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PROFITABLE DAY AND SWING TRADING

USING PRICE/VOLUME SURGES AND PATTERN RECOGNITION TO CATCH BIG MOVES IN THE STOCK MARKET

Harry Boxer

Profitable Day

Swing Tradin

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This book is dedicated to my lifelong friend Gary Fishman, who passed away suddenly in April 2012. He and I learned the markets and technical analysis together from the time we were teenagers until his passing. We shared somewhat parallel investment paths writing investment columns in our respective college newspapers and then professionally in our early years of employment in Wall

Street. Gary and I had planned to write this book together, and since he had just recently retired, the idea seemed to give him a spark of excitement. I count him among my best friends in life and miss him dearly.

[Organized, Focused Approach](#)

[Monitoring the Early Price/Volume Action Closely](#)

[Worden Brothers](#)

[Volume Buzz](#)

Determining Exit Points Using Fibonacci and Elliott Wave Cycle Analysis Theory Interpretation Series of Wave Categories

[Important Price Support Levels Are Violated](#)

[Setting Stops under Key Trend-Line Violations](#)

[Setting Stops Using Key](#)

[Underlying Technicals Diverging from Price](#)

[Balance of Power](#)

[MoneyStream](#)

[On-Balance Volume and Divergences](#)

PREFACE

For most of my nearly 50-year trading career I have been told or asked many times to put it all down on paper and write a book on my

knowledge, trading experiences, and personal methods of technical analysis. I just wasn't ready or motivated to do so until now. Likely, this has at least partially developed as a result of doing many online live webinars and personal training seminars for Worden Brothers, as well as speaking at many traders' expos and money shows over the past decade or so.

I've also come to see and feel that I truly enjoy the teaching aspect of technical analysis. Educating traders and investors on my site, thetechtrader.com, affords me that opportunity each and every trading day. The interaction with my subscribers, positive comments, and testimonials I have received over the years have not only been appreciated but very

gratifying as well. This, too, has added to my desire to get this book written.

For many years I hesitated to write this book because by nature I am not a patient person or personality type for the most part. That's pretty typical of Sagittarians. However, I now believe that age has mellowed me enough and increased my desire to write this book as an

educational tool to assist traders of all types in enhancing their knowledge base and trading skills.

I live and breathe charts and technical analysis and have read most of the generally accepted important books on the subject over the years. I can speak for hours and days on the subject and often find when my hour to speak has ended I've barely

scratched the surface of what I wanted to cover. This book is meant to complete that presentation in more depth.

If you are a trader who hungers for more in-depth knowledge of technical analysis, especially as it relates to methods of day and swing trading, this book is for you! However, traders with longer-term horizons will also find great benefit, as the

concept and rules in this book apply on all time frames.

I truly believe that no matter what level of trading experience you have, after reading this book, you'll find you have likely enhanced your skill set and become an even more efficient and, most important, more profitable trader.

ACKNOWLEDGME

I want to acknowledge several people who were largely responsible for my progress and successes over the past 50 years. First, Hank

Greenstein was responsible for introducing me to charting and technical analysis. My former brother-in-law, Stephen Feldman, was an early supporter of mine and cocreated our investment club in our late teens; he greatly increased my interest in investments and technical analysis. Joel Bernstein was one of my early mentors and supporters, who encouraged me to have a career in Wall

Street. Harris Shapiro, over the past 20 years or so, has greatly assisted and supported me. Harris is responsible for recommending me and introducing me to my current partner in our web site. I remain close friends with him and collaborate daily on investment ideas. I owe Harris a lot for his continual confidence in me to this day. Finally, but certainly not least, I thank my wife,

Denise, and daughters, Taylor and Rylee, for putting up with my many days and hours away from them, traveling to speaking engagements and focusing daily on my chart analysis and web site.

ABOUT THE AUTHOR

Harry Boxer has more than 45 years of Wall Street investment and technical analysis experience, including

8 years on Wall Street as chief technical analyst with three brokerage firms. He won the 1995 and 1996 worldwide Internet stock-market trading contest, "The Technical Analysis Challenge," sponsored by AmericanInvest.com. Boxer is widely syndicated and a featured guest on many financial programs and sites, including CNBC, CBSMarketWatch,

Forbes.com, DecisionPoint, and many more. In addition, he conducts nationwide training seminars on his methods for Worden Brothers. He is currently cofounder and chief writer of The Technical Trader (www.thetechtrader.com), a real-time diary of his trading ideas and market analysis, and is also a technical consultant to many Wall Street hedge funds and large

institutional traders.

CHAPTER 1

My Journey as a Trader

When I was in my early teens, I became intrigued by the stock market, how and why it moved, and how I could possibly analyze or gauge those movements to benefit financially. I was constantly scouring the newspapers for unusual stock movements using closing prices and wondered how could I use that information in an organized manner for

profitable investing.

My big aha moment came a couple of years later when I met a cranky old stockbroker named Hank Greenstein. During the summers in the early 1960s, my parents rented a bungalow in a bungalow colony at Greenwood Lake in upstate New York (quite typical of many Jewish families during that period). Hank was a

neighbor in that colony, and I had several conversations with him about the market and investing after I heard he was a stockbroker. One day after Hank and I talked for a while about investing, he said, "Young man, you are very bright and inquisitive and tuned in to the market in a way I have never seen in a young man." He then said to me, "Come over to my place. I want to show you something

related to investing I think you'll be very interested in." Hank proceeded to show me something he created by hand called stock charts on graphic chart paper. He literally would add a vertical line or bar to the graph each day showing the high, low, and last closing price. That was certainly a painstaking process, indeed, requiring patience for the patterns to develop over a period of time

until they became useful enough to trade on. Keep in mind this was 20 years before the first IBM PC hit the market and the subsequent arrival of charting software!

To say the least, I was very excited! Had I found the "Holy Grail" for stock investing and trading?? My thoughts ran to how I could use this method for myself, and I asked Hank how I could

learn more about this. He suggested I read Technical Analysis of Stock Trends by Robert Edwards and John MaGee (now widely considered the "bible" of technical analysis).

Based on the charts Hank had created by hand, he recommended three stocks to me in 1962 (shortly after the market had tanked during the Cuban Missile Crisis). Those

three stocks were Chrysler (nearly bankrupt earlier), now around $4; U.S. Steel, around $18; and Sperry Rand (maker of the first large mainframe computer UNIVAC), around $13. I decided to invest my summer earnings of $3,000 (a lot at that time) in all three, and the rest is history! Sperry ran to over $40, U.S. Steel over $80, and Chrysler more than 10-fold over $40! Wow, I certainly was hooked for

life!!

When I was back in New Jersey at home late that summer I acquired the book and immersed myself in it. I was fascinated and totally engaged. As a matter of fact, I then read it again. Over the years, I have read it six or seven times as a refresher—just to make sure I wasn't getting into bad technical habits or overusing certain

technical formations because I was "comfortable" with them.

After high school, I started an investment club called the "Mutual Growth Fund of New Jersey" along with my best friend at the time (Gary Fishman), my sister's boyfriend (later husband), Steve Feldman, and his best friend, Neil Prupus, who was a finance major, both in

school at Rutgers University in New Jersey. We took approximately $4,000 dollars and later added quite a few more of our friends and associates. Over the next couple of years using primarily technical analysis, we built the club's assets to nearly $120,000 on an investment of just 30,000!

At that time I also started an investments column in my

college newspaper at Fairleigh Dickinson University called "The Traders Corner." By doing that column I was able to write down my thoughts and market ideas, which helped me hone my technical analysis and trading skills as well.

During college I often found myself at a broker's office sitting in front of the

big electronic tape that scrolled across the top of the room in front where many seasoned (and older) traders congregated. They considered me a young whippersnapper until they saw how well my ideas worked and became curious how I came up with my picks. They were amazed at my knowledge and feel for trading, as well as my fearless approach. An example was a trade I made on then market

darling Syntex (the first company to develop a birth control pill). I saw it run from $190 to $250 in just a day after it had run earlier in the week from $150. I decided it was overbought and shorted it near the high and within a couple of days covered it under $200 for a quick 50-point gain!! I quickly became their friend (as you can imagine!) and became part of the trader's gang at the office.

That's where I met Joel Bernstein, assistant manager and also a technical analysis advocate. When he saw the depth of my technical skills, he introduced me to the branch manager, Bill Somekh, who asked me if I would be interested in a career as a stockbroker after I graduated from college, which I was thrilled about. However, he wanted me to get some brokerage

experience first and suggested I find a position with a smaller Nasdaq firm where I might build my book of clients and then come to work at his office, which I proceeded to do. I found a broker training position at a small firm called Carlton Cambridge in Fort Lee, New Jersey, and worked there for about two years or so before moving to Bill and Joel's firm, Weis Voisin & Cannon.

Later on, I moved to New York City and took a position with Pressman, Frohlich & Frost to be at the heart of Wall Street. They quickly were impressed with my technical knowledge and suggested I write a weekly technical letter for the brokers at the firm called "The Traders Corner." Sound familiar? My experience there was immense. I got to see how the "Street" works close

up and interfaced with many big traders and fund managers who loved my technical skill set. It was the mid-1970s, and volume on Wall Street was still quite paltry compared to current or recent levels. As a young man with very little experience as a broker and low volume levels on Wall Street, commissions were hard to come by, and I was not being compensated for my weekly

newsletter, other than a larger commission percentage take. Then came the Nixon bear market in 1974, and most brokers suffered big commission drops and loss of income. I witnessed several brokers' career demise and departures and eventually decided to leave Wall Street a disappointed young man.

During the following 20 years I continued to trade

actively and hone my technical analysis skill set while employed in the executive search business and excelled in that field as well. I continued to read every book on technical analysis I could get my hands on. I eventually decided to make the move to California and started my own executive recruiting firm (now the largest in Los Angeles). However, my love for trading and technical

analysis was rekindled with the advent of personal computers and charting/trading software programs that just kept getting better and better.

In 1993 I found TC2000 or TCNET (by Worden Brothers) and have been using it ever since. I eventually began doing webinars and then training seminars for the Worden

seminar training series. For me it's clearly the best charting software on the market and continues to evolve with more and more features and programs at every new release. I highly recommend it.

■ ■ ■

In 1995, with the Internet becoming more and more popular and expanding rapidly, I found a trading

contest called "The Technical Analysis Challenge" and entered it for kicks (no prizes were awarded, especially during the internet's infancy). I astounded the founder, Neil Hughes, with a winning percentage of 135 that year, and he encouraged me to enter again in 1996, which I did and won again! That year my gains were 148 percent. Neil asked me to fly up to Seattle, where he lived, to

discuss starting a technical web site, which I agreed to! We named it—what else?—The Traders Corner! We had some success with building subscribers, but during the early development of the Internet, it was very difficult to get people to pay for anything. Most curious surfers were trying to get something for free and not yet convinced the Internet was anything more than an

information-for-free tool! After about 18 months, I decided the effort I was putting into it was not giving me the financial returns I wanted, so I decided to discontinue the service.

By 1999 the Internet and the stock market were becoming popular and very active places, and the development of the Internet with faster servers and the

advent of computerized and online trading, I believe, was a chief reason for the boom in the markets, especially Nasdaq.

At that time, a friend of mine from my prior Wall Street days, Harris Shapiro (now a close friend of mine), recommended me to an executive he knew at a fast-growing Internet investments services site called America-

Invest. com. Its parent New York Stock Exchange–listed GlobalNet was America-Invest.com International, which had similar sites unique to many countries. The editor of America-Invest.com was Richard Hefter, who was asked to call and interview me for a possible spot on their site to do a technical analysis section. When I arrived at their offices in Santa Monica,

California, in 1999, Richard and I had a casual conversation about what I my knowledge was and what I could bring to the table. He finished our talk by asking me my technical opinion of Yahoo!'s chart. I believe it was about $240 a share at that time. After reviewing and analyzing the patterns and technicals, I projected a target over $400 over the next four to six months, and he was

astounded—he even chuckled! When Yahoo! reached $400 in just a few weeks, Rich called me to offer me a position, which I agreed to, but only on a part-time basis. I was still engaged in my executive search profession and doing very well. He agreed and we decided to call my section of the site "The Technical Trader."

As most of you know that time was not long before the great bull market top and implosion in March 2000, which caused the collapse of many Internet companies, including GlobalNet and [America-Invest.com](). When it all came apart Richard Hefter called me with an astounding fact. He said that my section of the site had more page hits than all the others sections combined! He suggested that

we should get together and form a new site of our own, which officially started in July 2001. And that's how our current site thetechtrader.com got started.

In the past 12 years of trading, our site has evolved from short and intermediate trading and stock picks to day and swing trading for the most part. This was a result of my pattern recognition skills,

noticing that those patterns form similarly in all time frames and may be used intraday, as well, for successful day and swing trading using 1-, 5-, and 15-minute charts in conjunction with the daily patterns.

Our site has had dramatic growth in the past few years, especially when we added a trading chat room and introduced intraday live

analytical videos that monitor the progress of chart patterns we are trading (I'm told a very instructive learning process for my subscribers). We also do nightly summary videos and Saturday morning weekly webinars as well, as part of our current service.

I have found over the several decades I've been actively trading that technical analysis is a long-term

learning process. Unfortunately, many of the best traders I know had to learn from making mistakes earlier in their trading careers! The key to trading is to review every trade after it's completed to see why decisions were made, what resulted, and what lessons can be learned from those trades. Only then can you really benefit and learn from your own educational process. Use

it! I am astounded how many traders do not do this and continue to make the same mistakes over and over, eventually blowing themselves out of the market with a major percent of their capital wiped out. The purpose of this book is to teach traders not only about my technical analysis skills and how to use them for profitable trading, but also how one must be disciplined,

using rules and stops to protect trading capital, at all times. The challenge is to always preserve your capital with protection so you can trade another day!

CHAPTER 2

Preparing for the Trading Session

The trading day does not just begin at the opening bell. Ask any successful trader and you'll discover he has a routine leading up to the trading day that is nearly as important as what goes on during set trading hours. Preparation is the key to many things in life, and trading is no exception. In this chapter, we'll cover premarket preparation and

analysis, which includes a review of the closing patterns from the prior session and a look at the premarket news and resulting price action.

Analyzing Patterns from Previous Trading Day

Proper premarket preparation always starts with analyzing the closing patterns of interest from the prior session for possible strong "setups" for

the next day trade. This should be done after the close of the prior session (or during that evening) before the next session begins. My strong suggestion is that you do your work when it's fresh in your mind and prepare your watch lists before the next day, when you should be monitoring premarket news and price action for possible trading candidates. In any case, you are looking for key

bullish price action with relatively higher volume than normal, hopefully on a significant price volume surge through a key technical resistance or support level or zone. You should be on the lookout for following bullish/bearish consolidations or orderly retracement patterns such as flags, wedges, coils, pennants, and so on.

The preceding patterns have distinctly different formations, although coils, pennants, and wedges may at first appear similar, and all eventually will move toward an apex or narrowing of price pattern until the lines meet. Coils usually are narrower at the start and then price moves in a smaller decreasing range. Pennants, although very similar to coils, are usually smaller and tighter and

shorter in time. Wedges can and usually do start with a wider price range and appear more symmetrical or triangular than coils before also narrowing toward the apex. Bull flags are more orderly and tend to remain in a parallel pattern, ideally moving in a lateral direction or with a slightly upward or downward micro trend.

These patterns may be

precursors or setups for the next move or extension of the prior move, otherwise called a possible new wave or leg up. Stocks that have those characteristics should be put on a "trading watch list" or "focus list," so they can be closely monitored for possible trades the next session and going forward.

(See three examples of pennants, coils, and flags in

one intraday session trend, resulting in additional up legs in Figures 2.1 through 2.3.)

FIGURE 2.1 58.com (WUBA)

FIGURE 2.2 Zhone Technologies (ZHNE)

Zhone Technologies Inc

Labels on chart:
- Bull coil
- Bull coil
- Early bull wedge first consolidation
- Opening large gap
- ZHNE
- Zhone Technologies Inc
- Telecommunications
- Communication Equipment

FIGURE 2.3 Foundation Medicine (FMI)

As you can see in [Figure 2.1](#), WUBA displayed an opening gap on a 2-minute chart, which was followed by an early mini bull pennant formation. That then elongated into a 3-hour bull coil. The pattern then breaks out and later on results in a 2-hour bull flag that also breaks out, extending the session run to near the close for a very nice day trade of nearly $3.50

or more than 10 percent.

[Figure 2.2](#), on a 1-minute chart, shows a strong intraday move by ZHNE: first the opening price volume surge gap, followed by a large bull wedge. Later during the session a bull flag and two bull coil continuation patterns developed and were precursors to the continuation of the intraday trend and up channel extension to the close

resulting in nearly a $1 gain or more than a 20 percent day trade!

In [Figure 2.3](#), Foundation Medicine (FMI), we see several early mini bull consolidations (coils, pennants, and flags) followed by a strong spike surge to a midday top. Then a late afternoon 3-hour bull coil forms. The pattern resulted in nearly a 20 percent gain from

the breakout of the first morning mini coil.

These patterns may be precursors or set ups for the next move or extension of the prior move, otherwise called a possible new wave or leg up. I've found over the years that stocks tend to move in steps or waves and that very often important moves occur in five waves (three up, two down or sideways

consolidations) and any time frame, as well! Obviously, the opposite will often occur in important down moves. We'll cover this subject in more depth in a later chapter, but Figure 2.4 shows some examples of five-wave intraday moves.

In Figure 2.4 the VISN chart shows an example of an intraday five-wave move up on a 1-minute chart,

displaying a second and fourth wave bull wedge/coil type consolidation formations. The five-wave advance was completed by midday and resulted in a nearly 25 percent move in just about two hours!

FIGURE 2.4 Vision China Media (VISN)

▼ Price History ▼ Exp Moving Average 21 ▼ Moving Average 10 ▼ Moving Average 10 ▼

5-wave advance completes

Price/volume
surge breakout

Price/volume
surge breakout

VISN

VisionChina Media

Media

Advertising Services

Early bull wedge formation

Opening surge

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Nov 15, 2013

▼ Volume ▼ OBV

▼ Balance Of Power ▼ MoneyStream

In [Figure 2.5](#), Mellanox (MLNX), we also see a distinct five-wave advance with an early bull coil, two flags, and a mini wedge during the course of the intraday move, but the fifth wave is a bit more complex in that it displays five waves within the fifth wave before completing the advance for a nearly 10 percent gain in less than three hours.

FIGURE 2.5 Mellanox (MLNX)
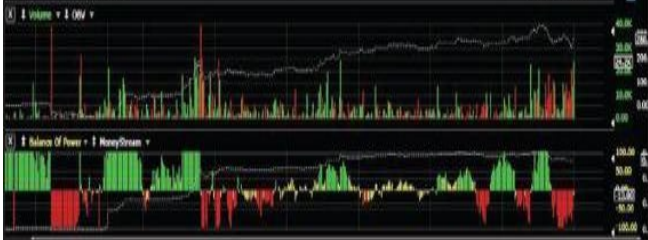
■ My Morning Routine

One of the first things I do is check the index futures and foreign markets to gauge if the general market pressures here and/or abroad will be up or down. This may adjust my thinking somewhat on whether I'll be looking to scalp trades for quick hit-and-

run profits or attempt longer multihour or session-long day trades to "milk the trend" during an especially bullish session.

Additional day-trade premarket information that may affect individual issues can be gleaned from news sources like bloomberg.com, marketwatch.com, seekingalpha.com and my personal favorite market news

source, briefing.com, just to name a few. I spend an hour or so in the premarket period early each morning poring over many of my sources for information or news that may be affecting stocks or markets domestic or international. I'll post all of the pertinent information I've deemed important for the trading day to my trading site (thetechtrader.com) for my subscribers to digest or

disseminate In addition, I check premarket price percent and volume percent gainers at nasdaq.com and on briefing.com to see what's moving before the markets even open for regular trading and also post that data to my trading room.

Preopening key news affecting price and causing opening gaps should be paid close attention to and

analyzed for possible "game-changing" conditions that could dramatically affect or alter the course of a trend and perhaps be an event trigger, not just for that session, but possibly over a period of days or weeks! I have found from my experience over the many years I've been trading and advising traders that the bigger and more important the news is and resulting gap it creates, the more likely it

can trigger significant price movement for even months and years! These significant news events often represent key turning points and or directional thrusts.

Also in the premarket periods each session, look for percent change leaders in price and relative volume. These can be clues to whether a post gap trend or rising intraday channel may form.

By monitoring the early price and relative volume action and resulting chart pattern formations that develop early on in the day you will be better able to determine what stocks may be strong day-trading candidates for starters.

Finally, about 40 minutes before the market opens, I conduct a premarket "talk" via a webinar with my

traders, the purpose of which is to analyze premarket trading 1-minute chart patterns and volume to narrow our early watch list to a "focus list" of 8 to 10 stocks or so that are likely to have the best potential to trade in the following session.

Of course, in the first few minutes of trading I usually discover additional stocks moving sharply higher and

possibly breaking out across key levels after they've opened that were not apparent in premarket. I will often add several of these to the focus list and perhaps even recommend some of them as "buy alerts" very early in the new session.

◼ What to Look For

When viewing or analyzing the chart patterns, it is important to check for previous resistance and support at prior lows or highs (depending on whether you are looking for longs or shorts). Moving averages, especially 10-, 21-, and 50-

day periods and key trend and channel lines, need to be paid attention to as well since they normally also represent key levels. By watching for important breakouts across these points on the charts, you will be able to spot potential trade candidates for the following session or sessions and more accurately be able to make price projections and set targets you can use and rely on when

trading.

Taking the time to carefully review and analyze the prior days' and weeks' patterns and underlying technicals, as well as preopening market action and related news, for the current session is extremely important in determining what stocks to have on your "watch or focus lists" and is critical to your potential day-

trading success. The best day traders I've known over the many years I've been trading stocks "plan their work and work their plan."

Analyzing Early Trend Development

It is my strong opinion that the vast majority of intraday day-tradable patterns are initiated at or very close to the opening of trading and that the close analysis of the first 15 to 30 minutes of pattern and related volume development is key to recognizing what stocks may be excellent day trades or at least strong early scalp play possibilities. Also, an early

indicator to pay close attention to is Worden Brothers Volume Buzz. We'll also look at the need to early on create a focus list.

■ Developing a Disciplined, Organized, Focused Approach

First and foremost, none of what you may learn from this book will do you much good unless you are able to

maintain a disciplined, organized, and focused approach to be able to benefit financially from what you have absorbed. Over the more than 45 years I've been trading and especially since I started thetechtrader.com in 2001, I've noticed that my trading skills and more successful trading record have been greatly enhanced since I evolved my trading style into a more focused and

disciplined approach. This was necessary due to the many subscribers to my service that rely on me for accurate technical advice. Because of this, I've been able to offer a more attractive and effective service.

It's my observation, especially since I started my trading advice site, thetechtrader.com, that the most successful traders

appear to be the most organized and focused among my many subscribers. In addition, most of them appear to have many years of trading experience behind them and have learned the necessity of discipline and focus, perhaps the hard way through trial and error. There's nothing like experience to instill confidence in what you know and do.

After I've done my prior day and premarket reviews and analyses, I feel very prepared and quite confident in my ability to create a very useable focus list that can be used for successfully trading the current market session.

■ Monitoring the Early Price/Volume Action Closely

In the very early action I'm searching for important gaps of at least 4 to 5 percent and preferably much more! Early analysis of opening price

gaps with volume (something I've coined the price/volume surge) and how that relates to the previous trend, as to overhead resistance and the recent technical trend is a must. The opening gap price will also often act as support for the session and, whether it holds that level early on in the day or not, is most often a key in determining if a stock will then start a tradable intraday uptrend or channel

for the session and be a "high probability" trade for at least that day. Usually, if the opening gap price is quickly broken as in a "pop and drop" scenario, it is most often a fairly reliable indicator in determining that the remainder of the session may be difficult for that stock at best and if it needs to be exited quickly or avoided altogether.

If a stock does gap significantly and then holds that level, usually the development of an intraday uptrend will become evident in the first 20 to 30 minutes of trading. Many successful traders I've known or observed over the years will not anticipate, but rather wait for that trend to begin to develop before committing funds or adding more positions. Others may choose

to wait for that first pullback or early consolidation I refer to as the "Boxer Wedge" (or coil, pennant, flag, etc.). It's that first consolidation pattern (no matter what you choose to call it) that comes on lower-volume "ebb" (indicating an abatement of sellers) and the hold of gap or other significant key support (or resistance if you are day trading it short).

Worden Brothers Volume Buzz Indicator

One of my favorite technical indicators that I feel is very important in increasing your ability to spot the early movers is Worden Brothers

proprietary technical indicator called "Volume Buzz." It clearly indicates at any point in time during the session, minute by minute, what the percentage of volume traded is at that moment in any stock compared to the average previous volume traded at that point in time historically. Volume Buzz is based on the 100-period simple moving average of volume over the previous 100 days. I don't

believe anyone else to date has developed such a useful technical tool. It's extremely valuable in determining where strong early money is flowing during any one session. Obviously, very valuable in helping one spot stocks that may be possible day trenders! I highly recommend traders access TCNET or TC2000 software (the charting software package is supplied for free).

This program has been rated among the top three charting software programs for the past 10 years!

Figure 3.1 shows a sample of the Volume Buzz leaders for a day. The list is sorted by the percentage increase in volume for that session versus the prior 90 days (both for advancers and decliners). During the session, the continuously updating list is

constantly being sorted by the percentage increase for that time of day versus the average for that time of day over the past 90 days!

FIGURE 3.1 Volume Buzz Leaders

"Technical Trader's Stock Universe" ▾

Flag	Symbol	Price	Net Change	Volume	% Change	Vol Buzz
▷	MBLX	1.63	+0.56	4.5M	+52.34%	+2682.5%
▶	BLDP	1.70	+0.27	13.9M	+18.88%	+1199.8%
▷	EVI	4.58	+0.82	381.9K	+21.81%	+1190.2%
▶	BOSC	8.40	+0.95	1.7M	+12.75%	+1164.9%
▶	SEAC	12.03	-2.37	2.6M	-16.46%	+1064.5%
▷	DHRM	4.10	-0.33	626.0K	-7.45%	+1009.9%
▶	PLUG	2.06	+0.25	51.6M	+13.81%	+992.3%
▷	BIG	32.47	-4.66	6.6M	-12.55%	+987.1%
▷	RALY	19.02	-6.44	2.2M	-25.29%	+952.0%
▷	NDLS	37.70	-2.43	4.1M	-6.06%	+830.3%
▷	WYY	1.24	+0.19	2.1M	+18.10%	+733.1%
▷	AUXL	21.64	+2.31	7.4M	+11.95%	+717.9%
▶	TNXP	9.05	+2.12	427.3K	+30.59%	+598.3%
▶	ADAT	1.82	+0.06	729.6K	+3.41%	+583.1%
▶	GERN	5.86	-0.01	22.5M	-0.17%	+554.4%
▷	NES	14.49	-0.68	1.7M	-4.48%	+517.2%
▷	PFPT	28.03	-1.42	1.6M	-4.82%	+512.9%
▷	ETAK	1.18	+0.12	2.2M	+11.32%	+497.4%
▷	MITL	9.54	+0.52	1.4M	+5.76%	+488.7%
▶	PBYI	86.75	+9.05	1.2M	+11.65%	+471.1%
▶	FCEL	1.72	+0.14	11.8M	+8.86%	+464.0%
▷	BKS	14.43	-1.96	7.2M	-11.96%	+462.1%
▷	CALI	3.76	-0.54	636.5K	-12.56%	+436.7%
▷	CBMX	3.00	+0.05	2.5M	+1.69%	+406.3%
▷	FNSR	21.82	+0.06	11.4M	+0.28%	+405.0%
▶	ICAD	10.50	+1.90	439.4K	+22.09%	+398.4%
▷	DAKT	15.80	+0.45	616.1K	+2.93%	+394.1%
▷	PSUN	3.28	+0.52	3.4M	+18.84%	+393.5%
▷	AMSWA	10.30	+0.14	233.1K	+1.38%	+386.6%
▷	OCLS	4.35	+0.18	1.3M	+4.32%	+385.7%
▷	KEQU	16.64	+0.28	43.3K	+1.71%	+378.7%

■ Creating a Focus List

After spending the early morning premarket period closely checking premarket price and volume movements and analyzing patterns, you should narrow your watch list of potential stocks you are interested in down to a "focus list" of a dozen or so "likely

trade possibilities."

I will create a focus list of candidates I've found for day trades, highlighting them on TC2000 by flagging them. This list will be very flexible and I'll usually be adding new members to that list as early market price/volume action uncovers early trends that may not have been apparent in premarket activity or I'll delete premarket picks

that quickly fail or fade from early strongly bullish action or fail to deliver desired price movement results early on.

The obvious key to being a successful day or short-term trader is your ability to "pick the winners" out of a list of potentials. In some respects, this is the most difficult and critical task for traders. One way to do that is to avoid the pitfalls of many traders in the

early session period by eliminating from consideration certain lower-priced (under $3–type stocks that may be too thin outstanding float–wise (unless the early price/volume surge is spectacular in terms of percentage above normal in the 5,000 to 10,000 percent–plus range or better). Even then, attention must be paid to key support and resistance early on, as many

lower-priced, thinner float stocks will more frequently "pop and drop," "gap and crap," or just fade slowly lower over the course of the trading session (especially in the junior biotech or Chinese stock sector, I've found).

It's usually best to pick more tradable liquid stocks that are experiencing the big price/volume surges and breaking out, perhaps

indicating better market "sponsorship." Institutions and/or institutional or high-volume traders most often will shy away from stocks under $5, and many will even avoid issues under $10!

Also, depending on the news or news sources, traders need to determine if any news is possibly a key trend-determining factor or "game changer" that might reverse a

trend or dramatically enhance one.

Once you are armed with the proper technical tools and have done your homework (created your "plan"), you will have a much higher probability for successful and profitable trading!

CHAPTER 4

My Favorite Day-Trading Patterns

In this chapter, I'll review my favorite day-trading patterns and give chart examples throughout. As you trade more, you'll quickly develop "favorites," too—they might look like these, or they might be different. Keep track so you can revisit them over the course of your trading.

The Intraday Rising Parallel Channel with High Relative Volume

During the course of my 45-plus years' trading

experience, I've noticed many patterns that develop during a single session, but the one that appears to be the best is the intraday rising channel. This usually starts with an opening gap or price thrust and ideally moves into an early bull consolidation ending with a low-volume, narrow range before extending in a rising channel.

■ The Best Day-Trade Pattern

An intraday rising channel up allows for staying in a day trade to milk the trend for the longest possible time frame intraday, resulting in the largest possible session-long profitable day-trade gain. It's

close to a parallel rising intraday channel trend that ideally stays in the pattern all session at approximately a 45-degree angle of ascent without violating key intraday channel and/or intraday moving average and price support during the entire session. It is truly amazing to me that the vast majority of intraday rising channels extend upward at or near a 45-degree angle during the

session. I've observed this for decades. This also applies to longer time frames such as daily chart patterns, as well. Simply said, the "best day-trade pattern" you can find! ([Figures 4.1](#) and [4.2](#) are examples of the intraday rising channel pattern.)

FIGURE 4.1 Zhone Technologies (ZHNE)

FIGURE 4.2 XPO Logistics (XPO)

In [Figure 4.1](#), ZHNE starts the trading session with a gap and run on the 1-minute chart. Then settles into an early bull wedge consolidation on lower volume. When a price/volume surge occurs breaking out of the early bull wedge, an uptrend channel is set in motion that maintains its angle of ascent for the remainder of the session

without breaking the channel or any intraday support level —the day trader's dream pattern, in my humble opinion! That's because it enables the trader to stay in the trade for the whole session, riding the up channel pattern all day for about a 20 percent day-trade gain after the initial pattern breakout occurred around 10:30.

In [Figure 4.2](), you will see

that XPO also starts the session with a gap, run and first consolidation bull coil. During the course of the session, it also maintains its angle of ascent, forming three coils and a flag during the day, but not violating a single support level all session. This pattern once again enabled the day trade to "stay in the trend" all day, finishing at the high of the day, going away for about an 18 percent day-

trade gain in 4.5 hours following the breakout of the first bull coil around 11:30.

◼ The Low-Volume "Ebb"

Most often, the previously mentioned trend channel will be started with either an opening gap "price/volume thrust" or a fast start out of the gate on strong relative volume. As discussed in the preceding chapter, an excellent gauge of relative

volume is Worden Brothers' "Volume Buzz," a proprietary indicator that measures the percentage of volume traded at any point in the session compared to its historical volume. This indicator allows one to see early on in the first part of any trading day which stocks are moving sharply and moving with high relative historical intraday volume. It's a terrific way of gauging strong, historically relative

money flow early in the session and draws your attention to candidates for possible day trades to add to your watch list, at the very least.

Volume during the formation of these early consolidation patterns should be dwindling to a low-volume "ebb" to be ideal. Near the end of the developing intraday 1-minute bull

patterns, very often the price narrows greatly, as does volume, usually dwindling to a near session low on several 1-minute bars. Low volume may be a signal of a balance of energy between the bulls and bears, as they withdraw waiting for the next momentum thrust to take place before entering new positions or perhaps adding to existing ones. This often is a precursor to an imminent

move and needs to be watched closely for a price/volume surge to end the pattern and potentially extend the previous move in the direction of the intraday prior ongoing trend. (Examples of intraday low-volume ebbs resulting in extension moves are shown in Figure 4.3 and 4.4.)

FIGURE 4.3 Aetrium, Inc. (ATRM)

Nearly 40% move in 1 hour following breakout of apex of bull coil!

Mini bull wedge

Long 3.5-hour narrowing bull coil

Low volume "ebb" with tight price ranges for several miunutes

Opening price/volume surge

Aetrium Inc

Technology Sector(S)

Semiconductor Equipment & Materials

FIGURE 4.4 Regado Biosciences (RGDO)

Figure 4.3 shows ATRM in an explosive opening run from 5.75 to 9.75 in the first 30 minutes of trading. This was followed by a 3.5-hour consolidation bull coil that narrowed dramatically on both price and volume to an "ebb." Another explosive move resulted when the coil broke out accompanied by a sharp pickup in volume, resulting in an additional

nearly 40 percent move in just an hour!

Figure 4.4 shows RGDO having the usual opening gap I look for, followed by three consecutive bull consolidation formations intraday, each culminating in a low volume and price ebb. After the first bull coil was broken, it surged from near 5.55 to near 8.40 during the course of the session,

resulting in a potential 50 percent gain from the first bull pennant breakout point!

Normally, the first early move is then followed by a pullback/retest or bullish consolidation pattern that holds at or near the opening gap price on the test and/or forms an early bull pattern as volume recedes, indicating a dwindling of selling volume or "low-volume ebb" as I like

to call it. To be ideal, these early bull formations should happen with lower volume and most often are found in the form of a bull coil, pennant, flag, wedge, or falling wedge.

Once the early consolidation pattern has successfully held support and is completed by a breakout of the formation with a price/volume surge that takes

out the first spike high, the probability percentage of an uptrending channel and resulting successful trade is greatly increased. Usually in the first 20 to 30 minutes of the session, we'll begin to see that up channel begin to formulate. Many traders will either wait for that "takeout" to occur or anticipate the breakout move when strong volume accompanies the price surge after apparent

support has held the price pullback or consolidation on lowering volume.

It is usually advisable to not overly commit funds to a stock still consolidating or retesting until the confirmation of a breakout has taken place. If you do decide that the action appears quite bullish and you want to "anticipate" a forthcoming move in order to have a

position in it, perhaps a smaller position may be initiated. Later, additional or full positions may be added when the breakout confirmation takes place, but only with a tight stop in place below the pattern lows, in case the pattern does fail. This stop is a trader's must and will act as protection at a small price.

As the intraday rising

channel begins to develop and extend, traders should continuously be monitoring that development, keeping in mind where overhead resistance from previous lows or highs might be. When looking at the 1-minute intraday charts for day-trading purposes, it's always best to refer to the 5- and 15-minute patterns to get a better idea of where those previous levels are likely to create

meaningful resistance or support.

One rule of thumb is that "previous support, when broken, becomes resistance; and previous resistance, when broken, becomes support"—a very important rule that I find many inexperienced traders are not as cognizant of. These intraday support/resistance points are key levels for the intraday channel traders to be

aware of, as they have the ability to "change the trend" or propel it in the opposite direction intraday if violated.

Probably the most important of the patterns to pay close attention to is that rising channel bottoms line, as a break of it can mean the intraday uptrend could be ending or reversing. In my opinion, one of the more difficult parts of technical

analysis intraday is knowing where and how to draw those lines and how to adjust the lines when the angles of ascent change, so as to stay in the trend without getting stopped out. That takes years of experience and "gut feel." I'll cover that in a later chapter.

In trading these intraday rising channels, it is important to use stops below

significant intraday levels to protect the gains you have from earlier in the session, should the channel crack or key support be violated. Many traders like to use trailing stops as the channel extends higher, but I prefer to examine where key intraday support may be. This is often near where price, moving averages, and rising channel line support lines intersect or are in juxtaposition to each

other. A stop below those levels will most often properly protect day-trade positions from further damage.

CHAPTER 5

Using Moving Averages

I have found over the many years I've been trading that the 10-, 21-, and 50-period moving averages work best on shorter to intermediate time frames, and I even use them on the 1-minute intraday charts I day trade with, because I find them to be just as useful intraday when day trading. The crossover of those moving averages can be a very

powerful indicator of trend reversal.

Just as previous high and lows can act as support or resistance, so do the various moving averages, and I pay close attention to them as well during the intraday day-trade session.

I used to use 40-day moving averages on daily charts and found them to be quite accurate over the years

but switched back to 50-day moving averages because so many institutional clients and trader friends of mine did. I find that the 50 gives you just the buffer you need to avoid the too-tight stop-loss trigger.

In addition to the other key support/resistance levels on a chart, the dotted-line moving averages I use are just as important in my trading experience to determine

whether a trend may continue or reverse, especially when they intersect or juxtaposition at the same or nearly the same point on a chart of any time frame! I have found over the many years I've been trading and advising investors and institutions that a violation of a key moving average, such as the 50-day in particular, on heavy volume on the daily chart very often can signal a trend reversal,

especially because so many large investors/traders follow that one religiously.

It is truly amazing how many historically high percentage gainers in strong uptrends and rising channels over a period of months and even years have adhered closely to their 50-day moving averages. An examination of the chart patterns of the biggest

winners of the past century will show that they were excellent buys when they retraced near and/or successfully tested their 50-day moving averages. This is where many institutional fund managers entered new positions or added to existing positions.

Figure 5.1 displays the daily chart of MU, showing that it started a major advance

in November 2012 near $5. Over the course of the following year, it channeled up at a 45-degree angle, reaching nearly $24 for a nearly 350 percent move in a year. On its way up, it had at least four important tests and ideal entry points near its rising 50-day moving average and held there each time, then extended its run.

FIGURE 5.1 Micron

Technology (MU)

45-degree paralell rising channel

Breakout of base!

Multiple holds of rising
50-day moving average

In Figure 5.2, you'll see that JKS started a strong run on its daily chart in April 2012 near $4. In just seven months, it moved sharply higher on a 45-degree angle to get near $35 by November for a more than an eightfold increase! Along the way, it retested the 50-day moving average successfully three times for excellent entry points.

FIGURE 5.2 Jinko Solar (JKS)

45-degree paralell rising channel

Price, channel bottom, & 50-day mov avg holds

Price support, channel bottom, and 50-day mov avg holds

Figure 5.3 shows P starting a strong run in November 2012 near $7 and steadily advancing in a 45-degree angle for 12 months. Eventually, it reached nearly $32 for more than a 350 percent gain, as well. Along the way, it successfully tested its 50-day moving average six times for terrific entry points.

FIGURE 5.3 Pandora Media (P)

45-degree paralell rising channel

Price retrace holds near 50-day moving avg several times

Pandora Media Inc
Consumer Cyclical Sector(C)
Broadcasting - Radio

Many professional traders who use Elliott Wave or Fibonacci analysis use moving averages more closely aligned to some of the rules of those methods. In Fibonacci, waves occur at 8-, 21-, and 55-day, -week, and so on time periods, pretty darn close to the 10-, 21-, and 50-period moving averages I use and recommend. This actually confirms and adds

credence to those numbers, especially for shorter-term trading. We'll cover Fibonacci and Elliott Wave analysis in a later chapter.

For the nonprofessional, it is highly recommended that 10-, 21-, and 50-day moving averages are added to your charts. My nearly 50 years of experience and close monitoring of thousands of stocks over those years has

shown me that the "nonprofessional" everyday day and short-term trader can greatly increase profit potential and add to percentage gains by adding and using these moving averages. They are extremely important in helping to determine trend direction and will greatly enhance the trader's buy/sell decision-making process.

■ Moving Average Crossover Signals

One key technical trend reversal signal for many traders and a personal favorite of mine occurs when the various moving averages

cross over each other as price appears to be changing direction. Because they are constructed on different time frames, they will "cross over" when a strong price directional thrust or reversal is taking place.

I have discovered over the years that very often the first pullback in price after the crossover occurs can be an excellent entry point,

especially for swing traders or longer-term core position plays. In many instances, the best possible point of entry is at the beginning of a major trend reversal.

If a trend has been moving up or down in a close to parallel channel and suddenly reverses with substantial relevant volume breaking the channel support/resistance, watch for a following first

pullback at or near those moving averages, which should act as additional support. If they have turned direction and are crossing over, indicating a possible trend change, then a pullback to retest that zone will often result in an excellent entry point.

In [Figure 5.4](#), you will see the impressive move in 2013 for ADEP on a daily basis

chart. It began a strong surge in late September with a price/volume thrust and with the 10-, 21-, and 50-day moving averages crossing over to the upside. The stock initiated its run at that point, taking it from 3.50 to 10.78 in just seven weeks, with the base breakout buy signal coming near 4.50. From mid-October to mid-December it added to its gains by reaching 12.50, a gain of nearly 200

percent in just 90 days.

Adept Technologies (ADEP)

Price reaches 12.50,
nearly 200% gain in 3 months

4 week support
holds 3 times

Price/volume thrust breaks
out of long base pattern

10, 21, & 50-day moving
averages cross over

Figure 5.5 shows that after basing bullishly for nearly a year on its daily chart, ARWR surged and broke out in mid-July near 2.50 as its moving averages also crossed over. That initiated a major new uptrend channel interrupted only by a second-wave bull wedge, with the third wave eventually reaching 8.88 by mid-October, a nearly 250 percent

gain in just 90 days.

FIGURE 5.5 Arrowhead Research (ARWR)

ARWR — Arrowhead Research Corp — Daily — 8.85 8.85 7.60 8.16 -0.54 -6.21% 665100 3.71

Moving Average 21 • Moving Average 10 • Moving Average 10

Nearly reaches $9 for more than 250% in 90 days

4-week bull wedge forms then pops

Breaks out of base with a price/volume surge

10, 21, & 50-day moving averages crossover
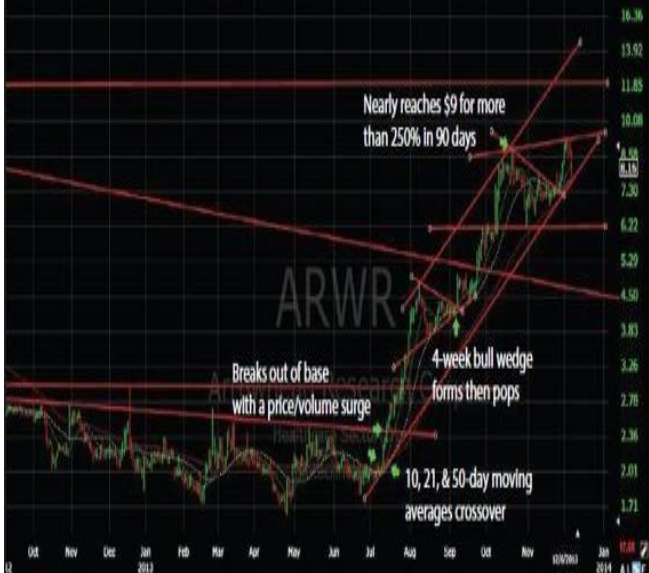
In Figure 5.6, RMTI's daily chart experienced a price/volume surge breakaway gap in mid-July 2013, with its moving averages crossing over. That was followed by a four-week narrowing bull wedge, which then popped and exploded from near 5 to 13 in just seven weeks. But it wasn't done yet! After another six-week bull wedge–type

consolidation, RMTI again surged and reached 15.67 by late November for a gain from the moving average crossover signal of over 200 percent.

FIGURE 5.6 Rockwell Medical (RMTI)

Price reaches 15.67 for more than 200% in 90 days

Base broken with a price/volume surge gap

First pullback retest bull wedge consolidation

10, 21, & 50-day moving avg's cross over at the same time under $4

As an example of how moving average crossover signals work in either direction, [Figure 5.7](#) shows VTR having a downside reversal occurring in May 2013. After a strong five-wave move ended, it sharply reversed with a 20-point downside plunge from 84 to 64 as its moving averages crossed over to the downside in mid-July. What followed

was a .382 Fibonacci retracement bear wedge formation that failed right at the retest of those moving averages and resulted in another sharp leg down taking it from over 72 to near 58.50. After a 2.5-month bear flag formed, it again plunged from near 68 to near 55 in a fifth-wave decline. The entire process from 84 to 55 took about six months.

FIGURE 5.7 Ventas (VTR)

End of 5th wave up in a spike move!
Followed by sharp high-volume reversal

Moving averages crossover

2nd wave bear wedge
ends at crossover
point retest

Major upchannel breaks

4th wave
bear flag

VTR

Ventas

Real Estate Sector(C)

REIT - Healthcare Facilities
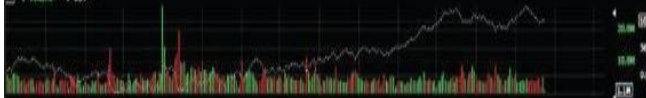
Finally, [Figure 5.8](#) shows another bearish example of downside moving average crossovers occurring on the RNF chart in February 2013, after a major five-wave advance had completed in late January, which took the stock from 16 to 49 the prior year. An initial downside price/volume trust occurred, cracking the up channel. RNF then attempted a rally back

but formed a bear. That rally also failed near the moving average crossover point, which initiated a decline from about 41.50 to near 18 over the next eight months.

FIGURE 5.8 Rentech Nitrogen Partners (RNF)

RNF — Rentech Nitrogen Partners, L.P.

Annotations on chart:
- 5th wave advance ends with spike up move
- Retest to nominal new high double top
- Price plunges, moving avg's crossover
- Bear wedge fails at declining moving avg. retest. In my opinion the BEST entry point for SHORTING
- MAJOR NEW DOWNCHANNEL

RNF
Rentech Nitrogen Partners, L.P.
Basic Materials Sector(C)
Agricultural Inputs

When used in conjunction with the other technical indicators I've discussed or will discuss, you will see how powerful a directional change indicator moving average crossovers can be. Some of those other technical indicators include trend lines, support/resistance lines, stochastics, moving average convergence/divergence (MACD), Bollinger Bands,

and so on.

I have found on my day-trading site (thetechtrader.com) that these moving averages can be critical for intraday entry/exit points on the 1-minute charts as well, especially in conjunction with those other indicators I previously mentioned, such as trend lines, support/resistance, and channel tops and bottoms, as

well as the bullish continuation patterns: flags, wedges, coils, pennants, and so on.

Although moving average crossovers on 1-minute charts usually occur very quickly at the outset of an intraday trend thrust, they appear to be more valuable as support for the ongoing intraday rising trend, particularly on the first early pullback that successfully

holds those averages. (Examples of moving average crossovers on 1-minute intraday charts are shown in Figures 5.9 and 5.10.)

FIGURE 5.9 Daqo New Energy (DQ)

FIGURE 5.10 Solar City (SCTY)

Figure 5.9 shows a particularly strong intraday session took place on DQ in late September 2013. After an initial thrust from under 20 to near 22, the stock set up an early mini bull flag that held the moving averages that had thrusted and crossed over. The breakout of that flag set off a sharp up channel that reached near $35, never violating an intraday support

level and resulting in a huge gain of 13 points or over 60 percent in just 3.5 hours.

Figure 5.10 shows another example of a strong intraday move that was triggered after a hold or retest of the intraday moving averages following an initial breakaway gap thrust. This is the pattern that developed on SCTY in mid-May 2013. After its initial pop, it then formed a mini

bull flag, which broke out after the first hour of trading near 38 and advanced steadily throughout the session until it reached near 46.50 in the afternoon, a gain of 8.50 or nearly 33 percent in a few hours.

Drawing Trend Lines and Why

They're Critical in Analyzing the Trend

Since my early years of trading, I have been actively drawing trend lines. I am a very visual person, and

drawing lines that determine the trend, trend angles, channels, support/resistance, and so on has greatly enhanced my ability to quickly see when an important move may be taking place. Trend lines eliminate guessing, and your eyes are immediately drawn to those levels that may be very important to determining key breaks or trend direction changes and possible buy or

sell action triggers.

It's been my experience that most important trend lines should remain on the chart for weeks, months, or even years (especially if major significant peaks or troughs have been determined). It's truly amazing to me how often a price will approach a long ago major high or low (even 10 to 15 years ago or longer)

and bounce near those levels. This fact can be used by traders to help determine buy/sell or scale-in/out strategies. This may also be effective for day and short-term trends, as well. Key intraday and swing-trade trend breaks, again accompanied by big volume, will often be shorter-time-frame trend changers.

The length of time a trend

line has been in force is also an important fact to consider. The more points that connect on a trend line on any time frame and the longer that line is, the more valid it becomes. A break of that line can be critical. That's why I pay special attention to any longer-term or multiple-point trend line that is suddenly broken, especially with a heavy volume thrust. When a key price/volume thrust does

take place, it can often signal a trend change may be taking place.

Subscribers to my trading service (thetechtrader.com) are often amazed when a line appears on a chart above or below the shorter-term intraday 1- or 5-minute charts. They question why it's there and are astounded when the price of a stock on a shorter time frame

approaches a key level on a daily or weekly chart only to back away from resistance or bounce off support near those lines on a shorter time frame, even on 1-minute intraday patterns. By keeping more significant longer-term trend lines on the chart, you will have added indicators as to possible resistance or support on the longer time frame, which often will determine key exit/entry levels for

shorter-term traders.

Channels and Angles

Over the nearly 50 years of technical trading and related trend-line drawing I've been involved with, I've noticed that the normal or regular bullish up channel (or bearish down channel) often moves in parallel channel line formations and at

approximately 45-degree angles. This fact alone can be very helpful to determine if a trend is moving at a regular pace or getting way ahead of itself or lagging (especially on a shorter-term time frame). This also can be very useful in determining whether to exit all or partial positions as the trend may be getting too overbought or losing momentum and possibly ripe for a pullback retrace or at

least a time-consuming consolidation.

In my mind, the major usefulness of analyzing parallel up or down channels is the possible determination of when a stock may soon be near or at a point where the sharp run up to a channel top or spike down to a channel bottom can result in at least a following time-consuming consolidation that can last for

days, weeks, or even months. Time-consuming pullback/retraces or lengthy consolidations are not only investment momentum killers, but contribute to anxiousness and often mistakes in the decision-making process. Remember, in trading, time is money, and exiting a full or partial position at the right time can enable the resourceful trader to better time exits and

entries. With this trading profit in hand, traders can look for new trading candidates with better timing and entry points to best utilize or diversify trading capital. I recommend that each trader determine what level of patience he or she can or wants to exercise.

Your strategy will likely be determined by the time frame you have in mind after you

decide what time frame of trading best suits your personality and investment goals.

To best determine the proper angle and how/where to draw trend lines, it is critical to continuously monitor and adjust the angles of ascent or decent. The early angle of ascent or decent is very often not the angle a stock will take on its

intermediate or even longer-term trend direction and, as a result, changing the channel angles to conform to recent price movement will greatly assist traders in determining the channel top resistance points as well as channel bottom support levels.

Over my many years of technical analysis experience, and as a result of a suggestion by Tom Demark in one of his

books on technical analysis, I have determined that the initial thrust a stock takes is likely not the angle it will eventually settle into. By connecting the first pullback low and subsequent lows, you will likely be better able to determine what angle a stock may be taking on an intermediate or longer-term time frame. When you connect the subsequent swing or intermediate highs, as well,

you'll be amazed how parallel the channel most often is!

In [Figure 6.1](), you will see that GENT exploded out of a five-month base on its daily chart in late July 2013, with a breakaway gap on heavy volume. That was followed by more upside progression interrupted by two mini bull wedges and a bull flag. The angle of ascent was steady

and exceeded a very strong 45 to 50% angle in a parallel rising channel. The move continued for five months without even breaking its 21-day moving average until it reached near $60 or more than a 300 percent gain!

FIGURE 6.1 Gentium (GENT)

[Figure 6.2](#) shows that Pandora (P) started its major ascent near $7 in November 2012 and moved steadily higher in a parallel rising channel with a near 45-degree angle. It also held its 50-day moving average in the process about a half-dozen times, until it reached just under $32 in 12 months for a more than 300 percent gain. Notice the various bull

wedges and flags along the way, as well!

FIGURE 6.2 Pandora Media (P)

45-degree paralell rising channel

Price retrace holds near 50-day moving avg several times

Pandora Media Inc

Consumer Cyclical Sector(C)

Broadcasting - Radio

[Figure 6.3](#) shows GTN popping out of a 16-month basing pattern in early January 2013, with a price volume surge across $2.50. It then quickly doubled to near $5 before consolidating in a six-week bull coil. That was followed by another run to near $7.50, resulting in a bull wedge formation. The 45-degree rising channel continued into December

2013 reaching just under $14 for a gain of over 400 percent in less than a year, never breaking support! (Figures 6.4 through 6.7 show rising channel patterns on intraday 1-minute charts.)

FIGURE 6.3 Grey Television (GTN)

FIGURE 6.4 AFOP 1-Minute

FIGURE 6.5 AMCC 1-Minute

FIGURE 6.6 BITA 1-Minute

FIGURE 6.7 STML 1-min

Figure 6.8 and 6.9 show examples of both rising and declining channel patterns on daily charts.

FIGURE 6.8 RNF 2-Day

FIGURE 6.9 STML 1-minute

Chart labels:
- SWI
- Solarwinds Inc
- Technology Sector(S)
- Software - Infrastructure
- Double top
- Rising channel breaks as moving averages cross over
- 45% rising channel
- 45% declining channel

◾ Support and Resistance Lines

Many of my subscribers and followers, as well as guests at my seminars and convention talks, have commented that they were amazed at how, where, and why I draw my lines. Since I'm a big believer

in prior support and resistance as being valid even years later, I will leave the lines on my charts for months and even years, as price will often test or retest those levels when stocks change direction and begin new trends. It is truly amazing how often the lines I drew many months or years earlier will create formidable resistance or support to a new trend, and I strongly suggest

that traders draw and use these lines as targets and possible stops as well!

When assessing the volume activity at or near a prior peak or valley on a chart that became a major or important high or low, it's very important to consider how heavy volume was at that point to determine whether that level or zone might be more or less formidable or

difficult for a stock to break through. I have found that the heavier a volume cluster was at a particular peak or valley on a chart pattern in the past, the more likely that area could be more difficult to get through, at least on the first attempt for sure. It should also be noted that the closer in time those highs or lows might be, the more important the resistance or support is likely to be. It makes sense

that recent volume action is more critical than action that took place months or years prior because over a longer period of time investors will have possibly exited some of those positions and the volume levels at those highs and lows may not be anywhere near as formidable as one might think. Regardless, those levels known to traders as prior highs and lows will still act as

important chart points, at least psychologically, and close attention should be paid to them.

Prior resistance highs and support lows, when occurring near the same levels, should be connected by drawing lines across those peaks and valleys. That is Charting 101. Charts with lines drawn at those levels tend to have those levels jump out at you

visually as reminders that those levels need to be monitored closely when price approaches them. A pause or countermovement or a move through those support and resistance levels, especially with high relative volume, may be signaling for a directional change or confirming a prior trend continuation.

Figures 6.10, 6.11, and

[6.12](#) are examples of key intraday support/resistance lines.

FIGURE 6.10 RGDO 1-min

FIGURE 6.11 KONG 1-min

FIGURE 6.12 XPO 1-min

■ Reviewing and Adjusting Lines

One of the more important actions to take when charting is the continuous monitoring of price action and the resulting need to change or alter the support, resistance, and trend-line angles

(especially on intraday day trading using 1- or 5-minute charts!) This needs to be done in order to gauge the proper and more important levels at which action may need to be taken. I have found that by constantly altering my angles and levels, my trading target accuracy and resulting percentage of profitable trades has immensely increased over the years. You need to let the market action

on a particular stock dictate where and at what angles the lines should be drawn, I think most of the readers of this book will greatly benefit by the use and constant altering of the lines they have drawn and highly recommend the active use of them.

A general rule of thumb when drawing and observing trend lines is that an angle that accelerates too far above

(or below) an approximate 45-degree normal or regular angle in a rising (or falling) trend will become overbought/oversold and ripe for profit taking. This will occur because fast sharp rises or quick deep plunges at too steep an angle most often cannot be maintained for very long before profit taking (or bargain hunting/short covering in the case of a downtrend) results in a

pullback retest at the very least. Too far too fast is my motto when trading, especially in the fifth wave of an advance or decline. I'll expand on that more specifically when we cover exit strategies in Chapter 7.

CHAPTER 7

Setting Targets and Price Objectives

There are many methods for determining where and how to set targets and objectives in trading, and in this chapter you will find several of my favorites that you will want to have knowledge of in order to be prepared to more accurately define your trading objectives. Some of the most popular and, I find, quite accurate technical price forecast tools are the

measured move, Elliott Wave analysis, price cycle analysis, and Fibonacci measurements. These historically proven methods of analysis, when learned and added to your trading skill set, will give you a terrific advantage over other, less knowledgeable traders.

■ Determining Exit Points

No matter what your time frame is, it's extremely important to know "when to sell." Trading is certainly difficult enough without knowing when to sell or how to set price objectives, especially when intraday day trading, but just as important

on all time frames with all trading objectives in mind. There are several methods traders have historically tended to use, including percent gain targets or percent loss stops, price projections based on fundamental values such as price earnings ratios, and so on. However, I have found over my nearly 50 years of trading experience that using my technical analytical

methods of determining exit points or sell objectives works very well for the active trader.

Determining how or where to set targets even before you enter an order is not only key in enhancing trading profitably, but also a major factor in gaining confidence in your trading ability. Be sure to write down your targets when you have

determined where to set them. Then enter your exit or sell points immediately after you get confirmation of your trade entry.

Using the Measured Move Method

During my 50-plus years of trading experience, I have found that stocks tend to move in similar "measured move" increments. That is, the length of the prior leg of a move can often be a good determining factor as to where the next move or up leg may find important or serious resistance and a

resulting probable good exit point, especially for the day or short-term trader who is not interested in waiting out a pullback or consolidation, even if it turns out to be bullish in appearance or construction, simply because time is money and funds may be best used elsewhere during this consolidation, resting, or retesting period.

The completion of a

similar measured move is even more reliable when it coincides with other important resistance levels on the charts, such as previous overhead resistance at earlier highs, declining moving averages, or channel bottoms and tops. However, in any case, it's very important to use the proper chart scaling methods. (Figure 7.1 and 7.2 are examples of measured moves on daily charts.)

FIGURE 7.1 Anika Therapeutics (ANIK)

FIGURE 7.2 Himax Technologies (HIMX)

Measured move achieved late December at 13.77 for a 5.64 gain

Measured move ends with 5th wave at 11.49 in October 2013 for a 5.92-point gain

5-wave advance ends up leg at 8.19 in May 2013 for a 5.19 gain

Another up leg begins in early November 2013 at 8.13

New leg up begins in August 2013 at 5.57

Move begins with price/volume surge near 3 in Feb 2013

shows that ANIK began a move on its daily chart in April 2013 near 12.25 and approximately three months later spiked to a near-term top at 27.80 to complete a move of about 15.50 points. It then consolidated in a coil-type pattern for about two months before beginning its next leg up. Adding the 15.50-point initial move to the beginning

of the next leg near 23.25, you have a target of 38.76. Two-and-a-half months later ANIK tagged 38.68, nearly an exact measured move for a gain of nearly 65 percent!

Figure 7.2 shows HIMX's daily chart displaying three moves of approximate similar measured move point length during 2013. The first explosive move started with a price/volume surge in

February 2013 for a 5.19 gain in less than 90 days. The next leg began three months later near 5.57 and advanced to 11.49 in just five weeks for a gain of 5.92. Finally, a third up leg began in early November near 8.13 and ran to 13.77 by late December, logging a gain of 5.64 points in about six weeks!

The Fifth-Wave Exit Method for Day Trading

During my nearly 50 years of trading experience, I've found that incorporating a five-wave target method and executing an exit on the fifth wave very often is an ideal point to at least partially, if not totally, eliminate your day-trade position. My

experience also shows this to be especially accurate if it's accompanied by strong volume. My analysis of thousands of intraday day trades indicates that stocks tend to move in five waves, after which a deeper pullback/retrace or more extensive consolidation very often takes place.

Often, the fifth wave can be an intraday exhaustion

wave, especially if it occurs before midsession. At that point a stock will have likely moved up sharply or substantially and may have gotten a bit ahead of itself, prompting profit taking by day traders (Figures 7.3 and 7.4 are examples of intraday five-wave moves and exit points).

FIGURE 7.3 Grey Television (GTN)

FIGURE 7.4 Mellanox Technologies (MLNX)

Labels on chart:

End of 5-wave intraday advance

Bullish consolidation patterns

Early bull coil/flag formation

Price/volume surge breakout

Opening price-volume surge gap

MLNX

Mellanox Technologies Ltd

Electronics

Semiconductor - Broad Line
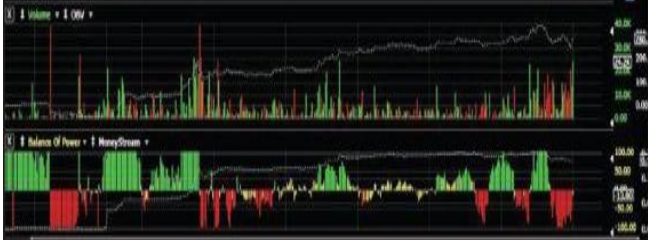
GTN starts the session with a big gap to just under $10 and surges to near 10.65 for a sharp first up wave. A second wave consolidation bull coil–type pattern develops. This is followed by the third leg from 10.45 to 10.90, followed by wave 4 consolidation bull mini wedge, and finally a fifth wave thrust to 11.20 to complete the five-wave morning advance. Notice that

the stock then pulls back and moves narrowly sideways for the rest of the session.

MLNX also starts the day with a solid gap up and runs from about 36.25 to 37.50 to complete the first leg, then consolidates in a 45-minute early micro bull coil before embarking on the wave 3 advance to near 39.25. After that, the fourth-wave consolidation flag forms and

results in a five-micro-wave fifth leg to near 40.75 to complete the five-wave move near midday. Notice that it, too, then moves sideways for the rest of the session.

Using Logarithmic or Percent Scaling

Since I have always highly recommended the use of logarithmic or percentage scaling when trading (as opposed to arithmetic scaling), it should be easier to determine those exits points. It's been my experience that because of the adjusted log values, point values can and should then be used to

determine targets. After determining those levels, you can then better decide where to enter a sell order at the determined possible exit points.

On a logarithmic scale chart, the vertical spacing between two points corresponds to the percentage change between those numbers. Thus, on a log scale chart, the vertical distance

between 10 and 20 (a 100 percent increase) is the same as the vertical distance between 50 and 100. Because these charts show percentage relationships, logarithmic scaling is also called "percentage" scaling. It is also called "semi-log" scaling because only one of the axes (the vertical one) is scaled logarithmically (Figures 7.5 and 7.6 show the contrast or differences of logarithmic and

arithmetic charts, examples of same chart, same time frame).

FIGURE 7.5 CSIQ Daily 101212 to 121512 Analog Chart

FIGURE 7.6 CSIQ Daily 101212 to 121512 Logarithmic Chart

Using Fibonacci and Elliott Wave Cycle Analysis

I have found over the course of the past 20 years in particular that adding Elliott Wave and Fibonacci analysis to my arsenal of analytical

tools has greatly enhanced my successful trading profitability percentage. These analytical methods, when used in conjunction with standard technical analysis, can be very powerful and should also be added to your personal trading tool kit.

They say a "little knowledge is dangerous," and certainly not having a firm

grasp of these tools in particular can lead to confusion since they usually offer different what-if scenarios. However, when used in conjunction with your other technical tools and abilities, they can only enhance your total skill set and likely result in better trading successes.

Fibonacci Analysis

Fibonacci retracement is a very popular tool among technical traders and is based on the key numbers identified by mathematician Leonardo Fibonacci in the thirteenth century. However, Fibonacci's sequence of numbers is not as important as the mathematical relationships, expressed as ratios, between the numbers

in the series. In technical analysis, Fibonacci retracement is created by taking two extreme points (usually a major peak and trough) on a stock chart and dividing the vertical distance by the key Fibonacci ratios of 23.6 percent, 38.2 percent, 50 percent, 61.8 percent, and 100 percent. Once these levels are identified, horizontal lines are drawn and used to identify possible support and

resistance levels. Before we can understand why these ratios were chosen, we need to have a better understanding of the Fibonacci number series.

The Fibonacci sequence of numbers is as follows: 0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, and so on. Each term in this sequence is simply the sum of the two preceding terms and sequence continues

infinitely. One of the remarkable characteristics of this numerical sequence is that each number is approximately 1.618 times greater than the preceding number. This common relationship between every number in the series is the foundation of the common ratios used in retracement studies.

The key Fibonacci ratio of

61.8 percent—also referred to as the "golden ratio" or the "golden mean"—is found by dividing one number in the series by the number that follows it. For example: 8/13 = 0.6153, and 55/89 = 0.6179.

The 38.2 percent ratio is found by dividing one number in the series by the number that is found two places to the right. For example: 55/144 = 0.3819.

The 23.6 percent ratio is found by dividing one number in the series by the number that is three places to the right. For example: 8/34 = 0.2352.

For reasons that are unclear, these ratios seem to play an important role in the stock market, just as they do in nature, and can be used to determine critical points that cause an asset's price to

reverse. The direction of the prior trend is likely to continue once the price of the asset has retraced to one of the ratios listed earlier.

In addition to the previously described ratios, many traders also like using the 50 percent and 78.6 percent levels. The 50 percent retracement level is not really a Fibonacci ratio, but it is used because of the

overwhelming tendency for an asset to continue in a certain direction once it completes a 50 percent retracement.

There is not any strictly rational reason why stock prices should behave as Fibonacci analysis predicts. While it is true that the golden ratio appears frequently in nature, this does not in any way imply that we

should expect it to play a role in financial markets. After all, rabbit population growth has very little to do with stock prices.

However, it would be a mistake to dismiss Fibonacci methods as useless superstition. The fact is that there are many active share traders who use Fibonacci retracements and extensions to guide their trading strategy.

If enough traders use and act on Fibonacci analysis, the method will work, regardless of whether it has any rational basis (even though it does). In the short term at least, even ill-founded theories can move markets. Regardless of whether Fibonacci explained in any way will influence the market, the use of this analysis by many traders leads to an overall self-fulfilling prophecy in stock

prices. Phenomena like these are not uncommon in markets, and in fact, market psychology is a major focus of study in the field of behavioral economics.

In essence, while Fibonacci retracements and extensions may not have any real basis from a strict financial analysis perspective, they are a useful tool for predicting the behavior of many traders

operating in the market. For this reason, Fibonacci analysis can be an effective part of an overall trading strategy.

The key is to develop an understanding of how other traders are applying Fibonacci analysis. Target selection is also important. If past price movements of a stock appear to conform to Fibonacci predictions, then it

is likely that traders using Fibonacci analysis are active in the trading of that particular stock.

This in turn improves the odds that Fibonacci analysis will be effective in predicting the future movements of that stock. Applied with a thorough understanding of how and where other traders are using it, Fibonacci retracements and extensions

can be solid tool in increasing traders' odds and accuracy!

Elliott Wave Cycle Analysis

Ralph Nelson Elliott developed the Elliott Wave Theory in the late 1920s by discovering that stock markets, thought to behave in a somewhat chaotic manner, in fact traded in repetitive cycles.

Elliott discovered that these market cycles resulted from investors' reactions to

outside influences or predominant psychology of the masses at the time. He found that the upward and downward swings of the mass psychology always showed up in the same repetitive patterns, which were then divided further into patterns he termed waves.

Elliott's theory is somewhat based on the Dow theory in that stock prices

move in waves. Because of the "fractal" nature of markets, however, Elliott was able to break down and analyze them in much greater detail. Fractals are mathematical structures, which on an ever-smaller scale infinitely repeat themselves. Elliott discovered that stock-trading patterns were structured in the same way.

Market Predictions Based on Wave Patterns

Elliott made detailed stock market predictions based on unique characteristics he discovered in the wave patterns. An impulsive wave, which goes with the main trend, always shows five waves in its pattern. On a smaller scale, within each of

the impulsive waves, five waves can again be found. In this smaller pattern, the same pattern repeats itself ad infinitum. These ever-smaller patterns are labeled as different wave degrees in the Elliott Wave Principle. Only much later did scientists recognize fractals.

In the financial markets, we know that "every action creates an equal and opposite

reaction" as a price movement up or down must be followed by a contrary movement. Price action is divided into trends and corrections or sideways movements. Trends show the main direction of prices while corrections move against the trend. Elliott labeled these impulsive and corrective waves.

◼ Theory Interpretation

The Elliott Wave Theory is interpreted as follows:

- ◼ Every action is followed by a reaction.
- ◼ Five waves move in the direction of the main trend followed by three corrective waves (a 5-3 move).

- A 5-3 move completes a cycle.

- This 5-3 move then becomes two subdivisions of the next higher 5-3 wave.

- The underlying 5-3 pattern remains constant, though the time span of each may vary.

Let's have a look at the following chart made up of eight waves (five up and three

down) labeled 1, 2, 3, 4, 5, A, B, and C.

In Figure 7.7 you can see that the three waves in the direction of the trend are impulses, so these waves also have five waves within them. Figures 7.8 and 7.9 show that the waves against the trend are corrections and are composed of three waves.

FIGURE 7.7 Three Waves in Trend Direction
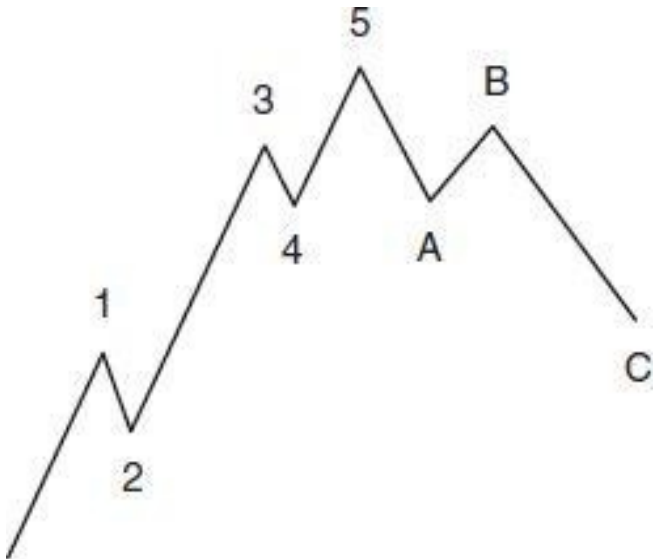
FIGURE 7.8 Three Waves against Trend Direction 1
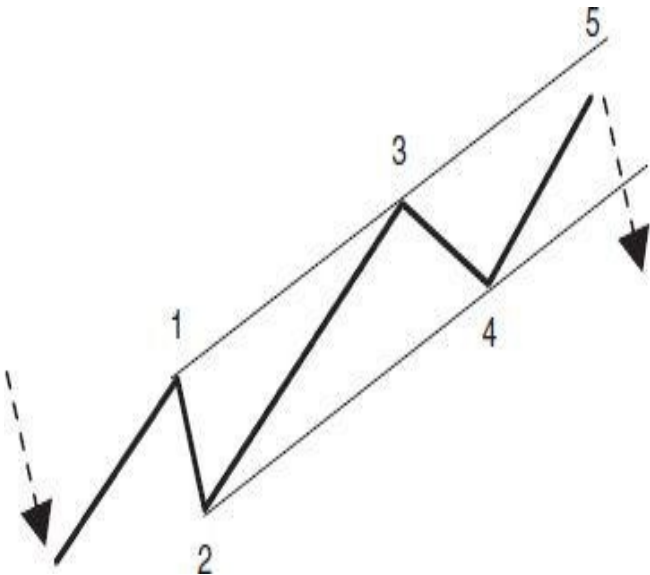
FIGURE 7.9 Three Waves against Trend Direction 2
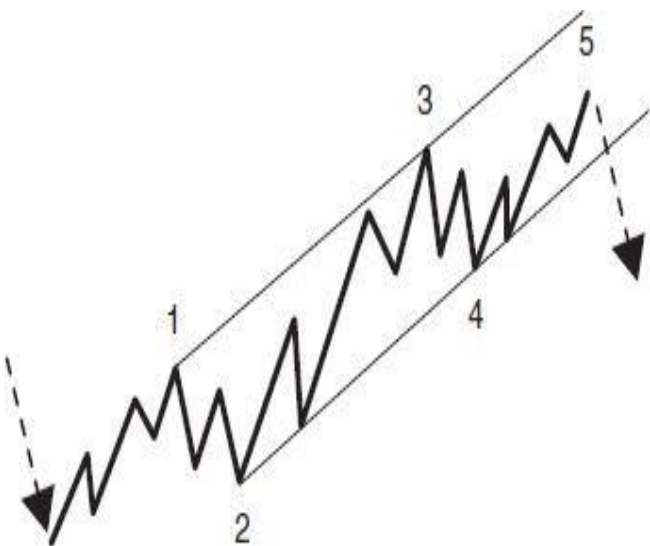
The corrective wave formation in [Figure 7.10](#) shows that normally it has three distinct price

movements—two in the direction of the main correction (A and C) and one against it (B). Waves 2 and 4 in [Figures 7.8](#) and [7.9](#) are corrections. These waves have the structure seen in [Figure 7.10](#).

FIGURE 7.10 A & C Impulse Waves
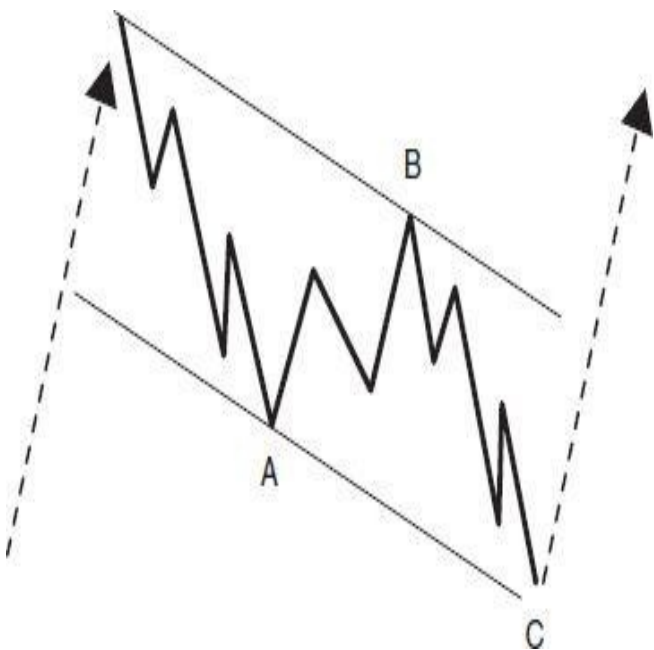
Note that waves A and C
move in the direction of the
shorter-term   trend,   and

therefore are impulsive and composed of five waves, which are shown in [Figure 7.10](#).

An impulse-wave formation, followed by a corrective wave, form an Elliott Wave degree consisting of trends and countertrends. Although the patterns pictured are bullish, the same applies for bear markets where the main trend

is down.

◼ Series of Wave Categories

The Elliott Wave Theory assigns a series of categories to the waves from largest to smallest. They are:

- Grand supercycle
- Supercycle
- Cycle

- Primary
- Intermediate
- Minor
- Minute
- Minuette
- Subminuette

To use the theory in everyday trading, the trader determines the main wave, or supercycle, goes long, and then sells or shorts the position as the pattern runs out of steam and a reversal is

imminent.

CHAPTER 8

What Kind of Trader Are You?

In my opinion, predetermining exit points is a critical skill to learn and needs to be known beforehand and entered shortly after you have received confirmation of your entry execution. By doing this immediately (and keeping that sell order active), you will create a disciplined approach to exiting at least a partial position and enhance

your probability of a profitable trade. We have already discussed several methods used to determine where and when to consider exiting partial or full trading or longer core positions. They include the fifth-wave exits, as well as measured move exits, Fibonacci retracements, and Elliott Wave projections.

However, let's start this chapter with a determination

of what kind of trader you are before we can discuss exit methods, as they differ somewhat depending on time frame parameters. Deciding your time frame comfort level will help determine your exit points.

Day trading takes much more discipline than swing or longer-term trading because you do not have as much "wiggle room" or flexibility,

since the goal is to be back "in cash" by the end of the trading session. You will need to be much more protective of your capital to avoid sharp intraday pullbacks or breaks of key intraday support so as to be able to trade another day! As a result, tighter, more defined rules of exit are needed.

Tighter protection may, and often does, result in day

traders' exiting positions when they least expect an execution to occur, and can and will result in small losses. I want to emphasize that smaller, quicker losses are part of the day-trading game but can and do usually get quickly compensated for by the solid and disciplined day-trade runner position that results in big-percentage day trade to wipe out any smaller losses that a tighter-

disciplined trader may experience.

We discussed the measured move in a prior chapter, and I've found over the years that by measuring the prior intraday move and adding it to the most recent low, one can project a possible day-trade or scalp exit point, which, more often than one would expect, turns out to be a terrific point to at least

partially exit a position. It is worth repeating here that "the prior leg of a move can often be a good determining factor as to where the next move or up leg may find important or serious resistance and a resulting probable good exit point, especially for the day or short-term trader who is not interested in waiting out a pullback or consolidation." It's a good point to be aware of!

I also touched on Fibonacci and Elliott Wave analysis as methods for determining targets. It does, however, take a much more detailed knowledge of those disciplines to be successful. I recommend that you read up on those theories and methods of price forecasting and learn them well before you try to incorporate them in your everyday trading tool box. Without solid

understanding and extensive experience using them, I would avoid relying on them, as "a little knowledge can be dangerous." If, however, what you are seeing based on those disciplines is in agreement with your other technical analysis skill sets, then you have a higher probability of correctly forecasting key levels to be aware of and possibly take action by entering exit orders

with your broker.

For starters, please refer to my earlier comments on those methods in the preceding chapter to gain at least a rudimentary knowledge of what they are about, and then do some extensive reading from a more detailed source. There are many books available on those subjects.

One of the most frustrating and annoying day-trading

mistakes for traders is when they are trading a strongly trending intraday pattern and invariably exit their position way too early.Watching the stock move substantially higher can be extremely frustrating. In order to assure that a trader "stay in the position" to "milk the intraday trend," I have developed a three-tier targeted approach.

Obviously, you will need to determine first if your intention is to scalp the trade or day trade it and exit late in the session and go to cash overnight (which I wholeheartedly recommend). Sometimes a decision is made to scalp a trade, only to find oneself in a very strongly trending stock with huge volume. This is obviously a good thing and a pleasant surprise, but the trader needs

to be vigilant and flexible in his or her approach. Obviously, by switching your objective, you will either extend your profits or quickly give them back. This is why I highly recommend not only setting stops but being alert to possibly having to raise or lower them depending on price/volume action.

Having said this, I want to show you my most favored

exiting methods to protect profits and at the same time give you the flexibility to at least partially stay in some of the positions longer.

■ **Where to Set Targets**

After you have done your scans, examined premarket movements, and reviewed the various individual technical indicators, as well as reviewed potential support, resistance, moving averages, and trend lines, you should be ready to set targets. I always

recommend using a three-tier approach to setting targets. I like to exit at least a quarter to half of the position when tier 1 is achieved. That will ensure at least a solid partial profitable trade. When tier 2 is achieved, another portion of the position can and should be exited. When and if the third tier is reached (which on a good portion of trades is not achieved), you will have a definite choice to exit or

tighten your stop. In any case, if you are day trading, the objective is to be out of the trade by the end of the session. No exceptions!

Other methods of determining target/exit points include the previously mentioned measured moves, Elliott Wave extensions, and/or Fibonacci levels as well. When these methods are used together with standard

technical analysis methods, increased accuracy will likely be achieved.

My most successful day trades have occurred when I was able to at least partially "stay in the trend." Traders tend to want to exit trades with profits, and that's obviously the main purpose of trading—to "make money." Certainly, the discipline needed to continue

in a position when the profit you have is tempting to take is a skill most want to have and strive to learn. You can't always go on gut feel, although the very experienced trader with many years of trading under his or her belt has likely, to a certain extent, learned this from years of hit-and-miss trading and perhaps large drawdowns in their portfolio.

I must admit that I and many successful traders I have known have gone through scary and frustrating down periods, likely because many of us were not as disciplined as we are now. One of the purposes of this book is to have you glean this knowledge without having to spend years learning it the hard way.

Premarket, when I do my

technical analysis of a chart pattern I'm considering trading or recommending to my subscribers, I first examine the 1-minute intraday pattern for bullish setups, or if the stock is gapping due to important news, I look out further time frame–wise, perhaps 5 or 15 minutes, to see what action occurred during the last few sessions that could be a key support or resistance zone. I

will always at least look at the daily patterns to see if any levels jump out at me as being important, which may not have been obvious on a shorter time frame. This will aid me in determining my three-tier targets for my day trade.

Prior support, resistance, trend lines, and moving averages should be taken into consideration and volume that

may have occurred at those levels should also be considered, as it will likely add to those levels' being key ones.

Once you have considered the patterns and technicals on those time frames, you will be more prepared to estimate levels or tiers and be able to set intelligent and more reliable targets where you can scale out of your day-trade

positions.

In conjunction with my chapter on how to draw trend lines, if you have previously used my trend-line drawing methods, you may have already drawn lines at some of those support/resistance levels. This will assist you in more easily determining where some of those exit points may be. It should make the job of determining where

to set these targets and resulting exit points a lot easier and more obvious, especially when you've used them for a while, have gotten used to drawing them, and, most important, leaving them on the chart until it is deemed no longer necessary or relevant.

Determining and Setting Stops

Trading is treacherous and difficult at best without protective stops, and likely eventual financial suicide without using them. The most imperative rule of trading is preservation of capital so you will be able to trade another day. Once your capital position is drained dramatically or lost entirely, you are financially, if not mentally, done. The stop-loss,

when logically applied, will normally prevent the big, disastrous loss. The most important task, other than stock selection and the determination of your targets and exit points, is where to set your protective stop-loss.

When seeking where to set key stop levels, I have always recommended looking for important chart points of technical support/resistance

from previous highs and lows, short- and intermediate-term trend lines, and moving average levels. When more than one of those price points coincide at or near the same levels, it adds credence to and validates the chosen exit strategies and should add to your confidence level in setting those targets/stops.

During the intraday rising channel or trend, it is

recommended that your stops be adjusted or raised to reflect the various new intraday support levels being developed as the chart develops. These should be set below minor pullbacks/retests within the trend.

■ Setting Stops Where Important Price Support Levels Are Violated

In an uptrend or rising channel of any time frame,

it's important to heed any movement that moves below a previous low on any time frame or takes out or violates a previous low, especially if this occurs accompanied by strong volume increases and pronounced selling pressure.

The tough part is determining when it's an "important violation" and if that violation gets a follow-through with volume as well.

The follow-through is key for me in determining whether to take action or if it's just a "one-day anomaly."

My personal preference is to tighten the stop to a level just below the last intraday pullback low, as a violation of that level could be signaling a loss of intraday momentum, possible pending rollover or a possible time-consuming consolidation

period ahead. It certainly signals that at least a short-term trend may have been violated. This applies as well in a downtrend when important resistance it taken out with volume as well, perhaps signaling that a key technical breakout could be getting started.

■ Setting Stops under Key Trend-Line Violations

Over my many years of trial-and-error trading using standard technical analysis, I have found that trend lines and rising channels are

probably the most important and useful tools in determining if a trend is continuing to extend or breaking and/or reversing.

It's always been clear to me that stocks in motion or trending are inclined to stay in motion and keep trending until that trend is obviously altered or violated. Remember this phrase because it holds true in so

many cases and is one of the basic rules of technical analysis. The only problem is determining if, in fact, a stock is indeed "trending" (please refer to Chapter 6 on drawing trend lines).

In addition to important price support violation with volume, trend line and channel breaks usually signal that a pending reversal may be under way or beginning.

You will find that this very often coincides with an important price support break and adds credence and validation when at least two key levels are simultaneously violated, especially with extraordinary volume accompanying the break.

Setting Stops Using Key Moving Average Violations

Most of the successful traders I've known use key moving averages on their charts to help determine key support

and resistance points, as well. Over the many years I've been trading and advising traders on my site, I have determined that the 10-, 21-, and 50-period moving averages are best used for trading on all time frames, even intraday trading using 1-minute charts.

A violation of any or all of those moving averages could also be not only an indication

of a trend change but a key alert signal to set stops below, if you have not already done so. When used in conjunction with key support/resistance violations and trend-line/channel violations, it further adds to the possible trend break probability and should be a confidence booster in determining your decision for action. (Chart examples of key moving average, trend-line, and price

support violations used to trigger stops are shown in [Figures 9.1](#) and [9.2](#)).

FIGURE 9.1 Rentech (RNF)

Key trend-line and price support violation

Bear wedge forms and price fails at multiple moving averges crossover resistance

Bear flag forms and fails near declining moving avg resistance

Rising bear wedge also fails at declining moving average resistance as well

Stock goes nearly full round trip to retest the Dec. 2011 low

RNF

Rentech Nitrogen Partners

Basic Materials Sector(C)

Agricultural Inputs

FIGURE 9.2 Calumet Specialty Products (CLMT)

In Figure 9.1 we see that RNF was in a strong uptrend from December 2011 to February 2013, running from near $16 to over $49, nearly tripling its price. Then a dramatic downside reversal took place, dropping it $10 in just two weeks. That cracked the major up channel and simultaneously also broke the 10-, 21-, and 50-day moving averages. The first bounce

failed to take out those moving averages, and the stock rolled over again, forming several bear flags and wedges over the next 11 months, which saw it decline in a steady down channel back near the $17 level.

[Figure 9.2](#) shows that CLMT rose sharply in a five-wave advance from October 2011 to March 2013, approximately tripling in

price during that time frame. Then a downside gap and price reversal in late March 3013 triggered a new downtrend with multiple bear flags and wedges along the way, which also saw it violate two important trend lines and its key moving averages and price support at midyear. Subsequently, the stock continued its decline from over $40 to under $25.

We've learned that a combination of price support violation with either key moving average or trend-line violation can be a powerful indicator of trend change, and proper stops should be set under those levels with a bit of leeway to protect from whipsaws (getting stopped because the stops were set too close to those levels and then watching the stock snap back sharply, reestablishing the

existing trend right after your stop took you out). How many of you have experienced that just too often?

Tightening stops, of course, can be done after the first level or tier is reached, but care must be taken and close attention paid to where you adjust them. One of the biggest complaints of most traders I have known,

especially those not highly experienced, is setting a stop too close and getting taken out, only to see the stock quickly turn around right after they have exited and then run up sharply.

Again, I do not advocate trading without set stops—ever! But I have found in my many discussions with seasoned traders who know where key support may be

that they sometimes use mental stops, although I personally will not let my emotions interfere with that decision, and neither should you.

If a stock is stopped and then turns around, you can always reenter if it calls for it, especially if it breaks back out over a key resistance level with a strong price/volume surge. I am truly amazed how

few traders will allow themselves to quickly reenter a position, sometimes very quickly, after a stock was marginally stopped and turned around sharply, breaking back out. Many traders' egos will not allow them to reenter a position that just resulted in a loss. Traders often tell me, "It left me with a negative opinion of it" or "Once a stock burns me, I won't trade it again."

Amazing! Some of my best trades ever have occurred right after I was stopped and went back in because the trend quickly reestablished itself with a strong thrust.

It's my strong belief that most stops that are violated are due to an incorrect method of setting a stop based only on a percentage loss basis. What's the logical reasoning for that? Why

wouldn't a trader consider setting stops just below breaks of important trend channels, moving averages, or simply previous price support breaks? My many years of trading experience have taught me that these are the technically logical points to set protective stops.

The question most often asked of me is: if a key previous low and resulting

price violation occur, where do I set a stop? The answer often depends on your pain tolerance, but I will then look at round numbers, if any, just below the break level. Round numbers are also psychological levels and when violated often can accelerate a stock's decline.

At least an additional 1 to 2 percent leeway below a violated level is suggested, or

a bit more depending on your time frame. Swing and intermediate traders may want to set the stop with a bit more leeway to avoid stopping a longer-term position. Either way, stops are a must especially for day and swing traders and getting comfortable knowing where to set them is a must for traders to learn.

Because humans have

emotions and may be at least partially irrational when emotions are part of the equation, proper interpretation of the key stock movement is sometimes skewed. This can result in misreading the meaning of an important move and result in improper judgments and opinions. However, the disciplined trader must have taken action to preserve capital, and this is why

learning to set protective stops is most valuable and quite critical for your long-term investment success.

Technical Divergences

and Loss of Momentum

The divergence of stock prices from their ongoing angle of ascent and/or divergence from their underlying technicals can be the first sign of a loss of momentum and is a dire warning sign of potential

trend change.

When analyzing the wide variety of underlying technical indicators which are provided on most charting services, I focus on just a few such as MoneyStream, Balance of Power, and Volume Buzz (Worden Brothers' proprietary technical measurements), total and relative volume, on-balance volume, stochastics

(an oscillator-like indicator measuring overbought/oversold) and relative price strength, just to name a few. It's never a bad thing to analyze as many indicators as possible to get confirmation of a price trend (or divergences if they are occurring). However, I believe in keeping it simple, as too much information can be confusing and even overwhelming, especially for

the inexperienced or novice trader trying to learn the benefits of technical analysis. Even the experienced trader can gain clarity by using just a few of the indicators I recommended earlier and eliminating some of the "noise" that too many indicators can cause.

I realize that many opinions in the technical analysis universe differ as to

which indicators are most accurate or powerful in determining the validity of a trend or price movement in either direction (long or short). However, my nearly 50 years of heavy trading experience has shown me that the indicators I recommend in this book to be among the most useful and accurate ones out there. I strongly believe that focusing your attention on them and gaining

familiarity with them will greatly enhance your trading accuracy and profitability.

■ Price Trend Angle Divergences

In my opinion, probably the single most important technical factor to watch for on any time frame is the divergence of price from trend. This is usually indicated by the break of

trend-line angles and/or violation of key moving averages, especially when they occur at or near the same time. This is often a precursor to impending trend changes and should be closely monitored especially if the others indicators I mentioned above are confirming that a trend change is likely taking place, as action may be warranted when it occurs.

Price divergences from the price trend angle when accompanied by a dramatic change in volume or a "price/volume thrust" in the opposite direction of the previous ongoing trend is the key for me in realizing when a stock may be at or near a dramatic change in direction

When you learn to observe these pending changes, your ability to take action and

protect your capital position will be greatly enhanced.

▪ Underlying Technicals Diverging from Price

One of the most powerful tools in technical trading is the ability to spot any divergences in the underlying technicals from the price

trend itself. I've discussed the ones I favor earlier, and the inability of any and especially several of those indicators to keep pace with price can be very important in determining if you will need to take action such as exiting or tightening stops. Examples of both price divergences from trend angle and underlying technicals nonconfirming negative divergences can be seen in Figures 10.1 and 10.2.

FIGURE 10.1 Markwest Energy Partners (MWE)

Price makes higher highs! Underlying OBV, MS & BOP Diverge negatively

Price breaks trend with gap down

Bear wedges form

Rising price trend line

MWE

Markwest Energy Partners Lp

Energy Sector(S)

Oil & Gas Midstream

Nonconfirming OBV

Dramatic technical deterioration follows

Nonconfirming BOP & MS

FIGURE 10.2 PDC Energy (PDCE)

PDCE — PDC Energy, Inc. 50.90 51.52 49.63 49.98 -0.74 -1.49% 505000 4.67

Daily — Exp Moving Average 21

More new highs as price trend continues higher
Not confirmed by underlying technicals

Price finally cracks trend line and rolls over

17-month rising trend line

PDCE

PDC Energy, Inc.

Energy Sector(S)

Oil & Gas E&P

Volume · OBV
Nonconfirming OBV

Balance Of Power · MoneyStream
Nonconfirming BOP & MS

Figure 10.1 is an MWE daily chart displaying a rising price trend during 2013, having a run from $47 to $75. However, it also shows a deterioration and nonconfirmation of the underlying technicals (specifically, the on-balance volume, Balance of Power, and and MoneyStream) at the October and November highs. Subsequently, the price

pattern diverged from the trend line and rolled over hard, and dropped back to the low $60s at this writing with two bear wedges forming along the way!

PDCE was in sharply rising parallel up channel from June 2012 to October 2013 running from $19 to $74. However, over the final six months of the uptrend, the new highs were not

confirmed by the underlying technicals, telegraphing some key negative divergences. Price soon diverged from trend and rolled over at the beginning of November 2013 and moved lower.

I especially favor Worden Brothers' Balance of Power and MoneyStream proprietary technical indicators to confirm or deny that a trend is continuing its momentum

and have been using them regularly for the past 20 years. Following is an explanation of what they are intended to indicate.

■ **Balance of Power**

Balance of Power (BOP) is the exclusive intellectual property of Worden Brothers, Inc. It was developed by Don Worden, a leading technical innovator.

BOP tells you whether the underlying action in the trading of a stock is

characterized by systematic buying (accumulation) or systematic selling (distribution). The single most definitive and valuable characteristic of BOP is a pronounced ability to contradict price movement. BOP goes far beyond the "divergences" that many technical indicators are capable of. In divergence analysis, the price and the indicator tend to move

together. A divergence is detected when, for example, the price makes a new high and the indicator fails to confirm.

BOP is capable of outright contradiction. Thus, while the price is attaining new highs, BOP may very well be attaining new lows. It is not unusual for BOP to move in the exact opposite direction of price.

BOP is plotted above and below a zero line. However, it is not an oscillator. It does not swing up and down with the price. It goes its own way, often quite independent of price movement. When BOP is above the zero line, it is depicting systematic buying. When it is below the line, it is revealing systematic selling.

For convenience, BOP is plotted in color. Green

signifies dominant buying, red dominant selling. When BOP is close to the zero line, revealing no clear dominance of either buying or selling, it is plotted in yellow. (This is all patterned after stop and go lights.) For even greater convenience, the price bars are plotted in the same colors as the corresponding BOP bars below. It is possible to interpret BOP using only the colored price bars. This is a

boon to those who have difficulty rectifying the spatial relationships inherent in chart reading.

BOP fits into a category of devices that can be termed trend quality indicators. A variety of methods lead naturally to buy and sell signals. What BOP tells you is something about the quality of the underlying trend. Not itself a pinpoint timing

indicator, BOP will modify your assessment of the vital risk-reward ratio of a trade or investment. It will help you determine whether the supply-demand balance will be in your favor. It will help you spot changes of character in a stock.

BOP brings out hidden patterns of accumulation or distribution, and it does so with great reliability. But,

you see, a significant increase in price is not the inevitable result of informed accumulation. Distribution does not inevitably lead to a collapse in price. Even well-informed buyers and sellers can be wrong about future price trends. BOP offers an inside glimpse of informed accumulation or distribution.

Let us just say that if you invest consistently in the

same direction as informed money, your chances of success will increase significantly. Watch particularly for changes in character at potential tops and bottoms. Be suspicious of stocks in which BOP hasn't worked well. If the BOP pattern was misleading in the past, it will probably continue to be so in the future.

The BOP scale runs from

100 to –100. The indicator itself can rise above or below these extremes, but it is relatively rare. When it happens, we just truncate the profile at the top or bottom of the chart. Since the scale is consistent from chart to chart, you are able to make direct comparisons from stock to stock. Some will ask, which is the most important: (1) whether BOP is above or below the zero line or (2)

whether the direction of the BOP profile is up or down, which is to say, whether BOP is improving or deteriorating? Of first importance is whether BOP is above or below the zero line. This indicates dominant buying or selling on an absolute basis. However, a positive BOP with a deteriorating pattern can be significant as well, but only in a divergent situation. Thus, a positive BOP moving down

in tandem with an eroding price could not be interpreted bearishly. But a positive BOP moving down into a rising price must be construed bearishly. This would be all the more so if the price is actually attaining new highs. Conversely, a positive BOP moving up into a falling price should be interpreted as a positive, and all the more so if the price is breaking so-called "support levels."

Where absolute BOP versus improving or deteriorating BOP seem to be contradictory, you will often find that the answer lies in the time implications. Absolute BOP (green or red) usually has the longer-term implications.

One last point: Before you arrive at a decision on any stock, check BOP in a variety of time frames.

MoneyStream

The Cumulative MoneyStream (CMS) was also developed by award-winning technician Don Worden and is the exclusive intellectual property of Worden Brothers, Inc. MoneyStream grew out of joint venture with a large

regional brokerage firm to develop a price/volume indicator. The result is an indicator with much the same objectives as OBV. CMS is interpreted in the same way you would interpret OBV. Generally, you look for divergences.

Important divergences can be seen at a glance, owing to our use of automatic linear regression lines in both the

price and indicator profiles. The chart is setup so that you can make direct comparisons between the slopes of the price regression lines and the indicator regression lines. (However, do not neglect to look closely for movements not necessarily reflected in the regression line, which is meant as a help, not a crutch.) If the CMS regression lines are sloping upward at greater angles than those of the price,

the message is bullish, and vice versa.

The main difference between OBV and CMS is that CMS has a greater ability to contradict price movement than OBV does. This is achieved by using all of the elements within the daily price bar rather than just the close. The high, low, close, and daily range are related to volume in a unique and

proprietary way. You may wish to compare CMS and OBV in a variety of stocks and time frames. Generally, you will find that CMS has the greater predictive power —but not always. Sometimes OBV does the better job. The more things you look at, and the more time frames you habitually check out, the better you are going to do.

MoneyStream was

developed after years of experience with price/volume indicators. In addition to Joe Granville's OBV, ideas by David Bostian and Mar Chaikin were influential in the formulation. The final result embodies a method of filtering out what is believed to be a logical error in the preceding indicators. CMS is not as volatile as Bostian's and Chaikin's creations and it has more power to contradict

than OBV.

CMS works very well in conjunction with BOP. CMS and BOP are based on entirely different concepts and sometimes they disagree completely. The idea is to wait for mutual confirmation. Together they are potent medicine. CMS lends itself better to precise timing than BOP. This is because CMS is affected considerably by the

price trend itself. BOP, however, is incomparable at ferreting out hidden patterns of accumulation or distribution.

MoneyStream has the option to be plotted with 30- and 100-period linear regression lines on the MoneyStream graph and the price graph so you can compare the trends of the two graphs.

On-Balance Volume and Divergences

OBV measures buying and selling pressure as a cumulative indicator that adds volume on up days and subtracts volume on down days. OBV was developed by Joe Granville and introduced

in his 1963 book, Granville's New Key to Stock Market Profits. It was one of the first indicators to measure positive and negative volume flow. Chartists can look for divergences between OBV and price to predict price movements or use OBV to confirm price trends.

Calculation

The OBV line is simply a running total of positive and negative volume. A period's volume is positive when the close is above the prior close. A period's volume is negative when the close is below the prior close.

Interpretation

Granville theorized that volume precedes price. OBV rises when volume on up days outpaces volume on down days. OBV falls when volume on down days is stronger. A rising OBV reflects positive volume pressure that can lead to higher prices. Conversely, falling OBV reflects negative volume pressure that can foreshadow lower prices.

Granville noted in his research that OBV would often move before price. Expect prices to move higher if OBV is rising while prices are either flat or moving down. Expect prices to move lower if OBV is falling while prices are either flat or moving up.

The absolute value of OBV is not important. Chartists should instead focus on the

characteristics of the OBV line. First, define the trend for OBV. Second, determine if the current trend matches the trend for the underlying security. Third, look for potential support or resistance levels. Once broken, the trend for OBV will change and these breaks can be used to generate signals. Also notice that OBV is based on closing prices. Therefore, closing prices should be considered

when looking for divergences or support/resistance breaks. And, finally, volume spikes can sometimes throw off the indicator by causing a sharp move that will require a settling period.

Divergences

Bullish and bearish divergence signals can be used to anticipate a trend reversal. These signals are truly based on the theory that volume precedes prices. A bullish divergence forms when OBV moves higher or forms a higher low even as prices move lower or forge a lower low. A bearish divergence forms when OBV

moves lower or forms a lower low even as prices move higher or forge a higher high. The divergence between OBV and price should alert chartists that a price reversal could be in the making.

The chart for Starbucks (SBUX; Figure 10.3) shows a bullish divergence forming in July. On the price chart, SBUX moved below its June low with a lower low in early

July. OBV, however, held above its June low to form a bullish divergence. OBV went on to break resistance before SBUX broke resistance. This was a classic case of volume leading price. SBUX broke resistance a week later and continued above 20 for a 30-plus percent gain.

FIGURE 10.3 Starbucks (SBUX)

SBUX (Starbucks Corp.) Nasdaq GS   © StockCharts.com
6-Nov-2009   Op 20.12 Hi 21.00 Lo 19.99 Cl 20.83 Vol 29.1M Chg +1.40 (+7.21%) ▲

— SBUX (Daily) 20.83

lower low

Volume 29,118,310
MA(200) 13,163,496

— On Balance Vol

OBV breaks out first

bullish divergence

Figure 10.4 shows OBV moving higher as Texas Instruments (TXN) trades within a range. Rising OBV during a trading range indicates accumulation, which is bullish.

FIGURE 10.4 Texas Instruments (TXN) Showing Confirming Bullish OBV

TXN (Texas Instruments, Inc.) NYSE ©StockCharts.com
7-Aug-2009 Op 23.98 Hi 24.17 Lo 23.52 Last 23.53 Vol 13.0M Chg -0.20 (-0.82%)

— TXN (Daily) 23.53

Volume 13,016,273
MA(200) 19,168,110

— On Balance Vol

OBV moves higher as prices range

The chart for Medtronic (MDT; Figure 10.5) shows a bearish divergence with volume leading price lower. The blue dotted lines identify the divergence period. MDT moved higher (43 to 45) as OBV moved lower. Also notice that OBV broke support during this divergence period. The uptrend in OBV reversed with the break below the

February low. MDT, however, was still moving higher. Volume ultimately won the day as MDT followed volume lower with a decline into the low 30s.

FIGURE 10.5 Medtronic (MDT) Showing Bearish Divergence with Volume

MDT (Medtronic, Inc.) NYSE © StockCharts.com
8-Sep-2010 Op 32.27 Hi 32.57 Lo 32.02 Cl 32.21 Vol 6.9M Chg -0.02 (-0.06%)

— MDT (Daily) 32.21

price follows volume

divergence period

Volume 6,922,006
MA(200) 6,510,366

— On Balance Vol

OBV breaks support first

The chart in shows Valero Energy (VLO) with OBV forming a bearish divergence in April and a confirming support break in May.

FIGURE 10.6 Valero Energy (VLO) Showing Bearish Divergence with Volume

VLO (Valero Energy Corp) NYSE
8-Sep-2010 Op 16.86 Hi 17.08 Lo 16.72 Last 16.83 Vol 4.9M Chg -0.05 (-0.30%)
©StockCharts.com

VLO (Daily) 16.83
higher high

negative volume was stronger

Volume 4,757,892
MA(200) 10,863,538

On Balance Vol
lower high

Trend Confirmation

OBV can be used to confirm a price trend, upside breakout or downside break. The chart for Best Buy (BBY; [Figure 10.7](#)) shows three confirming signals as well as confirmation of the price trend. OBV and BBY moved lower in December–January, higher from March to April, lower from May to August and higher from September to

October. The trends in OBV matched the trend in BBY.

FIGURE 10.7 Best Buy (BBY) with Three Confirming Signals in Different Directions
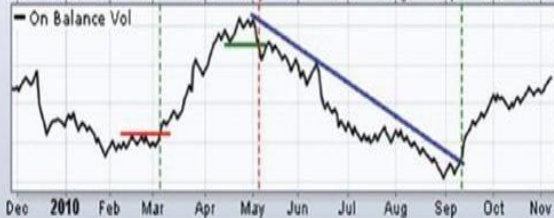
BBY (Best Buy Co., Inc.) NYSE — © StockCharts.com
8-Nov-2010 — Op 44.64 Hi 44.98 Lo 44.20 Cl 44.83 Vol 2.6M Chg +0.08 (+0.18%)

BBY (Daily) 44.83
Volume 2,616,944

On Balance Vol

OBV also confirmed trend reversals in BBY. Notice how BBY broke its down trend line in late February and OBV confirmed with a resistance breakout in March. BBY broke its up trend line in late April and OBV confirmed with a support break in early May. BBY broke its down trend line in early September and OBV confirmed with a trend-line

break a week later. These coincident signals indicated that positive and negative volume were in harmony with price.

Sometimes OBV moves step-for-step with the underlying security. In this case, OBV is confirming the strength of the underlying trend, be it down or up. The chart for Autozone (AZO; Figure 10.8) shows prices as

a black line and OBV as a pink line. Both moved steadily higher from November 2009 until October 2010. Positive volume remained strong throughout the advance.

FIGURE 10.8 Autozone (AZO) with Confirming On-Balance Volume

AZO (Autozone Inc. Nevada) NYSE
8-Oct-2010 Op 233.50 Hi 233.78 Lo 231.92 Cl 232.81 Vol 626.8K Chg -0.19 (-0.08%) ▼
©StockCharts.com

— AZO (Daily) 232.81
— On Balance Vol

OBV (pink)

OBV and price moving
step-for-step

Autozone (black)

■ **Conclusions**

OBV is a simple indicator that uses volume and price to measure buying pressure and selling pressure. Buying pressure is evident when positive volume exceeds negative volume and the OBV line rises. Selling pressure is present when negative volume exceeds positive volume and the OBV

line falls. Chartists can use OBV to confirm the underlying trend or look for divergences that may foreshadow a price change. As with all indicators, it is important to use OBV in conjunction with other aspects of technical analysis. It is not a stand-alone indicator. OBV can be combined with basic pattern analysis or to confirm signals from momentum oscillators.

CHAPTER
11

The
Interpretation

and Use of Stochastic Oscillators

There are several oscillator-type indicators that have been developed over the last 50 years to indicate overbought and oversold conditions. When used in conjunction

with the other indicators we have already discussed, they can be very helpful tools in determining possible points of exit and entry because price has been stretched too far too fast and likely to snapback in the other direction. This is especially true for the day or swing trader but can be applied to longer time frames as an extended price condition is likely to retrace as a result of

profit taking, especially if that condition exists near key support or resistance which must be factored in to make an intelligent judgment.

Oscillators and related indicators are not trend indicators but measure the speed of movement and can be a very powerful additive to your base of technical knowledge and certainly enhance your level of trading

accuracy and profitability. Below are several of those indicators, how they are constructed, and how to interpret them.

■ **Introduction**

Developed by George C. Lane in the late 1950s, the stochastic oscillator is a momentum indicator that shows the location of the close relative to the high-low range over a set number of periods. According to Lane, the stochastic oscillator "doesn't follow price, it doesn't follow volume or

anything like that. It follows the speed or the momentum of price. As a rule, the momentum changes direction before price." The stochastic oscillator indicator's sensitivity to market movements can be reduced by adjusting the time period or by taking a moving average of the result. The bullish and bearish divergences in the stochastic oscillator can be used to

foreshadow reversals. This was the first signal that Lane identified. Lane also used this oscillator to identify bull and bear setups to anticipate future reversals. Because the stochastic oscillator is range bound, is also useful for identifying overbought and oversold levels.

Calculation and Interpretation

The default setting for the stochastic oscillator is 14 periods, which can be days, weeks, months, or an intraday time frame. A 14-period %K would use the most recent close, the highest high over

the last 14 periods and the lowest low over the last 14 periods. %D is a 3-day simple moving average of %K. This line is plotted alongside %K to act as a signal or trigger line.

The stochastic oscillator measures the level of the close relative to the high-low range over a given period of time. Assume that the highest high equals 110, the lowest

low equals 100 and the close equals 108. The high-low range is 10, which is the denominator in the %K formula. The close less the lowest low equals 8, which is the numerator. Eight divided by 10 equals 0.80 or 80 percent. Multiply this number by 100 to find %K; %K would equal 30 if the close was at 103 (0.30 * 100). The stochastic oscillator is above 50 when the close is in the

upper half of the range and below 50 when the close is in the lower half. Low readings (below 20) indicate that price is near its low for the given time period. High readings (above 80) indicate that price is near its high for the given time period.

The IBM example in [Figure 11.1](#) shows three 14-day ranges with the closing price at the end of the period

(red dotted) line. The stochastic oscillator equals 91 when the close was at the top of the range. The stochastic oscillator equals 15 when the close was near the bottom of the range. The close equals 57 when the close was in the middle of the range.

FIGURE 11.1 International Business Machines (IBM) with Stochastic Oscillator Examples

IBM (International Business Machines) NYSE

©StockCharts.com

6-Apr-2010 Op 128.02 Hi 128.84 Lo 127.40 Cl 128.27 Vol 3.9M Chg -0.42 (-0.32%) ▼

IBM (Daily) 128.27

close in upper part of range
Stoch Osc ~91

close in middle of range
Stoch Osc ~ 57

close in lower part of range
Stoch Osc ~15

high-low range

Fast STO %K(14) %D(3) 56.73 54.65

■ **Fast, Slow, or Full**

There are three versions of the stochastic oscillator that show the location of the close relative to the high-low range over a set number of periods.

The fast stochastic oscillator is based on George Lane's original formulas for %K and %D. %K in the fast

version that appears rather choppy. %D is the 3-day SMA of %K.

In fact, Lane used %D to generate buy or sell signals based on bullish and bearish divergences. Lane asserts that a %D divergence is the "only signal which will cause you to buy or sell."

Because %D in the fast stochastic oscillator is used for signals, the slow

stochastic oscillator was introduced to smooth %K with a 3-day SMA, which is exactly what %D is in the fast stochastic oscillator.

%K in the slow stochastic oscillator equals %D in the fast stochastic oscillator.

> Fast Stochastic Oscillator
>
> Fast %K = %K basic calculation
>
> Fast %D = 3-period

SMA of Fast %K

Slow Stochastic Oscillator

Slow %K = Fast %K smoothed with 3-period SMA

Slow %D = 3-period SMA of Slow %K

The full stochastic oscillator is a fully customizable version of the slow stochastic oscillator. Users can set the look-back

period, the number of periods to slow %K and the number of periods for the %D moving average. The default parameters were used in these examples:

Fast Stochastic Oscillator (14,3)
Slow Stochastic Oscillator (14,3) and Full Stochastic Oscillator (14,3,3)
Full Stochastic

Oscillator:

Full %K = Fast %K smoothed with X-period SMA

Full %D = X-period SMA of full %K

In the QQQQ example in [Figure 11.2](), notice that %K in the slow stochastic oscillator equals %D in the fast stochastic oscillator.

FIGURE 11.2 QQQQ Daily Chart Comparing Various Stochastic Oscillators on One Chart

QQQQ (PowerShares QQQ Trust) Nasdaq GM
5-Mar-2010 Op 45.96 Hi 46.40 Lo 45.85 Cl 46.30 Vol 68.3M Chg +0.69 (+1.51%)
©StockCharts.com

QQQQ (Daily) 46.30

%D Fast = %K Slow

%D Fast

%K Slow

Fast STO %K(14) %D(3) 96.31, 94.83
choppy %K
Fast (14,3)

Slow STO %K(14) %D(3) 94.83, 93.59
smooth %K
Slow (14,3)

Full STO %K(14,3) %D(3) 94.83, 93.59
Full (14,3,3)
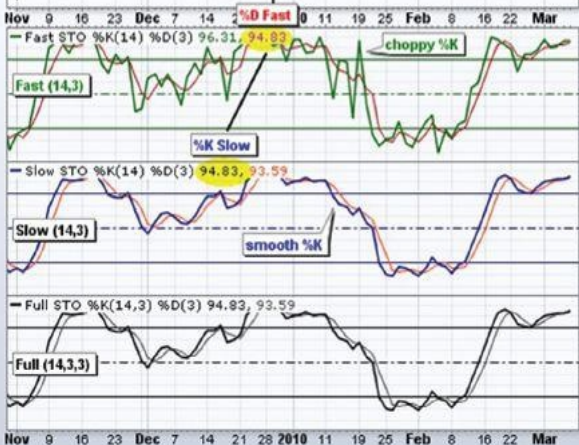
Overbought/Ov

Since it's a bound oscillator, the stochastic oscillator makes it easy to identify overbought and oversold levels. The oscillator ranges from 0 to 100. No matter how fast a security advances or declines, the stochastic oscillator will always

fluctuate within this range. Traditional settings use 80 as the overbought threshold and 20 as the oversold threshold. These levels can be adjusted to suit analytical needs and security characteristics. Readings above 80 for the 20-day stochastic oscillator would indicate that the underlying security was trading near the top of its 20-day high-low range. Readings below 20 occur when a

security is trading at the low end of its high-low range.

Before looking at some chart examples, it is important to note that overbought readings are not necessarily bearish. Securities can become overbought and remain overbought during a strong uptrend. Closing levels that are consistently near the top of the range indicate sustained buying pressure. In

a similar vein, oversold readings are not necessarily bullish. Securities can also become oversold and remain oversold during a strong downtrend. Closing levels consistently near the bottom of the range indicate sustained selling pressure. It is, therefore, important to identify the bigger trend and trade in the direction of this trend. Look for occasional oversold readings in an

uptrend and ignore frequent overbought readings. Similarly, look for occasional overbought readings in a strong downtrend and ignore frequent oversold readings.

The YHOO example in [Figure 11.3](#) displays a longer look-back period (20 days versus 14) and longer moving averages for smoothing (5 versus 3) producing a less sensitive oscillator with fewer

signals. Yahoo was trading between 14 and 18 from July 2009 until April 2010. Such trading ranges are well suited for the stochastic oscillator. Dips below 20 warn of oversold conditions that could foreshadow a bounce. Moves above 80 warn of overbought conditions that could foreshadow a decline. Notice how the oscillator can move above 80 and remain above 80 (orange highlights).

Similarly, the oscillator moved below 20 and sometimes remained below 20. The indicator is both overbought and strong when above 80. A subsequent move below 80 is needed to signal some sort of reversal or failure at resistance (red dotted lines). Conversely, the oscillator is both oversold and weak when below 20. A move above 20 is needed to show an actual upturn and

successful support test (green dotted lines).

FIGURE 11.3 Yahoo! (YHOO) with the Full Stochastic Oscillator (20,5,5)

YHOO (Yahoo!, Inc.) Nasdaq GS · @StockCharts.com
6-Apr-2010 Op 16.55 Hi 16.98 Lo 16.42 Cl 16.92 Vol 25.7M Chg +0.41 (+2.48%) ▲

YHOO (Daily) 16.92

Full STO %K(20,5) %D(5) 67   overbought
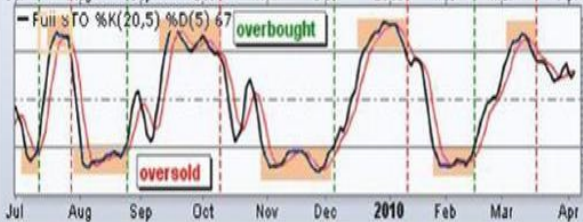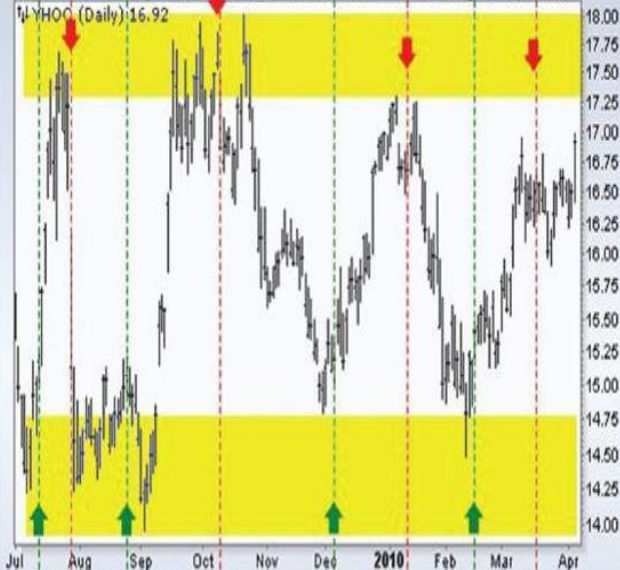
oversold

In the CCI example in [Figure 11.4](#) the full stochastic oscillator (20,5,5) was used to identify oversold readings. Overbought readings were ignored because the bigger trend was up. Trading in the direction of the bigger trend improves the odds. The full stochastic oscillator moved below 20 in early September and early November. Subsequent moves back

above 20 signaled an upturn in prices (green dotted line) and continuation of the bigger uptrend.

FIGURE 11.4 Crown Castle (CCI) with a Breakout in July to Start an Uptrend

In the AZO example in [Figure 11.5](#), showing a downtrend underway, the full stochastic oscillator (10,3,3) was used to identify overbought readings to foreshadow a potential reversal. Oversold readings were ignored because of the bigger downtrend. The shorter look-back period (10 versus 14) increases the sensitivity of the oscillator for

more overbought readings. For reference, the full stochastic oscillator (20,5,5) is also shown. Notice that this less sensitive version did not become overbought in August, September, and October. It is sometimes necessary to increase sensitivity to generate signals.

FIGURE 11.5 Autozone (AZO) with a Support Break in May 2009 that Started a

Downtrend

AZO (Autozone Inc. Nevada) NYSE
11-Nov-2009 4:00pm
Last 147.51 Volume 1.2M Chg +4.16 (+2.90%)
© StockCharts.com

↓ AZO (Daily) 147.51

support break

oversold readings ignored in a downtrend

overbought

Full STO %K(10,3) %D(3) 95.03, 90.79

Full STO %K(20,5) %D(5) 65.98, 42.95

no overbought readings
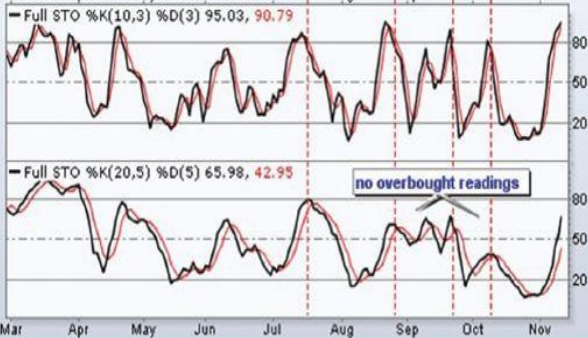
■ Bullish and Bearish Divergences

Divergences form when a new high or low in price is not confirmed by the stochastic oscillator. A bullish divergence forms when price records a lower low, but the stochastic

oscillator forms a higher low. This shows less downside momentum that could foreshadow a bullish reversal. A bearish divergence forms when price records a higher high, but the stochastic oscillator forms a lower high. This shows less upside momentum that could foreshadow a bearish reversal. Once a divergence takes hold, chartists should look for a confirmation to

signal an actual reversal. A bearish divergence can be confirmed with a support break on the price chart or a stochastic oscillator break below 50, which is the center line. A bullish divergence can be confirmed with a resistance break on the price chart or a stochastic oscillator break above 50.

Fifty is an important level to watch. The stochastic

oscillator moves between zero and 100, which makes 50 the center line. Think of it as the 50-yard line in football. The offense has a higher chance of scoring when it crosses the 50-yard line. The defense has an edge as long as it prevents the offense from crossing the 50-yard line. A stochastic oscillator cross above 50 signals that prices are trading in the upper half of their high-low range

for the given look-back period. This suggests that the cup is half full. Conversely, a cross below 50 means prices are trading in the bottom half of the given look-back period. This suggests that the cup is half empty.

The IGT example in [Figure 11.6](#) shows how it moved to a new low, but the stochastic oscillator formed a higher low. There are three steps to

confirming this higher low. The first is a signal line cross and/or move back above 20. A signal line cross occurs when %K crosses %D. This provides the earliest entry possible. The second is a move above 50, which puts prices in the upper half of the stochastic range. The third is a resistance breakout on the price chart. Notice how the stochastic oscillator moved above 50 in late March and

remained above 50 until late May.

FIGURE 11.6 International Gaming Tech (IGT) with a Bullish Divergence in February–March 2010

In the KKS [Figure 11.7](#) example, the stock moved to higher highs in early and late April, but the stochastic oscillator peaked in late March and formed lower highs. The signal line crosses and moves below 80 but did not provide good early signals in this case because KSS kept moving higher. The stochastic oscillator moved below 50 for the second

signal and the stock broke support for the third signal. As KSS shows, early signals are not always clean and simple. Signal-line crosses, moves below 80, and moves above 20 are frequent and prone to whipsaw. Even after KSS broke support and the stochastic oscillator moved below 50, the stock bounced back above 57, and the stochastic oscillator bounced back above 50 before the

stock continued sharply lower.

FIGURE 11.7 Kohls (KSS) with a Bearish Divergence in April 2010

KSS (Kohls Corp.) NYSE   ©StockCharts.com
25-May-2010   Op 49.90 Hi 50.90 Lo 49.43 Cl 50.78 Vol 5.9M Chg -0.19 (-0.37%) ▼
KSS (Daily)

higher highs

Bearish Divergence

support break

Slow Stochastics (14,3)

lower highs

break below 50

■ **Bullish and Bearish Setups**

George Lane identified another form of divergence to predict bottoms or tops. A bull setup is basically the inverse of a bullish divergence. The underlying security forms a lower high, but the stochastic oscillator forms a higher high. Even

though the stock could not exceed its prior high, the higher high in the stochastic oscillator shows strengthening upside momentum. The next decline is then expected to result in a tradable bottom.

NTAP formed a lower high as the stochastic oscillator forged a higher high (see [Figure 11.8](#)). This higher high shows strength in upside

momentum. Remember that this is a setup, not a signal. The setup foreshadows a tradable low in the near future. NTAP declined below its June low, and the stochastic oscillator moved below 20 to become oversold. Traders could have acted above 50. Alternatively, NTAP subsequently broke resistance with a strong move.

FIGURE 11.8 Network Appliance (NTAP) with a Bull Setup in June 2009
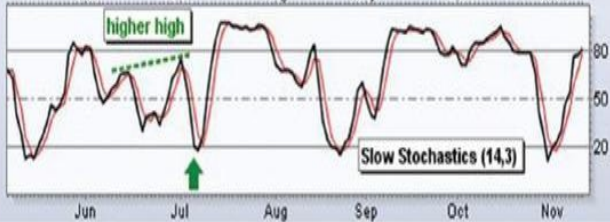
A bear setup occurs when the security forms a higher low, but the stochastic oscillator forms a lower low. Even though the stock held above its prior low, the lower low in the stochastic oscillator shows increasing downside momentum. The next advance is expected to result in an important peak.

Figure 11.9 shows Motorola (MOT) with a bear

set-up in November 2009. The stock formed a higher low in late November and early December, but the stochastic oscillator formed a lower low with a move below 20. This showed strong downside momentum. The subsequent bounce did not last long as the stock quickly peaked. Notice that the stochastic oscillator did not make it back above 80 and turned down below its signal

line in mid-December.

FIGURE 11.9 Motorola (MOT) with a Bear Setup in November 2009

■ **Conclusions**

While momentum oscillators are best suited for trading ranges, they can also be used with securities that trend, provided the trend takes on a zigzag format. Pullbacks are part of uptrends that zigzag higher. Bounces are part of downtrends that zigzag lower. In this regard, the stochastic oscillator can be used to

identify opportunities in harmony with the bigger trend.

The indicator can also be used to identify turns near support or resistance. Should a security trade near support with an oversold stochastic oscillator, look for a break above 20 to signal an upturn and successful support test. Conversely, should a security trade near resistance with an

overbought stochastic oscillator, look for a break below 80 to signal a downturn and resistance failure.

The settings on the stochastic oscillator depend on personal preferences, trading style, and time frame. A shorter look-back period will produce a choppy oscillator with many overbought and oversold

readings. A longer look-back period will provide a smoother oscillator with fewer overbought and oversold readings.

Like all technical indicators, it is important to use the stochastic oscillator in conjunction with other technical analysis tools. Volume, support/resistance, and breakouts can be used to confirm or refute signals

produced by the stochastic oscillator.

Moving Average

Convergence/D

Moving   average convergence/divergence (MACD) is a technical analysis indicator created by Gerald Appel in the late 1970s. It is used to spot changes in the strength, direction, momentum, and duration of a trend in a stock's price.

The MACD "oscillator" or "indicator" is a collection of three signals (or computed data series), calculated from historical price data, most often the closing price. These three signal lines are: the MACD line, the signal line (or average line), and the difference (or divergence). The term MACD may be used to refer to the indicator as a whole or specifically to the MACD line itself. The

first line, called the MACD line, equals the difference between a "fast" (short-period) exponential moving average (EMA) and a "slow" (longer-period) EMA. The MACD line is charted over time, along with an EMA of the MACD line, termed the signal line or average line. The difference (or divergence) between the MACD line and the signal line is shown as a bar graph

called the histogram line.

A fast EMA responds more quickly than a slow EMA to recent changes in a stock's price. By comparing EMAs of different periods, the MACD line can indicate changes in the trend of a stock. By comparing that difference to an average, an analyst can detect subtle shifts in the stock's trend.

Moving averages and the

MACD are examples of trend following, or "lagging," indicators. These indicators are superb when prices move in relatively long trends. They don't warn you of upcoming changes in prices, they simply tell you what prices are doing (i.e., rising or falling) so that you can invest accordingly. Trend-following indicators have you buy and sell late, and, in exchange for missing the early opportunities, they

greatly reduce your risk by keeping you on the right side of the market.

The QQQQ example chart in [Figure 12.1](#) shows the MACD indicator in the lower panel.

FIGURE 12.1 QQQQ Daily Chart

QQQQ (PowerShares QQQ Trust) Nasdaq GM   @StockCharts.com
3-Apr-2009   Op 31.83 Hi 32.18 Lo 31.61 Cl 32.13 Vol 135.5M Chg +0.59 (+1.86%) ▲
QQQQ (Daily) 32.13

MACD(12,26,9) 0.798, 0.535, 0.263

MACD-Histogram

MACD

Signal Line

■ MACD Formula

The most popular formula for the MACD is the difference between a security's 26-day and 12-day EMAs.

Of the two moving averages that make up MACD, the 12-day EMA is the faster, and the 26-day EMA is the slower. Closing

prices are used to form the moving averages. Usually, a 9-day EMA of MACD is plotted alongside to act as a trigger line. A bullish crossover occurs when MACD moves above its 9-day EMA, and a bearish crossover occurs when MACD moves below its 9-day EMA.

The histogram is positive when MACD is above its 9-

day EMA and negative when MACD is below its 9-day EMA.

Interpretation

MACD is a trend following indicator and is designed to identify trend changes. It's generally not recommended for use in ranging market conditions. Three types of trading signals are generated:

- MACD line crossing the signal line.

- MACD line crossing zero.
- Divergence between price and MACD levels.

The signal-line crossing is the usual trading rule. This is to buy when the MACD crosses up through the signal line, or sell when it crosses down through the signal line. When the MACD line crosses through zero on the histogram, it is said that the

MACD line has crossed the signal line. The histogram can also help visualizing when the two lines are coming together. A crossing of the MACD line up through zero is interpreted as bullish, or down through zero as bearish.

Positive divergence between MACD and price arises when price makes a new selloff low, but the MACD doesn't make a new

low (i.e., it remains above where it fell to on that previous price low). This is bullish, suggesting that the downtrend may be nearly over. Negative divergence is when price makes a new rally high, but MACD doesn't rise as high as before, this is bearish.

In Figure 12.2, the MACD line is in negative territory as the 12-day EMA trades below

the 26-day EMA. The initial cross occurred at the end of September (arrow) and the MACD moved further into negative territory as the 12-day EMA diverged further from the 26-day EMA. The other area shows a period of positive MACD values, which is when the 12-day EMA was above the 26-day EMA.

FIGURE 12.2 Home Depot

(HD) Daily Chart with MACD Crossovers
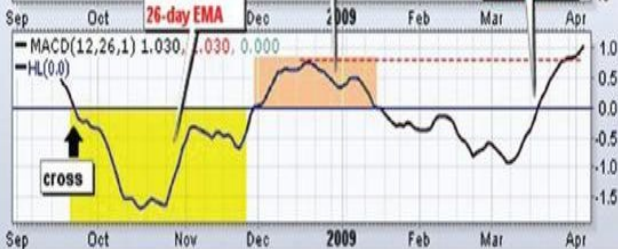
■ Signal-Line Crossovers

Signal-line crossovers are the primary cues provided by the MACD. The standard interpretation is to buy when the MACD line crosses up through the signal line, or sell when it crosses down through the signal line.

The upward move is called

a bullish crossover and the downward move a bearish crossover. Respectively, they indicate that the trend in the stock is about to accelerate in the direction of the crossover.

The histogram shows when a crossing occurs. Since the histogram is the difference between the MACD line and the signal line, when they cross there is no difference between them.

The histogram can also help in visualizing when the two lines are approaching a crossover. Though it may show a difference, the changing size of the difference can indicate the acceleration of a trend. A narrowing histogram suggests a crossover may be approaching, and a widening histogram suggests that an ongoing trend is likely to get even stronger.

While it is theoretically possible for a trend to increase indefinitely, under normal circumstances, even stocks moving drastically will eventually slow down, lest they go up to infinity or down to nothing.

Figure 12.3 shows IBM with its 12- and 26-day EMAs in the upper section and the 12,26,9 MACD in the indicator window. There were

eight signal line-crossovers in six months: four up and four down. There were some good signals and some bad signals. The upper section of the bottom panel area highlights a period when the MACD line surged above 2 to reach a positive extreme. There were two bearish signal-line crossovers in April and May, but IBM continued trending higher. Even though upward momentum slowed after the

surge, upward momentum was still stronger than downside momentum in April–May. The third bearish signal-line crossover in May resulted in a good signal.

FIGURE 12.3 International Business Machines (IBM) Daily Chart Showing Signal-Line Crossovers

IBM (International Business Machines) NYSE   ©StockCharts.com
10-Jul-2009   Op 98.61   Hi 99.34   Lo 97.47   Cl 98.47   Vol 7.6M   Chg -1.22 (-1.22%) ▼

IBM (Daily)

8 signal line crosses in six months

12-day EMA

26-day EMA

MACD
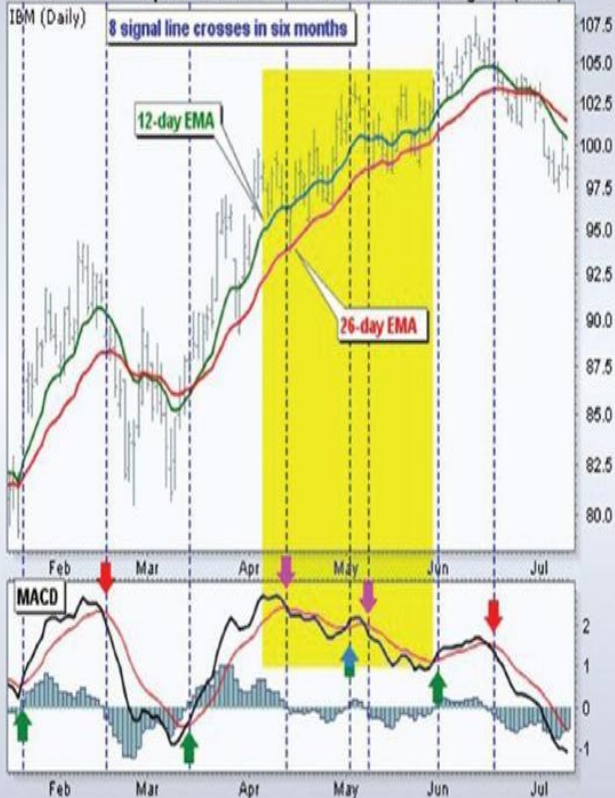
■ Zero or Center-Line Crossovers

A crossing of the MACD line through zero happens when there is no difference between the fast and slow EMAs. A move from positive to negative is bearish and from negative to positive, bullish.

Zero crossovers provide evidence of a change in the direction of a trend but less confirmation of its momentum than a signal-line crossover.

Center-line crossovers are the next most common MACD signals. A bullish center-line crossover occurs when the MACD line moves above the zero line to turn positive. This happens when

the 12-day EMA of the underlying security moves above the 26-day EMA. A bearish center-line crossover occurs when the MACD moves below the zero line to turn negative. This happens when the 12-day EMA moves below the 26-day EMA.

Center-line crossovers can last a few days or a few months. It all depends on the strength of the trend. The

MACD will remain positive as long as there is a sustained uptrend. The MACD will remain negative when there is a sustained downtrend.

[Figure 12.4](#) shows Pulte Homes (PHM) with at least four center-line crosses in nine months. The resulting signals worked well because strong trends emerged with these center-line crossovers.

FIGURE 12.4 Pulte Homes

(PHM) Daily Chart

PHM (PulteGroup, Inc.) NYSE @StockCharts.com
2-Feb-2010 4:00pm O 10.82 H 11.41 L 10.81 Last 11.35 V 11.0M Chg +0.79 (+7.48%) ▲
PHM (Daily)

26-day EMA

12-day EMA

MACD (12,26,9)
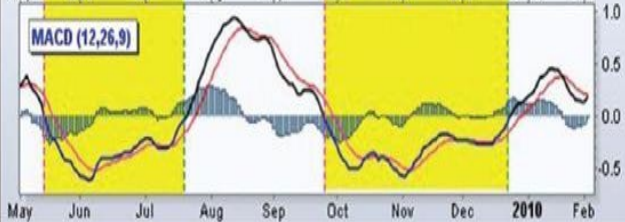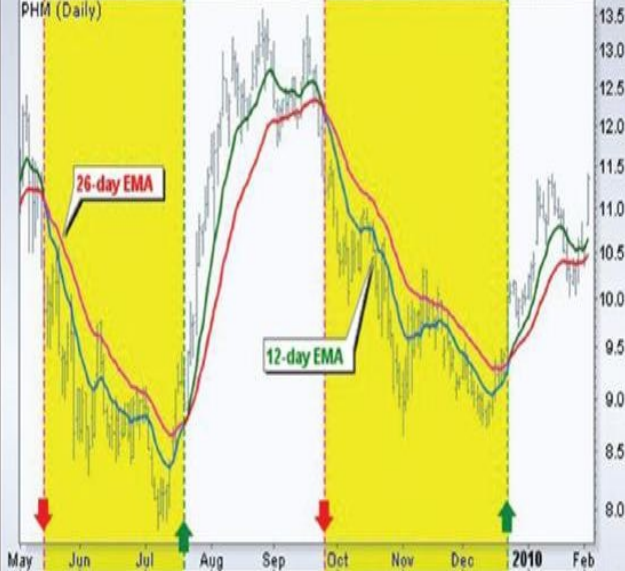
Figure 12.5 is a chart of Cummins Inc. (CMI) with seven center-line crossovers in five months. In contrast to Pulte Homes, these signals would have resulted in numerous whipsaws because strong trends did not materialize after the crossovers.
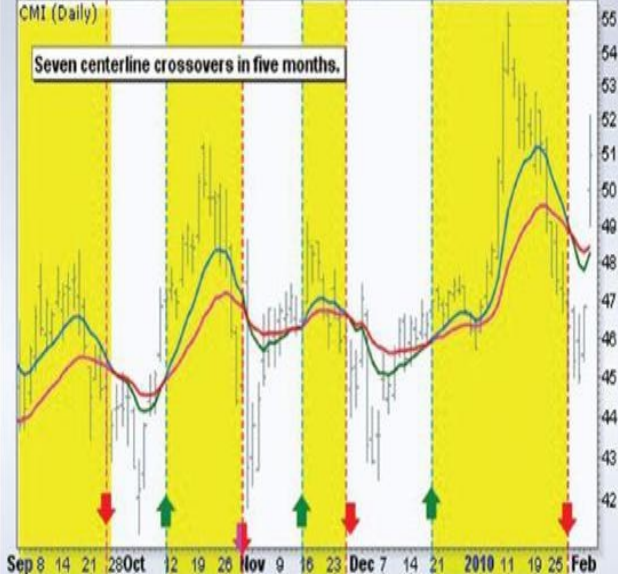
FIGURE 12.5 Cummins Inc. (CMI) Daily Chart with Crossovers

CMI (Cummins Inc.) NYSE © StockCharts.com
2-Feb-2010 4:00pm Op 50.00 Hi 52.10 Lo 48.97 Last 50.93 Vol 8.4M Chg +4.14 (+8.84%) ▲
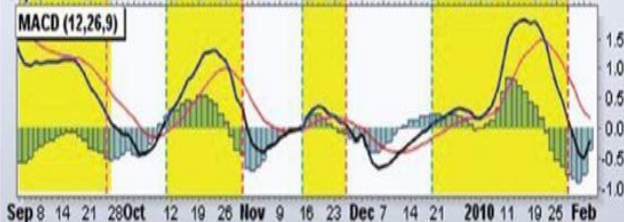
CMI (Daily)

Seven centerline crossovers in five months.

MACD (12,26,9)

Figure 12.6 shows 3M (MMM) with a bullish center-line crossover in late March 2009 and a bearish center-line crossover in early February 2010. This signal lasted 10 months. In other words, the 12-day EMA was above the 26-day EMA for 10 months. This was one strong trend.

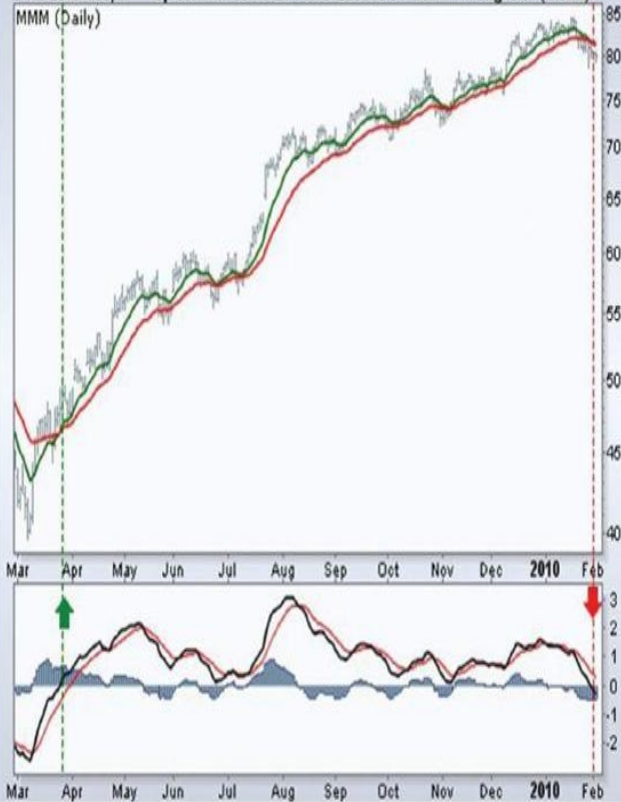FIGURE 12.6 3M Co. (MMM) Daily Chart Displaying Bullish Center-

Line Crossover

MMM (3M Co.) NYSE
2-Feb-2010 4:00pm Op 80.17 Hi 80.41 Lo 79.18 Last 79.91 Vol 4.7M Chg -0.01 (-0.01%) ▼

MMM (Daily)

©StockCharts.com

■ **False Signals**

Like any forecasting algorithm, the MACD can generate false signals. A false positive, for example, would be a bullish crossover followed by a sudden decline in a stock. A false negative would be a situation where there was no bullish crossover, yet the stock accelerated suddenly upward.

A prudent strategy would be to apply a filter to signal-line crossovers to ensure that they will hold. An example of a price filter would be to buy if the MACD line breaks above the signal line and then remains above it for three days. As with any filtering strategy, this reduces the probability of false signals but increases the frequency of missed profit.

Analysts use a variety of approaches to filter out false signals and confirm true ones.

■ **Divergences and Loss of Momentum**

In general, a divergence occurs when the trend of a security's price doesn't agree with the trend of an indicator. MACD divergences form when the MACD diverges from the price action of the

underlying security. A bullish divergence forms when a security records a lower low and the MACD forms a higher low. The lower low in the security affirms the current downtrend, but the higher low in the MACD shows less downside momentum. Despite less downside momentum, downside momentum is still outpacing upside momentum as long as the MACD remains

in negative territory. Slowing downside momentum can sometimes foreshadow a trend reversal or a sizable rally.

Figure 12.7 shows Google (GOOG) with a bullish divergence in October–November 2008. First, notice that we are using closing prices to identify the divergence. Second, notice that there were clear reaction

lows (troughs) as both Google and its MACD line bounced in October and late November. Third, notice that the MACD formed a higher low as Google formed a lower low in November. The MACD turned up with a bullish divergence with a signal-line crossover in early December. Google confirmed a reversal with resistance breakout.

FIGURE 12.7 Google (GOOG) Daily Chart Showing MACD Positive or Bullish Divergence

In Figure 12.8, we see Gamestop (GME) with a large bearish divergence from August to October. The stock forged a higher high above 28, but the MACD line fell short of its prior high and formed a lower high. The subsequent signal-line crossover and support break in the MACD were bearish. On the price chart, notice how broken support turned

into resistance on the throwback bounce in November. This throwback provided a second chance to sell or sell short.
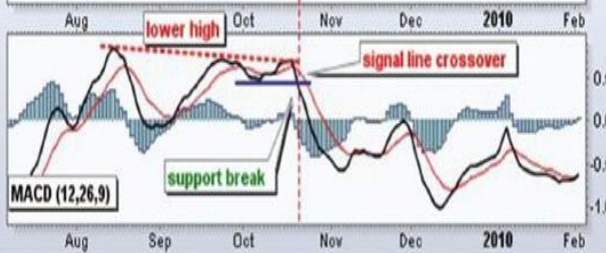
FIGURE 12.8 Gamestop (GME) Daily Chart Displaying Bearish Divergence

Divergences should be taken with caution. Bearish divergences are commonplace in a strong uptrend, while bullish divergences occur often in a strong downtrend. Uptrends often start with a strong advance that produces a surge in upside momentum (MACD). Even though the uptrend continues, it continues at a slower pace

that causes the MACD to decline from its highs. Upside momentum may not be as strong, but upside momentum is still outpacing downside momentum as long as the MACD line is above zero. The opposite occurs at the beginning of a strong downtrend.

Figure 12.9 shows the S&P 500 exchange-traded fund (SPY) with four bearish

divergences from August to November 2009. Despite less upside momentum, the exchange-traded fund (ETF) continued higher because the uptrend was strong. Notice how SPY continued its series of higher highs and higher lows. Remember, upside momentum is stronger than downside momentum as long as its MACD is positive. Its MACD (momentum) may have been less positive

(strong) as the advance extended, but it was still largely positive.

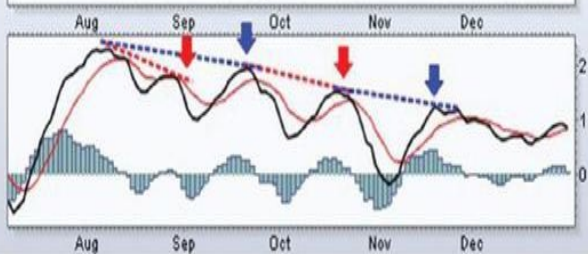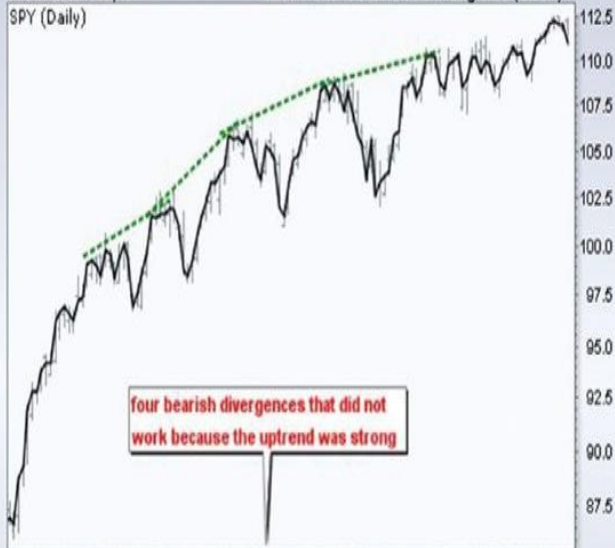FIGURE 12.9 S&P 500 SPDRS (SPY) Daily Chart with Bearish Divergences

SPY (S&P 500 SPDRs) NYSE — © StockCharts.com
31-Dec-2009 4:00pm — Last **110.98** Volume **90.6M** Chg **-1.08 (-0.96%)** ▼
SPY (Daily)

four bearish divergences that did not work because the uptrend was strong

■ **Conclusions**

The MACD indicator is especially useful because it brings together momentum and trend in one indicator. This blend of trend and momentum can be applied to daily, weekly, or monthly charts. The standard setting for MACD is the difference between the 12- and 26-period EMAs. Chartists

looking for more sensitivity may try a shorter short-term moving average and a longer long-term moving average. MACD (5,35,5) is more sensitive than MACD (12,26,9) and might be better suited for weekly charts. Chartists looking for less sensitivity may consider lengthening the moving averages. A less sensitive MACD will still oscillate above/below zero, but the

center-line crossovers and signal-line crossovers will be less frequent.

The MACD is not particularly good for identifying overbought and oversold levels. Even though it is possible to identify levels that are historically overbought or oversold, the MACD does not have any upper or lower limits to bind its movement. During sharp

moves, the MACD can continue to overextend beyond its historical extremes.

Also, remember that the MACD line is calculated using the actual difference between two moving averages. This means MACD values are dependent on the price of the underlying security. The MACD values for $20 stocks may range

from −1.5 to 1.5, while the MACD values for $100 stocks may range from −10 to +10.

Bollinger Bands

Developed by John Bollinger, Bollinger Bands® are volatility bands placed above and below a moving average. Volatility is based on the standard deviation, which changes as volatility increases and decreases. The bands automatically widen when volatility increases and narrow when volatility decreases. This dynamic nature of Bollinger Bands

also means they can be used on different securities with the standard settings. For signals, Bollinger Bands can be used to identify M tops and W bottoms or to determine the strength of the trend.

Bollinger Bands and the related indicators %b and bandwidth can be used to measure the "highness" or "lowness" of the price

relative to previous trades. Bollinger Bands are a volatility indicator similar to the Keltner channel.

Bollinger Bands consist of:

- An N-period moving average (MA).

- An upper band at K times an N-period standard deviation above the moving average (MA + Kσ).

- A lower band at K

times an N-period standard deviation below the moving average (MA − Kσ).

Typical values for N and K are 20 and 2, respectively. The default choice for the average is a simple moving average (SMA), but other types of averages can be employed as needed. Exponential moving averages (EMAs) are a common

second choice. Usually, the same period is used for both the middle band and the calculation of standard deviation.

Interpretation

The use of Bollinger Bands varies widely among traders. Some traders buy when price touches the lower Bollinger Band and exit when price touches the moving average in the center of the bands. Other traders buy when price breaks above the upper

Bollinger Band, or sell when price falls below the lower Bollinger Band. Moreover, the use of Bollinger Bands is not confined to stock traders; options traders, most notably implied volatility traders, often sell options when Bollinger Bands are historically far apart or buy options when the Bollinger Bands are historically close together, in both instances expecting volatility to revert

toward the average historical volatility level for the stock.

When the bands lie close together, a period of low volatility is indicated. Conversely, as the bands expand, an increase in price action/market volatility is indicated. When the bands have only a slight slope and print approximately parallel for an extended time, the price will generally be found

to oscillate between the bands as though in a channel.

Traders are often inclined to use Bollinger Bands with other indicators to confirm price action. In particular, the use of an oscillator like Bollinger Bands will often be coupled with a nonoscillator indicator like chart patterns or a trend line. If these indicators confirm the recommendation of the

Bollinger Bands, the trader will have greater conviction that the bands are predicting correct price action in relation to market volatility.

In the S&P 500 (SPY) example in [Figure 13.1](#) you will see normal Bollinger Band settings. Settings can be adjusted to suit the characteristics of particular securities or trading styles. Bollinger recommends

making small incremental adjustments to the standard deviation multiplier. Changing the number of periods for the moving average also affects the number of periods used to calculate the standard deviation. Therefore, only small adjustments are required for the standard deviation multiplier. An increase in the moving average period would

automatically increase the number of periods used to calculate the standard deviation and would also warrant an increase in the standard deviation multiplier. With a 20-day SMA and 20-day standard deviation, the standard deviation multiplier is set at 2. Bollinger suggests increasing the standard deviation multiplier to 2.1 for a 50-period SMA and decreasing the standard

deviation multiplier to 1.9 for a 10-period SMA.

FIGURE 13.1 S&P 500 SPDRS (SPY) Daily Candlestick Chart Displaying Normal Bollinger Band Settings

SPY (S&P 500 SPDRs) NYSE @StockCharts.com
30-Jun-2009 4:00pm O 91.41 H 91.74 L 89.98 Last 90.65 V 232.1M Chg -0.74 (-0.81%) ▼

SPY (Daily) 90.65
BB(20,2.0) 87.95 - 91.05 - 94.15

Upper Band

20-day SMA

Lower Band

SPY on June 30, 2009
20-day SMA = 91.05
20-day Standard Deviation = 1.55
Upper Band = 91.05 + (1.55 x 2) = 94.15
Lower Band = 91.05 - (1.55 x 2) = 87.95

STDDEV(20) 1.55

■ Signal: W Bottoms

Bollinger uses various patterns with Bollinger Bands to identify W bottoms. A "W bottom" forms in a downtrend and involves two reaction lows. Bollinger especially looks for W bottoms where the second low is lower than the first, but

holds above the lower band. There are four steps to confirm a W bottom with Bollinger Bands. First, a reaction low forms. This low is usually, but not always, below the lower band. Second, there is a bounce toward the middle band. Third, there is a new price low in the security. This low holds above the lower band. The ability to hold above the lower band on the test shows

less weakness on the last decline. Fourth, the pattern is confirmed with a strong move off the second low and a resistance break.

Figure 13.2 shows Nordstrom (JWN) with a W bottom in January–February 2010. First, the stock formed a reaction low in January and broke below the lower band. Second, there was a bounce back above the middle band.

Third, the stock moved below its January low and held above the lower band. Even though the February 5 spike low broke the lower band, Bollinger Bands are calculated using closing prices, so signals should also be based on closing prices. Fourth, the stock surged with expanding volume in late February and broke above the early February high.

FIGURE 13.2 Nordstrom (JWN) with a W Bottom in January–February 2010

JWN (Nordstrom, Inc.) NYSE @StockCharts.com
23-Apr-2010 4:00pm Op 45.33 Hi 45.97 Lo 45.05 Last 45.90 Vol 3.4M Chg +0.56 (+1.24%)

W JWN (Daily) 45.90
— BB(20,2.0) 40.14 - 42.64 - 45.13

breakout

W Bottom

Volume 3,373,267
— MA(200) 3,827,646

volume

In [Figure 13.3](#) Sandisk (SNDK), the stock first formed a reaction low in June (blue arrow) and broke below the lower band. Second, there was a bounce back to the middle band. Third, the stock moved below its January low and held above the lower band. Even though the June spike low broke the lower band, Bollinger Bands are calculated using closing

prices so signals should also be based on closing prices. Fourth, the stock surged with expanding volume in July and broke above the late June high.

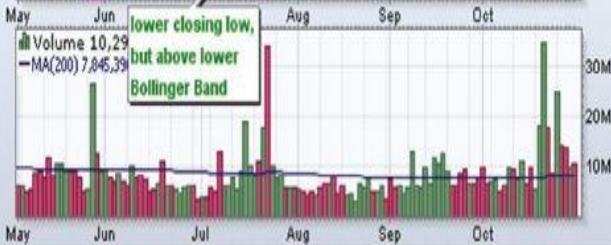FIGURE 13.3 Sandisk (SNDK) displays a smaller W Bottom in July–August 2009

■ Signal: M Tops

Bollinger uses these various M patterns with Bollinger Bands to identify M bottoms. However, Bollinger tops are usually more complicated and drawn out than bottoms. Double tops, head-and-shoulders patterns, and diamonds represent evolving

tops.

Generally an M top is similar to a double top. However, the reaction highs are not always equal. The first high can be higher or lower than the second high. Bollinger suggests looking for signs of nonconfirmation when a security is making new highs. This is basically the opposite of the W bottom. A nonconfirmation occurs

with three steps. First, a security forges a reaction high above the upper band. Second, there is a pullback toward the middle band. Third, prices move above the prior high but fail to reach the upper band. This is a warning sign. The inability of the second reaction high to reach the upper band shows waning momentum, which can foreshadow a trend reversal. Final confirmation comes

with a support break or bearish indicator signal.

Figure 13.4 shows Exxon Mobil (XOM) with an M top in April–May 2008. XOM moved above the upper band in April. There was a pullback in May and then another push above 90. Even though the stock moved above the upper band on an intraday basis, it did not close above the upper band. The M

top was confirmed with a support break two weeks later. Also notice that moving average convergence/divergence (MACD) formed a bearish divergence and moved below its signal line for confirmation.

FIGURE 13.4 Exxon Mobil (XOM) with an M Top in April–May 2008

XOM (Exxon Mobil Corp.) NYSE
1-Oct-2008   Op 73.50 Hi 75.44 Lo 71.35 L ...g +0.88 (+1.18%) ▲

© StockCharts.com

XOM (Daily)

close did not exceed
upper Bollinger Band

M-Top

support
break

bearish
divergence

Figure 13.5 shows Pulte Homes (PHM) within an uptrend in July–August 2008. PHM's price exceeded the upper band in early September to confirm the uptrend. After a pullback below the 20-day SMA (middle Bollinger Band), the stock moved to a higher high above 17. Despite this new high for the move, price did not exceed the upper band.

This flashed a warning sign. The stock broke support a week later, and MACD moved below its signal line. This top formed a small head-and-shoulders pattern.

FIGURE 13.5 Pulte Homes (PHM) within an Uptrend in July–August 2008

■ Signal: Walking the Bands

Moves above or below the bands are not necessarily signals. John Bollinger indicated that moves that touch or exceed the bands are not signals, but rather "tags." Moves to the upper band

show strength, while a sharp move to the lower band shows weakness. Momentum oscillators work much the same way. Overbought is not necessarily bullish. It takes strength to reach overbought levels and overbought conditions can extend in a strong uptrend. Similarly, prices can "walk the band" with numerous touches during a strong uptrend. An upper band touch that occurs

after a Bollinger Band confirmed W bottom could signal the start of an uptrend. Just as a strong uptrend produces numerous upper band tags, it is also common for prices to never reach the lower band during an uptrend. The 20-day SMA sometimes acts as support. Dips below the 20-day SMA can often provide buying opportunities before the next tag of the upper band.

Figure 13.6 shows Air Products (APD) with a surge and close above the upper band in mid-July. First, a surge that broke above two resistance levels took place. Such a strong upward thrust is a sign of strength, not weakness. The Bollinger Bands then narrowed, but APD did not close below the lower band. Prices, and the 20-day SMA, then turned up in September. APD managed

to close above the upper band at least five times over a four-month period. The lower indicator window displays a 10-period commodity channel index (CCI). Dips below –100 read as oversold, and moves back above –100 signal the start of an oversold bounce. The upper band tag and breakout starts the uptrend. CCI then identified tradable pullbacks with dips below –100. This is an

example of combining Bollinger Bands with a momentum oscillator for trading signals.

FIGURE 13.6 Air Products (APD) with a Surge and Close above the Upper Band in Mid-July

APD (Air Products and Chemicals, Inc.) NYSE — @StockCharts.com
31-Dec-2009 Op 81.61 Hi 81.78 Lo 80.45 Cl 80.53 Vol 386.8K Chg -1.17 (-1.43%)

APD (Daily) 80.53
BB(20,2.0) 79.48 · 80.82 · 82.16

closes above
upper band

close below
low band

CCI(10) 37.06

oversold

Figure 13.7 shows Monsanto (MON) with a walk down the lower band. MON broke down in January with a break of support and a close below the lower band. From mid-January until early May, MON closed below the lower band at least five times. Also, the stock did not close above the upper band once during this period. The support break and initial close

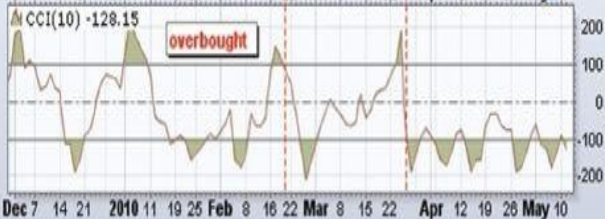below the lower band signaled a downtrend.

FIGURE 13.7 Monsanto (MON) with a Walk Down the Lower Band

MON (Monsanto Co.) NYSE — © StockCharts.com
11-May-2010 Op 58.50 Hi 58.67 Lo 57.35 Cl 57.52 Vol 8.1M Chg -1.84 (-2.77%)

MON (Daily) 57.52
BB(20,2.0) 57.59 - 63.23 - 68.88

closes below lower band

CCI(10) -128.15   overbought

■ **Conclusions**

Bollinger Bands reflect direction with the 20-period SMA and volatility with the upper/lower bands. As such, they can be used to determine if prices are relatively high or low. According to Bollinger, the bands should contain 88 to 89 percent of price action, which makes a move outside the bands significant.

Technically, prices are relatively high when above the upper band and relatively low when below the lower band. However, relatively high should not be regarded as bearish or as a sell signal. Likewise, relatively low should not be considered bullish or as a buy signal. Prices are high or low for a reason. As with other indicators, Bollinger Bands are not meant to be used as a

stand-alone tool. Chartists should combine Bollinger Bands with basic trend analysis and other indicators for confirmation.

22 Rules for Using Bollinger Bands

1. Bollinger Bands provide a relative

definition of high and low. By definition, price is high at the upper band and low at the lower band.

2. That relative definition can be used to compare price action and indicator action to arrive at rigorous buy and sell

decisions.

3. Appropriate indicators can be derived from momentum, volume, sentiment, open interest, intermarket data, and so on.

4. If more than one

indicator is used, the indicators should not be directly related to one another. For example, a momentum

indicator
might
compleme
a volume
indicator
successful
but two
momentur
indicators
aren't
better
than one.
5.

Bollinger Bands can be used in pattern recognition to define/clarify pure price patterns such as "M" tops and "W" bottoms,

momentum shifts, and so on.

6. Tags of the bands are just that—tags, not signals. A tag of the upper Bollinger Band is

not in and of itself a sell signal. A tag of the lower Bollinger Band is not in and of itself a buy signal.

7. In

trending markets, price can, and does, walk up the upper Bollinger Band and down the lower Bollinger Band.

8. Closes

outside the Bollinger Bands are initially continuatio signals, not reversal signals. (This has been the basis for many

successful volatility breakout systems.)

9. The default parameters of 20 periods for the moving average and

standard deviation calculation and two standard deviations for the width of the bands are just that— defaults. The actual

parameters needed for any given market/tas may be different.

10. The average deployed as the middle Bollinger Band should

not be the best one for crossovers. Rather, it should be descriptive of the intermediate-term trend.

11. For consistent price containment:

If the average is lengthened the number of standard deviations needs to be increased from 2 at 20 periods to 2.1 at 50 periods. Likewise, if the average is shortened the number of

standard deviations should be reduced from 2 at 20 periods to 1.9 at 10 periods.

12. Traditional Bollinger Bands are based on a simple moving average. This

is because a simple average is used in the standard deviation calculation and we wish to be logically consistent.

13. Exponential Bollinger Bands

eliminate sudden changes in the width of the bands caused by large price changes exiting the back of the calculation window. Exponential averages must be used both

for the middle band and in the calculation of standard deviation.

14. Make no statistical assumptions based on the use of the standard deviation calculation in

the construction of the bands. The distribution of security prices is non-normal, and the typical sample size in most deployments of Bollinger Bands is too small for statistical

significance. (In practice, we typically find 90 percent, not 95 percent, of the data inside Bollinger Bands with the default parameters.)

15. %b tells us where we are

in relation to the Bollinger Bands. The position within the bands is calculated using an adaptation of the formula for stochastics.

16. %b has many uses; among the

more important are identification of divergences, pattern recognition, and the coding of trading systems using Bollinger Bands.

17. Indicators

can be normalized with %b, eliminating fixed thresholds in the process. To do this, plot 50-period or longer Bollinger Bands on an indicator and then calculate

%b of the indicator.

18. Band Width tells us how wide the Bollinger Bands are. The raw width is normalized using the middle band. Using the default

parameters Band Width is four times the coefficient of variation.

19.   Band Width has many uses. Its most popular use is to identify "The Squeeze," but it is also useful

in identifying trend changes.

20. Bollinger Bands can be used on most financial time series, including equities, indices, foreign exchange, commodities,

futures, options, and bonds.

21. Bollinger Bands can be used on bars of any length—5-minute, 1-hour, daily, weekly, and so on. The key is that the bars must contain

enough activity to give a robust picture of the price-formation mechanism at work.

22. Bollinger Bands do not provide continuous advice; rather,

they help identify setups where the odds may be in your favor.

CHAPTER 14

Position Sizing and Money

Management

After you have learned most or all of the information in the preceding chapters (which may very well take years of trading experience to master), you still need to have guidelines to managing the portfolio and the position sizes. It's my strong belief and experience of observation

and discussions with many traders over the years that even with all the trading prowess and skills a trader might have gleaned or accumulated over a period of time, it's still very important to be able to manage the funds and positions sizes to reduce risk, accumulate a larger capital position, and, most important, protect your capital (my number one rule in trading!).

■ Position Sizing

There are many opinions on how to manage your money when trading and how many positions you should own at any one time. My personal belief from many years of trial and error is that position size certainly depends on portfolio dollar size. My

feeling is that leverage is a key in day and shorter-term trading and that smaller numbers of positions, say three to five or so, probably no more than a half-dozen positions, not only is more manageable but enables larger-size individual positions creating leverage and the ability to scale out of portions of positions when price objectives are met without eliminating the entire

position and possibly missing the "bigger move" over a longer time frame.

One of the biggest complaints I hear from traders is "I sold it too soon and missed a much bigger move." By leveraging your portfolio with a smaller number of positions, you will be able to milk a trend longer by scaling out at objectives, but still keeping a core

portion for the longer haul. By doing this you will be raising cash positions that can be used for new ideas, but after a period of time of doing this, you'll find that adding new positions defeats the leverage theory because the capital is becoming spread over more and perhaps too many positions for a short-term trader to properly manage.

This is obviously different than an investor with a large dollar amount in his portfolio who is more likely longer-term oriented and perhaps more conservative. This type of investor normally wants to "spread the risk" over a larger number of positions. Quite frankly, when you reach a point that your portfolio has grown so large that you become more and possibly too conservative, wanting to

diversify and reduce risk, it can become counterproductive to your trading.

When you realize at that point that your portfolio and investing goals may have transitioned or changed, I strongly suggest reducing the portfolio dollar size and perhaps putting some with professional money managers or mutual funds for your

longer-term retirement or even further diversifying in real estate or high-income instruments. I have found that one of the best approaches to keep the trading portfolio size in check and retain its manageability is to constantly peel off dollar portions, especially on the most successful trades, not only as a way of rewarding yourself for a trading job well done but as a way of building your

retirement plan. It's a twofold purpose that has worked for many bright individual traders I've known over the years. It keeps your trading portfolio size in check and more manageable and, at the same time, constantly increases your retirement plan size for the long haul.

I want to emphasize that no matter how large your trading portfolio may be, you may

want to seriously consider limiting the number of stock positions and keeping larger amounts in each to create leverage and flexibility when price objectives are met, enhancing your ability to maximize your trading profits.

■ The Stop-Loss as a Money Management Tool

Most of my subscribers and loyal followers are aware of my philosophy that before entering a position you must

know where to place your stop-loss entry. As stated earlier, my number one rule of investing is "protection of your trading capital position." The easiest way of doing that is by setting a stop-loss based on the possible violation of various technical charting parameters we discussed in earlier chapters.

When more than one or even several of those support

or resistance points on the charts are violated, especially with a dramatic pickup in volume, it's likely time to act. However, I would like to warn all of you not to rely on your ability to act once the stock has made it move, as your emotions and/or judgment can be swayed, misinformed, or misguided. By determining where ahead of time and setting a stop at the time of entry, you will

have done your duty as a disciplined trader and done all you can to properly protect your new position.

Nearly all electronic trading platforms today are quite sophisticated and give you the ability to set multiple stops at different levels. I suggest that larger, more leverageable positions have stops set just below various important chart support

points. This allows you to stay in a partial position should the first stop be taken out and avoids whipsaws or news events that may take you out of your entire position.

However, you must also determine if price and volume action are so severe and technically destructive enough to warrant letting the entire position go. This may

require you to make an educated judgment to remove the remainder of the stops in place and exit the rest of the position because it is readily apparent that a major trend change could be taking place. This action must be done only after careful evaluation of risk going forward without emotional reaction (easier said than done!). The more experienced trader should be able to more easily determine

if this is necessary or called for, but new or amateur traders will likely find this decision to change the course of protective action a much tougher decision. In this case, it may be best to just let your stops do their job. Simply said, at any time a decision may have to be made to change your protective plan and take a different course of action, and you will always need to be flexible in your

decision making based on price/volume action creating severe technical changes calling for possible action.

◼ Raising and Adjusting Stops as Price Progresses

It's certainly important to be monitoring your positions closely and evaluating the chart action at all times. Rising prices and trends will

require you to adjust the stops continuously if they are to have important protective value. A stop not altered as a price rises is most likely useless as a precise portfolio protection tool to maximize your profits and properly protect the position against sudden severe price changes, especially in the opposite direction of the ongoing trend.

My recommendation is to constantly be raising your stops as the trend progresses at a point a bit below where your technical analysis has determined that the next key support may be based on price, trend lines, and moving averages, as I stated in previous chapters. You may also want to decide to scale out partial positions when this occurs, making sure you've adjusted the stops for the

remainder of the position, again at a point below the next technical chart support.

Using this method of scaling your stops will enable you to at least take partial profits, and at the same time enable you to stay in at least part of your position for possible future price progress or extension of the move that's under way. However, you'll obviously have to

accept a smaller profit or larger loss if this method is used and the trend reverses, taking out the lower or secondary stop levels. That's a decision based on what amount of risk you are willing to accept in order for your entire position not to be eliminated. This method can be used on any time frame.

■ The Trailing Stop Method

A popular protective stop-loss tool used by many traders to protect gains and limit losses automatically is the trailing stop. With a trailing stop order, you set a stop price as either a spread in points or a percentage of current market value. The trailing stop offers

a clear advantage in that it is more flexible in nature than a fixed stop-loss. It is an attractive alternative because it allows the trader to continue protecting his capital if the price drops. But as soon as the price increases, the trailing feature kicks in, allowing for an eventual protection of profit while still reducing the risk to capital.

For example, imagine you

purchased 500 shares of a stock at $50 per share; the current price is $57. You want to lock in at least $5 of the per-share profit you've made but wish to continue holding the stock, hoping to benefit from any further increases. To meet your objective, you could place a trailing stop order with a stop value of $2 per share.

In practical terms, here's

what happens: Your order will sit on your broker's books and automatically adjust upward as the price of a common stock increases. As long as the stock keeps rising or holds relatively steady, nothing happens. However, if it turns south and hits your trailing stop, your broker sells and you pocket your profit. It is important to note that the trailing stop only goes up—it never goes down with a

market price.

At the time your trailing stop order is placed, your broker knows to sell the stock if the price falls below $55 ($57 current market price – $2 trailing stop loss = $55 sale price). Imagine that the stock increases steadily to $62 per share; now, your trailing stop order has automatically kept pace and will guarantee at least a $60

sale price ($62 current stock price − $2 trailing stop value = $60 per share sale price). In other words, the trailing stop order will increase in your favor and lock in any gains you've made in the interim. If the stock were to fall to $60, your trailing stop order would convert to a market order for execution, and your shares would be sold and should result in a capital gain of $10 per share.

This method of protection eliminates the need to continuously monitor prices and constantly adjust the stop level after prices increase. The stops will simply be adjusted for you as the prices increases. In the preceding example, once the stock turns lower by $2 or more you are automatically stopped out.

The difficulty with trailing stops and the reason I do not

normally recommend them is knowing how much leeway to give yourself. Frankly, the fault with this system is that the decision on how much the stops should be below the most current price is usually totally arbitrary and lacking in technical reasoning. Yes, the normal stop set below a logical support or confluence of several support points takes more work, but in my experience after nearly 50

years trading, it's much more accurate and worth the time you have to spend analyzing the technicals looking for the technically logical points to set your stops.

However, in any case, my philosophy is that a stop of any kind—be it based on technical analysis of support points or arbitrarily set trailing stops—is better than no stops at all or even

"mental stops," which totally rely on your discipline and ability to pay close attention to price movements and require you to monitor prices constantly.

CHAPTER 15

Swing Trading

It's my observation and belief, as a result of nearly 50 years of active trading, that price and other technical patterns are similar on all time frames. They can be used and analyzed in the same manner, as well. As I have previously and repeatedly stated, I prefer and recommend the use and close monitoring of 1- and 5-minute charts intraday for

day-trading price patterns. On my web site, frequent intraday, live video, webinar update, and chart pattern review sessions are conducted throughout the trading session to closely monitor price and relevant chart pattern development, along with intraday consolidation formation and trend momentum.

Price and related

underlying technical patterns on 15-minute, 60-minute, and daily charts should also be used to assist the trader in determining what effect longer time frame price trends, moving averages, and price support/resistance may have on intraday pattern trading. This will assist you in further determining where targets and stops may be set for your day trade.

I have found over the years that the use of 15-minute, 60-minute, and daily chart time frames are best for analyzing chart patterns in order to find strong, high-probability potential swing trade candidates. It's quite amazing, though, that most of the stocks I've recommended over the years for swing trades started out with a powerful day-trade move that we likely had day traded. The

impressive strength and technical thrust of the move accompanied by strong relative volume probably across key resistance was most likely the reason it came to my attention in the first place. So monitoring those huge daily price/volume percentage surges is certainly an excellent source for discovering potential swing-trade candidates. Just one very strong daily move itself

can and often does initiate an important price move that can last weeks or months.

Holding a stock for longer than just a day trade generally becomes known a swing trade, but there are differing opinions and definitions as to what exactly a "swing trade" is time-wise. Generally, traders consider a swing trade to be anywhere from a few days to a few weeks. My

personal opinion is as little as four to five days to probably a maximum of three to four weeks.

You will often hear swing trading defined as "momentum trading." A swing trade is open longer than a day, but shorter than trend-following trades or buy-and-hold investment strategies. Swing trading also differs from the buy-and-hold

approach to investing. Long-term investors may hold a security through periods of weakness that may last several months or years. Swing traders don't care for such poor performance in the near term. If a security's price is performing poorly, swing traders exit first and ask questions later. Swing traders are nimble and judicious in choosing potential opportunities, and market

timing is critical to swing trading stocks

Swing trading, as opposed to day trading, at least allows you to take a breath. While you still have to watch your stocks to ensure that key levels are not breached, you do not have to watch the tape very closely intraday, which many who are working and not trading for a living just do not have the time or stomach

for. Without offending the swing traders of the world, I would dare to say that you can swing trade on a part-time basis and still turn a profit. You'll probably have much fewer trade decisions to make, but you still need to develop a thorough trading plan with entry, exit, and stop points.

Swing trading can provide for a much larger profit

potential than day trading, which can tend to be hit and run or scalping oriented and beyond. Because your time frame for trading is larger, your profit targets may also be greater. This is where swing trading becomes fun. For example, you can have a set profit target, but because your holding period is much longer than day trading, you actually can let your profits run a bit.

Swing trading does not require you to place trades daily, making it easier for those occupied for most of the trading session due to work or vacations and so on. Generally, trades are placed every few days to two to three weeks. The reason for the lengthier time is that you need to provide the stock the ability to "swing" from one price point to the next. There are times when a stock will

just have a breakaway gap and you will, of course, hold off on the two- to three-week timeline and just let the stock run.

Holding positions for more than a day also has the exact opposite risk profile of day trading. Having less margin to use naturally reduces your risk; however, swing trades expose you to holding positions overnight. For me,

this introduces too much risk relative to day trading. Most news events such as earnings, public relations announcements, or analyst recommendations occur outside of normal trading hours. I personally just cannot risk waking up and seeing that my stock has gapped down 20 percent or more from the previous day's close on a surprise announcement.

Certainly, swing trading also requires you to have more patience, and I clearly do not like to wait for things (type A personality?). You may hold your trade for a few days or weeks. It really depends on how well the stock trends. The periods of time where it is unknown whether I will close the trade out with a profit increase my anxiety levels to a point outside of my comfort zone.

Make a swing trade that's more likely to yield good results by getting to know the following signs of favorable conditions:

Six Criteria to Look for When Choosing Swing Trades

1. The market is on your side. You've determined that the market is

trending in the same
direction you want to
swing trade. (If it isn't,
you may need to find a
different trending market
entirely.)

2. The industry group is
on your side. Stocks tend
to follow their industry
groups up or down. If
the security's industry
group is trending
strongly in the same

direction you want to swing trade, chances are that your trade will be profitable.

3. If you're trend trading, the candidate is moving out of a base. The candidate should be in an existing uptrend or downtrend that has pulled back in the short term.

4. If you're trading

ranges, the candidate has just bounced off of support/resistance with a technical indicator confirmation. Watch for the technical indicator (an oscillator) to generate a buy or sell signal. Divergences between your oscillator and the price action signal higher-confidence trades.

5. The stop-loss level is near your desired execution price. The best swing-trading candidates are those where your emergency exit is nearby. The closer your desired entry price is to your stop-loss level, the less you stand to lose if matters turn ugly.

6. You make a disciplined, not

emotional, decision to allocate the right amount to the trade. Loss is always possible, even with the best swing-trading candidate. Set your position size in accordance with your trading plan, which should put an absolute ceiling on your position size and set a maximum percentage of capital you're willing to lose.

Rules and
Guidelines to

Better Trading

The previous chapters have covered all the technical analysis methods, techniques, and philosophies that I have used and developed over the past nearly 50 years, and I believe they will make you a better and more profitable trader.

Before I conclude, I want

to give you some rules and guidelines to enable you to be a better, more profitable day and swing trader:

1. Know your entry price, exit price, and stop-loss even before you enter the trade in case of a worst-case scenario.

This is rule number one for a reason.

Before you press the "Enter" key, you must know when to get in, when to get out, and what to do if the trade doesn't work out as expected. A stop price is essential if you

want to minimize losses. Knowing when to get in or out will help you to lock in profits, as well as save you from potential disasters and large capital drawdowns.

2. Avoid trading during the first 15 minutes of the market open.

It's very tough to trade in the first 10 to 20 minutes, and it takes years of trading experience and an acquired confidence

level before you should consider trading near the opening. Those first 15 minutes of market action are often panic trades or market orders placed the night before. Novice day

traders should avoid this time period while also looking for reversals.

3. Use limit orders, not market orders.

A market order simply tells your broker to buy or sell at the best available

price. Unfortunately, best doesn't necessarily mean profitable. The drawback to market orders was revealed during the May 2010 "flash crash." When market orders were

triggered on that day, many sell orders were filled at 10, 15, or 20 points lower than anticipated. A limit order, however, lets you control the maximum price you'll pay or the

minimum price at which you'll sell. You set the parameters, which is why limit orders are recommended. Only the most experienced traders with the highest level of

confidence should consider market orders.

4. Rookie traders should avoid using margin.

When you use margin, you are borrowing money from your brokerage to finance all

or part of a trade. Full-time day traders (i.e., pattern day traders) are usually allowed 4:1 intraday margin. For example, with a $30,000 trading account, you'll

be given enough buying power to purchase $120,000 worth of securities. Overnight, however, the margin requirement is still 2:1.

When used

properly, margin can leverage, or increase, potential returns. The problem is that if a trade goes against you, margin will increase losses. One of the reasons that day

trading got a bad name a decade ago was the use of margin—when people cashed in their 401k(s) and borrowed bundles of money to finance their trades. When the bull market

ended in 2000, so did many traders' accounts.

Bottom line: if you are a novice trader, first learn how to day-trade stocks without using margin.

For the experienced

trader, margin can be one of the best vehicles for compounded profits exponentially, so it's very attractive and tempting, but the risk remains at all times, and one must be

disciplined or watch their trading capital rapidly disappear.

5. Have a selling plan.

Many rookies spend most of their time thinking about stocks they want to buy without

considering when to sell. Before you enter the market, you need to know in advance when to exit. "Playing it by ear" is not a selling strategy, nor is hope. As a day trader, you

need set a price target as well as a time target even before you enter your trade.

6. Keep a journal of all your trades.

Many pros swear by their journal, where they keep

records of all their winning and losing trades. Write down what you did right or wrong. Doing so will help you improve as a trader, which is your primary goal. Not

surprisingly, you'll probably learn more from your losers than your winners.

7. Rookie traders should first practice day trading in a paper-trading account for a few weeks.

Although not everyone

agrees that practice trading is important, it can be beneficial to most rookie traders. If you do open a practice account, be sure to trade with a realistic amount of

money. It's not helpful to practice trade with a million dollars if the most you have in your account is $30,000. Also, if you do practice trade, think of it as an educational exercise, not a

game.

8. Learn to unemotionally cut your losses.

Managing losing trades is the key to surviving as a day trader. Although you also want to let your winners run, you can't

afford to let them run for too long and turn against you. Learning how to control losses is essential if you are going to day trade.

9. Be willing to lose before you can win.

Although

many traders can handle winners, controlling losing stocks can be difficult. Many rookies panic at the first hint of losses, and end up making a series of impulsive trades that cost

them money. If you're day trading, you must be willing to accept some losses. The key: knowing in advance what level your protection is (stop-loss).

Although anyone can learn to day trade, few have the discipline to make consistent profits. What trips up many people are their emotions, which is why it's so

important to create a set of flexible rules. Your goal: follow the rules to help keep you on the right side of any trade.

10. Trade strong stocks long in an uptrend; short weak stocks in a downtrend.

Most traders will find it beneficial to trade stocks with a high correlation to the major indexes; stocks that are relatively weak or strong, compared to the index, can

be isolated. This creates an opportunity for the day trader, as he or she can isolate which stocks are likely to provide a better return, given the movement of individual stocks relative

to the index.

When the indexes/market futures are moving higher, traders should look to buy stocks that are moving up more aggressively than the futures. When

the futures pull back, a strong stock will not pull back as much, or may not even pull back at all. These are the stocks to trade in an uptrend, as they lead the market higher and thus provide

more profit potential and lower risk; smaller pullbacks mean less risk.

When the indexes/futures are dropping, short sell stocks that drop more than the

market, percentage-wise. When the futures move higher within the downtrend, a weak stock will not move up as much or will not move up at all. Weak stocks are less risky when in

a "short" position and provide great profit potential when the market is falling.

11. Wait for the pullback/retest.

Trend lines are an approximate visual guide to

where waves in price will begin and end. Therefore, we can use a trend line for entry into the next price wave in the direction of the trend. When entering a long position, buying after

the price moves down toward the trend line and then moves back higher tends to be profitable.

Short selling in a downtrend would be similar. Wait until the price

moves up the downward-sloping trend line, then when the stock begins to move back down, this is when the more probable profitable entry can be made.

These two trend line trade guidelines provide a very low-risk entry, as the purchases are made close to the stop level, which could be several cents below the trend line.

Some final additional guidelines to consider:

Don't commit all your cash at once. In a fast-moving market, opportunities come up all the time. Try to keep some cash on hand to take advantage of those opportunities.

Discover and use hedging techniques. Just because you're bullish

doesn't mean that you can't also put on a bearish position or buy an inverse exchange-traded fund (ETF) for portfolio protection when the markets look weak and headed lower, even intraday. Hedging techniques protect you when the market moves against you.

Use discipline and

patience versus emotion and panic. Part of the human equation in the world of financial markets is that fear and greed can become irrational, short-term drivers of prices. Instead of joining the crowd, watch them to give you an advantage in assessing a stock's price movements. Stick with your plan and use

discipline and patience.

Day and swing traders should ideally trade with the overall trend and patiently wait for low-risk entries to potentially profit from that trend. Trend lines, moving averages, and key support levels should be used as a guide to help traders determine these low-risk

entry points, as well provide potential stop levels. Buying stocks that are stronger than the index in uptrends and shorting stocks that are weaker than the index in downtrends should provide more safety and relative outperformance profits. Don't trade when the trend is unclear. Cash can be king in times of panic.

Don't let the money burn a hole in your pocket! Be patient!

Remember, many of the most successful traders I've known and admired were only in the market 30 to 40 percent of the time. The rest of the time they were being cunningly patient, doing their homework and analysis, holding cash positions, waiting for the next big

opportunity and the right setups to present themselves. Those are the traits of the most successful traders in market history.

CHAPTER
17

38 Steps to Becoming a

Successful Trader

Most traders will identify with this list and should be able to place themselves within these steps. Keep in mind that few people progress through these steps in an orderly fashion. Developing your trading

skills is an iterative process. For example, you may reach step 13 and find that, although you were making money, your basic premise for trading was flawed (you might have been benefiting from the bull market, rather than your own trading prowess and then have been rudely awakened when the market entered a bear phase). You may drop back to step 4 and start "climbing" the steps

again. Having the proper mind-set, attitude, and psychological makeup becomes increasingly important as you progress through the steps. The focus of the earlier steps is on external issues (i.e., developing proficiency in the mechanics of trading), while the focus of the latter steps is on internal issues (i.e., improving ourselves mentally and psychologically,

maturing as traders).

1. We accumulate information—buying books, going to seminars, and researching.

2. We begin to trade with our "new" knowledge.

3. We consistently "donate" and then realize we may need more knowledge or

information.

4. We accumulate more information.

5. We switch the commodities we are currently following.

6. We go back into the market and trade with our "updated" knowledge.

7. We get "beat up" again and begin to lose some of our confidence.

Fear starts setting in.

8. We start to listen to "outside news" and to other traders.

9. We go back into the market and continue to "donate."

10. We switch commodities again.

11. We search for more information.

12. We go back into the market and start to see a

little progress.

13. We get overconfident and the market humbles us.

14. We start to understand that trading successfully is going to take more time and more knowledge than we anticipated.

(Note: Most people will give up at this point, as they realize work is involved.

Keep going.)

15. We get serious and start concentrating on learning a "real" methodology.

16. We trade our methodology with some success but realize that something is missing.

17. We begin to understand the need for having rules to apply our methodology.

18. We take a sabbatical from trading to develop and research our trading rules.

19. We start trading again, this time with rules, and find some success, but overall we still hesitate when we execute.

20. We add, subtract, and modify rules as we see a need to be more

proficient with our rules.

21. We feel we are very close to crossing that threshold of successful trading.

22. We start to take responsibility for our trading results as we understand that our success is in us, not the methodology.

23. We continue to trade and become more

proficient with our methodology and our rules.

24. As we trade, we still have a tendency to violate our rules, and our results are still erratic.

25. We know we are close.

26. We go back and research our rules.

27. We build confidence in our rules and go back

into the market and trade.

28. Our trading results are getting better, but we are still hesitating in executing our rules.

29. We now see the importance of following our rules as we see the results of our trades when we don't follow the rules.

30. We begin to see that

our lack of success is within us (a lack of discipline in following the rules because of some kind of fear), and we begin to work on knowing ourselves better.

31. We continue to trade, and the market teaches us more and more about ourselves.

32. We master our

methodology and our trading rules.

33. We begin to consistently make money.

34. We get a little overconfident and the market humbles us.

35. We continue to learn our lessons.

36. We stop thinking and allow our rules to trade for us (trading becomes

boring but successful), and our trading account continues to grow as we increase our contract size.

37. We are making more money than we ever dreamed possible.

38. We go on with our lives and accomplish many of the goals we have always dreamed of.

ABOUT THE ONLINE VIDEO

Profitable Day and Swing Trading is accompanied by two online videos, which expand on the lessons and

examples presented in the book:

1. Day Trading with Harry Boxer

A video of technical analysis techniques for looking at 1-minute and 5-minute intraday trading charts.

2. Swing Trading with Harry Boxer

A video of technical analysis techniques for

short-term and swing trading.

To get the URL and access code for your online video, please refer to the printed card at the end of this book. If you purchased an e-book, you can find instructions for verifying your purchase and obtaining an access code at the end of this book.

INDEX

A

America-Invest.com
Anika Therapeutics (ANIK)
Appel, Gerald
Applied Micro Circuits (AMCC)
Arrowhead Research (ARWR)
Autozone (AZO)

B

Balance of Power (Worden Brothers)
Bearish crossover

parallel channel with high relative volume

low-volume "ebb"

time frame parameters

Demark, Tom

Divergences and loss of momentum. See also Technical divergences and loss of momentum

E

Early trend development,

Guidelines. See Rules and guidelines

H

Hefter, Richard
Himax Technologies (HIMX)
Histogram
Home Depot (HD) daily chart
Hughes, Neil

I

International Business Machines (IBM)

International Gaming Tech (IGT)
Intraday rising parallel channel with high relative volume

J

Jinko Solar (JKS)

K

Kohls (KKS)
Kongzhong Corporation (KONG)

L

Lane, George C.

Logarithmic or percent scaling

Low-volume "ebb"

M

M tops

Market predictions based on wave patterns

Markwest Energy Partners (MWE)

N

O

Overbought/oversold levels

P

Pandora Media (P)
Patterns
    best
    intraday rising parallel
    channel with high
    relative volume
    low-volume "ebb"
PDC Energy (PDC)
Pennants
Position sizing and money

Q

QQQQ daily chart

R

Regado Biosciences Inc. (RGDO)

Rentech Nitrogen Partners (RNF)

Rockwell Medical (RMTI)

Rules and guidelines

S

Sandisk (SNDK)

Shapiro, Harris

divergences

interpretation

trend confirmation

price trend angle

divergences

underlying technicals

diverging from price

Texas Instruments (TXN)

Theory interpretation

thetechtrader.com

3M (MMM)

Trading session, preparing for analyzing patterns from

V

Valero Energy (VLO)
Ventas (VTR)
Vision China Media (VISN)
Volume Buzz indicator (Worden Brothers)

W

W bottoms
Wave categories, series of
Wave patterns, market predictions based on

Wedges

Worden Brothers

      Balance of Power

      MoneyStream

      Volume Buzz indicator

WUBA

X

XPO Logistics Inc. (XPO)

Y

Yahoo (YHOO)

Z

Zero crossovers
Zhone Technologies (ZHNE)

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Profitable Day and Swing
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