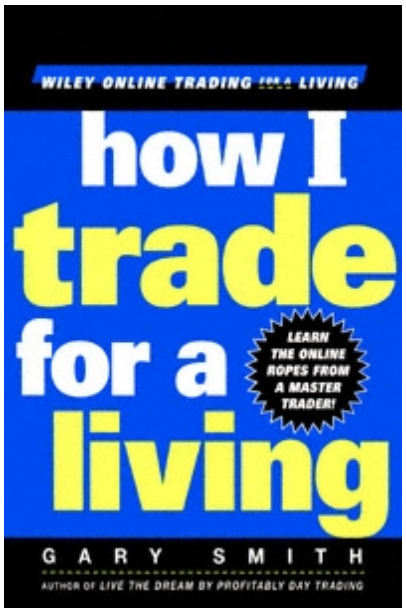
How I Trade for a Living



CRACKED TRADING SOFTWARE

70+ DVD's FOR SALE & EXCHANGE

www.traders-software.com

www.forex-warez.com

www.trading-software-collection.com

www.tradestation-download-free.com

Contacts

andreybbrv@gmail.com
andreybbrv@yandex.ru
Skype: andreybbrv

WILEY ONLINE TRADING FOR A LIVING

Electronic Day Trading to Win/Bob Baird and Craig McBurney

Day Trade Online/Christopher A. Farrell

Trade Options Online/George A. Fontanills

Electronic Day Trading 101/Sunny J. Harris

How I Trade for a Living/Gary Smith

How I Trade for a Living

Gary Smith

John Wiley & Sons, Inc.

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

This book is printed on acid-free paper.

Published by John Wiley & Sons, Inc.

Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Smith, Gary, 1947 Apr. 21–
How I trade for a living / Gary Smith.
p. cm.—(Wiley online trading for a living)
Includes bibliographical references and index.
ISBN 0-471-35514-3 (cloth : alk. paper)
1. Electronic trading of securities. 2. Investments. I. Title.
II. Series.
HG4515.95.S57 2000
332.64'0285—dc21 99-38492

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Nicholas Darvas.
Your trading methodology had a big impact
on an impressionable 14-year-old in 1961.

Bruce Babcock.
I will be forever appreciative
of everything you did for me.

My parents, Sidney and Esther Smith.

And, of course, Sandy and the gang—
Bandit, Whitney, Beige, Lover Girl, Samson,
Tomas, and King.

Contents

Acknowledgments	ix
Prologue A Typical Trading Day	1
Introduction	5
Chapter 1 Help for a Desperate Trader	9
Chapter 2 Dreams of Easy Money	17
Chapter 3 The Futures Market Beckons	23
Chapter 4 Almost Down for the Count	31
Chapter 5 Putting it All Together	41

Chapter 6 45
Why the Stock Market?

Chapter 7 51
Trading is a Profession

Chapter 8 61
Perceptual Trading Filters

Chapter 9 67
My Favorite Indicators

Chapter 10 91
Technical Indicators

Chapter 11 103
Monthly Seasonality

Chapter 12 111
The Nitty-Gritty of Trading

Chapter 13 151
Money Management

Chapter 14 155
Trading Mutual Funds

Chapter 15 183
Trading Junk Bond Funds

Chapter 16 193
Trading Stock Index Futures

Epilogue 229
Strictly Personal

Recommended Resources 231
Reading and Researching Your Way to Success

Endnotes 241

Index 249

Acknowledgments

The three people who helped me most with the charts in *How I Trade for a Living* deserve special recognition: Bob Miller of Foremost Futures, Chicago, Illinois; Jonathan Matte of Defender Capital, Portland, Oregon, and, most especially, Janet Boivin for her time and patience.

Special thanks also to Carl Swenlin at DecisionPoint.com, Eric Calvert at Caveland.net in Glasgow, Kentucky, and John Bollinger CFA, CMT of Bollinger Capital Management and Equitytrader.com.

My editor Pamela van Giessen and her assistant Mary Todd are to be commended for effectively dealing with my frustrations during the writing of the manuscript.

Michael Detweiler, managing editor at John Wiley & Sons, and Ginny Carroll, of North Market Street Graphics, deserve special mention for their professional handling of the day-to-day production of my book.

Prologue—
A Typical Trading Day

Many traders would be disappointed at how I spend a typical trading day. It's not glamorous nor is it bone-chillingly exciting. That's fine with me because I don't trade for a living for either the glamour or the excitement. I do it for the money and the freedom it brings me.

Prior to 1996 I lived out west in Reno, Nevada. Since that time I have lived in the cave-and-cow country of south central Kentucky. The town I reside in reminds me of something out of a 1960s sitcom—like Andy Griffith's Mayberry. After all, our county sheriff is named Barney and the guy who runs the local body shop is Goober. But I digress.

I don't get up in the morning until the 9:30 (sometimes later) opening of the stock market. What can I say? Ever since my childhood I have been a late riser. When I lived out west I never slept well knowing I had to be up for the 6:30 A.M. PST opening. Everyday I battled constant fatigue. Since living in the east, I'm always refreshed. However, I do set my VCR to begin recording CNBC at 8:00 A.M.

I try to be up by the 9:30 opening since the first 50 minutes of trading often sets the tone for the day. The action of the futures during that time period can often portend how the rest of the day will unfold. It's also during this first 50 minutes of trading that I'm most alert to any developing strength, weakness, or divergences that may be evident on the tape.

I'll eat my breakfast/lunch at 10:30 A.M. and review my CNBC tape for any relevant news or interviews I missed during the 1 1/2 hours prior to the market open. After that quick review, I begin recording again. I always have my recorder running during trading hours and the two hours after the close. I don't want to miss anything.

Around 11:00 A.M., I turn on my computer and check my e-mails and what's going on in some of the newsgroups. I then check the foreign markets at Yahoo.com and the portfolios of any funds I may be trading or thinking about trading at Quicken.com. This is something I do throughout the trading day. I also check how the various industry groups are performing at the www.dailystocks.com Web site. It's important for me to know each day precisely where the action is in the market.

Between 12:00 and 3:00 P.M. I try to sort out the moves I will make in my funds. Almost every day involves a constant adjusting of my trading positions. Will I add or decrease my exposure to the market? I stay in close contact with the CNBC ticker tape throughout the day. I'm sensitive to the slightest changes occurring intraday between the Dow, Standard & Poor's (S&P), the Nasdaq 100, and the Russell 2000 indexes.

I am not glued to the TV screen during the trading day until 3:00 P.M. Prior to that time I will shower and if necessary run an errand or two to the bank, post office, or grocery. If I do go out, I play back my tape upon returning to check the behavior of the market while I was gone. It's important that I stay in synch with the daily rhythm of the market. In the old days I couldn't trade without reading my *Wall Street Journal* and *Investor's Business Daily* as soon as I got up. Now that I trade primarily pure price action (momentum and divergences), I don't read these papers until much later in the trading day.

Between 3:00 and 4:00 P.M. it's showtime, especially the last 30 minutes. This is the home stretch and I have to get ready to make my move before the close of trading. Going into the last hour, I always have some idea of the moves I will be making at the close. In the last hour I'm completely focused on the tape, the stocks in my portfolio, and the action in the various indexes. It's during the last hour that I formulate an exact trading plan, detailing how much and into which fund. There is usually a fake-out move, albeit slight, in the market between 3:30 and 3:45. I call this the Rydex jiggle. The market likes to confuse the Rydex timers, since their orders have to be in before 3:45.

I call INVESCO between 3:50 and 4:00 P.M. It can get hectic if I also

have to call Janus and Strong. INVESCO and Strong rarely put you on hold for more than a few seconds, but Janus can take much longer. Sometimes during the time I'm on hold with INVESCO I will change the amount of my purchases based on how the market is trading while I'm on hold.

Between 4:00 and 4:15 P.M. I watch to see how much of a premium or discount to fair value the S&P futures are closing in Chicago. I usually stay around home until 5:30, listening to CNBC while reading my financial papers and magazines. During this time I will also review the various market summaries at Marketwatch.com. Between 5:00 and 5:30 Moneynet.com usually has the closing prices for my funds. I live and die for 5:30 in the afternoon. After getting closing fund prices I go out for my afternoon run.

My day isn't over at 5:30, however. I'll check in throughout the evening to see how the S&P futures are trading on Globex. I will also periodically look in to see how the Asian markets are trading, as well as to get any late-breaking business news at Yahoo.com.

I am focused on trading 24 hours a day. I'm always going over possible market scenarios in my mind and how they might affect my fund position. I'm constantly strategizing my response to potential market scenarios. Even when I get up in the middle of the night, my mind is always on the market and what I will do the next trading day if this or that happens.

Now that I've described a typical trading day and it appears that I have no life, let me say that I do have the freedom to go away for the day—maybe shopping or to the art museum or the zoo in Louisville, which is 100 miles to the north. When I'm out during the day it is usually because I don't expect to be making any adjustments to my trading account. But that can change if the market doesn't cooperate, so a phone is a necessity. Through a quote line available from my futures broker, I can access all the cash indexes I need—the Dow, S&P, Nasdaq 100, and Russell 2000. Many times when I was out for the day I have made unexpected moves in my account.

I sometimes wonder about the relevance of my daily trading rituals. Between Friday morning, October 16, 1998, and Thursday evening, October 22, I was on a cross-country trip, helping a friend move. During the trading days that period encompassed, all I was able to do marketwise was monitor the Dow, S&P, Nasdaq 100, and Russell 2000 via telephone. That was an active week in the market, especially for the

Russell 2000, and I made significant increases to my trading positions. During this week I went without CNBC, the Internet, and my financial publications, yet I still made over $10,000.

I do not have trading buddies with whom I converse during the trading day. I never much liked the idea of having trading buddies since I've always played a lone hand. I don't want to be swayed by the opinions of other traders during the day. And, frankly, I can't think of any trader whose opinion I respect. However, it could be argued that my participation in the chat rooms and newsgroups, where I'm constantly exposed to all sorts of opinions during trading hours, isn't much different from having a trading buddy.

Introduction

If you are a trader or aspiring trader and the stock market is your thing, then this book is for you. It doesn't matter if your trading weapon of choice is individual stocks, mutual funds, equity or index options, stock index futures, or the index-based shares on the American Stock Exchange (AMEX) such as the S&P Spiders or the Dow Diamonds. Regardless of your preferred trading weapon, the challenge remains the same: being in synch with the rhythm and momentum of the market. The trading strategies and philosophies presented in *How I Trade for a Living* will enable you to better understand price action to exploit that momentum.

How I Trade for a Living will detail as precisely as possible all the trading techniques I use to trade for a living. More than that, it will be a distillation of everything I have learned over a 33-year trading career—the good, the bad, and the ugly. I must be doing something right. After spending more years than I care to remember as a going-nowhere, break-even trader, everything finally fell into place for me. Since my trading awakening, I have methodically traded $2,200 into over $650,000 with virtually no losing months along the way.

Be aware that I'm not some flash in the pan who, thanks to an ebullient stock market, has just recently began making money as a

trader. Nor am I some faded trading star whose best years are behind him and who has resorted to writing books to sustain himself. I've been making money every year since 1985, and 1998 was my best trading year to date, with a gain of over $196,000.

It was a plea for help from a desperate and losing trader that initially motivated me to write this book. You will read about that desperate trader in Chapter 1. However, once I began writing *How I Trade for a Living*, I realized there were other factors motivating me besides that letter of despair.

One reason is the public's misconceptions of what is really involved in trading for a living. These misconceptions are nurtured by a never ending bounty of books, systems, seminars, newsletters, and fax services with their promises of risk-free and instant trading wealth. But it's all fairy-tale hype from the dream merchants. If you took the time to investigate the outrageous claims of these masters of manipulation, you would find that none of them are trading for a living themselves. They are great at talking the talk, but woefully inept at walking the walk. My book is one of the few from someone who can do *both* the talk as well as the walk.

Another motivation for this book was to counter the proliferation of current trading books authored by academics and theoreticians with limited or no hands-ons trading experiences. These books dazzle you with statistical studies, charts, and price patterns that only work retrospectively or because of the well-chosen examples used by the writers. No evidence is presented that the methods have ever worked for the authors over any extended period of time using real money. *How I Trade for a Living* details techniques and strategies based on actual trades over many years.

This book also stands as evidence that successful home-based trading is within the grasp of the average trader. Everyone has read about the trading exploits of the well-known market wizards and other superstar traders. But upon closer examination, you will notice that most of these highly publicized traders are not home-based, nor do they live solely off the profits from their own trading accounts. Instead, you'll find that they are floor traders in New York or Chicago, or they work as hedge fund managers and trading advisors, managing millions of dollars of other people's money. One then begins to wonder if trading success is reserved only for these heavy hitters and big-name players. Rest assured that it's not.

Unlike many recently released trading books, this book was not written as a front to promote some newsletter, fax service, or trading seminar. My reputation is that of someone who trades for a living and I want to keep it that way. The last place you will ever find me is on the seminar circuit hustling an expensive trading course or on the Internet peddling a trading-related service for a fee.

Chapter 1—
Help for a Desperate Trader

During the early to mid-1990s, I was a full-fledged member of the vendoring establishment. I wrote and marketed several manuals on day trading stock index futures. But unlike a lot of vendors, I actually knew a thing or two about trading and had been successful at the game for many years prior to my stint as a marketeer.

My day trading materials were well received within the trading community. As a result, I received numerous invitations to speak at trading seminars and was profiled in several national trading publications. Much of the notoriety resulted not so much from how much money I made as a trader, but from my trading consistency. Over a 10-year period, I rarely encountered a losing month. I garnered additional publicity for my willingness to provide years of real money-trading statements to document my trading prowess—a practice almost unheard of in the vendoring business.

It was never my intent, though, to seek fame and fortune as a seller of trading-related products. Instead, I wanted my reputation to be that of someone who successfully traded for a living. So in early 1996, I turned over my trading manuals to an outside marketing company and walked away from the limelight. I had no intentions of ever returning to Vendorland.

Once out of the spotlight, my trading thrived as never before. I was perfectly content in my life as a private trader. Then one day I opened my mail and found the following letter: "I'm a desperate trader, desperate to succeed. I left my job about eight months ago and was pretty optimistic. I have tried to do everything right. I bought the best computer, the best software, the best data feed, had a mentor, and paid $2,500 for a trading system. . . . I can honestly say that there isn't another trader that works harder than I do. I have completely dedicated myself and all my power and energy to learning and becoming successful at trading . . ."

The letter writer went on to say how he had worked two jobs for eight years to save $100,000 for his opportunity to trade. But everything had fallen apart. The system didn't work, his mentor turned out to be a crook who was fined by the regulatory authorities, and his $ 100,000 had been reduced to less than $10,000. At the end of the letter he asked if I could help him become profitable. He was frustrated that he had worked so hard and learned so much but couldn't seem to get his arms around it.

Although not particularly noted for my altruism, I was, nonetheless, affected by the letter. I truly felt the pain and frustration of this desperate and losing trader. That's probably because, for more years than I care to remember, I, too, desperately sought the answers on how to succeed in the trading game. So to help the desperate letter writer and others like him, I decided to return to Vendorland by writing *How I Trade for a Living*. During my struggles, there were many trading books that I looked upon as inspiration in my quest for trading success. Hopefully, many of you will regard this book as your inspiration for becoming a winning trader.

My Trading Credentials

Since you won't ever find my name among those of the elite hedge fund managers or trading advisors, you might wonder what my credentials are for writing a book about the realities of trading for a living. I'm a professional home-based trader whose trading passion is the stock market. Trading for a living was a dream of mine ever since 1961 when I was 14 years of age and read Nicholas Darvas's book, *How I Made Two Million Dollars in the Stock Market*. [1]

The road to successfully trading for a living was bumpy and filled with numerous potholes. I stumbled blindly for 19 years as a part-time

and break-even trader with a trading account that fluctuated between $2,000 and $4,500. My epiphany as a trader came in March 1985. After nearly 20 years of dreaming, wishing, and praying for trading success, it finally fell into place for me.

Since the spring of 1985, my trading capital has steadily increased without interruption. At the time of my trading epiphany, I had only $2,200 in my account. Today, despite withdrawals along the way for taxes and living expenses, my trading account is valued at over $650,000. Over the past several years I have averaged in excess of $10,000 in monthly trading profits. My hallmark as a trader is consistency. Losing months over the past 14 years have been a rarity, averaging about 1 per 20 months, and no monthly loss has exceeded $2,000.

I trade according to the philosophy that wealth accumulation involves a systematic and disciplined compounding of trading capital over time. As capital accumulates and compounds each year, so will trading profits. Never in my wildest dreams did I ever imagine my capital would compound to such a degree that I would be cranking out $196,000 in annual returns, as in 1998.

I apologize for what some readers may construe as unseemly boasting about my trading exploits. I do this only because I'm a stickler for credentials. And after all, one reason to purchase this book is to learn firsthand the realities of successful trading from a practitioner, instead of from someone who merely pontificates. There are far too many personalities in this business who predict, promote, or peddle trading tools, yet can't trade their way out of a paper bag.

Table 1. 1 and Figure 1. 1 show my monthly trading performance for 1996 through 1998 and the first eight months of 1999. Since I've been so outspoken in the past against traders who make unsubstantiated trading claims, my trading statements (for all my accounts) documenting these results are on file with not only the publisher of this book, but also an independent third party, Courtney Smith, the publisher of *Commodity Traders Consumer Reports*. [2] Courtney was chosen because, like myself, he has a long background in trading stocks, options, futures, and mutual funds.

Marching to a Different Beat

This is not a conventional book about conventional trading methods such as chart patterns, moving averages, and oscillators. I never found these overused methods to work very well. It is also not a book about

table 1.1 trading results by year

1999 Trading Results (through August)	**$63,099.19**
January	$14,228.59
February	(-1,788.50)
March	11,920.60
April	19,443.74
May	450.28
June	4,607.91
July	4,027.63
August	10,208.94
1998 Trading Results	**$196,390.24**
January	$8,596.69
February	19,953.82
March	29,317.18
April	8,265.19
May	3,038.30
June	12,192.73
July	13,315.15
August	2,298.34
September	3,925.27
October	23,468.39
November	59,190.88
December	12,828.30

(*table continued on next page*)

arcane trading strategies or complicated and esoteric mathematical formulae. I don't believe successful trading has anything to do with waves, cycles, astrology, numbers, ratios, numerical series, cubes, or lines drawn on a graph.

Fasten your seat belts while reading this book. There will be places you'll find yourself vehemently disagreeing with me. That's because I march to the beat of a different drummer in my trading philosophies. My personality, whether you love it or hate it, is what makes me tick as a trader.

For instance, besides not believing in charts and oscillators, I think all the glitzy equipment and software so frequently advertised for

(*table continued from previous page*)

table 1.1 trading results by year (*continued*)

1997 Trading Results	**$113,015.54**
January	$10,394.36
February	11,556.47
March	(-1,958.46)
April	8,788.59
May	18,374.48
June	11,348.71
July	16,708.22
August	4,851.26
September	16,408.76
October	4,105.60
November	4,043.72
December	8,393.83
1996 Trading Results	**$72,511.88**
January	$4,752.12
February	5,374.55
March	253.89
April	4,560.14
May	10,047.18
June	5,300.58
July	2,621.08
August	8,255.24
September	12,153.31
October	2,270.03
November	7,750.26
December	9,173.50

traders are unnecessary expenses. All I've ever needed to trade successfully has been the CNBC business station and a telephone. I'm also a very emotional trader who operates with a complete lack of confidence—losing trades eat away at me for days, sometimes weeks, at a time. That runs counter to the conventional wisdom of the psychological trading gurus on what it takes to be a successful trader.

Throughout *How I Trade for a Living* you will notice references to other trading books. I collect them and have accumulated a library of over 450 books. Many of these books aren't in the mainstream of trad-

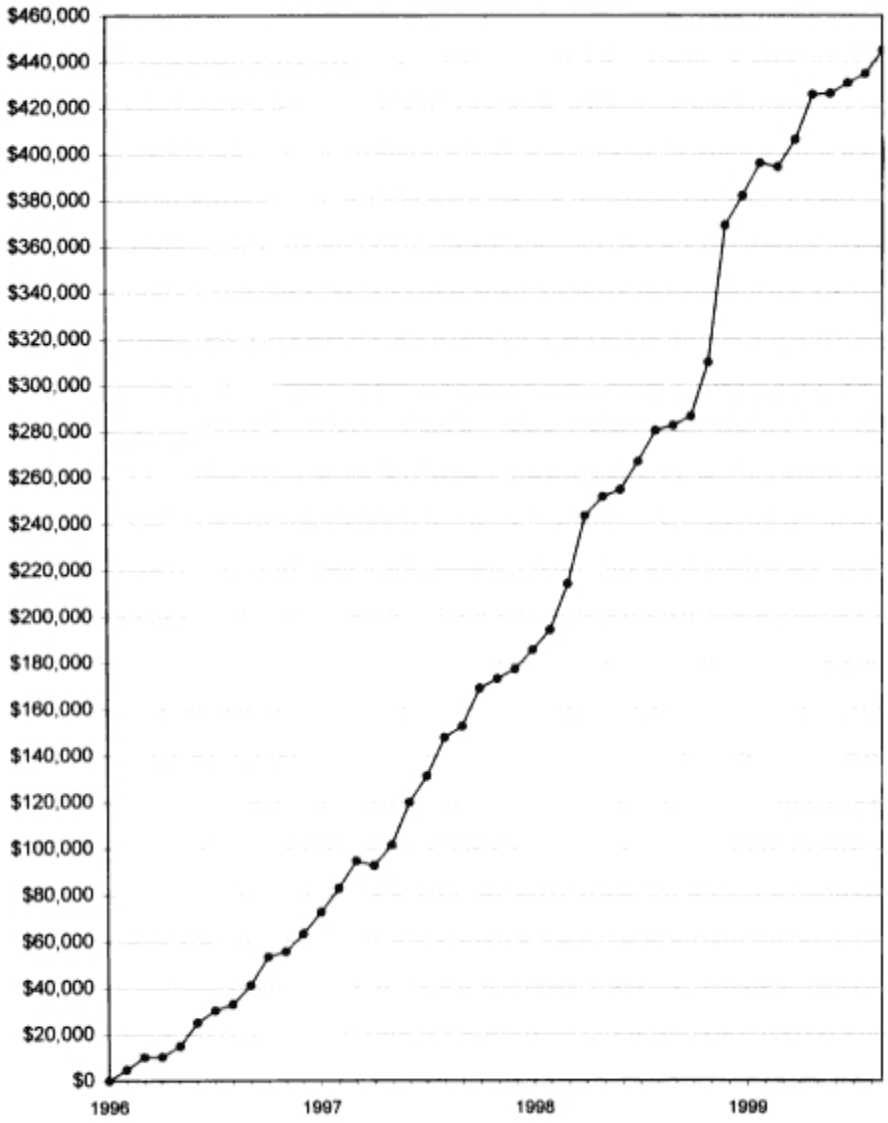


Figure 1.1
gary smith's real-time equity curve, january 1996-august 1999

ing literature and some are out of print. These books ingrained in me valuable trading principles, which eventually contributed to my trading success. In particular, the books from the 1960s and early 1970s are gems that reveal great insight.

Besides enjoying a reputation as a successful trader, I'm also known in the trading industry as a basher of vendors—especially those vendors who misrepresent themselves as trading for a living, when, in fact, all their income is derived from vendoring. However, I will not use this book as a forum to trash any vendors personally.

How I Trade for a Living was not written as an autobiography. It would be presumptuous for me to believe anyone would be interested in the intimate details of my personal life or my political and religious views. Yet I believe it is important throughout the next few chapters to detail my evolution as a trader. To better appreciate my trading accomplishments, it is helpful to first understand my initial trading failures. Many of you will identify with my plight, especially in my early years.

Some people may dismiss these trading achievements by attributing them to a particular innate talent or ability. Poppycock! That's simply an excuse for believing they can't emulate my trading results. The years of adversity I endured prior to becoming successful should dispel the notion that I have any special trading skills.

A few caveats about the way I trade. Trading, for me, is a very simple process. However, it took many years of struggling with needless complexities before I discovered the simplicity of the game. Be forewarned that my trading style has evolved over time and through much practice. You aren't expected to grasp everything at once. I'm not here to try and make anyone a Gary Smith trading clone. Take whatever bits and pieces of these insights and strategies you feel most comfortable with to incorporate into your own trading style.

Trading is an evolutionary process in which you progress through various stages from novice to advanced beginner, to competent, to proficient, and finally for a few, to expert trader. Regardless of your present status, *How I Trade for a Living* should assist you in your journey to the next level.

Chapter 2—
Dreams of Easy Money

My earliest memory of making money with money is from the fifth grade. Our class went on a field trip to a nearby church carnival. There I had my first experience with the spinning wheel. You could put your nickels, dimes, or quarters on particular sections of the wheel, and if it stopped on your section, you were paid off at a rate anywhere from two to five times your investment. I was fascinated with this seemingly easy way to make money—easy, because it was obvious to even a fifth-grader like myself how certain sections of the wheel seemed to come up more frequently than others. I spent the entire day at that biased roulette-type wheel, and I cleaned up.

This experience with the spinning wheel was the beginning of my search for easy money. Little did I realize that this would be a long and winding road with numerous obstacles and disappointments. Easy money held an allure for me as a child because of my fierce independence. I knew even then that the adult world of schedules, deadlines, and bosses would never work for me. I needed some way to get rich quick so I could do my own thing when I got older.

My next experience at easy money was in the seventh grade, when my father gave me a collection of coins he had saved from his days as a paper carrier. I took one of those coins, a 1915 commemorative 50-

cent piece, to a local coin dealer and was suddenly enriched by more than $35. Within a few weeks, I sold the rest of my father's horde of coins and netted an additional $150. Although Dad never said anything to me, I don't believe this was what he had in mind when he entrusted me with his collection.

Around this same time, coin collecting was in the throes of its first speculative burst. The game for me then was searching through rolls of coins at the local bank. Many valuable coins were still in circulation. It was simply a matter of finding them and taking them to the local coin dealer in exchange for more than face value.

By 1961, coin speculation was at its height and had evolved into something much like the buying and selling of stocks. Uncirculated rolls of coins were the rage, and prices were soaring. I fully participated in this trading frenzy during the early 1960s. I still recall buying a roll of uncirculated 1955 Philadelphia-minted dimes and reselling them a few months later for a 150 percent return on my investment. Of course, I also remember begging my godparents for $2,500 to invest in some uncirculated rolls of 1950 Denver-minted nickels. Good thing they turned me down, as that investment would still be under water today.

The Siren Call of the Market

Always alert to easy money-making opportunities, I read my first book about the stock market in the fall of 1961. It was Nicholas Darvas's *How I Made Two Million Dollars in the Stock Market*. Although only a high school freshman at the time, I decided after reading the Darvas book that my destiny in life was to trade for a living. To this day, it remains my favorite trading book of all time.

Nicholas Darvas was a professional dancer. His introduction to the stock market came in November 1952 when he was given stock in a Canadian mining company in lieu of cash for a dancing performance. It wasn't until two months later that Darvas checked to see how his stock was performing. Much to his surprise, it had almost quadrupled in price. Darvas wondered if it was always this easy to make a killing in stocks. So he immediately sold his stock and went in search of others that would double and triple in price over such a short time.

Darvas's book details his journey from trading neophyte to million-dollar trader. As an impressionable youngster of 14, I took to heart everything he had to say. It's a good thing I did, too, because I

doubt I ever would have made it as a trader if my introduction to the trading game had been through any other source.

Nicholas Darvas instilled in me the basic principles of successful trading: Trade the trend, cut your losses, and use a trailing stop as you allow your profits to run. More important, Darvas taught me that the only thing that really matters is price action itself.

A couple of years later, I read a second book about the market and trading, Benton Davis's *Dow 1000*. [1] Good luck trying to find this little treasure—it's out of print and difficult to locate even at the used bookstores that specialize in old and rare books on the stock market.

This book reinforced what I learned from Nicholas Darvas about trading the trend and buying strength and selling weakness. Other insights from the Davis book include his contention that "the basic fact of life in Wall Street boils down to just one thing: the action of the market itself. . . . The stock market is always right and always tells its own story best. . . . Stock market success comes from following a principle. The principle of everlastingly keeping your funds invested in the best performing issues.[2]

Both *How I Made Two Million Dollars in the Stock Market* and *Dow 1000* also contain some underlying psychological themes: There are no experts in the trading arena, and if you ever hope to be a success, you have to do the work yourself. Forget about the hot tips, the gurus of the day, and the newsletter seers.

Not that I needed convincing, but the next book I read about trading, *Wiped Out*,[3] really drove home the point that there aren't any experts who can see into the future. This slim, 125-page book was written by an anonymous investor. Set during the great bull market of the late 1950s and early 1960s, it's the sad tale of how a trader watched his $62,000 account dwindle to $297.78.

The anonymous author of *Wiped Out* spent nearly seven years chasing down hot tips and purported trading experts in his search for easy money. Perhaps if he had immersed himself more deeply in an understanding of trading mechanics, he would not have lost his entire trading account. What really annoyed me about *Wiped Out* was how the writer had the gall to bad-mouth Nicholas Darvas's book. He said it was "heady and dangerous inspiration to the novice."[4] Pretty strong words from someone who couldn't adhere to the most basic of Darvas' principles—that is, cut your losses.

The fourth book I read on trading was the classic *Reminiscences of*

a Stock Operator by Edwin LeFevre, [5] which is the story of the most acclaimed trader of all time, Jesse Livermore. *Reminiscences of a Stock Operator* is probably the most frequently quoted trading book and a favorite of many of the market wizards profiled by Jack Schwager.[6, 7] Throughout the course of my trading career, I've read and reread this book more than a dozen times. Even though it was written in 1923, the book is as timely today as back then. You will find more insights into the trading game in *Reminiscences* than in any other trading book.

Jesse Livermore was the consummate tape reader. He used the tape for clues to the strength and weakness of not only individual stocks, but the overall market. The most valuable information I learned from Livermore's techniques was his method of scaling into trades. Much like Darvas, Livermore would continually buy more shares of stock as prices moved in his favor after his initial purchase. You will see later in this book how I implement this type of trading strategy.

As brilliant as Livermore was, he never mastered the psychological aspects of the game. As described by Benton Davis in *Dow 1000,* "Livermore's success was due to an innate brilliance with figures and a complete lack of the thing most of us are endowed with—caution."[8] Livermore was a boom-or-bust trader and at least four times in his career went completely bust. Once the Securities and Exchange Commission (SEC) was established in the early 1930s and outlawed various types of market manipulations, Livermore was rendered impotent as a trader. He ended his life in 1940 with a bullet to his brain. In his suicide note he said that he considered his life a failure. His estate was valued at less than $10,000.[9]

Let the Games Begin

I made my first stock purchase in the fall of 1966: five shares of Chrysler for $200. At the time, I was a sophomore at the University of Dayton in Ohio. A few months later I sold my coin collection for $2,000 so I would have more capital to trade. During the remainder of my college years, I rarely opened a book unless it was related to the stock market. My time in the classroom was spent daydreaming how someday I was going to get filthy rich in the market.

Unfortunately, during my first few years of trading, I didn't come anywhere close to translating into reality my daydreams of getting rich. But it wasn't for want of opportunity—1967 and 1968 were vintage

years for traders and speculators. Known as the go-go years, stocks listed on the American Stock Exchange sizzled, rising 66 percent in 1967 and 33 percent in 1968. Stocks in nursing homes and mobile home manufacturers tripled and quadrupled—and more—in price. I was there and played all the hot stocks, but made nothing.

I learned early in my trading career that reading all the great trading books was one thing, but trading with real money was entirely another. When you're operating in the real trading world, the psychology of trading comes into play. At 21 and 22 years of age, I was wholly unprepared to handle the mental rigors of trading. One of my fatal trading flaws was thinking I could get rich overnight by taking my small trading stake and turning it into $100,000 instantly. My get-rich-quick trading mentality, coupled with limited trading capital, caused me to violate many of the trading principles I had learned from Darvas and Livermore. While I was in college, my main problem with trading was fear of giving back any profits. That fear prevented me from ever letting my profits run.

Even though I wasn't making any money trading, I never lost my enthusiasm for the markets. My afternoons were spent at the local brokerage office watching the prices roll across the TransLux ticker screen. My nights were spent at the college library reading *Standard & Poor's, Moody's,* and anything else available on stocks. I subscribed to, and memorized from cover to cover, the *Wall Street Journal* and *Barron's*. Believe it or not, there was a time in my life when I could recite the 52-week high, low, and last prices of just about every stock listed on the New York and American Stock Exchanges. Too bad that kind of knowledge never helped me make any money trading.

Into the Real World

I graduated from college in the spring of 1969 and married my high school sweetheart a few months later. I remember well our honeymoon. I was in International Controls, a fast-rising stock during a period when most stocks were trading down, so I had more than just an attractive new wife to be excited about.

My excitement about International Controls, however, turned into sheer panic several weeks later when the stock was abruptly suspended from trading on the American Stock Exchange. If you remember the company's CEO, Robert Vesco, you'll understand the reason for the suspension. When International Controls reopened for trading a month

later, I lost some 50 percent of my investment. That was a big hit for a small-time trader.

The Vietnam War was at its peak during the time of my graduation and marriage in 1969. I had interviewed and been accepted into a training program at the investment trust department of a large Columbus, Ohio-based bank. Apparently, I impressed the bigwigs there with the knowledge I had gained from consuming everything relating to stocks and corporate America. My plans were to work on a master's degree during my employment at the bank and then move on to a less stodgy money management environment. In the 1960s and 1970s, a master's degree was required if you ever wanted to get anywhere in the world of finance.

I never made it to the bank. As a member of the Army Reserves, I was committed to serving several months of basic training. During the wait to be called up for active duty, a recession hit and the bank enacted a hiring freeze. So after active duty, I moved to Cleveland and entered a management program with Sears. I wasn't much of an employee because I was more concerned with trading and following the markets than I was with learning how to become an effective merchandise manager.

Even in my earlier trading days, my life revolved around the stock market. In 1971 I had shoulder surgery. When I awoke from the operation I was throwing up and had a splitting headache, but the first matter of business was to call my broker and see how my stock was performing. You might think I needed to get a life. But I *had* a life—the stock market—and I enjoyed every second of it.

Chapter 3—
The Futures Market Beckons

During my first five years of trading, my account fluctuated between $2,000 and $4,500. I had good times and bad times. But in the end, about the best you could say about my performance was that I was nothing more than a break-even trader. While most of my efforts had been in stocks, I occasionally dabbled in stock options, better known as puts and calls. There were no regulated options exchanges in the late 1960s. Instead, you had to go through dealers who made markets in various stock options. However, just as today, it was the same sucker's game, where the premiums and time decay ate you alive.

Frustrated with my break-even trading results, I made my first foray into the futures market in June 1971. Like most small-time traders with big dreams and limited capital, I was attracted by the leverage of futures and the allure of multiplying my money manyfold if I hit it right. Hogs and pork bellies were where I thought my fortune would be made.

Instead of making a fortune, though, my account was nearly wiped out on my second trade in the commodities market. I learned the hard way what it meant when a market makes a limit move against you. I bought two pork belly contracts the day before an important report. During the next two days I watched in horror as the market moved against me and I was unable to close out my position. Still, I felt this

was just a beginner's mistake and that futures would someday bring me the fortune that trading stocks had denied me.

Working for Sears interfered with my futures trading, so I left the management training program there after one year and took a position as a manager at Spencer's Gifts outside Rochester, New York. I thought that being a manager would allow me the freedom to call my futures broker whenever and as much as I needed. It should come as no surprise that I wasn't a very productive store manager since I was so focused on trading futures. After a year and a half at Spencer's, I was released for lack of production.

Eventually, I moved back to my hometown of Louisville, Kentucky, and became a commodities broker at Clayton Brokerage. At the time, Clayton was one of the largest futures firms in the country. I thought being a broker and watching the prices change after each trade would improve my trading results. This was 1973, the year of the Russian grain purchases and the beginning of a decade-long inflationary spiral. There were times during the summer of 1973 when grain prices traded limit up day after day after day. Even though I was there in the heat of the action, I still couldn't make any money trading.

Stumbling Through the Seventies

I left the brokerage business in late 1973. In an attempt to increase my trading stake, I participated in an assortment of get-rich-quick schemes. Some actually worked, at least for awhile. When silver began skyrocketing at the end of 1973 and the beginning of 1974, I ran newspaper ads seeking to buy silver coins. The public had hoarded a massive amount of silver coins after silver ceased being used in the mintage of coins. They were more than willing to part with some of their hoard when dealers like myself offered two and three times face value. I then shipped the coins to a large buyer in the South who had contracts with smelters in New York.

In 1975 and 1976 1 became affiliated with several southern California companies that were marketing work at home franchises. For a fee of $3,000 each, investors could become jewelry manufacturers by producing wooden pendants and necklaces from their homes. The southern California companies then guaranteed they would buy whatever was produced and retail the merchandise to department stores.

The trouble with these work-at-home schemes was that many of

them were scams operated by fly-by-night companies. When I realized the investors would never see their money again, I contacted the local FBI office in Louisville. This led to an interview on a local television evening news program, where I warned the public to beware of work-at-home business opportunities.

It seemed like I spent the entire decade of the seventies seeking ways to add capital to my trading account. When I wasn't involved in some get-rich-quick scheme, I was working at menial and low-paying jobs, such as being a security guard. At various times in the 1970s, I was a watchman for a local fireplace accessory manufacturer, a nursing home, and, of all things, a convent. I spent many a lonely night dreaming of the day I would finally make it as a trader.

My only positive trading experience in the 1970s involved equity options on the Chicago Board Options Exchange (CBOE). After my father's retirement in late 1975, he gave me $30,000 to manage for him. I ran the account up to $70,000 during the first few months of 1976, primarily trading Merrill Lynch call options. Then I spent the remainder of 1976 giving it all back.

The 1970s was the decade of the commodity trader. Many of those profiled in Jack Schwager's *Market Wizards* attained their fame and fortune by riding the bull markets of that decade. I was trading during all those stupendous bull markets of the 1970s—soybeans in 1973, sugar in 1974, coffee in 1976, and gold in late 1979. Yet what did I have to show for it? Nothing, absolutely nothing.

While I certainly wasn't getting rich trading in the 1970s, I also wasn't losing. Treading water would be a more apt description. Futures brokers considered me a winner since I was able to survive so long without going broke. From my viewpoint, considering the time, aggravation, and lack of trading profits, I was hardly a success story.

If there was one thing I did right in my early trading years that enabled me to stay in the game, it was that I always learned from my mistakes and never repeated them. For instance, the losses I incurred holding those pork belly contracts through a Pig Crop Report taught me never to hold futures through a major report unless I had a big profit cushion going into the report.

In another trade I vividly recall, I got decimated trading six wheat contracts, even though the market had made only a small countertrend move against me. I learned then and there what can happen when you overtrade by loading up on too many contracts.

In the late 1970s I was routed by, of all things, a small two-lot trade in the slow-moving Mid-America corn market. In my Mid-Am corn trade I didn't place a stop, since I figured such a small position couldn't hurt me much if prices went against me. But I was definitely hurt as I watched the market slowly erode day after day, and I ended up losing a significant amount of money before I closed out the trade. The positive result was that never again would I make a trade without setting a stop-loss point.

Horses and Roulette Wheels

It shouldn't come as a surprise to anyone that I used to be a gambling aficionado. After all, isn't gambling the ultimate in the pursuit of easy money? Being born and raised in Louisville, Kentucky, resulted in an early introduction to the horses. During my teenage years, Louisville had three racetracks, two for thoroughbreds and one for standardbreds (pacers and trotters). I was able to play the horses from an early age since the tracks never enforced their 21-and-over betting rule. I spent most of my college summer vacations at the local racetracks. My experience with betting the horses was on par with my trading of stocks: strictly break-even.

During the mid-1970s I became intrigued with blackjack and how you could beat the casinos by counting cards. While I never was blessed with any special intellectual skills, one thing the good Lord did bestow on me was a near-photographic memory. Memorizing which cards were still in the deck was a snap for me. I was also fascinated with biased roulette wheels. Because of normal wear and tear, many roulette wheels become mechanically imperfect, thus creating betting opportunities along particular sectors of the wheel.

I made my first gambling trip to the casinos in December 1974. I chose Reno since, unlike Las Vegas, it had a casino with a single-zero roulette wheel, which gives the gambler better odds than wheels that have both a single-zero and a double-zero. When I arrived in Reno, I immediately went to Del Webb's Primadonna Casino and spent 30 hours at the blackjack tables. I was thrilled because I made $350 dollars in the process. Later I went across the street to the Nevada Club and began clocking their single-zero roulette wheel.

Clocking a wheel involves spending hours and even days recording every single spin of the wheel. The purpose of this is to see if any particular number or sectors of the wheel are coming up more fre-

quently than statistics would dictate. In other words, you're looking for a mechanically biased wheel. I really hit pay dirt here. Not only did the wheel have a bias, but the bias was more pronounced, depending on the dealer. The dealers often got into a rhythm in the way they spun the wheel. I made more than $900 during a two-hour period, betting only small chips.

My first visit to Reno was cut short because I needed to return to Louisville for the Christmas holidays. However, I returned to Reno in February 1975 and then again in November 1975. My results on those return visits, while not spectacular, were consistently profitable. I vowed that someday I would return to Reno on a permanent basis.

It Had to Got Better in the Eighties

No one was happier than me to see the 1980s roll around. At least from a financial and trading standpoint, I figured they had to be better than the 1970s. There was, however, one financial positive that came out of the late 1970s for me. I went to work on a part-time basis as an insurance investigator for Equifax Services in 1978. This was a job that paid well and gave me the flexibility to watch the market at my leisure. It was also a fun job and one at which I was very competent.

Frustrated at my continual inability to profit from trading futures during the 1970s, I decided to refocus my efforts in stock and stock options. I bought Merrill Lynch call options on April 21, 1980. I remember that day well because not only was it my birthday, but it was the day the Dow made its 1980 low. Yet somehow I mismanaged the trade to such an extent that I barely came out ahead.

In July 1980, I decided to transfer from the Louisville to the Reno Equifax office. Along with the transfer, I was offered a full-time salaried position. That wasn't as bad as it sounded since I could still work when I wanted, if I wanted, and as much as I wanted. The markets also closed three hours earlier in the afternoons in Reno, giving me time for my Equifax duties.

In the early 1980s, I became even more consumed by trading. The results weren't any better than they had been in the 1970s, as I still couldn't get my account beyond $4,500. There was a huge drought-related rally in grains during the summer of 1980. As was my style during the great commodity rallies of the 1970s, I was there at the beginning of the moves, but somehow found a way to only break even.

My inability to succeed as a trader was not for want of trying.

Over the years, I went through the usual evolutionary process all traders seem to go through. At various times in my trading career I put all my energies into such methods as spread trading, seasonals, cycles, and, of course, charting. Not only did I consider myself an expert chartist, but I also was proficient in the arcane art of point and figure charting. I subscribed to all the touted market letters, magazines, and newspapers such as *Commodex, Commodities* (now known as *Futures* magazine), and *Consensus,* which is a weekly paper that details the research reports of the various brokerage firms and advisory services.

Stocks hit a bear market in 1981 and I curtailed my trading. But as 1982 rolled around, I began looking for signs of a bottom. I was quite active through the summer of that year, trading options on E.F. Hutton stock. August 17, 1982, was one of the most explosive buying days ever on the New York Stock Exchange (NYSE). This blastoff was the beginning of the greatest bull market of all time. And—you guessed it—I was long going into August 17. Yet even though the market skyrocketed through the end of the year, my account went nowhere.

In 1983, for the first time in my trading career, I questioned whether I had the talent, skills, or whatever to become a full-time trader. I can still vividly recall sitting in the bleachers at a ball game one summer afternoon, wondering how I could have gone so wrong. The stock market had risen nonstop since August 1982, yet here I was, the so-called expert, with nothing to show for it. My girlfriend at the time suggested I get psychiatric help for my problem, which, she said, was a gambling addiction—the stock and futures market being my avenues of addiction.

I never really considered myself to have a gambling addiction. In fact, by 1983 1 had completely quit playing blackjack, roulette, and the horses. Even though I could consistently make money playing blackjack, I found it tedious and boring. The stench of cigarette smoke, combined with the lowlifes who patronized casinos, was a major turnoff. I enjoyed roulette much more than blackjack. But when it became apparent to the dealers that I could beat them at roulette, they made my visits as unpleasant as possible. They would spin the wheel and yell out, "No more bets," before I could get all my chips on the table. And the seedy characters who frequented the low-chip minimum roulette wheels were much worse than those who hung out at the blackjack tables.

I've never been too enthused with people who, after suddenly finding the path, become outspoken critics of their former way of life.

You know the types: the ex-smokers who preach about the evils of smoking or the reformed felons who suddenly find God and try to convert the world. So without getting too high on my soapbox, let me just repeat the sage words given to Victor Niederhoffer by his father: "All gamblers die broke and most of them become degenerates along the way." [1] It's been more than a decade since I have so much as put a quarter into a slot machine. When I patronize the racetrack, I never bet. I simply enjoy watching the competition among horses, trainers, and jockeys.

Chapter 4—
Almost down for the Count

In 1983 and 1984 I sustained back-to-back losing years. I was totally lost and adrift. After 18 years in the game, I suddenly realized I was clueless regarding price direction and trend. Nothing made any sense to me. For the first time in my trading career, I sought the advice of the trading gurus. Before then, I had always prided myself on my independence in making trading decisions. Yet it had got me nowhere.

I sought counsel from the gurus of Fibonacci, Gann, computerized oscillators such as the relative strength index (RSI), stochastics, and moving average convergence/divergence (MACD), wave, and cycle theories, even astrology-based trading. But you know what? It became very evident to me that these guys were as clueless as me. None of them traded for a living. Instead, their agenda was marketing some trading tool, service, or newsletter. Their methodologies worked great in hindsight, but were too imprecise to work in the real world of trading.

During the first two months of 1985, I sank to depths I never imagined even existed. I lost on an astonishing 22 of 25 trades. Currencies, bonds, cattle, bellies, beans—you name it and I lost on trading it in early 1985. I'd spent 19 years of my life in search of a dream that had been pure fantasy. Here I was approaching my thirty-eighth birthday and what did I have to show for my life? A measly trading account of

$2,200 and a beat-up old car. To complicate matters further, I learned in late February that, effective April 1, unless I was willing to transfer to the Bay area (no thanks!), my position at Equifax was to be eliminated. So now what? Back to becoming a minimum-wage security guard?

For the first time in 19 years as a trader, I decided to find out where I had gone wrong. Isn't that amazing? Throughout my trading career, I just assumed that someday I would strike it rich, that dreams always come true simply by dreaming. Never once did it occur to me that achieving my dream of trading for a living would require hard work, planning, and discipline. It also requires persistence. But that was one trait I didn't seem to be lacking. After all, even though I never succeeded in the game, here I was 19 years later, still plugging away.

In late February and early March of 1985, I set out to reconstruct as best as possible all of my trades from the past four years. I had never done anything like this before. Instead, I preferred to simply put my bad trades behind me and not question where and why I went wrong. One reason traders continually lose is that they are adept at self-delusion. They are afraid to learn where and why they erred. My problem, however, wasn't so much self-delusion as just plain laziness. I didn't want to be bothered with the minute details of my failing trades.

Now, though, I had no choice but to confront my trading inadequacies. I spent several weeks and over 100 hours poring over my trading statements, looking for recurring fundamental, technical, and psychological deficiencies in my trading approach. Just like a scientist in a laboratory, I meticulously dissected each trade, looking for clues to past failures and successes. Were there particular fundamental and technical indicators or chart patterns that were constantly failing me? Was I trading the trend or trying to pick tops and bottoms? What had the price action been in the days leading up to my trades? What was the price action on the days after I exited my positions? Was I setting my stops too close or too far away? Was I being unduly influenced by the opinions of others, such as newsletter writers? Was there a method or just plain madness in my trading techniques? From this in-depth analysis I hoped to find my weaknesses and strengths as a trader.

Trading Deficiencies

If you get anything out of this book, I hope it's a recognition of the need to scrutinize each and every one of your trades for clues to its failure

or success. My transformation from a break-even trader to a consistently successful trader was almost instantaneous as a result of my rigorous trade-by-trade analysis. While the study of my trading history uncovered numerous deficiencies, I found that my most grievous fault as a trader was operating without any goals or master plan. All I ever had was the dream of trading for a living and getting filthy rich in the process. Yet not once in nearly two decades in the trading game had I set any goals for how to translate that dream into reality.

In March 1985, I set a trading goal that still guides me today: to be profitable every month of the year. Not only did I set a trading goal, but I also modified my decades-long trading dream. The parts of my dream that involved getting rich as quickly as possible had adversely impacted my trading since day one. I decided that, regardless of the dollar amount, if I just concentrated on being profitable each month, over time my capital would accumulate to respectable levels.

Rick Pitino's *Success Is a Choice* [1] is an excellent book on setting goals. Pitino maintains that dreams are where we want to end up and goals are how we get there. Goals give us the routine we need to accomplish our dreams. He also says that our long-term success is the result of the small victories we accumulate along the way—that by looking for incremental progress, the small successes will lead to larger successes and achievement of our goals. I could be the poster boy for Pitino's book. It wasn't until I set my goal of no losing months that I became a winner. Over the years, the accumulation of winning months led to the larger success of realizing my dream of trading for a living.

Another theme Pitino stresses in his book is that if we didn't work hard and establish discipline in our lives, then all our dreams would merely be pipe dreams, little flights of fancy. My four-year trade review revealed that, in addition to not having a goal, I had poor work habits and no discipline. For example, I always considered the open and the price movement off the open as the most important events of the trading day. Yet, because of my lack of discipline and poor work habits, I could never roll out of bed for the early morning West Coast openings. Instead, I would get up two to three hours later and phone my broker for the opening range and intraday highs and lows.

My trade analysis revealed that most of my order placements coincided with my morning phone calls to the broker. It didn't surprise me to find that the vast majority of these trades ended up in the loss column. Being asleep for much of the morning prevented me from seeing, sensing, and feeling the flow of the market. I decided to set another

goal to awaken by the 6:30 A.M. opening time for the stock market and stock index futures. I also vowed that, regardless of the market I was interested in trading, if I wasn't awake for its opening, then I wouldn't trade it that day. In some respects, I was now treating trading more as a business and a profession, instead of a hobby or some easy money-making scheme.

Fear was the primary cause of my lack of trading discipline. The review of my trading history showed there were several occasions when I was right there at the beginning of major bull and bear markets, but I always seemed to come away empty-handed. Because of my fear of losing trading capital, I would either grab the smallest of profits or get scared out by the slightest of reactions. This led me to reread the insights of my mentors, Nicholas Darvas, Benton Davis, and Jesse Livermore. Somehow through the years I had lost sight of the trading principles in their books, especially the part about letting your profits run.

My trade-by-trade examination revealed another destructive pattern in my trading behavior, which also explained why I never made money on the big moves. Regardless of my reasons for exiting strongly trending markets, I never reentered them, even as they soared to unimaginable heights. I'm sure there were several psychological factors that could explain this flaw in my trading mechanics. But what counts is that I recognized the problem and turned that weakness into a strength. In my current trading practice, it's not unusual for me to close out mutual fund positions worth hundreds of thousands of dollars in one day, only to reenter the following day if market action proves me wrong for exiting.

My trade-by-trade study encompassed a four-year period during which I had traded stocks, stock options, and a variety of commodity markets. It was clear from my analysis that I was very good at determining the overall direction of the stock market, especially various sectors such as technology. But what was really disturbing was that I was psychologically inept at trading individual issues, be it stocks or stock options. It was hard to admit this, since trading stocks successfully is what I had devoted my life to since reading the Darvas book back in 1961.

My downfall as a trader of individual stocks was quite simple: I didn't believe in diversification. Whenever I traded, it was all or nothing on one particular company, whether that be via stocks or equity options. This was a weakness I realized could never be changed. I never have and never will believe in diversification. Maybe it has something to do with reading those books early in my trading career.

Darvas and Livermore would get on board a rising stock and then play it for all it was worth.

I thereupon made a monumental decision that spring of 1985. I would never again trade individual stocks or equity options. My plan was to concentrate only on mutual funds. I would still focus primarily on just one fund. However, unlike trading individual stocks, mutual funds forced diversification on me. But with only $2,200 in my trading account, I didn't have adequate capital to trade mutual funds. So I decided to stick with trading futures until I could increase my account to a larger base and then move into the funds.

Throwing Away the Charts

It was vital to my trading success to become focused on setting goals, working hard, and establishing discipline. But there was still the matter of determining the strategies, methodologies, and trading tools I was going to use to achieve my goals. My trade review made one thing perfectly clear: Being a chartist for the past 19 years had been an exercise in futility. Charts just weren't getting it done for me. They were great at telling me about the past, but were of little use in foretelling the future. Some who worship at the altar of charts may counter that the purpose of charts is not to predict, but to provide hints or clues to the future. Regardless of the semantics, I would have been much better off never looking at a chart. So it wasn't that tough of a decision in the spring of 1985 to throw out the charts and never consult them again.

I'm met with a lot of skepticism when I tell traders I never use charts in trading. But 19 years as a break-even trader relying on charts and then 14 consecutive winning years without them pretty much tell the story. As an experienced trader with an excellent memory, I don't need a chart to tell me the market is in an uptrend, downtrend, or sideways pattern.

Studies have shown that 98 percent of all chart patterns are random, squiggly lines on a piece of paper. Burton Malkiel in *A Random Walk Down Wall Street* [2] described an experiment his students participated in, using a hypothetical stock trading at $50 a share. Each day they flipped a coin, plotting heads as a 1/2-point daily gain and tails as a 1/2-point daily decline. The resulting stock chart from these random coin flips displayed all the revered classical chart patterns such as head-and-shoulder formations, flags, pennants, triangles, tops, and bottoms. There were even indications of cycles in the random tosses.

William Eckhardt, a trading wizard interviewed in Jack Schwager's *The New Market Wizards*, is arguably one of the better traders of our times. Although not well known by the trading public, Eckhardt has amassed one of the best long-term track records based on both percentage gains and consistency of returns. His comment on charts should be duly noted here: "Most things that look good on a chart—say, 98 percent—don't work." [3]

I should have been aware of the failure of chart analysis long before 1985. While I was a commodities broker, I saw hundreds of traders come and go. But in the end, not one ever made money. This was similar to Stanley Kroll's experience as related in a *Forbes* magazine article dated October 1, 1977.[4] Kroll stated that in his 13 years as a futures broker, commodity department manager, commodity trading specialist, and member of various commodity exchanges, he never saw a successful retail futures trader. I don't know about Kroll's customers, but all customers at my trading firm had one commonality: They were mesmerized by their charts.

The futility of charts to predict the market was never more evident than in an article that appeared in the August 31, 1998, edition of *Barron's*.[5] The previous week several of the best-known chartists were surveyed for their opinions on the Dow. One chart watcher said the top above 9300 made in July was an important market top akin to the situation in 1929. He was looking for a decline to at least 4600. Even worse, he said there was the chance of a real out-and-out crash, with the Dow dropping to 5000 by early November or early October.

Another bearish chartist and well-known author said the easy part was predicting that a test of the October 1997 low at 7000 would occur before the end of 1998. The tougher part, he said, was predicting what happens after that. Based on his readings of the charts, he looked for a decline to at least 6000, with the Nasdaq underperforming the broad market.

So what happened? The Dow made its 1998 closing low at 7539 and did so on August 31, the day the interview with the chartists was published in *Barron's*. It bounced around the 7600 to 8000 price level for another month before blasting off in one of the strongest momentum rallies of the past 30 years. Not only did the Dow exceed its July highs, but the rally was led by the Nasdaq Composite. So much for the expert chartists and their reading of the tea leaves.

Don't misunderstand: I will admit that, like most facets of the trading game, charting is an art, not a science. Just because I was unsuc-

cessful using charts is no reason to dismiss it out of hand. The only patterns I consider relevant on a chart appear when prices are moving in a straight line up, down, or sideways—and I don't need a chart to see those patterns.

Most of my negativism toward charts relates to traders who use them to trade commodities as opposed to individual stocks. From my experiences and observations, the failure rate among commodity chartists far surpasses that of traders who use charts to trade stocks. Then again, stocks have been in a historic uptrend for the past 200 or more years. With that type of bias, darts would be just as effective as charts in selecting stocks.

I don't expect or even encourage traders to toss their charts in the dumpster. The point I'm trying to make here is that if you have been struggling as a trader with a particular trading tool or methodology, isn't it time to move on? Maybe the partnership of you and that tool or method isn't meant to be. It amazes me how some traders will spend their lifetimes trying to master certain methodologies, yet have nothing to show for their efforts.

Oscillators such as the RSI, ADX (average directional movement index), MACD, and stochastics were tossed along with my charts. I also wholeheartedly concur with Eckhardt's comments about oscillators: "I think these indicators are nearly worthless. . . . They are close to zero in their profit expectations. What these patterns make during market consolidations, they lose during trends." [6]

In 1983 and 1984 I subscribed to a newsletter that was run by the self-proclaimed guru of computerized oscillators, and you guessed it—the promoter doesn't trade for a living. His newsletter was marginal at best. This guru is still around, though, and is a regular at those expensive trading extravaganzas. Although I'll discuss indicators later in the book, most duplicate themselves, especially the overbought/oversold indicators.

Market Sentiment

The most beneficial discovery that resulted from my exhaustive trade review was that the essence of the trading game is market sentiment. I stumbled onto the concept of market sentiment in 1984, while wading through a maze of methodologies from astrology to wave analysis in my desperate search for what moved prices. It was at that time that I purchased Earl Hadady's book, *Contrary Opinion*.[7]

This book explains why the conventional wisdom is almost always wrong in the trading game: When nearly all speculators are bullish, the market invariably declines, and when nearly all speculators are bearish, the market invariably rallies. I was drawn to the book because I lost count of the number of times I would place trades based on "perfect" fundamental or technical setups, and then almost instantly lose my money.

In addition to buying Hadady's book, I took out a trial subscription to his *Market Vane* newsletter. [8] This service conducts a weekly poll of the trading recommendations of over 100 market letter writers and trading firms specializing in futures. The consensus of these services, which Hadady refers to as his Bullish Consensus Index, is scaled from 0 percent as the most bearish to 100 percent as the most bullish. According to Hadady, the bullish consensus tends to stay in the range of 30 percent to 70 percent. At 30 percent an oversold condition is developing, whereas at 70 percent an overbought condition is developing. As the extremes of 0 percent and 100 percent are approached, a reversal in price is imminent. Figure 4.1 is a graphic depiction of Hadady's Bullish Consensus Meter.

During my trade analysis in March 1985, I matched up my trade dates with the weekly bullish consensus percentages from *Market Vane*. I was able to do this historically since *Market Vane* maintains a historical database of consensus readings. This matching of my trades with the consensus readings exposed my real fatal flaw as a trader. Almost like clockwork, I would buy when the consensus percentages were in the upper extremes of bullishness. Likewise, I would sell when the readings were in the lower bands of extreme bearishness.

It was apparent from my past trading habits that I was unduly influenced by the news of the moment. Although I always considered myself a trader with a very independent mind, I was shocked to find I was always bullish at the peaks in prices and bearish at the valleys. Often I would make my trades based on the capsule comments of the various commodity markets found each day in the *Wall Street Journal*. I would roll out of bed two hours after the markets had opened, read a positive review of a commodity like soybeans or gold, then immediately phone my broker to buy beans or gold. Is it any wonder I struggled for so many years as a break-even trader? Looking back, I realized I had the same problem while trading stocks. I made my trading decisions based on the positive or negative comments in various print media such as newsletters, magazines, or newspapers.

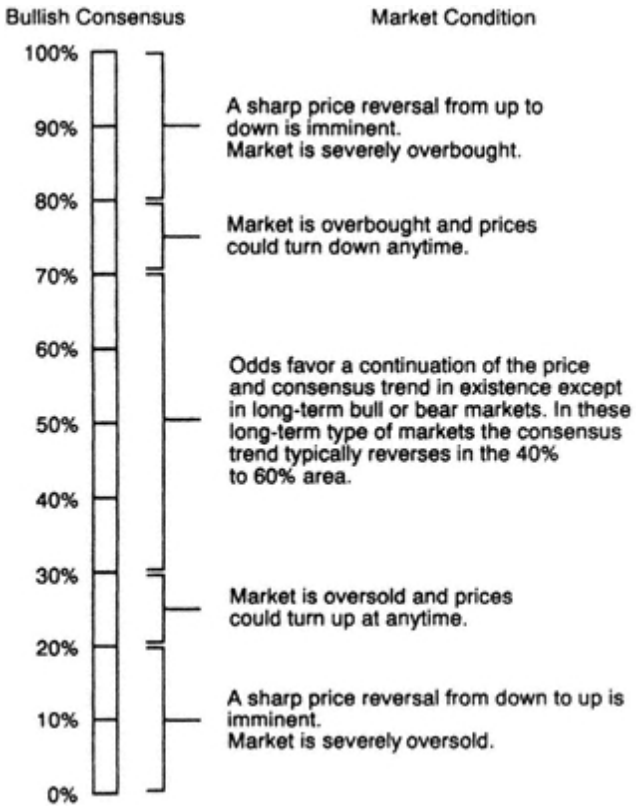


Figure 4.1
Hadady bullish consensus meter
(Source: reprinted with permission by R. Earl Hadady, author of Contrary Opinion © 2000 John Wiley & Sons, Inc.)

What really opened my eyes while matching my trades with the consensus percentages was how prices and sentiment seemed to move together in their own trends until sentiment reached extreme levels of optimism or pessimism. For the first time in nearly two decades as a trader I began to understand what moved prices in the short term—investor sentiment. I then began combing for other sources of insight on this topic. The best I found was a 15-year-old book by William X. Scheinman, *Why Most Investors Are Mostly Wrong Most of the Time*. [9]

Scheinman's book was further confirmation of my newfound discovery that investor sentiment was at the crux of the trading game. This book is another one of those trading gems that's nearly impossi-

ble to locate. I purchased my local library's last copy at the annual book sale many years ago. Scheinman reinforced what I picked up from Earl Hadady—namely, that the market always does what it has to do to make the majority wrong. According to Scheinman, it is superior psychological insight into the market that enables sophisticated investors to beat the Street.

Scheinman spent three years in the late 1960s working 12 to 14 hours a day looking for the secret to the stock market. He measured and recorded hundreds of categorized investment actions of sophisticated and unsophisticated investors. He then examined the behavior of the two groups of investors against differing price action backgrounds. What he found constitutes his theory of divergence analysis. At important turning points in the market, there would be a divergence between the actions of the sophisticated and the unsophisticated investor groups.

Scheinman is well known among old-timers like myself. He's written about the market in *Barron's* and has worked for NYSE member firms as an advisor to institutional investors. Unfortunately, Scheinman didn't uncover the Holy Grail. As quoted in Murray Teigh Bloom's *Rogues to Riches,* Scheinman had this to say about his discovery, "After all, it's not a sure-fire formula. It does work well at extreme points in the market, but in the interim periods it's much less clear and there's always a lot more interim than extreme points in the market." [10]

Still, I found Scheinman's book to be a much needed primer on how to approach the trading game. His book introduced me to sentiment indicators that are integral to my present-day arsenal, such as the public/specialist short sales ratio and the *Investors Intelligence* survey of bullish and bearish newsletter advisors.

You won't find any better insights into the trading game than William Scheinman's observations: "There is a rhythm to the markets, a pulse of alternating waves of investor optimism and pessimism, just as surely as there is to the ebb and flow of the tides. Successful investment timing comes in matching one's major decisions to this basic rhythm. . . ."[11] Later in this book I will present the indicators I presently use that not only keep me attuned to this rhythm, but alert me to when the beat is about to change.

Chapter 5—
Putting It All Together

After spending so much time on trade analysis, it was time for action. I had set my goal of making a profit each month, was willing to rise early every morning for the openings, and would let my profits run. I would also not be afraid to jump back into a market if I was stopped out. Most important, I would no longer buy long or sell short when the bullish consensus percentages were in the upper or lower ranges of their extremes. Just as important, I wouldn't base trades on the bullish or bearish comments of analysts or the summaries found each day in the futures section of the *Wall Street Journal*.

My first trade after the exhaustive trade study was in mid-March 1985. It was long one contract of May cocoa. The price of cocoa and the bullish consensus percentage had both bottomed recently, with the consensus numbers bouncing off the 34 percent area. The bullish consensus percentage was 58 percent, far from the 70 percent to 80 percent extreme range. The day I made my purchase, the *Journal* had negative comments about an oversupply of cocoa, which might lead to lower prices in the next few months. In the past, the last thing I would have done would have been to buy a commodity when the *Journal* had a negative article. If anything, I probably would have gone short.

Less than a week later, I sold my cocoa for a net profit of $1,473.72.

That was my largest single trade profit in many years. I often think back and wonder how my life might have unfolded had I not been successful on that trade. Since then, there have been days when I've made $7,000, $8,000, even $11,000, and more. I even had a week when I made $24,000. But no single trade had as big an impact on my trading career as that cocoa trade in March 1985. It gave me something I had been sorely lacking for 19 years: confidence that just maybe I was beginning to understand the basis of price action.

Over the next two months, I netted an additional $5,100, which gave me more than $6,500 in trading profits since overhauling my trading strategies. My most profitable trade was $1,752 in coffee. I was on top of the world. For the first time in my 19-year trading career, my account zoomed past the $4,500 barrier to $8,700. Then disaster struck. I lost on 28 of my next 30 trades. Obviously, I was doing something very wrong. Unlike before, though, I was now actively reviewing my trades. I took apart each closed-out trade to see what I had done right or wrong.

The problem during this horrendous losing streak was overtrading, which resulted from becoming too confident in my trading abilities. Another problem was reading more into the bullish consensus numbers than was there. I learned the hard way that the bullish consensus readings moving into their upper or lower extremes wasn't necessarily an indication that a reversal in price was imminent. Often, prices would get into those extreme ranges and remain there for prolonged periods.

Saved by the Stock Index Futures

Two things kept me afloat during my trading skid. As always, I kept my losses to a minimum. In addition, of the 30 trades during my losing streak, the 2 winners had been in stock index futures. The profits from those winning trades were almost large enough to offset the 28 losing trades. As a result, I made two adjustments to my trading: I vowed to have more patience in trade selection and to concentrate more on trading stock index futures.

Trading went smoothly during the remainder of 1985. From my mid-March trading epiphany through the year's end, I netted nearly $7,000. During the last few months in 1985, all my trading profits were coming from the stock index futures: the S&P, the NYSE Composite Index, and the Nasdaq 100. Since I was barely profitable trading the

other commodity markets, I decided to confine myself solely to the stock index futures.

In addition to my background in the stock market, another reason I had success with trading stock futures was George Angell's book, *How to Triple Your Money Every Year with Stock Index Futures*. [1] Chapter 5, "The Psychology of the Floor," and Chapters 7 and 8, about the three-day cycle, had an especially strong impact on me. (The specifics of trading stock index futures are discussed in Chapter 16.)

Trading Becomes My Profession

My struggles as a 19-year break-even trader abruptly ended in 1985. Since then, it's been up, up, and away. Over the years I was able to parlay my futures trading profits into a much greater amount through trading and investing in mutual funds—and that was primarily because I was more aggressive at trading mutual funds than at trading stock index futures. Regardless of what I was trading, however, I still used the same sentiment indicators and momentum patterns to detect the rhythm of the overall market. These indicators and patterns will be thoroughly covered throughout this book.

One thing I didn't do once I became consistently successful in 1985 was to depend solely on my trading income for my living expenses. The most foolhardy thing I hear from wannabe traders is their desire to quit their jobs and trade for a living. They just assume that they will live off their trading profits. That's no way to build a business—and trading is certainly a business. It's imperative for small-time traders, such as I was in the 1980s, to compound their trading capital. You can't do that if you are constantly withdrawing funds from your account for taxes and other expenses.

In my case, I returned to my insurance investigator job on a part-time basis a little over a year after my full-time position was terminated. That gave me what all budding full-time traders need: cash flow. The worst thing for a trader is to feel pressure to make money to pay the bills. I knew the bills would be taken care of by my part-time job, enabling me to completely focus on the goal of turning a profit each month in my trading account. It wasn't until 1993 that I felt comfortable enough to give up my insurance job and live solely off my trading income. By that time, though, I had another backup: the interest income from my junk bond funds. These monthly dividends more than compensated for the income I had received from my part-time job.

Tools of the Trade

A lot of traders will disagree with me on this, but I believe that all those sophisticated data feeds are an unnecessary expense. Most would-be traders arm themselves to the hilt with all sorts of state-of-the-art trading equipment before they have even made their first trade. In the process, they are taking on recurring monthly expenses for maintenance and fees. The CNBC business television station serves most of my needs as a professional trader. There's no better way to feel the flow and rhythm of the market than the CNBC ticker tape.

I'm also a ravenous reader of anything relating to trading—books, magazines, newspapers, a few select newsletters, and a couple of Internet sites. The "Recommended Resources" section of this book details my favorite informational reading sources. But I am not one for hardcore research. I don't spend laborious hours in front of a computer trying to figure out the direction of the market. I'm more concerned with what the market is doing in the here and now instead of worrying about the past or the distant future. The only concession I've made to such research over the years has been my 14-year accumulation of the "Market Laboratory" section of *Barron's,* [2] a weekly financial newspaper.

Chapter 6—
Why the Stock Market?

I'm a firm believer in specialization. Find a market you have an affinity for and make that your trading obsession. Thanks to Nicholas Darvas, my obsession has always been the stock market. I better warn you, though: If you choose to specialize in a market other than stocks, currencies, or bonds, be prepared for a lot of frustrations. If you think you are going to make your fame and fortune trading the meats, the grains, the metals, or the softs like cocoa or sugar, think again. I knew a fellow who worked for more than a decade at various discount trading firms in Chicago. He once confided in me that he saw only a handful of futures traders who ended their trading careers in the black. The few who succeeded shared one trait: They only traded financial futures—stocks, bonds, or currencies.

Figure 6.1 (courtesy of Jeremy Siegel's *Stocks for the Long Run* [1]) is a total return index for stocks, bonds, Treasury bills, gold, and commodities from 1802 through 1997. Many view such charts with disbelief. A $1 investment in the stock market in 1802 compounded to $7.47 million dollars by the end of 1997. The much-talked-about crash of 1929 was but a blip on these charts. Admittedly, it you were unfortunate enough to have been investing during the Great Depression it was more than a blip.

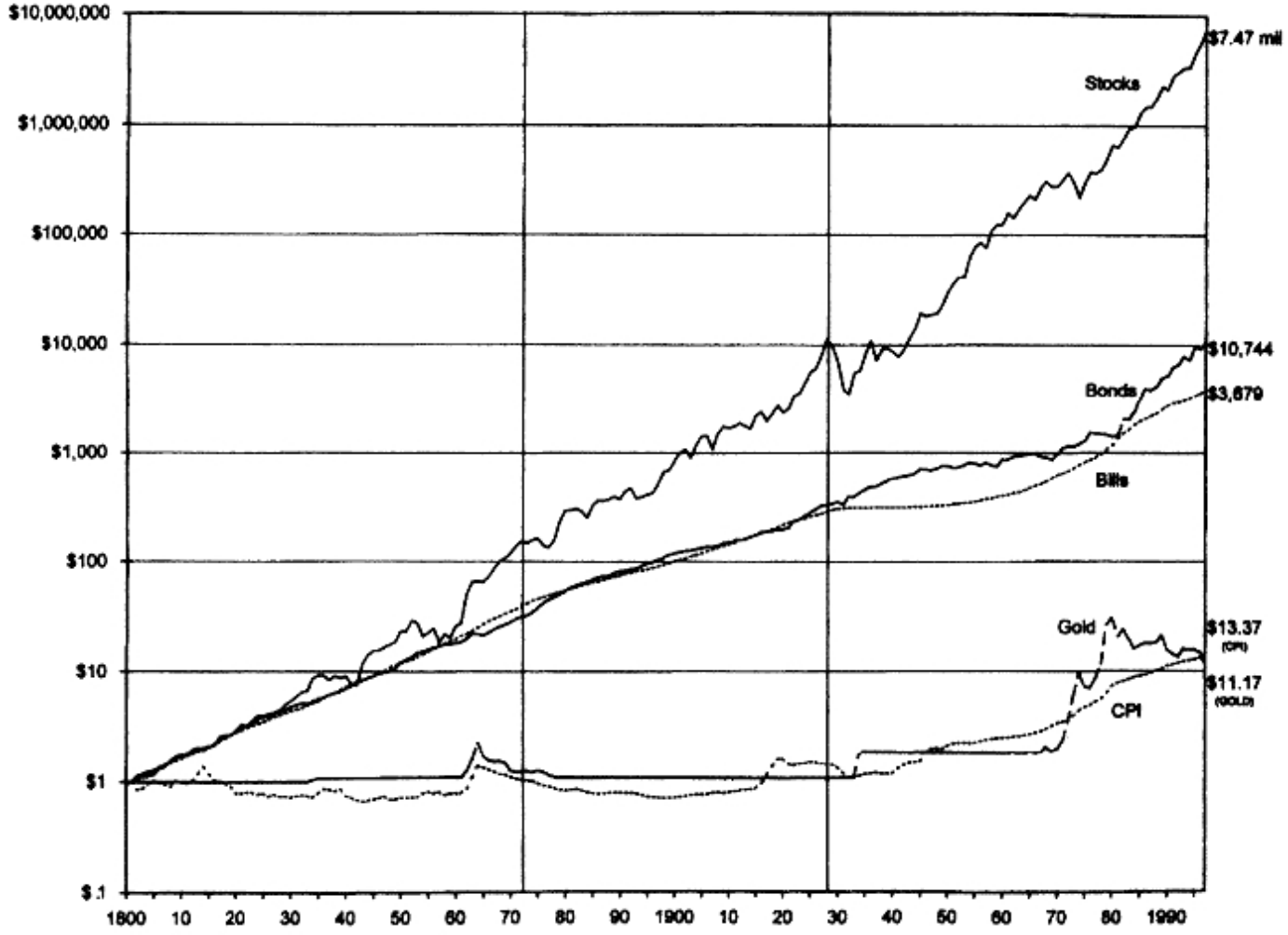


Figure 6.1
total nominal return indexes, 1802–1997
(Source: reprinted with permission of the McGraw-Hill Companies
© 1998 Stocks for the Long Run, 2nd edition by Jeremy Siegel.)

As shown in Siegel's book, even after adjusting for inflation, the $1 investment in stocks in 1802 grew to $558,945. The $1 investment in gold however declined to .84¢. The point is that there is a historic long-term uptrend in the stock market that is unsurpassed by any other investment vehicle.

Some of my favorite stories illustrate how the stock market is the great wealth accumulator. The first involves Anne Scheiber, who was profiled in *Money* magazine. [2] Scheiber worked as an auditor for the IRS and made $3,100 in her peak earning years. The biggest lesson she learned in her job was that the surest way to get rich in America was to invest in stocks. In 1944 she opened a $5,000 account with Merrill Lynch.

Anne Scheiber passed away in January 1995 at age 101. Her $5,000 investment had compounded to more than $20,000,000. At the time of

her death, her portfolio was paying out over $750,000 in dividends. One of Scheiber's investment tenets was never to sell. Instead, she bought and held until her death.

Mr. and Mrs. Joseph Robinson were profiled in *Investor's Business Daily*. [3] Between January 21, 1955, and January 21, 1956, the couple made two investments in the Pioneer Fund that totaled $4,015. That was it. They never invested another dollar. By the end of 1997, even though Mrs. Robinson had begun withdrawing dividends and capital gains beginning in 1993, the account was valued at $540,000. Had there been no withdrawals, the account would have stood at $637,682.

In early 1999, *Wall Street Journal* columnist Jonathan Clements invited readers to tell him about their smartest and dumbest financial moves. Then he reported the response regarding the smartest moves.[4] One respondent said that while he was on vacation from college in 1967, he earned $1,600 loading boxcars. Taking his father's advice, he invested his earnings in 37 shares of AT&T. Today, after reinvestment of dividends and various spin-offs, his portfolio is valued at $142,000.

The best story I've seen on the great wealth-accumulating abilities of the stock market involved Donald and Mildred Othmer.[5] Their road to riches began in the 1960s when each invested $25,000 with their friend from Nebraska, Warren Buffett. In the early 1970s, their investment was rolled over into shares in Berkshire Hathaway, Buffett's investment and insurance holding company. Mr. Othmer passed away in 1995. When Mrs. Othmer passed away in April 1998, the estate from their original $50,000 investment was worth $800 million.

So why is a short-term trader like myself so enamored with the long-term performance of the stock market? Because to succeed, traders need to capitalize on every edge and bias possible. What better edge is there than awareness of this historic upward bias in the stock market? Remember, my goal is never to have losing months. I read somewhere that since 1789, the stock market has gone up 71 percent of all calendar years. I find that this upward bias extends to monthly, weekly, and even daily price action.

One common criticism is that because since 1982 we have enjoyed the greatest bull market of anyone's lifetime, it hasn't taken a genius to make money. I couldn't agree more. But why is it that most of these sour-grapes critics haven't made one red cent during this great bull run? Success in any endeavor comes from recognizing and then capitalizing upon the opportunity at hand. Should those who had the foresight to exploit this great stock market boom be criticized?

Nicholas Darvas made his fortune because he exploited the great bull market of the late 1950s. Many of the market wizards made their fortunes because they exploited the great inflation-driven bull market in commodities during the 1970s. True, it may not take a genius to make money in a bull market, but what does it take to make nothing in such a market? I rest my case.

Clueless in Bearville

I have a reputation for being downright ornery when it comes to the persistent prophets of pessimism. Many of the self-proclaimed cycle, wave, and valuation gurus have been parroting their prophesies of peril since 1995, and some even longer. As the Dow has soared from one new high to the next, these trumpeters of never ending tragedy have ceased to be amusing.

Is it ego, arrogance, or just plain ignorance that motivates the misguided mavens of mishap? Are they blinded by such massive egos that they can't see they have been wrong month after month and year after year? Are they possessed of such arrogance that they refuse to acknowledge the ineffectiveness of their methodologies? Or maybe they are simply ignorant in not comprehending the demographic underpinnings of the greatest bull market of all time?

One annoying trait of the clueless bears is the way they conveniently forget to factor in the compounding of reinvested dividends when discussing past bear markets. For instance, we are always reminded that it took the Dow until 1954 to surpass its 1929 peak. Yet if you factor in the generous dividend yields of the Dow during the 1930s, stockholders would have recovered from the 1929 top by 1944. The bears also point out how the market was flat between 1966 and 1981. But again, they are overlooking the compounding of reinvested dividends, which averaged 4.1 percent per annum during that period. A startling fact is that from 1802 to 1992, 80 percent of the total real return of stocks was generated by the reinvestment of dividend income.

The blundering bears are forever using history as their rationalization for expecting an imminent and massive decline in the stock market. They warned us years ago how the market resembled the speculative excesses of the late 1960s and the period leading up to the huge declines in 1973 and 1974. As the market continued to soar and that analogy proved invalid, the doomsters went back to their computers

and mesmerized us with elaborate charts showing how the present-day mania was setting up a scenario similar to that of precrash 1929. Again discredited by a market that refused to die, they turned to the parabolic and euphoric gold market of 1979 and the Japanese market of the 1980s to convince us the stock bubble was about to burst.

The bears just don't get it, do they? History is not a road map to the future. If anything, history is riddled more with change and surprise than with repetition. But let's pretend the bears are right and history does repeat. Why don't they ever tell us how crashes never come from out of the blue. In 1929, the stock market topped out the first week in September and was on a decided downward trend prior to the late October crash. Same with the 1987 stock market crash. The market topped out in August of 1987 and had been trending downward prior to the October 19 debacle. Since traders like myself react more quickly to market movements than the buy-and-hold crowd, it's unlikely a crash would ever catch us unaware.

As you can see, I get carried away when it comes to the perennial peddlers of panic. Why do they bother me? Because I truly feel for the legions of investors and traders who bought into their doom and gloom rhetoric and missed participating in the boom of all booms. How can these gurus sleep at night knowing they have led so many investors astray? Remember this: The stock market is always right and always tells its own story best.

Shorting the Market

While we are on the subject of bears, now would be a good time to comment about my views on shorting the market. I have a reputation as a trader who rarely shorts. I'm often criticized for my reluctance to short, especially considering my track record of always selling out of my long positions at or near the tops. The implication is that I should reverse my position and go short instead of simply moving to cash. Some well-known bears have suggested that, when and if an extended bear market arrives, I will be lost.

My feelings on shorting boil down to this: Why bother if I can still make my monthly profits trading from the long side? You will note in my track record (see Table 1.1 and Figure 1.1) that I made over $19,000 between July 1998 and the end of September 1998. That was all from long trades. Yet during that period the Dow and S&P plummeted by nearly 20 percent, and other indexes declined even more. I also sur-

vived the crash of 1987, as well as the bear market of 1990. I did, however, do some shorting in October 1987.

What happens if we get a bear market like the devastating 1973–1974 debacle, in which many of the major indexes lost 50 percent and more? I say, fine, bring it on. I remember well the bear markets dating back to the 1960s. Traders don't realize that bear markets are accompanied by spectacular upside rallies. For instance, the often-mentioned bear of 1973–1974 saw two rallies over 10 percent and six over 7 percent. These rallies are often referred to as suckers' rallies. I prefer to think of them as traders' rallies.

One problem with shorting is that your timing has to be near perfect. When the market has the big declines, they are fast and furious and come with little warning. If you aren't in from the beginning, it's almost impossible to find a good entry point.

When you short, you are bucking the 200-year upward bias in the stock market. I don't like to bet against such odds. George Soros once told Victor Niederhoffer that he had lost more money on shorting stocks than on any other speculative activity. According to Niederhoffer, selling short stock is a ticket to the poorhouse. [6] I'll leave shorting to the perennial bears. They seem to have some sadistic compulsion for failure anyway.

There are, however, one or two short sellers deserving of respect—for example, hedge fund manager Bill Fleckenstein. In 1997, a year in which the S&P rose 33 percent, Fleckenstein's fund rose 58 percent. His return is amazing because virtually his entire portfolio consisted of short stocks traded in the United States. When I do short, I confine my activities solely to the stock index futures. (This will be discussed further in Chapter 16.) Certain mutual funds, such as the Rydex Ursa Fund, are considered short funds. These types of funds move inversely to the S&P or some other benchmark. However, these funds are also end-of-day funds, which you can buy or sell only at the close of trading. Because I'm more than aware of how bear market rallies can be killers, I would never trade short unless I had the means to exit intraday, such as with the stock futures.

Chapter 7—
Trading Is a Profession

Before getting into my actual trading strategies, let's examine the psychological aspects of the trading game. I realize this is a subject that bores some traders to death; however, the psychological aspects of trading are what ultimately determine your success or failure. My perspective on the psychology of trading is a bit different from those found in conventional trading books.

One of the many reasons I left the vendoring business was my disenchantment with the constant phone calls from wannabe traders all asking the same question: "Gary, I want to quit my job and trade for a living. What do you suggest I do?" Most traders just don't get it. Trading is a profession, and, like any profession, it takes years and years of learning and hands-on experience to master.

Everyone is looking for shortcuts. They think they can become full-time traders simply by purchasing the latest and greatest software packages, attending the overhyped trading seminars, or being trained by trading experts. Medical professionals and engineers are the worst offenders. In my experience, doctors and engineers constitute the greatest percentage of professionals who claim they want to leave their present career and trade for a living. Yet both of these professions

require years of study and training. So why do they think can simply waltz into the trading profession and begin trading for a living?

Trading is like any other profession that involves specialized skills. In my case, becoming a scientist, engineer, or computer programmer was never a consideration since I possessed no math or analytical skills. Nor would becoming an auto mechanic or machinist have been feasible since I had no mechanical abilities. I couldn't paint, sing, or play any musical instruments, so that ruled out striving to become an artist, rock singer, or band member. I was a very good ballplayer. But as I got older, I found I couldn't hit the ball as far or pitch as fast as the players who eventually made it to the big leagues.

Mind over Markets, by James Dalton, Eric Jones, and Robert Dalton, has the most pertinent comments I've seen about choosing a profession. This book states that very early in life we identify the skills we possess, and we choose our careers accordingly. "While there are many ways to develop these skills [when choosing a profession] through education, coaching, and experience, the seeds must already be planted if they are to grow." [1] I couldn't agree more. If you read the books about the market trading wizards by Jack Schwager, you will note that nearly every trader interviewed became interested in trading from a very early age.

That's usually how it is with successful people: They know early in life what they want to do with their lives and they focus their energies toward achieving that goal. My favorite section in *Investor's Business Daily* is the "Leaders & Success" column. Each day it showcases a biography of a successful person. Almost without fail, the subjects of these profiles knew from their childhood or teenage years where they were going to make their mark.

Don't be discouraged, though, if your interest in trading didn't come until later in your life. I'm not suggesting for a moment that it's impossible to become a successful trader if you take it up in your thirties, forties, or even later. I know and have heard of successful traders who weren't introduced to trading until much later in their professional lives, Nicholas Darvas being a prime example.

Why So Many Traders Lose

Over the years I've dealt with thousands of traders seeking the elusive dream of trading for a living. This contact with the public has given me some valuable insights into why so many end their trading careers in

the red—because they are lacking in either a knowledge of the markets or themselves, and thus are unable to develop a viable trading strategy.

The bridge between a knowledge of the markets and ourselves is extensive real-money trading experience. Only through such experience can we come to understand the logic behind the academic knowledge we have absorbed and gain insights into ourselves to discover whether we are psychologically suited for the game. Once we understand the logic of the markets and our psychological strengths and weaknesses, we can begin to build a lasting trading strategy.

The following trader story better illustrates this point. I once knew a fellow who, when not working at his regular employment as a computer programmer, spent every waking hour for eight years studying the markets. He read every book, bought all the systems, and attended as many seminars as possible. He spent over $125,000 in his thirst for trading knowledge. Much of his time was spent in research and testing so he could mold all his acquired knowledge into his own unique trading methodology, because all the books he had read emphasized the need to develop a trading style that is consistent with your personality.

After eight years of searching, this seeker of the Holy Grail finally thought he had it figured out. So he quit his job and began trading for a living. Within six months he lost not only his trading stake and life savings, but the money he had put aside for retirement. He was totally unprepared for the psychological aspects of the trading game. Dealing with risks, cutting losses, and letting profits run was something the books couldn't teach him. This story is not an isolated example. I've encountered scores of traders who have easily spent over $100,000 trying to learn the academics of trading, yet little to no time trying to master the mechanics of trading with real money.

Conversely, I've known many traders who have spent years trading, yet never took the time to learn the academics. One stock index futures trader I knew had been trading for four years, but without any knowledge whatsoever of options expiration or triple witching weeks.

Successful trading is a cumulative process that requires a commitment over time, in which you progress in stages from novice to expert. This evolution involves years, not months. There are no shortcuts. The best discussion of this topic can be found in the previously mentioned book, *Mind over Markets*, which captures the essence of trading.

Some may argue that after years of learning about the markets and years of trading the markets, they still have nothing to show for

their efforts. The culprit in these cases is the inability to handle risk and uncertainty. On the risk side, you must balance both the assumption of risk with the management of risk. I refer to this delicate balancing of risk aspects as a childhood issue, because, for many people, attitudes toward risk were shaped during youth. Such attitudes can be instrumental in whether we succeed or fail at the trading game.

Many traders are too risk averse for trading. This risk aversion manifests itself through their inability to pull the trigger by making the trade. Risk-averse traders might trade only if the sun, stars, and moon are in perfect alignment—meaning that unless everything is just perfect, they won't trade. Once in a trade, these overly cautious traders are easily shaken out by the stress of simply being there. True, risk-averse traders will never go bankrupt or lose much money trading, but they are likely to spend their careers much as I spent my first 19 years in the game—as going-nowhere, break-even traders.

At the other end of the risk spectrum are the gunslingers who trade with a gambler's mentality. Their trading is often characterized by overtrading or making big bets at the most inopportune times. Gamblers have no problems with risk assumption, but they self-destruct with the management side of the risk equation. Make no mistake about it, risk management is what separates the trading hobbyists from those who successfully trade for a living.

All trading involves risks, uncertainties, and unexpected events. Yet most traders won't accept this fact of life. They spend their trading careers in search of some way to eliminate all risks. These are the same traders who are so easily manipulated by the dream merchants who preach about order in the markets and peddle predictive trading methods. Successful traders, on the other hand, accept diverse possibilities, disorder, randomness, and chaos, and they develop strategies that deal with such uncertainties.

Paper and Simulated Trading

This is just my opinion, and I realize some people disagree, but I can't think of a more worthless endeavor than paper or simulated trading. Newcomers to the trading game are often advised to paper trade for six months or so before putting real money on the line. This way they can get a feel for the movements of the markets before risking their hard-earned money. If you *really* want to get a feel for the movements of the market, then put real money on the trade. It's amazing how your per-

spective of the market changes when real money is involved. With real money, you very quickly become focused on all the nuances of the market that you never would see when trading paper money.

Simulated trading isn't any better than paper trading. In simulated trading, you simulate real trading by calling a broker and actually placing buy and sell orders. However, as with paper trading, the all-important psychological aspects of trading do not enter into the trading equation. I know some super paper and simulated traders who have an uncanny ability to call market turns. Yet they fail miserably whenever they put their own money down on the trade.

Reminiscences of a Stock Operator is the source of some of the better observations on the worthlessness of paper trading. In this book, Jesse Livermore relates the story of the man who was going to fight a duel the next day. When asked by his friend if he was a very good duelist, he boasted that he could snap the stem of a wineglass at 20 paces. His friend, however, was less than impressed and shot back, "But can you snap the stem of the wineglass while the wineglass is pointing a loaded pistol straight at your heart?" [2]

Trading Contests

I am not a fan of trading contests—either simulated or real money. Several years ago I entered a simulated trading contest with over 20 trading gurus. I dropped out of this contest after four months even though I had been profitable in each of the four months. I found it was impossible to compete against a group of crash test dummies who traded as if there were no tomorrow.

In a simulated trading contest, with no real money on the line, the all-important psychological aspect of the trading game isn't a factor. In the contest I entered, few if any traders adhered to sound money management strategies. This explains why 75 percent of the contestants lost money—many, their entire account. Simulated trading contests often breed poor trading habits, which can kill you when trading real money.

Real-money trading contests aren't much better than simulated contests. Russell Sands wrote a very insightful article on this topic that appeared in the *Club 3000* newsletter in 1995. Sands said that trading contests are structured in a way that is by no means indicative of trading skill or prowess. Since a trading contest has a beginning and ending and, hence, a finite time frame, the name of the game is to maximize

your short-term results by going for broke to build up an insurmountable lead over your opponents.

As Sands goes on to say, "Is this prudent trading, or even proper trading, for somebody who is trying to grind a long-run living out of the markets? Would you follow this go-for-broke strategy in real life or give your hard-earned money to an advisor or money manager who subscribes to this way of thinking as his normal strategy?" Sands concluded by saying that there are indeed talented traders who win trading contests, "but not everybody who wins these contests is a talented or prudent trader." [3]

Psychological Trading Gurus

There's been a proliferation of psychological trading gurus in recent years. Devoid of any real-time trading success themselves, they boldly promote themselves as having the ability to teach and train anyone to become a successful trader. Of course, for this privilege, you must expect to pay thousands of dollars to listen to their psychobabble. Take my advice and save your money.

I am very biased against psychological trading gurus. Much of my prejudice stems from their refusal to admit that trading is a profession in which few are able to succeed. If they admitted this, how would they justify their out-of-this-world training fees? I know several wannabe traders who have trained under some of the better-known psychological gurus. The feedback I received was universally negative. These traders were so pumped up with psychological double-talk after their training that they went out and proceeded to lose money at an even faster clip than before.

One trader in particular, after spending $5,000, was diagnosed as simply not having enough technical expertise. A rather steep fee for such a diagnosis, wouldn't you say? The psychological guru then referred this trader to a technical guru in Chicago, who went on to train him for an additional $3,000. Sounds to me like a game of bait and switch between two greedy vendors.

The psychological gurus pump you up with pep talks about being optimistic and trading with confidence. From what I've seen, trading with confidence is the most dangerous gambit a trader can use. There's too thin a line between confidence and overconfidence, and most traders eventually cross over this line. Self-confidence and optimism in traders are a prelude to inflexibility.

I get a laugh whenever I recall the advice given in one of the bestselling trading books. The psychological guru pontificated on the beliefs that all traders must possess to succeed in the game, which were derived from his analysis of the beliefs of successful traders. These required beliefs include the following:

• Money is not important.

• It's okay to lose in the markets.

• Win the game before you start with confidence.

My track record certainly qualifies me as a top trader. However, my pattern is more like this:

• I trade for the money.

• I die after every loss, which sometimes eats away at me for days and weeks afterward.

• I begin each trade with a complete lack of confidence, convinced it will be a loser.

This talk I always hear about the great traders never doing it for the money is a crock. Those great traders have accumulated large sums of money, which affords them the luxury of such a cavalier opinion. You better believe, though, when they were starting out they were 100 percent in it for the money. I also find it's beneficial to dwell on my losses—another no-no in psychological trading guru-land. This way, I am less prone to repeat my mistakes. As for trading with a complete lack of confidence, I find it pays to prepare for the worst in every trade and assume it will not pan out. This way, I am never caught off guard psychologically when the market moves against me.

If I submitted myself to a psychological guru for analysis, he or she would say I am unfit to trade and would never be successful unless I changed some of my attitudes and beliefs. For instance, in spite of my trading achievements over the years, I always have and always will personally consider myself a loser in the trading game. Although losing months are rare, they hit me so hard psychologically that I'm often tempted to fold up my tent and never trade again.

Why am I unable to embrace my trading success? It's simply my defense against overconfidence and cockiness. The day I begin to believe that I am a better trader than the average Joe or Jane will prob-

ably be the day my downfall begins. I've seen the careers of too many successful traders get sabotaged because they began to believe in their own invincibility.

Many of the psychological trading experts like to stress the importance of such traits as persistence, determination, dedication, and commitment. I'm not so sure you can categorize successful trading with a bunch of rah-rah adjectives. I've seen too many traders devote their lives to trading, yet lose all their capital. Then, through determination and true grit, they return to trading and repeat the same losing cycle.

I've already offered my views on what it takes to succeed in trading: extensive academic knowledge combined with intensive, real-time trading experience, which lead to the development of a winning strategy suited to the trader's personality. But if I'm forced to play the gungho description game, the two characteristics I find most common in winning traders are passion and insane focus. Trading with passion and insane focus involves making trading the be-all and end-all of your life. I don't know many traders willing to make such a sacrifice.

Modeling Trading Success

I'm not down on all psychological trading gurus. For instance, I thoroughly enjoyed Jack Schwager's interview with Charles Faulkner in *The New Market Wizards*. [4] Faulkner is a disciple of neurolinguistic programming (NLP), which is the study of human excellence. Practitioners of NLP study individuals who are unusually talented in a particular field (such as trading) in order to determine the structure of that talent. The NLP credo maintains that trained experts can then transfer and teach this structure to others to give them a foundation for that ability or talent.

In theory, I can understand the allure of NLP. I am a firm believer that success leaves clues and that it's important to study these clues. There's a strong correlation between studying success and achieving success. Successful people are students of success. That's why my favorite trading books are those written by successful traders. But the bottom line is experience: finding out what works and what doesn't work for you.

Thus, I contend that NLP falls apart in the experience aspect of trading. To me, NLP is just another one of those shortcuts sought by traders trying to bypass the years of experience needed to learn the

game. From what I've seen, heard, and read, you would be much better off buying Rick Pitino's *Success Is a Choice* than spending your money on psychological trading gurus or practitioners of NLP.

Trading and Brain Dominance

I live a very simple lifestyle, and I'm not an aficionado of the arcane or esoteric. So when I talk about left- and right-brain trading, it's not psychobabble or mysticism. Brain dominance is a very important aspect of what makes us tick as traders.

The human brain has two hemispheres, left and right. Each of us is influenced predominantly by one side or the other. The left hemisphere is analytically oriented. It reasons logically and sequentially and is responsible for speech. Many jobs heavily emphasize left-brain skills, such as reasoning, analysis, and rule following. The right hemisphere operates nonsequentially; is responsible for intuitive, creative, and artistic endeavors, as well as feelings; and controls visual perception.

Most mechanical traders are left-brain-dominant people and often are engineers, doctors, lawyers, and scientists. This type of trader prefers black-and-white situations and crunching numbers into a computer. Right-brain traders such as myself are primarily discretionary traders. This doesn't imply that we are seat-of-the-pants traders or that we base our trading decisions on something akin to the flip of a coin. Instead, we rely on our accumulated years of trading experience, which can't be measured or accounted for with a computer. We also rely on our instincts, imagination, insights, and, especially, intuition.

Most of us don't have much of a choice about whether we are left-brain or right-brain dominant. It's something we are born with. In my case, it's almost as if I was left-brain damaged at birth. Here I am at 52 years of age and I still don't know how to operate a copy machine or a bank ATM. Simple computer-related tasks such as downloading are beyond me. I can turn the computer on and off and that's about it. This situation is much like that of elite runners. The best sprinters are born with fast-twitch muscles, while the best marathoners are born with an abundance of slow-twitch muscles. There's not much that runners can do to change their native ability. Elite sprinters can never become great marathoners any more than great marathoners can become great sprinters—regardless of how hard they train.

Mechanical traders prefer that style because they say it takes the emotion out of their trading. I think it's too bad we have to become

robotic trading machines and slaves to computer-generated buy and sell decisions. I could never imagine myself letting some machine dictate my trading decisions. Many left-brainers also believe there is some sort of order and rationality to the markets. They use mechanical trading tools and mathematical formulae to measure this rationality. I much prefer to accept the chaotic and irrational behavior of the markets and devise trading strategies based on that irrationality.

This is not intended as a slam against left-brain traders or a mechanical approach to trading. My point is simply that a trader's style is often mandated by his or her brain dominance. I would never suggest that my right-brain, discretionary approach is preferable to another trader's left-brain, mechanical approach. In fact, a left-brain trader could easily take the trading patterns discussed in Chapter 12 and quantify them into a mechanical trading method.

I've often thought that the truly great traders are those who have been able to merge their left-brain analytical functions with their right-brain creative functions. After all, it takes creativity and imagination to develop a mechanical trading system that is different from the pack's.

The best book written on whole-brain trading and investing is Bennett Goodspeed's *The Tao Jones Averages*, [5] which I read during my trading epiphany in the spring of 1985. I sometimes think I underestimate how much this book impacted me during that crucial time in my trading career. It made me see the market as flowing and rhythmic rather than something that could be fitted into a rigid mechanical framework, which the author sums up by suggesting that applying logic to the market's behavior is akin to understanding water by catching it in a bucket.

Chapter 8—
Perceptual Trading Filters

The most enlightened discussion I've read about trading appears in Jack Schwager's interview with Charles Faulkner in *The New Market Wizards*. [1] Faulkner describes some of the characteristics shared by all successful traders, one of which is that all traders have perceptual filters that they know well and use regularly.

As described by Faulkner, a perceptual filter is a type of methodology, approach, system, or understanding of market behavior. These filters could include classical chart analysis, Elliott wave, Gann, Market Profile, oscillators, or some other methodology. Even a combination of several methodologies would be considered a perceptual filter. All these methods and some others appear to work for successful traders, assuming they know them thoroughly and strictly apply them.

Schwager then weighs in with his insights on perceptual filters. These comments should be required reading for all traders. He says that all technical methods are based on price, and he compares various trading methods as a way of filtering price through the lenses of different-colored glasses. The particular shade, or method, each trader chooses to filter price is a matter of personal preference. Even though Schwager questions the validity of some of the more popular trading methodolo-

gies, they nonetheless work for some traders who are able to develop some sort of intuitive experience about price.

My perceptual filters for understanding price action are various sentiment and technical indicators, which are at the core of my trading method. However, if you review my trading record (see Table 1.1 and Figure 1.1), you will see a decided upward shift in my trading profits beginning in May 1997, at which time I tried to put on clear glasses to see price action in its purest form rather than through the tinted glasses of my perceptual filters. The sentiment indicators that I use as perceptual filters now serve more as a guide to how aggressively to trade than when to trade.

As you will see in Chapter 12, my actual trading involves various momentum patterns. These are the patterns that enable me to see price action in its purest form. However, I don't want to minimize the importance of perceptual filters. Because these filters are still integral to my trading success, it's important for the purpose of this book to fully describe them here.

Few illustrative charts accompany the descriptions of my favorite indicators. This was an intentional omission for several reasons. As I've mentioned, I never look at charts, be they price charts or indicator charts. I see everything as numbers, rather than lines on a graph. If I had my druthers, this book would be all text, just like *Reminiscences of a Stock Operator*. That way, readers have to concentrate more on what they are reading—mental visualization, as I like to call it (something I do all day long while contemplating my trading moves).

Most trading books are chock-full of charts with nice little arrows showing you how you could have bought all the lows and sold all the highs. That's not the real world, though. I wanted this book to reflect the realities of actually trading for a living. For me, charts simply are not part of that reality.

Indicatoritis

Indicators of future market direction have a mesmerizing effect on many new and inexperienced traders. Before making a trade, they consult a staggering array of indicators and charts. By the time they make a decision, the market has passed them by. Too much indicator analysis leads to trade paralysis. One trader I knew wouldn't make a trade

until 80 percent of his 24 indicators went into a buy or sell mode. Needless to say, he never succeeded in the game.

Trading is a game of uncertainties. Yet most traders seem to have a psychological need to make these uncertainties appear certain. The result is an overreliance on various indicators that purport to detect changing conditions. The vendoring establishment panders to this need for eliminating uncertainties from the trading arena. That's why Holy Grail systems based on magic indicators sell so well.

I have very strong feelings about trading indicators. They should never be used as precise, absolute, black-and-white trading signals. Indicators are best used as clues or hints to future price action. Thus, interpreting indicators is much more an art than a science. Too often, though, traders become prisoners of their favorite indicators and lose the ability to think for themselves. What counts in trading is what the market is saying, not the indicators.

Indicators are best used as confirmations of price action. For instance, if a market is trending in a particular direction and one of my favorite indicators says a reversal is imminent, I wait for the actual price reversal before taking a position. Indicators are best used at market extremes or when the market is range-bound, without any trend. In the latter case, indicators can alert you to which direction the market will move when it begins trending again. A look at many of my actual trades from 1998 and early 1999 later in this book will underscore this point.

Here's an example of how indicators can lead you astray. It's also an example of a terrible trading strategy. On Saturday, February 7, 1998, I received an e-mail solicitation from a long-time promoter hustling his fax service. The stock market had just closed out one of its stronger trading weeks—a gain of 282 points in the Dow and a percentage gain of 3 1/2 percent. There was strong momentum in the market, as evidenced by a gain of more than 600 points in the Dow since January 12. There is nothing more bullish than a market that rises on strong momentum. I was fully invested on February 7.

The promoter soliciting me was very bearish. He cited his favorite indicators as the reasons for his bearishness. The 10-day trin was overbought, put/call ratios were at low levels, and the 42-day cycle was calling for a top. Even though the market was in a strong rising mode, this vendor was recommending shorting the S&P futures because of the bearish readings of his indicators. This fellow obvi-

ously had no understanding of price action. Regardless of what your indicators may be saying, never short a strongly rising market or go long a rapidly declining market. Instead, wait for price action to confirm your indicators.

Even worse, the bearish vendor was recommending shorting the S&P on a scale-up. More specifically, he was saying to short the S&P at 1013, then another contract at 1019, another at 1022, and a final one at 1024. This type of strategy is financial suicide. Never sell on a scale-up. You buy on a scale-up and sell on a scale-down. If you went short at 1013, you would then look to go short at some price lower than 1013. To make a long story short, the S&P continued soaring throughout February and March of 1998. The promoter's recommended short trades were all stopped out at a loss within a matter of days. The point is that the action of the market always takes precedence over your indicators. Indicators are only used to warn us of a possible change in trend. The emphasis here is on *possible*.

While I don't mean to pick on the vendor of this fax service, he should know better. He's a well-known fixture in the futures industry. Yet he's not half as bad as some of the big bad bears who are always forecasting the end of the world based on the readings of their indicators. Two of these persistent prophets of pessimism are actually excellent researchers and market historians. These two market commentators and newsletter writers have over 60 years of market experience between them. However, in all that time, they still haven't been able to grasp the simplest of market principles: Regardless of your indicators, never buck a rising or declining market. Like most analysts, they live and die by their indicators. They remained steadfast bears as the Dow soared from 3800 to over 11000.

I can't emphasize enough that having a complete understanding of stock market indicators is meaningless in and of itself. I can rattle off the name of one market letter writer after another whose knowledge of arcane and esoteric indicators is unsurpassed. Yet year in and year out these masters of the indicators never get it right.

Indicators often lose their effectiveness for prolonged periods. Sometimes this loss of effectiveness can be permanent. The classic example of an indicator gone bad is the spread of the dividend yield on common stocks with the interest rate on long-term government bonds. Prior to the summer of 1958, the yield on common stocks had always been greater than the interest rate on government bonds. Whenever

these yields narrowed to within 1 percent, a major stock market correction was at hand. As Jeremy Siegel relates in *Stocks for the Long Run*, this indicator foretold the crashes of 1891, 1907, and 1929. [2]

During the summer of 1958, the spread of this infallible market indicator not only narrowed to within 1 percent, but it reversed for the first time ever. Suddenly the world was upside down, since bonds were now yielding more than common stocks. Combine that with an economy that had just recorded its highest rate of unemployment since the 1930s, and everywhere you looked were bears growling about an imminent crash. So much for infallible indicators. The market surged over 30 percent during the next 12 months and this once infallible indicator has remained on a major sell signal for more than 30 years and still counting.

The indicator junkyard is littered with many other seemingly infallible indicators gone awry. I recall reading in Dan Sullivan's newsletter[3] in late 1994 about a Merrill Lynch study on the Dow Jones Utilities. This study showed that over the past 50 years there had only been six occasions in which the Utilities fell more than 20 percent from their peak. Each of these occurrences also witnessed a similar drop by the Dow of at least 20 percent. At the time of the report, the Utilities had declined 29 percent from their highs. The implication was that the Dow, which had yet to decline even 10 percent from its high, was due for at least another 10 percent decline over the short term. So what happened? Instead of declining another 10 percent, the Dow soared over 180 percent during the following 4 years.

If you are an indicator junkie, you'll enjoy *The Encyclopedia of Technical Market Indicators*, by Robert Colby and Thomas Meyers.[4] This book is the most complete and comprehensive description and testing of technical stock market indicators ever published. More than 110 indicators are presented, and some of the test results date back 60 years. I highly recommend the book, but with the caveat that the 1988 edition is getting a bit outdated. That's because the reliability of many indicators rises and falls like the tides. I've heard that a revised edition of this excellent book was to be published sometime in 1999.

I keep abreast of the latest indicators and research reports through my subscriptions to the *Market Logic* and *Investor's Digest* newsletters.[5] Both of these publications are edited by Norman Fosback, whom I consider the dean of indicator research. While I may be an indicator skeptic and contend that the past is not a road map to the

future, I still believe it is important to have knowledge of as many indicators as possible. That's because I want to know all the fundamental, technical, and psychological factors that can have an impact on the market.

If you have access to the Internet and are predisposed to indicators, historical charts, and the like, you can't beat Carl Swenlin's Web site at www.decisionpoint.com. This Web site contains one of the largest collections of free technical analysis materials to be found anywhere.

Chapter 9—
My Favorite Indicators

One of the trading books I most recommend for both beginning and experienced traders is Alexander Elder's *Trading for a Living*. [1] I've examined, experimented with, and traded nearly all the conventional indicators so prominently featured in trading books like this. My only quibble with this book is that psychological indicators are barely covered. From my experience, the crux of winning at the trading game boils down to the trader's understanding of market sentiment, so it's not surprising that my favorite indicators are sentiment based.

The sentiment indicators I monitor give me a feel for the pulse of the market. However, I am very phobic when it comes to ratios and percentages. Unlike most indicator-based traders, I don't assign percentages or ratios to my sentiment indicators as guidance for buy and sell decisions. Instead, I monitor their directional changes for clues to possible rallies and declines. I take special notice of my sentiment indicators when they begin exhibiting out-of-the-ordinary behavior. One frequent criticism of sentiment indicators is that they are too imprecise as a timing or trading tool. My retort is that they are no more imprecise than any other indicator. It is vital to monitor sentiment indicators since it is sentiment that moves the market, especially in the very short term.

My sentiment indicators guide me under various market scenarios:

• After a period of rising or falling prices as measured by the Dow or S&P, it is significant when my sentiment indicators hit extreme measurements of optimism or pessimism and then prices begin moving in the direction opposite to that of these sentiment extremes. This is usually indicative of an intermediate-term change in the direction of prices, since the public is wrong at their extremes of optimism and pessimism.

• It is significant when prices are trending sharply higher or lower, but that trend in prices isn't confirmed by a like move in my sentiment indicators. This indicates skepticism on the part of the public and indicative prices have further to move in whichever direction they have been trending.

• Sentiment indicators are also useful for me when prices are moving sideways, especially if this occurs after a period of extreme strength or weakness. I find that during these resting periods, my indicators can be helpful in determining the direction of the breakout from such trading ranges.

I have also found sentiment indicators useful when comparing their readings with those of some of my favorite non-sentiment-based indicators such as the McClellan Oscillator, the High/Low Logic Index, and the 10-day trin.

Nyse Members Report

The specialists on the New York Stock Exchange are often referred to as your broker's broker. Every stock on the New York and American Stock Exchanges has a specialist firm, and orders to buy and sell are routed through this firm. The specialists' function is to maintain a fair and orderly market in the stocks to which they are assigned. When there is a disparity between supply and demand and when there is no competing public order, the specialists buy or sell from their own account. Specialists also maintain a book of orders from the public for prices above and below the market. This affords them insights into the supply and demand for stocks that is not available to the public.

It was imprinted upon me early in my trading career that the specialists on the New York Stock Exchange were the sophisticated traders. This view was heavily influenced from reading two books by Richard Ney from the early 1970s: *The Wall Street Jungle* [2] and *The Wall Street Gang*.[3] Ney believes that stocks move in rhythmic trends that are determined solely by the specialists' price objectives. According to Ney, these price objectives could be determined by a careful analysis of particular chart patterns. My views on the power of the specialists were also reinforced by William X. Scheinman's *Why Most Investors Are Mostly Wrong Most of the Time*, which maintains that it is significant when the buying and selling actions of the specialists diverge from those of other classes of investors.

Weekly data on the total trading activity of the specialists, the public, and NYSE members, including floor traders, are made available by the SEC with a two-week lag. This data is reported in *Barron's* "Market Laboratory" section. Table 9.1 shows the data as presented in the December 28, 1998 edition of *Barron's*. The data contain several sentiment indicators: the public/specialist short sales ratio, the member net balance trading index, and total shorts as a percentage of total volume. I have not found the two-week lag to blunt the effectiveness of this data, which gives me a perspective on major market movements.

At one time, the indicators found in the NYSE Members Report were considered to be superb timing tools. Now, however, they are ignored by the vast analytical horde. Today's conventional wisdom says these indicators have been rendered useless as a result of the explosive growth since the early 1980s in the derivatives markets (options and futures). These derivatives markets have led to a wide variety of new strategies involving short selling for hedging purposes. Nevertheless, I find the indicators from the NYSE Members Report indispensable to my trading, especially when integrated with other sentiment indicators, such as advisory sentiment.

Public/Specialists Shorts

My favorite sentiment indicator from the NYSE Members Report is the public/specialist short sales data. If you find ratios useful, divide the number of short sales of the public by that of the specialists to get the public/specialist short sales ratio. From the data in Table 9.1, the short sales ratio for the week ending December 11, 1998, would be

table 9.1 nyse members report

(Thou Shrs)	Week 12/11	Prev Week	Yr-Ago Week
		Total Volume	
Weekly total	3,549,319	3,715,599	2,854,079
Daily avg.	709,864	734,120	570,816
		Member Activity	
Spec buys (#)	470,453	508,283	367,411
Spec sell (#)	465,190	505,317	356,936
Floor Trad buy	1,807	1,366	1,144
Floor Trad sell	1,607	1,319	1,097
Other buy (#)	364,115	356,150	235,391
Other sell (#)	351,119	366,160	208,367
Total buy	836,376	865,799	603,946
Total sell	817,917	872,797	566,400
Net buy/sell	+18,459	-6,998	+37,546
% of total vol	23.30	23.40	20.50
		Short Sales	
Total	324,218	369,598	287,717
Public	142,983	168,317	131,167
Members	181,235	201,281	156,550
Specialists	145,987	165,661	111,179
Floor traders	551	426	59
Other Members	34,697	35,194	45,312
Spec Public %	1.0	1.0	.8
Members/Public %	1.3	1.2	1.2
		Customers Odd-Lot Activity	
NYSE	Week 12/11	Prev Week	Yr-Ago Week
Purchases	15,475	15,787	10,392
Purchases $	848,302	850,894	553,502
Sales	18,048	18,749	10,916
Sales $	859,298	900,145	527,387
Short sales	665	1,144	560
Short sales $	32,280	54,198	30,343

(*Source:*New York Stock Exchange, 11 Wall Street, New York, NY. Phone 212-656-3000. Reprinted with permission from Barron's © 1998; permission conveyed through Copyright Clearance Center, Inc.)

.98. Prior to the mid-1990s, the public rarely shorted at numbers above those of the specialists. One reason for this is that specialists are frequently required to short stocks to match buy and sell orders. The other more important reason specialists short in greater amounts than the public is that shorting is considered a professional activity and more a function of the sophisticated, smart money.

From the mid-1980s to the mid-1990s, one of my integral trading tools was to get aggressive on the long side whenever the public increased their shorting as compared to the specialists. The rare times they shorted above the specialists on a weekly basis proved especially profitable. This rare phenomenon occurred only once in 1985. This was in early November, right before a 10 percent surge in the Dow over the following six weeks. I fully participated in that rally and it was solely because of the public/specialist indicator. From that point forward, it became one of my most indispensable indicators.

It wasn't until two years later, in November 1988, that the public again shorted above the specialists on a weekly basis. At that time, another one of my favorite indicators, advisory sentiment (discussed later) was at extremely pessimistic levels. So I again became very aggressive on the long side and the market rallied strongly through the first quarter of 1989. I repeated this strategy many times when the public shorts went above those of the specialists and nearly always made above-average profits.

The real worth of the public/specialist indicator became evident during the summer of 1994 when a never-before-seen phenomenon began unfolding. Beginning in August, and for the first time in the history of the New York Stock Exchange, the public began shorting on a nonstop weekly basis in amounts above those of the specialists. This told me something very big was brewing in the stock market. In late 1994, not only was there a major buy signal from the public/specialist indicator, but many of the other sentiment indicators went into buy mode. I knew a huge rally was imminent. All I needed was confirmation from the market in the form of rising prices.

The initial buying surge commenced in January 1995. Yet most analysts and newsletter writers remained bearish throughout the month. Because of poor action in advancing issues versus declining issues and new highs versus new lows, the bearish seers thought the move was simply a bear market rally. Not once did I see any mention from these so-called experts of the historically bullish readings of the public/specialists short selling activity. But most shocking was the way

that, even after prices began rising, the public continued week after week to short above the specialists. This type of skepticism after a period of rising prices indicated the bull run had much further to go.

This unprecedented public shorting went on each and every week during 1995 and 1996, and through June 1997. There were even a few weeks during that period when the public shorted at levels above those of the members—something I never thought I would live to see. I can think of no other technical indicator that not only foretold the great bull market of the late 1990s, but never wavered in its accuracy as prices continued to soar.

Most traders aren't like me. They have this compulsion to measure everything numerically. The best predictive measurement I've seen for public/specialist data is a ratio used by Norman Fosback of *Market Logic*. A thorough discussion of this can be found in the July 17, 1992, issue of his newsletter. [4] One reason the public/specialist ratio has lost much of its past predictive value is that the public has not been consistent in their shorting activities. In the 1940s and 1950s, the public shorted at levels approximately 75 percent of those of the specialists. Then during the 1960s and 1970s, their shorting declined to around 40 percent to 50 percent of those of the specialists. However, since the early 1980s, there has been a pronounced secular trend toward shorting, to where the public now regularly shorts above the specialists.

To eliminate this trend toward an increase in secular shorting, Fosback has created a ratio that restores much of its past reliability as an indicator. He takes a 10-week moving average of the public/specialist ratio and divides it by its 261-week (five-year) ratio. For instance, in December 1998, the 10-week ratio was at 140 percent, with the 261-week ratio at 94 percent. Thus, the ratio of the 10-week to the 261-week was 1.49. Fosback has found that ratios in the 1.25 to 1.75 range have led to stronger-than-average performance in the S&P over the subsequent 3-, 6-, and 12-month time periods. Ratios greater than 1.75 have proved predictive of exceptionally strong performance over those same time frames. Note that I haven't seen any update of Fosback's studies since 1992.

Members Net Balance Trading Index

In addition to short selling activity, the NYSE Members Report provides information on the total trading activities of the exchange members,

specialists, and floor traders. A net buy/sell volume number is derived from these activities and is commonly referred to as the members net balance index. In Table 9.1, for the week ending December 11, 1998, the net balance index is +18,459,000 shares. For numerous reasons, some relating to arbitrage strategies, this index has a historical bias toward net selling.

Whenever I see a string of positive weekly readings, I'm comfortable that the smart money is buying and a rally will ensue. The only current research I've seen on this indicator was a report by Geof Brod in the January 1996 *Aeltus Weekly* newsletter. [5] Brod studied a 9-year, 473-week period beginning in December 1986. He found that when the 4-week moving average of the members net balance index had been positive, the market appreciated at a 20.6 percent annualized clip. This compared to an annualized gain of only 5.2 percent when the 4-week moving average was negative. The annualized buy-and-hold return over this time period was 10.3 percent. During the 473-week period of the study, the indicator had been in positive territory for just 36 percent of the weeks.

In his book, *Stock Market Logic*, [6] Norman Fosback discusses how the members net balance index rarely gives major buy signals. However, when buy signals are triggered, they're almost infallible. A buy signal is defined as massive and continued weekly net buying by the exchange members. The last major buy signal I've seen in this indicator was triggered during the period from September 15 through December 22, 1995. For 14 of 15 weeks, the members went on a buying spree not seen since 1974. This net buying occurred during a period when many other indicators and market pundits were calling for an end to the strong rally that had taken place since the beginning of January 1995. The end result was that the pundits were proven wrong, as the members net balance index correctly foretold a nearly 10 percent surge in the Dow through the end of February 1996.

Other Indicators from the Members Report

There are two other sentiment indicators embedded in the NYSE Members Report: total shorts/total volume and odd-lot shorts/specialist shorts. These indicators are based on the same principle of contrarianism as the others. When traders and investors are overly pessimistic and increase their shorting above historical norms, a rally is imminent. When they are overly optimistic and curtail their shorting below historical norms, a decline or sideways action is imminent.

I have only recently included total shorts/total volume in my trading arsenal. This percentage is derived from dividing total shorts by total volume. For the week of December 11, 1998, as shown in Table 9.1, this indicator would be 9.13 percent. Norman Fosback devoted four pages to this indicator in *Market Logic*. [7] As he points out, this indicator needs to be adjusted upward because of the growing secular trend toward increased shorting. For instance, in 1941, the average reading of total shorts/total volume was 2.3 percent. By 1976, the average reading for this indicator had risen to 7.8 percent. In 1998, 9 percent to 10 percent was considered average.

I look for periods when the total shorts/total volume is significantly above 10 percent or below 9 percent. For instance, in November 1998 the Dow had rallied strongly off its October low by over 1500 points. However, the total shorts/total volume hit 12.6 percent. This was the highest and most pessimistic reading in this indicator in not only the past year, but the past decade. This indicated to me that no serious decline was at hand. As it turned out, the S&P continued rising and made new highs in December 1998 and January 1999.

My problem with total shorts/total volume is that it lumps the smart money specialists in with the not-so-smart money public trader. I would think that the public shorts/total volume, instead of the total shorts/total volume, would prove the more reliable indicator.

The second sentiment indicator from the NYSE Member Report is odd-lot shorts/specialist shorts. The only reference I've seen to this indicator was by William Scheinman in *Why Most Investors Are Mostly Wrong Most of the Time*.[8] Scheinman tested hundreds of indicators and found this one to be highly reliable. Odd-lot shorts are considered to be the least sophisticated of all investor classes. To be perfectly honest, one reason I don't follow odd-lot shorts/specialist shorts is it simply slipped through the cracks. I was reintroduced to it while rereading Scheinman's book. I intend to add it to my sentiment arsenal.

Put/Call Ratios

Although I don't agree, most traders believe that the indicators derived from the NYSE Members Report have lost their predictive value because of the growth in trading of futures and options. As a substitute for the public/specialist short selling activities, many traders now monitor the trading activities of the options traders speculating in puts and calls at the Chicago Board Options Exchange.

A call option gives its owner the right to buy a stock at a specified price, called the strike price, within a certain time frame. Call buyers are bullish, hoping for rising prices. A put buyer is a bear. The put option entitles him to sell a stock at a set price within a given time frame. Put buyers make their money on declining stock prices. *Put/call ratios* (the volume of puts divided by the volume of calls) are used to quantify extremes in sentiment. They are contrary indicators, meaning that the higher the number of puts traded versus calls, the greater the possibility the stock market is at or near a bottom.

At the CBOE, options are traded on equities and indexes such as the S&P 100, the S&P 500, and the Dow Jones. The S&P 100, more frequently referred to as the OEX, is the volume leader among the index options. CBOE put/call volume is available intraday at half-hour intervals by phone at 888-586-5286. There you will find a ratio of total puts to total calls, commonly referred to as the CBOE put/call ratio. This ratio consists of the total volume of all equity and index options combined. After this ratio is given, the CBOE then breaks down the volume for equity options, for index options, and then for each category of index options, such as the S&P 100 and S&P 500.

Traders who speculate in the buying of puts and calls are considered the least sophisticated. One reason for this is that, of the group of traders who speculate in stocks, futures, mutual funds, or options, it's the option traders who tend to be the least capitalized. As Richard Band describes them in *Contrary Investing*, "By nature, people who play the options market tend to be gamblers, dreamers, who hope to parlay a couple thousand dollars into a fortune. As a group, they represent the dumb money at its dumbest." [9]

There are many ways to measure sentiment using put/call ratios. One of the more common is that CBOE put/call ratios over .80 are bullish and under .40 are bearish. Another interpretation says that in bull markets, four days of readings greater than .50 for the equity-only put/call ratio generally precede market rallies of at least 5 percent.

My favorite statistical models for measuring put/call ratios are the following:

• When daily total CBOE put volume doubles its 10-day average

• Single-day OEX readings of 1.60 puts over calls

• Consecutive daily CBOE put/call ratios of 1.00 or greater

• Equity-only put/call ratios above .75

Put Volume Doubling Its Ten-Day Average

In a March 1993 article in *Technical Analysis of Stocks and Commodities,* [10] John Bollinger discussed the significance of total CBOE put volume doubling its 10-day average. Bollinger presented a 10-year history of his indicator. The results were impressive. Not only did it flash a buy signal at important bottoms, but it often did so at the momentum low of the move rather than at the final price low. This gives traders time to cover any shorts and to go long at their leisure, free to devise a strategy for when prices begin to move up. Bollinger's put volume indicator has continued its accuracy throughout the most recent years.

Single-Day Oex Put/Call Ratios over 1.60

This indicator is the brainchild of Bernie Schaeffer, the author of *The Option Advisor*[11] and senior editor of *The Option Advisor Newsletter*. A reading in the OEX put/call ratio above 1.60 is indicative of extreme pessimism, and a market rally is imminent.[12] The 1.60 put/call indicator is especially effective when it occurs on a day the market closes up.

Table 9.2 shows how the S&P 100 index performed following single-day readings in the OEX put/call ratio above 1.60. Instead of using the S&P 100 Index as the benchmark, I found similar results using the S&P 500 or the Dow. The column titled "On Up Day" refers to a day that closed up in the S&P 100, in which the OEX reading was 1.60 or greater. A down day reflects a day in which the S&P 100 index closed down and the OEX put/call ratio was 1.60 or greater. The column titled "At Any Time" denotes the average day's trading performance during the test period.

As an example, if the OEX put/call ratio is 1.60 or greater, and this reading occurred on a day the S&P 100 Index closed higher, then expect that index to be 1.26 percent higher in five trading days. After 25 trading days, look for the market to climb 3.19 percent. This compares to an average gain of .28 percent over five days and 1.40 percent over 25 days.

Consecutive Cboe Put/Call Ratio over 1.00

A third effective measuring tool for the put/call ratio is to watch for consecutive-day readings of 1.00 or greater in the CBOE put/call ratio. This indicator is another discovery by Bernie Schaeffer. The most recent research I've seen on this indicator appeared in the April 1995 issue of *Investor's Digest*.[13] From January 1990 through March 8, 1995, there had been only 18 times that consecutive put/call ratios were 1.00

table 9.2 oex put/call ratio

Days	On Up Day	On Down Day	At Any Time
1	0.31%	0.26%	0.06%
2	0.59	0.43	0.11
3	0.91	0.31	0.17
4	1.15	0.32	0.22
5	1.26	0.38	0.28
10	1.39	1.15	0.56
15	2.10	1.60	0.84
20	3.06	2.00	1.12
25	3.19	2.40	1.40

(*Source: Schaeffer's; Research Review*. Reprinted with permission.)

or greater. One month later the market was higher 12 times, and three months later it was higher 14 times.

Cboe Equity-Only Put/Call Ratio of .75 Or Greater

The fourth put/call ratio indicator uses the CBOE equity-only put/call ratio. This indicator was discussed in a February 4, 1998, Standard & Poor's "Learning Curve" column [14] at the www.quicken.com Web site. In its entire history (data begins October 1, 1985), there have only been 11 times that the daily equity-only put/call ratio has hit .75 or higher. This is a very powerful signal, especially for longer-term traders and investors one year out. Factoring out multiple signals from this indicator that occurred within 30 days of each other leaves you with only five major signals. Table 9.3 shows the results for the S&P and Nasdaq one year after these major signals.

These results, especially in the Nasdaq, are most impressive and have afforded long-term investors excellent entry points. It is interesting that when this article appeared at the Quicken Web site, a sixth buy signal had been generated on December 19, 1997. The result of this signal was an annual gain in the S&P of 25.48 percent and a gain in the Nasdaq of 36.82 percent—once again, very impressive returns, most notably in the Nasdaq.

In the past, this indicator was valuable for short-term traders because, once it was triggered, the S&P had always been within 2 per-

table 9.3 cboe equity-only put/call ratio

Signal Date	S&P One Year Later	Nasdaq One Year Later
12/03/87	+20.29%	+23.23%
10/10/90	+26.34%	+54.90%
01/08/91	+33.17%	+65.08%
10/05/94	+28.27%	+37.69%
07/15/96	+45.09%	+40.63%

cent (on a close basis) of its ultimate low and the Nasdaq within 4 percent of its ultimate low. This historical reliability proved ineffective on August 21, 1998, when the equity-only put/call ratio was over 1.00, its highest daily level in more than 10 years. However, the S&P declined another 12.7 percent and Nasdaq 21 percent until their ultimate closing lows on October 8.

As I've mentioned, I'm not one for black-and-white trading rules. I find relevance in all the put/call ratios previously mentioned, but I will rarely take a trade based solely on put/call ratios. By synthesizing all my sentiment indicators, I get a feel for any subtle changes that may be occurring within the market. As for put/call ratios, besides the readings at the extremes, I'm most interested when periods of strongly rising prices are met with heavy put buying and, conversely, when periods of strongly declining prices are met with heavy call buying—in other words, when there are divergences.

A good example is early 1995. This was a period of rapidly rising prices, yet it was also a time when there was heavy put buying. This divergence existed because the public did not believe the rally and bought puts in anticipation of a reversal. This type of behavior by the public told me prices would only go higher. On the other side, I don't like to see heavy call buying when prices are selling off. This means the public is complacent about the decline and anticipates higher prices by buying calls.

Other than the rare instances when the equity-only put/call ratio reaches above .75, I pay little attention to equity-only ratios. Nor do I pay much heed to total CBOE put/call ratios. I'm primarily interested in the index ratios, which include the OEX and the S&P 500. I call the toll-free CBOE number several times during the trading day to see if any-

thing out of the ordinary is happening in these index ratios, which are the most beneficial for short-term traders like myself. In fact, the intra-day OEX put/call ratio was my primary trading tool as a day trader in stock futures in the late 1980s. For some reason, though, this indicator lost most of its effectiveness as an intraday trading tool in November 1989.

There Are No Experts

Before discussing advisory service sentiment, I should explain how I came to dislike the so-called experts. It all goes back to an incident in the 1970s, during which I spent much of my free time at a commodities trading firm where I formerly worked as a broker. One of the accounts at the firm had given power of attorney to an internationally known technical analyst, who had written a well-respected book on commodity trading systems. Much to my and the firm's surprise, this acclaimed guru traded a $20,000 account down to $3,000 in a matter of weeks. That really made me question whether experts in trading actually existed.

Many years later, in the 1980s, I became acquainted with a fellow who worked for several years at various discount trading firms in Chicago. At one time or another, most of the famed traders who marketed trading books, newsletters, and systems had traded at these firms. My friend told me one horror story after another about how unsuccessful these trading legends had been when real money was on the line. His most memorable tale was about the promoter who was running full-page ads in *Futures* magazine hawking a $4,000 trading system, while at the same time his real-money trading account was rapidly approaching zero—and from trading the system he was so heavily touting, no less.

Comic Strips That Predict the Stock Market

My agnosticism about experts is also a result of the many books I read about stocks in the 1970s. High on that list was John Springer's *If They're So Smart, How Come You're Not Rich* [15] and Murray Teigh Bloom's *Rogues to Riches*. Springer's book is an inside look into the performance of the investment advisory industry. Bloom's book

details how stocks are bought and sold, pushed and touted, and promoted and lied about to higher levels. After reading these books it's no wonder I've always been convinced that there are no experts on Wall Street.

One story that was highlighted by both Springer [16] and Bloom[17] was that of newsletter writer Frederick N. Goldsmith, an investment advisor who published a newsletter from 1916 to 1948. In the fall of 1947, the New York attorney general's office began an investigation of Goldsmith after he implied that his recommendations were from "inside information." During the investigation, Goldsmith said he started his newsletter after a friend of his had a psychic experience during a seance. During that seance, a spirit of a former Wall Street trader revealed a secret code for stock market success that was floating around in the newspaper. Goldsmith took this information and, after much study, found it to be absolutely correct. Many of Goldsmith's recommendations came from the comic strip "Bringing Up Father." The main characters in this strip were Jiggs and his wife Maggie. Goldsmith said this comic strip provided clues to the stock market and, once he broke the code, he was able to predict the market with 90 to 95 percent accuracy. For instance, if Jiggs had his right hand in his pocket, this was a signal to buy. If there were two rings of smoke rising from Jiggs's cigar, the market would rise in the second hour of trading. One comic strip showed Jiggs and Maggie at the theater. When Jiggs said the intermission was the best thing about the show, Goldsmith interpreted this to be a buy signal for Mission Oil.

Goldsmith's newsletter received praise from well-known brokers and became the bible for many large Wall Street trading firms. One well-respected analyst, who has written articles for *Barron's* and was a columnist for *Forbes* magazine, used Goldsmith's newsletter. Other subscribers testified that Goldsmith's advice had made them significant money and was the best newsletter out there.

Nevertheless, a New York supreme court justice signed an injunction that forced Goldsmith out of business. The justice said the subscribers were misled into believing that Goldsmith had superior knowledge of the stock market—that whatever information Goldsmith offered should have come from living people, not comic strip characters. And what about the creator of the comic strip? When questioned, he said if he knew anything about the stock market he certainly wouldn't be making his living from drawing cartoons.

Advisory Sentiment

There are several polling services that attempt to measure sentiment to determine extremes of optimism or pessimism. Various classes of investors are polled: newsletter writers, brokers, advisors, and the public. The theory behind these sentiment surveys is that when bullish or bearish opinions become too one-sided, the market has run out of new buyers and sellers and a reversal is imminent in the existing trend. The four most widely followed sentiment services are *Investors Intelligence*, *Market Vane*, *Consensus*, and the *American Association of Individual Investors* (*AAII*). The results of these sentiment polls are available weekly in the "Market Laboratory" section of *Barron's*. Table 9.4 is from the November 23, 1998, edition of *Barron's* and shows how these sentiment surveys are formatted.

One problem with using advisory sentiment as your sole sentiment indicator is that there has been a secular change over the years as to what constitutes extreme optimism and pessimism in many of the polls. This change has been most evident beginning in 1995 when the market began a sustained move upward. For instance, according to Alexander Elder in *Trading for a Living*, [18] when the percentage of bears among stock market letter writers (as tracked by *Investors Intelligence*) rises above 55 percent, the market is near an important bottom. When the percentage of bears falls below 15 percent and the percentage of bulls rises above 65 percent, the stock market is near an important top.

The problem with these percentages is that, although useful at one time, they are very outdated. For example, the 15 percent bears and 65 percent bulls, which supposedly are indicative of a top, last occurred during several weeks in March and April 1986. Even then, this period wasn't anywhere close to a market top. As for 55 percent bears being an indication of a market bottom, these percentages haven't occurred since 1994. Since then, bearish readings haven't surpassed 50 percent, much less 55 percent. Throughout the 20 percent decline the S&P suffered during August and September 1998, the highest percentage seen among *Investors Intelligence* bearish advisors was only 47.5 percent.

The same phenomenon also seems to be at play with *Market Vane*. I can recall how, like clockwork, whenever their bullish consensus number for stock index futures reached 60 percent, a top was imminent

table 9.4 investor sentiment readings

In *Investors Intelligence*'s poll, the correction figure represents advisers who are basically bullish, but are looking for some type of short-term weakness. High bullish readings in that poll, in *Consensus Inc.*, or in *Market Vane*'s, usually are signs of market tops; low ones, market bottoms.

	Last Week	Two Weeks Ago	Three Weeks Ago
	Investors Intelligence		
Bulls	57.0%	53.1%	47.8%
Bears	31.6	35.4	38.3
Correction	11.4	11.5	13.9

***Source: Investors Intelligence*, 30 Church Street, New Rochelle, NY 10801. 914-632-0422.**

	***Consensus* Index**		
Bullish Opinion	42%	63%	37%

***Source: Consensus Inc.*, 1735 McGee Street, Kansas City, MO 64108. 816-471-3862.**

	***AAII* Index**		
Bullish	40%	50%	38%
Bearish	18	14	20
Neutral	42	36	42

***Source. American Association of Individual Investors*, 625 N. Michigan Ave., Chicago, IL 60611. 312-280-0170. Results are based on a 51% response rate.**

	Market Vane		
Bullish consensus	66%	60%	59%

***Source: Market Vane*, P.O. Box 90490, Pasadena, CA 91109. 626-395-7436.**

within days. In the late 1990s, however, it hasn't been uncommon to see several weeks of readings above 60 percent, and even 70 percent, where the market just kept marching steadily higher.

Investors Intelligence

Investors Intelligence is the oldest of the sentiment-monitoring services. *Investors Intelligence* takes a weekly poll of over 130 investment advisory services, breaking down the results into a percentage of bulls, bears, and those who are bullish but are expecting a correction. The survey results are available each Wednesday at 11:00 A.M. eastern time through a pay-per-call number. [19] These results are also made available on CNBC, usually during the 11:00 to 12:00 A.M. program on Wednesdays.

I have been following the *Investors Intelligence* sentiment poll since 1985. Its accuracy in calling tops and bottoms was suspect during 1985, 1986, and much of 1987. Since mid-1987, though, it's been a different story. Nearly every major top and bottom since that time has been accompanied by extremes in optimism and pessimism in the *Investors Intelligence* sentiment survey. In fact, it was thanks to *Investors Intelligence* that I was able to completely sidestep not only the crash of 1987, but the carnage leading up to the crash.

There are no precise rules for interpreting the *Investors Intelligence* sentiment survey. Since 1995, I've looked upon a series of two to three consecutive weeks of bullish readings in the 50 percent to 55 percent range, combined with bearish readings between 25 percent to 30 percent, as a warning of trouble ahead for the market. Bearish readings below 25 percent, with bulls above 50 percent, have invariably led to market declines.

There is also cause for concern when the percentage of bullish advisors minus that of bearish advisors exceeds 30 percent. This net bull indicator was developed by John Bollinger, of Bollinger Capital Management,[20] and flashed a timely sell signal at the market top in July 1998.

It's not just the extremes in sentiment that are relevant, but the lack of movement toward these extremes in the face of rapidly rising or falling prices. A classic example of the latter phenomenon occurred in 1995. Stocks began rising in January of that year and then went ballistic in an almost straight shot through mid-August. Yet during the first several months of that meteoric rise, bullishness among advisory services barely budged. In periods such as this when sentiment doesn't

rise to match the rise in stock prices, you can expect even further gains in the market.

As a short-term trader, I am primarily interested in only the week-to-week changes in the *Investors Intelligence* poll. Some analysts, however, like to smooth out these weekly percentage changes with a moving average. Marty Zweig, in *Winning on Wall Street*, [21] and Norman Fosback, editor of the *Market Logic* newsletter, advise making a calculation of bulls divided by the total of bulls plus bears and plotting that percentage on a 13-week moving average. Fosback considers readings over 75 percent as excessive optimism and possible areas for market tops, and readings below 40 percent as excessive pessimism and areas for market bottoms. However, these levels are never seen anymore and my suggestion would be to use a shorter smoothing period such as four to six weeks.

The best analysis I've seen on the data from the *Investors Intelligence* surveys are in Jeremy Siegel's *Stocks for the Long Run*.[22] Siegel took the weekly readings of bulls as a percentage of bulls over bears (as previously described) and compared the results with the returns on stocks over the following three-, six-, nine-, and 12-month periods. He found a strongly predictive content to the sentiment index, particularly over the 3-, 9-, and 12-month periods.

Consensus and Market Vane

What I like best about the *Consensus* and *Market Vane* weekly sentiment polls is that they are geared more to shorter-term traders like myself than the *Investors Intelligence* poll. The sentiment numbers from these two services are for stock index futures. As such, these numbers fluctuate more rapidly between bullishness and bearishness than do the sentiment percentages from *Investors Intelligence*.

Advisors who specialize in stock index futures have much shorter trading time frames than do the investment advisors who recommend stocks. Most of the time there is agreement between *Investors Intelligence, Consensus,* and *Market Vane*. However, when there is a divergence in bullishness and bearishness between *Investors Intelligence* and the other two sentiment services, I go with the latter two, since, based on my experience, they are more reliable over the short run.

An example of this divergence between the services occurred between mid-November and December 1998. The *Investors Intelligence* bulls reached multiyear highs and remained there week after week. Yet

prices as measured by the S&P and Nasdaq 100 continued to make new highs. Those frightened off by the extreme readings in the *Investors Intelligence* bullish investment advisors data would have missed out on much of the run to new highs. However, the bullish consensus readings from *Consensus* and *Market Vane* were much more muted and proved to be more accurate in forecasting higher prices.

Sentiment figures from *Consensus* are available on Tuesday mornings from a pay-per-call number. [23] The *Consensus* poll has been consistent through the years that readings over 80 percent reflect too much optimism and hence are bearish, while readings below 25 percent reflect too much pessimism and are bullish.

Market Vane has a daily bullish consensus hotline that can be accessed after 5:00 P.M. pacific time through a pay-per-call number.[24] In the past several years, readings over 70 percent have signified too much optimism, and below 35 percent, too much pessimism.

AAII Investor Sentiment Survey

The *American Association of Individual Investors* is a nonprofit organization that caters to the education of individual investors.[25] Most likely, you have been solicited for their monthly publication, the *AAII Journal*. A weekly sentiment poll of members can be found on their Web site at www.aaii.com, normally on Friday morning. I have never found much consistency or any tradable patterns from the *AAII* sentiment survey. The readings of bullish and bearish sentiment jump around in too volatile a fashion on a week-to-week basis. If anything, I find the public, as represented by the *AAII* survey, to be more prescient of the market than the professional advisors and newsletter writers.

In *The Option Advisor,* Bernie Schaeffer suggests combining the sentiment measures from *Investors Intelligence, Consensus,* and *AAII* to get a composite reading of the bullish sentiment existing in the market at any given time. The example in his book is a five-week moving average of this composite, showing readings over 50 percent as excessive optimism and below 25 percent as excessive pessimism.[26] This idea is excellent, although I would substitute *Market Vane* for *AAII*. I would also want to do a bit more research to determine the levels that have constituted excessive optimism and pessimism during the most recent four to five years.

There are two other sentiment surveys, both available on the Internet, that I occasionally monitor. The first can be found at

www.techstocks.com/survey.html. This is a survey at the Silicon Investor Web site for technology stocks. The other survey can be found at www.lowrisk.com/sentiment.htm. This is a very timely contrary sentiment indicator. Lowrisk.com has a "Guess the Dow" contest each week, from which they measure investor sentiment. In 1999, the sentiment index at Lowrisk.com has been more accurate (on a contrary basis) than the more established sentiment services.

Rydex Asset Levels

This is a sentiment indicator you rarely read about. The Rydex family of funds specifically caters to traders and market timers. The assets in the various Rydex funds are reported daily a few hours after the close of trading. [27] Because of the higher minimums required to open an account, Rydex attracts a more professional base of traders and timers. However, their record at beating the market is no better than that of the average public trader. The professional traders and timers get overly optimistic at market tops and overly pessimistic at the bottoms. So extremes in the asset levels of particular funds at Rydex often give clues to market reversals.

The Rydex Nova Fund attempts to provide a 150 percent exposure to the S&P. For example, if the S&P rises 1 percent, the Rydex Nova Fund should increase by 1.5 percent for the day. This fund is also known as a leveraged fund, since stock index futures are used to achieve the 1.5 ratio to the S&P. Note, however, that this is a very inexact science. For instance, in 1997 the S&P rose 23 percent. Had the Rydex Nova Fund achieved its objective, it should have risen 34.5 percent, but it rose only 25.5 percent in 1997.

The Rydex Ursa Fund is a bear fund and is designed to move inversely to the S&P. So on a day when the S&P declines 2 percent in value, the Ursa Fund should rise by a like amount. The Rydex OTC Fund tracks the Nasdaq 100, is primarily a tech fund, and is most affected by the price movement in Dell, Intel, Microsoft, Cisco, and MCI WorldCom. The Rydex Arktos is a bear fund and is designed to move inversely to the Nasdaq 100 Index.

For the past two years, I've been recording the nightly asset levels of the Rydex funds, primarily looking for divergences between the asset levels and prices and the point at which asset levels reach extremes of optimism and pessimism. This is still a project under construction, and I haven't uncovered any ironclad rules using the Rydex

asset levels as a contrary sentiment indicator. However, the few times I have traded based on this indicator have proved profitable. October 14, 1998, is an example.

On the morning of October 14, I posted to one of the Internet newsgroups the following: "Rydex Ratio Predicts Rally Ahead." I went on to state that a rally could and should begin today. While the Dow closed up 30 points that day, the overall market was much stronger, with the S&P up almost 11 points and the Nasdaq 100 up more than 30 points.

What I saw in the Rydex asset levels on the morning of October 14 is shown in Table 9.5. The S&P closed at its yearly low on October 8. It then surged over 35 points to its October 13 close. Yet, the asset levels in the Nova Fund had barely budged. Normally during rallies of that magnitude, there is a decided increase in the assets of the Nova Fund and a decline in the assets of the Ursa Fund. The fact that this didn't occur between October 8 and October 13 indicated to me that no one believed the rally. I interpreted this to mean the rally had much further to run.

I was already invested in funds on October 14, having entered the market on the late-day V-bottom reversal of October 8 (more about this in Chapter 12). But because of the Rydex asset levels indicator, I increased my exposure to funds before the close on October 14. Of course, I never expected the fireworks that were to take place the next day, as the Dow skyrocketed 330 points in response to the surprise move by the Federal Reserve in lowering interest rates.

I again profitably used the Rydex assets indicator on October 19, increasing my exposure even further. I found it amazing that, in spite of the tremendous surge in the Dow and S&P on October 15, the assets in the Nova Fund decreased and the Ursa Fund increased the following day on October 16. It boggled my mind that, in spite of the runup in the S&P, traders were not taking this seriously, as evidenced by their maneuvers in the Rydex funds. As it turned out, the market continued running to the upside during the remainder of October and through the end of January 1999.

As one analyst told me, there are some market timing gems to be mined in the Rydex asset data. But uncovering them could prove difficult, since most traders can only relate to ratios and formulas. If you are into ratios (which, of course, I'm not), my advice would be to look for major bottoms in the market when the assets in the Ursa Fund are more than three-to-one that of the Nova Fund. The same thinking

table 9.5 assets in rydex funds

1998	Nova	Ursa	OTC	Money Market	S&P
October 5	509.2	992.2	380.9	944.1	988.56
October 6	488.7	980.3	358.0	954.8	984.59
October 7	462.4	1044.8	337.6	972.1	970.68
October 8	371.7	1022.8	309.9	1089.5	959.44
October 9	407.9	1005.7	388.8	886.7	984.39
October 12	445.4	956.4	438.5	892.9	997.71
October 13	399.9	1017.1	377.4	976.0	994.80
October 14	492.4	958.6	425.9	789.6	1005.53
October 15	545.1	845.9	510.1	807.0	1047.49
October 16	504.0	855.8	500.2	916.3	1056.42

applies to major tops. Three-to-one ratios in favor of Nova over Ursa spell trouble. However, the complicating factor here is the assets in the Money Market Fund. Tops and bottoms are also usually made when cash levels are historically low. I've seen periods when Nova has exceeded Ursa by three to one, yet assets were high in the Money Market Fund and the market continued rising.

My suggestion on the Rydex asset levels would be to do as I have done the past few years: Get in the habit of calling nightly and writing down the asset levels. With time and experience, you will begin to see patterns in the changes of the Rydex assets with the S&P and the Nasdaq 100.

Rydex has recently added sector funds to their stable of funds. The asset levels of these sector funds are also provided nightly. Divergences in the Rydex sector funds, with their underlying indexes, can also prove useful as timing tools for various sectors such as technology, energy, telecom, and basic materials. As with the larger Rydex funds, this process is still in the works for me as a trader.

Commitments of Traders Report

The Commitments of Traders (COT) Report is a biweekly report from the Commodity Futures Trading Commission (CFTC) detailing the long and short futures positions of the large commercial traders, the large speculators, and the small speculators. For the S&P futures, the com-

mercials comprise the banks, brokers, and mutual funds. The large speculators are the commodity funds, and the small speculators are traders like you and me. At one time, the COT Report was an integral part of my trading arsenal. Even though I religiously monitor this report, it is no longer that relevant to my trading. This report is yet another indicator that has been trashed by the greatest bull market of anyone's lifetime.

My sentiments about this sentiment indicator are best summed up by Howard Simons in an article in the June 1998 *Futures* magazine: "Many system vendors and analysts suggest trading on the Commitments of Traders Report is potentially lucrative. A quantitative look at one market suggests otherwise." [28] I say, amen, brother. In fairness, I must say the market Simons was looking at was wheat, not the S&P. But I've done extensive work with the S&P and know other traders who have done likewise. Our conclusion is the COT has lost much of its predictive relevance.

I recall an article many years ago in *Barron's* in which an analyst stated that anytime the commercials assumed a net short position in the S&P, a downturn was imminent. Betting on such an outcome since 1995, however, would have cost a trader a significant amount of money. I can still remember how, after the big 1995 runup in the S&P, the commercials suddenly went net short for several weeks late in the year. All the pundits were out in force calling for a major correction. Instead, the S&P soared, making one new high after another.

I've been told that Larry Williams, a legendary trader and analyst, has done some innovative research with the COT. If so, I would enjoy reading it. I respect Larry's insights immensely.

As with any indicator, the COT probably has some value when it approaches yearly or multiyear extremes. If I saw the commercials with a net short position not seen in years, I would certainly take notice, and especially if my other sentiment indicators were uniformly bearish.

The Commitments of Traders Report is available biweekly on Fridays at approximately 3:30 P.M. eastern time. It can be found at the CFTC Web site at www.cftc.gov. After you get the homepage, click on Commitments of Traders Report. Then scroll down that page and click on Chicago Mercantile Exchange—Short Form. Scroll down that page until you come to the S&P 500 Stock Index—International Monetary Exchange. There you will find the previous two weeks' (ending on Tuesday) net long and short positions for the three classes of traders.

Other Sentiment Indicators

Other widely followed sentiment indicators are short interest and the short interest ratio, mutual fund cash positions, insider trading, and the Wall Street Week Elves Index. I monitor these sentiment indicators, but find they are of little or no importance in my trading. Mutual fund cash positions are another one of those indicators that have been at least temporarily rendered ineffective by the great bull market of the late 1990s. Insider trading activity is a favorite forecasting tool of academics and market letter writers, which I find is useless.

The Wall Street Elves Index is shown weekly on the *Wall Street Week* television program and is a sentiment poll of 10 Wall Street technicians. This indicator used to be an excellent contrary indicator when it reached extremes of bullishness or bearishness. But in recent years the index has been of little importance, remaining in high bullish territory due to the sustained upward advance in stock prices.

Another sentiment indicator I've discarded is big block trades. A table of block trades of 10,000 shares and greater appears each week in *Barron's*. These block trades are reported daily for the preceding week and are broken down into trades that occurred on upticks and on downticks. In the late 1980s and early 1990s this indicator had some predictive value on a contrary basis when there was a period of days in which downticks swamped upticks. But during the late 1990s such predictive value has been all but lost.

Chapter 10—
Technical Indicators

In addition to sentiment indicators, there are a few technical indicators I find to be of some use, especially when combined with the sentiment indicators. As I constantly mention, the 1990s have not been good times for stock market indicator junkies. Fundamental valuation indicators were the first to falter around 1993, followed by many revered technical indicators beginning in 1995. Even some of my sentiment indicators have had a rough time of it in late 1998 and early 1999.

High/Low Logic Index

The High/Low Logic Index was invented by Norman Fosback in 1979 and is covered in his book, *Stock Market Logic*. [1] This indicator is also followed biweekly in his newsletter of the same name. The High/Low Logic Index can be calculated on a daily or weekly basis. The index is the lesser of either (1) new highs as a percentage of total issues traded or (2) new lows as a percentage of total issues traded.

For example, during the week ending November 20, 1998, there were 3,679 issues traded on the NYSE. Of these, 192 made new 52-week highs, while 103 issues made new 52-week lows. The High/Low Logic Index for the week was 2.8 percent. This is calculated by dividing 103

(the lesser of 192 or 103) by total issues of 3,679. Weekly highs and lows can be found in Monday's *Wall Street Journal* and *Barron's*.

The rationale behind the High/Low Logic Index is that when a large number of stocks are making *both* new weekly highs and new weekly lows, it's a sign of internal market weakness. Such weakness is usually characterized by a churning market and one in which the blue chips are masking weakness in the rest of the market. Historically, these types of internal market divergences have led to sell-offs and, often, bear markets.

The High/Low Logic Index is most predictive if used with a 10-week moving average. Readings above 4.5 percent constitute a sell signal, and below I percent, a buy signal. On a weekly basis, readings above 7 percent and under 1 percent are considered extreme and, respectively, are sell and buy signals. Weekly readings over 10 percent are rare, but particularly ominous.

High/Low Logic Index sell signals occurred near the market peaks of 1961–1962, 1966, 1969, 1972, and 1976. Of more recent relevance, the High/Low Logic Index gave a sell signal on October 2, 1987, prior to the October 19 crash and on July 13, 1990, prior to the bear market that began less than three weeks later. Another sell signal happened on March 11, 1994, just prior to a nearly 10-month "stealth" bear market. The High/Low Logic Index was also one of the few indicators that accurately called the July 1998 top.

The High/Low Logic Index, however, is not infallible. It gave a very false sell signal the week ending January 16, 1998, as the Dow was embarking on a vigorous 1400-point four-month rally. It also gave a very untimely sell signal on December 20, 1991. The very next trading day, on December 23, the Dow surged 3 percent and then another 6 percent through the end of that year. My advice is that tax loss selling in December can skew new highs and lows; thus, I would ignore buy and, especially, sell signals in the High/Low Logic Index during December and January.

Other High/Low Indicators

Carlton Lutts, the publisher of the *Cabot Market Letter*, [2] developed a timing tool based on new 52-week lows, called the *two-second indicator*. This method proposes that, as long as the number of daily new lows on the NYSE does not exceed 40, the market is sound and in no danger of any serious decline. Using this indicator of 40 new 52-week lows, Lutts

breaks down the market into three distinct categories of varying degrees of strength or weakness. It wouldn't be appropriate to reveal all the pertinent aspects of this proprietary indicator and I suggest you contact Lutts directly for more details. Although aware of this indicator, I no longer find it useful from a trader's standpoint in the market environment we have seen in the late 1990s.

Technicians now prefer to take new daily 52-week lows as a percentage of total issues traded on the NYSE as a determinant of the market's internal health. Some consider it a warning of trouble ahead when 2 percent of the total issues traded hit new 52-week lows for five consecutive trading days.

Norman Fosback at *Market Logic* developed a frequently quoted indicator based on the percentage of stocks hitting new lows on a weekly basis. According to Fosback, a market bottom is at hand when, on a weekly basis, 40 percent or more of the stocks on the NYSE are making new 52-week lows. [3] In the 1990s, this indicator has been two for two in calling the 1990 and 1998 lows.

Titanic Sell Syndrome

Many indicators are based on the principle that when the Dow is making new highs, you want confirmation from new highs/lows and advances/declines that the rest of the market is also healthy. One such indicator is the Titanic Sell Syndrome, developed by the late William Ohama.[4] This indicator is based on the following conditions:

1. The Dow makes a new 52-week high.

2. The 52-week daily lows equal or exceed the daily highs within seven trading sessions.

After these two conditions are met, you also must have two confirming signals:

1. After the 52-week high, declining issues on the NYSE exceed 1000 for two consecutive days and on one of these days the advance/decline ratio is less than .25.

2. After the 52-week high, there are four days of more than 1000 declining issues during seven trading sessions.

The sell signal reverses if the 52-week high is exceeded by 2 percent on the upside.

Admittedly, the Titanic Sell Syndrome is a mouthful. Stripped of all its jargon, it simply identifies tops that are accompanied by weak market internals. As you will see later in this book, I am usually long gone by the time indicators like the Titanic Sell Syndrome flash their warnings.

Advance/Decline Line

This is one of the most basic indicators of the market's overall health. To calculate the advance/decline line, take the difference between the daily number of advancing issues and the number of declining issues (ignore unchanged issues). This daily figure is then added or subtracted to a cumulative number to determine the advance/decline line. For example, on December 22, 1998, there were 1289 advancers and 1755 decliners on the NYSE. The advance/decline line number was - 488. This would then be subtracted from the cumulative advance/ decline line.

All sorts of rules and systems have been devised around the advance decline line. I just try to keep it basic, by adhering to these principles:

• When the Dow declines while the advance/decline line is rising, the market will rise.

• When the Dow advances—especially to new highs—while the advance/decline line is falling, the market will decline.

• When the Dow approaches a previous low and the advance/ decline line is well above where it was at the time of that previous low, it's time to become bullish.

• When the Dow approaches a previous high and the advance/ decline line is well below its previous reading, which corresponded with that top, it's time to be cautious.

• The direction of breakouts from trading ranges in the Dow and S&P can often be determined if the advance/decline line has already broken out of its trading range.

Figure 10.1, showing the advance/decline line, indicates the divergence beginning in early April 1998. Note how the Dow went on to new

Figure 10.1
advance/Decline line
(Source: © 1999 decisionpoint.com. Permission granted by www.decisionpoint.com)

highs a few months later as the advance/decline line trended down. Eventually, that type of negative divergence led to a severe market break during late July and August.

But as I continue to reiterate, no indicator is infallible. Note also in Figure 10.1 the extreme negative divergence between the Dow and the advance/decline line in early 1999. Just about every analyst alive was pointing to this divergence as evidence the market was setting up for a replay of July 1998. As you will see in Chapter 12, the opposite occurred. The advance/decline unexpectedly turned upward in April as the Dow rocketed ahead over 1000 points.

Dow Jones Utilities Average

Famed technician Edson Gould thought the Dow Jones Utility Average was one of the best early indicators of the stock market. As with any

indicator, though, the Utilities aren't precise as a timing tool. Still, they remain near the top of my list of favorite technical indicators. With but a few exceptions, a pronounced uptrend or downtrend in the Utilities eventually will be followed by the broader market. For example, the Utilities peaked in November 1972, and the worst bear market since 1929 was then ushered in when the Dow peaked a couple of months later, on January 11, 1973. The Utilities then signaled an end to that devastating bear market when they bottomed in September 1974, a few months before the ultimate Dow low in December.

While most of the time the lag between the Utilities and the overall market is but a few months, there are periods when the divergence can persist for much longer. For instance, the Utilities peaked in January 1987, while the broader market continued soaring through August of that year. There was a similar long lag in 1990 when the Utilities peaked in January, followed by the rest of the market in July. The utilities peaked on August 31, 1993, but the overall market didn't peak until the end of January 1994. More recently, the lags have been shorter between the Utilities and the broader market. The utilities made their highs and began selling off in late January 1997, six weeks before the Dow underwent a nearly 10 percent correction.

It's not just on the downside where the Utilities lead the broader market. There was a setback of more than 10 percent in the Dow beginning in the summer of 1997 and culminating in the 7 percent decline on October 27. Most of the market pundits were very bearish. Yet, a few weeks later, in November 1997, the Utilities suddenly broke out and began setting historic highs. Two months later, the Dow followed and moved up over 1600 points through May. Likewise, after the near 20 percent decline in the Dow from mid-July through the end of August 1998, the Utilities began making historic highs in September. One month later, the Dow and S&P followed the Utilities as they blasted off on their own run to eventual new highs.

One of the utility indicators that Norman Fosback monitors in his *Market Logic* newsletter is the Utility Divergence Index. [5] This indicator is simply the latest 20-week change in the Dow Jones Utility Averages minus the 20-week change in the Dow Jones Industrial Average. Changes of +10 percent and above are considered bullish, while -10 percent and below are considered bearish. This indicator has given some excellent buy and sell signals over the years, especially when it has gone to extremes above +15 percent and below -20 percent.

The McClellan Oscillator

The McClellan Oscillator, developed by Sherman and Marian McClellan, is the difference between two exponentially smooth moving averages of advances and declines (the 19-day minus the 39-day). If you understand that, go to the head of the class. It's beyond me. The McClellan used to be one of my favorite indicators for measuring overbought/oversold levels in the stock market. That, however, is not a ringing endorsement. Overbought/oversold indicators are my least favorite indicators and I tend to ignore them in making trading decisions. Many analysts will argue that overbought/oversold indicators are best used with divergence analysis, such as when the indicator fails to make a new low or high at the same time the market is making new highs or lows. Regardless, I still don't find these indicators all that effective.

The McClellan Oscillator normally fluctuates in a range of +100 to -100. Readings above and below these numbers are considered overbought and oversold, where reversals can be expected. Some technicians think it is significant when the McClellan Oscillator moves from positive territory into negative, and vice versa. I find that the significance is mainly academic. A companion indicator to the McClellan Oscillator is the McClellan Summation Index, although this has never been part of my trading arsenal.

As any experienced technician will tell you, during strong momentum rallies or declines, overbought/oversold indicators can go to extremes and remain there for weeks, even months, at a time. And the McClellan Oscillator is no different. Therefore, I tend to ignore the McClellan during such momentum phases in the market. However, if the McClellan Oscillator reaches +100 or -100 during trendless periods in the market, I find that is normally indicative of a reversal.

The value of the McClellan Oscillator is based on end-of-the-day data. Its closing value is shown on CNBC at approximately 5:15 P.M. eastern time. That same closing value is then shown at various times over the next trading session on CNBC. The McClellan is also available daily at Carl Swenlin's Decision Point Web site at www.decisionpoint.com.

Although the McClellan Oscillator was once one of my favorite technical indicators, it, along with most other technical indicators, has been left in the dust by a bull market that would put the Energizer Bunny to shame.

Trin, AKA the Arms Index

The trin was developed by Richard Arms and is also known as the Arms Index and the Short-Term Traders Index. The trin is a measurement of the ratio of advancing to declining stocks and compares that to the ratio of advancing to declining volume. The rule of thumb with the trin is that on a 10-day moving average basis, readings over 1.20 are indicative of an oversold market and one about to reverse upward. Likewise, readings below .80 indicate an overbought market and one ripe for a setback. Panic daily close readings in the trin occur at 3.0 and above and historically have signified market bottoms.

The trin is like any indicator that during strong momentum rallies and declines reaches extremes and remains there for weeks at a time. As with the McClellan Oscillator, I find the trin most useful when it reaches extremes during trading ranges. Although I monitor the trin, it is no longer a vital ingredient of my trading. It is yet another indicator that has lost much of its effectiveness since the great bull run began in January 1995. You can judge for yourself the effectiveness of this indicator, as shown in Figure 10.2.

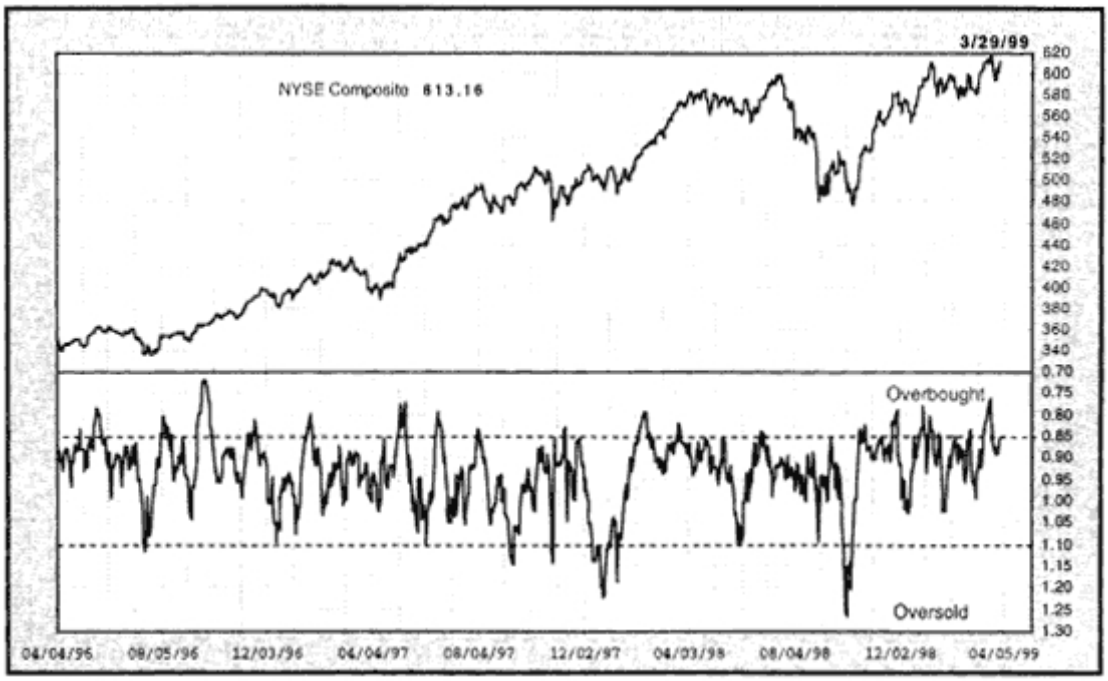


Figure 10.2
The trin (open arms 10-day)
(Source: © 1999 decisionpoint.com. Permission granted by www.decisionpoint.com)

Volume Indicators

This will be heresy to many old-timers, but I never look at volume. Other than the trin, which has a volume component, I don't believe in using any type of volume analysis. The academics like to point to all the upside breakouts that occur in stocks and various stock indexes on heavier than normal volume as a validation for monitoring volume. I can just as well point out all the upside breakouts that have occurred on normal to low volume. Ignoring volume has certainly been no impediment to me as a trader.

When I think of volume analysis, I'm reminded of Victor Niederhoffer's excellent trading book, *The Education of a Speculator,* in which he relates how he did his undergraduate thesis on volume and breakouts. Using data from 1928 to 1961, he found a positive correlation between comovements in price and volume. His testing covered data on both stock indexes and individual stocks. Thirty years later he had the opportunity to extend his thesis study through 1991. He found there was no predictive relation between stock prices and volume during the post-World War II period, from 1946 to 1991. [6]

I remember too many bear markets dating back to the 1960s where prices declined day in and day out regardless of whether it was a high-volume or a low-volume day. The same applies to many bull markets. I've seen too many steadily rising markets met with universal skepticism by the volume experts because the rise was accompanied by low volume.

Moving Averages

As with volume analysis, I never use moving averages in my trading. I find them to be much ado about nothing. You might want to read Larry Williams's *The Definitive Guide to Futures Trading*[7] and his moving average studies. After extensive research with moving averages, moving average crossovers, and channels, Larry's conclusion is that none of them consistently make money. While Larry agrees that moving averages may be good trading tools, he says it's next to impossible to build a winning system solely around moving averages.

The most popular moving average used by stock investors is the 200-day moving average. Several stock market newsletter writers and mutual fund timers use crossovers of the 200-day moving average as a basis for buy and sell signals. Crossovers above the 200-day moving

average are taken as buy signals, while crossovers below that average are considered sell signals.

The reason moving averages aren't for me is that they are too much of a lagging indicator. For instance, much was made about the 200-day moving average avoiding the crash of 1987 by giving a sell signal the trading day prior to the crash. Yet, when the sell signal was triggered on October 16, the Dow was already down more than 17 percent from its August highs.

Never Fight the Fed

All professional traders abide by the rule that you never fight the tape (the momentum of the market) or the Fed. In the short term, interest rates are the main driver of the market. The impact of an accommodative Federal Reserve Board is extremely bullish for stock prices. Some of the tools used by the Fed to control interest rates are the discount rate, the Fed Funds rate, bank reserve requirements, and stock margin requirements. The last two, however, are rarely used any longer by the Fed.

According to Norman Fosback, on average, the S&P increases 7 percent in the three months following discount rate reductions. [8] Even more dramatic, though, are announcements of two consecutive cuts in the discount rate. Such a move by the Fed triggers the Two Tumbles and a Jump Rule. (Announcements of two consecutive cuts in bank reserve and stock margin requirements also trigger this rule.)

Since the Federal Reserve was formed in 1913, there have been only 20 signals from the Two Tumbles and a Jump Rule, with the most recent being October 15, 1998. Three months after this rule is triggered the S&P has risen an average of 11 percent, and it is up an average of 30 percent within one year. The latest rate cut on October 15, 1998, has run true to form, with the S&P up 18.69 percent three months later.

Historically, it has also been very bullish when the Fed decreases the Federal Funds rate. In *Stocks for the Long Run,* Jeremy Siegel presents a table illustrating how changes in the Fed funds rates since 1955 have effectively predicted future stock prices.[9] According to Siegel, in the 12 months following Fed fund rate increases, the market, as measured by the S&P, has been about 7 percent higher. However, in the 12 months following Fed rate decreases, the S&P has been 18 percent

higher. The average annualized return over this same period was 12 percent.

What is most interesting about Siegel's study is how, in the 1990s, the predictability of Fed funds increases and decreases was reversed—meaning that the 12-month return after increases in the Fed funds was 16.21 percent, while it was only 12.76 percent after decreases. This may well be yet another indicator that the great bull market of the 1990s has temporarily rendered ineffective.

Chapter 11—
Monthly Seasonality

According to research by Norman Fosback [1] and Arthur Merrill,[2] the stock market has a definite bullish bias during the last trading day and first four trading days of each month. This bias is also evident during the two days preceding any market holiday. These would include Good Friday, Memorial Day, Fourth of July, Labor Day, Christmas, New Year's, and President's Day. Since Martin Luther King Day is now a trading holiday, the favorable seasonality would have to be incorporated there also.

Fosback tested this monthly seasonality via a computer simulation during the period from 1928 through the end of 1994.[3] The computer "owned" the S&P 500 Index (all stocks) only during the favorable month-end and preholiday days—28 percent of all trading days—and held cash the rest of the time. No consideration was given for commissions, taxes, and interest during the nonholding period, or for dividends paid by the stocks. A hypothetical $10,000 initial investment grew to $4.6 million during the period tested. In contrast, $10,000 invested during the remaining 72 percent of the nonfavored monthly trading days would have decreased to $569 by the end of 1994. These results are simply mind-boggling. I can only imagine what the $4.6 million has compounded to in light of the fact that the market has almost tripled since 1994.

Fosback has subsequently updated his research on monthly sea-

sonality to encompass the second-to-last trading day of the month and the fifth trading day of the month. These days are excluded, however, if they fall on the first trading day of the week. Fosback also maintains several real-money trading accounts based on his seasonality system. These are monitored regularly in his newsletter, *Market Logic*.

Monthly seasonality also explains the fabled year-end rally. Here's another mind-blowing statistic. According to Fosback, the 1 1/2-month year-end period starting two days before Thanksgiving and ending with the fifth trading day in January has accounted for 40 percent of the stock market's entire price return over the past 70 years. [4] The month-end and preholiday trading days graded favorable by the seasonality system within this 1 1/2-month interval have accounted for 45 percent of the market's entire price return over that 70-year time period.

Monthly seasonality has been integral to my trading success over the years. Whether it be stock index futures or mutual funds, I tend to be more aggressive during these seasonally favored days, especially at year-end. This doesn't imply that I blindly buy. But if the market's action has been favorable prior to monthly seasonality, I am more prone to trading larger-size positions.

What is amazing about the monthly seasonality pattern is how well it has held up over the years in spite of being so well publicized. Normally when favorable trading patterns become well known, their effectiveness is diminished and is often completely eliminated. According to Victor Niederhoffer, "When a recurring effect of practical significance is reported, the trade (smart money) takes advantage of it with great abandon, huge capital resources, and low costs."[5] The point is that profitable patterns tend to evaporate when everyone tries to exploit them at the same time.

Conventional wisdom states that the seasonality pattern exists because of the investing habits of the public, pensions, and mutual funds. The reasoning for this is that many people's wages are paid around the days of monthly seasonality and some of these wages find their way into the stock market.

The most rigorous computer testing of end-of-the-month seasonality in stock index futures is available through Bruce Babcock's Reality-Based Trading Company.[6] Babcock tested 100 different combinations of entries and exits for various time periods between the last five and the first five trading days of the month using five different

stops. This research is available for sale in system reports called *NYFE for Life* and *S&P Devotee System*.

In *The Education of a Speculator,* Victor Niederhoffer mentions a study by Robert Ariel that divided the months into halves. Ariel's study concluded that the first half of the month saw significantly greater returns than the second half. Niederhoffer then extended Ariel's study from the 1987 crash to August 1996 using S&P futures prices and found that the first half of the month was three times stronger than the second half, which was a confirmation that seasonals within the month still existed. [7]

In his April 28, 1997, *Crosscurrents* newsletter,[8] Alan Newman presented the results of being invested only half of the year. This study ran from 1950 through April 22, 1997. An investment of $10,000 in the Dow stocks from November through April (and then reinvesting each November through April) would have grown to $276,113 over the course of the study. Taxes and commissions were not taken into consideration. An investment only from May through October during the same period would have grown to only $11,484. Testing this strategy from the beginning of the bull market in August 1982 through April 22, 1997, still showed the dominance of the November-through-April period, with returns almost three times greater than those of the May-through-October period.

Niederhoffer also looked at the monthly performance of the Dow and its precursors from 1870 to 1995. His results showed January and August to be the best-performing months and May, September, and October to be the worst. The mean average return for May and September during his test period was negative.[9]

Yale Hirsch ran a similar monthly test, but using the S&P as a market proxy. His study ran from 1950 to April 1996. Hirsch's results listed December, January, and November as the best-performing months with September, June, February, and May bringing up the rear. However, over the last 10 years of his study, May was by far the best performer and had been up all 10 years.[10]

Knowledge of historical monthly performance has very little impact on my trading, except that I might get more aggressive from November through January. What dictates my trading decisions is the action of the market itself, not the particular month that happens to appear on the calendar. For example, in September 1997 the seers were calling for all sorts of market havoc because of a host of technical prob-

lems with the market. The fact that it was September, a notoriously poorly performing month historically, only added fuel to their bearishness. However, I had a great month and made over $16,000, because I went with the flow of the market and didn't become gun-shy simply because it was September.

Best Percentage Days

Old-time traders have been conditioned to believe that Mondays are negative days in the stock market, and Fridays are the strongest. In *Stocks for the Long Run,* Jeremy Siegel maintains that over the past 112 years, Mondays have been decisively negative, and Fridays have been the best day of the week, returning four times the daily average. [11]

The Blue Monday syndrome however is no more. In fact, Mondays have by far been the most opportunistic day of the week to press the long side during the 1990s. Some vendors have even developed trading systems capitalizing on this Monday strength. One such system merely recommends buying S&P futures on the open Monday and selling market on close.

In his newsletter, *Higher Returns,* Yale Hirsch presented a day-of-the-week performance analysis of the Dow from January 1990 through July 19, 1996.[12] Here are his results:

Monday	1817.96 Dow points gained
Tuesday	227.11
Wednesday	701.26
Thursday	66.55
Friday	-139.29

It's amazing that 70 percent of the Dow's gain through the mid-1990s occurred on Mondays. The reason I've highlighted day-of-the-week analysis is to show that adaptability is a prerequisite to being a successful trader. As this book emphasizes, history is not a road map to the future. What works in the past isn't necessarily going to continue working in the future. The demise of Blue Monday syndrome is an example of history not repeating itself.

A good trader must be aware of profitable patterns as they are occurring in the present and then exploit them for as long as they can. For example, for the 16-month period from September 1997 through

December 1998, the Dow gained an average of 87.29 points just on the first trading day of each month, and 14 of the 16 months were profitable. Once this pattern became evident, I took a more aggressive stance on the first trading day of the month.

Other Seasonal Trading Patterns

There are many other seasonal trading patterns and calendar anomalies to be aware of—not that they necessarily affect my trading decisions, but because traders should have as much knowledge as possible about the stock market. The January Barometer says that as January goes, so goes the rest of the year. Others say, as the first week of January goes, so go the month and then the year.

The best and clearest analysis of the January Barometer was by Victor Niederhoffer, [13] who tested the Dow Industrials from 1935 to 1995. In the 21 years when the Dow showed a decline in January, the average percentage change for the next 11 months was 2.3 percent. The Dow closed down for that 11-month period 50 percent of the time. In the 40 years when the Dow rose during January, the average percentage change for the following 11 months was 8.7 percent. The Dow closed up for the 11-month period 80 percent of the time.

The Presidential Cycle is another pattern often discussed by the academics. This pattern has been dissected, analyzed, and optimized in a number of ways. The bottom line, though, is that the third year of a president's term sees the best performance in stock prices. The next best performing year in the cycle is a president's fourth year, followed by his second and then first years. According to Yale Hirsch, the last two years of the 41 administrations since 1832 produced a total net market gain of 592 percent.[14] That dwarfed the 79 percent gain of the first two years of those administrations.

However, you should never base your trading decisions solely on patterns such as the Presidential Cycle. For instance, while the first year (post election year) is historically the weakest performer, it was the best performing year of the four-year cycle during Reagan's 1984 administration, as well as during Bush's 1988 administration. Many predicted doom and gloom for Clinton's post election year in 1997, yet the market soared over 33 percent. Clinton's midterm year wasn't so bad either—up over 28 percent.

Closely related to the Presidential Cycle is the Decennial Cycle. This pattern suggests that there is a bias in annual stock performance based on the ending digit of the year. For instance, since 1880 the S&P has never had a down year in the fifth year of the decade (years ending in 5). Also, the greatest percentage gains since that time have also occurred during fifth years of the decade. The worst performers since 1880 have been years ending in 7. [15] Nevertheless, 1997 was a bang-up year for the S&P.

Option Expirations Week

Stock options and stock index options expire the third Friday of each month. Every third month—March, June, September, and December—they are joined by expirations in stock index futures, also known as *triple witching weeks*.

Option expiration weeks have been very exploitable in the past. For example, nearly all of the 28 percent gain in the S&P for 1998 came in the monthly expiration weeks. The average advance during the 12 option expiration weeks in 1998 was over 2 percent monthly. In all the other weeks, the S&P was virtually unchanged. According to Merrill Lynch analysts, with the exception of 1995, the stock market has outperformed in expiration weeks every year since 1985. One of the reasons suggested for this outperformance is the generally bearish stance of options traders. Their unwinding of positions causes prices to rise.[16]

Over the years, I have exploited this upward bias during expiration weeks. It works best if the one to two weeks prior to option expiration have seen heavy put buying in relation to call buying. This is even more so if it is a triple witching expiration. Heavy call buying instead of put buying in the weeks prior to option expiration week can dilute and sometimes eliminate this upward bias. An example of this is the option expiration week in January 1999. That week was a downer primarily because the preceding two weeks had seen an exorbitant amount of call buying in relation to put buying.

Standard & Poor's published an interesting article, dated March 20, 1998, about triple witching weeks, which gave the odds of the S&P being higher for each of the five trading days during the triple witching week expiration.[17] The time period was from June 1987 through June 1997, during which the S&P 500 was higher than the previous day's close 54.0 percent of the time. For the triple witching week it looked like this:

Monday	Tuesday	Wednesday	Thursday	Friday	Monday After
66.70%	45.20%	54.80%	61.90%	71.40%	33.30%

End-of-Quarter Bias

During the past few years, it hasn't paid to be in the Dow and large-cap sectors of the stock market on the last trading day of each quarter—March, June, September, and December. The Dow declined in 9 of the past 10 quarters (ending March 1999) and lost a cumulative 812 points during that time. The real action on the last trading day of the quarters has been in the Russell 2000 and small-cap sectors, which have shown a cumulative gain over the past 10 quarters. This has been a very exploitable pattern for small-cap mutual funds and Russell 2000 futures traders. I have found, though, that since this pattern is becoming better known, it's best to take a position in the small-cap sector *two* days before the last day of the quarter. It's also best to exit the small-cap sector at the close of trading at the end of the quarter and roll your position over to the Dow and large caps, as they have tended to reverse their end-of-quarter decline over the first few trading days of the new quarter.

It should be noted that this end-of-quarter bias did not hold up on the last trading day in June 1999, at least for the Dow. On that day, the Dow had been meandering in the -30 to -60 range, but then suddenly turned on a dime later in the day, after the Federal Reserve announced a neutral monetary policy, and closed up 155 points. Fortunately for me, the Russell 2000 Index was also strong and I made 3 percent on my small company growth fund.

Chapter 12—
The Nitty-Gritty of Trading

This is the most important chapter in this book, as it details exactly how I trade.

My method of trading is a continually evolving process. Even though I still use the sentiment and technical indicators, described in previous chapters, as my perceptual filters for understanding price change, I have gravitated more and more toward trading pure price action. Through the years, I've come to see there is a flow and rhythm to the market, and that rhythm is its momentum. Being a successful trader hinges on being in synch with this momentum.

My trading methodology is based on several momentum patterns that keep me attuned to the market's rhythm. These patterns are V-bottom upside reversals; late-day upside price surges; extreme momentum days; Friday-to-Monday momentum and momentum break patterns; 1 percent true selling days; and divergence patterns in the Dow, S&P, Nasdaq 100, and Russell 2000 indexes. This chapter presents a brief explanation of each pattern and then, for a fuller understanding, I'll walk you through many of my real-money trades from 1998 and early 1999.

V-bottom reversals occur intraday where the Dow has been in decidedly negative territory the entire trading session, down at least

.75 percent, and then makes a furious comeback, closing either near the unchanged level or, preferably, up for the day. The later in the day the reversal occurs, the more significance I attach to it. I will instinctively trade V-bottom reversals if the previous day closed down or if the Dow has been in a recent downtrend. On the other hand, I don't attach much importance to V-bottom reversals occurring after a strong up day or during a period of rising prices. In most of these occurrences, I will already be in the market before the day of the V-bottom reversal.

Closely related to V-bottom reversals are the late-day upside surge patterns. These normally occur during the last 2 to 2 1/2 hours in a trading day that has seen trendless and choppy price action. These late-day price surges should take the Dow to a close of at least .50 percent above the prior day's close. As with the V-bottom reversals, this pattern is significant only when it comes after a down day or a period of declining prices.

Extreme momentum days are just that. They are trading days of out-of-the-ordinary price action that have not been seen for the past several months. The thrust of these types of momentum trading days normally portends a continuation in the direction of these thrusts over the following days. In other words, extreme strength begets more strength, and extreme weakness begets more weakness.

One of my more reliable momentum patterns over the years has been the Friday-to-Monday pattern. Stronger-than-average strength on a Friday is expected to be followed by more strength on Monday (or Tuesday if Monday is a trading holiday). Conversely, extremely weak price action on a Friday is expected to lead to more weakness on Monday. A Friday-to-Monday momentum break pattern occurs when the expected strength or weakness on Friday doesn't carry over to Monday. These weekend momentum break patterns are highly significant and indicative of a short-term trend change.

A 1 percent true selling day occurs after a period of rising prices of at least two weeks in which the Dow, S&P, Nasdaq 100, and Russell 2000 indexes all close down 1 percent or more on the same trading day. These types of days often are trend busters and can be harbingers of serious price declines ahead. I use a little leeway, however, in defining such selling days. For instance, if three of the four indexes are sharply lower—say, down 1.5 percent to 2 percent or more—but one is down only .75 percent to 1 percent, then I interpret that as a true selling day.

However, my limit is .75 percent. This means that if any index is down less than .75 percent on a day when the rest of the indexes are sharply lower, there is buying interest in at least one segment of the market, which rules out a true selling day.

Divergence patterns are my favorite, since they have made me the most money over the years. These divergences can be either with an index, such as the Dow, and its recent trading behavior or between the various indexes themselves—the Dow, S&P, Nasdaq 100, and Russell 2000.

Before getting into some real-life trading examples, a comment on the Nasdaq 100 Index is in order. I will reference this index numerous times. The Nasdaq 100 Index is a market value-weighted performance measure of the 100 largest, U.S.-based, nonfinancial companies traded on the Nasdaq National Market. It is a proxy for the technology sector of the stock market. Computer and software stocks together account for about 63 percent of the index's value. Telecommunications issues make up another 18 percent. Microsoft, Intel, Dell, Cisco, and MCI WorldCom account for 40 percent of the movement in the Nasdaq 100 Index. Other big contributors to the performance of the Nasdaq 100 are Amazon.com and Yahoo.

Real-Life Trading Examples

It's time to get down to some real trading. The only way to fully explain the way I trade is through the example of actual past trades. Another 100 pages could detail my various trading strategies, but you would never fully grasp them unless I took you through some real-life examples. We will start with 1998, a year during which I was in complete synch with the market.

The Dow openings I reference in my commentary are based on theoretical openings—the opening price of the Dow if all its components opened at the same time. The actual opening of the Dow at 9:30 A.M. is very misleading, since many of the stocks in the Dow don't actually begin trading until several minutes after the opening bell. These delays in the opening prices are caused by order imbalances.

I always approach new trading years with great trepidation. I want the market to show its hand, to tell me what it wants to do. I'm always leery of what occurs on the first trading day of the year. I remember too many Januaries when the market would begin the first trading day in

one direction, and then a few days later violently reverse that direction. In 1998, things went according to script. On January 2, the first trading day, the Dow rose more than 56 points. Then during the four trading days from January 6 through January 9, the market plunged nearly 400 Dow points. Much of that decline occurred on Friday, January 9, when the Dow dropped 222 points. The decline in the Nasdaq 100 was even more severe.

There was little reason to be bullish going into Monday's trading on January 12. One trading rule I live by is to expect weakness on Monday if the preceding Friday is extremely weak. Conversely, extreme strength on Fridays should also lead to more strength on the following Monday. Any aberration in these patterns gets my immediate attention.

Monday, January 12, was one of those days that got my immediate attention. As you can see from Figure 12.1, the Dow opened lower on January 12 by more than 100 points. That was its low for the day. It then weaved and bobbed above and below the break-even mark for much of the day. There were few signs of the extreme weakness indicated by Friday's plunge. The real attention-getter in Monday's action, however, was the last hour of trading. At 3:00 P.M. the Dow was down 16 points. It

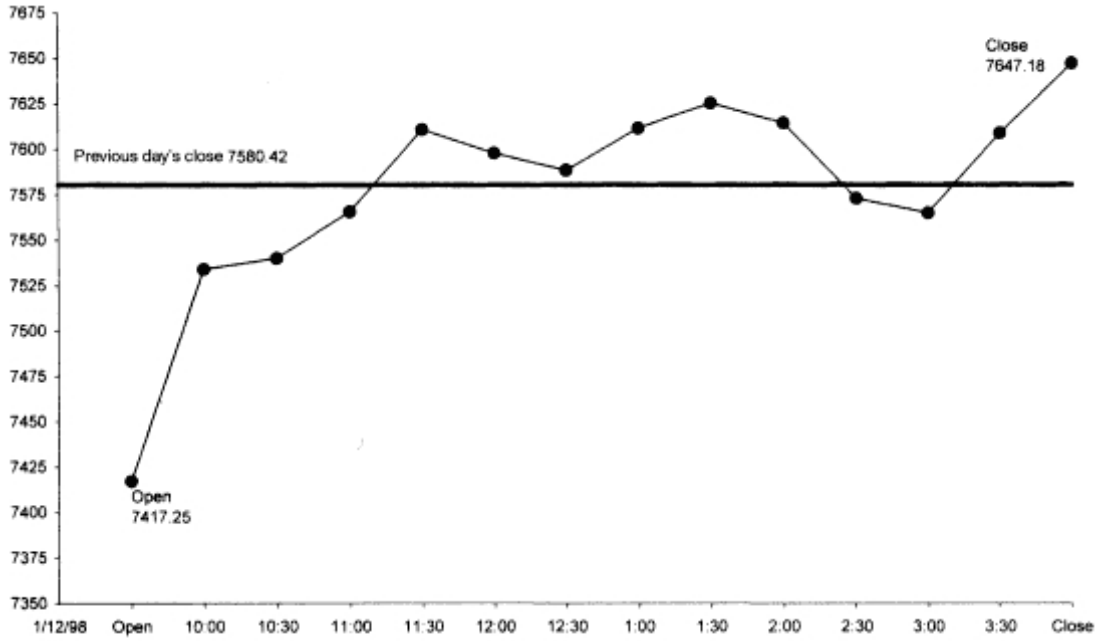


Figure 12.1
dow jones industrial average, 1/12/98—half-hour prices

then made a last-hour surge of more than 80 points to close up 66 points for the day.

I went long before the close on January 12 because of two of my momentum price patterns. First, there was the Friday-to-Monday momentum break pattern. The expected carryover selling from the 222-point drop on Friday failed to materialize. Then there was the late-day upside surge, when the market staged a furious last-hour reversal and closed up more than .50 percent. Both of these patterns pointed to additional strength on Tuesday. And that's exactly how it unfolded, as the Dow opened strongly higher and closed up 84.95 points. The action on Tuesday confirmed that Monday's price action was a change in trend, and I increased my long position further before the close Tuesday. The Dow tacked on an additional 52 points on Wednesday, January 14.

There were other reasons that the price action on Monday, January 12, should have been seen as a harbinger of more strength immediately ahead. For instance, the week of January 12 was an options expiration week. This followed a week that saw extremely heavy put buying (see page 108). Additionally, the equity-only put/call ratio (see page 77) had given one of its rare buy signals on December 18. Price action in the months following these signals has been uniformly bullish.

On January 12 1 began a multiweek buying campaign in INVESCO's Worldwide Communications Fund. But the trading weapon I chose on January 12 was irrelevant. Short-term traders would have profited handsomely had they instead chosen to trade stock index futures, index options, individual stocks, or the index shares on the AMEX such as the Spiders, Diamonds, or the QQQs, which are Nasdaq 100 Index-based shares. Longer-term traders also would have found January 12 a propitious time to purchase stocks, as the Dow rose some 1500 points, or 20 percent, through the first half of the year.

It was not by accident that I chose to enter the technology sector of the market on January 12. It has been my experience over the years that after my V-bottom reversal and late-day price surge patterns, the technology sector sees the most follow-through the next trading day.

You can see why charts, trendlines, oscillators, and other price-measuring filters were of little use to me on January 12. I was simply reacting to price action—and for the reasons cited here. Trading is not rocket science nor is it an endeavor for which specialized knowledge of math is required.

Suppose you missed your chance on January 12, 1998? There were other trading opportunities during the month. There were several days during January when I increased my stake in the INVESCO Worldwide Communications Fund. This fund often mirrors the move in the technology sector. Beginning on January 21, the technology-laden Nasdaq 100 Index began to positively diverge from the Dow and S&P.

Detecting divergences between indexes has been crucial to my trading success over the years. Following are the daily point changes in the Dow and the Nasdaq 100 for the period from January 21 through January 30, 1998. To find similar point moves between various indexes, simply divide one by the other. For the period in question, a 1-point move in the Nasdaq 100 Index equated to an 8-point move in the Dow. This is computed by taking the Dow close of 7794 on January 20 and dividing by the Nasdaq 100 close of 1026. That equals 7.67 points, which I round to 8 points for simplicity.

	Dow Change	Nasdaq 100 Change
January 21	(-78.72)	(0.36)
January 22	(-63.52)	(-5.89)
January 23	(-30.14)	+3.84
January 26	+12.20	(-8.07)
January 27	+102.14	+19.36
January 28	+100.39	+27.46
January 29	+57.55	+5.78
January 30	(-66.52)	+2.13
Totals	**+33.38**	**+44.26= 354 Dow points**

I noted the divergence between the Nasdaq 100 and the Dow from January 21 through January 23 and increased my position in the technology sector. The action on January 26 was negative and I was ready to exit part of my position if this negative action persisted for another day. Instead, the positive divergence returned on January 27 and January 28 and I again increased my tech exposure. The stock market then blasted off on the first trading day in February, rising 201 points. The Nasdaq 100 rose nearly 30 points, or the equivalent of 240 Dow points.

It was up, up, and away during February 1998. The Dow tacked on an additional 438 points for the month from its February 2 close. The Nasdaq 100 was even more impressive in February and continued its outperformance over the Dow, rising 93 more points from February 2,

or the equivalent of 744 Dow points. Many of the pundits, however, were scared to death during much of February because all sorts of technical indicators became overbought. As previously mentioned, during high momentum rallies such as the one that began on January 12, it is not uncommon to see many traditional technical indicators reach overbought levels and remain there for extended periods. If you recall from the discussion on indicatoritis (Chapter 8), one well-known technical guru advised shorting S&P futures in early February because of these overbought technical indicators.

A True Selling Day

From the January 12 low to March 5, 1998, there hadn't been a true selling day on which the Dow, S&P, Nasdaq 100, and the small-cap Russell 2000 Index closed 1 percent or more lower on the same trading session. Until I saw such selling, I had no intention of taking any profits on my positions. Prematurely taking profits is an exercise best left for fools and losers. To accumulate wealth, you need to maximize your winning trades as much as possible by riding them for as much as you can and for as long as you can.

Negative news from Intel after the close of trading on March 4, however, led to a true selling day on Thursday, March 5. Here are the percentage declines in the various indexes for March 5:

Dow	(-1.11%)
S&P	(-1.17%)
Nasdaq 100	(-4.50%)
Russell 2000	(-1.15%)

The decline in the Nasdaq 100 was severe and was its worst daily decline since the lows in January. Had one of the other indexes declined less than 0.75 percent, I would have considered this sell-off simply a tech-related phenomenon and not a true selling day. But since it did qualify as a true selling day, I had no choice but to lighten up on the positions I had been accumulating over the past two months.

On March 5, I sold 50 percent of my holdings. That's at the high end of my range, as I normally lighten up in increments of 25 percent, 33 percent, or 50 percent of my total position. The reason I sold as much as I did on March 5 was that the heaviest selling was in the technology sector, where I had my largest exposure. If the selling had con-

tinued on Friday, March 6, or if we had had another true selling day within the next week, I would have sold the remainder of my position.

There was no carryover selling the following trading day, March 6. The Dow soared over 125 points and made up its decline from the previous day and more. Although the Nasdaq 100 did not make up its previous-day loss, it nonetheless charged ahead 3.22 percent. Had I not been so concerned about the severity of Thursday's tech sell-off, my normal trading discipline would have been to immediately reenter before the close on Friday. That would be in accordance with my Friday-to-Monday pattern of extreme strength on Friday, to be followed by additional strength on Monday. As it turned out, I waited until Monday, March 9, to reenter the position I closed out on March 5.

I find that most traders are emotionally unable to make the type of U-turn I made on March 9. If you recall, that was one of my deficiencies during the 19 years I struggled as a break-even trader. I always seemed to be on board markets that were about to blast off. But for whatever reasons, I always found a way to exit before the actual fireworks began. Then when the market did take off, I just sat there, unable to reestablish my position. Let me tell you, if you ever hope to succeed in the trading game, you better learn how to overcome this type of psychological trading defect. In the preceding case, it's a good thing I reestablished my full position, since the Dow and other indexes rocketed ahead over the following three weeks in March.

Of all the patterns I trade, the least reliable is the 1 percent true selling day pattern. And it certainly gave a false signal on March 5. However, when it's wrong, I usually know within a day or two and get back in the market. As you will shortly see, when it's right, it more than makes up for its occasional false signals.

Excessive Optimism

As the market continued rising into March 1998, many of my perceptual filters began warning of danger ahead. Table 12.1 lists the sentiment readings from the major services as found in Barron's from March 23 through April 27.

The bearish readings from *Investor's Intelligence* were at lows not seen since early 1992. All I needed to begin closing out my long positions was a true selling day or deterioration in the internals of the mar-

table 12.1 investor sentiment, march 23, 1998–april 27, 1998

	Bulls	Bears	Correction
	Investor's Intelligence		
March 23	48.0%	27.6%	24.4%
March 30	49.6%	26.4%	24.0%
April 6	53.2%	22.6%	24.2%
April 13	52.4%	24.2%	23.4%
April 20	52.8%	23.6%	23.6%
April 27	54.6%	23.1%	22.3%

	***Consensus* Index**
March 23	78%
March 30	76%
April 6	76%
April 13	80%
April 20	62%
April 27	64%

	***Market* Vane**
March 23	68%
March 30	73%
April 6	65%
April 13	63%
April 20	66%
April 27	65%

(*Source: Barron's*)

ket. On March 23, the Dow declined more than 1 percent, down 90 points, but the tech-laden Nasdaq 100 was divergently strong and up more than 10 points. So that was not a day to get bearish. Good thing, too, since the Dow went on to rise more than 200 points through April 6. By that time, though, *Investors Intelligence* bullish advisors outnumbered bearish advisors by over 30 percent. In the past, such a wide gulf between bulls and bears has had ominous consequences for the market.

The bull run of more than 1500 points that commenced on January 12 began to seriously unravel on April 6. Before trading began that day, Citicorp announced plans to merge with Travelers. As a result, the Dow surged 110 points during the first 30 minutes of trading. But the rest of the day it was all downhill. Still, the Dow managed to close up 49 points and, more significant, at new all-time highs. However, major negative divergences were everywhere. The performance of the major market indexes, including advancing and declining issues, on April 6 were as follows:

April 6	Points Gained/(Lost)		Percentage Gain/(Loss)
Dow	+49.82		0.55%
Dow Transports	(-38.23)		(-1.05%)
Nasdaq 100	(-28.29)		(-2.29%)
Nasdaq Composite	(-26.26)		(-1.41%)
Russell 2000	(-3.91)		(-0.80%)
Advancing issues	1318	Declining issues	1727

It doesn't get more obvious than it was on April 6 that the market was in big trouble. On a day when the Dow closed at a historic high, all the other indexes were sharply lower. Combining the breakdown in the market internals with the excessive optimism of my sentiment indicators, I decided it was time to begin lightening up the positions I had accumulated over the past several months. More aggressive traders could have begun shorting at the close of April 6, looking for carryover selling in the coming days. That's exactly what occurred, as the Dow declined 76 points on Tuesday, April 7, and another 65 points on Wednesday, April 8. I lightened up even more on April 7, as that turned out to be a true selling day. The percentage declines were as follows:

Dow	(-0.85%)
S&P 500	(-1.05%)
Nasdaq 100	(-1.93%)
Russell 2000	(-1.39%)

An Internally Weak Market

The remainder of April was a choppy, volatile, go-nowhere market. Although the Dow and S&P went on to make minimal new highs, it was

amid a continuing deterioration in the advance/decline line and new highs/new lows. By the close of trading on April 24, I was 100 percent in cash. The market kept getting sicker and sicker, and on April 27 the Dow dropped 146 points. April 27 was also the first trading day since the January 12 bottom that new lows outnumbered new highs on the NYSE.

I remained sidelined in cash during the first two weeks of May. The market was telling its story best, and the story was that a broad topping formation was occurring. Although the Dow continued to make nominal new highs, it was always on days when declining stocks out-numbered advancing stocks. Much of the trading I did during late April and May consisted of one-day trades capitalizing on the lags between the U.S. markets and Europe. (This type of trading will be discussed further in Chapter 14.) It wasn't until June 4 and 5 that I returned to trading domestically. The 31-point, 2.7 percent gain in the Nasdaq 100 on June 4 is what enticed me back into the market. That gain was its largest in nearly three months.

If you are reading this book closely, you will see that I key on out-of-the-ordinary trading behavior. For me, out-of-the-ordinary trading behavior means a day that exhibits either extreme momentum in one of the major indexes or a day when there is extreme divergence between the major indexes. The momentum in the Nasdaq 100 on June 4 qualified as extreme since it hadn't been equaled in the preceding three months. I look for the market to continue to move in the direction of the extreme momentum day over the following one to three days, and, hopefully, longer.

That's precisely how the market played out after its June 4 surge, as the Nasdaq 100 Index rose an additional 28 points during the next three trading days. Anyone trading the Nasdaq 100 futures contract would have made $2,800. Because of my preference for mutual funds over stock index futures, I took a position in a technology fund on June 4 and added to that position on June 5. However, subsequent weakness in the market the following week had me selling my tech funds and returning to a 100 percent cash position.

Classic Market Divergence

The following list shows the net daily gain in points for the Dow and Nasdaq 100 from June 11 through June 24. During this time a one-point

move in the Nasdaq 100 equated to a seven-point move in the Dow. This was a period of classic market divergence between the Nasdaq 100 and the Dow. It doesn't get much more obvious than this that something big was afoot in the tech sector of the market.

	Dow	Nasdaq 100
June 11	(-159.93)	(-14.19)
June 12	+23.17	+1.88
June 15	(-207.01)	(-13.42)
June 16	+37.36	+37.33
June 17	+164.17	+13.18
June 18	(-16.45)	+3.25
June 19	(-100.14)	+12.38
June 22	(-1.74)	+24.22
June 23	+117.33	+38.46
June 24	+95.41	+28.77
Total points	**(47.83)**	**+131.86= 923 Dow points**

On June 15, the Dow collapsed 207 points. According to many technical gurus, it violated an important trendline that day and their prognoses were for much lower prices over the coming days. I was as bearish as anyone, and I was 100 percent in cash. I did note with interest the resiliency in the Nasdaq 100 in intraday trading on June 15. When the Dow was trading down 100 points during the day, the Nasdaq 100 Index was trading in the unchanged-to-slightly-up territory. Only during the last couple hours of trading when the Dow dropped another 100 points did the Nasdaq 100 finally succumb, ending down 13 points on the session. That was still quite a positive divergence from the much weaker Dow.

Then a funny thing happened on June 16. As bearish as I was on the previous day, I found myself buying into a technology fund at the close. June 16 was a classic day of major divergence between the Dow and the Nasdaq 100. It was also a day when an out-of-the-ordinary event occurred. After declining 207 points on Monday, some carryover selling was to be expected on Tuesday, June 16. Yet the Dow closed up 37 points. Although that was a surprise, I simply read it as a dead cat bounce.

The out-of-the-ordinary trading action on June 16 occurred in the Nasdaq 100. It rose 37 points, or the equivalent of 259 Dow points. In

the process, the Nasdaq 100 not only recouped it losses from the prior trading day, but from the prior week as well. The action in the Nasdaq 100 on June 16, coming after a day when the Dow dropped 207 points, was not normal trading behavior. Because of that, I bought into a technology fund.

The strength in the Nasdaq 100 Index on June 16 led the rest of the market higher on June 17, as the Dow rose more than 164 points. I then doubled the position in my technology fund. The Nasdaq 100 continued its outperformance over the Dow during the next trading week. On some of those days, such as June 19 and June 22, the divergence was particularly noteworthy. This type of divergence was a screaming buy signal to jump on board anything tech related—futures, options, funds, or individual stocks. Thus, I continued to purchase more shares in my technology fund. I wasn't disappointed, as the Nasdaq 100 roared ahead through mid-July.

Another True Selling Day and a Top

Even though the Dow and Nasdaq 100 went on a rampage upward between mid-June and mid-July, the market internals weren't all that impressive. New yearly lows were consistently running over 70 and more on a daily basis. The Russell 2000 Index, a proxy for the small-cap sector of the market, barely budged during the rally in the Dow and the Nasdaq 100. Another red alert came from the *Investors Intelligence* poll in late July. Here are the survey results as reported in the July 20 and July 27 issues of *Barron's:*

	July 20	July 27
Bulls	52.0%	54.3%
Bears	24.0%	23.3%
Correction	24.0%	22.4%

The last time bears went below 25 percent was in early April. That also marked the peak in the broader market, as measured by the advance/decline line. Therefore, with sentiment at optimistic extremes and the market internals looking so negative during the month-long rally from mid-June to mid-July, all I needed to exit my positions was a true selling day. I didn't have to wait long, as evidenced by the percentage declines of the major indexes on July 21 and July 23.

	July 21	July 23
Dow	(-1.13%)	(-2.15%)
S&P	(-1.60%)	(-2.09%)
Nasdaq 100	(-2.31%)	(-1.73%)
Russell 2000	(-1.25%)	(-1.90%)

I went 50 percent to cash at the close on July 21, with the Dow at 9190.19. 1 sold the remaining 50 percent of my funds at the close on July 23, with the Dow at 8932.98. The action during the week of July 20 was particularly disturbing because the carnage began so soon after the Dow had made a new historic high on July 17. Declines swamped advances every day of the week, while new lows began swamping new highs by a wide margin, beginning on July 22. I was happy to be in cash by the end of the week.

It Was a Sick Market

You can expect danger ahead when formerly reliable patterns suddenly cease to work. The week of July 27 saw not one but two of my favorite trading patterns get trashed. That was an alert to me that the dynamics of the market had changed and a bear market could be on the horizon. Over the ensuing month, the Dow declined more than 1300 points, or 15 percent.

Intraday on July 27, the Dow had been down 70 points, yet it staged a late-day rally to close up over 90 points. The Nasdaq 100 saw a similar price reversal, trading from down 30 points to close up 18 points. These types of V-bottom or late-day reversal patterns have made me a lot of money over the years. Normally there is always some type of follow-through buying over the next several days. Since I believe traders must be consistent in their trading style, I had no choice but to put some money to work. I felt confident about this trade, especially since the July 27 reversal pattern occurred after a series of down days the previous week.

So much for confidence. This time the reversal pattern failed miserably, as the Dow tanked 93 points the next day. In fact, there were no signs whatsoever of any carryover buying from the late-day reversal on July 27, as the Dow was in negative territory the entire trading day on July 28. This told me there was something seriously wrong with the market.

On Thursday, July 30, there was some out-of-the-ordinary price behavior in the Nasdaq 100 Index, as it rocketed ahead over 3 percent. Other technology indexes, such as the Morgan Stanley High-Tech Index, gained nearly 4 percent. All in all, this was one of the best upside momentum days in the technology sectors since early January. However, I did not jump onto the momentum pattern on July 30 as I would have in the past. While it may have been out-of-the-ordinary price action, the memory of the failed V-bottom reversal pattern on July 27 was still too fresh in my mind. It's a good thing, too, since on Friday, July 31, the Dow collapsed more than 143 points and the Nasdaq 100 lost back its entire gain from the previous day.

On August 3 and 4, the first two trading days of the month, the Dow lost a total of 396 points. Between July 17 and August 4, the decline in the Dow had totaled 900 points. It certainly looked as if a bear market was upon us and I was as bearish as ever. Yet the very next trading day, on Wednesday, August 5, I found myself buying. Once again, we had another one of those classic late-day reversals. The reversal on August 5 impressed me even more than the failed reversal on July 27. As shown in Figure 12.2, on August 5 the Dow was down 72 points with only 30 minutes remaining in the trading day. It then made

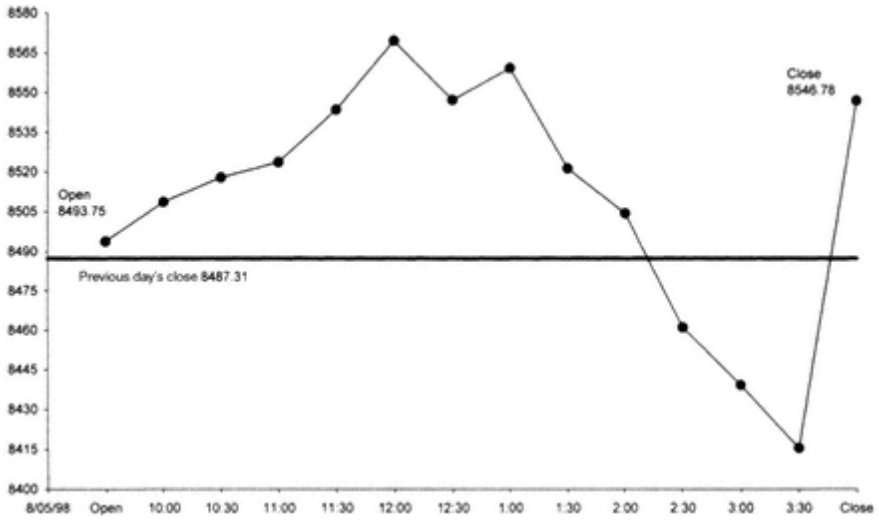


Figure 12.2
dow jones industrial average, 8/05/98—half-hour prices

a stunning reversal of 125 points and closed up 59 points on the session. I find that the later in the day these reversals occur, the more likely the buying will carry through the following day.

This time the reversal pattern worked as in the past. The Dow closed up on both August 6 and 7. Even though I trade these reversals with mutual funds, they are probably better suited for intraday traders in stock futures, index options, or individual stocks. The reversals of both July 27 and August 5 are good examples of why this is the case. When it was obvious there was to be no follow-through on July 28 of the July 27 late-day reversal, futures traders could have elected to close out their positions intraday. Fund traders, however, did not have that option. They would have had to wait until the end of the day and would have received end-of-day prices.

As for the reversal pattern on August 5, there was follow-through buying on both August 6 and August 7. Yet on August 7, the Dow closed nearly 100 points off its intraday high. Again, intraday traders could have elected to close out their trades on August 7 during that 100-point intraday sell-off.

One comment about late-day reversals bears reiteration. They normally occur in the Dow and the S&P. Then on the follow-through day or days, technology usually leads the way. With that in mind, I usually look to buy into the technology sector on late-day reversals. That's how I played it on August 5, as I went into a technology fund. I then sold half of my position at the close on August 7. That was because I didn't like the nearly 100-point intraday sell-off of the Dow into its close. I sold the remaining 50 percent of my position on Monday, August 10. The market was up most of the day, but sold off during the last few hours to close in slightly negative territory.

An example of what does not constitute a V-bottom or late-day reversal is the trading action on Friday, August 21. There was near panic intraday selling on August 21 due to a number of factors. There were sharp declines in many of the overseas markets. German stocks had closed down 5 percent. The Brazilian market was even shut down temporarily when its intraday losses hit 10 percent. Some of my sentiment indicators were at levels of pessimism not seen in a decade. For instance, the equity-only CBOE put/call ratio was at its highest reading since December 1987. The *Consensus* Index was at 19 percent, its most pessimistic reading since 1994.

As shown in Figure 12.3, after being down 244 points intraday on

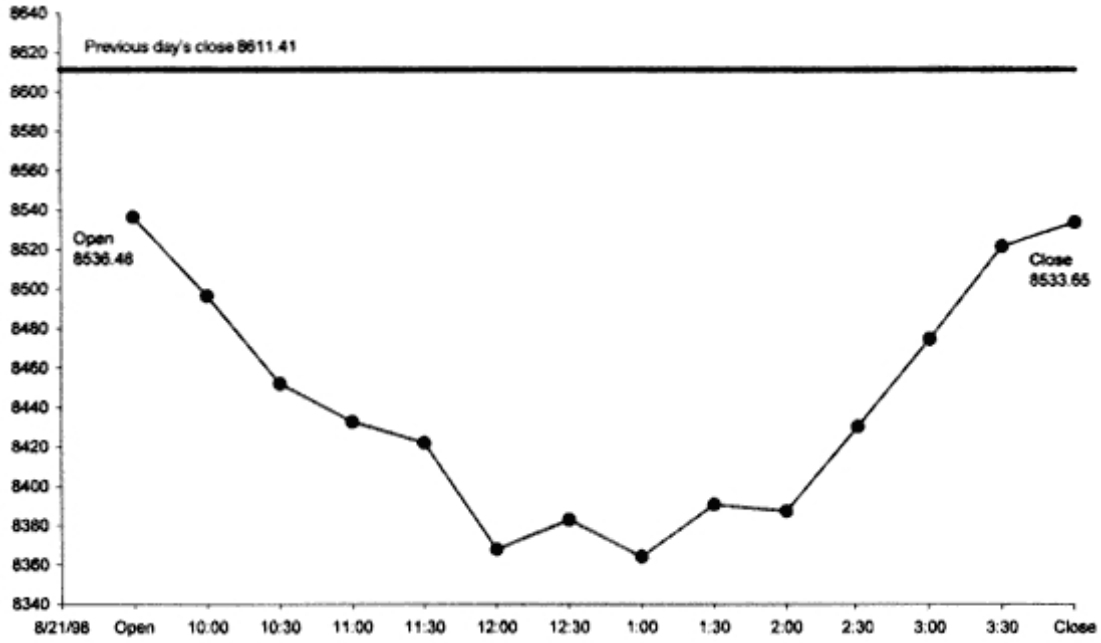


Figure 12.3
dow jones industrial average, 8/21/98—half-hour prices

August 21, the Dow made a huge turnaround and closed down only 77 points. However, this did not come close to qualifying as a V-bottom or late-day reversal pattern. To have qualified, the Dow would have had to close up or just slightly in negative territory. I've seen too many of these quasi-reversal days when the Dow makes the big intraday comebacks but still closes firmly down. In fact, I've been suckered into buying on some of these types of reversals and regretted it. As for the reversal on August 21, there was some weak follow-through in the S&P and Nasdaq 100 over the following two trading sessions. But the meager gains were wiped out when the Dow lost nearly 1100 points between August 26 and August 31.

A 9-to-1 Up-Volume Day

September was a brutal month, especially for the smaller stocks outside the Dow and the S&P 500. I survived by means of some well-timed trades in European funds, which Chapter 14 will discuss. However, one bad trade stands out in September. On September 8, the Dow soared 380 points. In the process, advancing volume outpaced declining volume by more than a 10-to-1 margin. Trading days in which this ratio is

more than 9-to-1 are rare and are considered to be an indication of extreme momentum thrusts.

In *Winning on Wall Street*, Marty Zweig devoted several pages to the 9-to-1 up-volume indicator. [1] As he points out, "Every Bull Market in history, and many good intermediate advances, have been launched with a buying stampede that included one or more 9-to-1 up days." More significant than a solitary 9-to-1 up-volume day are two such 9-to-1 days that occur within three months of each other.

The most extreme ratio of up to down volume occurred on August 17, 1982. This was the beginning of the greatest bull market of anyone's lifetime. Unlike in previous decades, 9-to-1 up-volume days have been rare in the 1990s, and two such days within three months of each other had been nonexistent until October 1998.

The 9-to-1 up-volume day that occurred on September 8, 1998, was the first since April 4, 1994. I therefore viewed the action of September 8 as one of extreme momentum and as an out-of-the-ordinary trading pattern day. I had no choice but to establish a trading position before the close. But it was not to be. There was no follow-through, as the Dow declined 155 points on September 9 and then another 249 points on September 10. I didn't wait around until September 10, though; I exited my positions on September 9. As a trader, I enter markets based on expectations of momentum follow-through. When my expectations aren't met, I immediately exit—no waiting, hoping, or praying.

I'd always been conditioned to believe the momentum of a 9-to-1 up-volume day was so significant that rising prices invariably followed in the short run. That scenario did not unfold with the 9-to-1 up-volume day on September 8, as the Dow moved several hundred points lower over the ensuing 30 days. This failure in September prompted me to check the performance of the Dow in the 1990s at 20- and 60-day intervals after the initial 9-to-1 up-volume trading signal.

Date	Up/Down Ratio	Dow	20 Days Later	60 Days Later
05/11/90	21.20-to-1	2801.58	2892.51	2710.64
08/27/90	11.00-to-1	2611.63	2485.64	2530.20
02/11/91	10.05-to-1	2902.23	2922.52	2930.90
08/21/91	11.50-to-1	3001.79	3024.37	3063.51
04/05/94	12.46-to-1	3675.41	3697.75	3624.96
09/08/98	10.52-to-1	8020.78	7742.98	9064.54

So much for the power of 9-to-1 up-volume days. The only one that really worked was the signal on September 8, 1998, and, as we will soon see, that was only because it was followed by a second 9-to-1 up-volume day on October 15. Next time I will tread more lightly when there is a singular 9-to-1 up-volume day. As Marty Zweig points out in *Winning on Wall Street*, more thrust is required to enhance the bullish odds; the real power of 9-to-1 up-volume days is when they occur two or more times within a three-month period.

The Utilities and Sentiment Sound a Bell

One pattern that had my attention during September 1998 was the very obvious upside reversal in the Dow Jones Utilities. From their intraday lows in early September to their intraday highs during the first week of October, the Utility Index climbed an impressive 18.5 percent. As discussed on page 96, the action of the Utilities is almost always a leading indicator to the direction of the broader market, albeit with a few months' lag. As for that broader market, it looked simply terrible. It was no surprise, then, that all the pundits were calling for another 1000 to 2000 points to the downside for the Dow.

The pessimism of the experts was reflected in the sentiment readings from the various polling services. For the first time in over a year, the *Investors Intelligence* percentage of bears had been running over the percentage of bulls for five consecutive weeks. The *Consensus* sentiment reading had been bouncing around in the high teens to low twenties—an extremely bearish reading. Then, during the first week in October, the *Market Vane* bullish consensus reading sank to 23 percent. I couldn't recall a bearish reading that low in the stock index futures at any other time during the 1990s. To top it off, the Rydex timers had over three times more assets in the Ursa Fund than the Nova Fund. All I needed to get long was some type of momentum trigger.

V-Bottom Upside Reversal

I'll always remember the October 8, 1998, bottom in the S&P. From October 8 through the end of December, I made nearly $100,000. This was by far my best three-month period as a trader. It all began with the late-day upside V-bottom reversal in the market on October 8. As you can see from Figure 12.4, the Dow was down over 274 points intraday. It

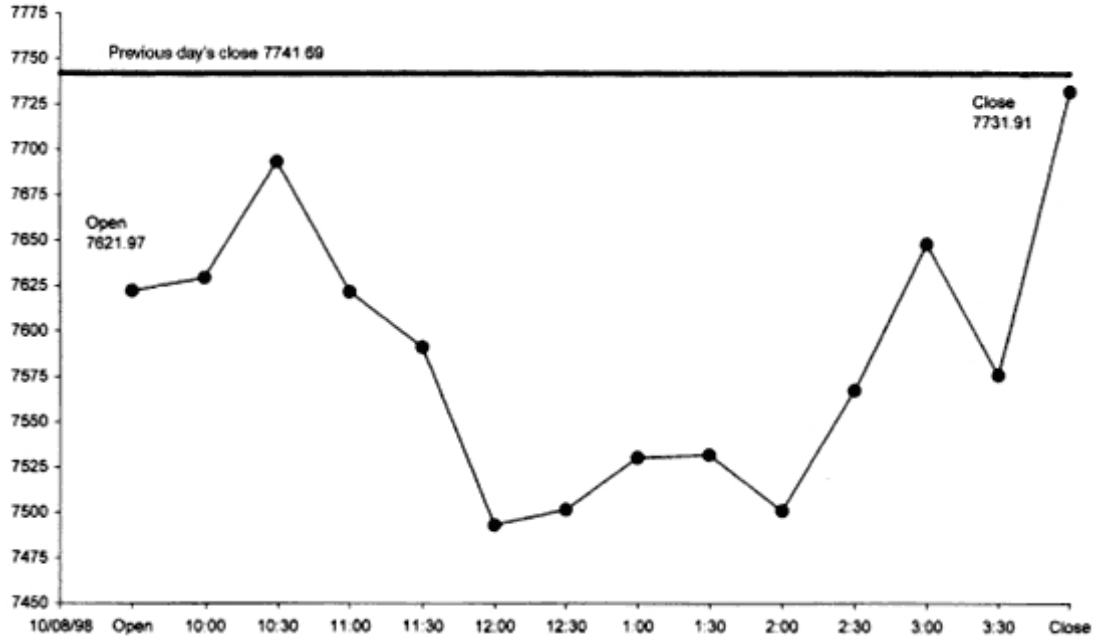


Figure 12.4
dow Jones industrial average, 10/08/98—half-hour prices

then staged a furious rally to close down only 9 points. In fact, with just a few minutes left in trading, the Dow had been in positive territory. The last half hour was particularly noteworthy, as the Dow rallied 155 points.

As my past trading examples demonstrate, I instinctively trade these types of late-day reversals when they come after a period of declining prices. V-bottom reversals aren't the Holy Grail, as we have seen. But when they work, it is often when the market is making a significant trading low.

Before the close on October 8, I established a position in a technology fund. I have found that the technology sector does especially well after V-bottom upside reversal days. That's exactly how it played out on October 9, as the Dow roared ahead 167 points while the technology-laden Nasdaq 100 Index soared even more, up nearly 70 points, or the equivalent of 490 Dow points.

Thunder in the Market

The fireworks on October 9 were but a sideshow to the real show, which came on October 15. That was the day the Fed unexpectedly

lowered the discount rate and the Dow jumped 330 points. Over 200 points of that gain came in the last hour alone. The up-volume indicator was 8.73-to-1. That was close enough for me to consider it a 9-to-1 up-volume day. This marked the first time during the 1990s that we had two 9-to-1 up-volume days within three months of each other.

I got real serious about trading on October 15. If ever in my lifetime there was a time to buy, buy, and buy more, it was October 15. It shocked me that so many traders and analysts were still disbelieving of the market after the lowering of the discount rate and its subsequent momentum explosion. Their logic in remaining bearish was that Alan Greenspan and the Fed must have known something bad was brewing and their surprise rate move was to stave off another hedge fund failure or third-world country from defaulting on their debt.

The momentum in the market after the October 15 surge was mind-boggling. The five-day change in the S&P from October 9 through October 15 was 9.18 percent. That was the sixth-greatest five-day momentum thrust since 1960. Extreme momentum thrusts to the upside must be respected. Table 12.2 is courtesy of Dan Sullivan's October 22, 1998, newsletter, *The Chartist*. [2] however, it includes the results from the October 15, 1998, signal, which weren't available at the time the original information appeared. Although this book is geared toward shorter-term trading, it is undeniable that the 6- and 12-month returns generated by this five-day momentum index are impressive.

table 12.2 five-day momentum

S&P 5-Day Gains	Date Ending	3 Months Later	6 Months Later	12 Months Later
+14.12%	10/11/74	+2.06%	+18.33%	+24.21%
+12.33%	11/02/87	UNCH	+2.27%	+9.11%
+11.84%	06/01/70	+3.99%	+12.37%	+28.72%
+11.55%	08/23/82	+14.48%	+26.42%	+40.18%
+10.67%	10/11/82	+8.41%	+15.37%	+26.67%
+9.18%	10/15/98	+18.69%	+26.29%	n/a
+7.79%	07/03/62	-0.59%	+12.79%	+23.80%
+7.69%	01/29/75	+10.84%	+14.14%	+29.57%
+7.58%	09/20/74	-4.61%	+19.20%	+22.44%
+7.41%	05/05/97	+14.56%	+11.71%	+31.90%

Always remember that the most bullish thing a market can do is rise on extreme momentum. Yet many people are fearful that this type of extreme strength is an invitation for a market correction. Historically, extreme strength only leads to additional strength. This is even more so if the momentum surge occurs after a period of declining prices such as the situation prior to October 8, 1998. The market went right according to script with the October momentum thrust. Between the close of October 15 and November 23, the Dow gained over 1000 points and reached several historic highs.

Another True Selling Day

I made over $59,000 in November 1998. It was the best of times. The fun came to an end, though, on November 30, when the market saw its first true selling day since the October 8 bottom. The major indexes had the following percentage declines on November 30:

Dow	(-2.32%)
S&P	(-2.40%)
Nasdaq 100	(-4.32%)
Russell 2000	(-1.08%)

Much as I disliked doing so, my discipline required that I begin selling part of the position I had built up over the past seven weeks. The Dow closed on November 30 at 9116. There was another near 1 percent selling day on December 3 and an ugly 1 percent true selling day on December 14, when the Nasdaq 100 led the market on a downward spiral. I was 100 percent in cash by the close of trading on December 14. From the close of trading on the true selling day of November 30 to the close December 14, the Dow had declined 420 points. On the surface, it appeared that, just as in July, the 1 percent true selling day rule had taken me out of the market at just the right time.

There were other reasons to be concerned about the market in December. The *Investors Intelligence* sentiment readings had an unprecedented 10 consecutive weekly increases in the percentage of bullish advisors. A streak like this had never occurred since this service began compiling data in 1963. Bullish advisors reached 57.9 per

cent, the highest weekly reading since January 1992. Also worrisome was that, as the Dow was declining from 9374 in late November to below 8700 on December 14, bullish advisors remained over 55 percent. It was as if no one believed the decline was for real and, from a contrary viewpoint, that was bearish.

Although my bearishness was tempered somewhat because we were in the normally strong seasonal period between Thanksgiving and the first five trading days of January, I was still happy to be 100 percent in cash and was expecting even lower prices. In hindsight, I was completely overlooking some very positive divergence between the action of the Dow and the Nasdaq 100. See if you can detect the divergence between those two indexes between December 1 and December 11. During this period, a one-point move in the Nasdaq 100 equated to a six-point move in the Dow.

	Dow	Nasdaq 100
December 1	+16.99	+74.57
December 2	(-69.00)	(-13.44)
December 3	(-184.86)	(-45.31)
December 4	+136.46	+56.23
December 7	+54.33	+46.88
December 8	(-42.49)	(-8.73)
December 9	(-18.79)	+17.22
December 10	(-167.61)	(-32.62)
December 11	(-19.82)	+22.25
Total points	**(-294.79)**	**+117.05 = 702 Dow points**

As you can see, there was some serious and obvious divergence taking place in the Nasdaq 100 versus the action of the Dow. At some point it was imperative that I take some type of a position in a technology-related trading vehicle.

I went into a technology fund before the close of trading on December 17. After the true selling day on Monday, December 14, the indexes had reversed sharply and made up the losses they sustained on December 14. It was a no-brainer to go into technology on December 17—not just because of the divergence that had been taking place with tech for the past two weeks, but also because of the extreme diver-

gence on December 17 alone. That day, the Dow jumped 85 points, but the Nasdaq 100 was much stronger, rising 32 points, or the equivalent of 192 Dow points. The follow-through on Friday in the tech sector was even more than I had expected. Whereas the Dow rose an additional 37 points, the Nasdaq 100 rocketed ahead more than 45 points. This equated to a 270-point move in the Dow.

The final two weeks of December made my month, as the Nasdaq 100 continued running and rose 100 more points. As I have mentioned more than a few times already, traders exploiting the extreme positive divergence in the Nasdaq 100 have several options at their disposal. More aggressive traders can trade Nasdaq 100 stock index futures or Nasdaq 100 index options. More conservative traders like myself can trade technology funds such as the Rydex OTC Fund, which mirrors the Nasdaq 100.

The Hazards of Trading Our Opinions

I can't recall many times over the past decade when I was so out of synch with the market as January 1999. I was very bearish because of my perceptual filters. The *Investors Intelligence* reading of bullish advisors went above 60 percent, a level not seen since before the great crash in October 1987. The equity-only put/call ratios reached extremes of optimism not seen in years. The market internals looked terrible and Internet stock mania was rampant. I thought we were in for some serious selling during January.

The serious selling I foresaw for January never materialized. The Dow and S&P were basically flat for the month, but the Nasdaq 100 Index soared into the stratosphere, gaining 291 points, or 15.86 percent. It's a good thing I'm not one for trading my opinions, but, instead, let the market tell me what to do. I made over $14,000 for the month. My profit would have been much greater had I been more aggressive. But I just thank my lucky stars I made anything, considering how ultra-bearish I was.

What saved me from my bearishness in January was paying attention to the divergences in the market. The strength in the technology sector was evident during the first six trading days of the month. Just seeing the extreme divergence during the first two days should have been reason enough to have taken a position in technology.

	Dow	Nasdaq 100
January 4	+2.84	+18.38
January 5	+126.92	+48.61
January 6	+233.78	+60.95
January 7	(-7.21)	+2.30
January 8	+105.56	+7.41
January 11	(-23.43)	+26.52
Total points	**+438.46**	**+164.17 = 820.85 Dow points**

More on Trading Patterns

There was some other noteworthy activity in January 1999 relating to V-bottom reversals and the Friday-to-Monday momentum break pattern. I previously commented that I attach no significance to V-bottom reversals that occur after a strong up day in the market. A good example of this is the trading action of January 15, 19, and 20. On Friday, January 15, the Dow climbed 219 points. On the following trading day, Tuesday, January 19 (Monday was a trading holiday), sellers came into the market and knocked the Dow down more than 120 points intraday. Yet, as you can see from Figure 12.5, later in the day there was a classic

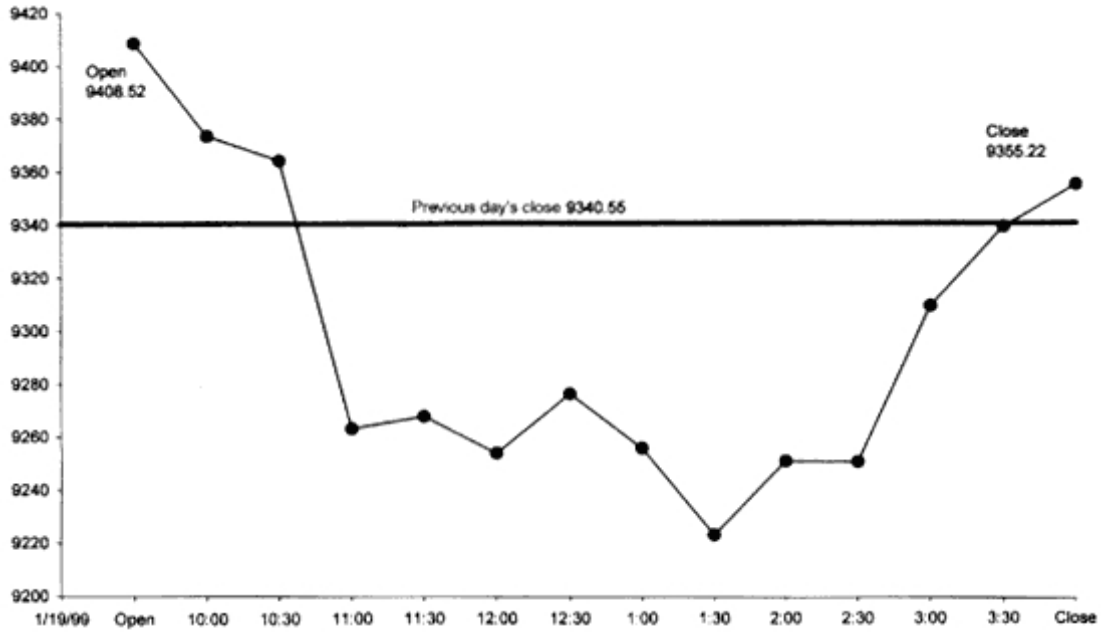


Figure 12.5
dow Jones industrial average, 1/19/99—half-hour prices

V-bottom late-day reversal, with the Dow closing up 14 points. Had the previous trading day been a down day, I would have jumped on this V-bottom reversal with both feet. But coming after a 219-point gain on January 15, I decided to sit this one out.

As Figure 12.6 details, there was the usual carryover buying early on January 20, with the Dow up more than 100 points. However, later in the day the market reversed sharply to the downside and closed down 19 points. To reiterate, be very wary of V-bottom reversals when they occur following a day or days of market strength.

You may be wondering if I advise shorting late-day downside reversals such as the one that occurred on January 20. That late-day reversal, by the way, was followed by two nasty days in which the Dow lost 71 points and 143 points, respectively. Even though the downside reversal pattern may have worked on January 20, I haven't found any evidence that it has been a historically profitable pattern.

A good example of my Friday-to-Monday momentum break pattern occurred a few days later on January 25. The previous Friday, on January 22, the Dow closed down 143 points. We therefore should have expected a down day on Monday, January 25. For most of the morning hours, the Dow did trade down, between the unchanged level and -20

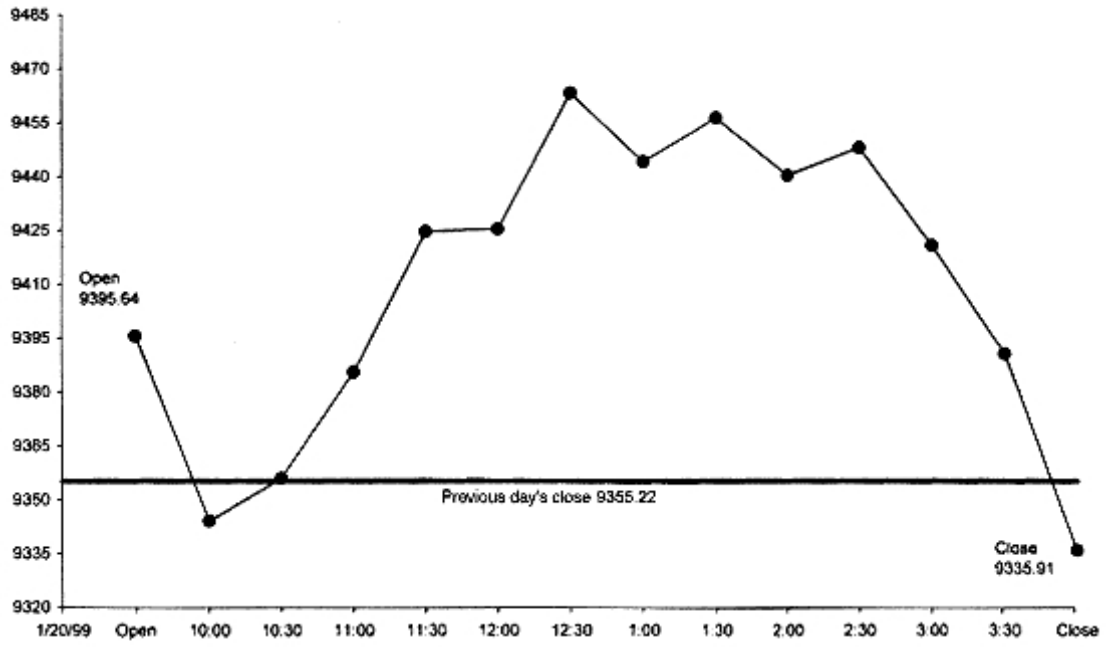


Figure 12.6
dow Jones industrial average, 1/20/99—half-hour prices

points. But, as seen in Figure 12.7, a late-day rally lifted the market, as the Dow closed up 82 points on the session.

This type of momentum break pattern on January 25 from Friday's action, as well as the late-day price surge, told me to buy in anticipation of follow-through buying the next day. And just like clockwork, the Dow soared 121 points on Tuesday, January 26. Even more impressively, the Nasdaq 100 roared ahead 65 points. I went into technology on January 25, since the Nasdaq 100 had been the index showing the most strength during the previous week's sell-off.

The Market Is Always Right

I've said this before and I will say it again: All that really counts is the action of the market itself. Or as Benton Davis liked to say, "The stock market is always right and tells its own story best." [3]

At no time in recent memory has Davis's quote been more prophetic than during the first four months of 1999. A lot of old-time traders were completely befuddled by the market in early 1999. Many reliable indicators had them sidelined in cash in anticipation of a severe market correction that never occurred. I, too, was extremely

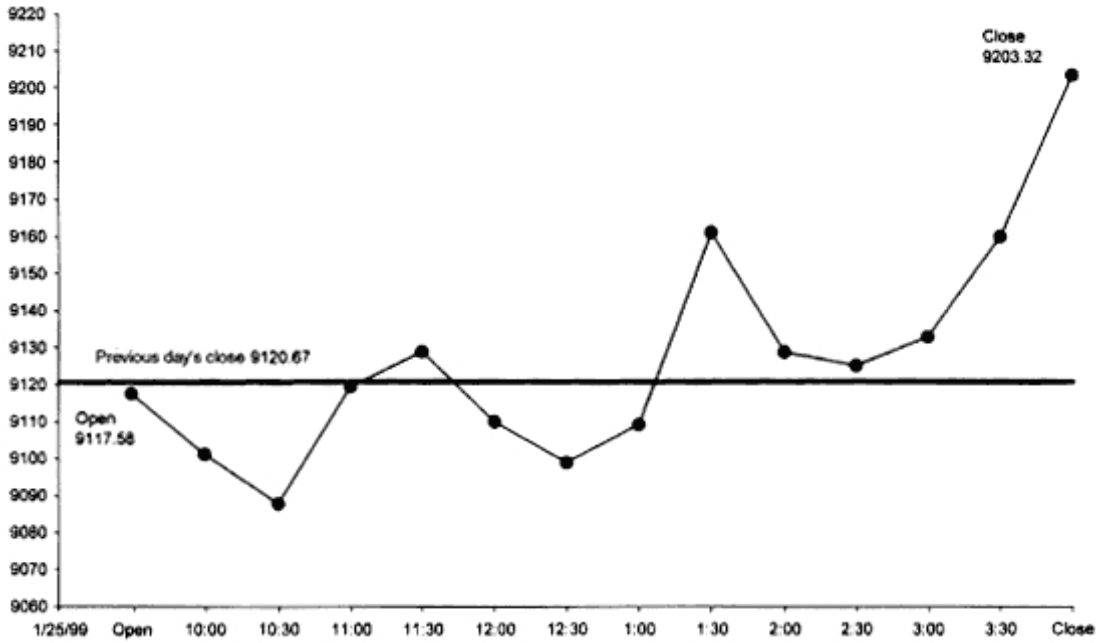


Figure 12.7
dow Jones industrial average, 1/25/99—half-hour prices

bearish, but at least I had the sense to listen to the market and continue trading from the long side, albeit a bit conservatively.

I've already discussed January 1999. A correction came in February, most notably in the tech sector. February was also one of my rare losing months since 1985. On average, since 1985, I can count on having a losing trading month about once every 20 months. These losing months are inevitable and something I have grudgingly come to accept. In most cases, my losing months result not so much from being out of synch with the rhythm of the market, but from psychological miscues, which could include anything from fear of pulling the trigger to over-trading. The key is to keep your losses as small as possible. As with all my past losing months, I managed to keep my trading losses in February below $2,000.

The real action in 1999 commenced during the first trading week of March. The Dow had been stuck in a trading range between 9200 and 9400 throughout much of February. Even though it had broken out above the upside of that range in late February, it quickly fell back to the lower band of the range. There was reason to believe that a downside breakout was just a matter of time.

Interest rates were rising steadily, and February had been one of the worst months of the decade for the bond market. Many of the perceptual filters and technical indicators that I use were flashing bright red. For instance, the Utility Divergence Index (see page 96) hit -25 percent, a very ominous level. The public/specialist short sales ratio was at bearish readings seen only a few times during the past two decades. The advance/decline line continued to deteriorate and was about to break below its October lows. New lows were swamping new highs on an almost daily basis.

One market technician wrote in his newsletter that the NYSE Momentum Index (a 200-day moving average of NYSE advances minus declines) had dropped to its lowest level in nearly 25 years, even though the popular averages were close to their respective all-time highs. The fundamentalists weighed in with their worries, pointing to historic market overvaluations based on book value, price earnings multiples, and dividend yield. It was no surprise, then, that in early March just about every pundit and market strategist appearing on CNBC was calling for an imminent decline of 5 percent to 10 percent in the market averages.

I posted my concerns about the market to an Internet chat group

on March 2 and 3. I said that even the bulls were in cash, awaiting the imminent correction the bears had so well articulated. But I thought it was doubtful the market was going to accommodate everyone—myself included—by going down. Any type of bullish news, such as the March 5 employment report, would result in cash being feverishly plowed back into stocks. What really had me anxious was that, in spite of all the negatives in the market, it was holding like a rock. The most bullish thing the market can do is not collapse when everyone is expecting it to.

The two traits that have been most instrumental to my trading success over the years deserted me in March 1999: quickness and flexibility. It all began on March 3. I was bearish, but I also knew everyone else was bearish. So I was paying close attention to the market, watching for any type of positive price action that might cause traders to stampede back in and bid up prices.

That price action occurred during the last half hour of trading on March 3. After breaking down earlier in the day below price levels the bears had considered critical, the market managed to rally back near the close. What really caught my eye was the action in the Nasdaq 100. During the last 30 minutes of trading, this index moved from down 10 points to up 11 points, a swing of 21 points.

I figured the bears had their chance on March 3, but couldn't keep the market down. Based on the late-day snapback, a rally was imminent. So just before the 4:00 P.M. closing bell, I phoned my broker to place a trade. But I blew it. I got cold feet and hung up before I could place my order. My usual quickness just wasn't there on that day.

Too bad I hadn't been able to pull the trigger on March 3, since on March 4 the market rallied strongly and closed up 190 points. In the past, I normally jump on that type of extreme momentum day. But, whereas on March 3 my quickness deserted me, on March 4 I was unable to buy because my flexibility wasn't there. I was worried about the employment report to be released on March 5, even though I knew in my heart it was a win-win situation. This means that there had already been such negative expectations built into the report that, even if it was negative, the market would have a relief rally. And, of course, if it came out positive, the market would soar.

Much to my dismay, the employment report on March 5 was a positive surprise and the Dow skyrocketed 268 points. My lack of quickness caused me to miss the 190-point move in the Dow on March 4 and

my lack of flexibility caused me to miss the 268-point move the following day. So I did the only thing a good trader could do under the circumstances: I plowed back into the market before the close of March 5.

Now stop right here and think about what I did on March 5, and ask yourself if you could do likewise. I went into the market after a 459-point, two-day rise. Most traders find that too difficult to do. They fear it's too risky to chase the market after such a rise because some type of setback is inevitable. The real risk, though, is not to be in the market after such extreme momentum.

Over the next two weeks the Dow moved up several hundred more points. The Nasdaq 100 was even stronger and gained over 4 percent. I made several thousand dollars during that period, but by the close of trading on March 19, I was again 100 percent in cash. March 19 was a triple witching Friday, on which the Dow had been up 60 points in the morning only to turn tail and close down 94 points. I once again became extremely bearish on the market and thought the top on March 19 would prove significant.

Two trading days later, on March 23, the Dow tanked 218 points. The Nasdaq 100 was particularly hard hit that day and declined more than 66 points. The Nasdaq 100 decline equated to 330 Dow points. I was thrilled to be in cash and convinced the worst was yet to come.

A funny thing occurred the next trading day, which was March 24. While the Dow did nothing and closed down 4 more points, the Nasdaq 100 surged ahead and recouped almost all of its 66-point loss from the previous day. That kind of out-of-the-ordinary momentum coming after the decline on March 23 was saying loud and clear that tech was ready to roll again. Yet as in early March, my quickness deserted me. I was psychologically unable to jump back on board on March 24. The next trading day, the Nasdaq 100 jumped 70 more points.

I made more trading mistakes in March than I had made in over two years, yet I still closed out the month with close to $12,000 in profits. I missed out on much greater profits because I was slow reacting to the momentum of the market on March 3 and 4, and then again on March 24. But at least I had the sense not to sit around and feel sorry for myself. I reentered the market as soon as I could and didn't worry about my missed opportunities. I know that regardless of how bearish I may be, the market is always right and tells it own story best. Always remember that traders *react* to the evolving market, they don't *predict* and they don't *anticipate*. What separates the good traders from the not-so-good is the quickness of their reaction time.

An April Fools' for the Bears

The Dow closed above 10000 for the first time ever on March 29. It then proceeded to lose over 200 points on March 30 and March 31, closing at 9786. Many of the market prognosticators were bearish when trading began in April. The main worry was how the advance/decline line had undercut its October lows. That set up one of the most negative divergences in stock market history between the Dow and the advance/ decline line. The thinking on Wall Street was that the deteriorating advance/decline line had to eventually topple the Dow and S&P. Another reason to be bearish was that day after day new lows were out-pacing new highs on both the NYSE and Nasdaq. There was also concern about the continuing failure of the Transports to confirm the new highs in the Dow.

The newsletter writers were having a field day with the problems of the Dow in closing above 10000. All sorts of parallels were drawn with the Dow problems at 1000 in 1966 and at 100 in 1906. The historians were saying that, just as it took many years for the Dow to surpass Dow 1000 and Dow 100, it would take many years for the Dow to finally break through the 10000 level.

On Monday, April 5, the Dow charged ahead 174 points and closed above 10000 for the second time ever. It wasn't a very impressive rally, as there were more new lows than highs and advancing issues barely beat out declining issues. I wasn't much impressed with the market either, but since it had been going up, I had no choice but to buy.

April 7 saw another strong rally, and this time the Dow closed convincingly above 10000, at 10085. This rally looked even worse than Monday's move above 10000. There were 69 new highs but 113 new 52-week lows. Still, as ugly as it looked, I had no choice but to increase my exposure to the market.

Another Bell Ringing

April 9 was a pivotal day in the stock market—at least for how the remainder of the month would unfold. Here are the net changes in the major indexes:

	Dow	S&P	Nasdaq 100	Russell 2000
April 9	(-23.86)	+4.37	+7.72	+5.97

The action of the Russell 2000 was divergently strong as compared to the other indexes. I was back to my quick ways and moved some money into a small-cap fund. Futures traders could have bought a contract on the Russell 2000, while option traders could have purchased a Russell 2000 index option. If there was any doubt that something was brewing in the small-cap Russell 2000 Index, look at its performance over the next five trading days:

	Dow	S&P	Nasdaq 100	Russell 2000
April 12	+165.67	+10.29	(-13.26)	+6.46
April 13	+55.50	(-8.82)	(-44.03)	+4.92
April 14	+16.65	(-21.38)	(-76.22)	+0.15
April 15	+51.06	(-5.58)	+32.18	+0.35
April 16	+31.17	(-3.86)	(-49.35)	+3.84

If April 9 was a pivotal day for the Russell 2000, the week of April 12 was even more of a pivotal week for the Dow Jones Industrials. The positive divergence that week in the Dow, compared with the S&P and Nasdaq 100, was extraordinary. These types of divergences should not be ignored. On April 12, I exited most of the positions I had been accumulating over the past few weeks, since they were in the technology sector.

As the action during the week of April 12 indicated, there was a shift taking place out of technology into the smokestack Dow-type stocks. This was the time for traders to begin focusing on Dow-related trading vehicles—Dow stocks, Dow futures, options, mutual funds, or the Dow Diamond Index shares on the AMEX.

The Rally No One Believed

I made over $19,000 in April, primarily because of some of the most negative sentiment I've seen in my 33 years as a trader. It was that negative sentiment that prompted me to keep a heavier than average exposure to the market. For the month, the Dow rose 1002 points, or 10.2 percent. That was one of its greatest percentage gains since January 1987, when it rose 13.8 percent.

What was shocking about sentiment were the extremely high

readings in the OEX put/call ratios, as the Dow was propelled higher and higher. No one believed the rally. Here are the daily OEX put/call ratios along with the daily changes in the Dow from April 7 through April 19:

	Dow	OEX Put/Cal Ratio
April 7	+121.82	1.64
April 8	+112.39	1.68
April 9	(-23.86)	1.61
April 12	+165.67	1.50
April 13	+55.50	1.42
April 14	+16.65	2.14
April 15	+51.06	1.64
April 16	+31.17	1.66
April 19	(-53.36)	2.40

During this nine-day period, the Dow gained 477 points, while the average daily put/call ratio was 1.74. As I said, I've never witnessed this type of bearishness with a market that was in one continual rise. During that rise, the market internals improved dramatically. Nearly every day, new highs were outnumbering new lows and advancing issues were well ahead of declining issues. Yet the bearishness persisted.

Advisory sentiment was as shocking as the put/call ratios. The number of bearish newsletter advisors as tracked by *Investors Intelligence* remained above 30 percent throughout the month. Normally when there is a meteoric rise in the Dow as in April, the percentage of bearish advisors drops to the 20 percent to 25 percent range or lower. For instance, during the huge Dow rise in January 1987, it went as low as 11.8 percent.

The *Consensus* Index of bulls stayed in the 50 percent to 56 percent range during the April rally. This, too, was unprecedented in the face of a 1000+-point move in the Dow. In the past, during a rally of April's magnitude, the *Consensus* readings would move above 60 percent. Probably the most shocking and most accurate from a contrary point of view were the sentiment readings from the Internet polling service at Lowrisk.com. Here are their percentages of bulls and bears for April 1999, from their weekly "Guess the Dow" contest:

Week Ending	Bulls	Bears
April 4	18%	54%
April 11	36%	51%
April 18	12%	56%
April 25	21%	46%
May 2	33%	46%

These are the types of readings you get when the Dow declines 1000 points, not when it rises 1000 points, as in April 1999. It seemed that no one believed the Dow could keep rising as it did throughout April. This kind of negative sentiment set the market up for even further rises, and it rose another 200+ points during the first week in May.

More Momentum and Divergences

I did not subjectively choose 1998 and early 1999 as examples of my trading methodology. You can go back to any year and find V-bottom and late-day upside reversals, extreme momentum days, Friday-to-Monday momentum and momentum break patterns, 1 percent selling days, and divergence patterns. Let's look at how my price patterns worked during an important market low and high in 1997.

Between March 11 and April 11, 1997, the Dow swooned 9.78 percent. That was its worst decline since the bear market of late 1990. The low of this decline occurred on a Friday (April 11), when the Dow dropped 148 points, or 2.27 percent. The damage was even worse that day in the S&P and the Nasdaq 100 indexes. After the close on April 11, there was great fear in the trading community that the following Monday could see a crash similar to that of Monday, October 19, 1987.

As seen in Figure 12.8, there was some continued selling on Monday, April 14, but not what everyone had been expecting. Over the first 4 1/2 hours of trading, the Dow was stuck in a range of -20 to -30 points. Over the last two hours of trading, the market had a late upside surge, with the Dow rallying over 90 points to close up 60 points. Carryover strength in the Dow and other market indexes should then have been expected on Tuesday, based on my Friday-to-Monday momentum break pattern, as well as my late-day upside reversal pattern. This type of action also may have portended a change in the recent month-long downtrend in the market.

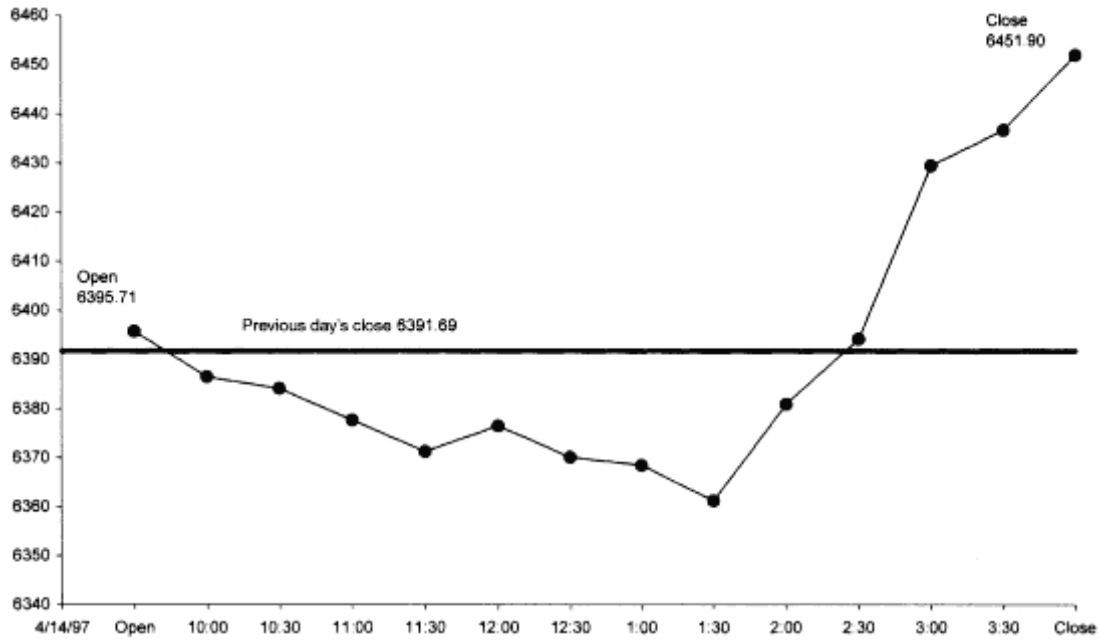


Figure 12.8
dow Jones industrial average, 4/14/97—half-hour prices

A change in trend on Tuesday, April 15, is exactly how it played out, as the Dow gained 135 points and another 92 points on Wednesday. If you are observant, you will note how the Friday-to-Monday momentum break pattern that occurred from April 11 through April 14, 1997, is almost identical to the Friday-to-Monday momentum break patterns that occurred from January 9 through January 12, 1998, as discussed on page 114, and from January 22 through January 25, 1999, as discussed on page 136.

During the last week in April 1997, two more of my favorite patterns appeared and led to a humongous 26 percent rally in the Nasdaq 100 Index through mid-October. Since June 1996, the large-cap Dow and S&P stocks had been leading the market higher. The tech stocks and small-cap stocks, as represented by the Nasdaq 100 and Russell 2000 indexes, had lagged behind. But during the week of April 28, 1997, a bell was rung loud and clear that a new beat was about to begin in the Nasdaq 100. Here are the five-day changes in points for the Dow and Nasdaq 100 during the week of April 28. During this period, a one-point move in the Nasdaq 100 equated to an eight-point move in the Dow.

	Dow	Nasdaq 100
April 28	+44.15	+10.82
April 29	+179.01	+26.87
April 30	+46.96	+18.48
May 1	(-32.51)	+7.38
May 2	+94.72	+27.37
Total points	**+475.62**	**+114.20 = 913 Dow points**

For the week, the Nasdaq 100 gained a stunning 11.1 percent. That was its largest weekly point and percentage gain since 1987. This was a textbook example of an extreme momentum pattern. There was also the extreme divergence pattern in the performance of the Nasdaq 100 with the Dow. As things unfolded, the extreme strength of the market the week of April 28 in the Nasdaq 100 led to a huge summer rally in all the indexes. The Dow rose 16.8 percent above its May 2 close, while the Nasdaq 100 and Russell 2000 rose 26.2 percent and 31.4 percent, respectively. In my trading, I went into a small-cap fund. (This will be discussed further in Chapter 14, on mutual funds.)

As my track record shows (see Table 1.1 and Figure 1.1), I had a good run from May 1997 through September 1997. In late September and early October, the small-cap Russell 2000 Index was on fire, making yearly highs nearly every trading day. Then out of the blue on October 16 and 17 came two consecutive 1 percent true selling days. The percentage declines were as follows:

	October 16	October 17
Dow	(-1.48%)	(-1.16%)
S&P	(-1.09%)	(-1.16%)
Nasdaq 100	(-1.76%)	(-2.20%)
Russell 2000	(-1.20%)	(-1.72%)

By the close of October 17, I was back to 100 percent in cash. The next week, on October 23 and October 24, the Dow lost over 300 points. But that was just a preview of the carnage to come on October 27, when the Dow suffered its worst one-day point decline in history: 554 points. As I've mentioned previously, the 1 percent true selling day is my least

reliable pattern. But the times it's right on, such as October 16 and 17, more than make up for its periodic lapses.

Never Buy the Dips

I operate under the theory that extreme strength leads to more strength, and extreme weakness leads to more weakness. This trading principle was deeply ingrained in me during the 1960s and 1970s. Consequently, I have always bought strength and sold weakness. This is one reason why my drawdowns have been negligible over the years. Since I never buy dips in the markets, I've never been exposed to those periods where the dips became routs.

Although selling extreme weakness is part of my trading discipline, I'm not blind to the fact that, in reality, extreme weakness is more often an excellent place to be buying, not selling, especially over the past decade. Victor Niederhoffer's research from 1988 to 1996 [4] showed that after steep daily declines in the S&P futures of 4.00 to 5.00 points, the average changes over the next day and the next five days were gains of .68 and 2.74 points, respectively. Tremendous declines of greater than 5.00 points showed next-day average gains of .37 points and five-day average gains of 2.91 points. This study would indicate that it isn't wise to be scared out of a position based on an extremely weak day in the market.

Following is a study of the eight worst daily declines in percentage in the Dow dating back to 1950 and what occurred the day after such debacles:

	Date	% Change	Next Day
1	10/19/87	-20.5	+5.3
2	10/26/87	-8.3	+2.4
3	10/27/97	-6.9	+5.1
4	01/08/88	-6.8	+1.7
5	05/28/62	-6.7	+4.6
6	09/26/55	-6.6	+2.3
7	08/31/98	-6.4	+3.8
8	10/13/89	-6.1	+2.8

Again, selling on extreme weakness doesn't appear to be a very viable strategy. Here are some recent examples of extremely weak

days in the Dow, as well as its daily performance one day after and its daily performance two days after.

Date	Decline (in points)	Next Day	Two Days Later
01/09/98	-222.20	+66.76	+84.95
06/15/98	-207.01	+37.36	+164.17
08/04/98	-299.43	+59.47	+30.90
08/27/98	-357.36	**(-114.31)**	**(-512.61)**
08/31/98	-512.61	+288.36	**(-45.06)**
09/10/98	-249.48	+179.96	+149.85
09/17/98	-216.01	+21.89	+37.59
09/30/98	-237.90	**(-210.09)**	+152.16
11/30/98	-216.53	+16.99	**(-69.00)**
01/14/99	-228,63	+219.62	+14.37
03/23/99	-218.68	**(-4.99)**	+169.55

Regardless of the study, it simply doesn't pay to be shaken out by extremely weak days in the market. Extremely weak trading days invariably lead to strength, not weakness. Had I used data for the Nasdaq 100 instead of the Dow, the results would have been similar. If anything, after severe declines in the Nasdaq 100, that index bounces back faster and with a greater magnitude than the Dow.

You may be wondering, if I consider myself such a flexible trader, why I still sell weakness in spite of such irrefutable evidence that it's a fool's strategy. I do so because I exit my positions on the weakness that precedes the real debacle days. In other words, debacle days rarely come from out of the blue. There is usually a period of a few days or weeks that leads up to the climactic selling days. It's at that initial weakness where I exit my positions and go to cash. For example, of the 11 debacles shown here in the Dow, I was 100 percent in cash each time, except for November 30, 1998, and January 14, 1999.

Trading Is Often Counterintuitive

Trading can often be counterintuitive. What instinctively feels right can sometimes be the wrong thing to do. There were several examples of that in my trading during March and April of 1999. Remember when I said I was bearish in early March? There were a 1,001 reasons for my bearishness. However, in the past I've found that whenever I'm ultra-

bearish about the market, it invariably will go up, and sooner rather than later. Although I unfortunately didn't do it in early March, normally when I'm ultrabearish I go long the market. While that may sound like a harebrained trading strategy, it has added greatly to my net worth over the years.

When the Momentum Dies

I am occasionally asked what happens to a momentum trader like myself in the unlikely event the momentum is ever wrung out of the market. No problem—I simply rely more on the perceptual filters, described in Chapters 9 through 11, and less on momentum patterns.

Will the momentum ever die? The academics point to the going-nowhere decade of the 1970s as a momentumless market. As someone who was around in the 1970s, I maintain that it was not a flat and trend-less market as some would lead you to believe.

Someday, though, we will get a bear market—and not some one-month or three-month affair like we saw in October 1987 or August to October 1990 and July to September 1998. I say, bring it on. The opportunities coming out of bear markets are a momentum trader's dream.

Chapter 13—
Money Management

This book most likely will be reviewed in various trading-related publications. One shortcoming the academics might point to is my limited discussion on the subject of money management. It's often said that proper money management techniques are what separate the winners from the losers in the trading game.

Over the past 14 years I have never sustained a losing month over $2,000 in my combined trading of mutual funds and stock index futures—and we are talking about a trader with an account in the hundreds of thousands of dollars. You would think that, with that type of track record, I could offer some real insights into money management. But to me, money management is all about discipline and how we handle risk—that is, not overtrading, cutting your losses, and letting your profits run. I'm sorry, but I simply don't believe those are things that can be taught or put into some mathematical formula, as many trading books would lead you to believe.

I also believe that if you are to become a successful and disciplined trader, you must practice discipline in aspects of your life beyond the trading arena. In my case, I have been a runner since 1978. While not a hard-core, seven-day-a-week runner, I'm still very disciplined in getting out there at least five or six days a week. Many times I don't get my run

in until late at night. If it's wintertime, that can mean running in some very unpleasant conditions. I believe that the discipline I acquired over the years as a runner has carried over to my trading.

Although I might believe that discipline and money management aren't something a trader can be taught, they can be learned. Nevertheless, discipline must come from within. I was never a very disciplined trader until I began setting goals in the spring of 1985. My goals gave me discipline as a trader. I am such a disciplined trader now that it is inconceivable I could ever have a losing year. Disciplined traders can control their profits and losses. They can pick and choose when to trade and how much to trade. Disciplined traders control the market instead of allowing the market to control them.

As you have seen, I trade various momentum patterns. In trading these patterns, there are no ifs, ands, or buts. Either the market immediately responds in my favor or I exit my position. How much simpler can a money management strategy get? If I buy because of extreme strength on a Friday that doesn't follow through on Monday, I'm gone. If I buy because of a late-day V-bottom upside reversal or price surge and there is no carryover buying the following day, I'm gone. If I buy the Nasdaq 100 because of a day or two of extreme positive divergence and the divergence dissipates the next day, I'm gone. I always enter or exit a market based on particular expectations. When the market proves me wrong by not immediately confirming those expectations, I act accordingly.

One important comment I should make about money management: Just as I feel a trader's particular trading methodology should be unique and something he or she alone has developed and fitted around his or her personality, the same applies to the trader's money management strategies. Traders have to develop their own unique money management strategies based on their specific risk tolerances.

Trading and Gambling

A frequent topic in the Internet discussion groups is whether trading is nothing more than gambling. My take is that gambling, unlike trading, is where the house (such as the casino) has a statistical edge. Without an edge, all the money management strategies in the world won't give the gambler a positive expectation.

When I used to gamble, I confined my activities to those in which I did have a statistical edge: counting cards in blackjack and exploiting

mechanically imperfect roulette wheels. However, most casinos ban professional card counters and when they see one of their wheels becoming biased due to wear and tear, the wheel is quickly replaced and repaired.

Unlike the casino and games of chance, the stock market offers all sorts of statistical edges and biases. Many of these were discussed in previous chapters—such as my favorite, monthly seasonality. Of course, the greatest edge for traders is the 200+ year uptrend in prices. Great fortunes have been amassed in the stock market by traders adhering to sound money management strategies and making their bets only when the momentum was in their favor.

Some could argue (and I wouldn't disagree) that trading commodities such as the grains, meats, softs, and metals is gambling, since those markets offer no edges or biases for the trader. I spent 19 years spinning my wheels trading commodities. It wasn't until the spring of 1985, when I decided to confine my trading solely to stock index futures, that my success story began. Coincidence? I think not.

Trading Vehicles without Leverage

I had no choice in the spring of 1985 but to trade commodities and stock index futures. My account amounted to only $2,200 so I needed the power of leverage to build it up to a more respectable level. *Leverage* is trading on borrowed money. For example, an S&P futures contract in the spring of 1985 was trading at 180 and was valued at $90,000. As I remember it back then, a futures trader needed only $3,000 in the account to trade the S&P futures. The $3,000 is known as *margin*. The leverage comes from controlling a $90,000 investment for $3,000. If the S&P futures moved up or down by 3.5 percent, or six points, you would either double your money or be wiped out. Options contracts work the same way in that you control a large dollar amount by putting up only a small amount of margin.

This will sound like heresy, especially coming from someone who built his reputation trading stock index futures, but I detest leverage and try to avoid it at all costs. If you are well capitalized or can build your account up to where you no longer need leverage, then by all means, avoid leverage like the plague. Stick to trading vehicles that aren't leveraged, such as mutual funds, stocks, or the index shares on the AMEX. With these trading vehicles, you have more control over your money management strategies. You can dictate how much money

to risk on your initial positions and how much to risk on further purchases if your initial position moves in your favor. You aren't controlled by the dollar amounts of the futures or options contract specifications.

If I were starting all over again today with limited capital, I wouldn't do anything different from the way I did it in the spring of 1985. I would trade stock index futures until I built my account up to where I no longer needed the leverage. I'm not alone in this philosophy. I read an investors poll in *Investor's Business Daily* that showed that 27 percent of investors with net worths below $100,000 used futures and options as their primary trading investment vehicles, compared to only I percent of investors with net worths above $500,000. The poll also showed that 15 percent of investors with less than five years of experience used futures and options, compared to only 3 percent with more than five years of investing experience. [1]

My most basic money management precept is that wealth accumulation comes from maximizing your winning trades—meaning that the name of the game is to make the big money when you are right. I'm a very conservative trader who becomes very aggressive when I get on board a winner. My method of exploiting winning trades is to continually add to my position on a scale-up, as taught by Darvas and Livermore. I try to milk winning trades for as long as I can and for as much as I can. Some would call this a pyramiding strategy. Try this type of strategy with futures, options, or any leveraged trading vehicle and you can get your head handed to you on just the slightest price reaction.

Chapter 14—
Trading Mutual Funds

It was always my goal to earn my living from trading the markets. I've achieved my dream of trading for a living, but not in the manner I envisioned when I set out on my quest. When I was young, I imagined myself someday being the second coming of Jesse Livermore. I was going to be this hotshot trader in stocks and futures, dashing in and out on a daily basis. Instead, most of my trading income is now derived from trading mutual funds and junk bond funds.

I learned the hard way, during my struggles in the 1960s and 1970s, that my risk tolerance was not suited for aggressively trading stocks and commodities. Successful trading is very much about finding a trading niche based on our personalities. To my surprise, I found my trading niche in mutual funds. Mutual funds are my preferred trading weapon because of their persistency of trend and lack of volatility as compared to stocks, futures, and options. Mutual funds enabled me to aggressively implement the scale-up buying strategies as practiced by Darvas and Livermore.

I trade mutual funds much more aggressively and frequently than I ever traded stocks, futures, or options. Depending on market conditions, I make almost daily adjustments to my mutual fund positions. When I'm told by the misinformed that trading mutual funds is akin to

watching paint dry, I shake my head in disbelief and feel like pasting my track record on their foreheads.

Timing Versus Trading

I consider myself a mutual fund trader, not a timer. I've always considered timers as those who rely on some type of mathematical formula or mechanical trading indicator for their entries and exits. Charts and oscillators are favorites of the timing crowd. Traders like myself react to the evolving trends as they are occurring, not after the fact when the timers are coming on board. Admittedly, timers do well in avoiding the bearish phases in the market. But bear markets occur so seldom that a passive buy-and-hold strategy will handily beat all but the elite of market timers.

If you want to see the performance results of market timing with mutual funds, look no further than Steve Shellans *MoniResearch Newsletter*. [1] Shellans tracks the real-money portfolios of many mutual fund timers, including several Rydex Fund timers. Rydex is a mutual fund family geared specifically for market timing professionals. Rydex and similar funds, such as ProFunds and Potomac Funds, cater to active traders and are free of redemption or transaction fees. They also offer leveraged funds, which seek to provide returns that correspond to 150 percent and 200 percent of various indexes such as the S&P and Nasdaq 100. Bear funds are also available, which correlate inversely to the S&P and Nasdaq 100. One drawback to these funds is that you have to place your orders anywhere from 10 to 30 minutes prior to the close of trading.

According to numbers supplied by *MoniResearch* for the three-year period ending September 30, 1998, none of the 12 Rydex timers monitored came close to beating a passive buy-and-hold strategy in the Rydex Nova Fund. That fund had an annualized 25.7 percent return over the previous three years, while the best timer's return was only 18.1 percent annualized. Over the previous two-year period ending September 30, 1998, only 1 timer out of 18 monitored beat a buy-and-hold strategy.

What I like about the *MoniResearch Newsletter* is that we are talking about real money here. That's the only way to judge the effectiveness of timing methodologies. Ignore vendors or pseudotimers who hawk hyped-up returns based on simulated or hypothetical trading

results. The only thing that counts is real money backed up with real brokerage statements.

Although he doesn't track real-money accounts, Mark Hulbert at the *Hulbert Financial Digest* [2] publishes an excellent newsletter on the performance of investment newsletters. In addition to tracking specific stock recommendations, Mark also tracks the market timing-only effectiveness of the newsletter writers. Over the past 10 years, through March 31, 1999, only 2 newsletter timing strategies out of 59 tracked were able to beat the returns of a buy-and-hold strategy in the Wilshire 5000 Index. Over the past five years, just 1 of 104 timing strategies beat the Wilshire 5000 Index.

Another study on market timing that I recently read about was by DALBAR Financial Services, a Boston-based consulting firm.[3] They mapped investor return data from January 1984 to December 1997. Over that period, the S&P 500 Index had an annualized return of 17.1 percent. But the DALBAR study found that the average equity fund investor had an annualized return of only 6.7 percent. This underperformance was attributed to market timing and chasing the hot funds.

The timers will argue that the returns listed here for *MoniResearch* and *Hulbert* are not adjusted for risk, and reducing risk is what market timing is all about. This may be true, but you can't eat risk-adjusted returns. Does reducing risk mean that any value has been added to the trading account?

I'm not suggesting it is impossible to both reduce risk and beat the S&P, just that it's extremely difficult. Most timers I know are more concerned with reducing risk, not beating the S&P. And in that regard, some have proved very adept.

Beating a Buy-and-Hold Strategy

Beginning in early 1986, I began taking my monthly profits from my futures trading account and parlaying them into a much greater amount by trading mutual funds. I stepped up the withdrawals from my futures account to the funds in late 1988 through the beginning of 1991. Those were good times for mutual funds, especially 1991, and my mutual fund account balances steadily increased.

In the early years, I made numerous switches annually, but I was by no means the trader I am now. In the early days, I found that accumulating wealth in mutual funds was more a function of patience than

brilliance. In fact, I used to preach against excessively trading mutual funds, saying it was an exercise in futility. My trading moves, while limited, were productive, and I comfortably beat the returns of the S&P each and every year.

In 1996, however, I decided to put myself, as well as the conventional academic wisdom, to the test. Instead of the goal of merely beating the S&P by a few percentage points annually in my fund trading, I embarked on an aggressive and excessive trading regimen with the goal of beating the S&P by a minimum of 10 to 20 percentage points each year.

Although I pursued this aggressive trading strategy in all my mutual fund accounts, I set aside one specific account at INVESCO as my model trading account. This account was selected, since it was one of the few accounts I wasn't continually adding to and withdrawing from. It therefore made it easier to compute annual returns. Of course, the problem is that my performance can only be judged through the limited numbers of funds offered for trading through INVESCO. Still, I was up for the challenge. Here are my real-money trading results for the first three years versus the S&P (with reinvested dividends):

	Gary Smith	S&P
1996	40.55%	23.25%
1997	46.88%	33.55%
1998	84.90%	28.56%
Three-year annualized return	**56.28%**	**28.28%**

My three-year annualized return was about double that of the S&P. In some of these years, returns from my other mutual fund accounts beat those of the model account. But figuring the difference would be a statistical nightmare due to constant additions and withdrawals. Now I am well aware that three years does not a genius make and is too short a time from which to draw many meaningful conclusions. But my out-performance came during a three-year period in which very few traders, timers, and mutual fund managers were able to beat the S&P, and especially by such a wide margin.

It's easy to become seduced by the conventional wisdom of how foolhardy it is to try and beat a buy-and-hold strategy by actively trading mutual funds. In a *Bloomberg Personal Finance* magazine article, Burton Malkeil says that after transaction costs are factored in, a buy-

and-hold investing strategy will outperform momentum investing. [4] Malkeil is the author of the highly acclaimed *A Random Walk Down Wall Street*.

Business Week's May 25, 1998, issue published an article entitled, "Stock Trading Can Be a Nasty Habit," which detailed a study by Brad Barber and Terrance Odean of the University of California at Davis.[5] They examined a large, unnamed discount stock brokerage firm's trading records for 78,000 households from February 1991 through December 1996. The average household return was 15.3 percent. However, of the households that were classified as frequent traders—more than 48 transactions per year—the average return was just 10 percent. The bottom line, according to the researchers, is that trading can be hazardous to your wealth.

I'm forever reading articles by financial columnists saying that it's senseless to trade the market and that using trading strategies with mutual funds is as good as a coin flip. Then, of course, there's that famous line about how you can't afford to miss the 10 best trading days of the year. Naturally, no mention is ever made about what happens if you miss the 10 worst days of the year.

My secret to consistently beating the S&P is very simple: While I sometimes miss the big up days, I *always* avoid the major declines. Some buy-and-holders may be wondering how that can be. What they don't understand is that major declines never come out of the blue. Strong momentum markets don't turn on a dime and then crash downward. There is always some type of momentum change before the real carnage begins.

Based on my first three years of returns as an active mutual fund trader, one has to question the rhetoric of the efficient market theorists and other academics on the futility of an aggressive in-and-out trading strategy of mutual funds.

How I Trade Mutual Funds

Chapter 12 covered my basic momentum trading strategies. My success as a mutual fund trader rests with my ability to be in synch with the basic rhythm of the market and where the divergent strength is—be that large caps, small caps, or tech-related sectors—and then to trade accordingly. With a few exceptions (to be discussed later), I'm more of a market-specific trader than I am a fund-specific trader. If the

momentum patterns dictate an entry into a specific sector of the market, I then select a fund from that sector that is available from the fund families where I maintain my trading accounts.

Earlier in my mutual fund trading career, I operated under the theory that each year there was always one very identifiable type of equity fund or sector you need be invested in. That could be anything from gold funds to health or financial services funds. Determining which fund category was leading the pack wasn't that difficult. I monitored the Lipper Mutual Fund Performance Averages each week in *Barron's* to determine the sectors with the most momentum. Listed there are the weekly, year-to-date, and 12-month performances for various fund groups.

When I traded using the Lipper Performance Averages, I was basically trying to be invested in the strongest sector with the most momentum. Many traders and mutual fund newsletters use this strategy of going with the proven winner until a fund with stronger relative-strength momentum emerges. Although this methodology served me well in my early years, I found I didn't enjoy the volatility associated with high-momentum funds.

One of my favorite fund trading strategies is the January Mutual Fund Barometer. I'm a big believer that the first five to seven trading days in January sets the tone for various sectors over the following two to six months. I want to become invested in the sector that shows the most momentum (percentage gain) over the first five to seven trading days of the new year. Going back for the last five years, this strategy would have had you in Japan in 1994, health care in 1995, gold in 1996, Latin America in 1997, telecom and computers in 1998, and any tech-related fund in 1999. One reason I did so well in 1998 was jumping on board INVESCO's Worldwide Telecommunications Fund on January 12. That fund proceeded to rise over 30 percent with nary a reaction through the first week in April. See Figure 14.1.

When trading the early January strategy, you can't fall asleep. These early January trends are short term in nature. While they usually peter out within two to six months, sometimes they may last only a month. That's what occurred with technology funds in 1999. On the other hand, you have situations like that of health care in 1995, where the trend persisted throughout the year. What I like most about this strategy is that it gets you off to a good start each trading year. I have never done any in-depth research on this January pattern and I'm not aware of anyone who has. I would think some black-and-white trading

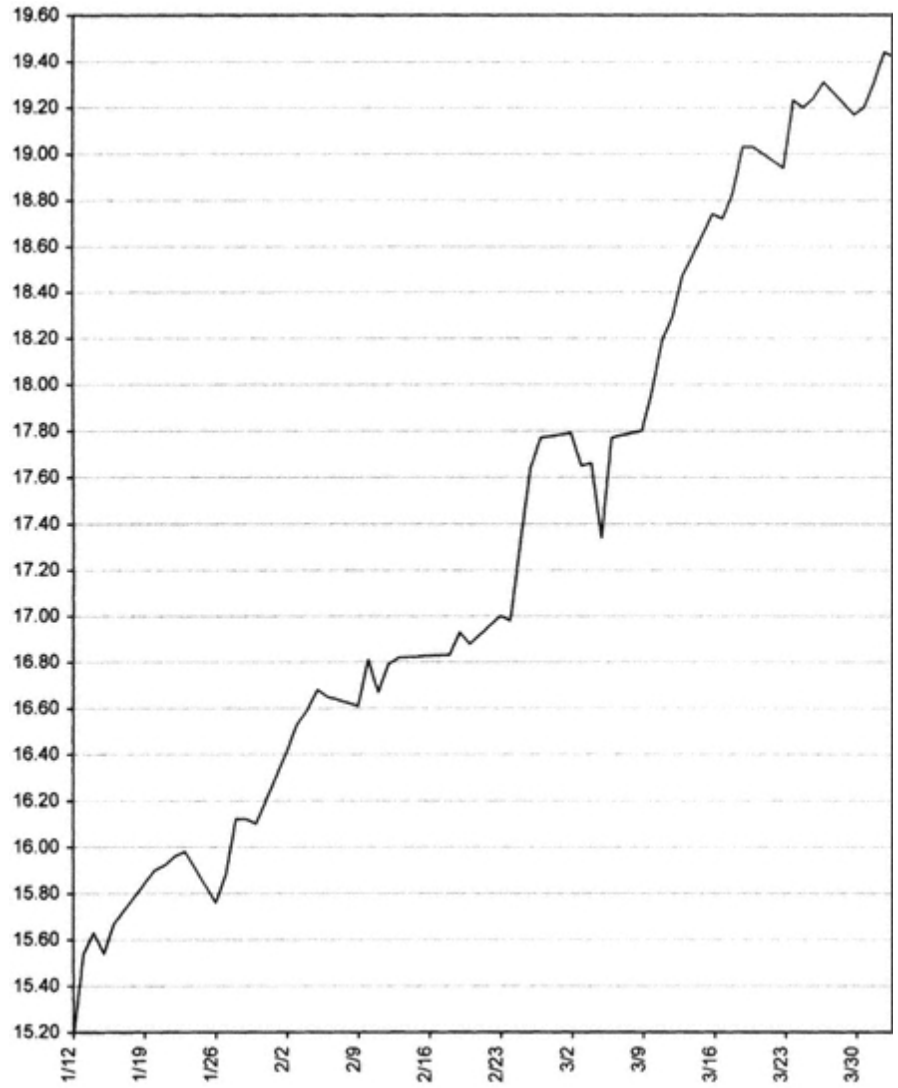


figure 14.1
invesco worldwide communications fund, 1/12/98–4/3/98

strategies using this early January pattern could be devised, especially with the Fidelity Select sector funds.

The first five to seven days of the new trading year are also a good barometer to indicate how trends from the previous quarter will persist in the upcoming year. Realty funds were one of the hottest sectors in 1996. Much of their gains came during the last quarter of that year. But as soon as the new year rolled around in 1997, the strong momentum in realty funds came to an abrupt halt. For the entire year, realty funds were one of the weakest market sectors.

Another one of my preferred fund strategies capitalizes on the seasonal strength in the stock market from the two days before Thanksgiving through the first five trading days of January. As discussed on page 104, this has historically been the strongest period in the market and has accounted for 40 percent of the entire gain in the market since 1928. With this strategy, you should buy a fund on the Friday before Thanksgiving that is trading at or near its 52-week highs and has had strong momentum over the prior four weeks. Preferably, this will be a sector fund whose sector also meets the same requirements. Although this strategy is for capitalizing upon seasonal strength during December and early January, often those seasonal trends can persist beyond January. So don't be in a hurry to cut your profits by prematurely exiting on the fifth trading day in January.

There are a few other fund strategies worth mentioning, although they are not part of my methodology. One of the more popular strategies is to buy the top-ranked fund from the previous year on the first trading day in January. Several newsletters espouse this hot-fund approach. The logic is that trends and momentum in funds persist, and whatever investment style has propelled a fund to the top one-year ranking should continue beyond that one-year period.

In my opinion, this hot-hands strategy has been so popularized that it has lost much of its effectiveness. One reason for this is that there have been huge cash inflows into funds in recent years. More often than not, the hot-performing fund manager is inundated with cash and finds it's harder to achieve stellar returns with more assets under management.

My suggestion, if you trade the hot-fund strategy, is to make sure the top-ranked fund you purchase in January is either at new 52-week highs or within 1 percent to 2 percent of such highs. It's conceivable you could buy a top-ranked fund from the previous year on the first trading day in January, yet the fund could still be 10 percent or more off

its 52-week highs. It defeats the purpose of buying a top-ranked fund if it has already lost much of its momentum by having declined so much from its recent highs.

While I'm not an advocate of the singular hot-fund approach, I do believe in the persistency of fund performance from year to year. Some of the academic studies on the persistency of returns have been conflicting: One study will present evidence to support that such persistency exists, while another comes to the opposite conclusion.

The most exhaustive study I've seen on the persistency of hot funds was an April 1998 special bonus report from the Institute for Econometric Research. [6] This is a four-page report that presents the future performance results of diversified domestic funds selected for their performance over the most recent 13-, 26-, and 52-week periods. For instance, there is a definite bias toward the strongest and weakest funds over the past 52 weeks to continue such outperformance and underperformance into the future 13- and 52-week periods. The results of this study demonstrate that over various time periods there is a definite tendency for strong fund performance to persist.

Tight Rising Channels

I'm a very risk-averse trader. Losing trades eat away at me for days on end. My experience has taught me that because of their volatility, I am psychologically unable to trade stocks, stock index futures, and index options in any appreciable size. That's the primary reason I gravitated to mutual funds. Because of their persistency in trend, trading larger dollar amounts with mutual funds hasn't been a problem.

Mutual funds get into what I call tight rising channels. Once in such a groove, they can go weeks, even months without so much as a 2 percent to 3 percent price reaction. This is the type of trading behavior I live for, since I can continually buy more shares as they gradually march to the beat of steadily rising prices. Whenever a fund in a tight rising channel has a reaction beyond 3 percent to 4 percent, it's usually a warning that a new beat is about to begin to the downside.

One reason both the January Mutual Fund Barometer and late November/early January seasonality strategies are so appealing is that funds selected by these criteria are notorious for moving forward in tight rising channels. I have two other strategies in which the tight rising channel phenomenon is even more pronounced and often much

longer lasting. One is the small-cap divergence pattern and the other is the new fund strategy.

Small-Cap Divergence

The best example of tight rising channels where there are barely any downside reactions are the periods when small-cap funds are in vogue. Once small-cap funds get running, they hardly ever correct. There were two such periods of small-cap dominance—albeit short—during 1997 and 1998. Getting on board the small-cap sector contributed greatly to my profits in 1997 and 1998.

Traders and investors have been faked out many times in small-cap funds during the 1990s. One guru after another has pounded the table about how small-cap funds were about to take off. At least in the 1990s, though, history has shown that small caps don't go anywhere until there is some type of initial price surge in the large caps. And usually these large-cap surges come after there has been a decline of 7 percent or more in the Dow and the S&P 500. The small-cap surge that began in 1991, and the mini-surges in small caps of May through mid-October 1997 and October through November 1998, all occurred under such a scenario.

Within a few days to a few weeks after the initial momentum rally in the large caps, there will be a day or two of very noticeable price divergence between the small-cap Russell 2000 Index and the S&P and Dow. It's imperative that you jump on these divergences as quickly as possible.

As an example, let's look at the price changes in the S&P and the Russell 2000 for the week of April 28, 1997. During this period, a I-point move in the Russell equated to a 2-point move in the S&P and a 20-point move in the Dow.

	Dow	S&P	Russell 2000
April 28	+44.15	+7.59	+0.25
April 29	+179.01	+21.09	+4.48
April 30	+46.96	+7.29	+2.42
May 1	(-32.51)	(-2.81)	+2.66
May 2	+94.72	+14.44	+8.32

I moved into the Dreyfus Small Cap Value Fund before the close of trading on May 2. You might question what prompted my move into small caps, since the S&P showed more divergent strength over the course of the week of April 28. I picked up on the divergence strength in the Russell beginning on May 1. The momentum that then followed on May 2 was out-of-the-ordinary price action in the Russell 2000. I couldn't remember the last time this index had as large a percentage gain (2.4 percent) or such a big point gain. It certainly wasn't in the past five or six years. This extreme momentum day in the Russell was a bell being rung loud and clear that small caps were about to blast off.

As you can see from Figure 14.2, it was one smooth ride upward in the Dreyfus Small Cap Value Fund over the next several months. The Russell 2000 Index soared 31.4 percent from its May 2 close to its ultimate high on October 13. More aggressive traders could have elected to trade index futures on the Russell 2000 Index at the Chicago Mercantile Exchange or Russell Index options listed on the CBOE.

Let's look at a similar situation where I went into small caps in October 1998. Following are the daily price changes for the Dow, S&P 500, and Russell 2000 indexes from October 9 through October 19. During this time, a 1-point move in the Russell equated to a 3-point move in the S&P and a 25-point move in the Dow.

	Dow	S&P	Russell 2000
10/9	+167.61	+24.95	+8.12
10/12	+101.95	+13.32	+7.22
10/13	(-63.33)	(-2.91)	(-5.29)
10/14	+30.64	+10.73	+4.65
10/15	+330.58	+41.96	+9.83
10/16	+117.40	+8.93	+8.07
10/19	+49.69	+5.97	+9.57

Just as with the week of April 28, 1997, there were several days of strong performance from the Dow and S&P followed by a day (October 16) with a strong momentum divergence in the Russell 2000. I switched into the INVESCO Small Company Growth Fund on October 16 when I saw the positive divergence between the Russell 2000 and the other indexes.

The divergence on October 19 was even more pronounced than

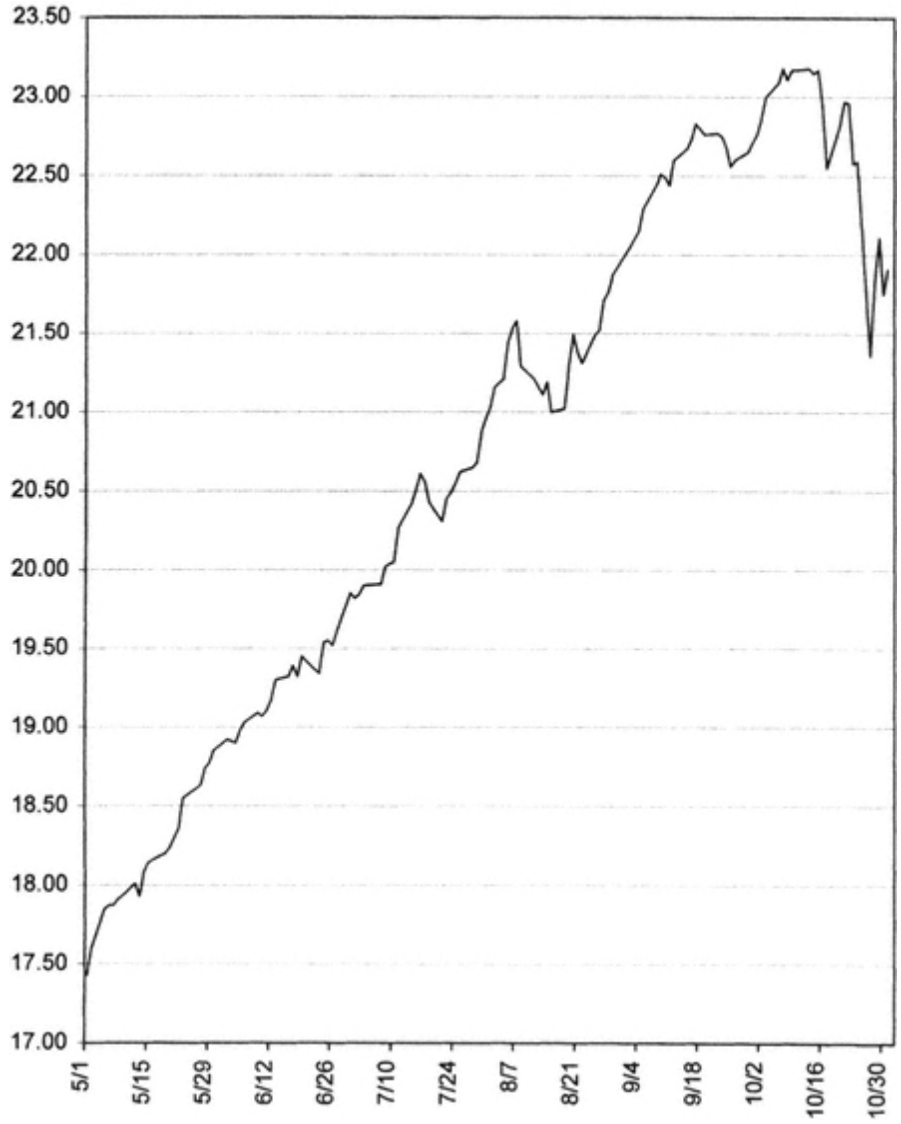


figure 14.2
dreyfus small cap value fund, 5/1/97–10/31/97

on October 16 and gave traders fair warning that something big was about to occur in the small-cap sector. The Russell 2000 Index went on to soar over 14 percent from October 19 through November 27 before any meaningful setback occurred. That return outpaced both the Dow and the S&P during the same time period. As shown in Figure 14.3, the movement in the INVESCO Small Company Growth Fund was straight up, with nary a reaction.

New-Fund Effect

Mutual fund investors are often advised to avoid new mutual funds until they have a track record of one to three years. It's a good thing I'm a trader and not an investor and that I don't listen to conventional wisdom. My favorite and most profitable mutual fund strategy is to buy new funds as soon as they become available. New funds tend to outperform the overall market and their peer group during their first one to three months in existence. The efficient market theorists who preach that there are no exploitable inefficiencies in the markets would be well advised to research this new-fund effect.

Nearly 50 percent of my $196,000 trading profits in 1998 came from exploiting two news funds: the Strong Small Cap Value Fund and the INVESCO Endeavor Fund. Much of my profit in 1996 came from a new offering, the Strong High Yield Bond Fund. That fund returned over 26 percent in 1996, trouncing its peer group's return of 14 percent and even besting the S&P's return of 23 percent.

The new-funds effect is not a myth. Two studies on the new-funds effect were cited in an April 22, 1997, article that appeared in *Investor's Business Daily*. [7] One study, by the Charles Schwab Center for Investment Research, examined the one-year returns of all new diversified U.S. stock funds from 1987 to 1997. It found that new funds had consistently higher returns in all investment styles than older funds. The Schwab study also found that the outperformance of new funds was concentrated in the funds' first six months of existence. This study also examined 724 new funds created in the five years from 1993 to 1997. It found that a greater than normal percentage of the top 100 performing funds in each of these years consisted of new funds.

The other study on new-fund performance was conducted by Kobren Insight Group. This study covered a 10-year period and supported the Schwab study of the outperformance of new funds in their first year over older funds. This outperformance ranged from 2.1 per-

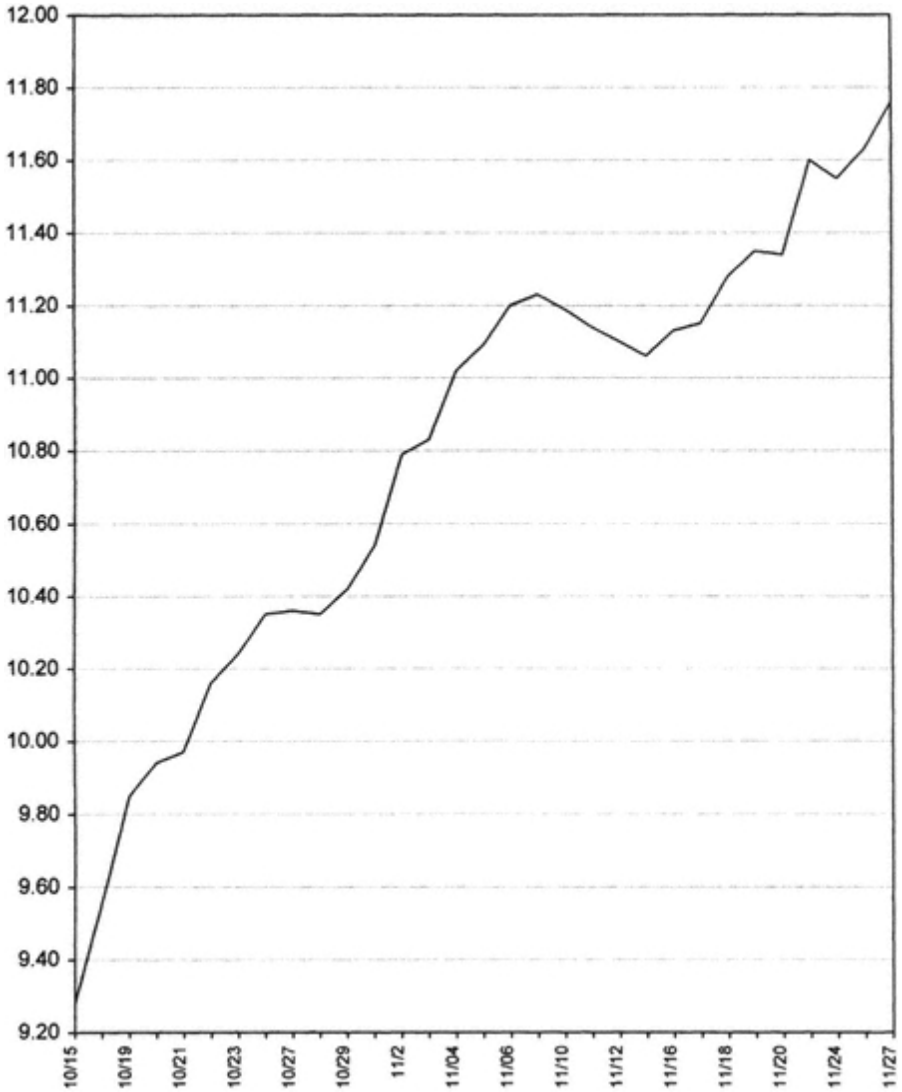


figure 14.3
invesco small company growth fund, 10/15/98–11/27/98

centage points for new large-cap and mid-cap funds to 6.9 percentage points for new small-cap funds. The most pronounced outperformance was for new small-cap growth funds, which outperformed their older peer group by a whopping 9.2 percentage points.

There are several reasons for the new-fund effect. New funds have fewer assets, allowing the managers to build positions in their best ideas. New-fund managers don't have to make sell decisions, instead concentrating their buying activities on those stocks or sectors that are displaying the most momentum. New funds also tend to concentrate their holdings during the first few months in a limited number of stocks. This can give a new portfolio a greater kick, especially if they are explosive growth stocks.

In my experience, the primary reason new funds outperform is because of the initial public offering (IPO) market. Mutual fund companies are allotted shares in IPOs from the participating brokerage firms involved in the underwriting of the IPO. The fund company will often allocate these shares to their newer funds to jack up their returns. When these IPOs double and triple in price on their first day of trading, it can give a newer mutual fund with a small asset base a larger than average increase in its net asset value.

I remember being in the new INVESCO Growth and Income Fund during a Friday in July 1998 when it jumped 6.6 percent. The overall market was rather subdued. The reason for this greater than average price performance was its allotment in a hot new Internet IPO that went public that day and jumped more than 500 percent.

Particular fund families are noted for the new-fund effect. Janus and Strong, in particular, have a history of doing well with their new funds. Other fund families that seem to outperform with their new funds are INVESCO, Van Wagoner, Berger, and many of the families that specialize in small-cap growth funds.

I prefer new funds that come out with little fanfare. Fidelity came out with a highly publicized new small-cap fund in March 1998. As a result, assets under management swelled to over $700 million during its first few weeks. That defeats the whole purpose of buying new funds. The smaller asset bases of new funds give the manager more flexibility in increasing share prices, such as buying IPOs. Fidelity eventually closed their new small-cap fund to new investors to keep the assets at manageable levels.

I am not suggesting that all new funds outperform during their first few months. It's primarily a function of the fund family that's offer-

ing the new fund, the sector of the new fund, and the health of the overall market. A good example would be the Janus Global Technology Fund. This fund was offered on the last trading day of December 1998 and had a lot going for it. Janus had a history of doing well with their new funds, the technology sector had the most momentum going into the new year, and the overall market had been strong. So it was no surprise to see the new Janus Global Technology Fund leap to a 15 percent percent gain for the month of January and continue to outperform over the following months.

There are two ways to play the new-fund effect. Either buy them as soon as they become available or wait a week or two to make sure the funds have some type of momentum. If you choose the first option, make sure you exit if the fund underperforms in its first week or two. Janus also came out with a new Global Life Sciences Fund at the end of December 1998. However, over its first week of trading, it declined in price, while the stock market overall was extremely strong. I was in that fund at its offering price. But I waited no more than three trading days to exit when it appeared it wasn't going anywhere. I took that money and doubled up on my position in the new Janus Global Technology Fund.

The two new funds that had a major impact on my trading results in 1998 were the Strong Small Cap Value Fund and the INVESCO Endeavor Fund. I didn't enter the Strong fund until January 30. As shown in Figure 14.4, this fund's performance was lackluster throughout much of January. But during the last week, it began rising strongly and diverging from the rest of the small-cap stock sector. I had no idea what was going on, but since it was a new fund I decided to make a small investment. Over the next few months, this fund rose steadily upward in a tight rising channel pattern and, as you can see from Figure 14.4, I continued adding to my original position.

The fund with which I made the most money trading in 1998 was the INVESCO Endeavor Fund—and this wasn't by accident. INVESCO had come out with a new Growth & Income Fund on July 1, which bolted ahead by more than 13 percent in its first several weeks of trading. The momentum of INVESCO's new Growth & Income Fund was stopped dead in its tracks when the overall market suddenly began a 20 percent decline from late July through early October. The Growth & Income Fund, however, held like a rock and barely dropped.

When I heard INVESCO was offering their new Endeavor Fund in

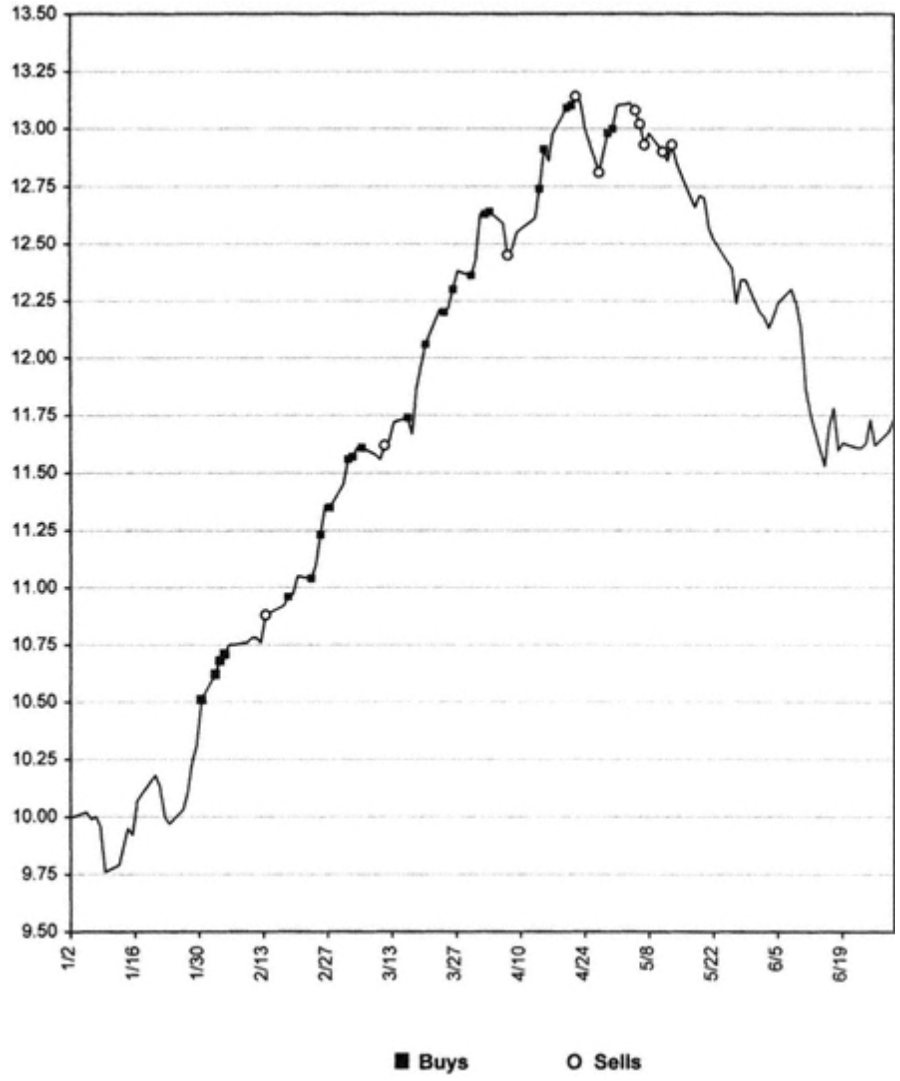


Figure 14.4
strong small cap value fund, 1/2/98–6/30/98

late October, I knew it would be a winner. I felt even more confident about the Endeavor Fund when the stock market began surging in mid-October. I wasn't disappointed as the Endeavor Fund rocketed ahead 19 percent in November, as shown in Figure 14.5.

Finding out when new funds are being offered can sometimes prove difficult. Some fund families don't notify their shareholders that new funds are trading until after the fact. Strong is notorious for this annoying habit. Other fund families will publicize their new funds before they are available for trading by accepting subscriptions for the fund. These subscriptions can appear as much as a month before the fund opens for trading. Most new funds are offered at $ 10 a share.

New funds must get SEC approval before their offering to the public. Wading through SEC documents to determine when new funds are coming out is a tedious process. Instead, I just maintain a list of fund companies that I periodically call to inquire about any new fund offerings that might be in the pipeline.

Mutual Fund Money Management Strategies

As I continually point out, the allure of funds is their persistency in trends. I try to focus on the mutual funds that are in tight rising channels with little to no volatility. I've already discussed the strategies that home in on this type of trading behavior—the new-fund effect, small-cap divergence, the early January Mutual Fund Barometer, and the pre-Thanksgiving to early January seasonality. The tight rising channel mutual fund strategy should not be confused with the trading of various momentum patterns, as discussed in Chapter 12. When I get a buy signal from one of my momentum patterns, I couldn't care less about buying a fund in a tight rising channel. For instance, on the V-bottom reversal of October 8, 1998, I moved into a volatile technology fund. That's because I expected the momentum of the V-bottom reversal to be greatest in the technology sector. I could have chosen a technology index option, a technology futures contract such as the Nasdaq 100, or selected technology stocks such as Dell, Microsoft, or Cisco.

On my initial purchase in a fund, regardless of my trading strategy, I am not willing to risk more than 1 percent to 2 percent of my investment. Some may argue that's too tight of a stop. I can't disagree—I can only say that it's my style of trading. My strategies are all geared to

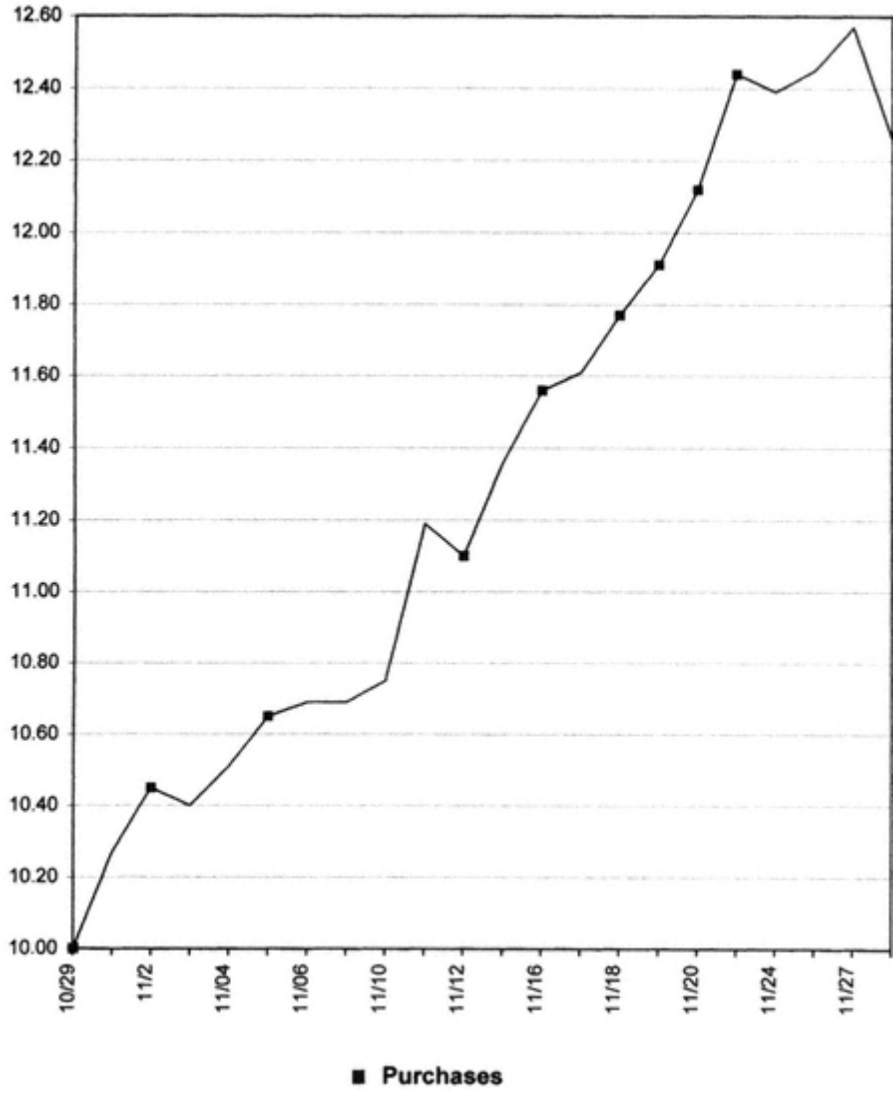


Figure 14.5
invesco endeavor fund, 10/29/98–11/30/98

immediate gratification. For instance, with momentum patterns, the market should move in my favor from day one. If it doesn't, that's an indication I'm wrong and I exit the funds immediately. With the tight rising channel pattern, if a fund moves 1 percent to 2 percent against me, that's a warning something is amiss and it's time to close out my position. Since I'm not willing to risk more than 1 percent to 2 percent on a trade, I know what my loss will be, based on the amount of my initial purchase.

Once a fund I'm in begins moving steadily higher, I try to stay on board as long as the fund doesn't have a reaction of more than 3 percent to 4 percent from any recent high. I have found that whenever funds in tight rising channels react 3 percent to 4 percent, it's a sign the rise has run its course and it's time to sell. Of course, if we get a 1 percent true selling day in the overall market before my fund has reacted 3 percent to 4 percent, that will spur me to action. Then I will sell anywhere from 33 percent to 50 percent of my entire position. Another 1 percent true selling day will have me 100 percent in cash.

I always make my fund purchases in increments. Sometimes that might be in increments of 25 percent to 33 percent of my intended position, while other times it may be in dribs and drabs. However, I never exit in dribs and drabs. It can take me weeks to build up a position in a fund but only a couple of days to be completely back in cash.

Figure 14.4, showing the Strong Small Cap Value, is a good illustration of my money management strategy. You can see how I continually purchased as the fund rose in price. I then exited my position in a series of sells in early May. In this particular fund my exits weren't because of the fund declining 3 percent to 4 percent from its high, but because of my concerns with the trading behavior of the overall market.

Playing the Overseas Lag

The overseas lag capitalizes on market-moving news events occurring while the Asian and European markets are closed. Asian markets begin trading in the early evening hours by New York time and close in the early morning hours. The European markets then open in the wee hours of the morning, with London and Italy the last to close between 11:30 and 11:45 A.M. New York time.

One of the most extreme examples of the overseas lag occurred during the week of October 27, 1997. On Blue Monday, October 27, the

Dow had its worst point loss in history, closing down 554 points. The Asian markets, which had already been tumbling throughout October, saw carryover selling Monday evening as a result of the drop in the Dow. Hong Kong lost a staggering 13.7 percent. That was on top of a 5.8 percent decline the preceding day. Japan lost 4.3 percent the evening of October 27 and that came after a 1.9 percent decline the previous trading session.

On Tuesday, October 28, the Dow dropped another 160 points during the first half hour of trading. It then staged a stunning turnaround and closed up 337 points, its largest, single, one-day point gain in history. Japanese and Hong Kong American Depository Receipts (ADRs) listed on the NYSE soared in Tuesday's trading.

Most telling for me was the action in the Nikkei futures traded in Chicago at the Mercantile Exchange. While the Nikkei cash index had closed lower, the futures were up sharply and indicating the cash index would open higher the next day by 500+ points. The Nikkei futures prices are available every 10 minutes throughout the day on the upper ticker tape on the CNBC cable station. They are also shown hourly on CNBC's futures board.

The portfolios of the Asian mutual funds are priced on their trading activity from the previous night. The effect of the 337-point surge in the Dow was thus not reflected in these prices. It was a no-brainer to see that the Japan and Hong Kong markets would surge in trading the evening of October 28 in reaction to the rebound in the Dow.

I had two choices before the close of trading on October 28: either buy the INVESCO Asian Growth Fund, of which Hong Kong is the largest country sector holding, or purchase the INVESCO Pacific Basin Fund, where the largest country sector is Japan. I chose the Pacific Basin Fund, since the Asian Growth Fund had a 1 percent redemption fee if sold within 90 days. I also wasn't looking to be a hero on this trade. I figured, better safe than sorry, since Hong Kong had been much more volatile recently than Japan.

As expected, the Asian markets soared in trading Tuesday evening and Wednesday morning in reaction to the big gain in the Dow. The INVESCO Asian Growth Fund rose 9.6 percent, while my Pacific Basin Fund rose 4.8 percent. This was a one-day trade for me, so I closed out my position on October 29.

I played this same type of lag between the U.S. markets and Asia again on November 20 and closed out the following day on November 21 for a 3.3 percent gain. This was another instance when the Nikkei

futures in Chicago on November 20 were indicating a big rise the next trading day in Japan.

I rarely play the lags between the U.S. market and Japan or Hong Kong. I can often go a year or more without playing these price discrepancies. Generally, what will get me into a trade is when the Nikkei futures in Chicago are indicating a minimum 300- to 400-point upside open in Japan the next day, as compared to the close of the cash index. I made several of these plays in 1994 when I maintained an account at T. Rowe Price and enjoyed several one-day percentage gains in the 4 percent to 5 percent range. T. Rowe Price has since cracked down on frequent traders.

The trade of October 27, 1997, was the only no-brainer, can't-miss trade I ever made. Not all these trades are sure things, however. A few, in fact, have turned out to be losers. I know one trader who plays these lags—although not as strictly as I do—and he hasn't made anything for his years of effort.

The activity on October 27 caused Fidelity Investments to take immediate action to thwart traders attempting to capitalize on the expected price surge in the Asian markets. Fidelity caused an industry-wide stir when they went to their fair pricing system. [8] Fair-value pricing, a valuation system sanctioned by the SEC, is an obscure tool that most traders have never heard of. It gives the fund company the option of establishing what they consider a fair price for a security under special circumstances. Fund managers have wide latitude in using fair pricing and they aren't obligated to advise investors when they use fair-value pricing.

Before the close on October 27, Fidelity decided that overseas prices would rise the next day and priced their Hong Kong and China funds accordingly. So while the net asset values of Asian funds at most fund families showed declines of as much as 10 percent to 14 percent at the close of trading on October 27, Fidelity's Hong Kong fund actually rose in net asset value. This was to prevent short-term traders from capitalizing on the rise in prices overseas in reaction to the big Dow rally.

This fair pricing strategy caused a public relations nightmare for Fidelity. I don't believe funds should arbitrarily set their net asset values based on how they think the markets will perform the next day. Instead, if they want to discourage short-term traders, they should impose a stiff redemption fee. I can guarantee you that will do the trick.

The European Lag

While I rarely use the lags between the U.S. and Asian markets, I frequently play the lags between the U.S. and Europe. And, unlike with the Asian markets where I always exit the following trading day, I sometimes will use my entry into the European funds as a base for a longer-term holding.

One of my favorite setups for the European play is for our markets to be sharply lower during the first two hours of trading, especially around 11:30 A.M. EST when London is closing. The second part of that setup is that most, if not all, of the European markets close lower—especially Germany, France, and Great Britain. The last piece to the setup is for a very sharp rally in the U.S. markets after 11:30 A.M., where they rally from down sharply to close up strongly. If the rally in the U.S. markets is because of some external news event, then I like this play even better.

Monday, September 21, 1998, is a good example of how I exploited this type of setup. This was a day when our market opened lower because of the carnage overseas, especially in Asia. There were also concerns about a damaging tape about President Clinton that was to be released later in the trading day.

At the time the last European market closed on September 21, the Dow was still off 120 points. The European bourses had closed down a sharp 1 percent to 4 percent, led by German stocks. Later in the day, however, when it appeared the Clinton tape was much ado about nothing, the Dow made a U-turn and closed up 37 points for the day.

These are the types of setups I like most when playing the European lag: both the U.S. and European markets all sharply lower at 11:30 A.M. New York time and then a violent upside reversal later in the day in U.S. stocks. So right before the close on September 21, I took a position in INVESCO's European Fund. As expected, the next day Europe soared in reaction to the late-day move in the Dow and I closed out my European Fund position with a 2 percent gain.

The setups aren't always like that of September 21. I also trade setups in which the U.S. markets are up at 11:30 A.M. and then add substantially to their gains as the day progresses. An example is September 1, 1998. The previous day, August 31, the Dow had its second-worst decline in history, down 512 points. Then on September 1, Europe reacted to the big Dow decline. London closed down 3.3 percent; Spain, 5.5 percent; and France, 5.5 percent.

The Dow was up 80 points at 11:30 A.M. on September 1. This was merely seen as a dead cat bounce by European investors coming after the 512-point decline of the previous day. However, later in the day, the dead cat bounce became something else entirely as the Dow tacked on another 208 points to close up 288 points for the day. The next day the European markets reacted to the big bounce back in the Dow and many of the European funds saw their net asset values increase 2 percent to 3 percent.

Another example of a European lag play is news-related. On Friday, September 11, the Dow was ahead 65 points as the last of the European markets were closing. The European exchanges had all closed down on skittishness over banking problems, Latin America, and the Starr Report, which was to be released later in the trading day of the U.S. market. After the release of the Starr Report, the Dow tacked on an additional 100+ points to close ahead 179 points on the day. I went into the INVESCO European Fund before the close, hoping for carryover buying when Europe opened for trading after the weekend. That's exactly how it unfolded and I closed out my position with a 2 percent profit on Monday.

May 1, 1998, provided another interesting way to capitalize on the European lag. Most of the European markets were closed this Friday in observance of May Day. The few that were open—the Netherlands, Denmark, and London—were strong and up 5.3 percent, 2 percent, and 1.38 percent, respectively. The Dow was strong on May 1, closing up 82 points. I thought this trade was a lock. It was obvious the European markets that were closed would see pent-up buying, as evidenced by the strong action in London, Denmark, and the Netherlands. There would also be buying as a result of the strength in the U.S. market.

Everything worked according to plan on Monday, May 4, as Europe soared. Italy closed up more than 4 percent; France and Spain, more than 2 percent; and Germany, up 1.84 percent. The Dow was up more than 90 points in the early going on Monday and this also lent support to Europe. I cashed out of my INVESCO Fund with another 2 percent gain.

Over the years, the extra 1 percent to 2 percent and more that I've gained playing the overseas lag has contributed greatly to my bottom line. Although capitalizing on these lags is about as sure a thing as there is in the stock market, it is not without pitfalls. One problem is the value of the dollar. On more than a couple of occasions, I have played these

lags and lost money, although the overseas markets rose as I expected. This was because a strong dollar negated the rise of the foreign markets, causing the net asset value of the fund to decline. Then again, there were also a few times when the overseas markets did not rise in price as I expected the next trading day, yet I managed to make money because the net asset value of the fund rose due to a weak dollar.

A Change in Fund Policies

The early part of 1999 saw several mutual fund companies cracking down on short-term traders like myself. No longer will I be able to play the overseas lag at INVESCO. Effective May 1, 1999, there is a 2 percent redemption fee on any of their international funds held less than 90 days. There are still some fund families with European and Asian funds without redemption fees, such as Strong. But it may just be a matter of time before they, too, impose trading fees on their international funds.

ProFunds of Bethesda, Maryland, offers unlimited switches in their two European funds. UltraEurope ProFunds seeks daily investment results of twice the ProFunds Europe Index (PEI), which reflects the daily changes of Europe's three largest markets—Britain's FTSE 100, France's CAC-40, and Germany's DAX. UltraShort Europe seeks daily investment results of twice the inverse of the PEI.

Playing the European lag is not feasible at ProFunds. The pricing of their funds is not based on the previous day's close of Europe (as with INVESCO), but rather on prices 30 minutes after the open of each of the three European markets. This would thus prevent a trader from exploiting the lag between the U.S. market and Europe.

Where I Trade Mutual Funds

I'm somewhat of a dinosaur in that, unlike most fund traders, I don't trade at a fund supermarket such as Waterhouse, Jack White, or Fidelity. I also don't trade at the fund families that encourage frequent traders such as Rydex, ProFunds, or Potomac. Instead, I maintain trading accounts at INVESCO, Strong, and Janus. My choice of where I trade mutual funds is limited by my three trading requirements:

1. I can place my orders right up to the close of trading at 4:00 P.M.

2. I can close out a trade within 24 hours if necessary.

3. No trading or redemption fees are imposed.

Although the landscape is changing rapidly as I write this book, the fund supermarkets can't accommodate my trading needs. They charge either redemption fees or commissions for frequent traders. There is also a one-to two-day settlement period after purchase before you can turn around and sell the fund. The funds that allow unlimited switching without redemption fees, such as Rydex and ProFunds, have time restrictions on placing orders, which range from 10 minutes to 30 minutes before the close of trading.

In the past I have traded at T. Rowe Price, Vanguard, Dreyfus, Northern Funds, Transamerica, Lindner, Nicholas, Janus, and Scudder. I could relate some horrible customer service experiences that I've had with some of these companies, but this book is not about trashing anyone. By far, my most pleasant experiences have been with INVESCO and Strong. I don't believe anybody could be more of an advocate of these two fund companies than I. Their customer service is unsurpassed. Even more important, you rarely have to wait on the phone more than a few seconds before speaking to a representative to place a trade.

The last thing I want to see happen is for INVESCO to clamp down further on traders and timers. But I will say they are very liberal in their switching policies. Their stated policy is to allow four switches per fund a year. In my experience, they seem to enforce that policy more against timers who move large sums of money in and out in one fell swoop than someone like myself who moves in and out in smaller increments.

Sometimes I wonder if I am shortchanging myself by trading primarily at INVESCO and Strong. The day may come when I have to open an account at a fund supermarket so I can have access to more fund opportunities. In early 1999 I missed out on tens of thousands of dollars in potential profits because I didn't have access to the Warburg Pincus Japan Small Company Fund. That fund's trading characteristic in early 1999 was custom-made for my style of trading—a gradual uptrend with little to no downside volatility. That type of trading behavior is most conducive to my scale-up buying campaigns.

Because I'm a computer phobic, I don't trade online, even though the service is offered by INVESCO and other fund families. The day may also come when I am forced to embrace technology by making my

trades online. I would have an unholy fit if I ever placed a trade online and found that it didn't go through because of problems either on my end or with the fund company. I prefer, for now, to keep my fund trading as stress free and low-tech as possible.

Mutual Fund Trading Books

There is very little literature on mutual fund trading. The best I've seen on the subject can be found in Jack Schwager's interview with fund trader Gil Blake in *The New Market Wizards*. [9] Blake averaged a 45 percent return trading funds during the 1980s—an extraordinary return during that time period. Even more impressive was Blake's consistency: An amazing 134 months in his 139-month track record were either break-even or profitable. In some ways I have patterned myself after Gil Blake. Anyone who can achieve consistent returns with little to no risk is my kind of trader.

Gil Blake was attracted to mutual funds because of their amazing persistency of trend. He found that in many funds, such as municipal bond funds, the probability that a price change on one day would persist into the following day was 83 percent. For example, there was a three-month period in early 1981 when there were rarely any upticks in the Fidelity Municipal Bond Fund. The net asset value changes during this time were either unchanged or down. This was obviously a period to be in cash. But the same persistency in trend in this fund was also a factor to the upside. There were periods when this fund would go weeks when its net asset value never showed a decline.

When the persistency of trend in bond funds began diminishing, Blake turned his attention to sector funds. There he found that if a daily price change was greater than the average daily price change, it had a 70 percent to 82 percent chance of following through the next trading day in the same direction. This observation is much like my main trading strategy, whereby I trade based on extreme price action in the stock market. I find that extremely significant price moves in the Dow, S&P, Nasdaq 100, or Russell 2000 on one day are likely to be followed by similar directional moves the next day.

I've seen only two books that I would recommend for mutual fund traders: Alan Lavine's *50 Ways to Mutual Fund Profits*[10] and Sheldon Jacobs's *Guide to Successful No-Load Fund Investing*.[11] While these books are geared more toward investors than traders, I nonetheless found them very informative.

Chapter 15—
Trading Junk Bond Funds

Junk bond funds are my one true love in the financial arena, and even that's an understatement of my appreciation for this asset class. As with many things in life, first impressions and initial experiences can leave an indelible mark. For me and junk bonds it was definitely love at first sight. My first foray into junk bond funds was January 1991. It was an almost never ending ride up that year as I made more than a 30 percent return.

The persistency of trend in junk bond funds has remained constant throughout the 1990s. They either go straight up or straight down. There is no other asset class that allows me to more fully exploit the scale-up buying taught by Livermore and Darvas. Figure 15.1, showing the price action in the Strong High Yield Bond Fund during 1996, is indicative of the strong persistency of trend in junk funds. The Strong Fund rose over 26 percent that year (capital gains + dividends), yet there was never so much as a 2 percent reaction from any price high during the year.

The term *junk* scares many potential investors away from this asset class. Some investors aren't aware that many of the companies that issue junk bonds are well-established names such as Ann Taylor Stores, U.S. Home, Playtex Enterprises, Kmart, Keebler Foods, North-

Figure 15.1
strong high yield bond fund, 12/28/95–12/31/96

west Airlines, Owens Illinois, and Tricon, which owns Pizza Hut, Taco Bell, and Kentucky Fried Chicken. Many of the larger Las Vegas casinos, national grocery chains, and cable companies are also junk bond issuers.

Junk bonds are bonds rated below investment grade. This would be BB or lower by Standard & Poor's and Ba or lower by Moody's. Junk bonds have lower credit ratings because there may be some doubt about their ability to pay interest on their obligations until maturity and to repay principal on time at maturity. Because junk bonds are rated below investment grade, you are compensated for any possible defaults by their generous yields. This is the allure of junk bonds and junk bond funds—high yields. When I first went into junk bond funds in 1991, they were yielding between 16 percent and 17 percent. As recently as October 1998, they were yielding over 11 percent. During most of the later part of the 1990s, the average yield of junk bond funds has been around 9 percent.

Prior to the 1980s, the term *junk* or *high-yield bond* was used to describe bonds of companies that suddenly found themselves in financial difficulty. These companies may have been about to go bankrupt or, conversely, about to emerge from bankruptcy. During the 1980s, a new kind of junk bond was created. These junk bonds were used to finance takeovers. In the mid- to late 1980s, junk bonds flourished and many institutional investors, attracted by yields of 400 basis points over 10-year Treasuries, flocked to junk bonds. But in 1989 and 1990, the bottom fell out of the junk bond market. The spreads between junk and Treasuries widened to over 1,000 basis points.

The horrendous declines in junk bonds in 1989 and 1990 were due to several factors. Hanging over the market was a major liquidity crunch, which began with the exit of Drexel Burnham Lambert, the primary market maker in the junk bond sector. This caused individual investors to bail out of junk bond funds, thus forcing fund managers to sell into an already illiquid market. Even worse, government regulators ordered thrifts and banks to get rid of any junk bonds they owned. Finally, default rates on junk bonds reached nearly 6 percent in 1989 and 9 percent in 1990. This was much higher than the historical norm of 3 percent. A *default* is when a junk bond issuer goes bankrupt and is unable to meet the obligations on the bonds. Many of the defaults during this period were due to the overleveraging of junk bond offerings used in mergers and acquisitions.

What many consider to have been a crash in junk bond funds during 1989 and 1990 was in reality something much less. The average junk bond fund lost a mere 0.48 percent in 1989 and 9.96 percent in 1990. Not good, but hardly anything approaching that of crash proportions. Many well-managed junk funds fared much better in 1990. INVESCO's High Yield Fund lost only 4.6 percent in 1990, while the Vanguard High Yield Fund was down 5.8 percent.

The declines of 1989 and 1990 washed out many of the excesses in the junk bond market and paved the way for some spectacular returns during the rest of the decade. Junk bond funds returned a dazzling 36.58 percent in 1991, 17.39 percent in 1992, and 18.84 percent in 1993; 1994 was a bad year for all debt-related funds, and junk funds declined 3.71 percent. But then came three straight years of stellar returns between 1995 and 1998, as junk funds averaged 15 percent per annum. Another one of those 1994-type years occurred in 1998, and junk rose only 0.47 percent. Through April of 1999, junk has been off to the races again—up nearly 6 percent year to date.

What's so hot about these returns? It's all about the risks you would have taken to achieve them—and in the case of junk bonds, not a whole heck of a lot. Investment strategist Leah Modigliani and her Nobel laureate grandfather Franco Modigliani devised a rating method dubbed "M-squared" to compare the risk-adjusted returns of various asset classes such as growth funds, small-cap funds, index 500 funds, and junk bond funds. They found that during much of the 1990s, junk bond funds provided the best risk-adjusted returns of all asset classes. [1]

I recently saw some longer-term returns that bear out the research by Leah and Franco Modigliani. From 1980 through 1997, the S&P returned 17.13 percent with an annual volatility of 17.24 percent. Junk bond funds over the same time period returned 13.71 percent, but with annual volatility of only 9.19 percent.[2] Because of their historical tendency of achieving outsized returns with limited risk, I often use junk bond funds as a substitute for cash and money market funds. My returns from trading junk bond funds from 1991 through 1997 were a little over 19 percent. That's about equal to the returns of the S&P over the same time period.

There are four factors to consider when investing or trading junk bond funds: recessionary fears, default rates, fund flows, and the spread between junk bonds and 10-year Treasuries. All four of these factors are interrelated.

The biggest threat to the performance of junk bond funds is the expectation of a recession. Recessions are the bugaboo of the junk bond market. That's because recessions bring declines in corporate profits, thereby making it difficult for companies with lower credit ratings to continue making payments on their debt. This inability to pay on their debt raises the default rates among junk bond fund issuers. When investors sense a recession and the specter of rising default rates, they begin liquidating their junk bond holdings.

The most important factor affecting junk bond fund prices are fund inflows and outflows. The reason for this is that the percentage holdings of the total junk bond universe held in junk bond funds is far higher than the total percentage holdings of stocks held by equity mutual funds. Therefore, the action of junk bond fund managers in response to heavy inflows and outflows by investors can often magnify the extent and direction of the moves in the junk market.

Heavy inflows into junk bond funds add liquidity to the overall junk bond market, as managers are aggressively bidding for junk bonds to add to their portfolios. Heavy outflows, however, often will have these same managers selling off part of their portfolios to meet redemptions. With junk bond funds, then, it's all about liquidity. Inflows increase liquidity, while liquidity dries up during outflows.

Of the thousands of junk bonds, only about 100 are actively traded. During times of heavy outflows, when no one is interested in junk, the universe of actively traded junk bonds can shrink to only 20 or 30 issues. During times of crisis such as the first week in October 1998, the market of actively traded junk bonds can be as low as 10 issues. During that period of crisis, the junk market had come to a near standstill. That was the main reason the Fed stepped in on October 15 and lowered the discount rate.

The most common valuation measure for junk bonds is their spreads between 10-year Treasuries. However, I'm more concerned with the momentum in junk bond funds than with valuation models. I recall many experts saying throughout 1996 and 1997 that junk bonds were overvalued because of their narrowing spreads to Treasuries. Yet all the while junk continued rising in price.

I've been fortunate that my introduction to investing and trading junk bond funds came during one of the greatest economic expansions of all time. Junk thrives during such periods. If the 1998 August-September 10 percent decline in junk is any indication, junk bond funds could become a real disaster if and when we get our next recession. But

as you will see in the following, junk always gives fair warning before such declines.

How to Trade Junk Bond Funds

Because of the lack of volatility in junk bond funds, you always have time to react to major trend changes. My rule of thumb for traders in junk bond funds is to be 100 percent in cash whenever they have reacted 2 percent (excluding dividends) from any recent high. Conversely, after a period of declining prices, look to begin a scale-up buying campaign whenever junk bond funds rebound 2 percent from any recent low.

Let's see how this trading strategy worked with the Strong High Yield Bond Fund during the period from July through November 1998. I'll also show how I traded this same fund during that period.

The stock market made a top on July 17 at Dow 9337. Two weeks later, on July 31, the Dow stood 450 points lower and the internals of the market were rapidly deteriorating, portending even further declines ahead. As shown in Figure 15.2, over that same period the Strong High Yield Fund only declined from 12.11 to 12.07. Its high during that time was 12.13. Traders therefore should have been using 11.89 as their exit point. That would equate to a 2 percent decline from the 12.13 top. On August 13, it hit 11.89. Note in Figure 15.2 how junk bonds funds headed south beginning on July 28 with no upward bounces along the way. This is an illustration of junk's strong persistency in trend.

August was the worst month for junk bond funds since 1990. This was a result of hedge fund selling associated with a global liquidity crisis involving Russia, Asia, and Latin America. The Strong junk bond fund eventually bottomed on October 20 at 10.59. From that low it moved up 2 percent to 10.80 on November 4, where traders should have begun reentering on the long side. From October 29 through the end of November, there wasn't one day when the Strong High Yield Bond Fund declined in price—again, an illustration of junk's persistency in trend.

Using the 2 percent rule would have worked well with the Strong junk fund. Even though that may be one of my trading rules, I often try to be much quicker in my entries and exits. For instance, I was completely out of Strong's junk fund by July 29. That was but a few cents off the 12.13 high.

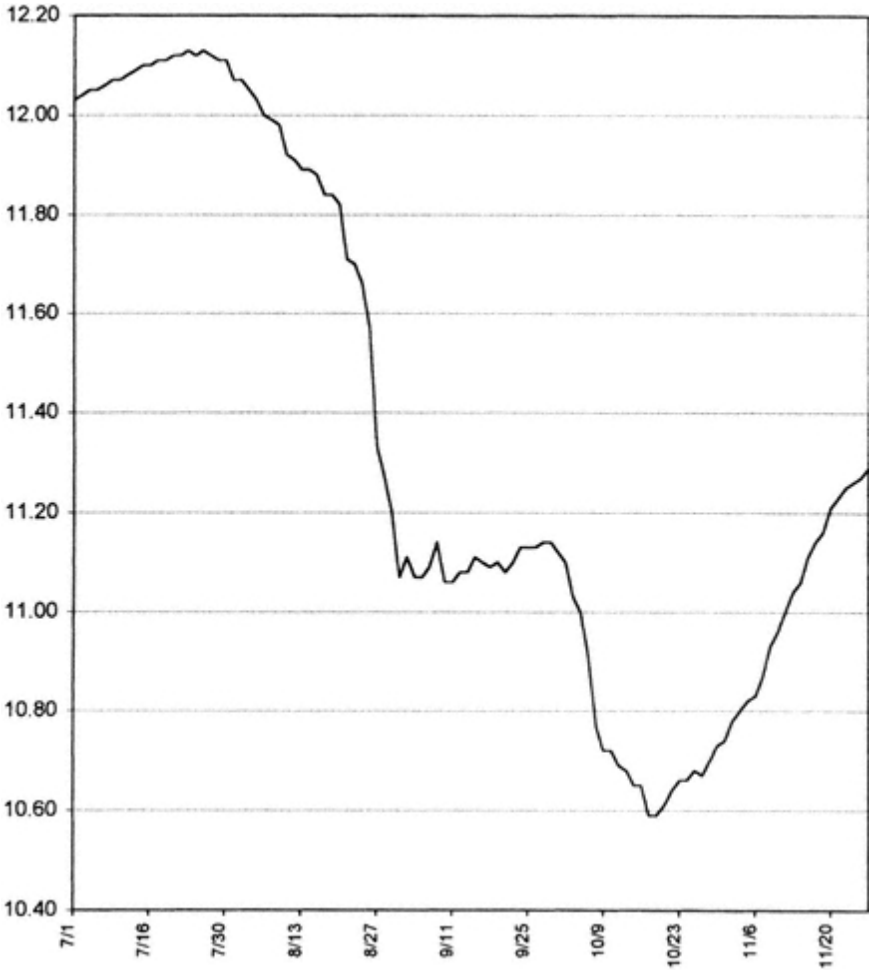


Figure 15.2
strong high yield bond fund, 7/1/98–11/30/98

My reasoning in exiting the Strong High Yield Fund before it declined 2 percent from its high was that I thought the overall weakness of the stock market would eventually work its way to junk. My reentry point was on October 15 at 10.65, just 6 cents from the October 20 low of 10.59. Then as junk began its rise, I continually added to my position. My logic on entering before the 2 percent upside rule was triggered was due to Fed chairman Alan Greenspan's worries about the spread between junk and Treasuries. That was his main reason in lowering the discount rate on October 15.

How much surer can you get in a trade when you have the chairman of the Federal Reserve Board on your side? I recall the last time the Fed chairman commented about junk bonds. That was in late February 1997. That time, though, he was worried about the narrowing of spreads between junk and Treasuries. The junk market immediately went into a one-and-a-half-month tailspin.

There's no rule that says junk bond fund prices will decline in unison with stock prices. There was a sharp decline of more than 7 percent in stocks during July 1996, where junk barely budged.

Historically, junk bond funds are 52 percent correlated to the movement in stocks and 41 percent correlated to the movement in 10-year Treasuries. The other 7 percent is for reasons specifically related to the particular fund—such as the composition of their portfolios. That's another reason I like junk bond funds so much. I've seen periods of weak stock prices when junk bond funds rise in price. Conversely, I've seen periods of weak Treasury bond prices, but strong junk bond fund prices. With junk you sometimes have the best of both worlds, since you aren't totally dependent on either stocks or Treasuries. What is poison to junk bond fund performance is both weak stocks and weak bonds. That's what occurred in 1994, when the average junk bond fund was down more than 3 percent.

There's a seasonality in junk bond prices that's worth noting. As with stocks, there also seems to be a January Effect at work in junk. Martin Fridson was quoted by *Barron's* columnist Jacqueline Doherty [3] on how January is the one month that shows up as statistically significant. From 1985 to 1996, the average January return for high-yield bonds was 1.85 percent, well above the 1.01 percent average of all the monthly returns. Fridson is the Chief High Yield Strategist at Merrill Lynch and a recognized guru of the junk bond market.

I can attest that the January seasonality in junk was in full force from 1997 through 1999. I always have a higher than normal exposure

to junk bond funds in January and it has paid off. In many years, the momentum of the January Effect in junk has carried over to February.

Variations in Junk Bond Fund Performance

There is normally not a wide variation in the performance each year of the various junk bond funds. Still, because of the amount of money I trade in junk bond funds, a few percentage points can be critical. With junk, there is good junk and there is bad junk. Good junk bonds are the highest-rated junk bonds and often are issued by companies that are about to be upgraded to investment-grade status. Junk bond funds that hold higher-rated junk bonds in their portfolios are less volatile and yield less than the funds that hold mostly lower-rated junk bonds. Many times these junk bond funds will have of portion of their portfolio in risk-free Treasuries.

Vanguard High Yield Corporate Fund is a prime example of a junk fund that sticks to the highest-quality junk issues. As such, it doesn't fluctuate in price as much or pay dividends as high as a fund that dabbles in the lower-rated tier of the junk universe, such as the Dreyfus High Yield Fund. In bad times like 1998, the higher-quality junk funds will vastly outperform the less conservative junk funds. We saw that in 1998 when the Vanguard High Yield Corporate Fund returned 5.6 percent, while the Dreyfus High Yield Fund *lost* 15.8 percent. But in the good times the roles are reversed. Through the first four months of 1999, the Dreyfus 16.7 percent gain has far outstripped the 3.1 percent gain from Vanguard.

It's important, then, to know what type of junk your fund holds. Some junk funds specialize in companies emerging from bankruptcy, while others hold a high percentage of Latin American debt. There are also junk bond funds that make big bets on specific market sectors such as telecommunications and broadcasting.

I used to confine my junk bond fund trading primarily to Strong's High Yield Fund. Many others apparently did likewise and, to curtail traders and timers, Strong recently imposed a 1 percent redemption fee on shares sold within six months of purchase. The traders then descended upon INVESCO's High Yield Fund. The result was that, effective May 1, 1999, INVESCO imposed a 2 percent fee on shares sold within 90 days.

I still haven't decided how I will handle the imposition of all these trading fees on junk bond funds, especially since I often use junk as a

temporary parking place for cash. Janus has a high-yield fund that, so far, is free of redemption fees. I have traded the Janus High Yield Fund in the past, but it's not one of my favorites.

Strong also offers a Short Term High Yield Fund and a Global High Yield Bond Fund. To date, these are free of redemption fees, and some traders use them to park cash. The Short Term High Yield Fund has a lower yield than Strong's regular high-yield fund. You also don't make as much in capital gains when junk prices are rising. However, in periods like 1998 when junk was under pressure, you don't lose as much. In fact, in 1998, Strong's Short Term High Yield Fund was the star of the party among all junk funds and returned 8.3 percent.

Monitoring Junk Bond Funds

At the end of each trading day I check the closing prices for several junk bond funds to get a feel for the strength or weakness in the market. A few of the funds on my monitoring list are from Strong, INVESCO, Janus, T. Rowe Price, Value Line, Dreyfus, and Fidelity.

Intraday monitoring of junk bond funds is a problem, and one I have yet to solve. It would be beneficial to know how junk is performing intraday so you could make your trading moves before the close of trading. One solution that I have tried is to monitor intraday all the closed-end junk bond funds traded on the New York and American Stock Exchanges. But I found no worthwhile intraday correlations between these closed-end funds and the daily net asset value changes of their open-ended brethren.

Chapter 16—
Trading Stock Index Futures

It is not my intent here to offer a lengthy tutorial for beginning stock index futures traders. My assumption is that you have either some knowledge of or experience in trading stock index futures. The stock index futures are often the engine that drives the stock market intraday. If you are serious about ever trading for a living, it's imperative that you know as much as possible about the trading nuances of stock index futures, even if you never plan to make them one of your trading weapons.

The kingpin among stock index futures is the S&P futures contract traded at the Chicago Mercantile Exchange (CME). The value of a single S&P futures contract is $250 times its price. For example, with the S&P futures trading at 1300, a contract would be valued at $250 times 1300, or $325,000. A one-point move in the S&P futures is worth $250 dollars. In the lingo of traders, a 1-point move is commonly referred to as 100 points, a 2-point move as 200 points, and so on. In early 1999, the average daily range on the S&P futures contract was approximately 24 points, or $6,000, per contract.

The initial margin required to trade the S&P futures is set by the Chicago Mercantile Exchange. These margin requirements will change

periodically, depending on the volatility of the market. In March 1999, the Exchange minimum was $20,625 for an S&P futures contract. The actual margin requirements charged to trade S&P futures will vary from one brokerage firm to another. Most are a few thousand dollars above that of the Exchange minimum. You can see where the leverage of trading stock index futures comes into play. For $20,625 you are controlling $325,000 worth of stock.

If you are a day trader and hold no positions overnight, trading firms will allow you to trade the S&P futures at a lower margin rate. My trading firm requires $12,500 for day trading the S&P futures. Some firms are very liberal in their day trading margin requirements and charge lower intraday trading margins, based on your account balance and how long you have been a customer.

There is also a mini-version of the S&P futures contract that is traded electronically outside of the futures pit. This mini-contract, known as the *E-mini,* is valued at $50 times its price. So at 1300, an E-mini contract would be worth $65,000. Margin requirements are one-fifth that of the full-size S&P futures contract.

The technology-laden Nasdaq 100 Index also has a futures contract. This is my preferred futures trading vehicle. The Nasdaq 100 futures contract is valued at $100 times its price. Recently the Nasdaq 100 futures contract has been trading around the 2100 level, giving it a value of $210,000. The initial margin required to trade this contract is $13,770. This futures contract has become quite volatile in 1999 and intraday swings in the $5,000 to $7,000 range have become the norm.

Other stock index futures contracts are on the small-cap Russell 2000 Index, the MidCap S&P 400 Index, the Nikkei Index, the Value Line Index, the New York Composite Index, and the Dow Jones Industrials. With the exception of the Dow Jones futures contract traded at the Chicago Board of Trade, most of the these other futures contracts are too illiquid for day trading purposes.

My Stock Futures Trading Record

Figure 16.1 appeared in my first trading book, *Live the Dream by Profitably Day Trading Stock Futures* [1] and shows an equity curve of my futures trading over a 122-month period. The profits were modest, to say the least. But my annualized returns were an impressive 86 percent

Figure 16.1
gary smith's real-
time stock index futures equity curve,
march 1985–may 1995

on an account balance that averaged a little under $10,000 over the 10-year period. My profits in trading stock index futures were, and still are, limited by the fact that I will never be more than a one-contract trader. Still, had it not been for those "modest" futures trading profits, I would never have been able to accumulate the hundreds of thousands of dollars I have from trading mutual funds.

I'm often criticized for my conservative futures trading approach of trading only one contract. But one ingredient of being a successful trader is understanding your limitations. In my case, I psychologically can't handle losing or giving back any of my trading profits. A significant drawdown in my trading capital would devastate me so much that I would probably close up shop and never trade again. It would be foolish of me to aggressively trade stock index futures in lots of 5 or 10 contracts where I could potentially be exposed to losses from which I could never psychologically recover.

I had a master plan in 1985 to trade mutual funds for a living. But with only $2,200 to my name, trading mutual funds was out of the question. I needed some way to build up my trading capital to respectable levels to make trading mutual funds worthwhile. For that reason, I will always be indebted to stock index futures. The small, yet consistent, profits I generated from trading stock index futures became my springboard to the much greater profits I would someday generate trading mutual funds.

Day trading stock index futures imbued me with the two traits that have been most instrumental in my success as a mutual fund trader: quickness and flexibility. Regardless of your preferred trading weapon, you must be quick and you must be flexible. And nothing will teach you quickness and flexibility faster than day trading stock index futures.

Reading the Tape

My experience in tape reading began in the late 1960s. While most of my fellow students spent their free time partying or debating and protesting the Vietnam War, I occupied myself in other, more profitable, ways. When not in class, I could be found at the local stock brokerage office. There, sitting next to veteran traders in their seventies and eighties, I watched excitedly as the stock quotations rolled across the large ticker tape displayed on the front wall of the trading firm.

I can look back now and see that the knowledge I gained studying the movement of stock prices at that time far exceeded anything I ever learned from four years of academic study. Without question, the two most important things I learned about the tape were how to spot divergences to detect signs of accumulation and distribution and how to determine the direction or price tendency of the market. Of course, it didn't hurt that I had read *Reminiscences of a Stock Operator* several times before I graduated. This is the story of the master of all tape readers, Jesse Livermore.

Tape reading is a lost art, having been replaced by the computer. Traders no longer feel the need to use the tape to detect patterns of behavior in the markets. It's much easier for them to crunch some numbers into their computers for their entry and exit points. Fortunately, because of the CNBC business station, I can still practice the skills I learned as a tape reader in the 1960s.

Much of my success as a futures trader can be attributed to my tape reading skills. There are so many nuances to reading the CNBC tape that it would require an entire book to wade through them. Even then it's more a matter of personal interpretation and experience. You will see in this chapter some of the patterns I look for on the CNBC tape. Basically, I'm watching all the indexes and indicators on the CNBC bottom ticker tape for hints as to the true strength or weakness in the market. I'm especially looking for any divergences that may be developing among the indexes such as the Dow, the cash S&P, and the Nasdaq Composite.

My Original Day Trading Methodology

I began day trading stock index futures in the spring of 1985, way before day trading became so faddish. A floor trader in the S&P pit told me he made his money each day by keying off intraday highs and lows. His piece of advice became the foundation of my intraday trading throughout the late 1980s and early 1990s. I became very attuned to how the S&P futures acted as they approached their intraday highs and lows, as well as when they made new intraday highs and lows. I found the key to day trading the futures was understanding bounces from intraday lows and reactions from intraday highs—and, most especially, the velocity and magnitude of such bounces and reactions.

Before the advent of CNBC in 1989, my futures trading consisted primarily of 10 to 12 daily phone calls to my broker. In order to day trade effectively I needed continual updates on the high, low, and current price of the S&P futures as well as the Dow. I also called the CBOE hourly to update the put/call volume. (These reports are now available on the half hour.) Just as I do now, I also monitored advisory sentiment and the public/specialist shorting activities in the late 1980s.

In the late 1980s through the mid-1990s, I looked for one of three particular price patterns before placing a trade. One was my bounce-off-the-low method. With this method, you bought S&P futures between 9:20 and 11:00 A.M. CST whenever they traded 180 points above their intraday lows. Please note that all times for futures in this chapter are central time.

I also traded a high/low tracking method. This was a pattern occurring during the first 2 1/2 hours of trading during which the S&P futures would just hang at or near their intraday highs by a few ticks for 45 minutes or longer. Often this pattern would be characterized by a series of new intraday highs, each new high a tick or two above the previous highs and without any significant reaction after making the new highs.

My favorite price pattern was the breakout-to-new-highs method. With this method you looked at the high of the S&P futures during the first 50 minutes of trading. You would then buy if that high was exceeded anytime between 9:20 and 11:00 A.M.

My success as a day trader did not come about from blindly following these three price patterns. As a tape reader, I wouldn't place a trade unless most of the market internals, such as the Dow, Transports, tick, and Arms, were also confirming the price action of the futures. In addition, I overlaid the daily futures price action with the indicators discussed in Chapters 9 through 11, including the McClellan Oscillator, put/call ratios, public/specialist short selling activity, and monthly seasonality, to name just a few.

Synthesizing Indicators

November 23, 1993, shown graphically in Figure 16.2, is representative of how I traded in my earlier years as a synthesizer of various tape indicators combined with the price action of the futures. This was a day I went long after one of my price patterns was triggered because of a confluence of monthly, weekly, daily, and intraday indicators. My reasons for going long intraday were as follows:

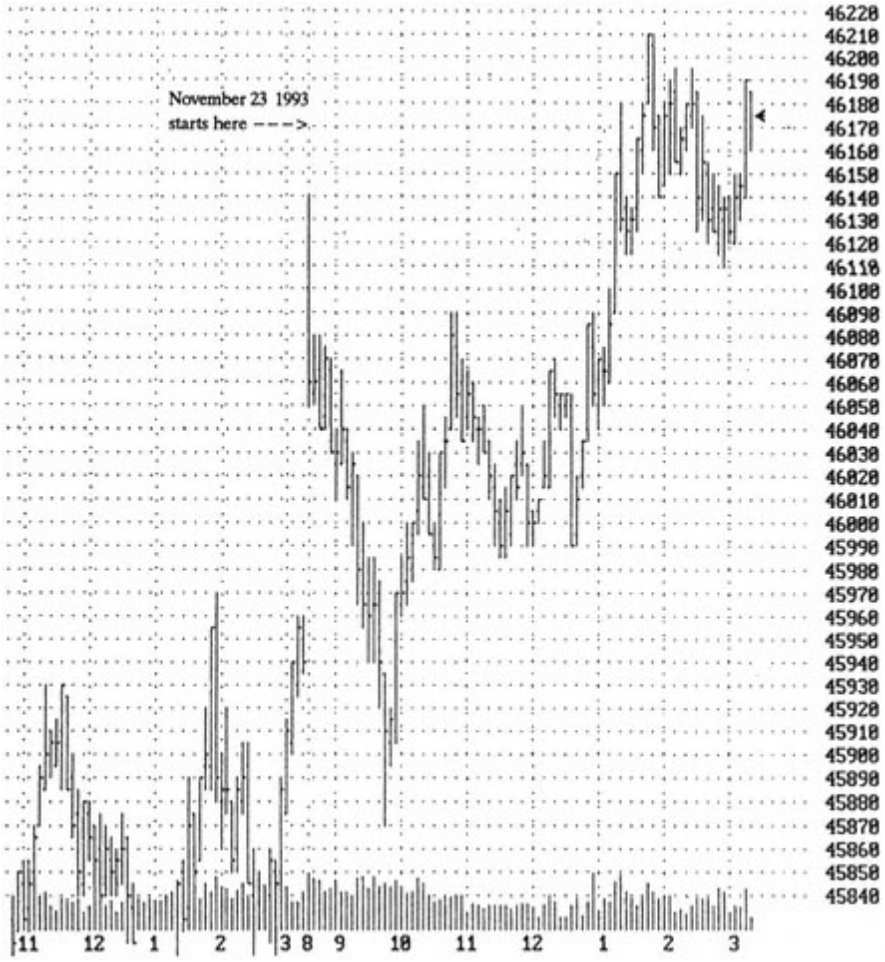


Figure 16.2
november 23, 1993, december 1993 s&p futures
(*Source* chart by ensign software)

• This was two days before the Thanksgiving holiday and rated as a seasonally favored day.

• The most recent Commitments of Traders Report showed that the large speculators were holding a near record short position while the commercials held a net long position.

• From a contrarian standpoint, the put/call ratios were extremely bullish. During the four weeks prior to November 23, OEX index puts were being bought at their highest percentage level of the year in relation to calls. On November 19 and 20, index puts on S&P 500 index options at the CBOE exceeded calls by a three-to-one margin. This was the highest ratio of the year.

• The McClellan Oscillator was at-127 coming into November 23. This was one of its most oversold readings in 1993.

• The *Investors Intelligence* survey of market letter writers showed 33.0 percent bulls and 40.9 percent bears. This was the highest reading of bears since January 1991.

• The NYSE Members Report indicated for the first time in 1993 that the public was shorting at levels above the specialists. At the same time, the members net balance index was above +10 million shares.

• The Dow Jones Utility average was uncharacteristically strong early in the trading day on November 23 and up more than 1 percent.

• The Nasdaq Composite and Nasdaq 100 opened unusually strong on November 23. Unlike recent trading sessions during which the Nasdaq weakened as the day progressed, today it seemed to pick up more steam each half hour.

In view of these bullish indicators, all I needed to get long on November 23 was some type of confirming price action in the futures. That came between 10:00 and 11:00 A.M., when the S&P futures bounced 180 points off their lows. Instead of buying S&P futures, though, I bought a MidCap futures contract. That's because the Dow and S&P were basically flat on the day, while the MidCap and Nasdaq were divergently strong. In 1993, futures contracts were not available on the Nasdaq 100.

The MidCap futures continued to strengthen into the close on November 23. As I often do on profitable day trades, I carry over to the

next trading day, looking for additional strength. That's what occurred on November 24, when I closed out my MidCap trade for a $1,100 profit. However, I no longer recommend trading the MidCap. It's become a very illiquid market, as much of the trading interest is now in the Nasdaq 100.

Trading Only Price Action

I occasionally traded solely on the pure price action of the futures without any regard for my tape indicators. For instance, look at December 2, 1991, as shown in Figure 16.3. This is a classic price action trading day and one I've seen repeatedly throughout the years. Some of the reasons I went long on December 2, based exclusively on price movement, were as follows:

• The rapidity and number of points the futures moved during the first 50 minutes of trading above their open and intraday low. This is especially noteworthy on days such as December 2, where there was a big gap opening. On that particular day, the futures opened down nearly 400 points from the previous day's close. I find that when the futures open with a large gap—either up or down—and then immediately reverse in the opposite direction of the gap, that tells you the direction for the day.

• The previous trading day, November 29, was the narrowest-range day in the futures for the preceding 13 trading days. Opening range breakouts are most accurate coming after narrow-range days.

• The eventual breakout above the highs set during the first 50 minutes of trading.

• Larry Williams's OOPS pattern was triggered, which occurs when the futures open above the previous day's high and then trade below that high, or when they open below the previous day's low and then trade above that low. On December 2, the futures gapped down and opened at 372.00. This was below the previous day's low of 374.75. Later in the morning they then traded above 374.75.

On December 2, I was ready to go long on any type of positive price action, as already described, since this was the first trading day of the month, hence, a seasonally favored day. So on this day I went

long for the first two of the aforementioned reasons. This had me in the market before the other two reasons were eventually triggered. As shown in Figure 16.3, the futures trended up throughout the day and closed at their highs.

The Birth of a Vendor

My style of futures trading brought me some notoriety within the industry. I was interviewed and featured in many of the prominent trading publications. Since I always considered myself a small-time trader, I never felt I was really deserving of all the attention I received for my futures trading exploits.

I probably would have remained anonymous had it not been for my sometimes vitriolic letters that appeared in the *Club 3000* newsletter. Beginning in 1991, I went on a crusade in *Club 3000* to rid the trading industry of the crooks and con artists who preyed on the naive with their promises of unlimited wealth from trading futures. I was forever challenging the rainbow merchants to either put up trading statements to validate their ridiculous trading claims or shut up and go away. The fact that I was willing to put up my trading statements going back to 1985 gave me instant credibility.

Bruce Babcock invited me to speak at one of his trading seminars in September 1992. I wasn't a vendor at that time. The flyer for the seminar said, "Gary Smith is living proof that the little guy can consistently make money as a day trader." I was surprised at the positive reception I received from the seminar participants. Many of the attendees encouraged me to compile my trading strategy into a book or manual.

It was around this time that my mutual fund profits began far outstripping my futures profits. This posed tax problems, as I had to take money out of my trading accounts to pay Uncle Sam. There's nothing worse than having to live off your trading profits when you are trying to build equity in your accounts. I saw marketing a trading manual as a way to generate additional income to pay the taxes on my trading profits. I already had my other basic living expenses covered, since I was working part-time as an insurance investigator.

In November 1992, I debuted with a $99 trading manual titled *Profitable Day Trading in the Stock Index Futures*. Sales were helped not only by my reputation in *Club 3000*, but also by my trader profile in the December 1992 issue of *Futures* magazine. I continued publishing my trading manual and various updates through December 1995.

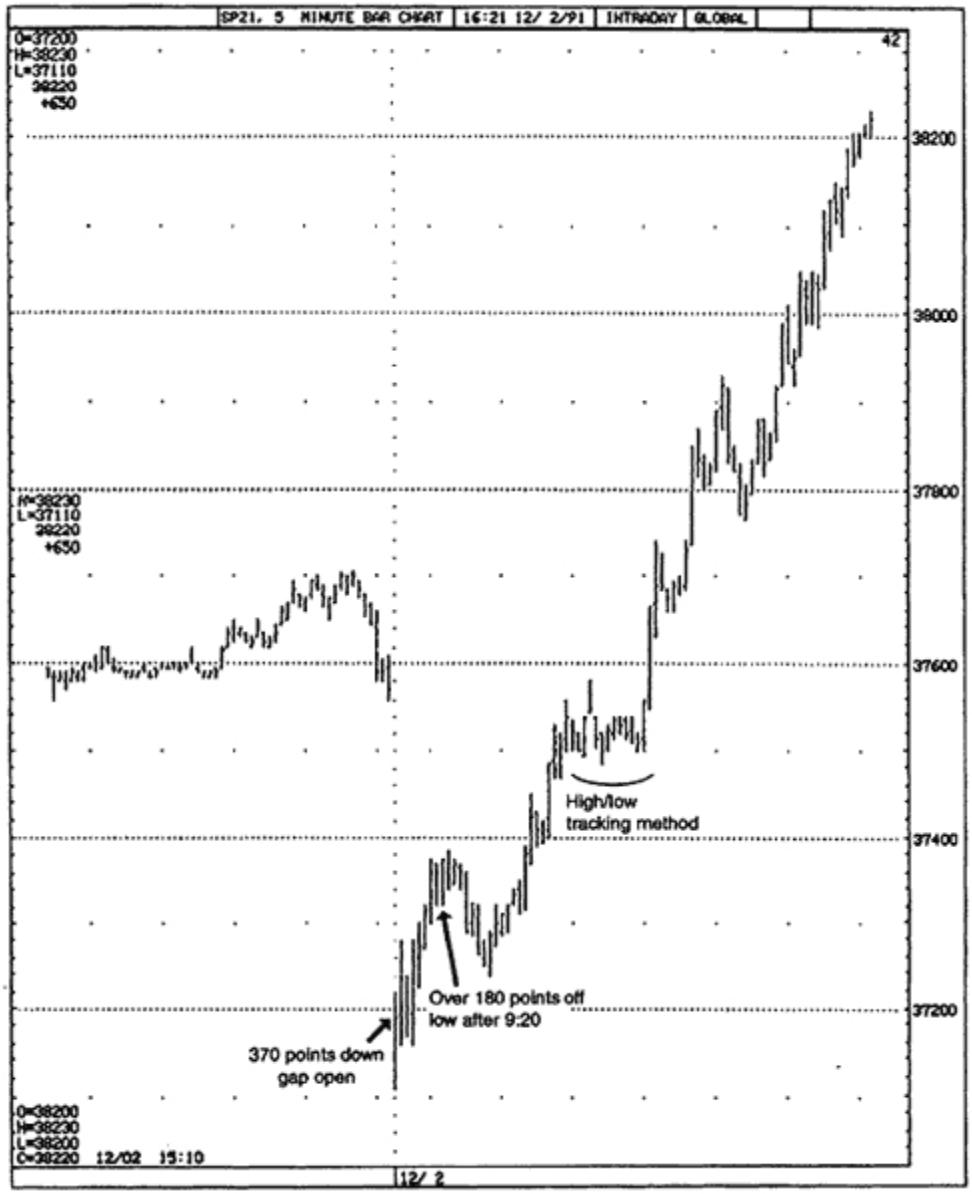


Figure 16.3
s&p, december 2, 1991

In late 1995, I said goodbye to Vendorland and turned over my trading manuals to Bruce Babcock, who compiled them into my first book *Live the Dream*. I left Vendorland for many reasons. The main reason was that I wanted my reputation to come from my trading prowess and not from my vendoring exploits. I wanted to be known as someone who "walks the walk," not simply someone who "talks the talk."

Being a vendor was a positive experience. Writing a trading manual enabled me to better formulate my trading methodology, making me an even better trader. I also was introduced to a diverse group of traders who purchased my trading materials. They ranged from those with no trading experience whatsoever to some of the trading turtles trained by Richard Dennis and a few of the market wizards featured in Jack Schwager's books.

Probably the darkest period of my vendoring career was when I was developing mechanical day trading systems. I had always been very forthright in my trading manuals and in articles I had written for various publications that I was opposed to a purely mechanical approach to day trading stock futures, so I had no business getting involved with mechanical systems. What I was trying to accomplish was to mechanize my discretionary style of trading, but I found out that you can't program the nuances of a discretionary approach into a computer.

Most of my mechanical systems were variations on my method of the 9:20 to 11:00 A.M. breakout to new highs. For a brief period, a few of my breakout systems were top-ranked among the S&P day trade systems monitored by *Futures Truth*, [2] an independent tester of commercial trading systems. I still occasionally get phone calls from satisfied customers, telling me how well they are doing with my breakout systems. However, they obviously have made modifications to my original parameters. From my observations, my mechanical breakout systems have lost much if not all of their effectiveness in the late 1990s because of increased market volatility. My original price patterns continue to work for me, but only because I filter my trades with the action of the tape.

Strategy Changes

Over the past several years I've made changes in how I day trade stock futures. I've completely eliminated the tick index and rarely look at the McClellan Oscillator. At least for me, these formerly reliable indicators have lost much of their past reliability. My primary tape indicators now

are the Dow, the Nasdaq Composite, and the cash S&P. These are followed by the Utilities, the trin, and the Transports. I still monitor the intraday volume of the index options (OEX and S&P 500) at the CBOE, but this, too, has lost much of its relevance for me as an intraday trading tool.

I used to have very strict rules about never making trades during the first 50 minutes of trading before 9:20 A.M., as well as not trading after 11:00 A.M. Now I'm apt to place trades 35 minutes after the opening and I frequently will put on trades during the Death Zone between 12:30 and 1:30 P.M. The S&P futures are forever changing their stripes, and you have to change with them.

In recent years there has been a trend toward releasing major economic reports at 9:00 A.M. CST. As a reaction to these reports, it's not uncommon to see big moves in the futures commence shortly thereafter. So it's likewise not uncommon for me to place trades beginning at 9:05, if necessary.

In my first book I made reference to the Death Zone as between 1:00 and 1:40 P.M. CST and as being a time frame during which there is often a scary countertrend move. This countertrend move is most pronounced when the market has been trending strongly up or down earlier in the trading day. With the increased volatility in the markets since 1995, the Death Zone price wiggle has become more of a quake. The time frame has also shifted to 12:30 to 1:30 P.M.

I can't think of any time period during the day in which the stock market is more prone to trend reversals than the Death Zone. I'm surprised the dream merchants haven't promoted any Death Zone systems, since this is a very exploitable time-of-the-day pattern. Intraday downtrend reversals are more reliable than intraday uptrend reversals during the Death Zone. This is because of the extreme upward bias in stocks in recent years. I know one trader who has done well over the years buying between 12:15 and 12:30 P.M. whenever the futures are down more than 0.75 percent on the day. Of course, he has some additional filters for this method, to which I'm not privy. His concept is valid in that market reversals on big down days most often occur between 12:30 and 1:30 P.M.

Shorting Stock Index Futures

I previously discussed my aversion to shorting the stock market. Being almost exclusively a long-side trader hasn't hurt my performance, even

during the bearish phases of the market. I will, however, occasionally short stock index futures. It wasn't until the end of 1994 that I finally stumbled upon a short pattern with which I felt comfortable in trading. But then we began one of the wildest bullish cycles the stock market has ever seen. As a result, this shorting pattern has appeared infrequently since 1995.

In my shorting pattern I want to see the futures setting new intraday lows sometime between 9:00 and 9:45 A.M. Then I want to see them just hang around their lows with barely any bounce upward whatsoever. Next, I look for even more new lows and, again, hardly any bounce off the new lows. The key to this pattern is that the trin index must be rising during this period of gradually declining prices and it must be at least .95 or higher. Trin readings below .90 negate this pattern from shorting consideration.

Figure 16.4, showing December 8, 1994, is an example of my favorite type of pattern to short. On this day, the futures began making new lows around 9:20 A.M. Note that there was hardly any upward reaction after making new lows. Instead, prices stayed right around the lows and then went on to make even lower lows. On this particular day I went short because the trin was above 1.00. Had the trin been below .90, I never would have shorted.

Current Trading Techniques

I'm continually refining and simplifying my stock index futures day trading strategy. Part of my motivation for the simplification part came from comments Donald Sliter makes in *The Outer Game of Trading*. [3] This 1995 book by Howard Abell and Robert Koppel describes the methods used by some of today's top traders. Since 1986, Sliter has been a floor trader specializing in day trading the S&P futures at the Chicago Mercantile Exchange. He is quoted as saying an average trading day for him was a couple thousand contracts.

When Sliter was asked about his trading strategy, he replied that it was a matter of understanding strength and weakness. Asked to elaborate, he said, "I scalp to the short side if we are trading weak to the Dow. I scalp to the long side if we're trading strong to the Dow." The authors were a bit incredulous that one of the biggest traders in the S&P pit used such a simple strategy.

In some respects, my method of reading the various tape indicators to judge the strength or weakness of the market is not a whole lot

Figure 16.4
december 8, 1994, december 1994 s&p futures
(*Source*: chart by ensign software)

different from Sliter's method of simply watching how the Dow is trading in relation to the S&P futures. Admittedly, Sliter is a scalper and goes for quick and small trading profits throughout the day. I'm looking for one good trade I can hold until the close or carry over to the next day's trading.

I began implementing a version of Donald Sliter's strategy a few years ago and I'm pleased with the results. Initially, I looked for trading opportunities on days when there were major divergences between the cash S&P and the Dow. My rule of thumb is that an eight-point move in the Dow should equate to a one-point move in the S&P cash. Whenever I see that ratio way out of alignment and I get confirmation from some of my other tape indicators, I make my move.

To better understand how I use divergences between the Dow and the cash S&P to trade futures, let's look at my trading on January 6, 1997, as shown in Figure 16.5. Here was a day on which my breakout-to-new-highs method kicked in around 9:45 A.M. In the old days I might have gone long with this pattern, since the market was strong, with the Dow up more than 44 points. But I saw a warning sign. The cash S&P was up only 3.43 points. It should have been up closer to 6 points to confirm the strength in the Dow. This negative divergence was enough to prevent me from taking a long trade, but not quite enough to get me to press the short side.

Around 11:00 A.M., the Dow hit its high for the day, up 74 points. But the cash S&P was up only 5 points and the negative divergence was becoming more pronounced. What really caught my eye, though, was that the trin suddenly begin ticking up and was at .96 on its way to above 1.00. That's all I needed to tell me that the negative divergence between the Dow and the cash S&P would be resolved to the downside.

I went short a New York Composite contract and, as you can see from Figure 16.5, the S&P futures collapsed and closed at their lows. I carried over my trade into the next morning, where I exited with a profit of over $2,300. I realize this is a different version of the way Donald Sliter judges the strength or weakness in the market. Whereas he looks at the relationship between the Dow and S&P futures, I have found that, as an off-the-floor trader, the cash S&P works better for me.

Although this new trading method was profitable for me over the next year, I still felt something was missing. That missing ingredient turned out to be the Nasdaq Composite Index. The intraday direction of the S&P futures became much more decipherable once I began com-

Figure 16.5
january 6, 1997, March 1997 S&P futures
(*Source* chart by ensign software)

paring the Dow with the cash S&P and the Nasdaq Composite. CNBC facilitated this methodology when they began posting (in the bottom right of the screen) the Dow, S&P cash, and Nasdaq Composite indexes. The strength and weakness in the market really jumps out at you when you watch the interplay among these three indexes.

Let's look at the interplay among the Dow, the cash S&P, and the Nasdaq Composite on March 18, 1999. This was a screaming divergence day. As you can see from Figure 16.6, the futures gapped down 570 points to open at 1306.50. They immediately reversed and tore out to the upside. That action alone would have told an experienced day trader that the lows were already in for the day. Notice how the futures got locked in a tight trading range between 1315 and 1319. Many traders figured they already missed a big move, so they called it a day.

Calling it a day early on the March 18 was a mistake. At 10:05 A.M. the Dow was up only 3 points. Yet the cash S&P was up 5.13 points, while the Nasdaq Composite was up more than 7 points. At that time, a 4-point move in the Dow equated to a 1-point move in the Nasdaq Composite. The extreme divergence of the cash S&P and the Nasdaq over the Dow indicated higher prices ahead. The Transports being up 47 points and the Utilities up a strong 2.61 points only added more fuel to the fire. As Figure 16.6 shows, the futures soared throughout the day and closed at their highs.

A few caveats about this divergence method: Wait until at least 10:00 A.M. before attaching significance to any developing divergences. Also, I find that divergences between the Dow, the S&P cash, and the Nasdaq are best used for identifying strength or weakness over the coming hour or two in the futures and not necessarily an indication of how the entire day will unfold.

The rule of thumb with this methodology is that when the S&P cash and Nasdaq Composite indexes are trading weak in relation to the Dow, the direction of the market and S&P futures will be down over the next one to two hours. Conversely, when the cash S&P and Nasdaq Composite indexes are trading strong relative to the Dow, the direction of the market and S&P futures will be up.

As with anything in trading, these rules are not set in stone. This trading strategy is still a work in progress on my part. I've seen days in which the market has unexpectedly soared and the Dow was stronger than the S&P cash and Nasdaq. Traders must be highly attuned to changes in the market that can impact their trading strategies. One of those changes occurred in April 1999. As discussed on page 142, the

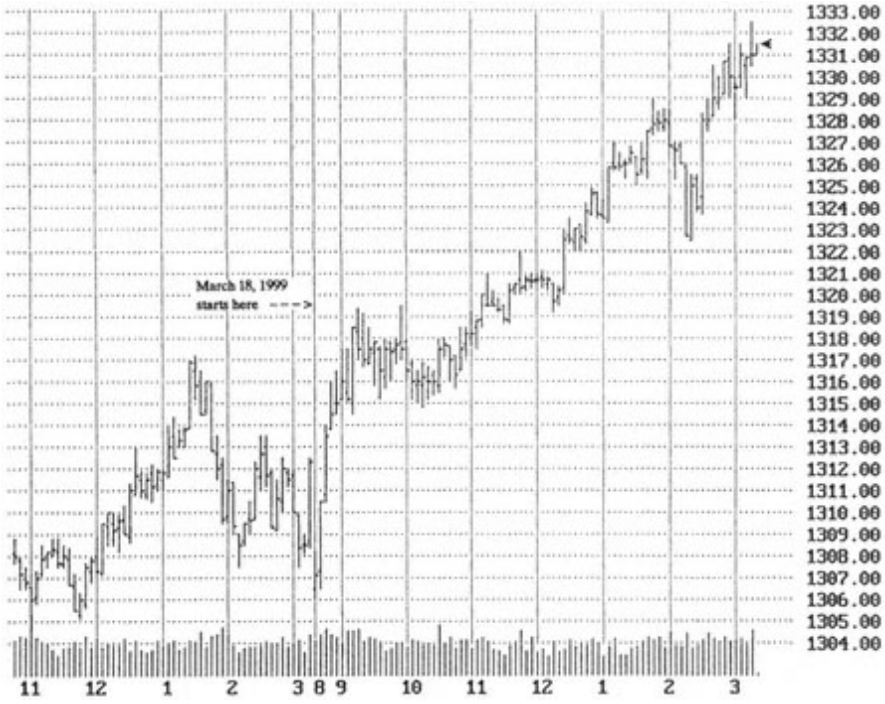


Figure 16.6
march 18, 1999, June 1999 S&P futures
(*Source*: chart by ensign software)

Dow suddenly took over leadership in the market. However, this control was short-lived, as the Nasdaq 100 regained control in late June.

Trading Nasdaq 100 Futures

My preferred futures contract is the Nasdaq 100 (see page 113). The stock market has been led by technology throughout the past several years—primarily Microsoft, Dell, Cisco, and Intel. These stocks and MCI WorldCom account for much of the daily movement in the Nasdaq 100.

My fondness for trading the Nasdaq 100 futures dates back to 1985 when they were first introduced. Unfortunately, because of liquidity problems, the original Nasdaq 100 futures contract had a short life. The Nasdaq 100 was reintroduced in April 1996 and volume has been increasing steadily over the past several years.

The CME recently introduced an electronic mini-version of the Nasdaq 100 contract. Each point move in the futures equals $20, as opposed to $100 for the full-size contract. At today's price levels, the new mini-contract is valued at around $40,000. I'm very excited about this new contract and hope liquidity isn't a problem. It would make for a great trading and investing alternative to the full-size contract. With the recent volatility in the market, the full-size Nasdaq 100 contract has had intraday swings of $7,000 and more. That's much greater on a percentage basis than the full-size S&P contract.

Besides its heavy weighting in tech, I've always preferred the Nasdaq 100 because its trendiness, both intraday and weekly, seems more pure and persistent than that of the S&P. Strong intraday trends in the Nasdaq 100 are less prone to reversals—and on the days when the Nasdaq 100 does reverse a powerful intraday trend, you can usually bet the reversal is for real and the trend in that new direction will likewise be strong and persistent.

When trading the Nasdaq 100 futures contract I pay close attention to the two other technology indexes on the CNBC tape—the Semiconductor Sector Index (SOX) and Morgan Stanley High Tech Index (MSH.). The SOX is an index of 16 semiconductor stocks, and the MSH consists of 35 stocks from nine technology-based sectors. If I am going to buy the Nasdaq 100, I don't want to see any divergent weakness in either of these two other technology indexes. Oftentimes, watching the SOX and MSH indexes gives clues to the eventual direction of the Nasdaq 100 Index.

It's amazing to me that system vendors haven't wised up to the trendiness of the Nasdaq 100. Part of the reason for this might be that few traders have historical intraday tick data on that contract. The last time I checked, not even Futures Truth had an intraday data bank on the Nasdaq 100. I would wager that the mechanical systems that have worked well over the years with the S&P would perform even better in the Nasdaq 100. Because it trends so well, I can only imagine how well opening range breakout methods would work with the Nasdaq 100.

Nonrepeater Patterns

These patterns are offered only as concepts in understanding the intraday movements of the S&P futures and, for that matter, the stock mar-

ket. The S&P futures and stock market usually do not trace out the same patterns, especially to the downside, from one day to the next. For instance, let's say that on a Tuesday the futures have a big down gap opening of several hundred points and then proceed to trend lower throughout the day. The opening on Tuesday was therefore near the highs of the day, since prices went lower from that point. It would be uncommon, then, on Wednesday for this identical pattern to occur. So if the futures were to again gap down on the opening, expect prices to reverse and trend higher on the day.

These nonrepeater patterns work especially well during the Death Zone and the last hour of trading. For instance, a sharp reversal during the Death Zone on a Wednesday shouldn't be followed by another sharp reversal in the same direction during the Death Zone on the next trading day, Thursday. Similarly, a sharp last-hour sell-off in the market on one trading day shouldn't be followed by another sharp last-hour sell-off the next day.

Some traders I know play these nonrepeater patterns, but only after two similar trading days in a row. Their logic is, if two consecutive trading days rarely repeat the same pattern, then three days in a row are even rarer, hence, more exploitable. Because of the extreme upward bias in the market during the past several years, it has paid to concentrate more on downside patterns not repeating than upside patterns. It should be noted that these nonrepeater patterns do not apply from a Friday to a Monday—only during consecutive trading days during the week.

Monitoring Globex Prices

Nearly all of the trading volume in the S&P futures takes place between 8:30 A.M. and 3:15 P.M. CST in the S&P pit at the Chicago Mercantile Exchange. Thirty minutes after trading closes in the S&P pit, it reopens on an electronic exchange called Globex and runs until 8:15 the following morning. Because of a lack of volume on Globex, I don't advise trading in this after-hours market. However, I do regularly monitor trading there to get an indication of how the overall market will open the next day.

An understanding of the spread between the cash S&P and the futures will tell you if there are any distortions in that spread with its fair value, which will lead to buy and sell programs taking place at the open of trading. Figuring the fair value of the cash to futures spread is

rather complex and involves such factors as short-term interest rates, dividends, and days remaining until the futures expire.

Fair value is displayed on the bottom ticker tape on the CNBC business station. Every few minutes on the tape you will see prices for various indexes and indicators. After the net change for the cash S&P 500 Index is shown, you will see "Prem" followed by a number. Next you will see "FV" and another number. Here's an example of an intraday reading from April 6, 1999, taken from the CNBC tape:

S&P 500 1323.25 +2.13 Prem 10.55 FV 9.90

At the time of these intraday prices, the cash S&P was trading up +2.13 points from its previous close. The "Prem" is the premium of the nearest S&P futures contract to the cash S&P. In this example, the premium was 10.55 points. This means the futures were trading 1333.80 (1323.25 +10.55). "FV" is the fair-value price for the cash to futures spread. Fair value for the futures would be 9.90 points or 1333.15. Figuring how much over or under the futures are trading in relation to their fair value is merely the difference between the premium and the fair value, or +.65 points.

Continuing with this example, let's say that at the end of trading at 3:15 P.M. on the Chicago Mercantile Exchange, the S&P futures closed at 1338. The cash S&P closed out the trading day on the NYSE at 1323. 10. This gives you an almost 15-point premium of futures above cash. With fair value at 9.90, the futures closed 5 points above their fair-value level of 1333.00. So when trading in the cash market opens at 8:30 A.M. on the NYSE, buy programs will enter the market, with arbitrageurs buying stocks in New York and selling futures in Chicago.

Buy programs should push up the S&P Cash Index by the amount of the difference over fair value, or, in this case, five points. Likewise, one can expect the Dow to be up around 40 after the open, since each one-point move in the S&P Cash Index equates to an eight-point move in the Dow.

It's important for me to watch Globex, since I like to have some idea what will happen on the open of the NYSE. Many times, news or activity in world markets can impact the S&P futures, causing them to go to big premiums or discounts to their fair value. Just remember, it's not how much up or down the futures are in Globex trading, but how

much above or below their fair value that will impact the following day's open.

Mechanical Trading Systems

It's no secret that I think there is a great deal of scamming going on in the futures promotion business (and maybe the stock systems promotion business as well). Many trading system developers spend all their waking hours trying to curve fit the past into a marketable Holy Grail system. The price tags for these optimized, computer-generated creations are frequently between $995 and $2,995, with some even higher.

If developers know a thing or two about the art of promotion, they can expect to sell between 50 and 75 copies and earn upward of $100,000 for a system that works on paper but is short on real money profits. If the vendor engages in an aggressive direct-mail campaign, then the stakes become much higher. One promoter I know sold over 200 copies of a $3,000 trading system that I think was questionable.

It can become a never ending cycle for some professional system developers turned promoters. Once is not enough. They are forever coming out with their latest and greatest. It's rare that any of these dream merchants trade their own systems. They may be greedy, but they aren't dumb. They know better than to trade a system with real money that was concocted in their optimization laboratory.

A few system vendors claim to trade their own systems and have several years of trading statements to validate such claims. These would be the types of systems I would seek out if I were into purchasing systems.

Futures Truth

Futures Truth, of Hendersonville, North Carolina, publishes a bimonthly magazine that reports on the performance of over 100 commercially sold trading systems. Futures Truth offers additional services such as private opinion letters about vendors and their systems, including equity curves and a brief performance summary. Futures Truth will test trading systems submitted to them by individual traders and offer suggestions on enhancing performance results.

Futures Truth's bimonthly magazine is must reading for anyone into mechanical trading systems. This magazine contains articles

about systems design and development, book reviews, editorial comments, and even interviews with some of the rainbow merchants themselves. The real guts of the magazine is the Master Performance Table, which contains the performance results of the trading systems since their release date to the public, including the month-by-month performance over the past year. There's a slew of other statistics on each trading system, such as percentage winning trades, average win and loss, and most consecutive losses.

The real eye-opener in Futures Truth's Master Performance Table is the maximum drawdown statistics, both since release date and for the past 12 months. Maximum drawdown tells you the most money you would have risked if you had begun trading the system during its worst period. From my perspective, nearly all of the commercially sold systems are untradeable due to excessive maximum drawdowns.

Because, by nature, all systems are optimized, there is a tendency for most systems to degrade over time from their release date. This is quite evident from a thorough review of the Master Performance Table. There also seems to be a randomness among systems, in that a top-ten-ranked system in one year can often be found scraping the bottom of the rankings in another period.

I'm not as hardened as I once was against trading systems. Some commercial system developers are honest and ethical, and some systems do work. One only needs to look at the results of the commodity trading advisors (CTAs) and commodity funds. Some 80 percent of these advisors use a mechanical approach to trading and many have been consistently profitable over the years. Of course, most of these systems aren't commercially sold systems, but are developed in-house by the advisor.

Nevertheless, as I've stated before, I could never trade a mechanical system. The best trading systems have drawdowns that I couldn't begin to psychologically handle. Another problem with some of the top-ranked systems by Futures Truth is the occasional losing or flat year. For instance, one system that has been consistently ranked at the top of the list since its release date lost over $4,000 in 1998. This is a good system sold by a very ethical vendor. But for someone like myself who trades for a living, a losing year is completely unacceptable. A losing month is jarring enough. But that's life when you trade systems. You have to prepare for the occasional losing year. No thanks!

As I've admitted, I went through a phase where I developed mechanical day trade systems for the S&P. Most of these were included

in my trading materials. But I did market a system once for $250. I restricted sales to 50 copies. That was a real learning experience and one I hope never to repeat. Much to my dismay, it seemed as if, for every copy I sold, 10 other traders got their hands on it free. That caused headaches with trading fills, as large orders were bunched at the same price levels. As a result, slippage was horrendous.

I've been tempted to write a book about the shenanigans that take place in the systems promotion business—maybe with a title such as *Crooks, Con Men, and Charlatans*. I recall one promoter who needed an addition to his house. Being short on cash, he slapped together some worthless system and priced it at $25,000—and, believe it or not, he sold a few copies.

A Dynamite S&P Day Trade System

I say the foregoing with tongue partly in cheek. This system has made more money over the past three years (1996–1998) than any of the S&P day trade systems monitored by Futures Truth during the same time period. Many of the S&P day trade systems followed by Futures Truth come with a price tag in the $3,000 range. You could easily add some bells and whistles to the basic system I'm offering here and become a rainbow merchant yourself. If you know how to master the art of manipulation, you might even rake in a couple hundred thousand dollars for your efforts.

Nearly all commercial S&P day trade systems are built upon two components: momentum off the open and retracements. The momentum-off-the-open component is also known as opening range breakouts and is based on the concept that, once the S&P surges a predetermined number of points away from the open, that trend should then continue to the close. The retracement aspect of S&P systems is based on the theory that, once the S&P has hit a predetermined level and then reverses by a certain percentage, a new trend is in effect.

The system offered here is an opening range breakout system and doesn't have a retracement component.

System #1—
Monday/Tuesday Opening Range Breakout

With this system you trade only on Mondays and Tuesdays. You go long (buy) at the opening price plus 30 percent of the average true range of the past 10 trading days in the S&P. You sell short at the opening price minus 60 percent of the average true range of the past 10 trad-

ing days. You use a 300-point stop and exit your position market on close if not stopped out. This isn't a retracement system, but it is a reversal system, where occasionally you might make two trades daily. This would occur on days when the market breaks out of the opening range to the upside, only to reverse and break out of the opening range to the downside.

When computing true range, ignore Globex prices. I don't want to confuse newer traders here, but because of gap openings, a day's true range is different from a day's actual range. Here's an example of a day's true range compared to its actual range:

Previous Close	Open	High	Low	Close
1302.50	1305.50	1321.80	1304.60	1320.60

The actual range on this trading day is 17.20, which is simply the high minus the low. The true range is 19.30. The true range is sometimes greater than the actual range because of gap openings. In this example, there was a gap opening and the low of the day was above the previous day's close. True range then is defined as the lower of the previous close or today's low subtracted from the higher of the previous close or today's high.

Here are the highlights of the summary results for System #1, as tested by Futures Truth for the three-year period from 1996 to 1998. A deduction of $100 was taken from each trade for slippage and commission. Personally, I think $200 to $250 per trade for slippage and commission is more reflective of reality in trading the S&P.

Total net profits	$96,820
1996 results	$10,943
1997 results	$37,625
1998 results	$48,253
Long trades	$67,530
Short trades	$29,290
Average win	$1,765
Maximum drawdown	$8,860
Total trades	264
Percent winners	43.2%
Most consecutive losses	9
Average trade	$367

The most impressive statistic of System #1 as compared to the S&P day trade systems monitored by Futures Truth is its low maximum drawdown. If you played around with System #1, such as optimizing the stop or adding a trend component whereby you take short trades only if the market is in some type of defined downtrend, you would find yourself a real marketable system.

While I was visiting Futures Truth prior to publication of this book, George Pruitt gave me an S&P day trade system that made even more money than System #1. Pruitt is the director of research at Futures Truth, and it took him all of five minutes to come up with this system.

Pruitt's system is an opening range breakout using the parameters of System #1 combined with a retracement component. Unlike my system, which takes trades only on Mondays and Tuesdays, Pruitt's system trades throughout the week.

The retracement component in this system has a trigger point that is 75 percent of the previous day's true range plus (for short trades) or minus (for long trades) that previous day's pivot price. Once your trigger point is hit, you then look to short on a retracement that takes you back to 25 percent of the previous day's true range plus the pivot price. To go long, you are looking for a retracement that takes you back to 25 percent of the previous day's true range minus the pivot price. Pivot price is defined as a day's high + low + close, divided by three.

If this sounds confusing, don't feel bad. It was confusing to me, too. I mention Pruitt's system because its concepts are similar to those behind many of the S&P systems that are marketed for thousands of dollars.

Scalping the S&P for a Living

At the beginning of this book, I related the story of a desperate trader who was in search of the keys to successful trading. In his quest for success, he responded to an advertisement in the back of a trading publication on how to day trade the S&P for a living. Big mistake. After taking the course, he rapidly lost much of his trading capital. No surprise, though, since the vendor who taught him to trade was later permanently prohibited by the Commodities Futures Trading Commission (CFTC) from engaging in any activity in the futures industry. This was a result of a seven-count civil injunctive action whereby this individual

was charged with cheating and defrauding customers and potential customers in commodity trading pools.

Teaching the public how to day trade the S&P is a big business. Some vendors clear $100,000 or more annually and their classes are often booked up months in advance. For fees ranging from $895 to over $15,000, you are purportedly taught how to scalp the S&P futures by trading in and out as many as four to six times daily. You usually target small profits and use ultratight trading stops.

I've been on a soapbox for years against the peddlers of these S&P day trade courses. I have begged, pleaded, and cajoled any teacher or former student of these courses to provide documentation that what is taught is a viable trading strategy off the exchange floor. All I've asked for were 18 months of recent trading statements. You would think at least one trader would have come forward to shut me up since I began my crusade in 1992.

Instead, I have received calls from over a hundred former students of these expensive day trading courses, telling me they wished they had heeded my advice and not wasted their time and money. Some of these traders had even left their chosen careers as doctors, lawyers, and engineers to master the art of scalping the S&P for a living. Sadly, with the exception of one trader, they all failed in their attempts. But their failures weren't the result of lack of dedication or commitment. Many had spent what seemed like 18 hours a day, seven days a week, trying to perfect this apparently futile task.

Over the years I've become acquainted with many futures brokers. One is even the president at one of the larger trading firms. And you know what? I hear the same story from them about the futility of scalping the S&P for a living. None of their clients are succeeding over any sustained period of time at scalping the S&P intraday.

Most of the vendors who teach the S&P day trading courses seem to have been spawned from the same gene pool. And judging by their rhetoric, they attended the same University of Hype. They tend to make outrageous claims.

Many of these promoters also claim to be home-based S&P scalpers themselves. Yet if you ask them for so much as 18 months of statements to validate their claims, you are met with 1,001 excuses for why that isn't possible. In the place of trading statements, you get a list of testimonials to validate the vendor's day trade course. But seeing is believing. You want statements before you plunk down any money.

One common tactic used by those who peddle S&P day trade courses is to invite you to watch them trade. Sitting in front of their computer screens, they dazzle you with near perfect buy and sell signals. Yet all the while, they never pick up the phone to call in any orders. Translating price action on the screen into real-money trades with real fills is an entirely different ballgame.

This has been the most difficult section in the book for me to write. I don't want to come across as some cynical, narrow-minded old codger on the subject of scalping the S&P intraday. Before I wrote this diatribe, I even posted to a futures newsgroup seeking successful S&P scalpers who were willing to show me some type of proof (as in trading statements) of their alleged prowess. These guys are forever bragging about their trading skills in scalping the S&P but when asked to substantiate their claims, they clam up real quick.

I don't doubt for a second there might be some traders out there who do successfully scalp the S&P for a living. After all, Marty Schwartz, the author of *Pit Bull*, [4] is the real deal; he has a proven record of scalping the S&P—and for more than just a few years. But just as there is only one Mark McGwire, I sometimes wonder if there is only one Marty Schwartz.

If I seem rather vociferous against these rainbow merchants who are ever so willing to sell us their magic trading pills, it's because I hate to see traders so easily duped by the deception and misrepresentation that is rampant in Vendorville. Anyone who thinks this is all in my imagination merely need read Bill Alpert's article, "Hard Knocks," in the July 31, 1995, edition of *Barron's*.[5]

Alpert's story is about a Florida-based software systems vendor that promised traders they would profit on 80 percent of their currency trades. The price of the software, which included a week's training at the company's headquarters, was a steep $75,000. But the students could buy in for a $15,000 up-front fee, with the remainder coming out of their monthly trading profits. This must have sounded like the deal of the century, because 125 eager traders signed on for training.

Alas, the software vendor was eventually shut down by the CFTC and the Florida attorney general's office for fraud. Of the 123 students using the software forecasting system, 89 percent were unprofitable. In the aggregate, the accounts lost $548,992, while showing profits of $12,956. But it gets even better. Just a few months before the firm began running their ads for their guaranteed trading system, one of the firm's

principals had left federal prison after serving 21 months for money laundering. He got that money from running illegal pyramid schemes.

You have to wonder how 125 traders could have been so gullible. Didn't they ask for any type of references? Of course, they did. But it was later discovered that the references consisted of two fellows who were partners in a firm that, through the Florida-based software firm, sold the students computers.

Perhaps no one would have bought into this scam if they had demanded 18 months of real-money trading statements from the software vendor. Some tried, but they were given the excuse that the firm's lawyers warned it might be considered unlawful enticement to provide trading statements. When the firm was shut down, the CFTC obtained the trading accounts of one of the principals and he showed trading losses of over $55,000.

The point of all this is that you must be very careful in giving your money to anyone who makes unsubstantiated trading claims that cannot be backed up with a year or two of trading statements—and that's real-money trading statements, not hypothetical or simulated.

As for scalping the S&P, I don't want to rain on anyone's parade. If that is your dream, then, by all means, go for it. If I had listened to all the naysayers who said I would never be able to trade successfully for a living, I would have given up long ago.

Beyond Intraday Trading

I realize that intraday trading, be it stocks or futures, is the rage nowadays. But had I not gone beyond intraday trading to a longer time frame, *I would be hundreds of thousands of dollars poorer*. I can't emphasize this enough. Day trading in the kind of bull market we've had in the 1990s has been inferior to holding for one day, one week, one month, and beyond, regardless of whether you are trading futures, stocks, options, or mutual funds. Look at how many days the S&P has gapped up 5 to 10 points or more, and then risen from there intraday. Those who are long going into such days benefit from the gap openings. The day traders, on the other hand, are hurt by such gap openings, since they have a smaller range with which to work intraday.

The reason I prefer trading based on end-of-day pricing, such as with mutual funds, is the emotional factor. I cannot begin to count the number of times in the past several years that, had I the opportunity to

exit my funds intraday, I would have jumped at the chance. Those were the many days the market looked liked it was about to fall off a cliff. Yet in most of those sell-offs that looked so convincing intraday, the market managed to bounce back, and sometimes the bounce was more like a pole vault. I would have shot myself in the foot exiting intraday.

I've made a lot of money over the years by either putting on new positions or adding to existing positions on Fridays and then carrying over the weekend. A lot of intraday traders can't trade this way because they believe that carrying positions over a weekend is too risky. But that's what successful trading is all about: accepting and handling risk.

People challenge me all the time on this issue of intraday versus end-of-day trading. The common argument is that day traders take less risk than end-of-day traders. I don't agree—and not just because of my track record. Look at the trading accounts of 100 day traders and those of 100 end-of-day traders to tell you where the risks are. That is intraday trading.

There are a couple of traders in the Internet newsgroups who boast about their S&P day trading prowess. They claim to make between $100,000 and $125,000 annually by scalping the S&P intraday, trading two contracts each time. Naturally, they have never been able to back up their talk. Let's assume, for the sake of argument, that these S&P scalpers are legitimate and compare their intraday trading to my end-of-day trading in mutual funds.

These scalpers are firmly glued to their trading screens each and every day. They have to make lightning-quick trading decisions throughout the trading session. They use tight stops with a trading objective of small but consistent daily profits. Each day these scalpers are playing with the equivalent of $650,000 in the S&P. That's based on trading two contracts per trade with the S&P at 1300.

I don't have to sit glued to a trading screen. As you read in the Prologue, it's primarily between 3:00 and 4:00 P.M. EST that I really have to pay attention to the market. During 1997 and 1998, I would estimate that my average daily exposure to mutual funds and junk bond funds was approximately $175,000. Of course, sometimes it was much more, while at other times it was zero. Over that period my trading profits averaged in excess of $154,000 annually. My analysis of this is that I had much less at risk on a daily basis than did the S&P scalpers, and I made more money, but more important, I avoided the constant daily stress involved in intraday trading.

As I have indicated throughout this book, trading is all about finding the time frame and trading weapon that you are most comfortable with. If you are successful at trading intraday, then by all means, stick with it. However, if you aren't successful at intraday trading, don't you think it's about time you broaden your horizon and investigate end-of-day trading and a longer-term time frame?

Curtailing My Futures Trading Efforts

The bull market of the late 1990s is one of the reasons I have curtailed my futures trading efforts. Except during market downdrafts, I usually have some type of position in mutual funds to capitalize on the short-term momentum trends. Under those circumstances, it makes no sense for me to trade stock futures from the long side. I call it double jeopardy.

I know I'm making money in my mutual funds on all the powerful up days in the stock market, so why jeopardize those profits by making an intraday long trade in the futures? There have been times when those big intraday surges reverse later in the day. In those cases, I would be losing not only on my mutual fund position but also my long futures trade. As my capital has compounded over the years, I simply have outgrown my need to trade the futures. Of course, I still maintain a futures account and I still occasionally trade futures.

Another reason I curtailed my futures trading was displeasure with all the discount trading firms. Prior to 1997, I traded at the same Chicago-based discounter for 14 years. I left that company in November 1996 when they changed clearing firms and my account was transferred to another company. I then spent a year trading at one firm after another. I never could find the level of service I had been accustomed to with my previous broker. What was really annoying was my inability to find a reputable trading firm that would give me flash fills in the Nasdaq 100.

I've known a lot of quality futures brokers in my time. Both Bob Miller at Foremost Futures in Chicago and Jonathan Matte of Defender Capital Management, Portland, Oregon, who helped me secure the charts for this book, are certainly in that group. Overall, though, the level of service at futures firms is a cut below that at the mutual fund companies. Part of this might be attributable to the high turnover in the futures business. Whatever the reasons, I find myself drifting farther and farther away from those in the futures industry.

Realizing a Realistic Return

The failure rate among futures traders is very high. Victor Niederhoffer's *The Education of a Speculator* has some insightful comments on this topic. In Chapter 8, "Gambling the Vig," the author says it's almost impossible for the average public speculator to stay in the game because of the vig and the leverage of futures. (*Vig* is defined as the bid-ask spread plus commissions plus bad execution.)

There are all sorts of classical reasons why so many futures traders lose—lack of adequate trading capital, overtrading, and not cutting losses top the list. These are all part and parcel of the real reason traders lose: lack of experience that teaches what works and what doesn't work.

Another reason, which you seldom read about, for why so many traders lose is that they have unrealistic return expectations. Many newcomers are lured into futures trading because of some brochure or television ad touting 200 percent and 300 percent trading returns in a matter of weeks or months. Easily disillusioned when such returns aren't achieved, these traders eventually walk away from trading futures—and in most cases, with nothing left of their trading accounts. On the other hand, some traders return again and again to the trading game after becoming intoxicated by the dreams of unrealistic trading returns.

So what is a realistic trading return? During the 1990s, the average commodity fund returned less than 10 percent annually. The people running these funds are not novices. They have at their disposal all the computer firepower and trading systems imaginable. What about the track record of the commodity trading advisors? A recent *Wall Street Journal* article stated that from January 1990 through August 1998, the average CTA returns were 11.1 percent. [6] These returns are actually misleading and overstated, since funds and CTAs that underperform or go out of business aren't required to report their returns.

We often hear about the outsized returns of the turtles trained by the legendary Richard Dennis. The June 1998 *Futures* magazine had an article about their returns in the 1990s.[7] A hypothetical $1,000 investment in December 1991 was made in the programs of the eight turtles who were still managing money. That combined $8,000 investment grew to $19,157 by February 1998, which works out to a compounded annual return of 15.27 percent. Interestingly enough, that same $8,000, when invested equally ($4,000 each) in the trading programs of

Richard Dennis and Bill Eckhardt, grew to $35,577, or an impressive annualized return of 27.38 percent. (Eckhardt is the fellow who bet Richard Dennis that traders couldn't be trained to be successful.)

What about the wild and woolly world of hedge fund managers and their big-time returns? A *Forbes* magazine article by columnist David Dreman [8] presented a performance index courtesy of Van Hedge Fund Advisors, of Nashville, Tennessee, of 2,600 hedge funds (1,500 domestic; 1,100 international). After deducting for fees charged by the hedge funds, their average annualized return from January 1993 through October 1998 was 13.4 percent. That trailed the 19.9 percent return of the S&P 500.

I read an article years ago in the *Wall Street Journal* about the returns of the greatest traders and investors of all time, including Warren Buffett, Peter Lynch, George Soros, and John Neff.[9] Their long-term average annualized returns ranged from 27 percent to 35 percent.

In view of the returns of the commodity funds, CTAs, hedge funds, and legendary traders and investors, it seems a bit foolhardy that average traders would think they are going to double and triple their money each year. Perhaps if traders lowered their sights a bit and traded accordingly, their bottom line would improve. It sure worked for me in 1985 when I gave up my dream of getting filthy rich from trading and decided just to concentrate on churning out a profit each month, regardless of how small.

To play my own devil's advocate, I think it is possible to garner returns of 50 percent and more annually, but only if you are trading a smaller account. Look at what I did over a 122-month period of trading stock index futures: an 86 percent annualized return. But I purposely kept a small balance in my trading account as I continually withdrew my trading profits to plow into mutual funds.

Many prospective traders don't understand that you can't trade a $10,000 account the same way you would trade a $100,000 account, whether it be stocks, options, futures, or funds. Let's say you open an account with $10,000 and go for broke, leveraging yourself to the maximum in options or futures. The trade goes your way and you suddenly have $100,000. Would you then do the same thing with your $100,000 account? Maybe if you are a gambler, but not if you are a serious trader. Then again, serious traders would never leverage themselves to the hilt in the first place.

It's much easier to be aggressive with a small account, since that

money can be replaced over time through income generated from your regular employment or by other means. But replacing a $100,000 trading account for the average trader could take a lifetime. The natural instinct should be to trade more conservatively as your account grows. Capital preservation becomes more important than capital appreciation.

Epilogue
Strictly Personal

My dream of trading for a living was merely to have enough money so I could do my own thing. Ever since I was a youngster I knew as a left-hander I marched to the beat of a different drummer and that a 9-to-5 job and a boss weren't for me. I was fortunate that, unlike many other dreamers of easy money, I knew exactly where I would make my money—the stock market. Otherwise, I easily could have drifted through life, bouncing from one get-rich-quick scheme to another.

I could care less about managing other people's money or becoming a big-time vendor by training other traders in how to trade. Both of these pursuits could bring me an even greater income. But I am not a materialistic person. During my years as a break-even trader I perfected the art of living below my means. Once I became a successful trader, I still maintained my frugal lifestyle. Money, for me, isn't what it can buy in material possessions, but it means intangibles such as freedom and peace of mind.

In another two to three years, my trading account should zoom past the one-million-dollar mark. I sometimes wonder when enough is enough and I can cut back my trading and live more on the dividends from my junk bond funds. Although I will trade until I drop from old age, do I want to continue to make trading the end-all and be-all of my exis-

tence, as I have since my teenage years? It would be nice to find other dreams, goals, and pursuits and to enjoy the simpler pleasures of everyday living. Returning to the west and spending my time hiking in the mountains and wilderness areas sounds real appealing.

As I conclude this book, I look forward to the feedback from readers about why I'm a successful trader, especially in view of the nearly two decades I spent spinning my wheels. I'm sure there will be varying opinions on the matter. If I do possess any special trading abilities, they are merely a by-product of the experience I have gained throughout my 33-year trading career.

I'm hopeful that many of the ideas and strategies presented in this book will enable you to bypass the number of years it took me to reach my trading goal. I thank you for reading my book, and I wish you a successful journey toward trading for a living.

Recommended Resources
Reading and Researching Your Way to Success

Back in 1978, a friend of mine came over to my place for a visit. He was aware of my dreams of someday trading for a living, as well as my failures to date in achieving that goal. My friend also had big dreams, but his were to just get rich with whatever opportunity presented itself. We differed in that I knew precisely where I would someday strike it rich—the stock market—and had set out to make my dream a reality. He, on the other hand, had no clue about where he would make his mark.

Looking at my massive collection of trading books, my friend commented about all the money and time I had wasted accumulating this stash of books since, obviously, they had done me no good. Fast-forward 21 years, and my friend is still searching for his opportunity to get rich, while my trading account is closing in on $700,000. At 54 years of age, he has recently moved back with his parents as he tries to regroup from his latest get-rich-quick scheme. He is working part-time as a night manager at a local restaurant and he has no health or retirement benefits.

In the long run, reading all those trading books my friend thought had been a waste of my time were instrumental in attaining my dream of trading for a living. I believe reading as much as you can about trad-

ing and the stock market is part of the process of becoming a successful trader yourself. But, as with everything related to trading, it's a cumulative process. Don't expect to read a couple of books on trading and instantly become a market wizard.

That desperate letter writer mentioned in Chapter 1 said there wasn't a trader around who worked as hard as he did in trying to master the game. He mentioned the hundreds of hours he had spent poring over charts and his nights of endless research. He also said he had read eight trading books, as if that was a lot. Reading eight trading books isn't going to cut it. I've read hundreds and hundreds of trading books. I learned a little bit about trading from each and every one of those books.

Use my recommended list of books to absorb as much as possible about trading. It's not important that you comprehend or agree with everything in the books. Over time, these books will begin shaping your time frames, goals, needs, and emotions as a trader. Then you can set about devising your own unique trading strategy.

What I often do while reading trading books is underline key passages. After I finish the book, I go back and type those passages on paper with their corresponding page number and I place them in a folder marked "Trading Insights."

Books 1 through 7 in the following list are my favorite books of all time and appear in their order of importance to me. I have not included the previously recommended books on mutual funds.

1. *How I Made $2,000,000 in the Stock Market*, by Nicholas Darvas (New York: Lyle Stuart, 1986). No surprise here, as I've mentioned this book throughout *How I Trade for a Living*. This is my favorite trading book for primarily sentimental reasons. I wouldn't expect others to feel as much of an impact as I did when I read an earlier edition in 1961. Traders are always asking me specific mechanical questions about the Darvas methodology. I tell them that the Darvas book, as with any of the books I recommend, should be read for its concepts and not for black-and-white trading rules.

2. *Reminiscences of a Stock Operator*, by Edwin Lefevre (New York: John Wiley & Sons, 1994). This is my kind of book—all text and not a chart in sight. This is the kind of book that should be read annually. Livermore's insights on trading are just as valuable today as they were nearly 100 years ago. This

goes to show you that successful trading is simply a matter of following the principles of cutting losses and adding to your winners as you let your profits run.

3. *Dow 1000,* by Benton Davis (Larchmont, NY: American Research Council, 1964). This is another one of those books that I like more for sentimental reasons than for actual content. Davis, like Nicholas Darvas and Jesse Livermore, stresses letting the market tell you what to do and not your opinions. *Dow 1000* contains my favorite piece of trading advice: "THE STOCK MARKET IS ALWAYS RIGHT AND ALWAYS TELLS ITS OWN STORY BEST." The capital letters are just as they appeared in Davis's book.

4. *The Education of a Speculator,* by Victor Niederhoffer (New York: John Wiley & Sons, 1997). While the books by Darvas, Lefevre, and Davis may be my three favorite books of all time, Niederhoffer's book is the best I've read about trading. Admittedly, Niederhoffer's book reads like a doctoral thesis, but it is well worth the effort. This is the only trading book I reread immediately after my initial reading—it was that good.

5. *Why the Best-Laid Investment Plans Usually Go Wrong,* by Harry Browne (New York: William Morrow and Company, 1987). Part One, which encompasses the first 235 pages of the book, is a must-read. Ignore Part Two completely, since it's about an outdated investment strategy. I underlined more passages in Harry Browne's book than in any other. His first paragraph tells it all: "The best-kept secret in the investment world is this: Almost nothing turns out as expected. Forecasts rarely come true, trading systems never produce the results advertised for them, investment advisors with records of phenomenal success fail to deliver when your money is on the line, the best investment analysis is contradicted by reality."

6. *Mind over Markets,* by James F. Dalton, Eric T. Jones, and Robert B. Dalton (Chicago: Probus, 1993). This book is about a trading methodology called Market Profile. Although this methodology is much like mine, I've never completely grasped Market Profile. I recommend *Mind over Markets* not for the method it preaches, but for its presentation of what it takes to become a successful trader.

7. *The Tao Jones Averages*, by Bennett Goodspeed (New York: E.P. Dutton, 1983). If you are a struggling analytical-type trader, then it is probably because you tend to resist change by making fixity out of flux. Or as Goodspeed likes to say, "trying to understand running water by catching it in a bucket."

8. *Rogues to Riches*, by Murray Teigh Bloom (New York: G. P. Putnam's Sons, 1971). This author went in search of investors and traders who had conquered the market because of some special insight or trading method.

9. *If They're So Smart, How Come You're Not Rich?*, by John L. Springer (Chicago: Henry Regney Company, 1971). Read this book and you will understand how at such a young age I came to mistrust anyone labeled as a market expert.

10. *Why Most Investors Are Mostly Wrong Most of the Time*, by William X. Scheinman (New York: Weybright and Talley, 1970). Yet another book that takes an unconventional approach to trading. Scheinman presents a methodology for measuring investor sentiment.

11. *Wiped Out*, by Anonymous Investor (New York: Simon & Schuster, 1966). How a typical investor lost all his money because he thought there were experts who knew better.

12. *A Fool and His Money*, by John Rothchild (New York: Penguin Books, 1988). The odyssey of an average investor as he searches far and wide for that one expert or guru who has all the answers.

The next five books are recommended for their research, indicators, and investing techniques.

13. *Stocks for the Long Run*, by Jeremy J. Siegel (New York: McGraw-Hill, 1998). I often use Siegel's book as a reference when debating the perennial prophets of pessimism in the various newsgroups.

14. *Stock Market Logic*, by Norman Fosback (Chicago: Dearborn Financial Publishing, 1995). If ever updated, this investment classic would become an investment bible.

15. *Winning on Wall Street*, by Martin Zweig (New York: Warner Books, 1997). Zweig has ingrained traders with the credo that

you never fight the tape and never fight the Fed. After reading his book, you will understand why.

16. *Stock Trader's Almanac,* by Yale Hirsch (Old Tappan, NJ: The Hirsch Organization). This reference book is updated annually and is the best source on historical seasonal trading patterns.

17. *101 Years on Wall Street,* by John Dennis Brown (Englewood Cliffs, NJ: Prentice Hall, 1991). This is my favorite reference book on the market. It covers 101 years (1890 to 1990) of market history. It's complete with charts and statistical information, and compares all the bull and bear markets.

18. *Market Wizards* (New York: Harper & Row, 1990) and *The New Market Wizards* (New York: Harper Business, 1992), by Jack Schwager. There have been many books about trading masters and mavens and what makes them tick, but Jack's interviews with the market wizards are by far the best. Beware, though: Some of these market wizards have lost their touch and have become promotional wizards, peddling systems, seminars, and fax services.

19. *The Trader's Edge,* by Grant Noble (Chicago: Probus, 1995). How can I not like a book in which the author gives me three paragraphs of exposure? Yet another book that takes an unconventional view of the trading game.

20. *Winner Take All,* by William R. Gallacher (Chicago: Probus, 1994). Ditto #19 about being an unconventional trading book.

21. *Trading for a Living,* by Alexander Elder (New York: John Wiley & Sons, 1993). As a rule, I dislike trading books that present a hodgepodge of trading methods. I much prefer books about one trading method and how the author made it work for him or her. But Elder's book is the exception to my rule. The first 68 pages, about the psychology of trading, are what set this book apart. This book is especially recommended for futures traders.

22. *Pit Bull,* by Martin Schwartz (New York: HarperBusiness, 1998). I have a thing about trading books by real traders—and Marty Schwartz is definitely a real trader. You'll see that he is also a big believer in synthesizing indicators.

I would be remiss if I didn't mention the old newsletters of Dr. Bruce Gould. Bruce wrote a biweekly commodity newsletter during the mid-1970s through the mid-1980s. Most of these newsletters have been bound together in soft-cover book form and are available as Volume 1, Part 1, through Volume 6, Part 2 (*Bruce Gould on Commodities,* Bruce Gould Publications, Box 16, Seattle, WA 98111).

As a fledgling trader in the 1970s, I always found Gould's advice to be invaluable. It wasn't so much what he had to say about the various markets, but his insights on trading in general and wealth accumulation. Volumes 1 through 4 are especially recommended.

Although the subject matter of my reading rarely goes beyond the stock market and trading books, there are two books outside of this realm that I would advise reading. One is Rick Pitino's *Success Is a Choice* (New York: Broadway, 1997). Normally I'm not much of a believer in listening to motivational speakers or reading self-help and pull-yourself-up-by-the-bootstraps types of books. But Pitino's strategies for succeeding in business are applicable to aspiring traders. I only wish this book had been available when I was embarking on my trading career.

The other nontrading book I liked was *The Millionaire Next Door,* by Thomas J. Stanley and William D. Danko (Atlanta: Longstreet Press, 1996). Many traders I run across, especially commodity traders, are a bit on the flamboyant and extravagant side—traits that are poison for anyone hoping to build and then sustain their trading capital at respectable levels. If you fall into the category of big spender and high liver, *The Millionaire Next Door* may give you pause for reflection.

Recommended Books on Stock Index Futures

West of Wall Street, by Barry Haigh and George Angell (Chicago: Longman Financial Services, 1988). In the 1980s, Haigh was one of the most active traders in the S&P pit. I knew this was my kind of book when Barry said, "The secret does not lie in crunching numbers or purchasing software. The computer doesn't exist that can ferret out the nuance of trading." Even though this book was published in 1988, it's still the best you can find on trading the S&P. I've always been partial to trading books written by the real thing.

How to Triple Your Money Each Year with Stock Index Futures, by George Angell (Brightwaters, NY: Windsor Books, 1984). Chapter Five, on the psychology of the floor, and Chapters 7

and 8, on the three-day cycle, are what make this a great book. These chapters were instrumental in the formulation of my stock index futures trading methodology in 1985. Beware of taking the three-day cycle theory too literally, however. I know too many traders who have tapped out trying to devise a mechanical strategy based on the three-day cycle method. Nevertheless, the concept is valid. I have profusely praised Angell's books in the past, but I have also made it known that I don't recommend his systems, seminars, and videos.

Trading S&P Futures and Options: A Survival Manual and Study Guide, by Dr. Humphrey E.D. Lloyd (Greenville, SC: Trader's Press, 1997). The author is a friend of mine and a genuinely nice person. Everything you ever wanted to know about the S&P futures is covered in this book—selecting a broker, placing your orders, pivot numbers, gaps, and more.

The Definitive Guide to Futures Trading, Volumes 1 and 2, by Larry Williams (Brightwaters, NY: Windsor Books, 1988). I rarely hear much about these two books by master researcher and trader Larry Williams, but I recommend them for the author's insights into pattern analysis. Williams is controversial because of his high profile as a promoter, but his research is second to none, and the few winning futures traders I have encountered over the years attribute much of their success to concepts learned from him.

Day Trading with Short Term Price Patterns and Opening Range Breakout, by Toby Crabel (Greenville, SC: Trader's Press, 1990). Crabel offers numerous original studies describing price action and price patterns in reference to the opening for various markets, including the S&P. The premise of this book is that the opening is the most important price of the day and that price action after the opening tells you more about what the market is doing and going to do than any other combination of market indicators. I don't recommend this book for beginners.

Live the Dream by Profitably Day Trading Stock Futures, by Gary Smith (Sacramento: Advanced Trading Seminars Inc., 1995), available through Reality Based Trading, Sacramento, California. As much as I liked and admired my publisher, Bruce

Babcock, I was appalled by both the title and the price he chose for my book. So, effective in January 1999, I gave up all future royalties on this book in exchange for a reduction of its retail price. I say this so no one accuses me of praising my book to increase my royalty income.

The mechanical systems in *Live the Dream* have become antiquated since publication by the more than doubling in the price of the S&P and its increased volatility, but I recommend my old book because the concepts it presents are still valid. There are numerous entries from my trading diary, which provides insights into how I read the tape intraday.

Other Informational Sources

I have never found computers, five-minute bar charts, and live quotes to be necessities for trading for a living. But I am a voracious reader when it comes to anything related to the stock market. This is not confined solely to books. Knowledge of trading is very important to me and I subscribe to numerous magazines, newspapers, and a couple of newsletters. Listed as follows are my reading resources:

Newspapers

1. *The Wall Street Journal*

2. *Barron's*

3. *Investor's Business Daily*

Magazines

1. *Money*

2. *Worth*

3. *Bloomberg Personal Finance*

4. *Mutual Funds*

5. *Forbes* (I especially enjoy the columnists such as Laszlo Birinyi and Kenneth Fisher)

6. *Smart Money*

7. *Business Week*

8. *AAII Journal*

9. *Technical Analysis of Stocks & Commodities*

Newsletters

1. *Market Logic*

2. *Investor's Digest*

3. *The Chartist*

4. *Commodity Traders Consumer Reports*

5. *Hulbert Financial Digest*

6. *MoniResearch*

I subscribe to the last two newsletters to keep abreast of the dismal track records of the newsletter writers and market timers. I will also periodically purchase the magazine from Futures Truth to check on the performance of various commercial commodity trading systems.

Television Programs

Wall Street Week

Internet-Based Informational Sources

I am not real fond of navigating the Net in search of business information. If you aren't careful, you can easily get information overload from the Internet. By far, the best site on the Net for market-related information is CBS MarketWatch at www.marketwatch.com. Another one of my favorites is www.dailystocks.com. I use this site to monitor intraday prices on various industry groups and indexes.

My preferred site for intraday monitoring for stocks and mutual fund portfolios is www.quicken.com. I have the top 10 holdings and more of several INVESCO and Strong funds set up at Quicken.com. Most of my time during the trading day is spent here.

After trading hours I will occasionally check in for late-breaking business news at www.yahoo.com. I also follow the Asian and European markets at the Yahoo site in real time.

I get my closing fund prices each day at the www.moneynet.com site. I've found that this site seems to post closing prices before the other sites.

I follow the S&P futures in real time on the Globex through the Chicago Mercantile site at www.cme.com. There presently are no fees for this service.

A recommended site for keeping abreast of the market's pulse is TheStreet.com—great commentary, both during and after the trading day.

The best site for mutual funds on the Net is Rob and Marla Brill's www.brill.com. *Barron's* ranked Brill's Mutual Funds Interactive as one of the top-20 investment sites. It gets a top-5 ranking from me.

Internet Chat Rooms and Discussion Groups

Internet discussion groups seem to bring out the worst in me. I don't react very well to the self-proclaimed experts in these discussion groups who endlessly pontificate about the intricacies of trading and investing. I'm reminded of Victor Niederhoffer's line that offering advice without expertise is aggressive ignorance. I also don't have much tolerance for the doom and gloomers who are forever forecasting an imminent stock market crash.

Some Internet discussion sites are moderated, while others aren't. I find it strange that I have more problems in the moderated groups than in the unmoderated. In the unmoderated groups, anything goes. Personality conflicts are often resolved in a no-holds-barred manner. With the moderated groups, because you can never really speak your mind for fear of being censored by the moderator, personality conflicts seem to fester forever.

Participating in various newsgroups keeps me in fighting shape for the trading game. I eat, sleep, and drink the stock market. Contributing to newsgroups is simply part of that process. It keeps me connected and focused.

Fundvision.com is the preferred discussion site on the Internet for mutual fund timers. I used to be a regular participant there, but, oddly enough, found I didn't fit in very well with timers. As I've said before, there's a big difference between a trader like myself and a timer. There was another Gary Smith who posted on the Fundvision board and his posts were sometimes confused with mine.

Endnotes

Chapter 1

1. Nicholas Darvas, *How I Made Two Million Dollars in the Stock Market* (New York: Lyle Stuart, 1986).

2. Courtney Smith, *Commodity Traders Consumer Reports,* P.O. Box 7603, New York, NY 10150–7603.

Chapter 2

1. Benton W. Davis, *Dow 1000* (Larchmont, NY: American Research Council, 1964).

2. Davis, pp. 48, 68, 99.

3. Anonymous Investor, *Wiped Out* (New York: Simon & Schuster, 1966).

4. Anonymous Investor, p. 15.

5. Edwin Lefevre, *Reminiscences of a Stock Operator* (New York: John Wiley & Sons, 1994).

6. Jack D. Schwager, *Market Wizards* (New York: Harper & Row, 1990).

7. Jack D. Schwager, *The New Market Wizards* (New York: HarperBusiness, 1992).

8. Davis, p. 81.

9. John Brooks, *Once in Golgonda* (New York: Allworth Press, 1969), p. 279.

Chapter 3

1. Victor Niederhoffer, *The Education of a Speculator* (New York: John Wiley & Sons, 1997), p. 173.

Chapter 4

1. Rick Pitino, *Success Is a Choice* (New York: Broadway, 1997).

2. Burton Malkiel, *A Random Walk Down Wall Street* (New York: W.W. Norton & Company, 1996), pp. 142–143.

3. Schwager, *The New Market Wizards*, p. 113.

4. Quoted in *Bruce Gould on Commodities*, Volume 2, Part 1 (Box 16, Seattle, WA 98111), pp. 147–148.

5. Jay Palmer, "Technical Havoc," *Barron's*, August 31, 1998, p. 19.

6. Schwager, *The New Market Wizards*, pp. 121–122.

7. R. Earl Hadady, *Contrary Opinion* (Pasadena: Hadady Publications, Inc., 1983).

8. *Market Vane*, P.O. Box 90490, Pasadena, CA 91109.

9. William X. Scheinman, *Why Most Investors Are Mostly Wrong Most of the Time* (New York: Weybright and Talley, 1970).

10. Murray Teigh Bloom, *Rogues to Riches* (New York: G.P. Putnam's Sons, 1971), p. 233.

11. Scheinman, p. 140.

Chapter 5

1. George Angell, *How to Triple Your Money Every Year with Stock Index Futures* (Brightwaters, NY: Windsor Books, 1984).

2. *Barron's*, 200 Liberty Street, New York, NY 10281.

Chapter 6

1. Jeremy J. Siegel, *Stocks for the Long Run* (New York: McGraw-Hill, 1998), pp. 5, 11.

2. Frank Lalli, "How She Turned $5,000 into $22,000,000," *Money*, January 1996, pp. 64–67.

3. Dan Moreau, "And Here's to Pioneer and Mrs. Robinson," *Investor's Business Daily*, February 13, 1998, p. B1.

4. Jonathan Clements, *The Wall Street Journal*, February 2, 1999, p. C1.

5. Frank Eltman, Associated Press article that appeared in the Louisville *Courier-Journal*, July 14, 1998.

6. Niederhoffer, p. 46.

Chapter 7

1. James F. Dalton, Eric T. Jones, and Robert B. Dalton, *Mind over Markets* (Chicago: Probus, 1993), p. 313.

2. Lefevre, p. 36.

3. Russell Sands, *Club 3000* newsletter, P.O. Box 20005, Kalamazoo, MI 49019, February 28, 1995 (Issue 95.04), p. 6.

4. Schwager, *The New Market Wizards*, pp. 414–438.

5. Bennett W. Goodspeed, *The Tao Jones Averages* (New York: E.P. Dutton, 1983).

Chapter 8

1. Schwager, *The New Market Wizards*, pp. 428–429.

2. Siegel, pp. 71–73.

3. Dan Sullivan, *The Chartist*, P.O. Box 758, Seal Beach, CA 90740, October 13, 1994, p. 2.

4. Robert W. Colby and Thomas A. Meyers, *The Encyclopedia of Technical Market Indicators* (New York: Business One Irwin, 1988).

5. *Market Logic* and *Investor's Digest* newsletters are services of The Institute for Econometric Research, 2200 S.W. 10th Street, Deerfield Beach, FL 33442.

Chapter 9

1. Dr. Alexander Elder, *Trading for a Living* (New York: John Wiley & Sons, 1993).

2. Richard Ney, *The Wall Street Jungle* (New York: Grove Press, 1970).

3. Richard Ney, *The Wall Street Gang* (New York: Avon Books, 1974).

4. *Market Logic* (newsletter), July 17, 1992, pp. 4–5.

5. *Aeltus Weekly*, 10 State House Square, Hartford, CT 06103.

6. Norman G. Fosback, *Stock Market Logic* (Chicago: Dearborn Financial Publishing, 1995), pp. 72–74.

7. Fosback, pp. 55–59.

8. Scheinman, p. 154.

9. Richard E. Band, *Contrary Investing* (New York: McGraw-Hill, 1985), p. 74.

10. John Bollinger, "Put Volume Indicator," *Technical Analysis of Stocks and Commodities,* March 1993, pp. 42–45.

11. Bernie Schaeffer, *The Option Advisor* (New York: John Wiley & Sons, 1997).

12. *Schaeffer's Research Review,* 1259 Kemper Meadow Drive, Suite 100, Cincinnati, OH 45240, March 19, 1998.

13. *Investor's Digest,* 2200 S.W. 10th Street, Deerfield Beach, FL 33442, April 1995, p. 11.

14. Standard & Poor's Investment Advisory Services, Inc., 345 Hudson St., Fifth Floor, New York, NY 10014.

15. John L. Springer, *If They're So Smart, How Come You're Not Rich?* (Chicago: Henry Regnery Company, 1971).

16. Springer, pp. 55–57.

17. Bloom, pp. 238–239.

18. Elder, p. 211.

19. *Investors Intelligence,* 900-990-0909, ext. 31.

20. John Bollinger, CFA, CMT, Bollinger Capital Management Inc., P.O. Box 3358, Manhattan Beach, CA 90266.

21. Martin E. Zweig, *Winning on Wall Street* (New York: Warner Books, 1997), p. 135.

22. Siegel, pp. 87–89.

23. *Consensus,* 900-872-9955.

24. *Market Vane,* 900-990-4266, ext. 10.

25. American Association of Individual Investors, 625 North Michigan Avenue, Chicago, IL 60611.

26. Schaeffer, pp. 42–43.

27. Rydex Funds, 800-717-7776.

28. Howard Simons, "Making a Commitment," *Futures,* June 1998, pp. 38–40.

Chapter 10

1. Fosback, pp. 76–80.

2. *Cabot Market Letter,* Cabot Farm, P.O. Box 3067, Salem, MA 01970.

3. *Market Logic* newsletter, September 10, 1993, pp. 4–5.

4. *Chartist* newsletter, August 11, 1994, pp. 2–4.

5. *Market Logic* newsletter, November 7, 1997.

6. Niederhoffer, pp. 104–106.

7. Larry Williams, *The Definitive Guide to Futures Trading* (Brightwaters, NY: Windsor Books, 1988), pp. 45–56.

8. *Market Logic* newsletter, November 12, 1998, pp. 6–7.

9. Siegel, p. 154.

Chapter 11

1. Fosback, pp. 154–164

2. Arthur A. Merrill, *Behavior of Prices on Wall Street* (Chappaqua, NY: The Analysis Press 1984).

3. "Seasonality Trading System," special report from the The Institute for Economic Research.

4. *Market Logic* newsletter, December 6, 1996, p. 6.

5. Niederhoffer, p. 275.

6. Reality-Based Trading Company, 1731 Howe Avenue, Suite 149, Sacramento, CA 95825.

7. Niederhoffer, p. 278.

8. Alan M. Newman, *Crosscurrents,* 40 Cuttermill, Great Neck, NY 11021, April 28, 1997.

9. Niederhoffer, p. 280.

10. Yale Hirsch, *1997 Stock Trader's Almanac,* The Hirsch Organization, 184 Central Avenue, Old Tappan, NJ 07675, pp. 146–147.

11. Siegel, p. 264

12. Yale Hirsch, *Higher Returns,* The Hirsch Organization, 184 Central Avenue, Old Tappan, NJ 07675, August, 1996.

13. Niederhoffer, p. 279.

14. Hirsch, *1997 Stock Trader's Almanac,* p. 139.

15. Hirsch, *1997 Stock Trader's Almanac,* p. 138.

16. "Markets Continue Trend of Climbing As Options Expire," *The Wall Street Journal,* December 18, 1998.

17. Standard & Poor's Investment Advisory Services, Personal-Wealth.com, Learning Curve, March 20, 1998.

Chapter 12

1. Zweig, pp. 86–91.

2. *Chartist* newsletter, October 22, 1998, p. 3.

3. Davis, p. 48.

4. Niederhoffer, p. 121.

Chapter 13

1. Nancy Gondo, "New Investors Consider Themselves Aggressive," *Investor's Business Daily*, September 25, 1998.

Chapter 14

1. Steve Shellans, *The MoniResearch Newsletter*, P.O. Box 19146, Portland, OR 97280, November/December 1998 issue.

2. Mark Hulbert, *The Hulbert Financial Digest*, 5051B Backlick Rd., Annandale, VA 22003, April 27, 1999 issue, p. 2.

3. "The 1999 Personal Investment Planning Guide," Special Advertising Section, *Forbes* magazine, May 3, 1999, p. 12.

4. Burton Malkiel, "Still on a Random Walk," *Bloomberg Personal Finance*, July/August 1998, pp. 33–36.

5. "Stock Trading Can Be a Nasty Habit," *Business Week*, May 25, 1998, p. 8.

6. "Mutual Fund Hot Hands: Go with the Winners," special report from The Institute for Economic Research.

7. Peter McKenna, "Studies Narrow Old Debate on New Funds," *Investor's Business Daily*, April 22, 1998.

8. Geoffrey Smith, "Commentary: Funds: A Hidden Trick Investors Should Know About," *Business Week*, November 17, 1997.

9. Schwager, pp. 230–250.

10. Alan Lavine, *50 Ways to Mutual Fund Profits* (Chicago: Irwin Professional Publishing, 1996).

11. Sheldon Jacobs, *Guide to Successful No-Load Fund Investing* (Irvington-on-Hudson, NY: The No-Load Fund Investor Inc., 1996).

Chapter 15

1. Randall W. Forsyth, "With New Yardstick, Junk Bonds Top S&P," *Barron's*, February 17, 1997, pp. 40–41.

2. DLJ Ibbotson Associates, as presented in the *Quarterly Portfolio* magazine of the Northern Funds, P.O. Box 2081, Milwaukee, WI 53201, December 31, 1998, pp. 2–3.

3. Jacqueline Doherty, "Trading Points" column, *Barron's*, December 29,1997, p. MW13.

Chapter 16

1. Gary Smith, *Live the Dream by Profitably Day Trading Stock Futures* (Sacramento: Advanced Trading Seminars Inc., 1995).

2. Futures Truth, 815 Hillside Rd., Hendersonville, NC 28791.

3. Robert Koppel and Howard Abell, *The Outer Game of Trading* (Chicago: Probus, 1995).

4. Martin Schwartz, *Pit Bull* (New York: HarperBusiness, 1998).

5. Bill Alpert, "Hard Knocks," *Barron's*, July 31, 1995, pp. 18–20.

6. Terzah Ewing, "Some Specialty Hedge Funds Weathered Ills," *The Wall Street Journal*, October 29, 1998, Section C, p. 1.

7. Carla Cavaletti, "Turtles on the Move," *Futures*, June 1998, pp. 76–79.

8. David Dreman, "Las Vegas on Wall Street," *Forbes*, January 11, 1999, p. 262.

9. John R. Dorfman, "Who's Number One?" *The Wall Street Journal*, August 18, 1995, Section C, p. 1.

Index

A

AAII Journal, 238

Abell, Howard, 206

ADRs, 175

Advance/decline line, explained, 94-95

Advisory sentiment.

See Sentiment-based indicators

ADX, failure of, 37

Aeltus Weekly newsletter, 73

Alpert, Bill, 221

Amazon.com, and Nasdaq 100 Index, 113

American Association of Individual Investors, sentiment survey, 85

American Depository Receipts (ADRs), 175

American Stock Exchange.

See AMEX

AMEX:

aspiring traders and, 5

specialists, 68-69

Analysis:

indicators as method of, 62-66

paralysis, 62-63

trading-history, 32-40

Angell, George, 43, 236

Ann Taylor Stores, 183

Ariel, Robert, 105

Arms, Richard, 98

Arms Index, 98

Asian markets.

See Overseas lag

AT&T, 47

Average directional movement index.

See ADX

B

Babcock, Bruce:

on author, 202-203

and seasonality research, 104-105

Band, Richard, 75

Barber, Brad, 159

Barron's, 238

analyst predictions in, 89

and block trades table, 90

on charting, 36

on junk bond seasonality, 190

Lipper Mutual Fund Performance Averages, 160

"Market Laboratory," 44, 81

Scheinman as contributor to, 40

specialist data reports, 69

as trading tool, 21

on vendor fraud, 221-222

weekly highs and lows in, 92

Bears, as prophets of doom, 48-50, 63-64

Berger, new-fund effect and, 169

Berkshire Hathaway, 47

Best percentage days, explained, 106-107

Betting. *See* Gambling

Blackjack. *See* Gambling

Blake, Gil, as mutual fund wizard, 181

Block trades, as sentiment indicator, 90

Bloom, Murray Teigh, 234

on investment advisory industry, 79-80

quoting Scheinman, 40

Bloomberg Personal Finance magazine, 158-159, 238

Blue Monday Syndrome, 106, 174-175

Bollinger, John:

as net bull indicator developer, 83

on put/call ratios, 76

Bonds:

long-term return on, 45-46

versus stocks, 64-65

Books, recommended.

See Resources, recommended

Bounce-off-the-low method, 198

Brain dominance, as trading factor, 59-60

Break-even trading:

author's years of, 23-29

breaking out of, 32-35

Breakout-to-new-highs method, 198

Brill, Rob and Marla, 239

"Bringing Up Father," as market predictor, 80

Brod, Geof, 73

Brown, John Dennis, 235

Browne, Harry, 233

Buffett, Warren, 47, 226

Bull indicator, net, 83-84.

See also Sentiment-based indicators

Bullish bias. *See* Seasonality patterns

Bullish Consensus Meter, 38, 39 (table)

Bush administration, Presidential Cycle and, 107

Business Week, 159, 238

Buy-and-hold strategy, beating, 157-159

Buy/sell volume number, net. *See* Members net balance index

C

Cabot Market Letter, 92

Call options, 26, 27.

See also Puts and calls

Capital appreciation:

versus capital preservation, 227

and trading profits, 11

Cash flow, trading income versus living expenses, 43

Casinos. *See* Gambling

CBOE:

author's experience with equity options, 25

equity-only put/call ratio, 77-79

put/call ratio and, 74-75

CBS MarketWatch, 239

CFTC, 88-89

Charles Schwab Center for Investment Research, 167

Chartist, The, newsletter, 12, 239

Chartist, author as, 28

Charts:

as perceptual filters, 61

uselessness of, 35-37, 62

Chicago Board of Trade, 194

Chicago Board Options Exchange. *See* CBOE

Chicago Mercantile Exchange (CME):

COT Report and, 89

and Nasdaq 100 futures contract, 212

S&P futures and, 193-194

Chrysler, 20

Cisco:

effect on Rydex OTC Fund, 86

Nasdaq 100 Index and, 113, 211

Citicorp, 120

Clayton Brokerage, 24

Clements, Jonathan, 47

Clinton administration:

effect on overseas lag strategy, 177

Presidential Cycle and, 107

Club 3000 newsletter:

author's vendor bashing in, 202

on trading contests, 55-56

CME. *See* Chicago Mercantile Exchange

CNBC:

McClellan Oscillator report, 97

Nikkei futures prices on, 175

predicting market decline in 1999, 138

reporting of *Investors Intelligence* poll, 83

tape reading and, 197, 214

as trading tool, 1-2, 13, 44

Cocoa trading, as author's turning point, 41-42

Coin speculation, 17-18, 24

Colby, Robert, 65

Comic strips, as market predictors, 79-80

Commercial trading systems. *See* Vendor bashing

Commitments of Traders Report. *See* COT Report

Commodex, 28

Commodities, 28

Commodities, gambling on, 153.

See also Futures

Commodity chartists, failure rate of, 37

Commodity Futures Trading Commission. *See* CFTC

Commodity Traders Consumer Reports (Smith), 11, 239

Common stock yield versus government bond interest rate, 64-65

Compounding of reinvested dividends, 48

Consensus:

research reports in, 28

sentiment polls, 84-85

Consensus readings, 38-39, 42

Contrary indicators, defined, 75

Contrary Investing (Band), 75

Contrary Opinion (Hadady), 37-39

COT Report, 88-89

Counterintuitive trading, 148-149

Crabel, Toby, 237

Crash of 1929, 49.

See also Great Depression

Crash of 1987:

forewarnings of, 49-50

High/Low Logic Index as predictor of, 92

Investors Intelligence prediction of, 83

moving averages as predictor of, 100

Credentials, author's. *See* Trading performance, author's

Crosscurrents newsletter, 105

Cycle theories, 31

D

DALBAR Financial Services, study on market timing, 157

Dalton, James, 52, 233

Dalton, Robert, 52, 233

Danko, William D., 236

Darvas, Nicholas, 232

author's introduction to, 10, 18-19

and bull market of 1950s, 48

effect on author's junk bond buying strategy, 183

as mentor, 34

and scale-up buying strategy, 155

stock market focus and, 45

Data feeds, 44

Davis, Benton, 19, 20, 34, 137, 233

Day Trading with Short Term Price Patterns and Opening Range Breakout (Crabel), 237

Death Zone, 205, 213

Decennial Cycle, 108

Decision Point Web site, free technical analysis materials, 66, 97

Default, junk-bond-related, 185, 186-187

Defender Capital Management, 224

Definitive Guide to Futures Trading, The (Williams), 99, 237

Dell:

effect on Rydex OTC Fund, 86

Nasdaq 100 Index and, 113, 211

Del Webb's Primadonna Casino, 26

Dennis, Richard, 204, 225-226

Derivatives market, short selling and, 69.

See also Futures

Diamonds, 5, 115

Discretionary versus mechanical approach to trading, 59-60, 204

Divergence analysis:

mutual fund trading and, 159

overbought/oversold indicators and, 97

stock index futures trading and, 208-211

theory of, 40

as trading methodology, 111-113, 116, 133-134

Diversification, as trading strategy, 34-35

Dividends, compounding of reinvested, 48

Doherty, Jacqueline, 190

Dow:

and bear market of 1998, 49

disproving chartists, 36

dividend yields as factor in, 48

end-of-quarter bias and, 109

monitoring, 2, 3

stock index futures and, 194

Utilities (Merrill Lynch study), 65

Dow Jones Utility Average, 95-96, 129

Dow 1000 (Davis), 19, 20, 233

Dreman, David, 226

Drexel Burnham Lambert, 185

Dreyfus:

High Yield Fund, 191

Small Cap Value Fund, 165, 166 (figure)

E

Easy money, 17-22

and coin speculation, 17-18

real-world investing and, 20-22

See also Failure to thrive, author's

Eckhardt, William:

on charts, 36

on oscillators, 37

and Richard Dennis, 226

Education of a Speculator, The (Niederhoffer), 233

on failure rate of futures traders, 225

and recurring market patterns, 105

and volume analysis, 99

E.F. Hutton, 28

Elder, Alexander, 235

on bears and market performance, 81

recommended reading of, 67

Elliott wave, as perceptual filter, 61

E-mini contract, 194

Encyclopedia of Technical Market Indicators, The (Colby and Meyers), 65

End-of-quarter bias, 109

Equifax Services, 27, 32

Equity-only put/call ratio, CBOE, 77-79

Equity options, 25

European markets. *See* Overseas lag

Examples of real-life trading. *See* Real-life trading examples

Extreme momentum days, 111-112

F

Failure rate of futures traders, 225-227

Failure to thrive, author's, 23-29, 31-32.

See also Methodologies, losing

Fair-value pricing, 176

Faulkner, Charles:

as disciple of NLP, 58

on perceptual filters, 61

Federal Reserve Board:

impact on market, 87, 100-101, 109, 130-131

junk bond market and, 187, 190

Fibonacci theory, 31

Fidelity:

as fund supermarket, 170

Municipal Bond Fund, 181

new-fund effect and, 169

overseas trading and, 176

50 Ways to Mutual Fund Profits (Lavine), 181

Fleckenstein, Bill, 50

Fool and His Money, A (Rothchild), 234

Forbes magazine, 238

on futures trading, 36

on hedge fund managers, 226

Foreign markets. *See* International markets; Overseas lag

Foremost Futures, 224

Fosback, Norman, 234

on bull/bear indicators, 84

on Federal Reserve's market impact, 100

High/Low Logic Index and, 91-92

as indicator research expert, 65

on members net balance index, 73

on monthly seasonality, 103-104

new lows indicator, 93

and public/specialist data ratio, 72

on total shorts/total volume indicator, 74

and Utility Divergence Index, 96

Friday-to-Monday momentum patterns, 111-112

Fridson, Martin, 190

Futures:

gambling on, 23-29

versus stock market trading, 45

See also Derivatives market

Futures magazine:

ads for trading systems, 79

on COT Report, 89

formerly Commodities, 28

on Richard Dennis's trading system, 225-226

Futures Truth:

performance rating of trading systems, 215-217

rating of author's day trading systems, 204

G

Gallacher, William R., 235

Gambling:

mentality of investing, 54

as prelude to investing, 26-29

trading as, 152-153

See also Easy money

Gann theory:

failures of, 31

as perceptual filter, 61

Get-rich-quick schemes. *See* Easy money

Globex:

S&P futures on, 213-215

as trading tool, 3

Goal setting, and successful trading, 33

Go-go years, 21

Gold, as investment, 45-46

Goldsmith, Frederick N., 80

Goodspeed, Bennett, 60, 234

Gould, Bruce, 236

Gould, Edson, 95

Government bonds versus common stocks, 64-65

Great Depression:

dividend yields during 1930s, 48

as historical blip, 45

Greenspan, Alan, 131, 190

Guide to Successful No-Load Fund Investing (Jacobs), 181

H

Hadady, Earl, 37-39

Haigh, Barry, 236

Hedge fund performance, 226

Higher Returns (Hirsch), 106

High/Low Logic Index:

compared to sentiment-based indexes, 68

explained, 91-92

High/low tracking method, 198

High-yield bonds. *See* Junk bond funds

Hirsch, Yale, 235

day-of-the-week performance analysis, 106

monthly performance test, 105

on Presidential Cycle, 107

Historic returns, comparison of, 46

Holiday bias, 103-104.

See also Seasonality patterns

Horse betting. *See* Gambling

Hot-fund strategy, 162-163

How I Made Two Million Dollars in the Stock Market (Darvas), 10, 18-19, 232

How to Triple Your Money Every Year with Stock Index Futures (Angell), 43, 236-237

Hulbert, Mark, 157

Hulbert Financial Digest, 157, 239

Hutton, E.F. *See* E.F. Hutton

I

If They're So Smart, How Come You're Not Rich (Springer), 79-80, 234

Indicators, sentiment-based:

AAII polls, 85

comic strips as, 79-80

Consensus poll, 84-85

COT report, 88-89

Investors Intelligence poll, 83-84

Lowrisk.com "Guess the Dow" contest, 86

Market Vane poll, 84-85

members net balance index, 72-73

NYSE Members Report as source of, 68-69

odd-lot shorts/specialist shorts, 73-74

polls as, 81-90

price movement and, 68

pros and cons of, 62-66

public shorts/total volume, 74

public/specialist shorts, 69-72

put/call ratios, 74-79

Rydex asset levels, 86-88

Silicon Investor Web site survey, 86

total shorts/total volume, 73-74

value of, 67-68

Wall Street Elves Index, 90

Indicators, technical:

advance/decline line, 94-95

Dow Jones Utility Average, 95-96

Federal Reserve Board policy as, 100-101

Fosback's new lows, 93

High/Low Logic Index, 91-92

McClellan Oscillator, 97

moving averages, 99-100

perceptual filters and, 61-62

Titanic Sell Syndrome, 93-94

trill (Arms Index), 98

two-second indicator, 92-93

Utility Divergence Index, 96

volume analysis, 99

Initial public offering market. *See* IPO market

Institute for Econometric Research, 163

Intel:

effect on Rydex OTC Fund, 86

Nasdaq 100 Index and, 113, 211

Interest rate, impact on market, 100-101, 138.

See also Federal Reserve Board

International Controls, 21-22

International markets, impact on junk bond market, 188.

See also Overseas lag

International Monetary Exchange, 89

Internet-based resources for traders, 239-240.

See also Web sites

Intraday versus end-of-day trading, 222-224

INVESCO:

Asian Growth Fun, 175

as author's model account, 158, 179-180

buying example, 115-116

Endeavor Fund, 167, 170-171, 173 (figure)

European Fund, 177-178

Growth and Income Fund, 169-170

High Yield Fund, 186, 191

Pacific Basin Fund, 175

Small Company Growth Fund, 165, 167, 168 (figure)

as trading tool, 2-3

Worldwide Communications Fund (figure), 161

Investor's Business Daily, 238

investment-vehicle preference poll, 154

"Leaders & Success" column, 52

on new-funds effect, 167

profiles in wealth accumulation, 47

as trading tool, 2

Investor's Digest newsletter, 239

and indicator research, 65

put/call ratios, 76-77

Investor sentiment. *See* Market sentiment methodology

Investors Intelligence:

bulls versus bears, 40, 81

as sentiment-monitoring service, 83-84

sentiment readings poll (table), 82

IPO market, 169

J

Jack White, as fund supermarket, 179

Jacobs, Sheldon, 181

January Barometer:

explanation of, 107

junk bonds and, 190

mutual funds and, 160, 163

Janus:

as author's choice, 179-180

High Yield Fund, 192

new-fund effect and, 169, 170

as trading tool, 3

Jiggs and Maggie, as market predictors, 80

Jones, Eric, 52, 233

Junk bond funds:

defined, 185

history of, 183-188

how to trade, 188-191

as investment vehicle for author, 155

performance of, 191-192

K

Keebler Foods, 183

Kentucky Fried Chicken, 185

Kmart, 183

Kobren Insight Group, 167-169

Koppel, Robert, 206

Kroll, Stanley, 36

L

Large-cap sectors, and end-of-quarter bias, 109

Late-day upside price surges, 111-112

Lavine, Alan, 181

LeFevre, Edwin, 20, 232

Left-brain traders, 59-60

Leverage, defined, 153-154

Lindner Fund, 180

Lipper Mutual Fund Performance Averages, 160

Liquidity, related to junk bonds, 187, 188

Livermore, Jesse, 20, 34, 55, 155, 183

Live the Dream by Profitably Day Trading Stock Futures (Smith), 194, 204, 237-238

Lloyd, Dr. Humphrey E.D., 237

Losing methodologies. *See* Methodologies, losing

Lutts, Carlton, 92-93

Lynch, Peter, 226

M

MACD, 31, 37

Malkiel, Burton, 35, 158-159

Margin, defined, 153

"Market Laboratory" section, *Barron's,* 69

Market Logic newsletter, 239

and bull/bear indicators, 84

and indicator research, 65

and public/specialist data ratio, 72

seasonality system and, 104

and total shorts/total voume indicator, 74

Utility Divergence Index and, 96

Market Profile, 61

Market sentiment methodology, 37-40

author's use of, 111

as market rhythm detector, 43

perceptual filters and, 62

See also Indicators, sentiment-based

Market timing:

author's rhythm-detection methods, 111-113

mutual funds and, 156-157

Scheinman on rhythm of, 40

Market Vane newsletter (Hadady), 38

bullish consensus and, 38

sentiment polls, 84-85

Market Wizards. See *New Market Wizards, The* (Schwager)

Master Performance Table, as reference, 216

Mathematical formulae and trading, 11-13, 60

Matte, Jonathan, 224

McClellan, Sherman and Marian, 97

McClellan Oscillator:

compared to sentiment-based indicators, 68

explained, 97

loss of reliability, 204

MCI WorldCom, 86

effect on Rydex OTC Fund, 86

Nasdaq 100 Index and, 113, 211

Mechanical versus discretionary approach to trading, 59-60, 204

Members net balance index, explained, 72-73

Merrill, Arthur, 103

Merrill Lynch:

call options, 25, 27

Dow Jones Utilities study, 65

junk bond market and, 190

on option expiration weeks, 108

Methodologies:

author's mutual fund strategies, 159-163

author's stock index futures strategies, 197-211

indicators as, 62-66

losing, 31-40, 52-54

and perceptual filters, 61-62

See also Real-life trading examples

Meyers, Thomas, 65

Microsoft:

effect on Rydex OTC Fund, 86

Nasdaq 100 Index and, 113, 211

Mid-America corn market, 26

MidCap S&P 400 Index, 194

Miller, Bob, 224

Millionaire Next Door, The (Stanley and Danko), 236

Mind over Markets (Dalton, Jones, and Dalton), 52, 53, 233

Modigliani, Franco, 186

Modigliani, Leah, 186

Momentum off the open, explained, 217

Momentum patterns:

lack of, 149

as market rhythm detector, 43

as methodology, 111-113

perceptual filters and, 62

See also Real-life trading examples

Money magazine, 46, 238

Money management:

author's views on, 151-154

mutual fund strategies and, 172-174

MoniResearch Newsletter, 156-157, 239

Monthly seasonality. *See* Seasonality patterns

Moody's, rating of junk bonds, 185

Morgan Stanley High-Tech Index (MSH), 125, 212

Moving average convergence/divergence. *See* MACD

Moving averages, explained, 99-100

MSH. *See* Morgan Stanley High-Tech Index

M-squared rating method, 186

Mutual funds:

author's fund preferences, 179-181

author's trading methodology, 159-163

buy-and-hold strategy and, 157-159

money management strategies and, 172-174

new-fund effect, 167-172

overseas lag and, 174-179

overview of trading, 155-156

recommended literature on, 181

short-term trader restrictions and, 179

small-cap divergence and, 164-167

tight rising channels and, 163-164

timing versus trading, 156-157

as vehicle for successful trading, 43

Mutual Funds magazine, 238

N

Nasdaq:

and CBOE equity-only put/call ratio, 77-78

disproving chartists, 36

monitoring, 2, 3

100 Index, as proxy for technology sector, 113

stock index futures and, 42, 194, 211-212

Neff, John, 226

Net balance index. *See* Members net balance index

Neurolinguistic programming (NLP), 58-59

Nevada Club, 26

New-fund effect, 167-172

Newman, Alan, 105

New Market Wizards, The (Schwager), 235

Charles Faulkner in, 58, 61

Gil Blake in, 181

on perceptual filters, 61-62

profiles of market wizards, 25

William Eckhardt in, 36

New York Composite Index, 194

New York Stock Exchange. *See* NYSE

Ney, Richard, 69

Nicholas Fund, 180

Niederhoffer, Victor, 233

on buying weak markets, 147

on expert advice, 240

on failure rate of futures traders, 225

on gambling, 29

on recurring market patterns, 104-105, 107

on shorting, 50

on volume analysis, 99

Nikkei, stock index futures and, 175, 194.

See also Overseas lag

9-to-1 up-volume days, 127-129

NLP. *See* Neurolinguistic programming

Noble, Grant, 235

Nonrepeater patterns, 212-213

Northern Funds, 180

Northwest Airlines, 183-185

Nova Fund, Rydex, 86-87

NYFE for Life, 105

NYSE:

bull market of 1982 and, 28

Members Report, 68-69, 70 (table)

Momentum Index, 138

specialists, 68-69

O

Odd-lot shorts/specialist shorts indicator, explained, 73-74

Odean, Terrance, 159

OEX:

defined, 75

put/call ratio, 76, 77 (table), 142-143

See also S&P

Ohama, William, 93

101 Years on Wall Street (Brown), 235

1 percent true selling days, 111-113

OOPS pattern, 201

Opening range breakout, explained, 217-219

Option Advisor Newsletter, The:

Bernie Schaeffer and, 76

on combining sentiment measures, 85

Option expirations week, 53, 108-109

Options. *See* Derivatives market; Futures

Oscillators:

failure of, 31, 37

as perceptual filters, 61

Othmer, Donald and Mildred, 47

Outer Game of Trading, The (Abell and Koppel), 206

Overbought/oversold indicators:

failure of, 37

McClellan Oscillator and, 97

Overseas lag, as market strategy, 174-179

Overtrading:

gambler's mentality and, 54

lessons of, 42

Owens Illinois, 185

P

Paper trading, 54-56

Perceptual filters, 62-66, 111, 149

Pig Crop Report, 25

Pioneer Fund, 47

Pit Bull (Schwartz), 221, 235

Pitino, Rick, 33, 59

Pivot price, 219

Pizza Hut, 185

Playtex Enterprises, 183

Polling services. *See* Sentiment-based indicators

Pork bellies. *See* Futures

Potomac Funds, 156, 179

Presidential Cycle, 107

Price action, as market predictor, 61-62, 111, 198, 201-202

Price movement, indicators and, 68

Professional trading:

- versus day job, 43
- psychology of, 51-60
- route to, 41-44, 229-232

Profitable Day Trading in the Stock Index Futures (Smith), 202

ProFunds, 156, 179

Pruitt, George, 219

Psychological trading gurus, 56-58

Psychology of trading, 20-21, 51-60

Public shorts/total volume indicator, 74

Public/specialist short sales ratio:

- explained, 69-72
- Scheinman and, 40

Put/call ratios:

- explained, 74-79
- as rally predictor, 142-143

Puts and calls:

- defined, 75
- as sucker's game, 23
- *See also* Put/call ratios

Pyramiding strategy, 154

Q

QQQs, 115

Quicken Web site, discussion of CBOE equity-only put/call ratio, 77

Quicken.com, 2

R

Racetrack betting. *See* Gambling

Random Walk Down Wall Street, A (Malkiel), 35, 159

Range-bound market, 63

Reagan administration, Presidential Cycle and, 107

Reality-Based Trading Company, Bruce Babcock's, 104-105

Real-life trading examples:

1997 March-April, divergence/momentum, 144-147

1998 March, true selling day, 117-118

1998 March-April, overoptimism, 118-120

1998 April-June, weak market, 120-121

1998 June, divergence, 121-123

1998 June-July, true selling day plus top, 123-124

1998 July-August, sick market, 124-127

1998 September, Dow Jones Utilities, 129

1998 September, 9-to-1 up-volume day, 127-129

1998 October, Federal Reserve effect, 130-132

1998 October, V-bottom upside reversal, 129-130

1998 November, true selling day, 132-134

1999 January, divergence, 134-135

1999 January, trading patterns, 135-137

1999 January-April, bulls win, 137-140

1999 April, bears lose, 141

1999 April, divergence, 141-142

1999 April, rally, 142-144

counterintuitive trading, 148-149

dip avoidance, 147-148

methods used, 111-113

momentumless markets, 149

overview, 113-117

Real-money versus simulated trading, 54-56

Real-time equity curve (table), 14

Recessions, impact on junk bonds, 186-188

Reinvested dividends, compounding of, 48

Relative strength index. *See* RSI

Reminiscences of a Stock Operator (LeFevre), 232-233

and charts, 62

and Jesse Livermore, 19-20

and paper trading, 55

tape reading and, 197

Resources, recommended, 231-240

Retracement, explained, 217

Rhythm, market. *See* Market timing

Right-brain traders, 59-60

Risk management, 53-54, 151-154

Robinson, Mr. and Mrs. Joseph, 47

Rogues to Riches (Bloom), 234

on investment advisory industry, 79-80

quoting Scheinman, 40

Rothchild, John, 234

Roulette. *See* Gambling

RSI, failure of, 31, 37

Russell 2000:

end-of-quarter bias and, 109

monitoring, 2, 3

as small-cap sector proxy, 123

stock index futures and, 194

Rydex asset levels, 86-88

Rydex Funds, for market timing professionals, 156

Rydex jiggle, 2

Rydex OTC Fund, as mirror of Nasdaq, 100

Rydex Ursa Fund:

inverse relationship to S&P, 86

as short fund, 50

S

S&P:

and bear market of 1998, 49

Cash Index, 214

futures, 88-89

monitoring, 2, 3

and put/call ratios, 75-79

stock index futures and, 42, 193-194

See also Standard & Poor's

S&P Devotee System, 105

Sands, Russell, 55-56

Scale-up:

as buying strategy, 155

and junk bonds, 183

versus scale-down, 64

Scaling into trades, 20

Scalping the S&P, 219-222

Schaeffer, Bernie:
on combining sentiment measures, 85
on put/call ratio indicator, 76-77
Scheiber, Anne, 46-47
Scheinman, William X., 234
on investor psychology, 39-40
on odd-lot shorts/specialist shorts, 74
on specialists, 69
Schwager, Jack, 235
Charles Faulkner interviewed by, 58
Gill Blake interviewed by, 181
on perceptual filters, 61-62
profiles of winners, 20, 25
on trading wizards, 52
William Eckhardt interviewed by, 36
Schwartz, Marty, 221, 235
Scudder Funds, 180
Sears, 22, 24
Seasonality patterns:
best percentage days, 106-107
calendar anomalies, 107-108
end-of-quarter bias, 109
holiday bias, 103-104
and junk bonds, 190-191
monthly, 103-106
mutual funds and, 162-163
option expirations week, 108-109
SEC:
established, 20
fair-value pricing and, 176

and IPO approval, 172

specialist data reports, 69

Sector funds, Rydex, 88

Securities and Exchange Commission. *See* SEC

Semiconductor Sector Index (SOX), 212

Sentiment-based indicators. *See* Indicators, sentiment-based

Sentiment methodology. *See* Indicators, sentiment-based; Market sentiment methodology

Shellans, Steve, 156

Shorting the market, 49-50, 64.

See also Public/specialist short sales ratio

Shorting stock index futures, 205-206

Short sales ratio. *See* Public/specialist short sales ratio

Shorts/volume indicator. *See* Total shorts/total volume indicator

Short-Term Traders Index, 98

Short-term traders' penalty, 179, 191-192

Siegel, Jeremy, 234

analysis of *Investors Intelligence* surveys, 84

on best percentage days, 106

on crash indicators, 65

on Federal Reserve's market impact, 100-101

on long-term trends, 45-46

Simons, Howard, 89

Simulated trading, 54-56

Sliter, Donald, 206-208

Small-cap divergence, 164-167

Small-cap sectors, end-of-quarter bias and, 109

Smart Money magazine, 238

Smith, Courtney, 11

Soros, George, 50, 226

SOX. *See* Semiconductor Sector Index

Specialists, 68-72

Spiders, 5, 115

Springer, John, 79-80, 234

Standard & Poor's:

put/call ratio Web discussion, 77

rating of junk bonds, 185

on triple witching weeks, 108

See also S&P

Stanley, Thomas J., 236

Starr Report, and overseas lag, 178

Stochastics, failure of, 37

Stock index futures trading:

author's curtailment of 224

author's record in, 194-196

divergence method and, 206-211

Futures Truth and, 215-217

Globex monitoring and, 213-215

intraday versus end-of-day system of, 222-224

mechanical systems of, 215

methodologies for, 197-211

Nasdaq 100 and, 211-212

nonrepeater patterns of, 212-213

opening range breakout sytem described, 217-219

overview, 193-194

price action and, 201-202

realistic return expectations, 225-227

scalping the S&P, 219-222

shorting and, 205-206

success and, 42-43

synthesizing indicators and, 198-201

tape reading and, 196-197

vendors and, 202-204

Stock Market Logic (Fosback), 234

High/Low Logic Index and, 91

and members net balance index, 73

Stock market trading:

and bears, 48-49

versus futures, 45

long-term return on, 46 (figure)

shorting and, 49-50

wealth accumulation and, 45-48

Stock options, 23

Stocks for the Long Run (Siegel), 234

analysis of *Investors Intelligence* surveys, 84

on best percentage days, 106

on crash indicators, 65

on Federal Reserve's market impact, 100-101

on long-term trends, 45-46

Stock Trader's Almanac (Hirsch), 235

Strategies, trading. *See* Methodologies

Strike price, defined, 75

Strong Funds:

as author's choice, 179-180

Global High Yield Bond Fund, 192

High Yield Bond Fund, 167, 183-184, 188-190, 191

new-fund effect and, 169

Short Term High Yield Fund, 192

Small Cap Value Fund, 167, 170, 171 (figure)

as trading tool, 3

Success Is a Choice (Pitino), 33, 59, 236

Success modeling. *See* Neurolinguistic programming (NLP)

Suckers' rallies, 50

Sullivan, Dan, 65, 131

Swenlin, Carl, 66, 97

T

Taco Bell, 185

Tao Jones Averages, The (Goodspeed), 60, 234

Tape reading, 197

Tax loss selling, 92

Technical Analysis of Stocks and Commodities, 76, 238

Technical indicators. *See* Indicators, technical

Technology stocks survey:

    Rydex OTC Fund, 86

    survey of, 86

10-day trin, 68

TheStreet.com, 239

Tight rising channels, mutual funds and, 163-164

Timing, market. *See* Market timing

Titanic Sell Syndrome, 93-94

Total nominal return indexes, 1802-1997 (figure), 46

Total shorts/total volume indicator, explained, 73-74

Trader's Edge, The (Noble), 235

Trading, as a profession, 41-44, 51-60, 229-232

Trading books, recommended, 231-238

Trading buddies, 4

Trading contests, 55-56

Trading day, author's typical, 1-4.

    See also Real-life trading examples

Trading deficiencies, 32-35

Trading examples, real-life. *See* Real-life trading examples

Trading for a Living (Elder), 235

    on bears and market performance, 81

    recommended reading of, 67

Trading indicators. *See* Indicators, sentiment-based

Trading methodologies. *See* Methodologies

Trading performance:

author's, 10-15, 204

rating of, 215-217

Trading profits and capital appreciation, 11

Trading results by year (table), 12-13

Trading S&P Futures and Options (Lloyd) 237

Transamerica Fund, 180

Travelers, 120

Treasury bills:

versus junk bonds, 185, 187, 190

long-term return on, 45-46

Trending. *See* Indicators, sentiment-based

Tricon, 185

Trin (Arms Index), 98, 206

Triple witching weeks, 53, 108-109

T. Rowe Price Fund, 176, 180

True range versus actual range, 218

Two-second indicator, 92-93

Two Tumbles and a Jump Rule, 100

U

University of Dayton, author's years at, 20-22

Upside rallies, bear markets and, 50

Ursa Fund. *See* Rydex Ursa Fund

U.S. Home, 183

Utilities:

as market predictor, 95-96

study of, 65

Utility Divergence Index, 96, 138

V

Value Line Index, 194

Vanguard Fund, 180, 191

Van Hedge Fund Advisors, 226

Van Wagoner, new-fund effect and, 169

V-bottom upside reversals, 111-112

Vendor bashing, 15, 202-204, 215, 219-222

Vendoring, trading-related, 9

Vesco, Robert, 21-22

Vietnam War, 22

Vig, defined, 225

Volume analysis, 99

W

Wall Street Elves Index, 90

Wall Street Gang, The (Ney), 69

Wall Street Journal, 238

as basis for trading, 41-42

on CTA average returns, 225, 226

profiles in wealth accumulation, 47, 226

as trading tool, 2, 21, 38

weekly highs and lows in, 92

Wall Street Jungle, The (Ney), 69

Wall Street Week, 90, 239

Warburg Pincus Fund, 180

Waterhouse, as fund supermarket, 170

Wealth accumulation:

by maximizing winning trades, 154

profiles in, 46-48

Web sites:

www.aaii.com, 85

www.brill.com, 240

www.cftc.gov, 89

www.cme.com, 239

www.dailystocks.com, 2, 239

www.decisionpoint.com, 66

www.fundvision.com, 240

www.lowrisk.com/sentiment.htm, 86, 143

www.marketwatch.com, 3, 239

www.moneynet.com, 3, 239

www.quicken.com, 2, 77

www.techstocks.com/survey.html, 86

www.yahoo.com , 2, 3

West of Wall Street (Haigh and Angell), 236

Whole-brain trading, 59-60

Why Most Investors Are Mostly Wrong Most of the Time (Scheinman), 234

on investor psychology, 39-40

on odd-lot shorts/specialist shorts, 74

on specialists, 69

Why the Best-Laid Investment Plans Usually Go Wrong (Browne), 233

Williams, Larry, 237

and COT Report analysis, 89

on moving averages, 99

OOPS pattern and, 201

Wilshire 5000 Index, 157

Winner Take All (Gallacher), 235

Winning on Wall Street (Zweig), 234-235

on bull/bear indicators, 84

on 9-to-1 up-volume days, 128, 129

Wiped Out (anonymous), 19, 234

Work-at-home franchises, 24-25

Worth magazine, 239

Y

Yahoo:

Nasdaq 100 Index and, 113

Web site, 2, 3,

Z

Zweig, Marty, 234

on bull/bear indicators, 84

on 9-to-1 up-volume days, 128, 129