More Tips from the Pros

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By Matt Blackman

Back in August 2008, I presented lessons learned from five trading professionals in "Tips from the Pros." This is a follow up. Originally that piece was to offer information from 10 professionals that could distill to one major trading concept. As with all plans, that turned out to be somewhat unrealistic as trading requires more than a single key decision or action—and 10 opinions was just too much for one article. However, I don't want to withhold the trading wisdom from the other five seasoned heavy weights, either.

1. MARK B. FISHER:
SEASONAL FACTORS + TECHNICALS + SENTIMENT = WINNING COMBINATION

Mark B. Fisher is founder and CEO of MBF Clearing Corp., one of the largest clearing firms on NYMEX. In addition to being a respected trader and leader to his more than 150-member trading team, Fisher is an influential participant in the futures industry at large and a regular guest speaker at industry conferences. Fisher began trading when he was 21 years old and still holds the record as the youngest trader to ever deal in the silver futures pit. His bestseller *The Logical Trader: Applying a Method to the Madness* (2002) outlines his unique and widely used ACD approach to trading.

A key premise of Fisher's ACD methodology relies on three key components in making trades. This system forms the cornerstone of his trading empire, which today consists of more than 75 proprietary traders.

Although daily, biweekly and monthly opening ranges are important, Fisher considers the first of the year ranges and midyear ranges (FOYs) essential to gauging the strength of the current trend and deciding which way to trade. But calendar factors must be combined with technical and sentiment indicators to provide the clearest possible picture of the market before placing a trade.

In a nutshell, this is how he uses all three together: "High and low pivot points set during the first two weeks of the year and first two weeks of the second half of the year often set floors or ceilings in the market and become crucial trading points," Fisher says. He saw this happen very clearly in 2008 with natural gas (see Figure 1).

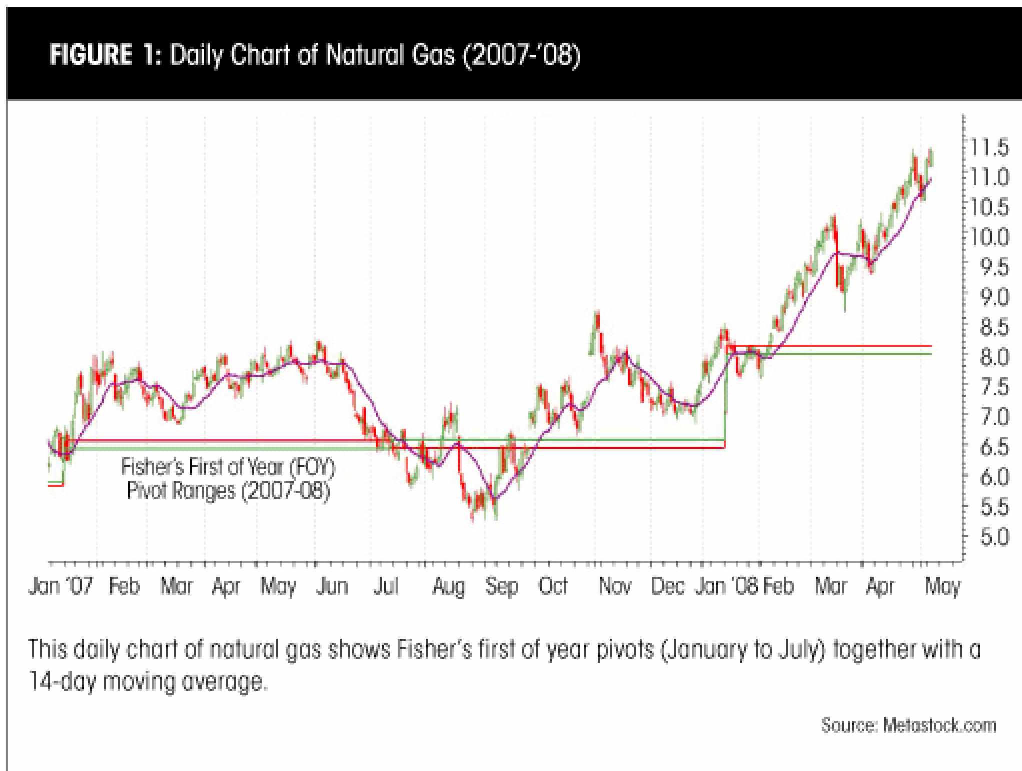


FIGURE 1: Daily Chart of Natural Gas (2007-'08)

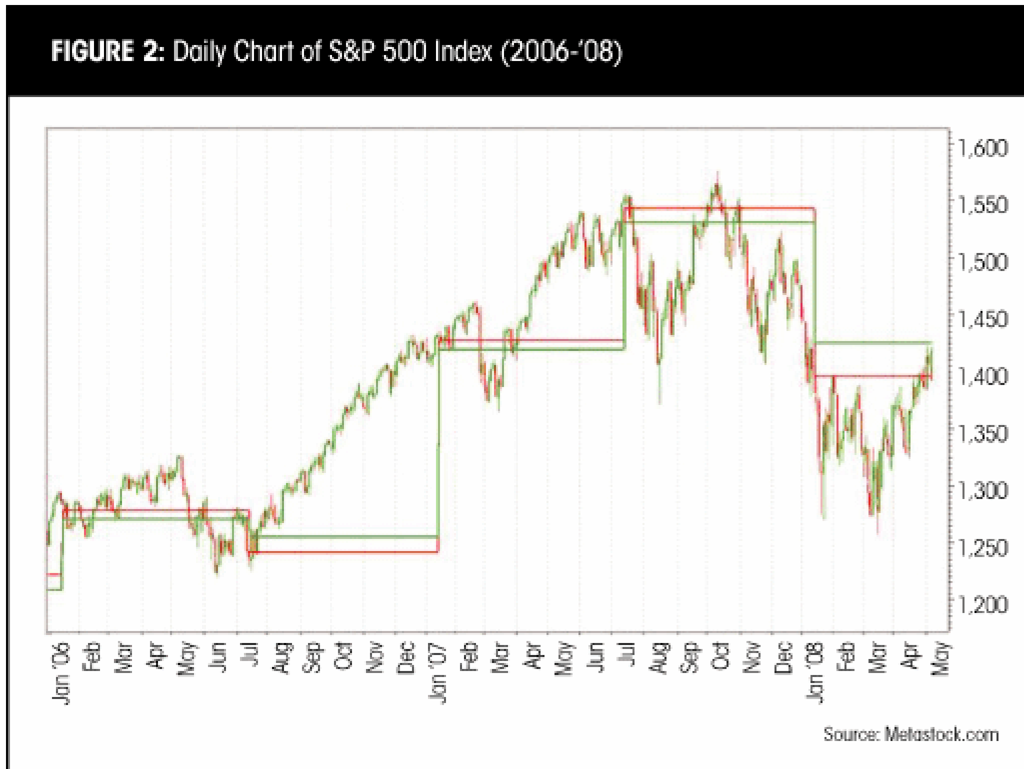
This daily chart of natural gas shows Fisher's first of year pivots (January to July) together with a 14-day moving average.

"Early in January, natural gas [NG] briefly moved below the FOY pivots and breached the 14-day moving average in a moving average fakeout. But it held above the 30-day MA—and that was bullish. After the market snapped back above the 14-day MA, NG was a buy," he says. This trade also provided a warning of a shift in sentiment.

Fisher also saw natural gas demonstrate the importance of the adage: good news, bad action and bad news, good action. The combination of good news and bad action typically occurs in bear markets, but when there is bad news, along with good action, it indicates a pivotal sentiment shift.

"Despite the spate of bearish economic and inventory news that should have had a depressive effect on prices, NG price action showed that underlying market sentiment in January was bullish. NG dropped just marginally, then it took off. May 1, NG numbers were bearish, but the very next day, the market was right back up where it started. This bullish action, in conjunction with the FOY bias, is a positive sign for the NG market," Fisher says.

I have calculated Fisher's FOY pivots on the S&P 500 Index (see Figure 2). The NASDAQ chart (not shown) also looks similar. FOY pivots for those indexes provided some good places to take short trades as of August 2007. In May 2008, both indexes returned to their FOY pivot ranges, thus they continue to provide resistance, that is, until they are decisively broken. But at some point they could have the potential to be a new buy signal *if* the following happens: prices break above the 14-day moving average, sentiment is bearish and volume supports the move.



2. DAN ZANGER:
IT'S ALL ABOUT PRICE AND VOLUME

Dan Zanger first gained media prominence when he was featured in the December 2000 Fortune article "My Stocks Are Up 10,000%!" The article told of his Cinderfella story from his ascent as a pool contractor to professional trader by turning $11,000 into $18 million in 18 months, which he subsequently parlayed into an incredible $42 million during the following five months. With more than 30 years trading, 10 years as the editor of The Zanger Report and host of ChartPattern.com he has plenty of real market experience.

So how does he do it? Volume and chart patterns are his major trading tools. For the most part, he avoids technical indicators. Rather, Zanger looks for high-momentum stocks with two to three times average daily volume exhibiting pattern breakouts. Some of his favorite patterns include flag and pennants, cups and handles, head and shoulders, rising and falling wedges, and triangles. He also is not a pure technical trader because he looks for companies with strong fundamentals, such as rapidly increasing earnings, a new product or service, strong management and dominance in their markets.

Watching Zanger trade is like watching a NASCAR driver behind the wheel during a race. Intently focused on his six flat panels, he carefully scans price and volume from his short list of targets that have met the trading criteria. Much of his trading day is spent on the phone to any one of his three brokers when his "frisky buddies" are on the move.

Each night he scans his chart universe of approximately 1,400 stocks looking for the next day's trading candidates. He has demonstrated a particular knack for finding high-alpha stocks that lead the market, especially during major moves.

"Trading for me is all about volume and price action. I buy on pattern breakouts when volume is rising, and as long as price is responding well to increasing volume, I stay on board. But when either price or volume stops rising, it's time to get out," he says.

3. MIKE GREEN: WRITTEN RULES ARE ESSENTIAL

Mike Green is a private trader and developer of day-trading and short-term trading systems, who, for the most part, now trades E-minis and exchange-traded funds. He is also the host of http://ConfluenceZones.com . Green trades both intraday and swing-trade strategies using a semiautomatic trading system that generates signals based on automatic Fibonacci-generated support-resistance levels and other proprietary algorithm methodologies.

He first became interested in trading as a hobby 25 years ago, but in 1992, he decided to make it his full-time vocation, which was of course before the days of electronic trading. After an eight-year stint in another business, he became more serious about trading in 2001. He started looking for a trading package, but like many in this business, he spent thousands of dollars on software, most of which he says ended up in the "round file." Thus, he decided to write his own in a project that took him approximately four years.

Here is what Green says he has learned over the years: "Money management and having written trading and business plans have been critical to my success in trading. It is very important to have a daily profit goal and make money every day. Once your goal is reached, stop trading! Daily goals are personal to each trader, but they must be achievable. If you are unable to reach the goal each day, reduce the goal until you can. Trading is as much psychological as it is having the right trading tools—maybe more so. Trust your tools and trade relaxed. If you are worried, preoccupied, emotionally distracted, tired or unhealthy, don't trade. Remember it makes absolutely no difference if the current trade works, what matters is consistency in reaching your daily, weekly and annual goals."

Regarding when to trade, Green provides this tip: "I have generally found that the best time to trade U.S. markets is during the first two hours each day. I don't trade during the lunchtime doldrums, and if I do trade in the afternoon, I only do so during the two hours before the close," he says.

When asked for his best advice to traders, he outlines three principles to accept before even starting to trade:

1. Trading is a business; it involves risk management and profit planning.

2. Proper written plans need to be in place. They are:

a. Long-term capital planning—Are you sufficiently capitalized?

b. Daily business operations—Can you make money consistently?

c. Weekly and monthly reporting—This includes trade post-mortems.

3. To succeed, perform these steps, learn to check both your ego and emotions at the door, and practice effective money- and risk management.

**4. GAVIN HOLMES:
FOLLOW THE SMART MONEY**

Trader, instructor and CEO of TradeGuider Systems Inc., Gavin Holmes has one simple rule: Find out what the smart money is doing and tag along. His approach can be summed up in three words: volume spread analysis. VSA takes a multidirectional approach to analyzing the market by examining the relationship between price spread and volume, much of which is based on the work of Richard D. Wyckoff.

But before exploring how it works, let's take a brief look at the traditional understanding of price and volume. Increasing volume on up bars and decreasing volume on down bars is generally considered bullish. Contrarily, rising volume on down bars and decreasing volume on up bars is generally considered bearish.

However, this traditional view of volume does not tell the whole story. The key to reading the market is by following the experienced traders, also called the smart money or strong hands (referred to as composite operators by Wyckoff). In markets, buyers do not push prices higher, that is done by the smart money, according to Holmes. And a buying climax is a good example of this practice in action.

To sell to the uninformed traders (herd or weak hands), the smart money pushes prices up at market tops. Herd buying provides a market for professional selling without driving prices lower until the pros have sold their shares. The culmination of a buying climax is an upthrust, which occurs on ultra-high volume and is a clear indication of strong professional selling (see red arrow in Figure 3). Such days are often accompanied by positive news. An upthrust also acts to trigger stop losses and catch the greatest number of traders offside. If the smart money is buying, prices should close near the high and continue to move higher on subsequent days.

In an uptrend, it is best to wait for further confirmation of weakness, such as a no-demand signal—an up bar with a narrow range, with the volume less than the previous two bars and with the high lower than the previous high (see black arrow in Figure 3)—before selling, according to Holmes.

On the flipside, a downward move on high volume in a weak market along with a wide price spread and a close at or above the middle of the range (on high volume) is usually considered bearish. However, this is called stopping volume, indicating a selling climax and is actually very bullish (see green arrow in Figure 3). It shows professional money moving into the market. And the wider the spread and the higher the volume, the more bullish the move. Stopping volume shows that demand is swamping supply—the composite operator sees that lower prices are attractive and starts to buy from the herd, many of whom are in losing positions and are fearful of further losses, thus they are very willing to sell. At a market bottom, there can be a number of stopping volume days, and they will continue until the strong hands have shaken out most of the weak hands in a selling climax. Stopping volume days often occur on bad news.

These are just two signature moves that show what Holmes calls the footprints of smart money—footprints that exist in all markets and in all timeframes, from one minute to quarterly. Like the talented scout who is able to track his or her prey through a rainy jungle or wind-swept desert, those who learn to read these footprints stand a better chance of finding success in markets.

5. DR. HOWARD BANDY: REGULARLY TUNE YOUR TRADING SYSTEM

Dr. Howard Bandy has academic degrees in mathematics, physics, engineering and computer science. He specializes in trading system design and validation. His books include *Quantitative Trading Systems* and *Introduction to AmiBroker*. His website is BlueOwlPress.com.

According to Bandy, any technical trading system depends on market inefficiencies. If markets were truly efficient, trading systems would not work.

Every system begins with an idea, whether simple or complex, that must be coded based on a set of parameters. It is valuable to separate the trading system into two components: the model and the data. Because a system usually has several variables, the developer runs an optimization—the orderly generation and evaluation of a number of alternative parameters.

Then the model is tested using in-sample data during a set period Because there is no way to tell whether the model accurately recognizes the important features of the data based on in-sample results, it must be tested. This involves using an out-of-sample period and the out-of-sample data—data and time periods that were not used in the original development of the model. If the model is still profitable, the trading system is potentially profitable.

One of the greatest mistakes traders make is to assume that a trading system will continue to be profitable. But any model, no matter how clever and even adaptive, is static. Markets are not. A trading system will only be profitable as long as the model and the market remain in synchronization. Because markets are dynamic, conditions change and

trading systems will become less profitable. It is then necessary to resynchronize the model to the current state of the data. This involves reoptimization and may even require the selection of a new set of logic and parameter values.

It is also important to appreciate the serious transition between developing the system and trading it. The trader must have confidence that his or her model has a high probability of trading profitably, and this confidence is developed by using the walk-through process, which is:

1. In-sample test—Choose a length of time for the in-sample period that is much shorter than the available data. This will be determined by varying the in-sample length and running tests. The first in-sample period (there will be more) begins near the beginning of the available data. The more data, the better.

2. Out-of-sample test—The length of time for the out-of-sample period is as long as the model and market remain in synchronization. It is usually chosen to be the same as or somewhat shorter than the in-sample period.

3. Optimization—Optimization (organized search) is run using that timeframe and the best model chosen. The logic and parameters from that instance of the best model are used to test the performance during the period immediately following the out-of-sample period, and the results recorded. The dates for the in-sample and out-of-sample timeframes are moved forward by the length of the out-of-sample period. And the process is repeated. It is repeated until all of the data has been used. If the combined out-of-sample results are acceptable, then there is a high probability that the system will be profitable when traded.

Each transition from in-sample to out-of-sample testing gives a trader an additional instance of experience—and the more instances there are, the greater the degree of statistical confidence. The out-of-sample results from the walk-forward process also provide a benchmark by which the health of the system can be statistically measured as it is being traded.

An effective walk-forward process maintains the system's profitability by fine tuning and keeping the model in synchronization with the market. This ensures that the system changes sufficiently as old inefficiencies are removed from markets and new ones crop up.

PUTTING IT ALL TOGETHER

Trading may not be black and white, but there is a world of difference between being consistently profitable and going broke. And there is no single methodology or approach that works. It is more about combining a complex array of variables into a cohesive and effective trading machine.

It is important to remember that the single greatest risk to any trading system is called trader-specific risk. In other words, you are the greatest risk to your system. But by constructing a robust trading system that contains crucial key components and by maintaining rigorous discipline, you have the greatest chance of succeeding in the market jungle.

Matt Blackman is a technical trader, author, reviewer, keynote speaker and regular contributor to a number of trading publications and investment/trading websites in North America and Europe. He also writes weekly and monthly market letters for http://TradeSystemGuru.com. He can be reached at Matt@TradeSystemGuru.com.

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