

SECRETS OF SUCCESSFUL TRADERS

**This book
was sent to you,
courtesy of
Equis International,
creators of
MetaStock software.**

MetaStock is the leader in charting and analysis software.

With MetaStock on your side,
you'll have the most advanced charting,
testing and exploration tools available today.

Tools that can help you more accurately forecast
when it's time to get in...or get out.

MetaStock[®]

For more information on MetaStock products,
please call 1-800-775-9341
Or visit www.metastock.com

This book is not a recommendation to buy or sell, but rather contains guidelines to interpreting various analysis methods. This information should only be used by investors who are aware of the risks inherent in securities trading. Equis International, Robert Deel, Price Headley, Mike Hurley, Steve Nison, Barbara Star, Simon Sherwood, Daryl Guppy, and John Bollinger accept no liability whatsoever for any loss arising from such use of this book or its contents.

©2003 Equis International, Inc.

MetaStock is a registered trademark of Equis International. All other names are trademarks of their respective owners.

Contents

Introduction: Secrets from Successful Traders	4
It's Your Money, Take Control...!	7
BY ROBERT DEEL	
How to Manage the Highs and Lows in Trading . . .	13
BY PRICE HEADLEY	
My Secret to Market Internals	19
BY MIKE HURLEY	
Using Candle Charts to Spot	23
the Early Turning Signals—The Basics	
BY STEVE NISON, CMT	
Catch that Trend! Directional Strength	31
and How to Find It	
BY BARBARA STAR, PH.D.	
One Custom MetaStock MACD...to go!	37
BY SIMON SHERWOOD	
Understanding the Crowd	43
BY DARYL GUPPY	
Bollinger Band Basics	49
BY JOHN BOLLINGER	

Introduction

Secrets from Successful Traders

Here it is! Some of the most valuable trading insights for winning in today's "tough markets" are waiting to be discovered in this book. This is your opportunity to "learn from the Pro's." So get ready to collect the latest strategies and tips on critical topics facing traders today.

First, **Robert Deel** gives you his "16 Rules of Investology." Compiled from his 20 years of experience, this checklist will keep you from making many of the common mistakes traders make.

You'll learn how to better manage the difficult highs and lows in trading from **Price Headley**. He shows you how psychological factors, such as perfectionism, fear, and lack of confidence can cause disastrous results in your trading, and how you can overcome them.

Studies show that the vast majority of stocks follow the trend in the overall market. **Mike Hurley** discusses market internals, and how they can help you measure what the overall stock market is *really* doing.

Steven Nison shows you how candle charts can help you spot early turning signals and enhance your trading power. You'll learn how this powerful tool can give you a jump on the competition, preserve capital, and "open new and unique doors of analysis."

Barbara Star discusses two powerful indicators that help you detect, not only trend direction, but strength as well. Learn how to use them to avoid trading pitfalls by signaling changes in price movement.

Discover the power of the MACD from **Simon Sherwood**. Learn what it is, what it can do, and how to create your own customized MACD to fit your unique trading program.

Daryl Guppy takes on some tough trading questions, such as, what signifies a rally...or a trend? He shows you how his Guppy Multiple Moving Average can help make these initial decisions.

Last, but certainly not least, **John Bollinger**, creator of Bollinger Bands, discusses 15 basic rules for using these popular bands. Learn how they can significantly boost your trading potential.

As Robert Deel mentions in his article, professional traders have made millions in the last three years because they have learned how to make money when it's going down, as well as up.

Now it's time to discover those secrets of success. Enjoy this book, and "Happy Trading".

It's your money, take control...!

BY ROBERT DEEL

Taking control in the management of your money in today's world is perhaps one of the most important financial imperatives facing us all. This checklist should serve you well, and possibly keep you from becoming a victim of the market and false media information. In my twenty-one years of trading experience I have found these rules to be an invaluable way of keeping me focused on the trade.

Deel's 16 Rules of Investology

1. TRADE WITH A PLAN

Set objectives before you ever buy. Define all outcomes—not only what you will do when it goes right, but what you will do if you are wrong. Determine the amount of capital you are willing to lose and conversely, define when you will take profits. Letting the market take away your profits by holding on to a losing trade is not a good strategy. Write out a trading plan on paper and follow it. Do not become a causality of emotionally involved buy or selling. Trade with a plan.

2. SCREEN YOUR TRADES

To select trading vehicles you must have a predefined method. Select a method based on price momentum and trend. Don't guess what the future is going to be, trade the current trend direction. Your method must consider your individual time frame and risk tolerance. Always address liquidity, sector rotation, and technical factors when screening stocks.

3. ALWAYS LOOK AT A CHART

Never buy a stock without looking at a chart of the stock first. Look at the one-year trading range. Ascertain where you currently are in the trend and what that trend is. Also determine if the chart reflects a stock split. Never trade against the trend. Buying and selling decisions are technical in nature. Fundamentals will never tell when to buy or sell a stock. Always look at a chart for entry and exit timing decisions.

4. STAY WITH A TREND

Your probabilities of success are far greater if you stay with a definable market trend. Statistically, these trends provide better profit potential with a lower amount of risk. A good rule of thumb is to watch a 50-day exponential moving average of the close. This moving average represents the intermediate trend of a stock. A 12-day exponential moving average represents short-term trend. The use of these two moving averages should yield excellent results in keeping you in the trend. If you perceive the trend beginning to change, act accordingly by taking profits or placing stops to protect your capital and locking in a profit.

5. USE MONEY MANAGEMENT TECHNIQUES

Determine the probable dollar losses of your trading plan or investment style based on your trading record for the current year. Then devise a way to generate income through passive sources.

Cutting a loss quickly is the best money management you can have. Too many times traders fall in love with stock, holding on as the stock begins to decline. Never use a hedging strategy, such as options, to justify holding on to a losing position.

The use of money market, bond, and stock dividend income to offset losses in your trading portfolio is an excellent technique.

Covered call options may be an appropriate way to generate income for your portfolio to offset losses. Be careful here because you can write covered calls into oblivion. If the stock is going against you, sell it.

If you are going to hold a trade overnight, never risk more than 3% of your available capital. If you are going to day trade, an excellent rule of thumb is to only risk 1% of your capital in any one trade.

6. BUY AND SELL ON CONFIDENCE

Many times you won't feel quite right about a buy or sell decision. If this feeling persists after you have done all your research and you have followed the rules to this point, don't take the trade. Too many times individuals try to rationalize a decision. Don't try to find a good reason for making a bad decision. Your decision must be a confident one.

7. BUY ONLY LIQUID STOCKS AND LIQUID MARKETS

Stay with major markets and stocks with millions of shares in the float. Make sure the average trading volume is enough for you to sell all of your position on any given day. By following this rule you should be

assured of a reasonably good execution of your trade. Don't buy stocks trading at the lower end of the price range. Generally speaking, do not buy stocks that don't have good trend characteristics or predictability. True professional traders avoid them and so should you.

8. DON'T BUY OR SELL ON HOT TIPS

More money has been lost on hot tips than is in the U.S. Treasury. While this is an exaggeration, it does make the point clear. If someone tells you about an investment or trade, research the recommendation before you put your money into it. Most novice investors and traders fall victim to tips every day. Please don't fall for the story no matter how good it sounds. Always use technical analysis to make your buy and sell decisions, and buy or sell based on facts.

9. DO NOT DOLLAR COST AVERAGE

If your timing decision was wrong on an aggressive stock, don't make the problem worse by trying to buy a stock that is going lower. The probability is that you will only compound the loss. I call this technique disaster cost averaging. Don't buy a stock until the trend is evident. Dollar cost averaging is good for your broker, but if you continue this technique, the 'broker' you will become.

10. NO ONE WINS 100 % OF THE TIME

Many people enter the stock market focused only on the profits and do not consider the losses. If you think for one minute you are going to win one hundred percent of the time, you are wrong. Losing is just part of the cost of doing business. Your goal is to make sure you control the risk and not blindly put your money at risk, like a buy and hold investor. You must come to the realization that you will never learn how to win until you first learn how to lose. How you handle loss psychologically is truly the difference between an amateur and a professional. Professional traders don't react the same way as an amateur to loss. When a professional trader loses, he or she simply says *next*. They don't take the loss personally.

11. ALWAYS USE STOPS

The proper use of stops will protect profits and limit your losses. Look at stops as profit and loss insurance. When you enter a trade, you place a stop to limit the loss in case the trade goes against you. When the trade becomes profitable, you use them to lock in a profit.

Anyone who would argue against risk control by discouraging the use of stops is a fool indeed. In effect they are saying you should put your capital at unlimited risk. Does this make any sense to you? Of course not, but that is exactly what a buy and hold investor does all the time. Most investors do not use stops because they are afraid of being stopped out. This is a psychological problem of not wanting to be wrong, or having to admit to yourself you lost on a trade. It certainly isn't based on logic or strategy. Remember, always use stops if you are carrying a trade over night.

12. I DON'T HAVE TIME

Make the time or suffer the consequences. If you are too busy to manage your money, maybe you're too busy. Take a look at your portfolio and if you lost half of your money without knowing it, you can congratulate yourself on being too busy. Was it worth it? Probably not. It doesn't make much sense to work yourself to death and have nothing to show for it. You must take time to educate yourself and take control of your future.

13. BE PATIENT AND LET TIME BE YOUR FRIEND

Making money safely takes time. The only time to hurry is when you're in trouble. Remember, "Everyday is not a trading day". Only trade when the sector, market, and the correlating stocks are in trend. Just because you want to trade doesn't mean you should. Only trade when the probabilities are in your favor, and let the market come to you.

The market is going to do what it is going to do and what you want is irrelevant. Don't become addicted to the action. You are not an action junky. You are a high probability trader. Profits are made the old fashioned way, one trade at a time. Be patient and make time your friend instead of your enemy.

14. LEARN FROM YOUR MISTAKES

The most successful traders and aggressive investors learn from their mistakes. Many even go as far as writing down what went wrong and analyzing the problem. Mistakes can be costly, so use them as learning experiences and don't make the same mistake twice.

Unfortunately a large number of people are doomed to make the same mistakes over and over again. This behavior is usually a sign of emotional reactions to price momentum and the absence of any well thought out strategy. My father once told me that the best education

was to learn from the mistakes of others. Most people fail in the market not because of technology or a lack of information, but because of emotional reactions, and never learning from their mistakes and the mistakes of others.

15. KNOW HOW TO SHORT STOCK

Markets do not go up all the time, a painful lesson some have learned over the last three years. From the year 2000 to the present time, we have experienced one of the most agonizing bear markets in the last 70 years. Does this bear market mean that you can't make money? *No*. What has the trend been for most of the last three years? The obvious answer is down.

Common sense says you are to follow the trend. So if the trend has been down, why haven't you been shorting stocks? The reason is sadly fear and ignorance. Only 2 % of the American public ever shorts a stock in their lifetime. This is shocking when you understand that markets and stocks fall 67% to 80% faster than they rise.

In other words shorting stocks tends to compound money faster than buying a stock to go long. Plus, if you can make money when the market is going down and when it goes up, what is it that you have to be afraid of? Professional traders have made millions the last three years. You must learn to short stocks if you are to have any chance of being successful in today's markets. Fear and ignorance must be overcome because you must know how to short.

16. FOLLOW THE RULES

Some people are doomed to make the same mistakes over and over again. Using this set of 16 trading rules, which has been compiled from over 20 years of experience, should keep you from making many common mistakes.

If you follow Deel's Rules of Investology, you have a much better chance of success than someone who doesn't. Always remember, there is never any guarantee of success. But if you are properly educated and develop the correct mindset, you have a major advantage. Don't become one of the sheep led to the slaughter by media nonsense. You must make your own fortune and control your financial destiny.

Always remember, it's your money. Take control...and follow the rules.

Robert Deel is an internationally recognized trading expert, and has trained groups of traders throughout the U.S., Europe, Asia, and Canada. He is the author of *Trading the Plan* and *The Strategic Electronic Day Trader*. He is also the President and CEO of Tradingschool.com, a school that trains individual and professional traders from all over the world.

How to Manage the Highs and Lows in Trading

BY PRICE HEADLEY

In order to manage your emotions effectively when trading, you need to create a written plan that you can review regularly to stay focused on your goal of trading success. By writing down your plan, you put yourself in the top 3% of individuals who have written goals and plans, giving you an immediate edge on most traders. Make sure you have answered these questions, which are covered in further depth in my book, *Big Trends in Trading*:

- 1) How will you enter trades? The key to good entries is putting on trades where there is relatively low risk compared to much higher reward. You should also write down a clear catalyst for the expected stock move.
- 2) How will you exit trades? You should define an initial stop point for your trade, at the point where the trend is invalidated. You will also need a 'trailing stop' technique to protect your profits.
- 3) What type of orders will you use to enter and exit? When entering, I like to use limit orders, good for the day only, while exits are often market orders. Why? Because limit orders allow me to define my risk and reward clearly on the entry of a trade, while when I need to get out, market orders allow immediate exit compared to the risk of missing my exit with a limit order.
- 4) How much capital will you need to trade successfully? There are economies of scale as you increase the amount of capital you trade with. Costs related to commissions, quote systems and equipment begin to diminish as the percentage of capital invested goes up.
- 5) What percentage of your capital will you invest in each trade? The amount of capital I typically use is 10% per trade in my own accounts. I know traders who commit anywhere from 5% of their account per trade, to 20% of their account per trade. Your goal should be to keep portfolio risk per trade at less than 2% per trade. For example, if you invest 20% of your portfolio in a trade, a 10% loss on that position would lead to a 2% loss on your portfolio.

- 6) How many positions will you focus on at once? I like to concentrate my portfolio on my best ideas, plus I like to stay focused on how each stock is acting. If my portfolio is too big (I'd say more than seven stocks is too many to focus on), then I will lose focus and invariably miss an exit on a trade that I should have previously exited.
- 7) What will your Trading Journal look like? In my Trading Journal, I note daily observations, particularly related to my ability to execute my trading plan. I also commit to doing a post-trade analysis every month. I note what I did right and wrong, and seek to learn from mistakes to minimize future errors in similar circumstances, while also looking for winning patterns where I seek to repeat big successes.
- 8) What is your Position Review process? I suggest you have an end-of-day routine to close your day. Review your trades, and assess if you followed your plan. Keep a log of all your trades, and make comments on each position.
- 9) What is your Preparation process before trading? You need defined time to prepare for the next trading day and build up your trading confidence. I prepare after the close for the next day's trading, which allows me to formulate a plan of action BEFORE I get into the heat of battle. This keeps my trading proactive instead of reactive.
- 10) What broker will you use? Most traders mistakenly think that commissions are the number one factor they can control. In reality, commissions are a small cost compared to the broker's effectiveness at executing your trade. Your focus should be finding a broker who gets you speedy and fair execution of your orders.

Once you have defined these facets of your trading plan, you are in an excellent position to have a strategy to control your emotions when trading. Make sure to review your plan on a regular basis to create effective trading habits.

Psychological Issue #1 in Trading: Perfectionism

Why do we let losses ride and cut profits short? Perfectionism tends to keep traders from taking their losses quickly, as they are too concerned about looking good to others and not wanting to admit they are wrong. This leads to the dreaded hope for a return to 'breakeven', to get out without a loss. But does the market care about where you bought the stock? NO! The market is going to go wherever it wants to go, and your job is to see that trend, recognize when you are not in tune with it, and get out of such trades.

We all have this tremendous desire to prove ourselves right. But in the markets, we should concern ourselves more with making money than the amount of times we are proved right. This means winning ideas need to be ridden longer than average, while losers need to be cut short quickly. Our school training says there is one right answer, but in the markets there are many ways to win.

Perfectionism cannot only keep you hanging on to losers too long, it can also keep you out of the best performing stocks. On stocks that rally sharply, I sometimes have to fight the feeling that I've already missed out on the move. In retrospect, many of these stocks go on to much bigger gains than the initial gain I missed. Traders tend to desire a perfect entry, and this leaves them on the sidelines during major trends. It is these huge trending trades that carry my portfolio historically, so I have to make sure I am participating in these big moves.

Ironically, perfectionism does not lead to higher performance or greater happiness. Perfectionism can destroy your enjoyment of trading. Focusing on flaws and mistakes depletes energy. This may escalate to panic-like states prior to making the trade, impairing objective performance. At some point perfectionist standards get set too high, and life is measured in units of accomplishment. The drive to be perfect becomes self-defeating, as the individual often places the intense pressure on himself, which can become crippling.

Perfectionists share a belief that perfection is required to be accepted by others. The reality is that acceptance cannot be gained through performance or other external factors like money or social approval. Instead, self-acceptance is at the root of happiness. Ultimately you must be the one who must live with yourself. If others think you're perfect, but you yourself are never happy, then perfectionism is not helping you to grow and develop to your fullest potential.

One way to be less of a perfectionist is to set one goal and make it process oriented, instead of being focused on the outcome. If you achieve the goal to improve your trading via that goal, you win no matter the outcome. Perfectionists often seek to control uncontrollable factors in a trade. For example, waiting for all the risk to be out and everything to look perfect (the quality of the fill on the exit especially), hoping or 'willing' a better outcome by doubling down on a loser, etc.

When a trader focuses on these "uncontrollables", he is more likely to tighten up and resist pulling the trigger and exiting a losing trade, or he'll miss out on a new winner that has moved 'too far.' By focusing on a process that you can control (such as to focus on only five stocks at a

time, or work on implementing your entries and exits consistently with a small amount of money to improve your ability to execute trades, or another process-oriented goal), you build confidence in your ability to execute your trading plan.

Based on these perfectionist tendencies, I recommend the following entry strategy for perfectionists. Enter half a position as soon as you see an opportunity that generates at least three times the reward for the risk at the current market price. Then place the remaining half at your desired 'perfect' entry price. For exits, always place market orders, as the tendency for the perfectionist is to try to get a better exit price with a limit, which often results in missing the exit on the way down.

Psychological Issue #2 in Trading: Fear

One of my subscribers, Vince, recently wrote to me: "Your commentary is truly excellent. And your 'batting average' has been exceptional during this most awful market that I have ever seen. Do you have any general advice that you would be willing to offer on a very serious problem that I — and perhaps many others — am experiencing in recent weeks? The length of this bear market — and the substantial financial damage that it's inflicted on me at my age (51), has seriously damaged my investment psychology.

Consequently, while I read and believe your judgment calls, I haven't been able to get myself to act — to pull the trigger, to try to begin to rebuild from the carnage — for several months. So, I guess you might say I'm suffering from the "deer caught in the headlights" syndrome. Which results in experiencing losses, and not experiencing the gains. These violent moves in both directions, changing on a dime without notice, with an overall 2 1/2 year huge down-move cumulative, have left me at sea. How does one begin to work oneself out of this state of mind after what we have been through?"

Vince is suffering from the fear of trading that, after a string of losses, many traders experience at one time or another. The reality is that human beings tend to do things that either maximize pleasure or minimize pain. Not pulling the trigger on trades becomes a way for traders to minimize pain, because mentally, the thought is that we are not causing ourselves any more damage if we do not trade. The problem is that we then remain stuck in a state of fear until we can TRUST our method again and start taking trades. This is why it's so critical to have a trading plan that is tested, one we'll be able to stick with it.

Here's a game plan for getting yourself back on track:

1. Define Your Trading Plan — If you already have a plan, reexamine it. Are you following your rules for entry, exit and money management? Does your plan still have an edge in the current market conditions?
2. “If In Doubt, Get Out” — Who says you have to trade every day? If you are not pulling the trigger on your trades, it is because you lack confidence in yourself or your plan. Try taking a step back for a short while. Consciously decide not to trade real dollars, but work on paper trading your buy and sell signals. Sure, it's not the same as trading real dollars, but this step allows you to work on executing your trading plan. I have found systematic trading to be much easier than discretionary trading, because it helps take my ego out of the equation. I focus instead on the execution of buy and sell signals, as opposed to my ego wanting to be proved right. Paper trading will allow you to get refocused on execution of your ideas.
3. Measure Your Results — Too often traders may have a good plan, but then lose sight of measuring their results on a regular basis. What happens is that 90% of your trades may be done properly, but it is those 5-10% of your trades that eat you up with big losses. If you monitor your results closely, you should start to develop a “Success Profile” which defines what your best trades look like. Once a trade doesn't fit this Success Profile anymore, you should look to exit— whether at a profit or a loss — as your edge no longer exists.

Psychological Issue #3 in Trading: Lack of Confidence

In trading as in life, how you think determines the results you achieve. Many traders are filled with doubts and a lack of self-confidence, so you need to coach yourself through tough times with positive and self-motivating beliefs.

Check to see if you possess the traits and beliefs of winning traders, including:

1. My trading objectives are perfectly clear, and I truly believe I will achieve these goals. If you have the belief that you will win, you increase your chances of trading to win. In order to have this level of conviction, you must have a thoroughly tested plan. You also must have a clear vision of how you will proceed with your plan in order to reach your goal. The more you can visualize your goals being

achieved, the more you will strengthen your internal belief and confidence that you will reach your goals.

2. I have created a plan to achieve my trading goals. I'm sure you've heard the saying "I didn't plan to fail; I failed to plan." Without a plan, your results will tend to be mixed and uninspiring. Commit to writing down your trading plan and reviewing it regularly.
3. I prepare my plan before the trading day starts. If you don't have a plan of action once the trading bell rings, you are moving from the proactive mentality into a reactive approach. I contend that the more reactive you become, the more you will get in late to market moves and dramatically diminish your reward-to-risk ratio. I prepare after the close for the next day's trading, seeking to stay proactive and a step ahead of the rest of the crowd.
4. I regularly monitor my trading results to measure my progress toward my goals. Trading results tend to follow a zig-zag approach similar to how a plane is guided to its destination. At periodic steps along the way, if a pilot is off course, he will set a new course towards the target. This is called course correction. Once you have defined your trading target, your periodic evaluation should lead you to assess what is taking you off course and encourage you to make the necessary corrections to get you back on target.
5. I quickly discard negative emotions that can hurt my trading results. When you lose, learn from the experience and put it behind you. You cannot afford to dwell on a loss once the trade is complete. You have to have total focus on the new moment and forget about the past, save for the time you allocate to evaluating past trades (which should be done outside market hours).
6. I am focused on the market during the trading day, and not easily distracted by non-market activities during trading hours. This can be a tough one for many traders who have many responsibilities. If this is the case, define the time you will be focused on the market and make arrangements not to be interrupted.

Price Headley is founder and chief analyst at BigTrends.com, which provides daily education and recommendations for active traders of stocks, futures and options. He is also author of the investment bestseller, *Big Trends in Trading*.

My Secret to Market Internals

BY MIKE HURLEY

Why care about market internals?

Put simply, market internals offer a very direct way of measuring how the stock market is *really* doing. Much like the doctor who monitors a patient's pulse and blood pressure, savvy technicians can glean a great deal of insight from observing the trends in breadth and leadership. The four basic numbers I work with include:

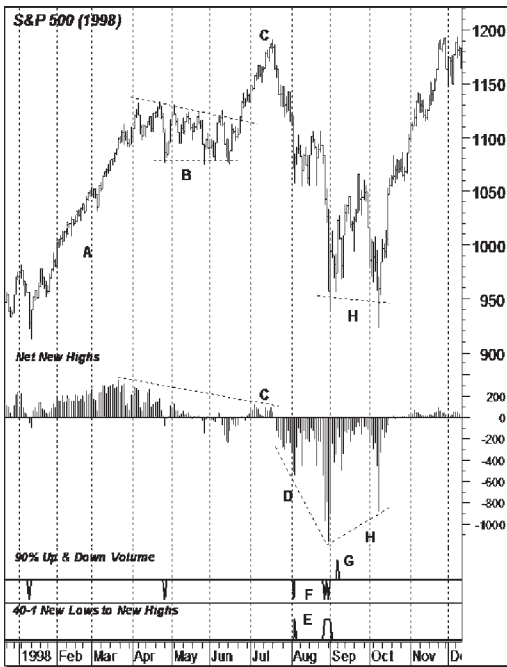
- Up Volume: The volume of shares traded on up ticks.
- Down Volume: The volume of shares traded on down ticks.
- New Highs: The number of stocks making a new 52-week high.
- New Lows: The number of stocks making a new 52-week low.

While studies vary on the exact figure, all show that the *vast majority* of stocks follow the trend in the overall market. This makes a 'top-down' approach absolutely critical to both investors and traders alike.

Art or Science?

A great deal of work had been done in this area, in large part due to the ease in quantifying these measurements. Norman Fosback's, *High Low Logic Index* is a good example, while Gerald Appel has conceived numerous valuable indicators in this area. While rules are very attractive to system testers, it seems that no two tops or bottoms are exactly alike, and the market rarely cooperates by flashing the perfect signal at just the right time! While clearly more subjective, actually *analyzing* the data often leads to more profitable results.

A good example of how to use market internals is with the 1998 market. After a strong move early in the year (A), stocks consolidated their gains in Spring (B). The breakout in June looked great until mid-July, which is when things got a little dicey technically. Specifically, as the S&P was scoring new all-time highs, the number of stocks scoring new 52-week highs was falling woefully short of what had been seen in Feb-



Mar. This formed a major divergence on the chart (C), and gave huge warning that the rally may be in trouble.

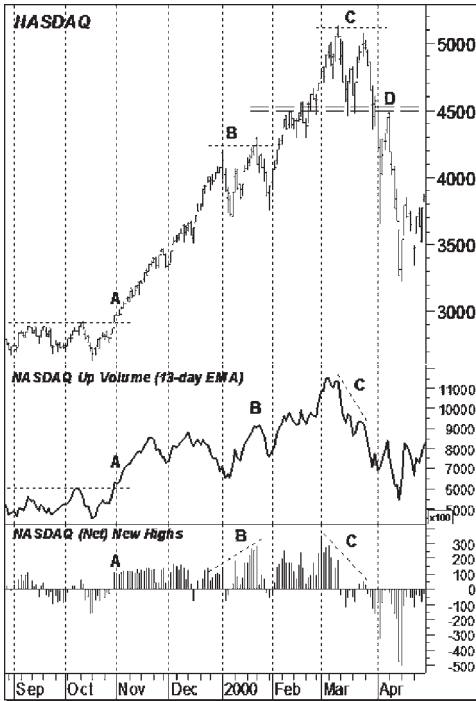
While obviously a very valuable piece of information, it also highlights the lack of specificity, which can be a problem for many traders and investors. After all, where *exactly* is the signal, and what *should* you do when these divergences appear? Sell as the S&P approaches the round number of 1200? Tighten existing stops? Well...yes! Whichever fits your individual style and risk-tolerance. The critical points is, that *market internals*

were clearly not in gear with the rally, and are literally shouting a warning to those willing to listen.

As stocks declined through July & August, leadership continued to deteriorate. In classic fashion, each time the number of Net New Lows scored a 'lower-low' it was a sign of further weakness ahead for the market averages (D). New lows exceed new highs by 40-1 on several occasions (E), an indicator often used to mark market bottoms. Using it as a mechanical system would have clearly been a mistake however, as it signaled "Buy" the S&P at 1081 — just in time for the next leg down!

"Panic selling" (as defined by down volume comprising at least 90% of up and down volume combined) occurred three times in August (F), with "panic buying" seen on September 8th (G). While this pattern is usually seen at bottoms, it is often better to wait for internals to *diverge* before diving back into the market. Leadership did in fact trace out a 'higher-low' in October, offering a much better entry point from a risk-management point of view. While it's certainly possible to catch falling knives, it's much safer to wait for them to stick in the ground!

Another great example of how important it is to look behind the scenes is with the market of 1999-2000. Few noticed the NASDAQ's surge through the 3000 mark in Nov. (A), much less thought it would amount to



much, given the worries over “Y2K”. Breadth and leadership clearly confirmed the move by scoring new highs of their own, which made the market a ‘screaming buy’ however, for anybody who happened to be paying attention.

January saw many well known chartists highlight the ‘double top’ in the NASDAQ, market internals remained strong, suggesting stocks were still in good shape technically (B). In March however, it was a very different story. Specifically, the first run at 5,000 showed nearly 400 net new highs while the second garnered only 50. Up volume was also quite weak. As a result, both formed major divergences on the charts (C).

While no one knew precisely what lay ahead for the NASDAQ, these dramatic divergences told all to at least be very careful, and to take any break of support in the 4500 area *very* seriously. Those who play the short side would have found an ideal entry at (D), as the NASDAQ made a classic ‘dead-cat bounce’, and then failed at what had been critical support.

‘Earning’ your money.

The bottom line is, whether you trade or invest in individual stocks, or market based vehicles such as the exchange traded funds or mutual funds, the very first step in your analysis should be with overall market. Put simply, when the market speaks, it pays to listen!

Mike Hurley is a Chartered Market Technician, and 20-year market veteran. He has served as the Technical Analyst for Preferred Capital Markets, E*OFFERING and SoundView Technology Group, as well as publisher of the Sector Fund Timer. His research is widely followed and he is frequently quoted throughout the financial media, including: Dow Jones, Bloomberg and CNBC. He currently manages money based on his proprietary market timing methods, and can be reached at: mike-hurley@sbcglobal.net.

Using Candle Charts to Spot the Early Turning Signals—The Basics

BY STEVE NISON, CMT

What are Candlestick Charts?

Candle charts are Japan's most popular, and oldest, form of technical analysis. They are older than point and figure and bar charts. Amazingly, candlestick charting techniques, used for generations in the Far East, were unknown to the West until I revealed them in my first book *Japanese Candlestick Charting Techniques* back in 1991 B.C (Before Candles).

Japanese candlestick (also called candle) charts, so named because the lines look like candles with their wicks, are Japan's most popular form of technical analysis. Candle charts are over 1,000 years old and as such are older than Western bar charts and point and figure charts. Yet, amazingly, these charts were unknown to the Western world until recently. Candle trading techniques have now become one of the most discussed forms of technical analysis around the world. Almost every technical analysis software package and Internet charting service now has candle charts. This attests to their popularity and usefulness.

This article is a very basic introduction to candle charting techniques. But even with the primary candle signals discussed, you will discover how candles open avenues of analysis not available anywhere else. My goal here is to provide a sense of the potential that the candles can offer.

What are the Benefits of Candle Charts?

Candle charts are easy to understand: Anyone, from the first-time chartist to the seasoned professional can easily harness the power of candle charts. This is because, as will be shown later, the same data that is required to draw the candlestick chart is the same as that needed for the bar chart (the high, low, open and close).

Candlestick charting tools will give you a jump on the competition:

Candle charts not only show the trend of the move, as does a bar chart, but, unlike bar charts, candle charts also show the force underpinning the move. In addition, many of the candle signals are given in a few sessions, rather than the weeks often needed for a bar chart signal. Thus, candle charts will help you enter and exit the market with better timing.

Candlestick charting tools will help preserve capital: In this volatile environment, capital preservation is just as important as capital accumulation. You will discover that the candles shine in helping you preserve capital since they often send out indications that a new high or low may not be sustained.

Candle charting techniques are easily joined with Western charting tools: Because candle charts use the same data as a bar chart, it means that any of the technical analyses used with bar charts (such as moving averages, trendlines, retracements, Bollinger Bands, etc.) can be employed with candle charts. However, candle charts can send signals not available with bar charts.

Candlestick charts can be used in stocks, futures, and any market that has an open, high, low and close. And they can be used in all time frames—from intraday to weekly.

CONSTRUCTING THE CANDLESTICK LINES

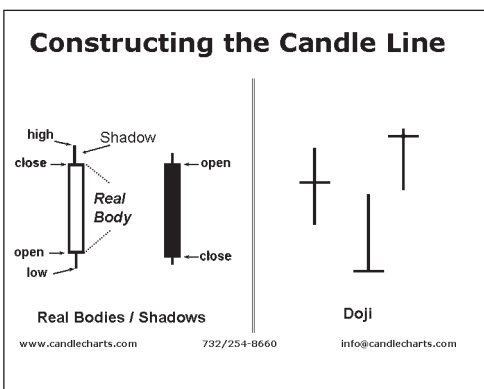


Exhibit 1

The broad part of the candlestick line in Exhibit 1 is called the **real body**. The real body represents the range between the session's open and close. If the close of the session is above the open, then the real body is white. If the real body is black, the close of the session is lower than the open.

The thin lines above and below the real body are the **shadows**. These are the session's price extremes.

The shadow above the real body is called the **upper shadow** and the peak of the upper shadow is the high of the session. The shadow under the real body is the **lower shadow** and the bottom of the lower shadow is the session's low.

Candle lines can be drawn for all time frames, from intraday to monthly charts. For example, a 60-minute candle line uses the open, high, low and close of that 60-minute period; for a daily chart it would be the open, high, low and close for the day. On a weekly chart the candle would be based on Monday's open, the high and low of the week, and Friday's close.

Notice that the candles to the left in Exhibit 1 have no real bodies. These are examples of **doji** (pronounced doe-gee). A doji is a candle in which the opening and close are the same. Doji represent a market that is in balance between the forces of supply and demand. We will look more at the doji in one of the chart examples below.

While the candlestick line uses the same data as a bar chart, the color of the candlestick's real body and the length of the candle line's

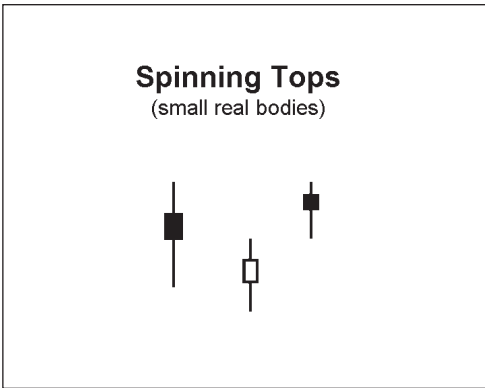


Exhibit 2

real body and shadows convey an instant x-ray into who's winning the battle between the bulls and the bears. For instance, when the real body is black, that means the stock closed below its opening price. This gives you an instant picture of a positive or negative close. Those of us who stare at charts for hours at a time find candlesticks are not only easy on the eyes, they convey strong visual signals sometimes missed on bar charts.

Spinning Tops

The logo of our firm is "Helping Clients Spot Market Turns Before the Competition". This is because one of the most powerful aspects of candle charts is that they will often provide reversal signals not available

with traditional bar charting techniques. Let's take a look at this aspect with a **“spinning top.”**

As mentioned previously, one of the more powerful aspects of candle charts is the quick visual information they relay about the market's health. For example, a small real body (white or black) indicates a period in which the bulls and bears are more in a tug of war. The Japanese have a nickname for small real bodies — “spinning tops”, because of their resemblance to the tops we had as children. Such small real bodies give a warning that the market's trend may be losing momentum. As the Japanese phrase it, the “market is losing its breath.” A spinning top is illustrated in Exhibit 2.

Let's look at an example of how candle charts will often help you preserve capital, a benefit so important in today's volatile environment. In this scenario I will illustrate how a candle chart can help you avoid a potentially losing trade from the long side.

I have two charts below. The top chart (Exhibit 3) is a bar chart. On chart 3, on the area circled, the stock looks strong since it is making consecutively higher closes. It looks like a stock to buy.

Using the same data as on the bar chart, we now make a candle chart (Exhibit 4). Note the different perspective we get with the candle chart than with the bar chart. On the candle chart, in the same circled area, there are a series of small real bodies — which the Japanese call “Spinning Tops”. Small real bodies hint that the prior trend (i.e. the rally) could be losing its breath.

As such, while the bar chart makes it look attractive to buy, the candle chart shows there is indeed a reason for caution about going long — the small real bodies illustrate the bulls are losing force. Thus, by using

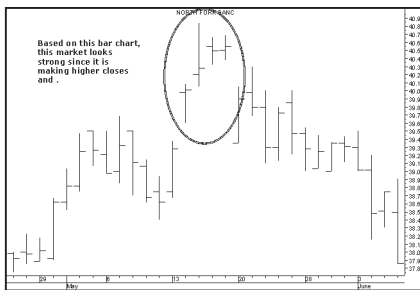


Exhibit 3

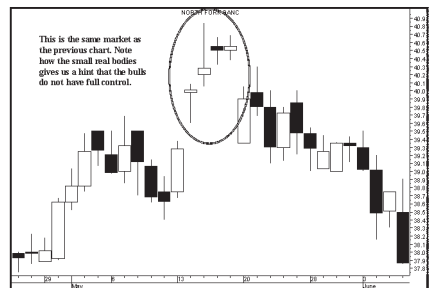


Exhibit 4

the candle chart, a trader would likely not buy in the circled area and thus help avoid a losing trade.

This is but one example of how candles can help you preserve capital. Warren Buffet has two rules: Rule 1—Don't lose money. Rule 2—Don't forget rule 1. Candles shine at helping you preserve capital.

Doji

As the real body shrinks we ultimately wind up with a doji. As shown on the right side of Exhibit 1, a doji is when the open and close are the same.

The doji indicates a market in complete balance between supply and demand. Since a doji session represents a market at a juncture of indecision, they can often be an early warning that a preceding rally could be losing steam. Indeed, with a doji the Japanese would say, “the market is tired”. (Keep in mind a close over the doji would “refresh” the market.)

Properly used, candle charts may not only help improve profits, but will assist in preserving capital. They can do this by helping you avoid a potential losing trade or exiting a profitable trade early.

Exhibit 5 shows an example of the latter.

The horizontal line in Exhibit 5 shows a resistance area near 135. A tall white candle pierces this resistance in early March. But observe what unfolded the next session—the doji. This doji line hinted the bulls had lost full control of the market (note: it does not mean that the bears have taken control). This is a classic example of the power of candle charting techniques. Specifically, within one session we were able to see a visual clue via the doji that while the market was maintaining its highs, the doji shouted that the bulls were not in complete control. So while the market

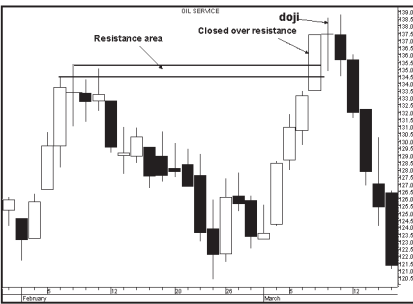


Exhibit 5

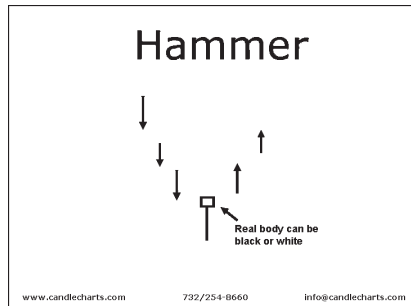


Exhibit 6

looked healthy from the outside, the internals (as shown by the doji) were relaying the fact that this stock was not as healthy as one would think.

The Hammer

We now look at a specific type of candle line that has a very long lower shadow called a hammer (Exhibit 6). So called because the market is trying to hammer out a base. The criteria for the hammer are:

1. The real body is at the upper end of the trading range.
2. The color of the real body can be black or white.
3. A bullish long lower shadow that is at least twice the height of the real body.
4. It should have no, or a very short, upper shadow.

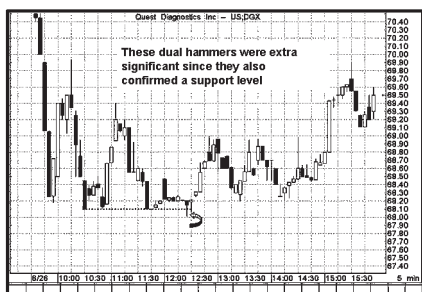


Exhibit 7

The hammer reflects the market insights obtained from a candle chart—specifically, the hammer's extended lower shadow shows that the market rejected lower price levels to close at, or near, the highs of the session. From my experience, most times when there is a hammer the market may not immediately move up, but may rally slightly, or trade laterally, and then, after expanding on a base, then rally. If the market closes under the lows of the hammer longs should be reconsidered.

Candle charts can be used in all time frames—from intra-day, day to weekly. In the intra-day chart (Exhibit 7), there are two back-to-back hammers (denoted by the arrow). These dual hammers took on extra significance since they confirmed a support level shown by the dashed line. This is a classic example of the power and the ease with which one can combine the insights of candle charts (the hammers) with classic western trading signals (the support line) to increase the likelihood of a market turn. This synergy of candle charts and western technical tools should provide a powerful weapon in your trading arsenal.

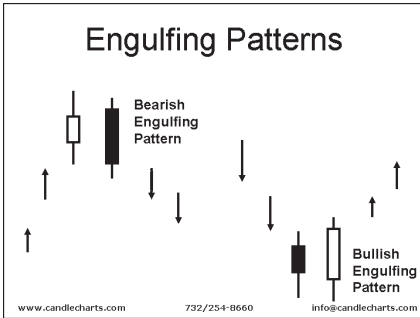


Exhibit 8

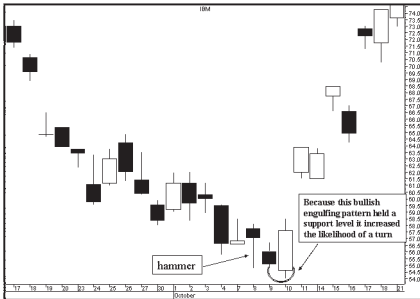


Exhibit 9

Exhibit 9 shows how a bullish engulfing pattern in early October called a reversal for IBM. This bullish engulfing pattern was especially potent because it reinforced a support area set by a hammer. Once again this underscores the increased likelihood of a turn if there is more than one signal confirming support—in this case, we had a hammer and a bullish engulfing pattern.

Candles and the Overall Picture

Remember a basic principle: candle charting techniques are a tool and not a system. Effective candle charting techniques require not only an understanding of the candle patterns, but a policy of using sound, coherent trading strategies and tactics. These include using stops, deter-

Engulfing Patterns

An *engulfing pattern* is a two-candle pattern. A *bearish engulfing pattern* (shown on the left in Exhibit 8) is formed when, during a rally a black real body wraps around a white real body. A *bullish engulfing pattern* (on the right in Exhibit 8) is completed when, during a descent, a white real body envelopes the prior black real body.

The engulfing pattern is illustrative of how the candles can help provide greater understanding into the behavior of the markets. For example, a bullish engulfing pattern reflects how the bulls have wrested control of the market from the bears. A bearish engulfing pattern shows how a superior force of supply has overwhelmed the bulls. The Japanese will say, for instance, that with a bearish engulfing pattern that “the bulls are immobilized”.

mining the risk and reward aspect of a potential trade, observing where a candle pattern is in relation to the overall trend, and monitoring the market's action after a trade is placed. By understanding, and using, these trading principles, you will be in a position to most fully enhance the power of the candles.

This is only a basic introduction to candle charts. There are many more patterns, concepts and trading techniques that must first be considered. But even with these basic concepts, you can see how the candles open new and unique doors of analysis.

May the candles light your path to profits!

Steve Nison, CMT, is acknowledged as the leading authority on candlestick charts. He is founder and President of CANDLECHARTS.COM which provides educational products and advisory services to institutions and private traders. He is the author of *Japanese Candlestick Charting Techniques* and *Beyond Candlesticks*. Steve's work has been highlighted in financial media around the world, including the *Wall Street Journal*, *Institutional Investor*, *Worth Magazine*, and *Barron's*. To sign up for his free bi-weekly newsletter, visit www.candlecharts.com.

Catch that Trend!

Directional Strength and How to Find It

BY BARBARA STAR, PH.D.

Traders usually favor moving averages to help them determine price trend. But, two other popular indicators, the Moving Average Convergence/ Divergence (MACD) and the Average Directional Index (ADX), can help traders detect not only trend direction but trend strength as well.

The MACD, created by Gerald Appel, is a momentum indicator that often identifies price direction as it rises and falls above or below its trigger line and its zero line.

The ADX, part of the Directional Movement system developed by Wells Wilder, is designed to detect the strength of price movement. ADX values in the 20 to 30 range indicate mild to moderate trending behavior while values above 30 usually signify a strong trend. A rising ADX indicates that prices are trending, but does not reveal the direction of that trend.

Plot the ADX 14 indicator above the MACD on the same price chart, as shown in Figure 1, and patterns emerge that show both trend strength and trend direction.



Figure 1

The ADX indicator rises when it detects a growing trend, but does not indicate the direction of the trend. Add the MACD, however, and the trend direction becomes easier to see.

Three Patterns

Three distinct, and profitable, patterns appear frequently. These patterns do not detect tops and bottoms, but can help traders confirm a trend. They are especially useful for those traders who prefer shorter-term trades.

Confirming Pattern The confirming pattern occurs when both the ADX and the MACD rise and fall in unison with price. When the indicators rise together they identify up trending price movement that presents bullish traders an opportunity to enter the long side of a trade. The strongest, and most ideal, trading configuration occurs when the ADX begins to rise and the MACD rises above its trigger line and also above its zero line. The level from which the ADX rises does not matter. In the Confirming pattern, when price changes direction so do both the ADX and MACD to indicate a loss of momentum and/or a potential trend change.

The Confirming pattern was evident on the daily Merrill Lynch price chart during the October through December 2002 period (See Figure 2). Both indicators rose in October confirming the price move from the \$30 to \$40 level. Both indicators declined in early November as prices dipped, but rose again later that month when price moved toward \$45. The indicators declined in December to reflect the falling to sideways price action.

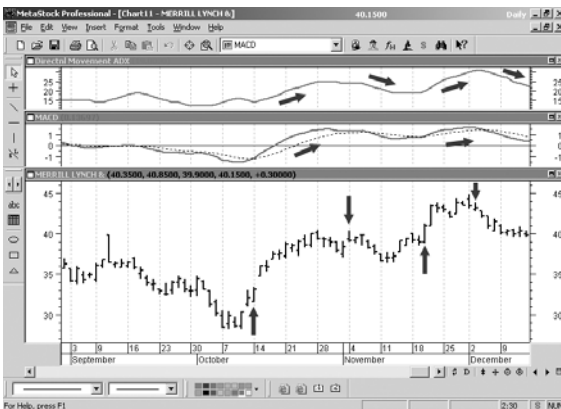


Figure 2

When the ADX and MACD rise and fall in unison with price, it creates a Confirming pattern. An up trend is in progress when both indicators rise together.

Diverging Pattern The diverging pattern identifies down trending price movement. Here, the indicators move in opposite directions. The ADX rises to indicate that it has found a trend, but the MACD declines which indicates that the direction of the developing trend is down. Its mirror-image formation makes it an easy pattern to spot visually.

This is a good pattern to follow for traders who are bearish and want to short a stock. It also serves to warn those traders who might wish to take a long position that they should wait for a more favorable time.

The strongest pattern occurs when the ADX rises while the MACD falls below its trigger line and also below its zero line. Two distinct Diverging patterns appeared on the Delta Air Lines chart in Figure 3 as prices took a nosedive from May through October 2002.

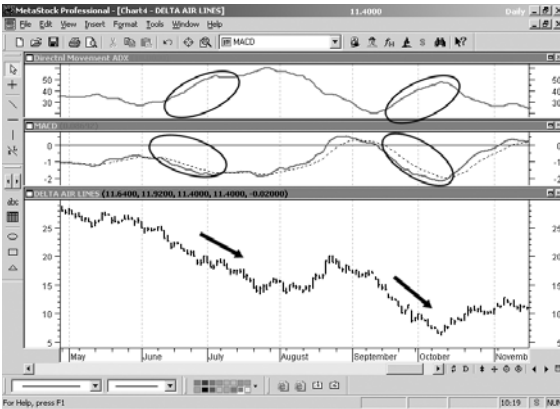


Figure 3

When the ADX rises but the MACD declines, look for falling prices.

Converging Pattern This pattern has an upward bias following a steep decline. In it the ADX rolls over and begins to decline, signifying that the strength of the trend has weakened. At the same time the MACD, which has been below its zero line, begins rising toward the zero line. Visually, the declining ADX and rising MACD seem to be converging toward each other. Although this pattern sometimes marks the beginning of a new up trend, more often than not it is a countertrend rally that produces a partial retracement of the price decline.

Figure 4 shows the Converging pattern on a chart of Exelon Corp., an electric utility holding company. Following the decline in the June-July 2002 time period that took the stock below the \$40 price level, price began moving up into August. It was able to retrace some of its loss by climbing above \$50 before declining again. The MACD reflected the ris-

ing prices by crossing above its dotted trigger line and moving up to (and in this case, through) its zero line as the ADX stopped rising and moved down to form the Converging pattern.

This is an enticing pattern, but often not as profitable as the others because moves can be short-lived and, even though the MACD rises, prices may move sideways instead of upward.



Figure 4

The converging pattern occurs after a decline. The ADX moves down and the MACD moves up as price retraces some of its losses.

A Trading Example

Traders could have profited from many of the patterns signaled by the ADX-MACD duo on the Coca Cola price chart from February to August 2002. Area A in February marked a Converging pattern that gave way in

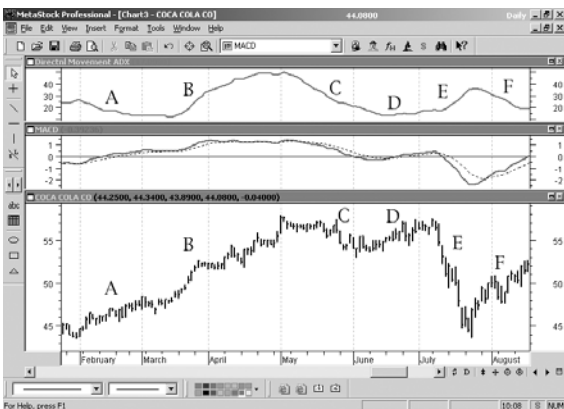


Figure 5

Many trading opportunities presented themselves during a seven-month period as all three patterns appeared at various times on the Coca Cola price chart.

March to a rising Confirming pattern in area B that rode price up until the end of April. Prices stalled and declined slightly in May (area C) to form a declining Confirming pattern. In June, a rising Confirming pattern re-emerged briefly (area D) only to fail as prices broke support in area E and produced a Diverging pattern. Finally, a Converging pattern (area F) appeared in late July as prices moved up into August, retracing about 50 percent of the decline.

Could you have profited from any of the six areas identified by ADX-MACD patterns?

Summary

The patterns displayed by the ADX and MACD combination appear on charts of commodities, indexes and mutual funds as well as stocks. Not only do they have profit potential, the patterns signal changes in price movement which can help avoid trading pitfalls. This dynamic duo may be worth adding to your trading arsenal.

Barbara Star, Ph.D., (818) 224-4070, is a former vice-president of the Market Analysts of Southern California. She is a frequent contributor to the magazine, *The Technical Analysis of Stocks and Commodities*. A former university professor, Dr. Star currently provides individual instruction and consultation to those interested in learning technical analysis. Her e-mail address is star4070@aol.com

One Custom MetaStock MACD...to go!

BY SIMON SHERWOOD

These days we are extremely lucky to have so many great books around on the mystical subject of Technical Analysis—*‘the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends’* (John Murphy). Most of these books have been written in recent times (i.e. after I was born!) hitting the shelves in the late eighties and then on through the nineties, and some even in very recent times...the noughties.

Whilst this is of great benefit to the *just starting* technical analyst, it can also be a bit like the old elephant and chain theory. If a baby elephant is tied up with a chain to a post, it will walk as far as the chain will allow and no further. The area that it can move in is therefore restricted to a circle, with the radius being the length of the chain. Now, once the elephant is fully grown, the chain can be replaced with a flimsy piece of rope. And even though the elephant could easily break the rope, it believes that it can only move within the ‘circle’, so it never tries to move outside of the box...I mean circle.

This ‘story’ is often used by motivational speakers to illustrate how we humans sometimes impose restrictions on ourselves that may not be as valid as we think.

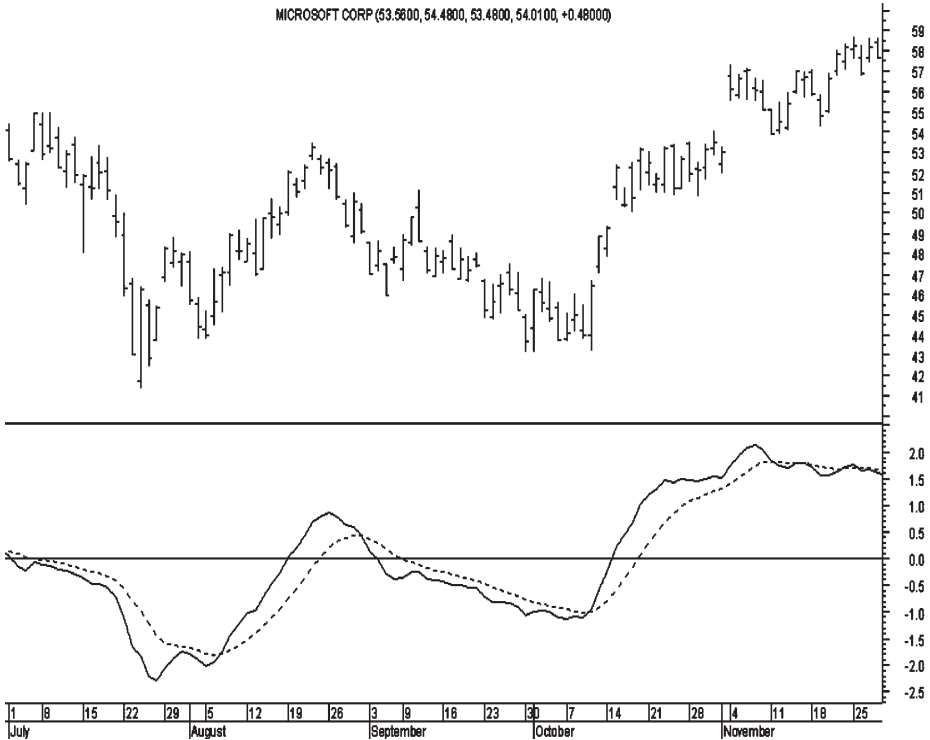
Now you are probably wondering how this is connected to Technical Analysis and the MACD. Well, it goes like this. When we first discover the wonders of the MACD, or any indicator/oscillator for that matter, we use the default values—those either recommended by the creator or the ones that the software automatically uses. Sometimes ‘we’ fall into the trap of not wanting to move outside the circle. We are told the default values are x, y and z, and that is what we use. The point of the elephant story is that we can move outside the ‘circle’ and in the case of the MACD, use different values. Of course to do this we will need the right software (please note that NO elephants were harmed during the writing of this piece).

Fortunately MetaStock is a lot more flexible than most charting software. Not only do you have complete flexibility as far as indicator/oscillator parameters are concerned, but you can create your VERY OWN indicators with the Indicator Builder and MetaStock Formula Language.

The Moving Average Convergence / Divergence (MACD) ...what it is, who created it, and how to build it in MetaStock.

The MACD was created by Gerald Appel. You will find detailed descriptions on how to use it in every good book on Technical Analysis (books by Achelis, Murphy, Pring and Schwager to name a few, plus MetaStock Online Help). To summarize, it consists of two lines — one being the difference between two exponential moving averages (of the closing price) referred to as the FAST line, and the other being an exponential moving average of the FAST line, often called the SIGNAL or SLOW line.

Generally buy and sell signals are given when these two lines cross each other. However, please note that the MACD is usually used in conjunction with other indicators to form part of your overall entry/exit strategy — it is not used by itself.



WHEN USED CORRECTLY, THE MACD WILL GIVE BOTH BUY AND SELL SIGNALS AS FOLLOWS:

- SELL signals happen when the FAST line crosses above the SIGNAL line
- BUY signals are the reverse—when the FAST line crosses below the SIGNAL line.

This can be further fine tuned by only taking BUY or SELL signals when they occur either above or below the zero line respectively.

THE DEFAULT VALUES ARE AS FOLLOWS:

- FAST Line: 12-period exponential moving average of the Close — 26 period exponential moving average of the Close
- SIGNAL Line: 9-period moving average of the FAST Line.

On page 38 is an example of the stock standard MACD straight from MetaStock (using the built in MACD from the Indicator QuickList).

Now whilst these values may work, there is nothing to say that we can't change them! But why would we want to change them?

Well, it is quite possible that we might find other values to use that give better results in a particular market, or are better suited to our style of trading. For instance, traders have been known to use different values for the MACD on different stocks and commodities, believing that each stock has its own 'personality'. For now, we are just going to work with one set of values and create our own personalized custom MACD. The values we will use are 3, 8 and 13 (as used by Tom Bierovic).

Creating a *custom* MACD

We will use the MetaStock Formula Language (MFL) function 'mov' for Moving Average. This function calculates the requested type of moving average of a specified data array (like the Closing Price) over a particular number of periods. This may sound very confusing but believe me, it's not. The function looks like this:

mov(C, 3, E)—this will plot a Three (3) period Exponential (E) moving average of the Closing Price (C) .

I won't go into the other possible values for the parameters; I'll keep it simple for now. Now that we know how to use the 'mov' function we

can build the entire MACD, believe it or not!

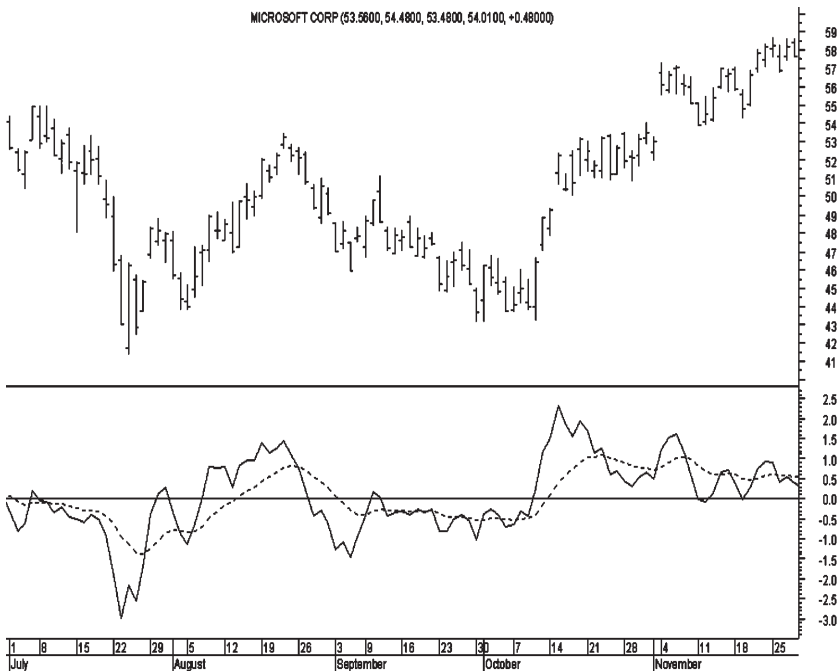
Here it is, the whole thing using the custom values:

- FAST Line: $\text{mov}(C, 3, E) - \text{mov}(C, 8, E)$
- SLOW Line: $\text{mov}(\text{mov}(C, 3, E) - \text{mov}(C, 8, E), 13, E)$

In the Indicator Builder, this can be simplified to the following:

- $\text{Fast} := \text{mov}(C, 3, E) - \text{mov}(C, 8, E);$
- $\text{Slow} := \text{mov}(\text{Fast}, 13, E);$
- Fast;
- Slow;

Please note that the 'input' function could easily be added to this to make changing values easier. I've added a zero line and made the SLOW Line dashed. Here is what it looks like:

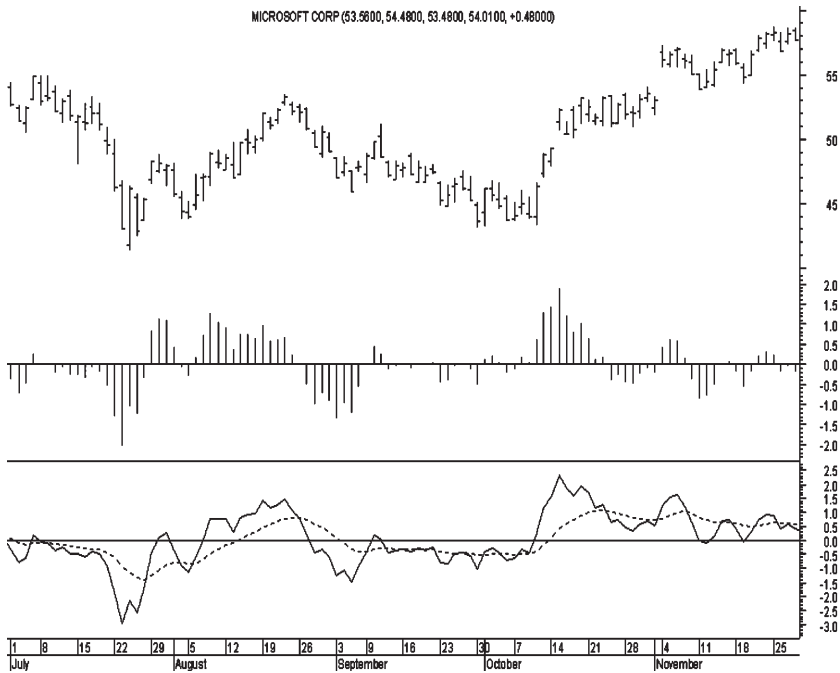


We could go one step further and add the MACD Histogram. There is sometimes confusion with the Histogram, as some people plot the MACD and then change one of the plotted lines to 'Histogram' style —

I must stress that this is NOT the MACD Histogram. The MACD Histogram is actually the difference between the FAST and SLOW lines, plotted in the 'Histogram' style.

Here's that chart again, complete with the MACD Histogram, zero line...in fact everything:

Once I have built my Custom MACD, things get even easier. Using more of MetaStock's built-in power, I can create a screen template and a button on the custom toolbar. Now all I have to do is click one button



and I can see my Customized MACD, complete with MACD Histogram. The hard stuff's all done... the only thing left to do is try to work out what the heck it all means!!!

Good luck and 'Keep on Charting'!

Simon Sherwood, author of *MetaStock® in a Nutshell* (John Wiley & Sons), works in an investment center that specializes in providing resources to Educated Investors. He runs the Center's MetaStock User Group, as well as trains MetaStock users one-on-one and in groups. Email: metashell@bigpond.com; <http://au.groups.yahoo.com/group/metashell>

Understanding the Crowd

BY DARYL GUPPY

In trading, there are three key questions:

- Is this a short-lived rally or a trend?
- Is this really a trend change?
- Is this price pullback in a rising trend an opportunity to join the trend, or a signal that the trend is ending?

Technical analysis indicators are generally designed to answer one or more of these questions. The answers help us to select better trading opportunities, and to trade them in the correct way. It is not good trading a rally as a major trend change. It calls for different techniques, and we need a method to decide when the rally has ended and the downtrend resumed.

I use a Guppy Multiple Moving Average to help make these initial decisions. Once the best opportunity has been found, and the nature of the opportunity identified, I then turn to other tools to fine-tune the entry, define and manage the risk, and to manage the trade. The Guppy MMA relies on understanding the fractal repetition of relationships across multiple time frames. It helps us to understand the behavior of the two most important groups in the market — traders and investors.

When traders use two or more moving averages, their attention is usually focused on the point of the crossover. This is a distraction from the more important messages contained in moving average relationships. The Guppy MMA uses the moving averages to track the activity of traders and investors, and to understand the difference between price and value.

Value is what we believe a stock is worth. We make this decision based on our future expectations. Price is what we pay to buy the stock today. When everybody agrees on price and value there is no market. You can walk to the nearest Wal-Mart and see agreement on price and value in action. It is not very exciting and not very profitable if we want to buy an item and later sell it at a profit.

The financial market is driven by the difference between price and

value. When some traders see a stock selling at \$50 they believe it is under valued. They buy because they believe they can make a profit on the difference between the current price and the future value. When we expand this concept to the broader market we observe periods where there is relative agreement on value and price. The market moves sideways. At other times there is a wide disagreement on price and value so the market moves quickly.

Traders make these decisions more rapidly than investors. Traders are always probing to see if current price is good value. Traders lead the market. Investors follow. Traders cannot maintain their momentum unless investors follow, and the Guppy MMA highlights these relationships.

Applying the Guppy MMA

Before we apply the Guppy MMA, we start with an observation of the behavior of the group of short-term averages. These are 3, 5, 10, 12 and 15-day exponential moving averages. When these averages compress, they tell us that short-term traders are in agreement on price and value. Inevitably a few traders see an opportunity to make a dollar because they believe the market is incorrectly valued. They start buying. To get stock they have to outbid their competitors. This causes a separation, or spreading in the short-term group of averages. Other traders pick up on the price moves, and before long we see a wide separation of the short-term group.

At its widest, this separation tells us that value has moved well away from price. You probably know the feeling. Desperate to buy a stock that is moving exactly as you anticipated, you end up chasing it to the top price of the day. Next morning you realize you have paid much more than you should have. When you, and other traders reach this conclusion, the selling starts, and the wide spread in the short-term group rapidly collapses. Compression is followed by expansion and followed again by compression. Agreement on value is followed by disagreement about value, and then followed by agreement about value.

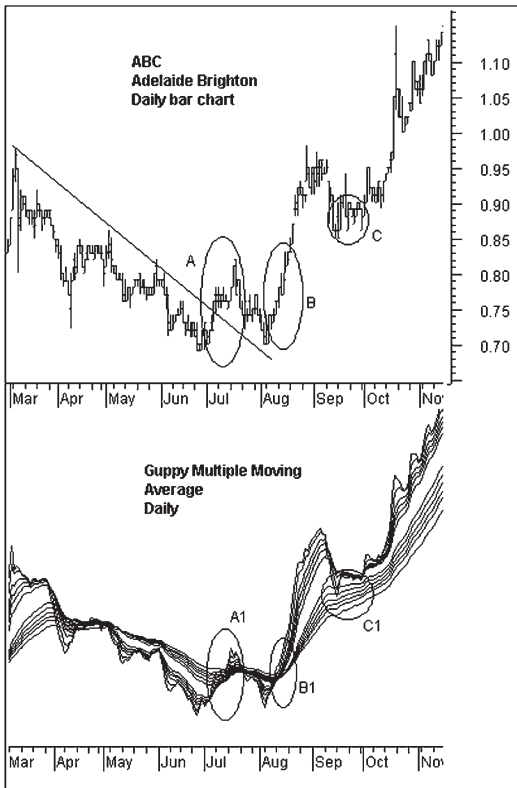
Investors show the same relationships, and these are captured with the long term group of averages. These are 30, 35, 40, 45, 50 and 60 day exponential moving averages. The compression and expansion does not develop as quickly as with the short term group but the same behaviors are repeated on a longer time frame. When the long term group of averages spreads out it tells us that the trend is well supported.

Combine these two groups into a single display and we create a Guppy MMA. This is available as a standard Metastock template in the template menu list.

There are four areas of importance in applying this indicator.

- The compression and expansion relationships in the short-term group of averages.
- The compression and expansion relationship in the long-term group of averages.
- The relationship and degree of separation between the short-term group and the long-term group.
- The crossover area and the nature of this crossover.

The accompanying chart shows how we use the Guppy MMA to identify the most appropriate trading opportunity. We start with the first trading question: Is this a short-lived rally or a trend?



Prices break above the downtrend line in area A on the bar chart. We confirm the probability of a rally by using the Guppy MMA.

The short-term group has compressed, but when the rally starts the long-term group is more widely spread. For this rally to succeed the traders have to convince the investors that this stock has a good future. We know this is more likely when the long-term group compresses and turns upwards. It would be unusual for traders to rapidly turn around investor sentiment when the long-term group is well spread apart. This is most likely a rally opportunity and has the

potential to deliver an 11% profit. We might not be comfortable trading the rally, but we are interested in the developing potential for a trend change.

The Guppy MMA helps answer the second trading question: Is this really a trend change?

Prices rebound from the trend line and by the time they get to 77, we are interested. The relationship between the two groups of moving averages, shown in area B1, is now quite different. There is no holding the traders back. This group of averages is moving sharply upwards with no sign of faltering. There is a smooth expansion in this group suggesting steady buying support.

The investors are also taking notice of the latest price moves. The long-term group has remained compressed—agreeing on value—since the first rally. Now they compress further before also moving sharply upwards and expanding. This group contains a 30-day and a 60-day moving average, and we would expect these to lag behind price action if we were looking just at moving average crossovers. By understanding the developing relationship in this long-term group, traders quickly identify the developing investor support.

The crossover of the two groups on moving averages is on the upside and confirms this bullish trend change. However the relationship in area B1 is different from that in area A1, and this difference confirms a trend change. Relying on moving average crossovers alone does not give the trader sufficient information to make good decisions.

These relationships suggest there is a high probability that this is the start of a new and strong up trend, led by traders and supported by investors. This opportunity offers a 49% return.

Plucking up the courage to enter on a price pullback in a rising trend is made easy with the Guppy MMA. In area C, the initial trend momentum fails and prices collapse. The reaction of the long-term group of averages tells us this is a buying opportunity. The group is well separated and when prices fall as traders take profits, the investors step in to buy stock at cheaper than expected prices. The long-term group does not compress and continues to move upwards.

Traders who took early profits can buy back into the trend around 88, confident that the underlying trend is intact. Traders and investors who missed out on the initial trend break now have an opportunity to join the trend and collect a 30% return. It is the relationship between the long-term group of averages that confirms the trend strength. This relationship is not revealed if we use just a 10-day and 30-day moving average combination.

Analysis on historical charts always looks good because we already know what has happened in the future. These notes are drawn from my analysis of this stock in real time. I opened a personal trade in area B and rode the trend using the Guppy MMA to deliver the exit signal. This is my primary tool for understanding the trend, the probability of a trend change, and the nature of trading opportunity.

Daryl Guppy is a private security and derivatives trader. He is the author of *Market Trading Tactics*, *Better Stock Trading* and *Chart Trading*. He publishes a weekly internet newsletter that highlights trading techniques. He speaks regularly on trading in Asia, the United States and Australia. He can be contacted via www.guppytraders.com.

Bollinger Band Basics

BY JOHN BOLLINGER

Bollinger Bands are available on MetaStock and most charting software. They have become popular primarily because they answer a question every investor needs to know: Are prices high or low?

What are Bollinger Bands?

Bollinger Bands are curves drawn in and around the price structure on a chart that provide a relative definition of high and low. Prices near the upper band are high prices, while prices near the lower band are low.

The base of the bands is a moving average that is descriptive of the intermediate-term trend. This average is known as the middle band, and its default length is 20 periods. The width of the bands is determined by a measure of volatility, called standard deviation. The data for the volatility calculation is the same data that was used for the moving average. The upper and lower bands are drawn at a default distance of two standard deviations from the average.

THESE ARE THE STANDARD BOLLINGER BAND FORMULAS:

Upper band = Middle band + 2 standard deviations

Middle band = 20-period moving average

Lower band = Middle band - 2 standard deviations

Learning how to use Bollinger Bands effectively cannot be fully explained in this article. However, the following rules serve as a good starting point.

15 Basic Rules for Using Bollinger Bands

1. Bollinger Bands provide a relative definition of high and low.
2. That relative definition can be used to compare price action and indicator action to arrive at rigorous buy and sell decisions.

3. Appropriate indicators can be derived from momentum, volume, sentiment, open interest, inter-market data, etc.
4. Volatility and trend already have been deployed in the construction of Bollinger Bands, so their use for confirmation of price action is not recommended.
5. The indicators used for confirmation should not be directly related to one another. Two indicators from the same category do not increase confirmation. Avoid colinearity.
6. Bollinger Bands can be used to clarify pure price patterns, such as M-type tops and W-type bottoms, momentum shifts, etc.
7. Price can — and does — walk up the upper Bollinger Band and down the lower Bollinger Band.
8. Closes outside the Bollinger Bands can be continuation signals, not reversal signals—as is demonstrated by the use of Bollinger Bands in some very successful volatility-breakout systems.
9. The default parameters of 20 periods for the moving average and standard deviation calculations, and the two standard deviations for the bandwidth are just that, defaults. The actual parameters needed for any given market/task may be different.
10. The average deployed should not be the best one for crossover signals. Rather, it should be descriptive of the intermediate-term trend.
11. If the average is lengthened, the number of standard deviations needs to be increased simultaneously; from 2 at 20 periods, to 2.1 at 50 periods. Likewise, if the average is shortened, the number of standard deviations should be reduced; from 2 at 20 periods, to 1.9 at 10 periods.
12. Bollinger Bands are based upon a simple moving average. This is because a simple moving average is used in the standard deviation calculation and we wish to be logically consistent.
13. Be careful about making statistical assumptions based on the use of the standard deviation calculation in the construction of the bands. The sample size in most deployments of Bollinger Bands is too small for statistical significance, and the distributions involved are rarely normal.
14. Indicators can be normalized with %b, eliminating fixed thresholds in the process.

15. Finally, tags of the bands are just that, tags, not signals. A tag of the upper Bollinger Band is NOT in-and-of-itself a sell signal. A tag of the lower Bollinger Band is NOT in-and-of-itself a buy signal.

These rules outline the basic guidelines for using Bollinger Bands. For a more comprehensive understanding of the bands, I suggest that you read "*Bollinger On Bollinger Bands*". This book starts with the basics, builds to the complex and teaches the technical analysis process, including which indicators to use and how to read charts. It is available at www.BollingerBands.com.

John Bollinger, CFA, CMT is probably best known for his Bollinger Bands, which have been widely accepted and integrated into most of the analytical software currently in use. He is the president of Bollinger Capital Management, a money management firm, and publishes two newsletters, *The Capital Growth Letter* and *Group Power*. He has five financial websites: www.EquityTrader.com, www.FundsTrader.com, GroupPower.com, www.BollingerBands.com and www.BollingerOnBollingerBands.com.

Plug In the Power!

One of the features that makes MetaStock so powerful is its ability to “plug-in” a variety of different trading systems & styles.

These plug-ins increase MetaStock’s already powerful capabilities, allowing you to customize the software to your exact trading style. Plus, they allow you to explore new types and methods of analysis, some that are totally new and innovative.

Plug-in modules are becoming increasingly popular with traders these days. In fact, *Technical Analysis of Stocks and Commodities Magazine* created a new category for plug-ins in their Readers’ Choice issue because of their growing popularity. And it was three MetaStock plug-in modules that took first, second, and third place.

You can choose from a wide array of trading solutions as a MetaStock user. And most of these plug-ins give you strong buy and sell signals for you to trade from.

The complete list of MetaStock plug-ins:



Chart Pattern Recognition™-- Identify the most profitable chart patterns in just seconds, based on the many years of experience of John Murphy. Chart Pattern Recognition is so popular, it was voted the WINNER of *Stocks and Commodities Magazine’s* Reader’s Choice award for best plug-in in 2002. This category includes plug-ins for all products, not just MetaStock plug-ins.

Bollinger Band System™-- This highly selective system is based on the very popular Bollinger Bands by John Bollinger. You’ll know when to get into a trade, how long to let your profits run, and when to exit. Bollinger Band System was the 1st Runner Up of *Stocks and Commodities Magazine’s* Reader’s Choice award in the plug-in category for 2002.



Nison’s Candlesticks Unleashed™-- Using candlesticks as a base, you’ll receive signals indicating reversals in the market. Steve Nison was instrumental in helping us develop this plug-in. It was the Finalist of *Stocks and Commodities Magazine’s* Reader’s Choice award in the plug-in category for 2002.

MetaStock's plug-ins can energize your analysis!



PowerPivots Plus™-- NEW! Identify, label, and evaluate the market's key support & resistance levels using 20 trading systems and seven indicators. Based on Fibonacci numbers.

Adaptive Trading Solutions™-- Get mathematically calculated confidence levels, in addition to daily buy and sell signals.



Performance Systems Plus™-- 54 trading systems and 70 explorations will be at your fingertips for you to make smarter trades.

The time to act is now.

Now is an excellent time to build your MetaStock plug-in library. Why not take this opportunity and select a plug-in to see what works best for you? With the 30-day money-back guarantee on each and every plug-in, there is absolutely no risk to you.

Call between 7:00 a.m. and 5:00 p.m. (MST), with any questions you may have, or to order the plug in of your choice. The number to reach us is 1-800-775-9341, code SST.

**Try a Plug-in of your choice today.
It's risk free with our 30-day
money-back guarantee!**



Call: 1-800-775-9341 code SST
or visit: www.metastock.com



Mention this code when you purchase MetaStock and we'll send you the book, *Technical Analysis From A to Z*, FREE!

You must have MetaStock for these plug-ins to work.

MetaStock provides amazing buy & sell signals!

Knowing when to buy and sell is often the most difficult part of trading. But with MetaStock you can improve your trading like never before.

That's because MetaStock gives you the strongest buy and sell signals available.

MetaStock even lets you know which securities you should be trading and what systems work best with them. But if you already have your favorite securities you like to trade, MetaStock helps you trade them better than any other program out there.

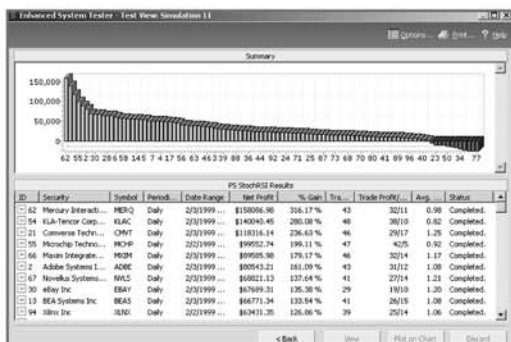
Just look at what MetaStock has to offer:

- **Powerful multiple system testing**
- **Match systems with securities**
- **Expert advice and training**
- **An incredible arsenal of indicators**
- **Option analysis and graphing**
- **10-time winner of Stocks & Commodities Magazine's Readers' Choice award for best analysis software**
- **Easy to learn and use**
- **Professional support team**

You will love MetaStock just like our customers that use it everyday to make better trades.

"If everything in life cost what MetaStock costs in relation to what I have earned from it, I would buy MetaStock once a day for the rest of my life."

*Dr. Edward Trieber, MetaStock user
New York City*



MetaStock's detailed reports give you the information you need to make smart trades.

MetaStock is the most reliable, flexible, and easy-to-use analysis software you can find. It even comes with a 30-day money-back guarantee.

Call today and put the Secrets of Successful Traders to use with MetaStock!



Call: 1-800-775-9341 code SST
or visit: www.metastock.com



