CHAPTER 1

Let's Get Started

Before we get to all the details, we are going to look at a couple of trades in the first two chapters. From them you will get a good idea where we are heading, and how we are going to get there. You may even be ready to get your feet wet with some actual trading. Later you will be able to fill in the details, but it is necessary to first get a feel for the overall methodology.

HOW THE BEGINNING OF THE BOOK IS STRUCTURED

Chapter 1 offers an example of a buy; Chapter 2 analyzes a short sale. You are not going to understand all of the intricacies of the trades unless you are already thoroughly familiar with the methodology. With that in mind, what I have done is insert, just in these two chapters, references to other chapters.

This is how the references look in Chapters 1 and 2.

Please read through these two chapters *at least* once without going to the other referenced chapters. Then, if you want, you can browse through the chapters or you can read them in order. Some later chapters are not referenced at all in these first chapters, although they do contain important information (particularly the chapters on forecasting market direction, since market direction can have a very big effect on trading results). Investment decisions are affected by the direction of the overall market, so be sure that you go to those chapters at some point.

Computer manufacturers have found that the buyers almost never have the patience to read through an owner's manual before hooking up, plugging in, turning on the computer, and stumbling around without knowing what they are doing. The manufacturers have therefore inserted quick-start guides. These one or two pages are enough to keep new computer owners from getting into too much trouble. Later the users are likely to go to the owner's manual and fill in the gaps in their knowledge. These two chapters are the quick-start guide for successful trading using the Equivolume methodology and the trading techniques that go with it. If you just can't stand to wait and want to fire up the charting program, follow the examples in these two chapters, and start to trade, this quick-start guide will probably keep you out of deep trouble. Then, if you run into problems or questions, you can go to the referenced chapters to get more information. But the rest of the book is the owner's manual. If you want to do it right, you are going to need to eventually read it all.

Chapters 20 to 23 deal with determining market direction.

A WINNING TRADE

What a great trade! You did everything right. You bought the stock just before the move got going, you held it through the entire advance, and then you sold it right near the top. All the way up you were protected by a stop order so you didn't have to lie awake worrying about the position. You didn't let greed get the best of you, so you didn't sell after the initial advance; you waited for the move to run its course. You had an objective, and it worked. It took six months, but the stock moved from 24 to 37. That's 54 percent in six months. If you could do that twice a year and you let the profits build, you would turn each $10,000 you started with into over $23,700 in the first year. In 10 years, at that rate, your $10,000 would grow to over $56 million!

It's a great feeling, and it sometimes happens. But often it doesn't go quite that way. Often you get out with a loss. Sometimes you take a small profit and leave a big one on the table. Occasionally you change your mind and get out because of a news item. But more often you decline to take a position in the first place because of the news background. There are times when you would have bought the stock, but the market seemed too risky. There are other times when you moved in too soon, thinking the stock just couldn't go any lower. There are times when you bought too late, because you didn't want to take too much risk.

In other words, a great trade does not happen often enough, and when it does, a great deal of the reason for your success may be just luck. In the pages that follow, you will be finding out why some of your trades worked so well and putting rules to your trading that you will make the big successes more frequent, and the losses smaller and less frequent.

To do this we will first pull apart and inspect each move in an ideal success story. We will try to put rules to the trading that will tend to capitalize upon the things that work. We will try to find the pitfalls that need to be avoided.

GENERAL MOTORS IN 2006

First, let's look at the success story alluded to earlier. In the early months of 2006 General Motors appeared to be the most hated stock on Wall Street. No one had anything good to say about it. The company was having massive troubles. The news media were full of negative stories about the company. You had to be either insane or a technician to buy the stock, or so it seemed. But there was obviously some buying that was going on, and any technician would have had to be aware of it. Evidently, in spite of the news, someone was accumulating the stock in a big way.

For information on how to use and not use the news, see Chapter 3. For reasons for using technical analysis, also see Chapter 3.

In early May, at the last entry on the chart shown in Figure 1.1, General Motors had been in a sideways move for about six months. After making a low in late December of 2005 it held well, making numerous attempts to rally but being repeatedly turned back. But the point is that it was not going lower in spite of the negative press and the gloom on

FIGURE 1.1 Bar Chart of General Motors.

the street. The reason it was not going lower was simply that there were buyers willing to soak up all offered stock when the price got down around the $19 level. But there were also aggressive sellers willing to lose stock any time the price got up around $24 or $25. The buyers did not yet have the upper hand, but neither did the sellers, hence the six-month period of consolidation.

Figure 1.1 is a bar chart. Each vertical line represents one day of trading. The top of each posting is the high of the day, and the bottom is the low of the day. The price scale is shown on the right-hand side of the chart, and is an arithmetic scale in this case. Volume is shown as a histogram across the bottom of the chart. This is the traditional way of graphing stock action, and it is useful and effective. But we will henceforth be looking at and using a method I believe is more informative. It is called Equivolume charting.

To learn about the construction of Equivolume charts, read Chapter 5.

Figure 1.2 is an Equivolume chart. It looks at General Motors over the same time frame as the bar chart shown first. In this methodology, the volume has been brought up off the lower margin and been included in the price plot. Therefore, each day is represented as a box. The high and low are the same as the high and the low on the bar chart, but the width of the box indicates the volume. The wider the box, the heavier the volume. It also means that the shape of the box is an accurate picture of the balance of fear and greed in the stock on that day. We are not seeing any new information. We are

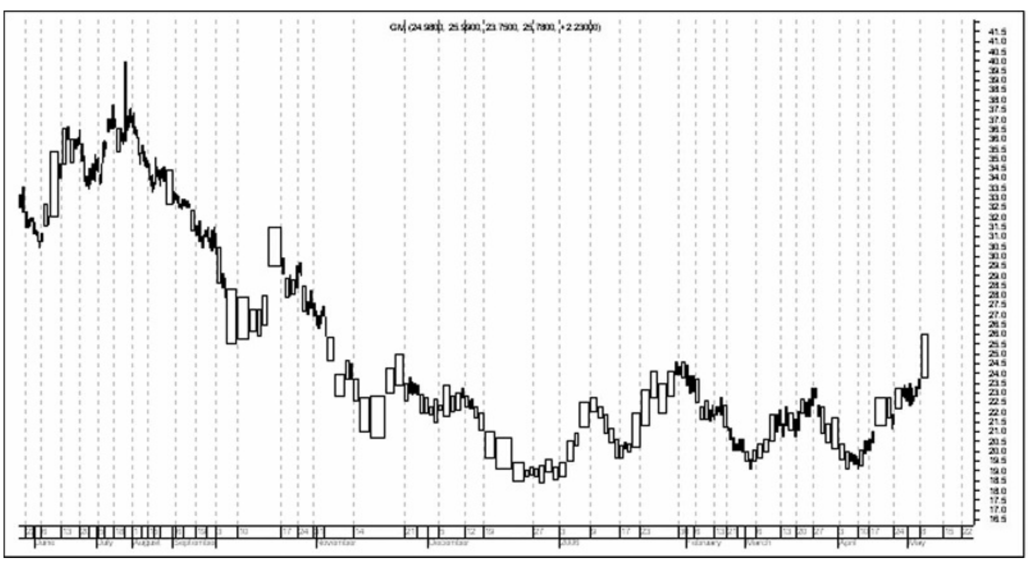

FIGURE 1.2 Equivolume Chart of General Motors.

just looking at the same information in a different way. By including the volume in the price plot we are getting a different picture of the data, and one that is more informative.

Now we have a different picture of that consolidation area we noticed on the bar chart.

Chapters 8 and 13 to 18 cover the interpretation of Equivolume charts.

The most important thing that immediately comes to our attention, or should, is the width of the various Equivolume entries. We are able to immediately ascertain where the volume is occurring. Notice that the wide boxes were mostly on the down days in the months leading up to the end of the year. Heavy volume on the down days indicated the stock was under distribution. But then something seemed to change. In early January, and on every rally thereafter, volume expanded, and on every pullback volume tended to decrease. The serious investors in the marketplace had inadvertently tipped their hand, and we saw, by looking at the volume, the strategy of their game. They were moving in and buying the stock until they drove it to the top of the range, and then they backed away and waited for another opportunity. The pullbacks were on lighter volume, because the big buyers had gone to the sidelines.

At the time of the last entry on this chart, though, there has been another change. The top of the consolidation, the six months of directionless trading, has been decisively penetrated. We have what I like to call a power box.

See Chapter 8 to learn about power boxes.

Both volume and trading range have become larger as the level of resistance has been broken. That resistance is the top of the consolidation area we have been watching. It is the level at which the buyers have moved to the sidelines in previous rallies. Now, though, the buyers have kept on going and have broken the stock out of the consolidation. It is an unequivocal sign of strength.

Chapter 16 illustrates support and resistance levels.

Looking more closely, there is much more information to be gleaned from Figure 1.3, which shows a number of trend lines, support and resistance levels, and volume signals. Had we been watching this stock back at the first of the year, we would have been aware of the first sign of strength. It was enough to break the descending trend line and suggest a change of direction. Volume was heavier, and the stock even left a small gap behind as it moved away from the very narrow base formed in the waning days of the prior year.

Gaps are explained in Chapter 13.

One might have decided at that point to buy the stock. The problem, though, was the very narrow base. If the market could be thought of as controlled by causes and effects, the narrow base provided very little cause, so we could not anticipate a very large effect.

FIGURE 1.3 Annotated Equivolume Chart.

In other words, it looked as though a move upward would be small and brief. Of course, if our intention was to trade each small move, we might have been inclined to move in on the stock.

Chapter 7 helps in ascertaining what wave pattern to trade.

But assuming we had already decided we were looking for the more lasting moves, the narrowness of the base would have kept us on the sidelines. Even the second move up on volume would have been met with skepticism, in that it did nothing more than fulfill the objective implied by that narrow base. The width of a base often indicates how far a move will go.

Price objectives and their measurement are covered in Chapter 18.

As the various swings built the wider base, we could see that some very regular support and resistance levels were being established. It is interesting to note that the first rally established a level of resistance that was visited again later. Then it held the stock back again for a few days before the power box that has become our focus. This important level is marked as the lower of the two resistance lines. The pullbacks also established a zone of support, so we ended up with a very well defined trading zone. A breakout through the top of that zone would suggest that it was a zone of accumulation, and a cause for a more lasting effect.

Chapter 18 provides a discussion of accumulation and distribution.

Now it looked as though it was time to buy the stock. But wait, we know that most of the time a breakout is followed by a pullback before the move really gets going. Do we want to jump in at this price, or do we want to try to buy it at a better price after a pullback? Perhaps the best way is to watch for the pullback, and buy just as soon as the advance resumes. A buy stop order can accomplish that.

Chapter 10 explains using a stop order to get into a position.

THE MECHANICS OF BUYING

The next question needs to be: How many shares? Also, you need to decide whether to buy your entire position now or just nibble, with the idea of adding more later if you are right.

Chapter 6 deals with how much money you are going to need. Chapter 12 considers whether to get in all at once or in stages.

There are a few new pieces of information included on Figure 1.4. At the top of the chart is a line labeled Ease of Movement. It is a measurement of just that: how easy or hard is it for a stock to move up or down. Notice that it tends to be above the zero line during advances and below the zero line during declines. At the time of the chart the

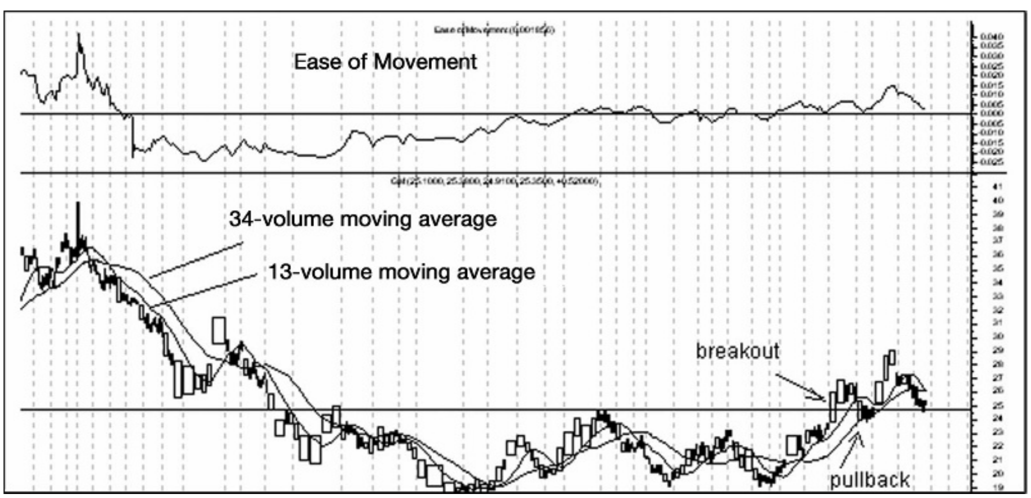

FIGURE 1.4 Other Analytical Tools.

Ease of Movement had crossed into plus territory enough to suggest the stock might be commencing an advance.

Chapter 19 explains the calculation and interpretation of Ease of Movement.

Overlying the prices are a pair of lines that are volume-adjusted moving averages. They are much like traditional moving averages, but they conform to the concepts of Equivolume, which say that heavier volume is more important than lighter volume. The parameters can be changed, but in this case I am using the 13-volume and the 34-volume moving averages. More on that later.

Volume-adjusted moving averages, their construction and interpretation, are explained in Chapter 19.

Notice that the two lines tend to cross one another, with the more volatile line being above the less volatile line during short-term advances, and below it during declines. At the time of this chart they are just going negative; that is, the more volatile line has gone below the less volatile one, after being the other way for the entire advance of about six weeks.

But we were just in the process of buying some of the stock. Let's take a closer look at that buying process. In Figure 1.5, I asked the computer to enlarge the data.

It would have been good to buy the stock earlier, on the first sign of strength, say, right after the first of the three gaps pointed out on the chart. But there were two problems. One was the fact that the stock had not broken out. It was, in fact, approaching

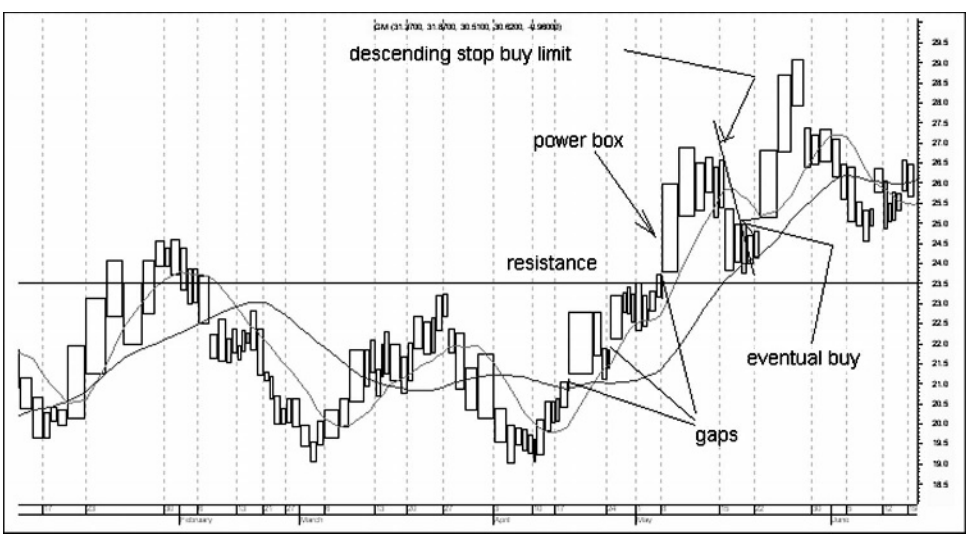

FIGURE 1.5 The Buying Process.

the old resistance level, which had a long history of turning the stock back down. The second was the shape of the box after the gap. It was so square as to suggest sellers were lying in wait just above that level. It made the gap look suspiciously like an exhaustion gap rather than a breakaway gap.

Box sizes and shapes are explained in Chapter 5. Gaps are wonderful indicators (see Chapter 13).

A week later there was another move that might have been tempting. Again there was a gap, and again volume increased. Moreover, the box shape indicated less difficulty in moving the price. However, there was still no powerful move through a resistance level, no breakout. In retrospect it would have gotten us into a winner earlier, but at the time we did not know it was going to break out.

In Chapter 4 we talk about anticipation and its pitfalls.

Two weeks elapse before we are again brought to attention by the action of the stock. Again it leaves a small gap behind, and again volume becomes very heavy. Moreover, it has wide trading range—it is a tall Equivolume box. But the most important feature of the day is that it penetrates the top of the consolidation area, and it does so decisively. It is not a small penetration on light volume, which would be suspect. It shows us power and determination. This looks like a strong indication to buy the stock.

But where do we buy it? If we were watching it very closely during the trading day we might have been aware that it was breaking out, that volume was increasing, and that the range was starting to expand. If so, we might have bought at least a partial position somewhere below the high of the day. It is more likely, though, that we would buy it the next day, after seeing the complete data for the breakout day. As noted earlier, by doing so we would be ignoring the fact that most breakouts are followed by a lighter-volume pullback before continuing higher.

Usually it pays to wait and see if a stock is going to pull back some before buying. I like to see a pullback and then the start of a new strengthening as a signal to buy. It is a more conservative approach that means sometimes missing opportunities, but it also helps to get a better price on many trades. The best approach would have been to follow the stock down as it pulled back, with a stop buy order just above the highs. Then, as soon as it turned up it would be bought. The number of shares is, of course, a function of how much money we are using in the account, and what part of it we are going to put in any single situation

Account size is discussed in Chapter 9. Size of trades and allocations to each issue are also discussed in Chapter 9.

We might even put on a second position on the pullback after the next advance. By stair stepping into a stock, we are changing from just a single position trade to a campaign. We are committing more than the normal amount of money to a single stock and turning a trade into what I like to call a play.

Refer to Chapter 12 (“A Play, Not a Position”).

So we contact our broker and place a buy order.

Choosing a broker is covered in Chapter 9. Types of orders are suggested in Chapters 9, 10, and 11. Read about stops to use when entering the market in Chapter 10.

PROTECTING THE POSITION

Using one of the two methods suggested, we now have a full long position in General Motors. But that does not mean we can just sit back and watch. In buying that stock we have assumed a risk. Now we need to limit the dangers imposed by that risk. In other words, we have to protect ourselves from a big loss. That calls for immediately placing another type of stop order, a protective stop. I believe that every position should be guarded by a stop order, or, if the investor has the fortitude and the position is too large for a feasible stop order, at least a mental stop that is obeyed.

Protective stops are discussed in Chapter 11.

In that the $23.50 area was the resistance to upward moves before it was penetrated, it is logical to look for that level as a new support level. Old resistance very often becomes new support. In fact, the pullback after the breakout went to just above that level. I would look at the stock and decide that I would want to continue to hold it as long as it held above that level. But a break very much below that would tell me that I had made a bad investment; I was wrong. So I would place a stop sell order at around the $23 level, giving the stock just a little leeway.

This stop order is to protect us from a loss, but it will later, if possible, be moved up so that it protects our profits in the same way. It is a trailing stop, but it is not placed on a percentage basis; it is placed on a logical basis. There is a point, at all times, at which we would have to admit we were wrong and the market was right. If we have been anticipating a further advance but the technical picture says that a decline is under way that is bigger than we had thought likely, it is at that point that we must get out of the way, take whatever loss or gain there is, and look for some other place to be putting our money.

Our stop-loss order is a one-way street. It can be moved higher, but it can never be moved lower. (See Figure 1.6.)

See closing a position in Chapter 11.

FIGURE 1.6 Progressive Stop Orders.

TAKING A PROFIT

As the stock moves higher, we look at the primary trend, which we are attempting to trade, but we make our stop decisions based on the next smaller wave pattern. This allows us to move the stop order higher as the advance progresses, but keeps us from holding the stock if the secondary wave pattern warns us that the primary move is losing momentum.

See Chapter 20 for a discussion on signals from the next larger cycle.

In this very well-behaving stock we are able to move the stop up five times. Each move protects more profit. As long as the secondary wave pattern is giving us a series of higher lows, the stock is acting well, and we want to stay with it.

There comes a time, though, when the move runs out of energy. We see the change in the characteristics of trading in Figure 1.7.

There are other clues that the move may be due to end. The most important is the cause-and-effect relationship, which allows us to determine approximate targets. The width of the base in this stock, General Motors, suggested the move would probably run out of energy quite soon.

Determining targets is covered in Chapter 18.

FIGURE 1.7 Changing Trading Characteristics.

When the stock drops below the prior low we are stopped out, only a little shy of the top of the move. As the stock price drops, the bottom of the ascending channel is penetrated, suggesting the advance is over. Moreover, the volume increases on the downside for the first time since the advance got under way.

Channels and trend lines are explained in Chapter 17. See direction of volume in Chapter 8.

So, now we are out of the stock. Volume has come in on a decline rather than an advance, and General Motors looks as though it may be headed lower. Shall we go short? No! The advance may be over, but we would need to see more evidence before going to the short side. But the short side should not be ignored. It can often produce bigger and quicker profits than the long side. In the next chapter we will look at an example of a short.