

The **TRADER'S** *Journal*

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Picking a Trading Timeframe

Before You Make a Trade

Identifying the Trend

Randomness of Financial
Markets

The Thought Demons of Traders

Trading Tools:

Applying Options

Statistical Analysis

MACD

Integrated Pitchfork Analysis

6 Steps to Money Management

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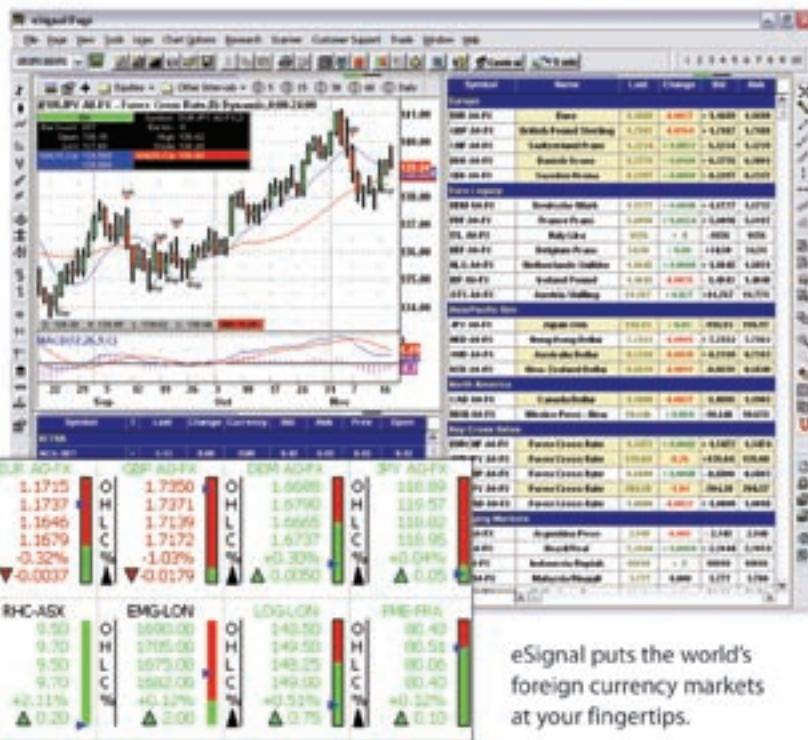
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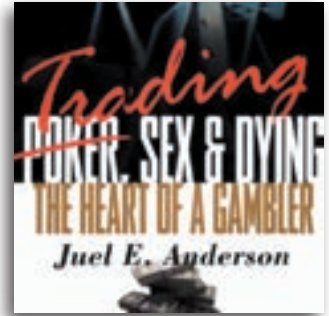
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The TRADER'S Journal

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FROM THE EDITOR

"In addition, losing traders tend to be disorganized and impatient. They want action now." Dr Van Tharp.

Welcome back to the latest issue of the Trader's Journal. Thank you for your comments to us about what you are enjoying with the publication and what you would like improved and changed. Thanks to you and your candid feedback, we are confident that each issue is only going to get better. A reminder that our primary focus here at the Trader's Journal is to educate you. It can be easily argued that it is the educated trader that will survive in the markets and we want to be a large part of your education. I like what Dr Van Tharp says above. Many traders don't fare well in the markets and he can attribute some of this to impatience and wanting action and results now. It can be too easy to start trading and want to see your account balance grow from day 1. For the more experienced trader, they know how foolish this can be. Successful trading requires many personal attributes and patience is one of them. It is important to set realistic goals, and then call upon your discipline and focus to enable you to commit to achieving them.

Many market commentators and professionals are now looking towards 2006 and what may possibly transpire. Of interest will be inflation in the US, the price of oil after it has moved more than 30% during 2005, and its impact on consumers. On a positive note, consumer confidence in the US surged in December 2005 to the highest level since August, before Hurricane Katrina hit the Gulf Coast.

As always, to help you along the path of trading well, we have compiled a number of quality articles written by leading educators, authors and traders for our third issue. Of interest is our interesting article discussing trading psychology using fables, quotes and proverbs. In the area of developing a trading system, Jim Wyckoff outlines some very useful tips to consider before you open any trade, and another article covers an often underestimated factor – the time frame.

In the technical analysis area, we look at Integrated Pitchfork Analysis in practical terms as well as identifying the trend. In addition, we have a follow up article about the geometry of financial markets and answering the question about markets being random, as well as a solid introduction to the popular indicator, the Moving Average Convergence Divergence (MACD).

Our regular futures and options expert, Nick Katiforis, goes back to the basics for us with our extensive introductory article on options, and how we can apply some of the basic trading principles to real life examples. Every issue, Nick will continue to develop our knowledge on trading options most effectively.

Again, we have been able to gather a highly qualified group of contributors to the Trader's Journal and all of them make a valuable contribution to enable us to continue to provide you a healthy balance of material. We are always very grateful for their contributions.

Again, I am very excited to be introducing this, the fourth issue of the Trader's Journal and I trust it will become a vital part of your education and your personal development into a successful trader. Let me leave you with a thought from American author Dr Van Tharp, who stresses the importance of focussing on the right things. When we start trading, we naturally move towards the unimportant things and focus on the wrong areas. Those who are able to, from an early stage, focus on the right areas to trading well like the mindset, and risk management will have a far greater chance of success. In an environment where success is difficult enough to achieve as it is, why not do everything you can to increase those chances. I hope you enjoy this issue of the Trader's Journal.



Stuart McPhee
Editor

"Everyone will flock to a talk on high probability entry signals, and less than 1 percent will learn anything significant. However, talks featuring the most important keys to making real money will have few people in attendance." Dr Van Tharp.

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Moving Average Convergence Divergence – Part One



Jason Sidney, Managing Director of Market Insight Pty Ltd, explains some practical applications of the popular MACD indicator.

The Moving Average Convergence Divergence indicator, commonly referred to as MACD, is a trend following indicator that measures the difference between two moving averages of prices. MACD (shown in red in the chart below the price plot), is the difference between a 26 day and a 12 day exponential moving average. A 9 day exponential moving average called the 'signal' line (shown in dashed blue on the chart), is plotted on top of the MACD to show buy and sell opportunities.

The moving averages used are exponentially weighted, which gives more weight to the more recent data. The name of the indicator comes from the fact that

the shorter exponential moving average (EMA) is continually converging toward and diverging away from the longer EMA.

The formula used when calculating the MACD indicator is as follows:

1. Calculate a 12 day EMA of closing prices
2. Calculate a 26 day EMA of closing prices
3. Subtract the 26 day from the 12 day EMA and plot their difference – this then becomes the fast MACD line
4. Calculate a 9 day EMA of the fast line and this then becomes the slow signal line

Traders will sometimes vary the calculation period of the MACD indicator depending on the market and their trading strategy. Some technicians choose time frames for their indicators based on a specific number series like the famous and wellknown Fibonacci numbers series. This number series is calculated by starting with the number one and simply adding each number to the previous number as follows: 0,1,1,2,3,5,8,13,21,34,55,89,144 and so on. Based on the Fibonacci number series, the equivalent time frames for the MACD indicator would be 13, 34 and 8.

The histogram is another interesting aspect to this indicator. When first viewed the histogram

is often mistaken for volume as it looks very similar to volume spikes seen on charts. The histogram is actually displaying the difference between the two MACD lines. To prove this to yourself, have a close look at the MACD lines and you will notice when the two lines cross further apart, the histogram will become quite large and when the two lines get very close together the histogram will become very small.

You will also notice a centre or zero line running through the middle of the histogram. When the histogram spikes are above this zero line it means the fast MACD line is above the slow signal line and when the histogram spikes are below the zero line it means the fast MACD line is below the slow signal line. The histogram is also used to act as a filter to the buy and sell signals generated when the two moving averages cross over and there are two ways the histogram can be used to confirm these buy and sell signals.

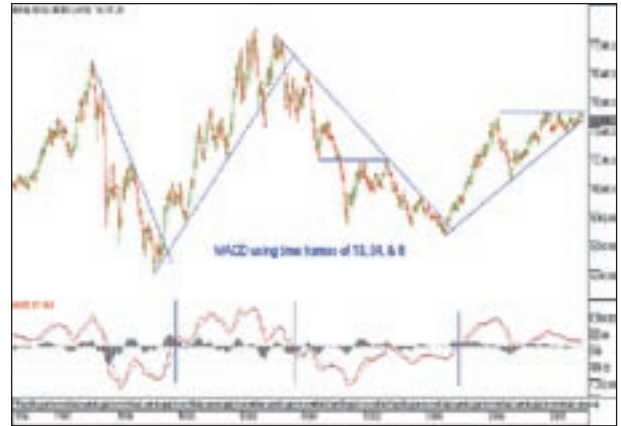
The MACD indicator is most effective in strongly trending markets and therefore should only be used in markets that are trending well, as ranging markets will tend to produce whipsaws or false buy

and sell signals.

The basic MACD trading rule is to sell when the fast MACD line falls below the slow 9 day signal line and to buy when the fast MACD line rises above the slow 9 day signal line. Ideally the buy signal generated by the lines should be occurring below the histogram, and sell signals should occur above the histogram. When the MACD lines cross producing the buy or sell signals, the histogram will confirm this by crossing above or below the zero line. A second and very useful way the histogram can be used to confirm the buy or sell signal from the MACD lines is to wait for both lines to cross through the zero line of the histogram. By doing this it will add further weight to the significance of the buy or sell signal and suggest a higher probability trade.

The other powerful and important aspect to this indicator which is not often explained or taught is how it can be used to measure the strength of the trend and give the trader the ability to let their profits run. This is achieved by again comparing the MACD lines to the histogram and is another reason why the buy signal should occur below the histogram and the sell signal above the histogram.

As previously mentioned the buy

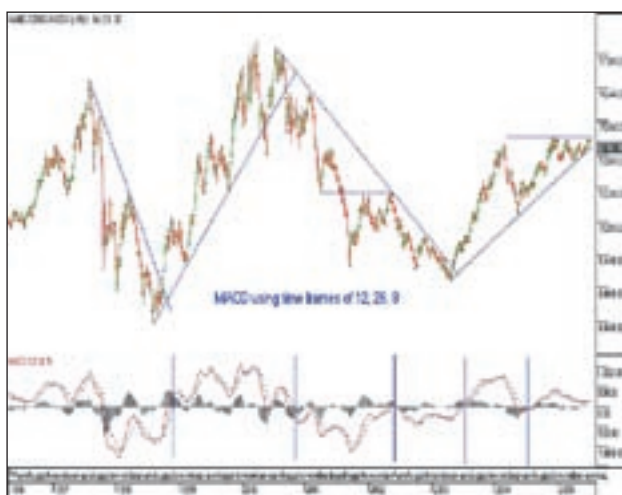


signal can be confirmed as a strong signal when both lines cross above the zero line of the histogram. As long as both lines then remain above the histogram the up trend is said to strong and likely to continue.

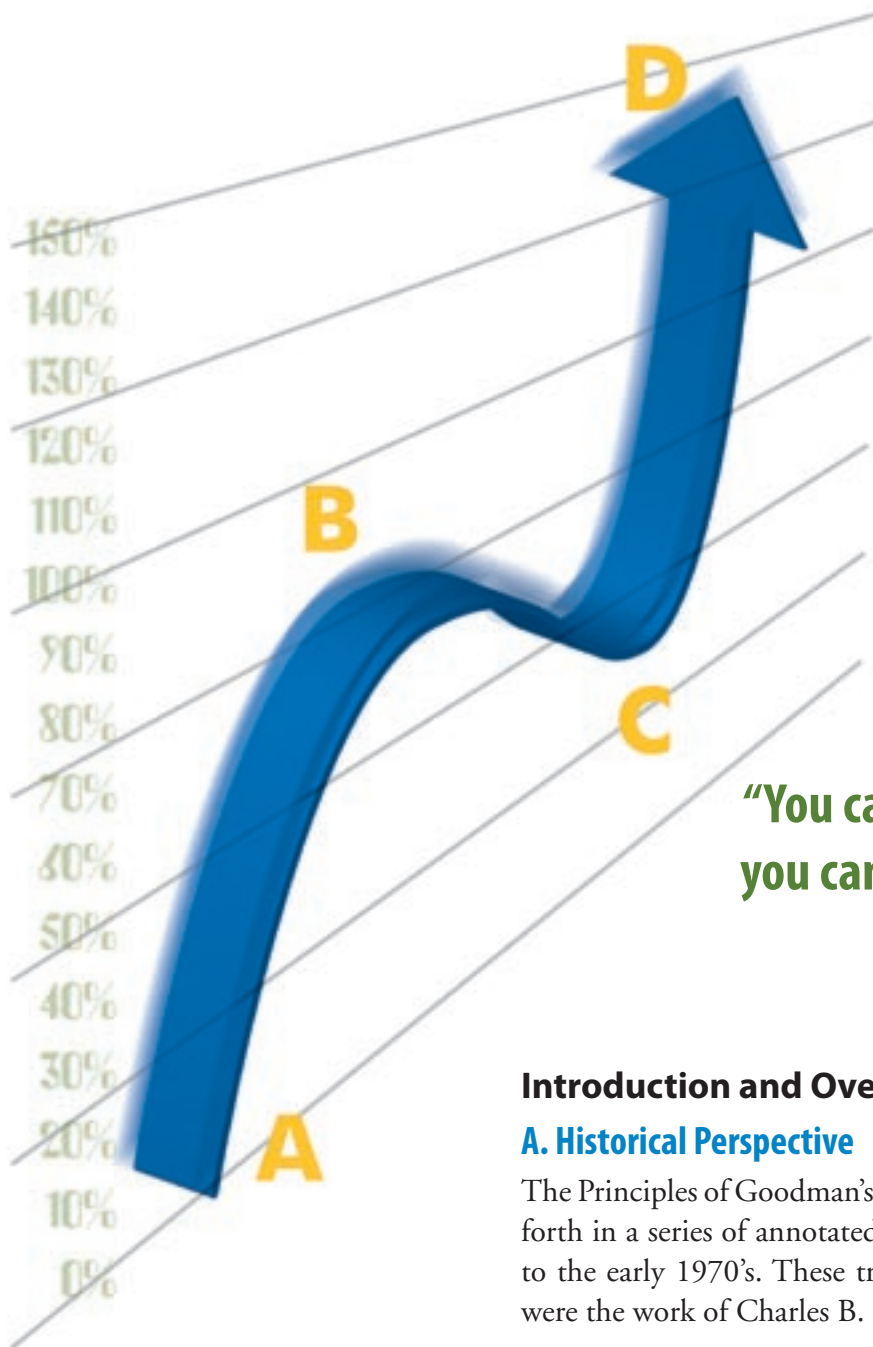
During the uptrend the MACD lines will often cross above and below each other, but as long as they are both still holding above the histogram the up trend is still intact and likely to continue. It's not until they cross back down through the zero line of the histogram that it would suggest that the up trend is over. This can be valuable information when trying to let your profits run in a trade and is of extreme value for people who try to trade or capture intermediate moves.

Jason Sidney is the managing director of Market Insight Pty Ltd. Market Insight is an educational company that teaches analysis techniques for financial markets. Market Insight Pty Ltd produces a free newsletter that promotes these techniques and how they are applied to financial markets. To subscribe to this newsletter, simply visit the Market Insight website.

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Goodman's Swing Count System - Part One



**“You can figure the markets, but
you can’t figure the human race”
– Charles B. Goodman**

Introduction and Overview

A. Historical Perspective

The Principles of Goodman's Swing Count System were informally set forth in a series of annotated commodity charts from the late 1940's to the early 1970's. These trading studies simply titled 'My System' were the work of Charles B. Goodman and were never published.

I met Charles Goodman at the Denver, Colorado offices of Peavey and Company (later, Gelderman) in the fall of 1971. It was the occasion of my maiden voyage in the great sea of commodity trading (later, futures). In 1971 silver prices were finally forging ahead to the \$2.00/ounce level. A 10-cent limit move in soybeans elicited a full afternoon of post-mortems by traders and brokers alike.

The Peavey office, managed by the late and great Pete Rednor employed eight brokers (later, account representatives). The broker for both Mr. Goodman and me was the colorful - and patient - Ken Malo. Brokers, resident professional traders - including Mr. Goodman and the Feldman brothers, Stu and Reef - and a regular contingent of retail customers drew inspiration from a Trans-Lux ticker that wormed its way across a long, narrow library table in the back of the office. Most impressive was a large clacker board quote system covering almost the entire front office wall. This electro-mechanical quotation behemoth made loud clacking sounds (thus its name) each time an individual price flipped over to reveal an updated quote. Green and red lights flashed, denoting daily new highs and lows. Pete, apart from being an excellent office manager was also a fine showman using the various stimuli to encourage trading activity!

Almost everyone made frequent reference to Charlie's *huge* bar charts posted on 2 ½ by 4-foot sheets of graph paper, mounted on heavy particle board and displayed on large easels. No one ever really knew what the numerous right-hand brackets () of varying lengths scattered throughout each chart meant. But there was always a great deal of speculation! The present work finally reveals the meaning of those mysterious trading hieroglyphics.

The quiet chatter of the tickertape, the load clacking of the quote board, the constant ringing of the telephones. The news ticker that

buzzed *once* for standing reports, *twice* for opinions and *three times* for 'hot news', the squawk boxes and Pete Rednor's authoritative voice booming, 'Merc!, Merc!'. What a spectacular scene it was! No wonder that this author, then a 21-year old trading Newbie would soon make commodity futures and currency trading his life's work.

But nothing made a greater impression on me than the work of Charles B. Goodman. He instilled first, some very simple ideas: "Avoid volatile markets when at all possible" - "Trade only high percentage short term 'ducks' " - "Sit on your hands, Dad, sit on your hands". It didn't take long for me to adopt the ultra-conservative 'Belgian Dentist' style of trading, that is - "Avoiding losing trades is more important than finding winning trades"

The Belgian Dentist approach carried with me when I developed my famous AI trading system in the 1980's - Jonathan's Wave. Even though it generated 48% annual returns with a zero expectation of a 50% drawdown (according to Managed Account Reports) it drove the brokers berserk because it could easily go a full month without making a single trade!

Charlie's trading advice, I am certain, allowed me to survive the financial Baptism of Fire that destroys most commodity and currency trading Newbies in a matter of months, if not weeks.

Mr. Goodman was to be my one and only trading mentor. Over the decade that followed he entrusted to me many, if not most of his

trading secrets. *To the best of my knowledge he shared this information on his work with no one else in such detail.*

Charlie and I spent hundreds of hours together analyzing the trade studies from My System. We also analyzed hundreds of other commodity, currency and securities charts. Charlie was happy with My System being 'organized' in his mind. But as a new generation technical analyst, I was anxious to see it formalized on paper and eventually in source code on a computer. (To be honest this created a small amount of friction between the two of us - Charlie was dead set against formalized systems and believed strongly in the psychological and money management elements of trading.) Notwithstanding, by 1979 I was finally ready and able to formally state the principles of My System. Because of its equal concern for price measurements (parameters) and price levels interacting together (matrices) I originally renamed My System 'ParaMatrix'. My first investment management company in the mid-1970's was ParaMatrix Investment Management and I acted as both a registered Investment Advisor (SEC) and Commodity Trading Advisor (CFTC).

Contrary to ongoing speculation, only two copies of my original 1979 'Principles of ParaMatrix' ever existed. I possess both of them. Charlie's original My System trade studies were mistakenly destroyed shortly after his death in 1984. What remains of them are the 200 or so examples I copied into

Principles of ParaMatrix.

The present work, Goodman's Swing Count System (GSCS), is a reorganized re-issue of Principles of ParaMatrix with updated charts and a simplified nomenclature that I am sure Charlie would have appreciated; "Keep it simple, Dad!" he would always advise. I've also expanded on Charlie's ideas by 'filling in' some less formed ideas such as his market notation, or calculus as he referred to it, and a method for charting which I have dubbed Goodman Charting.

Two of Charlie's less well-defined ideas are NOT included in this work: 1) Dependent/Scaled Interfacing and 2) Time-Based (cyclical) measurements. There are also a number of intra-swing formations I have not discussed. Nor does this include instruction on Goodman charts or his notational calculus.

My own direction in futures and currencies turned in the 1980's to artificial intelligence (Jonathan's Wave) and in the 1990's and today, artificial life and cellular automata (The Trend Machine). In spite of, or perhaps because of these complicated 'cutting edge' computer efforts I continue to view Goodman's Swing Count System (GSCS) in a very positive light. To this day, the first thing I do when I see any chart is a quick Goodman analysis!

GSCS is a natural 'system' for pursuing the conservative Belgian Dentist approach to trading, even without the aid of a computer. This article, in fact, could be used to make Goodman analysis without a computer at all! But it is in fact

intended as an introduction to the CommTools Analytic Suite GSCS software. That software is intended as a supplemental tool only for doing Goodman chart analysis.

GSCS trade opportunities are as frequent today (perhaps more frequent) than they were 40 or 50 years ago. I believe the system's foundations have well stood the test of time. Patterns today are no different than they were decades ago - nor are the twin human emotions - Fear and Greed - that create them. GSCS is an excellent method for finding support and resistance areas that no other method spots, and for locating *potential* turning points in any market. One of its best suits - it can easily integrate into other trading techniques and methodologies.

I would never recommend or advise anyone to use a 100% mechanical trading system, GSCS or any other!

Is it really a 'system'? Depending upon your perspective GSCS is between 70% and 90% mechanical. The program available from CommTools, Inc (www.commtools.com) represents the kernel idea of mechanizing perhaps 80% of the system. I now believe attempting to completely code Charlie's work would be inadvisable.

Mr. Goodman passed away in 1984. It was always his desire to share with others - although as is usually the case with true genius - few wanted to listen. These days we are ever more bombarded ever more cryptic and computer-dependent software programs and 'black-boxes'. Perhaps now is the time for the simple yet theoretically

well-grounded ideas of GSCS to populate.

The publication of this brief work and the GSCS software, I hope and pray, would meet with Charlie's wishes. His work in extracting an objective and almost geometrically precise (ala Spinoza) trading system out of a simple trading rule (the '50% rule') is most remarkable. It has certainly earned him the right to be included in the elite group of early scientific traders including Taylor, Elliot, Gann and Pugh.

Conforming to the spirit of the original My System, I've attempted to keep theoretical discussions and formulations to a necessary minimum. Trade studies in Part 3 of this article must still be considered the crux of GSCS, even though I am pleased with the formalization of most relevant principles in Part 2. The trader weary of theoretical discussions and intrigue will find all the concepts and principles delineated in the trade study examples. Nevertheless, those who invest time in the theory of GSCS will undoubtedly discover an area for further exploration where many new and fresh ideas are waiting to be mined.

In Mr. Goodman's worldly absence, the responsibility for this work and its contents is solely mine, for better or for worse.

B. Theoretical Overview and Definitions

The cornerstone of GSCS is the old '50 Percent Retracement and Measured Move' rule. This rule, familiar to most traders is almost as old as the organized markets themselves. It has been traced to the

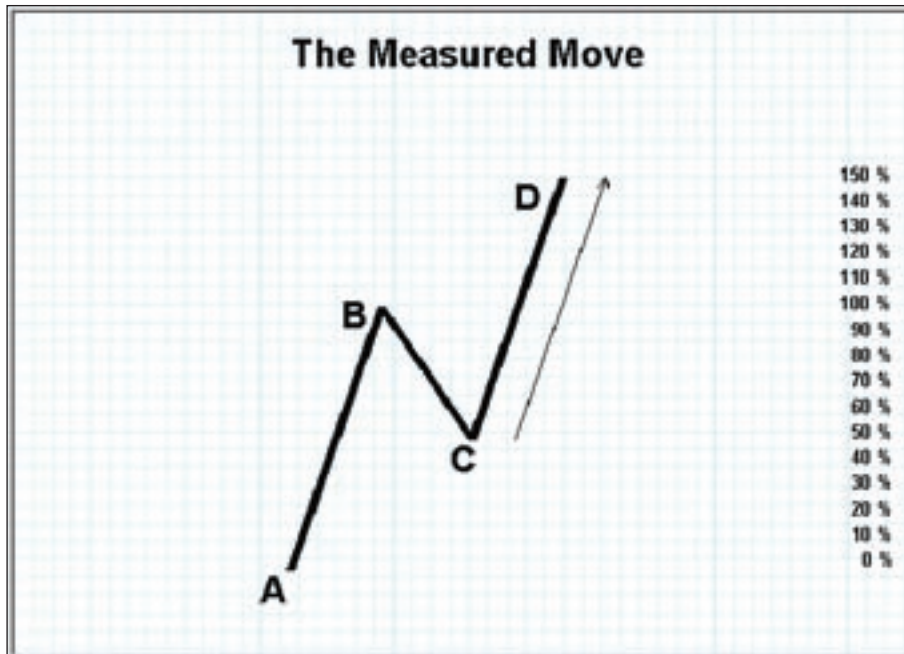


Figure 1 - The 50 Percent Retracement and Measured Move Rule

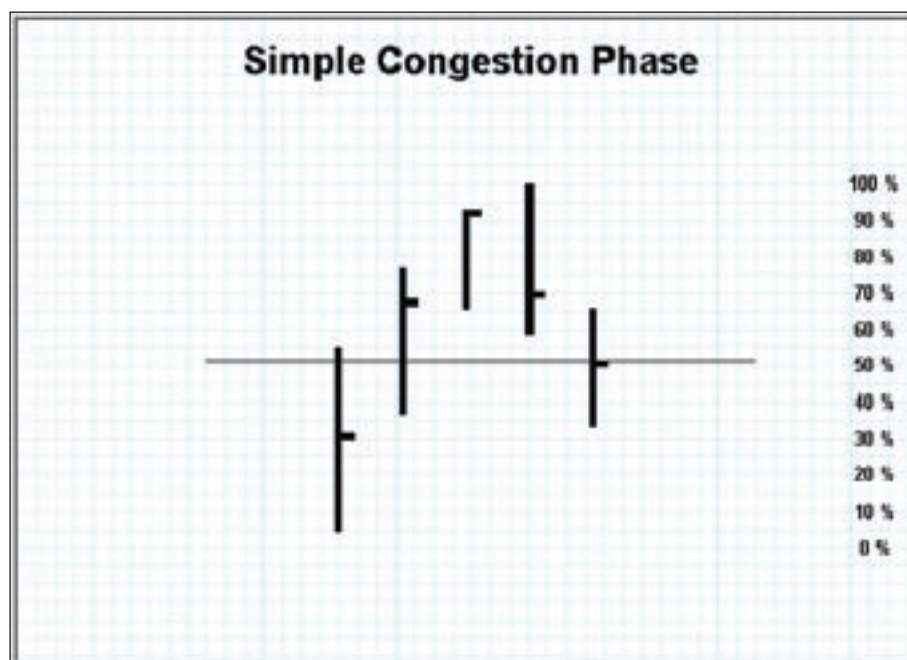


Figure 2 - A Congestion Phase

times when insiders manipulated railroad stocks in the 19th Century.

The first systematic description of THE RULE was given in Burton Pugh's *The Great Wheat Secret*. This book was originally published in 1933. In 1973, Charles L. Lindsay published *Trident*. This book did much - some say too much! - to quantify and mathematically

describe THE RULE. Nevertheless, must reading for anyone interested in this area of market methodology. Edward L. Dobson wrote *The Trading Rule That Can Make You Rich* in 1978. This is a good work with some nice examples. But none of these, in my humble opinion, even scratch the surface, relative to Goodman's work.

In 1975 a well-know Chicago grain floor trader, Eugene Nofri, published *The Congestion Phase System*. This small but power-packed volume detailed a short term trading method using simple but effective 'congestion phases'. While not precisely a work on THE RULE it touched - from a different angle - some of Charlie's ideas.

[I mention Nofri's work also because Charlie was especially taken by its simplicity and because it can work well in conjunction with GCSC. The idea of melding GCSC with a congestion phase approach ought to produce a method of finding those high percentage 'ducks' that the Belgian Dentist so much loves! Charlie also felt that Hadady's work on *Contrary Opinion* was a natural 'fit' especially since the GCSC support and resistance points seldom lie where anyone else thinks they should.]

Still, in the end, it was left for Charles B. Goodman, the great grain trader from Eads, Colorado to extract all the logical consequences from THE RULE and transform it into a robust, almost geometrically precise system.

The logic of THE RULE is quite simple. At a 50% retracement, both buyers and sellers of the previous trend (Up or Down) are *ceteris paribus* 'in balance'. Half of each holds profits and half of each holds losses.

The equilibrium is a tenuous one, indeed. The distribution of buyers and sellers over the initial price trend or *swing* is obviously not perfectly even: Some buyers hold more contracts than other

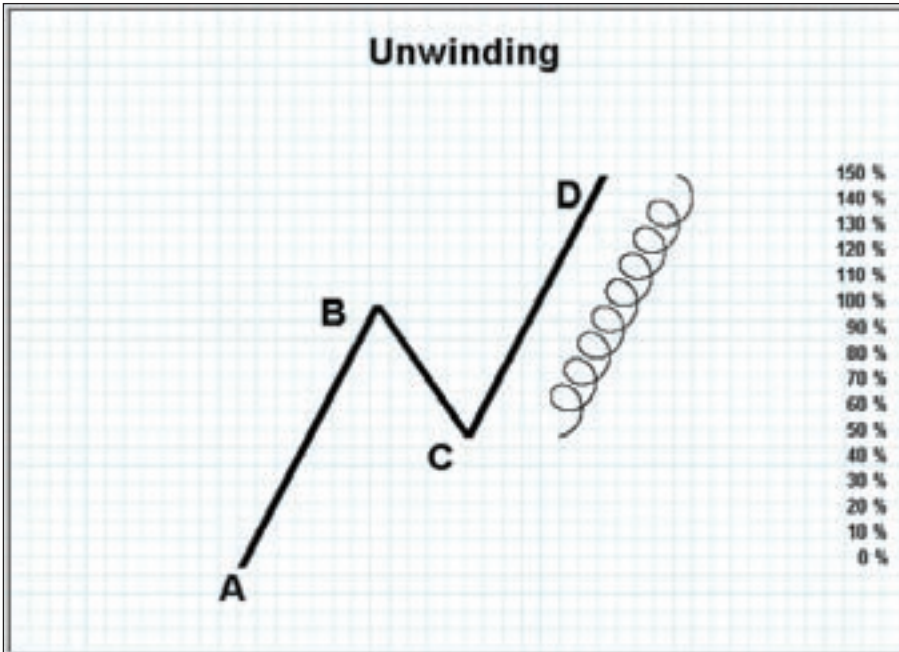


Figure 4 - The Measured Move and 'Unwinding'

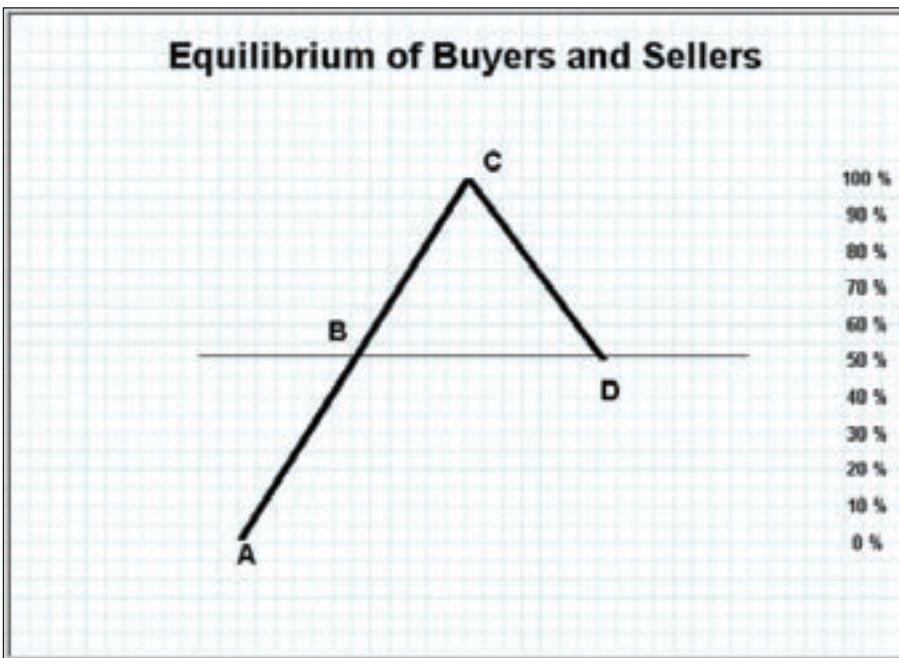


Figure 3 - A Market Tug of War

buyers. They have also different propensities for taking profits or losses. Nor does it account for the buyers and sellers who have entered the market before the initial swing or during the reaction swing. Not all of the buyers and sellers from the original swing may be in the market any longer.

Remarkably, GCSC eventually

takes all of this into account - especially they buyers and sellers at other price swing levels, called *matrices*.

Nevertheless, the 50% retracement point IS often a powerful and very real point of equilibrium and certainly a 'known and defined hot spot' of which one should be aware. Remember both the futures

markets and the currency markets are very close to a zero-sum game'. It is only commissions, pips and slippage that keep them from being zero-sum. At the 50% point it doesn't take much to shift the balance of power for that particular swing matrix.

THE RULE also states the final (3rd) swing of the move - back in the direction of the initial swing - will equal the value of the initial swing. The logic of this idea, called the 'measured move' is seen in the following diagram.

As we have alluded to examples of THE RULE occur at ALL price levels or matrices and many are being 'worked' simultaneously in any given ongoing market. This is a critical point. In modern terminology it would be said that price movements are 'recursive'. Simply stated this means that without labeling you could not really tell the difference between a 10-minute chart and a daily or weekly chart - they all exhibit the same behavior and operate under the same principles of Parameter and Matrix.

Michael Duane Archer has been an active commodity futures and FOREX trader for over thirty years. Mike has also worked in various registered advisory capacities, notably as a CTA (Commodity Trading Advisor) and as an Investment Advisor. He is currently CEO of CommTools, Inc., a corporation focusing on nonlinear solutions to trend forecasting, with a special emphasis on cellular automata models.

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Forecasting S&P500 with Technical Analysis

Will Slatyer, author and former commodities merchant and futures broker, explains a unique way of analysing the S&P 500 Index.

"I expect to continue to learn something every year as long as I live. Observations and keen comparisons of past market movements will reveal what commodities are going to do in the future, because the future is but a repetition of the past."

— W.D. Gann 1942



Market Analysis

A reasonably competent investor must have some resources to analyse the relevant stock index representing the overall market in which they invest. Most investors are fundamental analysts who use their basic knowledge of the financial factors of stocks to estimate future price movement. They should also have some basic understanding of technical analysis.

The technical analyst contends that even if a fundamentalist can reason the correct answers to all the questions involved in the stock-market equation, he/she cannot

be sure that all the questions have been answered, or even that all the right questions have been asked. The technician believes that all factors, known and unknown, come together in the market place and that the action of the market itself is the best indication of its true course.

The direction of financial markets are determined by thousands of people world wide - by dealers and computer cowboys, conservative bankers and aggressive fund managers, as well as individual investors, and corporate treasurers. Together they make up a crowd. Any

number of otherwise independent and partially separate individuals can form a crowd, provided that participants have a common cause, such as gaining wealth from the stock-market. The technical analyst examines price movements that illustrate the behaviour of the crowd, and can use techniques to forecast likely crowd behaviour.

The basic premise of technical analysis is that when the crowd or the cumulative number of buyers, acting on their individual assessments of the market, exceed or are more aggressive than the total number of sellers, the price

will rise. Greed and aspirations of more astute buyers will show in the price movement, possibly before the basis of their action becomes public. The crowd gains confidence. Alternatively when the sum of sellers, acting on their views and fears, overcomes the number of buyers, prices will retreat.

The more efficient the market, the more all known factors will be reflected in the market price movement. The technician attempts to use what has happened, in the past and what is happening now in the market, as guides to what will happen in the future.

To do this he/she follows the basic premises:-

- the market price movements follow trends most of the time
- the market price movements will react or rally as prices enter into the price zones which previously saw active trading
- the market price movements form recognizable patterns or chart formations following which, the next movements will take a predictable path

Recognition of trends, support and resistance zones and patterns is made possible by the use of charts which are a visual record of price movements. Modern traders have access to computerised on-line charting patterns and employ both fundamental and technical analysis to work the markets.

I follow the simple concept that markets tend to trend most of the time and that major trends will persist until new knowledge triggers a major change of direction.

Accordingly stocks or an index fund can be held while the market trends in a favourable direction, but risk management must be triggered when the major trends change. Risk management can indicate either quitting investments or hedging with options or futures. Investment trading action can be recommended on major changes which become apparent in monthly time-frames, as indicated by trend-following technical analysis.

Most investors like to feel comfortable if the positions can be held for long periods. Forecasts can provide some comfort so it is worthwhile using technical analysis to provide a credible forecast. I use techniques to provide analysis of trends, cycles and Elliot Wave chart patterns.

Analysis of Trends

There are a number of methods used to display price movements. In practice I use computerised Candlestick Charts, with moving average overlays together with early and confirming indicators.

I used to be a proponent of moving averages. In practice simple moving average crossover signals in monthly time frames can prove as slow as following subjective cues of market fundamentals.

I use the momentum indicator MACD on Price, with fast parameters as the key indicator to signal changes of trend. Once the MACD signal is in place, the trend is confirmed by a price breakout based on pivot point parameters. Any strategist needs confirmation of intelligence signals so the supporting indicator of

the MACD of Rate of Change (ROC) will confirm or deny that the markets are in sync. This is the basis of the MARS trading system but lack of space does not allow a full explanation here.

In practical terms a BUY signal will be on a price breakout with indicators in sync. and MARS will recommend quitting of stocks or cover of risk once a stop-profit/loss signals a change of direction. The MARS formula indicates that cover be taken within the month at a forecast stop level. A competent technical analyst should be able to reproduce the main features of the MARS System on computerised software. Action on these signals is illustrated in the accompanying S&P500 Table 1.

In the 51 year period 1954-2005 the MARS system would have recommended action in the market 26 times for a gain of 1832.70 points, if one could also have shorted the S&P500. In more conventional terms one would have bought on the Bull signal and quit on the Bull/Neutral signal, 18 times in 51 years for an overall return of 1397.75 points. This compares favourably with the "Buy and Hold" strategy which would have endured the uncomfortable Bear markets while returning a maximum 1530.15 points. Average percentage gain for each surge was 30%, greatly assisted by the 125% rise from 1995 to 1998. Research of the Dow Jones Industrial Average since 1929 suggests that the bull market 1990/99 was an unusual occurrence, assisted by an unfettered US dollar money supply. Readers will note from the table

TABLE 1 S&P500 STOCK INDEX MONTHLY TRENDS 1954-2005

Phase	Change	Index Price	+ or -	% gain	Phase	Change	Index Price	+ or -	% gain
BULL	Jan'1954	24.95			BEAR	May'1977	95.50		
Bull/Neut	Oct'1956	45.15	20.20	81	Bear/Neut	Apr'1978	95.15	0.35	
BEAR	Sep'1957	44.60			BULL	Aug'1978	101.85		
Bear/Neut	Feb'1958	41.90	2.70		Bull/Neut	Oct'1978	99.95	-1.90	-2
BULL	Sep'1958	49.15			Bull	Mar'1979	102.60		
Bull/Neut	Sept'1959	56.35	7.20	15	Bull/Neut	Feb'1981	125.30	22.70	22
Bull	Jan'1960	58.10			BEAR	Sep'1981	122.30		
Bull/Neut	Apr'1962	67.55	9.45	16	Bear/Neut	Aug'1982	112.50	9.80	
BEAR	May'1962	64.95			BULL	Oct'1982	126.45		
Bear/Neut	Jun'1962	59.95	5.00		Bull/Neut	Aug'1983	160.80	34.35	27
BULL	Jan'1963	63.50			Bull	Aug'1984	162.10		
Bull/Neut	Jun'1965	85.65	22.15	35	Bull/Neut	Oct'1987	302.55	140.45	87
BEAR	May'1966	86.70			Bull	Jun'1988	272.65		
Bear/Neut	Jan'1967	84.70	2.00		Bull/Neut	Jan'1990	327.10	54.45	20
BULL	Feb'1967	88.20			Bull	Feb'1991	343.95		
Bull/Neut	Jan'1969	101.85	13.65	15	Bull/Neut	Mar'1994	464.35	120.4	35
BEAR	Jul'1969	95.20			Bull	Feb'1995	477.60		
Bear/Neut	Aug'1970	79.95	15.25		Bull/Neut	Aug'1998	1074.4	596.8	125
BULL	Dec'1970	87.75			Bull	Nov'1998	1190.6		
Bull/Neut	Jul'1971	96.10	6.15	7	Bull/Neut	Oct'2000	1413.9	223.3	19
Bull	Jan'1972	102.25			BEAR	Nov'2000	1305.8		
Bull/Neut	Feb'1973	114.65	12.40	12	Bear/Neut	Nov'2002	924.00	381.8	
BEAR	May'1973	105.45			BULL	Sep'2003	1015.4		
Bear/Neut	Jan'1975	77.40	28.05		Bull/Neut	May'2004	1087.15	71.75	7
BULL	Mar'1975	83.55			Bull	Nov'2004	1146.35		
Bull/Neut	Oct'1976	100.45	16.90	20	Bull/Neut	Apr'2005	1163.7	17.35	2

that the MARS System suggested quitting the S&P500 in April 2005, and has not yet recommended re-entry.

The MARS trend following system, with technical improvements, has provided consistent profitable risk management to a number of companies and individuals over decades. I have found that investors and risk managers had more confidence in the recommended signals if they were accompanied with some forecasts. Forecasting is an art not the science of exact signals, but a relatively good track record has been attained by using cyclical timing.

Analysis of Cycles

Actions of the investing crowd are basically cyclical. Unfortunately for analysts the cycles are irregular due

to the fickle nature of crowds. Long cyclical phases occur when the crowd is comfortable holding stocks and adding to their portfolios. Sudden events can spook the crowd often commencing a bear phase that tends to be short lived because the stock-broking industry has convinced investors that the market basically continues to rise. At certain times, possibly only once a century, the stock market defies the stock broking industry so that a bear phase is prolonged. Many conservative investors in the crowd then question the stock-broking logic and are reluctant to fully invest. Subsequent bull phases can be shortened.

Cyclical patterns were explained in my book *"The Speculative Strategist"* (Will Slatyer; McGraw-Hill; New York; 1996). MACD

troughs and peaks produce cycles that do not necessarily occur in a standard cyclical pattern. My crowd explanation and practical experience have shown that a pattern of an average cycle can be determined with the occurrence of quarter, half, single and double cycles. There is a method of arriving at the average length of a cycle from trough to peak, and peak to trough.

Table 2 tabulates MACD cycles that assist my cyclical forecasting. The cycle estimates are very subjective and no doubt some mathematical genius can program a better way of estimation, but my rough method allows reasonable time forecasting.

At the London IFTA Conference in 2002 I suggested that a trough would occur in October 2002

TABLE 2 S&P500 STOCK INDEX MONTHLY TRENDS 1954-2005

MACD Peak	MACD Trough	No. Mo.	Peak	Trough	Price P - T	Market Speed	Speed %
	Sep'1953			22.70			
Aug'1956		2x35	49.65		26.95	0.85	1.7
	Dec'1957	28		39.00	10.65	0.38	1.0
Jul'1959		19	60.70		21.70	1.14	1.9
	Oct'1960	½ 15		52.20	8.50	0.50	1.0
Dec'1961		½.14	72.65		20.45	1.46	2.0
	Oct'1962	½.10		51.35	21.30	2.13	4.1
Feb'1966		2x40	94.65		43.30	1.09	1.2
	Sep'1966	¼.7		72.30	22.35	3.19	4.4
Dec'1968		27	109.35		37.05	1.37	1.3
	Jul'1970	19		68.60	40.75	2.14	3.1
Jan'1973		30	121.75		53.15	1.77	1.5
	Oct'1974	21		60.95	60.8	2.90	4.8
Sep'1976		23	108.70		47.75	2.08	1.9
	Mar'78	18		86.45	22.25	1.24	1.4
Nov'80		32	141.95		55.5	1.73	1.2
	Aug'82	21		102.2	39.75	1.89	1.8
Jun'83		½.10	172.65		70.45	6.40	3.7
	Jul'84	½.13		147.25	25.40	1.95	1.3
Aug'87		2x37	337.90		190.65	5.15	1.5
	Dec'87	¼.4		216.45	121.45	30.4	14.0
Jun'90		30	369.8		153.35	5.11	1.4
	Nov'90	¼.5		294.5	75.3	15.1	5.1
Dec'99		4x109	1552.85		1258.4	11.5	0.7
	Sep'02	33		768.65	784.2	23.76	3.1

(actual signal September 2002) but that the subsequent rise might not herald a major new Bull market. In November 2005 the Bull phase had lasted 38 months, which exceeded the average Bull cycle phase of 24 months (due September 2004) and is heading for a double cycle phase of 48 months (due September 2006). It should be born in mind that previous long runs that were registered as a double cycle did not reach the 48 month target Oct'62 - Feb'66 (40months) July'84 - Aug'87 (37 months). Accordingly a peak end 2005-early 2006 would not surprise. All that such a forecast means is that investors should be cautious in believing the born-again optimists that the current Bull phase is a return to the standard Bull market.

On the far right of the Table 2 is

the estimated speed of the S&P500 which, in all the market's history, only rose above 10 points/month or 5% in the 1987 crash. By mid 1998, the speed was above 50 points/month which indicated high risk for a high speed reversal and a sharp correction occurred in August 1998. After the correction, the speed of the rise had slowed so that the overall rise from Nov'1990 to Dec'1999 peak was only 11.5 or 0.7%. My 1999 lectures forecast another major turning point which in fact proved less serious in the S&P500 than occurred in the NASDAQ (as the Tech. Crash). The speed of the current Bull phase in November 2005 was 12.8pts/mo or 1% per month after the correction March-August 2004. This is compatible with a possible peak December 2005 - February

2006.

In the 1930s an American Ralf Nelson Elliot formulated the Wave Theory which bears his name, and which can be used to forecast the likely course of trend movement. The simple theory that bull markets form five wave patterns followed by a bear correction of three waves, has been made complicated by a number of corollaries to explain the minor exceptions to basic theory. Further studies on Elliot's theories are essential for the serious analyst, but I believe that the investor can make use of the Wave Theory by simply recognizing the current wave on a long term chart. The circled numbers on the Chart 1 represent an estimation of Elliot Wave Cycle phases which can be used for forecasting the likely target in time and price.

Elliot Wave theory can be explained to some extent by crowd psychology rationale.

The first impulse wave is born following a long trend move in the other direction. The crowd is slow to recognize that a trend is reversing, and often simply acts uncomfortable that momentum is changing. Following a downtrend, some astute traders notice the slowing momentum and commence to take profits. This often leads to the triggering of stop loss signals of other investors, which in turn causes the crowd to start to shift its position. Some in the crowd use the stop losses as signals to reverse position, and in general the crowd starts to relate to the signs of a rising market. This is the psychology of the first impulse wave.

Not all the crowd is convinced that the major movement has reversed. There were investors looking to sell who were waiting for a rally such as this to enter the market. These investors often risk managers, sell the market on the first sign of weakness in wave one. The market weakens further and triggers sell signals of short term speculators. The crowd has not yet gained enough confidence to hold long positions in the face of what looks like professional selling for the resumption of the downtrend. The crowd quits longs, and some even reverse positions. This is my explanation of the thinking behind corrective wave two.

A fundamental factor might enter the market to cut wave two short. It might have been this factor that bullish insiders knew would cause the major trend to change. A

reasonable forecast target for wave two is 0.382 or 0.5 times wave one.

If the correction continues past the half way point of wave one, the major low point of wave one becomes a target for those now committed to a falling market. Many in the crowd, having lost money in the last move, will want to add to short positions once prices move below the low. However this low point might be particularly attractive to risk managers and market professionals who believe that it was a major trend turning point. Buyers start to slow the down move and then it is reversed above the previous low at a level maybe around 0.8 times wave one. This causes the crowd to scramble for cover. Stop losses, reverses and fresh buying can cause an explosion upwards that shows up on the charts as a “double bottom” or “W” shape. Corrective wave two has finished and impulse wave three has started.

The high point of wave two then

becomes a target point. There might be some minor corrective action around the target but once the point has been exceeded, the crowd gathers confidence that the major trend is indeed now up. More long positions are added. Buyers become more aggressive than sellers, and the trend gains strength. The crowd should be able to sustain a rise 1.618 times the length of wave one. In most stock and financial futures markets, wave three is the dominant wave of the trend. In some commodity markets wave five is the longest.

Wave three often dies of exhaustion, and profit-taking and minor loss-taking can cause the turn. If the crowd is particularly smug, the corrective wave four might only be short-lived, because waiting in the wings have been those looking for a correction to add to long positions. These buyers calm the nerves of the crowd, and even encourage further “me too” buying to stimulate the last impulse wave five. Wave five can start confidently but fade fast once it has exceeded the wave three

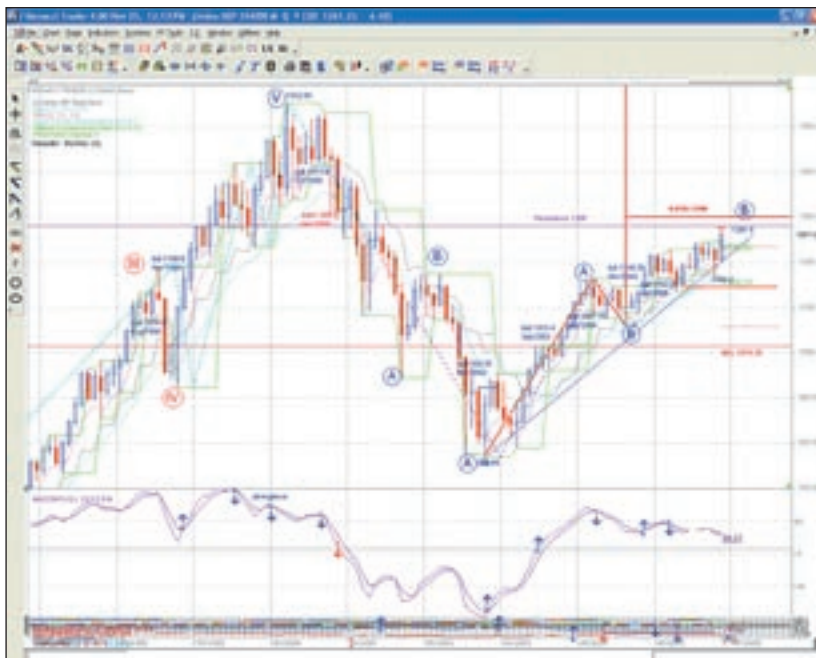


TABLE 3 S&P500 ELLIOT WAVES

YEAR		ELLIOT WAVES		WEEK	
		MONTH			
III	1932 - 1973 = 41 yrs =	A.A	Mar'00 - Oct'02 = 31mo 1552.85 - 768.65 = 784.2	B.a.	7/10/02 - 1/3/04 = 70wks 768.65 - 1163.25 = 394.6
IV	1973 - 1974 = 2 yrs 121.75 - 60.95 = 60.8 ? x III	B	Oct'02 - Dec'05? = 29mo 768.65 - 1286.22? = 517.5 0.66x A	b.	1/3/04 - 9/8/04 = 25 wks 1163.25 - 1060.7 = 102.55 0.26x a
V	1974 - 2000 = 26 yrs 60.95 - 1552.85 = 1491.9 ? x III	C		c.	9/8/04 - 19/12/05? = 67 wks 1060.7 - 1304.5 = 243.8 0.618x a
A	2000 - 2009 = 9 yrs? 1552.85 - 568.27 = 984.65 0.66 V				

major high. In many ways five is the easiest wave to pick because the length of previous waves can give good targets to those who have studied Elliot. Even knowing that the market is in its last stages of a trend can allow for caution, if one is not simply part of the amorphous crowd.

Waves four and five often follow the same nervous sentiment as waves one and two, except they are topping formations in a bull market. If wave three has been consistent, the crowd's confidence has grown, as has the size of the crowd, because late starters have joined. If the size of the crowd of buyers becomes too large, the number of sellers tends to become scarce. The scarcity of sellers can cause a sharp move at the top of wave three known as a "blow out" top. Sellers suddenly abound and the market reverses sharply to commence corrective wave four.

Elliot Waves of near term charts can be fractals of Waves identified in longer term time-frames. The actions in the near term can help identify the surges and reactions in the longer term. I commence with

the longest time frame of which I can gather data and estimate my waves as per Table 3

I have made the major assumption that the stock market peak in March 2000 completed the twentieth century unlimited bull market. This means that a major correction could be seen to as low as S&P500 568 by the end of the present decade. This correction will take three waves of which one (Wave A) has been completed in October 2002 at 768.65. Currently the market is enjoying a recovery wave (Wave B) which, if my simple estimate is correct will finish end 2005-early 2006 at around the 1300 level. I stress that this is a forecast at the time of writing and could well have been adjusted by the time this article is read. The wise analyst continually reviews market intelligence as it comes to hand and adjusts forecasts accordingly.

My simple techniques simply suggest that in November 2005, there were better opportunities elsewhere in the world than to invest in US S&P500 stocks. I

recommended quitting stocks in April 2005 and have not received sufficient intelligence to confidently recommend re-entry into the market. Those investors who are still in the market are currently enjoying a surge forecast by less conservative analysts. I simply suggest that all investors be cautious in case my less than optimistic forecast proves correct. Simple technical analysis such as the above outlined methods can make assist investors to make correct decisions.

Will Slatyer has been analysing commodities and financial markets since 1965, as a commodities merchant, futures broker, merchant banker and market risk consultant. He is founding member of the Australian Technical Analysts Assn. and Aust. Professional Technical Analysts Assn. and has lectured throughout Australia, England, USA, Japan, New Zealand, Indonesia and Malaysia. He is the author of five books, the most recent of which is "The Speculative Strategist" published by McGraw-Hill, New York in 1996. Mr. Slatyer now lives in Sydney, Australia where he consults, researches climatic and cultural cycles, and trading systems.

Random Not Random

Bill Wormald,
author, explores the
geometric structure of
World markets.



In my last article I asked *Trader's Journal* readers a question that has been debated for decades by fundamental and technical analysts and a wide range of market participants in between. Are financial markets truly random, or are they dominated by the major players to the point where very little of the trading activity that occurs on a day to day basis can be considered to be random? The main thrust of the argument is derived from the question: To what extent does computer intervention influence a typical financial chart, from the tiniest junior mining company to major banks and resource companies? Well it isn't possible to offer a definitive answer or any concrete evidence other than the often obvious recurring geometric shapes and patterns found in almost any financial chart in existence.

Shares, commodities, currencies, bonds and their derivatives all appear to display these constantly recurring lines and patterns in their charts and almost any technical analyst will tell you so. It is my belief, based on an extreme analysis of literally thousands of

charts world wide, that computers and the benefits they offer in terms of trading automation have encroached on the financial industry to a greater extent than many traders appear to realise.

With an almost microscopic analysis of a typical liquid chart we can see clear evidence of triangular shaped trading models influencing the ebb and flow of apparently random price bars every day. Again this is not to suggest that a sinister tone exists deep within the structure of financial markets, a useful analogy might be that a walk across a sandy beach is going to leave visible footprints that can be tracked by anyone with sufficient motivation.

When a farmer ploughs a field it is reasonable to expect to see tracks in the soil, it is undeniable that they will exist, we don't need to look, it is obvious. We could reverse engineer the activities of the farmer by carefully analysing the tracks in the soil and quite readily deduce some information about the size of the tractor and its trailing plough. We could see in which direction the tractor had travelled and how it had navigated the corners of the

paddock. If you think about it, the field is a historical map temporarily displaying clues that can help us to recreate its recent past. In this case there is no time to hesitate, the rains will eventually wash away these tracks along with the evidence of our tractor and like a fading photograph the picture in the soil will be gone.

Of course this is not so with financial data!

There are probably thousands of dedicated data collectors worldwide who will happily supply accurate (and not so accurate) historical financial data for a reasonable price. From pork bellies and steel companies to gold, diamonds, oil and wool, the seemingly neurotic zigzags of past price activity of these instruments have been faithfully immortalised in this data and we can dream away our lives searching for exciting, tradeable shapes and patterns on our computer screens, but what then has this to do with our farmer?

If we can easily find evidence of past activity in the tracks made by a farmer and his tractor in a roughly ploughed pasture, can we also find

such evidence on a financial chart in the high tech computer driven world of high finance?

The answer is of course yes and furthermore some of the information found is not only useful, it is very exciting, almost heart stopping at times and inspires dreams of fast cars and tropical islands. The most significant difference between our farmer and high tech finance is that the farmer will approximate his route and it may or may not be exactly the same route used last time.

Financial markets also appear to conform to a route in a way but it is perhaps more accurate to call it a grid or maybe an algorithm. The computer is more accurate by far, even though it can still deviate on its journey to a certain extent, the overall route appears to be enclosed by strictly pre defined boundaries. You can slide erratically down a ski run in a bob sled but the icy walls will prevent you from going off course.

But! If indeed these invisible but predictable trend boundaries actually do exist and furthermore if we have the appropriate skills to track them and their influence on world financial charts, why then are we not all billionaires?

At least a part of the reason lies in the fact that very few people seem to be aware of this fixed and recurring geometric framework that is clearly evident on thousands of charts and indices world wide and those that are aren't saying much. Another reason may be that individuals prefer to function in accordance with their own personal

programming whether learned or genetic, anything that appears to be counter intuitive is likely to be discarded.

It would of course take the rest of my life to analyse every chart in existence but the information suggested here has been painstakingly acquired by the author's analysis of literally **thousands** of randomly chosen (mainly) share and index charts from New York to Europe and Sydney to Japan. You have to be very sad and boring to go into this much detailed research but as anyone who had to know the answer will tell you, "I had to know the answer!"

Are we talking about the Holy Grail of financial markets?

Probably not, but I think the reader will agree it is certainly a large step in the right direction and the closest thing yet that I have found that resembles a market map of any description, a participant is certainly disadvantaged if unaware that such a map exists. Could this be the secret to the Stock Market? Is there a secret at all?

Readers will of course have to draw their own conclusions from these words but the information provided here will almost certainly add a major new dimension and level of understanding to any current analysis method.

If the market does as suggested follow a regular and recurring pathway or programmed grid / algorithm even though it **appears** to be entirely random, then those people who are unaware of this will always be at a significant disadvantage.

Speculatively this could possibly be the result of common trader methods or software tools or perhaps it could also be at least partly explained by a major programmed exposure to derivatives trading, where an excess in one market could be compensated for in the others by computer intervention.

Locating Trends and Triangles

These articles are for anyone who can recognise a triangle shape and I suspect that is almost everyone. A few years ago bored and looking for trouble, I "sampled" (a term borrowed from the audio industry), the outer shape of a typical trend on my computer screen with the aid of almost clear tracing paper and a sharp pencil. I simply drew straight edge lines across the highs and lows of a trend on my computer monitor and when these lines were extended they formed a simple triangle shape on the tracing paper simply because the lines were narrowing.

That is not too surprising as triangles have been analysed by technical analysts for decades as just one of many useful trading patterns.

What was very surprising however was that I found I could use my tracing paper triangle as a template, to enclose the majority of other trends on the same chart directly on my computer monitor and they seemed to fit almost perfectly. (I should emphasise that in reality from this point it took me almost five years to decide on the perfect shape)!

As you might expect I began enclosing trends on many different share charts with a similar time

scale, to see if I could also make them fit and to my amazement they all seemed to fit almost perfectly also. The beauty of a triangle shape is that it can be slid up or down on the computer screen or printed chart and enclose tiny short term trends as well as much longer term and wider examples. I soon came to the conclusion that *every trend is a triangle* and not just any old triangle but the same one, over and over again with the only difference being in the size of the shape. Immediately I suspected some kind of computer interference and with a computing background I set about trying to reverse engineer the *effects* of this possible “program” or algorithm with an intense analysis of world chart geometry without really knowing if it actually existed.

It is perfectly reasonable to ask how geometry of all things could possibly be of any value in examining a supposedly random share chart. Just for arguments’ sake let us employ a little lateral thinking and suppose that every trend is constructed from a similarly spaced grid enclosed in an overall triangle shape and that this has occurred not by sinister means but simply because the dominant players use such an algorithm in their automated trading software. If this is so then this standard shape will soon impose itself by brute force on financial share data at every level originating with the intraday chart. It appears to do this by brick walling price data automatically, supporting prices by buying when in contact with one of its rising support lines and resisting prices by selling when in

contact with one of the descending resistance lines.

If this is indeed so and the new book Trends and Tripwires 2 presents an argument in favour of this very scenario, then each trend should be enclosed by a similar shaped triangle which represents the outer boundaries of this proposed algorithm. Furthermore each trend will also display a cascade of price bars separated by fixed ratios and these slices should align with the support and resistance lines represented by the algorithm. If the word algorithm sounds too complicated then think of it as the last slice of a particularly popular pizza that had to be divided between four people and each receives a skinny but not quite equal slice. Before it was divided, the last slice of pizza represents the outer shape or boundaries of the algorithm and the skinny slices represent the layers or the ratios within. If we now extend this analogy to imagine a pizza shaped paddock enclosing some pretty confused sheep all running around and receiving electric shocks from the fences then I hope the scenario becomes a little clearer.

Once I had discovered initially only the outer boundaries of this remarkable triangular shape and felt that it was quite reliable and trustworthy, I printed this onto a standard transparency and within a very short time it was found to be indispensable in my work. I have now reached the point where it is not possible to analyse a chart properly without one.

The shape has been improved and tweaked endlessly over the years

to form what has become known to Trends and Tripwires followers as a “Wormald Triangle” (for unbelievably egotistical reasons). This triangle represents the outer boundaries (the pizza shape) of the algorithm and more recently it has evolved further to become the “Wormald Grid” (the pizza with the skinny slices marked but still attached). The thrust of this article will be concerned with the triangular outer boundaries as this is much easier to grasp and apply.

Almost Every Trend is a Triangle

The following charts have all been enclosed in the “Wormald Triangle” the outer boundaries of our shape, to illustrate how we can envelope each and every segment of a trend in this standard way. Notice that because the shape is *fixed* and recurring, the upper line of the triangle is always *relative* to the lower line by around 10 degrees. It is not even necessary to identify the charts for this exercise as I could have featured almost any liquid financial chart world wide. The advantage of this approach is that a break of the outer boundaries warns of an imminent change in short term trend direction.

Bill Wormald is the author of “Trends and Tripwires” (Wright Books 2001) and the forthcoming “Random Not Random” and contributes regularly to quality technical analysis publications. A Western Australia based educator and speaker on technical analysis, he is also the web master for www.trendsandtripwires.com and can be reached at billw@trendsandtripwires.com

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Integrated Pitchfork Analysis



**Dr Mircea Dologa, MD,
commodity trading advisor,
explains in practical terms
Integrated Pitchfork Analysis.**

We firmly believe that a trader's consistency must pass through a full comprehension of the context of the market. No action can be taken before we know exactly: where are we now, what phase are we in, and especially, where are we going.

We couldn't agree more with Charles H. Dow, when he said more than 100 years ago "To know values is to comprehend the meaning of the movements of the market".

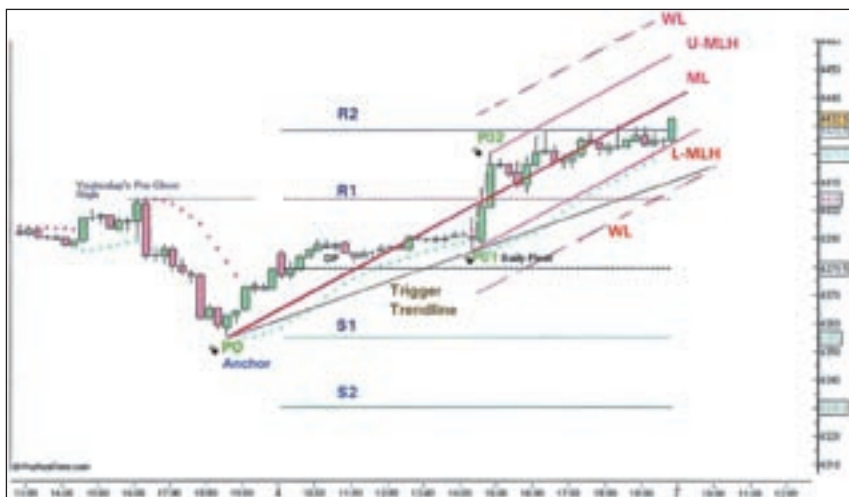


Figure 1 – The pitchfork is a very ergonomic and prolific tool, showing the patterns of directional movements in direct synergy with slant or horizontal trendlines (here shown only daily floor pivots), thus creating, through their intersections, the energy clusters.

William P. Hamilton, the illuminator of "The Stock Market Barometer", and the Charles H. Dow's faithful successor as editor of "The Wall Street Journal", enjoyed quoting one of America's greatest financiers, "If I had 50% of all the knowledge that is reflected in the movements of stocks (*securities*), I am confident that I would be far better equipped than any other man on Wall Street".

In order to have a global view of the market, and then act locally, we tried to create a synergy between the features of the pitchfork and "other tools".

1. Andrews' Pitchfork

In the beginning of 1960s, Dr Alan H. Andrews created a 60 page course, based on the work of Roger W. Babson, which mainly followed the Action and Reaction Newtonian Principle.

If we had to synthesize Dr Alan H. Andrews' course, in just few lines, we could say:

- the median line attracts in a “magnet” like manner the market price.
- the nearing of the price towards the median lines, creates at a time, one of the three movements: reversal, violent piercing or narrow range. The latter, will prepare the next price outburst.

It's not author's intention to exhaust here, Dr Alan H. Andrews' course. We'll try to expose first, the morphology of the pitchfork, and then later in the article, its indispensable dynamics.

The geometrical structure of the pitchfork is based on three pivots P0, P01 and P02 (*ensuing highs or lows*), chosen in such a way that the constructed formation, ideally describes the market (Figure 1). Be aware that the intersections of the median lines and other important trend lines, are creating the energy clusters, which are predominant in projecting the levels where the market price is susceptible to reverse or, on the contrary, to break through, with huge bars, at the high speed of a freight train.

Once we found the optimal three pivots, we draw the median line (ML) from the anchor (P0) through

the middle of the P01-P02 swing. The ensuing upper (U-MLH) and lower (L-MLH) median lines are constructed by drawing parallels to median line, from the P01 and P02 pivots. The further parallel lines to U-MLH and L-MLH, are the warning lines, especially needed in high volatile markets. The trend lines drawn from P0 to P01, or from P0 to P02, are named the trigger trend lines and are predominant in the movement of the market price outside of the pitchfork main area. Their breakout engenders low risk high probability trades.

2. Elliot Wave Principle

It's not really known if Ralph Nelson Elliott, was familiar with Dow's Theory, which explains the three market movements: the primary trend (*tide*), secondary reactions (*waves*) and minor fluctuations (*ripples*). It can be clearly observed that Elliott Wave Principle has some roots in Dow's Theory:

- market moves in waves are organized in impulsive and corrective patterns.
- the five waves of the impulsive pattern are in the direction of the market, where the waves 1, 3, 5 are impulsive, and the waves 2 and 4, correct them.
- the three waves, named A, B and C, of the corrective pattern are in the opposite direction of the market. The wave B, corrects the wave A. The wave C, ensues the direction of the wave A move.

Elliott Wave Principle is governed by strict rules and guides:

- wave 3, can never be the shortest wave of the impulsive pattern.

- wave 4 never overlaps the wave 1, in stock market. However, it's allowed a minor spike overlap of approximately 17%, when trading commodities.
- wave 2 can never retrace more than 100% of wave 1.
- alternation principle is the *guardian of the sanctuary*, voiding any wave structure which doesn't comply with the established rules mainly regarding the architecture of corrective waves, and that of the impulsive waves.
- in order to control the lengths of the extensions and retracements of all these impulsive and corrective waves, the Fibonacci ratios are the privileged tools.

Once again, our intention is not to exhaust Elliott's work in a few lines. After this brief synopsis of his waves' composition and function, we'll go through further explanations, while we'll present the specific market movements.

3. Market's Context

As we have already emphasized, the context comprehension of the current market is one of the vital points in trading life. It will provide a basis for market analysis defining the exact location at a given moment and the market outlook. Moreover, it builds the frame-work of a disciplined thinking. The *dual facets* of the context, will be revealed by doing the pre-open preparation which begins at the end of day's market, and it will be concluded by a last check-up, within the 60 minutes of the pre-open. Before studying the multiple time frames

charts (*first facet*), like weekly, daily and the specific operational time frame (60-min, 30-min, 15-min or 5-min, for index trading), the trader will concentrate on inter-market analysis (*second facet of the context*). The ensuing day's development will really not only depend on the fundamentals of the "just closed" market, but also on the "contiguous" markets. For instance, if you are trading European indexes like the DAX, FTSE or CAC40, the "contiguous" markets conditions are: how the S&P 500 closed before Nikkei 225 opened; what was Nikkei's 225 afternoon behaviour and how it closed; is Crude Oil price cruising along or attaining extremes (*once again*); is the US dollar still battling the Euro; what are the BUND's (German Bonds) fluctuations.

Like they say ... "always trade where the sun rises ... while the others sleep".

Larry Williams, a great trader and

teacher said: "...market movement is a combination of trend, which is a function of fundamental values and considerations and the gut-rav human emotions. Simply put, fundamentals are the father-of-trends and emotions the mother-of-daily fluctuations"

The study of the presented weekly, daily and 60-min charts witnesses a trending bias. The pre-close of the 5-min chart, reveals an up-sloping pitchfork (Figure 2) with a wave three in progress. We can say that the market is in an overall up-sloping trend and the price is continuing the impulsive pattern, toward the termination of its last wave (W5).

4. Preparing for the Morning Trade

Once we got out of the way, the dual facets of the context, let's concentrate on detecting our morning low risk high probability trades.

The synergy between the pitchfork and "other tools" defines the Integrated Pitchfork Analysis, giving a real edge to the trader. It shows a detailed description of how the market behaves and where it is going. From the multitude of the "other tools" used, we'll show on this chart: Elliot waves and Fibonacci ratios (primary and minor waves projections & retracements), multiple time frames floor pivots (*daily, weekly and monthly*), energy clusters and Stochastics.

Observing the pre-close pitchfork in Figure 2, the following corroborating factors instigate the trader for an imminent long entry, after the opening:

- a very steep up-sloping median line.
- a triple mirror bar pattern at the last reversal zone (4082 level).
- a zoom and re-test of the warning line n° 3 (4084.5 level).
- the huge up-sloping bar, having



Figure 2 – The Integrated Pitchfork Analysis frame-work.

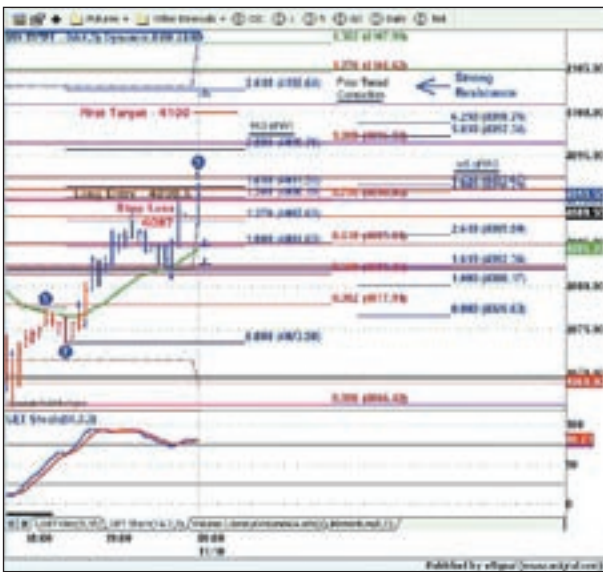


Figure 3 – The “three pawns technique” is the basement of consistent trading. It consists of a progressive order of entering the market, as soon as it is propitious, with three types of orders: trade entry (long here), stop loss order and profit target order.

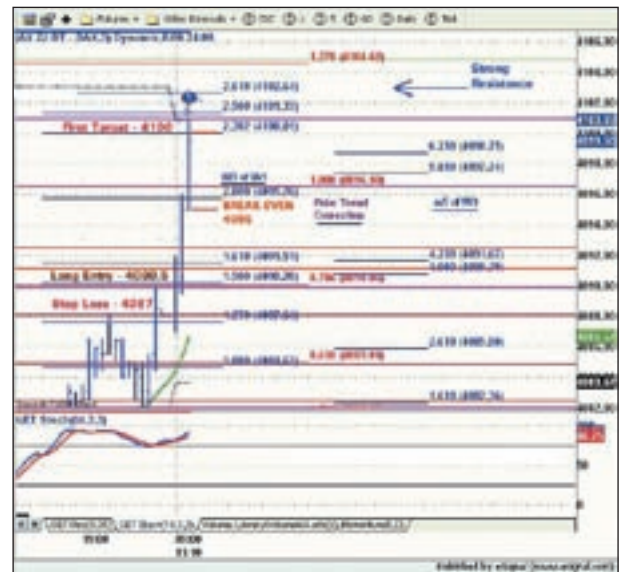


Figure 4 – The market shoots straight up, right through the opening. In only fifteen minutes (out of 11 hours daily trading time), it already travelled more than 20% of the daily trading range.

the high speed of a freight train, closing in its upper quarter.

- a “holy grail” pullback leaning on our weighted moving average.
- an overbought Stochastics, just after the inception of wave 3.
- the traditional wave three 1.618 of W1 limit, wasn't yet reached. The pre-close high at 4090, represents only a 1.500 Fib ratio. Judging after the steep slope of the median line, and the steamed momentum, we can expect an up-sloping morning market reaching at least 2.618 of W1 at 4103 level while topping the upper median line, or even the upper warning lines.

We used the primary W1, the minor wave w1 and w5 of W3 and the prior trend correction Fibonacci ratios, to better pinpoint the termination level of wave 3.

- a strict *pitchfork observance* will imply that the price projection of the ongoing steep slope market move, will have enough

saved energy to reach the upper warning lines (*WL-01 or WL-02*). If it fails to attain these levels, it will be a great proof of market up-sloping failure, and an excellent opportunity for a low risk high probability short trade.

5. Execution of the Morning Trade

The ideal *pre-arranged entry* for the morning trade (Figure 3) is at 4090.5 level, one tick above the high of the day's huge last bar (*close*) level with a stop loss two ticks under the day's close (*4087 level*). We will try to play with market's money, as soon as possible. We will enter a break-even stop with an ensuing cancellation of the already existing stop loss. Its value is one Average True Range bar - ATR(21) – having a size of 4-6 points, on this particular time frame. This value will only guide us, in the process of hiding behind an ongoing bar's low. Its location will probably be around 4095 level (*4090.5 + 5 points*).

The market opens through an “*Oops*

phenomenon” – an opening below the prior day's close, followed by a market counter move filling of the just opened gap.

For aggressive traders, there is a possible long trade opportunity of entering at 4088.5 level (*one tick above previous day's close*) with a stop loss at 4087 level (*opening bar's low*). We have rather chosen a more conservative trade.

The first target of two trading units (*out of three*), is chosen at the multi-level cluster around 4100 level, due to: floor pivot cluster (*daily R1, weekly and monthly*), W3 extension of $2.618 \times W1$ and because 4100 level is a whole, easily memorized value. Once the exit level is defined, the trader will enter immediately a pre-arranged order. There is no second target. We'll let the market come to us and be trailed out, for the remaining one trading unit.

As we have expected, the pre-open steamed momentum catapulted the price, in only 15 minutes, right through the target n° 1. We were

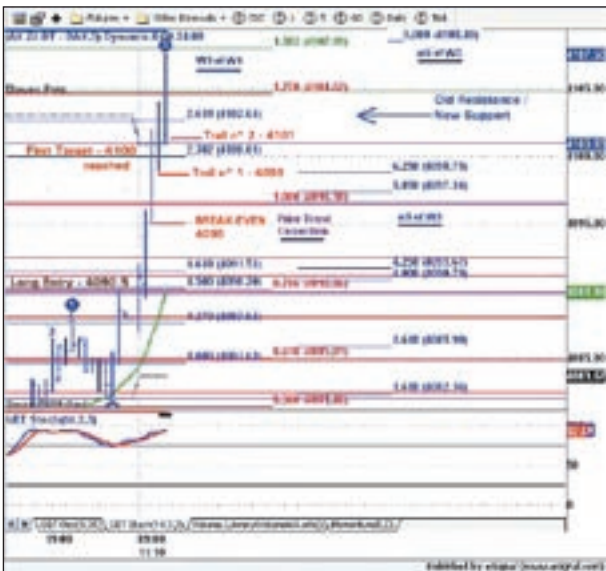


Figure 5 – The high steamed market is continuing its move behind the W3 extension of 2.618 of W1.

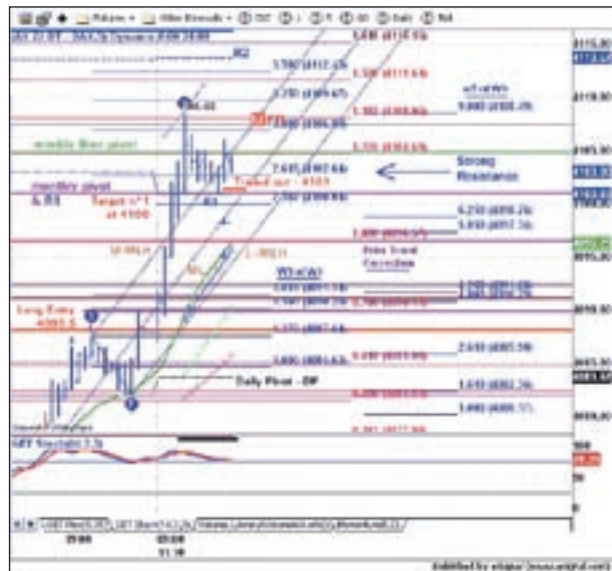


Figure 6 – The role of Integrated Pitchfork Analysis is clearly stated here; the market's high steamed momentum was suddenly stopped at the energy cluster formed by: pitchfork's warning line n° 2 and the multi-levels Elliott waves extensions.

exited with the two trading units at the 4100 level. The remaining one unit is waiting to be trailed out.

This high momentum market (Figure 6), was halted at the 4108.50 level, which coincides with a multi-levels cluster: the W3 extension of 3.00 of W1, the correction of the prior trend of a 1.382 Fib ratio and an elongated w5 minor wave of W3 (9.00 of w5). We can clearly see here that the use of the pitchfork is predominant in establishing energy clusters. The advance of wave three stopped exactly at the warning line n°2

Before stopping completely, ensuing a reversal, the market formed a trading range (not seen here), with a "last gasp" move to 4110.5 . The upper median line served again, as a strong overhead resistance, causing the reversal of the over-extended wave three (3.25 of W1).

6. Money and Risk Management

Let's talk a moment about money and risk management. We have expressly chosen a very tight stop loss of 3.5 points (75 euros), instead of the usual six to eight points, because of the omnipresent risk of the high steamed market momentum. The reward will come to 9.5 points per trading unit, against a risk of 3.5 points, giving a reward / risk (R/R) ratio of 2.7. One should never trade this volatile futures market using an R/R ratio below 2, because of the omnipresent risk due to the high leverage. Why should you take a high risk ? There is always another trade !

Concerning the P&L statement, the total number of trade points is 29.5: 19 points for the first two trading units, and 10.5 points for the third trailed out unit, an overall amount of 737.50 euros.

Conclusion

Every trader should have only one "credo": in this business you only make money if you don't

consistently lose money. This can only be accomplished through the use of risk control and money management. Most of the novices can hardly understand that the business of trading is the only business where the losses are planned and it is quite normal to lose money, as long as you have and you master the most adequate tool(s) to your kind of market. For today's trade the tool was the Integrated Pitchfork Analysis.

Dr Mircea Dologa is a commodity trading advisor who founded a new teaching concept, for young and experienced traders at www.pitchforktrader.com He can be reached at mircdologa@yahoo.com

Please note that the 'Copyright © 2005 by Thomas N. Bulkowski. All rights reserved' on the article titled "Trading Partial Declines and Rises" by Tom Bulkowski in Issue 2 was unintentionally omitted.

Finding the Right Trend and Direction



Ron Schelling, private trader, explains how a combination of the RSI and multiple time frames can help us clearly identify the trend.

The question is always, “what is the trend”. Can we define the trend with moving averages or certain indicators? No matter what you take to measure the trend, by knowing the tradable trend should be the basis for your trading approach. Combining this approach on the same chart with multiple time frames allows you to determine in what direction you should take the next trade.

The key to profitable trading is to have a valid method of determining the right direction and tradable trend by using different time frames on one chart. Late Robert Krausz introduced the TrendFinder strategy in which used the multiple time frame approach in variable ways.

Meanwhile several standard software programs using this now in their basic software and since then multiple time frame strategies are becoming more popular.

First we must select the two time frames we are going to use, like daily bars as the bars we trade and weekly bars which we use as the trend. Of course this can be done with all kind of variations, for example intraday 1 minute bars and 5 minute bars or any other combination.

Lets look at a basic set up.

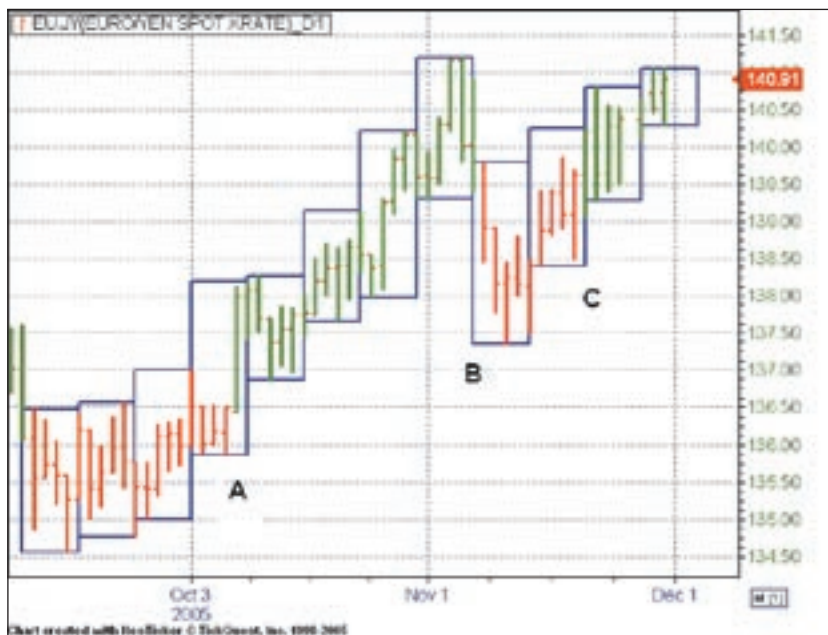


Figure 1 – EUR/YEN

Her are the rules:

- the trend can be only Up or Down
- the trend is Up when the daily bar closes above the previous weekly (blue) high, so the daily bar change from red to green on this chart
- the trend is Down when the daily bar closes below the previous weekly (blue) low, so the daily bar change from green to red on this chart
- at point A the close is above the previous weekly high, the trend is Up
- at point B the close is below the previous weekly low, the trend is Down

- at point C the close is above the previous weekly high, the trend is Up again

The multiple time frame analyses is based on the concept that every time period has it's own trend and also it's own support and resistance levels. The trend, support and resistance levels of, for example a daily bar, is different then those of the weekly bar. In this case the weekly bars takes the noise out of the daily bars. Of course you can also use this as intraday or any other usable time frames.

The next question in this strategy is if there is anything which can confirm the signal from the above time frame strategy? Let's look to the Relative Strength Index, not to be confused with a relative strength comparison of a stock to a market index or group of other stocks.

The RSI is a ratio - the numerator is a moving average of the up closing prices divided by a moving average of the down closing prices. Then the number is normalized to a value between 1 and 100. Readings above 50 indicate that the average net difference in closing prices is positive. A downward force is indicated when the reading is below the 50 level because the average net difference in closing prices is

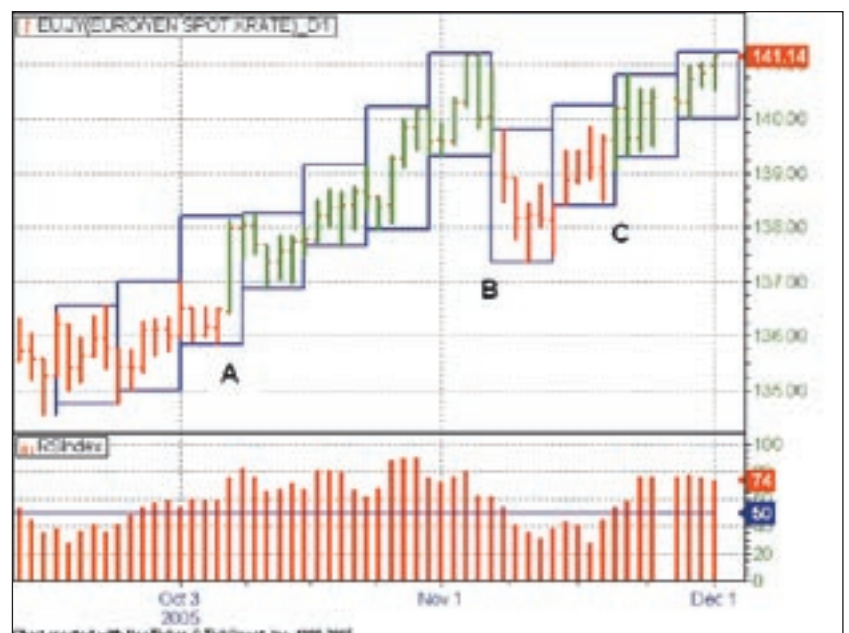


Figure 2 – EUR/YEN

negative. It is not important to look at peaks or bottoms of the RSI at this time.

Looking at the next chart we see the same YEN against the EURO but now we have added the RSI to it at the bottom of the chart.

At point A the close was higher the previous weekly high so the trend was up, while at the same time the RSI reading was above 50 confirming the strength. At point B the close was below the previous weekly low and almost confirmed by the RSI reading below 50, actually it was the next day. At point C see we got a change to up trend again because the close was above the previous weekly high and the RSI reading above 50 was confirming this signal.

Now let's have a look to another sample, the Singapore Dollar (Figure 3). This chart shows daily bars (red) and weekly bars around them (blue). At the point A the new down trend was confirmed by the RSI reading while at point B the up trend got confirmation from the RSI as well. Around point C the net result was actually zero after getting first a down trend followed by a quick trend change to a new up trend. At point D we got a nice downtrend signal again with clear confirmation by the RSI.

Of course many combinations are possible including intraday, like 1 minute bars and 5 minute bars of 1 hour/5 hour bars.



Figure 3 – SGD/USD



Figure 4 – AUD/USD

Figure 4 is the Australian Dollar/US Dollar using 3 hour bars and daily bars. The daily bars are based on a 15 hour time frame, so therefore we see intraday bars per trading day. On October 31 we see the intraday 3 hour bar closing below the previous daily low and the 3 hour RSI below the 50 level, so a first indication to close all long positions and take a first step for a short position.

At the close of October 31 we see for the first time that both RSI indicators, the one on the 3 hour bars and the one on the daily bars, are both below the 50 RSI level, so the trend has fully changed to down here.

Of course you can use another indicator for confirmation instead of the RSI, like the standard MACD or Ergodic Candlestick Oscillator. Also you can add several indicators to on the bars itself to get even a more clear picture.

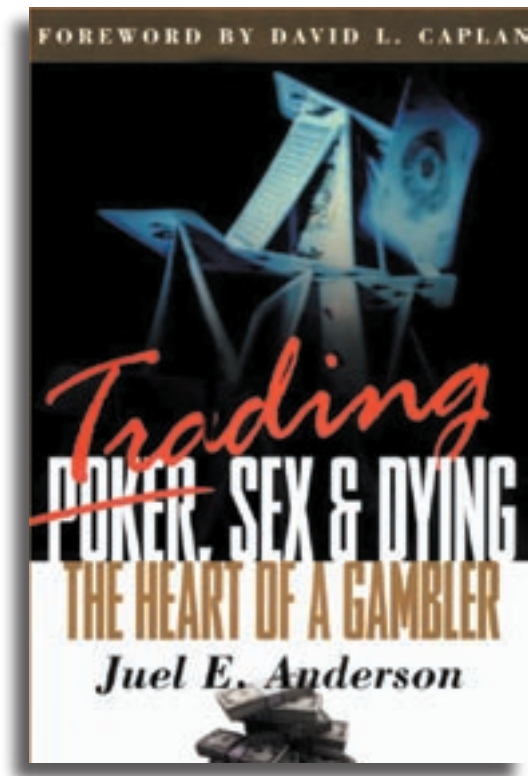
Think about the Swing on the bar highs and lows or moving averages, however the combination of RSI and multiple time frames is very simple and useful.

Ron Schelling is an independent trader in the Netherlands, trading commodities and Forex since 1983.

Ron can be reached at info@2hedge.com or via his website www.2hedge.com

BOOK REVIEW

Trading, Sex, and Dying by Juel Anderson



Price Headley, founder of BigTrends.com, details some of the lessons learned from the book, 'Trading, Sex, and Dying' by Juel Anderson

I first read 'Trading, Sex & Dying' by Juel Anderson because I was intrigued by the title. The title takes the word "Poker" and crosses it out and replaces it with the word "Trading". So right away I'm expecting this to be a book about the similarities between poker and trading. But it proves to offer much more than that.

The subtitle for Trading, Sex

& Dying is "The Heart of a Gambler", and this phrase may get more directly to the book's primary contents. Anderson details the characteristics that make up 13 distinct personality types. As a poker player sitting at a table, you make your returns not so much by the cards you draw but by sizing up your opponents' strengths and weaknesses, plus their dominant

playing style. The same analogy can be used for trading. Though we don't have the luxury of reading the non-verbal cues of our opponents, traders will tend to show their style in certain stocks. Is the stock a good trending play or is it full of noise? Do breakouts hold or do they tend to reverse? Are big traders and institutions jumping into the stock, evidenced by higher volumes

on rallies? Is the stock prone to volatile movements or a slow & steady climb or decline? These questions may help define the types of players who are attracted to various stocks.

One particular section on gambling early in the book hooked me with the logical extension to trading (substitute “trading” for gambling” in the quote below): “Gambling is difficult. In some respects, it’s the most difficult of all endeavors. To succeed takes enormous conviction and commitment. Most individuals don’t succeed because of the inability to know themselves and/or the inability to control their own actions. In gambling, the only asset you have is yourself. ...the self-developed habits or traits that undermine the very structure you’re dependent on.... In gambling, you set the guidelines and make the rules. In effect, you become God. When you’re God, it’s easy to change the rules. You simply say, ‘Well they don’t really apply to me.’ “ This hit home with me, as it is so easy to avoid the self-discipline you need to win at trading. Your mind will play tricks on you if you don’t have a systematic process for entry, exit and money management.

Anderson notes that “at any given time the behavior of 90 percent is working to create an advantage for 10 percent.” This is reminiscent of the fact that the majority of day traders went belly up in recent years, or that you often hear statistics on most futures or options traders losing, or at least only a small minority only really making it big. I believe this is often due to the emotional reactions of most

traders, which tends to cluster most individuals to sell near the lows or buy near the highs, as in the tech boom in early-2000.

The 13 dominant personality traits may be of most interest to many readers. The author particularly applies his experience in sales to the aspects of selling to each personality type. This certainly applies to poker, as the player must sell his good or bad hand to get the most out of his cards. Certainly traders may not have to worry so much about talking up their position, though some analysts and brokers have developed a reputation for this.

Several personality types that you may recognize in yourself or other traders you know include:

The Adventurer – Always looking for action and adventure, when at times it might be wise to wait. Adventurers need to be in the game, and are prone to overtrading. Adventurers do not fear much, but this can also lead to a lack of discipline.

The Aggressive – Ego is a powerful factor for Aggressive, who value winning very highly. Discipline is strength, though Aggressive may overreact in the heat of battle. Position sizing is a likely problem, as Aggressive want to win big now, and this impatience can prove costly.

The Emotional – Here the strong feelings can prove to be barriers in the Emotional mind. Internal self-talk may prove to be excessively critical as Emotional feel even small situations more intensely. Emotional may feed off

the excitement or lack thereof in a market, which may cause them to jump on uptrends too late or get out of slow stocks just before they break out again.

The Reflective – They may get tense and nervous in a new situation. Reflective are more at risk of not pulling the trigger due to too much introspection.

All in all, this book is a very interesting read for both traders as well as those in sales professions. The description of the 13 personality types is worth it alone. The introduction by renowned options trader David Caplan is also extensive and eye opening. I bet you’ll be glad you read this book. I know I’m glad to add this knowledge from *Trading, Sex & Dying* to my understanding of trading psychology.

Price Headley is the founder of BigTrends.com, which provides investors with specific real-time stock and options strategies and investment education to profit from significant market trends.

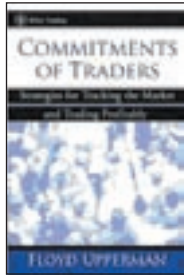
Price has appeared on CNBC, Fox News, CNNfn, Bloomberg Television and a variety of print and online financial news outlets, including The Wall Street Journal, Barron’s, Forbes, Investor’s Business Daily, USA Today, and Bloomberg Personal. He speaks regularly to investment audiences nationwide. He is a graduate of Duke University and a member of the Market Technicians Association. He is also a chartered financial analyst (CFA) charterholder and a chartered market technician (CMT) charterholder.

He can be reached at price@bigtrends.com or via his website www.bigtrends.com

BOOKS FOR TRADERS

Commitments of Traders : Strategies for Tracking the Market and Trading Profitably

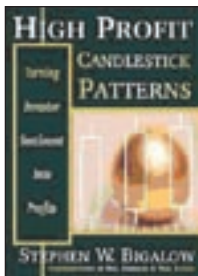
Type: Hardcover, 199 pages
Date Published : 2005
Prices : \$120.00
By Floyd Upperman



Commitments of Traders will teach you why the trading activity of commercial institutions—as evidenced in the COT report—is so valuable in analyzing particular markets. And you will learn how to leverage the COT with technical and fundamental analysis. A priceless moneymaking tool, Commitments of Traders is essential reading for anyone trading in the lucrative futures market.

High Profit Candlestick Patterns

Type: Hardcover, 432 pages
Date Published : 2005
Price: \$155.00
By Stephen Bigalow

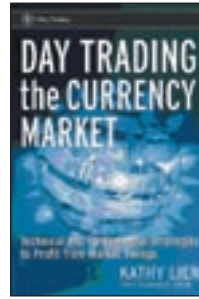


Stephen W. Bigalow's combining the proven results of Japanese Candlestick charting with effective Western technical analysis, produces even higher profit wealth-building stock selection techniques. Learn the key to profitable stock selection with this safer approach to investing and avoid expensive trading mistakes. Quickly learn the simplest, yet most intelligent, approach to stock selection. Candlestick signals visually produce compelling results. Japanese candlestick charting techniques, integrated with statistically proven Western technical analysis, produces an even more powerful investment platform. The ability to recognize trading patterns in their very early stages empowers an investor with high profit trading strategies.

Day Trading the Currency Market: Technical and Fundamental Strategies To Profit from Market Swings

Type: Hardcover, 240 pages
Date Published : 2005
Price : \$112.00
By Kathy Lien

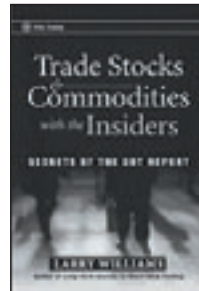
The currency/foreign exchange (FX) market is by far the largest financial market in the world, with trading volumes surpassing \$1.9 trillion a day. Although primarily dominated by a worldwide network of interbank traders, a new era of Internet-based communication technologies has recently allowed individual investors to gain direct access to this popular and profitable market.



Written by Kathy Lien, chief strategist for the number one online currency broker in the world Day Trading the Currency Market reveals a variety of technical and fundamental profit-making strategies for trading the currency/FX market, and provides a more detailed look at how this market actually works.

Trade Stocks and Commodities With the Insiders

Type: Hardcover, 224 pages
Date Published : 2005
Price : \$90.00
By Larry Williams



In this book, Williams discusses what the largest most powerful corporations (commercials) are doing with their money; money they need to grow to invest in their businesses every week of the year, every year, to continuously maximize their profits. By using the methods and systems that the biggest money super powers have always used and learned from, Williams helps readers to tap into the best resource for maximizing their profits, too. The commercial super powers issue a report to live by called the COT (Commitment of Traders). It is the most important report to follow and reveals all the buying and selling that the biggest players in the markets have been doing every week. Williams explains this reporting system and lays out a plan for traders to understand what the reported actions mean, and how to align themselves with them.

Trading in the Global Currency Markets

Type: Hardcover, 384 pages

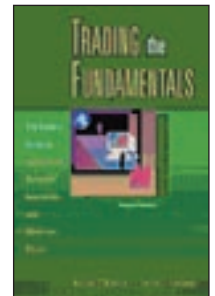
Date Published : 2000
Price : \$110.00
By Cornelius Lucas



Trading in the Global Currency Markets brings the universe of foreign exchange within the reach of every trader. Including complete coverage of the euro and the latest historical and economic changes in the market, this essential resource gives traders an indispensable overview of the market's workings and new technologies, then links this information to developments and case studies drawn from the real world, illustrating them with plenty of graphics, charts, and visuals.

Trading the Fundamentals

Type: Hardcover
Date Published : 1998
Price : \$70.00
By Zukowski and Niemira



Economic indicators and economic policy have an incredible impact on the volatile financial markets, yet it is often up to traders and investors to interpret the effects and take decisive action. Trading the Fundamentals explains the significance and market impact of all widely followed economic numbers, including the Consumer Price Index, Employment Report and other well-known indicators. Completely updated and revised to reflect today's highly computerized environment, Trading the Fundamentals provides readers with all the tools they need to analyze economic news and make appropriate investment decisions.

Mastering Elliott Wave aka Neo- Wave

Type: Hardcover
Date Published : 1990
Price : \$160.00
By Glen Neely

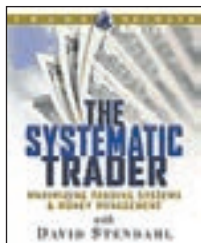


The definitive guide to interpreting Elliott Waves. In its original form, many concepts and ideas concerning real-time application of the theory were left unclear. Neely has greatly expanded upon and refined the concepts

first discovered by Elliott, to help you more accurately apply them to your trading and investments. For the first time, these concepts are presented in a logical, step-by-step fashion, in the actual order they should be applied to a price chart. Consequently, all the guesswork typically associated with the Wave Theory has been eliminated for you.

Systematic Trader

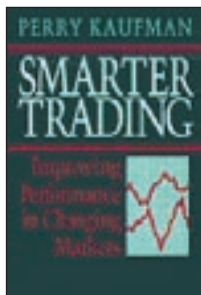
Type: 90 min video
Date Published: 2000
Price : \$570.00
By David Stendahl



In this video, Stendahl shows you how to apply effective money, risk, and equity management strategies to improve your trading performance. Actual trading systems will be used to demonstrate both the methods and the high-impact results! Active traders expose themselves to a fair amount of risk. But, they also stand to reap bigger rewards-if they use solid, sound trading strategies and money management techniques.

Smarter Trading

Type : Hardcover
Date Published : 1995
Prices : \$565.00
By Perry Kaufman



This was a good read on trading methodology and system development. The best concept is that of the “unable” trade, which is where your system gives a buy signal but you can not get your order filled. This is a double edged sword in that you would get filled on trades where a buy was signaled, but the trade results in a loss and not on trades that would have been highly profitable. The end result is hypothetical returns that are higher than they should be. Probably why so many successful paper systems fail when applied.

Complete Guide To Spread Trading

Type: Hardcover, 320 pages
Date Published: 2005
Price : \$590.00
By Keith Schap

The Complete Guide to Spread Trading outlines the many profitable advantages

of spread trading, along with explanations and illustrations of how you can expect spreads to perform in the heat of trading. Self-contained chapters introduce more than two dozen representative spread strategies, discussing the market background and driving economic factors of each strategy, showing how such spread trades have historically performed in various market environments.



New Money Management

Type: Hardcover, 205 pages
Date Published: 1995
Price : \$595.00
By Ralph Vince

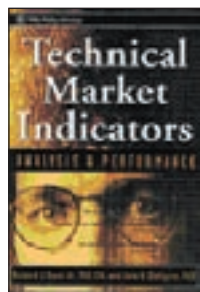


Ralph Vince brought the complex mathematics of probability and modern portfolio management theory down to earth for traders and investors. He introduced innovative new ways they could be used to maximize account management decisions. Now, in this groundbreaking new book, Vince takes a quantum leap forward to provide investment professionals with a proven new approach to portfolio management that overturns nearly a half-century of accepted wisdom about asset allocation and money management.

Technical Markets Indicators: Analysis & Performance

Type: Hardcover, 426 pages
Date Published: 1998
Price : \$598.00
By Bauer and Dahlquist

Unlike other books on the subject, Technical Market Indicators provides a comprehensive testing of indicators that uses a large sample of stocks over a twelve-year time period, encompassing varying market conditions. Instead of using the traditional technical analysis charts, this detailed analysis takes a different approach, calculating numbers based on various relationships and letting



the numbers dictate the decisions. This allows the investor to use technical methods without ever consulting a chart. From an objective standpoint, the authors address both the pro and con arguments of using technical analysis and attempt to shed additional light onto the controversy through their systematic testing.

Timing the Market

Type: Hardcover, 410 pages
Date Published: 2005
Price : \$5100.00
By Deborah Weir



It's well established that interest rates significantly impact the stock market. This is the first book that definitively explores the interest rate/stock market relationship and describes a specific system for profiting from the relationship. Timing the Market provides an historically proven system, rooted in fundamental economics, that allows investors and traders to forecast the stock market using data from the interest rate markets—together with supporting market sentiment and cultural indicators—to pinpoint and profit from major turns in the stock market.

Using Opening Range Breakout In Short Term Trading

Type: DVD, Video seminar
Date Published: 2005
Price: \$580.00
By Murray Ruggiero



In Short Term Methods for Trading Futures and Equities, Murray Ruggiero teaches the variations of Opening range breakout used by Toby Crabel, Larry Williams and Sheldon Knight. He then tests them on both a basket of commodities as well as a basket of individual stocks. This presentation will benefit both Futures as well as stock traders. In the presentation Murray also discusses how using split adjusted stock data can lead to 200-400% error in back tested results. He discussed how he solved this problem and shows his opening range breakout systems on the Nasdaq 100 stocks, based on the work of these masters in this area, including Toby Crabel.

Trading in the Eye of the Storm

The 2nd Part of the excerpt from Daniel Gramza's book



Techniques to Deal with Fear

Samurai warriors were without a doubt some of the fiercest fighters who ever existed. The key to the samurai's incredible fighting ability was the complete elimination of their fear of death and their complete focus on being in the present moment. They did this by entirely de-energizing their fear of death. If a person in a fighting situation is distracted by thoughts of being hurt or dying, he will be the loser. Samurai warriors were unencumbered by these fears. They were courageous in the face of the unknown. They were empowered by a lack of fear, and this allowed

them to completely focus, react and stay in the present moment. They fought without hesitation and with complete confidence. This is exactly the mindset of the successful trader.

Here are ways to deal with fear and eliminate it from your trading experience.

Face Your Fears

The first step in controlling fear is to face it. If you are not willing to face your fear, then fear, not you will control your life. When you are afraid, use deep centered breathing

(discussed in the relaxation section), acknowledge the fear, and face it head-on. Tell yourself, “I am stronger than my fear, I control my fear, and I can overcome my fear.”

You will become more comfortable in the presence of a fear by decreasing your sensitivity to it. As you repeatedly face your fear you will realize that your energy in the fear will decrease.

Courage is moving ahead even though you're afraid. There is a wonderful true story of Ishi, the last living member of a Native American tribe. Ishi and his tribe believed trains were monsters that ate people. One day, Ishi found himself in the position of having to take a journey by train. When he boarded the train, he was asked by a person who understood the beliefs of his tribe, how he could step on the train. Ishi responded, “Since I was little, I was taught to always be more curious than afraid”. Use fear as an opportunity to learn and progress.

Acceptance of Responsibility

A critical element in dealing with fear is to accept that you alone are responsible for the creation and intensity of your fear. You must realize that you are responsible for your thought choices and the amount of energy you feed them. This recognition alone can put fear in perspective, diminish the energy in the fear, and prepare you for the acceptance of new thought choices.

Accepting responsibility for your thought choices puts you in control of your fear, not the other way around.

Identify the Thought Choice

Our fears are created by our thought choices. In order to eliminate our fears, we must change the thought choices that create them. For example, if a trader fears losing money, he is unconsciously saying to himself, “I choose to experience the fear of losing money.”

That same trader can choose not to feed energy to this fear choice and make a different, conscious, choice. He can say, “I choose not to fear losing money and I accept that losing money is a part of the trading business.”

Until you identify your fear thought choice, you cannot change it, and you keep the fear alive. Allow yourself the freedom to make this new choice without judgment. Exercise your positive, conscious thought choice whenever the old fear choice returns. Each time you do this, you drain the energy from the old fear and you create the change you are striving for.

Acceptance of Risk

It is very important that the trader completely and honestly accept the risks involved in trading. Trading is a business of percentages. Not every trade will make money. If a trader cannot accept the risk, he cannot fully commit himself to the trade. If he cannot fully commit himself, taking the next trade can be a frightening experience. He will lose confidence and become frustrated and locked in a cycle of fear and doubt.

On the other hand, if the trader has complete acceptance of the risk and all possible results, then he can be optimistic, committed and

realistic about the next trade and its outcome. He can now move aside the interference caused by fear and confidently deal with any future outcome.

Eliminate Self-Sabotage

Every trader has a level of comfort and familiarity with trading. To go beyond this level of comfort usually requires taking a risk. This is when fear, as an unconscious act of self-sabotage, can creep in. This fear is actually misguided self-preservation, intended to protect the trader from the fear and anxiety he may experience if leaves his level of comfort and risks the possibility of things not going his way. A trader may fear that he would suffer embarrassment and personal devastation if he tried his best and failed. Fear as self-sabotage becomes the traders excuse to maintain his level of comfort and the status quo. The easiest way to protect himself is not to try.

He can also self-sabotage his trading by initiating a trade that does not meet his trading strategy requirements. This way, if the trade doesn't work, he can tell himself that it wasn't his best effort because it wasn't his main strategy. He unconsciously has protected his comfort zone and his false mental perceptions.

The bottom line with self-sabotage is that the trader is linking his self-worth to trading. If the trader doesn't meet his own expectations of what being a successful trader means, his self-esteem will suffer. To avoid this blow to his ego, the trader trades carelessly, doesn't give it his all, and then uses the excuse

that he didn't really fail because he wasn't really trying.

This trader doesn't realize that a trading decision outcome has nothing to do with his self-worth, but is merely a profitable or unprofitable business decision.

The first step in eliminating self-sabotage is to recognize it. The trader must ask himself: Do I select trades that imply illusions of grandeur? Do I select trades with total disregard for my trading strategy? Do I feel that the trade is too much to handle and I just want to get it over with? A "yes" would indicate poor trade selection and lack of a risk management exit, both of which imply a total disregard for his trading strategy.

Secondly, the trader must re-center himself with deep breathing and focus on the strict application of his trading strategy.

Reality Check

As a trader, if your greatest fear came true, what is the worst that can happen? Your honest answer can help you examine and deplete the energy of your fear.

Visualization

Visualization is a powerful tool that allows a trader to identify, examine, experience and de-energize a fear. It allows you to mentally envision solutions to your fears in a non-threatening way. Visualization will reduce your anxiety and prepare you if you're faced with the fear producing situation again. There are a number of visualization techniques that can assist in this process and are explored in the Visualization Section of the book.

Fear Lead Up

It is possible to stop fear before it gets started by identifying the conditions that immediately precede the fear, and by changing your reaction to the fear-producing situation.

For example, a trader has a solid, well-researched trading strategy. The trade entry and profit or loss exit is completely established before the trade is entered. However, once the trade is initiated, the trader watches every little price movement of the market. Eventually, the trader gets emotionally involved with each price move, becomes afraid, and feels a sense of urgency to exit the trade. The result is that the trader exits the trade before either its profit or loss price objective is reached. He never gave his well-researched trading strategy a chance to work for him.

The trader's lead up to fear was his watching every movement of the market. In order to de-energize his fear, he changes the fear-producing conditions: once he has entered a trade with the appropriate profit and loss orders in place, he does not continually look at that market. Instead, he periodically checks the trade. This change eliminates his anxiety associated with every price change, and gives his trade and his trading strategy an opportunity to work for him.

Trading Plan

A solid trading plan is crucial for any trading business. It provides the trader with strategies for trading in any market condition, and a solid foundation for a successful trading business. It can also protect a

trader from one of the things that can destroy a trading business, or any business for that matter - the surprise event. A well-planned trading strategy, including capital allocation parameters, and defined entry, exit and risk management criteria will allow the trader to trade without fear, knowing he is prepared for any potential event.

Daniel M. Gramza is President of Gramza Capital Management, Inc. and DMG Advisors, LLC. He is a trader, consultant to domestic and international clients and an advisor to the St. Croix hedge funds. He is completing a new book titled "The Handbook of Japanese Candle Trading Strategies". Mr. Gramza has appeared on CNN's "Moneyline" program, Reuters TV, Bloomberg TV and WCIU-TV. Mr. Gramza develops and presents worldwide public and private courses on Essential Mental Techniques for Traders, Japanese Candle Analysis, Market Profile, technical analysis, options and options trading strategies, security and futures industry fundamentals and operations.

He has presented courses to traders from over 30 exchanges, 400 institutions, and 35 countries. Mr. Gramza is an instructor for the Chicago Mercantile Exchange Education Center, the Chicago Mercantile Exchange \ DePaul University Certificate Program, The Chicago Board of Trade and the Chicago Stock Exchange. He was a member of the Chicago Rice and Cotton Exchange and an adjunct faculty member of the Illinois Institute of Technology's Master program in Financial Markets and Trading.

Daniel can be reached at dmgramza@att.net

SLIPSIDE



Once there was a millionaire, who collected live alligators. He kept them in the pool in back of his mansion. The millionaire also had a beautiful daughter who was single. One day he decides to throw a huge party, and during the party he announces, "My dear guests... I have a proposition to every man here. I will give one million dollars or my daughter's hand in marriage to the man who can swim across this pool full of alligators and emerge unharmed!" As soon as he finished his last word, there was the sound of a large SPLASH!! There was one guy in the pool swimming with all he could... the crowd cheered him on as he kept stroking. Finally, he made it to the other side unharmed. The millionaire was impressed. He said, "My boy that was incredible! Fantastic! I didn't think it could be done! Well I must keep my end of the bargain...which do you want, my daughters hand in marriage or the one million dollars?" The guy says, "Listen, I don't want your money! And I don't want to marry your daughter! I want the person who pushed me in the water!!!"

One day a stockbroker was riding in his limousine when he saw a guy eating grass. He told the driver to stop. He got out and asked him, "Why are you eating grass?" The man replied, "I'm so poor, I can't afford a thing to eat." So the stockbroker said, "Poor guy, come back to my house." The guy then said, "But I have a wife and three kids." The stockbroker told him to bring them along. When they were all in the car, the poor man said, "Thanks for taking us back to your house, it is so kind of you." The stockbroker said, "You're going to love it there, the grass is a foot tall!"

Two old friends met one day after many years. One attended college, and now was very successful. The other had not attended college and never had much ambition. The successful one said, "How has everything been going with you?" "Well, one day I opened the Bible at random, and dropped my finger on a word and it was oil. So, I invested in oil, and boy, did the oil wells gush. Then another day I dropped my finger on another word and it was gold. So, I invested in gold and those mines really produced. Now, I'm as rich as Rockefeller." The successful friend was so impressed that he rushed to his hotel, grabbed a Gideon Bible, flipped it open, and dropped his finger on a page. He opened his eyes and his finger rested on the words, "Chapter Eleven."

Two stock brokers are in a bank, when, suddenly, armed robbers burst in, waving guns and yelling for everyone to freeze. While several of the robbers take the money from the tellers, others line the customers, including the two stock brokers, up against a wall, and proceed to take their wallets, watches, and other valuables. While this is going on, one of the stock brokers jams something into the other stockbroker's hand. Without looking down, the second stockbroker whispers: "What is this?" The first stockbroker : "It's the \$100 I owe you!"

A young stockbroker decided to get his first tailor made suit. So he went to the finest tailor in town and got measured for a suit. A week later he went in for his first fitting. He put on the suit and he looked stunning, he felt that in this suit he can do business. As he was preening himself in front of the mirror he reached down to put his hands in the pockets and to his surprise he noticed that there were no pockets. He mentioned this to the tailor who asked him, "Didn't you tell me you are a stockbroker?" The young man answered, "Yes, I did." To this the tailor said, "Who ever heard of a stockbroker with his hands in his own pockets?"

A stockbroker was filling out a job application when he came to the question: "Have you ever been arrested?" He answered no to the question. The next question, intended for those who answered the preceding question with a yes, was "why?" Nevertheless, the stockbroker answered it "Never got caught."

Trading psychology in fables, quotes and proverbs



Simon Vine, former options trader and author, provides an interesting insight to the way our mind works in the market.

Once a wise man bought a bird at a market. He was about to enter his house when the bird opened its wings, stared at him and spoke in a human voice. “Don’t panic”, it said. “I’m a very cultured bird. The wise man of the birds, so to speak. Tell me, if I teach you three valuable truths, will you set me free?” The wise man contemplated for a second and agreed.

“The first one is, never believe nonsense, particularly if common sense tells you that something can’t be true. Secondly, soberly evaluate your abilities. Never undertake anything if your chances of success are slim. And thirdly, never regret the good deeds you have done.”

Having heard this, the wise man let the bird go. No sooner had it perched on the branch of a tree then it started teasing him. “Yesterday I swallowed a diamond! Had you

killed me, you would have found it and become a rich man!” At this point, the wise man became very angry and attempted to climb the tree to grab the bird. But, being old, he slipped from the tree and fell to the ground. The bird hopped onto his head and said in a strict tone, “Wise man, you seemed to have listened to and appreciated my advice, but you failed your very first exam miserably! Stop and think for a moment: What are the chances of a bird swallowing a diamond? And, at your age, did you really think you could still climb trees? Finally, you started having second thoughts about the good deed as greed consumed you!” Having said that, the bird flew away.

The bird’s first lesson

This story demonstrates several truisms that traders and investors nevertheless find hard to learn.

Enticing ideas flow from various sources – as well as talking to consultants and brokers, traders talk to each other and read numerous publications. Informational pollution has led to an ongoing need to weed out various opinions before making a decision.

One of the easiest types of opinion to transfer is the expectation of a major ‘inevitable’ market move. Very often, technical analysis¹ results in predictions of a technical breakthrough or the end of a trend. However, in reality, markets fluctuate within ranges 70% of the time and trend only the remaining 30%.

Addiction to ‘inevitable resolutions’ and belief in miracles are inherent in human nature. Within the past 30 years, investors have lost huge sums of money on fads such as emerging markets in the 80s, biotech in the

early 90s and TMT over the past three years. In other words, greed and fear block common sense with frightening regularity.

Clearly, most investors possess the same information and consider similar risks. As a result, they simultaneously “jump on the trend”. If a prediction does not materialise immediately, the “weaker hands” soon start doubting their own actions. This explains why historical graphs exhibit over-extensions on market edges, as well as immediate sharp reversals.

Floor traders track and bully those expecting a miracle. When at the critical technical level² they sense a decline in trading volumes of new orders and an increase in recently opened positions, they know that exchange clients are anticipating high reward-to-risk trades. In other words, short-term traders suddenly identify a technical level – points that if not broken, would force the market back into a certain range. However, once broken, the market would then start to trend away. Beyond the technical level, traders establish a trade stop-out level and give the order to close a position once that technical level is crossed.

A few times a day, once enough stops have built up at what is considered a key level, floor traders force the market through it. By doing so they “squeeze” clients through the stop-levels and earn a few points as the market goes through the stops. After triggering the stops, they re-establish their own positions and the market returns sharply to



Source: Bloomberg, L.P.

within the range, in the direction the unfortunate miracle-seekers so fervently hoped for just a few moments earlier. The moral of the story is that once an investor senses the desire to believe in miracles (such as high risk-reward trades), they should make a U-turn.

The bird's second lesson

According to one rather coarse French proverb: “One must have the stomach, and to make sure it is his.” It is common for investors to forget that their financial resources are finite and invest in just one idea. The pain of those who held their Individual Retirement Annuities in Enron stock exemplifies one possible outcome of such behavior. Always leave yourself a chance to return to the market.

When an investor takes on a large position, the first significant move in the market can throw them out of it – they simply cannot handle

this amount of risk. To determine the best comfortable position, the reader may try the following rule-of-thumb: determine the smallest position one would hold under any circumstances, given the expected level of risk, and then take a position one-half that size. The gains will not be extraordinary, but you will stay in the game.

The bird's third lesson

Of course, the original wise man story was not made up solely for traders. After all, try and find a trader who would perform a good deed free of charge! Rather, the third lesson highlights the importance of the ability to control your greed: “It is better to be out of the position wishing you were in, than in one wishing you were out.” Subconscious realisation of excessive risk leads to uncontrolled fear or the loss of faith in one's judgment and ability to succeed. As a result, the holder of a position

¹ Technical analysis – a method of forecasting based on the history of price behavior. Paul Tudor Jones once said, “To be a great trader you have to be a great price historian.”

² Technical level – the price level a specific asset should have difficulty breaking; such a level is determined through technical analysis.

becomes uncomfortable with it. At that point, bereft of psychological comfort, they are highly unlikely to succeed.

Therefore, when implementing chosen strategies, investors should never forget ‘the rule of the pyramid’ used by floor traders: the smallest portion of the position comes at the worst price, and the largest one, at the best. For example, however advantageous a price may be, an investor should buy only a fraction of the position. Should the market stick to a downward trend, they will still be able to buy a larger piece at a better price. Of course, this rule works best when the market stays in range. That is, the rule applies over 70% of the time, as the market tends to be range-bound.

However, what happens if the range is broken? By that time, an investor has bought (or sold) at two or three different levels, and the range breakout is causing substantial losses. When the market switches from being range-bound to trending, the rule is: “When you panic, panic first.” If the market appears to be on the threshold of a new trend, the investor must order their broker to follow it and double the position in the opposite direction.

Although somewhat dramatic, such a depiction is entirely appropriate. Any range breakout results in prices that have not been seen in a long time. At that moment, the reasons underlying the market’s changed behavior are still unknown, while the whole trading community continues to hope that comfortable levels will return. Although it is initially intimidating to stand

alone in the market, once the move has been confirmed, the winner ends up with a position secured at an advantageous price and can then build up its size with less fear, despite the residual possibility of the breakthrough proving itself false. “The trend becomes your friend”, and exhausting efforts at the beginning start to pay off. Therefore, don’t be afraid to panic, just pick the right moments to do so.

According to a classic saying on Wall Street: “Trees do not grow to the skies.” This proverb became popular at the beginning of the last century, and it reminds people that nothing lasts forever, even if the trend seems endless. When it is unclear about what to do with either a profitable or losing position, the investor should heed a poker oldie: “When in doubt, do a half.” Any discussion of discipline and greed is never complete without two more proverbs: “Bulls make money, bears make money, pigs get slaughtered.” Quite explicitly, this is a reminder to remain levelheaded and follow a plan. The second is an action plan championed by Will Rogers: “If I buy and the market goes up, I sell. If it goes down, I sell as well.”

The tale of the bird also warns against repeating previous mistakes. However, we often fail to avoid them and chastise ourselves afterwards. Nowadays, everybody tries to memorise as much as possible, and the necessity to purge your mind of superfluous thought is neglected. Imagine that you have been losing money for the first four days of a week. By Friday, you are worn out and distressed. It is surely

difficult to force yourself to take on a new position, as the losing streak has exhausted you. The skill of being able to forget rids your mind of euphoria as well as panic. Release the worries of your past – even the most recent ones. “Focus on your consequent steps”, was another piece of advice from Tudor Jones.

Finally, markets always outsmart even the smartest investors. Remember: “Those of us who were lucky were born smart, but those who were smart chose to be born lucky.” The winners only rarely explain how they made money, whereas losers have much to account for. But then again, everybody has a natural right to make dumb mistakes, ones that were undoubtedly made well before our time. That is why proverbs dealing with standard situations serve as useful reminders.

Simon Vine is responsible for developing equity, FI and FX derivative operations at Alfa Bank CIS-wide. Prior to Alfa Bank, Simon Vine was positioned in New York, USA. He was Senior Director in charge of derivatives at American Express Bank, ran the Foreign Exchange and Precious Metals Options Group for Union Bank of Switzerland (UBS), and was FX options trader with Societe Generale. Simon holds an MBA from Columbia Business School (US) and a BA from Institute for Finance and Economics (Moscow, USSR.)

Simon Vine is also author of Options Trading Strategies and Risk Management (Wiley, 2005). He can be reached at simon_vine@alfabank.ru

Before You Make a Trade: 10 Critical Questions



Jim Wyckoff, former financial journalist and technical analyst, outlines some useful tips to consider before any trade.

A “Trading Checklist” of prioritized criteria not only will help you decide when to execute a trade, but will also help you identify potential winning trades. What kind of stuff should a trader put on a Trading Checklist? That depends on the individual trader. Each trader should have his or her own set of criteria, or rules, that helps determine a market to trade and the direction to trade it--including when to get in and out.

Below are my Top 10 rules on my trading checklist.

1. Are shorter-term and longer-term charts in agreement on price trend?

I've told readers for years that this is my No. 1 trading rule. If the weekly, monthly and daily (and sometimes intra-day) bar charts are not in agreement on price trend, I'll likely pass on a trade. I'm usually a trend trader, and the "trend must be my friend" before I make a trade.

2. Is this potential trade within my financial risk tolerance?

To be a successful trader, I not only have to have winning trades, but I must survive the more numerous losing trades I am likely to encounter. If I see a potentially profitable trading "set-up," but the market is too volatile, I'll likely pass on the trade because of the potential for a big drawdown or even a margin call from my broker. An example is the energy markets a couple years ago. They were highly volatile. Certainly, there were some big moves (and trading opportunities for some) in the energies--both up and down. However, when a 75-cent, or more, daily move in crude oil is a "routine" trading session, that market is too volatile for my risk tolerance--at least when trading straight futures.

3. What is the potential risk-reward ratio of the trade?

My risk-reward ratio in a futures trade should be at least three to one on maximum profit

potential. In other words, if my risk of loss is \$1,000, my maximum

profit potential should be at least \$3,000. Anything less is not worth making the trade. Now, any eventual profit that is made may not always attain that three-to-one risk-reward ratio, but the point here is there should be the "potential" for a profit three times greater than your capital at risk in the trade.

4. Has there been a price "breakout" from a trading range?

One of my favorite trading "set-ups" is when prices have been in a trading range--between key support and resistance levels--for an extended period of time (the longer, the better). This type of trading range is also called a congestion zone, or a basing area when at historically lower price levels. If the price breaks out of a range (above the key resistance or below the key support), I like to enter the market--long on an upside breakout or short on a downside breakout. A safer method would be to make sure there is follow-through strength or weakness the next trading session--in order to avoid a false breakout. The trade-off there is that I could be missing out on some of the price move by waiting an extra trading session.

5. Is there a potentially good entry point if the trade looks good?

Entry points in trades most times should be based on some type of support or resistance levels in a market. If I see a potential set-up for a long-side trade, I will wait for the market to push up through a resistance level and begin a fledgling uptrend. Then, if I do go long, I'll

set my sell stop just below a support level that's not too far below the market. And if the trend does not develop and the market turns back south, I'm stopped out for a loss that's not too painful. Another way to enter a market that is trending (preferably just beginning to trend) is to wait for a minor pullback in an uptrend or an upside correction in a downtrend. Markets don't go straight up or straight down, and there are minor corrections in a trend that offer good entry points. The key is to try to determine if it is indeed just a correction and not the end of the trend.

6. Is there a support or resistance level nearby, at which I can set a protective stop when I enter the trade?

This is my exit strategy, and is one of the most important factors in trading futures. On when to get out of a market, I have a simple, yet very effective method: Upon entering a trade, if I place a sell stop below the market if I'm long (buy stop if I'm short), I know right away approximately how much money I could lose in any given trade. I will never trade straight futures without employing stops. Neither should you. Thus, I will never be in a trade and have a losing position and not know where my exit point is going to be.

7. Do "fundamental" market factors raise any warning flags?

I base the majority of my trading decisions on technical indicators and chart analysis--and also on market psychology. However, I do not ignore fundamentals that could

impact the markets I'm trading. Neither should you. There are U.S. government economic reports that sometimes have a significant impact on markets. Associations also release reports that impact futures markets. Even private analysts' estimates can move markets. I make it a priority to know, in advance, the release of any scheduled reports or forecasts that have the potential to move the market for which I'm thinking about trading. I don't like surprises when I am in the middle of a trade.

8. What do computer-generated indicators show? (RSI, DMI, Stochastics, etc.)

Some traders use the Directional Movement Indicator (DMI) as a complete trading system. Also, some traders use the Relative Strength Index (RSI), Slow Stochastics or other computer generated technical indicators solely for determining entry and exit points. I do neither and here's why: I consider these computer-generated technical indicators to be secondary, yet still important, trading tools. I will use these "secondary tools" to help me confirm or reject ideas that are based on my "primary tools"-which are basic chart patterns, support and resistance levels, trend lines, and fundamental analysis.

9. Do volume and open interest provide any clues?

Most veteran futures traders agree that volume and open interest are also "secondary" technical indicators that help confirm other technical signals on the charts. In other words, traders won't base their trading decisions solely on volume

or open interest figures, but will instead use them in conjunction with other technical signals, or to help confirm signals. As a general rule, volume should increase as a trend develops. In an uptrend, volume should be heavier on up-days and lighter on down-days within the trend. In a downtrend, volume should be heavier on down-days and lighter on up-days. Changes in open interest also can be used to help confirm other technical signals. Open interest can help the trader gauge how much new money is flowing into a market, or if money is flowing out of a market. This is helpful when looking at a trending market. Another general trading rule is that if volume and open interest are increasing, then the trend will probably continue in its present direction--either up or down. And if volume and open interest are declining, this can be interpreted as a warning signal that the current trend may be about to end.

10. What is the prevailing general opinion of the market? (Possible contrary thinking.)

When I was working on the trading floors of the major futures exchanges, traders would many times "fade" (or trade against) the featured articles on commodities in the major newspapers, such as the Wall Street Journal. They figured that if the general financial press had picked up on a market (such as a drought driving grain prices higher), then that uptrend must be about over. Contrary opinion in the trading business is defined as going (trading) against the popular or most widely held

opinions in the marketplace. This notion of "going against the grain" of popular market opinion is difficult to undertake, especially when there is a steady drumbeat of fundamental information that seems to corroborate the popular opinion. If you've read books on trading markets, most will tell you to have a trading plan and stick with it throughout the trade. A main reason for this trading tenet is to keep you from being swayed or influenced by the opinions of others while you are in the middle of a trade. Popular opinion is many times not the right opinion when it comes to market direction.

Jim Wyckoff has been involved with the stock, financial and futures markets for more than 20 years. He was born and raised in Iowa, where he still resides. Wyckoff became a financial journalist with Futures World News for many years, cutting his teeth as a reporter on the futures trading floors in Chicago and New York, where he covered every futures market traded in the United States at one time or another.

Not long after he began his career in financial journalism, he began studying technical analysis. By studying chart patterns and other technical indicators, he realized this approach to analyzing and trading markets could level the playing field between "professional insiders" in the markets and individual traders.

His extensive studies of technical analysis and knowledge of markets led to several positions, including chief technical analyst at several well-known companies. He says his mission is not just to generate profits for traders but to also provide them with educational and insightful information because, in the fascinating business of trading, one never stops learning.

Picking a Trading Timeframe



John Forman, author of *The Essentials of Trading*, explains one of the most important parts of developing a trading system – the time frame.

One of the most important parts of being an effective trader is knowing the parameters with which you are operating. These parameters including things like available capital, personal risk tolerance, market knowledge, and time availability. This last one, time, could be the most important of all when developing an operational trading plan. It can go a long way in determining what and how you trade.

How much time do I have to trade?

This question should be one of the first ones any trader asks her/himself. For some, the answer will be a lot. For others, it will be very little. Many trades fall in between. It does not really matter which area

of the spectrum any given trader falls in. Effective trading can be done in essentially any time frame. One must know, however, how much time can realistically be put into it before exploring what and how they will trade.

Trading requires two types of time. One can be referred to as research time, those hours dedicated to developing and testing trading systems, learning about the markets, etc. The other type of time could be described as market time. That is the time dedicated to market analysis, trade execution, and position management. Most people will (or at least should) spend a considerable amount of time on the former. How much time gets spent on the latter is a function of the trader's timeframe.

It is common in the markets these days to label trading timeframes. For example, scalpers are those in an out of trades very quickly, with holding periods measured in minutes. Day traders will have a slightly longer-term time horizon than scalpers, but are out of all positions by the end of the day. Swing traders generally have position holding periods in the 1-3 day range. Beyond that scope are the so-called position traders. These folks hold trades ranging from days to weeks, and even sometimes months.

Clearly, the amount of available time one has will determine which trading timeframe in which he or she can operate. Scalping and day trading requires dedicated, oftentimes uninterrupted periods

focused on the market. Someone who is frequently in and out, often distracted by phone calls and/or email, or in any other way unable to stay locked in to the price action is unlikely to trade in these short timeframes successfully. Swing trading does not demand quite so much market fixation, but still can be something of a challenge for the average person working in an office environment, depending on their work requirements. Longer-term position trading, though, is generally something anyone can do without much trouble.

Keep in mind, a trader can operate in multiple time frames. The author, for example, has times of year where anything but position trading is out of the question because of his inability to monitor the markets consistently. At other times, though, he has the freedom to swing trade. Actually, he could even day trade or scalp at times, but he chooses not to operate in those time frames because he really does not want to spend that much time in front of the screens.

One quick note before moving on - while operating in multiple time frames for your trading is fine, it is not recommended to switch those timeframes intra-trade. At least you should avoid making a short-term trade in to a longer-term one. That is something which tends to lead to disaster. Why? Because it probably means widening out your stops, and

therefore taking on more risk than you originally intended. That's not generally a good idea. Going the other way, long-term to short-term, is more acceptable because it usually means tightening up risk-wise.

When do I have time to trade?

Once you have figured out what kind of time you can dedicate to trading, you have to take inventory of exactly where in the day that time occurs. Do you have a few hours free in the morning? Can you look at the markets over your lunch break? Are you only able to think about trading in the evening, or maybe only on the weekends? Maybe your time is even shorter than that, and you can only look at the markets once or twice a month. The answer to this question can be important in determining what you trade.

For example, if you are someone who can only trade in the evenings, what could you effectively trade? Most likely, day trading stocks is out of the question, at least in your own country. Perhaps other stock markets would be available. The

foreign exchange (forex) market is 24-hour, but even forex has its periods of relative quiet, low volume times during the day. Most commodities (aside from gold and the energy products), are bound by their local exchange hours, so short-term trading them when your available hours don't match their open times can be a challenge. The major stock index futures and fixed income instruments (like T-Bonds) trade globally, but even they tend to have their most significant action during their country's primary business day.

The point is, you need to match up your trading time frame with your time availability. You might have a 6-hour block each day when you could do something like day trade, but it may not make sense to do so given what time of day that is. The longer-term position trading is usually not a problem in this respect, but swing-trading can be, depending on the market.

Does my timeframe match my risk profile?

We all have our own risk tolerance when it comes to trading. Some people take more risk, while others take less. Each trader needs to be able to match up his or her ability and/or desire to take risks with the time frame in which he or she is operating. Interestingly, it is the shorter-term timeframes which offer the best flexibility in this regard.

Consider the example of USD/JPY, the exchange rate between the US Dollar and the Japanese Yen (quote in Yen per Dollar). On the daily chart shown in Figure 1 we



Figure 1 – JPY/USD Daily Chart

can see that the swings which take place over the course of a handful of trading period is generally somewhere in the 1.5 to 2.5 point range (at least over the time period of the chart).

If we look at the weekly chart in Figure 2, though, the swings are bigger. The market often moves 4-5 points and more over the same sort of handful of trading periods.

This is significant because a trader operating in the timeframe of the daily chart (like maybe a swing trader) will generally be taking a smaller per-trade risk in terms of points than would the longer-term trader operating in the weekly timeframe. For a trader with deep pockets, this is probably irrelevant. The smaller trader, however, could find that the risk in terms of account/portfolio exposure is overly large. Fortunately, the advent of things such as mini contracts and other innovations which have lowered the required minimum trade size in recent years has widened the opportunities for the smaller trader. This makes it a lot easier for those with lower account balances to trade longer-term where the stops have to be wider.

Should I even be trading?

It is worth pointing out that sometimes trading is not the best idea regardless of how much time you have, when that is during the day, and your risk position. We all go through periods when we are distracted by external things. Maybe it's exams at school. Perhaps it's work, or family stuff. In my case, I dedicated a large amount of



Figure 2 – JPY/USD Weekly Chart

2005 to writing a book. During that spell, I pretty much stayed out of the markets because I just couldn't give trading the focus I normally do.

There is no shame in taking some time off. In fact, a lot of successful traders make a habit of it. Trading when you are off your game for any reason, can lead to poor performance. Active traders can suffer from burn-out, and even longer-term traders can find their interest and focus waning at points. When that happens, step back and take a break. You could very well trade better when you resume.

Conclusion

All the attention in the media seems to be on the day-trading phenomenon, especially in light of all those who left their jobs in the late 1990s to trade full-time. Just because it's sexy, or popular to do, doesn't mean it's the right thing for you. Sound like something your parents would have said to you? It applies, though.

Make your own decision as to the time frame that makes the most sense given your particular

situation. It doesn't have to have a negative impact on your returns. I was able to make over 200% on my stock trades in 2004 even though I took two significant breaks from the market and only had maybe a dozen positions over the course of the year. I don't say this to brag, but rather to demonstrate the fact that position traders do not necessarily give up the big gain potential the short-term traders supposedly have. Do what's right for you and you'll already be well ahead in the game.

John Forman, author of The Essentials of Trading, is a nearly 20-year veteran of the markets. He has traded just about everything, has worked as an analyst in the foreign exchange, fixed income, and energy markets, and has published literally dozens of articles on market analysis and trading methods. John currently works as content editor for Trade2Win, a trader support web site with over 40,000 members, where he interacts regularly with active traders from across the globe. He brings this wealth of experience and know-how to you in this book.

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Statistical Analysis for Intuitive Traders: Preparing for Chance



Brett N. Steenbarger, Ph.D, Clinical Professor of Psychiatry and Behavioral Sciences and author, explains how we can use Statistical Analysis to provide us an edge.

Like many research scientists, Pasteur realized that great discoveries often come through accident. The German physicist Roentgen, for example, stumbled across x-rays in 1895 when he was experimenting with filling cathode ray tubes with gases and passing electricity through them. Thirty-one years earlier, the chemist Friedrich August Kekule identified the ring structure of benzene after dreaming of a snake chasing its tail, forming a circle. In 1928, Alexander Fleming discovered penicillin when he accidentally left a mold culture exposed to staphylococci bacteria

and found that the bacteria did not grow in the mold. In the 1980s, Michael Marletta won a McArthur “genius” award for discovering the role of nitric oxide in the immune system—a finding he and his partner stumbled upon when a research subject donated urine samples during a bout with the flu.

These were matters of seeming chance, and yet the vast majority of people could not have taken advantage of them. As Pasteur recognized, it was the preparation of these scientists that allowed them to see what others might

have missed. They knew that their chance observations were significant, because they came to the situation prepared with a lifetime of prior observations. Knowing what to expect in nature helped them identify the unexpected.

Can traders benefit from such preparation as well? And, if so, what kind of preparation might be best? In this article, I will make the case that the majority of traders, even including intuitive, discretionary ones, can benefit from knowledge of the market’s historical tendencies. Such knowledge can help us know what to expect in markets, but—

just as important—can alert us to the unexpected.

Statistical Analyses and the Intuitive Trader

Quantitative traders identify what to expect in markets by conducting statistical analyses. Such traders collect a database of market behavior and identify what typically happens after particular market occurrences. For instance, after an unusually strong day in the market, I might go back ten years and examine all similar strong days and see what happened the next day. I can then compare those occurrences with the market's normal behavior to see if there is any directional edge following the strong day.

Let's say, for instance, that the average one-day change in the S&P 500 Index was .02%, with a ratio of up to down days of 11:10. After very strong days, however, the average next-day change is .15%, with a ratio of up to down days of 9-5. Statistical tests, performed either on the price change data or the up/down ratios, could tell us the likelihood of obtaining this difference by chance alone. Many times, the market proves to be efficient and the analysis will show nothing more than random differences. Other times, however, a distinct edge will emerge from the data.

How could a trader use such information? Perhaps an analogy will be instructive:

A baseball pitcher is facing a batter with no outs in the inning. The bases are loaded, and the pitcher knows he must get the hitter to either strike out or hit the ball on

the ground for a possible double play. The pitcher operates in a discretionary mode: he can accept the signal from the catcher or can wave it off if he feels that a different pitch might be better. Suppose, however, the team collected statistics that showed that the current batter was much more likely to strike out or hit a ground ball on a sinker pitch than a straight fast ball. Clearly, such data might influence the pitcher's decision making. He might start with a sinker and see how the batter responds, using that information to help him select the second pitch. His approach remains discretionary, but now it is informed by data that provide a possible edge.

Similarly, a trader might use discretionary judgment to fade an early market rise that seemed to run out of steam. Suppose, however, that the trader also received information that the odds of the market's returning to its average trading price were close to 90%, given the low volume of the early rise. Armed with the statistical knowledge, the trader might gain additional confidence in his trade idea and might even trade it more aggressively. Conversely, if he had the statistical information and then saw that the early rise was unusually strong with rising volume, he might—like the research scientists—take advantage of the unexpected and jump on board the strength. Knowing what to expect based on precedent—and then seeing if the market actually follows its historical tendencies—helps prepare the minds of discretionary traders for a variety of market scenarios.

The Importance of Mental Flexibility

The key to making historical analyses work for discretionary traders is mental flexibility. If the market forecast gets you locked into one way of viewing market action, it will be easy to miss developments that contradict your position. *Historical analysis provides a hypothesis only; current market action will either support or refute the hypothesis.* Remaining open to current data is an important part of being a good scientist. Your job is to test hypotheses, not become blinded by them!

Once again an analogy might be helpful. Many traders trade economic numbers. In trading the release of statistics, it helps to know how markets usually respond to the data. For instance, evidence of unexpected strength in the economy normally might be welcomed by the stock market, and our hypothesis would be to look for evidence of market strength if the numbers come out strong. Suppose, however, that the numbers are very strong and bonds sell off due to fears of inflation. Stocks start higher, but then size comes in and initiates selling, hitting bids. We might say to ourselves, "This shouldn't be happening!" Our prepared minds have enabled us to appreciate that something unusual is occurring, providing us with a potential opportunity to profit from the recognition.

I know from my statistical studies that markets tend to revert back to their volume-weighted average prices, especially under conditions of relatively low momentum. This

allows me to wait for markets to move outside their value regions—price ranges in which two-thirds of all volume has transpired—and then decide if I will trade the move or fade it. If there aren't signs of broad, significant momentum to the move, I can fade the move and potentially profit from the “false breakout”. Should the momentum look strong, I can wait for the first pullback and attempt to ride the breakout. Mean reversion is my hypothesis, but does not become a full-fledged trade idea until it is validated by current market action. Mental flexibility keeps me open to such action.

Perhaps the masters of integrating mental flexibility with a statistical perspective are poker players. Good poker players know the odds associated with their hands, and they will use these odds to help them decide whether to hold or fold. The best players, however, also look for clues in the current action to help them decide whether to go with the odds or bluff. Reading the strengths and weaknesses of opponents—and especially picking up on their “tells”—provides the validation that expert poker players need before acting upon the hypotheses of odds.

Research suggests that elite performers across a variety of fields are more flexible in their decision-making than non-experts. A good physician can make correct diagnoses, but great physicians know when cases are unique and might require additional tests. Chess grandmasters intensively study tournament games and acquire the ability to know when

to break the rules with unorthodox moves. The greatest jazz musicians not only play beautiful music, but provide it with their own interpretation and style—often improvised moment by moment. Across all performance domains, experts first learn the rules; then they learn to move beyond them. The market's statistical tendencies can be thought of as its rules: patterns that are followed by good traders and sometimes overridden by great ones.

Short-Term Market Sentiment: Example of a Market Rule

One of my trading rules is that market sentiment doesn't turn on a dime. A market must stop going up before bullish traders turn bearish; neutral sentiment will not change until price direction is established. When sentiment is highly bullish or bearish in a market that is making new highs or lows, that momentum normally will persist in the short run before the majority can be proven wrong. A nice example of this principle can be found in the NYSE TICK, one of the shortest-term measures of sentiment available.

The NYSE TICK measures the number of New York Stock Exchange issues that are trading on up ticks (they have just traded higher) minus those that are trading on downticks (their last price movement is lower). Another way of framing the TICK is that it is unusually strong when many stocks, simultaneously, are trading at their offering prices. Conversely, the TICK is very weak when many stocks are trading at their bid prices concurrently. In an

upward market, the NYSE TICK spends significantly more time above zero than below it, as traders and investors are willing to pursue stocks at their offering prices. Weak markets tend to stay below the zero line, signifying that traders are aggressive in hitting bids.

While the NYSE TICK can be used as an intraday measure of the bullish and bearish leanings of traders, I use it for slightly longer-term analysis. The Adjusted NYSE TICK that I post daily on my website is the sum of all TICK readings during the day (values calculated every ten seconds), statistically adjusted to create a zero mean. As you might guess, the Adjusted TICK, as a measure of trader sentiment, correlates quite well with daily price movement. The Adjusted TICK's correlation with daily price change in the S&P 500 exchange traded fund (SPY) is .75, meaning that well over half of all variance in price changes during a day can be attributed to short-term trader sentiment.

We can test our market rule that strong sentiment exerts persistent short-term effects on price movement by examining occasions when sentiment is at bullish and bearish extremes. For the purpose of our analysis, we're looking at trading days in which the Adjusted TICK either exceeded +600 or fell below -600. These are the occasions in which the Adjusted TICK is more than one standard deviation above or below its zero mean.

Since July 2003 (N = 527 trading days) we have had 72 occasions in which the Adjusted TICK was unusually strong and 74 occasions

	Strong TICK Days	All Other Days
Next Day SPY	.08% (45 up/ 27 down)	.04% (289 up/ 246 down)
Three Day SPY	.31% (50 up/ 22 down)	.09% (308 up/ 227 down)

	Weak TICK Days	All Other Days
Next Day SPY	-.13% (34 up/ 40 down)	.07% (316 up/ 217 down)
Three Day SPY	.11% (42 up/ 31 down)	.12% (300 up/ 233 down)

in which it was unusually weak. The accompanying Tables display what the SPY did following the strong and weak days, looking one and three days out.

The strong Adjusted TICK days were followed by modestly greater strength the next day that expanded over the next two days. The average gain three days after a strong daily TICK reading was more than three times the average seen on other days, with winning occasions outnumbering losers by better than 2:1. Weak Adjusted TICK days, however, tended to be followed by price weakness the next day, with losing sessions outnumbering winning ones and an average price loss across all occasions. Interestingly, however, the weakness tended to be reversed by the third day out, so that there was little difference between the weak TICK days and all other days at a three-day horizon.

This suggests something that I have observed in other research: price persistency is not symmetrical. Bearish developments tend to reverse more quickly than bullish ones. This reflects the fact that bull market swings tend to last longer than bear moves. After a strong daily Adjusted TICK reading, a trader can expect price firmness over the next several days. After a weak reading, however, the trader can only expect follow through weakness the next day before prices

reverse.

These statistical tendencies, which I track on a different free site (www.traderfeed.blogspot.com), provide guidelines for discretionary traders, preparing their minds for both the expected and unexpected. Let's say the market showed unusually positive sentiment during a price rise yesterday and closed two points below its high for the day. The market opens a point lower today, as the trader reads the Adjusted TICK values in real time. Once the net TICK value for the day turns positive, the trader assumes a continuation of positive sentiment and buys the market, benefiting from the high odds that the market will take out yesterday's high. Should the Adjusted TICK readings today never turn positive, however, the trader can avoid the long trade and perhaps, instead, sell the market for a move back to yesterday's average price (a different rule and tendency).

Knowing the market's tendencies provides the trader with well-grounded trade ideas, but also prepares the trader's mind for those "chance" occasions in which the market acts counter to its history. Once again, mental flexibility—keeping an eye on those real-time Adjusted TICK readings and adjusting one's trading accordingly—is the key to making maximum use of the statistical analyses.

Conclusion

It would be misleading for me to suggest that robust statistical edges occur every day in the markets. While markets are not perfectly efficient, as behavioral finance research has found, neither are they so inefficient as to routinely leave nickels lying on sidewalks. The most promising statistical analyses utilize data that have not been picked over: either unique measures or common measures that are assessed at unusual time frames. When you do find an edge, it allows you to pursue your trade ideas with greater confidence and can keep you out of bad trades. Most important, in the spirit of Pasteur, the market "rules" defined by historical tendencies prepare you to capitalize on those occasions when markets break those rules. It is very difficult to appreciate the unexpected if you don't first know what to expect!

Brett N. Steenbarger, Ph.D. is Associate Clinical Professor of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University in Syracuse, NY and author of The Psychology of Trading (Wiley, 2003). As Director of Trader Development for Kingtree Trading, LLC in Chicago, he has mentored numerous professional traders and coordinated a training program for traders.

An active trader of the stock indexes, Brett utilizes statistically-based pattern recognition for intraday trading. Brett does not offer commercial services to traders, but maintains an archive of articles and a trading blog at www.brettsteenbarger.com.

Brett can be reached via his website www.brettsteenbarger.com

Trading the Euro: Box it, Squeeze it, Love it, Leave it



John F. Carter, trader, explains his favourite setups to trade the Euro successfully.

Trading is the most deceptive profession in the world. A person cannot walk into an airport, jump into a 747, and take off down the runway without any prior training. Yet people will routinely open an account and start trading without any guidance whatsoever. For me, the biggest difference in my trading occurred when I learned to ignore my brain and just focus on a handful of good setups. Once I learned the setups, the next challenge was to have the discipline to follow them the same way, each and every time. No thinking, no hemming, no hawing. I did this by recording my trading activity and grading myself on how well I executed each setup . . . instead of how much money I was making or losing. Whereas focusing on the P&L automatically encourages the bad habits that plague many traders, a setup-based approach encourages habits that can push a trader into the realm of consistent profitability. Which setups do I like? Although I spend a large amount of my trading day

focused on the Emini S&Ps and the Mini-Sized Dow, there are plenty of times when these indices are dead in the water. On days when the indices are trading in a narrow range, I look to the currencies for my next setup. My two favorite setups in the currencies are what I call the Box Play and Squeeze Play. I execute these primarily on the EURUSD, but they work on all currency pairs. Let's take a look.

I like to focus part of my trading day on scalp plays, where I'm jumping in and out of the market with a little piece here, and a little piece there. However, I also like to focus a part of my time on catching potentially bigger intraday moves, as well as multi-day and multi-week moves. What I'll do is focus on scalp plays in one account, and use a second account for swing plays. The Box Play and Squeeze Play are diverse setups that can be used for both scalp plays and swing trades. For intraday trades, I use 5 and 15

minute charts. For swing trades, I use 60 minute and daily charts.

Box Plays: Measuring the Move Before it Occurs

The one thing a trader soon learns about the markets is that they will never move straight up or straight down forever. A market can definitely rip higher for long time, but at some point it will have to rest and consolidate, and sometimes it will even come back down to earth and reverse all of those spectacular gains. Just as a runner can only sprint for a limited amount of time before their body gives out, a market can only move so far before it needs to pause, take a rest, and build up its energy reserves for the next major move.

For Box Plays, what I'm looking for is a market that is taking a rest before its next spurt higher or lower. I want to see a period of horizontal consolidation with at least two tests of the highs and two tests of the lows. Once I get these two tests, then I'm looking to buy a breakout of the box, or sell a breakdown of the box. My target on these trades is the width of the box. These plays can be done on all time frames, though my preference for day trading is 5 and 15 minute time frames. For swing trades, a trader can look to the 60 minute and daily charts. I trade these as both swing and intraday plays, with each time frame independent of itself (meaning I could have a 60 minute box play going and a 5 minute box play going at the same time, with different parameters and in different directions). Also, since the Euro actively trades around the clock, these box plays can be setup at anytime. I like to try to get some sleep each night, but on those nights when I get shafted by the wait staff (i.e., I order decaf coffee after dinner but they give me caffeinated, so I end up lying in bed staring at the ceiling), I can at least get up and check if a box play is forming overnight.

TRADING RULES FOR BUYS (SELLS ARE REVERSED)

1. Set up a 24 hour chart so the overnight activity can be accounted for in this indicator setup.
2. I like to set up a simple bar chart on the time frame I want to play, without any other indicators or "junk" cluttering up the screen. I will search through various time frames to see where box plays are currently setting up.

3. As the market action progresses, I will take a horizontal line and start marking highs and lows. I will usually have to adjust this horizontal line a few times as the market action develops. Once I get two tests of one of the lines, I have a potential box play developing.
4. At this point I am watching to see if I get another test on the opposite side of the box. Let's assume in this example that I do, and now I have two tests of the highs, and two tests of the lows. The width of the box is 20 ticks.
5. Now that I have my box, I place two orders. I place a buy stop order 1 tick above the high end of the box. I place a sell stop order 1 tick below the low of the box. Whichever way the market breaks, I am sitting there with my order waiting to get filled.
6. My buy stop is hit. I place a limit sell order 20 ticks (the width of the box) away from my entry point. I leave my sell stop in place, as this now becomes my stop loss order on this trade. This represents a risk reward ratio a little over 1:1.
7. I stay in my play until my stop or my target is hit. I do not trail stops.
8. Note that all times listed are Eastern.



Figure 1 EURUSD Forex — December 2004

1. This is a daily chart of the EURUSD. This is an example of a swing trade and a bigger example of the “power of the box.” On May 20 and May 21 we form the lows at 1.1620.
2. On May 27 the market loses steam from its vault higher and sells off, forming the highs of the box 312 pips later (a little over 3 cents).
3. On June 4 and June 5 the market retests the lows of the box.
4. And on June 16 there is a retest of the highs of the box. Once this happens, I place my orders. I use a buy stop at 1.1933 and a sell stop at 1.1619.
5. My sell stop is hit at 1.1619. Since the width of the box is 312 pips, I calculate my target accordingly, and I place a buy limit order at 1.1307. My stop is my original buy stop order at 1.1933.
6. The market moves down nicely, and then shoots back higher. Anyone using a trailing stop for this trade would have been stopped out for a small gain. The reason I keep my stop wider, and the reason I do not trail it, is that I know this is a high probability play, and I want to give this setup “room to move” in order to give it a chance to work out. My target is hit nearly 2 weeks later for a gain of 312 pips, or \$3,120.00 per contract.



Figure 2 EURUSD Forex — December 2004

1. On August 3 The Euro formed a box on the 15 minute charts. The first high was marked here at point #1.
2. A few hours later we get a potential low for the box, and I initially draw a horizontal line at the lows here.
3. The market bounces and we get a retest of the highs.
4. Then the Euro sells off nicely and we get a retest of the lows. Since this low pushed a little lower than the low at point #2, I go ahead and move my horizontal line down to reflect this low. Once I have these lines setup, I place my orders. I use a buy stop at 1.2062 (one pip above the highs) and a sell stop at 1.2042 (one pip below the lows).
5. My sell stop is hit at 1.2042. Since the width of the box is 18 pips, I calculate my target and I place a limit buy order at 1.2024. My stop is my original buy stop order at 1.2062.
6. My target is hit and I’m out for a gain of 18 pips, or \$180.00 per contract. I don’t have to remember to cancel my open buy stop because my execution software does it for me automatically. Now, if I could just automatically remember to compliment my wife’s choice of clothing each and every day, I will be good to go.



Figure 3 EURUSD Forex — December 2004

1. On this 15 minute chart of the EURUSD we get a first test of the highs at 1.2347. Once the market sells off from this level, I draw a horizontal line across the high.
2. The market sells off and pushes as low as 1.2323. I start off drawing a line at this level. Later I move this line back up to 1.2331 because the rest of the price support tests were much close to this level than the “wayward tick.”
3. Here we get another test near the highs.
4. And here we get another test near the lows. Once the 4 price tests are complete, I place a buy stop order at 1.2348, and a sell stop order at 1.2330. Although this box isn't perfect, there is no doubt that we have a nice horizontal channel in place.
5. My buy stop order is hit. Since the width of the box is 16 pips, I place a sell limit order for my target at 1.2364. My sell stop remains in place as my stop on this play.
6. My target is hit, and I'm out for 16 pips, a gain of \$160.00 per contract. I could have also used the low of the “wayward tick” in my calculations and this would have been a more profitable trade. The bottom line is that when it comes down to a few ticks, it is not a big deal where you place your horizontal line, as long as it is crystal clear that a box is in place. As one of my former mentors hammered into me, “Don't be a weenie for a teenie.”

I always enjoy the act of opening and giving presents over the holidays. I find that I enjoy that feeling almost as much as discovering a new “box” to open up in the Euro. With this play, Christmas seems to happen a few times each week instead of just once a year. Let's take a look at the next setup.

Squeeze Plays: Jumping on the Train Just as it is Leaving the Station

The Squeeze Play takes advantage of “quiet periods” in the market when the volatility has decreased significantly, and the market is building up energy for its next major move higher or lower. These quiet periods are identified when the Bollinger Bands narrow in width to the point they are trading inside the Keltner Channels. This marks a period of reduced

volatility and signals that the market is taking a breather, building up steam for its next move. The trade signal occurs when the Bollinger Bands then move back outside the Keltner Channels. I use a 12 period Momentum Oscillator to determine whether to go long or short. If it is above zero when this happens, I go long, if it is below zero, I go short. These are all canned studies that come with most charting packages. For the parameters, I just use the default settings on TradeStation. I also took an extra step and turned all of these into an indicator which makes it easier to read on the chart.

TRADING RULES FOR BUYS (SELLS ARE REVERSED)

1. Set up a 24 hour chart so the overnight activity can be accounted for in this indicator setup.
2. The “heads up” on this setup is the first black dot. This is not a trade signal, but a “heads up” that a trade signal is setting up.
3. The signal on the indicator is the first gray dot after a series of black dots. (This will be shown in detail in the charts that follow).
4. Once the first gray dot appears after a series of black dots, I go long if the histogram is above zero. Once the signal fires, I just place a market order. This is a momentum play and I don't want to be messing around with limit orders that may not get filled (remember the whole thing about weenies and teenies).
5. I base my stops on the time frames I'm using. For 5 minute charts, I use a 20 pip stop. A 15 minute chart gets a 25 pip stop, 60 minute chart a 30 pip stop and a daily chart a 50 pip stop. One pip equals 1/100th of a cent and equates to \$10.00 on a regular sized contract, and \$1.00 on the minis.
6. My target is based purely on the momentum of the trade. Once the momentum signal starts to weaken (rolls over), I get out of the trade at the market.
7. I don't trail stops. I treat this position like my marriage—I may want to try to change something about the trade but in the end I've learned its best to just leave it alone.
8. Note that all times listed are Eastern.

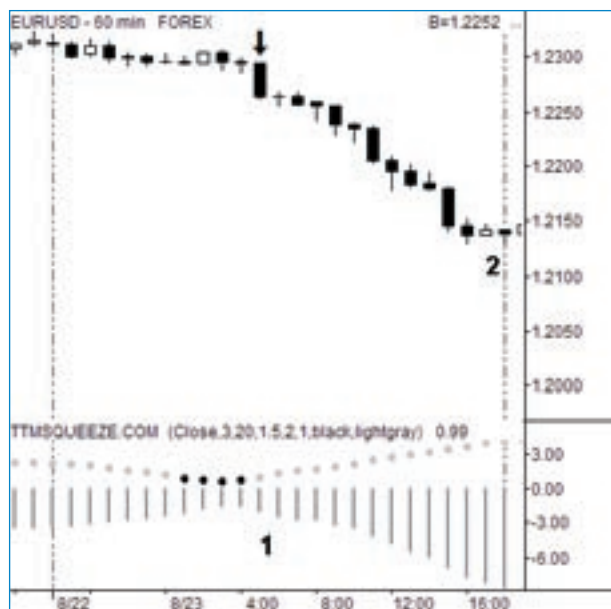


Figure 4 } EURUSD Forex — September 2004

1. On August 23 I woke up to see the Euro had just fired off a squeeze. This is marketed by the first gray dot after the series of 3 black dots. Since the histogram was below zero, I went in and shorted at the market, getting filled at 1.2252. I placed a 30 pip stop at 1.2282.
2. The market sells off considerably and the momentum on the histogram never lets up. I stay in the trade all day, exiting at 4:00 p.m. when the momentum begins to slow. I exit at the market and am filled at 1.2146 for a gain of 106 pips, a gain of \$1060 per contract.

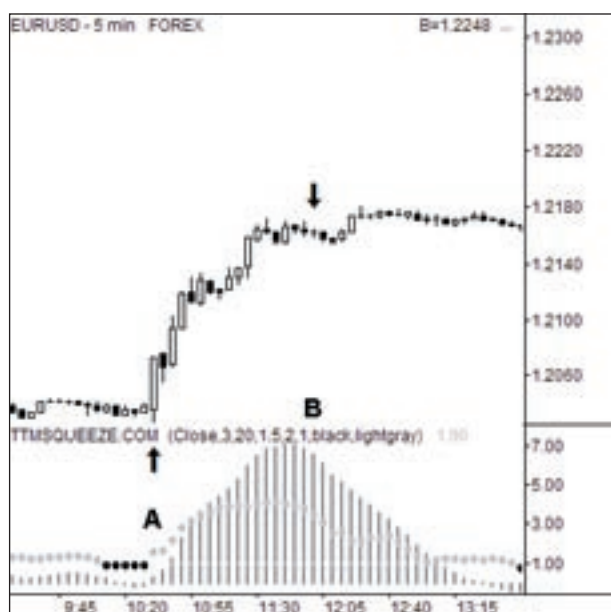


Figure 5 EURUSD Forex — September 2004

1. On this 5 minute chart of the Euro Currency we go into “black dot territory” a little before 10:00 a.m. and 25 minutes later we get our first gray dot (Point A). The histogram is above zero so I go long at the markets, and I’m filled at 1.2054. I place a stop at 1.2034.
2. The market rallies steadily for the next 90 minutes and starts to lose momentum just before 12:00 noon (Point B). I exit at the market and am filled at 1.2153 for a gain of +119 pips, or \$1190 per contract.

Box Plays and Squeeze Plays show me when the markets go into quiet mode. The only reason markets go into quiet mode is because they are building up energy for their next major move. I like to be on the alert for this move, and of course on the alert for the direction of the move. Both of these setups help me to take advantage of these ebbs and flows in the market.

In parting, I can’t emphasize enough how important it is for a trader to find a market that fits their own personality if they hope to be successful. If you find that you are only happy if you are buying breakouts and selling breakdowns, then the Euro is probably your market of choice. This market breaks and trends well, while the Emini S&Ps tend to suck in traders with false breakouts and breakdowns. In other words, if you are buying breakouts in the S&Ps and getting killed, then give the Euro a try.

John F. Carter grew up the son of Morgan Stanley stockbroker, and was introduced into trading as a sophomore in high school, and has been trading actively for the past 19 years. He studied international finance at the University of Cambridge in England before graduating from the University of Texas at Austin. John has been a full time trader since 1996. In 1999, tired of talking to his goldfish while trading alone in his office, he launched www.tradethemarkets.com to post his trading ideas.

*Today he and the Trade the Markets team have a following of over 10,000 people. John publishes separate daily newsletters for futures/single stock futures, options and equities trading, and, more recently, forex. He’s a Commodity Trading Advisor with Razor Trading, manages a futures and a forex fund, and McGraw Hill tapped him to write a book entitled *Mastering the Trade*, due out in January, 2006. To keep his sanity, John relies on physical activity after the close to deal with the financial swings he and his subscribers encounter. He clears his head running, water skiing, golfing and practicing Tae Kwon Do.*

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MARKET OBSERVATIONS

QQQQ: Is risk getting higher for investors?



Paolo Pezzutti, private trader, details his own opinion on the QQQQ



FIGURE 1: QQQQ MONTHLY. QQQQ recovered only partially the internet "bubble" crash. Graphic provided by: TradeStation.

A little bit of history

Prices after the March 2000 high at about \$120, moved very quickly to the downside, starting a 2-year downtrend and printing a new relative low only in October 2002 at about \$20. The downtrend burned an enormous part of the capitalization, dividing prices by 6. During the past 3 years, prices managed to double reaching the \$40 level in November 2005. QQQQ has been recovering from the end of the 1990s bubble, printing an uptrend that gave back partially the heavy losses suffered between 2000 and 2002. Not too bad indeed, but probably not enough for many investors badly hit after the year 2000.

Volatility

Markets tend to move fast from periods of price consolidation to new levels of price equilibrium. They oscillate from periods of low volatility to high volatility and back again. After periods of extremely low volatility, volatility increases. Prices move sharply.

In Figure 2, you can see the weekly chart of QQQQ and the historical volatility plot.

Volatility is close to its lowest levels in six years.

Since 2002, the decline of volatility has been fast.

My view is that a directional impulse, most of the time, brings volatility in the direction of the trend. I tend to interpret the last three years' movement as



FIGURE 2: QQQQ WEEKLY. QQQQ printed a declining volatility during the last three years' uptrend. Graphic provided by: TradeStation.

a reaction to the impulsive action to the downside, sustained by low interest rates that provided liquidity and helped corporate profits. There might be an ongoing structural change in the market, providing a lower-volatility environment than in the past. I believe

however, that high-volatility is due to be back. Trading range and reaction phases can be long, when you conduct your analysis at the weekly or monthly level, and there is no doubt that volatility is cyclical. The market, however, is not providing for the moment signs of increasing volatility.

Technical Analysis

Let's see analyze now the technical conditions using a simple, but useful indicator.

In Figure 3, you can see the moving average convergence/divergence (MACD) indicator applied to the monthly chart of QQQQ. It calculates two exponential moving averages (EMAs). The difference between these two averages is plotted as the MACD (blue line). This value is averaged and then plotted as the MACDAvg (red line). The difference between MACD and MACD average is plotted as the MACDDiff (red histogram).

Since 2004, prices have been moving within a slightly converging channel. Note that the MACD

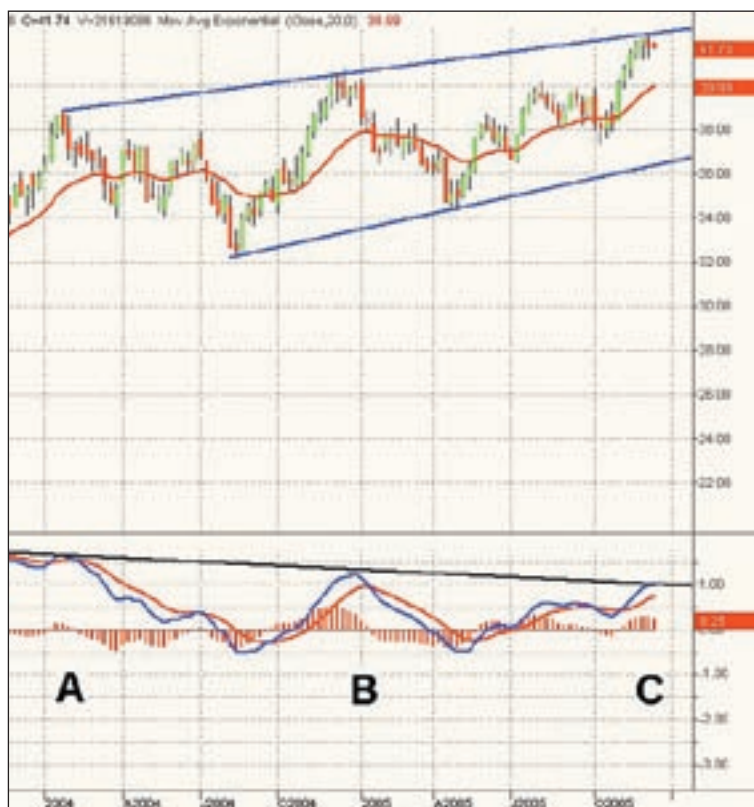


FIGURE 3: QQQQ WEEKLY. The MACD indicator displays multiple negative divergences. Graphic provided by: TradeStation.

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FIGURE 4 QQQQ DAILY. MACD is decreasing. The MacDiff is negative, indicating the current weakness. Graphic provided by: TradeStation.

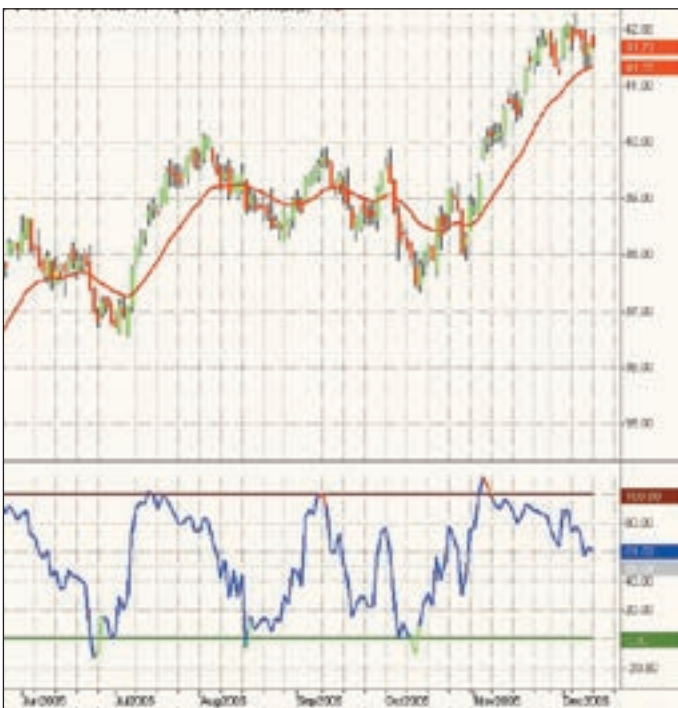


FIGURE 5: QQQQ DAILY. Bollinger %b (close) indicator displays a negative divergence in this time frame. Graphic provided by: TradeStation.

printed two negative divergences in coincidence with the January 2004, December 2004 and December 2005 tops (points A, B and C). At present, prices are testing the higher trend line and momentum is low.

At the daily level, in Figure 4, these divergences are not evident. MACD is decreasing. MACDiff is negative

indicating an ongoing consolidation at these levels. The test of this resistance is not easy, because QQQQ is arriving at these levels after an 8-month up leg and a 20% advance of prices. The divergence is present for another indicator, the Bollinger %b (close), which can be used to tell us where we are within the Bollinger Bands ($\%b = \frac{\text{last close} - \text{Upper Band}}{\text{Upper Band} - \text{Lower Band}}$).

If you look at Figure 5, you can see that the recent December high is printed in coincidence with a negative divergence of %b.

Assessment

Divergences alone cannot state the end of a trend. You can have many false signals before you have a correct indication. They are, however, a useful tool for traders to assess the risk of entering long positions when they occur. Looking at the volatility situation, my view is that most of the time, a directional impulse brings volatility in the direction of the trend, although the market is not showing signs of increasing volatility, but it appears only to be more “news-driven” than in the past months. In summary, I believe it is becoming increasingly risky to open new long positions at these levels. There are elements to believe that the risk of entering long positions is getting higher. I understand also that technically the uptrend is still intact and ongoing. It is difficult not to participate in the current up phase. Trying to spot lower-risk entry points during this correction/consolidation phase is an option. For example, should prices develop a trading range in the next weeks very close to the resistance level, without managing to correct significantly, this would increase greatly the market chance to reach new highs, extending the current ongoing up leg. At the same time, should QQQQ start a deeper correction, it will be difficult to see a new leg of the uptrend to develop soon.

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Foreign Exchange: Behind the scenes



Noble DraKohn, author, futures investor, broker, and analyst, provides a more detailed look at the working of the forex market.

Foreign exchange (forex) trading is definitely the most exciting new opportunity in the investment world today. Active traders worldwide have discovered this form of speculation over the past few years. Once the domain of only international banks, new rules allow skilled speculators the opportunity to participate.

Numbers vary, but the forex market's notional value reaches in the trillions daily. Far more than the stock market and bond market combined. In this brief article I will cover a simple way to determine what currencies are on the move and in which direction they may be headed.

The forex market is divided into two separate arenas. There is the over-the-counter (OTC) forex market and the futures forex market. Since the OTC market is not centralized it is impossible to obtain information

on volume, open interest, and the positions (long or short) that the major players i.e. banks, financial institutions, and international conglomerates hold. This inability to have a full picture of the OTC market makes it exceptionally difficult for speculators to properly analyze the speed and force that may drive a particular currency.

In order to resolve the lack of information provided in the OTC market the speculator needs to turn only to their futures forex exchange traded counterparts for guidance. In the futures forex market there are multiple contracts that expire in various months. The month closest to the OTC market moves in tight relationship to it. While the OTC market has little to no information about their participants, the government keeps highly detailed records on the futures forex market. What makes their constant fact gathering even more impressive

is their legal requirement to make this same information available free to the public.

Once a week the Commodities Futures Trading Commission (CFTC) issues what is known as the Commitment of Traders report. This insiders report details the exact positions (long and short) of the major players, as well as the total amount that their positions increase or decrease from week to week.

Why this information is valuable is two fold. First, it gives the OTC forex trader an idea as to the general sentiment of the major players. Second, over time it shows the gradual shift in momentum from weak to strong or strong to weak. With these two helpful pieces of information an OTC forex trader can determine what position he wants to take, based on the major players, as well as when the ride

Euro FX – Chicago Mercantile Exchange Futures Only Positions as of 12/06/05

EURO FX - CHICAGO MERCANTILE EXCHANGE FUTURES ONLY POSITIONS AS OF 12/13/05							Code=099741		
NON-COMMERCIAL			COMMERCIAL		TOTAL		NONREPORTABLE POSITIONS		
LONG	SHORT	SPREADS	LONG	SHORT	LONG	SHORT	LONG	SHORT	
(CONTRACTS OF 125,000 EUROS)						OPEN INTEREST:		192,392	
COMMITMENTS									
28,088	29,151	2,760	117,671	114,350	148,519	146,261	43,873	46,131	
CHANGES FROM 12/06/05 (CHANGE IN OPEN INTEREST: 13,039)									
-696	-22,205	-616	14,568	34,642	13,256	11,521	-217	1,218	
PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS									
14.6	15.2	1.4	61.2	59.4	77.2	76.0	22.8	24.0	
NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS: 101)									
33	27	12	32	27	65	64			

Figure 1 - Example of a Commitment of Traders Report from the CFTC

may be coming to an end, so he won't be left holding his position at the top, or bottom, of the market.

There are a myriad of other ways to trade the Commitment of Traders report, in both the OTC forex market as well as the futures forex market. With diligence and the willingness to trade both forex arenas, with and against each other, every speculator should have a fulfilling trading experience. Current and historical *Commitments of Traders* data are available on the Internet at the Commodities Futures Trading Commission's website: <http://www.cftc.gov>.

One of the little known secrets of "spot forex" trading is the concept of hedging. Hedging is defined as the ability to protect yourself from losses. There is an inter-relationship between spot forex, futures forex, and option forex. Each one is designed as a type of "insurance" for the other. The Commitment of Traders Report sheds light on what the "Commercials" also known as banks, governments, and major corporations are doing to protect themselves.

In the above example the Commercials have a long position of over 100,000 contracts. This could mean one of two things, either they have had a change of heart in the overall downtrend of the marketplace or they simply want to protect themselves just in case the market spikes up on its way down. The second instance is what is most likely occurring.

This strategy of combining spot forex with a futures contract can just as easily work for the average speculators. What you do is simple, once you are capable of defining the long term direction of the trend, you can setup a forex option, or a forex futures contract to follow along with the long term direction (the Commitment of Traders Report can help you determine that). When you trade spot forex positions, you only focus on the counter trends, the moves that go against the long term trend. By doing this you are capable of holding on to profitable trades for much longer, as well as still being able to profit from trades that go against you. By utilizing this strategy you are able to create

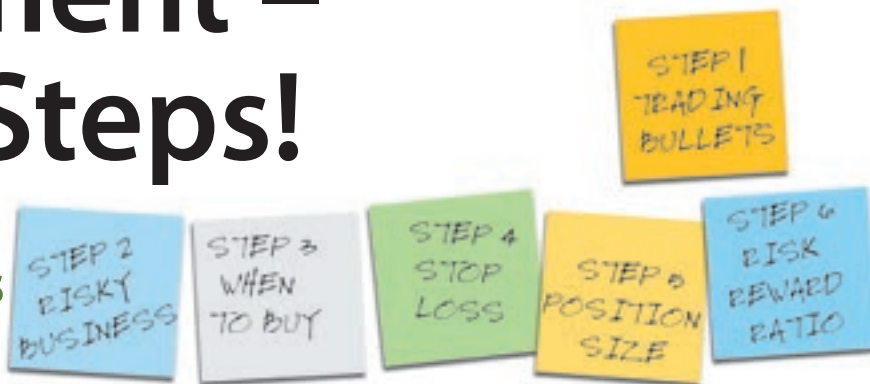
an advantage for yourself that over 90% of "spot forex" only speculators simply don't know how to do.

As speculators we want every competitive advantage available to us. In the spot market while the rewards are great, high leverage, high volatility, and short trading periods make it difficult for the average speculator to get ahead. By using the "commitment of traders report" you are capable of getting a complete snapshot of the players in a particular currency, which gives you the ability to strategize your spot forex trading for the long run.

Noble DraKohn, noble@liverpoolgroup.com, is the author of the best-selling books Forex for Small Speculators, Futures for Small Speculators, and Single Stock Futures, For Small Speculators. He has been a futures investor, broker, and analyst for almost 11 years. You can subscribe to his free monthly newsletter at www.liverpoolgroup.com, open a demo forex account at www.liverpoolgroupfx.com, or purchase his seminars on CD titles at www.smallspeculators.com

Money and Risk Management – In Just 6 Steps!

Jafli, author and private trader, explains his 6 steps to incorporating Money Management successfully.



Most people give very little attention to money & risk management aspects when it comes to stock trading. And to those who do, it is only treated as an after-thought.

In most cases, huge emphasis is given to analysis and techniques of assessing trading opportunities.

The following is a summary of 6 steps money & risk management strategies that have served me well over the years. They had **saved me from being poor** while at the same time gave me **space to fine-tune and modify my trading approaches** and got back what I've lost in the market. Now I'm not saying they are the only ones available in the market. It's just that they are the ones that have been **useful and profitable to me. And just what are the 6 STEPS? Well, read on!**

STEP 1 – TRADING BULLETS

No money, no trade! No argument there! You need to set aside some money just for trading purposes. Just like what you would do when

you set aside your money for children's education, emergency fund, etc. You should not, must not, borrow money from anybody (banks included!) just because you have that burning ambition to bring in huge rewards from trading.

Don't have enough money? Start saving. If you cannot even do this, then you're not ready for trading. Period.

Never do a Hail Mary and **dump everything that you have** in one single trade, no matter how much you love THAT stock! Don't be a Rambo in the stock market! Those who do not bother about money management are the ones who would dump all their money in one single trade. Don't put all your eggs in one basket.

STEP 2 – RISKY BUSINESS

Trading success depends on how you manage risk. It's NOT based on how you choose your stock.

Every Tom, Dick & Harry talks about risk control. But most

of them still lose money! Good trading means you lose only a small amount of money.

First and foremost, you need to **know your risk tolerance**. In other words, you must identify where your stress point is. How much money can you afford to lose without losing your sleep? How much money are you willing to lose in a single trade? These are some of the questions that you need to ask yourself in order to **determine your risk threshold**.

Risk can be controlled and minimized to a level that is comfortable to you.

STEP 3 – WHEN TO BUY

When do you jump into a trade? The simple answer is that it depends on the trading plan that you follow. There is **no right or wrong answer**. Whether or not you make money out of it will only be known **after you have sold** your shares. It is not uncommon that a sell signal to me may be a buy signal for you and we both still earn profits from our

own trading systems. **Anytime is a good time to buy** as long as the conditions are in accordance with **your** trading system.

There are as many trading systems or plans as there are the traders themselves. Within the technical analysis fraternity alone, there are the trend followers, breakout traders, momentum chasing players, day traders etc. Some traders would buy on price weaknesses, uptrend breakouts and rebounds. The trend followers would join in when they feel it is safe to hop on-board the moving trend train.

Many traders spend considerable amount of time in deciding when to enter a trade. My view is that **setting exit conditions is MORE IMPORTANT than entry conditions!** Why? It's the exit price that determines your overall risk and profit! It is for this reason that I spend more time defining the exit conditions for each of the trade that I intend to take rather than the entry conditions.

STEP 4 – STOP LOSS (EXIT CONDITION)

In property, the most important thing to remember is location, location, and location. In the stock market, its stop loss, stop loss & stop loss! Identify stop loss conditions **before** you enter trade. This is your insurance if you're wrong about the trade.

The ultimate role of stop loss is to **protect capital** and later, to **protect profit** as the trade progresses.

Not cutting losses is actually **one of the biggest mistakes** that traders make. Coming a close second

is the mistake of not letting your profits run.

Stocks do their own thing, not what we think they should do.

Suppress the urge to be "right" – focus on the need to be disciplined when executing your trading plan. Lose your opinion – not your money!

Most importantly, **choose a stop that you would definitely act on!**

STEP 5 – POSITION SIZE

It's inevitable that you're going to lose money from time to time in this business. Everybody does! But what separates the pros from the boys is that the pros minimize their losses and maximize their profits. The retail crowd would do exactly the opposite – let the losses run and cut their profits short!

If you're still new in the stock market and lack trading experience, it is absolutely important for you to know how to control and minimize risk effectively whilst you go over the learning curve.

And just how do you minimize the risk? One way is by simply **reducing your position size**, which is the number of shares that you intend to buy. Don't bite more than you can chew. Fact is, the traders who win are those who **minimize risk**. And those who don't? They pay the price and get wiped out.

In fact, it's a good idea to trade in small position sizes when you're new in trading. I also keep my position size small whenever I want to test out a new trading

approach. If it bombs out, that's OK as I've already planned for it. I consider that as "service charge" by Mr. Market for giving me such "advisory" service!

Ultimately, your intended or actual position size would depend on the level of risk that you're prepared to take.

STEP 6 – RISK REWARD RATIO

The purpose of using risk reward ratio is to assess whether the intended trade is **worth taking the risk**. This analysis tool is useful when you have already identified a sell price target for a particular stock that you want to trade.

Let's use an example to calculate the risk reward ratio. Suppose you have set your entry price at \$7.00. Your stop loss is set at \$6.34. And you have made up your mind that you want to sell this stock once it hits \$10.00 (your sell price target). The calculation of the risk reward ratio would be as follows:

$$\begin{aligned} \text{Risk Reward Ratio} &= (\text{Sell Price} - \text{Entry Price}) / (\text{Entry Price} - \text{Stop Loss}) \\ &= (10 - 7) / (7 - 6.34) = 4.55 \end{aligned}$$

Stocks that have ratios greater than 2 are potential trading candidates. **Better trading candidates** are those that have ratios greater than 3.

Risk reward ratio can also be used as screening criteria for trading candidates.

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Applying a Trading Edge

Nick Katiforis, private client advisor and author, explores the basics of trading options.



Last issue I spoke briefly about the benefits of trading options and how the traders that make money trading them understand and consistently apply an “edge” to their trading of options. I then went on to explain some of the key concepts of trading options using examples. This issue I want to continue the theme of finding out what that “edge” is and how to use it to your advantage when trading. The first principle to give you an edge is that of limited risk.

PRINCIPLE ONE

Limited Risk

Buying options offers unlimited profit potential for a limited risk. When buying options your total risk is the amount you pay for the option plus brokerage. You cannot lose any more than what you paid for the option no matter how far the market goes against you.

High leverage and limited risk is what attracts the majority of option buyers. In comparison to share trading, the extra leverage means your profit potential is magnified, with the loss potential limited to the price paid for the option.

The Benefits of Limited Risk

The major benefit of having limited risk is that it gives you the ability to stick with a trade no matter how far the market goes against you, or how volatile the market becomes. There is no margin to pay as is the case with futures and you cannot be stopped out of your position on a minor correction.

You can hold your position in the market knowing that your maximum loss can be no more than what you paid for the option.

You can then wait patiently for the market to resume moving in your favour once again.

Trading Tip

Options that are purchased with an exercise price reasonably near to where the market is currently trading have a greater probability of becoming profitable. This is because the market does not need to move in your favour as far for you to make a profit. The downside is that because they do have a better chance of being profitable these options will cost more to buy.

Example

- Buying a Gold Call Option

Let's now look at an example of buying a call option to see how this principle of limited risk applies in the commodity markets.

You have a view that the price of gold will rise to \$550 over the next four months. You don't wish to risk too much money in case your forecast is wrong. It is currently mid January. Gold is trading at \$510 per ounce. (Please note that all figures are in US Dollars and exclude brokerage)

Strategy - Buy 1 June 06 Gold Call Option with an exercise price of 530

- Premium (cost) of option is \$1000
- Every \$1 increase in the price of gold above the exercise price (530) at expiry is equal to \$100 in profit.
- Your breakeven point will therefore be at \$540 at expiry to make up for the cost of purchasing the option (\$1000).

The limited risk in this example is the \$1000, which is the premium (cost) of the option. June refers to the month of expiry of the option. The 530 is the exercise price, (price that the buyer of the option has the right to buy gold at if he wishes to exercise his right).

If the price of gold finishes below \$530 when the option expires (June) it will have no value and the amount lost will be the \$1000 initially paid for the option.

The unlimited profit potential in this example refers to the possibility of the price of gold moving above \$540 before or at the expiry of the option. Every \$1 increase above \$540 (our breakeven point) will be an extra \$100 in profit. The higher the price above \$540 the more profit you will earn.

Four Months Later ...

Your forecast is correct. The current price of gold is \$580. The call option you originally bought for \$1000 is now worth \$5,000

How did I come to this figure? I took the current price of gold (in this example \$580), less the exercise price (530) which left me with a profit of \$50. As mentioned earlier each \$1 move in gold is worth \$100 therefore $100 \times \$50$ move in gold = \$5,000.

Less the premium paid for the option (\$1000), this would leave a profit of \$4,000 per option contract.

When you consider that in 1980 gold made a high of \$875, you can see why people are attracted to the commodity markets by the leverage offered by options.

Can I Sell my Option Before Expiry?

Of course you do not have to hold the option to its expiry date. At any time you can sell your option in the market to lock in a profit or a loss.

How much your option will be worth will be a function of the amount of time remaining in the life of the option (the more time to expiry, the more the option will be worth), the current price of the underlying commodity, and how volatile the underlying market is (the more volatile, the higher will be the price of the option).

Trading Tip

Use the limited risk advantage gained by buying options when option volatility is low and the technical pattern or trend of the market suggest a large move is likely to occur.

A Real Life Example

Let's look at an example of a trade that I recommended to my clients in December 2005 that benefited from the limited risk advantage of options.

I recommended buying a February Gold Call Option with an exercise price of 490. The premium paid for this option was US\$850.

By buying an option in gold my clients were able to participate in the gold bull market following the gap move on the 16th December, knowing that the maximum risk they faced was \$850 which was the premium paid for the option. There were a few minor pullbacks along the way but because we held

the option we were able to stay with the trade and managed to capture a good portion of the move in gold. We were stopped out of the move when the market pulled back and triggered our stop of \$523 (you can place stops on options using the underlying market price). By that stage however we had made four times the initial premium that we had paid.

Trading Tip

Take advantage of medium to long-term trends in the market by buying options with three or more months left to expiry. If you are not prepared to risk the whole amount paid for the option, then set exit points either at a pre-determined price level or alternatively if the option loses half its value.

If you have ever traded futures you will know how frustrating it can be to have correctly picked the direction of the market, only to see it briefly turn around and take out your stop loss, before continuing in the original direction once again, this time without you in the trade. Trading options can help you to avoid this situation.

You never know when a good move will take place. There are indicators that can help you, but most of the time what is needed is patience. This means giving your trade the appropriate amount of time to work in your favour.

Limited Risk in Volatile Markets
The limited risk characteristics of buying options are also particularly useful in trading volatile markets, which have the potential for explosive moves and large profits.

Many of these markets you would probably not even consider trading futures with because of high margin costs as well as the high probability of being stopped out on a normal market fluctuation. Buying options however gives you staying power without the unlimited risk associated with futures.

The extreme volatility exhibited in the Coffee market in October 1999 meant that using futures to profit from the upward trend that began in October would have been very expensive due to the high margin requirements at the time. The potential rewards however are very attractive; a move from the low of 80 to the high 140 for one contract would be worth US\$22,500.

The probability of being stopped out of a move like this if you were trading futures would be high. The wider the stop, the higher the risk you would need to be prepared to take in order to stay in the trade.

Holding long-dated options on the other hand would have allowed you to stay in the trade despite the volatility, without incurring any additional risk above what you paid for the option.

Trading Tip

Buy 'cheap' options with an exercise price a long way from the current market price and with limited time to expiry only if you expect a sharp immediate rally or decline to occur. If the move does take place as expected these options offer the greatest leverage. If not, then be prepared to lose the majority of the premium. In options as well as in life, you get what you pay for.

Limited Risk Summary

- Buying put and call options gives you unlimited profit potential with limited risk.
- Buying options offers you high leverage with limited risk.
- Buying options with ample time left to expiry gives you the ability to stick with a trade through a minor correction with limited risk to take advantage of a longer-term trend in the market.
- Buying options incurs no margin.
- At any time up to the expiry of the option that you bought you can sell the option in the market to exit the trade.
- Buying options in potentially volatile markets, eg currency markets, can provide the potential for large gains with limited risk.

Next issue I will examine option time decay of options – what it is, how to minimise the impact on bought options and how to use to gain a trading edge.

Nick is the author of the much acclaimed "Professional Options Strategies for Private Traders". He is a former floor trader at the Sydney Futures Exchange and currently works as a Private Client Adviser with Tricom Futures and Forex in Melbourne, Australia. Nick also publishes the Weekly 'Option Wizz' Commodity Newsletter, available at his website.

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ECONOMIC CALENDAR

JANUARY 2006

Monday	Tuesday	Wednesday	Thursday	Friday
2 Holiday: New Year's Day All Markets Closed	3 EU – 3rd qtr GDP data – PPI data for DecUS – Minutes for Dec 13 FOMC meeting – ISM Mfg data for Dec	4 UK – Consumer credit data for Nov US – Factory order data for Nov EU – CPI data for Dec – Consumer credit data for Nov	5 US – Retail sales data for Dec	6
9 US – Consumer credit data for Nov – Wholesale inventories data for Nov AU – Trade balance data for Nov	10 US – Wholesale trade data for Nov	11 UK – BOE MPC begins two-day meeting AU – Unemployment data for Dec EU – Trade balance data for Nov	12 US – Trade balance data for Nov – Import and export prices for Dec UK – BOE MPC ends two-day meeting to set interest rates EU – ECB meets to set interest rates	13 US – PPI data for Dec – Retail sales data for Dec EU – PPI data for Dec – CPI data for Dec
16	17 EU – Retail sales data for Nov US – Industrial production for Dec	18 US – CPI data for Dec	19 JN – BOJ begins two-day monetary policy meeting US – Housing starts data for Dec – Philadelphia Fed survey for Jan	20
23 EU – Finance ministers hold meeting US – Leading indicators for Dec	24 AU – 4th qtr CPI data US – Consumer confidence data for Jan	25 JN – Minutes from Dec 15-16 BOJ monetary policy meeting EU – Unemployment data for Oct US – Chicago Fed national activity index for Dec – Existing home sales data for Dec	26 US – Durable goods data for Dec	27 US – New homes sales data for Dec – GDP (advance) for Q4 – University of Michigan consumer sentiment index (final) for Jan
30 US – Personal income for Dec	31 US – FOMC meets to set interest rates – Chicago PMI report for Jan UK – Consumer credit data for Dec EU – Unemployment data for Dec			

Legend

BoE = Bank of England BoJ = Bank of Japan CPI = Consumer price index CPM = Chicago Purchasing Managers
 ECB = European Central Bank EU = European Union FOMC = Federal Open Market Committee GDP = Gross Domestic Product
 MPC = Monetary Policy Committee NAPM = National Association of Purchasing Managers PPI = Producer price index



FEBRUARY 2006

Monday	Tuesday	Wednesday	Thursday	Friday
		1 US – ISM Mfg data for Jan	2 EU – ECB meets to set interest rates	3 US – Factory order data for Dec
6	7 US – Consumer credit data for Dec	8 JN – BOJ begins two-day monetary policy meeting UK – BOE MPC begins two-day meeting	9 UK – BOE MPC ends two-day meeting to set interest rates US – Wholesale trade data for Dec	10 US – Trade balance data for Dec
13	14 US – Retail sales data for Jan	15 US – Industrial production for Jan	16 US – Housing starts data for Jan – Import and export prices for Jan – Philadelphia Fed survey for Feb	17 US – PPI data for Jan
20	21 US – Leading indicators for Jan	22 US – CPI data for Jan	23	24 US – Durable goods data for Jan
27 US – New homes sales data for Jan	28 US – Consumer confidence data for Feb – Existing home sales data for Jan – GDP Q4p – Chicago PMI report for Feb			

Economic release	Release time (EST)	Economic release	Release time (EST)	Economic release	Release time (EST)
GDP	8.30am	Housing starts	8.30am	Construction spending	10 am
CPI	8.30am	Production & capacity utilization	9.15am	CPM report	10 am
ECI	8.30am	Leading indicators	10 am	Report on business on-manufacturing	10 am
Employment	8.30am	Consumer confidence	10 am	report on business	10 am
Personal income	8.30am	Uni of Mic consumer sentiment	10 am	New home sales	10 am
Business inventories	8.30am	Wholesale inventories	10 am	Chicago Fed national activity index	10 am
Durable goods	8.30am	Philadelphia Fed survey	10 am	Federal budget	2 pm
Retail sales	8.30am	Existing home sales	10 am	Consumer credit	3 pm

The information on this page is subject to change. The Trader's Journal is not responsible for the accuracy of calendar dates beyond press time.

UPCOMING EVENTS



1st – 4th February 2006

The World Money Show

The World Money Show, now in its second year, attracted over 10,600 high-net-worth investors, traders, and financial advisors with over 250 free workshops and nearly 300 exhibits. You will find highlights from the event including streaming video, and much more!

*Venue: The Gaylord Palms
Resort Orlando, Florida*

Organiser: Intershow

18th – 21st February 2006

Traders Expo

This is the largest and most important event of the year for active traders and as usual they've got some fantastic sessions planned to help you become a more successful trader. If you have time to attend just one event each year to improve your trading, this is the one.

*Venue: Marriott Marquis
Hotel, New York*

Organiser: Intershow

1st March – 2nd March 2006

Derivatives & Securities World

This two day exhibition will showcase the latest business enhancing technologies and services plus giving you the opportunity to meet with over 900 professionals who work in derivatives, securities, risk management and alternative investments.

*Venue: The Forum Messe
Frankfurt, Germany*

Organiser: FOW

15th March – 18th March 2006

31st Annual International Futures Industry Conference

Futures industry professionals attend the International Futures Industry Conference to exchange ideas, share information, discuss trends and network with peers. Boca has been the showcase for innovation. The place to introduce new products and express new ideas. The venue to seek convergence of the industry

*Venue: Boca Raton Resort
& Club, Boca Raton,
Florida*

Organiser: FIA

31st March – 1st April 2006

Forex Trading Expo

The Forex Trading Expo in Ft Lauderdale to learn ways you can confidently trade foreign currency and achieve the success you've been working toward ! Compare trading systems, software programs, charting services, brokers, advisory services and more.

Venue: Ft. Lauderdale

Organiser: Intershow

24th March – 25th March 2006

7th Annual Technical Analysis Expo in Paris

The expo is run by professional Technical Analysts and Traders who work on the markets throughout the year. Their lives revolve around stocks, futures, options or forex, and in order to pass on their knowledge, they have helped us to create this expo - dedicated to TA and Trading.

*Venue: Espace Pierre Cardin;
Paris - France*

Organiser: Salon AT

Note: Timing of events can be subject to change.



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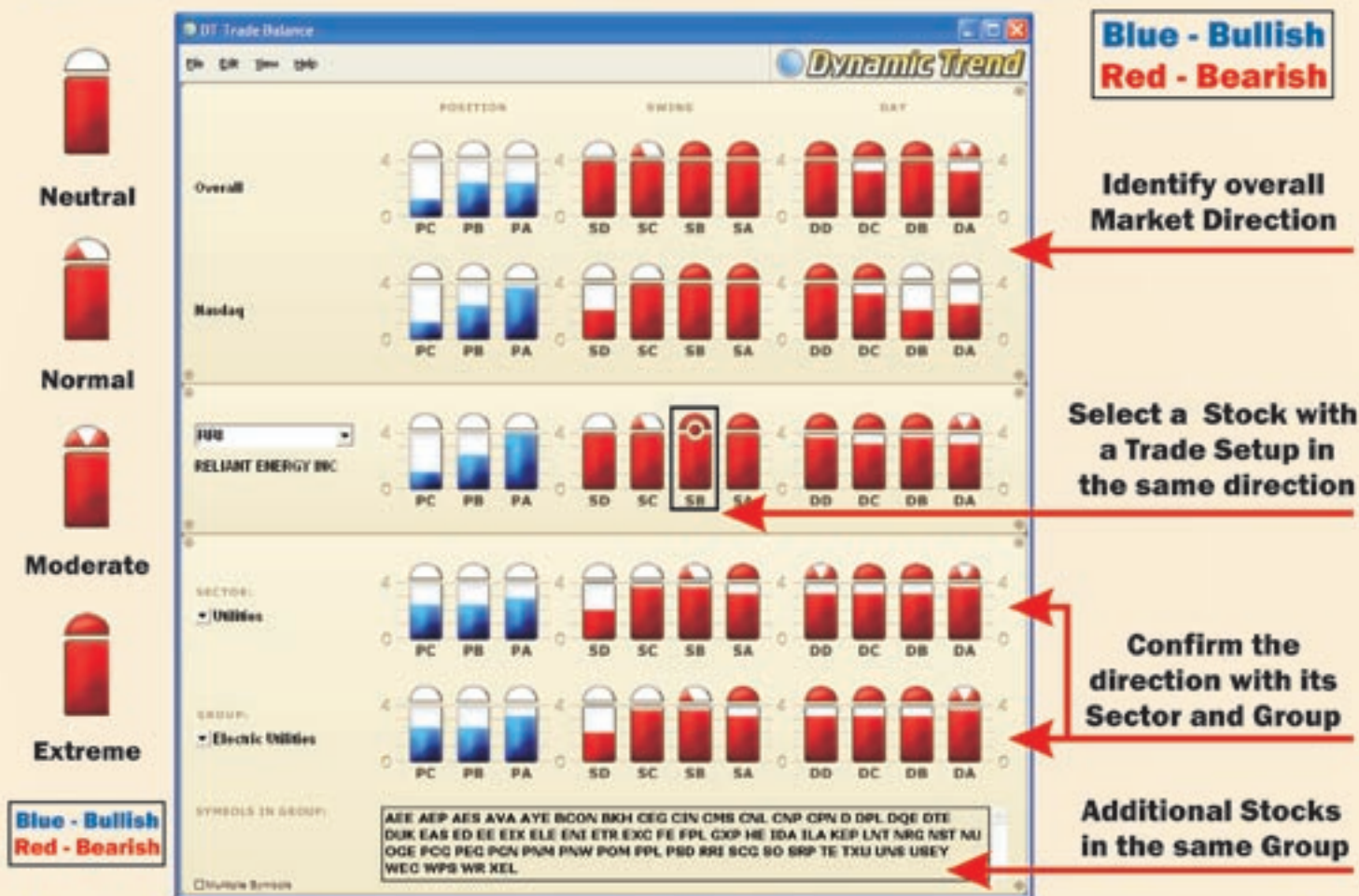
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