THE MINDLESS INVESTOR

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Make Money in the Market by Overcoming Your Common Sense

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To my wife, Cindy,
for her never-ending
support, patience and love.

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The Mindless Investor

You Can Beat the Market

You could make a lot of money in the stock market if you know my secret to finding winning stocks. Whether the market is good or bad, up or down, my secret trading signal can be found in stocks every day. It shows up early in the trend of almost every stock that makes a dramatic move higher.

This book is about this simple concept that will help you identify and profit from market-beating stocks. I estimate that 70–80% of strongly trending stocks show this one easy-to-identify element early in their uptrend as an obvious signal that is easy to spot once you know what to look for. In this book I will teach you what this characteristic is, how to find it and how to trade it.

You will not hear Warren Buffett talk about this signal or read about it in books on traditional investment techniques, because it doesn't work well for large institutional investors with billions of dollars invested in the market. My method is most useful for regular people managing their own money.

Whether you trade with a short- or long-term horizon, the application of my trading secret is the same. If you want to take a long-term approach to trading the stock market, I will show you

Chart 1 – Monthly chart of Apple (AAPL), showing its multiyear market outperformance.

how to find stocks like Apple Computer (AAPL), which has made market-beating returns over many years.

For those who prefer a much shorter-term approach to trading, you can also use my methods to find stocks like Pharmacyclics (PCYC), which moved up nearly 100% in about five weeks.

Making money in the stock market is simple, but it is not easy. While you can find the right stocks to trade in minutes without any knowledge of business, finance or economics, actually executing the trades properly can be challenging because normal people have an emotional attachment to money. I will show you how to overcome being normal.

I explain my simple secret trading tactic later in this book; all it takes is a few pages. The rest of the book will show you how to analyze the trades you take and overcome the emotions that cause destructive behaviour. I want you to understand why my methods work so that you can apply them effectively. Once you master these skills, you can beat the stock market.

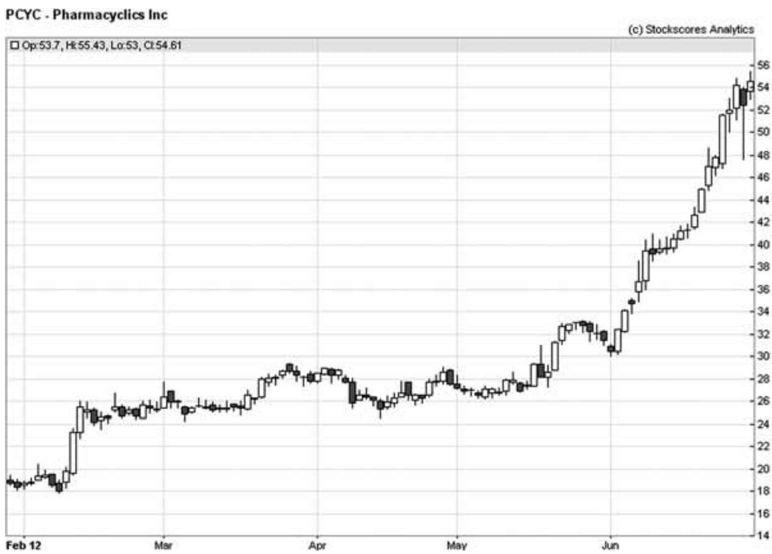

Chart 2 – Daily chart of Pharmacyclics (PCYC), showing its market-beating trend.

Overcome Your Common Sense

One important lesson—although not the most important, as you'll learn later—is that you can't apply your common sense to the stock market and expect to succeed. This is what frustrates investors so much; they think they're doing the right thing, sticking to sound investment principles promoted by seemingly knowledgeable, smart and well-intentioned people, and yet they don't see market-beating results in their portfolios. Many investors who think they are doing everything right actually see negative results.

So many people come to the market with great expectations, but leave feeling used and abused. Often, their response is to say that the stock market is fixed—designed to send profits to a small number of people who manage the system at the expense of the common investor. They make the mistake of blaming the market instead of looking in the mirror and realizing that it's not the market that's the problem, it's their approach.

If you are a normal, rational human being, you are predisposed to fail in the stock market. Not because you lack intelligence or desire, but because you don't know how the market really works. Without understanding what drives stock prices and how your decisions are affected by the stress of risk-taking, you can only do well in the market if you're lucky. Unfortunately, the downside of lucky is unlucky, and over time the two tend to balance each other out. The result is that any market-beating profits you earn are usually given back as losses. For most people, profits in the stock market are just short-term loans.

People base their decisions on what makes sense to them. It makes sense to buy stocks when the company's insiders are buying. It makes sense to buy stocks that are making positive announcements and showing increasing earnings. It makes sense to listen to investment experts or to what the person running the company has to say about its prospects. Yet doing these things rarely leads to market-beating returns. This approach might give you a winner here and there, but those winners will be offset by losing trades, making your success only random.

There are, however, a few simple techniques and bits of wisdom that can have a dramatic effect on your investing performance. Learning them does not require a background in finance or exceptional intelligence. They are simple things that will seem obvious once you understand them. Getting you to understand these things is the aim of the pages ahead.

The Trader Mindset

There is tremendous bias in the information that investors use to make decisions. Everywhere you look for information on stocks, you'll find someone who really just wants your money, and if you don't recognize this fact, you will lose control of your hard-earned investment dollars. Even the best-intentioned advisers don't care as much about growing your money as you do. You must take control of your investments.

That's why you must learn to think like a trader, not an investor. "Trader" doesn't have to mean "day trader" or someone with a short-term outlook. Being a trader is a mindset based on the realization that most stocks, most of the time, do not have a good chance of beating the overall market. To beat the market you have to be invested in the stocks that are trading beyond their tie to the general market, whether that disconnect lasts for days, weeks, months or years. When the stock ceases to be an outperformer, the winning trader feels no loyalty and moves on to the next trade without remorse. In the modern stock market, it is the traders and not the investors who have pocketed the biggest profits.

Average investors usually feel as though they operate at a real disadvantage to the large institutional investors that operate as the kings and queens of Wall Street. Don't despair if you invest in the market with capital of something less than 10 figures; as a small investor you have an advantage. The ability to extract a high rate of return goes down as your capital base goes up. It is far easier to beat the market with $100,000 than it is with $100 million.

A Complete Approach to Trading the Stock Market

In this book I put a lot of effort into changing your views on the traditional approach to the market, but do so with great regard for the mitigation of risk. Traditional investing methods are perceived as safe; the investment community wants you to think that you are protected from major losses as long as you do what they tell you to do. I will show that this is not the case.

Sadly, if you manage risk in a traditional way you are not very well protected from large losses; the past 12 years have proven that. If you do what is traditional you're doing what most people are doing, and that, by definition, makes you average. I want you to stop being average and look to new knowledge, methods and technologies to beat the market. Since the turn of the millennium being average has pushed you to a negative return. It's now time for you to use a modern approach.

To understand how to beat the market, you must start at the beginning with an understanding of what stock price represents and why it changes. Most investors pick stocks based on what a company does and what the company story is. Unfortunately, most make the mistake of looking at what the company *has done* and what the company story *was*. The stock market doesn't care what happened yesterday; it moves only on what investors expect will happen tomorrow. Predicting the future is difficult, if not impossible, for the average investor—unless you know what I know.

With hard work and some knowledge, an investor might be able to predict the future for a few stocks, but certainly not the entire market of stocks. When you get to know the companies you buy, you run the risk of being blinded by your hard work and the connection it creates to the stocks you own. You see what you want to see and ignore what the market tells you. You fail to realize that the truth is a moving target, changing with the emotional whims of the crowd. You fall in love with the stocks you own, and in the stock market, lovers lose.

No matter how skilful you are at picking winning stocks, you will be wrong some of the time. Until you accept that you cannot avoid losing you will be a loser in the stock market. More important than picking the right stock is the ability to manage risk effectively, limiting the size of your inevitable losses. You need to know when it's time to accept defeat and move on despite your natural desire to avoid pain. Hanging on to losers costs you financially and emotionally. It prevents you from soaring like an eagle because you are pecking on the ground with turkeys.

When you're right—and you will be right some of the time—you must accept your success as more than just luck. Don't lose confidence in your ability to pick stocks that can dramatically beat the market, and don't let go of these stocks too soon out of fear that your fortune will turn to misfortune. Your winners have to pay for your losers and provide you with a market-beating return. Exiting your winning positions before their time is up will hinder your ability to beat the market. You can go broke making a profit.

This Is Not Rocket Science

Do you have to be smart to do well in the market? No! You only have to be smart *enough*, and the intellectual threshold for success is not that high. Beating the market doesn't require a background in finance or a PhD in mathematics. You don't have to speak with the wisdom of a market guru; you simply have to listen without the influence of your heart or your mind. The market will tell you what to do.

The remora is a little fish that swims below the belly of a shark, never threatened or harmed by the shark's awesome killing capacity. Instead, the remora thrives on the shark's hunting ability by taking the little tidbits of food that the shark leaves behind. As traders, we can act like the remora and benefit from the actions of the best-informed, best-capitalized and most successful traders as they devour their market-beating profits. By following the biggest sharks in the market, you will be able to do your analysis in seconds.

There are tools that will help you do better in the market. I have created a set of special tools that fit in with my approach to trading, and I will share those with you. While the tools are necessary, it is knowing how to use those tools that will make you able to beat the market. A wrench is useless to someone who doesn't know how to repair his car, and a calculator is meaningless without the knowledge of what numbers to enter. I will show you some great trading tools, but don't forget that it's the mindset, trading strategy, emotional control and discipline that give those tools their power.

Take a progressive approach to the stock market. Think about it in a new way so you can escape the mediocre returns that it has been providing. Simplify your analysis and focus on the preservation of your capital so you have something to build up. Trade the situation rather than the stock, focusing on the relationship between risk and reward. Realize that it's you who prevents you from beating the market, not the market itself. The stock market is designed to make money for as small a group of people as possible. I look forward to giving you the means to be part of that group. Overcome your common sense; all it will do is ruin your market returns.

2

Everyone Wants Your Money

This Is War

The stock market is a war between buyers and sellers. Every day battles are fought; the buyers buy because they think the stock is likely to go higher, and the sellers sell because they think the stock deserves to go lower. Every time you make a trade you must recognize that on the other side of that trade is someone who disagrees with your prediction of the stock's future direction.

The market is a perpetual battle for money. Other traders want your money, the brokerages want it, the companies want it and even the media want it. You might be able to trust your spouse, friend or neighbour to do something in your best interest, but in the stock market you can only trust one thing. Everyone else wants your money. You should assume that from the moment you wake up each day, someone is going to try and take your capital.

I am not trying to make you afraid of the financial industry or of trading. I just want you to put your guard up so that you can win in the market. If you don't realize who is after your money then it is hard to defend yourself. Assume that everyone is trying to get their hand in your pocket.

Identify Financial Incentives

Stock brokerages facilitate your stock trades and charge you a commission on your trading transactions. To help you identify trading opportunities, these financial institutions employ well-paid research analysts to analyze the companies they follow and provide their customers with research and recommendations.

Most brokerages do not directly charge for this service, which should raise the question, are there other financial motivations for providing stock market research? The answer is yes. Brokerages use their research to facilitate the more lucrative side of their business, investment banking.

A large portion of brokerage house profits come from investment banking, financing companies listed on a stock exchange. Brokerages raise capital to finance the public companies listed on the world's stock exchanges. This money is necessary to grow a business, and raising it is a very noble pursuit. Without capital, companies cannot expand, create jobs and make the innovations that improve the world.

Money can be raised by investment banks as debt or equity. Debt financing is a loan that must be paid off with interest while equity financing is the sale of ownership in the company through the issuance of shares. When you buy stock in a company, you are buying a small piece of that business: a share. You become an owner of the company.

A public company that is shopping for an investment bank to underwrite their next financing has many investment banks to choose from. Since raising capital is a lucrative business, the investment banking firm will spend a lot of money trying to attract clients.

The money that an investment bank raises for the public company comes from investors who trust the bank's research and analysis. The bank employs analysts to rate a company's investment quality, typically with a "buy," "sell" or "hold" rating. Customers of the investment bank, who make trades through the brokerage arm, use the brokerage's research to help them make decisions on where to invest their capital.

Public companies have choices about which investment bank they use to raise the capital necessary for growth. A public company shopping for an investment bank to underwrite their next financing has many banks to choose from, and since raising capital is a lucrative business, investment banking firms spend a lot of effort and money trying to attract clients.

From a business standpoint, it makes little sense for the investment bank to put sell ratings on public companies. If you ran a public company, would you want to do business with a brokerage that has a sell rating on your stock?

The banks know it's bad business to be negative about companies that may need to raise money in the future, so they rarely put sell ratings on stocks. They have no financial incentive to be honest because most of their revenue comes from investment banking, not from making money for the clients who read their research.

This is not to say that there isn't a good business in providing good research—there is. However, there is not a good business in being negative with research and so there is an optimistic bias to most research that you will encounter.

Trust Thy Neighbour?

Bias in stock market information can come much closer to you. Most of us have friends or neighbours who have told us about a stock that is a sure thing, one that has to be bought. Why do they share this information?

The answer should be obvious: it's because they're trying to make money! If someone praises a stock, assume that he already owns it or has some vested interest in seeing it go up in price. Why else would he tell you about it?

How Are They Getting Paid?

What are the financial motivations of newsletter writers and other market gurus who give away their research for free? Many newsletter writers are being paid by the company to advertise their story in the form of research. Newsletter writers who get paid to write about a stock can't be unbiased sources, and their research is more marketing than analysis.

Even the media, who should work very hard to be neutral, inject bias into their information. It's our own fault; we want to be entertained while we are informed so the media provide us with conflict, drama and emotion. Because it's entertainment, the information is tainted and unreliable.

The media will work to explain what has happened in the past because that's what you want to know. You want to understand why your stocks have moved, even though what has already happened will have little effect on your ability to make money in the future. The media tend to react rather than predict, but as an investor you should only be focused on how stock prices will change in the future.

You must always ask a simple question: "How is the source of my investment information being compensated?" No one works for free, and you must think about whether your financial motivations are aligned with the financial motivations of your information source.

Beware of Contrepreneurship

Part of my trading success comes from learning early, and in the hardest way, that you can never trust what people tell you, no matter how well-dressed or smart the source seems to be. A contrepreneur is what my friends and I call a businessperson who lies and cheats to make money, and the financial world has its fair share of them.

I have been suckered by lies and the lessons I learned were expensive. I want you to save money by not having to learn those same lessons the hard way. You should approach trading with the idea that everyone wants your money and it is up to you to keep it. If something sounds too good to be true, it probably is. Take charge of your money, even if you engage others to help you earn a return.

Take Control

No one cares more about your money than you. I encourage all investors and traders to take control of their stock positions and understand what everyone's financial motivations are. I don't mean that you can't have someone manage your portfolio for you. There are some skilful people out there who can do that, if you choose to hire an advisor. What I mean is that you should never give people complete control over your assets, because they don't care about your money the way that you do.

In a broader sense, you must recognize that you are ultimately responsible for everything that happens to you and your money. If you don't approach life this way then you'll inevitably find misfortune. While there are things that can happen to you that seem to be way out of your control, the only person who has any chance of directing your life is you. No one else is going to pursue your best interest in the same way that you would, so take ownership.

There are many sad stories of people who have suffered great financial and emotional loss at the hands of others. I feel for these people, but I also think they only have themselves to blame. People who lost money to scam artists like Bernie Madoff (he perpetrated a multi-billion dollar Ponzi scheme) lost because they gave up control. You can stay in control of your financial destiny even with other people helping you make money as long as you understand what their incentives are, and you protect yourself from having them pursue their goals at the expense of yours.

In the market, always follow the flow of money to understand what the incentives are. If someone offers you free advice, ask yourself how that person is making money by providing that advice to you. The answer may be quite acceptable to you; it is possible for multiple parties to benefit if their incentives are not opposed to one another. But often, the incentives will be more in the other's favour than yours.

The Market Is Honest

Fortunately, there is one entity that doesn't care about you or your money. The one source of information that you can trust completely is the market itself. The market has no reason to lie to you; it has nothing to gain or lose, because the market is not a person or organization pursuing a profit. It is simply the outcome of the countless actions of those who participate in it, each with the intent of making a profit. Each little cog in the giant market machine may want your money, but the engine of the overall market doesn't care whether you make a profit or lose your shirt. There will never be a reason to get mad at the market after a loss, and you don't have to send it flowers because it gave you a nice profit. The market has no emotion toward you and what you do within it.

The market never lies.

3

Be a Trader

You should be a trader. That doesn't mean you have to be a day trader, a person who works to extract small profits from price fluctuations that last minutes. A trader can have a very short-term hold period or one that stretches out over years. Trading is not defined by time span.

Trading is a mindset, an approach to making money from the market without focusing on the companies. It's not the business that matters to the trader; it's the relationship between the potential risk and reward of owning the stock.

A trader might buy a terrible company simply because it has great potential to move up. A trader might sell a respected, well-run company because it has gone up too quickly and investors are likely to take profits and push it lower. Traders are only concerned with price direction. To a trader, a good stock is one that goes up after she buys it.

Dad, I Want to Be a Trader

Trading is not a traditional way to make a living, although it has grown in popularity since I started 20 years ago. While kids often aspire to be doctors or lawyers, they will rarely say they want to be traders when they grow up. The notion that a person can make a living by buying and selling stocks, commodities, bonds, currencies or derivatives is just not on most people's radars.

Calling yourself a trader may sound appealing if you relate trading to market-beating profits, a great quality of life or the freedom to live the way you choose; most traders that I know got into trading for one of these reasons. The best traders earn more money than people in any other profession by an incredibly wide margin. There are individual traders using their own capital who make over a million dollars a year from their home offices. There are also large institutional traders who have made over a billion dollars in a single year by managing large pools of capital.

That's billion, with a B.

For most traders, it's possible to work from anywhere in the world that has an Internet connection. I have made trades from some pretty bizarre workplaces, including a Hawaiian beach, my bed or on a bike at the top of a mountain.

As a trader, you have the freedom to choose when you want to work, and you can even earn money while you're not working at all. The explosion of technology over the past 20 years has changed how many of us work, but few professions have benefited more than trading. If you are somewhere you can talk on your cell phone, you can probably trade. That is one of the freedoms that trading affords.

Trader or Gambler?

Others may relate trading to inappropriate financial risk, emotional turmoil, a time-consuming endeavour or an unrealizable dream. Many people think of trading as a form of gambling and, to be fair, for many aspiring traders gambling is exactly what they're doing. They trade their way into a death spiral of emotional and financial decline.

If you approach the market with a gambler's mentality, then gambling is exactly what you are doing. But traders are not gamblers, just as people who race cars professionally are not lunatics. If you have the skill and knowledge to know how to trade, then you're a trader. Those who play the markets without the necessary skill and knowledge should take their money to Las Vegas—at least there they'll have some fun while they lose their money.

Trading Is Not About Time

There are a great many ways to trade, just as there are a great many assets to trade. Being a trader doesn't have to mean you're a day trader, moving in and out of stocks in minutes or hours. A good trade could last years, months, weeks, hours, minutes or even microseconds. Trading has nothing to do with how long you are in an investment.

The trader doesn't have to be glued to a computer screen for hours on end, unable to leave his chair for a bathroom break. Trading can occupy a few hours a year or every waking hour of the day. The actual trade only takes a moment; most of the money is made in the waiting.

The image of a Wall Street trading floor may inspire thoughts of high-strung Type A men on a path to heart disease, but there's no rule in the trader's handbook that says trading has to be stressful. In fact, successful trading feels easy. In the same way a professional golfer makes a great shot look easy or an architect makes a great design an example of simplified elegance, for an experienced trader, a great trade is effortless.

As with all things, trading can be simple or complex. There are large institutional investors who hire math PhDs to develop complex mathematical algorithms that will be plugged into banks of computers capable of trading hundreds of times per second. Other investors patiently wait for a few simple but rare conditions to come together so they can put in a trade before embarking on a month of travel through the Amazon rainforest. One is not necessarily more successful than the other.

I want you to be motivated to put in the effort it takes to become a successful trader but also aware that trading is not the get-rich-quick scheme that many portray it as. Yes, trading can provide great financial rewards; there are many stories of investors who turned small sums of money into fortunes. The world record holder for percentage gain in a portfolio earned 29,233% in a single year, trading from his home. Early in my trading career, before I was 30, I turned about $30,000 into half a million dollars in three months.

We shouldn't forget, however, that for every story of great success there are many more of financial tragedies. I have met too many people who tell me about money made and lost, confirming the adage that for many, profits in the stock market are just short-term loans.

What Kind of Trader Are You?

Whether you are already a trader or aspire to be one, remember that it is up to you to define the sort of trader you want to be. In fact, it is essential that you define your trading role in a way that is appropriate for you, your emotional makeup, capital and time constraints, and situation in life. I hope this book will help you answer the question, "What kind of trader am I?"

The wonderful thing about trading is that the markets don't have a preference for anyone. It doesn't matter whether you're a man or woman, young or old. The markets don't know the colour of your skin or what physical ailments you may have. You can be socially inept or the life of the party; the market doesn't care. A great-looking celebrity loved by millions has no advantage over a regular Joe. To the market, we are all the same.

Being a trader is a mindset, part of a modern approach to earning a return on your capital. For so many people, the stock market is a place to invest in stocks. The investor seeks to buy the shares of well-run companies because he expects that their values will appreciate over a very long time. The trader approaches the market differently. She seeks to fulfill a very simple goal of selling her shares for a higher price than she paid for them. The focus is on making money, and good traders recognize that there are many reasons why shares prices move up and down. Investors own assets; traders speculate on the price movement of those assets.

4

A Trader Is Born

To believe in the lessons that I teach in this book, it is helpful to know how I learned those lessons and came to be a trader. I started trading the stock market when I was 19, motivated by money, just as most people who play the markets are.

I bought my first stock on a tip from a friend. For weeks, he told me about a stock that I had to buy, one that was sure to move up in price. I knew nothing about the stock market and was wary of his recommendation, thinking it sounded too good to be true. I had been brought up to believe that you have to work to earn a paycheque, and it made little sense to me that you could make money simply by buying and selling something in a relatively short period of time.

However, I was intrigued by the idea of trading, and watched the stock's performance closely, checking the prices in the newspaper each day. My daily price check revealed that the stock's price was moving up at a fast pace, just as my friend had predicted it would. I was probably guilty of calculating in my head what I could have made had I bought the stock when he first told me about it.

At the time, I was at university, working towards a business degree so I could get a decent job or perhaps start my own business one day. Like many students, I didn't have a lot of money: something less than $2000, which I had saved by working as a gas station attendant. I went to school in the mornings and early afternoons before going to work at the gas station in the evenings. I can't say I was a great student; I think I was doing too many things to be great at any one of them.

After a few weeks of watching this stock move higher, I finally decided I had to make a move. It seemed that everything my friend had told me about this company was right. After all, the stock was moving up just as he said it would, and the company was releasing news that confirmed what my seemingly well-informed friend had already told me. I set up a meeting with the broker he used to find out more about the opportunity.

At that meeting, I asked a lot of questions about the stock I was considering. What did the company do? Who ran the business and what was their track record? How much money would the business make? Did it have a lot of debt? These were all questions that the early finance classes I was attending in university had taught me to ask, and I thought I was being pretty smart by asking them.

In hindsight, these questions were kind of ridiculous because this company that I was eager to buy was a very speculative penny stock with nothing more than an interesting story. The broker knew less about the business than I already knew, but he humoured me, digging up answers to my questions. There must have been enough good answers to my questions, because I gave the broker the order to buy some shares.

I used the cash I had saved and combined it with money borrowed from my Visa card to make that first trade. I think the total cost was around $3000, a pretty small order but one that represented more money than I had to my name. It takes a long time to save $3000 when you're working for $7 an hour and have school tuition to pay.

As it turned out, this first trade was also my first tuition payment to Stock Market College. After watching the stock move up week after week before I bought, I ended up entering pretty close to the high; the stock went up for two or three more days and then topped out and went lower. In the end, I held the stock for far too long and watched my money melt away. I ended up selling it for less than half of what I had paid, which meant I lost most of my equity, leaving me with barely enough to pay back Visa.

I bought a lot of lessons in that first trade.

Despite the financial and emotional pain I endured, I was hooked. If I had bought when my friend first told me about the stock and sold when I had bought, I would have doubled my money. All I needed to do in the future was get the timing right! I set out to learn as much as I could about stock speculation.

At the time, there were few books written about stock trading. Speculators tended to focus on commodity futures because those markets allowed much more leverage. Today, there are hundreds of books about trading the stock market, but back then I was challenged to find one.

That was OK with me because, after all, I was in school to learn how business worked and surely I would learn about how to pick good stocks. My early finance classes gave me some insight into the stock market, teaching the basics of valuing companies and identifying stocks that should move up in price. I worked hard using fundamental analysis to understand the business of the stocks I was considering and I soon became known among my friends as the guy who had the stock tips.

Since I didn't have much capital, I had to focus on the fast-moving, low-priced stocks that were listed on the junior stock exchanges. These were story stocks, ones that had little in the way of solid fundamentals but made up for it with an exciting story. These speculative stocks could easily more than double in price if the story was ever validated.

Despite my hard work, I wasn't very successful. The hours I spent reading news releases, brokerage research and company reports yielded mixed results at best. There seemed to be little correlation between business quality and stock performance. I had to fund my addiction to the stock market by pumping gas, because I was not consistently making profits.

With time, I became more and more knowledgeable and adept at explaining the stock market, so people started coming to me for information. I started a stock speculators club at the university that soon had over 200 members. That group exposed me to even more information about the stocks I was following and I often gained good insight into what companies were doing. I started to do better as a trader, but I certainly wasn't getting rich.

I eventually graduated with that business degree and tried to get a job associated with the stock market. I had lots of job interviews but never seemed to fit into the plans of the financial corporations I applied to. I really wanted to get a job on Wall Street and applied to every bank and brokerage I could. I still have a thick stack of rejection letters to prove it; I would say that every major Wall Street firm has politely told me to take a hike.

Without that high-paying corporate job, I had to stick with my dream of making money from the stock market as an independent trader. I am sure that more than one of my friends saw me as someone with unrealistic expectations and dreams. They were probably right, but I was also determined and stuck with that dream. I spent hours on end studying the market, working to learn as much as I could about how to trade it profitably. To say that I was obsessed with the market is an understatement.

There Has to Be a Better Way

Frustrated with my lack of success using fundamental analysis, I considered changing my approach to technical analysis. I was first exposed to chart-reading by a person who I found so odd that I gave little credence to what he showed me. He described how drawing lines across price and volume patterns could be used to predict price. He showed me mathematical algorithms that could provide entry and exit signals. It all seemed very baseless and I had a hard time understanding how lines drawn on a chart could determine how price would move in the future. Technical analysis went against everything I had learned about the stock market.

I was, however, intrigued with the idea of technical analysis, mostly because it seemed so much easier than studying what companies were doing. I was spending hours analyzing a single company, but reading a chart took only minutes. If a profitable result could be realized in less time with technical analysis then I was certainly open to giving it a try. I was not finding that much success with what I had been doing so far anyway.

By this time, I was working as a DJ because it was one job I could do while the markets were closed. I would follow the markets through the trading day and then pack up a van with sound and lighting equipment to head for a school and DJ a dance. My working life was far from glamorous, but it paid the bills and I enjoyed it. Most importantly, I had the time to analyze and trade stocks.

To help me learn more, and bring in some more income, I started to work for small public companies, doing their investor relations. This meant I took phone calls from people who were looking for information about the company. I would try to answer their questions or pass them on to company management when it was necessary. Doing this gave me a lot of insight into what investors were looking for when they researched companies and what companies were doing to add shareholder value. I learned a tremendous amount about public markets and grew more cynical about using fundamental analysis to research stocks. I found that companies injected their assessment of their business fundamentals with a lot of optimism when talking to investors.

I was now writing an email newsletter focused on stock trading. Email was a relatively new technology, but my list of subscribers grew quickly as more people began to communicate online. Each night I would write my comments on the market and provide stock picks based on my analysis. This is something I still do today.

Levelling the Playing Field

It was about this time that I started my first stock market website. The Internet was in its infancy then, and there were few places for investors to research stocks. I had been developing my own method for picking stocks, but I found that the research process was too time consuming and difficult to apply. Since I couldn't find the sort of research tools that I needed, I decided to create them for myself and share those tools through a website. I would eventually go on to create **Stockscores.com**, which continues to be the main tool I use for picking stocks and is now used by thousands of investors worldwide. I will show how I use **Stockscores.com** for trading stocks later in this book.

Each day spent trading the market brought new lessons and more hours of experience. Just as strong stocks build momentum, I was also building momentum in how I gathered knowledge and learned to trade. Success did not come quickly; it took me years before I was able to make consistent profits.

As the Internet grew in popularity, more and more people came to **Stockscores.com** to use my tools. Some of the tools on **Stockscores.com** required a subscription, and I found that the site was growing into a decent business. The website was an accidental success that grew out of my need for time-saving tools. Now I was getting many requests not only for more features but also for lessons in how to use the tools.

The popularity of trading exploded as the 20th century came to a close, helped in large part by the boom in technology and technology companies. These high-flying technology stocks were what I was trading now, and the action in the market made trading them a lot of fun. I recall making more money in a week of trading than I had made in an entire year. I even had a few single days where my profits eclipsed my annual earnings from previous years.

I no longer had to phone a broker to make a trade or wait hours to download stock market data for analysis. The Internet levelled the playing field for individual traders, allowing us to compete with Wall Street traders at the big banks that I had once aspired to work for. The financial industry changed more in those few years than it had changed in the hundred years before. Trading became a home-based business.

Teaching Others

Around this time I met the woman who is now my wife. She and I would attend trader conferences together, and at one of these conferences we watched a presentation by a trader education and tool company. I only watched for a few minutes before walking away in disgust. The knowledge that they were giving people seemed so basic that I saw little value in it. However, my wife stayed to watch the entire sales pitch and was amazed at how many people bought what they were selling. Not surprisingly, that company is now out of business, but their presentation caught my wife's interest.

She encouraged me to broaden the **Stockscores.com** business to include education. There was a tremendous hunger for knowledge about how to trade, and I had the experience to teach others what I had been using to make money in the market. At first, I was not eager, but she eventually talked me into teaching a trading class. Although I was only 30, I had accumulated thousands of hours of experience in trading which, given the infancy of home-based Internet trading itself, made me an expert despite my age. With her help, I taught our first "Stock School" weekend trading course. It quickly sold out and so began another business that revolved around the stock market.

Stories of success often begin with the person describing how their success is a surprise. When I started trading, I never thought that one day I would be making trades in a blink of an eye by moving a mouse pointer around a computer screen. I was never a computer expert, so the thought of developing successful websites for investors was not something I ever expected. Writing stock market newsletters and teaching classes so that others could be successful in the market was not something I thought about when I was in school. All of these businesses revolve around my love of trading, but none grew out of a master plan for what I would do as a career. Trading was a hobby that turned into my livelihood.

It is important that any aspiring trader realize that trading successfully is hard. To make it as a trader requires that you love trading, that you do it for more than just the money or the freedom.

People who trade so they can buy a Ferrari or live in a big house will fail because their focus will be on the wrong things. You have to make the trades that the market tells you to make. If you focus on the money, you will make trades for the wrong reason, and inevitably you will go broke. You may do well in a strong market, but you will give all your profits back in the end.

This book is about the lessons I learned the hard way. The market is cruel because it gives the test first and the lesson second. I have been able to succeed despite having no money, no family history in the financial industry, no mentor, no help from friends and no access to trading knowledge. I have made so many mistakes over and over again that I consider myself an expert on making them. The reason I am a good teacher of trading is the money I lost while learning how to trade well.

5

Think Like a Trader

Trading is using a strategy to pick buy and sell points to get a better return than a buy and hold approach would bring. You can trade stocks, corn, real estate, currencies, art, baseball cards, bonds or anything else that has a price and is traded between people. I prefer to trade stocks, but the methods I use can be applied to trading just about anything else.

The Trader Mindset

Most people believe that making money trading is about having good information or a great strategy. While those things are important, they are far from the most important. Successful trading is more about understanding yourself than understanding the market. Aspiring traders often ask me what books they should read, and my answer is to direct them toward books about human psychology. Understanding finance is not that important; I have a degree in finance but use very little of what I learned in business school in my trading. As you learn to trade, you will learn a lot about yourself and how you react to your emotional attachment to money. Good traders have mastered themselves.

The Difference between Trading and Investing

The common perception is that trading means having a short-term time horizon for your investments. Most people think "day trader" when they hear the word "trader," but trading has nothing to do with how long you hold a position. Instead, it's about the mindset you have when you're investing. The next two charts will help define this mindset.

Chart 3 – The 12-year monthly price change for the S&P 500 Exchange Traded Fund, SPY.

Charts 3 and 4 are both weekly charts of the S&P 500 SPDR Exchange Traded Fund (SPY) going back to the start of the millennium. Suppose you entered the market in 2000 with a simple strategy of owning a broad market index through the purchase of this ETF as shown in Chart 3. That would have put your entry price at around $139.56 in 2000 and, 12 years later, you sit on that investment with the current price of about $137.40. After 12 years invested in this index ETF, you would have made a return of

Chart 4 – The 12-year monthly price change for the SPY with entries at trend line breaks.

almost −2%. Clearly, you could have done better owning low-risk government bonds.

Chart 4 shows a number of entries and exits at the arrows based on a simple strategy of buying when a downward trend is broken and selling when the upward trend is broken. Just doing that had you making three buys and two sells in 10 years. The first trade made you 42%, the second 40% and the third is currently up 5%. In less than 10 years (since the first buy of the millennium was in 2003), assuming you reinvested the amount from the previous trade, your overall gain would be about 109%, or about 8.4% per year. That is a respectable return and a lot better than what the buy and hold strategy earned.

How much extra work was required to trade the market rather than invest in it? Once at the end of each month, you would have had to check the chart of the SPY to determine if the rules for a simple trend line break strategy had triggered a buy or sell signal.

That would take you less than five minutes a month—an hour a year. In nine years, you would have made five trades (three buys and two sells) but, in doing so, you transitioned from being a buy and hold investor to a trader. The reward was moving from losing with buy and hold to better than doubling of your money by adopting a trader mindset.

Trade Any Time Frame

We can take the trading mindset to the other extreme and look at an example of a day trade with a much shorter hold period. Later in this book, I will teach you how to read chart patterns and use my secret trading tactic. With those skills, you might have entered this trade at the arrow in Chart 5. The difference between this chart and those of the SPY shown earlier is that each bar on Chart 5 represents two minutes of price movement, where in the previous charts each bar represented a month of price change.

Chart 5 shows that in the span of less than a day, this stock moved 37% from the entry point highlighted by the arrow. Successfully making this trade required more experience and time but is based on the same simple chart-reading principles.

Where the long-term trade on the SPY required you to check a chart once a month, this very short-term trade would have required attention for the entire day. The mindset is the same, but the hold period is shorter, and the time required to complete the trade is greater. As a trader, you are taking advantage of a set of rules to provide entry and exit signals to extract a return. You are speculating on price movement.

What style of trading is right for you? Do you want to be a long-term trader checking charts once a month, a short-term trader monitoring the market all day or something in between? Before you decide, you must determine whether you're ready to think like a trader instead of like a long-term investor. Trading requires timing, and I'm sure you've heard countless experts argue that timing the market is a difficult thing to do and trying to do so leads to losses.

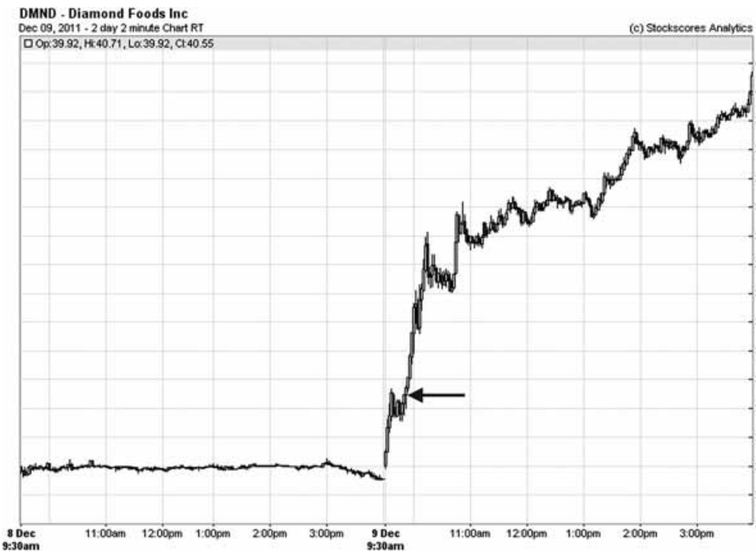

Chart 5 – DMND made a 37% move from the day trade entry signal at the arrow before the close of trading that day.

Why Traders Fail

Timing the market *is* hard to do, in the same way that designing a 10-storey building is hard or performing open-heart surgery is hard. Everything is hard until you know how to do it. One difference between being an architect or a doctor and being a trader is that there are barriers to entry for architects and doctors but not for traders. You can't just open up your own operating room and conduct surgeries on anyone willing to take a chance with you. City planners won't let just anyone design a building; they must have accreditation and meet engineering guidelines.

There are no barriers to trading. Anyone with capital can open a brokerage account and start trading the market. Every day, new people start trading businesses with little or no knowledge of what it takes to be a successful trader.

It has been said that 90% of traders fail. I think that's a conservative estimate; I would put the number even higher. It's not at all surprising to me that so many people fail, because I have met so many people who called themselves traders and yet had no idea what they were doing.

What would the failure rate be among people who first spent four years learning how to be a trader, the way a person spends four years earning an undergraduate degree before starting a career? How many traders who have spent as much time learning how to trade as a doctor has spent learning medicine are failures?

In most professions, you have to go through an education phase and an experience-gathering phase. Tradespeople learn the basics of their craft and then work as apprentices to gain proficiency. Aspiring lawyers typically spend seven years on their education and then one or two years as articling students, spending countless hours with minimal pay learning how to apply what they were taught in school. Is that what these failed traders did before they concluded that timing the market was too difficult? I don't think so; the lack of barriers to entry into trading helps people fail.

You Can Learn to Trade

The unfortunate thing is that it doesn't need to be that way. Learning to trade is simple; I will teach you things in this book that should make you a better trader immediately. I can teach someone everything I do as trader in a weekend, and most of my strategies could be outlined on the back of a napkin. Trading profitably does not have to be complicated; it's often the very simple strategies that work best.

With that said, trading well is not easy. It can take a long time to get good at it. This is not because the skills required are difficult to understand; it's following the rules that can be hard, mostly because it takes us time to learn how to overcome our emotional attachment to money. It also takes time to gain the experience to know which strategies to apply for the current market condition. Learning how to evolve with the market does not happen overnight.

Over the past 20 years, my approach to stock market analysis has changed from a very traditional approach, using business fundamentals, to the approach I use today. Although I use price and volume charts to make my decisions, I don't consider myself to be a true technical analyst. Most technical analysts focus only on mathematical indicators based on price and volume data. I look at charts, but I do much more too. I am a trader: I take information from the market and use it to make predictions about how price will change in the future. I look beyond the decision to enter a trade and focus on managing risk effectively. I know that I must exit my positions at a point that will maximize profitability over a large number of trades.

Each of the chapters in this book represents an important lesson I learned as a trader and a teacher of traders. Most were learned in the most memorable way: by losing money. My aim is to help you become a trader in much less time than it took me and to help you make better decisions with your money from the moment you finish reading this book.

Remember that trading comes with risk; even expert traders suffer losses. No matter what you choose to speculate on, never risk more than you can afford to lose. Don't get into the market until you've learned what you need to learn and are confident in your ability to trade well.

6

The Little Guy Has an Advantage

Size Is Not Everything

Warren Buffett is arguably the most well-known, perhaps the most successful, investor in the history of the stock market. He studied at Columbia University under Benjamin Graham, one of the great fundamental theorists and co-author of the 1934 book *Security Analysis*. He went on to make market-beating gains year after year and ultimately became one of the wealthiest people in the world. I don't need to tell you that the Oracle of Omaha is highly regarded for his investment prowess.

Despite his legendary status, in recent years, he has not been able to beat the market the way he did early in his career. His pool of investment capital has become so large that it's now nearly impossible for him to outperform the major market indexes. By the size of his portfolio, he is the market.

At a shareholders' meeting in 1999, Warren Buffett said he could get a lot better returns—truly market-beating returns—if only he had less money to invest. Since he has so much capital to place, he's unable to invest in many of the good opportunities that he finds and have them make a meaningful difference to his performance. For a fund manager with $100 million under management, an opportunity to invest $20 million to make $30 million has a meaningful impact on the overall performance of his fund. Make the same investment when you're managing $80 billion and it hardly moves the performance needle.

This is not just the case for Warren Buffett. Every large institutional fund faces this problem. For professional money managers, the better your performance the more capital you attract. The more money you attract, the harder it becomes to beat the market.

Therefore, investing with the managers that have been successful in the past may lead to performance that fails to meet your expectations. Managers of huge investment funds become victims of their own success. When your money is managed as part of a large pool of capital, expect your investment returns to be close to the market return. If that's acceptable to you then you might as well invest in a market index exchange traded fund, since it will earn a return that is very close to the market average.

Performance Is Easier with Less Capital

Assuming you don't have hundreds of millions of dollars or more in your trading account, you have an advantage over any fund manager. It's a lot easier to double $100,000 than to make a 100% return with $100 million, $1 billion or $10 billion. With a method that is appropriate for the amount of capital you have to invest, you can beat the market, and doing so is easier with a relatively small amount of capital.

The key, of course, is having a good method for trading the market—one that gives you the ability to beat the market. With that and a relatively small pool of capital, you can outperform even the most successful big money managers.

As an individual investor you can choose strategies that require you to move in and out of stocks quickly, to hold them only when they are trending and to get out when the trend is losing momentum. Since the size of your positions will be relatively small, you can buy and sell quickly and without a significant impact on the price you pay when you buy or the price you receive when you sell.

You can trade opportunities that can only be taken advantage of if the trade size is small. One of my strategies requires that I buy stocks as close to the open of the trading day as possible. This strategy works well, but there are few stocks that trade actively enough to absorb a trade of more than half a million dollars in the short time this strategy requires. A large investor could never make these trades and have an impact on the performance of the fund.

The Right Approach for the Capital You Have

The less capital you have to trade with, the less your ability to do in-depth analysis of the companies you buy. Analyzing a company's business properly takes time, knowledge and costly resources. When you try to compete with large investment funds on this level, it's unlikely that you can produce better results than a fund that has industry experts and millions of dollars to devote to research.

But you can be on a level playing field with the big investment funds if you use stock charts and trading data to make your decisions. This information is easily available and comes at a low cost. Whether you're a large or small investor, you look at the same stock chart.

There are advantages to being small. As an individual investor, you can probably enter and exit any trade in just seconds. You have a greater opportunity to beat the market because the market-beating opportunities you find can have a dramatic effect on the overall value of your portfolio. Provided you have the knowledge and discipline to trade well, it is better to manage your own money than to leave it to someone who has a large amount of capital to invest on behalf of many people. Not because the person running an investment fund lacks skill, but simply because the challenge of beating the market increases as the capital under management goes up. With an approach that matches your capital base, you can beat the big funds.

7

Don't Be Average

Why Be Normal?

If you do what most people are doing, you'll be average. Think back to how your high school teacher assigned marks using the bell curve, so that only a small number of people earned an A. In the market, only a small number of people consistently outperform the average return.

According to the S&P indexes, in 2011 84% of U.S. stock funds that were actively managed failed to beat the stock market. From 2009 to 2011, 56% of stock funds failed to beat the S&P benchmarks. Over five years, 61% failed to do better than simply holding the index.

These funds are run by knowledgeable, smart people with extensive education and experience in finance and fund management. If the pros, with all of their knowledge and resources, can't beat the market, how can you expect to?

To have any chance of beating the market you must approach it a different way. It amazes me how many people continue to apply traditional methods of analysis and expect to see better results. If you want to beat the market, you need to break free from the traditional approach to investing and use modern knowledge and methods that can be shown to be effective.

One of You Is Always Wrong

Every time you buy a stock, there's someone selling it to you. You're buying because you believe that the stock will go higher. The person selling is doing so because they believe the stock will go lower. One of you is wrong.

Keep this in mind any time you are making what you think is a no-brainer trade. I always try to look at the other side of the argument. I ask why someone is willing to sell when I want to buy and why someone will buy when I want to sell. Am I smarter than him or is he going to prove me wrong?

The stock market is a war between buyers and sellers; we're all trying to take each other's money. Every trade you make is a battle against someone else who may know more than you or have a better strategy than you. Never let your guard down and constantly work to discover new ways to beat the average.

The Finance Industry Avoids Risk

The financial industry will not encourage you to use a new analytical approach because it is financially dangerous for the industry to promote change. We live in a litigious society, and few things give people more motivation to sue than losing their money. Financial institutions have suffered huge losses from lawsuits because they pushed clients into investments that were perceived to be too risky or otherwise unsuitable for the client.

Clients don't share their profits with their brokers when riskier strategies lead to market-beating gains, but when risk leads to losses, many look for someone to blame. And those with the deepest pockets become the targets when things go bad.

The result is that financial institutions have a financial motivation to do what is safe and accepted. Promoting a traditional approach to the market is acceptable, even if that approach does not perform well. It's hard to place the blame for losses when the strategy being used has been accepted as correct for many years.

Are You Trading with Modern Methods?

The traditional approach to picking stocks is to identify companies with sound balance sheets, good management and a growing business. Determining a company's basic fundamental value and then buying when the company's stock goes below that value is what Graham and Dodd taught in their book, *Security Analysis*. Warren Buffett was a student of Benjamin Graham at Columbia University—the only student to earn an A+ grade. Many investors believe value investing is the only correct way to pick stocks.

The traditional approach for managing risk is to diversify the assets of a portfolio so that the expected return of the portfolio can be maximized. This theory is referred to as Modern Portfolio Theory and is widely accepted as the safe way for asset managers to manage their funds.

I am amazed how many people believe that the Graham and Dodd approach to stock selection and the modern portfolio theory are the correct and suitable way to manage money in the stock market. As an aspiring trader, I never believed in either and my doubt has been vindicated throughout my trading career.

Graham and Dodd wrote *Security Analysis* in 1934. Modern portfolio theory is hardly modern: it was introduced in 1952. Using these methods is like driving a Model T Ford home from work so you can catch black-and-white reruns of *I Love Lucy* for entertainment. Yes, both get the job done, but today there are much better ways to achieve the goal. Are you still popping cassettes into your Walkman or do you get your music from the Internet? Do you take a ship over to Europe for business or fly on a plane? It's time to approach the market with a truly modern approach, one that is suitable for the small investor who lacks time and expertise.

As I showed in the chapter "Think Like a Trader," the buy and hold approach has failed investors over the last 12 years. Over that period, the return for this approach has been close to zero—or even negative, depending on what day you invested. That has left many investors frustrated and cynical about the market, apt to call it fixed or unfair. But along the way, there have been dramatic price trends that have made those who trade the market with uncommon sense a lot of money. Is the market to blame for the failure of an outdated approach?

Modern portfolio theory assumes that the performance of different asset classes is uncorrelated, that some will go up in price while others go down. It tells us to manage risk by holding assets from these different groups so that our losses will be offset by the gains. The financial collapse of 2007–2008 taught us that virtually all asset classes can move together and there is no safety in owning a broad range of assets. Investors who managed risk through diversification were wiped out when everything plummeted together. Most of these investors will never recover.

I will teach you new ways to analyze stocks and manage risk. My methods aren't really that new, but they're far more modern than traditional methods. I have been using and refining them for 20 years, and I suggest that you and I never stop looking for ways to improve. Just as innovation can make how we listen to music easier and better, so too can it improve the performance of our investments. We must always stay ahead of the crowd, because as soon as what we're doing is what everyone is doing, we have to take another step or get caught in the mediocrity of being average.

8

You Should Not Do Fundamental Analysis

The Secret

What is a stock worth? That's the question people using fundamental analysis work hard to answer. Most market participants use the fundamental approach for analysis; it is considered the traditional way to pick stocks. There are many different ways to do fundamental analysis, but they all work toward the same goal. By studying the company's business, the fundamental analyst tries to determine if the stock is worth more or less than what it is trading at.

At the start of this book, I promised that I would teach you my secret to finding winning stocks. Before I can do that I need to explain why stock prices change and what price is ultimately based on. Without that background, it will be hard to appreciate why my secret trading tactic works.

My secret doesn't require you to know what companies are doing. Fundamental analysis is extremely important for the market to operate, but I don't believe it is the most effective, or even practical, way for most investors to pick stocks. Unless you are a large investor with considerable knowledge and resources, I recommend against using fundamental analysis.

That is a controversial statement that will have many of you up in arms, so I will spend most of this chapter explaining why I have this view. I've debated this topic with more people than I can count and have converted many of them to my way of thinking about the market. I'm confident that by the end of this chapter you will at least see that there is reason to doubt the effectiveness of fundamental analysis.

Drink My Kool-Aid

A number of years ago, a fairly successful investor came to me with a pretty cynical outlook on what I do as a trader. This person had always analyzed the companies he invested in and knew a lot about the stocks that he owned. He was well educated and had a high level of expertise in his field. He had also earned a Certified Financial Analyst (CFA) designation, rounding out his knowledge and belief in fundamental analysis.

We had a short discussion about my approach, which he recognized as conflicting with just about everything he believed about investing. Despite his reservations about the trader mindset and my ways of analyzing stocks, I think he recognized that he could do better if he broadened his skills. He decided to enrol in one of my weekend trading courses.

It took some time, but ultimately I converted him to having a trader's mindset. Not because he does not believe in his fundamental approach but because he found that my approach was easier, less time consuming, cheaper and more effective. He now puts a much greater emphasis on thinking like a trader and using the message of the market to make his decisions.

Around the same time, I was doing a presentation to a large audience of investors at an investor conference. Most of the attendees where non-financial-industry people, just regular folks looking to improve the performance of their investment portfolios, but after my presentation, I was approached by two gentlemen who started asking me questions that showed their understanding of the markets to be far beyond that of individual investors. The next day I got a call asking if they could meet with me at their office. It turned out that they worked for a very large fund with billions of dollars under management. They each managed hundreds of millions of dollars within this fund, and wanted to learn more about what I was doing. They took one of my courses and now employ my methods in their investment process.

I share these examples because I want you to read this book with an open mind. The content of this book is useful whether you are an individual investor or a professional fund manager. My grandfather used to remind me, "If you always do what has always been done, you always get what has always been got." For the past 12 years, thinking like a buy and hold investor has not provided a great return, but having the trader mindset has worked much better.

My aim in this chapter is to show you how fundamental analysis fails for most investors. When I say "most investors," I expect that you fall into this group. Large investors—those with more than a billion dollars to invest—have little choice but to use fundamental analysis, simply because the amount of capital they're working with means that they can't be nimble like you and I.

Safety in the Status Quo

Why does the financial industry encourage individual investors to do fundamental analysis? Countless books targeted at the do-it-yourself investor encourage it, the brokerage industry encourages it, the government encourages it and, as a result, most people try to study the businesses of the stocks they buy.

We live in a litigious society, and few industries are more tightly regulated than the financial. Brokerages fear being sued by their clients if they lose money because of bad advice. The result is that they have to take a conservative approach to how they communicate with their clients, and that encourages the status quo. Telling people to do anything innovative is not encouraged by the legal departments at brokerages.

Fundamental analysis is accepted because it has been around for a very long time. On the surface, it is defensible and it makes intuitive sense. Many investors have told me over the years that they are just not comfortable buying a stock that they know nothing about. The result is that this is the approach the financial industry pushes on people, whether it is effective or not. Doing so keeps them out of trouble because no one questions the wisdom of fundamental analysis, even if the analysis is wrong.

Fundamental Analysis Is Useful, But Not for You

I know that many of you are going to argue with me about the usefulness of studying the business when doing stock analysis. After all, there are so many people doing fundamental analysis and so many people using their reports, there must be some use to it.

Yes, you're completely right. There is a great deal of value in fundamental analysis. Without it, the stock market could not function, and people like us would not be able to make market-beating profits. My point is not that fundamental analysis isn't an effective way to pick stocks. I want you to know that it is not an effective way for *most of us* to pick stocks because most of us can't get an information edge.

The Pitfalls of Fundamental Analysis

Maybe it's unfair of me to blame my failures in applying fundamental analysis on fundamental analysis itself. Perhaps the fundamental approach for analyzing stocks is superior to all others and I'm simply bad at doing it. If so, then it's not fundamental analysis that is the problem but instead, my application of it.

There are many people who have made fortunes applying fundamental analysis; does that mean we should discount all of my criticism against it? No. I will show you a number of reasons why:

1. Good fundamental analysis is hard, time consuming and expensive to do well. Even if you do it well, there are further dangers.

2. You will not likely be right all of the time and, when you are wrong, the cost of the loss could outweigh many of your profits. Without a threshold where you admit you are wrong and take a small loss, you will hang on to losers because you believe in your analysis of what the company does. In "Plan to Be a Loser" I will show why good traders take small losses and never let a small and planned loss turn into a big one.

3. Fundamental analysis blinds you to the market's message. When I studied the company in depth and really thought it had great potential to move in the direction I expected, I lost my ability to see the company's weaknesses. The market would tell me there was something wrong, but I couldn't get the market's message because I was blinded by my belief in the company.

9

What Does Price Represent and Why Does It Change?

It is important to understand that stock prices are determined differently than the prices for most other assets, at least in theory. The price of a commodity like corn is dependent on supply and demand. If many people want to buy corn but there is a limited supply, the price should go up. Commodities and most products are priced in this way, but this is not how the market should determine stock prices.

How Is Stock Price Determined?

Stock price is based on the ability of the company's assets to generate a profit. It is the future earning power of the business's assets that is important, not the cost of those assets.

This is easier to understand with a simplified example. Suppose you spend $1000 to start a hot dog stand that, once up and running, makes you a profit of $200 a day. What is that hot dog business worth? Would you be willing to sell the stand for $1400? Doing so would make you a 40% profit over what the stand cost you to buy but selling the stand would mean you could no longer generate the $200 a day that the business has been earning. It only takes eight days to generate more profit than what you would receive selling the business for $1400, so why sell it?

The price paid for the assets of a business is not important to determining its value; it is the ability of those assets to make money that matters.

If you were considering selling your hot dog stand, you might instead calculate how much you expect to make over time and arrive at a price based on this expectation for future earnings. If you are willing to run the stand for 200 days a year then your annual expected earnings from the business is $40,000 (200 days times $200 a day).

You may decide that you're willing to sell the business if someone will pay you three times its annual earnings or, in this case, $120,000. After three years you would be worse off and the buyer of your business would start to generate a return, provided the earnings continued to be $40,000 per year.

A potential buyer may argue that the company does not make a profit of $40,000 for its owner, since there is work required to operate the hot dog stand. It might cost $30,000 a year to have someone make and sell the hot dogs, leaving a profit for the owner of only $10,000. Now the business is worth a lot less; using a three-times-earnings multiple it has a value of $30,000. Questions like these must go into the valuation of a business.

What if the business is growing? After the cost of running the business, it could be expected to make $10,000 this year, $20,000 next year and $30,000 the following year. Because of growth, the business is worth more than $30,000; in three years it is expected to generate $60,000 in profits. A seller would probably not let the business go for less.

Another question may arise. What stops another person from investing $1000 in a new hot dog stand and competing with you for the same business? Unless there are barriers to entry, your stand is worth less because it is easy for almost anyone to start a similar business. However, if you own a license for a great location, then you have something that adds value to your business.

Simplified, these are the kind of factors that a fundamental analyst considers to determine the value of a business and its shares. Earnings and growth are the most important considerations for determining value. These are referred to as quantitative factors because they are based on numbers. Factors that go beyond just numbers and focus on the qualities of a business, like location, product quality and management, are referred to as qualitative factors. Good analysis of the company fundamentals will often factor in both quantitative and qualitative factors.

Company shares represent a piece of company ownership. A company that has issued one million shares and has a total value of one million dollars should trade at $1 a share. In this case, each share represents a small, one-millionth piece of ownership of the overall company.

How Do You Decide on Value?

How do you determine the valuation of the company and its shares? It's a complex process, but the stock market does the work for you. The stock market is essentially a place where investors argue about what a stock is worth. The buyers buy because they think the stock is worth more and the sellers sell because they think the stock is worth less. Each time an investor buys or sells a stock they are casting their vote for what they believe the stock is worth.

When you buy a stock for $10 you state that you think the stock is worth more than $10 a share and that the stock will go up in the future as investors realize the company is worth more. On the other side of the transaction is someone with a different opinion. The shareowner selling to you is selling because she believes the stock is worth less than what it's trading for. For every transaction in the stock market, there is a buyer who thinks the stock is worth more and a seller who thinks the stock is worth less. One of them is wrong and the stock market is the place where this argument goes into arbitration.

The Price to Earnings Ratio

To determine whether a stock is a good buy or sell, the fundamental analyst has to study the company to figure out what the stock is worth. The simplest way to do this is to multiply earnings by a number that reflects the company's growth. This number is referred to as a price to earnings ratio (PE ratio). A stock that makes $1 a share per year and is trading at $10 has a PE ratio of 10. Companies with a greater potential for earnings growth will trade with a higher PE ratio.

You will often hear the media discuss PE ratios as an indication of whether a stock is undervalued or overvalued. Fundamental analysts will often say that the purchase of a stock is justified when its PE ratio is lower than similar companies in similar industries. The expectation is that the stock's price will move up until it is trading at a similar multiple.

Exxon Mobil (XOM) and Chevron (CVX) are two similar companies; both are large integrated oil businesses. At the time I write this, XOM has a PE ratio of 10.16 while CVX's is 8.17. Both trade with relatively low PEs because these are very large companies that have difficulty growing. They provide steady earnings and are considered safe but not too exciting.

A quantitative fundamental analyst might say that CVX is the stock that should be bought since it is trading with a lower PE ratio. XOM should come down in price and CVX should come up to narrow the spread between them.

An PE ratio between 6 and 12 is the current range for large integrated oil companies. Historically, the average PE ratio for companies in the S&P 500 index is around 15 or 16, but that has varied a lot over the past 100 years. What should an individual company's PE ratio be?

One often-used rule is to say that a company should trade at a PE ratio equal to twice its growth rate. A company with $1 a share in earnings that is growing at 10% per year should trade at 20 times earnings, or $20. If this company is trading at $10 then it is deemed to be undervalued and worth buying.

Using a PE ratio is a very simple way to do quantitative analysis, although accurately determining earnings and growth can be a complex pursuit. A large business with many products or services across many different markets will be much harder to value than a simple hot dog stand.

Does it make sense to use a simple quantitative factor like the PE ratio to pick stocks? On the surface, doing so is certainly appealing: it's simple and easy to research and the concept makes intellectual sense. Why not buy a stock that is cheaper than its peers?

Before you close this book and decide that your strategy will be to buy stocks with PE ratios lower than similar companies, there are some important concepts to understand and think about. Let's begin with the widely held belief that the stock market is efficient.

How Information Affects Price

There are millions of people buying and selling stocks around the globe. I like to think of it as the biggest strategy game ever played. Those millions of people are all looking for reasons to make a trade on a stock. The most important thing they have to help them make their decision is information about the company, the economy and what is going on in the world.

Investors can make informed decisions using two types of information: public and private. Public information is knowledge that is in the public realm, whether disclosed in a news release, the company's annual report to shareholders or some other communication between the company and the investing public.

Private information is known to a much smaller group of people, as the result of hard work or an advantageous position. For example, before earnings are formally announced to the public, there are people within the company who know what those earnings are—they have access to private information because of their position. There are also investors who have a great deal of knowledge about an industry or company who may be able to figure out what earnings will be. These investors uncover private information because of their hard work and expertise, although there is a degree of uncertainty in the private information they uncover.

Pricing In New Information

The stock market is a giant forum for debate where investors argue about what this information is worth. Since there are so many people involved in this debate, most people believe that the stock market is efficient. That means that all available information is priced in to the stock because opportunities that come from new information are accounted for almost immediately by the actions of investors. If you believe in market efficiency, then using information to make investment decisions, especially public information, has little value. Here's why.

Suppose you are thinking of buying a company that is working to find a cure for cancer. The company tests the cancer treatment and finds that it lengthens the life of the patient by 3.4 years. This is big news and increases the value of the company, because the business will generate more revenue and profits with this new treatment. The future earnings potential has increased, making the company worth more. Is that information worth trading on?

The answer to this question depends on when you get the information. If you are one of a small number of people who have this knowledge before the market has priced it in then yes, it's worth trading on. Since the information is not yet public knowledge, there's a good chance that it has not been priced in to the stock yet. You can expect to see a jump in the share price when other investors learn of the test results and bid the stock higher.

The problem is that trading on information deemed to be inside information is against the law. If you work at the company and know what the results are before they are announced, you are an insider and trading on the information is illegal.

What if you're someone who does great research to uncover private information? Acting on that information is probably not illegal because a degree of uncertainty remains.

Suppose you run a large hedge fund with a billion dollars under management. With the financial might of your fund, you can afford to do detailed research to uncover information that is not widely known. Perhaps you hire some researchers to talk to oncologists about this new treatment and get their opinion on it. Maybe you have contacts in the medical industry who have heard rumours about the efficacy of the new drug.

The knowledge you gather is probably not considered inside information because it is not certain. You are making a well-informed guess using insight, in-depth research and industry knowledge. In doing so, you are going beyond the public realm and into the private realm without being considered an insider.

What Happens When New Information Is Introduced

Now let's think about the effect this information has on share price. In the case of our cancer drug company, the market would know that the company is working on a new drug because so much of its money would be spent on research and development; those expenditures show up in the company's financial statements. The process of having a new drug approved is a long one, so there would likely be a number of news releases relating to the stages of drug approval that the treatment is in. As a result, we can expect that the market would begin to "price in" the new drug before it has been proven effective.

Suppose that before any work was done on this drug, the company's stock was trading at $10 a share based on the other products it owns. The company estimates that the market for the new drug is $300 million per year, and if the drug gets approved it will make the company worth about $20 a share. Investors will handicap the odds of the drug getting approval by increasing the price they are willing to pay for the stock.

The company begins to work on the drug and has some good initial test results. It announces them and the stock rises in price and trades at $12 a share. Since the stock was at $10 and is now at $12, we can say that the drug has a 20% chance of being approved because with the new drug the stock should trade at $20, and without the new drug the company is worth $10 a share. I know this is an oversimplification of the process, but it's necessary to make the argument.

One day, you get a tip from a friend who already owns the stock. She tells you this stock is going to $20 on the strength of the new cancer drug that the company has in development. Is it really going to $20 or is it just that it *could* go to $20 if the drug is approved? At this stage, the latter is true, at least in terms of what the market knows currently. Unless your friend with the tip knows more than what has been made public, the stock is fairly priced. Your friend believes the stock will go up, but without inside information, she's just hoping.

That means that buying the stock at $12 is nothing more than a gamble. You have a 20% chance that the stock will go to $20 and an 80% chance that the stock will go back down to $10. This means you have an even bet: the 20% chance of making $8 a share is worth $1.60 (0.20 times $8) and an 80% chance of losing $2 a share gives you an expected loss of $1.60 (0.80 times $2). The expected value of the trade is $0 because the profitability of being right, given the odds, is offset by the potential loss if your friend is wrong. We will expand on the concept of expected value later.

How do we know the odds? We assume that the market is efficient. Since there are probably thousands of people following the company, some well-informed and others just guessing, we must assume that all available information has been priced in to the stock. If the public information about the company made it worth anything more than $12 a share, it would trade at a higher price because the buyers would act strongly and bid the stock price up, while the sellers would be less eager to sell. The result is that the stock arrives at its fair value.

Assume for a moment that your tipster friend actually works in a doctor's office where they have been doing trials of the drug. She has watched patients with cancer get better when using the drug. She can see that there are a number of patients whose health is improving more than she has seen with other treatments. She assumes that the new drug is working.

With that information, you may be able to determine that the chance that the drug is effective and gets approved is actually 60% and not the 20% that the market has priced in. With the knowledge that you have, there is a 60% chance that the stock will go to $20, making you $8 a share and a 40% chance that it falls to $10, losing you $2 a share. Now the trade has an expected value of $4 per share ($0.60 \times \$8 - 0.40 \times \$2 = \$4.80 - \$0.80 = \$4$). The market has not accurately priced the stock yet because the market does not have the information your friend has shared with you. This is a good trade because it has a positive expected value and you used fundamental analysis to uncover it.

At this point, it seems the answer is to only use fundamental analysis when you are able to uncover information that is not widely known and therefore not already priced in to the stock. That's not always the case; I'll explain why later.

However, this example does show the advantage to being able to uncover better information than other investors are using. The problem is that finding better information than most people have is not an easy thing to do. I do have an important method that will help you do this, but I will save it for later in this book.

It becomes easy to see why using publicly available information has little value if you believe in market efficiency. If all the available information points to a stock being worth $20 a share, we should expect it to trade at that price, since there are so many smart and knowledgeable people studying the company to determine its value. With all those people doing fundamental analysis, the stock is likely fairly valued, at least as long as you don't have private information to give you extra insight.

Assumptions About the Efficiency of the Market

There are two assumptions of market efficiency. For us to say that the price of a stock is an accurate representation of all information about that company requires that we first assume that all investors have the same information. Second, we have to assume that investors use that information rationally. Both of these assumptions are often incorrect and that's what provides us with opportunities.

Have you ever made an emotional decision in the stock market? Have you ever acted impulsively or made a decision because of fear or greed? If you are a normal person, I doubt that you can answer no to either of these questions.

Normal people have an emotional attachment to money, something that I will go into in more detail later in this book. That emotional attachment to money causes us to avoid the pain of losing it and seek out the pleasure of making it. It is easy for us to act emotionally when analyzing a stock because we want to make money and avoid suffering losses. As a result, we often do not judge information about companies rationally, arriving at our estimation of value using only good analysis and logic. Instead, our impression of what a stock is worth is often swayed by what is happening in the market.

There are people trading on information that is not widely known every day. While most investors make decisions based on publicly available information, for every stock there will always be some people who know more and who use their better information to predict future price changes. You should not assume that all investors invest with the same information.

Fear and Greed

The great bull market in technology stocks was raging in late 1999 and early 2000. Stocks that made double-digit gains every day were not uncommon, and the overall market went up without any regard for fundamental value. When PE ratios got so far beyond historical norms, fundamental analysts simply said that the rules were now different and these valuations were justified.

Emotion was what was really behind the astronomical price rise. People were willing to pay more because their judgment was fogged by greed. The law of upticks says people will believe in the fundamentals more if the price is going up, and during the technology bubble, people had very irrational beliefs about the fundamentals.

In 2008, the market crashed as the global banking crisis had investors fearing financial Armageddon. The price drop in August of 2008 was one of the biggest on record, and much of the selling was based in panic. With big daily losses, investors were jumping out of their positions fearing that the decline would get worse.

Fear and greed cause people to act irrationally, presenting an opportunity for the fundamental investor who can identify the mispricing of stocks because of emotion. Unfortunately, these opportunities are fairly rare and it is often difficult to know where the bottom or top is. Recognizing that a stock is trading for far less than what it is really worth doesn't mean the stock is going to bounce back tomorrow. Markets can act irrationally for a very long time.

Fundamental analysis can give the investor the ability to take advantage of opportunity created by emotion. When fear and greed push stock prices away from their fair value, the astute fundamental investor can step in and act, taking advantage of the opportunity that emotion creates. Warren Buffett is renowned for his ability to take advantage of panic and make market-beating investments when few investors are willing to buy.

Trading on information that is not public and therefore not already priced in to the stock is the second opportunity for the use of fundamental analysis. Analysts with industry knowledge, contacts and resources can extrapolate public information to predict the headlines of tomorrow. Sometimes just having the resources to do the extra work can make the difference.

Some Investors Find Private Information

If you wanted to buy shares in a retailer, how would you do research? You could start by reading the company news releases and annual reports, but we know now that this public information has little value. What if you sat in a shopping mall and watched how many people went into the store and how much they bought? With enough time spent in the mall, you could at least figure out how much business that store was doing.

Of course, you would get a very narrow picture of the company's overall business if you only looked at one store in one mall. To really get a good feel for how well the company was doing overall you would need to survey many stores in many different regions of the country. You would have to analyze whether people were buying regular-priced merchandise or discounted products. You would need to know enough about the retail business to understand costs so you could estimate the margins the company was enjoying. With a lot of retail knowledge, hard work and time you could get a sense of whether earnings would be better or worse than expected. Would you do this?

As an individual investor managing your personal portfolio, you would probably not apply these sorts of research methods. The cost of doing so would be prohibitive, and unless you had a team of people helping you it would be impossible to do it in a timely way. There are, however, investors with sufficient capital under management to do this kind of work. There are firms who complete this work and then sell their research to deep-pocketed institutional investors. Is it legal? Absolutely. Is it fair to the little guy? Not really.

Don't despair, I will later show you how we can use these large investor tactics to our advantage.

Who should use fundamental analysis? Ignoring the opportunities created by emotion for a moment, large institutional investors with the resources necessary to uncover private information benefit the most from this analytical method. They are able to work in the grey area between inside information and knowledge in the public realm. They can uncover information that gives them an edge over the average investor making decisions based on information they gather in the mainstream.

Do you feel ripped off, that the odds are stacked against you, that it is not possible to compete against the big money players? If so, don't worry. What appears to be their advantage is outweighed by the disadvantages that come with size and, with some simple techniques, the advantages that come with size won't even matter.

The Price to Earnings Ratio Revisited

Let's return to the PE ratio indicator and decide whether it is as useful as it seems. If two similar stocks in similar industries are trading with different price earnings ratios, does that mean that one is undervalued or the other is overvalued? Or does it mean that one company is just not as good as the other?

If you believe that investors are well informed and act rationally then you have to agree that the difference in PE ratios between the two is fair. One company may have more debt than the other, making it riskier. One company may have older assets, making them more likely to spend money in the future on upgrades, which will lower their future earnings. One company may be the subject of a lawsuit that could cost millions. What if the two very similar companies use different methods to calculate their earnings? There are a lot of accounting tricks that companies can use to improve their financial statements, so perhaps one company has a more generous interpretation of its profitability. There are an infinite number of reasons why the difference in valuations between two seemingly similar companies is justified. We don't need to understand any of these reasons as long as we believe that the market is efficient and assets are fairly priced. The thousands of investors who vote with their capital each time they make a trade assure us that the price is fair, based on the information that investors have.

There Is No Truth

Fundamental analysis works to uncover the truth about a company's business, but in reality there is no truth. The truth is not based on fact or reason. In the market, it is simply what people believe. Just as people once believed the world was flat, so too did people believe that paying 200 times earnings was justified during the technology boom of the late 1990s. What people call the truth is constantly changing.

Eventually, investors in these technology stocks found their wits and the tech bubble burst. However, how much wealth was created along the way for investors who turned their backs on fundamentals and rode the wave of optimism that intoxicated the market? As 1999 came to a close, the truth was that stocks could go up day after day and money could be made riding the wave of irrational exuberance. Would you rather sit on the sidelines with your principles, watching as stock prices that could not be justified by any fundamental model went up each day? Or would you jump on the bandwagon and dance as long as the music was playing?

As a young person who was broke only two years before, I was making $10,000 a day trading during the tech boom. I knew that the prices I was paying for stocks were ridiculous, but I also knew I could sell them with a click of my mouse when the time was right.

That bubble burst, just as so many speculative bubbles before it had burst. The small investor, who realized that the perception of what the truth was had suddenly changed, was able to exit the market, leaving the believers to hang on for the dream of still higher prices. The end of that bull market was easy to see, just as the end of the housing boom was easy to see and every other bull market end will be easy to see. I will show how when I discuss exit signals in the "Gravity Works" chapter.

There is no truth; there's only what people believe to be true. Who decides what the appropriate PE ratio for a stock or industry should be? To the best of my knowledge, there is no stock market rule book that outlines the appropriate value for PE ratios or any other quantitative indicator. The historical average of PE ratios for the S&P 500 shows that this value has deviated greatly over time, particularly in recent years.

In the 20-year period between 1980 and 2000, the average PE ratio ranged from about 8 to over 40. Which one was right? If the average PE ratio over the history of the stock market has been between 15 and 16 times earnings, how many opportunities to

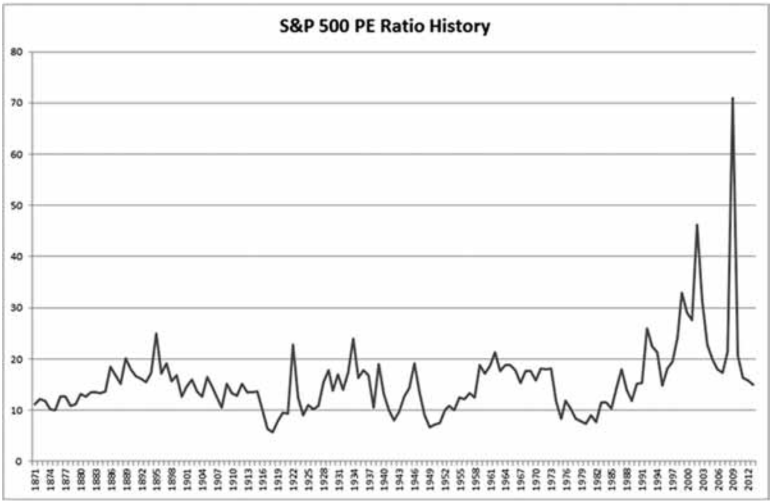

Chart 6 – Average PE Ratio for the S&P 500 1871–2012.

make money were missed when stocks traded over that midpoint? Avoiding stocks when the PE ratio was above the historical average would have meant missing out on some of the greatest bull markets ever seen.

You will counter that it would also have meant avoiding the greatest collapses the market has ever seen, and you're right. Markets that traded with abnormally high PE ratios eventually broke down and moved sharply lower.

There is no rule that says you have to stick with these stocks through the correction. Remember, this is a book about trading. A trader can sell his position in an instant and avoid riding the collapse of a bull market. A trader can short sell when the market says it is time to do so and take advantage of the market's collapse.

It can be argued that in the last 20 years, stocks have traded more on supply and demand than on business fundamentals. Baby boomers amassed a great deal of wealth, which they invested into the market as they approached retirement, driving stock prices up. It's not that the companies they were investing in were any better fundamentally, it's just that these investors were starved for places to put their money.

Your Mood Affects Your Beliefs

What people perceive to be the truth is largely dependent on their mood. The perceived truth that motivated investors to pay high prices for stocks in the 1920s and 1990s grew out of optimism. The perceived truth that made sellers accept low prices in the early 1980s grew out of pessimism. It is not just the information that matters; it is also the mood that is important.

Consider Netflix (NFLX). This stock's price appreciated from $20 to $300 in less than three years. In half a year, the stock fell from $300 to $60. Did the company's fundamentals change that

Chart 7 – Weekly chart of Netflix (NFLX).

dramatically in such a short period of time? No! What changed were perceptions—what people believed to be true. The motivations of buyers and sellers changed far more than the change in the fundamentals.

When using fundamental information to make an investment decision, understanding the context of the information is essential. News is only important if it has not already been priced in to the stock. How investors will react to news will depend on the mood of the market.

Have you ever seen a stock go down on good news? At the start of January 2011, I featured Disney (DIS) in my email newsletter; it fit the criteria that I will outline in a future chapter. In featuring the stock, I didn't know anything more about the company than anyone else. Instead, it was the market that told me the stock was likely to go higher, and I know how to listen to the market.

Within five weeks, the stock had climbed about 5%, a decent gain for a large-cap stock like Disney. Then the company announced their earnings from the previous quarter and the stock made a one-day gain of more than 5%. In less than six weeks, one of the biggest companies in the world had gained 10%.

Soon after that big jump on earnings news, the stock price began to fall. I put a sell alert on the stock in my newsletter, as the trade appeared to have run its course.

An investor who relied on the most recent bit of good news would probably have bought the stock after the company announced their

Chart 8 – The decline of Disney (DIS) after positive earnings news.

strong earnings, since business seemed to be good at Disney. Despite the good news, the stock proceeded to drop in price and never got back to new highs. Within a year the stock had fallen as much as 33% from the price it reached on the day of the great earnings news.

The market had started to price in good earnings long before the news came out. Perhaps large investors sent some of their research staff to Disney's theme parks to count traffic or used other techniques to gather private information. Whatever investors used to uncover this new information, they were proven right on earnings announcement day. The stock made its big jump, but once the news was released, their reason to own the stock was gone. The trade had run its course.

This example shows how the market is more than efficient. Not only does it price in all publicly available information, it also prices in private information before it is made public. If you wait for the news, you are a dinosaur. If you fight the mood of the market, you lose.

Fundamental Analysis Is Essential, but Not for You

I don't use fundamental analysis to pick stocks, but I recognize that the study of business fundamentals by other investors is essential for me to make money. If most investors were not analyzing every aspect of what companies do, what is happening in the economy and in global politics, the message from the market could not be reliable. Individual investors like me get a free ride from the big players in the market who do all the hard and expensive work.

It is ultimately what people believe about the fundamentals that is important. You should understand how people are voting with their money—what they perceive to be the truth. You could do all of the work necessary to get a seemingly complete understanding of a company's business. Will you know more than experts in that industry or a large institutional investor with the resources to uncover private information? What if, despite all your time and hard work, you miss out on that one important fact that the market ultimately cares about most and you get the trade wrong? Will you be able to admit your analysis is wrong if the market tells you so?

It is easier to follow the large, well-informed investors than it is to do the hard work yourself. By doing so, your success rate will be higher—provided you can reprogram your approach to investing. Your first lesson is never to fall in love.

10

Never Fall in Love

I have made thousands of trades in my life, and the ones that stand out as the worst—those that not only lost me a lot of money but also took a great deal of emotional capital—are the trades where I knew too much. I understood the company well, I listened to and believed in the story, and ultimately, I fell in love. In trading, love is cruel. By doing the in-depth fundamental analysis of the business, I established an emotional relationship with my stocks and overlooked their failings. When the trades went bad, I stuck with them and allowed big losses to happen.

I have suffered big losses as a result of love affairs with individual stocks more than once. We are supposed to learn from our mistakes, but that process can be slow, and along the way financial losses can mount. I want to help you avoid the pain that comes from love—at least, misdirected love for a company story.

Knowledge Can Be Dangerous

Suppose you are given a set of strategy rules by an expert trader who has found that the strategy makes $500 a trade when it is right and loses $200 a trade when it is wrong. The trader assures you that the strategy has been profitable 70% of the time.

You start trading the strategy, and, after making 100 trades, you find that the expert trader was right; it was profitable 70 times, making you an average profit of $500 each time and losing you an average of $200 thirty times. Over the 100 trades, you made $29,000 (70 × $500 – 30 × $200).

As you move into your next 100 trades, you find a stock that meets all the criteria of the strategy that the expert trader gave you. You move in and buy the stock, following the rules of the strategy. Later that day, you are discussing the trade with your neighbour, who tells you that she actually works for that company and that you have made a great trade because the company has big results coming. It turns out that the company is in the mining business and is exploring for gold in the Nevada desert. It has had excellent preliminary results, and she thinks it is going to be a sure thing. She tells you how everyone in her office is buying the shares because they know how great an opportunity it is.

You know the market agrees with her because your new system gave you an entry signal. You read up on the company a little more and find out that the company management has a great track record for finding viable gold mines; they have done it three times before. You also discover a website that has an analysis of the preliminary results by an independent geologist who does not work for the company, and he has put a strong buy rating on the stock with a $10 target. You already bought today at $5.

Although the rules of your expert's system limit position sizes, you decide to buy more. Breaking the rule at this point seems reasonable given the information you have, especially since people who work at the company are buying too.

You are surprised when, three days later, the stock price falls and hits the stop loss point defined by your system. This is the point where you were supposed to take a $200 loss, but because you bought a lot more of the stock you are faced with a $1000 loss. You decide to stick with the trade after your tipster neighbour tells you to expect results the following day. It feels good to have some inside information.

Results do come out the following day, but they are not what you expected. The company did not find gold, and the venture is a bust. The stock drops to $2 a share. Your loss has now ballooned to $15,000.

This single loss represents the profits of 30 winning trades in your system. What should have been a $200 loss grew to 75 times that, all because you broke the rules of your proven strategy. Your neighbour feels bad for giving you the tip, but she has her own problems: she had invested every penny of her savings into the stock and is now faced with a huge loss too.

Are You Normal?

Does this situation sound familiar? I have heard this kind of story too many times for it to not be common. We, as emotional human beings, easily fall into this trap, not because we are bad or stupid people but simply because we are normal. Normal people are predisposed to fail in the stock market.

When you know too much you ignore the message of the market. You avoid information that works against your thesis for a trade. You see what you want to see.

There is actually a good biological reason for this. Optimism is inherent in people; it gives them the will to overcome great obstacles to ensure survival. Imagine being a settler of a new land and facing a severe storm that threatens your existence. If you focused too much on the reality or your dire situation and had no optimism, you would probably not find the will to overcome the adversity. Optimism is what gives you the strength to survive.

It is easy to carry this survival instinct to the stock market. If you have a substantial amount of your net worth wrapped up in a stock, it is likely that you will do whatever you can to make yourself feel comfortable with it. You will read news releases with a focus on the positives. If you encounter some negative comments about your company, you will find a reason to discredit the source. If some bad news comes out, you will search for some expert, no matter how obscure, to tell you that the bad news is not important and that the long-term potential for the stock remains.

This is a love that grows out of our emotional attachment to money. Just as a mother loves her children unconditionally, so does the investor who has developed an emotional relationship with a stock.

Investors who study public information are really just looking for a reason to feel good about the stocks they own. There is no value in knowing something the market already knows because the information has been priced in to the stock. The danger is that this information could lead to an emotional attachment to the company that ultimately impairs your judgment. If impaired judgment is a risk and public information has no value, why consider it?

Avoiding a Personal Bias

When I am considering a stock, I try to make one argument for why I should buy it and another for why I should short sell it. These are two opposite trades with opposite expectations for future direction, and doing this encourages me to take out my personal bias and look at the facts rationally to determine the best trade to make. I don't really care whether I buy or short. I know that I can make money both ways, so I only want to do what my analysis tells me has the best chance of success.

I am not looking at fundamentals when I make a trade; instead I use the methods I will teach you later in this book. Whether you use my method or not, it's important to avoid information bias.

Missing the Point

When you fall in love with a stock, you tend to focus on the elements of the company story that fit with your optimistic outlook. Misguided focus can lead to bad results even if you interpret the facts correctly. The market tends to focus on only two or three key things, and those factors are what drive price performance. If you focus on the wrong information your analysis can lead you to a bad trade.

For example, someone doing fundamental analysis of a construction company will likely focus on things like the number of houses the company is building, the margin, how strong the company's balance sheet is and the quality of the company's management. This analysis could indicate that the company is very strong and the stock is worth buying.

What if that's not what the market is focused on? If the market is focused on an expectation that interest rates are going up, which would hurt the housing market, then this stock will not do well, despite the otherwise positive situation for the company.

This is a mistake that happens to investors all the time. They buy a stock for all the right reasons and still suffer a loss because they failed to see the one negative thing that the market ultimately cared about most. There are many factors that can affect how a stock's price moves; failing to account for all of the important ones can make good analysis fail.

Wanting a Return on Your Investment

Good and thorough fundamental analysis takes a lot of time, and that investment of effort creates another bias that can cause us to hang on to a loser. If you spend 20 hours analyzing a company before you invest in it, what are the chances that you'll admit your analysis is wrong?

Some people are capable of scrapping a trading idea no matter how much work went into it, but for most, it's hard to throw away that effort. We'd rather hang on, hoping the market will eventually prove our hard work was worth it, instead of throwing in the towel when the market has shown us to be wrong.

This investment of time gives us one more reason to see what we want to see. It provides a basis for optimism when the market is giving us adversity.

Never Fall in Love

There is a danger in knowing too much. We develop a significant bias when we put a lot of time into gathering information. We become loyal to a stock when we understand and believe in the company's fundamentals. It's easy for us to ignore conflicting information when we are emotionally attached to a stock.

These things can cynically be described as "falling in love," and they often end in pain. As long as you are a normal person, you are likely to succumb to emotion in some way. The market is going to prove us wrong some of the time, and we need to be capable of seeing that proof when it's in front of us. I will show you my method for knowing when you're wrong later, but for now, understand that you must avoid knowing so much about a company that you lose touch with reality.

11

Plan to Be a Loser: Managing Risk

It's Not About the Stock

If you ask 10 investors what the most important determinant of success in the market is, I would guess at least eight of them will say, "Pick the right stock." In the stock market, the focus is always on what to buy. Analysts working for banks put out buy ratings on stocks, market experts pick stocks, the media talks about the best stocks to own and water-cooler conversation is always about the next hot stock. Almost all conversation about stock trading focuses on the entry decision.

This is misguided, and it's one of the reasons most people don't beat the stock market. While picking the right stock at the right time is important, it is not the most important factor for overall profitability. In fact, I wouldn't even put the entry decision in second place on a list of the most important criteria for trading success. At the top of the list is something that is mentioned in passing from time to time by market experts but rarely put as the dominant reason for a person's ability to beat the stock market. Risk management, and understanding what risk really is, is the most important factor for success.

Risk Is Not the Same as Price Volatility

For most investors, stock risk is associated with the volatility of the stock. A micro-cap penny stock that routinely moves 5–10% in a day is considered a risky stock. The stock price changes a lot because buyers and sellers are unsure of what the company will make or even if they will ever make a profit. With uncertainty comes price volatility.

But much of the high price volatility can be blamed on the relatively small number of people who trade the stock, which makes it less liquid. A penny stock might trade 30 times a day, while Bank of America can trade over 100,000 times a day. With fewer people trading the stock, there are fewer people voting on what the company is worth. That makes the market price more uncertain, and is another reason for the price volatility.

Neither of these factors, however, truly address what the risk of the trade is. True, the small company behind this stock should be considered risky. Since most small-cap stocks have only one or two core prospects in their business, they are only one failure away from going out of business. An oil exploration company drilling on their one and only prospect is in a boom-or-bust situation with a lot of uncertainty and risk. But this is risk in the company and not in the trade.

Trading Risk

As traders, the risk we take on any one trade is a combination of how much of the stock we own and where we intend to exit the stock at a loss if we are wrong on the trade.

Yes, I wrote, "if we are wrong on the trade." Being wrong is part of making money in the market, and we have to accept that it's going to happen. In fact, the best traders are wrong a lot. Making money in the market is not about being right or wrong, it's about how much you lose when you're wrong versus how much you make when you're right. We'll get to that concept soon.

Everybody Loses

As you read this, I want you to think about all of the people you know who trade the stock market, yourself included. Do you know anyone who has been right 100% of the time? Do you know anyone who has never taken a loss on a stock or who is not sitting on a loser in his portfolio right now? I have asked thousands of investors this question over the years and I have never met anyone who has traded for at least a year who can tell me that she has never lost on a trade. Not one.

If you fill a glass with water and put it in a freezer, the water will turn to ice. We can say that with certainty because we know that water freezes at temperatures below 0 degrees Celsius or 32 degrees Fahrenheit. But unlike the science of freezing water, we can't say that we are certain to make money on a trade if we follow a series of rules. There is no scientific certainty in the market. Trading the market is an art, not a science.

Most, if not all, investors realize that they can't be right all the time in the stock market, but very few approach the market with respect for this fact. Stock traders try to trade the market as if losses never happen, even though they know this is not a reasonable expectation. This leads to the biggest reason the vast majority of investors don't beat the stock market: they don't know how to control the size of their losses. That means they don't understand how to manage risk.

A profitable trader has to plan to be a loser. Each time he makes a trade, the successful trader focuses on the potential for loss rather than the potential for gain. No one wants to lose on any trade, but, since we know that trading is an art and not a science, we know losses are inevitable. If they're going to happen we have to minimize the damage they inflict on our portfolios.

Determining Your Risk Tolerance

What is risk? It's the difference between our entry price and the price point where we plan to take a loss multiplied by the number of shares we take in the trading position.

If we buy a stock at $10 and plan to take a loss at $9, the risk is $1 per share. If we buy 1000 shares, we stand to lose $1000, assuming we are able to get out at exactly $9 and not factoring in transaction costs like the brokerage commission. There are a few numbers in this example and each deserves a name. Ten dollars is the entry price, $9 is the stop loss price, 1000 is the number of shares and $1000 is the risk tolerance.

As a good risk manager, you must start with the risk tolerance. How much are you willing to lose on any one trade? For every trader, the answer will be different. How much money you're prepared to give back to the stock market when you're wrong is a function of your emotional makeup, capital base, age, occupation and personality. A person with $100,000 in their trading account should be willing to take more risk than a person with $10,000. A $1000 loss is only 1% of $100,000 portfolio, but it's 10% of $10,000.

When determining your risk tolerance, you can think about how long you have until retirement, how hard you worked for the money you are trading with, what the market conditions are, how confident you are in the trade, how you did on your last trade—there's an endless list of factors that affect your tolerance for risk. There is, however, only one thing that really matters. How much of a loss can you take before your emotions are aroused so much that they affect your decision making?

This is your tolerance for risk. We can also refer to it as our "sleep well point." Are you comfortable losing $1000 on a trade or is that too much? If that's too much, then how about $500? Still too much? How about $100? For some, there's no amount that is correct; their tolerance for risk is $0. No problem, we can deal with that too.

What is essential is that you know what your sleep well point is and use that amount to size your trading position. Your risk tolerance will change over time; it's a function of your trading prowess and track record. For now, I want you to pick a dollar amount that you're comfortable using.

With that number in your head, understand that we can make every stock have essentially the same amount of risk. Whether you buy a large bank or a small oil explorer, the risk will be the same. Risk will no longer be attached to the type of stock you buy but instead to the size of the position you take.

This is where price volatility, which is what most people consider to be stock risk, comes into the equation. The more volatile the stock, the smaller the dollar size of the position will be. With a more volatile stock we will buy less, with a less volatile stock we will buy more. If we do it properly, each stock in our portfolio will have the same amount of risk, no matter how volatile it tends to be.

Managing Your Risk

Let's explore this concept with an example. Two stocks are showing a good trading opportunity. The first is a hot, fast-moving biotech stock trading at $3. The company has no revenue but has been working on a treatment for colon cancer for a number of years and the buzz in Internet chat rooms is that they have something really big. You analyze the stock (using the methods I will teach you later in this book) and decide that it is good stock to buy at $3 with a stop loss at $2.50.

The second stock is a large computer manufacturer who has had growing earnings and improving profit margins for the past few years. They have great management and a large pool of cash on their balance sheet. Seven out of 10 analysts have the stock rated as a buy with a $50 price target. The stock is currently trading at $40 and your analysis indicates that the trade is a good one as long as it can hold above $38.

Which stock is riskier? Clearly, the biotech *company* sounds a lot riskier, but hopefully you are starting to see that the risk of the trade has little to do with the company. It's about the position size that we take in each stock.

The difference between the entry and stop loss price on the biotech stock is $0.50 a share. On a $3 stock, that represents about a 17% loss if the trade doesn't work. On the trade of the large computer company's stock, the risk (entry price minus stop loss price) is $2 on a $40 stock, or 5%. This bigger, better-managed, better-capitalized company is less volatile and so we have a tighter (in percentage terms) stop loss price.

Let's say we're willing to risk $500 on each trade. That means you buy 1000 shares of the biotech stock, since $500 of risk tolerance divided by $0.50 a share in risk equals 1000 shares. Since the stock is trading at $3 a share, your position costs you $3000. In the trade of the second stock, you will buy 250 shares. Again, $500 of risk tolerance divided by the risk per share of $2 gives you 250 shares. For this trade, the position size is larger because the stock is trading at $40 a share, making the total cost of the trade $10,000.

You have now made the trade on the volatile and uncertain biotech stock have the same amount of risk as the trade on the large, well-managed computer stock. You did this by buying a smaller position of the more volatile stock.

Does that mean you limit your potential return on the biotech stock? No: relative to the computer company, both have the same potential. Since the biotech stock is more volatile, it has the potential to make a proportionally higher gain than the computer company. You used a wider stop on the biotech stock than you did on the computer stock to respect the greater volatility. Since you risked a 17% drop in the biotech shares, you should expect that you might earn 100% if the trade works. This would be the same as the computer stock going up about 30%.

There are a number of concepts and skills that you will need to learn before you can really apply this risk management method. You need to know where the stop loss point should be and how risk and reward are related. We will get to those things in future chapters. For now, keep it simple and focus on the idea that every stock can have the same amount of risk because you will buy less of a stock that has a higher degree of price volatility.

Taking the Loss

This method for managing risk has a very important requirement: the trader must be willing and able to crystallize the loss if and when the stock hits the stop loss point. That sounds simple and obvious, but it's remarkable how many people have trouble pulling the trigger when it's time to take a loss.

If you fall into this group, welcome to the club. I too am in this club; I call it the "Normal People Society." As I have said before, if you are a normal human being you are predisposed to fail in the stock market. The simple fact that normal people avoid pain is what makes us hang on to our losers even when we know it is better not to.

Failing to Sell

Suppose you buy the biotech stock at $3 and plan to get out of the stock at $2.50. Having studied the company, you are excited about the company's prospects and doubt that you will take a loss. Every bit of information you have read talks about how this is a stock that could go to $20 because initial trials using the company's treatment for colon cancer have been so positive. You are already planning what you will do when the profit rolls in.

For the first few days after you enter the trade, the stock does well, hitting as high as $4 a share. A nice 33% move, but not nearly what you are looking for out of the stock. So when the stock starts to pull back, you hang in there and stick with the trade. Within two weeks it's back to what you paid for it: $3 a share.

A bit worrisome, but the overall market has been weak as well so you consider the weakness as nothing more than a blip in the long-term price rise of the stock. The following day, you check the share price at the close and find it has dropped to $2.40 a share. It has gone through your stop loss price, which, based on your risk management, means you should exit the stock the following day and take the loss.

"The market must be wrong. This must be the result of something unrelated to this company," you tell yourself. That night you spend some time looking at company news, checking stock market chat forums and message boards, and watching a commentator on TV rave about the stock. You find nothing negative to explain the one-day price drop. Other investors blame the drop on short sellers who are trying to bring the company down or a large institutional seller that had to liquidate its position because of losses in other stocks. You decide that today's drop is a one-day anomaly and plan to hold the stock as it is going to bounce back.

The next day it does bounce back, rising to close at $2.70, back above your stop loss price. You watch the stock for the following few days and are relieved to see it continue to hold around that $2.70 price mark, although it fails to get back above the $3 price that you paid for it. You are happy that it's holding up, relieved that you didn't sell when it was at $2.40, but frustrated that it hasn't continued to move up the way the story would predict.

On a Monday, you find the stock has gapped down to $1 a share. News has come out stating that the treatment had severe adverse side effects during testing and that the company must end the trial. The news release spins the story in a positive way, stating that the company intends to bring the drug back for testing once it has made some changes to how it is formulated. That does little to console you because your loss has ballooned from $500 to $2000.

It appears that the selling pressure on the day that took the stock below your $2.50 stop loss price was a signal from the market that something was wrong. Perhaps the large hedge fund that was the principal seller that day had some inside information on how the clinical trial was going. Perhaps a company insider knew that bad news was coming and told his friends to sell the stock. None of it really matters to you now; this is a trade that has turned into a long-term investment.

Why People Fail to Sell

Why don't people take the loss when the market tells them to? There are two primary reasons:

1. If the trader takes more risk than she's comfortable with, she is likely to avoid the pain of taking the loss because it is, well, too painful.

2. He hasn't done enough work to have faith in the stop. This leads him to doubt that the stop loss price is at the right price or even necessary. Without confidence in this risk management rule, he is unwilling to follow it when faced with the pain of the loss.

Does this sound like something you've done or are capable of doing? If you belong to the Normal People Society, I expect that it does. It's not something to be embarrassed about or hide. Shout out to all who can hear, "I am a normal person and this causes me to fail when I invest!" With that recognition, we can move toward changing this behaviour for the better.

Hope and Loyalty Have No Place in Trading

When faced with a loss that goes beyond their tolerance for risk, most people will fail to take the loss and instead hope for a turnaround. Unfortunately, hope is not a good trading tactic; it is something that you must keep out of your approach to trading. I often joke that hope belongs in the church and the bedroom and has no place in trading.

As you will soon learn, your winners have to pay for the inevitable losers. It becomes hard to maintain this balance if the losers get too big. If we approach trading with the recognition that losing will happen then we can devise a plan to deal with these inevitable losers. This plan needs to consider our risk tolerance and how stock price moves so we can determine the right stop loss point and size our positions accordingly.

You should be loyal to your family, your dog and your team. Don't be loyal to your stocks. When they begin to inflict pain on you, get rid of them and look for the next trade. If you can take small, manageable losses you are well on your way to doing well in the market and a long way ahead of normal people, who have not yet learned this valuable lesson.

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Leverage Multiplies Risk and Reward

Trading with leverage is thought to be a risky way to approach the market. Certainly, in the hands of an undisciplined trader, leverage is risky and should be avoided, but for the trader who understands how to manage risk, leverage can be used responsibly and is a valuable tool for improving trading performance.

Trading with leverage means borrowing some of the capital necessary to carry the trading position. This is typically done in a margin account with the stock brokerage. Since the shares you buy sit with the broker, they have the collateral for their financial protection.

Most brokerages will give 2:1 or even 3:1 leverage on the stocks you buy. If you buy $10,000 worth of a stock with 2:1 margin leverage, you only need $5000 in capital.

The broker requires that you always maintain that 2:1 leverage ratio, so if the stock you bought with leverage goes down in price, you may be required to increase your equity stake. If the value of your $10,000 position drops to $8000, the broker will only be willing to lend $4000 against that position (instead of the original $5000), which means you have to put in another $1000 of equity (since you require $6000 of equity and have only put in $5000). This is referred to as a margin call.

The benefit of leverage is that you can increase your return on capital. If you buy 1000 shares of a stock at $10, the total cost for the position is $10,000 (plus commissions). If that stock goes up to $12 and you sell, you have made a $2000 profit and a 20% return.

Using 2:1 leverage, you would only need to use $5000 of capital to hold this same position, but your profit in dollar terms would be the same: $2000. This is now a 40% return on your investment, since you only put up half the capital.

Leverage Requires Discipline

Of course, leverage is a double-edged sword since you also suffer twice as much if the value of the position falls. That is why a disciplined approach to risk management is essential.

As discussed in the last chapter, if you go into every trade planning to be a loser, you can determine your likely loss exposure based on your stop loss price and risk tolerance. The difference with using leverage in your trades is that it will take less capital to carry the same amount of dollar risk.

If your risk tolerance is $500, your entry is $10 and your stop loss point is $9.50, then you can afford to buy 1000 shares ($500 risk tolerance divided by $0.50 a share in risk = 1000 shares). Without leverage, you need $10,000 to buy 1000 shares of a $10 stock. Using 2:1 leverage, you can do that with $5000 and borrow the other $5000 from your broker using margin.

If you're wrong and have to take a loss at the stop loss point, you lose $500 whether you use leverage or not, since you lose $0.50 a share times the 1000 shares you bought. The difference is that the use of leverage makes that loss 10% of your capital versus 5% if you made the trade without leverage. With leverage, you used $5000 of your capital to lose $500, but without leverage you had to use $10,000 of your capital to lose the $500.

Therefore, using leverage has the potential to eat away your capital base more quickly if you are trading a losing strategy. The key to making the use of leverage effective is to have a strategy that makes money over a number of trades. I will explore how to do that later in this book.

Leverage and Tax-Shielded Accounts

Most Western countries have some sort of tax-free retirement account that allows investors to grow their savings without having to pay tax or by delaying tax (401(k) plans, RRSPs and TFSAs are examples of these accounts). The tax shield seems attractive but most of these accounts do not allow the use of leverage, which inhibits the performance potential of the account. An effective trading strategy (one that makes money consistently) should do better outside these tax-shielded accounts. Here's why.

Suppose money you make in the stock market is taxed at 40%. This is probably higher than most people will pay on stock market gains because capital gains are taxed at a lower rate in most countries, but let's go with a high rate for this example.

If you have a $100,000 portfolio and you have a trading strategy that makes you 10% on your capital in a year, you make $10,000. If you achieve that in a tax-sheltered account without the benefit of leverage, you earn $10,000 after tax. It is likely, however, that you'll have to pay some tax on that gain when you take the money out during retirement, so you've really only delayed paying tax until retirement, when presumably your tax rate is lower.

With 2:1 leverage, you could increase the buying power of your portfolio to $200,000, giving you a pre-tax gain of $20,000 using the same strategy that earns 10% per year, since you can buy twice as much stock with your cash using leverage. When you pay the 40% tax you're left with $12,000, better than the gain in the tax-sheltered account, and you don't have to pay any more tax on that money when you're retired because you've already claimed it as income.

You Must Have a Profitable Strategy

It's extremely important to realize that none of this works if you have a losing strategy for trading the market. Leverage will get you to zero faster than trading without it, but if you have a losing strategy, you shouldn't be trading at all. We will work on ways to develop a winning strategy later in this book.

Traders must realize that being wrong is part of trading; it is inevitable. We must have a method for knowing when the market has proven us wrong and then have the discipline to take the loss when the market tells us the trade has failed.

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Let Your Profits Run

Reward is the reason you are willing to take risk. When you're effective at balancing the risk of losing against the profit that comes with being right, your portfolio grows. The amount you make in relation to the risk you take can be expressed as the reward for risk multiple.

Traders tend to take profits quickly and hold on to losers too long. In the last chapter, I discussed the importance of stopping the loss at a set point so that losses don't go beyond our risk tolerance. In a few chapters, I'll give you ways to know where to put the stop loss point so you have a good chance of staying with trades that will work but getting out of trades that are destined to lose more.

This chapter will show you how to measure your performance in the market using reward for risk multiples. The reward for risk multiple is a measure of how many times your reward is bigger than the risk you took. As traders, we want to maximize our reward and minimize our risk.

Calculating Your Reward for Risk

The reward for risk metric is pretty straightforward. If you buy a stock at $10 with a $9 stop loss point your risk is $1 a share. Sell that stock for $15 and you have made $5 a share. Your reward for risk multiple is five. So long as you can exit your losers at your stop loss point, a trade that earns a reward for risk of five pays for five losers.

You have to avoid talking about profit in dollar or percentage terms. Making $1000 might sound good, but if you risked $2000 to make that $1000 profit, you have made a trade that only earned a reward for risk of 0.5. A trade that makes a $1000 profit is much better if it came after risking $250, making the reward for risk ratio four.

You know you're not going to be right all of the time when trading the stock market, so it's important to manage the size of your winners and losers. Your winners have to pay for your losers, so the bigger the average profit, the better. To be more succinct, as your average reward for risk ratio increases, the need to be right goes down. I will expand on this concept soon.

It's Not About Being Right

For now, understand that most successful traders make money because of the occasional big winner. Over 10 trades, you may have seven or eight trades that are small winners or small losers, breaking even overall. It's the one or two trades out of 10 that really work well that give you your profit. Consider the following for a trader who risks $500 a trade.

Trade 1—lose $520
Trade 2—break even
Trade 3—lose $550
Trade 4—make $700
Trade 5—make $2700
Trade 6—lose $490
Trade 7—make $300
Trade 8—make $600
Trade 9—make $6400
Trade 10—lose $875

After 10 trades, this trader lost on 40% of his trades, profited on 50% and broke even 10% of the time. From a success rate standpoint, this is not outstanding. If this trader were writing an exam for school, he would barely get a passing mark. In the stock market, however, success is not judged by how often you're right, it's profitability over a large number of trades that matters.

The net profit after these 10 trades was $8265, for an average reward for risk of 1.65. This is calculated by taking the total profit of $8265 and dividing it by the total risk taken of $5000 (risk tolerance of $500 per trade times 10 trades).

Now consider what happens if you take the two biggest winners, trade 5, which made $2,700, and trade 9, which made $6,400, and make them small winners, netting only $500 each. It is common to exit strong stocks too early because it feels good to lock in a quick profit. By doing so, you have now lowered your total profitability over the 10 trades to $165 for an average reward for risk of 0.03—hardly worth the effort.

The success rate didn't change. All this second scenario did was put a cap on the size of the biggest winners. While it sounds foolish to limit the size of your winners, normal human beings are highly likely to do this.

Hold On to Your Winners

The reason is simple. As members of the Normal People Society, we avoid pain and pursue pleasure. That means we want to avoid the pain of losing, so we hang on to our losers, hoping that they will turn around and at least break even. It also means we like the feeling of cashing in a profit, so we tend to sell our winners early. Part of this tendency to sell our winners too soon comes from our fear of seeing a winner turn into a loser—another example of avoiding pain.

This example shows the importance of letting those relatively rare bigger winners materialize. Trade 5 earned a reward for risk of 5.4 and trade 9 made 12.8. Without those two big winners, this batch of 10 trades basically broke even.

To beat the market, you have to be patient with your strong stocks. The great challenge is overcoming your emotional, normal self so that you can do this. Believe it or not, the more you're right, the more you'll doubt yourself. The natural tendency is to be overconfident when we're wrong and underconfident when we're right. It is your natural survival instinct to be overconfident when you're wrong, because you're wired to be optimistic when faced with difficulty. Without this natural optimism you would fold when faced with challenges and likely not survive difficult situations. This same instinct to survive makes you fight to win when your stocks are losing, another reason why you hang on to the losers.

I find that most traders doubt the big winners because it feels too easy. What do you think when you see a stock that is up 40% in the first half of the day? If you are like most people, you naturally think that it has already gone up a lot and can't possibly continue to go higher. You doubt the strength and look for any excuse to get out of the stock because you fear the move so far has just been lucky and eventually the stock is going to come back down. Most will exit this kind of a winner at the first sign of weakness.

There is no limit to how much stocks can go up. It's not that uncommon for stocks to make considerable gains in a short period of time if there is a significant fundamental change in the company's business. I will show you how to find these hot stocks later in this book.

For now, you need to recognize the need to be patient with your winners. The profit comes with the time you give the stock to make its move.

Don't Set Price Targets

I have met many traders who set price targets for their trades. If the stock gets to that target, they exit and take their profit. These same traders often hold on to their losers, hoping they'll turn around.

The strategy described earlier was not profitable without the two big winning trades. The economics that made that strategy profitable required the trader to allow those big winners to happen.

The stock market is difficult to predict and you shouldn't rely on your ability to be right often to make money. Most good traders are wrong more than they're right, but they make money because they make some big profits when they're right and suffer small losses when they're wrong.

Imagine you're the owner of a basketball team and your star player tends to score between 10 and 40 points a game, with an average of 22. Would you pull him out of the game once he has scored 22 points, assuming that he's not going to score anymore because he has hit his average? Of course not! You know that there are times when he plays better than others. There's no good reason to limit him when he is showing strength.

Adopt that analogy to your trading. If the trade is working well, let it continue to work. Don't fall into the trap of assuming that a strong stock is more likely to go lower and give back profits than a weak one. There's a reason why that trade is strong and you will make more money if you refuse to limit its profitability.

You should work to limit the size of your losses but not the size of your winners. If a trade is working, let it work and exit only when the market tells you that the stock is likely to reverse. Doing this means you will never get out of the trade at the top but you will also stay in the strong trades and let those big winners happen.

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Losers Average Down; Winners Average Up

Averaging down is buying more of a stock that is losing you money. You find a stock that you think has a good potential to go up, but after your initial entry it goes down instead. Rather than recognizing that the market has proven you wrong and exiting the loser, you buy more at a lower price. As the stock price continues to fall, you buy more so you can lower the average cost of your position in that stock.

Suppose you buy 100 shares of a stock at $10. It falls to $9, and you buy 100 more shares. So far, you have spent $1900 for 200 shares, making your average cost $9.50 a share. To break even, the stock does not need to go back up to $10; it only has to go to $9.50. The stock fails to reverse its downward price slide and falls to $8, where you again buy another 100 shares. You have now spent $2700 for 300 shares; your average cost is $9 a share.

At this point, the stock only has to rise from $8 to $9, a gain of 13%, for you to break even. If the stock continues to slide, and you continue to buy 100 shares every time the stock falls to a new even dollar amount, you will need the stock to make a greater percentage gain to break even. If the stock falls to $5, you will own 600 shares with an average cost of $7.50 a share, and the stock will have to rise 50% to break even.

Is it realistic that a stock can continue to fall this way? Many traders make the mistake of assuming that stocks have to eventually bounce back—that a stock that once traded at $10 is still worth something close to $10 and the fact that it is trading at $5 is just a temporary mistake by the market.

You must remember that the market does not look backward, it looks forward. Lower expectations for future earnings is the reason a stock falls from $10 to $5, and many companies are never able to reverse this trend. You may not know the reason the stock's price is going lower; the price action may not make sense with what you know at the time. We often find out what was driving price lower long after it is too late.

Traders who average down rationalize that eventually the stock will do what they expect and go up enough for them to at least break even. By buying more of the stock at a lower price, they are bringing the average cost of their shares down, waiting for what they feel will be the inevitable bounce. The hope is that, eventually, the stock will reverse its down trend and the position will become profitable.

While this sounds like a reasonable explanation for the averaging down process, it is really the desire to avoid pain that motivates traders to buy more of their losers. Averaging down assumes that the trader's analysis is correct and the stock market's pricing of the stock is wrong. It shows a willingness to argue with the analysis of thousands of investors in favour of one. Really, it is likely that the trade is losing because the trader made a mistake in the analysis.

Certainly, there are times when short-term price swings take the stock away from its true value. A large investor with strong motivations to sell a stock may be willing to accept a low price for a block of shares in order to quickly exit that position. This can cause the stock to go down for a short period of time before it rebounds back to its trend. When this happens, averaging could make sense. The problem is that it's hard to tell a short-term drop from the start of a downward trend. They both look the same.

Many people enjoy betting on horse racing. They do their analysis (or guess) to determine which horse they think will win, and place their bets before the race begins. Of course, it's not possible to place a bet once the race has started, because, once under way, the leading horses have a greater chance of winning than those at the back of the pack, making it easier to predict which horse will win.

What if you *could* add to your bet once the race was underway? Would you do so if the horse you had picked to win was in last place? Likely not, but you would certainly be willing to add to your bet if your horse was leading going into the homestretch.

Averaging down is comparable to adding to a bet on a losing horse who's fading fast. If the results show your pick of horses to be wrong, why would you want to risk more of your capital by increasing your wager?

The difference between a horse race and a stock trade is that the horse race has a visible end point while the stock is expected to continue trading for a long time. Somehow, investors losing money on a stock feel that this extra time horizon provides hope that their losing trading will eventually become profitable.

Truthfully, I have seen many instances where averaging down on a trade did work and a loser was turned into a winner. I knew a skilled trader who went against my advice and averaged down effectively for many months in a row, turning great profits over that time. The problem is, when the practice of averaging down failed, it completely obliterated his capital base.

Protect Your Capital

Without capital, you can't trade. Your first priority must be capital preservation, and averaging down puts your capital in serious jeopardy. Most stocks will eventually bounce back from weakness, which gives the average down strategy a chance to get out without a loss, but there will be the occasional stock that doesn't make that bounce, at least not before you run out of capital. If you practice averaging down long enough, you will eventually hit one of these long-term losers, and it will take all your capital.

The best stop loss point is one where you know that if the stock price hits that point it is likely to continue to fall. If that stop is hit, you have to take the loss, because the stock is now likely to continue lower. I will provide you with a good method for defining the stop in such a way in a later chapter. For now, assume that if the stop is hit, the likelihood of it going lower is higher than the potential for it to go higher.

If a stock trade is losing and the market's message is that it is likely to continue to lose more, then it becomes economically and emotionally better to get out of the trade. By doing so, you take the small loss and have your capital to put into something with a greater potential to go up. You also avoid tying up your emotional capital; owning a growing loser is depressing and frustrating and will cause you to miss out on other money-making opportunities.

Averaging Up

Adding to your winners does make good sense. If your analysis is proven right by the market then why not increase your position size? Buying more of a winner is referred to as scaling in to a position. It can usually increase your potential reward without increasing your risk.

Here is an example of how the economics of scaling in work. Suppose you buy a stock at $10 with a stop loss point of $9, giving you a risk of $1 a share. If you have a $1000 risk tolerance, you buy 1000 shares.

Soon after you make the trade, the stock rallies to $11 and then trades sideways, building a base at $10.50 before breaking through $11 to $11.50, giving a new entry signal. At this point, assume that the market has given you a cue to raise your stop loss price from $9 to $10.50 a share. By doing so, you have locked in a profit of $500 on the first position, assuming the stock does not gap through your stop loss point and you are able to exit that position if comes back to hit $10.50.

Now, if you want to add to the position, you have the $500 profit to work with to mitigate your risk. If you buy another 1000 shares at $11.50 with a stop at $10.50, you have a second trade that has $1000 of risk. Remember, however, you have the $500 profit from the first entry at $10 to lower your overall risk. If the stock falls back to $10.50, you'll make $500 on the first trade and lose $1000 on the second position, making your total risk only $500. While your risk is now less than when you started, you have doubled your position size, so you have much more upside potential if the trade continues to work.

You can continue to add more of a position as the trade continues to trend, building a larger and larger position. By doing so, you are using the money made on the early trades in the sequence to lower the risk of building a larger position.

If you are able to scale in to the position in this way at $11.50, $12.50 and then again at $13.50, you will build a position of 4000 shares without ever taking on any more risk. If you ultimately get a sell signal at $15, your total profit is as follows:

- Original entry at $10, exit at $15 for $5000
- Second entry at $11.50, exit at $15 for $3500
- Third entry at $12.50, exit at $15 for $2500
- Fourth entry at $13.50, exit at $15 for $1500

The total profit from scaling in is $12,500, and, since the risk of the trade never exceeded $1000, the reward for risk ratio is a very good 12.5:1. If you had only taken the first entry, the reward for risk ratio would only be five on the $5,000 profit from that initial position entered at $10.

The downside is that we potentially forgo a profit if the trend on the trade doesn't last long. If we scale in a few times and then get a rapid drop that moves against us, we may end up taking a small loss or breaking even when we could have had a small profit had we not scaled in. There is also a chance that the stock could make a large price gap down before we get an exit signal and increase the size of our expected loss—a rare occurrence, but certainly possible.

What is important to know is that traders make most of their money on a small number of their trades. To make the big profits, you have to trade for the big wins and grind through the small losses or break-even trades. Scaling in to a trade gives you the additional upside on those occasional big winning trades without adding the emotional stress that comes from going beyond your risk tolerance.

Trading successfully requires respect for the fact that you can't predict with certainty when you'll be right and when you'll be wrong. You have to approach the stock market knowing there will be trades that really move in your favour and trades that lose. Wait for the market to tell you which trade you currently have. If it's a loser, get out rather than buying more. If it's a winner, add more because your analysis has been proven correct. Losers average down; winners average up.

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You Can Go Broke Making a Profit

Traders have to limit the size of their losses and allow their winners to move to their maximum potential. This should bring up a question: how much bigger do the winners have to be compared to the losers? The answer depends on the probability of having a winner.

How Often Are You Right?

If you do 100 trades and find that you are profitable on 70 of them, you can say with some certainty that you expect to be right on 70% of your trades. A hundred trades is a large enough sample to provide a prediction of your future success rate.

Of course, there are many factors that affect the probability of being right, and not all of them are under your control. While your trading skill is important, your success rate can rise and fall based on the trend of the overall market, political events, seasonal variations and many other factors. Your strategy for making money trading may work very well in an upward-trending market but then fail if the trend is sideways or down.

If your track record of past success is across a broad range of market conditions and strategies, your likelihood of future success improves. The larger the number of trades you use to determine your historic success rate, the more reliable your ability to predict your future trade record will be. But whatever you determine to be your expected probability of making money, realize that it is just a guess. Past performance does not guarantee future results.

Later we will work on developing strategies that can be tested to determine how often those rules make money. If you are like most traders, you have probably not yet put your trading rules on paper and tested them over a large number of trades to determine the rules' probability of being right or wrong. There is a good chance you have been trading without a set of rules, choosing instead to trade based on what you think makes sense. By this point in the book, I hope you're starting to see that trading what makes sense does not lead to profits.

How Much Will You Make When You *Are* Right?

Clearly, your need for a big spread between the size of your winners and the size of your losers goes down as your success rate goes up. If you can be right 70% of the time, you can make money even if your average winner is smaller than your average loser. If you make $500 on seven out of 10 trades and you lose $1000 three times out of 10, you'll still make money after 10 trades. You will, however, be much more profitable if you can increase the size of your average winner and lower the size of your average loser.

Expected Value

The basics of blackjack are pretty simple: combine the value of the cards you are dealt to come as close to 21 without going over, and get a total value that is greater than the dealer's hand. You win if your cards add up to 18 and the dealer's total 17. Draw cards that add up to 22 or more and you lose, no matter what the dealer has.

Statisticians can calculate the odds of winning for every combination of cards that the player holds against what the dealer is showing. If the dealer is showing a six and the player has a total of 10, the player should take another card and expect to win. If the player has 16 and the dealer has a 10 showing, a loss is expected whether the player draws another card or not. The chance of winning is slightly better if the player draws a card and risks going over 21 than if she doesn't take another card.

In the large hotel casinos of Las Vegas, thousands of hands of blackjack are dealt every day and the casinos expect to make a profit. No one can be sure who will win the next hand of blackjack, but because the odds favour the house, the hotels know that if they deal enough hands, the profits will come. For the casino, the game of blackjack has a positive expected value.

We can trade strategies with a positive expected value as well, effectively putting us in the same position of the Las Vegas casino when we trade. A trading strategy with a positive expected value is one where the expected profit over a large number of trades is greater than the expected loss. Here is the formula for calculating the expected value for any trade:

probability of profit × average profit – probability of loss × average loss

A strategy that makes \$500 70% of the time and loses \$1000 30% of the time has an expected value of \$50 (0.70 × \$500 – 0.30 × \$1000 = \$0.50). That means that over a large number of trades the average profit is expected to be \$50 per trade. Since this strategy has a positive expected value, it's worth trading.

There are two ways to determine the expected value for a trading strategy. First, you can devise the rules of the strategy and back-test them to see how they would have performed in the past. With this process, it's important to test across a wide range of market conditions so that you don't bias the results. It is also important that there be no room for judgment in determining the entry and exit points, since it's easy to shape the results by applying the rules subjectively.

Second, you can apply the rules in actual trading with real money and see how they perform over time. This will remove the testing bias, but it's also potentially more expensive. If your trading rules are not effective, you could lose money over many trades.

It's important that you have a large sample size for whatever method you use. Traders tend to judge a strategy's effectiveness by the result of their last trade. I've had traders tell me that they're never going to trade a certain strategy again after suffering a big loss on one trade using that strategy. Others will insist a strategy is effective because it has worked three times in a row. A small sample size is not an accurate predictor of the future. We have to avoid letting our current emotional state affect our judgment of a trading strategy's effectiveness.

Traders tend to focus on the success rate and ignore the average profit per trade. You're programmed from a young age to have this focus because our education system is based almost entirely on success rate. You receive an A if you get 98% of the questions on a test right and an F if you're only right 32% of the time. After many years of school, it's no wonder you think you have to be right more than you're wrong if you're going to consider yourself an effective trader.

Add in the average profit per trade dimension into the equation and you'll see that getting an A in trading is determined very differently than getting an A in school. Consider a strategy that makes money 92% of the time. Would you be willing to pay me $1000 to give you the rules for this strategy? Most people would, which is why there are many people making money selling such strategies. I googled "market-beating trading strategies" and instantly found a number of companies marketing their trading strategy with the marketing focus solely on picking stocks with a high probability of success.

If my strategy makes $100 92% of the time and loses $1500 8% of the time, is it a strategy worth trading? Let's calculate its expected value to answer that question: $0.92 \times \$100 - 0.08 \times \$1500 = \$92 - \$120 = -\$28$. A negative expected value for a strategy that is right 92% of the time! An A grade in school but an F in stock trading.

How about a strategy that makes $1000 30% of the time and loses $100 70% of the time? In this case, the expected value is $0.30 \times \$1000 - 0.70 \times \$100$, or $90 per trade. A positive expected value, even though it's only right 30% of the time.

It's not just about how often you're right. It matters how much you make when you're right versus how much you lose when you're wrong. While this now sounds obvious and is easy to appreciate, it remains a difficult concept for traders to truly take to heart. We're programmed from the day we enter school to try to be right, and it takes a lot of work to change that programming.

If you want to be a successful trader you must look at trading in terms of the probability and size of your profit, not just the probability. A trading strategy that is often right doesn't have to make huge profits on each trade. The trader can grind out small gains for a consistent profit over a large number of trades. There are also great trading strategies that make a lot of money even though they're rarely right. There could be a strategy that's wrong 99% of the time and still makes money, as long as the gains the other 1% of the time are massive compared to the losses that usually happen.

While a low success rate can be overcome by maintaining large winners and small losers, you will face psychological hurdles if you're usually wrong. Most traders will feel less confident if they are usually wrong and that can cause breakdowns in trading discipline. Losing a lot can make you break your rules in the pursuit of wanting to be right. Therefore, I don't recommend you trade strategies that have a low success rate even if they have a positive expected value unless you have a computer doing the trading for you. As humans, we have a hard time dealing with being wrong often, even if doing so means making money.

Do not make another trade until you understand whether your approach has a positive expected value. There are an infinite number of ways to make money in the stock market; the rules you use could be as simple as, "buy the market index on the last day of the month and sell after the first day" or be made up of a complex algorithm for picking entry and exit points. What matters is that whatever your criteria for making a trade are, you test them and make sure they show a positive expected value.

Many people consider stock trading a form of gambling. If you are not trading strategies that have a positive expected value, then gambling is exactly what you're doing. With a run of good luck, you could make a lot of money and think you really know what you're doing, but in time, your luck will turn and the profits you made will be lost, proving that for most people, profits in the stock market are just short-term loans.

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Don't Try to Be Smart

I never try to be smart when trading the stock market. It's not that I lack confidence in my intelligence or ability to gather information, but I realize that my knowledge of companies and markets, no matter how in-depth, may not matter at all. The stock market doesn't care what I think.

It's comforting to make decisions with your money based on what you know. Most traders will be more at ease if they have confidence in their trade, and that confidence usually comes from insight. Knowing what a company does, who runs it and what experts think about it makes us feel better about owning it. The question is, does any of that knowledge have value beyond creating comfort?

I have watched many traders pile all of their liquid assets into a single stock because they had a personal relationship with the person running the company or had learned of some private information that they were confident would drive the price higher when the rest of the world found out about it. So many times this kind of common-sense, smart trading has led to losses.

Many traders have looked to industry experts or market gurus for their trading ideas, trusting that the wisdom of their words proves their ability to predict price movement. There will be times when putting faith in the individual, whether it's you or someone else, will lead to a profitable trade. There will also be many times when trying to be smart will cause you to lose a lot of money. The reality is that no one—no company insider, industry expert or stock market guru—is smarter than the market.

You could spend countless hours studying a company's business. Reading the company financials, learning about the industry the company operates in, talking to the businesses customers and identifying catalysts for future growth are all pursuits that make a lot of intellectual sense when you're considering buying a company's stock. After this long and arduous process, you should know just about everything there is to know about the company and have a very strong sense that the stock is undervalued and destined to go up in price. What about the little bits of information that you don't know? What if you missed something important?

All of your analysis could indicate that the stock is worth buying, but if you miss out on one critical negative factor, you could end up making a losing trade. I have seen it happen countless times: the company story sounds great and ownership of the stock seems like a no-brainer, yet this "can't lose" type of trade leads to a loss because of a relatively unknown fact that eventually causes investors to sell the stock aggressively. We don't usually know what the problem is until it's too late.

Don't assume that you know everything there is to know about a company, but understand that the market does. Every little piece of available information will have been priced in to the stock by someone. With thousands of investors trading a stock, you can expect that nothing will go unnoticed. There is always a reason why a stock is doing what it's doing, and listening to the message from the market is the best way to analyze the stock.

The people who are able to uncover information that is not widely known are usually experts in that industry and often have the resources to uncover facts that most people don't know. They also tend to have more capital to invest, which makes how they show their opinion much more noticeable. An investor with billions or hundreds of millions to invest will leave a trail when he makes a move on a stock.

No matter how much you know, you probably don't know enough, and it's the information you miss that can lead to a bad trade. Fortunately, the market misses nothing, and as long as you know how to interpret market activity, you can benefit from its message.

Who Cares?

It's a common mistake to think that only information that relates to the company's earnings potential drives stock prices. In theory, this is how the stock market should work. In reality, the basic laws of economics often drive major price swings in a stock that can make a good company perform badly and a bad company perform much better than it should. Supply and demand can play a role in how a company is valued.

Many large funds use leverage to improve their investment returns. Like small investors, they must maintain a certain level of equity to offset the debt incurred when they use leverage to take trading positions. If stocks in its portfolio are moving lower, the fund must put in more capital to allow it to maintain the leverage. If there is no more capital available, it must sell some of its positions.

It is not uncommon for leveraged investors with large positions in a stock to sell for no other reason than to raise cash. There may be nothing wrong with the company's earnings capacity or business outlook. The sale of the shares is simply an event forced by the fund's use of leverage. The problem for the market is that the liquidation of these large positions can have a profound effect on the price trend, causing the stock to move down for a reason that is hard to explain with fundamentals.

Long-Term Capital Management (LTCM) was a hedge fund founded by John Meriwether, who had run the bond trading desk at Salomon Brothers. He was joined by well-known, very smart and credible people from the financial industry, including future Nobel Prize winners Myron Scholes and Robert Merton.

The fund used a great deal of leverage to improve returns. At the beginning of 1998, the company had $4.72 billion in equity and borrowed over $124.5 billion for a debt to equity ratio of 25:1.[1] With that kind of leverage, a series of unexpected declines in the value of their positions could destroy the company's equity, and that's what happened.

Financial crises in East Asia in 1997 and Russia in 1998 caused very abnormal price moves in the bond market, leaving LTCM with losses they had to cover by exiting otherwise good positions. The fund had found that Royal Dutch Shell traded at an 8–10% premium over Shell, which was the same company but listed on another stock exchange. The strategy was to short sell the higher-priced Royal Dutch Shell and buy the lower-priced Shell with the expectation that the values of the two would converge toward one another.

The losses in other areas of LTCM's portfolio forced the fund to liquidate the positions to raise capital. This meant covering the short in the shares of Royal Dutch Shell, sending them higher, and selling the shares in Shell, sending them lower. As a result, the price gap widened to 22% for the same company. A smart investor would have a hard time understanding why this price spread existed since it made no sense fundamentally. It was only later, when the market learned of LTCM's need to unwind the position, that the price anomaly made sense.

Don't assume that the market is trading on the same information you're using to make your decision. The market will often make what seems to be a mistake, but that's only because you don't have all of the information that the market has.

Finding Confidence

While it is tempting to put your confidence in what you know, you should now see the danger in doing so. Yes, it's comforting to have insight into what a company does and why you think the trade you

1 Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (New York: Random House, 2000), 191.

are making is justified. That comfort is unwarranted, however, because if you miss one piece of critical information your trade can be wrong. If the market is trading on something that you have failed to uncover, you will be wrong.

So how can you have confidence in the trades you make? You must replace your desire for knowledge with well-tested strategies that prove that your trades have a positive expected value. You must use risk management to limit the size of your losses so that you can sleep well knowing that the inevitable losses will be manageable and that they can be offset by the inevitable profits.

You must be smart before you make the trade. The trades you make will be based on the hard work and analysis you have done to develop strategies for consistently making money from the market. By the time you buy or short a stock, you should have confidence in what you are doing.

Soon I will show you how to interpret the market's message and develop a trading strategy. I will show you tools I have created to help you find stocks that meet the criteria of your strategy. You will learn how to use some of my other tools that will confirm your research and increase your confidence in your strategies. Approach the process with humility; you and I are no smarter than the market.

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The Market Can Be Stupidest

In Search of Value

Julian Robertson is a legendary value investor. His investment firm, Tiger Management, was one of the largest and most successful funds in the late 1990s. That fund closed in 2000 when his very sound and proven strategy for making money failed.

Simplified, his strategy was to find very good companies and buy them and find very bad companies and short them. The expectation was that, in a bull market, the good companies would go up faster than the bad companies. In a bear market, the bad companies would go down more than the good companies. Tiger was able to hire the best and brightest people and pay them very well because of the enormous size and success of the fund. They studied company fundamentals and looked for the best and the worst companies in the market to apply this hedged strategy to. Until the technology bubble of the late 1990s, Robertson's strategy served him very well.

An investor inspecting the fundamentals of many technology stocks in the late 1990s would undoubtedly find many examples of bad, or at least tremendously overvalued, stocks. While Tiger had the very best people to do the analysis, any person who spent eight hours learning how to do fundamental analysis could have arrived at the same conclusion; technology stocks were overvalued and deserved to be shorted.

Sell these overpriced stocks short is what the fund did but the strategy failed to work. The market was not trading on fundamentals; it was trading on emotion. What companies were earning didn't matter. As long as they were somehow related to the explosion of the Internet they went up in price.

I was trading during this time and recall profiting from stocks I knew had nothing more than a post office box for an office. Companies that had simply attached ".com" to their name were able to rocket higher because of what the U.S. Federal Reserve Chairman Alan Greenspan later called "irrational exuberance." The prices that stocks traded at made no sense fundamentally, but that didn't matter—at least until the bubble burst in March of 2000.

Imagine if your strategy was to short the companies with the worst fundamentals and buy those with the best. You would undoubtedly short these overpriced technology names and buy the strong companies that were being ignored by the market. Since there was a bull market in technology stocks, the companies you shorted went up fast and the ones you bought lagged. The hedged strategy failed miserably despite making very good sense. Eventually, the bad companies did go down and the sound, well-run companies went up, but by that time the losses were too much for many funds to survive. Tiger closed its fund in 2000.

Julian Robertson was ultimately right about valuations, and the overpriced stocks came back down to rational levels (for some that was $0). What this examples shows, however, is that it's not enough to be right; you have to be right at the right time. As the great economist John Maynard Keynes said after losing in the currency markets, "Markets can remain irrational longer than you can remain solvent."

One vs. Everyone

Do you think you could win a trivia game if you were playing against a thousand people? Even the most well-read and knowledgeable people will have a hard time beating the collective knowledge of a large crowd. In a large group, there's usually at least one person who will know the answer to a challenging question.

It's hard enough for one person to perform better in a trivia game than a large group because the collective knowledge of the group is likely greater than that of the individual. But what if, by virtue of its size and mob mentality, the group you are trying to beat in trivia gets to decide what the answer to every question is?

Suppose you were playing a trivia game against 1000 people from Russia who were loyal to the Communist party before the USSR collapsed. If you were asked, "What is the capital of Kazakhstan?" what would you answer? You may or may not know, but since you are reading this book, I expect that you are very knowledgeable and would reply "Astana," which is correct. The problem is that Astana used to be called Alma-Ata when Kazakhstan was part of the USSR. Since you are playing this trivia challenge against a large group of people who are still loyal to the USSR, you may find they disagree about what the answer is, answering "Alma-Ata" instead. Are you willing to argue with 1000 Soviets?

Remember, the truth is a matter of opinion, and what you consider to be correct may not be what the masses consider to be right. People used to think it was not unhealthy to smoke cigarettes and that the earth was flat.

Smart people can do great analysis, but that doesn't mean they're focused on the same facts that the overall market is trading on. Even if you're smarter than the crowd, if the crowd fails to see what you see, it won't matter. It's like playing a trivia game against someone who gets to pick the question and the answer with no respect for what's actually correct.

The Message of the Market

In the stock market, we know that people are going to look out for their own best interests, so we must avoid the bias that comes with information from others. We shouldn't trust what people say because it's impossible to know if their information is going to help or hurt us.

Since there are very few people who like to lose money, our focus should be on what other investors are doing with their money. They may not be right, but at least we know that when they make a trade, they believe they're doing the right thing.

Traders can find opportunities by studying market activity. The market speaks to all traders; it's constantly sending out the information you need to make decisions. The problem is that the market doesn't speak in a language that most people understand, so traders need to learn how to understand its message. Once fluent, the trader can identify and capitalize on opportunities.

A meteorologist observes atmospheric conditions to arrive at a weather forecast. A cardiologist looks at a cardiogram to gauge the health of the heart. We will look at the flow of money in and out of the market to determine where the market is likely to go and where there are opportunities to make a profit.

The stock market is essentially a giant polling mechanism. Investors are asked a simple question about each stock: "What do you think it's worth?" As an investor, you answer with your money: buying means you think the stock is worth more; selling means you think the stock is worth less.

With millions of people casting votes with billions of dollars each day, the price and volume action of the stock market is the outcome. We can analyze how price and volume change over time to understand what investors believe about future company earnings.

Not all votes count the same. A small investor might buy 100 shares, while a large institutional investor may buy 100,000. Only time will tell who's right, but the larger investors will have a greater influence on the market's message simply because of the size of their trades. Big investors have a louder voice in the debate that is carried out in the market each day.

Since big investors also have greater resources, it is reasonable to think that they may also have the ability to get better information. Large investors should be better able to uncover private information, and their actions will show what they have found.

Even When It's Wrong, It's Right

We shouldn't question whether the message of the market is right or wrong because the market will overpower anyone who tries to fight it. Throughout history, markets have done things that made little sense, driving investors crazy with their seemingly irrational behaviour. We often only find out why something happened until it's too late.

We make the assumption that the actions of investors are always based on their opinion of what is going to happen in the future, but there have been times when large investors have been forced to make trades for reasons unrelated to their fundamental outlook.

Suppose a large hedge fund specializes in trading commodities, specifically energy. Oil prices have been climbing for five months, and the fund believes that the price of oil is too high. The fund's analysts find that the fundamentals of oil are good, but the price has moved beyond what oil should really be trading at. Based on this analysis, they begin to short oil heavily. Unfortunately for them, oil continues to move up day after day. Convinced that the analysis is correct, they continue to short sell oil as it moves up and build a very large short position.

A month later oil is higher still, and the fund is now in financial trouble. The fund managers were not only shorting oil using their investment capital, they were also borrowing to increase their position. This use of leverage has put them in a difficult position because their lenders require that they maintain a certain level of equity in order to protect the position. The hedge fund is facing a margin call.

The financial media reports on the price action in oil every day and features industry experts who all believe that oil prices are too high and the fundamentals don't support the price. There is ample supply, and the global economy is not strong enough to push demand and justify the high price for oil. None of the experts can explain the price, but it continues to move up.

With oil moving up and the loss mounting on the hedge fund's short position, the fund managers are forced to cover their short. That means they have to go in and buy a lot of oil at high prices just to liquidate their position. Since their position is very large, they are moving oil prices up even more with their large purchases. The financial loss for the fund pushes it out of business.

Oil is now at an all-time high and the financial press announces that a prominent hedge fund may be in trouble because of a leveraged short trade on oil. Many viewers, expecting that oil will go even higher because of this news, rush to buy oil futures. The news of the fund's demise marks the top in the oil market. The fund's short position has been covered, and the losses wipe out its capital.

Oil soon plummets in price, handing losses to everyone that bought oil on the news that the large hedge fund was being forced to cover its short position. Three months later, oil prices have receded back to reasonable levels, and all the experts agree that the run up was nothing more than a speculative bubble that eventually burst.

Hindsight is 20/20.

This example is loosely based on something that actually happened in the market, but, more importantly, it demonstrates how easily price can be affected by nonfundamental elements. Traders do not always buy and sell for sensible reasons; their actions can also be guided by other factors.

If you fail to listen to the market's message, you could easily fight against trends that only make sense after they have run their course. The hedge fund was right about the fundamentals of oil but got the timing wrong, causing it to lose all of its capital and push oil prices even higher.

You will often not know why prices are changing. The headlines will try to explain it after the price has changed, but they will always be one step behind. If the message from the market says "buy," then you should buy even if it makes no sense. When the message changes to "sell," you must demonstrate that you are a good listener and sell, even if it conflicts with everything you know. It's the things you don't know that can hurt you.

Identifying Breakdowns in Efficiency

When you read stock charts, you are working to identify and exploit breakdowns in the efficiency of the market. The Efficient Market Hypothesis (EMH) was developed by Professor Eugene Fama at the University of Chicago Booth School of Business in the early 1960s. It states that all available information is priced in to the market, and since we can't predict the substance of new information and when it will be available, our success in the market will be random. Therefore, we can't expect to beat the stock market. Our return will move toward the average performance of the market itself.

As I have now discussed, markets are efficient most of the time, but when some investors have access to better information, an opportunity is created. These investors are able to make aggressive moves in the market because they have private information. I will show you how to see the signs of private information.

Opportunities also arise from the effect of emotion. Emotional investors will cause stock prices to go higher than the underlying company is worth in times of greed and lower than appropriate in times of fear. These emotional fluctuations can happen over a period as short as minutes or as long as months. The rise in the equity market in late 1999 showed the power of greed, and the drop in equity markets in late 2008 demonstrated how fear creates opportunities. Two of the sharpest price trends in the history of the stock market came out of these emotional conditions.

When you look at stock charts, you must focus on finding evidence that these two assumptions of market efficiency are falling apart. If new information that is not widely known by investors is coming into the market, there will be abnormal activity. Price action will show us when traders are motivated by fear or greed. Any stock chart analysis must be driven by an understanding of how market efficiency can break down and display in the trading activity of a stock. Once you know what to look for, analysis is surprisingly simple and quick.

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What Makes a Good Trading Approach?

We Need a Better Way

We know fundamental analysis isn't going to work for individual investors who lack the resources of well-capitalized investment funds. You need a better way to analyze stocks. The method you use shouldn't require a lot of time, because most individual investors can't afford that. Where does a person who has a career and a family find the hours it takes to study just one company? How about the many companies she will have to study before finding the one great undervalued opportunity?

Finding those opportunities also requires a degree of expertise that most of us don't have—at least not outside the industry we work in. Therefore, you need an analytical method that doesn't emphasize expertise, but instead allows you to be an expert on any stock in any industry.

Most individual investors are not particularly well connected so they have little chance of receiving private and valuable information about companies. Even if they get the odd bit of inside information, are they willing to risk making an illegal trade in pursuit of profit? Are you willing to lose money not because you are wrong, but because the market disagrees with you? You need a way to find better and more relevant information without being an insider.

If you know too much, there's a good chance your judgment will be clouded, so your approach to analyzing stocks should be impersonal. It will be best if you know nothing that you can be attached to. That way you can avoid any bias.

If you were creating a wish list for your stock analysis model, it might look like this:

- **Fast.** Your approach to the market shouldn't take you a lot of time, because, if you're like most people, you don't have a lot.
- **Unbiased.** Trade without being susceptible to the many biases that exist in the financial industry.
- **Low-cost.** Your search for good trading opportunities shouldn't cost a lot.
- **Legal.** The way you trade the market shouldn't use inside information and should comply with all securities laws.
- **Timely.** Finding trades after the stock has made its move has no value to you; you must be able to make the trade when the time is right.
- **Evolving.** While the core principles that drive the stock market change little, the way you approach the market should always adapt to market conditions.
- **Simple.** The simple approach is usually the best one. You shouldn't need a great deal of expertise to apply your trading strategy.
- **Tradable.** The opportunities you find should be tradable and not require faster entry or more liquidity than the market allows. Your strategy should work in the real market and not just in a back-tested simulation.

I call this list of requirements the FULLTEST for a good trading approach. Whether you develop your own approach to trading or use the one that I use, make sure it meets these criteria.

In the chapters to come, I will show you how to analyze any stock, market, commodity or currency in 10 seconds. This method is legal, can be done anywhere that you have access to the Internet, will cost you very little, is simple and avoids emotion. Most importantly, this method will help you find great opportunities before it's too late.

Reading the Entrails

How do we interpret the market's message? The price and volume chart is the answer. How price changes over time tells us everything we need to know about whatever is being traded. Each trade made in the market is an expression of the opinion of the people behind the trade. Every bit of information, whether public or private, is displayed in the chart.

Using charts to analyze stocks is commonly referred to as technical analysis. I did a Google search to find a specific definition of what technical analysis is. Here are a couple of the results:

"A method of evaluating securities by analyzing statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns that can suggest future activity." —Investopedia.com

"A method of evaluating securities by relying on the assumption that market data, such as charts of price, volume, and open interest, can help predict future (usually short-term) market trends. Unlike fundamental analysis, the intrinsic value of the security is not considered. Technical analysts believe that they can accurately predict the future price of a stock by looking at its historical prices and other trading variables. Technical analysis assumes that market psychology influences trading in a way that enables predicting when a stock will rise or fall. For that reason, many technical analysts are also market timers, who believe that technical analysis can be

applied just as easily to the market as a whole as to an individual stock." —Investorwords.com

I am not sure I agree with these definitions because they put too much emphasis on using the past to predict the future. For example, a commonly held belief among technical analysts is that the 200-day moving average acts as support for stocks. If the price is falling, it should bounce back up to or near the 200-day moving average. Therefore, stocks should be bought when they fall below the 200-day moving average.

If you believe that the market is efficient and enough people use this rule to buy stocks, then the strategy of buying at the 200-day moving average is destined to fail. If enough people know something works then they'll price in the effect so quickly that the opportunity no longer exists. The efficiency of the market takes away the opportunity.

Instead, you must use price and volume trading data to highlight breakdowns in market efficiency if you hope to beat the market. You should use stock charts only to identify a market that may be trading on private information or one where emotion has pushed prices beyond rational levels. That's the basis of my approach to reading stock charts.

Do You See What I See?

There are as many ways to analyze stock charts as there are people doing the analysis. I have not read books about technical analysis so I can't say who has the right method. I do know that 10 people looking at the same chart can each see something different. This makes it important to use a method of chart analysis that is simple and repeatable. As complexity increases, so too does the potential for different interpretations.

Fortunately, it's the simple approach that tends to work the best. I have broken chart analysis down into six components, each related to the others but based on an aspect of human psychology or fundamental analysis. Ultimately, I use the stock chart to analyze the market's perception of what the company is worth, marrying psychology with fundamental analysis.

10,000 Hours

Malcolm Gladwell, in his wonderful book *Outliers*, describes how it typically takes 10,000 hours of practice to become successful at any task, whether it's playing music or programming computers. This 10,000 hours is achievable by doing something for 20 hours a week for 10 years.

Gladwell's assertion is that talent is not as important as practice. In fact, you cannot develop a talent without practice; some of the most naturally talented people fail to achieve greatness because they just don't work hard enough. You don't have to be a genius to be good at something; you just have be smart enough and then work hard.

I wasn't born with an understanding of the market and what drives it; it has come with over 20 years of study. With all that practice, I can look at a stock chart and tell what the likely outcome for that stock will be. I will share with you the basic components of how to do that so that I can save you the more than 20,000 hours I have spent doing it. Realize, however, that even with the explanations I provide, learning to read a stock chart and interpret the market's message takes practice.

I have taught thousands of investors my approach to trading the market. I find that it takes most people a few months to get to the point where they can understand what the market is telling them. Having this ability doesn't make you a profitable trader, however. Understanding the message of the market is one criterion for success, but overcoming your emotional attachment to money is another, more difficult, skill to master. I will work to help you do both, but first, let's focus on how to understand what the market is telling us.

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You Can Determine a Company's Value with a Ruler

You should think of the stock market as a war being fought each day. On one side you have the buyers fighting to send stock prices higher. Opposing them are the sellers, who believe prices are too high and likely to go lower. Each trade is a battle cry by two investors, one buying with an expectation for higher prices and the other selling with the opposite opinion. Who wins is a matter of who is stronger and more motivated.

The ammunition for this war is information. It is now clear to you that information is what drives the actions of market participants. The buyers and sellers are constantly working to figure out what new information is worth and how it affects stock price. Among both buyers and sellers, some are more committed than others because there is a degree of uncertainty about what price should be. This is not a war of loyalists. It often happens that a buyer or a seller will switch teams in an instant, taking the other side of the trade with their change of opinion. In *The Art of War*, Sun Tzu wrote, "To know your enemy, you must become your enemy." That happens every second in the stock market.

Six Concepts for Predicting Price

CNN first captured war in real time for the mass audience when the U.S. took up arms against Iraq in the Desert Storm campaign. The war in the stock market has been captured in real time for over a hundred years, moving from the ticker tape to the instant quotes that now flash across a computer screen. I recall my first tour of a stock exchange; people wrote prices in chalk at the front of the trading floor.

The stock chart is the visual record of how the war is being waged between buyers and sellers. The fluctuations in price tell us a lot about the information that flows down to the investors who are charged with figuring out what it's worth. You can do fundamental analysis from the chart, ascertaining what the market's estimate of value is at any one time. From the patterns on the chart, you can make predictions about where price is headed.

Doing this requires an understanding of six simple but important concepts. They are:

- Support
- Resistance
- Optimism
- Pessimism
- Price Volatility
- Abnormal Activity

Knowing what these are and how to see them will allow you to analyze any stock, commodity, currency—anything that trades—in an instant. Teaching you how to do that is the goal of this section of the book.

Support and Resistance

This chapter focuses on the first two concepts in the list: support and resistance. These are basic tools in the technical analyst's toolbox. They are commonly used, but often used incorrectly. They're two examples of chart characteristics that can be seen differently by different people. To see these price ceilings and floors properly requires you to understand what defines them. It is helpful to think in the context of the war between buyers and sellers.

When the buyers are winning the war, price moves up. If the sellers have the upper hand in battle, price moves down. Any stock chart will show you how the war is progressing with the alternating price trends oscillating up and down on the chart, each representing a battle where one side has taken control over the other.

It is where control changes that we must take an interest. When the buyers lose control of the market to the sellers, a top is formed. The opposite can be said for bottoms, where the sellers yield control to the buyers. The points where control is changed appear as changes of direction in the line that shows the price history of the stock. I call them inflection points.

It's important to understand what inflection points represent. Since information is the ammunition that fuels the price trend and gives power to the group in control of the market, inflection points are where control is lost because information lacks sufficient power to maintain the price trend. Inflection points stand as limits on what the fundamentals are worth, at least as perceived by the participants in the market's battles.

Identifying inflection points on the stock chart is easy, but it's a skill that is essential to reading the market's opinion of anything that trades. To find them, simply look for points where the price stopped going up and started to go down or stopped going down and started going up. Inflection points exist in the very short term, visible on a chart that tracks the minute-by-minute fluctuations in price, and also in the very long term, showing up on the monthly moves in price.

Below is a chart of Pfizer going back five years. On a weekly interval I have highlighted the major tops and bottoms with arrows. These are the important inflection points:

Inflection points have meaning; they're more than just an arrow on the chart. They highlight the price point where buyers and sellers no longer feel that the information justifies the price. Inflection

Chart 9 – The arrows show inflection points, the price levels where control of the market changes.

point tops occur when the buyers say, "We don't think the company fundamentals are worth more than this price. We are not willing to push price any higher." At lows, the sellers are expressing an equally important opinion: "We don't think the company's fundamentals are worth less than this price. We will step in and buy the stock with enough vigour to end this downward trend."

Inflection points represent ceilings and floors for the fundamental value of whatever is traded. They're not based on the opinion of one person behind a desk doing analysis of the company; they represent the aggregate opinion of every person who goes to battle in the market by either buying or selling shares. Collectively, their opinions define the inflection points and express the entire market's answer to the question, "What is this company worth?"

The next page shows a weekly chart of IBM over a five-year period, also displaying a number of inflection points. Notice that investors were unwilling to pay more than $132 a share from 2008 until past the middle of 2010. For over two and a half years, the buyers stated

Chart 10 – Inflection points on a longer-term weekly chart.

clearly, "We do not think IBM's future earnings potential is worth more than $132 a share." Each time the stock rose to that price, the sellers took over control and stopped the price ascension. At $132, the buyers lost their motivation and the sellers gained the power.

For all of 2010, the sellers were unwilling to accept a price lower than $120 a share for IBM. The chart shows us very simply that the sellers did not believe the stock should be sold for anything less, and when the price fell to that level the sellers lost their motivation and the buyers gained power.

The result is that we can draw a horizontal line at $132 and call that resistance and draw another line at $120 and call that support (see Chart 11).

For the first half of 2010, the market showed clearly that it perceived IBM's fundamentals to be worth between $120 and $132 a share.

What causes a move through a well-established price ceiling or floor? The obvious answer is new information. A positive change in the fundamentals of the company will give the buyers reason to

Chart 11 – Support and resistance lines for IBM, showing the market's estimation of limits on fundamental value.

move the stock up through a ceiling while a negative change will make the sellers willing to accept a lower price.

It's not enough to say that information is sufficient to make a break through support or resistance, because information passes through a filter of emotion. To be accurate, you must say that it's a perceived change in fundamentals, recognizing that perception is as much about information as it is about mood.

In the fall of 2010, the buyers found a reason to pay more for the stock. Perhaps the economy was getting better, or IBM was cutting costs. It may be that new products created an expectation that earnings were going to improve. There are an infinite number of reasons why investors would be willing to pay more, but knowing the reason is not important. What is important is the message that the market gives when stocks make a move through a price ceiling or floor.

Such moves are called breakouts, and they are among the most basic of trade signals in chart analysis. I don't expect you'll be able to beat the market if you buy every breakout, though. It's important to understand what constitutes an important breakout, one that signals a trend is likely to be developing. To get to that point, you need to understand a few more things about charts that I will get to in the pages ahead.

Defining support and resistance is not too different from playing connect-the-dots. Begin by identifying price inflection points, giving greater emphasis to inflection points that have held up over a longer period of time. These stand out on the chart as major peaks and valleys. The longer an inflection point has withstood the test of the buyers or sellers, the more important it is. The more times inflection points occur at around the same price level, the more important it is. Strength in support and resistance is a function of time and how often the market's opinion validates that price level.

The chart of Home Depot (HD) below shows how a market can hit resistance and then fall away. When the buyers have the strength to take the stock back up to old resistance, they lose their

Chart 12 – Breaks through resistance are often caused by improving fundamentals.

power and the sellers hold them back. This process validates the market's opinion of fundamental value and makes the eventual break through the price ceiling important. The breakout represents a perceived improvement in the fundamentals of the company, and as this improvement continues, the stock's price goes into a market-beating trend.

When we use inflection points in our study of charts, we are essentially doing fundamental analysis with a ruler. It's not our own analysis, which would be based on information we had gathered; it's an interpretation of the analysis done by all the other investors in the market.

Since there is a constant flow of information, there is a great deal of price volatility. Within the span of a day, the uncertainty that buyers and sellers feel about how new information affects the company will cause the price to move up and down. The chart below shows how the price of Home Depot's stock moved in a single day, two minutes at a time.

Chart 13 – Support and resistance can be found on short-term intraday charts too.

From 11:00 a.m. until after 1:00 p.m., buyers and sellers agree that the stock's fair fundamental value was between $51.85 and $52.00. The fluctuations inside that range can be attributed to uncertainty and the absorption of orders to buy and sell.

While it may be an interesting exercise to look at the market's past perception of what fundamental value is, unless doing so will help you to make a profit there is little use in going through the process of defining support and resistance. Many traders look to simply buy breaks through resistance and sell breaks through support, but there is more to picking stocks than that. Before you can make a prediction about where the price is going to go, you must understand the other four components of chart reading.

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The Market Is Moody

The market for anything that is traded has a mood. Stock prices are determined by the people who trade the market, and people are emotional, whether they want to admit it or not. Assuming you are a normal person, how you react to information is largely dependent on your mood. The same can be said for the stock market: investors let the mood of the market affect how they respond to new information. This makes understanding the market's psychology around a stock essential to predicting where price will go.

Optimism and Pessimism

The stock market was in a state of euphoria in the closing days of 1999. The technology industry was stimulated by companies spending millions to update their computer systems for the Y2K problem. The Internet was becoming a mainstream necessity, and any business with ".com" attached to the end of its name seemed capable of achieving astronomical valuations in the stock market. It was a really fun time to be a trader.

The reaction to company news during the late days of the technology bubble was hard to believe. It seemed as though a dot-com enterprise could announce the appointment of a new secretary and its stock would shoot up 15%. There were many companies with market capitalizations in the hundreds of millions that had no real business, just an idea for one.

Investors were deemed to be irrationally exuberant by the then Chairman of the Federal Reserve Alan Greenspan. With the benefit of hindsight, that seems to be a great understatement. Investors were eager to buy stocks for no other reason than the fear of missing out.

It was a time of great optimism for all that making the Internet ubiquitous promised. The euphoria among investors meant that any news was good news, and good news gave stocks a price lift disproportionate to the true value of the news.

The technology boom was not the first bubble. It follows a list of market manias that have led investors to pay too much for the fundamentals. A similar psychological state existed more than a decade earlier in the Canadian mining market when Bre-x claimed to have found the greatest deposit of gold on earth on its Busang project in Indonesia. The market's response was to give lofty valuations to any company that had a mining stake anywhere near Bre-x's property. Bre-x shareholders watched their stock go from pennies to over $280 a share, giving a mining company that had not yet taken a single ounce of gold out of the ground a $6 billion valuation. Many of you will know that the find turned out to be a well-orchestrated hoax, and the stock eventually fell to zero, making the shares nothing more than interesting wallpaper.

People feel optimistic and eager to buy when the stock that they own or are watching goes up in price. The legendary stock promoter Murray Pezim called this the "law of upticks": the more stock prices go up, the more eager investors are to own the stock. This makes little rational sense, since higher prices mean the stock has a greater potential of being overvalued and likely to fall lower, but in our eagerness to make easy money, we often don't think rationally and will always be willing to chase stocks into the stratosphere.

The exact opposite is true of stocks that fall in price. It's depressing to own a stock that is moving lower, and you will have a difficult time convincing a friend to buy a stock that is lower today than it was a week ago. Investors tend to look to the market for confirmation of the information they receive. If you are told that a company has great fundamentals and is going to be higher in a month, you are less likely to believe in that tip if the stock price goes down. You wonder why, if the company is so promising, its stock is going down.

As 2008 felt the effects of overleveraged home owners and a collapsing real estate market, stock prices went into a death spiral. Investors were motivated to sell their holdings for no other reason than that they expected their stocks would be lower the next day if they did not exit today. Few investors considered the fundamental value of their holdings before they sold; they hit the exit button out of fear.

During the market's collapse, few companies were able to attract investor interest no matter how good their fundamentals were. The market just didn't care about what companies actually made as profits; it was a time when the economics of business didn't matter.

Find the Mood of the Market

While these examples are extreme, they show that the mood of the market matters. Investors will judge the same information about a company's earnings potential differently in a bull market than they will in a bear market. Therefore, it is essential to know what the market's mood is about any stock you are considering for purchase.

The ability to read people is something we all learn from a young age. While you may be unaware of it, you are capable of assessing a person's mood simply by looking at their eyes. Children know when it's a good time to ask a parent for something and when it's better to wait. As a father, I have experienced my children's skill at first making me feel good before they ask me for something they want.

How can we assess the market's mood? There are millions of people investing in stocks and we cannot possibly look into each of their eyes to try and determine how they're feeling.

We don't have to because we can trust that each investor approaches the market with the purest of intentions. They simply want to make money and will use their capital accordingly. The stock market is the most honest gauge of what people really think and feel, since no investor is interested in giving his money away. To read the mood of the market, we go back to the market's tea leaves—the price chart.

You already know that the market is a place where buyers and sellers fight over a company's value. If the buyers are winning the war, the price goes up. The price goes down when the sellers are winning.

You also know that rising prices bring on various degrees of optimism. Therefore, if you look at a stock chart and see prices rising, then you know the investors who are fighting for control of that stock are generally optimistic. The buyers are willing to push the stock up in price and the sellers have little power to slow them down.

The problem is that waiting for a stock to go up a lot before concluding that investors are optimistic can leave you as the last one to come to the party. You have to be able to see the optimism building early so you can enjoy the effects of the trend.

Using Inflection Points to Detect Changes in Mood

To do that, let's go back to the basic building block of the stock chart—inflection points. Remember that you can identify an inflection point anywhere the trend in price changes direction. Inflection points are the price peaks and valleys on the stock chart; they're the points where control of the market switched from sellers to buyers or buyers to sellers.

Chart 14 is a five-year weekly chart of Ford (F). I have highlighted some inflection points on it, but instead of highlighting all of them, I have focused on highlighting the inflection point lows when they are rising from left to right and the inflection point highs when they are falling from left to right. These points show where the bottoms are rising or the tops are falling.

Identifying the mood of investors is simple: if the bottoms are rising, investors are optimistic; if the tops are falling, investors are pessimistic.

From 2008 until early in 2009, investors were in a bad mood

Chart 14 – The trend of inflection points over time shows us the mood of investors.

and not eager to hear about positive fundamental changes in Ford. That changed in March of 2009, when optimism took hold and lasted until the beginning of 2011. Then the sellers took control. The first falling top was formed in April of 2011, and the market went back into a bad mood about Ford.

Have you ever tried to paddle a canoe up a river? If so, you'll know that it's possible but a lot of work. The same can be said of trying to fight the market's mood to make money. You can see that during the fall in Ford's share price starting in 2007 and lasting into the first quarter of 2009, there were some brief periods of strength. A really savvy trader might have been able to make some money buying Ford stock during the short upward spurts. However, the real money was made (or saved) by being short Ford stock during this time (or being out of it). Then, when the trend changed and the bottoms began to rise in mid-2009, it was easy to make money by owning the shares. During this two-year upward trend for Ford's shares, it was a good time be a buyer.

Optimism and pessimism are just two more of the six elements that you must understand to be able to analyze a stock chart. They're very simple to see but often overlooked—I'm amazed at how many people fight the market and buy stocks when investors are pessimistic about the company.

Have you ever done this? If so, it's not really your fault. You're normal and have been programmed to make this mistake. Our society teaches us that it's great to get a deal, that buying things when they're on sale is part of being a savvy shopper.

You have to break that programming. You're not buying a microwave or a three-pack of ketchup; you're buying stocks. Stock prices move up and down because the market's perception of fundamental value rises and falls. You will have an easier time making a profit if you trade with the group in control of the market.

You can choose to argue with this group, citing your analysis as evidence that the market is making a mistake and the stock does not deserve to be as low as it is, but the history of the stock market is littered with stories of people who lost all of their capital trying to fight the mood of the market. Often they're right, but they go broke before they are proven so.

Micro Moods

It's possible for the market to have moods within moods because investors have different time horizons. Long-term investors have an outlook measured in years, while day or swing traders are concerned with what will happen in the next day or two.

Is the market optimistic or pessimistic about the company in Chart 15?

Since the tops are falling from left to right, it's easy to see that the market is pessimistic and the sellers are in control. Now, how about the stock in Chart 16?

This stock has rising bottoms as we move from left to right, so the buyers are in control and the market is optimistic.

You may have noticed that the company name at the top of the chart is the same; the difference is that the first chart is a long-term,

Chart 15 – A long-term chart showing a pessimistic mood.

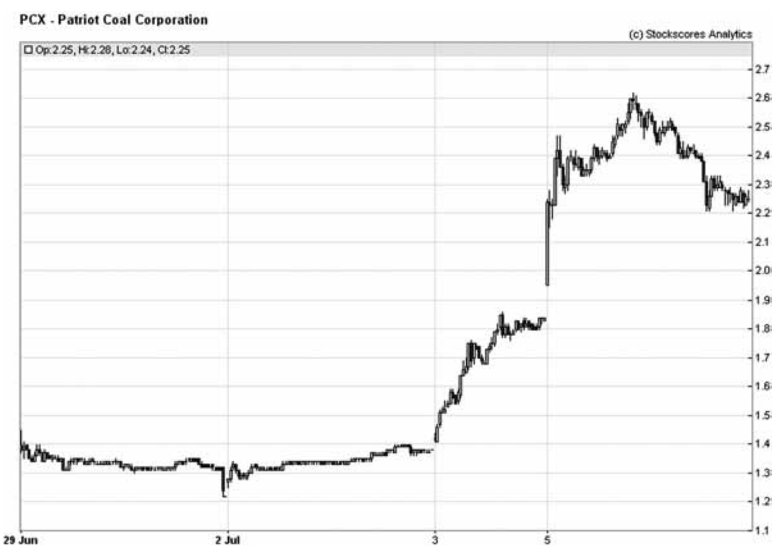

Chart 16 – A short-term chart that shows investors are optimistic.

five-year weekly chart while the second is a very short-term, five-day five-minute chart. Within the long-term pessimism there was a small show of optimism. A trader has been given an opportunity to make a nice profit on a quick two-day move in a stock that the market has disliked for a long time.

"The trend is your friend" is a cliché that you will hear often, but it really is something you should take to heart. Before you buy any stock, make sure there are rising bottoms building so you know the buyers are working to take control. Avoid owning stocks that have falling tops. Keep in mind that you have to adopt the chart time frame that matches your intended hold period and that there can be money-making moves against the trend if you shorten the time frame.

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Pursue Confidence; Avoid Uncertainty

Investors are given a tremendous amount of information to understand and evaluate. There is information specific to the company, details on sales, expenses, growth, debt levels and management as examples of what the market must value. There are also more general macro factors like economic growth, politics, regulations, currency fluctuations and spending patterns. With all of this information to digest, it's no wonder buyers and sellers are constantly pushing prices up and down. There is a good deal of uncertainty when working to determine what a company will earn in the future.

Each day the buyers and sellers go into battle, armed with this wealth of information, intent on proving the other side wrong. Is there so much animosity between the sides that they can never agree?

Buyers and sellers will always disagree to some extent, but how much their opinions differ can fluctuate a great deal over time. You can gauge the level of disagreement between buyers and sellers and use it to help you make money.

Price Volatility

Price volatility indicates uncertainty. The more a stock's price changes over time, the more unsure buyers and sellers are about what the company is worth. This makes a lot of sense; if the value of information isn't clear, buyers and sellers will be less certain of what the stock should be trading at and the price will change much more.

Price volatility tends to follow significant fundamental changes because it takes the market some time to value new information and determine what it's really worth. You can expect a great deal of price volatility 10 seconds after a company announces that they have discovered a large reservoir of oil, but as time passes, the fighting that goes on between buyers and sellers will narrow that volatility. Buyers and sellers argue back and forth by buying and selling the shares until, in a very efficient process, they determine the fair value of the new oil discovery.

The result is that price volatility will expand and narrow as new information comes to the market and is then priced in by investors. This process is far more efficient than having a single analyst try to figure out the value of new information from behind a desk. There are thousands of people taking in information and working to figure it out, and they use their best judgment to cast their vote. This process is a back-and-forth battle between buyers and sellers that results in the determination of price.

This process can take minutes, days, weeks, months or even years. The complexity and magnitude of the information affects how long it takes for it to be priced in by the market. The process is complicated by the fact that there is a constant stream of new information, making it necessary for the market to deal with multiple valuation processes at once.

Despite the many things that buyers and sellers have to work to evaluate, there will be times when they come close to agreement. When this happens, there is very little price volatility and the stock goes into a boring period of sideways, narrow-range trading. This is the point that the greatest trading opportunities come out of.

When there is little price volatility, you can say that the buyers and sellers agree about what the stock is worth. A solid foundation is built with little fighting going on between traders. This is a very important point because breaks from low volatility imply that new and important information is coming to the market, causing traders to come out of their slumber and move the stock's price again.

This makes the ability to find low price volatility a very important skill. It's not only a critical part of the market's message; it gives us an effective way to manage risk.

Identifying low price volatility is simple. Doing so requires nothing more than a ruler. Find the inflection point highs and lows, draw lines across them that best fit those points and look for a convergence of the lines. If the line across the tops converges toward the line across the bottoms, you have identified a stock chart pattern of diminishing price volatility.

Chart 17 – As inflection points converge toward one another, the market gains confidence that the stock's price is accurate.

On the left side of the pattern highlighted in the chart above, there is a lot of price volatility as the stock was trending higher. As time passed, the stock went into a narrowing trading range, defined by the lines drawn across the inflection points. This made the breakout through resistance late in April more significant: it came from a period when buyers and sellers had a high level of agreement about what the stock was worth.

By defining the pattern of diminishing volatility, you are identifying the process where buyers and sellers came together in agreement about what the stock is worth. As the magnitude of up-and-down price waves diminish, the market's confidence in price increases. A pattern of lowering price volatility is a pattern of diminishing uncertainty. As you move from left to right in the pattern, you track the process that makes buyers and sellers go from uncertain to confident.

This is an essential element to picking stocks that are going to go into a strong trend. We don't just want stocks that break through a price ceiling or floor; we want those that do so when the break comes from price confidence.

Remember, a break through resistance implies that new information is being absorbed by the market. Some fundamental change is significant enough to cause buyers to pay more and sellers to act

Chart 18 – The increasing volatility means investors are uncertain and makes the break through resistance a less reliable indicator of future strength.

with less motivation. How much can we trust that buyers and sellers are right? The answer to this question is in the price volatility before the breakout. If buyers and sellers had strong agreement about what the company is worth, a break from that confidence through resistance is significant. If there was a lot of price volatility and therefore a lot of uncertainty before the breakout, then the message that the breakout gives must be less trustworthy.

Stocks that break from high price volatility are more likely to fail to go into a price trend because the breakout has a greater chance of being motivated by bad analysis. A decision to buy or sell in times of uncertainty is going to have less conviction and a greater chance of being wrong. That is what makes the ability to find low price volatility so important.

Chart 18 on the previous page shows how a break through resistance from expanding volatility ultimately failed. While investors were optimistic about the stock, the growing uncertainty made the breakout suspect, and it failed because enough investors doubted it.

You should now know that buying a stock that breaks through resistance is good, but it's better if that breakout comes from a period of optimism when the buyers are in control. The breakout is even better if the price volatility before the breakout was low because that means investors had a high degree of confidence in what the stock is worth. This fact makes it more likely that the break was due to significant new information and not uncertainty about information that was already known.

Price volatility is the chart element most overlooked or misapplied by people interpreting stock charts. The tendency is to look for narrowing volatility over too short a time period. The longer it takes for price volatility to narrow, the more important the eventual break from that low price volatility is and the greater the chance that it will result in a strong trend.

Remember to think about what this pattern of narrowing volatility means. These are not just lines on the chart. When the lines drawn across the tops and bottoms converge toward one another, the market is telling you that the buyers and sellers are coming to agreement. While they are still eager to fight each other in the daily market battle, there is much less enthusiasm in how they wage the war.

Soon we will put all of these factors together to create a method for quickly evaluating stocks, but first we must understand a few more critical elements of chart patterns.

22

Buy High; Sell Low

The stock market is not fair. I have been preaching these words for a very long time, but I don't do so with malice toward the market. The fact that it isn't fair is what I depend on to make market-beating trades. If all traders worked on a level playing field, I'm not sure there would be opportunities to beat the market. The fact that some people consistently win in the market while many lose is a good thing, provided you are on the right side of that relationship.

The market isn't fair because some people get better information than others. This takes us back to one of the important ways that market efficiency can break down. The Efficient Market Hypothesis, that theory that says you can't expect to beat the stock market, assumes that all investors are making decisions with the same information. If that were the case, then picking the right stock would simply be a matter of doing the best analysis of the information that everyone has.

Of course, investors don't all make decisions with the same information. Most traders are using publicly available information, while those who can do better at predicting where a stock will go are using private information. Private information can be gathered by doing great research, knowing the right people or being in the right position.

Anyone using publicly available information is destined to be average at best. Public information is useless because it's already priced in to the stock. You will have an easier time beating the market by throwing darts at a list of stocks and picking the one that your dart hits. This stock-picking method takes less time and effort too.

You can use public information to help you uncover private information; that is what skilled fundamental analysts do. Those who know a lot about an industry can take what is known publicly and make an educated guess on what will happen next. The problem is that it's hard to do that for a long list of stocks across multiple industries. Few people are experts in a multitude of industries.

Even if you do this well, you should now be aware that missing just one important bit of information can leave you with a bad analysis, or at least a wrong analysis. It doesn't matter what you think about the fundamentals as you know them; it only matters what the market perceives about the fundamentals.

So rather than go through the long and arduous process of analyzing companies, let the market do it for you. You have five factors that you can look for in a stock chart to help you do that, and I am now going to describe the sixth and most important factor. This is the one that is rarely discussed, but it's the basis for everything I do as a trader.

My Secret: Abnormal Price Action

My secret to finding winning stocks is to look for abnormal price action. The reason is simple. When the people who do the very best analysis—those who uncover the important information about a company first—find something they believe makes the stock worth a lot more than it's trading at, they will act. Their actions are typically aggressive and noticeable. If they identify something positive, they will buy aggressively; if they find some significant negative information, they will sell aggressively.

I have informally studied the trading activity of stocks that have achieved market-beating price trends, whether those trends last five years or five hours. Approximately 70–80% of those trends start with abnormal trading activity. That means the great majority of market-beating stocks show abnormal price and volume behaviour in the very early stages of the upward trend. That's what makes this concept so important.

When investors have significant private information, they will be motivated to trade aggressively and create a statistically significant abnormal return for the stock. While it's hard to catch these abnormal price moves in a timely way simply by looking at stock charts, abnormal activity is easy for a computer to find. If I show you a chart of a stock that is behaving abnormally, you will instantly see what I mean. A computer can help you look at the right charts at the right time.

Stockscores and Abnormal Activity

I created my own indicator to find abnormal activity; it is an important part of what the Market Scan tool on **Stockscores.com** does for the people that use fit.

It's not enough to look for stocks that are up more than a certain percentage because every stock has its own inherent price volatility. A 3% move for one stock may be statistically significant; for another it could be normal. To find stocks that are likely moving on important fundamental change we need to look for a move that goes far beyond what we would normally expect.

If a stock is in a sideways range where most of the daily moves are no more than 2%, then a 5% move upward will stand out as significant. If that stock is trending higher and 3% daily gains are quite common, then the 5% jump may be a standout but not statistically significant. My indicators use statistics to measure what is abnormal so that traders can inspect the chart to see if trading activity really does jump out of the chart.

Chart 19 shows a stock that had a number of abnormal up days, highlighted by the arrows. On these days the price gains were more than what you would expect given the normal trading patterns of the stock in the days that led to the abnormal day.

Chart 19 – The arrows highlight days when this stock made a statistically significant abnormal price gain.

Why did this stock make big gains on these days? It wasn't because the buyers wanted to give their money away; it was because they had a reason to pay more. They had information that justified paying a higher price.

These price candles at the arrows should jump out at you because they have a lot of white space around them on the chart. The stock is up more than expected and is into prices that have not been seen recently. On these days the buyers are giving us the message that something is going on and some investors have found a reason to pay more.

Rarely will you know the reason the stock is trading abnormally, and it may be hard to trust the market's message. Keep in mind, however, that investors are no different than you; no one wants to lose money. All investors work from the same basic desire to make a profit, and that ensures that they will not lie to you with the actions they take in the market. That's what I love about looking at charts: there is no lying.

Buy High

It's smart to pay more for a stock if the situation is right. A stock that jumps 20% in one day hardly seems like a good deal to the bargain hunter, but the message that comes with that price jump is an important one. If the stock is up because investors are starting to price in significant change, then that stock is one that you want to jump on.

Companies can be worth dramatically more or less from one moment to the next because of an important change in their fundamentals. It usually takes time for the market to get the value adjustment from the new fundamentals right because the spread of information is not equal. Some investors will get (or figure out) the information before others.

Sell Low

This works with a negative change in fundamentals as well. If a stock makes an abnormal price spike lower, it is likely that something negative has given the sellers motivation to act aggressively. It happens so often that I can't remember all the times a stock has moved down well before the announcement of negative news.

Just Listen

Someone always knows more, and since everyone wants to make a profit, they will act in the market by buying or selling in a noticeable way. Since we can't possibly know everything there is to know about the thousands of companies that trade each day, we must wait for the market to tell us when something is going on. The market is very good at giving the right message to those who know how to listen.

By waiting for the market to tell you what to do, you will be one step behind those who know the most. You will also be 10 steps ahead of the public, who are making decisions based on publicly available information.

Chart 20 is a 15-day 30-minute chart of a stock that I featured in my newsletter about a week before I wrote this. I knew nothing about what this company does. What I know is that the abnormal price action highlighted by the arrow was caused by people who did know more. They probably know more about this company that I could ever know.

I don't want to be smart; I just want to follow the smart people who know the most. When the stock made that abnormal price gain early on the 27th, I saw what I needed to see to know the stock was worth buying. Within a week the stock moved up another 50%.

At the arrow, the stock was already up an abnormal amount. It was not on sale; it was trading at a higher price than anyone had

Chart 20 – The abnormal price action at the arrow telegraphed a further 50% gain in about a week.

been willing to pay for the stock for some time. You would never buy a microwave because they raised the price—you might only consider it if it went on sale. The stock market is different though, because higher prices *tell us* something about what's going to happen in the future. When prices rise abnormally from the right chart pattern, market-beating trends often develop.

23

Follow the Money

The movement of price is not the only element of market activity that provides you with a message. Volume, and changes to it, tells you a lot about what investors know about a company. Volume is typically defined as the number of shares that are traded in a time period, usually a day.

Number of Trades

Volume itself is somewhat misleading and not my preferred measure of the crowd. A stock that trades a million shares could be one large investor making a big trade or it could be the opinion of many traders making thousands of trades. If you see a noticeable spike in volume without accompanying price movement, it is probably a single large trade, likely one institutional investor crossing a block of stock to another.

There is also a big difference between a $1 stock that trades a million shares in a day and a $100 stock that does the same trading volume. To accurately assess the number of traders focused on a stock, you need a better measure of liquidity.

I prefer to look at the number of trades as a better measure of whether there is a crowd trading a stock. One trade occurs when a buyer purchases from a seller. Some stocks trade 50 times a day while others trade 50,000 times. How often a stock trades is the best indicator of liquidity because it measures how many people are trading the stock and is not dependent on the stock's price or the size of the trader making the move.

No matter how you define volume, it's an essential element to identifying trading opportunities. The importance of volume becomes clear when you understand the two types of risk that affect price movement.

Types of Risk

Risk is what gives you the potential for reward. If you are unwilling to take any risk then the return you earn on your capital will be low. Return is how you are compensated for risk.

There are two types of risk that traders can take advantage of. The first is systematic risk: the movement in a stock's price that is attributable to the overall market movement. These are factors like the condition of the economy, currency fluctuations, political conditions, commodity prices and government regulations. If the market moves up significantly, you should expect that most stocks will do the same. Every stock trades with some correlation to the overall market, but some do so more than others. As a general rule, the larger the company, the more closely it will match the performance of the overall market. Chart 21 on the next page shows Microsoft (MSFT) compared to the movement of the NASDAQ 100 index. You can see the strong correlation between the two.

The second type of risk is unsystematic risk: that portion of price action that relates to the company specifically. Company management, sales, product development, growth and innovation are examples of factors that affect unsystematic risk.

Chart 22 on the next page compares Expedia (EXPE) to the NASDAQ 100 ETF (QQQ), the line on the chart. You can see that for the first half of the year the stock traded with a noticeable correlation to the NASDAQ 100. Then, late in April, the stock was able to break free from its correlation to the overall market and outperform

Chart 21 – This chart shows how Microsoft trades in a very similar way to the NASDAQ 100 Index.

Chart 22 – Expedia broke from its strong correlation to the NASDAQ 100 in May and began to trade on its own story.

it. From May until July, the stock traded on its own story, on the unsystematic risk component.

Traders refer to these two types of risk as beta and alpha factors. Beta is the correlation to the market, and alpha is the stock's performance specific to what the company is doing. If you focus on trading beta, then your analysis should be focused on the overall market direction with less attention for the individual company.

To beat the market, you have to focus on alpha because this is the risk factor that sets some stocks apart from others. Alpha is what makes a stock move faster than the market. Expedia outperformed Microsoft over the same time period because there were factors specific to Expedia's business that attracted investors to its stock, sending it higher much faster than the NASDAQ index.

Look for the Crowd: Abnormal Volume

As a trader, you're in constant pursuit of alpha, and the easiest way to find it is to focus on volume. Stocks that are trading on their own story generate excitement and attract a crowd. The telltale sign of a crowd that is enthusiastic about a stock is abnormal volume. Chart 23 shows Expedia (EXPE) again, this time with volume included. Notice the big spike in volume the day the stock made its disconnect from the overall market.

Finding alpha is easy: just look for abnormal volume. I created an indicator to do this; it is available in the Stockscores Market Scan tool so you can filter the entire market in search of abnormal volume. Whether you're looking for a stock to hold for the next year or one to trade over the next few hours, abnormal volume will be an important determinant of your success.

Chart 24 shows Nanosphere (NSPH), which made considerable gains in a short time. Notice how abnormal volume accompanied the abnormal price action.

For stocks to go up there needs to be strong volume. Stocks don't need strong volume to go down; they can often fall on very light volume as sellers exit the stock into weak demand. Whether

Chart 23 – Volume increases when a stock's fundamentals attract a crowd.

up or down, abnormal volume is a show of excitement—a sign that there's a crowd attracted to the stock.

Stocks are much like rockets: to get off of the ground they need fuel, and that fuel is volume. Since it's inevitable that investors will want to sell a stock, an absence of buyers can cause a stock to drift lower. For a stock to make a steep and sharp move lower, volume is also necessary.

Price action is an important indication of what a stock will do in the future, but volume is the magnifier of that message. A stock that breaks out through resistance from a good chart pattern has a good chance of moving higher. One that does so with abnormal volume has an even better chance of trending up.

Since you want to beat the market, make sure that you focus on finding abnormal volume. It is the footprint of alpha, and traders focused on alpha have a better chance of making money.

Chart 24 – This chart of Nanosphere (NSPH) shows how abnormally high volume accompanies abnormal price change.

24

Channel Surfing

The majority of strong price trends will begin with abnormal price action. A catalyst for a positive shift in the market's perception of fundamentals ignites buyer interest and starts the stock higher. As the trend develops, improving fundamentals and the law of upticks help the trend to continue moving from the lower left to the upper right of the chart. An uptrend is in place.

It's inevitable that the upward move will see pullbacks against the trend. There will be shareholders who want to take profits as the stock's price climbs, and this causes shorter downward moves inside the upward trend. There is an increased chance of these pullbacks early in the trend because investors tend to doubt strength when it's just getting started. As the trend progresses, stock owners grow more confident, believing that the upward climb legitimizes the company's story.

The pullbacks are healthy. They work to shake out weak owners and build a more solid base of shareowners who will be committed to holding the stock. It's the pullbacks that allow us to buy strong companies when they are on sale—the one time it makes sense to buy weakness.

Defining a Trend

To take advantage of the opportunity that trends provide requires the ability to define the trend. This is as simple as drawing a line across at least two inflection points in the trend. Typically, the first is the low before the trend starts, and the second is the low of the first pullback. Once defined, it is quite remarkable how well trend lines act as support and resistance for a stock.

There is a bit of an art to defining a trend line. You begin by highlighting the inflection points and then look for a line that best fits as many of those inflection points as possible. For an upward trend, the focus is on the inflection point lows, which will be rising over time. Downward trends will have a line that cuts across the inflection point tops as they fall from left to right.

Price trends usually develop as a company goes through a period of improving fundamentals. This is what carries the general rise higher in the stock, allowing it to outperform the overall market. In upward trends the tendency is for stocks to run away from their trend line and then come back to them. These fluctuations are primarily attributed to emotion. As investors feel greed and excitement about the improving fundamentals, they chase the stock higher, causing it to go up too fast. At some point, the sellers step in and limit the enthusiasm of the buyers by acting with strength, causing the stock to pull back through a round of profit-taking.

These pullbacks are shorter than the trend that came into them, allowing the stock to maintain its cycle of rising bottoms. It's the pullbacks, and the resulting rising bottoms, that define the trend line. As chart watchers, we just have to pick out the lows of the rising bottoms and connect the dots, drawing a straight line that best fits the trend.

On the next page is an example of a stock that enjoyed a consistent upward trend for three years. Notice the tendency for the stock to run up and away from the trend line that I have drawn but inevitably come back to it.

A few important things about trends should stand out from

Chart 25 – The inflection point lows from pullbacks define the upward trend line.

this chart. First, there can be shorter-term trends inside long-term trends. On the CenterPoint Energy (CNP) chart, there was a steeper upward trend in 2009 that was eventually broken in 2010 to define the longer-term upward trend that has been in place three and a half years.

Breaking a trend line does not necessarily mean the stock is ending its trend, although it could. Often, stocks will break their trend line and go sideways for some time before making a new breakout from low price volatility to initiate the next leg of the trend.

Notice how reliably the stock comes back to the trend line after it has run higher and away from it. Upward trend lines do a great job of providing support to a strong stock and downward trend lines act as resistance for downward-trending stocks. I find that they are one of the most reliable features on price charts.

These facts create trading opportunities that are not based on abnormal price activity. Remember that beating the market requires you to exploit a breakdown in one of the assumptions of market efficiency. Abnormal price activity takes advantage of the assumption that everyone trades with the same information, since we know that's not always the case. Trading on trend lines takes advantage of the assumption that investors always act rationally. Have you ever made an irrational decision in the stock market?

Of course you have because presumably you're normal. That means you get excited when you see a stock you're following run higher and worry when a stock you own starts to move sharply lower. These moves create greed and fear, causing stocks to run away from their up or down trend lines.

Taking Advantage of Runaways and Pullbacks

You can take advantage of emotional trading in two ways, one more effective than the other. If a stock is trending higher and runs away from its trend line, you can short sell that enthusiasm with the expectation that the stock is going to pull back to the trend line. This is a reasonable strategy but not my favourite because the pullbacks tend to be less intense than the upward moves, making them less profitable.

You can predict where the stock is likely to stop running away from the trend line by drawing a second line parallel to the trend line but cutting across the recent inflection point top. This requires three inflection points: two points to define the trend and a third to define the other boundary of the price channel. This will make more sense when you consider the next chart.

The second method is to buy strong stocks when they are weak by waiting for them to come back to their upward trend lines. Once a trend line has been established by at least two well-defined inflection point lows, rising from left to right, look for a buying opportunity when the stock pulls back to the trend line.

On the next page is the chart of CNP again to highlight this approach. Point 1 is the low before the upward trend began and

Chart 26 – The trend line is defined by the inflection point lows at 1, 2, 4 and 6. The upper boundary of the price channel is found by drawing a parallel line that touches at least one inflection point top, like at point 3. Point 5 shows where the price rise is expected to end because price has hit the upper boundary of the channel.

point 2 is the first pullback, defining the trend line. Point 3 is the first high inflection point, establishing the upper boundary of the price channel.

Once these three points have been established, you wait for the stock to run up to its upward boundary, where it is likely to pull back. This occurs at point 5. Better yet, you wait for the pullbacks to the trend line at points 4 and 6, where the trend line provides support for the stock to bounce from.

Price channels are directional ranges of price movement defined by inflection points. They are easy to find and define if you begin by identifying inflection point highs and lows and then look for parallel lines that touch these price-turning points.

Channels are also useful for keeping you from entering a stock that is overbought. At point 5, the stock is very strong and optimism is very high. The stock is breaking to new highs, which could make the inexperienced chart reader eager to buy. When you consider the channel, however, it is clear that the sellers are likely to provide selling pressure at point 5 because the stock has already run away from its trend line.

I like to buy stocks when they are starting trends, not when they are well into them. The only way to buy stocks that have been strong for some time is to get them on pullbacks to the trend line. This is when high-quality, market-beating stocks are on sale. At the trend line, the reward potential can justify the risk.

You can find channels on charts of any time frame. Long-term traders should look for them on weekly charts. Those with a time horizon of weeks or months can focus on daily charts (position trading). If you like to trade with hold periods of less than two weeks (swing trading), look to the intraday 15-minute chart. You can even use trend lines and channels when entering and exiting within a day (day trading) with a focus on a two- or five-minute chart.

Measuring Emotion

The slope of the trend can tell us a lot about how emotional investors are. The steeper the trend, the more investors are chasing the stock and the less rational their actions will be. When stocks are hot—really hot—they will go up very steeply.

This is great if you own the stock, but a degree of caution is warranted. The steeper the trend, the more likely a steep downward move will follow. When you own a stock that is trending at a very steep rate, watch it closely for a signal to exit; you don't want to be too far from the exit if someone yells "fire."

The greatest emotion is shown when the trend goes from a straight line to a curve. The "parabolic" upward trend is a sign of euphoria, a time when people are buying because of their fear of missing out and not because the fundamentals justify the price ascension. Don't sell just because the trend has gone parabolic, but pay very close attention to the stock because a sell signal is likely a short time away. Never chase a stock higher if the trend is parabolic.

Here is the chart of gold, which was a great performer for a number of years when the overall stock market was languishing. For a few years, the trend was linear, defined by a straight line rising from left to right. In the second half of 2011, euphoria took hold and gold's trend went parabolic, sending it up and away from the trend line. The result was a lengthy period of underperformance for gold as the market worked to take the emotion out of its price.

Chart 27 – Investors are acting emotionally when price curves up and away from the trend line.

The boundaries of trending channels provide a reliable tool for chart analysts to use for predicting where price moves will begin and end. It's often tempting to buy stocks when there is great strength, but avoid chasings stocks that are running away from their trend lines. This strength is very different from the strength that comes when stocks make abnormal price breaks to start a trend. Stocks that run away from their trend lines are not responding to new information; they're responding to emotion and usually correct back to the trend line. Pullbacks to upward trend lines are a sensible way to buy weakness.

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Some Times Look Different

It is important to understand that you can analyze the market's opinion of a stock across many different time spans. The market's opinion over the past week can be very different from the market opinion over the past year. The market is constantly giving us a message—not based on the opinion of one person, but on the actions of every person who casts a vote in the market. Investors tell us exactly what they think of the fundamentals each time they buy and sell, and the longer-term opinion is based on many more investors than the short-term.

While all investors have the same basic goal—to make a profit—not all investors have the same time horizon for achieving that goal. There are algorithmic traders trying to make money in the next few seconds; short-term traders are concerned about how price moves in the next few hours or days; longer-term traders are focused on the next few months; and large institutional investors are concerned about where price is going in the years ahead.

With all of these groups playing the market simultaneously, there can be trends within other trends. A stock's chart can be pessimistic if you look back five years but optimistic if you focus on the last five days.

The chart you choose to look at has to match the time horizon of your trading style. If you are trading with an expected hold period of weeks or months then you should be analyzing the daily chart. If you want to make money in the next few hours, then focus on the intraday chart. A very long anticipated hold period may require that you analyze weekly or even monthly charts.

The Time It Takes to Manage Your Trades

The shorter your anticipated hold period, the more time you need to devote to watching the market. A day trader who wants to make a profit holding a stock for less than an hour needs to watch the market all day. If you intend to manage your portfolio by owning stocks for months or years using the weekly chart, you only need to devote half an hour a week to the process.

Active Trading

The more actively you manage your account, the more you can improve returns, simply because you're working harder to use your capital to generate profits. The problem is that more active trading requires more experience, discipline and time, and that leaves a greater chance of doing it poorly. While the potential reward for active trading is greater, so too is the risk.

That's not to say I think active trading is risky. Since you can manage risk much more closely when you monitor the market throughout the day, you can limit the size of losses. Active trading requires a greater level of emotional control, discipline and focus. If you lack those things or are not yet a skilled trader, your mistakes can cost you more when active trading.

Analyze the Time Frame That Suits Your Strategy

You shouldn't be dissuaded from buying a stock if the longer-term time frame is giving you a negative message. To find a good buying opportunity, you can shorten the chart's time interval until the message from the market is optimistic and then decide if that time frame fits your trading style. Of course, no matter what time frame you analyze, it's essential that the market's message is a good indication of future price appreciation.

The chart below is pessimistic. The tops are falling as the stock has suffered a considerable loss of value. This is not a buyable daily chart because there hasn't been the formation of a rising bottom and there's no break from low price volatility.

Chart 28 – This long-term chart shows the market is pessimistic about this stock because the tops are falling over time.

But when you look to the intraday 15-minute chart of the same stock, you see a very different picture. Over the past week, investors have been building some short-term optimism, and on the current day at the arrow there's a break through resistance, from low price volatility with abnormal price action. Volume is steady in support of the upward price move.

Chart 29 shows the same stock, but this chart time interval shows a very different investor mood. For the trader who has the

Chart 29 – The short-term chart shows a break through resistance from an optimistic chart pattern at the arrow.

time and ability to watch the market through the trading day, there's an opportunity to make a good trade.

Judge Performance Using Reward for Risk

You may be wondering why it's worth trading a shorter-term time interval, given that a stock doesn't have as much capacity to make a large percentage gain in only days as it could over weeks or months. True, large percentage gains tend to take longer to materialize (although not always), but a focus on percentage gain as a metric for success is misguided.

Remember, you must judge the success of your trades using reward for risk. A short-term trade could have a better reward for risk potential because the entry point will be closer to support where the stop is placed. It doesn't have to go up as much to earn the same reward for risk as a trade that is held for months. This means a swing trade held for only a few days could be a better performer than a successful long-term trade held for months. If the reward for risk of the short-term trade is seven and the long-term trade is only four, you make more money on the short-term trade and do it in less time.

Trading a short-term time frame is not for everyone because it does require better skill and more time. It is not, however, any more intellectually difficult; the chart analysis is still based on the same six elements.

Time Frame Confirmation

If you want to improve your probability of success when trading, look for time frame confirmation. Seek out trading opportunities where the short-, medium- and long-term charts are each telling you to do the same thing. If they all say "buy," then you can act knowing that different groups of market participants are all acting together.

Do your analysis on the weekly, daily and intraday charts, and remember that each time frame represents a different group of investors who participate in the market. If the weekly is giving a good buy signal, you know that investors who have an outlook measured in months or years are bullish. A strong daily chart tells you that traders who anticipate a hold of weeks or months are bullish. Finally, if the intraday chart is strong, it means the short-term day and swing traders are also bullish. It's rare to have all the groups working with the same outlook at the same time, but when it does happen, you have a well-timed entry into the stock.

When I'm making a longer-term trade, I like to look at the longer-term time frame to tell me what to do and then focus on the shorter-term chart to tell me when to do it. Typically, I look at the daily chart, seeking out breaks from good chart patterns. When I see one, I go to the intraday chart to find a good confirming chart pattern setup to trigger my entry.

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You Can Analyze Any Stock in 10 Seconds

You can analyze a stock by analyzing the market's perception of its fundamentals. This is not done by considering what the company does, how it's growing or who runs the business. Instead, you work to figure out what the market thinks about everything that's known, letting the awesome efficiency of the market do the work for you. Every day there are millions of investors arguing over what a company is worth. I want you to trust what they do with their money.

You can do this by looking at the action in the market and applying my six elements of chart patterns. Realize that reading charts is a skill, and skills take time to develop. The elements are intellectually simple but combining them and seeing them take practice. Don't expect to be able to do this well tomorrow, but if you practice looking at a lot of charts with these six elements in mind, you'll get good at it. I have taught thousands of people how to do this and have found that most are able to do it without a lot of thought after a few months of practice.

Before I discuss how to combine the elements, here's a quick review of each element.

- **Support**—a floor price for a stock defined by the inflection point lows on the chart. It is the place where buyers took control of the stock from the sellers and the sellers were no longer willing to push prices down. It represents the minimum that sellers are willing to accept for the stock's fundamentals. Lines of support that are touched multiple times are stronger psychological barriers, as are those that have held up as the floor for a longer period of time.

- **Resistance**—resistance is the opposite of support. It's a ceiling price defined by the inflection point tops on the chart. At resistance, the buyers lost control of the stock to the sellers because they were unwilling to pay more for the company's fundamentals. Lines of resistance that haven't been violated for a long time, or have been touched multiple times, are strong psychological barriers for the market.

- **Optimism**—the market is a war between buyers and sellers. Who's winning the war can be gauged by the up-and-down waves in price. If these waves are rising over time, there will be rising bottoms on the chart. This is a sign of optimism—an indication that the buyers are in control of the market.

- **Pessimism**—falling tops, defined by inflection point highs, are a sign that the sellers are in control of the market and able to push prices down over time. A chart with falling tops is an indication that the market is pessimistic about the company. Buying a pessimistic market is dangerous because investors tend to be less responsive to company fundamentals.

- **Price Volatility**—the range of price movement will change over time as investors find it more or less difficult to determine what a company is worth. A relatively large price range implies that investors are uncertain about what the company will earn in the future, making predicting the future direction for the stock difficult. When a stock's price volatility compresses, the message from the market is that investors are more confident about what the stock is worth, making breaks from this low price volatility a sign that investors have new information that justifies the increase in volatility.

- **Abnormal Activity**—to beat the market, we must seek alpha. This is the component of a stock's risk attributable to the properties of the company rather than the overall economic environment. Abnormal price and volume action are the best signals from the market that investors are focused on the company for its alpha risk component. Trading strategies that focus on abnormal activity have a better potential to beat the market because they are focused on the stock-specific factors for price change.

The next step is to combine these six elements to determine an overall outlook for the chart you are studying. I do this with the following priorities:

1. Who is in control? If the bottoms are rising, it's the buyers. If the tops are falling, it's the sellers. You don't want to buy into a market when the sellers are in control. This first question allows you to put the stock into one of two piles. If the stock has rising bottoms, it's a potential buy. If the tops are falling, it's a potential sell.

2. Is this an alpha stock? You want to see signs of abnormal activity, either in price or volume, to determine if the market has an interest in the stock for reasons specific to the company. If not, the stock will likely trade with its historic correlation to the market. Most stocks, most of the time, are not worth trading because they are not trading on alpha factors.

3. Is the stock breaking from low price volatility? A stock that shows abnormal activity from low price volatility has a higher

potential of working because the message from the market is clearer. Metaphorically, a stock showing abnormal activity from low volatility is like a person speaking to a quiet and engaged audience. If a stock breaks from high price volatility, the message of the market is drowned out by a noisy crowd, making it likely to be misunderstood.

4. Is the stock breaking through a ceiling or a floor? You want to see an indication from the market that traders perceive an important change in the company's fundamental value. Stocks that move up through resistance do so because traders have found a reason to pay more. If a stock falls through an important floor price, it's because the sellers have found a motivation to pay less.

On the next page is a chart of IBM (IBM). In only a few seconds, you should see that this is a stock to avoid because the sellers took over control from the buyers in the middle of May. Although the market is pessimistic about the company, I wouldn't short this stock because it is nearing support at $187 and is still showing too much price volatility to make a good prediction of whether it can break down through that floor.

My analysis is focused on a few things. First, the falling tops from May till July tell me that the sellers are in control. The first falling top was at the beginning of May and led to a break in the long-term upward trend line. Tops have continued to fall and the stock is now approaching the inflection point low created early in June. Right now, the market is not enamoured with IBM, but a floor price has been established. You can expect that the stock will likely see compressing volatility over the next few weeks as the line of support and the line across the falling tops converge toward one another. Near the point of convergence, the market will decide whether the stock deserves to be sold through support or break the cycle of falling tops. At that point, a good trading opportunity may develop.

Chart 30 – The sellers have taken control of IBM because the tops are falling after the upward trend line was broken, making this a stock to avoid.

On the next page is another chart. Before you read my assessment of it, try doing your own.

Chart 31 – The buyers are in control of AMGN over the long term, since the bottoms are rising from left to right.

The buyers have been in control of this stock for almost a year, and it's a good hold today but not worth entering. The last abnormal breakout from low price volatility through resistance was in mid-December, setting up for the recent rally. Currently, the stock is at the midway point of its upward channel, which gives entry here a neutral reward for risk. The stock may be worth considering on a pullback to the upward trend line.

Here's one more, this time without any lines drawn on it. Do your analysis, and then flip the page to see the chart I have marked up.

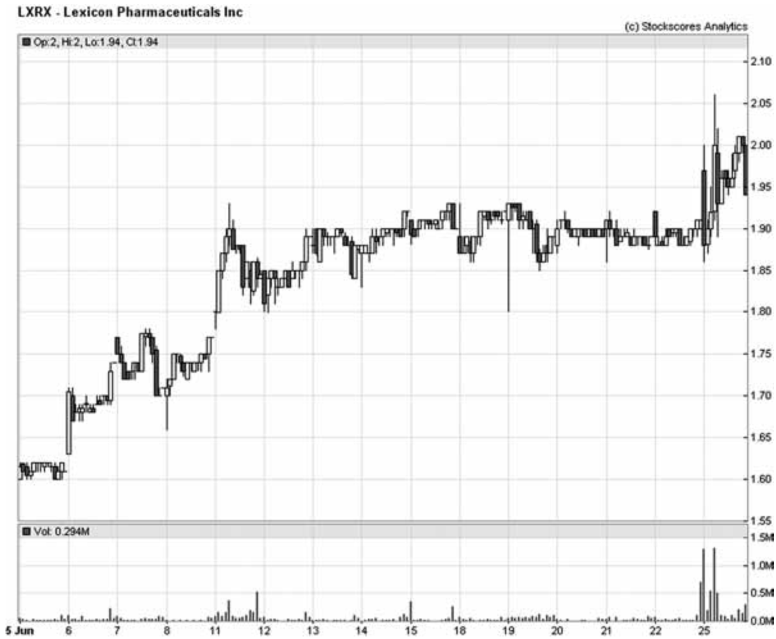

Chart 32 – Do your own analysis of this chart to determine whether it's worth considering or not.

Chart 33 – Rising bottoms, a recent break through resistance and abnormal volume supporting the breakout are signs that the market is excited about this stock.

You can see that there are rising bottoms on the chart, so we know that the buyers are in control. This line across the rising bottoms is converging toward the line of resistance drawn across the tops, indicating that price volatility is diminishing and confidence in the market's perception of fundamental value is increasing. On the current day, the market has found a reason to take an interest in the stock, making it trade more on alpha factors than beta. This abnormal activity has broken the stock out through resistance, making it likely that the stock will now go into an upward trend. This stock is worth buying and holding as long as support at $1.87 is not broken.

You may be curious to know how this stock did in the days that followed: it made a 35% gain from the day it started to behave abnormally.

Chart 34 – The market never lies. The initial signs of strength at the arrow accurately predicted the strong price trend that followed.

You don't have to know anything about this company to enjoy the profit from the opportunity that the market activity told you to take advantage of. What you need is trust in the people who are trading the market and showing you their willingness to pay more for the stock. Have trust that they have done the hard analytical work and know more about the stock than you or I ever will. Follow the actions of their money, knowing that they have the same desire as you to protect their capital and pursue profit. Believe in the message of the market because you now have the knowledge to interpret it.

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Gravity Works

For some investors, selling their stocks is sacrilege. These people argue that profits come from holding good companies that grow earnings steadily. They argue that selling and locking in a profit brings a taxable event that hurts long-term performance. For the buy and hold investors, there is no selling.

Buy and Hold Is Old

The performance of the stock market over the past 12 years has proven this approach ineffective. So many stocks have made substantial directional moves that lasted months or even years and then given back those gains and more. The life cycles of companies today are shorter than in the past and profits are often short-lived as a new company comes up with a better way, driving its competitors into the ground.

Consider the business of manufacturing cellular phones. Palm, Inc. (formerly listed as PALM) was once the industry leader, but the company's dominance was replaced by Research in Motion (RIMM, T.RIM). Then, along came Apple (AAPL), whose iPhone became the phone of choice, driving RIM's market share lower. Along the way, Nokia and Motorola have lost out as well.

If you look at the price history of a stock like RIMM, you can see that there was tremendous potential to make money. A person who bought in 2006 and held until 2008 could have earned a 700% return. The same investor who bought in 2006 and continues to hold is now down 50%. Examples like this make a great case for why you have to sell when the market tells you to.

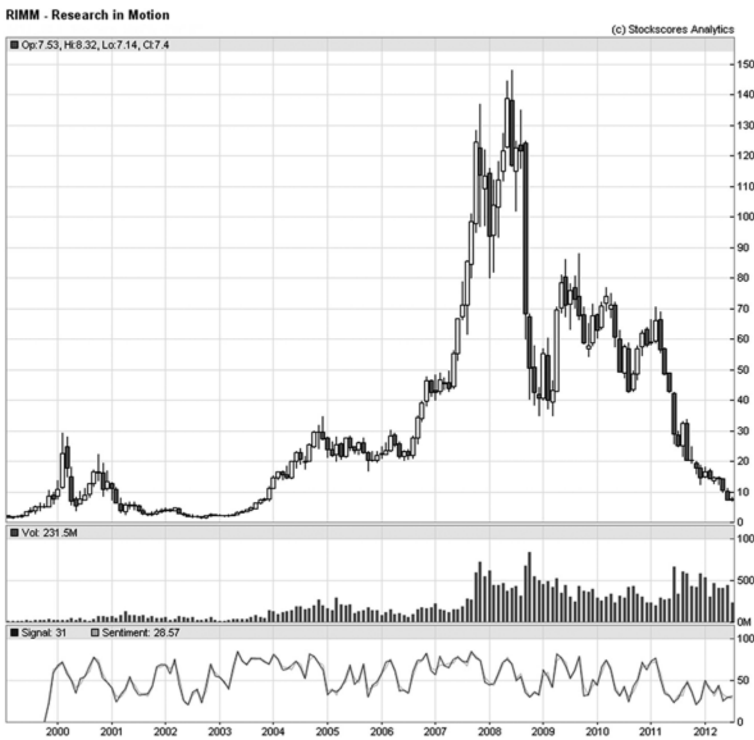

Chart 35 – RIMM was a great performer for those that sold to lock in their profits. Eventually, the stock fell back to where it started, leaving the buy and hold investor with a disappointing investment.

The buy and hold investor will counter with Apple (AAPL) as an example of why it pays to be patient and hang on to stocks. AAPL went up about 1200% from 2006 to 2012, although it lost half of its value during 2008.

Chart 36 – AAPL has been a great hold, but stocks like this are rare. Traders can still take advantage of stocks like this with a strategy to hold as long as the buyers are in control.

AAPL has been a very impressive stock, but how often do stocks like this come along? There are about 15,000 stocks traded in North American, and I bet I could count the number of stocks like this using just my fingers. No toes required.

With the benefit of hindsight, it's easy to say that AAPL was an obvious buy when it was $12, but I remember when the stock was $12 and it was not obvious. Holding AAPL for as long as it has been a market-beating stock is as much about luck as it is about analytical skill.

Large institutional investors with billions of dollars to invest have to hold on to stocks for a longer time because the market is not liquid enough for them to trade in and out of big positions. That's not the case for you (unless you manage billions of dollars) so why manage your capital with the constraints of a large pool of capital? You can be nimble, moving in and out of stocks when the market tells you the time is right. Yes, it requires skill, but so does anything else. With knowledge and time to practice, you can develop the skill.

Doing so will require that you pay taxes on your gains (unless you trade in a tax-shielded account), but paying tax means you're making money. If you have to pay the capital gains tax to avoid a winner turning into a loser, do so!

Picking the Exit Point: The Four Phases of an Upward Trend

There are four phases to an upward trend and each requires a different approach to picking the exit point. Monitor the charts of the stocks you own for the following four phases:

Phase 1—Selling at a Loss

Not all trades will work, and taking losses is a necessary part of trading. You must know the price level where the market has proven your trade wrong, making it necessary to take the loss. Look to the support price before the entry signal as the critical level. If the buyers were motivated to send the stock up on new information and the information turns out to be false, expect this floor price to be violated. At that point, take the loss.

Phase 2—Trends Start Slowly

In the early stage of a trend, the buyers will lack confidence and the sellers will question the strength. That makes it likely you will see more price volatility, with whipsaws back and forth as uncertain buyers and sellers argue about what the stock is worth. In the early stages of an uptrend, relatively few buyers are aware of the positive fundamentals that warrant the price appreciation. During this phase, use a stop loss point that is wider to give the stock room to move.

Phase 3—Stick with the Linear Trend

As the information becomes more widely known, the stock will move into a linear and relatively orderly trend. Upward price momentum will develop, and the stock will trade inside the boundaries of a channel. During this phase, let your exit point trail behind the current price based on the volatility of the stock, using inflection point lows as the trigger point. The more volatile the stock, the more room you have to give it to move before hitting the eject button.

Phase 4—Trends End Quickly

If the stock has a good story and lots of people take notice, expect the stock to enjoy a faster upward trend as the crowd rushes into

Chart 37 – There are four phases in a trend. Each requires a different approach to exiting the trade.

the stock. At this point, the buyers are more motivated by greed or the fear of missing out than they are by the fundamentals of the company. This leads them to pay irrationally high prices, making the stock's upward trend go parabolic. The farther the stock goes from its upward trend line, the more emotional the buyers are. This is the phase when the stock can correct sharply if everyone rushes for the exit at once.

Signs It Is Time to Get Out

Knowing when to sell doesn't take any new skills. You can stick with what you've learned from how to read stock charts. Begin by identifying the inflection point lows and highs on the chart of the stock you own.

Breaks of Support

Draw horizontal lines at the inflection point lows. These are areas of support. If the stock closes below the support price, exit. For your initial stop, look for the support area before the entry signal and use this to define the stop loss point. Use the difference between your entry price and the stop loss point to calculate the risk per share. With this, you can calculate the position size by dividing the risk per share into your risk tolerance amount. So, if you are buying at $10 with a $9 stop and a $500 risk tolerance, you will buy 500 shares, since your risk is $1 per share and you are willing to lose $500.

If the stock closes below that price, exit and take the loss. As long as support holds up, stick with the trade.

Chart 38 on the next page shows a strong linear upward trend that LeapFrog (LF) enjoyed. I have marked the inflection point lows on the chart as the trend developed. Notice that none of these areas of support were ever violated. Each time the sellers managed to push the stock lower for a pullback, a new rising bottom was formed. By only selling when one of these support areas defined by a rising bottom was broken, the trader stuck with this trade for the duration of the upward trend. There has still not been an exit signal.

Chart 38 – Each rising bottom defines a new area of support where a new stop can be put to protect profits in an upward-trending stock like LeapFrog (LF).

Breaks of the Upward Trend Line

Draw a line that best fits the upward trend of inflection points. This is the trend line. Draw a parallel line across the inflection point tops and you now have the boundaries of an upward-sloping channel. Expect the stock to migrate within these channel boundaries. If the lower boundary—the trend line—is broken, exit. If the stock is at the top of the channel and you want to protect profits, look to an intraday chart for a pattern breakdown, since the stock is likely to pull back to its lower boundary. For the more skilled trader, this allows you to lock in profits when conditions are overbought. You can always buy the stock back when it falls to the lower boundary.

The chart below is a weekly chart of Netflix (NFLX), which maintained a strong linear upward trend for over a year. Simply drawing an upward trend line across the inflection point lows and a parallel line across the inflection point highs predicted how the stock would oscillate in its trend and when the trend had run its course. Once the trend line was broken, the sellers took over and sent the stock quickly lower.

Chart 39 – Breaks of long-term upward trend lines are reliable signals to exit the stock before it moves lower.

Breaks Down from a Falling Top

Find the recent inflection point tops and look to see whether the current top is lower than the previous. If so, you have a falling top.

Falling tops are a sign that the buyers are losing strength. They will often come before a break of the trend. When you see a falling top, be more watchful for an exit signal.

Below is an intraday chart of a stock that ultimately sold off sharply on bad news. The market predicted this sell-off with the formation of a falling top and then a break of the upward trend line. The market's message was that the buyers were losing their strength and the sellers were taking over. The following day, this stock dropped more than 70%.

Chart 40 – A breakdown from a falling top is another reliable sign that the sellers are taking control of the stock.

Price Moves Far above the Upward Trend Line

Draw lines connecting the inflection point bottoms and look to see if that line is becoming steeper over time. If so, the stock's trend is going parabolic, and investors are emotional. In times like this, use a more aggressive exit strategy. If the stock is really moving quickly upward, look for a break of the trend line on an intraday 15-minute or 30-minute chart. When the stock is moving on emotion, look for exit signals on a shorter-term time frame.

This next chart shows two occasions when emotion drove the buyers to push the stock up too quickly, sending it up and away from the trend line. At these lofty price levels, it paid to sell at the first sign of weakness in anticipation of a pullback to the trend line. The final pullback actually broke the trend line, giving another long-term exit signal.

Chart 41 – Use a more aggressive exit method as the price runs away from the upward trend line.

The Profit Is in the Patience

While I don't believe in the buy and hold approach, I do know that overall trading performance depends on having occasional big winners. That means you have to be patient when you have a stock that is performing well.

It's easy to sell a winner because it feels good or because you're worried that the market will take back the profits you've made. In order to maximize the gain on a trade, you have to be willing to endure minor pullbacks against the trend. As long as the trend line remains intact, be patient.

When the trade is working, let it work. Only exit a trade when the market gives you a signal to exit, and when it does, listen to the market and act. Don't focus on what you could have made if you had sold at the recent high; that's history. You can only profit based on what the stock is trading at now.

The exit decision is an emotional one. We fixate on the profit and loss figure because we have an emotional attachment to money. To trade well, you have to focus on the market's message and not on what your heart desires. The market does not care about you or what you want, so don't expect it to react to your emotions.

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Trade the Situation, Not the Stock

You should not trade stocks; you should trade opportunities. Opportunities to make money in the market are about the relationship between reward, risk and probability. What the company does, who runs it, what its sales are and any other details relating to the value of the stock are irrelevant. You must focus on the likelihood that the reward potential justifies the risk.

I might like a stock for a trade at a particular moment if the chart pattern tells me the stock has a good chance of going higher. However, that's not enough: it must also have the potential to go high enough to justify the potential loss if my analysis is wrong. The opportunity is based on the convergence of these factors at a moment in time. The trade could be no longer valid five minutes later, or it could still be worth taking a week later. It's not the stock that makes the difference; it's the price action that's important.

A subscriber to my newsletter once emailed me about a stock I had discussed. The stock was Bank of America (BAC), a large U.S. bank that tends to move with the overall market, or at least with the financial sector, but which was moving abnormally on this particular day. He told me he had just bought the stock, a month after

I had featured it, because it was cheaper than when I had pointed out a trading opportunity in the stock.

He approached the trade with a focus on the company behind the stock, assuming that I had liked the stock for a trade because I felt that the company was worth more than what it was trading at. Since the stock was now cheaper, he reasoned that it must be an even better buy, since it was now cheaper relative to what the stock was actually worth.

This was not the case. I liked the trade because I felt the stock had a good potential to make a short-term gain that was greater than the potential for it to be stopped out by hitting support. For him, a good stock was one that was worth more than what it was trading at. To me, a good stock is one that goes up after you buy it.

In the week that followed my trade alert, the stock did exactly as I had expected, moving higher for about a week before the buyers ran out of enthusiasm and the sellers took control of the market. The entry came on a break through resistance, from low price volatility, out of optimism and with abnormal price activity. I identified an exit for the trade after the stock broke down from a falling top, and the result was a profit of about five and a half times risk. On the next page is the 30-minute chart for the month that covered the trade and the aftermath.

You can see that the stock, at the "Entry" arrow, met the criteria that you have learned about earlier in this book. You can see how it made a gain that was better than five times what had to be risked, allowing a trader with a $500 risk tolerance to buy 2000 shares and earn better than $2500 in less than a week. This trade had nothing to do with whether I thought BAC was undervalued or a good company; it was strictly related to the expected value of the trade that I found at the moment when the stock broke from a predictive chart pattern. The trade materialized, and then the opportunity was taken away by other market participants who priced in whatever caused the break that triggered my entry signal.

This is an example focused on a short-term chart with a window of opportunity that was only open for about 15 minutes. Trades

Chart 42 – An abnormal price break from a predictive intraday chart pattern showed that the buyers were eager to push the price of Bank of America (BAC) higher, which they did for about a week.

don't have to have such a short time frame. You can find similar opportunities on a weekly chart, where you might be given a few weeks to take advantage of the opportunity before it is priced in.

The critical point to understand is that we're not trading stocks; we're trading situations. Those situations are valid so long as the components of expected value remain. That means the probability of the stock going up versus going down and the expected gain versus the expected loss are what must be considered. You shouldn't spend any time considering the company's fundamentals; the market is doing that work for you.

Over the years, I have seen many of my students make a simple mistake: waiting for the market to confirm that the trade is a good one before entering. They wait for the stock to go up, proving to them that the market likes it. The problem is that waiting for the stock to go up means the entry price moves farther away from the stop loss price and closer to the exit price.

The result is that risk goes up and reward goes down. On the BAC trade, the entry signal price was $8.37 with a stop loss at $8.12, leaving $0.25 a share in risk. The exit was at about $9.75, giving a profit of $1.38 or a reward for risk of about five and a half. A good trade, but what if the entry had been higher?

With an entry two days later, you might have gotten in at $9.00. Since support was at the same price, the risk is now $0.88. With an exit at $9.75, this trade earns a reward for risk of less than one since you risked $0.88 a share to make $0.75 a share. You have to be right far more often when you have a lower reward for risk on your trades.

What about waiting until the stock had fallen back to $8.30 about a month later? At that point the stock is back to near support, but now you're buying a pessimistic chart. The tops are falling and the sellers are in control. That means your probability of success is much lower than when the stock was showing an optimistic chart pattern. The stock is no longer providing a good trading opportunity.

The same stock can be a great trading opportunity one day and a bad trade the next. The company has not changed significantly from one day to the next. The only thing that may have changed is how the market has priced the stock and what its outlook is for where the stock is going.

The market's message is time sensitive; remember to listen to what the market is telling you now and not what it told you in the past.

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Stop Working Hard

There are thousands of stocks trading every day. Some of them go up, and some go down. Your job is to figure out what's going to happen next. In your attempts to predict future price direction, you may have focused on a few names that you know well, relied on tips from friends or taken the advice of a market expert or media commentator. Whatever your method for making money in the market has been, I hope you're starting to see that you simply need to listen to the market itself. In that, there is liberty.

Why People Rush into Bad Trades

Traders, particularly those who *need* to make money rather than those who would *like* to make money, tend to have a fear of missing out. They hear about a trading idea or find an opportunity with their own effort and make the trade with less thought than they might put into buying a microwave. They can invest thousands of dollars on an impulse, much like the drunken gambler who throws down $1000 on Five Red.

One reason for this sort of reckless approach to trading is the belief that trading ideas are like gifts. They only come along from time to time and you should feel grateful for the opportunity. If you spend 10 hours researching a company or receive the occasional bit of insight from someone who should know more than the rest of us, it's easy to understand why you wouldn't want to let a seemingly promising trade slip through your fingers. The problem is that this gratitude for trading ideas leads you to lower your standards and place trades that are not much more than a gamble.

Have you ever made a trade and then, just a few minutes or days later, asked yourself what the heck you were thinking? If you are normal, then it's likely that you have because it is easy to focus on the dream of making a profit. You should focus your attention on the trading situation as it has been presented to you by the market rather than the words of an expert. Some trading opportunities are so well marketed that it's hard to see the truth because you fixate on the profit potential that has been dangled before you as the prize.

It is critical to only take trades that meet the criteria of a strategy that you have found to have a positive expected value. Rather than look for a reason to take the trade, which is easy, look for a reason not to. Ask yourself, "If I buy this stock, who will be selling to me, and what does she know that I don't know?" Looking at the other side of the argument will often highlight considerations that you have missed.

Being fussy is a lot easier when you recognize that the market—even a slow market—will give you opportunities. On the day I am writing this, a very slow summer trading day when the overall market is down, there are 63 stocks that made statistically significant abnormal gains. Out of the 15,000 stocks that trade in North America, you can usually find some kind of opportunity.

And if you can't find a trade today, tomorrow or in the next week, eventually you will. There is always another bus coming down the road. If you miss one, just wait for the next.

Make More Money by Trading Less

I have found that you will actually make more money by trading less. If you maintain a very high standard for what trades you make, you will always pass on some trades that end up doing very well. By being selective, however, you will also avoid many marginal trades that would tie up your capital and then incur a loss. By being fussy and trading less, you end up taking only the very best trades and your results will be better overall.

It is easy to be fussy when the market is strong and there are lots of opportunities. It's like fishing when every time you cast your line you get a bite. With that kind of success, you will quickly throw back any fish that is too small because you know there's going to be something better coming along soon. You only take the best of the best.

When the fish stop biting and you spend hours with no bounty, you take the first fish that grabs your hook. It could be a tiny fish that you would never keep on even an average day, but with your desire to catch something, you keep it anyway. It would be better to have just not gone fishing at all.

You'll do the same thing when trading a slow market. Eager to make a profit, you will take trades that show some potential even if they don't meet all of your requirements. You will work hard to uncover a trade rather than wait for the obvious no-brainer trades that you take when the market is in a giving mood.

I like to say that in trading, when the going gets tough, the tough get lazy. You can't control the market, so if the market is not giving you opportunities, it's better to do nothing. Your hard work will not change what the market does.

This is hard for many people who have been programmed to relate hard work to success. If you try harder than the next person in a sport, you should get a better result. If you study harder for an exam, you should get a better mark. If you work longer hours at your job, you should make more money. In the stock market, if you work harder to find good trades, you will probably lose money.

The best trades are easy to find. Working hard to uncover something leads you to find questionable trades that you have to talk yourself into. It's better to walk away when you have doubts.

This is not to say that hard work is not rewarded in trading. Traders who work hard at practicing their analytical skills or developing new strategies will be rewarded. People who devote their time and effort to improving their emotional control will be better traders. These are things that you can control and affect with hard work, but hard work won't change what the stock market does.

Don't Set Profit Goals

I often hear traders set goals that are based on money or profitability. They might set a goal of making $5000 a month or 20% per year trading, but they don't plan how they're going to achieve this. That's putting the cart before the horse.

There are times when making money trading is easy and you can make a lot of money in a short time. There are other times when trading action is slow and you have long waits between trading opportunities. You do not get to pick when each one happens, you only get to decide how you react.

With a monetary goal, your reaction will be to work harder to uncover some sort of opportunity that can allow you to hit your goal. You will probably take marginal trades that you would never take if the market was hot and you had more trade ideas than you could handle. In a slow market, a monetary goal is destructive.

Instead, your goals should be based on following your rules and being focused, disciplined and patient. These are the factors that will enhance your long-term profitability.

The best traders are the ones who don't care about the money. Be critical of the trades you take with no thought of what the stock might make you. Instead, think about how the trade could hurt you and what you can do to mitigate the risk.

Developing trading skill and coming up with strategies requires hard work. Once that work is done, the execution should be simple and obvious. If it isn't, either the market is not suitable or you have not spent enough time doing the hard work. Only take the trades that you have confidence in because they satisfy your well-tested strategy rules.

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Price Direction Does Not Matter

Most traders focus on buying stocks with an expectation that the price will rise. It is less common to try and make money from stocks going down. It is also possible to make money from price decline and, since markets often go down as well as up, it makes sense to be willing to do so.

Short Selling

Short selling is how you make money from a stock's decline. When you short, you still buy and sell the stock, you just do so in reverse order. Sell first and then buy back later. But how do you sell something you don't own?

The answer is to borrow the shares that you think are going to go lower. The brokerage you deal with has a great many customers. Between all of those investors, there are a large number of shares being held in many different companies. A person you have never met may have the shares of the stock that you think is going to go lower and, like a bank that lends out the money from its depositors, your broker is going to let you borrow someone else's shares to sell.

Eventually you will have to return the shares you borrowed. Hopefully, the price will fall as you predict so that you can buy them back at a lower price. In this scenario, you have bought at a lower price than you sold them, netting the difference as profit.

You borrow the shares and sell them in the market. With the sale, you get an injection of cash into your account, a pretty good deal considering you didn't even own the shares you sold. Sadly, it's not that easy to grow your capital base. Your broker requires that you have sufficient capital to buy back the borrowed shares, so that they can return them to the person who owned them in the first place. The brokerage is not going to take a risk on your trade, so you must always maintain 150% of the value of the shares you sold so that you have enough capital to buy them back if necessary. The sale of the shares gives you 100%, but you have to add in another 50% and maintain that 150% of whatever the borrowed position is worth. If the stock goes up, you need more capital segregated to cover the short. If the stock goes down, you require less.

Is Short Selling Ethical?

You make money as long as the shares go down and you buy them back at a lower price. As a short seller, you're speculating that the price of the shares is going lower—that the company is getting weaker and running into problems that make their shares worth less.

This has many people against short selling; they argue that it is counterproductive to business. These people reason that the job of the stock market is to give businesses a way to finance growth and innovation, and short selling only serves to limit that ability. These viewpoints are misguided.

Traders are always going to buy and sell, and the order in which they do it is irrelevant. Is it unethical to sell a stock that you bought six months ago because it has given you a 100% profit? Most would say no, so why is it wrong to short sell a stock that has gone up 100% if it looks like it's going to go lower?

Short selling is important because it helps take emotion out of the market and provide liquidity when few are willing to buy. If a stock is going up very quickly because investors are acting with greed rather than a rational assessment of value, the short seller can provide some strength to the sell side in an effort to balance the market.

More importantly, if the short sellers who acted when the stock was strong are proven right and the share price falls, it will be the short sellers who provide demand for the stock when pessimism is at its highest. You know that many investors are nervous about buying stocks that are in downward trends, but the short sellers will be motivated to provide some support to the stock so they can lock in their profits by covering the positions.

It is more difficult to short sell stocks, making it harder to make money from markets that are moving lower. In order to short a stock, your broker must have the shares to lend to you. Large, widely held companies are easy to short because there will be customers of the brokerage who own shares. Smaller companies without as many shareholders can be harder to short because your broker doesn't have the inventory. I have found that many stocks I would like to short are not shortable for this reason.

Exchange Traded Funds

Exchange Traded Funds (ETFs) have become very popular for traders. There are now ETFs that represent almost every industry, commodity, currency or index. ETFs are usually composed of groups of stocks managed to represent the aggregate movement of the group. ETFs can also represent other tradable assets, including bonds, commodities, currencies, real estate and others. With ETFs, you can trade the Euro or buy gold in the stock market rather than doing so on the currency or commodity exchanges.

The companies that create and launch ETFs are always looking for new ways to package a basket of assets for sale as a group. It was not long before ETFs were created that go up when the market goes down. These inverse ETFs will short a basket of assets rather than buy them, giving the fund an inverse price relationship to what the basket does in its market. If you think the Dow Jones 30 group is going up, you buy the Dow Diamonds ETF (DIA). If you believe that index will go lower, you could buy the ProShares Short Dow30 ETF (DOG).

These inverse ETFs make it easy to profit from the downward cycles in the market. If the market's message is that it is likely to go lower, buying these type of funds can allow you to profit.

These index ETFs don't have a lot of price volatility, since the basket of stocks that they represent will tend to move more slowly than the individual stocks within it. These funds take out the alpha component of the stocks and focus on the beta as the group will move together. That lowers the price volatility.

Less price volatility means you have to own a larger position in dollar terms in order to extract a profit. This is prohibitive for smaller investors who may not have the capital to make a $100,000 trade to make $1000 in profit. The answer to this low price volatility problem is leveraged ETFs, which can go up or down two or three times faster than the underlying basket of stocks.

For example, the ProShares UltraShort S&P 500 (SDS) will go up about twice as much as the S&P 500 goes down. If the S&P 500 falls 1%, we expect the SDS to go up 2%. This makes it possible to make a profit with less capital and benefit from a down market.

Unfortunately, leveraged ETFs do not come with warning labels. With the use of leverage, their pricing behaviour doesn't always make sense to those who don't understand how they are priced.

In order to maintain the 2:1 leverage that these ETFs provide, the fund has to be rebalanced each day so that its assets reflect the leverage to the underlying index. This maintenance is a complex process that can cause the price of the leveraged ETF to deviate from what a trader might expect from what the index is doing.

An ETF that has $100 million in equity controlling $200 million in stock enjoys 2:1 leverage. If the value of the holdings goes up 1% to $202 million, the value of the fund goes up to $102, providing a 2% rise. As a result, the fund manager must go out and buy $2 million more of the stock in the fund so that the leverage ratio of 2:1 is maintained, giving $102 million of equity controlling $204 million in stock.

What happens when the value of the stocks in the basket goes down? If the value of the portfolio drops 1% to $198 million, the equity is now at $98 million for a package of assets worth $198 million. The fund must sell $2 million of its portfolio to make it worth twice what the equity is, leaving the value of the fund at $196 million with $98 million in equity.

Consider what happens if the basket of stocks in the fund drops 1% for four days in a row and then rises 4% on the fifth day.

- Day 1: fund goes from $200 million to $198 million. Equity drops to $98 million, so fund manager sells $2 million of the fund to maintain the 2:1 leverage. Fund assets are now $196 million.

- Day 2: fund goes down 1% of $196 million, or $1.96 million. Equity drops to $96.04 million. Fund manager must get the assets of the fund down to twice the equity or $192.08 million by selling some of the fund.

- Day 3: fund goes down 1% of $192.08 million. Equity drops to $94.12 million. Fund manager liquidates some of the fund to maintain the double leverage. Now the fund has $188.24 million in assets.

- Day 4: fund goes down 1% of $188.24 million. Equity drops to $92.24 million. Fund manager liquidates some of the fund to maintain the double leverage. Now the fund has $184.47 million in assets.

- Day 5: fund goes up 4.1% of $184.47 million. Equity rises to $99.80 million.

In a nonleveraged ETF, this four-day loss of 1% a day followed by a 4.1% gain would have the equity start at $100 million, fall to $96.06 million and then on the fifth day rise back to $100 million.

The leveraged ETF didn't get back to $100 million because it had a smaller asset base as a result of the daily rebalancing that had to be done to maintain the 2:1 leverage.

The result is that the leveraged ETF suffers a decay in value that remains lost even if the underlying index goes back where it was. I have met countless traders who traded leveraged ETFS without knowing how this works. If the ETF is losing value, the gain necessary to get the ETF back to what the losing trader entered at is greater than what the unleveraged fund must gain. If a trade in a leveraged ETF is working against you, a bigger gain is required to get you back to even.

This makes holding leveraged ETFS trades that are losing value a dangerous pursuit. I urge anyone who wants to trade leveraged ETFS not to hold a losing position for many days in a row because you won't see that position get back to your entry price even if the underlying basket of stocks does. It's even more important to exit when the trade hits its stop. That is the other side of leverage.

With short selling and the use of inverse ETFS, you no longer have to depend on an up market to be profitable. Markets that sell off often do so quickly, giving the short seller or owner of an inverse ETF the ability to make a fast and market-beating profit. It is not unethical to short stocks, provided the rules of short selling are followed. The short seller does the market a service by providing liquidity and demand for the stock when buyers are sparse.

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Get Connected

The market is a puzzle with a million pieces. To see the big picture, you must first look at the pieces and how they connect to one another. By analyzing the pieces, you can get a good sense of where the overall market is going.

This is important because the overall market movement is the major factor that determines how a stock's price will change. We try to limit the effect of the general market by looking for alpha, but the beta risk component will always be prevalent in a stock's price performance. Therefore, you must get a sense for where the market is going.

You can do this by applying the same chart analysis techniques that you have learned so far to charts representing the overall market. You'll need to make a few modifications to the techniques you know. It's also important to understand how different charts interrelate.

Analyzing the Standard & Poor's 500

The S&P 500 is a good index for predicting the U.S. stock market since it represents a group of 500 large companies. As a group, these stocks provide a gauge of what the U.S. economy and, to some degree, the global economy is doing. Many of the companies included in the S&P 500 have a global presence.

You can analyze a chart of the S&P 500, although I usually look at the ETF that represents the index, the SPDR S&P 500 (SPY). Like all charts, you should identify support and resistance, whether investors are optimistic or pessimistic, and whether they are confident or uncertain. The one chart characteristic you will not see much of in an index chart is abnormal activity. This is because the index represents a large group of stocks, so by its nature there is no alpha. It is the market chart, so it represents beta.

The chart below is of the SPY. You can see that by using simple inflection point analysis, it was possible to predict a reversal of the

Chart 43 – You only need to use the six elements of chart patterns to predict when a market will turn, as the S&P 500 did in the spring of 2012.

upward trend in May. In the first week of May, the upward trend line was broken from a falling top. The market sold off and fell away from its downward trend line, leading to the bounce back from oversold conditions in June. Early in July, the index had risen up to the downward trend line where the sellers confirmed their control of the market, limiting upside and sending prices down again. Without knowing anything about the economy, it was quite simple to predict the price swings in the overall U.S. stock market.

There are many factors that affect how this market index moves, and you can use charts that represent those factors to predict where the market is likely to go.

Analyzing Other Markets

A good question to ask is whether there is demand for equities or if people are putting their money into other assets like bonds, real estate or commodities. I like to look at the chart of the U.S. 20 Year Treasury Bond iShares (TLT) to help me understand whether investors are in a mood to take risks or if they want safety. This ETF represents the ultra-low-risk U.S. Treasury Bonds. If this chart is optimistic it means investors are cautious about buying stocks. They'd rather put capital into a low-risk asset than buy riskier stocks.

It is not surprising then that this chart rose and showed optimism while the SPY chart was falling. TLT broke its downward trend line around mid-April, two weeks before the SPY gave its negative signal. Then, early in July, the TLT broke through resistance, from optimism and out of low price volatility, a strong sign that it was going to rise. If the TLT is likely to rise, then stocks are likely to fall.

Fear is another important factor that motivates investor action. During times of major political upheaval, the market will often shy away from owning stocks because of the fear that such an event could affect the global economy. When a country is at risk of defaulting on its debt, like Greece was in 2011, investors will look for protection from this risk by buying options. Options are used like insurance against a portfolio. If the value of the portfolio drops because of a

Chart 44 – As the S&P 500 was breaking its upward momentum, the U.S. Treasury Bond market was starting a new upward trend, confirming the impending weakness in the broader stock market.

significant world event, the value of the option position will rise to mitigate the loss.

With this in mind, an important chart that I watch when the market is faced with the potential for upheaval is the chart of the iPath S&P 500 VIX Short Term Futures ETF (VXX). This ETF is based on the futures of the Chicago Board Options Exchange Volatility Index (often referred to as the VIX). When there is strong demand for options (because of fear), the price of options goes up. This price change is attributable to what investors are willing to pay for expected price volatility in the S&P 500. If expectations are for a major sell-off, investors look to insure their stock holdings by buying put options, driving up the price of those options and causing a rise in the VIX. For this reason, the VIX is often referred to as the "Fear Index."

If I'm curious about whether the market is really worried about something that is happening globally, I look to the VXX for my answer. During the summer of 2011, the news was dominated by concerns over whether Greece would default on its debt. The concern was that a default would have a catastrophic effect on financial markets, particularly the banking industry. The market gave legitimacy to these concerns by buying insurance in the options market, causing the VXX to rocket higher. The fear was obvious early in August of 2011 when the VXX broke through resistance, from low price volatility and from optimism, as the chart below shows.

Chart 45 – As investors became worried about the stock market and sought some insurance against falling prices, the value of the VXX went up.

The VXX doubled over the next two months, while the overall market lost nearly 20% of its value, providing good insurance for the investor who refused to sell stocks. The message from the market, as told through the VXX early in August, was that fear about Greece was growing and it was time to own Fear and get out of stocks.

With the numerous ETFs and market indexes that exist, you can get an answer to almost any question you have about almost any market. If you have a question, figure out what chart you need to look at to answer the question, and then apply my chart analysis techniques.

You might wonder whether the Chinese economy is strong or weak, since, as the world's second-largest economy, it has an important impact on stocks traded in North America. You can analyze the iShares Trust FTSE Xinhua China Index Fund ETF (FXI) to get a sense of whether the market is optimistic or pessimistic about China and whether it is breaking down through support and likely to go lower or breaking up through resistance and likely to go higher.

You don't need to know anything about China because the market knows everything. You just need to analyze the chart using the six elements I have taught you and, in a few seconds, you get the answer to your question. Falling tops on the chart? That means investors are pessimistic about China, which will likely have a negative effect on any company that depends on the Chinese economy for its profits.

What about the state of the global economy? If there is economic expansion expected, then you should find that the price of many commodities will also move higher. If people are buying more stuff and the economy is growing, then demand for commodities like oil and copper will surge. Check the charts for these things, and you'll get your answer. You can look at the U.S. Oil ETF (USO) to see if investors are optimistic or pessimistic about oil. For copper, consider the iPath Dow Jones AIG Copper Total Return Sub-Index ETF (JJC). If this chart is showing rising bottoms after bouncing off support, it may be that the market is expecting the economy to improve and the demand for copper to rise, something that will be good for many stocks.

A popular investor question is whether inflation is coming because central banks are printing too much money. You can listen to an endless supply of experts who each have an answer to that question, but why not trust them all together? You can see what they're doing with their money by analyzing the chart for gold, which is easily done by looking at the SPDR Gold ETF (GLD).

The market will always be able to give you an answer to an economic or even a political question, if you just look at the right chart. To make your analysis even more astute, look at many different charts and work to figure out what the combined message is. If you find that industrial commodities like oil and copper are starting to go up, while money is coming out of U.S. Treasuries, you might reason that investors are speculating that the economy is improving and it's a good time to move back into stocks. I analyze the ETFs I have described here each week so that I can arrive at a clear picture of how the overall market is going to affect the individual stocks that I trade.

You will find that the message of the market is often very different from what you're reading in the newspaper. This is because the markets predict the future, they don't react to the past. What is happening now in the economy is what the media will report on. What is expected to happen in the future is what the markets are reporting on and prices will often move months before you get confirmation in the news.

A very well-informed and astute economist might spend hours looking at economic data to arrive at the same conclusion that you can arrive at in seconds by looking at the chart. You don't have to be smart; you just have to be a good listener. Look at the market's message in a number of variables as shown through the appropriate charts and you will get very good at predicting how the markets are going to move.

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Trade the Hot Market

The easiest way to make money is to trade the hot market. This rule applies to stocks, commodities, currencies, real estate, collectibles—anything traded between people. To put your odds for success at their highest, you have to trade where the action is.

Think back to when you had your best money-making success as a trader. Perhaps you made great profits trading silver stocks in 2010–2011. Maybe you made a fortune flipping houses in 2005. It's possible that you banked cash by shorting stocks or buying volatility in the fall of 2011. No matter when or where it happened, your best and most memorable success likely came when there was a boom in the market you were trading. You rode a strong trend.

If you revisit any of those trades, trying to relive the feeling of easy money, you have probably felt frustrated. Formerly hot markets are not much fun when they've gone cold. How does it feel to trade silver stocks now or to own a number of houses you can't sell? Lousy!

Hot markets make inexperienced traders look and feel like geniuses. Traders get away with mistakes and benefit from good moves when a market is trending higher. A good strategy that might perform well in an average market could perform exceptionally well when the market is hot. The downside is that performance can really suffer when the trend of the hot market reverses.

What's Luck Got to Do with It?

Often, getting in early on a hot trend is a matter of good luck. A person could have dedicated 30 years of his life to being bullish on gold, arguing that it was the safe haven the world would rush to when fiat currencies failed. I have listened to gold bugs preach their gospel for as long as I've been trading the stock market.

Toward the end of 2005, the market for gold started what would become a six-year upward trend in price. Not much was different. The gold bugs still cited the same reasons why gold was destined to go higher, just as they had for the last 15 years. What was different was that the market now agreed. Investors were motivated to buy gold as a safe haven against a dropping U.S. dollar fed by the growth of developing economies. Suddenly, the often-ridiculed advocate for gold became the life of the party, the person whose opinion was sought by the masses. Was the gold bug really smart or had the market just finally come to him?

Purveyors of financial advice often cite the explosive returns that they have made in the past when they market their services. Headlines like, "I turned $3764 into $1.2 million in only 14 months" quickly grab the attention of people who want to make fast money in the market, making the offered service an easy sell.

The success, when it is factual, usually grew out of a strategy that was traded in a hot market. You can trade your way to astronomical profits if you ride a strong trend. The problem is, what happens when the trend ends and the strategy no longer works? That's when the "trading genius" turns to selling his or her advice, resting on a success of the past that will probably not work again, unless a new hot market comes along.

Anyone can get lucky in the short term, but you shouldn't confuse success from a hot market as a sign of trading skill. It takes skill to know where to find the next hot market, and it takes good sense to not keep trading what was hot long after the trend has fizzled.

Finding the Hot Market

What do you think is the essential element to having a successful hot dog stand? You might consider a quality product, good location or price as key factors for success. The right answer is that the most important thing to have is *starving customers*. If the people who pass by your hot dog stand are hungry, they'll buy even if the other elements are not done well.

It is similar in a hot market. An asset class that is trending quickly higher brings in hungry investors. They're not buying because they believe in the fundamental value of what they are purchasing; they're buying because they're worried they'll miss out on an opportunity if they don't. Their greed clouds their judgment, causing these investors to push the price higher day after day. That is the market you want to own.

Chip Wilson is the founder of Lululemon Athletica, a maker and retailer of premium-priced yoga wear. Chip started out in retail with a small surfwear shop called Westbeach. I can remember buying Bermuda shorts from Chip himself when I was a student. Today, his stake in Lululemon makes him a billionaire.

I bring up Chip Wilson because of an article I read a number of years ago about what motivated him to start Lululemon. Quoted loosely, he said that if he heard about something new three times, he considered it to be a future trend, a future hot market. In the late 1990s celebrities like Madonna were preaching the positive health effects of yoga, moving it from the alternative fitness world into the mainstream. Chip heard about the growing popularity of yoga enough times to motivate him to start a yoga-themed clothing retailer.

I don't doubt that he worked very hard and had a developed skill for retailing. I'm sure he could have made any business a success. What made Lululemon a tremendous success was the simple fact that he participated in a strong, upward trend of popularity of yoga. Without that core of hungry customers, Lululemon could not have enjoyed the rapid growth that it has.

The Chip Rule

I call it the Chip rule: when you're looking for the hot market, look for signs of strength that happen at least three times. If you see that, you may be looking at the next trending sector of the market.

Each day, I look at the market, paying attention to what stocks did well and which sectors seemed to lead. I may see that an oil company was a big winner one day because of a significant new discovery they made, but that, by itself, does not make me too interested. If I find that over a short time period, three small oil companies make big gains after new discoveries, I get interested. This sort of market activity points to the kind of action that starts an upward trend.

The best and strongest trends don't always make sense. They are driven by investor enthusiasm and greed rather than a rational assessment of fundamentals. Improving fundamentals are usually part of the reason for the trend, but the biggest gains come when emotional investors all rush to ownership, concerned that waiting will leave them behind.

The process of finding the hot market is not complex; you just have to do some basic things and pay attention to themes. I like to use the Stockscores Market Scan tool to query the market for stocks that are up at least 3% and trading abnormal volume. I look through the list of names and see if there are a group of stocks from the same sector or trading idea. If, for example, I find four biotech stocks in one day, I will go and look at the biotech index to see if it's breaking higher from a good chart pattern.

Finding the hot market is really just about figuring out where people are making money now. There are varying degrees of what you can consider hot. Getting on the supertrending markets that come along only occasionally requires patience and a lot of false starts. When you find one, the money-making is easy.

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Bad Traders Diversify

The traditional way to manage risk is to diversify your holdings. The hope is that owning a number of stocks from sectors of the market that are not correlated to one another will lead to more consistent returns. If one stock in the portfolio suffers a large loss, it should not have a significant impact on the overall performance as the other stocks make enough of a gain to compensate.

I don't believe in using diversification to manage a portfolio. That doesn't mean I think it's appropriate to put all of your capital into just one stock; it means that the mindset that diversification is based on makes little sense to me.

Diversification Weakens Your Winners

Diversification's aim is to remove the alpha risk component and pursue the beta component. Strong moves up or down by individual stocks will not have a significant impact on the performance of the portfolio because they get watered down by diversification. By owning a basket of stocks, the diversified portfolio should perform in a way that is similar to the index. Why not just buy the index through an ETF?

In order to beat the market, you must find alpha, not take it out of your portfolio. Diversification would not allow you to buy a number of strong stocks if they were in the same sector because those stocks will tend to move together, increasing the risk of a substantial loss if the sector moves lower and takes your stocks down with it.

If the stocks you buy are trading on their own story then they shouldn't move together. Here is an example that shows what I mean.

Suppose you find a biotech stock that makes an abnormal break from a predictive chart pattern. The chart has everything your strategy seeks, so you buy the stock. You do some research and find that this company has a treatment for colon cancer. It's in testing, and they expect results in a month. It is apparent that the market is speculating on what those results will be, and those who know the most seem to think the results will be positive, which is why the stock is moving up abnormally.

The next day, you're hunting for opportunities and find another stock trading with abnormal activity and breaking from a predictive chart pattern. It turns out that this stock is also a biotech stock, but this company has a treatment for obesity. It's in clinical trials, and the buzz is that it's working very well. The market is speculating that this company's treatment is going to have a dramatic impact on its long-term ability to make a profit.

Given that these stocks are in the same sector, buying both would go against the principles of diversification because the expectation is that they will move in similar fashion. As the biotech sector moves, so too should these stocks.

However, these stocks are not trading higher because of their correlation to the overall market or the sector. They're trading up because of company-specific factors that are completely unrelated to one another. One company has a treatment for colon cancer and the other for obesity. If one company's drug fails to work, it won't take the other company lower, because one company's future earnings are not dependent on the other.

The aim of diversification is to mitigate the damage from being wrong. The hope is that losses in one stock can be overcome by gains in the others. Unfortunately, stocks that aren't trading on their own story tend to be highly correlated to one another regardless of their sector. If the S&P 500 index is down 2% in one day, you can expect that almost every stock that trades in the market will be down. Not just in the U.S.—these strong down days tend to affect the markets globally. When the markets sell off, there are few places to hide.

What you can do, however, is limit the effect the loss has on your overall portfolio. If a stock you own falls through support—if the market gives you a message that the stock is likely to fall lower still—then sell it. Take the small loss and move on.

If you really like the company (I hope you never like any company, only the trade of it!) then you'll get the opportunity to buy it back later, probably at a lower price. When a good trade goes bad and requires you to take a loss, take it and move on.

By diversifying, you are expecting to do a bad job at picking stocks. You intend to hang on to losers and use the profits from the winners to overcome the loss. It's better to focus on a strategy that does a better job of picking trades with a positive expected value and work on the discipline to take a loss when the market tells you to.

The Economics of Controlling Losses

My approach to risk management is to limit the size of a loss by planning the loss. That means using the market's message to define the entry and stop loss point and let the risk of the position and your risk tolerance determine the position size. So if you buy a stock at $20 and plan to lose at $19.50, you have $0.50 per share in risk. If you are willing to lose $500, then you buy 1000 shares.

A thousand shares of a $20 stock will cost you $20,000. What if you only have $20,000 of capital to invest? Should you put all of your money into one stock?

The answer is no, because although the $500 risk of the trade may be tolerable to you, there is a chance that a loss can far exceed the $500 risk tolerance that you have. This trade plans to exit the stock at $19.50 if the trade fails, but what if the market is surprised by some very bad news and the stock gaps down to $10? Now, instead of a $500 loss you are faced with a $10,000 loss: half your capital.

Although it's rare that stocks give you such large losses relative to your risk tolerance, it does happen. For that reason, never forget that there's always the potential for your risk tolerance to be exceeded if there is a very abnormal event. Be sure that you're comfortable with your position sizes relative to your overall portfolio.

Don't Hang On to Losers

Diversification implies that you are willing to hang on to losers—to stick with bad trades. You have to manage the risk of a big loser by holding enough different stocks in different sectors to overcome the occasional failure. Doesn't it make more sense to limit the impact of the losers rather than hang on to them?

To a bad trader—one who doesn't have a good method for finding market-beating stocks—it doesn't. They essentially resign themselves to not being able to develop a strategy that has a positive expected value. Instead, they invest in the shares of companies they consider to be good and hope that the values grow over time. They reason that it's OK if one trade fails because the others will pick up the slack.

It's pretty obvious when you own a dog: the losses show up on your brokerage statement each month. While it's painful to crystallize the loss, just taking the steps to insure that the losses never grow too big will be more effective than trusting in diversification. Remember, to beat the market, you have to find alpha. Diversification works against this goal.

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Stocks Aren't Risky; People Are

If I ask you what you consider to be a risky stock, you'll probably say that lower-priced stocks are riskier than higher-priced ones. You might argue that companies with no earnings are riskier than established names that have steady and predictable revenues. Businesses in stable industries are less risky than those that deal in new and progressive areas. Each of these answers is a common response to what's risky, but each fails to correctly interpret risk. Each answer makes the mistake of putting the emphasis on the stock instead of the real source of risk—you.

The potential to lose money is at the core of what determines risk. Since lower-priced stocks tend to show more price volatility, the potential for a larger percentage loss is greater. Companies with no earnings have a greater level of uncertainty, increasing their potential for higher price volatility. Progressive industries don't have the track record of earnings to make predicting the future easier, making it easier for the market to make a mistake in pricing the stock.

These are all valid arguments for why some stocks are more risky than others and should therefore be avoided by many investors.

These factors are also largely controllable by you, the trader, provided you have the emotional capacity to approach the market with discipline. You and your ability to do so are the real risk.

Failing to Get Out

You already know enough about how to control risk to know why you're the riskiest factor in the trade. Your ability to get out of a loser when the market tells you that your analysis was wrong is essential. If a stock you own, no matter how stable the company or strong its fundamentals, falls through an important support price, you must get out. As long as you can do this, your risk exposure is quite predictable and manageable. Unless you suffer from being normal, this is a simple way to control risk. For the normal people, this simple task of selling losers can be a challenging one.

Investors often believe that stocks that trade with low price volatility—that have well-known brands and businesses—are less risky. This perception causes them to hold on to losers because those losers are "blue chip," and therefore they must go back up eventually.

If blue chip means "established company that has no risk of falling significantly" then there is no such thing. Consider Kodak, WorldCom and Nortel, all well-known and once-respected stocks that fell off the cliff. As I write this, Research In Motion, once a leader in cellular telephones, is in a steady share price decline, which many believe will end in the company going out of business. An investor who hangs on to a losing stock because of past glory can feel a lot of pain.

Buying Too Much for Your Risk Tolerance

Having a target stop loss point gives you the ability to size your trading position appropriately for your risk tolerance. As I have shown a number of times, buy a stock at $10 with a stop loss point at $9 and you are risking $1 a share. If you are willing to lose $500, you buy 500 shares for a $5000 position. Apply this to a riskier stock, one that has a higher degree of price volatility, and the process is the same. Buy the stock at $0.50 with a stop loss at $0.40. Your risk per share is $0.10. With the same risk tolerance of $500, you buy 5000 shares for a total position size of $2500. The potential loss is the same for both trades because you buy a smaller dollar position of the more volatile stock.

You have the potential to screw this up, however, by taking the same dollar position of the more volatile stock, leaving you with a much higher dollar loss exposure. There is a tendency for traders to buy what they can afford based on the cash in their account. Instead of focusing on what you can afford to buy, you must focus on what you can afford to lose and let your risk tolerance and the risk of the stock determine your position size.

Again, this is easy to understand but harder to do. Normal people will focus on the potential to make money rather than the potential for loss. When faced with the excitement of owning a stock that is widely considered to be a trade with great potential for fast gains, normal people will take a position that is too large. Their focus is on the dream of making the big score instead of considering what will be lost if the trade doesn't work.

It is essential to not take more risk than you are comfortable with. Failing to stick to this rule will cause you to have too much emotional attachment to your trades and likely lead one or many of the following problems.

Leaving Too Early

If you buy a stock that you perceive to be risky and the trade works, you are more likely to exit the trade early for a less-than-optimal profit because of the risk that you perceive in the stock. While you may have grand expectations for what the stock can do, a pullback in the upward trend can easily spook you, taking you out of the trade because of your fear that the stock is headed back down. It's the fact that you associate price volatility with risk that is to blame, even though the price volatility is what provides you with an opportunity.

Not Listening to the Market

The market will tell you what to do, but will you listen? I have watched many well-respected, well-run and successful companies go off track and fall to zero. Putting faith in a company's brand or in what they've achieved in the past can leave you blind to what's happening now and what's expected in the future. There is a big risk in not listening to the message of the market. If the market tells you something is wrong by taking a stock down through support, you must listen! Don't place more faith in the words of a single expert or, worse yet, in what you hope will happen. Place the market's message on the highest pedestal, for it will be right far more often.

Averaging Down

Suppose you ignore all of these means of risk management and decide that you will add to a losing position, buying more at a lower price with the hope that the stock will eventually turn around and take you out of your painful situation. In doing so, you are asserting that your analysis is better than the analysis of the thousands of investors who have been trading the stock. Do you really feel that way?

Probably not. You're actually misdirecting your rationale for averaging down. You think you're buying more because you believe the company is a good one and doesn't deserve to trade at such a low price when what you're really trying to do is avoid the pain of taking a loss. Yes, the market does get emotional and misprice stocks because of fear. Many times, averaging down will allow you to escape a painful loss since, many times, the stock will bounce back and make your losing trade a winner. The problem is that when this fails to happen, you end up taking such a large loss that it can destroy the success of 20 other trades. Averaging down has the potential to wipe you out. Since capital preservation should be the number-one priority of every investor, you must never average down. Doing so makes you the risky factor in the trade.

The Risks You Can't Control

I have now shown you that most risks are under your control—that it's not stocks that are risky but how you trade them that matters. You can limit the downside potential by exiting a loser when the market tells you to do so. With proper position sizing, losses should not exceed your accepted risk tolerance by much. There are, however, risks that are not in your control that you should consider in your approach to the market.

Liquidity Risk

One major risk, felt primarily by traders focused on lower-priced stocks, is liquidity risk. Liquidity refers to how often a stock trades, or how easy it is to move in and out of the stock. Large-cap, widely held stocks can trade more than 25,000 times a day, making a move in or out of the stock easy and inexpensive.

For a stock that trades 20 times a day, trading can be costly and difficult. Less liquid stocks will have a wider spread between the bid and the ask—the price that people are willing to buy for and what sellers will sell for. A stock like Microsoft will typically have a $0.01 spread between the bid and ask: buyers will pay $30.50 and sellers want $30.51. To buy, you pay $30.51 and, if the stock didn't move at all and you wanted to sell immediately, you would only lose $0.01 a share since you could hit the bid at $30.50.

A less liquid stock will have a wider bid-ask spread. The buyers might be willing to pay $3.90 while the sellers want $4.00. The moment you buy the stock you're already at a $0.10 loss unless the bids move higher.

The greater challenge is exiting a position in a low-liquidity stock, especially if you carry a large position. How many people are lined up to buy, and how many shares are they willing to take? If you want to sell a 50,000-share position and there is a buyer who is only willing to buy 5,000 shares, you are likely going to have to accept a lower price to get out of the trade.

The lesson then is to avoid stocks that don't trade with enough liquidity to absorb your risk tolerance. Your risk tolerance determines your position size. Once you know your position size you can look at the market's trading volume to determine whether your order to buy or sell can be absorbed. Make sure you do this analysis using an average day's trading volume. Stocks that are trading abnormally might be trading 10 times their normal volume. What happens when that excitement quiets down and the stock goes back to its normal trading volume? Will you be able to get out of your trade easily or will you have to sell through a number of layers of buyers, suffering a good deal of slippage on your exit price?

Gap Risk

While you can control a lot of your risk by planning to take a loss when the stock hits your stop loss price, there is no guarantee that you'll be able to exit at that price. Stocks can make price gaps from one day to the next, jumping past your stop loss point to open at a much lower price. You could buy a stock at $10 with a plan to sell if the stock falls to $9. It's possible that the company could make a very negative and surprising news announcement that makes the stock worth a lot less. The stock could go from a closing price of $10 one day to an opening price of $5 the next. Now your planned loss of $1 a share has turned into a loss of $5 a share. This is not the result of you being undisciplined or emotional; it's just a bit of bad luck.

To overcome this risk, it's essential that you don't allow one position to take too big a percentage of your total capital. Your $500 risk tolerance may mean taking a $20,000 position if the stock trades with relatively low price volatility. This is too much money in one stock if your total capital base is $25,000 because a negative surprise would cause too big of an impact on your portfolio. As a general rule, I don't like to put more than 25% of my total capital into one trade. The amount you choose is a function of your tolerance for risk, age, income and other factors that are part of your long-term financial goals.

The potential for gaps is why I think that day trading is the least risky form of trading. It overcomes the one risk factor that is difficult for a trader to control because stocks rarely make intraday price gaps. If you are out of your positions before the close of trading you shouldn't suffer from the surprise price gaps that can really hurt performance. So long as you are disciplined and do what you can to control risk, day trading rarely leads to big, unexpected losses.

No matter what kind of trading you do, realize that you have the greatest impact on the risk you face. Stocks move up and down, some more than others. It's not how much they move up and down that is risky. What matters is how you deal with that price volatility. Your ability to manage risk effectively is determined by your ability to manage emotions.

Control Your Emotions

I have taught thousands of investors how to trade. Some succeed and some fail. The main reason people fail is inability to distance themselves from their emotional attachment to money. Their fear and greed lead to mistakes.

My best students, those who have had the greatest success, don't care about the money. They make decisions based on what the market is telling them and treat trading like a game where they don't really feel the pain. The trades are made with discipline and without regard for the profit or loss that shows up in their account. This is not to imply that these winning traders are reckless; they are the exact opposite. Winning traders succeed because they take control of risk and manage it effectively.

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Be Fearless

I think many traders have a hard time believing they can make money by buying a stock and waiting. Most of us are not taught to make our money work for us but instead that we must work for our money. Go to a job, put in the time and you get a paycheque. Work hard, and your paycheques will grow. But the thought that you can make money by putting your feet up is a difficult thing to grasp.

With that mental programming, most of us have difficulty holding on to our strong stocks and letting the profits grow. If we buy a stock at $1 and it goes up to $1.20 in a couple of days, we are likely to sell. In some ways we think of this fast return as good luck, not much different than buying a winning lottery ticket. We have a fear that someone is going to figure out that we have benefited from a mistake, and so we better get out now before we get discovered.

This thinking is strengthened when we take a trade that's less than ideal and it goes down as quickly as it went up. If we take a marginal trade we should expect marginal results, but somehow we only remember the negative feeling of watching a paper profit turn into a loss. We tell ourselves that next time we will sell at the first sign of weakness and crystallize the gain. Avoiding pain is human nature.

Our next trade is of higher quality but we sell it on a short-term weakness and lock in a quick but relatively small profit. While lost in self-congratulations we realize that someone named Murphy is writing the laws of trading, and we watch the stock march ever higher with us eating the stock's dust. We have jumped off a high-speed bus that is headed for Profit City.

What is behind this destructive behaviour? It's that deep-rooted emotional response to danger that keeps us out of trouble but also makes us avoid a greater feeling of fulfillment.

Fear is what makes us sell our winners too early and hold our losers too long.

The best traders are not afraid of holding on to strong stocks, they are afraid of holding on to losing stocks. What do you do when you trade?

If you are a normal human being, you do the opposite of what the pros do. Think about the last loser that you owned. As the stock fell lower and lower, what was it that you told yourself over and over?

"It'll bounce back eventually. I'll just be patient."

What your subconscious mind was really saying was, "It's much too painful to sell this loser and see that loss of my hard-earned capital. I'll hold on with the hope that it goes back to what I paid for it and then I'll sell." And of course, it continued lower because there was something wrong with the company and it deserved to go lower.

So what can we do to fight our destructive minds? How can we program ourselves to hold on to our winners and dump the losers? How can we trade without fear? Here are my seven criteria for fearless trading.

Only Trade Quality

Our fears are confirmed when we enter marginal trades. If you only trade the best opportunities, you will trade less but you will have greater success. This will put you on the road to fearless trading and help you simplify your trading approach. Write down your rules and do nothing unless every rule is satisfied. When you consider a stock, look for a reason to avoid the trade. If you can't find one, then you have a trade worth taking.

Buy with Confidence

The rules that you trade with have to have a foundation of success. You have to believe in your rules or you won't believe in holding the stock through the shakeout periods in the longer-term up trend. Analyze and test the strategy until you have proven to yourself that it works. Then trade it slowly without a lot of risk, so you can gain a greater level of confidence that it works.

Don't Watch the Scoreboard

Sports fans don't spend a lot of time watching the scoreboard during a game. It only matters when the game is over. In trading, the scoreboard is the profit and loss figure for your account. If you focus on the scoreboard, it is likely that you will lose sight of what's happening in the game. As a technical trader, all that matters to me is what the chart is telling me.

Plan Your Losses

Before you enter a trade, figure out what needs to happen for you to consider the trade a loser. For me, that is a move through chart support; I plan to exit the trade when the stock goes through a psychological floor price on the chart. Understanding where that point is requires some experience and knowledge, but once you know how to identify support on the chart, plan your losses.

Plan the Trade

I find it helpful to predict pullbacks. My rational side knows that stocks can't go straight up and that they must suffer pullbacks to recharge buyer interest and shake out weak holders. My emotional side feels fear when those pullbacks happen. If I plan my trade and build in expectations for the counter-trend pullbacks, I can deal with them better and have a greater chance of not succumbing to fear when they do.

Don't Fall in Love

I don't want to know too much about what a company is doing because I have found that the more I like a stock the more likely I am to ignore the message of the market. There is a lot of bias in the information that we receive about companies and what they are doing. The ultimate arbiter of truth is the market itself. We should have a greater faith in the opinions of thousands of market participants than a few biased sources of information.

Tolerate Risk

Without risk, there is no potential for return. To avoid trading with fear, we have to be comfortable with the risk. If not, we will let fear guide our decisions and those decisions will probably be wrong. Therefore, don't risk more on a trade than you are comfortable losing. Plan your losses based on how much you are willing to lose and let that determine the size of your positions.

The Profit Is in the Patience

When a trade is working, let it work for you. A business owner does not fire her best employee. A hockey coach does not send his best player to the minor leagues. A company does not stop making its best products. Hang on to your best stocks with the same attitude. Hold the stock until there is a rational reason to exit the trade rather than selling because it feels good. If you are taking quality trades and trading without fear, you will feel better over the long run.

The time to start your reprogramming is now. Don't expect to break habits built up over a lifetime in a couple of days. The battle against your fears is one that takes time to win, but with determination you can do it.

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Avoid Being Yourself

Trading can be a bit boring. You'll spend a lot of time waiting for a new trading opportunity to come along or for an existing trade to develop. I'm not complaining—trading can be very exciting as well—but it's nice to get out from behind my screens once in a while. Speaking about trading the markets at investor conferences is a good change of pace for me and something I do a few times a year.

While I'm at these conferences to teach the audience about trading, I also learn a lot by talking to investors. Since I do presentations in many different places, I have started to see patterns in how people approach the markets. These patterns shed light on some of the reasons why many investors have trouble beating the market.

People Buy What They Know

People tend to buy what they and their social network know. The main industries of a region are often the focus for investors in that area. Vancouver, Canada, is a centre for mining exploration companies, a focus that evolved out of the Vancouver Stock Exchange's function as a hub for raising money for speculative mining deals. Some of the world's biggest mining investment shows are held in Vancouver, so it's not surprising that when I do a presentation in

Vancouver the questions I'm asked are almost entirely about mining stocks.

Take a one-hour flight east to Calgary, Canada, and the questions now focus on oil and gas stocks. Calgary is Canada's epicentre of the energy industry; the tall glass towers that make this city's skyline so dramatic are home to many energy company head offices.

You won't find the people in Vancouver and Calgary to be a whole lot different: they speak with the same Canadian accent and are as polite as Canadians are reputed to be. Both cities are wealthy by global standards, and the population of each tends to be more educated than most. Both cities love their respective hockey teams and have hosted successful Winter Olympics: Calgary in 1988 and Vancouver in 2010.

But despite so many similarities, they have a very different focus in their investment approaches. I have met countless Vancouverites and Calgarians who have shown me their portfolios, and it's not uncommon to find that they're 100% invested in the native industry of their city. Most portfolio managers would be shocked to see a person's entire retirement portfolio invested in speculative mining or energy stocks, yet this is not uncommon in these cities. I once met a guy in Vancouver who had shares in over 100 mining stocks and not a single stock outside of that sector.

This lack of diversity can create great fortunes when there's a boom in that industry. I've seen it happen many times. The mining industry enjoyed great success over a number of years as the prices of gold and silver surged to record highs from 2006–2011. I expect that the Mercedes and BMW dealerships enjoyed a lucrative business in Vancouver during those years, funded by penny stock profits.

Mining and energy tend to run in boom-bust cycles making long-term success fleeting. When a sector is hot, it's easy to make money. When it ceases to be the trendy place to invest, these stocks can languish for years with negative returns. During these times, sector-weighted investors struggle through financial and emotional turmoil, watching seven- and eight-figure portfolios shrink to five- or six-figure amounts. I know people who have gone from a net worth of over $20 million to under $1 million in the span of a year when the sector they were invested in went from hot to not. These sorts of trend reversals flood the market with slightly used Mercedeses and BMWs.

In a hot market, everyone's an expert. A person who knows a little bit about oil and gas, enough to pick a few stocks with some decent potential, can make a lot of money. These people don't make money because they have exceptional analytical prowess, but simply because they rode a hot market. When the trend reverses, they go back to looking like neophytes. Even the most knowledgeable of sector investors look dumb when the trend is down. Profits in these markets are just short-term loans for the person who fails to realize that you have to sell and move on to the next hot market.

Trade What the Market Likes, Not What You Like

This is why I want you to avoid trading what you know—at least so long as the market doesn't care for the sector or stock that is dear to your heart. You have to trade a stock because the market likes it, not because you do.

It's hard to do this because success in a market creates an emotional attachment. If you make a million dollars trading biotech stocks, then you will constantly want to rekindle those elated feelings that came with your profits. Your focus will return to biotech because you have erroneously convinced yourself you know something about these stocks and have some expertise in trading them.

Let me be very clear. Even if you are the most knowledgeable person in a specific industry, you don't make dramatic profits because of what you know. You make market-shattering profits in your industry because your industry is hot. When it ceases to be hot, your in-depth knowledge will be your undoing because you'll continue to hold your favourite stocks despite the market's message to sell them. In this regard, knowing a lot about a business can be a severe handicap because it causes you to focus on that market when it's a bad place to be invested.

As a trader, you should be loyal to your family, your pet and your team. No such loyalty should exist between you and your stocks. It's OK to jump off the bandwagon when the music stops because it gives you the ability to jump onto another where the party is just getting started.

Like most lessons I have described in this book, I have learned this the hard way. I have lost money by being devoted, or at least missed out on opportunities elsewhere. I stuck around a party long after it was over and was left to wallow in the mess that the crowd left behind.

This philosophy carries over to investment vehicles as well. Commodities tend to be more popular with farmers for obvious reasons. I find that investors in big cities that have a high cost of living tend to trade more options. I presume this is because these investors have less capital to invest with, making the leverage that options provide attractive.

Older people tend to prefer large-cap stocks that provide income; young people seek stocks that can make quick gains. Men prefer high-risk stocks, while women like to trade the shares of companies that they know. A Chinese national living in Palo Alto will be more interested in the shares of a company that operates in China than his technology investing neighbour who works for Google. Doctors love to trade biotech and pharmaceutical stocks.

These tendencies become obvious when you get the opportunity to see these regional and social differences. I get to see their positive and negative effects because I travel from region to region and talk to so many different investors. The takeaway that I want you to apply to your own approach to the market is this: don't trade what you know; trade what's hot.

Not what was hot. Trade what is hot or what is starting to be hot. Markets that made you a lot of money in the past can be terrible places to trade once the trend is broken. Look at the charts of formerly hot markets and take notice of how much time there is between peaks and valleys. You can make a lot of money over a year or two and then have no success in that group for the next decade.

This effect is even more pronounced in individual stocks. Taking one of the best stories of a hot stock that went cold and then became hot again, consider Amazon (AMZN). It rocketed higher from 1997 until 2000, making investors fabulous market-beating profits. The stock then went cold, staying under its 2000 highs until late in 2009. That's a long wait for the buy and hold investor who bought at the height of the tech bubble. Amazon is unusual in that it made a comeback; most hot stocks from the tech bubble went to zero and are no longer listed.

Don't do what is natural for you unless what's natural for you is aligned with the market. Have an awareness of your biases that come from where you live, where you work or what makes you the person you are. Being yourself when trading can hurt your performance.

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Trade Less

Hard work will help you succeed in most aspects of life. Want to get ahead in your job? Work harder than the next guy. Want to be a champion in sport? Put in more hours of practice and do so with great determination. No matter what the pursuit, hard work is usually rewarded with positive results.

Not so with the stock market. As a trader, your hard work won't have an impact on how your stock performs. The stock market doesn't care about what you do, good or bad. It will not reward you for being a nice person, for working hard or for being smart. Stocks go up because the buyers are motivated to pay more for them. Nothing else matters.

When the market is challenging, hard work will lead to losses. Unlike any other aspect of life, hard work leads to poor returns because it makes you find trading opportunities that are hard to find.

If you use my approach for finding trades, you will focus on market activity. Your emphasis will be on abnormal price and volume action, evidence that the stock is trading on new and important information that is not yet priced in to the market. Abnormal price activity out of predictive chart patterns is obvious; it's like trying to spot a red dot on a page of black dots. All the dots are the same shape, but the red one really stands out. Working harder won't make it easier to spot the red dot, but you might work so hard that some of the black dots start to look like red ones.

There are a lot of good trading opportunities when the market is strong. When you're faced with more trades than you can handle, you will naturally focus on the very best. This high standard causes you to have a better success rate and better profitability. You only take the best of the best and the results in the market are better.

What happens when the markets are weak and not so generous with trading opportunities? It becomes very easy to lower your standards, taking trades that look pretty good instead of great. If the market is really stingy in offering good trades, you will have to work harder to find something to put your money to work on. The harder you work, the lower your standards go and the less likely your trades are to succeed. The result is that hard work results in poor performance.

Put Your Work into Improving Your Skills, Not Applying Them

This isn't to say that there's no place for traders who work hard. Learning to trade well takes hard work. Gaining mastery over your emotions comes with time and practice. Developing trading strategies with consistent, positive expected values can take countless hours of effort. Trading effectively requires focus and attention. Putting all of the skills involved in trading, however, should be simple and effortless.

Tiger Woods doesn't change his swing on the third hole of a major championship. By the time he's in the game and competing at the highest level, all of the hard work has been done. His muscles have memory, and there's no thinking as the club hits the ball. Great golf is instinctive, the product of countless hours spent refining and practicing.

You will often see Tiger Woods on the practice range or the putting green right after a round. That's when his hard work is being done to correct any errors he made in the round or overcome flaws in his game. At this point there's nothing to be lost from experimentation since a score is no longer being tallied. By the next round, this work should be done and hopefully allow for some improvement in his score.

I spend a lot of time in the evenings analyzing the hot stocks of the day. I look at the stocks that have done well over the previous year, week, month and day. I try to see if there are improvements that I can make to my trading strategies. I want to know if I missed good movers because my strategies weren't good enough or whether it was my application of them that failed. It's a time-consuming process that leads to better skills and more profits in the future. That's where hard work and determination are effective.

There are times when the market is easy and you'll be very busy. When the market is easy, work hard and exploit the many opportunities it gives you. When the market goes soft, recognize the change of condition and maintain your high standards by not working hard to find a trade.

Be Selective

It's better to miss a good trade than to take a bad one. Missing a good trade doesn't deplete your capital—it only fails to add to it. A bad trade will not only reduce the size of your trading account, it will eat up emotional capital and your confidence. A losing trade is not a bad trade, it is one that doesn't meet your requirements. Bad trades come from working hard to see something that's not there, guided by your need to trade rather than the market offering a good opportunity.

I have read very few books about the stock market, but one that I've read more than once and that I think is a must-read for every investor is *Reminiscences of a Stock Operator* by Edwin Lefevre. Here is a wonderful quote from that book that captures the essence of what this chapter is about:

> *What beat me was not having brains enough to stick to my own game—that is, to play the market only when I was satisfied that precedents favored*

> *my play. There is the plain fool, who does the wrong thing at all times everywhere, but there is also the Wall Street fool, who thinks he must trade all the time. No man can have adequate reasons for buying or selling stocks daily—or sufficient knowledge to make his play an intelligent play.*
>
> *—Reminiscences of a Stock Operator*

I advise all my students that they will make more money by trading less, at least so long as trading less is the result of having a high standard for what they trade. If you tell yourself you're limited to only making 20 trades a year, you're probably going to be very fussy about what trades you take. With less than two trades to be made each month, only the very best opportunities will pass your analysis. All of the "maybes" or "pretty goods" will get thrown out.

We take the pretty good trades because we're afraid of missing out. It's painful to watch a stock you considered buying but passed on go up. You remember this pain and the next time you see something that looks pretty good, you take it with little regard for the expected value of trading pretty good opportunities. Pretty good means the trade will make money some of the time and lose some of the time, and the average over a large number of trades may be close to breaking even. The fact that one pretty good trade did well is reasonable and expected. In the context of expected value, taking those pretty good trades many times will lead to less than stellar results when the losers offset the winners.

You shouldn't judge your trading success one trade at a time. You must look at your results over a large number of trades. To maximize overall profitability requires you to have a high standard for what trades you make. Maintaining that standard will be easier if you take the trades that stand out as an ideal fit to your strategy, not by taking those that are marginal and require a lot of hard work to uncover.

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The Market Is Not Out to Get You

To say that the market has been tumultuous in the new millennium is an understatement. Investors have endured massive sell-offs and then watched incredibly stable multiyear upward trends that seemed to defy logic. Stock market sectors that were once uncorrelated with others now trade in unison, giving the investor few means to escape weakness. Well-established stocks once considered to be blue chip have fallen dramatically, while companies with little in the way of earnings have enjoyed astronomical gains. It has not been a market that made sense.

By being difficult to understand, the stock market has become the scapegoat for all of the economic problems in the world. So many people associate the financial crisis with the stock market, although it was really leverage and greed that were to blame. When people watch their net worth rapidly decline, and when that net worth is wrapped up in the stock market, they're bound to have some animosity.

The contrepreneurs of the world have often been involved in the markets. Bad people doing bad things catch a lot of attention, especially when the numbers are immense. Bernie Madoff is just one person, and yet he was able to record a staggering fraud that was based in stock market investing. Put a few of these people in the news on a regular basis and pretty soon we have people camping out in public parks in protest.

We should be reminded that the stock market, like money, is not evil. As Ayn Rand wrote in *Atlas Shrugged*:

> *So you think that money is the root of all evil? . . . Have you ever asked what is the root of money? Money is a tool of exchange, which can't exist unless there are goods produced and men able to produce them. Money is the material shape of the principle that men who wish to deal with one another must deal by trade and give value for value. Money is not the tool of the moochers, who claim your product by tears, or of the looters, who take it from you by force. Money is made possible only by the men who produce. Is this what you consider evil?*
>
> —*Atlas Shrugged*

It's the people who can be evil, and the excesses of our past have brought out their actions. The stock market is not rigged; it's just a place where people make their trades. Problems arise when bad people with considerable financial power have used the market and people's greed to their advantage.

Just as the market doesn't care about me, it also doesn't care about you. It's not out to get you; it's simply a facility for people to buy and sell assets at a price that each party deems to be fair. The buyer thinks the stock is going up; the seller thinks the stock is going down. One of them will be wrong. The market itself has no influence on who gets to win.

The stock market allows innovators and leaders to finance the products and services that will add value to our lives. Whether it's a drug that will cure the disease you're going to get or a gadget that will tell you the best wine to pair with your tenderloin, the market is the engine of our economy. We just have to learn how to run it.

People who suffer a loss tend to look for someone to blame. This is a futile endeavour. Even if there is someone that deserves blame, little benefit will come to you from placing fault at someone else's feet. You can only improve your situation if you take responsibility for everything that happens to you. Only you can make the changes that will alter the direction your life is taking. You control your destiny, financial or otherwise.

Stop blaming Wall Street, Main Street and Government Street for the pain you feel. Evolve your approach to the market so that you have a better chance of living on Easy Street.

Don't Hate Your Losers

It's hard not to hate the stocks that hand you a loss, especially if that loss is significant and painful, but it's not the stock's fault that it went down and took away your capital. It's your fault for not sticking to your risk management principles or failing to listen to the message of the market. Don't refuse to go back to a losing stock for another trade; the probability of a former loser becoming a winner is no different than a former winner becoming a loser.

Recently, I traded a pharmaceutical stock that was trading with alpha characteristics. The market was moving the stock up in anticipation of results for a drug that the company was developing and I was enjoying the ride higher. It met the requirements of one of my strategies and I was following the rules of the strategy perfectly by owning it.

One morning, shortly after I entered the trade, I was surprised to see that the stock was set to open down significantly and far below my planned stop loss point. The company had announced some results from their drug tests, and the market did not like what it heard. The stock opened down 70% on a downward price gap, making it impossible to exit the trade at my stop loss price. Instead of taking my planned loss of one risk element, I was faced with a much greater loss with a reward for risk of –5.43. This was an example of those relatively rare occurrences where doing everything right can still lead to a much larger than expected loss.

The loss was significant and for a moment I was frustrated with the company for the poor results and the bad wording of the news release. My frustration was only hurting me, since it did not change the result and I was likely missing out on other trades, so I soon forgot about it and went back to business. That is the reaction that comes with having felt this sort of pain before: you get somewhat desensitized to it.

A couple of weeks later, the same stock came up in my scanning process as one that again met the rules of one of my buying strategies, albeit at a much lower price. I looked at the trade longer than normal before buying, unsure about going back to a stock that had been a great disappointment in the past. I reminded myself that I'm in the business of trading opportunities, not stocks. I must take the trade because it satisfied my rules, and what happened with the stock in the past is irrelevant.

I was thankful that I did, because the trade worked great, giving me a quick 6:1 profit, erasing the loss at my last swing of the bat on the stock. I would have missed out on a great trade had I held a grudge against the stock.

That's not to say that I executed the trade without some emotional attachment to the previous loss. I took less risk than normal because of fear. I sold earlier than I should have because I was afraid that it would again turn from a winner into a loser. The profit that I made was good, but it should have been three times as much. I too am a normal human being.

You won't make more money by blaming the market or a stock for your losses. You're in control of your money and how you risk it. If you don't like the results you're getting, work hard to figure out if there's a better way to trade the market you have. Remember, however, that the market is not out to get you. It's up to you to figure out how to get what you want out of it.

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The Best Opportunities Are in the Stock Market

You have many choices of trading vehicle. For a start, there are stocks, options, exchange traded funds, index futures, commodity futures and currencies. My focus throughout this book has been on stocks, but you may be wondering if my methods work on other assets. The short answer is yes, but there should be a large asterisk beside that answer. Here's why.

The chart-reading skills I have discussed can be applied to the chart of anything that is traded by human beings, because they focus on aspects of human behaviour. Fear, greed, optimism, pessimism, confidence, uncertainty, psychological barriers and how information moves from its source to investors are each related to how we react to our emotional attachment to money. These are universal among people no matter what is traded.

When you analyze a chart using support, resistance, trend lines, abnormal activity, price volatility, rising bottoms, falling tops and channels, you are essentially defining the actions of the crowd and working to extrapolate where there is new information coming into the market. It is the new information that is critical because it's what gives us our edge.

Stocks

It's easiest to beat the market by applying the mindless approach to stocks. Finding the edge—identifying opportunities that have positive expected values—requires that you exploit a breakdown in market efficiency. You now know that the efficiency of the market breaks down in two ways. First, when new information that's not widely known is being traded on, and second, when investors act irrationally because of emotion.

So we need to find instruments that are trading with either new information that is not widely known or with emotion. We need to find abnormal activity.

If you focus on stocks, you have over 15,000 stocks in North American to choose from, even more if you move outside North America. If you only focus on liquid stocks, the number is still about 5000. That means that each day, there's a good chance that one of those stocks will trade abnormally.

A focus on commodities gives you a much shorter list, perhaps a dozen actively traded and liquid assets that you can watch for abnormal trading activity. Go to currencies, and the list is even shorter. I am not an expert on currency trading, but I will guess that there are six actively traded currency pairs that traders focus on.

The great benefit of trading stocks is that there is such a long list of tradable vehicles to choose from. Even in a quiet market, I find that there are at least 10 abnormal stocks each day. It's a rare day when I can't find something to trade. Even if I'm looking for long-term trades where my anticipated hold is months, there still tends to be at least one good opportunity a week.

When market conditions are strong and the market is trending, the opportunities are even more plentiful. In a hot stock market, there are more opportunities than you can handle.

The greatest argument against trading stocks is the limited leverage that is allowable. I'm not even sure this is a bad thing, since leverage is a double-edged sword that can quickly destroy the equity in an account if not used responsibly. Assuming you are a great risk manager and capable of controlling the downside of leverage, are there better places to trade than stocks?

Options

The obvious answer is to look to stock options since they allow leverage on the stocks that you might find are trading abnormally. This is exactly what many of my students do; they will buy the option if they find that a stock is showing a good trading opportunity. For the trader who really understands options and how they are priced, I think this is a good way to trade, although I personally do not trade options.

The challenge is that option pricing is not based solely on the price of the stock. You can be right in your prediction of how the stock's price is going to change but still lose money on the option trade. The premium that you pay for the option is the implied volatility, the expectation that the option will move up before it expires.

If you buy a stock at $10 and it goes to $11, you make $1 per share. If, instead of buying the stock, you buy a $10 call option, you might pay $1 for the right to buy the stock for $10 before the option expires. Now, to make money, the stock has to go to at least $11 since the option—the right to buy the stock at $10—cost you $1. What is critical is how long it takes for the stock to go to $11.

If the stock goes to $11 in two days and the option doesn't expire for another two months, then there's a good chance that your option will be trading for more than $1. The premium that the option is trading at represents the value of time and the potential for the stock to go up even more. So with two months of life left in the option to buy this stock at $10, it might be trading at $2 when the underlying stock is trading at $11.

What if the option is set to expire tomorrow and the stock is trading at $11? Since the option gives you the right to buy the stock at $10 before tomorrow, you could exercise the option, buy the stock at $10 and sell it at $11 and make $1 per share. The problem is that you paid $1 for the option, so you end up only breaking even. You were right about where the stock was going, but the benefit did not outweigh the cost of the option.

The power of options is in the leverage. If we stick with this example and assume that the stock goes to $12 and the option is worth $2 when it expires, you have made $2 on an investment that cost you $1. You doubled your money and made 100%. On the stock trade, you bought at $10, sold at $12 and made $2 a share or 20%. Still a good return, but not nearly the gain enjoyed by the option.

It is important to keep in mind, however, that you could probably leverage the stock to at least 2:1, so your return could have doubled to 40%. Still not as good as the option, but you also didn't need the stock to go up as high to make money since the cost of leverage is not as high with the stock as it is with the option.

When trading options, you have to understand what the implied volatility is in the option price and how realistic it is that the market is wrong about what the expected price will be before the option expires. The option market, like the stock market, is very efficient. If a stock is trading abnormally, you can be sure that the price you have to pay for the option will go up to account for that. Options are challenging because you have to be right about two things: where the stock is going, and that the option price hasn't fully priced in the potential for the stock to go up enough to justify the option price.

There's also the issue of whether the stock trading opportunity has options trading on it. Often, abnormal price action occurs in lower-cap stocks with a higher potential to make a market-beating move. These stocks may not have options trading on them, which makes trading the stock the only way to capitalize on the opportunity.

Whenever I'm asked about options, I say that they're worth considering for people who really understand how they are priced. I have spoken to thousands of investors, many of them about options, and I found that most people really don't know enough about options to trade them responsibly. For most, options are simply the crack cocaine of trading.

Exchange Traded Funds (ETFs)

ETFs have become extremely popular among traders in recent years. Many retail investors only trade ETFs because, as I previously discussed, the inherent diversification in an ETF makes people believe they are less risky than individual stocks. Using a traditional understanding of risk, it's true that they're less risky. But using my approach to risk management you can show that ETFs are actually more risky.

To me, risk is determined by how likely you are to lose money and how much you will lose if that happens. When buying a stock, I can use the inflection point low before the entry signal to define my stop loss point and then buy a position size that reflects the risk of the trade (entry price – stop loss price) and my risk tolerance.

From testing and experience, I should know the expected value of the trade, the probability of the stock going up, and how much, on average, it will gain. I might have a strategy that works 70% of the time and earns an average of three times risk. That means I have a 30% chance of being stopped out. Since there is the potential of the stock gapping through the stop (this happens rarely, but it does happen) let's assume the average loss is 1.2 times the risk that occurs if the trade is stopped out as planned.

Can't you apply the same methodology to ETFs—particularly leveraged ETFs, which allow you to control a diversified basket of stocks with a lower amount of capital? Shouldn't this be less risky?

The problem with trading ETFs is that it's much harder to find alpha. Assuming we're talking about a conventional ETF that represents a basket of stocks, buying that ETF is like owning a diversified portfolio of stocks. Diversification waters down alpha.

Consider the SPY. It's the most liquid of ETFs and represents the 500 stocks that make up the S&P 500. Of the 500 stocks in this index, there might be four or five that are trading abnormally strongly and are able to produce market-beating returns on any one day. Those will be offset by stocks that trade with abnormal weakness. Collectively, the overall market will be nothing more than a representation of beta. Own the ETF and you own the market, with no potential to beat it.

Since it's not likely that there will be a breakdown in the market efficiency of a large basket of stocks, the probability of making a profitable trade goes down. This increases the chance of taking a loss, which is why I argue that trading an ETF, even with its high level of diversification, is more risky.

If I apply the strategy that earned me three times risk 70% of the time on stocks to an ETF, what can I expect for profitability? Since there is less chance of alpha in an ETF, I will probably find that the success rate and average profit goes down. The strategy might only be right 50% of the time on the ETF and the average gain may only be two times risk. Since there is diversification in the ETF, the potential for a gap through my stop might be less so the average loss may be minus one rather than the –1.2 for the stock trade. Still, with a 50% chance of losing minus one and a 50% chance of making two, the expected value is only 0.5. The same strategy applied to the stock had an expected value of 1.74—more than triple!

It is possible to beat the market by trading sector ETFs since a market sector could perform better than stocks in general. You might find that the mining sector makes an abnormal break from a predictive chart pattern and take the trade knowing that it has a positive expected value. I think this is a great strategy for the more conservative trader who does not have a lot of time to analyze the market. You can look even just once a week for opportunities in ETFs for long-term entry signals and have success beating the overall market.

The only issue with this approach is that you won't get a lot of entry signals—perhaps 10 per year. This is enough for the long-term trader but not sufficient for a more active trader.

I have tried to trade just about everything, including stocks, options, ETFs, commodities and index futures. Without a doubt, I have found the best success in stocks. The liquidity and availability of opportunities makes them a profitable venue. It is essential, however, to apply strategies that exploit breakdowns in market efficiency and practice good risk management.

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The Market Is Cruel: It Gives the Test First and the Lesson Afterward

The statistics are not very encouraging. It is estimated that more than 90% of people who attempt to trade fail to beat the market. Most aspiring traders just plain fail, losing enough of their investment capital to make them want to quit. Is trading too hard, or do people take the wrong approach to it?

If you want to be a doctor, you go to school for a very long time and then work long hours for little pay to gather the experience necessary to practice medicine. You can't just read a few books about medicine and then hang out a shingle proclaiming that you're ready to practice. There are significant barriers to entry preventing you from becoming a doctor.

The same cannot be said about trading. It's not hard to become a trader; brokerage houses will open an account for just about anyone who has the capital to fund the account. There are no tests to be written, no requirement for an education on how to trade. Your first trade is arguably the first lesson taught by the market's College of Trading. Sadly, the market tends to give the test first and lesson second.

I am confident that this book will help any trader, from a complete beginner to an experienced pro, improve their performance in the market. However, I don't believe that this book is all you need. Strategies with specific rules for when to buy and sell, risk management and emotional control need to be developed and written down in a trading plan. You can learn these rules from me through **Stockscores.com**, through many other trading schools or by yourself through trial and error.

Is the trading plan all you need? No. Just as a doctor must practice before being proficient, just as a professional athlete must put in the hours to become a champion, so too must the trader practice to become proficient. You can practice with your capital at risk, adding expense to the mistakes you make, or you can trade hypothetically on paper. I have created a trading simulator to help you learn in a realistic environment without risking your capital.

The Tradescores.com Trading Simulator

Tradescores.com has a number of useful features for traders, but the focus of the site is the Tradescores Trading Challenge. The Tradescores Trading Challenge is a stock-picking game. It doesn't consider overall portfolio performance, but instead, rates the quality of your trades based on reward gained for risk taken, percentage return and hold period.

The game requires you to make stock picks and virtual trades, but the difference is that you don't have a set amount of capital and you don't trade a number of shares. You simply make a mock trade with an entry price and stop loss price. When you exit the trade, a Tradescore is calculated, and there are analytical tools that will show you what your overall profitability would be with what you define as your risk tolerance.

This game requires that you use stop loss points for every trade. You can put the stop loss at any price you want, but where you place it will have a significant effect on your Tradescore. Set your stop too tight and you might get taken out before the stock makes its move. Set the stop too wide and you lose valuable points in the calculation of your Tradescore.

For example, suppose you buy Baidu (BIDU) at $115 with a stop loss at $113. This trade has a risk of $2 per share. A month later, you exit the trade at $125, leaving you with a profit of $10 a share. This means you have earned a reward for risk of five ($10 reward for $2 of risk), a percentage gain of 11.5% and a hold period of 30 days. The Tradescores game has an algorithm that considers all of these metrics to arrive at a Tradescore. In this case, the trade has earned a Tradescore of 41 out of 100. The Tradescores go up as the percentage gain and reward for risk improve.

You don't enter a number of shares to be purchased because the simulator has a tool that will show how many shares you would have taken based on what you define as your risk tolerance. If you

Figure 1 – The Trade Ticket on Tradescores.com allows you to enter a mock trade, which will be tracked and graded by the Tradescores scoring algorithm.

enter a risk tolerance of $500, then the system calculates that you would have bought 250 shares and earned a total profit of $2500. If you change your risk tolerance to $1000, then 500 shares would be bought for a total profit of $5000. Tradescores has an analysis tool that allows you to calculate the total gain or loss made on trades between a date range that you define for a given risk tolerance level. The methods for judging success in the market use the theories described in this book.

The game is designed to be ongoing; a player who joins six months after another is not at a disadvantage. It's your most recent trades that determine your ranking in the Challenge. A full description of how to play can be found at **Tradescores.com**, including videos that show you how to make your simulated trades and track your results.

I have spent hundreds of thousands of dollars building this tool but make it available completely for free to anyone that wants to use it. I have not found a better trading simulator anywhere, and at this price, who would complain anyway!

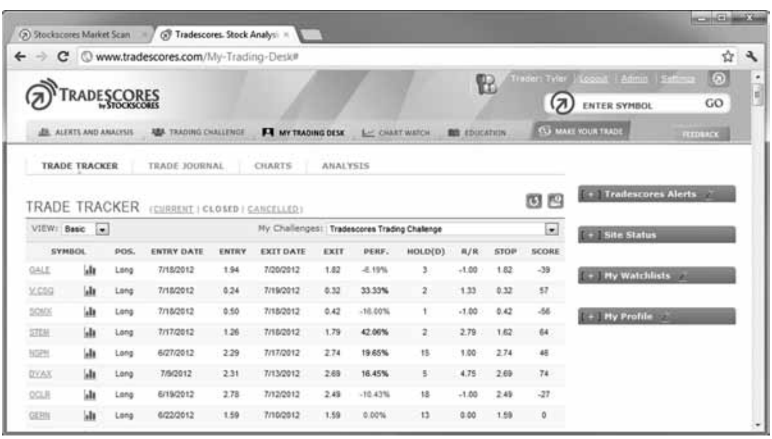

Figure 2 – The Trade Tracker on Tradescores.com shows the performance of your virtual positions and is updated throughout the day as prices change.

Before you trade, I strongly urge you to first learn how to trade, develop trading strategies that have a positive expected value, practice applying those strategies with a simulator, and then start trading your strategies with real money but a small amount of risk.

As you gain confidence, increase your risk tolerance. Whether you want to be a full-time day trader or simply manage your retirement portfolio with 15 minutes of work each month, this process will help protect you from financial and emotional hardship. While more than 90% of traders fail, there are also a significant group of people making a lot of money doing it. I know what side you want to be on, so take the time to learn before you trade and you will have a much better chance of success.

Remember that doing well in a simulator does not guarantee your success in the real market. You add a heightened emotional dimension when you risk your capital, and that can lead you to make mistakes. I have seen many people who are very good at following their trading rules when doing simulated trades but lose their discipline when there's real money on the line. That is why I encourage you to start slowly and work through the process one step at a time.

Perfect practice makes perfect.

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The Power of Stockscores.com

The Stockscores

In 2000, I developed the Stockscores indicators as a way to take the six important elements of chart patterns and put them into an indicator. These indicators are available at **Stockscores.com** for almost all North American stocks and are very helpful for doing an assessment of whether a stock is worth considering.

Here's how the Stockscores indicators are calculated. Every stock, index or ETF that Stockscores covers is given 50 points to start. Points are added for positive chart characteristics and deducted for negatives. For example, a break through price resistance is an indication that buyers are stronger than sellers, so the algorithm awards points when this happens. A downward-sloping moving average is a sign that the sellers are in control, so points are deducted when this happens.

I created the algorithm with about 15 different metrics that can be measured from market activity, each awarding or deducting points based on whether that metric was a positive or negative signal of future price direction.

This algorithm defines the Signal Stockscore, which tends to bounce around quite a bit. To smooth out the line, the system then calculates a seven-day exponential moving average of the Signal Stockscore to produce the Sentiment Stockscore. This is the important number to watch.

A Sentiment Stockscore above 60 indicates that investors are generally optimistic about the stock, index or ETF. A score below 40 indicates the market is pessimistic. The sweet spot is to find Sentiment Stockscore lines, which can be seen on any **Stockscores.com** chart, sloping upward and crossing through 60. You should then look at the price chart to see a confirming price pattern where the stock price is moving up through resistance from low price volatility.

I don't recommend buying a stock just because its Sentiment Stockscore is 60 or higher, but I do find that strong, market-beating

Chart 46 – The light-coloured line is the Sentiment Stockscore, which has not been above the critical 60 level for the duration of the downward trend in Research in Motion.

stocks tend to have good Sentiment Stockscores early in their trend. The Stockscores indicators are a great way to provide a quick reference for the strength or weakness of a stock.

You can check the Stockscore for most North American stocks, ETFS and indexes by entering the symbol in the upper right corner of the **Stockscores.com** website. The Stockscore algorithm requires 200 days of data to calculate the Stockscores indicators, so newly listed companies will only display a chart and not the indicators.

For example, Chart 46 shows that Research In Motion (T.RIM, RIMM) has been in a lengthy downward trend. RIMM has not had a Sentiment Stockscore of 60 or better for the duration of this downward slide. The simple rule of only considering stocks with

Chart 47 – The Sentiment Stockscore has held above 60 while this stock has been rising, a good indication that the buyers are in control of the stock.

a Sentiment Stockscore of 60 or higher has kept you out of RIM while it has performed so poorly.

The chart for Ariad Pharmaceuticals (ARIA) has been moving steadily higher with rising bottoms, and its Sentiment Stockscore has not dipped below 60 during this price climb.

You can review the charts of any North American stock and see the Sentiment Stockscore for free. Just enter the symbol in the box at the upper right of the site. Canadian symbols require a prefix: "T." for the TSX and "V." for the Venture. Members can use the Sector Watch to see what areas of the market are strong and the Market Scan to screen the market for stocks with good Sentiment Stockscores or perhaps those that are just crossing above 60 today.

It's important to remember that the Stockscores indicators are applied to daily chart data and are not useful for a shorter time frame. A stock may give a good entry signal on the intraday chart suitable for day or swing trading despite having a weak Sentiment Stockscore.

What's powerful about the Stockscores is that they allow you to use a computer to filter the market, seeking out stocks with optimistic chart patterns. **Stockscores.com** has a Market Scan tool for filtering a large universe of stocks in search of stocks that meet the filter criteria you establish. It's hard for a computer to look for chart patterns the way a human can, but the Stockscore is helpful because it attaches points to the different elements of chart patterns.

The market moves faster than ever. As a trader, you're not just competing against other traders, but also against computers, which are capable of finding and exploiting opportunities in less than a blink of an eye. The rise of computerized trading has taken away many opportunities for the very short-term day trader, but computers add to the effectiveness of the sort of strategies I trade because they increase the amount of buying or selling that chases abnormal market activity. The key, however, is to find the opportunity when the reward for risk profile is positive.

For a longer-term trade based on the weekly chart, you need to be able to find the trade within a week, so there's no great rush.

For a position trade off the daily chart, finding the opportunity the day it happens is sufficient, which puts a little bit more pressure on timing. Swing trades often need to be found within 15 minutes of the stock trading abnormally, and day trading can require the trade signal to be realized within a couple of minutes. The shorter the time frame you trade, the more important it is to catch it early.

If you wait too long and the stock is moving quickly, the entry price moves up and away from the support price. That increases the risk of the trade. Since the stock is moving up, it's also getting closer to the exit price, wherever that may end up being. Higher risk and lower reward means a weaker reward for risk ratio, and that hurts performance. You can be the greatest stock picker in the world, but if you catch the trades too late, your reward for risk will suffer and that hurts your overall trading performance.

The Stockscores.com Market Scan

There are thousands of stocks trading in North America. How can you find the ones that display the characteristics of an alpha stock with the ability to beat the market? You need a scanning tool, one that allows you to filter for support and resistance levels, price volatility, abnormal price and volume activity, and optimism and pessimism. Early in my trading career I went looking for such a tool and couldn't find one. So I decided to build one.

The main tool of Stockscores is the Market Scan. It allows you to filter the market for any combination of over 50 filters that focus on market activity. For example, you can search for stocks trading on the NASDAQ between $3 and $10, breaking through 15-day resistance, trading with abnormal volume, trading at least 1000 times a day and above the open for the day.

The Market Scan will do the search and provide you with a list of stocks meeting your criteria in only a couple of seconds. You then view the charts of the stocks the Market Scan found using the Stockscores Chart Viewers. Look at 10 charts per page to quickly find those that have the right chart pattern, or look at the charts one at a time in a slideshow so you can focus on the pattern even more.

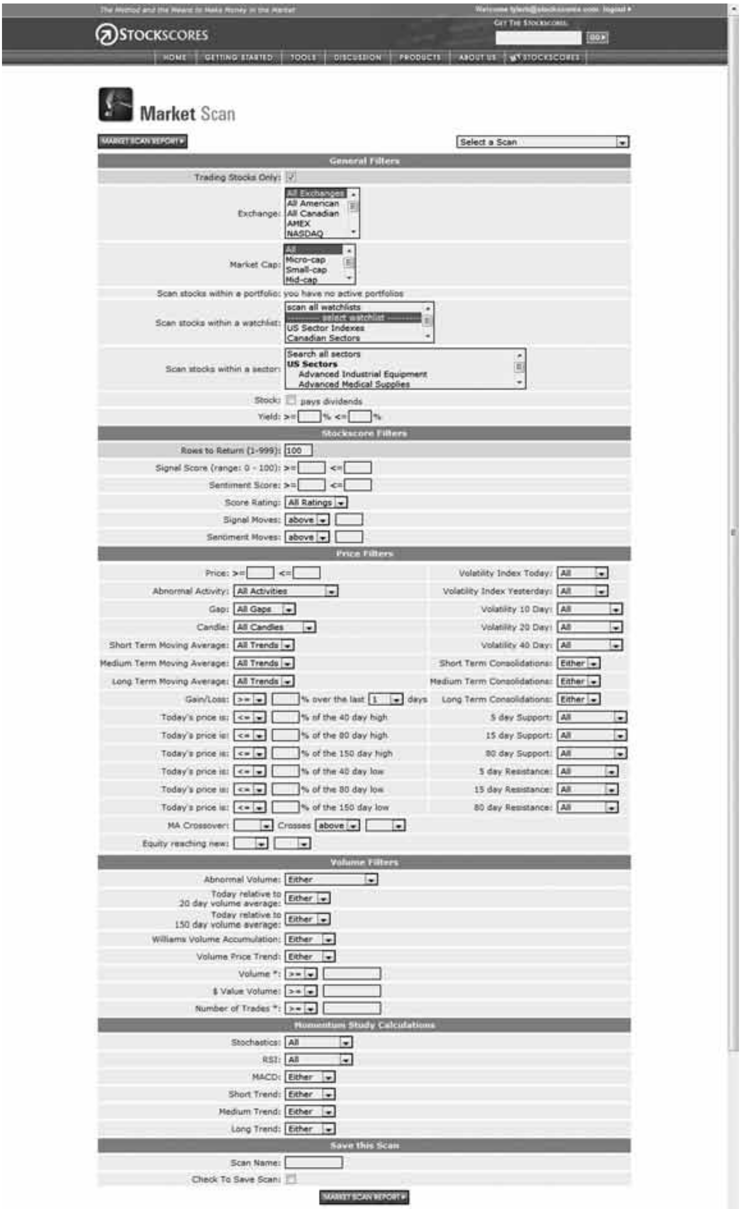

Figure 3 – The Stockscores.com Market Scan provides filters that allow you to scan the market for stocks that meet the requirements of a trading strategy.

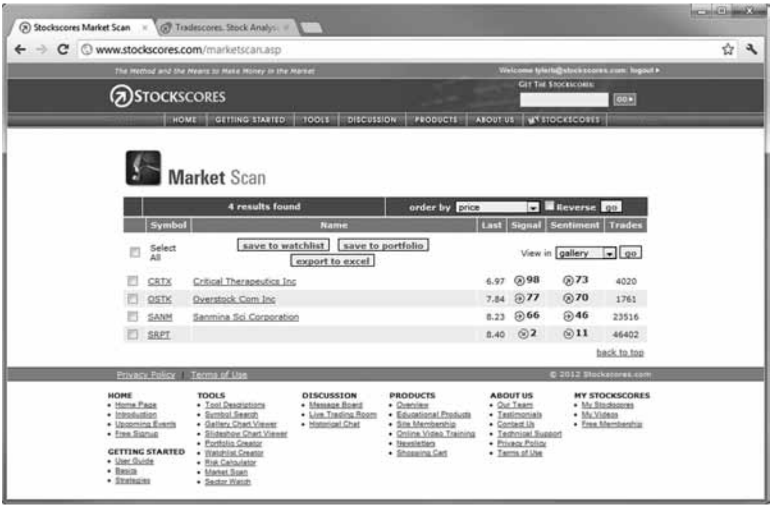

Figure 4 – In only seconds, the Market Scan provides a results table of the stocks that meet the criteria you choose to filter the market for.

There is a full user guide on **Stockscores.com** that describes what each filter looks for, so you can create a Market Scan to find the stocks your strategy seeks. I have also created a number of preset Market Scan settings based on strategies I use and teach.

You can subscribe to the Stockscores Market Scan tool on a monthly basis. The price is reasonable when you consider how many trading opportunities it will help you find and how much time it will save you in the process.

Plus, you'll be able to use the many other tools on **Stockscores .com**, including the Sector Watch, a tool that shows and ranks the market sectors by their Stockscores indicators. **Stockscores.com** also has a risk calculator that helps you define the size of your trading position based on the entry price, stop loss price and your risk tolerance.

I encourage you to set up Watchlists on **Stockscores.com** to track your portfolio and stocks you are considering. Doing so makes it quick and easy to check the charts of the stocks you're interested in. This tool and many more are provided for free.

Figure 5 – You can view the charts of the stocks found from the Market Scan in a chart viewer to quickly identify those that have the chart characteristics you're looking for.

Also free for registered Stockscores users is my weekly newsletter, *Perspectives*. Each week, I provide a short trading lesson and highlight stocks that I have found with good chart patterns.

Take the time to learn how to use **Stockscores.com**. Those who do find it an irreplaceable way to identify trading opportunities and track their stocks. We are a passionate group of traders who have used the site since its inception in 2000. I hope you join us.

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Plan to Be Successful

Would you build a house without a plan? How about starting a business? Would you do that without putting a plan down on paper? Most people will recognize the importance of having a plan for these things, yet very few people have a written plan for how they trade the stock market. This is just one more reason most people don't consistently beat the stock market. For most investors, their forays into the market are a lot like stepping into a casino.

It's more important than ever to approach investing with a solid trading plan. The markets are more volatile, faster-moving and seemingly irrational than ever before. They are not necessarily harder to trade, but they do require a well-thought-out approach that takes advantage of the way the modern market behaves. If you try to apply a traditional approach to the market, you will probably make a visit to the poorhouse. Your approach to investing has to reflect the market we have, not the one we had.

Your trading plan doesn't have to be long or complex. It's actually best to keep it concise and simple. Simplicity in trading demonstrates wisdom; complexity is the mark of inexperience. There are a number of key functional areas that the plan should have. Including these will help you to do better in the market.

Rules for Entry

What are your requirements for making a trade? Most investors don't clearly define these, and instead make investments that make sense to them. The investment might be based on something they read, a recommendation from a friend or a method they read about in a book. The problem with doing what makes sense is that it rarely works. Here's why.

Our brains tend to refer to something that happened in the past when trying to predict the future. What happened in the most recent past tends to sit at the top of our consciousness, influencing our future decisions. In investing, the result is that we focus on the characteristics of a past stock market winner and try to find something similar. This usually leads to a misguided correlation.

If you watch a stock move up 100% in three months, it is likely you will look for another stock with the same characteristics. If you know that the winning stock was a gold exploration company with operations in Ghana, would you go out and try to find another one with a similar business?

If you are a normal person, there's a good chance that you would—or at least follow the same thought process. The problem is that there's likely no strong correlation between gold exploration companies in Ghana and winning stocks. The one winner that caught your attention was more likely to be rare than it was to be the norm.

It's important to test whatever you use as your rules for entry and measure the expected value for trades that follow those rules. This test must be done over a large sample size so you can accurately determine whether the rules yield positive results over time.

Your rules can be simply that you only buy stocks with a PE Ratio less than the industry average or you buy stocks when their 50-day moving average crosses over the 200-day moving average. Rules don't need to be complex, but they do need to be tested. You need to identify how often they're right and how much they make when they're right versus how much they lose when they're wrong.

The strategies I have developed tend to have three to seven different rules for entry. I will use different strategies for different market conditions, but I don't usually apply more than two strategies at a time.

Your trading plan should have a checklist of rules. It is easy to get caught up in the emotion of making a trade and lose sight of what your rules are. Having the checklist will help you stick to your plan.

Risk Management

Most investors recognize that it's not possible to be right all of the time, but few have a plan for what to do when they're wrong. You must first define what it means to be wrong and then come up with a plan to control risk for those inevitable wrong decisions in the market.

Any time I make a trade, I also define the price point where the market will have proven me wrong. I go into the trade knowing that if the price falls to that trigger point, I'll exit the trade and take the small loss.

Doing this allows me to control the amount of capital I have at risk. Good traders know that they go out of business if they run out of capital, so controlling the size of your losses is crucial for success.

Rather than buy the number of shares you can afford, your position size should be based on how much you can afford to lose. If you are buying a stock at $10 and plan to take a loss if the stock falls to $9, the risk per share is $1. If you are willing to lose $500 on any one trade then, in this case, you would buy 500 shares.

When judging your success, don't look solely at how much you make or lose on each trade. Look at how much you made relative to the risk you took. Making $3000 when you risked $500 is a good trade because you made six times your risk. Making $500 by risking $1000 is not a great trade because it requires a much higher success rate.

The risk management portion of your trading plan should define how you'll know when to exit a trade at a loss and what your risk tolerance is in dollar terms. It is also a good idea to define your loss limits before you stop trading to assess what is causing you to consistently lose your capital.

Rules for Exit

Just as you need well-tested rules for entry into a trade you should also have well-tested rules for exiting. Obviously our aim is to maximize profits and minimize losses, but you shouldn't approach this aim one trade at a time. Instead, you should come up with a set of exit rules that maximizes your gains over a large number of trades.

Suppose you have a strategy that tends to be profitable 70% of the time. Testing your strategy finds that three out of 10 times you lose $500, six out of 10 times you make $1000 and one out of 10 times you make $10,000. What if I give you two choices for an exit strategy? First, sell all winners once they have $1000 profit. Second, only sell a winner if it achieves a $10,000 profit, but sell any stock that shows a $1000 profit and then falls back to break even.

The first rule will make you $1000 seven out of 10 times and lose $500 three out of 10 times for a total profit of $5500 every 10 trades. The second rule will make you $10,000 one out of 10 times, break even six out of 10 times and lose $500 three out of 10 times for a total profit of $8500 every 10 trades. This second exit strategy makes you more money even though it's only profitable 10% of the time.

The lesson here is to focus not on success rate but on profit maximization. Use the rules that make you the most money and not the ones that are right more than they are wrong.

Process

Trading requires discipline, so it's a good idea to include in your trading plan the process you will go through to research, identify and carry out your trades. Making a detailed, step-by-step process will make it easier to follow your plan and improve your likelihood of success.

Schedule when you intend to look for trading opportunities and the steps you will take to find trades. Also define how you will follow your open trades and what tools you will use. Be very specific, but keep it simple. You're more likely to follow your plan if it's easy to do so.

Emotional Control

Normal people are predisposed to fail in the stock market because normal people have an emotional attachment to money. This emotional attachment causes us to break our rules even if our testing has shown that they are effective. Most traders have a very hard time following their rules.

Fear of losing money is the biggest reason investors break their trading discipline. Therefore, it's important to include in your plan a way to stay on track and be disciplined. It is helpful to have leverage over your emotions. Perhaps have your spouse or friend regularly check your trades to make sure you're following your rules.

Most importantly, don't take more risk than you're comfortable with. If you're not scared of losing the amount you risk on a trade then you're more likely to follow the rules.

In the emotional control section of your trading plan, make a list of the things you will do to control your emotions. Think about what gets your emotions involved in your trade, and then come up with ways to overcome those obstacles.

Trading Journal

Your plan should include a process for reviewing and journaling your trades. Each trade is a lesson that the market has given you. Your losses will teach you something. You have paid the tuition to the College of Trading, so make sure you get your education.

A trading journal should include the chart showing your entry and exit points and the statistics of the trade. Keep track of the reward for risk, percentage gain/loss, dollar profit/loss, trading strategy and any other metrics that you want to consider. It is also important to write down your rationale for entering and exiting the trade, identifying what motivated you buy and sell the stock.

Be sure to go back and review your trades some time after you have exited them. You will find that you often don't see the same characteristics you saw when you were in the trade. This demonstrates how you often see what you want to see, and you will learn the importance of following a checklist in minimize the bias that you bring into the trade.

By reviewing a number of your trades, you will get an impression of the destructive tendencies that you have. From a large sample of trades, you can see patterns that hurt your performance and use those lessons to modify your trading plan or the execution of it to improve your future performance.

On the next page is a template that you can use for your trading plan. Use it for each strategy that you plan to trade.

My Trading Plan

Strategy Concept

____

____

____

Rules for Entry

1. ______________________________________
2. ______________________________________
3. ______________________________________
4. ______________________________________
5. ______________________________________
6. ______________________________________
7. ______________________________________
8. ______________________________________

Risk Management

Risk tolerance: ____________________________

Method for sizing my positions:

____

____

I will stop trading if I lose more than $____________________
in a ☐ day ☐ week ☐ month

Rules for Exit

1. ______________________________________
2. ______________________________________
3. ______________________________________
4. ______________________________________
5. ______________________________________
6. ______________________________________
7. ______________________________________
8. ______________________________________

Process

I will do my research with the following schedule and method:

I will monitor my holdings with the following schedule and method:

I will review my trades with the following schedule and method:

Emotional Control

My weaknesses in trading are:

I will overcome these weaknesses by doing the following:

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There Are Many Paths to the Top of the Mountain

There is a Chinese proverb that says, "There are many paths to the top of the mountain, but the view is always the same." Trading well can lead you to market-beating profits, financial and emotional freedom, and a fine quality of life. While the end result is the same, there are an infinite number of ways to get there.

This book has shown you my base approach to trading and understanding the market. What I share with you was not figured out after a quick research study; it is the product of over 20 years, thousands of hours and thousands of trades.

I have made every mistake possible, and I continue to make them. But as well as being an expert on what not to do, I also consider myself to be an expert on what works. I hope I have written this book without giving the impression that I am a perfect trader, because I'm not. I struggle with being normal just as most people do. Having engaged in that struggle for so many years, I now have a pretty good awareness of what causes mistakes to happen.

My way is not the only way to approach the market, and it's not going to be the best way for every investor. I believe it works well for people who manage their own money. It's not practical for the large institutional investors with millions of dollars under management, although many of my principles will be helpful to them too.

As an individual investor, you have many advantages over a large institutional investor. It is easier to manage a smaller capital base and extract a market-beating return with it. You must, however, make sure that your approach matches the amount of money you are using. Most traditional approaches to analyzing the market and investing in it require significant resources and knowledge. My approach does not. You need nothing more than a computer with access to the Internet.

You now know my core elements for analyzing stocks, managing risk and trading effectively. I haven't provided you with my specific rules for when to buy, but everything I do in my own trading is based on the principles explained in this book. The next step is for you to define your specific strategies for when to buy and sell.

I teach a small number of aspiring traders each year my trading strategies. You can learn more about these educational programs at **Stockscores.com**.

If you decide to come up with your own trading rules and write a trading plan on your own, be sure to emphasize a methodical approach based on trading strategies with a positive expected value. You don't beat the market using gut feel; doing so may lead you to some lucky profits but eventually, those profits will be given back as losses, since luck balances out over time.

Risk management is more important than picking the right stock. If there is one area of my approach that I recommend you focus on, it is the risk management component. Even poor stock pickers can make money if they can limit losses and let profits run. Remember that if you run out of money, you are out of the game. Preserve your capital.

Don't trade the market until you have proven that you can make money on paper. You can use the trading simulator at **Tradescores.com** to practice and gain confidence. Once you can succeed in the simulator, you are ready to try trading for real.

Do so initially with a low amount of risk. You will be more emotional when you use real money, and trading successfully with a simulator can give you a false sense of security. Start slowly with a low risk tolerance and increase your risk as you make profits.

When I start trading a new strategy, I use a small risk tolerance and only increase it once I have achieved a cumulative reward for risk of 10. I then increase my risk and maintain that tolerance level until I have achieved another reward for risk gain of 10. This step-by-step process of increasing risk exposure allows confidence to build and financial risk to be minimized, since you risk profits as you succeed more and more. You will maintain better control over your emotions if you go step by step like this.

Make sure you write down your trading plan. There will be times when trading frustrates you, and it's easy to get off track as emotions build. Having a written plan gives you something to go back to and a way to identify your problem areas.

Most importantly, have fun. I know of no pursuit that is more challenging or fulfilling than trading to beat the market. You will be a more successful trader if you enjoy it.

The Person at the Top of the Mountain Did Not Fall There

Whether you choose to trade my way or devise your own strategies is up to you. Trading is simple but it's not easy. As Yoda said, "Do or do not. There is no try." Like anything in life, you can only be successful with effort. You don't get successful at anything by trying; you must make success happen. Success does not care how nice a person you are. It is attracted to hard work and determination.

When you trade, you're competing against thousands, if not millions, of other market participants. There can be more than one winner, but there can also be many losers. Those who win have put in the effort to create market-beating strategies.

Finally, remember that you are not smarter or more knowledgeable than the market. The market has proven that to me almost every time I tried to be smart. It's much better to avoid common sense and simply let the market tell you what to do. Be a mindless investor.