JULY 2000 ISSUE

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TWO SIDES to every story

When it comes to short selling, it seems, there are those who do and those who don't and never the twain shall meet.

It's interesting. Talk to an experienced futures or options trader and you're likely to find someone who thinks no more of going short than going long — whichever direction current market conditions dictate, that's the direction they're trading in.

The average stock trader may have an idea of what short selling is, but he probably doesn't really *get it*, and the actual practice is as foreign to him as a week without a televised Alan Greenspan speech.

What's the big deal?

Well, to be fair, there are a number of perfectly logical reasons for stock traders to have a distorted perspective of short selling. First, there are the SEC-mandated restrictions on selling short — you can't do it whenever you want. Second, traders have been conditioned by years of a buy-and-hold investment industry that points to the long-term upward bias of the stock market as conclusive evidence that the long side, and the long side only, is the way to go. Selling short is branded as foolhardy and highly speculative (that dirty word). Finally, there's just the natural disinclination among many people to sell first — how can you sell what you don't own? — and buy later.

While giving the devil his due, these legitimate concerns are still no reason for active stock traders to completely ignore the short side of the market. Indeed, doing so not only eliminates opportunities for additional profits, but also ignores what can be a necessary trading skill in extended downtrends or bear markets.

That said, there are some realities to short selling stocks that must be addressed. For an overview of the rules and regulations of short selling and the basic market characteristics and trading considerations all short sellers should keep in mind, read "Awalk on the short side". Get a handle on the SEC rules regarding short sales, borrowing rules and the practical aspects of trading on the short side of the market.

Of course, knowing the rules and knowing how to trade effectively are two different issues. With that in mind, we have a number of articles in this issue that can help you understand some of the little-discussed aspects of price action that all short sellers should be aware of, as well as strategies that take advantage of potential price declines.

For example, in "Bearing down on the short side", senior editor Thomas Stridsman builds on the statistical analysis of last month's "It all adds up" by looking at the characteristics of bull and bear moves over the last 10 years and the realities of trading the short side of the market. Uptrends and downtrends in the stock market are not created equal, and it's essential to understand these distinctions to be able to sell short with any reasonable expectation of success.

Stridsman also analyzes an interesting short-side trading concept in this month's Trading System Lab. It's based on the differences between upside and downside volatility and should provide some food for thought for traders interested in volatility based systems.

The average stock trader may have an idea of what short selling is, but he probably doesn't really get it...

Also, in "Rally and dump", contributor Mark Seleznov details a short-selling strategy that limits risk to one point on each trade and uses a simple set of rules to identify points at which you can exploit intraday price declines.

The last few months were kind of rough for many traders (especially those trading the hardest hit Nasdaq sectors), and it's no surprise: When you're conditioned by month after month and year after year of rebounding stock market prices, it can be difficult, to say the least, to make the psychological and tactical transition to markets that are just as (if not more) likely to drop as go up on a given day. (For a little personal insight on this subject, see "Learning market lessons,".)

But as the old saying goes, you shouldn't try to fight the market. And if the market wants to go down, traders who operate exclusively from the long side are destined to lose money or, at best, watch the parade go by.

Trading is about acting quickly on opportunities when they arise. Stock traders can learn a thing or two from their futures trading brethren when it comes to short selling. In the long run, the flexibility of being able to effectively play the short side of the market is a key component of smart trading.

Mark Etzkorn, Editor-in-chief

Smart charting

There are a number of free charting and analysis sites on the Web. Some of them are fairly useful, but most of them are very similar, and even the best of them are fairly limited compared to full-blown software applications.

StockCharts.com (www.stockcharts.com) isn't a dramatic departure from some of the other higher profile analysis sites on the Web (see *Active Trader's* Web Watch section in the May and June issues), but its little extras, organization and thoughtful analysis set it apart from many of its brethren. It's not aimed specifically at short-term traders, but good analysis tools are good analysis tools, and there are plenty of interesting functions here that should appeal to all traders, regardless of time frame.

StockCharts.com has two major sections (even though the site doesn't break them down as such): charting and analysis tools, and commentary and education. The analysis tools include several charting, scanning and indicator options, as well as a comprehensive market summary. The commentary and education material includes market analysis and instructional articles from a number of contributors.

The basic charting function (SnapCharts) allows you to plot prices in bar, candlestick and line formats, using linear or log scaling. You can overlay up to three moving averages (or Bollinger Bands) and three (out of about 12) other indicators at a time, all of which can be modified as necessary.

You can set up default setting for all your charts, or use some of the site's "suggested settings." You can also customize the colors of chart elements and re-size charts a number of ways — a nice bonus, considering the condensed images many online charting sites produce. StockCharts also provides additional charting options through Profit Finance's Prophet JavaCharts, which include trendline drawing capability. (Note: The SnapChart and JavaChart features were discussed in *Active Trader's* May issue in a description of the Prophet Finance (www.prophetfinance.com) site. The JavaCharts don't always function that well — symbols get overlaid, among other problems; see Web Watch, May,, for additional information.)

On the downside, time frames are limited to daily and weekly; up to five years of data can be displayed. (The site also contains historical charts of several indices, bonds and gold; one of the Dow charts, for example, goes back to 1900.)

Two of StockCharts most interesting charting features are its interactive point-and-figure charts and "PerfCharts." The former allows you to plot customizable point-and-figure charts that display the high, lows and dates for each column of Xs or Os when you drag your mouse over them.

The PerfChart function allows you to view the relative performance (plotted in percentage terms) of up to four symbols and an index. For relative strength fans, it's a good way to get a quick feel for how different stocks measure up to each other and the overall market. You can drag your mouse along any of the performance lines and it will display (numerically) the performance at that point in time.

The site also features PerfCharts for various sectors and industry groups, giving you an at-a-glance look at what's hot and what's not in different areas of the market.

There's also a cool animated display of the yield curve: You

STOCKCHARTS

can scroll across (or have the screen do it automatically) over a chart of the S&P and see the yield curve chart updated in the accompanying window.

There are several other chart analysis features. The "CandleGlance" page shows recent candlestick chart snapshots of various indices (stock, commodity, currency and interest rate), highlighting common patterns. You can switch quickly to bar, P&F or PerfCharts for additional perspective. You can also plot charts of various sector indices, yield curves, and market internals like the A-D line and CBOE volatility index (VIX). There's also a sentiment chart page that compares the results of a survey conducted by LowRisk.com to the performance of the DJIA.

StockCharts has a number of scans that will list stocks according to a number of (individual) criteria, including new 52-week highs and lows, crossings above and below 200-day moving averages, bullish and bearish MACD crossovers, rising and falling relative strength index (RSI) readings, and penetrations of upper and lower Bollinger bands. These scans, while useful in and of themselves, are fairly limited. They would be much more useful if there was a wider selection and the parameters for each scan were modifiable. Then you could create customized scans that combined individual scans to locate stocks with more specific characteristics.

The site's commentary is geared toward longer-term trading and investing, but there's still a good deal of detailed information for shorter-term operators (especially those who appreciate the importance of understanding the bigger market picture). Featured writers include John Murphy (of *Technical Analysis of the Financial Markets* and CNBC fame), Arthur Hill, Rex Takasugi, Scott McCormick, Paulo Prazeres, Richard Rhodes, Mitch Harris, Clive Roffey and Jeff Walker. The articles we perused ranged from technical analysis based on the VIX, to analysis of the latest PPI release and fundamental breakdowns of various sectors and individual stocks.

The Arthur Hill Market ChartTour and StockWatch are two great features with a great deal of information for the newbie trader. Also, there are a number of instructional articles on the various technical indicators used on the site.

StockCharts.com is well organized compared to most trading sites: Information is integrated and cross-referenced intelligently and it's fairly easy to switch between different chart types and functions. It's not a site to monitor while trading during market hours, but rather during evenings or weekends to do groundwork and basic research. For free Web-based analysis, it's a smart stop for traders of all stripes.

STOCKCHARTS

Last Quote: 2000-05-18, Open: 3660.24, High: 3663.84, Low: 3538.71, Close: 3538.71
Using our P&F charts Printing our P&F charts

Have data, will surf

YAHOO

The Yahoo Stock Market Toolbar appears at the bottom of your browser window's menu bar, giving you access to Yahoo's market research tools regardless of where you are on the Web.

Yes, the Internet is the greatest source of financial information ever created. But let's face it: There's more to the Web than bar charts. There's sports scores, weather forecasts, Pamela Anderson's … latest movie.

However, if you're a trader, there's no doubt you want to stay close to the market at all times, regardless of where your Web surfing takes you. One easy and very practical way to do this is with the Yahoo stock market toolbar. It gives you quick access to the stock market news and research features of Yahoo Finance — no matter where you are on the Net.

Before you can download it, you'll have to go to Yahoo (www.yahoo.com) and sign up for a (free) Yahoo e-mail account. Once you have an account, go back to the Yahoo home page and click on the "personalize" (or "My Yahoo") link at the top of the page. Scroll down until you find the stock portfolio and the quote box, and click on Stock Market Toolbar to download.

The toolbar stays at the top of your screen, no matter where you happen to be surfing, keeping the market at your fingertips. It allows you to enter a stock symbol and get quotes, charts, news and research for any stock with just one mouse click, regardless of what Web site you're currently on.

For quotes, charts and research, the information is provided by Yahoo finance (http://finance.yahoo.com). There are five different news providers, including Red Herring, TheStreet.com and The Motley Fool. The toolbar makes it easy to switch between the news sites.

The quotes, alas, are delayed (15-20 minutes), as are charts. The basic charting function, however, allows you to view stocks from seven different time perspectives, ranging from intraday to the historical data back to 1970. You can chart a few basic moving averages and compare stocks to the S&P 500. Within the quote and chart functions, you also have the regular Yahoo news services within easy reach.

If you want to research a particular stock, the latest balance sheets, income statement and SEC filings are only a click away. Also in the research section are consensus analysis and buy/sell recommendations, upgrades/downgrades, new analyst coverage and research abstracts from a wide variety of research companies.

But you know better than to rely only on the recommendations of the Wall Street pros. To really get the Main Street perspective on a stock, all you have to do click on the Yahoo message boards.

You can add any symbol to a Yahoo stock portfolio, which is easy to create and modify. You can set up various types of alerts and automatically add an updated calendar to your portfolio. These will keep you informed on earnings announcements, stock splits, dividends, etc., as well as other important events such as the release of GDPfigures, interest rate changes and other leading indicators.

The "markets" icon on the toolbar has five sub-categories (indices, news, editorials, calendars, research) that aren't specific to any one stock. Under "calendars," you can select a link to an economic calendar that not only lists dates of important releases but also consensus estimates on those releases and, after the fact, whether the figure was better or worse than expected.

In the "research" category, a screening tool is available. It allows you to search both stocks and mutual funds using several different criteria, such as analyst recommendations, estimated earnings growth and P/E ratio.

For traders who want to keep tabs on the market while exploring other areas of cyberspace, Yahoo's stock market toolbar is worth packing for the trip.

NEW Products

- **Pristine.com**, an online educational site for active traders and investors, now offers an audio chat feature as part of its Real Time Trading Room service. Subscribers equipped with a microphone and computer sound card can communicate with Pristine staff, including founders Oliver Velez and Greg Capra, in addition to other site members in the general chat room. For more information visit www.pristine.com.

- **Beyond Solutions Inc.** has developed Trade Spotter, software designed to help online daytraders identify stocks ripe for trade and make the most of the bid/ask spread on selected stocks. It searches a subscriber's portfolios for stocks matching selected criteria and suggests the number of shares to buy based on available funds and the price to buy and sell in order to exploit the spread. The software features an integrated Web browser and is compatible with Medved QuoteTracker so users can get real-time stock quotes from virtually any provider. For more information go to www.beyondsolutions.com.

- New charting features are now available from **StockMaster.com** including Nasdaq extended trading hours (4-6:30 p.m. EST) tracking and intraday breakdowns (1, 5, 15, 30 or 60 minutes). In addition, the company has updated the function that allows users to simulate initial and recurring security investments with results charted over a specified time frame. For more information visit www.stockmaster.com.

- Options traders can now take advantage of **iVolatility.com**, a new Web site that features volatility data on U.S. options. Users can get analysis of single stocks, as well as such information as historical volatility, mean implied volatility, implied volatility for puts and calls, correlation to the S&P 500 and an options pricing grid with theoretical value and deltas. The site was free of charge at press time, but a monthly fee will apply by the end of the year. Go to www.ivolatility.com for more information.

- **MB Trading** has updated its MBTrader software including new options within the order entry function. Traders can now place an order (through the Archipelago [ARCA] ECN) with a discretionary price range and place a trigger price which activates a stop limit order. The MBTrader service handles conditional orders and will also hold a Nasdaq stop-loss order on a confidential ECN server and automatically activate it whether the trader is online or not. Additionally, traders can now change an order (via ARCA) at any time at no cost. For more on these and other changes go to www.mbtrading.com.

- **AlphaTrade.com**'s recently released streaming Level II application gives subscribers access to information on two companies at once. Market depth information on Level II quotes includes the market marker ID (MMID) and time as well as bid, bid size, ask and ask size and time of last trade. For more information go to AlphaTrade's Web site at www.alphatrade.com.

- **Vostock** is an online auction system for secondary and follow-on offerings developed as a joint venture between Wit SoundView and ITG Inc. At press time, a launch was expected in early summer. Auctions will last about 90 minutes and take place after market close. The Vostock interactive order book is capable of maintaining up to 40,000 connections with institutional and individual investors (accessing the system through existing relationships with ITG and a Wit SoundView account, respectively) and parties can watch as orders are entered. The Vostock Web site is www.vostock.com.

Software SCREENING: QCharts Trader/Investor

BY THOMAS STRIDSMAN

Product: QCharts Trader/Investor, version 3.1 (Version 4.0 available as beta.)

Company: Quote.com (www.quote.com)

Phone: (800) 498-8068, Monday-Friday, 5:30 a.m. to 4:00 p.m. (PST)

Online contact/customer service: www.quote.com/quotecom/about/cserv/writeus.asp

Price: $79.95/month for QCharts Trader, $99.95/month for QCharts Investor; Nasdaq level II quotes $50/month extra.

Required system: Direct (dialup or LAN) connection to the Internet (proxy servers or firewalls may pose a problem); Windows 95/98/NT; Pentium processor with 166 MHz or higher; 32 megabytes RAM; Microsoft Internet Explorer recommended. Mac (G3 or iMac) and Unix users can run QCharts using the following emulator software: Virtual PC (www.Connectix.com) or SoftWindows (www.fwb.com).

When I looked at QCharts 1.0 a couple of years ago, it was already a solid product, despite some flaws. Since then, Quote.com has continued to work on the program, and the company has now brought it to a level of sophistication that probably is unparalleled in today's marketplace.

Back then, compared to a competing product, QCharts had practically no analysis capabilities at all. Even so, I proclaimed it the better choice for the active trader because it would be much easier for QCharts to add the necessary analysis capabilities than it would be for any of its competitors to become as user-friendly and reliable.

Now, a few years later, QCharts has fulfilled its promise, adding a variety of analysis techniques without losing any of its ease of use. Quite the contrary, not only does the program seem to be as user-friendly as ever, it also seems to be very robust, delivering real-time data to a dynamically updating analysis platform with virtually no glitches.

Features

To begin using QCharts you need to put together a "Workspace," consisting of one or several different market-tracking windows. QCharts includes charting (bar, candlestick and line) and basic technical analysis tools, several types of quote windows (including a vast list of top-100 "hot lists"), time and sales, news and basic portfolio tracking capabilities. Nasdaq level II quotes also are available for $50 per month.

QCharts data is real-time, but the good news is none of it has to be stored on your computer, which means no data maintenance hassle on your part and no risk of running out of disk space. The multiple quote-sheet window can be loaded with more than 100 different data fields, including tick magnitude, tick volumes at bid and ask, and bid-ask spread. (Pay $20 extra for the "Investor" version and you also get access to a long list of fundamental data, such as balance sheet and earnings figures, insider activity and sector belongings.)

The data stretches back at least 10 years (or for as long the individual stock has been traded) and can be charted in any time frame ranging from tick to yearly bars. There seems to be no limit to how much data can be loaded, no matter the time frame (a big plus for short-term traders). I took a five-minute chart back to the summer of 1999, and considering I was doing this during the opening minutes of the market and using only a 28.8 Kbps modem, the data came rushing in at an amazing speed. There is more than two years of available time-and-sales data.

The analysis capabilities, though, are not much to brag about; the program has a fairly limited library of technical analysis tools (around 14 indicators and another seven or so charting tools, although all the basics are there). Another drawback is the program's alert function can't be used with any of the indicators or updated dynamically.

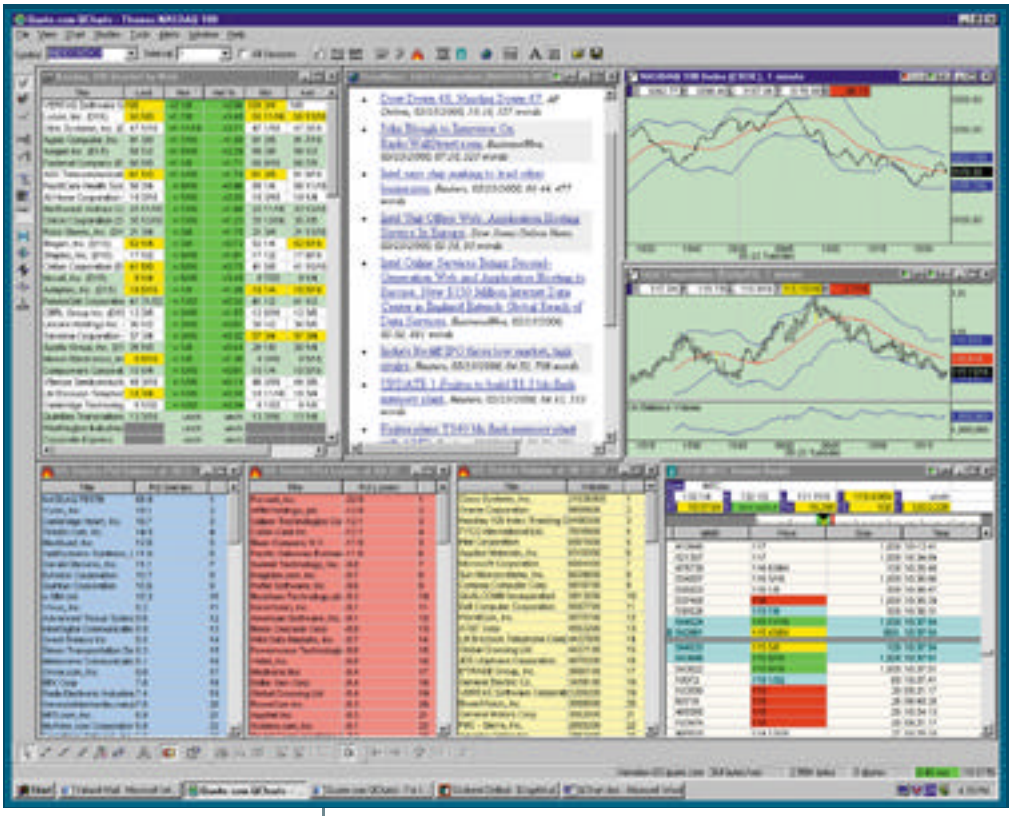
For those who would like to take their analysis work a little further, Quote.com also provides a program called QLink with which you can link all your data into Excel. This comes with basically no instructions whatsoever, but the installation provided no problem and was easy enough to get up and running with just a basic read-me text file.

Some other notable features: The "hot lists" include some interesting sorting categories, like "Very short-term up/down," that should especially appeal to active traders. Others are largest range, unfilled gaps and unusual volume. You can also access the Island ECN (ISLD) order book and have the ability to open an intra-program browser window through which you can link to news and other market information on any symbol.

User-friendliness

Thanks to QCharts true point-and-click and object-oriented interface, most features are easy to find and very intuitive. The charts are crystal clear and very easy to toggle between bars, lines and candlesticks. Moving back and forth in time, zooming in or adjusting the scales is simply a matter of clicking-and-dragging. It's easy to adjust a chart to look just the way you want it.

A little user-friendliness goes a long way. Case in point: the little red/green/gray check boxes that can be found on all win-



dows that only handle information for one stock or other market at a time (i.e., all chart, time-and-sales, news, Nasdaq Level II and ISLD windows.) By setting the check box to green, the content in that particular window will change every time you click on a stock, or other market, in any of the quote lists or top-100 hot lists. This is a true space (and time) saver that will help you avoid cluttering your workspace with tons of useless chart and news windows.

What is not so user-friendly is the Internet-based help. What's the problem with installing a few text files directly on the receiving computer, so traders can get the type of standardized help they're already accustomed to from most other Windows applications? Luckily for QCharts, the help files will rarely be needed after the first hour of use, since the program is so easy to operate. But during that initial hour or so the lack of help files provides an unnecessary obstacle between the program and a (potentially) happy user. Remember the old saying, "You only get one chance to make a first impression."

Performance

When it comes to the performance there really isn't that much to say. QCharts simply works like a charm, even using only a 28.8 Kbps modem. Prices are streaming in and all charts are updating with no noticeable delays. The possible exception is the news window, which is linked to a regular Web site, which might update a little slowly if you bog down the workspace with plenty of windows and then quickly try to jump from one stock to the next.

Opening up a new window of any kind and filling it with information of your choice shouldn't take any more time than it takes you to think it through and execute all the necessary steps. Saving, opening and switching between different workspaces, already full of various windows, also worked just fine with no noticeable delays.

Summary

QCharts' slick design and professional layout allow you to get away with a minimum of windows running within each workspace. Its true object-oriented, point-and-click interface and smart linking between all the different windows allow you to always keep the most immediately important information at hand at all times.

For the people at Quote.com, the next step should be to add to the list of technical indicators and do something about that rudimentary alarm function and the virtually non-existent help. Other than that, QCharts probably is one of a very few programs — in any genre — that truly does what it purports to do.

If somebody gave you a choice between QCharts and any of the old-school technical analysis packages with all their technical analysis indicators and back-testing capabilities — under the condition you'd have to stick to your choice for the next three years — go with QCharts. Again, the reason is that it will be much easier for QCharts to add (and improve upon) what the other programs have than it will be for the other programs to ever become as user-friendly as QCharts.

SOFTWARE SUMMARY

Product: QCharts Trader/Investor version 3.1.

What it is: Internet-based market monitor and trading platform, featuring real-time quotes, charting, news and portfolio-monitoring capabilities.

Who is the program for: Primarily for stock, stock option and mutual fund traders (but the program includes futures data as well).

Skill level: Beginner to professional.

Upside: Very easy (and fun) to use, extensive data, intellingently designed and well-integrated with the Quote.com Web site that holds a wealth of additional information, including IPO watches, trading and analysis tutorials, chats and message boards, and market reports and updates from third-party providers.

Downside: No indicator or system-testing features. Limited indicator library and alert/alarm capabilities. Help system needs help.

BY JEFF PONCZAK
AND MARK ETZKORN

Good traders are flexible traders: They admit when they're wrong, get out of losing trades quickly and move on to the next trade.

Ironically, traders who only operate from the long side of the market — even if they're well-diversified and cut their losses quickly — are denying themselves one of the most readily available means to add flexibility, enhanced profit potential and risk management to their trading: Short selling.

Selling stocks short has its unique rules and risks, but it is often the victim of a great deal of misunderstanding — and even superstition — among traders. Under the right circumstances, though, short selling is an important skill for traders — one that will become more so in the event of an extended downtrend or bear market. Certainly, anyone who trades actively cannot afford to rule out the potential offered by declining markets.

By exercising proper risk control, short sellers can turn downtrends into opportunities rather than liabilities. Doing so effectively is a matter of understanding the mechanics of selling short and knowing which situations are best for short-side approaches.

The short side of the street

When considering the short side of the market, it's important to remember that traders are not investors. Traders seek to exploit shorter-term price swings and trends while investors hope to capitalize on very long-term price trends and economic cycles, which in the stock market has translated into the traditional buy-and-hold approach.

But at any given time (within reason), a stock may be as likely to move down as it is to move up. Short selling is simply the process of selling high (first) and buying low (second) to take advantage of a potential price decline.

From a broad, strategic perspective, selling stocks short is simply a matter of inverting the principles that would normally trigger a long trade. Instead of identifying points where you think a stock is likely to move to the upside, and buying, you identify points where you think a stock is likely to drop, and sell. If the market goes your way, you buy back your position at a profit.

Well, it's not quite that simple. Short selling is a much more common practice in the futures markets because of the nature of futures as hedging instruments. One of the primary economic functions of futures is to protect against price drops in a financial instrument or commodity. If you were long a portfolio of S&P stocks, the Japanese yen, corn or crude oil and you wanted to guard against a downside move in your respective market, you would sell (go

short) the appropriate futures contract.

From an execution standpoint, there are no restrictions on short selling futures (as there are with stocks, which will be explained later in the article), and futures traders can — and generally do — sell and buy with equal ease.

There are two major elements that make shorting stocks a more complicated proposition than shorting futures: The first are Securities and Exchange Commission (SEC) rules dictating when and how short trades can be executed. Simply, you can only sell stocks short in certain conditions.

The second is the longer-term upside bias of the stock market and the inherent differences between uptrends and downtrends. Bull moves tend to be longer and more gradual, and bear moves tend to be shorter and sharper. (For more information on this aspect of stock market behavior, see "Bearing down on the short side," this issue).

The combination of these factors, as well as the established buy-and-hold bias of the long-term investment community, has given many traders an almost exclusively "buy first, sell (much) later" mentality when it comes to trading stocks.

In a sense, this is appropriate (or at least it has been for the last several years). It's true that you shouldn't try to fight the market. When the major trend is up, you want to trade with it, not against it.

But in another sense, this mindset limits a trader's options. After all, there are situations when short selling is appropriate. Understanding the mechanics of short selling and the realities of down moves vs. up moves will put you in a position to know when and how to effectively trade the short side of the market.

Short-selling becomes an even more important trading skill in extended downtrends or bear markets, when "not fighting the market" will be a matter of being able to capitalize on a prevailing downside bias. Bears may be endangered, but they're not extinct. No trend or market cycle lasts forever; when a bear market occurs, the unfortunate truth is that many traders who have profited handsomely in the current bull environment will be unable to make money when the market is trending down.

Seasoned traders understand that knowing how to operate on the short side of the market adds flexibility and diversification and, when done properly, should not be significantly riskier than trading from the long side.

A short history

While many people find the idea of selling something they don't own a completely unnatural concept, short selling has been around since the earliest organized securities markets formed in the Netherlands the early 1600s.

Short selling has been widely practiced in the United States since the early 20th century, when market legends such as Jesse Livermore and Bernard Baruch made fortunes shorting stocks. The practice eventually assumed a dark reputation as organized groups of shorters known as "bear raiders" would band together and repeatedly sell short in an attempt to deflate stocks and buy them back at a discount.

By exercising **proper risk control,** short sellers can **turn downtrends into opportunities** rather than liabilities.

Unrestricted short-selling allowed well-financed market manipulators to bully stocks down (often using pliant journalists to help spread rumors), triggering artificial sell-offs that victimized investors who did not have the financial wherewithal to survive such drops. The investors panicked, sold off their positions and the raiders swooped back in and bought back the stock at dirt-cheap prices.

Bear raiders were often blamed for the stock market crash of 1929, although investigations by the New York Stock Exchange in the years following the crash found no evidence that was the case. (However, short-side manipulation of stocks by high-powered market operators undoubtedly took place.) Nonetheless, these investigations did spark the foundation of all current securities laws and regulation — the Securities Act of 1933, the Securities Exchange Act of 1934 and the Securities Exchange Commission (SEC), which was formed in 1934. (Ironically, the first chairman of the SEC was Joe Kennedy, who was widely rumored to be a bear raider during his tenure on Wall Street.)

From the post-crash SEC came the rules regulating short selling that are still in effect today. It's crucial to understand them before attempting to short. The three big rules to keep in mind are: 1) you have to short on an "uptick"; 2) you have to short from a margin account; and 3) the stock has to be "available to borrow." Let's take a closer look at all three.

The "(up)tick" rule

The most important restriction on short selling stocks is the one that requires short sales to be executed when the market is moving up, if only temporarily.

The Securities Exchange Act authorized the SEC to regulate short sales, and Rule 10a-1, also known as the "tick rule," was established in 1938. Under the tick rule, short sales on listed (NYSE and AMEX) stocks are only allowed if the last price of a stock is higher (on an "uptick") than the previous price (or equal to the previous price, if the price before the previous price was an uptick — the "zero-plus" tick rule).

Basically, the most recent trade price has to be higher than the previous trade price for a short sale to be allowed. The purpose of this rule is to force short sellers to execute their trades when the market is rising (indicating there is at least some buying interest in the stock). For example, if the last three trades in a stock were 29 15/16, 30, 29 15/16, a short sale would not be allowed because the last trade was at a lower price (a downtick) than the previous trade. If the next trade occurs at 30 (an uptick), however, you could sell short at 30.

The zero-plus tick rule works as follows: If the last trade was at the same price as the previous one, but the previous one was an uptick from the trade before that, a short sale is allowed. In our example, if another trade at 30 followed the

first trade at 30, you could still sell short at 30, even though this most recent price was not higher than the previous price.

Nasdaq stocks were originally (the exchange began trading in 1971) not subject to the tick rule. (And, after the 1987 market crash, short sellers again had the finger pointed at them. As was the case in 1929, though, investigation found no correlation between the crash and the abuse of short sales.) Still, in 1994 the Nasdaq passed its own tick rule, which is slightly different from Rule 10a-1. For starters, the price to consider for the uptick is the bid price, which is not necessarily the trade price. A short sale can be made on an uptick of the bid, or on a downtick if that downtick is 1/16 above the current bid. (If the spread on a Nasdaq stock is 1/32, the stock can be shorted at or above the offer.)

For example, if the most recent trades on a Nasdaq stock were 29 15/16, 30, 29 15/16, you could sell short at the second print at 29 15/16 (even though it's a downtick) if the current *bid* is 29 7/8. Essentially, the Nasdaq rules allow a short sale at a price that would, when executed, represent an uptick, even if that price level is not currently an uptick.

It can sound complex, but it's really not. The goal is simply to require short sellers to trade into up moves so they don't exacerbate down moves. For more information on the tick rules, see the "Rules and regs: short-selling fine print" (see sidebar).

Selling what you don't own

Many novice traders are confused by short selling simply because they don't understand how you can sell what you don't own.

Actually, you can't. The second hurdle (after the uptick rule) the short seller must jump is "borrowing" stock to sell. When you go short, you are really borrowing the stock from your broker (who "borrows" it from another trading account at the firm or another broker); the process is transparent to you. You are then able to sell the stock in the open market and the proceeds from the sale go into your account. If the stock goes down, you can buy back the stock at a lower price, "paying back" your broker and pocketing your profit.

For example, if you sell short 100 shares of a stock trading at $50, your account is credited $5,000. If the stock drops to $45, you can buy back the position for $4,500 and pocket a $500 profit, minus commissions and fees.

Before a broker can lend you stock to short sell, he or she must first make sure that the stock is available for borrowing. In many cases, that will not be an issue. But in highly volatile markets (especially when the market is in a nosedive), brokerages produce "hard-to-borrow" lists, which typically contain stocks traders are most eager to short. A stock on the list may not be available for shorting. Brokerages typically produce lists you can consult each day to know which stocks can and cannot be shorted.

One way to tell if a stock might be difficult to borrow is to check its short interest, which is the number of shares that have been sold short but not yet repurchased. If a stock's short interest comprises, say, 25 percent or more of the float, the stock might be difficult to borrow. However, because of the level of arbitrage in the market today, short interest is not the straightforward barometer it once was. Short positions might be hedged with options or other positions, making what might seem like high short interest less significant.

Also, keep in mind that your broker can demand you buy back the shares at any time. This might happen if a stock, especially a stock with a large short interest, suddenly experiences a large run-up in price. If a broker is having difficulty locating stock for all the new buyers that have entered the market, he or she may require you to buy back your short position — regardless of the price of the stock, or the price you bought it at. Moreover, if your broker cannot contact you, he or she has the right an buy back your stock — without your permission — at whatever price the stock is trading. A broker buyback almost always occurs during times of volatile price increases and it is never good news for the short seller.

Margin

The final requirement for executing a short sale is that it must be done from a margin account (a *short margin* account). Contact your broker regarding opening and maintaining a margin account. Initial margin for a short account works the same as it does for a long account — whatever you have in your cash account, you can borrow the same amount for trading.

Because all short sales must be done on margin, your account will be subject to margin interest. However, brokers generally don't charge interest on day trades, short or long. Another note on interest: Usually, any cash a trader has in a brokerage account can be placed in an interest-bearing money-market fund. However, most brokerages will not pay interest on funds deposited from a short sale. Preferred customers (i.e., ones with a large account balance) can sometimes negotiate an interest rate with their brokers.

Understanding the tick rules, stock availability requirements and margin concerns unique to short trading takes care of the mechanics of executing a short trade. The more important issues are understanding the risks and knowing how to capitalize on short-selling opportunities.

Risky business?

If you buy a stock, your maximum risk is your original investment (unless you're buying on margin), even if the company goes bankrupt and the stock goes down to zero. Theoretically, however, the risk on a short trade is unlimited because there's no limit to how high a stock can go, and short sellers can lose many times their initial stake.

This, of course, assumes no risk control is being used to cap losses on a short trade (which, of course, should never be the case). Short selling stocks does have specific risks, but for short-term traders who control risk on all their trades through diligent use of stop-loss orders, these should not be significantly greater than for long trades.

One point to consider: While a high number of short sellers can contribute to a stock's decline, they can also, inadvertently, be responsible for a violent price rise — the "short squeeze." If a stock,

especially a hard-to-borrow stock with high short interest and a low float, rallies sharply, short sellers will scramble to buy back their stock and cut their losses, pushing the stock even higher.

Smart short selling

As discussed earlier, short selling, in the broadest sense, simply involves inverting the principles of a long trade. For example, a simple short-term trading approach is to look for a correction or pause within an established uptrend and buy when the stock moves back in the direction of the trend. A viable short-side approach would simply be to look for a correction or pause within an established downtrend and sell short when the stock makes a downside thrust.

There are a number of ways to measure such corrections or pullbacks: a retracement of a certain percentage, or a move back to a moving average or down trendline. The object is to define a downtrending market and look for upside corrections within it that represent selling opportunities.

RULES AND REGS: the short-selling fine print

Here are some of the nitty-gritty details of the SEC's short-selling regulations and other aspects affecting short trading.

Listed stocks: The SEC defines a short sale as any sale of a security that the seller does not own, or any sale consummated by the delivery of a security borrowed by, or for, the account of the seller. SEC Rule 10a-1 (the tick rule) requires a plus tick or zero-plus tick for a short trade to be made for listed stocks. (See the main story for scenarios showing when you can and can't sell short.)

Nasdaq stocks: The NASD's short sale rule is somewhat different; it's based on the current bid rather than the last trade: You can sell on an uptick of 1/16 above the current bid (or sometimes in a smaller increment — see Minimum Increment Rule, below). The Nasdaq level II screen indicates up bids and down bids with a green arrow or red arrow, respectively. This makes it easy to know when you can sell short: While the green arrow is showing, you can execute a short trade. Figures 1 and 2 compare situations in which short selling is legal and when it is not.

As with any rule, there are exceptions to the tick rules. Nasdaq market makers can sell short in certain circumstances regular traders cannot, including:

- Sales by market makers registered in the security as part of their bona fide, market-making activity (this exemption would not include a market maker taking speculative short positions);
- Sales to offset customer odd-lot orders;
- Sales for the accounts of exchange-registered options or index market makers for exempt hedge transactions.

Minimum Increment Rule

Short sales may be made on a downtick if executed at 1/16 greater than the inside bid. Also, if the inside spread is 1/32, a short sale may be made at the ask price or higher, in spite of a down bid. Short sales executed pursuant to the Minimum Increment Rule are sometimes referred to as legal short sales.

Manipulative acts

The NASD has rules designed to prevent market makers from taking advantage of their status in the market; specifically they cannot engage in transactions for the purpose of circumventing short-selling rules. Prohibited transactions include:

- Lowering and then raising the bid to create an uptick to facilitate a short sale;
- Raising and then lowering the bid to create a downtick to prevent short sales against the market maker's bid;
- Raising the bid when protected against loss through an agreement with a customer;
- Using customer or other member exemptions to evade the rules; and
- Lowering the offer to narrow the spread to less than 1/16.

— Courtesy of Mark Seleznov, Trend Trader LLC

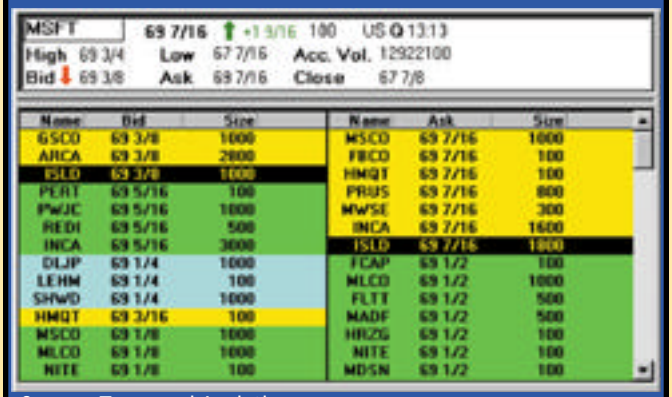
FIGURE 1 SHORT SALE: GREEN LIGHT

The up arrow (next to the bid price) on the Nasdaq Level II screen indicates short sales can be made at the bid price at this time.

Source: Townsend Analytics

FIGURE 2 SHORT SALE: RED LIGHT

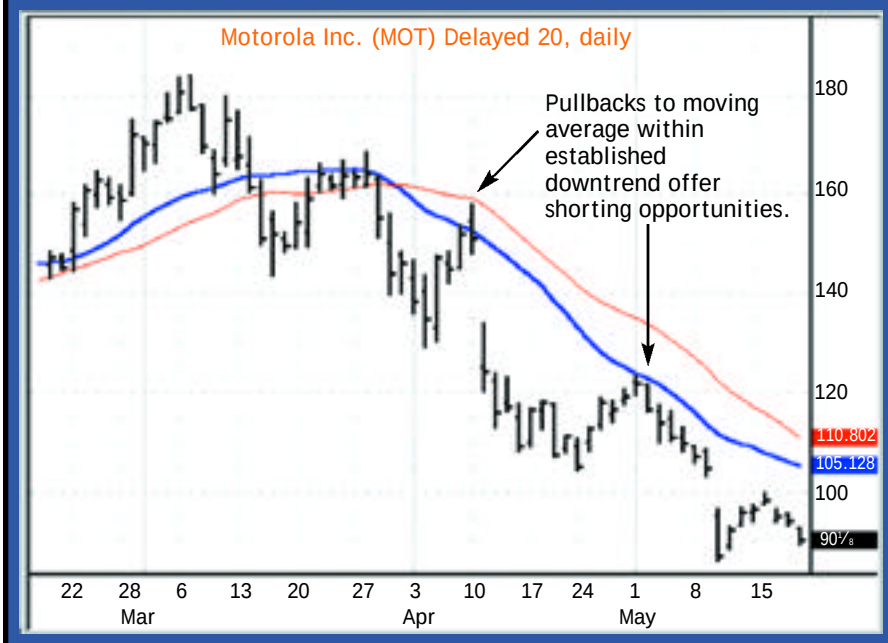
The down arrow (next to the bid price) indicates short sales can - not currently be made at the bid price.



Source: Townsend Analytics

FIGURE 1 PULLBACKS IN DOWNTRENDING MARKET

A representative short-selling technique



Source: Qcharts by Quote.com

Figure 1 shows a downtrend in Motorola (defined by a downward 10-day/30-day moving average crossover) and two subsequent pullbacks to the shorter-term moving average that offered short-selling opportunities. This is a simplified example, meant to illustrate technical signals upon which a short trade could be based. The basic principles illustrated here are to look for short-selling opportunities in downtrending environments (trading with the trend) and to enter at low-risk entry points. For more detailed discussions of short-selling (including intraday) approaches, see the subsequent articles in the Trading Strategies section of this issue.

Short-traders must also take into account the overall market environment and the characteristics of specific kinds of price behavior. While some traders argue there's no difference between trading the short and long sides of the stock market, research indicates otherwise. There are, in fact, distinctions between uptrends and downtrends in stocks that traders must consider when applying short-selling strategies. Since 1900, bull markets in the Dow Jones Industrial Average (defined by a 30 percent increase after 50 days or a 13 percent rise after 155 days) have lasted an average of just more than two years. Bear markets, though, lasted about 14 months on average.

Active Trader's articles "Bearing down on the short side" and "It all adds up" (June) also support the observation that down moves tend to be quicker and more dramatic than up moves. For example, a simple test to determine the best combination of moving average length (to define the dominant trend, up or down) and trade length (on randomly timed trades taken in the direction of the trend) revealed that the best combination for long trades was to use a 260-day moving average to define an uptrend and to hold a position for 18 days. By contrast, the best combination for short trades was a 100-day moving average and a trade length of two days.

The longer-term differences between uptrends and downtrends in the stock market may be of less concern to short-term traders, but they should still be taken into account when designing short-selling strategies. Simply attempting to invert the rules of a long-side system is a naïve approach.

But keep in mind that these characteristics described in the preceding paragraphs are representative of the current bull bias in the stock market. During an extended downtrend or bear market, the defining characteristics of up moves in a bull market — i.e., they develop more slowly and last longer — are more likely to be the hallmarks of down moves as a major bear trend asserts itself.

As with any strategy, strict risk control and money management are absolutely necessary. The risks of short squeezes in popularly shorted stocks make well-defined stop-loss levels and exit criteria critical for shorter-term traders.

More ways to play

Besides individual stocks, there are other trading instruments you can use to capitalize on the short side of the market, most notably index shares, futures and options.

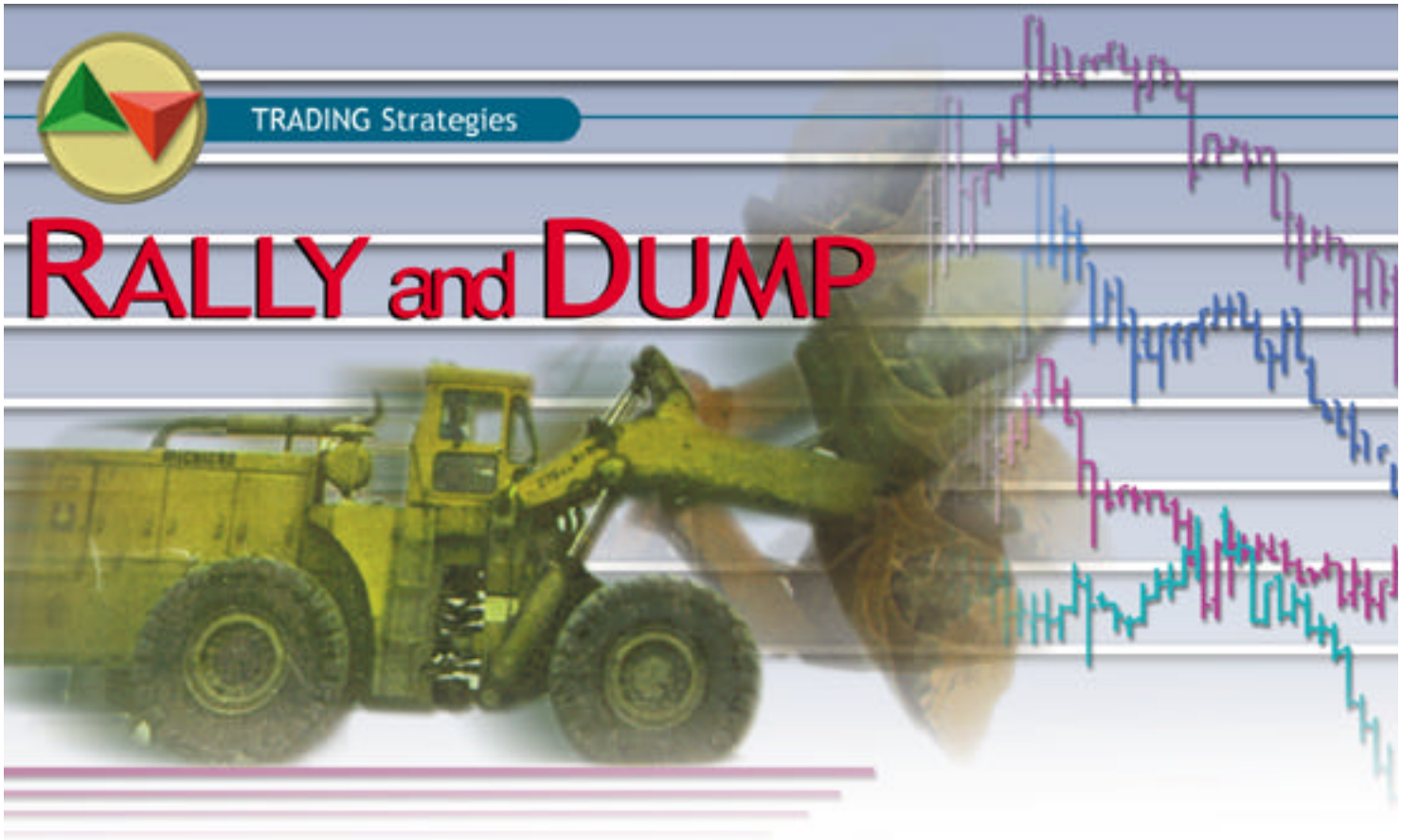
For stock traders, index shares represent the smallest adjustment in trading style and execution. They're exchange-traded stocks that closely mirror the performance of the major indices and some market sectors (see "Along came a Spider" *Active Trader*, June). Designed as an alternative to mutual funds, they trade like stocks, giving traders an easy way to trade an entire index or sector — free of the short-selling restrictions and borrowing availability issues of standard stocks.

Futures and options also allow traders to short indices and individual stocks without worrying about uptick restrictions. However, traders must take into account the expiration dates and margin considerations unique to these instruments. Interestingly, futures exchanges are currently lobbying the government to allow trading of futures on individual stocks, which would give traders yet another trading alternative (see "Are single stock futures in *your* future?"These instruments are legal overseas, but not in the U.S.)

In short

Short selling in the stock market has unique risks and restrictions, but it's hardly the mysterious "gamble" it is often portrayed to be. Markets go up and markets go down; traders who can profit in both situations have an edge over those who only think in terms of buying first and selling later.

Applying effective risk-conscious short-selling techniques under the appropriate circumstances actually decreases your overall risk by allowing you to profit in downtrending market phases (as well as by playing markets against each other — going long one market and short the other in an inter-market spread). Although short selling is sometimes treated like market witchcraft, professional traders know that shorting the market is an effective, and sometimes necessary, trading tool.



Every trading strategy should help locate low-risk entry points that capitalize on identifiable, repetitive price patterns. Here's a short-selling strategy designed to get you in the market at short-term emotional highs that precede intraday sell-offs.

BY MARK SELEZNOV

Different traders or investors may want to short a stock for different reasons. A longer-term investor may feel a stock is extremely overvalued, that the stock has experienced a material event that may change its future prospects, or that accounting standards, management changes or other fundamental factors may cause a real reversal of fortune for the company.

For day traders, short selling is simply a matter of determining the short-term demand for a stock has peaked; once that demand has been filled and supply still exists, the stock will drop, enabling the short seller to buy back the position at a profit.

Because we are all creatures of habit and tend to do the same thing over and over, recognizing repetitive price patterns in stocks is a good way to find trading opportunities, long or short. The best kinds of patterns are those that identify low-risk entry points with good chance of follow-through in your direction.

Most day traders and floor traders take many small losses or scratch trades each day. A small percentage of the total number of trades turn into large winners, generating the profit for the day. The "rally-and-dump" short-selling trade we'll describe here is designed to capture the kind of move that can become one of the day's large winners.

First, let's review the dynamics of price action a short-term trading pattern seeks to exploit.

Riding the wave

The market is an ongoing supply and demand battle between bears and bulls.

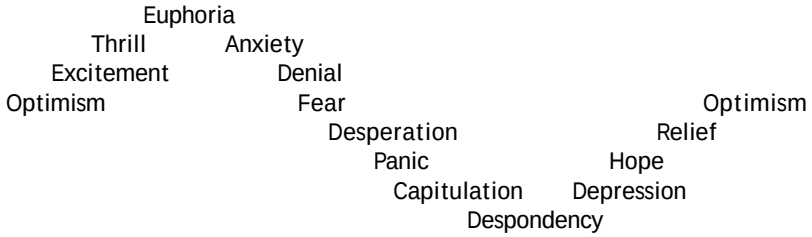
When prices are going up, demand is greater than supply and the bulls are in control. When prices are dropping, supply exceeds demand and the bears are in control. This battle goes on day in and day out, day after day and week after week.

There is a cycle of fear and greed that causes the waves of ups and downs in a trade. Excitement builds as an uptrend continues and increasing numbers of traders attempt to get in on the action. When these positive emotions reach their peak, the up move is exhausted and the market reverses, triggering a wave of negative psychology as the market continues to drop.

When this pessimism is at its worst and the situation seems hopeless, the market is ready to reverse again to the upside, beginning the whole cycle all over again.

A day trader just attempts to catch one of these waves and ride it for a profit. The short-selling strategy outlined below is a way to capitalize on this cycle of market emotions — identifying excessive euphoria in the market and establishing a short position as anxiety is setting in.

Cycle of market emotions



High anxiety, risk management

One of the most important advantages of this approach is that by seeking to short when the market is at a euphoric extreme, you can place a stop just above this level to effectively manage risk.

Risk management is the most important consideration in trading, regardless of the type or direction of the strategy you're using. You can virtually flip a coin to get in your trades if you learn how to manage risk (keep losses small) and let profits run. Not that you should start tossing coins to make trading decisions; simply understand that limiting risk and knowing how to maximize profits will prevent a few bad trades from turning into huge losses that put you out of business.

In short-term trading especially, risk management is not emphasized enough. You can be wrong more than 70 percent of the time if your losers are small and your winners big.

Now let's take a look at the mechanics of a short-selling strategy that will help keep these probabilities on your side.

Trade execution

Every trading system should contain several elements that define the context for the trade, the rules for getting in and getting out with a loss, and managing the position and taking profits. In "Playing the break(out)" (*Active Trader*, April p. 32), we defined these elements as time frame, studies, setup, trigger, stop, exit and filters.

Here we'll break down the short-selling rally-and-break pattern called the Credenza No. 2 in terms of these elements to give a complete picture of how and why this strategy works.

Time frame: The approach uses 10-minute bars during normal trading hours.

Studies: No technical studies are used. This is a pattern-based strategy.

Setup: Trade only Nasdaq stocks with this strategy.

1. The stock must make at least three consecutive higher highs. (The setup requires at least four bars — an initial bar and at least three more with consecutively higher highs.)

2. The following bar (after the three consecutive bars with higher highs) cannot exceed the high of the previous bar (i.e., the trade can occur on the fifth bar at the earliest.)

Short selling rules: the un-level playing field

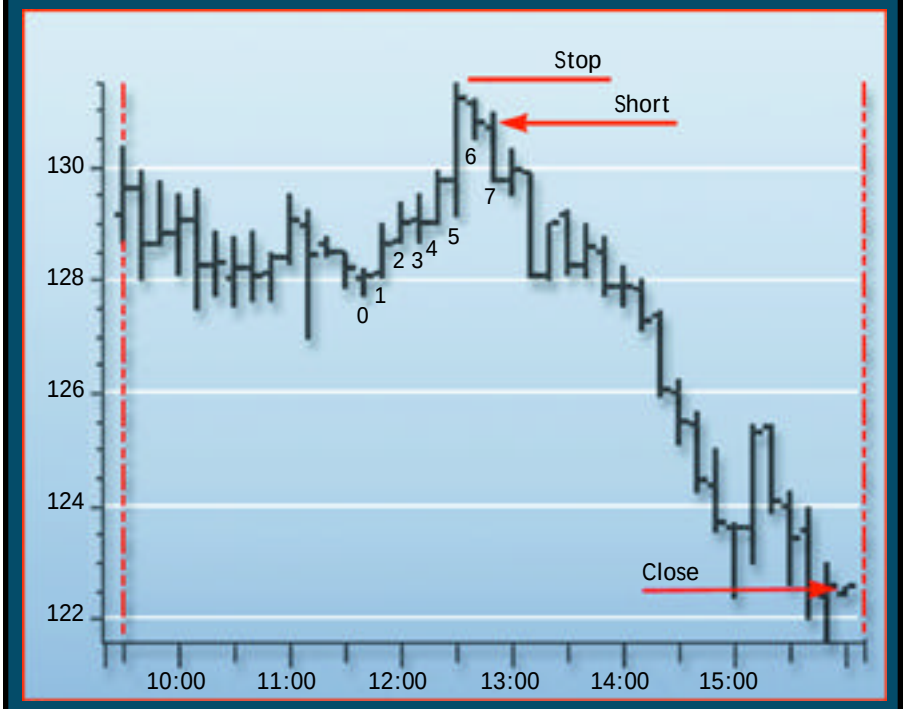
To prevent investors and traders from destabilizing the price of a stock when the market is falling, the Securities and Exchange Commission (SEC) has imposed restrictions on when a short sale may be executed.

There are different rules for NYSE stocks and Nasdaq stocks. A Nasdaq stock can be shorted either on an uptick of the bid, or 1/16 above the bid (or, in certain instances, 1/32 above the bid). A NYSE stock needs an "uptick" or "zero-plus tick" to be sold short. For more details, see "A walk on the short side," p. 32. All short sales are made in a margin account and must be marked as a short sale.

Although the public cannot, Nasdaq market makers can short a downtick. Yes, the person holding your orders may short a downtick. The SEC is considering lifting the Short Sale Rule.

If you have questions on short sales, or the obligations of sellers in such transactions, you may contact the Office of Consumer Affairs, Securities and Exchange Commission, Washington, DC, 20549. The SEC Web site is www.sec.gov.

FIGURE 1 YAHOO (YHOO), 10-MINUTE

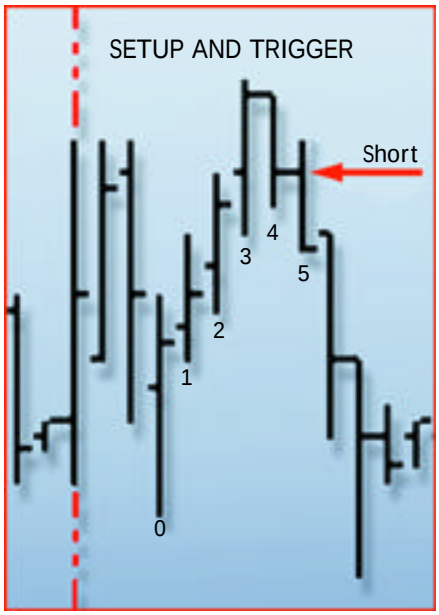


Source: Trend Trader and Townsend Analytics

FIGURE 2 CITRIX SYSTEMS (CTXS), 10-MINUTE

Source: WindowOnWallStreet.com

Trigger: Sell short the next bar (the bar after the bar that fails to make a new high) at the previous bar's close (see "Setup and trigger," below).



Stop: Place a stop-loss order ¼point above the high of the bar preceding the entry bar.

Exit: Exit on close.

Filters: These rules help weed out low-probability trades.

1. Only take trades with a maximum risk of 1 point.
2. Do not take trades after 3 p.m. EST.
3. Only trade stocks with a 30-day average daily volume of 1 million shares.

Strategies at work

The Credenza No. 2 came into play several times recently in the stock market. Let's review a few examples.

Figure 1 shows Yahoo (YHOO) on May 2. After moving sideways to lower most of the morning, the stock made a move to the upside at 11:50 a.m. EST with a series of five consecutive bars (1-5) with higher highs than the previous bar. The 12:40 p.m. bar (6) did not exceed the high of the previous bar (5). All the setup conditions were met at this point.

A sell short order was placed at 12:50 p.m. (bar 7) at 130¾, the level of the previous bar's close. A stop-loss order was

placed at 131 7/16, ¼-point above the high of the bar (6) preceding the entry bar, limiting risk on the trade to 1/16. YHOO declined the remainder of the day, closing at 122 9/16.

In Figure 2, Citrix Systems (CTXS) opened up the morning of May 5, then quickly sold off. At 10:10 a.m. the setup (bar 0) started. Each of the next three bars (1-3) exceeded the high of the previous bar. The 10:40 a.m. bar (4) failed to surpass the high of the previous bar, completing the setup. A sell short order was entered on bar (5) at 46 9/16 (the closing price of bar 4), with a stop order placed ¼-point above the high of bar 4 at 47 1/16, limiting risk to a half-point. The stop was never hit, and CTXS continued to decline, closing at 43 3/8.

Another trade on May 5 occurred in Flextronics International (FLEX). Figure 3 shows that the 10:10 a.m. bar (1) exceeded the high of the previous bar (0), followed by bars 2-4 all exceeding the previous bars' highs. The 10:50 a.m. bar (5) did not exceed the previous bar, fulfilling the setup requirements. A sell short order was entered on bar 6 at the previous bar's close at 57¾. A stop order at 58½ (¼-point above the high of bar 5) was immediately placed. After an hour of consolidating, FLEX broke down and finished the day at 54½. The risk on the trade was ¾ of a point.

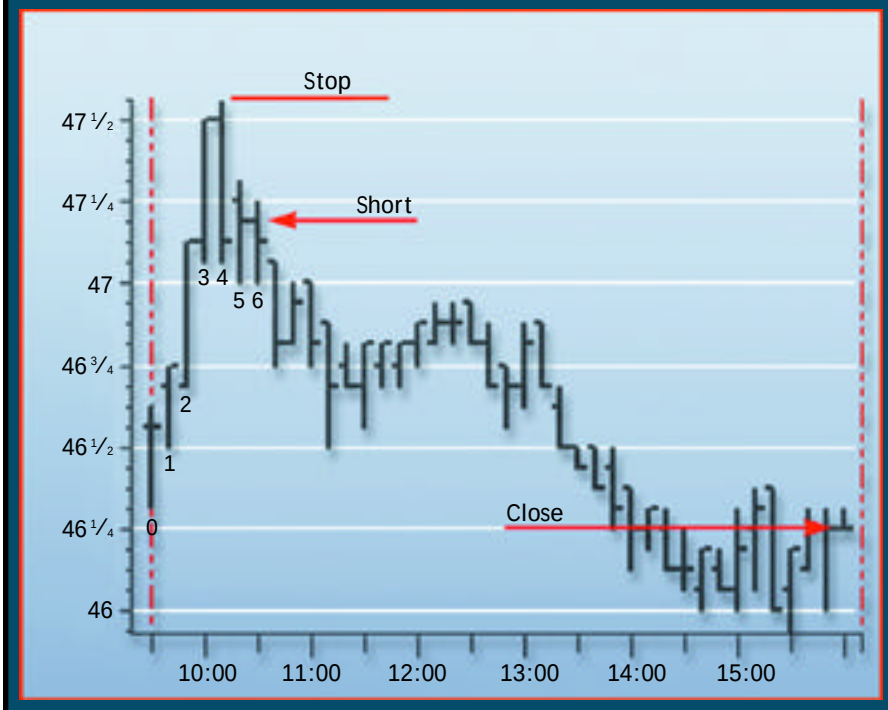
Although this strategy is designed for Nasdaq stocks, it can work with NYSE issues, too. On May 2, Coke (KO) really jumped out the box from the opening trade (Figure 4). Bars 1 through 4 all made higher highs. The setup completed when the 10:20 a.m. bar (5) did not exceed the high of the previous bar. A short sale was established on bar 6 at 47 3/16, with a stop placed at 47 5/16, ¼-point above the high of bar 5. KO closed the day at 46¼. This trade limited risk to ⅜ of a point.

Flexibility is an essential trading skill. Traders who can operate on both sides of the market can profit when their long-only brethren are taking losses or sitting on the sidelines. This strategy can help you locate intraday extremes at which you can establish low-risk short-selling trades that can capitalize on short-term down moves.

FIGURE 3 FLEXTRONICS (FLEX), 10-MINUTE

Source: Trend Trader and Townsend Analytics

FIGURE 4 COKE (KO), 10-MINUTE



Source: Trend Trader and Townsend Analytics

SPREADING your CHARTING options

How do you trade options effectively?

Know which strategies go with different market conditions.

Here's how to use chart patterns to determine the best option strategy to use in a particular situation.

BY THOMAS STRIDSMAN

One basic disadvantage to only trading stocks from the long side, or by using futures for selling short, is the limited risk protection and decreased ability to tailor a position to suit your specific needs. One way to "customize" your positions is to use a set of basic and easy-to-implement option strategies that complement a few equally basic technical analysis chart patterns.

Of course, if you believe the market will go up you could simply buy a call option and limit your risk to the amount paid, or buy a put option if you believe the market will go down. But what if you could weigh the possibilities of a certain scenario actually happening — say on a three-grade scale (e.g., unlikely, likely, very likely) — and then tailor an options position to fit the scenario and the potential risk-reward ratio you're willing to take on?

The probabilities of chart-pattern analysis can help you choose an appropriate option strategy for a given trading situation.

FIGURE 1 THE VERTICAL DEBIT CALL SPREAD

The vertical debit call spread consists of a long call and a short call at a higher strike price.

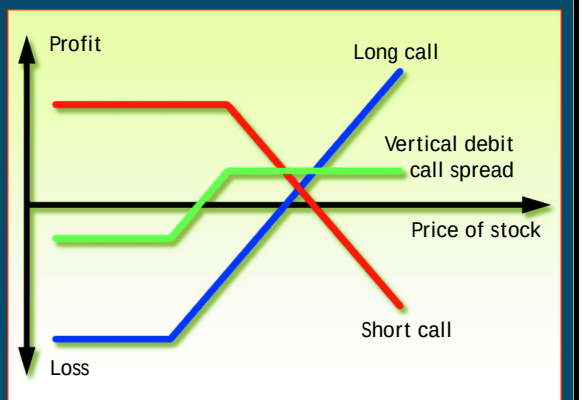
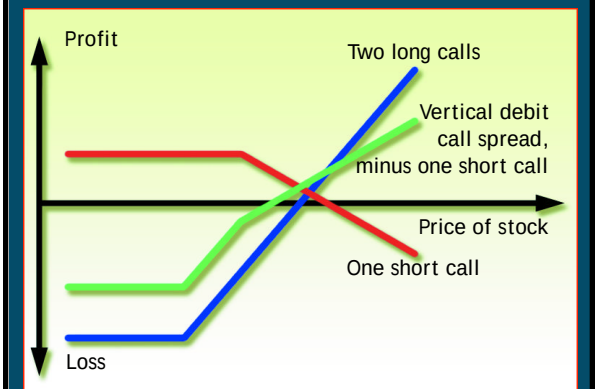


FIGURE 2 A MODIFIED VERTICAL DEBIT CALL SPREAD

A modified vertical debit call spread: The position is established with two long calls and two short calls; one of the short options is bought back when the market moves up, increasing the position's upside bias.



Vertical jump

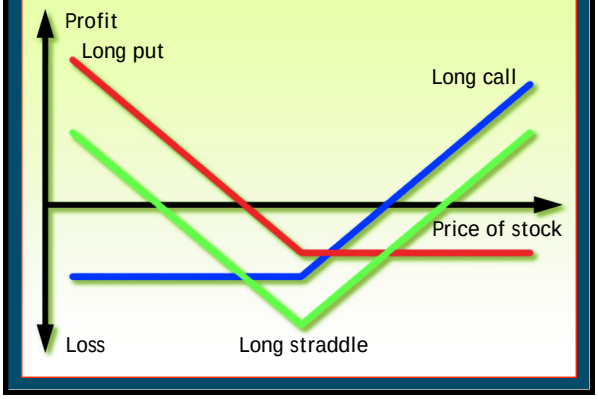
Consider a situation in which you think the market may rise, but you still want some protection against a potential drop. Instead of just buying a call option, you could buy one call option and sell one call option with a higher strike price to limit your risk.

This position is called a *vertical debit call spread*. The green line in Figure 1 shows what the profit potential for this position looks like. ("Debit" means it will cost money to put on one of these spreads; you cannot lose more money than the cost of the position.)

Granted, the profit potential will also

FIGURE 3 THE LONG STRADDLE

The long straddle consists of a call and put with the same strike price and expiration.



be limited, but why aim for a higher profit — and thereby also take on more risk — than your market analysis deems reasonable? To establish a similar position in anticipation of falling prices you could put on a *vertical debit put spread*, consisting of one long put option and one short put option with a lower strike.

To implement a vertical debit call spread you should choose the strike for the short option to be at or slightly above (below for a put spread) the targeted price for the underlying stock. The two options should not be more than two strikes apart because options too far out-of-the-money tend to become very illiquid.

The advantage of a strategy like a vertical debit spread is that you don't have to hold it until expiration. Depending on how the market unfolds, you can get rid of one half of the position or add even more options to either side of the strategy.

For instance, if you place a vertical debit call spread in anticipation of the penetration of a resistance line, you can easily buy back the previously shorted option once the market has moved in your favor, ending up with an outright long call position (the blue line in Figure 1.) Or, if the market goes against you, sell the long option to end up with a short call position that will allow you to take a small profit out of the declining market (the red line in Figure 1.)

Because it doesn't matter how many total options the spread consists of, as long as it has an equal number on both sides, buying and selling more than one option only adds to the position's flexibility.

For example, say you bought two call options and sold two call options with a higher strike. Figure 1 shows that a vertical debit call spread will become profitable earlier than an outright long option. Once your position has moved into profitable territory, you could then buy back one of the short options to end up with the position defined by the green line in Figure 2 .

As you can see, this position will not be as profitable as an outright long call position if the market moves very strongly in your favor. However, because it becomes profitable sooner, it will take a substantial move by the underlying stock before the outright long position will start to outperform this modified vertical debit call spread. Further, if and when this happens, you can always buy back the last remaining short option and end up with two outright longs.

Straddling volatility

Avertical debit spread is a useful position when you have a fairly clear opinion about what the market will do next. But what about when you're not so sure — when you think it can take off in either direction?

That's when a long straddle would come in handy. A long straddle consists of one or more long calls and an equal number of long puts with the same strike price. (See "Trading volatility," *Active Trader*, June). The green line in Figure 3 shows what this position will look like compared with the performance of an individual long put and long call. As you can see, the straddle will make money if the market makes a substantial move in either direction, but will lose money if volatility decreases and the market drifts in a narrow trading range

As with the vertical debit spread, the straddle allows you to get rid of the side of the position that loses money once the market takes off; the more options you use for the initial position the more flexibility you'll have as the price action unfolds. Figure 4 shows what a long straddle (initially consisting of two call options and two put options) would look like after selling one of the put options. As you can see, it's now slightly easier to earn a profit on the long side than the short side.

Now let's take a look at the kinds of chart patterns that offer trading opportunities for the option strategies we've discussed.

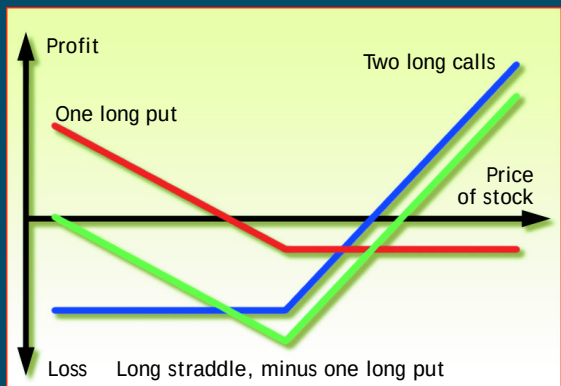
Chart patterns and directional bias

When you get right down to it, there are only four types of chart patterns: those that favor a strong move either up or down; those that favor a more modest move up or down; those that imply a strong move in either direction; and those that don't favor a move in either direction (i.e., price will continue to move sideways).

Most traders are probably better off avoiding the last type. The profit potential is very limited, unless you're a trader who specializes in volatility plays

FIGURE 4 A MODIFIED STRADDLE WITH TWO LONG CALLS AND ONE LONG PUT

This modified straddle performs more favorably if the market moves higher.



without any regard to the actual price of the underlying market.

Among the patterns that favor strong moves in a certain direction are top and bottom formations like head-and-shoulders, double tops and bottoms, and wedges. In Figure 5, the formation during the fall of 1998 is an example of a double bottom with its most important resistance (often referred to as the "neckline") at point 1 (the relative high between the two lows of the pattern, which also happens to coincide with the bottom of a consolidation pattern preceding the double bottom).

An upward sloping wedge, which implies a potential top and trend reversal, consists of two upward sloping, converging trendlines. In Figure 5, this pattern is forming between trendlines 5 and 8. A downward sloping wedge formed between trendlines 4 and 7.

Other patterns with a strong directional bias are consolidation patterns within trends, such as flags and pennants (See "Waving the pennant," *Active Trader*, May). Because these occur within the context of an established uptrend, the consolidation patterns at points 2a, 2b and 2c in Figure 5 all favor a break (continuation) to the upside — in the direction of the previous trend. (Such patterns are, in fact, often referred to as continuation patterns.)

FIGURE 5 CHARTING YOUR OPTIONS STRATEGIES

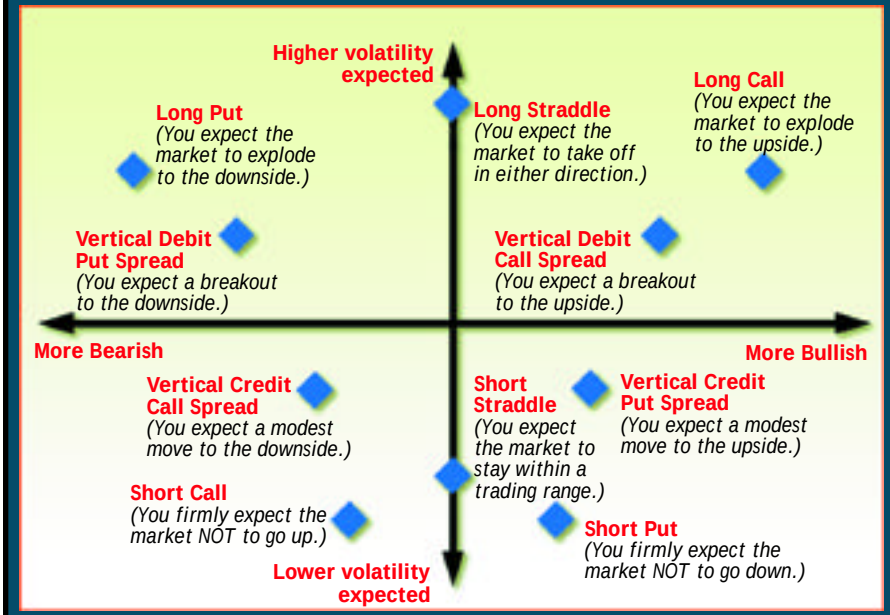
The various support and resistance levels that developed over an 18-month period in the S&P 500 provide clues to the direction and magnitude of price moves. This information can then be used to select appropriate option strategies at different points.

For these patterns, the magnitude of the subsequent move depends not only on other support and resistance levels present in the market, but also on the move leading into the pattern. To get a rough estimate, look for the move out of the pattern to be similar in size to the move leading into the pattern. That turned out to be fairly accurate for the patterns in Figure 5.

The patterns on this chart all represent support or resistance of one degree or another. The next step is to consider which option strategies to use to capitalize on the price action they imply.

FIGURE 6 OPTION STRATEGY MAP

A breakdown of different options strategies based on the expected price direction and level of volatility.



Combining pattern and strategy

The way to trade these patterns is to place a vertical debit spread in anticipation of the move through the support or resistance line in question, then liquidate the losing half of the position after the breakout has occurred.

Ideally, though, you should wait until the market pulls back slightly from the breakout before eliminating the losing half. However, because the market sometimes takes off without looking back, waiting might prevent you from getting out of the unprofitable side. As a result, it's a good idea to consider working with a total of four options. This way, you can get rid of half the losing position as the

TABLE 1 MATCHING UP: CHART PATTERNS AND OPTION STRATEGIES

Different chart patterns and the option strategies to use to capitalize on them.

Volatility	Strategy	Implementation	Suggested chart patterns
Higher volatility expected	**Long call:**	Buy one or more calls with the same strike price.	After breaking through a neckline and (preferably) also after a test of support
	Vertical debit call spread:	Buy one or more calls, and sell an equal number of calls with a higher strike price.	In anticipation of breaking through a neckline or consolidation pattern.
	Long straddle:	Buy one or more calls, and an equal number of puts with the same strike price and expiration.	In anticipation of a breakout of a horizontal consolidation area or symmetrical triangle (either direction), or a test of a major trendlines.
	Vertical debit put spread:	Buy one or more puts, and sell an equal number of puts with a lower strike price.	In anticipation of breaking through a neckline or consolidation pattern
	Long put:	Buy one or more puts with the same strike price.	After breaking through a neckline and (preferably) also after test of resistance.
Lower volatility expected	**Short put:**	Sell one or more puts with the same strike price.	After breaking through a neckline and (preferably) also after test of support.
	Vertical credit put spread:	Buy one or more puts, and sell an equal number of puts with a higher strike price	In anticipation of breaking through a neckline or consolidation pattern.
	Short straddle:	Sell one or more calls, and an equal number of puts with the same strike price and expiration.	When moving into (or when expecting to stay within) a horizontal consolidation area or symmetrical triangle.
	Vertical credit call spread:	Buy one or more calls, and sell an equal number of calls with a lower strike price.	In anticipation of breaking through a neckline or consolidation pattern.
	Short call:	Sell one or more calls with the same strike price.	After breaking through a neckline and (preferably) also after test of resistance.

breakout begins — giving you a position looking like the one in Figure 2 — and the other half at the pullback, giving you two outright long options.

In the event of a failed breakout, you have two choices: Stay with your recently modified position, or scale it back further so it consists of one long and one short option, which you can sit on in anticipation of a second breakout attempt.

When the market is about to test a major trendline or support or resistance level without any other kind of formation (such as any of the ones mentioned above) to indicate possible direction, price is equally likely to take off in either direction — and usually in a rather swift move with large, short-term profit potential for the correctly positioned trader. The magnitude of the move is usually limited to previously defined support or resistance levels and the other extreme of the price channel, such as the ones marked by trendlines 9a and 9b in Figure 5.

Another directionally unbiased pattern is the (preferably symmetrical) triangle, which forms with the intersection of two major trendlines, such as trendlines 5 and 10. Directionally neutral patterns like this are opportunities to put on straddles.

One excellent opportunity to place a long straddle occurred in October 1999, when the market attempted to test both support at about 1,300, and trendlines 4 and 5. It also would have been possible to add a vertical debit call spread to this position in anticipation of a breakout through the resistance at trendline 6 and the wedge at trendline 7. No matter how you might have handled the outcome and modified the positions as the market unfolded, these two strategies would have positioned you to profit from sizable moves.

Given the apparent longer-term wedge developing between trendlines 5 and 8, it could (at the time this was written) be a good place for a vertical debit put spread in anticipation of a breakthrough of trendline 5 and a move back to support at 1,350. This would be an acceptable move if the market continued down over the next couple of days.

But if this test failed the first time, the market would be very close to the meeting point of trendlines 5 and 10 — a more neutral pattern that would call for a long straddle. Figure 6 and Table 1 give you a quick overview of how and when to place these and a few other basic option strategies.

PARALLEL TRADING

BY WILLIAM YOUNG

Rather than try to fight the market and attempt to buy stocks they hope will go up, smart traders and short-term investors know it's more beneficial to follow the trend of the market — down as well as up. Doing so helps minimize the risks and maximizes the potential opportunity of trades.

Short side basics

Short selling is selling a stock (or future or currency, etc.) you don't own with the expectation that the stock price will drop and you can buy it back at a profit. Because of the long-side mentality that dominates the market, only a relative handful of traders sell stocks short.

Because you don't actually own the stock you're selling short, you "borrow" it from your broker, returning it when you have bought back the shares in the market, hopefully with a profit. But if the price increases, you will be forced to replace the stock at a higher price, incurring a loss.

You can think of short selling this way: When you buy a stock you are long stock and short money — that is, you owe your broker money and the broker owes you stock. By comparison, when you short sell a stock, you are long money and short stock. Your broker owes you money and you owe your broker the stock.

Many traders are leery of shorting stocks. Regardless of the reasons they give (ranging from "I don't know how" to "I didn't think it was legal"), there's only one cause: lack of knowledge and proper education.

There are specific regulations regarding short sales in the stock market (they do not apply to futures). The Securities and Exchange Commission (SEC) requires that stocks must be shorted on an uptick. In other words, a stock can only be shorted when there is an increase in the buying pressure of the stock. (The precise definition varies slightly between Nasdaq and NYSE issues, but the basic rule applies to all stocks.) As a result, this means that the short seller will almost always be in the red before the stock price begins to fall.

A progressive **decrease in volume** as price continues **to rise will be the first indicator** of a potential **downside reversal.**

The risks of short selling

While a long buyer can never lose more than the purchase price of the stock, short sellers theoretically face unlimited risk because there is no limit to how high a stock's price can go. For example, if you short a stock at $10 and the price rises to $100, you will lose 90 points, but if you went long the stock at $10 and it goes to zero, your maximum loss is 10 points.

Because of the additional risk of the short sale as opposed to the long trade, you must be extremely disciplined about the stocks you sell short and decisive about cutting losses when a short position goes against you.

Protect your trades at all times by using stop-loss orders. Never leave a trade unattended and never execute a trade without a plan.

Benefits of short selling

Short selling adds consistency to trading by giving traders the potential to profit in down markets. There are always stocks that are falling, even when the market is bullish. However, very few stocks rise to any great degree when the market is bearish.

Whether it's profit-taking in a bull market or liquidation in a bear market, short sellers can always find opportuni-

The interaction of price and volume can shed light on price direction and strength. The "13th Parallel" is a technique that combines several indicators to define trend direction and isolate resistance levels and potential short-selling opportunities.

ties to sell stocks short for a profit. This is why short sellers are among the most consistently profitable of all traders in the market.

Volume speaks volumes

Volume is one of the most useful indicators to determine trend strength and warn of potential reversals, whether traders are buying on weakness and supporting price or selling into strength and limiting price.

Volume has a direct relationship to price. The more buyers (increasing volume) the higher the price goes. The fewer buyers, the better the chance for market makers to lower the price. There are six simple rules to interpret price and volume movements:

1. Increasing volume on increasing price indicates increasing buying pressure and a possible price advance.
2. Increasing volume on decreasing price indicates increasing selling pressure and a possible price decline.
3. Decreasing volume on increasing price indicates easing buying pressure and a possible price plateau or reversal.
4. Decreasing volume on decreasing price indicates easing selling pressure and a possible price plateau or reversal.
5. Higher than normal volume at price highs indicates selling into strength and a price ceiling.
6. Higher than normal volume at price lows indicates buying on weakness and price support.

Burn these into your brain — they are the most reliable measures you can use to determine a stock's strength and direction. For the short seller looking to position near the top of a rally, a progressive decrease in volume as price continues to rise will be the first indicator of a potential trend reversal. It will occur before any other indicator begins to suggest an impending price reversal.

Short selling at resistance

Many stocks tend to move within trading ranges during the day, or during specific times of the day, bouncing off support at low points and retreating from resistance at high points.

When you recognize that a stock is fluctuating within a trading range, you can place short limit orders at or just under the resistance level of the range to take advantage of profit-taking off that resistance; you can cover at the support level. Make sure the volume has been decreasing as the stock nears the established resistance level. If the volume remains constant or begins to increase, a potential move through the resistance level could occur.

Never leave your **trade unattended**, and **never execute** a trade **without a plan.**

Breakouts above resistance levels (or below support levels) are often explosive and accompanied by high volume. Think of support and resistance levels as floodgates that are closed tight. When they open, they release an extreme amount of pressure.

The 13th parallel

One of the biggest challenges for traders is to learn how to determine entry and exit points, both for long and short trading. The "13th Parallel" is a trend-trading tool to assist in the decision-making process, using the price and volume principles we have outlined so far.

The 13th Parallel is a visual charting concept based on a well-defined characteristic of stock movement: A stock will always move back to its short-term moving average over a specific period of time. The approach uses a combination of indicators: Bollinger Bands, dual simple moving averages, stochastics and volume. The name "13th Parallel" is derived from the use of a 13-bar moving average paralleling a 21-bar moving average.

Figure 1 (p. 54) shows these indicators: The 13- and 21-bar moving averages are accompanied by a 14-bar Bollinger Band (using two standard deviations for the price bands), volume and a 14-bar stochastic (which is overlaid on the volume in this case, although it is calculated on price).

The 13-bar moving average is referred to as the short-term moving average (STMA) and the 21-bar moving average is referred to as the long-term moving average (LTMA). When the STMA crosses below the LTMA, a downtrend is in effect. Conversely, when the STMA crosses above the LTMA, an uptrend is in effect.

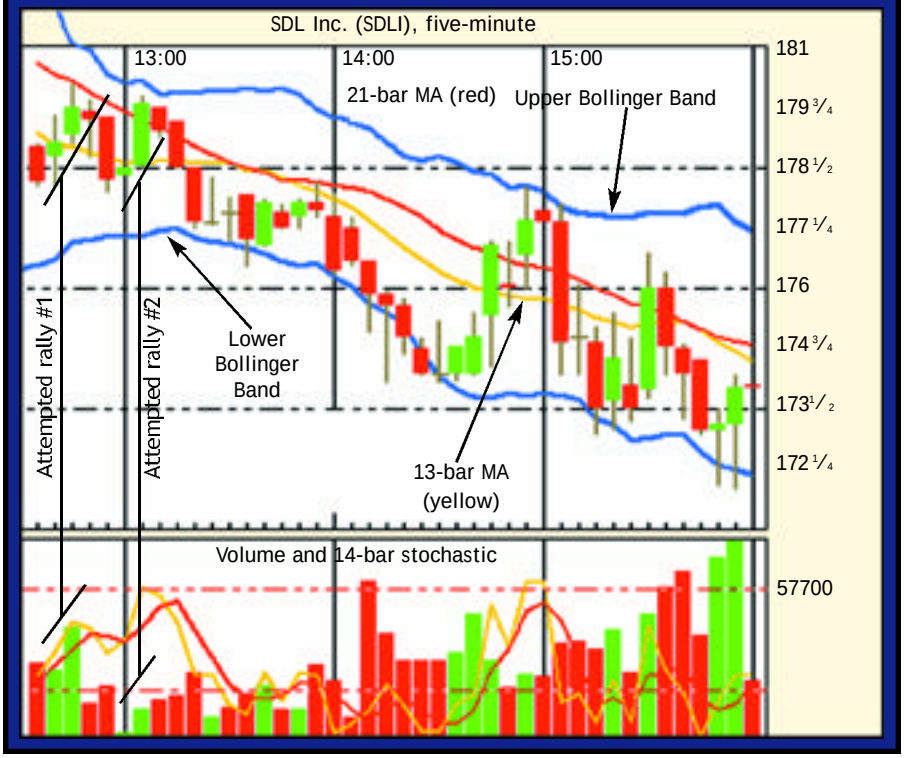
The STMA serves a dual purpose. First, it confirms the trend of the stock as mentioned above. Second, by intersecting with price on a bounce, it defines a near-term resistance level. Referred to as the "intersection," this near-term resistance level is reflected on a Nasdaq Level II price screen by a large build-up of sell orders at a particular price tier.

Once a short position has been established by combining the price and volume relationships mentioned earlier with the STMA, the 13th Parallel can be used as an additional tool to interpret trend as follows:

•If the stock bounces off of the lower Bollinger Band and approaches the intersection on decreasing buy volume, a continuation of the downtrend is signaled, with a reversal to occur at or near

FIGURE 1

The 13th Parallel uses 13- and 21-bar moving averages to define a down-trend. The interaction of price and volume, with confirmation from Bollinger bands and stochastics, are used to determine resistance levels.



the intersection.

• If the stock bounces off of the lower Bollinger Band and approaches the intersection on increasing buy volume, this confirms the (upside) trend reversal and a likely move through the near-term resistance level.

"Buy volume" means trades occurring at the ask; "sell volume" means trades occurring at the bid. In the chart, volume bars shaded green represent buy volume and volume bars shaded red represent sell volume.

Trade analysis

Now let's look a little closer at Figure 1, which shows an intraday (on a five-minute candlestick chart) downtrend in SDL Inc. (SDLI) on May 12.

For almost all the trading session, the STMA remained below the LTMA, indicating the trend of the stock was down. From 1 p.m. to 3 p.m. SDLI experienced a strong six-point sell-off and a four-point bounce.

At approximately 12:45 p.m., SDLI attempted to rally, moving up from approximately $178½ to $180. During this rally, buyers moved in, reflected in a slight increase in volume, as evidenced by the green ("buy") volume bar at 12:45.

However, as the price approached $180, sellers immediately moved in, forcing the price back down below the initial attempted rally point. At 1:05 p.m., a second rally attempt began, but this time with much lower volume, indicating a potential trend reversal. As the price neared the 180 level on the second rally, it was immediately met by selling, as indicated by the red ("sell") volume bars. Because of the two failed rallies, this level became an established resistance level.

The next thing to look at is the specific requirements for a trade.

Short entry conditions

Several factors combine to trigger a short sale. As the price approaches the established resistance level, the following conditions should occur:

1) The bid-ask spread increases.
2) Buy volume decreases into the attempted rally, indicating a reversal of trend.
3) Stochastics turn down.
4) The STMA remains under the LTMA.

(One rule to remember is never be dependent or rely on a single indicator. Always use multiple indicators for confirmation.)

Once decreasing volume into the second attempted rally (which indicates a reversal of trend) is established, a short trade order is placed near the top of the second failed rally, around 179¾, with a stop loss placed at 180⅛.

The stop is placed at this price because it is just above the resistance level established at 180 by the two failed rally attempts. If the volume suddenly increased, forcing a breakout above the 180 level, a stop order at 180⅛ would minimize losses and enable you to reverse to a long position. Also, placing the stop at 180⅛ reduces the chance of being stopped out prematurely if the stock just touches the resistance level and but does not trade above it.

Entering the short trade around 179¾ means you would be doing so into the remaining (decreasing) buy volume, increasing the odds of a fill. Placing the short trade at a higher level would put it at or near the saturation point of sellers. With the growing lack of buyers and an abundance of sellers, the chances of getting filled are greatly diminished in such circumstances.

Exit strategy

Stocks in downtrends will experience minor rallies or bounces. As a short trader, you must determine how to trade the trend — that is, do you hold a position during a bounce in anticipation of a further downtrend, or do you exit the position in anticipation of a strong upside trend reversal?

The 13th Parallel provides a visual indicator to determine when to exit a trade. At the beginning of a bounce or rally, the bid-ask spread decreases, the buy volume increases and traders and market makers line up on the inside bid to get their orders filled by the last remaining sellers exiting the bounce. As the price moves up, trades will increasingly occur at the inside ask.

One exit strategy is to cover the position as the stock begins to bounce off the lower Bollinger Band. Figure 2 shows a typical bounce of this type around 1:45 p.m. near the 177 level, with an exit at this level resulting in a profit of 2¼ points.

A second strategy gives you the ability to determine whether to exit or to maintain a short position to capture additional potential downside profits.

Again, refer to the bounce in Figure 2. As the stock began to move up to meet the STMA, it did so on decreasing buy volume and increasing sell volume, indicating a continuation of the downtrend and an opportunity to hold the short position for additional profits. At the bounce, the following conditions occurred:

1) Bid-ask spread decreased.
2) Price bounced off lower Bollinger Band.
3) Buy volume decreased immediately into the attempted rally, indicating a continuation of the downtrend.
4) Stochastics remained low.
5) STMA remained under the LTMA, indicating a longer-term downtrend was still in effect.

By contrast, the bounce in Figure 3 occurred with strong, increasing buying volume, indicating an upside trend reversal. As the bounce occurred, all selling stopped, and a strong increase of buy volume provided a signal to exit the short trade near 174⅛ for a larger multipoint profit. These were the conditions at the bounce shown in Figure 3:

1) Bid-ask spread decreased.
2) Price bounced off lower Bollinger Band.
3) Buying volume increased immediately into the attempted rally, indicating a near-term reversal of the downtrend.
4) Stochastics turned up.
5) STMA remained under LTMA, still indicating a longer-term downtrend was still in effect.

Selling into a rally provides a better chance of order execution because of the increased availability of buyers and liquidity. The 13th Parallel method can be used in a live, real-time environment, allowing trading decisions to be based on the occurrence of certain specific actions.

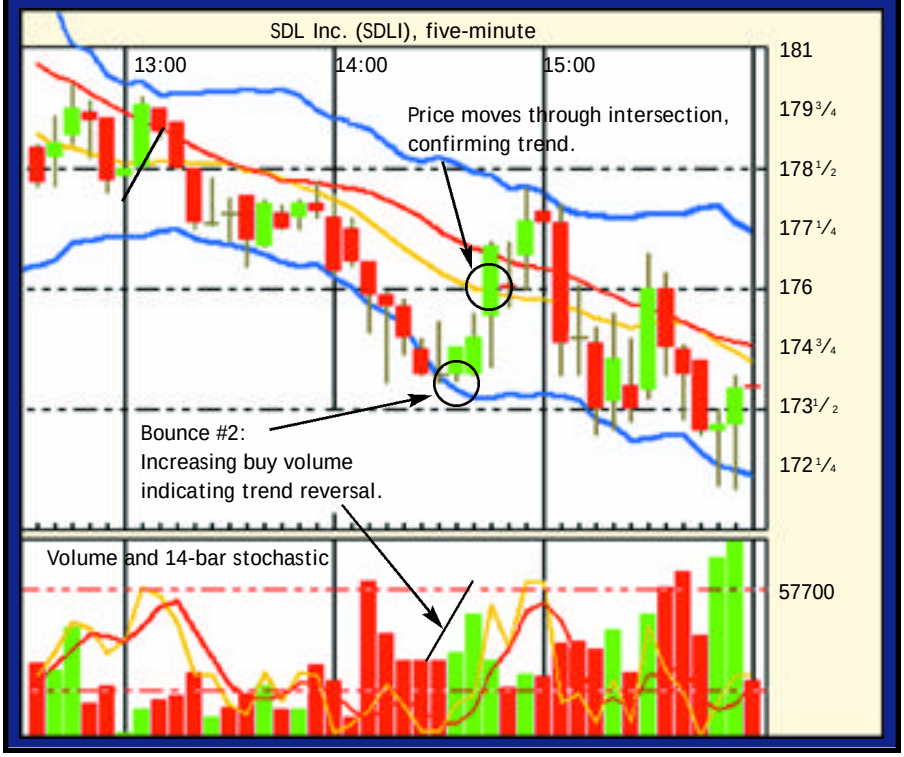
Using this approach can give you greater insight into taking short positions and when to cover quickly or to hold for a longer-term trade, based on trend, volume and resistance.

FIGURE 2

The pullback to the short-term moving average on decreasing buy (green) volume suggests a continuation of the downtrend.

FIGURE 3

Increasing buy volume at this intersection warned of a potential continuation of the upside move.



GAINING on the MARKET

BY KEN WOLFF

The Street always overreacts to news, both good and bad. A good trader learns to recognize overreactions and plays the predictable price oscillations caused by them.

"Gainers" — stocks up 20 percent or more from the previous day's closing price — illustrate this phenomenon perfectly. They offer the opportunity to capture short-term price swings resulting from emotional overreactions in the market.

The momentum driving these stocks can come from many sources, but the most common is good news such as positive earnings, FDAapprovals, pacts and deals, or the release of new products. If the news story is strong, such as unexpected "blowout" earnings after the bell, the stock will react in a predictable manner a good percentage of the time.

Oscillations

Before you can properly trade a gainer, you must first understand the theory of narrowing oscillations.

Stocks often (although not always) make their largest moves in the first two hours of the trading session. This is when momentum and volatility are normally the greatest and when a stock makes the widest intraday swings. Most of the time, the swing from the first high to the first low is the largest oscillation a stock will make all day; the remaining oscillations get smaller and smaller as the day goes on.

Figure 1 is an intraday chart of BroadVision Inc. (BVSN), a maker of Internet software. Notice the first swing just after the bell, from 68⅞ to 66¼. The oscillations that follow get narrower and narrower until the end of the session, when volatility increases again.

Gainer strategies

There are two parts to gainers: day 1, the day of the initial run-up; and day 2, the day after the run-up. The recognizable part of the pattern occurs on day 2.

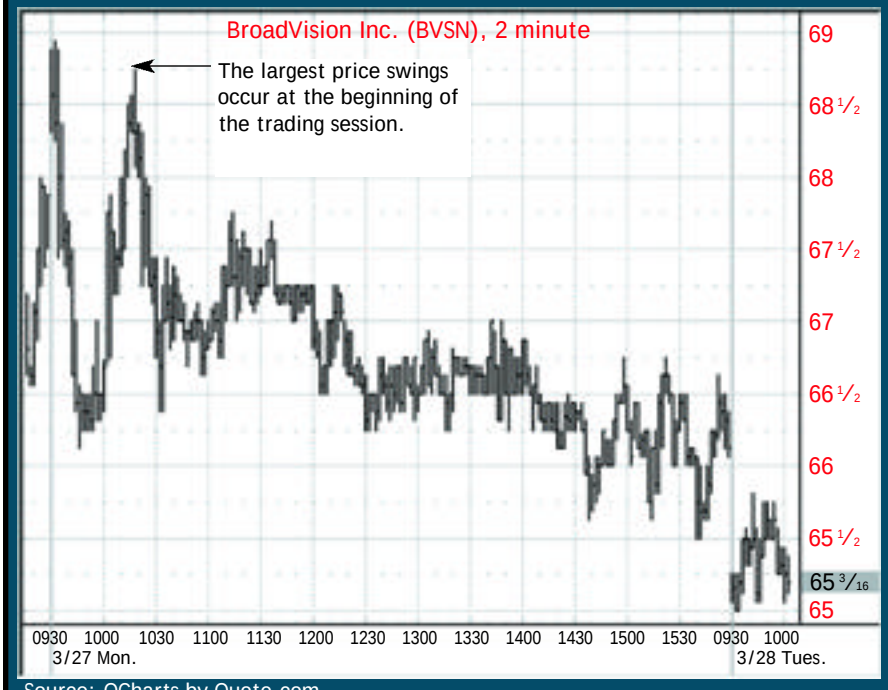
Gainer stocks will often gap open (open at a price significantly higher than the previous day's close) on day 2, then sell off in the first few moments as traders take quick profits. After this first sell-off, the stock price often bounces as value buyers, day traders and late investors jump in. The more the stock has gapped up, the more strength and upside potential this bounce has, and the greater its profit potential.

On day 2, you can play gainers two ways: Buy on the first dip, or sell short either on the open or on the first high. Alternately, you can trade the overnight gap at the end of day 1 or day 2.

Figure 2 shows a perfect example of a gainer pattern in American Software (AMSWA). The momentum was caused by news the company had formed a strategic alliance with IBM. Note the rise from 17¼ to 19 the morning of March 10

FIGURE 1 NARROWING OSCILLATIONS

Stocks often make their largest intraday moves in the first two hours of the trading session, with narrowing price swings as the day progresses.



Source: QCharts by Quote.com

(the alliance was announced on March 9). The next trading day (March 13) the stock gapped up to 22⅜, immediately sold off to 21¼ and then bounced back to 24 7/16.

Buying the initial dip

The first way to play a gainer is to enter the trade long at the initial dip after the gap on day 2. Short-term profit takers will exit on the open before value players and day traders jump on at the first bottom as the momentum turns.

At the first dip, when the panic selling and momentum slows and the rhythm of the trades pauses, look for buying to come in. One way to do this is to watch a time-and-sales screen and wait until the majority of the trades are buys (trades at the ask) while sells (trades at the bid) are decreasing. This is a key indicator of a potential bottom.

The trade should be exited at the first sign of weakness. Weakness can be also be identified by a time-and-sales screen: When the majority of the trades are sells, exit the trade.

One caveat for using this strategy: If the news that caused a stock to be a gainer is very strong, meaning the news has immediate impact on the company's bottom line *and* traders react positively to it, the dip may be small, or may not occur at all. Strong news tends to create bottoms that are very "fast" and difficult, so you must anticipate these fast bottoms and react quickly with your buy order to catch them.

Learning to interpret how the news will affect a stock's momentum is more of an art than a science and comes only from watching the stock's reactions to different information over time.

Generally speaking, a strong story will have an immediate and significant impact on the earnings of a company, such as a pact or deal made with a larger company creating an immediate influx of revenues. An example would be Iomega, a maker of high-capacity zip drives, announcing a deal with Dell Computer to include their drives in all of Dell's low-end computer systems. Anything else fizzles out fairly quickly.

Shorting strategies

The second way to play a gainer stock is to short it at the first high using the same method used to identify the exit point in the long-trade scenario: wait until the majority of the trades on the time-and-sales screen are sells (trades at the bid) while buys (trades at the ask) are decreasing. If the dips on the open are small, non-existent or bottom too fast to catch, the only way to play them is to short at the high.

Similarly, if a stock gaps up 10 percent or more on the open of day 2 on news that doesn't impact the immediate earnings of the company, consider shorting at the open — sell as soon as you see an uptick after the opening bell. Stocks that gap up on weak stories tend to drop very quickly because traders take short-term profits at the open and panic selling often follows. Investors just cannot understand why the stock has dropped on such great news until they realize the news doesn't really affect the company's bottom line in the immediate future.

However, a stock with a story that has a large immediate impact on the company's earnings, such as the Iomega zip drive example, should not be shorted on the open because it may run up an abnormal amount. (This has been the case with some of the recent Internet and biotech stocks.)

Playing the gap

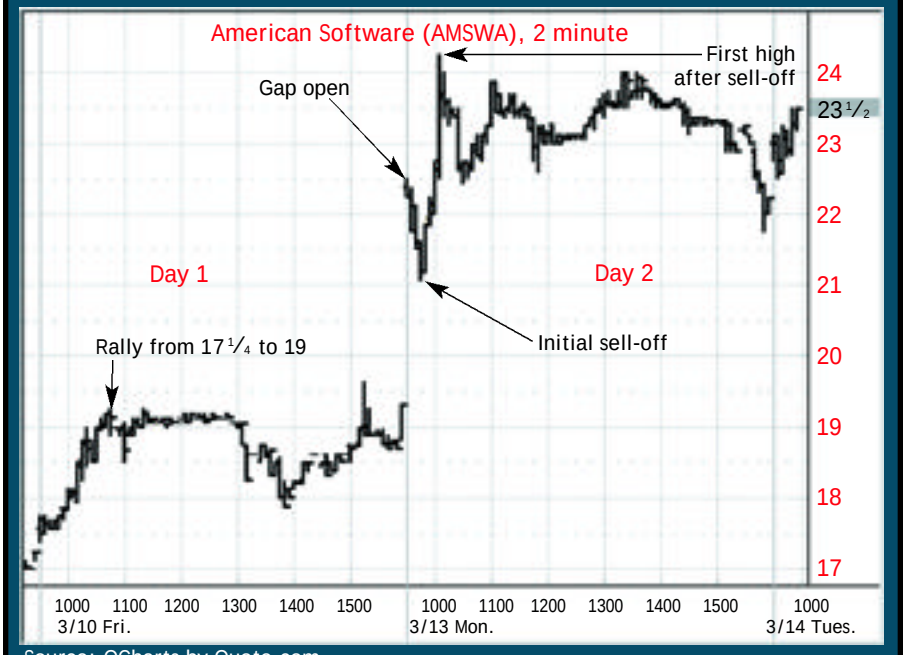
When strong news is released during the trading day and is repeated on CNBC and various news wires throughout the day and after the bell, it creates even more overnight buying pressure. Many times this momentum carries over to the following day.

Some traders try to take advantage of this late-day momentum by going long near the closing bell, anticipating the buying pressure to continue overnight and result in a gap opening the next morning.

Stocks often **make** their **largest moves** in the **first two hours** of the **trading session.**

FIGURE 2 GAINER STOCKS

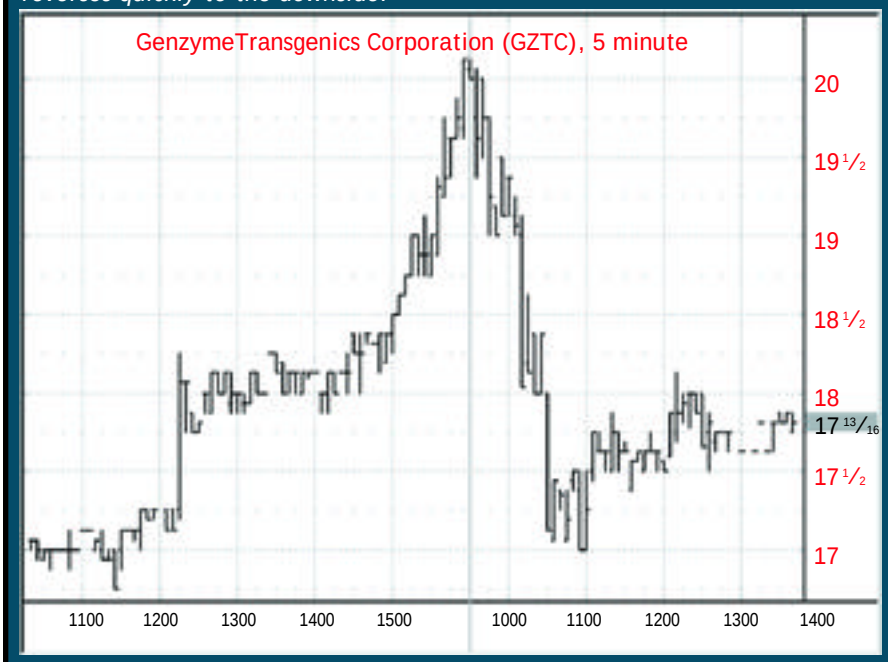
A gainer pattern triggered by news of a strategic alliance with IBM: AMSWA gaps higher on March 13 after a strong up day. The stock quickly pulled back, then made a strong move to the upside.



Source: QCharts by Quote.com

FIGURE 3 SELLING AT THE BELL

Always sell at the opening bell after establishing a long position on the previous close to take advantage of a potential gap open. Doing so will avoid the losses that can occur on days like this one when the market reverses quickly to the downside.



Source: QCharts by Quote.com

You can play gainer stocks for the overnight gap at the end of day 1 or day 2.

Because anything can happen overnight, holding a position in a stock after the close increases your risk exposure. The company could release bad news that may cause the stock to gap down or even halt the next morning. Many inexperienced traders who want to play overnight gaps tend to jump on anything that is moving and showing upward momentum near the end of the day, which is the No. 1 reason they normally fail. To increase winning percentages and decrease risk, make sure the stock meets these six criteria:

- It closes near the high of the day.
- It is up more than 20 percent from the previous day's close.
- General market conditions are positive.
- News driving the momentum is strong and has an immediate impact on earnings.
- There is heavy buying in the last five minutes of the trading session (watch time and sales).
- Gainers on day 2 are consistently following the same pattern (i.e., gapping open, dipping a small amount then climbing).

Many traders try to squeeze more profit out of potential overnight gaps by entering positions 30 minutes or so prior to the closing bell. This is dangerous because stocks can change direction quickly, leaving you with an overnight position on a stock with negative momentum. Waiting to buy in the last five minutes will give you a better idea of whether the momentum and direction is clear at the end of the day and will also make it easier to know whether the stock is likely to close near the high of the day. You may not get as much profit as someone who "guessed" the right stock 30 minutes earlier, but over time your profits will be greater and more consistent, and your risk will be smaller.

Before you play overnight gap patterns, you must ensure the pattern is active and acting predictably. Go back to earlier in the day and note how gainer stocks behave near the open. This does not rule out playing the gaps at the end of day 1; you simply need to look at a completely separate set of gainer stocks from the previous day and determine how they gapped that day. Consider the following factors:

- Other gainer stocks should be gapping up on day 2.
- Is there a dip near the open? How much and how many bottoms?
- How large or small was the bounce after the initial dip?
- How quick are the bottoms (i.e., does the downward momentum at the first dip stop and change direction too quickly to enter and fill your buy order)?
- How quick are the tops (for selling expectations)?

If all the criteria are met and the pattern is active and acting predictably, you should enter the trade as close to the bell as possible — perhaps 30 seconds to one minute before the bell.

When holding a stock overnight, always exit the trade at or before the bell the next morning. This is your insurance against a big sell-off that does not recover the next day.

Figure 3 of Genzyme Transgenics (GZTC) shows the value of the "sell at the bell" rule. The stock rose from 17 to 20 on March 31. It opened the next trading day, April 3, at 20⅛ and soon fell to 17. If you had played this stock at the close of the market on March 31 for an overnight gap play and had decided to wait out the first bounce April 3, you would have been in for a very painful and costly wait.

The profits of 10 good trades can be wiped out with one bad one like this. Cash in your insurance policy and always sell at the bell.

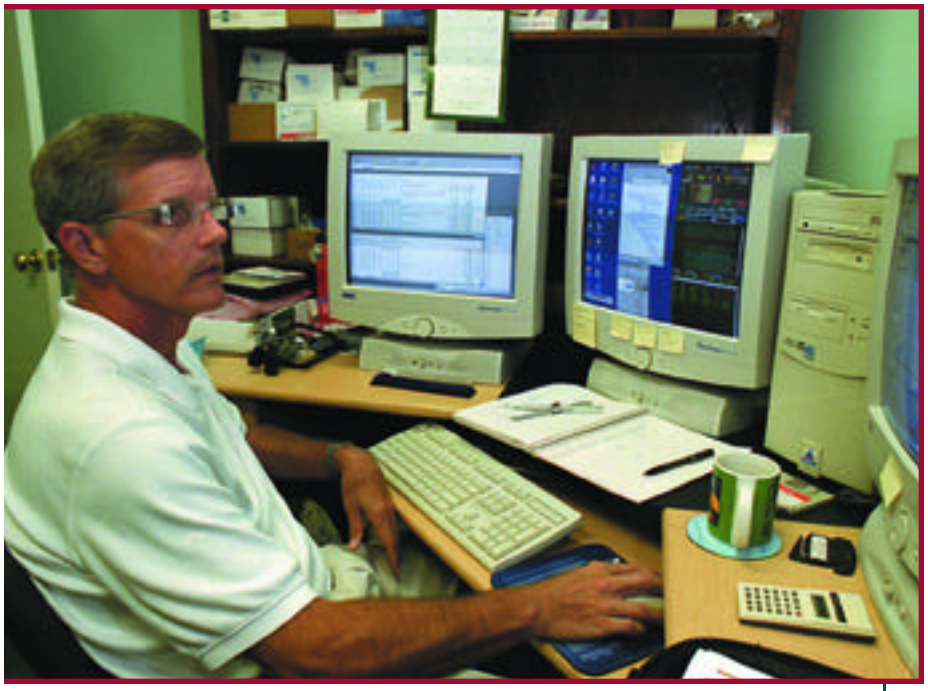
Risk control

When playing any stock, your No. 1 concern is capital preservation. The only way to protect your equity is to use a solid stop-loss program.

Before you enter a trade, identify what your pre-determined exit or stop-loss will be and honor these points. This should be dependent on portfolio size, size of position, market conditions and personal comfort. For example, a quarter-point stop-loss on a 500-share position would cap risk at $125. For a 250-share trade, a half-point stop would also limit risk to $125. But the acceptability of this risk level is in turn dependent on the size of your portfolio. If your trading portfolio is 40K, a loss of $125 is more than acceptable (a very low .03 percent), but would have considerable impact on a 10K portfolio (1.25 percent) and could be reduced. The bottom line: If the reason you entered a trade is no longer valid, exit.

Dentist tries new drill: SHORT-TERM TECHNICAL TRADING

BY ALLEN SYKORA



© Kellie McCann

" I don't think I'm nearly as good at this as I'm going to be. I constantly re-evaluate and study my trades and techniques. "

Kevin Bryant spent years thinking technical analysis was some form of "voodoo." Now, though, it's the only thing the Savannah, Ga.-based dentist uses in his trading.

Bryant has been a stock investor since 1982 and began trading shorter-term in 1999. Over the years, he read numerous articles suggesting there was little value in technical analysis.

Over time, though, he found that fundamental analysis alone was not helping him with his market timing. And a conversation with a friend who was taking a day-trading course eventually led Bryant to a completely different view of technical analysis.

"Are you nuts?" Bryant recalls saying when his friend told him what he was doing. "He asked, `Do you know what a (Nasdaq) Level II screen is?'"

The friend showed Bryant.

"It was all pretty much Greek the first time I looked at it," Bryant says. But at the same time, he found himself mesmerized.

Bryant and his 16-year-old daughter began simulating day trades. They found that with a hypothetical $100,000 account, they could regularly make $5,000 a day. He now knows that figure was exaggerated mainly because he wasn't accounting for slippage or brokerage commissions in his paper trading.

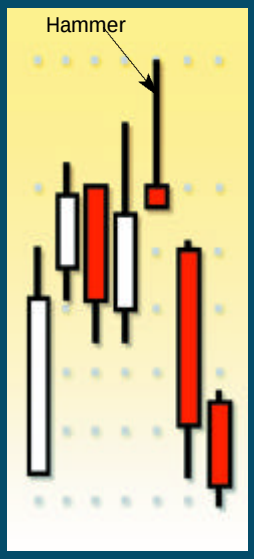
Bryant began experimenting with various forms of technical analysis, but "I was still convinced there was nothing to it." However, a particular one-bar candlestick pattern — the "hammer" — caught his eye because it routinely showed up in certain situations.

This particular candlestick has a small body with a long tail or shadow in one direction (see Figure 1). Bryant explains it has no significance in a sideways market, but can warn of a reversal in a trending market.

"It was obvious that something other than random occurrence was at play," Bryant says. "Prior to that, I would not have bothered trying to divine information from chart patterns. This is what caused me to question my bias [against technicals] and to see what else I may have been overlooking."

FIGURE 1 HAMMER

The "hammer" is a one-bar candlestick pattern that can signal a reversal in a trending market



Meanwhile, a certain saying — "cut your losses but let your profits run" — puzzled Bryant.

"That made no logical sense to me," Bryant says. "How do you know whether it's a winner or a loser when these things are always jiggling? If you hold a winner, do you hold it until it becomes a loser? How do you know when it stops being a winner?"

Things began to make sense to Bryant after he read an interview with trader Joe DiNapoli, who specializes in advanced Fibonacci analysis. Bryant liked the logic behind DiNapoli's approach, so he bought his book *Trading With DiNapoli Levels* and has since read it four times. DiNapoli uses a number of directional indicators, but Bryant mainly relies on a setup that DiNapoli calls "the bread and butter."

"You have an entry point. You have a profit objective. And you have a stop point when you get in," Bryant explains. He characterizes Fibonacci analysis — which bases entry and exit points on retracements and expansions to certain pre-determined levels such as 61.8 percent or 38.2 percent — as a "self-fulfilling prophecy." The methodology is predicated on the concept that prices will move from one Fibonacci point to another.

Now, Bryant says, "I don't pay any attention to fundamental analysis at all."

Bryant generally trades around seven to 10 times a day, and estimates his average trade length is three days. A trade he made in February in Verilink Corp. (VRLK) illustrates his favorite trading approach (see Figure 2). The stock climbed from a low of 6¼ on Feb. 7 to a high of 13¼ on Feb. 17. A Fibonacci retracement of 61.8 percent would have taken the stock back to around 8 15/16 (13¼ - [.618 (13¼ - 6 ¼)]).

Bryant uses a couple of entry techniques. One is to place a limit order right at the retracement level. Other times (including this particular trade) Bryant will wait until the next day and look for more retracement patterns on shorter-term charts, perhaps as short as five minutes.

Bryant bought the stock on Feb. 28 at 9 1/16. A 61.8 percent retracement of the move from 13¼ to 9 1/16 would have resulted in a move to 11 9/16. So, Bryant put in a limit order to sell when the stock got back to 11½.

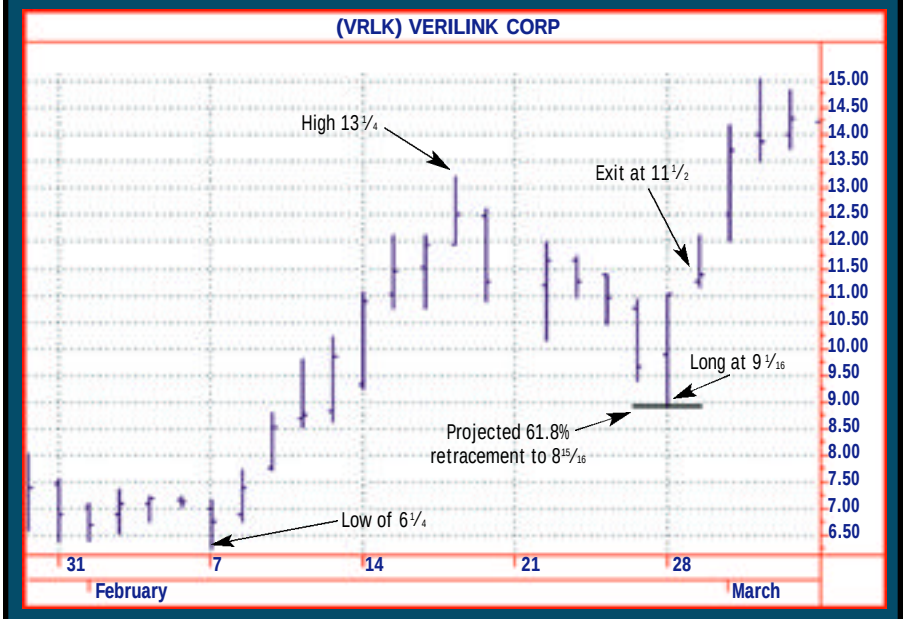
Bryant likes to place his limit orders slightly in front of the exact retracement level to increase the likelihood he will get out of the market with a profit, just in case other selling or profit-taking sets in before the level is reached and sends the price back down.

"I want to make sure I get filled before it heads back in the other direction," he says.

The day Bryant entered the Verilink trade, the stock rallied to 11. The day after that, he exited the position with a

FIGURE 2 CATCHING THE RETRACEMENT

An approximately 61.8 percent Fibonacci retracement provides the entry point for a long-side trade.



Source: WindowOnWallStreet.com

profit when his 11½ limit order was hit (the stock traded above 12 that day before closing at 11⅜).

Bryant won't enter a position without having a protective stop close to his entry level. For example, in the Verilink trade, he placed an exit stop at 8⅞, just below the retracement target of 8 15/16.

"If I'm wrong, I know almost immediately and I'll get stopped out for a small loss," he says.

Bryant points out that he has more losing trades than winning ones. During the three-month period prior to this interview, he had 79 winners and 160 losers. However, his profit-loss ratio (the ratio of dollars earned to dollars lost) was 2.63 to 1, allowing him to earn a profit even though he had two losing trades for every winner.

It takes time to develop a methodology and achieve success, Bryant cautions.

"I think I've knocked a good bit of time off the learning curve by obsessively looking at charts and repeating chart patterns," he says. "I'm finding that I'm surprised less and less by price action."

Bryant has been practicing dentistry since he graduated from the University of Louisville in 1979. He spent three years treating Marine Corps recruits at Parris Island, S.C., and has been in Savannah since. His current practice leaves him ample time to trade and study the markets.

In fact, he doesn't even schedule patients during the first 90 minutes of the trading session, or during the final hour before the closing bell. When he can't watch the market, he uses conditional orders (market orders that are triggered if a stock price reaches a certain level).

"I don't like to use those, because you can get lousy fills with market orders," he says. So, when he is able to monitor his charts, he'll use limit orders.

Bryant looks for a certain amount of liquidity so he won't take a beating on a fill through slippage. He uses a rough formula to identify acceptable stocks: The current price multiplied by the average daily volume of the last month has to be 8 million or more. He also looks for stocks that are volatile, which, obviously, includes a lot of technology stocks.

Bryant watches CNBC as he trades. But he's not looking for anything that will help him decide when or what to buy or sell.

"I would hate to miss any of the humorous brokerage commercials," he says with a grin. "It's also fun to see how many times each day some expert announces the end of the world vs. the number of times other experts warn that you better get in now or you're going to miss the boat."

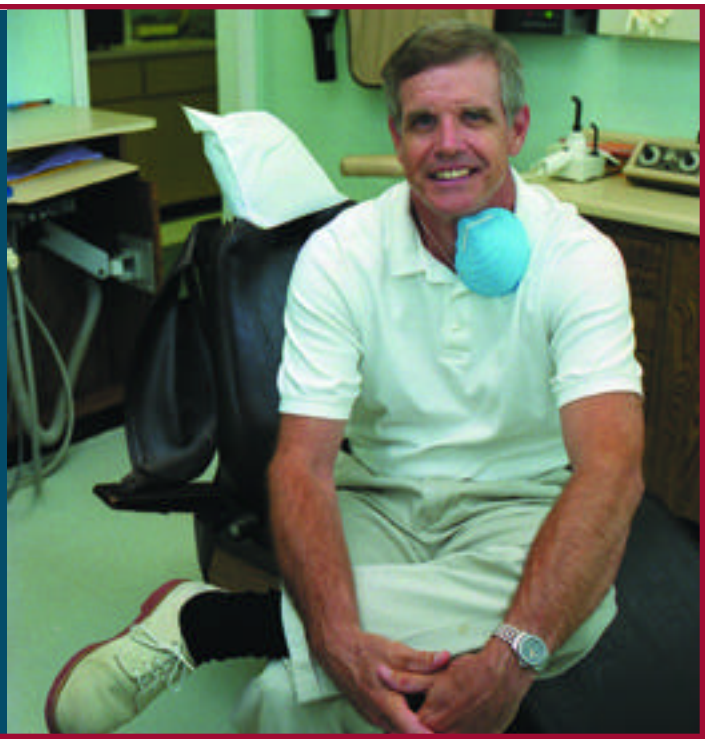
Away from the office and the markets, Bryant's pastimes include scuba diving, tennis and golf, but he concedes he sometimes gets frustrated at golf because he strives to be perfect.

"I don't try to be; I can't help it," he says.

That compulsion to be perfect has helped him with his trading, though. He spends "ridiculous" amounts of time studying charts and looking at computer screens.

"I don't believe I'm nearly as good at this as I'm going to be," Bryant concludes. "I constantly re-evaluate and study my trades and techniques."

> "I'm finding that I'm surprised less and less by price action."



Trading setup

Hardware: *Primary:* 450 MHz with 256 RAM and two 10-GB hard drives; three 19-inch monitors. *Secondary:* 300 MHz with 17-inch monitor, used mostly for e-mail and Web browsing.

Internet connection: ISDN, with a 56K modem backup.

Software: Real Tick III from Townsend Analytics. Big Easy Investor and Hard Right Edge for nightly stock screening.

Brokerage: CyberCorp (direct access), because of the stops and conditional orders that can be used.

Learning MARKET LESSONS

BY COREY GOLDMAN

It all started innocently enough in the library.

The year was 1999, and all the rage among the sages at York University in Toronto wasn't Nietzsche, Keirkegaard or Shakespeare. Rather, it was stocks — Internet stocks, particularly.

They would gather at the crack of dawn in the sprawling, ultra-modern school library and park themselves in front of brand new, state-of-the-art Pentium computers with T1 Internet access.

Some dabbled a bit in the pre-open market, trying to make ⅛ or 1/16 on a high-tech stock. Others would type away on instant message programs or monitor chat rooms, on the hunt for the hot stock of the day. Occasionally, an expletive or a fist meeting a table would break the silence.

Elliott Gwosdy was in the thick of it. Like a good soldier, the lanky, bespectacled 28-year-old would each day stuff his backpack full of the books and papers he needed to study for his Bar exam, take a swig of orange juice and head out to the library.

There, he would do what the others did — shove his books aside and begin surfing the Net for trade opportunities. He'd scour Web sites and chat rooms for any information he could find about stocks — small-cap, mid-cap, penny — anything that might have a little bit of momentum to trade.

Through his online brokerage, Gwosdy had 50 percent margin extended to him through his Registered Retirement Savings Plan (the equivalent of an Individual Retirement Account in the U.S.), giving him access to a grand total of $100,000 (Canadian) to play with in the market. He traded both U.S. and Canadian stocks.

"To me, it was almost like a game," Gwosdy says. "It was a way to make money. I'd be lying if I said I didn't get a rush out of it. For three months it gave me something to really focus on and work on each day, even though it was taking over my life and making me sick."

Gwosdy started out trading penny stocks. He traded on momentum — looking for a stock to jump and pull back, then eyeing the volume and looking for evidence of another move to the upside. He'd watch a particular stock rise, falter, rise, falter — and then he'd move in for the kill, scooping up 7,000 or 8,000 shares.

"If it broke the first resistance and there was still healthy volume on it, that's when I would buy," he says.

Soon Gwosdy graduated to the Nasdaq market, buying stocks such as Euroweb International (EWEB), an Internet Service Provider, for 12. He sold it at 19 "because they talked it up on CNBC and I knew people would get into it," he says.

He bought and sold stocks just ahead of their earnings reports, or just after they were profiled on CNBC (such as EWEB) or some other business show. He followed some companies based on volume, others based on price targets and charts. But mostly he looked for stocks that would get a boost from the prevailing "public opinion" he came across in the online chat rooms.

"I started to become obsessive," Gwosdy recalls. "I was very aware that this was starting to become irrational trading. You need strategy and discipline, and a good portion of what I was making was based on luck."

"You need strategy and discipline, and a good portion of what I was making was based on luck."

> "I was getting too impulsive... I was very aware that my trading was starting to become irrational."

Even so, he decided to move from the bowels of the library and trade full-time from home. He bought a new computer and had a high-speed digital access line installed in his mid-town Toronto apartment.

Although he was making money, and good money at that, Gwosdy didn't necessarily feel good about his trading.

"My timing was pretty good, but it was really taking over my life," Gwosdy says. "I was unemployed and I was stressed out of my head. You're buying stuff you don't believe in, but it's all going up. You never really feel comfortable with what you own, but you don't want to miss opportunities."

Gwosdy didn't bother putting any stop orders on any of his trades or using any other risk control techniques "because I really felt I was disciplined," he says.

But Gwosdy's run came to an end when he took a hit on software maker Microstrategy Inc. (MSTR). The stock took a dive in mid-March after it unveiled a worse-than-expected quarterly loss and announced it was revising its previous years' results (see Figure 1).

On March 20, Gwosdy assumed the stock would drop at the open, presenting a buying opportunity, and then recover. Drop it did, opening more than 100 points below the previous close of 226¾. He jumped in at 116, figuring the stock would rebound (see Figure 2).

It didn't.

"It got creamed," Gwosdy says. In less than 60 minutes, he sold at 99 (the stock traded as low as 85¾ that day). "That was when I decided I had had enough. That was my last trade. I was getting too impulsive."

If there was an upside to the situation, it was that Gwosdy's exit from the market preceded by about two weeks the steep market sell-off — triggered by concerns about overvalued tech stocks — in April. And overall, Gwosdy managed to end his three-month trading odyssey with a good profit. (During the height of his trading binge, he was up nearly 100 percent.) Still, Gwosdy has no regrets about getting out when he did.

"The whole thing was a calculated gamble," Gwosdy reflects. "And when you're on margin it's a whole different ball of wax. It makes the losses that much more pronounced, obviously. Will I go back to it again? Not as a full-time job. I like trading equities, but I'd be a lot pickier about what I traded if I went back to it again."

FIGURE 1 CRASH AND BURN

High-flyer MSTR collapsed in March, catching many traders off-guard

Source: WindowOnWallStreet.com

FIGURE 2 LOWER AND LOWER

Opening 100 points lower than the previous close, MSTR fails to rebound intraday.

Source: WindowOnWallStreet.com

Reining IN RISK

For many traders, money management is the ugly stepchild of the trading family. But you can ill afford to neglect this aspect of your trading plan.

Here's a breakdown of the fundamental money-management concepts you should understand, and tools and ideas on how to implement them.

BY GIBBONS BURKE

Money management is like sex: Everyone does it, one way or another, but not many like to talk about it and some do it better than others. But there's a big difference: Sex sites on the Web proliferate, while sites devoted to the art and science of money management are somewhat difficult to find.

There are many, many financial sites on the Web that let you track a portfolio of stocks on a glorified watch list. You enter in your open positions and you get a snapshot, or better yet a live, real-time update, of the status of your stocks based on the site's most recently available prices. Some sites, like Fidelity's, provide tools that tell you how your portfolio is allocated among various asset classes such as stocks, mutual funds, bonds and cash.

While such sites *get at* the idea of money or portfolio management, the overwhelming majority fail to provide the tools required to answer the central question of money management: "When I make a trade, how *much* do I trade?" (Try and find the topic of money management on the Motley Fool site.)

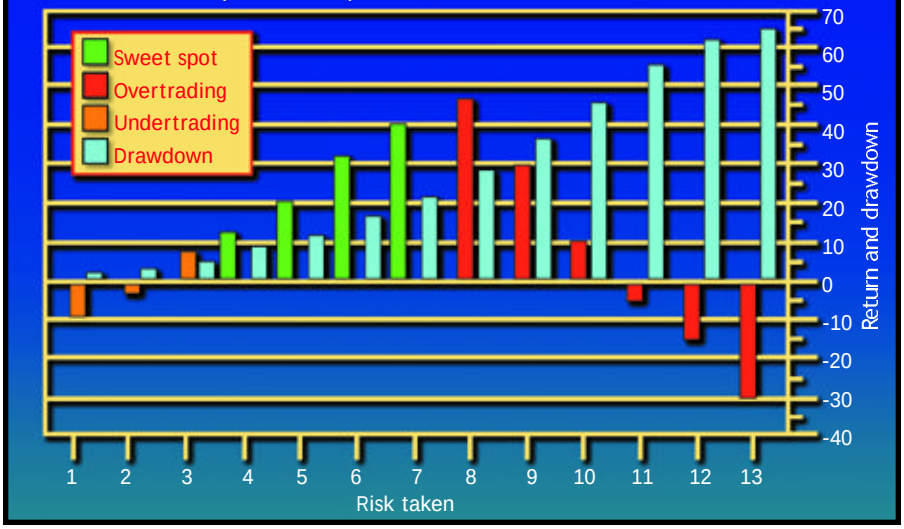
We'll discuss how to measure and manage trade risk and where to find the tools to help do it in a responsible and profitable manner. The key underlying concept is to limit how much money you are willing to let the market extract from your wallet when you inevitably make losing trades.

When any trader makes a decision to buy or sell (short), they must also decide at that time how many shares or contracts to buy or sell — the order form on every brokerage page has a blank spot where the size of the order is specified. The essence of risk management is *making a logical decision* about how much to buy or sell when you fill in this blank.

This decision determines the risk of the trade. Accept too much risk and you increase the odds that you will go bust; take too little risk and you will not be rewarded in sufficient quantity to beat the transaction costs and the overhead of your efforts. Good money management practice is about finding the sweet spot between these undesirable extremes.

FIGURE 1 RISK vs. REWARD AND DRAWDOWN CURVE

Proper money management is a function of finding the point that maximizes return within acceptable risk parameters.



Overtrading and undertrading

Figure 1 (below) shows the relationship between the long-term result of a series of trades and the amount of risk taken on a per-trade basis.

If you risk too little on each trade, shown by the undertrading zone, the returns will be too low to overcome transaction costs, small losses and overhead (quote feeds, electricity, rent, subscription to *Active Trader* magazine, etc.) and trading will be a losing proposition.

Risk more and the returns will increase, but note that the potential *draw* -

down (account losses you will need to endure to get the return — another cost of doing business) always increases as you increase the per-trade risk. Returns continue to increase moving into the overtrading zone. Trading at the peak of the potential return curve is very difficult psychologically because the per-trade drawdowns can be extremely high, and the margin of safety for dealing with unexpectedly high losing trades is very low. In other words, you're getting into territory where one unexpectedly large loser can blow you out.

The best place to live on this curve is the spot where you can deal with the emotional aspect of equity drawdown required to get the maximum return. How much heat can you stand? Money management is a thermostat — a control system for risk that keeps your trading within the comfort zone.

It's more than stops

It's surprising that even many active traders and investors have no idea what money management is about. They generally entertain a fuzzy notion that it has to do with setting stops, and that discipline is involved to make sure you execute the stops when they are hit, but their understanding doesn't go much further. Most people seem content to let their brokers track their trades for them, and the tools provided by the brokerage sites are adequate to the task.

But none of the online broker rating services tell you about brokers who provide the tools to help you manage these risks, and none of the traditional online or even most hyperactive day trading brokerage firms seem to cover this important contributor to trading success (or failure).

Why is this? Perhaps it can be explained by the extended bull run this market has enjoyed since 1982, and the speculative, maniacal extended leg of the bull market fueled by the dot.com land rush since 1997. This type of market — where making money consists of taking a ride on the back of the bull trend and buying the dips — tends to turn the merely bold (and possibly reckless) into market geniuses. The perceived risk in stock market investing has been very low, so the need to manage that risk has not been a pressing concern. Why worry when it will always come back and you can make a killing if you buy more?

More important to success than managing risk has been the ability to charm your broker into getting you into the latest IPO allocation.

Two types of player

There are really two types of people operating in the financial markets: traders and investors. It is useful to understand the difference between the two — it may explain, in part, why so many people ignore risk management.

Many people who call themselves traders are, in reality, active investors. The typical investor only purchases stocks and buys as many as possible with all the available cash in his or her account. The risk-free position, for the typical investor, is to be fully invested in stocks for the long term, because, as we all know, stocks "always" go up (*sure*). When active investors get more investment cash, they plow it into their mutual funds or buy individual stocks.

The investor's game seems to consist of selective hitchhiking on a freeway that is only going in one direction with the object of getting a ride from the Mercedes driving in the fast lane. They don't know how far the car is going to go and they don't really know when to bail out when the car starts driving in reverse.

These hitchhikers are slow to switch cars when one hits the brakes, runs out of gas or blows a head gasket. There is a great amount of hope and faith involved.

Many of these active investors don't pay attention because they operate under the assumption, reinforced by a 20-year old bull, that the market eventually will go up again and the safe thing to do is hold on or, smarter yet, buy more to lower the cost basis on the position. In this game it doesn't matter very much whether the car has good brakes or seatbelts — the gas pedal and cruise control are all that matter.

This sort of trading can work in good times, but when the bull turns into a bear, there is going to be a big pileup of fancy cars on the freeway full of drivers who don't know how to deal with the reality of investing risk.

Good *traders* operate differently. If buy-and-hold investing is like hitching a ride on the freeway, short-term, active trading is more like a demolition derby. Traders are not loyal to the stocks they buy and sell. They measure the risk of each trade. They may have profit objectives but more commonly they use strict risk management as brakes and seatbelts to protect them in the melee and allow them to maneuver quickly. Success in this game is often more dependent on the use of brakes than the accelerator pedal.

Bad traders bring the biases and habits of the freeway-hitchhiking investor into the demolition derby of short-term, active trading, which requires completely different skills and a unique way of thinking. These reckless traders go merely beyond simply buying dips and constant-dollar investing with all their cash: They trade on margin, borrowing money from their brokers to buy more dips and invest in more stocks. When they are tapped out on margin they use credit cards to plow more rental money into stocks — with little regard to the risk that goes along with this degree of leverage.

They are entering the demolition derby ring in a *borrowed* V12 Mercedes and, because they are not used to managing risk, they don't understand how to read the speedometer, operate the brakes or fasten the seatbelts.

Faith, hope and prayer should be reserved for God — the markets are false and fickle idols.

Money management tasks

You need to perform the following important money management chores to do the job properly:

- Determine how much you are will-

ing to risk on each trade.

• Understand the risk of the trade you are about to take and size the trade appropriately.

• Track the trade going forward.

• Pay attention to your risk points; take small losses before they become big losses.

• Review your performance.

Determining per-trade risk

The most important decision you need to make is how much you are willing to risk on each trade relative to your entire portfolio. For example, many of the top traders in Jack Schwager's *Market Wizards* books said they limited this amount to less than 2 percent of their stake.

The reason to keep this number small is to protect yourself from a series of

Tools for understanding and practicing good money management

A few Web sites provide software or Web-based tools for understanding money management. Most of the large finance sites do a fair job at letting you track the value of your investments, but none of them are really suited for tracking the performance of a trading program — for that you need a piece of software.

The popular finance software packages, such as Quicken and Microsoft Money, can track the history of your transactions but don't do as good a job at treating these as trades. They're fine

TABLE 1 SOFTWARE SITES — SIZING THINGS UP

Software	Type	Risk Mgmt?	Company	Web Address	Price	Comments
Athena Money Management	Software	Yes	International Institute of Trading Mastery, Inc.	www.iitm.com/software/ii05002.htm	$12,500	Associated with the money management practices of Dr. Van Tharp, an investment psychologist
kNOW Software	Web site	Yes	MoneySoft.com	www.moneys-oftware.com	n/a	Software is no longer available but the site has very good information
Money Maximizer	Software	Yes	Trading Research Design	www.moneymax-imizer.com	free trial; Full $159; Pro $259	Written by a top-rated hedge fund manager
QCharts	Software	Yes	Lycos/Quote.com	www.qcharts.com/	$89/mo.	Quote sheets track stops; calculate trade and portfolio risk updated in real time
Trade Tracker	Excel	Yes	TraderCraft Company	www.tradercraft.com/download	freeware fee $25	Excel spreadsheets updated in real time
Trade Factory.com	Web site	Yes	TradeFactory.com	www.tradefactory.com	$299 + $99/mo.	Based on the famous Turtle Trading methods
Captool	Software	No	Captools Company	http://captools.com	$249 - $3,500	Complete professional tool; includes tax accounting
Fund Manager	Software	No	Beily Software	www.beiley.com/fundman/desc.html	$39; manual $2	Specially suited for tracking mutual fund performance
Money 2000	Software	No	Microsoft	www.microsoft.com	$64.95	—
Quicken Deluxe	Software	No	Intuit	www.intuit.com/quicken	$59.95	—
Money Deluxe	Web site	No	Microsoft Investor	www.moneycentral.msn.com/investor	$59.30	—
Portfolio	Web site	No	Quote.com	www.quote.com	free	Daily portfolio valuations; e-mail alerts
Medved Quote Tracker	Webware	No	2GK Inc.	www.medved.net/QuoteTracker	free; no ads $60	—
Stocktick	Webware	No	NAC Consulting	www.nacon-sulting.com	$24.95	—
StockVue 2000	Webware	No	NQL Solution	www.stockview 2000.com	free; banner advertisements	—

losses that could bring you to the point of ruin. Losing trades are a fact of life when trading — you *will* have them. The key is to limit those losses so that you can endure a string of them and have enough capital to place trades that will be big winners.

Understanding trading risk

It's easy to determine how much risk there is in a particular trade. The first step is to decide — before you put the trade on — at what price you will exit the trade if it goes against you. There are two ways to determine this price level.

The first is to use a trading method based on technical analysis that will provide a reversal signal or a stop-loss price for you.

The second is to let money management determine the exit when you don't have a technical or fundamental opinion about where the "I was wrong" price point is. This is where you draw a line in the sand and tell the market that it cannot take any more money out of your wallet.

The point is that no matter what your approach — whether technical, fundamental, astrological or even a random dartboard pick — you should not trade or invest in anything without knowing, at all times, what your exit price will be. You need to know this price ahead of time so that you don't have to worry about the decision when that price is reached — the action at that point should be automatic. You won't have time to muddle it out when the market is screaming in the opposite direction you thought it would go!

If you are using the first method (where your timing method provides an exit stop automatically), you can use the following formula to determine how many shares of stock to buy or sell:

$$s = \frac{er}{p\text{-}x}$$

where

s = size of the trade
e = portfolio equity (cash and holdings)
r = maximum risk percentage per trade
p = entry price on the trade
x = pre-determined stop loss or exit price

Tools for understanding *continued previous page*

for showing you the value of your portfolio, and can save you time preparing your tax return, but they are not suited to executing the steps outlined in the main story.

Table 1 is a list of sites and software packages that help with these tasks, some better than others. Money Maximizer, software written by traders for traders, is a good package for managing your trading risk by sizing your trades to the amount of risk you want to take. The interface can be a bit clumsy and the program leaves a few things to be desired, but it's a good overall package; the "Size-It" tool (right) sizes your trades based on risk relative to core equity.

Another software package that showed a great deal of promise — but is no longer produced — is kNOW Software by MoneySoft.com. The Web site provides an excellent online manual and the tutorial is a worthwhile and instructive guide to good money management practices.

The Athena software looks good, too, but its price tag is rather steep: $12,500. The site is worth a visit — Dr. Van Tharp provides some good information on proper money management.

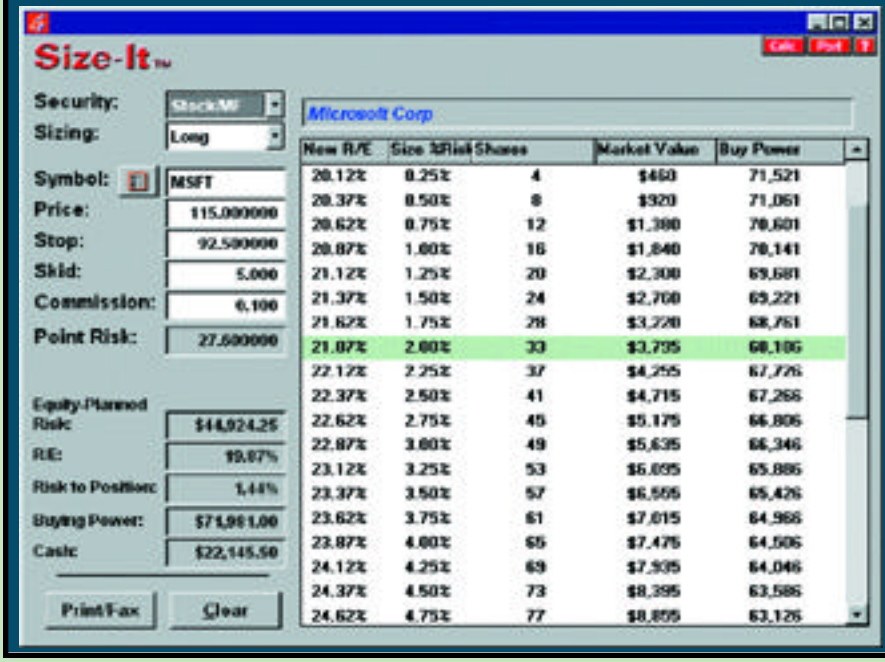
Excel makes an excellent tool for implementing the formulas listed above. (It's what I use for my own trading, in combination with Quote.com QCharts live quotes package. The Quote.com QFeed includes an add-in to power Excel spreadsheets with live quotes. The spreadsheet is freeware available at no charge on my Web site listed in the table.)

Some of the tools listed are a cross between software and a Web site ("Webware"). These packages are generally free but are paid for by banner ads displayed in the window of the software. The Medved quote tracker lets you turn off the ads if you register and pay the $60 fee.

Money management is a complex subject, but one that is necessary to master if you want to enjoy a sustained trading career. The books listed in "Money Management Reading" (above right) provide additional information on this multi-faceted topic.

FIGURE 2 SIZING THINGS UP — MONEY MAXIMIZER SAMPLE TRADE

The Money Maximizer's "Size-it" tool calculates how many shares to trade based on risk relative to core equity.



For example, Belinda has a trading account with a total value (cash and holdings) of $100,000 and is willing to risk 2 percent of that capital on any one trade. Her trading system gives her a signal to buy DTCM stock trading at $100 per share and the system says that the reversal point on that trade is $95. Plugging this into the formula tells Belinda that she can buy 400 shares of DTCM. The cost of this investment is $40,000, but she is only risking 2 percent of her capital, or $2,000, on the idea.

Belinda then gets a tip from her brother-in-law that KRMA is about to take a nose dive from its lofty perch at $40 because he heard from his barber that earnings of KRMA will be well below expectations. She's willing to go short another $10,000 of her stake on this idea. She studies a KRMA chart and can't see any logical technical points that would be a good place to put in a stop, so she uses the money management method to determine the stop according to this formula:

$$x = \frac{p(i-er)}{i}$$

where:

x = pre-determined stop loss or exit price
p = entry price on the trade
i = investment amount
e = portfolio equity (cash and holdings)
r = maximum risk percentage per trade

Since she's shorting KRMA, the value for *i*, $10,000, should be negative. Plugging these values into the formula above would tell Belinda that her stop price on the short sale of KRMA should be 48. If she didn't want to assign a high confidence on this trade she could reduce the max risk to 1 percent (r=0.01), which would bring the stop down to 44.

Another worthwhile variation to these methods is to use Ed Seykota's "core equity" for *e* in the formulas rather than the total value of all holdings in the portfolio. Core equity is what you have left when you subtract the total value at risk in all open positions from the total equity; value at risk in each trade is calculated by multiplying the number of shares in the position by the difference between the current price and the stop price on that trade.

Using the core equity value as the basis for sizing new trades has the desirable effect of automatically reducing the risk exposure on new positions when market volatility in your existing positions increases.

Tracking your trades

It is important to watch your positions as they progress and adjust your stop prices as the market moves in your direction.

In the first example, if DTCM moves from $100 to $120 and the stop is left at $95, what started as $2,000 or 2 percent at risk is now $10,000 (9 percent of the total equity) at risk.

The mistake most people make is to consider trade winnings on open "house money" — that somehow this money is less painful to lose than the money in your back pocket.

This is a bad mental habit. If losing 2 percent of equity on a trade would be painful to Belinda when her account was at $100,000, losing 9 percent after the stock has moved to $120 should be several times more so. Moving your stop loss up with the price on a winning trade does several good things: It locks in your profits and if you are using core equity to size new positions, it will allow you to take more risk on new trades.

Never move a stop backwards from its initial price — stops should always be moved to reduce, never increase, the amount of risk on a trade.

Past the initial risk you are willing to take, stops should be a one-way valve for the flow of money from the market to your account.

Terminating with prejudice

A money management plan will only be useful if you do what it says. As the saying goes, you must plan your trades and trade your plan. If a stop price is hit you must take that hit.

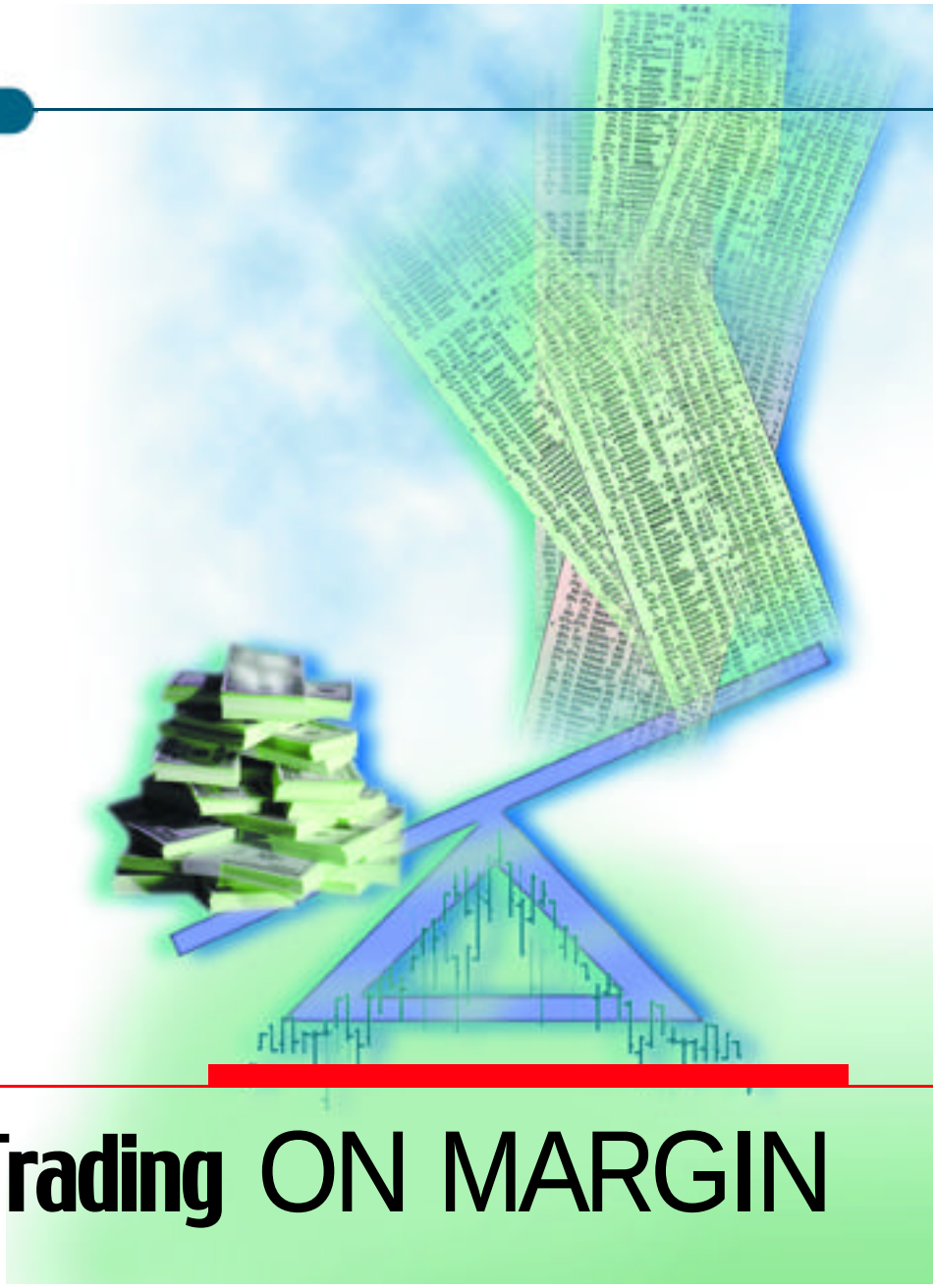
If you find that your system is generating stops that are constantly getting hit, then perhaps you should re-examine the rules of the system — but don't mess with your money! Second-guessing the approach will cause you to take on more risk than you planned, increasing the chances that a bad trading system will ruin you. Once your stop is gone, how will you know when to get out next?

Take your losses when they are small because if you don't they are sure to get large. In this regard, discipline is of the highest importance. It is a cardinal mistake not to take a stop if it is hit. It's even worse if the stock comes back and turns the trade into a winner because now you have been psychologically rewarded for making the mistake.

Get out quickly and re-assess the situation. If you think it will come back, put on a new trade with a new stop. Faith, hope and prayer should be reserved for God — the markets are false and fickle idols.

MONEY MANAGEMENT READING

Title	Author	Publisher, Date
Against the Gods: The Remarkable Story of Risk	Bernstein,Peter L.	Wiley, 1996
The Four Cardinal Principles of Trading	Babcock, Bruce	Irwin, 1996
The Futures Game: Who Wins, Who Loses, Why?	Teweles, Richard and Jones, Frank	McGraw Hill, 1987
Market Wizards: Interviews with Top Traders	Schwager, Jack D.	New York Institute of Finance, 1989
The Mathematics of Money Management	Vince, Ralph	Wiley, 1992
Money Management Strategies for Futures Traders	Balsara, Nauzer J.	Wiley, 1992
The New Commodity Systems and Methods	Kaufman, Perry J.	Wiley, 1987
The New Market Wizards	Schwager, Jack D.	Harper Business, 1992
The New Money Management	Vince, Ralph	Wiley, 1995
Quantitative Trading and Money Management	Gehm, Fred	Irwin, 1995



Margin may seem like a free ride when the market's going your way, but when it's not, the ride can get rough, as many traders found out this spring. Find out about the rewards and risks of this aspect of trading and whether it's a tool you should use.

Trading ON MARGIN

Trading, at every level, is a balancing act between risk and reward. Accept the risk of trading more volatile markets for the potentially higher returns? Use a tight stop to minimize losses but run the risk of getting taken out of a trade prematurely? The choices are endless.

One of the most fundamental risk-reward decisions you must make is whether to use *leverage:* Do you pay for a trade in a stock, futures contract or other instrument in full or on *margin* — that is, by putting up part of the money for a trade and borrowing the rest from your broker?

Trading on margin amounts to putting a "down payment" on your trade. The standard margin for stock trades is 50 percent, which means if you want to buy 100 shares of a stock trading at $50, you can do so with $2,500 in your trading account (rather than the full $5,000). Your broker lends you the other $2,500 necessary to buy the stock.

Margin trading is a basic issue many novice traders don't understand and take for granted — all they know is that they can buy $5,000 of stock with the $2,500 and it seems like a good deal. Given the remarkable run of the stock market this decade, it's not surprising that many stock traders don't think twice about the downside of using leverage. But it's not an issue to take lightly.

There are advantages to using margin (especially for short-term traders), but very real risks. Case in point: events like the April Nasdaq sell-off (see Figure 1), which brought the issue home to traders who finally felt the sting that comes with trading on margin in a market that

FIGURE 1 **THE DANGERS OF THE DOWNSIDE**

This spring's violent sell-off in the Nasdaq has brought home the downside of margin trading to many traders who had become accustomed to a habitually rising market.

Source: QCharts by Quote.com

decides to go down — dramatically — rather than up.

The trading fulcrum

Leverage is simply a generic term to describe the ability to buy more of a stock (or futures contract or currency, etc.) than you would with just the money in your trading account. When you trade on margin, you're using leverage, a practice that varies from market to market, and in different market conditions. A brief review of the use of leverage in the stock and futures markets will effectively illustrate its most important aspects for new traders.

Stock margin: As mentioned previously, trading on margin means putting up part of the money for a trade and borrowing the balance of the trade amount from your broker. There are a number of rules governing margin trades.

First, to trade stocks on margin, you have to open a *margin account* (as opposed to the standard "cash" account in which you have to pay for all trades in full). The typical minimum balance required for a margin account is $2,000. Certain firms (like direct access brokerages used by many active traders) may require much more money to open a margin account.

As mentioned, the typical margin rate for long stock trades is 50 percent ("2-to-1" margin), meaning you need 50 percent of the total cost of a trade in your account, and your broker lends you the rest (and, of course, charges you interest). For example, if you wanted to buy 100 shares of a stock trading at 60, you'd only need $3,000 in your account instead of the full $6,000 to make the purchase.

Why do this? Because your gains will be doubled — on a percentage basis — if the trade goes your way. Say the stock rallies 10 points to 70. The dollar value of the gain is $1,000, which is what it would be regardless of whether you bought it on margin or not. But a $1,000 profit represents a 33.3 percent gain on a $3,000 margin account while it's only a 16.7 percent gain on a $6,000 cash account.

What's the catch? Easy — the exact opposite occurs if the stock moves against you. Your losses are doubled if you're trading on margin. If the stock dropped 10 points to 50, you've lost 33.3 percent if you're trading on margin, while you've lost only 16.7 percent if you've paid in full.

Big deal, you say? Well, it can become a big deal very quickly, if the sell-off continues. If the stock falls 30 points (and if you think that's not possible, you haven't watched the Nasdaq market closely enough), your $3,000 account is gone, while you'd only be down 50 percent of a $6,000 account — small consolation, to be sure, but at least you'd still be alive and kicking.

Futures margin: Nowhere are the advantages — and very real dangers — of margin more on display than in the futures markets. The 50 percent margin rate available to stock traders is nothing compared to leverage available in futures — the precise reason many traders are attracted to this market.

While margined stock positions require a 50 percent down payment, futures positions (long or short) can be established with as little money down as 2 to 3 percent of a particular contract's value. Margin rates (sometimes referred to as "performance bond" in futures) vary from contract to contract and are adjusted by the exchanges on which they trade according to the level of volatility in the market, among other factors.

For example, in late May you could have traded one June S&P futures contract with $23,438 in your account. If that sounds like a lot, keep in mind that, trading at 1,470, one S&P contract has a nominal cash value of $367,500, which comes out to a margin rate of 6.4 percent.

This kind of leverage, of course, means that profits and losses are exaggerated to an even greater extent if you trade using the minimum margin requirement (which, of course, you don't have to do — see the concluding section). For example, if you bought one June S&P at 1,470 and the market rallied to 1,490, you could pocket $5,000 ($250 per point times 20 points), or a 21.3 percent return on the $23,438 minimum margin. By comparison, this gain would amount to only a 1.3 percent profit if you had paid in full for the contract.

The catch, of course, is the same as it is in stock trading: If the market goes against you, you can lose *more* than your initial stake, and given the very high leverage available in futures, traders who do not adequately limit risk on trades can watch their account equity evaporate quickly.

The two words you don't want to hear: margin call

Technically, there are two kinds of margin: initial and maintenance. Initial mar-

gin is what you must have in your account to execute a margin trade — 50 percent for stocks and variable for futures contracts.

Maintenance margin is the equity you must keep in your account to maintain your position. For stocks, it is 25 percent of the current value of the position. Your equity is your stock's current market value minus your margin debt. For example, if the $60 stock you bought on margin for $3,000 dropped 28 points to $32, the position's current value would be $3,200. But you borrowed $3,000 on margin, so your current equity is only $200 — less than 25 percent of the stock's current value ($3,200*.25 = $800).

A margin (or "maintenance") call occurs when a margin trade goes against you and your brokerage demands that you deposit more money in your trading account to cover your losses and bring your account equity back above the maintenance margin level. If you don't, they have the right (yes, the right — read your margin account agreement) to liquidate your position., i.e., sell off your losing position to prevent further losses.

Here's another important point: Brokerages have discretion in setting margin rates and issuing margin calls. The 50 percent initial margin and 25 maintenance margin rates are industry minimums established by the Federal Reserve Board — brokerages can, and do, establish more stringent requirements based on overall market conditions and the performance of particular stocks. Highly volatile stocks (like Internet stocks), for example, may be margined at a higher rate than more conservative blue-chip names.

Because the broker is, in effect, lending you money in a margin trade, he or she is participating in the risk of your trade — *not* the reason people get into the brokerage business. As a general rule, brokers have minimal tolerance when it comes to such losses. Traders have three business days, in most situations, to deposit the necessary funds to meet a margin.

Day trading and margin

Trades are margined after each trading session: Open trades are "marked to market" (valued according to the day's closing price) each night and margin calls issued when position's dip below the broker's maintenance margin level.

Beginners probably are better off avoiding margin and only making trades when they have the cash to do it...

Day traders avoid such margin concerns by closing all positions by day's end. If a day trader ends the day "flat," margin simply equals the net trading loss at day's end.

Day traders do not have carte blanche. The 50 percent minimum margin for all stock trades applies to day trading as well. (Technically, futures traders can sometimes trade contracts on an intraday basis with less than the minimum margin requirement [perhaps half], depending on their relationship with their broker.) Firms monitor positions and have the discretion to halt a trader's actions, liquidate trades that exceed a trader's proscribed trading limits or immediately demand additional funds be deposited in the trading account.

Intraday lending practices for day traders have come under close scrutiny in recent months, with some day trading firms being accused of giving traders extensive intraday credit lines (increasing their margin buying power to multiples of more than 100 to 1). Proposals are being discussed to increase the minimum account size for day trading margin accounts to $25,000 (from the current $2,000 for all margin accounts) but officially increasing the intraday buying power of a day trading account from the standard 2-to-1 (50 percent) to 4-to-1 (25 percent).

Short-term traders who cap losses quickly on their trades effectively minimize many of the potential risks of margin trading. Low-risk trading strategies would in most instances exit losing positions before they reached the level of triggering margin calls.

Margin homework

There a finer points to trading on margin — how you can use unrealized profits on open margin trades to trade other stocks, and so on — so make sure to read all your broker's literature (tedious though it may be) on margin trading and ask questions until you are thoroughly familiar with their margin policies.

Margin is not compulsory!

One commonly overlooked, but very important, aspect of this issue is that margin is voluntary. No one points a gun at your head and forces you to trade on margin. It can offer increased flexibility and the opportunity for greater returns, but these benefits will never materialize if you do not keep the downside in mind and practice strict risk control. In the May issue of *Active Trader* ("Mastering the trading arcade," p. 70), for example, trader John Saleeby pointed out that he did not use margin — at all — for more than the first year he traded professionally.

For longer-term traders and investors, trading on margin is a questionable practice. If you're really in it for the long haul, you take the bad with the good, weathering sizable losses on the way to a (hopefully) large payoff. If you buy long-term investments on margin you run the risk your broker will liquidate a position (if the market goes against you and you are issued a margin call) you would have stuck with had you paid for it in full.

But margin is a highly useful tool for the experienced and risk-conscious short-term trader. Beginners probably are better off avoiding margin and only making trades when they have the cash to do it, but traders who use strategies with well-defined stop-loss, exit and position-sizing rules can use margin to their advantage, increasing their percentage returns.

Again, if you decide you want to trade on margin, do yourself a favor and read the fine print of your account agreement (or, gulp, call your broker on the phone) and familiarize yourself with your firm's margin policies. When will you be issued a margin call? How long do you have to get the funds into your account and what methods can you use to do so?

Good traders tend to worry about risk first and let the reward side of the equation take care of itself. When it comes to using leverage, the prudent course of action for novice traders is when in doubt, don't.

Indicator INSIGHT: Volume

Indicator Insight is designed to give you a basic understanding of the calculation and use of various technical indicators, market studies and trading concepts.

Calculation: The number of shares (or futures or option contracts) traded over a particular period of time. On a price chart, volume is commonly shown as a histogram at the bottom (see Figure 1, below).

"Official" daily volume is typically quoted one day after the fact; that is, the volume figure released on Tuesday is the number of shares or contracts traded on Monday.

Volume is one of the most overlooked and least-discussed basic market indicators. Although it appears to be a simple indicator, it actually can be rather difficult to interpret when looked at in its most basic form — the raw number of shares traded.

Applications

Perhaps the most opportune time to monitor volume is during a sideways market that is moving back and forth between support (the bottom level of a trading range) and resistance (the top level of a trading range).

In these situations, volume should pick up when price nears either level. If it increases when support (resistance) is tested, there is an underlying buying (selling) pressure that eventually will favor a price swing to the upside (downside). In Figure 1, the down-pointing arrows show how volume increases as price approaches the bottom of the trading range.

A breakout of a trading range accompanied by a volume "spike" suggests a large amount of money has been awaiting the change and should help keep prices going in the same direction. Again, this principle is illustrated in Figure 1 in the late-April upside breakout of the trading range.

Key points

Abasic tenet of volume analysis is that a strong price move (i.e., a trend) should be supported by increasing volume. This is common sense: Increasing volume reflects greater market inter-

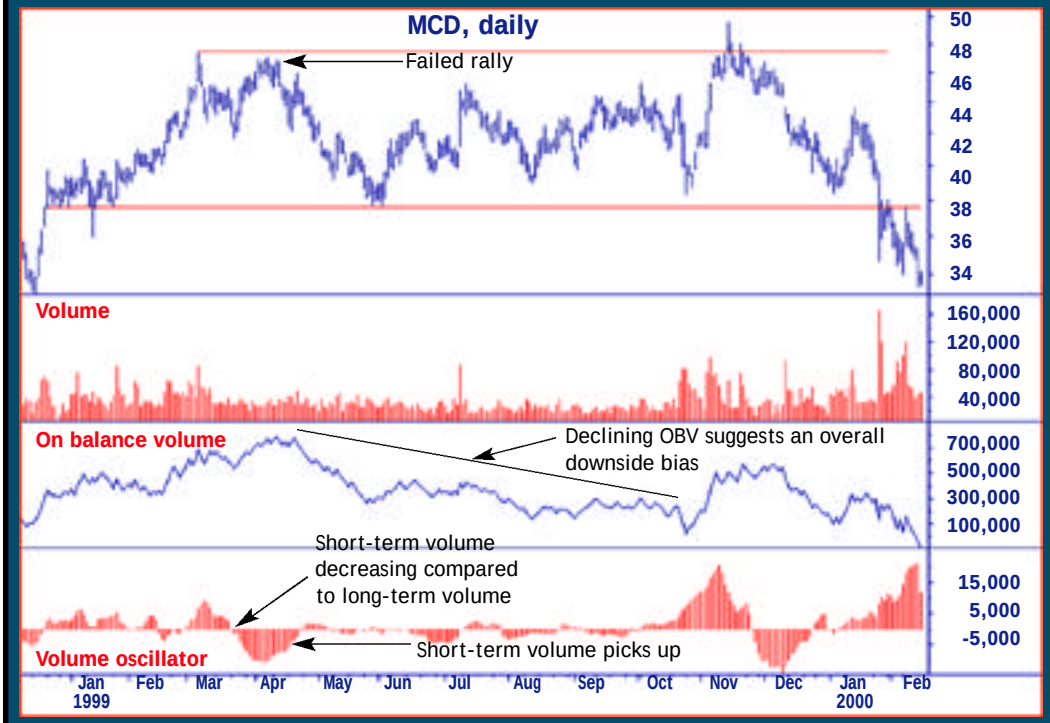
FIGURE 1 VOLUME

Volume can provide additional insight into price behavior. Here, volume increases as price bounces off support and spikes dramatically when the stock breaks out of the upside of a trading range.

Source: QCharts by Quote.com

FIGURE 2 VOLUME INDICATORS: THE VOLUME OSCILLATOR AND ON BALANCE VOLUME (OBV)

Volume is typically more volatile than price. Indicators like the volume oscillator and OBV can help provide a clearer picture of volume behavior and its relation to price action.



Source: TradeStation by Omega Research (Data: CSI, Unfair Advantage)

est and participation, which should help perpetuate the price move. Aperiod of ascending or descending prices is more likely to continue when accompanied by an increase in volume.

An important point is that volume should support the prevailing trend and not the counter-trend price action. In an uptrend, for instance, volume should increase when the market rallies, but decline when it corrects. However, because this relationship is much more important in a bull market than a bear market, and because prices occasionally can move into a long-term downtrend because of a sheer lack of interest in the market, there are quite a few exceptions to the basic rule. For example, a stock trading higher despite a relatively low volume can sometimes be a sign of strength. Ultimately, price patterns are more important than volume patterns.

Variations: Volume-based indicators

There are a large number of volume-based technical indicators. One of the most basic is the *volume oscillator*, which calculates the difference between shorter-term (say, 10 days) and longer-term (say, 40 days) moving averages of volume. (See "Indicator Insight," *Active Trader*, June for a discussion on moving averages.)

Figure 2 depicts price action in McDonalds (MCD) from late 1998 to early 2000, when the market traded in a range roughly between $38 (support) and $47½ (resistance). When the stock approached the resistance level in early April 1999, the volume oscillator indicated (by turning negative) that average short-term volume was decreasing compared to average long-term volume. This suggested prospects for a new high were marginal; in fact, an upside breakout never occurred.

After the failed April rally, short-term volume picks up (indicated by the rising volume oscillator) in conjunction with falling prices. That is the first indication the market bias is now to the short side.

Another popular volume-based indicator is *on balance volume* (OBV), which relates volume to price movement by adding the day's volume to a running total when a stock (or futures contract) closes higher and subtracting the day's volume when a stock closes lower. (For the OBV formula, see "Short-term strategy, long-term perspective," *Active Trader*, April p. 82.) The OBV line can then be analyzed like a bar chart.

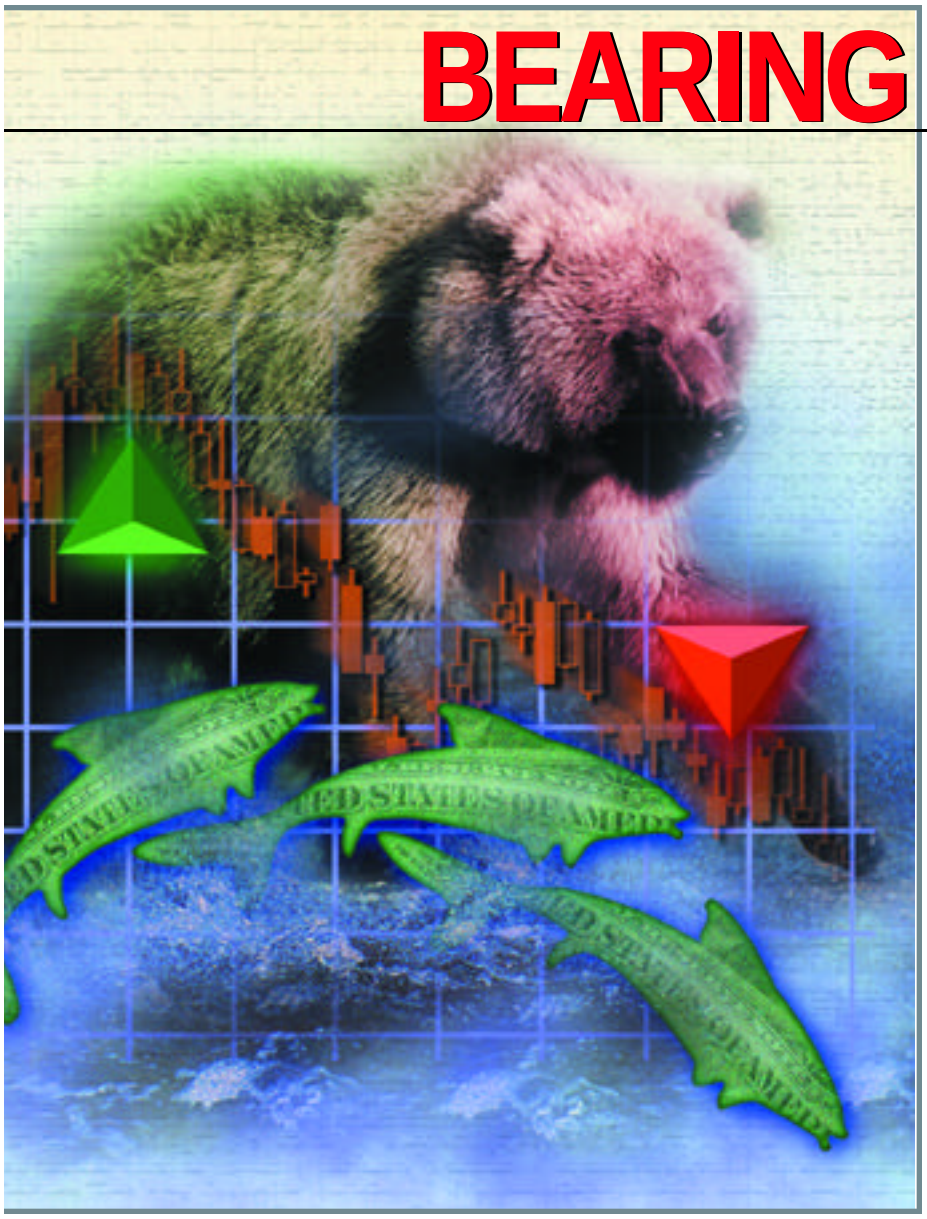
For the next six months or so after the failed April rally, it is very difficult to tell directly from the price and volume charts what the market bias is. However, the better-defined downtrend of the OBV indicator implies it is still to the downside. During November and December, the market once again tests the resistance level. When *this* test fails (a "false breakout"— a penetration of resistance followed by a quick reversal), the volume oscillator once again turns down, indicating a continued bias to the downside.

Not until early 2000, when the market forms a top around $43, does short-term volume surpass long-term volume. Soon after that, a breakout below support is accompanied by a large volume increase, revealing huge underlying selling pressure. The bias to the downside is confirmed by the falling OBV indicator.

Bottom line

Volume is much more volatile than price, and much more difficult (especially for beginners) to analyze effectively. It sometimes seems as if for no reason there will be a plethora of volume spikes followed by short periods of virtually no trading at all.

To the untrained eye, situations like this tend to cloud the picture enough to make the study of volume meaningless. Benefiting from volume analysis requires skills that can only be mastered through experience and time, and it is probably more of an art form than any other type of market analysis.



BEARING DOWN on the short side

BY THOMAS STRIDSMAN

Short selling isn't just a matter of reversing the rules of your favorite long-side strategy. Uptrends and downtrends are two different animals, and you have to understand the nature of the bear before you can use strategies to trade it.

Recent market action has taught us two things: No trend goes on forever, and when the end comes it can be abrupt — and devastating, if you haven't taken necessary precautions.

However, even with careful planning (and even if the market turn doesn't come as a complete shock) it still can be difficult to make money if you're only working from the long side of the market. Therefore, it's a good idea to explore the possibilities of profiting in both up- and down-trending markets.

One way to do this is to examine what distinguishes uptrends from downtrends in terms of the durability of the long-term trends, the swiftness of countertrend moves, the optimum number of days to hold on to a position and the magnitude of the short-term moves you are trying to catch.

For example, it is well known that down moves or downtrends tend to be much shorter in duration than most up moves of similar magnitude. If this really is the case, then it becomes very important to treat the two trend types separately, which, for instance, would result in different lookback periods for the indicators used to gauge the market.

Defining trend and trade length

Technical traders have long used the moving average to monitor long-term trends. The longer the average, the longer the trend it reflects. For example,

the 200-day moving average is a commonly referenced gauge of a long-term trend: If a market is trading above its 200-day moving average, it's perceived to be in an uptrend (and in a downtrend if it's trading below its 200-day moving average). However, is that the best moving average length for both uptrends and downtrends, or should a different average be used for each?

How can you find the best average trade length, as well as determine which moving average works best for a specific type of market environment? One way is to test each market several times using randomly timed entries (most trading software has a random function), but only taking trades in the same direction of the underlying trend indicated by the moving average. Exit trades only after a predetermined number of bars (hours, days, weeks, etc.).

Figures 1 and 2, show the results of testing different combinations of moving averages and trade lengths (with randomly timed entry) on the 30 stocks comprising the Dow Jones Industrial Average. Each stock was traded 10 times for every trade length-moving average combination from January 1980 to January 2000. The different colors in the figures indicate different levels of profitability, measured in terms of profit factor — total dollars made divided by total dollars lost.

The differences between trading the long and short sides of the market quickly become apparent. For instance, in Figure 1 (long trades) you can see that the best profit factor is achieved on an 18-day trade with a 260-day moving average. In Figure 2 (short trades), the most profitable combination is a trade length of two days combined with a 100-day moving average, which confirms the previously noted conventional wisdom that most down moves, in fact, do have a shorter duration than similarly sized up moves.

As you can see from Figure 1, most trade length-moving average combinations for long trades have a profit factor greater than 1. That means that, on average, for all markets and all testing sequences, gross profits have been larger than gross losses and, consequently, are likely to produce a profitable result in the long run. On the short side (Figure 2), however, the picture is a bit

FIGURE 1 MOVING AVERAGE AND TRADE LENGTH, LONG TRADES

The profit factors of randomly timed long-trade entries, using different moving average filters and trade lengths.

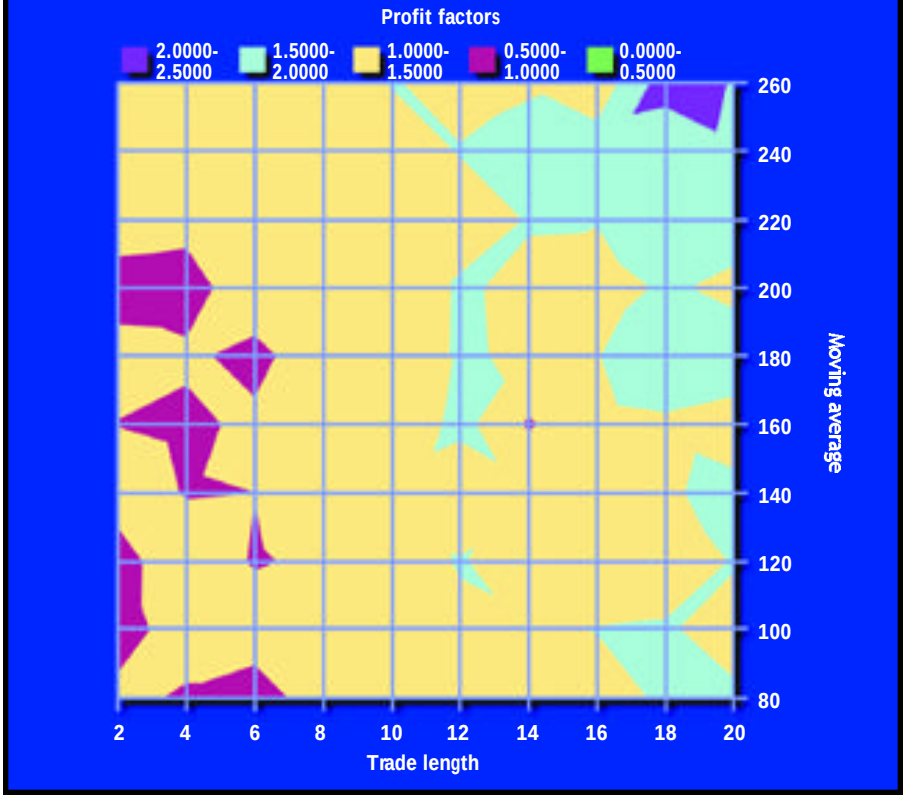
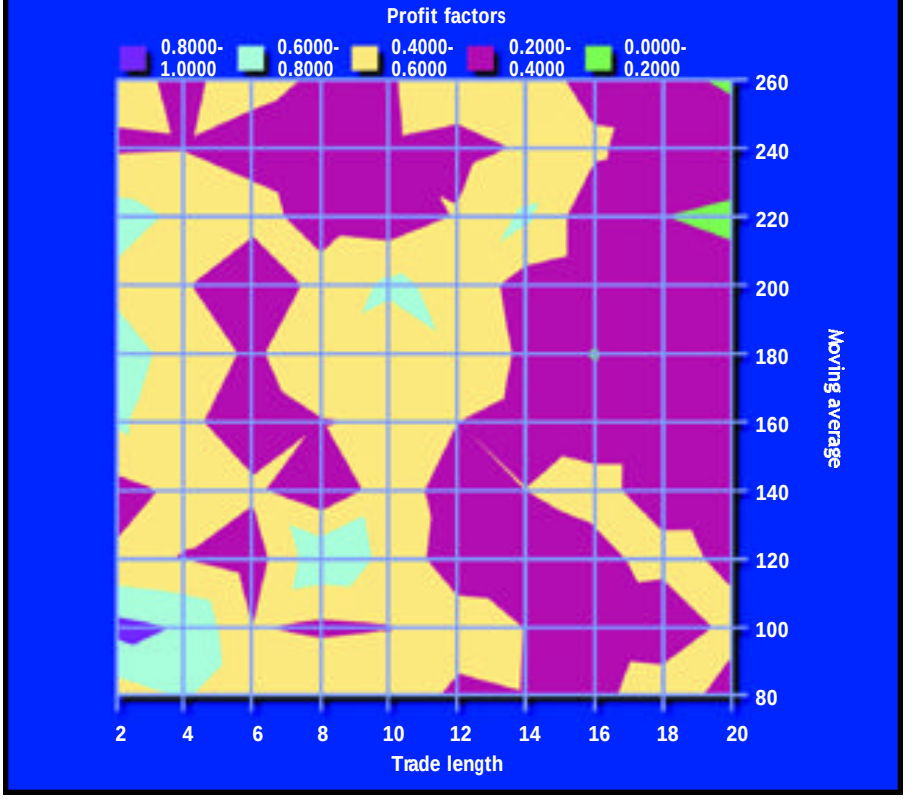


FIGURE 2 MOVING AVERAGE AND TRADE LENGTH, SHORT TRADES

The profit factors of randomly timed short-trade entries, using different moving average filters and trade lengths.



All trends are **not created equal**: **Down moves** tend to be **shorter** in duration than **up moves** of similar magnitude.

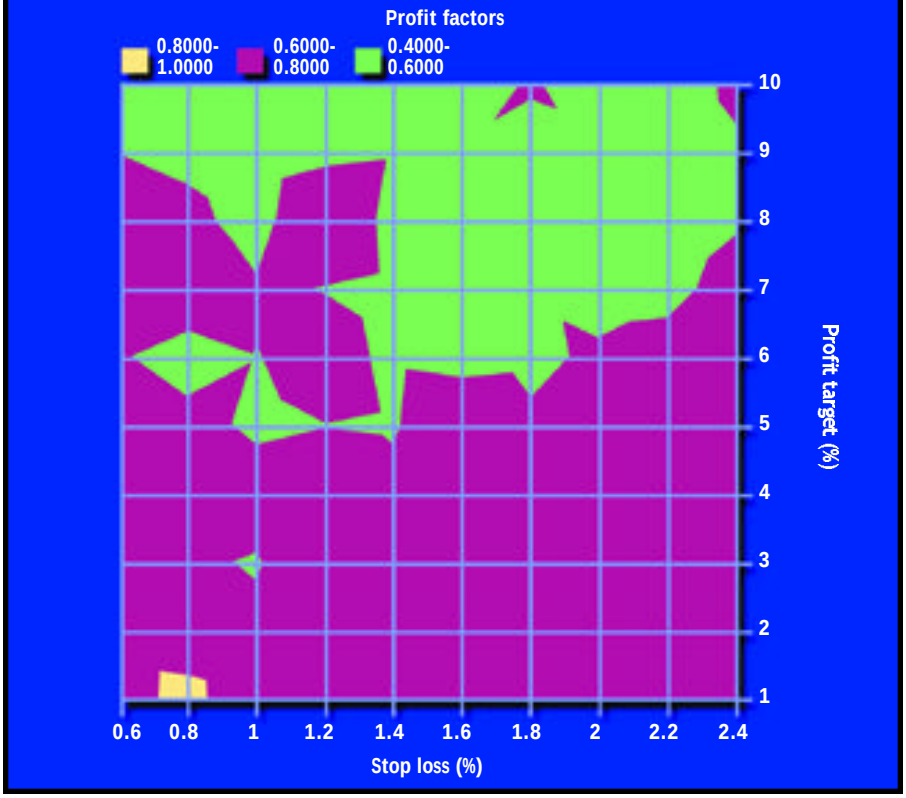
grimmer, with only one combination producing a profit factor close to (but not above) 1.

The fact that each trade is entered randomly means that no specific entry method is being followed. If the markets were truly random, there would be an equal chance for each trade to become a winner or a loser. If this had been the case, all combinations, for both the long and the short side, would have resulted in a profit factor very close to 1 (indicating an equal amount of total dollars won and total dollars lost). Clearly, however, this is not the case, which indicates that certain combinations are better than others and that the short side is more difficult to trade than the long side.

Once the best combination is determined, further analysis can show the best stop-loss and profit-target levels. Figure 3 shows the results of using different stop-loss and profit-target combinations for short trades (the maximum trade length is two days and the moving average trend filter is 100 days). In this case, the stop-loss and profit-target levels have been measured in percentages, while the final result is still measured by profit factor. The best combination is a stop loss of 0.8 percent combined with a profit target of 1 percent.

FIGURE 3 STOP-LOSS AND PROFIT TARGET, SHORT TRADES

The best-performing moving average and trade length combination from Figure 2 is tested across a range of stop-loss and profit-target percentages.



Synthesizing all the findings allows us to trade a complete random-entry strategy to see how it would have performed. The first column of Table 1 shows the results of such a test on the short side, with each stock hypothetically traded 100 times. To avoid picking non-representative parameters at the far end of the test spectrum, the criteria used for the trade were: 100-day moving average, four-day holding period, 0.8 percent stop-loss and 2 percent profit target.

For test results to be considered "robust" and reliable enough on which to base real-time trading, it is important they don't vary too much between different similar parameter settings. For example, if a 100-day moving average and a four-day trade length produce good results, but a 102-day moving average and a four-day trade length (or a 100-day moving average and a five day trade length) produce terrible results, it's impossible to know whether the results of any of these combinations are just the result of chance, because there's no consistency. The goal would be for all these similar parameter pairs to produce comparable (if not identical) results, suggesting this rough area of moving average and trade length combinations captures some basic aspect of market behavior and is consistently successful for that reason.

As you can see, only three stocks ended up with a profit factor greater than 1, and two of them only marginally. This will hardly allow them to produce a profit in real time, when such important considerations such as slippage and commission come into play. The average profit factor for all stocks comes out to 0.84 with a standard deviation of 0.13. In statistical jargon, that means we can be about 68 percent sure the true average profit factor would lie somewhere between 0.71 (.84 - .13) and 0.97 (.84 + .13).

However, if the trading system uses one moving average to identify the

uptrend and another to identify the downtrend, there inevitably will be situations when the two contradict each other. For instance, if the current price is below its 100-day average but above its 240-day average, should the trend be considered up, down or sideways? The best way to avoid such conflicts is to not trade them at all.

To see if the results of Table 1 are likely to improve if we take the uptrend into consideration as well, we added a 240-day moving average to the strategy. Now, the trade will only be entered (on the short side) if price is below both its 100- and 240-moving averages. However, as you can see from column 2, this didn't help results at all, further underlining the difficulty of trading the short side profitably.

Before we end, let's take a look at the results for a similar strategy, trading long only. In this case, we entered a trade only when price was above its 100- and 240-day moving averages, and exited the trade either with a 6-percent profit or 1.8-percent loss, or after 18 days. Column 3 shows that the average profit factor comes out to 1.11 with a standard deviation of 0.15, meaning that we can be 68 percent sure that the true average profit factor should rest somewhere between 0.96 and 1.24. Of the 30 stocks tested, only six had a profit factor less than 1.

The conclusion from this research is that you should be able to trade the long side profitably even if you use a random entry, as long as you have identified the trend and the magnitude of the moves you are trying to catch correctly.

To be able to squeeze a profit out of the short side, however, identifying the trend and the magnitudes are not enough without a pretty darn good entry technique.

One point to keep in mind is these tests were conduted on data from an extended bull market. But at least now, when you are aware of the dilemma, you can start to do the necessary research to get one leg up on everyone else when this "Greatest Bull Market Of All Time" finally comes to an end and the greatest traders will be those who know how to sell when everyone else is still trying to buy.

TABLE 1 **THE LONG AND SHORT OF IT**

Tests of complete, randomly timed entry strategies, with stop-loss and profit targets, on both the long and short sides of the market.

	Short Strategy	Short Strategy with additional filter	Long Strategy
Company	**Profit factor**	**Profit factor**	**Profit factor**
Alcoa	0.81	0.81	1.10
Am. Express	0.92	0.99	1.22
Boeing	0.91	0.84	1.06
Citigroup	0.71	0.97	1.24
Caterpillar	0.86	0.78	1.02
Du Pont	0.90	0.83	1.12
Disney	0.92	0.98	1.11
Kodak	0.97	0.93	0.83
Gen. Electric	0.79	0.78	1.31
Gen. Motors	1.00	0.93	1.00
Home Depot	0.66	0.59	1.41
Honeywell	0.85	0.92	0.95
HP	0.82	0.78	1.21
IBM	0.93	0.90	1.33
Intel	0.59	0.62	1.22
Int. Petro.	0.80	0.76	0.82
J & J	0.70	0.89	0.98
J.P. Morgan	0.90	0.91	1.06
Coca Cola	1.02	0.93	1.27
Mc Donalds	0.84	0.91	1.03
3M	0.79	0.78	0.99
Ph. Morris	0.85	0.83	1.19
Merck	0.82	0.84	1.15
Microsoft	0.53	0.50	1.22
P & G	0.82	0.78	1.09
SBC Comm.	0.80	0.72	1.00
AT&T	1.21	1.26	1.02
United Tech.	0.88	0.96	1.30
Wal-Mart	0.77	0.88	1.19
Exxon	0.73	0.69	0.90
Average	**0.84**	**0.84**	**1.11**
St. Dev.	0.13	0.14	0.15

To INC. *or not to* INC.

This is the first installment of a three-part series:

I **To Inc. or not to Inc. — *A look at the different options traders have for establishing a trading business.***

II Practical decisions — *Weighing the factors involved in forming an entity.*

III Added value — *Specific tax advantages of entity structuring and programs available through such setups.*

BY TED TESSER, CPA

You're trading full-time: Is it a smart tax move to form a corporation or some other business entity in which to structure your trading? In the first installment of a three-part series on setting up a trading business, we look at the pluses and minuses of corporations, partnerships and other business options traders can use.

In consulting with traders around the country, I am stunned by the lack of information concerning the use and formation of an "entity" (a formally structured business or corporation) through which to conduct trading.

The two most common misconceptions I come across are: Trader status can only be gained by trading through an "entity"; and this entity should only be a corporation.

Hopefully, I can put both of these misconceptions to rest.

First, it is not necessary to trade through an entity to receive the tax benefits afforded to traders. If an individual meets the criteria for trader status (e.g., a large number of trades, short holding periods, trades as a business, etc.), they will receive the tax advantages afforded to traders. The existence of a trading entity is irrelevant. But if an individual only marginally meets the criteria, the

An "entity" in general and corporations in particular are not necessary to gain trader status.

use of an entity may be helpful.

Second, corporations are not necessarily the preferred entity for conducting a trading business. While there are many reasons to use a corporation for a trading business, there are also reasons to not place trading accounts into a corporation.

Corporations are just one weapon in your tax-avoidance arsenal, as are Limited Partnerships, Limited Liability Companies, Business Trusts and other entities. Each has its own benefits and potential disadvantages.

Individuals who have gained trader status in the eyes of the IRS have a significant tax advantage over non-traders. They are granted far more deductions, which are reported "above the line" (i.e., they are subtracted from gross income before net income is determined). In the simplest terms, when tax time rolls around, traders can file a Schedule C (profit or loss from business) and, as far as the IRS is concerned, they are sole proprietors.

Simply put, an entity in general and corporations in particular are not necessary to gain trader status. In most cases, however, proper entity structuring will give traders additional advantages not available to sole proprietors. Still, before any trader answers the question, "To Inc. or not to Inc.," careful consideration should be given to all options.

Sole proprietorship

Most self-employed individual traders are *sole proprietors*, by far the easiest designation to establish, maintain and control. There are no governmental filings required and no special taxes. The big problem with sole proprietorship is that all income is considered a capital gain (or loss) and not self-employment income. Therefore, it does not qualify for pension plan contributions and does not allow traders to deduct self-employed health insurance (but also, income is not subject to self-employment tax).

Another problem for sole proprietors is retirement plan contributions. The only way to establish a retirement plan and allow for deductions associated with VEBAs (tax-avoiding trusts), defined benefit and defined contribution plans (all these will be discussed in more detail in an upcoming article) is by drawing salary against the trading income. For retirement planning purposes, a sole proprietor trader cannot contribute to a Simple IRA, Roth IRA, Simplified Employee Plan (SEP), Keogh, VEBAor any similar retirement plan.

From a non-tax standpoint, sole proprietors have unlimited personal liability for debts, losses and claims against the business (e.g., margin calls). Thus, 100 percent of their assets (subject to certain limited exemptions) are at risk to litigation, poor business decisions and divorce. These non-tax implications, as well as the self-employment restrictions, make the sole proprietorship the most vulnerable and undesirable form for conducting a trading business.

While not unmanageable, corporations are the most complex business structure to formulate and maintain.

General Partnership

When two or more people come together for a common business enterprise, a partnership is established. Like sole proprietorships, they are easy to form (a handshake will do), require no governmental filings and have no special taxes. An informational return is filed to show the partnership's activities and each partner is issued a Form K-1, which reflects his or her individual share of the income or loss. These are attached to and reported on each partner's individual tax returns.

One of the main disadvantages of this setup is that each partner is deemed to be an "agent" of the union, which means he or she is capable of making decisions that bind the partnership, even without the knowledge of other partners. Each person has joint liability for the debts and claims against the partnership; therefore, an unaware partner with deep pockets can be held fully liable for financial decisions made by other partners.

Limited partnerships

Because of the potential problems with general partnerships, limited partnerships are preferred for business purposes.

Limited partnerships are comprised of one or more limited partners whose liability is confined to the amount of their individual initial investment and a general partner who assumes unlimited liability. Because of the separation of liability, the general partner is typically issued a very small percentage of ownership in the entity (perhaps 1 to 2 percent) to reduce the vulnerability to creditors.

Limited Partnerships must be legally granted. A written agreement is

Even if **you reside in a state** that has a **state income tax,** you can still **form a corporation** in a state that does not.

required, there are restrictions on the ability of limited partners to participate in management and there are statutory procedures to be followed in terminating them.

The IRS requires the filing of an informational return (Form 1065); however, income or loss is apportioned to each partner in proportion to his or her initial partnership interest. Whereas partners in a general partnership are required to pay a 15.3-percent self-employment tax on their income, limited partners are not.

A variation of limited partnerships known as Family Limited Partnerships (FLP) is allowed when the entire partnership is comprised of family members. One of the big tax and estate-planning benefits of an FLP is the ability to shift partnership shares (and income) to family members in lower tax brackets. As a result, income for the FLP is taxed at a lower rate, and the asset (whatever is transferred to the FLP) can be removed from the owner's gross estate for estate tax purposes. I have placed a great number of active traders in FLPs because of the tremendous benefits they afford for tax planning, retirement planning and estate planning.

Limited Liability Company (LLC)

This entity is a hybrid between a corporation and a limited partnership. The liability of LLC members is limited to the amount of their original investments. And, as is the case with limited partners, the gain or loss of the entity flows through to the members to be included on their individual tax returns. Unlike limited partners, however, members in an LLC may participate in management.

LLCs can be either single- or multi-member; however, for tax purposes, the IRS disregards single-member LLCs and some states don't authorize them. So, while a single-member LLC may enjoy asset protection, it will continue to be taxed as a sole proprietorship.

A multi-member LLC is taxed more like a limited partnership, in which income is generally not subject to self-employment tax.

While there are some circumstances in which an LLC is appropriate, in most

cases we prefer to use limited partnerships because there is much more legal precedent concerning their use.

Corporations — General

The consideration of whether to form a corporation requires a preliminary understanding of the two different types of corporations: *S-corporations* and *C-corporations*.

Both types of corporations have similar characteristics. They are created by state statutes and are the only business entity considered totally separate and distinct from their owners (i.e., shareholders). They are the most complex structure to formulate and maintain. Still, the requirements are by no means unmanageable and corporations (especially when used in tandem with other entities) provide the greatest tax advantages for business owners — particularly traders.

All corporations begin as C-corporations; however, the corporation can elect, for tax purposes, to become an S-corporation and have its income or loss reported on the individual tax return of its shareholders.

C-Corporations

The country's big corporations — IBM, Proctor & Gamble, General Motors, etc. — are C-corporations. However, mom-and-pop grocery stores, shoe repair shops and traders can operate as C-corporations, too.

C-corps receive the most beneficial tax deductions of any business entity. They have far more flexibility in establishing trusts and retirement plans. Also, travel and entertainment, training expenses, medical and educational expenses, and many other benefits, which are either unavailable or severely limited in other forms of business, are more widely deductible.

The most frequently cited disadvantage of C-corps is the double taxation issue. The income of a corporation is subject to taxation at the corporate level and then is taxed again at the individual level when paid as dividends (although dividends are not always paid; see below). However, through the use of proper planning and implementation of corporate programs, taxation at the individual level can be kept to a minimum. This is because more "personal" expenses can become legitimate "business" expenses, which are tax deductible. Additionally, the income of C-corps is taxed at 15 percent for the first $50,000 of income (compared to 28 percent for individuals).

In reality, the only time the issue of double taxation arises is when the corporation pays an individual a dividend that is taxable to the individual but not deductible through the corporation. Any other payments to shareholders (salary, management fees, etc.) are deductible and the double taxation

issue is non-existent.

One caveat: If all of your C-corp's income is derived from trading, it may be considered a Personal Holding Company and subjected to an additional tax. If trading is your only means of income, you should first consult with competent accounting and legal professionals to implement strategies to avoid this classification.

S-Corporations

An S-corporation is taxed on the individual's tax return. The flow-through nature of this entity makes it an ideal vehicle for trading. S-corps also provide great asset protection. Anybody suing an individual trader would generally not be able to get to the assets of the S-corp. Likewise, anyone suing the S-corp would not be able to reach the trader's assets (provided the corporate entity is properly maintained).

S-corps, do, however, have some drawbacks. Key tax limitations include the non-deductibility of disability premiums, limitations on deductibility of medical insurance premiums, limitations on deductibility of travel and entertainment expenses, and heightened scrutiny on the employment of family members. Additionally, there can be no more than 75 shareholders.

Both C- and S-corporations are similar from an asset-protection standpoint. But the surest way to lose all of the tax and non-tax advantages of incorporating is by conducting corporate affairs without properly maintaining the corporate structure (i.e., holding regular board of directors meetings, maintaining and updating minutes, adhering to various state compliances like tax reporting, and so on). It has been my experience that S-corporations are particularly susceptible to this, perhaps more so from a psychological standpoint than anything else (i.e., the owners perceive themselves as being more akin to a partnership than a "true" corporation and thus lose sight of the fact that certain formalities must be adhered to).

Incorporate in a tax-free state?

Most states charge an income tax. However, Florida, Texas, Nevada, Washington, Tennessee, Alaska and New Hampshire do not. A corporation, no matter what state it is authorized in, may legally operate in any other state.

Thus, even if you reside in a state that has a state income tax, you can still form a corporation in a state that does not. The advantage is that income earned within the out-of-state corporation will not be subject to taxation in your home state.

However, if you are an online trader, be careful. There are many ads floating around cyberspace telling you to form a corporation in Nevada. Much of this misinformation is from companies who want to "sell" you a corporation. Do not be deceived. What they don't tell you is if you place your trading business in a Nevada corporation but you are sitting in a taxable state (New York, for example) executing your trades, you may have just subjected yourself to registering in New York and are subject to New York taxes. You've defeated the entire purpose of incorporating in Nevada. There are ways to do this in a more advantageous manner, which will be addressed in future articles.

Online traders beware: Don't be deceived by **ads floating around cyberspace** telling you to **form a corporation** in **Nevada.**

Structuring your trading business in a tax-free state can work, but it requires very specialized knowledge and sophisticated planning and structuring.

Do not attempt to do this without competent professional advice and assistance.

The bottom line

There are a great number of factors, both tax and non-tax, to consider before forming an entity. We've provided a broad outline of the types of entities and their ramifications. Next month, we'll explore the factors individual traders should consider before establishing a trading entity and analyze some case studies illustrating bottom-line results that can be achieved from proper structuring strategies.

For a free Trader Evaluation Questionnaire and more information on entities, call (800) 556-9829, e-mail TBTesser@TaxTrader.com or visit www.taxtrader.com.

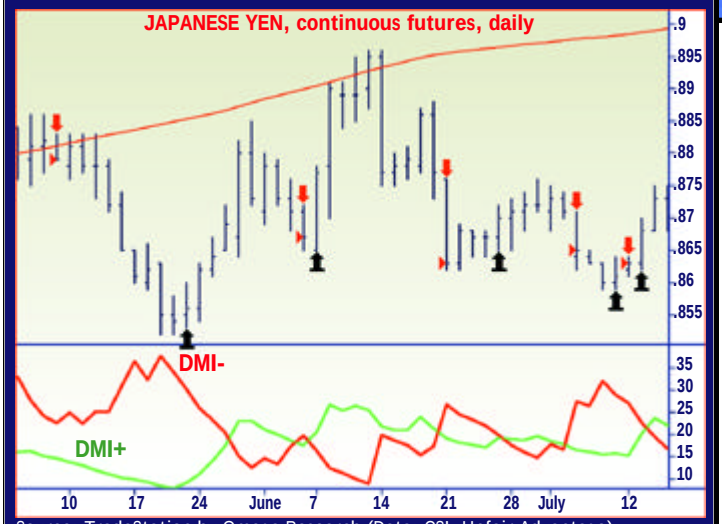
Bear claw

Market: Currencies (in this case Euro, Japanese yen, Australian dollar, Canadian dollar.)

System logic: This system uses the DMI+ and DMI- indicators (lookback periods: 14 and 8 days, respectively) to distinguish between upside and downside volatility. Alternatives include combining the system with a profit target and a stop-loss, as well as the average directional movement index (ADX).

FIGURE 1 BEAR CLAW TRADES

Red arrows: sell signals. Black arrows: exits.



Source: TradeStation by Omega Research (Data: CSI, Unfair Advantage)

EQUITY CURVE

Source: CSI, Unfair Advantage

The DMI calculation is rather extensive and can be found in Welles Wilder's book *New Concepts in Technical Trading Systems* (1978, Trend Research, Greensboro, NC). The indicator reflects the strength of up or down price movement based on the largest part of today's range that is outside (above or below) yesterday's range. In Figure 1, the green line is positive directional movement (DMI+) and the red line is negative directional movement (DMI-).

Rules: Enter on the close (short side only) if:

1. Today's close is below the 200-day moving average.
2. The DMI- line is above the DMI+ line, indicating greater downside volatility.
3. The DMI+ value is lower today than yesterday, indicating decreasing upside volatility.

Do not risk more than 0.5 percent of available equity. Calculate the number of contracts per trade as 0.005 times available equity, divided by the dollar value of the distance between the entry price and the highest high of the last two days.

Exit on the close if the DMI+ value is higher today than yesterday, indicating increasing upside volatility.

Test period: Jan. 1, 1981, to Dec. 31, 1999.
Test data: Daily currency futures prices.
Starting equity: $100,000 (nominal). $50 deducted for commissions per contract.

System drawbacks: Less than 50 percent of trades are profitable. The system favors already high-volatility situations that turn into even more explosive moves, resulting in nerve-wracking trading. Results should be improved considerably with limit orders to better capture tops and bottoms, but this, too, would make trading a very harrowing experience.

Conclusion: Research shows there is a definite difference between upside and downside volatility, and it is important to distinguish between the two. Other indicators that can be used for the same purpose include the Relative Strength Index (RSI), average true range and the Market Facilitation Index. A system like this would be best used in conjunction with a longer-term, trend-following strategy that would likely underperform during major trend changes.

SYSTEM SUMMARY

Profitability		Trade statistics	
End equity ($):	136,825	No. trades:	1,088
Total (%):	37	Avg. trade ($):	34
Year (%):	1.66	Tr./Mark/Year:	14.32
Profit factor:	1.09	Tr./Month:	4.8
Risk measurers		**Time statistics**	
Max DD (%):	-44.32	Longest flat (m):	131.81
Largest loss ($):	-7,350	TIM (%):	69.80
Winners (%):	48.44	Avg. days:	3.00

Source: CSI, Unfair Advantage

LEGEND — End equity: *equity at end of test period* • Total (%): *total percentage return over test period* • Year (%): *annualized average return per year* • Profit factor: *gross profit/gross loss* • No. trades: *number of trades* • Avg. trade: *dollar amount of average trade* • Tr./mark/year: *trades per market per year* • Tr./month: *trades per month* • Max DD (%): *maximum drawdown (equity loss)* • Largest loss: *biggest losing trade* • Winners (%): *percentage of winning trades* • Longest flat (m): *longest period spent between two equity highs, in months* • TIM (%): *amount of time system is in the market* • Avg. days: *average trade length*