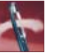


Professional Traders Still Day Trade

By Linda Raschke and Christopher Terry

Market Wizard Linda Raschke and partner Chris Terry debunk the notion that day trading is a singular trading discipline. In fact, day trading and other trading styles often can intersect and overlap — depending on market conditions, of course.

Day trading. Swing trading. Momentum, technical and position trading. In the past five years, these terms have virtually shed their meanings as they were liberally and loosely used in the unique high-volatility environment we saw in the late nineties. I say unique because we only see back-to-back returns of +30 percent a year in the market once every 50 to100 years! Can traders expect to make a living day trading as the trend in historical volatility turns back down? How have things changed near the turn of the 21st century? Or have they really changed at all?

First, it's time to clarify the above terminology and **get rid of the misconception that one style of trading is exclusive from another.**

In fact, the great majority of professional traders have *always* made "day trades." For some, a day trade may mean that the trade entered was a losing one and, thus, was exited instead of holding overnight. For others, day trading profits may supplement those made from holding longer-term positions. Sometimes, if the market serves up a windfall in one day, it is best to take profits at the end of the day because there is 50-50 chance the market will open up or down the next day. And many professional traders make small day trades to "probe" the market's strength or weakness.

In the '80s and early '90s, the bulk of professional traders were exchange members, floor traders or specialists. There was not the advantageous commission structure available to the retail client, nor was there inexpensive access to data or the ease and speed of execution that has come about in the past seven years.

Most professionals who day traded in the '80s for a living often "scalped" — buying on bid, selling on offer, and constantly turning their inventory over. The specialists and equity option floor traders held longer-term positions, but constantly traded around their positions and made "small adjustments" every day. In the futures markets, the majority of pit traders did not hold positions overnight but, instead, were pure scalpers. So, historically, the "professional trader" has tended to make a high number of short-term trades. Interestingly, a study done by one of the major clearing firms analyzed what percentage of their retail accounts were profitable in the mid-'80s to mid-'90s, and that number came in at around 8 percent. The most profitable accounts were those with the highest activity levels. But, overall, the floor traders and specialists have always been the most profitable group of traders in history.

As you can see, then, day trading is not singular in definition. It means many things to many people.

Swing Trading the Markets from Both Sides

Swing trading is a term that was made popular in the early 1900s. It described a methodology that was purely technical and in which the length and duration of the previous market's swing relative to its overall technical structure was used to forecast the next swing. A swing on the daily charts could last several weeks in duration. One of the main appeals of swing trading was that it encouraged the active speculator to take advantage of the market's movement in both directions. The principles of classic swing trading can be applied equally well to a one-minute S&P chart or a weekly bond yield chart. Swing trading, in fact, can include *both* very short-term day trades and position trading off of the weekly swings.

Momentum Trading Favors Strong, Trending Markets

Momentum trading is a style that came back into vogue in the late '90s, when the markets were awash with excess liquidity and crowd behavior was rising to a frenzy. Most momentum traders try to "jump on board" a rapidly moving market, and the proficient ones understand the power of holding winning positions overnight, playing for the next morning's follow-through. Any market that shows accelerating price gains, (starting to go parabolic), is best traded using a "momentum" style.

This brand of trading became popular when the commodity markets were lively in the late '70s and is a form of trend following that works well only in the strongest trending markets. It is quite a different game than pure scalping – buying on bid/selling on offer, or applying the classic finesse used in swing trading. With momentum trading, a trader who does not pay up to take the offer will most likely miss the trade. And since the risk on losing trades can be high, (as the trader has already paid a "retail price"), it is a losing game to play if the objective is a short-term scalp at best. **With momentum trading, one must know how to capitalize on milking the "juice" out of trade**, and that means truly letting profits run while trailing a tight stop or exiting at the first sign of the market stalling out.

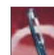
As liquidity started to contract, equities have stopped favoring a momentum style of trading (traders may easily recall that after the buying climax three years ago, there were some good initial momentum plays to the downside). A momentum style of trading can be applied equally as well to the short side as to the long side as long as there is a strong trend in place. We are starting to see a favorable momentum environment in other futures markets now, as demand is starting to overcome supply in many of the cash commodities.

Waiting for the Trade to Ripen

We often have a trending market that is not a momentum type of environment, yet offers favorable opportunity for those who are disciplined enough to methodically manage a position. The best position trades often come when the market just starts to break out of an extended accumulation or distribution period. Thus, a position trader must have the patience to monitor the markets on a daily basis, waiting for the trade opportunity to ripen. Yet, there may only be two to three worthwhile opportunities a year to put on a longer-term position in any given market.

Position Trading – A Season or a Reason

Position trading was a favored method in the mid-1900s for market speculators who were not exchange members. Charting techniques that required posting by hand on a nightly basis kept the trader in tune with the market. A position trade most often has a definite technical, seasonal, or fundamental reason as to why the trade is entered, and



usually has an objective level that is being played for or a time window during which that trade is being held. In this, it differs from outright long-term investing. Many professionals will often have positions working in one or two markets, while trading other markets on a shorter time frame.

So, Where Do We Go from Here?

Now that we have explored the backgrounds and perceptions of a few trading styles in the past and the types of environments in which they are best suited, let's address our original question as to what type of environment should we expect in the future and figure out if anything has *really* changed over the past decade.

Recently we looked back over the past 20 years of data to assess the actual volatility in stocks, indexes, cash commodities, bonds and currencies. Historical volatility in equities jumped up at the beginning of 1997 and has remained at elevated levels. It is just starting to trend down and still has a long way to go before it regresses to its historical mean, let alone the dull levels we saw from 1991 to 1995.

It would have been very difficult for a professional upstairs trader to make a decent living day trading stocks in the early '90s, and the downtrend in volatility suggests that it will be difficult to do so in the future, too. This is not bad news for traders, though. It merely suggests that a trader needs to either lengthen his time horizon and holding period or look to other trading vehicles. Many traders who looked solely at equities over the past six years have been gravitating towards index futures. We are also seeing the volatility in currencies and cash commodities starting to turn back up after a period of flat ranges in the late '90s.

Volatility Makes for Good Short-Term Trading

Here is a good rule of thumb: The more volatility an individual market has, the better suited it is for short-term trading. To assess which stocks are better day trading vehicles, one way to calculate volatility is simply to divide its price by its average daily range. The *lower* this number, the more important it is for a trader to hold positions for longer periods of time in order to rise above the noise and overcome the vig (spread between the bid/ask, plus commissions).

In the commodity markets, it would be silly to try to day trade corn. This market is best suited toward establishing a position either on a seasonal play or, perhaps, a technical breakout from a chart formation. However, in the S&P futures, for example, there are both sufficient volatility and enough intra-day swings for a trader to actually make a living day trading.

The big money is made on capturing the larger swings in any market. However, these types of opportunities only come along a few times a year. **A good trader will make smaller scalp trades, constantly probing the market until the technicals line up for a play where bigger leverage can be used.**

For newer traders, the best advice is to forget about the longer-term trades, place less emphasis on playing for higher-percentage returns and, instead, learn to trade on the shortest of time frames — perhaps small scalps only while foregoing carrying positions home overnight. The smaller the account size, the less risk a trader should assume. The more time a trader has a position on, the more exposure they have to the markets and, thus, the greater the risk.

Also, execution skills will ultimately play a large role in a trader's overall profitability. Constant practice getting in and out of the market, even if it means scratching many trades, is key. Only with practice will a trader learn to get the "feel" of placing his orders at just the right time. And, frankly, it is only after a trader has made numerous trades that there is a lessening of the emotions and anxieties that invariably go along with pulling the trigger. Perhaps this is why most of the more profitable traders have been on the trading floor at one time or another. A pit trader can make more than 500 trades a day, and quickly learns to ditch the losers for a small loss or scratch the trades that do not show an immediate gain. **The best professionals are exceptionally good at playing defense.**

How We Look at the Markets — Daily

Perhaps the way that we approach the markets each day will give potential day traders some food for thought. The night before, we analyze the daily charts to see if we are in an overall trending environment *or* a trading environment, and note if there are any chart formations indicating distribution or accumulation. Breakouts from chart formations tend to lead to the better position trades. We want to be right on top of any impending breakouts, because a late entry on these can substantially increase the risk.

It does not take very long to go through the individual futures markets, the major market indexes and sectors. Next, we analyze what type of individual day we are expecting. Is there potential for a trend day – the easiest type of day on which to make big profits — or is a consolidation day expected, where we can look to make small scalps in either direction? We also make notes for each individual market if there is a key pivot about to come into play – perhaps a 20-day high or low, or a gap area. We usually have anywhere from 10 to 15 different setups among assorted markets for the next day's trading, and we will also have a list of 8 – 12 interesting stock plays that bear watching.

The next day, we may only make one to three trades that will be held overnight. It is not possible to trade every market or every setup, but if we have done the necessary "homework" and preparation, we find that a few of these may "fall into our lap" each day. We also will be ready to take advantage of any opportunities to put on longer-term position trades, but these conditions may only happen once every two to four weeks. We then tend to make anywhere from one to five day trades or scalps in the index futures, or higher beta stocks. Most often, we find that there is a main trend for the day, and in this case, the market can be worked most efficiently when trading with a bias to the long or short side for the day.

There is no question that it also requires a hefty chunk of work to manage existing positions. Traders hear this over and over again, but it bears repeating — one of the hardest things for a trader to learn is to stay with a trade that is working! Lots of patience and preparation goes into finding the choicer long-term trades. This can sometimes be where the big money is made, but only if a trader is not tempted to take

profits too soon! And for a position that is not working as expected, the trader must be quick to let go of the investment in time and energy that went into initiating the trade in the first place and cut bait! We find that we can do that best if we have already noted the "danger levels" at night.

So, regardless of whether we are simply making short-term day trades or monitoring longer-term positions, much time and preparation is still done when the markets are closed for all types of trading. Day trading can be a great deal of work, since a trader must constantly be looking for new ideas and trade setups. Serious concentration is also necessary each time a trade is about to be entered. Something to be considered, however, is that for a newer trader, there may be less stress in not having to worry about overnight exposure.

We find that for optimal profitability, traders should not limit themselves to one style of trading, nor should they draw too sharp of a line between time frames. At certain times of the year, there may be choice opportunities for establishing positions at key market turning points. These trades can lead to substantial profits. However, until these occasions come along, a trader still needs to pay the rent. The ability to consistently take small profits out of the market on a majority of the days is even more important than playing for the longer-term positions.

Perhaps nobody does a better job of comparing short-term trading to playing for the broader swing than Richard Schabacker: **"If a trader is willing to give a large share of his time and energy to study of the markets and of technical considerations, and if he has the proper ability and proper personal makeup, then it seems quite certain that he will make greater profits on the shorter time frame as opposed to position trading.** Certainly, the possibility for such profit is much greater in short-term trading."

"On the other hand, the individual who is unable or unwilling to give up a good portion of his time and energy to the study of technical considerations, who knows or finds himself erratic in his trading success or unfitted psychologically for short-term trading, will, of course," he adds, "find greater profit, slower but more certain, by confining his operations to those for the long-swing."

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