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CHECK YOUR EGO at the door

Ego is a strange thing. Possess too little and the world will walk all over you. Exhibit too much and you won't get invited to any more parties. On some level, ego is necessary for survival, but it sure can make you do stupid things sometimes.

This dichotomy is particularly evident in trading. Exceptional traders typically balance pronounced self-confidence (*I will succeed*) with prudent respect for the market and recognition of their own limitations (*I'm not going to succeed all the time).*

Tales abound of traders who got too cocky, abandoned the discipline that brought them success in the first place, pushed the envelope too far and paid the price. A new trader, flush with confidence after that first big winning streak, is likely to feel unconquerable…and intelligent. *Hey, this isn't so tough— I must be pretty smart!* Friends and family are often deluged with glib market insights from the hot trader, who is more than happy to show just how clever he or she is.

Few things are as gratifying to the ego as making a call on the market and watching it pan out the next day, week or quarter. It's one of the sneakier tricks the market plays on people: It plants the desire for us to prove how intelligent we are — how neatly we can interpret events and forecast the twists and turns of the market.

One of the sneakier tricks the market plays is planting the desire for us to prove how intelligent we are — how neatly we can interpret events and forecast twists and turns in the market.

So many people are desperate for trading guidance that any "guru" who can make a handful of well-publicized market calls is likely to develop a rabid following and bask in the media spotlight for months, if not years. But lest we forget, the point of trading is to pad our wallets, not our egos.

Traders who have been around the block a few times tend to put little faith in opinions — both their own and (especially) other people's — about what the market is going to do. Instead, they are busy developing plans and strategies for what to do no matter what the market does. It's not that such traders don't have egos, it's just that they have learned how irrelevant "looking smart" is when it comes to making money in the markets (or they've learned to tuck their egos away at the right times when trading).

In this month's Active Trader Interview, we talk to Mark D. Cook, a short-term trader whose matter-of-factness about his profession is matched only by his success. Cook is someone who learned over the course of his 25-year career that there are no shortcuts in trading. You take your lumps, pay your tuition and keep plugging.

While Cook does not lack confidence — his career has been characterized by the ability to persevere and rebound from setbacks — his trading is the direct product of a long trial-and-error process where he meticulously critiqued his performance and refined his technique. This is a practical look at what trading each day for a living is about — what the job can offer and what it demands of you.

Continuing with this theme, Trader's Bookshelf features a multi-perspective review of Ned Davis Research's *Being Right or Making Money*, a book that addresses the split between the practicalities of making money as a trader and the ego gratification of using the markets to prove how smart you are. Find out what three reviewers thought of the book that was long available only to clients of Davis' firm.

In the Trading Strategies section we feature a broad range of methods ranging from simple intraday relative strength techniques ("Short-term trading with relative strength") to advanced instruction on how to split money between different markets for optimal performance ("Dynamic asset allocation"). In between, we offer practical insights on volatility and options trading, as well as how the chart patterns of market leaders can indicate the bias of the overall market ("Follow the leaders").

Finally, for a look at how the direct-access world is handling a topsy-turvy market, see associate editor Jeff Ponczak's "Report says there's no slowing direct access". It's an eye opener.

Mark Etzkorn, Editor-in-chief

THIS MONTH'S Contributors

▼ **Jay Kaeppel** is the director of research at Essex Trading Company Ltd. (www.essex-trading.com) in Wheaton, Ill. He is a registered CTA and actively manages futures accounts for the Essex Trading Group. Kaeppel is author of *The Four Biggest Mistakes in Option Trading* (Traders Library, 1998), *The Four Biggest Mistakes In Futures Trading* (Traders Library, 1998) and *The PRO-VEST Option Trading Method* (Essex Press, 1996). He is the co-developer of Futures Pro and Option Pro and provides ongoing commentary at eCharts.com on sector investing using the Fidelity Select Funds.

▼ **Leslie N. Masonson, CCM** (lesmason@frontiernet.net), founder of Cash Management Resources, has been investing in stocks, mutual funds, options and commodities for more than 40 years. He has day traded the stock market using technical analysis since 1994. He is the author of *Day Trading on the Edge*, *Corporate Treasury Management Manual*, and *Cash, Cash, Cash: The Three Principles of Business Survival and Success*. Masonson's career includes 15 years in banking with Irving Trust Company, Bank of America and Citibank.

▼ **Barry** and **Ryan Watkins** are a father-and-son trading team and co-founders of Day Trader Products (www.daytraderproducts.com), a Web site dedicated to specialized day-trading products.

▼ Brothers **Barry** and **Matt Rudd** are private equities traders at Protrader Securities in Dallas. In 2000, Barry generated a 267-percent return on a six-figure personal account. Matt generated 133 percent. Barry is the author of *Stock Patterns for Day Trading*, volumes 1 & 2, (Traders Press, 1999) and the producer of the *Stock Patterns for Day Trading* home study course, a video training course based on Barry's training class. He may be reached through his Web site at www.sceptretrading.com

▼ **Stacey Winter** is a research analyst and assistant portfolio manager with Kuhn Capital Management in Los Angeles. William J. O'Neil, founder of *Investor's Business Daily*, recruited Winter in 1998 to be an Institutional Representative at William O'Neil & Co. Her previous positions included time at PaineWebber and as an financial consultant, where she helped investors manage their portfolios and implemented O'Neil's methodology. She received her bachelor's degree in business administration, with a finance option, from California State University, where she graduated cum laude.

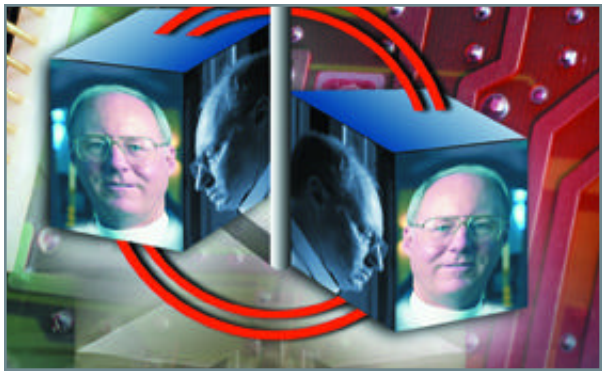
▼ **Michael de la Maza** is the president of Redfire Capital Management Group. He can be reached at RedfireGrp@aol.com.

▼ **Dan Keen** is the author of the new book, *Covered Call Writing: A Low-risk Cash Flow Money Machine* (TradeWins Publishing). Keen is the publisher of a county newspaper in New Jersey. Since the 1970s he has written hundreds of articles for national computer magazines, as well as several books on computer programming and other science topics for both Sterling Publishing and McGraw-Hill Publishers. Keen taught computer science at Stockton College in New Jersey.

▼ **Jon Ossoff, MA,** is a consultant and trading coach with more than 20 years experience in the field of psychology and mind/body integrative techniques. He is founder and CEO of TradeAware.net, a consulting firm offering seminars and private consultations to the active trader/investor. Ossoff can be contacted at focus@tradeaware.net.

▼ **Robert A. Green** is a CPA and his firm, GreenTraderTax.com, consults traders on tax solutions, reviews or prepares their tax returns and sets up business entities and retirement plans. For more information or help about this and other trader tax matters, visit www.green tradertax.com or www.tradertax.com. Contact Green at green@greencompany.com.

▼ **Thom Hartle** is a private trader and president of Market Analytics Inc. He also is editor of eCharts.com (www.echarts.com), an educational Web site for stock traders, and vice president of Wizard On Wall Street Inc. (www.the-wow.com). In his career spanning more than 20 years, Hartle has been a commodity account executive for Merrill Lynch, vice president of financial futures for Drexel Burnham Lambert, trader for the Federal Home Loan Bank of Seattle and editor for nine years of *Technical Analysis of Stocks & Commodities* magazine.



Multiple monitors

Great article in the April issue by Scott Os about using multiple monitors ("Two heads are better than one," p. 36). Of the video cards featured in the article, which one allows you to organize your applications and folders in multiple "virtual desktops"? And does the program walk you through the process? — *Mario Mendoza*

Scott D. Os replies:

Thanks for the kind words. Both of the Matrox cards (G450 and G200 Multi-monitor) as well as the Appian cards (Gemini and Jeronimo) come bundled with "virtual desktop" software.

The Appian products come with Hydravision software. This package has a function called MultiDesk, with which you can create, name, organize and arrange up to nine active multi-monitor desktops and switch between them with a mouse click.

You can also assign hot-key shortcuts for the functions or desktops you use most often. More information can be found at www.appian.com. Unfortunately, Hydravision does not have a "wizard-based" setup; however, the combination of drag-and-drop and multiple dialog boxes makes it relatively easy to use.

The Matrox products come bundled with Powerdesk software. This application uses a mechanism called "schemes." These are virtual desktops that you can create, name and organize through Powerdesk. In addition to a drag-and-drop type feature, this software allows you to drag the active application window (making it whatever size you wish in the process) to the appropriate monitor, and Powerdesk remembers where to put that application the next time you use it. If you save this layout as a scheme, you can easily switch back and forth between them.

Matrox has just introduced another new feature called eDualHead, which provides browser enhancements in addition to the desktop features. More information can be found at www.matrox.com/mga/dualhead/edualhead/home.cfm.

Even if you don't have more than one monitor, you may find the virtual desktop idea to be productive. There are a number of products on the market that allow Windows users to create multiple desktops loaded with applications and their settings. You can then toggle between these desktops using mouse clicks or hot keys. Two of these applications are Cool Desk (www.shelltoys.com/cdesk/) and Enable Virtual Desktop (www.enablesoftware.com).

Have fun and enjoy the "wide open spaces."

Bull, bear, beall or bur?

I enjoyed "Trading in tough markets" (*Active Trader*, May 2001, p. 40), but found the logic in the sidebar ("Before and after: Nasdaq 100 performance") somewhat confusing.

You state that in a bear market, the market opens higher or unchanged 58 percent of the time and that "in a bear market, intraday trades have a higher profitability when placed in the direction of the open." If that were the case, then, in a bear market, the majority (58 percent) of the time you would be looking to go long in a market that, according to your statistics, will close lower than it opened 53 percent of the time!

Also, it states that if you are looking to go long in a bear market, you should enter as soon as possible and exit as late as possible.Entering long shortly after the open in a market with a 53 percent chance of closing lower than it opens seems even worse!

I love your magazine. —*Kathie Angione, San Diego*

First, by no means do we encourage you to use such statistics without taking other techniques into consideration. That said, your first observation is correct. We simply misstated the implications of the statistics. In a bear market, intraday trades have the highest profitability if the market opens lower — period.

As far as your second observation is concerned, yes, it does appear that entering long shortly after the market open seems even worse. However, we don't suggest you enter long without considering other analysis. The statistics simply suggest that if a long trade is your preferred strategy for the day, you should enter as soon as possible in such conditions.

For example, if your analysis can correctly forecast 60 or 70 percent of all daily up moves within a downtrend, and your indicators forecast such a day tomorrow, you should enter at the open or as soon as possible after the markets open. If it is indeed an up day, the opening price is likely to be near the low of the day.

Questions about an article or trading issue? Send them to us at chatroom@activetradermag.com
Active Trader reserves the right to edit letters for clarity and length.

Helping or harming traders?

The battle over Regulation FD

It has been more than six months since the Securities and Exchange Commission (SEC) passed Regulation FD, a rule it hoped would free up the flow of market information (see "SEC votes to end selective disclosure," *Active Trader*, October 2000, p. 22).

In a nutshell, Regulation FD requires any information disclosed by a company be released to the entire trading public, not just to select groups such as analysts. While an increasing number of companies are making their earnings announcements available to the public via conference calls, webcasts or press releases, much debate remains over how effective Regulation FD has been.

The people most directly affected by Reg FD are likely the investor relations (IR) professionals at publicly traded companies. It is ultimately their job to make sure any information released by the firm is available for consumption by everyone.

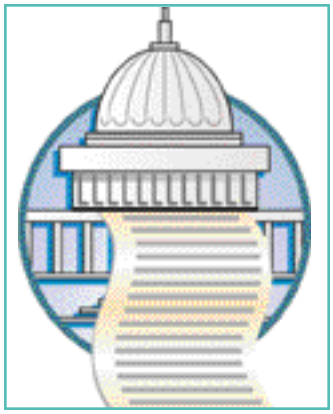
However, according to Reg FD, only "material" information needs to be released to everyone. That brings up the question: What is material?

"You're putting corporate America in the decision-making mode of having to decide at the time they're making a statement whether it's material," says David Ruder, a professor at Northwestern University law school and former SEC commissioner. "Many lawyers will say to someone, 'If the statement is material, it's going to create a lot of problems, so don't make it.'

"There is a 'shazam' effect in the rule that says the minute something becomes material, you have 24 hours to act. That puts a big burden on the people who have to decide whether it's material or not."

There is no question, however, that anything regarding earnings is material. And while companies are finding it easy to make sure their quarterly announcements are available to all, it's what happens in the interim that is causing the problems.

For example, if an analyst releases a statement saying he or she believes a company will miss its earnings estimate, that company is often loath to respond for fear of violating Reg FD.



"Reg FD is way too broadbrush," says Bina Thompson, vice president of investor relations for Colgate-Palmolive. "It killed the normal give-and-take of information about how things are going in the business. Why is it wrong for a company to have a dialogue with investors who care enough to ask about current operations?

"I think it is absurd to prevent a company from discussing an analyst's outlook that is based on [the analyst's] faulty premises," she continues. "Why does it do the market good to have such faulty ideas out there until earnings announcements are made?"

Adding to the mix are the legal departments at public companies, which are cautioning their officers to be very careful about what they say. As of mid-May, no company had been cited for Reg FD violations, and nobody wants to be first.

In addition to her work at Colgate-Palmolive, Thompson is also the president of the Investor Relations Association. She has received plenty of input from her peers.

"One told me, 'One of the unfortunate consequences is that [Reg FD] has shifted some of the communication impetus to legal and away from investor relations. Although legal has always reviewed investor presentations, I find legal wanting input as to the actual meeting program I propose, with veto power being given on certain meetings and presentations,'" Thompson says. "That to me says people are getting muzzled, in a sense."

Analysts are another group that has been significantly impacted by Reg FD. In the past, they were the conduit between the investing public and the companies, often being privy to certain information. However, that was part of the reason behind the passage of Reg FD — that information often allowed certain market insiders to take an advantageous position in a stock days before the public had access to the same information.

Because of Reg FD, analysts receive their information about a company at the same time everybody else does. Needless to say, it has changed the way they do their job.

"It has probably made our job a little harder," says David Berry, executive vice president/director of research at Keefe, Bruyette and Woods. "There are certain kinds of conversations that we are no longer having, such as, 'So, how is the quarter going?' It means our estimates are not as good as they used to be, so the opportunity for companies to surprise with earnings releases or pre-announcements is greater. At one level that's good, because we're all surprised at the same time, but it also means there is less good information in the marketplace."

Most analysts agree with Berry's assessment that if the quantity of information available is the same, the quality is certainly lessened. While some may claim that's just sour grapes, there's no doubt analysts are finding alternate means to gathering exclusive nuggets about a company.

Since Reg FD only applies to a company's senior management, investor relations professionals and others in the company who regularly communicate with market professionals, analysts are free to talk with customers, suppliers or

salespeople.

It's the salespeople that are of most concern to the IR department. Generally, they don't know everything about the inner workings of a company and are likely to give faulty information, or they are too positive about the prospects for the company. In many cases, IR professionals have cautioned their sales staff to not talk to analysts or investors.

And, as Berry says, "If somebody thinks that an analyst ferreting out information by talking to a supplier or a customer is more fair than an analyst talking to a CEO or director of investor relations, I find that a peculiar point of view."

Still, it would be difficult to prove the trading/investing public is severely disadvantaged by an analyst's inability to get inside information. However, some claim Regulation FD is causing volatility in the market. The argument is because companies are hesitant about responding to rumors or predictions of earnings shortcomings until they hold their quarterly meeting, the uncertainty surrounding the stock creates volatility.

Floyd Norris, the chief financial correspondent for the *New York Times*, isn't convinced that's the case. If it is, though, Norris says, "So what?"

"If Reg FD is producing extra volatility, I think the answer is to do nothing and wait for the market to learn to cope with it," Norris says. "From block trading in the '60s and '70s to program trading in the '80s to day trading in the '90s, I've been told that volatility was being horribly enhanced by these and they had to be stopped. Traders learn how to adapt, and if they don't, they find other professions. They will learn to adapt to this."

Like most journalists, Norris is a big fan of Reg FD. The new rules have allowed journalists access to places they weren't always previously welcome.

"Regulation FD has enabled me to do a better job," Norris says. "I've been in this business for more than two decades. I've been kicked out of road shows that allowed every retail broker on the presumed basis that the brokers were professionals and I was someone who might sully the mind of innocent investors with what the companies were saying.

"I've been lied to by companies, I've been refused permission to listen to conference calls. I found myself calling analysts just to try and get them to tell me what they've been told by the company.

"Now, people who choose to release information have to release it in a way I can get at it, and to me, that is a wondrous change."

Still, there are far more questions than answers about Reg FD. The regulation was passed to give the investing public equal access to information, and while it appears that has been a success, it's unclear what — if anything — has been sacrificed.

Those in the financial community aren't the only ones interested in Reg FD. In mid-May, the U.S. Congress began hearings on the subject. Among the witnesses was Tom Gardner, co-founder of financial Web site The Motley Fool.

He summed up the thoughts of thousands of investors who wrote the SEC in favor of the proposal, saying, "As an individual investor, I am insulted by the implication that individual investors are not smart enough to flesh out the information they need without the help of an analyst."

Opponents of Reg FD don't want the rule abolished, just modified to provide more specific guidelines. In any event, the debate over Regulation FD won't go away anytime soon.

The little engine that could

Report says there's no slowing direct access

Direct-access brokers have been quick to point out they have continued to flourish in the bear-market conditions that have had a significant negative effect on traditional online brokers. A research report released in late April backs up their claims.

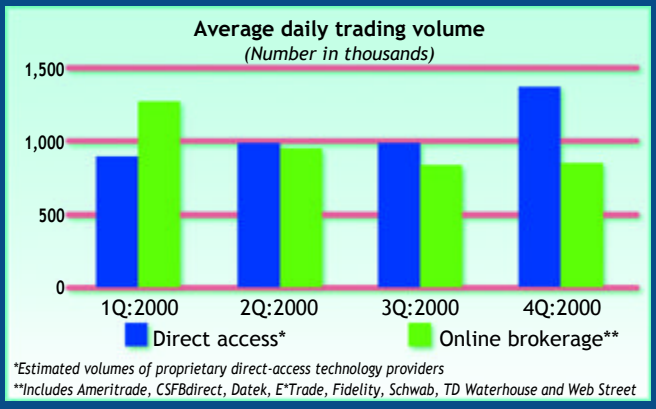
The report, "Direct access: The evolution and growth continues," was released by research firm Keefe, Bruyette and Woods. It paints a rosy picture of the direct-access industry. To those familiar with the technology, the report doesn't present any earth-shattering news. However, it does provide plenty of statistics that show the impact direct access is making.

The KBW report details four key points:

- Direct-access volume is growing at a greater rate than the broader market.
- There exist numerous opportunities for continued growth in the field.
- Select direct-access providers are positioning themselves

FIGURE 1 DIRECT ACCESS VS. ONLINE BROKERS

While volume for "traditional" online brokers declined in 2000, it surged for direct-access brokers.



Source: Company reports and KBW calculations and estimates

to become a greater part of the mainstream financial world.

- The regulatory environment is helping direct access.

According to KBW, the average daily volume from direct-access platforms was 890,000 in the first quarter of 2000. By the fourth quarter, that number had reached 1.37 million. Meanwhile, volume from online brokers declined from 1.264 million to 854,000 (Fig. 1).

"These strong trends are being driven by the market-timing benefits that result from the consolidation of multiple liquidity pools into a single execution platform," the report states.

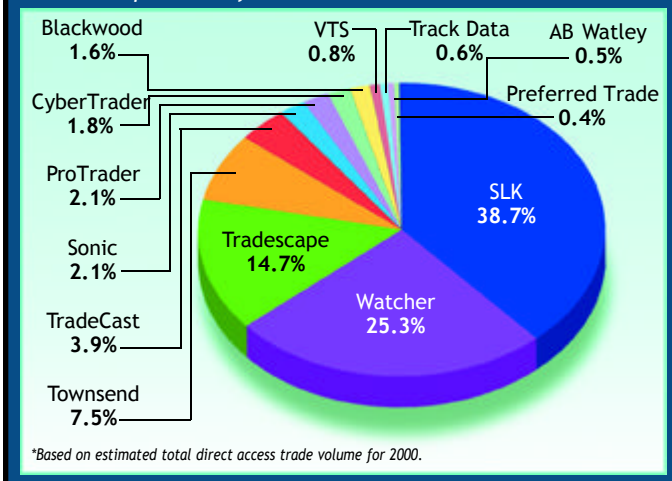
KBW estimates there are about 75,000 traders using direct-access technology and three platforms are responsible for nearly 80 percent of the total volume — Spear, Leeds and Kellogg (38.7 percent), Watcher Technologies (25.3 percent) and Tradescape (14.7 percent).

Note that platforms and brokers are two different animals. On-Site Trading, for example, is a broker. However, the platform it uses is provided by Spear, Leeds and Kellogg. SLK provides the technology for many brokers, allowing the company to gain almost 40 percent of the market share. Likewise, firms such as Heartland Securities and Broadway Trading use Watcher Technologies.

Townsend Analytics (7.5 percent) and TradeCast (3.9 percent) were fourth and fifth, respectively, and the remaining eight firms accounted for the remaining volume (Fig. 2).

FIGURE 2 SLICING UP THE PIE

Three direct-access providers — Spear, Leeds and Kellogg; Watcher Technologies; and Tradescape — account for almost 80 percent of all direct-access trades.



Source: Company reports and KBW calculations and estimates

From a user standpoint, more traders (about 18,000) use Townsend Analytics's technology than that of any other firm. Preferred Trade (about 13,000) is next, followed by Track Data (about 11,000). Figure 3 shows the totals for all providers.

From a growth standpoint, Blackwood showed a 27-percent increase in average sequential growth for the final three quarters of 2000. Sonic Trading was second with 22 percent and, despite the tough conditions, nine of the 13 platforms grew over the final three quarters of 2000. And, the prospects for future growth look good.

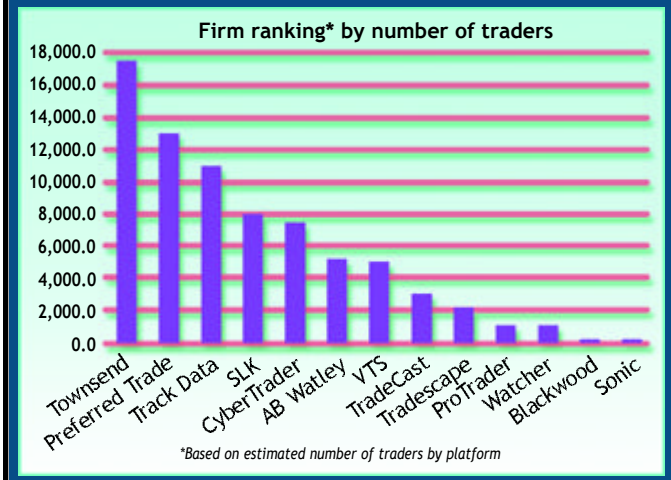
"The two largest untapped markets for direct-access trading technology from a volume perspective appear to be professional traders (defined by KBW as someone who makes between 10 and 800 trades per day) and semi-professional traders (between one and 10 trades per day) while the active trader market (between one and 20 trades per month) likely offers the most growth potential from a number of users perspective," the report says. "We estimate the total trader population in these three segments is just shy of 1 million traders."

Of course, that's potentially bad news for online brokers who, in many cases, have already taken a hit.

"Ameritrade, CSFBdirect, E*Trade and TD Waterhouse all experienced declines in transaction activity as trades per average account fell more than 50 percent from the first quarter of 2000 to the fourth quarter of 2000," the report says. "While much of this decline … was related to a plunge in market sentiment, we believe a portion of the decline may be attributable to active trader attrition."

FIGURE 3 WHO'S No. 1?

More direct-access traders use technology provided by Townsend Analytics than any other platform.



Source: Company reports and KBW calculations and estimates

It's a start

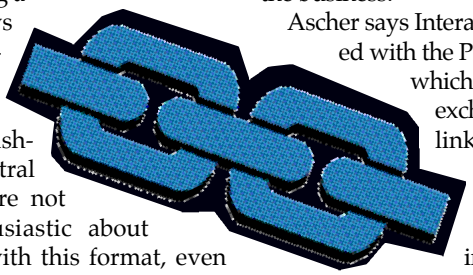
ISE, CBOE put options linkage plan into action

The SEC gave approval to an options linkage in July 2000 (see, "Options linkage gets government OK," *Active Trader*, October 2000, p. 16). In late April this year, two of the five options exchanges — the International Securities Exchange (ISE) and the Chicago Board Options Exchange (CBOE) — became the first exchanges to implement an interim plan.

The interim linkage allows market makers from the ISE and CBOE to automatically execute trades on the other exchange if it is showing a better price. Previously, it was unusual for trades to be executed anywhere except on the exchange the order was placed. This led to "trade-throughs" — trades made at a price inferior to a price available elsewhere — which was the main thing the SEC tried to eliminate in allowing this linkage.

The specific agreement between the ISE and the CBOE was approved by the SEC in late January. At the time, the other options exchanges (the AMEX, the Pacific Stock Exchange and the Philadelphia Stock Exchange) opted to not join the interim linkage, although their future participation is inevitable.

"The CBOE and the ISE … believe this type of linkage [among exchanges where you have multiple service providers] is preferable to having a central hub," says Mike Simon, general counsel for the ISE. "The other exchanges were pushing more for a central hub, and they were not particularly enthusiastic about moving forward with this format, even on an interim basis. But once we agreed that we would build a central hub, although it would take some time, they have decided also to join us."



The linkage plan specifies that any existing technology provider that is a member of all exchanges can apply to be a service provider for the linkage. Technology for the initial linkage is being supplied by Interactive Brokers.

"The exchanges had an application process, and we asked them, 'What is it that you need us to do,'" says Tom Ascher, Interactive's executive vice president. "We have to demonstrate that we meet that standard through a testing process. It's a competitive arena. We were first out of the gate and have a pretty meaningful head start on folks. But we're not looking at it [like] we own the market. We have to earn the business."

Ascher says Interactive has already tested with the Pacific Stock Exchange, which will likely be the next exchange in the interim linkage. However, when all five exchanges are participating — and when the "interim" tag is taken off the linkage plan — it's difficult to predict what changes will be necessary.

"I don't have a tidy answer to that," Ascher says. "Ultimately, the market will decide."

As of mid-May, only five options — Bank One (ONE), Commerce One (CMRC), Home Depot (HD), Mattel (MAT) and Tricon Global Restaurants (YUM) — were trading via the linkage.

"There's no formal timetable [for adding more options]," Simon says. "We would like to get more options in and get more members participating. [A]s we get more linkage providers participating, that will happen. We're just moving slowly and making sure that everything works well."

Public vs. private

Own a piece of the Nasdaq

With its private placement complete and its status as a for-profit company nearly established, the Nasdaq is taking the next step. In late April, it announced plans for an IPO.

Although no date has been set, the offering will not take place until 2002 at the earliest. Before the IPO, the Nasdaq needs to gain exchange status from the SEC (the NASD, which still owns a percentage of Nasdaq, is an exchange), proceed with planned technology advances (such as SuperMontage) and consider the overall market conditions.

"We're preparing for it," says Nasdaq chairman Frank Zarb. "When all the conditions are met then we will move forward and announce a date."

The approval of exchange status is expected to be a simple process.

"There are some questions that go back to the original legislative basis of the NASD that are being worked on," Zarb says. "Other than that, we believe all the qualifications to being an exchange have been met, so it is now some administrative untangling that the SEC has to come to grips with."

The previous private placements raised more than $500 million for Nasdaq and allowed for NASD members to own a piece of Nasdaq.

"There are well over 1,000 members of the NASD who are shareholders of Nasdaq and the vast majority of the 500 market makers are investors," says Nasdaq president Rick Ketchum. "All of the top 50 market makers are investors to some degree in Nasdaq."

Nasdaq has made no secret of its plans to create a global stock market. It already has agreements with several foreign exchanges and recently purchased a majority stake in European stock exchange Easdaq, renaming it Nasdaq Europe (see Quick Scalps, *Active Trader*, July 2001, p. 17). Zarb thinks being a publicly traded company will be a benefit as Nasdaq pursues further deals with foreign stock markets.

"The fact that we are publicly owned establishes a value; it gives us a currency," Zarb says. "We can act like a real company."

Of course, the Nasdaq stock will trade on the Nasdaq exchange. That brings up the probability that market makers, who may be heavily invested in the stock, would also be handling the daily trading of the stock — a potential conflict of interest.

"As an exchange, we have the statutory obligation to ensure that we have fair and orderly markets and that our market is properly regulated," Ketchum says. "We will be delegating that responsibility through a long-term contract to NASD Regulation, so we will not be affecting regulatory disciplinary actions in market surveillance on a day-to-day basis in any way, though we maintain the obligation to do so.

"With respect to [a conflict of interest], I think frankly it's the opposite," he says. "From our standpoint, it's important for our major participants to have the opportunity to participate as investors in our market. They have always had input into the Nasdaq stock market as members. I guess while I hope we're providing more upside than they had as a membership, I'm not sure that the governance situation is dramatically different than what existed before."

During the red-hot IPO market of the late '90s and early 2000, many traders were shut out because only a small number of shares were available to the trading public. While a Nasdaq IPO figures to draw significant interest, Nasdaq hasn't determined how much of the offering will be available to Joe Trader.

"I think a lot of that will depend on the breadth and width of the market at that particular moment in time and also our strategic determinations," Zarb says. "There's no in-house driving force that says we should have a large percent owned and controlled by non-public holders. I think the [Nasdaq] board would like to see the broadest possible

distribution of our equity both here and outside the United States."

Issuing an IPO means opening up the books and balance sheets to the public. While the Nasdaq is subject to the ups and downs of the business cycle like any other company, Ketchum is confident about the financial health of the Nasdaq.

"Nasdaq is a very effective and very profitable venture," Ketchum says. "It has been consistently profitable over the years and that profitability has increased substantially over the last three years. While the last quarter has been a bit more challenging for the entire financial industry than the period preceding it, we remain a very profitable company."

However, certain things — a bad week for the Nasdaq index or a stock switching from the Nasdaq to the New York Stock Exchange — will now be scrutinized by investors and analysts alike. While Zarb thinks the investing public is sophisticated enough to disregard minor short-term events, he might have another problem on his hands.

The Nasdaq has always intended to serve the companies that trade on it and the traders and investors who buy and sell the stocks. However, public companies often have to placate their investors before anything else, and the needs of the big Nasdaq shareholders and of the trading public may not always mesh.

"When we become registered as an exchange, we will continue to be a creature of the securities laws and statutes," Ketchum says. "With that we have obligations to adopt rules that do serve the investing public and maintain fair and orderly markets. We do continue to view ourselves as having a public obligation. We just think the best way we can serve those investors as well as our key participants — whether they be investors, market makers or ECNs — is to operate as a public company."

QUICK SCALPS

THE UNKINDEST CUT

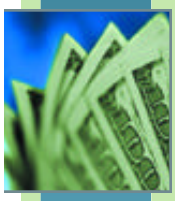
▼ The hard times continued for online brokers, as five companies announced in late April they would cut staff to reduce payrolls. TD Waterhouse is the latest firm to get out the shears, eliminating almost 1,500 workers. Earlier, Datek got rid of almost 23 percent of its staff — about 300 employees — while Ameritrade cut its advertising budget and laid off between 100 and 130 employees. Schwab let go of about 3,000 workers and CSFBdirect slashed 150 jobs.

LEAVE ME ALONE!

▼ NASD Regulation proposed a rule that prohibits firms from harassing customers who transfer funds to an account at another broker. Often, brokerages will issue temporary restraining orders against customers who want to leave, but the new rule would make that illegal. The rule would not restrict signed contracts that allow a brokerage to solicit a previous employee's customers, nor would it prevent a firm from suing a former employee for breaking the rules of an employment contract.

THEY PAID WHAT TO WHOM?

▼ A new feature on the Web site of Nasdaq Dispute Resolution (www.nasdadr.com) will allow users to look up the details of any arbitration ruling. NASD Dispute Resolution has reached an agreement with the Securities Arbitration Commentator (SAC), which developed the database and will maintain it. The full text of the award will be available for free, while more sophisticated and enhanced tools will be available for a fee.



A BANK THAT WORKS LIKE A BROKER

▼ While it's commonplace for brokerages to offer savings and checking accounts, it's unusual for banks to offer their customers the ability to trade stocks. However, Pittsburgh-based Citizens National Bank is doing just that. Clients of Citizens Bank, which has branch offices in 10 states, will be able to buy and sell stocks. Trades will cost $29.95 for orders up to 1,000 shares.

GETTING WISE

▼ Terra Nova Trading, a Chicago-based direct-access firm, purchased fellow direct-access firm Market Wise, which also owns educational firm Market Wise Stock Trading School. Terra Nova will now be able to provide its customers with the education program previously available only through Market Wise, as well as acquiring Market Wise's customer base.

IT'S HIP TO BE SQUARE

▼ ECN Instinet moved its international headquarters to Times Square in New York in early May. The new building is just across the street from the Nasdaq Market Site, and, among other things, it allows Instinet to create a new and more technologically advanced trading site.

FLAT AS A PANCAKE

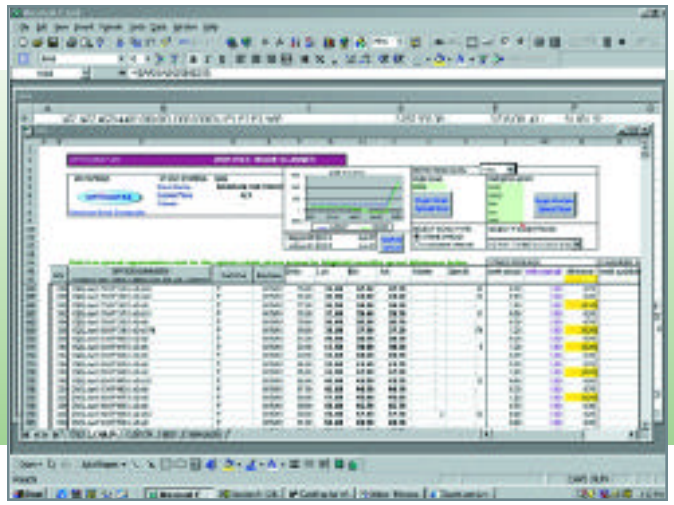
▼ For hyperactive traders, commission can cost tens of thousands of dollars per year. Direct-access firm A.B. Watley is trying to help its clients cut into those costs by offering a flat monthly fee for certain traders. A.B. Watley estimates its most active traders could save as much as 90 percent a month in commission costs. The exact fee schedule was not available as of press time.

FALLING TO EARTH

▼ Theglobe.com, whose IPO sparked one of the biggest controversies (and arbitration award) of the dot-com era (see, "Cleaning up an IPO mess," *Active Trader*, January/February 2001, p. 14), officially fell from grace in mid-May when its stock began trading on the OTC Bulletin Board. The stock, which will still trade under the symbol TGLO, was delisted from

NEW Products

▼ **Optionstar**, an options analysis software for Excel, has added a feature that helps users find arbitrage opportunities that may exist throughout the day. With the Risk-Free Trade Scanner, users select an underlying stock or index symbol to scan for and an alarm will sound if an arbitrage comes up. The options will be highlighted and a P/L graph will automatically be displayed. For more information on Optionstar or the Risk Free Trade Scanner go to www.optionstar.com.



▼ **Stormchaser Technologies** has released Stormtracker V3.0 for the RealTick platform. New features of the stock scanning program include more intraday dynamic alerts (IDAs) such as moving averages, momentum and delta volume strength. It allows users to customize their own IDAs from any combination of Stormtracker alerts and features a back-testing module that test IDAs after hours. Additionally, the company announced a new price structure of $50/month. For further information and system requirements visit www.stormchasertech.com.

▼ **Innerworth.com** is a Web site focusing on the psychological side of trading. At press time, the site was scheduled to be ready for the public in July. The site is to have free information, as well as subscription-only offerings. Among the free features are daily discussions of trading topics, case studies and an interactive Trade Diary tool that provides feedback on a user's trading decisions. In addition, users can employ the Risk Assessor, which tests an individual's ability to handle the risk of a typical investing scenario, then issues a report based on the answers to given questions. Subscriber features include an assessment of individual users' investing personalities, a weekly newsletter, contrarian commentary, and a proprietary risk projection and control system for portfolio management, as well as discussion of market action and strategic pointers. Visit www.inner worth.com to learn more.

▼ **eSignal**, a division of Data Broadcasting Corporation, has launched TurboFeed — a service offering companies, brokerages and business professionals access to eSignal's streaming, real-time or delayed market quotes for redistribution. ESignal receives equities, options and futures data directly from every major North American exchange. TurboFeed can be accessed via the Internet or dedicated private connections depending on the customer's needs. IXnet Inc., a Global Crossing company handles the private connections to eSignal. For more information go to www.esignal.com/turbo feed.

▼ **Wall Street Access** has launched its latest online trading platform, AccessPoint. AccessPoint features include the ability to enter spreads, buy-writes, married puts, straddles, butterfly spreads, box spread and ratio spreads online; a range of institutional research from Deutsche Banc Alex. Brown; and institutional-quality market information. In addition, AccessPoint calculates the market value of a customer's total account and individual holdings using real-time prices and asset factors for equity and options positions, and customers can get intraday cash balances including intraday buying power on margin. For more information visit www.wallstreet access.com.

▼ The Day Trader's Glass Top Desk from **Day Trader Products** accommodates up to six 19-inch monitors or four 21-inch monitors, which can be angled underneath the glass for easier viewing and maximized space. Desk dimensions are 28½ inches (h) by 60 inches (w) by 39½ inches (d). The desk's total weight is approximately 140 pounds. The desk is made of a steel tubing frame with a wood platform to hold the monitors on the top. The glass inserts into the top of the desk. For more information go to www.daytraderproducts.com.

Forexnews.com

When it comes to finding currency (Forex) Web sites that offer good, basic information, the pickings are a bit slim, but Forexnews.com (www.forexnews.com) delivers just that.

Forexnews.com offers a mixture of free and proprietary tools and information. The tools include an educational section, currency market forums run by technical analysts Cornelius Luca and Jim Chorek, news and market sentiment analysis by Forexnews writers, and market commentary (via audio clips).

The educational section offers basic information for those new to Forex, such as the definitions of economic indicators and the currencies they impact. The Forex guides provide information on what factors influence specific currencies and include the names of various government officials who make the policy decisions that affect different currencies. Also included in this section is a discussion of fundamental and technical analysis tools, linked to debates about which approach is better to use.

The Web site's premium services include technical buy and sell recommendations provided by Chorek and Luca, as well as a charting and news package. The subscription price for Luca's analysis is $135 per month, while Chorek's comes in at $99 per month. No explanation is given for the difference in costs, but they do provide examples of the reports and a seven-day trial is available for $7, so you can look before you leap. Forexnews.com's charting program is priced at $34.95 per month.

If you want more in-depth information, or you are already familiar with currency trading, the site probably will not interest you. (The site could add a bit more detail in the technical analysis portion, for example.) But for those starting out, Forexnews is good place to get your feet wet. You can get a good indication of the different factors that affect the market, and the forum provides quick access to other Forex traders.

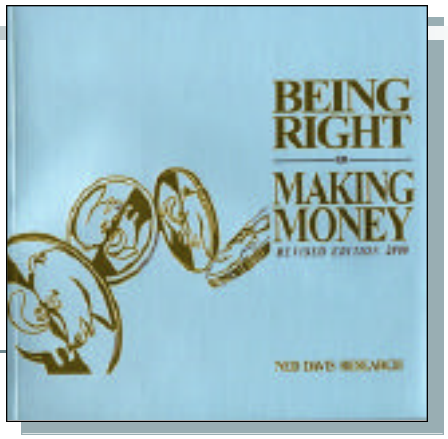
— Kiara Ashanti

FOREXNEWS.COM

Forexnews.com offers research and educational tools for currency traders.

Being Right or Making Money

Ned Davis Research
Ned Davis Research Inc., 1991 (Revised edition 2000)
Paperback, 149 pages
$29.95



REVIEWED BY *ACTIVE TRADER* STAFF

In *Being Right or Making Money*, Street investment research firm Ned Davis Research (NDR) expounds its philosophy of favoring objective, quantitative market timing models over forecasting techniques.

It's an area company founder Ned Davis knows well. He built a stellar reputation for himself as a forecaster in the 1970s, but was disappointed by the lack of financial remuneration he had to show for it. Sure, he was a star on the guru circuit, but what about the bottom line?

In the first chapter — the one that lays the groundwork for the rest of the book — Davis describes his realization that successful forecasting might be psychologically gratifying, but it didn't have much to do with making a living trading. In switching from market forecaster to designer of objective timing models, he found his predictive abilities subsequently suffered, but his actual profits went through the roof. "Proper investment strategy and good money management," he found, were the keys.

Davis also discusses the most important principles for making money (objective indicators, discipline, flexibility, risk aversion) and the common traits of successful traders. The material in this section of the book is frank, easy to understand and none the worse for wear for being repeated, in some form or another, in other good trading media. On the contrary, it's great to get such precise confirmation from another reputable source. In short, you can't read, absorb and apply this stuff enough.

The rest of the book illustrates various aspects of the arguments Davis puts forth in the first chapter. The second chapter is Davis's analysis of the stock market bubble of 2000 (the book was published last year), followed by chapters from NDR associates detailing different market timing models and testing approaches, all accompanied by numerous charts. There's not much material directly geared to active traders (although Chapter 7 addresses contrarian techniques and the use of the put-call ratio for shorter-term trading), but it is all compelling analysis that will expand your understanding of timing models, and objective trading and testing techniques. NDR uses many multi-input trading models, and the assimilation of various data — including economic factors and financial inputs most traders ignore — is educational.

The book's primary drawback is its repeated recognition of the paramount importance of risk control and money management, coupled with its failure to offer any explicit instruction on these topics beyond the necessity of cutting losses and letting profits run, and revealing that the firm uses stop-losses on its indicators. NDR's basic message is that "being right" doesn't amount to a hill of beans and making money is essentially a matter of money management — developing objective trading models that capture profits while controlling risk. The next edition of the book should cover the money management subject in greater detail.

That said, there need to be more trading books like this: objective and analytical. Actually there needs to be more of *this* book. If NDR put together an expanded, detailed and comprehensive discussion of the concepts they outline here, it would provide a great service for the trading industry and the investing public (and probably win a few more converts and clients). As it stands, it's a pretty good book, anyway.

—Mark Etzkorn, editor-in-chief

Regardless of what you might think after reading *Being Right or Making Money*, one thing is certain: It doesn't lack for detail. The book presents a bounty of information and almost all of the concepts presented are backed up with full-page charts. Sometimes, though — particularly in the sections detailing trading models/strategies — it assumes a fair amount of knowledge on the behalf of the reader.

Early on, *Being Right* mentions three warnings for would-be successful traders: Don't fight the tape (the market trend); don't fight the Fed; and be wary of the crowd at extremes. The first maxim is reflected throughout the book, as the information is not designed to trade a specific stock, but rather to determine the overall market trend.

Chapter 7 goes into greater detail about the third warning. From public opinion to media headlines to political quotes, a handful of charts shows several occasions where going against the trend would have made you money. The chapter concludes with a trio of specifics to look for to make money being a contrarian trader: certain short-term indicators, sentiment indicators and the path of managed money.

Ned Davis, author of the first two chapters, is certainly well-versed in the market. *Being Right* was re-issued (with a new chapter) in 2000, before the bears chewed up Wall Street. Davis

correctly predicted that the booming economy and the stock market were in for a reversal of fortune. While the section entitled "Stock Market Risk Factors" provides a good history lesson, it relies primarily on charts to relay its message.

For example, when discussing the price-to-book ratio, the entire explanation reads: "(The) charts … show just how out of line equity market values are relative to their book value or net assets. In other words, it would be far cheaper to build a new company rather than buy one in the stock market."

Two charts follow, one dating back to 1925, the other to 1945. Both are detailed and annotated, but unless the reader has a working knowledge of price-to-book ratio, the charts will not do much good. Davis gives similar treatment to price-to-sales and price-to-earnings ratios, among others.

Chapters 3 and 4 make up the real "how-to" section of the book. Chapter 3 explains how to build a model for trading stocks using external indicators (such as sentiment or valuation indicators), monetary indicators (interest rates, money supply), economic indicators (GDP, CPI) and internal indicators (moving averages, momentum). A similar discussion of building a bond model is detailed in Chapter 5.

Chapter 4 provides a specific nine-indicator timing model that traders can use, explaining each of the indicators in depth. For instance, the first indicator is weekly new lows divided by issues traded. The book states, "The indicator is bullish below 1.95 percent, bearish above 7.2 percent and neutral in between." Specific percentages for the other indicators also are provided.

Traders looking for a book that will hold their hand and lead them step-by-step through the ABCs of trading will be lost. The paperback edition is 140 pages and only six deal with how to choose specific stocks. In addition, very little emphasis is placed on specific entry and exit techniques.

However, for those who are already well-grounded in the mechanics of trading, *Being Right or Making Money* will provide another way of looking at the markets.

— Jeff Ponczak, associate editor

"…I began to realize that smarts, hard work, and even a burning desire to 'be right' were really not my problem, nor the solution to my problem. What I realized was that my real problems were a failure to cut losses short, an inability to be disciplined, letting my ego get personally involved in my market view (which made it difficult to admit mistakes), fear and greed, and a lack of risk management."

—Ned Davis, from *Being Right or Making Money*

Even though *Being Right or Making Money* shows why Ned Davis Research is one of the most respected and thorough market-analysis companies in the world, this book leaves you wanting more.

Most of the book is devoted to different long-term trading/forecasting models and what they imply about market direction. Many of them are remarkably accurate and ingenious in their simplicity, and could have made a killing for anyone who followed their signals, but the book is missing some follow-through.

For instance, in the first two chapters of the book Davis explains why the bull market of 1999 was more overbought than any previous bull market and why it was due to come to an end. He illustrates his point with sell signals from almost 50 indicators. Although these tools are very precise in terms of time and price, the book does not offer much help on how much to risk and commit to each trade. That essentially goes against Davis' own findings that "proper investment strategy and good money management" are the keys to trading.

One thing that would help is more data to back up some of the indicators which simply have generated too few signals to be statistically reliable. Most have around 30 to 40 signals each, but the Consumer Price Index indicator on p. 40, for example, has generated only 20 signals since 1966. By the same token, it would be nice to get a feel for the kind of results these signals produced, using standard deviation analysis (which would allow us to see how much an individual trade varies from the norm).

Granted, it's hard to create enough signals to make a long-term market-specific indicator statistically valid without making it short-term or causing it to lose its accuracy. Also, the lack of statistical support for a few of the indicators is balanced by the common-sense logic behind them, as well as the sheer number of indicators used. Overall, though, I would have appreciated a few more numbers supporting the research.

Another concern is that many of the indicators seem a little too precise. For example, the bond yield percentage reversal indicator on p. 91 calls for a long trade in the S&P500 when the yield falls 8.7 percent from the high of the current trend, and a flat position when it reverses upward 11.7 percent from the low of the current trend. It would be helpful to know what the results would be if, for instance, these threshold levels were set to the closest whole number, or perhaps even reversed. Looking through the charts, it is easy to see the results could be altered significantly for several indicators by nudging the trigger levels ever so slightly.

However, because most of the indicators are very simple and logical, with spelled-out rules, diligent traders should be able to replicate and analyze them. Also, there is nothing keeping traders from grouping several indicators into a combined model, in which each indicator either stands on its own merits or confirms the others. From this point of view, the book is a gold mine.

—Thomas Stridsman, senior editor

Software SCREENING: NeuroShell (Day)Trader Professional 3.21

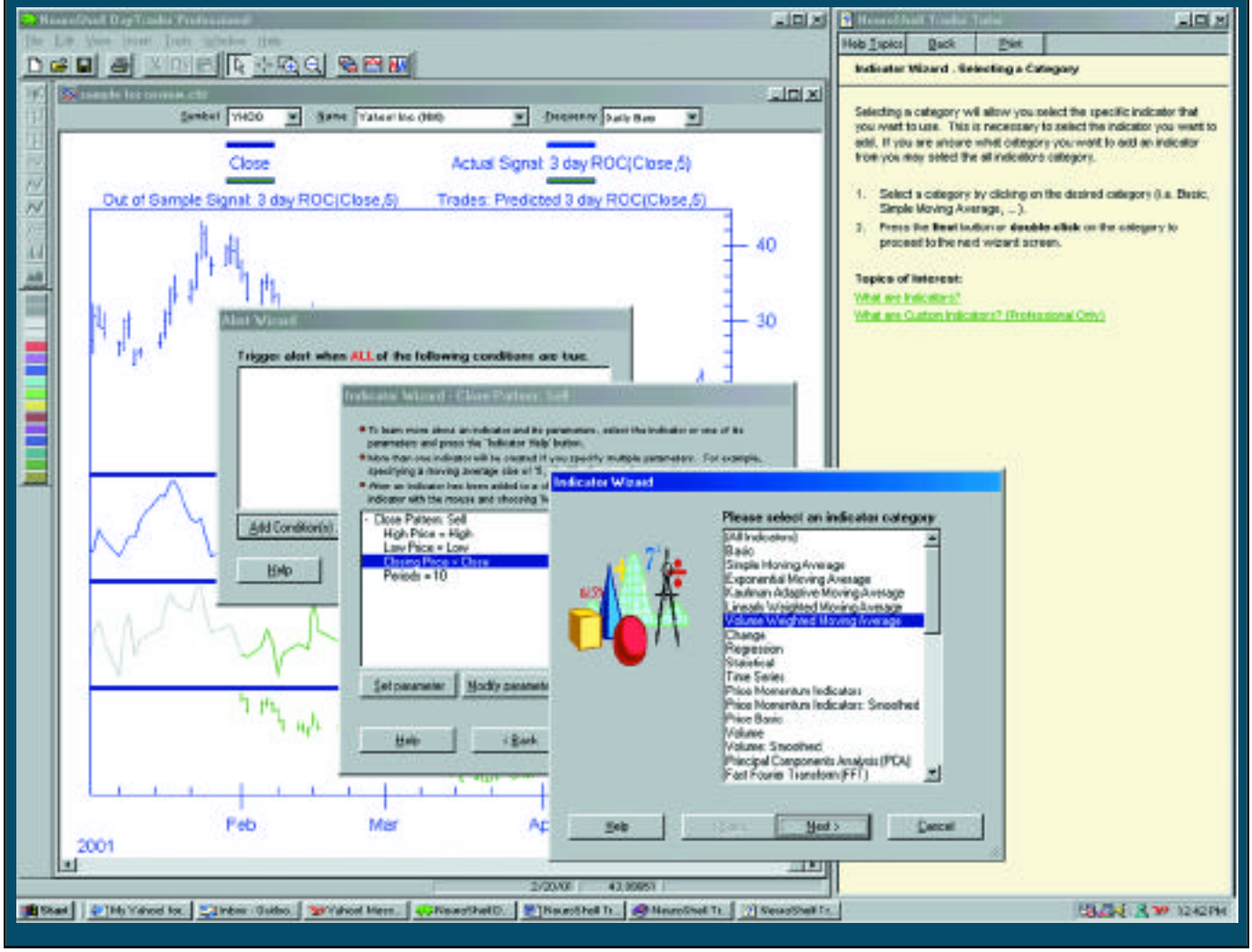
BY THOMAS STRIDSMAN

If you're looking for an advanced software package that provides plenty of features and analysis concepts, NeuroShell (Day)Trader Professional by Ward Systems Group could be for you. This is a well-designed program with a wide range of analytical tools, ranging from the most commonly used technical indicators (e.g., RSI and moving averages) to very sophisticated forecasting capabilities. It's not a program for beginners or casual traders.

Few programs have such an expansive set of ready-made formulas. It's difficult to count how many "true" indicators

FIGURE 1 EXCELLENT HELP, PLENTY OF DIALOG BOXES

In this screen, we're about to substitute the closing price (in the dialog box, second from top) for a formula from another category (top). The help window to the right gives ample help for each step of the operation.



Product: NeuroShell (Day)Trader Professional, version 3.21

Company: Ward Systems Group (www.neuroshell.com)

Phone: (301) 662-7950, Monday - Friday, 8:30 a.m.-5:30 p.m. EST

Online customer service: www.ward.net

Price: $1,395 for end-of-day version (excluding price for data from separate data provider); $2,295 for DayTrader version (excluding price for data from separate data provider). Both versions support a variety of end-of-day data formats, such as MetaStock, CSI, Omega and ASCII. DayTrader version requires QCharts/Qfeed from Quote.com, starting at $79.95 per month, plus applicable exchange fees.

Recommended system: Windows 98, 2000, ME or NT; Pentium 200 MHz; 32 MB of RAM; 20 MB hard drive space (plus estimated 200 MB for database).

there are because the program counts every pre-programmed formula, relational test and rule as such. To give an estimate, however, the program's indicator wizard contains some 800-plus formulas divided into 45 different sub-categories, such as price momentum, statistical, volume, chart pattern identification, economic and Boolean, just to mention a few.

Features

NeuroShell's features can be broken down into four areas. All work with each other and, thanks to the step-by-step approach of each one, they are very intuitive to work with. The main drawback is sometimes there are too many dialog boxes to sift through, which can make you lose your perspective.

Many times, however, this is a necessary evil. The 800-odd formulas have to be sub-divided but still kept close enough to make it possible for all of them to interact. In the world of Windows, this usually requires a dialog box to bridge the gaps.

In this regard, the one-thing-at-a-time process of applying a feature is very much like applying a "wizard" in any of Microsoft's office programs. Appropriately enough, this is also the method NeuroShell uses. The four different NeuroShell wizards are:

- The Indicator Wizard, which allows you to chart any of the many indictors that come with the program.
- The Prediction Wizard, which helps you build a model to forecast a future market or indicator value, using advanced neural network technology built into the program.
- The Trading Strategy Wizard, which helps you build and back-test a trading strategy, using both indicators and forecasted values as inputs.
- The Alert Wizard, which lets you scan your database for securities fulfilling your trading criteria.

The Indicator Wizard

With more than 800 formulas that can interact with each other in various and seemingly limitless ways, it takes some tinkering and getting used to before you can start building your own custom indicators — or even applying the most basic ones. Despite the simplicity of the wizard, it still is a little intimidating getting started. Once up and running, however, only your imagination stands between you and any indicator under the sun.

While the number of formulas and their potential combinations are strong points, charting them is not. The program produces charts that look and feel old, with a limited number of options when it comes to selecting chart styles, font types, background and foreground colors, etc. For example, there are only three chart types (bar, candlestick and line) and there are no drawing tools for trendlines or support and resistance lines.

That said, however, the charting engine does hold a few pluses: Applying the same indicator to several securities at once is very easy, as is building and charting indicators containing data from markets other than the one the indicator will be applied on. It also is very easy to hide (or show) indicators and securities you want to keep readily available without distorting your current analysis.

Also, if you're not pleased with NeuroShell's interface, the program lets you link your indicators back and forth between both MS Excel and TradeStation.

SOFTWARE SUMMARY

Product: NeuroShell (Day)Trader Professional, version 3.21

What it is: Analysis platform featuring end-of-day or real-time charting and formula building; advanced forecasting, system-testing and optimization capabilities using neural-network technology and genetic algorithms.

Who the product is for: Traders of all kinds, ranging from stock and mutual fund traders to commodity futures and currency traders.

Skill level: Advanced (mathematically inclined) traders.

Upside: Very expansive menu of analytical tools. Interfaces with and imports/exports additional analysis tools to and from TradeStation 2000i. Very extensive system testing and optimization capabilities.

Downside: Rudimentary charting capabilities with an "old-feel" interface. Many dialog boxes make it hard to get a grip of the program. Relatively expensive.

The Prediction Wizard

Every indicator you build can also be used as an input or output in the Prediction Wizard, which uses neural-network technology to predict future values of both prices and indicators. Once you have created a prediction, you can chart its values like any other indicator. You also can have several predictions running at the same time

Neural networks can be described as a number of mathematical engines that have the ability to remember, store and use past data to predict future performance. For example, a neural network designed to compute rate of change will consider current data but will also use past results from the other engines to give a better indication of what might happen in the future.

The Prediction Wizard in NeuroShell is especially designed for financial data and is a truly unique and value-adding feature of this program.

The Trading Strategy Wizard

Another unique feature of NeuroShell is its Trading Strategy Wizard, which also is based on so-called artificial intelligence technology. However, instead of neural networks, the Trading Strategy Wizard uses genetic algorithms.

Genetic algorithms decipher what produces good results and what doesn't work, steering the optimization process in the desired direction.

In turn, with the ability to speed the optimization process, it is possible to test on a longer time series, using a wider range of inputs and parameters for those inputs, and test several different entry and exit rules. In NeuroShell, you can chose between three different optimization procedures:

- Optimize both rules and input parameters.
- Find the best input parameters to go with the fixed rules.
- Find the rules to go with the fixed input parameters.

Each optimization procedure can then be used to maximize your strategy for a wide range of different criteria such as percent profitable trades, average profit per trade and minimum drawdown.

One strange thing is that in both the Prediction Wizard and the Trading Strategy Wizard, the number of winning trades minus the number of losing trades is the most recommended optimization objective. If this is so, a strategy producing 211 trades of which 111 (52 percent) are winners is considered better than a strategy producing 30 trades of which 20 (67 percent) are winners — even if the 30-trades strategy also happens to produce a higher average profit-per-trade, produces more uniform trades and spends less time in the market. Clearly, this is not a good most-recommended optimization objective.

Instead, the average percentage profit-per-trade is a better one to use. Another could be percent profitable trades.

The Alert Wizard

The Alert Wizard can make use of all indicators, predictions and rules to set up a range of conditions and alert you to good trading opportunities. However, in a program with so many other high-quality features, there isn't much to say about the Alert Wizard other than it seems to alert as it should, when it should.

Operation and handling

The best way to get started is to watch all the instructional videos and then try to repeat the same steps. In the beginning, you will likely feel there is no end to the many dialog boxes, but after a while, you will get used to it and see the logic. One dangerous trap, however, is that a few of the dialog boxes can alter their contents and meanings ever so slightly, depending on what path you took to reach the box.

When it comes to the Indicator Wizard in particular, with the 800-plus formulas in 45 different categories, it's almost impossible to remember what's where. Perhaps the next version of the program could make it possible for the user to store his or her own indicators in custom sub-folders. For example, if I frequently use a 20-day moving average (from the Simple Moving Average folder) of a 10-day RSI (from the price momentum folder) I could store the entire combined indicator in my own "frequently used" folder.

One dialog box that doesn't lead into other boxes and different sub-folders — but probably should — is the chart-creation box. Today, many data providers let you collect your data under different sub-folders on your hard drive, so that you have all the Nasdaq 100 stocks in one folder, all the Dow 30 stocks in another, etc. NeuroShell recognizes this when you set up the program, but when the time comes to create a chart, all stocks are meshed together into one long list.

The complexity of the program will make it impossible for you to learn it all in one sitting, or even several sittings over a few weeks. Ward Systems Group has recognized this by adding a context-sensitive help feature that has to be one of the best and most extensive around. Do not turn off this feature unless you absolutely have to, and do take the time, during the first few weeks or so, to read all the help sections as they appear next to what you are working on.

Bottom line

NeuroShell comes jam-packed with the latest in analysis technology. If that wasn't enough, there are several available add-ons that provide indicators dealing with such matters as fractal dimensions, Hurst exponents, fuzzy logic, data cluster analysis and even astrology. All this makes NeuroShell a very high-end, sophisticated product that takes time to learn and master.

This is not a program for newer traders, or discretionary traders who rely on instincts and simple patterns rather than mathematics. Instead, this is a full-fledged quantitative analysis tool for advanced traders interested in researching and testing trading ideas based on statistics and complex market relationships. For the right person, NeuroShell (Day)Trader Professional is well worth its price.

Correction: The wrong telephone number was mistakenly printed in the July 2001 Software Screening review of MetaStock 7.2. The correct number for Equis International (www.equis.com) is (800) 882-3040. *ActiveTrader* regrets the error.

Product REVIEW: "Strategies for Profiting With Japanese Candlestick Charts"

REVIEWED BY
LESLIE N. MASONSON

"Strategies for Profiting with Japanese Candlestick Charts (with Steve Nison)" is a set of four videotapes that provides the basics of candlestick charting and trading strategies.

Nison, a chartered market technician, is president of Candlecharts.com and author of two books on candlestick charting techniques: *Japanese Candlestick Charting Techniques* (1991, Prentice Hall Press) and *Beyond Candlesticks* (1994, John Wiley & Sons). The video was shot at a one-day seminar given by Nison last year in front of an audience of paying customers. The videos are especially suited for beginning to intermediate traders.

Subject matter

The video starts with the construction of candlestick charts and the components of a candle (e.g., shadow or wick, open, high, low and close). Nison then describes basic candlestick chart patterns, including doji, hammer, hanging man, shooting star, high wave candle, engulfing patterns, dark cloud cover, blended candle, piercing pattern, harami, morning star and evening star. He illustrates these patterns on overheads (using a zoom lens in most cases), and pinpoints trading opportunities (potential buy or sell signals).

He covers the related analysis topics such as "windows" (price gaps between candles), spinning tops, springs and upthrusts, moving averages, and resistance and support levels. The discussion also incorporates the critical subject of capital preservation and money management techniques. To put the candlestick methods in context, Nison briefly reviews Western technical analysis, covering support and resistance lines, trendlines, oscillator divergence and the head-and-shoulders pattern.

Nison also talks about the pros and cons of candlestick charting techniques. He argues candlestick charts provide superior insight into the way markets are ruled by emotions, but also says they do not "predict" price moves as well as bar charts. Accordingly, he believes candlestick charts do not replace, but rather complement, bar charts.

Format

The video is in lecture format. Because Nison has to cover a great deal of material in a specified time frame, there are only a few cases where he allocates time to practice what he has presented with an exercise. Viewing the seminar on video gives you the opportunity to stop the tape at any point to review what Nison has said, review the appropriate charts and move on once you understand the concept or pattern presented. This is one of the great benefits of viewing the video compared to attending a live seminar.

Nison has an easygoing, friendly delivery. He is well organized and he uses his time efficiently. He also brings some flavor to the presentation by using Japanese proverbs to make key points. He takes questions from the audience, repeats the question and provides detailed answers.

Limitations

The package has its drawbacks. First, the 199-page "manual" is accessible only online (rather than in print form). Therefore, you either have to view the charts on your computer screen while watching the video or print out the pages you want, neither of which is an optimal scenario. Second, on a number of occasions, there's no zoom on the pattern being discussed, so it's difficult to see unless you look at the chart on your PC or have a hard copy printed in front of you. Finally, there aren't enough exercises to reinforce the knowledge of specific patterns or their buy and sell points. In a self-paced learning environment, such exercises are important.

Bottom line

If you are interested in learning the basics of candlestick charting, and if you prefer video rather than book learning, this will give you what you need. Nison is extremely knowledgeable, enjoys teaching the subject and provides a logical, clear-cut explanation of candlestick charting. He is a master at providing a simple explanation of a complex subject. This is a good place to begin your study of candlestick charting techniques.

Product: "Strategies for Profiting With Japanese Candlestick Charts (with Steve Nison)"

Running time: 6 hours, 15 minutes (four videotapes). A 199-page manual in PDF format is accessible online.

List price: $695

Ordering information: www.candlecharts.com/private.htm or call (732) 254-8660.

Short-term trading WITH RELATIVE STRENGTH

BY BARRY AND MATT RUDD

How do you find the best trading opportunities from day to day? Compare a stock's performance to the rest of the market. Relative strength analysis can alert you to stocks with great momentum potential.

FIGURE 1 STRENGTH IN THE FACE OF WEAKNESS

Veritas (VRTS) held its own when the index (top) declined between points A and B, suggesting it was an exceptionally strong stock. When the index turned back up, VRTS rallied strongly between points B and C. From point C to D, the stock once again showed relative strength vs. the index.

Source: TradeStation Pro by TradeStation Group Inc.

Comparative relative strength measures a stock's performance over time against the performance of its corresponding market index. The goal of relative strength analysis is to identify and buy the strongest stocks as the market moves up and sell the weakest stocks when the market moves down.

For longer-term traders or investors, the time frame for measuring relative strength may extend from several days to months. However, by shrinking the time frame down to intraday price moves, this principle becomes a useful tool for day traders as well.

Relative strength is often expressed numerically — e.g., as the percentage move of a stock over a certain period divided by the percentage move of the index over the same period. However, a mathematical calculation is not crucial, especially for intraday traders. An effective way to visually track relative strength is to align a chart of the index directly above the chart of a stock, as shown in Figure 1. By comparing the five-minute bar chart of a stock with the

FIGURE 2 BUCKING THE TREND

The stock's strength (bottom) from A to B set up a potential buy when the index reversed at point B. The stock continued to show relative strength by making higher highs between point C and D while the index only managed to make a lower high. Even when the index sold off to point E, the stock pulled back only slightly.

Source: TradeStation Pro by TradeStation Group Inc.

five-minute bar chart of the index, you can discover when a stock is outperforming or underperforming its index throughout the trading day. These situations often present good buying or selling opportunities.

Bucking the intraday trend

Some of the best relative strength trades occur after the index has made a significant move up or down, lasting from one to several hours. After such a trend has run its course, the index often reverses direction (often after trading sideways for a while) and retraces a significant portion of the initial move. It is at these reversal points that relative strength trades present themselves.

For example, if the market moves down in the morning and subsequently reverses up, stocks that hold up at or near their highs of the trading session are strong relative to the earlier index weakness. As the index begins to move higher, these strong stocks are typically good buys — it's almost as if the index was the only thing keeping the stocks from advancing.

A good entry point for a long position is when the stock sets a new high for the day, or when the index takes out its latest lowest high in its preceding downtrend. Figure 1 shows one such trading opportunity in Veritas (VRTS) on March 30. Figure 2 shows a similar example in Abgenix (ABGX) from Feb. 26.

In a short-selling scenario, stocks that sag at or near their session lows when the index is up tend to break down faster if the market trend reverses to the downside. A method for entering such weak stocks is to sell when they penetrate their current daily lows, which preferably should coincide with the index falling below its most recent highest low.

Opening moves

You don't have to wait until the latter part of the day for a comparative relative strength trading opportunity to develop. For example, if the index gaps down from the prior day's close but the stock opens at or slightly above the prior day's close, that stock is strong relative to the market. If a broad market rally ensues, the stock that held up strong on the open is likely to move higher and faster than the index. These moves off the open (or during the first 10 to 30 minutes of the trading session) are often strong, fast price spikes.

Conversely, if the index gaps up strongly on the open and the stock languishes, opening at or slightly below the prior close, sellers are likely in control of that stock. If the market rolls over and begins to sell off, usually no one is there to support the weak stock. This kind of anemic introduction to the trading session often precedes a plummet in a stock's price. Figure 3 hows such an example in Flextronics (FLEX) from March 15.

Closing clues: One-day relative strength

Another approach is to use "one-day relative strength" to prepare for the next day's trading by generating a list of stocks that exhibit strength or weakness (based on closing prices) relative to the index.

For example, if the market moves down strongly and closes at or near its low of the day, look for stocks that close up on the day. In such circumstances the best opportunities will come in those stocks that close at or near their daily highs, displaying good relative strength compared to the market as a whole. In other words, even though sellers had control of the overall market, buyers remained strong enough to push that particular stock higher. If the market

FIGURE 3 **TWO-DAY RELATIVE WEAKNESS**

The index (top) gapped higher at the open, but Flextronics (FLEX) opened lower, confirming the relative weakness previ - ously hinted at by its close the previous day. When the index started to fall, FLEX gave a sell signal when it fell below its previous low at point B. The stock followed through on the short side until the final hour of the day.

Source: TradeStation Pro by TradeStation Group Inc.

starts to rally the next day, the stock that had closed up strongly is more likely to follow through to the upside.

The opposite scenario holds for stocks displaying one-day relative weakness when comparing its daily bar to the index's daily bar. On a day when the market rallies strongly to close at or near its high, the stocks that sell off and close the day at or near their lows are good potential short-selling candidates for the next trading session. Notice in Figure 3 that March 14 was an up day for the index (top), but FLEX (bottom) closed near the low of the day, indicating weakness going into the next trading session.

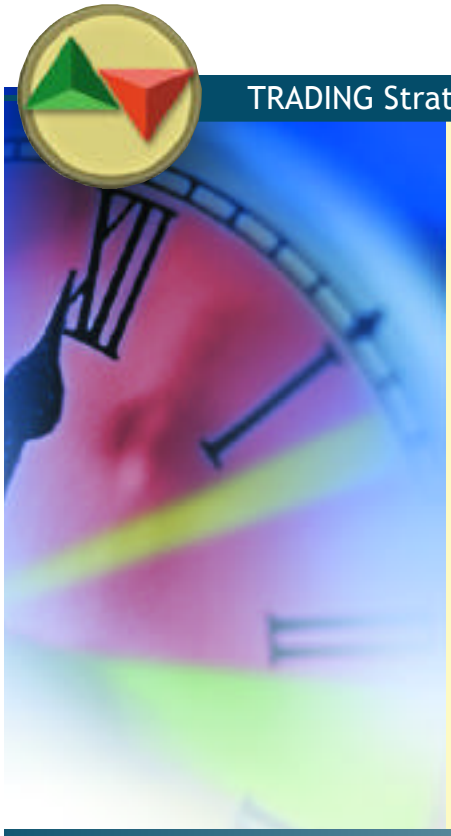
Preferably, the strength or weakness of the stock compared to the rest of the market should be a little bit more pronounced for these setups. However, a word of caution is in order here: It can be too much of a good thing if a stock has gained or lost a substantial amount in one day. In such cases, it may not follow through in the desired direction.

Scanning for trading candidates

To find trading opportunities, you can use any software or Web site that will allow you to scan for stocks with specific minimum price and daily volume values. This helps you catch potential one-day relative strength/weakness trades in stocks you normally do not follow. Wait for a day when the overall market closes up or down strongly. After the market is closed, set up a scan to identify the largest-percent gainers or the largest-percent decliners for that trading session.

If the market was up, scan for largest-percent decliners. Conversely, if the market was down, scan for the largest-percent gainers. Generate a list of the top 40 to 50 stocks and analyze the daily charts of each. Focus on those with the most potential and assemble a list to watch and trade the next day.

Alternately, you can closely monitor a particular basket of stocks throughout the day. With time you will recognize the distinct "personality" of each stock and how it behaves on its five-minute chart. You can then pair this knowledge with a stock's current relative strength to uncover quality relative strength trades. If you are tracking a Nasdaq stock, use either the Nasdaq 100, the Nasdaq Composite or Nasdaq futures contract. For a NYSE stocks, use the NYSE Composite or Dow Jones Industrial Average.



Putting time on your side

Trading is not just a question of what the indicators are telling you, it also depends on timing. Here's a breakdown of the most opportune trading periods throughout the day.

BY BARRY AND RYAN WATKINS

Trading isn't just a matter of what, it's a matter of when. Your analysis can lead you to what may turn out to be a correct assumption of the market's direction. But if you enter your trade too early or too late, your research won't do you much good.

The stock market makes several pauses or reversals every day. Identifying likely market reversal time zones is critical to maximizing profits for short-term traders. The ebb and flow of trading throughout the day is influenced by a number of factors, including the supply and demand situation before the open, when traders typically take lunch and the need for many traders to square away positions by the end of the day.

Because no two trading days are ever exactly the same, trading time zones are general guidelines — not rigid rules. When combined with other analysis tools, they can give you a better idea of when a trade may or may not be a good idea.

In the zone

On a normal trading day, the stock market is open for 6.5 hours, or 390 minutes. The trading session can be divided into approximately 14 time periods, or zones. Each of these zones can be classified according to the colors of a traffic signal.

For experienced traders, the first 20 to 30 minutes of the trading session can be a very profitable time, but for less experienced traders, it probably is the most dangerous period of the day.

The red zones: These are the most dangerous times of the day to trade. There are two red-zone trading periods, which comprise a total of 200 minutes, or 51 percent, of the typical trading day.

The yellow zones: These six time zones represent typical (and approximate) times when the market pauses or reverses. These periods account for about 14 percent of the trading day.

The green zones: While not necessarily safe, the six green time zones represent those periods when market activity follows more consistent patterns. The market will spend approximately 35 percent of each day in green territory.

Watching the clock

To illustrate the 14 time zones, we'll walk through a typical trading day. But first, it's important to remember there is no such thing as a risk-free trade. To generate a profit, the market must be moving, which also increases the risk. The largest profits usually occur during the most dangerous (volatile) times.

FIGURE 1 S&P INDEX

1) The index makes a high around 20 minutes after the open. 2) A doji candlestick (one for which the open and close are the same) marks a reversal during the 9:50 to 10:10 a.m. reversal period. 3-4) The market bottoms at 10:10 a.m. 5) Another down move starts during the 10:25 to 10:30 reversal period. 6-7) Prices drift lower during the majority of the midday doldrums. 8) A brief consolidation period coincides with the close of the bond market. 9) Short covering closes the day with a rally.

Source: QCharts from Quote.com

Therefore, a market environment that is marked as red and dangerous for you might be another trader's dream market. It depends on your level of expertise and trading style. Figures 1 through 3 provide chart illustrations of the various zones.

Period 1: 9:30 to 9:50 a.m. EST (red zone)

The market opening at 9:30 a.m. is the first red time zone, which lasts for approximately 20 minutes, until 9:50 a.m. EST. For experienced traders this can be a very profitable time, but for less-experienced traders it probably is the most dangerous period of the day.

The abundance of pre-market orders essentially gives the market makers and specialists "inside information" about the expected supply and demand in a stock — an extreme advantage. To make the most of supply and demand imbalances, the market makers and specialists often open the stock much lower or higher, creating extremely large price gaps.

This might entice less-experienced traders to chase the stock. However, they often put on a trade only to watch the stock move against them shortly thereafter when the forces behind the early imbalance have disappeared. Depending on the volume it usually takes about 20 minutes for the market makers and specialists to fill the pre-market orders and make the most out of those traders who were lured into the trap. After this period, more realistic prices should emerge.

The professionals essentially get themselves a good price on the open and profit when the market snaps back the other way. For example, when a market maker or specialist gaps a stock higher, it's because there are more buyers than sellers (perhaps some bullish news came out before the open). When this happens, the market maker will exploit the greed and open the stock at an unrealistically high price. Once the buying frenzy has died down, the stock will typically pull back and the market maker or specialist (who shorted the stock at the inflated high price) will buy the shares back at a profit.

Period 2: 9:50 to 10:10 a.m. (yellow zone)

Many of the bigger stocks (as well as the S&P 500 futures contract) often reverse around this time. Because all the opening orders have now been filled, more realistic prices based on immediate supply and demand are likely to emerge. If the stock isn't extraordinarily strong, this can be a very profitable time of the day because the initial rally sets up the possibility of a short trade.

Usually, the longer it takes for the first reversal to occur, the more pre-market orders there were. If the market remains stable throughout this period it usually also remains stable until the next yellow period (period 4).

Period 3:
10:10 to 10:25 a.m. (green zone)

The first green trading zone can start during the first yellow zone as soon as price has reversed and can stretch into the second yellow zone, which is the next likely reversal zone.

This zone is usually one of the safest periods to trade and will generally go in the opposite direction of period 1. For example, if a stock trades higher in period 1, it often reverses during period 2 and continues down during period 3. If prices move lower in period 3, the end of this period presents an opportunity to enter a low-risk long trade.

Period 4:
10:25 to 10:30 a.m. (yellow zone)

This zone often marks a pause in a strong market, but a full reversal can sometimes occur, going against what initially seemed to be a good long position. Reverse the reasoning if the market reaches this zone on lower prices. If you're trading short-term, you should consider closing your position before the market enters this zone (but be ready to re-enter once it is over). If you're trading longer-term, use stop-loss orders to protect your positions.

> Most traders likely would eliminate 50 percent of their bad trades if they refrained from trading during the midday doldrums.

Period 5:
10:30 to 11:15 a.m. (green zone)

After the market has taken a breather, it usually continues in the same direction it established during the third period.

Period 6:
11:15 a.m. to 2:15 p.m. (red zone)

This time zone is often referred to as the "midday doldrums" because activity dips when traders take their lunch breaks. On an uptrending day, you will often notice that prices start to sag, like air slowly leaking out of a tire. During this period prices show the least amount of follow-through because of the lack of volume.

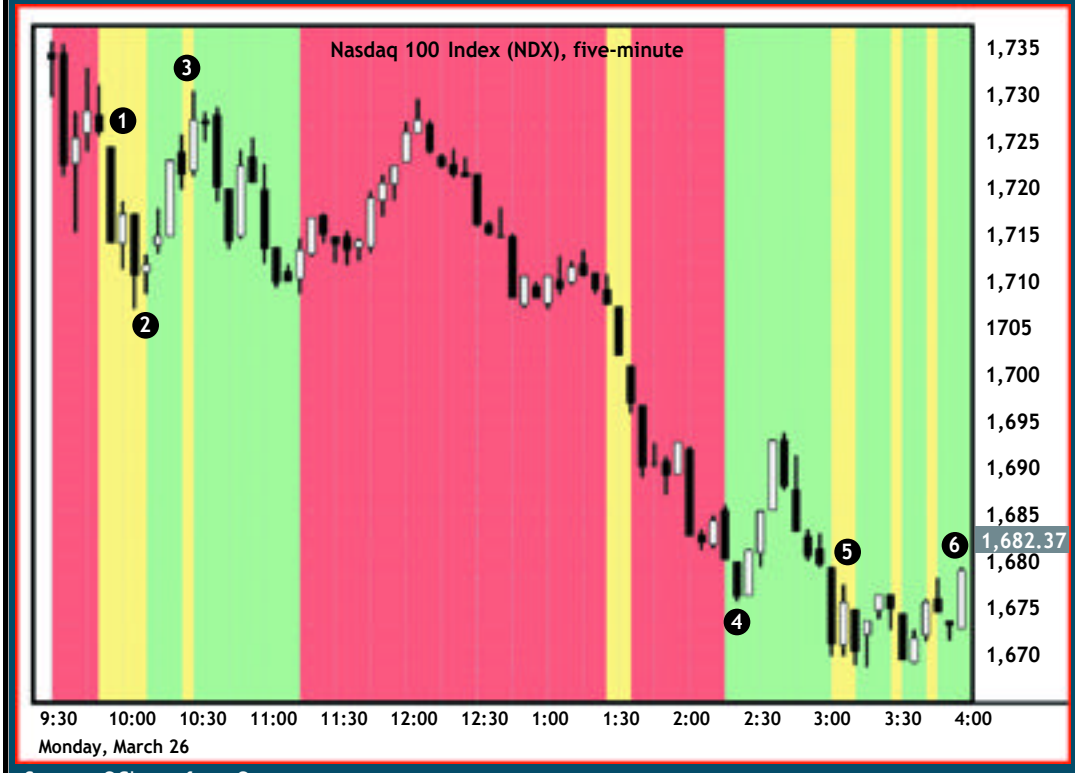
Most traders likely would eliminate 50 percent of their bad trades if they refrained from trading midday. Instead they should monitor this period for price patterns that can act as setups for trades later in the day. For example, the lowest price before an afternoon breakdown often occurs between 1:30 and 2 p.m. EST. While this may or may not have any consequences for your trading later in the day, it still could be a good idea to mark it off, as an indication the market is behaving as it "should." Note that this time period is counted as one zone, although technically it is divided into two parts by a short yellow period (see below).

Period 7:
1:25 to 1:35 p.m. (yellow zone)

This is the weakest and least significant of the

FIGURE 2 NASDAQ 100 INDEX

1-2) *A high is reached immediately after the open. At the end of the reversal period a doji candlestick signals the next move is likely to be up.* **3)** *A new reversal at the 10:25 a.m. to 10:30 a.m. reversal period.* **4)** *The midday doldrums, with declining prices, ends in an upside reversal.* **5)** *The close of the bond market forces the stock market to stall.* **6)** *Short covering induces end-of-day rally.*



Source: QCharts from Quote.com

Reversals are often significant in the period after the close of the Chicago bond market.

six reversal periods because it typically occurs in the middle of the midday doldrums. Volume can drop dramatically during this period; professional traders normally avoid it.

Period 8: 2:15 to 3 p.m. (green zone)

After the midday doldrums, this green time zone commences and continues until 3 p.m. EST when the Chicago bond market closes. This period can be very exciting to trade because it is often like a new trading day. Patterns that started to form during the lunch hours now find support from broader volume, resulting in frequent breakouts in both directions.

Period 9: 3 to 3:10 p.m. (yellow zone)

This reversal period coincides with the close of the Chicago bond market. Pay close attention during this time period; reversals are common and often significant.

Period 10: 3:10 to 3:25 p.m. (green zone)

A short period of relative calm between two significant reversal periods.

Period 11: 3:25 to 3:30 p.m. (yellow zone)

Like period 9, this reversal period is another high-probability reversal zone.

Period 12: 3:30 to 3:40 p.m. (green zone)

Another period of relative calm before the last reversal period of the day.

Period 13: 3:40 to 3:45 p.m. (yellow zone)

A major reason for this final reversal period of the day is many market makers and specialists settle their accounts for the day. Many day traders also exit their trades.

Period 14: 3:45 to 4 p.m. (green zone)

Quite often, the last 15 minutes of the day resemble period 10 (3:10 to 3:25 p.m.). Also, if the day was characterized by selling pressure, an upward hook in prices sometimes occurs right before the close (caused by increased buying to cover short positions).

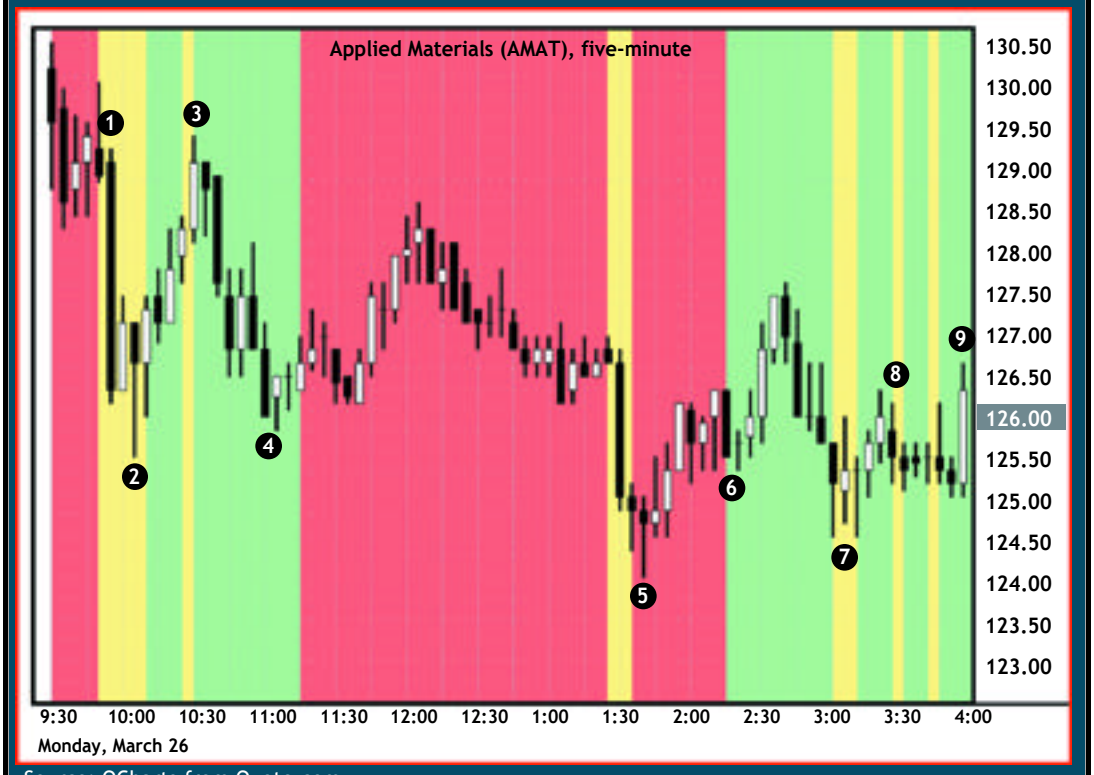
Maintain perspective

These time zones were originally designed to indicate a high-probability reversal periods for the S&P 500 futures market, but they can be applied to individual stocks as well.

Remember, however, the time zones only are approximate indications meant to give you a "heads up" of what might happen next. Time zone analysis should be combined with other analysis to confirm price movement.

FIGURE 3 APPLIED MATERIALS

1-2) *The first reversal period begins with a sell-off and ends with a consolidation period and subsequent upside reversal.* **3)** *The rally ends during the second reversal period.* **4-6)** *Prices drift lower during lunch.* **5)** *The lowest price of the day often coincides with the 1:25 p.m. to 1:35 p.m. reversal period.* **7)** *Close of bond market.* **8)** *Consolidation period starts at 3:25 p.m.* **9)** *Day ends with up hook.*



Source: QCharts from Quote.com

Option trading S-P-E-L-L-E-D OUT

Option traders understand volatility provides an edge in the market. A technique called the PRO-VEST method can help you find high-probability options based on their volatility characteristics.

BY JAY KAEPPEL

Losses in the options market often occur because traders fail to fully recognize options are a wasting asset within a certain time window. Yes, you pay the premium for unlimited profit potential with limited risk, but the fact is most long option trades are unprofitable because of the time decay factor.

However, by adhering to a few guidelines, you can increase the probability of making profitable trades. First, you need to know the keys to trading options successfully:

- Understand the different option strategies available.
- Know the appropriate strategy for a given set of circumstances.
- Understand the difference between historical volatility and implied volatility.
- Use a strategy to take advantage of disparities in the implied volatilities of different options.
- Know when to buy premium and when to sell premium.
- Buy undervalued options and sell overvalued options.
- Have a strategy to cut losses.
- Have a strategy to take a profit.

We'll illustrate these points in the context of the *vertical spread* trade. Before detailing this approach, let's review the most important component to trading options: implied volatility.

Historical vs. implied volatility

Traders who know at a glance if options are "cheap" or "expensive" on a historical basis have a distinct advantage. The best traders buy premium when volatility is low and sell premium when volatility is high, and establish spread positions in which they buy undervalued options and sell overvalued options. Using spread strategies gives the trader the best of both worlds.

There are two basic categories of volatility: historical volatility and implied volatility. Historical volatility is the standard deviation of the price fluctuations of the underlying security over a specific period of time, such as 90 days. For example, we can calculate the standard deviation of the Nasdaq 100 Index tracking stock (QQQs) over the last 90 days to determine the 90-day historical volatility.

While this statistic can be of some value for traders desiring the day-to-day risk of holding a position, implied volatility is more important for options traders. The difference between historical and implied volatility is that the former looks at the past while the latter reveals the marketplace's current expectations of future volatility. In options, value is determined by implied volatility.

The price of an option is composed of the following elements: The strike price, the price of the underlying instrument, days to expiration, interest rates and volatility.

If you had to calculate the price of an option, you would have to estimate the volatility variable to use because you don't care what the volatility has been in the past (the historical volatility). You are concerned about what the volatility is going to be in the future (the implied volatility). That will affect the value of the option going forward.

The implied volatility value for a given option is the value that is "backed out" of an option pricing model when you plug in all of the other known variables and is thereby the volatility "implied" by the current market price.

(For a detailed discussion of historical

and implied volatility, see "Putting volatility to work," *Active Trader*, April 2001.)

Ranking volatility

Relative volatility (RV) ranking is a technique that allows traders to determine whether the current implied volatility for the options of a given stock is high or low on a historical basis.

With RV you can determine the best option trading strategies to employ for a given security. To calculate RV, take all the implied volatility readings for a given stock's option over the last one to three years and divide them into 10 groups, or deciles. As a simplified example, if you divide 120 observations of implied volatility into 10 equal groups (deciles) of 12, the first 10 observations might range from 9 percent to 15 percent, the second 10 might range from 16 percent to 22 percent, the third might range from 23 percent to 35 percent and so on.

If the current implied volatility is in the highest decile, the RV is 10 (i.e., it is in the highest 10 percent of volatility readings over the period you are reviewing). If the current implied volatility is in the lowest decile, then RV is 1 (i.e., it is in the lowest 10 percent of volatility readings over the period you are reviewing).

With this information, you can objectively determine whether implied option volatility is currently high or low for a given security. This information is used to select the appropriate trading strategy.

Current implied volatility and relative volatility rank

Using relative volatility is based on a simple premise: Relatively low-volatility options result in relatively low option premiums, which present buying opportunities. The opposite is true for high relative volatility.

If RV is low (on a scale of 1 to 10) for a given security, traders should generally focus on buy premium strategies and avoid writing options. Conversely, when RV is high, traders should generally focus on sell premium strategies and avoid buying options.

This simple filtering method is a critical first step in making money in options. The best way to find "good" trades is to first filter out the "bad" trades. Buying premium when volatility is high and selling premium when volatility is low is a low probability approach, as it puts the odds immediately against you. Proper trade selection is the most important factor in trading options profitably in the long run.

Volatility skew

Determining the exact strategy to employ can be fine-tuned by examining the differences in the implied volatilities of various options for a given stock. Often out-of-the money (OTM) options trade at a much higher or lower implied volatility than at-the-money (ATM) options. These situations create great profit opportunities.

The pattern of the differences between implied volatilities of various options is referred to as the skew, or "smile." OTM options are more "expensive" if the pattern of the skew is upward sloping — in other words, they trade at a higher volatility than ATM options. If the skew is downward sloping, the OTM call options are "cheaper" than ATM options — they trade at a lower volatility. Monitoring the skew provides opportunities for traders to buy "cheap" options and sell "expensive" options.

Next, let's combine this volatility information with market timing.

Market timing

Many traders will purchase options based solely on their outlook for the price of the underlying stock. However, there are potential problems if you buy options just because you are bullish or bearish on a stock:

- No matter how accurate you believe your market timing is, the probability is just 50/50 that the underlying stock will move in the predicted direction between the time an option is purchased and the expiration date.
- A purchased option will lose its entire time premium by expiration and will expire worthless if it is out of the money at expiration.
- If implied option volatility is high at the time the option is purchased, the amount the underlying stock must move in order for the option position to generate a profit increases.
- Traders rarely consider the slippage from getting filled at a higher price than anticipated and commissions, which constantly eat into a trader's capital, even on profitable trades.

This list of factors lowers the probability of making money on any outright option purchase. It's not that you should never buy naked calls or puts; you simply need to pick your spots carefully and take advantage of anomalies in implied option volatilities.

Different option strategies are appropriate for overbought and oversold conditions. Traders can use a number of indicators to determine when a given underlying stock is overbought or oversold. Two well-known oscillators are the relative strength index (RSI) and stochastics. These indicators range from 0 to 100, with 50 representing neutral momentum or market movement. The higher the reading, the more overbought the market; the lower the reading, the more oversold the market. (See *Active Trader*, August 2000, for detailed information on stochastics, and this issue for detailed information on the RSI.)

Another indicator you can use for options on market indices is the 10-day TRIN (see *Active Trader*, December 2000).

The PRO-VEST method

The PRO-VEST option trading method was developed to determine precise criteria in the following key areas: probability, volatility, time to expiration, the skew of implied volatilities and market movement.

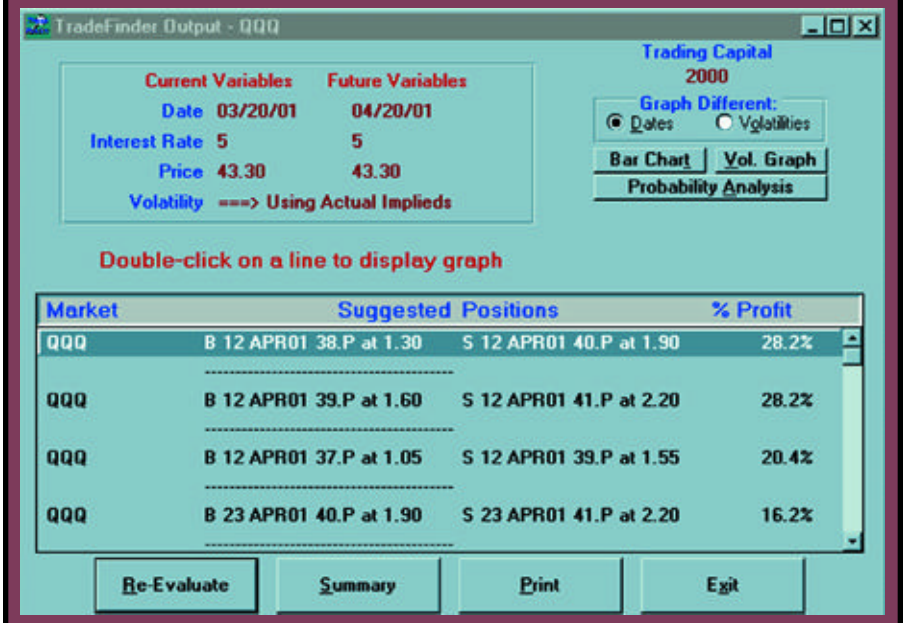
"PRO" is for Probability: The PRO-VEST method uses option deltas to measure the probability that a given option will expire "in-the-money." (Delta is the amount an option moves relative to a 1-point move in the underlying market. For example, a call option that rises 50 cents for a 1-point move in the underlying stock has a delta of .50, or 50 percent. A delta of 50 implies there is approximately a 50-percent chance the option will expire in-the-money.)

Always ask the question: Should I buy or sell "in-the-money" or "out-of-the-money" options?

"V" is for Volatility: Look at RV to determine if implied option volatility is high or low on a historical basis. A RV of

FIGURE 1 EXPECTED RETURNS

The TradeFinder software allows you to construct hypothetical option trade scenarios. Here, the most favorable vertical spread would return 28.2 percent.



Source: Option Pro by Essex Trading Co.

1 to 5 suggests options are cheap and premium should be bought. A RV of 6 to 10 suggests that options are expensive and premium should be sold.

"E" is for Expiration: How much time is left until expiration of the option (and will the position be helped or hurt by time decay)?

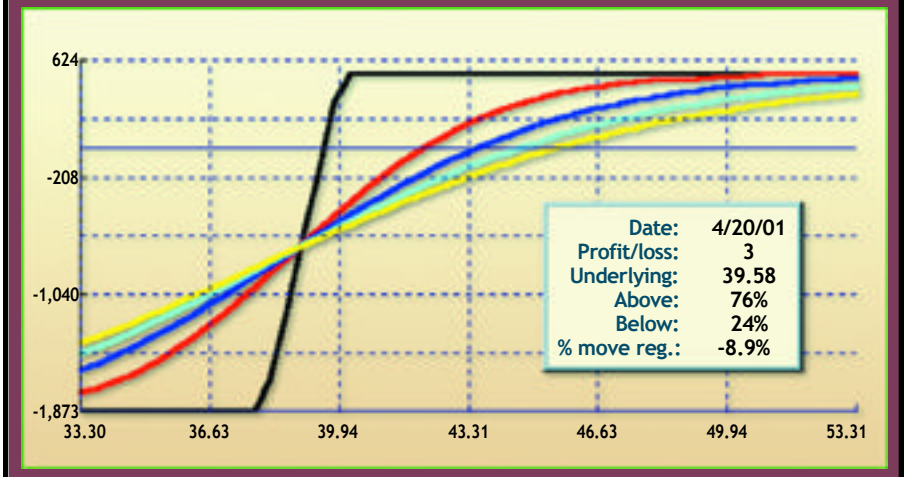
"S" is for Skew: Is there an edge available by spreading (i.e. simultaneously buying cheap options and selling expensive options)? If so, the higher the implied volatility of the option sold vs. the implied volatility of the option bought, the better.

"T" is for Timing: Is the market overbought or oversold? What market conditions should you look for before implementing a given strategy?

Defining appropriate PRO-VEST factors for options trading strategies creates a structured approach for options trading. We can zero in on trades that generate the highest probability of making money, rather than relying on gut feel or luck. Let's look at one example of the PRO-VEST method to selling a vertical spread.

FIGURE 2 VERTICAL SPREAD PROFILE

The breakeven point for this vertical spread on the QQQs is 39.58.



Source: Option Pro by Essex Trading Co.

The short vertical spread

For this position you sell slightly to far out-of-the-money options and buy farther out-of-the-money options. Selling a vertical spread is appropriate if you don't expect the market to move quickly against you. The RV ranking should be greater than 5 — the higher the better.

There are a number of advantages to selling a vertical spread. Time decay works in your favor when you sell OTM options and you can take advantage of volatility disparities between different options. In addition, you can enter a trade with limited risk, rather than the unlimited risk you face when selling options outright. Finally, if RV is extremely high, you can profit from an approach that helps identify overbought and oversold points.

The disadvantage is that profit potential is limited to the difference between the premium received for the option sold and the premium paid for the option bought. In fact, the profit potential is often less than the maximum risk. As a result, you need to monitor this trade closely and cut your loss if the need arises.

The PRO-VEST parameters for an vertical spread are:

Probability: Only sell call options with a delta of 35 (35 percent) or less. Only sell put options with a delta of -35 or more. Sell options at least one strike out-of-the-money. Do not sell in-the-money options.

Volatility: RV is greater than 5 (precluding outright call or put buying).

Expiration: Sell options with less than 45 days until expiration.

Skew: The higher the implied volatility of the option sold vs. the implied volatility of the option bought, the better.

Timing: If the 14-day RSI is greater than 50, sell vertical calls only. If the 14-day RSI is less than 50, sell vertical puts only.

Exiting with a loss

Because short vertical spreads generally have greater risk than potential reward, you must be prepared to cut losses. Ideally, you should risk no more than the maximum profit potential for the trade to keep your reward-risk ratio at about 1:1. As we will see, this can vary based on market conditions.

Exiting with a profit

When selling a vertical spread you should not hold out for the last dollar. Once your open profit reaches 80 percent or more of your maximum profit potential, you should generally take your profit rather than risk allowing the market to reverse against you prior to expiration.

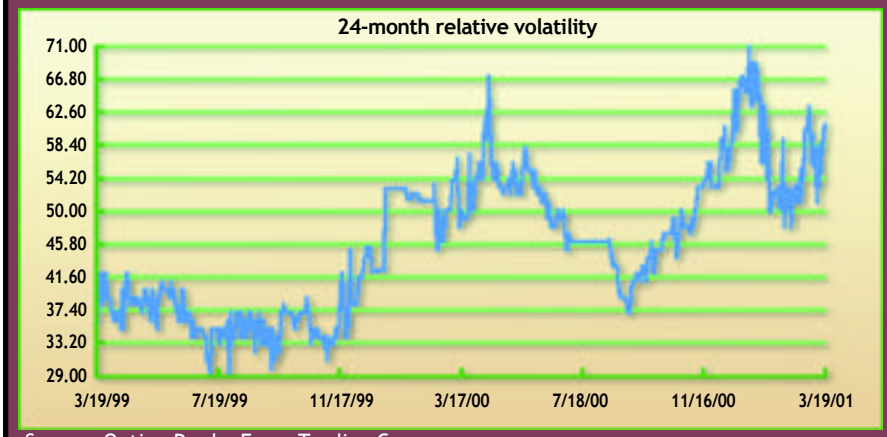
Trading the QQQs

Let's look at a recent example of selling a vertical spread (a bull put spread) in the QQQs. Our data is from March 20. Analysis of the QQQs determined the following was the appropriate strategy: Buy 12 April 38 puts @ 1.30, and sell 12 April 40 puts @ 1.90. This trade has a profit potential of $720 (before commissions).

Figure 1 shows the expected returns over the time to expiration, while Figure 2 shows the breakeven point on the expiration day is approximately 39.58 — below the recent low of 40.56. Based on the historical volatility of the QQQs, the probability of this index trading above 39.58 at option expiration is 76 percent. Thus, at the time this trade is entered, there is a 76-percent probability of profit. Figure 3 shows that the implied volatility is very high, with a relative rank of 10. We enter into this position as a credit spread to sell at a credit of 60 cents or better (Figure 4).

FIGURE 3 RELATIVE VOLATILITY

The high relative volatility at the time of the trade suggests these options are expensive and should be sold.



Source: Option Pro by Essex Trading Co.

Generally you should risk no more than your maximum profit potential when selling a vertical spread. However, there may be good reason to give this trade more room to move.

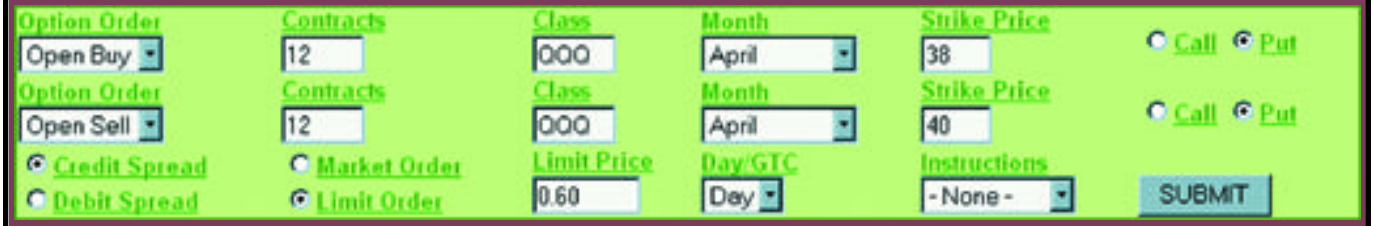
The 10-day TRIN indicator offers some insight into market behavior that we can use to determine the market's course. The 10-day moving average of TRIN pierced the significant 1.50 level for just the eighth time in the last 35 years on March 20. Looking back at the previous seven signals — which occurred in 1966, 1970, 1974, 1980, 1982, 1987 and 1997 — the S&P 500 index never closed more than 6 percent below the closing price on the day after the signal before beginning a rally. In addition, the previous seven signals were all followed by higher stock prices 12 months later.

As a result, we will exit this trade if the S&P falls more than 6 percent below its close on March 21 (1,122.14 minus 6 percent yields a stop-loss point of 1,054.81 on the S&P 500 index). This illustrates how the market timing aspect of the PRO-VEST method can influence an individual option trade.

Profits will be taken if the spread narrows to 12 cents or lower. The required capital for a 12-lot trade: $1,872. The expected profit before commission if the trade is exited with a 12-cent spread: $576. The after-commission profit will vary depending on how much you pay your broker to execute option trades.

FIGURE 4 ORDER ENTRY

The trade is entered as "credit spread," at a price of .60.



Source: www.mrstock.com

Trade options with an edge

The PRO-VEST method provides a framework for you to evaluate any options strategy, from buying outright calls to selling credit spreads.

The key is to track and determine the relative volatility rankings and select the appropriate strategy to raise the probability of success. Avoid the mistake of paying too high a price for an option solely as a leverage opportunity based on your market indicators.

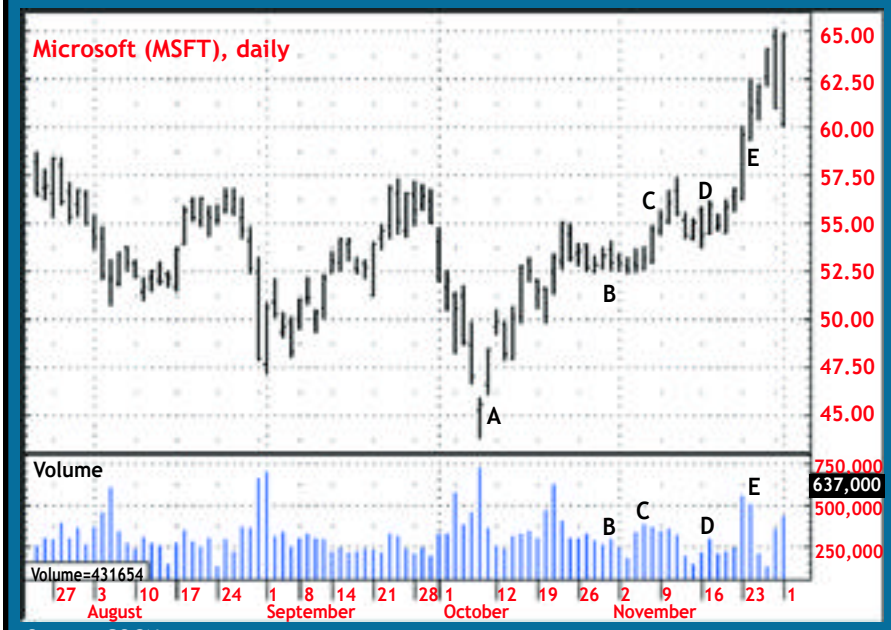
Follow the LEADERS

Here, we use examples of the cup-with-handle pattern in various stocks to illustrate how the behavior of leading issues can shed light on the state of the broader market.

BY STACEY WINTER

FIGURE 1 CONSTRUCTIVE PRICE ACTION

After the October 1998 shakeout (A), market leader Microsoft exhibited bullish price action that foreshadowed the developing Nasdaq rally. Down days were accompanied by lighter volume (B) than up days. The stock broke resistance around 57.50 on heavy volume as new buyers pushed the stock to new highs (E).



Source: CQGNet

The best resource for evaluating the state of the market is the market itself. To recognize new leadership, including which stocks are setting up for big moves, follow the chart patterns of the current leaders.

This is accomplished by following individual stocks on a day-to-day basis and by quickly reacting to our analysis of the chart patterns. This requires paying close attention to the nuances of the market, especially price/volume action. The basis of our interpretation will be the "cup-with-handle" chart formation as detailed by William O'Neil (see "Cup-with-handle basics").

There are two ways to identify market leaders. The first is through a bottom-up look, and the second is using a top-down approach.

Bottom-up screening

Proper stock selection is just as important to short-term traders as it is to long-term investors. You want to be in stocks with the best chances of movement.

Begin by selecting stocks institutional money managers are interested in. Their investment capital flows are what trigger tradable trends. Focus on stocks with good fundamentals, such as positive earnings and sales momentum in a new or progressive industry because those names get the most attention from big investors when the market is moving.

Next, analyze price and volume. Check each day for stocks with large up volume or down volume, stocks breaking to new highs or new lows, and stocks with very strong relative strength readings compared to the broad market.

You greatly increase the odds of capturing changes in the market — including rotation and the emergence of new leadership — if you employ this kind of systematic approach to identifying stocks with significant changes in volume, breakouts and relative performance analysis.

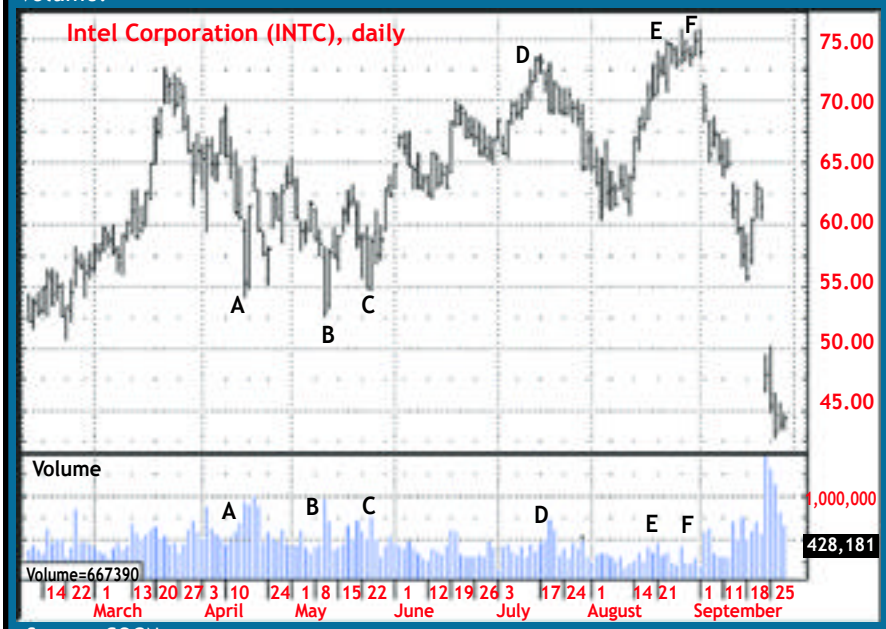
Top-down screening

Alternately, instead of scanning the market for individual stocks with positive price-volume action, you can scan for industry groups making dramatic changes that will set the stage for new leadership.

In the mid-1990s, Cisco Systems, Dell Computer and Microsoft led the market. Later in the 1990s and into early 2000, stocks such as Ariba, Juniper Networks and Ciena pushed to the forefront.

FIGURE 2 WEAK LEADER

Former market leader Intel (INTC) exhibited weak price development during the May-July 2000 rally. For example, while forming a base, the stock closed at the bottom of the daily ranges on heavy volume (A and B). As the base continued to unfold, the up-day volume did not outweigh the down-day volume.



Source: CQGNet

Once you have identified a group that has made a dramatic advance, start analyzing the individual stocks within the group. At this point, you can turn to the bottom-up approach to find the stocks with the strongest fundamentals. Then, narrow your focus to those issues with the strongest relative strength. Finally, find the stocks with the strongest chart patterns.

Chart pattern analysis

Analyzing the chart patterns of the leading stocks in an index is a better way of finding market trends than tracking the indices themselves. Case in point: During the bear market rallies that have occurred since the Nasdaq topped out in March 2000, many leading stocks formed negative chart patterns that warned of a continuing steep decline.

We'll look at two examples shortly, but first we'll review the chart of a leader setting up a bullish chart pattern just as the Nasdaq was about to take off in late 1998.

Bullish setup patterns

Figure 1 provides a good example of a constructive chart pattern in an individual stock that preceded a bullish breakout. This action occurred just as the Nasdaq was beginning a 150-percent increase.

While forming the base, the stock went through a heavy volume shakeout in October 1998 that coincided with a sharp sell-off in the Nasdaq. The closing price relative to the day's range is critical when trading volume increases for a stock. At point A, the stock closed toward the upper end of that day's trading range. A close at the bottom of the range would have implied further selling was ahead. Instead, buyers supported the stock at the lower levels, pushing the stock towards the high for that day.

Next, as the stock worked its way back to the top of the base, the down days were accompanied by lighter volume (point B) while the up days were accompanied by better-than-average volume (point C). In mid-November, the daily trading ranges narrowed and volume declined (point D) — an indication that supply and demand was finding a short-term equilibrium level. This is typical of the kind of consolidation that sets up a bullish move.

As the stock broke resistance around 57.50, the volume surged as new buyers pushed the stock to new highs (E). The volume should be at least 40 percent higher than average as price pushes through the resistance level. (You can estimate the volume for the day by taking the current intraday volume and dividing it by the number of minutes that have passed so far in the trading day, and then multiplying by 390, the number of minutes in a daily trading session.)

You can use the breakout as the entry point to buy the stock, keeping close watch on how it reacts when it retests the breakout level. Make sure your stop-loss is tight, just beneath the breakout point, to keep risk on the trade low.

During constructive bases, you should see heavy volume up days, and light volume down days. This price-volume action is especially important during the latter stage of the basing pattern. However, heavy volume down days may be constructive if the stock also tends to close in the upper half of that day's trading range, as happened mid-October in Figure 1.

Bearish setup patterns

It took a while for the reality of the bear market to sink in for many traders. The market's intermittent rallies were greeted with enthusiasm — the hope that the bull might be back to stay.

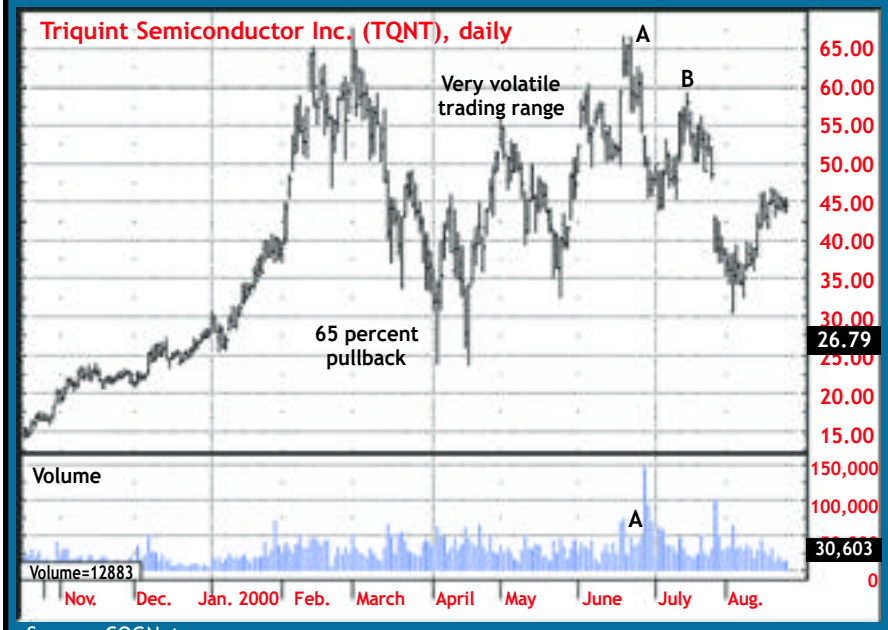
However, the market always failed to follow through to the upside. Throughout most of 2000, there were many attempts by old leaders to re-emerge and new leaders to appear. Careful scrutiny of bellwether stocks in such circumstances can indicate whether an up move is evidence of a potential broad market advance or merely a bear market rally.

The Nasdaq initially bottomed in May 2000 and advanced until July. However, as the broad market was moving higher, the old leaders were warning that more selling was in store for the future. Intel (INTC) is a good example of a past leader that was not displaying a bullish setup during what turned out to be the May-July 2000 bear market rally (see Figure 2).

First, while the stock was forming a base, it closed at the bottom of the daily ranges on heavy volume at points A and B. As the base continued to unfold, the up-day volume did not outweigh the down-day volume (e.g., point C). This

FIGURE 3 **BAD SIGNALS**

During the May-July rally, when Triquint Semiconductor (TQNT) had been reporting triple-digit earning growth, there were a number of problems: The stock had fallen almost 65 percent off its high, trading was very choppy, the stock lacked a solid price-volume consolidation and when the price finally ran to the old high, its last breakout attempt took place on light volume.



Source: CQGNet

behavior indicated there was little demand and the base may have been, in fact, a distribution phase. Notice the constructive action along the right side of the base: the consolidation with light volume and tight daily trading ranges. But the attempted breakout above resistance around $70 (point D) occurred on light volume and failed.

Edging to a new high and pulling back indicated the cup-with-handle pattern was still developing. After another consolidation, the stock did break out to a new high, but on lower-than-average volume (point E). As the stock made another new high, each heavy volume day was accompanied by the stock closing in the bottom half of its trading range (e.g., point F). This pattern was bearish and the breakout should have been sold. This lack of investor conviction for a bellwether stock such as Intel suggested the broader market would not go higher.

Another example in a market leader of the period is shown in Figure 3. During the May-July rally, Triquint Semiconductor (TQNT) had been reporting triple-digit earnings growth and strong sales growth, and the stock's price was nearing new highs. However, there were a number of problems with the cup-with-handle pattern that was forming.

First, the stock had fallen almost 65 percent off its high. Second, trading was very choppy, with wide daily trading ranges. Third, the stock lacked a solid price-volume consolidation and fourth, when the price finally ran to the old high, its last breakout attempt took place on light volume. The stock eventually reversed at point A.

How could you trade this weak pattern? The stock gapped past 60 in June, which should have provided support for the stock. Instead, after attempting to make new highs, TQNT broke back down (on expanding volume) through the support at 60. This downside penetration was the signal to exit long positions.

An attempt to short the stock could have been made after this second failure to rally above 65 as the stock filled the gap it created when it first broke out through 60. However, a better place to short the stock was after it retested the support level three weeks later at point B. The stock rallied right to resistance at 60 on extremely light volume, and the breakout failed. The stop-loss point for a short sale should have been on a move back above 60.

Many solid breakouts happen immediately after a tight price-volume consolidation, but TQNT's basing pattern did not form solidly and provided insight into the weak state of the market. With both market leaders INTC and TQNT displaying poor price action, a critical trader would consider the possibility that the May-July movement was a bear market rally.

Figure 4 is third example of a failed setup during the January 2001 bear market rally that, based on the bottom-up approach, warned the first quarter of 2001 would not be a positive upside trading environment. Like the other examples, Brocade Communications (BRCD) had explosive earnings and sales growth, and was outperforming most other stocks — typical qualities of market leaders.

The base that started in November 2000 was characterized by heavy volume down days, an indication of heavy supply (e.g., point A). The rallies during this period occurred on decelerating volume. As the stock made higher highs, volume failed to expand, a sign the stock wasn't going to break through the overhead supply. In fact, the final rally of the year (point B) occurred on very light volume. The January 2001 advance failed to hold above the late-December highs (point C). This is a negative sign during a basing pattern. The final phase of the potential base from November through early February in the consolidation turns out to be the beginning of supply outweighing demand (point D). With the evidence suggesting a negative pattern was developing, we can anticipate a problem with the stock and step away from buying.

Although this chart was shaping up in a negative manner, not everyone agreed. On Feb. 2, a major Wall Street firm named BRCD as one of its favorite stocks, and the stock closed at 82 that day. On Feb. 22, after a cautious conference call by BRCD, many street analysts lowered expectations — including the same Wall Street firm that had touted the stock just three weeks earlier. Brocade closed around 42 that day — down 60 percent from where the chart showed distribution in the base followed by the wedge pattern up into resistance.

While Brocade was displaying negative price-volume action during January,

FIGURE 4 DOWNSIDE MOMENTUM

The base that started in November 2000 was characterized by heavy volume down days, an indication of heavy supply (e.g. point A), while rallies occurred on light volume. As the stock made higher highs, volume failed to expand, a sign the stock wasn't going to break through the overhead supply.

the days leading up to the conference call told their own story. First, on Feb. 12 and Feb. 13 (point E), the stock broke below support on huge volume, closing at bottom of the daily trading ranges — a sell signal. Next, on Feb. 14 (point F), the stock rallied on lighter volume. On Feb. 15, the stock reversed to the downside on heavy volume, closing at the bottom of the trading range — another sell signal.

On Feb. 20 and 21, the stock experienced continued heavy volume down days and light volume up days — more bearish price action.

Signs of a bottom

Let's turn our attention to two bullish pattern setups that occurred late in the first quarter of 2001 and suggested the Nasdaq was making a bottom. The first occurred in Pulte Corp (PHM), shown in Figure 5.

The left side of the cup formed on heavy volume (point A). The rally attempts occurred on above-average volume (e.g., point B), but there was a heavy volume day and the stock closed at the

Cup-with-handle basics

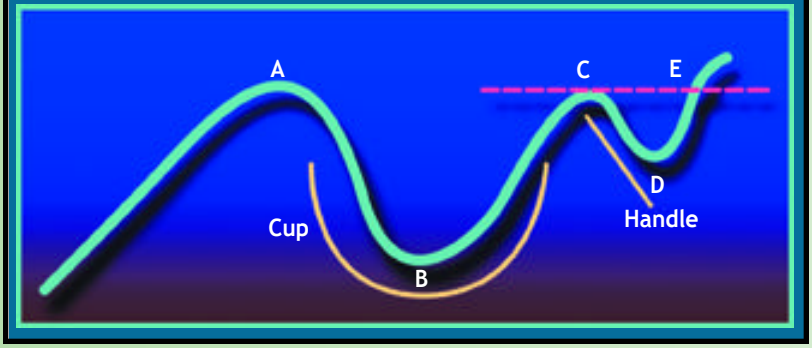
William O'Neil detailed the cup-with-handle pattern in his books *How to Make Money in Stocks* (1994, McGraw-Hill) and *24 Essential Lessons for Investment Success* (1999, McGraw-Hill). O'Neil originally used the pattern to indicate longer-term price developments on weekly charts, but traders have adapted it to daily and even intraday charts for shorter-term trades. The following discussion is given in terms of daily price bars.

The cup-with-handle is a basing, or consolidation pattern that develops before a stock moves into an uptrend (see the diagram below). Leading up to point A, the stock should have increased in value by at least 30 percent. Points A and B define the left-hand side of the cup. Point B is the bottom of the cup, and points B to C mark the right-hand side of the cup. The handle is the pullback from points C to D.

The cup should take at least seven weeks to form on a daily chart. Some cups may take as long as three to six months to complete. The decline from point A to point B should be approximately 20 to 30 percent of the previous rally. During the formation of the cup the advances should, on average, occur on greater volume than the declines, and the closes should be near the upper end of the price bars. These characteristics reflect a stock that is building bullish momentum for a future rally.

CUP-WITH-HANDLE PATTERN

The classic cup-with-handle pattern is typified by an extended basing formation (the cup) and a pullback and re-test (the handle) of the resistance level defined by the cup.



The handle can take as little as one week to form, and volume should dry up as the lower side of the handle forms (point D). The handle should retrace no more than 10 to 15 percent from the top of the right-hand side of the cup or more than 50 percent of the advance from B to C.

The entry point (point E) is when the price trades above the resistance implied by the top of the right-hand side of the cup (C). The volume on the breakout should be 40 to 50 percent greater than the typical volume.

If there is a retest of the level after the breakout, the volume should decrease — a sign the retracement is only profit-taking by short-term traders and the price should continue advancing.

bottom of range (point C). This price-volume action was an indication to be cautious. Then the stock retested the low on very light volume (point D), rendering the previous concern moot. The stock then advanced on high volume, completing the right side of the cup.

Finally, the handle formed as prices consolidated and volume dried up (point E). Long entry would come on the move above the high price of the handle, so when the stock broke 42 on better-than-average volume, a buy was triggered. Light volume pullbacks to this level would have represented additional buying opportunities, while any heavy-volume downside breaks through 42 would have been sell signals.

The second example is Metro One Telecomm Inc. (MTON), shown in Figure 6. First, the left side of the handle formed on heavy volume (point A). Next, constructive price-volume trading appeared as the consolidation formed on very light volume (point B). The market rallied on heavy volume and ran into old highs, completing the cup (point C). However, the fact that the handle retracement was too deep (point D) would have precluded entry on a move above it; in such circumstances, you should wait for another consolidation before buying the stock. In this case, the stock quickly jumped back to resistance level and formed a brief consolidation pattern (point E) before breaking through the resistance on very heavy volume (point F). This was the buy signal. Like the previous example, you could also have entered on low-volume retests of the breakout level and liquidated the position if the level was violated on heavy volume.

The whole picture

Sometimes analysis of the index doesn't reveal everything that's happening. Evaluating the behavior of individual leading stocks can provide insight into the state of the overall market. The cup-with-handle is a chart pattern particularly useful for determining when a stock is poised to embark upon on new trend. The strength or weakness of the pattern as it develops can shed light on the prospects for the stock and the market as a whole. Focusing on stocks that are setting up strongly and avoiding trades that are not properly developed will lead to greater consistency.

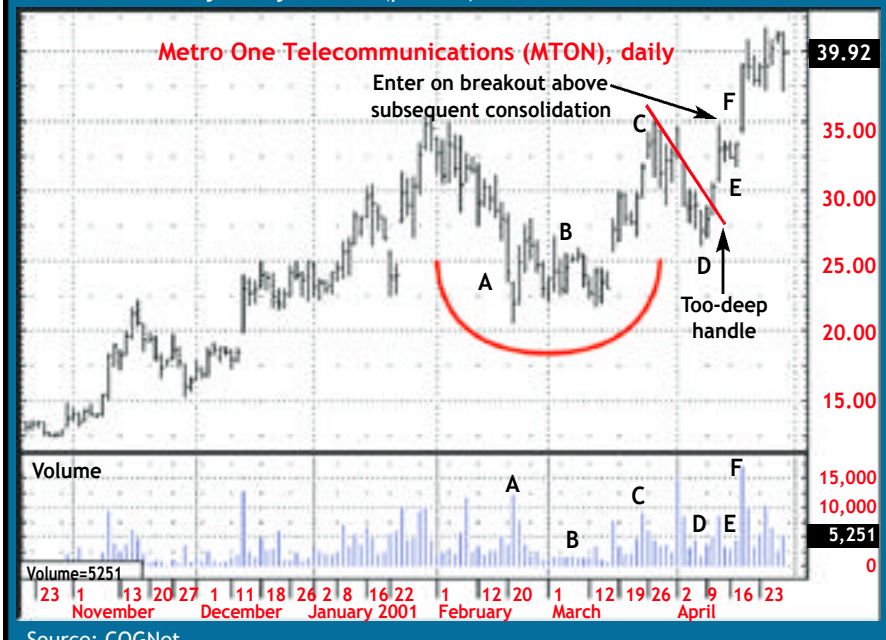
FIGURE 5 UPSIDE MOVE

The handle in this example formed as prices consolidated and volume dried up at point E. Long entry would come on the move above the high price of the handle, in this case when the stock broke 42 on better-than-average volume. Light volume pullbacks to this level offered additional buying opportunities.

Source: CQGNet

FIGURE 6 DEEP PULLBACK

The fact that the handle retracement at point D was too deep would have precluded entry on a move above it. However, a subsequent buy opportunity developed when the stock quickly jumped back to the resistance level and formed a brief consolidation pattern (point E) before breaking through the resistance on very heavy volume (point F).



Source: CQGNet

THE EXECUTION Solution

BY M. ROGAN LABIER

Q. I recently placed a sell-short stop order on the NYSE. The stock traded at the price, then moved up a little from there, and I received my fill — two hours later! I guess I was lucky, because by the time I found out about the fill, the stock was down, which was what I wanted. But it could have gone the other way. What gives? — John D.

A. When you enter an order into the "Machine" (SuperDot, the NYSE's electronic order-handling facility), several things can happen. If the order is marketable (i.e., at a price at which it can be executed at the time you enter it) and the stock is currently available, your order may be presented to the exchange as a "direct" order that will be executed at electronic speed. If it is a limit order and the result is a partial fill, the remainder will go into the specialist's book. On the other hand, if it is an off-the-market (not marketable) limit order, it will go straight into the specialist's book.

The final possibility only happens when you place certain types of orders (described shortly), but it can result in the unpleasant situation you described in your question. In this case, these kinds of orders will not stay in the Machine. Rather, they will be printed out onto paper in the specialist's post, and the specialist will then hand-retrieve the order and "baby-sit" it until execution.

Order-handling rules on the NYSE are different from those on the Nasdaq. For example, Nasdaq market makers are required to respond to a SelectNet preference (an order routed to a particular market maker via the Nasdaq's order delivery system) in 30 seconds or less. On the NYSE, by contrast, when an order is monitored by the specialist by hand, there is no set amount time in which he must respond. Combine that with the fact that the order is printed on paper (and could be in the specialist's pocket, for example), and that specialists are by and large terrifically busy, and you have a potentially bad situation.

The following types of orders get printed out and handled manually by NYSE specialists: sell-short stop orders, immediate-or-cancel orders and fill-or-kill orders, which differ from immediate-or-cancel orders in that a full fill must occur or the order is canceled. Immediate-or-cancel orders allow for a partial fill.

Specialists are human and, therefore, fallible. On rare occasions, these kinds of orders fall through the cracks. It doesn't happen often, but when it does it can have unpleasant consequences.

This seems to be a problem unique to the specialist system and the current NYSE order-handling rules. Until the NYSE updates its order-handling procedures there is not much that can be done about it. The digital age has sped up the trading process so much that it has outrun the tried-and-true procedures on the NYSE.

But the NYSE is evolving. New products like NYSE Direct (see Execution Solution, *Active Trader* June 2001) and decimal pricing show that the Big Board has every intention of keeping up with the times. None of that, of course, helps your situation, but here's what you can do: When you place one of the order types mentioned earlier on the NYSE, watch the order like a hawk. If you see the stock trade there but your order remains in limbo, call your broker immediately and ask for the "status" of the order. They will call the member firm, which will in turn check the order's status with the specialist. If nothing else, this will remind the specialist about your order. If the order is done, you'll get your report right there. If not, you can alter your plans.

Better yet, consider using "Limit Alerts," a feature of higher-level trading platforms that notifies you when a stock trades at a price limit you have specified. This ensures you won't miss a move, while allowing you to place an order that can be executed electronically, without human intervention. If you are unfamiliar with this feature, have your broker explain it to you.

Keep in mind the specialist is monitoring all his stocks, all of the limit orders in the Machine and all of the manually handled orders. At the same time, he has to deal with the crowd. A specialist in a busy stock can trade tens of millions of shares each day. This is not an excuse for poor performance; rather it's a warning. Watch what they do, and make sure you don't get screwed by the occasional error.

Also — this is not really in response to your question — it is interesting that odd-lot orders (less than the minimum trading unit of 100 shares) are handled differently from those orders

Q. When major news comes out (like the Fed announcing a rate cut) and everything tanks immediately, what is the best way to get out of a stock? —TK J.

A. That is the $1 million question. There is no one-size-fits-all answer. You really have to look at the specific situation: see who is bid and offered, and use whatever route will work best given the particulars of the market at the time. Remember, some routes will work at lightning speed in certain situations, but will not work at all in others.

Here's a simple example. SOES, the Nasdaq Small Order Execution System, will auto-execute against a market maker — that is, fill an order at electronic speed. However, SOES will not execute against Electronic Communication Networks (ECNs). So, if only ECNs are best bid and offer, you wouldn't consider using SOES. But if market makers are also showing the best bid and offer, SOES might be your best bet.

You really have to have a complete understanding of the workings of all the routes available to the direct-access trader. Once you do, Level II becomes like a map — a quick glance will tell you which route will work best.

Q. *My broker offers Level II quotes, but no direct-access execution routes. Will the former be of any help to me without the latter? — Sarah W.*

A. Level II will be of some help because it will give you a deeper understanding of market conditions, but the lack of access to the various execution routes means you will not be able to act directly upon this information. On the plus side, Level II quotes also will help you to better evaluate the quality of the executions you receive through your broker.

described above. Odd-lot market orders will automatically execute in the Machine at the current quoted price. Odd-lot limit orders, on the other hand, will automatically execute upon the next sale price, provided it is at your limit or better.

Q. I recently sold some stock (which I had held for more than a year) and then bought it again and sold it, same day, for a small profit. I like the stock and selling it was painful, but I thought I'd learned my lesson and had decided not to hold it overnight anymore.

Then, I got on a plane for a three-week business trip. When I got back, my account was closed! The broker said I had a (margin) call while I was gone. I didn't meet it, so they closed my account — and they will not open it again. I repeat — I was on a plane and did not trade anything, so how could I have gotten a call? I didn't even hold stock during the trip. Please explain this. I have had margin accounts for 20 years, and never have I received such ridiculous service. Nobody at my brokerage can explain it clearly. What is my recourse? — Thomas R.

A. This is a terrible situation, and one that I have heard of time and time again. Here's the problem: Margin in "pattern day trading" (PDT) accounts is calculated differently from standard margin accounts. In a nutshell, there is an additional calculation that your account will be subject to if it is coded as a PDT account. If you have a direct-access trading account, it likely will be a "pattern day trading" account. If your account is at a standard online broker, it is probably a standard margin account.

The additional calculation is called rule 2050, and it is a killer. Few brokers seem to take the time to explain it to new account holders. They assume account holders have read all the documents (that, admittedly, they have signed, attesting to having read). Many traders who have had margin accounts for years are not even aware of this rule. In a PDT account, you will be subject to rule 2050, as well as Regulation T — the margin rule that gives traders twice the buying power of their account (i.e., if they have $10,000 in their accounts they can purchase up to $20,000 worth of stock). Rule 2050 looks at the trades you have made intraday, regardless of what your account balance was when the day began.

In your case, where you sold your stock, then bought and sold it again for a profit, what 2050 will see is a sale, then a buy, and then a sale. Rule 2050 does not consider the position you started the day with, only what you did that day. It sees a short sale, followed by a purchase, followed by another short sale. So using rule 2050, you ended the day short — even though you were really flat! It sounds nuts, but that's the way it works.

To your knowledge, you left town flat, but you had generated a call by your trade. When you were unavailable for that extended time, you missed the opportunity to meet the call. And so the account was eventually closed in accordance with margin regulations.

This is a profoundly troubling situation. It has killed more accounts than you could imagine. More than a year ago, when many stocks were in the $200 range (and folks had held them from much less) similar things would happen. Traders would sell their thousand shares, then buy them and sell them again intraday for a profit, and then be hit with an unexpected margin call — often in the hundreds of thousands of dollars!

How do you avoid this situation without having to make lots of cumbersome calculations? Here's a simple rule of thumb: If you hold a stock overnight, do not trade it the next day. That way you'll be assured of never getting this type of call. You'll often hear this mantra from brokers (without explanation of the underlying rational).

Now the bad news (the rest was *good* news?): If your account has been closed because of failure to meet a margin call, there is not much you can do. Firms will not re-open an account once it has been closed because of failure to meet a call.

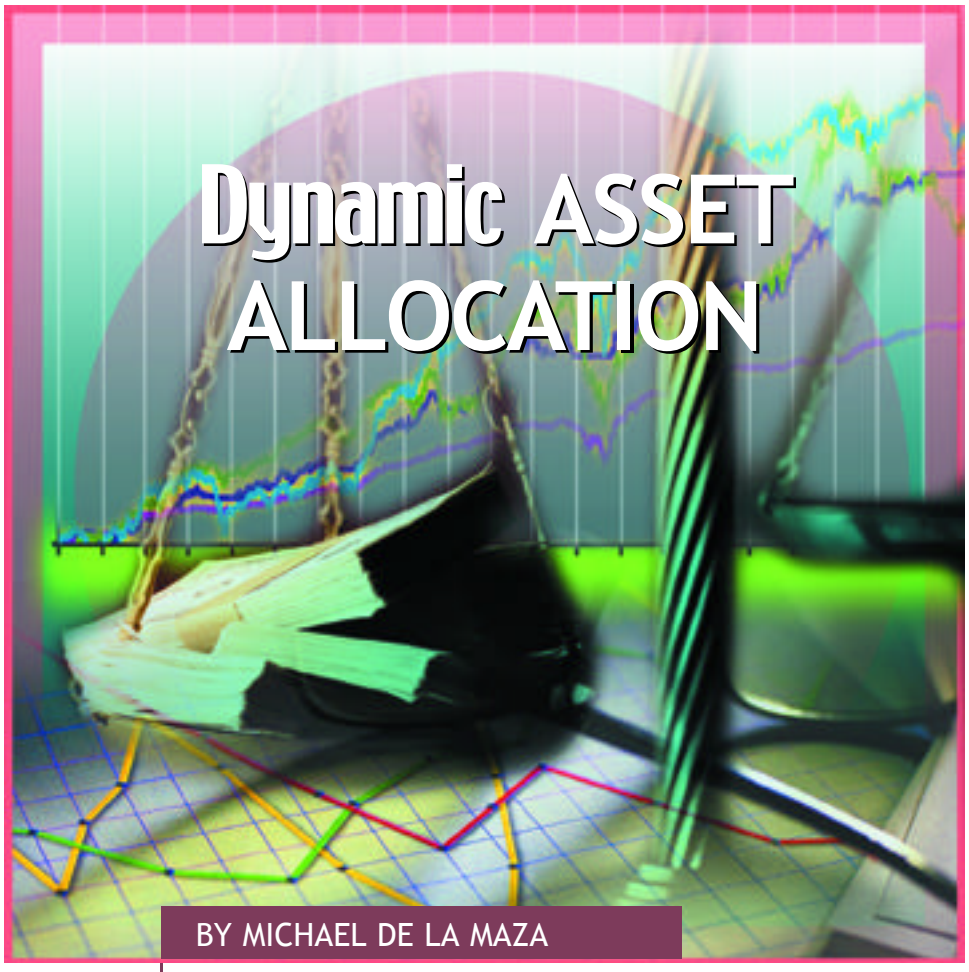
The regulations may be confusing, but the bottom line is that your account is your responsibility, so be totally aware of how your margin account operates. Have your brokerage explain everything in detail. This is part of their job. What you've read here is only a cursory outline; you'll need to talk with your broker and get all the facts — before you find yourself in another unexpected, unpleasant situation.

Q. Do you know of any wireless ISP that is fast enough for trading Level II? — Mark G.

A. The only one I can personally speak for is Metricom (MCOM; www.metricom.com). The company makes an external wireless modem called Ricochet that has great speed and solid connections. However, Metricom service is only available in selected cities and airports: Atlanta, Baltimore, Dallas, Denver, Detroit, Houston, Los Angeles, Minneapolis-St. Paul, New York, Phoenix, Philadelphia, San Francisco Bay Area and San Diego. But what fun it is to place the modem on your laptop, sit at a cafe and have great Internet access.

The price for unlimited Internet access is just slightly higher than standard service at any major ISP. Of course, you'll have to purchase the modem, which will set you back a few hundred dollars. Metricom has been around for several years, and the company is slowly expanding its network. Major players back Metricom, and the technology is battletested.

Note: Rogan Labier does not own MCOM stock, nor does he have any kind of business arrangement (other than customer) with Metricom.



Dynamic ASSET ALLOCATION

BY MICHAEL DE LA MAZA

When to buy and sell is far less important than knowing how much to risk on each trade. Here we show how you can rebalance your risk by combining short-term risk management with a long-term trading horizon.

If you truly are a long-term investor, you shouldn't be fazed by the recent stock market collapse because you know that, over a long time span, stocks go up. However, investors with a shorter horizon may desire a way to re-allocate their holdings on a daily basis to adapt to market conditions.

We'll discuss a strategy based on a Nobel Prize-winning idea that uses the Sharpe ratio to allocate capital among a set of mutual funds. However, this technique could also be used to allocate capital among any set of securities — individual stocks, futures or exchange-traded funds. As long as you can compute the same periodic returns (such as daily, weekly or monthly) for all securities under consideration, the Sharpe ratio approach will tell you how much capital should be allocated to that strategy or security.

Understanding the Sharpe ratio

The Sharpe ratio is a measurement of trading performance relative to risk. A system that makes $50,000 over the course of a year but risks $40,000 is obviously less desirable than a system that makes $50,000 but risks only $10,000. The Sharpe ratio puts returns in the context of their associated risk. DataChimp (www.datachimp.com) offers a fun way to learn more about the Sharpe ratio and other related financial topics.

The Sharpe ratio (SR) can be defined as:

SR = (Rx – Rf)/Sx

where

Rx = the strategy's return

Rf = the risk-free rate of return (usually the T-bill's current rate of return) and

Sx = the standard deviation of the strategy's returns.

If you were to compute the Sharpe ratio of a mutual fund using a spreadsheet you might set it up as follows:

- Column A: Net Asset Value (NAV), as reported in your daily paper
- Column B: Daily return =NAV / NAVt-1 (today's price divided by yesterday's price)
- Excel formula in cell B2: =A2/A1
- Column C: Standard deviation of daily returns
- Excel formula in cell CX: =STDEV(B2:BX) (where X equals number of observations)

TABLE 1 PERFORMANCE SUMMARY CHART

This spreadsheet example summarizes what we've learned so far. The values in column F show, for this particular three-market combination should be divided evenly between markets Y and Z, and none of the capital should be invest - ed in market X.

	A	B	C	D	E	F	G
1	Strategy	Sharpe	Adjusted Sharpe	Standard deviation	Numerator	Fraction	Denominator
2	X	-1	0	6	0	0	12
3	Y	1	1	1	6	0.5	
4	Z	1	1	1	6	0.5	

- Column D: Sharpe ratio = (Rx – Rf)/Sx
- Excel formula in cell DX: =(AVERAGE(B2:BX)-$E$1)/CX
- Cell E1: The risk-free rate of return
- Excel formula in cell E1: =1+RR/250 (where RR is the risk-free rate of return and 250 is the number of trading days in a year)

Using this formula, along with some ideas from Nobel Prize winner William F. Sharpe, you can create a mutual fund re-allocation strategy that will capture most of the market's returns with much less risk than simply buying and holding a single fund.

Portfolio management theory

One of the tenets of portfolio management theory is that the risk taken in a strategy should be proportional to its Sharpe ratio. Sharpe explained this idea in "The Sharpe ratio" (Journal of Portfolio Management, 1994), saying "… the risk levels of the strategies should be proportional to the Sharpe ratios. Strategies with zero predicted Sharpe ratios should be ignored.

"Those with positive ratios should be 'held long', and those with negative ratios 'held short.' If strategy X has a positive Sharpe ratio that is twice as large as that of strategy Y, twice as much risk should be taken with X as with Y."

For this to be true, certain assumptions on the returns need to be verified. But for the purposes of this article, we will simply assume that those assumptions hold.

A few examples will help to clarify the idea and what it means. First, suppose that strategy X and strategy Y have the same level of risk. Here, as in most academic literature, we use standard deviation as a measure of risk, so when two strategies have the same level of risk this means the standard deviation of their returns is also the same.

So, if the risk is the same, then the amount invested in each strategy is proportional to the respective Sharpe ratio. If X and Y have the same Sharpe ratios, then 50 percent of the capital should be invested in each strategy. If X has a Sharpe ratio three times greater than Y, 75 percent of the capital should be invested in X and 25 percent of the capital should be invested in Y.

Now, suppose the Sharpe ratios of X and Y are the same, but the risk is different. Our portfolio allocation should adjust for the different levels of risk. If strategy X has a standard deviation that is twice as large as strategy Y, then half as much capital should be invested in strategy X as in strategy Y. If an investor has $90,000 to split between the two strategies, this means that $30,000 should be invested in strategy X and $60,000 in strategy Y. If strategy Y has nine times the risk of strategy X, then the amount invested in Y should be one-ninth the amount invested in X (e.g., if $100,000 is available, $90,000 should be invested in X).

The math

In general, the fraction of capital (Fx) to invest in strategy X is

Fx = SxRy/(SxRy + SyRx)
where
Sx = the Sharpe ratio of strategy X
Sy = the Sharpe ratio of strategy Y
Ry = the risk of strategy Y
Rx = the risk of strategy X

While the examples above show simple calculations, the formula will allow more complicated examples to be solved. For example, suppose the Sharpe ratio of strategy X is 1.5 and the standard deviation is 10 while the Sharpe ratio of strategy Y is 1.2 and the standard deviation is 6. The formula [(1.5 * 6)/ ([1.5 * 6] + [1.2 * 10]) * 100] determines that 42.85714 percent of the capital should be invested in Strategy X. So, if the investor has $100,000, $42,857.14 should be invested in X and $57,142.86 should be invested in strategy Y.

Both the idea and the formula also can be generalized to an unlimited number of strategies. For a three strategy-allocation the fraction of the capital to invest in Strategy X is:

Fx = SxRyRz/(SxRyRz + SyRxRz + SzRxRy)
where
Rz = the risk of strategy Z

Sz = the Sharpe ratio of strategy Z

A spreadsheet that implements this formula is shown in Table 1.

In this spreadsheet, all of the strategies with Sharpe ratios of less than 0 are set to a Sharpe ratio of 0 (the Adjusted Sharpe column). As Sharpe mentions, strategies with negative Sharpe ratios should be shorted. However, since this particular allocation strategy trades mutual funds, shorting is not possible. So, no investment will be made in funds that have negative Sharpe ratios. If all of the funds have negative Sharpe ratios, then the denominator in cell $G$2 will be zero and all of the capital should be placed in cash (a money market fund). This table uses the following formulas:

- Cell C2: =IF(B2>0,B2,0)
  (cells C3 and C4 are analogous)
- Cell E2: =C2*D3*D4
- Cell E3: =C3*D2*D4
- Cell E4: =C4*D2*D3
- Cell F2: =E2/$G$2
- Cell F3: =E3/$G$2
- Cell F4: =E4/$G$2
- Cell G2: =E2+E3+E4

Implementing a strategy

Although this idea was not originally intended for active trading, we will use it in that manner. To implement Sharpe's idea in a trading account we must bend theory to conform to the real world of trading. Academic purists may blanch, but practical traders know that it is only very rarely that academic theory can be lifted from a journal and immediately applied to the markets.

Sharpe's technique makes use of two properties of a strategy: The Sharpe ratio and the risk (standard deviation). To implement this strategy you must estimate the Sharpe ratio and the standard deviation of each mutual fund that you would like to trade using past data. When doing so, remember that the shorter the look-back period, the more sensitive the strategy will be to recent changes in relative performance. Longer periods will be less sensitive.

The strategy can be implemented using many platforms, including TradeStation, Ensign or Excalibur. It can also be implemented with a simple C or Perl program, or in a spreadsheet. One way to implement the strategy in a spreadsheet is as follows:

- Column A: Date
- Column B: NAV of strategy 1
- Column C: Daily return of strategy 1
- Column D: Standard deviation of strategy 1
- Column E: Adjusted Sharpe ratio of strategy 1
- Column F: NAV of strategy 2
- Column G: Daily return of strategy 2
- Column H: Standard deviation of strategy 2
- Column I: Adjusted Sharpe ratio of strategy 2
- Column J: NAV of strategy 3
- Column K: Daily return of strategy 3
- Column L: Standard deviation of strategy 3
- Column M: Adjusted Sharpe ratio of strategy 3
- Column N: Fraction of portfolio to allocate to strategy 1
- Column O: Fraction of portfolio to allocate to strategy 2
- Column P: Fraction of portfolio to allocate to strategy 3
- Column Q: Strategy's daily return;
  Example: =1+N10*(1-C11)+O10*(1-G11)+P10*(1-K11)

Columns A to P make use of the formulas previously described. Column Q computes the return of the strategy based on the daily returns of each of the three mutual funds and the fraction of the portfolio allocated to each.

An example

Any set of mutual funds could be used to illustrate how the strategy works. We will look at the Gabelli funds because they are a family of no-load mutual funds that are available in many mutual fund "supermarkets," including Schwab, Fidelity, E*Trade and TD Waterhouse. No-load mutual funds do not charge an initial fee, or load, when an investment is made. The allocation strategy invests in the following three funds:

- **Gabelli ABC Fund (symbol: GABCX):**

Academic purists may blanch, but practical traders know that it is only very rarely that academic theory can be lifted from a journal and immediately applied to the markets.

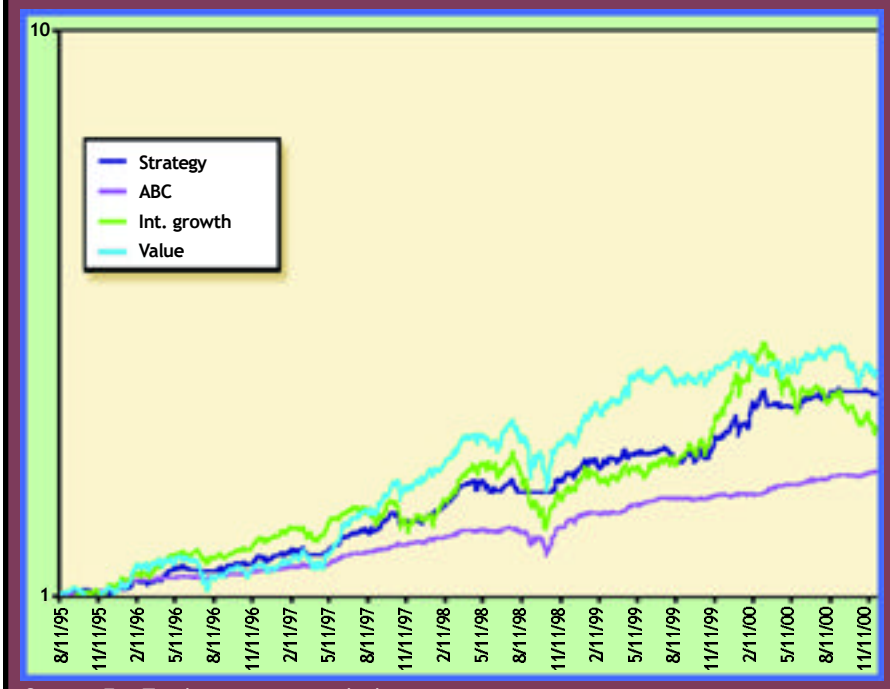
  A non-diversified fund Morningstar classifies in the domestic hybrid category. According to the FastTrack (www.FastTrack.com) mutual fund database used in this study, the ABC Fund has a compound annual return of 9.9 percent.
- **Gabelli International Growth (symbol: GIGRX):** Morningstar classifies this fund in the foreign stock category. It has a compound annual return of 14.3 percent.
- **Gabelli Value (symbol: GABVX):** One of Gabelli's flagship funds. The fund is in the mid-cap blend Morningstar category and sports a compound annual return of 15.7 percent.

These funds were chosen because they provide exposure to different pools of risk and return, which means that when one zigs another is likely to zag. This gives the strategy manager an opportunity to move capital from funds that are performing poorly to funds that are performing well. Choosing three domestic large cap growth funds would almost certainly lead to relatively poor performance because the diversification properties of the strategy would not be as effective.

The performance of the strategy relative to the three mutual funds it trades is shown in Figure 1. The chart illustrates that

FIGURE 1 PERFORMANCE SUMMARY CHART

This shows the performance of the strategy relative to the three mutual funds it trades from August 1995 to November 2000. Note that the strategy has very low volatility compared to the three funds, but its return is almost as good as the Value fund, the highest performing of the three mutual funds.



Source: FastTrack, proprietary calculations

the strategy is particularly adept at avoiding large declines. For example, during the long-term capital crash in 1998, all three funds swooned but the strategy was safely in cash for an extended period of time. Note that absolutely no optimization was performed on this strategy. The lookback period was arbitrarily set to 250 days, based on previous experience. You are encouraged to do more experimentation to find the strategy that best suits your trading style.

The Sharpe ratio, standard deviation and compound annual return for each of the three funds and the strategy is shown in Table 2. The statistics suggest that the strategy is able to capture much of the return of the highest performing fund with volatility that is close to that of the least volatile fund. The strategy's Sharpe ratio, which combines both return and risk, is higher than that of any of the individual funds.

Shortcomings of the strategy

This strategy has several shortcomings. First, you need to re-allocate the funds in your portfolio on a daily basis, which makes the trading frequency very high. Many mutual fund companies have become sensitive to mutual fund traders ("switchers") and have placed restrictions on the frequency of re-allocations. Many others have closed their doors to mutual fund traders all together.

Competitive pressures have kept enough doors open, however, to allow the implementation of the strategy, for those investor/traders willing to spend time to locate the companies that do allow frequent switching. Various message boards, such as www.investormap.com/forums, provide information on mutual funds companies that continue to allow trading.

A second shortcoming of this strategy is that it requires daily maintenance of a mutual fund database. The most recent NAVs must be added to the database and the strategy must be run nightly. Holes in the database or incorrect numbers will cause errors in the Sharpe ratio and the standard deviation computations. The strategy could be simplified by simply running the re-allocation process on a monthly or weekly basis. There are two ways of doing so. Monthly or weekly returns could be used in the spreadsheet, instead of the daily returns used in this article. Alternatively, the daily returns could be used but the re-allocation would simply take place on a weekly or monthly basis.

This strategy is designed for traders who are interested in reducing the volatility of their mutual fund holdings without reducing the return. To use this re-allocation strategy on a portfolio of stocks, futures or other trading strategies, simply substitute the mutual fund returns for the returns of whatever instruments you are trading.

TABLE 2 PERFORMANCE SUMMARY TABLE

The strategy's Sharpe ratio is higher than the Sharpe ratios of any of the mutual funds that it trades. Its return is second only to that of the Value fund, the highest performing fund, and its standard deviation is second to that of the ABC fund, the least volatile of the funds.

Name	Compound annual return	Sharpe ratio	Daily standard deviation
Strategy	16.59%	1.27	0.0053
Gabelli ABC	9.93%	1.16	0.0025
Gabelli International Growth	13.75%	0.62	0.0090
Gabelli Value	18.41%	0.88	0.0093

Source: FastTrack, proprietary calculations

A bad compromise

Markets: Stocks and index tracking stocks (SPDRs, DIAs, QQQs), mutual funds and currencies.

System logic:
This system tries to identify short-term, low-volatility consolidation periods where the high and low of a given day stay between the average high and low of the last five days.

When such a day is identified, the short-term trend is identified as the difference between the average price (AP) of the last five days and the average price of the immediately preceding five days (AP5). If AP is larger than AP5 (signifying an uptrend), the system will enter long on the next open if the market opens above the previous day's close. If AP is smaller than AP5 (signifying a downtrend), the system will enter short on the next open if the market opens below the previous day's close.

The logic is that your success rate will increase if you only trade in the direction of the underlying trend, especially if it also is confirmed by an opening price in the same direction. The relatively low volatility of the bar preceding the entry helps avoid many bad trades when the market makes a swift move in the wrong direction. A stop loss at the "wrong-end boundary" of the low-volatility bar (the opposite end of the bar from the direction of entry) also controls losses.

Rules:
1. Prepare to go long if today's high and low are inside the average high and low prices of the last five days and average price of the last five days is above the average price of the preceding five days.
1a. Prepare to go short if today's high and low are inside the average high and low prices of the last five days and average price of the last five days is below the average price of the preceding five days.
2. Enter long tomorrow if the market opens above today's closing price. Risk 5 percent of available equity per trade.
2a. Enter short tomorrow if the market opens below today's closing price. Risk 5 percent of available equity per trade.
3. Exit long trades if the market trades below the average low of the last five days.
3a. Exit short trades if the market trades above the average high of the last five days.
4. Exit all trades if the market moves against the position more than 4 percent.

Test period:
September 1991 to April 2001

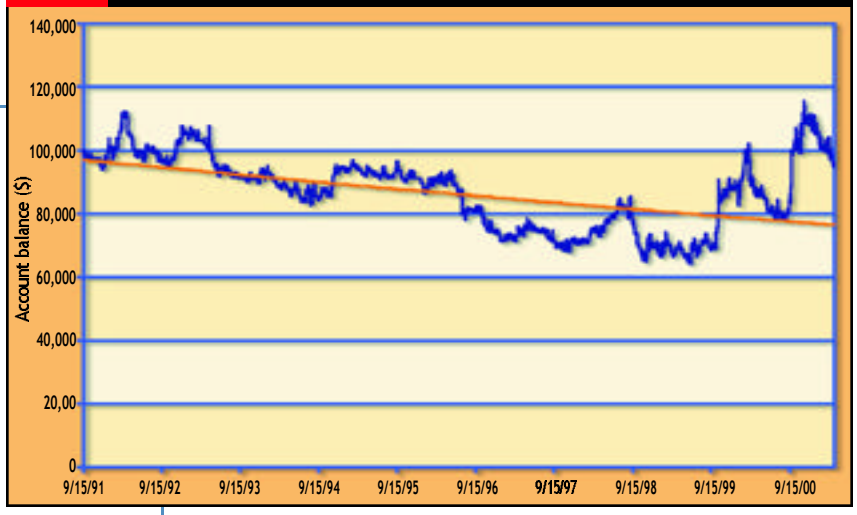
Test data: Daily prices for the 30 Dow Jones Industrial Average (DJIA) stocks. $20 commission deducted per trade.

Starting equity: $100,000 (nominal)

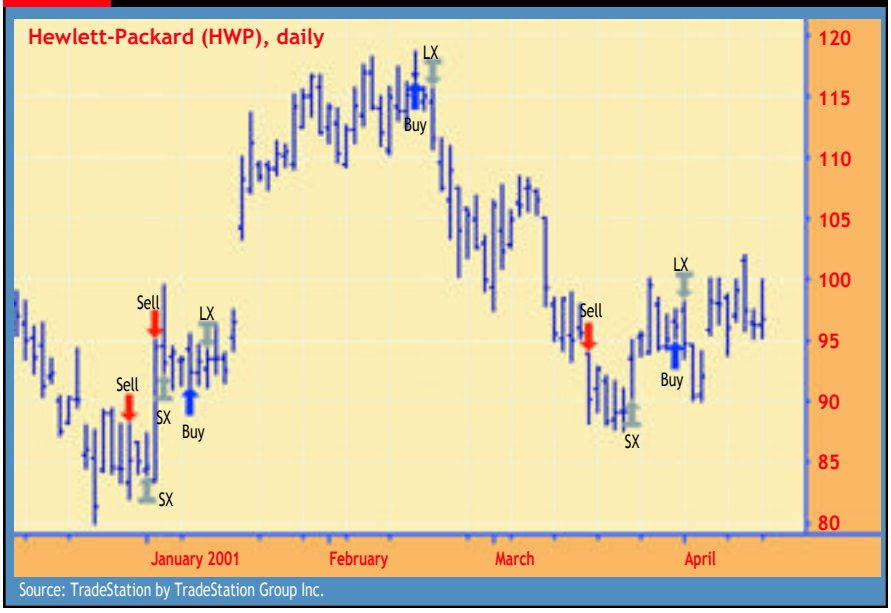
Buy-and-hold stats:
DJIA: Total return — 232 percent; Max DD — 22.5 percent (current); Longest flat — 16 months (current).
S&P 500: Total return — 198 percent; Max DD — 30 percent (current); Longest flat — 13 months (current).
Nasdaq: Total return — 451 percent; Max DD — 72 percent (current); Longest flat — 13 months (current).

System pros and cons:
Admittedly, we've all seen better equity curves than the one presented here. But we decided to feature this system because it

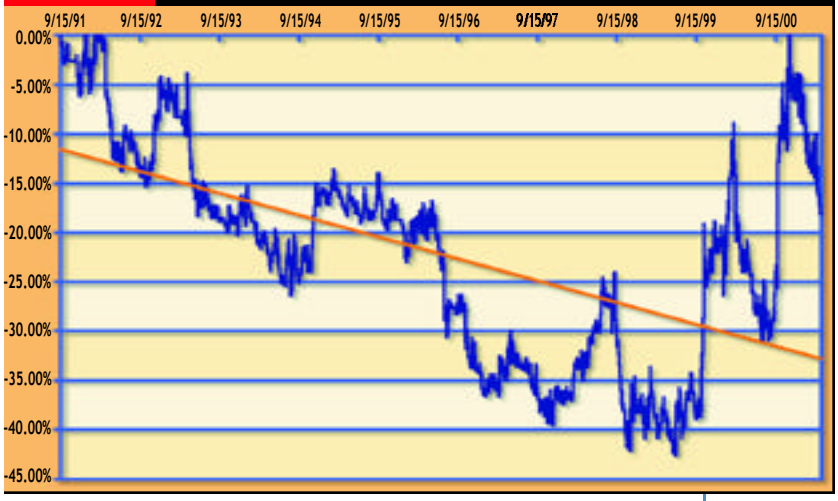
EQUITY CURVE



SAMPLE TRADES



DRAWDOWN CURVE



illustrates two important points you should consider during the trading system development process.

First, there are no differences between the rules for long and short trades. Trying to make a system work equally in all types of market conditions is very difficult, to say the least. It is not as easy as just applying a filter or some other form of trend indicator, because inevitably what you gain on one side of the market, you lose on the other. In this case, we could have made it more profitable by working with different lookback periods for the long and the short sides. The question is, however, if this would decrease the likelihood of the system to be profitable in the future (had we been a little more profitable in the first place).

The second point is that you need a sufficient number of markets that are profitable enough to make up for all the losing markets. In this case, 15 of the 30 DJIA stocks were profitable; usually the number is between 18 to 22. But because many of the profitable markets were *very* profitable, we wanted to see if this would be enough to make up for a larger number of losers, a few of which also were *very* large losers.

It was not, which leads us to conclude a system is more likely to work the more similar the results are between the markets traded and, as mentioned, the greater the number of profitable markets.

STRATEGY SUMMARY

Profitability		Trade statistics		
End. equity ($):	94,771	No. trades:		901
Total return (%):	(5)	Avg. trade ($):		(10)
Avg. annual ret. (%):	(0.56)	Avg. DIT:		6.3
Profit factor:	0.98	Avg. win/loss ($):	959	(499)
Avg. tied cap (%):	67	Lrg. win/loss ($):	4,090	(2,141)
Win. months (%):	36	Win. trades (%):		32
Drawdown		TIM (%):		89/7.2
Max DD (%):	42.7	Tr./Mark./Year:		3.1
Longest flat (m):	107.5	Tr./Month:		7.8

LEGEND: End. equity ($) — *equity at the end of test period* • Total return (%) — *total percentage return over test period* • Avg. annual ret. (%) — *average continuously compounded annual return* • Profit factor — *gross profit/gross loss* • Avg. tied cap (%) — *average percent of total available capital tied up in open positions* • Win. months (%) — *percentage profitable months over test period* • Max DD (%) — *maximum drop in equity* • Longest flat — *longest period, in months, spent between two equity highs* • No. trades — *number of trades* • Avg. trade ($) — *amount won or lost by the average trade* • Avg. DIT — *average days in trade* • Avg. win/loss ($) — *average wining and losing trade, respectively* • Lrg. win/loss ($) — *largest wining and losing trade, respectively* • Win. trades (%) — *percent winning trades* • TIM (%) — *amount of time there is at least one open position for entire portfolio, and each market, respectively* • Tr./Mark./Year — *trades per market per year* • Tr./Month — *trades per month for all markets*

ROLLING TIME WINDOW RETURN ANALYSIS

Cumulative	12 months	24 months	36 months	48 months	60 months
Most recent:	10.34%	38.81%	26.67%	29.28%	6.61%
Average:	0.21%	-1.72%	-4.90%	-9.91%	-15.01%
Best:	42.92%	59.33%	63.04%	48.99%	21.28%
Worst:	18.95%	-25.61%	-26.68%	-30.76%	-33.98%
St. dev.:	13.19%	19.27%	20.51%	19.38%	14.51%
Annualized	**12 months**	**24 months**	**36 months**	**48 months**	**60 months**
Most recent:	10.34%	17.82%	8.20%	6.63%	1.29%
Average:	0.21%	-0.87%	-1.66%	-2.58%	-3.20%
Best:	42.92%	26.22%	17.70%	10.48%	3.93%
Worst:	-18.95%	-13.75%	-9.83%	-8.78%	-7.97%
St. dev:	13.19%	9.21%	6.42%	4.53%	2.75%

LEGEND: *Cumulative returns* — Most recent: *most recent return from start to end of the respective periods* • Average: *the average of all cumulative returns from start to end of the respective periods* • Best: *the best of all cumulative returns from start to end of the respective periods* • Worst: *the worst of all cumulative returns from start to end of the respective periods* • St. dev: *the standard deviation of all cumulative returns from start to end of the respective periods*

Annualized returns — The ending equity as a result of the cumulative returns, raised by 1/n, where n *is the respective period in number of years*

Send *Active Trader* your systems

If you have a trading system or idea you'd like to see tested, send it to us at the Trading System Lab. We'll test it on a portfolio of stocks or futures (for now, maximum 30 markets, using daily data starting Jan. 1, 1990), using true portfolio analysis/optimization.

Most system-testing software only allows you to test one market at a time. Our system-testing technique lets all markets share the same account and is based on the interaction within the portfolio as a whole.

Start by e-mailing system logic (in TradeStation's EasyLanguage or in an Excel spreadsheet) and a short description to tstridsman@activetradermag.com, and we'll get back to you.

Note: Each system must have a clearly defined stop-loss level and a suggested optimal amount *to risk* per trade.

Disclaimer: The Trading System Lab is intended for educational purposes only to provide a perspective on different market concepts. It is not meant to recommend or promote any trading system or approach. Traders are advised to do their own research and testing to determine the validity of a trading idea. Past performance does not guarantee future results; historical testing may not reflect a system's behavior in real-time trading.

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MARK D. COOK:

The deep roots of trading

BY MARK ETZKORN

Like the markets, trading careers are rarely one-way affairs. Instead, they are characterized by fits and starts, taking two steps forward and one step back, learning and adjusting and refining.

In his 25 years as a trader, Mark Cook admits to having traded "just about everything" and having lost his trading stake "too many times to tell" early in his career. But in 1986, after approximately eight years of losing money or scraping by, Cook turned a corner. Not surprisingly, the change was the result of an understanding of risk control and recognition of his trading personality.

Cook had always posted a high winning percentage — typically 80 percent or higher. However, in his losing days, he would often make money on seven trades and give it all back on the eighth. He discovered that moving to a short-term trading horizon and putting strict time limits on his trades reduced the likelihood a trade would get away from him and end up in the minus column.

"It was not 'money management' per se, as in risking *x* dollars," Cook says of his change in thinking. "It was more a time parameter assigned for a probability of the position working. In other words, the position should move a certain amount in my direction within a certain time frame, or I had to conclude that I had misjudged the situation and I would get out."

Such practical observations and techniques have been the hallmark of Cook's career. The 47-year-old trader and erstwhile farmer is a classic example of what persistence and the ability to "trade your personality" can do for your bottom line.

I never thought of things in terms of the greed factor; I was always thinking of the loss potential first.

In the years following his realization, Cook's trading became more consistent. His reputation grew after he finished at or near the top in several trading contests, including a first-place showing in the 1992 U.S. Investing Championship where his return-on-portfolio was 563.8 percent. Now, in addition to his personal trading, Cook tutors traders and publishes a twice-daily advisory service for trading the S&P and bond futures (see www.markdcook.com).

Cook occasionally speaks at industry seminars, where he is known for his plain talk about trading. He minces no words about the hard work required to succeed, although he is unapologetically enthusiastic about his profession. He is a font of practical wisdom on the art and science of trading, and he can back up his platitudes with years of first-hand market experience.

"When people say, 'I want to avoid these drawdowns I've been experiencing,' I tell them, 'Don't trade,'" he says bluntly. "It's how you weather the drawdowns and fight your way back that counts."

Today, Cook's self-described "bread-and-butter" is day trading the S&P 500 and Nasdaq 100 futures. He also trades options and individual stocks, though on intermediate and longer-term time frames, respectively. Unlike some traders, Cook has no problem segregating his trading between markets and techniques.

"All my futures and option trading is technical," he says. "My day trading is very much time-oriented, rather than price-oriented. I use a completely different framework for individual equities. For stocks, time is not even a factor, and I also use some fundamental analysis when making stock decisions."

The fifth generation of an eastern Ohio farming family, Cook trades out of his great-grandfather's original farmhouse, circa 1890. He's acquired other farms over the years (500 acres or so) with his trading profits and says he still enjoys farm work for the stress relief it offers.

His farming background also provided him, at a young age, with a practical look at the forces that shape markets of all kinds.

"I always thought farmers were very typical of the greed factor of only selling when the pressure was greatest," he says. "When things were cruising along, they always started thinking $3 corn was going to be $4 corn, which would soon be $5 corn.

"I remember when we went to the grain elevators. Some of the old farmers would write down the price of wheat and the date on the walls of the silos," he continues. "Sometimes they'd initial what they wrote, and you could see the accumulation of prices over time. I noticed there was always a preponderance of these initialed messages and prices at market bottoms. It was very intriguing. Also, I always knew when we'd hit a high because there wasn't any selling."

Despite his exposure to the basic forces of commodity trading in his early life, Cook found himself more drawn to the stock market. As a student at Ohio State University in the early 1970s, he researched stocks and charted prices, looking toward the day when he could trade. His career began after he graduated in 1976 with a degree in agricultural business. He wanted to trade stocks, but had no money.

Experience as a livestock judge at national farming contests and expositions when he was still a student, as well as work with Borden's (as a caretaker for the company mascot, Elsie the cow), sharpened his knowledge of the cattle industry. Atimely sale of cattle off the family farm provided Cook with his initial trading stake.

He struggled for quite a while, making and losing money while continuing to work in farming (and as a stockbroker) until he managed to make a consistent living from his chosen profession.

Cook's "formula" is straightforward. First, he acknowledges he made plenty of mistakes and lost lots of money early in his career. But he loves what he does and has a world-class work ethic. He combines a penchant for detailed analysis — of his own personality as well as the market — with determination, which has allowed him to learn from his mistakes and improve his trading by building on his ever-expanding base of knowledge.

It sounds simple, but the reality is it took a long time and a great deal of work (including a mind-boggling — obsessive, even — level of record keeping) for it to pay off. Trading has been an ongoing process of self-discovery for Cook, and he values the profession for its mental challenges as much as for its financial benefits and the level of independence it provides him.

AT: *What were your first trading experiences like?*

MC: I did my own thing — everything was trial and error. [In college] I kept a ledger and would write down prices of about 30 stocks every day and track where the dips were — a very medieval kind of charting, you might say. It wasn't really point-and-figure or bar charting — I was tracking the actual numbers. So, I'd follow a stock as it would dip down to 28, come up to 31, dip back down to 28½, and so on. That kind of monitoring gave me a feel for the stock.

When I finally got money to trade after college, I poured it into stocks I'd studied that looked like they were going to do well. And that actually worked out pret-

ty well. I had one stock that got bought out, for example, which brought me a lot of money.

Then my broker introduced me to stock options in late 1977 and, of course, I was very intrigued by the leverage — I've loved leverage ever since.

AT: *Were your positions at this time investments or trades?*
MC: It was really trading. I was always a trader, from the start. I've always been a singles hitter by nature, not a home-run hitter. I would think in terms of capturing 10 to 20 percent per trade — for example, buying a stock at 28 and selling it at 31. And I liked the action.

My farming background taught me that good years are generally followed by bad years. It was the same in the market: If stocks had been rising for the most part, look out, they were probably going to go back down. So, I would take my profits quickly.

I just shook my head when I thought of long-term trading. How could anyone sit with a profitable stock for 12 months? I never thought of things in terms of the greed factor; I was always thinking of the loss potential first.

AT: *You had your share of rough experiences earlier in your career — losing your trading stake more than once. What lessons did you take out of those experiences?*
MC: My first five years were very tough. What I learned was to put together a plan, which I hadn't done before. I didn't look at worst-case scenarios. I would think, "This stock can go from here to here" in terms of its profit potential, but I never looked at the other side — how bad it could get.

Back in the 1970s, you didn't hear much about stop orders. I read book after book on trading — even though there weren't that many at the time. There was plenty of information on how to perform chart analysis, but very little on risk management. And brokers, like they do today, had the buy-and-hold mentality: If you hold it long enough, it will come back. Well, some stocks didn't, and I didn't have anything in place to protect against that.

When I started trading options in 1978, I quickly learned a longer-term approach doesn't work with long options because of the premium erosion [time decay].

> What separates the pros from the amateurs is when a trade doesn't reach its potential profit level and you are still able to get out with a profit. You're taking what the market is giving you with a smile.

That's what hurt me initially in my trading. The first 15 to 18 months, I think, I lost all the money I made in income from farming and other jobs. I thought, "What's wrong with this picture? I'm just throwing money down a rat hole."

Then I started studying more and identified where I was making mistakes. The conclusion I came to was to narrow my time horizon. I just kept compressing and compressing. I got to where I was down to a two-week holding period, and over the years I evolved into a day trader. If you give positions more time, they can get away from you. I ultimately found that controlling the time factor worked best for me in terms of handicapping risk.

AT: *How long was the process to determine, "I'm a very short-term trader, and this is what works for me"?*
MC: It was a gradual evolution. But I really realized what I was doing — what the risks were, where the dangers were — after about five years [around 1982-1983]. Then I started putting together a plan.

So, for the first five years I lost money. Then I went through a period of treading water for about three years, where I'd make some money, then I'd lose some, and so on. But at least I wasn't going backward anymore, and I was really learning a lot about the nature of trading and how to stay alive.

I had lost my trading stash in the past and I had to go through the process of building it back up from scratch, so at this point, preservation of capital became my No. 1 priority. I realized my approach was not working and that I had to keep hold of what I had. I've worked with that in mind ever since.

After that treading water period, I just kept analyzing my trading approach and tweaking my system. In 1986, for some reason, a light bulb went off. It was really up, up and away from there. I had good money management at that point and I started making some really serious money. Sure, I'd have drawdowns and go through bad periods, but I never exposed too much of my capital — I was keeping my drawdowns to manageable levels. I wouldn't say I was proficient, but I was more efficient in that I could stay in the game and find consistently profitable trades.

AT: *How exactly did you get a handle on money management and risk control? Was it just a matter of cutting your losses more quickly than you had in the past?*
MC: Yes, it was cutting more on a time basis than a price basis. I still never arbitrarily pick a price level I think of as the stop point or "uncle" price. It was more a matter of time for me — that's why I kept shortening my time horizon.

At that time I was simply buying calls or puts. I would notice that if an option made a 50 percent decline — say, if you bought it at 4 and it went to 2 — you were out of luck. The odds of it coming back to where you could make money

off it were minimal. It was a simple realization: "You idiot, don't let your trades get away from you that much. You're just beating a dead horse."

So I decided to cut my losses when an option declined to around 55 percent of its original value. When a $4 option would drop below 2½ or 2⅜ I was just looking to kick it out — whether it was one day, two days or a week.

But then I also noticed the time element: If an option trade didn't work within three days, it was like holding an ice cube in your hand. If you don't use that ice cube, it's just going to melt away. That's the way an option is — it's a depleting asset. That realization put the fear factor into me and I eventually narrowed things down to the point that if I didn't get satisfaction on the position after three days, I got out, regardless of where it was trading.

Just having that mechanical function — combined with the 55 percent rule — made the difference in my bottom line. To this day I use a time-profit objective where the trade has to reach a price point within three days. Second, I had a time limit to exit a losing position, and third, I had the insurance of getting out if the position dropped to the 55 percent level.

AT: *Did your realization that options were "melting ice cubes" ever lead you to short them?*

MC: Well, we should back up a bit. I got into trouble in the early 1980s selling naked options. I'm big on "grade cards," or report cards, of my trading. I really analyze every trade I make — it's the best learning tool I've ever seen.

Winning percentage vs. losing percentage is of the utmost importance to me. Even during my losing period in the first five years of trading, I would still have seven out of eight winners. But what was different back then was that the eighth trade would wipe me out. As a result, one of the things I'm very adamant about now is that I don't believe in pyramiding [increasing trade size and risk as your equity grows] at all. If you pyramid, you always have the maximum exposure and the greatest potential risk

Several times I'd be rolling along, with six, seven, eight winning trades in a row, and then I'd pyramid the profits — go into the next trade with both my principal and my profits on the line. It amazes me to this day, but trading options I could take $20,000 to $100,000 in a month when I had a string of winners and I was pyramiding the profits. But then on the next trade I'd take the 55 percent hit and take my account back down again.

The reality of the situation just slapped me in the face. It didn't have anything to do with indicators, reading the markets, or time — it was that I was executing trades with too much size.

That's when I switched to trading the same size on every trade. Suddenly, with the exact same trades, the same methodology and risk control, my account never got severely hit again. I'd have maximum drawdown of perhaps 15 to 20 percent instead of 40 to 50 percent.

AT: *Was there anything specific that helped you turn the corner at the time?*

MC: The thing that triggered the light bulb in 1986 was that I started keeping a daily diary. I wrote down pertinent events for each trading day. It could be anything. If there was an FOMC meeting that day or if retail sales or the CPI [consumer price index] was coming out — anything that I could put in a journal about the stock market.

I was a profuse reader of any type of information. I just started trying to correlate what was said and what I heard with what I saw happening in the market. Was a news item or something else viewed as a positive or negative — bullish or bearish? I'd note my perceptions of it. Then I formulated a plan from that.

That's when a sentiment element entered into the picture. I had various technical tools, but I didn't have any sentiment-type tools. Whenever every newscaster and financial journal was very negative, it was probably the start of a bull market. That really put things in perspective for me that the majority was often wrong.

AT: *Are you a literal day trader? Do you actually close your positions at the end of each day?*

MC: In the futures, very much so. I'll trade several round-turns per day — three to 11 trades, with an average duration of a little less than 30 minutes. If I want to hold a position for any [greater] length of time, I'll use the QQQs or SPYs.

AT: *What's the basic methodology behind your typical intraday trade?*

MC: It's based on extremes. I'm a "fade trader." I'm always going against the market and looking for exhaustion points. I'm not a trend trader at all — I don't look for trend days. I'm best in what I call a "banger day," when the market moves up, moves down, moves up and the net change for the day is minimal.

I use several distinct trade setups depending on the environment. Case in

I really analyze every trade I make — it's the best learning tool I've ever seen.

point: If we're in a very docile, contained environment — what I call a "box" environment — where the market establishes a high and low and trades within that range for three days or more, I just trade within the support and resistance of that range until the market violates the box.

I'm an old-fashioned tape reader, and by that I mean I don't look at charts during the day at all. Many people have a hard time believing that. I have a scroll function on my main computer that shows me time and sales for the S&P, bond and Nasdaq futures, and I also watch the NYSE and Nasdaq TICK. I think it actually makes me sharper because I commit prices to memory on a numerical basis for my support and resistance. If anyone asks me what the high or low of the previous day is, I can spit it right out.

My "catapult" day trade is based on double- and triple-probes of a price level. I'll look for the S&P futures to trade in a narrow range, say, five points, for an extended period — maybe 30 to 45 minutes.

Say the S&Ps are trading at 1,300, rally to 1,305, come back down to 1,301, rally back up to probe 1,305 and then come back down. Now the market has declined twice and established 1,300 as a floor — with a slightly higher retest at 1,301, which suggests the market might go to the upside because it's made a higher low and made a run at the high.

Now, it comes back down to 1,301.50 — a little higher than before — and then creeps back up. That's when I'll get in, because the odds are it will catapult through the 1,305 level. The idea is that the trading floor is seeing the same thing I am, and they start taking out stops. If the market moves back up to 1,304.50, the whole floor sees this, and as it pushes through 1,305, there will be stops they can hit at 1,305.50, smaller stops at 1,306 and so on. Even if I get in around 1,303 — which would not be a great fill — it should catapult up to 1,307 or so. If it's more, great. Generally, these trades can generate between three and five points, with an expectation of greater than 75 percent.

The risk control I use on this kind of trade is twofold. The first protection is to place a stop below the support area in case the market reverses back down; that's the insurance. The second thing I

Cook Cumulative Tick indicator

One of Mark Cook's proprietary trading tools is his Cook Cumulative Tick indicator (CCT), which is based on a running calculation of the TICK indicator. (The TICK is the number of stocks that last traded on an uptick minus the number of stocks that last traded on a downtick. For more information see Indicator Insight, *Active Trader*, March 2001) He uses it to identify longer-term extremes in the stock market.

Cook developed the indicator on a trial-and-error basis from 1986 to 1990 based on what he observed in the market vs. the standard interpretation of the TICK. The traditional view was that rising TICK values represented strength and falling readings reflected weakness. However, Cook concluded that extremely high or low TICK readings actually implied market exhaustion, similar to the overbought and oversold signals of many oscillators.

"Initially, I saw that when the TICK got to a high-plus or a high-minus level, the market was moving very energetically in that direction, and the move was often exhaustive in nature," he says. "After the high-plus or high-minus reading, the market would often reverse. In fact, a high percentage of the time the market was exhausted and would reverse strongly. So I started plotting the TICK count against prices and I used it religiously in that manner.

"With option trades, for example, I'd see that on a high-plus TICK reading, a call option might rally to $4.50. On a high-minus TICK, the call might erode to, say, $3. That determined a range for me — support and resistance — that the option would trade in. Then I carried the concept forward: If this works in such a short time frame during the day, what if I did a cumulative reading of it and tracked it day after day, week after week and month after month?

"What I found between 1986 and 1990 was that extreme cumulative signals would develop about four times a year. The rest of the time the market would be more in equilibrium. But the extreme readings were generally accompanied by some external news item that would distort the market."

Cook takes TICK readings at specific times and adds them to a running total. The "equilibrium" range for the indicator is between +400 and -400. When the indicator reaches its 99th high percentile, it's overbought. When it reaches its 99th low percentile, it's oversold.

"The great test I finally put it to was the Gulf War in 1990," Cook says. "I had kept track of it for approximately four years but I hadn't put any serious money behind it. When the Gulf situation developed in early August until Oct. 11, which was the low of the stock market in the 1990s, that was the highest reading I had ever seen. It eclipsed the 1987 reading.

"I put money into it in October 1990, and there was a significant bounce into December. It looked increasingly likely we were going to war. And in early January, around the 7th to the 10th, there was another extreme reading right before the shots were fired, and I loaded up on calls. I didn't know how long it would take to resolve to the upside, so I bought February options. When the shots were finally fired, the market went up 300 points almost immediately.

"I've used the indicator ever since. The most euphoric example of the indicator I saw was when [Fed chairman Alan] Greenspan opened the spigot in late 1999, supposedly because of the potential Y2K crisis.

"I calculate the indicator on the Nasdaq as well as the NYSE, and I had the most overextended Nasdaq CCT plus count in December 1999. Actually, the indicator didn't get that much more extended, even in February 2000.

"Right now [March 17], the Nasdaq cumulative tick is the most oversold it's ever been, so the Nasdaq is going to have a very violent up move, probably within three weeks to three months, which is the time window for the indicator."

For more information on the CCT, see "Principles in action,".

use, which, along with the profit objective, gets triggered the majority of the time, is a time limit of 21 minutes. What I found from my trade "report cards" is that the greatest profit potential for this trade is in the first seven minutes. The second seven minutes, the trade is losing energy, and from minutes 14 to 21, you're scurrying to get out as best you can.

AT: *These rules were a direct result of the records you kept of your trades?*
MC: Exactly.

AT: *Have you always logged your trades?*
MC: I've always recorded all my trades, but the process has matured over time. Now I grade every trade for its individual significance, as well as grade my performance. In other words, a catapult trade has a definite profit objective and a definite risk-control mechanism in it. Because I know the risk vs. profit potential, I can grade myself on how well I execute a given trade.

For example, I feel the catapult trade has a 3- to 5-point profit potential. If I can get within that range, I give myself an A. If I only capture a point or two, that's not very good — I'll probably give myself a C.

But the thing that will get me an A+ is if the trade doesn't reach its 3- to 5-point potential profit level and I'm still able to get out with a profit. That's what separates the pros from the amateurs. In those situations, you're acknowledging you're not going to reach your profit objective and you're taking what the market is giving you with a smile.

People who overstay their welcome in trades end up using the worst four-letter in our vocabulary: hope. When you're thinking, "I hope this thing comes back," you might as well get the heck out because emotions have replaced rational thought and your objectivity is gone.

AT: *Did it take you a while to develop a certain emotional balance or sense of perspective about your trading, or did you develop that over time?*
MC: I would say I still haven't arrived at that point yet. I'm not being facetious. I know a number of well-known traders, and I think something we have in common is that we're all really scared to death. But I also think that fear keeps us alive.

Emotions can be very healthy in trading if you learn to use them according to what the market is telling you. I can throw all my indicators out the window, but whenever my gut is churning, that's when I know to belly up to the bar and do something.

I'm such a contrarian that when markets get the way they are now — extremely oversold or overbought — I'll trade more aggressively and more frequently. I'm more energized because I know the market is at an extreme and it's going to turn the other way, like the proverbial rubber band — the more it's stretched, the more it will bounce back.

I'm much more nervous in docile markets — they scare me to death. In those situations the market is building energy, and if you're on the wrong side when that energy comes out, you can really get hammered.

AT: *What are the most important lessons you try to impart to other traders?*
MC: I believe in the psychology of trading. People need to know their trading personalities. That's what separates winning traders from losing traders.

Losers try to trade vehicles that don't suit them. For example, the Nasdaq attracted oodles of people over the last two or three years because of its volatility. Well, everyone loves it when it's going [his or her] way, but it's a double-edged sword. Very few people can handle the volatility when it goes against them.

I love efficient markets, and the Nasdaq was not an efficient market — it was a euphoric market driven by emotions. As markets mature, they become more efficient. The S&P, for example, is more efficient, but the best of all in that regard may be the bond market. It's very large, very efficient and difficult to manipulate for a long period of time.

In fact, I often recommend that people learn to trade bonds first. Some people think that's stodgy and boring, but that's the point. You need stodgy and boring to stay alive!

If new traders can live the first six months to a year, they have hope of succeeding.

AT: *So you're not necessarily talking about being really profitable, you're talking about being able to keep your head above water?*
MC: Yes. The losses have to be monitored, but the profits take care of themselves. People sometimes tell me, "I made *x* dollars over such-and-such a period." That doesn't impress me at all. My question is, how long have you been trading? If someone tells me three years, that impresses me because it tells me they've withstood the test of time — even if they haven't been successful.

I talked to someone the other day who told me, "You know, I've been trading for six years and I really haven't made money." I stopped him right there and said, "You don't need to tell me anything else. You've been trading for six years and you're still at it. That means you haven't lost much money, either."

I give individual trading seminars and I basically see three types of people. The first type is the "wannabe" trader. They're looking at trading as a potential vocation and the first thing they have to do is find out what suits them — their trader personality. You develop a certain personality over the course of your life — it's who you are. Apply it to trading and find what fits you. If you can do that, you'll be on the right path.

The second type of person is the "bleeder." These are the ones who have been trading for a while, and they're losing money. You have to identify their problem quickly. They need to get the bleeding stopped or they're going to die.

The third type is the pro trader, or at least someone who's done it for a while and has made money, who has never really kicked [his or her] performance into high gear. I try to tweak [these people] a bit by breaking down what they do: "OK, you're very good at this, you're good at this, but you're weak at this. How can we fix this weakness?" Maybe it would be smart to avoid it completely — whether it's trading a particular trading environment or period of the month, or whatever the case may be.

For example, I've found I'm a weak trader on Fridays. When I won the U.S. Investing Championship in 1992, I didn't trade on Fridays the entire year. I also found from my trade report cards that my best trading day is Tuesday.

AT: *Do you find it useful to back off from trading occasionally?*
MC: I think it's very important. You have to do something to occupy your mind away from the market.

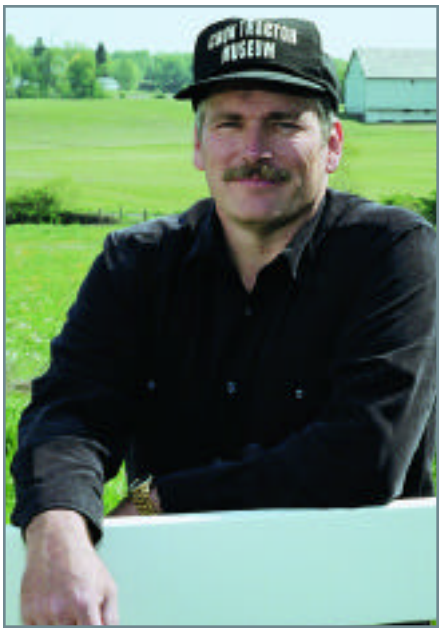
One thing I've realized about myself is that my trading is very good at the beginning of each month — approximately the first 10 days. I think it's a factor of being re-energized because I start each month as a fresh challenge: I'm at zero and I've got to pay my bills. That's my motivation. When I get into the second or third week of trading, I've expended a lot of energy and I'm not operating at 100 percent — I'm not as focused.

I'm a goal-oriented person in a lot of ways. I love consistency in my trading. Things like consecutive winning days are a big deal to me, so I'll do things like see how many days I can string together without a losing trade.

In July 1987 I made a pact with myself that I would trade every day that month. I got up to July 27 and every day had been a winner. There were three trading days left in the month. And even though I knew I was getting tired and pushing the envelope, I thought, "I'm not going to stop now, I'm going to keep going."

And you know what happened? I traded the last three days, lost two out of the three, and gave back two weeks of profits. I was ready to hit myself over the

I'm an old-fashioned tape reader — I don't look at charts during the day at all.



head. But it taught me a valuable lesson. Now I never trade the last three days of the month and the first day of the new month — that's four forced vacation days each month, when I really recharge my batteries. It's also practical for me not to trade then because of end-of-month market activity — the institutional "window dressing" that can really distort the market and affect my trading.

I also create a business plan each year in which I lay out what I should be doing given every environment or situation. For example, one of the things I have written down in my current plan is, "Any month that I'm up 25 percent, take time off."

Trading can really wear you down, and although most people obviously think the opposite, I actually think it wears traders down more when they're profitable than when they're losing. From my own experience, when I have a long, successful run I can tell I'm getting worn out — kind of like a sprinter who tries to become a long-distance runner.

AT: *What's your typical trading day like?*
MC: I've structured my day in a way that fits my work personality. One of the things that everyone needs to recognize is what type of person they are regarding their work habits. In a way, the routine is kind of like finding your trading personality

I think there are two types of people: morning people and night people. Some people can't get it going in the morning, but they get sharper as the day progresses. They should make their decisions in the afternoon or even the evening. Other people are sharp right when they get out of bed in the morning and their energy and attentiveness dissipates as the day wears on.

I'm a morning person. I always have been. I have what I call the "daily ritual." The first part starts at 6:30 a.m. and goes until about 8 a.m. (EST). I put out a fax advisory service at 8 a.m., and another one at 3 p.m. It's really an outgrowth of what I've been doing for myself for decades: I write down all the possible scenarios for the trading day, and then assign a probability to what each market can do for the day.

6:30 a.m. to 7:30 a.m. consists of a lot of information gathering — it's a quiet time when I can digest things. I calculate my cumulative tick numbers (see "Cook Cumulative Tick,") and look at historical patterns of things such as the time of the month, time of the quarter, where option premiums are — all kinds of things that help me assign probabilities. I also force myself to assign a probability for what kind of day I think it will be: up, down or sideways.

From 10:30 a.m. to 11:30 a.m. I reassess my initial projection to see how accurate I was and/or if the market has changed. The market often establishes a pattern by that time of the day — the current prices are telling you what the market is doing— and generally doesn't deviate much from it.

This, in turn, dictates how I apply my trades for the day. For example, if it's a sideways "banger" day — and most people don't realize that trend environments are the exception — I have certain strategies I'll use, like the catapult trade.

By around 1 p.m. to 2 p.m. I've usually completed my trading for the day. Again, because of my trade analysis, I've found that after 2 p.m. my winning percentage diminishes dramatically. And I think that just goes back to the way I am. At that

Principles in action

According to Cook, the impetus behind the Cook Cumulative Tick (CCT) indicator was advice from his grandfather: "Buy what no one wants and sell what everyone wants."

Cook designed the CCT as a contrarian indicator to identify overbought periods when everyone wants stocks and oversold periods when no one wants them. He then trades in the opposite direction.

On Dec. 27, 2000, the CCT posted a -500,000 reading, which was the second most extreme oversold reading Cook had recorded.

"When the market gets that oversold the snap-back — especially initially — is very sharp," says Cook.

Accordingly, from that point, Cook traded exclusively from the long side of the market, putting on a "core" position in the Nasdaq futures (on Dec. 29, which he held until Jan. 3, 2001) and day trading around this position.

In this case, the core Nasdaq trade actually produced a loss. However, the intraday surge that occurred on Jan. 3 resulted in a windfall profit in the S&P futures, which Cook bought at 1,309.60 and sold at 1,355 (see Figure 1). Cook will often use the intraday TICK reading to exit such trades.

"If the intraday TICK goes to an extremely high reading, say +1,000 or greater, it's an overbought signal and you should exit," says Cook. "That day [Jan. 3], actually, the TICK went to +1,500 — that's about as extreme as you'll ever see. When you see a reading like that after a bottom, you just kick your trade out. That's what I did."

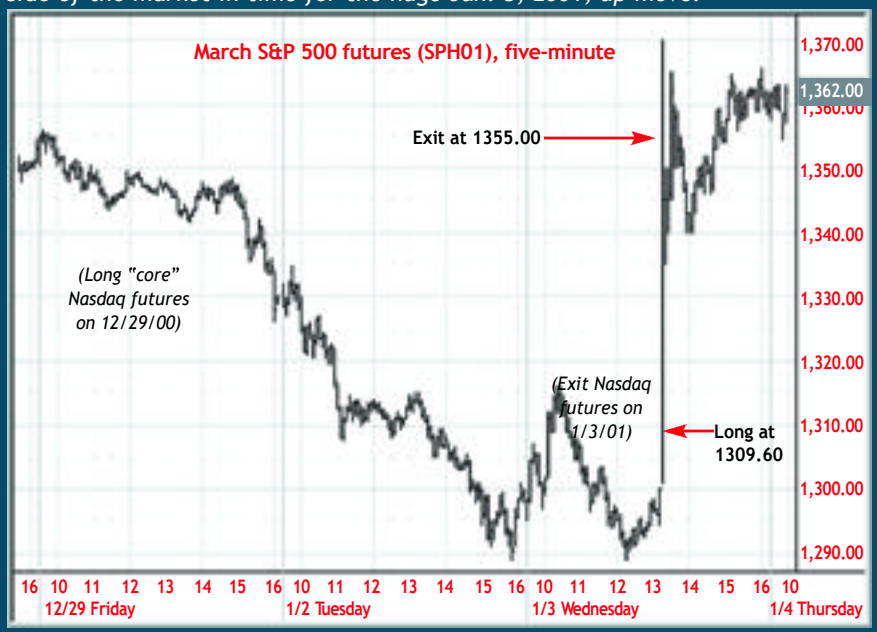
Cook notes that the timing of the CCT signal is not necessarily precise, requiring discipline to stay with the trade indication.

"I do take some heat [on my core position] on this kind of CCT trade," he says. "But I will trade smaller positions around the core position."

[These trades were verified by brokerage statements.]

FIGURE 1 COOK CUMULATIVE TICK INDICATOR

An extreme oversold reading in late December 2000 put Cook on the long side of the market in time for the huge Jan. 3, 2001, up move.



Source: QCharts by Quote.com

point I've already been thinking "market" for seven hours, and that's about my limit. I also don't trade the last hour of the day because the markets can be influenced by people having to close or open big positions. If you get hurt, you don't have much time to recover.

I don't do anything after the market closes. My mind is mush at the end of the day. I need to recharge after that, so I spend time with my family and do other things.

AT: *Don't you think the fact that you like your job so much has had something to do with your success?*

MC: That's a good point — you have to have a passion for it. It's like anything else. If you don't have a passion for your job, you're going to be mediocre.

I believe trading is the best vocation there is. It gives everyone an equal footing in capitalism, allowing someone like myself who operates in a farmhouse in rural America to make the living someone in New York or Chicago can.

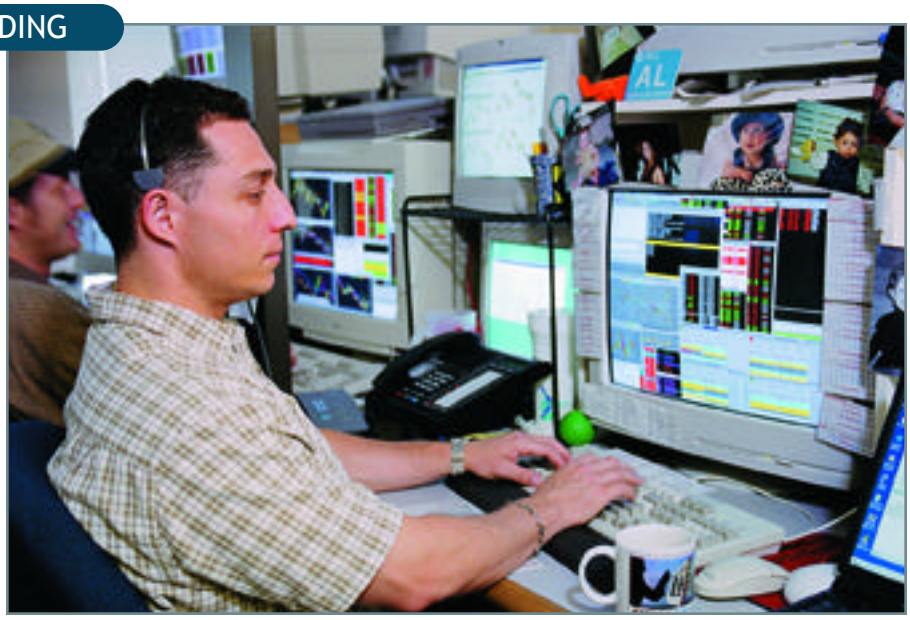
Second, it's a business that doesn't have a time limit. You can trade for decades. Even professional athletes have a finite time window. But I think traders can trade successfully into their 60s and 70s, even into their 80s — I've known a few who have been able to do that.

The third and probably most important thing to me is the mental aspect. I don't think our culture has recognized the importance of developing the mind. In fact, in the United States, I think we see just the opposite — an atrophy in mental capacity that starts immediately after we leave college. If you don't find a stimulating, perpetually challenging vocation, you won't expand your mind.

I feel that my mind is much sharper now than it was 20 years ago. What I do every day is a mental exercise that increases my mental dexterity. I have to assimilate information so fast because of my short-term trading horizon. It really heightens efficiency.

Even people who try to trade and are not particularly successful can benefit from the experience because it will develop their minds and make them more aware of themselves. I think very few people in their lives really understand the depths of their beings — what makes them tick — because they never try to bring that out or understand it. At most jobs you can function at 50 or 75 percent and get by.

But I really do believe that someone with a true passion for trading can have some degree of success if they're willing to do the work — and I think the passion and work really go hand in hand. I always say, "I am not a trader, I am trading." Trading has engulfed my being. If I wasn't trading, I don't know what the heck I'd do.



Developing market feel

BY KIARA ASHANTI

In Russell Conwell's book, *Acres of Diamonds*, a man sells his farm to go searching for the precious gems, only to die penniless. The man who buys the farm, however, finds a trove of diamonds on the farm itself. The moral of the story? Don't go searching elsewhere for riches when you may have them already.

For many traders, the search for diamonds leads to "black-box" software programs and esoteric mathematical formulas, each promising success by unlocking the complexities of the markets. This is a notion at which 33-year-old trader Adrian Lufschanowski scoffs.

"Trading is 10 to 15 percent technical, and the rest is all psychological," he says. "A trader's success or failure *always* comes down to his mental state."

Lufschanowski's view on the mental aspect of trading is not surprising. He holds a master's degree in psychology and counseled adolescents for six years. He first became interested in trading in 1995 through a friend.

"I was working while going for my master's and not really making any money," he says. "Afriend told me about trading as a way to generate income. I checked it out and decided to try it. I still wasn't making any money, but I really liked it."

Once Lufschanowski graduated, he decided to make trading a full-time career — a decision he made, ironically, because of the money he could potentially *lose*.

"One key factor in my decision was I realized that I could lose more [money] in one day than I was likely to make in a year," Lufschanowski says. "That really revved me up and I saw it as a challenge."

Six years later, Lufschanowski routinely makes money more often than he loses it, although he remembers his first year as a trader was a tough one.

"The first six months were misery — I mean just brutal," he says.

The mistakes he made read like a laundry list of "don'ts" for new traders: trading highly volatile stocks, trading too much size, being impatient, and holding on to losers while getting rid of winners.

"My first year, I basically refined the art of losing money," Lufschanowski says. "I would make a quarter, and then lose a half. I'd make a point, and then lose a point and a half."

Lufschanowski thinks the big change came when he got over his fear of the market.

"It got to the point where I was calling out good trades, but I was scared to get into them," he says. "I realized that I was giving the market the power."

Once Lufschanowski had this revelation, his trading turned around.

Lufschanowski began as a scalper, but he uses a more hybrid method today. He does not hold positions overnight, but he will stay in a trade throughout the day. He does not rely exclusively on technical analysis, but tries to keep things as simple as possible.

"I use 20-, 50- and 200-day simple moving averages on a five-day, five-minute chart," he says. "[But] I don't make trading decisions based on a mov-

I realized I could lose more [money] in one day than I was likely to make in a year. That really revved me up and I saw it as a challenge.

If you focus on the money, you make more mistakes because you're emotional. But if you focus on what the stock is doing, you will make better decisions.

ing average. I just use [the moving averages] as a way to confirm market direction on the stocks I am following. The rest I leave up to the market in terms of directing me."

For example, if cyclical and defensive stocks are going up during the trading day, he will buy those or short the tech stocks.

"I follow where the institutional money is going," Lufschanowski says. "I listen to the market."

This is important to Lufschanowski, since he believes many traders were shaken out of the market in the last year because they refused to pay attention to what the market was telling them.

"The difference in the current market vs. a year or so ago is that traders used to be able to buy a Yahoo or CMGI and hold them if they went down," he says. "They would always come back eventually. You can't do that anymore."

Lufschanowski follows several market sectors. Using intraday and daily charts, he looks to see if a sector has made new highs or lows from the previous day. If he believes a break in either direction is likely, he'll prepare to trade stocks in that sector, waiting to see if the market confirms what he saw on the charts.

In addition, he uses a filter that automatically sorts stocks according to the pullback they have made from their entry point. He pays attention to only the biggest pullbacks.

"I focus on my losers, and why they may be losing," he says. "I don't pay attention to my winners at all, because they are doing what I want them to do. If something changes, my [filter] and tickers will tell me and I can evaluate from there what to do."

He tries to keep his profit-loss ratio in the 2:1 area, but he's flexible depending on the market trend and the size of his position.

"It's market feel," Lufschanowski says. "After you have traded for a while you get to know the market and the stocks you trade. I know my sectors and my stocks. If things are going to turn against me, the signals will be there."

Lufschanowski is quick to stress the mental part of trading and its importance.

"It's all in how you look at the market," he says. "People forget we don't trade money. We trade stocks. If you focus on the money, you make more mistakes because you're emotional. But if you focus on what the *stock* is doing, you will make better decisions."

Lufschanowski also points out he still gets his hat handed to him sometimes. When this happens, he says it is usually because of arrogance.

"If I have had a good couple of weeks, I find I get a little too aggressive," he says. "I lose my discipline and I get smacked."

His advice is for traders to make disciplined rules and follow them — keep losses small and trade small in the beginning, keeping the risk-reward balance on their side.

"If you're willing to risk losing a half-point to make an eighth, you're being idiotic," he says.

Lufschanowski's last bit of advice goes back to the mental state of trading.

"Sometimes it is not about us," he says. "Sometimes the market is just not going to do what we think. It does what it wants and is never wrong. It's what you do when you are up or down that will determine how successful you will be. Control yourself and the rest is easy."

Trading setup

Hardware:	Pentium III PC, 500 Mhz CPU, 256 MB RAM; two 21-inch monitors
Internet connection:	T1 line
Brokerage/ Software:	Direct access (ProTrader); trades in ProTrader office

Fighting ATTACHMENT in trading

Learn about a few simple concepts that can help you avoid emotional traps in trading.

BY JON OSSOFF

No matter what style of trading we practice, we bring with us unique personalities and life experiences that shape who we are and how we perceive the world. These elements in turn color our relationship to the market: how we observe it, how we evaluate it and, as a result, how we trade it. The way we label and perceive events (and especially our own emotions) dictates our trading.

Much of our perception and action is shaped by something psychologists call "generalization" — how we take what we learn in one situation and apply it to other situations. For the most part, this is a good thing. For example, if you are computer literate on a Gateway, you will also be computer literate on a Dell. Or, the fact that your old love disliked your roving eye will allow you to intuit your new love dislikes it just as much.

The problem with generalization is that patterns of behavior or emotion that may work very well in other aspects of our life often fail miserably in trading. Why? Because active trading demands we cut our ties to past conditioning and focus on the present, while generalization brings up prior models of conditioned behavior and emotions.

For example, we continually hear about how greed and fear impact the market and the detrimental effects they can have on an individual's trading. But is this necessarily the case? It depends on how you perceive the market.

The multitude of traders, institutions and hedge funds interacting in the market constitute a collective herd ruled by group dynamics. On a broad scale, traders enter and remain in positions out of greed (to gain more profits) and exit positions out of fear (to lock in gains or to protect capital). Because groups are by nature more primitive than the individuals who comprise them, a macroeconomic view of the market as an exotic bazaar where greed and fear proliferate makes perfect sense.

However, each of us is ruled by subjective beliefs that preclude a purely collective market interpretation. Thus, generalizing from the

macroeconomic to the intrapersonal represents distorted thinking and can trap us in poor trading behavior.

Greed, fear and attachment

Greed and fear are the commonly referenced twin enemies of trading. But what many traders assume is simple greed or fear — the overwhelming desire to make more money or the fear of losing it all — is often something else: psychological attachment.

This attachment is frequently driven by considerations other than money. For example, a trader might not sell a position in a particular stock because it may have been the first stock in which he or she made money; or it may represent the market when trading was simple and profitable. (It may even remind you of the person you were dating when you bought it.)

There are many reasons we hold on to positions. Why do we "hold on" to anything? For security. For protection. We hold on because there is the fear of letting go. We think, "If I get rid of this stock, what do I do then? Do I stay in cash? Do I buy something else? If I buy something else, I might end up with less than I have now. That would mean I would have to face the fact I've made two mistakes, not just one. So I'll just keep things the way they are." Fear of change results in strong emotional responses, and emotions are unequivocally a poor foundation on which to base trading decisions.

As an example of this, consider the situation of an investor, Jim, who owned Lucent Technologies (LU) at virtually no cost basis when it spun off from AT&T (T) in 1996. He rode the stock up to a high of 83.75 in December 1999, then proceeded to watch in revulsion as it came back to earth. He was up about $90,000, then $80,000, $60,000 etc. As it declined, he continued to give the proverbial reply "It will come back." Sound familiar?

As a stock makes new highs there will be ample evidence that greed has taken over. In our heads we plan our futures, pay off our mortgages, buy a new car. And with each of these pleasant reveries ("paper-profit fantasies") we become increasingly enamored of this thing that is going to emancipate us financially.

The mind believes the "correct" price is the current high and attempts to will the price even higher. If the stock does go higher, we discard the most recent high and latch on to the new one, always readjusting our belief that the highest high is the "right price." This experience is what fuels greed in the individual trader.

Yet as a stock retraces its gains, it is attachment that reigns supreme. And this attachment is often something other than not wanting to take a loss and admit you were wrong about the trade. For days, or weeks, you've checked the stock in the paper or the Internet, and discussed it with friends — or worse — in chat rooms. It's no longer simply a stock; it's virtually a living, breathing entity with which you're having a relationship. The irony is that as the stock price decreases, our attachment to it increases. Like a sick friend we want to nurse it back to health. Meanwhile we are too wrapped up in the emotional hazard to recognize reality.

> The multitude of traders, institutions and hedge funds interacting in the market constitute a collective herd ruled by group dynamics. But, each of us is controlled by beliefs that preclude collective market interpretation.

Although the active trader may hold a position for no more than two or three minutes at a time, he or she is just as susceptible to attachment as a longer-term trader or investor. The time frame may change, but the psychology of attachment remains. For example, you may have traded a stock 50 times with good results. As the trades become less profitable and worthwhile, you rely on the past and unconsciously assess the stock's strength predicated on what it did then, not what it is doing now. You may be glancing at a stock quote on your screen at 36.375, but you may be reacting as you did when it was 136.375.

Learned helplessness

Let's get back to Jim. As the stock continues to drop, a second psychological process manifests itself — a process that, paired with attachment, makes it virtually impossible to avoid huge losses and market miscues. It is called "learned helplessness."

About 35 years ago, researchers conducted an experiment in which they electrically shocked dogs when they attempted to leave their cages. Later, the dogs were provided with an escape route, but chose to remain in their cages even in the face of continued shocks. Evidently, they had learned they were "helpless" even though they could have fled their enclosures.

This phenomenon manifests itself in human beings in countless settings where negative experiences have shaped behavior. What is intriguing about this theory is that non-control alone is not sufficient for learned helplessness to occur. A person must come to expect the outcome as inevitable.

It's impossible to divine why Jim fell victim to learned helplessness. However, we can surmise that experiences of feeling little or no control, either in the market or in other areas of his life, had generalized to this situation, making it virtually impossible for him to act rationally as his position melted down.

Some of Jim's comments during LU's fall into oblivion were revealing. On Jan. 6, 2000, when the stock fell $20 from 72 to 52

on earnings warnings: "I knew I should have sold before." (Had he sold that day, he still would have made more than $60,000.)

Between May 25 and June 5, 2000, when the stock rallied from 50 to 65: "I'm gonna hold it. It will come back to 80. Then I'll sell."

Fall 2000 to spring 2001, as Lucent fell to 14: "There's nothing I can do. If I sell it will go higher. If I hold it might come back. I should have done something before. I knew I should have sold before."

Such thoughts are typical of many traders whose stocks plummet. They feel paralyzed and incapacitated — a classic symptom of being in the grasp of learned helplessness. They become immobilized and incapable of making decisions and, as a result, their profits shrink to naught.

It is important to realize that emotions can never be completely eliminated from trading. However, the more awareness we cultivate and the more aware we are of patterns that may impact our trading, the better we will manage that emotional edge.

Emotions can never be completely eliminated from trading, but by cultivating an awareness of patterns that impact our trading, the better we will manage that emotional edge.

Taking action

Acknowledging these problems is one thing; doing something about them is another. What steps can traders take to combat these issues? Although behavioral change is not the only means to greater trading success, it is assuredly part of the solution.

Using stop-loss orders is a concrete way to sidestep the danger of becoming attached to positions and holding them too long. Unfortunately, many new traders often look at initial stops as an admission of defeat. For this reason, sell stops can be considered "prenuptial market agreements." You go forward on the assumption that things can work out according to your plan, but you have protection, just in case. It's just like a personal relationship. Why go through a long, ugly divorce when you can have a nice clean annulment? Stops are the surest way to cut your ties and move on.

Because attachment and learned helplessness are emotionally driven, they feast upon the passions of traders who have lost control of their trading and are responding irrationally to the market. If you wait until you are in serious peril, you risk being unable to extricate yourself when you most need to.

How do you know if you are attached to a stock? Simple: Imagine selling some or all of it. Feeling peculiar? Kind of empty? So, what to do?

One solution is quite simple. When a trader is attached to a stock, he or she holds it, neither selling nor adding to the position. Learned helplessness also prevents a trader from taking action. Thus, both patterns induce immobility. The answer, then, is to do something, because by doing something you automatically break the pattern of being immobilized.

Taking partial profits is a way of decreasing the emotional connection to a position. A common money management technique is to take partial profits (say, half the position) and move the stop-loss to the breakeven point when a position is profitable by an amount equal to the original stop-loss amount. For example, if you bought 200 shares of a stock at 50 and had a sell stop at 47, you would sell 100 shares when the stock reached 53 and move your stop up to 50 on the remaining 100 shares. Taking partial profits lessens the attachment, inasmuch as the attachment is generating the inability to act. Then you will be in a position to evaluate your remaining shares in a rational and unemotional manner.

Be cognizant of attachment, and cultivate a greater awareness along with behavioral change. Your trading decisions will become more objective, which just may give your P&L an added boost.

How to write A COVERED CALL

The covered call is a good introduction to the simple uses of options. Here are the steps for selling options against stock you own.

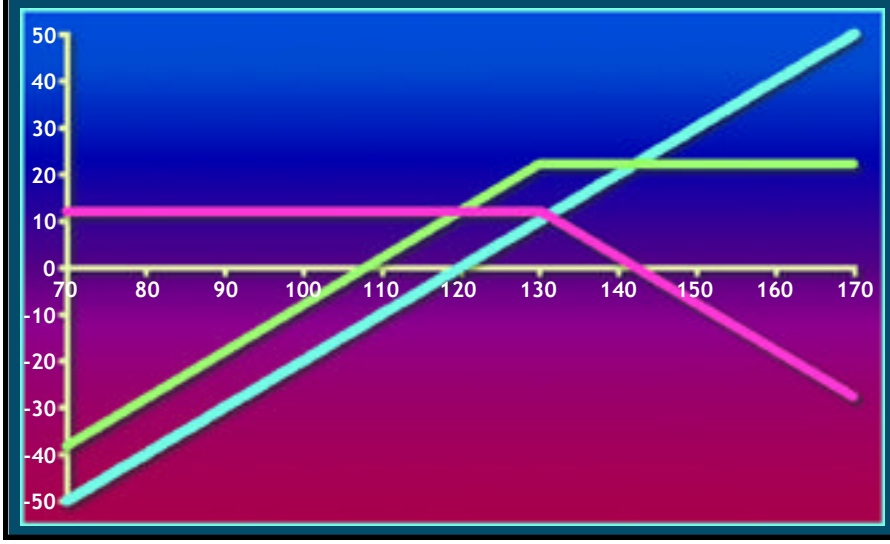
BY DAN KEEN

As everyone knows, a stock can move in one of three directions: up, down or sideways. When trading a stock, there's no guarantee the investment will become profitable, but by writing (selling) covered call options a trader can stack the odds of a successful trade in his or her favor.

By writing a covered call option, we are selling someone the right to buy a particular stock we own from us at a specified price (the strike price) on or before a set date (the expiration date). By doing so, we will not only make money if the stock goes up, but also if it goes sideways. That increases the odds of making money to two out of three possible scenarios. Writing a covered call even offers some downside protection. If the stock drops, the income made by writing a covered call offsets some of the loss. Figure 1 shows a profit-loss diagram for a covered call position.

FIGURE 1 THE COVERED CALL

The covered call (green line) is the combination of a long position in the underlying stock (blue line) and a short option position (red line) with an appropriate strike price and time to expiration. The resulting net position is most profitable if the stock price stays close to or slightly above the strike price of the option.



Writing covered calls is a conservative option trade. In fact, writing a covered call is low enough in risk that it is allowed in an IRA brokerage account. This is a strategy even a novice investor can become proficient in.

The logic

The concept of covered call writing is often compared to buying, owning and earning income from real estate.

A real estate investor may purchase a house with the intention of holding it for several years until it appreciates in value, then selling it for a profit. Meanwhile, the owner can rent the property, generating additional monthly income.

Similarly, a stock investor can purchase a stock he or she intends to hold on to long term for capital appreciation and periodically write covered calls on the stock, generating additional income every month or two.

Trade criteria

The stock you consider for writing a covered call must meet certain criteria.

First, it must be optionable — that is, it needs to have listed options traded on it (not all stocks are optionable). To check, go to the Chicago Board Options Exchange Web site (www.cboe.com), click on the delayed-quotes link and enter a stock's ticker symbol. If the stock is optionable, a table of option information will be displayed.

Second, you also must own at least 100 shares of the stock, because options contracts represent 100 shares of the

underlying stock.

Third, it must be a stock about which you have a neutral to slightly bullish opinion for the short term. Because you typically would write a covered call with an expiration date of one or two months out, you don't want to write calls on a stock whose price you believe will rise significantly within that time period. Remember, once you write a covered call, you are obligated to hold the underlying stock shares until either the option expires, is exercised by the buyer or is bought back by you.

Finally, the price of the option (the premium), plus the expected change in price of the underlying stock, must provide an expected return on the total investment at least equal to the risk-free rate of interest plus a few percentage points extra for the risk you're assuming by holding the position. There are many factors that go into determining the price of option premiums, with the most important being the volatility of the underlying stock, how close the option's strike price is to the stock price and the time until expiration.

Figure 2 shows a simplified sample options listing for XYZ Corp. Assume the date is the beginning of September and the current stock price of XYZ is 33.76. The first column shows the month, the strike price and the option symbol. When we write a covered call, the amount received is shown in the bid column.

Suppose you think XYZ won't go above 35 in the next three weeks (options always expire on the third Friday of the month). You could write a September 35 covered call and receive a premium of $56 (0.56 * 100 shares).

Note that the longer the time to expiration, the higher the premium paid to the trader who assumes the risk of selling the option. For example, notice that if you are willing to extend your call to October, the premium is much higher at $156.25. This is because there is a better chance that the stock will hit the $35 strike price in this larger time window and, thus, you have a greater risk of losing the stock.

Also, the closer the current stock price is to the option strike price, the higher the premium. For example, with the stock at 33.76, the Oct. 35 call is paying 1.56 while the Oct. 37.5 is paying only 0.81. If you would rather hold the stock, choose a strike price that is two or more strikes away from the current stock price, although you will receive a lower premium.

FIGURE 2 OPTIONS QUOTES

A call option will decrease in price the higher the strike price is in relation to the current stock price; it will increase in price the farther it is from the expiration date.

XYZ Corp.	(XYZ)	33.76
Calls	**Bid**	**Ask**
Sep 30 (XYZ IF)	3.75	4
Sep 32.5 (XYZ IZ)	1.81	1.94
Sep 35 (XYZ IG)	0.56	0.69
Sep 37.5 (XYZ IU)	0.19	0.25
Oct 30 (XYZ JF)	4.5	4.75
Oct 32.5 (XYZ JZ)	2.69	2.94
Oct 35 (XYZ JG)	1.56	1.69
Oct 37.5 (XYZ JU)	0.81	0.94

The risks

Although writing covered calls is a conservative strategy, there are a few risks to consider. As is true with stock ownership, there is always the risk a stock price may drop. If a stock drops in price, you can simply hold it, as long as the fundamentals of the company or industry haven't turned ugly. Or, you may have a stop-loss point at which you wish to sell the stock.

However, if you have written a covered call on the stock, you cannot simply sell the stock without first buying back the call. Unfortunately, you will have to pay a premium to buy the call back, and you will incur another commission fee. But you will have ended your obligation, and you are then free to sell the stock.

Because writing covered calls limits your upside potential, another risk is the opportunity lost. Suppose you wrote a covered call on a stock with a strike price of 20, but the stock goes up to 24 before your option expires. You will most likely be "called out" and have the underlying stock purchased from you at $20 per share. You could have made more money from buying the stock and selling when it hit $24. Therefore, only write covered calls on stocks you are neutral to slightly bullish on during the period you will be holding the option.

Benefits & strengths of writing covered calls

- Low-risk strategy
- Can generate monthly income (cash flow)
- Easy to learn and implement
- Good return on investment (typically 3 to 10 percent, monthly)
- Stacks the odds in your favor
- Can be applied to stocks in the $10 to $20 range
- Puts time decay (the natural characteristic of options to lose value as expiration approaches) in your favor

A sample trade

Suppose you believe XYZ Corp., whose stock price is currently at 19, has a price target of 25 within the next year. You buy 100 shares of the stock (for $1,900) and intend to hold it until the price reaches the target. While you are holding it, you can write covered call options to generate additional income.

Let's also assume it is the end of June and it is your opinion that the stock will hover around its current price for a while since the summer doldrums are coming and no news is expected on the company that would move the stock price significantly.

Indications are that the stock will probably not rise above 20 within the next month or two. You decide to write a covered call for July (one month away) with a strike price of 20. This means you are selling someone the right to buy the stock from you at 20 anytime between now and the third Friday in July. This isn't really such a big risk, since you bought the stock at 19 and will pocket $100 profit if the option is exercised. Your bet is that the stock won't go above 20 in the next few weeks. For taking this

risk, you are paid a premium of $1.25

Because you have 100 shares, and option contracts are written in 100 share increments, the premium received would be $1.25 x 100 or $125 (not including slippage and commissions). No matter what happens, that $125 is yours to keep, whether the stock goes up, down or nowhere, or whether you are assigned the stock or you get to keep it. To determine what your return on investment would be, divide the profit by the invested amount, then multiply by 100 to express as a percent and you will arrive at 6.5 percent (125 / 1,900 * 100).

However, your intention is to hold on to the stock long term. But if by chance the stock goes above 20 and you are assigned the stock position, you will make an additional $100, since you bought the stock at 19 and are being paid 20. In this case, you must give up your stock, but you will make a total of $225 profit, or 11.8 percent ([100 + 125] / 1,900 * 100), in four weeks.

Rounding off

Writing a covered call also reduces the downside risk of simple stock ownership. Every time you write a covered call on the stock, the premium income received effectively reduces the cost of the stock. For example, if you purchased 100 shares of a stock at 19, wrote a covered call on it that produced a $100 premium income, the stock could drop to 18 and you would break even if you sold the stock. And, covered calls can be written almost every month on a stock, further reducing its cost. As long as you don't get assigned, it's just like getting a monthly check from a tenant in a rental property.

Also, to increase your rate of return, look for a deep-discount broker with option transaction fees under $20. When you are only making $50 to $100 on a call, taking $20 or more out in a commission fee decreases your returns considerably. Writing covered calls is a straightforward, low-risk trading concept. To learn more, check out the free tutorials at the Web sites listed in Figure 3.

FIGURE 3 FREE WEB SITES OF INTEREST TO COVERED CALL OPTION TRADERS

The following Web sites provide additional information on covered calls.

www.allinthemoney.com
Free tutorials on covered calls

www.cboe.com
The Chicago Board Options Exchange
Free with complete options quotes and tutorials

www.optionsclearing.com
The Options Clearing Corp.
Free options quotes

www.coveredcalls.com
Free daily list of stocks with the current highest rates of return when writing covered calls

www.optionfind.com
Free options covered call screener and message boards

www.schaefferresearch.com
Free daily intraday options comments and sentiment analysis snapshots

www.optionstrategist.com
Free covered call calculator

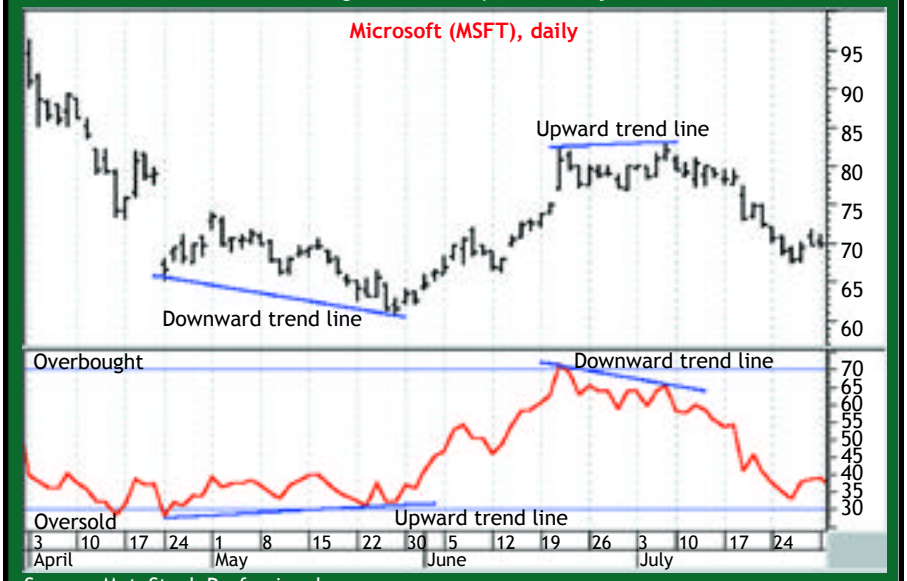
Indicator insight: Relative Strength Index

The relative strength index (RSI) is a momentum oscillator used to identify short-term momentum extremes (overbought and oversold points). J. Welles Wilder, developer of the RSI, provides step-by-step instructions for calculating and interpreting the indicator in his book, *New Concepts in Technical Trading Systems* (Trend Research, 1978). Wilder described the indicator in terms of daily price bars, but the RSI can be used on any time frame.

The relative strength index should not be confused with the concept of relative strength (see "Short-term trading with relative strength,") which compares the price action of a stock relative to the broader market's price action. Other well-known indicators similar to the RSI include stochastics (Indicator Insight, August 2000), momentum and rate of change (Indicator Insight, October 2000).

FIGURE 1 DIVERGENCES

In April and May, the RSI stayed above 30 while price dropped. In late June and early July, the RSI turned down while price made a slightly higher high. In both instances, these divergences were followed by reversals.



Source: MetaStock Professional

Calculation

The basic RSI calculation is a ratio of the average up closes (those that closed higher than the previous close) to the average down closes (those that closed lower than the previous close) over a certain period. The ratio is then normalized to have a range of values between 0 and 100 using the following formula:

RSI = 100 – (100/[1+(U/D)])

where
U is the average of the up closes over a given period;
D is the average of the down closes over a given period.

For example, to start the calculation of a 10-day RSI, the close-to-close price changes of all the up closes over the most recent 10 days would be summed and divided by 10, resulting in U in the formula. Similarly, the close-to-close price changes of all the down closes over the most recent 10 days would be summed and divided by 10, resulting in D. (Wilder actually used a modified exponential smoothing calculation to simplify calculation from day to day.)

The RSI measures price momentum by measuring the strength of up days (or bars) to the weakness of down days (or bars) over a given period. If there are more up days than down days over a given period, the RSI will rise; if there are more down days than up days, the indicator will fall.

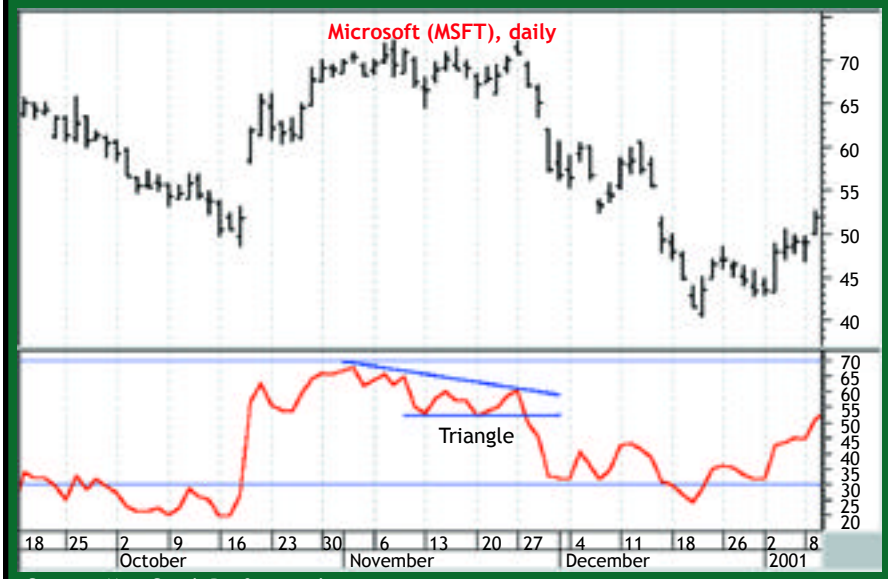
The most common "lookback" periods for the RSI are nine days, 14 days and, for a longer-term view, 25 days. However, no time period is better than any other — it depends on the market conditions and the trader's time frame. The fewer days or bars used to calculate the indicator, the more sensitive it will be to shorter-term price fluctuations.

Interpretation and application

Overbought and oversold. The RSI's most common use is to indicate overbought and oversold conditions — when a market has exhausted itself in the short-term and is presumably due for a correction or reversal. For the 14-day RSI, Wilder proposed readings of 70 or higher to indicate an overbought condition and readings below 30 to reflect an oversold situation

FIGURE 2 RSI CHART PATTERNS

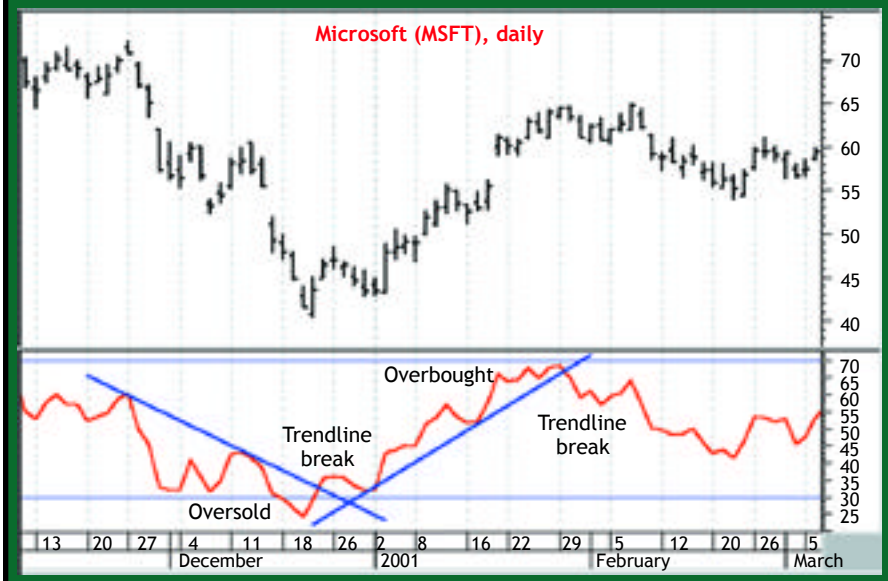
When the RSI broke out of a triangle pattern to the downside, price gapped down the next day.



Source: MetaStock Professional

FIGURE 3 MOMENTUM CHANGES

Penetrations of trendlines on the RSI chart coincided with trend changes in the stock.



Source: MetaStock Professional

(50, the midpoint of the indicator's range, represents an equilibrium level).

However, overbought and oversold levels will vary relative to the number of days used in the RSI calculation. A very short-term RSI — say, five days — will fluctuate more than a 14-day RSI. As a result, the overbought and oversold levels for the shorter-term indicator would need to be higher and lower, respectively — perhaps 85 and 15.

Divergence. Another use of the RSI is to look for divergences between price and the indicator. A divergence occurs when the market makes a higher high (or lower low) but the RSI fails to confirm the new price high by making a lower high or higher low. This suggests the most recent price high or low is being established on weaker momentum — a potential reversal signal.

Overbought and oversold signals and divergences are sometimes combined to improve the quality of signals. For example, some traders might wait for the RSI to move to an overbought level (say, above 70) and post a divergence before taking profits or selling short. To indicate a bottom, the RSI should become oversold and then diverge from the market — that is, the RSI will trace out higher lows, while the price makes lower lows.

Figure 1 illustrates an oversold condition with bullish divergence (one that implies a price rise) in April and May. Notice that the RSI dropped below 30 as prices gapped down. Prices quickly recovered, but fell to new lows in late May. The RSI, however, did not make a corresponding new low; in fact, it stayed above 30, the oversold level. This divergence, marked by the up trendline for the RSI and the down trendline for prices, signaled downside exhaustion and forewarned of a rally.

Prices rallied during June and the RSI hit 70, an overbought condition. Prices moved sideways and then made a new high, but the RSI again failed to confirm, making a lower high (a bearish divergence). The market subsequently reversed to the downside.

RSI chart patterns. Pattern analysis can be used on the RSI, similar to a price chart. For example, Figure 2 shows a triangle forming on the RSI while price moves sideways. The break of the support line by the RSI occurred one day before the gap down in price.

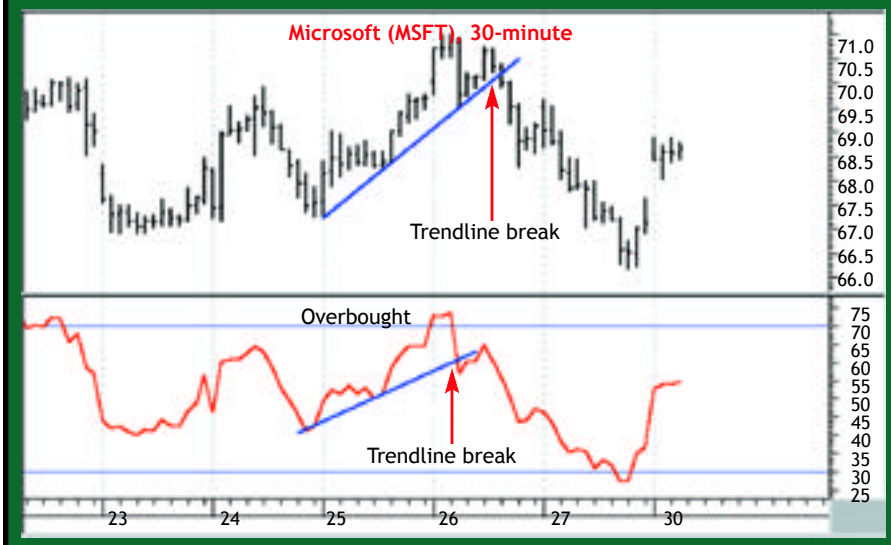
Similarly, drawing trendlines on the RSI can indicate changes in the direction of price momentum. Figure 3 shows changes in momentum in Microsoft. In December 2000, Microsoft was trending down and the 14-day RSI hit the oversold level of 30. However, no divergence occurred, just an upside penetration of the RSI down trendline as prices advanced during January. Next, the RSI fell just shy of the overbought zone, but the RSI broke the up trendline, signaling

a reversal of the upside momentum. While prices edged slightly higher, the RSI begin to trend lower, indicating an emerging downtrend.

The RSI can also be used for intraday trading. Figure 4 shows 30-minute bars of Microsoft. The RSI broke its up trendline before the stock did (after the RSI had penetrated the overbought level), and price dropped nearly five points over the next day.

FIGURE 4 THE RSI AS A LEAD INDICATOR

On an intraday chart, price breaking a trendline was preceded by RSI breaking a trendline.



Source: MetaStock Professional

Key points

The kind of behavior exhibited in Figure 4 — when a momentum oscillator reverses before price itself — is referred to as lead (the opposite of the lag demonstrated by moving averages).

For any momentum indicator such as the RSI to continue to rise, price gains from day to day (or hour to hour, etc.) must continue to increase. If the price increases remain static (say, gaining two points each day) the momentum indicator will move sideways, reflecting steady, but not increasing, momentum. If price increases are smaller from day to day (say, three points one day, two the next, one the next) the momentum indicator will fall — even though prices are still rising. Because price gains can shrink as a trend reaches its conclusion, this kind of behavior can result in the momentum indicator leading (and diverging) from the price action.

However, in an extended trend, multiple false divergences can occur. For example, a market may continue to make higher highs in an uptrend and the RSI may make successive lower highs — diverging from price. These divergences may be followed by temporary corrections, but the market will still reverse back in the direction of the prevailing trend.

Trend, therefore, is the enemy of any momentum indicator and the reason so many traders advise using indicators such as the RSI in trading-range markets rather than trending ones. (The catch is that it's impossible to know when a market will switch from one mode to the other.) In an uptrend, the RSI may generate repeated overbought signals and bearish divergences (which would trigger sell orders) and few, if any, oversold signals. This would result in a trader repeatedly selling into an ongoing uptrend.

As a result, the RSI is often used as a secondary indicator that "alerts" traders to potential reversal points; trades are only taken when specific price action confirms a particular move.

> By watching for divergence between the price and the RSI, a trader is alerted to potential trend reversals.

Bottom line

The RSI is one of a number of popular oscillators used by technicians to determine overbought and oversold states in the market, as well as changes in the trend of momentum. By watching for divergence between the price and the RSI, a trader is alerted to potential trend reversals.

The RSI is not a systematic tool that can be used to generate automatic buy or sell signals independent of other factors. You should not buy or sell simply because the RSI indicates a market is oversold or overbought. Some traders use the RSI as one component among several in a trading approach.

See the online version of this article at www.activetradermag.com for more on the RSI.

Additional reading

Getting Started in Technical Analysis by Jack Schwager, 1999, John Wiley & Sons

Finding VALUE OPPORTUNITIES

Where can you find high-potential stocks in a battered market? Adding technical signals to basic fundamental analysis can allow you to identify value stocks poised to move.

BY THOM HARTLE

During the latter part of the 1990s, successful stock traders had one mantra: High tech is the place to be. In reaction to the phenomenal bull market, traders quickly adapted to techniques that measured momentum, be it price, earnings or sales momentum.

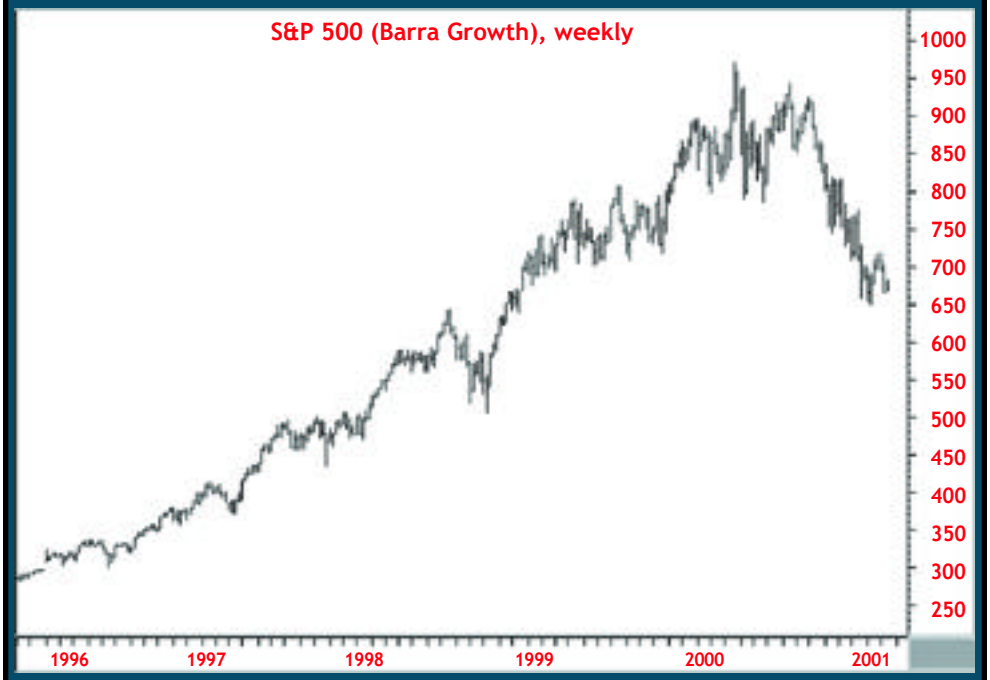
The goal was to hop on the backs of stocks that showed acceleration of any kind, whether it was price- or fundamental-based. Capital flowed to the leaders in the high-tech industry because the growth rates using the aforementioned measurements were so high. The risk, though, was great. If there was any hint of slowdown in the acceleration of a company's business — not even anything as serious as an actual loss — your position was hammered in a wink of an eye.

In the first quarter of 2000, a slowdown engulfed the entire high-tech sector, and these stocks — measured both individually and by the Nasdaq Composite — lost more than 50 percent of their value over the subsequent 12 months. Once seemingly invincible market leaders such as Cisco Systems (CSCO), Sun Microsystems (SUNW) and Yahoo (YHOO), among others, plummeted.

That's been the headline news. But away from the front page, everything isn't falling apart. In fact, a new theme appears to be shaping up in the market: undervalued companies. We'll explore techniques for identifying undervalued companies and methods for trading them.

FIGURE 1 S&P BARRA GROWTH INDEX

This index represents the stocks within the S&P 500 with price-to-book ratios greater than the average price-to-book ratio in the S&P 500 index.



Source: MetaStock, Equis International (www.equis.com)

Value and growth square off

Figures 1 through 3 illustrate the changes that have taken place in the market in 2000 and early 2001. Figure 1 is the S&P 500 Barra Growth index and Figure 2 is the S&P 500 Barra Value index.

The growth index is a capitalization-weighted index of the common stocks within the S&P 500 index with price-to-book ratios higher than the index average (the book value of a stock is the net worth of the company divided by the number of outstanding shares).

The value index is a capitalization-weighted index of the common stocks within the S&P 500 index with price-to-book ratios lower than the index average. Figure 1 shows that growth stocks fell precipitously beginning in the first quarter of 2000, while value stocks, shown in Figure 2, moved to new highs over the same period.

Figure 3 provides a clearer picture of the relationships between these two indices. Here we see the growth and value indices using a logarithmic scale, which measures how the indices performed on a percentage basis. You can see that the two tracked in close fashion from 1996 until the middle of 1998, at which point growth stocks took off (A). Then, in 2000, the relative strength comparison traced out a double top and growth stocks fell relative to the value stocks.

Whether or not this current trend will continue is difficult to know. However, because it is in place it warrants bringing a value-oriented approach to your trading and investing. The following approach shows how to identify value stocks and how to determine when to commit capital to them.

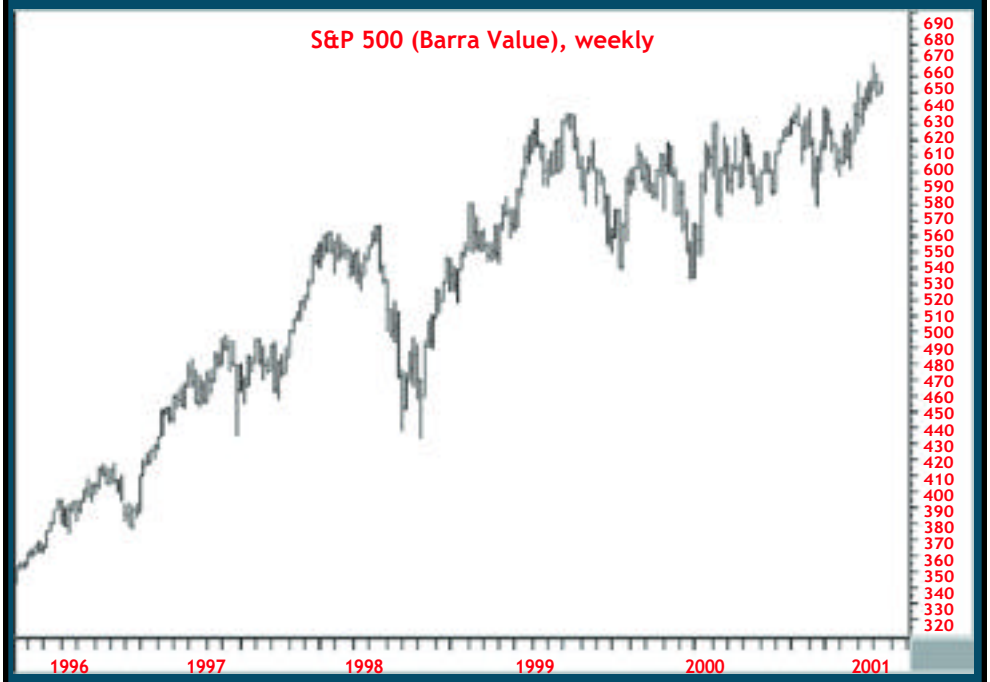
Finding value

Traditionally, value is defined by comparing various "fundamentals" to the price of a stock — for example, price earnings (P/E) ratio, book value, sales ratio and so on.

Avalue-oriented technique dictates that investments should only be made in companies whose ratios are at historical low values. The logic is that such a company has fallen out of favor with Wall Street, (as reflected by the low value ratios), but that its management team will respond to pressure from shareholders and take steps to improve earnings. The price of the stock will ultimately rise as management improves its business practices.

FIGURE 2 S&P BARRA VALUE INDEX

This index represents the stocks within the S&P 500 with price-to-book ratios lower than the average price-to-book ratio in the S&P 500 index.



Source: MetaStock, Equis International (www.equis.com)

FIGURE 3 S&P 500 BARRA GROWTH VS. VALUE INDEX

The relative performance of growth and value stocks. The top chart shows a double top formed on a relative strength basis, a bearish sign for growth stocks.

Source: MetaStock, Equis International (www.equis.com)

Market timing: ECO

The Ergodic Candlestick Oscillator (ECO) is detailed in William Blau's book, *Momentum, Direction, and Divergence* (1995, John Wiley & Sons). To calculate it, two other concepts must first be explained: "double smoothing" and the Candlestick Indicator (CSI).

Blau uses exponential moving averages (EMAs) extensively in his calculations. In an effort to create smooth signals while minimizing price lag, Blau used a double-smoothing technique — that is, he applied an EMA to the raw price data, and then performed a second smoothing of the first EMA using an additional EMA. Blau uses the standard formula for an EMA, which takes a price observation, such as the close, and multiplies it by a constant, called the alpha (a), which, in the following formula, represents the lookback period used for a simple moving average:

a = 2/(n+1)
where
n = the lookback period for a simple moving average

In other words, the exponential smoothing constant (a) to approximate a 20-day simple moving average would be .095 (2/[n+1]).

The adjusted closing price using 1-alpha is added to yesterday's EMA value, which has been multiplied by alpha. Here is the formula for the EMA:

EMA = (1-a)P + a(EMA $_{(t-1)}$)
where
p = price
EMA $_{(t-1)}$ = yesterday's EMA

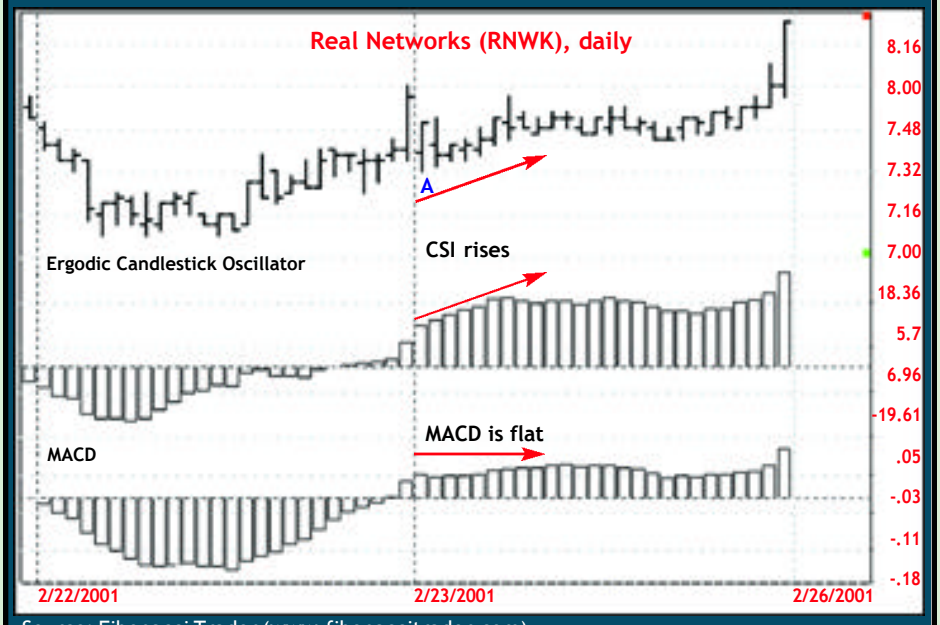
The double-smoothed closing price series (EMA Double) uses the EMA of the closing price:

EMA Double =
(1-a) EMA + a(EMA $_{Double(t-1)}$)
where
EMA $_{Double(t-1)}$ = yesterday's EMA value

Blau uses the notation EMA(EMA(P,r),s) to indicate a long-term EMA (generally 26 days for the CSI) and a short-term EMA (generally five days for the CSI).

CHART 1 GAP-DOWN OPENING

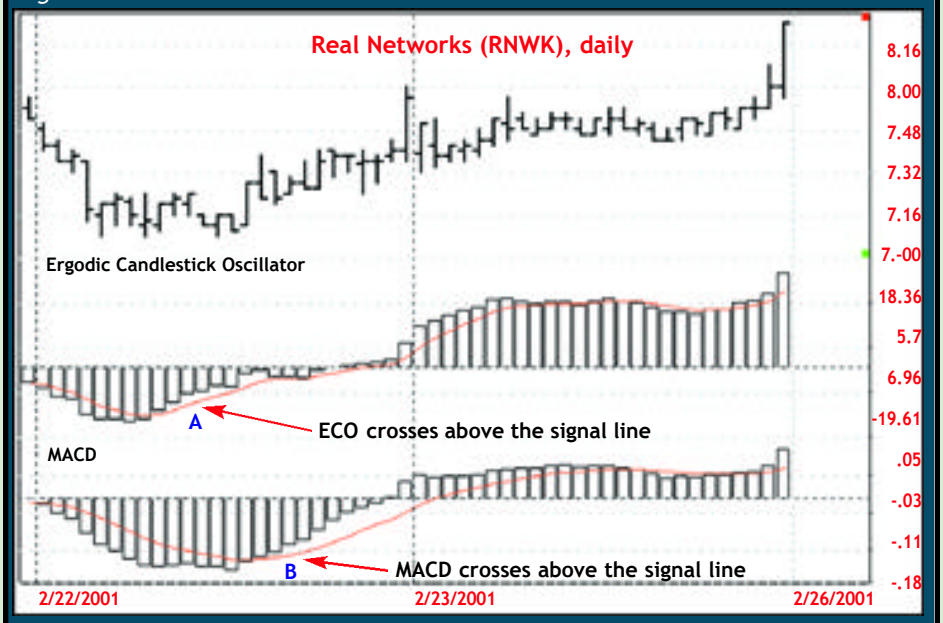
Even though RNWK opened on a gap-down, the CSI continued to rise and the MACD remained flat.



Source: Fibonacci Trader (www.fibonaccitrader.com)

CHART 2 PENETRATING THE SIGNAL LINE

The ECO crossing above and below the signal line generates buy and sell signals, respectively. In this case, the ECO signal occurred eight bars before the MACD signal.



Source: Fibonacci Trader (www.fibonaccitrader.com)

The next step is the calculation of the Candlestick Indicator. The CSI is a ratio of the double-smoothed difference between the open and close of each price bar and a double-smoothed difference between each bar's high and low:

CSI = 100(Ema(Ema (close-open,r),s)/
(Ema(Ema (high-low,r),s)

The CSI measures momentum based on how each bar closes relative to the range for the bar. Closes at the upper end of each bar's range and above the opening price indicate strength and positive CSI raw values. Closes at the lower end of each bar and below the opening price indicate weakness.

A trend in either direction will have persistent readings. The double-smoothing technique will create a smooth indicator line that rises if the market is in an uptrend and falls if prices are in a downtrend.

Intraday traders will value this indicator because the calculation does not reference the previous bars' closes. Consequently, any large price gap — such as a gap open or gap close — will not cause this indicator to fluctuate dramatically.

For example, Chart 1 is a 15-minute chart of Real Networks (RNWK). The upper histogram chart is a 26-period CSI and the lower histogram chart is the 12-26-period moving average convergence-divergence (MACD) indicator (see Indicator Insight, *Active Trader*, July 2001). Notice that at point A, there is a gap-down opening, but the MACD, which looks at the market on a close-to-close basis, remains virtually flat. On the other hand, the CSI continues to rise from the previous day's reading because the majority of the 15-minute bars are closing near their respective highs, indicating strength.

The ECO is a plot of two lines. The primary is the ECO, which uses the CSI with an additional smoothing by a five-period EMA, and the addition of a "signal line," which is a five-period moving average of the ECO (similar to the default nine-period moving average signal line of the MACD).

Basic buy and sell signals occur when the ECO crosses above and below its signal line, respectively. Chart 2 compares the ECO (upper histogram) and the MACD (lower histogram). As a short-term bottom was forming, the ECO crossed above its signal line eight bars before the MACD.

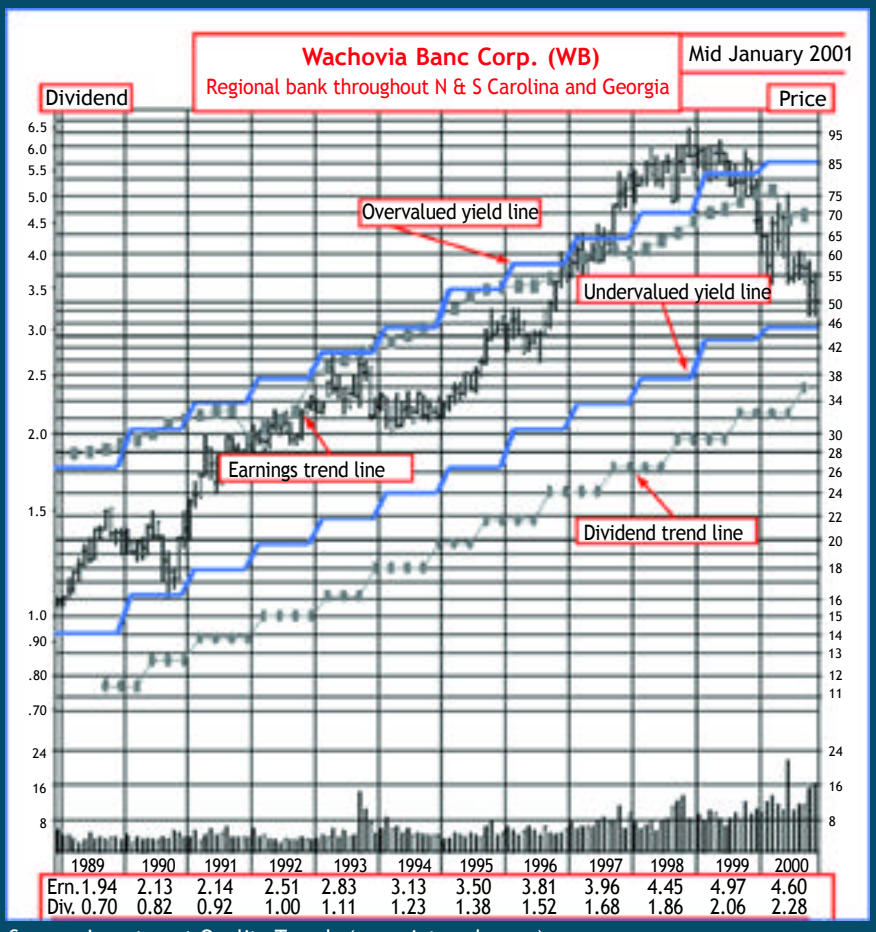
There are a number of value-oriented techniques; the one we will look at uses historical dividend yields as a basis for value.

Value Trend Analysis is a company that publishes Investment Quality Trends (IQ Trends), a value-oriented appraisal of stocks. It uses individual historical dividend yield analysis of each stock from the company's approved list of 350 "Blue Chips" to determine when a stock is undervalued (i.e., has a historical high dividend yield), in a rising trend, overvalued or in a declining trend. IQ Trends uses the following requirements to qualify stocks as blue chips:

- The dividend has been raised five times in the last 12 years.
- The company carries a Standard and Poor's Quality ranking of "A."
- The company has at least 5 million shares outstanding.
- At least 80 institutional investors hold the stock.
- There have been at least 25 years of uninterrupted dividends.
- The earnings have improved in at least seven of the last 12 years.

FIGURE 4 **IQ TRENDS CHART**

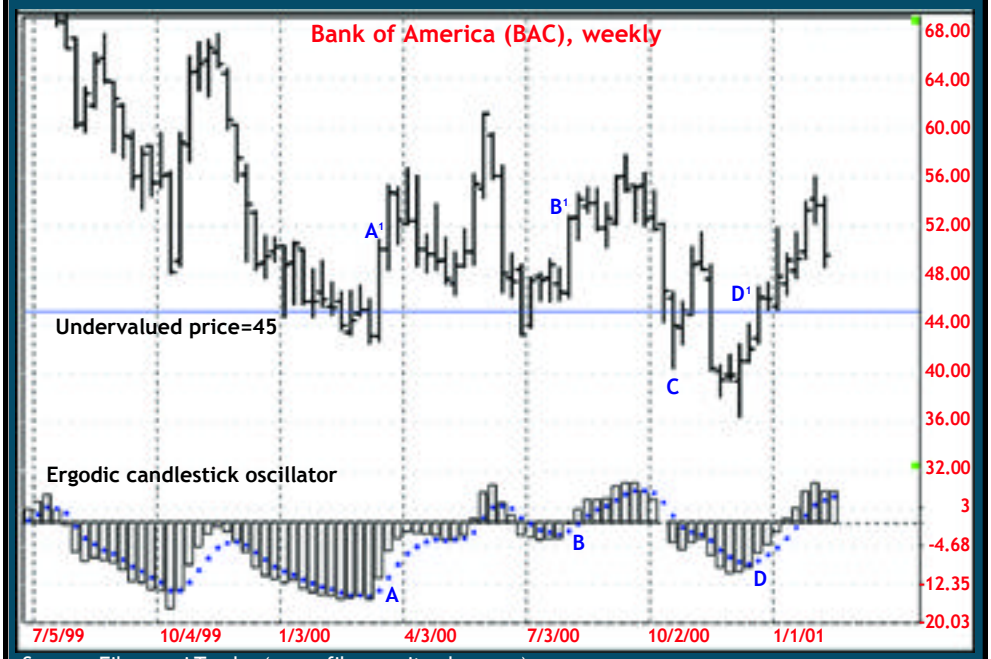
IQ Trends measures an individual company's undervalued and overvalued levels based on historical yields.



Source: Investment Quality Trends (www.iqtrends.com)

FIGURE 5 BANK OF AMERICA

Bank of America has traded into undervalued territory a number of times, offering trade opportunities at points A, B and D (confirmed by the ECO crossovers).



Source: Fibonacci Trader (www.fibonaccitrader.com)

S&P 500/Barra Growth and S&P 500/Barra Value Indices

In 1992, Standard and Poor's (S&P) and Barra worked in partnership to produce growth and value subsets of S&P's equity indices. The S&P 500/Barra Growth and S&P500/Barra Value Indices separate fast-growing companies from slower growing, or undervalued, companies, based upon a price-to-book value calculation (the price of the stock divided by the "book value," or net worth of the company).

The price-to-book ratio captures one of the fundamental differences between companies classified as value companies or growth companies: Growth companies tend to have higher price-to-book ratios than value companies. Also, price-to-book ratios tend to be more stable over time compared to alternative measures such as the price-to-earnings ratio, historical earnings growth rates or return on equity. Consequently, the growth and value indices experience relatively low turnover.

Companies in the growth index have higher market caps, on average, than those in the value index. As a result, there are many more companies in the value index than the growth index. As of this writing, the Growth Index had 125 companies while the Value Index listed 375 companies. More information can be found at the Standard & Poor's Web site (www.spglobal.com or www.spglobal.com/indexmain500style_data.html) and Barra's Web site (www.barra.com).

In mid-January 2001, IQ Trends listed 30 companies as undervalued, 89 in rising trends, 116 overvalued and 114 in declining trends. Many of the companies listed have been around most of the past century and are household names, such as JP Morgan Chase and Eastman Kodak. Figure 4 is an excerpt from the newsletter that illustrates the price chart, dividend yield bands and other attributes of the company, including earnings trend.

These companies are certainly less volatile than the typical Nasdaq stock. While the list of blue chip stocks may not be the most exciting, they do offer opportunities for traders and investors alike.

The technique to be discussed may be primarily of interest to investors or longer-term traders, but since shorter-term traders also improve their chances of success by identifying stocks and sectors most likely to move, it will also provide valuable information for them. Consider this technique as one of a number of trading strategies you could employ. In other words, diversify not only into different markets, but among different techniques as well.

Combining fundamentals and technicals

As our first criterion, we will begin with a list of undervalued stocks — those that have fallen in price and reached their high historical dividend yield. However, we are faced with one problem: By putting capital into undervalued companies, we risk the possibility that the stock price may languish, trading sideways for a considerable amount of time.

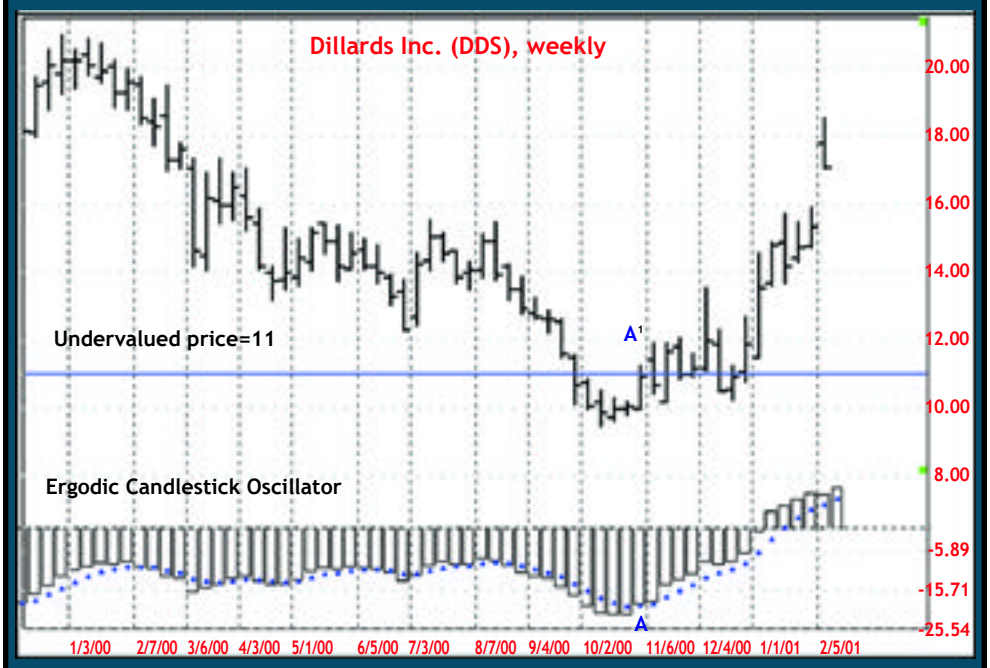
However, use of technical analysis allows you to spot situations that indicate price action is beginning to move into an uptrend. A good tool for this is called the Ergodic Candlestick Oscillator (ECO), developed by William Blau. In the charts that follow, we will plot the ECO as a histogram and the signal line as a dot. For more information, see "Market timing: ECO".

Our plan is to look for stocks from IQ Trends' undervalued list and then use the ECO to determine which ones are in an uptrend. The trend turns up when the ECO histogram is in negative territory and rises to the point that the signal line is not within the histogram. Our work will be with weekly charts.

Figure 5 shows Bank of America (BAC). According to the January IQ Trend, BAC was undervalued at a price of 45 (giving it a dividend yield of 5 percent). During the first quarter of 2000,

FIGURE 6 DILLARDS INC.

This company reached undervalued territory for a three-month period before an uptrend began, as signaled by the ECO (point A).



Source: Fibonacci Trader (www.fibonaccitrader.com)

FIGURE 7 HJ HEINZ

Heinz traded into undervalued territory twice last year. Each buy signal was followed by a greater than 10-point gain.

Source: Fibonacci Trader (www.fibonaccitrader.com)

BAC traded below 45. At point A, the ECO histogram rose above the signal line. On this bar, BAC closed at 50. BAC then moved above 60, a gain of more than 20 percent. In late June 2000, BAC again dropped into undervalued territory, and the ECO flashed a buy signal (point B) with a closing price of 52.50. The stock then advanced to 57.63 for a 5-point gain. At point C, BAC again dropped to below the undervalued level. However, notice that during the short two-week rally, the ECO never gave a buy signal. BAC again fell back into undervalued territory at point D, and the ECO gave a buy signal at a price of 46.13. The stock rallied nearly 10 points after that. In regard to taking profits, you can use a trailing stop or a hard money target, or take partial profits at a combination of the two.

Figure 6 is Dillards Inc. (DDS). The undervalued price for DDS is 11, or a yield of 1.5 percent. DDS reached this price in October 2000, and the ECO gave a buy signal that same month (point A) at a price of 10.88. In mid-May 2001, the stock traded above 18.

Our final example, Figure 7, is HJ Heinz (HNZ). The undervalued price is 35, or a yield of 4.5 percent. HNZ reached 35 twice in 2000. The first time, (point A) was in the first quarter. The ECO gave a buy signal at 33.59, and the stock advanced to 45.94. The second signal came in September 2000. The ECO flashed a new uptrend at a price of 38.94. In May 2001, the stock traded as high as 48.

Trading the current market

Will the price/earnings ratio compression continue in the Nasdaq stocks? Will value stocks be the market for this decade? No one knows, but broadening your methods to position yourself for whatever happens is a good step to take. That way, you can take advantage of the current theme driving the market.

No (TAX-) FREE lunch

Is it a good idea to set up your trading business in an income tax-free state? Some traders may think so, but we look at the realities of this arrangement.

BY ROBERT A. GREEN, CPA

In trading, headaches can take many forms: stock market bubbles, accounting nightmares, computer crashes, liquidity squeezes, margin calls.

Another headache can be taxes. Smart traders use the new trader tax laws and strategies to save money on taxes and avoid headaches. Less savvy traders create headaches for themselves by playing the "audit lottery," increasing their risk of an IRS or state revenue department audit by trying to cut corners with a trading business.

Of particular note is the issue of setting up a trading business in a state without income taxes when you live in another state. At face value, this seems like it might save you money, but this tactic has very real risks.

The ink on inc.

As explained in "Keeping your trading business simple," (*Active Trader*, June 2001) traders can enjoy tax benefits even if they're unincorporated — that is, they have not established an incorporated trading business or legal partnership (a business "entity").

Such unincorporated traders must make sure they qualify as traders, in the eyes of the IRS, so they can report their trading business expenses as "ordinary" expenses from gross income, rather than "investment" expenses, which are restricted itemized deductions. Qualified traders should also elect mark-to-market accounting (MTM) on time in order to convert trading gains and losses from short-term "capital" gains and losses to "ordinary" gains and losses, and to avoid the wash-sale rule (see "Get the tax refund you deserve," *Active Trader*, March 2001).

Smart traders use separate legal entities only when appropriate — such as when a trader in securities (not commodities) is consistently profitable from year to year and wants to save for his or her retirement with tax-deductible contributions to a qualified retirement plan. Such stock traders can form LLCs (Limited Liability Company) in their home states and conduct trading activity from a home office or nearby trading office.

However, it's generally not advisable to establish out-of-state trading entities in an effort to save on state taxes. The risks are much greater than the rewards.

The tax-free myth

Some incorporators promote the benefits of separate legal entities in tax-free states such as Nevada, Delaware and Wyoming. These states do, in fact, have very attractive tax laws that can protect people and businesses — including traders, in very limited circumstances.

In the right situation, some taxpayers can reduce taxes in their home states using these tax-free state entities. For example, an e-commerce business selling products in cyberspace can claim that, although the employees and managers live and work in California or New York, their e-commerce function is virtual and not conducted from those states. This is aggressive, but it might work.

Unfortunately, a trader will have a much more difficult time making a case along these lines (See "Joe vs. the tax man,")

The risks

Traders who do choose to set up a business entity in a tax-free state (when they live in another state) are inviting two kinds of tax problems. The first is actually breaking tax laws and risking tax liabilities, penalties and interest if caught. This includes setting up a legal entity in "form" for trading in a tax-free state, but in "substance" actually conducting all operations from a different state. Many states consider this scheme illegal if you don't register your "foreign" corporation to do business and pay taxes in your home state.

The second type of tax problem is setting up the wrong tax structure. This is legal but unwise, because it ends up costing you extra tax savings.

Whenever you form a corporation, it is automatically taxed as a C-Corp, a separately taxed business entity. However, you may elect to be taxed instead as an S-Corp. S-Corps are not taxed on the entity level; instead all income and losses "pass through" to the shareholders, who are taxed on the individual tax level.

Suppose a trader registered his Nevada entity to do business in California and was ready to pay California taxes on its income. Also suppose he had large trading losses in his first year of business. He now has the second type of problem because, being taxed as a C-Corp, he does not receive any immediate tax relief from his losses.

The trader can fix this problem by electing to have his Nevada LLC taxed as a pass-through entity (one for which the losses flow to his individual tax return).

The benefits of pass-through

Pass-through entities are wise choices because you can avoid "double taxation" and receive immediate relief for tax losses. C-Corps are good for deducting fringe benefits that are not deductible by pass-through entities.

Limited Liability Companies (LLCs) can choose to be taxed as C-Corps or pass-through entities. Being taxed as a C-Corp is unwise for traders because they cannot consistently forecast large trading gains, small gains, small losses or large losses. C-Corps are good entities if you can count on having small gains.

If a stock trader has very large trading gains in a C-Corp he or she can reduce the entity-level income tax by paying a large salary to the owner/traders in the corporation. However, there would be Social Security and Medicare taxes due on the salary — taxes that would not otherwise be due.

If a securities trader has very large losses in a C-Corp, the trader would not be able to use these trading losses against individual taxable income. For this reason alone, it is unwise to use any entity other than a pass-through entity.

A trader with a pass-through entity has the same tax treatment as an unincorporated trader. All income is reported on an individual tax return. Again, the only clear benefit to an entity is for stock traders interested in setting up a retirement plan.

The tax-free myth cont.

The tax-free state "scheme" is based on having the entity taxed as a C-Corp. For the reasons stated above, entities taxed as C-Corps are unwise for traders. If a trader chooses a pass-through entity, all the entity's income will flow through to the trader's home state, making the out-of-state scheme flawed for three reasons: First, it defeats the original purposes of avoiding state taxation. Second, it is trying to use form over substance. Third, if it works because the trader is not caught initially, the trader can be caught by his or her own greed. The trader can end up

Less savvy traders create headaches for themselves by playing the "audit lottery," increasing their risk of an IRS or state revenue department audit by trying to cut corners when setting up or running a trading business.

with a large loss and, ironically, be unable to get tax relief through the entity he or she has set up.

Traders should consult tax advisors who are experts in "multi-state" and trader tax laws before they hire an online incorporator. A tax advisor should run pro-forma tax returns in a trader's home state, and also out of state, to compare and see the different tax scenarios so there are no surprises later on.

When it comes to business entities, traders need to look before they leap. If it sounds too good to be true, it probably is. When entities sound complex in structure, it's an indication the promoter may be trying to cover problems in substance with a façade of form.

Respect substance over form. The IRS does.

Joe vs. the tax man

Consider the case of Joe Trader, an individual trader living in California and trading from his home office. Joe hears a radio ad about the benefits of setting up a trading entity in Nevada: asset and liability protection, anonymity of ownership, privacy and, most importantly, the avoidance of state taxation.

Joe signs up for the Nevada incorporator's service. A Nevada LLC is formed and Joe elects for the LLC to be taxed as a C-Corp. Joe makes this election so the income does not pass through to Joe's individual tax return in California.

The Nevada incorporator points out that Joe is trading from his home office in California and should try to cover up the substance of this fact with the form of doing business in Nevada. Hence, they sell Joe the right to use their Nevada mailing address and forwarding service. Joe opens a trading account with a brokerage firm outside of California in the name of the Nevada entity and he uses the Nevada address for all purposes. Joe now feels safe in form and figures substance will only come up as an issue in audit.

Under California tax law, what Joe is doing is a tax-avoidance scheme. He is "doing business" in California and the state does not respect the entity for doing business in Nevada. Joe recently read reports that California started an audit program to catch the customers of many online incorporators, going so far as to force, by lawsuit, the Nevada incorporators to provide the names of their California customers. Joe's name is on one of the lists and the California department of revenue wants to have a word with him.

After reviewing the facts and circumstances, California determines Joe's LLC was a Nevada business in form only. In substance it shows that Joe is doing business in California, not Nevada. California follows up with a tax deficiency notice and tells Joe he owes state taxes on all gains to date, plus penalties and interest. California also assesses Joe penalties for failing to register his Nevada entity as doing business in California in the first place.

Joe goes to his Nevada incorporator for help. The incorporator tells Joe to move out of California and not to worry, as his entity asset protection will stand up. Under California law, the state then "pierces" the Nevada entity and seizes the Nevada assets. Joe is unable to get his calls returned from the incorporator. The incorporator is not at risk because it "did not know" the true facts and circumstances of the entity. The fine print also laid out the risks to Joe, but he ignored them. Joe ends up the loser in this case. However, Joe realizes he lost money trading and did not earn money in the entity, so California tax authorities should get off his back. But Joe still had to register his Nevada entity to do business in California and is still subject to penalties and interest. To make matters worse, Joe finds out he cannot deduct the losses in the C-Corp on his federal and state individual income tax return. Joe wakes up and realizes he was fooled and got too greedy about saving state taxes.

High-tax states don't care what business entity residents set up in tax-free states. They look at the facts and circumstances of what happens in their own state. The key point is there is no mutual exclusivity. For example, a trader can own and maintain a "place of abode" (living quarters) in New York City and also be domiciled with a tax home in Florida (a tax-free state). In this case, the trader is a domiciled resident of Florida and a "statutory resident" of New York City and New York State. Each state is entitled to assess taxes on the trader's entire federal income. The trader made $500,000 while in his home office in Florida in the winter months and in New York City in the summer months. In this case, the trader pays New York State taxes for the entire year and gets no credit for taxes paid to Florida — because there are no Florida income taxes. New York doesn't care about what the trader does to create domiciled residence in Florida. It simply looks at the facts of "statutory residence" in New York.

This same concept of multi-state taxation applies to trading entities. Most states follow the rules of "nexus," a formula used to calculate what percentage of your business is conducted in their state. When entities have true operations in more than one state, each state apportions the entity's income based on the following "apportionment factors:" office rent and tangible property, sales, and employees. The state divides the in-state factor by the total factor to figure a percentage for each factor. The factors are then totaled and divided by the number of total factors.

Joe Trader has no rent or property in Nevada. All transactions are made from his home-office in California, not Nevada, and he is deemed an "employee-owner" of the corporation doing business in California. The result is that California would tax 100 percent of Joe's Nevada trading entity's income.

Behind the numbers

The Securities Industry Association (SIA), a group that represents more than 740 securities firms across the country, is the proud author of *Powering the Global Economy*, a book sent to member firms and various media outlets. The publication discusses capital markets, foreign markets, regulation, and savings and investments.

It's actually a rather informative book. For example, did you know that while the average Baby Boomer owns four stocks or mutual funds, the average Generation Xer owns only three? However, while anybody can simply present the facts and figures, the truly inquisitive mind wants to know more. This quiz may not help you become a better trader, but it certainly will open your eyes to a few things about the market you might not have known before.

1. Holdings by foreign investors in U.S. stocks reached $4 trillion in 2000. Why are foreigners so interested in American stocks?
   a.) The U.S. markets provide better liquidity than the markets in their home country.
   b.) They know how important it is to have a diversified portfolio.
   c.) Who can trade stocks in all those funny foreign languages?

2. In 1998, 48 percent of U.S. households owned stock — an increase from 19 percent in 1983. The significant increase in the number of people trading stocks can be attributed to:
   a.) A strong economy, giving people more money to invest.
   b.) Increased education, making more people aware of the importance of investing.
   c.) Banks have discontinued the tradition of giving customers free toasters when they open a new savings account.

3. Mutual fund assets reached more than $7 trillion in 2000. Seven trillion $1 bills:
   a.) Would stretch from the earth to the sun and back more than three times.
   b.) Would completely fill up the Superdome in New Orleans.
   c.) Would pay for the latest addition to Bill Gates' home.

4. In the 30-year history of the Nasdaq prior to 2000, there were only 13 days for which the index gained or lost 5 percent. In 2000, there were 27. The increased volatility can be attributed to:
   a.) A significant increase in volume.
   b.) High-tech stocks that have violent price swings.
   c.) Tom Costello wearing the same tie more than two days in a row.

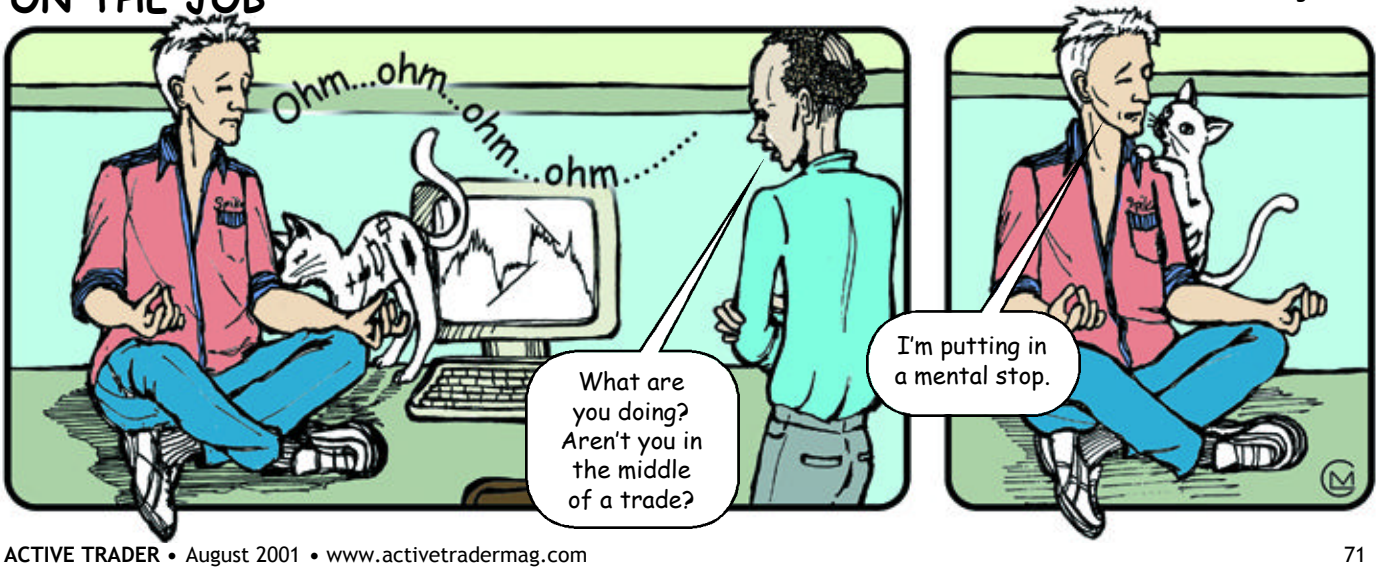
5. In 2000, governments raised nearly $200 billion in municipal bonds. This money was used to finance:
   a.) Roads.
   b.) Schools.
   c.) The new James Bond movie.

6. Between the three major exchanges and all the regional exchanges, an average of $5.9 million of share value traded per second in 2000. $5.9 million would buy:
   a.) 80 luxury cars.
   b.) 25 new townhomes.
   c.) The entire assets of Pets.com, Etoys.com and Living.com — and you'll still have $5.85 million left.

7. On Jan. 3, a record 5.2 billion shares traded among the nation's exchanges. The reason for this unprecedented volume was:
   a.) An encouraging economic report.
   b.) People were investing their holiday bonuses.
   c.) Alan Greenspan accidentally left his house without any pants.

8. More than 10 million households have Roth IRAs. The biggest reason why people don't have IRAs is:
   a.) They prefer to rely on Social Security.
   b.) They don't like the tax consequences.
   c.) They think they are supporting the Irish Republican Army.

ON THE JOB

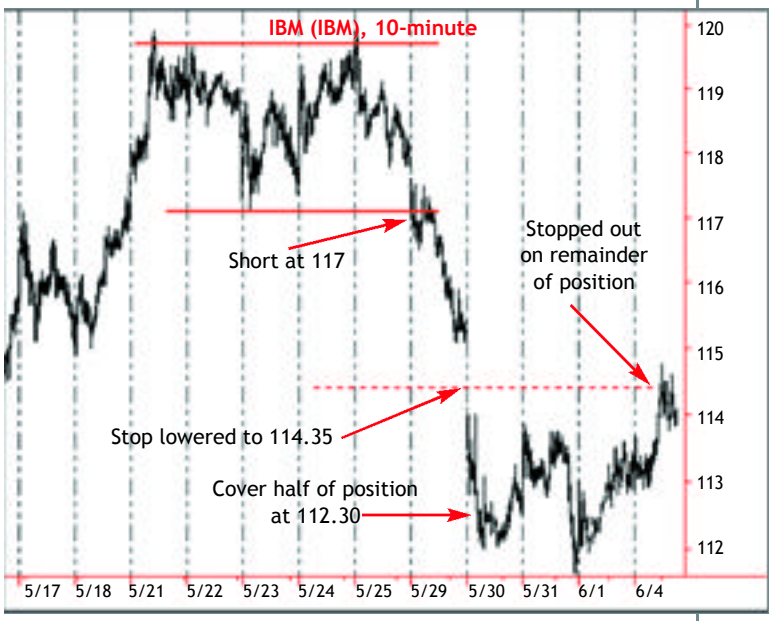


TRADE Diary

An ongoing look at a trading journal and the analysis of individual trades.
In this example, strong overhead resistance and a consolidation set up a short trade.

Trade 1

Date: May 29, 2001
Entry: Short IBM (IBM) at 117.
Reasons for trade: Short-term, the stock has established a fairly narrow consolidatione (which appears on a daily chart as a flag formation at the top of the trading range) between 117 and 120. Anticipating a breakout trade out of this smaller flag formation (up or down) provides the basis for a low-risk trade. Entered intraday on downside penetration.
Initial stop: At 120.25, .35 above the high of the flag pattern.
Target: Will look for an initial move near the bottom of the daily trading range, around 110. Take half of profits at this point and trail stop on remainder of position. (The next clearly defined support levels do not appear until 101-102 and 88.)
Pluses: The stock is bumping into overhead resistance on a number of levels. On a weekly chart (not shown), IBM is in a trading range with a slight downward bias (like the DJIA).
Minuses: Not trading in the direction of the short-term uptrend; stock could make a run at its highs around 134.
Update (May 29, 4:30 p.m.): IBM closes on lows, around 115.25. No action taken.
Update (May 30, 11:07 a.m.): Bid entered for half position at 111.40.



Trade summary

Date	Stock	Entry	Initial stop	Target	Initial reward-risk	Exit	Date	P/L
5/29/01	IBM	117	120.25	110 (intial)	2.15	112.30 (half position)	5/30/01	4.70
						114.38 (half position)	6/4/01	2.62

Update (May 30, 2:14 p.m.): Stock consolidating. Bid raised to current market and profit taken on half position at 112.30. Stop on remainder of trade lowered to 117 to lock in profit.
Update (May 31, 3:58 p.m.): Stock makes new session lows and drops below yesterday's low. Stop lowered to 114.35, .25 above yesterday's high.

Result

Exits: 114.38 (second half of position), on June 4.
Reason for exit: Trailing stop was hit.
Profit/loss: 3.66 points (total)
Trade executed according to plan? Yes.
Lesson(s): There's a great advantage to identifying trades in which the risk and potential reward are clearly defined, and when patterns on different time frames coincide. In this case, the stock had consolidated to the point that a breakout trade was viable in either direction. We went with the first tradable signal, kept the stop relatively tight and took what the market gave us. Stick to the plan and you can continually get on base, even if you might not hit one out of the park.