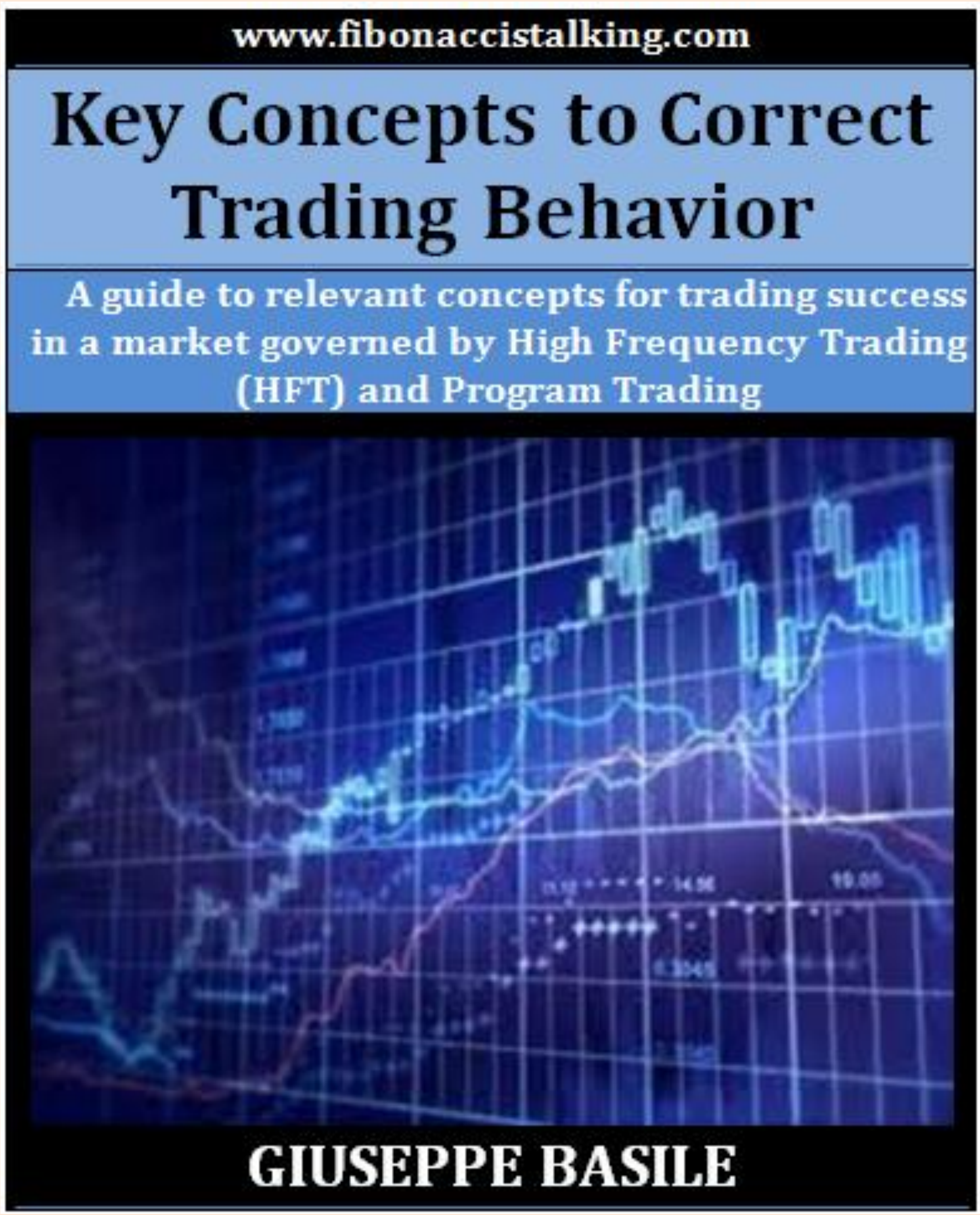

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Introduction

Are you interested in trading or a seasoned trader but still not part of that elite 5% of consistent traders? Do you want to be a successful trader regularly extracting profits out of the markets? If so, it is important you start thinking of trading from a different perspective, as well as, start doing something differently. One thing could be to re-focus on those key concepts that truly describe, explain and affect price behavior. If you are a new or inexperienced trader you will benefit from the content of this book much more than more experienced ones. The reason is that you have a unique opportunity to shape up the right beliefs and mindset about trading from the very beginning. Traders with experience will need to work a bit more to change or slightly modify their current beliefs, as needed. But if they face the effort they will be able to quickly turn around their trading.

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The key concepts presented in this eBook help understanding the psychology behind price moves, mainly driven by emotions in a way that rationalizing market behavior is not relevant and even counter-productive for successful trading. For instance, all the hype on market news and on its interpretation is misleading. News can and will only affect price on the smaller timeframes like 15min and 4-hour, but very often (if not always) it will have no effects on price patterns already in place, neither will on the outcome of well-formed daily and weekly setups.

In trading perception is much more important than facts and their rational interpretation in relation to how price could and will be affected, i.e. what is the anticipated traders' reaction after a key event. An introduction to each of the five concepts that are paramount for trading success will prepare the trader to build the needed beliefs or help shifting the existing beliefs in order to (re)learn how to trade successfully.

If you have been in the trading system for some time, you will have realized that trading success requires useful and focused beliefs and the right psychology. The concepts presented in this book are counter-intuitive and challenge the widespread 'truths' of trading. Probably this is the reason why it is meaningful to analyze and study them carefully. A deep understanding of key concepts will also help understanding where the real profit opportunities lie.

They key concepts discussed are:

- The Bandwagon Theory

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- The Psychology of Trading: the Bandwagon Theory illustrated
- The Danger of Asking "Why?"
- Facts and "Truth" Do Not Make Money
- Professionals Trade People's Psychology and Not the Markets

1. The Bandwagon Theory

The Bandwagon theory is an allegory for markets behavior that is worth alone the equivalent of months, if not years, of trading exposition and can save a lot of time, money and mental pain. It is not an overstatement that a profound understanding of the message and the hidden wisdom in this theory can create the conditions to reach true trading mastery.

The theory[1] provides an insight into the inner workings of the market and how the average trader is '*manipulated*' for profit. In reality it would be honest to mention self-manipulation because consistent, professional traders and those '*in the know*' cannot directly cause others to lose money. What they can do is use information that the average trader does not have to position themselves successfully in the markets. This is not about COT, insider trading, secretive information or special technical indicators. It is about understanding that the psychology people bring into everyday life activity is dis-useful for correct and consistent trading. The responsibility of poor trading results is the lack of market-oriented psychology. Traders are paid for the quality of their

[1] "Tools and Tactics for the Master Day Trader", Oliver Velez and Greg Capra – Mc Graw Hill, pag. 29

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decisions. Losing money clearly means that the decision and/or execution process is ineffective and professional traders understand that.

Bad trading decisions cause a continuous transfer of wealth from the larger group of average traders and hedgers onto the smaller group of consistent professionals, and this is what keeps the markets moving. The whole game called trading is contained in and explained by the Bandwagon Theory that is offered below. It is important and beneficial for the reader to make no assumptions but rather check for himself or herself and then carefully consider how the following could be the real truth about the markets.

I often encourage traders to carefully study and think about the Bandwagon Theory. After all, professional traders are not smarter individuals, they just know and understand how the crowd deceives itself and leverage on wide-spread weaknesses. Make your choice and decide which side you want to be on.

Before proceeding I want to remind the reader that the theory is an allegory, so it may be difficult to link it back to trading the markets and price behavior in a straightforward way. For this reason, and to make the Theory easier to understand, it will be illustrated in Chapter 2 using a real market, the Euro-dollar foreign exchange cross (EUR/USD). This will allow easier access to the wisdom and '*secrets*' hidden in the Bandwagon Theory.

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Hereunder the Bandwagon Theory as it has originally been published[1], to be read and studied carefully:

"Imagine a bandwagon that is rolling forward at a quickened pace. Music that is very pleasing to the ear is being played from speakers on each side of this bandwagon, and a few people currently on the back of the wagon are partying, having the time of their lives. The music, loud and clear, starts to attract many other onlookers that happen to be idly standing on the sidelines. These onlookers, unable to resist the sweet sounds being played, run to join the party that seems to be going on.

Progressively, more and more onlookers jump on the back of this bandwagon, and those few who were initially enjoying the first phase of the party begin to leave. As the crowd of new party animals on this bandwagon grows larger, the bandwagon finds it harder and harder to move forward at the same pace. It slows, enabling more and more late onlookers, witnessing the great fun, the chance to jump on. The crowd grows even larger. Larger and larger this crowd grows, until the bandwagon, heavily laden with the bodies of drunken party animals, can no longer move forward. It finally comes to a complete stop. Now that the bandwagon is at a complete standstill, more people jump on. And why not? At this point, joining the fun is easy. Absolutely no work is required, for individuals wanting to join the crowd no longer have to run to jump on board.

The nature of the bandwagon is to move forward. Its motionless state is unnatural, and therefore cannot last. It tries to move forward again, but can't. The crowd, piled on back, is much too large. It must free itself of the heavy

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burden. And it does. It quickly shifts into reverse, and jolts backward, knocking a few of the party animals off the back. The music stops. Puzzled faces from the crowd begin to emerge. Before anyone figures out what's going on, another backward jerk takes place, only this one is more violent. Another large group of people gets thrown off the back. Now, reality sets in. The fun has turned into a nightmare of epic proportions, and panic begins to run rampant. Some decide to jump to their deaths. Another thrust backwards sends an even larger group of drunken, off balance people, hurling to the muddy ground. It doesn't stop. The jolts backward continue, each successive one more violent than the last. At this point, only a few die-hard wagon dwellers are holding on, their very lives hanging in the balance by a very thin thread. Failing to be completely free, the bandwagon angrily puts the pedal to the metal, and this final thrust backward is so vicious that its front wheels lift high off the ground, momentarily suspending the wagon in a perpendicular position. The last of the hangers-on crash to the ground, broken and maimed to no end.

At this point, a new group of onlookers emerge from the nearby woods. They are clean and serene. Each movement they make is deliberate and powerfully energetic, for they did not take part in the tragedy that just transpired. Or did they? A few of the dejected souls lying on the ground take a closer look, a look that reveals something very interesting. This seemingly new group is not new at all. It is the same group that was seen quietly exiting the party before it came to its violent end. An even closer examination by a few more beaten-down onlookers reveals something even more stunning. This group not only exited the party early, they were the originators of it! "My God," someone exclaims.

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Paralyzed, and unable to move freely, all these dejected souls can do is watch, as the masters of the game go to work, again. No sooner does the bandwagon's wheels hit the ground than this professional platoon bolts for the wagon. In a flash they are on board. Easy. The bandwagon, now free of the larger crowd, can move forward freely and gracefully, comfortably carrying the more astute group with it. Its pace quickens, and before long a smooth elegant stride is in place. After a few miles of uninterrupted movement, someone from this masterful group flips on a switch, and suddenly the loud sounds of entertaining music start again. Someone yells, "OK everyone. Here they come. Let's do it again." Within moments, those who were the former victims of the backward crash become interested again. The music almost calling them from the grave. And once more, the never-ending cycle repeats."

The metaphor of the bandwagon is a compelling one. But what does it mean in practice? What should an average, non-professional trader be aware of? In order to show how the Bandwagon Theory works in practice two stories are provided in the following: the first one applying to investors; and the other relevant to intraday traders. The next Chapter 2 will delve a bit more in the meanings of the Theory.

The first story it is set back in 2000. Weeks before the burst of the so-called technological bubble a lot of investors (and traders) were not able to recognize the current state of the market. Too often people were making bad trading decisions and getting bailed out by general performance of the irrational market. For instance, people buying overbought conditions in a very

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strong market were rewarded by prices continuing higher. Something however that would not be considered a good trade, even if it made money; on the other hand, making money only reinforced bad behavior.

These people, who were not experienced investors or traders, just bought something and it went up. It did not matter what they bought, it went up. It did not matter they were chasing stocks at highs for less than $10 or $20 points, it went up. It did not matter that they did not have a method, a position sizing technique or exit strategies: the market (the tide) and all stocks (the boats) went up. They may have believed they were great traders but many of them have not fared too well since the bubble burst and many have lost everything. These investors and traders joined the bandwagon at the exact wrong time, when the professional players had already left the stock market or were in the process of doing so. This scenario repeatedly occurs, for example during the 2007 US markets topping process, and will happen again, maybe in 2013 or 2014.

I know personally people who played the US stock markets in 1999 and 2000. One of them did not have a method but would simply buy highs in a reactionary way. He ended up losing money, the equivalent of "a small car", as he once confessed, a loss estimated at around €12,000 (or $15,000) in just a few weeks.

The second story relates to the bad but widespread behavior of buying highs after big green or white candles, and selling lows after big red or black

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candles. This happens in all timeframes. For instance, when people see a 15min green bar they assume "the market is going higher" and they buy highs. The market typically reverses and suddenly their position is in the red. As they have no plan for this unanticipated behavior, because that was a reactionary trade, i.e. simply a reaction to a green bar without any understanding of price structure, they end up selling in pain.

This type of action, shows psychological weakness that prompts the trader to jump onto the bandwagon at the worst possible time. When professionals see a green bar they are either taking (partial) profits or not doing anything in anticipation of even higher prices, if price is not in a profit taking area. Their actions are planned in advance and in detail. Professional traders wait for their price with limit orders and have well defined profit targets, so they do not act out of fear of losing a move or based on the shape and color of a price candle.

In conclusion, these two stories show how widespread, among investors and traders, is the behavior of entering the market at the very worst time, in all timeframes. A common mistake is to use indicators to decide on market entry. In fact, very often the information provided by classic price-derived indicators will prompt the trader to enter at those very spots where he/she should, instead remain calm and examine the situation more carefully.

When traders do jump on the bandwagon at the worst possible time, often without a trading plan, the outcome is always the same: they are pushed out

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of the wagon, which means they are pushed to close the position at a loss and in a state of psychological pain, because it was in the red since the beginning and/or it 'never worked', or it worked only temporarily. The real reason for the loss is the trader entered at the wrong time, even if the market idea was good. Becoming part of the realm of professionals – the elite 5% – as I call the group of participants consistently making money, requires a deep understanding of market psychology and dynamics. The traders who succeed are the ones able to objectively manage those basic instincts and impulsive actions that make us all act like the crowd.

2. The Psychology of Trading: Bandwagon Theory Illustrated

The previous Chapter illustrated the Bandwagon Theory. Grasping the hidden wisdom embedded in the allegory will improve the reader's level of understanding and trading mastery. The theory tells the story of how Wall Street manipulates the markets for profit. The purpose of this eBook is to facilitate the move from the group of novice or average traders into the much smaller group of consistently profitable traders. Thus to help the reader to understand and internalize the hidden message the Theory is illustrated on daily price of the Euro-Dollar forex cross.

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"Imagine a bandwagon that is rolling forward at a quickened pace. Music that is very pleasing to the ear is being played from speakers on each side of this bandwagon, and a few people currently on the back of the wagon are partying, having the time of their lives. The music, loud and clear, starts to attract many other onlookers that happen to be idly standing on the sidelines. These onlookers, unable to resist the sweet sounds being played, run to join the party that seems to be going on. Progressively, more and more onlookers jump on the back of this bandwagon, and those few who were initially enjoying the first phase of the party begin to leave." (Figure 1)

Figure 1 – Late players (former victims) jump on the Bandwagon

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In this phase (Figure 1) above the trend is already well established and late players, and former victims, jump on the bandwagon. It's late and it is going to be a troublesome trip, but some profits are still possible.

"As the crowd of new party animals on this bandwagon grows larger, the bandwagon finds it harder and harder to move forward at the same pace. It slows, enabling more and more late onlookers, witnessing the great fun, the chance to jump on. The crowd grows even larger. Larger and larger this crowd grows, until the bandwagon, heavily laden with the bodies of drunken party animals, can no longer move forward. It finally comes to a complete stop." (Figure 2)

Figure 2 – The Bandwagon gets heavy and crowd grows larger

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In this phase (Figure 2 above) more people get on board of the trending market which starts decelerating. The move higher is almost completed and price is ready to reverse. Opening a position at this stage is a mistake: it's too late and losses are very probable. Yet this is what a lot of retail traders will regularly do. Wall Street professionals and hedge funds sell to retail traders at this stage (this is also very common in the stock markets).

"*Now that the bandwagon is at a complete standstill, more people jump on. And why not? At this point, joining the fun is easy. Absolutely no work is required, for individuals wanting to join the crowd no longer have to run to jump on board. But the nature of the bandwagon is to move forward. Its motionless state is unnatural, and therefore cannot last. It tries to move forward again, but can't.*
The crowd, piled on back, is much too large. It must free itself of the heavy burden. And it does. It quickly shifts into reverse, and jolts backward, knocking a few of the party animals off the back.
The music stops. Puzzled faces from the crowd begin to emerge. Before anyone figures out what's going on, another backward jerk takes place, only this one is more violent. Another large group of people gets thrown off the back." (Figure 3 below)

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Figure 3 – The Bandwagon stops and jerks backwards

At this stage (Figure 3 above) more people get onto the move higher that has already finished. Price starts moving against the trend and some people are stopped out. But price has just not reversed yet, but moves laterally.

"Now, reality sets in. The fun has turned into a nightmare of epic proportions, and panic begins to run rampant. Some decide to jump to their deaths. Another thrust backwards sends an even larger group of drunken, off balance people, hurling to the muddy ground. It doesn't stop. The jolts backward continue, each successive one more violent than the last. At this point, only a few die-hard

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wagon dwellers are holding on, their very lives hanging in the balance by a very thin thread. Failing to be completely free, the bandwagon angrily puts the pedal to the metal, and this final thrust backward is so vicious that its front wheels lift high off the ground, momentarily suspending the wagon in a perpendicular position. The last of the hangers-on crash to the ground, broken and maimed to no end." (Figure 4 below)

Figure 4 – More people are sent off balance by backwards thrusts

At this stage (Figure 4 above) those who entered late are in panic and are being thrown off balance and out of the bandwagon, i.e. stopped out of their

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positions. Some, pushed by greed or cognitive dissonance, or even frozen by fear still hold onto their long positions now showing a loss. Eventually they will be stopped out, some of them at near swing lows.

"*At this point, a new group of onlookers emerge from the nearby woods. They are clean and serene. Each movement they make is deliberate and powerfully energetic, for they did not take part in the tragedy that just transpired. Or did they? A few of the dejected souls lying on the ground take a closer look, a look that reveals something very interesting. This seemingly new group is not new at all. It is the same group that was seen quietly exiting the party before it came to its violent end. An even closer examination by a few more beaten-down onlookers reveals something even more stunning. This group not only exited the party early, they were the originators of it! "My God," someone exclaims. Paralyzed, and unable to move freely, all these dejected souls can do is watch, as the masters of the game go to work, again. No sooner does the bandwagon's wheels hit the ground than this professional platoon bolts for the wagon*." (Figure 5 below)

In this phase (Figure 5 below) those who were not yet thrown away by the market, i.e. where still in their long positions, give up thinking the move will continue on the downside. They exit in panic or disgusted by price action at or near the very low. In the meantime a new (or same?) group of smart money traders is buying the market.

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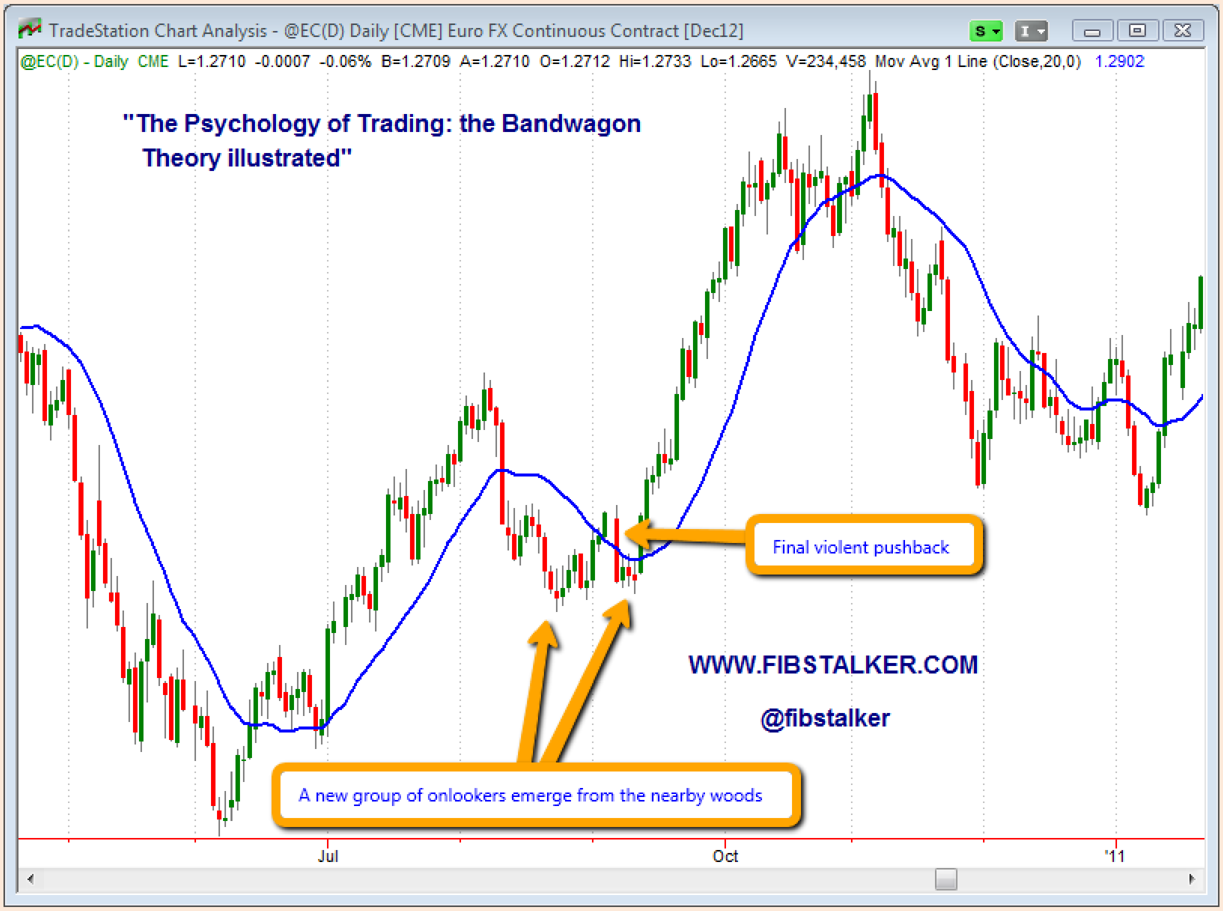

Figure 5 – Last shakeout and smart money emerging

"In a flash they are on board. Easy. The bandwagon, now free of the larger crowd, can move forward freely and gracefully, comfortably carrying the more astute group with it. Its pace quickens, and before long a smooth elegant stride is in place. After a few miles of uninterrupted movement, someone from this masterful group flips on a switch, and suddenly the loud sounds of entertaining music start again. Someone yells, "OK everyone. Here they come. Let's do it again." Within moments, those who were the former victims of the backward crash become interested again. The music almost calling them from the grave." (Figure 6 below).

Figure 6 – Smart Money keeps adding to their initial position

At this point (Figure 6 above) smart money traders can easily and safely add to their positions. Non professional retail traders and professional traders (i.e. the majority of participants) who do not have a clue of what is happening do not have the emotional capital to get involved again, totally destroyed by their previous, disastrous experience. But time (even small time) heals the effects of that bad experience and then, when are healed, their strong emotions of greed and fear of losing make them consider entering the market again. At the very wrong moment.

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"*And once more, the never-ending cycle repeats.*"

3. The Danger of Asking "Why?"

In the midst of a trade, asking the question "why" is a clear sign that the trader is trapped in a state of confusion and maybe even paralyzed and unable to act. Thinking "why" in such a context, is dangerous. Actually the word "why" is generally dangerous when dealing with the markets because the real reason of a price move, or lack of thereof, might never be known. Moreover the reason is not important for the purpose and outcomes of trading, which is profit. A trader could and should investigate the reasons of something happening in the markets for pure intellectual interest; for instance, why an ongoing price move in a well defined trend did not continue but stopped and then reversed? Asking "why" and knowing the reason is a need for most people because we, as human beings, do not accept or acknowledge a lack of control over the world. Rationalization and knowing (or thinking of knowing) the reasons is what gives people the "*illusion of control*". But as we cannot control the physical world, so we can't control the markets. The only aspect we can control is how we react to price moves. It is okay to ask "why", but not during a trade: the battlefield is not place to be questioning a trader's game plan. The very moment a trader begins doubting his or her plan, this is a cue to exit. The quest for "why", the search for a reason is a proof that the trader is lost. The correct time to ask "why" is before and after a trade. During the

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battle there is only room for action, not questions. The reasons for a trade should only be collected ahead of time or found after the trade is exited.

It is often heard that "the stock market is complex and very confusing". The author does not subscribe to this notion and neither should students and followers of any trading method. The market can only do one of three things: go up, go down or move sideways. Despite this simplicity trading is not "easy", if it was, there would be no need for mentoring. While trading is not easy – because besides a sound trading system it requires the right psychology, approach to risk and position sizing – market mechanics are quite simple. A stock or futures market can only go up if participants are more eager to buy than to sell. If this justification sounds obvious, it is not enough for the majority of people. People want to know "what are the reasons for the participants to be more willing to buy rather than sell". Again, this is due to the human need for control or, as said, just the illusion of control. For instance, if negative news about a stock comes out but price keeps going higher, this can only mean one thing: that the buy side (demand) is overwhelming the sell side (supply) and there is no regard for the negative news. But why should the reason matter? Traders are in the markets to make money and not to be right and guess the reason a market is going up or down. Regardless, a lot of people cannot subtract themselves from this mental trap and they will often do what logic suggests rather than what price suggests. But if the trader carefully thinks about it if price is going up there is only one course of action left, and that is to be long the market, despite the negative news. What else matters?

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Whenever a trader is looking for the reason (asking "why?") a market is behaving in a certain way versus "what" the market is doing then troubles can be foreseen ahead. The "*why*" is always reflected in the price of the market thus it is better to focus on the "*what*": what the market is currently doing. That is way far more important.

Market price dynamics will push the unprepared trader to asking "why?" during trading, but the trading method and especially the trader's discipline are responsible for this behavior, too. There are a few trading methods that work but the it is important to understand the basic concepts being traded by them. We must know why we can trust a trading method and why it produces, and we can expect from it valid trading ideas that rooted into objective and reliable market behaviors. For instance, the author has a rational and proven explanation of why the proprietary method of Measured Moves and Fibonacci Stalking really works. The reason is the existence of *Program Trading* (or Algorithmic Trading, AT) in the most liquid markets and and the way AT has evolved taking into account trader group psychology and their behavior. Program Trading does not rely on news, on contingent situations or on traditional Technical Analysis, but it does rather rely on unchanged group psychology of traders. The exact logic and algorithms used by Program Trading are not known, but repeated participation and profit taking at predictable and observable price levels, often executed to the pip or to the tick, or a small front-run, are objective and tangible facts. Since the effects of Program Trading are evident and factual, we can afford the

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development of a bias in relation to such effects on price, and their usefulness in trading.

The author adopts the technique suggested by Van Tharp with regards to useful biases: if a mental bias is useful then it can be adopted even not knowing the exact reason for it, provided that it serves the purpose. The purpose of trading is twofold: 1) providing liquidity to the capital markets; and 2) profiting from such a service. Knowing "what" price is doing is the most important aspect of trading, even if we don't know all the details of such price behavior. The trading method can help, not only to understand "what" price is doing, but also and especially to properly and consistently time jumping on and off the Bandwagon. If the objectives are proper entry and exit timing of a profitable trade, knowing "why" is not important and, actually, it can even have a negative influence on the decision and execution process. Some trading methods and techniques, like Measured Moves and Fibonacci Stalking, of course give more: low risk ideas, setups and entries, proper risk management, stop-losses, sizing and profit targets. But over all they offer confidence that you are not trading against the market psychology and against Program Trading, in those markets in which Algorithmic Trading is prevalent.

4. Facts and "Truth" Do Not Make Money

Traders who spend their time delving into the information on facts and events that governments, central banks, companies and news services ceaselessly put out will not be successful like those who learn to focus and capitalize on how the crowd and *Program Trading* react to those facts and events, i.e. learning to

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observe price behavior. Typically only the crowd of emotionally driven traders (both retail and professional) will react to news, although nowadays new High Frequency Trading (HFT) algorithms that scan news titles are emerging. Indeed Program Trading will just keep executing the rules encoded into the computerized algorithms and will not be affected by news at all. Of course the crowd's perception and/or reaction to the news will often be out of sync with the reality of the related facts and events. This is why Program Trading does not trade news (but more and more High Frequency Trading programs will do that) and some AT programs on the smaller timeframes are turned off when important events capable of generating high price volatility are planned. There are times when the reaction of price to news is diametrically opposed to what it could be logically anticipated by the facts and events being reported. This really throws most novice market players onto a state of even bigger confusion.

The huge focus on news and the fact that some market services or 'professionals' base their 'systems' on news interpretation generates a widespread but wrong idea that learning to interpret the news is important and even fundamental to forecast (but it would be better to say *guess*) market direction. The money-making potential is in the recognition of the reaction to facts, events and news which requires an objective analysis with relation to what price is already doing.

Who has not witnessed a stock or futures market dropping in the face of positive news, while other markets rise on the heels of what appears to be

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damaging news? In essence the successful trader has to come to terms with the belief that it is the understanding of people behavior and what moves them that makes for truly profitable trading. So instead of investigating the actual news the right question is "*how are people likely to respond or are responding to this news?*" In reality it is even better to not go that far in trying to interpret people's response; before showing the reason for this later in the section let's delve a bit more on why markets apparently behave irrationally.

Why do markets, at times, totally defy facts and logic? The important truth is that reality does not matter in the trading and investment world. It is the *perception of reality* that is important and, actually, it is the crowd's and smart money traders' perception that counts and not the trader's own perception. Moreover the crowd's perception is often different with regards to similar news in different time and states of the economy, fundamentals, sentiment and technical price patterns in place in the market. This is often hard to accept because it requires acknowledgment that a trader has no control over the markets. But, on the other hand, this is also liberating because it releases time and resources to focus on the most important aspect: price dynamics.

There will be times in which the *truth* – i.e. facts, events and their interpretations – and crowd's perception will be identical, perfectly in sync. Other times the *truth* and the perception of it will be completely opposed, or their relation distorted. In the shorter timeframes the truth does not always win out. It can certainly be argued that the crowd's perception and the actual reality cannot stay out of sync forever, and that what is real will ultimately

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prevail. Besides the fact that behavioral finance shows that biases can affect the evaluation of what is real, i.e. the fair value of a market or stock, traders (and investors[2], too) do not have the luxury of a great deal of time. Traders' success only depends on the correct evaluation of price dynamics in the "*here and now*". In such a context the *truth* does not count at all.

Believing that the market responds to what is real and true is an erroneous assumption that generates million of dollars in losses among inexperienced traders every year. The truth is that futures, stocks, ETFs, commodities and other markets rise and fall based on beliefs, not facts. The reality does not matter but perception of reality does. Therefore when a trader buys a futures or a stock what he is really buying is people and the beliefs they have about the traded instruments.

Van Tharp says that "*we do not play the markets, but our beliefs about the markets*". Indeed when a trader puts money on the line he is betting on the knowledge of how people, investors, professional traders and the crowd will perceive price action in that market over the short-term. These days we can also add that the trader is betting on its knowledge about how Program Trading and Algorithmic Trading (AT) tackle and run some very liquid (high volume) stock and futures markets. This happens because, with time, less and lesser people and more and more AT programs move the markets one way or

[2] Investors about to retire today who had most of their retirement funds in the stock market 10 years ago, at the beginning of the *lost decade*, would have today a portfolio worth only half of the value in 2000, if they invested in the Nasdaq Index..

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the other and not the reaction to facts or events. A fact has never moved a market and never will.

Another important point is that markets are anticipatory in nature, i.e. they try to play on what will happen and not what has happened. Facts are remnants of the past and they tell very little about what will happen tomorrow. This is why they say that professionals tend to "*buy the rumors (perceptions) and sell the news (facts)*". How traders and investors as a whole interpret the facts in the context of current conditions is the reality, the true driving force behind a market move. This is the reason why markets can and do depart from logic - the recurring phenomenon that makes trading difficult. Traders should bet on how others feel about such markets. Because it is people and their feelings and emotions that ultimately move markets. People are far more unpredictable than any other entity in existence due to free will.

Nowadays markets look even more complicated, but when things are put in perspective and placed within a domain where Program Trading, HFT and Algorithmic Trading (AT) are prevalent, *they are indeed easier*. Let me explain: facts are '*known*' in advance and are already reflected in price. Program Trading sets up technical patterns that reflect and push price in a direction that discounts the facts with days and weeks in advance. When news come out they typically complete the technical pattern already in place on bigger timeframes, i.e. weekly and daily, and sometime months[3] in advance. News

[3] In my Blog I showed the 1.3430 area of first target of a move started at the 1.2680 area of support in the EUR/USD the first time on November 18th, 2012 video of my free Newsletter. The target was hit on January 11th, 2013 (please, check the 18/11/2012 video on my Blog's Forex page: http://wp.me/P2oF7p-n0).

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however can affect price on the smaller timeframes (e.g. 4-hour and 15 min charts). Thus the trader is invited to build a belief that news, facts, events and truths are not important for successful trading. It is much better to understand how specific computerized programs tackle the markets. A successful trader could setup a profitable trading method deriving the rules Algorithmic Trading (AT) uses from the behavior of price because, in a world dominated by Program and AT trading, news will always move price in the direction that completes the technical pattern already in place.

For similar reasons news fading is dangerous too. Forex related news, for instance, whether apparent or real, immediately precede an upward spike or a downward spiral. This happens because news is the most accessible means of information gathering for traders in general, and it is provided and reported by reputable news institutions that are generally considered '*reliable*'. Price spikes and spirals usually last for 15 to 60 minutes or slightly longer during big events like, for instance the FOMC (FED) or ECB meetings, respectively for the Dollar or Euro-related forex pairs. After that traders will see a slow return to previously traded levels and price structure re-enter into the areas and thresholds identified studying Program Trading rules. This is true even when when price spikes related to news break technical levels watched by Program Trading.

It is quite cheerful for example to hear that, historically speaking most traders determine the value of the US Dollar (USD) based on the *Non Farm Payroll (NFP)* which is released at the 1st Friday of every month. In practice, all a

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trader should do is to pay special attention to when the new are released and not what are the actual numbers. News is relevant only when it contributes to break sequences of measured moves induced by Program Trading on the larger timeframes, i.e. daily and weekly. But very rarely news is capable of doing that. That only happens when price is very close to reversal areas on the larger timeframes (e.g. weekly). What can really change market direction is the strong and coordinated participation of smart money and/or central banks. For instance, the S&P500 US market index was turned higher twice in the last 3 years by the intervention of the FED with Quantitative Easing initiatives: the first time in March 2009, and the second time in May-July 2011.

In conclusion when dealing with news the indications to follow are: 1) understand the technical pattern Program Trading has already created and that is in place and being completed; 2) take partial profits before news; 3) know well when news is released and never attempt to play it, but just stop trading; 4) resume trading the next day, or at the beginning of the following week (if the news comes out on Thursday or Friday), in the direction of the current technical pattern, if not yet completed (i.e. targets where not reached), and just wait for targets to be hit, or wait for a new setup in the opposite direction.

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5. Professionals Trade People's Psychology and Not the Markets

It should never be forgotten that professional traders really trade people not financial instruments. As strange as this sentence may sound, it represents a correct assessment and critical point novices and more experienced traders often fail to comprehend. Typically the outcome when trying to understand this is confusion as of the reasons a market often contradicts rationality and common sense. Futures and stocks cannot do anything in and of themselves; their prices are determined by the perceptions of people which, in turn, are completely determined by emotions and reactions to price dynamics. It is these emotions, primarily greed and fear of losing that often cause a market to extend too far both upwards or downwards, well beyond levels that are perceived as '*reasonable*' (but there is not such a thing in the markets). Financial instruments do not behave according to neat, simple mathematical models of value. They rather oscillate frequently from over depressed states to overextended ones without rest. This behavior is what creates opportunities in larger, as well as, smaller timeframes. Sadly, this is what keeps the new people coming in, and the old beaten people leaving the markets.

The professional trader, understanding this behavior, builds his or her skills around knowing when one emotional state is about to give way to another. This is trading success in a nutshell. Success is not knowing what a forex cross futures contract reaction will be to a central bank announcement or trying to

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guess if a company will announce or be able to develop a new product. Trading is all about people and their emotions and this is why chart reading is so important. Fundamental data contained in balance sheets, income statements and other information sources represents elements from a picture of the past, a time to which market players have already emotionally reacted to. On the other hand, price and Technical Analysis (TA) serve as a living map, built trade by trade, of players' current emotional state. Price and TA are important tools for the active short-term and swing trader or those who want to time position trades, but even longer-term investments.

However not all technical analysis tools are useful to build that living map of market participant's emotions. In the days of Program Trading and High Frequency Trading (HFT), the majority of Technical Analysis (TA) tools are not adequate. When TA works it often provides signals too late with a sensible lag, or it does not provide setups and signals at all. Besides the lag, trade setups indications from TA are more subject to stop-losses. Moreover the majority of TA tools only provide a point in time when it looks reasonable to enter a trade, but without indicating where the stop-loss should be placed and, more importantly, where profits should be taken. Thus the construction of a complete trading plan would require the use of a coordinated set of TA techniques, along with price action analysis (for stops and profit targets) which often provide readings that are in contrast with one another.

Price Action (PA) analysis and tools, on the other hand, seem more appropriate for forex and futures trading. However Fibonacci retraces, pivot

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lines, resistance and support levels along with one or multiple-bars price patterns (e.g. pin bar) suffer from the same disadvantages and drawbacks of traditional Technical Analysis: 1) signals and setups are offered with a lag leading to smaller reward/risk ratios or even losses; 2) no attempt is made to systematically frame, model and explain market price structure. Yet other methods like Elliot Waves[4], DiNapoli Levels and Fibonacci Stalking offer ways to systematically explain price structure and development.

The author's belief that it is very difficult to make money with traditional TA is strengthened by the fact that the majority of people (more than 95%) lose money in the markets. If you don't want to be part of this large group but rather aspire to be part of the 5% of consistent traders, it is paramount to start thinking and doing things differently.

Most new traders are attracted into learning classical technical analysis (TA) or price action (PA) but to make it work strong discipline, tight risk/money management and a rounded psychology are needed. The reason is that when using TA and PA, in the majority of cases we deal with trading signals (e.g. oscillators crossovers) and patterns (i.e. triangles, pin bars, head and shoulder, ect.) that have a reliability close to 50%, or quasi-random. Typically a trader will focus most of his/her time and resources on the trading method while TA and PA require a better grasp on money management and psychology. While psychology is probably the most important aspect of

[4] The author does not endorse the Elliott Wave method that falls in the '*there-is-an-order-to-the-universe*' trading concept and requires continuous adjustments. However several traders can still make money with it thanks to discipline and strict money management.

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trading success, the trading method is probably the less important, although critical one. Time learning a good trading method is well spent, but it is better to spend time on a method that works and is capable of catching market participants' emotional state, i.e. trading people's psychology, while providing a complete trading plan. A good trading plan is made up of 8 to 10 different elements, depending on whether you trade one or a basket of markets and implement money management at the portfolio level, which classical Technical Analysis (TA) and Price Action (PA) is not able to identify without the need of resolving contrasting readings from different tools and techniques.

A trading method that helps avoiding this issue is the method of Measured Moves and Fibonacci Stalking which helps modeling price structure, building a complete trading plan and timing trades without the need of contrasting tools. Actually the above method only uses a small part of TA (a selection of Fibonacci studies) because starts from a completely different viewpoint: the observation of the effects of modern Program Trading on price dynamics. Computerized programs do not have an emotional component, but repeat continuously the trading rules at every setup and opportunity. When program trading is active on a market, related price dynamics are largely based on cause and effect, because trading rules themselves are based on price levels. Anyway, as already noticed, market news can temporary modify price structure on the smaller timeframes.

Trading rules used by Program Trading were born and improved upon from the analysis and observation of price subdued to the actions induced by

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human emotions having the effects of dynamically altering the balance between demand and offer. Such rules became very efficient with time and, with the increased volumes and the continuous rising of computer-based trading in the stocks and derivative markets, nowadays they bring about price behavior that materializes in self-fulfilling prophecies. These days Program Trading is active on several markets and its effects are somehow similar to what happens when price approaches some important moving average (like 50-day, 100-day and 200-day moving averages), there is always some sort of reaction. When the setups by identified using the rules that model Program Trading are applied backwards to price data going back to the last 100 years (for instance, using Dow Jones index end of day data) it is disconcerting how the related trade setups work and offer valid entry, stop and target areas. This is a very significant fact because it shows that the logic of computerized programs, which was initially derived from the study of the psychological response to price dynamics of average traders groups, evolved in a direction that correctly manages position size, risk and profits while taking the paramount crowd psychology aspects into account, too. Moreover it shows that the rules implemented nowadays computer algorithms worked before computer technology was even invented.

In conclusion, not only professionals trade people's psychology, but nowadays Program Trading – along with High Frequency Trading (HFT) – does the same conquering more and more volume on the stocks, forex and futures markets. A

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recent research[5] shows that more than 30% of the UK stocks market volume is traded by HFT; same figures reach more than 75% in the US markets.

Conclusions

This eBook focused on some important concepts, truths and realities about trading that need to be understood and internalized in order to become successful in today's markets. The Bandwagon Theory provides an important metaphor to help understand and develop the psychological skills needed to play the markets successfully. In a nutshell, the above theory suggests to anticipate counter-trend moves or shakeouts when a market is in a strong move up or down while not buying long, green candles and not selling long, red candles, especially in the forex and futures markets. Indeed some highly respected professionals say: "*if you see a move and you are not in it, the move has ended*", so don't attempt to jump on it. Jumping on the bandwagon is what our common sense and, specifically, our human psychology tracts of greed and fear of losing push us to do in a very compelling way, under total unawareness.

Visualizing the Bandwagon Theory on the daily chart of the EUR/USD helped putting the allegory at work, showing where the trader can be pushed out of the wagon (i.e. stopped out because of bad timing) and why, even when he or she is generally right about market direction. Now you need to convince yourself that price behavior highlighted in Chapter 2 presents on every

[5] "The Future of Computer Trading in Financial Markets"- Foresight, Government Office for Science, a working paper commissioned as part of the UK Government's Foresight Project on The Future of Computer Trading in Financial Markets. Views expressed are not those of the UK Government and do not represent its policies

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timeframes. A careful review of price structure of any instrument traded with high volume will highlight this truth. This is easy to do: you can try it yourself; review price on smaller timeframes and you will witness the same price behavior and patterns.

Asking the question “why?” is a clear sign that the trader is trapped in a state of confusion and fear. Asking “why” is dangerous for two reasons: firstly, because the real reason for a price move, or lack of thereof, might never be known; secondly, because it redirects trader’s resources away from the real question: “what” the market is currently doing, that is way far more important. Rationalization gives people the “*illusion of control*”. But we cannot control the markets; at most we only control how we react to price moves and that alone is very difficult to do, as well. Regardless, a lot of people cannot subtract themselves from this mental trap and they will often do what logic suggests rather than doing what price suggests. The main objective of trading is profiting so knowing “why” is only important to our intellectual ego. A good trading method can help understanding “what” is happening and trading price accordingly with low risk ideas, setups and entries, proper risk management, stop-losses, position sizing and profit targets.

We often see traders, especially beginners, trying to explain every single price move by attempting news interpretation. There is a big focus on news interpretation and it is very widespread the idea that learning to interpret news is important and even fundamental to *guess* market direction. Nowadays things are different: facts are known in advance and are already reflected in

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price. Program Trading sets up technical patterns with very specific entry and target levels. When news come out they typically only complete the technical pattern already in place on bigger timeframes, i.e. on the weekly and daily charts. There is no need and no value in attempting to determine the value of financial instruments based on news. It is much more important to know the setup and the technical pattern price is already in.

Professional traders trade people and not financial instruments, which do not behave according to neat, simple mathematical models, like those implied by Technical Analysis (TA). Markets rather oscillate frequently from over depressed to overextended states following rules based on specific price levels and price swing highs and lows. These levels are picked and often changed by Program Trading. The professional trader builds his/her skills around knowing when one emotional state is about to give way to another and the Bandwagon Theory directly points to such skills. In a world of Program Trading and High Frequency Trading (HFT), the majority of Technical Analysis (TA) and Price Action (PA) tools and techniques are not adequate. When it works TA provides lagging signals, smaller reward/risk ratios and setups more prone to stop-losses, compared to other methods. PA analysis has similar problems of TA and, like TA, is not able to explain price structure in different timeframes. A good trading method, not using traditional TA, like the Measured Moves and Fibonacci Stalking method, can help trading the market like Program Trading does. This way crowd and average traders' groups (i.e. market) psychology is already built into the trading method.

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If you want to learn how to become part of the elite 5%, the group of consistently profitable traders, or you just want to become a more successful trader, you need to start thinking and doing things differently. To learn a trading method that builds on the key concepts presented in this eBook and based on the same rules used by Program Trading on the major markets, come to visit me at my Blog: www.fibstalker.com or write to: fibonaccistalker@investidea.biz.

You can also subscribe my free Newsletter here: http://eepurl.com/pV6mL. In my Newsletter I provide timely video review, analysis and forecasts, as well as, trading plans for the Euro FX currency, Dollar Index and S&P500 e-mini futures, for a few major Forex pairs (including, among others, USD/JPY, GBP/USD, USD/CAD, USD/AUD) and a few high volume US stocks traded on Nyse and Nasdaq exchanges. I also publish articles on HFT, Program Trading, trading method and other trading-related topics.

About the Author

I hold a Masters in Computer Science Engineering since 1999 at the University "La Sapienza" of Rome. Before getting into futures trading I worked for Accenture, one of the big 4 of consultancy (www.accenture.com), as an IT architect and then IT project manager. During the 10-year period of employment I travelled extensively in several European countries. I started developing an interest in the markets in 2001 but only in 2004 I resolved to become a full-time trader and mentor. Of course, that decision required a lot of preparation, study, experience and a total change in my own personal psychology.

I have studied on tents of books, executed hundreds of trades and made a much higher number of mistakes. Moreover I have studied with several traders and success mentors in England, Europe and USA.

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From 2006 to 2010 I lived and worked in Dublin, Ireland where I have joined the CFA program and in October 2010 I obtained Masters in Fianance at the “National College of Ireland”. At the beginning of 2009 I left my paid job at Accenture to become a full time trader. Nowadays I am an active trader specializing on the CME Euro FX currency futures and a bi-lingual blogger (www.fibonaccistalking.com) focusing on forex, futures and stocks trading. I am a member of SIAT (www.siat.org), the Italian chapter of the larger IFTA (International Federation of Technical Analysts, www.ifta.org).

I have published articles for SIAT in 2012 and 2013, respectively on Money Management and High Frequency Trading. In 2012 I presented a proprietary technique for stocks trading at the June 2012 TraderFest (www.traderfest.it) and in October created a VideoLive on the “Measured Movements and Fibonacci Stalking technique” for SIAT. In 2013 I participated to the SIAT Technical Analyst of the Year competition. In May 2013 I presented at the biggest Investment and Trading event in Italy (www.itforum.it).
I trade part-time, blog and study continuously new trading ideas and techniques, write research papers and do statistical analysis. I also write books and articles and hold courses on forex, futures and stocks trading.

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