Chapter 1

The Big Picture
How Swing Trading Works

Everyone knows that big institutional investors such as mutual funds have a tremendous advantage over the individual investor—more money, better research, broad diversification. In some respects, however, you have an advantage over the big institutions. They cannot make decisions quickly in the market; pay attention to the subtle, short-term price gyrations that characterize market cycles; or watch only a few key stocks. The big institutions have to take a shotgun approach to investing, just because of their size.

You probably don't have millions of dollars in your portfolio and you don't have to answer to anyone else. This flexibility and mobility is your advantage; and this is where you can benefit from *swing trading* strategies. With swing trading, you operate within a very limited window, two to five days worth of activity in most cases.

swing trading
a strategy that involves two- to five-day market cycles and identifies high and low points in short-term cycles; and flags key points for moving in and out of stock positions based on specific chart pattern signals.

You will observe that stock price movement in the short term tends to react (or more specifically, to overreact) to each and every market event. This range of events includes trading volume, broader market activity, and all financial, economic and political news. Later in this chapter, this tendency of

efficient market hypothesis
the theory that pricing of stocks reflects all information currently known by investors at any given time, resulting in the conclusion that all stock prices are fair and reasonable.

random walk theory
a belief that all pricing of stocks is random, and that at any time there is a 50/50 chance that a stock's price will either rise or fall. This theory discounts the value of fundamental analysis and assumes that stock pricing is a battle between buyers and sellers for purely technical reasons.

stock prices is explained in the context of the three dominant emotions that literally rule the market: greed, fear and uncertainty.

Short-term price movement can be defined and anticipated in terms of these three emotions, and this is where you gain your swing trading advantage. Rather than making decisions based of greed, fear and uncertainty, swing trading is a technique based on logic and analysis rather than on emotion. An old adage about the market states that "bull and bears can make profits, but pigs and chickens cannot." This is entirely true. You can make profits in all types of markets, but only if you are able to see past the emotional reactions that govern the thinking of the majority.

In fact, those emotions largely determine and cause those short-term price changes in the market. The fact that short-term pricing is chaotic disproves the *efficient market hypothesis*, the belief that all pricing of stocks reflects everything that is publicly known at any given time. The reality proves that this is untrue.

The efficient market might exist on a different level. For example, the long-term averages of price movement may occur on some level of efficiency, but the two- to five-day movement of price is virtually caused completely by those three troubling emotions and their domination of market thinking.

So it is reasonable to believe that the efficient market hypothesis might be a valid theory over the long-term, but not in the short-term. The opposite is true of another market concept, the *random walk theory*. This is a more fatalistic view of the market. The random walk is a belief that at any given time, there is a 50/50 chance that a stock's price will rise or fall. The whole pricing of stocks is believed to be completely random.

The random walk accurately describes the two- to five-day tendency of stocks. Short-term pricing is obviously responsive to emotional overreaction and illogic. However, over the long term, an analysis of stock pricing

Key Point

Swing traders observe how emotions affect price, and act when those emotions exaggerate a trend to present a profit opportunity.

demonstrates a clear connection between strong fundamentals and strong price growth (or, on the other hand, weak fundamentals leading to price deterioration). So the two major theories can be quite instructive in understanding both short-term and long-term stock pricing:

1. The efficient market hypothesis makes sense but only over the long term. For the short-term pricing of stocks, there is no apparent efficiency involved; stock pricing changes due to emotional effects.
2. The random walk theory makes perfect sense in the two- to five-day window and perfectly describes the way that stocks behave. However, it is not so much a random event, but the outcome of a struggle between the greed and fear of investors (with uncertainty representing a stalemate between the two). However, over the long term, the random walk theory falls apart.

An Overview: The Basic Definitions

Any approach you take in the market will determine your success, of course. But there is a tendency among investors to believe that some systems are effective in ensuring consistent profits, and this is simply not true. Timing is the key to profits. While picking fundamentally strong stocks is essential, of course, it is timing more than anything else that determines whether your decisions create profits or losses.

Most people who buy shares of stock automatically assume that the price they pay is a “starting point” or the “zero base” of their investment. From that zero base price the stock is supposed to rise. But as everyone who has put money into stocks already knows, the stock’s price sometimes falls.

Key Point

Everyone tends to believe that their purchase price is the starting point in a stock's price. Realistically, though, it might be midway through a trend or at the trend's very peak.

fundamental analysis
the valuation of stocks based on a company's financial strength, earnings, and trends, including assessment of working capital, equity and debt capitalization, and operating results.

technical analysis
the study of stock price and volume trends, charts, and trading patterns, for the purpose of anticipating short-term price movement to time trades.

The system you employ to pick stocks may serve as your real starting point; the strategy you employ controls the timing for putting your strategy into place. This is the primary difference. It does not matter whether you are a believer in *fundamental analysis* or *technical analysis*. The rule remains the same: the method is used to isolate those stocks you want to trade, and the strategy controls the timing of your decision. Swing trading provides you with one effective strategy.

Swing traders use the timing of short-term trading patterns to take advantage of the tendencies of stock prices. These tendencies are to trade in brief waves (thus, the importance of the two- to five-day time span) in which stock prices rise and fall. After specific patterns and signals occur, a reversal often takes place and this is where swing trading becomes a powerful timing strategy.

The swing trader recognizes these patterns. After a stock's price has risen in a specific pattern (in the movement of the price, the price distance in a day's trading range, and the volume), the swing trader recognizes a sell signal. After the price falls in a specific pattern, the swing trader moves in and buys. This timing goes in opposition to the most recent price pattern, and is aimed at anticipating a reversal. The natural tendency for pricing is to operate in these short-term back-and-forth cycles. Because swing trading involves timing a trade in anticipation that prices are going to go the opposite, way, swing trading is a short-term form of *contrarian investing*.

Key Point

When investors respond to greed and fear, they tend to buy high and sell how. Swing traders are able to respond unemotionally, and achieve the opposite: Buy low and sell high.

contrarian investing
an approach to investing based on the assumption that the majority is more often wrong than right in its buy and sell decisions, and that timing will be improved by taking actions opposite the market as a whole.

Typically, traders tend to be reactive rather than contrarian. So when people see a stock moving up, they want to buy; and when they see it moving down, they want to sell. Swing traders, in comparison, are faithful to the best-known market advice: *Buy low and sell high.* The unfortunate truth is that the majority of investors do exactly the opposite. They buy when prices have moved higher out of greed, and they sell when prices fall, out of fear. Swing trading is a strategy for short-term trading that puts the concept of "buy low and sell high" into effect.

Contrarian investing in practice is far more complex than the timing of trades. The contrarian interprets both fundamental and technical signals in ways dissimilar to the common thinking seen in the market. Timing is only one aspect to the contrarian point of view; but for swing traders it is a critical point.

The struggle between "crowd mentality" of the market and the contrarian view extends as well to philosophies about which kind of data to employ for decisions. The fundamental view (adherence to recent historical financial results as the basis for making trades) and the technical view (based on price movement and patterns to anticipate the next move or series of moves) are not always at odds. Although swing trading is a purely technical strategy, it can be employed in a manner that combines both fundamental and technical indicators. The distinction should be kept clear: picking specific stocks is not the same as timing buy and sell decisions. With that in mind, you may consider using the fundamentals to pick a range of stocks you want to trade; and then use swing trading and other technical tools to actually time your decisions.

Too often, investors are asked to choose between fundamental and technical schools of thought. It makes more sense to use both. Both approaches may limit your view of what is occurring in the market; and both sides contain flows. Fundamentals are strictly historical and may be outdated by the time you need to make a decision. Technical indicators are invariably short-term in nature and short-term indicators are historically unreliable for long-term investing.

The lesson to learn from this is that both fundamental and technical sides are going to contain flaws, but both contain useful aspects. Either theory should be dependent on a study of trends, both short-term and long-term. The trend is the key to picking stocks and to timing buy and sell decisions.

Swing Trading, Day Trading, and Long-Term Hold Strategies

speculators
individuals willing to take greater than average risks in exchange for the opportunity for higher than average profits.

long-term hold
description of a strategy for portfolio management, involving selection of stocks with the intention of holding shares for many years in order to build a secure base for long-term growth.

There are many ways to invest in the market. The most conservative investors want low volatility and slow but steady growth; *speculators* welcome volatile stocks and the unsure future because such stocks exhibit broader price swings. A speculator welcomes higher risk in recognition of the inescapable relationship between risk and profit. With few exceptions, risk and profit are two sides of the same market coin.

The most conservative position within the market is selection of a company perceived to be safe. This normally means that capitalization is high; the company has been in business for many decades; and the company dominates its sector. Such companies have grown over the long term but only slowly and steadily. The conservative *long-term hold* is far from exciting, but it does create a solid, safe base for your portfolio.

On the opposite side of the risk spectrum is the highly speculative approach. People in this part of the market buy penny stocks, IPOs, and highly-volatile issues; trade options to achieve leverage; and may even

Key Point

Conservative investing is safer than high-risk; but it also offers far lower opportunities for profit. The elements of *risk* and *profit* are directly related and cannot be separated.

combine high-risk stock trades with index investments, commodities trading, and stock futures. These are very exotic forms of risk, and only those who thoroughly understand the market *and* the risks themselves should be involved. To a degree, swing traders may want to employ options as part of their strategy (this is explored in later chapters). But options can be employed in relatively safe ways to leverage money without exposing yourself to the possibility of huge losses. That is the distinction between a swing trader's use of instruments like options, versus pure speculation. A speculator intentionally exposes capital to the risk of loss, but a swing trader uses options to limit losses and to leverage capital.

day trader
an individual who executes trades within a single day or over the shortest possible time, often moving in and out of positions within a matter of hours and employing a high volume of trading activity.

Somewhere in between these extremes is the *day trader*. This is a trader who intentionally moves capital in and out of stock positions in the extreme short-term, usually within a single trading day. Day traders are also usually high-volume traders, executing numerous daily trades in more than one stock; or many trades in the same stock. If an individual buys and sells the same stock on very high volume (four times or more within five consecutive days), they are classified as a *pattern day trader* by the Securities and Exchange Commission (SEC) and are subject to special rules for cash held in a trading account.

pattern day trader
as defined by the SEC, any trader who buys or sells a single stock four or more times within five days; a pattern day trader must maintain no less than $25,000 account equity before a high volume of trading is permitted.

The swing trader is likely to belong closer to the side of the speculator than that of the conservative investor. This does not mean that swing trading is necessarily high-risk in comparison to other strategies. You can limit your capital exposure to swing trading, your volume of trades, and the number of stocks you swing trade—all to reduce overall risk or to limit your exposure. But in the spectrum of investing, everyone should be able to identify where a specific strategy belongs.

Any strategy may also be used in combination with other strategies with dissimilar risk characteristics. Diversifying by risk is a wise and effective way to manage your portfolio. For example, you may have the majority of your capital invested in your own home, certificates of deposit, and Blue Chip stocks; and use a relatively small portion of your capital for swing trading and other strategies.

The Swing Trade Approach: The Strategy in a Nutshell

The precise method of swing trading is going to vary among individuals. Everyone has their favorite variation on any strategy. If you have observed how people behave in the market, you also know that investors are at times ingenious, at other times irrational, emotional, or unrealistically hopeful. The "what if" factor is always present.

Swing trading is a process of fixing a series of "rules" that trigger a trade decision. It is based on the study of stock price patterns over a short period of time, the two- to five-day window. Because swing traders recognize that short-term price swings reflect investor emotions, they trade in a unique manner. Rather than trading the stock, swing traders time their decisions to trade the emotions that dominate the market. This does not mean that the stock's fundamentals are unimportant. In fact, a starting point should be to narrow a list of stocks you will swing trade, based on both fundamental and technical analysis. These may be at conflict to a degree. The purpose of using the fundamentals is not to find the safest stocks because these will not be good candidates for swing trading.

Key Point

The market is characterized by prevailing myths. The beliefs of many investors and traders are provably irrational in many cases, but continue to be widely believed. For example, there really is no "system" for creating 100% profits.

Key Point

It makes sense to be flexible. You might start out swing trading only to realize that a stock is a solid long-term hold. In that case, buying the stock makes sense ... and does not prevent you from continuing to swing trade in the stock as well.

The "ideal" stock is one with strong fundamentals (excellent management, long-term growth history, etc.) but with short-term volatile technical signals. This means, of course, that the trading range (the distance between typical high and low prices) is broader than the average stocks.

So swing traders need well managed companies whose stocks are somewhat volatile. This is a middle ground; many well managed companies experience short-term volatility because they are in the news; earnings are uncertain; or product news may cause the stock to rise or fall, or to do both in turn. So if you must define the ideal stock for swing trading, it would be one with strong long-term fundamentals and very volatile short-term technical signals.

The majority of investors are not well informed; and this is where you have the advantage as a swing trader. In the environment where greed and fear dominate decision-making, you are matched up against people who will be willing to buy stock from you at too high a price; or who will sell stock to you at a bargain price. You recognize these tendencies by tracking the daily chart patterns and identifying the turning points and reacting to the reversal signals you find through swing trading. As a swing trader, you benefit from the way that most people make decisions—impulsively, emotionally, and at the wrong time.

Most people buy when they should sell and sell when they should buy. Swing trading may be thought of a technique for trading emotions (or even trading people and their tendency to react with the emotions of greed and fear). In some respects, this means that it doesn't really matter which stocks you trade, because the technique applies to all stocks and to all short-term price trends. But because stocks are different, it remains a wise idea to identify a range of stocks by attribute that are best suited for (a) short-term swing trading based on an appropriate volatility level and (b) long-term safety based on strong fundamentals. This is sound advice because some swing traders decide to hold onto their stocks even when the original plan was to swing trade. If you are going to end up keeping some of the stock you buy, it should be high-quality stock from a long-term perspective.

Using the swing trading technique, you identify some very specific short-term trends. While day traders watch price movement moment to moment, swing traders normally base their timing decisions on end-of-day chart patterns. The two-to five-day window is based on the theory that a day's trends are revealing. This means that the opening and closing price, the trading range and the breadth of that range (distance from top to bottom price) are all important in executing a swing trade. For example, one day might have an opening and closing price close to the day's highest and lowest price levels; and another day might have very little gap between opening and closing price, but demonstrate a lot of action in between, with prices moving far above and below the actual open and close price levels.

uptrend
a movement in a stock's price to the upside; for swing traders, an uptrend is defined as three or more consecutive days in which the closing price was higher than the opening price.

downtrend
a movement in a stock's price to the downside; for swing traders, a downtrend is defined as three or more consecutive days in which the closing price was lower than the opening price.

A "swing" is a change in direction. So a stock that has been trending upward will swing to the downward, and vice versa. A swing trader uses the charting techniques involving open, close, and trading range to recognize when such swings are most likely to occur. Daily volume is also significant in the mix of signals that you will come to depend on in developing your swing trading strategy.

Within this short-term daily trend watching, the direction of each day's price movement is also important. By definition, a swing is most likely to occur when the open and close of the stock has been occurring in the same direction. This means that in an existing *uptrend*, the day's close should be higher than the open for at least three consecutive days before the trend can be relied upon to put a trade into action. And when the price trend is downward, by definition, a *downtrend* requires that for at least three days in a row, the closing price was lower than the opening price. So the overall *price range* of a day's history is not enough; the direction of price movement must confirm the apparent trend as well.

Key Point

There is a distinct difference between traditional market primary and secondary trends on the one hand, and very short-tern price trends on the other. Swing traders limit their analysis to a two- to five-day window.

The uptrend and downtrend used by swing traders are not the same as the more universally recognized market trends. Technicians track trends in stocks as well as various indices and these are well known. They also use moving averages of various configurations to signal or anticipate major uptrends and downtrends. The short-term trends described above and used in swing trading are entirely different.

price range
the overall range of a stock's price within a single day, from highest price attained down to lowest price, and distinct from opening and closing prices.

This explains as well why swing traders usually stick to the complete trend of a single trading day. When you first consider this guideline, it does not appear to make sense. A valid question may be, "Shouldn't the decision be made when trading patterns are met rather than at the end of a trading day?" The answer, of course, is that any strategy should be as flexible as you need it to be. There is no hard-and-fast *requirement* that trading occur only when a day's trading has been completed. However, swing traders have discovered that while their timing of trades may be flexible, the complete day is most revealing. Patterns emerge during a trading day based on the time of day and overall direction of the market. Many technicians, for example, give great importance to trends established in the first hour, or the first two hours. A specific stock's final hours of trading may be largely influenced by overall market trends on the day.

In order to establish the trend for purposes of swing trading, the full day is considered the template and also makes comparisons uniform. This is always useful in any type of price analysis. In addition, another important type of signal may be found between the close of one day and the open of the next day. Swing traders, like many other technicians, are likely to assign importance when price changes between the two days show large gaps, or when a low-volume day is followed by a high-volume day. These are examples of the kind of changes occurring between days that will be viewed as important to swing traders, and it further supports the belief that to establish the two- to five-day window to identify a swing trading opportunity, you need to have the complete day and not just hour-to-hour change. A day trader is inclined toward recognizing and grabbing profitable opportunities as they occur, but day trading is a far less sophisticated market strategy than swing trading. So while some traders may prefer the excitement of continually watching a stock's price during the day, swing traders employ a more methodical system.

Chapters 3 and 4 provide you with a far more detailed explanation of the exact signals and methods of finding them. The purpose here is to provide you with an overview of how swing trading works and how you can use short-term trends to zero in on profit opportunities.

The basic swing trading rule is to act after three or more consistent signals occur. When the price has been moving to the upside, the signal is to sell; and when price has been moving to the downside, the signal is to buy. Remember, the *swing* is the key. The theory of swing trading is based on the belief that short-term price change occurs in predictable rhythms and cycles. Upward movement is followed by downward movement in these short-term trends, and vice versa.

There are several attributes required in order for these "rules" of swing trading to go into effect. These are:

1. *Recognize an uptrend.* A true two-to five-day trend consists of a specific pattern in opening and closing prices. In an uptrend, each day should exhibit a series of higher highs, offset by a series of higher lows. So each day's price passes the previous day's peak on the upside; and each drop is less than the previous day. Figure 1.1 illustrates this principle on a simplified line graph; note that the trend lines for both high and low price levels conforms to the uptrend rule.
2. *Recognize a downtrend.* The downtrend also develops over a two- to five-day period. But it is characterized by a series of lower highs and lower lows. So each day's high will be lower than the previous day; and each day's low is lower than the previous day. The swing trading downtrend is shown in Figure 1.2. This figure shows the swing trading downtrend; the high prices are progressively lower each day, and the offsetting low prices are lower as well.

Key Point

Swing trading is so called because of the tendency for price to swing back and forth in a two- to five-day window. This occurs because day-to-day trading is dominated by emotion.

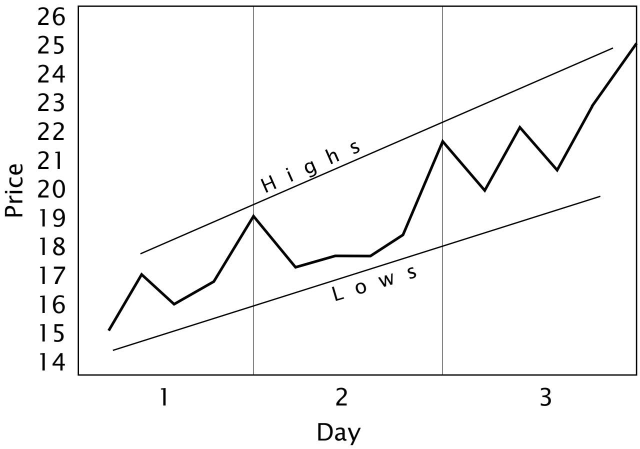

FIGURE 1.1 The Uptrend

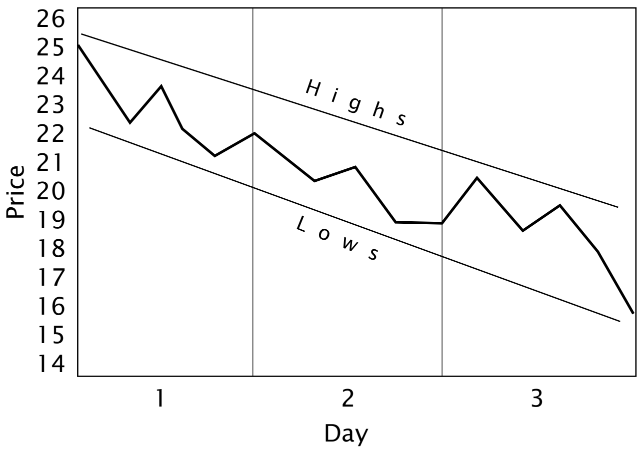

FIGURE 1.2 The Downtrend

setup
a signal to act in a swing trade pattern; the setup at the top of an uptrend is a sell signal, the setup at the bottom of a downtrend is a buy signal.

narrow range day
a day in which the high-to-low price of a day is much smaller than the typical day, and when it occurs after three or more established trend day patterns.

3. *Identify a setup.* The *setup* is a signal that it is time to take action. The setup at the top of the two-to five-day uptrend is a sell signal. And the setup at the end of a two- to five-day downtrend is a buy signal. In other words, the swing trade is premised on the idea that these specific signals can be used to time decisions and to profit from the cyclical swings in price.

4. *Look for the narrow range day.* All signals are stronger when they are confirmed. The *narrow range day* is a day in which the distance from high to low price is much smaller than preceding "typical trading ranges. For example, if a stock has been trading in a range of two to three points and the two- to five-day trend is established, a narrow range day at the end of the established trend is a strong confirming signal.

   Remember that the narrow range day pattern is important only after a substantial price move. A typical narrow range day at the end of a downtrend is a strong buy signal. This is illustrated in Figure 1.3.

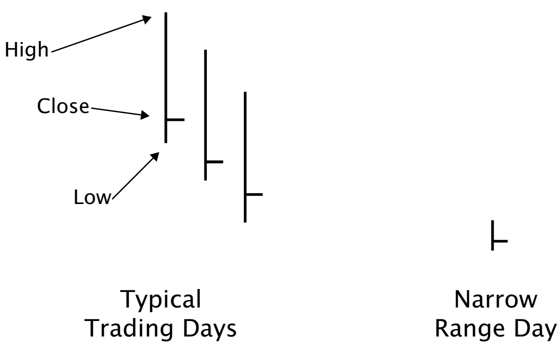

FIGURE 1.3 Typical Trading Days and Narrow Range Day

Key Point

No single indicator should be used alone for timing trades. The principle of confirmation makes sense and is a valuable way to combine different types of information to time your trades.

5. *Keep an eye on changes in volume.* Stocks tend to trade with "typical" daily volume, but when that level changes it often signals a change in the interaction between buyers and sellers. For swing trading, an exceptionally high-volume day *accompanied by a narrow range day* is a strong signal to act. So when the breadth of trading narrows and volume increases substantially, that signals that the established trend is probably on the verge of reversing.

These signals should be used in conjunction with one another. When a two-to five-day uptrend has been established, look for the setup. *Confirmation* is a very important concept in swing trading: when you are able to confirm the trend with a setup, you have an exceptionally strong buy or sell signal. The confirming indicators are a narrow range day and increased trading volume. When you see both of these together, you have exceptionally strong confirmation that it is time to act (to sell after the uptrend or to buy after the downtrend).

confirmation
a signal that provides additional indication to another signal, that reinforces the indicated timing of a buy or sell move.

The Theory of Chart-Watching

There are two general schools of thought about how to pick stocks and time buy and sell decisions. The fundamental school relies on financial reports and trends and the technical school of thought bases these decisions on price.

Key Point

There is no reason to shun one type of analysis and favor the other. You can gain valuable insight from both fundamental and technical analysis.

OHLC chart
a type of stock chart summarizing the open, high, low, and close for a day using a single vertical line and two horizontal tabs. The top of the vertical line is the line and the bottom is the low; the left tab is the day's opening price and the right tab is the day's closing price.

While both points of view have merit, it makes sense to use not one or the other, but both in tandem. Swing trading is a technical strategy, but the stocks you pick to use for swing trading may be selected based on fundamental strength. To the extent that you are going to rely on technical signals, you will use charts as a primary timing tool. Investors use many different kinds of charts, the most popular being the *OHLC chart*. This consists of a vertical line extending from the high to low price for a day; and two horizontal tabs. The one appearing to the left is the day's opening price, and the one to the right is the day's closing price. This type of charting tool is illustrated in Figure 1-4.

point-and-figure chart
a stock chart reflecting rising prices with columns of Xs extending from high to low price; and columns of stack's Xs. This chart does not distinguish trading days, only trends.

The OHLC chart is popular because using only three lines, it conveys the essential information about activity over a period of time. This is efficient. A more obscure chart is the *point- and-figure chart*. This consists of stacks of Xs and Os without any regard for the time involved. The Xs are shown when the price rose, and the Os when the price fell. This chart gives technicians a quick view of trading range trends, but for most investors it is not as easy to use as the OHLC chart.

Time is usually important to traders in order to make sound judgments for their stock decisions; for this reason, the point and figure chart provides a particular kind of information for some purposes, but is not as valuable as the OHLC. Today's charting services invariably include a *moving average* as

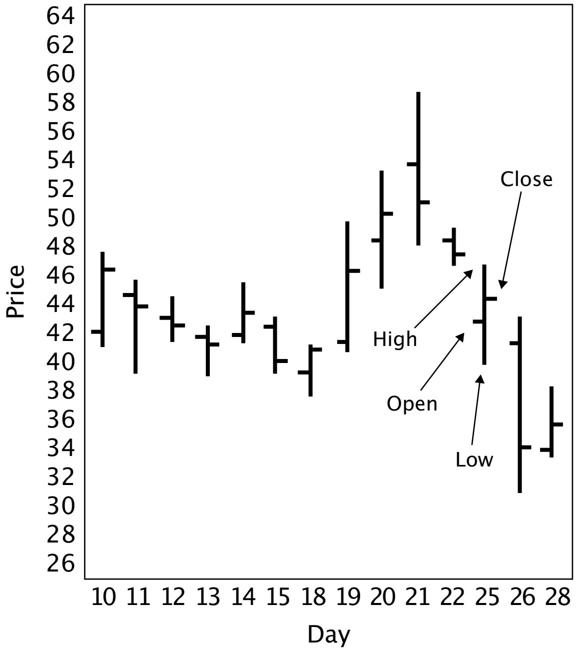

FIGURE 1.4 The OHLC Chart

well as daily changes in the stock's price. In addition to showing the important open, high, low and close price points, charts also include one or more moving average lines. The most popular are 200-day and 50-day moving averages. These do away with the distractions of short-term volatility and show how a stock's price has evolved over time.

> **moving average**
> a statistical method of showing a trend that is representative of changes without short-term volatility. The average is computed by adding up the fields in the period, and then dividing by the number of trading days.

A final type of chart, and one used in coming chapters in this book, is the candlestick chart. This descriptive term is given because each day's trading has a body that is either white or black, with vertical lines extending above and below the main body. This type of chart was developed in 18th Century Japan to track rice prices. In the 20th Century, U.S. technical analysts and chartists began to recognize the value of candlesticks for tracking the OHLC but also to get an immediate picture of whether a trend is moving upward or downward. Chapter three explains candlesticks in detail.

Key Point

Charts display the short-term tendency of prices to swing back and forth. These trends are not erratic or random; they reflect visually the dominate market forces of greed, fear and uncertainty.

Charts all summarize the flow and pattern to a stock's price cycles, both short-term and long-term. There is a natural rhythm to price trends that reflects the interaction between buyers and sellers *and* the dominance of one of the three market emotions: greed, fear and uncertainty.

Technicians may consider themselves to be *chartists*, people who rely on specific price patterns to predict the next direction of a stock's price. Chapter two explores the many popular charting signals and explains how to recognize them. The chartist tends to believe that fundamental analysis has limited value because it is historical and does not affect the forces of supply and demand that determine price movement. Some chartists acknowledge that long-term trends are dominated by fundamental strength or weakness of a company, but rely on chart price patterns for the short term.

chartists
technical analysts who rely primarily on recognition of specific price patterns and short-term trends to predict and anticipate the next price direction in a stock's price.

There are both pro and con arguments concerning taking the chartist's approach. On the positive side, the pattern of price movement does contain a specific predictability. This is not the same as a guarantee, but there is a tendency for price to move in a pattern. Swing trading is a typical charting strategy because it is designed to observe and predict price movement. When prices move in one direction and in specific ways for three or more trading days, the tendency is for price to then reverse and go in the opposite direction. Because you cannot know how many periods a trend involves, swing traders look for reversal signals in order to time their decisions.

Key Point

No investment decisions should be made in isolation. Fundamental information is not merely historical; it also indicates whether a company is financially sound—or even solvent—today.

Chartists believe that buyers and sellers continually interact. When a stock's price rises far enough, current owners want to sell to take profits; and that causes the price to fall. When price falls far enough, the stock becomes a bargain so new buyers place orders. The outcome of this never-ending interaction is the two- to five-day wave action of stocks.

On the negative side, charting is focused only on price and volume and those who track price movement may ignore fundamental news. This is a mistake. For example, in spite of how a stock's price patterns evolve, when a company misses a deadline for filing a financial report that is a danger signal. For example, in October 2005 Krispy Kreme (the doughnut chain) stock fell below $6 per share and the stock chart may have looked to some chartists like a buying opportunity. But something more profound was going on. The company had missed its filing deadline with the SEC and it was disclosed that improper accounting practices had been in place for several years. The company's stock recovered somewhat by late 2006 but continued to report quarterly losses. In this situation—where profound fundamental problems were evident—relying strictly on chart patterns would have been a mistake.

Chartists do better when they combine fundamental and technical signals. You may use charts as a primary timing mechanism for short-term swing trading; but selection of stocks for this play should be made based on at least a preliminary review of fundamental issues:

- Is the company solvent?
- Has a profit been reported (recently or, more significantly, ever)?
- How much debt is the company carrying?
- Does the company compete well within its industry sector?

Even without looking at a financial statement, you can learn a lot just by reading the recent headlines. Online brokerage services provide news for each company. For example, if you research Krispy Kreme (KKD) on Charles Schwab & Company's brokerage service—*https://investing.schwab.com*—you find the stock price, reports of rating services, comparative price performance data, and recent news headlines. Obviously, using both fundamental and technical information provides fast and reliable information, and vastly improves a chartist's information base.

The Primary Emotions: Fear, Greed and Uncertainty

Chartists employing a variety of strategies will usually agree on one premise: Short-term price movement is predictable most of the time. Some chartists depend entirely on some specific patterns and tests within a price pattern. Others, like swing traders, believe that the cornerstone of the strategy is the three-part emotional trend that rules how most of the market works. So greed, fear and uncertainty determine price patterns and make it easier to time and predict price movement.

Some swing traders describe the strategy as one that trades emotions, not stocks. But this is not entirely true. A wise trader will always be aware that stock selection is key to a smart program, so a starting point should be to pick stocks that are going to act and react to the normal market forces. If you pick a distressed stock (such as that Krispy Kreme in 2005) or a stock that has risen in value beyond any fundamental explanation (like Amazon.com or eBay in the recent past), you cannot rely on the normal cyclical patterns of short-term charting; so those situations may not provide reliable signals either. Later in this book, you will find guidelines for picking stocks for swing trading.

Once you have limited your range of potential swing trading stocks, the timing of trades can be based on the three emotions that rule the market. Market observers and the financial news media like to give names to these emotional trends other than the raw emotional names. When greed is in control, it is called a *rally*. When fear dominates and prices begin to fall, it is called a *correction*. And when a period of uncertainty is dominant, that is referred to as a period of *consolidation*. The three market conditions are summarized in Figure 1.5.

rally
a period when prices are rising, also known as a condition where greed dominates the market.

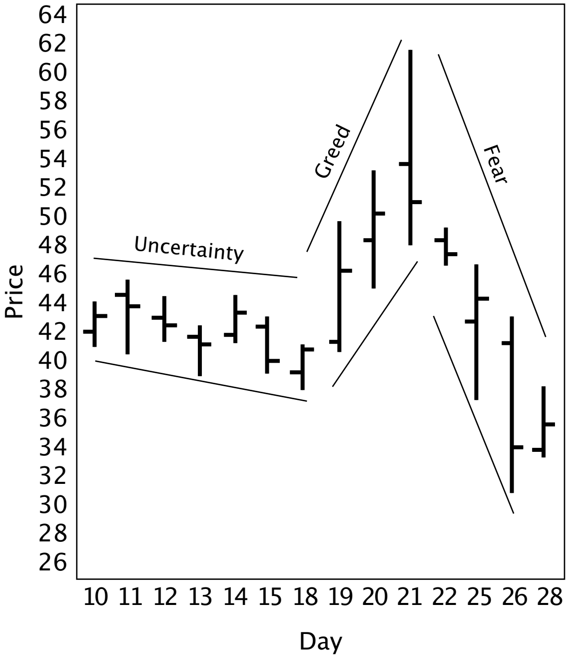

FIGURE 1.5 Emotions and the Market

The consolidation period—when uncertainty rules—is sometimes described by analysts as a time of "agreement." In other words, under this interpretation, the current price range is agreeable to both sellers and buyers. This is inaccurate. It is not a time of agreement at all, but rather a time when neither buyers nor sellers dominate the market. During periods of uncertainty, the buying and selling activity tends to be well matched, so that no changes in supply or demand are evident. There is no agreement at all; both sides have no idea where the stock's price is going to go next.

In all three market conditions—characterized by the emotions of greed, fear and uncertainty—one fact remains constant: most traders do not learn from their past mistakes. Logically, everyone knows that no direction remains forever. When a stock's price begins to rise, there is going to be a limit but greed ignores this. When the price is

correction
the description of a market in which prices are falling, when the emotion of fear dominates the market.

consolidation
a time when price is not moving upward or downward, but remaining within a narrow trading range; a market dominated by uncertainty.

Key Point

The market likes to give exciting names to upward-trending prices, and to soften downward-trending prices. Thus you hear about a rally (up market) versus profit-taking (down market); or enthusiasm (up market) versus caution (down market).

falling, it cannot fall forever and at some point shares drop to a bargain price level, but fear ignores that fact. And when uncertainty rules the market (even if for only a few days) traders tend to become impatient. They either lose interest in the stock or make an uninformed decision which is likely to be wrong at least 50 percent of the time. So holders will sell right before prices rise at the end of the uncertainty, or they buy right before prices fall. These actions occur because traders act impulsively and emotionally. So with this in mind, you may add a fourth emotion: impatience. The impatient investor acts too quickly and makes a lot of timing mistakes.

Swing traders manage their emotions and simply observe the interaction between the emotions of other traders and market prices. This contrarian approach is more sophisticated than the common definition. A swing trading contrarian does not simply buy when most people are selling and vice verse; the more advanced version involves making decisions contrary to the dominant emotion of the moment. When prices peak in a frenzy of greed, the swing trader looks for the sell signal. When prices fall rapidly in the ravages of fear, the swing trader remains calm and looks for the signal that the price has bottomed out. When uncertainty is the dominant emotion, swing traders resist the temptation to "do something" and remain patient until a signal emerges.

Before delving into more about specific swing trading examples, you need to review the basic rules of technical analysis and chart interpretation. The next chapter goes through these basics as a building block to turning swing trading into a powerful market tool.