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Introduction

Investing in the stock market can be an intimidating experience for the individual investor when you consider that you are a small fish in an ocean dominated by whales. The institutions are armed with the latest and greatest computer wizardry. They are on top of the game and can move in an instant, leaving people like us in the dust. But this doesn't have to be the case anymore. The information age is upon us. Institutional research, which was once reserved for only the elite Wall Street money managers is now available to individual investors for pennies a day.

The problem facing individual investors today is what to do with all of the available information. Contrary to what you may believe, successful investing in the stock market does not require a great deal of time or a plethora of market information. What is required is an understanding of what makes the market tick, proper money management and a consistent, disciplined approach. ‘Trade Like A Pro’ details a comprehensive approach to investing in the stock market and shows you how to become a proficient and confident participant.

There are two basic approaches to the stock market, fundamental and technical analysis. Fundamental analysis deals with a company’s earnings expectations, their management, product life and other economic considerations. Technical analysis, which is one of the most misunderstood applications on the planet, analyzes price trends, chart formations and an array of supply/demand indicators to forecast a stock’s future direction.

Odds are your stock market experience has been confined to some sort of fundamental analysis since, on the surface it seems to make a lot of sense. A company makes a lot of money therefore its stock should go up - right? Wrong! The fact of life is that the only factor that causes a stock price to go up is if there are more Buyers than Sellers, i.e. demand outstrips supply. Granted, when good things are happening to a company, an imbalance of buyers vs. sellers will develop causing the stock price to appreciate. The problem is that what is happening to a company today is inconsequential. What is important is the public's perception of what will be happening six months from now. It is virtually impossible for the majority of the general public to know this information. It is for this reason why a rigid fundamental approach is flawed.

In practically every scenario, there is smart money and the general public influencing the price of a stock by their buying and selling activities. The smart or informed money crowd has a good idea of what will occur in the future and typically express their conviction through their trading activity. It is this activity that causes a stock to go up or down. By monitoring trading activity, a technician can detect what the smart money is doing. The technician's tools of the trade are charts and various indicators that interpret price and volume characteristics. Technical analysis disregards most of the typical fundamental approaches. Technical analysis works simply because it is impossible to conceal trading activity since all trades are reported to the exchanges and available for all to examine.

Technical analysis has long been viewed by the majority of Wall Street professionals as some sort of voodoo, mumbo jumbo that had little if any predictive power and was not to be trusted. Brokerage firms have traditionally proclaimed their research expertise in deploying fundamental analysis to uncover tomorrow's big movers. Nothing could be further from the truth. The fact is that technical analysis is the only form of analysis that you can trust and with the right tools, it isn’t too difficult to understand and master.
Think of it in these terms. Imagine that you are playing blackjack in a casino. Skilled blackjack players have the ability to count the cards that are dealt and determine when the deck is favorable to the player, i.e. an abnormal number of 10's and face cards remain in the deck. When this occurs, they bet more money in anticipation of the dealer, who has to hit on 16 or lower, dealing himself a 10 and busting out. Imagine that you are in a game and the count is very favorable, meaning that there are twenty cards remaining in the deck of which sixteen cards are 10's and there are no aces. You would bet the ranch since the worst you can do is push, i.e. you and the dealer both get two 10's and tie. Now at the same time news comes across the ticker tape that the Federal Reserve Board has raised interest rates, Iran has bombed Iraq and unemployment has shot up during the previous month. Would you change your betting strategy? Of course not. It hasn't anything to do with the game you are playing.

The same is true in the stock market and it is the hardest thing for investors to understand. The stock market is a barometer, not a thermometer. A barometer measures barometric pressure that changes prior to changes in temperature while a thermometer measures the current temperature. The stock market measures economic conditions six to nine months in the future. It is not a gauge of what is happening now but of what will occur in the future. The only way for an investor to determine what will happen to a company’s stock in the future is to know what the smart money crowd is doing today. Let's say your neighbor is the president of XYZ corporation and he tells you that XYZ has made a major oil find that won't be disclosed until further testing is done to determine the richness of the find. Would you wait six months before you bought the stock? Of course not. You would start buying today in anticipation of the news. Depending on how many people had knowledge of the find, the stock's price would begin moving up as demand outpaced supply. The company's fundamentals would not appear to have changed but the technician would recognize that something good is about to happen.

"Trade Like A Pro" utilizes technical analysis to formulate a disciplined, consistent approach to investing in the stock market. It divides the process into three segments: Market Timing, Stock Selection and Money Management. In addition, there are sections that cover pertinent chart formations, reliable technical indicators and studies, short-term trading systems and a description of classic market situations that will keep you ahead of the crowd.

Shakespeare once said, "The play is always the same but the actors are different". The market is a gigantic play and it always works in the same fashion. However, the actors or investor’s mind sets are always changing. At market bottoms, they run for the hills convinced that the world is ending once again. Conversely, at major tops the ‘greed factor’ takes over and they can’t get enough of it rationalizing that "things are different this time around". Probably the easiest way to make money on a consistent basis is to Buy when everyone hates the market and Sell when they fall in love with it. The approach presented in this book is obviously more sophisticated than that. However, with a little bit of effort it can be mastered in a relatively short period of time.
Chapter One: Market Timing

Timing is everything. This is especially true when investing in the stock market. While the market can experience periods of extreme volatility, the reality is that around 70% of the time it remains in a sideways range. It is the 30% of the time that the market experiences significant moves, whether up or down where opportunity lies.

Identifying the market’s intermediate-term trend is critical. The stock market is like the ocean. When the tide comes in, of the boats will the tide. Such is the case with the stock market. When the market is in an uptrend, a large majority of stocks will follow the trend and move higher. Stronger stocks will obviously outperform the weaker ones but even the dogs will usually go up. Conversely, when the market heads south, few are spared the ensuing carnage with the fundamentally weak stocks seeing the brunt of the damage. If you don’t believe me, check out the number of advancing issues versus declining issues on the NYSE over a thirty-day period when the market, as measured by Dow Jones Industrial Average (DJIA) experiences either a 10% up or down move. What you will typically see is a large majority of the issues performing in line with the DJIA.

If one can accurately time the major moves in the market, 80% of the battle is over. Not only would bad stock selections be buffeted from major declines but by simply avoiding bear markets, long-term performance would be greatly enhanced. Add to this the capability to play the market on the short-side during bear phases and the game gets even better.

Most will tell you that it is impossible to accurately time the market. Surprise! It just isn't true. Granted it is tough to forecast every blip but it is not impossible to identify when the market is either favorable or to be avoided and to identify when these trends are changing. By mastering the market timing components described in this book, you should become proficient enough to forecast the market with better than 70% accuracy.

The Momentum Index

The Momentum Index is designed to measure market divergence by comparing the performance of nine non-Dow Jones Industrial Average (DJIA) indexes to that of the DJIA. Divergence is a technician's term that describes whether the DJIA is performing better or worse than the majority of the other market indexes. Whenever the DJIA goes its own way or diverges for a period of time, whether up or down, a market turn is usually at hand. Typically, negative divergence (DJIA is up while broader indexes are trending lower) exists at significant market tops, while positive divergence (DJIA is down while broader indexes are trending up) occurs at major market bottoms. In order to spot market divergences, the following indexes need to be followed on a daily basis:

- Dow Jones Industrial Average (DJIA)
- Dow Jones Transportation Index (DJTA)
- S&P 500 (S&P)
- NYSE Advances & Declines (A/D)
- NYSE New Highs & New Lows (H/L)
- NASDAQ Composite (NASDAQ)
- Dow Jones Utilities Index (DJUI)
- New York Stock Exchange Index (NYSE)
- NYSE Advance & Decline Line (A/D Line)
- American Stock Exchange (AMEX) or the Russell 2000

The Wall Street Journal provides this information on a daily basis or you can get the figures for the
whole week in the Market Laboratory section of Barron’s magazine. In addition, the Momentum Index is maintained on a weekly basis for Market Edge (www.marketedge.com) subscribers and is located in the in the Weekly Market letter under the Market Edge Feed section of the Home tab.

To track the performance of these indexes, set up a column paper or a spreadsheet with eleven columns. The only calculation that you will need to do is totaling the NYSE Advance/Decline Line (A/D Line). The A/D Line is a running total of the number of NYSE advancing issues minus declining issues and is an excellent indication of the market’s underlying strength or weakness.

You will be looking for those indexes that are making new highs or new lows on a daily basis. Star new highs with a black star and new lows with a red star. Bearish divergences occur when the DJIA makes a new high and the majority of the other indexes do not. Conversely, bullish divergences occur when the DJIA makes a new low and the majority of the other indexes don’t.

When new highs are being recorded by a majority of the market indexes and the DJIA is not, positive (bullish) divergence exists in the market pointing to higher levels for the DJIA. A bearish momentum setup would occur if the opposite scenario existed i.e. the DJIA records a series of new highs while the majority of the other indexes do not creating a negative (bearish) scenario. When the DJIA makes a new high and the majority of the other market indexes are doing the same, the DJIA’s move is said to be confirmed. Conversely, a new DJIA low which is accompanied by diverse moves from the majority of the other indexes is referred to as a non-confirmed move.

Typically, you will see a series of confirmed highs or lows over an extended period of time that can last for several years. When this occurs, the Momentum Index is telling you that the market is in a long-term bullish or bearish trend. When divergences do occur, the Momentum Index is sending a signal that a change in the prevailing trend is in the making.

Why does the Momentum index have predictive value? The Dow Jones Industrial Average is a weighted average of thirty blue chip stocks. It is the most widely followed equity index in the world and has over the decades become the standard measurement of the health of the US equities markets. Since the DJIA only contains thirty stocks, its performance can mask the underlying strength or weakness of the market as a whole. Look at it this way. The market tends to act much like the weather in that trends develop and tend to remain intact until they change. The market is either in an uptrend, a downtrend or a consolidation phase. Similarly, the weather is either warming (uptrend), cooling (downtrend) or stuck in a holding pattern (consolidation). Weather trends change very slowly creating the four seasons. Likewise, changes in major market trends occur over an extended period of time. Seldom is it the case that the DJIA turns on a dime and reverses its prior trend. Usually what happens is that during a bull phase, the DJIA makes a series of new highs, corrects and then continues on its merry way posting another series of new highs. Throughout most of the move, demand (money) exceeds supply (stock). At some point, the scenario reverses with supply (stock) out stripping demand (money) and the trend reverses as a bear phase takes hold.

During a bull to bear transition, the DJIA remains robust giving the appearance that the market is healthy and the trend is intact. However, underneath this veneer, the broader based indexes are beginning to deteriorate. The phrase "when the generals walk alone" describes this negative divergence as the Dow’s generals march to new highs while the broader market indexes falter. Of particular importance at this juncture is the action of the NYSE Advance/Decline Line and the number of NYSE New Highs/Lows. If the DJIA is making new highs while the A/D Line is declining, the number of NYSE New Highs is shrinking.
and the number of New Lows is increasing, you are witnessing the setup for a significant reversal of the market’s trend. Conversely, at major market bottoms the broader based indexes will begin to show signs of improvement long before the beaten down DJIA perks up. Again, improving action of the A/D Line and the number of NYSE New Highs/Lows are significant telltale indicators at this crossroad.

**The Sentiment Index**

Bull markets climb a wall of worry. They start when things look terrible. Usually the market has been in a long bear market, economic conditions are horrible and the public could care less about the stock market. Conversely, bear markets typically start when things look great. The market has been in an extended up trend, economic conditions are great and the public can’t get enough of Wall Street.

The Sentiment Index measures the market's bullish or bearish sentiment and is an important tool when determining the market's future direction. As with the Momentum Index, the procedure that follows reduces the prevailing market sentiment to an absolute value. The following indicators are included in the Sentiment Index which is maintained on a weekly basis for Market Edge (www.marketedge.com) subscribers. It is located in the Weekly Market Letter under the MarketEdgeFeed section and measures excessive speculative or sentiment conditions prevalent in the market.

1) Odd Lot Short Ratio: The number of Odd Lot shares sold short divided by the total number of Odd Lot sales: 10% to 50% is Bullish, 6% to 9% is Neutral and 0% to 5% is Bearish. The Odd Lot Short Ratio measures the activity of the less sophisticated investor on the street, the odd lotters. When the odd lotters heavily short stocks resulting in a high short ratio, 10% or higher, it is typically a sign of a market bottom. Conversely when the odd lotters are extremely bullish, neglecting the short side of the market, a top is usually at hand. This ratio can be calculated on a weekly basis. The numbers can be found in Barron’s Magazine in the Market Laboratory section.

2) NYSE Short Interest Ratio: The number of shares sold short on the NYSE divided by the average monthly trading volume: 3.5 to 9.0 is Bullish, 3.0 to 3.5 is Neutral and 0 to 3.0 is Bearish. The NYSE short ratio, unlike the odd lot short ratio, is a measurement of sophisticated investors trading activities. Its importance lies in the fact that shares sold short must eventually be bought back providing potential Buying power for the market. The indicator has lost some of its significance since the mid 1980’s as a plethora of trading strategies were developed that employed shorting shares as part of the approach which artificially inflated the ratio. This ratio is published weekly in Barron’s magazine in the Market Laboratory section.

3) Public-Specialists Short Ratio: The number of NYSE shares sold short by the public divided by the number of shares sold short by the specialists: over 60% is Bullish, 36% to 59% is Neutral while less than 36% is Bearish. NYSE specialists are the most sophisticated traders on the street. Their function is to maintain an orderly market in the stocks in which they make a market. They accomplish this by Buying stocks when there is an imbalance of buy orders on their books and by shorting stocks when there is a shortage of supply. When the ratio moves over 60%, it reflects a situation whereby the public is shorting more stock than the specialist, which is a bullish condition. This can be the result of either a large public short condition, which must be covered, or a small specialist short position due to a lack of Buying pressure in the market. Either scenario sets up a bullish condition for the market. Conversely, when the ration declines below 36% it reflects a situation whereby the public is shorting less stock than the specialist is. This can be the result of either a small public short condition, which doesn’t provide any fuel to the market, or a large specialist short position due to large Buying pressure in the market. Either scenario sets up a bearish condition for the market. This indicator is published on a daily basis in Investor’s Business Daily.
4) Put-Call Index Option Ratio: A five or ten-day moving average of the number of CBOE Index put options divided by the number of index call options: 70% and higher is Bullish, 41% to 69% is Neutral and 0% to 40% is Bearish. The Put-Call Option Ratio is an excellent measure of current bullish/bearish sentiment in the market. Whenever the crowd gets overly bullish or bearish, odds favor the market heading in the opposite direction. Note that this ratio is compiled from index puts and calls not the equity options. Individual stocks are subject to numerous arbitrage and trading strategies that involve the use of options as a hedging mechanism to provide accurate sentiment readings. The five-day put/call totals are available in Barron’s magazine in the Market Laboratory section.

5) Dividend Yield Spread: The relationship between the yield (dividend rate) for the stocks in the DJIA and the yield on the highest-grade corporate bonds: +3.00 to +5.74 is Bullish, +5.75 to +6.75 is Neutral, +6.76 to +9.99 is Bearish. A low spread is bullish since it indicates that on average, the rate of return from dividends compares favorably to those from high-grade corporate bonds. Large differences suggest that higher yields can be gotten from bonds, a negative for stocks. This ratio is published weekly in Barron’s magazine in the Market Laboratory section.

6) Mutual Fund Liquid Asset Ratio: The ratio of mutual fund cash to total assets. 11% and higher is Bullish, 9% to 10% is Neutral and 0% to 8% is Bearish. With the explosion of mutual funds in the 1990’s, the liquid asset ratio has become a significant sentiment indicator. When cash levels fall below 8%, the public exposes the funds to potentially forced sales in the event of a rash of redemptions. Conversely, when funds have a surplus of cash, 11% and up, explosive Buying potential exists. This indicator is published in Investor’s Business Daily.

7) Bullish Investment Advisors: The percentage of newsletter writers who are Bullish on the prospects for the market as measured by Investors Intelligence: 0% to 35% is Bullish, 36% to 54% is Neutral 55% to 99% is Bearish. The majority of newsletter publishers utilize trend following methods in determining their market calls and stock selections. As a result, this indicator typically trends either up or down in step with the market. As the market moves higher, a greater number of advisors hop aboard resulting in an increase in the Percentage of Bullish Advisors. Assuming that individuals follow these advisors recommendations, the amount of available cash that they have earmarked for stocks declines leaving less fire power to fuel the advance. This number is published weekly in Barron’s magazine in the Market Laboratory section or in the Thursday edition of Investor’s Business Daily.

8) Bearish Investment Advisors: The percentage of newsletter writers who are Bearish on the prospects for the market as measured by Investors Intelligence. 50% to 99% is Bullish, 21% to 49% is Neutral, and 0% to 25% is Bearish. This indicator also trends either up or down in step with the market. As the market moves lower, a greater number of advisors give up the ghost resulting in an increase in the Percentage of Bearish Advisors. Investor’s cash reserves that are earmarked for stocks rises leaving a reservoir of potential firepower to fuel the next advance. This number is published weekly in Barron’s magazine in the Market Laboratory section or in the Thursday edition of Investor’s Business Daily.

9) Bearish + Corrections Total: The total percentage of newsletter writers who are either bearish or forecasting a correction for the market as measured by Investors Intelligence: 0% to 29% is Bearish, 30% to 69% is Neutral, 70% to 99% is Bullish. The correction figure is simply the difference between the sum of the bullish and bearish advisors less 100. A lot of newsletter writers never take a bearish stance while always expressing concern for the potential of a market correction. By taking this stance, they can claim that they are always right. By combining both the percentages of advisors who are bearish and those who
are warning of a correction, a truer picture of the market's advisor sentiment is formed.

To keep track of these indicators, set up a column paper or a spreadsheet with ten columns. As with the Momentum Index, star bullish conditions with a black star and bearish conditions with a red star. Leave neutral readings blank. Each indicator should be assigned a +1, -1 or 0 value depending on whether its reading is deemed to be bullish, bearish or neutral. The sum of these values is the Sentiment Index. Plus 2 to plus 9 readings are bullish, indicating that the crowd is bearish while minus 1 to minus 9 readings are bearish reflecting an over confident attitude. Seldom do these totals reach the extremes. Typically, the number will fluctuate in the +3 to -3 range. However at major tops or bottoms, when it looks like either the market is going to the moon or down to zero, the index has the potential to move into the +7 to -7 area.

**General Conditions**

The indicators incorporated into the Sentiment Index are hard figures that are generated on a daily or weekly basis. They can be quantified and included in a model. However, attention needs to be paid to general conditions that can't be quantified but usually exist at major bull market tops or bear market bottoms. These conditions are also contrarian in nature while measuring investor's emotions at major turning points.

**Market Tops:**
1) Everything looks great. The financial publications proclaim that economic conditions are great and good for the stock market. Unemployment is low, interest rates are low, inflation is non-existent and corporate profits are soaring.

2) The market has been in a long extended bull phase, typically between 32 - 36 months.

3) The "It's Different This Time" theory is promoted by the financial geniuses who continue to rationalize that despite historical benchmarks, the market will continue to roll this time around.

4) Major bullish headlines appear in the media. Remember when gold was approaching $1,000/ounce in late 1970 and oil was heading to $150 a barrel in 2005? Both prophecies appeared on the covers of Time and Newsweek magazines. Both commodities topped out days after these publications appeared. Moral of the story-by the time the media guys figure out that something is red hot, the party is usually over.

5) Consumer confidence approaches record highs. People are not optimistic because they are going to Buy stocks, they are optimistic because they already have bought stocks, typically at very high prices.

**Market Bottoms:**
1) Everything looks horrible. The financial publications paint a gloomy picture. Unemployment is high, interest rates are high, bankruptcies are soaring and corporate profits are tanking.

2) The market has been in a long extended bear phase, typically between 12 - 16 months.

3) The "Its Different This Time" theory is circulated by the financial geniuses who continue to rationalize that despite historical benchmarks, the market is going to zero.

4) Major bearish headlines appear in the media. Remember when inflation was running at 18% - 20% in
1981 - 1982 and interest rates were going through the roof. Had you believed the media you would have concluded that there was no way out of that mess.

6) Consumer confidence approaches record lows. People are not pessimistic because they are going to sell stocks. They are pessimistic because they already have sold stocks, typically with large losses.

   Always remember that the market does not move in step with the economy. It leads the economy. By the time the good news comes out, the market has already moved up in anticipation of that news. There is no need to methodically track these conditions. By being aware of what is going on, you will know when either extreme bullish or bearish conditions permeate the market.

   By incorporating the readings from the Sentiment and Momentum Indexes into an overall market timing model you will have at your disposal a powerful tool which will give you the confidence and conviction you need when forecasting the market’s future direction. However, there will be periods when you will get conflicting signals from your Momentum and Sentiment Indexes. Seldom is the case when all of the indicators will be in sync, i.e. all bullish or bearish. The fact is that most technical indicators are not very reliable on their own. However, when the majority are either bullish or bearish, the odds are good that the forecast will be accurate.

   As you have probably figured out by now, correctly forecasting the market is the most important skill that you can develop. Remember that on average the market has 2 to 3 significant moves in a year. As you become proficient in this area, you will alter the way that you have approached the market in the past as you gain an understanding of how the game is really played.
Chapter Two: The Game Plan

The vast majority of individual investors lack a sound strategy when it comes to the stock selection process. Everyone is looking for the next home run which typically leads them to small stocks that have a great story, are heavily promoted and in reality have a 100-1 shot of ever fulfilling the promise. Traders that look to short stocks are typically drawn to the high flyers that are making new highs every day assuming that they will have to fall back to earth one of these days. Both of these approaches will usually lead to lousy results.

A successful strategy for selecting stocks should be based on the principle of not losing money instead of trying to amass a fortune. To accomplish this goal, it is necessary to have the odds on your side, have a realistic expectation of what can be achieved and a consistent, disciplined approach that must be adhered to.

With the help of the market-timing model described in Chapter 1, you should know when market conditions are favorable and that is half the battle. Temptations to buy a "hot stock" during periods when market conditions are not good must be avoided. Understand that if you lose 40% on a stock you have to make 67% on the next one just to get even. Dropping 40% on a stock in a bear market is easy; making 67% in any market environment isn’t. If you think you are going to turn $10,000 into $100,000 every year, you might as well put this book down right now. During the explosive bull run that occurred from January 1, 1991 through December 31, 1997 the DJIA gained 5275 points as it moved from 2633.66 to 7908.25. This represented a 200% gain and an average annual increase of 20.2% with no down years. These types of returns don’t represent the norm. However, it provides a reference point as to the limits that one can hope to achieve.

The Stable

Just like a successful thoroughbred horse trainer, you need to create a stable of stocks that you should follow on a regular basis. The stable should contain liquid stocks with average daily volume, of at least 200,000 shares per day, preferably optional and in the $15-$50 price range. The liquidity requirements assure that you will be able to get in and out of positions without getting killed by slippage. Stocks that trade 200,000 or more shares per day typically trade in narrow spreads and can absorb your Buy or Sell orders without disturbing the market. Stocks that have listed options are also preferred since in some instances, you will want to write (sell) options against your existing positions or use them to hedge your position. Finally, stocks in the $10-$50 range will allow you to initiate a decent position, i.e. enough shares to matter based on a percentage of your capital.

You should create a stable of between 50 - 100 stocks. Try to include those stocks that you are familiar with to some extent. Either create one master list or preferably, produce a Buy list and a Short-Sale list.

Buy Candidates

There are several technical indicators that identify stocks that, from a technical aspect are in a
healthy condition and have a high probability of going up in price. All of these indicators are included on the Market Edge (www.marketedge.com) Second Opinion report and can be charted in the Charts module. The following is a brief description of these indicators and an explanation of why they are important tools when identifying good Buy candidates.

**Relative Strength:** Relative Strength is a measurement of a stock’s performance versus the performance of the S&P 500 index. To calculate this ratio, take the stock’s closing price minus the price of the stock 50 days ago and divide that number by the closing price from 50 days ago to get a percentage increase or decrease for the period. Do the same with the S&P 500. Now divide the stock’s percentage change by the percentage change of the S&P 500. This is the 50-day Relative Strength for the stock. Relative Strength ratings of 1.01 or higher identify stocks that have outperformed the S&P 500 over the last 50 days. Readings of .99 or less identify those stocks that have underperformed the S&P 500. Stocks being considered for Long positions should possess Relative Strength ratings of 1.05 and higher, while Short-Sale candidates should have ratings of .95 or less. The line located at the bottom of UTX’s chart is the 50-day Relative Strength.

**On-Balance-Volume:** Joseph Granville developed the original theory of On-Balance-Volume (OBV). The basic assumption underlying this technique is that the market is divided between "Smart Money" and the "General Public." Smart money accumulates stocks at low prices and distributes it to the general public at higher levels. By analyzing a stock’s OBV, you can detect the smart money’s accumulation or distribution activities before significant price moves occur.
OBV is computed in the following manner. If a stock closes up for the day, the total volume for that day is considered to have been buying induced and therefore the stock is under accumulation. Conversely, if a stock closes down for the day, the total volume is regarded as having been selling induced and the trading activity is considered to have been a day of distribution. The volume on up days is totaled against the volume traded on down days. The net is a running total of OBV, and is either a positive or negative number.

Calculate net OBV totals based on trading activity during the preceding 40-days. What you are looking for is a stock whose OBV total is increasing meaning that the stock is under accumulation. The best scenario is when a stock's OBV is at a higher level than it was when the stock was previously at the same price level. This condition suggests very smart buying by informed money and is usually a prelude to a sharp advance by the stock. Global Partners LP (GLP) 40-day OBV is plotted at the bottom of the chart located below. Compare where OBV was in early July 2015 when the stock was trading around $33.00 and then in early September 2015 when GLP approached $33.00 again. This type of positive divergence identifies major accumulation that typically results in a significant move to the upside.

50-Day Simple Moving Average (SMA): Add the closing prices of the stock over the previous 50 days and divide the total by 50. This is the stock's 50 day simple moving average (SMA). When the 50-day moving average turns up, the odds are in your favor that a tradable trend is in place and is likely to continue for a minimum of 25 days. The chart below shows the 50 day SMA for Amerigas (APU) turned up in mid-December 2014 when the stock was around $46 and trended higher as the stock moved to the low $50's by early February 2015.
**Moving Average Convergence Divergence (MACD):** MACD is a sophisticated, technical indicator developed by Gerald Appel. MACD incorporates three exponential moving averages of price into an indicator that gives Buy and Sell signals based on crossovers of the various averages. A standard MACD setup consists of a signal line, which is the difference between the 12 and 26 day exponential moving averages and the directional line which is the 9 day exponential average of the signal line. MACD Buy signals occur when the directional line crosses the signal line from below. Sell signals are generated when the reverse occurs.

The MACD indicator is displayed on the bottom of Boeing's chart displayed below. The signal line crossed the directional line from below on 12/30/14 ($131.83) producing a Buy signal. A Sell signal was created on 03/24/15 ($151.65) when the signal line crossed the directional line from above.
Once you identify a stock that meets one or more of the above criteria, you will need to develop a method for determining when to pull the trigger and actually buy the stock. There are several techniques and indicators that you can use to identify entry points. The stochastic oscillator is an indicator that identifies overbought and oversold conditions and is a good tool when identifying entry points. The stochastic oscillator compares where a stock’s price closed relative to its trading range over x-time periods. Values range from 0 to 100. Readings over 80 signal an overbought (Sell) condition, while readings below 20 are regarded as an oversold (Buy) situation. There are two stochastic indicators, Slow (%K) and Fast (%K). The difference between the two is that Slow %K is a smoothed version of Fast %K, typically with a 3 day moving average and is therefore less erratic.

As you accumulate Buy candidates, monitor them on a daily basis checking for the Slow %K stochastic oscillator to fall below 20 signaling an oversold (Buy) condition. A more sophisticated approach is to buy the stock when Fast %K is below 20 (oversold), is increasing in value and crosses Slow %K from below. Market Edge subscribers can monitor several lists of stocks in the ‘Stock Watch’ module waiting for
stochastic Buy signals. Fast %K and Slow %K are plotted on the bottom of the General Motors (GM) chart located below. As can be seen from the graph, Fast %K crossed Slow %K generating a Buy signal on 10/15/14 ($29.69) and again on 12/16/14 ($30.73).

Short-Sale Candidates

Shorting stocks in a bear market can be a very rewarding experience. For whatever reason, most investors seldom short stocks. It could be that they feel that there is an unlimited risk when shorting stocks or it is just a non-American thing to do. It is true that when you short a stock your potential loss could be unlimited. A stock shorted at 20 could go to 200 but any sane person should use Buy Stop orders when initiating Short-Sales to prevent such a disaster. The fact is that shorting stocks can be very profitable, it is cheaper than Buying stocks on margin and when right, can generate profits at a much faster clip than most long positions. It is no secret that most things, including stocks, go down a lot faster than they go up. If you don't believe this phenomenon, see how long it takes you to climb up the stairs of the Empire State Building. Then jump!
You will want to monitor the same set of technical indicators when looking for Short-Sale candidates as outlined previously but they should be viewed in an opposite fashion. Stocks that meet some of the following conditions will have a weak technical condition and have a high probability of going down in price. What you are looking for are stocks whose Relative Strength is less than .95. The OBV total is decreasing, meaning that the stock is under distribution. The 50-day simple moving average is pointed down, signifying that a down trend is in place and is likely to continue and the MACD directional Line has crossed below the Signal Line from above. Again, use the stochastic oscillators to identify overbought conditions (readings over 80) which would signal an entry point or short the stock when Fast %K is above 80 (Overbought), is decreasing in value and crosses Slow %K from above.

Contrary to logic, initiating a Short-Sale is not the same process as opening a long position. First of all you will have to get permission from your broker to short the stock so your broker can borrow the shares that you are selling but don't own for delivery to the buyer.

Here is what happens. Your broker contacts his stock loan department to see if the stock is long in the firm's vault, meaning that other customers are long the stock in margin accounts and have had them held at the firm instead of taking delivery. Whenever you open a margin account, a line in the margin agreement allows the brokerage firm to loan your stock at their discretion. If the brokerage firm doesn't have any stock, they call other firm's stock loan departments and try to borrow the stock from them. If your broker tells you that you can't short the stock because there is none to borrow, breathe a sigh of relief and walk away. Don't even think about buying put options as an alternative. Here is why. If there is no stock to loan, this tells you that there is a massive short position in the stock. Remember, if you are short a stock, some day you will have to cover the position by buying back the stock. If there is a substantial short position, the potential exists for a short squeeze whereby everyone that is short rushes to buy back the shares causing a big run to the upside, something that you don't ever want to experience. Remember, you always want the odds in your favor and shorting a stock that has a large short interest ratio (# of shares sold short / the average daily trading volume) is like spitting in the wind.

The short position will be placed in a segregated short account. Your short account will receive a credit but it will not earn any interest unless you can negotiate a deal with your broker. You are liable for any dividends that the company pays out while the short position is open and are subject to margin and maintenance requirements as with long positions.

Options

Options can be a good tool when hedging positions, protecting your portfolio from disasters and increasing your over all returns. This can be accomplished by implementing some of the the following basic strategies:

**Selling Covered Calls:** A covered call is a call option sold against an existing long position. As long as you sell the same number of call options, one contract per 100 shares of stock, there are no additional margin requirements and you keep the premium from the sale. The risk is that if the stock trades above the strike price, your stock will get called away and any further gains will be lost. Another problem that can arise is that if you get stopped out of the position, you will have to immediately buy back the option but it will obviously be trading at a much cheaper premium. This is not something that you will want to do for every position simply because the option's premium may not be large enough to warrant the risk.
**Selling Covered Puts:** The same strategy as outlined above but employed with put options against Short-Sale positions.

**Buying Puts Against A Long Position:** Instead of using Stop loss orders, put options can be used to protect a long position from a serious decline. The advantage to this strategy is that you don't have to liquidate your position until the option expires at which time you would sell both positions.

**Buying Calls Against A Short Position:** The same strategy as outlined above but employed with call options against Short-Sale positions.

**Buying Index Calls & Puts (Portfolio Insurance):** There are several index ETFs that have listed options which can be used to protect a portfolio against adverse market moves. OEX is the symbol for the S&P 100 Index, DIA, the symbol for the Dow Jones Industrial Average and SPY for the S&P 500. These ETFs trade in conjunction with their respective index.

Index options are good vehicles to hedge a portfolio that is either net long or short. Let's assume that you have a $100,000 portfolio that is invested on the long side. If the market took a 10% hit, odds are that most of your positions would be stopped out resulting in a 10% loss or $10,000. Buying DIA index puts in the proper ratio would lessen the blow. Each point move by the DIA equals $100 and reflects a 100-point move by the DJIA. If the DJIA dropped 10% from 18000, the DIA puts would gain around 18 points or $1800. To hedge a $100,000 net long portfolio that could lose $10,000, you would need to buy 6 DIA put options. If your portfolio were net short, your hedge would be accomplished by buying DIA call options in the same ratio.

When I started in the business back in 1978, options had only quarterly expirations or four expirations a year. As you might guess, a lot has change since then. In 2010, options with weekly expirations were introduced which opened up a whole new ball game. Weekly options have grown to be the hottest option product in the U.S. market.

With weekly options, there are many different strategies available to individual traders which range from conservative, yield enhancement approaches to risky, speculative methods of trying to hit a home run. They all have their good and bad points. So what is my favorite approach? I would have to say that selling weekly credit spreads gives you the best opportunity to take advantage of the great leverage inherent in options while limiting your risk, which is very important. Most people don't understand that approximately 70% of options expire worthless so it makes a lot of sense to do what the professional floor traders do – *Don't Buy them, Sell them*. The best way to sell them is via a credit spread, which is the sale of an option, either a put or call and the simultaneous purchase of a similar put or call at a different strike price. Sounds confusing? It can be at first but the basic strategy is very simple.

In 2017, Computrade Systems Inc. formed a joint venture with one of my life long friends, Bob Seifert - a.k.a. Mr. Seifert. Mr. Seifert is a thirty-five year veteran option trader. For almost twenty years, he was a market maker for options at the CME, CBOT and CBOE in Chicago. He founded and managed two successful floor trading operations and taught option strategies to hundreds of successful traders. He also taught Finance 485 - Applied Derivates at the University of Nevada Las Vegas - UNLV. It was the most advanced option course offered at UNLV.

Unlike most of the self proclaimed option gurus on the internet, this guy knows what he is talking about. The result of the partnership was a new company called The Optionomics Group LLC, which
combines Mr. Seifert’s proven option trading strategies with the computerized stock selection techniques develop by Market Edge. It’s a great one-two punch that you can put to work right off the bat since they do all of the work for you. You can check out their web site at www.optionomics.com. They offer a Free 2-Week Trial to all of their subscription services plus a Free copy of Mr. Seifert’s latest book “Trading Options My Way”. This book provides detailed descriptions of the various strategies used by Mr. Seifert and other professional floor traders. I doubt that you have ever seen anything like this.

Price Projections

When approaching the stock market, there are times when you should be long, times when you should be short and times when you should ‘go fishing’. So far, we have described two market timing models that identify favorable or unfavorable market conditions but nothing that suggests when it’s time to go fishing. As noted above, a good time to go fishing is when the indicators are in a conflicting status. Another good ‘go fishing’ scenario is when projected price targets for either the market or an individual stock are modest which creates a lousy risk-reward ratio.

There are several techniques which can help you determine both short and intermediate-term price projections for both the DJIA and individual stocks.

Moving Averages: One of the most reliable price projection techniques is obtained by analyzing the 10-week or 50-day simple moving average (SMA) of the closing prices of a particular stock. When the moving average turns up, note the closing price of the stock. Now count back either 5 weeks or 25 days and note the closing price. Take the difference between the two closes and add it to the most recent close. The total, +/- 10% of the difference is the preliminary target which should be achieved over the ensuing 5-6 weeks.
To illustrate how this works, refer to the weekly chart for Apple Computer (AAPL) located above. A 10-week simple moving average has been overlaid on the chart. Apple put in a double bottom in late June 2013 and began to move higher. On 08/02/13, its 10-week moving average turned up when the stock closed at $66.14. To determine the intermediate term target, count back 5 weeks to 06/28/13 and note the close for that week ($56.70). Subtract $56.70 from $66.14 ($9.44) and add the difference to $66.14. The result is a price projection of $75.58, +/- 10% ($0.94 points) or $74.64 - $76.52 over the ensuing 5-7 weeks. As it turned out, AAPL traded above the high end of the range the week ending 11/1/13 ($77.11). Note that the rally did not end once the target was achieved. AAPL continued upward and topped out on 12/06/13 at $82.25. This will occur on many occasions and shouldn’t be of concern. The initial projection was based on a 5-6 week time frame. In this example it took almost twelve weeks to hit the high end of the projected range.

Reverse the process when looking to short a stock or index. When the simple moving average turns DOWN, note the closing price for the stock. Count back 5 weeks or 25 days and note the closing price. Take the difference between the two closes, +/- 10%, and subtract it from the most recent close. That is your preliminary target that should be achieved over the next 5-6 weeks.

Computing targets in this manner gives you another tool when narrowing your stock selections. Using the 10-week moving average is measuring the stocks short-term momentum. A large projected gain simply means that the stock has been experiencing a powerful move over the past 5 weeks, a move that is likely to continue. When selecting stocks, you obviously would rather buy one that has a 25% upside potential versus one with only a 5% projection. It should be noted that the price target generated via this
technique is only the initial forecast. It is by no means to be construed as the ultimate top in the stock's move. So when do you sell? The answer is whenever you want to. Sound strategies could include selling when the stock reaches its target, exiting if the stock falls below the protective Stop or blowing out the position when your stomach can't handle it any more. Whatever you do, once you’re gone don't go back. When you decided to get into the stock, conditions were very favorable. The only time that you should reenter the stock is after a correction of some sort and favorable conditions are once again prevalent. It is important not to get emotional about a stock or the process since this is 'strictly business’. Never looking back is a good way to avoid becoming married to a stock.

**Head and Shoulder Formations:** Although seldom seen, Head & Shoulder formations are very powerful chart patterns and can signal major structural changes in the trend of a stock or index. The significance of a Head & Shoulder formation is the penetration of the neckline. Once this occurs, a drop in prices is usually eminent. To determine the first price objective, measure the distance from the center of the head to the neckline and subtract it from the neckline value located at the center of the head. This will give you the first price projection. Usually this level will be achieved rather quickly with more down side to follow.

The chart for Green Mountain Coffee (GMCR) located above shows a Head & Shoulder pattern which was formed from mid-September 2014 through mid-January 2015. The neckline, which connects the bottom of the left and right shoulders, was around $127. The head was formed on 11/18/14 when the stock
topped $158. The difference between the neckline and the head of the formation was 32 points. Subtracting 32 from the neckline produced a price projection of $95 which was achieved on 05/07/15. This same technique works when a Reverse Head & Shoulder formation develops. Simply reverse the procedure to determine the preliminary price projection to the upside.

**The 50% Principle:** When a stock or index declines for a period of time and then begins to rally note the number of points that the stock has lost from its previous peak to the most recent bottom. If the stock rallies back more than 50% of the previous decline, the odds are good that it will recover the entire loss. The faster the 50% retracement occurs, the higher the probabilities that a complete retracement will occur.

American Airlines (AA) experienced a 50% retracement over the June – October 2014 time frame. As can be seen from the chart below, the stock got slammed from $44.88 to $28.10, a 16.75-point loss, over a four-week period beginning in late June 2014. Then the stock began to rally. The 50% principle was activated as the stock crossed $36.50 on 10/21/14 pointing to a complete retracement of the previous decline. By mid-November, the entire loss was recovered as AA traded through the $45 area.

**Extended Chart Base Formations:** Often, a stock will get hammered and the price will remain depressed for an extended period of time. At some point, one of two scenarios is likely to develop. Usually, the fundamental reason behind the sell off gets resolved and the stock, after having traded in a narrow range for a long period will begin to recover. When the stock breaks out of the basing pattern, measure with a ruler the distance on the chart from the beginning of the base to the spot where the stock broke out of the
basing pattern. Place the ruler on a forty-five degree angle with the left edge of the ruler at the breakout point in the center of the trading range. Where the right edge of the ruler lays on the chart is the price projection for the stock.

The DJ Utility Index (DJUI) remained in a narrow trading range from July 2013 until February 2014 between 471 and 510. The index broke out or the trading range in mid-February. As can be seen from the chart below, the forty five-degree line at the time of the breakout forecasted a move to the 565 area by September 2014. DJUI surpassed 565 in late June, corrected and then rallied back to the target area in mid-September 2014, right on schedule.

Protective Stops

By developing a systematic, disciplined approach to the market, you will greatly reduce the probability of losing money. One of the most important tools in your arsenal should be the use of properly placed Stop loss orders. Selling a stock at a loss is probably the hardest thing for an investor to stomach. Understand that a loss is a loss whether you realize it or not. When the ship is sinking-jump, don’t pray. Turning a small loss into a large loss is the worst thing that you can do. Not only will it hinder your overall performance, it will wear on your confidence. By using Stop loss orders you will be forced to do the right thing at the right time. Accept the fact that if a Stop loss order is properly placed, a penetration of that price point is telling you that a significant support area has been broken and the odds favor a reversal of the perceived trend.
As long positions are opened, you should immediately enter Sell Stop orders, good till canceled (GTC). The best method of determining Stop loss levels is derived from a form of analysis called ‘Cyclical Analysis’. Locate the most recent identifiable, cyclical low from the time the position was originated and deduct 1/2 of a point from that low to produce a protective Sell Stop. The Stop should remain unchanged if the price of the stock moves adversely from its opening price. The Stop should change if the price of the stock moves favorably in which case the Stop would be adjusted up with the stock. The following chart for Big Lots shows proper adjusted Sell Stops as the stock moves up in price.

The opposite is true for Short-Sales. Locate the most recent cyclical high from the time the position was originated and add 1/2 of a point to that high to produce a protective Buy Stop. The Stop should remain unchanged if the price of the stock moves adversely from its opening price. The Stop should change if the price of the stock moves favorably in which case the Stop would be adjusted down. The following chart show proper adjusted Buy Stops as Blackrock Energy (BGR) moves down in price from $21.50 in late April 2015 to below $14.00 in August 2015.
Using Stops to close a position has its advantages. Since you should be on the right side of a favorable move, you will realize most of the potential gains by letting the market take you out of the position. The problem is that most stocks typically trade in a 10% to 30% range and using Stops will usually result in a series of small gains. Better results can be achieved by determining price targets and exiting when they are reached. Several methods of determining targets are listed in Chapter 2.

Money Management

Probably the most important part of the ‘Game Plan’ is the development of a properly structured money management strategy. The secret to making a lot of money in the market is by compounding returns. With the advent of internet brokerage accounts in the mid 1990’s, the cost of transactions is practically zero. With the cost of trading no longer an issue, a major roadblock has been removed from the decision making process. The main premise of a sound money management plan is to invest the same percentage of one's investment capital in each stock selection. Depending on the size of your bankroll, percentage allocations should vary between 5%-10%. This would translate into a portfolio consisting of 10-20 stocks when 100% invested. Using the approach that has been outlined so far, you should be right on your market calls around 70% of the time. Your stocks should also make money 70% of the time with your winning trades outperforming your losers by a 2 to 1 ratio.
Let's assume that you apply 10% allocation with a bankroll of $100,000. You would invest $10,000 in ten different stocks. Suppose that seven of these stocks (70%) result in an average gain of 20% for a gain of $14,000. Three result in an average loss of 10% or $3,000 resulting in a gain of $11,000. Commissions at your friendly on-line brokerage firm should be around $8 per trade or $16 round turn ($160) leaving you with a net gain of $10,840.

Typically the stock market experiences three significant moves a year. These patterns are either an up-down-up scenario or a down-up-down pattern. This type of market activity should provide you with at least three opportunities to turn your portfolio a year. By duplicating the above example, you would realize a net gain of $32,500 or 32.5% per year. If you leverage your account to the hilt, $32,500 would turn into a net gain of $65,000 or 65.0% year. Margin interest charged in a leveraged account should be offset by dividend income.

If you compound your returns, the picture gets even rosier. The first swing, you invest $100,000 and return $10,840 (10.84%). Round two you would invest $110,840 and net $12,015. Round three you would invest $122,855 and net $13,317 for a total gain of $36,173 for the year (36.1%). Compounding and trading on 50% margin would boost your return to 72.3% the first year.

While these results are a big deal over a one-year time frame, things really start to balloon if you carry the exercise out over a five-year period. Your original bankroll would grow to $468,218 in a cash account and $936,435 if leveraged at 50% margin. That works out to a total gain of 368.2% (cash account) and 836.4% (margin account) over the five-year period.

I think by now you get the picture. Compounding profits can greatly increase your returns. In the real world the duplication of this scenario is highly unlikely. Somewhere along the road you will find yourself in a market environment that makes no sense. Remember, leverage is a two-edged sword. When the wheels come off and you experience a string of losing trades, your bankroll will not grow on a linear basis and you're overall results will be reduced. When the inevitable losing streaks occur, the best advice is to go fishing and wait until things get back in sync.
Chapter Three: Short-Term Trading Strategies

With the advent of on-line brokerage accounts and the low transaction costs that they charge, short-term trading strategies or even day trading schemes have become very popular among individual investors. For the record, I don’t advocate such strategies simply because it is hard enough to beat the market with an intermediate-term approach. Trying to spot short-term moves is very difficult. However, in the interest of those that have this ‘seat of your pants’ trading mentality, the following combination of technical indicators and studies should help you isolate stocks that posses a good probability of performing favorably over the short-term.

The strategies that follow are not to be construed as trading systems per se since they only provide entry points and not exit points. Don’t make the mistake of assuming that a trading approach that generates Buys or Short-Sale signals should be used to reverse a position. The reason this doesn’t work very well is that by the time a system gives you a Short-Sale signal following a Buy signal the potential gains from the Short-Sale will probably have dissipated to an unacceptable level.

By combining several un-correlated technical indicators, entry points for various trading strategies can be developed which will generate Buy and Short-Sale signals that have a good probability of success. Exit points are left to the discretion of the user. The following discussion describes the indicators that should be combined to create either day trading (1-2 days) or short-term (1-2 weeks) trading approaches.

In order to implement these strategies, you will either need a sophisticated charting program that has the various indicators or spread sheet software and poses the programming skills to write the appropriate formulas. Better yet, subscribe to Market Edge whose ‘Advanced Tools’ module contains all of the following trading strategies that produce both Buy and Short-Sale candidates on a daily basis.

**MOVING AVERAGE CONVERGENCE/DIVERGENCE (MACD):** Developed by Gerald Appel, MACD utilizes various exponential moving averages of a stock’s closing price to generate Buy and Sell signals. Exponential moving averages assign greater weight to the most recent price data and therefore are more sensitive than simple moving averages. MACD consists of the Differential Line and the Signal Line. The Differential Line is constructed by measuring the difference between two exponential moving averages, typically a 12 and 26-day time period. The Signal Line is a 9-day exponential moving average of the Differential Line. Buy signals are generated when the Differential Line crosses the Signal Line from below while Sell signals occur when the Differential Line crosses the Signal Line from above.

For the Differential line to cross the Signal Line from below the difference between the 12-day and the 26-day exponential moving averages must widen (diverge). For this to occur the shorter term moving average (12-day) must move away from the longer term moving average. The Buy signal is triggered when this divergence is sufficient enough to cause a cross of the Signal Line.
The above chart shows a great example of a MACD Buy signal which occurred on 08/06/15 for Central Garden & Pet when the stock was $11.24 on its way to over $15 by 09/09/15.

**10 & 21 DAY MOVING AVERAGE CROSS:** The A stock’s moving average is the average of the closing prices over a designated period of time. The last point of a ten-day moving average is the average price that the stock closed over the last ten trading days. The second to last point is the average close of the next most recent 10 days, and so on. These points are plotted over time to form a graph representing the smoothed price movement of the stock. The fewer the number of days used in a moving average, the more erratic the moving average will be.

Many traders employ the use of moving averages in their trading strategies. Typically these strategies are based on crossings of faster and slower moving average to trigger Buy and Sell signals. The logic behind this approach is that as a fast moving average crosses a slower moving average, the price trend of the stock is reversing. Research has demonstrated that this methodology is not always profitable and can result in numerous whipsaws and losses. However, moving average crosses are effective in establishing good entry signals for either Long or Short-Sale transactions.

Moving average cross Buy signals are generated when the faster moving 10-Day Moving Average crosses the slower moving 21-Day Moving Average from below. Conversely, Short-Sale signals are generated when the faster moving 10-Day Moving Average crosses the slower 21-Day Moving Average from above. In the example below, a Sell signal was generated on 05/19/15 followed by a Buy signal on
RELATIVE STRENGTH INDEX (RSI): RSI was developed by J. Welles Wilder to detect Overbought and Oversold conditions. The Index is comprised of three variables: 1) the average of all Up closes during a given period, 2) the average of all Down closes during the same period and 3) the length of the period in days over which these averages are taken. RSI measures the degree of strength left in a price trend. If Price has been declining and RSI drops below 30, traders should be alerted to a probable reversal of the downtrend, since momentum would appear to be losing its strength. If RSI moves above 70 as the price of the stock rises, an intermediate top is usually imminent. Use a nine-day period when computing RSI.

Oscillator indicators such as RSI are most effective in a trading range market environment. The problem with oscillators is that stocks can enter an Overbought/Oversold area and remain in this condition for an extended period of time. Research has demonstrated that the best signals obtained from the RSI oscillator are when the stock is coming out of these extreme conditions.

Short-Sale signals are produced when a Stock's RSI value exceeded 70 (Overbought) and then crosses down under 70. Buy signals are generated when the stock's RSI value is under 30 (Oversold) and then proceeds to move higher, crossing above 30.
The six-month chart for Apple Computer (AAPL) shows textbook RSI Buy and Sell (Short-Sale) signals over a three week period in July 2015. On 07/09/15, AAPL closed at $120.07. RSI was 17 indicating an oversold condition (Buy). On 07/21/15, RSI crossed above 75 while the stock closed at $130.75. A Short-Sale at that point would have resulted in an 8.38 point gain by 07/30/15 when the stock closed at $122.37 and RSI fell to 22.

**STOCHASTIC CROSS BUY AND SELL SIGNALS:** The Stochastic oscillator compares where a stock's price closed relative to its trading range over x-time periods. Developed by Dr. George Lane, this oscillator is designed to identify Overbought and Oversold conditions by comparing today's price to a present window of high and low prices.

Stochastic oscillators can either be Slow or Fast. Slow %K is the same as Fast %K except that it is smoothed with a simple moving average to make it less erratic. Use a 5-day time period to calculate fast %K and smooth it with a 3-day simple moving average to create the Slow %K. Stochastic values range between 0 and 100. Readings of 20 or less denote an Oversold (bullish) condition while values of 80 or greater signal an Overbought (bearish) scenario.

The relative movement of each stochastic value is used to identify both Buy and Short-Sale entry points. Buy Signals are generated when Fast %K falls below 20 (Oversold), is increasing in value and crosses Slow %K curve from below. Sell or Short-Sale signals occur when Fast %K is above 80 (Overbought), is decreasing in value and crosses Slow %K from above.
The above example is a six-month chart of U.S. Steel from 03/11/15 to 09/11/15. Over this period there were numerous Buy and Sell signals generated by Fast %K crossing Slow %K from both below (Buy) and above (Sell). The most recent Buy signal occurred on 07/27/15 when X closed at $16.80 on its way to $21.39 on 08/10/15. On 08/31/15, there was a good Sell (Short-Sale) signal when the stock closed at $16.38. Two weeks later (09/11/15), it closed at $14.10.
Chapter Four: Technical Indicators & Chart Formations

The following is a description of some popular technical indicators, an explanation of how to construct them and put them to use. Most charting software allows you to construct the indicators that are listed below. As you might expect, Market Edge can also do the job.

Technical Indicators

**ADXR:** J. Wells Wilder's Average Directional Movement Rating. This indicator was designed to measure the intensity of a stock's trend. Readings over 20 suggest that a stock is experiencing a trending movement while readings under 20 suggest that the stock is in a trading range. The higher the ADXR reading, the stronger the magnitude of the trend. ADXR does not indicate the direction of the trend, only its intensity.

**Beta:** Beta is a measurement of a stock's volatility as compared to that of the S&P 500. Readings greater than 1.00 denote stocks that have demonstrated a greater degree of volatility than the S&P 500 during the previous year. Stocks with a Beta of .99 or less have demonstrated less volatility than the S&P during the same period. Traders who desire above average volatility should choose stocks with a Beta of 1.2 or higher. Conversely, conservative traders should only select stocks with a Beta less than 1.00.

**Bollinger Bands:** Developed by John Bollinger, these trading bands are plotted at standard deviation levels above and below a moving average of a stock's price. Use a 20-day simple moving average and 2 standard deviations when computing Bollinger Bands. The spacing between Bollinger Bands is reflected as a number that varies between 0 and 100 and depicts the volatility of the stock during the previous twenty days. Whenever these bands tighten (a value below 20), volatility has contracted, a condition that typically precedes a sharp price movement. The direction, however, of the anticipated move is not indicated by contraction of these bands.

**Linear Regression Line Of OBV:** Linear regression lines are unique straight lines that best approximate the points being observed. This indicator identifies the direction in which the OBV is pointed. Although the OBV total is a valuable indicator, it is the direction or slope of the least square fit of the OBV indicator that forewarns of a stock's trend change. Best results are obtained when calculating this line over the previous 25-day period. When the stock is under accumulation, the regression line will be +1. Minus 1 denotes a stock that is being distributed.

**Moving Averages:** Moving averages are a popular tool in identifying a stock's trend. Moving averages come in three flavors. The most popular is the simple moving average which is the average of a stock's closing prices over an x period of time. An exponential moving average is a complex calculation that gives more weight to the most recent closing prices than to earlier ones. Weighted moving averages are similar to simple moving averages except you assign a weight to each close. A 10-day simple moving average has a weight of 1 assigned to each close where as a 10-day weighted moving average would have a weight of 10 assigned to the most recent close, a weight of 9 assigned to the next most recent close and so forth with the first close having a weight of 1. Moving averages are typically formulated for 10, 21, 50 and 200 day time periods.
10-Day Simple Moving Average

21-Day Simple Moving Average
50-Day Simple Moving Average

200-Day Simple Moving Average
**Stochastic (Slow %K & Fast %K):** Stochastic oscillators are designed to identify Overbought and Oversold conditions. The Stochastic Oscillator compares where a stock’s price closed relative to its trading range over x-time periods. This oscillator is designed to identify Overbought and Oversold conditions by comparing today’s price to a present window of high and low prices.

Stochastic oscillators can either be Fast or Slow. Slow %K is the same as Fast %K except that it is smoothed with a simple moving average to make it less erratic. Use a 5-day time period to construct Fast %K. Smooth this value with a 3-day simple moving average to create the Slow- %K. Stochastic values range between 0 and 100. Readings of 20 or less denote an Oversold (bullish) condition while values of 80 or greater signal an Overbought (bearish) scenario. When looking to buy a stock, wait until Slow %K is below 20. Overbought - Oversold conditions typically resolve themselves by the stock trading sideways for 3-4 days or a price reversal.

**Stochastic-Slow %K**

Looking at the chart for American Airlines (AAL) located above you will see that a Slow %K Buy signal was generated on 07/01/15 when the stock closed at $38.80 and Slow % K was under 20. On 07/15/15, AAL closed at $41.54. A Sell or Short-Sale signal was created on 04/22/15 when the stock closed at $51.40 and Slow %K was 97. On 05/06/15, the stock closed at $47.04.
The chart located above is also for American Airlines (AAL) over the same time period. The difference is that Stochastic Fast %K is plotted below the stock's chart. In this example, a Fast %K Buy signal was generated on 07/24/15 when the stock closed at $39.63 and Slow %K was under 20. On 08/04/15, AAL closed at $42.71 when Fast %K was 98. A Sell or Short-Sale signal was created on 08/17/15 when the stock closed at $43.95 and Fast %K was 98. On 08/21/15, the stock closed at $39.75 as Fast %K fell to 7.

**Support/Resistance Trend Lines:** Trend line analysis is an important tool in determining potential trend reversals as well as determining entry and exit points. Support/Resistance trend lines are constructed by connecting either the most recent, significant lows (Support) or highs (Resistance) on a stock's chart. To have a valid Support trend line, the slope of the line should be pointed Up. Conversely, a valid Resistance trend line should be pointed Down. You should construct as many trend lines as possible in the same fashion. Initially, the trend line that you are interested in is the one that is farthest away from the closing price of the stock provided that this number is less than a 20% differential. As the stock moves more than 20% away from either the Support or Resistance trend line, focus on the next trend line for areas of support and resistance. Penetration of these trend lines is a warning that the prevailing trend is waning and a reversal is highly probable.
Wilder’s RSI (Wilder’s 9-Day RSI Value): J. Welles Wilder developed RSI to detect Overbought and Oversold conditions. The Index is comprised of three variables: 1) the average of all Up closes during a given period; 2) the average of all Down closes during the same period; and 3) the length of the period in days over which these averages are taken. RSI measures the degree of strength left in a price trend. If Price has been declining and RSI drops to 30 or lower, traders should be alerted to a probable reversal of
the downtrend, since momentum would appear to be losing its strength. If RSI moves above 70 as Price rises, an intermediate top is usually imminent. The standard time period when computing RSI is 9-days.

In the above example RSI crosses above 92 on 04/24/15 when American Airlines closed at $52.71 setting up a good Short-Sale entry point. Six days later (04/30/15) AAL had fallen to $48.28, a decline of 4.43 points as RSI fell to 50.50. On 08/24/15, RSI was 18 when AAL closed at $37.62 setting up an Oversold Buy point. On 09/02/15, AAL closed at $41.51, a gain of 3.89 points.

**RSV (Relative Strength Value):** Relative Strength Value differs from 50-Day Relative Strength (50- Day R.S.) in that it is not a measurement of a stock’s performance as compared to a market index. Relative Strength Value is the percentage price change of a stock during the preceding twelve months or 250 trading days. The calculation is weighted, with the most recent three months assigned a 40% weight, while the previous nine months receive a 60% weight. All of the stocks in the database are then arranged in order of price change and ranked with a value of 99 to 1. A Relative strength rating of 92 would mean that the stock has outperformed 92% of all other stocks in the database. RSV can be found in Investor’s Business Daily and on the Market Edge ‘Second Opinion’ report.

**Bar Chart Formations**

The Bar chart is the most common form of a chart associated with stocks. A Bar chart consists of a series of Open, High, Low and Close prices plotted on a series of vertical lines with ticks to the right and left representing the Open and Close. There are several formations that you need to be aware of because
they can be very reliable in predicting future price direction.

**HEAD AND SHOULDER FORMATION:** A head and shoulder pattern is a very strong trend reversal formation. The pattern consists of a left shoulder, the head and the right shoulder. Typically, the stock will rally to a peak (left shoulder), correct and then rally to a higher peak (head), correct and rally again to a lower peak than the head and often lower than the left shoulder (right shoulder). When this pattern develops, the chartist draws a line known as the neckline which connects the valleys or bottoms created during the correction phases of the left shoulder and the head. If the right shoulder corrects and penetrates the neckline to the down side, a trend reversal is highly probable. If the neckline is not penetrated, a significant price rise is very likely. To determine the first price objective, measure the distance from the center of the head to the neckline and subtract it from the neckline value at the center of the head. This will give you the initial price projection. Usually once this level is reached more downside will follow.

![Chart showing penetration of neckline on 12/16/14 when Central Garden & Pet (CENTA) traded](image_url)

**REVERSE HEAD AND SHOULDER FORMATION:** A reverse head and shoulder pattern usually occurs at significant bottoms and as is the case outlined above, is also a very strong trend reversal formation. The pattern consists of a left shoulder, the head and the right shoulder. Typically, the stock will decline to a low (left shoulder), rally and then decline to a lower low (head), rally and decline again to a higher low than the head and often higher than the left shoulder (right shoulder). When this pattern develops, the chartist draws a line known as the neckline which connects the peaks or highs created during the rally phases of the left shoulder and the head. If the right shoulder rallies and penetrates the neckline to the up side, a trend reversal is highly probable. If the neckline is not penetrated, a significant price decline is very likely. To determine the first price objective, measure the distance from the center of the head to the neckline and subtract it from the neckline value at the center of the head. This will give you the first price projection. The chart below shows the penetration of the neckline on 12/16/14 when Central Garden & Pet (CENTA) traded
above $8.50. The difference between the head of the formation ($6.95) and the neckline ($8.80) is 1.85 points which when added to the value of the neckline produces a price target around $10.65 which was reached on 01/13/15.

CUP & HANDLE FORMATION: A C&H is a classic bullish formation that occurs when there has been a significant price decline followed by a long, base building period in which there is little price movement. This base building phase is followed by a sharp price rise, a small correction and then another price rise. The Buy signal is given after the correction and the breakout of the previous rally. The chart below is an example of a Cup & Handle formation.
PENNANT FORMATIONS: Pennant formations are very common and can be either bullish or bearish depending on how the formation is formed. A pennant or triangle resembles a flag with the pole being on the left side of the formation created by either a sharp rise in the stock's price or similar decline. The flag or pennant is formed as the stock trades in an increasingly narrow range. The longer that the flag process takes, the larger the ensuing move will be.

Typically, the stock will come out of the flag formation in the same direction that it came in. If a pennant is formed after a sharp rise, the odds favor a resumption of the advance once the stock breaks out to the upside. Conversely, a pennant formation formed after a sharp decline will usually see lower prices once the flag is broken to the downside.

The reason for this phenomenon is simple. Whatever caused the sharp rise or decline creating the "pole" was due to some change in the company's fundamentals such as an earnings surprise or an unexpected news release. The flag is formed as the event is disseminated and opinions are formed. Usually, whatever caused the spike (pole) is resolved in favor of the event and price continues in the same direction. However, sometimes the opposite occurs as can be seen in the example below.
**UP AND DOWN PRICE GAP FORMATIONS:** An Up Price Gap occurs when a stock’s opening price is higher than the previous day’s high. In order for an Up Gap to occur, an abnormal influx of Buy orders exceeding the available number of shares for sale must exist indicating that demand exceeds supply, a bullish condition. A Down Gap (Bearish) occurs on a stock’s chart when the stock’s opening price is lower than the previous day’s low. In order for a Down Gap to occur, an abnormal influx of Sell orders exceeding the available number of shares to be bought must exist indicating that supply exceeds demand, a bearish condition. The chart below shows the Up Gap for Celgene (CELG) on 07/15/15.
Up Price Gap For Celgene

Down Price Gaps That The Nasdaq Experienced In Late August 2015.
Point & Figure Chart Formations

Point & Figure charting dates back to the inception of modern market analysis and is unique in that it is only concerned with price movement. The significance of Point & Figure patterns lies in identifying price trends and reversals. The user unfamiliar with Point and Figure Charting techniques is referred to the Chartcraft publication, Three Point Reversal Method of Point and Figure Stock Trading, published by Chartcraft, Inc., Larchmont, N.Y.

Typically Point & Figure charts are constructed using a box size that equals 3% of the closing price of the stock and a 3-point reversal when constructing Point & Figure charts. Therefore, a stock that closes at 100 would require a 3-point move to earn either an X or an O designation. Stocks that close at 20 need only a 1/2 point move on a daily basis to generate either an X or O entry. So that there is a time reference on the chart, X’s and O’s are replaced by numbers and letters that represent the months of the year. Number 1-9 indicate January (1) through September (9). The letters A, B & C are inserted for October, November and December. The most popular and profitable Point & Figure chart formations are the Double Top-Double Bottom and the Triple Top-Triple Bottom formations.

DOUBLE TOP/BOTTOM FORMATIONS

**DOUBLE TOP**

B DOUBLE TOP The most recent column is an X.
X O X FORMATION This X column exceeds the previous X column.
X O X O X
X O X O X

**DOUBLE BOTTOM**

O X O X FORMATION This O column exceeds the previous O column.
O X O X O
O X O
O X
S

TRIPLE TOP/BOTTOM FORMATIONS

**TRIPLE TOP**

B TRIPLE TOP The most recent column is an X.
X O X O X FORMATION This X column exceeds the previous two columns.
X O X O X
X O X O X

**TRIPLE BOTTOM**

O X FORMATION The most recent column is an O.
O X O X FORMATION This O column exceeds the previous two columns.
O X O X O
O X O X O
O X O X O
O X O X O
S
Point & Figure Chart - (GPC) Double Top Formation-Bullish
Point & Figure Chart - (CYH) Double Bottom Formation-Bearish

Point & Figure Chart - (APOG) Triple Top Formation-Bullish
Point & Figure Chart - (HRS) Triple Bottom Formation-Bearish

Market Edge goes one step further and produces Quadruple Top and Bottom P&F Charts.

**QUADRUPLE TOP/BOTTOM FORMATIONS**

**B Quadruple Top**

<table>
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<tr>
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<th>X</th>
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<th>X</th>
</tr>
</thead>
</table>

The most recent column is an X.
This X column exceeds the previous three columns.

**B Quadruple Bottom**

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<th>X</th>
<th>O</th>
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</tr>
</thead>
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The most recent column is an O.
This O column exceeds the previous three columns.
Point & Figure Chart - (ADS) Quadruple Top Formation-Bullish
Report Date: 9/28/2015

Point & Figure Chart - (VIXY) Quadruple Bottom Formation-Bearish
Chapter Five: Classic Situations

The stock market is constantly exposed to conflicting forces. Typically there is an imbalance one way or the other resulting in either a bullish or bearish trend. Whenever the imbalance intensifies, situations set up that usually identify either the end of a major trend or a resumption of an existing trend. These situations repeat over and over again and can provide exceptional profit opportunities.

Blow Off Top

Often bull to bear market reversals follow what is referred to as a ‘Blow Off Top’. While a Blow Off Top isn’t a must for a major reversal to occur, it is important that you are aware its existence and act accordingly when they occur.

A Blow Off Top usually occurs in the final phase of a bull market. This phenomenon can occur with market indexes as well as with individual stocks. Typically, the stock or index will have been in an uptrend for a long period of time. The blow off top occurs when the stock surges to the upside on very high volume, reverses course to the downside and either closes down for the day or opens lower the following day. In the above example, ABB Ltd. surged on 06/04/15 on twice its average volume while closing at $23.66, up 1.32 points for the day. This was followed by a down price gap the following day as the stock closed at $22.80. As is usually the case, the blow off marked the beginning of a significant decline as ABB Ltd. dropped to $18 by late August.
Selling Climaxes

Frequently, bear to bull market transitions follow what is referred to as a ‘Selling Climax’. A Selling Climax usually occurs in the final phase of a bear market but can also occur at the end of a short-term correction. Typically, a stock or market index will have been in a long downtrend, lasting 1-2 years. The reversal occurs on very high volume as the stock collapses to the downside, reverses to the upside and closes up for the day. Selling Climaxes are the opposite of a Blow Off Top as investors throw in the towel, confident that everything is going to zero. Since this usually occurs after a sustained sell off, there is a lot of cash around providing the fuel necessary to launch a new bull phase. The chart of the DJIA located below shows a good example of the Selling Climax that occurred on 08/24/15.

Reflex Rallies

Reflex Rallies, also known as counter trend moves or dead cat bounces can provide excellent opportunities to initiate new short positions. The rally usually occurs after a stock gets hammered over a short-period of time. Not to be confused with Selling Climaxes, Reflex Rallies lack the convolutions and volume expansion that occurs during a Selling Climax. To the contrary, the rally usually occurs over several days after an extended decline that sees volume dry up as the rally progresses. While initiating a Short-Sale during a reflex rally can be very profitable, it can also be tricky business. Usually a Reflex Rally will carry the stock back to a declining 50-day simple moving average. This is a good entry point. The reason this occurs is that the 50-day moving average represents the average price that investors have paid for the stock over the last 50-days. Since everyone has a losing position, the tendency is to sell the stock and try to get even. The supply of stock
for sale at this point is usually sufficient to squash the Reflex Rally. Another good time to initiate a short position is 5-7 days after the rally starts. Keep an eye on the stock's daily volume. Initially, volume will exceed the 20-day average daily volume but as time goes on it will contract indicating that the stock is topping out.

The chart below for Applied Industries (AIT) shows a typical Reflex Rally which occurred in mid-November 2014. After topping on 11/12/14 at $49.69, AIT traded down to $42.93 on 12/17/14. From there, the stock rallied back (Reflex Rally) to within one point of its 50-day moving average ($47.07) closing on 12/29/14 at $46.43 before trending lower to below $40 by mid-January 2015.

Last Hour Trading

There is an old saying on Wall Street; "All that matters is the first and last hour of trading. The rest is noise." There are a lot of sayings on Wall Street but this one has some merit, especially the last hour. What you should monitor is which direction the market moves during this time. There are four scenarios that can occur: 1) The market is down all-day and then rallies during the last hour. This is regarded as a bullish condition and is typical when the market is in a bull phase. 2) The market is up all day and then declines during the last hour. This is regarded as a bearish condition and is typical when the market is in a bear phase. 3) The market is up all day and then rallies further during the last hour. This has little significance, as does the fourth scenario. 4) The market is down all day and declines further during the last hour.

The reason why it is advisable to stay abreast of the last hour’s trading activity is to confirm your "Market Posture". Conflicting last hour trading signals should alert you to a potential change in your market
forecast. Conversely, confirmed last hour activity would add confirmation to your posture.

**Volume Traps**

Volume is the weapon of the bulls and should be monitored on any rally to confirm the rally's validity and strength. Be suspect of any rally by the major averages that develop when the daily volume doesn't equal or surpass the previous twenty-day average volume. Typically, a volume trap takes place in the early stages of a bear market as the diehard bulls view market setbacks as buying opportunities. Usually, the market will experience a setback as the bear market begins. The "Buy On The Dip" traders move into the market thinking that the correction is another buying opportunity. The market rallies but the volume is well below the average volume that existed during the bull phase. This type of rally usually tops out at lower highs, confirming the fact that a bear market is underway.
Chapter Six: Street Stuff

Wall Street can be a very confusing place. There are numerous terms, sayings and expressions that are unique to the securities industry that you need to understand so as to avoid any nasty surprises.

**Know What You Are Talking About**

1) **Margin:** Borrowing money from your brokerage firm to purchase securities. The percentage that is available to borrow differs between stocks and bonds. Stocks typically require 50% margin while bonds require 20%. Therefore, if you wanted to Buy 1000 shares of a $20 stock, you would be required to put up 50% or $10,000 and you would be charged margin interest on the $10,000 balance. Options cannot be bought on margin.

2) **Short-Sale:** Selling a stock that you don't own in anticipation that the stock will decline. When placing a Short-Sale order, you must get permission from your broker. The position will be segregated in a short account. The margin requirement for a short-sale is usually 50%. You are not charged margin interest since your short account will show a credit balance. Unless you have a lot of clout with your broker, you will not earn interest on the credit balance. In lieu of cash, you can also deposit other securities, such as T-bills to meet the margin requirements.

3) **Options:** A call option gives the holder the right to Buy 100 shares of stock at a specific price (strike price) by a certain date (expiration date). A put option gives the holder the right to Sell 100 shares of stock at a specific price (strike price) by a certain date (expiration date). You cannot buy options on margin. Typically you cannot buy them in retirement plans.

4) **Stop Market Orders:** Orders that are entered to close out an existing position if a certain price is obtained. Stop orders can be either Sell Stop which is used to protect a current Long position from further loss due to a decline in the stock or Buy Stop which is used to protect a current Short-Sale position from further loss due to a rise in the stock. In either scenario, the order is executed on the next trade once the price has been reached.

5) **Stop Limit Orders:** Orders that are entered to close out an existing position if a certain price is obtained. Stop orders can be either Sell Stop which is used to protect a current Long position from further loss due to a decline in the stock or Buy Stop which is used to protect a current Short-Sale position from further loss due to a rise in the stock. In either scenario, the order is executed once the specified limit price is reached and then only if the trade can be executed at or better than the specified limit price. If the stock tanks, odds are you’re going to tank with it thus defeating the whole purpose of a protective Stop.

6) **Market Orders:** Buy or Sell orders that are not limited to a specific price. When the order reaches the floor, the order will be filled at the prevailing market price.

7) **Limit Orders:** Buy or Sell orders that are limited to a specific price. If the price is obtained, the order will be filled at the specified price or better.

8) **Arbitrage:** A sophisticated trading strategy whereby a simultaneous Long and Short position is initiated to try to capture a spread or profit regardless of what the stock does in the future.

9) **Short Against The Box:** A tax strategy whereby you have a Long position that you don't want to sell for tax
purposes but you are afraid that your gains may evaporate. In a short account, the same number of shares is shorted leaving the account both Long and Short the same stock.

11) Ex-dividend: A stock trades ex-dividend on the date that the dividend is declared, not necessarily paid. The stock’s price is marked down on the opening the amount of the dividend. For example, if a stock closes at 30, has declared a $0.50 dividend and goes ex-dividend on Monday, the stock will open down 1/2 point to reflect the distribution. Don't think that you can buy a stock the day before it goes ex-dividend and make any money.

13) Ex-date: The date that the stock will begin trading without dividend rights to the new owner and its price is adjusted downward on the opening to reflect the distribution.

14) Record date: The last date of ownership to be eligible for a dividend.

15) Divergence: Indicators, markets etc. are said to diverge when one makes a significant new high or low while the other does not. Very important in market timing techniques especially when the DJIA is making new highs or lows and the majority of the other market indexes are not.

16) Bid-Ask: The Bid price is the price at which the market maker will purchase a security while the Ask is the price that he is willing to sell the stock.

17) Market: The current Bid-Ask for a security, i.e. 22 1/2 bid - 22 3/4 ask.

18) Spread: The difference between the bid price and the ask price.

19) Call Feature: The Call Feature entitles the issuer of corporate and municipal bonds to call in the bond prior to maturity, typically at a slight premium to the initial offering price. If there is a decline in interest rates, the issuer will call in the higher interest bearing securities and issue new bonds at a lower rate. US Treasury bonds don't have call features.

20) Option Premium: The price of a call or put option. Option premiums are the result of a stock’s price in relationship to the strike price, the time remaining until the option expires and the volatility of the underlying security.

21) Market Maker: A broker-dealer or a bank that makes a two way price to purchase or sell a security. The market making function is employed by the NASDAQ exchange. Typically, large market cap stocks will have up to 50 market makers while small unknown stocks will have 1 - 2 firms making their stock. Don't assume that a market maker has an in depth knowledge of the stocks that they trade. They usually don't and could care less.

22) Specialist: The market maker for a specific stock that is listed on either the New York Stock Exchange or the American Stock exchange.

23) P/E Ratio: A ratio calculated by taking a company's annual earnings per share divided by the stock’s current price.

24) Splits: A tactic whereby a company reduces the price of its stock by a set ratio while increasing the number of shares outstanding in order to make the stock attractive to a broader group of investors. Typical ratios are 2/1, 3/1, 4/1, 3/2. A reverse split occurs when the company does the opposite which raises the price of the
shares will decreasing the number of shares outstanding.

25) Fast Market: A condition that exists when an abnormal amount of trading activity occurs in a security. Often times market quotes cannot be relied on during fast market conditions.

26) Breadth: A measurement of the market's strength or weakness measured by monitoring the number of new highs/lows and the number of advancing/declining issues.

27) Breakout: The point when a stock's price or market index moves out of a trading range or channel.

28) Expiration: The last day on which an option can be exercised. Usually, this is the third Friday of the month.

29) Fill: An executed order

30) MOC (Market On Close): An order that is to be filled at the closing price of the day.

31) Fill Or Kill: An order to either execute the order immediately at the market or cancel.

32) GTC (Good Till Cancelled): A limit order that stays on the books until it is either filled or cancelled.

33) Good For The Day: An order that is entered for the day only. If it is not executed during the day that it was entered, it is cancelled. Unless specified as a GTC order, it is usually assumed that the order is for only the remaining part of the day.

34) All Or None: An order that stipulates that the entire order must be filled or none at all. This type of order is placed in conjunction with a Limit Order whereby you have placed a price limitation on the Buy/Sell order.

35) IPO (Initial Public Offering): The initial offering of company's stock to the public.

36) Secondary Offering: A public offering of a company's stock after the initial IPO.

37) Order Not Held: An order given to a floor broker to be executed at the broker's discretion.

**Do's And Don'ts**

There are several things that you need to keep in the back of your mind when trading the stock market. These suggestions are not based on technical or fundamental conditions but will save you a lot of money in the long run if they become part of you arsenal.

**DO'S**

1) If a company reports bad news and the stock rallies, Buy the stock.

2) If company reports good news and the stock declines, Sell the stock.

3) Invest the same percentage of your investment pool in each stock selection.

4) Use protective Stop *market* orders.
5) When the ship is sinking, jump don’t pray. Recognize the fact that you aren't going to be right 100% of the time. If you were that good, you would own the NYSE exchange.

6) Be suspect of any rallies that aren't accompanied by rising volume.

**DON'TS**

1) If a company reports bad news and the stock rallies, don't Sell the stock.

2) If company reports good news and the stock declines, don't Buy the stock.

3) Shorting stocks in a dull market environment is not a good idea.

4) Never reverse a position in a stock from long to short or vice versa.

5) Don't use Stop *limit* orders.

6) Don't Buy naked options.

7) Don't trade against the prevailing trend of a stock or the market.

8) Don't invest more money in a one stock versus another because it looks exceptionally strong. Your dollar commitments should always be a fixed percentage allocation.

9) Don't use limit orders unless you are using charts to determine your entry and exit points. If you are trading large cap listed stocks, the spread between the *bid* and the *ask* should be very narrow so there shouldn't be much difference in the long run. Placing Buy limit orders under the market will usually result in missed opportunities. Sell limit orders are completely ridiculous. When you want out of a position, get out at the market.

**Back Testing Trading Strategies**

Most approaches to back testing computerized trading strategies are a waste of time. The problems associated with back testing are numerous. The dilemma begins with the erroneous belief that a single indicator can produce profits on a regular basis. Stocks don't act the same in bear markets as they do in a bullish environment. I have never seen a single indicator perform to my satisfaction and I have back tested a lot of them. This predicament leads to a second pitfall called ‘curve fitting’. Curve fitting is a method of optimization where by the indicator is adjusted until the tester thinks utopia has been realized. The results can be seriously flawed if your data has any errors such as non-adjusted splits or zero volume figures. Also, a single trade that produces abnormal results can greatly skew your results. Finally, computer output is an unemotional event and in all probability cannot be reproduced in real life. Executions will never approach those achieved during the test and unless you have ice water in your veins, the stress associated with trading will take its toll on your trading decisions.

That being said, here are some suggestions to help you find the perfect system. First of all, use combinations of non-correlated indicators when building your system. These indicators should have a blend of short and intermediate-term time horizons and be a combination of trend following and oscillators. The reason for these guidelines is twofold. If you are testing a short-term trading approach, you want to make sure that the
longer-term trend is in your favor. Therefore, a combination of a short-term oscillator, such as a stochastic indicator combined with a 50-day moving average would make sense. When the stochastic indicator gives a Buy signal (an oversold condition) it would have to be confirmed by a rising 50-day moving average confirming an upward trend.

Don't use a reversal of your entry setup to exit a position. Better results will be achieved by using a different exit strategy since you will in all likelihood give back too much profit. To avoid the temptation to curve fit a strategy, test your strategy on a stable of at least 50 stocks preferably big caps over at least a three-year time frame. Also, if you find something that works, retest it over several three-year periods. Make sure that your data is pristine. Always check your results and discard any abnormal trades that produced unrealistic profits to get a more credible picture.
Chapter Seven: Summing Up The Deal

The following are some basic rules that you should add to your investing arsenal. As time goes on, you will probably be confronted with some or all of these situations. By following the guidance listed below, you should be in a position to profit when these events occur and more importantly not lose money by making incorrect moves.

Survival Guide

1) Timing the stock market is critical to your investing approach and it can be done with a high degree of reliability. You are not going to catch every wiggle but it is possible to identify the intermediate term trend.

2) The way to make a lot of money is to trade not invest and compound your returns. This is not to suggest that you jump in and out on a daily basis but rather turn over your portfolio 3 - 4 times a year as your market forecast dictates.

3) There is nothing wrong with trading on margin provided that you use protective Stops. Trading on margin increases your leverage. Leverage can be a two edged sword if not properly managed. By using Stops, the risk is lowered during adverse times while your profit potential is greatly enhanced.

4) A stock's movement is dependent on the perception of what the company earnings will be, not necessarily on what the company actually reports. When the company actually reports their quarterly earnings, things can really start happening especially when growth stocks miss the mark. The problem with growth stocks is that their prices are heavily predicated on a combination of earnings and perceived growth rate of their earnings. Traders don't forgive even an insignificant earnings disappointment since it destroys their estimates and they dump the stock on the spot. This can wreak havoc for the stock especially if it is a thinly traded stock that trades on the Nasdaq. The moral of the story is that growth stocks can be great on the way up but a disaster when the party is over.

5) Shorting stocks should be an integral part of your investment strategy. Assuming that you become proficient at timing the market, you will either be out of the market or on the short side 30% - 40% of the time. In a bear market, shorting stocks can be a very profitable endeavor.

6) Buying naked options is for suckers and the temptations of big profits should be avoided at all cost. Selling covered calls or puts can at times be a good tactic. Buying calls and puts as a protective measure instead of Stops can also be a good strategy depending on the premiums that the options demand.

7) Story or rumored stocks are the work of promoters/bucket shops and should be avoided. Odds are that the company's stock is worthless and is trading at artificial inflated prices. Once the boys have run up the price to a desired level, they unload their stock and leave guys like you holding the bag.

8) Insider Buying is a positive sign, especially when several individuals are Buying at once. Barron's Magazine lists insider Buys and Sells on a weekly basis.

9) Despite the fact that the stock market is a favorable game, you are not going to double your money every year. Remember, historical returns from the stock market have averaged 10% a year. The vast majority of money managers never beat the market averages so don't expect miraculous returns.
10) A loss is a loss whether you realize it or not. I have heard individuals say over and over again that despite the fact that a stock they own is down 20%, they don't have a loss until they Sell it. When a stock is moving against you, odds are your analysis is wrong and you should get out. Remember, when the ship is sinking jump, don't pray. I have nothing against praying but if it worked in the stock market everyone would be rich.

11) The stock market is probably one of the straightest games in the world. Although funny things happen at times, the game is not fixed. Stay with liquid stocks, no penny issues and reputable brokerage firms and you will become a believer in this establishment.

12) All stock brokers are not crooks, there just not that bright. The vast majority of the brokers that I have known over the last twenty years were actually very honest and hard working people. Realize that on average they have no training or knowledge of how the markets work and typically are simply conveying comments originated from the firm’s research department. The exception to the rule is the bucket shop operators which should be avoided no matter what.

13) Despite the amazing bull market in the 1990's, the stock market doesn't always go up. Down years will and do occur and can be devastating to a portfolio. Those that think they can't lose by Buying on market dips or corrections will get their heads handed to them when a severe bear market develops.

14) The market is not necessarily a good hedge against inflation. If you had bought all of the DJIA stocks at the bottom of the last 1929-1932 disastrous bear market (DJIA - 32), and sold those stocks in the fall of 1982 (DJIA 800) a 50 year period, adjusted for inflation you would have broken even.

15) Stocks and bonds don't always move in concert with each other. Decoupling of the two securities usually occur during periods of explosive economic growth which historically is a prelude to inflation, a no-no for bonds. The best example of this occurrence happened in 1987 as the yield on the 30 year treasury bond soared from 7% to 10% between February and August. The stock market continued to make new highs during this period, topped out in late August and then crashed in October.

16) Just because a reporter on TV or from a major business publication says something is so it doesn't mean they are right. Typically media types have no idea what their talking about when it comes to the markets.

17) Neither seasonality nor the Super Bowl winner has anything to do with the direction of the stock market. The media makes a big deal of year end rallies, favorable months of the year, etc. but the facts don't support the argument.

18) When a company splits its stock, there is no evidence to support the fact the stock is going to go up. This misconception has more to do with the state of the market than with the mechanics of a split. Companies typically split their stock when it becomes too high priced to attract the average investor. The stock is typically too high because the market has been in an extended bull phase. After the split, if the bull market persists, odds are that the stock will continue to go up. However, should a bear market ensue, split or no split, the stock will in all probability decline.

There are many approaches to the stock market. Most will result in favorable results simply because the stock market is a favorable game. Once mastered, the methodology outlined in Trade Like A
Pro should produce good results. Since the approach is so diabolic to conventional wisdom, it will take some time for you to acquire the confidence needed to achieve maximum success. Practice on paper before investing any real money and then walk don't run. The market is not going to go away any time soon and since it doesn't matter whether it is going up or down, you have plenty of time to become comfortable with this approach. In most cases, you should be ready to roll in less than thirty-days.

About The Author

Tom Ventresca received his B.A. degree from Penn State University in 1968. He began his career in the securities industry in 1977. He spent fifteen years in the industry which included positions as a retail broker, bond trader, office manager, technical analyst and money manager, In 1990 Tom founded Computrade Systems, Inc., the developer of the Market Edge (www.marketedge.com) web site. Market Edge has been used by individuals, brokers and money managers around the world since 1992. Tom remains active at Computrade Systems Inc. where he is the Managing Director in charge of research. He currently lives in St. Augustine, Florida.