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How to Take Profits, Cut Losses, and Benefit from Price Declines

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Expanded Second Edition

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To Inna Feldman,
the manager of elder.com
whose care, kindness, and integrity
have helped shape our company
for the past twelve years.

Contents

Introduction

There is a time to grow and a time to decline. A time to plant and a time to reap.

That cute puppy bouncing up and down in your living room will someday become an old, decrepit dog whom you will have to drive to the vet's office to put it out of its misery.

That stock you bought with such great hopes and which you enjoyed watching grow has now rolled over and is cutting into your capital instead of increasing it. It is high time to look for an exit.

Buying is fun. It grows out of hope, great expectations, a chest full of air. Selling is a hard, unsmiling business, like driving that poor old dog to the vet for its final injection. But sell you must.

And once you and I talk about selling—that essential reality at the end of every trade—we will not stop. We will talk about selling short. Amateurs don't know how to short and are afraid of it, but professionals love shorting and profit from declines.

Stocks go down much faster than they rise, and a trader who knows how to short doubles his opportunities. But before you sell short you must learn to sell and sell well.

So let us take off those rose-colored glasses and learn to sell.

WHY SELL?

The markets inhale and exhale. They get a full chest of air and push it out. They must fall just as certainly as they must rise.

To live happily in the markets, you need to get in gear with their rhythm. Any beginner buying stocks knows how to inhale. Knowing when to exhale—when to sell—will set you above the crowd.

We buy when we feel optimistic—or are afraid of missing a good thing. Perhaps you read a story about a new product or heard rumors of a merger. Maybe you ran a database scan or found a promising chart pattern on your screen. You go online or call your broker and place an order to buy. You receive a confirmation—you own the stock. Now the stress begins.

If the stock stays flat and goes nowhere, you feel restless. Did you pick the wrong one again? Other stocks are going up—should you sell yours?

A rising stock creates a different kind of anxiety. Should you take profits, add to your position, or do nothing? Doing nothing is quite hard, especially for men, who are told from childhood "Don't just stand there, do something!" When your stock drops, you feel pain—"I'll sell as soon as it comes back to even."

For many, the most psychologically comfortable position is a slight decline in their stock. It is not sharp enough to be painful, and with the stock near your entry price, there is probably not much reason to sell. No action is required, and you have the perfect excuse to do nothing.

Throw a frog into a pot of hot water and it will jump, but if you heat the frog slowly, you can cook it alive. Traders with no clear selling plans, holding a slowly sinking stock, can suffer a great deal of damage.

Stress is the enemy of good decision making. It is hard to be objective when our skin is on the line. This is why I urge you to write down a plan before you enter a trade. Your plan must list reasons for entering a trade and define three numbers: your entry price, a protective stop, and a profit target.

Make your decision to sell before you buy. This simple rule will allow you to use your intellect instead of some other point of your anatomy and then boil like some poor frog. You are likely to increase your profits, reduce losses, and improve your equity curve by writing down your selling plan before you buy.

Why do so few people do it?

Two reasons. First, most traders have never been taught what you have just read. Beginners and outsiders simply do not have this knowledge. The other reason is that people like to dream. A written plan cuts into their sweet daydreaming business. A vague fantasy of riches feels nice and comfy. Sitting up straight and writing down your specific goals and contingency plans takes away that happy fantasy.

Since you have picked up this book I'd like to think that you have chosen the pleasure of real profits over the sweetness of daydreaming. Welcome to the book, and let us move on to selling and selling short.

ABOUT THE Q&A

It feels exciting to discover an attractive stock and watch it go vertical after you buy. It is just as exciting to see it collapse soon after you short. This joy is only a small part of the game.

You can expect to spend the bulk of your time doing your homework. At times you might scan a long list of stocks and not find anything particularly attractive. At other times you may find a stock that you like, but your money management rules will not allow you to buy. You can put on a trade in moments but spend half an hour documenting it in your diary. The toil of homework takes up the bulk of a serious trader's time. Whoever said "success is 10% inspiration and 90% perspiration" must have come through Wall Street.

I created the questions and answers in this book to help you prepare for the road ahead. My goal was to point out some of the best opportunities, flag some of the worst risks, and get you into the habit of tracking your performance. I often say to my students, "Show me a trader with good records, and I will show you a good trader." I hope this will help you acquire the habit of asking hard questions, testing all ideas on your own data, and keeping good records.

I took great care in crafting the answers in the back of the book. I wanted to go beyond merely saying that A was right and B was wrong—I wanted to explain the reasons behind the answers.

Please do not rush through this book. Trading is a marathon, not a 100-yard dash. Take your time to think and work through a few questions each day. After you have worked through the answers and rated your performance, put it aside for two or three months, then pick it up again and retake the tests to see whether your grades have improved. Trading is like many other serious pursuits—the more you put into it, the more you will get out of it.

Trading is a lonely business, which is why I encourage traders to connect with others and share research and learning. Some of my students have become good friends. Now, by picking up this book and facing its hard questions, you have made the choice to face reality. I wish you success in your trading career.

Dr. Alexander Elder
New York City, 2011

PART ONE

PSYCHOLOGY, RISK MANAGEMENT, & RECORD-KEEPING

To be a successful trader you need an edge—a method of discovering opportunities and placing orders. An edge plus a lot of discipline will put you ahead of the pack.

A beginner has no plan and no edge. He hears different bells on different days and jumps in response to all of them. He may buy today after seeing a piece of news about earnings. He might sell tomorrow after seeing—more likely imagining—a head-and-shoulders top. This is the normal stage of initial ignorance. To move beyond it, to graduate to trading for a living, you need a clear concept for buying and selling. You need to define a trading plan that is fairly clear and bulletproof in order to enjoy a rising equity curve.

My own search for an edge led me to focus on the gap between price and value. Surprisingly few people are aware of it, although when I point it out on a chart they see it immediately.

The concept is quite simple: price and value are not the same. Price can be below value, above it, or equal to it. The distance between price and value may be large or small, increasing or decreasing.

Few technical traders ever think about the difference between price and value. Fundamental analysts are much more attuned to the idea, but they do not own it—technicians can use it as well.

Most buying decisions are based on the perception that price is below value. Traders buy when they think that some future event will increase the value of their trading vehicle.

It makes sense to buy below value and sell above value. To implement this idea, we need to answer three questions: How to define value? How to track its changes? How to measure the distance from price to value?

CHAPTER 1

On Buying

Trading requires confidence; but, paradoxically, it also demands humility. Since the markets are huge, there is no way you can master everything. Your knowledge can never be complete.

This is why we need to select an area of research and trading and specialize in it. Let's compare financial markets to medicine. Today's physician cannot be an expert in surgery, psychiatry, and pediatrics. Such universal expertise may have been possible centuries ago, but modern physicians must specialize.

THE THREE GREAT DIVIDES

A serious trader also needs to specialize. He must choose an area of research and trading that appeals to him or her. A trader needs to make several key choices:

- **Technical vs. Fundamental Analysis**

  Fundamental analysts of stocks study the values of listed companies. In the futures markets they explore the supply-demand equations for commodities. Technicians, by contrast, believe that the sum of knowledge about any stock or future is reflected in its price. Technicians study chart patterns and indicators to determine whether bulls or bears are winning the current round of the trading battle. Needless to say, there is some overlap between the two methods. Serious fundamentalists look at charts, while serious technicians like to have some idea about the fundamentals of the market they are trading.

- **Trend vs. Counter-Trend Trading**

  Almost every chart shows a mix of directional moves and choppy trading ranges. Powerful trends fascinate beginners: if you were to buy at a bottom, so clearly visible in the middle of the chart, and hold through the entire rally, you would make a ton of money. Experienced traders know that big trends, so clearly visible in the middle of a chart, become foggy near the right edge. Following a trend is like riding a wild horse that tries to shake you off at every turn. Trend trading is a lot harder than it seems.

  One of the very few scientifically proven facts about the markets is that they oscillate. Markets continuously swing between overvalued and undervalued levels. Counter-trend traders capitalize on this choppiness by trading against the extremes.

  Take a look at the chart in Figure 1.1, and the arguments for and against trend or counter-trend trading will leap at you from the page. You can easily recognize an uptrend from the lower left to the upper right corner. It seems appealing to buy and hold—until you realize that a trend is clear only in retrospect. If you had a long position, you'd be wondering every day, if not every hour, whether this uptrend was at an end. Sitting tight requires a great deal of mental work!

  Swing trading—buying below value and selling above value—has its own pluses and minuses. Trading shorter moves delivers thinner returns, but the trades tend to last just a few days. They require less patience and make you feel much more in control.

  In his brilliant book *Mechanical Trading Systems: Pairing Trader Psychology with Technical Analysis*, Richard Weissman draws a clear distinction between three types of traders: trend-followers, mean-reversal (counter-trend) traders, and day-traders. They have different temperaments, exploit different opportunities, and face different challenges.

  Most of us gravitate towards one of these trading styles without giving our decision much thought. It is much better to figure out who you are, what you like or dislike and trade accordingly.

- **Discretionary vs. Systematic Trading**

  A discretionary trader looks at a chart, reads and interprets its signals, then makes a decision to buy or sell short. He monitors his chart and at some point recognizes an exit signal, then places

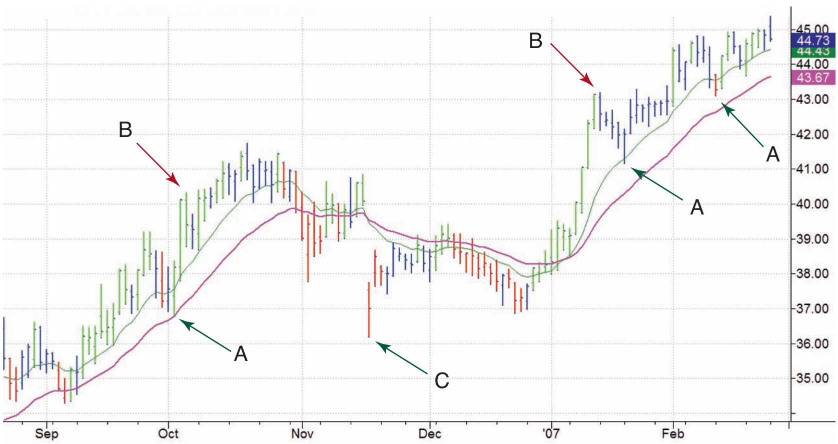

Figure 1.1 Moving Averages Identify Value
Daily chart of MW, 26-day and 13-day EMAs

A. Pullback to value in an uptrend—Buy!

B. Price far above value—Sell!

C. Price far below value—Buy!

The slow EMA (exponential moving average) rarely changes direction; its angle identifies the increase or the decrease of value. The faster EMA is more volatile. When prices dip into the zone between the two lines during an uptrend, they identify good buying opportunities. Prices are attached to values with a rubber band; you can see that prices almost always get only so far away from the EMA before they snap back. When a rubber band extends to the max, it warns you to expect a reversal of the latest move away from value.

an order to exit from his trade. Analyzing charts and making decisions is an exciting and engaging process for many of us.

A systematic trader cannot stand this degree of uncertainty. He does not want to keep making decisions every step of the way. He prefers to study historical data, design a system that would have performed well in the past, fine-tune it, and turn it on. Going forward, he lets his system track the market and generate buy and sell signals.

Systematic traders try to capitalize on repeating market patterns. The good ones know that while patterns repeat, they do not repeat perfectly. The most valuable quality of a good system is its robustness. We call a system robust when it continues to perform reasonably well even after market conditions change.

Both types of trading have a downside. The trouble with discretionary trading is that it seduces beginners into making impulsive decisions. On the other hand, a beginner attracted to systematic trading often falls into the sin of curve-fitting. He spends time polishing his backward-looking telescope until he has a system that would have worked perfectly in the past—if only the past repeated itself perfectly, which it almost never does.

I am attracted to the freedom of discretionary trading. I like to study broad indexes and industry groups and decide whether to trade from the long or short side. I work to establish entry and exit parameters, apply money management rules, determine the size of a trade, and finally place my order. There is a sense of thrill in monitoring the trade and making a decision to exit as planned, jump a little sooner, or hold a little longer.

The decision to be a discretionary or a systematic trader is rarely based on cost/benefit analysis. Most of us decide on the basis of our temperament. This is not different from deciding where to live, what education to pursue, and whether or whom to marry—we usually decide on the basis of emotion.

Paradoxically, at the top end of the performance scale there is a surprising degree of convergence between discretionary and systematic trading. A top-notch systematic trader keeps making what looks to me like discretionary decisions: when to activate System A, when to reduce funding of System B, when to add a new market or drop a market from the list. At the same time, a savvy discretionary trader has a number of firm rules that feel very systematic. For example, I will never enter a position against the weekly Impulse system, and you couldn't pay me to buy above the upper channel line or short below the lower channel line on a daily chart. The systematic and the discretionary approaches can be bridged—just don't try to change your method in the middle of an open trade.

Another key decision is whether to focus on stocks, futures, options or forex. You may want to specialize even further, by choosing a specific stock group or a few specific futures. Making a conscious decision will help you avoid flopping around, the way so many people do.

It is important to realize that in all of these choices there is no right or wrong way. What you select will depend primarily on your temperament, which is perfectly fine. Only greenhorns look down upon those who make different choices.

ONE TRADER'S TOOLBOX

In the first edition of this book, I dedicated an entire section to a description of my trading toolbox—its development and its current state. Some readers liked that, but many complained that they already had this information from my earlier books.[1] As a result, in this edition I decided to limit a discussion of the tools I use to a thumbnail sketch.

Looking at a day's bar or a candle on any chart, we see only five pieces of data: open, high, low, close and volume. A futures chart also includes open interest. This is why I have a rule of "five bullets to a clip"—allowing no more than five indicators on any given chart. You may use six if you desperately need an extra one, but never more than that. For myself, I do well with four: moving averages, envelopes, MACD and the Force Index.

You are not obligated to use the same four indicators. Please feel free to use others—only be sure to understand how they are constructed, what they measure, and what signals they give. Choose a handful of tools, and study them in depth until you become comfortable with them.

What about classical charting, with its head-and-shoulders tops, rectangles, diagonal trendlines, and so on? I believe that much of their alleged meaning lies in the eye of the beholder—traders draw lines on charts to confirm what they want to see.

[1]My methods and techniques are described in the following books:

Trading for a Living (1993) has a broad coverage of trading psychology and technical indicators. It introduces the Triple Screen trading system and the Force Index.

Come into My Trading Room (2002) covers psychology and technical analysis but stresses money management and trade planning. It introduces the Impulse system and SafeZone stops.

Entries & Exits (2006) features interviews with 16 traders who share both winning and losing trades. There are my comments on every trade; the album-sized book is printed in color.

If you are going to read only one of these books, I recommend *Come into My Trading Room*, but if you plan to learn more it is better to read them in the order shown above. All of these books also have study guides.

I am suspicious of classical charting because it is so subjective. I trust only the simplest patterns: support and resistance lines as well as breakouts and fingers, also known as kangaroo tails. I prefer computerized indicators because their signals are clear and not subject to multiple interpretations.

Many beginners have a childish faith in the power of technical analysis, often coupled with quite a bit of laziness. Each month I get e-mails from people asking for "the exact settings" of moving averages, MACD, and other indicators. Some say that they want to save time by taking my numbers and skipping research so that they could get right on to trading. Save the time on research! If you do not do your own research, where will you get the confidence to trust your tools during the inevitable drawdown periods?

I believe that successful trading is based on three M's—Mind, Method, and Money. Your Method—indicators and tools—is just one component of this equation. Equally important is the Mind—your trading psychology—and the Money, or risk control. All three are tied together through good record-keeping.

CHAPTER 2

Trading Psychology and Risk Management

What are your trading tools? You probably have a computer, some software packages, and a database. You probably visit several trading-related websites and may have a shelf of trading-related books. If you think that this is all, you are overlooking a hugely important trading instrument.

YOUR MIND AS A TRADING TOOL

Your emotions, hopes, and fears have a direct and immediate effect on your trading. What goes on inside your head has a greater influence on your success or failure than any technology.[1] Your decision-making process must be transparent and unbiased to enable you to learn from your experiences and become a better trader.

Trading psychology is discussed in all of my books, but especially in *Trading for a Living*. Let's touch on just a few key points:

- **Solitude is essential**
  When feeling stressed, we tend to huddle and imitate others. A successful trader makes his or her own decisions. You need to isolate yourself while you make and implement your own trading plans. This does not mean becoming a hermit. It is a good idea

[1] You can take a test to rate your current trading aptitude at www.spiketrade.com.

to network with other traders, but you should not talk about your trading plans while a trade is still open. Stay alone with your trade, learn all you can, make your own decisions, record your plans, and implement them in silence. You can discuss your trades with the people you trust after closing a trade. You need solitude to focus on open trades.

- **Treat yourself well**
  If your mind is a part of trading, you've got to treat it well. It only seems as though impulsive traders have fun—losers tend to be extremely harsh and shockingly abusive towards themselves. They keep breaking the rules and hitting themselves, breaking and hitting. Beating yourself will not make you a better trader. It is better to celebrate even partial achievements and soberly take stock of your shortcomings. In my own trading, I have a reward system for celebrating successful trades, but do not punish myself for losses.
- **Some traders are destined to fail**
  The markets produce endless temptations, which is why people with a history of poor impulse control are likely to lose in trading. Those who are actively drinking or using substances are highly unlikely to succeed. They may have a few lucky trades, but their long-term forecast is grim. If your drinking, eating, or other behavior is out of control, you are better off not trading until you resolve your addiction problem. Obsessional nit-pickers and greedy people who cannot tolerate losing a dime are also unlikely to do well in trading.
- **It is better not to trade when you are in a foul mood**
  Remember that even a good trader has only a very narrow edge. Anything that reduces that edge shifts the balance of power against you. Feeling calm, relaxed, and in a pleasant mood is extremely important for your success. If you have a severe toothache or if a problem with a spouse distracts you, you would be better off taking a break from the markets. If you feel preoccupied, stand aside until your personal stress clears up.
- **Successful traders love the game more than the profits**
  On Sundays, with my weekend homework completed and plans for the next week drawn up, it is a pleasure to anticipate Monday's opening. A surfer probably has a similar feeling at night, knowing