

Planning for Trading Stocks and Stock Indexes: Considerations for Serious Traders

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Planning for Trading Stocks and Stock Indexes

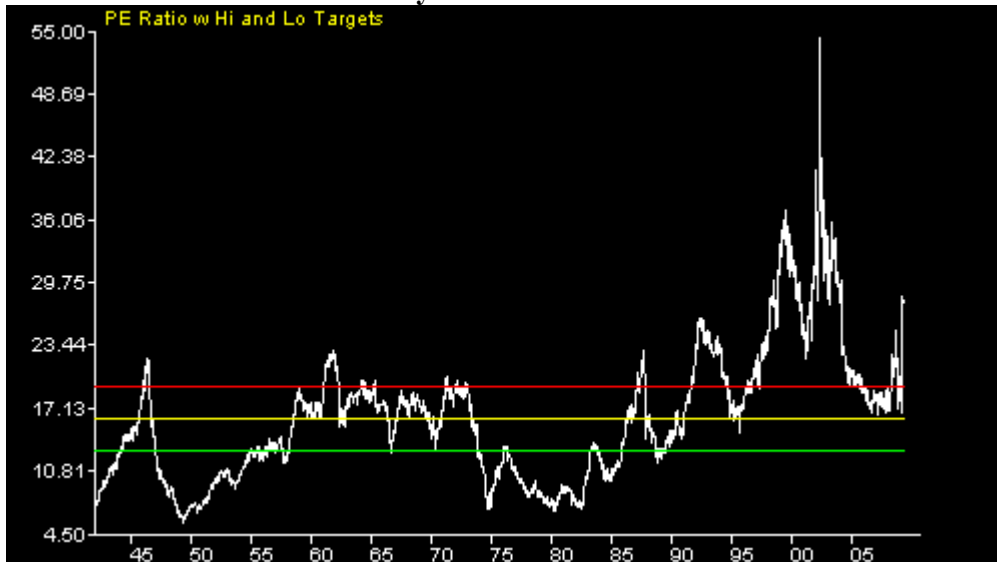
David B. Center

Step One: Perspective

You need to have some method for getting a perspective on the market and developing an opinion about its general direction. Ultimately your success will depend to a large extent upon getting the general trend, not the day-to-day fluctuations, right more often than wrong.

On the very long term (secular) measured in years, perhaps decades, I suggest using a price to earnings ratio chart for a widely followed index for which the data is available such as the S&P 500. Stock prices will trend upward when the PE ratio is increasing from low levels and downward when it is decreasing from high levels. The long-term mean is around 15 and 20 is considered high while 10 is considered low. Major market declines (secular bear markets) begin at the apogee of this ratio, which is usually in the range of 20 to 30 and major market advances (secular bull markets) begin at the nadir of this ratio, which is usually in the neighborhood of 6 to 10. I suggest creating a chart such as the one below using monthly data.

Chart One: Secular Market Cycle



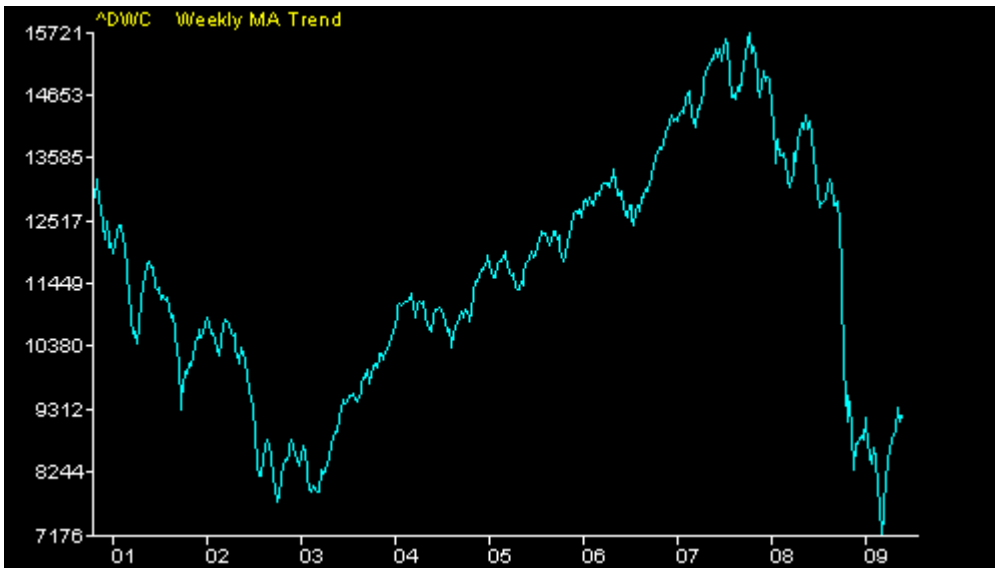
Next, I suggest a long-term trend indicator based on a broad index of the market such as the New York Stock Exchange or the Wilshire 5000 stock index. I prefer the latter. A monthly trend indicator based on a moving average can give you a long term perspective on market direction but one not as broad as the secular model discussed above. This trend doesn't turn quickly but investments based on such a trend indicator are more profitable than buy and hold. I suggest creating a chart like Chart 2 below using monthly data.

Chart Two: Long-term Trend



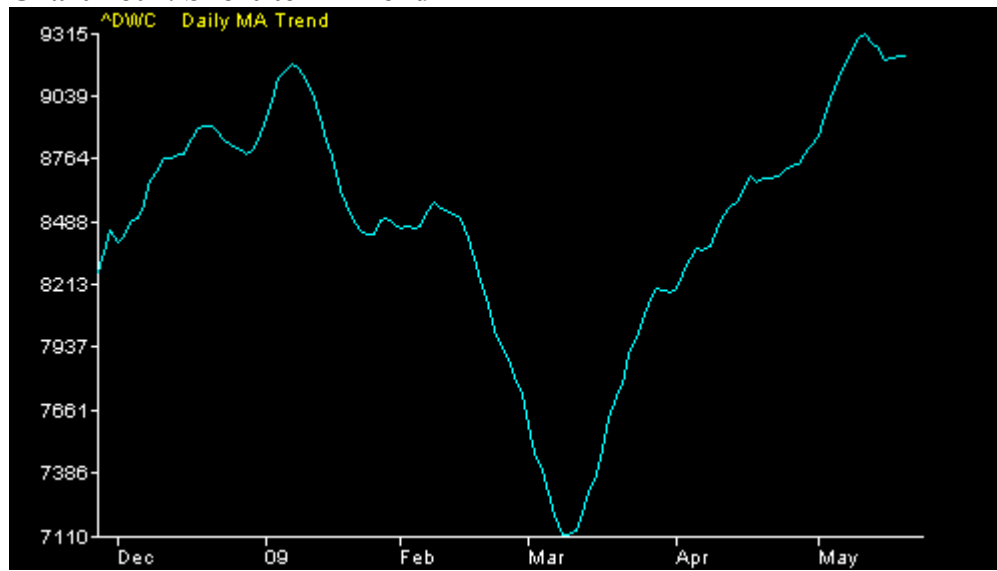
You also need an intermediate-term trend indicator. I suggest using a broad index such as the Wilshire 5000 stock index. This indicator should be based on a moving average using weekly data similar to Chart 3 below.

Chart Three: Intermediate-term Trend



Finally, you need a short-term trend indicator. I use a moving average of daily data from a broad index like the Wilshire 5000 similar to Chart 4 below.

Chart Four: Short-term Trend



With each moving average trend one needs to make three decisions. First, is selecting the best type of moving average. There are a number of choices but the most common are the simple moving average, weighted moving average and the exponential moving average. Second, is selecting the proper length for the moving average in months, weeks or days. The final consideration is the lag factor. A lag factor is simply how many units of time the average must show a change in direction before declaring a change in trend. I set up an evaluation protocol that simulates trading the trend in which I can vary all the factors and look for the combination that seems to work best before making my selections.

Range-based Perspective. It is also helpful to look at price action into the context of some type of framing structure. Doing this helps you judge the relative level of the market within different time frames. To do this I use Fibonacci levels for different time periods. Typically, these levels are computed from a selected high point for descending prices and from a selected low point for ascending price. The most commonly used ratios used for Fibonacci levels are .236, .382, .500, .618, .786 and 1.0. Technically, .5 is not a Fibonacci ratio but is useful to mark a mid-point in the computed levels. Typically, retracements will be to one of three levels .382, .500 or .618. However, it is possible for there to be retracements to some of the other levels mentioned and even extensions of previous highs and lows such as 1.236, 1.382 and so on though these are rare.

Below are two long-term charts. Note in Chart 5 that the market peaked from a low in 1974 to a high in 2000 and then completed a 50% descending retracement of this up move. As you can see in Chart 6, it then completed a 100% retracement of the 50% descending retracement to form a double top in 2007. From this second high, it then completed a 100% descending retracement of the previous 100% ascending retracement. This is where we are as this is written. The market has given back approximately half the gains from the previous secular bull market and on an intermediate-term basis appears poised for another ascending retracement.

Chart Five: Long-term Targets Down



Chart Six: Long-term Targets Up



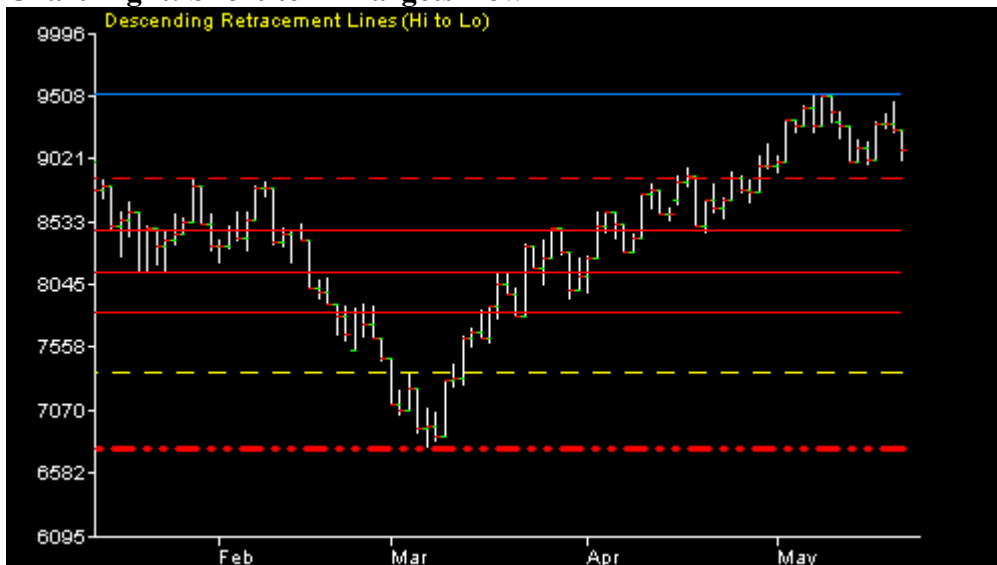
One might ask, if we've had two descending retracements that ended at the 50% level and that is one of the common ending levels might this be the end of the secular bear market that we appear to have entered in 2000? I would suggest that the best guide to an answer is Chart 1 of PE ratios that the discussion began with. Once begun a secular bear market does not end until PE ratios have dropped below 10. There is a long way to go on the down side before the market arrives at that level. Thus, I would argue that while we could get an intermediate-term bull rally and another ascending retracement the long-term direction is still down. This will not conclude until enough of the gains from the secular bull market have been given back to bring PE ratios below 10 where a new secular bull market can begin.

We can gain further insight about what the nearer term direction of the market might be by looking at a shorter time frame. For this perspective I like to use the Fibonacci number 89 to frame the chart. Thus, I find the 89-day high and the 89-day low and create a chart similar to Charts 7 and 8 below. As you can see in Chart 7 a short-term ascending retracement appears to have stalled. In Chart 8, an apparent short-term high has been reached and there is a set-up for a possible descending retracement. The short-term moving average trend line in Chart 4 supports this.

Chart Seven: Short-term Targets Up



Chart Eight: Short-term Targets Down



What we see in Chart 1 is that a secular bull market has ended and a secular bear market has begun. On an intermediate-term basis, there appears to be a possible bull rally in the making, which is supported Chart 6 above and by the long and intermediate-term moving average trend lines in Charts 2 and 3. On a short-term basis a downside correction seems to be most likely. This is supported by Chart 8 and by the short-term moving average trend in Chart 4.

This is essentially how I try to get some perspective on where the market is at and where it might be going. Once you have an opinion about what the market is likely to do in the near term, you are ready to give some consideration to picking a trading vehicle or vehicles and finding entry points. This of course is just a working hypothesis and is subject to revision any time the market supplies enough evidence to the contrary. In my experience, it is almost impossible to make useful predictions about what the market is likely to do tomorrow or the next day. You have to operate in larger time frames and not get distracted by daily fluctuations in the market, which are more often than not just static or noise.

Note: You can find the Secular Market Status and the long and intermediate-term moving average trends on my web site. Computational procedures for all of the indicators that produced the charts above are available from me in WaveWiSe spreadsheets.

Step Two: Trading Vehicles

One can trade using individual stocks, exchange traded funds, mutual funds or options. My personal choice is exchange-traded funds (ETF) that track stock indexes. I prefer these ETFs because they have the flexibility of trading individual stocks with less volatility, because they provide both long and short versions that let you go with the market trend regardless of whether it is up or down and they provide both unleveraged (beta one) and leveraged (beta two) versions. Here are some of the most common index tracking ETFs.

Dow Jones Industrials:

DIA Beta one long DOW
DDM Beta two long DOW
DOG Beta one short DOW
DXD Beta two short DOW

Standard and Poor 500:

SPY Beta one long SPX
SSO Beta two long SPX
SH Beta one short SPX
SDS Beta two short SPX

NASDAQ-100:

QQQQ Beta one long NDX
QLD Beta two long NDX
PSQ Beta one short NDX
QID Beta two short NDX

Russell 2000:

IWM Beta one long RUT
UWM Beta two long RUT
RWM Beta one short RUT
TWM Beta two short RUT

Step Three: Selecting Entry Points

You now need some method of selecting an entry point for your trading vehicles. There is a tendency among traders to overly complicate this step and put far too much time and effort into it. It is what I've come to think of as the "Holy Grail Trap." We would all like to find the perfect system that never fails and makes lots of money. A lot of money has been made with such systems but the people selling the systems to traders made it.

Since you already have done an analysis of the market and developed a hypothesis about the near term direction of the market, the method of selecting an entry point is a minor consideration, if you've gotten the overall market direction right. If you've gotten that wrong, it won't matter what entry method you used – you lose.

I will briefly introduce several methods from among the many that you can find in any good book on technical analysis. You can use one of these methods for making entry decisions or you can do combinations, if you like. However, keep the KISS principle in mind and don't make this step overly complicated.

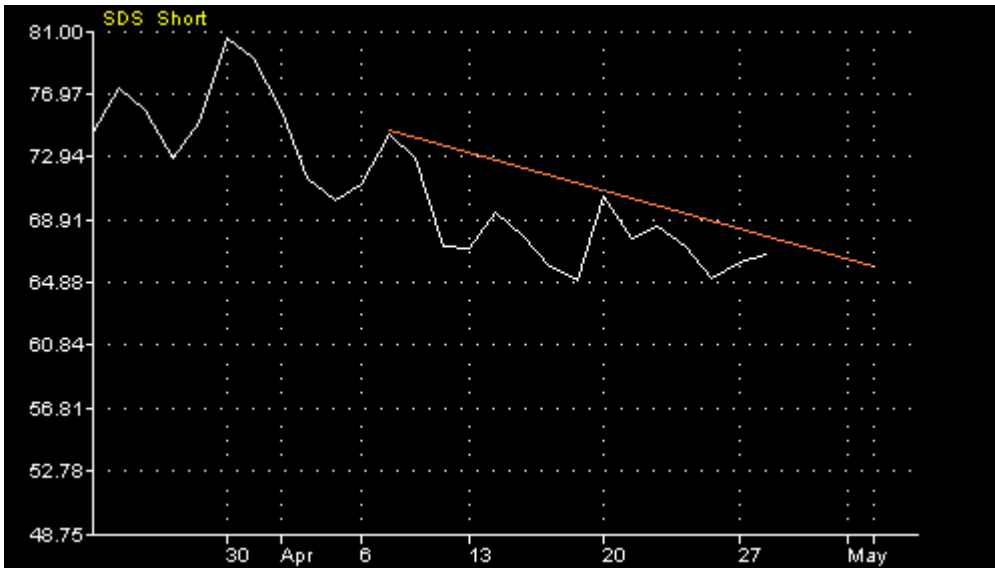
Breakouts. This is a simple approach that relies on chart work. It is particularly well suited to trading inverse ETF pairs. It does depend on there being some apparent trend present in the chart data. Below are Charts 9 and 10 illustrating the use of this approach with the pair SSO and SDS.

Chart Nine: Support Line



As you can see in Chart 9, SSO is in an up trend and the two most recent low points have been used to draw in a support line. If SSO closes below that support line, we will tentatively consider a reversal in trend may be underway. In Chart 10 below, the two most recent peaks have been used to draw in a resistance line. If SDS closes above that resistance line, we will consider a reversal in trend may be underway.

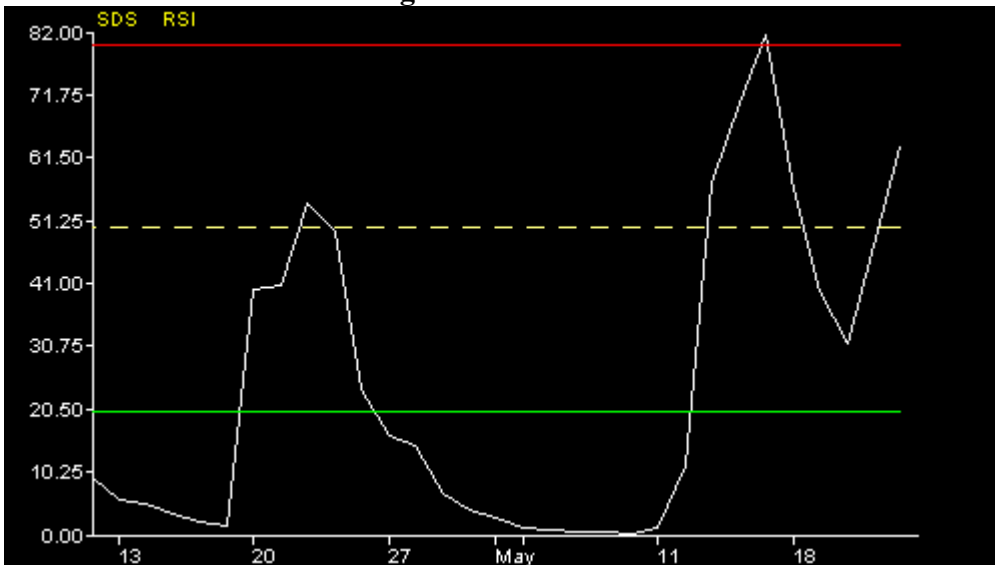
Chart Ten: Resistance Line



The entry signal with this method is a violation of both the support and resistance lines in a direction consistent with one's prediction. In the above case, such a violation would be consistent with a near term prediction that the market will work lower. Thus, one would enter a position in SDS.

Relative Strength. This is an indicator that assesses the current price momentum relative to some set point in the past. The most commonly used period is fourteen days. However, I prefer to use a three-day weighted moving average and then do a three-day relative strength computation on that average. Chart 11 below illustrates an RSI graph.

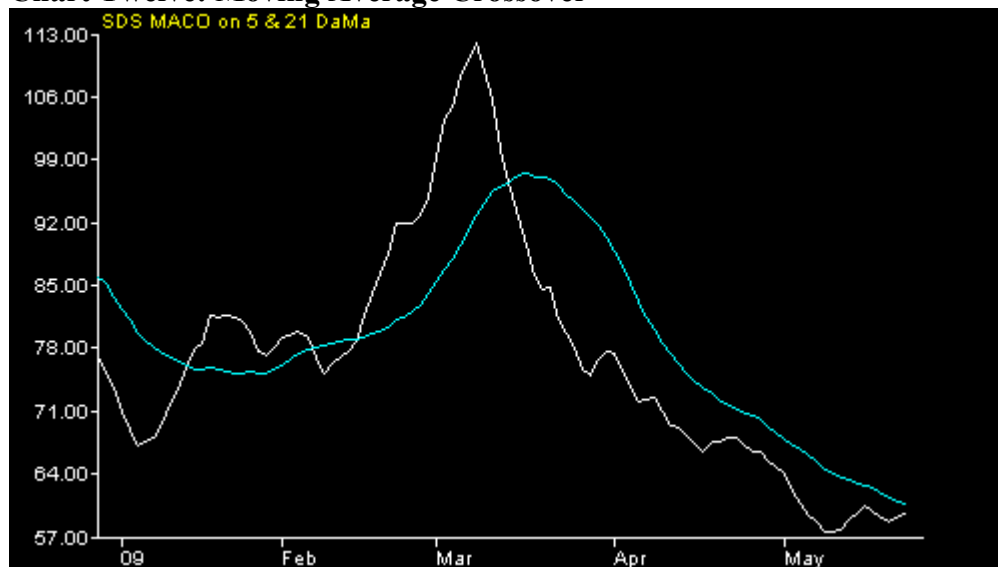
Chart Eleven: Relative Strength



Below the lower green line the issue is considered oversold and above the upper red line the issue is considered overbought. What one would look for would be a line that has dipped and begun to rise or one that has risen and begun moving sideways above the red line. You would not enter on a declining line, as that would not be consistent with your prediction.

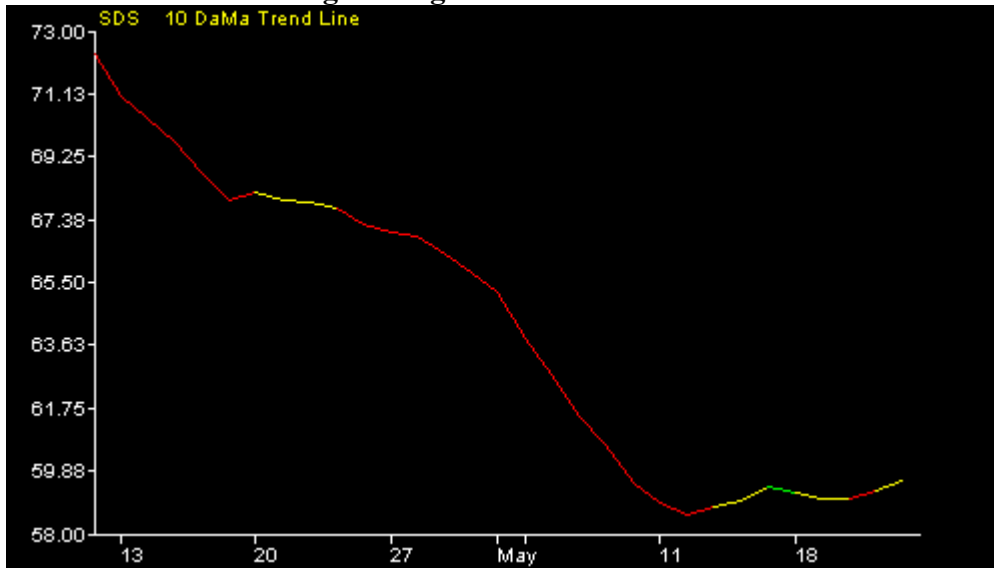
Moving Average Crossover. This approach makes use of two moving averages. In Chart 12 below, the faster moving average is white and is a five-day weighted average. The cyan line is the slower moving average and is a twenty-one day simple moving average. You would enter when the faster moving average moves above the slower moving average, if this is consistent with your prediction.

Chart Twelve: Moving Average Crossover



Moving Average Trend Line. The moving average trend line is a single moving average line that signals a change in trend when it turns up or down in direction of movement. Chart 13 below is an example of such a line. This line is produced by a weighted 10 day moving average. It uses a criterion of three consecutive days that are progressively higher or lower to define a change in trend. In the case of the chart, if the line is green it meets the up trend criteria and if it is red it meets the down trend criteria. In conclusive moves are colored yellow and may signal an imminent change in trend or just a minor fluctuation in the consistency of the changing price. The line depicted is currently yellow. The several and recent changes in the color of the line suggest the trend line is in a transition phase. When the line turns green that would be a entry signal is the signal is consistent with your prediction.

Chart Thirteen: Moving Average Trend Line



Note: Computational procedures for all of the entry methods that produced the charts above are available from me in WaveWiSe spreadsheets.

Step Four: Setting Overall Risk

First, decide how much of your capital you're going to trade with, e.g., \$100,000. Second, decide how much of that you're willing to risk losing, e.g., 5%. Now take 5% of \$100K and you get \$5,000. Third, decide what is the maximum number of positions you want to hold and manage at one time, e.g., 5. Finally, you must decide if you will spread the risk evenly over the positions or allocate it disproportionately across the positions. If the risk will be evenly spread across the positions, you would set \$1000 as your loss limit on each position. This loss limit will be important for determining position size and for setting stops as will be discussed below in Step 5.

Step Five: Initiate Position

The way I determine an initial position is to calculate either the daily or five-day range between the high and the low for one year. Use one-day volatility if you want to be stringent and five-day volatility if you want to be more lenient. Next, I find the median of those change calculations (e.g., \$2.00) and their standard deviation (e.g. \$.59). The median plus one standard deviation ($\$2.00 + \$.59$) becomes my base unit of movement (BUM). One could use two or more standard deviations depending on how loose you want your stops.

One thing you should do is to estimate the probability of your computed stop being triggered. Once you have your BUM do a count of how many times in the past year the daily or weekly range was greater than the BUM then divide that value by the number of trading days for which you've computed ranges. I use a spreadsheet to that is set-up to

compute the needed values to initiate a position. This sheet automatically calculates the probability of the stop being triggered intraday. I have another spreadsheet into which I can enter any stop that I want to test and it will give me intraday, five day and twenty day probabilities of the stop being triggered. If you select an alternative stop using a method such as this don't forget that altering your stop will alter the number of shares that you should buy to hold your risk at the predetermined level.

The size of your position will be your loss limit (e.g., 1000) divided by your BUM (e.g., \$2.59). Thus, in the example, you would buy 386 shares. Your base stop loss price will be the entry price minus the BUM (e.g., \$32.24 - \$2.59 = \$29.65). Incidentally, in this example your investment amount would be \$12,444.64 ($\32.24×386) and your potential loss would be \$999.74 ($386 \times \2.59).

Whether or not you will be able to take positions with all of your trading capital will depend on the volatility of the issues you buy. In some cases, you may not be able to use all of your trading capital and hold your loss risk at the desired level. In such a case, you'll have to be content with being less than fully positioned or raise your risk level (not recommended). The next topic will be managing a position once established, which includes how to determine exit points for profitable positions.

Note: A computational spreadsheet for initiating a position and one for estimating the probability of a stop are available from me in a WaveWi\$e spreadsheet.

Step Six: Managing Each Position

Now you use the BUM value to set potential take profit prices or positive exit prices. You do this by adding multiples of the BUM value to the entry price.

You used the BUM value to compute your base stop loss or a negative exit price. An elaboration on this method is to make it adaptive. You make the exit price computation adaptive so that the recommended exit price rises as the stock rises. This is similar to a trailing stop price. To make the exit price adaptive, you must compute a new exit price each day by subtracting the BUM from a current day price. You could use the high price for the day to compute this value, the closing price or an average price of the open, high, low, and close price. I favor the close price but either of the other two can be used. The biggest problem with using the high is the possibility of getting a spike in price so that when a new exit price is computed using the high the new exit price exceeds the current price. In short, it is useless because it can't be implemented. This can happen even using a close price, if the open the next day is significantly below the close the previous day. This however is not a common event. As new exit prices are computed, the exit price is always the highest price computed since the position was entered. If an exit price is computed that is below the base stop loss price set at entry, the lower price is ignored.

You should also link the exit price to take profit targets. You compute take profit prices by adding BUMs to the entry price, that is, 1 x BUM, 2 x BUM, 3 x BUM and so on are added to the entry price. For example, if BUM is \$2.59 and the purchase price is \$32.24 then adding one BUM would give you \$34.83; two BUMs would give you \$37.42 and

adding three BUMs would give you \$40.01, and so on. When the current price reaches one BUM the exit price will be the entry or breakeven price, when the current price reaches 2 BUM the exit price will be 1 BUM, when the current price reaches 3 BUM the exit price will be 2 BUM and so on. By setting your exit prices in the manner described, you use a BUM as your volatility filter. That is, you allow for fluctuations as large as a BUM but either stop losses or take profits, if the volatility exceeds a BUM. Using this method, you always have an exit price that limits your losses and protects your profits while allowing a reasonable amount of room for normal fluctuations in price.

Note: A computational spreadsheet for initiating a position is available from me in a WaveWi\$e spreadsheet.

Step Seven: Monitoring Your Portfolio

You need a summary sheet that helps you monitor your positions and gives you aggregate values on number of positions, total amount invested, percent at risk and dollars at risk. Figure One below illustrates such a monitoring program.

Figure One: Portfolio Monitoring

Total Port:	100000	% Risk:	3							
Actual Port:	20625.50	% Risk:	14.54							
Positions:	4.00	\$ Risk:	2998.10							
Date	Name	SYM	Shares	Buy @	Value	Stop \$	Stop @	Exit @	Exit Val	Support
	Lg Dow	DDM			0.00		0.00	0.00	0.00	
	Sh Dow	DXD	80.00	50.31	4024.80	6.25	44.06	0.00	3524.80	47.97
05.11.09	Lg NDX	QLD			0.00		0.00	0.00	0.00	
	Sh NDX	QID	85.00	36.74	3122.90	5.85	30.89	0.00	2625.65	34.92
05.11.09	Lg SPX	SSO			0.00		0.00	0.00	0.00	
05.11.09	Sh SPX	SDS	135.00	59.10	7978.50	7.41	51.69	0.00	6978.15	55.72
	Lg RUT	UWM			0.00		0.00	0.00	0.00	
05.20.09	Sh RUT	TWM	115.00	47.82	5499.30	8.70	39.12	0.00	4498.80	44.24
					0.00		0.00	0.00	0.00	
					0.00		0.00	0.00	0.00	
					0.00		0.00	0.00	0.00	
			4.00		20625.50				17627.40	

As you can see in the above spreadsheet, the current dollar amount at risk (\$2998.10) is 3% of the total portfolio and 14.5% of the amount invested (\$20,625.50). At no time should the Total Port Risk percentage or at Risk dollars exceed the levels set in Step Four. The BUM amount is entered in the Stop \$ column and the stop loss price is computed in the Stop @ column. When the exit price in your manage position program exceeds the Stop @ price, it would be entered in the Exit @ column. The Support column provides a place to enter any value that you consider to be an early warning price such as

the 89-day low price. This spreadsheet gives you an overview of your positions for quick reference.

Note: A computational spreadsheet for monitoring a portfolio is available from me in an Excel spreadsheet.

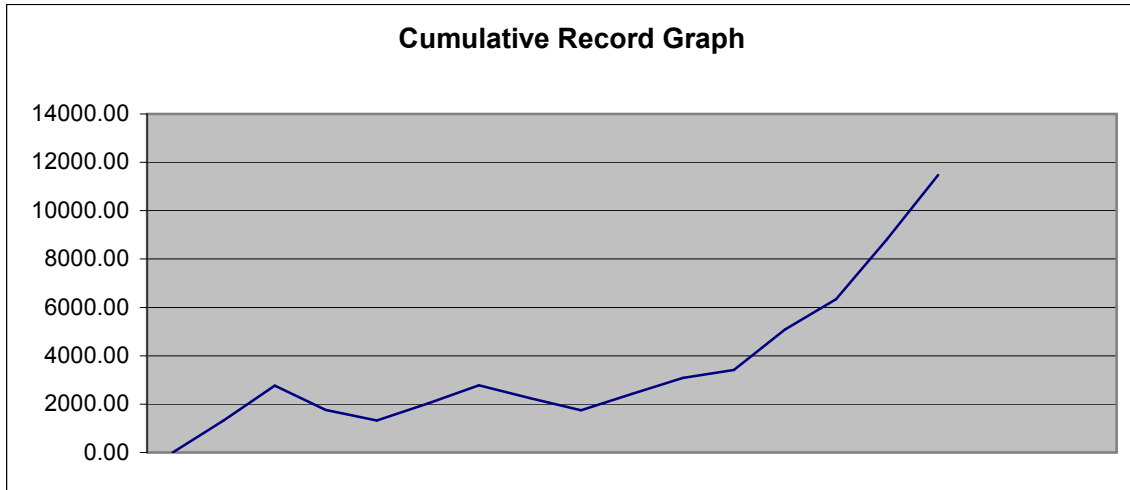
Step Eight: A Cumulative Record of Trading Outcomes

The last thing that you need to complete your preparation for trading is a cumulative record of trading outcomes in which you can monitor the profit and loss outcome for each trade and the cumulative or net outcome of your trading activity. Consistent negative outcomes suggest a reevaluation of what you're doing is in order. Figure Two below illustrates such a monitoring program.

Figure Two: A Cumulative Record

BuyDate	Issue	Shares	Entry	Cost	Exit	Proceed	Net	CumNet	SellDate
01.16.08	QID	435	46.65	20300.75	49.72	21628.2	1319.45	1319.45	01.22.08
01.16.07	SDS	250	61.36	15347.25	67.19	16797.5	1442.25	2761.70	01.22.08
03.12.08	SSO	300	65.61	19690.16	62.3	18690	1008.16	1753.54	03.14.08
03.12.08	SSO	150	65.28	9800	62.493	9373.95	434.05	1319.49	03.14.08
03.26.08	QLD	250	72.30	18083	75.162	18790.5	699.50	2018.99	04.08.08
03.26.08	QLD	250	72.08	18028	75.17	18792.5	756.50	2775.49	04.08.08
04.02.08	SSO	210	70.46	14804.6	68.06	14292.6	520.00	2255.49	04.11.08
04.02.08	SSO	210	70.48	14808.8	68.12	14305.2	511.60	1743.89	04.11.08
04.10.08	QLD	600	75.17	45110	76.33	45798	680.00	2423.89	04.23.08
04.10.08	QLD	400	72.82	29135	74.515	29806	663.00	3086.89	04.18.08
04.22.08	QID	500	43.37	21693	44.06	22030	329.00	3415.89	04.22.08
05.05.08	SDS	400	56.24	22504	60.46	24184	1672.00	5087.89	06.12.08
06.02.08	QID	600	38.43	23063	40.53	24318	1247.00	6334.89	06.12.08
06.16.08	SDS	400	59.69	23884	65.93	26372	2480.00	8814.89	06.30.08
06.16.08	QID	600	39.06	23441	43.51	26106	2657.00	11471.89	07.02.08

Invested:	319692.56	Capital:	50000.00
Trades:	15	Net:	11471.89
Avg Size:	21312.84	Percent:	22.94



Note: A computational spreadsheet for compiling a cumulative record is available from me in an Excel spreadsheet.

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