With major market changes continuing to occur and a majority of investors still reeling from the recent financial meltdown, many people have no idea what to do next. The solution is not to panic, but to become educated in the new dynamics of today’s market—and with Winning Edge Trading as your guide, you’ll discover what it takes to thrive, even amidst the most adverse conditions.

Author Ned Gandevani—a professional trader and developer of the renowned Winning Edge Systems™—has trained and coached traders for more than a decade. Now, with this new book, he provides both seasoned professionals and aspiring individuals with a practical approach toward becoming better traders and active investors. Written in a straightforward and accessible style, Winning Edge Trading outlines an approach based on long-term and strategic planning, but short-term and tactical management. It opens with an informative discussion of the new trading paradigm and quickly moves on to address the sound trading system and proper trading psychology that will allow you to successfully navigate this dynamic environment.

Divided into four comprehensive parts, Winning Edge Trading:

- Provides an in-depth exploration of the Winning Edge Trading System—from its signals to its protective stops—and reveals how the system can be used to day trade, swing trade, or position trade.
- Explores the various instruments and markets—such as stocks and futures to exchange-traded funds (ETFs)—and how you can successfully trade them.
- Compares technical and fundamental analysis and covers the Fibonacci Concept in detail.

And as a special offer for those purchasing this book, you’ll receive a free one-week subscription to any of the Winning Edge Trading Signals for the S&P Futures markets. This will allow you to gain access to the Winning Edge Trading Signals—day, swing, or position—of your choice.

Filled with in-depth insights and expert advice, Winning Edge Trading is essential for active investors and traders who are frustrated by stagnant and declining markets. With the strategies and systems found here, you’ll be in a better position to maximize trading profits while minimizing potential risk.

NED GANDEVANI, PhD, is a professional trader and developer of the renowned Winning Edge Systems, which is based on chaos theory. He has trained and coached many professional traders for more than a decade and written numerous articles, which have been published in magazines such as Technical Analysis of Stocks and Commodity, Futures, and Stocks, Futures, and Options (SFO). Dr. Gandevani is a member of the American Finance Association (AFA), the Society of Quantitative Analysts (SQA), and an affiliate member of the Market Technician Association (MTA). He teaches graduate-level and MBA courses at Keller Graduate School of Management in Long Island City and Manhattan.

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PRAISE FOR WINNING EDGE TRADING

“Dr. Gandevani has written another excellent book. This time, he shares some of his most specific and practical trading strategies and insights. After describing the ‘pitfalls’ of old trading systems, he very usefully and concisely explains his system to help day traders, swing traders, and position traders. The section on investment psychology is also a must-read for every serious trader. I am very pleased to recommend this excellent piece of work focusing on trading and investment in practice.”

— DR. EHSAN NIKBAKHT, CFA, Professor of Finance, Hofstra University

“The recent credit crisis has permanently altered the financial landscape we knew and trusted. Ned convincingly documents this important paradigm shift in financial markets, and more importantly, his forward-looking approach incorporating investor psychology can greatly benefit both the novice and experienced trader.”

— ANDREW C. SPIELER, PhD, CFA, FRM, Director, Quantitative Finance Program, Frank G. Zarb School of Business, Hofstra University
Winning Edge Trading
Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia, and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers’ professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market’s ever changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional or somewhere in-between, these books will provide the advice and strategies needed to prosper today and well into the future.

I dedicate this book to my dear family, who have been a major source of inspiration in my life: my patient wife Mieko and my beautiful girls, Ariana, Analisa, and Malisa.
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Preface

The purpose of this book is to help people learn how to become successful as traders and active investors. Designed with both the novice and the professional in mind, it is chock full of useful information for traders at every level. With the major changes in the stock market and all the confusion and misinformation that have surrounded it recently, this book offers essential advice for thriving in this field, even in adverse conditions. There are multitudes of people out there (perhaps you are one of them) who have lost a great deal of money and have no idea what they should do now. The solution is not to panic; the solution is to become educated in the new dynamics of today’s market.

Part I begins with an analysis of the great stock market meltdown that had serious ramifications for the world economy in 2008. We demonstrate that traders who did not have a robust trading system in place were not equipped to handle the volatility of the markets. We explore the various causes of the crisis in some detail, delving into the financial history that led up to it.

We see how the housing “bubble” burst and the adverse impact that event had on the overall economy. We also see how credit dried up and various banks and other financial institutions failed.

A “rescue plan” is then introduced—not the kind that comes from the government but a realistic strategy for trading in this new environment. The concept of making the transition from an “investor” to a “trader” is outlined, highlighting the many benefits of the latter approach.

New market conditions, emphasizing flexible and active management, are considered, along with factors such as trading volume, volatility, and intermarket relations. The section ends with a comparison of the older methods and the newer ways of trading.

Topics considered in this section include flexible and active management, intraday trading, diversification, and tax efficiency.

Part II begins with an exploration of the various types of trading markets. We also examine things such as profit-and-loss calculations,
regulations, and taxes. Strategies involving things such as leverage, short-selling, and margin buying are introduced.

Part II introduces the many challenges of trading stocks. These include things such as fundamental valuation methods, which utilize different financial ratios such as price-to-earnings (P/E), earnings per share (EPS), price to sales, price to book, and other ratios.

Futures markets, including various types of futures commodities, are explored as well, in a good degree of detail.

Part II also goes into some detail regarding various challenges when it comes to trading in today’s markets. The concept of “mark to market” is also explained, as are exchange-traded funds (ETFs). Technical analysis and fundamental analysis are compared and contrasted. The Fibonacci concept is studied in some detail as well.

Part III begins by describing how the market operates as a system. We consider different types of systems and the roles that fear, greed, and hope play in the market. Habitual patterns, cyclical behavior, and market trends are discussed, along with various observations about the market’s behavior.

In this part we also begin an in-depth exploration of the Winning Edge Trading System. We discover that it has various types of signals, including long, short, and exit signals, and we examine various protective stops, too. We also see how the Winning Edge System can be used successfully for day trading, intermediate trading, and “swing” trading.

We also describe a day-trading system for e-minis futures. This demonstrates how you have a better chance to become successful if you execute the signals successfully and with proper discipline. Taking a short signal in the S&P 500 futures contracts is explored as well.

Part III concludes by examining things such as Russell futures contracts and ways to cover or exit your trades.

Part IV contains an in-depth discussion of personality profiles. It closely examines the various scientific theories of human behavior and goes into detail on the most prominent ones. It demonstrates how and why it is so important that a trader’s system be a good match with his or her individual personality. The futility of working with a system that is incompatible with your unique character traits is explained, and we discover the secrets of using our own particular habits and ways of thinking to our financial advantage as professional traders.

Not only is each personality profile studied in great detail, but so is the concept of personality itself and its importance to trading. Two primary approaches to studying human personality are considered: the ideographic approach and the nomothetic approach.

The ideographic approach is briefly presented. It encompasses the major theories such as Freud’s psychoanalytic theory and humanism, social,
and cognitive theories. The second approach to the study of human personality, the nomothetic approach, includes personality types and traits theories, which try to study the similarities and differences between individuals and categorize them.

Other approaches that are studied include social-cognitive, humanistic, and dispositional. We discuss various personality tests and their relevance for determining the best kind of trading system for each individual to adopt.

*Winning Edge Trading* provides you with a practical and proactive approach to your investment and trading activities. The recent financial market crisis proves once and for all that the old paradigm of investing does not yield profitable and sustainable investing returns. Billions of dollars in public wealth have been destroyed. The majority of the investing public lost their hard-earned fortunes and retirement hopes just by listening to the advice of long-term investing proponents. *Winning Edge Trading* offers you a new alternative to the investing myth of the “buy-and-hold” strategy. This book presents you with a new way of investing based on long-term and strategic planning but short-term and tactical management.

NED GANDEVANI  
May 2009  
New York
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My efforts for this book could not have come to fruition without the great help and hard work of Meg Freeborn, my development editor, and the prudent guidance of Kevin Commins, executive editor, at John Wiley & Sons. Thank you!

—N. G.
PART I

The New Trading Paradigm
The turbulent U.S. economy and stock market have recently encountered a chaotic and challenging chain of events. The year 2008 may be recorded as the worst year ever for the phenomenon of wealth destruction for investors and traders. Despite the massive $820 billion U.S. government bailout, the stock market has continued its spiral sell-off and meltdown. For early March 2009, the Standard & Poor’s (S&P) 500 index, since peaking at an all-time closing high of 1,565.15 on October 9, 2007, had lost 57 percent. The Dow had lost nearly 54 percent since closing at an all-time high of 14,164.53 on the same day in 2007. Since hitting a bull-market high of 2,859.12 on October 31, 2007, the NASDAQ had lost 56 percent.

Investors suffered a great blow when the S&P 500 plunged to a 13-year low as fears of a prolonged recession sparked a massive selloff, closing at its lowest point since April 1, 1996. However, as investors experience their biggest-ever losses in pension funds and investment portfolios, some financial gurus and advisors continued to spew out “stay the course” advice. They dispense this so-called wisdom as though we hadn’t learned the hard lesson of listening to their irresponsible and downright fraudulent advice just months before on some of Wall Street’s long-term holdings, such as Lucent, WorldCom, Enron, Merrill Lynch, and Bear Stearns.

Wall Street today is encountering its most disastrous crisis in decades. The demise of Lehman Brothers and Bear Stearns, the federal bailout of mortgage giants Fannie Mae and Freddie Mac, and the forced sale of Merrill Lynch to Bank of America are on the growing list of casualties in this ongoing financial crisis. As of July 10, 2009, the Federal Deposit Insurance Corp. (FDIC) announced that 79 banks failed in 2008 and 2009.
According to an FDIC press release dated August 26, 2008, "rising levels of troubled loans, particularly in real estate portfolios, led many institutions to increase their provisions for loan losses in the quarter. Loss provisions totaled $50.2 billion, more than four times the $11.4 billion the industry set aside in the second quarter of 2007. Almost a third of the industry’s net operating revenue (net interest income plus total noninterest income) went to building up loan-loss reserves."

A great deal of consumer wealth has dissipated as a result of recent stock market losses; consumers now have far less money to spend. Unemployment has been rising as well, so overall there is less money in the economy. Without this money circulating in the economy and with nothing to replace it, it is hard to see where the resources will come from to generate an economic recovery.

According to the Washington Post of October 8, 2008, a top Congressional budget analyst said, “The stock market’s prolonged tumble has wiped out about $2 trillion in retirement savings over 15 months, a blow that could force workers to stay on the job longer than planned, tighten their wallets and possibly further stall an economy reliant on consumer spending.”

Many investors have been shocked to open their 401K, individual retirement account (IRA), and pension funds statements to see a tremendous loss in their nest-egg savings. What happened? they ask, dumbfounded.

A quick glance at the prices for stocks held by the majority of the investing-class population amply illustrates the ugly side of the “investing for the long term” theory. Table 1.1 depicts 15 of the most widely held stocks in pension funds, mutual funds, and institutional and investor portfolios. As an investor you might have experienced the agony of opening your monthly statement, only to see the latest loss in your investment and pension fund portfolio. You have no doubt noticed how drastically your equity account has depreciated if you were holding any of the well-publicized “sound” investment stocks, including National City Corporation (NCC), Morgan Stanley (MS), Fannie Mae (FNM), Freddie Mac (FRM), Wachovia Corp. (WB), General Electric Co. (GE), Apple Inc. (AAPL), Washington Mutual (WM), American International Group (AIG), MBIA (MBI), Ambac Financial Group (ABK), Citigroup (C), Lehman Brothers Holdings (LEHMQ), Merrill Lynch (MER), UBS (UBS), Bank of America Corp. (BAC), General Motors Corp. (GM), or Ford Motor Company (F).

According to Bloomberg News, about 56 percent of hedge funds posted losses in October 2008. They lost 18.3 percent in 2008, their worst year on record. Their total loss amounted to $350 billion globally in 2008, the highest on record. Hedge fund assets fell $100 billion in the month as investors withdrew their money and funds were forced to sell stock, exacerbating the severe volatility that pounded global markets during the month. Hedge
TABLE 1.1 Price Changes for Some of the Most Widely Held Stocks, 2007–2008

<table>
<thead>
<tr>
<th>No.</th>
<th>Stocks (Ticker Symbol)</th>
<th>52-Week High</th>
<th>52-Week Low</th>
<th>52-Week Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>National City Corp. (NCC)</td>
<td>$20.49 (11/30/07)</td>
<td>$1.25 (9/29/08)</td>
<td>−91.82%</td>
</tr>
<tr>
<td>2</td>
<td>Morgan Stanley (MS)</td>
<td>$55.39 (12/24/07)</td>
<td>$6.71 (10/10/08)</td>
<td>−79.86%</td>
</tr>
<tr>
<td>3</td>
<td>Fannie Mae (FNM)</td>
<td>$40.45 (12/31/07)</td>
<td>$0.30 (11/21/08)</td>
<td>−99.07%</td>
</tr>
<tr>
<td>4</td>
<td>Freddie Mac (FRE)</td>
<td>$37.18 (12/7/07)</td>
<td>$0.25 (9/17/08)</td>
<td>−98.45%</td>
</tr>
<tr>
<td>5</td>
<td>Wachovia Corp. (WB)</td>
<td>$45.43 (12/7/07)</td>
<td>$0.75 (9/29/08)</td>
<td>−89.94%</td>
</tr>
<tr>
<td>6</td>
<td>General Electric Co. (GE)</td>
<td>$38.67 (11/30/07)</td>
<td>$12.58 (11/20/08)</td>
<td>−62.76%</td>
</tr>
<tr>
<td>7</td>
<td>Apple Inc. (AAPL)</td>
<td>$202.96 (12/27/07)</td>
<td>$79.14 (11/21/08)</td>
<td>−51.86%</td>
</tr>
<tr>
<td>8</td>
<td>Ambac Financial Group (ABK)</td>
<td>$32.28 (12/10/07)</td>
<td>$0.76 (11/19/08)</td>
<td>−95.19%</td>
</tr>
<tr>
<td>9</td>
<td>Citigroup (C)</td>
<td>$35.29 (12/11/07)</td>
<td>$3.05 (11/21/08)</td>
<td>−88.11%</td>
</tr>
<tr>
<td>10</td>
<td>Lehman Brothers Holdings (LEHMQ)</td>
<td>$66.58 (2/01/07)</td>
<td>$0.02 (9/30/08)</td>
<td>−99.95%</td>
</tr>
<tr>
<td>11</td>
<td>Merrill Lynch (MER)</td>
<td>$63.11 (12/10/07)</td>
<td>$7.08 (11/21/08)</td>
<td>−84.42%</td>
</tr>
<tr>
<td>12</td>
<td>UBS (UBS)</td>
<td>$51.89 (12/10/07)</td>
<td>$8.33 (11/20/08)</td>
<td>−79.11%</td>
</tr>
<tr>
<td>13</td>
<td>Bank of America Corp. (BAC)</td>
<td>$47.00 (12/11/07)</td>
<td>$10.01 (11/21/08)</td>
<td>−73.42%</td>
</tr>
<tr>
<td>14</td>
<td>General Motors Corp. (GM)</td>
<td>$29.95 (11/30/07)</td>
<td>$1.70 (11/20/08)</td>
<td>−88.73%</td>
</tr>
<tr>
<td>15</td>
<td>Ford Motor Co. (F)</td>
<td>$8.79 (4/24/08)</td>
<td>$1.01 (11/20/08)</td>
<td>−80.11%</td>
</tr>
</tbody>
</table>

*Data source: Yahoo! Finance.*

fund assets totaled $2.497 trillion at the end of the third quarter, according to HedgeFund.net, a hedge fund data provider.⁴

The demise of Bear Stearns and Lehman Brothers, for years seen by investors as reliable, represented two of the more prominent failures, reinforcing the fact that many institutional and professional traders were caught by surprise when the current financial crisis struck. Their trading systems and risk management strategies, which were based on some market model that had presumably worked well in the past, were unable to foresee the financial markets’ meltdown.

The events of 2008 have led to seemingly peculiar and strange market behavior for many active investors and traders. Traders who lack an organic market timing method and a robust trading system have been unable to cope with the current market volatility. You could be like the many active investors and professional traders who have lost a great deal of
money by trying to apply an old system to new market behavior. Despite your disciplined methodology and your best efforts to follow a trading system, you might be finding that your trading losses are growing faster than your profit. Maybe it’s becoming more challenging and difficult to trade your favorite security and market. Times have changed—but your way of thinking has not!

Needless to say, to be successful at trading you need a sound system that is resilient enough to adapt to different market conditions. All trading systems are rule based, and the simpler systems seem to be more successful and adaptable when there are major market shocks. However, to develop a system, you need to have a realistic view of market behavior. In other words, without a valid and sustainable market model, you can’t develop a robust system. And without a robust system, you cannot become a successful trader. What you must always keep in mind is that a thriving and profitable trading system, which is a collection of rules and trading strategies, has to be based on some realistic market model that explains market behaviors in varying conditions.

In this book I present you with my Winning Edge market model, which is nonlinear and based on dynamic system behavior. Furthermore, I show how you can develop a winning system based on my model. Before we proceed any further, however, let’s see what is so unique and different about recent market price actions. To do so, we first review the current market conditions to build a foundation for developing a robust system.

### PRIMARY CAUSES OF THE CURRENT FINANCIAL CRISIS

The current financial crisis is attributed mainly to three factors: cheap money due to low interest rates; excessive borrowing by three economic sectors (consumers, corporations, and government); and lack of proper oversight and vigorous standards.

Low interest and cheap money were available for all, with less discretion. As a prolonged response to September 11, 2001, Federal Reserve Chairman Alan Greenspan cut the overnight Fed rate 13 times, to a mere 1 percent effective rate. After the stock market crash in 2000 and the bursting of the tech sector bubble, this action carried down all the major indices. It seemed that investors once more learned that “irrational exuberance” leads to a correction in market participants’ mindsets and financial settings. The NASDAQ index fell 60 percent while the S&P index and Dow Jones, two other major equity market indices, fell 50 percent and 40 percent, respectively. However, the housing market was on a path to reach an “exuberant” growth.
The stage was set by Baby Boomers at their peak productivity, by low interest rates, and by Bush Administration policy that encouraged banks to lend to low-income sectors and poor neighborhoods under the Community Redevelopment Act. Finally, the relaxed lending models used by Freddie Mac and Fannie Mae contributed to the creation of one of the highest-ever price appreciations for the U.S. housing market. Hedge funds and financial managers kept pumping more cash and funds into ever-heating housing sectors. Quasi-government agencies such as Fannie Mae and Freddie Mac, which had the unofficial backing of the government, purchased all types of mortgages, called papers, either grade A, B, or C. The clever investment bankers seized the opportunity to make more profit by buying these papers in bulk and securitizing them in more values to sell them to money markets, pension funds, insurance agencies, and public investors. Wall Street and the financial markets were shifting into a new gear to create a highly artificial and shallow economic expansion.

However, homeowners used their houses like automatic teller machines to withdraw more funds under home-equity lines of credit (HELOCs) for all types of discretionary and unwarranted expenses and speculative investing in real estate and hedge funds. Corporations kept buying their own shares to boost up their stock prices by borrowing more money and issuing more debt. The U.S. government and the Bush Administration were on a shopping spree of their own kind and kept spending, to become the second largest spender and holder of deficits since the FDR Administration.

In the past few years, about 60 percent of our gross domestic product (GDP) growth was the result of big government spending. The other 40 percent was primarily from the housing bubble. However, as the saying goes, all good things must come to an end. Some of the subprime borrowers were not able to make their mortgage payments because the interest rate was going up. They rushed to sell their real estate. Consequently, as more supply came to the market and there was less demand, prices had to come down. As the housing market fell and real estate prices dropped, the vicious market meltdown cycle began. Consequently, more borrowers and homeowners had more difficulty making their monthly mortgage payments, resulting in an even greater price drop. However, some homeowners found that their houses were less valuable than the amount they owed to the bank. This led them to file for bankruptcy and leave the houses for the banks to foreclose on.

Securitization of mortgages created a huge supply of mortgage-backed securities (MBSs), which were sold to mutual funds, money market funds, pension funds, and insurance agencies. The Wall Street genius investment banks went even further. That is, if mortgage-backed securities were sold to investors, they created collateral mortgage obligations (CMOs), some of
them very high risk and below investment grade. To push these securities into financial distribution channels, our clever financial engineers created credit default swaps (CDSs) to insure the CMOs, MBSs, and other bonds and papers so that the sellers of debt instruments could convince buyers to buy their bonds. Now MBSs and CMOs were in big trouble. However, as the CMOs, MBSs, and other structured debt instruments got into trouble, the CDS market and the insurance market got into hot water, too. Giant international insurance agencies such as American International Group (AIG), which insured a large number of CDSs, were not able to keep up with payment defaults. As AIG went under, the foundation of the CDS market, which had grown to about $6.5 to $7 trillion, was shaken.

As the housing prices dropped and more homeowners were forced into foreclosure, the values of MBSs and CMOs dropped as well. Furthermore, since 2001 the financial institutions reporting rules had changed from cost-basis to mark-to-market value. (See Appendix A for more information on valuation methods.) During the housing market rise, financial institutions had been quite happy and felt rich because they could show very valuable assets on their financial balance sheets. Consequently, showing high-valued assets enabled them to borrow more and create stronger leverage.

However, as the housing prices fell, the same institutions did not have much to show for it. Moreover, since they had to report based on mark-to-market, either there was no market for their assets or it was very low, about 25 to 30 percent of original prices. This meant that each asset had to be devalued.

New Federal Reserve Chairman Ben S. Bernanke presented the situation at the National Association for Business Economics 50th Annual Meeting in Washington, D.C., on October 7, 2008:

...financial systems in the United States and in much of the rest of the world are under extraordinary stress, particularly the credit and money markets. The losses suffered by many banks and nonbank financial firms have both constrained their ability to lend and reduced the willingness of other market participants to deal with them. Great uncertainty about the values of financial assets, particularly more complex and opaque assets, has made investors extremely reluctant to bear credit risk, resulting in further declines in asset prices and a drying up of liquidity in a number of funding markets. Even secured funding has become expensive and difficult to obtain, as lenders worry about their ability to sell collateral in illiquid markets in the event of default. In addition, many securitization markets, such as the secondary market for private-label mortgage-backed securities, remain closed or impaired.\textsuperscript{5}
The equity and stock market sold off to react to a financial crisis that seemingly began in the United States and soon spread across the globe. As the credit market dog was wagging its stock market tail, more financial problems came into play. The liquidity crisis changed to a confidence crisis. The central banks in the United States and across the world tried to calm the market anxiety by injecting more liquidity and reducing the overnight rates.

Fed Chairman Bernanke continued:

AIG’s difficulties and Lehman’s failure, along with growing concerns about the U.S. housing sector and economy, contributed to extraordinarily turbulent conditions in global financial markets in recent weeks. Equity prices have fallen sharply, the cost of short-term credit, where such credit has been available, has spiked, and liquidity has dried up in many markets. One money market fund’s losses forced it to “break the buck”—that is, the value of its assets fell below par—an event that triggered extensive withdrawals from a number of money market funds. Those funds responded to the surge in redemptions by attempting to reduce their holdings of commercial paper and large certificates of deposit issued by banks. Some firms that could not roll over maturing commercial paper drew on back-up lines of credit with banks just as the banks were finding it even more difficult to raise cash in the money markets. At the same time, a marked increase in the demand for safe assets—a flight to quality and liquidity—resulted in a further drop in the value of mortgage-related assets and sent the yield on Treasury bills down to a few hundredths of a percent.6

In the following sections, we preview methods that you can use to deal with the current financial market meltdown.

DEALING WITH THE EMOTIONAL TOLL

Don’t count on the market or on government to rescue you. You need to be proactive and take matters into your own hands. It’s easy to blame the market and feel petty, falling into the victim mindset. If you are like many traders who experienced great losses in their investment and equity accounts, you might have gone through four distinct emotional stages: denial, anger, helplessness, and hopelessness.

First you went into denial due to total shock over the unexpected losses you experienced. It might have taken some time for you to realize what happened and what consequential changes you had to make to your
lifestyle and spending habits. However, as time passed and you watched more TV reports, read more articles, and heard more financial news, you gradually came to an emotional realization about what occurred. You understood that a financial crisis had swept the nation, wiping out the majority of your equity.

Then perhaps you grew angry as the second stage of dealing with this phenomenon. You felt upset and aggravated and couldn't take it anymore. You felt like screaming and expressing your anger. But then the anger passed and you moved on to feeling helpless. You felt you had lost control and there was nothing you could do to stop the massive loss and burden on your life. As the catastrophe spread to other financial institutions and companies, you recognized this is a massive market correction that was becoming a great market meltdown. You decided to follow the advice of the best financial advisors. You invested in the top-name hedge funds, which had enjoyed an impressive return in the past five years or so.

As you continued dealing with your losses, you reached the last stage: feeling hopeless. You started to experience emotional withdrawal. You didn't feel like socializing with your friends and kept quiet in family and social gatherings. Sometimes you felt like you wanted to sleep forever and shield yourself from the burden of your financial losses, which had created a glum outlook for your life. You could care less what came next.

This stage, if not dealt with quickly, could create a major psychological problem for you. This is the time when you need to take control of your financial destiny again, seeking solutions and, if necessary, professional advice.

If you are among those who have been holding the bluest of stock market blue chips, hoping that they go back up so you can at least break even, here's some sobering news for you. Your stocks and investments need to have moved up 1,000 percent in some cases, or even more, just to reach the price they were before this great stock market meltdown! If you think this is incredible, think about Freddie Mac's stock price, for example; it was $37.18 on October 31, 2007, and dropped to $0.25 on September 17, 2008. It would take more than a 14,000 percent increase just to reach the original price for breakeven!

It's time to look for a real plan and implement a real solution to get you out of such a financial mess.

The past is past; there is no sense feeling bad about your past losses. Take your past as an expensive life learning lesson and move on. Remember,
there is no way you can control market behaviors. But you can control your own behavior. Here is a five-step process for rescuing yourself from this financial disaster:

1. Don’t blame the market, or anyone else, for your investing losses.
   
   Even people who’ve built careers studying economics were caught by surprise when the recent market turmoil struck. If professional investors were hard hit by the crisis, you obviously weren’t going to emerge from it unscathed. And don’t blame the market itself, either. It is simply a function of various factors and the dynamic ways in which they interact with one another. Accept what has happened—and the fact that the markets as well as your financial situation will not snap back to the way they were—and move forward. Life goes on, and the life of the market does, too.

2. Take personal responsibility for the things that you can control.
   
   Whatever you do, never adopt the mentality of a victim. Whatever losses you have taken, you know that investing always comes with a certain amount of risk. You can never truly win at something if there is zero chance of losing. I urge you to use this sobering realization as a launching pad for greater success in the future. It is a sign of wisdom and maturity to know the difference between those things that are within your control and those that are not. You must learn to skillfully control and benefit from the former and bravely accept and endure the latter.

3. Become a trader.
   
   As part of taking control of your own financial destiny, you should take a more active role in your investing. This means becoming a more active trader. The main difference between an investor and a trader is the frequency of their decision making. A trader makes more investing decisions with the help of a system. A trading system is a collection of trading rules that have been tested in various market conditions through a back-testing process (against historical data) and have proved to constitute a sound and robust system.

   Never forget that you are captain of your own financial ship, so to speak. Steer her in the right direction and you are headed for a happy destination. But it is also your duty and obligation to yourself to be a vigilant watchman, on the lookout for any icebergs that may loom on the horizon.

4. Learn a winning investing plan and trading system.
   
   To become a successful trader, first and foremost you need a proven and sound trading plan or system. In this book, I’ll teach you about my Winning Edge System that can help you become a successful trader.
5. Trade your plan.

Having a winning system is an essential part of your trading success. However, you need to work your plan and implement it properly. To execute your plan flawlessly with no emotional burden, your trading system should be compatible with your personality and psychological makeup. In this book I provide you a test that can identify your important personality traits. By knowing your trading personality, you could achieve a much higher level of success and execute your trading plan under stressful market conditions.

The essence of this rescue plan is taking an active role in creating your own financial destiny. Devise a proper strategy to adapt to those events that are not under your control. However, be proactive and implement a sound plan to achieve your financial prosperity and success. This begins with transforming yourself from a passive investor to a proactive trader. Consequently, for maximum performance you must plan for the long term but monitor and execute your plan in the short term.

**TRANSITIONING FROM INVESTOR TO TRADER**

One of the most important steps to achieve your financial rescue is to transform yourself from a passive and long-term investor to a proactive trader. You could become a part-time or full-time trader, but if you invest actively and decide what to invest in and how to monitor your investment portfolio and positions, you’re a trader.

Make sure you go into your trading endeavor with both eyes wide open, realizing how the investment world has changed. There’s an important mental shift that you need to make to begin your journey toward financial independence and success. You need to fully comprehend the various drastic changes that have taken place in terms of the way investments work. To become a successful trader, you should have a better understanding of the new market conditions, which is the topic of Chapter 2.
The investment world is in the midst of a paradigm shift. This change might be stressful and cause many losses for traders who fail to recognize it or for those who do indeed recognize the change but fail to adapt to it. Conversely, traders who wisely utilize the new conceptual framework of the financial system will succeed and enjoy better performance from their trading.

The new paradigm of trading offers you opportunities to achieve higher performance with less risk in a speedy manner. This represents a major departure from what was once, not long ago, commonly accepted practice. Now, short-term and flexible investment management and decision making are the order of the day. They replace protracted, inefficient, long-term buy-and-hold strategies that are no longer practical in today’s investment environment.

New concepts, such as the exchange-traded fund (ETF), for example, are swiftly replacing mutual funds, its old counterpart. This is because traders display more inclination toward risk in exchange for higher performance by embracing hedge funds and other exotic investment strategies.

To be a successful trader and achieve great performance from your trading, you need to change the way you were taught and trained about investing. The old ways of doing things are simply not going to work anymore. You need to learn and understand new concepts, tools, and trading models that are more suitable and productive for the current information age. The advent of technology has enabled us to obtain information faster than ever. The Internet makes all the information you might need only a simple mouse click away. There’s no longer any need to get locked into an
investment idea or any particular stock. That type of conundrum belongs to the old ideas we were taught that insisted that to make a great return we should buy and hold for the long term, since that was the only way to be profitable. Otherwise, we were told, we were trading “noise.” However, we saw many of Wall Street’s darlings drop from their historical high to almost zero while we held them. So much for buy and hold!

You need to adapt a new mindset. To benefit and harvest your optimal return on your investment, it’s time to think differently about investing. Consider this: When your stock was at an all-time high, if its fundamentals were still valid, you could have sold it and then bought it again at a much lower price. You were taught that you should invest for the long term, but you never realized that “long term” is a vague concept with no real benefit. You invested your hard-earned money in a mutual fund, you waited and waited, but now that it is time for you to retire, all your gains have been wiped out due to market corrections. You’re left with nothing except a hollow dream and empty pockets as you enter your Golden Years. Don’t let this happen to you, or at the very least don’t let it happen to you again.

In the following sections, we explore some of the main characteristics of the new trading paradigm.

**ONLINE TRADING**

Not too many years ago, you probably had to make a phone call or see your broker in his office to tell him what to do about your stock and investment holdings. However, these days you’re likely to use a trading platform provided by a brokerage house to place your orders. Whether you are a professional or novice trader, you could go online and buy or sell your stocks or any other investment holdings in a matter of seconds. What a huge difference this makes when it comes to the ease with which you can conduct business. You no longer have to leave a message for your broker and wait for him to call you according to his work schedule. The speed of transactions has jumped from tediously slow to lightning fast. Thanks to advanced technology and the Internet, even in hectic markets you can do what you like.

You should keep in mind that dealing with brokers does bring its emotional burdens, too. How many times didn’t you make that phone call to sell your stock because you just didn’t want to hear your broker try to sell you another stock story? Then you waited and kept losing on the stock. The resulting regrets that you suffer can really take a toll on your peace of mind and even your health.

According to World Economic Forum, J. Joe Ricketts, chairman and chief executive officer of Ameritrade Holding Corporation, one of the
largest online brokerage firms in the United States, predicted that “... no more than six or seven brokerage firms would ultimately dominate the market for online investing, forcing the remainder to consolidate or exit the industry.” Ricketts estimated that the total customer base for online brokerage in the United States now includes approximately 100 million investors.  

Figure 2.1 depicts steady increase in trading volume shares at the New York Stock Exchange from 1996 to 2005.

FLEXIBLE AND ACTIVE MANAGEMENT

You no longer need to wait for the end of the year to make proper tactical changes in your asset allocations and holdings. Astute traders with proper technical analysis knowledge and tools are able to adjust their portfolio’s holdings for maximum performance in response to adverse market conditions or new promising opportunities at any time of the year.

EXCHANGE-TRADED FUNDS

Since the inception of the first exchange-traded fund (ETF), SPDR by State Street Global Advisors in 1993, ETFs have continued to gain popularity and attract assets at a rapid pace. Contributing factors in the popularity of ETFs
are their low associated costs and expenses, flexibility, and tax efficiency. These great benefits have made ETFs one of the favorite new kids on the investment block and quite popular. Let’s briefly review each of the ETF’s features:

- **Trading market basket or index with one stock.** ETF is like a mutual fund that is comprised of many possible stocks but trades like a single stock. This enables you to hold different market indexes as just one single stock. The most popular ETFs are SPY, Spider, which represents Standard & Poor’s 500 Large Cap Index; QQQQ, or Qs (Cubes), which represents the NASDAQ 100 technology index; and D, Diamond, which represents 30 Dow Jones industrial stocks.

- **Intraday trading.** Since ETFs are like stocks, you can trade them in intraday trading. Contrary to their counterparts, mutual funds, which can be bought or sold at the end of the business day, you can buy or sell any of your ETFs during market hours. This feature provides great flexibility and enables you to manage your investments in the presence of adverse market conditions.

- **Short selling.** As we’ve discussed, trading ETFs allows you to short-sell them if you think their price may fall. Then you can repurchase them at a lower price and turn a profit. Since ETFs are like single stocks representing baskets of specific sector or market stocks, this could mean a great advantage in producing more profits for your investment dollars.

- **Low expense ratio.** ETFs, in general, carry a much lower cost and expense ratio compared to mutual funds. The average expense ratio for an ETF is about 0.02 compared to mutual funds. This feature not only helps you gain better return on your investment capital, it helps you save money, too. ETFs truly could replace index funds, which usually have low turnover and broad diversification. You could come to really appreciate this feature, since about 80 percent of the more expensive mutual funds are unable to match or beat their corresponding benchmarks.

In mutual funds, the Vanguard 500 Index Fund is among the lowest expense index funds. However, its expense is 18 basis points compared to its counterpart SPDR 500 ETF, which is only 11 basis points. Conversely, SPDR 500 ETF’s cost is 40 percent lower than the most cited low-cost mutual fund, the Vanguard 500 Index Fund. This by itself should help you earn more money from your investment. However, you should note that since an ETF is a like stock, as with other stocks you’d need to pay a commission to buy or sell it.

- **Effective tool for diversification.** To construct a winning portfolio, you must diversify. However, your low investment capital may prevent
you from diversifying efficiently across different markets and asset classes. Fortunately, by using ETFs you are able to diversify efficiently and hence maximize your portfolio return, even when you have not invested a large amount of money. There are hundreds of ETFs that could be very useful for diversification. These ETFs cover a vast array of market indexes.

For example, there are ETFs that track major and more popular market indexes such as Dow Jones, S&P, NASDAQ, large caps, small caps, growth, and value. There are also many international ETFs that cover Europe, the Pacific Rim, emerging markets, Japan, Australia, and the United Kingdom or precious metals, gold, oil and energy, real estate, or real estate investment trusts (REITs). Some of the ETFs also pay dividends or are fixed income and more. Later chapters of this book review various types of ETF.

- Tax efficiency. Another attractive feature of ETFs is their tax efficiency. This is due to less turnover and the special structure of ETFs. For example, people trading large volumes could receive in-kind redemptions. In other words, you could redeem your ETFs for a share of stocks that they track. This arrangement, conversely, reduces tax implications for the large investors. Furthermore, you could choose to trade ETFs that don’t pay dividends or significant capital gains distributions. We’ll learn more about this in future chapters.

### MORE CHOICES, BETTER TRADING OPPORTUNITIES

Financial markets have undergone a total about-face. Today, as a result of a continuous flow of financial innovations and tactical implementations, the market scenery has become dense and far more complex than ever. There was a time when there were primarily few financial instruments, such as bank deposits, bonds, and equities. Today there are many more types of financial instruments in both cash and derivatives categories, such as stocks, bonds, money markets, futures, forward contracts, options, and the Forex spot market. Some of the new trading instruments that have taken part in forming the current financial crisis are asset-backed securities (ABSs), mortgage-backed securities (MBSs), credit default swaps (CDSs), and many more.

Nevertheless, as long as there are enough liquidity, meaningful price movements, and volatilities for any trading instruments, there lies opportunity for you to take advantage of. As a trader this new proliferation of financial trading markets could offer more chances to achieve your trading goals and become a successful trader.
NEW MARKET CONDITIONS

Financial markets have transformed into a new phase that exhibits different dynamics and price behaviors. Indeed, this is not the first time, and won’t be the last time, we witness the beginning of a new cycle in the financial markets. However, if you try to use the same trading rules you used in slower and less volatile times, you will certainly end up losing your shirt. Traders’ lack of proper flexibility and dynamic adaptation are among the chief contributors to the fact that the majority of traders lose their trading capital. If your system is not robust enough to adjust for the various financial markets’ cycles, sooner or later you will end up losing all your hard-earned money—not to mention losing your sanity!

High Trading Volume

Trading volume has increased substantially over the past few years compared to the past. In 2008, 47 percent of all households, or some 54.5 million, participated in the market through equity or bond ownership, according to a joint study by the Investment Company Institute and the Securities Industry and Financial Markets Association. This has caused the market to behave rather erratically in response to any good or negative news. On key economic reporting days, this is even more evident as the market takes wild swings in response to breaking financial news. However, later, as the market’s interpretation of the same news alters, it may fully reverse its original reaction. This in turn exacerbates the “herd mentality” effect that typically happens in the marketplace. A wide array of literature confirms the herd mentality behavior in retail and professional traders. It causes market rapid movement and an expansion of the noise level about historical and important support and resistance. This is because important price levels have been violated and can no longer be relied on, a critical element in many professional trading systems (see Figure 2.2).

In reaction to the recent economic news, traders have increased their level of participation in financial markets, which in turn could cause the markets to behave more in line with the herd mentality market model. In other words, financial markets in general, and the stock market in particular, are exhibiting even more evidence of the herd mentality. Consequently there are more upside and downside swings. When bad news hits the market as an external factor, professional fund managers and traders react, adjusting their portfolios and holdings accordingly. However, the retail investors either don’t hear about it or don’t realize the severity of the news until the next day, when mass media covers the news and the financial pundits and experts opine on the subject. This leads to a lagging effect and slow reaction from public investors, which could pressure them to withdraw
and make proper adjustments in their mutual funds or holdings. This delay causes the market to move beyond an important and historical support, which often is respected by a majority of professional traders. As a result, we see more violations of the historical levels. For example, in recent times financial markets' price levels cross frequently below or above 50- and 200-day moving averages due to high volatility. This drives a majority of mutual funds managers and financial institutions to initiate buy and sell orders accordingly.

Most professional traders incorporate some support and resistance into their trading systems. If you trade a linear system that is based on support and resistance or moving averages, you may experience two major problems. First, those levels are less respected than before. This could cause more trading and loss. In other words, as traders keep making losing and bad decisions, they look to buy some support levels and sell some resistance levels. But the market gyrates around “important” and historical support and resistance levels, thus creating a whiplash effect and even deeper losses.

Furthermore, if you consider the concept of support and resistance as many other traders do, when a support is taken out and violated, the same level is expected to act as a resistance level. Conversely, you may be guided by your trading system to short the market off the same level. However, since the noise levels of the support level do not carry meaningful volume, the market may not respect and recognize the same level as a resistance. In other words, that level never changed to a resistance to begin with. Yet your system is considering it as a resistance and tends to short the market, which may well result in further loss for you.

To become a successful trader you need to be equipped with a robust trading system that considers high trading volume and looks into the
market internals rather than just simple price behavior. Market price behavior is just the outer shell of market internals. In this book, I present to you the Winning Edge Trading System, which goes far beyond just market price consideration.

High Volatility

The recent economic news and high trading volume have induced a high volatility into the financial markets. Traders react to news based on preconceived notions. Consequently, if a majority of market participants view the recent earnings, economic news, and political or geopolitical confrontations, they tend to sell their holdings or buy new positions. This in turn creates rapid and wild swings in securities prices. One measure of volatility that is reported is the Volatility Index, or VIX. When there is too much optimism or positive sentiment in the market, VIX denotes a low reading. Conversely, when there is too much fear, the index records a high reading.

The VIX was introduced in January 1986 and is based on prices paid for put and call options published by the Chicago Board Options Exchange (CBOE). However, since January 2003 the VIX has been computed based on the implied volatility of the S&P 500 options series. This index, which is calculated throughout the trading hours, is quoted in percentage points per annum. For instance, on November 17, 2008, the VIX had a value of 81.48, which indicates an annualized implied volatility of 81.48 percent.

Traders use the VIX as a measure of market risk. However, some traders use the index as a contrarian sentiment indicator, and it's often referred to as the investor fear indicator. The VIX could determine the extreme levels of market participants' optimism or fear in the market. When the index reaches a high level—for example, 70—traders expect the market to rally since there is too much fear. This, of course, is based on the commonly quoted Wall Street adage, "The market rallies against the walls of worry." On the other hand, if the index has a low reading—for example, 15—it would indicate there is too much optimism and hope in the market, which usually ends with a sell-off and subsequent market corrections.

In the past year, the level of anxiety and concern rose among market participants so much that the VIX recorded all-time high levels, reading above 80 percent. However, despite these high readings, there was no meaningful and sustainable rally in the market. By glancing through Figure 2.3, one could note that from early 1990 to about September 2008, the market volatility index went through periods of contract and expansion but never exceeded 45 percent. However, after September 2005, the market volatility index jumped close 90 percent. Figure 2.4 depicts the volatility index for throughout 2008. In other words, according to Figure 2.4, the
level of apprehension and nervousness was rather high in 2008. If you had used the old trading rule to buy the market when the VIX reading is high, in just a few trading days you could have lost all your trading capital, if not your entire fortune! This is more evidence that the market is going through some radical changes, which, if not considered in your trading activities, could be very costly and disastrous for you. To be a successful trader, you should be equipped with a system that can adapt to new market dynamics.

High Intraday Price Swings

In addition to the recent market volatility and violent swings observed in the marketplace, we should note the intraday price swings, which have been increasing as well. On Friday, October 10, 2008, the Dow Jones

FIGURE 2.4  The 2007–2008 VIX Reading Depicts Increasing Volatility
Data source: Compiled from New York Stock Exchange data.
Industrial Average recorded its highest intraday swing: 1,215.42 points. On the next Monday, October 13, the market displayed another impressive intraday swing of 1,039.49 points.

In the past year, not only has the market made wide intraday swings, but the rate of change has increased as well. Glancing at Figure 2.5, you can observe how sharply the progressive intraday price change and range expansion escalated.

These intraday price swings are another new behavior that the market has exhibited due to the current financial crisis and the great stock market meltdown. As a trader, you should benefit from the volatility, since your profits are all based on capturing the market’s different directional moves. However, this could be true only if you have a proper trading system that can convert this seeming adversity to your benefit by issuing more profitable trading signals. Otherwise, this behavior can lead you to great loss because your system cannot withstand the recent market price vacillations.

**INTERMARKET ANALYSIS DYNAMICS**

Intermarket analysis typically reveals the relationship between two different markets. In the hands of the technical trader, this type of analysis is primarily used as a tool to evaluate supportive and confirming information of the performed analysis. It can also be a valuable tool for the position trader, whose primary outlook is the major daily trend of a market. For the day trader, however, intermarket analysis can be nothing less than a disaster.
A systematic approach to the market’s behavior supports this important assumption. External factors may perturb the market’s dynamic equilibrium and cause deviations from its habitual patterns for a short time, but after a while the market will resume its natural order and rhythm. I refer to external factors that are strong enough to influence market movement and direction as focal points (and you’ll find more on this topic in future sections). Focal points help both day traders and swing traders to take full advantage of intermarket analysis and avoid any associated pitfalls. However, in the face of the current financial crisis, some of the more established relationships don’t seem to work for now.

Markets, like elements of real life, constantly interact with one another, so movement in one will most likely cause a movement or reaction in another. Intermarket analysis takes this fact into consideration and acknowledges that markets do not behave in isolation. In a systematic approach to the study of financial markets, the elements of economy and crowd psychology influence market behavior. Along with this behavior, each market acting as a member of a larger group will interact with other members as well and therefore create intermarket relationships. The basic concept of systems theory is that everything is part of a system and each system is, in turn, part of another greater system. Analysis of any single part of a system without giving recognition to the other parts of the system as a whole (including their structures and functions) will fall short of a fuller understanding. The general systems theory enables technical analysts to better appreciate the complexity and interrelated nature of their studied markets. A good example of an intermarket relationship is when the equity market reacts to a sell-off in the bond market, which in turn affects the commodity and U.S. dollar markets.

Bar Rosenberg, in the Journal of Portfolio Management, writes:

Studies in equity and bond markets confirm that broad-based indexes of returns within each market are highly correlated, even though the included securities and index weights are different. The correlation is high because any widely based and correctly computed index tends to show up the prominent factor and becomes a surrogate for it.3

According to John Murphy, “Intermarket technical analysis refers to the application of technical analysis to these intermarket linkages.” Furthermore, he asserts that:

[It] is no longer possible to study any financial market in isolation, whether it’s the U.S. stock market or gold futures. Stock traders have to watch the bond market. Bond traders have to watch the commodity markets. And everyone has to watch the U.S. dollar.4
In the recent market meltdown, we could see those markets that used to act against each other and move in reversal to each other instead moving in lock-step and in tandem. For instance, the energy sector in general and the oil market in particular would move down as the broad markets like S&P and Dow Jones sold off. However, in the past any upward move in the oil market would signal a possible sell-off in the general market due to possible high energy costs and less potential profits.

**FUNDAMENTAL ANALYSIS, HELP ME NOT!**

According to fundamental analysis, markets could misprice a security in the short run, but in the long run it would find and correct to its “fair value.” Therefore, an investor could use this opportunity to make a profit. The primary tools of fundamental analysts are the company’s financial statement and ratio analysis. They use different stock and bond value models to determine the under-priced or over-priced security.

However, there are two major problems with this approach when it comes to trading. First, the information is old and has already been considered or discounted by other investors and market participants. Second, traders tend to make their decisions based on emotions and justify them via rationalization. Moreover, as confirmed by behavioral finance findings, investors are heavily influenced by their emotions in their decision-making process. This is evident in the market when a certain stock is widely sold despite good fundamental news about the company, or when investors buy a stock despite the company’s negative earnings and poor financial health. But it’s not a good idea to use fundamental analysis in your trading strategies. Many “value” stocks that have been the darlings of Wall Street now are trading with more than 90 percent correction from their highs in just the last year (see Table 1.1 for an example). The main premise behind fundamental analysis is this belief that ultimately, a security or company’s stock value will be governed and determined by the firm’s productivity and profitability.

Among the widely used ratios in fundamental analysis is price-to-earning (P/E). There are several pitfalls in using this method to buy or sell a security. The first and foremost is the accounting method for calculating earnings. Although a publicly held company must adhere to the generally accepted accounting principles (GAAP), earning per share (EPS) could nonetheless be distorted and twisted by companies. More than 100 accounting and financial scandals have taken place recently, such as those at Enron, MCI, and Worldcom, just to name a few. The accounting method of inventory is another tool that a company could use to manipulate its
earnings. Consequently, a low P/E ratio does not necessarily indicate that a security is underpriced and therefore is a good buy for an investor. However, a low P/E ratio could easily mean that market participants have learned about the company’s problems with earnings or do not trust the reported figures. In future chapters, we examine in more detail why you should use technical analysis instead of fundamental analysis to become a successful trader.

However, successful traders know that using fundamental analysis alone does not help them identify a buying or selling opportunity in the market. You’ll be equipped with my Winning Edge Trading System, which enables you to identify any potential shift in a security’s price behavior. If a security has been advancing upward and making new highs, a trader with the advantage of the Winning Edge System is poised to project the turning point, an overbought condition of the security. This alerts the trader to sell his positions in the security and protect his profits. By doing so, he is able to create much better profits and returns for his account.

As the market changes and shifts into seemingly new behavior, the majority of professional traders began to notice their trading performance spiral downward into massive losses. Both institutional and novice traders have been experiencing this phenomenon. However, if your trading system had been developed based on chaos theory, which is capable of examining market behavior, you would not have been worried. In Chapter 7, we go over some of the basic tenets of my market model, which is based on nonlinear dynamic system behavior, so we can develop a robust trading system. A profitable trading system in any market conditions should be based on a realistic model of market dynamics.
CHAPTER 3

Pitfalls of the Old Investing Paradigm

To appreciate the major changes that have taken place in our investment world, you should be cognizant of the old-paradigm investment traits. They include buy-and-hold strategies, investing for the long term, using mutual funds as major investment vehicles, heavy reliance on fundamental analysis, light portfolio monitoring, and asset selection based merely on asset-specific risk. Let’s review the main traits of the old paradigm.

BUY AND HOLD

As mentioned, one of the signature elements of the old investment paradigm is an almost obsessive fixation on the buy-and-hold strategy. Every investment book and college course has always taught that you should buy a good stock and hold it until you retire or need to sell it. What the books and courses didn’t tell you, however, was that by the time you sell your stock or investment portfolio, its value may be even lower than the price you paid for it.

The problem with the buy-and-hold strategy preached by universities and investment academies is that it pays no attention to an investor’s particulars, such as personal needs and timing. I don’t know about you, but I’m not sure I would want to hold my investment through unexpected events such as death, illness, or job loss. Or, conversely, what if I’d retired sometime in 2002 and had to pull out my investment and liquidate my equity positions only then? I’d have lost about 40 to 70 percent of my portfolio.
value if all of it had been invested in the equity. In reality, the buy-and-hold strategy might never have truly held any benefit for most of us. And these days, it could well be a recipe for disaster.

Let’s take a look at a real-life example. According to a study from 1994 to 2000, based on I/B/E/S data, there were 225,885 stock recommendations by Wall Street’s high-paid analysts. However, only about 2 percent were sell recommendations. In particular, in 2000, there were 32,663 stock recommendations by professional analysts. Fewer than 1 percent of those were recommendations to sell.¹ That same year, however, Wall Street suffered one of its worst markets in 35 years due to the bursting of the technology bubble. The “experts,” while selling any of their own stocks that were tanking, as common sense would dictate, continued to advise their customers not to sell. Their motive for giving such advice was the traditional idea that unless you are extremely savvy about the ups and downs of the market, your best bet as the “average” investor is just to hang on to your portfolio; eventually the market will adjust and everything will be fine.

Proponents of this buy-and-hold approach will try to support their claims by pointing out statistical averages of stocks over the past 50 to 100 years. There are several flaws to their theory, however. First, the Dow Jones Index, for example, does not represent the same set of companies today as it did 100 years ago; in fact, the index is readjusted every few years, which means you aren’t really buying and holding. That is, you’re not really holding the stock you bought. Rather, the portfolio you purchased is frequently being adjusted along the way.

Second, who has 50 to 100 years to grow a portfolio? Perhaps you have 20 or 30 years, at best—that is, if you want to enjoy your profit before you’re too old. Realizing this realistic time horizon in itself introduces another risk you may not have thought about. Here’s an example: Had you started your buy-and-hold portfolio of technology stocks in March 2000, or in 1929, or in the early 1970s, or in 1987, or at many other similar times in between, you would have experienced such a crippling loss that you might not have recovered within your lifetime.

In fact, many “blue chip” stocks that were traditionally Wall Street’s darlings for long-term investments—for example, Zenith and Pan Am or, in recent years, WorldCom and Enron (which never recovered after its fall in 2001)—would have indeed been disastrous for your investment portfolio. And these are not isolated cases. In fact, you’d likely be surprised at how many companies that for all the world appear to be reputable and profitable are harboring secrets that might one day destroy them.

For example, the PBS show Frontline explored the implosion of one of America’s best-known corporations, Sunbeam, in a documentary that aired in June 2002. According to PBS, in the late 1990s Sunbeam CEO Al
Dunlap used simple accounting tricks to paint a picture of a turnaround in earnings that didn’t exist. With a pay package that included more than 7 million shares and options, Dunlap stood to make more than $200 million personally if he could keep Sunbeam’s stock price flying. But in the spring of 1998, when Dunlap and his team ran out of tricks, Sunbeam corrected its books, declared bankruptcy, and the stock price plunged from $53 at its peak to just pennies. If you’d been an unfortunate stockholder in Sunbeam at the time, or in any one of the many similar companies that are out there, and adhering to the rigid buy-and-hold strategy as you’d been taught to do, you’d have paid a heavy price. Even if the law (or in most cases, just the natural dynamics of the marketplace) had been able catch up with the people behind such tricks, it would have been too late for you. Table 3.1 depicts how much of a gain you would require just to make up for such investment capital losses.

The lack of flexibility that is so integral to the buy-and-hold strategy, combined with the reality of such a bear market—one that can permanently cripple a buy-and-hold portfolio—is one reason that this strategy is fading into oblivion; it’s become more evident than ever that buy and hold was never a proven or even reliable strategy in the first place. A bear market, which is the opposite of a bull market, occurs when the stock market drops for a prolonged period of time, usually by 20 percent or more. This decline and sell-off is due to a few factors such as market psychology, high and sometimes unrealistic valuations of stocks, and low earnings by companies. After paying dearly for stocks, investors realize that companies

<table>
<thead>
<tr>
<th>Loss of Capital</th>
<th>Gain Needed to Recover</th>
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</thead>
<tbody>
<tr>
<td>5</td>
<td>5.3</td>
</tr>
<tr>
<td>10</td>
<td>11.1</td>
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<tr>
<td>15</td>
<td>17.6</td>
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<tr>
<td>20</td>
<td>25.0</td>
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<tr>
<td>25</td>
<td>33.3</td>
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<tr>
<td>30</td>
<td>42.9</td>
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<tr>
<td>35</td>
<td>53.8</td>
</tr>
<tr>
<td>40</td>
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<td>45</td>
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<tr>
<td>55</td>
<td>122.0</td>
</tr>
<tr>
<td>60</td>
<td>150.0</td>
</tr>
</tbody>
</table>
cannot sustain estimated earnings, so they decide to sell their holdings. As the market falls, more market participants note their losses and decide to sell their stocks. This creates a vicious cycle of selling. A good example for a prolonged bear market occurred in the 1970s, during which markets moved sideways for over a decade.

**INVEST FOR THE LONG TERM**

This advice is in direct line with the buy-and-hold strategy. You have likely always heard that stocks perform better over the long term and result in loss if held for only a short term. In the old investment paradigm, short-term trading is considered “noise” trading.

*Long term* is a subjective concept, though. How long is long term? The old-paradigm proponents try to convince you of the merits of long-term investing by presenting statistics about stock-market performance over about 100 years. They calculate average yearly performance and argue that despite all the major market corrections in history—including some as recent as 1930, 1976, 1987, 2000, 2007, and 2008—yearly performance has been consistently positive for the “long term.” And then they conclude by saying that to enjoy market return, you should invest for the long term and avoid market timing.

However, glancing over any long-term or short-term market price charts, you could easily conclude that markets don’t go straight up or down. For example, consider the S&P 500 chart in Figure 3.1. The S&P 500 index is similar to the Dow Jones averages to the extent that both are designed to obtain the overall performance of the market. This index is based on 500 large-cap companies. Figure 3.1 indicates that if you had to withdraw some or all of your investment at any point in 2002, you’d have lost close to 40 percent of what you had invested just since August 2000. And according to American Association of Retired People (AARP), a dollar invested in an index fund in March 2000 would have been worth 55 cents in August 2002. Further, $700 billion in retirement savings was depleted in the 2000–2002 market correction. Total loss in the last three years of 2000–2002 amounted to $7 trillion.2

Similarly, in November 2008, the market was unable to recoup its losses since 2000. Furthermore, if you had invested in the market for the long term, by 2008 you’d have lost a good portion of your hard-earned savings.

The year 2008 may be recorded as the worst year ever for the phenomenon of wealth destruction for investors and traders. Despite the massive $820 billion bailout by the U.S. government, the stock market continued its spiral sell-off and meltdown. About one year previously, the S&P
500, an index of 500 large-cap common stocks published since 1957, made an intraday all-time high at 1,576.09 on October 11, 2007. As of November 21, since peaking at an all-time closing high of 1,565.15 on October 9, 2007, the S&P 500 Index lost 52 percent. The Dow lost nearly 47 percent since closing at an all-time high of 14,164.53 on the same day. Since hitting a bull market high of 2,859.12 on October 31, 2007, the NASDAQ lost 54 percent. According to a report in The Washington Post quoting the top Congressional budget analyst, by October 2008 the stock market’s prolonged correction had wiped out about $2 trillion in retirement savings over 15 months.3

I don’t propose market timing that intends to forecast market bottoms and peaks. On the contrary, I propose timing with a proper trading method and system via which an investment expert can show you when you should buy or sell your investment for maximum profit potential. In other words, although no expert can predict the market’s top or bottom—that would
not be realistic or even practical—I can, however, teach you under what market conditions you should buy or sell your investments to make the most profit. That strategy is indeed not only realistic, it is also trustworthy.

None of this, of course, is meant to imply that you should not have a long-term plan for investing. In fact, long-term investment planning is an absolute must. Long-term planning, however, should not be confused with long-term investing. Let me clarify: Long-term planning typically corresponds to the buy-and-hold strategy and connotes taking a passive attitude toward your portfolio, complacently waiting for market “corrections” to take care of any problems with your stocks. The idea is that if you just wait long enough, you’ll see improvement. In reality, of course, standing idly by waiting for things to get better is really no strategy at all. For instance, if the “check engine” light on your car went on, would you assume that if you waited it out, gave it enough time, whatever problem your car was having would just take care of itself? Only if you want to destroy your engine! A smarter move would be to take corrective action at the first sign of serious problems—and that strategy applies to your stock portfolio as well.

On the other hand, my definition of long-term planning is setting clearly definable and achievable goals for where you want to be financially at various points down life’s road, taking into account any changing financial circumstances you may face as your values and living situation change over the years; for example, you may marry, have children, buy a home, or change careers. Such goal setting also involves a detailed assessment of your risk tolerance as well as your present financial situation. Then, once you’ve established these goals, you can devise the strategy that will most likely help you achieve them. The main point of this approach, though, is that you can be proactive and take charge of your own future for the long term. You don’t have to simply wait (and hope) for conditions to improve based on nothing but shaky historical statistical analyses and, in large part, blind luck. That’s a strategy that doesn’t even work in Las Vegas.

Mutual Funds, No More!

Another primary characteristic of the old paradigm is investors’ heavy reliance on mutual funds. Traditionally, mutual funds were considered the best option for many investors. However, these investment vehicles came with hefty expenses and lower-than-market-average performance.

So, why did the mutual funds industry grow larger than it could handle? Mainly because investors were told that mutual funds would provide diversification. What they were not told, however, was that most of these funds comprised just a few major stocks. And most of those investors didn’t learn about that fact until the recent stock market correction, when a majority of funds, which were basically holding only the stock of a few technology
companies, went into the red—not exactly the “diversification” these investors had hoped for.

**Slow to Enter and Exit**

Using mutual funds as primary investment tools has another problem. For example, if you wanted to buy a mutual fund, you’d have to wait until the end of closing day and purchase it for the next day’s opening price, missing potential good opportunities. Likewise, if you decided to exit a mutual fund or try to protect your hard-earned investment against market corrections and sell-off, you’d have to wait until the end of the day and get the closing price. In other words, in both entry and exit sticker prices, you were dealt the short end of the stick.

**Hefty Loads and Fees**

Mutual funds charge you a fee to either buy or sell them. In addition, some mutual funds advertised as no-load funds still charge hefty fees under Section 12-b, which allows for advertising expenses. Either way, you have to pay high fees. To justify such a large expense, your fund should gain high returns, but usually funds perform at less than the market average.

**Taxes and More Taxes**

When you invest in a mutual fund, you have to pay taxes on your return. That’s fine if you’re making a profit on the fund. But as incredible as it may seem, you also have to pay taxes if you have a losing year. Since your mutual fund manager had to buy and sell the holding stocks, you, as the stockholder, also have to carry the fund manager’s burden. Even when your mutual fund has a negative return, you have to pay taxes on it. This is called capital gains distribution.

**Inability to Sell Short**

It’s important to understand the concept of short-selling (also called shorting), so do not be afraid of it. Armed with a proper understanding of this concept, you could yield much better returns. Shorting in finance and trading is selling a security without first owning it, for the purpose of repurchasing it later for a lower price. This strategy could be very profitable if your analysis indicates a high probability that the security will fall and lose its value. For example, say that your market analysis indicates that ABC stock, priced at $50, could fall to $25 in the near future. You could short-sell it at the current market price and then, as soon as it drops to the
anticipated lower price, repurchase it, making a profit of $25. The market offers many great opportunities short-selling. However, your mutual fund managers may be unable to take advantage of them.

**HEAVY RELIANCE ON FUNDAMENTAL ANALYSIS**

Fundamental analysis is a good method by which to gauge global investment trends. However, it’s slow and doesn’t reflect all the dynamic price fluctuations. In today’s fast-moving global economy, you need more agile and flexible analysis methods to decipher market information. This means understating and practicing technical analysis, which is mostly absent from the old paradigm.

**LIGHT PORTFOLIO MONITORING**

The tradition in the old paradigm is to look at your investment portfolio once a year. However, active monitoring of your investments can save you from losses that could make the difference between a winning portfolio and a losing one. And with today’s high-speed mobility of information, you can access your portfolio and monitor its progress as often as necessary, rendering the old once-a-year practice useless.

**ASSET SELECTION BASED MERELY ON ASSET-SPECIFIC RISK**

Many sophisticated theories and metrics can help you identify the risk associated with a security or asset: solvency, liquidity, profitability, interest risk, inflation risk, political risk, and more. However, any investment decision should factor in another aspect of risk: your personal tolerance for it. Ultimately, you are the one who has to decide whether to hold an asset in an adverse situation. The old investment paradigm has neglected this aspect of risk analysis, focusing on the assets rather than the investor.

**TIME TO TAKE CHARGE**

Table 3.2 exhibits the main differences between the old and new investment paradigms.
TABLE 3.2 Comparison Between Old and New Investment Paradigms

<table>
<thead>
<tr>
<th>Old Paradigm</th>
<th>New Paradigm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broker assisted</td>
<td>Online trading</td>
</tr>
<tr>
<td>Low trading volume</td>
<td>High trading volume</td>
</tr>
<tr>
<td>Buy-and-hold strategy</td>
<td>Active/short-term trading</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>Exchange-traded funds (ETFs)</td>
</tr>
<tr>
<td>Few asset class choices</td>
<td>Wider asset class choices</td>
</tr>
<tr>
<td>Smaller risk tolerance</td>
<td>Willingness to risk for higher performance</td>
</tr>
</tbody>
</table>

To be successful in your investing and trading, you need to begin to take charge and implement a winning trading system to bring great returns and manage your risk. It’s about you taking responsibility and a more active role in managing your money. It is all about understating your risk and execution of proper risk management methods. In the next chapter, we go over the components of a sound and winning trading system.
PART II

Trading Instruments and Markets
CHAPTER 4

Understanding the Financial Markets: Common Stocks

In the previous chapter, we established that active investing or trading is an essential requirement for financial prosperity and safeguarding your capital and portfolio. However, to make active investing work for you, you need to learn about trading markets. Trading or financial markets provide a medium to trade a security. Therefore, financial markets become an aggregate of all market participants who are either buyers or sellers.

There are many types of financial markets, some, such as the New York Stock Exchange, with physical locations and others, such as NASDAQ, that consist of only electronic systems and networks.

WHAT ARE FINANCIAL ASSETS?

In financial markets you trade assets for profits. There are two major types of asset: physical assets and financial assets. Physical assets produce economic output. They are part of the production and wealth creation process. Examples of real assets are buildings, plants, land, machines, technology, and knowledge that is used in the production of goods and services. These assets add real value to an economy. Since real assets are usually illiquid and have much longer turnaround times and require a great deal of wealth, we don’t trade them.

Financial assets, which are another major type of asset, deal with claims on the income generated by real assets. For example, it is difficult for most, if not all, of us to buy a manufacturing plant or major company. However, we could participate and have some claims on a company’s profits simply by buying its stock. By holding a stock such as that of a car...
company, we could benefit from the company’s profits. Furthermore, financial assets define the distribution of wealth among investors. Now, we could save and invest in a company, or we could consume our wealth. When we buy a company’s security, for example, we provide funds for its expansion and growth. Thus financial assets play an essential role in distributing profits and circulating wealth. As traders, we help a company grow by directing our funds. However, if we don’t like the company for any reason, by selling our stock or claim in that company, we are redirecting our funds to another company.

There are three main types of financial asset, each traded in different financial markets. They are fixed income, equity, and derivatives.

**TYPES OF TRADING MARKETS**

Financial markets could be divided into the following types depending on the kind of securities they trade. They are capital markets (stock markets and bond markets), commodity markets, money markets, derivatives markets (futures, options, and swap markets), insurance markets, and foreign exchange markets. However, for the purpose of trading and materials covered in this book, I cover three markets: common stocks in this chapter, exchange-traded funds (ETFs) in Chapter 5, and futures markets in Chapter 6.

**CHARACTERISTICS OF THE COMMON STOCKS MARKET**

The first trading market we’ll discuss in detail is common stocks. Common stock is one of the most popular traded securities. There are close to 7,000 different common stocks listed on the NYSE and NASDAQ exchanges. Corporations, both domestic and international, issue stocks to raise funds for their current operations or future expansion plans. Stocks with prices of less than $5 are known as penny stocks, which institutional investors and fund managers stay away from dealing with.

**Market Size**

The size of the world stock market was estimated at about US$36.6 trillion at the beginning of October 2008. As of that month, the combined capitalization of all domestic NYSE listed companies was US$10.1 trillion.

   Market participants are institutional and pension fund investors, corporations, and retail investors. Due to the advent of technology, most stock markets are open 24 hours and can be traded through electronic platforms.
Profit-and-Loss Calculations

If you buy stocks, you are long or holding long positions. To make a profit, you need to sell your stocks at a higher price than you purchased them for. By doing so, you exit your long positions. Suppose you decide to buy X stock at $25. Its price goes up to $30. At that point, you decide to sell and exit your long. You make $30 − $25 = $5 profit. Usually stocks are traded at multiples of 100 shares. If you trade fewer than 100 shares or an odd number, you may have to pay a bit higher for each stock compared to trading 100 stocks or more.

If you short-sell a stock, you are short or holding short positions. To make a profit on your trades, stock prices should go lower. If you buy back the stock at a lower price or to cover your short positions, you would make a profit. Suppose you recognize that Walt Disney Co. (DIS:NYSE) stock will not report good earnings due to the current recession. If you have the stock in your portfolio, you may sell and exit long. However, if you are an aggressive trader, you may decide to short-sell the stock in August 2007 for, say, $30. Then you decide to cover your short on February 23, 2009, at $16.47. If you short 100 shares, your profit would be $30 − $16.47 = $13.53 per stock, or $1,353 for 100 shares.

Regulations and Taxation

You do not need to have a license to trade stocks. You simply need to open an account with an equity broker such as Fidelity or Brown Co. Depending on your cash and equity in your account, you can buy shares. If you have experience trading stocks and have enough capital or good credit, your broker may allow you to short-sell a stock or even buy on a margin account. These topics are discussed in more detail in the following sections.

The stock market is one of the most highly regulated industries in the United States. The U.S. Congress has created and authorized the Securities and Exchange Commission (SEC) and other agencies involved in regulatory duties to oversee stock trading. The SEC is the top regulatory agency responsible for overseeing the securities industry. All the public companies must register new securities with the SEC and follow its strict guidelines for filing their quarterly financial reports. The SEC also oversees the stock exchanges and monitors all the activities related to selling securities, such as advertising and marketing.

After the SEC, the Financial Industry Regulatory Authority (FINRA), created in 2007, polices the security industry. FINRA conducts comprehensive examinations and issues licenses for stock brokers and industry professionals. It also fines brokers and licensed professionals for any illegal and unethical activities. In addition to the SEC and FINRA,
states also monitor brokers’ activities and handle consumer complaints against them.

You need to pay taxes for capital gains and dividend income you receive for your stocks. Capital gains are calculated based on the difference between your “basis” and the sale price of your stock. The basis is usually the price you paid for your stock. If you hold a stock for more than one year, you have to pay long-term capital gains taxes; otherwise, it is a short-term capital gains tax. If you are in the 25 percent income tax bracket or higher, the tax on a long-term capital gain is currently 15 percent. However, if you are in the 15 percent or lower tax bracket, you pay just 5 percent tax. For short-term capital gains holding less than one year, the IRS considers it ordinary income, which is taxed at your income tax rate. Dividends are taxed at 15 percent. However, this rate, which is a tax-relief provision, may expire after 2011.

Note that in this book I provide you with only general information in regard to taxes and regulations. You must seek a competent tax counsel before you act on this information.

**Leveraged Strategies**

You can open a stock trading account with any registered brokerage house. Some brokers require minimum funds. However, you can only buy stocks based on what you have in your account unless you use some leverage strategies.

*Leverage* is a key concept in utilizing your assets and maximizing potential returns. But you need to be very careful and understand the risks involved with leveraging. As much as leverage helps you capture high profits, you could also lose a great deal, if not all, of your capital. Let’s go over a bit more about this concept so we will be able to use it wisely. Basically, leverage is like a loan—“borrowing” assets that you already have in one investment to make another investment for an even greater profit. Leverage allows greater potential returns to the investor than otherwise would have been available, but the potential for loss is also greater, because if the investment becomes worthless, the loan principal and all accrued interest on the loan still need to be repaid.

In trading stock, you could use two leverage strategies to maximize your return: short-selling and margin buying.

**Short-Selling**

In short-selling, you borrow stock from your broker and sell it so that when its price falls, you could buy it back or cover it at lower price for a profit. In reality, your brokerage firm should have the stock in its shareholding
account. However, if your broker does not have the stock in its holding and lends it to you anyway, it has committed “naked short-selling,” which has become illegal in most markets, according to the SEC. Moreover, if you’re wrong and stock prices move up, you’ll end up losing money. In that case you would need to have enough funds in your account to offset your losses. To short-sell a stock, you used to follow the uptick rule, which meant that the stock had to first move one tick higher before you could short-sell it. However, as of this writing (in February 2009), this is no longer the case.

**Margin Buying**

If based on your analysis, you believe that a stock price could move up, you could buy it. However, if you do not have enough funds in your account, you might have to borrow from your broker—with interest, of course. This is called margin buying. This strategy would work in a strong bull market, secular trend. However, you need to be right in predicting not only your stocks’ upward move but its timing as well. In other words, if you are wrong in your timing but correct in guessing the direction your stock would take, you could end up losing money. The cost of your margin borrowing may exceed the overall return on your stock, minus any commissions costs.

There are specific regulations regarding the amount of money you can borrow to buy a stock on margin. In most developed countries, you are required to have some collateral assets, either stocks or bank accounts, to back up your borrowing. However, in the United States, you may borrow up to 50 percent of the stock value, depending on your credit rating and your broker’s approval. For example, let’s say you want to buy 100 shares of a stock priced at $20, but you only have $1,000 in your account. You may borrow $1,000, 50 percent of the stock’s value. However, if the stock price drops further below your purchase price, you may receive a margin call from your broker, since your account cannot support the loss. If you don’t provide the necessary funding, your broker would liquidate your positions and collect the any deficit from you. After the stock market crash of 1929, the Federal Reserve put forth new regulations for margin requirements, which you can obtain from your broker or the SEC.

**Day-Trading Rule**

After the technology bubble burst in the 2000s, some rigid rules have been imposed for stock day traders. Since the majority of stock day traders tend to scalp, looking for a small profit in a short time, they tend to lose a great deal of money. Some day traders buy and sell stocks throughout the day, frequently with the hope that stock prices may move up or down within a few seconds or minutes. These types of traders may show more propensity for gambling than for trading.
According to NYSE and FINRA, you must have at least $25,000 in your account and can trade only if you have a margin account. Brokerage houses may designate margin accounts to individuals with experience and proper funds. However, I do not recommend any type of scalping. The commission costs along with the probability of winning do not support scalping in any markets. A floor trader who has a seat on an exchange floor may consider it due to the low commission costs and faster execution, though cautiously.

**Challenges of Trading Common Stocks**

There are many opportunities in trading to make great profits. In future chapters I will show you some of the potential. However, I believe you should stay away from trading stocks because there are so many factors that can affect prices at any time and without warning.

But if you want to trade, there are some things you need to know. You need to diligently study stocks before you trade. You can do this by making a fundamental analysis, which looks into the company’s balance sheet and compares its financial ratios with competitors, industry, and market benchmarks. Or you may perform a technical analysis, which looks for stock price and chart patterns in the past and identifies important price levels, known as *support* and *resistance levels*. Either method you use, you’re exposed to possible abrupt changes due to the company’s surprise earnings and announcements. In other words, your stock is more susceptible to external news and exogenous factors. In some cases you may hear in the financial media about a possible merger or acquisition, which could move the stock against your holding position. Consequently, to trade a stock for short or long term may expose you to more risk than you want to take. In other words, stocks not only bear the overall stock market risk known as *systematic risk*, they also carry the company’s risk, or *unsystematic risk*.

To make your effort meaningful and profitable, you need to achieve big moves in the stock you trade. Otherwise, you may need to allocate a great deal of capital to make the typical stock moves meaningful. A stock with an average daily big move would have high volatility, which means that you would need to have a bigger stop loss. Conversely, to take advantage of big moves, you may have to risk big capital, which might not work out for you. Nevertheless, Chapter 3 reviews various types of trading systems that you could use to profit from short- and long-term stock trading.

If you use fundamental valuation methods that utilize different financial ratios such as price-to-earnings (P/E), earnings per share (EPS), price to sales, price to book, or any other ratios, you should note that the majority of these ratios are constructed based on analysts’ estimates for the company’s future operation and earnings. Since not all analysts have the same consensus about prospective growth for company, the average of
### TABLE 4.1 Partial List of Corporate Scandals, 1986–2004

<table>
<thead>
<tr>
<th>Company</th>
<th>Year</th>
<th>Notes</th>
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<tbody>
<tr>
<td>ZZZZ Best</td>
<td>1986</td>
<td></td>
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<tr>
<td>MiniScribe</td>
<td>1989</td>
<td></td>
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<tr>
<td>Phar-Mor</td>
<td>1992</td>
<td></td>
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<tr>
<td>Cendant</td>
<td>1998</td>
<td></td>
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<tr>
<td>Waste Management, Inc.</td>
<td>1999</td>
<td>Financial misstatements</td>
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<tr>
<td>Microstrategy</td>
<td>2000</td>
<td>Michael Saylor</td>
</tr>
<tr>
<td>Unify Corporation</td>
<td>2000</td>
<td></td>
</tr>
<tr>
<td>Computer Associates</td>
<td>2000</td>
<td>Sanjay Kumar</td>
</tr>
<tr>
<td>Xerox</td>
<td>2000</td>
<td>Falsifying financial results</td>
</tr>
<tr>
<td>Enron</td>
<td>2001</td>
<td>Jeffrey Skilling, Kenneth Lay, Andrew Fastow</td>
</tr>
<tr>
<td>Adelphia</td>
<td>2002</td>
<td>John Rigas</td>
</tr>
<tr>
<td>AOL</td>
<td>2002</td>
<td>Inflated sales</td>
</tr>
<tr>
<td>Bristol-Myers Squibb</td>
<td>2002</td>
<td>Inflated revenues</td>
</tr>
<tr>
<td>CMS Energy</td>
<td>2002</td>
<td>Round-trip trades</td>
</tr>
<tr>
<td>Duke Energy</td>
<td>2002</td>
<td>Round-trip trades</td>
</tr>
<tr>
<td>Dynegy</td>
<td>2002</td>
<td>Round-trip trades</td>
</tr>
<tr>
<td>El Paso Corporation</td>
<td>2002</td>
<td>Round-trip trades</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>2002</td>
<td>Understated earnings</td>
</tr>
<tr>
<td>Halliburton</td>
<td>2002</td>
<td>Improper booking of cost overruns</td>
</tr>
<tr>
<td>Homestore.com</td>
<td>2002</td>
<td>Improper booking of sales</td>
</tr>
<tr>
<td>ImClone Systems</td>
<td>2002</td>
<td>Samuel D. Waksal</td>
</tr>
<tr>
<td>Kmart</td>
<td>2002</td>
<td>Misleading accounting practices</td>
</tr>
<tr>
<td>Merck &amp; Co.</td>
<td>2002</td>
<td>Recorded copayments that were not collected</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>2002</td>
<td>Conflict of interest</td>
</tr>
<tr>
<td>Mirant</td>
<td>2002</td>
<td>Overstated assets and liabilities</td>
</tr>
<tr>
<td>Nicor</td>
<td>2002</td>
<td>Overstated assets, understated liabilities</td>
</tr>
<tr>
<td>Peregrine Systems</td>
<td>2002</td>
<td>Overstated sales</td>
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<tr>
<td>Qwest Communications</td>
<td>2002</td>
<td>Inflated revenues</td>
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<tr>
<td>Reliant Energy</td>
<td>2002</td>
<td>Round-trip trades</td>
</tr>
<tr>
<td>Sunbeam</td>
<td>2002</td>
<td></td>
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<tr>
<td>Tyco International</td>
<td>2002</td>
<td>Improper accounting; Dennis Kozlowski</td>
</tr>
<tr>
<td>WorldCom</td>
<td>2002</td>
<td>Overstated cash flows; Bernard Ebbers</td>
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<tr>
<td>HealthSouth Corporation</td>
<td>2003</td>
<td>Richard M. Scrushy</td>
</tr>
<tr>
<td>Chiquita Brands International</td>
<td>2004</td>
<td>Illegal payments</td>
</tr>
<tr>
<td>AIG</td>
<td>2004</td>
<td>Accounting of structured financial deals</td>
</tr>
</tbody>
</table>

*Source:* Compiled from various sources, including the Securities and Exchange Commission.
analyst predictions is used. This by itself adds another layer of estimate, which might or might not be correct. In other words, the overall fundamental analysis is constructed mainly on estimation of a company’s future performance, which could be right or wrong. Therefore, trading stocks based on so-called fundamental analysis might not yield you much.

Financial statements of a company might not reflect its real financial health, since—depending on the method of accounting a CEO or CFO employs—you may have different income and profit. Companies may use a depreciation method or inventory reporting system to inflate their earnings and income. Consequently, companies could show different earnings and profits on their tax returns than in their publicly filed financial statements. Conversely, to rely on companies’ financial statements to trade stocks might not be your best choice.

Recent financial scandals and mischief constitute a strong indication of how some corporate leaders may abuse their power to deceive the public by manipulating their companies’ financial statements and reporting. Just a quick glance at SEC complaint files reveals a long list of public companies that tried to manipulate their financial accounting reports, among them AIG, WorldCom, and Enron. For more, see Table 4.1.

Overall, I do not like too much stock trading based on fundamental analysis. However, you may use technical analysis to trade stocks with high volatility and price fluctuations, which could be profitable. I discuss this idea in more detail in Chapter 8.
CHAPTER 5

The Exchange-Traded Funds Market

The Philadelphia Stock Exchange was the birthplace of the first U.S. ETF, in 1989. Europe made ETFs available in 1999. Originally seen as traditional index funds, a cluster of traded securities tracking a sector, the concept of the ETF evolved by 2008, when the SEC authorized the creation of actively managed ETFs.

In recent years, according to the Investment Company Institute (ICI), ETFs have become more customized, tailored to an increasingly specific array of regions, sectors, commodities, bonds, futures, and other asset classes. As of April 2008, the United States had a total of 660 ETFs, representing about $596 billion in assets—a $129.41 billion increase over the previous 12 months.¹

CHARACTERISTICS OF ETFs

Since the inception of the first ETF, SPDR by State Street Global Advisors, in 1993, ETFs have continued to gain popularity and attract assets at a rapid pace. The contributing factors in ETFs’ popularity are their low associated costs and expenses, flexibility, and tax efficiency. These great benefits have made ETFs one of the favorite new kids on the investment block and quite popular. Let’s review each of the ETF’s features, starting with using them as a single security stock to trade a basket of various market sectors.
Trading Market Basket or Index with One Stock

ETF is like a mutual fund that comprises many possible stocks but trades like a single stock. This enables you to hold different market indexes as just one single stock. The most popular ETFs are SPY, or Spider, which represents Standard & Poor’s 500 Large Cap Index; QQQQ, or Qs (Cubes), which represents the NASDAQ 100 technology index; and D, or Diamond, which represents 30 Dow Jones industrial stocks.

Intraday Trading

Since ETFs are like stocks, you can trade them in intraday trading. Contrary to their counterparts, mutual funds, which can be bought or sold at the end of the business day, you can buy or sell any of your ETFs during market hours. This feature provides great flexibility and enables investors to manage their investments in the presence of adverse market conditions.

Short-Selling

As discussed earlier, trading ETFs allows you to short-sell them if you think their price might fall. Then you can repurchase them at a lower price and turn a profit. Since ETFs are like single stocks representing baskets of specific sector or market stocks, this could mean gaining a great advantage in producing more profits for your investment dollars.

Low Expense Ratio

In general, ETFs carry a much lower cost and lower expense ratio compared to mutual funds. The average expense ratio for an ETF is about 0.02. This feature not only helps you gain a better return on your investment capital, it helps you save money, too. You truly could replace index funds, which usually have low turnover and broad diversification. You could come to really appreciate this feature, since about 80 percent of the more expensive mutual funds are unable to match or beat their corresponding benchmarks.

Among mutual funds, the Vanguard 500 Index Fund is among the lowest expense index funds. However, its expense is 18 basis points compared to its counterpart, SPDR 500 ETF, which is only 11 basis points. Conversely, the SPDR 500 ETF’s cost is 40 percent lower than the most cited low-cost mutual fund, the Vanguard 500 Index Fund. This fact by itself should help you earn more money from your investment. However, you should note that since an ETF is a like stock, you’d need to pay a commission to buy or sell it, as with other stocks.
Effective Tool for Diversification

To construct a winning portfolio, you must diversify. However, your low investment capital may prevent you from diversifying efficiently across different markets and asset classes. Fortunately, by using ETFs you are able to diversify efficiently and hence maximize your portfolio return, even when you have not invested a large amount of money.

There are hundreds of ETFs that could be very useful for diversification. These ETFs cover a vast array of market indexes—for example, major and more popular market indexes such as Dow Jones, S&P, NASDAQ, large caps, small caps, growth, and value. There are also many international ETFs that cover Europe, the Pacific Rim, emerging markets, Japan, Australia, and the United Kingdom or precious metals such as gold, oil and energy, real estate, and REITs. Some of the ETFs also pay dividends or are fixed income and more. I review different types of ETF in future chapters.

Tax Efficiency

Another attractive feature of ETFs is their tax efficiency. This is due to less turnover and the special structure of ETFs. For example, people trading large volumes could receive in-kind redemptions. In other words, you could redeem your ETFs for a share of stocks that they track. This arrangement, conversely, reduces tax implications for large investors. Furthermore, you could choose to trade ETFs that don’t pay dividends or significant capital gains distributions. We’ll learn more about this in future chapters.

In the previous chapter we discussed constructing an investment portfolio by considering different asset classes such as cash, bonds, equity, and diversification. Here I explore ETFs as effective tools for achieving better performance.

Investing in the stock market can be a very complex undertaking. Yes, if you do your homework, you might make a significant profit. Of course, there’s also the possibility of losing a large part of your portfolio. And if you are not a professional in the field, the odds are not good that you’ll pick winning stocks. That is what makes ETFs so attractive. They keep you from spending countless hours of guesswork trying to pick the right stocks.

An ETF is a type of mutual fund that trades as a listed security on one of the stock exchanges. Up to now, all ETFs have been created as index funds, set up to match the performance of a market segment. An ETF is an index, which is a collection of securities such as stocks, bonds, or futures but is traded intraday, like a stock, during market hours.

ETFs provide the professional money management of traditional mutual funds but at much lower cost and with the trading flexibility of a
stock. The biggest and oldest ETFs are based on S&P 500 and are known as Spiders (SPDRs). But the most actively traded stock in the world is the NASDAQ 100 ETF known as Qubes. In addition, there are Diamonds, based on the Dow Jones Industrial Average, and many other ETFs based on international markets such as those in Japan, China, Russia, Brazil, and Australia and many other indexes tracking different market segments and sectors. The next asset values or prices of ETFs are set as fractions of the underlying index value at any given time. For example, if the S&P 500 index is at 925.80, the Spider (ticker symbol: SPY) is priced at 92.60, or about 1/10 of the index value. Likewise, if the Dow Jones Industrial Average is 9,034.69, the corresponding ETF, Diamond (ticker symbol: DIA) trades at 90.35, or about 1/100 of the index value.

ETFs offer an advantage over actively managed funds, in which managers decide on the type of securities and their portions in the portfolios, based on their own unique strategies. Despite the hefty fees they charge, actively traded funds perform less than broad market indexes 80 percent of the time. Since ETFs track the underlying indexes, they do not implement any market timing strategies.

In addition, actively managed funds are expensive to run because fund managers, analysts, traders, and numerous other experts need to be paid. Costs associated with index funds are, therefore, much lower. ETFs, which represent passive index funds, are low-cost investment vehicles, in part because their expenses are spread around more efficiently than, for example, no-load mutual funds. For that reason, including ETFs in your portfolio can help you achieve a better return with relatively less cost.

ETFs are new investment vehicles and an important component of the new investment paradigm matrix. They are increasingly popular across the globe because they are low cost, highly diversified, and easily traded. The number of ETFs increased nearly 50 percent in 2006 alone, and now more than half a trillion dollars are invested in 800 ETFs around the world. The United States represents by far the largest market for ETFs, with over 70 percent of its global assets. The European market has seen impressive growth as well, with assets increasing over 60 percent to nearly US$90 billion in 2006.2

The proper use of ETFs is an important component of the new investment paradigm. The following sections show you how to select an ETF for your portfolio and, later, how to manage ETFs profitably.

ADVANTAGES AND DISADVANTAGES

A unique set of advantages makes ETFs attractive. They offer broad diversification with just one trade. They have liquidity because they are traded
on the stock market and they are not constrained by the trading restrictions that impose limitations on mutual funds.

As an investor you should be able to recognize the strong appeal of ETFs. They could help you benefit from the recent phenomenal growth of oil, energy, precious metals, and commodities.

ETFs combine the best features of both mutual funds and individual stocks. For example, they offer the broad diversification of mutual funds as well as the ability to track a benchmark and to target specific sectors and segments.

Since they can be traded at any time during market hours, ETFs are highly liquid compared to index mutual funds. They also have better valuation, since they can be traded in the secondary markets and offer trading options such as selling short, placing stop-loss or limit orders, and buying on margin. They provide a simple pathway toward greater diversification and open up market segments that otherwise might not be included in your portfolio (e.g., international stocks or stocks in diverse sectors or industries). In addition, ETFs remove a great deal of risk because they generate premiums only when there is significant appreciation of the underlying stocks.

Further, dividends are reinvested immediately in most cases, and there is less exposure to capital gains distribution taxes than with mutual funds.

As with all investment vehicles, there are also certain drawbacks to ETFs. For example, the expense ratios of international ETFs can be substantial. Furthermore, ETFs can be traded too frequently, causing lower returns due to mounting brokerage fees. In addition, the bid-ask spread can be quite large, which can be like trading in a less efficient market.

**SECTORS AND TYPES**

There are many different types of ETFs. As of April 2008 there were 660 ETFs, broken down into categories as follows and as Figure 5.1 depicts: 35 percent sector and industry domestic ETFs, 30 percent broad based, 26 percent global and international equity funds, and the remaining bond and hybrid ETFs. Conversely, ETFs types could include index, sector, style, commodities, international, currency, inverse and bear market, bond, and actively managed ETFs.

**Index ETFs**

Index ETFs offer investors the ability to invest in major market indexes such as the S&P 500, the Russell 2000, and the Dow Jones Industrial. Examples are iShares S&P 500 Index (IVV), iShares Russell 2000 Index (IWM), PowerShares QQQ Trust, and Series 1 (QQQQ).
FIGURE 5.1 Breakdown of ETF Types, Compiled Using Investment Company Institute Data

**Sector ETFs**

ETFs provide opportunities to invest in different sectors such as basic materials, consumer discretionary, consumer staples, energy, financials, healthcare, industrials, technology, telecom, transportation, and utilities. For example, if you decide to expose your portfolio to international markets, you could use iShare MSCI ex US or iShare S&P Asia 50 ETFs. A list of the various sectors follows:

- **Basic materials.** Stocks that primarily deal with raw materials for production and construction are categorized under basic materials. This category of stocks includes the mining and refining of industrial metals such as steel, copper, gold, platinum, forestry products, and chemical products. Consequently, this sector is sensitive to changes in economy and business cycles, since it is largely a demand-driven sector.

- **Consumer discretionary.** This category of stocks primarily sells to consumers products and services that are not necessities. This sector includes industries such as automobiles, high-end clothing, restaurants, hotels, and luxury goods. Since companies in this category deal with discretionary goods, it’s generally sensitive to economic changes and business cycles.

- **Consumer staples.** This sector refers to companies that provide and produce consumer staples such as food, beverages, household products, prescriptions, and tobacco. This sector is less sensitive to economic changes and business cycles.

- **Energy.** This sector consists of stocks that engage in the exploration, production, refining, transportation, and marketing of oil, gas products, and coal. This sector could be sensitive to economic changes and business cycles.
• **Financials.** This sector includes banks, insurance, investments, real estate investment trusts, and savings and loans.

• **Healthcare.** This category includes stocks in the provision, distribution, and consumption of healthcare services and products. This sector includes hospital management firms, health maintenance organizations (HMOs), and biomedical and biotechnology companies. This category is considered to be defensive since the products and services are necessary and less sensitive to business cycles and economic conditions.

• **Industrials.** This category enlists companies in agriculture, construction, fisheries, forestry, and manufacturing. This sector is called cyclical since it is sensitive to business cycles and economics conditions.

• **Technology.** This sector encompasses companies from several areas, including aerospace, business data processing, computer leasing, electrical equipment, specialized machinery, and precision instruments.

• **Telecom.** This category of stocks deals with telecommunications technology, services, and products.

• **Transportation.** This sector deals with companies that have a primary business of transporting people and goods from one physical location to another. This sector includes mainly trucking companies, cargo trains and airplanes, and ships and barges.

• **Utilities.** This is a category of companies involved in production, delivery, and services of utilities to other companies and consumers.

**Style ETFs**

Style ETFs allow investors to invest in companies by the size of companies and investors' objectives toward growth or value. For example, SPider (ticker symbol: SPY), which tracks the S&P 500 index, is a large-cap index. Examples are S&P 500 Pure Value (RPV), S&P 500 Pure Growth (RPG), S&P MidCap 400 Pure Value (RFV), S&P MidCap 400 Pure Growth (RFG), S&P SmallCap 600 Pure Value (RZV), and S&P SmallCap Pure Growth (RZG).

**Commodities ETFs**

Commodities ETFs let you invest in physical commodities such as natural resources, basic materials, and agricultural products. Investing in commodities ETFs provides your portfolio with exposed growing demand for agricultural products, energy, precious metals, and more. Examples are street TRACKS Gold Shares (GLD), iShares COMEX Gold Trust (IAU), and iPath Dow Jones-AIG Commodity Index (DJP).
International ETFs

Investing in international markets could be an effective way to diversify your portfolio. International ETFs let you diversify without the hassles of dealing with foreign stock exchanges and currency conversions. International ETFs are especially useful if you're trying to gain exposure to smaller markets that would otherwise be costly or prohibitive to access on your own. Examples are iShares Belgium Index (EWK), which tracks the MSCI Belgium Index; iShares Mexico (EWW); iShares FTSE/Xinhua 25 (FXI); Singapore (EWS); Malaysia (EWM); Taiwan (EWT); and iShares S&P Europe 350 (IEV).

Currency ETFs

If you like to participate in the recent foreign exchange market explosion, using currency ETFs is an effective way. Since 2005, currency ETFs have offered investors the capability to participate in currency markets. Examples are CurrencyShares Euro Trust (FXE) and CurrencyShares Japanese Yen Trust (FXY).

Inverse and Bear Market ETFs

Based on your analysis, if you conclude that the stock market could sell off and drop lower, you could use inverse ETFs to short-sell the market. These ETFs are a good way to ease the pain of declining your portfolio value in bear market individual stocks or indexes. Examples are Short QQQ (PSQ), Short Dow 30 (DOG), and Short S&P 500 (SH).

Bond ETFs

An effective method for diversifying your portfolio is to allocate part of it to bonds. These ETFs are great vehicles if you're looking for fixed income, and they provide broad exposures to U.S. Treasury and corporate bonds. Examples are iShares, issued by Barclays Global Investors (BGI); iShares Lehman 1-3 Year Treasury (SHY); iShares Lehman 7-10 Year Treasury (IEF); and iShares Lehman 20+ Year Treasury (TLT). iShares Lehman TIPS Bond (TIP) invests in treasuries that are inflation-protected.

Actively Managed ETFs

Actively managed ETFs are like their counterpart mutual funds but with higher expense and most probably lower returns. My recommendation is to stay away from these ETFs since they are counterproductive to the main ideas of ETFs.
### TABLE 5.1 Major Sponsors of ETFs

<table>
<thead>
<tr>
<th>Sponsors</th>
<th>ETFs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Global Investors</td>
<td>iShares</td>
</tr>
<tr>
<td>State Street Global Advisors</td>
<td>TRACKS and SPDRs</td>
</tr>
<tr>
<td>Vanguard Group</td>
<td>VIPERs</td>
</tr>
<tr>
<td>Rydex</td>
<td>Rydex ETFs</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>HOLDRSs</td>
</tr>
<tr>
<td>PowerShares</td>
<td>PowerShares ETFs and BLDRS</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>PowerShares DB commodity- and currency-based ETFs</td>
</tr>
<tr>
<td>WisdomTree</td>
<td>WisdomTree ETFs—fundamentally weighted</td>
</tr>
<tr>
<td>ProFunds</td>
<td>ProShares—inverse and leveraged ETFs</td>
</tr>
<tr>
<td>RevenueShares</td>
<td>Revenue-weighted ETFs</td>
</tr>
</tbody>
</table>

### SPONSORS

Table 5.1 lists the top 10 sponsors that issue ETFs. Some of them, such as WisdomTree, take a fundamental approach, such as the dividend and cash flow approach, in constructing their ETFs. Others, like Rydex and ProFunds, issue leverage and inverse ETFs.

### ETFs: ATTRACTIVE TRADING INSTRUMENTS

ETFs are new investment vehicles and trading instruments. They are an important component of the new paradigm trading and growing rapidly. They offer you flexibility to trade intraday, low cost, tax efficiency, and various market indexes for profit. Furthermore, ETFs offer you a great tool to diversify your investment portfolio.

Compared to stocks, ETFs are a much better choice for active trading. However, in choosing them you should be cognizant of their trading volumes and liquidity. Some of the sector ETFs may have less liquidity and higher expense ratios, which could work against your profit and performance. If there is a thin market for an ETF, you might have to pay higher than market to buy it. Conversely, when you decide to sell it, you might have to sell for less. In other words, there is a bigger spread between bid and ask for thinly traded ETFs.
Futures markets are part of a derivative family, another type of financial asset that provides potential opportunities for trading. Trading the futures market is an effective way to hedge your equity position or just speculate for profit.

In the stock market, you trade stock; in the futures market, you trade futures contracts. A futures contract is a standardized contract traded on a futures exchange. It calls for the delivery of a commodity, either physical or financial, at a specified delivery date or maturity, for a specified price. In other words, a futures contract lists contractual obligations that stipulate delivery of a commodity at a certain date and price in the future. The futures price is called the settlement price; the futures date is called the delivery or final settlement date.

For example, one futures contract for an agricultural commodity like wheat would specify No. 1 soft red wheat or No. 2 hard winter wheat. The place and date of delivery to warehouses that have been preapproved by exchanges are denoted. The delivery for financial futures is made by wire transfer; in the case of index futures, delivery is done by a cash settlement procedure. As a trader, you buy or sell a futures contract with the intention that any time before the delivery or expiration date, you could sell or buy back your contract for a profit.
Futures markets offer a great opportunity for active traders to make substantial profits. This is due to the fact that as an active investor or trader you can assume any financial or physical commodities with a relatively small initial investment. Accordingly, due to a high degree of leverage, if you are correct you can profit a great deal. Conversely, if you are not equipped with a proper trading model and system to decide when you should buy or sell a commodity, you stand to lose plenty. Nevertheless, futures markets present you with many great benefits and trading advantages that can help you reach your financial goals. In the following sections, we discuss various characteristics of the futures markets, beginning with market size.

Size of Futures Markets

The commodities futures markets’ size is much smaller than the capital markets’ size. Compared to worldwide equity markets, which total $144 trillion, the total value of futures markets for all 25 index commodities is only about $180 billion.¹

In recent years, total market equity size has fallen sharply. On December 31, 2007, it dropped from $144 trillion to $66.82 trillion.² However, the commodity futures markets have grown higher. Since 2002, after a stock market correction of the 2000–2002 bear market, many institutional investors who were not active participants in this market took part because they viewed it as a new asset class and alternative investment vehicle. If in the past the main participants in the futures markets were speculators, now the major financial institutions rely on historical founding that the futures market is uncorrelated with the fixed income and equity markets, pouring funds into these markets. Commodity index trading strategies increased from $13 billion at the end of 2003 to $260 billion as of March 2008.³ There is no wonder that the prices of the 25 commodities that are listed in these indices have moved up about 183 percent in those five years.⁴

According to the CFTC Commitment of Traders Report, the index speculators allocated $55 billion in the first 52 trading days of 2008. That’s an increase in the dollar value of outstanding futures contracts of more than $1 billion per trading day.⁵

Futures Commodities Types

When I speak about commodities at trading seminars and training sessions, many participants think about agricultural commodities such as corn and
wheat. In general, we can divide all the futures contracts into two major types: those that provide physical delivery and those that call for cash settlement on contract expiration dates. However, within these two general categories, there are many types of commodities, as depicted in Table 6.1.

**Profit-and-Loss Calculations**

In trading futures, like any other markets, you can buy or short-sell a commodity futures contract. If you buy a contract, you’re holding a “long” position. If you short-sell one, you’re holding “short” position. If your contract price goes higher than your purchase price, you make money on your long position. However, if it goes lower than your initial price, you earn profit in a short position. The amount of money you make or lose on a contract depends on the specifications of that contract. For example, let’s look at S&P futures E-mini contracts.

Suppose you purchased an E-mini S&P futures contract for 805 on January 15, 2009. Since you initiate or open your position on January 15, you would trade March 2009 contracts, which expire on March 19, 2009. However, the next day the futures price appreciates to 820.50. As depicted in Table 6.2, every one-point move in E-mini S&P futures contracts equals $50. Consequently, if you decide to sell or exit your long position on March 19, you would make a profit of $820.50 − $805 = $15.50 points. Since every point equals $50, you make $15.50 × $50 = $775 profit for your one contract.

Futures contracts are identified by a code such as SPH09, where SP identifies the commodity (standard size or big-contract S&P), and 09H indicates the contract expiry month (March 2009). For some commodities, a smaller contract called a mini or e-mini is also available. For instance, ES is a mini-S&P that is 1/5 the size of the big SP contract. This means that every one full-point move in the standard size S&P is $250. An e-mini S&P contract has 1/5 of that, or $50 per full point.

**Margin and Futures Trading Brokerage Accounts**

To trade futures markets, you don’t need to be licensed, but you must open an account with a broker. The broker should be registered with the Commodity Futures Trading Commission (CFTC) and be a member in good standing of the National Futures Association (NFA).

Congress created the CFTC in 1974 as an independent agency to regulate commodity futures and option markets in the United States. The CFTC is mandated to ensure the economic utility of the futures markets by creating a competitive and efficient market while protecting market participants against fraud, manipulation, and abusive trading practices. It also guarantees the financial integrity of the clearing process. The NFA is the
**TABLE 6.1** A Sample of Various Commodity Futures Contracts

<table>
<thead>
<tr>
<th>Equity Indexes</th>
<th>Foreign Currencies</th>
<th>Interest Rates</th>
<th>Agricultural</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dow Jones Industrials</td>
<td>Euro</td>
<td>Eurodollars</td>
<td>Corn</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>British pound</td>
<td>Treasury bonds</td>
<td>Oats</td>
</tr>
<tr>
<td>S&amp;P Midcap 400</td>
<td>Canadian dollar</td>
<td>Treasury notes</td>
<td>Oats</td>
</tr>
<tr>
<td>NASDAQ 100</td>
<td>Japanese yen</td>
<td>Treasury bills</td>
<td>Soybeans</td>
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<tr>
<td>NYSE</td>
<td>Swiss franc</td>
<td>Bonds</td>
<td>Soybean meal</td>
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<td>Russell 2000</td>
<td>Australian dollar</td>
<td>Euroswiss</td>
<td>Soybean oil</td>
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<td>Nikkei 225 (Japanese)</td>
<td>Mexican peso</td>
<td>Sterling</td>
<td>Palladium</td>
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<td>FTSE (British)</td>
<td>Brazilian real</td>
<td>British government bonds</td>
<td>Wheat</td>
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<td>CAC (French)</td>
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<td>German government bonds</td>
<td>Barley</td>
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<td>DAX (German)</td>
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<td>Italian government bonds</td>
<td>Flaxseed</td>
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<td>All ordinary (Australia)</td>
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<td>Canadian government bonds</td>
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<td>Toronto 35 (Canadian)</td>
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<td>Gas oil</td>
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<td>Titans 30 (Italian)</td>
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<td>Rye</td>
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<tr>
<td>Dow Jones Euro STOXX 50</td>
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<td></td>
<td>Natural gas</td>
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<td>Industry indexes</td>
<td>Banking</td>
<td>LIBOR</td>
<td>Gasoline</td>
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<td>Natural resources</td>
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<td>Commodity index</td>
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<td>Electricity</td>
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<td>Technology</td>
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<td>Municipal bond index</td>
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<td>Federal funds rate</td>
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<td>Bankers’ acceptance</td>
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<td>S&amp;P 500</td>
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<td></td>
<td>Interest rate swaps</td>
</tr>
</tbody>
</table>

Sources: CME and CBOT exchanges; www.cme.com.
TABLE 6.2 S&P E-Mini Futures Contracts Specifications

| **Trade unit** | $50 times the Standard & Poor’s 500 Stock Index |
| **Settle method** | Cash settled |
| **Point descriptions** | 1 point = 0.01 index points = $0.50 |
| **Contract listing** | Five months in the March quarterly cycle |
| **Product code** | Ticker = ES |

| **Hours** | **Regular session:** Mon.–Fri., 8:30 a.m. to 3:15 p.m. CST |
| **After hours at CME® Globex® session:** | Mon.–Thurs., 5:00 p.m. to 3:15 p.m. and 3:30 p.m. to 4:30 p.m.; shutdown period from 4:30 p.m. to 5:00 p.m. nightly; Sun. and holidays, 5:00 p.m. to 3:15 p.m. Month end, 3:15 p.m.; LTD, 8:30 a.m. |

| **Listed** | The percentage price limit is calculated at the beginning of each calendar quarter. Limit is based on 5% of index value. |
| **Limits** | 5%, 10%, 15%, and 20% limits. See Equity limits |
| **Minimum fluctuation** | Regular 0.25 = $12.50, or 1 full point = $50 Calendar spread, 0.05 = $2.50 |


...industrywide, self-regulatory organization for the U.S. futures industry. It develops rules and provides services to preserve futures market integrity. The NFA offers investors protection and help while ensuring that its members meet their regulatory responsibilities.

To trade a commodity, you need to put up some minimum amount of money, called the margin. The margin is about 10 percent of the value of the contract you want to trade. However, depending on the typical price fluctuations of a commodity, its margin requirement may change. For example, to trade an e-mini S&P futures contract, as of the date of this writing, you need to have about $6,500 in your account. This figure could move higher or lower based on market volatility. However, if you want to day trade, the margin requirement is typically cut in half, since there is no risk of overnight price changes for your positions.

To buy or sell a futures contract, you pay a commission and some fees. The commission size differs from one broker to another, depending on services they provide. For a round-turn or round-trip—a buy and sell—commission charges may vary from $5 to even $50. Your broker charges you a commission based on services she offers you. For that you should shop around. But be sure you deal only with brokers who are...
financially sound and are NFA members in good standing. More important, since the majority of futures trades are executed online, brokers must have a reliable electronic trading platform.

A good broker should offer you a simulated online account, with which you could practice trading funny moves in real time. With a simulated trading account, you place trading orders and get fills, just as you might expect when you trade for real, but without the risk. You gain valuable experience trading on an order-entry platform and build confidence in your futures trading style and approach. By using a simulated account, you could test your trading ideas and systems in real time before utilizing your hard-earned money. I strongly recommend that before you apply your trading system with real money, you practice using a simulated account.

Clearinghouses

Buyers and sellers of futures contracts use a third party to clear their trades; this third party is called the clearinghouse. A clearinghouse is a company, approved by an exchange and registered with the CFTC and NFA, that collects and maintains margin monies from traders. Your broker has to clear your trades through a clearinghouse. However, sometimes a broker could be designated and registered as a clearinghouse as well. Before you open an account with any broker or clearinghouse, you should verify their status with CFTC and NFA online at www.CFTF.gov and www.nfa.futures.org to ensure that you deal with real brokers and clearinghouses and avoid any scam artists.

Mark to Market

In futures trading, any losses or gains as a result of your trading activities are realized at the end of each trading day. Your daily statements show a profit or loss. If you have a loss greater than your margin requirement, you will receive a margin call. If you are unable to add funds to meet the margin in your account, the clearinghouse would liquidate your positions to meet the margin. Since the futures trading gains and losses are realized, you could withdraw your profit at the end of the day, or any time for that matter. However, this is not the case for stock trading. Suppose you bought a stock for $20 and now its price is $25. At the end of the day, your statement would reflect a profit for $5 per stock. However, this profit is unrealized, which means you could not withdraw it from your account unless you decide to sell your stock. Then, after three settlement days, you will be able to withdraw the profit from your account. This could mean a great deal of convenience and fund availability for you, since you might not want to have any kind of restrictions on your liquid funds.
Open Interests and Volume
Futures markets have open interest, which sometime could be confused with volume for beginners. In futures markets, like stock trading, volume represents the total amount of trading activity in a single trading day. For a commodity, it indicates the number of contracts that have changed hands in a trading day. Consequently, a high trading volume depicts market participants’ activities, which usually reveal pivotal prices and maybe turning points for the commodity. One could argue that the trading volume depicts a measure of intensity or pressure behind a price trend. An unusual trading volume could reveal two possible scenarios. If the price is falling and we see volume increases as well, we could expect more sell-off. However, if at a pivotal low price point—for example, if volume increases as market rises—we may ascertain that the prevailing trend is reversing rather than continuing.

Open interest is the aggregate number of outstanding contracts that are held by market participants at the end of each day. If volume measures the pressure or intensity behind a price trend, open interest measures the flow of money into the futures market. To consummate a futures trade, there must be two parties: buyer and seller. In other words, for each buyer there must be a seller for a futures contract. Therefore the number of sellers or buyers each could indicate the number of open interest for a commodity. Consequently, when there is a high number for open interest, it indicates that there is a high number of market participants for the contract. Conversely, if traders close their positions by either buying or selling, the open interest should drop.

One could postulate important information based on the increase or decrease of open interest for a commodity. If at the end of trading days open interest increases, we could assume that new traders have entered the market, which could sustain or continue the prevailing trend. However, if the open interest decreases, it indicates that market participants are liquidating their positions. This could mean that the prevailing trend is near its end and the market could reverse. As a trader you could gain a great deal of knowledge and benefit by monitoring open interest of a commodity market.

Regulations and Taxation
As mentioned earlier, futures markets are regulated by the CFTC, which sets capital requirements for member firms and the futures exchanges. As part of its Congressional mandates, the CFTC authorizes trading for new contracts and supervises maintenance of daily trading activities.

The futures exchange imposes limits on a commodity’s daily price change. This is to prevent any violent move and meltdown for a commodity
market. For instance, during the 2008 financial crisis, the S&P futures market opened the limit down to prevent the market from falling further due to the international monetary crisis.

You could open a futures account with any funds as long as you meet the margin requirement to trade the commodity of your choice. Unlike stock trading, to day trade you don’t need a set minimum amount of capital in your account. Although a clearinghouse should pay attention to your annual income with respect to your potential risk for a market, it is rather easy to open an account.

Due to market-to-market procedures in which gains or losses are realized, you are subject to short-term capital gains taxes unless you hold your position for more than two years. Therefore, at the end of a year you are subject to taxes for accumulated profits, whether you close your position or not.

LEVERAGE OPPORTUNITIES

Since futures trading requires relatively small capital, it offers a high leverage for traders. The value of the contract and market volatility are two primary factors that make a futures market less affordable to trade. During peak market prices for crude oil, close to $150 per barrel in 2008, crude oil futures were more expensive to trade than wheat futures because crude oil futures were worth more. For instance, if the market value of a crude oil futures contract is around $32,000 and a wheat futures contract is $12,500, it requires more margin to trade a crude oil futures contract than wheat—about four times more. Volatility is another factor that adds to required margin fund to trade a futures contract. In addition to initial margin, you should have additional funds in your account to tolerate intraday price movements or “noise.” For instance, the Swiss franc and Canadian dollar futures each have roughly the same contract size, yet the Swiss franc is nearly three times as volatile as the Canadian dollar.

Table 6.3 depicts margin requirements for most active commodities as of February 17, 2009. Since margin requirements could change depending on each market’s volatility, you should check with your broker for exact amounts.

Futures markets move much larger amounts relative to the equity market. This means there is a greater potential for profit. However, some markets could be in trading range for a long time before making any significant move. For that, you should check to see which particular market volatility and price moves might be more suitable for your risk tolerance. You
<table>
<thead>
<tr>
<th>Contract</th>
<th>Exchange</th>
<th>Spec. Initial</th>
<th>Maintenance</th>
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<td>Ethanol</td>
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<td>5,400</td>
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(Continued)
### TABLE 6.3 (Continued)

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<th>Contract</th>
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<td><strong>Grains and Oilseeds</strong></td>
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<td>CBOT</td>
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<td>Oats</td>
<td>CBOT</td>
<td>1,350</td>
<td>1,000</td>
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<td>Rough rice</td>
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<td>1,500</td>
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<td>Soybeans</td>
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<td>Soybean meal</td>
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<td>Barley</td>
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<td>120</td>
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<td><strong>Meats</strong></td>
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<tr>
<td>Live cattle</td>
<td>CME</td>
<td>1,620</td>
<td>1,200</td>
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<td>Feeder cattle</td>
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<tr>
<td>Lean hogs</td>
<td>CME</td>
<td>1,080</td>
<td>800</td>
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<tr>
<td>Pork bellies</td>
<td>CME</td>
<td>3,240</td>
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<tr>
<td>GSCI Index</td>
<td>CME</td>
<td>12,750</td>
<td>8,500</td>
</tr>
</tbody>
</table>

*Source:* Compiled from CME and CBOT data.

should remember that the larger price movement a market has, the larger
the profit or loss will be.

Futures markets are liquid. In particular, bond and S&P futures mar-
ket s are among the most liquid markets due to the high participation by in-
stitutional and retail traders. When a market is liquid, the spread between
bid and offered prices is small. This means less cost and more potential
profit for you.

To be a successful stock trader, you need to gather a lot of information about a particular stock. For that you might need to spend a lot of
time screening and selecting a proper and potentially good stock to trade.
However, you do not need to be bothered with that task when you’re
trading futures markets, since you could spend your time understanding the dynamics of a special market to gain a great deal of advantage. As much as insider trading is illegal and prohibited in trading stock, it’s encouraged for futures trading. In other words, feel free to gather as much inside information as you desire for your market.
PART III

Trading Tools
Most investment and trading books and gurus advise the same old Wall Street adage, “Buy low and sell high.” Well, of course anyone knows that to make a profit, you should buy a security at low price and sell it at higher price. Or as a trader, you could also short-sell a security at a high price and buy it back at a lower price. That’s easier said than done. But how do you do it? How do you identify a low or value price for a security? How do you know that the price may not go further down? How do you assess its potential upward move? Conversely, when do you know you should sell a security for potential maximum profit before it turns around? These questions all have a lot to do with the method you use to identify price levels to trade a security or open and close your position. Nevertheless, as an active investor or trader you need to learn a variety of methods to buy low and sell high.

In this chapter and in Chapter 8, we describe two main methods to analyze a security for best price level at which to buy or sell. These two chapters could play an important—even crucial—role in your trading success. Even as an active investor, you could use the methods we discuss in these chapters to monitor your portfolio; that is, regularly review the securities or ETFs that make up your portfolio. Using the information in this chapter, you should know which security has reached peak performance, which one’s not performing as expected, and which one has more potential. Your goal in such monitoring is to determine which assets should be part of your portfolio and which should not and then to rebalance your holdings accordingly, to maximize performance.
There are two primary methods to analyze a security: fundamental analysis and technical analysis. Fundamental analysis seeks to find an undervalued security to buy or an overvalued security to sell. Similarly, technical analysis looks for oversold conditions to buy and overbought conditions to sell. In other words, fundamental analysis seeks to find out “whys”; technical analysis strives to identify “whens” for a market.

**WHAT IS FUNDAMENTAL ANALYSIS?**

According to the practice of fundamental analysis, markets can misprice a security in the short run but then find and correct it to its fair value in the long run. In turn, a trader using fundamental analysis would look for such an opportunity to make a profit.

The main premise behind fundamental analysis is that, ultimately, the firm’s earnings and profitability govern a company’s stock. As such, the primary tool of a fundamental analyst trader is the company’s financial statement and ratio analysis. The investor then uses different stock- and bond-value models to determine the underpriced or overpriced security.

Macroeconomic trends, which determine supply and demand, constitute additional important information for a fundamental analyst trader. In the following sections, we discuss some of the pivotal analysis utilized for stock valuation. The main theme behind any kind of stock valuation is to identify its intrinsic value (IV), the price that represents stock price, and compare it against the market price or value (MV). If IV < MV, then one could conclude that the stock is overpriced by the market and hence should be sold or stayed away from. However, if IV > MV, this could represent that market value is lower than the stock’s real value. Therefore, you should buy the stock and sell it at a later time and expect to make a profit from its price appreciation. Finally, if the IV is about the same as the MV, you should not buy the stock, and if it is part of your portfolio, you should hold.

**FINANCIAL STATEMENTS**

Financial statements are primary means for fundamental analysis. By studying financial reports, investors ascertain information about a company’s earnings, income, and cash flow. However, as important as these three data points are, they fail to reflect the true financial health of a company. Let’s review each of these points to realize the extent of their efficacy and limitations in helping investors properly value a company’s stock.
Company Earnings

It’s plausible to assume a relationship between a company’s earnings and its stock price. The evidence from research indicates a definite link between good earnings or bad earnings news and the stock price return. In other words, when there is a positive surprise about a company’s earnings, its stock price appreciates. Conversely, when there is a negative surprise, the stock experiences a negative return. However, a substantial portion of the stock returns related to positive surprises occurs prior to the earnings announcement. Additionally, research conducted over a 40-year period for a large cross-section of companies indicates that earnings and book values, separately and combined, explain between 50 and 75 percent of stock price behavior. Although the research depicts a relationship between earnings and stock price return, it does not prove a causation. In other words, the aforementioned research does not establish the extent to which earnings and/or book value directly determine stock prices.

Conversely, research also confirms that the importance of earnings reports has declined. In particular, in the past two decades earnings have had less influence on stock price returns. Some of the suggested reasons are associated with increased reporting losses, increased size of one-time charges, reporting of R&D, and intangible assets.

Company Income

Income could be a viable indicator of a company’s financial condition, which may lead a fundamental analyst to decipher the company’s stock price. Recall that, as stated at the beginning of this chapter, the ultimate goal of fundamental analysis is to discover the intrinsic value of a stock. If the IV is more than the MV, you could buy the stock for future price appreciation. However, if the intrinsic value is less than the stock market value, as a rational investor you would then sell your holdings. If you are an aggressive investor with high risk tolerance, you may short-sell the stock to gain profit when its market value drops.

You should make a clear distinction between economic income and reported income or accounting income. Economic income is usually assessed based on cash flow generated during the period plus any changes in the present value due to asset price changes. In line with economic concepts of income, there are permanent or sustainable income and operating income. Sustainable income mainly covers the recurring portion of a company’s income and engulfs a long-term perspective. However, operating income refers to income generated by a company’s operation and does not include the investing income or expenses. This type of income is known as net operating profit after taxes (NOPAT).
Accounting or reported income mainly focuses on converting cash flow to the reported income. Conversely, the reported income does not attempt to measure either economic or sustainable income. This is due to the fact that reported income is generated based on a set of ever-changing rules to satisfy several conflicting objectives. The accounting income is produced according to accounting standards, enforcement mechanisms, and managers’ incentives. Most notably, the governing rules require managers to estimate, which in turn could be utilized for personal incentives and showcasing numbers. Consequently, the reported income is subject to accounting distortion.

Accounting Distortions

Investors utilizing fundamental analysis rely heavily on a company’s financial reports for earnings and cash flow determination. Financial statements are prone to accounting distortions. The term accounting distortions refers to any kind of deviation and divergence between information reported by financial statements and the reality of the business.

Accounting Standards

Some of the well-known sources for accounting standards can cause accounting distortions. One is the accounting method for an employee stock option (ESO), which could be influenced by the political mood and will of different groups. The second one is some of the accounting principles, such as inventory reporting system (last in, first out, or LIFO; first in, first out, or FIFO; and average unit cost) or depreciation methods (straight line, declining balance, and modified accelerated cost recovery system, or MACRS). The third main factor that could cause an accounting distortion is write-off or write-down of impaired assets.

Estimation Errors

Since all publicly held companies are required to use the accrual accounting basis rather than the cash basis accounting method, managers need to estimate many relevant figures, such as future earnings and cash flow. Consequently, utilizing the accrual basis accounting method is subject to many estimation errors that cause financial statements to not reflect the true reality of the company.

Reliability versus Relevance

Another source for accounting distortion is trade-off between reliability and relevance. For example, before a loss contingency is reported as a loss, companies must reasonably estimate it. For that many of loss contingencies are reported in financial statements until their existence is proved to be beyond reasonable doubt. This in turn may take few years. Thus the financial reports do not reflect reality of the business.
Earnings Management  Since accrual accounting requires managers to estimate some of the numbers, some managers have manipulated some important figures in their financial reports, for their own benefit:

... some managers exercise this discretion to manage accounting numbers, particularly income, for personal gain, thereby reducing their quality. Earnings management occurs for several reasons, such as to increase compensation, avoid debt covenants, meet analyst forecast, and impact stock prices. Earnings management can take two forms; (1) changing accounting methods, which is a visible form of earning management, and (2) changing accounting estimates and policies that determine accounting numbers, which is hidden form of earnings management.4

Company Cash Flow

Some fundamental analysts abandon the reported income in favor of cash flow in analyzing a company’s value. As we’ve illustrated, the reported income fails to give a realistic view of a company’s financial health and condition. However, cash flow offers no better superiority for determining a company’s intrinsic value, either.

There are different types of cash flow that a fundamental analyst must recognize. Operating cash flow (OCF) refers to cash produced from the firm’s operation. A company’s business activities could be categorized under three headings: financing, investing, and operation. Financing refers to the company’s pursuit to secure loans and financing to expand its operation either organically or by merger and acquisition activities. Investing activities represent a company’s capital investments by purchasing any capital equipment and machinery to increase the firm’s productivity. A mature company may invest in other companies by buying their stocks or other forms of investment to increase its available cash return. However, operating activities encompass all the company’s engagements and operations to accomplish what it was established to do.

Free cash flow (FCF) is another type of cash flow that pertains to operating cash flow and added effects of investments and divestments in operating assets. Finally, free cash flow to equity considers the addition of the firm’s debt to FCF. In other words, free cash flow to equity represents the total cash available for equity holders.

You may use any of these three types of cash flow to determine the intrinsic value of a company’s stock. In the next section, we describe a few prominent models that aim to identify the intrinsic value of a stock based on cash flow.
A key concept in fundamental analysis is to determine the value of an asset such as an equity or bond. There are different types of valuation methods. However, the quintessence of any fundamental valuation method is present value theory. The intrinsic value of a stock is determined mainly by employing present value calculations. According to the theory, the value of a security such as a stock is equal to the sum of all possible future payoffs from the security, discounted to the present value for a proper discount rate. Consequently, investors have to estimate future cash flow of a security. Furthermore, they are required to identify a proper discount rate. However, how could they determine with certainty that a company would continue to generate cash flows or pay dividends?

Another component for fundamental valuation is the cost of capital or weighted average cost of capital (WACC) for a company, which can change due to future capital structure, the company’s earnings, and external factors such as economic conditions. Consequently, investors utilizing any type of fundamental valuation methods strive to make educated guesses. In the following sections, we review various valuation models.

**Book Value**

How do you calculate the intrinsic value of a stock? One way to calculate the stock’s book value is to obtain the net worth of common equity from the company’s financial statements. For example, as of April 2007, the share price for General Electric (GE) was $34.03, whereas its book value per share was $10.49. One could argue that since the book value is about one-third of the stock price, the stock market price should be expected to go lower in future. As of February 19, 2009, GE was selling for $9.38. A fundamental analyst trader could have sold the stock in 2007 for $34.03 and bought it back in 2009 at $9.38, for $24.65 in profit.

Many analysts believe a better measure of a floor below which market price should not fall is the liquidation value. This represents the amount of value or money that could be realized by selling an asset. The idea is that if a stock’s price falls below the liquidation value, the company becomes a target for takeover. A corporate raider may buy the company and break it into pieces for sale. By doing that, the raider could make a profit. Another alternative to book value is the replacement cost of a company’s assets less liabilities.

Any of the aforementioned valuation methods rely heavily on the company’s balance sheet. However, companies could easily manipulate their financials by utilizing different types of inventory systems and deprecations.
For this reason, for most companies the income reported to the Internal Revenue Service (IRS) is different from what they reported on the financial statements available to investors and filed with the SEC.

**Market Multiples**

A popular stock valuation method among analysts is the *market multiple*. This method seeks to identify the value of a stock by comparing it to its peers and its industry. The market multiple method utilizes the P/E ratio of a company and multiplies it by the EPS estimates of similar companies or the industry to which the company belongs. For instance, the P/E of GE from the company’s financial statement is 5.46, whereas its EPS is 1.72.\(^5\) If you multiply the P/E by the EPS, you could get the stock price for $9.39, which is just about the same as the market price of $9.38 on the close of the trading day on February 20, 2009. Now, if we look at comparable companies or the industry’s E/S, we could multiply it by GE’s P/E to calculate the comparable valuation of the stock. GE belongs to the conglomerates industry and sector, which has an E/S of 8.3.\(^6\) Consequently, according to the market multiple valuation method, GE should be valued at \(5.46 \times 8.3 = 45.32\) Thus one could buy the stock and hope its price appreciates to about $45, which might be a far-fetched wish for some time to come!

One main reason for this huge discrepancy between GE’s market price and its so-called intrinsic value based on the market multiple is the E at the denominator of P/E or at the nominator of EPS. First, note that E is influenced somewhat by accounting distortions and arbitrary accounting rules such as the use of historical cost in calculation of depreciation and inventory valuation. For example, in higher inflationary times the historic cost depreciation and inventory cost tend to be higher, which makes the P/E lower and underrepresented. Conversely, in the relatively low inflation, the P/E tends to be higher, so in both economic conditions the ratio becomes distorted.

**Dividend Discount Model**

The dividend discount model, or DDM, method looks to identify the intrinsic value of a stock by discounting its future expected dividend. An investor may buy a stock and hold it for one year and then sell it at a higher price after he receives the dividend. In other words, the stock price \(P_0\) is the discounted value of the dividend \(D_0\) and the expected sale price \(P_1\), or \(P_0 = (D_0 + P_1)/1 + k\). There are few variations of this basic DDM—for example, if the dividend grows continuously or just for few years. In any case, for this valuation method one has to guess the dividend growth rate for the company. However, in recent years, a handful of established
companies such as Citibank and General Electric had to cut their dividends due to financial problems. Furthermore, firms such as growth companies that pay no dividends could not be valued based on DDM.

Discounted Cash Flow

DDM cannot be used for all firms because some do not pay dividends if they are young or use their earnings for capital expenditures to grow their companies. An alternative to DDM is discounted cash flow (DCF), which discounts a firm’s FCF based on WACC. FCF is available cash after all expenses and taxes are deducted from the earnings and investment. Using this method, we can calculate a firm’s value and subtract it from its debt to identify the total value for equity. To figure the stock price, we divide the total equity value by the number of outstanding common stocks.

DCF may provide a better valuation over DDM. However, since an analyst has to guess the growth rate to calculate the minimum required rate of return for a stock, this method has the typical pitfalls for estimation. In other words, using a correct “estimate” of future earnings determines the accuracy of one’s valuation, which makes this method rather a subjective one. Now, if we average the estimates for several analysts, we get the market consensus.

This and other valuation methods are heavily dependent on an analyst estimate of a company’s future earnings and dividends growth, which makes them rather subjective and “feel-good” numbers. No wonder that only the smallest fraction of stocks (less than 2 percent) are assigned sell recommendations; as it turns out, many analysts have given buy recommendations for stocks that were privately called dogs or worse by the same market analysts. According to reports, it seemed that these analysts’ main motivation has been to get new clients or to keep their good-paying clients. Remember Jack Grubman of Salomon Smith Barney, part of Citigroup, who upgraded his rating of AT&T to win Salomon a role as co-manager of AT&T’s massive stock sale. But he was hardly alone. Ten Wall Street firms paid $1.4 billion, including $75 million to fund independent stock research, to settle claims of improper behavior.7

There are two major problems with the DCF approach, however. First, the information is old and has already been considered or discounted by other investors and market participants. Second, as confirmed by behavioral finance findings, despite their use of such information for decision making, investors actually tend to make decisions based on emotions and justify them via rationalization. This phenomenon is evident in the market when a certain stock is widely sold despite good news about the company, or when investors buy a stock despite the company’s negative earnings and poor financial health.
The fundamental analysis seems to work in a secular bull market as long as all the stocks are moving up. Therefore, any recommendation will most probably end up being correct if it is in the upward direction, in line with the buy-and-hold strategy. In the past few years, as the great stock market meltdown has occurred, fundamental analysis has been unable to offer any help or truthful guidance.

**FUNDAMENTAL ANALYSIS CAN'T DELIVER TIMELY INFORMATION**

Fundamental analysis seeks to determine the intrinsic value of a company’s stock. Intrinsic value, also called fundamental value, is the “inherent” value of a company, regardless of its market price. When the intrinsic value is greater than the market value, a fundamental analyst or an investor utilizing fundamental analysis looks to purchase for a future price appreciation, to make a profit. Conversely, if the intrinsic value is more than the market price, traders may sell their holdings or initiate new short positions. For short position holders, when market price drops below their entry price, they stand to make profit.

Investors utilizing fundamental analysis rely heavily on a company’s financial reports for earning and cash flow determination. Financial statements are prone to *accounting distortions*—any kind of deviation and divergence between information reported by financial statements and the reality of the business.

However, since financial reports are subject to management estimates and earnings manipulations through utilization of various accounting methods (that is, depreciation method, inventory systems, and assets and liabilities valuation methods, to name a few), they might not reflect the true financial health of a company. Furthermore, financial statements do not reveal any new information and are relatively old news. Consequently, an active investor does not see any advantage to employ fundamental analysis for making timely investment decisions.

Fundamental analysis is inept for delivering timely information to the new-paradigm trader. The main focus of fundamental analysis is long term. However, as John Maynard Keynes once remarked, “In the long run, we are all dead.” Compared to fundamental analysis, technical analysis offers a better explanation for security price behavior. In particular, it provides a superior platform to project stock prices in the short term.

In Chapter 8, we discuss technical analysis, an important method you can use to analyze a security for an optimum price level at which to buy or sell.
Technical analysis enables traders to identify potential shifts in a security’s price behavior, including the start of a new trend or the end of a long-lived trend. If a security has been advancing and making new highs, for example, the trader is poised to project its turning point—an overbought condition of the security—at which point he can sell his positions, protect his profits, and create a much better return in the end.

Using technical analysis doesn’t necessarily reject the value of fundamental analysis, however. Technical analysis proposes that each single price point is a reflection of market participants’ cognitive and emotional decision-making points. Investors gather all the available information and project their opinions into the price behavior. Thus the market as an aggregate of all market participants with all available interests and opinions becomes a discounting system for possible price action of a security. However, technical analysis opposes the Efficient Market Hypothesis (EMH) notion that market participants who look for trends or any order in the market simply tread water. Conversely, the proponents of EFH proffer that any shift in market fundamentals is reflected in the market immediately due to its efficiency. Therefore, there is no advantage or benefit for traders to look for a trend in the market, since there is no trend.

According to EMH, the market is trendless and exhibits random price movements. However, technical analysts argue that any shift in market fundamentals is discounted in a gradual process. Furthermore, economic agents as claimed by EMH are not rational decision makers, since they are influenced in their judgments by emotions. Indeed, this finding has been
supported by a vast array of literature, which has resulted in forming a new theory about markets: the *behavioral finance* theory, or BF.

BF submits that market participants are heavily influenced by their emotional and biased decisions. According to research and theories regarding decision making (sometimes called *behavioral decision theory*), there are two fundamental reasons we succumb to such decision traps: heuristic-driven biases and frame dependence.

In general, the term *heuristic-driven biases* refers to errors we encounter when making decisions. In decision making, our minds tend to reference sets of guidelines or rules of thumb that it has constructed based on our past experiences, cultural influences, social values, biases, and other information. The other type of decision trap, *frame dependence*, generally refers to the way we make decisions based on what we see at that moment (i.e., our perspective). There are two main tools used for technical analysis.

### TOOLS USED FOR TECHNICAL ANALYSIS

The main tools used for technical analysis are a security’s price chart and trading volume. The astute trader looks at different *chart patterns* and uses indicators called *technical indicators*, striving to exploit recurring patterns and historical price activity to generate high investment returns and trading profits.

If the available information indicates that a company’s liquidity, solvency, and profitability are positive, the investor might assume a higher demand for it, which would drive up the price. In fact, increased buying might even send the price to a level that seemingly includes or discounts new information, even when it does not. This level is called a *ceiling* or *resistance*. To get past this resistance level, market participants must buy more and push the price yet higher, which would require still more positive information. If we assume that market participants purchased at the high value, as the price drops many become anxious to exit their positions by selling the securities. Therefore, when the market moves back up, they look to sell and exit as close to break even as possible. This aggregate market behavior establishes a resistance level.

On the contrary, if a security appears to be overvalued and would presumably not generate any meaningful profit, the trader would sell. Aggressive investors may even short-sell, which would cause the price to fall to what’s called *floor* or *support level*, to adjust for proper valuation. Conversely, at a low price level, traders may buy the security to sell it at a higher price. Due to this positive experience, they may look to repeat it by purchasing the security at the previously marked level, now called support.
The existence of support and resistance price levels in a security chart denotes market short-term memory that clashes head-on with EMH advocates.

Bar Charts
Several types of price charts can be used to depict price action and market behavior. The most popular type in trading is the bar chart. This type is also more popular on the Internet and, therefore, easily accessed for free. Nevertheless, the Winning Edge Trading System, which we'll discuss in future chapters, is equally equipped with other types of charts such as candlestick charts as well as figure and point charts.

Trading bar charts typically depict price changes. As illustrated in Figure 8.1, each bar shows the opening price (denoted simply as open) and the closing price (or close) as well as the high and low prices (high and low) for a specified time period. Of course, there are slight variations among different bar charts: Price action can be presented with a line that connects the close of each time period, for example, and various charts depict different time periods, from minutes to months or longer. The Winning Edge Trading System, for instance, uses a one-minute chart for day trading or short-term trading, a 30-minute chart for swing or intermediate-term trading, and a daily chart for position trading or long-term trading. In Figure 8.1, low and high indicate the low and high prices within a time period specified by the bar chart, and open and close indicate the opening and closing prices in relation to the same time period.

Trading Volume
Trading volume is another tool central to technical analysis. It refers to the total trading shares for a security that has been traded. Consequently, the
higher the trading volume, the more meaningful a security price move is. In other words, trading volume acts as a confirmation for price behavior of a security.

Technical analysts utilize trading volume for confirmation of price breakouts and measurement of trend strength. For instance, consider a security price that has been vacillating in the past month between $90 and $100 price levels. However, its price spikes above $100. Technical analysts look for heavy trading volume more than its daily average to confirm the validity of the breakout. If it is supported by high volume, they may look to buy the stock on the pullback to $100. Otherwise, they sell short it to “fade” the false breakout, since they expect that the stock price would fall below the $100 price level again.

Another application for trading volume is either to confirm the underlying strength of a continuing trend or to note its reversal. Consider Figure 8.2, which depicts the ETF for the S&P 500 Index, SPY. The price points
A and B on January 23, 2008, and March 17, 2008, both correspond to higher than usual volume bars, shown below the price chart. Accordingly, the SPY moved up after making lows on those two dates. In other words, a reversal occurred, which was confirmed by a spike in trading volume.

**TECHNICAL INDICATORS**

A technical indicator uses mathematical calculations of past security prices to project future behavior. That’s because technical analysis presupposes that any stock or market in general repeats its behavior.

Market behavior—in fact, any type of price move—can be identified as either trending or trading (also called a range bond). A trending security closes at sequentially higher prices (called an uptrend) or sequentially lower prices (a downtrend). However, a range bond or trading security has prices that are typically constrained between two price levels: the upper resistance and the lower support. When the price breaks out from a range, it can signify the beginning of an uptrend or downtrend.

In general, there are two types of technical indicator: momentum indicators and oscillators.

**Momentum Indicators**

Momentum indicators, which are generally used for longer timeframe investments, identify a trend and follow it. Examples of momentum indicators include moving averages, regression analysis, average true range, and ease of movement. In a long-term uptrend market, momentum indicators could help you manage your positions better or find the support level in order to buy a security. Let’s review the two most common momentum indicators: trend lines and moving averages.

**Trend Lines**

Trend lines show overall market direction, indicating an upward or downward move on a bar graph. (If the market is neither in an uptrend or downtrend, it’s said to be sideways.) To draw an upward trend line, you connect the lows of the bars. As Figure 8.3 depicts, the upward trend line (also called a support trend line) is connected to the pivot lows. In an uptrend, investors expect the market to hold the trend line as a floor for its price action and gyrations. If the market penetrates and breaks down, however, they conclude that the upward trend is broken or, at the very least, question the trend line’s validity.

A downward trend line connects the bars’ highs or pivot highs to create a resistance (see Figure 8.4). For this reason, a downward trend line is also called a resistance trend line.
To draw a trend line, you need two points (i.e., on two different bars). However, to confirm a trending move, you need three or more such price points tracking movement within a timeframe—either for the long, intermediate, or short term, or for a combination of timeframes. Within a long-term trend, for example, you could track a few intermediate-term trends and many short-term trends. For any trend that you identified, you could assume that a trending market would stay intact until the prevailing trend is violated.

Consider Figure 8.5, which depicts an uptrend in a security. To establish a trend line, you’d need at least two price points, such as A and B, but to confirm an uptrend, you’d need point C as well. When the security price falls, it requires the equivalent of price point D to indicate that the trend is no longer valid. At that point, you could exit your position by selling the security. Or, if you’re an aggressive investor with high risk tolerance,
Technical Analysis

**FIGURE 8.4** A Resistance Trend Line Connects the Highs of Bars and Forms a Resistance Line

**FIGURE 8.5** Confirming an Upward Trend
you could either short-sell the security and buy it back later or cover your position at a lower price for profit.

**Uptrend Reversal**  As trend lines identify a trending price move, they also could be used to signify a trend disruption and reversal. To examine this idea, let’s review Figure 8.6, which indicates that an uptrend move was broken. Note the first market moved down below the trend line, then subsequent highs were lower highs, which indicated that the uptrend move had been violated. As a trader, you could use this information to exit your long position and protect your profit. Or you could short-sell and initiate a

![Figure 8.6: Lower High Prices Below an Upward Trend Line Denoting a Trend Reversal](image)

**FIGURE 8.6** Lower High Prices Below an Upward Trend Line Denoting a Trend Reversal
new short position and look to buy it back or cover it at lower price levels for some profits.

**Downtrend Reversal** When a downtrend is violated to the upside, you could expect a downtrend reversal. As Figure 8.7 depicts, the downward trend was broken when the market made a low but higher than the previous low. A trader could use this information to either cover his short positions or initiate new long positions. It is important to wait for the market to make the higher low to confirm the reversal. Otherwise, it could be just a short pause before the market continues with its previous downtrend move.

**FIGURE 8.7** Higher Low Prices Above a Downward Trend Line Denoting a Trend Reversal
Moving Averages  Another popular momentum indicator is the moving average (MA), which tends to “smooth” a data series to enable you to spot a trend more easily. These types of indicators are especially helpful in volatile markets.

An MA is a calculation of the average (mean) price of a security or market index over a specified number of time periods. And although it is possible to create MAs from the open, high, and low data points on a bar graph, most MAs are created using the closing price. For example, a three-day simple MA is calculated by adding the closing prices for the last three days and dividing the total by 3, as shown below:

Close of Day 1 = $1,181.70
Close of Day 2 = $1,189.20
Close of Day 3 = $1,193.20

$1,181.70 + $1,189.20 + $1,193.20 = $3,564.10

$3,564.10 ÷ 3 = $1,188.03, or, rounded off, $1,188.00

Daily MA = $1,188.00

The calculation is repeated for subsequent time periods. The resulting MAs of several consecutive time periods are then joined to form a smooth curving line, called the moving average line. So, continuing with this example, let’s say that the closing price of Day 4 is $1,192.00. To calculate the subsequent three-day MA, you’d add $1,192.00 to the equation and subtract the closing price from Day 1—the oldest day. The new three-day MA would be calculated as follows:

($1,189.20 + $1,193.20 + $1,192.00) ÷ 3 = $1,191.46, or, rounded off, $1,191.50

MA indicators and charting programs are commercially available in both brick-and-mortar stores and on the Internet.

There are different types of MAs that you could use to manage trading, such as simple, exponential, and weighted MAs. These indicators don’t provide any advantage for short-term or swing trading but are used mainly for exit and stop-loss price levels. However, you may track 50- and 200-day MAs for your daily chart, since the market seems to pay particular attention to these two. Figure 8.8 illustrates the previously mentioned three types of MAs.

Most investment managers and institutional traders like to use 50- and 200-day MAs to help them manage their portfolios and trading positions.
Figure 8.8 illustrates a daily chart for the S&P 500 Index ETF, SPY. As the chart depicts, on December 27, 2007, after the market took out the slow 50-day MAs, the MAs acted as a resistance level until April 1, 2008. At that point, when the market moved higher, the 50-day MA behaved as a support level until it was broken again on June 6, 2008. The 200-day MA acted as a good resistance level on May 19, 2008.

As a new-paradigm trader, you can use such information to monitor your portfolio or place a new position. For example, when the 50-day MA was a support, you could have bought into SPYDR and sold your positions on May 19, 2008, pocketing a nice profit for about 9 points. Or, if you are an aggressive investor, you could have experienced the same sort of security on May 20, 2008, buying back to cover some of your short positions on June 5, 2008, for about 5 points profit, and still remain in a short position for more profits to come. In Figure 8.9, Line 1 is a 50-day simple MA. Lines 2 and 3 show exponential and weighted 50-day MAs, respectively.
FIGURE 8.9 Two Moving Averages Shown on the SPY Daily Chart

Oscillators

The second type of technical indicator is an oscillator. Oscillators look to identify a high or low point while considering that the market, as an aggregate of all securities, is influenced by economic cycles and, consequently, displays cyclical behavior. In addition, they recognize that each market cycle is divided into shorter cycles. Three of the most popular oscillators are the moving average convergence and divergence, the relative strength index, and the detrended price oscillator.

Depending on your timeframe, using a sound, time-tested oscillator could help you identify a probable high and low for the market or security you’re monitoring. There are three major uses for oscillators:

1. To identify overbought and oversold conditions. If the oscillator crosses above the 70 percent line that is part of the oscillator readings on a bar chart, that indicates an overbought condition for the security
FIGURE 8.10 The RSI Confirming a High and a Low for the Security QQQQ

and a possible top. Conversely, if the oscillator crosses under the 30 percent line, it depicts an oversold condition, meaning that its sales have been overextended and should soon see a turnaround in price. See the example in Figure 8.10, which uses one of the most popular oscillators called the relative strength index (RSI). In Figure 8.10, after the market crossed over the overbought boundary, the security called QQQQ put a top in place and sold off. Conversely, after QQQQ reached the oversold line, or the 30 percent boundary, it turned around and took off.

2. To identify divergence. Another important use of the oscillator is to identify a divergence between price action and the oscillator’s readings. When the security price is making higher highs than the oscillator, it’s called a bearish divergence. When a security price is making lower lows than the oscillator, it’s called a bullish divergence. Such divergences are important concepts that, as a new paradigm trader, you should take advantage of. Consider the chart in Figure 8.11, which illustrates divergence between financial security XLF and another popular oscillator called the detrended price oscillator (DPO).
In Figure 8.11, the security, XLF, has made higher highs between price points 1 and 2, whereas the DPO has made lower highs—a bearish diversion. The same type of divergence occurred between price points 3 and 4. XLF sold off in both cases of bearish divergence.

When a bullish divergence occurred, however, the XLF took off due to the low prices. The oscillator was able to confirm a short-term low, which could be profitable for an investor. Suppose you were holding this security and you observed the bearish divergence at price points 1 and 2 or between 3 and 4. Wouldn’t you sell your holdings? Of course you would. This is how a new-paradigm trader increases trading profits. Meanwhile, the old-paradigm investor who subscribes to the buy-and-hold strategy would have to suffer all the losses.

3. *To identify zero-line crosses.* The third usage of oscillators is considering the zero line. Each oscillator inherently moves around a zero line that separates negative values from positive ones. When an oscillator crosses above the zero line, it could indicate an uptrend. Conversely,
when the oscillator crosses to below zero, it could indicate a downtrend. Figure 8.12 depicts this concept for SPY, an ETF that represents the S&P 500 Index. The moving average convergence/divergence (MACD) oscillator moves over the zero line, indicating a new uptrend.

Also, keep in mind that you can use oscillators in a combination of ways—for example, to identify diversion and to confirm a low or high for a security. Now let's go over the three most widely used oscillators in more detail.

**Moving Average Convergence and Divergence** The MACD indicator is among the most popular oscillators because it can be used as both as an oscillator and a momentum indicator.

The MACD calculates two exponential MAs for the time period you specify: FastLength and SlowLength. FastLength measures an exponential MA with a short interval; SlowLength determines the same for a long period. The oscillator plots the difference between these two averages as the
TABLE 8.1  Input Information for a MACD Indicator

<table>
<thead>
<tr>
<th>Name</th>
<th>Input Values</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FastLength</td>
<td>12</td>
<td>Number of bars to include to calculate the fast</td>
</tr>
<tr>
<td></td>
<td></td>
<td>exponential average.</td>
</tr>
<tr>
<td>SlowLength</td>
<td>26</td>
<td>Number of bars to include to calculate the slow</td>
</tr>
<tr>
<td></td>
<td></td>
<td>exponential average.</td>
</tr>
<tr>
<td>MACDLength</td>
<td>9</td>
<td>Number of bars used to calculate the MACD</td>
</tr>
<tr>
<td></td>
<td></td>
<td>exponential average.</td>
</tr>
</tbody>
</table>

MACD. It also plots the MA for MACD, denoted by MACDAvg, based on the number of bars indicated in the input variables. Finally, it plots the difference between the MACD and the MACDAvg as the MACDDiff.

As such, as an oscillator, the MACD can be used to identify overbought and oversold conditions for a security or market. As a momentum indicator, it can be used to follow a trend, as would an MA—if the MACD crosses above the MACDAvg, it may indicate the beginning of an uptrend; if the MACD crosses below the MACDAvg, a downtrend may be near.

**Input Information**  Various charting programs may represent input names differently. Table 8.1 indicates the setting used by the TradeStation charting program, which is a professional trading platform. This indicator is also available for free on many Internet financial sites such as Yahoo! Finance.

Figure 8.13 illustrates the MACD on a daily chart for XLF, the financial ETF. The thick line depicts the MACD; the thin line shows the MACD average. The histogram graph represents the difference between fast and slow MAs.

**Relative Strength Index**  The RSI calculates a value based on the cumulative strength and weakness of a price over a period of time. RSI accumulates the points gained on bars with higher closes and the points lost on bars with lower closes. These two sums are indexed and plotted on the chart as an oscillator with a value from 0 to 100. The direction of the RSI oscillator should confirm price movement. For example, a rising RSI would confirm rising prices.

RSI can also help identify divergences. For example, a new high in price without a new high in RSI may indicate a false price breakout. In other words, as the security price is making higher highs, that trend may not continue. RSI is also used to identify overbought and oversold conditions when the RSI value reaches extreme highs or lows. Figure 8.14 shows the use of an RSI as a technical indicator.
FIGURE 8.13  MACD Indicator on the XLF Daily Chart

FIGURE 8.14  RSI Indicator on the QQQ Daily Chart
RSI could be used to measure the extent that a security has outperformed another security. For example, you may compare a financial company stock such as Citigroup with the S&P financial index to measure how good or bad Citibank has performed compared to the underlying benchmark market. This type of study is conducted to identify leading stocks in an industry or sector. Or you might want to ascertain which market has been performing better than others. Suppose you decide to diversify and trade other markets, such as gold or crude oil. However, you are not sure which one been doing better. You could compare these two markets using RSI. To do so, you should subtract gold’s daily price, as an example, from crude oil’s daily close and graph the calculated data. If the line descends to the downside, it would indicate that gold has had lower performance than crude oil. However, if the graph ascends upward, you could ascertain that gold has been performing better than crude oil. Then you could expect the same trend to continue for some time. A study examined this strategy and provided some support for it.¹

**Detrended Price Oscillator** As mentioned earlier, the DPO is similar to an MA in that it filters out trends in prices to more easily identify cycles. The DPO draws an MA as a horizontal line and places prices along that line. This method provides a means of identifying underlying cycles not apparent when the MA is viewed in a price chart. See Figure 8.15 for an example.

**More About Oscillators** One of my favorite oscillators is the DPO, which I’d like go over in more detail here. A typical market price chart might not reveal the market’s cyclic patterns. For example, Figure 8.15 exhibits a SPY price chart. As it moved up from point 1 to point 2, one could assume that the uptrend move might continue. However, the DPO oscillator did not confirm it. On the contrary, it indicated that the corresponding points 3 and 4 formed a downtrend move. Conversely, the DPO oscillator revealed the market downturn cyclical move. The divergence between market price and DPO, as shown in Figure 8.15, may indicate the security price will discontinue its upward move.

A main focus for a trader is to determine short-term high and low price points. Identifying a short-term high enables us to take a short position or exit our long position. On the reverse side, knowing where the probable high or low is enables us to sell or buy the market for a profit. We could also use intermediate-term highs and lows to exit our positions.

If, for example, you hold a long position and you identify an intermediate- or short-term high, it would make sense to sell your position for a profit. Or you could move your trailing stop to lock your profit. A
FIGURE 8.15 Divergence Between the Market Price and the DPO

trailing stop is a stop-loss order, which you could adjust according to the favorable market move from your entry price. By using a trailing stop order, you can replace your original stop-loss order with a new one to protect your profit in case of an adverse market move. Accordingly, if the market continues upward, you could manage your position by moving your trailing stop up farther.

Repetitive patterns of price movement create market cycles, and many securities and markets tend to move in cyclical patterns. By identifying such patterns, the DPO indicator determines turning points in the market—that is, certain highs or lows that could arise due to recurrent external factors, such as seasons, elections, fluctuations in market participants' psychology, and other underlying cycles not apparent from observing a price chart.

As shown in Figures 8.16 and 8.17, divergence between price levels and the oscillator readings can be used to identify the market's potential turning points.
FIGURE 8.16 Diversion Between the Market Price and the DPO Can Identify a Potential Reversal in the Uptrend, Generating a Sell Signal

RSI and DPO Combined-Signals Confirmation I will go over this topic in more detail in the next chapter, but for now, remember that it’s possible to use another oscillator—the relative strength index (RSI)—in conjunction with the DPO to increase the probability of accuracy in the readings you get from the DPO for a signal confirmation or of a potential reversal in a trend line. Figure 8.18 exhibits how the RSI indicator correctly identifies the turning points in the market.

MARKET RETRACEMENT LEVELS

A popular concept in investment management is retracement levels. In a trending market, as the price moves up and attains new highs, it can reach a point at which the flow of buyers levels off, whereby it loses its uptrend momentum. Since the market can’t find any more buyers, sellers come to short the market, at which point, the retracement theory proposes, the market could move down, traveling in a step-like fashion to levels such as
75 percent, 50 percent, and 25 percent. Conversely, in a downtrend, the market would rise in stepwise format from the lowest low to its highest price point.

Market retracement is only one tool that you can use to manage your investment holdings, however, and it might not work all the time. Nevertheless, the majority of short-term trades require the use of this concept.

**FIBONACCI RETRACEMENTS**

Leonardo Fibonacci, an Italian mathematician, was born in the 12th century. His study of the Great Pyramid of Giza and rabbits’ breeding habits led to his discovery of the relationship of Arabic numbers. Soon after, he developed what became known as *Fibonacci numbers*, a sequence of numbers in which each number is the sum of the two previous numbers. Here is the Fibonacci sequence:

1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 610, etc.
So, in creating such a sequence—for example, to get the next value after 13—you’d add 8 to 13 and arrive at 21. Likewise, to arrive at each successive number, you simply add together the two previous numbers.

In addition, if you take any two adjacent numbers and divide each by the sum of the two, the values converge to 38.20 percent and 61.8 percent (see Table 8.2).

**TABLE 8.2** The Fibonacci Sequence Depicts an Interesting Property That Could Be Used by Traders

<p>| | | | | | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>1 ÷ 3 = 33.3%</td>
<td>2 ÷ 3 = 66.7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>3</td>
<td>2 ÷ 5 = 40%</td>
<td>3 ÷ 5 = 60%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>5</td>
<td>3 ÷ 8 = 37.5%</td>
<td>5 ÷ 8 = 62.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>8</td>
<td>5 ÷ 13 = 38.5%</td>
<td>8 ÷ 13 = 61.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>13</td>
<td>8 ÷ 21 = 38.1%</td>
<td>13 ÷ 21 = 61.9%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>21</td>
<td>13 ÷ 34 = 38.2%</td>
<td>21 ÷ 34 = 61.8%</td>
<td></td>
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</tr>
</tbody>
</table>
What might be more interesting still is that any given Fibonacci number is approximately 1.618 times the preceding number and about 0.618 times the following number.

Many securities, after making sustained moves in either an upward or downward direction, eventually retrace to levels that are consistent with the percentages gotten through such calculation of Fibonacci price retracement numbers—namely, 23.6 percent, 38.2 percent, 50 percent, 61.8 percent, 76.4 percent, and 100 percent. So, to do a Fibonacci retracement (Fib retracement), just draw a trend line between the most recent peak and valley. Then subtract the peak value from the low value and divide it by 23.6 percent, 38.2 percent, 50 percent, 61.8 percent, 76.4 percent, and 100 percent. Values corresponding to the Fibonacci levels are potential market retracements, which you can use to predict future movement of the market and thereby manage your security more effectively. Since there is a high degree of subjectivity in choosing the peak and the low, you may end up with many potential retracement levels, but each would be valid until the market invalidated it.

Figure 8.19 depicts a daily chart for SPY. After making a low at 109.00 on October 24, 2004, the market moved up to 121.76 on January

![Figure 8.19 Using Fibonacci Levels to Manage Positions](image-url)
TRADING TOOLS

3, 2005. The Fib retracement levels for this security would be calculated as follows:

\[ 121.76 \text{ (recent high value)} - 109.00 \text{ (recent low value)} = 12.76 \]
\[ 38.2\% \text{ level} = 12.76 \times 38.2\% = 4.87 \text{ points} \]
\[ 121.76 - 4.87 = 116.89 \]
\[ 50\% \text{ level} = 12.76 \times 50\% = 6.38 \text{ points} \]
\[ 121.76 - 6.38 = 115.38 \]
\[ 61.8\% \text{ level} = 12.76 \times 61.8\% = 7.89 \text{ points} \]
\[ 121.76 - 7.89 = 113.87 \]

According to the Fibonacci concept, one could guess that the market would pull back to 116.89 first, but given that the market was in a strong uptrend move, it would not go down much farther and would in fact resume its upward move after dropping to 116.89.

If the market reached the 50 percent area of 115.38, the uptrend may not be strong. And if it moved all the way down to 113.87, the uptrend would be suspect and the odds greater that the market could reach its previous low at 109.00.

But then how do you use Fib retracement to manage your trades? If you were holding a short position, you could scale out some of your position when you saw that the market was gravitating to areas around 116.89. Or you could simply trail your stop to lock some of your profits. Then if the market kept moving down to areas around 115.38, you’d cover some more positions and move down your trailing stop to lock your profit, and so on.

In Chapter 9, we’ll discuss how to use the Winning Edge Trading System for optimum performance of your favorite security and market.
Regardless of the type of trading system you employ, a key component for a system’s success is its underlying market model. The term *market model* refers to the manner in which your system deciphers market price behavior. Your model explains factors that may cause a security’s price to go up and down. The more realistic your market model, the better you could explore and benefit from its operation.

A sound market theory and model describes the inner workings of capital markets based on a set of assumptions. A theoretical model, therefore, analyzes the behavioral regularities by reducing them to more basic components and quantitative terms. If the assumptions are more realistic and reflect the dynamics of the real world and everyday experience, the accuracy of the model increases. Furthermore, a model insinuates how certain principles govern market functions. Thus a model should explain the working of the market. However, the real test for a model is its practical implications. In other words, the value for a market theory is measured based on the accuracy of the representation it offers. For a trader, this means how useful and functional the proposed model is for profitable and successful trading. Finally, a theoretical model should be compared and contrasted with other established models to point out its advantage over the others.

The principles governing capital market functions and behavior according to my Winning Edge Market Model are as follows: A market is a nonlinear, dynamic, and complex system; hence it exhibits simple behavior based on its habitual and cyclical patterns. It displays a periodic deterministic behavior, which vacillates between two market price extremes, peak
and trough based on market participants emotional states. In other words, it follows the universal principle of contraction/expansion. Moreover, market behavior mirrors market participants’ emotional decision making and reactions. Thus fear plays a greater influence than greed in shaping market price action.

THE MARKET AS A SYSTEM

It should be noted that the market as a whole operates as a system. A system comprises various smaller parts called subsystems, each of which provide a specific function’s part of the overall system’s goal. For instance, your body is a system composed of nine subsystems: circulatory, digestive, endocrine, muscular, nervous, reproductive, respiratory, skeletal, and urinary. All these important systems are designed to ensure that your body functions properly to survive, grow, and reproduce. Let’s consider another example: financial systems. They play essential roles in allocating resources and wealth in our modern economy. Through their intermediary function, financial systems channel capital from consumers, who are net savers, to business and government, which are net borrowers.

A system’s engine and growth are its internal dynamics. External factors may just create shocks that in turn perturb a system’s dynamic equilibrium. However, after a shock’s influence dissipates, the internal dynamics take control and play the essential role of guiding the system’s behavior. For the futures market, as an example, market participants and their particular behaviors and perceptions are determining factors in shaping the price behavior. Consequently, they create pivotal price levels, which are displayed as support and resistance levels in the price chart. Support and resistance levels are temporary or periodic floors and ceilings for the market price vacillations. Accordingly, to understand and be able to decipher market behavior and its seemingly random moves, one must study its main players’ psychology and cultural beliefs.

Dynamic Systems

Since market prices fluctuate and change over time, a market is considered a dynamic system. It is also an open system that interacts with other systems. In other words, the stock market system, due to its interaction and constant influx of energy from market participants, behaves in an ever-changing and dynamic manner. Every day, even every moment, the market goes through changes and therefore is not what it was just moments ago. Consequently, it is interrelated, interdependent, and interconnected.
with other financial systems and subsystems. This is the reason that we can observe and identify intermarket relations. When a market such as energy goes up, we can see other upward stock market moves, too. However, the relationship between two markets could at some time have inverse or direct relationships.

**Nonlinear Systems**

A main difference between a linear and a nonlinear system is its feedback process. For a linear system, there is a reaction for every action imposed on the system. Accordingly, a linear relationship could be defined and stated by a simple equation. For instance, if we suppose that the stock market is a linear system, we can express its price behavior with a simple equation such as $y = ax + b$. Since this is a linear equation, every change in the independent variable $x$ would result in a change in the dependent variable $y$. If we suppose $a > 0$ and $b > 0$, we can draw a graph for this linear equation that represents the stock market. This would imply that we could predict the stock market’s behavior with close to 100 percent accuracy. Consequently, if $x$ and $y$ represent time and price, respectively, we could say what price level the market would have at a specific period, such as next month or next year.

However, the market is a nonlinear system, which means that for every $x$ we may have a different value for $y$, which is dependent mainly on the reaction or feedback from market participants. For instance, if market prices fall too fast to a low level, they may reach an oversold condition. As a result, market participants may rush in to buy the market, since they perceive that the value is below the market fair value. Feedback is a main reason for the market to experience crashes or euphoric buying surges.

**Complex Systems**

The market is a complex system; the relationship among its various subsystems and components is very complex. This is mainly due to the presence of a feedback process between the components, which causes a complex reaction. In other words, at any given time, we cannot say what exact effect a good economic report, for example, could have on market prices. In some instances, some good news could create a positive reaction in the market. However, sometimes good news may create a sell-off in the marketplace. Conversely, we cannot decipher with certainty, even guided by experience, how the market might react to any type of news. Yet, since it is a complex system, it exhibits a simple behavior. This might not seem intuitive.
However, according to chaos theory, a complex system exhibits simple behavior, whereas a simple system exhibits complex behavior. Understanding this important concept could help you develop a simple but powerful trading system. In other words, since the market displays a simple behavior, a sound but simple system could provide better solutions. As a result, a successful system should be simple and objective rather than complex and ambiguous. Conversely, an ambiguous or complex system merely creates more hurdles for traders’ performance. Based on my research and observations, traders tend to deviate from their systems’ recommendations under time constraints and stressful conditions. This is more so if the system’s variables are confusing and hard to analyze or follow. In other words, the more complex a system, the greater the likelihood it is less effective for trader performance. Consequently, since the market as a dynamic and complex system exhibits simple behavior, we should develop a sound but simple system that can be followed flawlessly in different market conditions.

CONTRACTION/EXPANSION PRINCIPLE

As a dynamic system, the market goes through periods of expansion and contraction. The universal principle of contraction and expansion reigns over all organic and dynamic systems in nature as well as in the markets. Just look around; almost everything you see may be influenced by this principle and go through periods of expansion and contraction. A happy and upbeat individual may have his downtimes after a while. After some sadness and disappointment, we may expect some good news. Note how negative events keep occurring in one’s life until they get to their cyclical peak; then hope and happiness appear. There is a popular adage that says when it rains it pours. This principle has many manifestations in our everyday life. It’s the eternal struggle between the optimist and the pessimist. Do you see the glass as half empty or half full?

We often get depressed during the long, cold winter in northern climes, only to feel refreshed by the first hints of warmth in the spring. There’s another old saying: “It’s always darkest just before dawn.” It’s meant to epitomize this up and down, cyclical nature of the world we live in and indeed the vicissitudes of our very lives. When things are at their worst, the bright side of the situation is that it means there’s nowhere left to go but up. It’s the same as the bear and bull markets that we see in economics. In all these examples, change is the only thing that you can count on to stay the same.
FEAR IS STRONGER THAN GREED AND HOPE

The market as an aggregate of its participants’ psychology is influenced by fear (a form of emotional contraction) and greed (a form of emotional expansion). Fear, as part of the internal dynamics of market participants, creates selling and market corrections. However, the extent of the fear’s influence is much greater than the greed. This in turn causes the market to drop faster than it moves up. In some financial markets in recent turbulent times, the five-year gain was wiped out in just two days. However, in the long run, market gains have been greater than losses. We have never seen anyone have a heart attack by being happy and jolly. But fear just shuts down the system for survival.

Both fear and greed or hope are two primary motivation factors. However, they act differently and create many diverse reactions in people. Fear, for example, is a strong motivator compared to hope. Almost all management theories in one way or the other utilize fear in their structures. When a government wants to enforce a law, it uses fear. In corporate management, fear has a very distinct and pronounced position. Parents, clergymen, everyone uses fear to implement their wishes. Although in our troubled economy we see hope for better promotions and jobs being advertised, hope is not as widespread as fear.

The human psyche reacts much more strongly to fear than to hope. For example, stock market corrections and price drops affect consumer spending more than the market’s rise. That is, fear influences consumers and market participants more than greed. This has been documented both at the conceptual level and empirically. The literature states that consumption responds asymmetrically to the stock market. In other words, consumers behave negatively faster and more vigorously as stock market prices drop than they behave positively as stock market prices rise.

As an astute trader you should differentiate between the effects of fear in the market and greed. In other words, you need to differentiate between market downfall/selling and price rises. The market seems to fall three times faster than it rises. You should be cognizant of this trend and develop your trading system accordingly. If your trading system treats downside sell-off and upside rally equally and with the same variable values, you could see some imbalances in performance between your long and short positions. For example, your stop-loss orders might be too small for long positions, since the market may take more time to move up and stay in a range bond. Technicians call this process making base and
support for an upside move. However, if you exit your short positions with the same indicator or signal that you use for long positions, you could miss a great deal when prices fall and ultimately miss profits. That is, you may cover your short positions rather prematurely. Not only could this cause lower trading performance, it also could affect your psychology as well.

HABITUAL PATTERNS

As a dynamic system, the market exhibits habitual patterns that are depicted by its dynamic cyclical moves. This is another pivotal concept in developing a profitable and successful system for trading. Let me illustrate this important concept with an example that I use often with my students and professional traders: Think about your best friend you have known for a long time. If you are married, think about your spouse. If I say “Xyz” to my wife, I could say with a high probability, even close to 100 percent, the kind of reaction I would get from her. This example demonstrates that I could “predict” and forecast her behavior with a high probability. This is very powerful, considering that she is a dynamic, complex, and nonlinear system that at any given time may exhibit a different behavior. However, since she is a complex system, her behavior could be mapped rather easily due to her habitual patterns or periodicity properties. Traders who take into consideration the habitual patterns of a security or market behavior benefit greatly by making successful trading decisions.

Cyclical Behavior

Since the market is a nonlinear, dynamic system and it behaves based on its habitual patterns, we can detect cyclic moves in its price action. In other words, the market exhibits a strong tendency toward cyclical moves. However, this is not a statistical cycle that could be identified by simple time or price periods. The market’s cyclical behavior is dynamic in nature and should be studied accordingly.

Market behaviors depict repeated patterns that are fashioned by the market participants’ habitual behavior. Consequently, this creates a cyclical price behavior from which traders with proper tools and indicators could benefit for profitable performance.

A security’s price behavior is swayed by the influence of different cycles. As a result, a long cycle could be embedded with smaller ones. In other words, the trough of a longer cycle may be in phase with the trough of a shorter cycle. When two different periodic cycles share the same price
level for their troughs, we could see a stronger rebound of the price. Accordingly, we could see a powerful sell-off and price fall for a security when the longer and shorter cycle peaks are the same value. However, when the periodic cycles’ troughs are not in phase, the security’s upward move could be relatively short-lived. Equally true, when the periodic cycles’ peaks are not in phase, the price fall would be relatively less significant.

Consider a year with 12 months and each month with four weeks. The end of each month might not be in line with the end of a year. Consequently, a longer cycle has precedence over short cycles.

**MARKET TRENDS**

Since the market moves in a cyclical pattern, it creates trends. An uptrend occurs when the market continues its upward movement by making higher highs, which may result in sequential higher prices. There are three types of trends: major, intermediate, and minor.

1. **Major trends.** A major or secular trend is a long-term trend that can last between 5 and 20 years. In a secular bull market, any kind of market correction is short. Consider the recent secular bull market, which began in 1982 and lasted to about 2000. Any market corrections, such as those occurring in 1987 and 1997, were rather short lived. The same is true for a secular bear market. For instance, the secular bear market of 1966 lasted until 1982, and during that period any market surge lasted for only a short period.

2. **Intermediate trends.** An intermediate trend lasts between three and six weeks. Within a major bear market, we could uncover few intermediate trends.

3. **Short-term or minor trends.** Within a major and intermediate trend there are many shorter time trends, called minor trends.

**MORE OBSERVATIONS ABOUT MARKET BEHAVIOR**

The Efficient Market Hypothesis (EMH), which claims that market price action moves in a random fashion, has been seriously challenged. There is a wide array of research and literature that produced at least 13 major anomalies against the validity of EMH. Some of them are the January effect, the security’s relative market size, and P/E ratio, just to mention a few.
Behavioral finance (BF), which was developed through a great deal of research into human psychology, propogates the idea that human beings are emotional decision makers. This is in contrast with the EMH proposition that humans are rational economic agents. As both traders and investors, we must make numerous decisions when following our chosen courses of action. When making these decisions, we take into account, either consciously or subconsciously, past trading experiences that may color our perspective regarding the probable outcomes of our trades.

According to decision-making research (sometimes called behavioral decision theory), there are two fundamental reasons that people fall into decision traps: heuristic-driven biases and frame dependence. Heuristic-driven biases are the errors that we may encounter when making decisions during uncertain conditions. To facilitate decision making, our minds tend to reference a set of guidelines or rules of thumb that we have constructed on the basis of our past experiences, cultural influences, social values, personal biases, and other important information from our lives. Frame dependence refers to the way we make our decisions based on what we see at that moment—our perspective.

**TREND-LINE ORDERS**

The market moves in trends, which could be identified trend lines as discussed in previous sections. However, sometimes a shorter trend might look like a random move relative to a longer time trend. According to chaos theory, there is an underlying order in the market or any other dynamic nonlinear system. In other words, globally there is an order, but locally we could see randomness. That smaller-timeframe look may appear random in contrast with a longer-period trend. Based on this idea, we derive the principle of trend-line order, which asserts that the longer timeframe trend has precedence over short timeframe trends.

The Winning Edge Trading System is a nonmechanical, technical trading system with objective rules. It aims to increase your investment performance by applying time-proven rules while also taking real-time market and security conditions into consideration. Consequently, we apply cyclical indicators to identify possible profitable prices at which to buy or sell an equity. You might remember from our discussions in earlier chapters that a security price discounts and reflects all the available information related to it. Therefore, a security chart price is one of the most effective pieces of real-time market information. The Winning Edge Trading System uses two technical indicators: the RSI and the DPO, both of which provide sufficient information for sound trading decisions.
To be a successful trader, you should have a realistic view of the market and its inner dynamics. A sound market model helps you identify the market’s underlying order, despite the seemingly complex and random price behavior. My Winning Edge Market Model is based on chaos theory, which seeks to decipher the market global order and to have an appreciation for its local randomness. In other words, the market as a complex system exhibits simple behavior, which is mapped based on its market participants’ habitual behavior. Consequently, a simple and realistic trading system yields a successful trading for you.

The principles governing capital markets behaviors are that the market is a nonlinear, dynamic, and complex system; hence it exhibits simple behavior based on its habitual and cyclical patterns. It exhibits a periodic deterministic behavior that is range bond to market participants’ emotions. In other words, market price fluctuates between two high- and low-price levels based on traders and investors emotional states. Thus, it follows the universal principal of contraction/expansion. Furthermore, market behavior is a manifestation of market participants’ emotional decision making and reactions. Hence, fear inflicts a stronger influence than greed.
In this chapter we describe the mechanics of the winning edge trading system, which are entry and exit signal generation with money management techniques. Let’s begin with entry price.

Entry price in the system utilizes two indicators: the relative strength index (RSI) and the detrended price oscillator (DPO) in issuing entry and exit signals. When there is a divergence between price bar and DPO and RSI, the entry signal is generated.

**ENTRY SIGNALS**

As mentioned, the Winning Edge Trading System uses two indicators—the RSI and the DPO—to confirm an entry signal and indicate an entry point. Similarly, every entry point should be initiated with two conditions via DPO and RSI. A long signal happens when there is a bullish divergence between the DPO and security price bars and the RSI has crossed above the overbought condition. Accordingly, a short signal occurs when there is a bearish divergence between the DPO and security price bars and the RSI has crossed below the oversold condition. Now let’s look at the details of these two types of signals.

**Long Signals**

A long signal signifies a good price level at which to buy a security. It occurs when there is a bullish divergence between the DPO and security price bar...
at the same time the RSI has crossed below the 30 percent, or oversold, boundary. Figure 10.1 depicts a long-signal entry produced for a QQQQ ETF. The signal appeared on a March 17, 2008, daily chart at $42.50, which then moved up to over $50.50, for a potential $8 profit, excluding commissions. At price point 4, the security made a lower low than price point 3, whereas the DPO made a higher low at the same price points; simultaneously, the RSI crossed under the oversold boundary at price point 3—the two conditions for a long signal.

Figure 10.1 shows an entry signal generated by the Winning Edge Trading System, which requires two simultaneous conditions: bullish divergence between the DPO and a price bar, and an oversold condition marked by RSI.

**Short Signals**

A short signal signifies a good point at which to short-sell to initiate a new short position. As in a long signal, a short signal occurs as a result of two simultaneous conditions: a bearish divergence between the DPO and security price bars, and a crossover of RSI above the overbought, or
70 percent, boundary. Consider Figure 10.2, which displays a short signal for a QQQQ ETF security. As the chart depicts, the QQQQ made a high at point 2, which was higher than the price level at point 1, while the DPO made a lower high at price point 2—a bearish divergence. This satisfies the first condition. The RSI simultaneously crossing under the overbought 70 percent boundary provides the second condition. As a trader, you could have used this signal to short the QQQQ from $54.50 and then covered it at least at $43.50—a nice profit of $11, excluding commissions.

Figure 10.2 depicts a short signal generated by the Winning Edge Trading System, which requires two simultaneous conditions: bearish divergence between the DPO and price bar, and an overbought condition marked by RSI.

**EXIT SIGNALS**

The exit price point is a trading system’s criterion to close a previously opened trading position. In other words, if you are long, an exit signal
should issue a sell signal to close your long position. Accordingly, if you are holding a short position, an exit signal is to cover your short position. The Winning Edge Trading System employs one of the following strategies for its exit signals: new reversal signal, one confirmation, moving average, or Fibonacci retracement levels.

**New Reversal Signals**

If you hold a long position, a new short signal issues an exit for you. Accordingly, if you are short on a security, a new long signal issues an exit to cover your short position. Therefore, a bullish divergence is formed by the DPO and RSI, confirming a long signal, which means you should buy the market to cover your short position. Conversely, when the two indicators generate a bearish divergence, that would be a signal to exit or sell your long position.

Consider Figure 10.3, which illustrates the DIA (pronounced *diamond*) ETF, holding 30 Dow Jones Industrial stocks. The figure portrays a short

![Figure 10.3](image.png)

**Figure 10.3**  The Winning Edge Trading System Exit Signal by Creating a Reverse Signal to Entry
signal on October 11, 2007, at about $141. Then, on March 17, 2008, you had a new bullish divergence to cover your short at about $119, a profit of $21, or about 16 percent.

One Confirmation

Earlier, we discussed using double confirmations—DPO and RSI—as exit signals. However, you may often need only one such confirmation—for example, if the DPO forms a diversion, signaling an exit. Figure 10.4 depicts a long signal on August 20, 2007. Having used the first confirmation in October 12, 2007, as the exit signal, the bearish divergence between the price bars at points 1a and 2a and the DPO price points 1a and 2a would have provided a quicker and more profitable exit. Similarly, price bar and DPO points 3a and 4a offered an exit signal for the long signal generated on March 18, 2008.

FIGURE 10.4 The Winning Edge Trading System Exit Signal with Only One Confirmation
Moving Averages

Another signal to exit a profitable position is called a moving averages crossover. In Figure 10.5, you’ll see two 50- and 200-day MAs. You may exit some of your position when the security price crosses over the 50-day MAs, shown in the dotted line. (The illustrated circle shows the exit price.) Note: If you were using 200-day MAs, you’d still be in your short position as prices decrease. Therefore, after using both types of MA for some time, you could figure out which one worked better for you.

Retracement and Fib Numbers

In a previous chapter, we learned about Fibonacci price levels and how to use them as technical indicators to estimate a security’s price movement. You can use the same method to retrace movement and exit at a better price—for example, if the market moved from a recent high, say, 150.00 in SPY (pronounced Spider) to a recent low of 120.00, or vice versa. Then you could divide the total move of $150 - 120 = 30$ points by 3 and have three levels: 138.54 or 38.20 percent, 135.00 or 50 percent, and 131.46 or
61.80 percent. (Other retracement levels exist, but they will not be covered here, since these three are the most commonly used by professional money managers and traders.)

Consider Figure 10.6, which identifies the high and low of a recent move, along with its various retracement levels. Note that the security sold off after a short-sell signal generated by the system. Then it retraced back to 38.20 percent, 50 percent, and 61.80 percent, respectively, which corresponds to $125.59, $128.65, and $131.72. You could exit at one of those levels or just scale out your position as the price increased. For example, exit one-third at $125.59 and another one-third at $128.65, and since the price did not hit the $131.72 retracement level, you could still be short and reap more profit as it dropped lower.

**THE SYSTEM’S PROTECTIVE STOPS**

Part of every winning system has losing trades. After all, any given system is based only on high probability at best, and it’s natural to be wrong at least
occasionally. In other words, it’s okay to have losing trades, but how much of a loss is acceptable? It’s crucial that you answer that question in advance by identifying the price level or technical indicator that would provide ample warning that your security was not headed in the right direction.

For this reason, the Winning Edge Trading System offers two types of protective stop: money stops and technical stops. Let’s go over each briefly.

Money Stops

Assigning in advance how much of your capital you are willing to risk is called placing a money stop. For example, based on your calculation and on the system’s historical performance, you might decide that you would not risk more than 3 percent of your capital. This means that if you bought DIA for $120 and it dropped 3 percent to $114.40, you’d sell it to exit your position and limit your loss. The smaller the percentage, the more stops you may experience. With large percentages, however, you might not be able to trade the security after a couple of times.

FIGURE 10.7 Using a Trend Line as a Protective Stop and Exit Price
One way to determine what price percentage might be suitable for a protective stop is to analyze the security’s price fluctuations and volatility, and set a stop at least that high. So, if a security’s volatility is about 5 percent, having a stop at less than that might not be beneficial.

**Technical Stops**

Another protective stop is a technical indicator. Any of the technical indicators in this book would qualify to help you protect your position against adverse market moves. Take MAs and trend lines, for instance. Suppose you’re in a long position and the market price goes below the uptrend line; that could indicate that you’re not in the right position and should exit. Or suppose you’re holding a short position and the market price crosses over a MA; that could indicate that you should exit your short position. Consider Figure 10.7, which exhibits a daily chart for SPY ETF, holding S&P 500 Index stocks. Suppose you bought the security at $126.50. As the figure depicts, you could exit your position at about point B, when the uptrend

![FIGURE 10.8 Using an MA as a Technical Protective Stop and Exit Price](image-url)
line was violated. Alternatively, you could exit all your positions when the price point dropped below your entry or purchase price.

For using MA as a technical stop loss, consider Figure 10.8, which depicts a daily chart for SPY. Suppose you short-sold the security at 149.40. You could exit your short position at point A in the chart, when the price bar crosses over the 50-day MA. Or you could trail your stop by moving down, just above the MA. The latter action would lock your profit while giving you a chance to hold your short position. In case SPY sells off and the price moves farther down, you could exit at another point, probably with better profit.

In Chapters 11, 12, and 13, we describe how to use the Winning Edge Trading System to trade various markets such as futures and equity in different timeframes. In other words, we discuss examples for day, swing, and position trading styles using proper time-scale charts.
In this chapter we describe the Winning Edge System trading signals for day trading two popular markets: e-mini S&P futures contracts and QQQQ, an example of ETF.

**DAY TRADING E-MINI S&P FUTURES CONTRACTS**

For this discussion we use a one-minute chart for our examples. You could also use any other timeframes, such as 2-, 3-, 5-, or 10-minute charts. However, as you increase your trading time, your stop-loss and target profits should increase accordingly. Furthermore, longer timeframes produce fewer signals, so it might take a longer time to reach your profit targets. Nevertheless, let’s start by discussing trading based on a one-minute chart in the following sections.

**Short Signals**

We look for DPO and RSI to provide us two confirmations for short-signal price entry. A bearish divergence between the DPO and price bar is one confirmation. For the second confirmation, we look for RSI to cross above the overbought 70 percent boundary, oversold condition. Consider Figure 11.1, which depicts a one-minute chart for e-mini S&P June futures markets with the indicators. As the chart in Figure 11.1 indicates, the e-mini futures market was making a higher high from price point 1 to 2;
simultaneously, the DPO indicator made a lower high from point 1a to 2a. Finally, the second confirmation for a short-sell signal occurred when the RSI indicator crossed the overbought 70 percent boundary.

Input values for DPO and RSI indicators in the TradeStation charting program are depicted in Tables 11.1 and 11.2.

<table>
<thead>
<tr>
<th>TABLE 11.1</th>
<th>Input Values for DPO in the TradeStation Charting Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name</td>
<td>Value</td>
</tr>
<tr>
<td>Price</td>
<td>Close</td>
</tr>
<tr>
<td>Length</td>
<td>4</td>
</tr>
<tr>
<td>ColorNomLength</td>
<td>4</td>
</tr>
<tr>
<td>Upcolor</td>
<td>Black</td>
</tr>
<tr>
<td>Dncolor</td>
<td>Black</td>
</tr>
<tr>
<td>GridForegroundColor</td>
<td>Black</td>
</tr>
</tbody>
</table>
### Table 11.2

<table>
<thead>
<tr>
<th>Name</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>Close</td>
</tr>
<tr>
<td>Length</td>
<td>14</td>
</tr>
<tr>
<td>OverSold</td>
<td>30</td>
</tr>
<tr>
<td>OverBought</td>
<td>70</td>
</tr>
<tr>
<td>OverSColor</td>
<td>Black</td>
</tr>
<tr>
<td>OverBColor</td>
<td>Black</td>
</tr>
</tbody>
</table>

Figure 11.1 depicts that the Winning Edge Trading System issued a short signal for day trading e-mini S&P futures contracts when two conditions were met: bearish divergence between price bars and the DPO, and the RSI crossing over the overbought 70 percent boundary.

**Long Signals**

For the system to issue a long signal, there should be a bullish divergence between the price bars and DPO. Furthermore, this should be confirmed by the RSI crossing under the oversold 30 percent boundary. Figure 11.2 illustrates a long signal that is generated when two conditions are met: bullish divergence between price bars (price points 1 and 2) and DPO (points 1a and 2a) and the RSI crossing under the oversold 30 percent boundary.

**Stop Loss**

To protect your trading capital against any adverse move against your trading positions, you should use a protective stop or stop-loss order. This could be done through any of the methods we discussed in the previous sections, such as a technical stop or a money stop. For instance, you could place a sell stop order for your long position from 715.50 at 713.50.

**Exit Signals**

If you are in a long position as per the earlier example, you could use a technical indicator such as two simple moving averages. The input variables for two simple moving averages for the TradeStation charting program are depicted in Table 11.3. If the fast moving average crosses under the slow one, you could either exit all your long positions by placing a sell order or take some profits and use a trailing stop to lock your profits. Either way, you are using technical indicators to exit your profitable positions.

Moving averages are very popular indicators and are found in any charting program. To exit your day trading positions, you could use two moving averages. Note that you may experience using different input...
values for better performance. For instance, if you trade NASDAQ futures, your input values for MAs could be 5 and 12, respectively. A moving average with a shorter time period reacts faster to market price changes than the one with higher input value. You might notice that moving averages generate faster and more frequent exit signals when a market is bound to

<table>
<thead>
<tr>
<th>Name</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>Close</td>
</tr>
<tr>
<td>FastLength</td>
<td>9</td>
</tr>
<tr>
<td>SlowLength</td>
<td>18</td>
</tr>
<tr>
<td>Displace</td>
<td>0</td>
</tr>
</tbody>
</table>
FIGURE 11.3 Using a Simple MA as an Exit Signal for a Long Position for Some Profits

a trading range. Figure 11.3 illustrates how to use a simple MA Avg 2 lines to exit a long position.

To cover a short position, you could use the same set of MAs that you used when the fast moving average crossed above the slow MA. See Figure 11.4, which exhibits using two simple MAs for an exit signal.

Day Trading System Performance for E-Mini Futures

To gauge the possible profit that you could create with this powerful day trading system, let’s review what we have done so far. The two trades, long and short, generated $587.50 each, or $1,175 per contract. Remember that each e-mini S&P futures full point is worth $50. To produce this profit, we only had to risk 2 points for $100 per trade. Conversely, the risk-to-reward ratio is 5.875, or about 6, which is an impressive number. You need to have
about $6,000 or even less to produce this profit, which is about a 20 percent return on your initial account. Of course, you should note that you could lose money. However, since your risk is low and the probability of winning is high, you get a better chance to become successful if you execute the signals successfully and with proper discipline.

As you increase the timeframe from 1-minute to, say, 5- or 10-minute charts, you would have fewer signals. Consequently, profits could be more, since your exit signals are produced more slowly than, say, a 1-minute chart. However, you do not need to increase stop-loss size if you use the Winning Edge System for day trading, since we simply use a money stop for about two points below the lower low for a long signal. Conversely, we use two points stop-loss just above the higher high in a short signal setup. Table 11.4 shows the example signals' profit for trading one e-mini S&P futures contract.
TABLE 11.4  Snapshot of the Winning Edge System for Trading One E-Mini S&P Futures Contract

<table>
<thead>
<tr>
<th>Position</th>
<th>Entry Price</th>
<th>Exit Price</th>
<th>Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long</td>
<td>715.25</td>
<td>727.00</td>
<td>$587.50</td>
</tr>
<tr>
<td>Short</td>
<td>801.00</td>
<td>789.25</td>
<td>$587.50</td>
</tr>
</tbody>
</table>

Two trades for a total of profit for $1,175.

**DAY TRADING QQQQ**

Let’s look at some examples for day trading a popular ETF such as QQQQ.

**Entry for a Long Signal**

You could use the Winning Edge System to day-trade an ETF. For instance, let’s look at QQQQ, a popular ETF that represents the NASDAQ 100 index. Figure 11.5 depicts a 10-minute chart. As the figure shows, there was a bullish divergence between price bars at price points 1 and 2 on February 4, 2009, and February 5, 2009, and the DPO. The second confirmation was given when the RSI crossed under the oversold 30 percent boundary. We could have bought the security at about $29.60.

**Stop Loss**

As soon as you initiate a position, you should place a stop-loss order to protect your position against possible market moves against it. You could simply money stop, say a few pennies below the pivot low at price point 2 at $29.46, such as $29.38. If the market goes below $29.38, you get stopped out.

**Exit Signal**

To exit your long position from $29.60, you could use several methods. I do not recommend scaling in. By that I mean adding to your positions as the market goes in your favor. Doing so would increase your risk-to-reward ratio for the additional positions you add. However, I think it is a prudent strategy to scale out. As the market goes in your favor, you exit part of your positions with a profit while trailing your stop to lock profit for the remaining of your positions. This is based on the view that market trends do not continue forever.

In particular, in short-term trading as with minute charts, we might not see a long-lasting trend move on either the upside or downside.
Nevertheless, Figure 11.6 depicts two price levels for potential exit. In the first one, which is at price $30.50, you see a bearish divergence between price bars and the DPO on February 15, 2009, at about 3:00 P.M. EST. You could have exited some positions at this point and moved up your stop loss to break even for the remaining of your positions. Then, at about 3:10 P.M. EST, toward the end of the day, the DPO crossed under the zero line, which may indicate a possible turnaround for the market. Consequently, at that point you might have decided to exit the rest of your positions for more profits.

**Entry for a Short Signal**

As you used the Winning Edge System to generate a long signal to trade QQQQ, you could use it to generate a short signal as well. As Figure 11.7
FIGURE 11.6 Two Different Exit Strategies for a Long Position QQQQ

illustrates, when there are two conditions, a short signal is generated. They are a bearish divergence between price bars and DPO, as shown by price points 1 and 2 and 1a and 2a. This is confirmed by the second condition as the RSI crosses above the 70 percent overbought condition boundary. Glancing at Figure 11.7, you will note that a short signal for QQQQ was generated on March 4, 2009, for a $27.60 price level.

**Stop Loss**

You could place a stop loss order just above the price level of point 2 in the chart in Figure 11.7. In other words, you could use a money stop just above the pivot high or higher high price level on QQQQ, which is $27.70. Therefore your stop should be placed at $27.77.
Exit Signal to Cover a Short Signal

To cover your short position from $27.60 in the previous example for QQQQ short-term trading, you could use a crossover of two simple moving averages. In this example, when the fast moving average crossed above the slow one, you could cover your position for about $27.60 − $26.00 = $1.60 per share. So if you are trading 100 shares, for example, you could have made $1.60 × 100 = $160 on this trade. Figure 11.7 exhibits the exit price with a shaded circle. Note that you could also use the DPO for your exit signal as well. In the figure you could notice that the DPO has crossed over the zero line, which could indicate the end of the downward move.

In Chapter 12, we review some examples in futures and equity markets using the Winning Edge System for intermediate trading, or swing trading.
The Winning Edge System for Intermediate-Term or Swing Trading

The Winning Edge Trading System uses two conditions that can be applied for intermediate or swing trading. As discussed in the previous chapter, we look for two conditions to initiate either a long or short position. When there is a bullish divergence between price bars and the DPO and the RSI crosses under the 30 percent oversold boundary, we have a buy signal. Conversely, when there is a bearish divergence between the price bars and the DPO and the RSI crosses above the 70 percent overbought boundary, we could initiate a short position by selling short the security.

SWING TRADING S&P FUTURES

You could use any timeframe charts for swing trading a security or market. It all depends on the risk level and amount of profits you are looking for. For instance, if you use shorter time period charts such as 30 minutes, you could use a smaller stop loss, since price movements and market volatility are relatively small in 30-minute charts compared to 100-minute or even daily charts. Conversely, using a 30-minute chart for your swing trading would require much larger stops than, say, a 1-minute chart. However, your target profits should vary from smaller timeframe charts to larger ones. In other words, you would exit your position in a 1-minute chart much faster than in a 30-minute chart, whereas you’d exit a position in a 30-minute chart faster than using a daily chart. This is due to the fact that the extent of a security’s price movements is larger in longer-period charts than shorter ones.
LONG SIGNALS FOR S&P FUTURES CONTRACTS

As in the chart in Figure 12.1, a long signal was generated and confirmed by using the DPO and the RSI. The price bars made a lower low in price point 2 compared to price point 1, whereas the DPO had a higher low in corresponding price point 2a. Consequently, a bullish divergence was formed on March 3, 2009, between e-mini S&P futures contracts for May 2009 with the DPO. To confirm this newly generated buy signal, we inspect the RSI indicator. Since the RSI has crossed under the 30 percent oversold boundary at point 1b, we have confirmation to initiate a long position from about a 686 price level.

FIGURE 12.1 A Long Swing Signal for E-Mini S&P Futures Contracts as Confirmed by the RSI
Stop Loss

As always, it is important to use a stop-loss order to protect your trading capital against any unforeseen market action. Since trading is a probability game, this means that regardless of how sound and profitable a system may be, there is no doubt that you will sometimes have losing trades. However, the extent of your loss would all depend on how wisely and what size stop losses you utilize. For instance, if you place very small stops, you could get stopped out frequently, which would increase your losses. More important, you would note that many times after you get stopped out from your position, the security price will have moved away in your favor. This observation could affect your psychology and make you give up a potentially good trading system. Furthermore, you could decide to try to avoid getting stopped out frequently by increasing the size of your stop. However, by doing so, you create larger losses, which in turn could create negative emotions for yourself. Consequently, not having a proper method and amount for stop loss could sway your behavior from one extreme (small stop) to the other extreme (using unusually larger stops that ultimately would not be beneficial to your trading, emotional, and physical health).

One factor that could determine the extent of a stop loss for swing trading is the price dynamics of that particular market or security. For instance, a physical commodity such as corn may have smaller moves than the energy market. Furthermore, any related news could create larger than usual price moves in a futures contract or security. Consider the large movements corn or crude oil contracts could experience right after important inventory reports, or the fast move that S&P 500 futures contracts go through right after economic news or the Federal Open Market Committee (FOMC) meeting statement is released. Accordingly, the size of a stop loss should be based on a security's particular price move behavior and dynamics.

For the S&P 500 futures contracts, you could use a money stop. Identify the lower low price level in the buy signal setup and place your stop-loss order just below it. Since the Winning Edge Trading System performs very well, the majority of times we could just use small money stops, such as three to five points below the pivot low. As depicted in Figure 12.1, the price level at price point 2 is 678.75. As a result, we could use 674.20 as a good protective stop.

You may also consider using a stop loss based on important support or resistance price levels. For instance, for a long signal, we could use an important support level. However, at that time as the market dropped it was making multiyear lows. Conversely, there was no recent support level for the S&P market at that time. The closest support level was at about 660–665. However, since the entry price for the long signal was at about
686, as shown in Figure 12.1, to have a stop loss at 665 or 660 would be too much and very risky.

**Exit a Long Signal**

To sell a long position, we could use a trend line that connects the lows, as depicted on Figure 12.2. Note that the next day, on March 5, 2009, the market broke down the trend line at 21:30 Eastern time, closing at 700.25 at that bar. This generated a profit of $700.25 − 686 = 13.75$ points, or $13.75 \times \$50$ (so, for each point in an e-mini contract, you could have $\$687.50$ per contract).

It is noteworthy that after we exited our long position for a profit, a new long signal was generated at price points 3 and 4. Consequently,
this is a great reminder that if we had increased our stop, we would either have stopped out and if not we would have missed another good long signal—not to mention all the emotional stress that we had to go through to carry a losing position.

**SHORT SIGNALS FOR S&P FUTURES CONTRACTS**

Now let’s review the workings of the Winning Edge Trading System for taking a short signal in the S&P 500 futures contracts. The system generates a short signal when there is bearish divergence between the price bars and the DPO. This should be confirmed by the RSI crossing over the 70 percent overbought boundary. Consider Figure 12.3, which depicts two conditions for a short signal. At price point 2, the e-mini contracts for June 2009 made a higher high, whereas the DPO at corresponding price points made a lower high at 2a, hence a bearish divergence. This first condition was confirmed by the RSI reading, which crossed over the 70 percent overbought boundary at point 1b. Consequently, one could have sold short the contract at about the 755 price level right after the pivot high at point 2. The bar following the price bar at point 2 had a high and a low of 766.75 and 750, respectively.

**Stop Loss**

For the short position generated on March 16, 2009, at the 755 price level, as depicted in Figure 12.3, we use a money stop just a few points above the pivot high at price point 2. As a result, we could have had a stop-loss order at 771.75 or so as a meaningful stop loss.

**Cover a Short Swing Signal for S&P Futures Market**

For the short position we had in the e-mini S&P futures for June 2009, contracts were stopped out with a loss, as stated earlier. However, one quality of an experienced and successful trader is to manage a trade actively and not to wait for a stop-loss order to be activated. In other words, if we have managed or monitored a short position, could we have exited before we were stopped out?

There were a few important signs that could have alerted us to cover the short position before it was stopped out. We’ll review them here.

First, examine Figure 12.3, which depicts a support line that connects the lows at about the 746 price level. However, after the market’s initial
sell-off, it was unable to break down the support level. This could have signaled us that there are fewer sellers than buyers. Looking at the overall volume for bid and ask prices could also have supported our conclusion. Consequently, we could have covered our short position at about 746–748 price-level areas.

Second, consider the readings of price points X and the DPO at Y in Figure 12.3. Note that as the market was unable to sell off further and stalled for some time, and the DPO crossed over the zero-line price point Y, which was indicative of a higher probability of upward movement in the market. This was further supported by the RSI turning upward at point Z. Consequently, according to our indicator’s readings, we could have covered our short position with less loss than our original protective stop.

As a trader, you should take an active role in managing your positions rather than waiting for your stop to be triggered by the market price

**FIGURE 12.3** A Support Line and DPO and RSI Readings
behavior. However, you should also keep in mind that too much interference and monitoring may hinder your performance. In other words, by being super-active, you tend to anticipate future market moves, which does not allow proper room for the system to perform. Furthermore, by pre-empting future market moves, you tend to shortcut your system and sway away from its proper execution. Accordingly, you would be likely be opting to experience a psychological and emotional drawback from your mixed trading performance. I discuss more about the psychological aspects of trading in future chapters.

In Chapter 13 we review the workings of the Winning Edge Trading System for long-term or position trading.
You can use the Winning Edge Trading System to position trade markets such as futures and equity. For instance, you could utilize the system to trade Russell futures contracts and ETF-like securities such as SPY and Spider, which represent the S&P 500 Index.

To position trade futures contracts, you could use a different timeframe, such as daily and weekly charts. Your period selection determines two important aspects of your trading. First, you would need to use a larger stop loss for a bigger timeframe than you’d use for a shorter one. For instance, your stop loss for using a daily chart should be larger than a 30-minute chart due to market price movements and fluctuations in each chart. Second, your choice also indicates a larger move and higher anticipation for profits. Since using a larger-scale time chart, you might need to hold your position longer, and then it would be natural to expect higher profits for exposing yourself to a higher possible risk.

Position or long-term trading may be more suitable for individuals who do not take trading as their main job but rather are active investors on the side. You might want to monitor or manage your investment or retirement account with proper implementation of the system for position trading. Since as a long-term trader you work with longer timeframes such as daily and weekly schedules, you might not need any real-time data and
charting programs, which means less cost and expense for you. In other words, you could use free Internet charting programs offered by Yahoo (www.yahoo.com), MarketWatch (www.marketwatch.com), or any other major financial site. Most of the time your retirement account custodian and companies such as Fidelity and Vanguard offer you delayed charting programs.

The advantage of the Winning Edge Trading System is that, since it is so simple but powerful, you could use it for mutual funds or any asset as long you could follow its price behavior with a chart and DPO and RSI indicators. In the following sections, we describe the application of the system to futures and equity markets.

LONG SIGNALS FOR RUSSELL 1000 FUTURES CONTRACTS

To use the same system for generating an entry signal for long-term trading periods, or position trading, we look for double confirmations. For instance, we use Russell 1000 Index futures contracts to illustrate how you could utilize the Winning Edge Trading System to position trade in this market. Russell 1000 Index is an established equity index that tracks the large and midcap equity segments of the U.S. equity market. It’s a broad measurement of the U.S. stock market performance since it represents about 92 percent of the U.S. equity universe. As Figure 13.1 exhibits, a buy signal was issued on August 16, 2007, when there was a bullish divergence between the price bars on August 6, 2007, and August 16, 2007, and the DPO was at points 1a and 2a. As the Russell 1000 futures contract made a lower low, the DPO made a higher low. This bullish divergence was confirmed by the RSI crossing under the 30 percent oversold boundary. A long position could have been initiated at about the 800 price level on August 17, 2007.

Stop Loss

Regardless of your trading style, placing a stop loss should be an important part of your trading and money management. There is a tendency among position traders to be easy on using protective stops. Indeed, traders who like to use longer time charts are less reactive and more responsive. This could mean that a swing or position trader’s personality profile might show less urge to react to market moves. Depending on your trading personality profile, which highlights your personality traits, you could tend to react less actively than a short-term trader (see the author’s book, How to Become a
Successful Trader). Conversely, if you want to engage in long-term trading, you should be more vigilant in using a stop loss.

You could use either a money stop or a technical stop. However, for a long-term trading style, it is better to use a technical stop due to the evidence that a security’s price exhibits more fluctuations around previous pivot lows or highs. For example, let’s say that you want to use a stop loss just below the pivot low at price point 2 in Figure 13.1. The market could hit lower than that but end up closing higher. A pivot low is a price point in a chart for that market, which reverses its move from that point. Thus, a pivot low becomes a reversal or turning point in a price chart. However, a pivot low could be a minor or major turning point. Nevertheless, a possible vacillation around a pivot price could impede your trading performance. In other words, since the market fluctuates around important pivot prices in longer timeframe charts, using them for your stop loss may be less effective.
Exit Long Signals for Russell 1000 Futures Contracts

To exit a long position in a Russell 1000 futures contract, we could use a short signal—in other words, a reversal short signal, which could give us an exit price for our long. At the same time, we could initiate a new short position. Accordingly, when we are long on a futures contract, we sell two contracts to exit one long position and initiate a new short position at the same time. Since we are dealing with a longer time period in position trading, we could afford more short-term price volatilities.

Consider Figure 13.2, which displays a new short signal that was generated when there was a bearish divergence between the price bars for price points 3 and 4 and the DPO for 3a and 4a. Note that price point 4 was higher.

**FIGURE 13.2** A New Short Position Provided an Exit Signal for the Previous Long Position
than price point 3. However, the corresponding price point 4a was lower than price point 3a, hence there was bearish divergence. The confirmation was generated by the RSI crossing above the 70 percent overbought line. The short signal was issued on October 11, 2007, at a price level of about 845.00. Consequently, we had a potential profit of $845 - 800 = 45 points for each contract, which is equal to $100 \times 45 = $4,500 in profits, not including commissions.

SHORT SIGNALS FOR NASDAQ FUTURES CONTRACTS

For a short signal, according to the Winning Edge Trading System, we look for a bearish divergence between price points 1 and 2 in the price charts and 1a and 2a in the DPO, as shown in Figure 13.3. This short signal has been confirmed by point 1b in the RSI since it crossed over the 70 percent overbought boundary. Based on these conditions, we could have sold the NASDAQ 100 futures on June 9, 2009, at about the 2005 price level. Note that you should wait for a complete setup of divergence before you short-sell the market. The short-sell signal initiated by the system, as shown in Figure 13.3, is based on two conditions: bearish divergence between the price bars and the DPO, and the RSI crossing over the 70 percent overbought boundary.

Stop Loss

You could use a technical stop for the short position issued on June 9, 2008, for the NASDAQ 100 futures market. For instance, you could extend the same trend line that connected two pivot highs for divergence purposes. Then, if the market moved up and violated or took out the resistance trend line, you could exit your stop. Or you could measure the price level and place your stop based on that accordingly. As depicted in Figure 13.3, the price level for resistance trend lines connecting the highs is about 2,081. Thus, you could place a protective stop at 2,087.75. This should give you enough room for possible market hovering around the resistance trend line.

Cover a Short Position in NASDAQ Futures

To exit or cover your short position from 2005 on June 9, 2009, we could use Fibonacci retracement levels to scale out your positions. Suppose you have five e-mini NASDAQ short positions. When the market created a pivot
low, as shown in Figure 13.4, at 1,774 on July 15, 2008, you could have used that price level and pivot high on June 6, 2008, at 2,080.50 and created retracement levels. If you used a charting program like TradeStation, you could have used its drawing tools to draw the Fibonacci levels. Otherwise, you could have used simple one third, one half, and two thirds retracement price levels with a few simple calculations as shown here:

\[
2,080.50 - 1,774 = 306.50 \text{ points}
\]

\[
306.50 \times \frac{1}{3} = \text{about } 1,876
\]

\[
306.50 \times \frac{1}{2} = \text{about } 1,928
\]

\[
306.50 \times \frac{2}{3} = \text{about } 1,979
\]

Consequently, you could exit one third of your positions at price level 1,876 and another third at 1,928 while moving down your stop loss to break
even. As Figure 13.4 illustrates, the market price dropped further, to about 1,019 areas. Using this method to exit, which works very well in a strong trending market, could have benefitted you greatly, since you would have been in a short position, of course, with only one third of your total contacts, all the way to an intraday low price level of 1,019. Consequently, using Fibonacci levels, you could have covered your short position from at 1,019 price level.

**SHORT SIGNALS FOR NASDAQ FUTURES CONTRACTS WITH NO RSI CONFIRMATION**

Often you might have only the diversion part of a short or long signal. Conversely, the second component that confirms a signal by the RSI might not
be developed. As Figure 13.5 depicts, you still could have a winning and profitable signal, but the probability of its accuracy drops. For instance, consider Figure 13.5, which shows only a bearish divergence between the price bars and the DPO but with no confirmation by the RSI crossing over the 70 percent overbought boundary. As you see, that signal was still profitable. However, as stated before, you should be cautious and implement a proper stop loss, since a signal without a second confirmation by the RSI might not yield well.

So far in this book we have discussed components and implementation of the Winning Edge Trading System for short, intermediate, and long terms. We presented many examples that illustrate how simple, yet very
powerful and profitable the system is. In the next chapters we deal with
the psychological aspect of successful trading. We will learn how impor-
tant it is for you as a trader to know your trading personality so that you
can choose a proper trading style such as day, swing, or position trading.
Furthermore, we will delve into psychological factors that you should con-
sider for successful trading.
PART IV

Investment Psychology
In the previous chapters, we discussed the changing face of financial markets and showed you how you could benefit from these changes. The current market volatility should provide you with some great trading opportunities. To help you profit and become a successful trader, I presented a simple but powerful trading system for trading equity and futures markets. Furthermore, due to the system’s robust structure and sound market model, you can trade using your preferred trading style, whether day, swing, or position trading. Indeed, to become a successful trader you need to have a dynamic and profitable trading system that is able to generate buy and sell signals in all market conditions with a high probability of winning trades. However, a winning system by itself does not and cannot make you successful. As good as a trading system might be, it ultimately needs an operator to execute its recommendations.

In this chapter, we examine the two determinant factors that could help you become a successful trader. They are a sound trading system and a fit trading psychology. Furthermore, we review the psychological aspect of trading and provide you with a test to determine your trading style: short term, intermediate, or long term. We’ll also discuss suitable trading systems—discretionary, mechanical, or hybrid system—for each trading style. Through taking the personality test, you will also learn more about your strengths and weaknesses in dealing with trading issues.
In my trading seminars, when I ask participants what is the single factor that could make them successful traders, they almost unanimously respond, “A winning trading system.” No wonder that almost every trader I meet looks for a “holy grail”—the best of the best trading systems. However, the fact of the matter is that as much as having a winning and robust trading system is necessary, it alone is not sufficient. A good and powerful system without a trader who follows its recommendations does not offer a winning edge. This observation is confirmed by the fact that many traders lose money in trading. Furthermore, when a winning system is provided to two different traders with different personality traits, they produce totally dissimilar and disparate performances.²

To become a successful full trader, you need to know how to trade profitably and be able to execute your trading plan accordingly. Consequently, your success as either a part-time or full-time trader is based on two pillars: a sound trading system and a good fit with your trading personality. Without a sound trading method, if you somehow survive by mere luck, your trading performance and profitability would vacillate from large gains and profits to heavy losses. This in turn inflicts agonizing stress and may cause a severe psychological blow, resulting either in losing your hard-earned capital or being forced to give up trading altogether. Thus, having a sound trading system is a necessary condition for your trading success but is by no means sufficient. Conversely, having a fit and apt trading psychology without a robust trading system would also not take you too far in your trading endeavor due to possible losses and the system’s poor performance that you may experience, which could lead you to give up your trading pursuit forever.

For many business professions and technical vocations, one could easily close the gap between the necessary knowledge and performance. You could learn the required know-how to become successful in that business and enterprise. However, this is not true for fast-paced trading, which requires constant decision making under stressful conditions. You may learn how to operate equipment or conduct any business operation. Naturally, as you go through your learning curve, your operating skills will advance as well. By acquiring and developing more skills, you consequently can demand more salary. Thus, as you increase your knowledge, your performance is enhanced. There is a linear relationship between your know-how or cognitive capability and your performance. However, this is not the case for the trading profession. You as a trader have to make constant and speedy decisions under time constraints and stressful conditions. Since the market may move in any of three directions—up, down, or sideways—with no certainty, any unfavorable move against your trading positions could cost you money and result in loss. This lack of certainty and knowledge about the market’s next directional move induces a great deal of stress for
you. Furthermore, in trading, your emotions could play a critical role in making decisions and executing them. Consequently, in the trading profession, there is no direct relationship between your trading knowledge and your personal performance.

Having a profitable and robust trading method is necessary for you to become a successful trader. But it never guarantees or ensures your trading success.

The second element that leads you to trading success by complementing your sound trading system is your trading personality. Accordingly, since you may not change your personality, except for short-lived behavioral modifications, you should select a trading method that is compatible with your personality, to ensure your trading success.

There are many traders who always seek out the “Holy Grail” of trading. They feel that by acquiring the best possible system, they can secure their trading success. However, in reality this line of thinking and pursuit only end up being very costly and often futile. There is no doubt that you should seek the best and most robust trading system that could yield high profits under different market conditions. However, you should also make sure the characteristics of your chosen trading system are compatible with your unique personality profile. For instance, a system may carry a large stop loss, which might look good in performance reports and on paper. However, if you are a risk-averse individual who cannot bear carrying a large stop for your position, you could give in and interrupt the system’s operation. Or perhaps the system seeks to identify market trends by taking more small trading losses in order to catch a big and profitable move. Although rationally you may agree with the system’s logic, you might stop using the system since the high number of losing trades has diminished your confidence in the system. At the end of the period the same system may produce a great profit while you end with a great loss. This performance gap between the system or know-how and your execution of the trades is primarily due to the lack of compatibility between the system and your trading personality profile.

Conversely, as a trader you may be very well fit for day trading and quick decision making. However, the system you’ve developed or purchased is a day-trading system with only one or two trades per day. As you execute the system, you realize that you have more of a tendency to over-trade and take positions that are not recommended by the system. In other words, since the system is slower than your trading personality profile, you attempt to diminish the pain of waiting for the system to produce more trades by injecting more trades. Consequently, you are disobeying the system by acting on your own, regardless of the system’s recommendations. Then you complain that the system is not doing well and your performance is not as promised by the system.
Successful trading is built on two elements or foundations: the robust system and the proper personality trading profile. The first element is technical knowledge. This involves the mechanics of a specific trading methodology or system that must be followed. The second element is a trader's ability to carry out the specific trade recommendations of the method or system. This aspect of trading is rooted in the psychology of the trader. Although many traders have developed a viable trading methodology or system and know how to trade it, the fact remains that most are unable to implement their own system's trade recommendations. It would be wise to know whether you have the proper psychological profile for a particular style of trading before you invest your time and money in learning a trading methodology or purchasing a system. It does not matter how profitable a system might be; if you do not have the proper psychological profile to trade it, you will not be able to take full advantage of the system's potential.

Therefore, trading performance is based on two major factors. One is the trading system or trading methodology, the other is the behavior of the trader in relation to the system—the trader's psychology. The trading method or system encompasses the trading knowledge, market research, proper back-testing and statistical analysis, and sound money management. A trader's behavior is all the emotional and cognitive factors that can influence the trading decisions in relation to the trading system. Figure 14.1 depicts the two trading factors leading to the trading performance outcome. These two factors maintain a dynamic relationship that results in the subsequent trading performance.

In this book, we have explored the essential components for a sound and winning trading system that could endure under various market conditions. I offered you my Winning Edge Trading System, which is based on a realistic market model. I showed you how you execute the system for maximum performance while minimizing your losses. Now I'll explain the necessary personality traits that are needed to become a successful trader.

![Figure 14.1](image-url)
WHAT IS PERSONALITY?

There has been a great deal of research about the personality and its make-up. When we talk about personality, we usually refer to a set of behaviors that differentiate us from other individuals. If I ask you, “Do you know your family members or your good friends?” you would most certainly reply that you do. But what are you really saying? What is it about them that you know? In your mind you have established a general understanding of or perspective on those individuals. They have a set of characteristics, behaviors, habits, moods, or some other traits that are unique to them. Suppose that your best friend behaves a bit differently than his usual manner; you might say that he is “not himself.” So, when we talk about personality we are referring to a set of behaviors and attitudes that differentiate us from one another.

Personality is a stable collection of thoughts, feelings, and behaviors. Gordon Allport, founder of the Personality Traits Theory, defines personality as “the dynamic organization within individuals of those psychological systems which determine his characteristics, behavior, and thought.”

Along this line, some researchers define personality as an intrinsic organization within each individual’s mental world that is both stable and consistent over time and in different situations. This definition presents three important characteristics. First, individuals organize their behaviors based on internal structures. The system is located within and is not imposed by the external environment or situations. Second, personality is stable over time. Who we are and what we are stays fairly consistent throughout different periods in our lives. Typically, we would not expect some major changes in our personality over time. Finally, personality remains consistent in different situations. This means that if we are faced with the same situations over and over, we would be expected to act and behave in a consistent manner, with no significant changes.

It’s important to note that the stability and consistency aspects of personality do not imply that our personalities are static. On the contrary, personality is a dynamic concept. As we go through different stages and mature through experience, our personalities develop. The inner disposition of our personality gets a chance to develop and show itself in different environments and in different situations. Our personality starts from a simple form and grows and develops over time in line with its potential. Therefore, our personality is a dynamic and ever-evolving process.

Personality is determined and shaped by three major factors: heredity, environment, and situation. Heredity is an individual factor that differs from person to person; the internal traits and characteristics that we are born with do not change over time. Our behavior is shaped by heredity, which, in turn, helps us react to the environment and varying situations.
around us. When people deal with the environment around them, heredity helps shape how they will react. Over time, our dispositions motivate us to either react or not react to external stimulus in our environments.

According to research, our genes determine approximately 41 to 51 percent of our personality. Our personal experience, environment, and culture determine the rest. A better understanding of our personality will help us understand why we act the way we do. It also helps us better relate to other individuals as well. Therefore, to have a greater appreciation of “who” we are, it is critical to understand our specific personality traits. By knowing our own personality traits we can better determine a course of action that allows us to take advantage of our individual strengths and compensate for our weaknesses.

### WHY IS PERSONALITY IMPORTANT TO TRADING SUCCESS?

A major pillar of successful trading is psychology. To succeed at what you do, aside from knowing and understanding the necessary tasks or obligations that are required in a particular field, if you are to truly succeed you must like what you do. However, desire alone will not compensate for incompatibilities between you and a chosen endeavor. To succeed there must be compatibility between your personality traits, your personality profile, and the psychological requirements of a particular career. It goes without saying that to be successful at trading you must first and foremost enjoy the process of trading. You must be able to welcome the intellectual and emotional challenges that successful trading will bring.

Unfortunately, most would-be traders enter the professional arena of trading without the slightest idea whether they have the necessary skills or specific personality traits for a successful trading career. Usually when you ask aspiring traders what their primary reason is for wanting to become a trader, the response is usually the allure of big money. They further believe that with little time and effort, they will be able to make a large fortune and therefore bring financial security to their lives. To complicate matters even further, with the most recent version of the latest trading software boasting the back-testing of trading ideas and hundreds of indicators, the aspiring trader enters the world of “technical analysis.” Now, with years of market history in their data banks, they are able to design and develop the perfect trading methodology or mechanical trading system based on back-testing their ideas. Using their system’s back-tested performance, they further justify their claims that they are ready to prove themselves, using a few market behavioral characteristics they have identified and validated in
hindsight, believing that they now have the ability to “forecast” real-time market activity. Yet when they actually start to apply that trading system or methodology in real time, they are unable to implement their own plans and suffer losses. They begin to second-guess their method or system and wonder why. Successful trading first requires a sound trading methodology or system and the knowledge to trade that system effectively based on the rules or signals generated. Second, successful trading requires the proper psychology for that specific style of trading.

When I started to train professional traders for day-trading the S&P 500, I realized that some people were unable to generate a compatible performance with my Winning Edge S&P Day Trading System. Further investigation led me to realize that some of the students who wanted to be professional traders did not have the proper trading personality profiles for this given style of trading. Therefore, I started to offer a proprietary test as a guideline for them to gain a better understanding of their own psychology in dealing with the market and implementing the strategy according to the method’s guidelines.

For example, a trader might know when to enter the market but might not know how to tolerate its abrupt fluctuations. One strategy might be to place a protective stop. If the market moves against you, you are protected; you will be stopped out. If it does not, you will still be in your trade. The problem with this view is that it is too mechanical. You think that putting a simple protective stop in the market will optimize your performance. However, many times when you get stopped out, the market then moves in your favor. If this scenario is repeated often enough, as a reasonable person you would investigate your stop. Maybe your stop is too tight. Maybe it is not placed at a proper technical level or it is based on an arbitrary dollar figure. To correct this, you keep changing your stop. Although you may back-test the new stop before you apply it to the market, you realize you are now being completely stopped out. This amounts to emotional frustration. At this point, you start to feel helpless; you feel like the market is acting against you. If you increase the size of your stop, you get stopped out with a larger loss. If you reduce the size of your stop, you get stopped out more frequently.

Many traders at this point will abandon all the hard work that was put into developing this particular method of trading, or they will stop trading an expensive mechanical system. However, they often start the same pattern all over again. The trader spends more time, money, and energy to develop a brand-new method or system or purchase another one. Much to her dismay, she sees that she is facing the same problem as before. Still she is not able to follow her trading plan based on her new system’s rules. She doesn’t realize that the system or method, although not perfect, has been created with a sound understanding of market behavior, back-testing and
efficient forward-testing. The problem lies not with the system but with the trader.

A core belief among successful traders is that they are not trading the market but trading their own psychology. The market becomes a mirror for a trader and reflects his own attitudes and beliefs. It is imperative that you have a thorough understanding of your own psychology and have a good inventory of your own personality traits. If your personality is not compatible with trading as a whole or your personality traits are not compatible with your system’s or method’s variables in particular, it will not matter how good your system is. You could have the Holy Grail of systems but never be able to produce a satisfactory performance.

PERSONALITY THEORIES

Understanding human psychology and behavior has been a never-ending goal of psychologists. Different cultures and philosophers have presented a wide variety of theories regarding human behavior. Each has tried to figure out why we do what we do. What is the motivation behind our actions? What is the thought process? What capacity do we have to change our behavior? Could a person with undesirable personal characteristics change for the better? How could a model citizen carry out heinous acts? What is our personality, and can we change it?

When we look around, we easily see distinctive features that differentiate others and ourselves. We also see similarities between our siblings, our immediate family members, and ourselves. A collection of similarities and differences make us unique individuals. The purpose of personal psychology and its scientific investigation into these similarities and differences is to categorize different personality types and traits.

In general, there are two approaches to studying human personality. One emphasizes the person and how he acts in different situations. This type of approach, which is the *ideographic approach*, is presented with most of the major theories such as Freud’s psychoanalytic theory and humanism, social, and cognitive theories. It is from this perspective that we’d like to know why different people react differently to the same situation, such as a social event. An introverted individual may feel shy and try to stay away from crowds, but an extrovert may seek participation in various social events. The aforementioned theories look at each individual and try to understand and gain insight about individual personalities.

However, there is another major approach that is utilized in understanding human psychology and personality. This approach focuses on learning about similarities and differences between individuals. Called the *nomothetic approach*, it includes personality types and traits theories.
These theories try to study the similarities and differences between individuals and categorize them. For example, we know that an individual who has a high score in the openness dimension is more creative and imaginative and will look to try different or novel approaches in his or her field. These types of individuals usually are open-minded and show a higher tolerance toward their differences from others in social settings. Now, if we have several individuals with high scores of openness, we could expect them to act and behave in the same manner while dealing with social events or handling challenging obstacles in business.

To gain some appreciation for these different approaches, we briefly examine how using the Personality Traits Theory to assess our strengths and weaknesses in trading is a practical, realistic, and useful tool for this purpose. By knowing our strengths and weaknesses, we can choose or develop a trading system that is more compatible with our personality. Since it’s more compatible, we have a better chance of following the signals to achieve an acceptable performance. Once we learn about our personality traits, we can develop a sound trading plan with precise strategies to achieve our trading goals.

Before we look at a very brief outline regarding the major theoretical approaches to human personality, it’s worth noting that for each of the approaches mentioned here, you could read many volumes of books. The purpose of mentioning these approaches is to give the reader a quick overview of different theorists who have tried to understand the personality and its characteristics. The reader might choose to study many of the major researchers to further his knowledge about each specific approach. This will give you a better understanding as to why I chose Personality Traits as a viable tool to identify a trader’s personality profile and how to use this tool to gain extensive knowledge about individual strengths and weaknesses with regard to trading success.

Psychodynamic Approach

The psychodynamic approach asserts that an individual’s unconscious process influences behavior and that the individual is in constant turmoil due to the conflict among biological urges, perceived realities, and social environment. This type of approach proposes that the origin of our thoughts, feelings, and motivations lies in our unconscious. The leaders of this perspective are Freud, Jung, Adler, Erikson, and Fromm. Each of these psychologists tackled human personality through the psychological effects of one’s unconscious influence. For example, according to Freud, the individual goes through different psychosexual stages, and the resolution of each of these stage’s conflicts, in developing the personality. This type of approach might be useful in psychotherapy as a guide to explore one’s
unconscious or hidden motives and feelings, but it is too vague to be applied for the purpose of trading.

**Social-Cognitive Approach**

The social-cognitive approach proposes that an individual will learn different types of behavior through the reward/punishment mechanism. Some behaviorists, such as Watson, reject the notion of mind, feeling, and introspection and limit the personality theory to observable human behavior. On one hand, this approach is represented by a simple mechanistic operant, that operant being conditioning. According to B. F. Skinner, conditioning is the main influence in shaping one’s personality. On the other hand, this approach proposes that one’s personality is developed and shaped through social learning and the realization of reward and punishment by behaving differently in different situations. This perspective proposes that through the study of past behavior, you could predict future behavior.

Leaders in the field of this approach are Skinner, Rotter, Bandura, and Mischel. Some of these theorists have added to and/or modified the social-cognitive approach. In general, this perspective on personal psychology relies on external factors such as culture, society, or environment as a source of change that helps to shape one’s personality. For example, Skinner asserts that our behavior is a result of the conditioning process. Through reward and punishment, we shape our behavior to avoid pain or punishment or to gain pleasure or reward. As an extreme, this is a mechanistic view that does not take into account any genetic or biological influences on behavior or personality. For example, students are rewarded for doing their homework by receiving good grades and recognition from their teachers.

Therefore, a student will work hard to do homework if he really cares about good grades. A trader tries to follow a good trading system, receiving a profitable performance in return.

Some of the variations on this theory propose that beliefs and cognition influence the shaping of our behavior. Some theorists, such as Mischel, have heavily weighted the element of cognition and propose that both personality traits and situational variables are important in explaining behavior. In other words, personality traits influence behavior only in relevant situations and lead to certain behaviors, depending on the situation, and individuals have a tendency to gravitate toward circumstances that are compatible with their personalities. Mischel also proposes that personality traits are more important in some situations than in others.

This approach is helpful in predicting human behavior based on past behavior and could be used effectively in training individuals to develop and learn new social skills. However, it is too specific and is unable to measure personality variables for trading.
Humanistic (Phenomenological) Approach

Theories related to the humanistic or phenomenological approach propose that each person perceives a different reality. Each individual’s unique ideas and perceptions about their environment and the world create her personality. Each individual’s view and personal constructs, as this approach suggests, are the guiding elements of that person’s behavior. The humanistic approach claims that self-actualization and growth are basic human tendencies. This approach totally de-emphasizes the hereditary factor of personality. The lead theorists for this approach are Rogers, Maslow, Laing, May, and Kelly.

This approach provides an understanding about the universal tendencies of humans. However, it’s too vague and idealistic for application toward measuring one’s trading behavior. In trading environments competition and survival are more pronounced. For that, it is a zero sum game. In other words, not all could be right and correct in their market perceptions. The correct views yield in winning while wrong market perceptions result in losing.

Dispositional Approach

The dispositional approach proposes that personality is a collection of internal characteristics or traits that shape our behavior. Personality traits are viewed as an enduring tendency or predisposition to respond to the environment in a particular manner. The basic tenet and assumption of this approach is that an individual’s behavior is guided by a set of traits that go through a developmental process as one grows and matures. These traits create a tendency in an individual to act and behave in a particular way in a particular situation. However predisposed, the long-lasting mental and psychological tendencies are stable over time and are consistent in different situations.

This approach assumes that people have unique combinations of traits and that these traits are rooted in biology. Some of the great names associated with this psychological approach to personality are Allport, Cattell, Eysenck, and Norman.

There are two major theories that represent this approach in personality psychology; they are personality type theory and personality traits theory.

PERSONALITY TYPE THEORY

According to personality type theory, individuals are classified into one or more categories or types. Throughout history, philosophers have created
systems based on typology and categorization in order to understand people's similarities and differences. Various systems of typology have been developed to explain the obvious similarities and differences of individuals' behaviors. A wide array of these systems, ranging from astrology to geographic direction, attempted to describe an individual's personality. For example, ancient Greeks developed a system based on four bodily fluids, or humors: blood (cheerful and energetic), phlegm (skeptical and sluggish), black bile (skeptical and sad), and yellow bile (cynical and irritable). Each of these fluids was used to label people so that their behavior could be recognized and explained. Despite the fact that the ancient Greek theory of Hippocrates has been disproved, personality types remain popular, mainly due to their simple behavioral classifications and ease of application.

A new version of this approach was developed based on the ideas of a Swiss psychiatrist, Carl Jung. A personality test developed from Jung's theory is the Myers-Briggs Type Indicator (MBTI), which classifies people in four dimensions:

1. Extraversion-introversion (E-I)
2. Sensing-intuition (S-N)
3. Thinking-feeling (T-F)
4. Judgment-perception (J-P)

According to this self-report survey, individuals have a combination of types, which includes one from each of these four parts. For example, one could be I-S-F-P, which stands for intuitive, sensitive, feeling, and perceptive.

Along this same line, there is another typology that identifies individuals as having Type A or Type B personalities. A Type A person is usually known as competitive, hard working, aggressive and hostile, and prone to anger and reactive behavior. On the other hand, a Type B personality describes an individual who has a tendency to be easygoing, relaxed, non-competitive, and aloof.

**PERSONALITY TRAITS THEORY**

Since humans are dynamic and interact with their environments, this interaction creates feedback and affects other changes in our behavior. Therefore, understanding the origin of behavior goes back to understanding the general system theory. In particular, there are two schools of thought. One believes that environment and external factors are underlying reasons for
behavior, called behaviorism. The other believes that the main factors of our behavior are internal dynamics such as genes, biology, and physiology. The first group falls into the category of people who believe that the source of change is external (that is, environment, society, situation) and the other group proposes that the source of change is internal (that is, human biology, physiology, genes, and internal traits and dispositions).

When we talk about traits or dispositions, we are referring to a potential or capacity within each of us to behave in a particular way in specific situations. Each individual has a unique combination of biological endowments that could develop to their full potential in a suitable and nourishing environment. The personality traits theory proposes that each person has an innate potential, dependent on genes or biology, that requires the proper environment to grow. The personality traits theory claims that our behavior is the outcome of our inner traits and outer environmental interactions.

A wide array of research has been done on personality traits propositions. Among the most important ones that make the point are the twin studies.

According to Galton, a well-known psychologist in genetics research, first cousins have one eighth of their million genes in common, siblings have half, and identical twins have all. Therefore, if there is any correlation between genetic make-up and behavior and personality, identical twins must show the same or very similar personality traits. This relationship has been identified through a vast body of research conducted in the past half century. Research in this field has grown to the extent that some research has shown a close genetic relationship that has been indicative of similarities in mental health as well as physical illness. Other research has identified that a close relationship between individuals’ genes is also indicative of their intellectual similarities.

In studies of twins, psychologists have concluded that identical twins show a closer relationship in their personality traits than fraternal twins. In one case, researchers studied identical twins separated at birth. Jim Lewis and Jim Springer, identical twins separated at birth, were reared 40 miles away from each other in Ohio. For 39 years they each had no idea that the other existed. In 1979, Professor Thomas Brouchard of the Minnesota Center for Twin and Adoption Research at the University of Minnesota, conducted a study of fraternal and identical twins who were reared apart. Except for their clothing, Jim Lewis and Jim Springer were physically indistinguishable. Both men had wives named Betty, were heavy smokers of Salems, drove Chevrolets, bit their fingernails, and had dogs named Toy.

Some of the similarities could have had to do with being reared in a similar part of the country; other things were left to chance. More important, the evidence from a battery of psychological testing was remarkable.
Bouchard and his research team found that the responses and trait scores of Jim Lewis and Jim Springer were nearly identical.

Fraternal twins, on the other hand, have also been studied. Researchers found that although both identical and fraternal twins have similarities, fraternal twins are less alike than identical twins. However, if they have been reared together in the same home, the evidence is less than perfect; they have had the same or very similar environmental influences all along (and identical twins, in particular, are even treated alike by their parents). The evidence is rare and ambiguous because the best data comes from experiments of twins separated at or soon after birth and raised in different homes and areas, where the environments are at least somewhat dissimilar.

Since Bouchard and his researchers began their work, they have located and studied 80 pairs of identical twins and 33 pairs of fraternal twins. After 50 hours of intensive tests and interviews, the data was compiled. The same experiment was done as a comparison study with identical and fraternal twins reared together. Statistical analysis of all the correlations within the twin pairs and among these various groups led the team to conclude that about 50 percent of variance in personality is due to heredity.

Many other psychological variances were studied in conjunction with this experiment. General intelligence, language ability, social attitudes, homosexuality, substance abuse, and even religious interests were remarkably similar among twins in this study.

NATURE OR NURTURE?

What is the origin of our personality? Do successful traders have a natural inborn talent that allows them to succeed at trading? Can a person learn to be a successful trader? These questions beg to be answered in considering a full-time trading or professional investment career. An aspiring trader needs to know and be convinced of the answers to these questions before she can consider a serious commitment of time and money. Are we born with the skill, or can we learn to trade?

When we talk about a career or a profession, we are usually referring to the knowledge contexts of that area—a knowledge module. Learning the mechanics of trading is quite easy. By utilizing some type of mechanical system or putting in sufficient time to study the markets, you could easily acquire the necessary knowledge and skills to execute proper trades. By doing so, you would be able to familiarize yourself with the mechanics of a market and the related logistics in placing orders, open or closing positions, and so on. However, when we talk about mastering trading, that is something else entirely.
Consider this example: Learning to fly is not a difficult task. The necessary intelligence needed to learn to fly can be found in the average individual. Nowadays, with flight simulators, a person can go through most if not all of the possible scenarios he might encounter during flight and find the resolution to those problems before ever leaving the ground. But why might the same individual, who has been doing fine in simulated flight, when put in a real plane, break down and end up crashing his plane? This example illustrates that the knowledge of flying is totally different from the art and experience of flying.

Therefore, a clear distinction between knowledge and insight must be made. By knowledge, I refer to any type of information that can be learned, transferred, or memorized. But insight is experiential knowledge. Application of knowledge in the real world becomes insight. Insight cannot be transferred or learned by reading or taking extensive training courses. Insight can only be acquired and cultivated through constant application of learned knowledge in real-life situations. Gaining an in-depth understanding and directly experiencing the various aspects of reality in relation to knowledge are the heart and soul of insight. Although you could easily study and learn different trading methods or systems and acquire a satisfactory level of knowledge to understand those methods or systems, acquiring that knowledge is by no means a guarantee of being successful in trading.

To be a successful trader, you also need to develop your own unique insight that only comes from the direct experience of trading. Trading insight, like insight in any other area in life, requires you to have a personal and private experience with the market; to feel, smell, see, touch, and hear the market’s messages through the application of your trading plan. To gain an insightful experience, you must have a personal and very private understanding of market behavior in relation to trading. It’s easy to see how a naïve individual thinks that by signing up and learning some “Holy Grail” trading method or purchasing an over-optimized back-tested system, he can become a successful trader. Nevertheless, as we’ll discuss later on, a trading system or method, as a collection of techniques or formulated trading knowledge, is a crucial part of being a successful trader.

The process of cultivating trading insight depends in general on one’s personality, in particular on one’s personal trading profile. Intelligence alone is not enough. A trader must have the proper personality that is compatible with her trading methodology in order for her be a successful trader. If an inventory of the personality traits or a trading personality profile is necessary to find compatibility between a trader and a given style of trading, what is the best way to acquire that trading personality profile?

According to Dr. Joseph E. LeDoux, among the most important and significant findings of modern neuroscience research is the theory that nature
versus nurture has been constructed under a false dichotomy. Nature, or biology, is at one end of the spectrum; environment, family, and experience are at the other end. Both influence our behavior and personality in fundamentally different ways. The pure separation of these two forces is a mechanical prospective. In other words, from a perspective of the general system theory, real-life experience is the result of many causes and interdependent factors. Biology and genes only provide innate potential; in no way do they guarantee the full development of that potential. An individual may have inherited a genetic make-up with the potential to be a world-class musician. However, if he does not commit the time and effort to learning music and practicing it diligently, he won’t be able to develop this potential.

For example, identical twins, having identical sets of genes, might not necessarily produce identical personalities and physical attributes. If they are separated at birth and one of them is raised under harsh conditions and does not get enough nutrition in his daily diet, the height, weight, and development of some of his physiological aspects might be totally different from the twin who is raised in another type of environment. Since an individual’s physical features have some influence on his psychology, his personality could also differ from that of his twin brother. According to researchers, approximately 41 to 50 percent of personality traits are related to genes; the balance of those traits are dependent on the way an individual is raised, the values that have been engrained, and the culture, environment, and life experience. Therefore, it would be rather misleading if we separate the interaction and interdependence of genes or biology from life experience and environment. In a nonlinear relation, these factors influence each other and create an outcome that is totally different for each of the twins.

Personality traits theory gives us a great understanding of the foundation of the personality. By gaining this understanding, we can identify a trading system that matches our own personality profile and increase the probability of success. Genes and biology, environment, and life experience are all essential forces in shaping our personality. Therefore, both nature and nurture, working in an interdependent relationship, play important roles in our success as traders.

**GENOTYPE AND PHENOTYPE**

If both genes and environment shape our personality, it is important to realize the different components that make up our personality. To understand personality, we should be able to see which part of our personality is moldable and flexible and which part is not. To aid us in this task, it is
necessary to know which part of the personality is genotype and which part is phenotype.

*Genotype* refers to the building blocks of our personality—the genes and innate potential. *Phenotype* refers to the expression of our genotype at various times and in different situations. Since personality is dynamic, the changes and behaviors of an individual may differ throughout her lifetime.

According to Dr. Ralph L. Piedmont:

* A genotype refers to the fundamental organization of the individual; the basic “stuff” that a person has been endowed with through their genetics. Genotypes are latent dimensions that establish for an individual, a trajectory through time. Phenotype, on the other hand, refers to the expression of the genotype at any given moment in time. Put all the phenotypes together, and you have the genotype.10

Consider an outgoing individual. In her teenage years, she might enjoy going to parties and being in a crowd. But as she grows and matures, she will not have wild parties, but she might invite her friends over often or choose a profession or career that is people oriented. Although her outgoing traits have not changed (her genotype), her behaviors in different time periods have changed and formed new shapes (her phenotype). This shows that in understanding personality, we need to look at these concepts and realize the time variance or dynamics of her personality.

Dr. Piedmont adds:

* These two concepts tell us that there is a lawfulness to change. Certain quantities or qualities may vary over time, but such variability may not necessarily reflect any fundamental change. Rather, change may be indicative of a gradual unfolding process for a given characteristic.11

An individual who has high score in neuroticism is prone to quick reaction. This person gets angry quickly and has strong emotional reactions. As a young man, he may get into fights with his schoolmates. He tends to snap faster than usual and his anger and emotion may take over his rationale. Now when he is married, he may get into more arguments with his wife and be short and abrupt with his children. If the same individual decides to be a trader or professional investor, he would prefer short-term or day trading to long-term trading. However, he might not hold his position in one stock for very long. Often he would switch back and forth in his positions. When the market sells off and heads south, he might quickly exit his position, or when the market goes up he might buy with the crowd. The same genotype has been reflected in different phenotypes in his life. His
behavior may have changed from one circumstance to another, but it all reflects his innate genotype traits.

Therefore, our behavior is based on our innate personality traits that may take different forms under different circumstances. Although you may be a talkative person, this does not necessarily mean you would talk in any given situation. Your propensity toward being a talkative person is not negated by this fact; rather, it reinforces the fact that our personality traits are innate.

Whatever factors play a role in the creation of our personality traits, the fact remains that we exhibit discernable traits and behave in a habitual manner. These traits make up our personality and project our character for all to see.

Having insight into our personality traits can help us in several ways. It can help us take advantage of our strengths and minimize our weaknesses in reaching our goals, either in life or in trading. One of the many benefits gained in the pursuit of a successful trading career is the understanding of our own psychology—being able to better know our strengths and weaknesses. Another benefit of knowing our personality traits is that we could have a greater understanding of why we keep repeating some of the self-defeating behaviors that create a sense of frustration and helplessness. If we know the specific traits and characteristics of our personality that cause us to repeat certain types of behavior, we are able to effectively devise either a developmental strategy to modify the behavior, or a complementary strategy to eliminate that undesirable element from our behavior.

Suppose you tend to increase your trade size as you incur more losing trades. In essence, you take a “kamikaze” or “make or break” approach and deal with your trades from a purely emotional basis. After you exhibit this behavior a few times and suffer the consequences, you will find it difficult at best to continue to trade. It doesn't matter how good your system is or how much capital you might use for your trading. This type of behavior is certainly a nonsystematic approach to trading, and more important, it's a clear deviation from your plan. Knowing what causes you to take this type of action is necessary for you to deal with the problem and provide a practical solution. Say you have a high score in both your neuroticism and openness domains; this would provide a suitable foundation for an extreme behavior like the one just mentioned. In that case, you may implement a developmental strategy to alter your thought process and therefore your behavior.

You may also utilize a form of neural linguistic programming to modify your behavior. In some cases, due to your high score in these particular aspects, you may have to enlist someone else to trade your system. This would be utilizing a complementary strategy. You might also modify the design of your system to keep you out of the market after a predetermined
number of losses, to provide a cooling-off period. Or you may just set a limit on your losses and then walk away until the next trading day. Depending on your personality traits, poor performance could be linked to self-sabotaging behaviors that need to be stopped or modified for you to achieve your goals in trading.

Another great benefit of knowing your personality traits is the ability to match your personality profile with a particular field of interest that will take advantage of your strengths. Success in trading will be hard won if there are some elements of your personality traits that are not compatible with your chosen trading system or methodology. Perhaps even more important than the system or method is selecting a particular style of trading that is suited to your personality type. You might want to focus your attention on day trading, while you are really more suited for position or swing trading. Understanding our personality traits will help us choose the proper trading methodology or system that will not create obstacles and hinder our trading performance. Knowing our personality traits also helps us have a better relationship with others. Relationships with a spouse, child, business associate, or friend can all be improved with this knowledge. With this information we have a greater understanding of the areas that might act as possible triggers for undesirable behavior. Armed with this awareness, we can then begin to change our actions and put into practice ideas designed to enhance our relationships with our loved ones.

**FIVE-FACTOR OR BIG FIVE MODEL**

Having been around for about a century, the personality traits theory has attracted a lot of attention from researchers and personal psychologists alike. This theory proposes that our behavior is a projection of personality traits that have been cultivated through genitive factors and the social learning process or environment. Each of us has an innate potential for certain traits that require social and environmental contexts to develop. In short, our behavior is a result of certain personality traits within different social contexts.

The Five-Factor Model (FFM), sometimes called the Big Five Model, is rooted in traits psychology and appreciates and acknowledges these individual differences. It identifies the origin of human behaviors in individuals, implicitly crediting individuals as proactive. Regardless of the origins of traits, either genetic or environmental, once they are established they define individuals and their unique personalities. We do not inherit our traits. Traits are the outcome of a complex interaction between our genetic dispositions and environmental opportunities. Traits are behavioral envelopes that encompass our genetic tendencies, habits, feelings, emotions, and
motivations. The complex interaction between genes and environment could be compared to planting the proper seeds in proper soil to create a beautiful flower.\textsuperscript{12}

FFM is rooted in the lexical hypothesis, an insight of Sir Francis Galton. He recognized that language as the best tool to decode the most important differences between individuals in their interactions with each other. Therefore, he was one of the early scientists who consulted a dictionary as a means of estimating the number of words that describe human behaviors and personality traits. To him, words and language seemed to be the best collection of common descriptives shared by that language. Later on, Allport and Odbert (1936) and Norman (1967) sharpened this concept. Other seminal researchers, such as L. L. Thurstone, who developed the Factor Analysis Technique, were able to narrow down the personality traits descriptive adjectives to five factors. Furthermore, Raymond B. Cattle conducted his research by identifying 4,500 words in the English language that describe personality traits. He was able to narrow down all the lexical descriptive traits into 35 complex bipolar variables. Later on, when other researchers further analyzed Cattle’s variables, they found that they could be narrowed down into five replicable factors. Other researchers have also included a similar five-factor structure in their research.\textsuperscript{13}

These five factors are openness, conscientiousness, extroversion, agreeableness, and neuroticism. An easy way to remember them is to use the acronym OCEAN. Any combination of these traits has the ability to create secondary traits. We consider each of these primary traits as a domain, or dimension, of our personality. Each domain may also have some additional facets.

**Major Differences Between the MBTI and FFM Models**

To appreciate the practical usage and functionality of the Five-Factor Model, it would be a good idea to compare and contrast this model with a relatively well-known model, the Myers-Briggs Type Indicator (MBTI). For about three decades, psychologists and trainers have relied extensively on the MBTI for assessing personalities. The MBTI model, which originated from Carl Jung’s personality theory, identifies personality differences under these assumptions. The MBTI model identifies four dimensions for personality: thinker, intuitor, sensor, and feeler. These have been translated in the MBTI instrument along, respectively, bipolar dimensions: extrovert/introvert, sensor/intuitor, thinker/feeler, and judger/perceiver. Therefore, the four dimensions are considered in a bipolar format and scores in each dimension fall in a bimodal distribution. Furthermore,
the judge/perceiver appears to be a key indicator of one's personality characteristic.

However, the FFM has been created based on experience, not theory, even though it could be considered evolved from the MBTI instrument. It proposes that the Five-Factor Model has gained widespread acceptance both in academia and practice. The FFM states that personality has five dimensions, and the score of each dimension is a normal distribution (bell curve) rather than a bimodal distribution. In other words, one's score of a personality dimension could be stated as one of degree rather than a black-and-white score. Personality, according to the Five-Factor Model, is described in individual traits and facets rather than as types. Therefore, the strengths of traits identify an individual's preference.

Successful trading is built on a sound and profitable system and the proper personality trading profile. Accordingly, to identify your own unique personality trading profile, you need to explore your personality. However, doing so would be futile without utilizing a valid and practical personality theory. Among the current theories, personality traits theory offers a more realistic knowledge of human personality and its psychological make-up. Moreover, it offers a proper foundation for practical applications. In other words, it ascertains necessary tools to identify whether your personality is compatible with a particular market and associated style of trading.

In Chapter 15, we discuss how we could use the Five-Factor Model of personality traits to identify your trading personality profile for a more profitable and less stressful trading experience.
In Chapter 14, we discussed various psychological theories that could be utilized for trading. We made clear distinctions about two approaches to a trader’s psychology. One, discussed and prescribed by the majority of trading (pop) psychology in the market, expects you as a trader to change who you are. They propagate different methods and recommend you to get into a “zone” or self-discipline yourself. They advise different methods such as a neurolinguistic program (NLP) to disassociate and unlearn your behavior or promote a hypothesis, or they even offer you tapes and DVDs to enforce some type of positive affirmations. Well, if they work, their effects are short-lived, since their focus is behavioral modification. The aforementioned methods all aim to modify your behavior temporarily, anywhere from a few days to few weeks. However, as soon as your stress level and anxiety rises due to the complexity of the trading decision-making process and possible accumulated loss, your behavior will revert back to who you really are.

The second approach is that which have I presented to the trading community and financial world since 2002 with my book, How to Become a Successful Trader. In this book I presented a new and revolutionary idea based on personality traits theory. I proposed that it’s futile for traders to spend so much time and energy trying to change who they are. Since about 50 percent of our behavior stems from our genetic make-up, it’s more prudent to identify our personality strengths and weaknesses in relation to the dynamics of trading and making decisions under stressful times. I proposed that since changing is more or less a futile effort, we should identify
our forte and strong points as well as hurdles and limitations and use them as our guide to make proper selections for our trading method and style.

**FIVE-FACTOR MODEL OF PERSONALITY**

As described in the preceding chapter, the Five-Factor Model (FFM) of personality traits is a normal personality model that is widely accepted and practiced among researchers and practitioners. Since the writing and creative research approach of Gordon Allport in the early 1930s, the field of personality psychology has come to accept the FFM. According to the FFM, one’s personality is defined and expressed by five dimensions or factors. Each domain is a bipolar continuum progressing from one extreme to another in a graduated process. This unique aspect of the FFM provides a better handle in understanding one’s personality than a simple bipolar, black-and-white expression of personality type theory.

The FFM uses a classification system based on language. It identifies five domains of the personality: openness, conscientiousness, extraversion, agreeableness, and neuroticism (or OCEAN). The domains’ scores range from extremely high to extremely low, which makes them more practical and realistic for our purposes than specific personality types. Each of the domains is divided into three general levels: low, midrange, and high.

**Openness (O Domain)**

*Openness* refers to the extent to which you like to explore new things. Novelty is at the core of the openness domain. Are you usually interested in knowing why something has happened? Are you curious? This domain describes personality aspects such as creativity, artistic tendency, originality, imagination, and insightfulness.

The openness dimension refers to the degree to which a person is curious about her inner and outer worlds. At one end with a high score, one has broader interests, is fascinated by novelty and innovation, would generally be perceived as liberal, and reports more introspection and reflection. Although the individual is not unprincipled, she tends to be open to considering new approaches.

At the other end with a low score in this dimension, one has narrower interests, is perceived as more conventional, and is more comfortable with the familiar. Individuals at the low end of this dimension are thought to be conservative but not necessarily more authoritarian.

Each domain comprises six different facets. They define the effect of the domain in an individual’s behavior and psychology in narrower perspectives. Each domain, including openness, according to Costa and McCrae (1992), has six facets, as stated in Table 15.1.
TABLE 15.1 Six Facets of the Openness Domain

<table>
<thead>
<tr>
<th>Facet</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fantasy</td>
<td>The ability to create an interesting inner world through imagination and fantasy.</td>
</tr>
<tr>
<td>Aesthetics</td>
<td>A wide and deep appreciation for art and beauty; sensitivity.</td>
</tr>
<tr>
<td>Feelings</td>
<td>The ability to value and experience a wide range of positive and negative emotions.</td>
</tr>
<tr>
<td>Actions</td>
<td>A preference for novelty and verity over the routine and familiar.</td>
</tr>
<tr>
<td>Ideas</td>
<td>Intellectual curiosity; openness to new and unconventional ideas.</td>
</tr>
<tr>
<td>Values</td>
<td>The willingness to examine social, political, and religious values; lack of dogmatism.</td>
</tr>
</tbody>
</table>

For the sake of simplicity, we divide each dimension or domain into three distinct parts based on high, intermediate, and low scores. For more detailed discussions of these domains and their facets, refer to the author’s book, *How to Become a Successful Trader*.

1. *Preserver*. A preserver tends to develop expertise in one specific area and focus his interest in a narrow field. As traders, when preservers learn a new system, they tend to stay with it; they also prefer to work with tried and proven indicators. In their trading, preservers probably have few indicators on their screens. Once these individuals have rooted, it is difficult for them to move from one familiar system or area of knowledge to another. They tend to trade one or just a few markets and to get stuck on a few particular investment stocks or sectors. Preservers have clear habits and patterns and for the most part appear to their friends to be predictable.

2. *Moderate*. Moderates tend to have the best of both worlds. They like to stick with their old, proven way of doing things, but if somewhere along the way they come up with a new idea or someone convinces them that a new system will work, they will give it a try. As traders, moderates tend to maximize a system. They do their best to trade a system to its full potential, and they give it enough time to work before they make any decisions about it. They will look at a given system from different angles until they ultimately find out whether it really is worth using any further. However, if they are convinced that a system is not working or that another trading system is better, moderates do not mind shifting gears and learning a totally new system.

3. *Explorer*. Explorers tend to be imaginative, dreamy, and sometimes unrealistic; they are less practical and more motivated by novelty. Traders with high scores in the O domain tend to switch to new trading systems as often as possible; this creates an impediment for trading.
Explorers may find it hard to follow a particular trading system. They tend to try new and different indicators or systems; they find attractive any theory or market analysis that is new and novel. As traders, explorers try to escape from the present and focus on the future.

Conscientiousness (C Domain)

Some adjectives that describe characteristics of the C domain include organized, self-confident, thorough, efficient, precise, determined, and ambitious. The ideal score for a trader in this domain is in the high range.

The conscientiousness dimension concerns self-control and self-discipline to achieve one’s goals. On one extreme with a high score, the individual exhibits high self-control, resulting in a consistent focus on personal and occupational goals. In its normal state, this trait is characterized by academic and career achievement, but when it turns extreme, it results in workaholism. Focused people are difficult to distract.

On the other end of the conscientiousness continuum, the individual with a low score is more easily distracted, less focused on goals, more hedonistic, and generally more lax with respect to goals. A person with a low score on this dimension is easily seduced from the task at hand by a passing idea, activity, or person; that is, he has weak control over his impulses. That individual does not necessarily work less than the other extreme people, but less of his total work effort is goal-directed. People at the low end of the dimension tend to be more creative and open to possibilities longer without feeling driven to achieve closure and move on.

The facets covered in the conscientiousness domain are presented in Table 15.2.

This domain could be described by the following three general levels.

1. Flexible. A flexible person seems to be less ambitious and less determined, and she may appear to be lazy, absent-minded, and careless.
a trader, if you are flexible, you might have a hard time committing to a trading system or methodology. You may need to light a fire under yourself to get motivated.

2. **Balanced.** As is so often the case in life, a moderate view works the best, and such is the case for the balanced individual. These people tend to be organized and follow the rules, but they also find time to relax and go out of bounds once in a while. As traders, balanced personalities sometimes follow the chosen system and at other times abandon it. For this type of person, coaching as a part of a developmental strategy would work well for improving trading performance.

3. **Focused.** Focused individuals are organized and ambitious and perform their tasks in an orderly manner. Focused individuals are usually striving to achieve their goals, and their mindsets are quite clear when it comes to accomplishing their objectives. The most common personality trait among highly successful traders is a high score in the C domain; research has shown that these individuals have the greatest capacity to change their personalities and modify their behaviors. As traders, focused personalities have great potential and are committed to success. They have clear trading plans and follow them diligently.

**Extroversion (E Domain)**

Aspects of this domain are usually described with words such as *sociable, friendly, warm, cheerful, talkative, outgoing, enthusiastic, confident, assertive, active, spontaneous, humorous, jolly, optimistic, determined, quick, energetic, pleasure-seeking, and adventurous.*

The extraversion dimension is about the extent of one’s preference for being actively engaged with other people. On one hand, with a high score, the individual tends to exert more leadership, to be more physically and verbally active, and to be more friendly and outgoing around others than most people.

On the other hand, with a low score, one tends to be more independent, reserved, steady, and comfortable being alone than are most people.

Facets in this domain are shown in Table 15.3.

The extraversion domain could be categorized in three general levels as follows.

1. **Introvert.** This individual prefers to work in a solitary environment. He prefers to tackle projects alone and may appear to others as cold and reserved. Introverts prefer writing e-mails and participating in newsgroups as opposed to talking in person with a group of people. As traders, introverts tend to work alone from home or from a private office. It is important for a trader to identify his E score to find a
TABLE 15.3  Six Facets of the Extraversion Domain

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warmth</td>
<td>One’s capacity for affection, friendliness, and cordiality.</td>
</tr>
<tr>
<td>Gregariousness</td>
<td>A preference for being around other people.</td>
</tr>
<tr>
<td>Assertiveness</td>
<td>The tendency to express oneself forcefully and without reluctance.</td>
</tr>
<tr>
<td>Activity</td>
<td>Level of energy; the tendency toward fast-paced lifestyles.</td>
</tr>
<tr>
<td>Excitement seeking</td>
<td>An appetite for the thrills of bright colors and noisy settings.</td>
</tr>
<tr>
<td>Positive emotions</td>
<td>One’s capacity for laughter, joy, and love; optimism; happiness.</td>
</tr>
</tbody>
</table>

suitable environment for optimum trading performance. Regardless of the type of trader you are, you need to make sure your trading environment reflects your E score.

2. **Ambivert.** Ambiverts have a high degree of flexibility with regard to working environments; they find that working with other people can be just as satisfying as working alone, and their preference to work at home alone or to work in the office with others can change from day to day.

3. **Extrovert.** An extrovert derives energy from the outside world. She likes to be around people and to mingle, talk, play, and interact with them. This type of person prefers to participate in meetings rather than talk on the phone or send e-mail. If you are a trader with a high score on the E domain, you should arrange to work with other people. If you do work at home, have your TV or radio on in the background. If you are unable to leave your trading room, make sure you have enough stimuli. You might light a scented candle in your room, or you might want to paint your room lively, bright colors. You can also change your screen colors to brighter, more pleasant ones so they can help you remain focused on your trading. In some instances, if an extrovert is not stimulated in his environment, he may try to compensate by overtrading to create that needed energy.

**Agreeableness (A Domain)**

The fourth dimension of the FFM is agreeableness. Characteristics of the A domain are usually described in the following terms: forgiving, sympathetic, kind, trusting, and peaceful.

The agreeableness dimension is a measure of altruism versus egocentrism. At one end of the continuum, one tends to subordinate personal needs to the needs of the group and to accept the group’s norms rather
The Trading Personality Profile Test

TABLE 15.4 Six Facets of the Agreeableness Domain

<table>
<thead>
<tr>
<th>Facet</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust</td>
<td>The tendency to regard others as honest and well intentioned; lack of skepticism.</td>
</tr>
<tr>
<td>Straightforwardness</td>
<td>Proneness to candor and frankness; tendency not to be deceptive or manipulative.</td>
</tr>
<tr>
<td>Altruism</td>
<td>Generosity; consideration; the willingness to help others.</td>
</tr>
<tr>
<td>Compliance</td>
<td>Proneness to submit to the will of others; cooperativeness as opposed to competitiveness, inhibition of aggressive feelings.</td>
</tr>
<tr>
<td>Modesty</td>
<td>Humility; lack of arrogance or narcissism.</td>
</tr>
<tr>
<td>Tender-mindedness</td>
<td>The ability to feel concern, pity, and sympathy for others.</td>
</tr>
</tbody>
</table>

than insisting on one’s own personal norms. Harmony is more important for individuals with a high score for this domain.

At the other end of the continuum, one is more focused on one’s own personal norms and needs than on those of the group. The people with a low score for this dimension are more concerned with acquiring the exercising power. These individuals follow the beats of their own drums rather than getting in step with the group.

This domain includes the six facets outlined in Table 15.4.

The agreeableness dimension is divided into three general levels:

1. **Challenger.** Challengers tend to be cynical and skeptical and may question authority. As traders, challengers seem to see the market and floor traders as enemies and then try to beat them. Challengers initially blame the floor traders for any losses they incur; they may also suspect that forces are conspiring against them. When challengers sign up for a trading course, they demand proof of the system’s performance; interestingly, however, when the proof is presented, they do not question it. In some cases, even though they claim to be convinced of the profitability of a trading system, with every trade they make challengers will question the system’s validity, and so they have a hard time following its recommendations. The end result is hefty losses and a dismal trading performance that only seems to confirm the challenger’s initial skepticism.

2. **Negotiator.** Negotiators can be both competitive and cooperative, depending on the situation. They can be part of a team and submissive to authority, but at times they can be independent and question authority. As traders, negotiators tend to accept at face value the system they have purchased or the methodology they have learned;
however, at times they may question its validity. Negotiators would do best in a coaching strategy as part of an overall developmental approach.

3. **Adapter.** Adapters tend to be forgiving, trusting, kind, sympathetic, and warm; friends of adapters feel comfortable talking with them. As students, adapters have great respect for their teachers and accept instructions easily; they tend to be the favorites on any team. When adapters sign up for a trading course, they follow the course materials more easily because they trust the content and the teacher. Adapters are excellent candidates for almost any type of trading system; they do their best and give their full attention to learning the system’s functions. One drawback to this type of person is that he tends to ask few questions. This can create functional problems when the trader applies the newly learned system, because he did not question its practical side.

**Neuroticism (N Domain)**

The neuroticism domain deals with the capacity for dealing with stress and surrounding stimuli. Characteristics are usually described as anxious, worrying, fearful, tense, moody, irritable, sarcastic, loud, hasty, inhibited, timid, tense, and impatient. The three levels of neuroticism (also referred to as emotional stability) are resilient, responsive, and reactive.

The negative emotionality dimension of the Five-Factor Model relates to one’s threshold of response to stressful stimuli. At one extreme with a low score is the individual who tends to experience life on a more rational level than most people do and who sometimes appears rather impervious to his or her surroundings.

At the other extreme is the individual with a high score who experiences more negative emotions and reports less satisfaction with life than most people do.

Negative emotionality, like other domains, according to Costa and McCrae (1992), has six facets, outlined in Table 15.5.

<table>
<thead>
<tr>
<th>Table 15.5</th>
<th>Six Facets of the Negative Emotionality Domain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worry</td>
<td>The level of worry and fear about how things will turn out.</td>
</tr>
<tr>
<td>Anger</td>
<td>How quickly one comes to feel anger and bitterness.</td>
</tr>
<tr>
<td>Discouragement</td>
<td>One’s capacity for feeling sad and hopeless.</td>
</tr>
<tr>
<td>Self-consciousness</td>
<td>Embarrassment or shame at awkward public situations.</td>
</tr>
<tr>
<td>Impulsiveness</td>
<td>The tendency to yield to temptation.</td>
</tr>
<tr>
<td>Vulnerability</td>
<td>The tendency to panic in emergency or stressful situations.</td>
</tr>
</tbody>
</table>
The negative emotionality dimension could be described in three general levels as follows:

1. **Resilient.** An individual with a low score on the N domain tends to react to her environment with a calm and even temperament. A trader who is low in neuroticism usually has a calm manner in dealing with losses. She also takes time before entering a trade and tends to be less worrisome and anxious.

2. **Responsive.** An individual with a mid-level score on the N domain tends to be calm and relaxed most of the time; however, in some stressful situations he may react with anger or hostility. The threshold for this individual’s anger is lower than that of a resilient but higher than that of a reactive (see next section). A responsive individual is a rational investor. He looks at the losses in his account in the light of overall performance. When losses get out of hand, a responsive tends to put a hold on the situation and figure out the root cause; typically, he would prefer to take a break from the heat of trading.

3. **Reactive.** If a person has a high score on the N domain, she is living on the edge. Many events, one after the other, trigger this person’s anger, anxiety, worry, hostility, and depression; this type of person feels as though external factors were controlling her. Individuals with a high N score tend to have a lower level of self-control and to be more anxious about decisions they make, and they feel less secure or comfortable with their lives. These individuals tend to relinquish control of their lives to outside factors; luck, chance, faith, a bad economy, and a bad social system all wreak havoc. When discussing losing trades, reactivies blame brokers and floor traders first. These individuals are reluctant to take personal responsibility for their actions.

Your Trading Personality Profile (TPP) or OCEAN score can guide you in selecting or developing a more compatible trading system for an improved trading performance. In the next section, I provide you a sample TPP test for you to take to be able to interpret your TPP score based on the five domains in OCEAN.

**WHAT THE TPP TEST REVEALS ABOUT YOU**

Your Trading Personality Profile (TPP) test will answer the following questions for you:

- Should you use a mechanical system, a nonmechanical or discretionary system, or a hybrid one?
Should you focus your efforts to short-term trading (day trading), intermediate (swing) trading, or long-term (position) trading?

Which market should trade with less or more volatility?

How much risk should you consider for your trading positions, based on your trading capital size or protective stops?

How much of a trading position size should you have—say, 10 contracts or 1? 1,000 shares or 100 shares, or any other numbers?

Should you trade at all or have someone else to trade for you?

Depending on your TPP score, proper developmental and/or compensatory strategies should be devised for you. Developmental strategies focus on cognitive modifications and changes that are essential to transform an undesired behavior. They could also be utilized to enhance an appropriate quality of a trader. However, compensatory strategies are used solely when a candidate does not have the minimum psychological make-up for trading or active investing. In that case, few strategies could be devised for him if he still likes to trade. For instance, a trader could have a high openness domain score and a high N score, both of which could create hurdles for her performance. In that case, we could have her recommend trading ideas or signals to someone else and have him trade on her behalf, following her general guidelines. Or a trader with a high O score may have several trading platforms to work with. This would give him proper settings to focus on his trading while tweaking other systems or technical indicators in other charts and platforms. Based on your TPP test results, a specific strategy should be designed to help you achieve maximum performance with your sound and profitable trading system.

I use my TPP testing instrument in developing proper selection criteria in hiring fund managers for major financial instructions and fund management. I help them hire a new fund manager, or fire or promote one. This is all done based on the results of TPP tests that candidates take. In many instances, without meeting any traders for a major financial institution, after I submitted my recommendations, the executive who was in charge was totally blown away with my accurate assessments of his firm’s traders. My assessments were based solely on traders’ TPP results without even meeting or speaking with them.

The TPP test is a powerful and quantitative instrument that identifies your strengths and weaknesses. Along those lines, as you go through the selection process for a robust system or develop one on your own, you should also consider some of the crucial factors. These include the number of trades generated by the system, frequency of trading, risk-to-reward ratio, the type of market and relevant market volatilities, and your trading position size. In this section, I offer a sample of my TPP test in Table 15.6.
TPP helps to figure out why, in the heat of real-time trading, you sometimes are unable to “pull the trigger” or to follow your system’s recommendation closely. There are personality traits that may not be compatible with your trading style. Awareness of this incompatibility is highly significant so that we may adjust these pitfalls to avoid constantly making wrong decisions that result in losing trades. Some individuals are simply unable to handle the stress of the outcome of a trade. Though your system provides buy and sell signals, you do not follow them; this may be due to incompatibility between your TPP and your system’s variables. Consequently, it could result in elevated levels of anger, which can, in turn, affect your health and emotional state, yielding to irrational decisions and losing trades.

In some cases, traders hide their losses from others, while they do not hesitate to boast about their gains. Others are so perplexed by the risk of making a trade that they delay their trade, often losing out on a profitable opportunity. Some have enough courage to make the trade but then exit too quickly. All these characteristics may be indicative of the trader’s TPP.

In the following sections, I have provided a sample test for you to assess your TPP. However, there is a more detailed and involved test with more than 200 questions that I offer on my web site at www.WinningEdgeSystem.net.

**TRADING PERSONALITY PROFILE SAMPLE TEST**

Please answer the questions as honestly as possible. Use the scale below to select the responses that describe you most accurately.

**Response scale:**

1. Strongly disagree
2. Disagree
3. No opinion
4. Agree
5. Strongly agree

**Instructions**

Answer each question with a number from 1 to 5. Then add up all the responses and multiply the total by 4. This is your score for that domain.
<table>
<thead>
<tr>
<th>TABLE 15.6</th>
<th>A Trading Personality Profile (TPP) Sample Test</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Openness domain</strong></td>
<td><strong>O</strong></td>
</tr>
<tr>
<td>1</td>
<td>I have a rich vocabulary.</td>
</tr>
<tr>
<td>2</td>
<td>I have a vivid imagination.</td>
</tr>
<tr>
<td>3</td>
<td>I am quick to understand things.</td>
</tr>
<tr>
<td>4</td>
<td>I spend time reflecting on things.</td>
</tr>
<tr>
<td>5</td>
<td>I am full of ideas.</td>
</tr>
<tr>
<td><strong>O</strong> Add scores for rows 1 to 5</td>
<td></td>
</tr>
<tr>
<td>For O score, multiply total score on “O” row by 4</td>
<td></td>
</tr>
<tr>
<td><strong>Conscientiousness domain</strong></td>
<td><strong>C</strong></td>
</tr>
<tr>
<td>1</td>
<td>I am always prepared.</td>
</tr>
<tr>
<td>2</td>
<td>I pay attention to details.</td>
</tr>
<tr>
<td>3</td>
<td>I get chores done right away.</td>
</tr>
<tr>
<td>4</td>
<td>I follow a schedule.</td>
</tr>
<tr>
<td>5</td>
<td>I never leave my belongings around.</td>
</tr>
<tr>
<td><strong>C</strong> Add scores for rows 1 to 5</td>
<td></td>
</tr>
<tr>
<td>For C score, multiply total score on “C” row by 4</td>
<td></td>
</tr>
<tr>
<td><strong>Extroversion domain</strong></td>
<td><strong>E</strong></td>
</tr>
<tr>
<td>1</td>
<td>I am the life of the party.</td>
</tr>
<tr>
<td>2</td>
<td>I feel comfortable around people.</td>
</tr>
<tr>
<td>3</td>
<td>I start conversations with people easily.</td>
</tr>
<tr>
<td>4</td>
<td>I don’t mind being the center of attention.</td>
</tr>
<tr>
<td>5</td>
<td>I always have something to say.</td>
</tr>
<tr>
<td><strong>E</strong> Add scores for rows 1 to 5</td>
<td></td>
</tr>
<tr>
<td>For E score, multiply total score on “E” row by 4</td>
<td></td>
</tr>
<tr>
<td><strong>Agreeableness domain</strong></td>
<td><strong>A</strong></td>
</tr>
<tr>
<td>1</td>
<td>I make people feel at ease.</td>
</tr>
<tr>
<td>2</td>
<td>I sympathize with others’ feelings.</td>
</tr>
<tr>
<td>3</td>
<td>I take time out for others.</td>
</tr>
<tr>
<td>4</td>
<td>I feel a lot of concern for others.</td>
</tr>
<tr>
<td>5</td>
<td>I tend to give a helping hand to needy people.</td>
</tr>
<tr>
<td><strong>A</strong> Add scores for rows 1 to 5</td>
<td></td>
</tr>
<tr>
<td>For A score, multiply total score on “A” row by 4</td>
<td></td>
</tr>
<tr>
<td><strong>Neuroticism domain</strong></td>
<td><strong>N</strong></td>
</tr>
<tr>
<td>1</td>
<td>I usually feel blue.</td>
</tr>
<tr>
<td>2</td>
<td>I get stressed out easily.</td>
</tr>
<tr>
<td>3</td>
<td>I worry about things.</td>
</tr>
<tr>
<td>4</td>
<td>I have frequent mood swings.</td>
</tr>
<tr>
<td>5</td>
<td>I get irritated easily.</td>
</tr>
<tr>
<td><strong>N</strong> Add scores for rows 1 to 5</td>
<td></td>
</tr>
<tr>
<td>For N score, multiply total score on “N” row by 4</td>
<td></td>
</tr>
</tbody>
</table>
Ranges

\[
\begin{align*}
\text{High} & = 56 - 100 \\
\text{Midrange} & = 46 - 55 \\
\text{Low} & = 0 - 45
\end{align*}
\]

TPP OR OCEAN SCORE GUIDE

After taking your TPP test, you could use the following score guidelines to discern your TPP score. Your TPP should reveal the make-up of your personality based on the personality traits theory.

**O Domain Score**

The O domain score is divided into three general levels: the preserver (1–45), the moderate (46–55), and the explorer (56–100).

**C Domain Score**

The three levels for the conscientiousness domain are flexible (1–45), balanced (46–55), and focused (56–100).

**E Domain Score**

The E domain ranges from introvert (1–45) to ambivert (46–55) to extro-vert (56–100).

**A Domain Score**

The three levels for the A domain are challenger (1–45), negotiator (46–55), and adapter (56–100).

**N Domain Score**

The three levels of the N domain, neuroticism (also referred to as emotional stability), are resilient (1–45), responsive (46–55), and reactive (56–100).
REVIEWING YOUR TPP SCORE

Before you review your TPP test score based on the five domains, you should note that these domains do not stand alone in space. The extent of a domain’s influence is governed by the overall score level of other domains. For example, one might have a high N domain score but a low score in E. An individual with this combination may be a worrier and tend to stay alone. Conversely, an individual with a high N and a high score in her E domain may be more expressive and seem aggressive. Nevertheless, you should not consider each domain’s score by itself but rather in relationship to your overall personality traits make-up.
Throughout this book, we have explored two determinant factors in successful trading: a profitable and sound system and proper psychological personality traits. In other words, we discussed that utilizing or emphasizing one factor without the other might not lead you to a successful trading career. Moreover, the absence of one of these two factors might not yield a sustainable, consistent, and profitable trading performance. In this chapter, we describe an important step that you should take before you engage in trading. If you have already begun your trading journey, you could use it to boost your performance and ensure a successful trading path.

CONSTRUCTING YOUR TRADING SUCCESS BLUEPRINT

To ensure a successful and rewarding outcome, you should construct a trading blueprint or plan. For that, let’s go over important steps you should consider: motivation, trading style, and trading system.

Motivation

When I ask my trading seminar attendees and traders what their primary motivation to trade is, I almost always get this unanimous response: “To make money.” Of course, you like to make money and enjoy your life with abundance and become financially independent. Naturally, like any other
endeavors, one may go into the business of trading or engage in trading for the sake of making money. However, money is a byproduct of doing something well. If you choose trading as your profession based merely on the desire to make money, you will realize you will expose yourself to financial instability and emotional stress. After a while, you might just give up and pursue a new career. Accordingly, if you are offered another good-paying job, you probably will switch and give up trading. If this describes you, I strongly recommend that you reconsider your intention to pursue a career in trading.

Any endeavor you choose in life needs to be based on your love and passion for that field. Consider trading as a business if you’d like to own and operate your own business, benefit from your hard work, and enjoy your triumphs over daily challenges that you meet. However, you also need to be able to deal with uncertainty about your income. You never know if you will have enough sales or income by the end of the month to pay your daily expenses and monthly obligations. Sure, as you grow your business, you could reach a point of having enough confidence that your earnings and revenues will come in on a somewhat steady basis. Nevertheless, as a business owner you can never eliminate the element of uncertainty about your future income. This is much different from a 9-to-5 job, which provides you some relative certainty about your salary. If you enjoy pursuing your goals and dreams and accept the insecurity and vacillation of your income, you won’t mind becoming a full-time professional trader.

You need to identify your true motivations in pursuing a career in trading before you become a full-time trader. I love trading because it provides me freedom, choice, many great opportunities, and exercise of my own individual responsibility. If I do well or badly, it is all because of my own decisions and actions. If I do not do well because of my own shortcomings and faults, there is no one to blame and no one to complain about. In my belief, our individual growth and progress is achieved based on our own internal dynamics. Who we are plays a decisive factor in this change and is a necessary condition in our growth and advancement. However, the environment provides an opening and opportunity for our talents to prosper and bloom. Accordingly, the external factors act as catalysts. If external factors such as culture, our upbringing, social environment, and government regulations are suitable, we can grow better and faster. However, their absence should not stop us from finding proper methods to grow our talents and utilize them to our benefit for a happy and prosperous life. Trading is an ideal form that proves this theory and helps you accomplish your financial and professional goals despite all the difficulties you could encounter due to your social and family limitations.

If you love trading, look to enhance your education and find or develop a robust and profitable trading system. Then, if you follow your system’s recommendations and do the right thing and trade accordingly, sooner or
later, depending on the soundness of your system, you will make money and become a profitable trader. However, if you just look to make some quick money and become a millionaire overnight, this career is not for you. You would be swaying left and right with no clear direction in search of making quick money. Conversely, if you love trading and enjoy every moment of it and cannot wait to wake up in the morning to begin trading, I assure you that you will eventually find the right system and become a successful trader. Your passion will prevent you from becoming disappointed and disheartened after a couple of losing trades. Your frustration and seemingly temporary failures just become a springboard to take off for a higher level of success. You must love the virtues of trading and active investing to survive and flourish in this great field.

To identify your motivations, you should look to your values and belief system. Through questions in my TPP test (see Chapter 15), I look for respondents’ primary motivations to assess whether they are suitable for trading. By discovering your motivations, you could steer your trading career onto a successful and rewarding path.

**Trading Style**

As we discussed in the previous sections, you should know which trading style feels more comfortable for you. In other words, you should decide on a trading style, day, swing, or position, based solely on your trading personality profile. When I am asked by professional traders and my students which one of my trading systems makes more profit so they can sign up for it, my answer to them is it all depends on who they are. Your choice of trading should be based on a trading style that your personality is more compatible with, not based on its potential profit. For example, if a short-trading system makes a great profit, but you hate doing day trading, the end results would potentially be a great loss for you. The system is designed to issue short-term trades that last a few minutes to a few hours. However, if you hate day trading, you might have more tendency to hold a day signal overnight, since it feels more comfortable for you and you hate making numerous trading decisions throughout a day. You think to yourself that if you hold a good position, you may even make more profits. However, the next day the same trade has resulted in a great loss for you and caused you to miss other possible profitable trading signals as well. Conversely, you may hold a losing position longer than you should with the hope that the market price may go in your favor the next day. But a small losing position may have converted to a much bigger loss the next day.

By holding a position longer than your system recommends, you may hit a few winners. By doing this, you just convince yourself that it is okay to disobey your system and interfere with its recommendations for better profits. This would cause you to not follow your system even further. In
other words, the system that you spent so much money to purchase and so much time and effort to develop and learn is now being thrown out the window, since you are no longer following it. There is no upside to this scenario. If you choose a trading system that has a different style than your trading personality and you feel uncomfortable with it, you are wasting your hard-earned money and valuable time for nothing.

In some cases, when I ask my new students why they want to pursue and sign up for my day-trading system versus my swing system, they simply tell me they don’t have enough money for a required margin to hold a position overnight. Thus they can only do day trading. Well, you guessed it right, my answer to them is a big No, do not do it. Since they are deciding based on their available trading capital, not their personality profile, they are gambling. They feel that if they hit a few winners, they could make enough money to move on to swing trading. This is not a proper way to enter a business. This is just an attempt to gamble, which I do not condone.

In choosing your trading style, your primary factor for consideration should be your trading personality profile. In other words, you will make a decision regarding a trading style based on who you are, not on what you are able to afford.

Your Trading System

Trading systems play a critical factor in your trading performance. A sound and robust trading system that is dynamic would perform well in all market conditions. A system based on a realistic and nonlinear market model should have the inner ability to adjust under market conditions. However, a linear system would perform well only in particular market conditions, such as trending or a trading range price action. (See the author’s book, Trading Systems as a Determining Factor in Trading Performance.)

What type of trading system will you choose to trade? Certainly, you will look for systems that have produced a great profit in the past and have the smallest drawdown. You look for systems that have been back-tested and operated in real time. They should have some type of simulative trading performance that should represent how they would have performed in real time with “funny money.” For instance, consider the two-day trading system variables listed in Table 16.1; they are both profitable and have high profit factors. However, System A has about two trades per day, compared to System B, which has 25. If your N score is low, System B might not be suitable for you. Conversely, System A has a $700 average loss compared to System B, which has only a $100 loss per trade. If you are risk averse and do not have proper trading capital in your account, you have more of a tendency toward System B. You should be cognizant of this fact that your TPP is not compatible with having 25 trades in a day. Consequently, it might be that neither of these two profitable systems is suitable for you. Thus, you
TABLE 16.1  Partial Performance Variables of Two Systems, A and B

<table>
<thead>
<tr>
<th>System</th>
<th>Average Daily Trades</th>
<th>Average Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>2</td>
<td>$700</td>
</tr>
<tr>
<td>B</td>
<td>25</td>
<td>$100</td>
</tr>
</tbody>
</table>

should look for a new profitable and sound system with fewer trades per day and a smaller stop loss.

As much as a profitable and robust trading system is imperative for your success, you should choose a system based on your TPP recommendation. To do otherwise might not bring you consistently profitable trading. Any incompatibility between your TPP and your trading system would result in disappointment and abandonment of the system. This is, of course, assuming that you do not give up first.

Test-Drive Your System

Now that you have decided which profitable system might be suitable for you based on your TPP, you should test-drive it in real time before you embark on your new trading system. In other words, you should run your trading system in real time with funny money in a simulative mode. This process helps you identify any possible problems with the logistics and to see how the system performs in real time. Regardless of how good or profitable a system is, applying real money to it right from the beginning is not a good idea.

Nowadays, many brokers and trading platforms offer you some kind of simulative trading, sometimes called *paper trading*. This simulation should reveal to you some good information both about the system and your ability to follow the system’s recommendations. It might seem that trading in simulative mode or paper trading are just futile practices, since you’re not using real money. For that reason you assume you will always be ahead since your real emotions will not be triggered in paper trading. This might be correct. However, most of the time paper trading or running the system in a simulation account should help you gain better confidence in the system’s performance and in your ability to follow its recommendations.

Suitable Trading Environment

Your trading room environment could influence your trading performance. If your TPP indicates a high score for the extraversion (E) dimension, you
should surround yourself with other people and traders in a trading room. If you trade at home, you should have your TV or radio on. Have some bright and enticing pictures on your walls. Consider changing your room decor once a while. Since you attain energy from your environment, you should keep your surroundings live and active. You may participate in chat rooms as you trade, since despite how it might look to others, doing so could create better concentration and focus for your trading.

Conversely, if your E score is low, you might not want to trade among other traders. You should stay in a cubical or your room and keep the TV and radio off. Your goal should be to create a serene, quiet area with few distractions. Noise or a scenic view from the window of your room could distract you from focusing on your trading and making better decisions.

Healthy Mind, Healthy Body, Happy Trader

A healthy mind makes better decisions. A healthy body and healthy mind create healthy emotions, which in turn help you maintain peak physical condition. The relationship between mind and body has been well established. There is a field in medicine known as psychosomatic medicine, an interdisciplinary medical field that studies the relationship between physical symptoms of individuals and their mental health. In other words, psychosomatic medicine proposes that there are a handful of illnesses and disorders whose symptoms are primarily caused by mental processes rather than physiological reasons. Consequently, if you are under stress, your body and physical health could suffer. If you do not eat properly or do not engage in proper physical activities and exercise, your mental state would also suffer. As a trader, you cannot afford to let your mind be preoccupied with stress and problems.

Numerous studies have demonstrated that stress is a major factor in various forms of heart disease and even cancer. People who do not learn how to cope effectively with the stresses that all of us face in life are at increased risk for stroke, heart attack, and other life-threatening conditions. In stark contrast, those who have learned the importance of relaxation and incorporate it into their everyday lives (through exercise, meditation, music, yoga, or the like) are less prone to disease and recover more quickly when they do get sick. Clearly, nothing that happens to you, whether it is something personal or a financial setback, is worth literally worrying yourself to death. This is particularly true for those who choose to make their living in the often stressful world of professional trading.

Create a Business Plan

Trading is a business and should be considered as such. Accordingly, you should develop a business plan for your trading venture. As with any other
business plan, you should devise your short-, intermediate-, and long-term objectives and strategies. Your plan should also include your specific action plan and appropriate tactics to achieve your goals. Furthermore, you should consult an accountant or a lawyer to set up a proper form of organization for your business. Subsequently, you would consider any business expenses related to your trading business along with your earned income.

As soon as you become profitable in your trading, you need to withdraw some kind of salary from your profit. Since trading might be your primary source of income, you should set up some minimum base and an additional amount based on your monthly performance.

Trying to accomplish big goals may become overwhelming for you and discourage you from pursuing them. However, if you break down your bigger goals into smaller parts, you could achieve them more satisfactorily and easily. Furthermore, doing so creates a number of small successes for you. Since success breeds success, you gain more confidence to stay on course despite some trading challenges. It is imperative that you set up your goals in your journey toward successful trading. In the following section, I present you with a SMART model that you can follow to achieve your goals.

**SET SMART TRADING GOALS**

Your goals to achieve successful trading should be SMART. Without setting proper goals, you would find it difficult, if not impossible, to accomplish your desires. You need to steer clear from futile dreaming, which does not have a specific plan for execution. Moreover, having goals helps you focus your mental and physical energy. Human beings are goal-oriented organisms. Without goals, you are just wandering around. By setting goals, you create a laser-like focus and ignite your brain to look for opportunities to achieve your goals, like a missile looking for its target. In the following sections, we present the components of a SMART goal.

**S is for Specific**

To achieve your financial desires through trading, you should set up specific goals. Consider the following:

- I want to be filthy rich so I don’t ever worry about money again.
- I wish I were a successful trader.
- I want to buy a good house in a decent neighborhood.
- I’ve always wanted to buy a new car.
The main difference between a dreamer and an achiever is that the latter focuses his energy, somewhat like a laser beam, toward specific goals. By sharp contrast, his counterpart has no target for her energy, so her energy just generally radiates, not going anywhere. Both have the same brightness in total, but one uses specific goals to help focus that light into an intense, effective tool; the other just sits wondering, letting the energy go to waste. In other words, the difference between financial success and failure is often caused by an inability to focus on specifics.

That’s why any financial goals you set for yourself should be specific. As humans, we’re naturally goal oriented, which means that when we set our goals properly, our subconscious minds look for opportunities to guide us to accomplishing those goals. Conversely, if our goals are not clear and specific, we act more like drunkards, wobbling around without a destination.

M Is for Measurable

The second important component of the SMART model is M, which stands for measurable. You should be able to measure your progress, and to do so you should have clear benchmarks. Benchmarks help you measure your progress toward achieving your objectives. To set benchmarks, you just divide the goal into smaller portions. For example, if your goal is to make $120,000 per year in your trading, that means you should generate $10,000 per month, or $2,500 per week. If you trade e-mini S&Ps futures contracts, this translates to 50 points per week, or about 10 points per day per contract. If you trade five e-minis, this means you need to place a trade with only 2 points profit per day. Using the Winning Edge System we described in this book should easily allow you to make that goal with almost no effort. And in case you have a setback any particular week or month, your benchmark helps you know how much more you need to save the following week or month to make up for it. (And in this vein, you must remember that while working toward a benchmark, every choice you make takes you either one step closer to it or one step farther away.) Without any specific, measurable benchmarks, however, you could never expect to reach your goal. Before you knew it, your time would be up and you’d still be dreaming about getting that $120,000.

Do you see how it would be more doable to try to make 10 points of e-mini S&P futures per day than to make $120,000 at once? Breaking down your financial trading goals into benchmarks that are measurable not only makes accomplishing them more doable, it also motivates you more to take action, by helping you to not feel overwhelmed by what could otherwise seem like giant-sized goals.
A Is for Attainable

A is the third important element of the SMART model; to achieve your goals, they should be attainable. Suppose you want to make $50,000 by the end of this month. Is that attainable? Do you see any possibility of it happening in your current financial condition?

Furthermore, when it comes to trading goals in particular, note that although earning a high return on your investment might be attainable, it might not always be something you can be sure of. In other words, it might be possible, but it might not be probable. Here’s an example. Suppose that in the next month you want to generate a profit of $100,000. But based on your experience and trading system, you can’t earn more than $10,000 per month. Then, to achieve your goal, you must trade more markets and use a wide array of profitable systems with proper trading account capital. This might be possible, but considering your circumstances, it might not be probable yet.

Your trading goal needs to be not only attainable but realistically so. Otherwise, it’s just wishful thinking.

R Is for Realistic

The R in SMART stands for realistic. Yes, I know you’d like to make a million dollars overnight through some magical formula or trading system. But is that realistic? Suppose one of my goals is to grow wings and fly anywhere I want. If you laughed aloud at that statement, you know what I mean by being realistic.

T Is for Timetable

Any SMART goal must have a timetable to be meaningful. In fact, any financial goal without a timetable would not even qualify as a goal by definition. That’s because when you set a goal, your main objective in doing so is to achieve it. But if you don’t know by when you want to achieve it, you really don’t have a goal. Putting a timetable on your investment goals shows you’re serious about them. A timetable allows you to schedule your efforts and create a specific action plan through which you can achieve your goals step by step.

Your timetable should be specific, too; to become a millionaire at a “young age” is too vague. What is “young age” to you? If it’s 55, you need to figure out what type of financial lifestyle you’d need accordingly: the investment vehicle you’d need, for example, or the type of investing you’d need to consider along with its associated risks.
Let’s apply this idea of having a timetable to one of our goals in the earlier example:

- I’d like to make $120,000 by next year.
- To become a successful trader, I’d like to make 200 points per contract in my S&P e-mini futures trading by the end of the year.
- I’d like to make $100,000 to pay as a down payment for my new house within the next two years.
- I’d like to make $90,000 to purchase my dream car by next year.

In the next section, we look at a triple-A formula to create an executable action plan.

**THE TRIPLE-A FORMULA FOR SUCCESS**

Once you have identified and written down your financial goals and made them SMART, you need to jump into the process of achieving them with a good formula for success: the Triple-A Formula. The three As in this formula are: attitude, aptitude, and attain. These three facets of the successful financial life are not things that we are born with, however; rather, we must carefully and deliberately cultivate them within ourselves.

**Attitude: The Right One Is Half the Battle**

We all bring a certain attitude to everything that we endeavor to do in life. So much of our potential for success or failure begins in our own heads. We can use discipline to keep our minds positive and logic to help us think our way through any situation we encounter—especially when it comes to money. This might not be easy, but having the right attitude sets the stage for ultimately achieving your goals.

You also need to be determined when it comes to your financial life, not allowing yourself to waver from your stated objectives. Yes, life’s priorities change sometimes, but your long-term plans, if they were properly designed with your best possible future in mind, should not be subject to drifting whichever way the wind blows.

**Aptitude: Learning About Proper Investing**

There is no excuse for failing to educate yourself in every detail that you need to know to become a successful trader. Become a voracious reader, attend seminars, and allow yourself to be mentored by those who are
already farther down the path than you are. Gaining knowledge, however, is useless if you don't diligently apply it toward executing your plan. After all, a plan is useless unless you have both the know-how and the will to carry it out.

**Attain: Begin Investing**

Make your function as a trader one of your highest priorities. Do whatever it is that you need to do find success at it. Dream big, but never forget that a dream only becomes reality through hard work.

There is no reason that your efforts should ever result in utter failure. Sadly, for many people, they do. Is it just fate? No! It's mostly because people let themselves become distracted and get bogged down in the minutiae of life, losing sight of the lofty goals they had originally established for themselves. But if you keep your eye on the ball and believe in yourself and in the plans you have so carefully made, success becomes inevitable.

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**SEE YOU AT THE TOP!**

Throughout this book I endeavored to present you with a practical and proactive approach toward your investment and trading. Based on the recent financial market crisis, one could easily ascertain that the old way of investing has not yielded profitable and sustainable investing results. Billions of dollars in public wealth have been destroyed. The majority of people in the Baby Boom generation lost their hard-earned fortune and retirement hopes just by listening to the advice of long-term investing proponents. However, now and forever, the myth of long-term investing based on the “buy-and-hold” strategy should be buried in the dark pages of our financial market history. In this book I submitted to you a new way of investing based on long-term and strategic planning but short-term and tactical management.

I presented you, as a novice or seasoned trader, a road map for becoming a successful active investor and trader based on two pillars: a sound trading system and proper trading psychology. As I revealed my Winning Edge Market Model, I offered you a simple but powerful trading system. You can use the Winning Edge Trading System to trade successfully for any timeframe: day, swing, or position trading.

To strengthen your efforts to become a successful trader, I tendered my Trading Personality Profile theory, which is based on personality traits theory. Furthermore, I offered you a short version of my TPP test so that you can identify your personality strengths along with your weaknesses.
However, rather than embarking on a futile and time-consuming path to change your personality, I propose that you to focus on your strengths and utilize a trading system that is compatible with who you are.

Finally, I offered a blueprint for successful trading and encouraged you to utilize a business plan and set your financial goals based on the SMART model. Furthermore, I presented you my Triple-A formula to achieve your financial success.

Now it’s your turn to convert your knowledge gained through reading this book to your own successful trading.

Good luck. I look forward to seeing you at the top!
In Chapter 1, we reviewed some of the main factors that led to the great market meltdown in 2008. Among them was the utilization of the mark-to-market valuation method, instituted since 2001 by the Financial Accounting Standards Board (FASB). In this appendix, to help you appreciate this valuation method, we review three available valuation methods and compare and contrast them with each other.

Financial companies comprise approximately 10 percent of the S&P 500 Index, which is a broad market performance measure. However, it holds a critical role in igniting the capital markets’ healthy performance. To sustain dynamic growth, developed countries need to provide an efficient flow of credit from savers to borrowers. Accordingly, credit is the life’s blood of the economy and must be available to corporations and economic agents. Therefore, if banks and other financial institutions do not prosper, they cannot facilitate credit and leverage. Earnings and profits help banks capitalize on their assets and provide capital for new projects, expansions, and social and private commercial developments, which in turn creates more jobs and prosperity for communities and individuals. Consequently, nourishing the financial health of banks and the financial sector is a major step toward long-lasting prosperity. Market participants have realized the current pathetic and dismal state of major financial institutions and thus have very little desire to buy this market. Appropriately, institutional investors and traders do not anticipate any major stock market rebound, despite the market’s oversold conditions.

There are three major methods for valuing the balance-sheet assets of financial companies: historical cost basis, mark to market, and market to
model. Each of these three methods provides some advantages, but none is free of limitations and pitfalls. After a brief overlook of each of these three methods in the following sections, I propose a method as an alternative for balance-sheet asset valuation. If we agree on a practical but comprehensive approach to measure and clean toxic assets held by banks and other financial institutions, the market, and later the economy, should ultimately pare off losses and begin their recoveries.

The historical cost-basis method considers the acquisition cost for an asset less its depreciation value. For example, if a piece of equipment was acquired for $1,000 two years ago, today’s value could be estimated as the purchase price less depreciation for the two-year period. However, depending on which depreciation method (straight line, declining balance, and the modified accelerated cost recovery system, or MACRS) a company employs, it could obtain different values. This is a popular and relatively straightforward practice, since the company values assets at the production cost or purchase price, less depreciation. Long-term and fixed assets such as land and buildings are valued at net historical costs, and current assets at cost or net realizable value, whichever is the lowest. The main limitation of this method is its lack of dynamic adjustment with market conditions. Financial institutions utilizing this method are unable to capitalize on their assets’ value. In other words, the historical cost method could create an enormous cost of opportunities in a booming economy.

The second method is mark to market, which values balance-sheet assets based on their fair market value. This method has the ability to absorb market conditions and adjust accordingly. Consequently, as asset prices rise, banks are able to capitalize on them and in turn increase their lending activities. However, when asset prices fall, as in the current situation, it could literally destroy the holding companies’ equity values.

In discovering market price, several methods could be utilized to equate historical values and comparative methods. Both assets and liabilities could be discounted based on current ongoing market prices. Conversely, if there is no market for it, asset prices could literally fall to zero. Traders have used this method successfully in the futures markets for many years. In futures and commodity markets, there must be a buyer for every seller, and in many cases the clearinghouse is the other end of the transaction. During price limit moves due to significant external factors, the clearinghouse provides liquidity to ensure the existence of the market, thus creating the market. Henceforth, the mark-to-market method is a valid and realistic approach as long as there is a market. Internal Revenue Code Section 475, which covers the mark-to-market accounting method rule for taxation, states that qualified securities dealers and commodities clearinghouses, when electing to use mark-to-market treatments, should recognize
Appendix A: Toxic Assets and the Modified Mark-to-Market

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gain or loss based on selling price for the properties at a going market rate or fair value at the end of the reporting year.

Another method for balance-sheet asset valuation is mark-to-model, in what companies may develop financial models with internal assumptions. This method is far less reliable than the others, since it might be unclear how realistic are the assumptions of the assigned model variables. Moreover, a company could deceive investors by hiding its model due to a “highly proprietary nature” justification and thus have less transparency. Enron is a good example of a company deceiving the investing community by valuing its balance-sheet assets based on mark to model. Regardless of how complex a model might be, if there is no real counterpart to purchase the assets, the model is doomed to fail.

Considering the limitations that each of the previously mentioned pricing approaches imposes, to solve the toxic assets issue I propose a modified mark-to-market (MMM) approach whereby assets would be valued based on mark to market. However, the Federal Reserve would have to create an exchange type of clearing mechanism for financial assets. Undertaking this task would create a floor for asset prices and bestow a healthy dose of confidence in the marketplace in times of economic contraction. Since this method is dynamic in nature, it ultimately captures high valuations during economic booms and will contribute more growth opportunities to the economy. Furthermore, the ability and skills of financial institutions should enable them to implement proper risk management strategies against any systematic risk. This allows them to preserve the value of their financial assets, despite any market sell-off and correction. Since the Fed will always be there to be the buyer and provide liquidity, under this method financial markets should experience relatively increased stability during turbulent times.

To diminish any uncertainty about the future of financial institutions such as Citibank and Bank of America, there should be a clear decision about adherence to a proper method for balance-sheet asset valuation. MMM, a dynamic and realistic asset valuation model, could be utilized with the backing of the Federal Reserve as the buyer and assessor of last resort in times of selling pressure. When there is a clear and concise established method for balance-sheet asset valuation, we could see a meaningful turnaround in our stock market and our economy.
As a special offer to readers of this book, I offer you a one-week free subscription to any of my Winning Edge Trading Signals for S&P futures markets (see www.winningedgesystem.com). Readers who submit their receipts as a proof for purchase are given the privilege of accessing any of the Winning Edge Trading Signals, day, swing, or position, of their choice for one week.

Winning Edge Strategies offers a wide variety of trading courses as well as day, swing, and position trading signals. It also offers an appreciation of one of the most important trading components: your unique trading style and personality. In short, this site provides you with all the crucial educational elements to make you a successful trader, including links to various articles and books. Browse through the site and take advantage of all the outstanding features that Winning Edge offers.

**TRADING SIGNALS SUBSCRIPTION SERVICES**

**Day-Trading Signals**

Subscribe to Winning Edge Day Trading Signals to access our web site each morning right after the market opens. Each signal is accompanied by a protective stop (of 2 points) and an initial profit target of 4 to 6 points.
Key Benefits

- Web site is easily accessible with your password at any time and from any place.
- High percentage of winning trades (77 percent in the last 64 months).
- Never a losing month in the past five years of the service.
- Small 2-point stop and average profits for 5 to 7 points per trade.
- Exact entry signals with stops and an initial profit target.
- Daily recap and reporting of the day’s trades in the next day’s posting.
- Each morning, get one buy and one sell signal with a clear entry, a stop, and an initial profit target.

Swing Trading Signals

Subscribe to Winning Edge Swing Trading Signals to access short-term trading signals on the password-protected web site every morning. Each day, after the market triggers the signal, precise updates are posted on the Web to help you capture the maximum trading profits in a timely manner.

Key Benefits

- Signals given via the web site.
- Updates posted in a timely manner on the web site for a high percentage of winning trades (70 to 80 percent).
- Exact entry, exit, stop, and trailing stop points.
- Daily recap and reporting of the day’s trades in the next day’s report.

Position Trading Signals

While swing trading signals are applied over a few days, position trading signals, meant to appease the long-term investor, can hold their place in the market for one, two, even three weeks—or more.

Position trading signal subscribers receive a password to access our designated Web pages, which provide weekly updates on assumed positions and offer new buy and sell recommendations for major market indexes such as the S&P 500. Position signals give a macroeconomic outlook along with implications for the S&P market. These signals also include initial profit targets and suggestions for protective stops. Subscribers may use our signals to take positions in SPY (the symbol for SPDR) and QQQQ.
Appendix B: About Winning Edge Trading Strategies

**Key Benefits**

- Advisory pages for position signals can be accessed 24 hours a day via a password-protected web site.
- Weekly updates help you take the most advantage of market conditions.
- A macro outlook of the economy is given, based on the Winning Edge Strategy, a nonlinear chaos-based analysis.
- Major S&P Index futures market is covered.
- Simple and practical entry and exit signals.

**TRADING SYSTEMS FOR PURCHASE**

**Winning Edge Day System**

The Winning Edge Day System, designed for the S&P Futures Market Trading System, is quite simple, avoiding complex calculations and procedures. My proprietary technical indicator aids in locating objective key points that could offer profitable trading opportunities. The indicator, programmed for the Omega Research TradeStation, may be programmed for other popular charting platforms as well.

There are typically two to four signals generated by the Level 1 strategy each day. Each trade gives a target profit of about 4 to 10 points ($1,000 to $2,500). The protective stops are technically based and typically vary from $250 to $750 per trade for one big S&P contract. The system is based on a combination of trend-following techniques and momentum expansion.

**Key Benefits**

- Comprehensive manual.
- Precise, objective entry signals.
- Clear exit signals.
- Average risk and stops of 2 to 3 points.
- Average profits of 5 to 7 points.
- Typically trades two to five times a day.
- Training course available in person, over the phone, or on the Internet.
- Training is one-on-one, providing a relaxed environment and the full attention that each student needs.
Winning Edge Swing System

The Winning Edge Swing Trading System is designed to take the maximum advantage of short-term market swings. If you are a part-time or a full-time trader, you can enjoy trading futures and stocks with great profit. The system can be used to trade the S&P, Dow, and NASDAQ futures as well as popular stocks such as Spiders (SPY), Diamonds, and QQQQ.

You don’t need to be constantly glued to your computer. Just spend a few minutes every day to get all you need to trade your favorite stocks for a profit.

The Winning Edge Swing Trading System is quite simple, avoiding complex calculations and procedures. My proprietary technical indicator aids in locating objective turning points—Swing Key Points—that could offer profitable trading opportunities. The indicator, programmed for the Omega Research TradeStation, may be programmed for other popular charting platforms as well.

Key Benefits

- Comprehensive manual.
- Precise, objective entry signals.
- Clear exit signals.
- Average risk and stops of 3 to 5 points.
- High number of winning trades.
- Typically trades two to five times a month.
- Training course available in person, over the phone, or on the Internet.
- Training is one-on-one, providing a relaxed environment and the full attention that each student needs.

Winning Edge Position System

The Winning Edge Position Trading System is designed to take the maximum advantage of long-term market moves. If you are a part-time or a full-time trader, you could enjoy trading any futures or stocks with great profits. The system can be used to trade S&P, Dow, and NASDAQ futures as well as popular stocks such as Spiders (SPY), Diamonds, QQQQ, and currency markets.

You don’t need to be glued to your computer. Just spend a few minutes every once in a while to get all that you need to trade your favorite stocks for profit.

The Winning Edge Position Trading System is quite simple, avoiding complex calculations and procedures. My technical indicator aids in locating objective turning points—Position Key Points—that could offer
profitable trading opportunities. The indicator, programmed for the Omega Research TradeStation, may be programmed for other popular charting platforms as well.

**Key Benefits**

- Comprehensive manual.
- Precise, objective entry signals.
- Clear exit signals.
- High number of winning trades.
- Training course available in person, over the phone, or on the Internet.
- Training is one-on-one, providing a relaxed environment and the full attention that each student needs.

**Winning Edge Forex System**

Forex trading offers many great benefits that can help you achieve financial independence. About $2 trillion in size, this trading market is the biggest worldwide.

**Key Benefits**

- *Low risk and high profit.* The system’s highly accurate signals help you achieve your financial goals with low risk and high profit.
- *Precise entry and exit prices.* No winning system could be easier and more precise than the Winning Edge Forex. The proprietary indicators for TradeStation paint price bars and entry prices indicating that you should buy or sell your favorite Forex market.
- *Full-time or part-time trading.* With the Winning Edge Forex System, you could trade part-time or full-time via the Internet, 24 hours a day, from anywhere.
- *Day trade, swing trade, or position trade.* The amazingly robust characteristics of the Winning Edge Forex System allow you to choose your favorite Forex market for any timeframe with which you feel most comfortable.
- *High leverage.* Many Forex brokers offer up to 100:1 and 200:1 leverage.
- *Liquidity.* With a daily trading volume of about $2 trillion, you cannot find a more liquid market.
- *No commission trading.* There is no commission charge for trading the Forex market. This is due to the fact that the broker pockets the difference between the bid and the ask price.
CHAPTER 1: THE GREAT STOCK MARKET MELTDOWN


4. Reported by the Associated Press on CNNMoney.com, November 12, 2008.


CHAPTER 2: INTRODUCING THE NEW TRADING PARADIGM


2. As reported on CNBC, retrieved on April 1, 2009; www.cnbc.com/id/29471950.


CHAPTER 3: PITFALLS OF THE OLD INVESTING PARADIGM

2. AARP 2002 survey.

CHAPTER 4: UNDERSTANDING THE FINANCIAL MARKETS: COMMON STOCKS


CHAPTER 5: THE EXCHANGE-TRADED FUNDS MARKET

2. Ibid.

CHAPTER 6: THE FUTURES MARKET: FINANCIAL AND PHYSICAL COMMODITIES


4. Obtained from Bloomberg Financial Data and *CFTC Commitment of Traders Report*, as mentioned in testimony of Michael W. Masters, a portfolio manager, before the Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008.

5. Obtained from *CFTC Commitment of Traders Report* and Bloomberg, as mentioned in testimony of Michael W. Masters, a portfolio manager, before the Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008.

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**CHAPTER 7: FUNDAMENTAL ANALYSIS**


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**CHAPTER 8: TECHNICAL ANALYSIS**


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**CHAPTER 9: THE WINNING EDGE**

**TRADING SYSTEM MARKET MODEL**


2. Shea, 1995; Shirvani and Wilbratte, 2000; Patterson, 1993.

CHAPTER 14: TRADING PSYCHOLOGY AND YOUR TRADING PERSONALITY PROFILE

1. The contents of this chapter have been extracted, with some modifications, from the author’s book, *How To Become a Successful Trader: The Trading Personality Profile—Your Key to Maximizing Your Profit With Any System*, New York: Writers Club Press, 2002.


7. Ibid, 344.

8. Ibid, 345.


10. Ibid.

11. Ibid.


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Dr. Ned Gandevani is a professional trader and developer of the renowned Winning Edge Systems, based on chaos theory. He holds MBA and Ph.D. degrees in finance. He has trained and coached many professional traders for more than a decade. He has written numerous articles, including those published in magazines such as *Technical Analysis of Stocks and Commodities, Futures, and Stocks, Futures, and Options* (SFO).

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Dr. Gandevani teaches graduate-level and MBA courses at Keller Graduate School of Management in Long Island City and Manhattan.
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