

Course Schedule

PART 1- The Mental Game. Most traders believe that correct trading patterns or setups are the ultimate key to success. Lewis strongly disagrees! Knowing yourself first is more important. In Part 1, Lewis will teach you how to identify the proper trading style that is best suited to your personality and how to take advantage of your innate style to gain insight into your trading and improve your results. You will then learn how to use this knowledge and apply it in the upcoming weeks' lessons.

PART 2- The Trend. One of the toughest things traders encounter is how to identify if today is a trend day or a range-bound day. Knowing how to trade in these two very different environments is a major key to most professionals' success. In Part 2, Lewis will show you how he identifies these two distinct trading environments and how you can exploit characteristics of each.

PART 3- Executing - Part I. Building upon the first two weeks' lessons, in Part 3 you will learn where to enter, when to exit, and where to place your stops in the S&P and Nasdaq 100 futures. You will also be taught when and how to scale into and scale out of a position, and how to properly evaluate the risks vs. rewards before entering a position.

PART 4- Executing - Part II. In Part 4, Lewis will teach you how to read daily and intraday charts, how to exactly pinpoint support and resistance areas, and how to trade pivots and breakouts. Also, as an added bonus, Lewis will show you how to determine a "false breakout" vs. "the real thing." Not only will you be able to apply this knowledge to stock index futures trading, but you will also be able to apply it to other major markets as well. Finally, at the end of this lesson, you will learn how to trade economic events, including the release of significant reports such as PPI, CPI, and key employment reports.

PART 5- Executing - Part III. In Part 5, Lewis will share with you how he uses stocks to foretell the futures markets and how he uses futures to foretell the movement of key stocks. Also, Lewis will teach you the best momentum and sentiment indicators he uses to enter and exit the markets.

PART 6- Trading The Nasdaq 100. A special focus on the Nasdaq 100 futures market. You will learn how this volatile index differs from the other stock index futures and specific strategies for trading it.

PART 7- Direct Access. In an effort to make sure you fully understand the material you've been presented, Lewis will answer any and all of your questions. Please submit these questions to questions@tradingmarkets.com and a special web page will be posted during Part 7 with Lewis' replies to your inquiries.

Dear Fellow Trader,

Welcome to my seven week trading course!

To trade effectively, you must first have a plan, laying out a strategy for the upcoming trading day. Your plan should encompass your mental preparation, your technical analysis of the market, entry and exit points, and the nature of the market, itself.

In this Seven-Part Course, I'll lead you through the highlights of devising a plan to trade. Our focus is on Stock Index Futures - in particular, S&Ps and NASDAQ - but many of these lessons can be applied to any market. My goal is to help you - whether a novice or an experienced trader - to trade better by preparing better.

In Part 1, we examine the first step in devising a plan - preparing mentally for the trading day. You can't just start trading without mental preparation any more than a professional football player could just suit up and go out on the field. This mental preparation underscores what I consider to be the first requirement of trading - discipline.

Discipline is what enables you to devise a trading plan, execute that plan and stick to it when things don't go your way. With a little discipline, you may have a little success. With more discipline, your successes will be more frequent and more consistent, and a totally disciplined trader will have the best opportunities of all.

In Part 2, we'll examine the personality of the market. In order to devise a trading plan, you must know, for example, if you're in a trending market or a range-bound one. I'll share some hints and advice on how to tell the kind of market you're trading - and how to learn from your mistakes.

In Part 3, we'll look at trade execution with entry and exit points and stop-order placement. We'll discuss risk and reward, dealing with losses - and wins, and how to keep your focus when everyone else in the market is losing theirs.

In Part 4, we'll go a little deeper, looking at false signals and breakouts. I'll share my advice on when it's best to be on the sidelines, and when - and why - it is important to vary your trading size and your stop-order placement without increasing your overall risk.

In Part 5, we'll examine how to use stocks and other indicators to help you trade futures. Traders should use every tool at their disposal to improve their performance. We'll discuss some of our favorites.

In Part 6, we'll look at trading the NASDAQ, a high-octane market that's dominated by the tech-sector and has been known to make some pretty wild moves in a day.

In Part 7, we'll answer the questions that you've generated - so be sure to e-mail your queries throughout the course.

Most of all, I hope to give you an insight into my mental and strategic processes as I trade the futures markets, where I've spent nearly 20 years. While a trader's style is unique - a reflection of personality, preferences, risk tolerance, and so forth - there are some things that remain constant. Among them (and at the risk of oversimplifying) is that basic law of trading: Buy low, sell high. It may sound easy, but to do that requires intense preparation and discipline each and every day.

Good luck - and good trading.

Lewis J. Borsellino

CEO and Founder, TeachTrade.Com

THE MENTAL GAME

Trading is a mental game. The best trading system, the most accurate technical analysis, the best online order-entry system, and the fastest Internet connection won't help you if - FIRST - you're not psychologically prepared for trading. When I teach about trading, I use a lot of sports analogies because I believe there are a lot of parallels that can be drawn between the two endeavors - the intensity, the emotional highs and lows, the risks and the rewards.

Just as every serious athlete has a mental routine before each game, so must you prepare psychologically each day before you begin trading. That preparation is just as necessary for a veteran like me, who has been trading nearly 20 years, as it is for the newbie. Granted, our preparation may be slightly different, but it will encompass the same factors:

- Clearing and centering your mind.
- Preparing/Studying indicators and technical analysis.

Let's take the first one - Clearing and centering your mind. At this point, if you're saying to yourself, "Come on, I want to get to the indicators and trade set-ups," then you really need this step. You cannot dive into trading any more than a professional football player would just suit up and go out onto the field. You must have some ritual each day to separate your trading from the rest of your life. The purpose is to clear your mind of distractions and to get centered. Trading is serious business. Treat it that way.

Your choice of mental preparation will be a personal one. For me, my favorite good-weather preparation is to chip golf balls onto the green for an hour-and-a-half each morning. Or else I'm on the treadmill. Maybe you jog, meditate, do Tai Chi, whatever? There must be an activity (I prefer a physical one) that tells your mind, "Okay, the rest of my life is being put aside. I'm preparing for trading."

I've seen so many talented young traders "blow it" because they lacked the discipline or the ability to take on risk. Either they took on too much risk and lost all their capital in one or a few trades, or else they became the proverbial deer in the headlights when it came to risk. The underlying factor, I believe, was they failed at the mental game of trading.

The first rule in trading is to "know thyself." If you can't control your own emotions, keep your ego in check, and remain, at all times, disciplined, then you can't succeed. It's as simple as that.

Most importantly, you **MUST** control your emotions when it comes to losses. Novice traders don't want to think about losses. They only want to think about how much money they can make. The truth is, losses should **ALWAYS** be on your mind. Why? Because losses are what will take you out of this game. Profits take care of themselves - if you keep the losses to a minimum.

PSYCHOLOGICAL PREPARATION PLAN

What does it mean to be psychologically ready? It means you have to get your head in the game before you put your money on the line. Here are a few steps to help any trader - veteran or novice - become psychologically prepared for the trading day. Even after 20 years as a trader - much of it spent in the S&P pit - I still go through these steps.

Step 1 -

Prepare your indicators. Whatever you use as a guide, you must study before you begin trading. This will not only refresh your memory as to where the market has been - where there are key support and resistance levels, for example - it will also put your mind in the market.

Step 2 -

Clear your mind of distractions. You can't trade if your mind is elsewhere. If your money is in the market, your brain had better be there, too.

Step 3

Have realistic expectations about your own physical and mental limitations. You cannot expect to sit in front of the screen from 8 a.m. CST until 4 p.m., five days a week, without taking a break. Work smart. Concentrate your trading time during the first 90 to 120 minutes of trading and then take a break. Regroup your thoughts. Do some research, and then prepare anew for the final 90 to 120 minutes of trading.

When I started out in the futures market some 20 years ago, I was both filling orders for customers and trading for my own account, as was allowed in those days at the Chicago Mercantile Exchange. I had to be in the pit, bell to bell, to fill customer orders. But when it came to my own trading, I saw that the best opportunities for me were usually from the open until 10 a.m. CST and then again around 1:30 p.m. until the close. The rest of the time, I usually got chopped up.

So, much of trading is really trial and error. Your mistakes will be your best teachers, which is why I always tell new traders, "You have to love your losers like you love your winners."

Step 4

Avoid trading during times of personal problems or disruptions. If something is weighing heavily on your mind, it will distract you from trading. Even positive events - such as the birth of a child or buying a new house - can affect your trading. For example, when we moved offices in February 2000, we were out of sorts for a week. Our data lines were not in; our phone lines were not completely up and running. In plain words, it was not an ideal environment for trading "upstairs" at the screen. Because of this, we had to limit our market activity. When you're in personal turmoil or in the midst of big life changes - both positive and negative - be careful of your trading activity.

Step 5

Know that you will have bad days. You must be able to bounce back psychologically the next day (or the day after that) and look at the market and your trading with a fresh perspective. You can't come in the next day, psychologically carrying your losses from the day before. Here's what I mean: You can say, "Yesterday I lost a lot. If I don't make that money back today, I'm in trouble...." OR you can say, "I made some mistakes yesterday that cost me, but I've learned a few things. I had better start out slow today, make some profits, and then move on." Believe me, the latter is a far better mental attitude for success. Granted, when you're going through the loss, it's very painful. But exiting a losing trading provides a tremendous amount of clarity and even relief in some instances. It's not the end of the world if you lose money. It's only a problem if you let those losses eat at you and cloud your judgment.

Step 6

When you have a loss, take it. The most common mistake among our junior traders is trying to "get even" or "scratch" a trade. A scratch is not necessary. If you have a losing trade, get out. Accept the fact that you made a bad decision. End it, and move on. When you can accept the fact that you will have losses, it's a big psychological shift that can greatly improve your performance.

Just one thing about "scratches" though: If you put on a position and the market doesn't do much of anything and you exit with a scratch, congratulate yourself for having the discipline to exit a trade before it turned into a loser. A scratch is a "winner."

MENTAL DISCIPLINE

Mental discipline is as necessary for me as a veteran trader as it is for a novice. In fact, experienced professional traders face a special breed of mental demons, borne of their own successes. And to be truthful, these are demons I've wrestled with myself on several occasions, situations such as:

- Focusing on a monetary goal instead of the market.
- Forcing a trade. Making a trade when market conditions don't warrant it.

The two go hand-in-hand. The situation usually happens like this. You go into the market saying to yourself, "I'm going to make a lot of money today." Or maybe you say to yourself, "I NEED to make a lot of money today. I want to have a big day. I need to have a big day today." Your motivation may be anything from previous losses to the need to make a down payment on a house.

Complicating matters is the fact that you've had big days before when the market presented opportunities for large profits. That makes it all the more tempting to believe that you can pull it off again. But if the market conditions don't present themselves, you're forcing trades that won't materialize. You will trade too big, risk too much. Instead of the big profits, you may end up with big losses.

School Of Hard Knocks

I can tell you from my own school of hard knocks that there have been times when I've been up \$17,000 and I'd like to make \$3,000 more - just to have that nice round profit number of \$20,000. So I stick around for the extra \$3,000, even though the market may have quieted down and there aren't that many opportunities to trade. And you know what happens next? I end up losing all of the \$17,000.

Or I'll be down, say, \$15,000 and I'll stay in the pit to make it back, even though the market conditions aren't there. What happens? I lose even more. Or take a day like I had recently when I made \$42,000 in a morning. Then the next day, it's dead quiet in the pit. I know better than to stay there. But I do ... and I lose \$80,000.

Your best days happen when you're prepared and the market presents the opportunities. The more volatility, the more opportunities you'll have to make money. Daytraders and short-term traders thrive on volatility. But when ranges are tight, volume is light and the market is slow, don't trade. You can't make the opportunities happen. Just keep working on your mental game. Study the market. On days like that, keep your mind in the market, but your money out.

This underscores a trading maxim that is as important for novices as it for experienced traders: **Trade the market, not the money. Think about making good trades, not about making money. Focus on the trading process. If that process is sound, the outcome will be a profit.**

NO EXPECTATIONS

As part of your mental preparation, you must not have any expectations about your performance. Your emphasis must be on the opportunities presented by the market that day, not on having a "big day." As we discussed in Point #5 of the Psychological Preparation Plan, if you've suffered previous losses, you can't think about "making it all back." Rather, it's time to slow down and take extra care to prepare for that day's trade. You should cut down your trade size and make a few small profits to gain your confidence. Get back in sync with the market.

Your concentration must be on making good trades, not on making money. As soon as monetary objectives enter the picture, you will be distracted. Emotions begin to rule your trading, and you'll be distracted. To trade successfully, you must be emotionally quiet and focused on the market.

As a trader, you must be methodical about the trades that you make. You put a trade on because you believe the market is going from "here" to "there." If not, you know where you'll exit with a pre-set loss level. If you have anxiety about making a trade, then emotions have entered your mental landscape, and your decision process will be negatively affected.

When emotions infect your trading process, you'll soon find yourself in the "wishing, hoping, praying" mode. Instead of making a decision based on your technical research, you'll be "hoping" that the market turns your way to wipe out a loss instead of exiting an unprofitable trade and beginning anew. And believe me, "hope" is not a trading method.

PREPARING YOUR INDICATORS

Once your mind is ready to trade, it's time to focus on the market. In fact, the preparation and study of your indicators and technical analysis of the market go hand-in-hand with clearing your mind of any outside distractions.

When I began trading, I would pour over price charts for an hour every morning, committing the prices on the paper to my memory. Today, my technical review time is compressed. For one thing, as a large independent trader (or "local") at the Chicago Mercantile Exchange where I trade S&P futures, I am on the frontlines of the market every day; I am part of the market every day. In addition, I employ the services of technicians who provide a synopsis of the market and indicators.

As we'll discuss in Week Two, you cannot devise a trading plan without first studying previous market patterns. Looking at such things as previous highs and lows, moving averages, and so forth, you can determine the type of market you're in – rangebound, trending, or setting up for a trend-reversal.

My technical study of the market spans the macro to the micro. I'll look at price patterns over the past year, half-year, month, week, day, hour and even minute. I'm looking, in particular, at where the market is at that moment compared with the high and low for the year, month, week, day, and in relation to recent moves.

While I focus on S&Ps, no market moves in a vacuum. That's why at the start of my day, I look at what happened overnight on Globex and in overseas markets. I want to know what the market reaction has been to news that has come out overnight, and I want to know what news events – such as major economic reports and/or speeches by Greenspan – are scheduled for that day, which may also have an impact.

I also want to look at what's happening in other markets, which might influence the tone, if not the direction, of the S&Ps. In August 2000, for example, the S&Ps have been outperforming the NASDAQ futures. However, sporadic selling pressure in NASDAQ has been tempering the moves in the S&Ps.

Regardless of whether you're an active daytrader or a short-term trader waiting for the next set-up, you must dissect the market every day. You have to see where the market is, where the market has been and, based on that technical study, where it's likely to go (as we'll discuss in Week 2 of the course).

In time you'll be able to couple technical analysis with your own experience, recognizing patterns that you've seen numerous times. What develops is a kind of "gut instinct" that's really equal parts of technical analysis and experience in the market. You place trades based on the probable outcome, gauged by what you've seen or experienced on numerous occasions.

INDICATOR PREPARATION EXAMPLE

Here's an example. In our "Morning Meeting" recently (at which the traders who work for me and I discuss the market), we identified good support in the market at 1470.50. Further, we knew that 1478.50 was a 50% retracement level of a recent major move. Above that, we saw 1491.40 as a 61.8% retracement level. (As we'll discuss in later sessions, we believe that key retracement levels - 38.2%, 50%, 61.8%, 88% -- act as magnets in the market.)

In the S&P trading pit at the Chicago Mercantile Exchange, I perceived the market firming up at 1470.50 with solid buying activity. At that point, I knew that the market had made a bottom, and I jumped on the long side. I played the long side all the way to 1478.50, the 50% retracement level, at which point I exited.

What were the factors that played into my decision-making process? Our technical research that identified support at 1470.50 and a retracement level at 1478.50; my perception of the market firming at 1470.50; and my experience that told me the market should at least hit that retracement level.

Now the market later moved higher, going to 1490.50. But I was out of the market (and in meetings) by the time that happened. I didn't bemoan money I "could" have made by hanging in there. Rather, I executed my trade from 1470.50 to 1478.50 based on my experience, my perceptions and, above all, my technical research.

DEVELOPING A MARKET "FEEL"

Every golf instructor I've ever studied with has told me about "visualization." When you step up to the tee, you see the shot that you need to make. In your mind, you see yourself making that shot. And then you execute the shot.

There is an analogy that can be drawn to trading. Granted, you cannot make the market move a certain way just by thinking. (If only that were true.) But you can develop a market "feel," a sense of "knowing" that will help you to identify and execute low-risk, high-probability trades - as long as it's based on thorough technical analysis.

Your technical analysis will encompass the recent highs and lows, support and resistance levels, and key retracements. Then, since I've been a part of the market day in and day out, I know the "feel" of the market as it gets bogged down in a range, is choppy and thin, or builds momentum for a breakout. From this perspective, I can then "visualize" the likelihood of the market making a particular move.

- Technical analysis plots the course.
- Market behavior sets up the trade.
- Based on my experience, I can "feel" (or "know") the likelihood of the market making a particular move.

WHAT KIND OF TRADER ARE YOU?

Any discussion of the mental game of trading must, obviously, focus on the individual trader. Over the past few years, daytrading has exploded. The Internet and electronic brokerages have made accessibility to the market greater than ever before. People who would normally consider themselves buy-and-hold investors are trying to make shorter-term plays in the market and calling themselves "daytraders."

Those of us who have traded futures are among the original breed of "day traders." On the majority of days, I go home "flat," without a long or short position. Day trading has been my living for nearly 20 years. But like everyone else, I followed a learning curve that had plenty of tough lessons along the way. What many novice traders don't plan on - and as the veterans among us have experienced - is the fact that you'll be lucky to break-even the first year you trade. In fact, I tell the young traders I bring on board that I don't expect them to turn a profit the first year. What I want to see them do is make a lot of small trades to build their knowledge of the market, and their skill and confidence in executing trades.

Remember, to be a successful daytrader, this must be your primary professional endeavor. It will be how you pay your bills, finance your mortgage and pay your kids' college tuition. Can you handle that reality and still trade with a clear head?

The average Joe and Jane investor like to believe that they are good "traders" when they pick stocks that go up, courtesy of a bull market. (The common adage for this is confusing brains for a bull market.) This year-to-date, we've seen a big spike up, a big spike down, and now a range-bound, consolidating market. These are the market conditions that reveal just who the really good traders are. A good trader has the ability to survive, and indeed thrive, in all types of markets - bull, bear and range-bound.

A daytrader can find opportunities each day and intraday, whether buying dips and selling rallies within the range, or looking for the breakouts to the up or down side. They are 100% technical. The price, time and market momentum are their guides.

Others may discover that they do better on position trades of a few days, or even longer. They combine the technical with the fundamental. Perhaps they are more patient and, perhaps, more cerebral. They are studying a company, dissecting the dynamics of the market, and placing trades infrequently - but expect to make trades that have a big payoff.

Daytraders, by definition, are making frequent trades, only a percentage of which will be winners. (In fact, as we'll discuss later, if your risk/reward ratio is 1:2 or better, you can have only 40% winners and still turn a profit.)

At the end of the year, both the daytrader and the position trader can make a substantial living. The importance, however, is first to know what suits you best, because if you're trading outside your style or personality, successes will most likely be short-lived. No one can answer that for you. There may be some trial and error involved. Perhaps you love the fast action of "scalping" in and out of the market, moving quickly and decisively. Or perhaps you enjoy being more strategic, plotting longer-term moves.

Whatever your choice, be aware of your own style. And keep in mind that you can have different styles in different markets. For example, I don't daytrade stocks. In stocks, I'm definitely an investor. But when it comes to S&Ps, I may trade 3,000 contracts a day!

How do you know what suits you best? Again, use your own trading as a guide. Keep a log of every trade you make: time in, time out and size of trade, Did you enter on the long side? The short side? What was your profit? What was your loss? This log will be your guide throughout your trading career. You'll see how and when you make your best trades. The results might surprise you. As we'll discuss in later weeks, your trading mistakes will tell you much about your own style, how you can improve and what type of market conditions suit you the best. But first, let's take a look at three types of "traders" - the trend-follower, the "fader" and the break-out player. Over time, you may combine all three of these. But when you look at your own trading log, you'll see the kind of trades you make the most frequently and the kind of trades that have the best results.

Trend-Followers, Faders and Break-Out Players

When you're a beginner trader, you may find it's easier - or at least more intuitive – to follow the market. The market goes up and reaches a high and starts to fall, so you sell. Then the market bottoms out, reaches a low and starts to rise and you buy. This is a buy-after-the-dip-and-sell-after-the-high strategy.

For example, say S&Ps trade from 1475 to 1476.50 in two minutes. The trend-follower will be looking to sell after the market makes its high. Conversely, if S&Ps fall from 1475 to 1473.50 and then start to move up, the trend-follower wants to buy.

The other kind of traders are those who like to "fade" the next move. They're watching the same upward and downward movements as the trend-follower, but they're noticing something else. They're seeing that the momentum isn't quite "there" when the market approaches its peak, or the selling begins to die out as the market approaches the low. So they buy (or attempt to) just before the dip and sell just before the break.

Using the previous example, when S&Ps move from 1475 up to 1476.50, the "fader" would be looking to sell if he/she perceives that this rally is not going to continue. The "fader" may sell, for example, at 1476.30 or 1476.40 – where his/her price targets indicate. Or, when it moves from 1475 to 1473.50, the fader wants to buy before the market makes its upward turn.

Breakout Players

Or a trader may want to play the "breakout." Using the example, as S&Ps rise from 1475 to 1476.50, the "breakout player" may believe - based on technical analysis - that the market is building for a breakout. Resistance at 1476.50 is wearing down. The next target is 1480 or 1481, or whatever the charts indicate. Conversely, as the market falls to previous support of 1473, the trader believes the market is going to extend to the down side to 1470 or 1468 or whatever downside targets have been pinpointed.

Now, experienced traders may combine all these styles with varying time frames. For example, I may be bullish overall on the day, but I'll scalp - in and out of the market - as the market gyrates on its way (hopefully) upward. In one instance, I'm looking for the break-out move, but in the meantime, I'm trading through a series of fake-outs before the "real" move comes.

How do you know what suits you best? Again, go back to your trading log. What kinds of trades have you been making? How successful have you been? More importantly, what kind of mistakes have you been making? Are you following the trend, only to have the market rally in your face after you've sold what you think is the top? Do you buy what you believe is the bottom, only to have the market suddenly drop through old support? As we'll discuss in Week Two, it's vital to know the **personality** of the market that you're trading. If it's a range-bound market, you can buy dips and sell rallies more effectively than if it's in a break-out mode.

As we'll discuss, your strategy will be based on your study of the market in a variety of time frames - from long-term charts - yearly, monthly - to shorter-term periods such as weekly, daily, hourly, five-minute, and down to a tick-by-tick basis. The patterns on these charts may look similar. But what you're looking for are those times when the breakouts are likely to occur or a reversal will happen. By studying the charts, you can manage your positions, including for the day and intraday.

And no matter if the market is range-bound, trending or breaking out, remember, it's your mental preparation that gets you in the game - and keeps you there.

WEEK IN REVIEW

I've been asked countless times about the "secret" to trading. It's not a formula. It's not an indicator or a system. It's a one-word answer. **DISCIPLINE**. Without discipline, you're not going to succeed - even if you have every trading tool at your disposal.

The most important part of being - and staying - disciplined as a trader is your psychological preparation. Each day you must put your head in the market before your money is on the line.

1. Do your homework. Study your charts and indicators. Read up on the stocks and markets that you're trading. What economic reports and events might affect the market that day?
2. Clear your mind of distractions.
3. Trade smart. You might not be able to handle at the screen eight hours a day. Focus your efforts in a time frame that best suits you. Monitor yourself for how and when you perform the best.
4. Accept the fact that you'll have bad days, or a string of them. Losses in trading are inevitable.
5. When you have a loss, take it. Don't hang on hoping to "break even."

Remember, trading is a mental game. As any professional golfer has a routine before a shot, as any professional basketball player goes through the same preparation at the free-throw line, so does every trader. Train your mind as you hone your trading skill.

FOR THE INDIVIDUAL TRADER:

Ask yourself these questions:

- What kind of preparation do I do EACH DAY before I trade? Do I enter the market feeling prepared for the day session?
- When am I the most active in the market? At the open and the close? All day? When do I have the most profitable trades?
- Can I keep my head in the market? Am I distracted by other things in my life and/or environment?
- Does the fear of losses cloud my judgment? Can I take a loss and move on?

In the next section we we will get more into specific technical matters. See you next week.

Welcome Back To Week Two Of The Course

Trading comes down to one simple objective: buying low and selling high. The problem, of course, is that in between the inevitable rise and fall of the market there can be a lot of whipsaws, stalls, gyrations and breaks in both directions. A market that looks like it is moving higher may encounter resistance that sends it sharply in the other direction. Or a market that has been grinding lower can suddenly react to positive news and take off like the proverbial rocket, causing a scramble to cover short positions that propels the market even higher.

As difficult as the market is to predict, there are some rules that can help you to determine the likely direction the market will take. This will also help you to see whether the market is range-bound or trending in one direction or another. Once you know the personality of the market, you can better determine the strategies that will best suit these conditions.

For example, if a market is **range-bound**, trading between previous highs and lows, the best strategy may be to pick the places at which to fade the tops and bottoms (buying as the market tops out and selling as it approaches the bottom). Or, if the market is setting up for a **breakout**, you are going to look to buy the highs and/or sell the lows.

At all times, your guide will be your **technical analysis**. Perhaps you are doing the chart analysis yourself. Or, you may subscribe to one or more technical analysis services that pinpoint support, resistance and key retracement areas. Whatever the source of your technical analysis, you must have at least a basic understanding of the chart patterns that the technicians are studying.

I remember when I started out in the trading pit filling orders some 20 years ago. As a young broker still on the learning curve, I saw that customer orders would come into the pit, sometimes within 50 cents of each other. Or else buy and sell stops that were way off from the current market would come in from a customer. More often than not, the market did move to those price levels, converting stops to market orders. What I saw in the order flow around me was the result of technical analysis conducted in dozens of trading rooms and offices.

Once I, as a trader, could identify price levels using technical charts and analysis, it was like I had a footprint diagram to learn to tango. I could follow the steps and dance with the market. (Of course, there are days when the market stomps on you?)

It is impossible in this venue to go over every variation of charts and patterns. Technical analysis is both art and science, and volumes have been written on the subject. My goal is to go over some of the more familiar patterns and indicators that I look at, which may also help you to analyze where the market has been to determine where it is likely to go.

The Trend...

Many traders start out looking for the "trend." Simply put:

- An uptrend is higher highs and higher lows.
- A downtrend is lower highs and lower lows.

Think of a price chart as the cross-section of a mountain range with a series of mountains of increasing altitude, separated by dips in between, with each of these "valleys" higher than the one before. A downtrend is the opposite, descending to lower highs and lower lows (lower peaks and lower valleys).

Of course, as discussed in Week 1, there is a subjective – or psychological – component to trading, which can sometimes cloud or undermine the objective part. The subjective component involves how well you know yourself, your discipline, your risk tolerance, and your trading timeframe. (In upcoming weeks, we'll also discuss how the subjective and objective sides of trading come together in trade execution.)

But for now, let's take a look at the objective side. The easiest place to start is with a few daily charts. Just looking at chart of recent market prices, you can begin to see patterns with a loose symmetry of peaks and valleys. It may be easy to see that the market is moving higher, with a clear pattern of higher highs and higher lows. Or, it could be moving lower with a jagged line that has an overall downward direction.

Moving Averages

One of the easiest indicators to start with is the moving average. The 200-day is used by many, especially long-term traders. Short-term traders use shorter-term moving averages, such as the 5-, 10- or 20-day. (Or it could be 5-, 10- and 20-periods, in the case of intraday charts.) Here we'll discuss the 200-day line because it is the easiest to see the relationship with the market. In particular, to judge the trend and its relative strength, we'll look at the slope of the 200-day line and its position versus the current market.

In an uptrend, the market will be considerably above the 200-day line. In a downtrend, the market will be considerably below the 200-day line.

Think about what we've seen recently. The S&P and the Dow had went over its 200-day moving average August 4, and has not closed below that line since, although it went below on August 10 and 11 on an intraday basis. The Dow crossed over its 200-day moving average on August 7 and has not touched it since. The NASDAQ Composite finally closed decisively over its 200-day moving average on August 14 and hasn't touched it since.

- In the **early stages** of the uptrend, the distance between the market line (the line delineated by closing prices) and the 200-day moving average will increase. The market line will have the sharper incline or slope. In the early stages of the downtrend, the distance between the two lines will also increase, but the market line will have a steeper decline or downward slope.
- In the **middle stages** of the trend (up or down) the distance between the lines becomes roughly constant and parallel.
- In the **later stages** of the trend, the distance between the two lines will narrow, and the 200-day line will have a sharper slope. This will continue until the market has a dramatic reversal or trades sideways for a long enough time to cause the 200-day line to flatten out.

That's not the only way the 200-day moving average can help you. Another characteristic we look at is [the distance between the market line and the 200-day line](#). For example, in an uptrend, the farther the market is above the 200-day line, the less likely it is to break below the moving average. And if it does break, it will likely not go very far below the 200-day line, nor trade below it for very long. Similarly, in a downtrend, the farther the market line is below the 200-day line, the less likely it will rally above the moving average. And if it were to rally, it will likely not go very far above the 200-day line, nor trade above it for very long.

Why? Because it would take a lot of "energy" for the market to hit a faraway target and go through it, unless there were some major surprise to propel it in one direction or another – such as the Iraqi invasion of Kuwait or the Russian debt default.

This kind of analysis applies to any moving average, which you will select depending upon your time frame and risk tolerance. The shorter the time frame, the less overall risk you will face. However, there will be more potential for small losses and whipsaws. For example, you can trade the market based on the five-day moving average. However, this kind of trading means you'll be in and out of the market frequently. Using a 200-day moving average as the basis of your analysis, you will have fewer whipsaws and the potential for big profits -- at least on paper. But you could give back a large percentage of those profits before you get a signal to get out of your position.

Breakouts

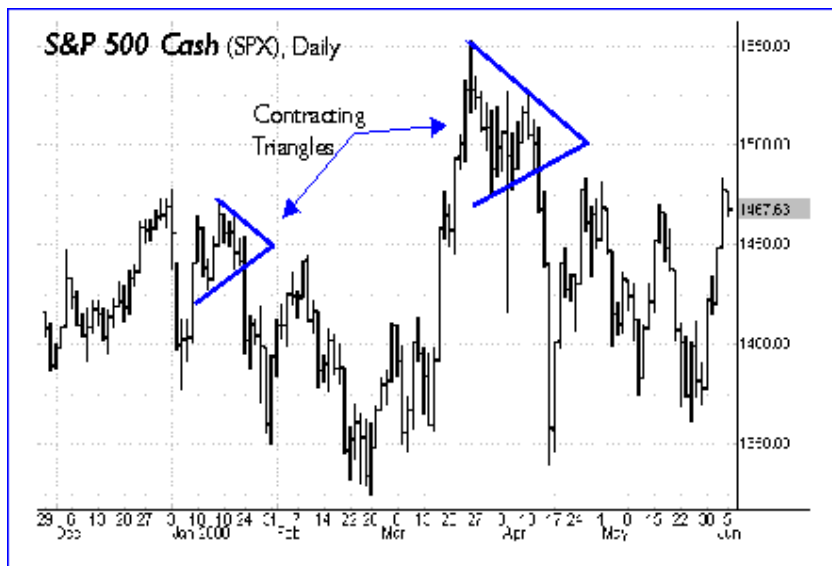
Looking at a chart, it is obvious to see where the market has been. The challenge is to determine where it's likely to go next. One of the things traders look for is a sign of a pending "breakout" when a market will move out of a range to the upside or downside. One of the common breakout patterns we look for is the "triangle."

Triangles: Think of an isosceles triangle, turned on its side with the apex or "point" facing to the right (>). As the range of the market gets narrower and narrower, the pattern formed goes from the "base" of the triangle toward the "apex." This contraction is caused by up and down movements that do not surpass the previous highs nor go below the previous lows until the range is very tight (like a spring that is coiled tightly.) Then, just like the spring, when the market does break out of this contraction, it is usually with increased volatility and volume. (Contracting triangles

can also be ascending triangles – as the market contracts and moves higher -- and descending triangles – where the market contracts and moves lower.)

The question, however, is what direction the market will take when it does break out. Usually, the direction of the market before the triangle was formed is the direction it resumes after the breakout. A *descending triangle* usually breaks out to the downside – especially if the market was moving lower before this pattern was formed. For *ascending triangles*, the market usually breaks to the upside in a rising market.

The next step would be to add trend lines. If you connect all the tops and all the bottoms of the previous highs and lows, you'll end up with two lines that, when extended, will cross at some point in the near future. That point becomes the apex of the triangle. The normal breakout point for this move is usually around three-quarters of the way from the base of the triangle to where the apex would be.



Now moving averages come into play. In a sideways market, the moving average is usually not much help. But once the market breaks out to the upside or down, the moving average will help to confirm the trend that's taking shape. Usually, the first three to five days of a breakout are the trickiest since that's when a fake-out – a breakout that isn't sustained – can occur.

Fake-out

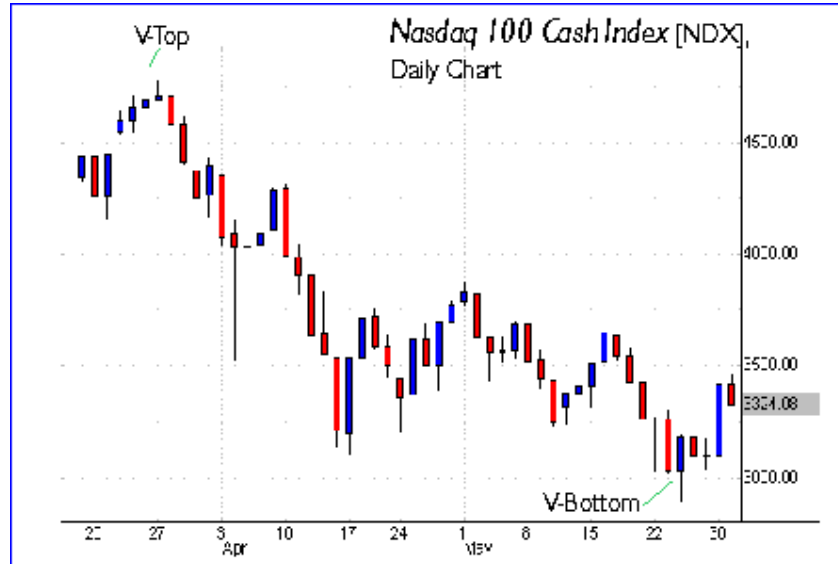
One of the most critical times to be on the alert for fake-outs is when there is a news announcement. For the equities markets, especially lately, that's been during times of "*Fed speak*." When the FOMC meets and Mr. Greenspan takes action or even hints about taking action, this is fertile ground for a fake-out. In fact, I believe that as a rule of thumb, there may be three or four [fake-outs](#) in the market after a Fed announcement before the real trend emerges.

Luckily, there are technical-analysis techniques to help you evaluate fake-outs and breakouts. One is the moving average. Just as we discussed earlier in "trends," if the market is accelerating faster (evidenced by a sharper slope to its line) than the breakout, it has a good chance of being sustained. Here, shorter-term moving averages may be very helpful, particularly the three-, five- and 10-day. Also, keep an eye on the volume. Increasing volume with a breakout is a generally a good sign. Little or no increase in volume may mean this is only a fake-out or at least lead to a retest of the breakout area.

Unfortunately, the only sure way of telling the breakout from the fake-out is when it's all over. But of course, then it's too late. That's why – as we'll discuss in upcoming weeks – risk management is so vital, helping you to contain your losses and maximize your profit potential during these volatile times. But for now we're just concentrating on the charts, looking at what the price patterns can tell us about what's likely to develop.

Reversal Patterns

One of the common reversal patterns which we've seen recently in the equity futures markets is the "V-Pattern Top or Bottom." This is formed by a sharp move downward followed by a sharp move upward, forming a V shape on the chart. This may span several days. The last one we saw in NDX Cash was May 24 with a V-bottom. March 24 was a V-top. Spike reversals are usually at the V point.

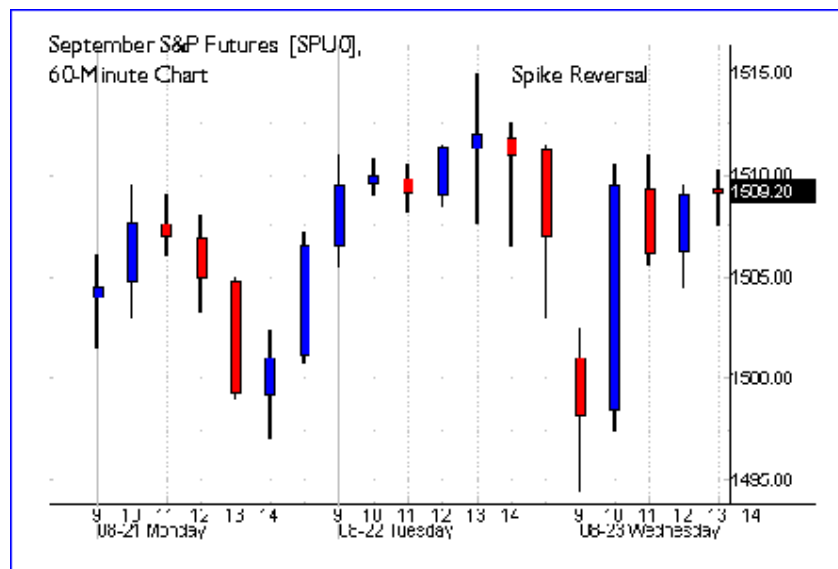


Trend/Spike Reversals

In a volatile market such as the S&Ps or NASDAQ, it's not uncommon for a trend to accelerate and then suddenly reverse. Not only do these reversals occur at major tops and bottoms, but also along the way!

The problem, however, is that it can catch even an experienced trader off guard.

Here's an example: Say, the market has been going up for a month and then all of a sudden it explodes to the upside for three or four days. Then on the last day of the upmove, it suddenly reverses and closes near its low of the day – leaving a spike high and a considerably lower close. The three-day pattern would have a spike high sandwiched between two considerably lower highs on the day before and the day after.



In the pit, you know you're in the midst of a spike reversal when one minute there is nothing but buyers and the next minute there's nothing but sellers. What happened behind the scenes? Perhaps there was news that caused

an upward movement that triggered buy stops, followed by a sell-off when there was no follow-through. In this case, the buying was capitulation by the shorts, when they had to get out at any price and were in a panic situation.

Think of the Four "C's" of trading -- complacency, caution, concern and capitulation. At capitulation, we see the big spikes, when everyone stampedes to be buyers to get long or cover shorts, or to be sellers to either get short or get out of longs quickly and at any price.

Crash "Reversal"

I've told this story dozens of time, but the memory has never ceased to have an impact on me. I was out of the country on **Black Monday of the Crash of 1987**. In fact, I wasn't able to get back to the trading pit until Tuesday afternoon (even though I flew standby on the Concorde). I made six-figure profits on Tuesday afternoon and Wednesday. But that all paled in comparison to what happened on Thursday.

Before trading began, the pit was tense. The brokers, I noticed, were especially nervous. Having been a broker in my early days, I could read their body language clearly. They were acting as if they had a large order to fill. Just before the bell rings, brokers start to make their offers. A broker offered to sell S&Ps 4.00 points lower. (In the pit we'd think of that as 400 points lower.) Then another broker, this time from Shearson, said he was 10.00 lower. (Remember this was 1987, and we didn't have any limits to act as brakes on a sharply falling market.) This was unbelievable, I thought! Within seconds we were already 10.00 points down. As a local, I wondered just how far down this market would go.

"I'm 20.00 lower," I yelled out.

A Shearson broker was lower still – 30.00 points lower. I said I was 40.00 points lower. The Shearson broker shot back that he was 50.00 lower.

S&Ps opened 56.00 points lower. In the midst of this freefall, I knew it had to be the bottom. I turned buyer. I bought 150 contracts from a broker behind me and sold them **two seconds later for 20.00 points** higher. I walked out of the pit with a **\$1.3 million profit made in less than a minute**. I went into the bathroom and threw up. As much as I had made on that one trade, I could have lost if the market had turned against me.

Today, of course, there are circuit breakers to limit or at least slow down those sharp moves in the pit. But even so, there are plenty of panic moves in which S&Ps can go 15.00 to 30.00 very quickly, and the NASDAQ can go 100.00 to 200.00.

At this point, the time frame will weigh heavily on what happens next. After the first three to 10 minutes of a big move, the question becomes will the market keep falling (or rallying) or will it reverse and go in the opposite direction. In most crashes, the pattern is a sharp decline, then a quick bounce/reversal, and then a sideways move as if the market (or at least the participants) had to catch their collective breath. Then the market is poised to make another move.

This type of pattern can also be exhibited on a much longer time frame. For example, in the 1998 "crash" there was a sharp decline from July to October, then the market bounced and traded sideways for a period of time until it collapsed again. This down-sideways-down-again pattern can be seen on a daily basis and intraday as well.

After these sharp moves, however, the market will have to recover first – consolidating in a range – before it can then stage a rally higher. As of August 2000, that's a pattern we've seen thus far this year. We went straight up – particularly in the tech and biotech sector – topping out in mid-March, and then collapsing in late March through mid-April. Throughout the spring and summer, the market has become more segmented with some biotechs and high-techs making new highs, some trading sideways and others making new lows. Blue chips, meanwhile, have gone both in and out of favor.

Range-Bound

When the market enters a period of **moving mostly sideways** – with no significant new highs nor significant new lows – it's **range-bound**. Remember the Dow earlier this year? For much of June we were looking for it to get above 10,800.

That's when the trend "fader" (as discussed in Week 1) will execute the strategy of selling the tops and buying the bottoms, trading in between the previous highs and lows.

A second way to identify a range-bound market is with moving averages with what are known as "percentage envelopes." Let's say the market has been, basically, moving sideways for a month. The moving average goes flat for the 20-day and the 30-day time periods. Now, take a look at the relationship between the previous high and the previous low versus the moving average. In a true range-bound market, you'd expect that relationship – on a percentage basis – to be roughly the same. Thus, if the top of the range is "X"% above the 30-day moving average, you'd expect the bottom of the range to be about the same percentage below the moving average line.

When the market begins to move beyond those ranges – after all, **the market won't move sideways forever** – that's when we begin the process all over again, to see if what is developing is a fake-out or the beginning of a real move.

One indication of a real move would be an increase of volume and activity. If the market goes up on increasing activity and volume – and retraces only a portion of that up move on decreasing activity and volume – that's an indication of an uptrend. (A downtrend is the opposite.)

Thus far, we've looked on trending, breakout and range-bound markets. While there are many variations on these themes, these are some of the concepts that can be identified with technical analysis.

Subjective Market Identification

There is another way to identify the "**personality**" of the market, and that's looking at your own trading record. I strongly recommend all traders – novices to professionals – keep a log of their trades. As we discussed in Week 1, this trading log will show the kind of trader you are – or the kind of trades you're making most frequently. Are you buying dips or selling rallies? Are you buying tops and selling bottoms looking for extensions?

If the strategy you're employing works well for you, then you have successfully identified (at least for the moment) the personality of the market. But what if the strategy that you've employed for the past week or maybe longer is suddenly not working as well? What if you're buying dips only to have the market pause and break further? Or what if you're selling tops, just to have the market rally in your face? Or maybe you're buying tops looking for extensions only to have the market begin a downtrend.

As any experienced and **battle-scarred** trader will tell you, there are numerous ways to lose money in the market. But what these mistakes will tell you is that you're out of sync with the market. These mistakes are signs that you need to go back to your analysis – using the various indicators we've discussed (as well as other indicators) – to help you identify the kind of market you're in.

What we've looked at thus far is the objective part of trading. The subjective part – which we discussed in Week 1 – is what will help you to execute the plan that you devise, and to know when and how the plan needs to be altered. At all times, you must be disciplined. A lot of people are very good at setting rules, but when it comes time to act, they're not very good at adhering to those rules.

As we'll discuss in Weeks 3 and 4, this discipline is what will allow you to set entry and exit points and identify your stop placements without your emotions clouding your decisions. You'll set your risk per trade based on your capitalization and your risk-tolerance so that no single position or trade exceeds your risk levels and threatens your liquidity.

Most of all, at each phase of the trading process you must know yourself – honestly. It's easy to say, I can risk \$10,000 on a particular trade. But what happens when the trade you execute has a quick \$6,000 loss. **Can you handle it?** It's possible that the market could turn against you until you have an \$8,000 loss on paper, which would still be short of your objective stop-loss. However, your subjective/emotional panic point was closer to \$6,000 and has already taken you out of the market. Now what would happen if at that \$8,000 loss the market suddenly reversed and goes the way you expected in the first place for, say, an \$80,000 profit? But you're no longer in the market because you misjudged your risk loss/panic level.

That's why, along with your technical analysis, your trade execution must reflect your experience level – and the personality of the market you're trading.

The Week in Review –

-- To look at where the market will likely go next, traders must study where it's been. Charts will enable you to identify patterns that – when used with other indicators such as moving averages – will help you determine how to trade the market.

-- Common formations include:

- Trends. Higher highs and higher lows is a classic uptrend. Lower highs and lower lows defines a downtrend.
- Moving averages will help you to determine if the market is in the early, middle or late stages of a trend.
- Breakouts. One of the patterns to look for is a the "triangle" or "wedge," which shows the markets coiling like a spring into a tighter range – getting ready to make a move.
- Spikes and Reversals – Sudden news announcements, panic and capitulation can change the market from (virtually) all buyers to all sellers, or all sellers to all buyers.
- Range-bound – The market may trade in a range, between previous highs and lows, as it "catches its breath" after a major move.

-- Keep a log of your trades. What you've done – and how you've done – will teach you volumes about trading. You'll see what you do right and what you do wrong. As you analyze and study your results, you'll look at your trade execution, in particular how you're entering and exiting trades.

Coming Next Week – Entry and Exit Points, Stop-Order Placements. Can you execute your trades as if you were just putting gasoline in the tank?

Welcome Back To Week Three

Making a trade can be reduced to three basic steps. **Ready aim fire.** If you've ever been to a firing range, you know you can't aim if you're not ready, and you can't fire if you haven't aimed. It's the same thing with trading. You must go through a three-step process even if you're experienced enough to complete it in a few seconds.

READY: This encompasses your **trade setup**. As we discussed in Week 1 of the course, the key element is your mental preparation. You clear your mind of distractions and focus on the job at hand, namely trading. You study your price charts and indicators and, as outlined in Week 2, analyze the kind of market (trending, range-bound, poised for a breakout?) that you're in. You identify the key price levels (support, resistance, retracements) and how you'll play them.

AIM: At this stage, you're watching the market for those setups that you outlined in your technical preparation. For example, let's say you identified key support for S&P futures in your technical analysis at 1500. The market opened at 1503.50, trades up to 1505.50, and then drifts down to 1501. If it dips below 1501, you tell yourself, it's not going to stay there. You're poised to buy.

FIRE: This is where it all comes together. Your technical analysis has identified key areas for making trades. The market, indeed, is behaving the way the analysis indicated. You're taken aim? at a price level? in the example below, 1501? to buy. Now it's in your sights. You fire? and execute the trade with a stop in at 1499.50 and a first profit target at 1503.50.

Over and over again, traders of all experience levels go through this three-step process. Even after nearly 20 years of trading, I still go through these steps, although in the pit, it may look like I'm just firing? at will. But I'm armed with technical analysis, which I've studied in my Morning Meeting? with the traders who work for me. I have technical analysis updates available to me all day, whether I'm trading on or off the floor. And I'm looking for the trade setups continuously, where I can aim? and fire?.

STEPPING THROUGH A TRADE

As an example, let's take a look at a trade I made just a few days ago. I was trading off the floor (actually, I was traveling on business), which made my three steps even more deliberate.

READY: In our "Morning Meeting" we identified a pivotal area for S&Ps between 1511.50 and 1512.50. That's a number (or most likely, a tight range of numbers) above which we're looking for upside objectives to be reached, and below, we'd look for the momentum to grow to the downside. The first upside objective was 1519 and then 1522.30, followed by 1530.

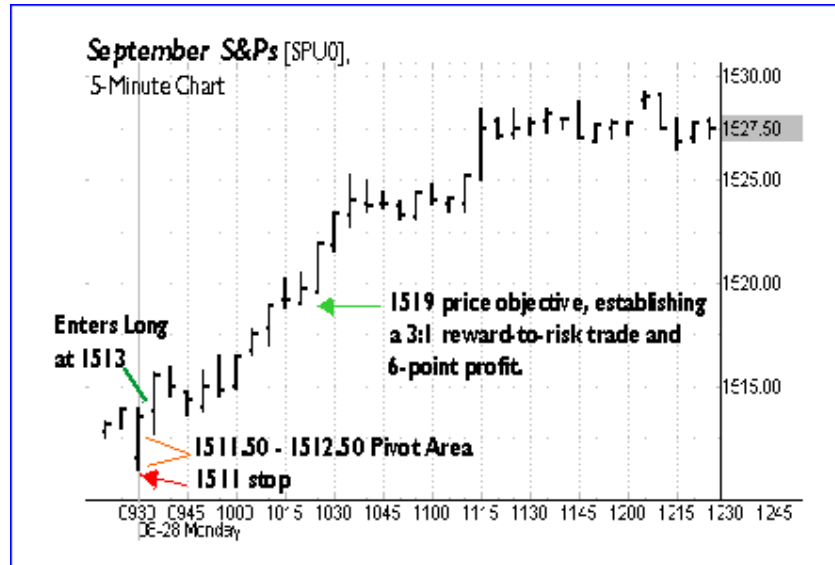
AIM: At the opening, the market was between 1512 and 1511, and then hovered slightly above that area at 1511.50 to 1513. With a bottom built just below the low end of our morning pivot, I believe we'd find good support there. There was little chance, based on our technical analysis and what I was seeing in the market, for a break below 1510 at that point.

FIRE: I went long at 1513 with a stop at 1511, which was the low of the day at that point. I had a 2-point risk to the downside. My upside objective was 1519, a 6-point profit potential. (As we'll discuss later, my risk/reward ratio on this trade was 2:6, or 1:3.)

The result: The market hit my 1519 target, at which, I exited the trade, making the 6-point profit. Later, it actually moved higher, ultimately going to 1529. But I didn't kick myself about getting out at 1519. I was comfortable with my exit target because it was also based on my technical analysis, even though in hindsight (which makes everything look clear) it proved to be conservative.

- 1519 was the profit objective I had identified before I placed the trade, based on technical analysis.
- Implied volatility in the market had been abnormally low, so I wasn't looking for any big range extensions.

- Volume had been extremely light, which added to the risk that upward moves could simply evaporate.
- Contrary to the advice of Gordon Gecko (remember “Wall Street”?) greed is NOT good. Greed that makes you want to wring every last dime out of a trade will squeeze the profits out of you.



Could Haves, Should Haves

If there is a common complaint among traders, it's about what they “could” have made. It's like the proverbial fishermen who spend their time talking about “**the one that got away.**” If you make your trades based on sound technical analysis, backed by mental discipline and with your risk/reward in balance, you should have nothing to complain about.

I'll take it a step further. Let's say you go long at 1513 with a stop at 1511. Instead of heading upward to 1519, the market reverses and makes a new intraday low of 1510. You're stopped out at your pre-determined loss level at 1511. The market hovers there for a while, edges up to 1511 and then makes a strong, quick move up to, say, 1517. Would you be happy about being stopped out? No. But you should **congratulate yourself** on having the discipline to stick with your stops (and not canceling or moving them). Remember, a disciplined trader is one who will come back for another day.

Besides, after you were stopped out, if you managed to keep your emotions out of your trading, you would have been looking for a new entry point. Perhaps you would have sold if the market broke through 1510 to the downside, or bought if it went above 1513 again – all based on your technical analysis. So when the market did rise from 1510 to 1513, you would have entered from the long side with a stop at 1510 and taken a profit at 1519.

NO "50-50" TRADES

Whenever you place a trade, you must ensure that your strategy gives you enough potential on the upside (in the case of a long position) or downside (when you go short). Put another way, you can't make “50-50 trades.” It's better to wait until the market is in a more favorable position for the upside or downside, than to place a trade that could go “either way.”

Here's what I mean. Let's take the example of a range between 1510 and 1511. You believe that 1510 is going to hold as support and 1511 will pose resistance. Are you going to buy at 1510.50? Would you go short at 1510.50? Neither, because at that point, the market could go either way between your support and resistance targets.

Rather, a better strategy would be to wait until the market goes to 1510.10 and buy with a stop, say, at 1509.80, with a target at 1511.

At the risk of stating the obvious, I think it's worth repeating one of the basic tenets of trading. **Maximize your profit potential and keep your losses to a minimum.** In fact, the goal for novice traders should be only to keep

their losses to a minimum. With experience and confidence, profits will take care of themselves. The losses, however, will take you out of the game.

The best way to control losses is to **trade with stops**. When you place a trade, you must determine – in advance – where you'd exit if the market turns against you. In the pit, I might use a "mental stop," meaning I set a level in my mind of where I'd get out if the market did the opposite of what I planned. When you trade at the screen, you must be even more disciplined about using stops. As I stated earlier, even if you get stopped out on a trade and the market turns around and goes the way your analysis had indicated, you should applaud your execution. Using stops is the hallmark of a discipline trader

What determines your stop placement? That goes hand-in-hand with your risk-and-reward ratio.

RISK/REWARD RATIO

Ideally, traders should aim for a **minimum of a 1:2 risk/reward ratio**. Even better, is a ratio of 1:2 ½. What that means is for every \$1 that you risk, you must make \$2 or \$2.50. Put the other way, for every \$2 to \$2.50 that you make, you don't want to risk more than \$1.

Stops will help you keep your losses to a minimum, while providing a safety net as you let your profits run. Where you place your stops will also be confirmed by your technical analysis. If you believe 1510 is key support and you go long at 1510, you might place your stop at 1509.80. Another factor is whether you're a short-term or a long-term player. Essentially, if you are holding trades for several days, you most likely will have wider stop placement than someone who is making ultra-short-term trades as a daytrader.

The most important thing to remember is that stops are integral to your trade setup. They're not an "afterthought." Here's another example. Let's say you're playing a breakout. You know that 1516 is an old high where the market has made seven tops around that area. Now, it's setting up for a momentum play. Your plan is to go long above 1516 – say, at 1516.20 – because your analysis has pegged 1522 as the next upside target. That 1522 is not a "pie-in-the-sky" number. Rather, all your indicators are pointing to that as the next objective.

But you don't just "buy" at 1516.20 and wait for the market to move higher. Even if every indicator signals the up move, you must still put a stop in – just in case the market moves against you. So if your target is 1522 on the upside (roughly 6 points above your entry point), your stop will be a maximum of 3 points below, in this case, around 1513 to keep a 1:2 risk/reward ratio. Or you may trade with a tighter stop at 1514, especially if you believe that once the market breaks below 1515, it could sell off to 1510 or lower.

TRAILING STOPS

The only time you should move a stop is when you're using trailing stops. In effect, you're moving the safety net as the market approaches your target. Here's what I mean:

- Your technical analysis indicates support at 1510. You go long at 1510.10.
- You place a protective sell stop at 1509.
- Your profit target is at 1515 and a second target is at 1522.
- The market moves to your first target at 1515. Upward momentum is still strong. You take off half your position at 1515 for a five-point profit.
- With a half long position, your next target is 1522. You move your stop upward to, say, 1514. That way if the market turns downward, you would still make a profit – albeit a smaller one – on the remaining long position.

MONEY MANAGEMENT

The whole purpose of risk management is to preserve your capital. Truly, if you limit the amount of capital you expose to risk on every trade, you will do much to preserve your trading career, as well.

Put another way, you can never trade so large – or risk so much – that you put yourself at risk of "crapping out" on one or a few trades. This all-or-nothing attitude is borne of despair and panic and almost always ends with disaster.

I've seen far too many young traders, after a string of losses that have eaten away at their capital, lose heart. Instead of buckling down, becoming even more disciplined, reducing their trade size and trading more deliberately, they do the opposite. They put on the "go for broke" trade.

They risk all or most of their capital on a trade. If they win, their errant theory goes, they'll make back everything they lose. And if they lose...well, it was going to happen anyway. The problem is they undermine any chance they had of gaining ground.

THE GAS TANK RULE

How large you can trade depends upon many factors, including your experience level and, of course, your overall capitalization. Even if you have a large amount of capital at your disposal, you can't just start throwing around five or 10 S&P major contracts (at \$250, times the value of the index, or roughly \$375,000 each) as if were just "paper."

As a rule of thumb, I'd suggest the "gas tank" rule. When you trade, you shouldn't think about the money on the line any more than you'd consider how much money you just spent to fill up your gas tank. After all, when you pull up to the pump and fill up the gas tank, you'll spend \$20 or \$30. You might feel that pinch when you pay, but after you drive away, you don't think about that money any longer. It's simply a necessary cost to drive your car.

When you place a trade, you should not worry about the money on the line. If you're thinking about that \$500 or \$5,000 or \$50,000 that you've risked, **you're trading too large** for your risk tolerance and your capitalization. It takes money to trade. When you trade, you're putting money on the line, and sometimes the trades you make will be losers. If the risk-per-trade that you're taking affects you more than filling your gas tank, then you should re-evaluate your trade size in light of your capitalization and risk tolerance.

The concept is to find a risk level for yourself that does not evoke emotions and, therefore, allows you to stay as objective as possible so you can follow your game plan. Of course, there are others who believe you need a higher sense of risk and aggressiveness to be alert and achieve higher returns. While that may work for some, the most important thing is to find the ideal level of risk that will allow you to perform at your best potential, while keeping your emotions out of it. This balance, I believe, will help you become a better trader faster -- without the wear-and-tear on your stomach and personality.

JERRY AND THE PSYCHIATRIST

Money management can even be a problem with experienced traders who, after a few losses, can find their capital compromised. When I see Jerry, a successful trader, we can chuckle about this story, although when he was in the thick of it, it was no laughing matter.

It had to be 10 years ago when Jerry and I ran into each other in the most popular pre-market meeting place at the Merc (the washroom). He was complaining about a bad streak he was having. He'd do well on Monday, Tuesday and Wednesday, but on Thursday, he'd give it all back, and on Friday, he'd lose some more.

His pattern had been plaguing him for weeks. He'd have a few profitable days in a row and then one loser on which he'd give it all back. Then he'd have nothing to show for his efforts.

Jerry knew what was happening. He'd start to panic when the losses set in and he'd over-trade. That's a sin that all of us have committed at one time or another. We trade too much or too big, sometimes chasing the market after it's made a big move that we've missed, only to have the market turn around and go the other way. You try to make up for that loss with a couple of quick trades, but they end up being losers, too.

I tried to commiserate with Jerry, but he was convinced that there was a deeper problem. He thought he was losing his discipline. He decided to see a psychiatrist to help him.

Trading, as I outlined in Week 1 of this course, is largely a mental game. In fact, if your mental discipline isn't in place, you can't possibly hope to succeed in this business.

Personally, I didn't think that was Jerry's problem. To me he was experiencing a **crisis of confidence**. All he needed was one profitable week. It didn't matter if he made \$1 or \$10,000, he just needed one week with a profit, and then he'd change his mental attitude.

How? When a trader has a string of losses, it's time to go back to the basics. You need to focus on each step deliberately – your mental preparation, your technical analysis, your trade entry and exit points, your stop-placement. You must examine each step along the way to see what you're doing wrong.

Now, to finish the story about Jerry, he did pull out of his slump and went on to enjoy (and continue to enjoy) a profitable trading career. The psychiatrist, meanwhile, didn't think that trading was so complicated – it was just “buy low, sell high.” What was the big deal – especially for a guy with a wall covered with diplomas?

Jerry suggested the psychiatrist try his hand at trading to see just how difficult it was. The psychiatrist did just that. He lost \$100,000 in a few months. So much for giving up his day job.

What's the moral of the story? Losses don't just “happen.” When you have a string of them, chances are you're trading too large or too frequently. Or your entry and exit points aren't based on sound technical analysis. When the outcome goes awry repeatedly, there's a problem with the process.

That's when you go back to the drawing board – and come back disciplined.

WISHING, HOPING AND OTHER "SINS"

There are other “sins” that, when committed, can seriously undermine your trade execution and your capitalization. One of the most common is **to add to a losing position**.

When a trader adds to a losing position, chances are, he or she hasn't really done the necessary technical-research homework. Most likely, they are putting on trades without a sound plan behind them. Here's what I mean:

The market has been climbing steadily since the open, and S&Ps are now at 1515. You jump in, buying at 1515.20, without realizing that – according to the charts – the market just entered a resistance area. The market stalls around 1515.30 and starts to drift lower. Sellers come in, and now the market is at 1513.

Needless to say, you don't have a stop in – or if you did, you might even be panicky enough to cancel it. This has to be the bottom, you tell yourself. So you buy more at 1513. It goes even lower. Believing the market can't go lower, you buy there. It goes to 1512...1511...1510 (which your research would have shown you was a support level and a logical place to buy).

Now you're long from 1513, 1512 and, say, 1510.80. The market is at 1510. You've added to a losing position all the way down. This is a misuse of the strategy known as “averaging” or scaling into a position. When it's part of your plan, averaging is a fine way to get into the market at a variety of prices. But when averaging is employed because you're “wishing, hoping and praying” that the market will turn around, then it's a different story.

Going back to our example, if you're long from 1515.20 1513, 1512, and 1510.80, you're clinging to the “hope” that the market will at least go back to 1513 or 1514 so you could get out of the whole mess with a “scratch,” or no win or loss. If that happened, you'd feel pretty lucky. But in the **School of Hard Knocks** known as the market, that's probably the worst thing that could happen. Why? Because if that false strategy works even once, you'd be tempted to try it again. And that time, the market could tank and your losses would be compounded.

Scaling And Sticking To Your Plan

There are times, however, when it will be part of your plan to execute trades at a variety of prices, based on your technical analysis. For example, say you've identified support in S&Ps at 1514, and you want to buy 10 contracts. But you're concerned that if you wait until the market reaches 1514, you'll miss the buying opportunity. So you may choose to buy some at 1514.30, some at 1514.20 and some at 1514.10. You've scaled into your long position according to your plan. Similarly, you may want to scale out of a position, again, based on your technical analysis. Your price target on the upside may be 1516, but instead of waiting for that level to be hit -- perhaps because you're concerned it may reverse before it hits that level -- you sell out as you approach that target. For example, you may sell out a few of your contracts at 1515.50, 1515.60, 1515.80 and so forth.

It bears repeating. Your entry and exit points must be based on sound technical research. When you're placing a trade, know where you plan to get out for a profit, and where you'd bail out (with a stop) if the market turned against you.

If that sounds robotic and methodical to you, then you've got it! As I explained in the opening, there is a three-step process that can be reduced to "*Ready, Aim, Fire!*" When that rhythm becomes your second nature, then you're on the road to increasing your success as a trader.

It's akin to what the athletes know as "*muscle memory.*" Golfers (even weekend warriors on the links like me) will practice a swing over and over and over again until the motion happens without the conscious mind engaging in the process.

Your trading setup should have that same feel.

Now get out there on the target range known as the market and take aim.

Week In Review --

Trading can be reduced to three steps -- Ready...Aim...Fire!

- Ready: Are you mentally prepared to trade? Have you done your technical research?
- Aim: Have you identified key prices at which to go long or short?
- Fire: Once the market reaches the key prices, execute your trade -- with your profit targets and stop placement.

A "50-50" trade will not pay off. If you believe there is support at 1510 and resistance at 1511, don't enter from the short or long side at 1510.50! Trade at or near your price targets.

Always trade with a stop. Period.

Your risk/reward ratio should be at least 1:2. Meaning, for every \$1 that you risk, you must make a minimum of \$2. Or to make \$2, you should not risk any more than \$1

Keeping your risk-and-reward in balance is the key to sound money management. Never risk more on a trade than you can handle. Never expose so much of your capital in any trade that you risk taking yourself out of the game.

Welcome Back To Week Four!

There is a story in Greek mythology about **Sisyphus**. The gods, it seems, condemned Sisyphus to an eternity of rolling a rock to the top of a mountain, only to have it roll back down again. It was a pretty fruitless fate?

Sometimes I think Sisyphus was a trader without discipline or a plan.

The problem may very well be that while you can analyze the price history of the market (finding the key support and resistance area), you lose your way when you are in the thick of things. It is one thing before the market opens to see that, for example, 1512 is key support. It is another to decide what to do and execute a trade when the market breaks through that support, hits 1511 and then bounces back to 1513. Were you short? Were you long? Did you put a stop in? Were you in the market at all?

This comes down to what I call **intraday dynamics**. You must be able to recognize, analyze, and react to changes in the market including (and especially) those dramatic moves that render your morning analysis virtually useless.

The key is to be able to read the market as it is developing. This does not lessen the importance of the technical analysis that you do before you trade. Rather, your study of the market cannot end there. Whether you do the analysis yourself or you subscribe to a service (or you use other people's technical research to confirm or counter your own), you must constantly monitor the market around you.

On the most basic level, even a beginning trader knows that what was once support becomes resistance after a break that sends the market lower (and vice versa). But there are other factors, as well. In general, you must consider:

- Key price levels in the market, including support and resistance areas.
- How the market behaves around those key price levels.
- Other factors in the market, especially volume.
- Related market indices. For the S&P, this would be the NASDAQ, which is usually the most influential, and the Dow, which is also influential, but will go through periods of disparity.
- Bullish or bearish divergence.

Taken together, these factors help you to adjust and apply your intraday strategy for trading.

KEY PRICE LEVELS

One of the maxims of trading is that the market **usually trades back to levels of high activity**. In other words, let's assume you're looking at a 10-minute bar chart, and you see that 20 bars were recorded at 1510 to 1513. The market closes at 1520. Looking at that chart, you could expect that the market would at some point the next day trade back to that 1510 to 1513 level.

When it did return to that level, that would be a **critical time** for the market to "make up its mind" – moving upward or downward from there. If this level turned out to be support, that should lead to a rally. If the market had opened below the 1510 to 1513 level – therefore, making it resistance – that also would be significant and suggest a move downward.

RETRACEMENTS

Among the key price levels that you should look at intraday are retracements of previous up and down moves. These retracement levels act like magnets for trading. Whether they're highlighted on everyone's chart or there's

some quasi-mystical connection (commonly referred to as “the guiding hand of markets,” as explained by Adam Smith in *The Wealth of Nations*), these areas tend to be targets for future moves.

Retracements that are commonly looked at are 25%, 33%, 50%, 66% and 75%. These progressions – quarter, third, half, two-thirds, three quarters – are natural points along the way of a major move. Another of our favorite retracement is 88% of large moves.

The 88% retracement is something that we use as a target for future moves. Let’s say we’re long S&Ps from 1498. The market has moved up to 1512. But 1518.40 is an 88% retracement of a recent down move. At 1512, we’d be likely to hold on toward 1518 – but only if our other indicators confirmed that. Or if the market was decidedly bullish, we might even add to the position at 1512 for the move to 1518.

The market could top out at what turns out to be a 90% or 91% retracement. But typically, the 88% target is where the market moves to before reversing.

There are other retracements that we, and other traders, look at – 38.2%, 50% and 61.8%. These are **Fibonacci retracements**.

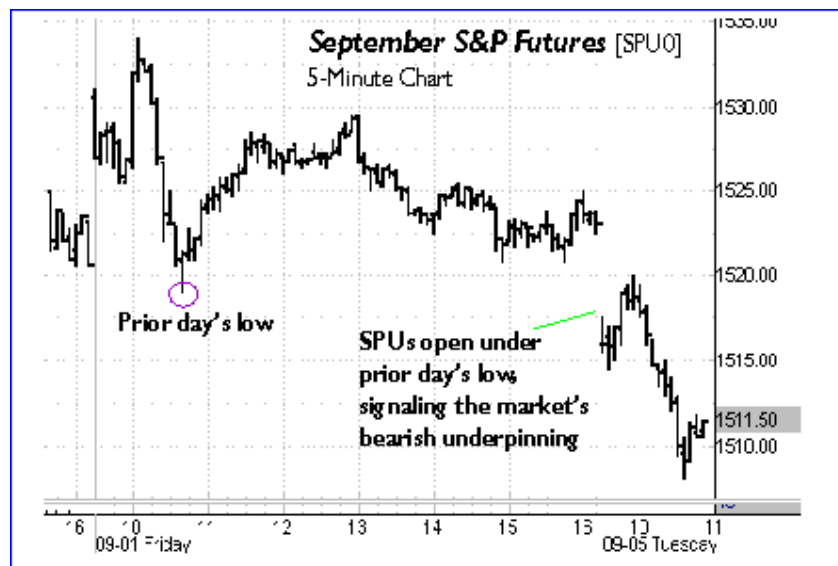
(Fibonacci was a European mathematician during the twelfth century. He studied a series of numbers, produced by adding the first to the second, then the third to the second, and so on (1, 1, 2, 3, 5, 8, 13, 21...) that became known as the Fibonacci series.)

Whether you’re a Fibonacci fan or not, you should know these levels because everybody else is looking at them. Also, you should know that this Fibonacci ratio shows up in nature and in architecture. (Self-fulfilling prophecy or not, if everyone is looking at the same numbers, they become important for just that reason.)

THE OPENING

The intraday analysis must begin right at the opening. While it may take a few minutes for the market to decide upon a direction for the morning – let alone the rest of the day – it’s vital to see where the market opens with regards to certain key price areas like previous highs or lows and pivotal areas.

For example, on Tuesday, September 5, S&P futures opened below the previous session’s low. This was the first signal that there was a bearish underpinning to this market (which we’ll explain further in this course). Since this occurred early – in the first 30 minutes of trading – I knew there was a good selling opportunity in the market, as the downward pressure was likely to continue.



Once trading is underway, the point to watch is the opening range. Let’s say the market trades lower than the opening range then, later in the morning, it comes back and breaks through that range to the upside. This is a good

indication that there is upside momentum building that may lead to a rally. In fact, when the market trades below the opening range, many traders will have a buy stop above the opening range to get long.

"MORNING PIVOT"

In our analysis every day, we outline a “**morning pivot.**” Before I go any further, I should clarify that this has nothing to do with Pivot-Point Analysis. Rather, this is our nomenclature for a pivotal area that should weigh heavily in importance in the morning trade – **particularly in the first hour.**

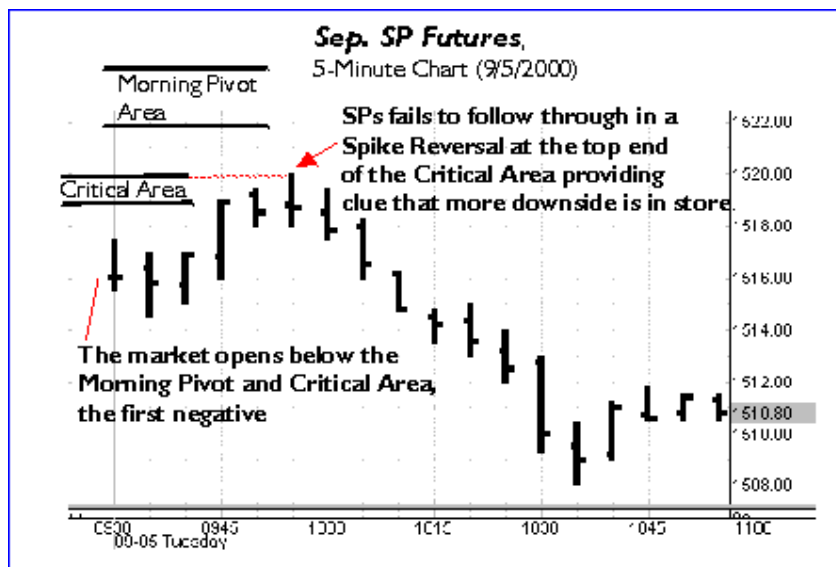
Simply put, if the market trades above the morning pivot and trades “light” (like a feather, which tends to go up more easily than down), we’d expect to see the upside build momentum. If it trades below or, “heavy” (going down more easily than it goes up), we expect to see downward pressure begin to escalate.

Think about what I see every day in the trading pit. The interplay is between the bids (wanting to buy as low as possible) and the offers (wanting to sell as high as possible). The price rises when the bids are forced to move up; it falls when the offers are forced to go down. In the midst of that tug-of-war, which is as old as the “auction” process itself, there will be a **pivotal point**, at which, there is a change in perception from bullish to bearish, or vice versa, and suddenly the bids and offers will run very quickly in one direction or another.

The “Morning Pivot” that we identify in our analysis is based on proprietary, dynamic trending indicators. For us, the morning pivot is a price level – or a range – that we watch very carefully. And it’s more than whether the pivot level is “hit.” We’re watching the subsequent behavior of the market around that pivot area to give a clue as to whether the current move will continue or if we’re setting up for a reversal.

STEP-BY-STEP

Let’s take Tuesday, September 5 as our example. We’ll examine the first hour or so of trading to see what the market did – and the clues that it gave us for what would happen next. Of course, from our perspective (that of hindsight), the view has 20/20 clarity. But the purpose is not just to review previous action, but rather to give an example of the kinds of things that you, the trader, should be watching for intraday.



Our Morning Pivot for September 5 was 1522 to 1524. We had also identified another critical area at 1519 to 1520. Again, the behavior of the market around those price points was going to be a strong clue as to what we might expect to happen next.

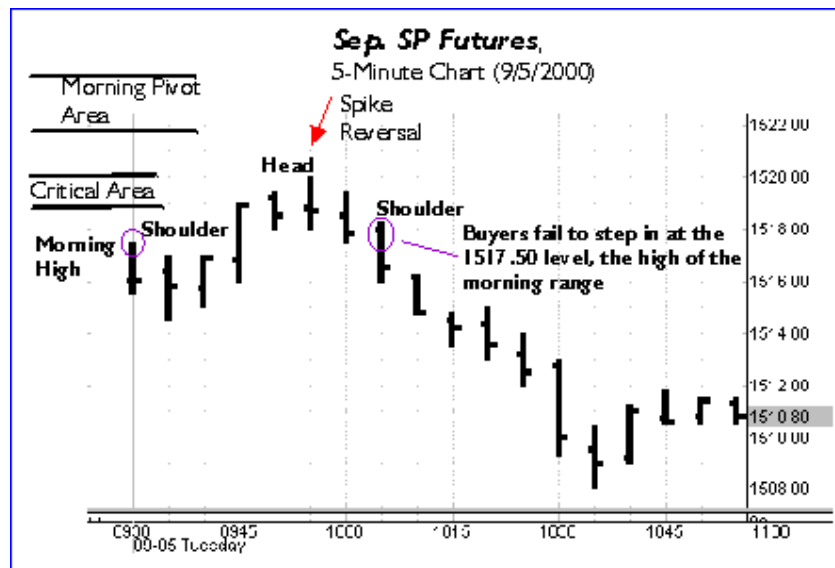
The market opened at 1516.50, well below both our Morning Pivot and the critical area that we had identified. This was the **first negative** for the market.

The market then made a high of 1517.50 – still below those key numbers – and then traded lower to around 1514.50.

At approximately 9 a.m. Central, it hit 1520, the top end of the critical area in the market, and then made a small spike reversal (see [Week 2](#)) down to 1518. The market's failure to continue its upward movement through 1520 to the upside targets was the **second negative**.

S&Ps then bounced up to 1519.50, and quickly broke down to 1517.50. (One of our technicians identified a very small, but important, head-and-shoulders pattern in this area).

One of the most important things to observe was what didn't happen at 1517.50. Think about it. It was the morning range's high (made some five minutes after the opening) and the market had already traded up to 1520 and then failed at 1519.50 on its second attempt. If it was going to come alive at that point, it would be at this 1517.50 area. If it didn't, the downside was gaining strength.



In fact, buyers did not come in at 1517.50, and the downside pressure was on. The market went below the morning's low, dropping down to 1513.50. That was yet another negative signal for this market.

Ready, Aim, Fire!

Remember – as we discussed in [Week 3](#) – trades have a clear three-step process, which I like to call “**ready, aim and fire!**” This is particularly true when trading at the screen, where you are looking for larger trades than just “scalping,” as can be done in the pit. The **ready** is the analysis, **aim** is recognizing the patterns that you've been targeting and **fire** is trade execution. Clearly on this day, we had identified key price levels (ready) and were watching the market take on a bearish tone as it worked overall lower (aim). What we needed was the entry point (fire) to lead to an expected profitable trade.

At 1513.50, the market had a bounce up to 1515, then collapsed. By 9:38 a.m. Central – just over an hour after trading began – S&Ps were at 1508.

Before that collapse occurred, the market had generated four negative indications – the second of them occurring at the intraday high. If you had watched it all develop, you could have gotten short after 1517.50 and ridden the market as it declined to 1508. Of course, it's much easier to see this now, following a chart of what are now historic prices. But the key is to recognize patterns – the market repeats patterns continually – to be able to extrapolate the next likely move.

Very often, market analysis consists of “**if X happens, and then Y happens, then look for Z.**” The basis of that scenario will be the key price points that you've identified in your analysis – the previous highs and lows, support and resistance, and pivotal areas. That's the “**X**” of this equation.

Added to that is the “Y” factor – that behavior. If the market opens above the pivotal range, trades down to near it, then takes off as buyers step in, the “Z” outcome is for a move higher. If the market opens below the pivot range, meets resistance as it approaches it, and then sells off, then look for the downside.

Put another way, when things begin to “line up,” that’s when you get a good tradable move. But just like our “ready, aim, fire!”, you can’t pull the trigger until you have the market in your sights. The setup must be there, and confirmed by indicators. It’s not enough to say, “1522-1524 is my pivot; if the market goes above 1524, I’m going to get long.” You must look at the market’s behavior on its way to 1524 and what it does once it gets there, to help you decide if that’s the best move. True, the market may rise above 1524 and keep on going. Or it could hit 1524.10 – and then collapse.

In that last scenario, it’s a “fade trade.”

FADE TRADE

A good opportunity for a fade during that first hour of trading on September 5 was at 1520. Why? Remember, the market opened well below 1520 and had difficulty reaching that critical zone in the first few minutes. So when it hit 1520 and had a small spike reversal, the odds were the downside was still dominating and the market would sell off. To fade that move, you would have sold around (or at, if you were lucky) 1520.

There are other factors that play into the decision to fade a move or look for an extension. Among them are volatility and volume. This past summer was marked by both low volume and low volatility. It was classic summer doldrums. With the market in a tight range and participation on the light side, it would be **unlikely that we’d see range extensions** of any substance. That means there could be opportunities for “fade trades” as we approached old highs and lows.

Let’s say 1525 is the top of the range; the market has hit there two or three times in recent days, but has not broken through. On the bottom is 1510, which is solid support. So the range has been set at 1525 to 1510.

In times of low volume and low volatility, you’d expect to stay within that range. And if it DID break out – say, to the upside – the market could have difficulty sustaining higher levels.

But sometimes moves can happen on light volume, which are particularly noticeable in the pit, when independent local traders are trying to make something happen. (I swear sometimes it’s out of boredom...)

FAKE OUT FADES

A fake-out in the pit would look something like this. The market approaches 1525; the bid/offer “noise” in the pit gets lower. It breaks through 1525 to the upside, reaching 1525.50. There is a ROAR in the pit with a flurry of locally dominated activity. You think for a moment that this is “it;” the market is going to break out of the range...Then the pit is silent. There is no follow-through to the upside, and the price drifts lower.

At the screen, of course, detecting a fake-out takes different skills (than just auditory ones in the pit). You’ve seen slow-moving trade all day, with light volume. Then the market will approach a key area – in this case, around 1525 – but then it doesn’t go any higher. With a lack of participation, the price will either reverse quickly or start to drift lower.

The lower it goes, the more the market could accelerate to the downside. There will be those who bought the break, thinking it was the “real thing,” who now have to get out with a loss. Also, the market may hit sell stops, which will again accelerate the downside.

TIME OF DAY

There are nearly seven hours to the S&P trading day (from 8:30 a.m. to 3:15 p.m. Central time), but those hours are hardly “equal.” There are certain times of the day when activity takes on **greater** importance.

It’s well known that very often many traders sit on the sidelines from, say, late morning through the noon-hour, because volume is comparatively light. This light action (as we stated above) makes the market **rife** for fake-outs. It’s better to trade when the market is more decisive and strong moves are accompanied with a commensurate

amount of volume. Typically, these times are the market opening (up to the first 90 minutes) and market closing (encompassing the last 90 minutes or so of the market). In between, things can get slow and very choppy, when the market will spurt and then die.

Then there is **program-trading** time...Program trades can be as regular as clockwork, particularly if you know how to read this kind of “**clock.**” Program trading tends to come in at the top and bottom of each hour (i.e. 10:00 and 10:30 a.m.). Another critical program-trading time is 2:40 Central time – especially on expiration day -- and 2:20 p.m. is becoming an important time frame as well.

What happens during these program-trading times is that paper from institutions or professional traders will come into the brokerages at this time. That means at a time like 2:20 p.m., the market could quickly go one way for 200 to 300 points. If you have the timing – and you learn the setups that indicate which way the market is likely to head – you may have a very low-risk trade.

For example, there are instances in which you can buy, say, 1500 and sell 1503 in a minute to a minute-and-a-half because you've identified the setup that leads to program trading.

LOOK WHO'S TALKING

There is yet another consideration in intraday dynamics – the backdrop of economic reports and events such as “Fed speak” (when a Fed governor or Alan Greenspan, himself, takes to the microphone). When there is a report – such as Beige Book, which is released during the afternoon – or an FOMC meeting when the Fed is going to issue a statement on interest-rate policy (typically around 1:15 p.m. Central), the market is usually very reactive.

Market sentiment can whipsaw between euphoria and panic in seconds. This is particularly true whenever the Fed meets. Personally, I wish the Fed would meet before breakfast and make its announcement before the market opened. (If it were a perfect world...)

We call this Fed Fake-Out time. Whether the Fed announces the “status quo” or a rate hike or cut, the market typically has three or four fake-outs – usually in the first hour or two after the announcement. Sometimes, the true direction doesn't emerge for a day or so. Knowing that can go a long way toward keeping you from getting caught on what you think is “the move” – only to have it stop and then reverse, again, and again.

The problem is, that's what the market usually does. It's not what the market ALWAYS does. The market, like life, has its exceptions. That's why it's important to do your homework ahead of time.

Let's take the example of a Fed meeting. Well before Alan Greenspan takes his now-famous briefcase in hand (thick, meaning lots of reports to back up a rate-change or thin, meaning no big deal...), there are lots of market pundits giving opinions on what the Fed is likely to do. Every economic report that might give even the slightest hint about inflation (or lack thereof) is dissected. And the Federal Funds Futures will give the likelihood of a rate hike (or cut, as the case may be...).

So if the market assumes there won't be a rate hike or has already factored in a 25-basis point move, would you expect any dramatic reaction to an announcement in line with those expectations? Probably not. There would most likely be the inevitable fake-outs, but overall, the market would likely continue to have the tone – and the governing dynamics – that it had before the Fed announcement.

Consider the August meeting. Status quo was expected, and the only possible surprise would come from the Fed's “bias” statement – especially if it hinted of a further rate hike. (The Fed now uses more elusive language anyway since it has abandoned its “bias statement.”) When August came and went, the market resumed its dynamics of the summer: low volume, low participation, and a tech sector that continued to weigh heavily on this market.

In short, trading intraday is more than just waiting for the market to touch a price level – to the upside or the downside – and then going short or long. It involves a continuation of the technical analysis that started your day. You must continually monitor not only where the market is, but how it has reacted in the meantime.

It's not enough to notice that, for example, the market has returned to an intraday high. You must consider whether the market opened above or below the previous low (or high), and whether buyers have been strongly present or noticeably absent. You must watch your indicators closely – both short and long-term – for signals as they appear. A market that has been neutral can suddenly turn bearish or bullish.

Most importantly, you must keep your eyes open – and your mind free of distractions. Then, with discipline and a plan, you'll be able to trade this market. Otherwise, you'll be *rolling boulders uphill for a living...*

WEEK IN REVIEW:

There are times, however, when it will be part of your plan to execute trades at a variety of prices, based on your technical analysis. For example, say you've identified support in S&Ps at 1514, and you want to buy 10 contracts. But you're concerned that if you wait until the market reaches 1514, you'll miss the buying opportunity. So you may choose to buy some at 1514.30, some at 1514.20 and some at 1514.10. You've scaled into your long position according to your plan. Similarly, you may want to scale out of a position, again, based on your technical analysis. Your price target on the upside may be 1516, but instead of waiting for that level to be hit -- perhaps because you're concerned it may reverse before it hits that level -- you sell out as you approach that target. For example, you may sell out a few of your contracts at 1515.50, 1515.60, 1515.80 and so forth.

- You must focus on intraday dynamics, recognizing, analyzing and reacting to changes in the market. This includes the occasional dramatic moves that render your morning analysis virtually useless.
- Watch for the market's behavior as it approaches and then reaches key price levels. Is there solid upward or downward momentum? Or is the move running out of steam?
- Retracements act like magnets for certain activity. Common retracement levels are 25%, 33%, 50%, 66%, 75% and 88% of major move. Plus, Fibonacci series – 38.2%, 50% and 61.8% -- are also targets.
- Volume and volatility should be observed. If volume is low and volatility is absent, don't expect big range extensions – or that a dramatic move will be sustained.
- Be aware of the time of day. The first hour (hour-and-a-half) and the last hour (hour-and-a-half) tend to have the most activity.
- Also, be aware of program-trading times. Riding these moves can lead to low-risk trades.

Coming next week we'll discuss how certain key stocks and other indices can give you clues in your futures trading.

Welcome Back To Week Five!

Sometimes we traders are so focused on the markets or the particular stocks that we trade, we develop a kind of "yopia." It's easy to lose perspective when you are so intently watching the gyrations of a market or of a stock (or even a group of stocks).

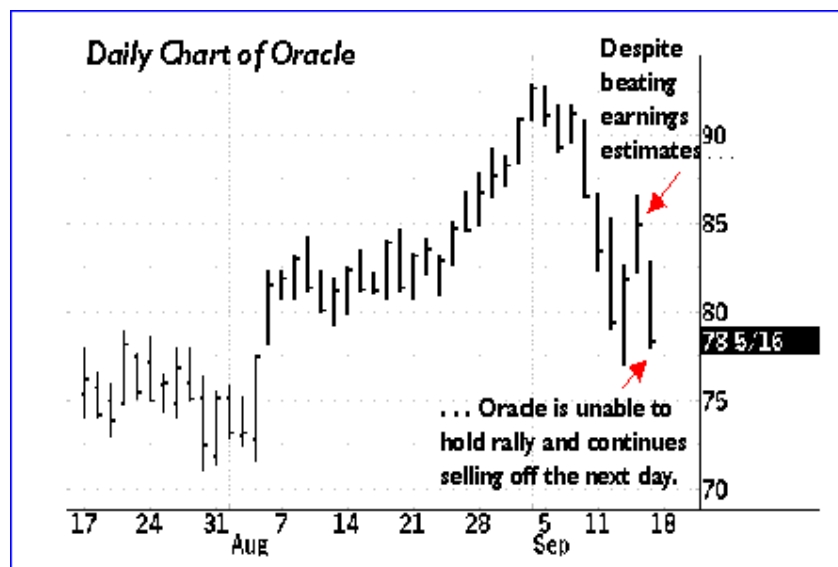
You'll know you're in this phase when suddenly all your analysis seems off. An uptrend gets undermined. A downtrend turns seemingly without reason. That's when it's essential to step back and widen your scope. For stock traders, that means looking at the stock indexes, and for stock-index futures traders that means looking at individual stocks.

Let's take NASDAQ 100 futures, for example. This market obviously has been dominated by what's happening in the technology stocks. So when we trade NASDAQ futures, we keep a close eye on what the largest stocks in the index are doing. The ones we pay the most attention to are: Intel (INTC), Cisco (CSCO), JDS Uniphase (JDSU), Oracle (ORCL) and Sun Microsystems (SUNW).

Oracle Wags Naz Dogs: An Example

Example

Let's take an example from this week: On Friday, September 15, 2000, our attention was focused on Oracle. The stock was up on Thursday before its earnings release, and then traded lower after the earnings came out. What this underscores is the NASDAQ's and Oracle's inability to hold rallies. What did that tell us? That we were going to be sellers of rallies until this trend changed (a factor mentioned in my [morning commentary](#) before Friday's open). In fact, by the end of the day Friday, Oracle closed down 6 5/8 at 78 15/16... and December Nasdaq 100 futures [NDZ0|NDZ0] finished down 78.00 at 3718.50.



Top 50

In addition, since the NASDAQ 100 Index [NDX|NDX], the index the NASDAQ futures is based on, is a weighted index, we tend to focus only on the top 50 listings.

We are looking beyond just whether a stock is up or down. What we're looking at is the dynamics within those individual stocks. At the risk of sounding too simplistic, after all, indexes are a group of related stocks – whether by

sector or by market capitalization. Therefore, one or a few stocks can have a large impact on what's going on within the index.

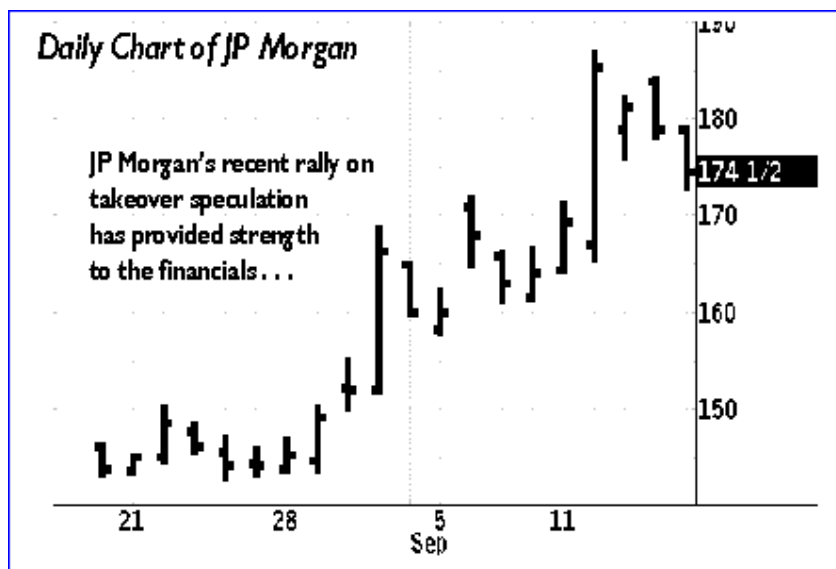
This is especially true in a market such as the NASDAQ, which is so dominated by technology. So when you're using stocks to trade an index, one of the keys is to study these equities in much the same way you would the index. You must know where the intraday support and resistance levels are. This is critical when it comes to the sectors. For the NASDAQ, we are using the SOX (semiconductor index) as a leading indicator for the NASDAQ futures. The DOT (Internet) index is also crucial.

Here are some of the things we're looking for:

- If there is general weakness (unchanged to down 1 point) in the top five listed, but index higher, then the conclusion is that our main indicator is not working. What we need to then look at is what we call our "second-tier stocks." These issues include Voicestream Wireless (VSTR), Verisign (VRSN), Applied Materials (AMAT), Xilinx (XLNX), Yahoo! (YHOO), Siebel Systems (SEBL), Veritas Software (VRTS), i2 Technologies (ITWO) and CIENA (CIEN). The performance of these stocks should provide the clue as to the direction of the market.

Now, let's look at the inverse, using stock index futures to trade individual stocks. While I've been a futures trader for some 20 years, I've been a "stock watcher" for 20. Obviously, the stock index futures market is impacted on a daily basis by what's happening to major issues within that index.

Just look at the last few weeks. The financial sector has been boosted, in large part, by JP Morgan and expectations that it could be a takeover target. And as we all know by now, JP Morgan is being purchased by Chase Manhattan. If you were trading the Dow with blinders and were not aware of the impact of the financial sector strength, that would be nothing short of downright foolishness.



But what would strength in the Dow, for example, tell you about the Dow issue(s) you were trading? The most important consideration is what sector your stock is in. If you're trading a big-cap technology stock, such as IBM, you wouldn't be (obviously) watching the financial sector. But if you were trading a financial stock and the financial sector was pushing the Dow higher, that would be an important consideration.

Remember, what affects a particular stock is not just what's going on with that particular company. Certainly, things such as earnings warnings and analyst ratings will have a direct impact on a stock. But sector-wide, industry-wide and market-wide news, events and perceptions are also going to affect the price of an individual stock.

Put another way, if one chip-maker has a bad revenue forecast, wouldn't you expect that to affect the entire sector?

Stock Index Futures – A "Game" for Everyone

My expertise for the past 20 years, of course, has been in stock index futures, most specifically S&P futures, although we closely watch (and trade) NASDAQ and Dow futures. Thus, my message to stock traders is, why not consider stock index futures?

Truly, my "trading evangelism" message is for anyone who is trading stocks to consider at least adding stock index futures to your arsenal. As an active stock trader (as opposed to the Ma and Pa investor) you are already well aware of lessons such as risk, reward, and margin. And presumably you are already doing technical research on the stocks that you're trading. You are already looking at support and resistance, previous highs and lows, and (see Week 2) the relationship between the current price level and the 200-day moving average.

Now all you have to consider is "[leverage.](#)" Futures, by their very nature, are leveraged. So, for example, you can trade an S&P contract worth about \$375,000 (250 times the index, which is now trading around 1500) for a margin of about \$15,000, giving you more bang for the buck. While this point is obvious, it bears repeating: leverage is a double-edged sword. Both your profits -- and your losses -- will be predicated on the \$375,000.

But leverage isn't the only reason to consider stock index futures. Rather, these futures allow you to play in the broader market. If you trade technology stocks, why not trade (as well as watch) the NASDAQ?

Let's put it another way. The online brokerages introduced retail players to the "casino." By "pointing and clicking," individual traders can enter and execute trades online with ease. Now that you know about the "casino," why not learn a few more of the games? (However, I emphatically state that no one should mistake trading for gambling. Gambling is a game of chance. Trading is calculated risk-taking for pre-determined profit based on technical analysis).

Plus, I believe (as I stated in Week 1) that there are certain attributes that are common to all traders. Among them discipline, the ability to handle risk, managing your capital, and controlling your ego so that when you're in a losing trade, you'll know when and how to "get out." If you possess these characteristics you can trade "anything." I mean if they introduced futures on snow tomorrow, you'd be able to trade it, if there were enough liquidity to make a market.

If you are going to make trading your pursuit, your passion and maybe your full-time profession, why limit yourself? If you are trading stocks, the next logical progression (or extension, if you will) is to trade stock index futures for precisely the reasons we've outlined above. You're already trading in the equities market; why not trade the whole market, or at least a large slice of it?

The Bigger Picture

The most important thing to keep in mind is that the Market itself is like a huge animal (monster, beast...depending upon your perception or metaphor of choice!). It's not just a claw, or an eye, or a tail, or a tooth. It's the whole.

As traders, we're focusing on one portion – an index, a sector, an industry, or one or a few stocks. We can't lose the perspective, however, that we're really part of a greater whole.

Here's what I mean: In this financial universe of the Market, there are countless indexes, sectors, issues and derivatives. There are derivatives of derivatives! We have stocks, futures, indexes, options on stocks, options on indexes and, someday soon, futures on individual stocks. But at the root, everything in the financial world begins and ends with stocks.

When I began trading S&P futures, I learned the connection between the cash and the futures market very quickly. I saw orders coming into the futures pit that seemed contra-trend. What I then learned was that people were using the futures to hedge and protect their stock portfolios. So their opinions on the stock market – or individual, key stocks – was affecting their plays in S&P futures.

By 1990, I was already aggregating technical research from a variety of sources. I had a chartist who was a fan of W.D. Gann (the legendary chartist). Others used Fibonacci, and so forth. With this collection of opinions, I then added my own analysis based on what I saw every day in the pit and my own experience.

But there was a piece missing, I believed. As a floor trader, I did not have direct access to what was happening in the stock market. I was afraid of becoming too myopic. So I decided that what I needed was to add stock analysis to my research.

Today, of course, my Chicago-based trading firm has numerous screens displaying stock prices, options prices, and other indicators (including proprietary ones). But back in 1990, I spent 100% of my trading time in the S&P pit.

So I made a trip to New York with the intention of meeting with specialists in individual stocks on the New York Stock Exchange. My idea was to have a morning conference call among the specialists, the technicians who worked for me, and myself. They would know exactly what was going on in their stocks. I could tell them the perspective of the S&P market, including the technical factors in this market.

Needless to say, while the specialists met with me, they did not go along with my plan. But the S&P market was one that these specialists were certainly respectful of. They knew that this was the broader market, with high volatility and growing volume. Even post-Crash (when Wall Street wanted to blame program trading in futures as the culprit), there was still an awe for S&P futures.

I walked away without the alliance that I had hoped for, but it confirmed my belief that holds to this day. You can't trade one market without looking at the big picture.

Watching the Markets

For an S&P trader like me, that also means watching other indexes. You can't just ignore the impact of the NASDAQ, especially last year when it had a bigger-than-normal influence on the overall stock market. And you can't ignore the fact that the Dow, while it doesn't have the influence it used to, has been relatively strong this summer because of the financial sector.

Typically, what we look for among the stock indexes themselves – S&P, NASDAQ and Dow – is for them to move in sync. Intraday gyrations aside, what I like to see are the three indexes moving in the same direction. For those of you who tune in to our daily commentary, you know we've been saying that until the S&P, NASDAQ and Dow move in the same direction, we won't see a sustained rally. If one of those three is out of sync with the others, we're in for volatile times that will make a rally unsustainable.

Week in Review:

While we all tend to focus only on the index, sector or stock that we trade, we can never lose sight of the fact that we're all part of one big integrated "Market." (Capital "M" intended!)

Thus, if you're trading stocks, you must watch the behavior of certain indexes or sectors to give you insights into the greater dynamics at work

If you're trading stock index futures, the behavior of certain key stocks will give you insight into what forces are impacting that particular market. One only has to look at the correlation of the technology stocks and the SOX index and their impact on the NASDAQ for proof of this. Moreover, the NASDAQ continues to exert a heavy influence on the overall stock market.

Whatever you trade, you must use all the analytical tools at your disposal. As we laid out in Week 2, you must look at the indicators from trendlines to moving averages to determine the trend in the market that you're trading. Moreover, you must look at these dynamics within markets that have a correlation to whatever you're trading. In plain words, you have to analyze the "big picture."

And if you're trading stocks, you should consider trading stock index futures as well. You're already analyzing the market and key components of it. Why not apply that knowledge –and take advantage of leverage – by trading stock index futures as well?

Coming next week... Trading the Volatile NASDAQ Futures Market... An inside look.

Welcome Back To Week Six--

When we're asked the difference between trading S&Ps and NASDAQ 100 futures, we can give two distinct answers:

1. There is essentially no difference. All equity index futures – and all futures contracts for that matter – function essentially the same. The same technical analysis, trend-line indicators, risk/reward ratios, and so forth that we've discussed for the past five weeks all apply here.
2. Yet, there are distinctions about the Nasdaq 100 Index ([NDX](#)), and therefore, the futures contracts based upon it that give it unique characteristics. This is what we'll focus on this week.

Namely, we'll concentrate on six key areas that we use when trading NASDAQ futures.

- Key stocks to watch
- Volatility
- Liquidity
- "Air balls"
- Extensions
- E-mini vs. the Major
- NASDAQ vs. S&P

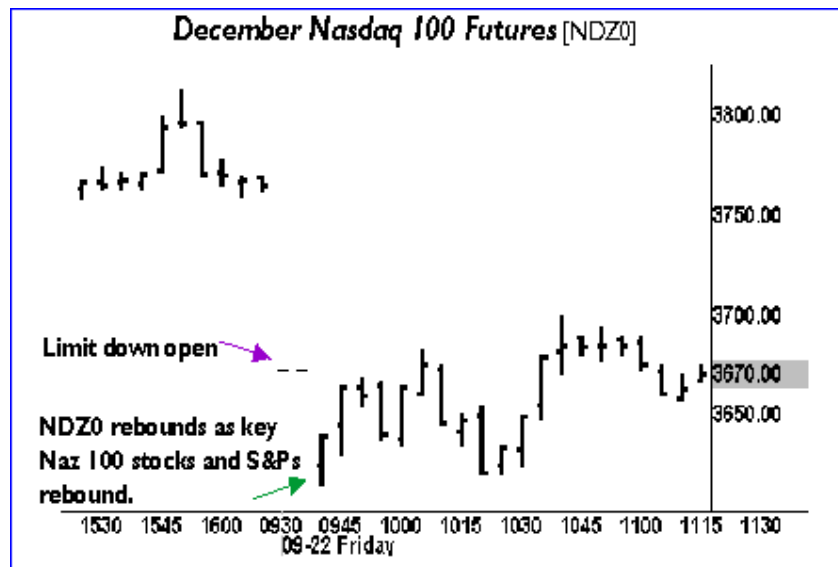
(Note: throughout this lesson we will refer to NASDAQ 100 futures as just NASDAQ).

Key Stocks To Watch

The Nasdaq 100 Index ([NDX](#)), as you may well know, is a modified market capitalization weighted index, with the composition of stocks on the index adjusted quarterly. At this time, **the five top holdings** Cisco ([CSCO](#)), Intel ([INTC](#)), Microsoft ([MSFT](#)), JDS Uniphase ([JDSU](#)) and Oracle ([ORCL](#)) – equate to roughly 25% of the entire index's cap. It only stands to reason, therefore, that you must understand and know the movements of, at least, these issues on a daily basis.

Let's take Friday, September 22, as an example. After the close on Thursday, Intel released a warning that its third-quarter results would be significantly below expectations. That rocked the equities market. S&Ps traded 2000 points (20 handles) lower overnight. Intel was called to open \$15 lower on Friday morning. NASDAQ was already **limit down** – meaning trading would be limited for the first 12 minutes (they could trade no lower than 92). If they went double-limit, they would be 184 handles lower, which on that day was 3581.

What actually materialized was, after the limit came off, NASDAQ traded down 43 points (which was then down 135 on the day) on the very first trade after the halt was limited, and then went down another 10 in the second minute of the trading day. At that point, it was off 145 points to 3620. What was happening in the S&Ps, meanwhile, was that they were 8 handles off their low, which helped to pull the NASDAQ higher. The dynamic between the NASDAQ and S&P will be explored later.



With this kind of scenario, watching Intel – even though it's one of our key stocks – was not going to tell the whole story. Its “bad news” was splattered all over the market. Rather, the real key to the future direction of the market that day – as we advised in our September 22 "Borsellino's S&P's AM" column – would be to watch other tech stocks. These included the other NASDAQ key issues – Cisco, Microsoft, JDS Uniphase and Oracle – as well as IBM ([IBM](#))

If these stocks could withstand initial selling pressure and turn around, that would help set the stage for a spike reversal. In fact, we did see a spike reversal on Friday, albeit a slow one. The NASDAQ 100 cash ([NDX](#)) opened at 3505 and closed at 3701. The NASDAQ futures closed at 3776.

Volatility

The technology-driven NASDAQ is a very volatile market, even on so-called normal days. We estimate that the NASDAQ futures, for example, have a **three-times greater** volatility factor than S&P futures. In other words, if you trade three S&P futures contracts, an equivalent NASDAQ futures contract would be one contract. NOTE: this is only on a volatility basis, not on contract values.

If you think of S&P's as a jet-propelled contract, then the NASDAQ is powered by a rocket with no inertia. The NASDAQ can change direction quickly, without losing speed. As a result, NASDAQ futures have bigger and quicker moves – and the fake-outs can be more dramatic.

Of course, all this volatility gives traders opportunity – and terrific chances to trade every day. There is no doubt that this is the general appeal of trading this market.

But because of the volatility, NASDAQ futures, in our opinion, require traders to use wider stops. The way this market bounces around, it could turn against you momentarily, and then reverse before you have time to react.

Our professional traders use fairly wide stops as a rule in NASDAQ futures. In general, you might consider stops that take into account a 0.5% to 1.25% move. At 3585, that would be 18 to roughly 45 handles – depending upon your risk/reward ratio, the size of the trades you're making, and the market conditions.

On September 22 before the market opened, we expected an incredibly volatile market and very thin conditions. We knew there was a possibility that this market could be 2000 points wide at any given time – meaning 3500 bid and 3520 offered. If those conditions existed, we would have widened our stops even further – to between 1.25%, or 45 handles, and 2%, or about 70 handles. At the same time, we would make commensurate cuts in our position size to keep our overall risk/reward ratio in balance.

Liquidity

Another crucial element when trading this market is the general **lack of liquidity**. NASDAQ futures trade about 20,000 contracts per session. Add to that the volatility of this market, and the **liquidity-factor** is compounded. The stocks in the NASDAQ index include some of the largest cap companies in the country. These issues move quickly – certainly more so than their NYSE counterparts. One of the reasons is because the Nasdaq is a dealer-based market, while the NYSE uses a specialist system aimed at keeping a smooth and orderly market. Another is that the majority of the momentum daytraders trade Nasdaq Composite stocks, taking advantage of access provided by ECNs – electronic communications networks. Faster access can increase the volatility. (About one month ago, ECN-access was added to at least some of the NYSE stocks; it remains to be seen the effect on their volatility).

Because this contract is comparatively illiquid, the NASDAQ futures (the major, not the electronically traded e-mini, which we'll discuss later) can trade a wide bid-ask spread. It's not unusual to call the trading floor for a quote and find that the market is 1000 points wide, meaning 3680 bid at 3690 offered. If you're trading 10 contracts, that's a \$10,000-wide bid/ask spread (which is another reason why you can't have your stops too close).

“Air Balls”

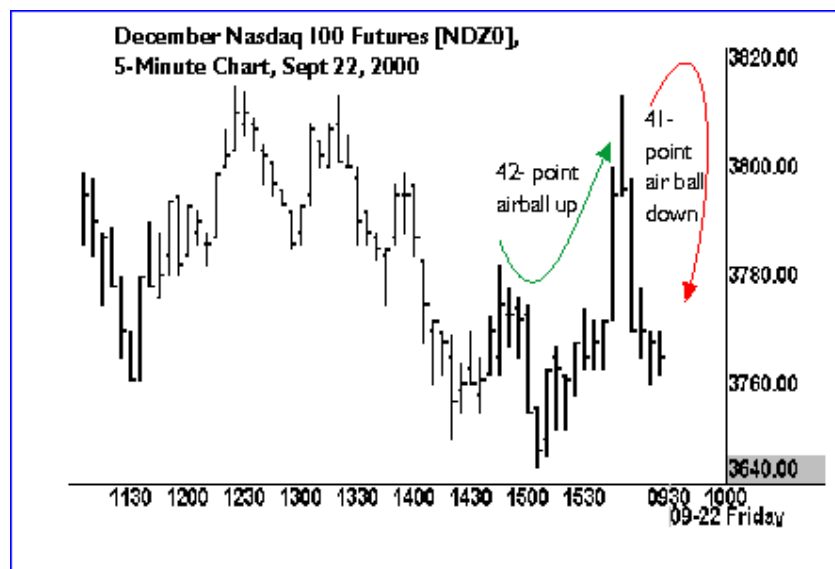
The volatile nature of the NASDAQ, the fast movements of the key, underlying stocks, and the **illiquidity** of the NASDAQ major is a perfect setup for a phenomena we call “air balls.” Let me explain. In basketball, when a player shoots for the hoop but misses – no backboard, no rim, no net – it's called an air ball. On that shot, there's nothing between the player's hands and the floor but air.

That can and does happen frequently in the NASDAQ. Of course, these sudden moves can be seen in other markets, as well. But in the S&Ps, these air balls usually account for moves of just two to six handles. In the NASDAQ, an air ball can be as many as 20 handles, and sometimes 30 handles – or even more.

What happens then is there is nothing between one price and another but “air” – or more precisely, massive acceleration.

Case in point: Thursday, September 21. In the last half-hour of trading, the NASDAQ took off, rising from 3768 to 3810, or 42 handles – all in seven minutes. Six minutes later, NASDAQ futures were back down to 3769, or 41 handles, and closed at 3765, three points below where they took off. Let's take a closer look at this action: at 2:48 p.m., NASDAQ futures went from 3780 to 3795 in one minute. That's an air ball.

Then at 2:51 p.m., it went from 3799 to 3810 – 11 handles – in another minute, and another air ball. On the downside, in six minutes, NASDAQ dropped all the way back to 3775 – or 35 handles.



What caused this could be debated for a long time. Conspirators would say that perhaps there was a “leak” on the Intel news that would come out after the market closed. But more realistically, it could just be the result of a confluence of opinion or just general nervousness – whether they knew about Intel or not.

Whatever the reason, it’s important to know that air balls – sudden, rapid and sometimes unexplained movements – are going to happen more often and more dramatically in NASDAQ.

Extensions

When it comes to analyzing the NASDAQ, one of the things we look for are “extensions,” which are simply a **percentage change from various moving averages**. For example, if the 20-day moving average in the NASDAQ is 3900 and we’re trading at 3700, that would be a 5.1% extension. We plot these extensions on a graph to analyze these correlations. What we have found is that this market typically bounces/reverses if we trade **more than 12% from the 20-day moving average**.

As traders, we use this information in a few ways. For one thing, we know that when we’re extended around 12%, the odds are slim that we’ll get much more out of a position. Instead, we’d be looking for the best place to cover a short position or exit a long. Then, the next step would be to wait and look to eventually reverse the position – usually the next day – to take advantage of oversold or overbought conditions.

E-mini vs. NASDAQ Major

One of the characteristics of this market is that the NASDAQ major contract does not trade that often in the pit. There are more price changes in the electronic, or NASDAQ 100 E-Mini, contract. In the NASDAQ E-mini, orders, cancels, fills and reversals can all be done in seconds. But in the pit, these actions can take 10 or 20 seconds – or maybe even in minute.

As part of the phenomenon, the quotes and trades in the pit are actually trying to keep up with the e-mini, most of the time. That sets up an arbitrage opportunity between the two venues. Granted, to do this you must have a Globex machine, the electronic terminal from the Chicago Mercantile Exchange, to trade the e-mini directly. And you must have someone in the pit trading the NASDAQ major.

But professionals with this setup can play the price differential between the e-mini, which tends to react faster to changes in the underlying stocks, and the major.

NASDAQ vs. S&P

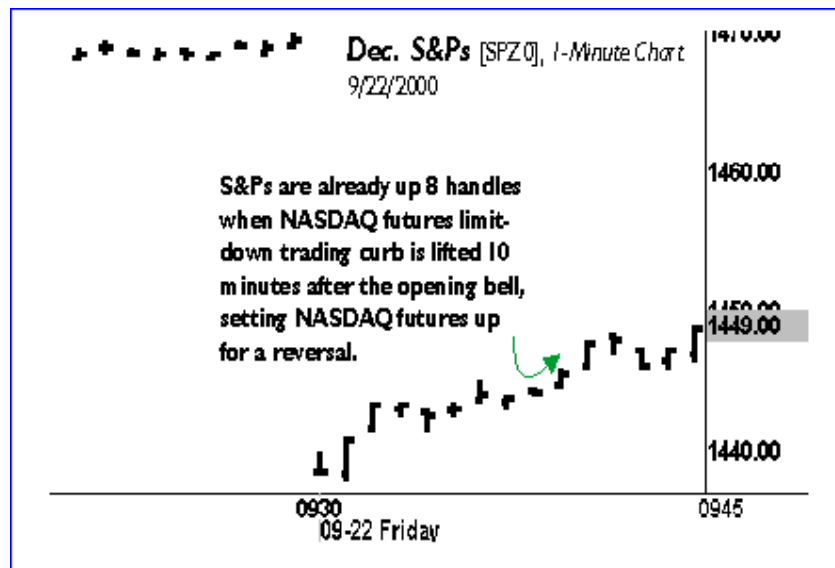
There is a dynamic between the NASDAQ and the S&Ps that sets up an interesting interplay between the two markets. At times, the NASDAQ will be the strongest index, pulling the S&Ps and even the Dow higher. Or the S&P may be stronger, acting as a brake on a fall in the NASDAQ.

Curiously, both indexes are reacting to the same thing – that being the price movement of the stocks in their relative cash indices. But the technology-dominated NASDAQ is quicker to move and react.

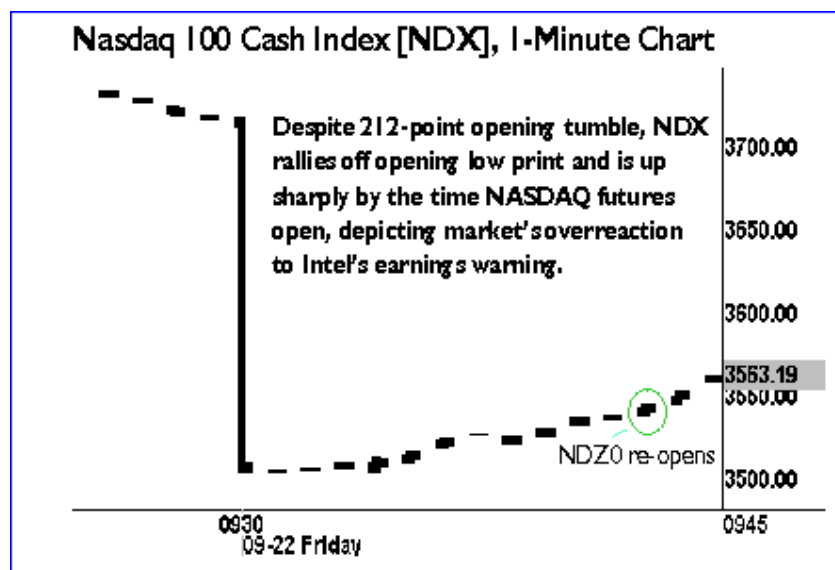
One interesting correlation between the NASDAQ and the S&P that we’ve seen, particularly during the strongest part of the bull market over the last two years until April 2000, is when the NASDAQ would hit limit down, but the S&Ps would be only half of the way – or less – to its limit. What happened next was the most telling: When a trading halt (limit move) on the NASDAQ expires, within three to seven minutes, if NASDAQ futures DO NOT go down another 30 to 60 handles AND stay down in that range, and the S&Ps DO NOT see a five-to-eight-handle drop, then usually any uptick in either the S&P and NASDAQ would be met with massive short-covering. And this starts the big reversal. Part of the reason is that the S&Ps did not go down and, therefore, NASDAQ futures were probably overdone.

Friday, September 22, was an example of both of these phenomena. The NASDAQ came off its limit at 8:42 a.m. As we outlined earlier, it traded down 43 points, then went down another 10 – for a total decline of 145 points at 3620.

Meanwhile, as stated earlier, S&Ps hit their low in the second minute of trading at 1438. When the NASDAQ hit its low, S&Ps had already come back 8 points from the bottom at 1446. That's the type of divergence we look for: the NASDAQ had hit its limit and reopened, but the S&Ps were no longer at their low and, in fact, were 8 handles above it. This was a setup for a potential reversal, especially because of the emotional nature of the Intel news, which was an overreaction in the first few minutes of trading.



Another clue could be found in the NASDAQ 100 ([NDX](#)) cash, which opened 212 lower, but by the time the futures began trading was nearly 50 points off that low. This was another confirmation that the market had a psychological overreaction to the Intel news.



This was along the lines of what happened on the Wednesday **after the Crash of 1987**. S&Ps were closed, but the former "MAXI" contract on the Chicago Board of Trade (which at the time was based on 20 of the largest-cap stocks) kept trading. The MAXI went from an 80-point discount to an 80-point premium, which set up buy programs in the equities and, by the time the S&Ps reopened, the foundation had been laid for a rally. Of course, this was an almost mechanical, very strong arbitrage-based reason for a rally (i.e. massive buy programs). On Friday, the setup was a divergence in the magnitude of the psychology of the two markets. In plain words, both markets were down, but NASDAQ was **way overdone** to the tune of roughly seven times more than the S&P. To put this in perspective, Intel said it was "only" going to make 12-20% per year, based on the third quarter. It wasn't the end of the world...

A NASDAQ Trade

Putting this all together, let's look at a trade that we made on Friday. At the open, the NASDAQ cash market was off about 5%. A trader can take advantage of this in several ways.

First, the futures were locked limit down at -92. The second limit, as we stated above, would be -184. Now, the smart trader would be watching the cash and individual stocks, especially the top five (although, as we stated, we paid far less attention to Intel than the others).

The first key in Friday's action was that the NASDAQ futures did NOT open at the second limit, even though the cash was -195 at the time. In fact, a premium was being created in the futures market, as we opened nearly 90 points above the cash market – even though fair value was about 50. Secondly, the NASDAQ futures never traded through the most recent low of 3600. All it could muster was 3615 on the downside.

At this point, three key things happened: The first was a potential spike reversal rally on negative news from one company. Remember, this was not a global catastrophe or a financial crisis. It was Intel announcing it would miss earnings expectations.

Secondly, when sellers had a chance to offer the market down to a second limit and really put a scare out there, it failed. In fact, traders were willing to buy the reopen at a significant premium.

Thirdly, the four other major stocks (CSCO, ORCL, MSFT and SUNW) opened at the bottom and immediately rallied on large volume. This was coupled with the inability of the market to penetrate its most recent low of 3600.

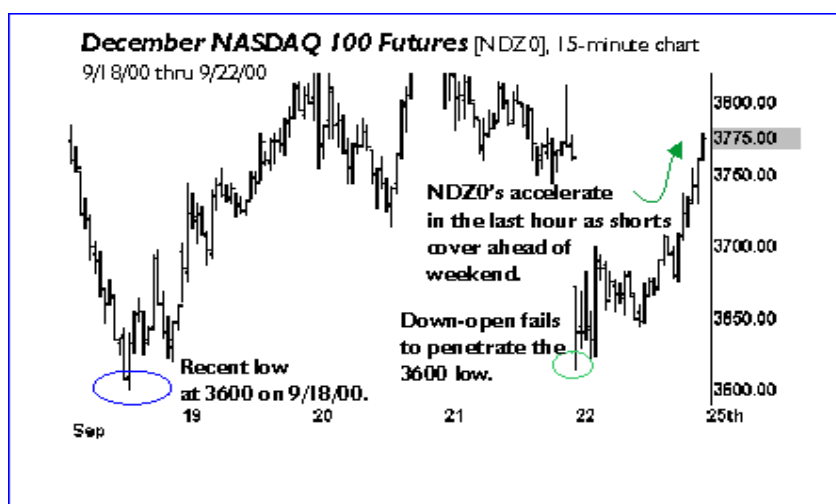
All of this added up to a long scenario. Now on days like this, the key is just getting in. The market is so wide and volatile, that you cannot try and squeeze every last tick. If you try, you won't get filled. You buy and wait for the oversold effect to work its magic.

On the way up, you have some existing levels of resistance that allow you to take off part of the position as it goes your way.

Then it is the final hour. The NASDAQ futures contract has a **strong history** of huge rallies and/or breaks in the final 60 minutes, and even more so in the last 30 minutes. At this point, say you were still long, and you're looking for the market to rally all the way back to unchanged on the day. What was the play? Buy more...a final hour trade with the wind at your sails.

Why? Because the market had already spent five hours and 30 minutes proving that it was more than Intel. Now, a trader would have to ask himself the key question: *If I was short, would I cover before this close?* And if I was on the sidelines, would it be a safe bet that we continue higher on Monday?

The answer to both of these questions is "yes." So we purchased more for the final thrust of the day and exited profitably at the bell.



Week in Review

- The NASDAQ is dominated by the five top holdings – Cisco, Intel, Microsoft, JDS Uniphase, and Oracle. Therefore, it pays to understand and to know the movements of these issues on a daily basis. The reason is these five holdings equate to roughly 25% of the entire market cap.
- Liquidity can be thin in this market, which typically trades 20,000 contracts per session. So when you call the floor for a quote to do 10 contracts, you may hear a 1000-point range – or 3780 bid at 3790 offer.
- Volatility is high in the NASDAQ. That can mean both a challenge and an opportunity. To handle the increased volatility, traders should consider widening stops vs. what they'd use in S&Ps, for example, and cut down their position size when they use extraordinarily wide stops.
- Volatility and poor liquidity can result in “air balls” – big, fast moves in one direction or another with nothing but acceleration in between.
- Range extensions are a key indicator. For example, if this market trades more than 12% vs. the 20-day moving average, it typically has a “bounce.”
- Overall, keep your wits about you in this market. The NASDAQ is a market that will give you some lumps. But its action can also provide a lot of opportunity.

Coming Next Week: Your questions answered.

Send them in to questions@tradingmarkets.com

Welcome to Week 7!

Whenever I speak at a conference, the most lively (and often the most informative) part of the presentation is the Q&A. That's why I wanted to conclude this course with a chance to answer your questions.

For the past several weeks, I've explained to look at the markets and the different strategies I employ to successfully trade the S&Ps. **My hope is that most of what I've said is applicable to whatever type of vehicle you're trading.** I know that the majority of TradingMarkets.com members trade individual stocks on a short- to intermediate-term basis. If you're one of them, everything I've said about money management, trend analysis, indicators, support and resistance, breakouts, etc. is relevant. I also want to emphasize that if your focus is individual stocks, you'll want to **learn to keep an eye on the S&P futures in order to time your entries and exits with the flow of the overall market.**

If you're a trading veteran, you may have noticed that some of what I've presented covers familiar territory. There's good reason for this. **There are no simple shortcuts or magical tools that make trading a mechanical operation.** You have to watch the markets and reevaluate the situation every moment of every day. Remember, it's not the tools that make you a consistent winner, rather, it's what you do with the tools that matters. I'm sure you've heard that one before too.

Finally, I want to thank all of you for sending the questions you've sent in. I enjoyed answering them and look forward to meeting you at TradingMarkets2000.

Now, let's begin.

How I Calculate Pivots

Q: Can you please tell me how you arrived at the pivots and the support/resistance numbers in your September 5 article "Welcome Back, Volatility?" I really appreciate your daily commentaries. They have been very helpful to my trading.

LJB: First, our "Morning Pivots." **To be clear, I should really say this is a "pivotal" area, above which we expect upside momentum to increase and below which we think the downside targets will come into play.** These pivots are produced each morning based on our proprietary indicators, looking at the previous day and overnight (Globex) trading action. What we're looking for, based on a variety of indicators, are the key levels that will determine market direction. In the case of the morning pivotal area, this is the direction we expect in the first hour to 90 minutes of trading.

Our support and resistance areas work much the same. We look at a variety of indicators, including previous highs and lows and areas at which the market had difficulty moving higher or moving lower. We also look at previous price levels at which the market saw a lot of volume, indicated by the amount of time spent at this level.

Another indicator we use is the moving average. As we outlined in Week 2 of the course, one strategy is to look at the relationship between the current market and a moving average such as the 200-day (or a shorter time frame for shorter term trades). For example, in an uptrend, the farther the market is above the 200-day line, the less likely it is to break below the moving average. And if it does break, it is not likely to go very far below the 200-day line, nor trade below it for very long. Similarly, in a downtrend, the farther the market line is below the 200-day line, the less likely it will rally above the moving average. And if it were to rally, it is not likely to go very far above the 200-day line, nor trade above it for very long. Why? Because it would take a lot of "energy" for the market to hit a faraway target and go through it, unless there were some major surprise to propel it in one direction or another – such as the Iraqi invasion of Kuwait or the Russian debt default.

How I Calculate Support and Resistance

Q: I would like to know how you derive your support and resistance numbers. It looks like you're using bands of support/resistance instead of support/resistance numbers used by the floor traders. What time frame do you look at? The past three days or just the day before?

LJB: In our morning commentary, we give support/resistance bands, or areas, because you can't consider this to be an exact science. At TeachTrade.Com, we update these areas throughout the day as patterns emerge, are confirmed, or are negated. We're looking at a variety of indicators and trend lines to help us determine the "consensus" on the market.

As for the areas that we do outline, **it's important not only to focus on that target, BUT ALSO on the behavior of the market in that area.** For that, we look not only at the past day, but the past several days (or maybe even a longer time frame if the market is approaching a key level at which we saw significant dealer buying or selling, or support or resistance).

Here's how we might trade a key area on a given day: On September 26, we outlined 1461-1464 as our morning pivotal area. The market did spike above 1467 on Microsoft news, but could not sustain that level. When it drifted below 1465, I played from the short side because I knew the market had difficulty earlier in the day in this area.

It's worth repeating: The behavior of the market in a specific area is really more important than the target itself.

What Time Frames I Use

Q: I Read your book The Day Trader: From the Pit to the PC and found it very insightful. I've been trading futures for five years, and daytrading e-mini's full-time for about a year. I know we need to trade in a way that suits our personality. And my personality says to trade the swings. This has worked out wonderfully for me. Everyone says to look at intraday charts with not less than five-minute bars. I understand this, since it reduces noise and sets you up for the bigger future moves. My problem is I start with five-minute bars but ALWAYS end up gravitating back to one-minute bars. Any advice?

LJB: My advice is to set up your charts with 45-minute bars, 15-minute bars, five-minute bars and one-minute bars. That way you'll be able to study the patterns as they develop on a very short-term and daily basis. I like the 45-minute chart because, from 8:30 a.m. until 3:15 p.m., it divides the day into nine segments of equal length.

How I Use Volume

Q: In your column, you often refer to high volume levels, even for the e-mini as support and resistance levels and use them as reference points in your trading. These are a key part to my trading in T-Bonds, as the CBOT produces the Liquidity Data Bank which tells you how much volume is traded at each price level and breaks the volume down by trader class. Do you acquire this information for the full-size S&P from your floor operation, or do you estimate the volume by how much time is spent at the price level, and how do you acquire this information for the e-mini? Also, do you believe that subscribing to one of the squawk boxes would be beneficial, and what specifically would you listen for?

LJB: **As for the volume levels, we use the time spent in a particular zone,** as well as our floor operation, to identify volume traded at key levels. I do not know of another way to get this information for the e-minis.

As for the "squawk box," one of our own traders uses a headset to communicate with us from the floor. But he does not quote the market unless we ask him for something. **Otherwise, we just use it for the "noise level."**

The problem with other "squawk" services is they always try to quote the market, which is very difficult and non-productive in my opinion.

Selecting a Futures Broker

Q: My highest priority question is about futures brokers. What are the futures brokerage firms that you would most recommend? Also, what other sources might I access that have reviewed the various firms (e.g., magazine articles

and web sites). As you well know, often the most heavily advertised firms are not necessarily the best. I basically simply need execution capability via the Internet.

LJB: There were some vitally important issues that I considered when I selected our futures commission merchant (FCM). These are the same issues you or anyone should consider when it comes to selecting a broker: **Number one is reliability**. The best price in the world doesn't mean anything if you don't get good service. In trading, that means you need an easy process for entering your trades and good information on the market if you choose to use it. Price, of course, is always a consideration. Transaction costs are a big part of trading. In futures, these costs are not highly advertised (as they are in stocks) so it pays to comparison shop. Also, see what restrictions apply on account size and margin requirements to make sure they are not going to be restrictive for you.

Selecting a Futures Broker for E-mini Futures

Q: First off, awesome course! My learning has grown leaps and bounds because of your TeachTrade site and now this TradingMarkets course you're teaching. Thanks for your time and knowledge. My question is: Can you recommend some online web brokers for trading the E-mini futures? I currently have Brown and Co. I think they do a good deal with stocks and options, but I'll need another broker for futures. Also, I currently follow the futures from Quote.com using the NQ00z's and ES00z's, but should I be using the CME site instead? Thanks in advance.

LJB: I don't want to recommend a particular futures broker. But, in addition to what I wrote earlier about reliability, price and margin, it's also good to deal with an experienced firm. You want to make sure your brokerage is well-versed in futures. Look around the major names and see what meets your needs the best.

As for quotes, there are a lot of vendors for this information, the selection of which comes down to price, reliability and personal preference. If you go to the CME web site, you'll see the Exchange is offering three live-quote pilot programs. Only selected CME contracts are available on this pilot, so make sure it meets your needs.

Why I Daytrade the S&Ps and Not Individual Stocks

: Lewis, in Part 1 of your course, you said you don't daytrade stocks, you only invest. What is your rationale for not daytrading stocks in addition to futures. Is it solely due to the limited leverage possible via stocks? The reason I'm asking is this: On any given day, the S&P might be doing okay as a trading vehicle but not necessarily great. On the other hand, every single day, one can filter among thousands-upon-thousands of stocks to find several stocks that are moving incredibly well and predictably on that particular day.

Therefore, given hypothetically equal margin availability, I would think one would choose to trade the "perfect" stock for the current day instead of being "stuck" with trading the very same vehicle (i.e., the S&P futures) day in and day out. Am I missing something? My assumption is that one would select futures (versus stocks) only because of the extra leverage possible (and the ability to short on a downtick). True?

LJB: I've been happily "stuck" with S&P futures for nearly 20 years. Why? Because **I like the volatility, the liquidity and the action of this futures market**. S&Ps have plenty of volatility to make money, "slow days" notwithstanding. Further, they have plenty of liquidity, which is imperative for trading. **Some of the high-flying stocks have a liquidity problem at times.**

But mostly this is a personal choice. I still trade on the floor, using the leverage inherent in futures to trade large size every day. This is my arena, one in which I (at the risk of sounding boastful) am a dominant player. **For me, stocks are longer-term investment vehicles, such as for my retirement portfolio. No doubt, there are plenty of opportunities to daytrade stocks. In fact, some of the traders who work for me in our Chicago trading firm do trade stocks along with futures. But for me, I like to WATCH the movements of key stocks to help me trade futures both on and off the floor. With leverage, liquidity and the kind of size I can move, S&P futures is the place for me.**

Preparing for Fast Direction Moves Off Program Trading

Q: I have been daytrading for over a year now, and I have managed to survive. I must start off by saying that your morning commentaries are incredible and highly accurate. The S&Ps are always pausing reversing or doing something significant at the numbers you give. Your commentaries have been a blessing for my trading! I do have a question about Week Four's Lesson. Can you give me more information about Program Trading at 2:40 and 2:20

central and how to figure out which direction it will be moving? Thanks, any information you can give me will be greatly appreciated!

LJB: First of all, congratulations to you for surviving more than one year as a daytrader. **For all the traders I've trained and backed over the years (and in my own early days, for that matter), the first year is the hardest.** In fact, no one should expect to make a profit the first year of serious daytrading. A scratch (no loss/no win) is actually a great accomplishment. That first year should be spent learning to trade, getting over the "stage fright" of executing a trade, and building up both knowledge and confidence. **The losses one has in the first year are just tuition that must be paid to the university of the market.**

As for the Program Trading between 2:20 and 2:40 p.m. Central, the most important thing to note is that this is the time frame during which the programs tend to come in – so be prepared. **When these programs come in, the market moves very quickly and usually in one direction. Knowing that in advance can help you prepare for a fast, directional move.**

The Importance of Hourly Lows

Q: Frequently in your morning commentary you indicate the significance of an hourly close above or below a certain price point. What is the significance of an hourly close over a single point above or below that level? How can someone who trades off the five-minute chart use this in their trading?

LJB: **An hourly close can indicate a change of trend or a continuation of a trend.** Speaking of hourly closes, keep in mind that I also like the 45-minute chart, because it dissects the day into equal portions, which tend to be significant in the market.

My Favorite Books On Trading

Q: What are the best couple of books on trading, as opposed to technical analysis, that you can recommend? I find traders' memoirs, like your own (The Day Trader: >From the Pit to the PC), more useful in knowing how to trade than the TA (technical analysis) books out there. What books and memoirs would you recommend and why?

LJB: Thanks for your kind words about the book. I believe that these memoirs are helpful for a few reasons. First, they give insight into the rationale, strategy and approach of successful traders. Equally important, the best books give insight into the learning curve (and often the setbacks) that traders have endured on the road to success. Among the titles that I'd recommend are any of the [Market Wizards](#) books by Jack D. Schwager and TradingMarket's own The Best: [TradingMarkets.com Conversations with Top Traders.](#)

In Closing...

I'd like to end this with a few closing thoughts, which are important for ALL of us traders, whether novice or experienced professional.

- The key quality for any trader – in any market – is discipline. Each day you must take a disciplined, methodical approach with a plan that is based upon technical analysis. The greater your discipline, the better your chances of success.
- You can never know too much about the market. That's why, even if your money isn't in the market, your mind should be. In 20 years of trading, I've learned to recognize certain patterns and behaviors that will be repeated. But I must be alert and aware to recognize them as they are setting up – and to act on them.
- Use every tool available to you. Watch the indicators – whether it's a group of stocks or another index – that can give you the best sentiment. Look beyond the price patterns on the charts at other indications such as volatility.
- Never think you can outsmart the market. You might pull it off once or twice. But then the market will turn around and flatten you. The market determines its own trend. Your job is to discover what that trend is, how long it's likely to be sustained, and what your highest probability move should be.
- Losses will happen. They are inevitable. In fact, they are the cost of doing business in this profession. Take a break, clear your head, and dissect what happened in your trade. It's the best education you'll ever have.
- Don't let the wins go to your head. The worst thing that can happen to novice traders is a week of wins. They immediately believe they are invincible. They are unbeatable...then they're busted the next week.

- Trading has the highest highs and the lowest lows. There is no other profession like it for pure adrenaline rush. You live and die by your wits, your brain and your endurance. If you're going to be the trader, having these abilities are the pre-requisites to get you into the game. Your ability, alone, is what will keep you there.

Good luck...and good trading.

Lewis J. Borsellino