

Active Trading

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Course Notes

by Alan Hull

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Introduction

There are 3 simple rules when it comes to successful share trading;

- 1 Buy a rising share - sell a falling share
- 2 Always use a stop loss that moves up with price activity
- 3 Never risk more than 2% of total capital on any individual trade

Buy a rising share - sell a falling share

This rule is often confused with 'buy low - sell high' which has 85% of share traders buying shares that are going down in price in the hope that they will immediately turn around and start going up. This mistake leads to the sad statistic that 85% of share traders lose money.

'Buy a rising share - sell a falling share' is all about buying into markets that are already rising, which is so painfully obvious that the majority of share traders, ie. 85% of them, don't do it. The reason for this is simple and psychological; human beings are counter-intuitive by nature. So in order to be successful we must be prepared to stop thinking like everybody else.

Always use a stop loss that moves up with price activity

An initial stop loss is a price level that defines the point at which we are ready to admit that the market is not behaving as we would expect and we are prepared to sell. In other words this is the point where we admit that the trade is a failure. All share traders have losing trades and the only fatal failure in the marketplace is the failure to execute one's stop losses.

When the market moves in the direction we expect it to then the price at which we are prepared to sell should move with it, locking in profits. If our stop loss has moved beyond our entry price (the point at which we bought into the market) and we fail to sell if it is triggered, then we are being greedy; this will also prove fatal.

Never risk more than 2% of total capital on any individual trade

The game of coin toss is a fair game of chance where no participant should expect to win or lose over the long term. As global equity markets have risen by an average of 9% per annum for the past 100 years, all share traders should expect to profit by an average of 9% per annum. So why do only 15% of share traders make money? Answer...the ability to survive.

If a participant wishes to remain in a game of coin toss for the long term then they would have to be able to sustain a string of up to 8 consecutive losses. This is because a string of 8 consecutive losses is likely to occur in a game where there are 2 equally possible outcomes.

The same logic applies to the Stockmarket where the majority of share traders in the U.S. in the 1990s had an average life expectancy of only 8 trades. So in order to survive in the marketplace long enough to enjoy the average return of 9% per annum over the long term, it is essential that share traders can sustain an extended string of losses. By only risking 2% of total capital on any individual trade, a share trader can sustain up to 194 consecutive losses.

Active Trading is based on the 3 simple rules of successful share trading

The 'Rate of Annual Return' Indicator

The 'Rate of Annual Return' (ROAR) indicator is used to calculate the annual rate of return of a share given its current rate of climb or fall. It achieves this by calculating the annual increase in price activity and then dividing it by the current share price. The result is then multiplied by 100 to convert it to a percentage.

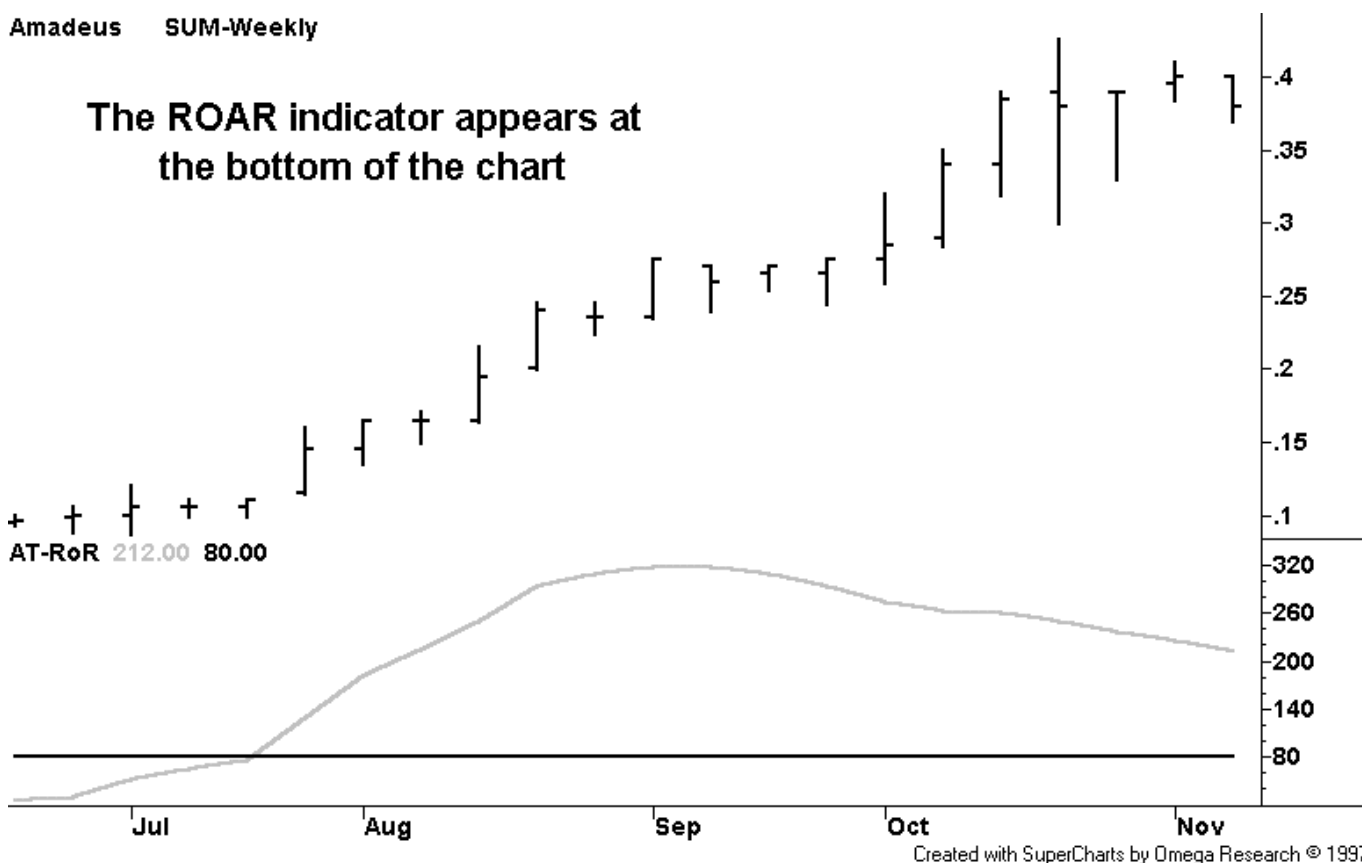
Example

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- Lets assume that a share is climbing at a rate of \$2 per year.
- The current price of the share is \$1.
- The 'Rate of Annual Return' would be 2.0 (\$2 divided by \$1).
- Converting this to a percentage we get $2.0 \times 100 = 200\%$.

The 'Rate of Annual Return' (ROAR) indicator can be seen in the chart below. The ROAR indicator uses linear regression for measuring price activity as opposed to moving averages.

Amadeus SUM-Weekly

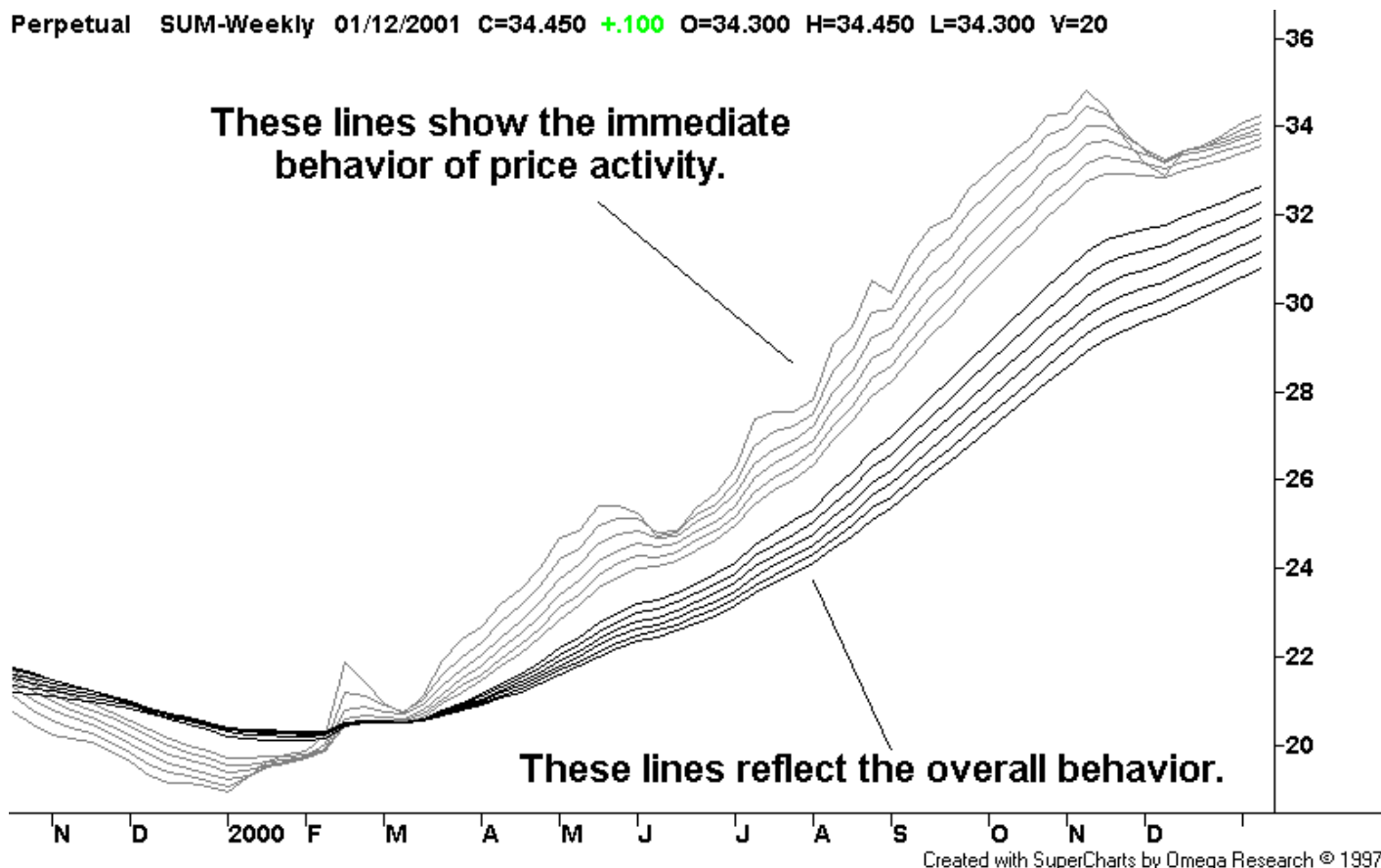


Amadeus is enjoying a rate of annual return of 212% according to the above chart. The horizontal bar placed at 80% is a cutoff level. Searches can be performed using the 'Rate of Annual Return' indicator to sift out shares that only have a rate of annual return higher than the 80% cutoff. The ROAR indicator switches itself 'On' when it detects a trend of at least 80% per annum and money flow of at least \$3.5 Million/4 weeks (Money Flow = Volume x Avg. Price). It automatically switches itself 'Off' if the rate of annual return falls below 80% or the money flow falls below \$5 Million/8 weeks. By using a search indicator that can also test for adequate liquidity (money flow), we avoid having to manually check it later on.

The ROAR indicator is used to generate the values in the weekly ActTrade newsletter.

Multiple Moving Averages

Multiple moving averages, MMAs, are a sophisticated tool that can be used in a range of applications. MMAs are a series of lines that track and filter price movement. They consist of 2 sets of lines that allow Technical Analysts to observe and compare the immediate behavior of price activity with the long term behavior of the price activity. Exponential moving averages are used for this type of analysis. The price bars in the following weekly price chart have been switched off to improve readability of the MMA lines.



Short term group (Grey Lines) - 3, 5, 7, 9, 11 & 13

Long term group (Black Lines) - 21, 24, 27, 30, 33 & 36

We must examine the MMA chart of any share that has an acceptable 'Rate of return' in order to make a qualitative judgement of the trend (Note that all of the MMA charts that appear in the weekly *ActTrade* newsletter have already been tested for a rate of return of at least 80%). We're looking for strong, consistent trends that aren't likely to reverse just after we enter the market. The following points are critical;

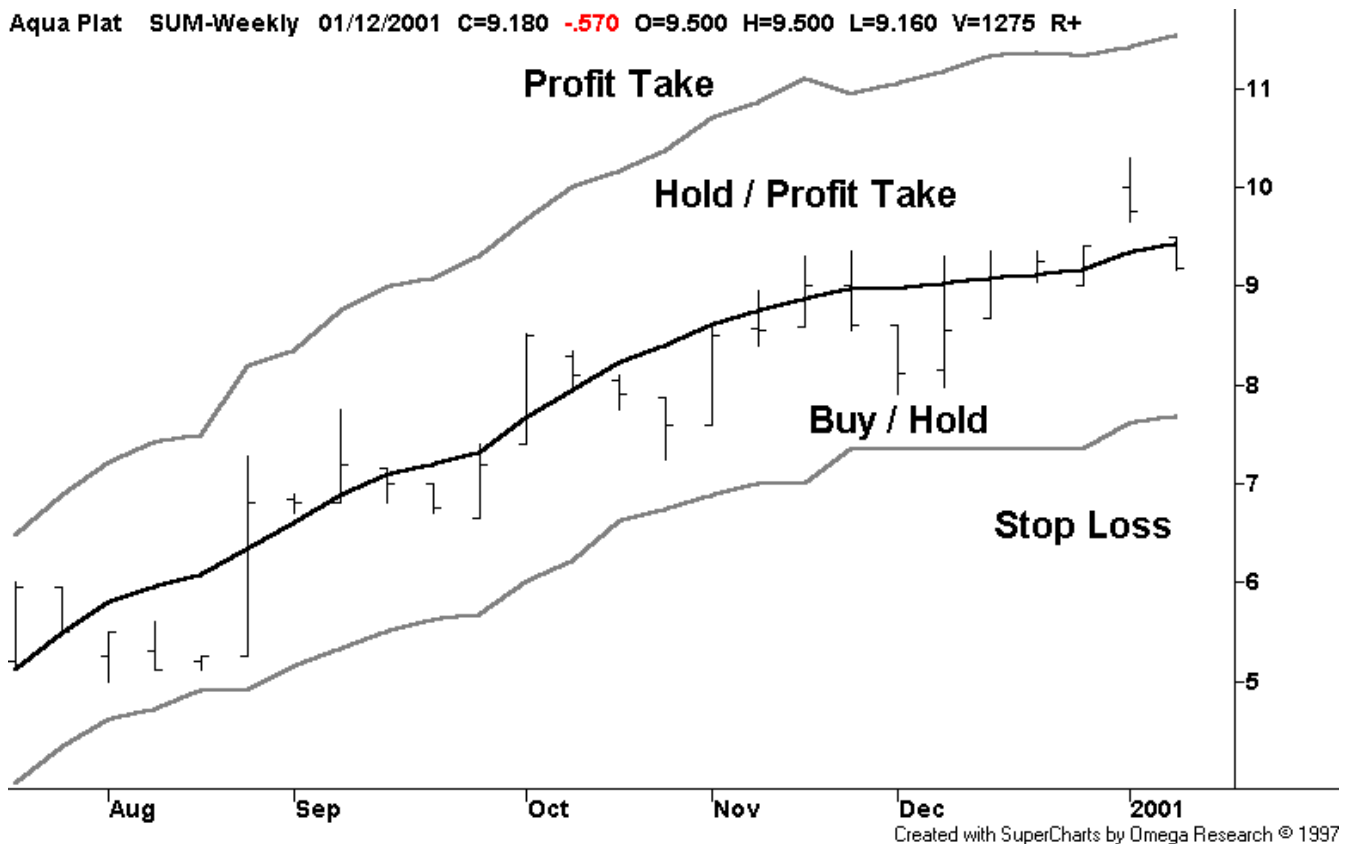
- The long term group must be spreading apart or running parallel with each other.
- The long term group must be pointing upwards.
- The straighter the long term group of lines are; the less volatile the trend is.
- The short term group can pullback (ie. compress together) but they shouldn't come into contact with the long term group of averages

This type of qualitative analysis is only used when entering the market and the idea is to avoid volatility. We want to 'Ride the Trend' and not get bounced in and out of the market.

The Range Indicator

The Range indicator provides us with a series of price ranges that tell us when to buy, sell, hold or profit take. Although simple in construction, it tells us when the price activity is pulling back, rallying up or the trend is reversing. Its construction is based on an electronically generated line that tracks price activity, known henceforth as the central cord. A function called 'Average true range' that measures price volatility is then used to position upper and lower lines based on the central cord. These lines are referred to as the upper deviation line and lower deviation line. These two lines create an envelope that defines our tolerance towards price activity. The central cord, upper deviation and lower deviation lines create four distinct price zones that tell us when to buy, hold, take profit or sell.

The following chart illustrates how the Range indicator is used to set buy, hold & sell zones.



When price trends either up or down it moves in a sawtooth pattern and not a straight line. In an upward trend this behavior is caused by the repetition of a rally/profit-take cycle. As long as the buying force behind the rallies is greater than the selling force behind the profit-taking the trend will continue. Upward trends end when the buying force is exhausted which is an inevitable occurrence. Share Traders often forget that all trends must ultimately end.

By using the range indicator to control our entry and exits we can avoid buying overpriced shares and sell when a trend reversal occurs. Although the Range Indicator is applied to weekly charts, the buy and sell signals are applied primarily on a day-to-day basis.

If price rallies beyond the upper deviation line then there is a heightened probability that it will then fall past the lower deviation line. At this point it is prudent to sell and lock in profit.

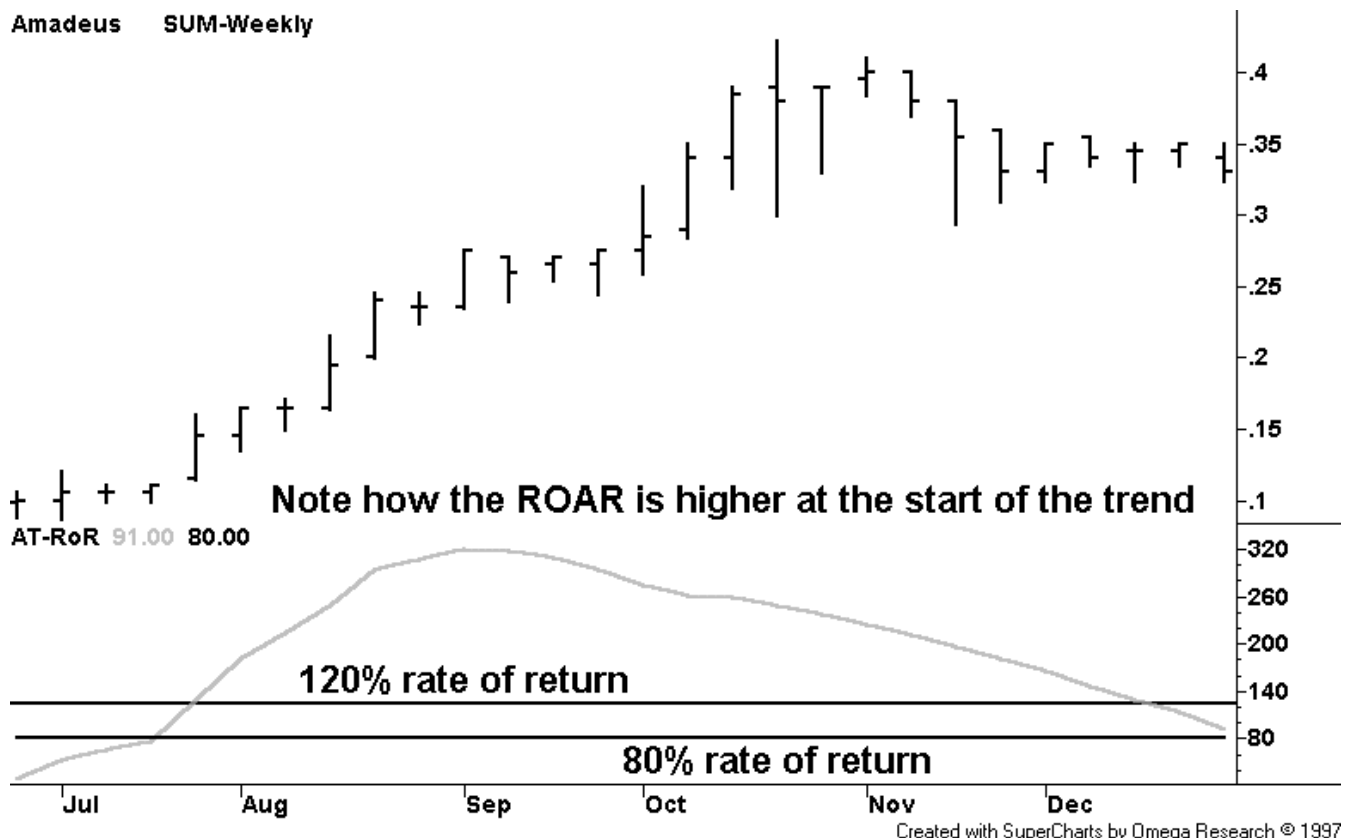
Range indicator values, ie. upper, lower and central lines, are provided in the newsletter.

The Trading Strategy

We want to put a minimum amount of effort into locating and trading shares that are in stable, upward trends. Whilst the analysis is done on a weekly basis, the trading strategy must be implemented on a day to day basis. As Active Traders we need to be prepared to monitor the market on a daily basis or rapid intraweek price movements could prove fatal.

'Rate of Annual Return' Searches

We begin by searching the entire Stockmarket with the ROAR indicator. We hold shares with a rate of annual return of at least 80% per annum but we only buy when the rate of annual return is at least 120%, reducing unwanted whipsawing. (Average ROAR = 100%)



The best point to have entered the above trend was soon after July when it had a rate of return of at least 120% (Our 'Entry' level). As the trend has worn on, the rate of return has dropped due to the rising share price and slowing trend. (The indicator uses the current price to calculate the rate of annual return). By late December it was still acceptable to hold this position (Our 'Hold' level is 80%) but an entry into the market was no longer permissible.

Rule Only enter shares with a ROAR of at least 120%. If a share's ROAR drops below 80% or its money flow drops below \$5 Million/8 weeks then it will disappear from the rising equities list. This is a stop loss (sell) condition and the share must be sold during the next 3 trading days.

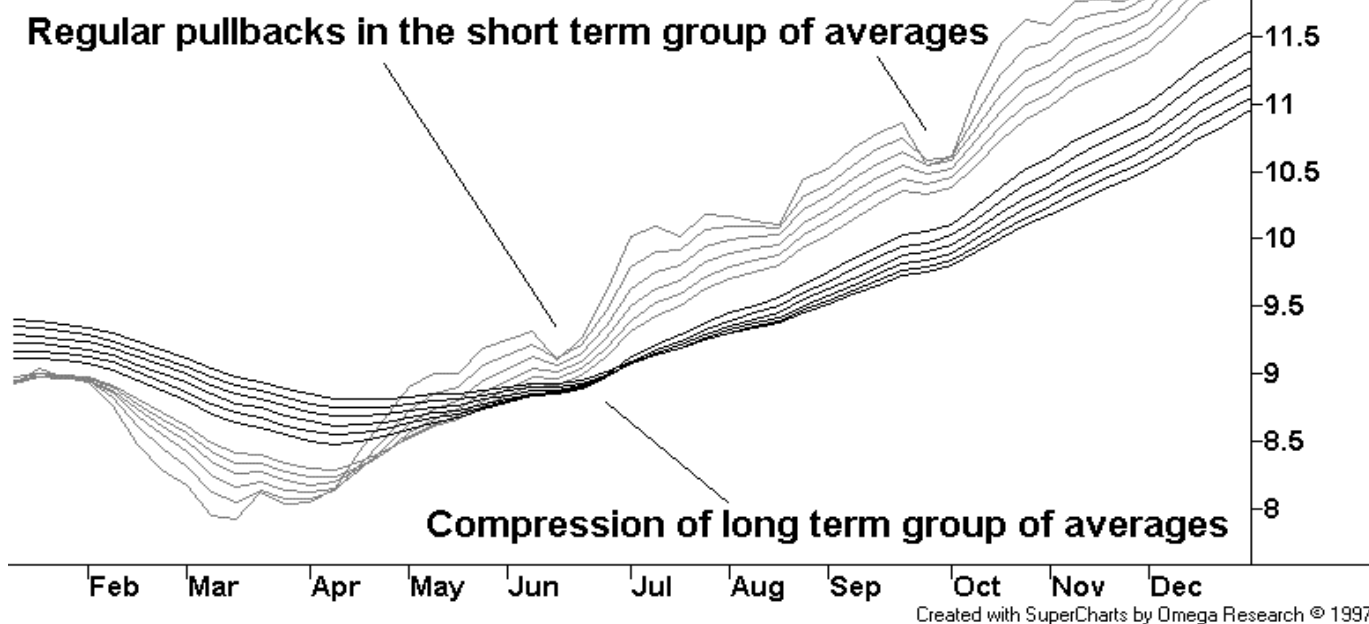
This 120%-plus entry criteria ensures that we are using our capital efficiently and it prevents us from entering worn out trends. Don't fall for the common trap of judging the profitability of a trend by the current share price, 'Rate of Return' is a proportional measurement.

Verifying & evaluating the Trend

The next step is to ensure that the share is in a stable upward trend (in practice, this is one of the very first steps...see page 16 - 'Using the *ActTrade* newsletter for the first time'). In the early stages of a trend the long term set of lines will initially compress and then expand as the trend gets under way. Only enter trends where the long term set of averages has begun moving out of compression. Note that the quality of the trend is central to our success.

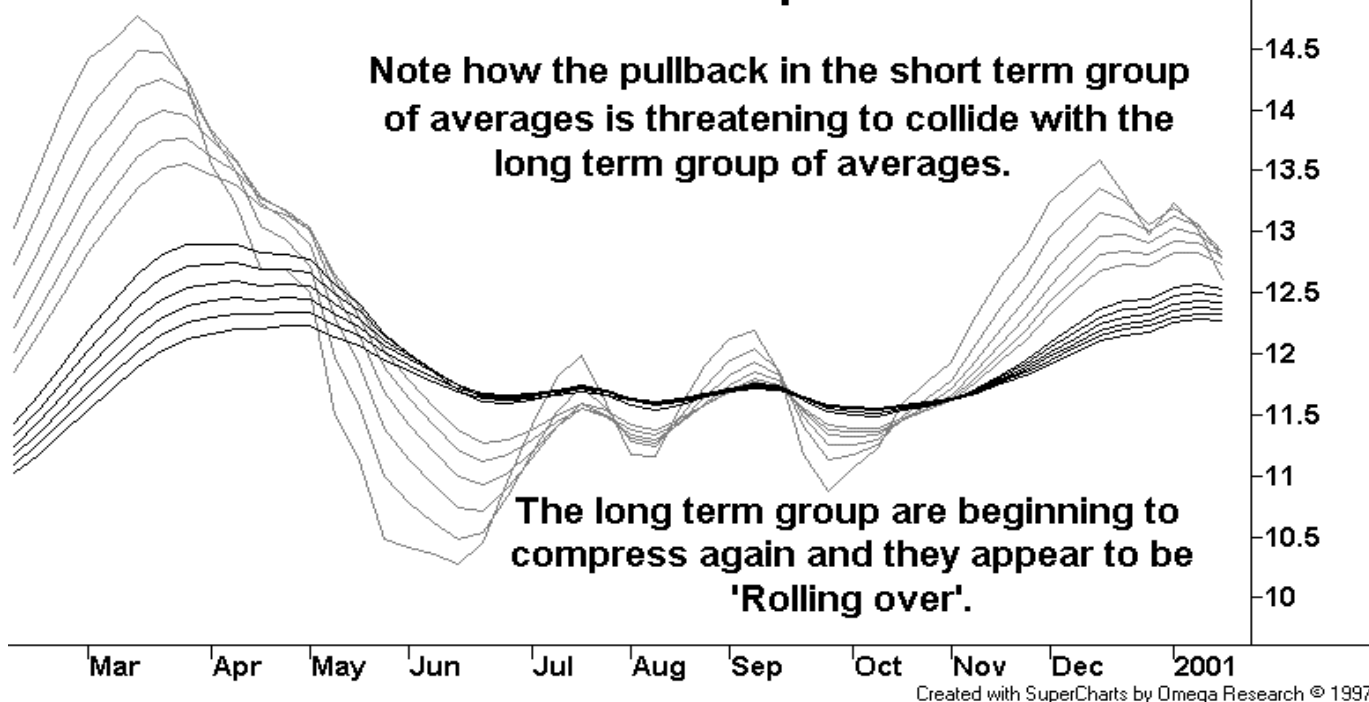
AGL SUM-Weekly 01/19/2001 C=11.730 +.010 O=11.740 H=11.820 L=11.670

This is an acceptable Trend !



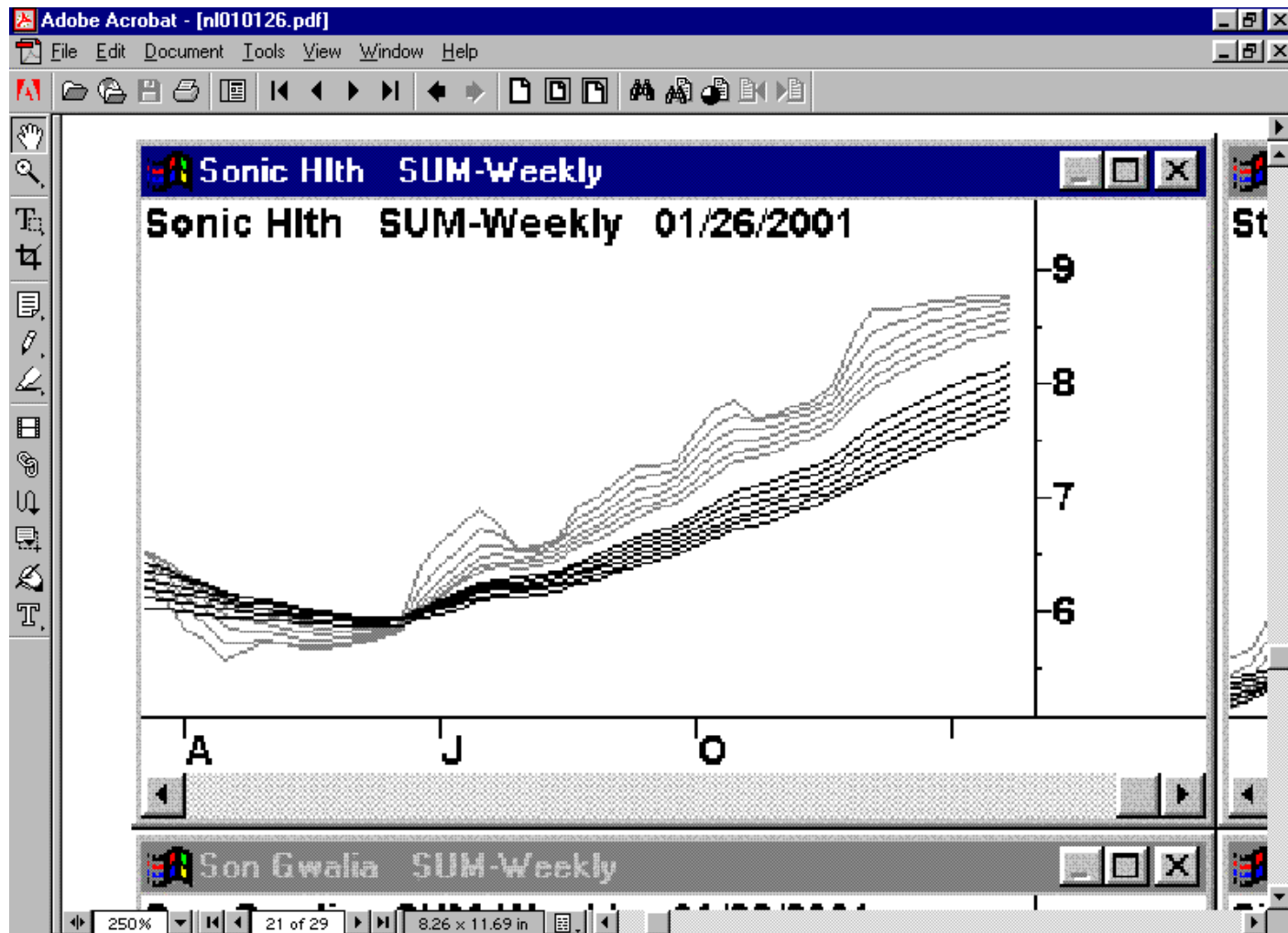
ASX Ltd SUM-Weekly 01/19/2001 C=12.190 -.610 O=12.693 H=12.750 L=12.190

This would be an unacceptable trend !



Using the *ActTrade* Newsletter MMA Charts

The *ActTrade* Newsletter is available in PDF file format and is viewed using the Adobe Acrobat Reader which is freely available on the Internet. There are 8 MMA charts per A4 page... making them quite small. You can use the 'Zoom' function in the Adobe Acrobat Reader to enlarge the charts. Using the 'View' pulldown menu at the top of the screen; select 'Zoom to...' and type '250' into the box that appears in the middle of the screen. This magnification level will increase the size of an MMA chart to the point where it almost fills the entire screen as shown below. Having the newsletter means not having to buy expensive and complex charting software nor having to pay for an ongoing data feed from the ASX.

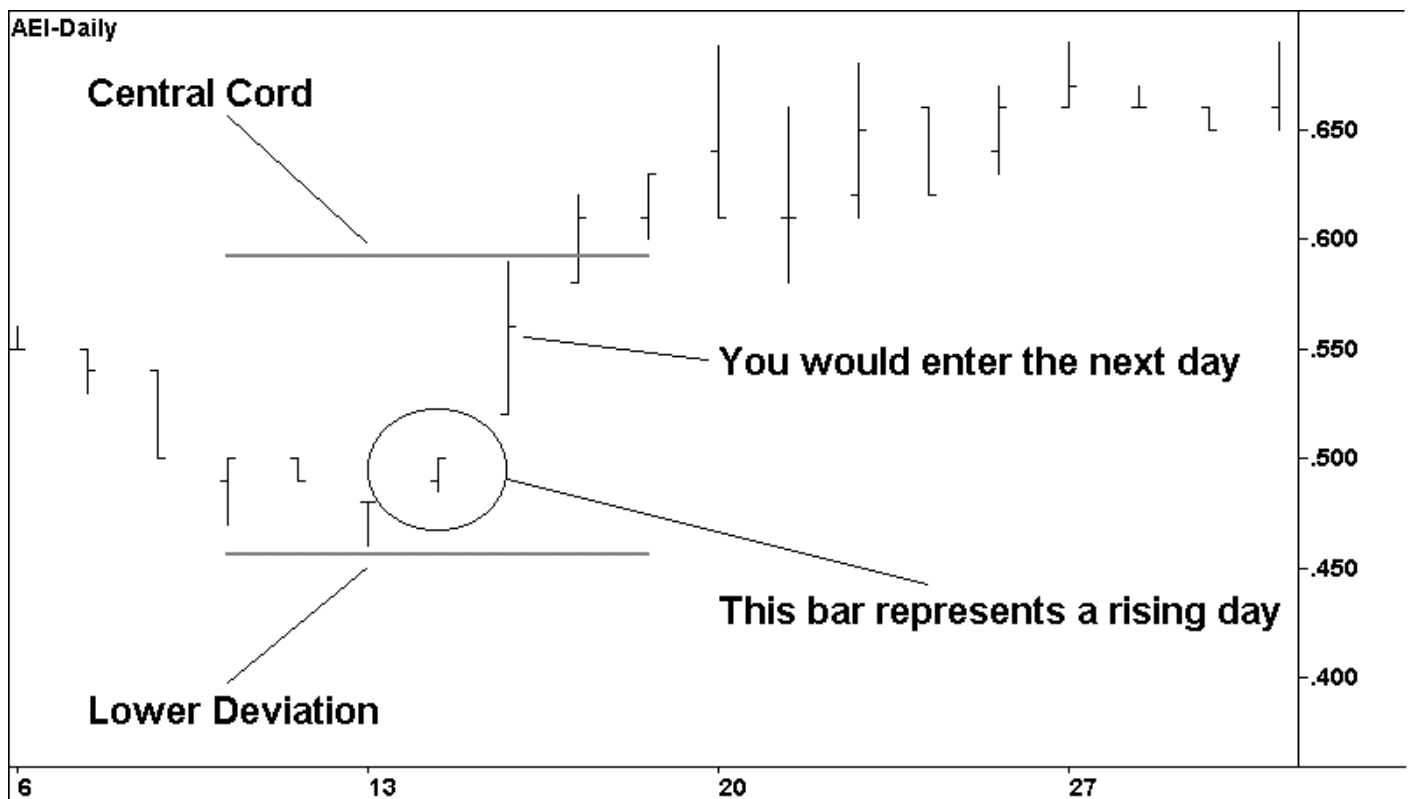


You can then use the slide bars situated on the right hand side and right hand bottom of the screen to navigate around the charts. To zoom out again simply go back to 'Zoom to...' and type '125' into the magnification box. This will return you to the full page width display.

Identifying a good trend using the MMA charts is a matter of opinion and there is no right and wrong answer. Your ability to interpret MMA charts will improve with practice and your hip pocket nerves will guide you better than any external guidance can. However I can share my opinion on the above MMA chart of Sonic Healthcare which shows a consistent trend up until the last few weeks where it has begun to go sideways. It would pay to wait until SHL begins to rise in price again, which will be seen in the short term group of averages. I often refer to the above type of chart pattern as a 'Flat top' situation.

Market entry

Once we have found a share with an acceptable trend and a ROAR greater than 120% we must fine tune the entry. Although we want to jump on board a trend when the price is in a dip it is important not to enter the market whilst the price activity is 'Gunning the stop loss'. We need to wait for the market to reverse and show evidence of buyer support. This is evidenced by a rising day where the closing price is higher than the opening price of the same day and higher than the previous closing price. In order to identify a rising day you will need to have access to daily bar charts like the one below. Online Brokers often provide this type of chart as does www.asx.com.au and www.sharesmag.com.au (look under 'Tools')



Using the values for the central cord and the lower deviation from the *ActTrade* newsletter, determine that a rising day has occurred in the 'Buy/Hold' zone (see diagram on page 7 for an explanation of the 'Buy/Hold' zone). You must then purchase the share on the day immediately following the rising day, ensuring that your purchase price is not greater than the central cord value. Hence the rising day must have closed in the 'Buy/Hold' zone and the purchase price must also be between the central cord and lower deviation, inclusive.

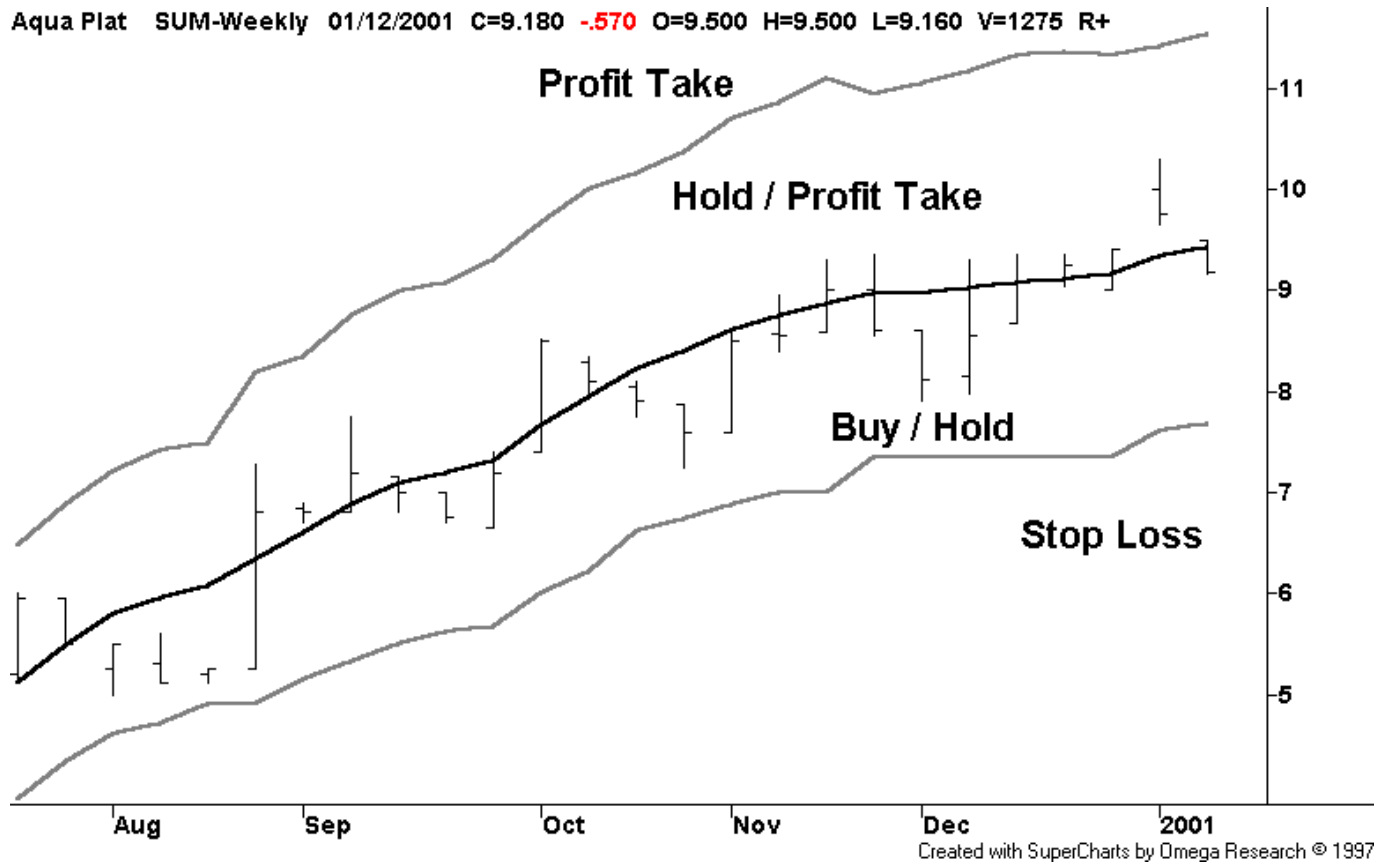
Rule **Only enter the market in the 'Buy/Hold' zone during the day immediately following a rising day, which must have closed in the 'Buy/Hold' zone. (A rising day is where the closing price is greater than the opening price of the same day and higher than the closing price of the previous day)**

We won't always be able to purchase the shares we want immediately because many of the them won't be in the buy/hold zone . It is normal to have to wait several weeks for an entry.

The ActTrade Newsletter contains the Central Cord and Lower Deviation values for all of the shares that appear on the rising equities list. These values are updated every week.

Holding and Profit Taking

Although holding or profit taking are often conceived by market newcomers to be the easiest aspects of trading they are in fact one of the few areas of trading that require the use of human discretion. The range indicator as shown in the following chart dictates, as much as possible, the boundaries for holding and profit taking.



Active trading is a trend following strategy and, providing price activity remains between the upper and lower lines of deviation, there is no need to close a position. If, however, the price activity overheats and closes at the end of the week in the 'Profit Take' zone then selling is mandatory. A true cliché is 'You will never go broke by taking profit'.

The reason for selling when the price activity exceeds the upper deviation line is because the next stop, on the balance of probability, is the 'Stop Loss' zone. As mentioned earlier, price activity moves in a sawtooth pattern and a weekly close outside our trading range is a powerful indication that the volatility has reached a critical level. The fact that the trading range has initially been breached to the upside is fortuitous as we can make a timely and profitable exit. Our actions as share traders should be driven by the balance of probability and if our upside exit proves to be premature then we can always re-enter the ongoing trend. Re-entering trends that have recovered after 'Stopping out' is also a common occurrence .

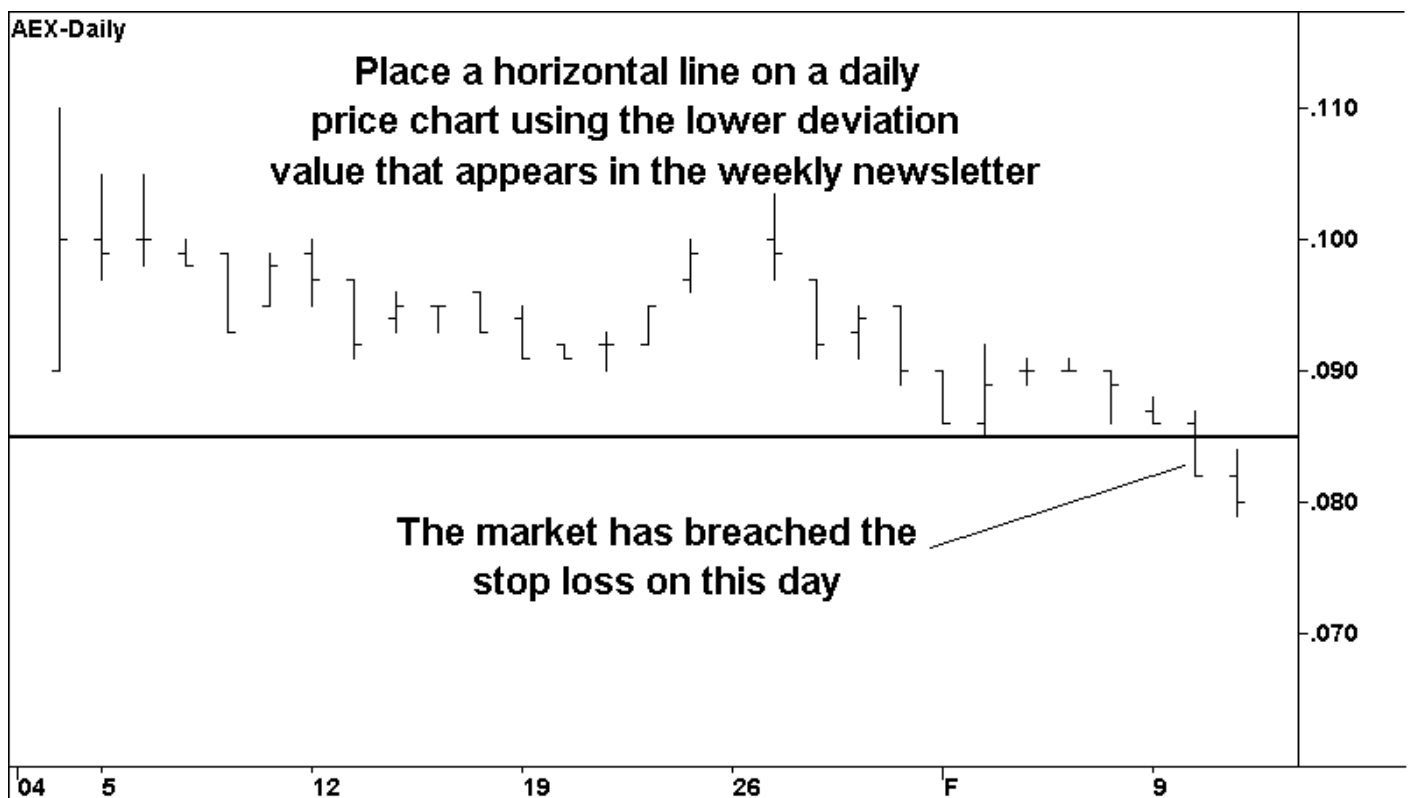
Rule **If the market closes at the end of the week above the Upper Deviation then the share must be sold during the next 3 trading days. If it closes at the end of the day above the Upper Deviation then profit taking is optional.**

The ActTrade Newsletter contains the Upper Deviation value for all of the shares that appear on the rising equities list. These values are updated every week.

Selling

This is the most critical aspect of any strategy and the decision to sell must be mechanical and carried out with total discipline. The stop loss must always be monitored on a daily basis; if the price closes at the end of the day below the lower deviation then you must sell the position during the next 3 days . Daily monitoring of your portfolio and daily stop loss execution is critical in fast moving markets when it comes to protecting your trading capital.

The easiest way of monitoring your daily stop losses is to setup a daily chart for each of your open positions and place a horizontal bar (often referred to as a support/resistance bar in many charting programs) at the lower deviation value. This technique is shown in the following chart.



The above daily price chart of Acclaim (AEX) illustrates the simplicity of monitoring a stop loss. It is a far simpler process than either entering the market or taking profits. It should also be noted that you must complete the sale of the position within 3 days of a stop loss being breached. If you wish to re-enter the market, having just executed a stop loss, then you must abide by the normal 'Market entry' rules as explained on page 11. (Re-entry is quite common)

Rule **If the price closes at the end of the day below the Lower Deviation then the share must be sold during the next 3 trading days. This is a sell condition.**

As mentioned earlier, the ROAR indicator can also signal an exit if it drops below 80% or the money flow drops below \$5 Million/8 weeks. If so, the share will disappear from the list.

The ActTrade Newsletter contains the Lower Deviation value for all of the shares that appear on the rising equities list. These values are updated every week.

Risk Management

Share Traders can only manage the risks involved in share trading if they use clearly defined entry and exit prices. As Active Traders these are defined for us by the Range Indicator.

Position Risk

The potential loss in owning each share is referred to as position risk. Traders normally use the 2% risk rule that states;

‘The total loss for any single trade must not exceed 2% of total capital’

Your total capital is the current value of all shares held plus the total amount of cash on hand. By risking only 2% of our total capital on each trade it would take well in excess of 150 consecutive losses to lose all of our money. Statistics from the U.S indicate that 20% of Traders use risk management which coincides with the fact that only 20% of Traders survive.

Example

- We are trading with \$20,000 total capital and using the 2% risk rule
- Assume that the closing price of a share is 12 cents & the stop loss is set at 10 cents. (It is assumed in this example that the closing price is the probable entry price.)
- The potential loss per share is $12 - 10 = 2$ cents and 2% of $\$20,000 = \400
- Divide $\$400$ by 2 cents to get the number of shares we can buy = 20,000 shares
- Multiply 20,000 by the closing price of 12 cents to get the position size = $\$2,400$
- Divide $\$2,400$ by $\$20,000$ and multiply by 100 to get the percentage of total capital that can be spent on this position = 12% (This is the maximum position size)

Sector Risk (Also referred to as Industry Risk)

We want to be able to capitalize on strong sectors without being overly exposed to sector 'Fads'. To limit our exposure we will only allocate a maximum of 30% of our total capital per sector and a maximum of 6% position risk per sector, ie. 3 positions/sector ($3 \times 2\% = 6\%$). (GICS Industry Group information can be found at the ASX Website - www.asx.com.au)

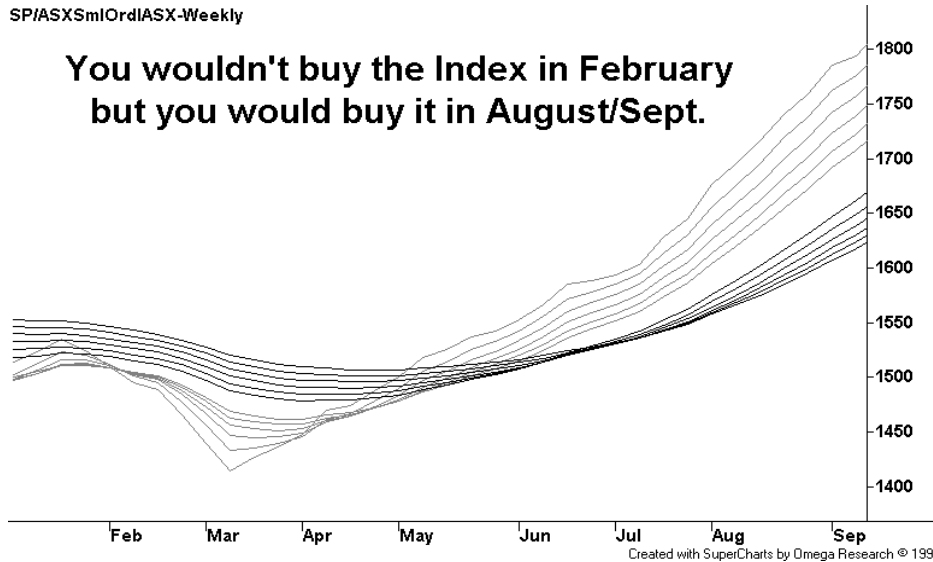
Portfolio Risk

Portfolio risk is the sum total of our position risk. Therefore we must limit our maximum number of positions at any given time in order to control our total exposure to the market. A maximum of 20% portfolio risk will yield a maximum of 10 positions ($10 \times 2\%$). In fact it is a good idea to operate well within this limit at say a total of 5 positions. This is because most of us will find even just 5 positions difficult to manage on a day to day basis if the market suddenly turns volatile. An example of such an event was the impact on markets by S11.

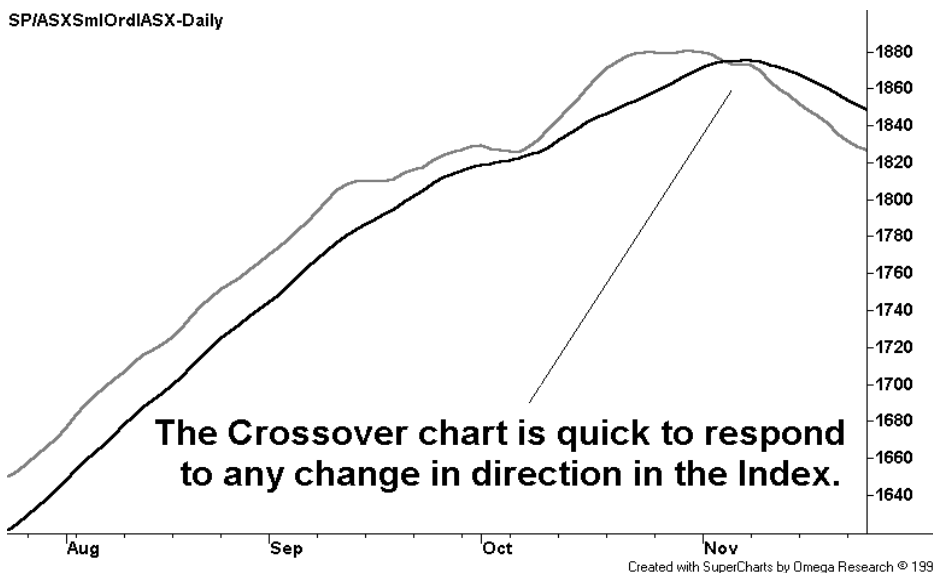
The '2% Risk Rule for T.C.(%)' column in the ActTrade Newsletter is calculated using the central cord and the lower deviation values. The amounts shown are the maximum weightings for total capital, ie. a 10 in this column means 10% of your total capital. This column will display a maximum value of 20 because the largest allowable position is 20%.

The Broad Market

Mid to small capitalization shares are part of a market segment that has a high positive correlation with the S&P/ASX Small Ordinaries Index. It is therefore very prudent to only trade this market segment when the Index is performing well, otherwise you will often find yourself working hard for little profit. The Index is performing well when its MMA chart (as shown below) is trending up, in much the same way as an MMA chart of an individual share trends up. In short...if you wouldn't buy the Index, then don't buy a share within the Index.



We can take this approach a step further by using a 'Crossover' chart as seen below. This chart contains a 9 day (Grey) simple moving average and a 21 day (Black) simple moving average. When the Grey line is below the Black line then the Index is in retreat and heading down and when the Grey line is above the Black line then the Index is trending upwards.



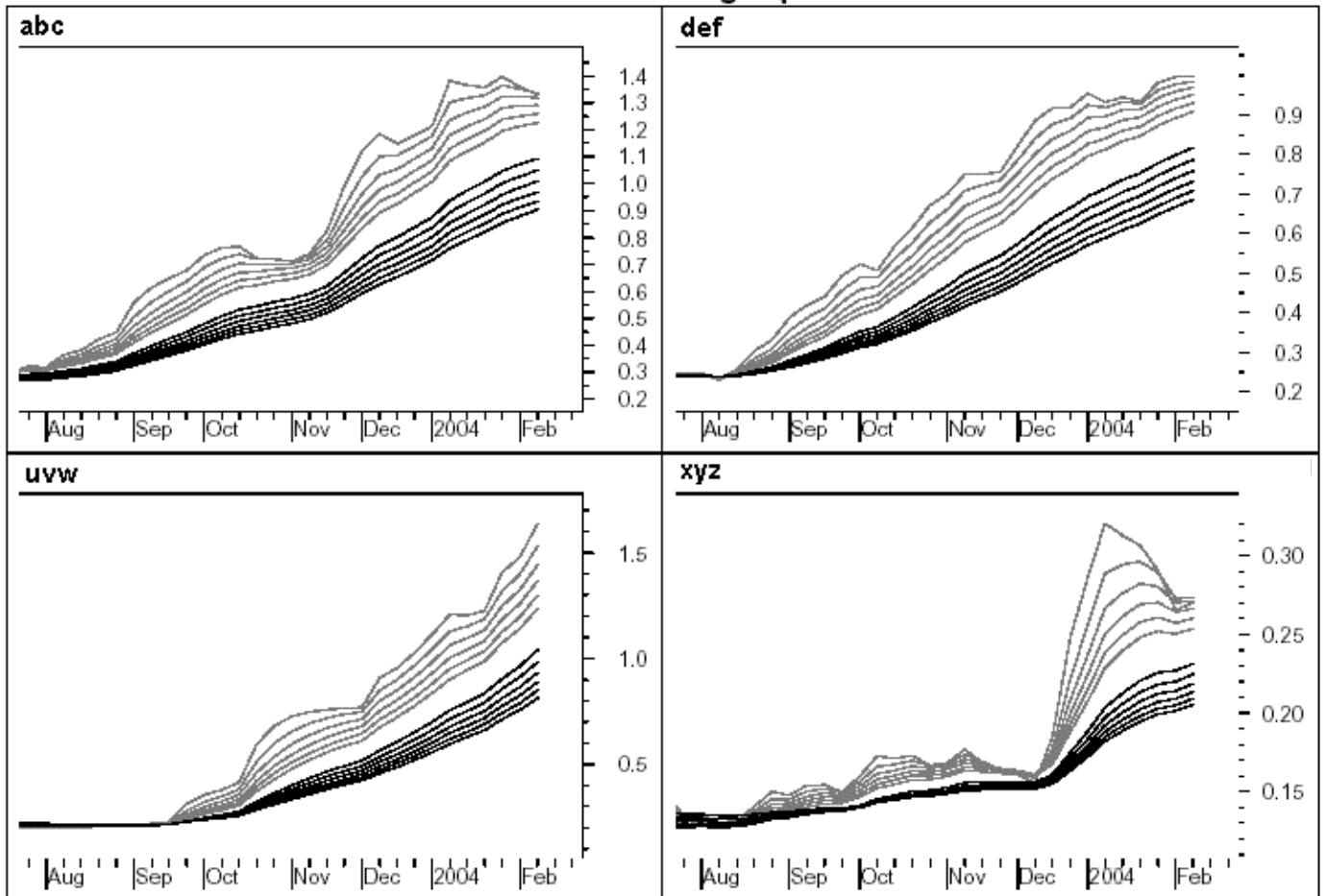
If the grey line is above the black line at the right hand leading edge of the chart then it is OK to enter the market, ie. buy shares during the forthcoming week. But if the grey line is not above the black line then no new positions should be opened during the forthcoming week. The Crossover chart will prevent us from buying into the market the moment it starts to retreat while the MMA chart will keep us out of the market until the overall situation improves.

The newsletter includes an MMA & crossover chart of the S&P/ASX Small Ordinaries Index.

Using the *ActTrade* Newsletter for the first time

Lets assume that you are now studying your very first *ActTrade* Newsletter. Having checked that the Broad Market conditions are O.K. (both the MMA and Crossover charts of the Small Ordinaries Index are acceptable), the next step is to go to the MMA charts and make a short list of the shares that you believe have the least amount of volatility and that are trending upwards in the strongest possible manner. The following charts are indicative of those shown in the weekly *ActTrade* Newsletter and show 30 weeks (just over 6 months) of price activity.

MMA Charts - Rising Equities



ABC (top left) is showing some volatility in the short term group of averages and is 'Rolling over' on the right hand leading edge of the chart. This 'rolling over' indicates that the trend is starting to soften. What's more this softening can be seen in the long term group of averages.

DEF (top right) is a less pronounced version of ABC. Whilst the situation with ABC looks terminal, I would be prepared to enter DEF if I saw the MMA chart begin to turn upwards.

UVW (below left) is near perfect and I would have no hesitation in buying into this market.

XYZ (below right) isn't a trend at all. It ran up sharply in December but has fallen ever since.

Your ability to read MMA charts will improve with time and practice. Avoid volatility and you will be more profitable, with less work, over the long term. Remember the more critical you are...the better. (Expect to find only several good MMA charts each week and in a dull market there may be none) Having scrutinized the MMA charts you should now have a short list of potential trading opportunities and be ready to turn your attention to the Data Tables.

Weekly search results are presented in the following format.

| Share Code | Closing Price(\$) | Central Cord(\$) | Upper(\$) Deviation | Lower(\$) Deviation | Rate of Ret.(%) | 2% Risk Rule for T.C. (%) |
|-------------------|--------------------------|-------------------------|--------------------------------|--------------------------------|------------------------|--------------------------------------|
| ADJ | 0.370 | 0.413 | 0.495 | 0.330 | 180 | 10 |
| EHY | 0.650 | 0.788 | 0.998 | 0.579 | 235 | 8 |
| REM | 0.320 | 0.333 | 0.403 | 0.285 | 110 | 14 |

We now have to check each of the shares in our short list to see which ones have an acceptable rate of annual return. REM is the only share listed above that doesn't have an acceptable rate of annual return. (The minimum entry level rate of annual return is 120%)

Next we must take note of the share's central cord and lower deviation values as we must transcribe these values onto a daily price chart. We then have to sit back and wait for an entry where an entry is signalled when a rising day occurs with a closing price between the central cord and lower deviation, inclusive. As described earlier, a rising day is where the closing price is higher than the opening price of the same trading period and also higher than the closing price of the previous trading period.

Once an entry is signalled you can purchase the corresponding share with an amount of your capital less than or equal to, but never greater than, the percentage given in the '2% Risk Rule for T.C.(%)' column. The entry is only valid for the forthcoming trading day...during which time you can 'Buy' the share providing the purchase price is between the 'Lower Deviation' and the 'Central Cord', inclusive.

As it is highly probable that you will only be able to enter maybe 1 or 2 positions each week, you will have to repeat the above process over and over again. It is in fact quite normal to spend several weeks waiting for shares to give an entry signal. Of course there are always shares that 'Get away' from us by never slowing down long enough for us to get on board.

This is a perfectly normal occurrence and one that often leads novice traders into becoming overly aggressive and ultimately breaking their trading rules so they can get into the market. Don't try to be omnipresent in the marketplace and always remember that there will be many missed opportunities. It is an inevitable reality of share trading that whilst you are losing money on a trade, someone else is making money on another trade...learn to live with it!!!!

Once you have acquired positions you can write down the 'Lower Deviation' values for each of your shares on a weekly basis using the Newsletter. At the end of each day you can check to see if any of your shares have closed below their respective lower deviation values, thus signalling an end-of-day stop loss. This is inevitable and when it occurs you must sell the share during the next 3 trading days. If a share that you own is removed from the rising equities list then the ROAR indicator has switched 'OFF', also signalling an exit condition.

You may also elect to monitor the upper deviation on a day to day basis. Profit taking on an end-of-day basis when the share price closes above the upper deviation is optional. But if the closing price is above the upper deviation in the weekly newsletter then selling is mandatory.

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General Considerations

The following points, whilst not critical for success, will undoubtedly enhance your performance as an Active Trader.

Don't commit all of your trading capital to the Market at once

Unlike Blue Chip share trading it's a good idea to aim to have no more than 75% of your total capital allocated to the market at any given time. This way you will always have some capital in reserve for new opportunities.

Don't buy into Market rallies

As Active Traders we are attempting to identify upward trending shares where a trend is defined as a series of higher highs and higher lows. In other words a trend is where price activity runs up for several weeks and then pauses for several weeks and then repeats the whole process all over again.

We do not want to buy into a market rally where price activity has continued to move up week after week. To avoid this situation it pays to overlook MMA charts where the price activity has been rising for less than 2 months because rallies rarely last beyond this time.

Don't 'Make the Market'

The ROAR indicator tests market liquidity by testing money flow. The benchmark used by the ROAR indicator equates to an average daily minimum of \$150,000. It doesn't ensure that you won't 'Make the Market' by buying or selling too many shares, thus moving share prices significantly up or down. A good rule of thumb is to ensure that your daily transactions in any market don't exceed 10% of the total volume of shares being traded.

Capital Allocation

Different market segments (ie. Blue Chip shares, small capitalization shares, etc) represent differing degrees of risk and reward. They also have non-correlating performance which means that while large capitalization shares are enjoying a strong rally, usually in unison with their offshore cousins, small capitalization shares may be suffering a general decline. So to ensure exposure to the entire market it is a wise idea to allocate capital to several market strategies that are targeted at different market segments, ie. Active Trading for small to medium capitalization shares and Active Investing for Blue Chip shares. To download free information on Active Investing (PDF files) please visit our website at www.alanhull.com

Fundamentals

Whilst 'Active Trading' is purely a technical approach (analysis of price activity) it certainly doesn't hurt to analyse a company's fundamentals as well. Our overall objective is to shift the balance of probability as far as possible in our favour and seeking good fundamentals as well as rising share prices will only assist us in this endeavour. This added research will also help improve our win/lose ratio which can easily fall below 50/50 in tough market conditions.

Sectors

We can shift the balance of probability even further in our favour if we perform what is commonly known as 'Top Down Analysis' or 'Sector Analysis'. By buying a rising share within a rising Sector we will be trading in the same direction as the entire Sector, not just the share. As with fundamentals, Sector analysis will further enhance our win/lose ratio.

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