CONNORS ON ADVANCED TRADING STRATEGIES

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INTRODUCTION

This book was written with the me of 10 years ago in mind. My goal has been to produce the book I wish I had a decade ago when I made a full-time commitment to my trading.

Over the years I have read hundreds of books on investing and trading. The ones I learned the most from were written by individuals who removed their egos from their writing. Their books were written simply, and without the need to show the reader how smart the authors were. I hope to do the same here. I suspect, if I tried, I could bore you with 12-letter words, run-on sentences, and I could quote Nietzsche and Plutarch to show you how intelligent I am. I could drop names of some of the financial market celebrities I barely know, and I could fill the back of the book with a huge bibliography. But I will not, for as I mentioned earlier, I am writing the book as I would have wanted it myself, and I suspect my need to keep things simple and to the point are also yours.

This book is a compilation of two years of my monthly newsletter, the *Professional Traders Journal*. I have taken the best strategies and updated them for you. I have also added new strategies, concepts, and thoughts to hopefully bring the research to a new level.

The majority of the strategies presented were originally created by my research firm, Oceanview Financial Research. I have attempted to give reference and credit to those individuals from whom other strategies were derived. If I missed anyone, I give you my strongest apologies.

Good work must be acknowledged and only I am to blame for any oversights.

I would like to thank Mark Boucher, Fernando Diz, Jeff Cooper and Derek Gipson for their contributions. They have helped make a good publication better. I would also like to thank my editor Bill Masciarelli, Bob Pisani, Danilo Torres, Irene Golden, Judy Brown, David Landry, Joe Calandro, and Jeff Cox for their invaluable contributions in helping create this book.

Finally, I would like to thank my wife Karen for again lovingly putting up with my nonsense while writing a book. Thanks also to my daughter Brittany, who is now the only ten year old, who knows how to create historical volatility charts from a Bloomberg terminal, and my daughter Alexandra, who is, as far as I know, the first five-year-old to help collate a financial markets trading book. I marvel at both of you and can only wonder in amazement what the future will bring.

CHAPTER 1

THE BASE

This first chapter is more important than the trading strategies chapters. It will provide you with a basis for understanding why a small handful of players make extraordinary money trading while the majority do not. This chapter will create the foundation you must have to maximize the effectiveness of the strategies which are the heart of the book.

I have traded the markets directly or indirectly since I was in college more than twenty years ago. I began, as most traders do, by searching for the perfect trading system. If I told you that I have outgrown this pie in the sky pursuit, I would be lying. I still wake up in the middle of the night and go to my home Bloomberg terminal to test something that I believe will change the course of trading history. I suspect that if I am still alive 50 years from now, I will be doing the same.

As I have grown older, I have learned to lessen my expectations. I have come to realize that it is good to think big, but success in trading is not dependent on finding the holy grail trading system. It is much more dependent upon having a trading method that meets the following three criteria:

1. The method must be conceptually correct.
2. It must provide you with a small "edge."
3. Most importantly, the method must be able to manage the "bad tail."

Let's look at each component in further depth.

COMPONENT 1—THE STRATEGY MUST BE CONCEPTUALLY CORRECT

If a strategy is not based upon inherently correct market principles, it is probably useless. I suspect that if I looked at the schedule of every Major League Baseball team over the past decade, I could find some sort of pattern that predicted market behavior. An example would be when the Seattle Mariners win by two runs or more on Tuesday night, and Randy Johnson doesn't pitch the game, soybeans rise 72 percent of the time the following day. You may laugh at this example (don't trade it), but I have seen methodologies and strategies sold to traders that make as much sense as the one above.

Markets have built-in characteristics. For example, strongly trending markets will pause, pullback, and then continue their original move; in bear markets, sessions tend to close below their opening; low volatility is preceded by high volatility, etc. Any middle level student of the game has come to know these and similar truths. When you read the upcoming chapters, you will see that the inherent market features I have just listed and others like them are the basis of my strategies.

I strongly believe that in order to improve upon your trading you must only trade strategies that exploit inherent market characteristics.

COMPONENT 2—THE EDGE

Over the past 100 years, which industry has been one of the most consistently profitable? The insurance industry. Why? Because insurance companies have a built-in "edge." They can statistically show that based on a normal distribution of events—mortality rates, average life span, etc.—they will profit in the long run. Casinos and bookmakers work from and profit from the same long-term statistical probabilities.

In sports betting, there is a 4.5 percent edge to the house. It is even higher on parlays, teasers, etc. Last year an acquaintance of mine used this edge to earn more than $12 million from his offshore sports betting establishment. Even though it is a bit more complicated than this, this gentleman needs only to match-up both sides of a game and he is assured a profit. The same type edge holds truc for the casinos in craps, roulette, and any other game of chance. A well-know casino executive wasn't kidding when he said, "When a sheep is on the way to the slaughter, he *may* kill the butcher . . . but we always bet on the butcher!"

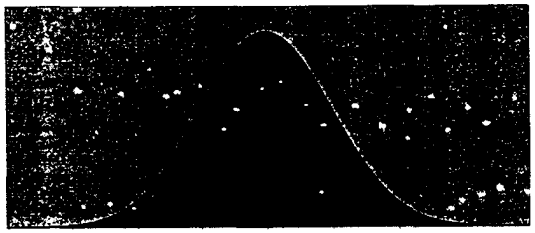
In trading, the edge immediately goes to players like the market makers who buy on the bid and sell on the offer. One does not need to be a genius to figure out that the guy who buys at 46 and can immediately sell it at 46 1/2 has the edge over guys like me who have to buy at 46 1/2 and can only immediately sell it at 46.

Your strategies must provide you with some sort of edge. It does not have to be big! The casino's edge is usually only a few percentage points and the edge for the market maker in the previous example is less than 1.5 percent. This small edge is enough to make one rich if the opportunity arises enough times and if you can conquer the third component which is . . .

COMPONENT 3—YOU MUST MANAGE THE BAD TAIL!

This is the single most important and critical point I will make in the book. It must be burned into your memory. Anyone can make money when things work out as they *normally* should. The majority of traders who blow-out, do so when they succumb to the "it-will-never-happen-to-me" syndrome.

Let's look at a bell curve to understand this further.



As you can see, normal events occur around 67 percent of the time. In market terms, this means that prices will fall within one standard deviation of their mean (average) 67 percent of the time within a specific time frame. When this happens, (approximately two-thirds of the days are like this) one's methodology makes some money and loses some money. As we move further and further away from the mean we get into the areas where the large profits or substantial losses occur. This is when our nor-

mal $200/trade edge makes $5,000 or loses $5,000. When our methodology makes $5,000, we are geniuses, and when it loses $5,000 it hurts badly, but usually not enough to wipe us out. It is when a trade occurs on the "very edge" of the tails that the rumor mill gets cranked up. When the trade lands on the **"good tail,"** it becomes the story of the trader who turns $10,000 into over $3 million in one option trade (a true event told to me by a friend who handled the trade) and on the other end of the spectrum, it is the well-known money manager who recently sold thousands of naked puts into a severe market decline and turned his client's money into dust after a decade of stellar performance **("the bad tail").**

My main concern for you (and for me) is how to manage the bad tail. The risk of ruin can never be eliminated but it can be greatly lessened when the bad tail occurs. It is mostly done with protective stops, it is done with spreads on options (instead of a naked position), and it is done with adjusting your trade size to reflect current volatility (see Chapter 5). As you will see, trading 1000 shares of a stock that has a current volatility of 10 percent is vastly different than trading the same stock when its volatility rises to 40 percent.

There are many unsuccessful traders who grind themselves to death because they do not have an edge. There are more traders, though, who die because of one reason: they did not manage the bad tail!

One more point: when creating market strategies, you must realize that market generalities are useless. A "market generality" is different from a conceptually correct market characteristic. For example, most traders believe that sustained TRIN readings under one are bearish and sustained TRIN readings above one are bullish. I have yet to see a money manager take this information and consistently make money from it. Other examples that you have heard include fade the morning move, buy the market after lunch, go long heating oil in the fall, buy the breakout-fade the test, etc. We can all name many more generalities, but I suspect you get the point.

Before you trade "market lore," ask yourself, "Why isn't everyone rich if something so simple is true?" In order to gain an edge over some of the smartest people in the world, you cannot trade generalities. You must step outside the box and think differently. This is easier said than done, but as you will see from the strategies in the upcoming chapters, the best ones were conceived by looking at things from a perspective that is decidedly different.

SECTION ONE

S&P AND STOCK MARKET TIMING

The strategies in this section identify when the stock market is at psychological extremes and likely to reverse. The strategies, "Connors VIX Reversal I, II, and III," "TRIN Thrusts," and the "Percent Advance/Decline Indicator" are among my favorites for trading the stock market and stocks. They identify times when fear or greed are at maximums and market reversals are likely to follow.

James Cramer, who is one of the best traders on Wall Street and oversees a terrific web site, TheStreet.com, is a master at instinctively identifying these periods. In a recent article he was quoted as saying "I'm neither bull nor bear. I try to take advantage of emotional swings in stocks that are probably unjustified by fundamentals." Though I do not personally know Cramer, based upon his track record, I suspect his abilities to identify market extremes—to smell the fear and punish the greed—are as good as they come.

I do not possess Cramer's magic touch. I need to rely on some sort of statistical evidence to confirm my instincts at these extremes. The following strategies are among my best and are the ones I use to "smell the fear and punish the greed." Before trading these strategies, you should be aware of the risks involved in trying to identify large market reversals. You are many times using your face to stop a runaway train and when you are wrong, you will be punished. Your largest profits, though, will come when you are correct. Therefore, I strongly recommend using some type of money management strategy combined with these signals.

One final note: The testing in the following chapters show the results using $500 per contract point on the S&P's. Due to a recent split, the value is now $250 per contract point. Also, even though I am publishing mechanical results, none of my methods are intended to be mechanical systems, nor do I trade them as mechanical systems. I use them only to help me identify a potential directional bias in upcoming days.

CHAPTER 2

CONNORS VIX REVERSALS

In 1994, when Blake Hayward and I wrote *Investment Secrets of a Hedge Fund Manager*, we included a chapter entitled, "New Markets, New Indicators." Among the strategies mentioned in that chapter was one which incorporated the VIX indicator. I mentioned that up to that point markets made very short-term tops when the VIX dropped under 11 percent and very short-term bottoms when the VIX traded above 15 percent. Because the indicator was so new, I felt it was too soon to blindly fix upon those levels, but the concept certainly had promise.

Since that time, and especially after 1995, the normal daily trading range for the VIX has greatly increased. In this chapter, I will show you how I have adjusted the parameters of the indicator to identify one- to three-day market tops and bottoms. I have also included more than four years of test results. We will also look at how to apply the readings to trade the S&P's and the stock market.

CONNORS VIX REVERSAL I

The VIX (CBOE, OEX, Volatility Index) reflects a market consensus estimate of future volatility based on "at-the-money" quotes of OEX index options. Periods of low volatility (a low VIX reading) basically reflect a quiet, rising market, whereas periods of high volatility (a high VIX reading) are associated with sharp market sell-offs.

The VIX is used as a contrary indicator. The higher its reading (and hence the more fear in the market), the more likely the market is reaching a short-term bottom, and the lower the reading, the more likely the market is reaching a short-term top. In my opinion, due to the increasingly speculative role that OEX options have assumed, *the significance and the reliability of the VIX as a market timing indicator have greatly increased over the past few years.*

Until now, most traders have used predetermined static bands (as I did in 1994) to identify what is a "high" reading and what is a "low" reading. Although this works, one never knows if those bands are truly reflective of today's market or if they really only reflect how markets reacted in the past. I endeavored to create a way to look at the VIX only within the context of its very recent price action and settled on the relative VIX action of the previous fifteen trading days. I then addressed the matter of the indicator reaching an overbought or oversold condition but continuing to become even more overbought or oversold. Finally, I added a feature that identifies when market sentiment has reversed intraday from an extreme reading. From these pieces comes the "Connors VIX Reversal I."

Here are the rules:

FOR BUYS

1. Today the VIX must make a 15-day high.
2. Today, the close of the VIX must be below the open.
3. If Rules 1 and 2 are met, buy the S&P's (or the market) on the close of today. This will have to be done at the same time Rule 2 is met and in the last few minutes of trading.
4. Hold the position at least one to three days.

FOR SELLS

1. Today the VIX must make a 15-day low.
2. Today the close of the VIX must be above the open.
3. If Rules 1 and 2 are met, sell the S&P's (or the market) on the close of today. This will have to be done at the same time Rule 2 is met and in the last few minutes of trading.
4. Hold the position at least one to three days.

FIGURE 2.1 CBOE OEX Volatility Index—Here Is What a Setup Looks Like

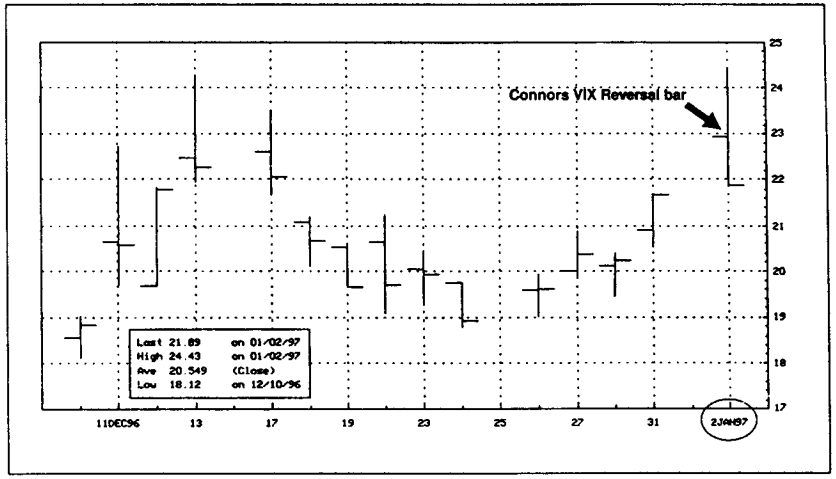
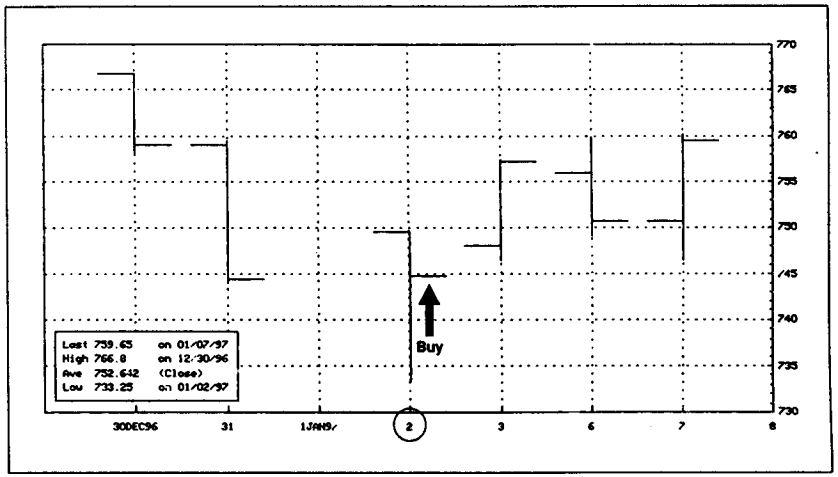


FIGURE 2.2 S&P 500 Futures



Before looking at the results, let's look at the basis of the rules:

- Rule 1 overcomes the weaknesses inherent in having a predetermined VIX buy and sell zone. We now have a dynamic (as opposed to static) indicator which is truly reflective of current market conditions.
- Rule 2 helps us avoid markets which become overbought/oversold and then continue to move further in that direction. By waiting for the VIX index to reverse intraday, we are identifying a definite *change in market sentiment* occurring at extreme levels.

Let's look at the results:

CVR I S&P 500 Index—CME—Daily—01/01/93–10/01/97

Performance Summary: All Trades

Total net profit	$ 81,400.00	Open position P/L	$ 0.00
Gross profit	$ 151,175.00	Gross loss	$ -69,775.00
Total number of trades	72	Percent profitable	65%
Number winning trades	47	Number losing trades	25
Largest winning trade	$ 16,950.00	Largest losing trade	$ -9,275.00
Average winning trade	$ 3,216.49	Average losing trade	$ -2,791.00
Ratio average win/average loss	1.15	Average trade (win and loss)	$ 1,130.56
Maximum consecutive winners	7	Maximum consecutive losers	3
Average number bars in winners	3	Average number bars in losers	3
Maximum intraday drawdown	$ -18,275.00		
Profit factor	2.17	Maximum number contracts held	1
Account size required	$ 18,275.00	Return on account	445%

Performance Summary: Long Trades

Total net profit	$ 52,425.00	Open position P/L	$ 0.00
Gross profit	$ 110,175.00	Gross loss	$ -57,750.00
Total number of trades	50	Percent profitable	64%
Number winning trades	32	Number losing trades	18
Largest winning trade	$ 16,950.00	Largest losing trade	$ -9,275.00
Average winning trade	$ 3,442.97	Average losing trade	$ -3,208.33
Ratio average win/average loss	1.07	Average trade (win and loss)	$ 1,048.50
Maximum consecutive winners	6	Maximum consecutive losers	2
Average number bars in winners	3	Average number bars in losers	3
Maximum intraday drawdown	$ -18,225.00		
Profit factor	1.91	Maximum number contracts held	1
Account size required	$ 18,225.00	Return on account	288%

Performance Summary: Short Trades

Total net profit	$ 28,975.00	Open position P/L	$ 0.00
Gross profit	$ 41,000.00	Gross loss	$ -12,025.00
Total number of trades	22	Percent profitable	68%
Number winning trades	15	Number losing trades	7
Largest winning trade	$ 12,100.00	Largest losing trade	$ -3,675.00
Average winning trade	$ 2,733.33	Average losing trade	$ -1,717.86
Ratio average win/average loss	1.59	Average trade (win and loss)	$ 1,317.05
Maximum consecutive winners	5	Maximum consecutive losers	2
Average number bars in winners	3	Average number bars in losers	3
Maximum intraday drawdown	$ -4,950.00		
Profit factor	3.41	Maximum number contracts held	1
Account size required	$ 4,950.00	Return on account	585%

As you can see, I went back more than four years, from January 1, 1993 up through October 1, 1997. I did not include slippage and commission, as this is not a mechanical system, but $150 slippage and commission per trade won't greatly affect the results. Finally, I used no stops in the testing. This led to a few good hits, yet in spite of this the results were solid.

The daily signals for the Connors VIX Reversal I can be found in the Appendix.

SUMMARY

The Connors VIX Reversal I does a solid job of identifying short-term market tops and bottoms. What is also significant is that in spite of the fact that we had been in a raging bull market during the test period, the setup worked well to the short side.

Now, the question of how to trade the indicator. Obviously, if you are an S&P trader, you will trade the futures and implement some type of protective stop to avoid the 18-point drop that occurred in 1996. You can also use this indicator to derive directional bias to complement your other indicators. (If you trade stocks, and have a buy signal, it behooves you to take your profits in your short positions and reverse to the long side.)

I am not advocating using this as a mechanical system. I specifically use it to help identify short-term market tops and bottoms. Also, you may wish to adjust the look-back period and holding period to create more trades. I will many times look at less than 15-day highs/lows and if it is in confir-

mation with other indicators, I am quite likely to take the signal. Finally, to me, the most exciting and most profitable strategies for this indicator are in the options markets. On the long side alone (selling puts) you have a directional bias combined with implied volatility collapsing! This will be further discussed in the options section.

CONNORS VIX REVERSAL II

Here is another methodology that uses the VIX to measure overbought and oversold conditions. The "Connors VIX Reversal II" (CVR II) adds the use of the Relative Strength Index (RSI) of the VIX to provide insight into another way to time your entries more precisely.

"Common Wall Street wisdom" states that when the VIX is high, the market is likely to rise and when the VIX is low, the market is likely to drop. As far as I am aware, until the CVR I was introduced, no one could show where was the best high/low level to enter, and certainly no one has combined it with an intraday reversal. The CVR II takes the same concepts of the CVR I and uses an even more efficient way to measure overbought/oversold levels.

Here are the rules:

1. Take a five-period RSI of the closing VIX.

2a. When the five-period RSI gets to 70 or above, it signifies the VIX is overbought and the market is oversold.

2b. When the five-period RSI of the VIX gets to 30 or below, it signifies that the VIX is oversold and the market is overbought.

3. When a daily RSI reading above 70 is followed by a downtick in RSI, buy the market that day on the close. When an RSI reading below 30 is followed by an uptick in RSI, sell the market that day on the close.

4. Exit five to eight trading days later (or use some type of trailing stop exit).

Here are the results using an eight-day exit for the period January 1, 1993 through October 1, 1997. They are among the best of any strategy I have presented (a trade-by-trade summary is in the Appendix).

CVR II S&P 500 Index—CME—Daily—01/01/93–10/01/97

Performance Summary: All Trades

Total net profit	$ 179,100.00	Open position P/L	$ -4,500.00
Gross profit	$ 312,500.00	Gross loss	$ -133,400.00
Total number of trades	96	Percent profitable	61%
Number winning trades	59	Number losing trades	37
Largest winning trade	$ 30,700.00	Largest losing trade	$ -10,525.00
Average winning trade	$ 5,296.61	Average losing trade	$ -3,605.41
Ratio average win/average loss	1.47	Average trade (win and loss)	$ 1865.63
Maximum consecutive winners	5	Maximum consecutive losers	6
Average number bars in winners	7	Average number bars in losers	8
Maximum intraday drawdown	$ -44,450.00		
Profit factor	2.34	Maximum number contracts held	1
Account size required	$ 44,450.00	Return on account	403%

Performance Summary: Long Trades

Total net profit	$ 161,725.00	Open position P/L	$ 0.00
Gross profit	$ 214,400.00	Gross loss	$ -52,675.00
Total number of trades	55	Percent profitable	67%
Number winning trades	37	Number losing trades	18
Largest winning trade	$ 30,700.00	Largest losing trade	$ -10,525.00
Average winning trade	$ 5,794.59	Average losing trade	$ -2,926.39
Ratio average win/average loss	1.98	Average trade (win and loss)	$ 2,940.45
Maximum consecutive winners	7	Maximum consecutive losers	4
Average number bars in winners	8	Average number bars in losers	8
Maximum intraday drawdown	$ -24,475.00		
Profit factor	4.07	Maximum number contracts held	1
Account size required	$ 24,475.00	Return on account	661%

Performance Summary: Short Trades

Total net profit	$ 17,375.00	Open position P/L	$ -4,500.00
Gross profit	$ 98,100.00	Gross loss	$ -80,725.00
Total number of trades	41	Percent profitable	54%
Number winning trades	22	Number losing trades	19
Largest winning trade	$ 14,100.00	Largest losing trade	$ -9,900.00
Average winning trade	$ 4,459.09	Average losing trade	$ -4,248.68
Ratio average win/average loss	1.05	Average trade (win and loss)	$ 423.78
Maximum consecutive winners	7	Maximum consecutive losers	6
Average number bars in winners	7	Average number bars in losers	9
Maximum intraday drawdown	$ -50,550.00		
Profit factor	1.22	Maximum number contracts held	1
Account size required	$ 50,550.00	Return on account	34%

SUMMARY

The most significant aspects of the test are the percent correct and the total net profits. Also, the average profit per trade is about as solid as I have seen in my research. Please note that the above results reflect a mechanical system which used no stops. I, again, strongly recommend using some kind of protective stop with this methodology.

CONNORS VIX REVERSAL III

This is the third VIX Reversal strategy I follow. It was co-created by a member of my research staff, Dave Landry. Dave, who is also a CTA, is in my opinion, a top researcher. More importantly, he very much understands underlying market principles.

As many of you are aware, volatility is mean reverting. This means periods of high volatility are likely to revert back to their normal levels and periods of low volatility also revert back to their normal levels. I have found that this concept is an inherent feature of the VIX. Dave and I found that by applying the *reversion to the mean* principle, we could predict S&P behavior. We found that whenever the VIX closed 10 percent above or below its 10-day moving average, it had a tendency to revert back to its mean. At the same time stock market prices also reversed.

Here are the rules of the "Connors VIX Reversal III" (CVR III):

FOR BUYS

1. Today, the low of the VIX must be above its 10-day moving average.
2. Today, the VIX must close at least 10 percent above its 10-day moving average.
3. If rules 1 and 2 are met, buy the market on the close.
4. Exit (on the close) the day the VIX trades (intraday) below yesterday's 10-day moving average (reversion to the mean).

FOR SELLS

1. Today, the high of the VIX must be below its 10-day moving average.
2. Today, the VIX must close at least 10 percent below its 10-day moving average.
3. If rules 1 and 2 are met, sell on the close.
4. Exit (on the close) the day the VIX trades (intraday) above yesterday's 10-day moving average (reversion to the mean).

CVR III S&P 500 Index—CME—Daily—01/01/93–10/01/97

Performance Summary: All Trades

Total net profit	$ 120,675.00	Open position P/L	$ 0.00
Gross profit	$ 176,250.00	Gross loss	$ -55,575.00
Total number of trades	75	Percent profitable	72%
Number winning trades	54	Number losing trades	21
Largest winning trade	$ 14,425.00	Largest losing trade	$ -10,025.00
Average winning trade	$ 3,263.89	Average losing trade	$ -2,646.43
Ratio average win/average loss	1.23	Average trade (win and loss)	$ 1,609.00
Maximum consecutive winners	10	Maximum consecutive losers	3
Average number bars in winners	4	Average number bars in losers	5
Maximum intraday drawdown	$ -22,025.00		
Profit factor	3.17	Maximum number contracts held	1
Account size required	$ 22,025.00	Return on account	548%

Performance Summary: Long Trades

Total net profit	$ 74,450.00	Open position P/L	$ 0.00
Gross profit	$ 88,625.00	Gross loss	$ -14,175.00
Total number of trades	41	Percent profitable	78%
Number winning trades	32	Number losing trades	9
Largest winning trade	$ 14,425.00	Largest losing trade	$ -2,950.00
Average winning trade	$ 2,769.53	Average losing trade	$ -1,575.00
Ratio average win/average loss	1.76	Average trade (win and loss)	$ 1,815.85
Maximum consecutive winners	9	Maximum consecutive losers	3
Average number bars in winners	4	Average number bars in losers	5
Maximum intraday drawdown	$ -19,050.00		
Profit factor	6.25	Maximum number contracts held	1
Account size required	$ 19,050.00	Return on account	391%

Performance Summary: Short Trades

Total net profit	$ 46,225.00	Open position P/L	$ 0.00
Gross profit	$ 87,625.00	Gross loss	$ -41,400.00
Total number of trades	34	Percent profitable	65%
Number winning trades	22	Number losing trades	12
Largest winning trade	$ 14,400.00	Largest losing trade	$ -10,025.00
Average winning trade	$ 3,982.95	Average losing trade	$ -3,450.00
Ratio average win/average loss	1.15	Average trade (win and loss)	$ 1,359.56
Maximum consecutive winners	5	Maximum consecutive losers	4
Average number bars in winners	4	Average number bars in losers	6
Maximum intraday drawdown	$ -20,925.00		
Profit factor	2.12	Maximum number contracts held	1
Account size required	$ 20,925.00	Return on account	221%

SUMMARY

As you can see, the results are solid both to the long and short side. The average profit per trade is excellent and the percent profitable is also quite strong. Finally, as always, a protective stop helps avoid potentially large drawdowns.

In my opinion, and as you can see from the three CVR strategies, the VIX is a superior vehicle to the put/call ratio for using options to predict market direction. By combining the three reversal methods, you will be able to identify reversals in the stock market on a more efficient basis.

CHAPTER 3

TRIN THRUSTS

This chapter focuses on another method to time the overall market. The "TRIN Thrust Strategy" is one that will be of special interest to S&P futures traders, mutual fund timers, and OEX traders.

As you probably know, the TRIN is the NYSE Short-Term Trading Index. It was originally called the ARMS Index in honor of its creator Dick Arms.

The TRIN measures a ratio of the number of advances and declines on the NYSE and relates those totals to the up-and-down volume activity in the stocks. Wall Street views extended periods above 1.00 as an indication of a weak market and extended periods below 1.00 as an indication of a strong market. The TRIN Thrust strategy does not look at the readings this way. It simply looks at the daily percentage change in the closing TRIN from yesterday to today to predict the market direction for the next two trading days.

As was just mentioned, the TRIN is used to identify strong and weak markets. Conventional wisdom (this term should now make you nervous) states that extended readings above 1.00 indicate the market is oversold and due to decline; extended readings below 1.00 signal the market is overbought and due to rise.

This arbitrary generalization in the selection of greater than 1.00 or less than 1.00 for the TRIN carries as little weight of evidence as someone telling us a VIX reading above a certain number means the market is oversold or an advance/decline reading above a certain number means the market is overbought. Such generalities are what cause traders to get hurt badly when overbought becomes *more* overbought and oversold becomes even more oversold.

Does this failure of absolute TRIN values to predict market turns mean it's a useless indicator? No, only that in my opinion and experience, it has been and is misused by the majority on Wall Street.

Instead of looking at the TRIN as an oscillator which varies between overbought and oversold, let's break it down to its core components, as we did with the VIX, and then see how it adds to our understanding of current market action.

- By measuring the flow of funds into and out of stocks relative to their volume, the TRIN does signal that a market has been strong or weak.
- We also know that many times the market moves to an area that is overbought and remains that way until some force causes it to revert to the mean and pulls it back into oversold territory.
- As we saw with the VIX, for this change in direction to take place, the market's momentum needs to be stopped and reversed.

Taking these pieces into consideration, I have found that sharp one-day reversals (thrusts) off the TRIN are often the beginning of a one- to two-day general market reversal. (That is, the sharp change in the percentage TRIN reading is indicative of a momentum change and this new momentum surge takes approximately two days to run its course.)

Before looking at the rules, you must know that I rarely use the TRIN Thrust signal as a stand-alone indicator. *It is much more effective when it is combined with another signal such as a VIX reversal or a short-term pattern.* This combination, many times, gives further confirmation to the pending move.

FOR BUYS

1. If today's closing TRIN is 30 percent or more *below* yesterday's closing TRIN, buy the market on the close today. For example, yesterday's closing TRIN reading was 1.00. If today's closing TRIN reading is .70 or less, buy the market.
2. Sell on the close two trading days later.
3. For your protection, I strongly recommend using a 1 1/2 to 2 percent protective stop. This means if the S&P's are at 900, your stop should be in the 982 to 987 range.

FOR SELLS

1. If today's closing TRIN is 30 percent or more above yesterday's closing TRIN, sell the market on the close today. For example, yesterday's closing TRIN reading was .70. If today's closing TRIN is .91 or higher, sell the market.
2. Close the position two trading days later.
3. Use a 1 1/2 to 2 percent protective stop.

Here are the mechanical results using a 1 1/2 percent stop.

TRIN Thrust S&P 500 Index—CME—Daily 01/03/90–10/01/97

Performance Summary: All Trades

Total net profit	$ 186,495.00	Open position P/L	$ –4,450.00
Gross profit	$ 851,195.00	Gross loss	$ –664,700.00
Total number of trades	764	Percent profitable	51%
Number winning trades	387	Number losing trades	377
Largest winning trade	$ 14,665.00	Largest losing trade	$ –12,875.00
Average winning trade	$ 2,199.47	Average losing trade	$ –1,763.13
Ratio average win/average loss	1.25	Average trade (win and loss)	$ 244.10
Maximum consecutive winners	9	Maximum consecutive losers	11
Average number bars in winners	2	Average number bars in losers	1
Maximum intraday drawdown	$ –37,350.00		
Profit factor	1.28	Maximum number contracts held	1
Account size required	$ 37,350.00	Return on account	499%

Performance Summary: Long Trades

Total net profit	$ 197,535.00	Open position P/L	$ 0.00
Gross profit	$ 439,055.00	Gross loss	$ –241,520.00
Total number of trades	342	Percent profitable	57%
Number winning trades	194	Number losing trades	148
Largest winning trade	$ 13,800.00	Largest losing trade	$ –12,875.00
Average winning trade	$ 2,263.17	Average losing trade	$ –1,631.89
Ratio average win/average loss	1.39	Average trade (win and loss)	$ 577.59
Maximum consecutive winners	9	Maximum consecutive losers	12
Average number bars in winners	2	Average number bars in losers	1
Maximum intraday drawdown	$ –29,175.00,		
Profit factor	1.82	Maximum number contracts held	1
Account size required	$ 29,175.00	Return on account	677%

Performance Summary: Short Trades

Total net profit	$ –11,040.00	Open position P/L	
Gross profit	$ 412,140.00	Gross loss	$ –423,180.00
Total number of trades	422	Percent profitable	46%
Number winning trades	193	Number losing trades	229
Largest winning trade	$ 14,665.00	Largest losing trade	$ –12,250.00
Average winning trade	$ 2,135.44	Average losing trade	$ –1,847.95
Ratio average win/average loss	1.16	Average trade (win and loss)	$ –26.16
Maximum consecutive winners	6	Maximum consecutive losers	8
Average number bars in winners	2	Average number bars in losers	2
Maximum intraday drawdown	$ –55,800.00		
Profit factor	0.97	Maximum number contracts held	1
Account size required	$ 55,800.00	Return on account	–20%

SUMMARY

As with the Connors VIX Reversal, the TRIN Thrust strategy shows good profits. Even though the per-trade profit is lower than the VIX strategies, it does provide us with a small edge. Also, as I mentioned, this strategy should not be used as a stand-alone indicator. Use it in conjunction with other signals. In addition, as you can see, the strategy did significantly better on the long side than on the short side. This is due to the seven-year run the market has had. In 1990 and 1994, the two weakest years of the period, TRIN Thrusts showed good profits on the short side. When a bear market occurs, the results on the long side will be less and the results on the short side should increase substantially.

With the new smaller S&P futures contract, and derivative products for the Dow Jones Index, the TRIN Thrust strategy, combined with other indicators, should be helpful in assisting you to successfully trade these new vehicles.

CHAPTER 4

PERCENT ADVANCE/ DECLINE INDICATOR (PADI)

The "Percent Advance/Decline Indicator" (PADI), is one of the better advance/decline indicators I have developed. As you will see from the results, it does a good job of identifying short-term tops and bottoms in the stock market and in the S&P futures.

In my opinion, advance/decline indicators do a very good job of identifying overbought and oversold stock market conditions. Unfortunately, the overwhelming number of traders use them as a static indicator and instead of increasing profits, lose money trading with them. Why is this? Because, as I've written again and again, markets that are overbought can and will become more overbought, and markets that are oversold can and will become more oversold. The fact that an advance/decline indicator has reached some extreme number absolutely does *not* mean that the market cannot move to even more extreme levels. I have seen too many traders use these fixed static numbers as if they were the Holy Grail and eventually get killed as the market kept running against them.

To take full advantage of these indicators, the market itself must first signal a reversal. This means that even when the market is grossly oversold, until the indicator reverses, you must remain patient. By letting the market reverse, you are not putting yourself in front of a speeding train in an attempt to stop it. Therefore, we must use a method that shows the market is either overbought or oversold and then combine it with a methodology that signals a clear reversal. Also, I have found it to be even more advantageous to only trade advance/decline setups in the direction of the market's longer-term trend.

Here are the calculations and rules for the PADI:

1. Add the total number of shares traded today on the NYSE. This is done by adding the advances, declines, and unchanged.
2. Divide the number of advancing issues by the total issues traded (advances + total) to get today's advancing percent.
3. Divide the number of declining issues by the total issues traded (declines + total) to get today's declining percent.
4. Take the six-day average of the advancing percent and the six-day average of the declining percentage.
5. If yesterday's advancing average was 40 percent or higher and today's advancing average is less than yesterday's advancing average, sell on the close (only if the stock market is trading below its 100-day moving average).
6. If yesterday's declining average was 40 percent or higher and today's declining average is less than yesterday's declining average, we buy on the close (only if the market is trading above its 100-day moving average).
7. Exit in five to seven days or if there is a signal in the opposite direction.

As with the other strategies, I recommend using a protective stop. Here are the results using a 1 1/2 percent stop with a five-day exit.

PADI S&P 500 Index—CME—Daily 01/01/90–10/03/97

Performance Summary: All Trades

Total net profit	$ 142,932.50	Open position P/L	$ 0.00
Gross profit	$ 285,525.00	Gross loss	$ -142,592.50
Total number of trades	109	Percent profitable	61%
Number winning trades	66	Number losing trades	43
Largest winning trade	$ 18,775.00	Largest losing trade	$ -7,725.00
Average winning trade	$ 4,326.14	Average losing trade	$ -3,316.10
Ratio average win/average loss	1.30	Average trade (win and loss)	$ 1,311.31
Maximum consecutive winners	7	Maximum consecutive losers	4
Average number bars in winners	6	Average number bars in losers	5
Maximum intraday drawdown	$ -17,340.00		
Profit factor	2.00	Maximum number contracts held	1
Account size required	$ 17,340.00	Return on account	824%

Performance Summary: Long Trades

Total net profit	$ 125,912.50	Open position P/L	$ 0.00
Gross profit	$ 238,300.00	Gross loss	$ -112,387.50
Total number of trades	83	Percent profitable	64%
Number winning trades	53	Number losing trades	30
Largest winning trade	$ 18,775.00	Largest losing trade	$ -7,725.00
Average winning trade	$ 4,496.23	Average losing trade	$ -3,746.25
Ratio average win/average loss	1.20	Average trade (win and loss)	$ 1,517.02
Maximum consecutive winners	8	Maximum consecutive losers	3
Average number bars in winners	6	Average number bars in losers	4
Maximum intraday drawdown	$ -17,340.00		
Profit factor	2.12	Maximum number contracts held	1
Account size required	$ 17,340.00	Return on account	726%

Performance Summary: Short Trades

Total net profit	$ 17,020.00	Open position P/L	$ 0.00
Gross profit	$ 47,225.00	Gross loss	$ -30,205.00
Total number of trades	26	Percent profitable	50%
Number winning trades	13	Number losing trades	13
Largest winning trade	$ 6,525.00	Largest losing trade	$ -6,067.50
Average winning trade	$ 3,632.69	Average losing trade	$ -2,323.46
Ratio average win/average loss	1.56	Average trade (win and loss)	$ 654.62
Maximum consecutive winners	3	Maximum consecutive losers	3
Average number bars in winners	5	Average number bars in losers	6
Maximum intraday drawdown	$ -9,835.00		
Profit factor	1.56	Maximum number contracts held	1
Account size required	$ 9,835.00	Return on account	173%

SUMMARY

The reason I like the PADI is because it is continuously self-adjusting to the number of issues that are traded each day. This means that when there is an onslaught on new issues that flood the market, or when an abundance of takeovers occurs, the PADI will adjust itself to this new number. Another point should be made: If you lower the percentage, you will get more trades and, even though the profit per trade is lower, the results are favorable.

As I stated earlier, advances versus declines do a good job of identifying when markets become overbought and oversold. By waiting for the market to reverse, as we have done with our other timing indicators, we improve their performance significantly.

As we discussed earlier, we want to trade strategies that give us an edge. The five market timing strategies presented give a directional bias which, if traded correctly, leads to that edge.

SECTION TWO

VOLATILITY

Volatility and its application to trading has been a favorite field of research for me. The subject is in its infancy stage and is fertile ground for traders looking to go beyond the many worn out concepts and strategies that exist today.

In the following few chapters I build upon the work I released in *Investment Secrets of a Hedge Fund Manager* and *Street Smarts*. For those of you who have not read these books, I will attempt to explain some of the ideas presented in those publications to help you further your understanding of the subject.

A friendly warning: The Volatility section is built upon years of research and is by far the most complex in the book. If it is difficult to grasp at first, don't despair. With repeated study it will come and the rewards will be worth the time spent.

CHAPTER 5

MODIFYING TRADE SIZE AND STOP PLACEMENT BASED ON VOLATILITY MEASUREMENT

When I was a junior in high school, I had a chemistry teacher by the name of Lenny Brown (I've changed his name to avoid any embarrassment to him). Some people felt Lenny had a screw loose (no argument here), but most also felt he was a great teacher. One of his quirks, though, was to announce our weekly test scores to the entire class as he passed them back to us. Whenever someone got zero answers correct (a common occurrence), Lenny would look at the paper, announce the student's name, put a stupid grin on his face, and then in a loud booming voice he would scream "GOOSE EGG" for the grade.*

* I was once on the receiving end of Lenny's wrath. In 1975 I was a food vendor for the Boston Red Sox. When the now famous sixth game of the World Series ended at nearly 1 A.M., it left little time to prepare for Lenny's test of the upcoming morning. To this day, I can still hear Lenny screaming "GOOSE EGG" after my name

In the money management industry it is quite difficult to blow out and get a Lenny Brown goose egg. In 1997, Victor Niederhoffer did. Before I go on, I need to say that I have absolute respect for Niederhoffer's accomplishments, especially up through 1996. He put together one of the best performance track records of any CTA for over a decade. It was done with guts, brains, and great trading. This accomplishment can never be taken away from him.

How could a man with his smarts and ability completely blow out? It is impossible to know the full story, but it appears it was a direct result of not adjusting his position size and stops to *greatly increased* volatility during the late October 1997 stock market sell-off. This one mistake cost his investors 100 percent of their money and destroyed a terrific career. (I suspect though, if you are reading this book five years after it was published, Niederhoffer is probably at the top of the trading world again.)

Let's look at what adjusting your stop and position size to current volatility actually means. Every stock and commodity has its own volatility reading. For example, two stocks trade at $100 per share. If stock A has a historical volatility reading of 10 percent, this means its annualized trading range was between 90 and 110, two-thirds of the time (based on an assumptive normal distribution). If we assume that the volatility will remain at 10 percent, we can safely assume the stock will trade between 90 and 110 two-thirds of the time over the next year, and we can get a feel of what our risk will be and where we can safely place stops.

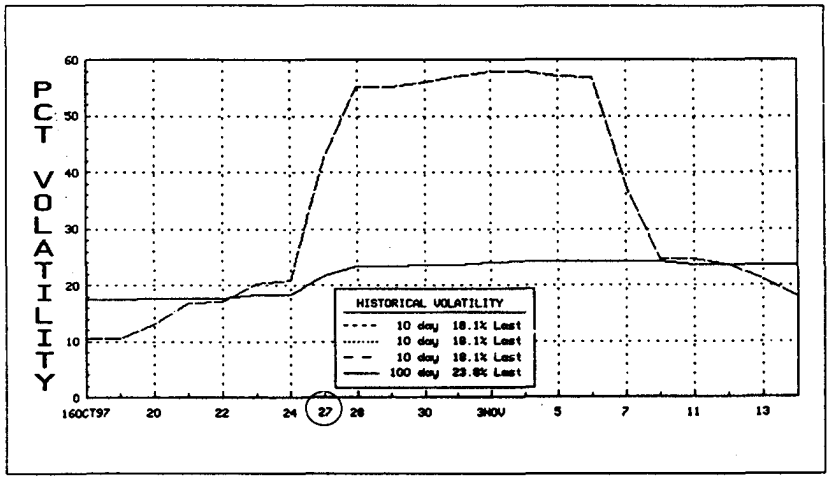
Stock B has a 100-day volatility reading of 25 percent. This means that its annualized range has been between 75 and 125 two-thirds of the time (based on an assumptive normal distribution). Looking back, stock B is more volatile than stock A.

Going forward, if the volatility of these stocks stays the same, our drawdowns (assuming we don't use stops) from stock B will be higher than stock A and our profits when we are correct are likely to be higher than with stock A. Therefore, if you go into a trade telling yourself you will risk 2 points, you are much more likely to be stopped out of stock B than stock A. Also, if you trade with 100 percent of your cash, you will be much more likely to be destroyed by stock B than stock A.

Now let's look at what happens when volatility drastically changes (as happened to Niederhoffer in October). Stock A, with the 10 percent volatility all of a sudden sees its volatility explode to 40 percent. This means there is a 67 percent chance that stock A's price will be within 60 and 140

at the end of one year and has put your risk level at new extremes. In Niederhoffer's case, he used a healthy portion of his investors' capital to sell puts when market volatility was under 30 percent. As you can see from the chart below, the short-term volatility exploded to above 50 percent. This means that his risk greatly increased and the increased volatility took what started as an "X" percent bet and brought it to a more than 100 percent of the portfolio size bet. Because he bet wrong, he wiped out his clients' assets.

Figure 5.1



I can fully understand why Niederhoffer did what he did. I was *strongly* tempted to sell puts that same day (Monday, October 27). I had buy signals all over the place (one day too early!) and it seemed too good an opportunity to pass.* What ultimately stopped me from taking these signals was the increased volatility that continued to grow throughout the day. (On the negative side, it also stopped me from taking the trades on Tuesday, therefore completely missing the correct opportunity.) *What Niederhoffer failed to do was stop himself out as the risks grew throughout the*

* In fact, I picked up the phone three different times to call the trading desk and each time hung up without placing a trade.

day. What he also failed to do was adjust his position size down as the volatility increased. Sol Waksman, president of Barclay Trading Group, was quoted in Bloomberg as saying, "In this case, money management was entirely lacking. Any position can go against you and it is a manager's responsibility to guard against that."

How can we learn from this lesson? By being aware of the role that volatility plays in risk management. For example, if you normally trade 1000 shares of a $50 stock with a volatility reading of 20 percent, you should only trade 500 shares of the a $50 stock with a 40 percent volatility reading. The dollar risks for both are now approximately the same and even though you cannot predict what future volatility will bring, it's a good bet that it won't change drastically in the near future. If it does, you must adjust your position size to reflect the change.

As far as stop placement goes, you need to look at what the normal volatility is for the security you are trading. This will then tell you what the average likely range will be for the time period you are looking at. For example, let's assume you are buying a $100 stock with a volatility (100 days) of 20 percent and your system tells you to be in the trade for five days. You would take the following steps:

1. Divide 260 trading days by 5 days = 52
2. Take the square root of 52 = 7.2
3. Divide the HV by #2. 20% ÷ 7.2 = 2.7%
4. Take the stock price and add and subtract #3 from it.
   100 ± 2.7 = 97.3 and 102.7

This means that if the volatility remains at 20 percent, there is a two-thirds chance the stock price will be between 97.3 and 102.7 at the end of five days. Therefore, a stop placed at 99 is very likely to get hit, whereby a stop placed at 94 is unlikely to get hit.

To go further, if you then move into a $100 stock that has a volatility reading of 35, you should not be using the same stop placement as the example above.

In conclusion, there is no *exact science* to this. Because volatility is constantly changing, you must be constantly aware of these changes and act to adjust position size and stops in accordance with your risk tolerance.

CHAPTER 6

TRADING WHERE THE ACTION IS

As was mentioned in Chapter 1, one of the common traits of successful professional traders is that their strategies are usually based on conceptually correct principles. This means that they know how to exploit built-in characteristics that are fundamental to the markets they are trading. In this chapter I point to another factor which I believe is a major key to successfully and consistently profiting from the markets. *This principle is the role volatility plays in identifying the correct equities and commodities to trade.* Armed with this knowledge, you will know when and why to ignore nonmoving markets and will understand why you should trade only those markets that are moving.

I begin with the concept that *trading in sideways markets will chew you up.* As short-term traders, we do not have the luxury of waiting for a market to move. Because our profits tend to be small, we need to be trading those specific markets that provide us with the opportunity to maximize our profits on a daily basis.

This means that unless we are trading in active markets, our likelihood of locking in healthy profits is diminished. For example, the profit potential is always much higher in a volatile stock like Dell Computer (DELL) than it is in a lower priced, nonvolatile stock like the REIT, Simon Debartolo

Group (SPG). Dell Computer's average daily volatility is more than four times the average daily volatility of SPG and its price is more than three times the price of SPG. A winning setup on SPG may lead to, at most, a small profit, whereas the same setup on Dell will lead to a much greater profit. Even if the prices of these securities were equal, the higher volatility in Dell leads to larger moves than in the lower volatility stock.

This is just as true for the futures markets. *No matter how successful you are in predicting the direction of a move, a lack of meaningful day-to-day movement virtually guarantees that, as a short-term trader, you will be unable to make substantial profits.*

We therefore must identify the markets that will provide us with the most profit-making potential. How do we do this? There are a number of ways, but the measurement I use is historical volatility (HV). This can be measured with a period of as short as 25 days or as long as 200 days (for reference in this chapter, we will use a 50-day HV number). As you can see from Figure 6.1, as of December 1997, the most volatile commodity markets (hence the best markets to trade) are Natural Gas, Pork Bellies, and Coffee and the least volatile market (the worst market to trade) is the Canadian Dollar. The same holds true for equities. Figure 6.2 shows the best stocks to look at (as of December 1997) for setups and obviously, unless market characteristics change, you will want to avoid stocks such as utilities, REITs, etc.

Your volatility list should be adjusted on a weekly basis. This will assure you of consistently knowing which markets are likely to provide you with the best opportunities. Also, we must remember that there are over 10,000 stocks and more than 30 commodity markets available to trade. By using volatility to filter out the quiet markets, you will be able to focus on where the action is on a daily basis. I can't stress enough the importance of this concept.

Finally, you may ask, "Aren't I increasing my risk by trading in highly volatile markets?" The answer is yes, but if the setups you are trading are correct, your profits from these setups will be greatly increased because of the higher volatility.

Figure 6.1 50-Day Historical Volatility as of December 1997

Under 10%	*10–20%*	*20–30%*	*30+%*
Canadian Dollar	Gold	S&P's	Pork Bellies
DM	Yen	Silver	Coffee
	Swiss Franc	Corn	Natural Gas
	Cattle	Crude	
	Cocoa	Heating Oil	
	Hogs		
	Soybean		
	Wheat		
	Cotton		

For future reference, you should be aware that the Canadian Dollar is historically a less volatile entity than Pork Bellies, Coffee, and Natural Gas, which tend to have 50-day volatility reading predominately above 25 percent. Therefore, your position size and stop placement should reflect these inherent characteristics.

Figure 6.2 Highest 50-Day Historical Volatility Stocks as of December 1997

NYSE	*NASDAQ*
CA—Computer Associates	ALTR—Altera Corp.
CMB—Chase Manhattan	COMS—3 Com Corp.
CPQ—Compaq Computer	DELL—Dell Computer
CTX—Centrex Corp.	KLAC—KLA-Tencor Corp.
TER—Teradyne	LLTC—Linear Technology
BSX—Boston Scientific	TLAB—Tellabs, Inc.
PDX—Pediatrix Medical	SNPS—Synopsys Inc.
SCI—SCI Systems	PSFT—People Soft Corp.
MWD—Morgan Stanley/Dean Witter	

CHAPTER 7

ADDITIONAL VOLATILITY RESEARCH

In *Investments Secrets of a Hedge Fund Manager*, we showed what I still consider to be the best and most efficient way to correctly identify and measure the reversion to the mean principle as it applies to volatility. By using a 100-day period as the normalized base, we showed that whenever a 10-day period volatility was 50 percent or less than the 100-day period, a large market move was likely to occur (reversion to the mean). For example, if the 100-day historical volatility reading is 30 percent, a 10-day historical volatility reading under 15 percent is likely to be followed by a large market move.

Since the book was released a few years ago, I have published additional research on the subject. On the following pages you will learn some new and advanced volatility concepts which should assist you with your trading. Please note that most of the examples shown use a six-day lower trading period. As I stated earlier, almost any pairing of a shorter time period versus a longer time period will identify markets that are likely to explode. For the record then, any short-term versus long-term historical volatility reading under 50 percent will many times be followed by a larger than normal market move.

THE ADDED PROFIT FROM MULTIPLE-DAY SIGNALS

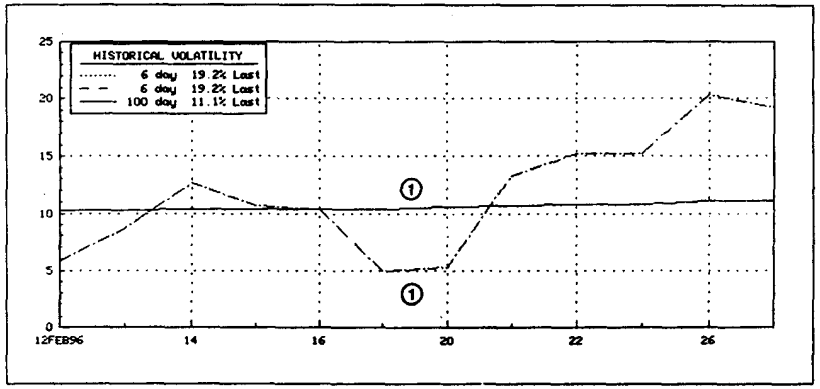
Our research has shown us that the longer the time frame a historical volatility ratio reading is under 50 percent, the larger the market move will be. Ideally, we would like to see the historical volatility ratio reading stay under 50 percent for more than one day. The more days it is under 50 percent, the more likely the market will explode.

Since I live in Southern California, an appropriate analogy would be that of an earthquake. The longer the build-up between quakes, the larger the resultant explosion will be. This principle holds true with volatility. The longer the period of low volatility, the larger the move will be to revert volatility to its longer-term mean.

Is this setup perfect? No! There will be times when the market has a change in overall volatility and is not accompanied by a large move. Over time though, this is a superior vehicle to use to identify potential market explosions.

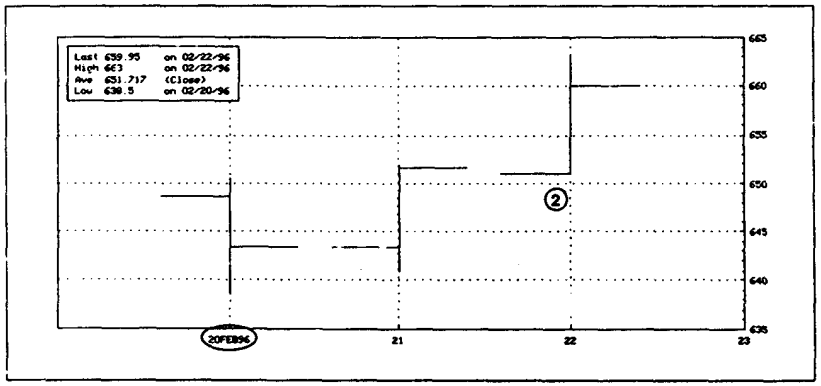
Let's look at some examples.

FIGURE 7.1a March 96 S&P 500 Futures—Historical Volatility



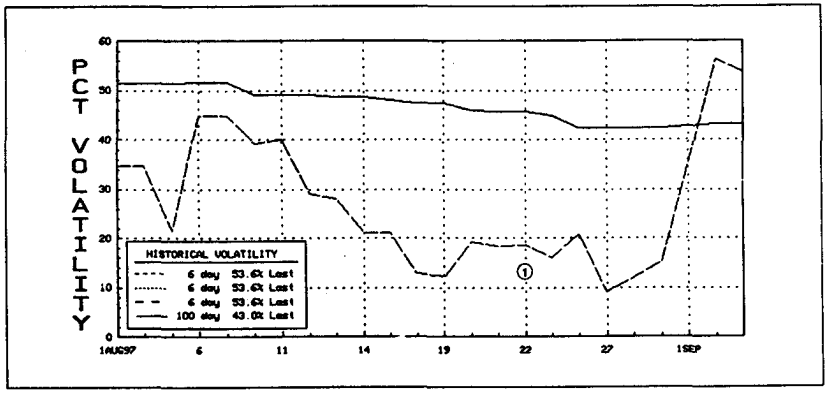
1. The 6-day/100-day historical volatility ratio reading is under 50 percent for two consecutive days (please refer to the values on the left-hand axis, not those in the box).

FIGURE 7.1b March 96 S&P Futures



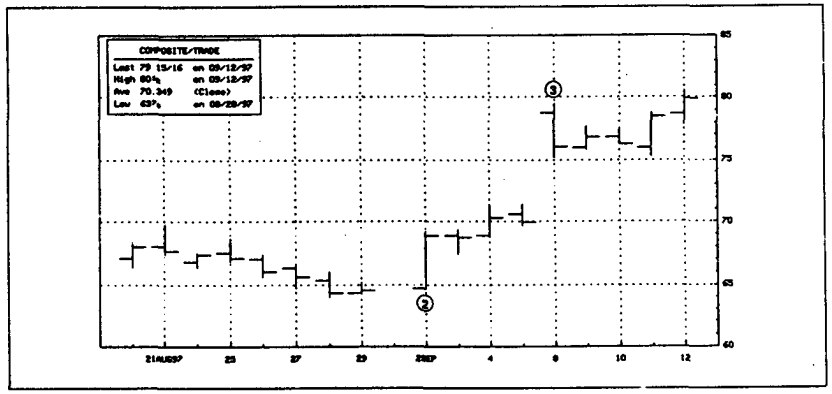
2. As you can see, after the multiple day historical volatility readings under 50 percent, the March S&P's explode more than 16 points to the upside over the next two trading sessions.

FIGURE 7.2a American Online



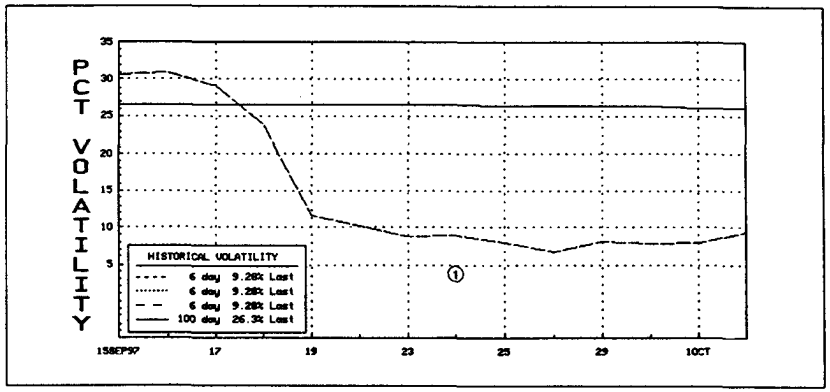
1. Here we have American Online (AOL) with a multiple day historical volatility reading under 50 percent. This signal remains for two weeks (!), thereby increasing the pressure on the market to explode.

FIGURE 7.2b American Online



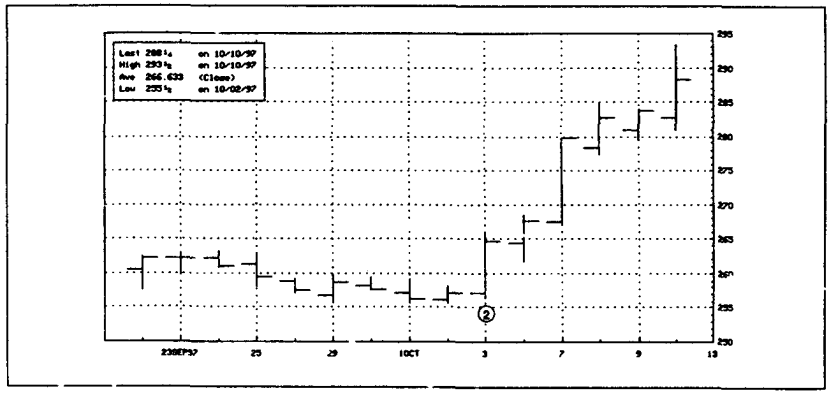
2. On September 2, AOL moves 4 3/8 points higher on double its average daily volume. The breakout holds and the stock rises more than 20 percent in a week.

FIGURE 7.3a December Corn



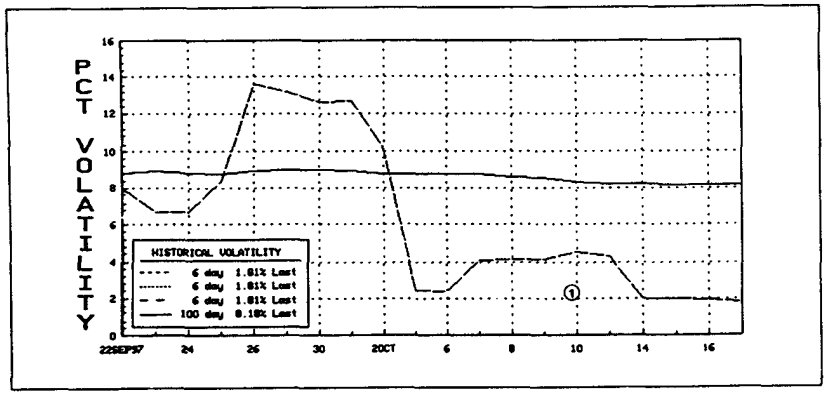
1. In mid to late September 1997, corn goes through a two-week extremely low volatility period as measured by historical volatility.

FIGURE 7.3b December Corn



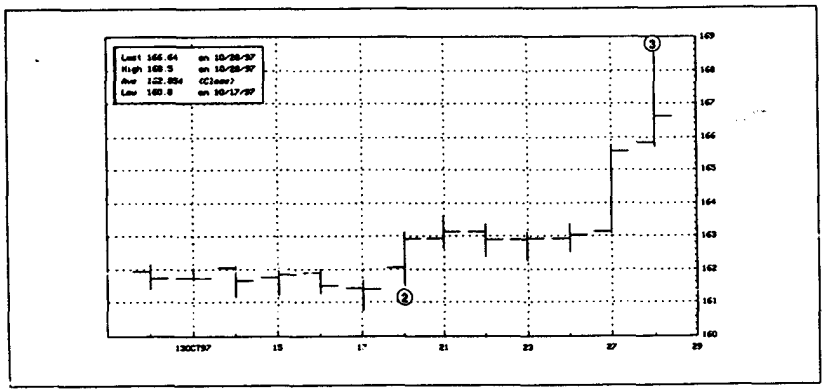
2. On October 3, the market wakes up as volatility reverts to its mean. December corn rises more than 30 cents in only six trading days.

FIGURE 7.4a British Pound



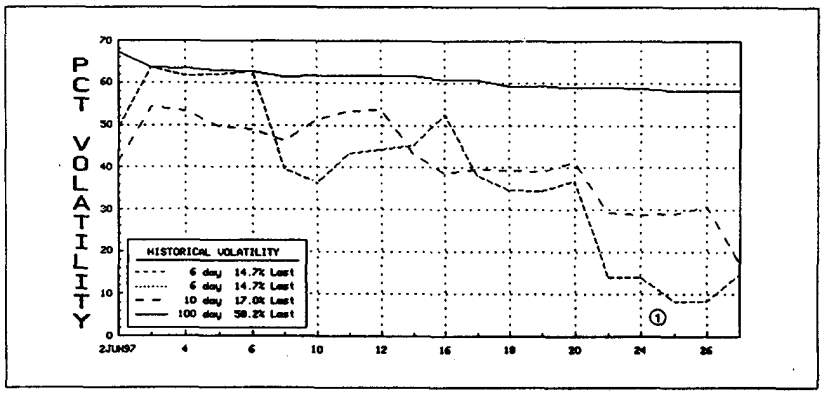
1. A sustained period below normal volatility tells us a large move is near.

FIGURE 7.4b British Pound



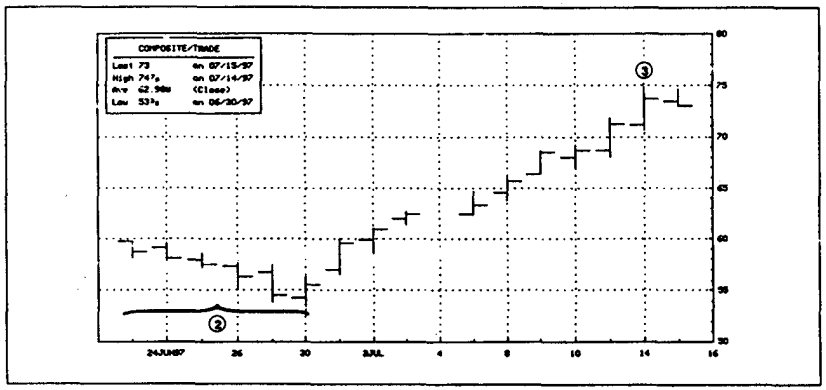
2. The market moves 150 points higher.
3. The British Pound explodes to a closing high of 166.66 in a week and a half.

FIGURE 7.5a American Online



1. Here is AOL again, this time a few months earlier. For one week, the 6/100 historical volatility reading is under 50 percent.

FIGURE 7.5b American Online



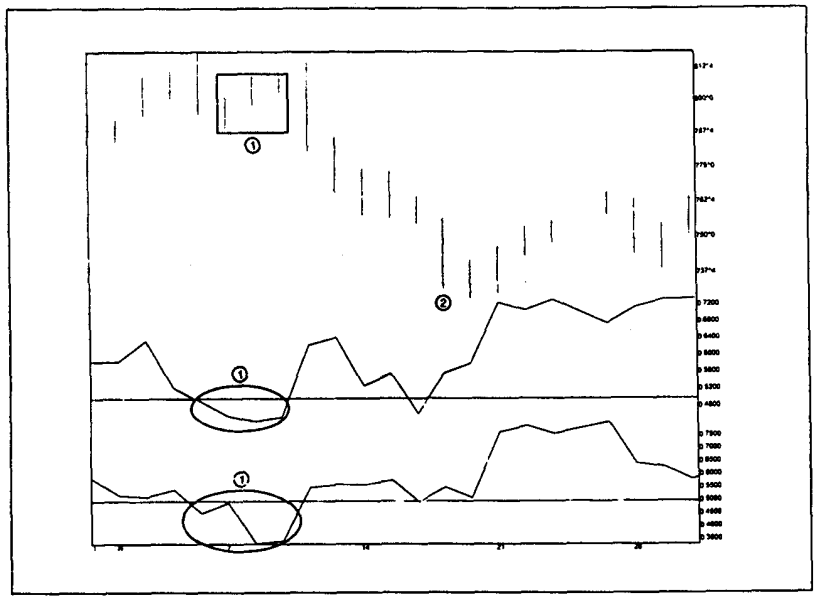
2. Signal period.
3. A better than 35 percent change in prices over a few weeks.

COMBINING MULTIPLE-PERIOD HISTORICAL VOLATILITY READINGS

One of the ways to closely pinpoint when a market is likely to have a large move is to look at multiple period historical volatility readings under 50 percent. My research and trading has found that combining a 10-period reading and a 6-period reading is a superior method to only using a 10-period reading. This holds true both on a daily basis and on an intraday basis.

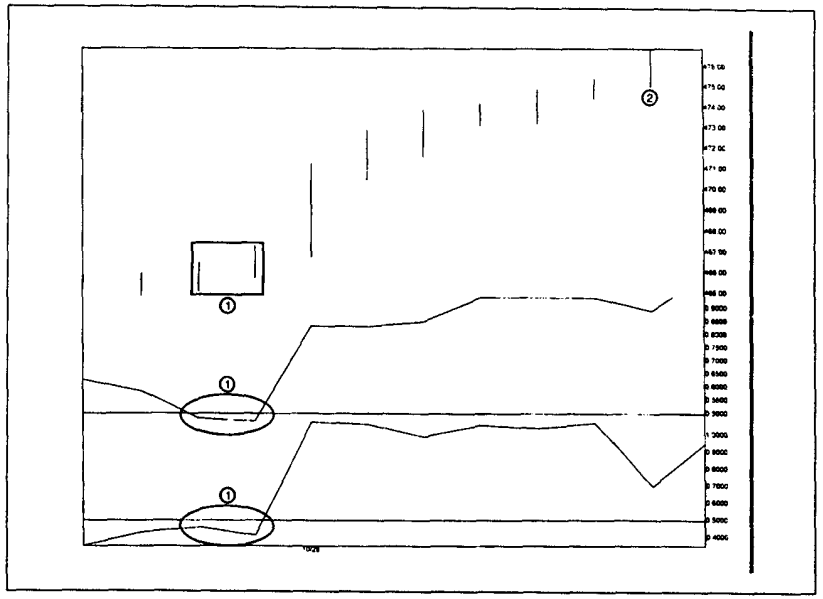
Let's look at a few examples.

FIGURE 7.6 January Soybeans



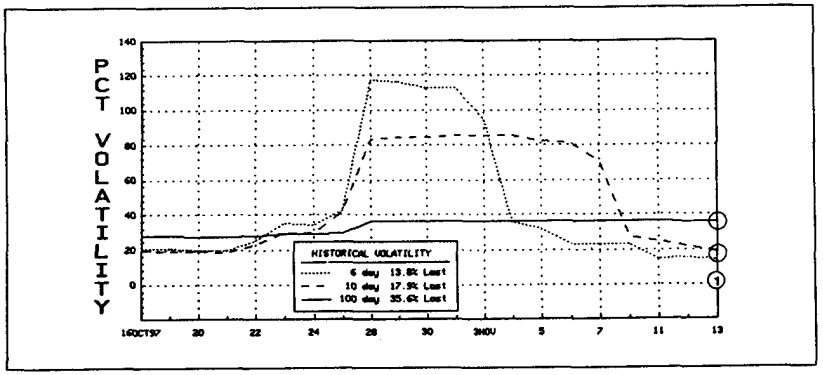
1. Both the 10/100 historical volatility reading and the 6/100 historical volatility are under 50 percent, signaling a large move is near.
2. Over a six-day period, beans drop more than 50 cents.

FIGURE 7.7 An Intraday S&P Setup Using 40-Minute Bars



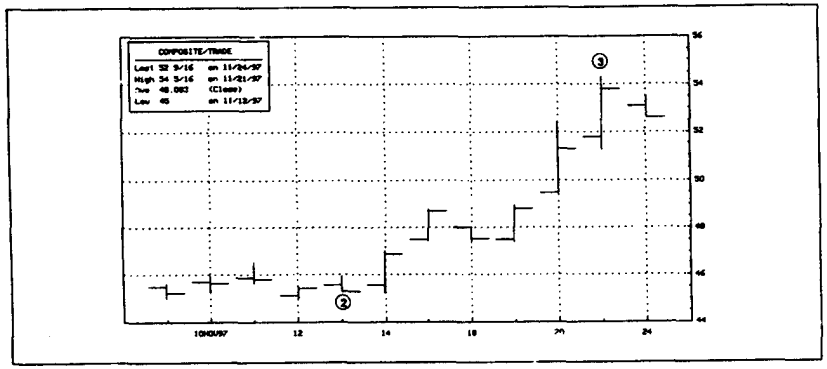
1. A 10/100 historical volatility reading combined with a 6/100 historical volatility reading under 50 percent.
2. The S&P's explode 8 points higher within a day.

FIGURE 7.8a Estee Lauder



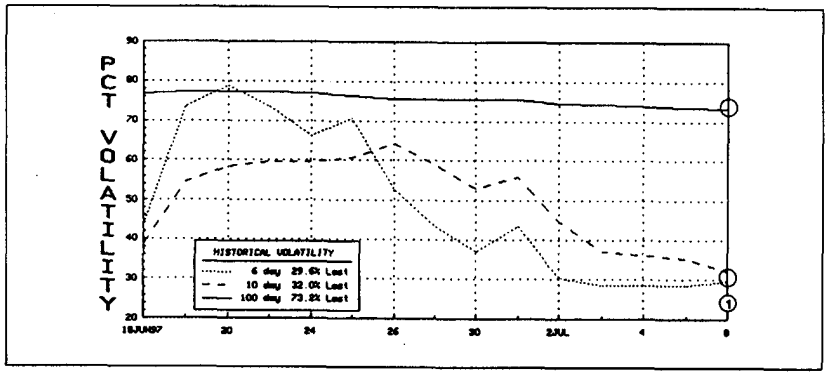
1. In this example, the 6-day historical volatility is well under the 50 percent level and the 10-day is at 50.2 percent. When the number is this close, I will not stand on ceremony, as the reversion to the mean principle will certainly kick in.

FIGURE 7.8b Estee Lauder



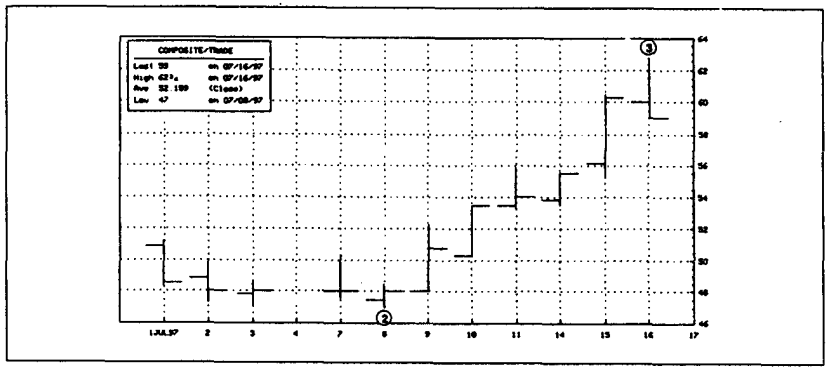
2. Signal date.
3. A nearly 20 percent move in prices six trading days later.

FIGURE 7.9a Viasoft



1.. Viasoft, an extremely volatile stock, has a 6-day and 10-day volatility reading more than 50 percent under its 100-day reading.

FIGURE 7.9b Viasoft



2. Signal date.
3. An explosion in price as the stock moves more than 20 percent higher within six trading days.

SUMMARY

The one drawback to using multiple readings is that it gives a trader fewer signals than does a single reading. The advantage is that it does an even better job of pinpointing explosive opportunities that lead to larger gains.

FILTERING FALSE VOLATILITY SIGNALS

When a market has a very large, extraordinary move, historical volatility readings under 50 percent are usually false. This lesson is important to remember.

The extraordinary move causes the 100-day reading to increase drastically, thereby causing a long period of 6/100 and 10/100 readings under 50 percent. At these times we must wait for the 100-day reading to revert to its normal mean.

Let's look at the crash of 1987. As you can see from the Figure 7.10, the hundred day reading exploded from 20 percent to approximately 50 percent after the crash. During the months of November, December, January, and February, there were many 6/100 and 10/100 readings under the 50 percent ratio. These were false signals due to the volatility created during October.

FIGURE 7.10

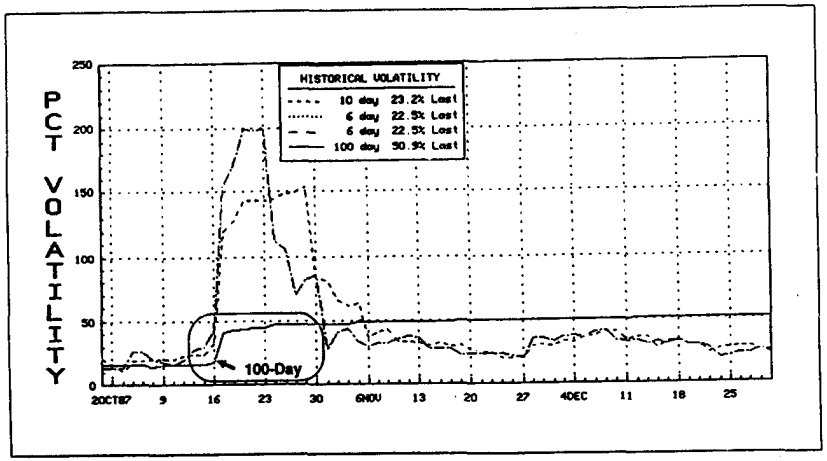
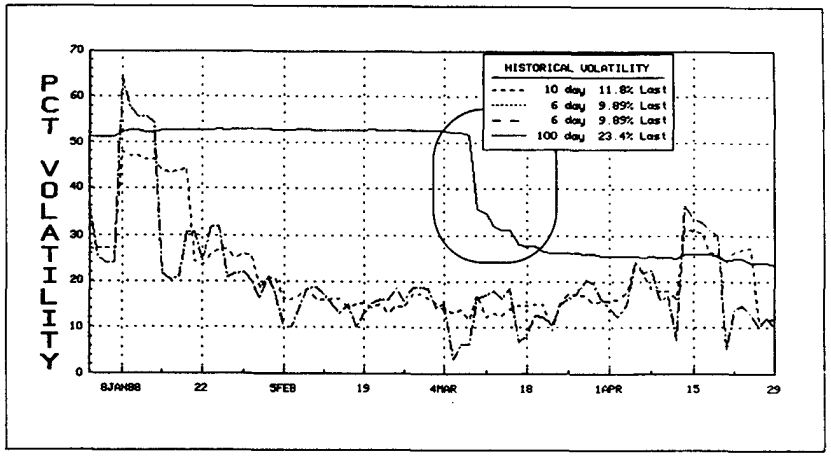


FIGURE 7.11



By March 1988, the effects of the crash were no longer part of the 100-day calculation and the 100-day volatility began making its way back to the 20 percent level (*see* Figure 7.11). We therefore must wait a full 100 days to remove the extraordinary event from our calculations.

Among the events that have triggered this type of move have been the crash of 1987, the semi-crash of 1989 and the oil crisis in 1990. Obviously, these types of situations are rare but when they do occur historical volatility readings are skewed and must not be used until they become normalized.

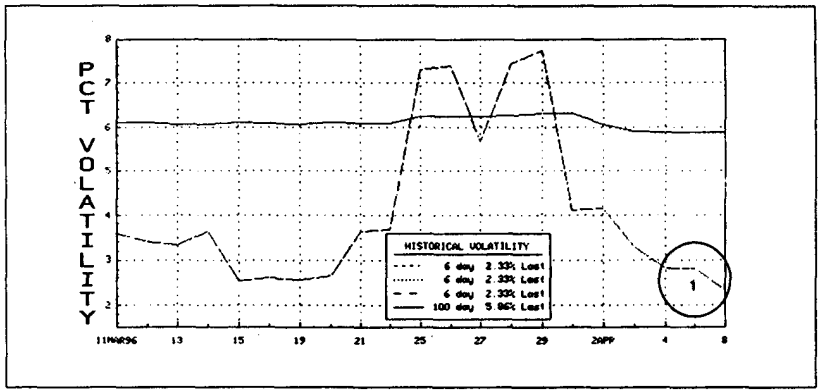
HV THRUSTS

One of the filtering techniques I use to trade historical volatility is to combine extreme readings with range expansions. Extreme readings that are accompanied by single-day large moves tend to have a higher likelihood of both short-term and intermediate-term follow-through.

Here are the rules:

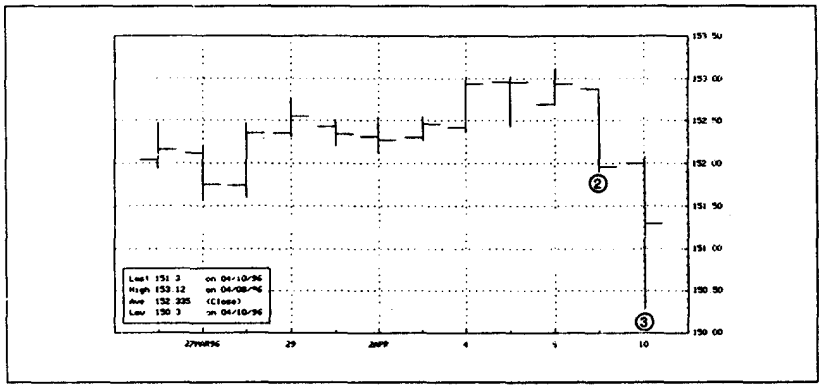
1. Identify a market whose 6-day or 10-day volatility is less than 1/2 its 100-day reading. As we discussed, it is even better to have both readings under 50 percent or for either reading to have multiple days under 50 percent.
2. On the day of the readings under 50 percent look for a daily price range that is larger than the daily range of the previous nine days.
3. If rules 1 and 2 are met, expect a follow-through in the direction of the large-range day for the next one to ten days.

FIGURE 7.12a June 96 British Pound



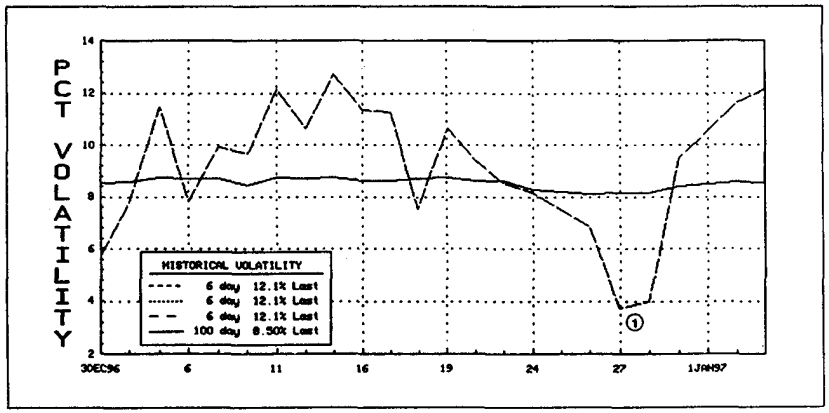
1. April 8—The six-day historical volatility reading has been less than half the 100-day reading for three consecutive days.

FIGURE 7.12b June 96 British Pound



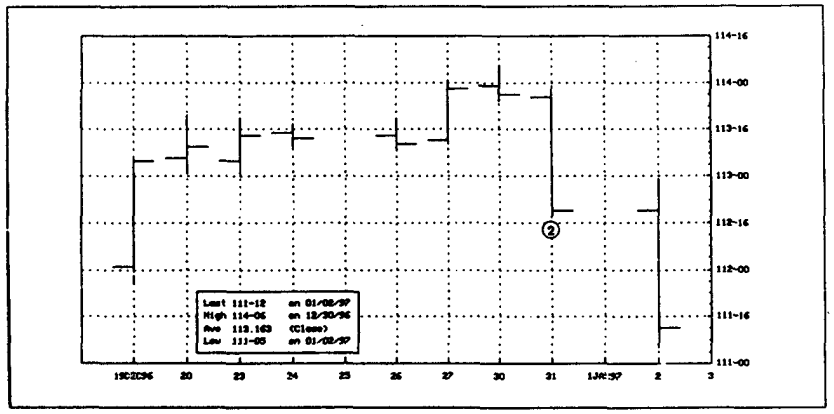
2. On April 9, the British pound breaks to the downside and its range is larger than the daily range of any of the previous nine days.
3. The next day the sell-off continues taking the pound to as low as 150.30 intraday.

FIGURE 7.13a US Long Bond



1. The 6-day historical volatility is under 50 percent the 100-day historical volatility.

FIGURE 7.13b US Long Bond



2. Largest daily range of previous nine days.

SUMMARY

Measuring historical volatility as we do identifies tightly wound markets. The larger-range day confirms a breakout and many times these breakouts can be substantial.

SECTION THREE

NEW PATTERNS

I have always been fascinated by bar patterns. To me, they tell a story of where a market has been and more importantly, where a market is likely to go.

The following three chapters are the easiest ones to understand in the book. They are simple chart patterns that provide an edge when triggered. The "8-Day High/Low Reversal Method" and the "Spent Market Trading Pattern" are setups that identify times when markets are likely to reverse. The "1-2-3-4" pattern is a wonderful setup which allows you to climb aboard strongly trending markets after they have had a brief pullback. All three patterns also combine good money management techniques by using tight protective stops.

CHAPTER 8

1-2-3-4

Among the benefits I have received from writing two books are the traders I have met whom I now consider friends. One of these traders is Jeff Cooper. Jeff makes his living doing what most people only dream about—he mostly day trades momentum stocks.

Over the past few years Jeff and I have had long conversations on how to identify which stocks and commodities are likely to have large moves and how to properly climb aboard for these moves. Most traders (both stocks and futures) can identify markets that are in a runaway mode, but many do not have a proper method for climbing aboard as the move continues.

Here is a trading pattern Jeff and I developed which first was introduced to the trading world in his book *Hit and Run Trading*. Both he and I use the setup as a fundamental part of our strategy. We believe it solves the predicament of when and how to enter runaway markets.

By way of background, W. D. Gann, more than 65 years ago, observed an interesting phenomenon for extremely strong markets and extremely weak markets. He noted that very strong and very weak markets usually do not correct for more than three days.

As Jeff and I worked on our methodology to enter these markets, it became clear that Gann's analysis and insight were absolutely correct. It is amazing how often a runaway market will experience a *few days pause* and then resume its trend.

The "1-2-3-4" trading pattern is a specific short-term setup which combines:

- ADX
- Pattern recognition
- A specific price entry placement to give a trader the opportunity to profitably enter in the direction of the resumption of a longer-term trend.

Here are the rules:

FOR BUYS

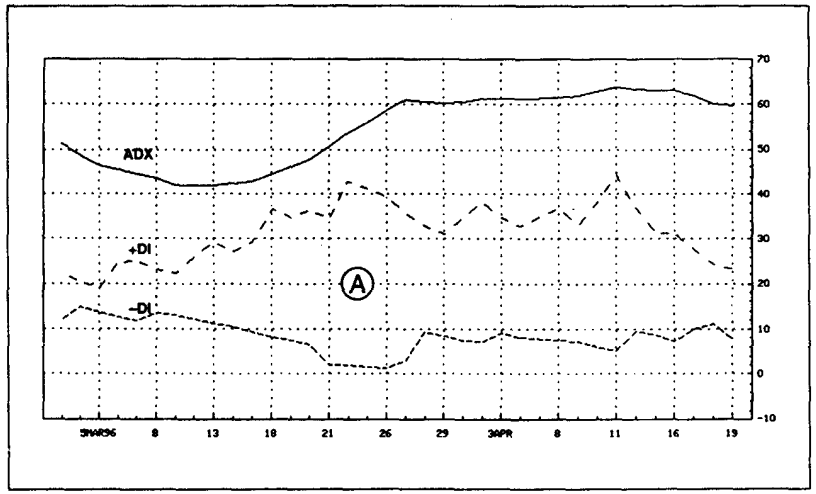
1. Identify a market whose 14-day ADX is greater than 30. *The higher the ADX, the better.*
2. The 14-day +DI reading must be greater than the 14-day –DI reading. (If you do not understand ADX, please see either *Street Smarts* or *Hit and Run Trading*.)
3. Wait for the market to have a 1-2-3 correction. This means that the market must make three consecutive intraday lower lows or any combination of two lower lows and an inside day. The examples will clarify this further.
4. On day four only, buy 1 tick (1/8 for equities) above the day-three high.
5. When filled, your initial protective stop should be near the day-three low.
6. As the position moves in your favor, you should trail your stops. In this setup we tend to allow for a little more breathing room on our stops because of the upside potential of the move.

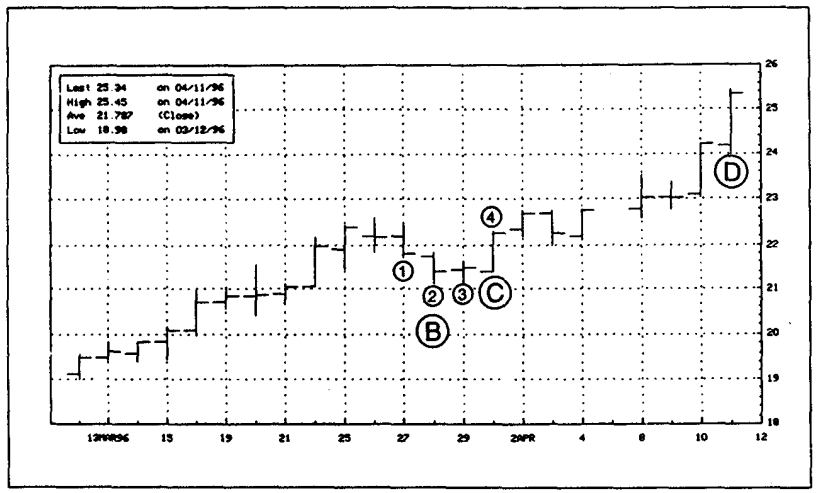
FOR SELLS

1. ADX > 30. The higher the ADX, the better.
2. The –DI must be greater than the +DI.
3. Wait for a 1-2-3 rally. Three higher highs or any combination or two higher highs and an inside day.
4. On day four only, sell (short for equities) 1 tick (1/8) below the day-three low.
5. Your initial protective stop should be near the day-three high.
6. As the position moves in your favor, trail your stops.

Let's look at some examples from the futures and equities.

FIGURE 8.1 May 96 Crude





A. In late March, the ADX for crude oil is well above 30 and the +DI is greater than the -DI, signifying an upward trend.

B. 1. March 27 has a lower low.

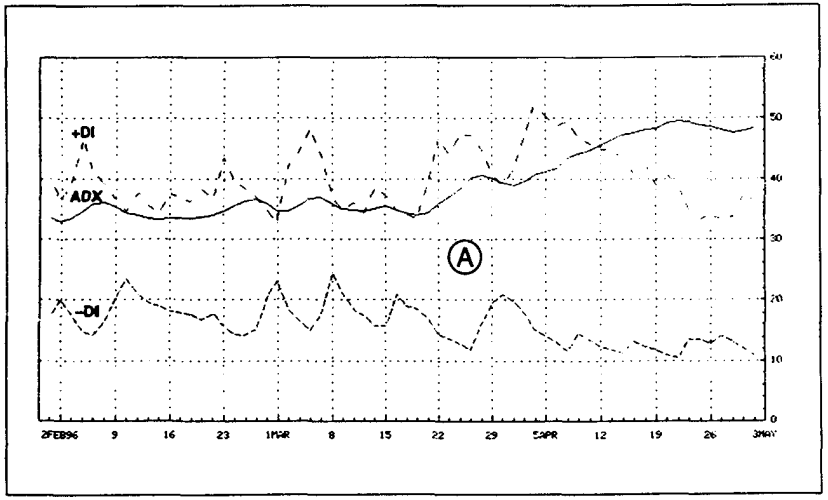
2. March 28 has a second lower low.

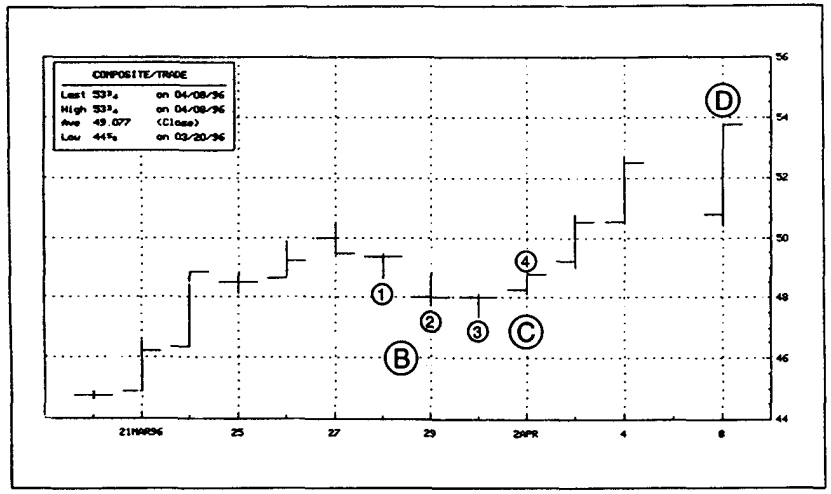
3. March 29 is an inside day. We will buy one tick above the March 29 high of 21.65 on April 1 only.

C. The market explodes higher and we are long. Our initial protective stop is near the March 29 (day 3) low.

D. The 1-2-3-4 trading pattern does a nice job of letting us participate in a better than $3,000 per contract upside move.

FIGURE 8.2 Gucci





This strategy works especially well with higher priced momentum stocks.

A. ADX is greater than 30 and +DI > -DI.

B. 1. A lower low.

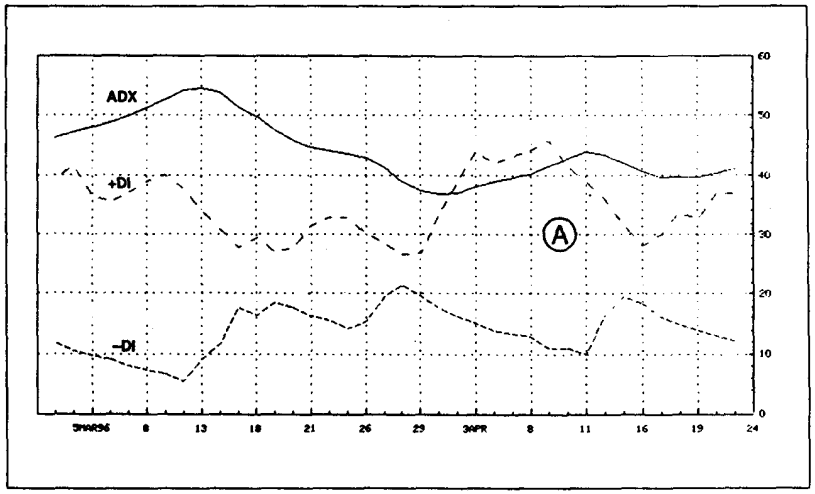
   2. A second lower low.

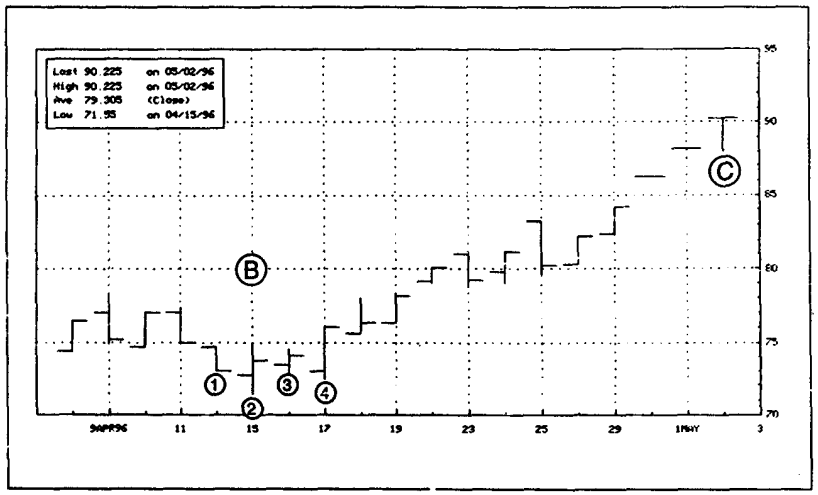
   3. A third lower low.

C. We buy on the opening as it is at least 1/8 point above the April 1 high of 48 1/8. Our initial protective stop is near the low of April 1 of 47 3/8.

D. Gucci trades nearly 6 points higher (12 percent) in four trading sessions.

FIGURE 8.3 Pork Bellies





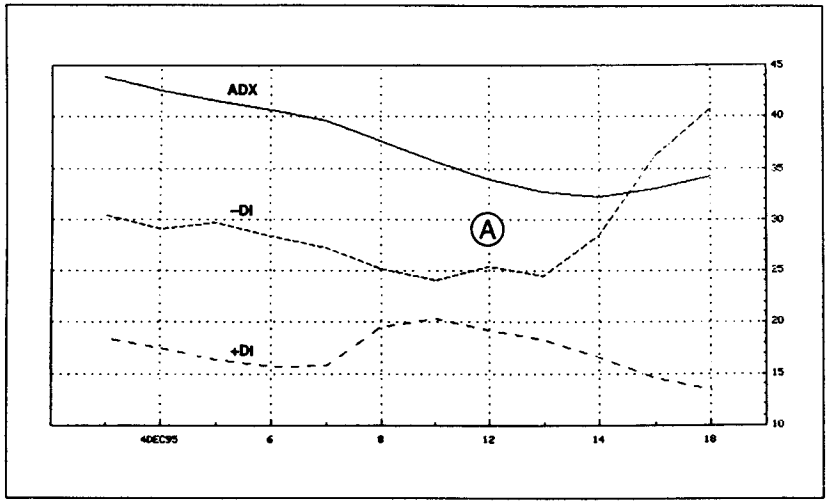
A. As you can see from the top chart, May bellies are in a strong uptrend. In mid-April, the ADX is greater than 30 and the +DI is greater than the -DI.

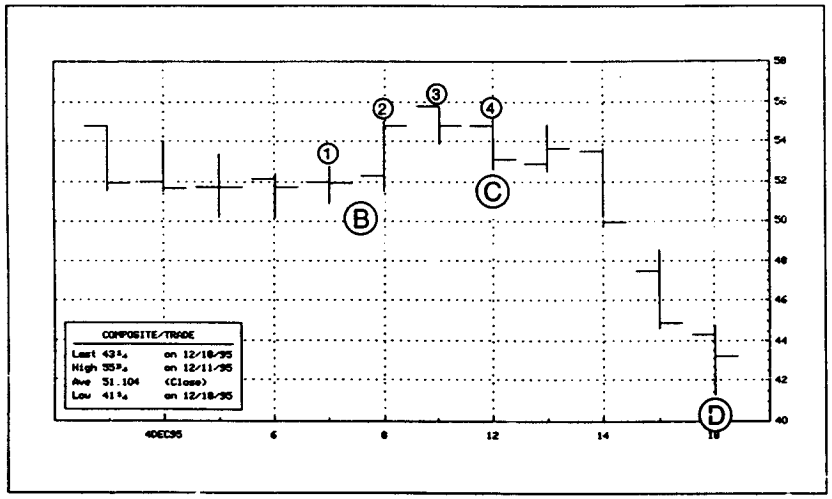
B. A 1-2-3-4 Setup

1. A lower low.
2. A second lower low.
3. An inside day.
4. Bellies trade lower in the morning and then begin an upward rise. We are filled at 74.52 and our initial protective stop is near the previous day's low.

C. May Bellies trade more than 15 cents higher ($6,000 per contract) over the next two weeks.

FIGURE 8.4 Micron Technologies (MU)





This strategy works equally well on the short-side for equities. Here is an example when the semiconductor stocks collapsed in late 1995.

A. ADX > 30, -DI > +DI—A bear trend.

B. 1. First higher high.

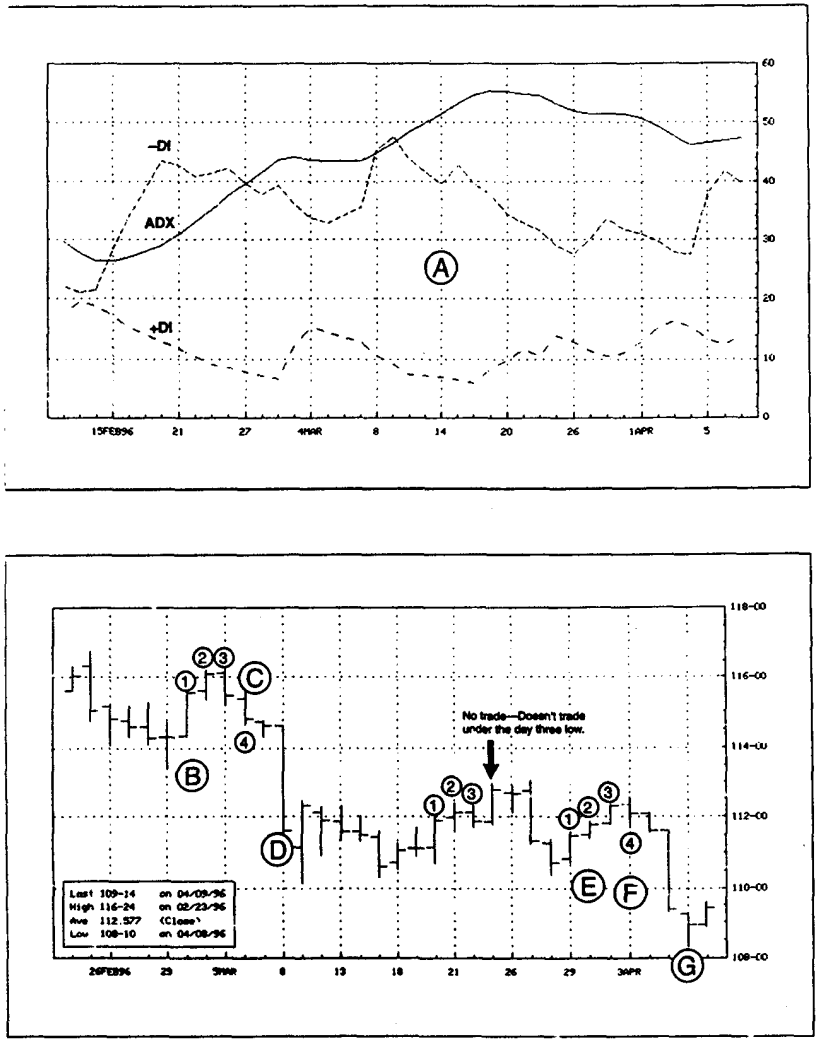
2. Second higher high.

3. Third higher high.

C. 4. Sell short at 53 3/4.

D. Micron drops 12 points in five trading sessions.

FIGURE 8.5 June Bonds



A. The ADX and DI confirm a strong downward trend.

B. Three consecutive higher highs.

C. Trades one tick under the March 5 low.

D. Bonds lose more than 3 points in three days.

E. Three consecutive higher highs.

F. Even though a fourth high is made intraday, we still trade today under the previous day's low and we are short.

G. Bonds again lose approximately 3 points, this time in four days.

SUMMARY

As you can see, this pattern works well in both futures and equities. An added benefit to trading this strategy with stocks is there are signals almost daily.

One of the hardest things to do is climb aboard a market that is in a run-away mode. As markets rapidly rise, the likelihood of entering near a top increases. By waiting for a pullback, which is a natural market phenomenon, and then climbing aboard as the trend resumes, you are looking at a lower risk entry for your trading. Also, by risking only a small amount (with your protective stops), you have an opportunity to participate in some potentially very large market moves.

Finally, even though I am not a fan of buying options, this setup obviously lends itself to call and put buying. From some of the moves that occurred in the examples, option traders surely benefited.

CHAPTER 9

THE 8-DAY HIGH/LOW REVERSAL METHOD

One of the earliest observations, made both by traders and academic researchers, is that markets go through various dominant cycles. These cycles range from decades to minutes. I suspect, the cycle many readers are most familiar with is the Taylor 3-Day Cycle: the Buy Day, Sell Day, Sell Short Day pattern discovered by George W. Taylor and described in *Street Smarts*.

Here is "The 8-Day High/Low Reversal Method," a longer-term cycle-trading methodology. The method is a distant cousin of Gerald Appel's 8-Day Action System which was introduced as an S&P scalping system approximately a decade ago. The 8-Day High/Low Reversal Method exploits the fact that normally markets go through three to four week cycles. Markets tend to rise for half this period and then decline for the other half. Instead of blindly trading the cycle and guessing at an entry, this methodology waits for a market to test its cycle's highs or lows and if the test is successful, we climb aboard for the reversal.

Markets tend to have dominant cycles. Too many of us, though, have been wrongly influenced by the prognosticators who attempt to predict market highs and lows based on these cycles. In reality, although markets

do not strictly adhere to these cycle points, it does not mean we cannot take advantage of them.

The 8-Day High/Low Reversal Method works because it combines an observed market cycle with confirmed price action. The method is further enhanced with the use of tight money management.

Because it may be difficult to grasp at first, I have included additional examples. Before we go to the examples, let's look at the rules.

FOR BUYS

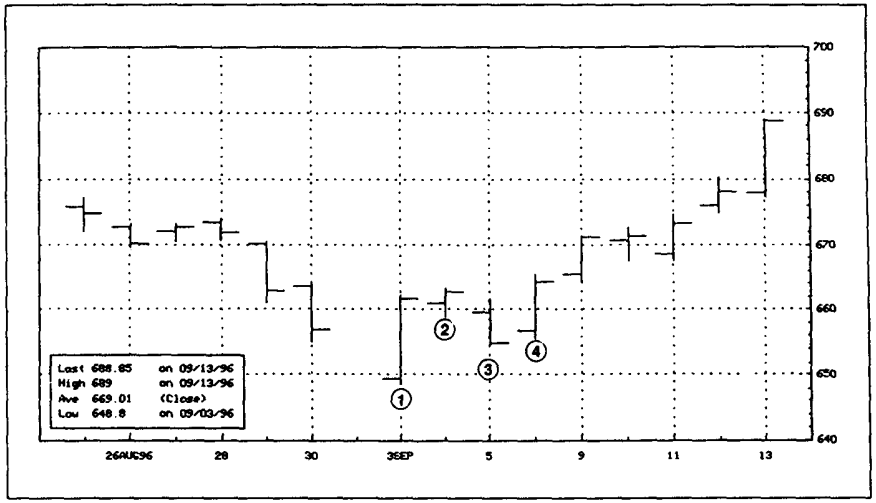
1. Day one must be an eight-day low.
2. Day two must trade above the day-one high.
3. Days three or four or five or six must trade under the day-two low (this can be a new low).
4. When condition three is satisfied, we buy one tick (1/8 for equities) above the day-two high as long as the one-tick breakout occurs within four trading days of condition three.
5. Our stop goes one tick below the day-two low.

FOR SELLS

1. Day one must be an eight-day high.
2. Day two must trade below the day-one low.
3. Days three, four, five, or six must trade above the day-two high (this can be a new high).
4. When condition three is satisfied, we sell (short) one tick (1/8 for equities) below the day-two low as long as it occurs within four trading days.
5. Our stop is placed one tick above the day-two high.

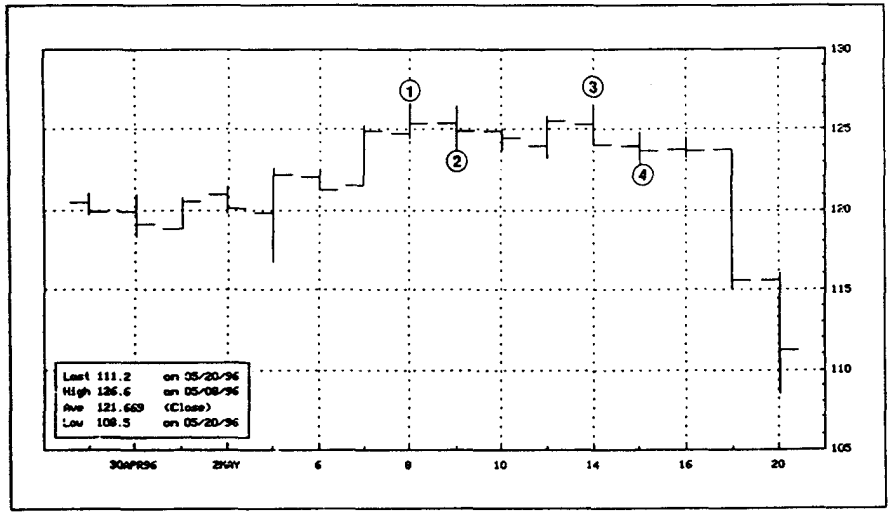
Let's look at a handful of examples.

FIGURE 9.1 S&P Dec 96



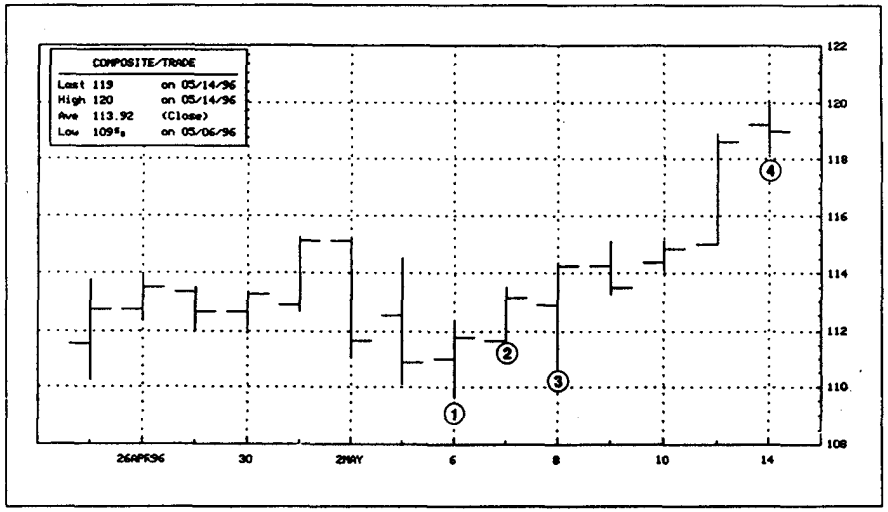
1. An eight-day low (day one)
2. Day two trades above the day-one high.
3. The next day trades under the day-two low. We will buy above the high (of day two) today (day three) or over the next four trading sessions only if the price trades one tick above the day-two high.
4. We are triggered at 663.15 and our stop is one tick under the day-two low.
5. The market explodes more than 25 points higher over six trading sessions.

FIGURE 9.2 July Copper



1. An eight-day high (day one)
2. The next day, we trade under the day-one low.
3. Three days later, we trade above the day-two high.
4. The attempted rally is short-lived and our sell signal under the day-two low is triggered. Our stop is one tick above the day-two high.
5. The market collapses over the next three days.

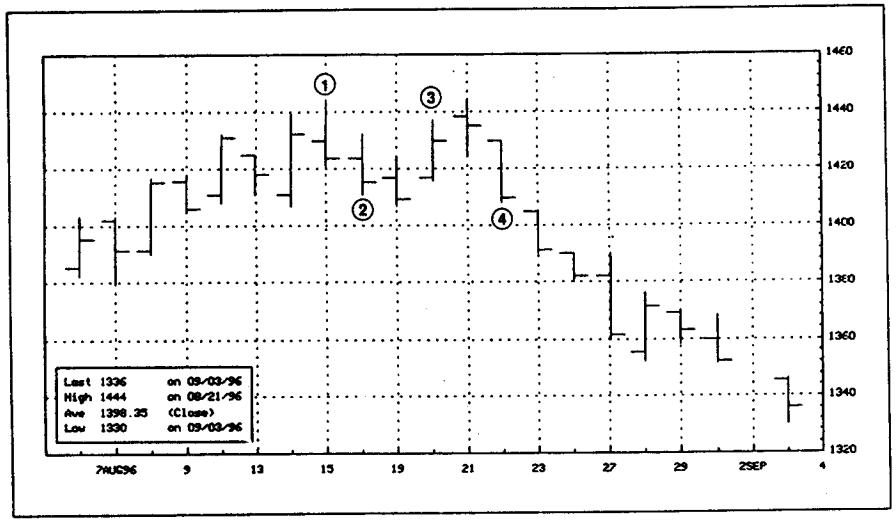
FIGURE 9.3 Microsoft



Here is a variation of the method. Notice how rules three and four are triggered the same day.

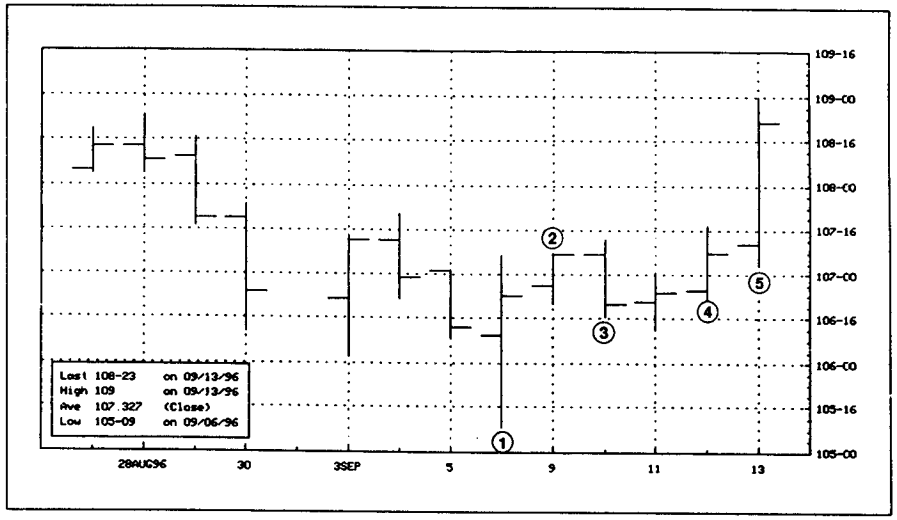
1. An eight-day low (day one).
2. The next day it trades above the previous day's high.
3. We trade under the day-two low and immediately reverse to trade above the day-two high.
4. Microsoft trades more than 6 points higher over the next week.

FIGURE 9.4 December Cocoa



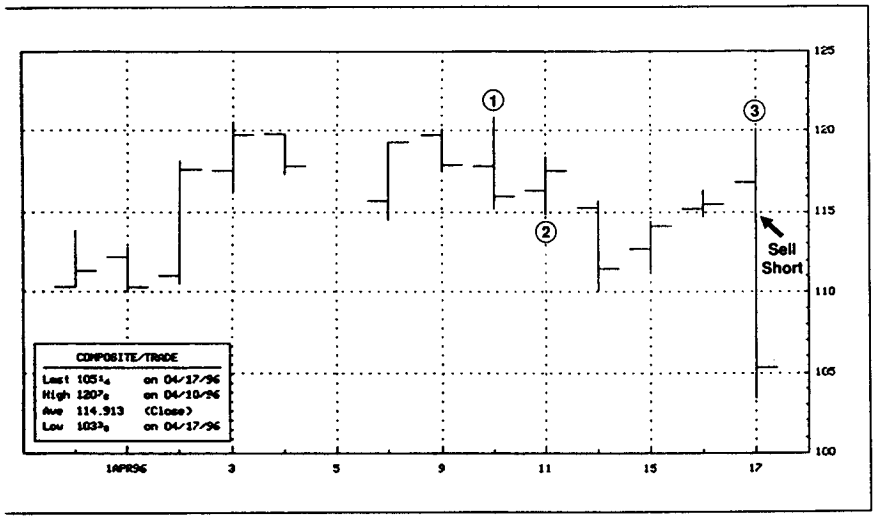
1. An eight-day high.
2. We trade under the day-one low.
3. We trade above the day-two high and our sell stop is placed one tick under the day-two low.
4. Our entry is triggered two days later and the 8-Day High/Low Reversal Method profits as cocoa sells off.

FIGURE 9.5 December Bonds



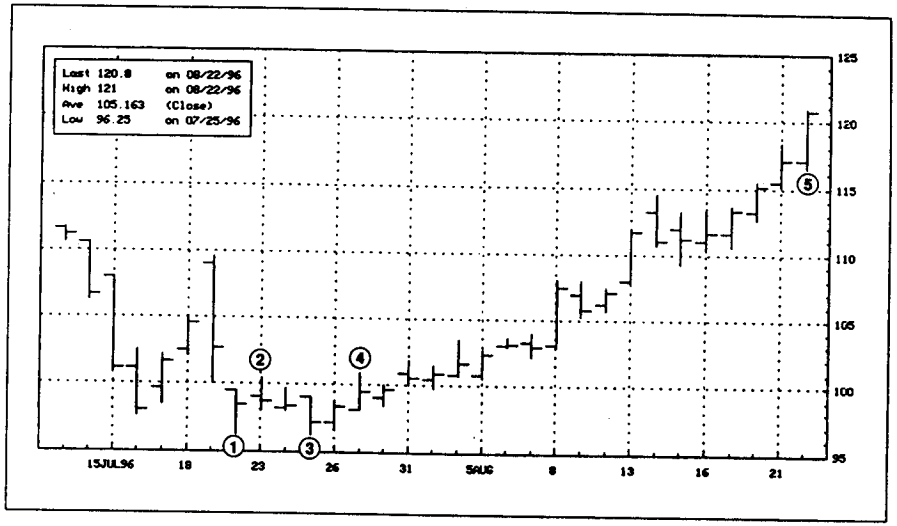
1. An eight-day low.
2. Trades above yesterday's high.
3. Trades under the day-two low.
4. The shorts are forced to scramble as a short-term bottom has been made.

GURE 9.6 IBM



1. An eight-day high (day one).
2. The next day we trade under the day-one low.
3. Four days later (our time limit), IBM trades above the day-two high and then trades under the day-two low. We sell the stock short and by the end of the day, IBM is trading more than 12 points under our entry point.

FIGURE 9.7 December Coffee



Even though I mostly short-term trade, this setup did a nice job of getting into an intermediate term bottom in coffee.

1. An eight-day low.
2. We trade above the day-one high.
3. Trades under the day-two low.
4. We buy one lick above the day-two high.
5. A solid low-risk move over four weeks.

Notice the strength of this move. The market does not make two consecutive lower lows after the buy signal is triggered. This is fairly rare but it does show what markets will do when the selling is completed and legitimate bottoms are made.

SUMMARY

As you can see, this is a fairly low-risk setup that does a nice job of identifying markets that are likely to experience short and intermediate term reversals. Also, you may want to combine it with the Two-for-One money management method (*see* Chapter 28) to allow you to participate in those reversals that are substantial.

CHAPTER 10

SPENT MARKET TRADING PATTERN (SMTP)

For years we have read about the virtues of trading reversal bars. Unfortunately, their track record is horrendous. I will quote Jack Schwager from his fine book, *Schwager on Futures: Technical Analysis,*

> "It can be said that reversal bars successfully call 100 out of every 10 highs . . . in my opinion, the standard definition of reversal days is so prone to generating false signals that it is worthless as an indicator."

I agree with Jack.

Fortunately though, the story doesn't end there. I have had very good success trading a variation of reversal days which I call the "Spent Market Trading Pattern." This strategy has structured rules that combine reversal days, spike bars, trends, and a specific entry method to provide a low-risk setup.

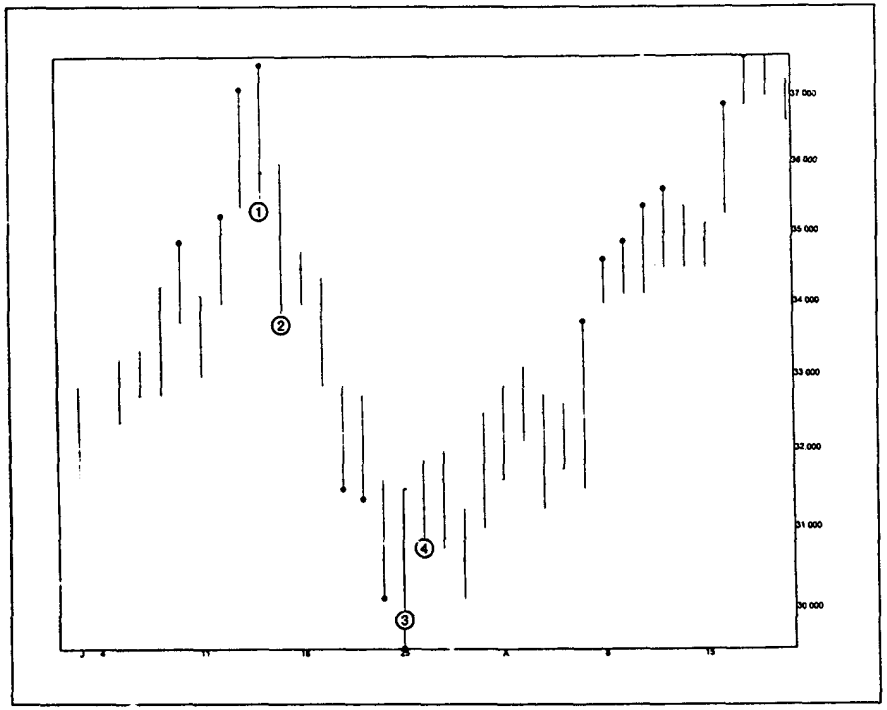
Here are the rules:

FOR BUYS (SELLS ARE REVERSED)

1. Today the market must make a 10-period low.
2. Today's range must be the largest range of the past 10 bars.
3. Today's close must be in the top 25 percent of today's range.
4. Tomorrow, or the trading day after tomorrow, buy one tick (1/8 for stocks) above today's high.
5. If filled, place an initial protective sell stop at today's low and trail it appropriately to lock-in profits.

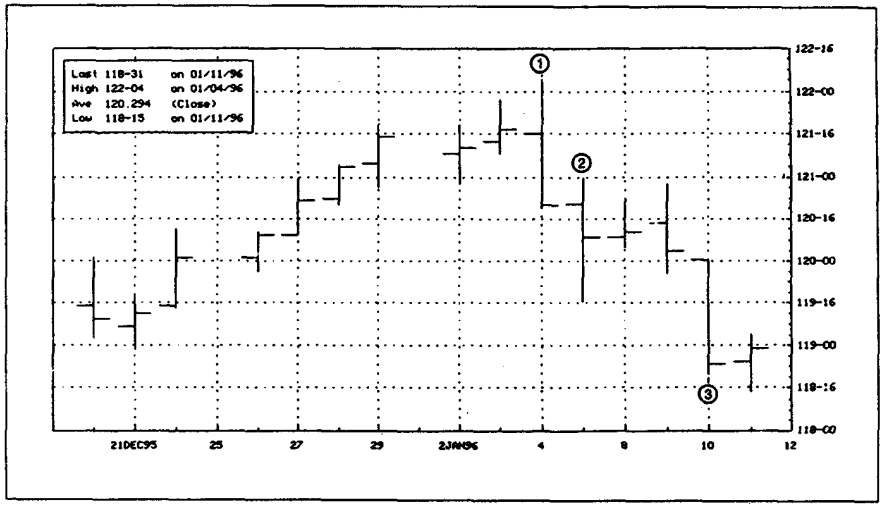
Let's look at three examples.

FIGURE 10.1 Compaq Computer



1. Today's high is a 10-period high, the range is the largest of the past 10 trading sessions, and the close is in the bottom 25 percent of its range.
2. A sell short stop is triggered 1/8 below yesterday's low of 35 1/2 and our protective stop is at yesterday's high of 37 1/2. The market proceeds to lose over 10 percent of its value over the next few trading sessions.
3. A 10-period low, the largest range of the past 10 periods, and a close at the top 25 percent of the range.
4. A buy is triggered at 31 5/8, one tick above yesterday's high and our protective stop is placed at yesterday's low of 29 1/2. The SMTP identifies an intermediate term low as Compaq rises nearly 20 percent over the next month.

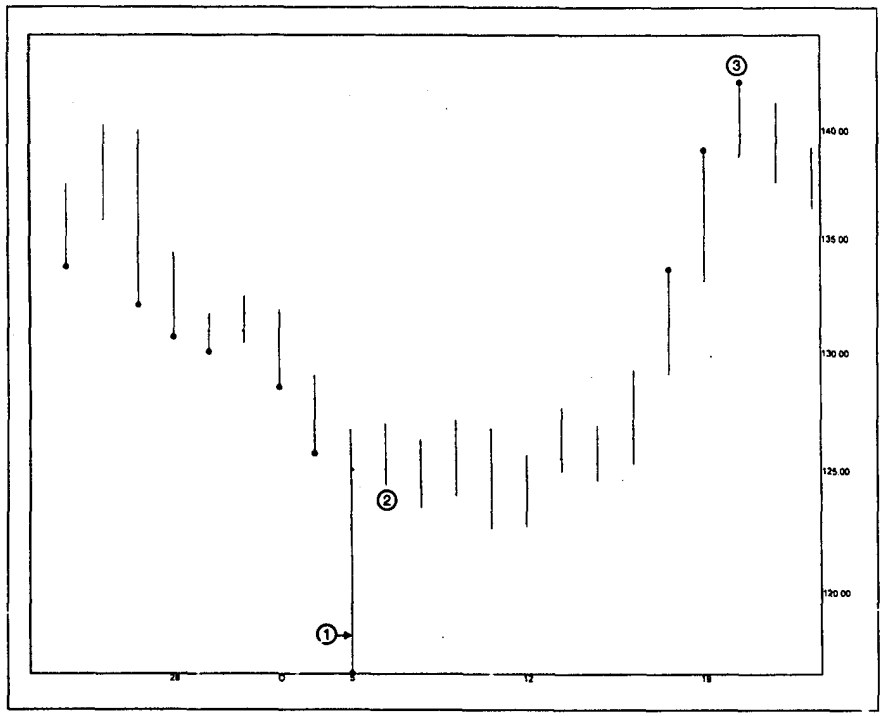
FIGURE 10.2 US Bonds



1. A 10-bar high, the largest range of 10 days and a close in the bottom 25 percent of its daily range.
2. Our sell stop is triggered one tick under yesterday's low of 120-25 and a protective buy stop is placed at 122-04.

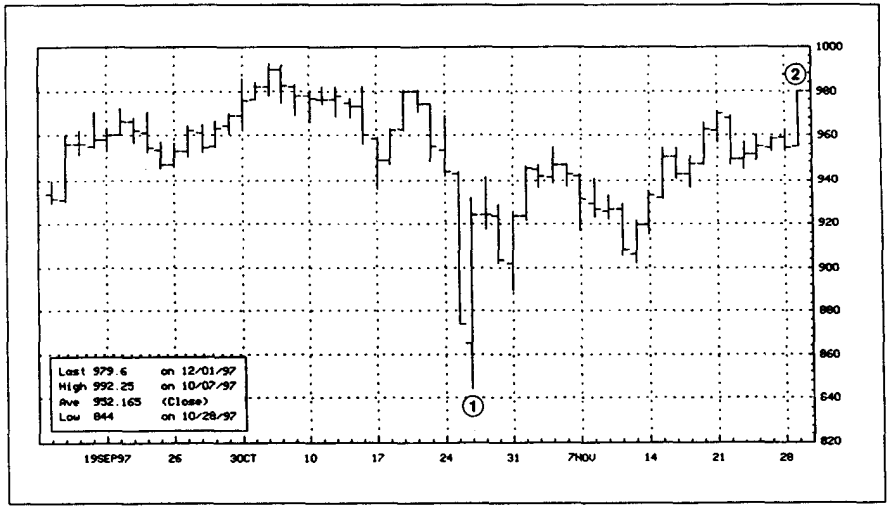
3. The setup identifies the life of the contract high for bonds and the market drops more than 2 points in four trading sessions. An additional strategy to look at with this setup is to sell options. In this example, both the 120 and 122 calls lost more than half their value in four days.

FIGURE 10.3 Biotechnology Index



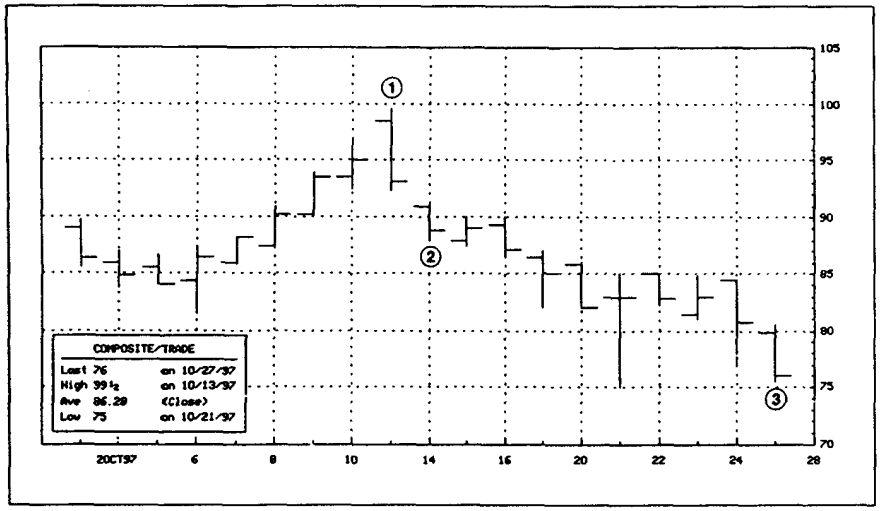
1. A 10-bar low, the largest range of 10 days, and a close in the top 25 percent of the range.
2. A buy stop is triggered.
3. The market trades 15 points higher over the next few weeks.

FIGURE 10.4 December S&P 97 Futures



1. A 10-period low, the largest range of the past 10 days, and a close in the top 25 percent of today's range.
2. The sell-off exhausted itself and the market moves back to near all-time highs.

FIGURE 10.5 SLOT



1. The market makes a 10-period high, the range is the largest of the past 10 days, and the close in the bottom of its range.
2. Sell short at 91 3/4.
3. The stock drops 15 points in two weeks.

SUMMARY

In all time frames this setup indicates the exhaustion phase of a move and a short-term to intermediate-term reversal can be expected. Even though we only looked at daily examples, this setup works equally well with intraday and weekly time frames.

SECTION FOUR

EQUITY TRADING

The following five chapters will cover trading equities. The chapters "Crash, Burn, and Profit," "When They're Late They Are Probably Dead" and "The Double Volume Market Timing Method" are a short-seller's delight. In spite of what the mutual fund and brokerage house industries want you to believe, stocks actually do go down. As shocking as this news is I will top it; stocks drop much faster than they rise! This means traders who can properly identity and time stocks before they collapse can make substantial profits quickly.

The other two chapters are for very short-term traders who want to be in and out of a stock within a day or so. A couple of these strategies relate closely to other chapters and should be fairly simple to master.

CHAPTER 11

THE CRASH, BURN, AND PROFIT TRADING STRATEGY (CBP)

If you look at the results of the major hedge funds from 1991 through 1997, you will see that the short-sellers have performed the worst. This is easily explained as the market more than doubled in value during that period. The one common characteristic of these short funds, though, is that when they are correct, they are very correct.

The majority of short sellers tend to focus on high flying stocks with hyped stories and then short them. Many times these short sellers are correct, but most times they are too early. Some of these stocks tend to go to stratospheric levels, moving 100 percent, 200 percent, and 300 percent above where they were shorted. Needless to say, most of these fund managers are long gone (stopped out) before the inevitable collapse.

I have studied these high-flying stocks and looked at the common characteristics they had before they collapsed. What invariably comes into the picture is that their weekly ADX reading reaches above 60 and then upon the ADX downticking, the stock also declines, at times never to see those price levels again.

Let's understand what is happening before moving onto the rules. For a stock to reach a level of 60 on its daily ADX, it must be climbing very strongly. For it to reach 60 on its *weekly* reading, it must be parabolic. Greed, fear (from the shorts), and volatility are at a maximum and it doesn't take much to make this bubble burst.

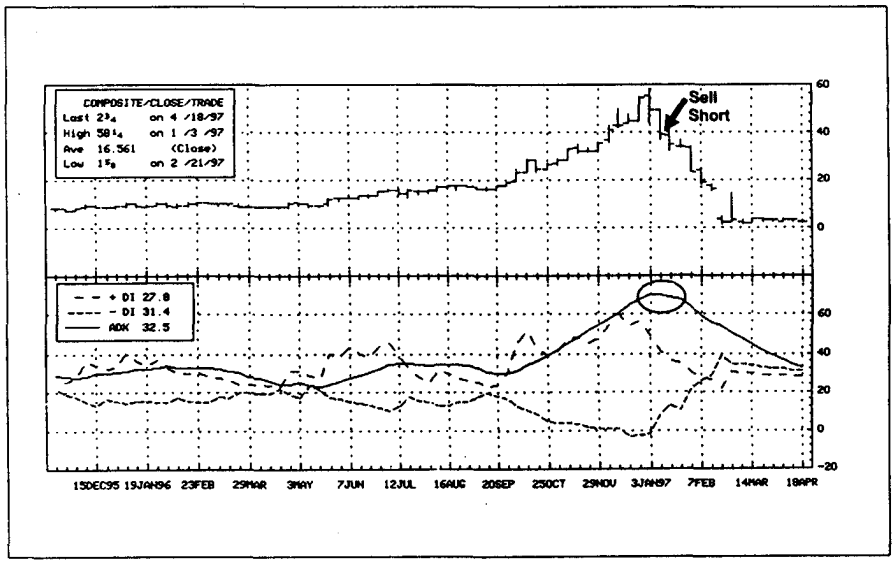
A word of warning needs to be given. *These stocks can and do go even higher and I highly recommend using some type of predetermined protective buy stop.* Because you will be looking to make larger gains on these setups, I recommend a 15 percent stop-out point. Also, deep in the money puts are a good choice instead of shorting the stock, as your loss will be limited if you are wrong and you avoid the difficulty of borrowing the stock. (The latter is a good tactic to keep in mind whenever a short sale is hampered by your broker's inability to find shares to borrow.)

Here are the rules for our short selling strategy:

1. Identify a stock whose weekly ADX reading is above 60.
2. The stocks price should be above 20, as I have found this setup to work even better on higher priced stocks.
3. After the weekly ADX reading reaches 60, wait for the first lower ADX weekly reading to occur.
4. When the above 3 rules are met, short the stock and risk no more than 15 percent.
5. Cover one-half the position upon a 20 percent profit and use trailing stops on the other half.

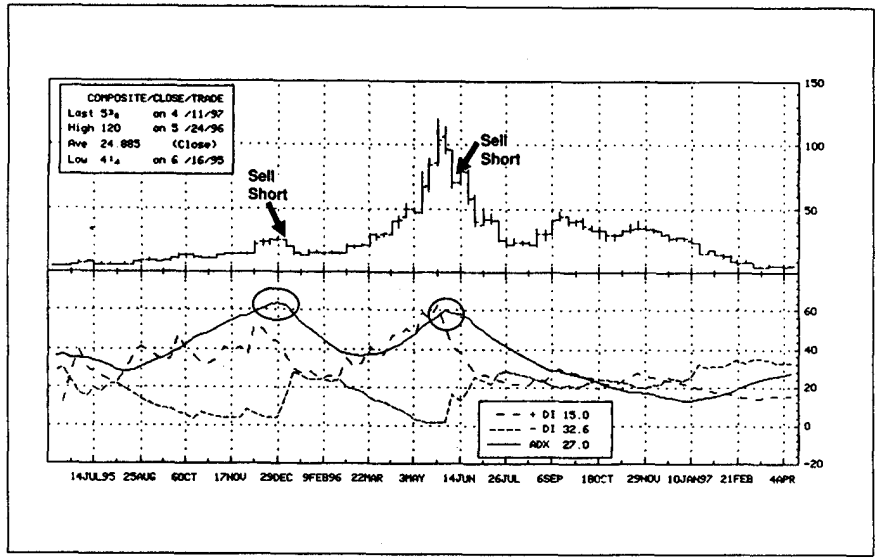
Here are some examples:

FIGURE 11.1 Centennial Technologies



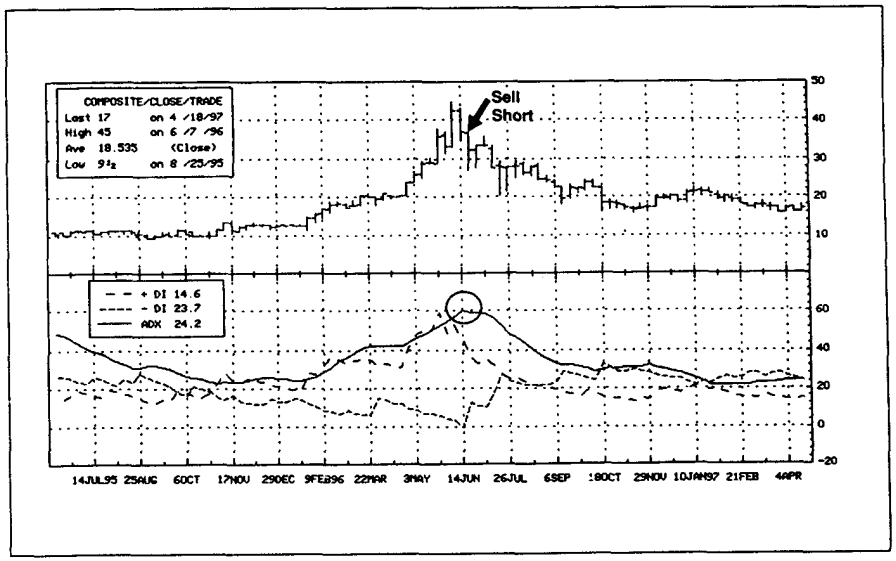
Centennial Technologies is a good CBP example. The PC solution company entered 1997 trading at more than 150 times stated earnings and promising investors the road to riches. On the week of January 10, 1997, the weekly ADX downticks for the first time since closing above 60. A short signal is triggered at 49 1/8 and the profit (as many times occurs when the bubble bursts) is immediate with the stock closing the week at 39 3/8. Six weeks later, the game is over as fraud has been uncovered and the company's chairman is indicted. The stock currently trades in the 2 1/2 range.

FIGURE 11.2 Diana Corp.



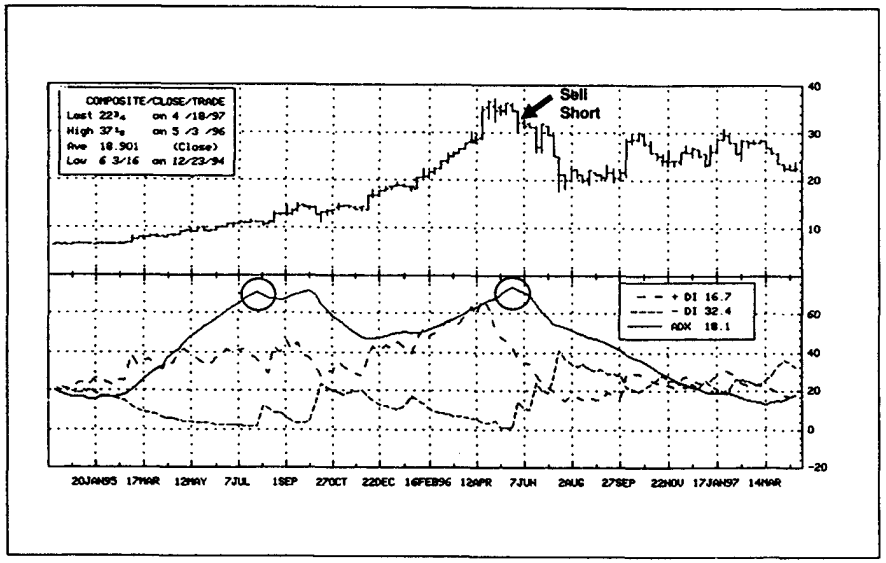
Diana Corp. (the symbol was DNA before the NYSE delisted them) is a telephone networking company. The stock had two CBP setups. The first occurred January 6, when the ADX downticked from its above-60 level. The next week, the stock lost 35 percent of its value. As you can see though, it's tough to keep a good story down and the stock rose another 100 points (!) triggering another CBP signal on June 7 at 67 3/8 (the stock had almost halved in the previous two weeks). Three weeks later, DNA was trading more than 30 points lower and as of April 22, 1997, it was changing hands at 4 3/8.

FIGURE 11.3 Wackenhut Corrections Corp.



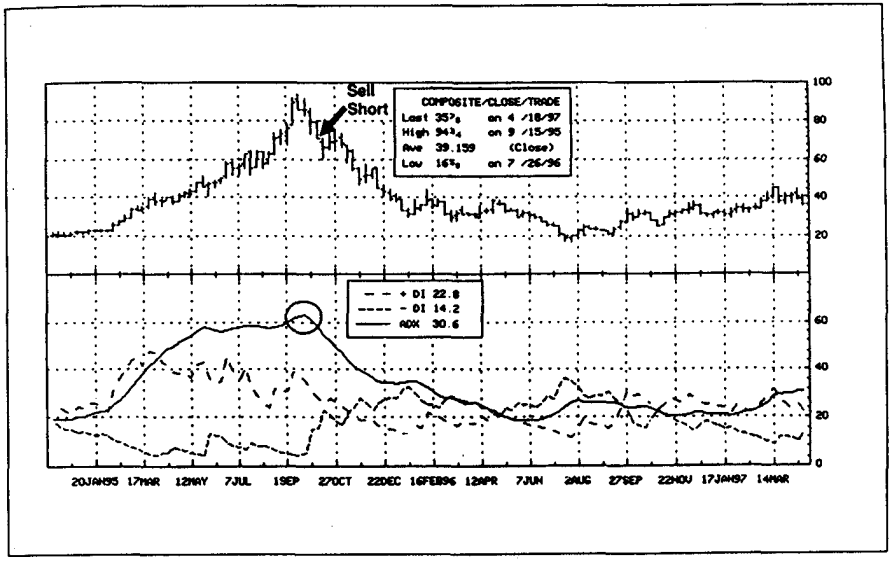
In the summer of 1996, momentum investors and money managers were tripping over themselves to buy Wackenhut Corrections Corp. On June 21, 1996, a CBP signal gets triggered at 32 1/8 and within one month the stock was nearly 40 percent lower.

FIGURE 11.4 Delta and Pine



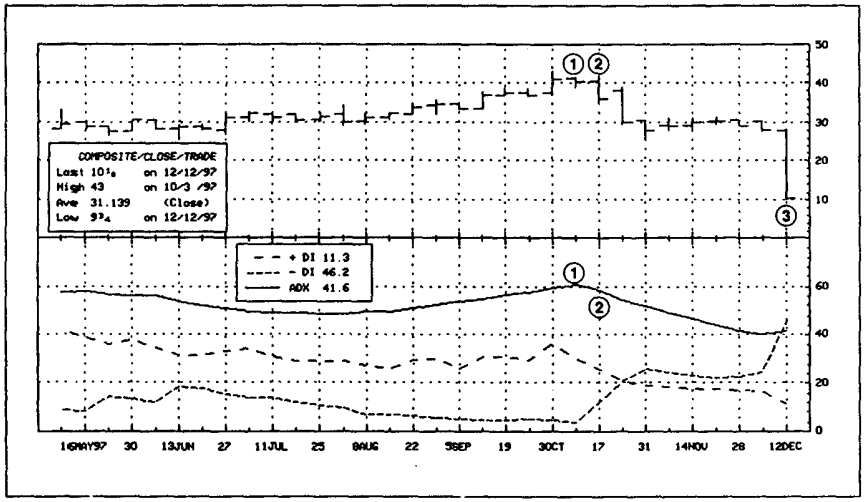
Delta and Pine breeds cotton seed. Here we have one unsuccessful setup in August 1995 and one very quick successful setup (eight weeks) last June leading to a 40 percent gain.

FIGURE 11.5 Micron Technologies



Micron Technologies was the darling of growth investors in 1995. Unfortunately for those investors who got caught owning the stock during its downturn, the sell-off that was triggered after the CBP signal was quite painful.

FIGURE 11.6 Fine Host Corporation



1. Here is an example that occurred as the book was ready to go to the printers. Fine Host Corporation, a contract food service company, was reporting record earnings since going public. The stock rose five-fold in 14 months, bringing the weekly ADX above 60.

2. A downtick in ADX and we are short.

3. Two months later the company announces it would restate earnings due to "accounting irregularities" and it fired its CEO and treasurer. As I am writing this, the stock has been halted and may not resume trading for as long as a month.

SUMMARY

As the funds which short equities on fundamental analysis alone have learned, one needs to properly time when to short these highest-flying stocks. The ADX above 60 reversal method does a good job of doing this.

You need to be somewhat patient as this method is fairly rare, but with the proliferation of momentum-based money managers and investors, ample opportunities do occur over the course of a year. The best way to identify these opportunities is to do a weekly scan if you have the software, or to use Investor's Business Daily and identify those stocks whose Relative Strength is 98 or 99. This will keep you focused on the correct names to follow and allow you to participate when these crazy stocks collapse.

One final point should be made. Some of the examples showed companies whose stock completely collapsed. In reality, these are more the exception than the rule. Ideally, you should expect smaller moves, and when the home runs occur, view them as a gift.

CHAPTER 12

WHEN THEY'RE LATE, THEY'RE PROBABLY DEAD

This strategy looks at a method to identify when companies will probably disappoint with their earnings. As you know, when a growth company has an earnings downfall, prices implode and those traders fortunate enough to be short are amply rewarded.

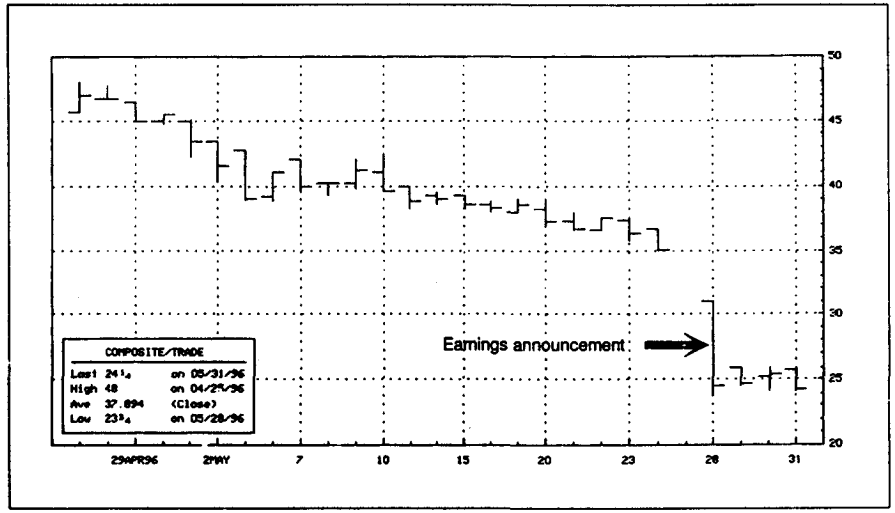
This is a method I have used over the years to exploit negative earnings surprises. Unfortunately, this strategy doesn't happen often but when it does the results are powerful.

The "When They're Late, They're Probably Dead" trading strategy targets companies:

1. That are late reporting their earnings.
2. Whose price trends lower before the earnings are due.

Let's look at an example.

FIGURE 12.1 Baby Superstores



Baby Superstores,* a rapidly growing infant products company is expected to report earnings during the week of May 15, 1996. When the week comes to a close, the company still hasn't released their numbers and a red flag is triggered. We then look at the recent trend of the stock. As you can see, the stock is not only declining while the stock market is rising, but it is hovering around the year's lows.

We put these two pieces together and come to the conclusion that there is a potential problem. The safest strategy is to buy puts. If by chance we are wrong, this will limit our losses.

In this example, I paid 2 1/4 for the June 35 puts.

The company goes the entire next week again without reporting earnings! On Tuesday morning of the following week, Baby Superstores finally releases their numbers and they are terrible. The stock immediately collapses and the puts climb to above $10 intraday.

* When this trade occurred, I was in Washington, D.C., to listen to a friend speak at the Managed Futures Association annual meeting. The options desk I trade through called my office with the good news and I closed my position very near the high of the day from a pay phone in the hotel lobby. Sometimes you're better lucky than smart.

Why is the company late reporting earnings? My guess is that senior management is taken by surprise by the shortfall and it takes them a week or two to digest the problem and create a new "strategic plan" to announce to Wall Street.

A late earnings report alone though is only one piece of the puzzle. The other piece is the price action preceding the announcement. It is obvious by the trend that the so-called "smart money" was unloading its positions ahead of the report. There is no other way to explain a momentum stock like Baby Superstores trending downward in a climbing market.

Again, this situation does not happen everyday, but when it does, it pays to take a good close look at it.

CHAPTER 13

DOUBLE VOLUME MARKET TOP METHOD

In the 1980s, there was a wonderful bookstore in West Los Angeles that sold nothing but investment books. In a one-room loft, it had copies (mostly photocopies) of nearly every book and course written over the previous 50 years on the markets. The owner unfortunately passed away six or seven years ago and the store was closed. On one of my last visits I was lucky enough to purchase a copy of Tubb's *Stock Market Correspondence Lessons*, written in the 1930s.

This book is one of the worst written treatises I have ever come across, but it is also one of the single best books published on how to trade the markets. Tubb's was decades ahead of everyone else in formulating "rules" and "laws" that dictate market behavior. One of his areas of expertise was how volume preceded and affected price. One of his concepts was that when the volume of a stock had a large spike relative to the previous 15 days, and the stock was near its highs, a reversal was likely.

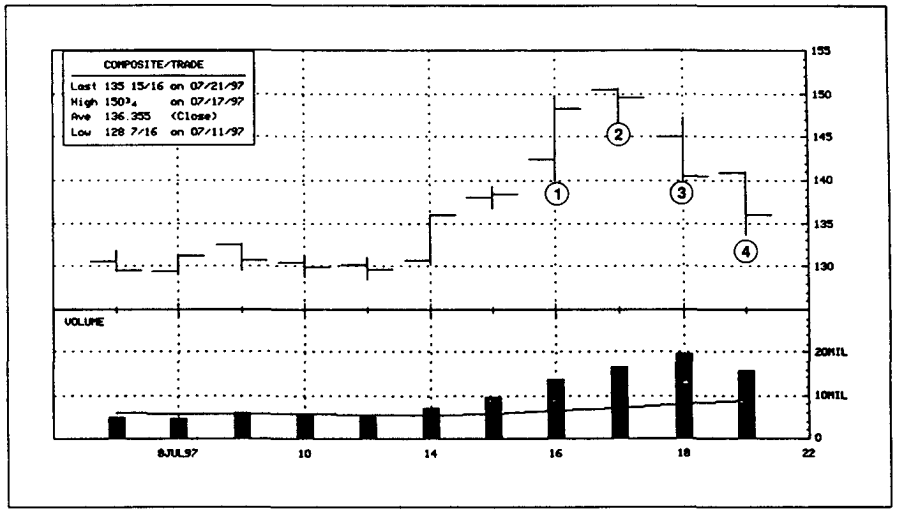
For me this made sense but the rules were too vague and needed to be tightened and made more specific. Building on Tubb's observation, I created the "Double Volume Market Top Method" (DVMTM) which combines exact volume rules with an exact pattern to better pinpoint market tops.

Here are the rules:

1. A stock must be trading near or at a three-month calendar-day high.
2. Today's volume must be double its 15-day average volume. This means if the volume has averaged 1 million shares daily for the past 15 trading days, it must trade at least 2 million shares today.
3. Either today, tomorrow, or the next day, the stock must close below its open.
4. When Rule 3 is met, over the next two days sell 1/8 under the Rule 3 day low.
5. Your initial protective stop should be the top of the Rule 3 day bar and trailing stops should be used to lock-in profits.

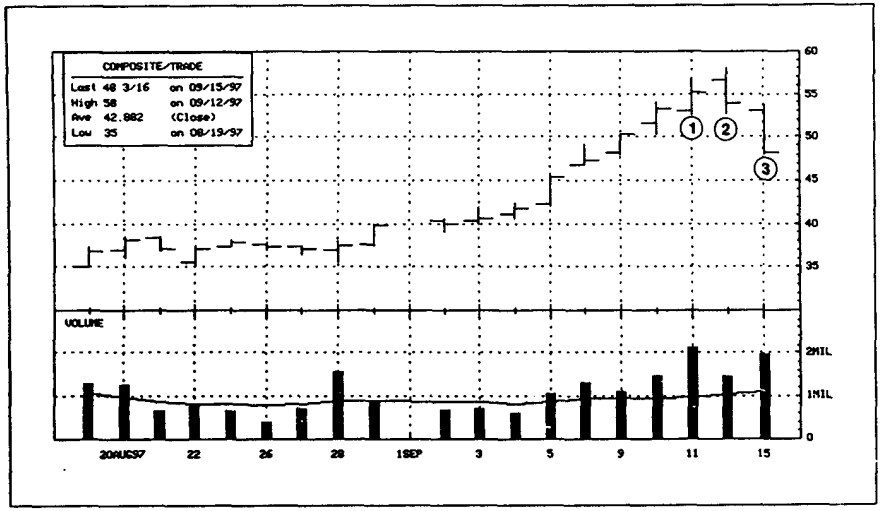
Let's look at a handful of examples to further understand this strategy.

FIGURE 13.1 Microsoft



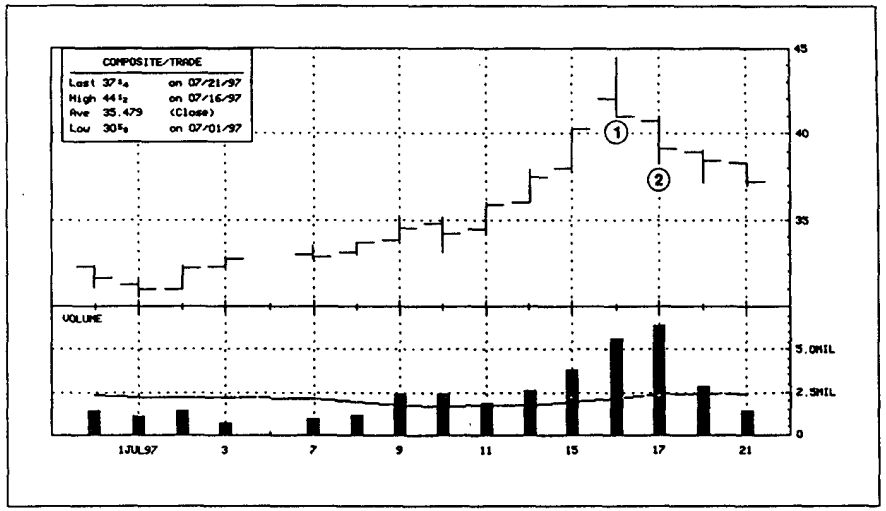
1. On July 16, 1997, Microsoft makes a new high on more than double its normal daily average volume.
2. Another new high and a close below its open.
3. Sell short at 145.
4. The stock closes 9 points below yesterday's fill.

FIGURE 13.2 Yahoo



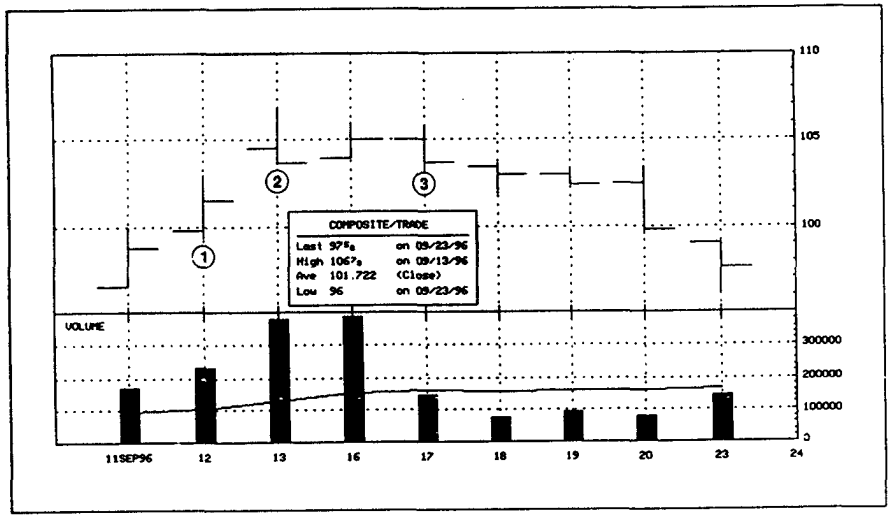
1. A new high on double its average daily volume.
2. Yahoo closes below its open.
3. Sell short at 53 and it closes at 48 13/16.

FIGURE 13.3 Western Digital



1. On July 16, WDC makes a new high, has volume of double its daily average, and the close is below its open.
2. We sell short on the opening at 40 3/4 and the stock closes 3 1/2 points lower two days later.

FIGURE 13.4 Fila



Here is an example of the DVMT catching the all-time high on Fila.

1. A new high on double the average daily volume.
2. A close below the open.
3. Sell short at 103 3/8 and we catch the absolute top. In fact, a year later Fila traded under 30.

SUMMARY

If you have historical data going back into the 40s, 50s, 60s, and 70s, you will see this setup identify short-term tops over and over again. Tubb's observations of 60 years ago, when tightened with our rules, make this an excellent pattern with which to short stocks.

CHAPTER 14

TRADING EQUITIES WITH THE CONNORS VIX REVERSAL

With a methodology that does as good a job of identifying short-term highs and lows in the stock market as the three Connors VIX Reversal strategies do, it only makes sense to identify those stocks in the Dow and/or S&P 500 that are likely to lead the markets up or down.

In an upcoming chapter, "Maximizing Profits in Short-Term Market Declines," I highlight strategies to exploit declining markets. As you will see, the interest-sensitive stocks, brokerage stocks, and to a lesser extent technology stocks tend to lead the market both higher and lower.

In order to fully maximize our profits in equities when a CVR signal occurs, we want to be in these market leaders. In my opinion, the two best stocks to trade for this are Merrill Lynch and Intel. Both provide excellent, consistent market leadership at extreme market levels and both are weighted heavily in many of the indices.

Now, the answer to the question of how to best trade these stocks: exactly as you would trade the futures—buy (sell) on the close and hold for three days with some sort of protective stop in place. Because the VIX closes at

4:00 P.M., you will need to front-run the signal by a few minutes to assure getting filled.

Let's look at the results over a 15-month period using the CVR I for both Merrill Lynch and Intel. Please note that in the following results slippage and commission were not included, but the results should give you a rough guide to performance.

MERRILL LYNCH

Date	Signal	Entry Price	Exit Price	P/L P	P/L L
01/05/96	B	51 1/2	49 3/8		2 1/8
02/07/96	B	60 1/4	61 7/8	1 5/8	
02/14/96	B	60 7/8	57 3/4		3 1/8
02/29/96	B	57 5/8	60 1/4	2 5/8	
04/04/96	SS (1 DAY)	61 5/8	58 1/2	3 1/8	
04/08/96	B	58 1/2	56 1/4		2 1/4
04/22/96	SS	60 5/8	60	5/8	
06/07/96	B	64 7/8	63		1 7/8
07/16/96	B	58 3/8	59 1/2	1 1/8	
07/24/96	B	58 3/4	58 7/8	1/8	
09/03/96	B	62	61 3/8		5/8
09/27/96	B	65 1/4	69	3 3/4	
10/07/96	SS	71 5/8	68 3/8	3 1/4	
10/17/96	SS	69 1/4	67 5/8	1 5/8	
10/23/96	B	68 5/8	67 5/8		1
10/31/96	B	70 1/4	74 1/2	4 1/4	
11/15/96	SS	78 3/4	78 1/4	1/2	
12/04/96	B	79	79 3/4	3/4	
12/13/96	B	78 5/8	80 1/8	1 1/2	
01/02/97	B	79 3/4	80 3/8	5/8	
01/23/97	SS	84 1/8	80 1/8	4	
02/26/97	B	98 3/8	97 7/8		1/2
02/28/97	B	96	98 1/2	2 1/2	
03/20/97	B	91 3/4	91 7/8	1/8	
03/27/97	SS	87 1/2	85 7/8	1 5/8	

Total Results: **18 profitable**
7 unprofitable
+ 22 1/4 points

INTEL

Date	Signal	Entry Price	Exit Price	P/L P	P/L L
01/05/96	B	57 1/2	54 1/8		3 3/8
02/07/96	B	58 1/4	58 1/4	—	—
02/14/96	B	58	57 7/8		1/8
02/29/96	B	58 7/8	55 3/8		3 1/2
04/04/96	SS (1 DAY)	59 1/4	60 5/8		1 3/8
04/08/96	B	60 5/8	60 1/2		1/8
04/22/96	SS	67 3/4	69 5/8		1 7/8
06/07/96	B	75 1/4	76 3/4	1 1/2	
07/16/96	B	70	72 3/4	2 3/4	
07/24/96	B	69	72 7/8	2 7/8	
09/03/96	B	81 5/8	81 1/4		3/8
09/27/96	B	96 7/8	99	2 1/8	
10/07/96	SS	104 3/4	99 7/8	4 7/8	
10/17/96	SS	110 3/4	105 1/2	5 1/4	
10/23/96	B	109 3/8	106		3 3/8
10/31/96	B	109 7/8	114	4 1/8	
11/15/96	SS	115 7/8	120 7/8		5
12/04/96	B	129 1/2	130 1/8	5/8	
12/13/96	B	132 3/8	135 3/4	3 3/8	
01/02/97	B	130 3/8	143 3/8	13	
01/23/97	SS	151 3/4	151	3/4	
02/20/97	B	149 7/8	148 7/8		1
02/28/97	B	141 7/8	149 1/2	7 5/8	
03/20/97	B	133 1/4	133 1/4	—	—
03/27/97	SS	139 1/8	137	2 1/8	

Total Results: **13 profitable**
10 unprofitable
2 breakeven
+30 7/8 points

SUMMARY

You can select your own leaders to trade this strategy with but I believe that these two stocks move most consistently with the overall market. Also, as a reminder, always place protective stops to protect yourself!

CHAPTER 15

TORPEDOES

"Torpedoes" is an intraday strategy created by Jeff Cooper. Torpedoes are volatile, market-leading stocks which rise in spite of a sharply declining market. These stocks are on a mission of their own and tend to lead the rise most dramatically when the market bounces back.

Let's look at how to identify Torpedoes and how best to trade them.

FOR BUYS (THERE ARE NO SHORT-SALE TORPEDOES)

1. Identify the recent market leaders. These are usually higher priced, big cap names such as Microsoft, IBM, 3COM, Intel, Dell, etc. Another group of names to identify is the higher-priced, highly volatile names that can be screened using the "Trading Where The Action Is" chapter.

2. Wait for the stock market to be down at least 1 percent in the first hour of trading. At that time, look for any market leader or highly volatile stock that is defying the trend. This means stocks which are up for the day or down only a small amount.

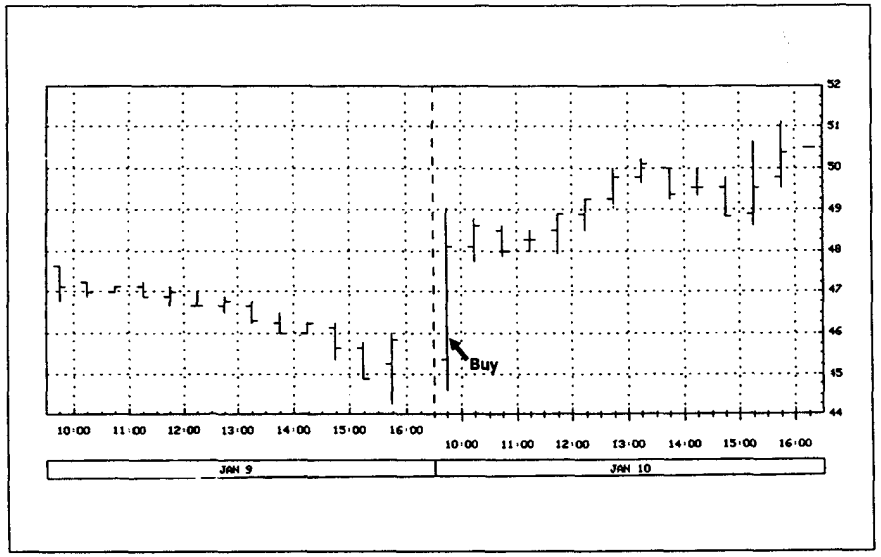
3. Here is where it gets a bit subjective. If the overall market begins to bounce back, buy the strongest stock(s) from Rule 2. The key to this strategy is the initial protective stop you are using. *Your risk should*

be only one point from your entry. If you are stopped out, it is OK to re-enter if the stock begins rising again.

4. When this strategy works, it often works big. On numerous occasions, I have seen Jeff make between 2 and 5 points within a few hours.

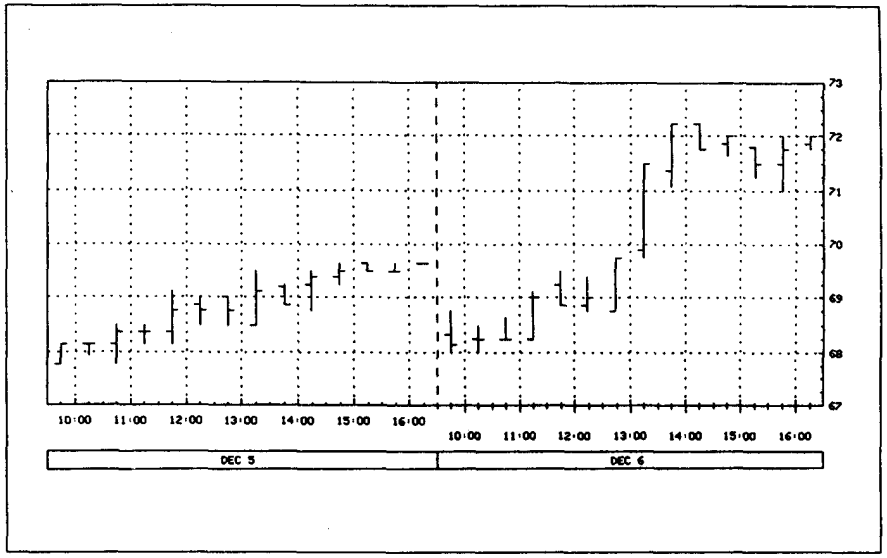
Here are three examples.

FIGURE 15.1 Vitesse Semiconductor



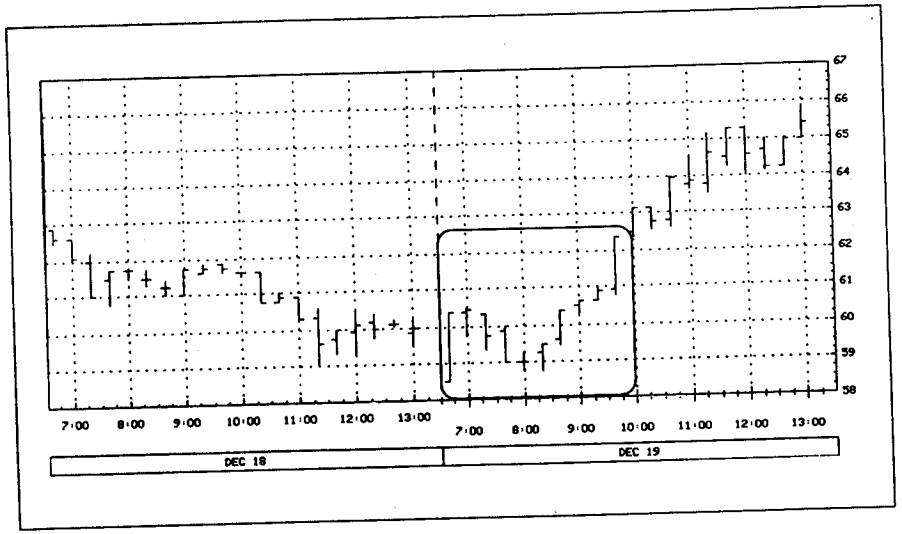
In January 1997, Vitesse Semiconductor, a *highly* volatile NASDAQ stock, opened down only 3/8 point in spite of the S&P's trading more than ten points lower near the opening. The stock immediately reversed and proceeded to trade 3 points higher with 30 minutes and 4 11/16 points higher for the day. This action is the epitome of the Perfect Torpedo.

FIGURE 15.2 Paccar



On December 6, 1996, the DOW trades 140 points lower but Paccar, a volatile NASDAQ stock, trades only 1 3/4 points lower. Within 90 minutes, the stock starts moving higher and proceeds to trade up for the day in spite of the market closing down approximately 60 points for the day.

FIGURE 15.3 Maxim



On December 19, 1997, the S&P's dropped as much as 30 points intraday while the Dow was down as much as 265 points.

Maxim (MXIM), after selling lower, shrugs off the market decline and begins rising quickly.

In spite of the day's sell-off, this Torpedo rises more than 5 3/8 points for the day.

SUMMARY

This is a volatile strategy and one that leads to quick profits. Remember to keep your initial stop tight and let your profits run when they occur.

SECTION FIVE

OPTIONS STRATEGIES

A few years ago, the options columnist for Barrons ran a survey of its quarter million readers. He asked if any non-market maker could prove that he or she had made money trading options for the past three consecutive years. I am recalling this story from memory, but as I recollect, only one person (an elderly gentlemen) could prove he was a three-years-in-a-row profitable trader.

The odds are greatly stacked against your success in trading options. Most options (other than the OEX) trade with a 10 percent spread and with slippage and commission added in, the "take" is just too large.

With that said, I believe the option game can be beaten, but only by traders who are patient enough to wait for the few times when prices are out of line and can be exploited.

SECTION SIX

DAY TRADING

In 1994, I had my best year (in percentage terms) trading in the futures markets. I produced this performance predominantly by day trading.

In spite of having a solid year though, the mental strain was enormous (I was at the same time overseeing my private equities investment partnership). By the end of the year my brain was about as tired as it could be, and I knew that a few more years of day-trading would make me the only resident of the local nursing home who was under 40 years old.

This does not mean you should not day trade. Jeff Cooper has successfully done it in the equity markets for more than a decade. But the truth is that the wear and tear of day trading is tough and you should ask yourself how much torture you are willing to endure before you commit yourself to it.

With that said, the following are what I consider to be among my best day-trading strategies. I feel that if you only traded two, the "15-Minute ADX Breakout Method" combined with the "10% OOPS" strategy, you could make a comfortable living.

CHAPTER 20

15-MINUTE ADX BREAKOUT METHOD

In this chapter we will look at a day trading strategy I created a few years ago. This strategy is not for the faint of heart or for conservative traders. It is for *very aggressive traders* who are willing to take *larger than normal risks* in hopes of achieving larger than normal gains.

With the "15-Minute ADX Breakout Method," you will be trading the strongest moving and, many times, most volatile markets nearly every day. Profits come quickly, but so do losses. With that noted, this strategy, if harnessed correctly, has the potential to lend itself to some of the most spectacular day-trading moves you will ever experience.

Before looking at the rules, I want to make sure you understand conceptually the underlying forces that make it work.

Let's first look at the characteristics of a bull market. Bull markets are usually associated with daily closes higher than the daily opening. This means that in an ideal world you want to buy the market near the opening and sell it higher later in the day. Unfortunately, just blindly doing this does not work. One never knows when a strongly rising market will open at its high and then collapse. Therefore, to fully maximize the effectiveness of a bull market bias, we daily want to wait for the market to tip

its hand early in the session. This is done by letting the market trade for 15 minutes and then, and only then, do we enter when the high of that first 15-minute bar is taken out. We will have entered what looks to be setting up as a typical bull market day with us buying low soon after the open and selling higher later in the session.

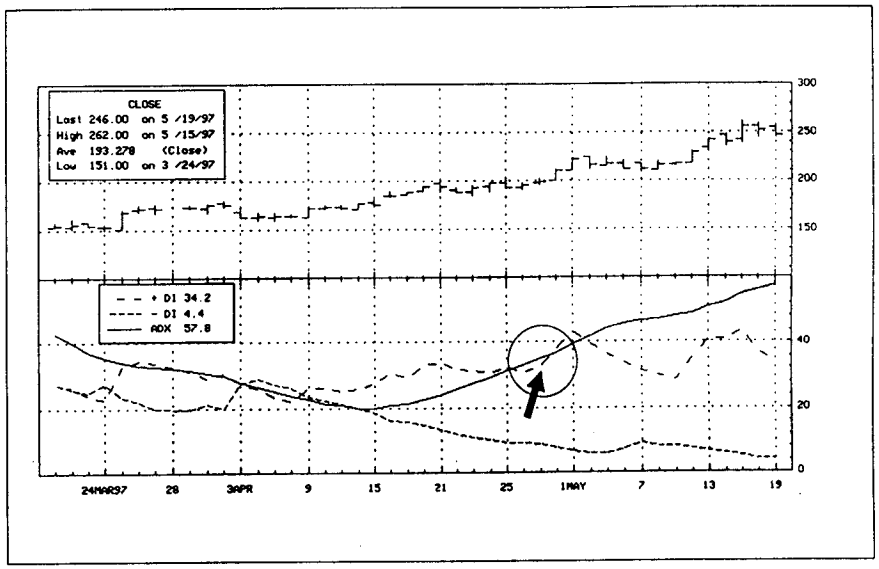
Let's look at the rules:

FOR BUYS (SELLS ARE REVERSED)

1. We will use this method only in the strongest trending markets! Therefore, we want the daily 14-period ADX reading to be above 30 and the 14-period +DI to be greater than the –DI.
2. Wait for the first 15 minutes of trading to pass.
3. Place a buy stop one tick above the first 15-minute bar high.
4. (This is critical.) Place a protective sell stop one tick below or at the first bar 15-minute low.
5. Hold onto your hats as you will probably experience more volatility than you ever have.
6. Where you take your profits is a personal choice. Ideally, you will use trailing stops to help lock in the gains. Also, please read the "Two-For-One Money Management Strategy" chapter. With a methodology as volatile as this one, it is important to be prepared to lock-in profits on half the position and let the other half run.
7. Close all positions out before the end of the day.

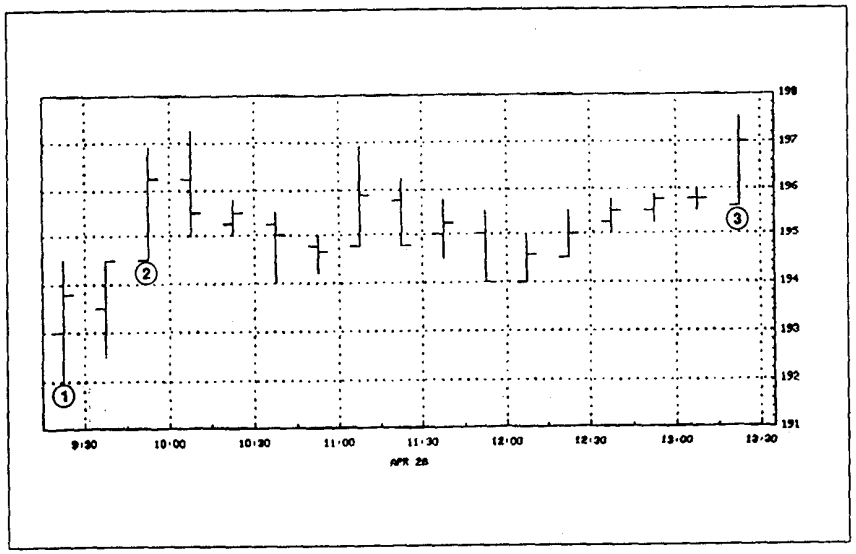
Let's look at a move in coffee to help understand how this strategy works. Please note these are the daily trades beginning April 29 and running through May 15, 1997.

FIGURE 20.1



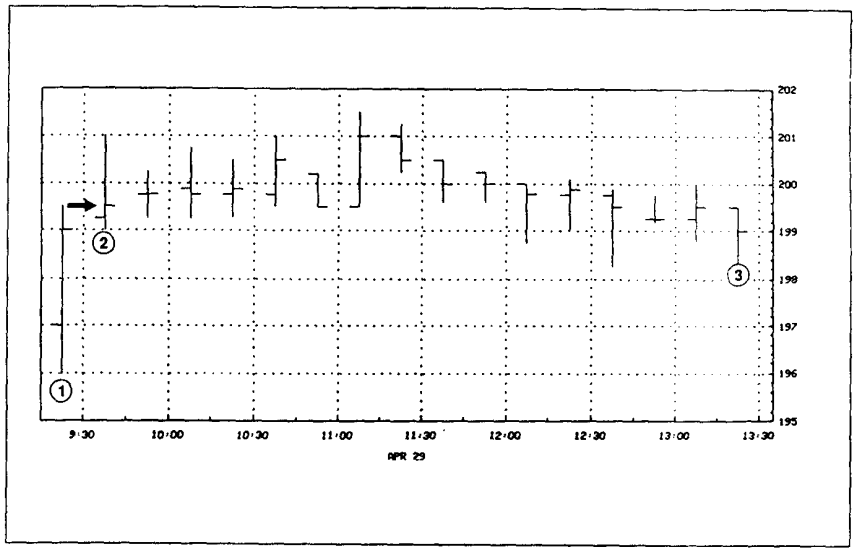
Here we see the ADX for July 97 Coffee crossing above the 30 level in late April 1997.

FIGURE 20.2



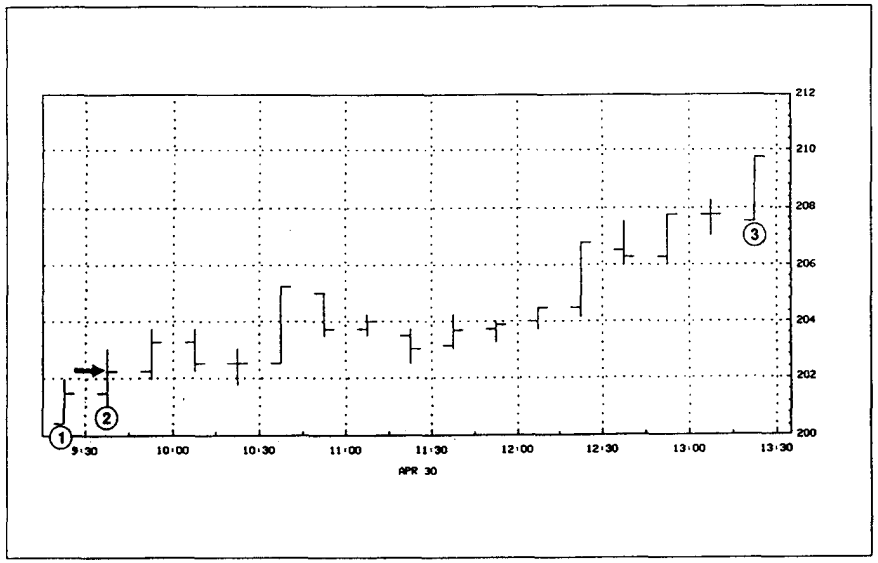
1. The first 15-minute bar and our buy stop is placed one tick above it at 194.60.
2. We are filled and the protective stop is near the first bar low of 192.00.
3. The market closes 1.8 cents above our entry.

FIGURE 20.3



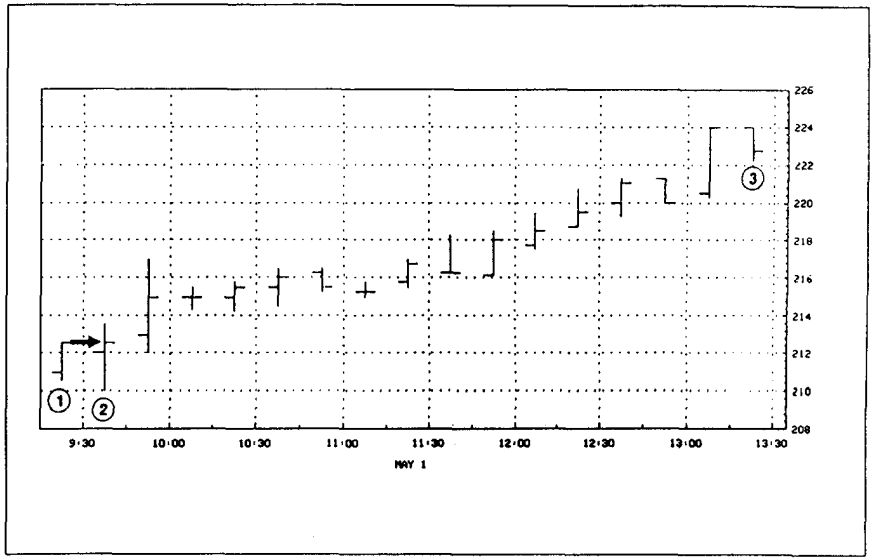
1. The formation of the first 15-minute bar. Our buy stop is placed one tick above the bar.
2. We buy at 199.70 and our stop is near the low of the first bar of 196.
3. After a small rally, the position closes the day for a loss.

FIGURE 20.4



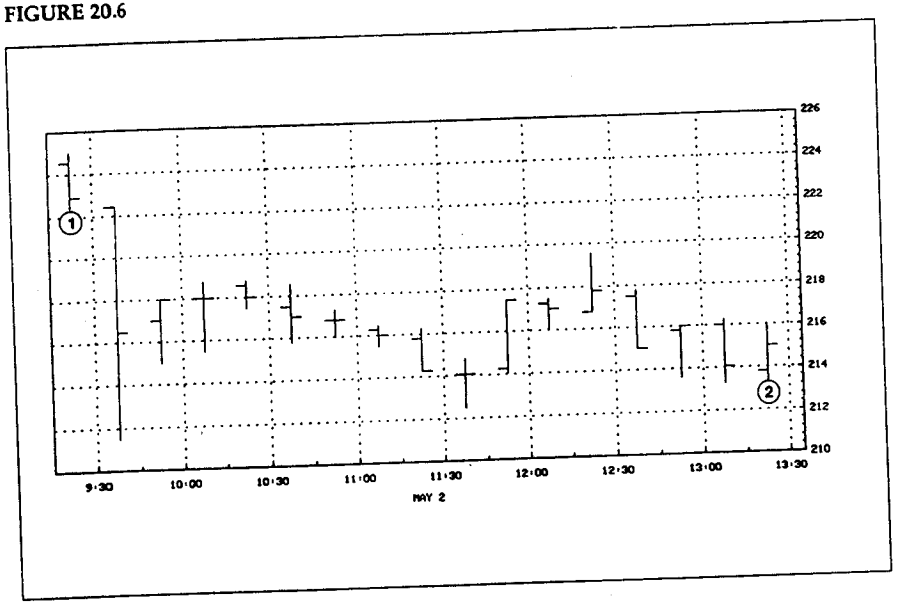
1. The opening 15-minute bar.
2. The buy stop is filled at 202.10 and the sell stop is near 200.40.
3. A better than eight-cent gain ($3,000/contract) if you held until the close. Multiple contract traders should certainly take profits on a piece as the day progresses.

FIGURE 20.5



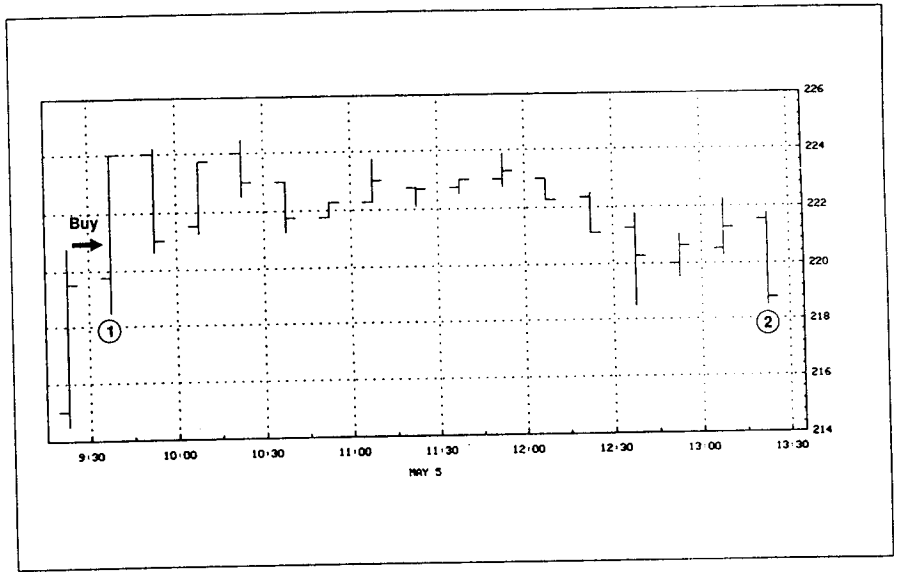
1. A buy stop is placed one tick above the bar.
2. We are filled and the market immediately collapses, stopping us out for an approximate two-cent loss. It then does what a good volatile market should do and re-rallies allowing us to re-enter (and giving us enormous stress!).
3. The trend is too powerful and the market rises approximately 10 cents from our initial entry.

FIGURE 20.6



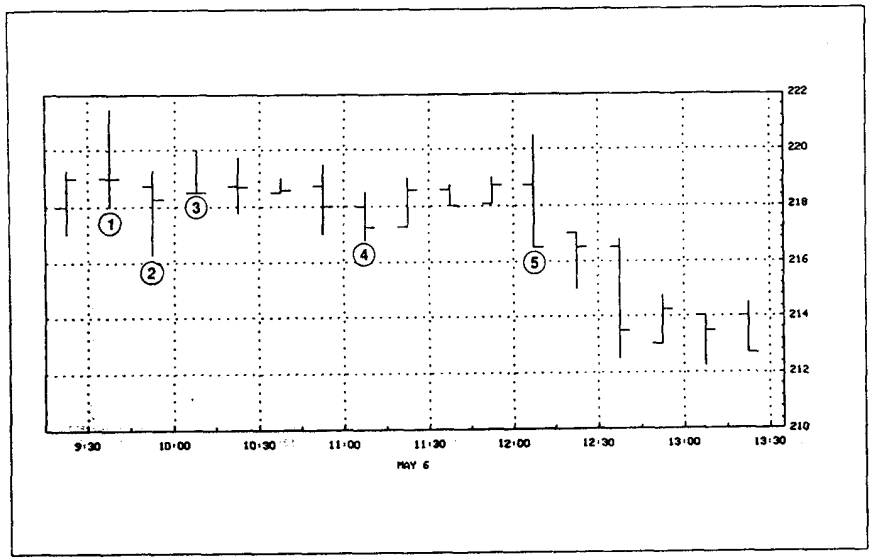
1. 15-minute opening bar.
2. No trade for the day and we avoid the sell-off.

FIGURE 20.7



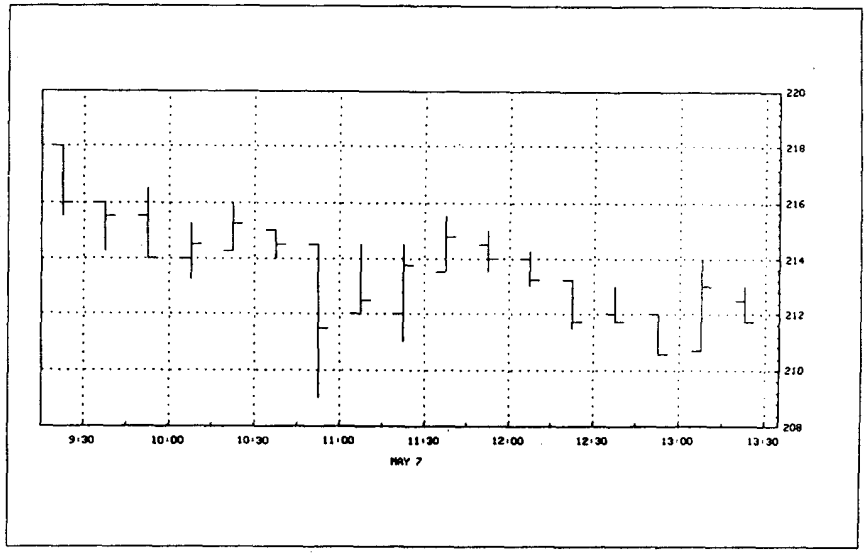
1. A buy in the 221 range and . . .
2. A loss of 3.5 cents for the day.

FIGURE 20.8



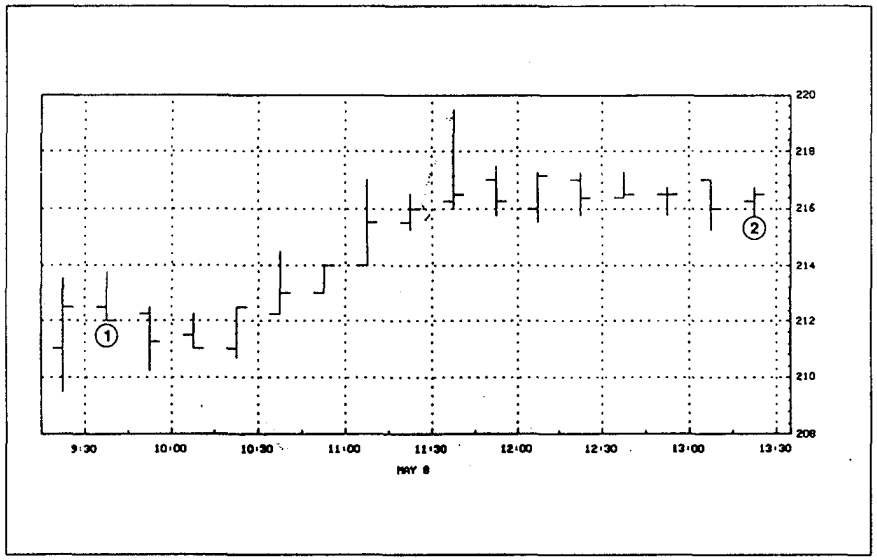
1. Buy entry.
2. A loss of two cents.
3. Re-enter.
4. Another loss of two cents.
5. I will not enter a trade three times in a day. Two losses are my psychological limit.

FIGURE 20.9



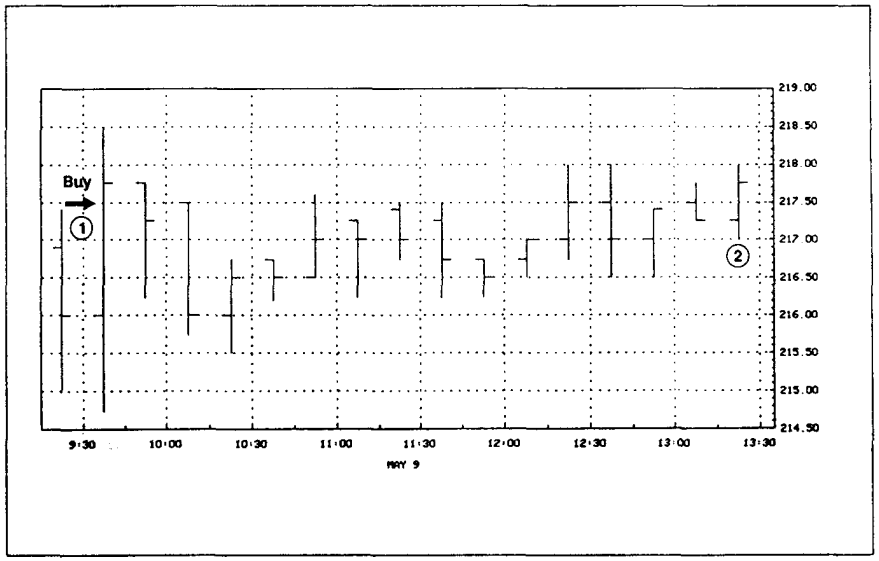
We avoid the sell-off as our buy stop is never triggered.

FIGURE 20.10



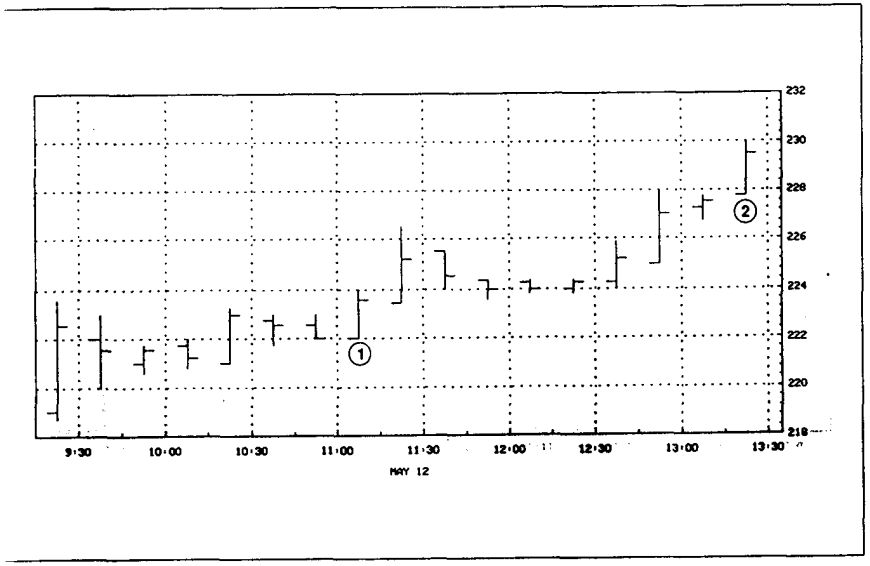
1. Our buy stop is filled and our stop is near 209.50.
2. A profitable trade.

FIGURE 20.11



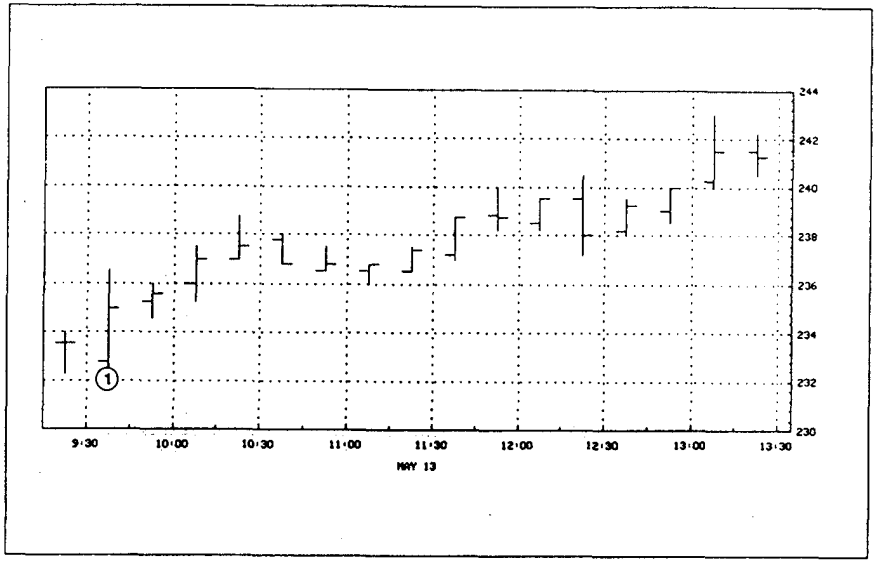
1. We are filled at 217.50 (the second-bar low comes before our fill).
2. The market closes at 217.90 and the trade is basically a scratch.

FIGURE 20.12



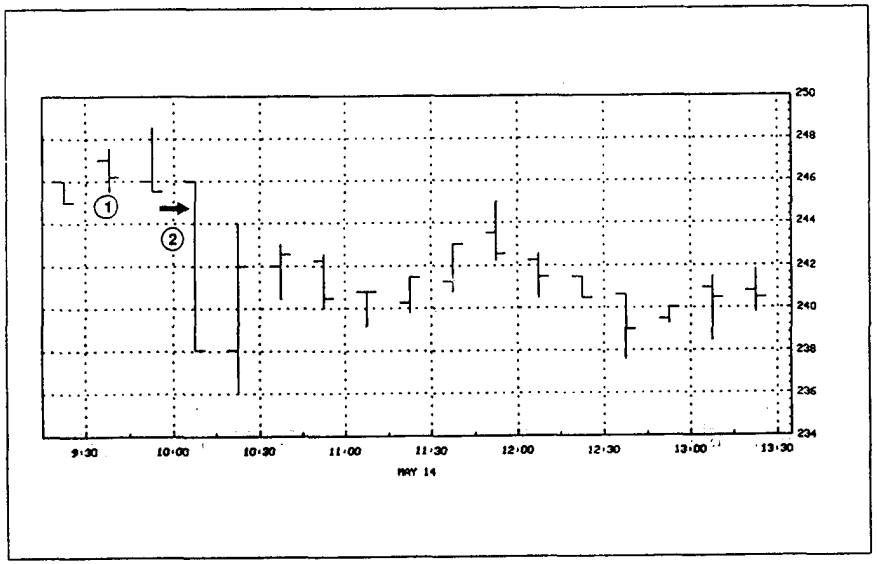
1. Our buy stop is filled after 1.5 hours and it leads to . . .
2. A better than five-cent gain.

FIGURE 20.13



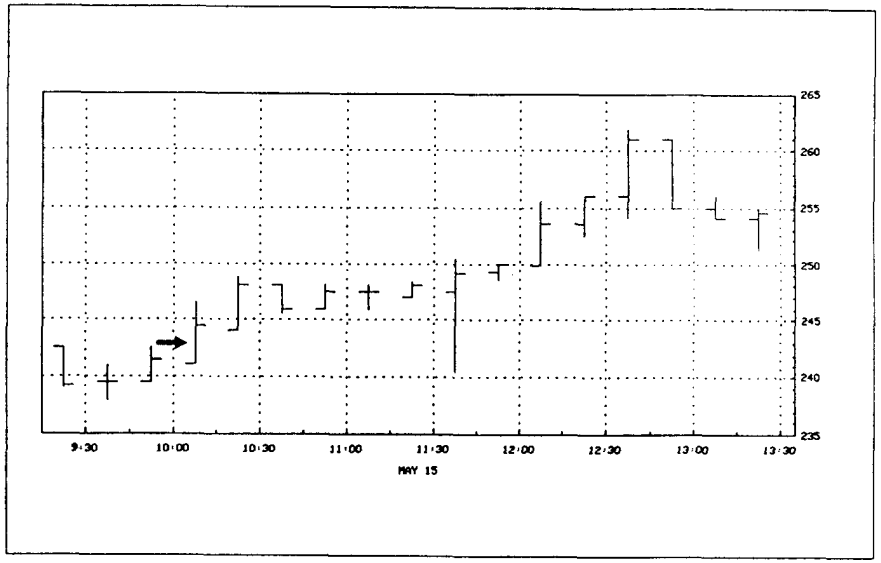
1. Filled at 234.10 and it closes for a better than $2,600 profit.

FIGURE 20.14



1. Filled at 246.10
2. Stopped out at 245 (and avoiding a sharp sell-off).

FIGURE 20.15



Bought near 244 and closed above 255. Notice also that at one point the gain is as much as 18 cents ($6,750/contract).

SUMMARY

The coffee examples replicate the pattern this strategy takes—small losses, sometimes three, four, or five in a row, and large, sometimes spectacular gains. Again, I encourage you to please be sure that you can handle this volatility both emotionally and financially before taking on this strategy.

TRADING THE 15-MINUTE ADX BREAKOUT METHOD WITH EQUITIES

This strategy provides more opportunities in the equities markets than it does the futures markets. This is because there are only 25–30 commodity markets to choose from but there are over 10,000 stocks. Unlike the futures markets, stocks as a whole do not provide large leveraged day-trading moves. Therefore, to maximize the effectiveness of this method, *you must trade volatile stocks that have large intraday ranges.*

To identify these stocks, please look again at the chapter entitled "Trading Where the Action Is" in the Volatility section. In it you learn how to select the most volatile stocks using what I consider to be the purest indicator to accomplish the job: historical volatility. The ideal situation is to trade those stocks whose 100-day historical volatility is above 40 percent *and* whose price is at least $40/share. These two criteria combined give you the stocks which have large daily ranges. The daily range is critical as you want the stock to be able to move at least a few points intraday in order to capture good profits.

Thus, the filter for the stocks to trade with the 15-Minute ADX Breakout Method is as follows:

FOR BUYS

1. ADX > 30, +DI > –DI
2. Price must be above $40/share.
3. 100-day historical volatility of 40 percent or higher.

FOR SHORT SALES

1. ADX > 30, –DI > +DI
2. Price must be above $40/share
3. 100-day historical volatility is 40 percent or higher.

Finally, I suggest you program the stock search in your computer. There are thousands of stocks to choose from and it is too time consuming to do by hand.

FURTHER INSIGHTS INTO THE 15-MINUTE ADX BREAKOUT METHOD

1. The higher the ADX, the stronger the trend and the higher the volatility.
2. Markets are correlated. If you have a high ADX reading in heating oil, you will most likely have one in unleaded gas. Trade only one correlated market at a time.
3. You should be in the position to watch the screen all day. This is a pro-active methodology which must be constantly monitored in order to maximize its effectiveness.
4. *Reminder:* If you are stopped out, it is correct to re-enter. These second entries tend to be the best trades.
5. 15-minutes is not the only time frame to use. I have traded this with 10-minute bars. This is a personal choice and you should use the time frame you are most comfortable with.
6. Be prepared for higher than normal slippage. Greed, fear, and panic are many times at their highest level in these markets.
7. One last caution—I have yet to trade a methodology that is this crazy. It is so wild that I cannot trade it unless I have absolutely no other positions and setups to look at. The 15-Minute ADX Breakout Method requires *total* concentration on the position.

CHAPTER 21

10% OOPS

In the 1980s, Larry Williams introduced traders to his "Oops" strategy. The strategy stated that when a commodity gapped above (below) the previous day's high (low) and reversed, a sell (buy) signal is triggered near the previous day's high (low). In *Street Smarts*, I introduced a strategy that filtered the Oops strategy with ADX and traded only in the direction of the trend.

Here is another gap reversal strategy I use to very good effect. This strategy was originally mentioned in *Techniques of a Professional Commodity Chart Analyst*, written in 1980 by Arthur Sklarew. We will also look at one year's trades on the S&P's using this technique.

The "10% Oops" strategy is a derivative of the 80–20's strategy from *Street Smarts*. Briefly, an 80–20's sell setup occurs (buys are reversed) when a market opens in the bottom 20 percent of its daily range, closes in the top 20 percent of its range, trades higher the next day and then reverses back into the previous day's range. The 10% Oops applies the same principles as this strategy but includes a gap.

Here are the rules:

FOR BUYS

1. Day one—A commodity or stock must close in the bottom 10 percent of its daily range.

2a. Day two—The next morning, it must gap lower (night data is omitted).

2b. If Rule 2a is met, buy at the day-one low. Your initial protective stop should be near the day-two opening.

3. Lock in profits with a trailing stop or sell MOC.

FOR SELLS

1. Day one—A commodity or stock must close in the top 10 percent of its range.

2a. Day two—The next morning it must gap higher.

2b. If Rule 2a is met, sell at day-one high. Your initial protective stop should be near the day-two opening.

3. Buy MOC or take profits via a trailing stop.

Here are some examples of what the setup looks like:

FIGURE 21.1 December 96 Cotton

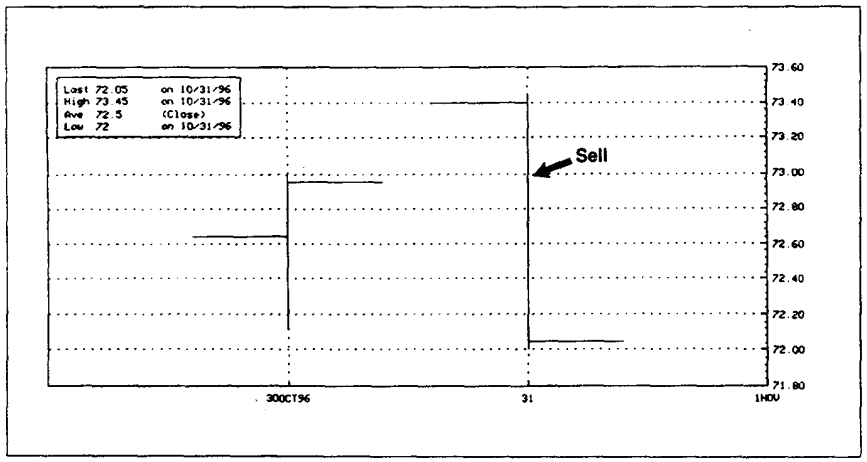
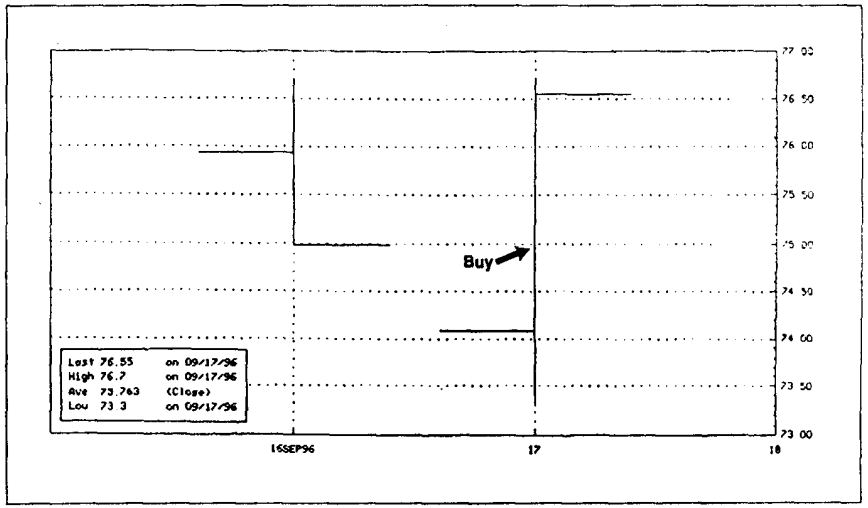


FIGURE 21.2 February 97 Pork Bellies



I am not recommending this as a mechanical system as I am a discretionary trader and prefer to use trailing stops to take profits. Finally, I recommend using this strategy with all commodities except bonds. Bonds have their big moves off the morning economic reports and the *Street Smarts* "Morning News Reversal" strategy works better on them.

Here is how the 10% Oops strategy fared in 1996 as a mechanical system with no stops.

S & P
1/1/96 to 12/31/96

Signal Date	*Signal*	*P*	*L*
01/03/96	S		(-1.65)
01/09/96	S	+14.10	
03/19/96	S	+2.30	
03/28/96	B	+3.85	
03/29/96	S	+3.65	
04/09/96	S	+2.60	
04/16/96	S		(-1.35)
04/24/96	S	+3.50	
05/23/96	S	+2.75	
06/07/96	B	+1.15	
06/10/96	S	+3.00	
06/27/96	B	+4.55	
07/24/96	B	+2.70	
08/09/96	S	+4.05	
11/15/96	S		(-1.45)

12 profitable
3 unprofitable
Total P & L includes $100 slippage and commission = $19,880

SUMMARY

This strategy is a good companion to the ADX Gapper strategy and the 80-20's strategy from *Street Smarts*. Those of you who also trade equities can use it to good advantage. My recommendation is to supplement it with the volatility filtering technique presented in this book's chapter, "Trading Where the Action Is." This will assure you of being in the stocks that will take best advantage of the setup.

CHAPTER 22

REVERSALS OFF THE MORNING CALL

This strategy is a method you can use to profit from extreme overreactions off the opening. Even though the strategy works for both the buys and sells, the sell side usually leads to the larger gains.

Here are the rules:

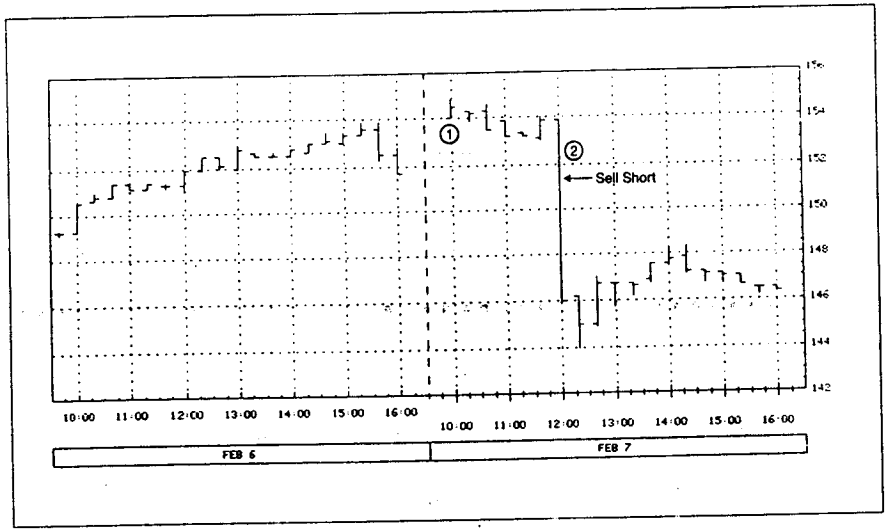
FOR SELLS (BUYS ARE REVERSED)

1. Identify a market that is called to open significantly higher due to some fundamental event; i.e., weather for the futures, an earnings report for stocks (a gap is not needed). This information is available from most news services and your broker.
2. Monitor the call for any signs of weakness. For example, a stock is originally called to open at 57–59. The call is then lowered to 56–58 and the stock opens at the low end of the range. This is an obvious warning signal of overhead supply at higher levels.
3. After the opening, place a sell stop (sell-short stop for equities) at yesterday's closing price.

4. On being filled, a protective buy stop should be placed one tick above the high reached thus far today.

Let's look at three examples:

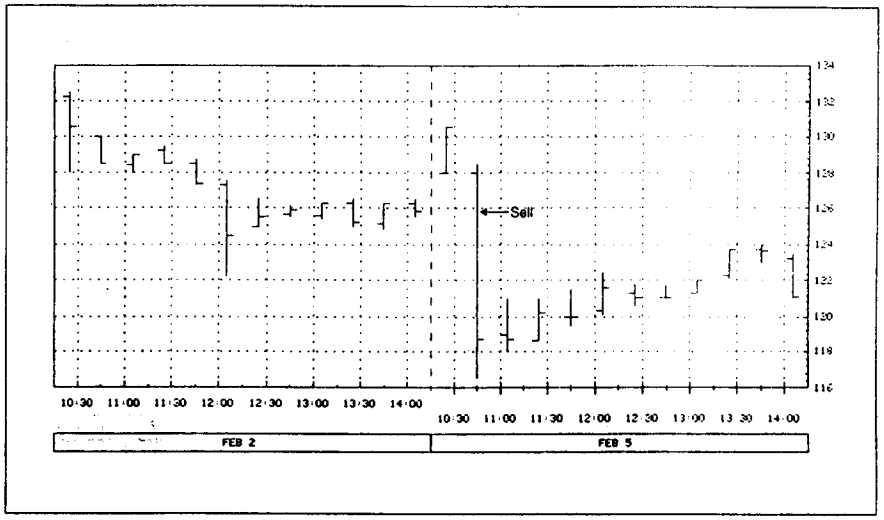
FIGURE 22.1 General RE Corp.



1. The first example is General RE Corp. (GRN). On February 6, 1996, after the close, the reinsurance company announced better than expected earnings. The next morning, the stock was indicated to open at 156–158 (previous day's close was 151 5/8). The indication was then lowered to 154–156 and in fact opened at the low end of the range at 154. Because of the weakness off the morning call, a sell-short stop is placed at yesterday's close of 151 5/8.

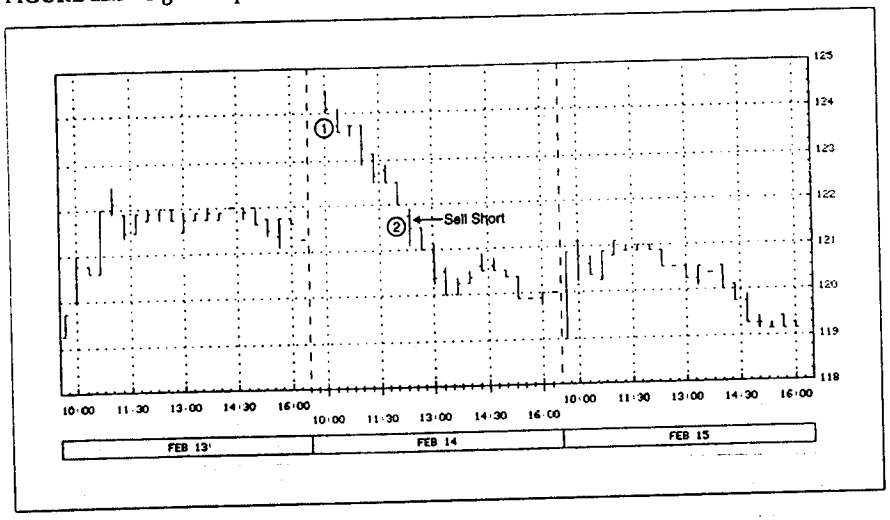
2. After trading sideways for a short time, the market collapses. As you can see, the stock closes more than five points under our short sell price.

FIGURE 22.2 Orange Juice



On February 5, March OJ is called to open 400–600 points higher due to cold weather. OJ in fact opens only 215 points higher and after a brief rally collapses. A sell stop in the 125.80 range is filled and a protective buy stop is placed at today's high of 130.50. The market proceeds to immediately lose over 900 points from our stop before gradually recovering.

FIGURE 22.3 Cigna Corp.



1. Before the opening on February 14, 1996, Cigna Corp. reports better than expected earnings. The stock which is originally called to open as high as 126, opens only at 124 1/2 (an indication of overhead supply) and begins to immediately sell off.

2. A sell-short stop is placed and filled at the previous day's close of 121 5/8 and Cigna closes the day at 120. The selling follows through the next morning with the stock opening at 119. Over the next few days, the sell-off continues taking the stock to as low as 115 1/8.

SUMMARY

The weakness off the morning call leads to potentially large gains. Obviously not all opening call reversal weakness follows through. However the ones that do lend themselves to significant profits.

The examples show that a reversal off the morning call can lead to panic selling. One drawback to the strategy is the number of times the reversals never take place. A trader must be patient and disciplined to fully take advantage of this phenomena. In the long run though, your patience will be rewarded.

CHAPTER 23

WIDE RANGE EXHAUSTION GAP REVERSALS

As you have seen, I am a fan of Larry Williams' Oops strategy. In reality though, it is impossible to identify and trade every potential gap setup on a daily basis. This is especially true in the equities markets with over 10,000 stocks now publicly traded. I have therefore, over the years, attempted to focus only on the potential gap reversals that have the highest profit possibility.

In the section "More Advanced Trading Strategies," in the chapter entitled "Large-Range Days," we will look at markets that have had a two standard deviation daily move. We will see that these markets tend to rest for three to four days after the move (the opposite of conventional wisdom). When these same markets have a large move (measured again by two standard deviations) and then gap the following day, there is a higher than average likelihood that this gap will be an *exhaustion gap*. This is tied into the reversion to the mean principle that is inherent in volatility and to a lesser (but just as important) degree, price. In these situations, both price and volatility have been pulled too far from the mean and from this condition the likelihood of reversals increases.

Let's look at the rules and then look at examples.

FOR BUYS (SELLS AND SHORT SALES ARE REVERSED)

Day 1

1. Identify a market or stock that has had at least a two standard deviation daily move to the downside.

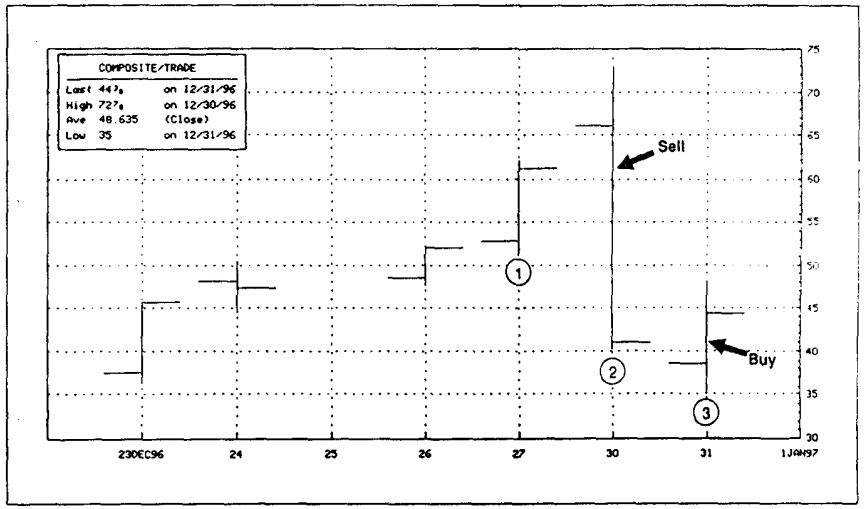
Day 2

2. Tomorrow, if this market gaps lower (night data is omitted), place a buy stop near the previous day's *close* (not its low!). I use the close instead of the low to acknowledge the increased volatility period we are trading in.

3. Your initial protective stop should be placed at the day-one low. Please note, if the day-one low and close are extremely close, give your stop some additional breathing room. *The key here is to risk a small amount in order to participate in those reversals that provide large moves.*

4. If the position closes in the top 10 to 15 percent of its daily range, carry it into the next morning. Otherwise, lock in your profits near the close.

FIGURE 23.1 Zitel



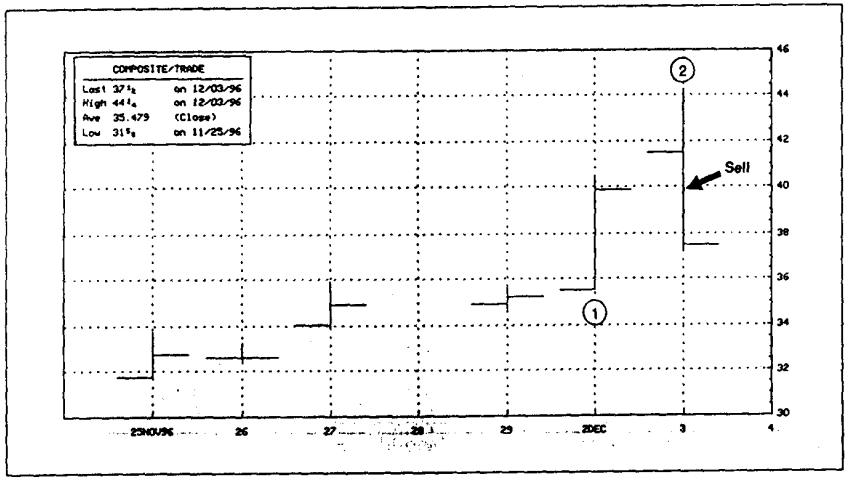
This is an extreme example but it does show what happens when markets pull too far.

1. Zitel has a larger than two standard deviation move.

2. This is followed by a large gap reversal and another two plus standard deviation move.

3. This is then followed by another profitable wide range exhaustion gap reversal.

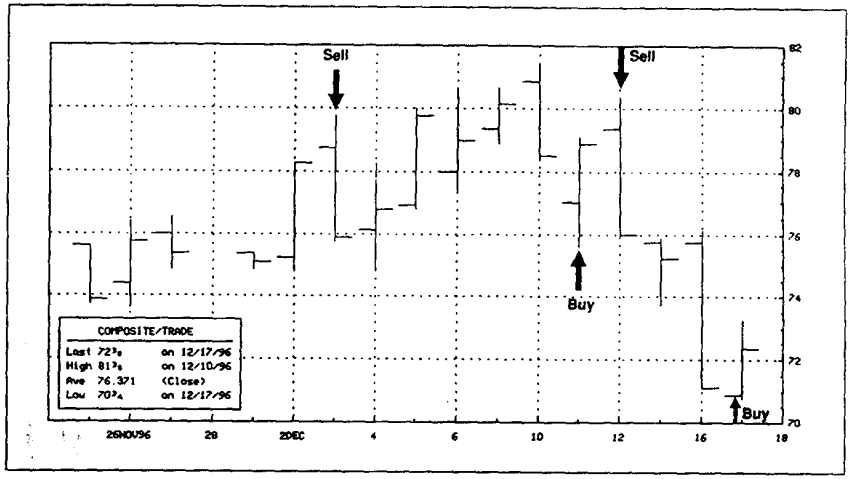
FIGURE 23.2 American Online



Here is an example from American Online:

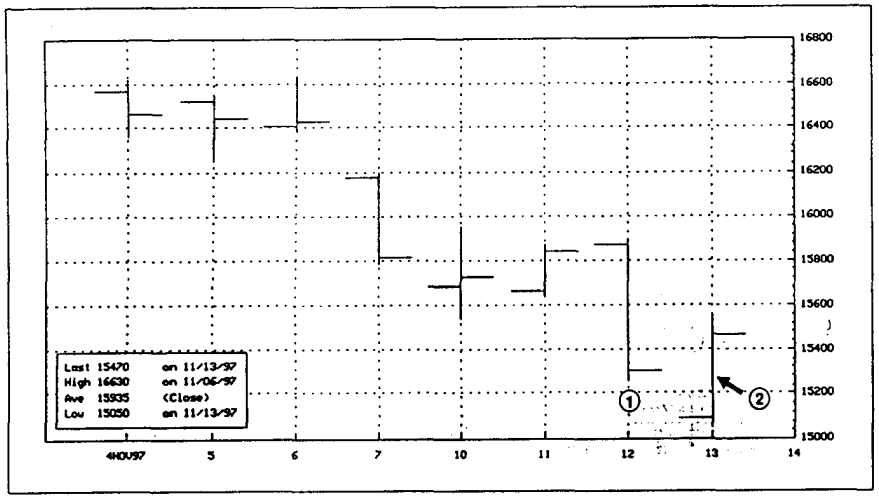
1. A two standard deviation move.
2. The stock gaps to 41 3/4 and our short sale is triggered near yesterday's close at 39 7/8.

FIGURE 23.3 3COM



Here you see four setups over a two-week period in 3COM. Though this many setups over such a short period is rare, it does show the reality of "pulling the rubber band too far" and reversing.

FIGURE 23.4 Nikkei



1. A two standard deviation move.
2. Buy.

SUMMARY

Even though I showed equity examples, this strategy works equally well on the futures markets. Wide Range Exhaustion Gap Reversals are fairly rare but when they do occur, they should be traded. By combining them with the other gap reversal strategies, you will have isolated what I believe to be the best gap setups to trade.

SECTION SEVEN

MORE ADVANCED TRADING STRATEGIES AND CONCEPTS

This section of the book covers a mixture of strategies. Two of the chapters are written by friends of mine, Mark Boucher and Derek Gipson, and reveal how to identify and enter strongly trending markets. I consider these strategies and the strategies presented by Fernando Diz and Jeff Cooper to be among the best presented in my *Professional Traders Journal*.

The next to last chapter covers a topic I have been fascinated with for many years. "How Superior Individuals Become" looks at whether great traders are made or born. As with most things in life, the study stresses the importance of hard work and the lack of importance of genetics.

CHAPTER 24

TRADING RUNAWAY MOVES

Mark Boucher is the author of the following. Mark is a long-time friend and a very successful hedge fund manager from Northern California. In 1990, I purchased one of Mark's original courses. To this day, I feel it has had a large and most profound effect on my trading. Mark has grown his fund using the techniques from his course into one of the most consistently performing funds in the country.

One of the most reliable and profitable situations a stock or futures contract can develop is after a strong breakout of a flag-type trading range. A flag trading range is a pattern in which a vehicle runs up strongly and then consolidates for a prolonged period of time before breaking out in the original direction again. Particularly in stocks, but also in futures, strong breakouts from flag trading ranges often lead to prolonged moves higher. In fact, simply trading flag trading ranges in their own time frame can be a very profitable endeavor.

However, for the purposes of short-term trading patterns, we will be discussing how to take advantage of these situations in order to position short-term by mixing time frames. In mixing time frames, one will often

find that he or she is able to position with low, short-term bar risk distance between an open protective stop and entry, and yet participate in a move that is many, many times initial risk and which may develop into a longer than short-term move. This is how capital can be multiplied many-fold without significant risk—by finding low-risk trades that return many times that risk, and by finding short-term risk opportunities that have the potential to develop into longer-term moves than the original time frame one is looking at.

For our examples, and in our own use of this pattern, we first look at daily bars and then go to half-hourly bars for the pattern. In other words, we screen a half-hourly pattern with a longer-term bar chart. Even shorter-term traders could do the same thing on a shorter time frame. One could look at a half-hourly bar chart to screen 5- or 10-minute bar patterns for instance. The key point is that you are entering with entry points set on a shorter time frame—and may be able to capture a move that develops into a longer time-frame run-up in order to profit many multiples of your initial risk.

The pattern we are going to show you is called the "flag within a flag pattern."

As a brief side note, investors using these patterns should understand that they can achieve better results, both in terms of reliability and profitability, by concentrating on commodities that meet our runaway criteria and stocks that meet our runaway-up-with-fuel criteria as explained in our *Science of Trading* course and published monthly in our letter to clients, *Portfolio Strategy Letter*. Adding these filters is certainly not necessary to very profitably trade these patterns, but it does also enhance results rather dramatically.

Investors lacking a list of runaway-up-with-fuel stocks, as well as all those traders seeking as many investment opportunities as possible, should go through a daily process of reviewing all the stocks on the new high list. We're looking for stocks making new highs after having just broken out of at least a 17-day flag trading range pattern. Again, the flag pattern is a sharp run-up in price followed by a consolidation for 17+ days that does not retrace 38 percent of the initial sunup. We are looking for prices to break out on a gap from the prior close or on a large-range day.

Let's look at an example to clarify. Tuboscope, Inc. (symbol TUBO) began to make the 52 week new high list in mid June when it broke out of a

FIGURE 24.1a Tuboscope, Inc.

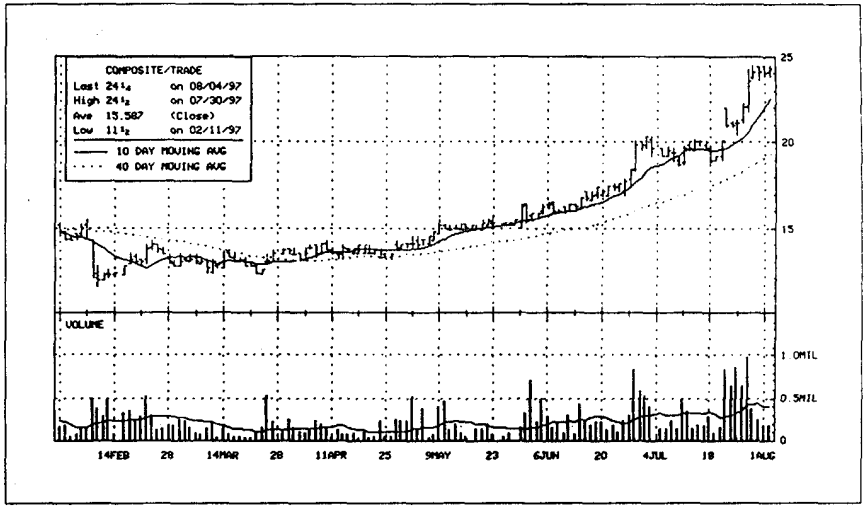
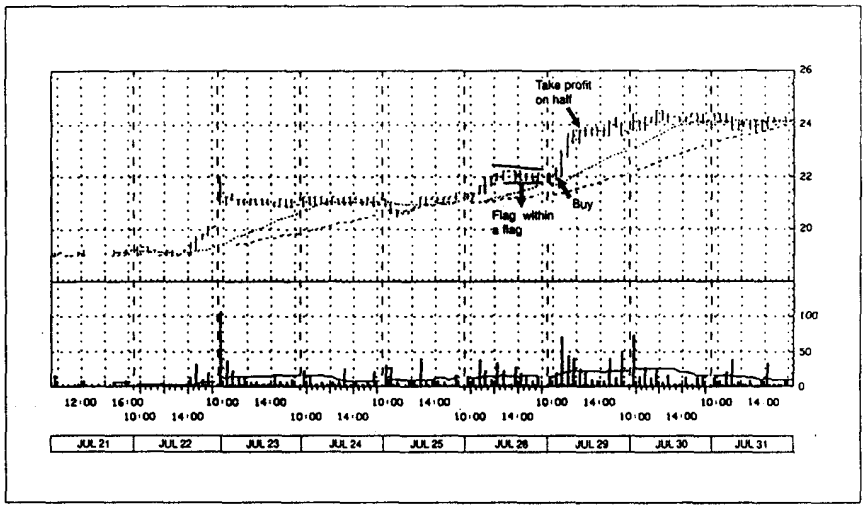


FIGURE 24.1b Tuboscope, Inc.



six-month trading range. (It also met our runaway-with-fuel criteria). It moved up from a low of 11 1/2 on 2/11 to 20 3/8 on 7/3, an 8 7/8 point move. From 20 3/8 it developed a consolidation pattern that declined to 18 5/8, a drop of 1 3/4 points, or 19.7 percent of the prior upmove (<38 percent). The consolidation lasted 17 days or longer before a breakout developed on a gap on 7/23. Our criteria for a flag breakout on a daily chart were met. Note that we need to first find daily flag patterns making new 52-week highs before looking for what will ultimately be our two shorter-term patterns. In this way we are adding a short-term element to an already explosively profitable situation.

Now an investor could certainly buy the breakout and use an open protective stop just below 18 5/8 with pretty low risk for a decent trade, meeting the criteria established in our courses flag pattern. But we're going to show you how you can get far more bang for your buck by adding a short-term pattern to this already lucrative setup.

We suggest investors monitoring the new high list daily put alarms above the high levels of all those stocks that have made new highs and have consolidated in a flag pattern for 17 days or more without retracing 38 percent of the prior upmove, so as not to miss an opportunity. One could use CQG, Bloomberg, TradeStation, Investigator, or even several sources on the internet (like Quote.com) to set these alarms.

The short-term flag within the longer-term breakout works as follows: once you get alerted of a breakout or a new high following a breakout, go to the half-hourly chart. Often, following an initial upthrust half hour, a stock will consolidate, making a short-term flag pattern of four bars or more that does not retrace 38 percent or more of the last half-hourly upswing. A breakout above the high bar of this half-hourly pattern is the entry signal, with a protective stop-loss (ops) below the low of this half-hourly flag pattern.

TUBO for example, broke out on 7/23, consolidated via a half-hourly stochastic correction and rose to new highs again on 7/28. It made a flag pattern consolidating between 22 1/4 and 21 3/4 for eight half-hourly bars before breaking to new highs again in the second half hour of 7/29, where it could be purchased at 22 3/8 to 22 5/16 with a 21 5/8 protective stop—a risk of only 3/4 points. By the end of the day the stock had traded as high as 24 1/4, closing at 23 5/8. Traders could exit half the trade when original risk is first covered, making the trade a break-even at worst and let the rest ride. This is one way to build a big position with low risk in a runaway stock.

A trader risking 1 percent of capital per trade (risk = distance between entry and protective stop) starting with $100,000 account could have risked $1,000 or if we allow a generous slippage and commission estimate of 1/4 point, could have purchased 1000 shares. Taking a quick 1/2 position profit at 23 3/8 to clear risk would have yielded $475 after commissions and open profits at the close were $625 on the remaining 1/2 position—a profit of 1.1 percent in a day with the strong possibility of being able to hang on to 500 shares of a stock that has just broken out of a trading range and is likely to move much higher with no more risk to original capital (at least theoretically) because the profit taken on the first 1/2 position more than covers the risk on the second 1/2. We have just locked in a large potential profit with very little risk—and a portfolio filled with several of these trades can return large amounts of profit with very little risk of capital, which is what we're trying to accomplish as traders.

Remember that once a stock or future emerges from its flag base it will go on our list to watch for this pattern each time it moves into new 52 week high territory until it gets overvalued (stock: PE its five-year growth rate or its current quarterly earnings growth rate), overowned institutionally (stock: 40 percent or higher institutional + bank ownership of capitalization), overbought (weekly, daily, and monthly RSI above 85), until the trend turns (below 50-day moving average is a good rule of thumb but I prefer the GTI trend method as explained in my *Science of Trading Course*), or until the Relative Strength drops below 65 on a reaction or below 80 on a new high. In other words, once a stock breaks out of a flag if it continues to not violate any of the above criteria we still watch for internal half-hourly flags on each new 52-week high because the stock still shows strong potential for a big move. The prime time to buy is just after a breakout, but one can continue to watch for this short-term pattern even if the stock has broken out recently and continues to be one of the strongest in the market as shown in the following example (*see* charts of CTS.).

CTS first broke out of a trading range flag in early April and traded sharply higher making the new high list almost daily into early June, where it formed another flag and broke out in early July. On July 23 it made a strong close to new highs on a wide half-hourly bar. It was still undervalued via its quarterly and five-year growth rate compared to PE, still owned less than 40 percent by institutions, not yet wildly overbought on a weekly, daily and monthly basis all at once, was definitely in a

FIGURE 24.2a CTS

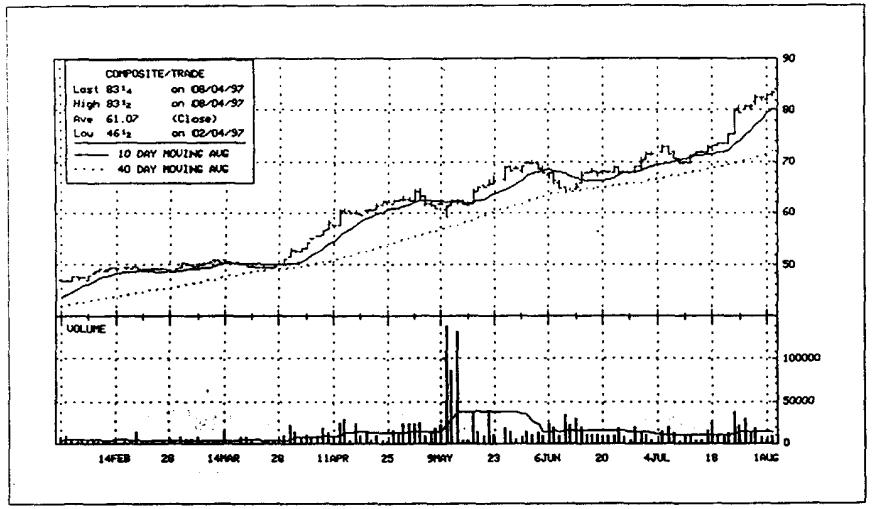
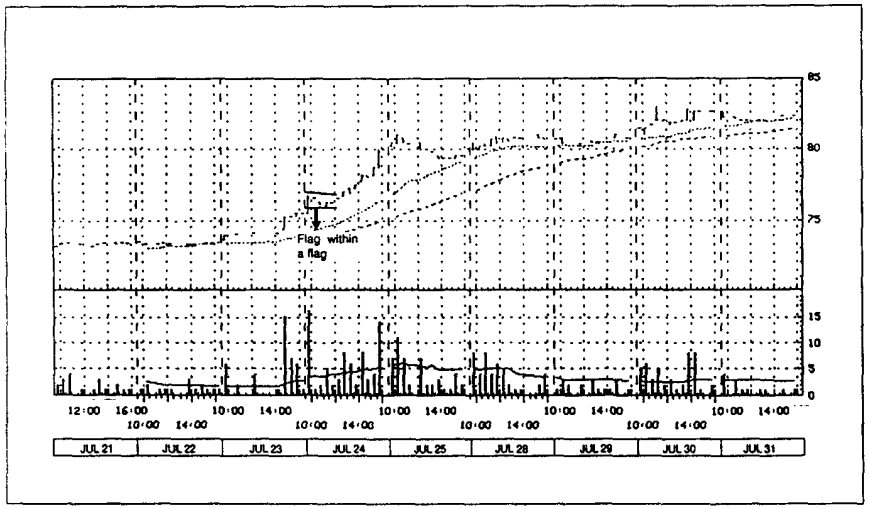


FIGURE 24.2b CTS



strong uptrend with RS above 90. And making new highs yet again. It clearly qualified for a potential short-term internal flag pattern.

The next morning it consolidated for five half-hourly bars below the highs of the last bar of July 23 (75 1/2) with a low of 75 1/8. When it broke above 75 1/2 if you bought the high of that half hour you got in at 75 5/8 and could have used a 75 protective sell stop—a risk of only 5/8 of a point. 1100 shares could be purchased with 1 percent risk. July 24 closed at 79 13/16 a profit of 4.19 points or almost five times your initial risk! If you took quick profits on 1/2 position at 76 5/8 you still ended up over $2,600 on the day (2.6 percent) and had no original capital at risk in a very explosive stock that has continued to move higher.

What about bear markets and what about futures? Surely if the pattern is robust it should hold up in runaway down vehicles as well as runaway up markets. Our next example should help answer those questions. If you run a relative strength analysis (O'Neil's RS) on futures contracts around the globe you can pinpoint the strongest and weakest futures just as you can in stocks. One of the weakest futures recently (RS < 5) has been the nearby D-Mark futures. There was a very recent flag within a flag pattern in this runaway bear market.

On June 30 (*see* D Mark charts), the D-Mark gapped down to a new low breaking out of a daily chart flag pattern. It continued to decline thereafter. On July 22 the D-Mark gapped down on the open to a new low—with a new low, clear very bearish runaway characteristics, and super low RS, traders should be on the lookout for bearish flags within a flag in this market. The D-mark consolidated and then made a big thrust to new lows on the seventh 1/2-hourly bar of the day. It then made a four-bar flag pattern on the 1/2-hourly chart off of 5515 low and a rally to 5528. Traders with a $100,000 account would have sold five contracts on a 5514 stop with a 5529 protective stop for a 15-tick risk, about $200 after commissions per contract risk. The market closed at 5502 and in order to cover risk traders would have taken a quick $400 profit after commissions on three contracts, keeping two open with risk more than covered by profits taken. With the D-Mark continuing to collapse, traders who took a 1 percent risk on 7/22 would now have $3,200 (3.2 percent) in open profit on those remaining two contracts with large potential profits on a break-even worst-case situation.

When a futures contract is especially bearish we can apply the exact same pattern in reverse for short signals. And when the stock market eventually turns lower in a bear market, we can do the same in stocks. Until

FIGURE 24.3a D-Mark

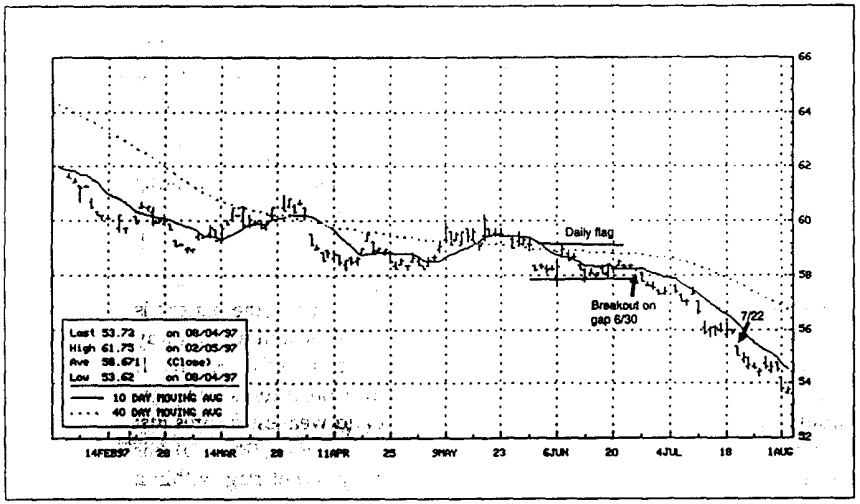
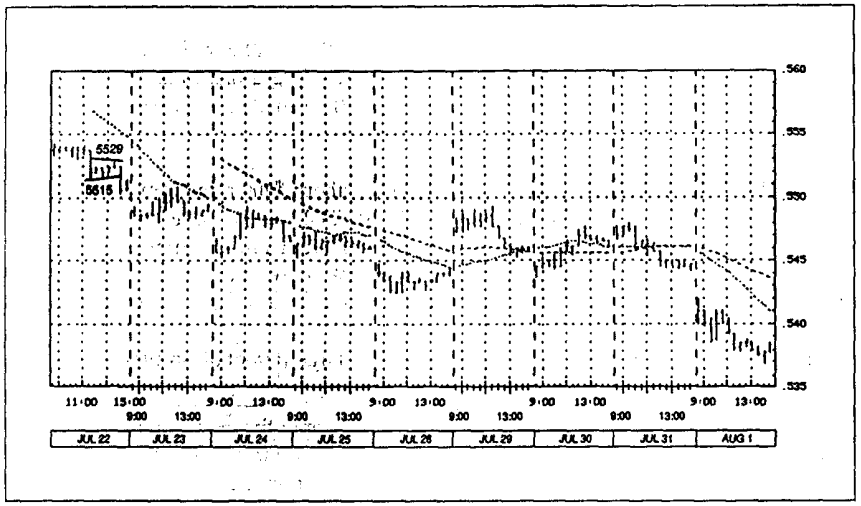


FIGURE 24.3b D-Mark



such time that new 52-week lows move above new 52-week highs, we recommend investors stick with bullish patterns in the U.S. stock market.

The bottom-line is that this simple pattern allows us to get in on a good short-term day-trade, and also leaves open the potential of a much more lucrative opportunity in the some of the most explosive stocks or futures available in the markets. It allows us to position heavily in the strongest stocks, but in a way that takes very small risk to original capital and yet still allows traders to profit at sometimes astronomical rates.

If you can't take enough profits the first day (or second day if it is entered in the second half of the day) on half the position to cover the risk on the remaining half then get out and wait for another opportunity. Cautious traders may only want to take trades in the first half of the day so that they don't have to take overnight risk unless they have large open profits and have booked profits on a day trade in the first half position. More cautious traders may also want to book the whole profit at the close unless the close is at least as far above your entry as your original protective stop was below it.

Traders should note that we are finding this simple pattern in new-high stocks at least twice a week—which should continue as long as the broad market remains strong. This is many more opportunities than any trader can exploit with limited capital. We hope you can watch and profit from such a pattern in the future, and that it becomes a key arrow in your quiver of short-term trades toward maximum profits. In addition, we hope short-term traders note that the huge upside potential of this trade comes from taking a risk on a short-time frame and getting into a move that can last much longer and move up many many times that small initial risk. Probably the biggest problem with short-term trading is that it is rare to get a reward 10 or 20 times risk because you have to get out at the end of the day. However by positioning in vehicles set to move up sharply on a daily basis, by taking quick day-trade 1/2 profits, and by only staying in overnight when a large profit exists at the close, short-term traders can not only book reliable trades consistently, but can often find a ten-bagger without taking very large risks—and without having to wait years to realize it by using this pattern.

CHAPTER 25

GIPSONS

This strategy was created and written by Derek Gipson, a friend of mine and an extraordinary researcher. Derek will share with you his findings regarding predicting direction during times of low volatility. The academic world has claimed for 40 years that volatility and price direction are not correlated. Derek's findings of a directional-trend bias in low-volatility, high-ADX situations, appears to refute the academic assertion.

By way of personal background, Derek is a trader for a major investment firm. I have known him for more than seven years and have regularly relied on him to assist me with my research. What makes Derek's work special is that he begins with the premise that markets have inherent features which repeat themselves. He builds his models based on these features. You have heard me use the term "conceptually correct" in describing a strategy. By looking at the markets as he does, Derek's research leads to strategies that are both conceptually correct and profitable.

A built-in feature of all markets is the concept that periods of low volatility lead to periods of high volatility and vice versa. This has been shown true by academics for more than 40 years. The general consensus among academics is that even though volatility can be predicted, the price movement accompanying a change in volatility cannot be. In the following presentation, I will show you why I disagree and I will show you the

method that identifies specific situations where there is a directional bias coming out of low-volatility situations.

Before going forward, let's review a few basic concepts that I will be using. The 6/100 historical volatility (H.V.) reading under 40 percent means that the six-day H.V. is .4 or less of the 100-day number. When this occurs, markets are poised to explode. ADX is a mathematical measurement which calculates the strength of a trend. The higher the ADX, the stronger the trend. +DI and –DI calculate the direction of the trend. +DI is greater than –DI means the market is rising and vice versa.

I have spent the last two years doing research uncovering specific situations when direction and volatility coincide. I have done this research to further my trading in the options market but the methodology I am about to reveal can and should be used in both the futures and equities.

Here are the rules:

1. Identify the markets or stocks which are trending most strongly. I use a 14 period ADX reading and I look for readings above 25. *The higher the reading, the better.* I also identify the trend with +DI and –DI. This is critical because we only trade in the direction of the trend.

2. If a market or equity qualifies with a high ADX reading, I then wait for its 6/100 day historical volatility reading to drop under .40. This means the six-day reading is less than 40 percent of the 100-day reading. I prefer a lower reading because it tells me the market is truly poised to explode.

3. When rules 1 and 2 are met, I then wait for the market to resume its move in the direction of the trend. I will not take signals opposite the trend. A long entry is triggered for uptrending markets when the high of the signal day is exceeded; a short entry is triggered for downtrending markets when the low of the signal day is taken out.

4. My initial protective stops are extremely tight. For uptrending markets, my initial protective stop is usually near the low of the signal day and for downtrending markets, my initial protective stop is near the high of the signal day.

5. Exits: There are three ways to exit profitable positions.

   a. Follow the price with a trailing stop until you are stopped out.

   b. Look to make a specific percentage return on your investment. That is, if you buy an option at 5, you might have a target exit at 7 1/2 to 10; for stocks you should look to exit at profit levels of at least 5 to 10 percent, etc.

   c. My recommendation: Exit half your position and tighten your stops on the other half when the 6-day H.V. reading reaches the 100-day reading. This shows that volatility has returned to normal.

Let's look at four examples to help better understand how to trade this methodology.

FIGURE 25.1a IBM

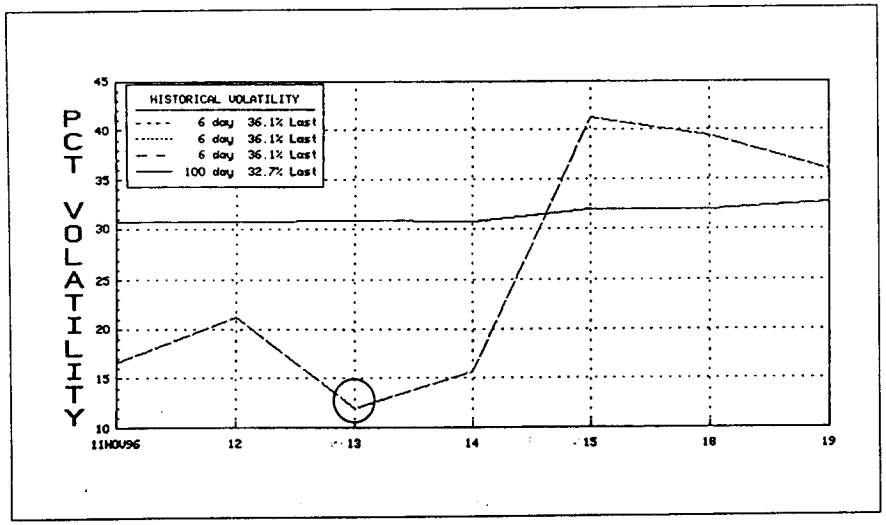


FIGURE 25.1b IBM

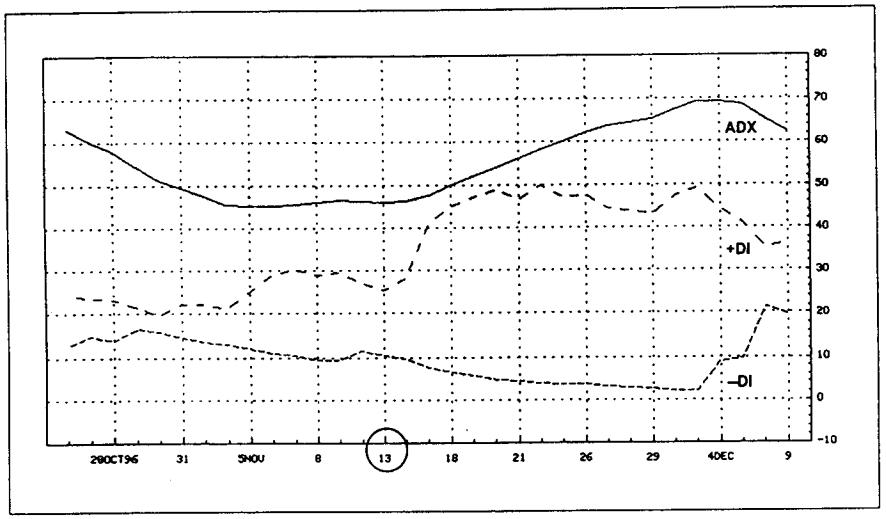
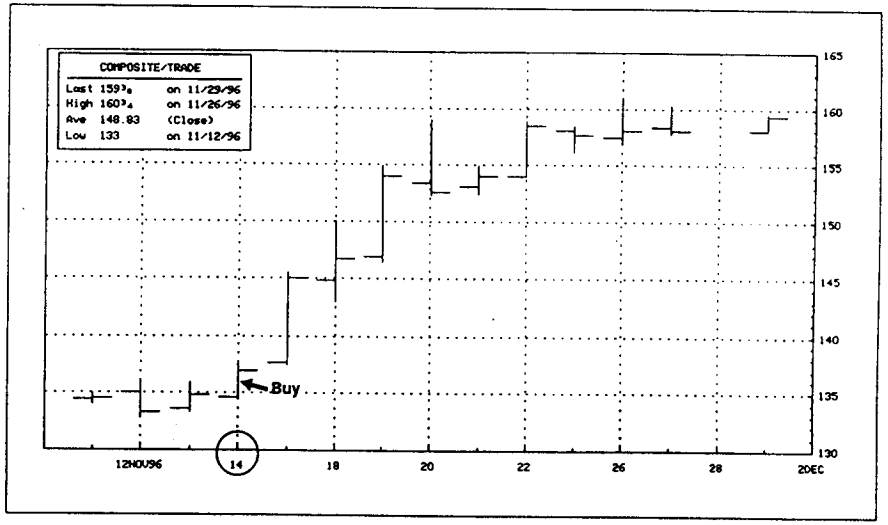


FIGURE 25.1c IBM



November 13, 1996—IBM has a six-day H.V. reading of 11.6 percent which is less than 40 percent of its 100-day reading of 30.9 37.5 percent). At the same time (Figure 25.1b) its ADX reading is well above 25 and its +DI > –DI signifying an uptrend. On November 14 (Figure 25.1c) it trades above its signal-day high triggering a buy signal and proceeds to explode nearly 19 points in four days.

FIGURE 25.2a Pediatrix Medical Group

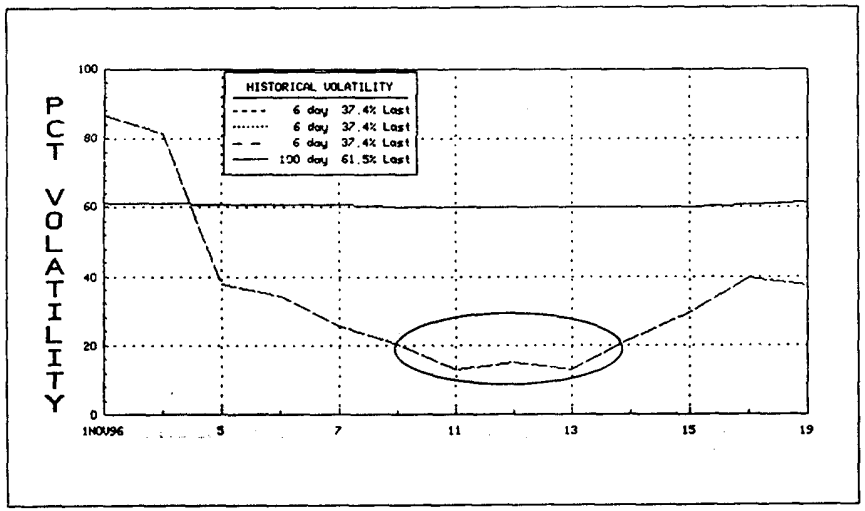


FIGURE 25.2b Pediatrix Medical Group

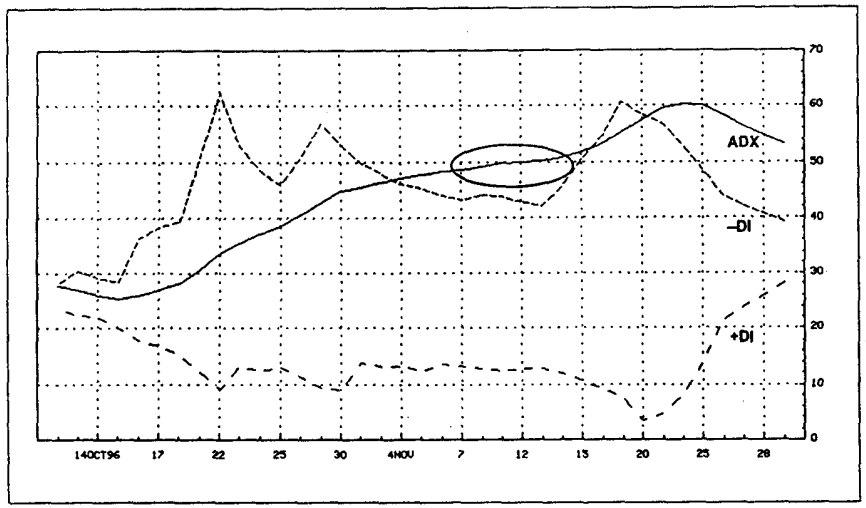
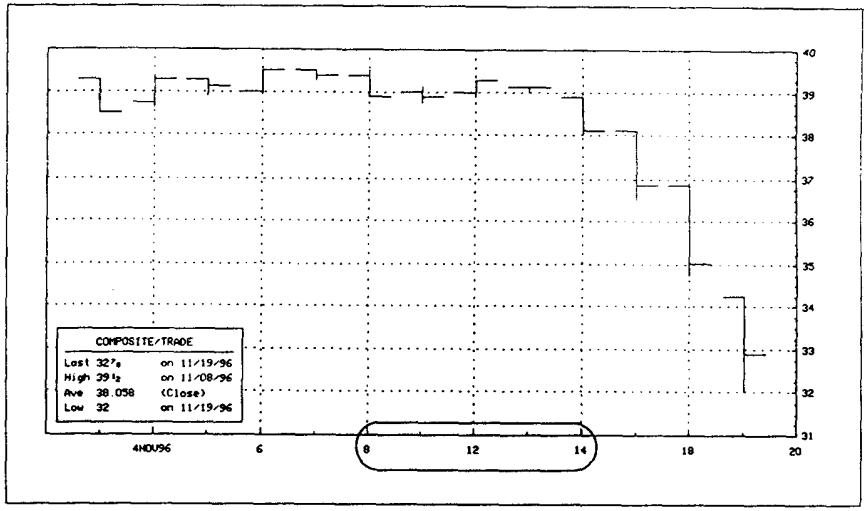


FIGURE 25.2c Pediatrix Medical Group



This is a terrific example because it shows a stock collapsing while there was a major uptrend in the overall stock market. November 8–13 (Figure 25.2a) shows a period of extreme low volatility combined with a downtrending market as defined by ADX (Figure 25.2b). November 11 (Figure 25.2c) shows a false move to the downside and when we again enter on November 14, we are amply rewarded with an almost 20 percent move to the downside.

FIGURE 25.3a November Crude

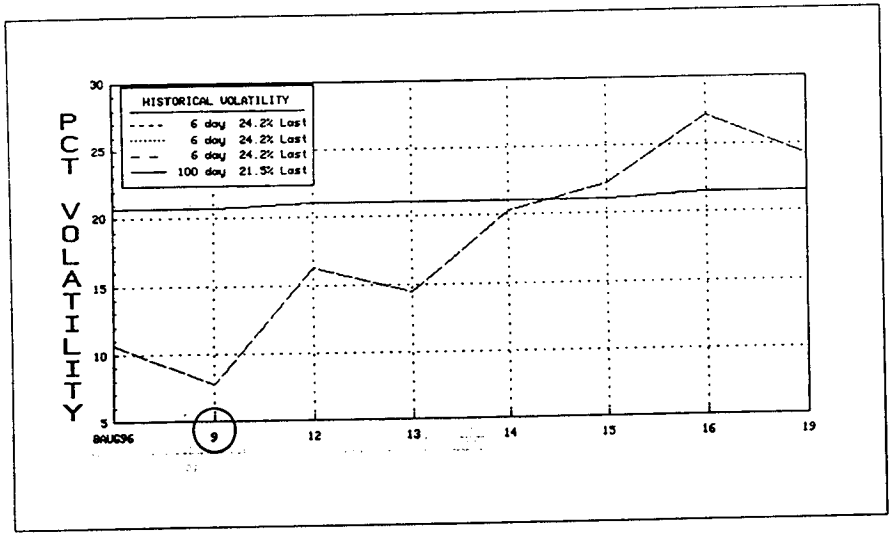


FIGURE 25.3b November Crude

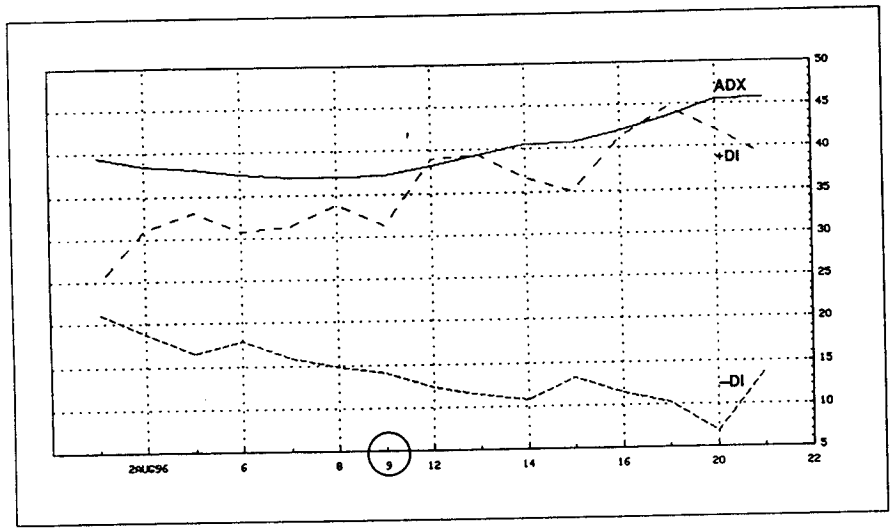


FIGURE 25.3c November Crude

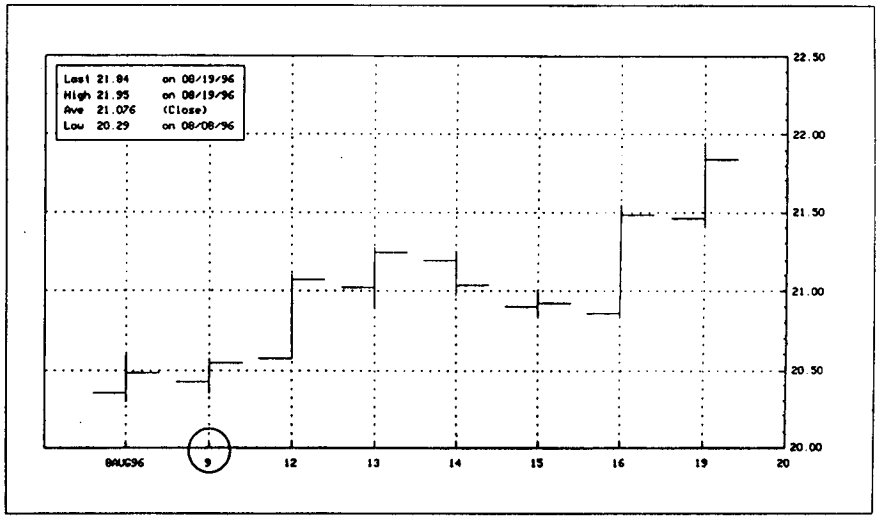


Figure 25.3a shows the 6-day reading at less than 40 percent the 100-day reading. At the same time, Figure 25.3b shows crude is clearly in an uptrend. We buy on the opening of August 12 as the trend resumes.

FIGURE 25.4a December 96 S&P 500 Futures

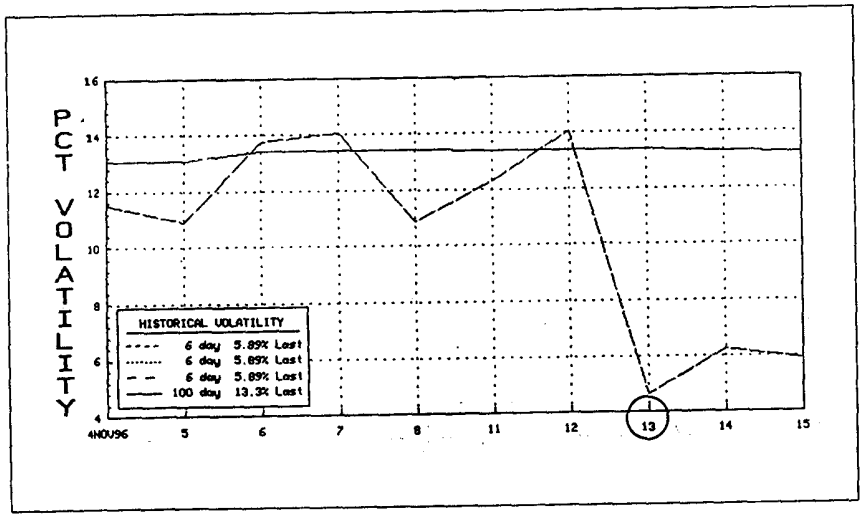


FIGURE 25.4b December 96 S&P 500 Futures

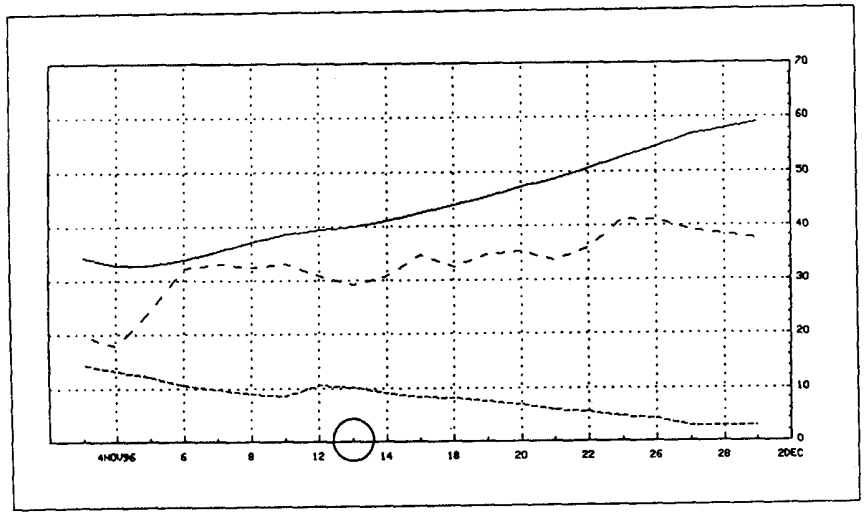
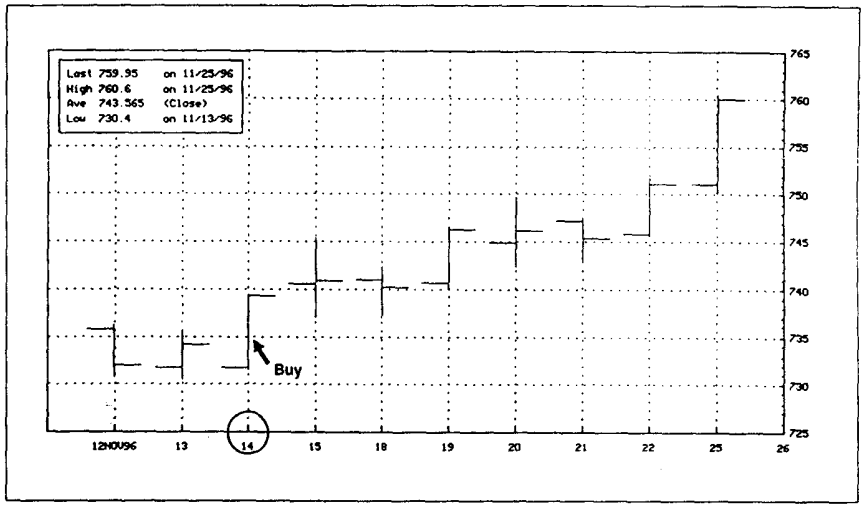


FIGURE 25.3c December 96 S&P 500 Futures



On (Figure 25.4a), November 13, 1996, the six-day H.V. reading is less than 40 percent of the 100-day H.V. The ADX reading (Figure 25.4b) is a powerful 44 and the trend is up. A buy signal (Figure 25.4c) is triggered the next day on November 14 and the futures explode nearly 25 points in eight trading sessions.

SUMMARY

Gipsons are obviously not 100 percent correct, but they do give you an edge in predicting direction during periods of low volatility. What occurs is, a strongly trending market (ADX) rests (low volatility), and when its rest is over, the trend resumes and many times does it in explosive fashion. I mentioned earlier that I created this methodology mostly to use in my options trading, but it assuredly lends itself to traders looking for short-term moves in the futures and equities markets.

CHAPTER 26

MAXIMIZING PROFITS IN SHORT-TERM MARKET DECLINES

Imagine this scenario: It is late Friday afternoon and the stock market has been acting poorly over the past few days. Bigger picture, the market has risen for six straight years without a major correction. With 14 minutes to go in trading, a major negative news event with long-term consequences hits the wires. The market immediately begins to sell off. Your adrenaline is racing because you know that this sell-off will surely follow through on Monday.

Do you have an exact game plan to fully maximize the profit potential of the situation?

Common sense tells you to either buy OEX puts or to sell the S&P futures to capture the profits. This chapter will show you these strategies are potentially wrong (certainly not the best) and will show you which strategies are the best to exploit the situation.

USING OPTIONS

Do *not* buy OEX and SPX puts! *Do* buy puts on the brokerage house index (XBD), the NASDAQ 100 index (NDX), and the insurance index (IUX).

There are a number of reasons for this, but let's look at the most important: implied volatility. During periods of market weakness and periods of uncertainty, the implied volatility of the OEX options (especially the puts) greatly increases. *This means that you are almost certainly buying overvalued options.* These options will become even more overvalued in the scenario I presented because of the thousands of traders who have reached the same conclusions as you. I have witnessed times where the puts options were so overpriced that they actually lost value after the market opened lower the next day. (Traders think, "No market crash—sell the puts.")

Which options should you use to participate in a market sell-off? The following three are, in my opinion, the best.

Strategy #1—Buy Puts on the Brokerage House Index (XBD), the NASDAQ 100 Index (NDX), and the Insurance Index (IUX)

Why these three indices? Three reasons.

1. These three indices will not only participate in any market decline, they will probably exceed the broader market decline.

   Let's look at the three indices individually:

   - On Monday, October 17, 1987, the stock market as a whole lost 22.6 percent. Not only did the brokerage house stocks also decline, they lost an average of a nearly 29 percent for the day. Why? Who are the biggest losers in a bear market? (Enough said).
   - The NASDAQ 100 (NDX) is made up of the 100 largest OTC stocks. This index is more volatile than the S&P 500. Because of this volatility, the index usually drops on a percentage basis more than the other averages.
   - The insurance index is the most conservative of the three indices. This index should especially be used when a stock market sell-off is accompanied by a drop in the bond market. Why? Because insurance companies' profits are tied to the profitability of their stock and bond portfolios. Insurance companies get hurt badly when both stock and bond markets drop. An example of this occurred on March 8, 1996, when bonds collapsed. The stock market dropped just under 3 percent, yet the insurance index lost more than 4 percent of its value.

2. The options on these three indices are usually priced in-line with the historical volatility readings. Let's look at the pricing of these as of March 29, 1996.

   As you can see from Figures 26.1a, 26.1b, 26.2a, 26.2b, 26.3a, and 26.3b, the historical volatility for the XBD index is 23.1 percent and the implied volatility is approximately 27 percent, the historical volatility for the NDX is 27.6 percent and the implied volatility is approximately 24.5 percent. The historical volatility for the IUX index is 15.4 percent and the implied volatility is approximately 17.9 percent. During market sell-offs, the puts on the OEX are at times as much as 50 percent overpriced, whereas these three indices basically trade in-line. You are therefore not "paying up" as you are on the OEX.

3. The final reason for trading these indices instead of the OEX, is that the option prices of the indices are not as quickly marked up by traders. Whereas traders stampede into the OEX options and immediately inflate the prices, trading in the three indices is more orderly. Also, because the pricing mechanisms of these indices tend to be done off the cash market, one has more time to get in before a sell-off snowballs.

FIGURE 26.1a Brokerage House Index—Historical Volatility

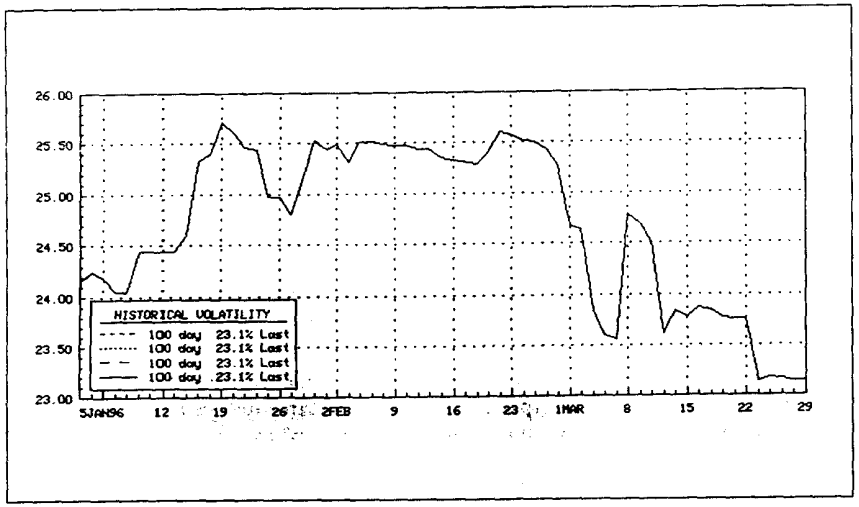


FIGURE 26.1b Brokerage House Index—Implied Volatility

XBD Index OHT
Screen printed.
11:28
Mon 4/1

DG28 Index O H T

DISPLAY: C C-chg/%chg, D-delta/volat

O P T I O N H O R I Z O N A N A L Y S I S
APR OPTIONS ON AMEX SEC BROKER/DEAL IDX
W O R K S H E E T

X B D

OPTION PRICING:	TODAY 403.17 CALLS Prc	Del	I.Vol	PUTS Prc	Del	I.Vol	7 DAYS LATER 403.17 unch Volat=Same CALLS Prc	Chg	%Chg	PUTS Prc	Chg	%Chg
385				0	n/a	n/a				0	unch	n/a%
390				3 13/16	.28	25.28	13 11/16	-5/16	-2%	2 1/8	-1 7/16	-38%
395		n/a	n/a	6 3/16	.36	27.17	8 11/16	-5/16	-3%	4 1/4	-1 11/16	-30%
*400	12 1/16	.57	27.10	7 11/16	.43	26.68	9 7/8	-2 3/16	-18%	6 1/16	-1 7/8	-24%
*405	8 3/4	.50	25.12				6 3/4	-2	-23%			
410	6 3/4	.42	25.61				4 11/16	-1 5/16	-29%			
415	0	n/a	n/a		n/a	n/a	0	unch	n/a%	11 11/16	unch	+0%
420												
	Mon 4/ 1/96 (19days Expr)					5.17%Fin	Mon 4/ 8/96 (12days Expr)					5.17%Fin

OPTION PRICING: T -"Tickr" volatility S -"Same" volatility
M - Trade "Match" volatility 1 2 . 5 % (or any other volat.)

FIGURE 26.2a NASDAQ 100 Index—Historical Volatility

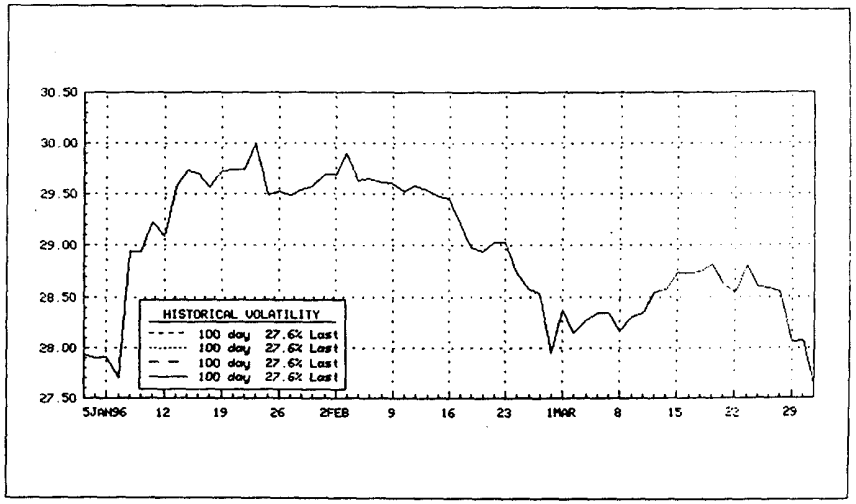


FIGURE 26.2b NASDAQ 100 Index—Implied Volatility

NDX Index OHT
For specific month: OHT 5 for May, OHT 6 for June, ...
16:56
Mon 4/1

DG28 Index O H T

DISPLAY: C C-chg/%chg, D-delta/volat

O P T I O N H O R I Z O N A N A L Y S I S
APR OPTIONS ON NASDAQ 100 STOCK INDX
M A R K E T I S C L O S E D

N D X

OPTION PRICING:	TODAY 612.99 Tickr CALLS Prc	Del	I.Vol	Tickr PUTS Prc	Del	I.Vol	7 DAYS LATER 612.99 unch Volat=Same CALLS Prc	Chg	%Chg	Volat=Same PUTS Prc	Chg	%Chg
595				7	.29	26.91	21 1/4	-2 1/8	-9%	4 7/16	-2 1/8	-34%
600	23 3/4	.66	27.88	8 3/4	.33	26.09	20 1/2	-3 1/4	-14%	5 1/4	-2 1/8	-30%
605	18 3/16	.62	24.22	10 3/4	.39	27.22	15 1/4	-3	-16%	8	-2 1/8	-26%
*610	16 1/4	.56	24.87	11 1/4	.43	24.17	13 1/8	-3 1/8	-19%	8 11/16	-2 7/16	-22%
*615	12 7/8	.51	23.41	14 3/4	.49	25.43	9 15/16	-2 15/16	-23%	11 1/4	-2 1/8	-18%
620	12 [illegible]	.45	25.92	15 15/16	.56	23.12	8 11/16	-3 1/16	-27%	13 7/16	-2 [illegible]	-14%
625	8	.38	22.21	20 1/8	.60	25.53	5 1/8	-2 5/8	-33%	17 15/16	-2 [illegible]	-12%
630	5 1/4	.31	21.02	23 3/8	.65	25.55	3 7/16	-2 1/16	-38%	21 1/16	-2 [illegible]	-9%
	Mon 4/ 1/96 (19days Expr)					5.16%Fin	Mon 4/ 8/96 (12days Expr)					5.16%Fin

OPTION PRICING: T -"Tickr" price S -"Same" volatility
M - Trade "Match" volatility 1 2 . 5 % (or any other volat.)

FIGURE 26.3a Insurance Index—Historical Volatility

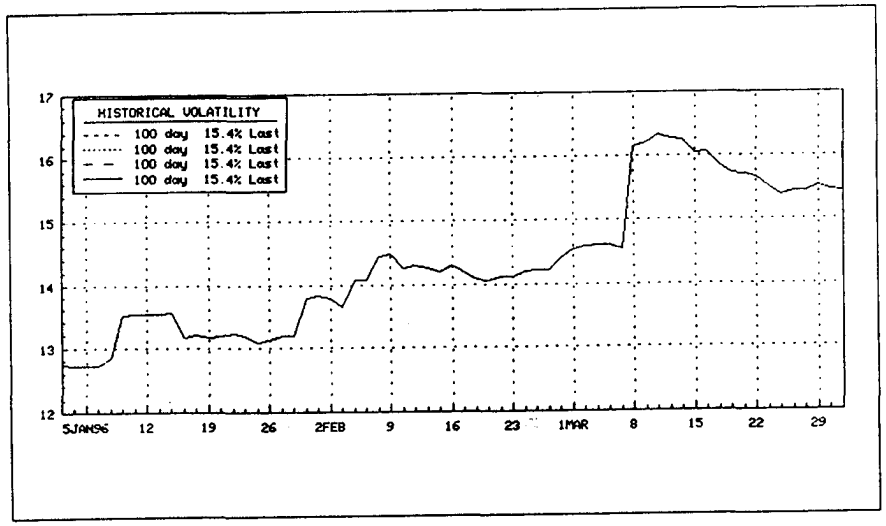


FIGURE 26.3b Insurance Index—Implied Volatility

IUX Index OHT DG28 Index O H T
Screen printed.
11:31
Mon 4/1
DISPLAY: C C-chg/%chg, D-delta/volat

O P T I O N H O R I Z O N A N A L Y S I S
APR OPTIONS ON S&P INSURANCE INDEX
W O R K S H E E T

I U X

OPTION PRICING:	TODAY 334.97 CALLS			PUTS			27 DAYS LATER 334.97 unch Volat=Same CALLS			Volat=Same PUTS		
STRIKE	Prc	Del	I.Vol	Prc	Del	I.Vol	Prc	Chg	%Chg	Prc	Chg	%Chg
315												
320												
325				1 3/4	.21	18.31				1	-1/4	-43%
330				3 1/4	.33	18.11				2 3/16	-15/16	-30%
*335	5 3/4	.53	17.89	5 1/8	.47	17.80	4 1/2	-1 1/4	-22%	4 1/8	-1	-20%
340	3 1/2	.38	17.66	4 1/2	n/a	n/a	2 1/8	-1 1/8	-32%	4 7/8	+1/4	+6%
345	1 1/4	.24	16.62	9 1/8	n/a	n/a	15/16	-1 11/16	-46%	9 7/8	+1/4	+3%
350										14 7/8	+1/4	+2%
	Mon 4/ 1/96 (19days Expr)					5.17%Fin	Mon 4/ 8/96 (12days Expr)					5.17%Fin

OPTION PRICING: T -"Tickr" volatility S -"Same" volatility
M - Trade "Match" volatility 1 2 . 5 % (or any other volat.)

Strategy #2—Sell OEX Calls

Though you will not hit a home run if the market crashes, you will make money with this strategy. More importantly, you may profit even if the market rises. How is this possible? When the market rises, the implied volatility in the options tends to drop, thereby offsetting a portion of the market's increase in price. Remember, they are overvalued derivatives with time decay in your favor (*see* Figure 26.4). Finally, as with all strategies, stops must be used to protect yourself in case you were wrong.

FIGURE 26.4

OEX Index OHT DG28 Index O H T
For other months enter a month # such as "CVT 4" for calls in April.
17:07 DISPLAY: C C-chg/%chg, D-delta/volat
Mon 4/1
Assume Index $ 7.7/yr Div.

O P T I O N H O R I Z O N A N A L Y S I S
APR OPTIONS ON S&P 100 INDEX
W O R K S H E E T

O E X

OPTION PRICING:	TODAY 630.80 Tickr CALLS			PUTS Tickr			2 DAYS LATER 633.00 + 2 . 2 0 Volat=14.71 CALLS			Volat=15.85 PUTS		
STRIKE	Prc	Del	I.Vol	Prc	Del	I.Vol	Prc	Chg	%Chg	Prc	Chg	%Chg
615	21 1/8	.73	18.66	4 5/8	.27	19.29	20 7/8	-1/8	-2%	2 1/16	-2 15/16	-51%
620	17 1/8	.68	18.21	5 1/8	.33	18.51	16 11/16	-9/16	-3%	3 1/16	-2 1/16	-41%
625	13 1/8	.61	16.95	7	.39	17.72	13 1/8	-1/4	-2%	4 9/16	-2 9/16	-31%
(1) *630	10 1/8	.54	15.71	8 3/4	.47	16.85	(2) 10 1/4	+1/8	+1%	6 1/4	-2	-23%
635	7 1/8	.46	15.13	10 3/4	.55	15.77	7 5/8	+1/4	+3%	9 1/8	-1 5/8	-15%
640	5	.37	14.41	13 1/4	.63	15.71	5 1/2	+1/2	+10%	12	-1 1/4	-13%
645	3 1/8	.28	13.67	16 1/8	.73	14.74	3 11/16	+11/16	+22%	15 5/16	-1 7/16	-9%
650	1 5/8	.20	13.41	22 1/2	.73	19.03	2 9/16	+5/8	+32%	19 5/16	-3 1/16	-15%
	Mon 4/ 1/96 (19days Expr)					5.16%Fin	Wed 4/ 3/96 (17days Expr)					5.16%Fin

OPTION PRICING: T -"Tickr" volatility S -"Same" volatility
M - Trade "Match" volatility 1 2 . 5 % (or any other volat.)

1. When the OEX is at 630.80 and the implied volatility is at 15.71, the at-the-money option is priced at 10 1/8.
2. Two days later, even though prices are higher, the drop in implied volatility combined with the time decay, leaves option prices with little gain.

Strategy #3 (Equities)—Stocks to Sell Short

No reason to get cute. Short the stocks of brokerage houses and the stocks of the mutual fund companies. As I mentioned earlier, no industry gets hurt more than the brokerage houses in a bear market. The industry's profits are highly correlated and dependent upon higher stock and bond prices. These are the first stocks to decline in any sell-off.

As I mentioned earlier, if interest rates are rising, also look to short the insurance stocks and possibly the major banks and mortgage companies.

A final note: if you are unable to get an uptick before the market closes to short these stocks, buy deep in the money puts on these companies (to make sure the premium is small).

Strategy #4 (Futures)—Short the S&P 500 Futures

Obviously, the strategy with the largest profit potential is to sell the S&P on the futures market. What concerns me here is the risk and the volatility. Unlike buying the index options, your risk is unlimited if you are wrong. With that said, let's look at a way to minimize the risk.

- Sell the futures "market on close." This will allow you to avoid a market snap-back which may happen in the last few minutes of trading (short covering). Research has shown that sharp afternoon sell-offs have a higher likelihood of follow-through into the next morning.
- Protect yourself on Globex. Should the market rally in the evening, there is less likelihood of a down opening the following morning. Though you may lose some sleep during these occasions, it's better than losing money.
- Finally, one of the surest phenomena I have observed is that Friday afternoon weakness begets Sunday evening weakness. This is a scenario that all futures traders should be aware of.

Strategy #5—Spiders (SPY)

Spiders (Standard & Poor's Depository Receipts) are the safest, most efficient and most liquid vehicle to trade to capitalize on market moves. These American Stock Exchange securities are simply a basket of the Standard & Poor's 500 index divided by 10. For example, if the Standard & Poor's cash index is at 935.00, the spiders will be trading at approximately 93 1/2 (935 ÷ 10). Also, a terrific feature of this derivative is you do not need an uptick to go short, therefore, giving you an instant fill on a market order.

The specialist of the security usually maintains a market of 100,000 shares on each side which means that there is always liquidity. Also, the spread (difference between the bid and ask) tends to rest between 1/16 and 1/8, which is as low as you will see on a listed security. (The daily volume is approximately one-half million shares per day.)

One final thought: Spiders are an inexpensive method to hedge a net long portfolio when you do not have the time, nor the inclination, to liquidate your stocks.

SUMMARY

The profits from declining markets come fast and large. I cannot stress enough the importance of being prepared for these sell-offs. At times they come so quickly that unless you are fully ready, you will miss the move. As I am writing this, we are still in a major uptrend, but the recent increase in volatility may signal more opportunities for traders to profit from market declines. With the strategies in this chapter, you will be better prepared than the average trader who will attempt to participate in these declines by "shooting from the hip."

CHAPTER 27

LARGE-RANGE DAYS

In this chapter we will look at the times markets make large one day moves. I will show you why it is usually wrong to enter these markets immediately following these moves and I will show you why it is an even bigger mistake to buy options immediately following such a move.

Conventional wisdom states that large one day moves immediately continue in the direction of the move. My research indicates otherwise. Markets that have big one day moves attract attention. For example, when the Dow has a large move (100+ points) most news channels carry the story, most newspapers make it the lead business story and every market analyst and guru tells how the move will certainly continue. In looking at these large one-day moves, the reality is that the majority of time these markets do not follow through—they move sideways!

In studying this phenomenon, I looked at a market which closed two standard deviations (*see* box for calculation) from its previous days close (this occurs approximately once out of every twenty trading days). The majority of the time, the market didn't follow through over the next few days. In fact, from a directional viewpoint, you could flip a coin as to whether the move would be up or down the next day. Just as importantly, the market many times closed near the closing price of the large move day, three to four days later.

Here is how to calculate a two standard deviation move in bonds. We will assume bonds are trading at 110 and its 100 day historical volatility is at 10 percent.

10% H.V. / Square Root of 265 trading days = .6250%

.6250% × 110.00 (bond price) = .6875 or 22/32 (one standard deviation)

22/32 × 2 (standard deviations) = 1.375 or 1 12/32

110.00 + 1 12/32 = 111 12/32

110 – 1 12/32 = 108 20/32

Now, let's apply this to the real world. The strong urge (human nature) is to allow ourselves to get caught up in the hype and trade in the direction of the move. Worse, the urge among traders is to do this via options. These options will be overpriced. This is because the implied volatility increases due to the excitement among traders caused by the move. Not only is there a high likelihood that the move won't continue (causing time erosion in the options) but worse, you are buying overvalued options! You have the *worst* of all worlds. In fact, the smarter strategy is to sell the overpriced options via a naked combination. You can sell the calls that are one standard deviation from the large day move's high and the puts that are one standard deviation from the big move's low. If the market moves sideways the premiums on both sides will collapse.

When markets move two standard deviations from their normal volatility, the reversion to the mean principle will kick in and more than likely, the market will take a few days to rest.

A word of warning—in strongly trending markets (ADX greater than 25), this principle does not hold true. Our research has found it works best in non-trending markets.

As an example, the following dates in the bond market had a two standard deviation move from the previous day's close. When you look at these moves, notice how many times the market closed within the large-move day's range three to four days later.

Daily Two Standard Deviation Moves in Bonds Over the Past Two Years—Reflects 100-Day Historical Volatility

Date	*Date*	*Date*
1/13/95	7/21/95	3/11/96
1/27/95	8/25/95	3/12/96
2/3/95	9/21/95	3/27/96
3/14/95	9/29/95	3/28/96
3/24/95	10/13/95	4/5/96
5/4/95	12/4/95	4/12/96
5/5/95	12/18/95	5/2/96
5/9/95	12/20/95	5/10/96
5/24/95	1/5/96	6/7/96
6/2/95	1/10/96	7/5/96
6/9/95	1/25/96	8/1/96
6/13/95	2/20/96	9/13/96
6/29/95	2/23/96	10/4/96
7/6/95	3/1/96	10/29/96
7/19/95	3/8/96	

CHAPTER 28

TWO-FOR-ONE MONEY MANAGEMENT

Here is a specific money management methodology to use which helps maximize profits while keeping risks to a minimum. I believe the "Two-for-One Money Management" strategy gives you more confidence in taking trades as it allows you to enter into potentially explosive setups while reducing the risk inherent in these setups. *Please note that this is not original research.* Variations of this method can be found in other publications. To me it is one of the better money management methods a short-term trader can rely on.

The Two-for-One Money Management strategy allows you to minimize risk while maximizing gains. Many traders I've talked to say they do not have the proper method to allow profits to run. This strategy partially offsets those concerns.

Here's how the strategy works:

1. We will use one "unit" as our position size. For our purposes in this chapter, each unit will be worth 1,000 shares for equities and two contracts for futures.

The general idea is to take off half a unit at a profit target equal to the position's original stop loss. As you will see, by having cashed in half a

unit early, there is no loss if the trade turns against you and takes out the original stop. You've created a free trade (minus commissions).

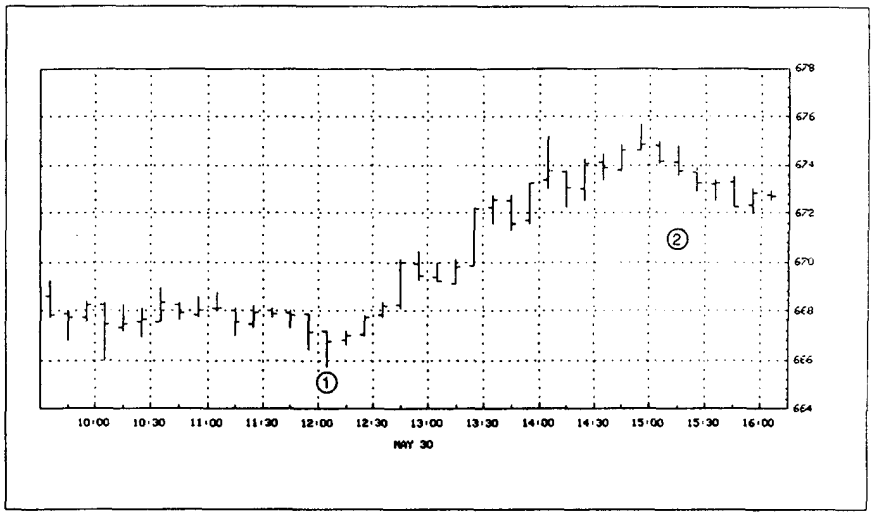
You should note that while this is a "conservative" method of trading, it many times leads to two profits. The first at the "free trade" profit target and the second on the profitable close of the second half of the unit. (You'll see this in example two in the bonds and in others).

2. Let's assume for equities we have a set-up pattern which triggers a buy signal at 53 and our initial protective stop is at 52 1/4 (risking 3/4 of a point). If our sell stop is not triggered we will take profits on 1/2 of our position (500 shares) at a distance off our entry price that is equal to our original stop, (53 + 3/4 = 53 3/4) and leave the stop on the other half at 52 1/4.

We now have a free shot at being in a position that may continue to run. With strategies such as 1-2-3-4's, historical volatility, etc. many times markets explode from our entry point and with the "Two-for-One" method you have a low-risk strategy to participate in these explosions.

To help clarify this strategy let's look at intraday Turtle Soups (from *Street Smarts*) and daily 1-2-3-4's.

FIGURE 28.1 June S&P's (10 Minutes)

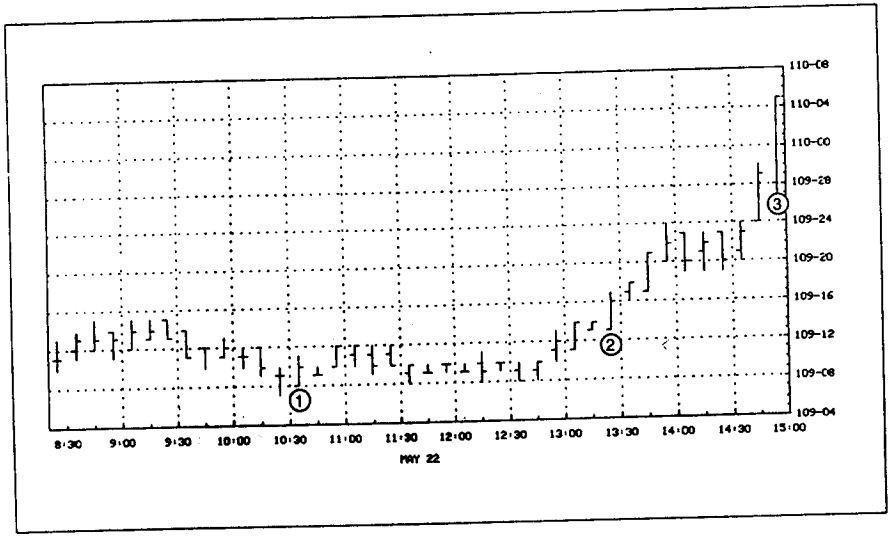


1. On May 30, 1996, the S&P's make a 20-bar low and reverse triggering a Turtle Soup buy signal at 666.05 for two contracts (one unit). Our stop is at 665.65, one tick under this bar's low. Let's assume the unthinkable and there is no slippage, so our risk is .40. We will sell 1/2 our position (one contract) at 666.45 (666.05 + .40). On being filled we cancel selling two at 665.65 and replace it with selling one at that price.

2. Our strategy gave us a free shot at picking the low for the day. The market rallies sharply and we have the option of locking into profits at higher levels or selling MOC.

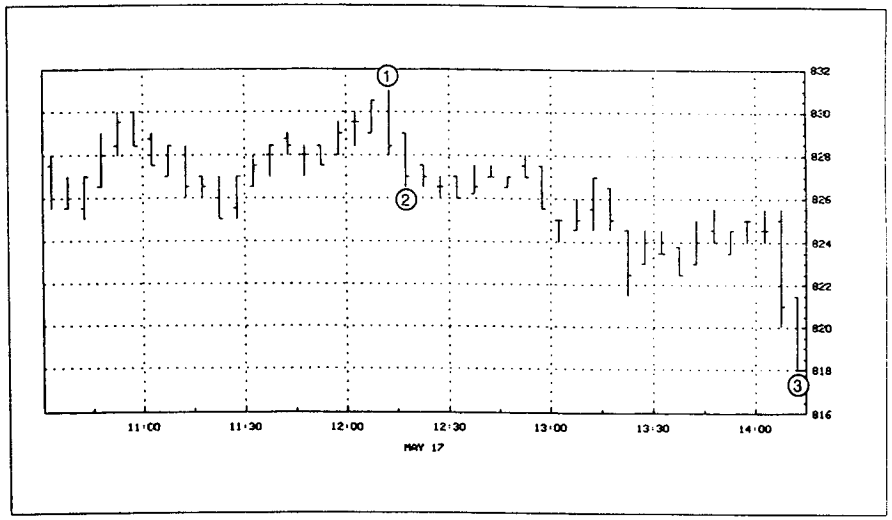
In studying and trading this strategy, I have observed that the Turtle Soup setups on average tend to pick the top or bottom of the day approximately one out of every eight days. That is, on one out of every eight days the daily high or low is created via a Turtle Soup setup.

FIGURE 28.2 June Bonds (10 Minutes)



1. A Turtle Soup Plus One setup. We buy two contracts at 109-11 and our initial stop is a 109-06 risking five ticks.
2. After trading sideways for two hours, bonds explode to the upside and we sell one contract at 109-16 and cancel and replace our two-lot stop with an order to sell one at 109-06.
3. The second half of our unit closes at 110-05. We make five ticks on one contract and 26 ticks on the second.

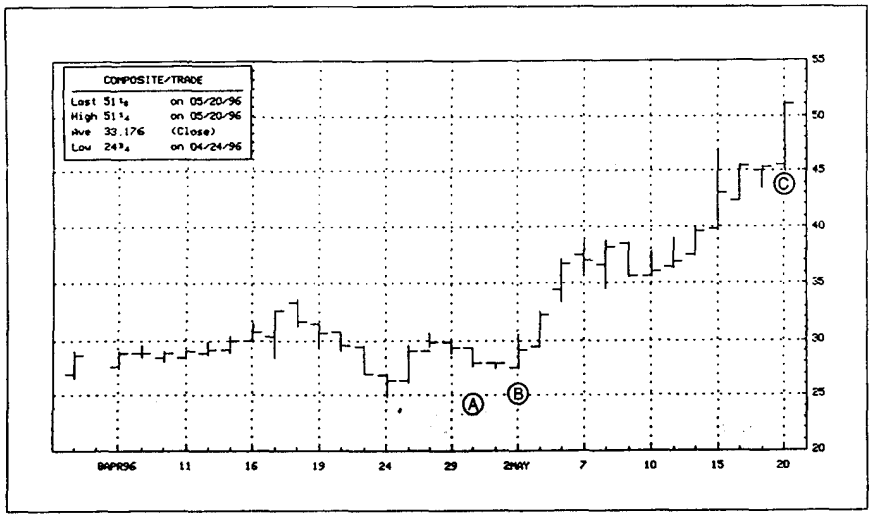
FIGURE 28.3 July Soybeans (10 Minutes)



1. A short Turtle Soup Plus One setup on July Beans on May 17. Sell at 829 1/4 and our protective stop is at 831 1/4 (risking two cents).
2. Take profits on half at 827 1/4 and reduce the sell stop size by half.
3. Beans close on their low with a good profit for those trading this methodology MOC.

Please don't think that picking tops and bottoms happens every day. However, setups like the Turtle Soup and Turtle Soup Plus One combined with "Two-for-One" money management do meld into a strategy which allows you to maximize profits at intraday tops and bottoms.

FIGURE 28.4 Proxim Inc. (PROX)



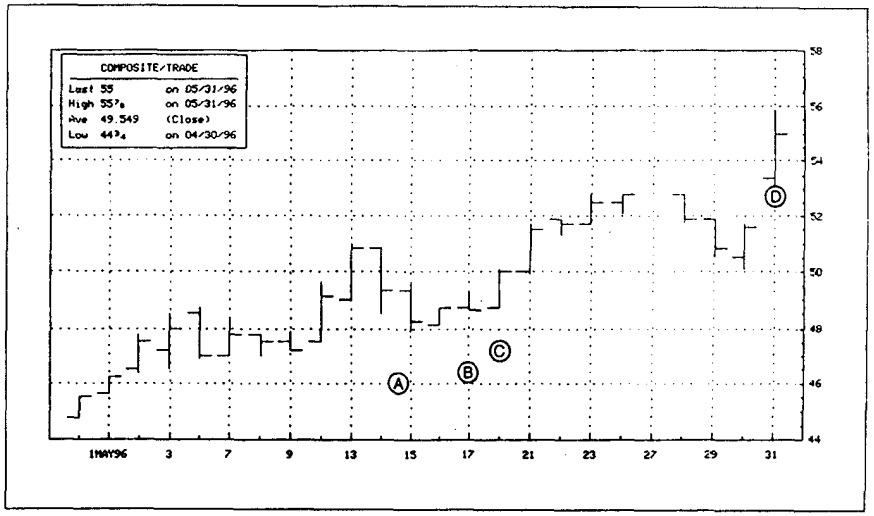
Here's "Two-for-One" money management in action on 1-2-3-4's.

A. A 1-2-3-4 buy setup (ADX is above 30)

B. On May 2, we buy one unit (1,000 shares) of Proxim at 28. Our sell stop is at 27 3/8, the low of the previous day and our risk is 5/8 of a point. The market immediately trades higher and we sell 1/2 our position at 28 5/8 and reduce our sell stop to 500 shares.

C. As does happen from time to time with this strategy, the stock explodes and moves more than 65 percent higher over the next three weeks. (Note that we have again shown a profit on both halves of the unit).

FIGURE 28.5 Tommy Hilfiger (TOM)



A. 1-2-3-4 setup. ADX @ 37.

B. Buy one unit @ 48 7/8. Stop @ 47 7/8.

C. Sell of 500 shares @ 49 7/8.

D. Six points higher in two weeks.

(1-for-1 reward/risk on 500 shares, 6-for-1 reward/risk on 500 shares)

SUMMARY

As you can see from the examples, this exit strategy does a good job at allowing us to participate in potentially large moves with reduced exposure.

CHAPTER 29

MORE THOUGHTS

I had a small handful of friends who trade read the galleys of this book and they came back to me with a series of questions. I hope this section will help answer many of your own questions.

Q: Do you trade every strategy?

A: No, there are obviously too many. A good handful now make up the methodology we use in our money management firm.

Q: Can these strategies be improved upon?

A: Yes, and I have evidence of this. I consider the subscribers to my newsletter the *Professional Traders Journal*, to be among the smartest people who trade. Over the last two years I have received numerous suggestions of enhancements for many of the strategies.

Q: Why don't you publish those enhancements?

A: Unless someone gives me specific permission, I will never reveal their improvements. As with many other traders, I have unfortunately been associated with a few individuals who have revealed my research after I have asked them not to (I was dumb enough to let one person do it to me twice!). Fortunately, these individuals are

the exception, not the rule. Therefore, I will always keep private the research that others share with me.

Q: What do you think is the best way to improve one's trading?

A: Obviously, the first and most important thing to do is to implement very disciplined money management. A second way is to act in a manner opposite to human nature.

Let me dwell on this point a bit. I am as guilty as anyone of pouncing on a methodology after it has had two or three successful trades. After these successful trades I immediately ask myself why don't I make my life simple and only trade this strategy? I then load up on the next signal only to watch my net-worth get reduced. Every methodology has a "reversion to the mean" principle built into it. This means, that the best time to trade the methodology is after it has had two or three consecutive losses, not winners! Human nature is to trade a strategy only after it has worked a number of times in a row. This success reinforces in your mind the pleasure of the strategy, not the pain. If a trader waited only for each of these strategies to have two or three consecutive losses and then traded it, his returns would be much higher. Unfortunately, we all do the opposite.

This is further evidenced in the money management world. There is a high-profile hedge fund manager whose overall performance is well above average. The problem is that many people lose money with him. This is because he has large swings in his quarterly and yearly performance. When he has a spectacular quarter (or year) the money pours into him. Then the reversion to the mean principle kicks in and he has horrendous drawdowns and these same investors, who originally believed they were investing with GOD, now hate him and pull their money out, usually at the bottom. His smallest account accepted is one million dollars so we are not dealing with an uneducated group of people. These are successful pension fund managers and businessmen—all affected by the same human nature.

If you can find the courage to trade a methodology only after consecutive losses instead of gains, you will likely improve your performance.

Q: Why publish your research. Why not keep it only for yourself?

A: Obviously, it's an extension of my business. More importantly, it serves no purpose to take the information to my grave. And most importantly, I have yet to see it have a negative effect, in terms of slippage, on my trading.

Q: Why not trade just one strategy?

A: I have thought about that a lot and I have great deal of respect for traders who do it. Unfortunately, I am not wired that way and I need diversity.

Q: What about mechanical exit strategies?

A: Even though I have presented mechanical exit strategies with some methods, I can never use them myself. I am much too hands-on to sit tight as a position is running one way or another. This does not mean this is the way you should trade. This is the way *I* need to trade. I know successful traders who exit mechanically and I know successful traders who exit with discretion. These people are successful not because of their exits, but because they have an edge, and they know what works for them.

Q: Can you recommend other researchers/traders whom you look up to?

A: There are too many to list, but I'll name a few. I relate well to many things written by Gerald Appel. I think most of Larry Williams research is very strong, I have business relationships with Mark Boucher and Jeff Cooper, and I'm biased toward their work. Nelson Freeburg's research is solid, Welles Wilder's techniques such as ADX and RSI are brilliant, Shellie Natenberg's work on option volatility is the best. The list can go on but if you study the concepts of the above group first, you won't go wrong.

Q: Why not a chapter on money management?

A: First, because this is an advanced trading book, I assume everyone understands the importance of stops. Without them you will eventually get blown out. I have attempted to show you where to place your stops in many of the strategies.

Where you decide to place your stops and the position size you decide to take is a personal decision in which many factors come into play. The most important factor is your risk tolerance. If past history is any guide, thousands of traders will read this book. Every single one will have a different level of risk tolerance. I will not impose my risk tolerance levels upon you. You know what is best. I cannot tell you that your position risk should be 1 percent or 5 percent of your portfolio size. I cannot tell you that your account size should be $50,000 or $250,000. I cannot tell you how many shares or contracts to trade per $25,000. You, and only you, know the correct answers.

Let me go one step further. Over the past decade or so, one of the best performing groups of traders in the money management business have been the original Turtles Richard Dennis taught. They employ a breakout method that has stood the test of time. Their method has one major drawback though: it experiences large, and sometimes very large, drawdowns of 20, 30, and 40 percent.

I am convinced the Turtle methodology works. Will I trade it? Never! Why not? I do not have the stomach to live through the drawdowns. Those Turtles who are the most successful have learned to live with the risk levels associated with the drawdowns. Their money management risk tolerance is far different than mine. If I worked for them, I would think they were insane to take such risks. And if they worked for me, they would think I was insane for keeping my stops so tight. Again, only you know what your risk tolerance is and your stop placement, account size, and position size should be reflected upon it.

With that said, let me mention a few additional thoughts on the topic:

1. Every position must have a protective stop in place. This rule must never be broken!

2. If you are selling options, you should have an offsetting long position (creating a spread) to avoid a catastrophe (the bad tail).

3. You must be aware of markets that are related. If you are long bonds and long Euro dollars, you have basically doubled your risk as they move in a high correlation to each other.

4. Volatility changes! As mentioned in an earlier chapter, the Canadian dollar usually trades with a volatility of under 10 percent. If you normally trade 10 contracts in it, you must lower your position size when the volatility drastically rises. Very few people follow this guideline and it is a major reason why catastrophic loses occur.

5. When multiple signals occur, a larger than normal position size should be considered. For example, a Connors VIX Reversal combined with a TRIN Thrust increases the likelihood that the market will follow through for the next few days.

These guidelines are a good place to begin to build your money management strategies. If you desire a more in-depth academic view on the subject, read *The Mathematics of Money Management* by Ralph Vince. It is filled with solid statistical advice.

CHAPTER 30

HOW SUPERIOR INDIVIDUALS BECOME

I would like to conclude this book with a look at the role that practice, experience, and psychology play in leading one to become a superior trader. Through the use of a study done on elite musicians, chess players, and athletes published in 1993, we will correlate these findings to our own profession.

One of the subjects I have always been fascinated by is how and why individuals achieve greatness in their fields. Why does one individual dominate a sport, an industry, or an art, while the masses fail? Does genetics predetermine greatness or is it some other factor that allows individuals to become leaders in their field?

I recently finished reading a book by Howard Gardner entitled *Extraordinary Minds*. In the bibliography, he refers to a study published in *Psychological Review* in 1993. The study, "The Role of Deliberate Practice in the Acquisition of Expert Performance," looked at whether "great" musicians, chess players, and athletes were genetically predisposed to achieve greatness (physiological) or whether greatness came as a result of external factors such as practice. (Of course, since I am a trader, I ask the question from this perspective—"are great traders born or can they be developed?")

The study's findings overwhelmingly showed that there was absolutely no basis to the argument that genetics is the sole determinant in predicting success. In fact, genetics played at best a very minor role in differentiating between those who were "great" in their field versus those who were merely "good." *The number one factor in determining whether or not one reached the highest levels in their field was the amount of time these individuals spent on "deliberate practice."* Deliberate practice is defined as the amount of time one spends in attempting to *improve* their performance. Simply performing the act is not deliberate practice; deliberately attempting to *push oneself further* is.

Drs. Ericksson, Krampe, and Tesch-Roemer found that those who achieved greatness in their fields spent anywhere from 30 minutes to 2 hours *more* per day on deliberate practice than those who were only "good" in their field. The authors go on to say that 30 to 120 minutes of extra practice does not seem like much until one begins adding up the difference over a period of time. For example, they cite numerous studies that show that *it is virtually impossible to reach the pinnacle in one's field without at least 10 years of concentrated effort.* Therefore, the 30 to 120 minutes each day the "future greats" spend on improving themselves works out to be *many thousands of hours of extra practice* over a 10-year period!

I suspect that had the authors looked at the most successful traders, their findings would be the same. Buying blackbox systems, trading crazy methodologies, or listening to gurus who claim they can tell you where the Dow will be three years from now will never bring you into the ranks of the trading elite. Simply put, 10 years of deliberate practice and hard work is the only sure recipe for success!

CHAPTER 31

FINAL THOUGHTS

I am writing these final pages after four friends read, proofed, and critiqued the galleys. These individuals all trade. Two are private traders whose main source of income is derived from the markets, one is a CTA, and the fourth is not only a professional trader, but he also possesses a Ph.D. in mathematical statistics. Each is as different as night and day and I have a great deal of respect for their insights.

Their response to the trading methods was very good. I would expect that, for each is a trading strategies junkie, just as I am. More importantly, these four very different gentlemen saw something that was bigger than the strategies. They each saw my point of first needing to understand market dynamics before creating a trading methodology. They saw things such as the principle of volatility reverting to its mean and when it is extremely low you trade breakout strategies and when it is extremely high, you trade strategies to exploit price implosion. They saw that markets are made up of human beings and human beings are irrational. The Options on Stock Splits strategy exploits this, but bigger picture, these types of irrational occurrences will be with us long after the stock split strategy fades away. Each, in their own way, was fascinated by the Victor Niederhoffer saga, not because they liked to see someone get hurt, but because, like me, they saw a piece of themselves in him. Each realized

that without a proper understanding and respect for volatility, it could just as easily have happened to them.

The majority of readers will finish this book and tell themselves they now have 30 plus more strategies to trade the markets. This is fine, and it is the main reason they bought the book. A small handful, though, will see deeper and realize that markets have inherent features. They will go on in the future and trade methodologies that best exploit these features. If you are part of this small group, congratulations. I strongly suspect you will become a far better trader than most.

APPENDIX

While the following formula for historical volatility may be of use to a mathematician, you should ideally have a software program calculate this for you.

HISTORICAL VOLATILITY BENCHMARK CALCULATION

Historical volatility (HVG) calculates the volatility of the underlying security log-normally following the assumptions of most standard option pricing models. The N-day price volatility as of a specific date is the unbiased standard deviation of the "N" minus one most recent logarithmic daily returns times the annualization factor, expressed as a percentage. (Logarithmic daily return is the log of one day's price divided by the prior day's price. This is algebraically the same as the difference of the logs of the individual prices.) For example:

	10/8/92	*10/7/92*	*10/6/92*	*10/5/92*
price:	81.76	82.87	83.43	83.35
natural log:	4.403788	4.417273	4.424007	4.423048
difference:	–.01348	–0.00673	.000959	
unbiased std. dev.:	.007227			
times sqrt (260):	.116536			
times 100%:	11.65% (same as HVG)			