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Gold Series Part 1: Why do People Buy Gold?

By Edwin Tucker

Sandwiched between mercury and platinum on the periodic table, gold is just another element occurring naturally in the earth's crust. This shiny yellow metal differs from its peers in that it has a powerful effect on human beings. The search for gold has consumed untold resources and countless lives. Often dubbed the currency of kings, entire nations have been sent to war over this treasure. Once acquired, protection from theft becomes an owner's main concern. While gold might be seen as many things, it is most simply money.

The next logical question may be: what is money? In order for something to function as money it must be all of the following:

- A medium of exchange
- A unit of account
- A store of value

Throughout recorded history many things have been used as money. At times raw commodities served the purpose. In colonial America cotton and tobacco were periodically treated as currency. The biggest problem with these alternative sources is that they are subject to spoiling or rotting and can easily be tainted causing them to unexpectedly lose value. Modern money, still made of cotton, is subject to a different set of perils.

If you are to survey ten random citizens asking each “What is money?” you will likely find that nearly 100% of them reach for their wallet to display a paper copy of their national currency. Whether it is Yen, Euro, Dollar or any other modern note, this is where their understanding of the subject ends.

The dollar for example is issued by The Federal Reserve and is acceptable tender for tax liabilities. This creates the basis for trade and valuation. The Fed was created in 1913 and most citizens have no idea that this private institution is owned by a group of private banks. The Fed was given the power to create and issue currency on behalf of the nation. The nation was told that this authority would carefully govern the money supply through its network of reserve banks eliminating bank runs and economic volatility. The nation had just experienced the San Francisco earthquake of 1906 and the financial crisis of 1907.

The earthquake and massive fires that followed caused a great amount of destruction in San Francisco. Much of this destruction was indemnified by British insurers causing a tremendous amount of capital to flow across the Atlantic. In 1907 The Bank of England, another private institution, raised rates fiercely in response to these capital flows. This action lured capital away pushing the United States into recession. In the wake of these events congress formed The National

Monetary Commission who recommended the creation of a central bank.

Initially the Fed created an amount of currency that was worth 1/20th of an ounce of gold. In 1933 president Franklin D Roosevelt issued executive order number 6102 demanding that all citizens turn their privately held gold over to the government. Failure to comply with this order carried the threat of up to a $10,000 fine and imprisonment. In the weeks preceding the order many wealthy, well-connected citizens moved their gold overseas. The average citizen followed the order and turned in their gold.

Once the gold of the citizens had been confiscated by the government it was revalued to reflect a conversion rate of $35 to each ounce. Now the government had more ounces and could create more currency denominated by those ounces. This newly-minted money could be used to accomplish the goals of the government including redistributing some of the money to secure votes before elections.

After World War II the US claimed to have more than 22,200 tons of gold. Since the beginning of recorded history there have been approximately 160,000 tons of gold mined and most of that gold still exists above ground in some form. To put things into perspective, all of that gold would fill roughly two Olympic swimming pools. One nation controlling nearly 15% of the world supply creates a superpower that can only be defeated from the inside.

As World War II drew to a close leaders from all 44 allied nations met at The Mount Washington Hotel in Bretton Woods, NH. The purpose of this meeting was to form a monetary system that would govern the post-war world. This system established many entities that we still know today including The World Bank and the IMF. Due to its dominance in the war effort and vast gold reserves the US dollar would be chosen to anchor this new system. Member nations would be required to maintain an exchange rate with the dollar which in turn would always be convertible into gold at a rate of $35 to one ounce.

The security created by the combination of post-war peace and a stable monetary system would somehow not be enough for the United States. Eventually the true nature of politicians and their insatiable quest for power would put pressure on the most important part of this system. John F. Kennedy's New Frontier program was the beginning. Lyndon B. Johnson followed with The Great Society. These well intentioned efforts stressed the US Treasury as tax revenues were not sufficiently available to fully fund the new entitlements. The US began creating slightly more currency through bond issuances in order to cover these budget gaps. Along comes the first need for defense in the form of a shadow conflict with communism disguised as a freedom fight in Vietnam. Debt is issued to finance this conflict and soon the US is secretly running deficits financed with the same currency that is pegged to gold at $35 per ounce.

As young Americans die fighting and protestors dominate the nightly news, another entirely different war begins to rage. The newly printed excess dollars created to finance US expenditures began to make their way through the world markets. Savvy international traders would gather these excess dollars and return them to the Gold Exchange Window requesting ounces at the $35:1oz conversion rate established in Bretton Woods. By the summer of 1971 the United States was in serious financial trouble. The nation's leaders were not able to stop spending on handouts and war. Foreigners were raiding the nation's gold supply at an alarming rate. On August 15, 1971 Richard Nixon slammed the gold exchange window shut thus ending international convertibility. The US dollar was now officially a fiat currency created by government decree and backed by nothing.

We may never truly know how much gold was lost due to the reckless and irresponsible behavior of power-hungry politicians lacking foresight. We do however know that the US government officially claims to own 8,133 tones. While this still represents 5% of the world's known supply it is a far cry from the spoils of victory controlled after World War II.

As we approach the 40th anniversary of Nixon's decree the exchange-window politicians seem to have learned little from past events. In 2010 the US government spent a record $1,500,000,000,000 more than it took in through treasury revenues. Astonishingly the balance was funded by arranging for the Fed to electronically mint dollars which would then be used to purchase excess bonds. This behavior is not likely to subside as recent headlines detail intense fighting on cuts of a mere $40,000,000,000, or less than 1% of annual expenditures. This is not a political issue; it is a series of economic facts caused by choices that have already been made.

Many respected figures claim that gold is a barbarous relic. It pays no dividend and in fact creates negative cash flow as ownership is fraught with storage problems. While these accusations and others might be true we must never lose sight of gold's true purpose. This metal is a sound currency that provides safety when elected leaders are knowingly or unknowingly destroying the medium of exchange that the nation's citizens blindly trust.

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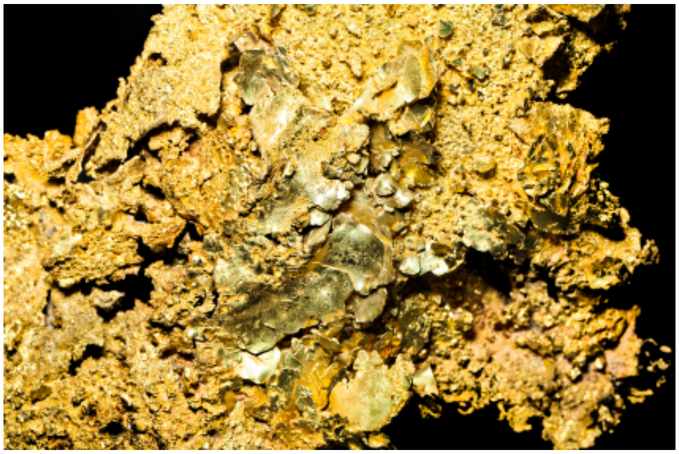
Gold Series Part II: How To Own Gold?

By Edwin Tucker

We have established gold's critical role as the backbone of monetary systems. Hopefully there is an understanding at this point that your personal assets should likewise be backed by something real. The logical question remains, how should one acquire this misunderstood asset?



In order to properly own gold an allocation of physical bullion, exchange-traded bullion, large, medium and small mining companies and exploration stocks must be achieved. Capital should be placed in a manner that balances the gold-rush excitement of exploration-stage companies with the boring stability of physical metal.

Physical Gold 15%

It is common to see physical gold in the form of jewelry or as an accent on luxury items. This same gold can be melted down and sold at many Cash for Gold type stores today. Once scrap is melted, purified and combined with other gold it takes the form of investment-grade bullion. An assay process determines the purity of the gold and is detailed in a certificate presented to the owner. This form of gold is one of the most efficient means of storing wealth. The largest bar available is a 400oz Good Delivery bar which many have seen pictured in Hollywood movies. More practical 1,000gram, 10oz, 100gram and 1oz bars are also available. This section of our gold portfolio provides stability and real wealth acting as a form of insurance against governmental abuse of the fiat currency you call money.

Exchange-Traded Bullion 15%

While this section of our portfolio has striking similarities to that of our physical holdings, there is one glaring difference: we don't physically possess the asset. This creates a need to carefully chose the entity in which we place our faith. We do however need this holding, as lugging our physical metal to the bullion broker in the event of a sale is not always practical.

Your stock broker will reluctantly suggest a position in the most popular ETF which you will politely decline to purchase. Gold is traded in contract form on futures exchanges around the world. It is common for this fund to hold a great deal of futures contracts, or paper gold, in addition to unaudited physical holdings. It is critical for us to be sure that the fund we purchase has actual, physical, audited metal held in private, secure vaults.

Large Mining Companies 30%

Companies positioned in the business of mining seek out pieces of land with definable mineral deposits. These deposits are studied to determine how much of the desired mineral exists and what the cost of extraction will be. Typically a tiny exploration company will first purchase the prospective land. Once surface samples indicate there could be an economic deposit they will sell the asset to a small mining firm. The small, or junior, firm will develop an economic assessment of the asset and if favorable will sell the project to a large firm. This large firm will operate the mine in a financially predictable fashion.

The reason we intend to own these large firms is that they have acquired deposits at a discount to the gold price over time. For example, when gold was $1,250/oz they might have purchased a development stage mine paying $700/oz for proven reserves. They intended on operating that mine at a cost of $300/oz over a 15 year period. As year one of that period commences they are selling mined product at $1,550/oz. Rising labor and fuel costs have caused operating expenses to rise by say 10% to $330/oz but the increase in revenue far surpasses this amount. As these companies release quarterly earnings detailing this revenue growth the market will be surprised. Remember, the research your stock broker provides you with is very helpful in studying what happened yesterday. You must think for yourself in order to profit from what will happen tomorrow.

Mid-Tier Producers 15%

While large mining companies offer financial and operational stability, mid-tier firms deliver more direct exposure to a rising gold price. In this sector we want to seek out firms that will produce 100,000-400,000 ounces of gold per annum. At this level they have taken the business risk of building a processing facility and are attempting to produce product from start to finish. Usually management has determined that this makes sense based on market conditions and the quality of the company's mineral assets.

Concerns in this sector are two-fold. With respect to operations these firms can be hit hard by rising costs or turbulent capital markets. Also, the larger firms have a more pronounced ability to lobby local foreign governments and protect their mineral rights in the event that geopolitical risks take hold. While these risks are true concerns, they do not keep us out of this sector. We will mitigate them by spreading our capital over a minimum of three mid-tier holdings.

Prospect Generators 20%

We have established a firm base in our portfolio using physical metal holdings as our foundation. Next we added operating exposure to a rising gold price which will translate into increased earnings. The final portion of our portfolio should focus on speculative positions as we hope to benefit from windfalls created by new mineral discoveries.

Throughout history men have risked everything as they were sucked into an irresistible gold rush. Capital seems to chase the dream of discovering a giant gold deposit in hopes that the ensuing windfall will change one’s life forever. Unfortunately this is rarely the outcome.

In current times this gold rush takes the form of penny stock solicitations, rumors, message board activity and slick salesmanship. Mark Twain famously said, “A mine is a hole in the ground with a liar standing next to it.” How do we benefit from mineral discoveries while avoiding being swindled? The answer lies in the business model espoused by prospect generators.

These firms attempt to acquire a large number of initial land claims in areas where previous discoveries have been made or geological signs show hints of rich deposits. It is critical to choose firms that are managed by experienced industry veterans with a track records of success. Also, we want to pay close attention to share structure, favoring firms that show conservative share issuance along with a closely held float. Finally, we need to have some understanding of the region where our money will be spent.

This model is currently the most effective way to gain exposure to the Yukon gold rush which is in progress. In a very short due diligence period it is possible to see that there are a handful of companies that seem to know just where to look in the region. Capital is flowing swiftly into the area and unfortunately much of it will be lost. By sticking with the winners we have a greater chance of being part of a large discovery.

Explorers 5%

It is impossible to fully eradicate the dream of making that big discovery and being part of a stock that soars from $0.25 to $50.00. While this certainly does happen we must be disciplined enough to keep these dreams contained in a small portion of our portfolio.

By following the same due diligence standards employed in our search for prospect generators, people, share structure and region, we should be able to find a handful of small exploration companies that have a chance to make it big. No more than 2%

of our gold related capital should ever be wagered on any one single pick in this sector.

We are in a period of rising gold prices driven by political mismanagement and poor decision making. It appears that this trend is firmly in place and far from finished. Our goal is to invest in the sector in a way that allows us to profit from this economic reality. If capital is properly placed it is possible to benefit greatly as the price of gold continues to rise.

3

Gold Series Part 3: Gold Rush!

By Edwin Tucker

We began this series with an attempt to cut through media spin and answer the question what is gold? Next we laid out a fundamental strategy for owning gold in a balanced portfolio. This proper mix of assets included physical metal, large mining firms, junior mining firms and finally exploration companies. The latter is by far the most exhilarating of all gold related asset classes. As we focus in on this exciting sector one question remains; how do we protect and preserve capital while participating in this gold rush?

Many investors dream of having the opportunity to tell a cocktail party story about their stock pick that began as a $0.50 share traded on the pink sheets and ended in a $50 takeover. The desire to fulfill this dream is one of the most dangerous of all human instincts and ironically can cause even a competent investor to ignore nearly every sign of peril. Some investors will recklessly shift capital in and out of thinly traded stocks searching desperately for their winner. In the end, debilitating losses typically triumph and instead of an objective look at the facts blame is placed on the market.

The problem with this portion of the market is that there are real tangible success stories. Some companies do set out to explore a prospective claim and end up making a discovery that produces returns in the range of several 1,000% for early shareholders. In order to capture gains produced in this gold rush we need to focus on proper capital placement using the facts, not emotion, to guide our decisions.

The Business

Exploring is fairly simple and begins with determining a target area. Once this area has been identified the newly formed company must raise capital. Debt will not be available because the company's only asset is hope. $10,000,000-30,000,000 in initial capital is typically sufficient depending on variables unique to each project. 5% of this capital is immediately paid to investment bankers for handling the equity offering. The remainder will fund salaries, expenses, drilling activities, core sample analysis and the acquisition of additional nearby claims if necessary. Success in this business will follow this timeline:

- Initial claim analysis and soil sampling
- Round 1 of shallow drilling based on initial sampling
- Analysis of drill results produces next year's target area
- Round 2 of deep drilling in targeted area
- Analysis of drill results forms basis for 43-101 compliant resource estimate

- ★ Additional fill-in drilling provides data needed for preliminary economic assessment
- ★ Further sampling and drilling conducted to produce a bankable feasibility study
- ★ Project is sold to a major mining firm who will develop the mine

Over 4,000 companies claim to be in this business today. More than 85% will fail, generating capital losses for shareholders. While 15% will experience some degree of success only a very small percentage of these will properly reward us for the risk associated with our share purchases. In order to be successful we must use the following filters to sort out the trash.

Project

The location of a company's target project acts as our first filter and encompasses two parts. Everything can line up perfectly but if there is no gold in the ground we are destined for a capital loss. Geological considerations form the first layer of this filter. If there have been mineral discoveries in the past on adjacent properties or in the general region we can assume a realistic chance of success. What we want to avoid is speculating in an area with either no history or a long track record of failure.

Part two of this filter takes into account the geopolitical environment. We want to speculate in regions that are mining friendly. Some governments have a history of terminating mining rights or seizing companies all together. If we have taken all of the many risks involved in financing this venture we want to be reasonably certain that we will be able to experience the rewards associated with a large discovery.

People

As a company progresses through the sample timeline we listed above an executive makes each decision along the way. Where to drill, when to drill, how to finance, who to hire and when to sell are only some of the critical decision that must be made in order for a company to stand a chance at survival. These companies are burning cash by the minute and it is your cash that they are spending.

The mining business is fairly incestuous and we can use that to our advantage. Most executives have an accessible track record. If someone is asking us to finance these activities and they have run eight mining firms into bankruptcy we have something to be concerned about. Conversely, if an executive has had several projects that progressed through development and ended in a sale creating shareholder value we can assume that they know what to look for when taking on a new project. We can also look back to see who else worked on those successful projects. This search will often tip us off to other new firms that deserve our attention.

Just like investing in any other business we want to stick with the winners. As they say, 80% of the value is created by 20% of an industry. It requires the same amount of capital to purchase shares in a mediocre firm as it does a possible winner.

Share Structure

In this early stage debt is almost completely unavailable. Companies are forced to access financing in the equity markets. We need to pay careful attention to what we are buying as share structures can differ drastically from company to company.

Typically initial financing occurs in the form of a small private placement offering. This event is only accessible to accredited investors who are somehow connected to the executives who have identified a target project. Once some certainty has been established, an initial public offering will be structured. Canada is currently the most financially friendly jurisdiction for mining firms and a large majority of them have chosen to be headquartered there. Shares are often issued on the Toronto Venture Exchange and Americans can purchase equivalent tracking shares on the pink sheets. Some brokers offer direct access to the Canadian exchange and this is ideal as more robust volume creates better trading conditions.

Once shares are freely trading we want to be sure that management has a clear financial direction. They must be using capital to progress along a reasonable timeline. Some firms continuously issue press releases in an effort to artificially pump up stock prices. This is often an effort to facilitate constant additional share issuance. Staying focused on the fundamentals of the business will keep you from being lured in by this seductive scheme.

Finally and perhaps most importantly, we are looking for a very tight share structure. If management owns very few shares and public filings show a pattern of incentive shares being rewarded and then immediately sold we can assume a lack of commitment. No one knows the potential of a project like the people calling the shots. We want to see them putting their own money where they are asking us to put ours. There is nothing wrong with management using our capital to advance a worthy project. If they are successful the returns will be significant for all parties involved.

The intention of this series has been to help investors understand what is driving the bull market in gold. Once this has been accomplished careful attention should be paid to the individual phases that exist during the bull market. Initially bullion, or physical metal, preforms best. The second phase is characterized by constant surprises in quarterly earnings statements as large mining firms begin experiencing the effects of higher output prices. Finally, a speculative mania takes hold as investors seem to be overwhelmed by the potential windfall that accompanies a gold discovery. Many market participants will race to purchase any potential gold explorer in the hopes that they can be the next one to tell of fantastic profits.

Sticking to a fundamental due diligence process built around a solid understanding of the mining business will help investors pick good exploration stage companies. If this sector is kept to a maximum of 25% of overall gold exposure in a balanced portfolio the chances of profitably participating in the bull market will be greatly increased.

What is Silver?

By Edwin Tucker

Silver is a naturally occurring element that can be found in your jewelry, at the dinner table, in your digital camera, in your car and in your pocket. It is a monetary metal with roots that run parallel to gold. It is also an essential ingredient in many products that we take for granted in modern life. Silver is often misunderstood due to its multiple uses and critical nature.

Most metals are obtained through direct mining. Target areas are determined, geology is mapped and exploration begins. The entire excavation process is designed to retrieve one element be it gold, copper or iron ore. Due to historically low prices, silver is often only a mining byproduct. The element is considered a bonus for miners and until recently was rarely the target or direct exploration. This is changing however as critical demand and tight supply have joined forces driving prices to more realistic levels.

Throughout history, approximately 5 billion ounces of gold have been excavated and refined. That compares to nearly 46 billion ounces of silver. While The World Gold Council estimates that nearly all of the gold mined by man remains stored above ground, only a mere 2% of silver has survived. Most of the mined silver has been consumed by production. In 2010, a total of 778 million ounces of silver was consumed for use in industrial applications, photography, jewelry and silverware. Add to this number 101 million ounces used in coin production, and the total usage was 879 million ounces.

The current annual mined supply of silver is roughly 730 million ounces according to The Silver Institute. This immediately creates a deficit of 149 million ounces. Cash for silver scrap companies, recyclers and government stockpile sales were called on to make up the difference. One sector remains uncovered in this analysis, and it is silver held for investment purposes. In 2010, an estimated 178 million ounces of silver was acquired as an investment. When this number is added to traditional uses, demand begins to outstrip supply.

Why would someone hold silver as an investment? A silver coin is accepted as currency by any broker, dealer, trader or institution that is willing to accept a gold coin. In the United States, legal tender coinage contained silver until 1964. Most readers have been given a silver dollar at some point and likely considered it useless. The term silver dollar originates from the standard that one US dollar carried an accepted value of 1/20th an ounce of gold. There is approximately 16 times as much silver in the earth's crust as there is gold. Gold is a traditionally favored store of wealth surviving in that role for nearly 6,000 years. Silver serves the same purpose but makes trade more effective due to its naturally practical denomination.

Inflation, uncontrolled currency printing, and monetary debasement affect silver in the same manner they do gold. Silver is a naturally occuring element that cannot be faked or easily acquired and provides monetary protection when the above mentioned threats to savings are concerned. Accepted history documents the Romans and other governmental attempts to debase currency by shaving small amounts of gold and silver from coins. This was a desperate attempt to steal wealth from trusting citizens and was needed to avoid the pain associated with misdirected and excessive spending. History continues to repeat itself and even today is driving the same behavior as current political conditions force citizens to seek protection for their accumulated wealth.

While the face value of this coin is still $1 the actual market value of the coin is currently $37.50. The ounce of silver used to produce the coin accounts for the increased price. In 2010, the US mint sold 34,662,500 silver eagles. In 2011, they estimate sales will eclipse 41,000,000 before the end of December. Demand for coins made of silver and issued by sovereign nations is rising along with other forms of the metal. As this trend persists, investors are optimistic that the price of silver will continue to rise as production is not able to keep pace with demand.

While the supply and demand fundamentals of the market for silver are very interesting, the price is not always affected by them. A spot price per ounce of silver is used to set terms of trade when metal changes hands. This price is derived from a quote available at the COMEX. The COMEX is a division of the New York Mercantile Exchange or NYMEX. The NYMEX was recently acquired by CME Group, the leading name in commodities trading.

Trading on the COMEX is conducted in the form of futures contracts. These contracts represent the right to purchase 5,000 troy ounces of silver at a predetermined date in the future. The buyer is only required to post an initial amount of cash, determined by the COMEX, in order to control the contract. Currently, a 5,000 ounce contract is worth $167,500 can be purchased using $24,975 in cash. This cash requirement is subject to change at any time and when raised, speculative behavior is effectively curbed in a matter of seconds. Holders of leveraged contracts are required to post additional cash to meet the new requirements. If they are unable to post additional funds they must sell their contract. Either choice creates a bearish situation for the price of silver in the short term.

Silver bulls have long suspected sinister activity surrounding the COMEX. At times, there have been allegations that the supply of silver held by the exchange is not sufficient to meet even a fraction of contract demand and therefore is not a true representation of the market. The exchange also holds the right to settle contracts in cash at its option. This further enrages silver bulls. At the core of their case is the fact that the entire annual production of silver has at times traded hands via paper on the exchange in a single trading session. The fact that this occurs with less than 2% of that traded silver held on hand for settlement does cause some concern. Silver bulls advocate physical holding of silver and assert their belief that the paper market will eventually be seen as a house of cards leaving contract owners with only paper.

The world markets are facing tremendous headwinds today. Developed nations are struggling to manage the massive debt burden that their societies have acquired over the past few decades. The world has embraced a fiat currency system and that very system is being challenged. For now, new debt seems to calm the deflationary forces that continue to haunt many nations. Savvy readers recognize that more of the same is not likely to solve this problem in the long term. While a stagnant economy might slow industrial demand for silver, investment demand quickly steps in to fill the void. When demand for a material is growing faster than the market is able to supply it, the price is forced materially higher. With multiple drivers of demand and limited availability of new supplies, silver is likely to remain in a bull market for some time.

5

The 10 Key Differences Between Bull and Bear Rallies...

By Matt Blackman, CMT

...That You Need to Recognize to Make Money

Legendary trader Dan Zanger and host of ChartPattern.com, who holds the stock-trading record with an annualized return of more than 29,000%, makes no bones about which type of market he prefers.

“What motivates me to be at my trading desk no matter what the market is doing, is because you never know when the next big rally will arrive,” he says. “Unless you’re sitting at your desk everyday, you risk missing the next big run as it develops. Every big bull market can trace its origins to a bear market rally.”

Much of his success is due to his uncanny ability to measure the pulse of the market. He can tell when trader sentiment is shifting and market players are becoming more bullish. The real trick is in gauging whether the next move is real or a fake-out. An important factor in gauging markets is in understanding the difference between a secular and a cyclical market.

Figure 1 shows the four secular bull markets (blue) and four secular bear markets (red) that have occurred over the last 130 years. Secular markets last decades and indicate the primary or dominant trend.

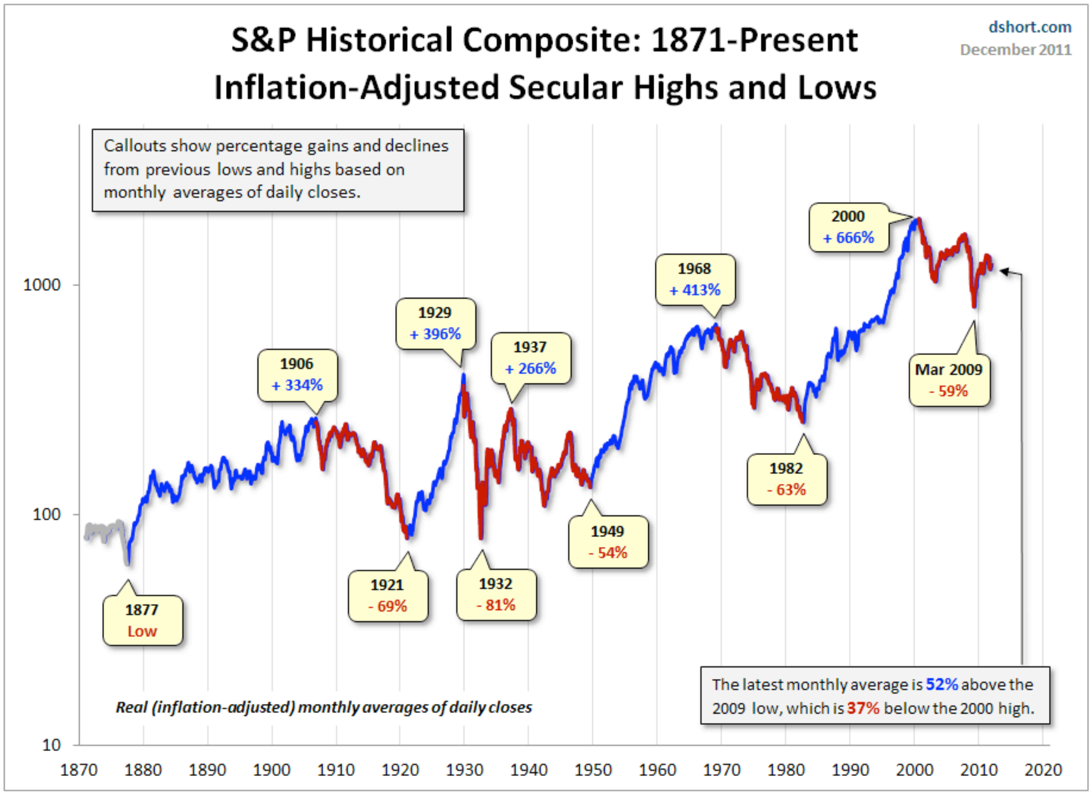


Figure 1 – Long-term chart of the S&P500 after adjusting for inflation showing the percentage gains during secular bull markets (blue) and losses in secular bear markets (red). Cyclical markets are much shorter and there have so far been two cyclical bulls since the beginning of the latest secular bear market in 2000. Note that the shortest secular market lasted 14 years. The current secular bear market is now nearing 11 years old. Chart courtesy of Advisorperspectives.com.

A new secular bull market is confirmed when the stock or index puts in a new all-time high and a secular bull ends (and a secular bear begins) when the issue fails to put in a new all-time high and instead puts in a series of lower highs over a period of years, as the red sections on figure 1 show.

But as figure 1 also shows, new secular bull markets often begin in the depths of a secular bear. This is an important distinction because the trader never knows for sure when a new secular bull has begun until a year or more after the fact which is why it's so important to be watching the market daily.

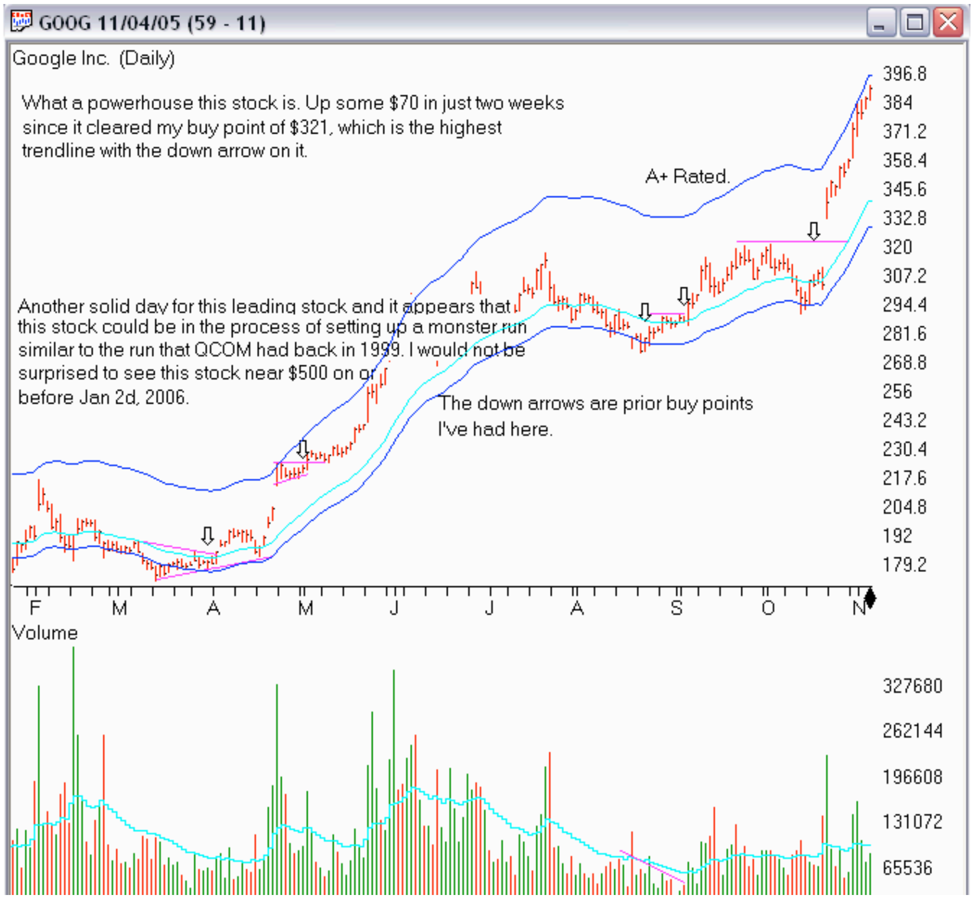


***Figure 2** – The next two charts from the Zanger Report newsletter show the difference between a powerful cyclical bull and bear market. In this chart from 2005, Google experienced strong, sustained rallies with modest corrections. Flag and pennant patterns continually succeeded providing great buying opportunities and any weakness was short-lived after which the stock broke to new highs. Chart courtesy [ChartPattern.com]() and [The Zanger Report]().*

Cyclical trends, on the other hand are shorter-term, typically lasting from a few weeks to a few years. Cyclical trends occur within the larger secular trend. A counter trend rally occurs when a stock or index moves in the opposite direction to the secular trend. Recent examples of counter-trend cyclical bulls are the rallies from 2003-7 and 2009-11 in the S&P 500.

At the short-end of the scale are moves such as the one-day rally on November 30, 2011 that led many to believe that the bear market might finally be over. Only those who have studied such rallies through history can appreciate what's really going on and act accordingly, Zanger says.

Figure 3 *– This chart from 2011 shows Google struggling after peaking in late 2007. Even before the market peaked in May, this long-term stock market leader had begun to exhibit weakness as it entered a cyclical bear market in late 2007, warning that overall market conditions had changed. This chart also shows what can happen after a powerful relief rally in a bear market. Note the strong gap up in July that is quickly filled before GOOG continues to fall in August. Chart courtesy [ChartPattern.com] and [The Zanger Report].*

Zanger doesn't consider himself a day-trader. He prefers moves that last from a few days to a few months and like a champion surfer will ride the rally wave as long he's making money. And as soon as it begins to weaken, he starts feathering out, gradually selling his position into strength.

Another big reason for his success is his skill in identifying different types of rallies – learning to separate a real money-making rally from a brief relief or sucker's rally that will eat the portfolios of those who jump in too early.

Here he shares his list of the top 10 key considerations when analyzing trend moves.

1. Learn to instantly recognize cyclical versus secular trends on any stock chart. Cyclical bulls and bears are much shorter-term compared to a secular market bull or bear. At the other end of the scale are the powerful but brief one-day sucker's rallies. Those with short investment time horizons can still make money buying stocks during a cyclical bull within a secular bear market. However, cyclical bulls can be very expensive for those without clearly defined exit strategies. No matter what your time horizon, it's important to be aware of the prevailing secular and cyclical trends and trade accordingly. Overstaying your welcome in a trade during a cyclical trend can be very costly for those who get it wrong when the secular trend resumes.

2. Short-term bear market rallies are much more powerful than shorter-term bull rallies. Relief rallies are extremely powerful and why selling short can be so dangerous. This is one big reason why traders such as Dan Zanger prefer long trades.

"You can make money in both bull and bear rallies, but it's a lot tougher in bear markets. It's important to remember that the max you can make shorting a stock is 100% and that is only if the stock goes to zero. You have a limited upside but unlimited risk if the trade goes against you," opines Zanger. "But you can make thousands of percent during a strong bull rally and unless you're trading on margin, the max you can lose is what you paid for the stock in the unlikely event that it goes bust."

The next table shows the 12 biggest daily rallies in the Dow Jones Industrial Average during the last decade with cyclical bear rallies in red and cyclical bull rallies in green.

12 Biggest One-Day Rallies Since 2001

Date	Daily%Chng
10/13/2008	11.08%
10/28/2008	10.88%
3/23/2009	6.84%
11/13/2008	6.67%
11/21/2008	6.54%
7/24/2002	6.35%
3/10/2009	5.80%
7/29/2002	5.41%
10/15/2002	4.80%
10/1/2002	4.57%
11/30/2011	4.24%
10/11/2002	4.20%

Data courtesy Reuters/Metastock

Note that with the exception of two cyclical bull rallies at the very beginning of the 2009-11 bull market; the biggest one-day rallies occurred during bear markets.Since stocks have been in a secular bear market since 2000, we also examined the 12 biggest one-day rallies since 1900 in the next table. Cyclical bull markets are shown in green and cyclical bear markets in red. Secular bull and secular bear markets are identified in the right-hand column.

12 Biggest One-Day Rallies Since 1900

Date	Daily%Chng	Market
3/15/1933	16.83%	S-Bear
10/6/1931	14.87%	S-Bear
10/30/1929	12.34%	S-Bear
10/13/2008	11.08%	S-Bear
10/28/2008	10.88%	S-Bear
10/21/1987	10.15%	S-Bull
11/14/1929	9.36%	S-Bear
9/5/1939	7.26%	S-Bear
3/23/2009	6.84%	S-Bear
3/8/1946	6.75%	S-Bear
3/15/1907	6.69%	S-Bear
11/13/2008	6.67%	S-Bear
Data courtesy Reuters/Metastock		

Of the 12 biggest one-day rallies, only one (March 23, 2009) occurred during a cyclical bull market; the rest occurred during cyclical bear markets. With the exception of a single rally which occurred during the secular bull in 1987, all of the biggest one-day rallies over the last 111 years occurred during secular bear markets! It is also interesting to note that 4 of the 12 biggest one-day rallies in the last century occurred in the wake of the 2007-9 financial crisis.

In other words, odds are extremely high that a huge one-day rally (greater than a 4% gain) is a sucker's rally.

This clearly demonstrates the risks of being too optimistic when it comes to markets, a trait that can be very expensive during bear markets. To be successful long-term, traders and investors must learn to kill the urge to buy into powerful relief rallies. There is a good reason they're called sucker's rallies.

3. Relief rallies in bear markets generally lack follow through. This point is a subset of point 2. Unlike bull market rallies, powerful bear rallies are often followed by ugly down days. In other words, buying into a big bear rally can be even more expensive than trying to catch a falling knife, the dangerous habit of buying during a big correction. So even if you do make money initially buying a bear rally, the gain can become a loss in short order.

4. Buying volume is higher on up days in a bull rally. In a bear rally volume is higher on the down days. This is one way that a trader who's been away from the market can quickly tell which kind of market he is in. Stock rises tend to occur on falling volume in a bear rally. If volume falls during an up move, it often signals that the rise is nearing an end. Don't get caught.

5. Bullish pattern failures are more frequent in bear rallies. According to Zanger, a pattern failure can often be a powerful signal to reverse direction. He provides a detailed description of the most powerful chart patterns such as cup & handles, head & shoulders, flag and pennants and parabolic curves here. If you are in a long trade and there is a pattern failure, it is an exit warning. Cyclical chart patterns also tend to have a shorter duration than the same patterns occurring in a secular market.

Figure 4 *– Chinese internet stocks like Sina Corp and Sohu.com soared in 2010 and 2011 but have since become laggards in another sign that conditions have clearly changed. Chart courtesy ChartPattern.com and The Zanger Report.*

6. Market sentiment responds differently in bull and bear markets. Bull markets climb the proverbial wall of worry. Both bullish and bearish sentiment tends to be more muted with euphoria usually only occurring near the end of the move. Bear markets on the other hand, slide down the slope of hope and are generally accompanied by extreme highs in sentiment followed by extreme lows (highs in bearish sentiment) which is another reason why volatility is higher during bear markets. Hope is one big reason why relief rallies can be so powerful. Pent-up investor optimism causes investors to pile into stocks on positive news, whether it is real or perceived.

7. Volatility is higher during bear rallies. Large shifts in sentiment aren't the only reason for increased volatility during bear markets. As we have witnessed in the last four years, there are a number of other factors. Institutional traders must quickly react to big swings by unloading large positions. Governments also get involved in markets, especially around election time, making changes in monetary policy that can have a large impact on stock prices like we saw on November 30, 2011 when central banks led by the Federal Reserve announced that it was opening the discount window to European banks. This was perceived as good news and caused the huge spike in stock prices.

8. Short squeezes occur more often and are more powerful during bear markets. This is one big reason that shorting can be so dangerous. A short squeeze occurs when those who have borrowed a stock to sell short get caught when unexpectedly good news temporarily propels the price higher. Those with short positions scramble to cover (buy back) their short positions and in the process help propel the stock price even higher. Unfortunately for these shorts, the price usually hits their selling target but only after they have been forced out of the trade.

***Figure 5** – Amazon.com, another long-term market leader experienced three strong rallies since it was launched in 1998, put in a new all-time high in October 2011. It has struggled afterwards. Spikes in volume are followed by falling volume and a subsequent correction. Also note that bullish chart patterns like the flags in this chart either failed altogether or experienced breakouts that were short-lived. We also see that the most recent flag on the far right-side of the chart broke down in a move that was accompanied by rising volume, which is bearish. Chart courtesy ChartPattern.com and The Zanger Report.*

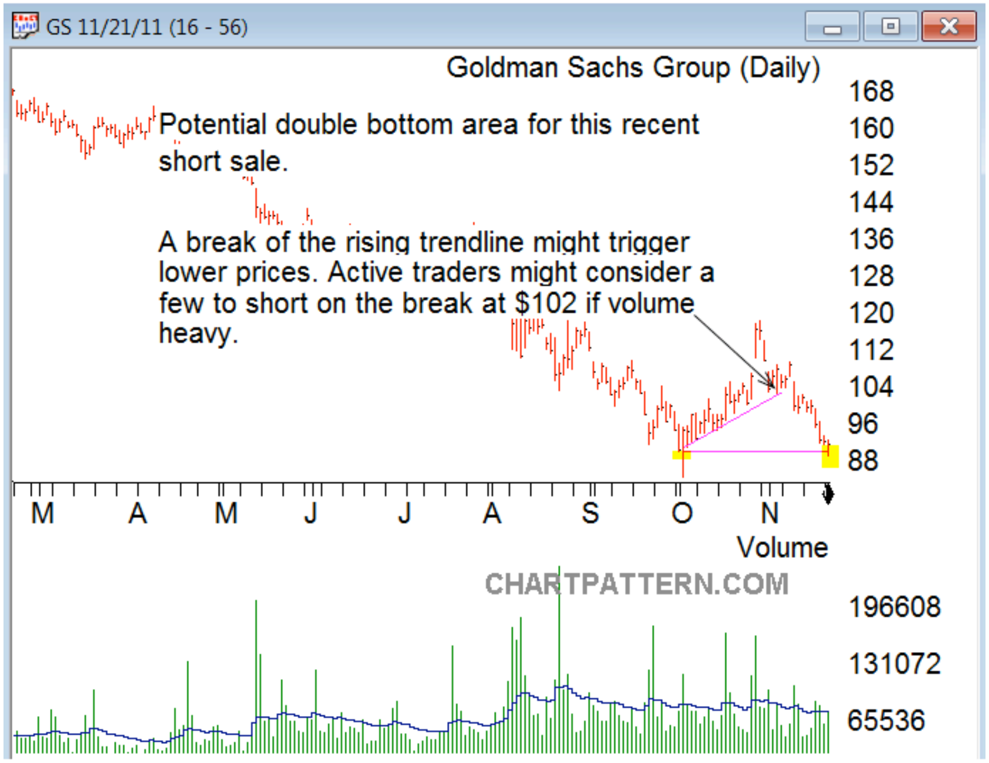


***Figure 6** – Goldman Sachs, a strong market leader in the rally of 2003-7 has struggled since then. Recently breaking below $100 per share, it is well off its all-time high of $250 of October 31, 2007. Chart courtesy ChartPattern.com and The Zanger Report.*

9. Leadership isn't clear during a bear market rally. Different stocks generally lead the next bull market than did during the last bull. During the tech bubble in the 1990s, Internet stocks were the dominant leaders but financials led the next bull rally in 2003. Changing leadership is further confirmation that a new bull rally has begun according to Zanger. However, if leaders are defensive stocks such as utilities, it usually indicates a countertrend rally, which is a shorter-term rally in the opposite direction of the larger trend.

10. If a rally is occurring below a previous high, it's either a bear rally or cyclical bull until proven otherwise. A new secular bull trend in U.S. stocks in real terms won't be confirmed until the S&P500 breaks well above the 2000 high of 1527 and the longer that takes to occur, the higher the confirmation threshold will be. Until that time, any rally will simply be a cyclical bull rally.

Putting It All Together

It is a key requirement that to be successful traders must learn to differentiate between moves that are potentially profitable and those that aren't. Zanger relies on his stock market leaders to help him decide when the time is right to buy. He then uses chart patterns and volume to help him confirm the trade and then tell him when it's time to get out. Assessing the strength and duration of the current rally is an essential requirement.

About the author

Matt Blackman, CMT is the host of TradeSystemGuru.com. Matt's articles have appeared in publications such as***Technical Analysis of Stocks & Commodities magazine***, ***SFO (Stocks, Futures & Options) Magazine, Trader Monthly Working Money, Physicians Money Digest, Laffer Economics, The Wellington Letter, Traders.com Advantage, Traders Mag (Europe), Active Trader*** and ***Investopedia.com***. Matt is a member of the Market Technicians Association (MTA) and the Canadian Society of Technical Analysts (CSTA). He earned the Chartered Market Technician (CMT) designation and a B.Sc. (Honors) degree from Simon Fraser University.

Get Matt's latest trading ideas and market comments on Twitter.

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Buy, Hold and Fold Tricks of the Trade

By Matt Blackman, CMT

When the market is rallying and bulls stampeding, it's easy to get caught up in the hype. But every trader must learn when its time to step back or step out altogether if he or she is to survive in the trading game.

Like the run from 1998 to 2000, the 2003-7 rally offered the bulls lots of opportunities to make money. Those who bought and held over this period looked liked geniuses. It wasn't until the rallies had ended and markets became more volatile that greater skill was required to play the game. When the going gets tough a simple buy & hold gets very expensive as does the age-old practice of buying dips.

"It would be great if making money in markets was as simple as buying a stock and holding it for a few months or years," says Dan Zanger, host of ChartPattern.com and author of the Zanger Report stock newsletter. "Unfortunately, markets only work that way a small part of the time but that doesn't stop folks from trying thanks to the 18-year bull market that ended in 2000. Over the long-haul, stocks spend a lot more time either in a trading range or bear market and that can wipe out a static portfolio. "

Zanger should know. Since he started trading seriously more than thirty years ago he's made and lost a few fortunes. Dan will be ever remembered for parlaying an ante of $10,775 from the sale of his Porsche into more than $18 million during an 18 month period in 1998-9 and in the process set the stock trading world record with an audited annualized return of more than 29,000%. It wasn't until he learned how to recognize an impending market top and get out in time that he was able to keep his profits.

"I never held on to my gains until I learned to unload and scale back positions when they sold off on high volume with poor bar action," he laments. "It was an expensive lesson but one that every trader must learn one way or the other."

According to Zanger, silver provided one of the best examples of a classic market top that he's seen in a while.

"It was an active trader's dream on the way up showing a beautiful parabolic move. But like most such moves, those who overstayed their welcome got creamed."

Diary of a Market Top Trader

Those unfamiliar with Zanger's newsletter and chatroom will be interested to know that he also offers regular updates at no charge on his Twitter page. But as well as giving followers insights into what the market and his favorite market leading stocks are doing, it provides another valuable learning tool. Traders can go back and see what he was saying at key points in the market since the site provides a record of his calls.

For example, here is a brief overview of what he was saying as silver ran up in the spring of 2011. Not only does it show his buy points but also when he began to get cautious. The Zanger

Report subscribers who also have access to the intraday chatroom have a ring-side seat.

The Proshares Ultra Silver ETF (AGQ) moves twice as much as the underlying silver benchmark index in a single day. So when silver is rallying strongly like it was in early 2011, it's a trader's dream. These characteristics made it one of Zanger's trading candidates. As the next chart shows, it gave a beautiful buy signal following a bullish cup & handle pattern around $150. From there it rocketed to more than $350. Then on April 25, Zanger issued this warning in his newsletter.

"Gapping up $23 at the open attracted strong selling interest on record volume... The leading averages rested today while a number of recent selections noted here moved up as much as $8 each. The market seems like it needs a rest."

In his chatroom that day, he offered this advice, ""Locking in some profits on a big gap after a run like this might not be a bad idea."

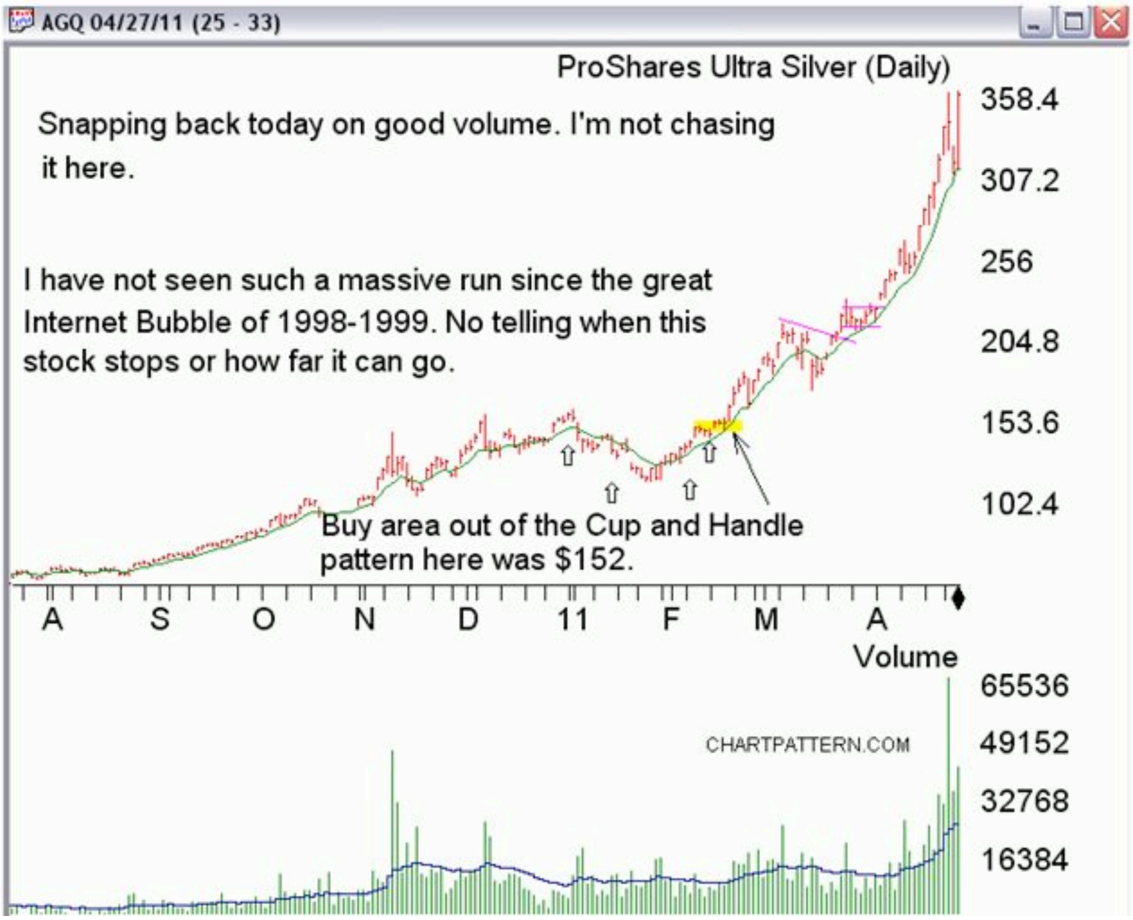


***Figure 1** – Daily chart of the ProShares Ultra Silver ETF (AGQ) showing a classic parabolic move and peak as of April 27, 2011 and Zanger's comments. Chart courtesy ChartPattern.com.*

And as the above chart shows, AGQ looks to have hit a ceiling by April 27 then failed to break above it. What signals provided the clues that silver was due for a correction?

It was a combination of three factors says Zanger.

First and foremost, parabolic moves usually signal an end to a rally because it shows that investors and traders are getting irrationally exuberant in their frenzy to buy the stock. But the biggest challenge is that profits increase since momentum accelerates into the peak. Traders who exit too early risk leaving money on the table. Those who exit too late risk giving all their profits away. It's not the type of move for the faint of heart.

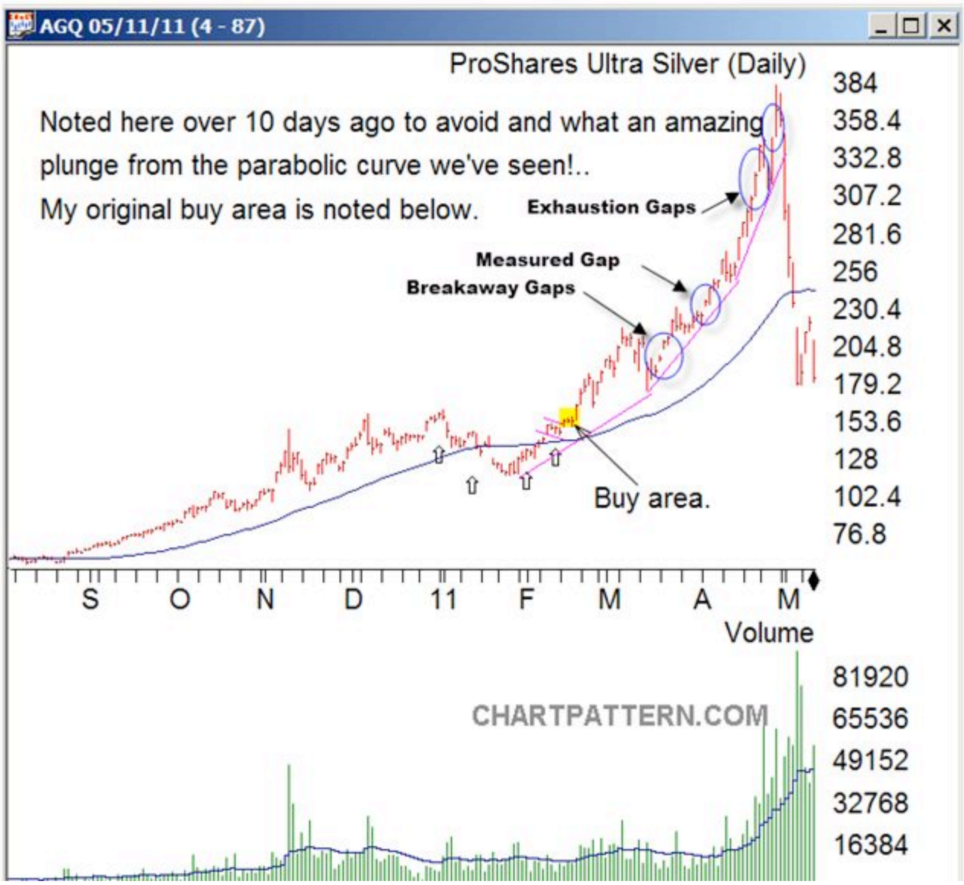


***Figure 2** – Post mortem on the rise and fall of the Ultra Silver ETF AGQ with Zanger's notes. Note the clear parabolic move and blowoff in late April, 2011 followed by the cliff dive. Daily Chart courtesy ChartPattern.com.*

Second, parabolic runs often experience exhaustion gaps near the end of the move. There are three types of gaps that provide trading opportunities – breakaway gaps that occur at the beginning of a move, measured or continuation gaps that occur around the middle of a move and exhaustion gaps that occur near the end of a move (see Figure 2). AGQ flashed three brief exhaustion gaps during the third week of April.

Third, AGQ posted something Zanger calls a naked bar on April 28 in which the stock moves strongly higher early in the day but then gives back those gains to close at or below the midpoint of its daily range. A naked bar is a good topping indicator and is confirmed when the stock closes lower the following day. (Bearishness was further confirmed by the appearance of an engulfing bear candlestick pattern on April 29).

Next, we'll look at another banner market top indicator – the bearish head & shoulders chart pattern. We saw an example of this pattern on the S&P500 Index forming in June 2011 (Figure 3). That it appeared on the SPX had bearish overtones for the market. It was one reason that motivated Zanger to go to all cash in his portfolio. A fully formed head & shoulders top pattern has bearish implications and they often occur at major tops.

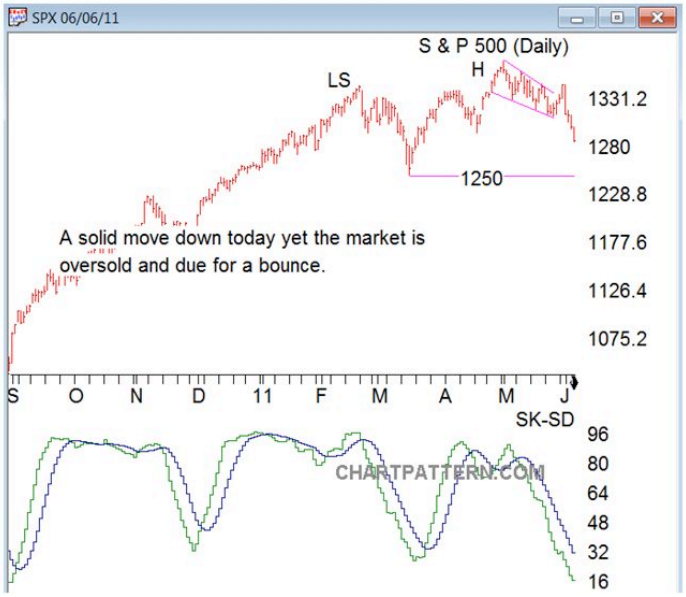


***Figure 3** – Daily chart of the S&P500 showing a head & shoulders top pattern in the process of forming. To be confirmed, the SPX would have to drop to near 1250 (neckline) rise to form the right shoulder then drop decisively through the neckline again. Chart courtesy ChartPattern.com.*

Another good indication of a top forming is the bearish rounding top pattern (Figure 4) which became clear on the Russell 2000 Index in June. A break below the horizontal neckline under the index confirms the pattern. Zanger posted this chart in the June 10, 2011 Zanger Report and warned his readers to get ready for a larger move down.

Stocks rarely reverse direction without giving powerful warning clues according to Zanger. Some are clearer than others so it’s important to learn how to recognize these chart patterns and volume profiles he says.

Here is a list of the biggest mistakes traders and investors make which prevent them from being successful long-term in the market. As trader and teacher Mike Epstein once said, “Ours is not to say what should be, but to analyze and exploit what is.”

Figure 4 *– Daily chart of the Russell 2000 Index (RUT) showing a bearish rounding top chart pattern in the final stages of formation. Chart courtesy ChartPattern.com*

10 Errors That Can Wipe Out Your Portfolio

1. A belief that markets are efficient. The efficient market hypothesis is a myth that has been promoted by factions of the fundamental investment community that would have you believe that since all that is known about a stock is already built in to the stock price, any attempts to time the market are futile. Famed investor Warren Buffett perhaps exposed this myth best when he said, “I’d be a bum on the street with a tin cup if the markets were efficient.”

As traders or proactive investors, our job is to exploit market inefficiencies until they no longer exist. A large part of this skill is learning how to read a stock chart and understanding rates of change in stock prices as well as fundamental and economic data.

2. A belief that markets are random. Another self-limiting Wall Street myth is the Random Walk Hypothesis. Like the efficient market myth, it is an excuse for those who can't make money. As one smart trader once said; markets are either efficient/random or they are emotional. They can't be both. Learning to recognize how crowd behavior works in both bull and bear markets is essential to making money in markets.

3. A failure to recognize a parabolic curve and other signs of a top. A parabolic move, also known as a hockey stick pattern, is hard to miss but it's amazing how many can be fooled into thinking it will last forever. But tops aren't always made by parabolic moves.

4. A failure to recognize important chart patterns. Other formations that warn of a top include double or triple tops, head and shoulders patterns and rounding tops (see Figures 3 and 4), exhaustion gaps, and naked bars. Here is a list of some of the more powerful chart patterns that Zanger still uses to make money. Take as much time as you need to recognize them on stock charts. It might take months or even longer but the effort is well worth it. Like the fighter pilot who spends countless hours learning how to recognize enemy aircraft in a heartbeat, chart pattern recognition is a valuable skill that will help you make money. One of the best chart books on the market is

Thomas Bulkowski's*Encyclopedia of Chart Patterns* (2nd Edition, Wiley & Sons).

5. Inability to read volume. An understanding of how volume works is another essential money-making skill. If a chart pattern is the vehicle, volume is the fuel that drives it. Volume can be used to help confirm chart patterns, measure the strength of a rally or bear market move and forecast a potential trend change. It is also important to remember that stock price can fall by its own weight but a rally generally needs expanding volume to power it. Once volume starts to fall in a rally, look out below. Spiking volume in a bear can also warn of an impending trend change.

6. Focusing on the wrong fundamentals. Knowing how to read corporate profit and loss statements, determine PE ratios and calculate price-to-book or price-to-sales ratios is great but there is one major problem with this type of data. No matter how current, they are all lagging indicators. The same holds true with many economic indicators. More important when looking for stocks that have the potential to soar is focusing on how quickly revenues and earnings net of expenses are increasing (i.e. rate of change). This information provides an indication of where a company is headed. For example, it is far more desirable to buy a company where earnings growth is accelerating not slowing down.

When looking at the macro economic picture, government produced statistics like unemployment, the consumer price index (CPI) or GDP are subject to nearly constant revisions for a year or more after the fact. It is therefore fool's play to rely on revised data since it's a moving target.

7. Misinterpreting the news. There is an age-old saying in markets – buy the rumor, sell the news. Less well known but even more useful is this simple measure of whether the bulls or bears are in control. Bad news – good action, means players are discounting the bad news and buying stocks anyway and the bulls are in control. Good news – bad action means just the opposite and shows that the bears run Wall Street. Regardless of the market, it is a bad idea to hold through earnings report of any company. Granted, if earnings are better than expected you'll make money but if they disappoint, especially in an uncertain market, you could lose your shirt. This is one of Dan Zanger's 10 Golden Stock Trading Rules.

8. Letting someone else tell you when to buy and sell. Hot tips and rumors run rampant on Wall Street but trading or investing without doing your own homework is a suckers' game.

9. Not using a trading plan. It may sound corny but it's true. Those who fail to plan, plan to fail. To be successful it is essential the all traders develop a written plan outlining their goals, risk tolerances, stop losses and profit targets.

10. Letting your emotions rule your trades. Where money is involved, emotions run high. Although it's impossible to be like a robot and eliminating emotions altogether, it's important to realize that your emotions can be very expensive if they are not kept in check. It is also important to remember that trader specific errors are the greatest risk to any portfolio. Put another way, of all the challenges to making money, you represent the greatest single risk to your portfolio. That is why it’s important to have a rule book to keep you on track when emotions threaten to get in the way.

Suggested Reading and Links

My 2003 interview with Dan Zanger – Chart Patterns, Trading and Dan Zanger

Death of the Efficient Market Hypothesis and Japanese Centenarians

Warren Buffett on the Efficient Market Hypothesis

About the author

Matt Blackman, CMT is the host of TradeSystemGuru.com. Matt’s articles have appeared in publications such as***Technical Analysis of Stocks & Commodities magazine***, ***SFO (Stocks, Futures & Options) Magazine, Trader Monthly Working Money, Physicians Money Digest, Laffer Economics, The Wellington Letter, Traders.com Advantage, Traders Mag (Europe), Active Trader*** and ***Investopedia.com***. Matt is a member of the Market Technicians Association (MTA) and the Canadian Society of Technical Analysts (CSTA). He earned the Chartered Market Technician (CMT) designation and a B.Sc. (Honors) degree from Simon Fraser University.

Get Matt’s latest trading ideas and market comments on Twitter.

Decoding the Derivative Dilemma

By Matt Blackman, CMT

Derivatives have grown from a relatively small market thirty years ago to the 800-pound financial gorilla in the world today. At over $600 trillion in notional value, it's nearly ten-times the size of total annual world economic output. So when a derivative-related "credit event" triggered the financial crisis of 2008, it shook confidence around the globe. Could another one be lurking around the next corner?

When financial markets came unglued in 2008, few had seen it coming. Lehman Brothers and Bear Stearns collapsed, Merrill Lynch had to be taken over by Bank of America, insurance company AIG was bailed out, government sponsored enterprises Fannie Mae and later Freddie Mac were taken over and programs such as the Troubled Asset Relief Program (TARP) and the FDICs Temporary Liquidity Guarantee Program (TLGP) were signed into law – all in the space of six weeks. It was the first part of an overall action plan that was to become known as Quantitative Easing 1.

Why? Financial instruments such as Collateralized Debt Obligations (CDOs), Credit Default Swaps (CDSs), Collateralized Bond Obligations (CBOs), Collateralized Mortgage Obligations (CMOs), Special Purpose Vehicles (SPVs), Structured Investment Vehicles (SIVs), Residential Mortgage Backed Securities (RMBS) and other complex instruments whose names would forever be etched into the financial crises lexicon, had suddenly turned toxic.

But how could a market that was miniscule in comparison three decades ago, push our financial system to the brink of collapse and no policy makers or government regulators saw it coming? It was a painful demonstration of just how much risk the derivatives market posed. And since the over-the-counter (OTC) derivatives market is an unregulated and clandestine, few can assess its risks even when they understand how these complicated instruments work.

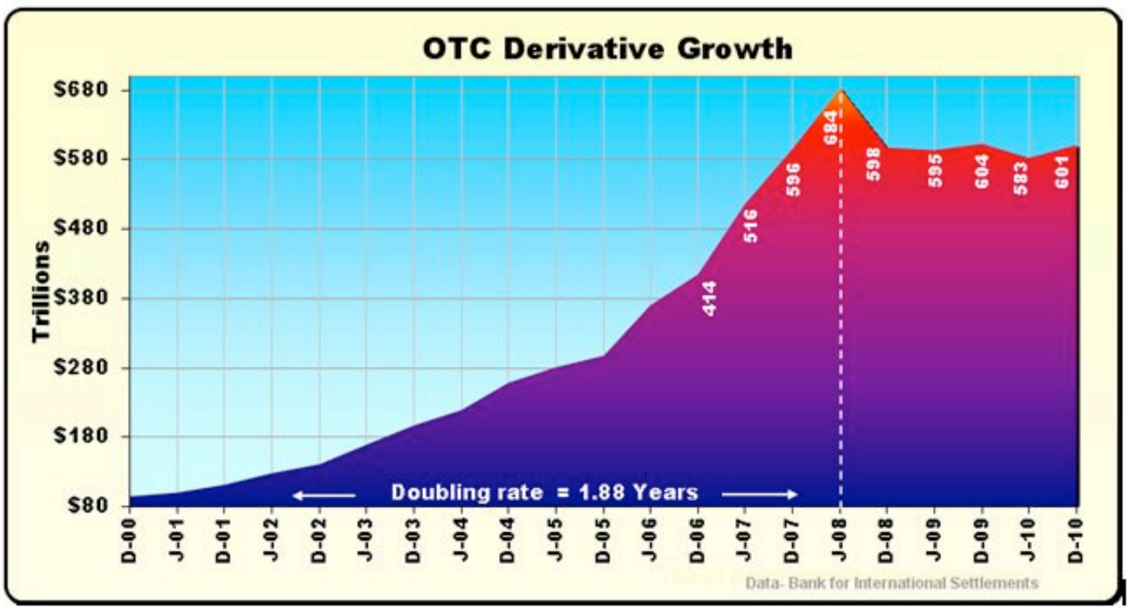


Figure 1 *– Graph showing the rapid growth of the Over-the-Counter derivatives markets since the turn of the century which until 2008, was doubling every 1.9 years. Data – Bank of International Settlements.*

What is a derivative anyway?

Put simply, a derivative is an asset, the value of which is derived by an underlying asset. Equity and futures options and futures contracts are better-known examples. Underlying assets include metals such as gold and silver, commodities like orange juice, grains and cotton, energy sources such as oil, gasoline and coal, and marketable assets such as shares, bonds and currencies traded through exchanges. And then there are a host of financial derivatives products such as those used to pool mortgages and other loans that are traded directly through dealers on the over-the-counter (OTC) market. These are generally larger and a lot more complicated.

There are four major classes of derivatives according to Andrew Chisholm author of Derivatives Demystified – A Step by step Guide to Forwards, Futures, Swaps and Options (John Wiley & Sons, 2010).

Options – Most familiar to retail traders and investors, an option of a stock (like Amazon) gives the buyer the right but not the obligation to buy the stock at a future price (strike price) by a specific date (expiry date). The price of the option is based on the price of the underlying security. Options are also popular with retail traders in currency (Forex) and bond markets.

Forwards – A forward is a private contract between two parties. It can either be on a physically delivered basis (where a commodity or asset changes hands) or cash-settled basis (where profit is the difference between the price paid and price at expiry of the contract).

Futures – Similar to a forward, except that a futures contract is made through an exchange which sets the price and terms as opposed to an agreement between private parties. Like forwards, futures contracts can either be fulfilled by physical delivery or on a cash basis. But unlike a forward, futures are generally guaranteed against default so that the risk is limited to capital loss.

Swaps – A swap is an agreement between parties for payments made on future dates, each of which is calculated on a different basis. Although considered one of the most basic derivative products according to Chisholm, a swap is actually composed of a series of futures contracts. It is used to minimize currency risk in cases where a company's income may be in one currency but expenses or revenue is in another currency.

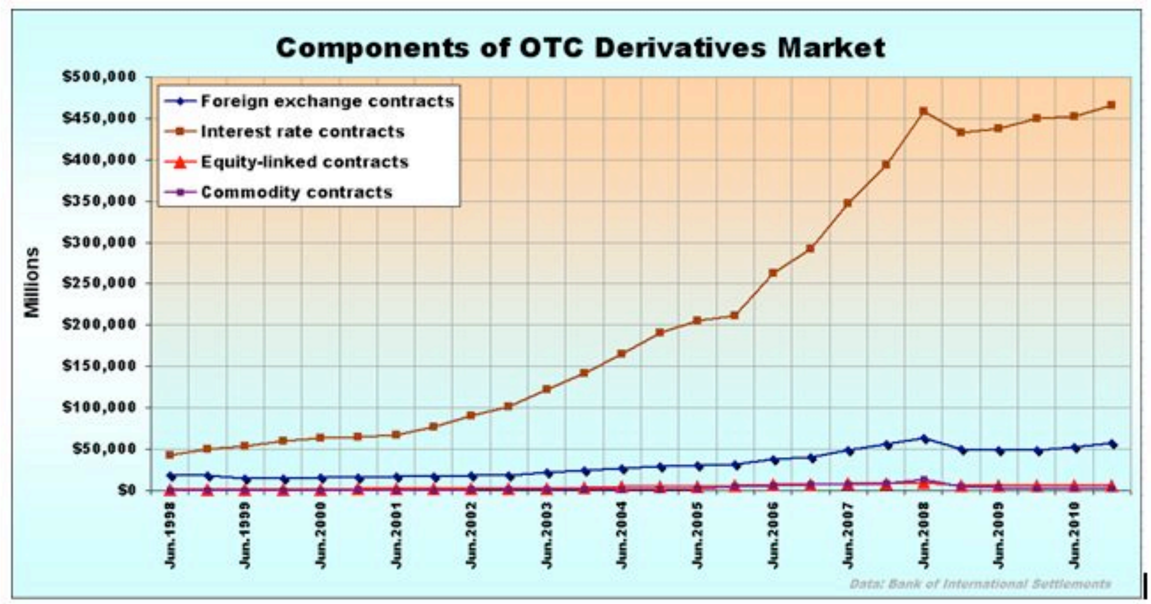


Figure 2 *– Major components of the OTC derivatives market showing the relative dollar amount of each. Interest rate contracts with the lion's share followed by foreign exchange contracts with a notional value of $465.3 trillion in 2010. Commodity contracts were the smallest totaling $2.92 trillion with gold derivatives equaling $396 billion of that total. Data – Bank of International Settlements.*

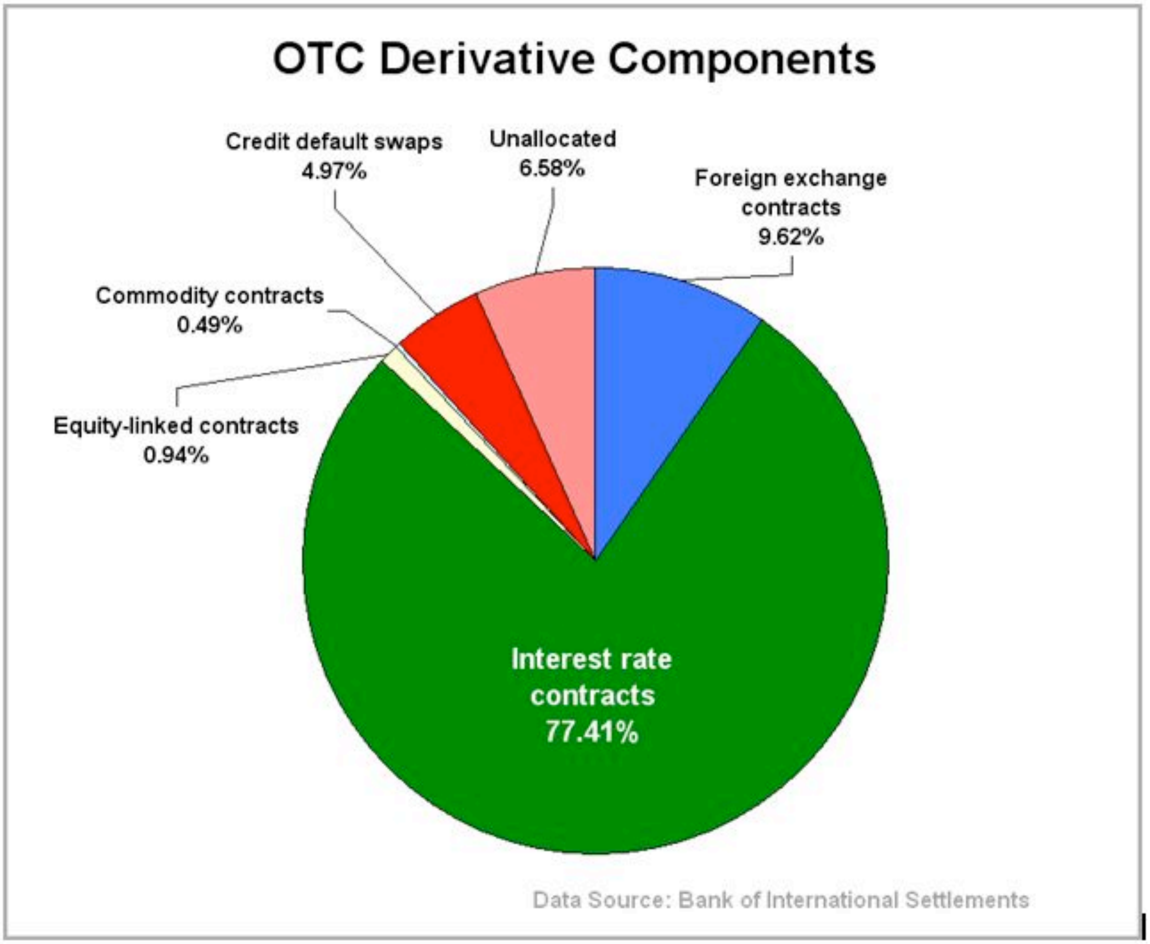


***Figure 3** – Further breakdown of derivative contract type. Interest rate contracts, forwards, swaps and options total 77.4% of the OTC derivatives market. Foreign exchange contracts, forwards, options and swaps are a distant second at 9.6% with credit default swaps third at 5% of the market. Data – Bank of International Settlements.*

When It All Hits the Fan

Derivatives are well suited to speculating on prices of commodities and financial instruments because they employ leverage according to Chisholm. This allows buyers to participate in a market by investing only a fraction of the total value of the asset they are buying. Potential returns are greater but so are losses when the trades go awry causing investor Warren Buffett to declare in a 2002 letter to Berkshire shareholders that “derivatives are financial weapons of mass destruction, conveying dangers that, while now latent, are potentially lethal.” In 2007, the dangers that Buffett referenced quickly mutated from latent to very real.

But that was not the first time the use of derivatives had triggered financial crisis. Prior examples include the £6 billion Hammersmith and Fulham Council fiasco in 1988-9, the £800 million loss by trader Nick Leeson in 1995 which effectively wiped out Barings Bank, the Long-Term Capital Management differential spread trades gone horribly wrong in 1998, and the collapse of Enron in 2001 in which the company used “aggressive accounting techniques and derivative products to inflate earnings and boost asset valuations,” according to Chisholm in *Derivatives Demystified*.

Credit default swaps (CDS) are a basket of securities whose value depends on the creditworthiness of the product (like mortgages) and the entity that backs it (like AIG). Similar to an insurance policy, CDSs are used to transfer risk from one party to another in exchange for the payment of a risk premium by the buyer. But there are some big differences.

Normally an insurance policy involves three parties, the insurer, the insured and the beneficiary. But a CDS can be purchased by multiple parties (buyers) on the reference entity, all of which must be paid by the seller in the event of default or bankruptcy (called a credit event) by the reference entity. The other big difference is that unlike an insurance policy, the seller of a CDS does not need to prove sufficient reserves (ability to pay) in case of a credit event since this market, unlike the insurance industry, is unregulated.

It became painfully obvious that few bankers, regulators, central bank chairs or even credit rating agencies understood how derivatives worked before 2008 when AIG needed an eleventh hour $85 billion bailout from the government due to a raft of CDS losses to avoid bankruptcy. Lehman Brothers filed for bankruptcy on September 15, 2008 with $639 billion in assets and couldn’t be saved. One investor, the Norwegian government pension fund, which had over $800 billion in Lehman’s stocks and bonds, lost a bundle according to Gary Shilling in his book, *The Age of Deleveraging* (Wiley 2011).

In 2004, which is the first year credit default swap data is available, the market totaled $6.4 trillion according to data from the Bank of International Settlements. In 2007 just three years later, the CDS market had ballooned more than 800% to nearly $60 trillion. By 2010, this market had been cut in half to less than $30 trillion as Figure 3 shows.

But CDSs are just one of dozens of complex financial instruments whose sudden decline in value threatened global financial stability three years ago.

Could It Happen Again?

How could a 2008 crisis that came dangerously close to financial Armageddon have been primarily caused by derivatives worth just 10% of the OTC market? Could it happen again?

CDSs are making a comeback but this time they're being used to insure nations like Greece, Japan, Italy, Spain and Portugal against default. Together Greece, Spain and Italy have government debt totaling more than $4 trillion. But this is dwarfed by government debt of more than $10.7 trillion owed by Japan and more than $14 trillion by the U.S. Concerns about the ability of the governments to repay creditors have risen after the U.S. lost its AAA credit rating in August and Italy was downgraded by Standard & Poor's in September. Five-year CDSs for Germany soared to new heights on September 26 and competitor Moody's Investor Service cut Japan's credit rating to Aa3 August 24.

On October 7, we learned that rating agency Fitch Ratings had again cut the Spanish credit rating from AA+ to AA- citing the "intensification" of the euro crisis, slower Spanish growth and regional finances as risks to the nation's debt outlook according to Bloomberg. Moody's Investors Service warned on October 4 that "all but the strongest euro-area sovereigns" are likely to see further downgrades, when it cut Italy's rating for the first time in almost two decades.

Investors are buying CDSs on these and other nations hoping for whopping payouts should one or more default. But assessing the risk posed to financial systems of derivative market failures like we experienced in 2008 is nearly impossible since without much regulation or transparency, we only learn of failures after they have happened. According to the latest data from the U.S. Comptroller of the Currency, more than one-third of all derivative risk or $249 trillion (notional value) is held by U.S. insured banks as of Q2-2011. The majority of this is held by two banks – JP Morgan Chase and Citigroup. Derivatives held by U.S. banks increased $28.9 trillion in the last year or roughly twice the size of U.S. GDP. Credit default swaps totaled $15.2 trillion.

Is it any wonder investors are getting nervous about the potential risks posed by sovereign defaults in Europe? What other "latent" and "potentially lethal" risks are waiting to unravel in the huge derivatives market?

Suggested Reading

Chisholm, Andrew – *Derivatives Demystified – A Step by step Guide to Forwards, Futures, Swaps and Options* (John Wiley & Sons, 2010).

Lancaster, Brian, Shultz, Glenn and Fabozzi, Frank – *Structured Products and Relative Credit Derivatives* (John Wiley & Sons, 2008)

Shilling, Gary – *The Age of Deleveraging* (John Wiley & Sons, 2011).

Default Swaps Reach Record on Bonds Still Beloved by Banks: Japan Credit

About the author

Matt Blackman, CMT is the host of TradeSystemGuru.com. Matt's articles have appeared in publications such as***Technical Analysis of Stocks & Commodities magazine***, ***SFO (Stocks, Futures & Options) Magazine, Trader Monthly Working Money, Physicians Money Digest, Laffer Economics, The Wellington Letter, Traders.com Advantage, Traders Mag (Europe), Active Trader*** and ***Investopedia.com***. Matt is a member of the Market Technicians Association (MTA) and the Canadian Society of Technical Analysts (CSTA). He earned the Chartered Market Technician (CMT) designation and a B.Sc. (Honors) degree from Simon Fraser University.

Get Matt's latest trading ideas and market comments on Twitter.

8 Ideas for Building Your Personal Trading Journal

By Tim Racette

The #1 reason traders fail is due to lack of experience. The best way to speed up your learning curve is to keep meticulous records using a trading journal. In this article I will give you ideas for setting up your own trading journal as well as examples from my own.

The business of trading is filled with some of the brightest minds in the world. These veteran traders have 10, 20, and 30 years of experience trading the markets. How do you become one of them? Trade to trade well and the money will follow.

Whether you choose to journal by pen and paper, on the computer, by audio recording, or through video screen captures your objective is to identify mistakes and develop ways to avoid the same mistakes in the future. The ideas discussed here can be used as a framework to get started. Be creative and adapt them to your own style, there's no right or wrong way to journal.

Creating Means to an End

The first think you must do before creating a journal, before placing a trade, even before learning about the markets is to pull out a piece of paper and write down your answers to the following three questions.

- ★ If you had unlimited supply of money, what would you spend your time doing, and who would you spend it with?
- ★ What will happen to you 20 years from now if you do not learn the skills necessary to become a successful trader or investor today?
- ★ Why trading? Given the four basic ways to make money (employee, self-employed, business owner, and investor) why do you want to be a trader?

Spend some time thinking about your answers and reasons behind them. It may seem like a silly exercise, but you really must start from a top down, holistic approach if you are going to succeed as a trader over the long term.

The Benefits of a Journal

The benefit of using a trading journal is to build confidence in your trading system. You are the most objective when you have confidence in your trading setups and methodology. In taking meticulous notes and recording the conditions surrounding your trades you will find see trading improve over time.

Some important things to note are your emotions as you enter the trade, during the trade, and at ext, outside market forces, why you decided to exit when you did, etc. You can then determine profitable habits and discard the harmful ones.

Tools for Your Journal

Jing - If you're a visual learner this is a great tool. Jing is a great tool that allows you to screen capture images and videos. You can then make notes, and document right on the chart itself.

Microsoft Excel – For mass data analysis nothing beats Microsoft Excel. I choose to use a combination of handwritten notebooks and Excel for my own trading journal. If you're not tech savvy or simply wish to use prefabricated excel templates I urge you to check out Greg Thurman's Trading Journal Spreadsheets.

StockTickr – A third option for documenting your trades is with the online platform StockTickr. They have a lot of useful tools as well as different level package options to choose from.

A Look at My Trading Journal

Now that you have some ideas on how to get started I'd like to share with you how I organize my trading journal(s). Like I said, I use a combination of handwritten notebooks for my emotional and daily market notes, and Microsoft Excel for the analytics and trade analysis.

All my excel templates discussed below can be found here.

Feel free to tweak them and make changes as you like. If you have questions go ahead and leave them in the comments section below as often times many readers share the same questions. I will respond to all questions.

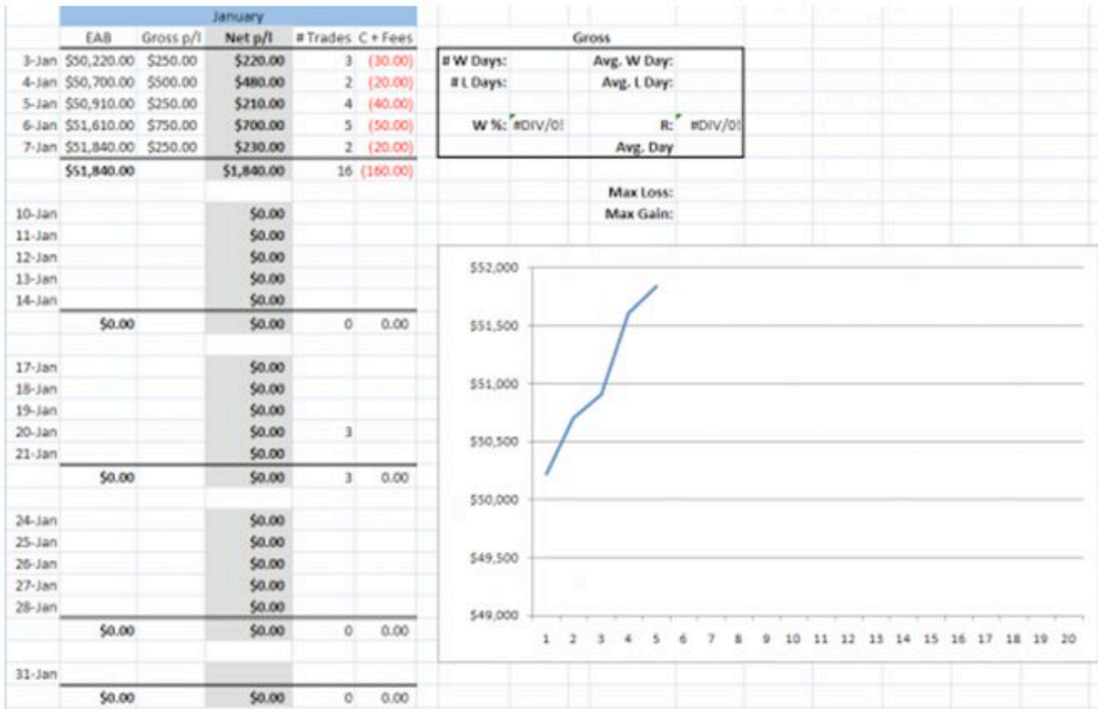
Trading Log

Date	Total Trades	Net Points	W	L	S	W %	Trade Notes
1/3/2011	5	9.25	3	1	1	60%	2 - 6E/mL, 1 - 15L, 1 - E7/L, 1 - 15S
1/4/2011						#DIV/0!	
1/5/2011						#DIV/0!	
1/6/2011						#DIV/0!	
1/7/2011						#DIV/0!	
Weekly Totals	5	9.25	3	1	1	60%	
1/10/2011						#DIV/0!	
1/11/2011						#DIV/0!	
1/12/2011						#DIV/0!	
1/13/2011						#DIV/0!	
1/14/2011						#DIV/0!	
Weekly Totals	0	0.00	0	0	0	#DIV/0!	
1/17/2011						#DIV/0!	
1/18/2011						#DIV/0!	
1/19/2011						#DIV/0!	
1/20/2011						#DIV/0!	
1/21/2011						#DIV/0!	
Weekly Totals	0	0.00	0	0	0	#DIV/0!	

I use this spreadsheet for recording and tracking the effectiveness of my individual setups. I break out the setup and win percentage to see which markets and setups are working the best.

Things I Learned: After a few weeks of inputting trades it was really clear that some of the smaller time frames I was trading were not as profitable as the 15-min time frame. In some cases, these smaller time frames were my only losing trades for the week. The result, I went back and tweaked my entry for these setups and reduced the number of contracts I was trading for the smaller time frames which minimized my losses and increased profits.

Profit/Loss Report



	January				
	EAB	Gross p/l	Net p/l	# Trades	C + Fees
3-Jan	$50,220.00	$250.00	$220.00	3	(30.00)
4-Jan	$50,700.00	$500.00	$480.00	2	(20.00)
5-Jan	$50,910.00	$250.00	$210.00	4	(40.00)
6-Jan	$51,610.00	$750.00	$700.00	5	(50.00)
7-Jan	$51,840.00	$250.00	$230.00	2	(20.00)
	$51,840.00		$1,840.00	16	(160.00)
10-Jan			$0.00		
11-Jan			$0.00		
12-Jan			$0.00		
13-Jan			$0.00		
14-Jan			$0.00		
	$0.00		$0.00	0	0.00
17-Jan			$0.00		
18-Jan			$0.00		
19-Jan			$0.00		
20-Jan			$0.00	3	
21-Jan			$0.00		
	$0.00		$0.00	3	0.00
24-Jan			$0.00		
25-Jan			$0.00		
26-Jan			$0.00		
27-Jan			$0.00		
28-Jan			$0.00		
	$0.00		$0.00	0	0.00
31-Jan					
	$0.00		$0.00	0	0.00

Have you made money at the end of the day? This is the bottom line report.

Things I Learned: This spreadsheet keeps track of my individual p/l each day, number of trades, and commission expense. I also track my progress over the month in chart form. One particular discovery was that my biggest days were sometimes the days with the fewest number of trades. It also made it clear that a typical month is made up of a few big winning days, a number of average winning days, and only a couple small down days if any.

On days when the market is providing quality setup after quality setup I continue to trade. Days where the market is slow and I have a couple scratch trades with no follow through I usually lock in gains that I may have and stop trading by noon CST.

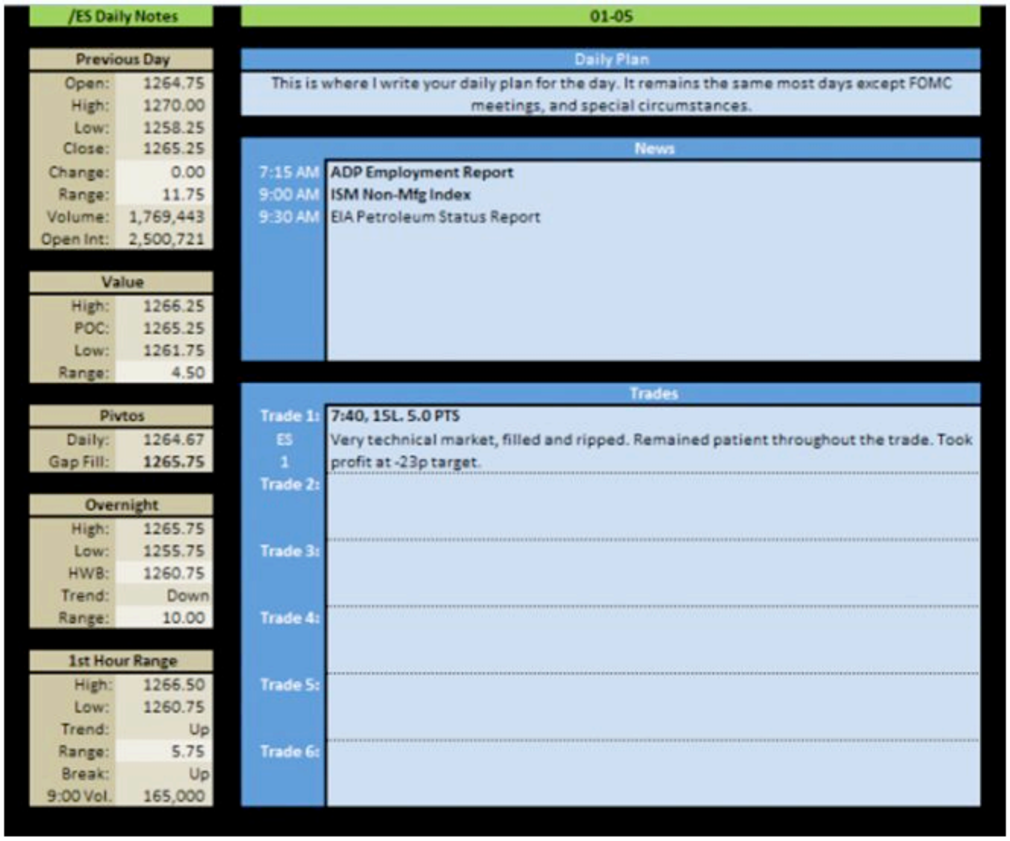
NASDAQ										Commodities				SPDR ETFs	
NASDAQ	%	Volume	%	Breadth Ratio	% Bullish	A/D Line		$Trin	VIX	Spot Gold	Crude Futures	Put Call Ratio	Unfilled Gaps	Strongest	Weakest
$2,691.52		1,941,304		3.9 :1	79%	1407	A	0.81	17.61	n/a	$91.55	0.65	$1,254.25	XLF XLY	XLU XLP
$2,681.25	-0.4%	2,027,676	4.4%	1.1 :1	47%	-954	d	0.52	17.38	$1,388.50	$89.38	0.65		XLU XLK	XLB XLE
$2,702.20	0.8%	2,101,997	3.7%	2.3 :1	69%	1105	A	1.03	17.02	$1,368.00	$90.30	0.71		XLF XLY	XLP XLU
$2,709.89	0.3%	2,105,373	0.2%	1.4 :1	58%	-317	d	0.55	17.40	$1,368.50	$88.38	0.75		XLK XLV	XLF XLE
$2,703.17	-0.2%	1,981,044	-5.9%	1.5 :1	61%	-674	d	0.91	17.14	$1,367.00	$88.03	0.69		XLE XLU	XLP XLF
$2,707.80	0.2%	1,878,368	-5.2%	1.4 :1	58%	268	a	0.87	17.54	$1,368.25	$89.25	0.78		XLI XLB	XLE XLU
$2,716.83	0.3%	1,905,107	1.4%	1.4 :1	57%	682	a	1.24	16.89	$1,374.00	$91.11	0.84		XLE XLB	XLP XLK
$2,737.30	0.8%	1,884,076	-1.1%	1.3 :1	75%	939	a	0.66	16.24	$1,378.75	$91.86	0.82		XLF XLE	XLU XLY
$2,735.29	-0.1%	1,940,113	3.0%	1.1 :1	51%	-315	d	0.73	16.39	$1,381.50	$91.40	0.72		XLP XLI	XLV XLB
$2,755.30	0.7%	2,043,478	5.3%	2.0 :1	66%	748	a	0.88	15.46	$1,367.00	$91.54	0.57		XLF XLE	XLV XLP
holiday										$1,360.50					
$2,765.85	0.4%	2,036,873	-0.3%	1.5 :1	60%	-69	d	0.63	15.87	$1,369.50	$91.38	0.73		XLI XLE	XLP XLF
$2,164.35	-21.7%	2,137,419	4.9%	5.5 :1	15%	-1742	D	1.19	17.31	$1,372.00	$90.86	0.84		XLP XLU	XLF XLB
$2,704.29	24.9%	2,349,505	9.9%	3.0 :1	25%	-1190	D	1.13	17.99	$1,345.50	$88.86	0.93		XLF XLI	XLY XLK
$2,689.54	-0.5%	1,935,234	-17.6%	1.7 :1	36%	-476	d	1.20	18.47	$1,343.50	$89.11	0.79		XLI XLF	XLB XLK
	######		-100.0%												
	#DIV/0!		#DIV/0!												
	#DIV/0!		#DIV/0!												
	#DIV/0!		#DIV/0!												
	#DIV/0!		#DIV/0!												

Daily Notes

This is my go to spreadsheet that I use every day. It began as a handwritten piece, but after drawing the same boxes and grids day after day I moved it into excel. In the beginning I would record the market internals every 30-mins, I have since added a code in my Thinkorswim platform that tracks this for me. Here's the link to that Thinkorswim code.

Things I Learned: This spreadsheet acts as a checklist. I fill it out each night for the following day. During the trading day I record my individual trades on this sheet as well, then input them into the Trading Log at night.

Market Analysis



/ES Daily Notes		01-05	
Previous Day		**Daily Plan**	
Open:	1264.75	This is where I write your daily plan for the day. It remains the same most days except FOMC meetings, and special circumstances.	
High:	1270.00		
Low:	1258.25		
Close:	1265.25	**News**	
Change:	0.00	7:15 AM	ADP Employment Report
Range:	11.75	9:00 AM	ISM Non-Mfg Index
Volume:	1,769,443	9:30 AM	EIA Petroleum Status Report
Open Int:	2,500,721		
Value			
High:	1266.25		
POC:	1265.25		
Low:	1261.75		
Range:	4.50		
Pivtos		**Trades**	
Daily:	1264.67	Trade 1:	7:40, 15L. 5.0 PTS
Gap Fill:	1265.75	ES	Very technical market, filled and ripped. Remained patient throughout the trade. Took
		1	profit at -23p target.
Overnight		Trade 2:	
High:	1265.75		
Low:	1255.75	Trade 3:	
HWB:	1260.75		
Trend:	Down		
Range:	10.00	Trade 4:	
1st Hour Range			
High:	1266.50	Trade 5:	
Low:	1260.75		
Trend:	Up		
Range:	5.75	Trade 6:	
Break:	Up		
9:00 Vol.	165,000		

This is the Mack daddy of spreadsheets.

I record all my market data here. It may be a little overwhelming at first, but after years of recording this data each night it becomes pretty easy to spot patterns and trend changes.

Things I Learned: I look to the market internals each day to really gauge the strength or weakness of the market. This spreadsheet has helped me uncover very interesting patterns and occurrences. These indicators are also talked about in the book [Mastering the Trade] by John Cater.

End of Day Questions

At the end of the day asses your trading by asking yourself the following questions…

- ★ Did I follow my rules?
- ★ Did I take all the valid setups?
- ★ Did I hold to my targets?

Review the setups for the day and congratulate yourself if you followed your rules, took all the valid setups, and held to your targets. If you operate in this way, the money will follow as I can personally attest to.

Since incorporating these journals into my routine back in 2007 I have been able to increase the efficiency of my strategy and continue to become more profitable each year.

Leave Your Questions and Other Ideas Below

I hope by sharing my trading journal you have uncovered a number of ideas to create and build your own. If you have more ideas (as I'm sure I haven't touched on them all) please share them in the comments section for everyone to enjoy. Thank You!

9

Using Market Internals to Improve Your Trading

By Tim Racette

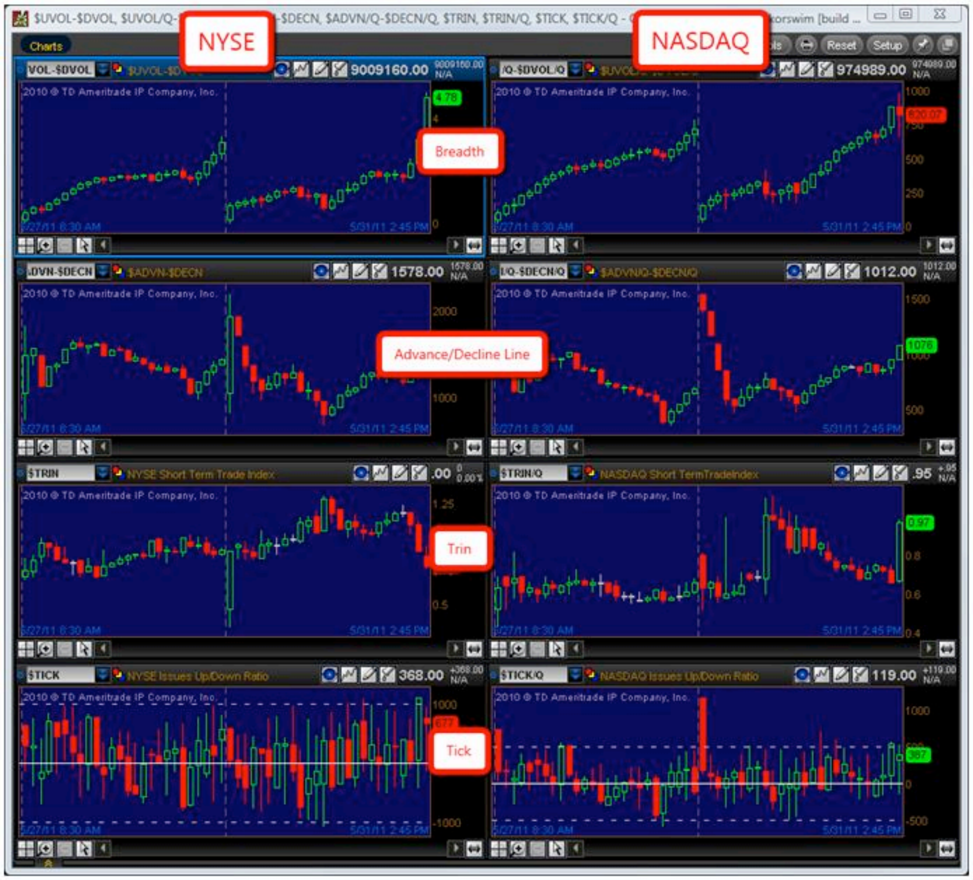
The Market Internals are similar to the instrument cluster on your car, without them you really don't know which direction you are headed or how fast you're moving.

There are four indicators that make up the core market internals:

- Breadth Ratio
- Advance/Decline Line
- Trin
- Tick

Each indicator has a separate reading for the NYSE and NASDAQ, but our primary focus will be on the NYSE.

You can setup your trading screen to neatly display all four market internals in both chart form and numeric form. I have mine setup in grid chart format using the Thinkorswim platform.



Specific instructions for setting up your own market internals charts using Thinkorswim can be found at the end of this article.

Breadth

The 'Market Breadth' or 'Breadth Ratio' is a volume ratio composed of volume flowing into up stocks versus volume flowing into down stocks.

The breadth ratio is expressed: Up Volume / Down Volume.

This reading is important in relation to where it has been, especially where we are now compared to where we opened on the day.

For example:

If at 10:00 AM we have 10M shares moving up and 5M shares moving down, the resulting breadth ratio is 2:1 positive (10M/5M), twice as much volume is flowing into up stocks as down stocks.

If at 10:30 AM the market has sold off but we now have a breadth ratio of 3:1 positive, this is a signal that the markets are actually becoming stronger and it's time buy the pullback, so look for a long setup.

The image above displays the NYSE and NASDAQ opening breadth numbers for the day, as well as the current breadth reading. (This Thinkorswim code can be found here).

Out of all four internals, the breadth ratio is the most important.

Advance/Decline Line

The 'Advance/Decline Line' or 'A/D Line' for short, is the second most important of the internals. This indicator tells us the net sum of advancing stocks minus declining stocks.

The A/D Line is expressed: # of Advancing Stocks – # of Declining Stocks

There are roughly 3000 stocks listed on the NYSE and 3000 on the NASDAQ. An A/D Line reading of 1,500+ is very bullish and a reading of over 2,000 is extremely bullish. On the flipside readings of -1500 and below are very bearish and readings below -2,000 are extremely bearish.

These extreme readings are indicative of trending days where once the market continues to trend all the way into the close. We look to the A/D Line in conjunction with the Breadth Ratio to confirm these trend days.

For example:

A day with 2,500 advancing stocks and only 500 declining stocks would yield a net of +2,000 (an extremely bullish reading). It would take a large catalyst to shift the market direction with a reading this bullish.

If on the open you continue to see the A/D Line moving +500, +700, +900, this is a sign of market strength. If however, the market is moving higher, but the A/D Line is moving lower, a divergence has occurred and could be a sign of a market turn.

It's important to look to the other market internals for confirmation as one indicator alone is not sufficient to confirm a move.

Trin

TRIN stands for TRaders' INdex and was developed by Richard Arms in 1989 (it's also referred to as the Arms Index). Its main purpose is for detecting overbought and oversold levels in the markets

The Trin is expressed: # of advancing stocks / # of declining stocks divided by

volume of advancing stocks / volume of declining stocks

The resulting Trin # is inverse to the market (a + reading is bearish, a – reading is bullish). A ratio of 1.0 means the market is at parity. A reading of 2.0 means much more volume is flowing into declining stocks. A reading of below 0.6 means much more volume is flowing into advancing stocks.

With the introduction of inverse ETFs the Trin has lost some of its appeal to intraday traders.

John Carter talks about the Trin in his book *Mastering the Trade* and has this to say…

If the Trin closes below 0.6, the market has an 80% change of selling off the next day.

If the Trin closes above 2.0, the market has an 80% change of rallying the next day.

If after closing above 2.0 the markets can't rally the next day, a major selloff could be in store.

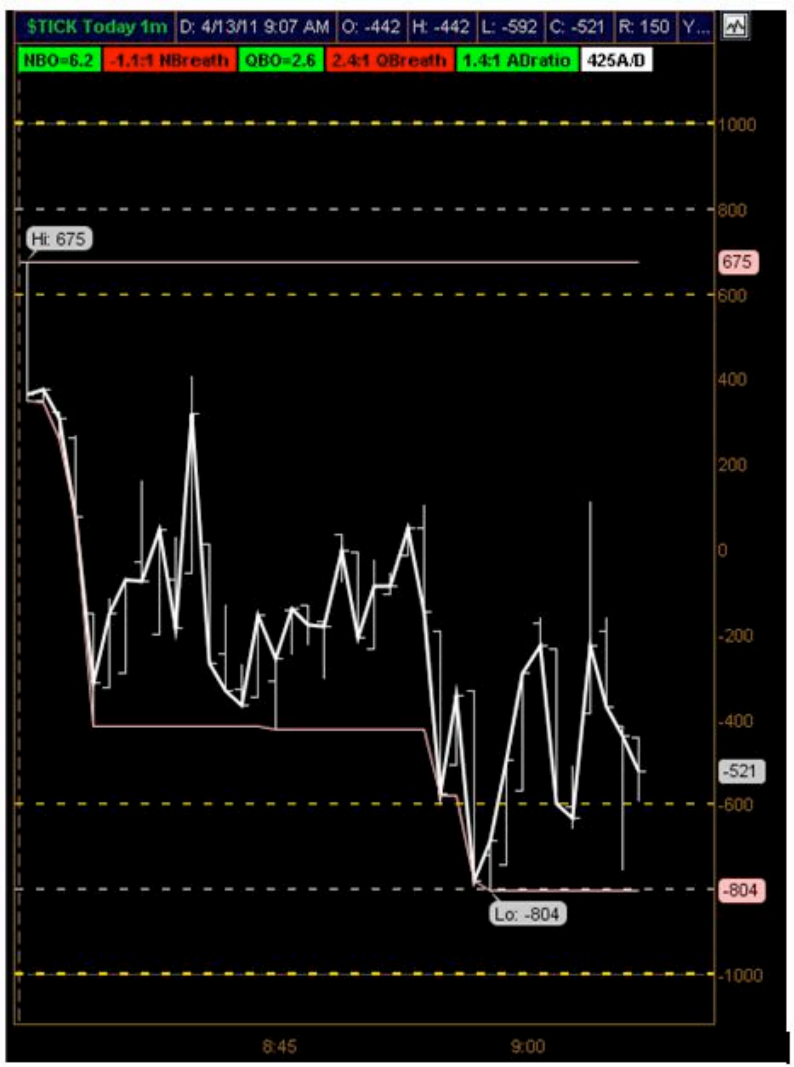
Tick

The NYSE Tick Index gives us the relationship of stocks up ticking versus down ticking at their last traded price. The Tick is an extremely useful tool for intraday traders.

For Example:

If there are 3000 stocks trading on the NYSE and 1500 trade higher from their previous price and 500 trade lower than their last price the Tick will read +1000. But wait what about the other 1000 stocks? They could be unchanged from their last price.

When using the Tick we are looking for extremes to enter or exit a trade. Tick readings of +1000 or -1000 are considered very strong as we typically trade between 1000 most of the time on the NYSE.



Tips for Using the Tick

* Tick readings within |400| indicate chop, ignore them
* On a range day you can look to fade tick extremes
* A 1 period moving average can make it easier to see the trend of the Tick

Note the extreme tick readings for the day:

* When we get a high tick and a high in price at the exact same time, this could indicate the high of the day.
* When a high tick prints without a simultaneous high price we can continue to make new highs, until a new high tick is reached (the reverse is true for a low tick followed by new lows).

Here are some live trading videos using the tick.

Market Internals Setup Instructions for Thinkorswim

- Market Internals Chart Setup
- Tick Chart Setup

10 Key Tools and Strategies for the Electronic Futures Trader

By Tim Racette

The first step to becoming a successful trader is developing a sound foundation of tools and knowledge in which to trade. Whether you're new to trading or been at it for years, the tools and strategies outlined here provide a solid foundation for a successful trading career.

Before we delve into actual tools and strategy we must address the most important aspect of trading, you. Trading successfully, above all else is dependent on your ability to fully accept the risks associated with placing each trade. If you can learn to detach yourself from the money and trade with size small enough that does not instill fear of loss, then you stand the greatest chance to succeed as a trader.

Now, let us move into the tools of the trade.

Tools:

Charting Package

My vote for best charting package is Thinkorswim. They provide the most advanced tools, with a full range of customization and features. You can think of them as the Apple of the online brokerage world.

5 Factors to consider when choosing a charting package:

- Reliability
- Quote speed
- User interface
- Data costs
- Customer service

Thinkorswim I've found provides the highest value with the lowest costs. Other platforms like Trading Technologies(TT) and CQG have incredibly reliable and lightning fast data feeds, but retain high monthly fees. Do a trial run before you commit, most platforms will let you demo their platform for free.

Order Execution Platform

I prefer to keep my charting package and order execution platform separate for two reasons.

1) It provides me with another data feed to confirm I am getting the most accurate data
2) In the case that my charting package freezes up I am able to manage my trades separately on my order execution platform (which typically take up a much smaller amount of memory to operate on your computer).

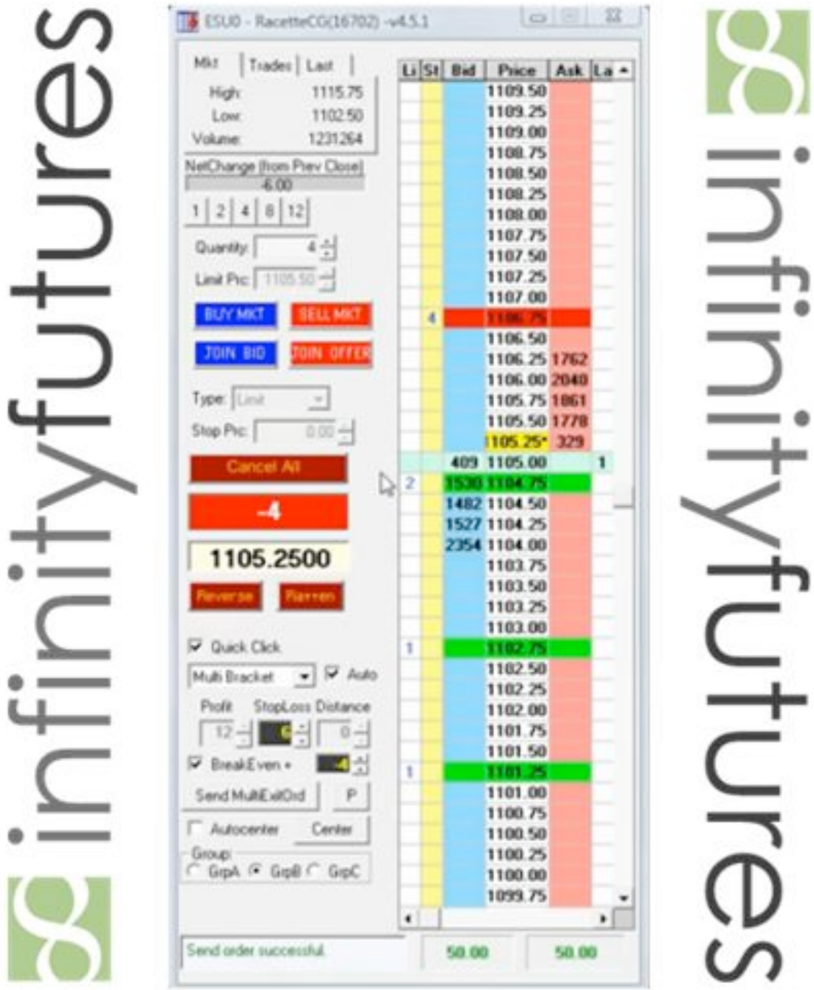
After testing out a number of order execution platforms the one I use and recommend is the Infinity Futures Active Trader (AT) Platform. They offer low commission rates, a state-of the-art trading ladder, and very reasonable intraday margins.

Oh and best of all, no monthly software fees!

Their customer service is top notch and overall quality is the best in the business. My personal broker is Anthony Giacomin, he’s offered outstanding service and rapid response in the rare case where I’ve lost power or my computer has locked up on me.

Economic Data

There are many places to gather economic data online. The best economic calendar I’ve found is at ForexFactory.com. Of course it never hurts to double check with other sites like Econoday and Yahoo.



Trading Knowledge

As I'm sure you've already discovered there is a lot of content on the web about trading. The first place to start is with the book *Reminiscences of a Stock Operator*, the classic account of trader Jesse Livermore from the early 1900s. There is a wealth of knowledge in this book.

When it comes to electronic futures trading and becoming well versed on the markets I refer people to three books…

- *Trading in the Zone* by Mark Douglas
- *Pit Bull* by Martin “Buzzy” Schwartz
- *Mastering the Trade* by John Carter

These three books cover everything from developing a winning mindset, to techniques for profiting from the markets over the long term, and the use and implementation of specific indicators in your trading. They are a must for any trader’s book shelf.

Strategy:

Think Risk First, Then Reward

The number one way new traders fail is by counting the money that could be made on the trade when they should be focusing on how much they could lose on the trade. To succeed you must be able to accept the risks and apply money management techniques such as stop loss orders, max daily loss limits, and account draw down rules.

Stop Loss Orders

In order to limit downside risk, a stop loss must be placed on every trade. It is imperative to your long term success that you do this. There is no getting around losing trades, we all have them. The key is to keep those losers as small as possible.

2 crucial rules for stop loss orders

- Stops must be placed at the time of entry
- A stop can only be tightened, never widened

Max Daily Loss Limits

To prevent the dreaded “blowing up” of your account you must place a max daily loss limit on your account. I recommend setting this loss limit with your broker.

When we are at our weakest is when our rules become the most important, yet the hardest to follow.

A rule of thumb for max daily loss limit is no more than 5% of your account balance. This ensures that you will live to trade another day and not lose everything on what is in some cases, one bad decision or mistake.

Draw Down Rules

Another way to limit your risk is to cease trading after 2 full stop outs on the day. If you have two stop outs the market is telling you that it is not conducive to your setups that day and you need to stop trading.

Chances are your profit/loss statements are made up of a handful of average days, a few big winning days and a few big losing days. If you can eliminate the big loser the profits can then emerge.

Trade with the Trend

Yes we've all heard "the trend is your friend," but how many actually trade with the trend? It is your job as a trader to identify the trend and formulate a method for entering into that trend. Once you are in the trade, your job is to stay in the trade until the trend fails.

Methods for Identifying the Trend

An uptrend can be defined as higher highs and higher lows, while a downtrend can be defined as lower highs and lower lows.

A great exercise for intraday traders is to print out a 5 or 15-min chart of the market you are trading and go through identifying the highs and lows of the day. After a few weeks you will become better able to define the trend.

Moving Averages

Whether you're on a daily, weekly, 15-min, or hourly chart, a moving average can be a great way to identify the general trend. It's important to place more weight on larger time frames such as the daily and weekly when determining the longer term trend and then look to trade with that trend on the smaller intraday timeframes.

A 20-period Exponential Moving Average is a great tool for intraday trading.

Candlestick Patterns

As talked about in the book *Japanese Candlestick Charting Techniques*, candlestick charting is a great way to identify market sentiment. The open, close, high, and low of these candlesticks have a lot more to say as compared to a bar chart. To get a really clear picture of the trend try switching to a Heikin Ashi chart.

Methods for Entering the Trend

Fibonacci Retracements

Buying on a retracement as opposed to chasing the market is a great way to enter a trend with less risk that your stop will take you out of the trade. Once you have identified a new trend try drawing from lows to highs (in an uptrend) and waiting for a pullback to the 50% of a Fibonacci retracement before going long.

Reversal Patterns

Buying over the high of a low bar (in an uptrend) or shorting the low of a high bar in a down trend are two ways to enter a trend close to its reversal. These patterns accompanied with a moving average or other momentum indicator can be a sound strategy with very good risk/reward ratio.

How to Become a Winner

Your success as at trader is determined your ability to detach yourself from the money and trading with size small enough that it does not instill fear of loss.

Most people treat trading as a hobby. To win, you must treat trading like a business. In a business, there will be losses, there is risk involved, and it is your job as CEO to limit your risk, identify the trend, and stay in the trend until it fails. In doing this you will give yourself the best chance to succeed in the game of trading, and in life.

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A Step by Step Process for Developing a Consistently Profitable Trading Strategy

By Tim Racette

Your current trading strategy blows; it's time to search for a new one. That's what a lot of traders think when they are not seeing consistently profitable results. What you probably don't realize is that you have all the tools; it's just a matter of fine tuning.

In this article I will share with you a step by step approach for creating and fine tuning a custom trading strategy fit to your personality. If you have developed a plan or are currently working on one, this process can help you uncover the specific areas that need fine tuning. Let's get started!

The Pieces of a Winning Trading Plan

Your trading strategy should fit with your trading plan like a baseball fits in a catcher's glove, comfortably. You might be wondering what the difference between a trading plan and a trading strategy is in the first place. Your trading plan is your business plan and your trading strategy is a piece of your trading plan. I break down the trading plan into two parts.

Section 1: Market Ideology

Included in this plan should be your specific goals, perhaps a motivating quote which acts as your inspiration, and your ideology towards the markets. This section of your plan is important because it gives your direction and guidance, which is especially helpful through the hard times (as there will be some).

Section 2: Trading Strategy

This is the section we will be addressing today. If you haven't completed section 1 you can read about developing trading goals and their importance in my **Getting Started** post.

A winning trading strategy should be incredibly detailed. Every possible outcome must be thought out and accounted for in order to succeed. Often times, once a trader places a trade their plan and objectivity go out the window. As the saying goes, luck favors the prepared. So take the time to develop your strategy before making that first live trade.

Outline of a Winning Trading Strategy

A trading plan may contain multiple strategies, but I recommend first going through the process of fully developing and fine tuning one strategy before moving on to a second. Once you have your first strategy to the point where you can visualize the setups in your sleep and enter your trades without hesitation you are ready to build additional strategies.

Set your risk limits at the time you open your trading account:

- Max Daily Loss: How much are you willing to lose in a day before you stop trading?

(Rule of Thumb: No more than 5% of your trading capital)

- ★ Max Loss per Trade: How much are you comfortable risking on each trade?

(Rule of Thumb: 1% of your total trading capital)

Specify the markets and times of the day you will trade:

- ★ Pick a Market: What market and trading vehicle fits your goals and personality?

While there is always a market open somewhere, the best traders focus on a select few and specific times to trade them. There are other vehicles out there besides the common Stocks, Options, Futures, and Forex. What works for one trader may not work for you and vice versa.

- ★ Pick a Time: What does your schedule allow for trading time?

Integrating trading into your already hectic schedule probably means incorporating work, family, and recreation. When first starting out I recommend sticking to the larger time frame of a daily chart rather than jumping into day trading. This is because the moves take longer to develop. You can build a strategy and your patience at the same time. Remember, speed does not necessarily equate to more profits. In most cases it’s the larger time frames that pay the biggest rewards.

Choose a Methodology

Your methodology is only a small piece of a winning trading system. Success results from perfect execution. When searching through various indicators, technical analysis studies and fundamental analysis criteria remember to K.I.S.S – keep it simple stupid.

- Picking an Indicator: Begin with price and volume

Open up your trading platform and remove all the indicators from your screen. In fact, remove everything except a candlestick or bar chart of the market in which you have selected to trade. Watch the price action and study the volume patterns for two weeks.

Print out daily charts and identify the inflection points. That is, points when the market starts moving. Go back and look for trends in volume and similar candlestick or bar formations that happen repeatedly. Once you've identified a number of similar patterns you can then introduce and indicator to help filter out the false moves and help pinpoint the best entries.

My Own Trading Strategy

Fibonacci retracements, market internals, and candlestick charts are the three tools that make up the basis of my own methodology.

If you're interest, you can check out my Trading Rules for the ES & 6E Futures.

Develop a Structure of Trading Rules

Here are some examples of general trading rules that I use:

1) Plan your trade and trade your plan.
2) Keep things simple.
3) Only place trades when you are in a calm, cool, and collected state. Do NOT trade if not in this state of mind.
4) Be selective with your trades!
5) Don't chase trades.
6) Don't buy highs, don't sell lows.
7) Never let a big winner turn into a loser.
8) If the market doesn't act as initially anticipated, get out.
9) Never add to a losing position.
10) Understanding the psychology of human behavior is more important than understanding economics.
11) You alone are held accountable for every trade.
12) Attitude influences behavior so keep a positive attitude.
13) Hold opinions loosely.
14) Don't dwell on past trades.
15) Be prepared to adapt as market conditions vary.

Establish Your Position Size

If trading contract markets such as options and futures, begin with one contract. However, once you develop a feel for the markets it will be more beneficial to move to two. This is because you now have the ability to scale out which can dramatically improve your returns.

If trading stock, use the following equation to determine how many shares to buy.

- Stock Position Calculation: $ risk per trade / $ stop

For example if your risk per trade is set to $100, and you plan to place a $5 stop on the trade you are allowed to purchase 20 shares ($100 / $5 = 20).

Things to account for before you place EVERY trade:

- Defined Entry
- Defined Stop
- Defined Profit Target(s)

Hands down this is the most important part of your strategy, defining your entry, stop, and target before you place the trade will keep you objective and thinking clearly as the trade starts to unfold.

Calculations to Help Fine Tune Your Trading Strategy

Once you've placed some trades with your strategy you can begin to analyze the data. A paper trade account is a great way to tweak and fine tune, but switching to a live trading account WILL change your results (this could be good or bad).

The more data the better, as a rule of thumb place at least 100 trades with your specific setup before analyzing the data.

Use these calculations to help analyze your data:

Winning and Losing %: # of Winners / Total # of Trades

Losing % = 100 – Winning %

Avg. W/L $ Amount: Sum of Profitable Trades/Total # of Winning Trades

Sum of Losing Trades/Total # of Losing Trades

Avg. W/L Hold Time: How long do you stay in a winner versus a loser, find the sweet spot.

Reward/Risk Ratio: Avg. W / Avg. L

(How much your winners are beating your losers)

Expectancy: [(W % x Avg. W) – (L % x Avg. L)] – round turn commission

(The average $ amount you can expect to win (or loose) per trade.

Record Keeping Tips:

Keep track of your profit loss, commission, daily winners and losers, weekly profits, and individual trade setups. This will help you spot trends in your trading and fine tune even more. In my post Ideas for Building Your Personal Trading Journal I outline some more ways to make this process easier.

Tools to Fine Tune Your Trading Strategy

- **Trading Journal Spreadsheets** – The best trading spreadsheets around.
- **Stock Tickr** – A great web based tool for in depth analysis.
- **FinViz** – My favorite stock screener.
- **Jing** – Makes capturing screenshots a breeze.

To become successful you must focus on trading effectively and not on the profit/loss. Do your research, and then act. Use this step by step approach and the tools above to guide you in developing a strategy that is consistently profitable over time.

Spotting Stock Market Winners

By Michael J. Carr, CMT

Traders like to shoot for big wins and are willing to accept small losses along the way. In the stock market, big winners unfold over years and could be a valuable core holding in a trading account. Stocks can be traded on margin and many brokers allow traders to margin stocks, futures and options in a single account. Finding stocks that can offer steady gains may not seem appealing to the short-term trader, but the potential profits and diversification could make it a worthwhile endeavor. We'll look at a couple big winners of the past to find lessons for the future and then fit that into a trading strategy.

An additional benefit of this idea is that with stock holdings, traders can reduce cash holdings. From the MF Global bankruptcy traders have learned that cash holdings have a significant degree of risk in some cases, which makes the use of margin even more attractive. No two financial crises are ever exactly the same, so the problems at MF Global will probably not recur in precisely the same way, but new and different problems will present new unknowns for traders in the future. Cash should probably not be held at a broker since the risks are unknown.

While the stock market has some volatility, the addition of futures strategies to the account should help steady the overall returns. Diversified strategies are an effective way to reduce risk. However, while futures strategies offer great potential returns, these markets are not suitable for all traders. Risk is greater in leveraged markets and without the ability to accept additional risk, traders should not use the futures markets. Traders could limit themselves to stocks, and long-term holdings could be the core of their portfolio. Short-term stock strategies can offer the benefits of strategy diversification.

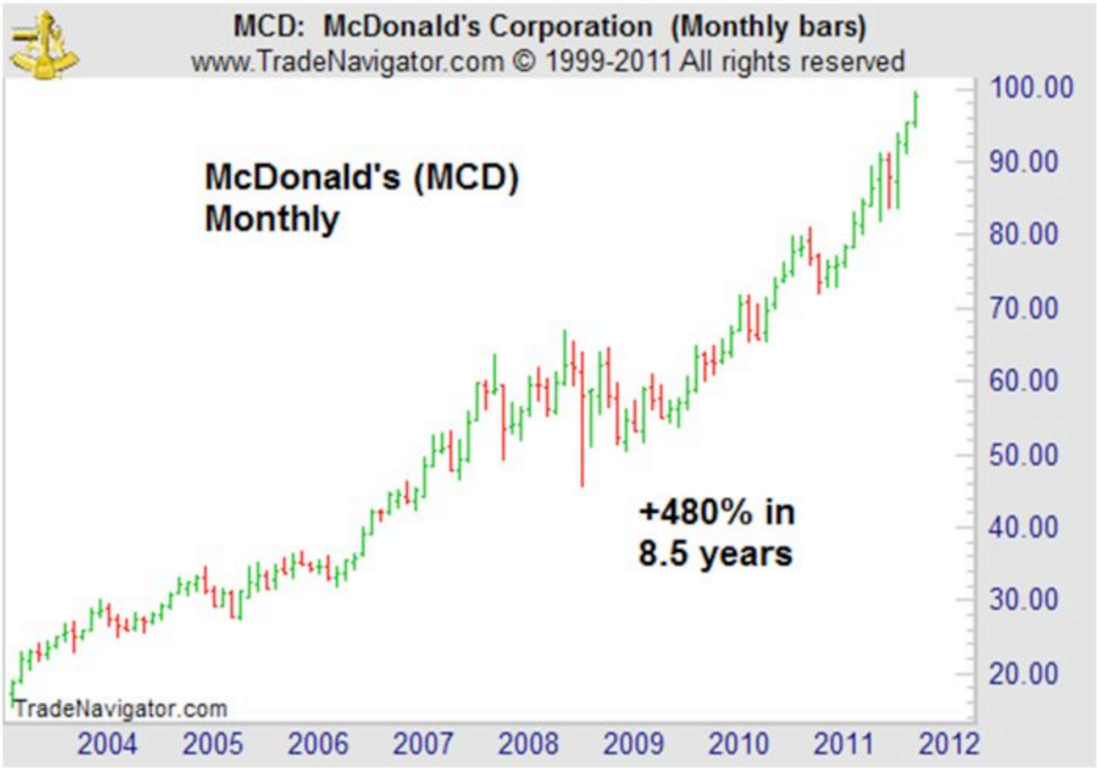
The goal of trading is to grow the account balance over time, not to be right on any individual trade or make money over a short time frame. In the long run, stocks have been shown to deliver steady gains. While many studies use holding periods of 80 to 100 years or more to define the long-term, significant returns are possible over periods of less than 10 years. In order to hold a stock for that long, it would be important to buy the ones that have the greatest chance of success.

While trading usually relies heavily on technical analysis, long-term stock market winners usually have solid fundamentals. To some degree, this means that fundamental analysis is needed to spot potential stock market winners. Fortunately, there are a number of studies available that highlight the key variables to look at. Many studies agree that the price-to-sales (P/S) ratio is among the most effective fundamental ratios.

James O'Shaughnessy's book, *What Works on Wall Street,* is being released with an update and is an exhaustive review of variables that can be applied to find winners in advance. In *Quantitative Strategies for Achieving Alpha*, Richard Tortoriello also reviews the factors that contribute to stock market success. *Beat the Market: Invest by Knowing What Stocks to Buy and What Stocks to Sell* by Charles D. Kirkpatrick, II, CMT, is yet another example of this type of research for those who are interested.

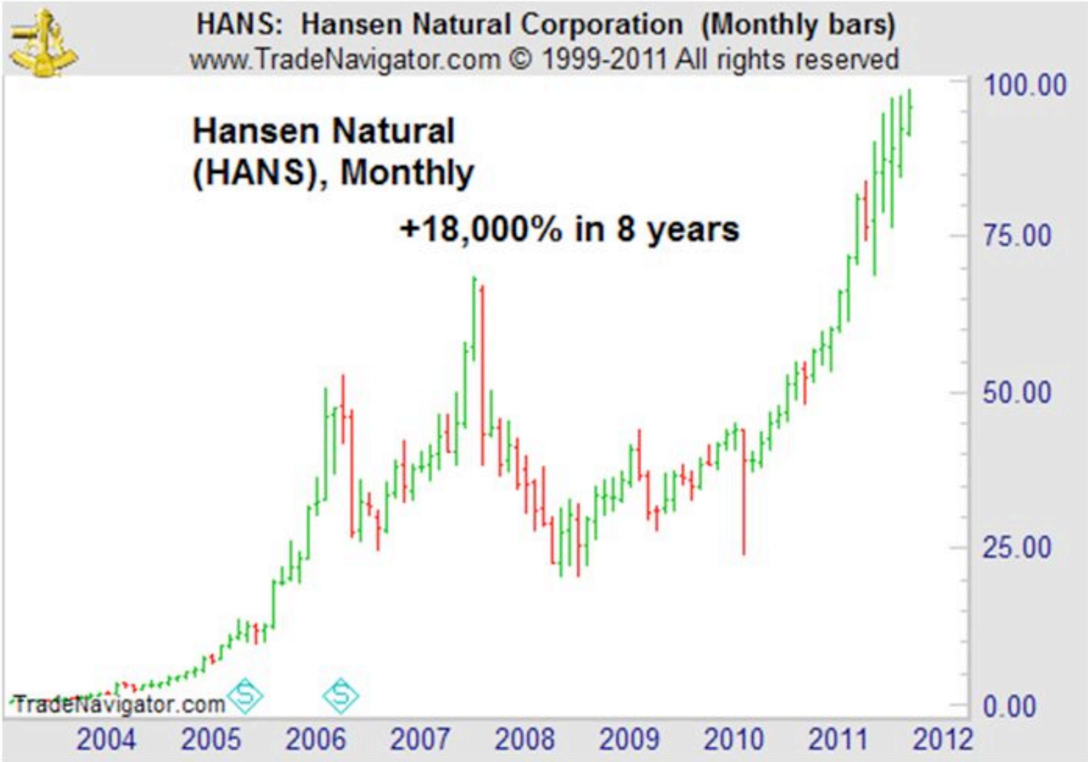
Another example of Kirkpatrick's work can be found here. This short paper demonstrates a method to combine the P/S ratio with relative strength to create a complete trading strategy with a long-term record of success.

Since the P/S ratio is consistently cited as valuable tool, traders can screen for low P/S ratios as a starting point. The only other step in the fundamental analysis process would be to verify that sales are increasing. Over the long-term, changes in sales, earnings and stock prices are highly correlated. It is difficult to find a big winner that doesn't increase sales, and the sales growth needs to be steady rather than spectacular. McDonald's (MCD) presents an example of this concept.



McDonald's has reported increases in global comparable store sales (a fundamental data point) for more than 100 months and the stock price has climbed steadily higher over that time. Overall sales growth has averaged about 5% a year during those 8.5 years, but the company has been able to compound earnings per share at a rate of 21.9% because it operates efficiently. The result has been a winning stock with annualized gains of more than 20%.

Another long-term stock market winner has been Hansen Natural (HANS). This company makes natural sodas and energy drinks and has delivered gains of more than 18,000% to investors over the same timeframe that MCD was a winner among large caps. Sales have increased more than 42% a year for Hansen allowing the company to grow earnings at more than 60% a year, and those factors seems to have been the drivers behind the jump in the stock price.



In studying stock market winners, fast sales growth is a factor that is common to the stocks that superstar mutual fund manager Peter Lynch called ten-baggers because you could make a 10-fold profit on your investment. Most of the really big winners started at a relatively low price, with HANS being about $5 a share (pre-split price) at the beginning of its run.

It is logical that the biggest stock market winners have generally started from low prices, often less than $5 a share. Bigger percentage gains seem to come easier for lower priced stocks. This does not mean that the biggest winners of the future are trading as penny stocks right now. Companies that trade as penny stocks often have no sales, and many do not maintain current regulatory filings. Penny stocks, generally meaning stocks that trade for less than $1 a share, should be considered a very speculative investment and are honestly unlikely to become long-term successes until they have a record of sales.

Traders looking for possible big winners should start with a simple screen of stocks that are low-priced and have recorded revenue gains in each of the past three years.

Margin requirements vary by broker, but some will require additional collateral for low-priced stocks. As one example, a broker may require you to put up 50% of the value of stocks you own if the price is over $5, but could require something like “the greater of 50% or $2.50 a share” for low priced stocks. You should check with your broker before screening for stocks. If they will not allow you to margin stocks trading for less than $5 a share, it might be best to screen for stocks priced between $5 and $10.

After creating a short list of possible buys, the next step should be to verify that the companies are current with all required SEC filings. It should take less than a minute to verify they have filed a quarterly report within the past ninety days and this is an added safety check that is very important if the stock is priced at less than $5.

The final step that is required in this process is to check the stock’s relative strength. You want to buy the strongest stocks. It is important to remember that Enron once had a record of sales growth and a low stock price but it was falling into bankruptcy and its stock price was headed towards zero. Adding a relative strength screen will help avoid buying the next Enron. This step would also have helped you avoid owning MF Global.

We can see the importance of relative strength by adding it to the chart of HANS.

Owning this big winner only when its relative strength rank was above 50 on a monthly chart would have captured almost all of the gains.

Relative strength rankings are available on a number of web sites and although each will be calculated in a different way, any one of them should be satisfactory for this approach. While weekly or daily rankings of relative strength can also work, using monthly data will help you to stay in the long-term winners for the greatest amount of time.

Finding stock market winners that can serve as core holdings starts with three simple screening criteria:

1) Price less than $10 (or some lower amount but usually above $1)
2) Sales growth recorded in each of the last three years
3) Relative strength rank greater than 50

Applying advanced analysis is optional, but these stock trades could be profitable and allow you to hold positions for several years at a time. When faced with multiple possible buys, select the ones with the lowest P/S ratio.

This simple analysis process frees up time to pursue short-term trading strategies. By applying strategies focused on different time frames, you should increase your chance of trading success.


HANS: 12/31/1985 - 12/30/2011 (Monthly bars) Hansen Natural Corporation — Template: RS Percentile
Fri 07/29/2005: O=10.78 H=13.50 L=10.33 C=11.55
Hansen Natural
(HANS), Monthly
+18,000% in 8 years
12/30/2011 = 96.92 (+4.72)
Buy
Buy
Percentile Rank RelStr = 86.27
2005
2006
2007
2008
2009
2010
2011
2012

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Do Stops Work?

By Michael J. Carr, CMT

One of the first lessons that new traders are taught is that one of the keys to success is to cut losses and let winners run. This almost always leads traders to believe stop loss orders should be used to cut losses and are a valuable part of any trading strategy. Individual traders also seem to place stops under the market and forget about them, knowing their losses are limited.

Before testing this idea, a single chart example can provide a dramatic demonstration that individual traders seem to enter standing stop loss orders.

Many individual traders use exchange traded index funds to invest. They believe that active managers can't beat the markets so turn to indexes as an alternative. The S&P 500 ETF Trust (SPY) is a popular ETF to use as an investment in the S&P 500. Individual investors also often believe that management fees are as harmful to their wealth as active management and they seek the lowest cost index fund. SPY currently has an annual expense ratio of about 0.09 percent. A competitor, the iShares S&P 500 Index Fund (IVV), also has a current expense ratio of 0.09 percent. At times, the IVV has been slightly cheaper and it has gained a reputation in some individual investor communities (many of whom follow the advice of index fund pioneer John Bogle to avoid all unnecessary expenses) as the preferred choice.

An investor focused on expenses and buying ETFs is most likely a do-it-yourself investor. They will learn all they can from the popular media and they will understand that using a simple stop rule would have helped them avoid the losses of the bear market that started in 2008. Implementing investment advice that they could also have obtained from The Who, they place stops about 20 percent below the market and go off to work knowing “they won’t be fooled again.”

We can see evidence of what stop orders look like in the trading of IVV and SPY on May 6, 2010, the day that the Flash Crash occurred. The Dow Jones Industrial Average famously fell about 1,000 points in 20 minutes that day and many other stocks suffered steep sell offs in that time frame. But prices quickly recovered and the markets closed almost unchanged that day.

On a normal day, IVV and SPY track each other very closely. Both opened near 116 on May 6, 2010 and both closed near 113 that day. But in the moments of the Flash Crash, the impact of stop orders drove IVV to a low of 88.42 while the SPY never fell below 105. The only possible explanation I can see is that stop orders in IVV were so plentiful and widely placed that they prevented arbitragers from keeping the IVV ETF in line with the index. An intraday chart shows gaps lower throughout the 20 minute drop and then a gap back up. At 88.42, some trader made a riskless profit at the expense of the individual who sold their holdings into panic.

Individuals with mental stops (a level below which they will sell but without an actual order entered with their broker) were able to get out of IVV the next day at a better price. The problem with stop loss orders is that sometimes they fail to protect capital and simply make the loss permanent.

One example is dramatic, but not statistically significant. Testing is needed to assess whether stops help or hurt in the long run.

Before presenting test results, it is important to understand the purpose of a stop loss order. Some think of them as a way to avoid large losses. If a stop is set at $1,000, for example, that is assumed to be the maximum loss on any single trade. This thinking ignores the reality that markets gap and the loss could be significantly greater than that. The order will be triggered when the market trades through the stop level. It will not necessarily be executed at that price. In a day like the Flash Crash, stops became market orders and were filled at significantly lower prices. Slippage of 2 or 3 percent on each order is likely to be the best case that an investor could hope for in a market decline.

Another reality is that the markets exist to execute orders. If you have a stop order entered, the market doesn't know if it is a stop loss or a stop designed to enter a trade at a better price. It is the market's function to execute the order if possible. On days where the price action comes close to your stop price, the order itself does act as a magnet for price. If the market is declining, as it did in the Flash Crash, it will reverse when all open sell orders are filled, and that is exactly what happened that day.

Given these facts, it should be expected that stops will have an adverse impact on performance.

In testing, a stop loss level of 10 percent will be used. That value is selected because a stop is intended to protect against catastrophic losses of capital. Ideally, they will help the trader avoid the largest losses.

A simple system test is to apply the MACD indicator to the e-mini S&P 500 contract. The strategy is always in the market – long when MACD is greater than zero and short when it falls below zero. Default settings for MACD are used on daily data. This very simple system is profitable on the e-mini. About 64 percent of trades are winners and the system has a profit factor of 1.20. The profit factor is the ratio of gross profit compared to gross loss. Having a profit factor greater than 1.00 signifies there is more gross profit than gross loss in the system. It is a quick way to evaluate a system but should not be used to assess the overall system's tradability. Other factors are much more important, like the worst draw down or maximum number of consecutive losses.

Adding a stop loss to this strategy hurts performance. We'll add a stop loss of 10 percent of the initial trade, selling if prices move more than 10 percent against the position on any trade. The number of winning trades declines to 43 percent and the profit factor falls to 1.12. Total profits decrease by more than 50 percent.

Results with a stop loss are a little better on a diversified basket of futures using the MACD strategy. Without a stop, 31 percent of trades are winners and the profit factor is 1.48. Adding a stop decreases the number of winning trades to 29 percent but the profit factor declines only slightly to 1.45.

The futures tested included crude oil, cotton, the US dollar index, feeder cattle, five-year Treasuries, copper and sugar. Commissions and slippage of $45 per round turn were deducted from each trade.

Using the same basket of futures, tests were also completed on the Donchian strategy. This well known system is named after analyst Richard Donchian who is considered by many to be the first to publish trading system rules. It is always in the market, taking a long position when prices move to a new four week high and reversing to a short position when price falls to a new four week low. In testing, we used 20 days and daily data although results would actually be a little better with weekly data.

This is another very simple strategy and it is also very profitable. It has a low percentage of successful trades, 33 percent in this test; however the profit factor is 2.43. Adding a stop loss to the rules degrades the performance. With a 10 percent stop, only 29 percent of the trades are winners and the profit factor falls to 2.11. A 5 percent stop loss results in only 25 percent of the trades being winners and a profit factor of 2.09.

Back test results likely minimize the damage that would be done with a stop loss order. In a fast moving market, the trade would most likely be filled at a worse price than the stop level and testing assumes it is filled with the same level of slippage as any other order.

Stop loss orders do little more than provide a false sense of comfort. In testing, they usually decrease profits. The best way to preserve capital is to have a well designed trading system with a high probability of success. The Donchian strategy described above fulfills that objective better than a more complex strategy with stops.

My Best Idea for Small Investors

By Michael J. Carr, CMT

Stocks are a wonderful investment but they will not be the right choice for small investors looking at trading for a living. A widely cited figure is that stocks return about 10 percent a year in the long run. If a successful trader can triple that, a 30 percent annual return will not amount to a significant annual salary on a small account. That represents a profit of $3,000 on a $10,000 account and many traders will start with less than $10,000. Assuming that 30 percent gains were steady, it would take about 8 years to reach $100,000 and an annual income of $30,000 with all profits reinvested for the first 8 years. Starting with a smaller amount would require even more time to grow a $100,000 trading account. There is also no guarantee that 30 percent returns could be achieved and the odds are that returns would be sharply lower.

To make big money, or just to make enough to earn a living, a small investor must use leverage. Foreign exchange is usually thought of as a high leverage investment. It is not suitable for all investors because it is a fast moving market and requires a large commitment of time. Another reality small investors must face is that time is a limited commodity and they will be working at a full-time job which limits the time available for trading. Ideally, a forex trader will be glued to their charts and this is incompatible with a full-time job. Dedicating a few hours in the evening to trading could be productive some nights, but other nights the markets won't move during that exact time. In the end, there can be no assurance that the trader will make money consistently.

My best idea for small investors is to turn to the futures markets. Commodities have been the source of some of the most legendary trading fortunes, like that of George Soros. They offer a high degree of leverage and risks can be managed to avoid catastrophic losses. This market offers the best chance for a small trader to make a living trading quickly.

The next question small investors need to face is how to trade. A disciplined approach with objective criteria is usually best for beginners.

There is a seemingly easy approach that is not likely to work. Charts are visually appealing and seem to offer clear cut signals, but that clarity is really only available in text book examples. In the real world, in real time, even experienced analysts will disagree on how to interpret charts. There is also a tendency to interpret the charts in a way that validates the trader's bias – bullish traders spot patterns that tell them to buy and bears see sell signals in every chart. With so much discretion, success ultimately comes down to luck.

While technical analysis is usually associated with charts, there is more to the discipline that. Technical analysis also includes a number of indicators that can be applied in a consistent manner to maximize the chances of winning. Traditional indicators apply different mathematical techniques to price – adding, subtracting, multiplying and dividing prices in a variety of ways to generate signals. All have their advantages and disadvantages, and all require time to understand. Given the assumption that time is a limited commodity for small traders, this means that new traders often try to apply indicators without understanding them. As with chart reading, this is an unlikely path to success.

Realizing that indicators are simply reinterpreting price data, we can cut out the middleman so to speak and use nothing except price in a trading strategy. The advantage of this idea is that we will minimize the tools required to trade. Closing prices can be tracked in a spreadsheet and signals generated without needing specialized software.

My best idea for small investors is to use a simple strategy. Buy when price reaches a new four week high. Sell and enter a short position when price sets a new four week low. This is a strategy known as the four-week trading rule.

With forex, traders can start with a very small account and that is appealing to many small traders. Some futures contracts offer low margins and are suitable for small traders. A general commodities index, the CRB Index, has a margin of only $400 at some brokers. It is a very good trending market and profitable with that simple four-week trading rule. The chart below shows winning and losing trades with winners marked by green boxes and red boxes signifying losses. Since the beginning of 2000, the system has averaged about one trade a year. It is always in the market long or short, winning about 80 percent of the time. On a single contract, it offers an average annual return of about 20 percent a year. As profits mount, you can use the gains to add contracts and build equity faster. It is a great futures contract with a low margin and is an excellent way for new traders to learn the markets and build a larger trading account.

Margins in Fed Funds futures are about $500 per contract. These contracts have very low volatility and they are also a great starting point for new traders. Another example of the trading strategy applied to Fed Funds futures is shown below.

Treasuries are also low margin contracts with strong trending characteristics. As additional capital accrues in the account, or for traders starting with higher initial balances, the Brazilian Real, US Dollar Index and sugar are contracts with strong back test results using the four-week rule.

New traders should avoid complexity and stick with the simplest methods as they learn the markets. The four-week rule is a strategy that has been written about since the 1970s and it has withstood the test of time as a winning trading plan.

Traders need realistic expectations, and this is especially true for small and inexperienced traders. Small account balances will yield small dollar amounts in the stock market but can be leveraged for superior returns in forex or the futures markets. Of the two, trading futures is more likely to deliver steady returns for the part-time trader.

My best idea for the small trader is to apply the four-week rule in futures markets with low margins. You should add additional markets as your account size grows, and it is very possible to be trading for a living fairly quickly.