Chapter 4

ADMIT WHEN YOU'RE WRONG

CASE HISTORY

In Trading Is a Business I showed how several characters refused to admit when they were wrong about a trade.

Here is a true story of a greatly disgruntled trader. It is another tale of woe involving the failure to admit being wrong.

As an electronic day trader, he first contacted us to tell us that he was unhappy with the data he was receiving.

He wanted to know if we could recommend a good trading book for him. We mentioned a couple of our own to him, and he decided on one.

An interval of time went by, and he called again. This time it was because he was dissatisfied with his computer. His hardware just wasn't fast enough. Could we recommend a good computer for him? If he had a good computer like other people had, he would be able to turn his current losers into winners – or so he thought.

A month or two went by and he called to tell us that he liked the book, but he was still losing. He wanted to know if we could recommend a few trading techniques for him. He was sure that if he changed his technique, his luck(?) would change. We complied with his wishes and gave him a few trading hints he might like to try.

There was another period of time before we heard from him again. When we did, he complained that there were too many distractions at his house. He said he was looking for office space. He asked if we had any students in his area that might be willing to share office facilities with him.

We hope those of you reading this will appreciate the fact that we do not sic characters like him on any of you.

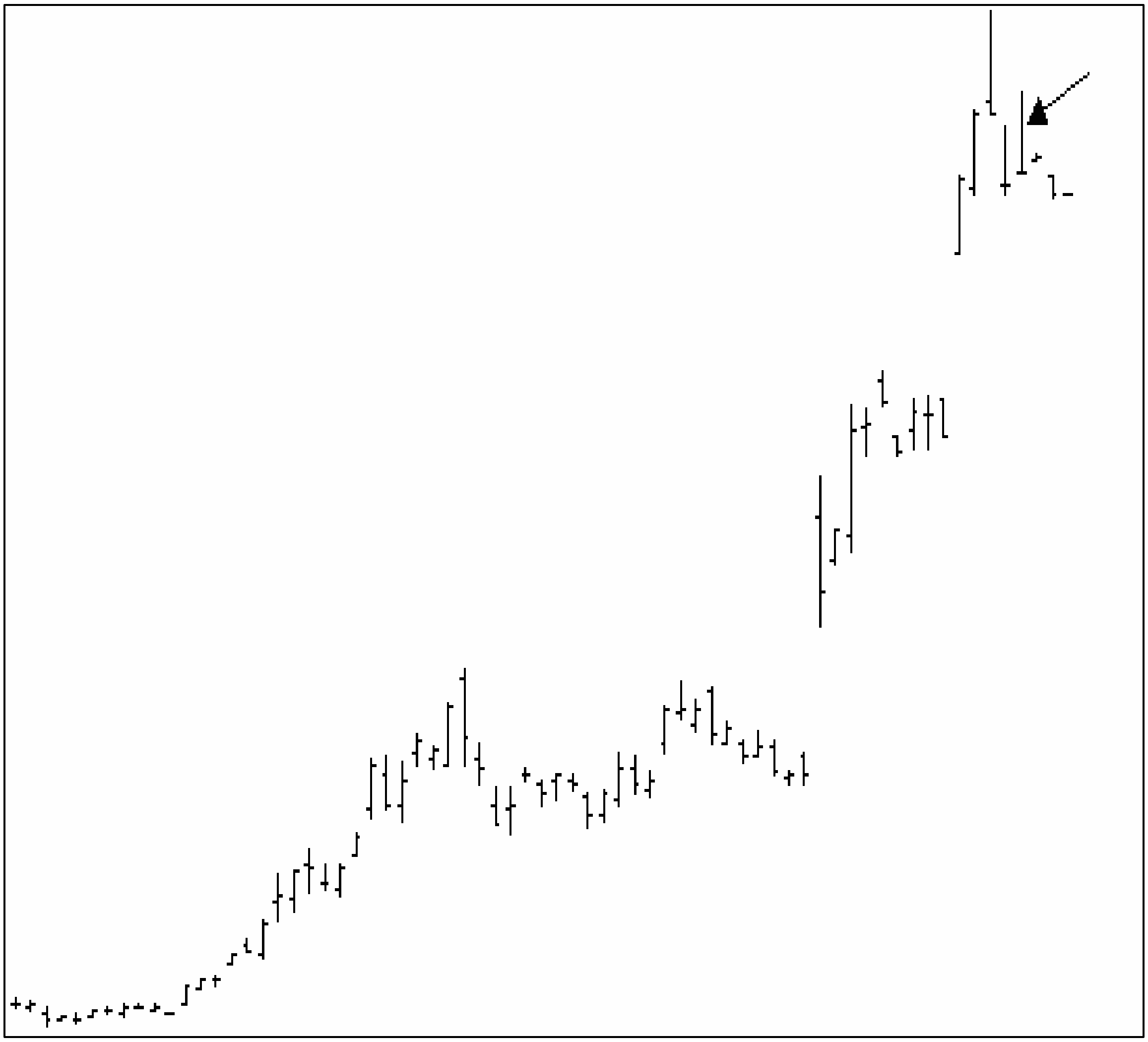
The next time we heard from him was when he called to ask for assistance with a trade. He was told him that we do not mind answering questions about the content of our books. Nor do we mind answering questions about brokerage, equipment, software, data feeds, etc. But in answering questions directly related to a trade, to a trading strategy, or to the management of an account, we feel we are entitled to a consulting fee. He agreed to pay it.

A month later we heard from him again. This time it was by fax. He sent us a chart indicating a trade he was contemplating. He wanted us to fax him back an answer. The only answer we faxed back was that he would be charged a fee if we were to spend time to analyze his position and give him an answer.

He called to tell us that by faxing a chart he thought he would not incur a fee. He said that by not faxing him back an immediate answer, we had caused him lose on the trade. We'd like to be able to say he lost because we did not fax him back an answer. The truth of the matter is that we weren't even in the office when the fax came. Even if we had chosen to answer, it would have been hours after he'd already lost.

As we viewed the chart he faxed, we saw that he had gone long at just the time he should have been going short.

The chart he faxed is shown below. Examine it closely. Sometimes you simply have to know when to trade. How would you have handled this situation?

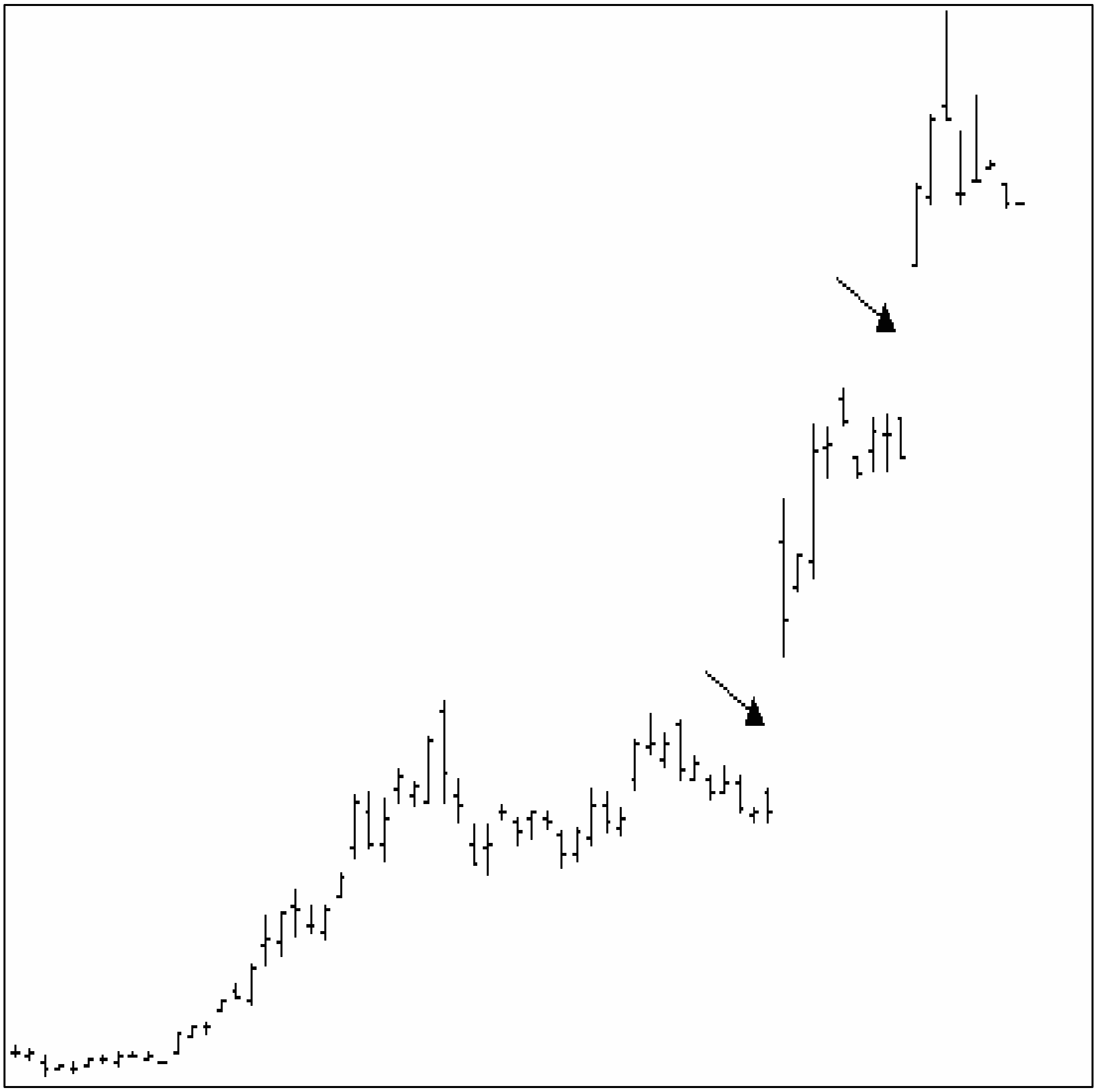


Disgruntled bought at the arrow. He had bought into a buying climax. But how was he to know?

There are a number of visual clues on the chart that gave a strong indication of a climax situation.

Let's look at those now!

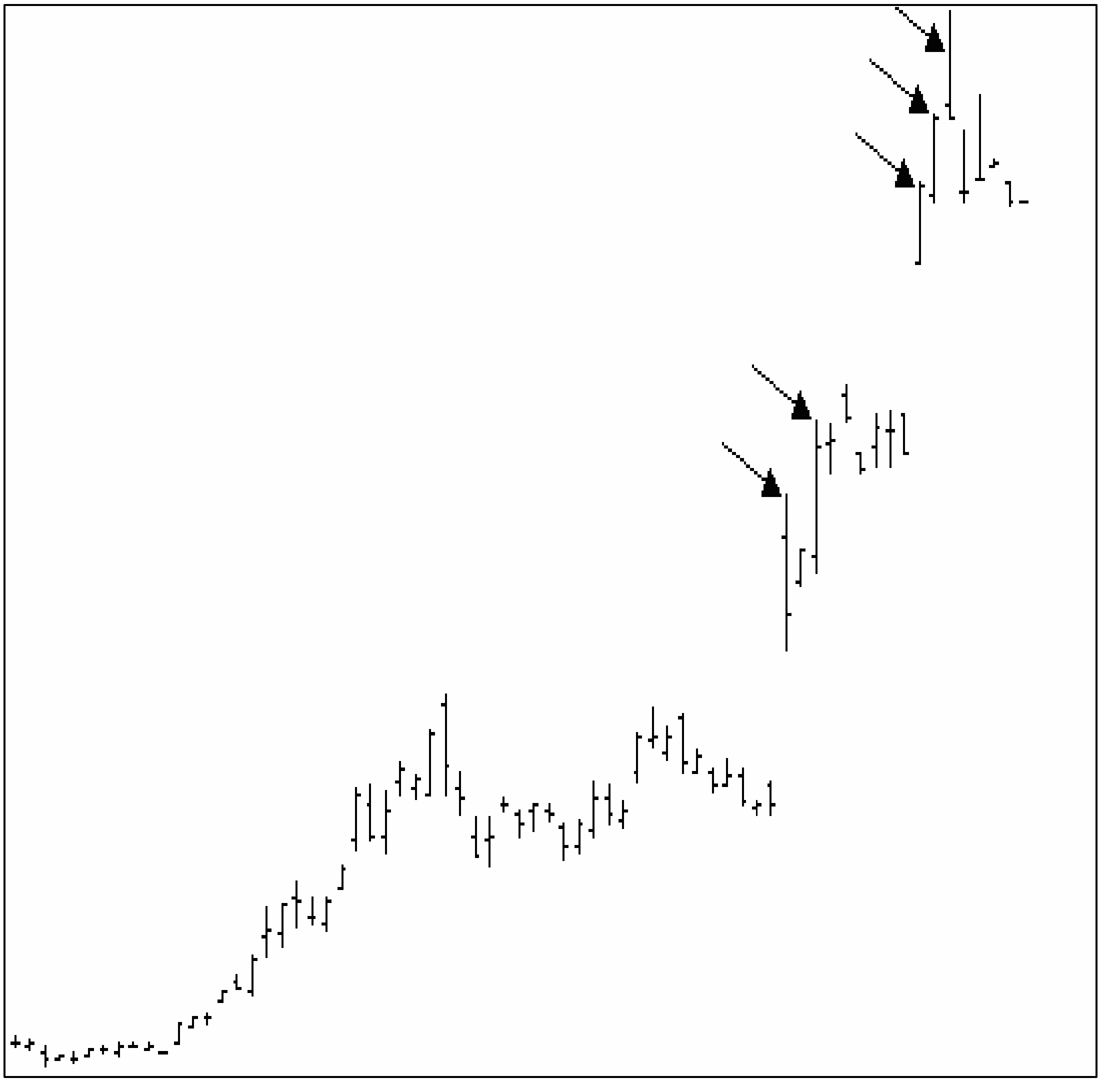
The first item was the two explosive gaps.



Gaps of the size seen on the chart above often precede a buying climax. Prices have moved too far, too fast!

Over the years we have taught that traders should be very aware of gaps. They often predict an imminent end to any move, whether it be up or down.

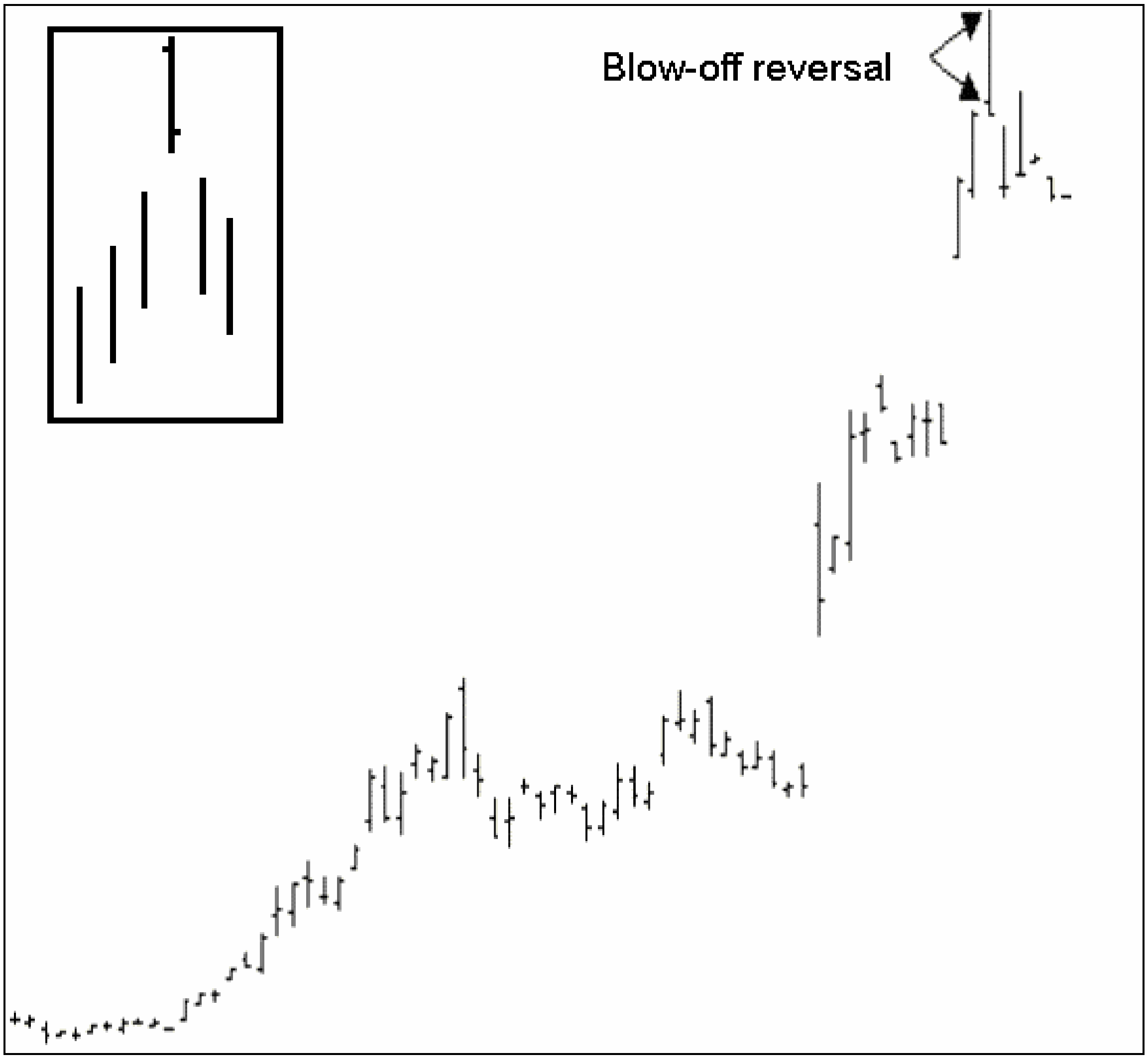
The second item was the size of the individual price bars leading up to and including the top.



Widening price ranges on the individual price bars are often caused by news or fundamental information. In this instance, there were rumors involved. When they failed to come to pass, the blow-off was a sure thing. By widening price range on individual bars, we are referring to the height of those bars with the arrows. Volatility is measured by the height of those bars. When you add in the size of the gaps to the height of the price bars, you can see that on at least two of those days, volatility was exceedingly great.

Sharply accelerating trend or explosion. In fact, such sharp acceleration as we see on this price chart constitutes an explosion in prices and in volatility. From a visual point of view, we can see that the market has “arched its back.” It has become “parabolic.” From a psychological point of view, the herd instinct is at work.

Let's look at the blow-off reversal bar at the top. If the low of this bar had been only slightly higher, we would have been looking at an island reversal (see inset).

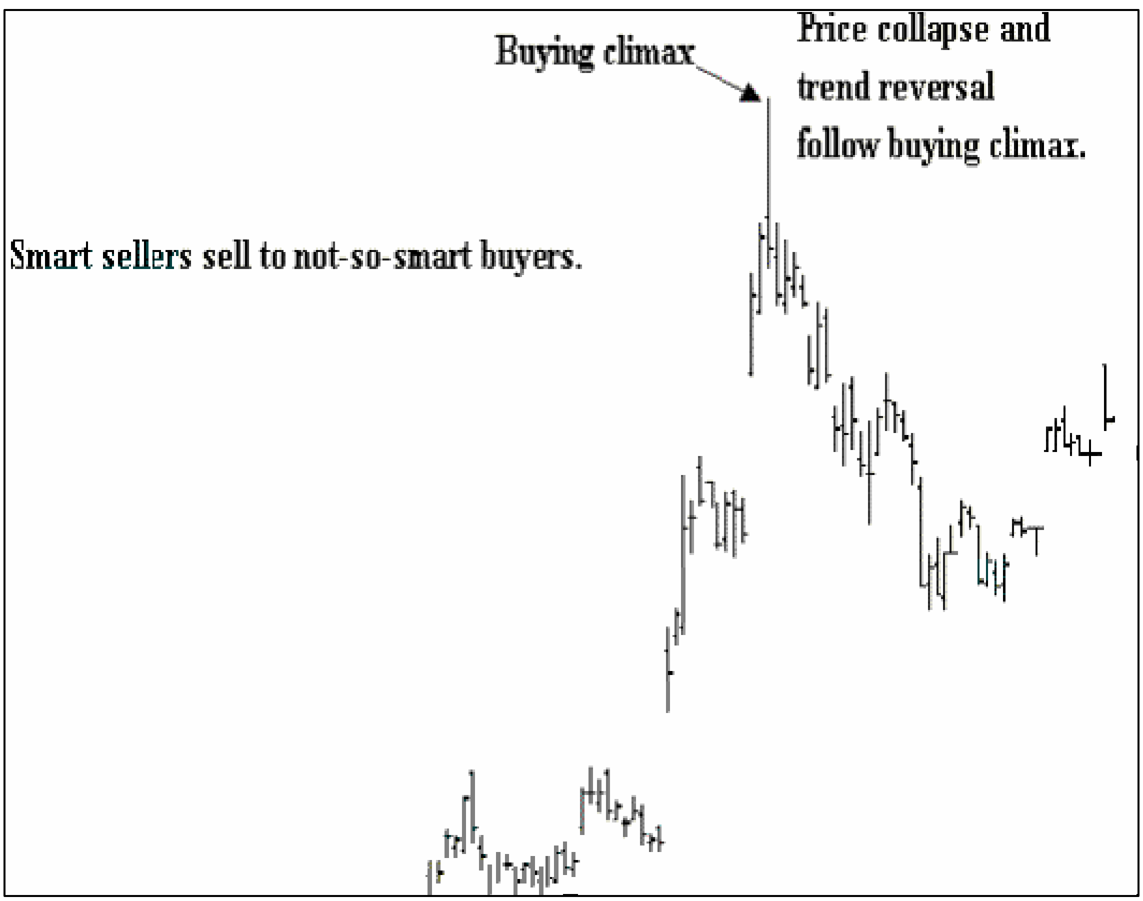


When a bull market enters its final stage, the rise in price increasingly attracts the attention of traders who fear they will miss the boat, as well as the attention of those who shorted the market prematurely. Eventually some news or rumor triggers an emotional response that results in a stampede of panic driven buying. The mad rush to buy drives prices to overvaluation.

Overvaluation in turn gives rise to selling by well informed, professional interests. The "pros" contribute to the climactic price action by selling into the increasing demand. They do this to fatten their profits. This selling into ever increasing prices drives the market to a point where there is no one left to buy – prices are simply too high.

The result is that the weak hands in the market (usually the public and traders who are afraid they will miss the move) are being met by a superior force, the selling by the strong hands, the professionals.

At the pinnacle of the move, both buying and selling, *supply and demand,* are at their greatest level. The stepped up trading from both sources produces another characteristic of climactic action which shows up as an expansion of volume. Once the buying frenzy ends and is turned back by massive selling, we see the that prices change direction. We have a price reversal. In the case of the chart we've been viewing it is manifest in a price bar that gaps open, rushes to its high, and then, as the selling overpowers the buying, closes on its low – a true key reversal (buying climax below). You can see what happened to prices in the days and weeks following the climax:



Of course, the opposite is true in the case of a “selling climax.” The herd instinct is triggered when losing longs, who had been riding the market down, reach their psychological and financial breaking point. This releases a flood of panicky selling which drives price to under-valuation.

When the market is depressed by heavy supply, large funds and insiders begin the process of accumulation by covering shorts from higher levels.

Who is it that is liquidating near the bottom of a selling climax and buying near the top of a buying climax? You guessed it! The less informed, less expert, non-professional, thinly financed ~~sap~~, er, trader. They are the weak hands in the market. They trade too often. They trade greatly undercapitalized. They trade emotionally out of fear and greed.

They trade a size “too big for their britches.” They trade the wrong markets. They trade at the wrong time. They don't know when to trade and they don't know which way is up (or down, as the case may be).

The more experienced we become, the more we realize that waiting for the right trade is the wisest of strategies. Across a broad range of futures, one can usually find markets that are in the throes a buying or selling climax. We would rather “load up” on the trades that are the most likely to be winners. Buying and selling climaxes present just such an opportunity, if you are trading them in the right direction. Buying climaxes are wonderful for writing Call options above the climax high or simply for selling futures. Selling climaxes are wonderful for selling Put options below the climax low, or simply buying futures. While you are waiting for the great opportunities, enjoy a day at the beach, a round of golf, go fishing, or just relax and enjoy the money you've made from trading market climaxes.