Bottom Fishing
<u>Buying Strategy</u>

Concept

Bottom fishing is the quest for stocks that are inexpensive relative to previous levels, but show signs that the bargain is going to end soon. Find stocks that are a showing a break from pessimism, an increased level of confidence that the stock is undervalued, and signs of optimism for the future. Filtering for these situations gives the investor a short list of companies to perform their necessary due diligence on before speculating on a change in trend.

Background

Buying a stock that is in a long standing down trend can be as dangerous as stepping in front of a freight train. It takes time for stocks to reverse trends, and buying what seem to be bargains can be a crush to your portfolio. However, bargain hunting can be profitable if the timing is right. To effectively bottom fish beat-up stocks, you have to enter when there are signs that the downslide is slowing and a move back upward is imminent.

Market psychology takes time to turn around. When bottom fishing, we want to focus on stocks that have suffered a sell off and are cheap relative to where they once were. However, we want to also look for signs that market psychology is turning favorable on these stocks and that they are ready to head higher again.

This strategy focuses on three stages:

Stage 1 – a break from the show of pessimism
Stage 2 – a show of confidence
Stage 3 – a show of optimism

Stage 1 is essentially a breaking of the downtrend. If we draw a line along the top of the declining trend, we have defined the downtrend. A break of the trend arises when the stock can break upward and through that declining trend.

Chart 1 - here we see a break above a well-defined down trend. This demonstrates a break from the pessimism that has prevailed for a couple of months.

In *Stage 2*, we want to see signs that there is confidence in the break from pessimism. The market needs to show resilience that the downtrend is indeed slowing, and that the potential for an uptrend is real. A consolidation following the break is a good show of this, and is more significant if it as at a level higher than the previous low. This is referred to as a rising bottom.

Chart 2 – this stock has broken the downtrend and is now forming a rising bottom. There is increased confidence that the lows have been seen and optimism is beginning to show.

Finally, we want to find signs that there is optimism about the future of the stock. *Stage 3* is best shown by a breakout from a rising bottom.

Chart 3 - a break from pessimism, increased confidence and finally, a show of optimism. This stock has shown each of the three stages often indicative of a break from a downtrend and a good bottom fish.

The filter criteria of this strategy will reveal stocks that are in all three stages. Investors should put stocks showing the characteristics of Stage 1 or Stage 2 on a watch list as stocks with the potential to move to Stage 3. Investors can wait for the move to Stage 3, or take a greater risk and anticipate the move.

Criteria

- Set **Candle** to **Bullish Candle**. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Set **Short Term Moving Average** to **Bullish**. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Set **Medium Term Moving Average** to **Bearish**. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Set the **Price from 150 day high** to **>= 25%** . This will bring up stocks that are more than 25% down from their 150 day high. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- We want to find stocks that are being accumulated. Set **Williams Volume Accumulation** and **Volume Price Trend** to **Bullish.** These filters are found under the Volume Indicator Queries section of the Stockscores.com Market Scan tool.
- To filter out stocks that have poor liquidity, also set a minimum volume requirement. Set **$ Value Volume >= $250,000.** This filter is found under the Volume Indicator Queries section of the Stockscores.com Market Scan tool.

Variable Criteria

- You may want to restrict your search to stocks that are above or below a particular price. Use the **Price >=, <=** tool to do this. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.

Visual Assessment

When looking at the charts of stocks meeting the filter criteria, we want to simply find stocks that show a break in trend, the formation of a rising bottom and then a break from that rising bottom. Doing so can yield good results:

Chart 4 – first, a break from the downtrend. Then, a period of confidence building followed by the show of optimism. The results can be very rewarding.

Where It Can Fail

No strategy is 100% effective. Smart traders take losses early when the market proves them wrong. The line of resistance that the stock breaks through when it completes Stage 3 becomes a floor of support for the stock. Pessimism may be returning if the stock penetrates the floor price after the breakout. In this instance, caution is warranted.

Summary

It is tempting to buy stocks that are in downtrends. It appears that these stocks are on sale, and purchasing them will be nothing short of a bargain. However, it is difficult to know where these stocks will find their bottom, and getting in too soon can be disastrous. Instead of anticipating the exact low, it is better to wait for signs that the downtrend is ending and an uptrend is beginning. Stocks rarely move in sharp V formations, so expect that the downtrend will take some time to slow. A break from a period of consolidation after the downtrend has been broken is a good sign that there is increased optimism coming into the market.

Support and Resistance

Educational

Stockscores.com

Introduction

The concepts of support and resistance are among the most important in technical analysis. They represent psychological barriers that can impede a stock's move, but can also be utilized to anticipate new information. When making a visual assessment of a stock chart, a solid understanding of support and resistance can help investors determine entry and exit points for profitable trading.

Support

Simply, support is a floor price that the market for a stock has shown a hesitation to break through in the past. The more times a stock touches this floor price, the stronger the support is said to be. It can be defined by a low point in trading, or by a period of price consolidation.

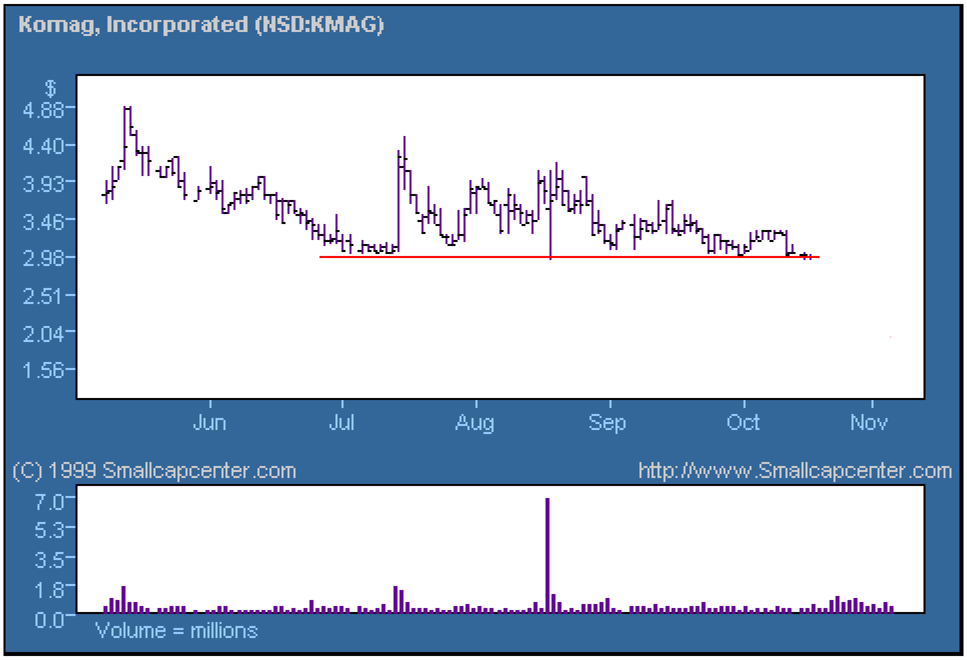

Chart 1 - The red line represent a floor price that this stock has bounced off of numerous times, making it a level of good support.

It is not uncommon for support prices to occur at even dollar values, as these tend to be psychological barriers for market participants. The longer the time period that the level of support has held up, the more important it is. Stocks that penetrate strong levels of support often head lower.

Defining support is relatively simple. Looking at the stock chart, find areas where the stock has trade sideways for a period or, a low point in recent trading. If the stock has pushed the floor price on numerous occasions, then that level of support will be strong as it holds greater significance in the memories of investors.

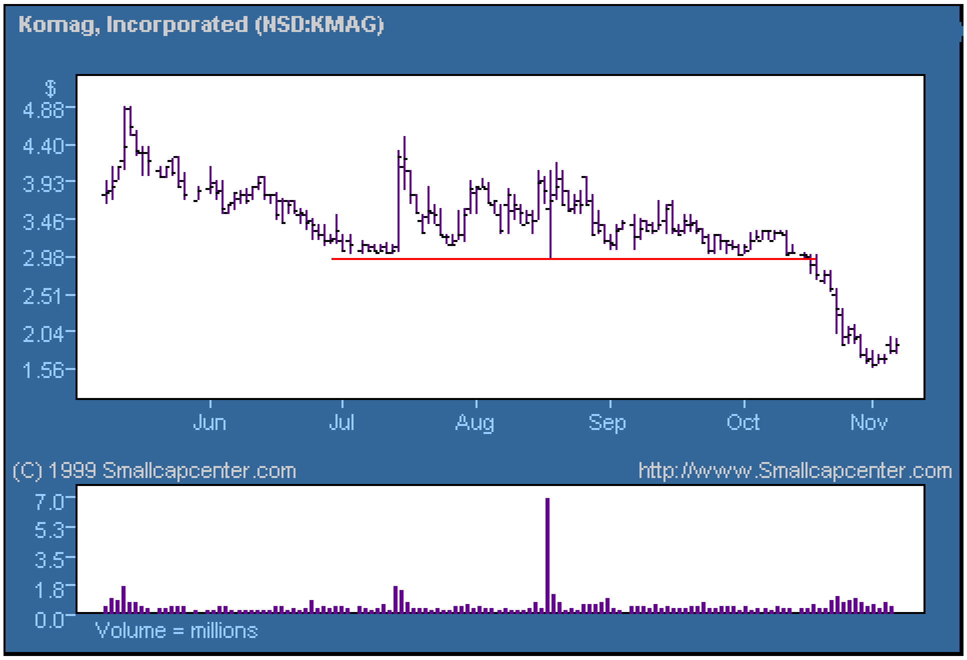

Chart 2 - once the level of support was penetrated the stock headed lower.

From an investor's standpoint, the level of support can serve as an exit point from a long position, or an entry point for a short position. If a stock penetrates a support level after a period of consolidation and general pessimistic trading, it often heads lower. Owners of stocks that are testing support should be wary of the downside risk that is evident, and may want to exit the position if that support level is violated. Short sellers should look at these situations as an opportunity to make a successful trade on an abnormal downward move.

As a caveat, however, it should be recognized that support often serves as a potential reversal point for negative market psychology. If a stock is undervalued, it often bounces off of support and reverses a downtrend. While this can happen, it is more the exception than the rule. In these situations, be sure that the bounce actually breaks the market's pessimism and is not just a feeble attempt to dissuade the inevitable downward trend.

Resistance

Resistance is just the opposite of support. Instead of a floor price, it is a ceiling that the market has shown an unwillingness to trade above. For a stock to break through resistance often requires a dramatic shift in psychology, often brought by positive new information.

To find the line of resistance, look at the stock chart and seek out high points or trading ranges. High points provide an upper limit of value for the stock, and trading ranges define an area where the market had a strong consensus on the value of the company. As with support, the more often a stock touches the line of resistance, the stronger that ceiling is. Again, resistance often forms at even dollar values as they sit well in the minds of investors.

Chart 3 - This stock touched against the $38 level three times over three months, but was never able to break through. The market was unwilling to pay more than this price based on all the information it had about the company.

Investors want to pay attention to a stock's resistance point, because a break through that point is often followed by an uptrend. Theoretically, resistance represents the maximum the market is willing to pay for the company. If the market becomes willing to pay more than that price, it is often because there are new developments that make the company worth more. Stocks that are trading near their resistance point have the potential to show upside volatility as the market is showing expectations for new information.

Chart 4 - Once the stock broke through the resistance point, it continued higher and showed a greater degree of volatility than it had in the past. This directional move combined with the added volatility is an excellent opportunity for the trader.

Stocks that come through with positive new developments are able to break through resistance and go into uptrends. Those that don't live up to the market's optimistic expectations often bounce off the ceiling price and remain in the trading range. Legitimate breakouts are often combined with an abnormal trading volume at the time of the breakout.

Summary

Understanding support and resistance is essential to becoming a successful technical investor. They act as visible thresholds indicating the state of market psychology. Breakouts and breakdowns are strong signals for directional moves that should not be ignored. Experience in visual assessment of charts and their levels of support and resistance will help determine exit and entry points for investors.

Profiting from Euphoria

Selling Strategy

Stockscores.com

Concept

Hot stocks are an ideal opportunity for traders. By being hot, and having the attention of many investors, these stocks often push dramatically higher as investors all rush to purchase the stock. This euphoric buying activity is motivated by emotion, and often causes the stock to go higher than it deserves. Eventually, rational behavior sets in and these stocks pull back, often dramatically. Knowing how to recognize the signs that this reversal is set to happen can help owners of the stock take profits near the high and short sellers to profit from the move lower.

Background

There are four factors that cause movements in stock price:

- New information
- Uncertainty
- Psychological Factors
    - Fear
    - Greed
- Supply and Demand

This Profiting From Euphoria selling strategy focuses primarily on the opportunity created by the psychological factors that cause stocks to move higher than new information warrants.

When positive new information about a company is made public, it often creates a feeding frenzy in the market. Investors who are excited about the positive news clamor to buy the stock, creating rapid price appreciation. This creates a bubble of euphoria which, when the excitement subsides, often breaks. As rationality returns to the market, the stock will fall dramatically as investors take profits and short sellers take positions. Simply, greed causes the stock to go too high, and fear makes everyone rush for the exit door at once.

Consider the example below:

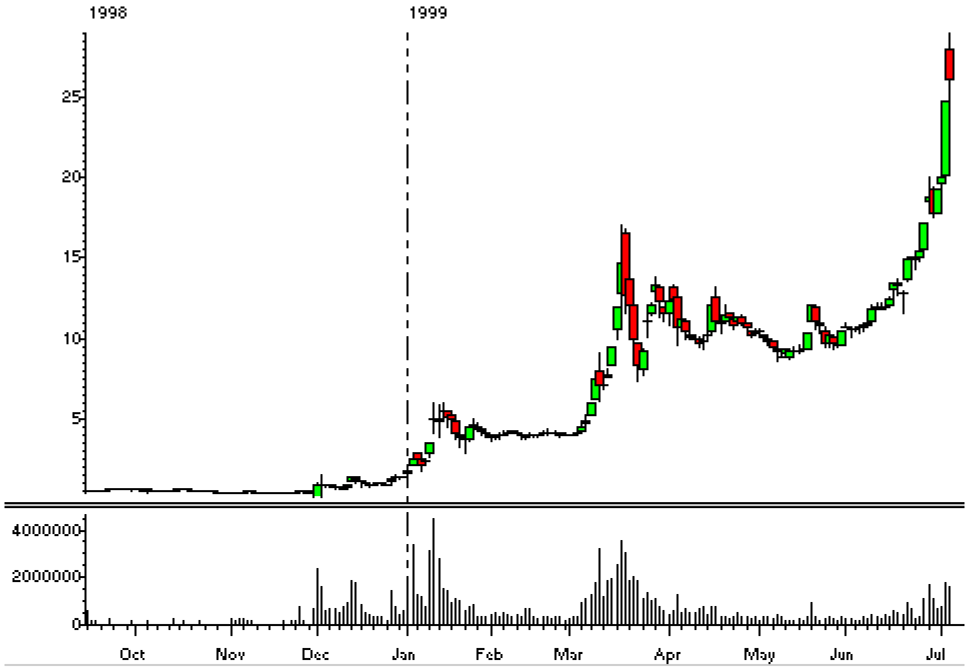

Chart 1 - This stock made significant gains in a very short time period, and traded heavy volume along the way. In less than a month, the stock more than doubled, making it an excellent candidate for this strategy.

The chart below shows what happened the following week:

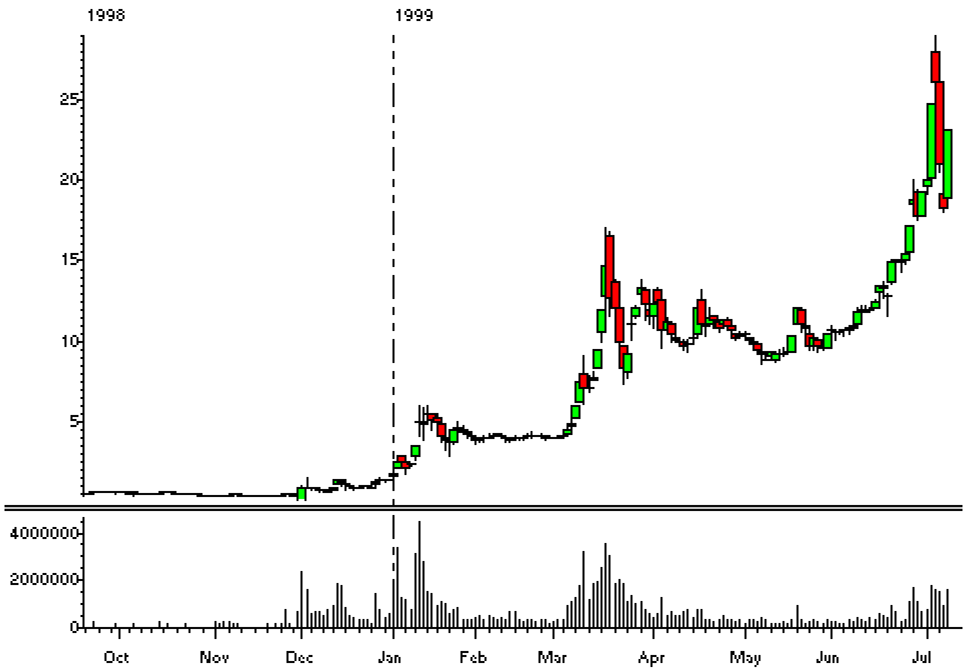

Chart 2 - In the next two days, this stock lost about 30%, which is a very impressive gain for the short seller in such a short time period.

What this demonstrates is that the strategy is a very good one for the short-term trader. Activity is often fast and furious, so it is necessary that those utilizing this strategy be nimble and on top of these opportunities. They do not happen very often, but they are relatively easy to find since stocks that climb so dramatically often receive a good deal of attention from the media. Whether you have ridden extraordinary gains in a stock and are looking for an exit point or, you missed this kind of freight train and are looking to make money on the short side when the train comes off its track, this is an excellent strategy.

What to Look For

There are a number of conditions that have to prevail for this strategy to be effective. If you own a stock with these criteria, then watch for the signals below. If you are looking to make money on the short, then use our scanning tools to find stocks with these criteria and then look for the visual signals.

<u>Criteria</u>

- The stock has to have made abnormal gains recently. We want to find stocks that are trading on some euphoria as the psychological condition of the market makes it ripe for over pricing. To find stocks that have done this, you should use the Stockscores.com Market Scan tool to filter out all the stocks that are up at least 25% in the past 30 days. Select **>=25% over the last 30 days** for the filter, **Gain/Loss**. This filter is found under the Price Indicator Queries section of the Market Scan tool.
- Trading volume is also essential, as stocks that are trading on euphoria will trade dramatically more volume than normal. To find stocks that have done this, you should use the Stockscores.com Market Scan tool to filter out all the stocks that are trading above their 150-day moving average for volume. Select **Above** for the filter, **Today relative to 150-day volume average**. This filter is found under the Volume Indicator queries of the Market Scan tool
- Stocks that fit this strategy will have very strong momentum. As an extra filter, we want to find the stocks that are heavily overbought, as this implies that they have gone too high. Use the Stockscores.com Market Scan tool to filter out all the stocks that are overbought according to the Relative Strength Indicator. Set **RSI** to **Overbought**. This filter can be found under the Momentum Study Calculations of the Market Scan tool.
- For there to be euphoria, there must also be volatility. We want to find stocks that have traded in a wide trading range today and have been volatile in the very recent trading history. To do this, use the Stockscores.com Market Scan tool and set the **Volatility Index Today** to **High**, and set the **Volatility 20 Day** to **Increasing**. These filters can be found under the Price Indicator queries of the Market Scan tool.
- Finally, and most importantly, we want to select stocks that are showing a Bearish candle. This means that they are closing below where they opened. Use the Stockscores.com Market Scan tool to set the **Candle** filter to **Bearish Candle**. This filter can be found under the Price Indicator Queries of the Market Scan tool.

<u>Options</u>

- You may wish to limit your search to stocks within a certain price range or those that have traded a minimum volume requirement. Utilize the Stockscores.com Market Scan tool to set the **Price >=, <=** tool and the **Volume** >= tool.

<u>Visual Assessment</u>

Utilizing the above filter criteria, the Stockscores.com Market Scan tool will reveal a filtered list of stocks which are likely to meet the requirements of the Profiting from Euphoria strategy.

However, you will need to visually assess the charts to find the best candidates. Look for stocks that have had strong starts to the day, and have hit a short term new high today. If you are using the Candlestick charts, you will also find that the candle is red, indicating that it closed below its low. Here is an example:

Chart 3 - This is a prime shorting candidate because there are signs of profit taking after an euphoric run up.

Where the Strategy Can Fail

No strategy is 100% effective. If the market proves you wrong, you are very smart to take your loss. If a Bearish candle is followed by a day of strength and a bullish candle, it may be that the stock is not ready to die yet. Take your loss and move on. Also, beware of stocks that show a Bearish candle after a euphoric run up, but did not make a new high on the day of the Bearish candle. These are often signs of a stock simply taking a short-term breather before heading higher again. Don't get caught shorting a fast moving stock because you can take significant losses. Discipline is absolutely essential.

Summary

Profiting From Euphoria focuses on stocks which have made euphoric moves higher and assumes that these stocks will suffer some profit taking as investors look to take money out of the stock and bring it closer in price to its true fundamental value.

Short sellers can profit from the deflation of the bubble, and owners of the stock can benefit by getting out as close to the top as possible.

Focus on stocks that have had rapid price appreciation and then close below their open on a day when volatility is high and the stock has hit a new high. As confirmation of the market euphoria, volume should also be higher than normal.

Adoption Cycle of Stocks

Tyler Bollhorn

Have you looked at purchasing a Plasma television lately? If you have, then you will know that prices are a lot lower than they were five years ago. As I browsed through the electronics flyer that came with my Friday newspaper, I started to think about the adoption cycle of new products, and how it compares to the adoption cycle of stocks. There are a lot of similarities, consider the types of consumers that take a new product like a Plasma television through its product life cycle:

Innovators - these are the people that created the Plasma screen and had one hanging in their house at an enormous cost. I remember hearing that Bill Gates had them all over his newly built home before you could really even buy them in the store. He has a little better access to upcoming technology than the rest of us.

Early Adopters - Plasma screens show up in boutique electronic stores and the guy who has everything (and lets everyone know that he has everything) rushes down to buy one, despite the very high cost. He has thoroughly studied the technology and believes that it is the next great thing.

The Astute - this group catches on to trends early and waits for prices to get a little more reasonable before purchasing. The increasing consumer buzz convinces this person to get the Plasma.

Majority - as Plasma prices approach the prices paid for an old style television, mainstream consumers start to buy them and soon it is not cool if you don't have one. We are not there yet on Plasma TVs, but getting closer.

Reactors - some people hold out on purchasing a Plasma, citing the technological weaknesses of the product. Finally, the prices are so low that they too must have it because they would never pay the astronomical prices for the new TV technology that will one day replace the Plasma.

Holdouts - those who do not care about the innovation, they buy a Plasma screen because they simply can't find someone who will fix their old Zenith.

Garage Sale Buyers - on a Sunday morning, those who find sorting through some one else's old stuff cathartic are out looking for deals on a discarded Plasma screen. When they find one, they buy it cheap and brag how they got a Plasma for $100 that used to sell for $10,000. Now, does it work?

You are probably wondering what the heck all this discussion of Plasma TVs has to do with the stock market? Well, just as new products go through an adoption cycle, so too do stocks. We can think of stocks like products, and the companies have to convince the investment community to buy them. However, unlike a new product whose price drops as it goes through the product adoption cycle, stock prices will ascend as investors accept their positive fundamental change.

Consider a similar adoption cycle:

Insiders - these people know that the company is doing good things because they run the company. With the benefit of better information than anyone else, they can own stocks destined to go higher and actually guide the company to justify higher prices. While it is illegal to trade on inside information, it is not illegal to do nothing. Most insiders hold massive amounts of their company stock, and if good things are coming, they choose not to sell. That creates an imbalance between buyers and sellers in the market, and the stock begins to move up.

Early Adopters - this group either knows an insider or are particularly astute at reading market activity. They see signs that something is going on, and accumulate a position without really knowing why. They never buy at the bottom, but are good at getting in to uptrend early.

Aspiring Traders - as volume picks up, technical indicators tell them that the buyers are winning, and they accumulate the stock. As buzz about the company begins to circulate in the media, the big funds begin to take positions wishing they had known about it sooner.

The Momentum Players - the stock is now well in to its up trend and the media begins to talk about the success of the stock somewhere outside the headlines. Investors are calling their brokers about the stock, and investors with some experience are taking positions because the company is obviously good. Trading volumes are getting very heavy and the Insiders and Early Adopters are selling in to the strength.

The Greedy - after the last bear market, these investors swore they would never buy another stock. However, they have been watching this one climb for some time and feel they are missing out on a great opportunity to get rich the easy way. They buy at the top as the insiders sell the last shares he can without getting too much heat from his shareholders. Meanwhile, the hot stock makes front page news because the media are very good stock pickers.

The Uninitiated - your grandmother that does not know the difference between a bid and an ask opens an account and relieves the mattress of its bulge by putting money in to those "hot shares" that she heard about at Bridge club. The grandchildren won't get put through college with this one, the stock is on the decline.

The Bargain Hunters - "Hey, Nortel used to $100 and now it is only $50, I am going to buy it because I know it will go back to at least $75 again". Uhh huhhh, still waiting for the turnaround?

So what are the lessons to be learned from this? First, most of us don't know enough about any company to get in to the stock in the early stage of an up trend, so we have to trust market activity to tell us when an up trend may be starting. Second, the higher a stock goes, the riskier it gets. Third, when you are reading about it on the front page of the newspaper, a trend reversal is probably not far away.

The stock market is not always the same. Stocks behave very differently in a down trend as opposed to an up trend. For that reason, you can not apply the same strategy all of the time. The overall market condition should determine your approach to the market.

This week, the major indexes suffered an important technical breakdown. Concerns over oil prices, terrorism and rising interest rates have dissuaded buyers from acting enthusiastically, and the sellers are winning in the stock market.

Over the next six weeks, I expect that stocks will move lower through the 2004 Olympic games as investors have heightened concerns over a terrorist attack in Athens or later, at the Republican convention. Provided there is no act of terrorism, stocks should start to bottom and oil prices should top out. Interest rates will be raised a quarter of a point, but the US Federal Reserve may indicate that a further rate increase will not be likely. As we move through September and toward October, stocks should bottom and start to firm up in anticipation of the stock trader's money making season, November till May.

Therefore, there is a good opportunity to short sell stocks showing weak technical charts, with an anticipated hold period of 2 to 6 weeks. With that in mind, I went through the Nasdaq 100 and Dow 30 using the Sector Watch, and found the following stocks that I think are likely to go lower, making them good short sell candidates.

Keep in mind that the hypothesis about where stocks are going is only valid so long as resistance is not violated on the major market indexes. Good stock traders never get married to an idea, don't be committed to it if the market begins to tell us something different.

Efficient Market Theory

Tyler Bollhorn

Here are some disturbing facts for those who aspire to make money in the stock market. Most people, including most professional money managers, fail to consistently beat the stock market. Of those that try to make a living trading the stock market, I would guess that 90% fail.

The Efficient Market Hypothesis is at the root of this poor performance. This most basic of financial theories states that the stock market is efficient at pricing in new information and therefore, no investor can consistently outperform the market average. That is a nice textbook definition but what does it really mean?

Consider what would happen if you were to drop a $100 bill in a crowded shopping mall. Would it stay on the ground for long, or would someone quickly pick it up? The answer is obvious; almost anyone who spots a $100 bill on the ground would pick it up and put it in their pocket.

The same can be said for the stock market. The market quickly adjusts the price of a stock when the company announces a significant advancement in their business. Announce a cure for Avian Bird Flu and your stock will go up in price almost instantly.

That means that using publicly available information to make an investment decision is a futile pursuit. The market takes every bit of fundamental information pertaining to each individual company and prices it in through the buying and selling of that stock in the open market. The buying and selling is essentially the result of an argument between buyers and sellers about the true value of the company.

This argument for market efficiency is the reason most financial theorists suggest the simple purchase of a market index when investing in stocks. That way, your performance closely mirrors the long term performance of the stock market, which historically, has been better than any other class of investments.

So why bother trying to beat the market? Because, there are some holes in the theory of market efficiency that can be exploited

The theory has two critical assumptions. First, investors are assumed to be rational in their deduction of the value of information. Second, it is assumed that the spread of new information is fair and that all investors learn of new information at the same time.

If you have been investing in the stock market, you will likely laugh at these assumptions. Have you ever bought a stock with an irrational feeling of greed? Have you ever sold a stock out of fear?

Do you think that there are some investors who get new information before the broader market? Have you ever watched a stock move up in price before a big news announcement?

The truth is, some investors are trading on private information that is not yet widely disseminated. This is referred to as information asymmetries in the market. And, for some reason, we humans are prone to making emotional investment decisions.

This is good news, because it opens some holes in the theory of market efficiency that savvy traders can exploit. These breakdowns are the basis for the Stockscores Approach.

The Sentiment Stockscore is a measure of investor psychology. By looking at the general patterns of trading in the stock market, we can gauge whether the buyers or sellers are in control of the market. If the Sentiment Stockscore is above 60 we suggest that investors are optimistic.

When investors are optimistic, they will tend to judge fundamentals favorably.

The Signal Stockscore is a much rougher line that looks for abnormal trading behavior as a clue that some investors may be trading on new information that is not widely disseminated. If a stock jumps up in price with heavy volume, expect the Signal Stockscore to jump above 80.

This leads to the three rules for picking a stock using the Stockscores Approach. First, make sure the Sentiment Stockscore is above 60. Next, check that the Signal Stockscore is spiking up above 80. The final rule is to check the chart to see if the is making a good chart pattern.

This is where some skill is necessary since good chart patterns are a matter of judgment. At this point, it is important to stress that we never buy a stock because it has good Stockscores. We stocks when the chart patterns suggest that the probability of the stock going up are in our favor.

So, what makes a good chart pattern? For purchasing a stock, there are four factors to consider:

- is the stock breaking through a price ceiling or level of resistance?
- is the stock showing optimism (have there been rising bottoms on the chart leading in to the breakout)?
- is the stock behaving abnormally?
- was the stock trading with very little volatility (sideways and not in a trend) before the break?

These are the basic elements of a good buying chart pattern but only the beginning of the successful trade.

Suppose you are a very good stock picker, you can spot good chart patterns and find winning stocks 70% of the time? Are you guaranteed to make money in the market? Sadly, the answer is no.

The next key component to trading the Stockscores Approach is Risk Management. Since picking stocks is really just a probability game, we have to be able to control our losses when we are inevitably wrong. That requires planning our losses and letting the plan determine our position size. If the stock chart tells you that a break below $9 will prove your decision to buy the stock at $10 wrong, then you have to plan to sell on a move below $9. That means you have $1 per share in risk, and if you don't want to lose more than $500 on any one trade, you should not buy more than 500 shares. This is a simplification of the Risk Management concept but hopefully you get the idea.

Reward potential is also important in the risk management calculation. There has to be enough upside potential to justify the downside risk. The expected value of the trade has to be positive or the trade is not worth taking.

Is good stock picking and effective risk management all there is? Sorry to disappoint you, but no, there is more.

Once the market has proven your decision to enter a trade correct (by a show of profit on the trade) it is smart to add to that position, a practice called scaling in. Buying more of a winner is good because the probability of success is greater when your trading decision has already been proven successful.

Finally, and most importantly, the ability to have emotional control is necessary to beat the performance of the market. This requires that you do not make decisions based on fear or greed, that you follow proven and rational rules of trading. This is what makes trading the stock market difficult.

Most people have an emotional attachment to money. They are afraid of losing it and get excited at the prospect of making it. As a result, they tend to sell their winners too early and exit their losers too late. They tend to take risks in the pursuit of pleasure and avoidance of pain. If you are a normal human being, you are predisposed to fail in the stock market.

I can teach most people the basic rules of the Stockscores Approach through our StockSchool Pro course in a relatively short period of time. However, trading is not so easy to learn in a weekend. That is why the StockSchool Pro course is a six month mentoring process. If you are looking to learn how to trade the stock market, don't expect the instant solutions offered by some companies to work. Learning to trade will take at least a couple of months, but typically longer.

So, we must ask the question again, why bother? Here are some other things to consider:

- with the power of compounding, an improvement in the annual return of your retirement portfolio can have a dramatic effect on when you retire. Would you put in an hour of effort a week to retire 10 years earlier?

- making a career out of trading the stock market can be very lucrative and give you a kind of freedom that few other choices offer. I have seen my students make more in a day than the average person makes in an entire year. I have sat on a beach chair in Hawaii with my feet in the Pacific while trading the market with a lap top computer. Trading is a lot of fun.

Mr Theory & Mr Trader

Tyler Bollhorn

One day, Mr. Theory went to pick up his friend, Mr. Trader. Mr. Theory, a very smart man, liked spending time with Mr. Trader. While Mr. Trader was not as smart as Mr. Theory, he was very successful and Mr. Theory admired Mr. Trader's ability to make money. Perhaps that made him pretty smart too.

As Mr. Theory and Mr. Trader were walking down a busy street, Mr. Trader exclaimed, "Hey, that looks like a $20 bill on the ground up ahead." He ran forward to pick it up. Mr. Theory laughed to himself, for any intelligent person knew that with all these people walking on this road, it could not be real money. If it were real, it would have been picked up already. It was just like the efficiency of the market, and there was no way he was going to look silly picking up some garbage that looked like money.

"Look at that, $20 bucks just lying there," shouted Mr. Trader. He was quite happy with having discovered the money on the sidewalk. Mr. Theory shook his head in disbelief. "I can't believe your luck Trader." It was real.

As they walked along, they noticed a sign for a garage sale, only another block away. "Let's go check that out," said Mr. Trader, "we might find something of value!" Mr. Theory begrudgingly agreed, knowing that it would be a waste of his time.

At the garage sale, Mr. Theory picked up a vase and turned it over in his hands. It seemed quite old and interesting, but he did not really have an interest in owning someone else's junk. Soon after putting it back on the table that he found it, Mr. Trader picked up the same vase and promptly paid the owner the $2 price that the vase was tagged with. Mr. Theory and Mr. Trader left the garage sale with Mr. Trader carrying the vase under his arm.

"Why the heck did you buy that piece of junk Trader?" asked Mr. Theory. Mr. Trader smiled sheepishly, "I must confess, I have an interest in antique pottery, and this vase is worth about $1000. I can't believe I found something like that!"

Mr. Theory looked at his friend in disbelief. "Hey, I saw it first, let me have it for the $2 you paid!" he yelled.

"Listen Theory, you should know. Just like the stock market, sometimes life is not fair. I have better information, and it paid off today," replied Mr. Trader. Mr. Theory shook his head in disbelief again.

As they walked down the street, Mr. Theory noticed that there was a crowd forming outside an electronics store. "Let's go take a look at what is going on over there Trader," said Mr. Theory.

"Ohh, it will probably be a waste of time," answered Mr. Trader. But Mr. Theory persisted. "Look at the size of the crowd, there must be a good deal on there." And so, they joined the crowd. When they got to the front of the line, Mr. Theory saw his reward. The store was selling computers for half price! Without hesitation, Mr. Theory handed the clerk his credit card and bought the last one they had.

"Hah, it is my turn to get lucky today. I can't believe the deal I got," said Mr. Theory. He did not even wait for a reply from his friend, but continued down the street with his new computer under his arm. Mr. Trader shook his head and laughed.

Mr. Theory eventually got tired of carrying his computer so they decided to stop in at a magazine stand to take a break, and take a look at some magazines.

"Hey Theory, isn't this the same model of computer that you just bought?" asked Mr. Trader as he pointed to a review in his magazine. "Yes, it looks just like it," replied Mr. Theory. "What does it say?"

"Umm, it says that the computer has a flaw that prevents it from doing anything more than playing games. It won't run any business software. I guess that is why they were on sale."

"Oh no, what the heck am I going to do with it now? If that stupid crowd of people had not caught my attention, I would never have bought the boat anchor," wailed Mr. Theory.

They walked on in silence.

Finally, Mr. Theory looked at his friend, and asked, "How come you are so lucky. Today, you found a $20 dollar bill, you bought a $1000 vase for $2 and then watch me buy a piece of junk computer. And to add to all that, you make millions of dollars in the stock market. When will your luck run out?"

Mr. Trader looked at his friend and said, "Look Theory, I am no luckier than anyone else. Our day has been an almost perfect example of why I do well in the stock market. We both saw the $20 bill, but I ran to pick it up because you were too caught up in your ‘efficient market theory' to bother. Then later, I bought a vase that you saw first because I had better information, which is something that happens everyday in the stock market. Finally, you got caught up in the emotion of a crowd and made a hasty purchase decision while I ignored the opportunity. The stock market, like life, makes mistakes because of human emotion. I make money in the market every day using the same principles that have been our experience today."

"Ahh, you're just lucky," answered Mr. Theory.

Perceptions & Fundamental Analysis

Tyler Bollhorn

If a tree falls in the forest, and there is no one there to hear it, does it make a sound? If you share my philosophy on the stock market, your answer will be an obvious no. What do gravity and trees have to do with investing? Let me explain.

The most common approach to identifying stock market opportunities is fundamental analysis. By analyzing the company's business and industry, the fundamental analyst can calculate the value of the company. If this calculated value is less than the value given to it by the stock market, the stock deserves purchase. The idea is, eventually, the market will figure out that the stock deserves to be higher and make it so, creating a profitable investment for the fundamental stock picker.

Alternatively, the fundamental analyst will compare statistics of companies in the same industry. If the average price/earnings ratio (PE Ratio) for large oil companies is 10, then those with lower PE Ratios should be bought, and those with higher PE Ratios should be sold. This same approach can be applied using a multitude of calculations from the company income statement or balance sheet.

While all this makes good sense to the analytical mind, I have always wondered why so much in the stock market does not make sense when viewed under the fundamentalist microscope. Why does Yahoo (YHOO) trade at a PE ratio of 165.8? Why does book seller Amazon (AMZN) have a market capitalization of over 22 billion dollars when they can't even make a profit? Why do hundreds of photographers, reports and fans drive and wait for hours to see Michael Jackson walk in to a courtroom? Admittedly, I am not the smartest guy on the planet, but am I missing something?

The truth is, fundamentals are not the most important factor in determining share value. What matters more than anything when determining if a stock will go up or not is whether invstors are willing to pay more for the shares. We are destined to fail in the stock market if we think that fundamentals are the soul motivation for opening our wallet. Fundamentals certainly contribute to our view of the stock market, but our perceptions of fundamentals are often swayed by our emotions.

If no one is in the forest when the tree falls, it makes no sound. If CNN, NBC, ABC, CBS, BBC, CBC and 1500 passionate tree huggers are there to witness the crackling of a falling tree, the tree makes a sound heard around the world. Similarly, fundamentals only matter if we as investors care about them.

I am proponent of technical analysis because I believe that it is the perception of fundamentals that matter, not the fundamentals themselves. How we as investors judge information is based on our state of mind. The behaviour of a crowd can cause some unexplainable perceptions of reality.

Many investors are more motivated to buy a stock because it is going up than because they like the company's business. That is why there is a tendency for volumes to increase dramatically when stocks move in sharp up trends. Like the bargain table at Wal Mart, crowds bring in more crowds of curious onlookers. Greed captures the dreams of the onlooker, and sucks them in to ownership at prices that don't make sense. Fundamentally speaking of course.

The madness of crowds does cause the market to make mistakes in pricing stocks. Eventually, perceptions change, and over time, I believe that stocks regress to their fundamental value. Does that mean that we should not take advantage of the rise and fall of the market through the process? It is a simple fact that any fundamental analyst can understand; it is easier to make a profit on a lousy company whose stock goes from $1 to $10 than a good company that goes from

$5 to $3.

When considering a stock for purchase, you must first ask if the market is listening to the company with a favorable ear. If investors like the story, and are optimistic about the company, then any positive fundamental change will be rewarded with higher prices. Otherwise, the company is a lonely tree destined to fall.

Psychological Support & Resistance

Tyler Bollhorn

For a long time, I have considered support and resistance as horizontal lines on a stock chart, defined by highs and lows established in the past. The more times that line was touched, the more important the floor or ceiling price was. Breaks through support or resistance were considered important, for they were often caused by significant changes in the fundamentals of the company, or perhaps a shift in investor psychology. But in recent weeks, I have started to think differently about support and resistance.

Slow markets are viewed by most investors as a drag, a limit to profitability. However, when the markets go in to a slow period like we have seen this past week (trading volumes were at their lowest for the year last week), good traders work to find new approaches to making money. Necessity is the mother of invention, and a quiet market is difficult to trade unless you can find a new way to approach it. I typically work on new trading methods when the market is slow.

While trading activity was slow this week, I was able to achieve a very high success rate in my trading this past week. It is hard to always make profitable trades, but this week, I would guess that I was profitable 80% of the time. For a very slow week, that was pretty good. Most of my trades were based on a very simple set up based on a slanted view of support and resistance.

If you took at stick, and laid it down on the highs of a stock that is trending downward, you would have a downward sloping line of resistance. If you took at stock that was trending upwards, and pushed a stick up against the bottoms of the upward trend, you would have a line that was sloping upwards. Not a conventional, horizontal line of support or resistance, but a line defining the psychological limit of investors just the same.

Stocks don't fall forever. Stocks don't rise forever. If you are short a stock that is falling, eventually you want to convert your paper profits in to real money, so you cover the short. If you own a stock that is rising, eventually you want to sell it and take your profits. This causes the market to move in waves, with pull back waves in the midst of the primary trend. These breaks of the primary trend are reliable ways to trade.

If a stock breaks its upward trend line, it tends to behave pretty predictably. A stock that is in an up trend will have a group of traders take profits, causing a break in the uptrend. Other traders will doubt the stall, and continue to buy while the optimism is shifting to pessimism, causing a brief stall after the break of the uptrend. Then, traders inflicted with a bit of pessimism sell on the next sign of weakness, and a more substantial sell off occurs, often pushing the stock down to the next level of horizontal support. For certain stocks, it happens over and over again, and is pretty predictable.

Therefore, it makes sense to short sell the stock that breaks it uptrend, and is working through the stage of second guessing that typically follows for a brief period. This strategy works particularly well if the overall market is also at a point where it appears likely to go lower. Conversely, you can buy stocks that break their downward trend line, accumulating them at that brief period when sellers second guess the strength.

I applied this strategy by day trading a particular group of stocks this past week, and found it to be very effective. You don't only have to look to buy stocks breaking through horizontal resistance, or sell stocks breaking below horizontal support, the break of sloping trend lines is also important.

Support is a *psychological threshold* among investors, and it can be an upward sloping trend line. If that trend line is broken, short sell the stock. Resistance can be a downward trending line that consistently resists buyer pressure. A break of that downward trend line can be a reason to buy.

Stock Trading and the Art of War

Tyler Bollhorn

The stock market is a forum for debate between buyers and sellers on the values of companies. That is the nice explanation. The reality is that the stock market is a war between buyers and sellers, who each want to take the others money. The stock market is rough, and if you don't approach it with the disposition of an irritated general, you will lose. In the stock market, nice guys finish last.

Sun Tzu's, The Art of War serves to highlight many aspects of trading, since trading the market is much like warfare. Here are some quotes from the book, and their application in trading:

"All warfare is based on deception."

This point was made perfectly with trading in TARO on Thursday. The stock was hammered lower on bad news, but seemed to want to go higher as the morning wore on. Watching trading activity, you could just tell that there were some big buyers in the market looking to bottom fish the stock. At one point, on the Stockscores Live Chat, I alerted our members to the opportunity shaping up on TARO. However, the big buyers can play tricks.

Suppose you are a large hedge fund, and you want to accumulate a stock. You know that taking a sizeable position will move the stock higher, and you will end up paying higher prices as day traders jump in to the frenzy. With shares on the books already, you can afford to sell a little bit and paint the chart with a negative technical set up that should entice some selling pressure from nervous retail investors and overzealous short sellers. That selling pressure will help you fill your larger buy order.

Shortly after 10:30 ET, TARO was trading in the pointy end of a pennant pattern, a chart set up that typically precedes a break in to a trend. The direction of the trend is determined by the breakout from the pennant, a fact that most chart readers are aware of. The big fund looking to shake some stock out of the market can mislead the market on the future direction of the stock by instigating some selling pressure to cause a break to the downside from the pennant. That is exactly what happened on TARO.

Selling pressure picked up, and the large investor switched to their real intention, which was to accumulate the stock. The deceptive trap had been laid, and traders were enticed out of a stock that was destined to rally higher for the rest of the day. The large investor was able to lower their average cost of their position.

Further words from Sun Tzu:

"Therefore, in your deliberations, when seeking to determine the military conditions, let them be made the basis of a comparison, in this wise:

(1) Which of the two sovereigns is imbued with the Moral law?
(2) Which of the two generals has most ability?
(3) With whom lie the advantages derived from Heaven and Earth?
(4) On which side is discipline most rigorously enforced?
(5) Which army is stronger?
(6) On which side are officers and men more highly trained?
(7) In which army is there the greater constancy both in reward and punishment?"

Let me translate this in to stock market terms:

Among buyers and sellers, the side who will gather the greatest profits will be determined by:

(1) Which side believes that the stock market is always right?
(2) Which side is led by the largest investors?
(3) Who is trading with the trend?
(4) On which side is discipline most rigorously enforced?
(5) Which side has more money?
(6) Which side has the best understanding of fear and greed, and how the crowd behaves when pressured by either?
(7) Which side lets profits run, and limits losses?

"According as circumstances are favorable, one should modify one's plans.

We should only add to winning positions and never average down on a loser. Profits are carried by momentum, and if you are on the right side of momentum, you can make a lot of money. When losing, stick to the plan and exercise stop losses. When winning, increase position size as new entry signals are confirmed.

"When you engage in actual fighting, if victory is long in coming, then men's weapons will grow dull and their ardor will be damped. If you lay siege to a town, you will exhaust your strength."

If the expectation of your trade is not working out in a timely fashion, then you have read the market wrong and it is best to exit the position.

"It is only one who is thoroughly acquainted with the evils of war that can thoroughly understand the profitable way of carrying it on."

If you think the stock market is fair, quit trading immediately.

"Hence the saying: If you know the enemy and know yourself, you need not fear the result of a hundred battles. If you know yourself but not the enemy, for every victory gained you will also suffer a defeat. If you know neither the enemy nor yourself, you will succumb to every battle."

If you know the market and know yourself, you will consistently profit. If you know the market but not yourself, your success will be random. If you do not know the market or yourself, you will consistently lose money. Success in the stock market is not just about the market, it is also about knowing how you react to fear and greed.

"The onset of troops is like the rush of a torrent which will even roll stones along in its course."

The trend is your friend.

"The good fighters of old first put themselves beyond the possibility of defeat, and then waited for an opportunity of defeating the enemy."

Good traders know that they can consistently make money, and that confidence fuels them to consistently make good decisions.

"To lift an autumn hair is no sign of great strength; to see the sun and moon is no sign of sharp sight; to hear the noise of thunder is no sign of a quick ear."

Great traders see more than the obvious.

"There are not more than five primary colors (blue, yellow, red, white, and black), yet in

combination they produce more hues than can ever been seen."

Keep stock trading simple. You need only understand support, resistance, optimism, pessimism, price volatility and abnormal behavior.

Stock Trading Personalities

What kind of trader are you? There are a variety of personailities at work in the market, many of them self destructive. Ideally, you want to have aspects of each as a sort of personality disorder, but most of us are just one or another.

Even Steven
After suffering a loss, they are eager to right what has been made wrong. On their next stock trade, they sell the moment their profit exactly offsets the previous loss. Now they are even, and don't have to go through the emotional despair of losing in the market. Unfortunately, that stock they sold to make back the previous loss keeps going higher. Emotion is Even Steven's master, happily riding a fence of risk aversion is his destiny.

The Scientist
A perfect score on the LSAT for logical reasoning, and often seen wearing a small steel ring on their writing hand, the Scientist is a victim of their own intelligence. They can provide the mathematical derivation of any techincal indicator of fundamental ratio, and often show charts that appear like a basket weaving class gone terribly wrong. Lost in the details, they may not make a whole lot of money in the market, but they can always offer a well thought argument for why.

The Gambler
Like a bull in a china shop, these maverick traders often end their trading career broke but full of exciting tales of the one that got away. Capable of turning a simple stock tip in to a rollercoaster ride of amazing profits and admiration but ultimately culminating in two mortgages on the family spread.

The Borrower
In a Bull market, they are the all knowing experts on financial markets. In an uptrend, they do quite well because they buy hot stocks and hang on to them believing in the legitimacy of the company's sexed up story. Alas, all profits are but short term loans, because when the market turns their expertise is exposed as a fallacy and they give back all that they gained. Voted most likely to return a BMW to the dealer before the lease expires.

The Professor
Often seen smoking pipes and listening to Vivaldi, the Professor is a student of financial theory and knows that in the long run, the stock market can not be beat. Rather than disprove theory, they instead indoctrinate anyone who will listen, including naive business school students, with their theories of market efficiency. They drive sensible cars, wear sensible shoes and don't make any money in stocks.

The Value Investor
Value investors have refined the art of buying good companies that nobody likes. Unfortunately, stocks don't go up until other investors like it, so most value investors are experts at practicing patience. They typically sleep well because they own quality, but are also forced to grow grey waiting for their investments to pay off.

The Doubter
There are a multitude of garbage stocks out there that go up. The Doubter looks for pigs adorned with lipstick and short sells them. This variety of investor loves to uncover speculative stock scams that, like a house of cards, eventually must fall because they lack a solid foundation. The Doubter's greatest weakness, however, is bad timing. Bad stocks can go up a lot before the bubble bursts, and it can be difficult to carry a short through the price appreciation. Doubter's need deep pockets.

Stock Trading Perspectives

Tyler Bollhorn

I often wait for stocks to break out of trading ranges before buying or short selling them. Many have asked me, "Why wait for a stock to go higher before buying, or wait for it to go lower before short selling?' It is a good question, since it would seem that buying a good stock at a lower price would be smarter. Short selling a stock that is destined to go lower at the highest price possible also seems smart. However, this is not the case.

Breakouts give us a message. They tell us that investors have found some fundamental factor that warrants paying more for the stock, or accepting less. Remember that the stock market is a discounting mechanism. Through the process of buying and selling, investors are casting their vote on what they think that the stock is worth. When stocks go in to trading ranges, the market is essentially telling us that it has come to consensus on what the company is worth.

That trading range is bounded by upper and lower limits. Based on all the fundamentals that the market has to judge a company's value, the upper boundary represents the most that investors are willing to pay, and the lower boundary is the minimum that investors are willing to sell at. The upper boundary is resistance, and the lower boundary is support.

When the market takes a stock through resistance, it may be telling us that there are new fundamentals that warrant a higher price. A stock moving down below support may be indicating that there are new fundamentals which warrant selling at a lower price. Since the spread of information from the company to the investor is rarely an equitable process, stocks tend to move in anticipation of the public announcement of new fundamentals. The stock market is not fair, and some investors are able to trade on privileged information.

The reason I buy breakouts is because I trust that some investors are trading on new information that, when fully public, will take the stock higher. I am trying to ride the coat tails of the well informed investor, but still staying ahead of the public.

It is important to qualify breakouts by only trading those that are breaking from low volatility. We want to focus on the high probability trades, and those exist when stocks break from narrow trading ranges where the market has a strong consensus on what the company is worth.

This explains why it is better to pay more for a stock, or short sell at lower prices. The breakout tells us that there is a good trade, and increases the probability of success. Unless we have access to inside information, we can not predict breakouts, only listen to their message.

What makes a good stock market trader? A person beginning their study of the stock market will put their focus on identifying opportunities, how to find the next winning trade. There are numerous stock trading programs that focus on knowing when to buy. Some of these software programs have simplified the entry decision with green lights, others produce buy signals with seemingly very sophisticated analysis. Most all of these magical systems for trading the stock market miss the point.

Contrary to the beliefs of the neophyte investor, trading the stock market is not about knowing what to buy, or when to buy it.

The decision to enter a trade is only one part of the formula for successful stock market trading, and its mastery will not ensure success. While we have all heard of the guy who bought some hot stock early in its up trend and held on till it was worth a fortune, the reality is that most of these stories have an epilogue. For most who lack the complete suite of trading skills, stock market profits are nothing but short term loans.

Long term success in the stock market also requires the ability to manage risk effectively. How much of a stock do you buy once you have identified it as an opportunity? More importantly, when do you decide that the market has proven you wrong and it is time to take a loss? For many traders, the quantity of stock purchased is dictated by the amount of capital at their disposal, and the exit point is driven by emotion and not analysis. Many traders turn in to long term investors because they would rather ride out a loser instead of take a loss.

Suppose that the trader has evolved in to a very good stock picker, and has a firm grasp on proper risk management techniques. Are they now ready to take the market bull by the horns? Unfortunately, they are only half way there, because the other half of the trade is something called selling. I find that this is where most aspiring traders truly lack skill.

The stock market is a probability game, which means that each of us can not expect to be right all of the time. Our success is dictated by how we do over a large number of trades, and should never be judged one trade at a time. We must accept the idea that our winners have to outweigh our losers, which makes the ability to know when to sell so important.

This is a double edged sword, for we must learn to minimize losses by selling stocks when the market proves us wrong, but also let profits run higher when we have made a good decision. It may feel good to sell a stock that makes you a thousand dollars in a very short time, but selling a thousand dollar winner is foolish if the stock is destined to gain another four thousand dollars. Limit downside, and let profits run.

The ability to identify good opportunities is important. Knowing how to manage risk effectively is essential. Proficiency at selling stocks at the right time is also mandatory for success. However, above all else, it is important to have the discipline to consistently apply good methods. Emotion is the enemy of every trader, and all good traders must learn to fend off emotion at its earliest appearance.

This is what turns the simple act of trading in to a difficult endeavor. When we put cash on the line, we get nervous because most of us have an emotional relationship with money.

Good traders are cool when watching a profit grow, and unshaken when the inevitable loss presents itself. They look at the big picture of trading, and judge their success on a weekly or monthly basis, rather than by their last trade. There is an art to trading the stock market, and that successful trader know how combine many different skills to paint a very pretty picture of profit.

It is a scary world inside my head. If you could cut through the thick skull and navigate the cobwebs, you would still be left with a slanted, cynical view on the world. However, it seems there are a few people who want to know my thought process when evaluating a stock, so I thought I would go through some of the things that I think about when seeking opportunities. While it seems somewhat self indulgent, I hope it helps some of you to understand the thought process of a trade.

To begin, the thing that I look for more than anything are good chart patterns. I have been trading a long time, and considered a multitude of technical analysis indicators in my pursuit of the market's holy grail. Over that time one thing has become clear to me; there is no better way to predict a stock's price action than chart patterns.

The problem is that chart patterns are hard to define mathematically. A trained eye can pick them out of a chart easily, but having a computer automate the search is difficult. I often stress that I only buy stocks because they have good chart patterns.

When I look at a chart, the think that I am really looking for in a good chart pattern is a break from low price volatility. Price volatility is an indication of uncertainty; the more volatile a stock is, the more unsure the market is about a company's value. Stocks that are trading in narrow, sideways trading range are demonstrating confidence among investors that the price is right. That makes breakouts from low price volatility more significant.

A stock breaking from low price volatility implies to me that some investors in that stock are trading on new fundamentals, and I find that the general market does not usually know what those new fundamentals are. By following breakouts, we are really following well informed investors who are trading on tomorrows improving fundamentals, rather than that which is already known and already fully discounted in to a stock.

Once I have found a stock that is breaking from low price volatility, I then look to see if there will be price resistance above where I am purchasing the stock. If I can see that some investors own the stock at higher prices, I should expect that they will be eager to sell the stock when it gets back to their entry point, where they can break even. It is typical of investors who have been losing money for some time to just want to get out of the stock without a loss. If there are ceiling prices above what I am going to buy the stock at, I expect that this ceiling will limit my upside. If I look at a stock that has limited upside potential because of resistance, I will likely not purchase the stock even if it has a good pattern.

Ideally, I want to purchase a stock that has no resistance on the stock chart, and is breaking from a period of low volatility. If that occurs, then the next thing that I think about is the probability that the stock will suffer a pull back after the breakout. It is common for stocks to pull back for a few days after a breakout, but one way to decrease the chance of that happening is to look at an intraday chart to see how stable to stock was before the breakout. If the stock was rallying strong in to the close, it is more likely to pull back over the next few days. A stock that was strong in the morning on a breakout day and then trades sideways in the afternoon, near the high of the day, has less chance of that short term pullback.

Assuming I am now satisfied with my entry decision on a stock, I must now decide where the market will prove me wrong. Any time I buy a stock, I plan to lose. I want to know in advance when I will sell at a loss if the market proves me wrong. If it gets to that floor price, I sell and take the small loss. Small losses are the sign of a good trader. Big losses are the sign of an amateur who has a fear of losing.

Many traders will set a price target when they buy a stock, but that is not something I believe in. I think we should sell stocks when they appear more likely to go lower than higher, but I never want to limit upside by selling stocks at a price target. Limit downside, don't limit upside.

There you have it, a journey through my thought process when evaluating a buy opportunity. In consideration of the multitude of evaluation methods and indicators available, it may seem hard to believe that this is all I do. However, I have made a lot of money in the market by keeping things simple. I hope this helps you do the same.

You can buy a stock or you can sell it. For most investors, the buying usually comes first. We buy a stock in anticipation of it going up, so that we can sell it at a profit.

It is also possible to sell the stock first. Sell the stock with the expectation that it is destined to go lower, so that we can buy it back cheaper in the future. This simple reversal of the process is called shorting. Successful investors utilize this strategy, taking advantage of the simple fact that stocks do not always go up. However, there are a few different rules that investors need to be aware of when shorting stocks.

The most important thing to realize is that, when you short a stock, you have to borrow it from your brokerage house. To do that, your brokerage house has to have the stock to lend. If you short a stock, the brokerage house will actually deliver the shares to the new owner by using shares that another of their customers own. The idea is that they will replace the borrowed shares when you buy them back, effectively covering your short.

The ramification of this is that you can not short any stock that you want as the brokerage house has to have the stock in inventory. Generally speaking, stocks that have good liquidity (trade at least 30 time a day) have a wide enough circulation that your brokerage house will allow you to short the stock. However, an added risk of shorting is that the brokerage house could order you to buy the stock back if they are unable to cover the borrowed shares. That order to buy back can come any time and may come at a time when you are forced to take a loss.

Another important consideration is that there is no limit to how high a stock can go. When you buy a stock, the maximum amount you can lose is your investment. However, when you short a stock, the potential loss has no limit because the stock could keep going higher and higher. It is for this reason that many people consider shorting too risky. My opinion is that buying or shorting are both risky if the individual doing it lacks discipline to limit losses. For the disciplined and experienced investor, shorting can be worth the extra risk.

Because of this added risk, many brokerage houses will not allow you to short stocks that are under $3. Their concern is that cheap stocks are at risk to show more volatility and could go dramatically higher, effectively wiping out a lot of a client's equity.

The added risk of shorting also requires that the client maintain more money in their account than is necessary to buy the stock back. This extra amount is referred to as margin. Generally, brokerage houses require 150% of the market price of the stock that is shorted. So, if you short sold 1000 shares of a $10 stock, you should have $15,000 in your account. Remember, of course, that when you short sold the 1000 shares you put $10,000 in your account. So, you really only put up $5000 in equity. But, if the stock goes up, you may be required to add more equity to your account to ensure that the 150% requirement is kept.

Having the option of shorting open to you is liberating, as it no longer forces you to only buy stocks that you think is going to go up. A psychological hurdle for investors is "hoping" a stock will go higher instead of heeding the truth, which often says the opposite. When an investor can make money on either side of the market, he or she is likely to make better judgments.

Another advantage of shorting is that stocks tend to move down more quickly than they move up. Perhaps this is because fear is a more powerful emotion than greed. Those proficient at anticipating stocks that are destined to go lower are often rewarded with shorter hold periods, and therefore, lower opportunity costs.

The key to taking advantage of the shorting mechanism is, of course, knowing how to find shorting opportunities.

Do you aspire to be a professional stock trader? Does working from home buying and selling stocks appeal to you? A lot of time is spent describing how to buy and sell stocks effectively, but very little information is available on just getting started. Who do you set up a trading account with? What kind of computer hardware and software is necessary? How much time is required? Is it a smart thing to do? Here is an overview of how to start a stock trading business.

To begin, let me be very clear. Stock trading may seem simple, but it is not easy. Most people that day trade, lose money. The reason, I believe, is quite simple. There are no barriers to entry to stock trading. Opening a day trading account is a matter of filling out some paperwork and depositing some money. With a few hours of effort, you can get set up, and tell your friends that you are a day trader.

There are many books on the shelves of your local bookstore on active trading, and how to pick winning stocks. The book store also has books on how to fly airplanes, build houses and you may find one explaining how to do open heart surgery. To buy a book and consider yourself an expert on stock trading makes as much sense as performing a triple bypass on your friend with a good how to book as your guide.

Trading stocks is a great business, but recognize that to do it effectively requires time and education. Take time to learn, most of us work way too hard to earn our money, and throwing it at the market on a whim is bound to bring heartache. If 90% of day traders are losing money, the other 10% are making lots of it. And guess whose side experience is on.

There are many companies offering education, some are good, most are lousy. A simple rule is to not get an education from someone who does not have a track record of success trading the market itself. I don't believe a person can teach another to trade if they have not gone through the toils of actually making money in the stock market themselves.

Assuming you are comfortable with your knowledge of trading, the next step is selecting a brokerage house to facilitate your trades. There are four kinds of stock brokerages available. First, are the full service brokerages, which have advisors who will tell you what to buy and sell, and charge you for that service. The commissions are highest with these kinds of brokerages because you are paying for advice. For active trading, this is not a good choice. Nesbitt Burns in Canada and Merrill Lynch in the US are examples of these kinds of brokerages.

Next, you have discount brokerages that do not offer advice, but often offer a variety of tools for the trader to utilize for their stock research. These operations have much lower prices for execution of trades, but do not typically have order entry that is fast enough for the very active trader. Orders are typically placed electronically through a web site, or by the phone, and can take 10 second to a couple of minutes to be executed. Examples of these kinds of brokerages are TD Waterhouse or Charles Schwab.

The third group is the deep discount brokerages. These offer very little service, but have extremely low commission rates, some as low as $5 per trade. There is often, however, a hidden cost, as these brokerages try to make a profit from your order flow. If you are willing to purchase a stock for $10 a share, but the deep discounter can find those shares for $9.95 a share, they will keep the $0.05 difference. While it seems cheap, the inability to get the very best price can actually increase the price you pay. Examples of deep discount brokerages are E-Trade or Ameritrade.

The final group is the direct access brokerages. These are the kind of brokerages that I believe are the best choice for day or swing traders. Their commission fees are lower than all but the deep discount brokerages, but their order execution is direct to the marketplace, so there is no potential for price skimming. That means that you have the ability to get the very best price in the market, rather than have a middleman try to make something on the fulfillment of your order. More importantly, the order execution is extremely fast, often providing for confirmation of a fill on an order within a second of that order being placed. For short term trading, this is essential. Examples of these kind of brokerages include Trade Freedom in Canada, and MB Trading in the US.

If you intend to position trade, direct access is appropriate but not necessary. If you want a higher level of service, consider a discount brokerage that will offer more support than direct access. However, if you want low commissions, direct access is a better choice. If you are day or swing trading, speed of order execution is important, making direct access brokerages the best choice.

I am often asked about computer hardware and software requirements for trading. While trading may seem sophisticated, the equipment you use does not need to be. If you are trading, what is most important is a reliable and fast connection to the Internet. Nothing is more frustrating than losing your Internet connection in the midst of trading a fast moving stock.

The speed that you can move through the Internet is dependant on the speed of your connection, the processor on your computer, and the amount of memory your computer has. If you find that your computer is too slow when you are navigating the web, you will need to improve the slowest component of the three.

I use three computers and have seven monitors running in my office today. Is this necessary? No, but it does make life easier. I can trade as well on my laptop in a hotel room as I can in my office with all of the technology I have, but it is less work when you have multiple monitors to look at many different stock charts at once. Connecting multiple monitors to one computer is actually quite easy. Each monitor requires a video card. Most computers have the space to house two or three video cards, so most computers can run two or three monitors by installing two or three video cards. However, it is also possible to get video cards that have multiple heads on them, making it possible to connect two to four monitors to one video card. This means that you could have 8 or more monitors connected to one computer! The great thing about Windows is that it treats a configuration of multiple monitors as one big screen, allowing you to move your mouse across all monitors and move programs that you have opened across the space that the multiple monitors affords.

From the software side, there are three things necessary for stock trading. First, is the order entry software that allows you to place buy and sell orders. The direct access brokerages will each have their own order entry software which allows you to enter in the quantity of shares to buy or sell, the price, and the type of order. When considering a brokerage, see what types of orders are available. Your trading will be better if you can utilize stop loss, trailing stop and other sophisticated order types.

Next, you will need a real time charting program, so that you can see what is happening in the market, and pick your entry and exit points. There is a wide variety of systems available, at a wide variety of prices. Features and reliability determine the price of the system; consider companies like Real Tick, QCharts, ESignal or EGate for their charting packages.

Finally, you need a tool to help you find opportunities that you can capitalize on. With admitted bias, I recommend Stockscores.com for its ability to scan the market to identify opportunities.

How much time does active trading require? Swing trading will take one to two hours of your time each day, as you look for stock positions that you will hold for one to five days. Day trading is a full time job that requires your attention throughout the trading day. Many charting platforms will monitors stocks you are watching for criteria that you establish, so you can do other things while day trading, but when a trade is on, you will likely be pretty focused on what is going on.

A career as a successful stock trader is incredibly rewarding. Financially, it can be very lucrative but I think the rewards go beyond monetary gain. Trading stocks can also provide the freedom to spend more time with your family, to travel or do those things that require the time that many high paying careers do not allow. It takes effort and determination to become a good stock trader, but it is more than worth it.

Risk is in the hand of the trader.

Financial wisdom teaches us that stocks are risky, and we must protect ourselves by diversifying away that risk. By buying stocks in a variety of industries, we can minimize portfolio losses by letting the winners balance out the losers. Diversification is meant to insure our portfolio.

I have a different view on risk, and do not believe that diversification is the best way to protect against it. Instead, I think that stocks are risky the way a deck of cards are risky.

They are not.

Instead, it is the investor or stock trader that is risky. A person who sits down at the Blackjack table is taking a risk. A person that buys stocks is taking a risk. But why do a few people consistently walk away from the Blackjack table with a profit? Because they know how to manage risk, and play probability.

Stock trading is no different. Most people can not beat the market, just as most people can not beat the house in Blackjack. But those that do well in the market are good at playing the probabilities, and are good at managing risk.

How do you manage risk in stock trading? Rather than diversify, I think it is important to plan to lose. When you buy a stock, pick the price where you believe the market will prove your investment wrong, and plan to take a loss at that point. If the stock gets to that price, take the loss and move on.

That means that every stock should have a loss limit. You should never risk more than a small portion of your portfolio on one stock. That does not mean you can't put a large portion of your portfolio in one stock, it just means that your loss limit should not be that large relative to your overall portfolio size.

Stock trading is a probability game, but it is different than Blackjack, which is also a game of probability. In stock trading, we can control the size of the loss when we are wrong, but we can also have bigger gains when we are right. Aside from drawing Blackjack, the gains on a winning hand are the same as those on a losing hand. With stock trading, you can have losses that are a fraction of your gains if you limit the size of losses. This means that proper risk management can mean you make money even if you are not right more than you are wrong.

However, it all comes back to what is most risky about stock trading; the trader. If you do not have the discipline to limit losses, then you are taking a big risk when you buy stocks. You can be right more than you are wrong, but if your losses are bigger than your gains, you can still be a loser. Risk management is essential, and the best way to do that is to set a stop loss every time you buy a stock. Plan to lose, and let your profits run.

Over the last few years, I have taught a lot of people how to trade the stock market. That process has taught me a lot about what makes a good trader, and helped me to improve my own stock trading skills. When I started trading 15 years ago, I thought successful stock market trading was all about picking the right stocks. While this is important, I have realized that there is a lot more to successful trading than just knowing what to buy. While successful trading is simple, it is not easy. Here are some things to think about if you aspire to consistently profit from the stock market.

First, you have to realize that trading stocks is an art, and not a science. You will not be right all the time, no matter how good your indicators are or how sharp your ability to read the market. Losing money trading is part of the business.

What separates good traders from bad is how good traders handle this reality. It is not a question of whether you will lose money on some trades, but instead, how much you do lose when you have a trade go against you. Risk management is very important, and a trader who does not plan their losses is destined to fail. When you buy a stock, pick the price where you will take a loss.

I don't believe intelligence has a great influence on the success of a trader. I have met people that are very smart, but unable to make money in the market. I have met others who would not be considered rocket surgeons, but are able to do very well with stocks. However, I think the idea of emotional intelligence is important to a trader's success. Daniel Goleman wrote a book called Emotional Intelligence, which defines it as "a type of social intelligence that involves the ability to monitor one's own and others' emotion, to discriminate among them, and to use the information to guide one's thinking and actions." The ability to manage emotions is an important consideration of emotional intelligence.

When I think of the people that I know who are good stock traders, they all seem to have one thing in common. They are cool.

I don't mean this in the Teen Beat sense of the term; how they dress or the friends they have are irrelevant. I mean they have a very calm personality, and are not easily excitable. In the face of adversity, they are composed and able to face the challenge. These people do not show strong emotional responses to problems or successes. While they may be boring at parties, they are sharp traders because they just don't care that much.

Therefore, I think it is important to be cool if you want to be a good trader. You have to teach yourself to not care about the money, which is a very hard thing to do. Train yourself to think of profit and loss like a scoreboard, instead of framing your trading finances in how much work it takes to make the money (which is what most of us do).

I think good traders are disciplined. They follow a methodology and stick to the rules. They don't search for new methods every time they suffer a loss. They take the time to test their rules so that they will have confidence in following them.

Finally, the most important criteria for success is that which governs success in all aspects of life. Determination is what sets winners apart from the crowd. If you want to make a million dollars trading the stock market, you just have to be determined to do so. With unwavering focus and the desire to succeed, profitable trading can be achieved. As Yoda once said, "Do or do not, there is no try."

Price volatility is a very important concept when applying technical analysis to stocks, yet it is not given a lot of attention. Understanding what volatility is and how to use it can make a big difference in the success or failure or your investments, whether you are a long term investor or a short term day trader.

Price volatility describes how much a stock moves up or down over time. A penny stock will tend to have much more volatility in price than General Electric since penny stocks can routinely move 10% in a day, while that much of a move in a large cap stock like GE might take an entire month to occur.

What price volatility really indicates is the uncertainty that investors have about a company's future. The reason penny stocks can experience significant price change is because there is a lot of uncertainty about their future as a company. A well established, diversified large company has predictable earnings and revenue, so the price of their stock will not move as much.

What I want to focus on in this discussion of price volatility is not how one stock's volatility compares to another, but instead, how a stock's price volatility compares to its historic volatility. How volatile is the stock relative to its normal trading activity?

This is an important question because our success as investors will improve if we can understand the level of uncertainty that investors in a company feel. Risk is minimized when we purchase stocks that demonstrate a low amount of investor uncertainty. Opportunities arise when we identify stocks that are breaking from periods of low uncertainty.

Here is an example to demonstrate the point. A stock is trading at $10, and has been trading around $10 for the past few weeks. The stock might rise or fall $0.20 in a day, but it is showing a minimal amount of price movement around that $10 range.

The market activity on this stock tells us that investors believe the company is worth about $10. Since there is very little volatility in price around that $10 range, there is a high level of confidence that the stock is worth $10. If investors were not sure what the stock was worth, we would expect it to move up and down much more in price.

One day, the stock jumps to $11, far beyond the normal range that the stock is trading in. Why would this occur? If investors believe that the stock is worth $10 (give or take $0.20), what would cause some investors to pay $11? The answer is probably that there is new information to justify the increased price. The company may have made significant fundamental changes, or the market may have become aware of new information that justifies a higher price.

Stocks that break from periods of low volatilty tend to move in to trends, as the new information causes other investors to jump in to the stock. This is why an understanding of price volatility is so important. Volatility is uncertainty, the more volatile a stock is, the more uncertain the market is about what the company is worth. Low volatilty indicates confidence, and we should take a close look at stocks that break from confidence.

I have often said that trading the stock market is simple, but not easy. I can teach someone my stock trading strategies in a two day classroom session, and most people find it relatively easy to understand. When my students leave the classroom, they are full of optimism about trading the stock market, but most will make critical mistakes when they actually start to trade. The emotions that come with putting money on the line are what turn the simple application of my trading rules in to a difficult endeavor for some aspiring traders. Here are some common psychological breakdowns and some suggested remedies.

It has been said that beauty is in the eye of the beholder, and so to, is a good chart pattern. It is quite common for my students to send me a question about a stock that they feel has a highly predictive chart pattern, and I am left wondering if they were looking at the chart through rose colored glasses. I have come to realize that what makes good chart patterns is subjective, and identifying them requires practice. More importantly, chart pattern recognition is subject to emotions, and many traders will see what they want to see. The traders' standards may fall if a trader is eager to make a trade or if they own the stock already.

For this reason, I stress that traders should not trade because they need to make money. That seems oxymoronic, since we all trade the stock market to make money, but the difference is in whether our motivation is need or desire. When we trade out of necessity, we tend to force the market, and often see things that simply are not there. Good traders know that there are times when it is better to do nothing, and wait for excellent opportunities. Desperate traders will make mountains out of mole hills.

While most of us spend more time learning methods for finding stocks to trade, most mistakes come after we enter a position. The greatest problem that I have in trading is an inability to let profits run. Like so many other traders, I often sell too early. There are a number of reasons why this happens.

Watching the market tick away before your eyes is hypnotic. The closer you watch the trading activity of a stock, the faster your heart pulses and the higher your blood pressure rises. I am not sure why video game manufacturers have not found a way to package this in a game, for it is as intoxicating as guiding Pac Man through a maze of dots.

The problem is that the market hypnotizes us in to making bad decisions. With every tick of the real time stock chart, we get closer to hitting the eject button on a trade. The simple remedy, then, is to not watch the trading activity of the stocks we own. After all, watching it won't change what happens, it only affects how we respond to the market's stimulation.

When I enter a trade, the first thing I do is set a stop loss. By doing so, I know that my down side is limited and I don't need to watch the market for a signal to take a loss. That gives me peace of mind, and allows me to take my eyes of the trading screen. Since my selling methodology is based on signals from five minute charts, I really only need to check my stocks every five minutes. If there is a signal to sell, then I do so. Otherwise, I can look for other opportunities or watch Jerry Springer.

Another thing I recommend traders do is turn off their profit and loss indicator. How much money you are making or losing is irrelevant to the trading decision, so why count your money? We do so because it is the center of our universe when we are trading, but it is also a reason to make bad decisions. Check the charts for entry and exit signals, not the financial scoreboard.

I often advocate a lazy approach to trading. You can not work harder to find opportunities; the market won't give you one to reward you for your effort. Good opportunities are not hard to find, they are obvious. Working hard often causes us to identify marginal opportunities that can only be uncovered with extra sleuthing.

However, that does not mean that good trading skills can not be better developed with hard work. The trader who spends more time practicing the art of reading charts, analyzing past trades for errors and developing new ways to control emotions will improve their trading skill. Successful stock traders make a lot of money because they work hard at becoming better traders.

After trading for 15 years, I still analyze the opportunities of every trading day to see what I missed, and what I did right. The more charts you look at, the better you will get at reading them. You can never stop learning.

My final point is one that relates to one of those over used colloquialisms that pervade every self help book out there. You can give a man a fish, and he eats for a day. You can teach a man to fish, and he eats for a life time. Too many traders are relying on other traders, trading systems, indicators or hope to make them money. The only thing that will make you a successful trader is you. I spend time in the Stockscores Live Chat to teach our members how to identify and execute trading opportunities. The successful traders I have taught do not wait for me to tell them what I am buying and selling, they strive to identify those opportunities first. I encourage our members to ask me questions about how to trade, or how to identify opportunities. I am not doing anyone a favor when I tell them what to buy or sell (and so I don't). No one cares more about your money than you do, so take control of it.

Trading is simple if we keep our emotions out of it. All my new students grin and nod when I tell them that, as if to say that they will have no problem following the rules and maintain a disciplined, unemotional approach. And yet, when they actually start trading with their hard earned money, many will enter inappropriate trades, sell to early, or fail to sell when the market proves them wrong. Successful traders work hard at mastering their emotions, and reprogramming their brains to trade well. Easy to say, harder to do, but the rewards of mastering stock market trading certainly make the effort worthwhile.

Risk. Are you comfortable with it? This is an important question that you must ask yourself when trading stocks. While we all understand that risk is part of the stock market, many of us don't realize that how we react to risk is an important determinant of our success.

How do you feel when you buy a stock? I remember that my first stock purchase decision took me weeks to make, and when I finally pulled the trigger, I was filled with anxiety. I checked the stock constantly, and did all I could to find out as much as possible about the company. From what I have seen over the years, this is a pretty typical response to that first trade, but it is not a good way to make decisions.

I lost money on my first stock purchase, in part because I did not know what I was doing, but also because I was way too emotional to make an intelligent decision. I did not understand the risk of the stock I was buying; much less have a comfort level with it.

Over the years, I have learned to manage risk more effectively, to the point where I now plan my losses by picking a stop loss point. By doing so, I know what my downside risk is on the position, so long as I have the discipline to stick to the stop loss point.

More importantly, I have learned that to make smart, unemotional decisions, I have to be comfortable with the risk I am taking. Simply, I need to take no more risk in a stock than I care to lose. By being comfortable with the risk I am taking in a position, I am more likely to follow my rules for risk management and trade execution.

Consider the trader who has a $20,000 portfolio. How will that trader feel if he purchases a stock and sets his stop loss point where the loss will amount to $3000? Since this represents 15% of his portfolio potentially lost on one trade, chances are he will be pretty nervous. There are two effects to doing this. First, if the stock starts to make him money, he will be looking for a fast exit to lock in a profit and end his anxiety. Selling good stocks too early is a common problem among stock traders.

The second effect is in dealing with the stop loss point. If the stock starts to fall toward that predetermined stop loss point, and the trader begins to face the loss of 15% of his portfolio, he may begin to find reasons to hang on to the trade by canceling his stop loss point. We tend to associate losing money with the exit of a trade, so by not selling, we have not really lost (which is an error in logic). By ignoring the $3000 loss limit point, the trader is now flirting with an even bigger loss that could bring a serious set back to his portfolio performance.

Both of these problems begin when the trader takes more risk than he is willing to accept. Facing a potential loss that exceeds the comfort level of the trader causes him to make emotional decisions. The trader either sells too early, failing to let a strong stock run higher, or he fails to sell at his predetermined stop loss point to avoid the pain of taking the severe loss. Both are deadly mistakes for any one playing the stock market.

Don't take more risk than you are comfortable with. Build your trading confidence by taking monetary risk that you can handle, and you are more likely to make unemotional trading decisions.

There is a fairly predictable cycle that stocks go through. Where a person enters the cycle makes the difference between successful investors and those who fail to profit. An investor's emotional reaction to the cycle can be even more important.

Cycles begin with a period of consolidation, when the stock trades sideways with not a lot of interest from investors. When signficant fundmental change catches the interest of those who follow the company closely, there will tend to be a break from this consolidation. This break is often followed by a short pull back where uninformed investors second guess the strength and sell in to it. Typically, the post breakout pull back is relatively short, for as news of the significant fundmental change becomes more widely known, more investors show a willingness to buy the stock, and it can start to go up.

With an improving business, and a market that is interested, the stock can surge higher until it gets to a point where shorter term investors want to take profit. This profit taking phase often causes another, more substantial pull back, but does not necessarily mark the end of the uptrend. As the sellers finish their work, the stock stabilizes and goes back in to its up trend.

Eventually, the up trend gets over extended as euphoric investors buy on emotion, and pay more than what the company is worth. Strong volume and a steep up trend signal this topping out phase. A quick and sharp pull back is followed by a weak move back upward as investors caught up in the company's story try to buy the stock cheap. They are buying in to a sucker rally, as the stock fails to make a new high and instead shows signs of longer term weakness. The stock breaks support levels, and moves from an up trend in to a down trend.

As the stock falls, investors recall the strong fundamentals of the past, and still buy while the smart money takes their profits. Soon, the pace of the fall lower increases, as investors begin to sell on fear rather than rational thought. Eventually, fear causes the stock to go too low, and savvy traders work to accumulate the stock cheap in anticipation of the next cycle.

Understanding this cycle is important for knowing how to play the process. Losing investors may hold the stock during the initial consolidation phase, but then sell on the break thinking that they are fortunate to see higher prices. The winning trader is buying the breakout as it is a signal of improving fundamentals.

A losing trader may get shaken out of the stock on the pullback, thinking that there is something wrong. The winning trader knows that the pull back, provided the stock does not go below support, is a normal reaction in the market cycle. They hang on.

When the stock bounces back and begins to go in to a strong up trend, the losing trader believes that the rally is not destined to last, and fails to enter the stock in its early stages. As the stock rises, however, the cynical loser begins to become a believer again. As the stock goes up and up, the losing trader feels a sense of loss for having not held on to the stock, or bought it sooner. This feeling culminates in the purchase of the stock near the high of the first leg of the uptrend. They buy right before the first profit taking pull back.

The pull back brings back fear to the losing trader, and they quickly sell with the concern that the stock is going to head lower. Shortly after they sell, the stock ramps up again, and the emotional rollercoaster takes hold yet again. The losing trader may again buy in to strength, since they associate up ticks in the stock with a quality company. When the stock tops out this time, they decide to hang on. After all, on each previous pull back, selling was a mistake.

This time, however, the pull back is a real sign of a turning trend. The upward move is running out of power, and the stock is destined to go in to a downward trend now that the market has more than priced in the new fundamentals. However, the losing trader hangs on, believing in the fundamentals of the past, rather than taking a forward look at the company's business prospects. The loser fails to set a loss limit, and decides to hang on no matter what. After all, they have bought a good company.

Eventually, the downtrend picks up momentum, and brings fear in to the heart of the losing trader. They sell in a panic, taking a big loss and resolving to never be undisciplined again.

Have you ever ridden the cycle, one step behind the smart money. Most investors have as emotion took a tight grip on their decision making. It is hard not to fall in the these traps, but if successful trading requires that you stay ahead of the curve, and the crowd.

While technical analysis offers hundreds of indicators all designed to offer some insight in to the future direction of a stock's price, one cliché rings true for successful stock traders.

A picture is worth a thousand words.

Reading chart patterns is a basic skill that all stock traders should master, for no single technical analysis indicator has made me money in the way that understanding chart patterns has. My approach to stock selection is simple; find stocks with good chart patterns and ignore most other aspects of stock analysis. Amazingly, the ability to read stock charts only requires the mastery of six simple concepts.

Support - this is a floor price that investors have established for a stock. Based on all fundamental information available to investors, this is the lower boundary for what investors are willing to accept for the stock. It is the bottom line, and is important because a break through the bottom line often signifies new and negative information, or a change in investor psychology.

Resistance - the exact opposite of support, resistance is the ceiling price that investors have established for a stock, and represents the maximum price investors are willing to pay for a stock, based on all the fundamental information that they have to judge. Breaks through resistance are often motivated by new, fundamental information in the hands of some investors who can then justify paying more for the stock.

Optimism - it has been said that investors should never fight the trend of the market. Ideally, we want to buy stocks that the market is optimistic about, since this optimism will help the stock to move higher. Optimism is characterized by rising bottoms on the price chart of the stock.

Pessimism - if the investment community is in a bad mood about a particular stock, that stock will not likely move higher since few investors will see the company's fundamentals in a favorable light. We can see pessimism on a stock chart if there are falling tops in the price behavior.

Volatility - volatility equals uncertainty. Investors are not really sure about what the stock is worth if the stock's price volatility is high. Therefore, the market has come to some consensus on what the company is worth when there is relatively less volatility in price. Most good chart patterns show breaks from low price volatility, because breaks from low price volatility often occur when there is significant fundamental change in the company's business.

Abnormal Behavior - as new information becomes available to investors, price and volume behavior often become relatively abnormal. The reality of the stock market is that it is not fair, and some investors have access to information before others. When these investors act on new information, they often create abnormal activity.

Good chart patterns are comprised of some combination of these six factors. For example, breakouts from Ascending Triangles often telegraph an up trend. Ascending Triangle Breakouts are defined as follows:

1. Rising bottoms on the stock chart, showing optimism.
2. A horizontal line of resistance at the top of the chart, showing an upward limit on fundamental value.
3. A movement from high price volatility to low price volatility over time, signifying an increased consensus among investors on what the company is worth.
4. Abnormal price and volume activity on the day that the stock breaks through the resistance price.

There are many chart patterns that have the predictive ability of Ascending Triangles. The Stockscores Approach was created around high probability chart patterns; good chart patterns will usually have good Stockscores. Essentially, the Stockscores indicator is based on Support, Resistance, Optimism, Pessimism, Volatility and Abnormal Activity. While chart patterns are difficult to define mathematically, it is possible to assign points to these six characteristics of chart patterns, and we have combined them to create the Stockscores.

Chart patterns are relatively easy to understand, and with practice, easy to identify. The StockSchool Pro home study training course teaches what good chart patterns are and how to find them. It teaches specific strategies for using Stockscores.com to identify high probability chart patterns to make money in the market.

Do you think you judge information differently, based on your state of mind? A person in a bad mood who receives good news will likely react differently than a happy person receiving the same information. How we judge information is dependant upon our mood, and since the stock market is a collective of individuals judging information, understanding the mood of the market is important to predicting stock price change.

In the late 1990's and in to the first quarter of 2000, the market was in a very good mood. Federal

Reserve Chairman Alan Greenspan characterized it as "irrational exuberance" in a speech he delivered. The effect of this extreme optimism about stocks was that company fundamentals were awarded a very high valuation. Stocks traded at astronomical multiples to company earnings, because investors were enjoying strong stock market gains and were willing to pay more. Everyone was having a party.

Ultimately, the bubble of exuberance burst, and stocks tumbled lower. Three years later, the market was gripped in an extremely bearish stock market, where investors were very unhappy with their returns. Many stock market participants became so fed up that they opted out of the stock market, choosing real estate and other investment vehicles instead. Pessimism was at an all time high.

In the strictest theoretical sense, stock price is based on the ability of a company to make money in the future. This means that information about the company's business and its ability to make money defines what stock price will be. However, while most theorists argue that company fundamentals drive stock price, I will assert that it is only the perception of fundamentals that matter.

Since our perceptions are shaped by our psychology, our perception of company fundamentals is dependant both on information about the company and by the state of the market's collective mind. How the market judges fundamentals will depend on the mood of the market.

Simply put, the market can either be optimistic or pessimistic about a stock, a business sector or the market in general. Successful traders will tend to buy optimistic stocks, and sell pessimistic stocks. By doing the same, you can put one more factor in your favor.

Think of the market's mood as a river. A stock is like a canoe on the river, and its future price direction is determined by how strong the company can paddle. Even a good company that paddles hard will have a difficult time if it is working against the current. It will always be easier to paddle with the current, and we as investors should do the same.

Optimism and pessimism are easy to see on a stock chart, simply by drawing some lines. Look at the bottoms on a stock chart, the lower boundaries of price troughs. If they are rising over time, the market is optimistic. Pessimism exists when the tops, price peaks, are falling. Rising bottoms are optimism, falling tops are pessimism.

The Stockscores can also be used to determine whether the market is optimistic or pessimistic. A Sentiment Stockscore of 60 or better generally means that investors are Optimistic. If the Sentiment Stockscore is less than 60, investors are likely pessimistic. I tend to only buy stocks that have a Sentiment Stockscore of 60 or higher.

Utilizing optimism, pessimism and the Stockscores in your trading will help you improve your market performance. The StockSchool Pro home study training course goes in to greater detail about these important concepts, and shows specific strategies that you can use to identify good trading opportunities.

In the long term, the stock market is efficient. That means that good, well run companies will be rewarded with stock prices that reflect their strong business. In the long term, company fundamentals matter.

Stockscores.com is not a tool designed to find long term investments. We do not appraise company fundamentals, and care very little about what companies do. Stockscores.com is a tool for traders, who unlike investors, look for breakdowns in market efficiency rather than depend on it.

The assertion that the stock market is efficient assumes that the spread of fundamental information is fair, and that investors are rational. While this may hold in the long term, in the short term it is not always true. The reality is that some investors have access to fundamental information before others, and investors can be down right irrational at times. These break downs in market efficiency create opportunities for the trader.

There are three time frames that traders can operate in. Which you choose will depend on your time constraints, interest and risk tolerance. What does not change, however, is my opinion that savvy traders can dramatically outperform long term investors.

Position Trading - position traders are long term traders; they tend to hold stocks for five days to three months. Relying mostly on daily stock charts, they trade stocks during moves motivated by significant changes in the perceived fundamentals of the company. This style of trading does not require a lot of time, perhaps half an hour a day for someone utilizing the tools of Stockscores.com. Most of your market research can be done after market hours, allowing the trader to carry on a normal career during the trading day.

Swing Trading - swing traders will tend to hold stocks for one to five days, and trade price swings that often relate to emotion, rather than company fundamentals. The swing trader looks for trade confirmation on daily and intraday charts. This type of trading requires more time than position trading, but is still not a full time occupation. One to two hours a day of research and trade execution is what is typically necessary to identify short term trading opportunities that can provide very good returns.

Day Trading - often associated with risk, day trading is actually less risky than any other kind of trading provided the trader utilizes proper risk management techniques. A trader who is at the mercy of their own emotions should avoid day trading, which involves holding stocks for less than 1 day, typically only minutes or hours. The day trader takes advantage of significant new information that is motivating rapid and volatile price action. Day trading is a full time occupation that can reward savvy traders with significant financial reward. However, an uneducated day trader will typically suffer losses to those who know what they are doing.

How do you pick the stocks for your investment portfolio? Most people believe that it is smart to invest in the stock of good companies. It makes sense to buy into leaders like Wal Mart, Microsoft, General Motors or Home Depot. Why not buy established names that are dominant players in their industry?

However, over the last six months, Home Depot is down about 10%. One year ago, Microsoft was trading at almost the exact same price as it is now. General Motors? In three years down about 10%. Certainly buying the greatest retailer in the world would be a smart move. Try again; Walmart is lower than it was two years ago.

This begs the question, what is it that makes a stock good? Contrary to what you learn in Finance 101, well run businesses can have little to do with stock performance. Instead, the thing that makes a stock worth buying is really much simpler than most of would imagine.

Good stocks are the ones that are going to go up after we buy them.

I know you are all thanking me for this piece of intellectual insight, but sometimes the obvious needs to be said. To know what stocks we should buy, we first need to understand what makes people willing to pay more for stocks.

Generally speaking, stocks start to go up because the people closest to the company get motivated to buy them. Insiders, mutual funds, large investors; those with the best access to information are the first to accumulate stocks early in their up trends. Therefore, one of the things that make stocks go up is new and positive information. Unfortunately, most investors hear positive information about a company when it is no longer new. If you are waiting to hear about

As stocks start to go in to up trends, it creates excitement among investors. Most of us do not talk about stocks that are going lower, we find interest in stocks that are doing well. Therefore, psychology has a lot to do with how we make investment decisions. Stocks that start to go up gather momentum as more and more investors get greedy and take an interest in the up trend. This is the law of upticks; the more a stock goes up, the more investors want to buy it.

This provides us with the two simple but important foundations of the Stockscores Approach to trading the stock market. First, the realization that the stock market is not fair, and we have to trust what the stock market is telling us about what the future news will be. Second, the fact that investor psychology has an important impact on how investors judge information, and trends tend to perpetuate because the mood of the market takes time to change.

Therefore, the stocks with the best chance to go higher, the stocks that investors will most likely want to pay more for in the future are the ones where insiders know about positive future developments before the rest of us, and, stocks that investors are optimistic about.

When insiders know good things are coming, they will tend to cause abnormal trading activity in a stock. This is what the Signal Stockscore looks for. If the stock is making abnormal moves to the upside, the Signal Stockscore will jump up above 80.

Stocks that have an optimistic investor audience will form chart patterns that demonstrate this optimism. The Sentiment Stockscore seeks these stocks out by giving them a Sentiment Stockscore of 60 or higher. A Sentiment Stockscore of 80 is not necessarily better than one with 60. What is important is that the Sentiment Stockscore be above 60 and preferably rising.

Often, the best performing stocks will leave us wondering why they are doing so well. They won't have the fundamentals to warrant their strong performance because the market does not look backward, it looks ahead. The stocks that will go up after you buy them have good news coming, and are creating optimism among the investment community. Use the Stockscores indicators to help you identify these stocks.

Have you ever entered a trade, only to later ask yourself why? Particularly when Daytrading, the stress of having to make a fast decision can cause us to enter a trade that does not really fit our criteria. It is not that we don't understand the criteria of the strategy we are applying; it is simply that we don't apply the strategy correctly because executing the strategy has not yet become instinctual.

In an interview with a hockey player that I saw the other day, this point was driven home. The player was asked how he prepares for the different players they are going to play, since the coaching staff will often tell them what the strengths and weaknesses of each player are. The answer to the question was that he simply practices over and over the play to be made in certain situations. He said that, as a player in a fast game, he does not have time to say, "Oh, that is number 32, he is not good on his backhand so I should make my move to that side." By practicing the appropriate move over and over, it becomes instinctual by game time.

The same technique can be applied to stock trading. In the evening, I will go through the stocks that I was watching that day, and apply my strategies. Where I see a stock that fits the criteria, I will quickly, and audibly, call out the requirements of the strategy so that I go through my strategy checklist. Of course, doing this when the market is not open for trading is silly, but it trains me to do it quickly, and instinctively, during the actual trading day.

While your spouse may think you are somewhat crazy for talking to yourself, there is something to be said for doing so. In a fast moving market, talking to yourself out loud stresses each criteria of your strategy, and references the practice that you did during the far less stressful review session that you do when the market is closed. Talking to yourself will build your confidence, and put you in a calmer, happy place where you can make the right decision.

You may wonder if we really have time to go in to self analysis in the heat of a trading moment, so let me be clear. We are not having a nice friendly conversation with ourselves, but instead, just running through a quick check list. For example, when I am applying one of my day trading strategies, I might rattle off:

Abnormal Volume
Message Candle
Low Volatility
Daily Confirmation
Risk Management

(This will probably make no sense to those who have not taken our StockSchool Pro course, but you get the idea).

That will take me maybe three seconds, and I will do it while I am preparing the order entry, so it really takes no extra time. However, it helps me ensure that the set up is appropriate, and gets me in to the instinctual rhythm that I have built up during my practice.

Stock trading is simple, but not easy. What makes it tough is the cloud that our emotional brain puts between rational thought and execution. Hopefully talking to yourself during the execution of a trade will help you apply your trading method properly.

Most investors make the mistake of trying to be smart. They analyze companies, study the overall economy and gauge political conditions to arrive at an intelligent investment decision. Many times I have listened to a well thought out argument for why a particular stock represents a great investment opportunity. Many times I have wondered why so many individual investors spend so much time trying to be smart.

The market does not care how smart you are, it will always be smarter. The stock market is a mechanism for people to cast their opinions on what stocks are worth. If you think a stock is undervalued, then you buy. If you think that a stock is overvalued, you sell. Every time you enter a trade, there is another person on the other side of the transaction that disagrees with you. You may buy because you think the stock is going to go up, but someone has to sell that stock and they are doing so because they believe the stock is going to go down. Kind of humbling, isn't it?

Since there are thousands of investors all trying to be smart, the market has become very efficient at effectively evaluating a stock's worth. Are you smarter than thousands of investors? If you were to compete in a quiz game against a team of thousands, would you be able to win? Probably not.

In a quiz game, you could be on the side of truth. If a question is asked about who won the 1975 Indianapolis 500, you know that providing the correct answer will win you the point, even if everyone on the opposing team all agrees in an answer that is wrong. In the stock market, it does not really work that way.

The entire investment community could believe that a stock is worth $10 a share and nothing more. You could do detailed analysis utilizing the very best methods and calculate the true value to be $15 and be, as far as the stock market gods are concerned, completely correct. But, will that make you a winner?

No, because until the market agrees with you, the stock will not go above $10 a share. The thousands of investors that believe in the wrong answer will sell the stock if goes above $10, effectively keeping it below that price level. It does not matter if you are right, because the power of the crowd will ensure that you are proven wrong.

Stocks don't jump from one price to another, they instead move in trends where price gradually changes from minute to minute, day to day. It takes time to change the opinion of a large crowd, and new information is what motivates change. Individual investors do not have access to the information of tomorrow that will motivate the opinion of the crowd, which is why it is so ineffective to try and be smart when making investment decisions.

Be a follower, not a leader. There are some investors who get better information than the general public. This group of investors has the power to predict future stock prices and change the opinion of the crowd. We as individual investors and traders can only follow their lead. If you can learn how to read stock charts, you can learn to read what the smart people are doing. That is Ok!

We as individual investors can not outsmart the market because we do not have the same depth of information as some investors have and, more importantly, because it does not matter whether the market is right or wrong in its evaluation of information, it is the determinant of price and is therefore always right.

If you have a smart investment idea, you must then test to see if the market is going to agree with you in the future. For example, you might say that the political uncertainty of the Middle East, combined with rising inflation in the West will ensure that Gold prices go up in the next few months. Therefore, buy Gold stocks.

This is a good idea, but when you go look at the chart of Gold stocks, you see that pessimism currently dominates the mood of gold investors (as shown by the falling tops on most of the gold stock charts). While the Gold market has made a bounce back over the past couple of weeks, there remains a good deal of pessimism which will likely limit the upside potential of Gold stocks in the near term. No matter how smart and well thought out your argument for buying Gold stocks is, it won't succeed until the general market starts to agree with you.

The stock market is a tough place. Don't try to outsmart the thousands of investors who cast their opinion on a stock's value every day. Keep it simple by learning to read what the market believes, and the cues that it provides for where it will go in the future. That is the smartest thing you can do.

Do you ever feel that doing the exact opposite of what you do would make you a lot more successful as a trader? Particularly in a sideways market like we are having now, many traders may feel that they should sell when they think they should buy, and buy when the think they should sell. However, while their results in the market would seem to support this reversal of trade entries, the actual position type is probably not the problem.

Because a market lacking conviction (like the one we find ourselves in now) is frustrating, traders will tend to make important mistakes. When they are in a losing position, they will tend to hang on in hopes that the position will turn around. When in a winning position, they will tend to exit the position and take profits at the first sign of weakness because they fear giving their profits back.

As a result, many traders are limiting upside, but not downside. This is a critical mistake in any market, but particularly in a market like we find ourselves in now.

Since trading is a probability game, we have to limit losses when we are wrong, but maximize gains when we are right. The gains have to pay for the losses, plus provide a return for our money and effort.

However, what we do instead is sell our winners early (it feels good) and hold on to our loses too long (taking losses feels bad). The simple pursuit of pleasure and the avoidance of pain is the source of our trading woes, and not the trading strategies.

To combat a market that does not yield many great opportunities, we have to do the following:

- Be patient for good picks. In a bad market, fewer good opportunities appear, so we should be trading less.

- When we enter a trade, use a stop loss order to limit downside. If the trade is successful, let the profit run until a strong exit signal appears. Do not limit upside by setting an exit order ahead of the trend. Sell on a stop order.

- Don't work harder. In a tough market, it is important to wait for obviously good trades, and not gamble on trades that are marginal. You can get away with entering marginal trades in a good market, but you can not in a market that lacks conviction.

So much of trading is a mind game, yet we think that it is all about the decision to enter the trade. If you have a sound strategy, then it is a matter of following the strategy properly and focusing on what you do after you enter the trade. Do not limit profit potential, set a stop to limit loss potential.

What does it all mean? Technical analysis has a way of mechanizing stock market research, making the future direction of stocks a matter of logical mathematical indicators. "Buy when the short term moving average crosses above the long term moving average" say some while others argue "sell when the Stochastics get to overbought levels". "The VIX is at an all time high, it is time to buy in anticipation of a reversal."

Those who excel at logical reasoning love these kinds of indicators because it makes a science out of investing in the stock market. By establishing rules that can be tested with rational thought processes, the investor can have confidence in their trading decisions.

My greatest complaint about technical analysis, and perhaps the reason I don't consider myself a true technical analyst, is that the application of many aspects of technical analysis miss the point. In general terms, stocks don't go up because the MACD Signal line crosses in to positive territory. Short sell opportunities are not created when the Williams Volume Accumulation indicator goes negative. We should not buy stocks simply because the Sentiment Stockscore crosses above 60.

Investors and traders need to remember that all technical analysis indicators are just a reflection of what really drives the stock market; information and emotion. When we consider any technical analysis indicator, we should discuss it in terms of how that formula reflects what a company's future holds, and what the investing public thinks of it.

Since I choose chart patterns as my main motivation for entry and exit signals, let me discuss what the six aspects of chart patterns truly represent. Support and resistance, optimism and pessimism, low volatility and abnormal behavior are the basis for virtually every trading decision I make, and it is important to understand what these technical analysis criteria are based on.

Support and resistance are typically horizontal lines drawn on a chart that represent floor and ceiling prices that the market has shown a willingness to bounce from. However, if we understand that stock price is based on the present value of future earnings expectations, then support and resistance represent the limits on what the market believes the company's fundamentals to be worth. Based on all available information, investors don't believe that a stock is worth more than the resistance price, or less than the support price. The oscillation of stock price inside the limits of support and resistance is due to the uncertainty that the future holds.

Therefore, breaks through support or resistance are significant because these breaks may be motivated by new information. A group of investors may know of a significant change in the fundamentals of a company, and act on that information before it is widely disseminated to the public. Breaks through support or resistance offer a privileged glimpse in to the insider's world of information.

Optimism and pessimism are relatively easy to see on a stock chart; optimism is characterized by rising bottoms while pessimism is shown in falling tops. How can the application of a sloping line on a price chart say so much about the mood of investors?

Consider what a rising bottom represents. If we understand that a downward trend demonstrates a greater motivation among sellers than buyers, and an upward trend is created when buyers are more eager than sellers, then a rising bottom pattern is created when the enthusiasm of buyers outweighs that of sellers. Over time, the sellers show less strength, which causes the bottoms made in the waves of the uptrend to rise. Over time, the mood of investors is generally optimistic, as they are more willing to buy and less willing to sell.

Falling tops are created by the precise opposite motivation. During the short waves when the stock is rising, the buyers are unable to push the stock as high as they did on the previous up wave, which creates the falling top pattern. Over time, the buyers are losing strength, and therefore, investors are generally showing pessimism.

We should think of price volatility as an indication of how confident investors are about the value of the company. Remember that price is based on the market's expectation for future earnings. If the market is uncertain of what future earnings will be, then prices will move with a lot of volatility. If investors are confident in what they know the company to be worth, then the stock will not trade with a lot of volatility. This is why penny stocks, whose future is very uncertain, tend to be very volatile compared to the shares of established companies.

If investors have new information that is important, stocks will tend to behave abnormally. Price volatility will increase, and trading volumes will pick up. Therefore, abnormal behavior in the trading activity of a stock can indicate that new information is being priced in to the market.

To summarize, support and resistance represent limits on the fundamental value of a company, and breakouts can be motivated by new information. Rising bottoms and falling tops represent optimism and pessimism among investors, and are important considerations when evaluating a trading opportunity. Price volatility defines investor uncertainty, and abnormal behavior is often caused by the pricing in of new fundamental information.

It is important to try and relate these technical analysis concepts, and all others, to the market dynamics that move them. Understanding what is behind a technical analysis indicator will help you make better investment decisions.

I have often said that trading the stock market is simple, but not easy. I can teach someone my rules in a Weekend course or through our Home Study course, and with a few months of practice, most people can be well versed in applying the Stockscores Approach to trading the stock market. However, my own inability to always follow my own rules proves that understanding how to trade the stock market is very different than actually doing it. Why do I and so many others break the rules of the Stockscores Approach and what can be done about it?

Let me begin with an example from my own trading this past week. I was applying a new day trading strategy that I have shared with our members on playing stocks that gap on the open. I entered a trade for 1000 shares of CYBX at $36.80 on Thursday, and added another 1000 shares to the position later in the morning to put my average cost at $37.55 on 2000 shares. I sold the position at $38.41 to make a profit of about $1700 after commissions.

I would never say that it is bad to make $1700 in less than an hour, but it was not the right thing to do. Applying the rules I have devised for selling on this kind of a strategy, I should have sold the position 10 minutes later for $39.43. For those not strong in basic math, my mistake cost me about $2000.

Why did I make this mistake? What causes so many other traders to make mistakes like this, and some much more critical, and thus hinder their profit potential in the stock market?

The answer is very simple; we have an emotional attachment to money.

Aside from the occasional mistake made in executing a trade order, most mistakes in the market are made because of emotional. Therefore, it should be the goal of every trader and investor to keep emotion out of the decision making process. Here are some of the reasons why we get emotional, and some possible remedies:

Too Much Risk - if the loss potential on a stock trade is more than the trader is comfortable with, then the trader is more likely to not exercise a stop loss order, or sell too early to avoid a loss if the stock should reverse.

Remedy: Take position sizes that you are comfortable with. If buying 1000 shares means that your stop loss point will result in a $500 loss, make sure you are comfortable with losing $500. If not, take a smaller position.

Lack of Confidence - you have to believe in the strategy that you are applying in the market. If you are unsure about whether the strategy really works, then you will second guess it when you are in a position, and may exit a winning trade too early.

Remedy: test your strategies until you have convinced yourself that they work. Then, apply the strategy with less risk than you are comfortable with. Make sure that the strategy works in real market conditions, and when you have proven that to your self, increase the amount of risk that you take.

Lack of Focus - the other day someone commented to me that day trading was better than working. Make no mistake, trading is hard work and requires focus. It is hard to make the right decision when distracted by your job (the one you are actually supposed to be doing when you are trading from the office), kids, spouse, dogs, the golf tournament on TV or the sunny weather beckoning you to the golf course.

Remedy: trade when the conditions are right and be disciplined to avoid distractions. I know, easier said than done.

Undercapitalized - like any business, trading requires capital. If you are depending on your trading to pay your bills, then you need to have enough capital to realistically make enough to pay your bills. If not, you put unnecessary pressure on your trading decisions to make money, and that leads to mistakes.

Remedy: as a general rule, a good trader can make 1% on their capital a day. So, if you have $10,000 in your trading account, you can make $100 a day (this gets harder as the size of your account goes up, it is harder to make $10000 a day with a $1,000,000 account). However, keep in mind that this is once you are good at it, and can keep emotion out of the equation.

A Good Memory - nature has equipped us to avoid pain. As a result, the memories that stand out most in our mind are those that caused us pain. Anyone who has been stung by a bee knows that it hurts, and will go out of their way to avoid a bee. That avoidance of pain is often stronger than the pleasure of eating sweet honey, so the effort to avoid a bee will be stronger than the pursuit of eating honey. In trading, we remember the bad feeling when we took a loss, or the negative feeling that we felt when a winner turned in to a loser. As a result, we place greater emphasis on avoiding the pain of losing than on the pleasure of winning.

Remedy: remind yourself of the probability of something negative happening. If I do an analysis of my trading records, I know that following my selling rules yields the best profit over a number of trades. The occasional loss that evolves out of a good trade set up is a price to be paid for the numerous profitable trades that come when I follow my rules.

Every time I teach a course, I remind the aspiring traders that they will make mistakes despite it seeming so simple to make money in the market. Trading the stock market is not easy, and mastery over your emotions is the most difficult thing for traders to learn. However, focusing on achieving that mastery can yield great rewards.

I receive a lot of email asking me about brokerages. With so many choices available to investors, picking one brokerage to open an account with is a daunting task. The difficult decision is complicated by the many marketing tricks that brokerages use when advertising their services and commission structures. When selecting your brokerage house, here are some things to think about.

Price: the first thing that investors consider is price. While it may seem easy to compare commission structures, there is actually a lot to know and understand. The commission you pay on a trade is only part of what you are paying. Brokerages have choices on how they can get your order to buy or sell stock filled, and there can be hidden costs that you don't see.

Brokerages can route your order directly to the stock exchanges (called Direct Access) or they can route through a market maker. Routing an order through a market maker carries a hidden cost, because the market maker can try to get the stock at a better price than you are willing to pay or accept and keep the difference. This can increases the total cost of your trade.

For example, suppose you would like to buy 1000 shares of a stock that lasted trade at $10. If you enter an order to buy the stock at $10, then a market maker will sell you that stock at $10. However, if the market maker can find that stock for sale at $9.97, then the market maker will keep the $0.03 a share. If you route the order through a Direct Access brokerage, you will get the stock at the cheapest available price. If you enter an order to buy at $10, but there is stock available at $9.97, you will get filled at $9.97, and save yourself $30.

Many brokerages offer very low commission rates but route the order through market makers to make their profit. A Direct Access broker will skip the middleman, but there is a fee (typically $0.003 - $0.006 a share) for the direct access.

In this example, if the broker who routes the order through a market maker charges you a $7.95 commission, while the Direct Access Broker charges you $14.95 plus $0.004 a share, it seems like the first broker is cheaper. However, if you get the best price available in the market by going through a Direct Access broker, you actually save on the overall cost of the transaction.

When evaluating the prices that a brokerage charges, you have to consider the commission plus the cost of order routing. Direct Access saves money in the overall cost of the transaction because you can get the best price in the market.

How do you know if you have a Direct Access broker? If you are paying an ECN fee, you are going direct. Some Direct Access brokers will give you the ability to route through an ECN (and therefore pay the small price per share) or they will offer you a commission rate that does not have the ECN fee. While it may seem cheaper to go outside the ECNs, it may not be as you are not going direct and therefore may not be getting the best price on the stock.

Speed: If you are an active trader, speed is important because hot stocks can move very quickly.

If it takes too long to get your buy and sell orders filled in a fast moving market, you may pay too much to buy or get less when you want to sell. When considering brokerages, ask yourself how long it will take to get your order filled. In my experience, the process of entering your order and getting it filled can take as little as one or two seconds with the fastest direct access brokerages.

Service: Full service brokerages have brokers that will give you investment advice and tell you what to buy and sell. This is a service that you pay for through higher commission rates. Other brokerages don't tell you what to do, but give you tools to help you make your decisions. Finally, some brokerages do nothing more than facilitate your trades.

The level of service required depends on the individual needs of the trader. If you just want a brokerage to exercise buy and sell orders, then you don't need to pay for the extra services. However, it may be important that the brokerage house have a help desk to help you learn the order entry platforms and help with technical difficulties. When selecting a brokerage, ask what level of support is available to you.

The selection of a brokerage is difficult because the marketing makes it difficult to compare what you are really getting and what you are really paying. Take the time to do your research, you can save thousands of dollars a year.

You would think that a rational, intelligent person would be good at predicting and trading the stock market. After all, stock prices are based on a company's ability to make money and it can't be that hard to determine who will make the most. Yet, so often, apparently good news is met with selling pressure, and bad news finds the interest of buyers. Some days, good news really is good news and is met with a favorable market response, but the same sort of news some time later will bring the opposite reaction by investors. If your personal pastime is trying to figure all that out and make money from it, well, you may soon believe that digging ditches is a more enjoyable profession.

Those who intend to pursue market profits need to straighten something out very early in their trading career; we can not try to figure out what the market should do, only react to what it is doing. What it is doing is what is always right, no matter how wrong it may seem.

Interest rates went up in the US this week, something that in theory should be bad for stock prices. Stock prices went up too, despite the fact that, in theory, they should not. Would stock prices have gone down had interest rates not been raised? That would make even less sense.

The truth is, the market usually knows how it will react to news before the news comes out. The market predicts news, and does not react to it. When the expectation of news culminates in its announcement, the market has already forgotten about the freshly announced news and is now looking forward to the next important price moving catalyst.

There are two types of investors in the stock market. Those who look ahead to make their decisions, and those who look to the past. The former group is much smaller than the latter, yet it is comprised of the investors who make the most money.

Membership to the money making group of investors, those who look ahead to make their trade calls, can be achieved in one of two ways. The first is based on the privilege of being in the know, to be part of the inner circle of a company's information machine that will ultimately determine future price. The second is to be a member of the lower class information scavengers who simply try to figure out what the privileged investors are doing.

The stock market is not fair, there are some investors that have better information than the general public, and have a money making advantage when they can act upon it. However, those who learn to read what they are doing can achieve the same sort of market beating returns without really knowing what the inner circle knows.

There is actually an advantage to being a scavenger of private information. While it may seem to be more difficult to follow the smart money than it is to be the smart money, the truth is, the profit potential is even greater if you are a follower. Those with private information typically possess it only occasionally and on a specific company that they are close to. Scavengers can follow the smart money on any stock, and always be busy taking advantage of their advantage.

Abnormal trading activity is the greatest hint that an information scavenger can use to figure out what tomorrow holds for price movement. Stocks whose price changes abnormally, volume changes abnormally or whose price moves through important levels often do so because of significant fundamental change. The kind that is priced in to stocks before the news is announced.

The wisdom of an intelligent person would suggest that investment decisions should be made on what we know; the fundamentals of a company's business that has been recorded in the official record. If you want membership in the money making club, forget about taking this approach. The stock market is not fair, and it often makes no sense because most of us don't have the information to make sense of it. Unless you are part of the privileged group, you success will be based on your ability to figure out what the privileged are doing in anticipation of the future. Trust what the market tells you.

Successful trading of the stock market requires a lot more than knowing what to buy or sell. While most beginning traders focus their study on when to enter a position, traders who make money know that the money goes to those who do a lot of other things right. Here are ten things that every trader must know:

1.**You can't take more risk than you are comfortable with -** emotion is the enemy of the trader. Most of us are slaves to our emotion, which is why most traders fail despite the apparent simplicity of trading. To be successful, you have to manage emotion, and the first step toward emotional mastery is to not take more risk than you are comfortable with. If you can't sleep at night over the potential of losing more than $500 on a stock trade, then you should not risk more than $500 on a stock trade. The less you care about the outcome of a trade, the smarter you will execute it.

2.**Stops loss orders must be used -** one big loss can wipe out the gains of five winning trades. Success requires that you don't take big losses, so utilize stop loss orders. Once you are entered in a trade, enter a stop loss order and stick to it. If your brokerage does not provide the ability to execute stop loss orders, then change brokers.

3.**No one cares more about your money than you -** only you really care whether you make money or not. Therefore, do not depend on others to make you money; you have to take control and know what is going on. You can use the skills of others to help you make decisions, but ultimately, your success in the market will come down to what you do.

4.**Losers react, winners predict -** the market does not care about what happened in the past. If you are using publicly available information to make trading decisions, then you are using old information. The stock market moves on what it expects to happen in the future, and not on what has already happened. Use what has happened in the past to provide clues to what may happen in the future, but don't make decisions on information that is widely known.

5.**The stock market is not fair -** Within every stock, there are a small group of investors who know more than the general public. They have an advantage, because they can better predict what a company will do in the future. To be successful, we have to figure out what the investors with better information are doing, and then do the same.

6.**Information is biased -** the financial industry wants you to buy stocks. The brokerages that finance the companies, the newsletters that get paid to advertise company stories, the promoters that get paid to promote stocks, the media that sell more advertising in an up market and of course, the companies themselves all benefit when stock prices go higher. The more buyers, the higher prices go. Trust no one when making investment decisions, because everyone can have a bias. Only the market can not lie (although it can seem pretty stupid sometimes), therefore, trust what the market tells you.

7.**Hard work does not make money in the market -** you need to work hard to learn how the stock market works. You need to work hard to learn how to manage your emotions. You need to work hard to learn discipline. However, the most money is made in a market that is trending, one where there are lots of opportunities and it seems easy to make money. When the market is not trending, it is harder to find opportunities. Working harder when the going gets tough will cause you to take marginal trades. Take the obvious trades, they are more likely to work.

8.**Black boxes don't work -** there are a lot of companies selling trading systems that magically spit out buy and sell recommendations. The stock market is like a flu virus; just when you think you have it figured out, it changes in to something else. Therefore, systems too must evolve with the market. A system that worked in the past may not work in the future. However, what seems to always work is understanding how humans and crowds behave. Learn that, and you can begin to pick stocks in any market condition. More importantly, learn the art of trading well, knowing that you can not always be right, that you have to limit losses and let profits run and that you have to understand what motivates people to buy and sell. Systems, indicators, and computer programs are simply tools to help you make better decisions.

9.**The stock market is usually efficient -** actually, stock, futures, currencies and any other market that has enough people trading them are usually efficient. That means, most of the time you can not beat the markets. To do better than the masses, you have to identify situations where market efficiency is breaking down. That occurs when the crowd is emotional or when small groups of investors are trading on private information. Usually, that is most easily found when stocks are trading abnormally in terms of price and volume. Focus your attention on abnormal behavior when looking for trading opportunities.

10.**Discipline is essential** - you have to manage risk effectively, you have to use stops loss orders, you have to always be looking for high probability trading opportunities, you have to avoid taking too much risk and you have to let winning positions run. The laws of trading are nothing if you don't have the discipline to follow them.

A recent study found that approximately 80% of day traders lose money, and 20% are able to consistently make a profit. Numbers like that are not too encouraging, but when examining the path that many take to become day traders, it begins to make a lot of sense.

Doctors and lawyers go to school for a long time to learn their craft. Professional athletes spend most of their youth developing their abilities to win in sport. A carpenter spends a few years developing woodworking skills. However, most aspiring day traders read a couple of books, open a brokerage account and start trading. Is it any wonder that most fail?

I spent 8 or 9 years trading the market before I found success. While I was able to support myself through those years, I was not living the high life. Living in a 600 square foot basement suite, working at night so I could trade during the day were the realities of my time in training. My friends and family thought I was crazy, but I stuck with it.

With time, I learned how to trade. In a hot market, I was averaging $10,000 a day in profits. In a slow market, I can still find opportunities that make a few thousand dollars in an hour or two. Easy money, right? Wrong.

Trading the stock market is simple, but not easy. I can teach someone the rules and mechanics of trading in a couple of days, but the art of trading takes time to learn. I have seen some of my students catch on right away, and make $20,000 in their first week. I have watched others quit in frustration after mounting losses convince them that profitable trading is impossible.

What is it that makes the difference between a good trader and a bad one? After teaching hundreds, I have a few ideas about what is necessary to be a good trader. If you are considering a career as a trader, consider the common failings of the rookie trader:

1. Unrealistic expectations: the potential to make a few hundred thousand dollars a year is achievable, but don't expect that to happen right away. You have to not only learn how to trade, but also, how to manage your emotions. The latter is more important.

2. Fear: good traders make good decisions. Trading with a fear of losing will cause you to make destructive decisions. If you can not afford to lose, then you will be afraid of losing, and you will make mistakes.

3. Greed: we all want to make money, but those who want to make money the easy way will trade like gamblers. Successful traders make trades that have a high probability of success. Gamblers make trades that make them dream of fast profits. In gambling, the house always wins.

4. Lack of training: you can spend eight or nine years like I did trying to learn how to trade, or you can have someone that knows what they are doing teach you how to do it. Some people think that the two or three thousand dollars that I charge to teach people how to trade is expensive. However, it is a bargain when you consider how much it costs to learn it on your own. Find some one that has succeeded as a trader and is a good communicator, and pay them to teach you how to trade.

5: Confusion of what is important: most traders think that knowing what to buy and when to buy it is what makes a good trader. In my learning process, I had that part figured out in the first year or two. What makes good traders is the ability to manage risk and emotions. Make that the focus of your learning. Many traders are always searching for the best system to beat the market, when they really just need to learn how to follow their rules instead of their emotions.

6. No determination: to excel at anything, you have to possess the determination to get you through the hard times. There will be days when you feel beat by the market, but good traders don't give up.

7. Penny wise, pound foolish: good tools will help you make money, but good tools cost money. If a good, reliable charting package costs you $300 a month, but allows you to find more opportunities than an unreliable tool that is free, isn't it a smart business decision to buy the expensive product? Consider your return on investment when judging the cost of any tool.

8. Lack of confidence: emotional mistakes can also come from a lack of confidence. If you don't believe in what you are doing, how can you expect to succeed? Any time I lack confidence in a strategy, I go back to testing that strategy until I have convinced myself that it is effective. With confidence, I can trade better.

9. Failure to recognize that the market changes: in my courses, I teach a variety of strategies, but I also teach an understanding of the market. The market changes, and we have to change with it. That means applying a different strategy, or coming up with a new strategy that fits current market conditions. A strategy might make you lots of money today, but if you fail to adapt to changing market conditions, those profits will only be short term loans.

10. Inability to laugh at your self: all traders make mistakes. If you let your mistakes get you down, your negative psychology will become destructive to your trading. If you screw up, laugh at your mistake and get focused on disciplined trading again.

There is a rivalry between those who use Fundamental Analysis to identify opportunities in the stock market and those who utilize Technical Analysis. While both methods are very different in approach, the one common theme is that most people applying either methodology fail in their pursuit to beat the stock market. Both analytical approaches are flawed.

Fundamental analysts take the facts of the business and try to find a fair value for the company. After pushing cash flow, debt levels, growth, revenue and other factors through a spreadsheet, the fundamentalist arrives at a value for the shares of the company. If the stock is trading at a lower price, then the shares should be bought. If the value of the shares is trading at a higher price, the stock should be sold short.

While fundamental analysis makes a lot of sense to most people, technical analysis does not. Technicians consider the past trading prices and volumes of a stock to determine where that stock will go in the future. The idea is that the past repeats itself, and certain patterns or indications can provide a clue on the future direction of the security. Many people have difficult putting faith in this approach, and many also fail to make it work.

At opposition to both approaches is the Efficient Market Hypothesis. This theory argues that markets are efficient at pricing in information, which means that all available information is priced in to a stock, making the profits of an investor random. Therefore, over the long term, investors should only expect to earn the average return of the market.

The facts support this theory well. Even highly educated and trained mutual fund managers are unable to consistently beat the stock market. With that in mind, people who believe in the efficiency of the stock market argue that we should simply put our money in to an index fund and let our return equal that of the market, which over the long term, are pretty good.

This is obviously not an encouraging commentary if you are an investor or trader who aspires to make money from the stock market. My aim is not to depress you, but rather, show you what I believe is the best approach to achieving what academic theorists believe is impossible; to consistently beat the stock market.

There are two assumptions that are the basis of the Efficient Market Hypothesis. First, you have to believe that the spread of information is fair, and second, you have to believe that investors are rational. I believe that both can be proven incorrect.

The truth is, the stock market is not fair. Every day, there are investors who benefit from their access to better information than the general market. To prove this, consider how many stocks behave abnormally before significant fundamental information is made public. Clichés like "Buy on rumor, sell on news" are based on this idea.

Secondly, investors are not always rational. In fact, investors are often emotional in their decision making, and tend to succumb to the whims of fear and greed when making investment decisions.

Therefore, to make money in the stock market, to achieve what Finance professors deem impossible, you must seek out opportunities where market efficiency is breaking down. You have to play stocks with inside information, or take advantage of human emotion and the short term mistakes that it causes in stock pricing.

Market efficiency breaks down through the valuation process of new information before the news, and when investors get emotional because of rapid price appreciation or decline. The best indication that either factor is at work is abnormal price and volume behavior. Private information is often at work in a market when a stock begins to trade abnormally, and this abnormal behavior tends to bring emotion with it. To beat the market, you have to trade abnormal behavior.

What do I mean by abnormal? Using statistical analysis, we can determine what a stock's price and volume ranges should be in the future based on how that stock has traded in the past. If the stock goes outside those ranges, then it is behaving with statistically significant abnormal behavior. This is the analysis that Stockscores does for all North American stocks.

The reason most people do not beat the stock market with either approach is because they apply their preferred analytical methodology with a view of the past, instead of a view toward the future. Forward thinking fundamental analysts (or those with inside information) motivate abnormal market behavior and abnormal market behavior gives some technical analysts clues as to what is going to happen in the future.

When you are analyzing a company, you have to ask, "What are the facts telling me will likely happen in the future? What do the well informed investors know that the rest of the market does not?"

As a trader, I focus on abnormal behavior because that is where market efficiency is usually breaking down, giving me a window of opportunity. I would love to have inside information on every stock out there, but that is a hopeless dream that would be illegal to act on even if it could happen. Instead, I trust that the stock market is not fair, and I follow the trail that the market leaves. While certainly not 100% effective, it does allow me to make a living from the stock market.

There are two factors that affect the future price movement of a stock; factors relating specifically to the company, and those that relate to the general economy. Many investors focus on the individual characteristics of the company and forget that all stocks have some correlation to the overall market. Good companies have difficulty doing well if the overall market is going down. And in a good market, even bad companies can go up. Rather than a market of stocks, it truly is a stock market.

This point can be seen more clearly by comparing a stock with a very strong market correlation to the overall market. If you enter MSFT,QQQ on Stockscores, you will see a chart of Microsoft compared to the Nasdaq 100. The chart will show you that MSFT and the overall technology market tend to move together.

You will also see that MSFT has performed better over the last six weeks than the general market. That tells me that investors like MSFT better than the general technology market right now.

That presents a trading opportunity, because it implies that in if the technology market were able to make a bottom and begin to move higher again, MSFT would probably lead that advance upward.

This way of looking at the market is not restricted to longer term trading only. When I day trade, I always look at how a stock is performing relative to the overall market index. One of the most important indicators of a stock’s future performance is its Relative Strength as compared to other stocks, other stocks in its sector or the sector itself. This can be measured and the higher the better. Contrariwise. stocks with low Relative Strength may present good shorting opportunities.

Recently certain stocks gapped down significantly on the open, and were trading very abnormal volume. While very weak at the open, they managed to hold up quite well through the first couple of hours of trading, while the overall Nasdaq market was weak. With this in mind, I feel they would rally if the Nasdaq in general could turn higher. It seemed like the weakness in the general market held them back from going higher, but if the market could bounce, then they would rally to the upside with greater intensity.

With this in mind, I accumulated 10,000 shares as the clock approached 11 ET. The Nasdaq had hit support at the previous day's low, and seemed to want to bounce back. My trade was based on short term optimism fueled by a bounce back in the general market.

Soon after entering my position the stock managed to break from a good chart pattern and moved up about 60 cents. A bullish intraday chart was able to break out because the general market also rallied.

When trading, it is important to not look solely at the stock you are considering, but also the overall market. Focus on where the market has support and resistance, and how the stock you are considering is performing relative to the overall market. Consider buying stocks exhibiting strong relative strength if the overall market is near support, and shorting weak stocks if the overall market is near resistance. Particularly on larger, liquid stocks, this approach works very well.

Professional stock traders make money at the expense of the crowd. Crowds move in predictable patterns, and cause short term breakdowns in the efficiency of the market. Most investors are moved to action by fear and greed, and understanding how these forces act in a fast moving market can help to make profitable trading decisions.

How do you feel when a stock that you own is moving up quickly? How do you feel when a stock you considered owning, but don't own, is moving up quickly? Many investors get emotional in these situations, and make trading mistakes. Since the markets have not been really strong for the past few years, most traders are fearful of having a profitable trading position turn in to a loss. When they are in a position of uncertainty, they will be quick to sell at the first sign of weakness, causing a pull back in midst of a good up trend.

Those who miss out on opportunities will often jump in at higher levels, motivated by their sense of loss in having missed the opportunity in the first place. This group will often move a stock higher well in to its uptrend, but they play a much riskier strategy because of the gains made before they enter the position.

These forces, and others, all play out in the market every day, and lead to a relatively predictable cycle that stocks go through.

First, there is the breakout cycle, where typically savvy traders, and some lucky traders, latch on to a hot story early and break the stock from a trading range and begin its abnormal trading activity.

Next, there is a quick pull back as owners of the stock, who are not aware of what is causing the breakout, sell in to the strength as they consider themselves lucky for getting out a higher price. What is critical in this stage is to see whether the stock penetrates support, or if the first group is able to hold back the selling force and maintain its technical strength.

The next stage is the critical one. If there is good justification for the breakout, then the bigger money momentum players will come in to the stock and give it a surge upward to new highs, with heavy volumes. Initial selling pressure abates and the stock can often surge dramatically higher.

Along the way there will be short pullbacks as groups of traders nervously take profits. These are shake-out phases that can be difficult to separate from the stock truly topping out.

Finally, there is the exhaustion phase, when emotional traders enter late but the big money clears out their positions. There is often very strong volume, but upward momentum slows. The peak is typically marked by a pullback, and rally that fails to make a new high and then a breakdown from a falling top. The party is over.

So, where do the Pros make money and the Rookies give it up? Pros may buy in to the breakout, but instead of getting out nervously on the post breakout pullback, they actually add to their positions. Unless support is violated, the stock has good potential to go higher.

As the stock moves upward, the Pro may anticipate where the stock will find some resistance and sell in to that price point, with the aim of getting back in at lower prices on the next pull back phase. Rookies buy the stock as it approaches resistance, and then get shaken out when the stock pulls back sharply on emotional selling.

Finally, Pros will liquidate most of their position through the major upward phase while the general public buys. Pros look to short the stock when the greenest of the Rookies is buying in to the exciting up trend. When the stock breaks down from a falling top, the Pro is short while the Rookie is hoping for a turnaround.

Human beings are programmed to fail in the stock market. From our childhood, we are taught to avoid pain (don't touch that, it is hot!) and seek out pleasure (if you are good, you can have some ice cream). Stock traders have to spend a lot of time reprogramming to buy weakness in strong stocks, and sell strength in weak stocks. That means seeking pain, and avoiding pleasure, a very hard thing to do.

This week, I want to talk about the Risk/Reward trade off, and why understanding it is so important to successful investing and trading. Most traders are concerned with when to enter a stock, and neglect understanding the appropriate position size and profit potential of the trade.

When considering a trade, it is important to establish a loss limit. You can not be right on every trade, but limiting losses when you are wrong will improve your long term performance. When buying a stock, plan to sell if it moves below support. When shorting a stock, plan to cover the short when it moves through resistance.

The difference between the entry price and your stop loss price represents the basic risk of the trade. If you are buying a stock at $10, and will take a loss if it moves to $9, then you have a risk per share of $1. If you don't want to lose more than $500 on the trade, then your position size should be 500 shares (this is a simple example, we should also factor in commissions and slippage).

When looking at the stock chart, we should also consider what the potential gain on the position is. If we are buying a stock at $10, but the stock will encounter technical resistance at $11, then we only have $1 of upside. If the stop loss point is at $9, then we have the same upside potential as downside potential. That makes the risk reward trade of 1:1.

When trading, I have found that it is better to have a 1:2 or better risk reward ratio. That would mean that we would not take the trade at $10 unless we saw good potential for it to move to $12.

You can take trades that have less than a 1:2 risk reward trade off if the probability of success is very high (70% or better). You can also take low probability trades if the risk reward ratio is very high.

When you find a good stock chart, you should then consider the position size based on the entry price and stop loss point. Then, consider the likely upside potential of the trade, and calculate the risk reward ratio. If the trade has a good probability of success, and the profit potential is two times or better the loss potential, then the trade is worth considering. A good chart that does not have enough upside potential to compensate for the downside risk is not worth doing unless there is a very high probability of success.

Good traders are more than good stock pickers, they also practice good risk management, limiting losses when they are wrong and letting profits run when they are right.

Bottom fishing is the quest for stocks that are inexpensive relative to previous levels, but show signs that the bargain is going to end soon. We want to look for stocks that are a showing a break from pessimism, an increased level of confidence that the stock is undervalued, and signs of optimism for the future. Filtering for these situations gives the investor a short list of companies to perform their necessary due diligence on before speculating on a change in trend.

Buying a stock that is in a long standing down trend can be as dangerous as stepping in front of a freight train. It takes time for stocks to reverse trends, and buying what seems to be a bargain can be a crush to your portfolio. However, bargain hunting can be profitable if the timing is right. To effectively bottom fish beat-up stocks, you have to enter when there are signs that the downslide is slowing and a move back upward is imminent.

Market psychology takes time to reverse. When bottom fishing, we want to focus on stocks that have suffered a sell off and are cheap relative to where they once were. However, we want to also look for signs that market psychology is turning favorable on these stocks and that they are ready to head higher again.

This strategy focuses on three stages:

Stage 1 - a break from the show of pessimism
Stage 2 - a show of confidence
Stage 3 - a show of optimism

Stage 1 is essentially a breaking of the downtrend. If we draw a line along the top of the declining trend, we have defined the downtrend. A break of the trend arises when the stock can break upward and through that declining trend.

In Stage 2, we want to see signs that there is confidence in the break from pessimism. The market needs to show resilience that the downtrend is indeed slowing, and that the potential for an up trend is real. A consolidation following the break is a good show of this, and is more significant if it as at a level higher than the previous low. This is a rising bottom.

Finally, we want to find signs that there is optimism about the future of the stock. A breakout from a rising bottom is Stage 3.

Understanding Short Selling

Education

By Tyler Bollhorn, **Stockscores.com**

You can buy a stock or you can sell it. For most investors, the buying usually comes first. We buy a stock in anticipation of it going up, so that we can sell it at a profit.

It is also possible to sell the stock first. Sell the stock with the expectation that it is destined to go lower, so that we can buy it back cheaper in the future. This simple reversal of the process is called shorting. Successful investors utilize this strategy, taking advantage of the simple fact that stocks do not always go up. However, there are a few different rules that investors need to be aware of when shorting stocks.

The most important thing to realize is that, when you short a stock, you have to borrow it from your brokerage house. To do that, your brokerage house has to have the stock to lend. If you short a stock, the brokerage house will actually deliver the shares to the new owner by using shares that another of their customers own. The idea is that they will replace the borrowed shares when you buy them back, effectively covering your short.

The ramification of this is that you can not short any stock that you want as the brokerage house has to have the stock in inventory. Generally speaking, stocks that have good liquidity (trade at least 30 time a day) have a wide enough circulation that your brokerage house will allow you to short the stock. However, an added risk of shorting is that the brokerage house could order you to buy the stock back if they are unable to cover the borrowed shares. That order to buy back can come any time and may come at a time when you are forced to take a loss.

Another important consideration is that there is no limit to how high a stock can go. When you buy a stock, the maximum amount you can lose is your investment. However, when you short a stock, the potential loss has no limit because the stock could keep going higher and higher. It is for this reason that many people consider shorting too risky. My opinion is that buying or shorting are both risky if the individual doing it lacks discipline to limit losses. For the disciplined and experienced investor, shorting can be worth the extra risk.

Because of this added risk, many brokerage houses will not allow you to short stocks that are under $3. Their concern is that cheap stocks are at risk to show more volatility and could go dramatically higher, effectively wiping out a lot of a client's equity.

The added risk of shorting also requires that the client maintain more money in their account than is necessary to buy the stock back. This extra amount is referred to as margin. Generally, brokerage houses require 150% of the market price of the stock that is shorted. So, if you short sold 1000 shares of a $10 stock, you should have $15,000 in your account. Remember, of course, that when you short sold the 1000 shares you put $10,000 in your account. So, you really only put up $5000 in equity. But, if the stock goes up, you may be required to add more equity to your account to ensure that the 150% requirement is kept.

Having the option of shorting open to you is liberating, as it no longer forces you to only buy stocks that you think is going to go up. A psychological hurdle for investors is "hoping" a stock will go higher instead of heeding the truth, which often says the opposite. When an investor can make money on either side of the market, he or she is likely to make better judgments.

Another advantage of shorting is that stocks tend to move down more quickly than they move up. Perhaps this is because fear is a more powerful emotion than greed. Those proficient at anticipating stocks that are destined to go lower are often rewarded with shorter hold periods, and therefore, lower opportunity costs.

The key to taking advantage of the shorting mechanism is, of course, knowing how to find shorting opportunities. Visit the Selling Strategy area of this site for some ideas.

What Causes Movement in Stock Prices

Education

By Tyler Bollhorn, **Stockscores.com**

We all want to make money in the stock market. We do so by selling stock at a price higher than what we buy it for. It makes sense, then, that to make money in the stock market, we need to understand what causes prices to change. By having an appreciation for the things that motivate stock price change, we can be better at anticipating the direction and velocity of price moves.

What is Price?

To begin, we must first understand what price is. Financial theorists define stock price as the present value of all future earnings expectations for the company, divided by its number of shares outstanding. What this means is that the earning capacity of the company is what defines price. Often, companies can get significant value out of a relatively small investment in assets because the ability for those assets to make money is significant.

Even companies that lose money today can have a high share price because price is based on the future earnings of the company. No enterprise is in business to lose money, so the expectation is that every business will make money some day. So long as there is the potential for future revenue streams to shareholders, there will be a price that someone is willing to pay for the shares.

The earnings that a company could make in the future, the growth that the company could realize and the time to the realization of those goals are all factors which affect the estimate that the market makes on the earnings potential of the company.

The Market Mechanism

The value of publicly traded shares is liquidity. Publicly traded companies are worth more than private ones simply because there is greater access to buyers and sellers, and market efficiency can better determine share price. The stock market provides value to any company that chooses to list its shares because the company gains liquidity.

In a theoretical sense, any time someone buys the shares of a company in the market, they are effectively stating that they believe the shares of the company are undervalued. The fact that they are buying implies a belief and expectation that the shares will increase in value in the future. At the same time, the person who is selling the shares is expressing the opposite belief. By selling, they imply that the stock is overvalued and the expectation that the stock will go lower in the future. In this way, the stock market is forum for debate on what the value of the company and its shares is.

What Affects Price?

There are four factors that cause movements in stock price:

- **New information**
- **Uncertainty**
- **Psychological Factors**
  - **Fear**
  - **Greed**
- **Supply and Demand**

Information

If you read a financial textbook, you may find only this factor mentioned as the determinant of share price. Information is key, as it gives the market a reason to value a stock at a particular price level. The market will price a stock based on all information that the public is aware of. As new information comes into the public realm, the market will adjust prices up or down based on how the market perceives the information will effect the future earnings capacity of the company.

It is important to understand how information flows from the company to the public. The public is supposed to learn about significant new information through the issuance of news. The reality is that the information usually makes it out before the news is released. Rumor plays a big part in the flow of information, particularly today when technology allows for the rapid and wide dissemination of information. Those close to a company often have access to privileged information that they act upon by buying and selling in the market.

The ramification of this is that investors who wait for news to make investment decisions often get into stocks long after the information contained in the news has already been priced in. “Buy on rumor, and sell on news”, is a saying that has grown popular because it is often the case that stocks move up in anticipation of positive news and then sell off when expectations have been answered by the news release.

Technical analysis is very useful because it provides tools that allow investors to identify the signs that new information is being priced into a stock before news is released. Stocks that trade abnormally often do so because of significant new information, both positive and negative. In this way, technical analysis helps to reveal fundamental changes in the company before the broader market is aware of it.

Uncertainty

What a company will make in the future is far from certain. For this reason, we should expect stocks to bounce around a little bit because of the nervousness of the market about the future of the company. The uncertain future of the company will bring some volatility in share prices even during a period in which there is no new information.

Companies that have established a performance record will tend to show less volatility as determined by uncertainty. General Motors, which is a well-established company with many years of revenues, will show less volatility than an upstart technology company that has not yet had an opportunity to establish a track record of revenues and earnings. Because of uncertainty, these stocks will trade differently and will present different kinds of trading opportunities.

Psychological Factors

Humans are behind the trading activity of the stock market. That means human characteristics are also factors in how share prices move. Understanding human psychology is extremely valuable when evaluating investment opportunities because human psychology creates and accentuates many of the opportunities that investors can capitalize on.

For example, greed often causes stocks to go higher than they deserve to go. By deserve, I mean that they go higher than the present value of future earnings potential can justify. New information can cause a frenzy in the market that makes investors lose sight of rational valuation and simply buy the stock for fear of being left behind. This phenomenon is the basis for some great speculative bubbles that we have see in history.

At the same time, fear motivated by negative information can cause everyone to rush for the exit door at once and take a stock, or entire markets, dramatically lower very quickly. Much of the selling pressure that prevails during market crashes is out of fear, not a rational thought process based on information.

Fear and greed present incorrect valuations in the market that can exist for relatively short periods of time but long enough for smart investors to capitalize on. Emotion in the market can be viewed as an amplifier for new information. It can make moves more extreme than they should be. However, often the power to this amplifier is pulled and the stock moves back to where it should reside based on the information that is known about the company.

Supply and Demand

While popular stocks like Dell Computer or General Motors trade millions of shares every day, the majority of stocks that we can choose to invest in do not have such liquidity. As a result, stocks that trade smaller volumes of shares are subject to fluctuations because of supply and demand. If a large shareholder wants to sell a large number of shares into a market with weak liquidity, that shareholder can dramatically move share price. The flip side is also true when a large buy order comes into a market that lacks sellers.

Supply and demand can take the short-term balance out of the stock market and present opportunities for investors who have the patience to see that balance restored. Investors who can anticipate abnormal supply or demand variations can also capitalize.

Summary

Price reflects all the information that is known about a company and their ability to make money in the future. As information about a company's prospects is made public, prices will change. Uncertainty of the future can bring added volatility while psychological factors can amplify the effect of new information. Finally, supply and demand considerations can cause fluctuations not motivated by new information. Understanding why prices change is essential to success in the stock market.
