The Dating & Trading Game

By Christopher Terry

When I was asked to write an article for ***Stock Futures & Options***, my original thought was to cover some of the more useful technical analysis topics that are so crucial to charting the markets. But as I considered the bigger picture, I felt it should have less to do with technical analysis and more to do with some concepts that merely *tie* into the technical aspects. Though I will explore various types of stocks that people love to trade, various time frames that can be used, some methodologies and a few charts, I felt it was important to make an equal balance between personal trading behaviors and the technical side of the market in this article.

We all attempt to *play the trading game "correctly,"* either from buying breakouts, pullbacks or shorting the rallies, fading the gaps, or using our stochastic or MACD indicators and moving averages. That's all fine and good, but the real question we need to ask ourselves is, *do we play the RIGHT game*? Does the style we use in our trading really fit our particular profile or personality?

I recently had a pretty frank conversation with one of my close trader friends, Mary, and her "game" is what this article is built around. Mary is quite an intelligent person, but she was really having difficulties making a profit in the markets, buying every gap down, shorting gap ups, taking swing trades, buying bull flags and shorting bear flags, counter trend trading and, also, trading breakouts. She traded anything and everything that she could find, but wasn't having much "luck." She explained to me her criteria for trading, specific trade ideas, why she pulled the trigger to enter, how she placed her stop losses and profit targets, and it all seemed logical to a point. So, how could she lose doing the right thing? Everything sounded right and, yet, it turned out to be wrong in her case. Was she overtrading or not trading enough or…?

Of course, there are many others like Mary who want to become good traders and have a rewarding career in this field. And, like her, they do not have a set game plan, a clearly defined roadmap of what's right for them and what will help them on their journey toward being a successful trader.

Initially, I thought that perhaps there were some very obvious trading errors that I could identify for Mary. I asked myself if it might be possible that Mary was trading NYSE stocks on a 60-minute chart when she should be using a 5-minute chart, and on and on. Each question I asked her led to a series of new questions and, finally (as you'll see), I began to understand what made her tick, what her profile was and what the "right game" for her was.

Find your match!

Then the light bulb went on – I thought of all the people with whom I have come into contact over the years, and the same identical thread seemed to run through the middle of each of them – that is, they clearly did not know what questions to ask themselves in a very introspective manner to determine what their particular style or game was. Without that, they continued to make errors that could blight what might be a successful relationship with the markets.

As a trader and mentor, I have stayed very close to the trading community over the years. For the last few years, I've been a moderator for a stock chat room that allows me to learn each day what other traders' profiles and personalities are and what makes them tick. I've also been a speaker at various seminars and workshops and, because of that exposure, I've had the good fortune to speak to and learn from those that are "hungry" and willing to travel long distances to become educated about trading. I also make it a point to keep a close watch on the pulse of what traders think.

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I previously worked as an assistant to one of the largest stock traders in the nation and currently am a full-time professional trader who has been personally mentored by a New Market Wizard. In fact, I am a partner with that individual. Thus, it might appear that I had it easier than the next person. However, I am *no different* than Mary in many respects. I have stood in her shoes. I have gone through the same type of growing pains that many traders do. I have questioned my talents and abilities many times, and I chased my tail for years until I found what the right game for *me* was.

Pablo Picasso, Spanish painter and sculptor, generally considered the greatest artist of the 20th century, created more than 20,000 works. That does not mean, however, that anybody could use Picasso's brushes and be as great an artist. Just because someone sits at Liberace's piano does not mean he or she will be able to play like Liberace. They had their game, their style and what works for them, but not for others.

Define Your Game and What Works for You

We hear some of the better traders say that they have a business plan or a game plan. What exactly does this mean? If they want to have a chance, traders have to ask themselves a score of questions before they risk capital in the markets. To start, do they have a sound methodology that has a high percentage of winners to losers?

Do they have the right tools to assess the market environment on a particular day, such as:

- Has the market been consolidating so much that it is in a breakout mode? – for example, looking for a trending market that opens on *one* extreme of its range and closes on the *other* extreme?
- Or has the market been trending so much recently that we are looking for a consolidation environment, where volume dries up leading to a dull sideways trading range, before the cycle begins again in a breakout mode?
- Or are we trading in a holiday environment, an expiration environment, or during a week where the FOMC [Federal Open Market Committee, the board that directs activities of the Federal Reserve Bank] is a factor?
- As well as countless other similar questions.

What Do You Like to Trade?

Speaking to Mary, my questions led to questions that led to even more questions until we were able to define her game. I asked her, what stocks do you like to trade the best? Do you like the Dow stocks or have a favorite index? — the Banks, Biotechs, Oils, Drillers, Nasdaq100? How about the utility stocks or broker-dealer stocks? The list went on and on.

This was the first of several steps in building a plan. Once we got the process going, it became less of the overwhelming task I originally had anticipated.

She finally explained to me that many of her losses came while attempting to get filled properly while trying to enter and exit NYSE stocks. She hadn't been very successful. On the flip side, she loved to trade the more volatile Nasdaq stocks — KLAC, QLGC, BRCM, MSFT, EBAY, QCOM, etc. (in all, 15-20 stocks based on their volatility and prices). Other favorites included the QQQ (Nasdaq tracking stock) and SPY (S&P tracking stock), and the DIA (Dow tracking stock). Finally, she indicated "fondness" for the S&P and NASDAQ futures indexes and the E-minis, due to their leverage and hedging benefits. So, there's step one — we defined "her" stocks and also her indexes.

How many of us trade every single stock out there and find that, for us, getting filled on some of the NYSE stocks is not the easiest? Or maybe we feel that the Nasdaq is too volatile for our likes and we like the NYSE ever-so-much better. So, guts it out and ask yourself the question – what is *my* stock list or *my* futures list or whatever? What specific products fit my comfort level? Oils? Drug stocks? NYSE or NASDAQ? E-Minis? The Dow? Do I even *have* a favorite list or do I just trade *anything that moves*?

And What's the Time Frame?

After we locked in the type of stocks that Mary liked to trade, the goal was to find what particular time frames she liked best. Working a one-minute chart, for example, is a very short-term time frame, but short term is a *relative term* dictated again by a trader's own comfort level. Some traders dislike short time frames and would rather hold for a few hours or a few days. There are other traders who simply cannot be in the markets that long or they will pull their hair out, and Mary was one of those. From experience, she felt that, mentally, she could not hold on to stocks for a few hours or a few days. Yet, she wanted to stay away from an *extraordinarily* short-term time frame as well.

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Her weakness and subsequent losses came from "swing trading" on daily charts or using such large time frames as 60-minute or 120-

minute charts. She could not stand the "heat" when a trade went against her. For Mary, those longer time frames were tortuous, but scalping on a one-minute chart was too fast and noisy. As a result, she ended up scalping in and out of the market 50 times a day, and that resulted in paying predictably *larger* brokerage commissions for her *small* wins.

> **...if she used more than one indicator, she might find herself facing a buy and sell signal at the same time and not be able to trust either of them.**

We concluded that "her" favorite time frames to trade were 5-minute and 15-minute charts, with the 5-minute time frame the clear favorite. Does this mean she *only* watches a 5-minute chart? No. In fact, Mary *watches* a number of time frames across four monitors for support and resistance levels on higher time frames. However, she executes and trades patterns on *only* the 5-minute chart. That's her comfort level. So, the question is, do you have your "right" time frame defined? What is your time frame of choice? Are you a day trader scalping 50 to100 times a day on a tick chart or a one-minute chart, or do you like to put your positions on and wait it out for a few hours to a few days?

With a defined stock list and the chart time frame best suiting her personality well in hand, we moved on to other factors.

Recognizing "Friendly" Price Patterns

Next step? —Identifying price patterns that Mary was able to recognize without forcing herself too much. I asked her if she preferred channels, triangles or wedges, bull or bear flags, head-and-shoulders patterns, Fibonacci retracements or breakout plays from a consolidation mode. If the markets wind down to a point of breakout, perhaps she'd like the idea of buying new highs or shorting new lows after the first 30 or 45 minutes of the day. Or maybe not.

Mary felt her eye was *best* at seeing higher-probability patterns, like bull and bear flags (a "flag pattern" is a continuation pattern in the direction of the trend). "Flag" patterns have been around since the early days of technical analysis and are considered to be one of the higher-probability trade setups. Simply, a bull flag is a buy pattern in an up trend, and a bear flag is a sell pattern in a downtrend. Mary felt that since this was a very easy pattern to recognize and that working with the trend is better than fighting it, this would be the best price pattern for her to trade. *(See **Figure 1** for "Bull flag" example and **Figure 2** for "Bear flag" example).*

At this point, it was time to begin defining risk and profit objectives based on the stocks and futures Mary liked to trade and the time frame and chart pattern she felt most comfortable using. Connecting the dots, so to speak. I explained to Mary that I personally like to use a 20 period exponential moving average on all my charts and felt it would help her as a short-term moving average support in an up trend… and resistance in a downtrend. Thus, we included that in her "game plan." ***Figures 1*** and ***2*** show this moving average plotted on the chart examples.

What's your pattern? Have you found one good pattern that repeats itself over and over in a consistent manner that allows you to enter and exit the markets each day? Or do you have many different setups and throw darts until one hits the target? Find your favorite pattern and master it.

Figure 1 — 5-Minute Chart of the S&P 500 E-mini Futures Contract Showing a Bull Flag Pattern

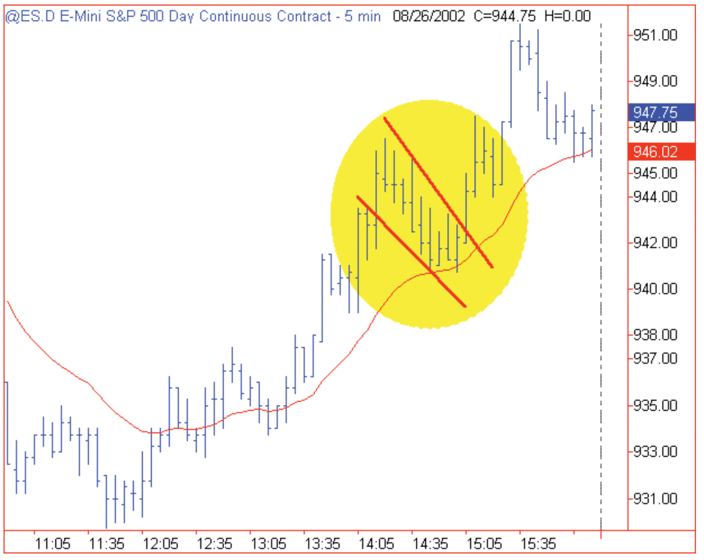

Chart by tradestation.com

Figure 2 – 5-Minute Chart of the S&P 500 E-mini Futures Contract Showing a Bear Flag Pattern

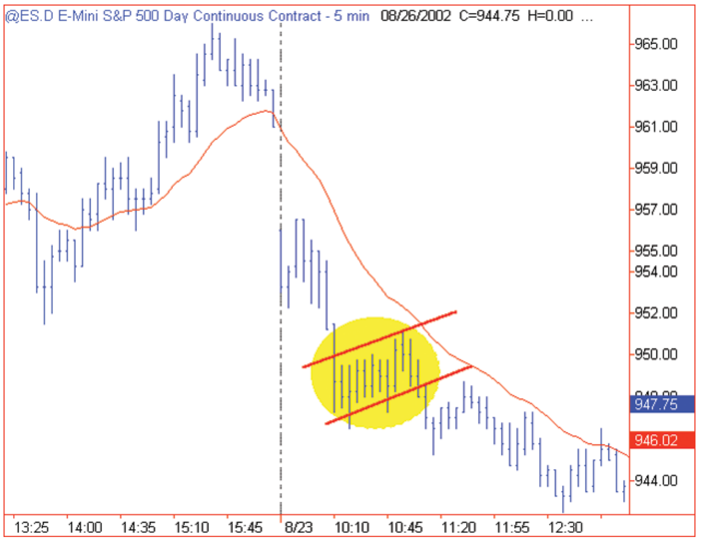

Chart by tradestation.com

Which Indicator Rocks Your Clock?

The next step was to learn if she had a preference for any indicators — an RSI or Stochastic or an MACD, for example. With the variety of studies available, we concluded that she felt best using a short-term Slow Stochastic with a 5,3,3,1 setting for her 5-minute chart time frame. I also needed to explain to Mary that indicators only *confirm* what the price pattern is telling a trader. For example, the retracement in an up trend would be a buy, and the slow stochastic would confirm the price pattern when it became oversold (***Figure 3*** shows confirmation of the price pattern when the stochastic went into an oversold condition*)*. She had used several indicators at one time, and I explained to her that if she used more than one indicator, she might find herself facing a buy and sell signal at the same time and not be able to trust either of them. It's similar to wearing two watches, one on each hand; if each tells a different time, one will never know what the true time is. So, a trader should look toward the one particular indicator that he or she feels good about using.

Figure 3 — Confirmation of Bull Flag Pattern When the Stochastic Went into an Oversold Reading

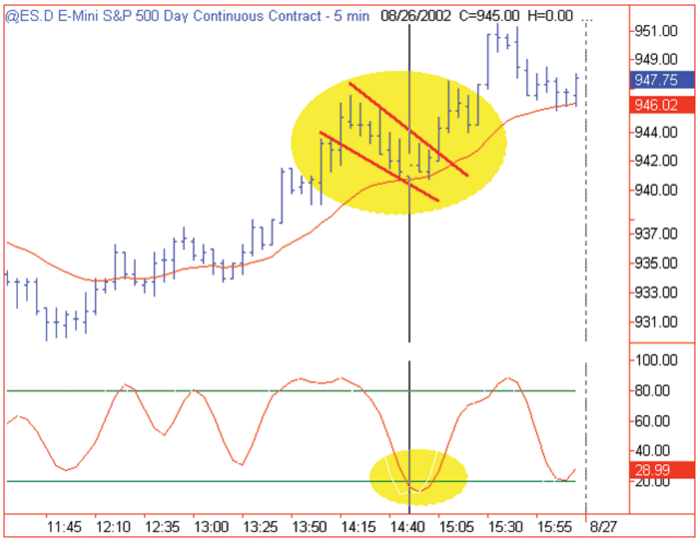

Chart by tradestation.com

Figure 4

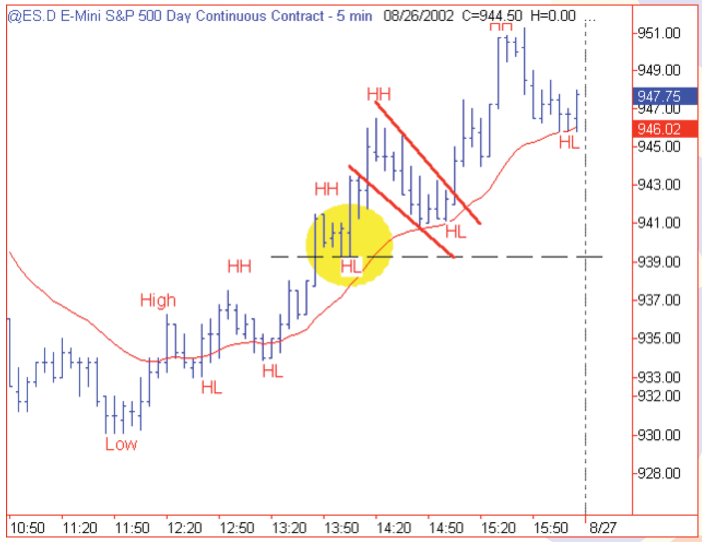

Chart by tradestation.com

What Can You Afford to Risk?

Next consideration — defining risk levels and target levels, based not just on a dollar value but also on the chart, pattern and trend of the market. An up trend is defined by higher highs and higher lows. In ***Figure 4***, we see an up trend. For this trend to stay valid on this time frame, we want to see if the price retracement has a higher low to its last higher low. In this example, the last higher low was 939.00, and the market retraced to 940.75. Therefore, the risk on this trade was around two points. I explained to Mary that sometimes the risk of a trade is too high — maybe four to five points — and sometimes the risk is not as great—maybe one to two points. That risk, I explained, also will determine the *size* of the position she will enter. One S&P E-mini futures contract equals $50 per point, and for the larger S&P contract, it would be five times that size, or a point value of $250. And, of course, her risk level would be a factor in her position size. A full position would be five E-Minis, and risk would normally be two points or $500 ($250 x 2 points). If, on the other hand, the trade required a four to five-point risk, her contract size would have to decrease to accommodate the dollar value she was willing to risk.

We determined that her account was funded such that she could afford to trade one large S&P contract (or five E-minis), and that the average risk per trade would be around two S&P points and, further, that the greater the *point risk* in the S&Ps, the less contracts she would trade. The same applies to the stock side of the equation if a trader is trading 500 shares with one point as the average risk. Intuitively, the greater the risk in price, the less shares the trader can assume for that setup. Have you determined your share or contract size and risk level based on the time frame of your trading?

Another cog in the wheel is in knowing when to get into and out of the market so as to reasonably maximize profit and to avoid undue losses. Those decisions, though, need to be made *before* Mary puts on a trade, so an exit price is predetermined both for a loss and *also* for a win. The pattern she felt most appropriate for her trading is based on a trending market environment in an intraday time frame; typically that occurs when an intraday trend exists and, based on other factors, a trader expects the market to open on one extreme and close on the other extreme. Mary's profile pointed to the fact that she did not want to stay in too long, but still didn't want to get out too fast. It was important to lock in a profit, and the plan unfolded – To bring the risk exposure to a minimum, when the price rallies from its Bull flag pattern, she would raise her stop loss to just under the last low. When the markets made a re-test of its prior highs, she then would take a profit on the position. Before you enter, do you know your risk level and when to take your profits?

Putting all of these factors together, Mary learned how to play the right game for her personality. Some traders will never look at a bull flag pattern, never consider a five-minute chart nor use a Stochastic or anything less than a 50-period average. Some traders prefer the five-minute chart as a time frame and love to use a 14-period RSI. There are as many variations as there are traders.

I've taken you through a journey – a journey that puts together a "custom" game plan for someone who lacked one. Mary no longer has to trade 50 times a day and does not need be in the market every waking moment. With help, she was able define a clear, concise trading plan with 1) the financial products she enjoys trading the most; 2) the time frame/s that fits her comfort level; 3) a solid chart pattern that has endured the test of time, with an indicator to confirm what the price is telling her; 4) a clear concept of risk, and the realization of how much *she* can reasonably risk; and 5) a profit objective.

Mary now can go in and out of the markets three to five times per day in both stocks and stock index futures. The patterns described above also have taken into consideration the higher time frames for support and resistance levels.

Mission accomplished!

Christopher Terry is a full-time stock and index futures trader. In addition to his trading, Chris and his partner, New Market Wizard *Linda Bradford Raschke, provide a real-time online trading service that provides entry and exit signals for stock traders at lbrcapital.com*