released by the Australian Industry Group which is an independent not for profit association and their results have a reasonably good correlation with the government's figures.

## Consumer Prices

### ***Tip: Look at Producer Prices***

A country's consumer price report is also a tradable news release because keeping prices stable is a part of the mandate for many central banks. In fact, for the European Central Bank and the Bank of England, it is their top priority. Thankfully forecasting CPI is not as difficult as it seems. Producer prices, which measures inflation on a wholesale level is typically reported before consumer prices. If PPI accelerates quickly, there is a good chance that CPI will rise as well as producers

pass their costs to consumers. If PPI falls, CPI has a good chance of declining.

Forecasting economic data is not easy but a Masters in Economics is not needed either – just some common sense. Try it for yourself, and if you still find it challenging, there is always reactive trading.



## Part 5: Testing Simple Strategies: MACD Works and Futures are Rewarding

By Michael Carr, CMT

**TRADERS ARE FASCINATED BY INDICATORS.** But just because something is interesting, logical or mystical does not mean it works in the market. Testing is needed to be sure the indicator adds value, and we will define value as improving profits. If an indicator beats a simple trend following strategy, it adds value.

Over the years, probably thousands of indicators have been developed as traders spend time looking for ways to beat the markets. Some like the relative strength index (RSI) or stochastics are very well known and widely followed. Others, like Chaikin Money Flow or the Chande Momentum Oscillator, are much less studied. All indicators are developed with the objective of providing traders an edge in the market. An edge should be quantifiable and to determine whether or not an edge exists, we can look at whether or not the indicator increases profits compared to a baseline trading strategy. This week we will look at two standard and widely followed indicators, saving the less followed ones for a different article.

For testing, we will look at a diversified basket of futures contracts that could be traded with an account balance of about \$25,000. Smaller accounts could adapt the strategy to use only a few of the contracts but that increases risk. The futures contracts used in the tests will include crude oil, cotton, the US

dollar index, feeder cattle, five-year Treasuries, copper and sugar. Commissions and slippage of \$45 per round turn will be deducted from each trade to duplicate the reality of trading costs. The test will cover the twelve years ending December 31, 2011.

For the smallest accounts, five-year Treasuries test very well and can be traded with about \$1,000 in margin. Of course it is best to have more than the minimum margin available in a trading account. Small traders can also use day trading strategies in futures markets since many brokers allow day trading with even lower margins.

The baseline system will use only prices to determine whether to buy or sell. It will always be in the market, taking a long position when prices move to a new 20-day high and reversing to a short position when price falls to a new 20-day low. Closing prices are used in this study.

The indicators we will test will be MACD and RSI, using the standard default values in each case. MACD is a trend following indicator and RSI is an overbought/oversold indicator. Default values used to calculate the indicators are 12 days and 26 days for MACD and 14 days will be used for RSI. Optimization can be done on these or any indicator but that is a dangerous path for traders to follow. With optimization you are actually decreasing the odds of future success by fine tuning the rules to precisely fit the past which will be different from the future. The value of optimizing parameters is to find out if the indicator is stable. For example, RSI is usually considered oversold when it falls below

30. We could optimize and find that it delivers great results at a value of 28, loses money when it is set to buy at 29, and breaks even at 30. This would show that the past performance is actually due to luck rather than adding any value to trading. If the results with the default values show that the indicator is tradable, an optimization test should be completed to make sure a small change in the parameters has only a small impact on the results. Otherwise, profits in the future are unlikely to be similar to the back tested results.

For MACD, we will be taking long positions when the histogram crosses above zero and going short when the MACD histogram is negative. The RSI strategy will be long when the indicator crosses above 30 after reaching an oversold extreme and short when it falls below 70 after becoming overbought. The results of the three systems tests are summarized in the table below. The initial evaluation of a trading strategy should simply look at the potential rewards and the risks. Returns are presented as the average annual returns because that is the most common way investors look at rewards. Risk is the ratio of the largest drawdown to the account value, a measure of how big the worst loss would be. This is really the way many investors think of risk. As a standard to measure performance against, a buy-and-hold stock market strategy would have a risk of about 60% over the test period and the S&P 500 showed a loss over that time. Buy-and-hold investors in a stock market index fund would have enjoyed a small gain when dividends are considered. Futures do not pay any dividends and all of the returns come from price action.

	Annual Return	Risk
20-Day Rule	20.53%	35%
MACD	24.05%	15%
RSI	Loss	Loss

Looking solely at returns, the results are impressive and a \$25,000 account would grow to more than \$230,000 over twelve years with the 20-day rule. The default settings for MACD applied as a trading strategy would result in an account worth more than \$330,000. A buy-and-hold stock market investor using a low cost ETF to track the S&P 500 would have seen \$25,000 grow to about \$27,500 over that time after accounting for dividends. Either futures trading system has less risk than the S&P 500 in addition to providing significantly better returns.

These results show that trend following strategies like the 20-day rule or MACD applied to the futures markets work well over time. RSI is an oscillator that tries to capture profits when the trend is changing. Using an indicator to buy oversold markets and short overbought markets doesn't result in profits because trend reversals tend to be sharp moves. By the time the signal is given, a significant part of the move has already taken place. Trend followers are not trying to pick tops or bottoms, they are simply trying to get in once a trend has been identified.

These incredible results were obtained in the futures markets. Trend following strategies do not work as well in the stock market. Testing over the same time period using the S&P 500 gives the exact opposite results – losses are realized with the 20-

day rule and MACD while RSI delivers a small gain. RSI actually provides results that are in line with a buy-and-hold strategy and does not offer any benefit when compared to that approach. When tested on a basket of stocks, the results are the same. Trend following strategies lose money and RSI is no better than a buy-and-hold approach.

Given these types of results, the obvious question is why do most individual traders focus on the stock market? Almost all individual traders limit themselves to the stock market with individual stocks or ETFs that track the broad market indexes. This is probably due in part to the perception that futures are risky. I have met individuals who believe that if they do something wrong they will have a truckload of corn, or whatever they are trading, delivered to their front door. Many also believe they could lose their house to a margin call. Fortunately your broker will sell you out of your position before either of those things happen. But the numbers actually show that a diversified basket of futures has less risk than the stock market.

Futures are risky and the leverage does mean that you can lose more than you invested. However with proper risk management, they can be a very rewarding investment. Those MACD test results show that profits are possible and the risk can actually be less than that seen in stocks.

Individual traders, even small traders, should consider futures. Futures and foreign exchange markets can both be more profitable than the stock market. Making big profits and

successfully trading for a living requires you to do things differently than the average investor who is not successful and not making a living from the markets. Trade in the markets where you can actually meet your goals.



## Part 6: Catch a Falling Knife...

“How to buy bottoms and sell tops with confidence.”

By Jason Alan Jankovsky, FOREX Analyst & Trader

**ALMOST ANY TRADER WITH SOME EXPERIENCE** has heard the trading maxim (or rule) “Don’t try to catch a falling knife...” It usually refers to buying a market falling in price and alludes to how dangerous it can be to try to get positioned when a market appears to have a lot of potential to continue moving lower. It also has the connotation that the trader himself is part of the problem because of his desire to try and buy a low price; he might “rush” to participate—thereby handing himself a loss. In the case of a market on the move higher traders tend to use the phrase “Don’t stand in front of that freight train...”

In either case—the assumption is that the market is behaving in such a way that it becomes more difficult to go against the prevailing price action in hopes of selling a top or buying a bottom; and that the trader is part of the problem because he can’t wait to make his move. Both metaphors have solid imagery of getting seriously hurt or killed if you were to do such a thing; that is certainly no less painful than losing a large portion of our trading equity in a way that appears to be completely avoidable. It is also important to note that both metaphors imply you have a choice to wait to do something; and you are smart enough to use some common sense. In other words, “What kind of moron stands on a railroad track when a train is coming?” or “What idiot would try to catch a carving knife on the way to the floor?—wait until it gets there.”

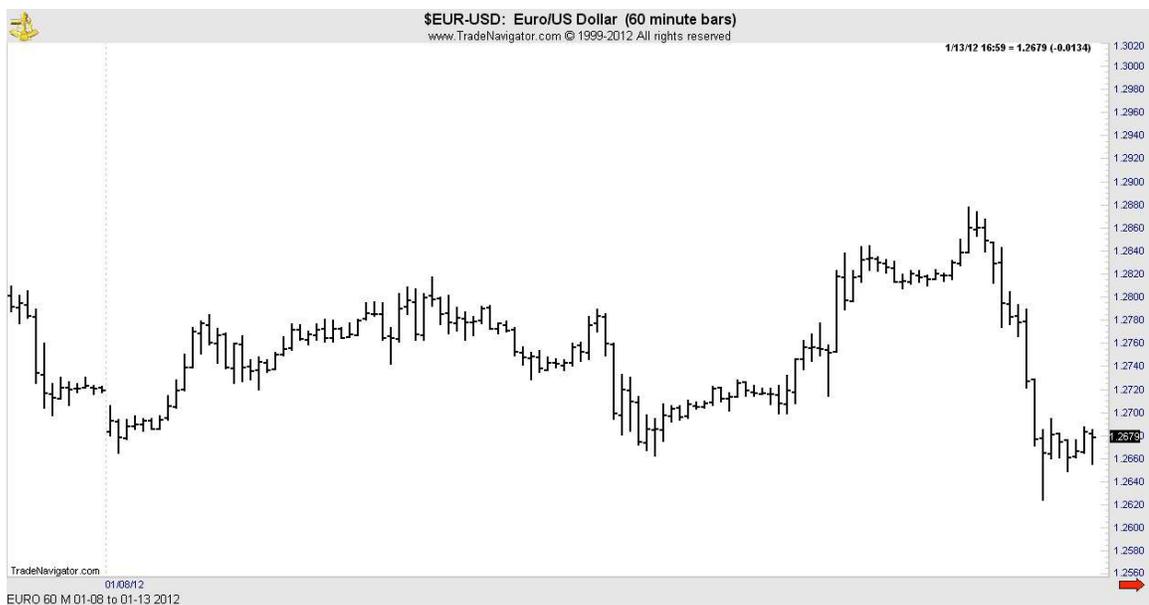
In my opinion, this is certainly good advice and full of common sense when applied to a real-life situation (like crossing a railroad track or carving a turkey). But trading is not the real world and the reason most people have frustrating results at best and mounting losses at worst is because they approach the markets in the same way they approach anything else they do—from the SAME real-world paradigm of thought. As I teach in my Psychology of Trading course “Trading is not the real world because it is a zero-sum environment—that doesn’t exist anywhere else in our lives or in society” Without a solid understanding of the psychology of price movement in zero-sum markets it is virtually impossible to get positioned for consistent and significant gains. What is called “common sense” in the real world is exactly the opposite in the markets. In the markets it would be called “following the herd”

**What idiot would try to catch a carving knife on the way to the floor?**

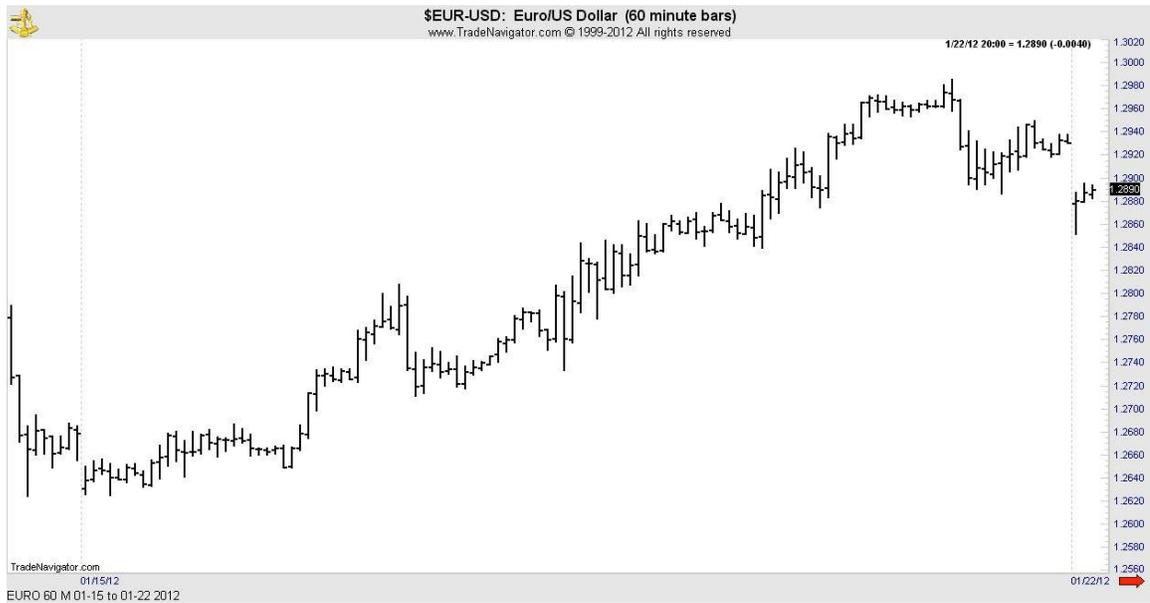
I think it is important that we discuss the fact that EVERY trader out there that is watching a market “crash” is thinking the same thing; namely: “Where will it stop so I can buy? And/or cover my short at the best price?” This is not new and it has always been this way. The vast majority of traders see the same thing in the markets and usually interpret what they see in virtually identical ways. They all do this the same way because they use the same method of thinking that everyone uses in the real world; and they use this thinking in mostly identical ways. That means—as a market “crashes” there will be very few people interested in buying it when it stops declining. They will be interested in buying it AFTER it has shown that a bottom is in

place. In other words—they will wait for confirmation before they do anything.

I want you to look at illustration “A” below. Most people would say “don’t try to catch a falling knife” as prices appeared to be REALLY taking the downside seriously. In fact, the price action into the lows was the ENTIRE weekly range from fresh highs to fresh lows in about 10 hours on the clock; not typical price action for any market.



Now look at illustration “B”. This is the same market 72 hours later.



What would have happened if you had indeed “caught the falling knife”? You would have bought at the perfect time for the entire month, taken no heat on the trade, and likely had a substantial open trade gain very quickly.

In my view, the reason most traders will not step up and buy at the actual bottoms or sell at the actual tops—when the risk is the lowest and the profit potential the greatest—is only because they are afraid to be wrong. That is why they wait for confirmation. It reduces their fear of a potential loss. But in reality—it is this fear and need for confirmation that robs them of taking the lowest risk trade at the right time to take it. When the market is already moving in the opposite direction the risk is increasing for a reversal and the profit potential is dropping. This is exactly the opposite of the “common sense” approach that the real world tells you would work—“wait and watch” works wonderfully when you are trying to buy a car or a house—or get a deal on putting in a swimming pool. But “wait and watch” increases your risk and reduces your profits in the markets—so why do

most traders do it? Why would you wait for confirmation when it is costing you so much opportunity to do so?

The reason is simple. Most traders will tell you “don’t try to catch a falling knife” because they personally don’t know how to do it. If they did—they would be buying those breaks and selling those rallies ALL THE TIME—because THAT is where the real money is. In fact—no matter how you want to slice it—every trader is trying to buy bottoms and sell tops every day in some fashion—but they don’t call it that. Which is another illusion about the markets that leads to losses. Simply put—no matter where you buy or sell—you are expecting that price to be the LAST time the market was at that price while it moves in your favor—otherwise you would have waited. In effect—you are looking to buy bottoms and sell tops even though you might call it “going with the trend on a pullback” or “going with the breakout” It really doesn’t matter what the method is—you ALWAYS want to be long just before a rally (in effect—long from the bottom) or short just before a drop (in effect—short from the top). There is no way around that thinking and you know it. The problem is—you don’t know how to do it and that is why you suffer losses when you don’t have to—the exact opposite of what you expect from following the “common sense” rule of “don’t try to catch a falling knife”.

### **So how do we learn to “Catch a falling knife”?**

I’m going to show you how I attempt to buy bottoms and sell tops with a high degree of confidence but I want to preface my remarks with a few conditions. First, what I am going to show you is from the sum-total of my 25-plus years of trading

experience; some of it will not be an easy thing to grasp at a first look. A lot of it will not make sense to some people or sound overly complicated. None of this is complicated or difficult; it is a learnable skill that requires some effort. Second, there is NO SUCH THING as a 100% reliable way to pick a top or a bottom. Something that can do it more than 60% of the time would be considered an exceptionally beneficial approach. The approach I am going to show you is around 60% successful at finding a LEAD on the market—not necessarily getting to KEEP that lead should a market bounce along that top or bottom for a period of time; or extend a bit further before the actual top/bottom is there. That is more of a money management issue and my rules are different than other traders, so there are times when I let an open-trade gain run back to break-even or a small loss. Last—and probably most important—trading is a thinking man’s game. Conditions change and situations change; that means that every top or bottom is lightly different in quality. It would be foolish for any trader to take what he finds here and run with it exactly as you see it here, all the time. You need to THINK about the bedrock issues first before placing your capital at risk. Again, this is what works for me—think about what the common issues are to your own trading and don’t just try to “plug this in” to your trading today.

I base my analysis on a few assumptions about the market that I have come to understand as factual. First—most people are losing and it is the loser’s liquidation that will drive pricing. A reversal is usually going to happen when the trader going with the trend is “late”; when the loser liquidates he drives prices the other way. For example, if the market has been climbing, at

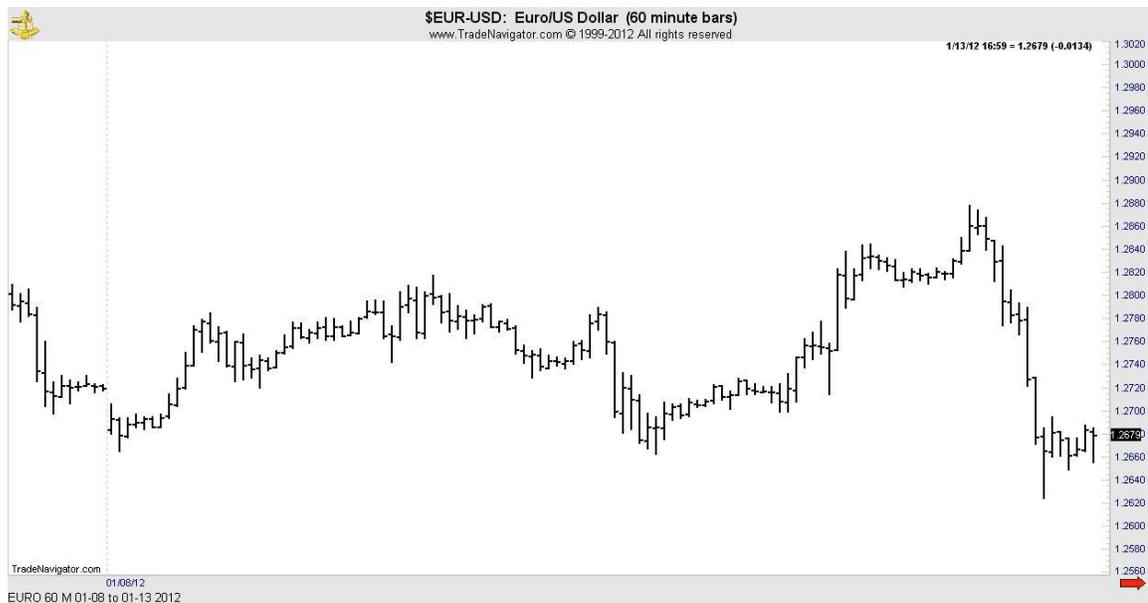
some point the longs coming in will be late; when they sell to liquidate a losing long position the market will reverse lower.

Second, the late trader is ALWAYS waiting for confirmation before doing anything so a top (or bottom) can't happen until prices have advanced far enough to draw the late trader in. That is a function of TIME and not price. For example—if a market is “crashing” to a buy point the market will make an absolute bottom price and bounce a bit—then go sideways for some amount of time. If enough time goes by, the buyer will come in. After that happens, the price must rise for a long enough period of time for the late buyer to execute his new long position. The early buyer makes the money on the long—the late buyer forms the reversal point.

Third—the sideways price action will be on a lower time frame because the net loser is ALWAYS on a short time frame. When you compare the short time frame consolidation or sideways action it will be at a significant price point on a larger time frame. The large time frame controls the market.

Last—there will need to be a precipitating event to cause the late trader to come in hoping to win; once that event is passed the market will reverse.

Here's the breakdown on how I went long at the bottom of the market in illustration “A” above:

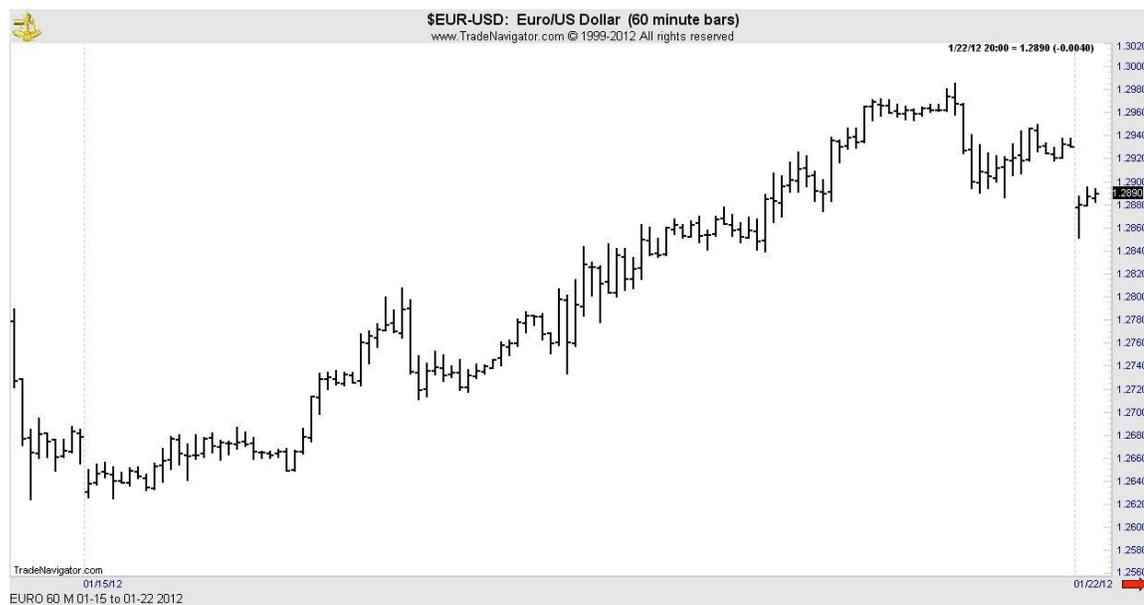


The market “crashed” to a new 17 month low on high volume and died. The large buy-wick on the candle into the traded lows suggests that the sellers were met with enough buying to stop the decline. THAT IS WHAT SAYS IT IS TIME TO BUY—the fact that the market STOPPED declining on heavy volume. Someone MUST have absorbed those selling orders. I bought right there—1.2640/60 area with several positions. For the skeptic—I place all my traders on Twitter in real time and you can go back and confirm my tweets showing a BUY in EURO at this precise time/price relationship. That was on 01-13-2012. My Twitter handle is “theliononline” and you are welcome to subscribe and watch me trade everyday if you wish.

As the market was trading sideways at or near my entry price that was the clue the selling was indeed about over and I was in long at about the right time/price relationship SO FAR. I want you to note that there is NO CERTAIN WAY to know that this particular bottom was “the” bottom—I had to step-up and do the

trade WITHOUT anything that most traders would view as “confirmation” In other words, I had to TRUST my instincts that the bottom (which is going to happen sooner or later anyway) was trying to form RIGHT AT THAT POINT.

The market “crashed” into the 17 month lows on the news report that the ratings agency S&P was about to downgrade the credit ratings of several European nations. This would be seen as a bearish development for the EURO. The late sellers were likely afraid to miss the new lows they were certain would occur. Additionally, the COT report (commitment of traders) showed EURO with the third record short position by speculators in as many weeks—more people ALREADY short than ever in history; who was left to sell?



The market was closed over the weekend—which included a federal holiday the following Monday making it a three-day weekend here in the USA. That means the late seller who could trade in Asia Monday created the gap lower seen into the holiday action. Anyone here in the USA waiting for confirmation

would have said “that’s it—time to sell!” The market returned to full activity on Tuesday absorbing those sellers until Wednesday and never looked back. The rally was fueled by the late sellers needing to get out from a losing position—there were no traders willing to buy into the 17 month low EXCEPT shorts from above taking gains off the table and the few professional traders who could see that a bottom COULD form. Professional traders who got long at those lows didn’t know the market would ACTUALLY form a bottom until later. The point is—professionals don’t wait for confirmation. They know that it is the loser wanting to wait for confirmation that creates the opportunity. The sideways price action at/around the lows shows that the order-flow was balanced (buyers and sellers about the same size mostly); that means the sellers NO LONGER had the advantage. Something in the market had changed; and that change ALWAYS means a reversal because a market can only do three things—trend up (order-flow imbalance BUYER), trend down (order-flow imbalance SELLER), or trend sideways (order-flow balance—which is ALWAYS temporary).

If you absolutely positively must have some sort of confirmation before trying to buy a bottom or sell a top try and consider that small sideways price action at a significant low or high as what is important.

I’m not trying to give you a two-cent answer to a million-dollar problem. I’m simply saying that if you understand the nature of zero-sum markets, and that the loser is the one who pays the winner, then you would approach price action from a different point of view entirely; namely: “Where is the loser?” not “What will the price do next?” In the case of a sharply falling market

that was driven by an unexpected negative news event—once that news event has passed and the market can't make any additional new traded lows, the probability that the loser is the late short is very high. You buy now—don't wait for confirmation. As the loser liquidates his losing position—his buy order to liquidate is the bulk of the buying seen as the market rises in price. Prices will rise until all the late sellers are cleared out of the market and the late buyer believes the new trend is now “up”—the late buyers will wait for the uptrend to be confirmed and if there is a precipitating news event that is bullish—they will buy on that news. Now the market is set to reverse lower. Sometimes that structure happens in both directions in just a week or so—sometimes it takes months. But it is ALWAYS this underlying structure that creates a top or bottom so the astute trader must pay attention to what is happening from a slightly different point of view in order to time the buy or sell into the actual market bottom or top.

You will have to really think through this issue but the clues are there. If you are interested in learning more about how to better buy bottoms and sell tops with confidence I would encourage you to attend my daily FOREX briefings and consider attending my quarterly six-week Psychology of Trading course. All the details are on my website [www.theliononline.com](http://www.theliononline.com)



## Part 7: The Power of Persistency

### Trading Persistent Pullbacks

By Dave Landry

**“One should not increase, beyond what is necessary, the number of entities required to explain anything.”** – Occam’s Razor

**“Simplicity is the ultimate sophistication.”** – Leonardo Davinci

### In Was Right In Front Of Me All Along

I spent many years searching for the perfect methodology. I would wake up early and stay up late knowing that if I worked hard enough, I would find it. I have tried every indicator that I could get my hands on. I went through numerous texts on technical analysis and spent many hours studying each and every indicator, oscillator, moving average convergence divergence, stochastics, Fourier Transforms, Relative Strength Index, and cycles. You name it, I tried it. Not only did I study these indicators carefully but I would even create new indicators from the indicators, making the complex even more complex. I have even studied arcane methods such as counting price bars and price waves. I was obsessed.

It took me many years to come to the realization that there is no holy grail — no method that will lead to eternal profits while avoiding all losses. More importantly, I learned that simple is

better. Since the ultimate goal was to capture a price trend, I began to think I should focus on that. So I did. Little by little I began peeling away the indicators and focused more on price, seeking out trend. I reached a point where I was back to a blank chart. In fact, other than the occasional moving average, I do not use any indicators.

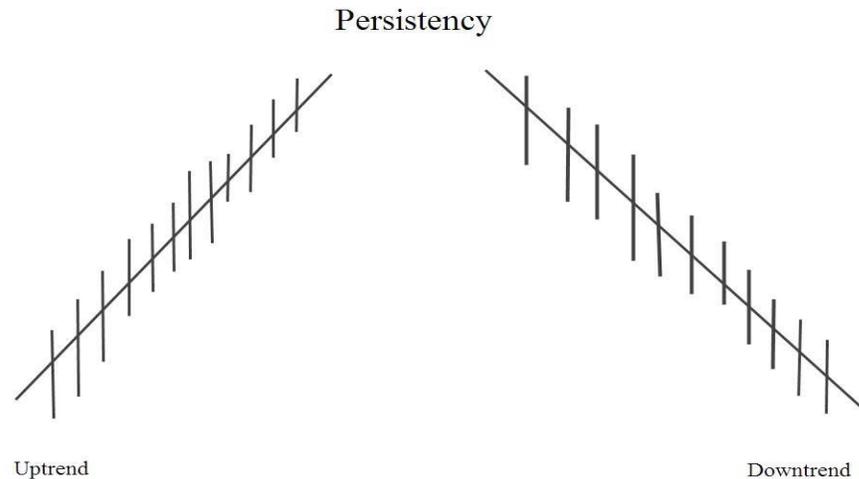
Although not perfect, I discovered that the best way to enter a trend was after a correction, also known as a pullback. While studying trends, I found that those markets in the most persistent trends had the greatest chances of resuming that trend after the next pullback. This is how Persistent Pullbacks became one of my favorite patterns.

In spite of their simplicity, they can be very powerful and effective. They keep you on the right side of the market during trending periods and out of the market during less-than-ideal conditions.

Let's break it down.

## Persistency

Persistency is simply a market's ability to follow through from one day to the next. This is illustrated below. For those more mathematically inclined, this can be measured by complex methods such as linear regression. However, for the rest of us, we can simply look at the chart and draw a trendline through as many bars as possible.



An advantage of the Persistent Pullback pattern is that it self regulates. This is especially true if you also require sector confirmation, which I highly recommend. In choppy markets, it is virtually impossible to find any stocks set up as persistent pullbacks. In bull markets, it is virtually impossible to find shorts. And in bear markets, it is virtually impossible to find longs. In fact, I studied thousands of charts from the slide that began in 2007 to the March lows of 2009. I could not find any buy side examples during this period. Further, both long and short side setups were very few and far between during the trendless market of 2011.

This self regulating nature can be great for those new to trend trading. It keeps them on the right side of the market. And it keeps them out of the market during less than ideal (e.g. choppy) conditions. This is why I suggest that those new to trend trading only trade persistent pullbacks until they gain confidence.

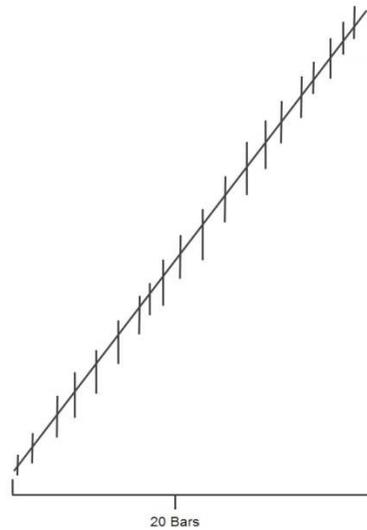
More experienced traders will find persistent pullbacks very useful when they find themselves fighting trends and

overtrading during choppy markets. During these difficult times, I suggest that they return to trading only this pattern. This will put them back on the right side of the market and will keep them out during choppy conditions. In fact, on more than one occasion, I have suggested traders in a slump to do just that. Alternatively, when you find yourself having difficulties, you can pay me a lot of money to work one-on-one with you. Or, you could just exclusively trade Persistent Pullbacks until you regain your confidence.

Now, let's look at the rules for the pattern. This setup was originally published in my second book [\*Dave Landry's 10 Best Swing Trading Patterns and Strategies\*](#) and is also in latest book: [\*The Layman's Guide To Trading Stocks\*](#).

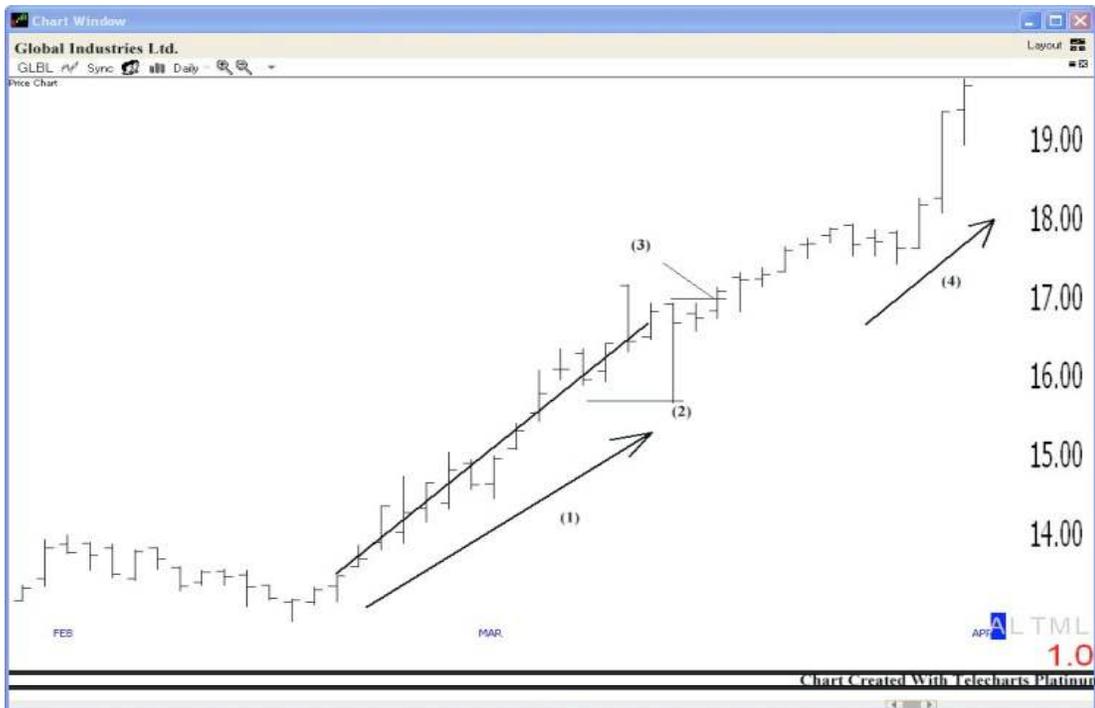
Below are the rules for buys. Short sales are reversed.

- 1) The stock should have moved one month, approximately 20 bars, in one direction. Ideally, a trend line drawn through the bars should intersect as many bars as possible. This can be done by hand or by using a linear regression trendline. During this period, the stock should have had made a significant move.

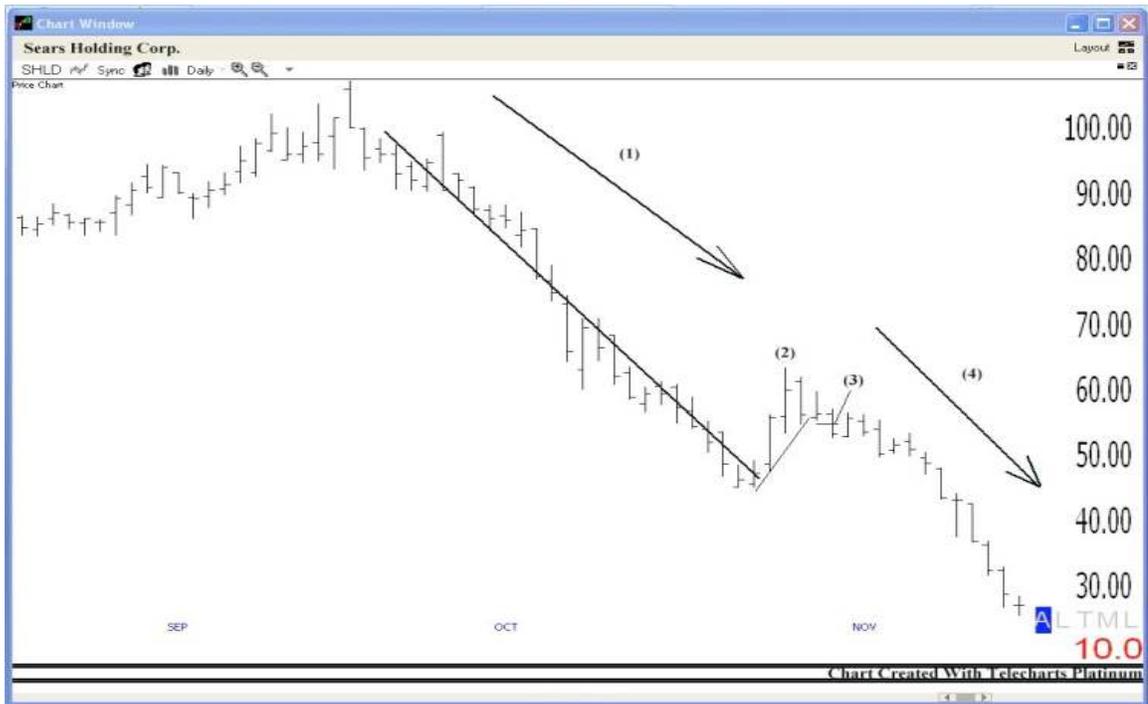


2) After Rule 1 has been satisfied, look to enter on a pullback or pullback related pattern. One of my favorite patterns that often occurs out of a persistent move is a Trend Knockout (TKO). A TKO is simply a market in a strong trend that has a “knockout” bar—it makes a new 2 bar (at least) low on an expansion of range. This helps to shake out the weak hands and attracts eager shorts. Both can help clear the way for the stock (or other market) to trade higher. See the aforementioned books for more on this pattern.

Now, let’s look at some examples.



- 1) Global Industries was in a sharp, persistent uptrend.
- 2) The stock has a sharp one day pullback, forming a TKO.
- 3) Enter as the high of the knockout bar is taken out.
- 4) The trend resumes, gaining over 18 percent in the next 2 weeks.



- 1) Sears Holding Corp. is in a solid, persistent downtrend.
- 2) The stock pulls back.
- 3) Enter as the trend resumes
- 4) The stock resumes its slide, losing over half of its value over the next few weeks.

At the time this article was being submitted for publication (March 2012), the major indices set up and were rallying out of Persistent Pullback Patterns.



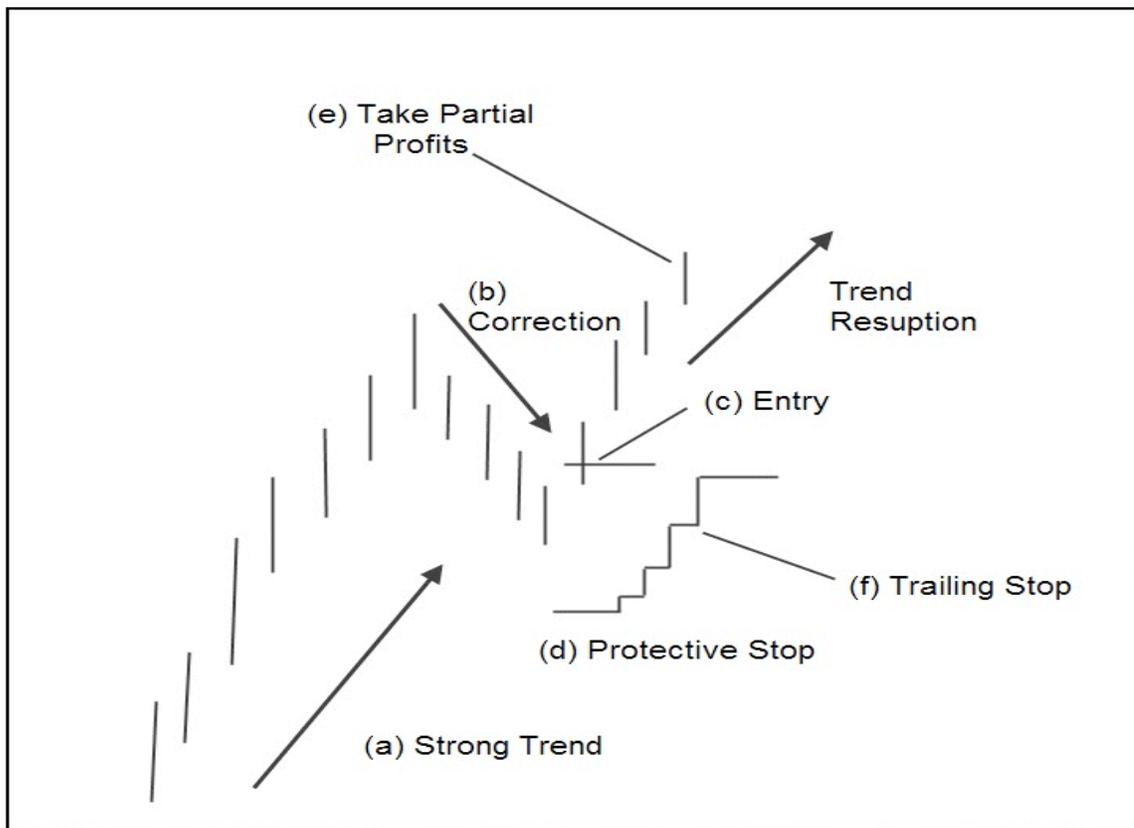
- 1) The Nasdaq Composite Index was in a persist uptrend. Notice the line through most of the bars. Also notice that those the line does not intersect are above the trend line. This is a sign of further strength.
- 2) The index pulls back.
- 3) Enter as the trend resumes.
- 4) The Nasdaq rallies nicely out of this pattern.

## Ready, Set, Wait

Before jumping in, make sure you fully understand the pattern you're going to trade. Study it in good conditions and more importantly, study it in less-than-ideal conditions. Then, paper trade it for a while until you get comfortable with it. This will give you a feel for things both good and bad. Further, without real money on the line, it'll be easy to follow your plan. This brings us to our next point. I've never met an unsuccessful paper trader.

Once real money is on the line, trading psychology becomes very important. You have to know the pattern inside and out and more importantly, know yourself. You have plan your trade and trade you plan. This is much easier said than done. You will have to know where you will get in, place your protective stop, how you will trail your stop, and where you will take partial profits. As I preach, obsess before you get into a trade, not afterwards. Trading is much easier if the majority of the decisions are made ahead of time instead of during the heat of battle.

It's beyond the scope of this article to get into a complete game plan for trading, but there are a few things you should know. Below is what I call my "Methodology In A Nutshell" figure. If you understand this figure, you understand the basics of my methodology. The rest is just details.



For those interested in more details, refer to the background information at the end of this article.

## Summary

Persistent pullbacks are a very simple, very effective pattern. They are self regulating. You get more setups in good times and fewer setups in bad. This is especially true if you require the sector and the overall market to also be in a trend. Ideally these would also be characterized as a persistent trend.

Persistent pullback's self regulating nature helps keep traders on track. When discipline breaks down, persistent pullbacks force us to stick with the trends instead of fighting them. Most importantly, the pattern will keep us out of the market when it is trendless.

## Pattern Application

The pattern works equally well on the long and short side of the markets. However, because they “slide faster than they glide,” you are more likely to find orderly persistent uptrends than downtrends. The best trades occur when the sector and overall market are also in persistent trends.

## For More Information

[\*Dave Landry's 10 Best Patterns & Strategies\*](#)

[\*The Layman's Guide To Trading Stocks\*](#)

## About The Author

Dave Landry has been have been actively trading the markets since the early 90s. In 1995 he founded Sensitive Trading, LLC, (d/b/a [www.davelandry.com](http://www.davelandry.com))--a trading and consulting firm. He is author of *Dave Landry on Swing Trading* (2000), *Dave Landry's 10 Best Swing Trading Patterns & Strategies* (2003), and *The Layman's Guide to Trading Stocks* (2010). His books have been translated into Russian, Italian, French, Japanese, Chinese, and Korean. He has made several television appearances, has written articles for several publications including *Technical Analysis of Stocks & Commodities*, *Active Trader*, *Currency Trader*, and *Traders Journal-Singapore*. He has been publishing daily web based commentary on technical trading since 1997. He has spoken at trading conferences both nationally and internationally. He holds a Bachelor of Science in Computer Science and has an MBA. He was registered Commodity Trading

Advisor (CTA) from 1995 to 2009. He is a member of the American Association of Professional Technical Analysts.

## **Background Information: Trading Pullbacks In Trending Markets--Some Details**

Obviously, all of the details about trading pullbacks cannot be covered in this article. Entire texts have been dedicated to the subject—I have written three. However, if you understand the following crucial concepts, then you will understand the crux of my approach. Referring back to the “Methodology In A Nutshell” graphic:

- a. Trend: Trend is the key word in the title of this section. It’s the most important thing. If markets are not trending then they should be ignored. And, ideally, for equities, the corresponding sector/other stocks within the sector and the overall market should also be trending.

Markets don’t always trend, so there will be times where there is no action to be taken. This can create performance anxiety for the individual trader looking for income or the fund manager who is under pressure to produce results. Although it’s beyond the scope of this article, I would be remiss if I didn’t mention the psychological aspects of being patient. For a trending methodology, the trader must be able to sit through extended sideways markets and resist the temptation to try to make something happen where no opportunities exist.

- b. Correction: For uptrends, the market must correct by moving to oversold. “Oversold” is a relative term based on the market’s previously measured volatility. A volatile market will have to pullback significantly to become

oversold. Conversely, a low-volatility market can pull back must less percentage wise but still be considered oversold.

- c. Entry: The trade is taken if, and only if, the trend shows signs of resuming. If it does not, the trade is avoided. This helps to avoid losing trades based on false moves. The further the entry is away from the current market price, the less likely it will trigger and more false moves will be avoided. In trading though, there is always a tradeoff. Higher entries give up more of the reversion to the mean move (i.e. the move from the oversold pullback back to the old highs). Further, if the longer-term trend does not resume, it's possible that an entry too far away from the current price would trigger just as the reversion to the mean exhausts itself.
- d. The protective stop. No matter how great a potential trade may look, there's always the potential that it might not work. Therefore, a protective stop is always used. Based on the volatility of the underlying instrument, the stop is placed far enough away to avoid the normal noise of the market in an attempt to ride out a short-term "swing" type move as the market reverts back to its mean.
- e. Partial profits (half) are taken when the profits on the initial trade are equal to (or exceed) the initial risk.
- f. The stop is then trailed higher as the position moves in our favor. Initially, the stop is trailed fairly tightly--usually on a one for one basis—to keep risks relatively low. Once the market has proven itself by hitting the initial profit target, the stop is then gradually loosened to hopefully ride out a longer-term winner.

Understanding this transitioning of the trailing stop from a short-term tight stop to a longer-term looser stop is crucial. It's what allows you to capture the occasional "homeruns." Without these, returns would be mediocre at best.

If you're looking for even more details, read further.

## For More Information

*[Dave Landry's 10 Best Patterns & Strategies](#)*

*[The Layman's Guide To Trading Stocks](#)*

## Contact

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# 8

## Part 8: Leading Signals with Lagging Indicators?

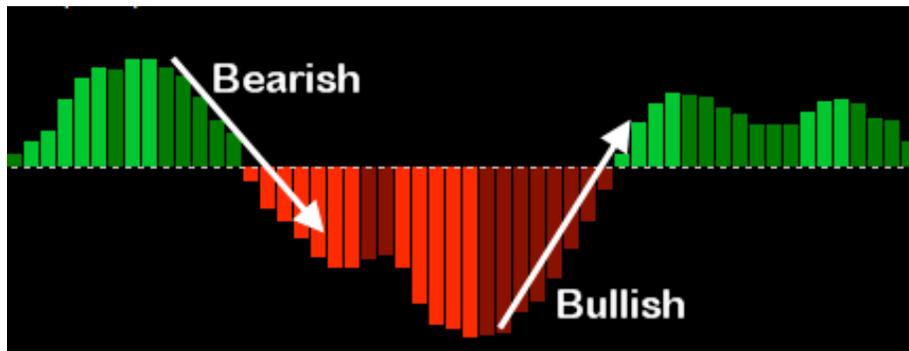
By Andrei Knight - fund manager, trading coach, and founder of *fxKnight.com*

**WE'VE ALL SPENT TIME** pouring over various indicators, trading systems, and other gizmos, trying them in various combinations, and often to our eventual frustration and disappointment.

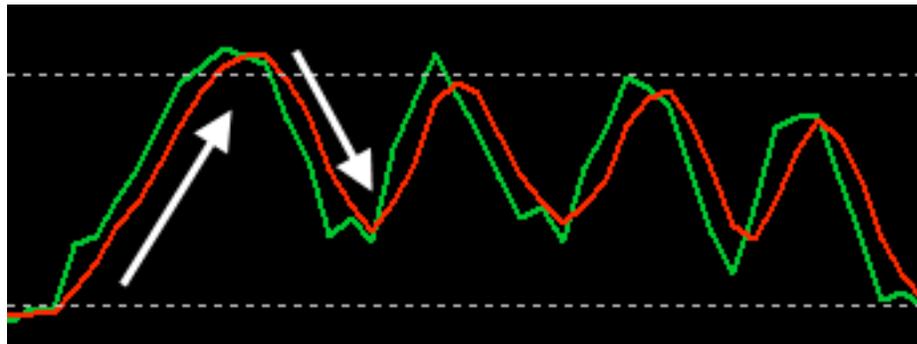
They all seem to work for a time, and then suddenly stop. What made them quit working? Are they broken? No... chances are, the market conditions have changed – and they often do – but you're still using the same indicators the same exact way. In other words, they no longer fit the situation.

### The Two Kinds of Indicators

No one really mentions this in discussions of indicators, but most of them actually fall into one of two groups. You have your *trend-followers*, which measure increasing or decreasing momentum, and you have *oscillators*, which cycle through bullish and bearish cycles or waves. On the trend-following side, you have indicators such as MACD (Moving Average Convergence and Divergence), OsMA (an Oscillator of Moving Averages), and ADX (Average Directional Index).



Oscillating indicators include things like the Stochastics, RSI (Relative Strength Index), and CCI (Commodity Channel Index). Stochastics oscillate between 20 and 80, the RSI between 30 and 70, and the CCI has 0 in the middle and oscillates between -300 and +300 – but the idea behind all of them is more or less the same.



Which is the best? Here's the cool part... *it doesn't really matter!* Use whichever you like. The important thing is to have one indicator from each group, and – here's crucial bit – to know *when* to use *which*.

How do we do that? Glad you asked!

## Evaluating Market Conditions

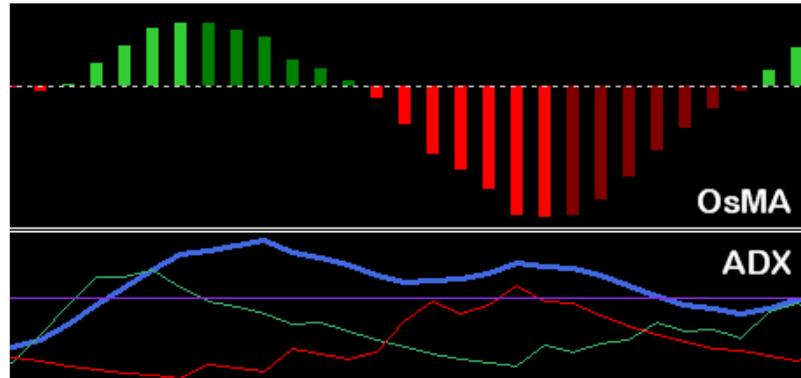
In order to pick the right indicator for the job, we first have to understand what the markets are up to. At any given moment, markets are doing one of three things: they can be trending, ranging, or reversing – and a reversal is nothing more than a new trend emerging in the opposite direction out of a range.



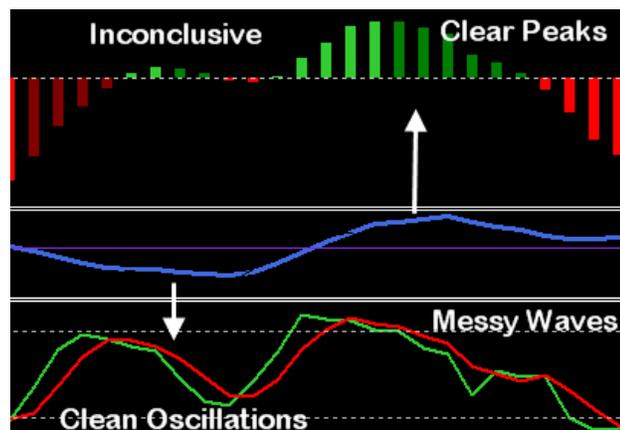
Sure you can probably look at a chart and figure out which of these it is (and if you're not sure, try a higher timeframe, or simply get out of your chair and look at the chart from the back of your room while squinting your eyes – it helps, *really*). But, in order to be disciplined traders, and follow a repeatable system, we have to take as much subjective judgment out of the process as possible. What we need is a “market conditions indicator”. And thankfully we have one, in the form of the ADX.

Wait! Didn't you just say that the ADX is a trend-follower? Well, yes, technically it is. If you color the +DI line green and the –DI red, and put the indicator right under a MACD with the standard settings (12, 26, 9), you will notice they are telling you almost the same data. When the green line is on top, your MACD histogram will be printing bullish bars, and when the red is on top, you will see bearish bars. When the +DI and –DI lines get further apart

you should see taller bars, and when they get closer together you will see shorter ones.



For our purposes, though, we're going to color the +DI and -DI lines black (or whatever the color of the background of your charts is), and simply focus on the average line. Set the number of periods being averaged to 14, and add a horizontal line at the 30 level. When the ADX is over 30, you are in a trend, and should switch to using your trend-following indicator (I prefer MACD or OsMA histograms here, as they are easier to see than the ADX's DL lines, especially when you have multiple charts open). When the ADX drops below 30, you have fallen into a range, and your oscillating indicator will most likely give the clearer, and *earlier* signal. It's that simple – pick the right indicator for each job, know when to switch them, and you will find them being much more accurate in their readings for you.



## Hold On... Aren't All Indicators “Lagging”?

In principle, yes. Indicators perform their calculations on changes in price. Therefore, price has to move first, *then* the indicator has something to calculate, and afterwards it displays the result. But this doesn't render them useless. Far from it!

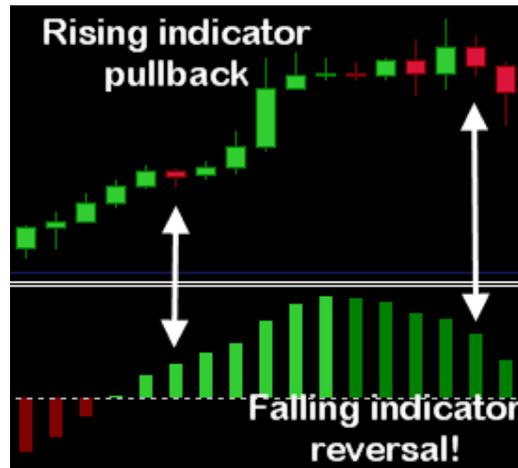
For starters, indicators should not be used to generate entry signals. They are used to *confirm* entry signals, once you think you've spotted a potential entry from the price action itself. Analysis begins with the chart itself, not with the things underneath it. In other words, don't try to lead with a lagging indicator. Price is always king.



Second, it is precisely their “lagging” nature (and we're really talking a matter of seconds here, folks – computers are pretty fast these days) which keeps us from over-trading, which study after study has proven is *the* number one cause of losses.

When we are in a trade, and price moves against us, we must decide if this is just a short-term retracement, or the beginnings of a longer-term reversal, in order to determine whether to stay in or get out. If price reverses but the indicator remains pointing in the original direction, then the counter-move is likely

to be short-lived. If, on the other hand, both price and indicator turn together, you're likely facing a reversal.



Again, *simple*. I like simple – because it *works*.

## Using Old Indicators in New Ways

Depending on how it is used, a “lagging” indicator can sometimes even give you *leading* signals. There’s no need to shuffle your system around and try or buy every new widget that comes along. The key to solid trading is using a few basic tools, but getting to know them and their responses really well. This is where practice and “screen time” come in.

Trending-following indicators can sometimes form a divergence. This is when price makes a higher high, a new peak, but the indicator’s peak fails to form a higher high, or when price makes a lower low, but the indicators fails to follow. This is usually a sign that your trend is at an end.



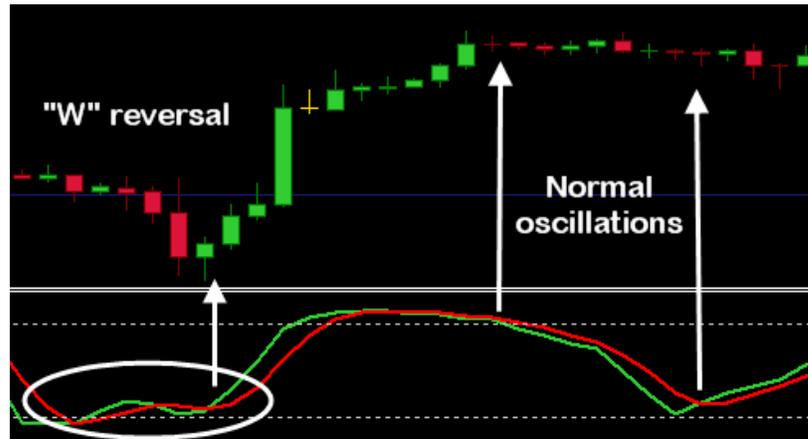
Sometimes, your trend-following indicator will go towards 0 in the middle, but then reverse and come back out. This is what is known as a “zero-line rejection” (or simply a ZLR for short). This is a sure sign that the current trend, even if ranging or retracing a bit, is about to resume and go even further. Often *much* further.



And, as you’ve probably guessed, a ZLR cancels a prior divergence signal, and a divergence cancels any prior ZLR. Each signal basically is valid until we get the next, new signal. Since both of these are significant signals, beyond just momentum increasing or decreasing, I tend to take notice of them even when the ADX is below 30.

Besides oscillating up and down to indicate bullish and bearish waves, oscillators also have their unique signals – when they

form Ms at the top or Ws at the bottom, they are often predicting a longer-term shift in overall direction.



Finally, just like on the price chart, I like to draw trendlines, triangles, and ranges (on both of my indicators) whenever I see them. Just as with price, a break of a trendline can foreshadow a significant change in the overall market conditions, often heralding the emergence of a new trend.



## In Conclusion

As you can see, very often it is not the indicator that's the problem, but how and when the trader chooses to put them to use. Hopefully this article has given you a few new and useful ideas on how to use your favorite ones! The best part is everything presented here can very easily be combined with

whatever trading system you may be using already to help confirm the accuracy of its signals.

Be sure to visit [fxKnight.com](http://fxKnight.com) for even more great trading tips and ideas!



*Andrei Knight is a fund manager, trading coach, and a highly sought-after speaker who has appeared at events including the World MoneyShow, The World Energy Forum, Traders Expo, IX Investor, and the International Traders Conference. He is the author of “Trading Forex for a Living” from Harriman House, and is featured in the forth-coming documentary “Fibonacci: Unlocking the Market Code”. He has appeared on CNN, CNBC, and contributes regularly to TradersLog, FXStreet, DailyFX, and the International Business Times, where he also sits on the advisory board.*

*Mr. Knight provides strategic market analysis for leading Swiss broker Dukascopy, and has previously worked for giants such as UBS (one of Switzerland's largest banks) and Deutsche Bank (trading the world's largest volume of forex transactions), as well as a prominent Los Angeles investment firm which manages funds for celebrities and other high net worth clients (named a top asset manager by Bloomberg). With his background as both a martial artist and a tournament chess player, he brings a unique perspective to the financial markets.*

*His website, [fxKnight.com](http://fxKnight.com), provides real-time streaming news, live chat, trading forums, custom software, training videos, and*

*award-winning educational services for active traders. He tweets regularly as [@BlackKnightFX](#)*



## Part 9: One Traders Journey

By Derek Frey

**STOPPED OUT AGAIN!** That was number 13 in a row and I thought 13 was my lucky number! It was the last straw. I was right to think I hated trading. I couldn't see how I'd be able to go on in this business for one more day. I wanted to pick up my laptop and smash it into the ground. Still, I was determined to succeed and just refused to quit, so again, I decided to give it one more try. I knew there were at least a few successful traders out there and I was determined to find or make a way to become one of them.

I started reading everything I could get my hands on about trading success written by those who'd actually achieved it. I spent four years only reading books about trading written prior to 1900. It really reinforced the "nothing new under the sun" idea. After a while I began to realize there were many commonalities between traders. Many things were "common knowledge" but still seemingly hidden in plain sight. The commonalities were not so much in the way they traded, not at all. In fact, every single one of them used a different trading system from the other, but what they did share in common was their overall view of what a market is and what is possible within it. They began to treat it as a set of probabilities rather than possibilities. That was part of the epiphany for me. Most new traders, myself included at the time, looked at the markets with eyes of wonder and hope. But it became clear that the pros did not see the markets this way at all. They recognized the overall opportunity the market presented, but they also realized the way to get to the possible was through the probable.

One of the first things all traders hear and try to learn is, "don't trade emotionally". This is fine in theory, but the human animal is an emotionally driven machine and we can no more stop having emotions than we can stop breathing. Is it possible that one could completely remove emotion from trading? Yes. Is it probable? No. Still it remains true that trading with nothing more than pure emotion is also not likely to be profitable. So how do we deal with this? I went back to the masters and looked at how they dealt with it, and here again were a few keys hidden in plain sight.

The first was they all had some kind of mechanical or semi-mechanical system they followed as seriously, if not more so, than they did

their religion. By system I mean some sort of repeatable way of identifying select trading opportunities in whatever markets they were trading. They each had some kind of system that told them specific parameters to look for and they only traded when those were present. The interesting thing this did was to remove much of the emotion because the trader was not actually making the decision but rather the system was. So the trader's emotions were not as fully engaged as they would be if it was based on a "hunch", or idea. This level of detachment from the trade itself allowed them to ultimately be repetitive even in the face of the occasional losing streak.

That was the second key. They each repeated the same basic trade set up or set ups over and over again without fail, therefore generating the consistent results that all traders strive

**Many things were  
"common knowledge" but  
still seemingly hidden in  
plain sight.**

for. They realized that consistency was not something that traders got, but rather something they did. Consistency was not really an effect but rather a cause. Most importantly they kept going even in the face of a string of losses. They knew that the only way to realize the statistical advantage that lay within their system was to keep trading. This brings us to the next key, patience.

Professional traders realized that successful trading was not going to come from being a hero and betting the farm on a few trades, but rather the sum total of many thousands of trades over a much longer period of time. They realized that staying in the game was clearly the most important thing and the only way to ensure that was by keeping leverage low and risks clearly defined and limited on EVERY trade.

I had “discovered” the keys that were hidden in plain sight, but I still had no idea how to put them to use. I knew I needed a mechanical way to find probabilities not possibilities. I then needed to repetitively use that system until I realized it’s statistical advantage while keeping leverage to a minimum and risks clearly defined and limited.

It sounded easy enough, so I started using any and all methods I could that had some kind of verifiable edge. Things that most of you are already familiar with like breakouts, trend following, moving average crosses, etc. Still, I struggled staying consistent. I suddenly realized there had been one other key I’d overlooked. It was also hiding in plain sight. Remember when I said each trader used a different method? I started thinking about this and wondered how that could be. I re-read “The New Market

Wizards” by Jack Schwager (which is a fantastic book) in which at the end he has a brief “Personal Reflection” where he says the following:

“I am frequently asked whether writing this volume and the first Market Wizards helped me become a better trader. The answer is yes, but not in the way people expect when they ask the question. No trader revealed to me any great market secrets or master plan unlocking the grand design of the markets... For me, the single most important lesson provided by the interviews is that it is absolutely necessary to adopt a trading approach precisely suited to one's own personality.”

Ah Hah!!!! There it was. Even though I'd found systems that worked both mathematically and for other traders, I'd been unable to make them work for me. Now I understood why. It was simply that they did not fit my personality.

Think about it this way. Are you going to repetitively do something that by its very nature goes against your personality? I don't just mean in trading, but in anything in life? Of course you're not. And how could one expect consistent results without acting consistently? Clearly you could not. So I finally had all the pieces of the puzzle and I must say they were not at all the pieces I thought I was looking for when I first started on my journey. Since I now finally knew what I was looking for, I set out to find it.

Here again I still went up a lot of blind alleys and had a number of “false starts” but I finally found something that fit all the parameters and most importantly, fit my personality - Vibratory

Harmonics and the patterns therein. Right away it sounds both esoteric and complicated, and frankly it is. But I found a way to take all the great science and math that had already been done by much greater minds than my own and exploit it for my own benefit. In much the same way Jeff Gordon is not the smartest guy or engineer on his NASCAR team, but he gets to use the collective knowledge of all the team members to his benefit simply by hopping in the car that they built.

When I was finally introduced to Harmonic Patterns I quickly realized that I was being handed the equivalent to a championship winning car much like Jeff Gordon was. But just like him, having a car that can win is not enough. It matters how you drive it. And while these harmonic patterns were anything but a secret, it was the rules that I'd devised around them that gave me both my edge and my ability to be consistent just like Jeff Gordon. These Harmonic Patterns have been proven to offer greater than a 70% edge when used properly. The best part was there were only a few rules and they were clear and easy to follow along with (at least for my personality). So what I am going to do is lay out the exact rule set that I started with. I have since made some minor changes but these original rules served me well and still do. Think of these as a starting point not an end.

- 1) Identify one of the four major Harmonic Patterns (Gartley, Bat, Butterfly, or Crab).
- 2) Once a pattern is found measure the risk to reward ratio to determine if it is worth pursuing further. Rewards should be at least 1.5 times the risk, and preferably 2 times or greater.

- 3) If the Risk reward is acceptable then take the trade if not return to step 1.
- 4) Repeat these steps for no less than 1,000 trades.

The complete instructions that I use can be found here:

### [Harmonic Master Trading Guide](#)

So once I finally started following the above rules my trading shifted from a wild emotional rollercoaster ride to an almost emotionless systematic execution of my strategy. I knew all along that while trading is not easy it is, in fact, simple. Einstein said it best when he said **“Everything should be made as simple as possible, but no simpler.”** Trading success comes down to finding a verifiable “edge” that you can be consistent with and then systematically applying it over time until you realize the fruits of the statistical edge that lies within. Realizing this simple truth that was hidden in plain sight from me for many years has turned me from being just an average trader to a trader who recently won a trading contest in December 2011 with a [199% return](#). I hope that by describing my journey that it both helps and inspires other traders to never give up!



# BONUS SECTION

## Part 10: Managing Money to Stay in the Market

By Ann C. Logue, author, *Day Trading for Dummies* (second edition, Wiley 2011)

**TRADERS LOVE MILITARY METAPHORS:** they keep copies of "Art of War" on their bookshelves and talk about attacking the market. And, they need to keep some powder dry.

You can't trade if you don't have money. Margin will only get you so far; you have to have some cash in your account before the broker will extend you credit. Money management is the process of determining how much of your account you should place on each trade, and it can make or break you as a trader. The better you manage your account, the more profits you can gain from your winning trades. You will be able to keep powder dry so that you can charge forward another day.

### Risk, Return, and Ruin

Obviously, you trade in order to make money. Still, every trader has losing trades, bad streaks, and negative returns. The down periods can be long and miserable, too, but you can survive them. The trick is to have more winners than losers. If one loser wipes out all your capital, though, you won't be around for the next winner.

Traders take risk in order to get a return. Different traders have different preferences for risk. The market, meanwhile, is relentless. It cares nothing for your risk preferences, it just does what it does. Some days, that's great. But other days, that's not. A

long series of losing trades can ruin any trader That's why a key starting point has to be finding your probability of ruin. How likely is your account to be annihilated?

The first number you need to find is your advantage, which is the percentage of winning trades over losing trades you are likely to have. It should be more than 50%, but it may not be a lot more. You can get this from your trading diary or your back-testing data. If you find that 55% of your trades are winners and 45% of your traders are losers, then your advantage is 55% - 45% 10%. Using this number (call it  $A$ ) and the number of trades you can make in a day (which you can call  $C$ ), you can find your probability of ruin:

$$R = \left[ \frac{1 - A}{1 + A} \right]^C$$

If your advantage is 10% and you can make 20 trades in a day, then your probability of ruin is:

$$R = \left[ \frac{1 - .10}{1 + .10} \right]^{20} = 1.8\%$$

In other words, on any given day, you have a 1.8% change of losing all the money that you trade that day. If you trade all of your money, then that day will bust you. You can reduce your risk of ruin by finding a strategy that gives you a greater advantage or by making more trades, if those are feasible for you.

Calculating the risk of ruin is your first step. The higher your number, the more money management matters to your success.

### Sizing Up Your Trades

There are several different systems used for money management, and your choice and how you apply it will be as much art as science. Each system starts with a mathematical calculation that you can work out on your own or through the money management tools found in most day trading software packages. And each will put limits on how much money you commit to a trade in order to limit the damage done by your losers.

Money management only works if you stick to it, and some traders are reluctant to do that because they think that it will keep them from making good money on the best trades. Why not throw all the funds you have at a sure thing? Well, because if the sure thing turns out to be a pathetic loser, you've lost it all.

Moreover, if you have all of your money committed to one trade, then you have no funds to place on the next trade, which might be even better. Money management helps ensure that you have

funds to place on good trades by limiting the dollar hit of losses on bad trades.

Three of the easier systems to use are fixed fractional and martingale. They are hardly the only systems out there, but the other systems that traders use are usually variations of these.

Under the fixed fractional system, you first determine how much of your account you want to risk on each trade. This will depend in part on how many trades you can make at once with your strategy, and it should be 10 percent or less in most cases. You need two more numbers: the dollar value of your account and the dollars you could lose on a given trade. Suppose you have an account with \$50,000 in equity and you trade stock using stop loss orders to keep your risk of loss on any share of stock to \$5. (Trade risk has to be a positive dollar value, so if you think of percentage loss, convert it to dollars for any given trade to do the calculation.) If you have decided to trade only 8 percent of your account, the number of 100-share orders you should trade can be found with this equation:

$$N = f \left( \frac{\text{equity}}{\text{trade risk}} \right)$$

If you plug in the account data,

$$N = .08 \left( \frac{\$50000}{\$5} \right)$$

you get an answer of 800. In other words, if you limit your losses to \$5 per share, you can trade up to 800 shares at a time. Worst case, you may lose \$4000, but you will still have \$46,000 available for the next trade.

Under fixed fractional, the second trade would be adjusted for the results of the first. If you now have \$46,000 in your account, you can trade 736 shares (which would probably have to be rounded down to 700). If you made \$4000, though, your account equity would be \$54,000, giving you a trade size of 864 shares. That would most likely have to be rounded down to 800, but over time, you'd be able to increase your position size.

The martingale system was developed centuries ago for casino gambling, and it is popular with many traders. You start with a trading dollar limit, so if you have a \$50,000 account and want to limit your first trade to 8 percent, then your trade limit is \$4000. You open the day with a \$4000 trade. If it pays off, then enter your second trade at \$4000. If it does not work, then place a second trade for twice the amount - \$8000. If the \$8000 trade works, your next trade goes back to \$4000. If it does not, then double it again - to \$16,000. Martingale has one major drawback - you can run out of money if you have a series of losers, which

is possible when the financial markets are under stress and rising or falling rapidly. In ordinary trading conditions, though, it can work quite well.

The fixed fractional system is one of several that limit the percentage of money that you can commit to any one trade. Any of these will keep you from running out of money, which is especially important in volatile markets. Of course, this is a mathematical formula; your account equity could become so small that you cannot meet a minimum trade size. Martingale can increase your return over time, if your account size is large enough, your initial trade is relatively small, and the returns are normal.

### Thinking Beyond Your Trading Account

If your account size declines enough, then you are out of the trading game. It happens; even people with day jobs face layoffs and firings. That's why there's a third component of money management that goes beyond risk calculations and trade size: pulling funds out of your trading account. Come up with a schedule for withdrawing a percentage of your equity and moving it to an investment account: a tax-advantaged retirement account, a long-only mutual fund, even bank CDs. If your day trading is your occupation, determine a regular salary amount and transfer that to your checking account.

If you aren't trading in order to make money, then take up World of Warcraft instead. It will be a lot safer!

The enemies of the trader are doubt, fear, and greed. Money management can defeat them. If you know your risk of ruin, you can conquer fear. If you have a set system for sizing your trades, you can reduce your doubt. And if you build assets outside of your trading account, you won't need to be greedy in your trades.

Like war, trading is as much about mentality as it is about tactics. Your armor is money management.



## Part 11: The Basics of Trader Tax

By Robert A. Green, CPA

**BY DEFAULT, THE IRS LUMPS ALL TRADERS** into the category of “investor tax status,” and investors get penalized in the tax code, with restricted investment interest and investment expenses, capital-loss limitations (\$3,000 per year), wash-sale loss deferrals, no retirement plans and more. Business traders with “trader tax status,” however, are entitled to several tax breaks. (See our “Golden Rules” for qualifying for trader tax status.)

To qualify for these tax breaks, business traders must first learn these mostly unpublicized rules, navigate around the vague, yet strict business-qualification requirements, make certain tricky tax elections on time, and execute the strategies properly on their tax returns. It’s difficult to sort through different tax-treatment rules and tax rates for securities, stock options, ETFs, commodities, futures, indexes, options on futures, forex, physical foreign currency, foreign futures, precious metals, and other types of instruments. It’s often hard to tell which financial instrument falls into which category. Yet the burden is on you, the taxpayer, to get what you’re entitled to. That may be unfair, but rules are rules — take them or leave them!

In this tax primer, we’ll cover new rules for 2011 tax returns, tax strategies for traders, retirement plan options, and reporting your funds in foreign accounts. The details here offer a quick

overview — for more in depth coverage, check out *Green's 2012 Trader Tax Guide* and our Web site ([greencompany.com](http://greencompany.com)).

## **New rules for cost basis reporting**

New tax legislation effective January 2011 requires brokerage firms to report cost basis and holding periods for securities transactions. These new rules brought forth Form 8949, which is proving to be a real challenge for many traders. Form 8949 is constructed to mirror and receive the new 1099-B with cost-basis reporting. Part A is for cost-basis reported, Part B is used when cost-basis is not reported, and Part C is used when there is no 1099-B. We've been seeing a major problem: The 1099-Bs brokerages have issued aren't matching up with our clients' calculations. We cover this in great detail on our Web site: <http://tinyurl.com/gtt-costbasis>. If you're in this mess, please consult with us for the best way to proceed. We highly recommend TradeLog software for these calculations.

## **Sole-proprietor business traders and Section 475 MTM**

Some business traders are satisfied to operate as sole proprietors (with a Schedule C) because it appears less complicated, they can claim trader tax status after year-end, and it often costs less than other methods. This group is able to deduct business expenses, which generally save a trader up to \$8,000 per year in taxes. (Note: Over the years misinformation from other service providers suggested traders could easily deduct pre-business education expenses in full. They are very wrong. Education is a material expense for traders and it's often incurred before a trader establishes trader tax status.)

If business-expense treatment is only saving a small amount in taxes and if you're a close call on trader tax status, it may be prudent in this IRS environment to skip trader tax status for your 2011 tax return. Keep in mind that Schedule Cs draw more IRS attention because business traders have trading gains and losses reported on other tax forms like Schedule D.

It's a pity to get stuck with a large wasted trading business loss when you could otherwise have made the necessary timely elections to have Section 475 MTM ordinary-loss treatment (with trader tax status as a prerequisite), generating full and often immediate federal and state income tax refunds. Unutilized or wasted trading losses are the biggest pitfalls for traders. You need capital gains to use up capital-loss carryovers, and you want Section 475 MTM if you have new trading losses. How can you do both? It's not easy, so consult a trader tax expert when dealing with this challenge.

## Entities for traders

Profitable business traders often need a separate legal entity to deduct contributions to retirement plans and health-insurance premiums — i.e., adjusted gross income (AGI) deductions. Losing and part-time business traders can also use separate entity tax returns to deflect IRS prejudice against Schedule C tax filings. There are many other reasons to have an entity, such as late-year mark-to-market (MTM) accounting elections, generating performance records to attract investors, avoiding Form 8949 problems (entities don't file this form), and business continuity. We strongly recommend entities for business traders this year. Skipping an entity may save you a few hundred dollars in the

short term, but it could cost you thousands over just a few years.

Our incubator fund strategy is ideal for traders who want to start an investment management business at a lower cost than a for-profit hedge fund. You can include friends and family in the incubator fund providing you don't charge compensation for investment management services. You're allowed to be reimbursed for your trading expenses.

### Retirement plans for traders

Retirement plans provide significant tax savings for traders in several different ways. Annual tax-deductible contributions to retirement plans generally save traders more in income taxes than they cost in self-employment (SE) or payroll taxes. A married couple can save up to \$17,000 with Individual 401(k)

### Our "Golden Rules" for trader tax status:

To qualify for trader tax status, the trader must:

- ★ Trade full time or part time, all day, every day.
- ★ Spend more than four hours per day, almost every market day working on his trading business.
- ★ Have few to no sporadic lapses in the trading business during the year.
- ★ Execute trades on more than 75 percent of available trading days.
- ★ Make close to 500 round-turn trades per year on an annualized basis.
- ★ Make mostly day trades or swing trades.
- ★ Have the full intention to run a business and make a living.
- ★ Have significant business tools, education, business expenses, and a home office.
- ★ Have a material account size.

plans established for each of them. SE or payroll tax is charged on the declared earned income component only. (One exception: Members of a futures exchange are subject to SE taxes on their trades made on those exchanges.)

Traders can also actively trade a retirement plan, building up cumulative tax-free returns until retirement distributions are taken out. With a Roth IRA, those tax savings become permanently tax free. Roth IRA conversions are also a good idea. The income threshold rule was repealed starting with the 2010 tax year, opening the door to many other taxpayers. Now, you don't need to wait until year-end to see if you qualify.

Traders should avoid the pitfall of taking early withdrawals from regular retirement funds; this is often a mistake made by those looking to fund a trading business. Early withdrawals from retirement plans are subject to regular income taxes (at higher ordinary tax rates) plus a 10-percent excise tax. *Green's 2012 Trader Tax Guide* shows how to tap these funds earlier than age 59½.

You can deduct your investment expenses and losses within the retirement plan, rather than suffer investment expense restrictions on your taxable account. Usually, an intermediary trust firm is required to allow this feature for direct payment or reimbursement of investment expenses on behalf of the retirement plan. Few brokerage firms allow this feature in their prototype plans.

## Plan ahead

Planning your taxes ahead of time is also important for traders. Whether it's pre-paying state income taxes for an additional tax deduction (without triggering the alternative minimum tax [AMT]) or accelerating expenses and deferring income to defer taxes — it's important to get a handle on trader tax status. With Bush-era tax cuts expiring at the end of 2012, tax hikes for 2013 may be significant. Conversely, if Congress and the President can make a major tax reform deal in 2013, tax rates may be lower than the 2012 rates. 2012 year-end tax planning will be a big challenge.

Futures and *some* forex and ETF options trading can benefit from lower Section 1256 60/40 tax rates, meaning trader tax status is mainly beneficial for business expense and AGI deductions. If your business expenses are low and you already saved enough for retirement and are on Medicare coverage, or you have tax-deductible health insurance through your spouse, you don't need to push the envelope on trader tax status.

### **Compliance is the only option**

Many traders have offshore bank, trading and investment accounts or they are involved with family assets offshore. The IRS has raised its game big time for foreign compliance, busting taxpayers left and right over the onerous reporting rules. Our content expands on initiatives including Report of Foreign Bank and Financial Accounts (FBAR) and the offshore voluntary disclosure initiative (OVDI). All traders need to comply — otherwise, huge penalties and criminal fines could result.

Not taking care of your tax affairs can be costly. Filing a sloppy tax return with tax treatment or trade accounting errors, or reporting trades on Schedule C, can initiate a painful tax exam. An exam can cause the IRS to challenge your trader tax status in multiple tax years. Don't ignore tax reporting — the IRS will surely catch up with you, especially with the beefed-up 1099-Bs this year.

