Short Term Trading Strategies That Work

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A Quantified Guide to Trading Stocks and ETFs

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CHAPTER 1

Introduction

In the late summer of 1987, I made the decision to leave the brokerage industry and trade for myself full time. The one problem with that goal was that I knew no one else who had even attempted this. Nor were there any books or courses available that showed the path to be able to do this.

Money was not the problem. I was fortunate enough to have been hired by Merrill Lynch in 1982 when the Dow was at 800. Five years later and the market 300% higher; I had the good fortune to be earning about 3-5 times more than nearly everyone else who I had gone to college with just a few years back.

The real problem was a lack of credible information on how to trade! The reality was that in 1987, real traders didn't talk about what they did or how they traded.

Seven years later, I reached my goal. In 1994, I left Donaldson Lufkin and Jenrette (if Merrill Lynch was my undergraduate school, DLJ was my graduate school). On Monday, March 4, 1994 I got up at 5 o'clock in the morning and looked out over the Pacific Ocean from Malibu California. I had begun my first day of professional trading.

More than two hundred years ago Samuel Johnson said, "When a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully." That saying was never more true than for me in 1994. Having been making a healthy six-figure salary just about every year for the previous decade, I was now faced with the knowledge that there would be no income unless I performed. It was a scary thought for someone who didn't want to spend his life wearing a white shirt and blue tie, especially since I had a family to provide for, including my two young daughters.

Jump ahead to today and the world is very much different. In some ways it's good and in other ways. . . it's not so good.

It's good in that there is an abundance of information on how to trade. Sometimes I think it's everywhere. And if someone doesn't want to take the time to learn how to trade, they can turn on the television and have the stock picks fed to them all day long. According to a recent article in *Fortune* magazine there are at least 100 different people every day parading through CNBC telling you which stocks to buy. Add media outlets like *Fox Business*, and everything else on the Internet, magazines, television, and radio and you can pretty much guarantee that any stock that's moving will likely be mentioned.

Another part of the good is the advanced ability to quantify strategies. When I was teaching myself how to trade, I quantified by hand. I still have notebooks of tests that I did by hand, writing down the entry and the exit and then adding up the results. What used to take days to test, today takes minutes. And now my research process is simpler and more efficient with my Director of Research being one of the people who helped Microsoft further create and build out Excel in the 1990's.

The not so good news is that many of the edges I saw in the 1990's are no longer there. Markets have become more efficient. In 1995 you could sit in front of a Bloomberg screen, and if you were patient enough you could catch 1-2 important news stories each day that were released by Bloomberg 2-3 minutes before Dow Jones reported them. And considering that at the time, most institutions relied upon Dow Jones News, you simply had to disseminate the news, make the trade and you would often be rewarded within a few minutes. Not a bad way to make a living. Today though, that advantage is gone.

Another way to go about it is to do as many good traders were doing at the time. Keep a list of good stocks, especially REITs with rising dividends, and wait for a retail trader to dump some of their holdings. The specialist would take the stock down 5-10% in a heartbeat, and then a bid for size would come in. All you had to do was step in front of the bid and place a stop just under the bid. This game used to drive the bigger players crazy. But for nimble individual traders, it was the 1990's version of an ATM.

I could share with you many of these strategies. But what worked then is not always relevant to what works today. **In this book, I'm going to show you what worked then and STILL works today.** And even though there is no guarantee of future performance, the hope is that they will continue to work for years to come.

In this book, I'll share with you more than two decades of research and trading knowledge. I've been very fortunate to have gotten to know some great traders and in one way or another, their thoughts are encompassed in my own. The ability to learn from people like Kevin Haggerty who ran Fidelity Capital Markets Trading Desk for 7 years and co-founded TradingMarkets with me, has been invaluable. I've also co-written a book (*Street Smarts*) with Linda Raschke who was featured in the book *New Market Wizards*, and is one of the best S&P traders I've ever seen. She's one of the only traders I know who could probably flip a coin to decide which way to trade the S&P's and turn that position into a profitable trade. That type of trading skill is unparalleled. Another Market Wizard, and someone who is a close friend, is professional options trader Tony Saliba. Tony and his team are some of the more successful options traders in the world. Many options traders succeed for a few years. Tony and his team have succeeded for over thirty.

The one thing these people have in common is that they know what it's like to **trade from a position of strength**. Each has the institutional and floor experience to fully understand that in order to consistently make money from the market, they want to buy into the selling and sell into the buying. The statistics and the strategies you will find in this book, further confirm this.

I've also had the good fortune of learning from many other successful traders. Through my books and our TradingMarkets website, I've gotten the opportunity to witness many traders take our research, apply their own unique touches, and make it even better. Many of these traders have gone on to start their own trading and money management firms. They followed their dream and have become successful because of their brains and most importantly their tenacity.

I've learned that people trade for many reasons. The goal of making money is obviously an important part of that reason. But I believe it goes even further than that.

For many it's the never ending challenge of figuring out a game that may be the most complex and fascinating game in the world. It's a game with a fixed set of rules, but with the pieces always moving. Every day brings new opportunities and challenges and as time passes they become exponentially larger as more markets become liquid and more trading instruments become available. When I started trading in college in the late 70's, there were only stocks, and a few commodities. A few years later when I joined Merrill Lynch, the Dow was at 800 and there was no such thing as index futures. Today, the markets have become global and the exchanges have transformed themselves from government controlled entities into publicly traded corporations whose mantra is growth through technology and new product development. It's capitalism at its best and it continues to offer us the ability to play a game that gets better every day.

The following chapters are a combination of market philosophy, market psychology, and market strategies. They encompass many markets and can be applied both in the United States and abroad. *Philosophically, I live in the world of reversion to the mean when it comes to trading.* What that simply means is that something stretched too far will snap back. I didn't come up with that idea. It's been around for decades. **What I have done though is attempt to quantify it.** It's one thing for someone to give you a handful of rulesand say "trust me, this works." It's another thing to have it backed up by statistical evidence.

In my book *How Markets Really Work* we quantified a great deal of short-term behavior. We showed how buying the market after its dropped three days in a row outperformed the times that it had risen three days in a row. In chapter after chapter, it was shown statistically that *buying low and selling high outperformed buying high and selling higher for short-term trading*. In this book, we'll do the same and we'll go further. This book is not only about the statistics. It's about taking statistics and putting them to work. In 2003 in *How Markets Really Work* we asked, "Why has baseball embraced statistics to make decisions whereas Wall Street is run on hearsay? Why is Billy Beane, the General Manager of the A's, able to successfully run an organization with a limited budget using statistics yet most financial market analysts still use "opinions" to manage literally trillions of dollars? Since that book was written, two baseball teams which rely upon statistics to guide their decisions have won three of the past four World Series (the Red Sox have won two World Series and the Cardinals the other). Each of these teams relied upon the proper statistics to guide them and then properly applied them. In this book, you'll get to do the same. You'll have the statistics in front of you and I'll teach you the ways to apply them.

Here is how the book is laid out. First we'll look at certain behavior which is inherent in the marketplace. This behavior is not something that the mainstream press even begins to understand. You will learn that what seems to be logical and obvious is often wrong when it comes to trading. We'll then look at pullbacks and why they have worked. We'll look at daily pullbacks, intra-day pullbacks and how one oscillator, the 2-period RSI, can help you identify when and how to trade these pullbacks.

We'll then move onto the Strategies section. All of the strategies you will learn are backed by more than a decade's worth of research. I'll share the rules to each of the strategies and their results with you. You'll learn stock strategies and S&P timing strategies, again all quantified. For those of you who are looking for daily strategies to apply, you'll find them here. For those of you who like to do your own research and want to go further with these concepts, there's a potential goldmine here for you to run with.

We'll then look closely at exits. Getting into a trade is one thing. But the edges can be maximized with the proper exits. We'll look at a handful of exit strategies and the statistics to verify that they're valid to use.

We'll end this book with what may be the most important aspect to your trading success. It's psychology. But instead of us covering the same ground that many other books have covered, we're going to go further. We'll discuss real world situations that you'll be faced with for the rest of your trading life. And then I'll share with you an interview I did a few years back with a 10-year Navy Seal veteran. In this interview, you'll not only learn how to become a better trader; you'll learn how to become better in everything you do in life.

I hope you learn a great deal from the knowledge in this book. Now let's get started.

CHAPTER 2

Think Differently: Rule 1 – Buy Pullbacks, Not Breakouts

George : It's not working, Jerry. It's just not working.

Jerry : What is it that isn't working?

George : Why did it all turn out like this for me? I had so much promise. I was personable, I was bright. Oh, maybe not academically speaking, but . . . I was perceptive. I always know when someone's uncomfortable at a party. It became very clear to me sitting out there today, that every decision I've ever made, in my entire life, has been wrong. My life is the opposite of everything I want it to be. Every instinct I have, be it something to wear, something to eat. . . It's all been wrong.

Waitress : Tuna on toast, coleslaw, cup of coffee.

George: Yeah. No, no, no, wait a minute, I always have tuna on toast. Nothing's ever worked out for me with tuna on toast. I want the complete opposite of tuna on toast. Chicken salad on rye, untoasted. . . and a cup of tea.

Elaine: Well, there's no telling what can happen from this.

Jerry: You know chicken salad is not the opposite of tuna, salmon is the opposite of tuna, 'cause salmon swim against the current, and the tuna swim with it.

George: Good for the tuna.

(A blonde looks at George)

Elaine: Ah, George, you know, that woman just looked at you.

George: So what? What am I supposed to do?

Elaine: Go talk to her.

George: Elaine, bald men, with no jobs, and no money, who live with their parents, don't approach strange women.

Jerry: Well here's your chance to try the opposite. Instead of tuna salad and being intimidated by women, chicken salad and going right up to them.

George: Yeah, I should do the opposite, I should.

Jerry: If every instinct you have is wrong, then the opposite would have to be right.

FROM THE SEINFELD TELEVISION EPISODE "THE OPPOSITE"

We're now going to look at six rules which will show you that when it comes to trading, doing "the opposite" of one's instinct (and the media) has been one of the best ways to consistently make money from the markets.

RULE 1 - BUY PULLBACKS, NOT BREAKOUTS!

Let's begin by taking a quick quiz. . .

Question #1

Let's assume that it's January 1, 1995, and the S&P 500 is at 459.27. 13 years later the market has risen over 200%, rising to above 1450 by December 31, 2007. How would you have done if you had been a breakout trader and bought every new 10-period high (as all the breakout traders were piling in, most of the money managers were likely adding to positions and the press was jumping up and down about how great things were), and used a trailing stop of exiting when prices closed under their 10-period moving average?

a. You made a ton of money and are now a member of the *Forbes* 400, because if the market more than tripled during that period, you as a breakout trader made a fortune.

b. You made good money. You paid for your kids' college, have lots of money to retire on and have a second home adjacent to the Spielberg family in the Hamptons.

c. You outperformed buy and hold.

d. You lost money. The market tripled in value and you lost money.

Question #2

Same assumption as above, but you did the *exact opposite* of what we have all been taught. You SOLD the market as it made new highs. You put your face in front of a speeding train and shorted the market when the "smart" money was buying. How would you have done?

Question #3

Final question. Let's go a step further. You didn't buy any breakouts. You're a complete nut. You only bought the breakdowns! You only bought when the market made new 10-day lows. When everyone was yelling "SELL, SELL, SELL" — just like Randolph Duke was yelling in the movie "Trading Places" — you were just buying away (including during the bear market of 2000-2003, and the credit crisis debacle in the summer of 2007), and exiting when the market closed above its 10-period moving average. How did you do?

THE ANSWERS

Let's first discuss this and get into the guts of what is exactly happening when the market is making a new 10-period high. This will help you better understand the correct answers.

By the time the stock market makes a new short-term high, there is likely an abundance of good news that has occurred over the past week. Solid economic reports, good earnings reports, upgrades on stocks, and more have all likely occurred. The world is looking very good during those times. Right? Right! So what should stock prices do from there? "Logically," they should go higher, isn't that so? So then "logically," the answer to the first question is a, b, or c. Well, the logic is wrong.

In spite of the fact that the market rose over 1000 S&P points during that time, had you bought the 10-day breakouts and exited when prices crossed below the 10-day MA, *you would have lost money!* In the S&P 500 index, you lost nearly 100 S&P points. Incredible, isn't it? We've all been taught and told to "buy strength." Great. Super advice. Except in this case, you were right a whopping 41.1% of the time. We've all been told to be mesmerized by lists that focus on today's new highs. Yet, reality is, it appears to be wrong. . . very wrong.

So the answer to **Question #1** is that you did not beat buy and hold, you are unfortunately not a neighbor of the Spielberg family in the Hamptons, and you are also not a member of the *Forbes* 400. Buying new highs lost money. . . lots of money.

Now, let's move to **Question #2.** You sold the new highs. While everyone was buying because of the good news, you were "the dummy" who was shorting into this buying. So, how did you do? The results are the opposite of the breakout buyers (you exited when the market crossed under its 10-period MA). Selling new highs in a rising market made almost 100 points and was correct 59% of the time, whereas buying the new highs lost money. Who would have thought?

We'll now move to **Question #3.** What happened if you bought a market that made 10-day lows? Again, let's first get into the guts of the marketplace and understand what is happening. When the markets make 10-day lows, it almost always occurs while bad news is permeating the environment. Bad economic news, missed earnings from major companies, scandals and more are being discussed by the press, money managers and nearly everyone else. Again, "logically," no reasonable person would be buying here, but again, the logical ones are very wrong. Since 1995, had you bought every 10-period low and exited when the market crossed above its 10-period moving average, you would have made 1048.70 S&P points being invested only 28.81% of the time. Plus, 73.5% of your trades would have been profitable. Nice . . . very nice.

1. **So How Do You Use This Information?**
   Many ways. But first let's remember that these are just statistical results that don't take into account trading costs, slippage, etc. And there is no way of knowing whether these results will do better or worse in the future. With that said, here is what the past 13 years of data tells us:

2. **You don't blindly buy breakouts in the stock market.**
   Yes, the world looks great, yes the news is wonderful, and yes there's lots of excitement out there. But unless you have some superior exit strategy, you will likely have a very tough time making money buying the highs over the long run. If you didn't make money buying highs in the move since 1995, it's going to be awfully tough to do it in the future.

3. **As the markets are making these highs, the odds are increasing that a short-term reversal is near.**
   You should be looking to lock in your trading gains as markets make new highs, not add new positions.

4. **Buying markets which pullback (in this case, to 10-day lows) is a superior strategy.**
   We strongly believe that. And the statistics throughout this book prove this out.

5. **Don't get caught up in the hype when markets make highs.**
   The press and the investment community are jumping up and down telling us just how great things are during these times. They're right. . . *except that prices already reflect this.* That's why prices are at new highs. And on the opposite end, there is nothing but negative news near the lows. A few days of incidental negative news is not a formula for the market crashing. The world-is-coming-to-an-end doom and gloom crowd use these few days to tell you why the market is going to zero and the end of mankind is near. Don't get caught up in this! They're always wrong.

And the most important thing to take from this rule is the same as the theme from one of Apple's commercials, and it's the theme throughout this book. . . **think differently.** Because at the end of the day, when everyone is thinking the same way, they're usually wrong. And, as you can see from these statistics, this is especially true when it comes to the financial markets.

CHAPTER 3

Rule 2 – Buy the Market After It's Dropped; Not After It's Risen

We've all watched CNBC and seen how emotional the reporters and the analysts become after the market rises sharply for a few days or drops hard for a few days.

After the market has risen, everyone is jumping up and down and telling you how good things are and why prices are likely going higher. After a hard drop, the doomsayers come in repeating over and over again why the market dropped and why it will likely continue to drop.

As most of us have seen, these people are usually wrong. Why? Because as we just saw in the previous chapter they are only repeating what the market already knows. And the market has already factored in much of the good news (that's why it has risen) and it has already factored in much of the bad news (including the potential for future bad news).

This has been the way markets have worked for decades and in my opinion, they will likely work like this for decades to come.

How do you profit from this information? By not buying the market or a stock right after it's risen a number of days in a row, and not selling (or shorting) a stock after it has dropped a number of days in a row.

Here are the statistics to back this up:

From 1995-2007, after the S&P 500 index has dropped three days in a row, it has risen more than 4 times its average weekly gain over the next five trading days.

And, after the S&P 500 has risen three days in a row, it has on average lost money over the next five trading days.

In conclusion, it's better for you to buy the market after it's dropped, not after it's risen!

CHAPTER 4

Rule 3 – Buy Stocks Above Their 200-day Moving Average, Not Below

Many people like to buy stocks when they've been beaten down over a long period of time. You'll see people "bottom fishing" stocks as they are plunging lower under their 200-day moving average (the kiss of death is when a "growth stock" is referred to as a "good value"). Once a stock drops under its 200-day moving average, all bets are off. It's better to be buying stocks in a longer term uptrend than in a longer term downtrend, and here's why.

We looked at over 8 million trades of stocks from 1995-2007. We then looked at the 5-day behavior of these stocks when they were above the 200-day moving average and below the 200-day moving average. As you can see, the gains have been better above the 200-day moving average.

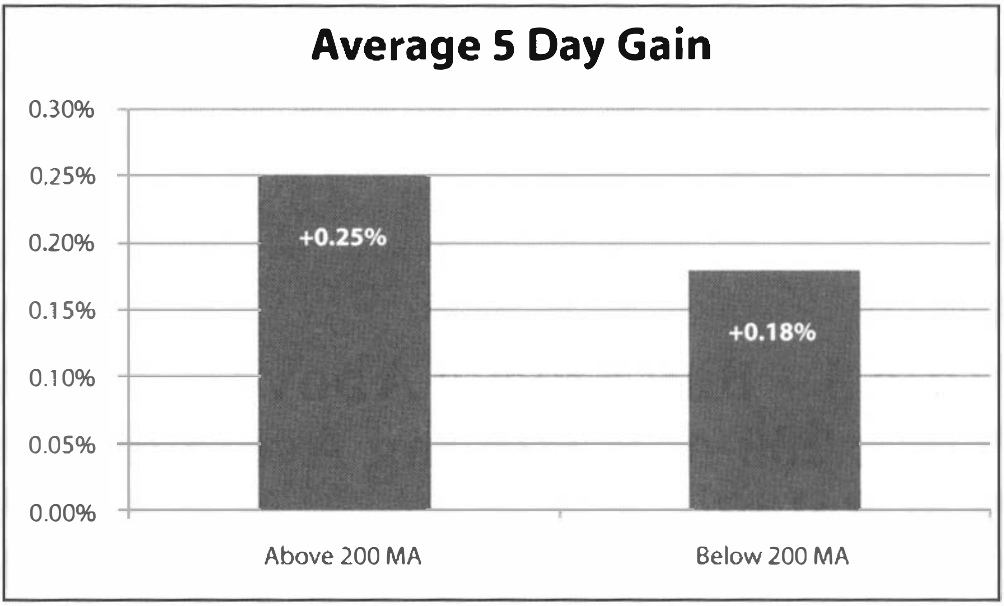

Figure 4.1 Average 5-day Gain

But there's more to this. **Most cataclysmic individual stock drops, over the past century, have occurred when the stock was under its 200-day moving average**. A stock's decline may have started above the 200-day MA but in nearly all cases, the majority of its decline occurred after it broke below the 200-day moving average.

From Enron to Bear Stearns, from the Internet stock collapses in 2000-2002 to the housing and brokerage stock collapses in 2007-2008, they were all at one time above the 200-day MA, but eventually they all went under the 200-day, preceding the immense losses.

Remember These Stocks?

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc

Figure 4.2 Bear Stearns

Bear Stearns eventually disappeared after dropping under its 200-day moving average.

Chart created on TradeStation®, the flagship product of TradeStation Technologies, In

Figure 4.3 Washington Mutual

The losses in Washington Mutual could have been avoided simply by not being in it once it dropped under its 200-day moving average.

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 4.4 United Airlines

Flying the friendly skies of United was fine until it plunged under the 200-day MA.

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 4.5 Citigroup

Again, large losses could have been avoided simply by avoiding the stock under the 200-day MA. How many times did you watch analysts on TV tell you the stock was cheap as it dropped lower and lower?

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 4.6 Countrywide

Countrywide – enough said.

Ouch! And I can show you hundreds of examples that look like this. They all looked "cheap" along the way down. And they became cheaper and cheaper and cheaper.

This rule is not fool-proof. Many good stocks represent real value below the 200-day MA. But as a whole, without adding any other filters, it's easier (and less stressful) to make money when buying the market and stocks when the longer term trend is up, not down.

CHAPTER 5

Rule 4 – Use the VIX to Your Advantage . . . Buy the Fear, Sell the Greed

The VIX is one of the best indicators to use to guide you in timing your index and equity trading. We have many studies which support this theory.

First, let's quickly define the VIX. The Chicago Board Options Exchange SPX Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities.

When markets are declining, the VIX usually rises as fear enters the marketplace. Extreme market sell-offs are associated with extremely high VIX readings. These tend to identify very good times to enter on the opposite side of the emotion and go long the market.

On the opposite end of the spectrum is when the market rises and complacency (and usually greed) takes hold. You will see this with lower than average VIX readings and these have historically been the times to lock in gains and even short the market.

Many web sites, books and analysts attempt to use *static* numbers for the VIX. **This is completely incorrect** and I will go into this in more detail later in the book.

The proper way to use the VIX is to look at where it is today relative to its 10-day simple moving average. The higher it is above the 10-day moving average, the greater the likelihood the market is oversold and a rally is near. On the other end of the spectrum, the lower it is below the 10-day moving average, the more the market is overbought and likely to move sideways-to-down in the near future.

If you only follow one market sentiment indicator, it should be *the VIX 5% Rule*.

The VIX 5% Rule is as follows– Be careful buying stocks (and the market) anytime the VIX is 5% below its moving average. Why? **Because since 1995, the S&P 500 has "lost" money on a net basis 5 days following the times the VIX has been 5% below its 10-day MA.** That's right, in spite of the S&P 500 rising over 200% since 1995, it has lost money on average 5 trading days following the VIX closing 5% or more below its 10-day MA.

The VIX 5% Rule is also a powerful indicator on the buy side. **Since 1995, whenever the VIX has been 5% or more above its 10-day MA, the S&P 500 has achieved returns which are better than 2-1 compared to the average weekly returns of all weeks.**

What does this mean for you? It means that the edge lies in buying the market and stocks when the VIX is at least 5% above its 10-day MA, and to lock in gains (and also not buy) when the VIX is 5% or more below its

10-day MA. When fear is great and the VIX is high, we want to be buying. When greed is prevalent and the VIX is low, we want to be locking in our gains and/or shorting the market.

We'll go deeper into this in the Market Timing chapter.

CHAPTER 6

Rule 5 – Stops Hurt

For many years, I advocated the use of stops in trading. If you look at any of my published work until 2004, you will see the words "use stops" alongside most strategies.

In early 2005, we started running tests with the hope of identifying the optimal stop levels to use. What came back though was completely the "opposite" (there's that word again) of anything we ever imagined. Special thanks goes to Cesar Alvarez, my Director of Research, and David Weilmuenster for bringing this to my attention. We've run literally hundreds of variations of stops tests and they all come to the same conclusion – when it comes to stocks and equity indices – *stops hurt.*

Here's one example (again I could show you literally hundreds of tests we've run which have shown the same type of behavior).

TEST: A stock is above its 200-day moving average and closes at a 10-day low. The exit is a close above its 10-day moving average, or when a stop is hit x% below the entry. Here are the results.

Stop %	# Trades	Avg % Profit/Loss	Avg Bars Held	% of Winners
None	236,237	0.58%	7.74	69.81%
1	394,480	0.19%	2.89	26.89%
3	321,824	0.20%	4.11	47.31%
5	286,991	0.20%	5.01	57.54%
7	268,410	0.22%	5.65	62.72%
10	253,863	0.27%	6.31	66.55%
20	239,605	0.39%	7.26	69.35%
50	236,337	0.56%	7.70	69.81%

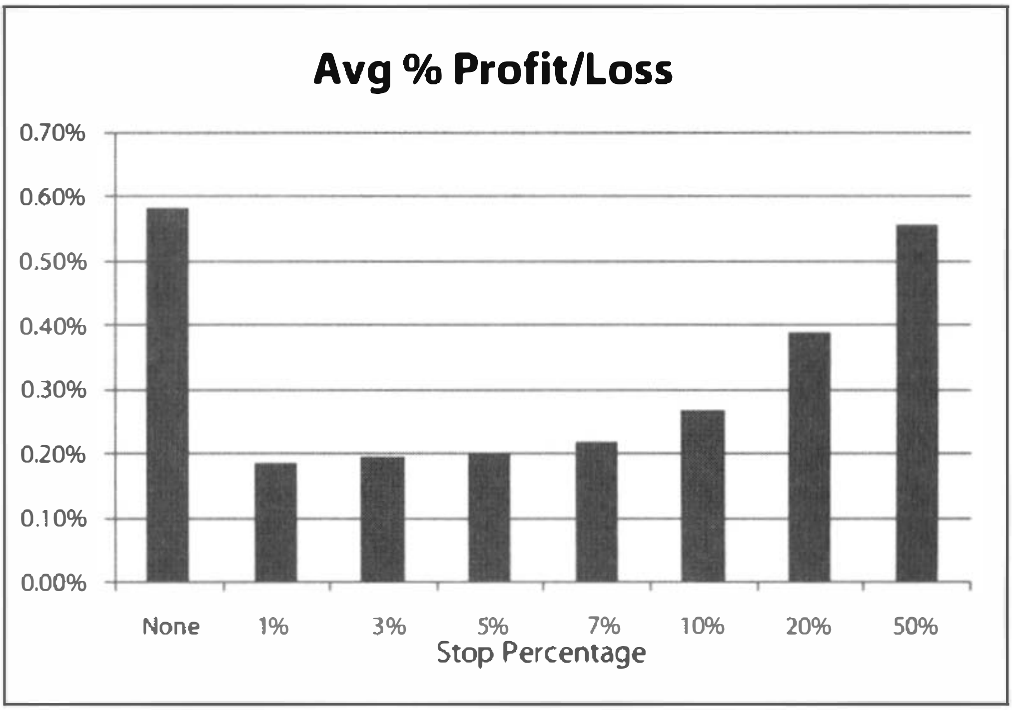

Figure 6.1 Average Percentage Profit/Loss based on Different Stop Levels

As you can see, no matter where the stop is placed, it hurt performance. The tighter the stop, the worse the performance. Amazingly, even stops as far as 50% away (few of us would even consider this a credible stop) hurt the performance! Obviously market makers, specialists and professional traders know that the stops are sitting there and many times they are gunning for them.

And with stocks reverting as they do, you can see from hundreds of thousands of setups, that a stock will drop, the stop gets hit, and then the stock reverses and proceeds to rally. Obviously, this does not happen all the time. But it does happen enough of the time to lessen the returns. I suspect you also see this in your own trading. These test results bear this out.

Stops negatively impacting performance applies to stocks and indices but it does not apply conclusively to options, futures, and forex because we have not run tests on those markets as of this writing. Also, for many people, stops are a psychological comfort zone. If they make you comfortable, use them. Just know that in the long run, they will potentially cost you money.

CHAPTER 7

Rule 6 – It Pays to Hold Positions Overnight

From 1995-2007, many negative events occurred that had severe impacts on the U.S. markets. The United States twice went to war in the Middle East, the World Trade Center was attacked killing just under 3000 people, one of the largest hedge funds in the world, Long Term Capital collapsed leading to a near meltdown of the entire financial system, one of the largest energy firms in the world, Enron, collapsed, the Nasdaq lost over 70% of its value from its peak, and the housing and financial credit crisis wiped out many billions of dollars along the way.

So in 1995, if you knew all this was going to happen over the next 13 years, how would you have traded the market? There were landmines everywhere and many of these landmines occurred while the U.S. markets were closed for the night. What would be the safest thing for you to do assuming you really wanted to be long the market?

1. Would you say, "I'll only buy the market during the day and then get out by the close so I can protect myself"?

2. Or in 1995, would you have decided that you were going to buy the market on the close each day and sell it on the open? You would not have had the opportunity of protecting yourself overnight from any of these events while the market was closed. YOU HAD TO ASSUME 100% OF THE OVERNIGHT RISK WITH NO CHANCE OF GETTING OUT WHILE ALL THIS WAS HAPPENING.

Which path would have been the logical one to take?

As you're beginning to see by now, the obvious answers to questions like these are usually wrong. And the obvious answer – "I'll only hold positions during the day so I can avoid all the overnight risk" has been extremely wrong since 1995. Hard to believe, I know. But it's true. Let's look at the following results:

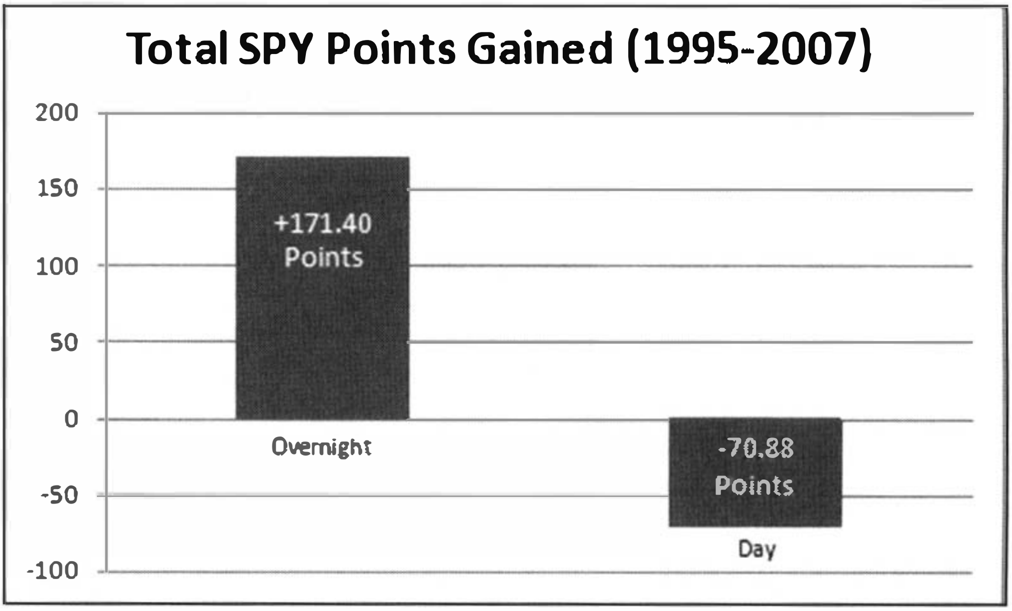

Figure 7.1 Total SPY Points Gained (1995-2007)

Overnight – Buy the SPY on the close and sell on the next day's open.
Day – Buy the SPY on the open and sell on the same day's close.

As you can see, incredibly all the gains and then some in the market have come from assuming the overnight risk by buying on the close and exiting on the open. By buying on the open and selling on the close (*and assuming no overnight risk*), one would have actually **lost money** in the S&P 500 using the SPYs, in spite of the fact that the market tripled in value during this period of time! And the same holds true for the Nasdaq using the QQQQs.

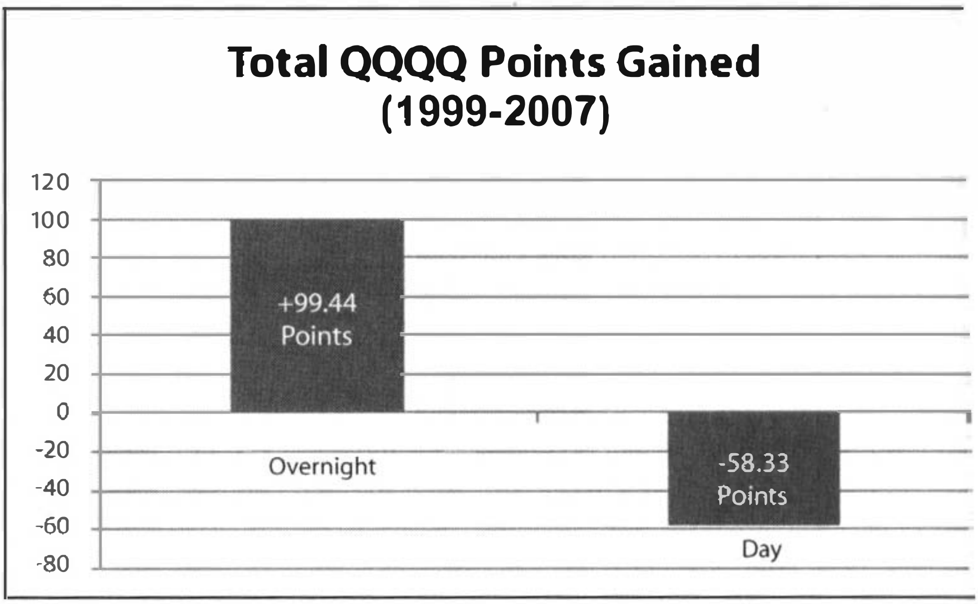

Figure 7.2 Total QQQQ Points Gained (1999-2007)

When I show this to people, they are usually stunned. It flies in the fa of conventional wisdom. But as we've seen from each of these studie successful trading often involves doing *the opposite* of what everyone el is thinking and doing. If it's logical, and everyone is thinking the sam way, it's not likely going to make money. And unless you're trading fc the entertainment, the edges lie in looking at the obvious and many time looking to do the opposite. It helps to have this philosophy... and it fu ther helps to have the statistics to back it up.

Now let's take the next step and start applying this knowledge to trading

CHAPTER 8

Trading with Intra-day Drops – Making Edges Even Bigger

"Buy it from them when they're puking and sell it back to them when they're quacking" – Wealthy Trader (Name Withheld)

As we've seen, buying stocks on pullbacks has been superior to buying stocks on breakouts for short-term trading. We've further seen that buying weakness has been far better than buying strength. In this chapter we'll look at how to further take advantage of buying pullbacks by combining both short-term pullbacks along with intraday pullbacks.

Healthy, Healthy Edges

I strongly believe that markets behave more efficiently as a time period lengthens. This means that over the longer term, market participants are more able to assimilate market information and make rational decisions. But, shorten the time period and this ability becomes lessened. Shorten it even more; meaning to a few hours, minutes or seconds and chaos often breaks loose. **The key here is that the greater the chaos, the greater the opportunity there is for stocks to become mis-priced leading to the potential for gains for those who are fast enough and smart enough to take advantage of this chaos.**

Shoot First and Ask Questions Later

We've all seen stocks go down day after day (sometimes for no other reason than the stock market has dropped), then plunge further on an intraday basis only to quickly recover and rally sharply higher.

Why would a stock drop from 120 to 80 in a week and then within a few hours move 10-15% higher? Did the companies' "fundamentals" miraculously change in a few hours? Did they discover a cure for the common cold or create a revolutionary technology within a few hours period of time?

Of course not! Stocks behave like this for one reason. *Fear and irrational behavior.* The stock drops dramatically and people start looking for some fundamental reason why. And like a self-fulfilling prophesy, selling begets more panic selling until the stock reaches some level, leading to an "extremely oversold condition" before it snaps back (usually intraday). Buyers step in, short sellers scramble to cover and before you know it the stock has moved a healthy amount higher, all without a single "fundamental" event occurring. And as we know, this is also what is known as **reversion to the mean** and pullback trading.

On the opposite end of the spectrum, we see stocks that run up day after day, taking the company's value millions of dollars higher. These stocks are usually the food for the financial news network's hype machine.

> *We ideally want stocks to become even more overbought and even more oversold intra-day.*

"Company XYZ's stock is up another 10% today and traders are telling me that the company's outlook for the next 10-20 years has never been greater" (I struggle to see things 10-20 days ahead yet on television they find all these brilliant people who can forecast events 10-20 years). Whenever I hear this my first instinct is often "I need to get into this stock, (many people have this same instinct— it's known as *blind greed*)."

Fortunately, I've learned the hard way (with money) so whenever I have this urge, I do my best to ignore it, and sometimes, though not often enough, I try to do *the opposite* and look to short these stocks.

New Highs, CNBC Party Hats and Victoria Secret Models All in the Same Day. The Result? The End of a 5-Year Bull Market Run.

We can all remember the many times these crazy bubbles have occurred and none better was in the summer of 2007. My Director of Research, Cesar Alvarez and I were invited to lunch at the home of one of our customers. This customer and his business partner run money abroad and they were here in the United States to visit clients. Does the date July 17, 2007 ring a bell to you? It may. Why? It was the first time the Dow crossed 14,000. And as we were sitting in this gentleman's Park Avenue apartment, the people on CNBC literally had party hats on (I'm not kidding). Excitement was everywhere and the excitement was magnified by the

Victoria Secret models CNBC was *coincidently* doing a story on at the same time.

Wow, just think about it; the Dow is making all time highs; 14,000 for the very first time! We were watching history (and the Victoria Secret models at the same time). This was fantastic, right? *Not for us.* **The four of us were mostly in cash having sold into the market strength a few days earlier.** That's right, the market was running like crazy, everyone was making money and we were the only people not invited to the party!

It was painful for a few days. But, as the statistics consistently show, these parties usually end. And this one ended far worse than anyone could have imagined. Shortly thereafter, the credit crisis took a serious toll on the U.S. markets and the Dow lost over 3000 points within a year. Billions of dollars were gone. And so were the CNBC party hats and the Victoria Secret models.

One of the lessons you can learn from this is that whenever you see people on CNBC wearing party hats, you may want to start hitting bids. . . aggressively.

And the next two lessons tie into how we want to trade overbought and oversold conditions. We ideally want stocks to become even more overbought and even more oversold *intra-day*.

On the way up, we want the Victoria Secret models on CNBC jumping up and down in excitement because the market is so, so exciting. And on the way down, we want money managers and investors to be puking it up. I apologize for being so graphic but you only need to ask any successful professional trader when they make the most money and most will tell you it's when others are doing just that- *puking it up.* **Buy the fear, sell the greed.** And as with most trading strategies we trade with, we have statistical evidence to back this up.

Let's look at how stocks react when we wait for them to move to an extreme and then a further extreme intra-day:

The Tests

Test 1 – Buying into Further Strength Intra-Day

We looked at every stock from 1995-2007 that had an average daily volume of at least 250,000 shares over the previous 100 trading days and was trading above $5 a share. Each of these stocks had closed at 10-day highs and was above their 200-day moving average. As you can see below, these stocks on average were higher 50% of the time, five days later with an average edge of .06%. There has been very little edge to these "momentum" stocks.

Test:

1. Stock closes at a 10-period high and is above its 200-day simple moving average (a momentum move in a longer term uptrend).

2. Average volume over the past 100 days is at least 250,000 shares per day.

3. Price is greater than $5 per share.

4. Buy on the close.

5. Exit on the close 5 trading days later.

Results:
Total Trades 1,264,571
Percent Correct 50%
Average Gain per Trade: +.06%

As you can see, there's little edge here. Buying 10-day highs has been, on average, dead money for the next 5 days.

Now let's see what happens if we climb aboard the same stocks as they continue to move higher. What we did was take these stocks and put in a limit, in order to *"buy into further strength."*

Test:
1. Stock closes at a 10-period high and is above its 200-day simple moving average.
2. Average volume over the past 100 days is at least 250,000 shares per day.
3. Price is greater than $5 per share.
4. Buy on a limit order the next day 1% above the previous day's close. We also tested buying 3% higher, 5% higher, 7% higher and 10% higher than the previous day's close.
5. Exit 5 trading days later.

Results buying the next day 1% higher
Total Trades: 597,063
Percent Correct: 49%
Average Gain per Trade: +.02%

Results buying the next day 3% higher

Total Trades: 201,156

Percent Correct: 47%

Average Gain per Trade: (-.18%)

Results buying the next day 5% higher

Total Trades: 87,606

Percent Correct: 45%

Average Gain per Trade: (-.42%)

Results buying the next day 7% higher

Total Trades: 44,131

Percent Correct: 43%

Average Gain per Trade: (-.62%)

Results buying the next day 10% higher

Total Trades: 18,784

Percent Correct: 42%

Average Gain per Trade: (-.90%)

One glaring thing stands out. **The greater the intra-day momentum to the upside, the worse the performance has been over the next five days.**

When buying these strong stocks while they were rising even further during the day has on net basis been a losing proposition. Buying them intra-day 3% higher has seen these stocks lower 53% of the time 5-days later for a -0.18 return. Buying them 5% higher has seen the losses grow to -0.42%. Buying them 7% higher takes the losses to -0.65%. And when stocks close at 10-day highs and then rise another 10% intra-day (imagine the hyperventilating that's going on when the television reporters are discussing these "exciting stocks"), has led to losses of -0.90% per trade. And these stocks have been lower 58% of the time. Great looking stocks- bad looking trades.

Obviously strong stocks that are also moving strongly intra-day are not stocks with positive edges. These are overbought stocks and the majority reverse in price within five days.

Now let's look at the stocks on the opposite end of the spectrum. We'll look at the stocks that are usually accompanied by "concerns" and "heavy selling." Let's look at stocks that closed at 10-day lows and then sold off further on an intraday basis.

Test 2 – Buying into Further Weakness Intra-day

1. Stock closes at a 10-period low and is above its 200-day simple moving average (a pullback within a longer term uptrend).
2. Average volume over the past 100-days is at least 250,000 shares per day.
3. Price is greater than $5 per share.
4. Buy on the close.
5. Exit on the close 5 trading days later.

The Results

Total Trades: 661,570
Percent Correct: 54%
Average Gain Per Trade: +.61%

We clearly have a better head start right away when buying stocks at their 10-day lows versus buying them at their 10-day highs. Now, let's see what happens when we buy these pullbacks further on an intra-day basis.

Results buying on a limit the next day 1% lower
Total Trades: 342,091
Percent Correct: 55%
Average Gain Per Trade: +.62%

Results buying on a limit the next day 3% lower
Total Trades: 134,436
Percent Correct: 57%
Average Gain Per Trade: +1.17%

Results buying on a limit the next day 5% lower
Total Trades: 63,154
Percent Correct: 59%
Average Gain per Trade: +1.97%

Results buying on a limit the next day 7% lower
Total Trades: 33,831
Percent Correct: 62%
Average Gain per Trade: +2.95%

Results buying on a limit the next day 10% lower
Total Trades: 14,939
Percent Correct: 63%
Average Gain per Trade: +4.35%

As you can see, the greater the intra-day sell-off, the better the performance has been over the next five days.

First, the returns buying on 10-day lows have been 10 times greater than 10-day highs (0.61% versus 0.06%). And when we start adding limit orders to these stocks, we start seeing these edges significantly increase.

At 5% limits, we start seeing edges of nearly 2% a trade versus the losses that accompany stocks making highs and running higher. And on the times which these stocks have dropped 10% or more intraday, they've been higher 63% of the time and the average 5-day gain has been a strong 4.33%/trade for five days. Annualize these returns out and you will get an even better idea of how large these edges are.

Let's look at what a stock making a 10-day closing low and has a 10% intra-day drop looks like.

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 8.1 GIGM

Who in their right mind wants to buy a stock like this? And as its plunging intra-day, few of us have seen anyone coming onto television saying "Wow, GIGM looks awesome here!"

That's why stocks like this provide outsized rewards to the smart money (the strong money) that steps in because as the statistics bear out, this type of plunge often leads to moves like this…

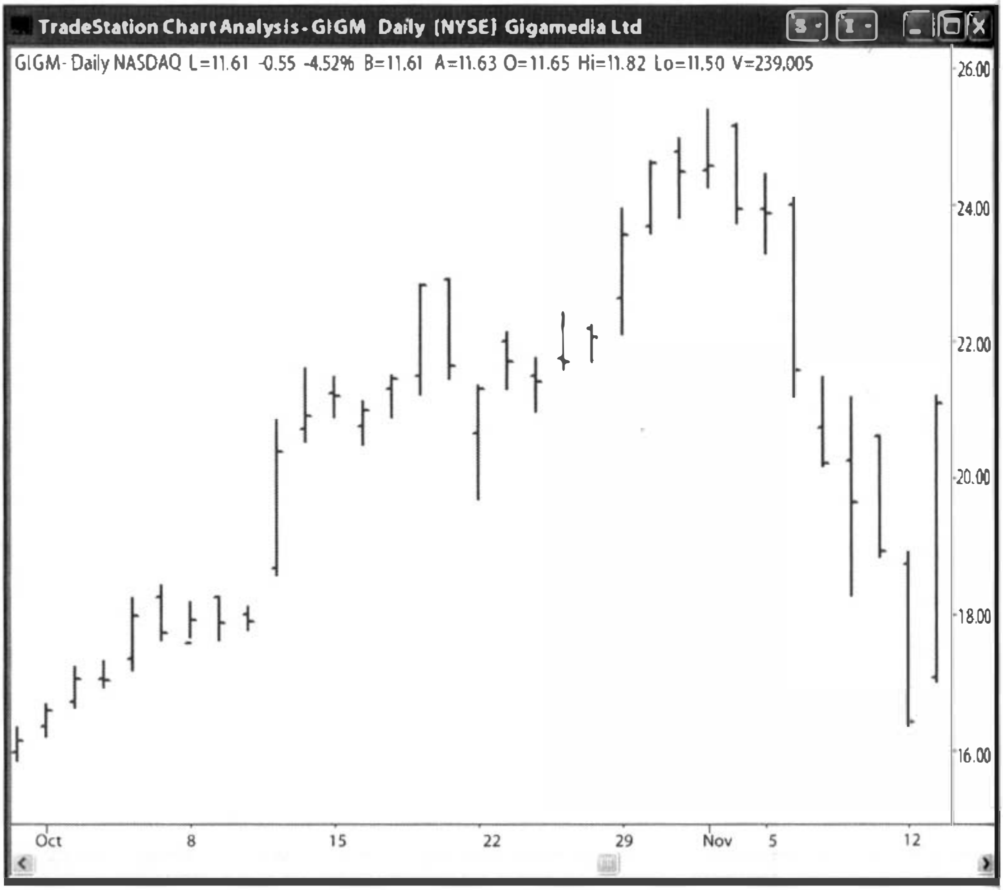

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 8.2 GIGM

Few books or courses teach chart patterns like this (some do, but they teach you to "avoid" or worse to "short" these stocks). The difference in these returns and the fact that its happened so many tens and hundreds of thousands of times will hopefully get you to the point where you understand to avoid the breakout stocks that are so exciting as everyone is chasing them and be on the lookout for buying the stocks that are experiencing large daily declines along with large intra-day sell-offs.

As you are learning, reversion to the mean in short-term trading of stocks has had healthy edges for many years. And these edges are even greater intra-day when the stretch gets pulled far from the mean.

In summary, the goal is to buy low and sell high when it comes to trading (and obviously anything in business). Be patient, be selective, and wait for these healthy edges to present themselves to you in the future. CNBC won't always have Victoria Secret models on their show at every market high. But the excitement from these highs will always be there for you to take advantage of. Just as important, when there are strong pullbacks, especially when these pullbacks occur both daily and intra-day, you want to be there waiting to buy them in order to take advantage of the strong historical short-term upward bias.

CHAPTER 9

The 2-period RSI – The Trader's Holy Grail of Indicators?

I'm now going to introduce to you an oscillator which is the backbone of many of the strategies I'll be sharing with you. The **Relative Strength Index (RSI)**, when applied correctly, is one of the strongest indicators available to equity traders.

There are a number of books and articles written about the RSI, how to use it, and the value it provides in predicting the short-term direction of stock prices. Unfortunately, few, if any, of these claims are backed up by statistical studies. This is very surprising considering how popular the RSI is as an indicator and how many traders rely upon it.

Most traders use the 14-period RSI. But our studies have shown that **statistically, there is no edge using the 14-period RSI**.

However, when you shorten the time frame of the RSI (meaning you go much lower than the 14-period) you start seeing some very impressive results. Our research shows that more robust and consistent results are obtained by using a 2-period RSI and we have built many trading methods that incorporate the 2-period RSI.

First, here's some background on the RSI and how it's calculated.

The Relative Strength Index (RSI) was developed by J. Welles Wilder in the 1970's. It is a very useful and popular momentum oscillator that compares the magnitude of a stock's recent gains to the magnitude of its recent losses.

A simple formula (see below) converts the price action into a number between 0 and 100. The most common use of this indicator is to gauge overbought and oversold conditions. **Put simply, the higher the RSI reading the more overbought the stock is, and the lower the reading the more oversold the stock is.**

$$\boxed{\textbf{RSI} + 100 \quad \frac{100}{1+RS}}$$

RS = Average of x days up closes / Average of x days down closes

As mentioned above, the default/most common setting for RSI is 14-periods. You can change this default setting in most charting packages very easily but if you are unsure how to do this contact your software vendor.

2-Period RSI

As I stated earlier, most information available for the RSI looks at it using a 14-day period. But, we know that at least looking back more than a decade, the better way to use it is by shortening the period, especially to a 2-period RSI. Here's the evidence:

We looked at over eight million trades from January 1, 1995 to December 31, 2007. The table below shows the average percentage gain/loss for all stocks above their 200-day moving average during our test period over a 1-day, 2-day, and 1-week (5-days) period. These numbers represent the benchmark which we use for comparisons.

Table 9.1 Average Percentage Gain/Loss for All Stocks Above their 200-Day Moving Average (1995-2007)

Time Period	Gain/Loss
1-day	0.05%
2-days	0.10%
1-week	0.25%

We then quantified overbought and oversold conditions as measured by the 2-period RSI reading being above 90 (overbought) and below 10 (oversold). In other words we looked at all stocks with a 2-period RSI reading above 90, 95, 98 and 99, which we consider overbought; and all stocks with a 2-period RSI reading below 10, 5, 2 and 1, which we consider oversold. We then compared these results to the benchmarks and here's what we found:

Oversold

> *The lower the RSI, the greater the performance.*

- The average returns of stocks with a 2-period RSI reading below 10 outperformed the benchmark 1-day (+0.07 %), 2-days (+0.21%), and 1-week later (+0.49 %).

- The average returns of stocks with a 2-period RSI reading below 5 also outperformed the benchmark 1-day (+0.13%), 2-days (+0.13%), and 1-week later (+0.62%).

- The average returns of stocks with a 2-period RSI reading below 2 significantly outperformed the benchmark 1-day (+0.21%), 2-days (+0.47%), and 1-week later (+0.79%).

- The average returns of stocks with a 2-period RSI reading below 1 further significantly outperformed the benchmark 1-day (+0.25%), 2-days (+0.56%), and 1-week later (+0.93%).

When looking at these results, it is important to understand that the performance improved each step of the way. The lower the RSI, the greater the performance. The average returns of stocks with a 2-period RSI reading below 2 were greater than those stocks with a 2-period RSI reading below 5, etc.

This means traders should look to begin building strategies around stocks with 2-period RSI readings below 10.

Overbought

We see the opposite performance when we look at the higher RSI readings.

- The average returns of stocks with a 2-period RSI reading above 90 underperformed the benchmark 2-days (0.00), and 1-week later (-0.07).

- The average returns of stocks with a 2-period RSI reading above 95 underperformed the benchmark and were negative 2-days later (-0.03%) and 1-week later (-0.07%).

- The average returns of stocks with a 2-period RSI reading above 98 were negative 1-day (-0.04%), 2-days (-0.14%), and 1-week later (-0.19%).

- The average returns of stocks with a 2-period RSI reading above 99 were negative 1-day (-0.09%), 2-days (-0.23%), and 1-week later (-0. 29%).

When looking at these results, it is important to understand that the performance deteriorated each step of the way. The higher the RSI, the worse the performance. The average returns of stocks with a 2-period RSI reading above 98 were significantly lower than those stocks with a 2-period RSI reading above 95, etc.

This means stocks with a 2-period RSI reading above 90 should likely be avoided over the short-term. Aggressive traders may look to build short selling strategies around these stocks.

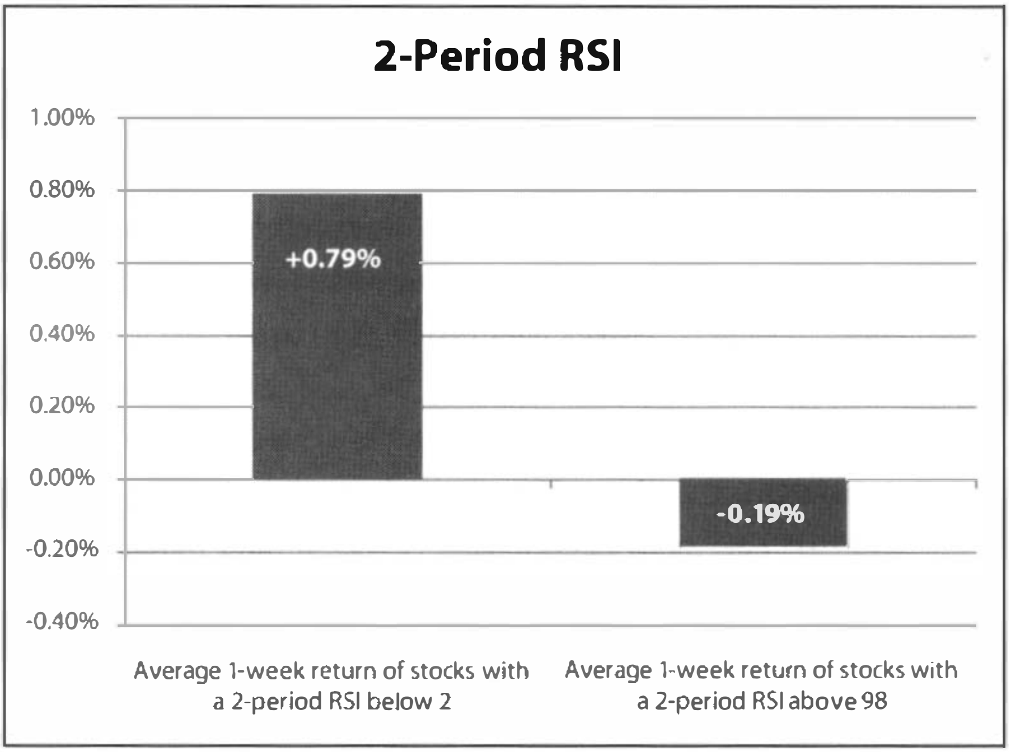

Figure 9.1 Performance of Stocks Based on 2-Period RSI

As you can see, on average, stocks with a 2-period RSI below 2 show a positive return over the next week (+0.79%). Also shown is that, on average, stocks with a 2-period RSI above 98 have shown a negative return over the next week. And, these results can be improved even further by buying the low RSI stocks the next day on further pullbacks (as we saw in the last chapter) and by combining the 2-period RSI with PowerRatings which you can find on the TradingMarkets website.

Examples

Chart 9.2 (below) is an example of a stock with a 2-period RSI reading below 2:

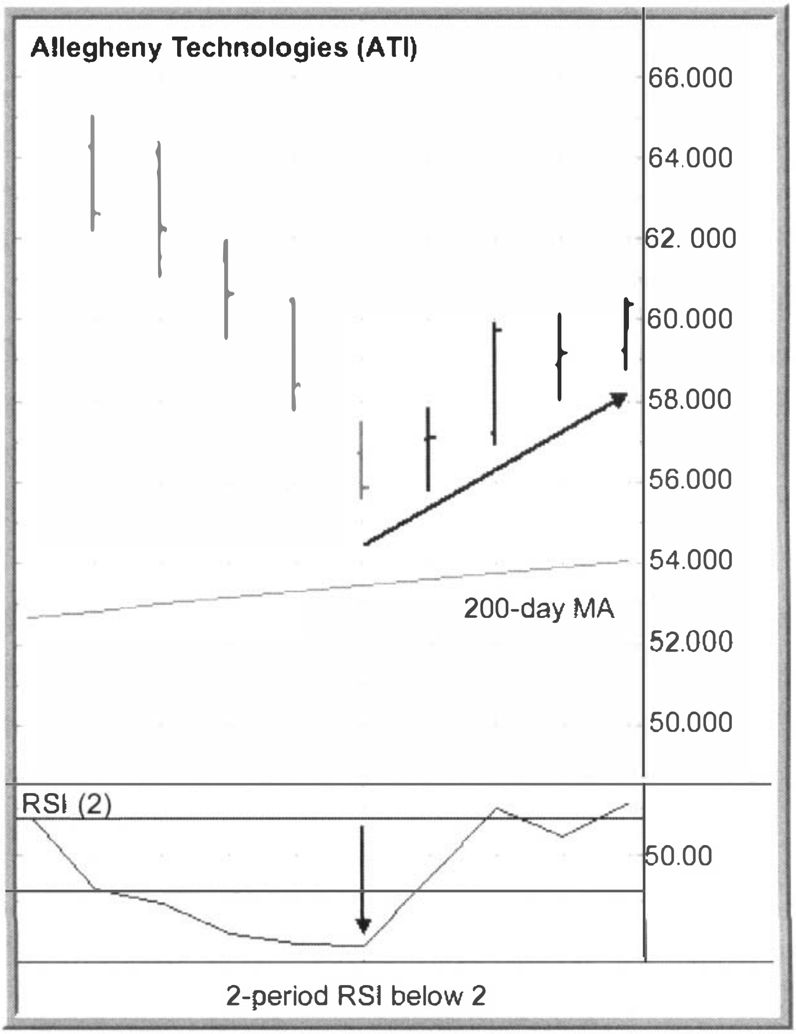

Figure 9.2 Allegheny Technologies

Chart 9.3 (below) is an example of a stock with a 2-period RSI reading above 98:

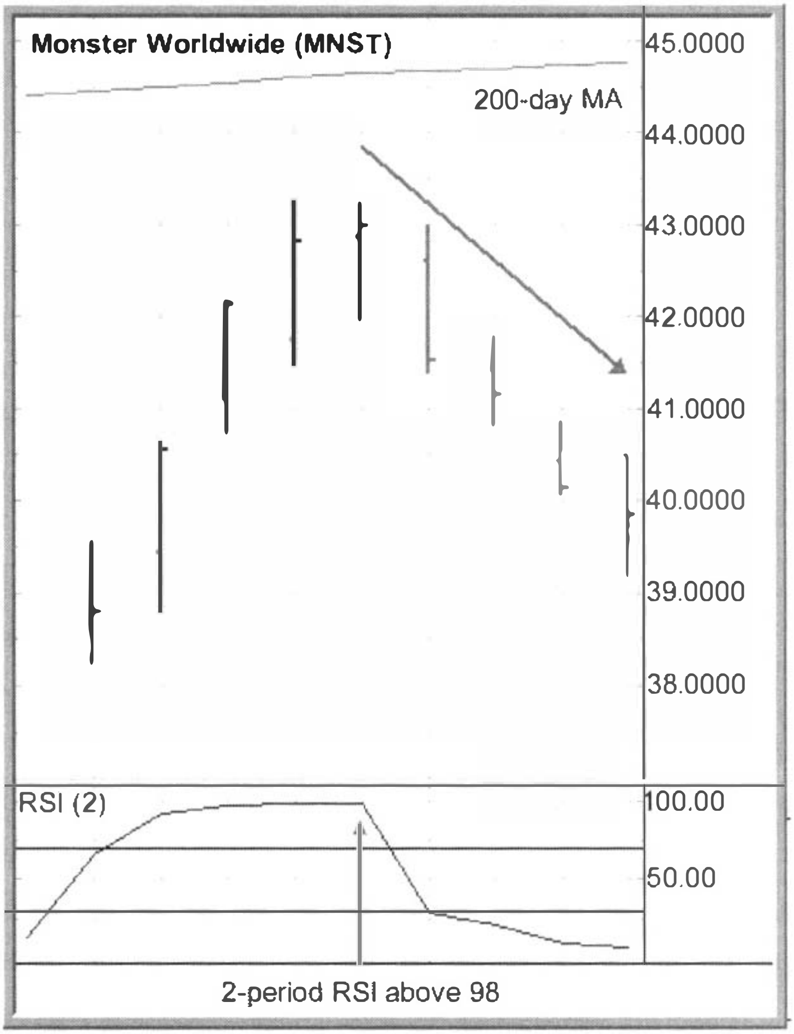

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 9.3 Monster Worldwide

The Relative Strength Index is an excellent indicator, *when used correctly*. I say this because our research shows that it is possible to catch short-term moves in stocks using the 2-period RSI, but it also shows that when using the *"traditional"* 14-period RSI there is little to no value to this indicator. This statement cuts to the very core of what proper trading represents – basing your trading decisions on quantitative research. This philosophy allows you to objectively assess whether a trade offers a good risk/reward opportunity and what might happen in the future.

TradingMarkets provides a daily list of stocks that have a 2-period RSI below 2 (bullish) and another daily list of stocks that have a 2-period RSI above 98 (bearish). You can find a list of these stocks everyday on the TradingMarkets.com website.

Now, let's look at two strategies you can apply using the 2-period RSI. Here is an example of using the RSI results and applying them systematically to the S&P 500 Index (for SPY and e-mini traders).

Strategy

The 2-period RSI under 5 on the S&P 500

This strategy is just one example of what you can do with the 2-period RSI. Just four rules, and yet it's correctly predicted the short-term direction of the S&P 500 83.6% of the time.

1. The S&P 500 Index is above its 200-day moving average.
2. The 2-period RSI of the S&P 500 Index closes below 5.
3. Buy the S&P on the close.
4. Exit when the S&P closes above its 5-period moving average.

The Results From 1995-2007

Number of Signals: 49

Percent Correct: 83.6%

Total S&P Points Made: 522.92

Average Hold: Three Trading Days

Here are three consecutive set-ups from 2007.

Market	Entry Trade Date	Entry Price	Exit Date	Exit Price	% Gain	Total Points Made
SP-500	Long 6/7/07	1490.72	6/13/07	1515.67	1.67%	24.95
SP-500	Long 7/27/07	1458.95	8/2/07	1472.2	0.91%	13.25
SP-500	Long 10/19/07	1500.63	10/25/07	1514.4	0.92%	13.77

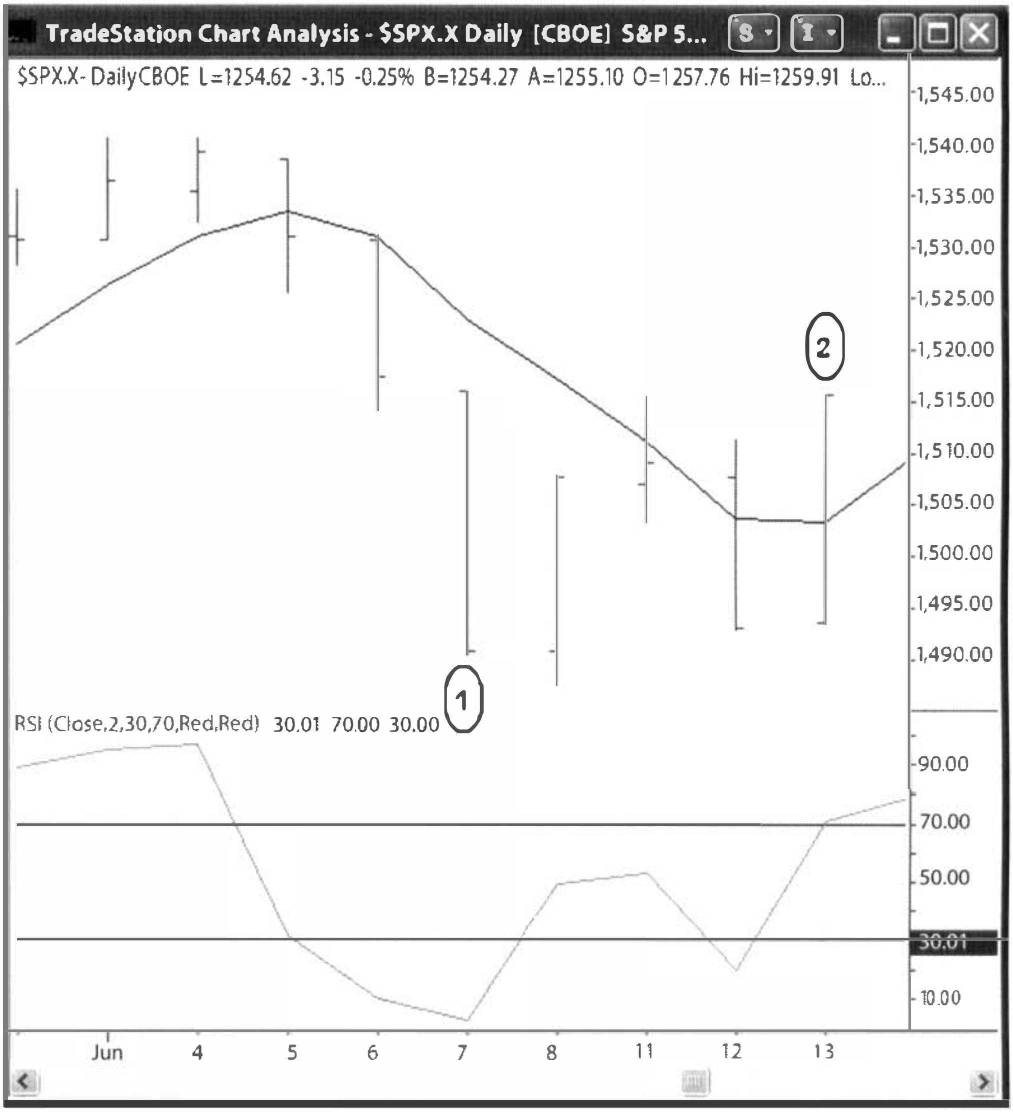

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 9.4 SPX.X

1. Strong sell-off in the market and the 2-period RSI drops under 5. Buy at 1490.72.

2. A close above the 5-period MA and gains are locked into nearly 25 S&P points higher.

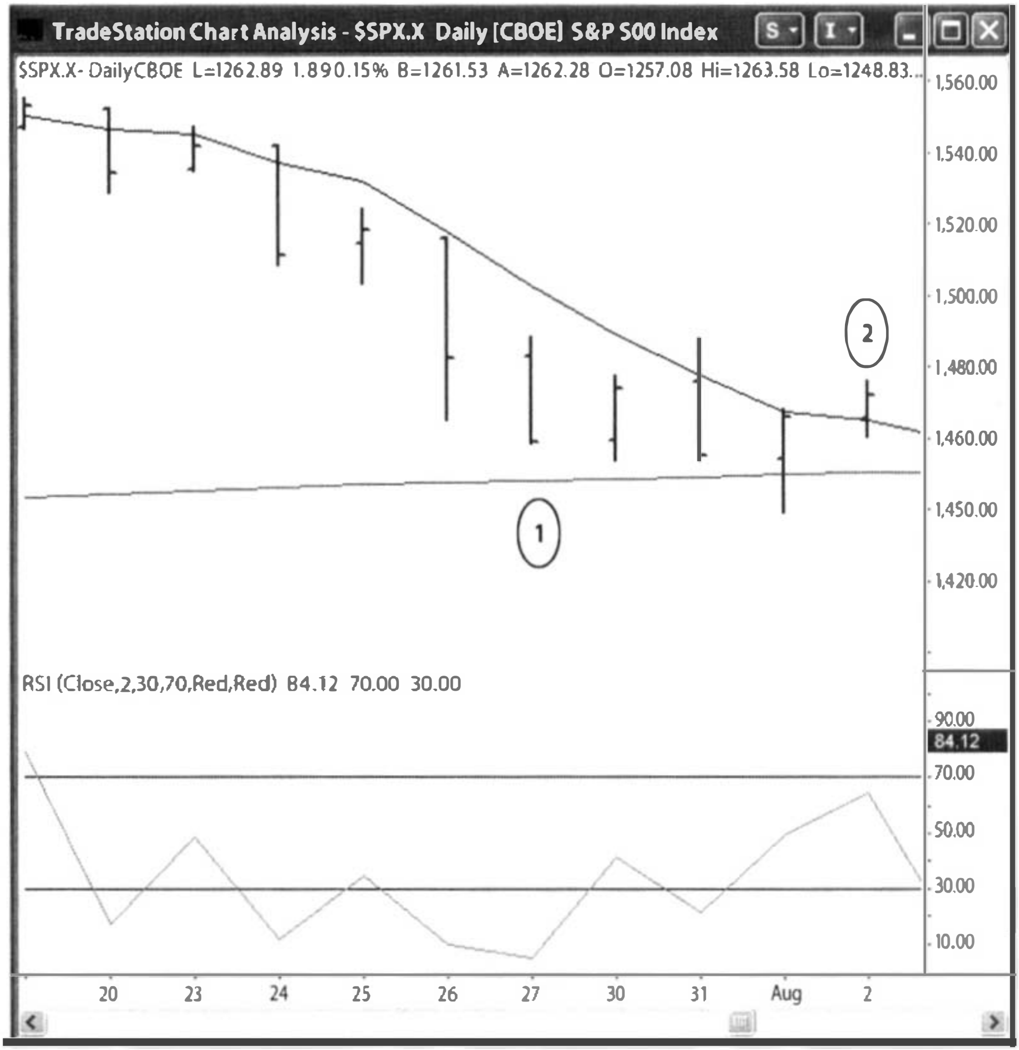

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 9.5 SPX.X

1. The S&Ps pullback over 80 points and the 2-period RSI drops below 5 triggering a buy signal.

2. Lock in the 13.25-point profit above the 5-period MA.

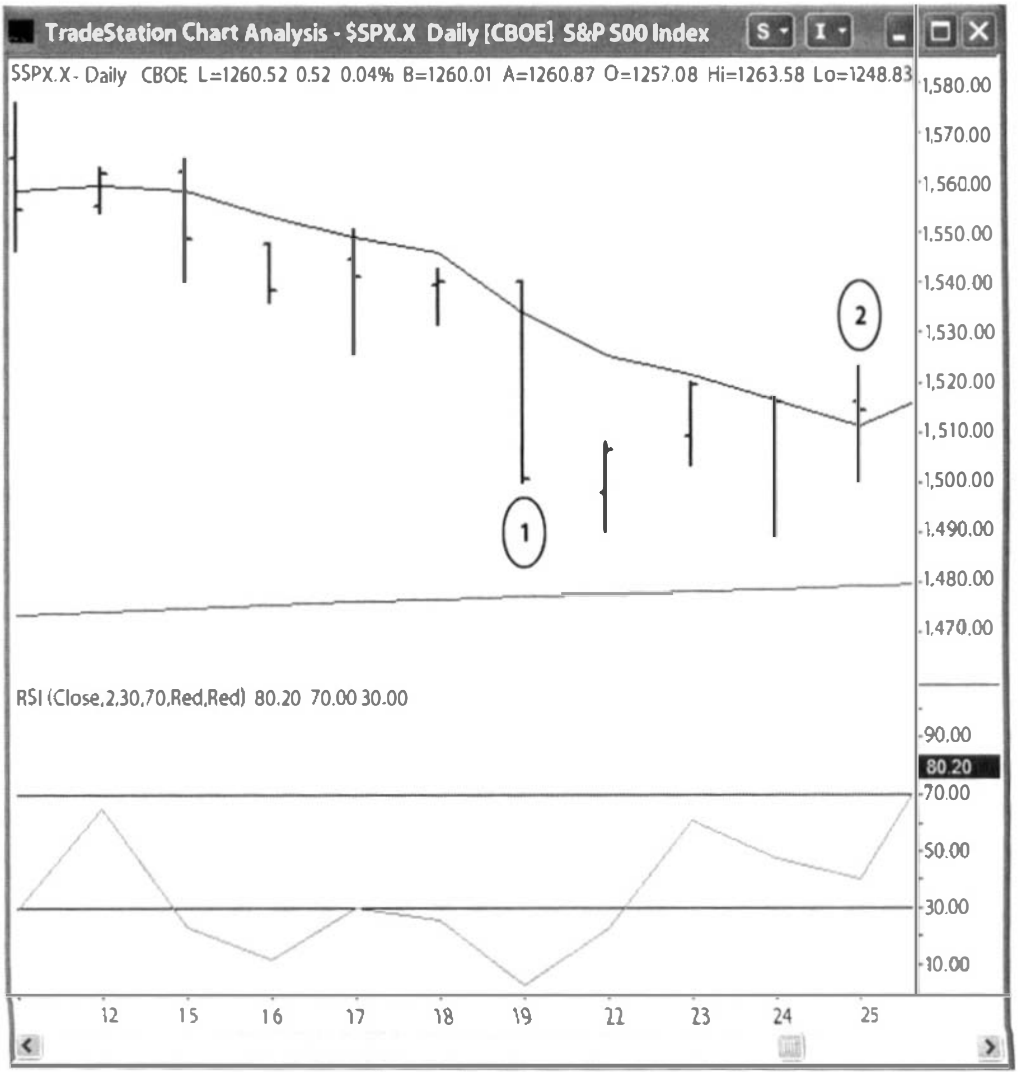

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 9.6 SPX.X

1. A 60-point sell-off in the S&Ps in 7 days triggering an RSI reading under 5 signal. Buy.

2. Lock in the gains four days later on the rally higher.

The S&P is just one vehicle this strategy derived from the 2-period RSI can be applied to. Stocks, ETFs, and other market indices all show edges using these few simple rules. The key concept to take from this is that there is a healthy edge with the 2-period RSI and you may want to seriously consider making it one of the cornerstones of your trading.

Let's now look at a more advanced strategy to apply the 2-period RSI.

The Cumulative RSIs Strategy

We now know there is a healthy edge to being long extremely low RSI stocks versus extremely high RSI stocks and many strategies can come from this information. What I'd like to do now is share with you one strategy which has never before been publicly published. The strategy was taught in-depth only to members of our Swing Trading College and I'd like to share it with you now.

The strategy you will learn here is called ***Cumulative RSIs***. Unless you have attended our Swing Trading College (or are reading this book long after it was first published), this strategy will likely be new to you.

What are Cumulative RSIs? They're a running day total of 2-Period RSI readings. This means that by adding up the past number of days of 2-period RSI readings, you get its cumulative reading.

When we first looked at this concept, we were pleasantly surprised by the results. As we went deeper, we saw the results to be even more robust than we first imagined. We saw positive healthy returns in U.S. indices, in ETFs, on world indices, in individual U.S. stocks, and in international stocks going back more than a decade's period of time.

We further saw this robustness using multiple cumulative RSI readings, and using multiple exits. In my opinion Cumulative RSIs are special and you can take this research, trade it and apply it in many parts of your trading.

Rules for the Cumulative RSI Strategy

1. The security being used is above its 200-day moving average.
2. Use a 2-Period RSI.
3. Take the past X days of the 2-period RSI and add them up.
4. Buy if the Cumulative RSI is below Y (I'll share with you results using different numbers for X and Y).
5. Exit when the 2-period RSI closes above 65 (you can also exit using any of the exit strategies taught later in the Exits chapter).

Let's now look at some results and then a few chart examples.

We ran the test results on the SPYs from the inception of their trading in mid-January 1993 through December 31, 2007 (a period of almost 15 years). Adding up the RSIs for two days (meaning X=2 in the rules above) and stating that the Cumulative RSI had to be under 35 (Y = 35 in the rules above) gave us the following results:

Total Signals: 50
Percent of Signals Correct: 88%
Total SPY Points Made: 65.53 Points
Average Gain Per Trade: 1.26%
Average Hold Per Trade: 3.7 trading days

Now let's look at the results if we loosen the parameters a bit in order to get more trades. Whenever this happens, the results usually drop (sometimes significantly) so this is where you start seeing how robust a methodology is.

What we did was we kept X at 2, meaning we used a 2-day cumulative RSI total. But we changed Y to 50, meaning the 2-day total only had to add up to 50. Here are the results.

Total Signals: 105
Percent of Signals Correct: 85.47%
Total SPY Points Made: 105.95
Average Gain Per Trade: 1.05%
Average Hold Per Trade: 3.57 trading days

By loosening the parameters a bit, we added more trades and more SPY points. **In fact, it picked up approximately all the SPY gains made in 15 years while only being in the market less than 20% of the time. And it was correct 85.47% of the time.**

What's interesting is that when we ran these tests on other U.S. indices, a basket of other U.S. ETFs, and over a dozen world indices (some going back to the 80's), we saw consistently strong results throughout. On average the majority of the indices and ETFs we looked at were correct better than 75% of the time, using a 2-day 2-period RSI with cumulative RSI readings under 40 as the entry level.

Let's now look at the charts of a few Cumulative RSI set-ups.

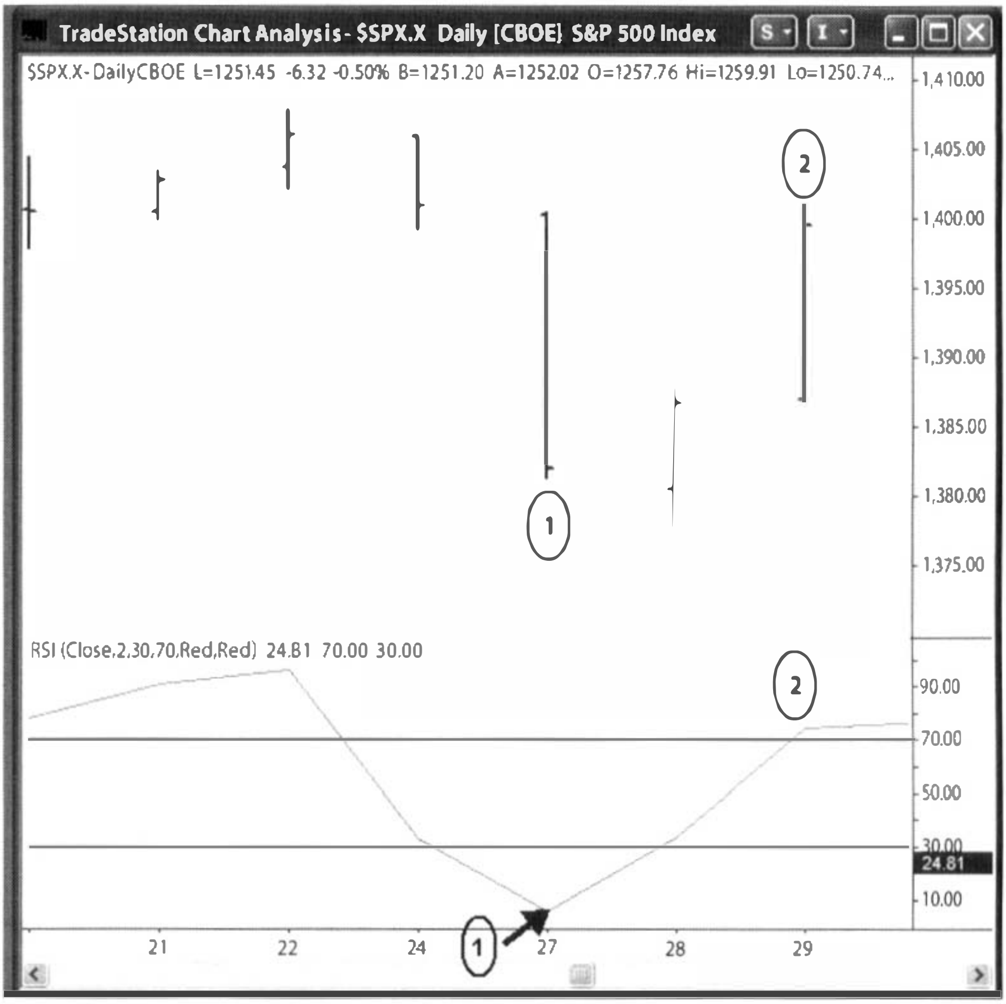

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 9.7 SPX.X

1. The past two days' RSI totals under 50. You can also see the panic.
2. The RSI closes above 65 captures the rally in the SPY in two trading days.

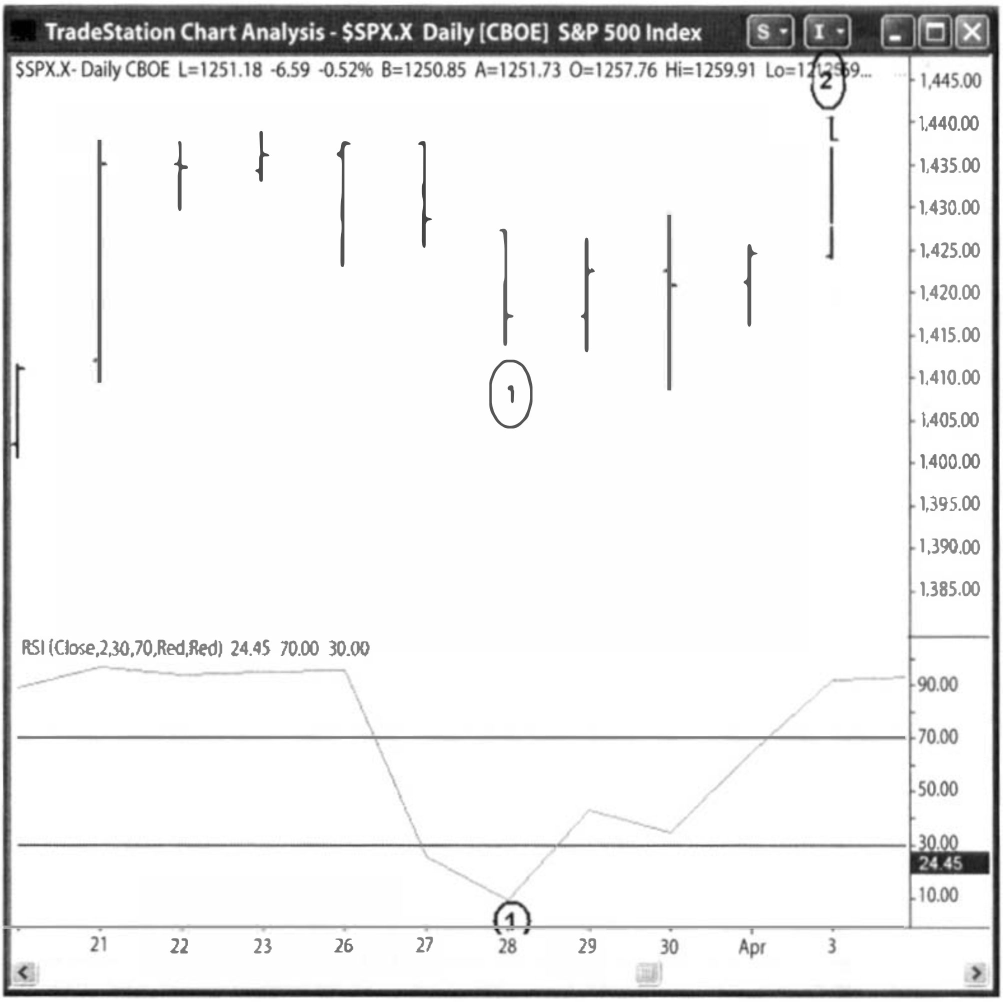

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 9.8 SPX.X

1. The 2-Day Cumulative RSI on the SPYs is under 50 triggering a buy signal.
2. The market rallies over 20 points higher and we exit.

Cumulative RSI Strategy for Stocks

Stocks have an added risk versus indices and ETFs. Indices and ETFs do not go to zero. Stocks can and sometimes do. Therefore in order to offset the corporate risk inherent in equities, you want to use lower cumulative RSI readings.

We went back to 1995 (our standard starting date for US equities) and looked at all stocks which had Cumulative RSI readings below 10 and average daily volume of 250,000 shares a day and a stock price above $5 per share. There were 77,068 trades, of which 69% of the trades were profitable exiting above a 2-period RSI of 65. The average gain on these stocks was nearly four times greater than the gains for all stocks for the same holding period.

SUMMARY

Is the 2-Period RSI the Holy Grail of Oscillators?

In my opinion, it's pretty close. It does a solid job of identifying markets that are extremely overbought and oversold on a short-term basis. From there it can be used many ways including the ways we just looked at and the many other combinations of ways that I mentioned in this chapter.

We all know that no trading indicator is perfect but the 2-period RSI does a better job of identifying market swings than any other indicator we have tested or use for ourselves. I strongly recommend you consider using it and applying it to any equity, ETF, and indices trading that you do.

CHAPTER 10

Double 7's Strategy

"It's 30-minutes away… I'll be there in 10."

– Winston Wolfe
Pulp Fiction

Can a strategy with three rules really have correctly predicted the markets' direction over 80% of the time since 1995?

In *How Markets Really Work* and throughout this book, I showed you how when the markets pullback, they have outperformed the times that the market has broken out. This has been further tested out by us on a universe of many thousands of stocks, encompassing hundreds of thousands of simulated trades going back more than 13 years.

We can demonstrate this many different ways and in this chapter, I'm going to share with you a simple strategy using this concept. And the best thing about this strategy, known as the **Double 7's Strategy**, is that it only has three rules. Here they are.

1. The SPY is above its 200-day moving average
2. If the SPY closes at a 7-day low, buy.
3. If the SPY closes at a 7-day high, sell your long position.

You're probably thinking to yourself *that's it*?

We did the same. But here are the results since the inception of the SPYs in 1993.

Symbol	Inception Date	# Trades	Avg % p/l	% Correct	Net Points
SPY	1/29/93	153	0.85%	80.4%	122.36

The Double 7's Strategy picked up 100% of the gains and then some in the SPY since 1993 being in the market less than 25% of the time. Here is what the set up looks like.

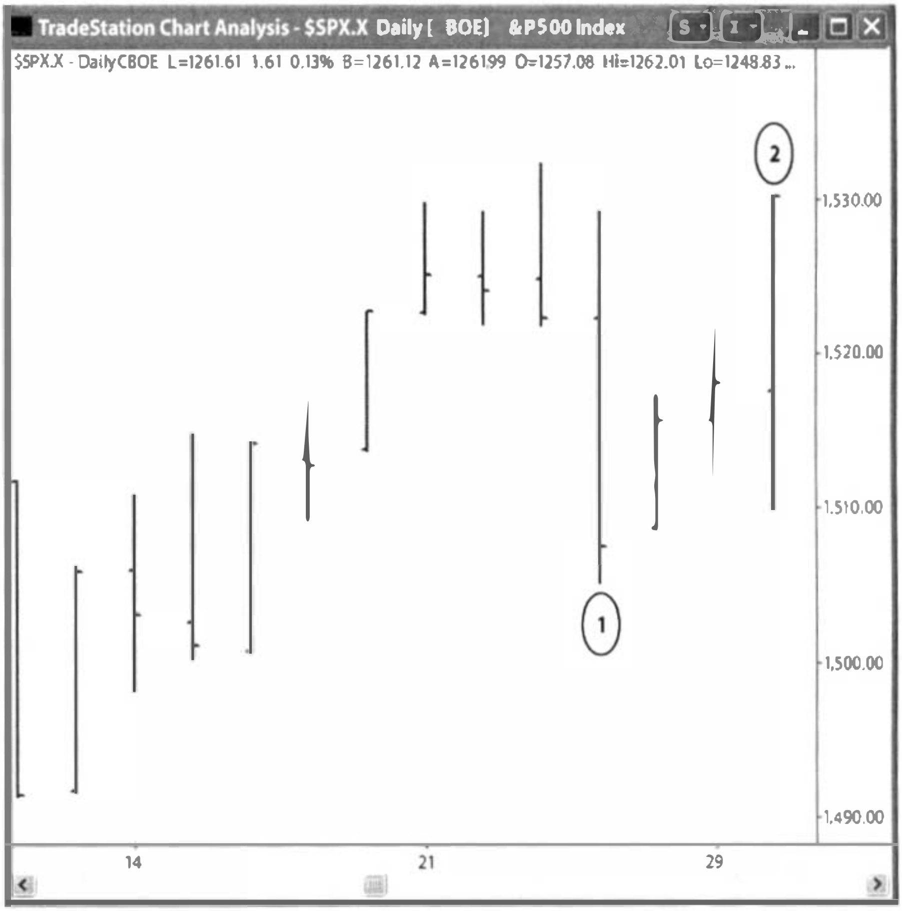

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 10.1 SPX.X

1. 7-day closing low – buy.
2. 7-day closing high – sell.

Going further:

This same concept holds up in the Nasdaq too. Here are the results.

Symbol	Inception Date	# Trades	Avg % p/l	% Correct	Net Points
QQQQ	03/10/99	68	0.93%	79.4%	31.30

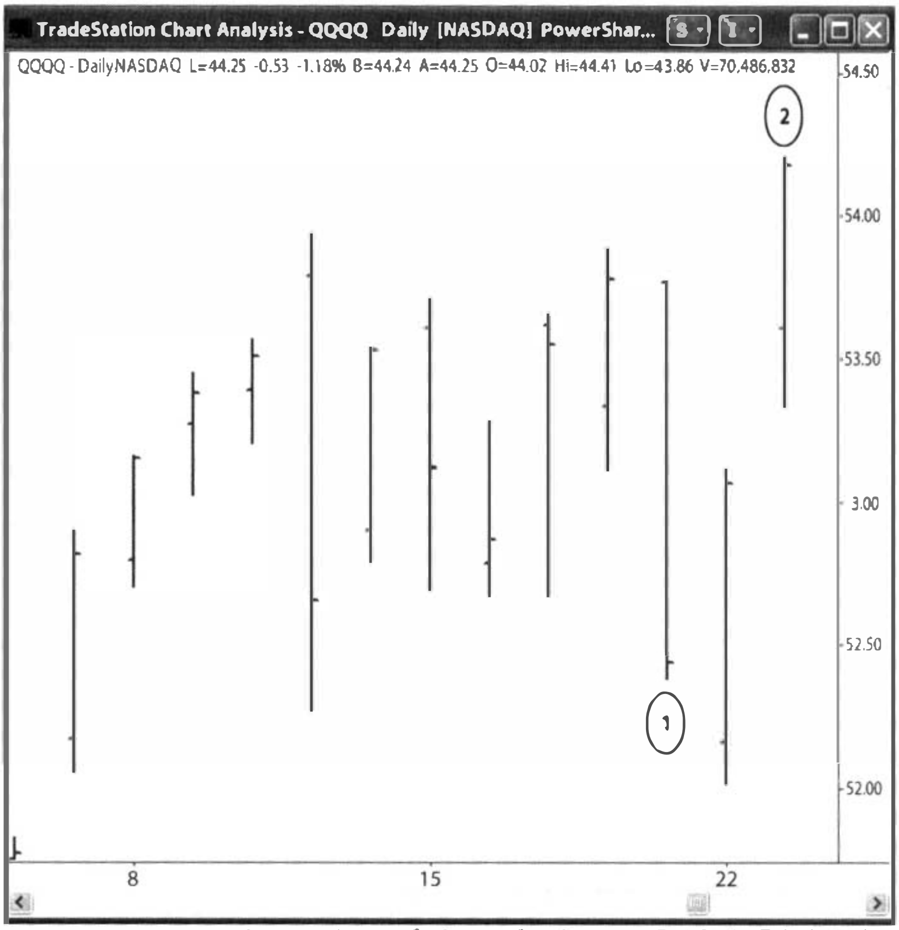

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Figure 10.2 QQQQ

1. 7-day closing low – buy.

2. 7-day closing high – sell.

And we can take the Double 7's Strategy to other countries too. Here are the results for China using the FXIs since their inception of trading through the end of 2007.

China (FXI)

Symbol	Inception Date	# Trades	Avg % p/l	% Correct	Net Points
FXI	10/08/04	26	1.41%	76.9%	33.20

And Brazil using the EWZs since their inception of trading through the end of 2007.

Brazil (EWZ)

Symbol	Inception Date	# Trades	Avg % p/l	% Correct	Net Points
EWZ	7/14/00	63	1.82%	81.0%	52.75

And you can apply this same concept to Double 5's, Double 6's, Double 8's, Double 9's and Double 10's. They all hold up well in the testing. They also hold up in the majority of the equity ETFs as of 2008.

I get real, real concerned when I see trading strategies with too many rules (you should too).

Three hundred years ago the Spanish philosopher Baltazar Gracian said "If brief, good. If briefer, better." When it comes to trading strategies (and many other things in life) this wisdom is exactly correct.

You can find a daily list of set-ups for the Double 7's Strategy on my Daily Battle Plan Trading Service which is also available on TradingMarkets.com.

CHAPTER 11

The End of the Month Strategy

Do stocks show an upward bias at the end of the month? It looks like they do.

This behavior was first brought to my attention in 1999 by Kevin Haggerty who I mentioned earlier in the book. Kevin was the head of trading for Fidelity Capital Markets for seven years and when he says something about market behavior, I've learned to listen.

You may be aware of the "end-of-the month" concept whereby money managers supposedly pile into the stocks at the end of the month in anticipation of 401k and retirement savings money coming in. Well, we decided to take a look at whether there was any statistical evidence to support this concept, and if there was, how we could potentially profit from this behavior.

We looked at over eight million trades from January 1995 through December 2007. We then broke these trades down to the day of the month, meaning we asked "if we bought every stock today, how would we have done over the next five trading days?" We did this for every day of the month, for every stock that was trading in a longer-term uptrend, meaning above its 200-day moving average that had an average daily volume of at least 250,000 shares.

Here are some notes of our findings:
The average gain for all days (meaning you randomly bought a stock and held it for five days) when it was above its 200-day MA from January 1995-December 2007 was 0.25%. I've bolded the days that did double this return.

Table 1: Baseline Days of the Month

Day of Month	Trades	Gain/Loss	% Higher
1	**160,924**	**0.57%**	**52.67%**
2	171,195	0.15%	49.92%
3	174,833	-0.04%	48.44%
4	154,388	-0.28%	44.87%
5	175,793	-0.31%	47.09%
6	176,675	-0.26%	46.55%
7	177,402	-0.29%	47.82%
8	179,729	-0.18%	48.98%
9	176,334	0.34%	53.54%
10	175,869	0.19%	53.18%
11	170,399	0.21%	51.47%
12	178,502	0.04%	48.71%
13	176,973	0.15%	51.20%
14	170,529	0.25%	51.03%
15	173,155	0.27%	50.14%

16	173,030	0.08%	48.65%
17	171,703	-0.08%	47.89%
18	168,970	0.14%	49.67%
19	168,807	0.21%	51.48%
20	175,043	0.04%	49.74%
21	169,534	0.02%	49.20%
22	174,451	0.36%	52.17%
23	173,305	0.45%	53.61%
24	**169,917**	**0.84%**	**57.94%**
25	**150,251**	**1.23%**	**61.03%**
26	**171,468**	**0.81%**	**57.32%**
27	**170,899**	**0.79%**	**57.56%**
28	**168,296**	**0.69%**	**56.52%**
29	**159,963**	**0.69%**	**56.83%**
30	**159,260**	**0.79%**	**56.05%**
31	102,070	0.18%	49.51%
Grand Totals	**5,219,667**	**0.25%**	**51.60%**

Look at what happens as we start approaching month's-end. The average gains rise significantly. On the 23rd day of the month, the average gain for these stocks nearly double. On the 24th, it more than triples. On the 25th it nearly quintuples! And this type of behavior holds through for an additional 5 days.

Let's go further by looking at what happens at the early part of the next month. In spite of a strong upward move in stock prices over the past 13 years, stocks on average have *lost money* for the six consecutive days from the 3rd through the 8th. Money spent is money spent, and it looks like the fund managers spent their money near the end of the previous month.

And now let's go even further and look at something which is even more eye-opening. Let's look at what happens after a stock drops the previous day. The returns for those stocks increase even further near month's-end.

Table 2: One or More Down Closes

Day of Month	Trades	Gain/Loss	% Winners
1	**62,001**	**0.58%**	**53.39%**
2	71,315	-0.05%	49.14%
3	80,794	-0.06%	49.08%
4	63,951	-0.22%	45.45%
5	81,091	-0.31%	47.38%
6	77,488	-0.27%	46.31%
7	88,388	-0.19%	49.16%
8	83,481	-0.21%	48.33%
9	84,447	0.41%	54.86%
10	85,684	0.02%	52.94%
11	77,818	0.25%	52.53%
12	78,258	0.17%	50.11%
13	82,581	0.06%	50.91%
14	74,658	0.26%	51.09%
15	80,094	0.38%	51.04%
16	72,976	0.19%	49.92%
17	79,395	0.04%	49.43%
18	77,322	0.20%	50.82%
19	77,293	0.40%	53.35%
20	83,511	0.22%	51.13%
21	75,545	0.13%	50.87%
22	**81,961**	**0.52%**	**54.10%**

23	81,535	0.47%	53.75%
24	**80,172**	**0.89%**	**58.34%**
25	**63,594**	**1.42%**	**62.77%**
26	**73,753**	**0.99%**	**58.76%**
27	**82,302**	**0.94%**	**58.78%**
28	**73,175**	**0.82%**	**58.08%**
29	**64,431**	**0.55%**	**56.13%**
30	**69,561**	**1.18%**	**59.52%**
31	**39,607**	**0.68%**	**52.23%**
Grand Totals	2,348,182	0.32%	52.49%

And if the stock has dropped two days in a row, the gains become extreme.

On the 25th and the 26th, the stocks which have dropped two days in a row have risen on average more than 1.2% higher over the next five trading days. If you annualize that out, it's pretty obvious one can make a nice living with returns like these.

Table 3: Two or More Down Closes

Day of Month	Trades	Gain/Loss	% Winners
1	**22,509**	**0.93%**	**55.89%**
2	27,286	0.23%	51.90%
3	33,791	-0.25%	47.55%
4	30,109	-0.09%	46.72%
5	35,828	-0.08%	49.24%
6	34,876	-0.37%	45.40%
7	38,218	0.06%	51.48%
8	38,931	-0.01%	50.62%

9	36,970	0.40%	54.16%
10	42,170	0.29%	54.55%
11	37,455	0.09%	51.73%
12	36,221	0.29%	51.43%
13	36,352	0.20%	51.75%
14	35,354	0.33%	51.49%
15	**34,507**	**0.58%**	**52.40%**
16	32,041	0.34%	50.51%
17	33,764	0.28%	50.79%
18	**35,202**	**0.50%**	**54.07%**
19	**35,334**	**0.57%**	**54.84%**
20	35,554	0.36%	52.10%
21	34,163	0.33%	51.65%
22	**37,596**	**0.77%**	**55.58%**
23	**37,166**	**0.81%**	**56.55%**
24	**36,939**	**1.09%**	**59.65%**
25	**31,195**	**1.53%**	**63.53%**
26	**32,375**	**1.22%**	**60.65%**
27	**35,606**	**1.11%**	**59.63%**
28	**33,180**	**0.97%**	**59.00%**
29	**27,799**	**0.63%**	**56.66%**
30	**28,042**	**1.24%**	**59.16%**
31	**15,973**	**1.16%**	**54.11%**
Grand Totals	**1,042,506**	0.47%	53.62%

We see that over the past 13 years stocks have been much stronger near months-end than they have been any other time of the month. And, stocks which have dropped a day or two near the end of the month have out-performed the averages even more. The fund managers like to buy near month's end, and it looks like they especially like to buy stocks as cheap as possible near month's end.

The use of this research can go much further. The size of the drop, ETFs, short selling, pairs trading, further intraday drops, and combining TradingMarkets' PowerRatings with the day of the month are all there for a deeper look for you to use.

CHAPTER 12

5 Strategies to Time the Market

In 1995, I published for the first time one of my S&P market timing strategies. In the spirit of being "ahead of the curve" the strategy I decided to publish applied the VIX to timing the S&P. Today, the VIX is widely cited. But in 1995, very few people knew about it and as far as I could tell, Bloomberg was the only place one could find VIX data (remember, this was before the Internet became mainstream). I could have taken many strategies to show at that time. But again, I wanted to show everyone something that was new. The good news was that I was one of the first (and possibly *the* first) trader to teach people how to apply the VIX to time the market. The bad news was that I was dead wrong with my research.

Fortunately I was quick to see why I was wrong. At the time, I originally viewed the VIX as a *static indicator*. Buy the market when the VIX goes above 13; sell when it gets under 9.

Lesson Number One Learned – *The VIX is not a static indicator.* Incredibly, 13 years later authors and publications (including the Wall Street Journal in July 2008) are still writing articles applying the VIX on a static basis.

As the VIX rose in the 90's, traders were creating rules that were adjusting these static numbers. Possibly one of the bigger mistakes I saw was when a well known trader and fund manager published his study that showed that whenever the VIX hit 30, buy the market. And short the market when the VIX got below 20. This strategy shot its way throughout the Internet because it was correct for a few years nearly 100% of time. Unfortunately, the sample size was very small but no one paid much attention to that. It was close to perfect until the VIX went under 20 in 2003 and stayed under it for approximately 5 years. One would have gone short the S&Ps around 1000 and been tortured day after day for the next 500 S&P points ($25,000 loss per E-mini position). Thank you, but no thank you.

Within a year after looking at the VIX as I was originally doing, I realized that the VIX is a dynamic indicator. In fact, most if not all volatility indicators are dynamic indicators. What does this mean? It means that volatility is always adjusting. And if volatility is always adjusting, so should your volatility indicators (a lesson that in hindsight many fund managers and bank trading desks wish they applied in the summer of 2007).

Let's now jump ahead and look at two VIX market timing strategies along with three other strategies you can apply to your trading. Each of these studies are from 1995-2007 and give market timing signals that have been correct on the long side, on average, approximately 4 out of every 5 times signaled.

1. VIX Stretches Strategy

The first strategy we'll look at is VIX Stretches. As we saw with *the VIX 5% Rule*, markets tend to behave differently when the VIX is above its 10-period moving average versus when it's below. When it's above, it usually coincides with market declines and market nervousness. The longer it stays above its 10-period moving average and the more stretched it is above the average, the higher the likelihood that the market is going to rally soon.

Now let's take this knowledge and place it into a systematic strategy we can use.

1. The SPY is above its 200-day moving average (you can use the SPX also).
2. The VIX is stretched 5% or more above its 10-day MA for 3 or more days. If this occurs, we'll buy the market on the close.
3. Exit when the SPY closes above a 2-period RSI reading of 65 or more.

The Results:

Trades: 33
Percent Correct: 84.85%
SPX Points Made: 363.90
Average Hold: Under Five Days

The average gain per trade and the percent correct are high. Even though the number of times this has occurred is low, I encourage you to take the research yourself and grow with it. Look at different VIX stretches and look at different amounts of time above the 10 MA. As with most of the strategies in this book, the research is robust and you'll be pleasantly surprised if you take this concept and delve further into it.

Let's now look at an example.

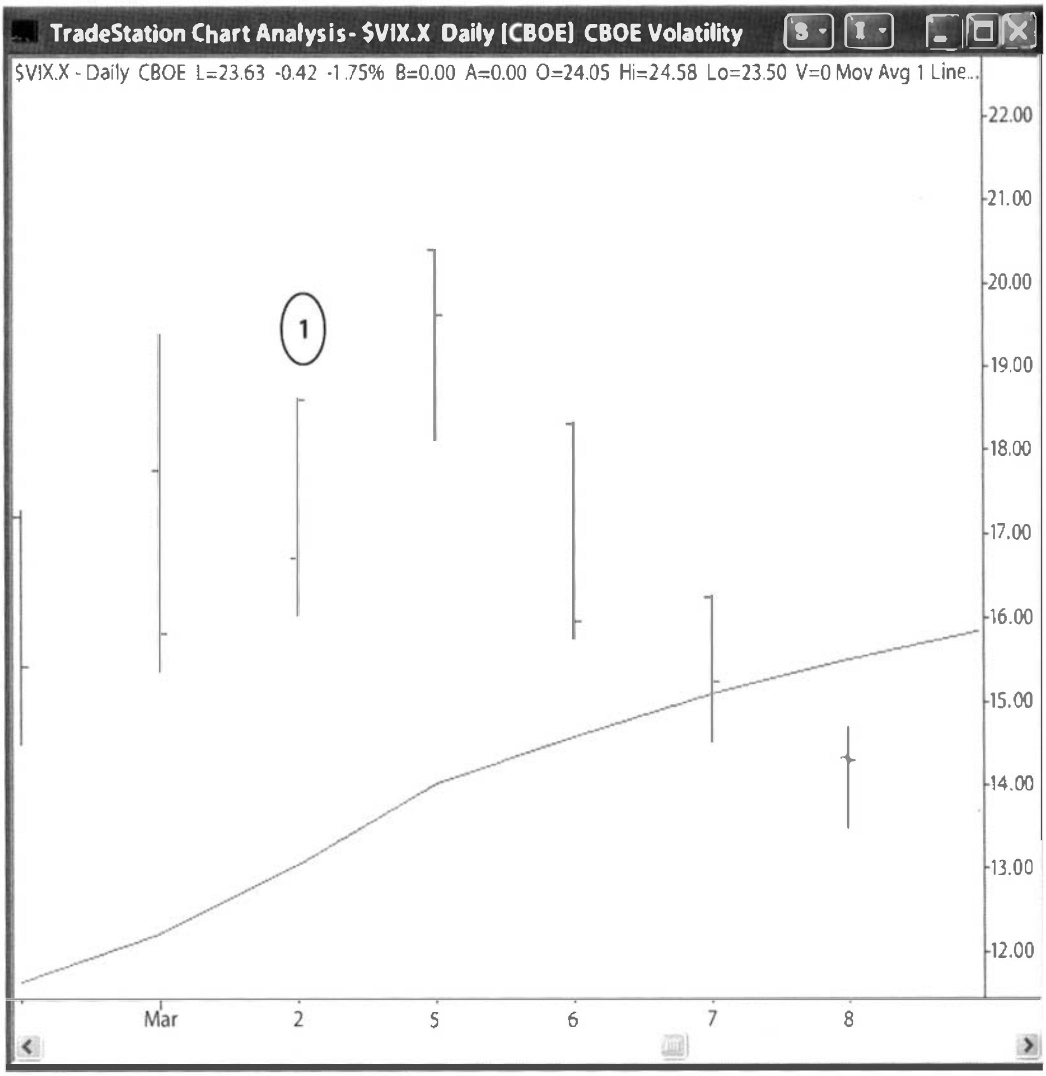

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc

Figure 12.1 VIX.X

1. The VIX is stretched 5% or more above its 10-period MA for three consecutive days.

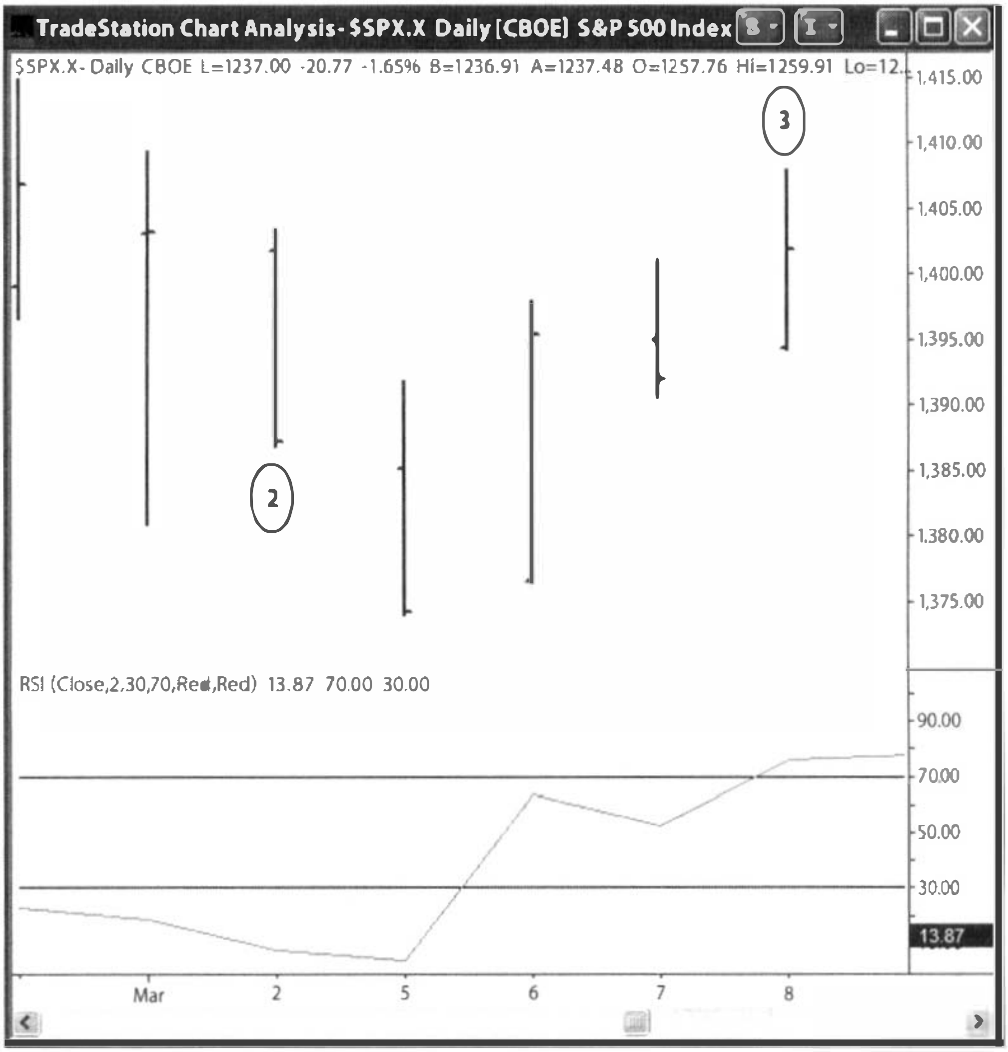

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 12.2 SPX.X

2. Buy the market.
3. Exit as the 2-period RSI closes above 65.

2. VIX RSI Strategy

As we saw earlier in the book, the 2-period RSI is an excellent indicator for trading stocks, indices and ETFs. And now you'll see the same concept applies to the VIX and in timing the market. First, let's look at the rules, then we'll look at the results followed by some examples. What you will see is a strategy which triggers often and has picked up over 879 S&P points in only 92 signals with an average holding period of under a week per trade. Here are the rules:

1. The SPY is above its 200-period moving average. I like using the SPY to guide the market timing signals as it's more dynamic than an index. For those of you who want to keep things simpler, use the SPX. The test results are basically the same.

2. The 2-period RSI of the VIX is greater than 90. This tells us that the VIX is overstretched (fear and possibly even some panic has entered the market as the implied volatility on the S&P options is rising) and likely due to reverse (often meaning the market is heading higher).

3. Today's VIX open is greater than yesterday's close signifying further panic has entered the market this morning.

4. The 2-period RSI of the SPY is below 30 further telling us that stock prices have been weak and the market is oversold.

5. Buy on the close.

6. Exit when the 2-period RSI of the SPY closes above 65.

<u>Results</u>

Trades: 92

Percent Correct: 79.35%

SPX Points Gained: 879.46

Average Hold: Under Five Days.

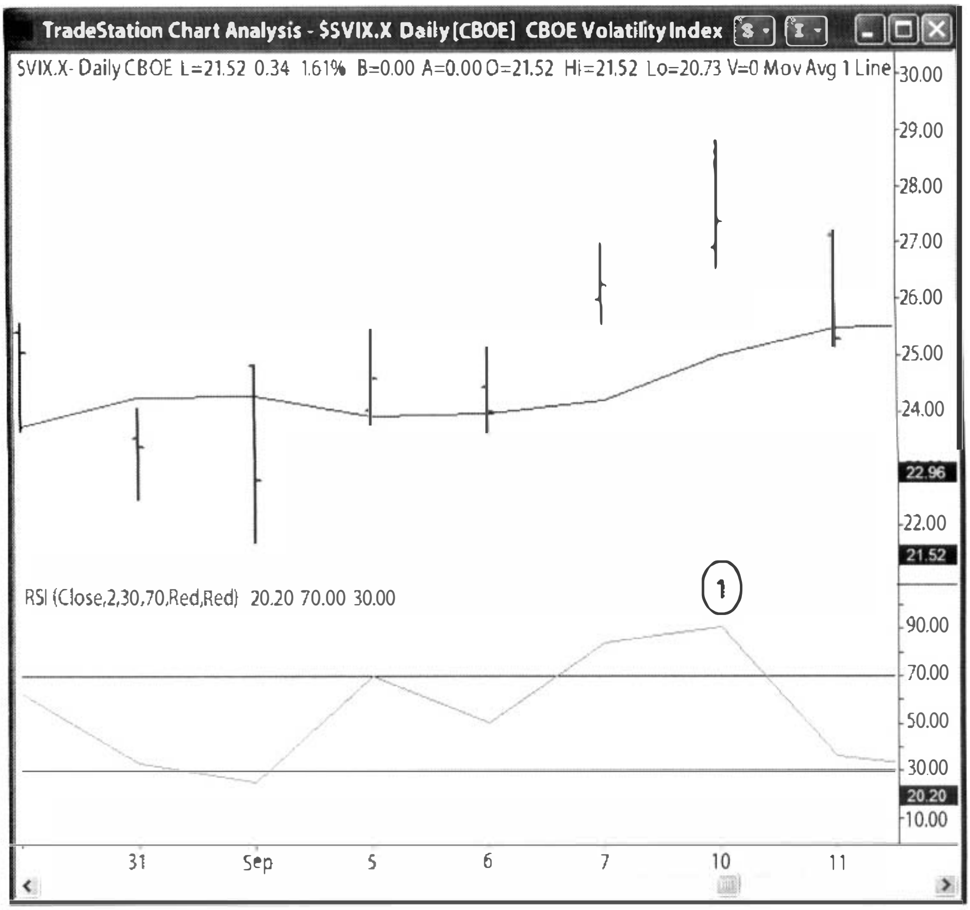

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Figure 12.3 VIX.X

1. The 2-period RSI of the VIX is above 90.

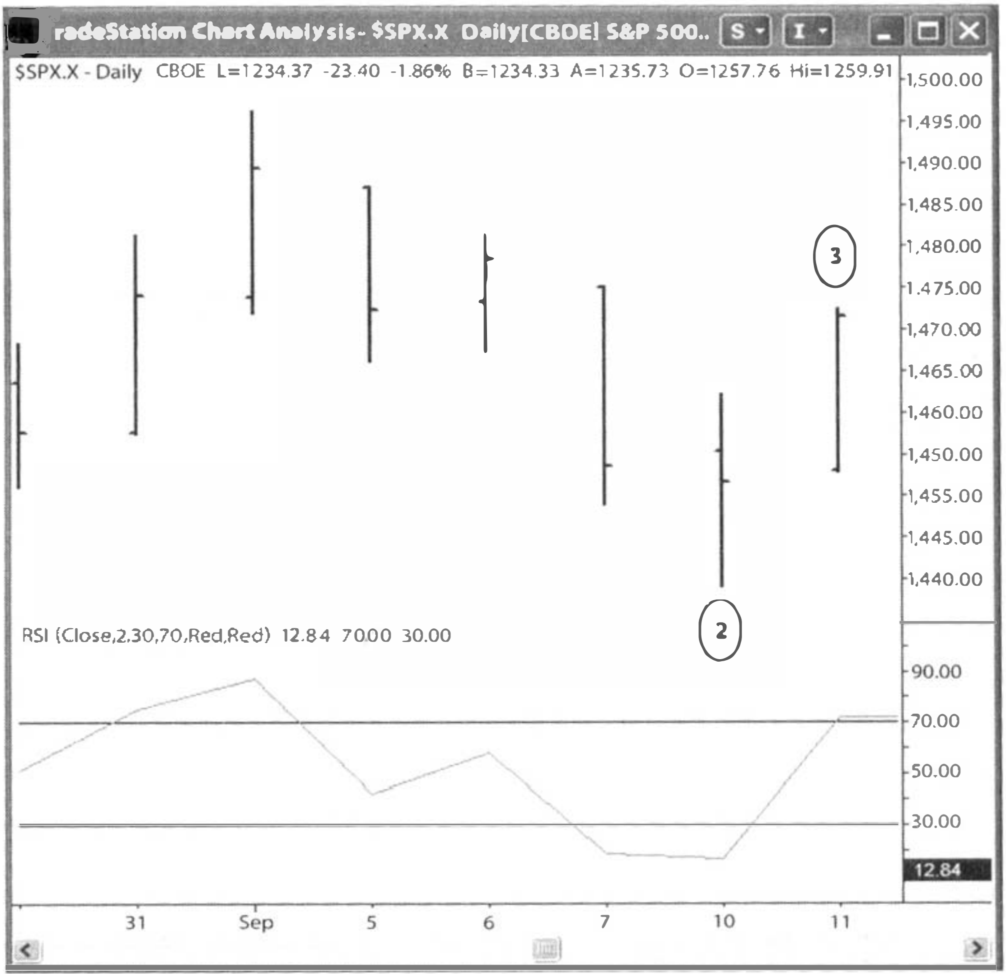

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Figure 12.4 SPX.X

2. Buy the market on the close.
3. Lock in gains as the 2-period RSI of the SPX closes above 65.

There are many, many strategies you can use by applying the VIX to the market. The key thing to remember is that you want the VIX to be extremely stretched from recent levels in order to give you a lower risk, higher reward opportunity to enter the market.

3. The TRIN

A few decades ago, Richard Arms created the Arms Index which ultimately became known as the TRIN. It remains today one of the more popular indicators used by professional traders in the United States.
What I find so interesting about this is that very few people have been able to quantify the use of the TRIN. It's referred to in numerous books and articles, yet few have shown whether or not it really has any sort of predictive ability.

The good news is that it does. We have found a number of ways to use the TRIN which are backed by statistical results and in this book I'll share one of them with you.

First, to make sure everyone is on equal footing, let's look at the definition of the TRIN and its formula. The TRIN uses advancing and declining issues on the NYSE along with advancing and declining volume.

The formula is as follows:

$$\frac{\text{Advancing Issues / Declining Issues}}{\text{Advancing Volume / Declining Volume}}$$

The TRIN's point of equilibrium is 1.0. Readings above 1.0 tend to occur when markets decline and readings below 1.0 tend to occur when markets rise. Readings above 1.0 lead to oversold markets which are likely to reverse. Readings below 1.0 are usually accompanied by overbought markets which are likely to reverse.

Here is a good example of applying the TRIN systematically with good long term results.

TRIN Strategy

1. THE SPYs are above the 200-day.
2. The 2-period RSI of the market is below 50, signifying the market is at least a bit oversold.
3. The TRIN closes above 1.00 for three consecutive days. When the three rules are met, buy on the close.
4. Exit on the close when the 2-period RSI of the SPYs is above 65.

That's it. Four rules and rule number three is the key rule. Let's look at the results from 1995-2007:

Trades: 90
Total S&P Points Made: 558.30
Percent Correct: 75.56%
Average Hold: Under Four Trading Days.

These four rules have been consistently profitable every year but one with only 2002 showing a loss (just 5.11 S&P points). And because of the 200-day moving average rule keeping us mostly in cash during the market decline, it did a very good job of generating over 40 points of SPX gains from 2000 to 2002, during one of the worst bear markets in history.

Here is an example of the set-up.

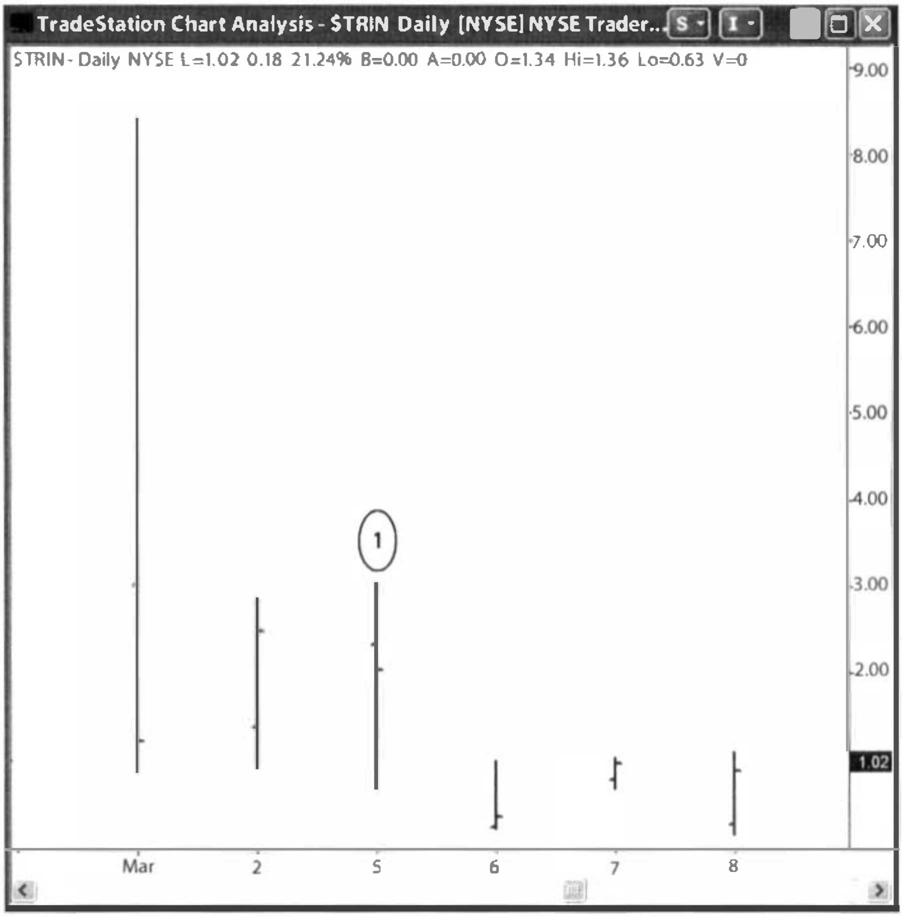

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 12.5 TRIN

1. The TRIN closes above 1.0 for three consecutive days.

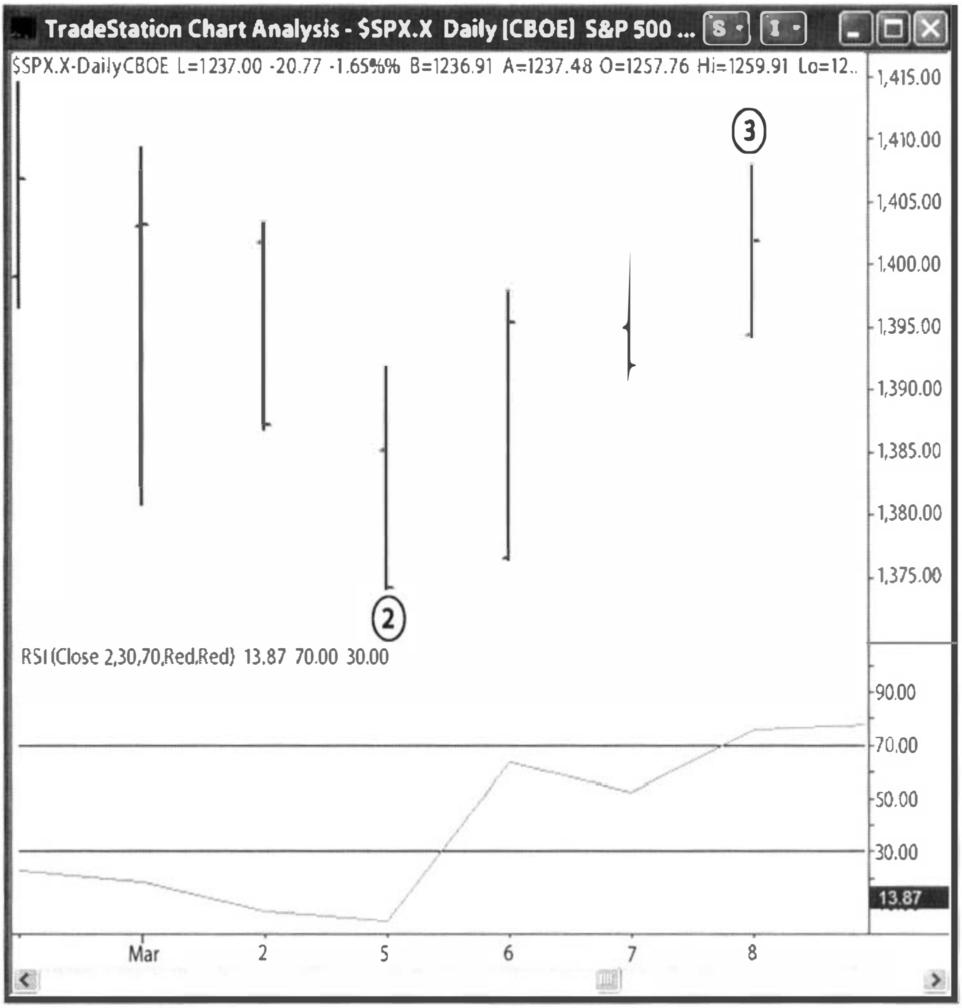

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Figure 12.6 SPX.X

2. Buy the market on the close.
3. The market rallies over 25 S&P points in three days.

I'm sharing this strategy for a number of reasons. First, it can be traded as is. Second, it's to broaden your thinking with the TRIN.

The TRIN should not be used on a daily basis as a standalone indicator. It does however have edges at specific market extremes. Trading with the trend and waiting for a persistent high TRIN reading as we did above, and exiting at the proper time, lends the TRIN to being an excellent indicator that can be added to your timing repertoire.

Now, let's look at another market timing strategy, this time applying the 2-period RSI to the SPX.

4. One More Market Timing Strategy with Cumulative RSIs

In an earlier chapter, we learned the Cumulative RSI Strategy. As we saw, the lower the Cumulative RSI, the bigger the historical edge has been. Why is that? Because multiple days of low RSI readings, especially above the 200-day identifies markets that are potentially washed out. And we all know that washed out markets tend to lead to some of the biggest edges time after time.

Let's look at using a slightly different parameter for the Cumulative RSIs on the S&Ps. We'll go to a 3-day Cumulative RSI this time and use 45 as the total reading. As we know, Cumulative RSIs are robust and there are many different combinations that can be applied.

Here are the rules.

1. The close of the SPY is above its 200-day simple moving average.
2. If the sum of the past 2 day's 3 period RSI is below 45 (the lower the better) buy on the close.
3. Exit is when the 2-period RSI closes above 65.

Very simple. And very consistent.

Here are the results:

Trades: 78
Percent Correct: 79.49%
Total S&P Points Made: 779.51
Average Hold: Under Five Days.

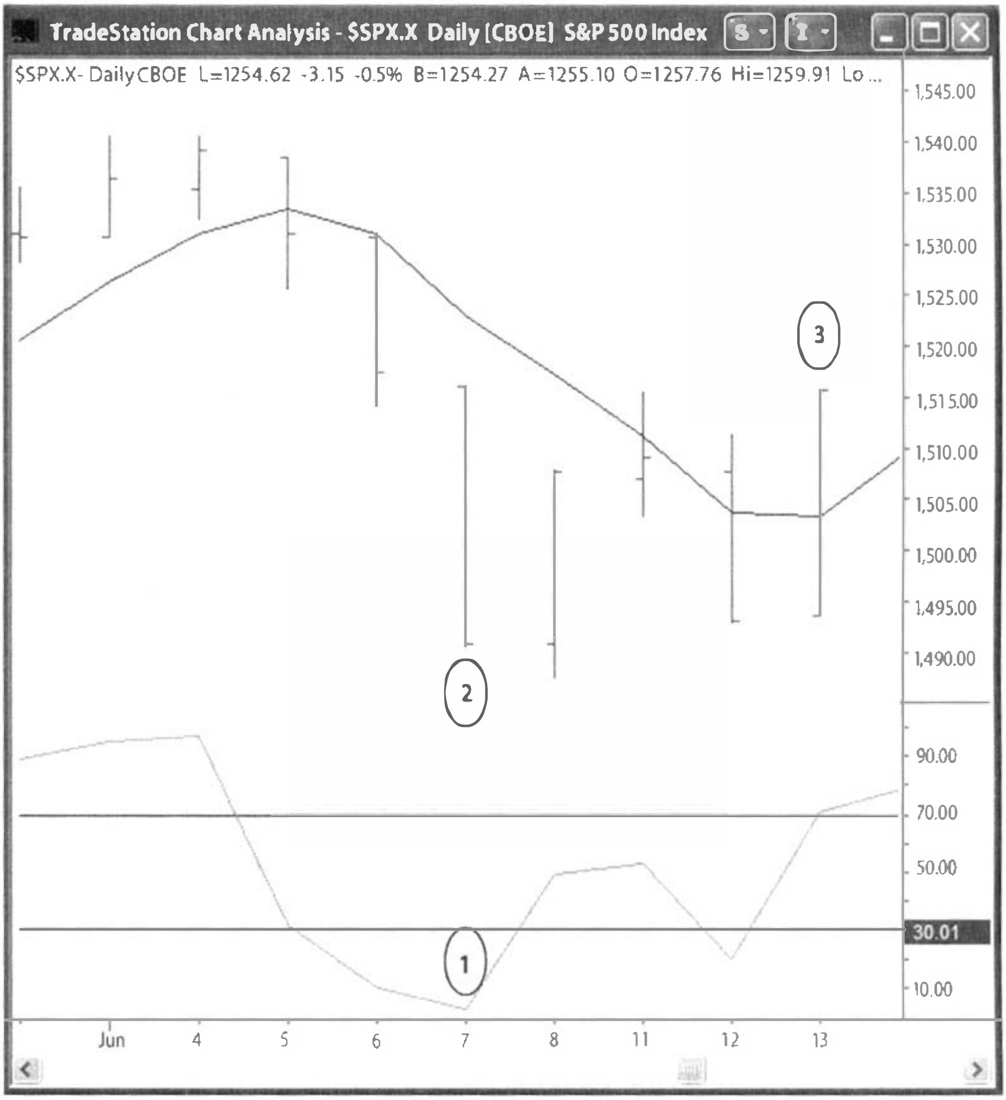

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 12.7 SPX.X

1. The 3-day cumulative RSI reading is under 45.
2. Buy on the close.
3. 20 points of gains in four trading days.

There are numerous ways to apply Cumulative RSIs and you can take this research and use it many ways.

Now let's look at a strategy to profit on the short side of the S&Ps

5. Trading on the Short Side-The S&P Short Strategy

There has been a strong upward bias in stock prices since 1995. But, there have been some excellent short opportunities during the times the market has been below its 200-day moving average. As we've seen throughout this book, ideally we want to be long when a security is above its 200-day MA. And with the stock market indices, we want to be shorting below the 200-day.

The S&P Short Strategy is a simple strategy to apply. Like many of the strategies I've presented in this book, it applies reversion to the mean along with a dynamic exit. Here are the rules.

1. The SPY (or the SPX) is below the 200-day MA.
2. The market closes up 4 or more days in a row.
3. Sell on the close.
4. Cover your short position when the SPY closes under its 5-period moving average.

Here are the results.
Trades: 16
Percent Correct: 68.75%
Total S&P Points Made: 169.91
Average Hold: Under Five Days.

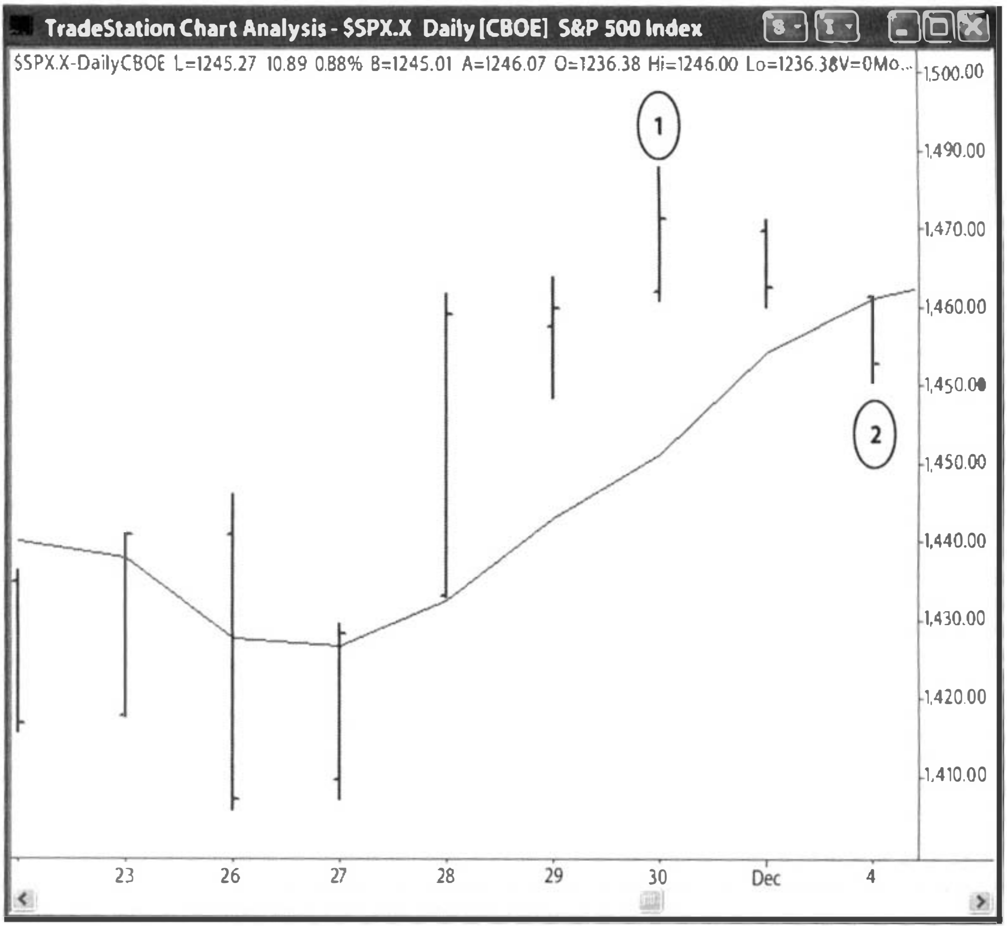

Chart created on TradeStation®, the flagship product of TradeStation Technologies, Inc.

Figure 12.8 SPX.X

1. As you can see the market rallies sharply higher rising four consecutive days off its low. We sell short on the close.
2. The market declines about 20 S&P points in two days and closes under the 5-day MA – lock in the gains on the sell-off.

The market has spent the majority of its time above the 200-day MA since 1995 and therefore has allowed for fewer opportunities on the short side. But, as you can see from this strategy, money can be made in bear markets. And this strategy can be further applied to other indices and ETFs in order to get additional trades when the markets are trading below their 200-day moving average.

Summary

You now have in your possession five market timing strategies using four different indicators – the **VIX**, the **TRIN**, the **RSI**, and **Price**. Each of these strategies is robust, meaning that if you adjust the parameters, you will continue to find strong test results. Each provides you with a multitude of possibilities on how to apply them and I encourage you to take this research and further explore the many ways you can use them.

CHAPTER 13

Exit Strategies

A broker calls me yesterday and tells me about this great stock at 60 cents a share. I say "terrific buy me 10,000 shares." He calls me back 10 minutes later and says it's up to 70 cents a share. I say "Wow, buy me another 10,000 shares." He calls back a few minutes later and says it's now at 80 cents a share! I'm so excited I tell him to buy me buy me another 10,000 shares. He immediately calls me back and says "it's now up to 90 cents a share"! I say "Fantastic! Sell!" He says . . . "to who"?

– Henny Youngman

We live in a world of people telling us what stocks to buy and why. Whether or not the reasons for buying these stocks are valid is secondary to the fact that we rarely hear back from these people when to sell.

As traders, we ideally want to be buying when there are edges. As we have seen throughout this book, buying stocks (and indices and ETFs) on pullbacks, especially with large intraday pullbacks have had excellent edges. Once the entry edges are in place, we then need to know when to lock in the gains. In this chapter, I'll teach you how.

Over the years, I've met many terrific traders. And at times when they tell me how they trade (meaning they share their strategies), I'll ask them permission to test these strategies. It's always interesting to see the many different ways successful traders make their money. Most have strategies which have edges and they know how to take these edges and turn them into profits.

But occasionally, I meet a successful trader that has no edge to his entries. It sounds pretty hard to believe, until we take a deeper look.

One trader in particular comes to mind. He leases a seat on the CME and professionally trades the E-minis. And he's successful. Successful enough to have many six figure months (I've seen some of his monthly statements that confirm this) and these six figure months are now adding up to seven figure years. I know his entry method. **He has no edge.** That's right, he makes seven figures a year and in my opinion, his entries have absolutely no edge. We've tested his entry methods many different ways. None show edges. In fact, some even have *negative edges*.

So, how is he so successful? It comes down to one thing. He has a superior exit methodology. He instinctively knows when to get out. Ask him how he gets in and you'll see his exact rules. Ask him how and why he gets out of a position and it turns into gibberish. I've seen this first hand when he traded for two days in front of me. He took every trade that his rules told him to take. And he then exited as the market unfolded using some *basic guidelines* but mostly from "feel."

This gentleman has a superior exit methodology. He can't define it but his instincts in exiting positions are the main reason for his success. He's entering trades with the set-ups having little to no edge and he's making money because as the trade evolves, he's somehow reading things that even he can't describe. And this trader is not the only successful trader I've seen do this (on the other hand I've also witnessed traders turn winning strategies into losers, but this is usually due to some psychological reasons which would require another book from someone with an MD or a PhD in clinical psychology to explain).

Ideally, we want to enter trades with edges. And then we want to exit these trades at levels where the edges are maximized and before they start disappearing. We obviously want to buy into weakness and sell into strength. And we want to be as structured and as consistent as possible with this process. Some people can do this intuitively but most of us can't. Therefore, just like our entry rules, we want to have exit rules that are statistically backed and we want to be consistent in following these rules. Let's look at some ways to do this.

When we discuss selling into strength, we're doing what the market makers and specialists have been doing for years. We saw the phrase "feed the ducks when they're quacking" earlier and it's well known among successful professional traders (especially among market makers and specialists). And the research we've done confirms why so many of these professionals like to use this phrase.

I'll share with you five different exits, in order of my preference to them, along with the statistics to guide you…

Fixed Time Exit Strategy

Fixed Time Exits tell us to exit when a certain amount of time has passed. Buying today and exiting in a week is an example of this. They may work for some traders (and they do a good job in helping us look at behavior when we do our testing) but I do not like to trade with fixed time exits. They are not in the spirit of selling into strength. We ideally want to sell our long positions into strength and buy back our short positions into weakness.

First Up Close Exit Strategy

This means exiting after the stock or index has its first up close versus the previous day. If I remember correctly, this exit was originally introduced a few decades ago by Larry Williams, a brilliant researcher and trader. When we first tested this exit, we were very surprised at the results. We knew that it would do well, but we were surprised to see just how well it did. Not many methods last decades and kudos to Larry for coming up with this concept.

New High Exit Strategy

Another way to exit is to sell your position after it closes above a new high. This is more in the spirit of selling into strength. For example, exiting after the stock closes at a 7-day high as we saw in the Double 7's Strategy. This type of trading is popular among some traders and the results show that it has validity to it. As you can see, the returns are comfortably better than using a fixed day exit.

Close above the Moving Average Exit Strategy

This is simply exiting after a stock has closed above its simple moving average. I like this type of exit. It's simple, it's dynamic (meaning its adjusting itself to recent price) and it gives consistently high results in many strategies we've tested it on. Two moving average exits that we like are 5-day moving average exits and 10-day moving average exits. Our highest preference is for the 5-day moving average exit because it often gets us out of a trade quicker.

2-Period RSI Exit Strategy

It's no secret that I really like the 2-period RSI. It does a very nice job of finding oversold positions and it also does a very nice job of finding proper places to exit.

There are a number of ways to use a 2-period RSI exit and my favorites are an RSI close above 65, 70, or 75.

Results of Various Exits

We looked at all stocks above the 200-day MA from 1995-2007 which had closed at a 10-day low, and entered the next day on a 5% limit. We then tested various exits. Here are the results.

Exit	# Trades	Avg % p/l	% Correct
1 Day Hold	63,101	0.61%	56%
3 Day Hold	63,101	1.76%	60%
5 Day Hold	63,101	1.97%	59%
7 Day High	63,101	2.05%	58%
C > MA5	63,101	2.65%	70%
C > MA10	63,101	2.80%	69%
RSI2 > 65	63,101	2.76%	70%
RSI2 > 70	63,101	2.83%	70%
RSI2 > 75	63,101	2.93%	69%

What stands out from this example is that the dynamic exits, like a moving average exit and an RSI exit, make the edges greater. This is consistently seen in most of the strategies we've tested.

What about Using Trailing Stops?

Go back to the earlier chapter on Stops Hurt. I wish the results were different. But in hundreds and hundreds of tests, few if any "stop strategies" *consistently* improved test results. We see this over and over. And even as this book was being written, we attended an online presentation for a new software testing program. It was fun to watch them construct the strategy model (it was very well done). Then someone suggested adding trailing stops to the model. Talk about taking all the air out of the

room. The more ideas they had with the trailing stops strategies, the worse the performance became. For us it was like going to a movie premier and already knowing the ending (an ending that no one else could imagine). For everyone else attending, it was bewildering. Now you know why.

Properly Getting out of a Position is as Important as Properly Getting In!

Many professional traders will tell you that knowing when to get out is as important, if not more so, than knowing when to get in. I'm in full agreement. Ideally, we want our exit strategy to be robust and dynamic, meaning it adjusts to recent prices. As we have seen, this can be done profitably a number of ways by us having exit strategies which sell into recent strength. Choose one exit strategy, stay with it and follow the premise that the stronger the move, the more likely you want to be locking in your gains.

CHAPTER 14

The Mind

The warrior knows if he chooses the weakest path, the only person he truly cheats is himself – Richard Machowicz, "Unleashing the Warrior Within"

Any individual pursuit of excellence requires two things. The skills in order to achieve the excellence, along with an extreme mind frame combined with a will to win to assure that this excellence is attained. Trading is a game of psychology. All the best strategies in the world are useless unless the person behind executing the strategies is mentally strong. Anyone can make money when everything goes according to plans. But as in all things in life, few things go exactly as planned. And those are the times that separate the great from everyone else.

As I am writing this, the Dow has lost over 3000 points in the past 12 months. Brokerage houses are beginning to evaporate and the first bank (reportedly of many to come) was just taken over by the government. Yesterday I watched a slew of banks announce that "everything was fine" as their stocks were imploding from rumors of impending runs on their capital.

This market environment is not only isolated to the financials. GM is trading near a 50-year low, many airlines are on the brink of collapse and the "can't miss' investments of China and India have seen 30-50% losses over the past 9 months. The game is always easy when it goes in the direction everyone expected. It's very different when volatility breaks loose and the markets implode in price.

Trading is part art and part skill. But it's also a large part psychology. It's not only the psychology of the market place which can quickly move from one extreme to another. It's also the psychology of the individual. Each day is a new challenge and how we respond to these challenges ultimately dictates what our long term success will look like.

Let's look at a few situations. Do you have answers for these questions right now?

1. You start trading a new strategy which has tested well and it immediately starts losing money. What do you do? Do you abandon the strategy? Why or why not?

2. You start trading a new strategy and it immediately starts making an abundance of money. What do you do? Do you allocate more money to the strategy?

3. You lose money for eight consecutive days and you're long multiple positions as the market is imploding. What do you do? Get out?

4. The market has one of its worst months in years and you do too. What do you do next month? Do you change your trading rules? Why or why not?

5. You are long 1000 shares of a stock and you put in an order to sell it at 48. You look at your account at the end of the day and instead of selling it at 48 you accidently bought it. The stock dropped 5 points since this morning and you're now long 2000 shares at 43 and $10,000 poorer than you were this morning. What do you do?

6. The past three trades you took, trading the Cumulative RSIs in ETFs, made money. But each time you sold the ETF using the RSI 70 as your exit strategy, it proceeded to rally to much higher levels. What do you do with the next trades? Do you now adjust the exit to reflect the fact that you've been getting out too early and leaving thousands of dollars on the table?

7. You are a successful model-driven quantitative trader. The smartest most successful investor in the world was just on television and he feels that stock XYZ can't miss. Do you shift capital from your successful trading account to jump into this guru's favorite stock?

8. Last week, one of the companies you were long, announced better than expected earnings and the stock jumped higher. This week one of the companies you were long, announced earnings and they missed the numbers badly. The stock lost over 40% the next day. Today another company you are long will be announcing earnings after the close. What do you do?

What's your long term plan? Do you take positions into earnings, not take positions into earnings, or jump around time after time?

9. Your plan is to scale into positions the more oversold they become. In theory that's good. In reality, in order for you to buy at the extreme pullback time, you will likely be losing money (possibly lots of money) when those extreme signals are telling you to buy. What do you do? Do you risk greater loss or do you take the trades knowing that these have been the highest returning trades but you're also taking these trades at the riskiest times?

10. You hear that everyone is making money in forex. You have no statistical evidence that the strategies out there make money but everyone else is trading forex except you. Do you take away time and resources from your equity trading to focus on forex trading? If yes, why?

Guess what? People touting stocks and their opinions on television never discuss things like this. But these questions must be dealt with every day in the "real world" when real money (your money) is at stake. Some of these questions can be answered easily like question number 5. It's the first rule taught to entry level traders when they join trading firms. You get out. Period! No questions asked. It really sucks to lose money like this. And you know what? Everyone who gets into this situation begins their thinking the same way. They're thinking they're going to trade around the position and hope to get out higher. Human instinct. But it's wrong! And even though every junior trader has been taught this rule from the beginning, there are still numerous traders who, no matter how great their trading is, succumb to the urge to "trade around the position."

Other decisions are tougher to make. And you should (in reality you "must") have the answers ahead of time. Because without these answers, you will be making stressful decisions at the worst time. Or worse - make no decision at all because of the fear. We've all heard about the traders who have taken major losses for their firms and hid them. We hear about the ones who got caught doing this. What we don't hear about are the ones that are never mentioned to the public or the ones that occur to many traders throughout the world every day. You may think you are in the business of trading. **But in reality, you are in the business of decision making!** And the better you can make these decisions ahead of time, the better your results will be – period.

I'm now going to leave you with an interview I did a few years back with a friend of mine who was entrusted with making decisions at the highest and most stressful levels for 10 years. Richard (Mach) Machowitz is a long time friend of mine who is a retired Navy Seal and served our country as a member of SEAL Team One and SEAL Team Two for a decade. Since retiring from the SEALs, Mach is the Producer and Host of the highly acclaimed show "Future Weapons" now in its fourth season (as of 2008) on the Discovery Channel. As he and all other SEAL team members will tell you, an incorrect decision along the way could cost them and their team members their lives. In training, SEALs are taught how to make decisions and execute perfectly on these decisions. They then apply this knowledge in battle. In my mind, the same applies to trading.

In this interview, you can see just how extreme his thinking is in order to achieve success at the highest levels. This interview is not just about learning to think correctly when it comes to trading. It's about learning to think correctly in anything you undertake in life.

Since this interview was first published, it's found its way into many places. It's been seen on major portals like Yahoo, numerous military sites, and sites that help people overcome serious events and illnesses in their life. We still get emails today thanking us for doing this interview, which has touched people in ways that we never could have imagined. I hope you enjoy this interview and, of course, feel free to share it with anyone who you feel it may have a positive impact on.

Richard J. Machowicz is a martial arts specialist who achieved certified instructor rating in the U.S. Navy SEAL hand-to-hand combat program. Even though he is not a trader, Larry Connors interviewed Machowicz for TradingMarkets because so many of the insights in his book, "Unleashing The Warrior Within: Using the 7 Principles of Combat to Achieve Your Goals," apply to trading. This conversation took place in late 2002.

LARRY CONNORS: Welcome Richard. I have a number of questions for you, and our main focus in this interview will be on extreme achievement. Our members tend to be type A individuals, many of whom have been successful in a previous profession and are now trying to succeed in the trading industry, which is a very, very difficult game. It is an extremely mental game which has less to do with having the ability to get in and out of positions than being able to sustain losses and handle chaos in those positions. Most people can't handle it. The failure rate in the industry is high. And it's high with people who are incredibly intelligent. It also has to do with the fact that trading tends to be counterintuitive. That confuses people because they have previously succeeded by being intuitive and logical. Trading is just the opposite. What we're going to try to do here is focus on achievement — why people achieve great success — not only in trading, but in all walks of life.

Richard J. MACHOWICZ: Sounds great.

CONNORS: The main thing that people are interested in is the fact that you were a successful Navy SEAL. Let's talk about the extreme training process that one has to go through to become a SEAL. As I see it, it becomes a mastery over two things. The first thing is the mastery over the

> *"What it takes to make it as a SEAL and to achieve extreme success in anything in life really comes down to one thing: How bad do you want it?"*

SEALs which is one skill set, and the other thing is the mastery over yourself, which is harder to do. Do you want to talk about that and take it from there?

MACHOWICZ: Sure. What it takes to make it as a SEAL and to achieve extreme success in anything in life really comes down to one thing: How bad do you want it? There are times when you think that the SEAL instructors are literally trying to kill you. You have to be able to generate the capacity to keep moving forward in spite of that fact. Or at least in spite of that belief. I think that's the real challenge, but I also think that it translates to everything you want to do really badly in life.

It's not some magic formula that's going to allow somebody to go after the thing they want to do. It's the consistent progress or moving toward the thing they want to do, regardless of whatever thing comes up — and I call that thing "quitting."

That quitting conversation will show up a hundred different ways. You can say, "This thing is bullshit. This thing is crazy. I can't believe I'm doing this." Or you can create things like, "Well, that person's just trying to hold me back," or "I'm just not good enough." Whatever. . . I'm telling you, quitting sounds very reasonable. Literally, it's a very simple process of getting on target and moving forward vs. the conversation that leads to quitting. And those conversations show up every day for people. And really, that's the battle. That's the war. If there's a war going on, really the war is within yourself and one you have to confront day after day.

The majority of people who get selected to SEAL training will quit, drop out or simply go away. You've got to be able to generate within yourself the mind frame that you must always be going forward. And you've got to want the thing bad enough to be willing to do anything to get there, regardless of and in spite of all the obstacles, in spite of all the hurdles, in spite of all the doubts that get in and the stress and the pain, you've got to keep going forward.

CONNORS: Is it necessary to have the mind frame to reach extreme goals that you are either going to achieve the goals or die? Because that seems to be the common characteristic for many people, such as Navy SEALs, who achieve extreme success. It's tough for somebody to sustain that type of mind frame, but is that the type of mind frame it takes to get there?

MACHOWICZ: Well, it makes it very binary. You're either going forward and accomplishing or you're not. It's very clear under pressure, under stress, under doubt, under hesitation, under pain, under intense fear, to make that clear decision. You're either going forward toward it, or you're not. It gets all the excuses out of there. I'm telling you: quitting is very reasonable. I can have a million reasons to quit. But can you find the one reason to keep going forward? And literally, by saying, "Well, I'm going to keep going until I die." As long as you're still breathing, as long as you have a single pulse in your body, you can still go forward. I think it just makes it very easy to distinguish whether you're going forward or you're not.

Under stress and pressure, you think about the doubt... and it's just self doubt. I think everybody has self doubt. Everybody has those things that

> *"And so I live by the axiom, 'Not dead. Can't quit.' "*

occasionally creep in. I don't care how strong you are. You've still got to be able to go one step further. And as long as you can breathe, you can still go one step further. You're not dead. And so I live by the axiom, "Not dead. Can't quit."

"On the back of this picture was a quote that said, 'A man can only be defeated in two ways. . . if he gives up, or if he dies.' "

I got a quote that really drove me forward when I was trying to get ready for the SEAL team and getting ready for BUD/S. It's a six month course and people get badly injured. We had four broken necks, broken legs, and broken arms in the class. It's a severe, intense course. And they have this thing everybody knows about called Hell Week in which 80% of the participants fail. . . I think we had a class of about 140 people and eventually we finished with 23 or 24 people graduating. That's a significant drop off, especially considering the screening process you had to go through just to qualify for the class. I was like 150 lb. soaking wet at 6 ft. I was desperate to have some kind of advantage. Some kind of thing that would give me an edge. When it was going bad, I needed something to keep me going forward.

I was fortunate to have a friend whose brother had made it through SEAL camp. I didn't know the guy personally, but what happened was he sent me a picture. On the picture was just his platoon jumping out of an airplane. It gave me a visual representation of what I wanted to be able to accomplish. But more importantly, when I turned the picture over, there was a quote. On the back of this picture was a quote that said, " A man can only be defeated in two ways: if he gives up, or if he dies." That radically shifted where I was ever going to come from that day to the day I die. A man can only be defeated in two ways — he gives up or he dies. I carried that quote with me until the ink disappeared off that piece of paper.

CONNORS: Great mind frame.

Your means of execution to achieve your goals is centered around a phrase you coined: "targets, weapons, movement." You choose your target, which is basically what you are trying to accomplish. This target will dictate what weapons you will use to achieve the target. And your movement will be based upon the weapons you will be using. I know this concept is new for many people who are reading this for the first time, so let's walk through it.

MACHOWICZ: Yeah. I created this thing called the play dynamic for combat. Basically, it's: Targets dictate the weapons. Weapons dictate movement. As long as you are very clear on what your target is, you don't even have to think, and weapons will show up. You don't have to think and the appropriate movement will show up. That way you see the things that matter vs. all the things that don't. That's what we're competing for on a second-by-second basis, especially under stress and pressure. You're competing with all the information that doesn't matter vs. the specific information that does. And what happens is most people fixate on the minutiae that don't matter vs. the one laser point that will drive them to the thing they want to accomplish.

CONNORS: The target applies to anything in life. For the Navy SEALs, you guys went quickly into a foreign country to execute a mission. That mission became your target. That's all that mattered. But that same focus applies to everything in life. I recently read an article by a professor from Harvard Business School. His research found that there is no formula to business greatness. There are, however, themes, and the number one theme was a clear mission. So essentially, the people who achieved greatness in their businesses had a clear mission. They had a clear target. And when it comes down to trading, it is the same thing. A clear target can be wanting to earn $1 million a year, or wanting to become the #1 hedge fund manager in the world. That becomes a clear target.

MACHOWICZ: Yes, for sure. You just talked about big targets. I also categorize targets as primary and secondary. . . once you get a target that big, I call it the mission. Inside of that mission, there have to be incremental targets. In other words, there is a target before the next target. I call that target the primary target which will, if you hit it and knock it down, set up the secondary target.

CONNORS: Give us some examples. Let's say we know what the ultimate target is, what the mission is. What are examples of the primary targets here within this mission?

MACHOWICZ: In a SEAL team context, what is our mission? Let's say, we're supposed to do a kidnap, what they call a body snatch. In other words, we need to collect the general. We go to grab a specific person because that person has intelligence, and we need to capture that person alive. That is the mission. There can then be literally a hundred or two hundred different targets inside that mission. Now all that matters is accomplishing the mission, but before you can accomplish the mission, you have to do planning. You make a target of setting up a good plan. In other words, creating a time, a very specific time frame where we've got to have a good plan by this time. Period. The end. Now that's the target.

Now you start to break up little things. Ultimately, inside of a mission you have insertion — you could be jumping out of an airplane or coming in by a boat or being inserted via submarine. Then you have infiltration — the process of getting to the target, the main objective. And then you have the actions you do, what they call actions on the objective. What specifically are you going to do on the objective? Then you have to leave the objective and exfiltrate, in other words get out of that dangerous territory now that you've told everybody in the world that you're probably in that town. . .

CONNORS: So are these all targets on the way?

MACHOWICZ: Yes, because if I started focusing on exfiltration before I actually got the guy, what are the odds of me being able to get the guy, or to actually infiltrate?

CONNORS: It's one step at a time.

MACHOWICZ: You've got it.

CONNORS: Let's talk about this in trading terms then. Your first target would be to identify the setup. Then it would be to properly get into that setup. Then it's to properly put in your exit strategy. You're going one step at a time. You're not thinking about losing money or how you're going to spend the money or whether or not this is your third win in a row. You're not jumping ahead four steps — your total focus is on simply executing the next step.

MACHOWICZ: Exactly. Which helps you stay focused on the main target.

CONNORS: And it takes the chaos out of the situation.

MACHOWICZ: Exactly! In other words, thoughts or feelings or things that don't belong get thrown by the wayside and only what is essential to accomplishing your overall mission is kept in the mix.

CONNORS: So targets dictate weapons; weapons dictate movement. We've talked about the targets, let's talk about weapons. How does this all work?

MACHOWICZ: Really, when we talk about weapons, I use it as a physical metaphor because usually I try to teach it through a physical metaphor. I want you to develop weapons that easily knock down the target without you getting hurt. And that's really important, for example, when you talk about using stops in your trading. Minimizing losses is one of the steps in helping you hit your target and one of the weapons you use to do this is to use stops. What you're trying to do is use specific weapons to maximize a profit or maximize an income without putting yourself in major jeopardy.

CONNORS: Go further. . .

MACHOWICZ: The weapons are. . . let's call it a skill set. The weapons could be skills, they could be strategies. They could be actual tools. They could be the technology you are using. It depends on how you're looking at it. What your target is. Again, it really depends on what your target is. But most likely it's skills, or equipment, gear. . . whatever it is that helps you knock down the target. And movement is simply the act of making the weapon hit the target.

The longer it takes for you to pull the trigger. . . the more that doubt, hesitation, pain and fear will creep in. . .

CONNORS: I see this a lot where traders will not pull the trigger on a trade . . . they have a movement problem. They have everything put together, they know they're supposed to take the trade, they know where the entry is, and then when it comes time to pull the trigger, they won't do it. That's the movement you're talking about. They become paralyzed.

MACHOWICZ: Well, that's what happens. Somewhere in this chain of "targets dictate weapons, weapons dictate movement," someplace between target and weapon, the whole world can fit in there. When I say the whole world I mean your whole world of doubt, second-guessing, hesitation, fear, the unknown. And the longer it takes for you to pull the trigger – like you said – the more that doubt, second-guessing, hesitation, pain and fear creep in to that mechanism. . .

CONNORS: How do you get them to not creep in?

MACHOWICZ: Go back to the target! Focus only on this one thing. Just ask yourself, "What is the target? What is the target?" This incredibly reduces the chaos and brings everything back into focus.

CONNORS: Always focus on the target.

MACHOWICZ: Yes. And the second half of this is having guts.
What I like to do — basically it's a really simple question. I do this thing called the "gut check." I was really trying to find out what it was going to take for me to be able to just really handle BUD/S and become a SEAL. What it was going to take for me? Was it going to be that the kind of shorts I wore would reduce chafing? Would it be some kind of socks I wore to reduce some of the chafing or maybe try and keep my feet warm? Was it going to be some kind of supplement that

was going to help me? It turned out that all that stuff was garbage. That didn't matter. The one thing that kept coming back to me when I would check in, trying to find out what that secret was, was you have to have guts. You've just got to have guts. I got the experience of learning what guts were by sticking through to the end. I got that visceral feeling of what "guts" was. So what I wanted to do was develop a very simple way so that you could get a *gut check*. If you could answer yes to these three questions, you have the guts you need to take on anything in life.

CONNORS: What are those three questions?

MACHOWICZ: The first question is: Are you willing to make a choice?

Now, a lot of people make choices every day. They choose to watch TV, or to do something else, or they choose to be nice to somebody or they choose not to be nice to somebody. But rarely do they make a choice that would substantially improve the quality of their lives. I'm willing to give the benefit of the doubt to the person willing to play the game, and yes, a lot of people are willing to make choices. But when we come to the second question, we start losing people.

We probably lose half the people on the second question: Do you have the courage to start?

A lot of people talk the talk, but when it comes to walking the walk, they disappear. Really, that's it. Are you willing to step up and show up and get the work done?

CONNORS: Why do you think half the people stop?

MACHOWICZ: I think people are afraid.

CONNORS: Why?

MACHOWICZ: Why? Number one, I think people don't think they're good enough, for the most part. People think there's something inherently wrong with themselves.

CONNORS: Self doubt.

MACHOWICZ: Yes, they just don't feel they're worthy. They're afraid to even try. They're so sure they're going to fail. They're so sure they're going to get screwed. They're so sure it's going to fall apart that they refuse to even show up in the first place.

CONNORS: How do you overcome that?

MACHOWICZ: How? Recognize you don't even know what's going to happen. You do not know from second to second what is going to happen in your life. You've got an idea. You think you know. But the reality is what's going to happen ten seconds from now you really don't know. What's going to happen an hour from now? You really don't know. A year from now? You really don't know. That's the state, that's the condition of our lives.

CONNORS: So if you don't try, you do know that you're not going to succeed.

MACHOWICZ: But you know what? You didn't even have an opportunity. The mind doesn't want to even go there. It will just assume that it knows that you can't succeed, so it validates the fact that, guess what? "I know everything."

> *"When I look at the guys I've worked with that have been successful, the one thing I see consistently is the commitment to finish. Yes, they were willing to make a choice, they had the courage to start, but the thing that made the difference, was the commitment to finish no matter what."*

CONNORS: How do you trip the mind up to make it believe it will succeed?

MACHOWICZ: I don't think you have to trip the mind up. I mean you can do that. You can short-circuit that process. You can.

CONNORS: And the third question is...

MACHOWICZ: Do you have the guts to finish? Do you have the guts to succeed at the mission you set out to achieve? Do you know what the only common characteristic there is amongst the thousands of people who haven't made it through Hell Week?

CONNORS: What's that?

MACHOWICZ: They quit.

CONNORS: The things that you're teaching here are not just appropriate for Navy SEALs, they are appropriate for any walk of life, no matter what you're doing.

MACHOWICZ: That's absolutely correct.

CONNORS: You've obviously been around extremely successful achievement-oriented people who have achieved extreme levels of success in their field, including your teammates in the SEALs. I've read that from application time to the finish of BUD/S only one in 6000 get through the process. So these are people who are executing at a level in life beyond what most people can comprehend. You also work directly with individuals who are professional athletes, top names in the entertainment industry and some very successful businessmen. If you could state a single characteristic, a common theme, what would it be for their success?

MACHOWICZ: A very clear target and perseverance.

When I look at the guys I've worked with that have been successful, the one thing I see consistently is the commitment to finish. Yes, they were willing to make a choice, they had the courage to start, but the thing that made the difference, was the commitment to finish no matter what. Even if they were going to finish dead last, they were going to finish. I think that's the big thing. People do not finish what they start. A lot of people will start things but never see it through to the end.

CONNORS: These guys pick a target and are always moving forward to that target. Is that correct?

MACHOWICZ: Absolutely. If you're at least going forward to the target, you're always moving forward in your world. And that's the most important thing. You have one life. You've got to play it full out. If you play it half-assed, if you play it partially, I'm telling you, on your deathbed, you'll be wondering why you ever were born.

CONNORS: Going back to the SEALs, had that become the mind frame? You'd be killed; you'd be out immediately...

MACHOWICZ: Oh yeah, I mean what happens is -- Vince Lombardi had a great quote, "Fatigue makes cowards of us all." Literally, what happens with BUD/S, you will have work that will have mentally and physically fatigued you to the point where you only have to blink for a second, when you're on your third or fourth day of Hell Week, and you're freezing cold and you're miserable and you just saw three other people quit. You only have to have one moment... it only takes you 30 seconds to quit, and you've destroyed all that time that you've put in. You lose sight of the target and it is over.

One of the things I did early during Hell Week was I would say, "Well, I made it through one evolution, I can make it through one more. I made it through two. I can make it through one more. I made it through three, I can make it through one more. If I made it through four evolutions, I can make it through one more. If I made it through four, I could probably do another four. If I did eight, I could probably do another eight. Oh, I've got one day down, let me try another day. I got two days down, I bet I can do one more day. I got three days down. You know what? I know I can do three more days."

Just let it go. And next thing you know, you start building this motor of momentum, this engine of momentum that just keeps driving you forward, keeps driving you forward, keeps driving you forward. Because I'm telling you, that conversation is not a conversation you're going away from. That is a conversation of moving forward. And moving forward toward a target that you set for yourself and refuse to quit. People say, "Refuse to lose." I say "refuse to quit." Recognize the dialogue that leads to quitting and you won't have to worry about losing.

CONNORS: Paul "Bear" Bryant's famous quote, "The first time you quit it's hard, the second time is a little easier and the third time you quit, you don't even have to think about it."

MACHOWICZ: Perfect.

CONNORS: You talk about this in your book. Act as though it is impossible to fail.

MACHOWICZ: Act as though it is impossible to fail. If you are doing these things, if you are clearly on your target, if you are persistent and committed to finishing and you are really committed to results vs. reason, you will succeed. Success is not some magic mystery out there. It is a clear connection to the target.

CONNORS: Let me go back and ask you a question regarding chaos. During your combat missions, your life was very much on the line. If something goes wrong - you're dead. How do you eliminate the stress of that knowledge?

MACHOWICZ: Stay focused only on the target, that's how!

CONNORS: And they teach you that in the SEALs? They teach you how to...

MACHOWICZ: It's not even "teach," it's just "stay focused." What is the target? You may have to ask yourself that moment to moment. What do I have to do now? What's the target now? This moment, this moment, this moment, this moment...

Always come back to the target. I can't stress that strongly enough. I don't care what's happening... the universe could be falling apart around you. As long as you keep going, "What's the target? What do I have to do right now? What's the target right this second?" The results will take care of themselves. And to the outside world it will look like nothing ever phases you.

CONNORS: Summarize your message to us.

MACHOWICZ: Intense focus on hitting the target and never quitting. It worked for me in my 10 years with the Navy SEALs, it works for the professional athletes I work with and it works for the other very successful people I work with. Live with the mind frame, "Not dead. Can't quit."

CONNORS: Thank you, Richard. This is a great way to end.

CHAPTER 15

The Finale

We've come a long way from where we started. Early on, we learned over and over that it pays to be buying weakness and selling into strength. We learned that buying into extreme intra-day weakness increases edges and selling intra-day strength takes our edges and makes them even greater. We learned that the 2-period RSI may be one of the best indicators available for equity and ETF traders. We also learned two easy to understand strategies which have been correctly predicting the direction of the S&P 500 index greater than 80% of the time over a 13 year period of time. And, we learned that simple is always better when constructing trading strategies. The Double 7's proved this not only in the U.S. but also abroad.

We learned 5 different profitable strategies to time the stock market using popular indicators like the VIX and TRIN, along with the 2-period RSI and price. And every concept and strategy we looked at in this book has been quantified, in some cases, on millions of trades. Opinions are fine. But as many major growth industries, from professional sports to the fastest growing segments of the Internet have learned, statistics are better.

We learned that there are a handful of ways to properly exit our trades. We know it's just as important knowing how to get out as to get in. And then we spent well deserved time looking at what is the most powerful tool when it comes to your trading – the one thing that will ultimately dictate your success in trading and in life – your mind. Most of us will never be entrusted with the mission of body snatching a General from an army base in a hostile country. But it doesn't mean we can't learn and profit from the mind frame that is needed to execute at such extreme levels of stress. Trading can be stressful, but as Richard Machowicz has taught us, stress can be used to your advantage when you focus on your targets day in and day out.

Here in Summary are 16 Short Term Trading Strategies That Work

Strategy 1 – Buy pullbacks, not breakouts! The statistics overwhelmingly prove that out.

Strategy 2 – Buy the stock market after it has dropped multiple days in a row, not after it has risen.

Strategy 3 – Buy stocks above their 200-day moving average.

Strategy 4 – Buy stocks when the VIX is 5% or more above its 10-period moving average. Lock in gains (or short stocks) when the VIX is 5% or more below its 10-period moving average.

Strategy 5 – As you saw, stops are potentially an expensive form of insurance.

Strategy 6 – Hold positions overnight in times of concern. One has been amply rewarded doing so.

Strategy 7 – Buy stocks on intra-day pullbacks in order to increase the edges even more.

Strategy 8 – Apply the 2-period RSI to all of your trading. It's as close to the holy grail of indicators that's available to you.

Strategy 9 – Buy the market and stocks when the 2-period RSI is below 5.

Strategy 10 – Trade with Cumulative RSIs. The lower the Cumulative RSI, the better.

Strategy 11 – Trade Double 7's on U.S. and World Indices, and ETFs.

Strategy 12 – Time the market using the TRIN, the VIX, the 2-period RSI, and price as described in the Market Timing chapter.

Strategy 13 – Buy stocks at the end of the month, especially those that have dropped 1-2 days in a row.

Strategy 14 – There are many good exit strategies. The key is to make sure the ones you choose are dynamic. The best are the close above the 5-period moving average, and the RSI exits.

Strategy 15 – Have a plan in place to deal with the many realities of daily trading. Professional trading requires professional preparation.

Strategy 16 – The most important strategy begins with your mind. Your mind will dictate your success. The more focused you are on your targets, the more successful and profitable you will become.

I hope you enjoyed and will profit from the strategies and information in this book. Please feel free to email me with any comments or questions you may have at L.Connors@tradingmarkets.com.