CHAPTER 1

Determining Your Trading Style

Many investors in the market never stop to consider what type of trader they truly are. While it doesn't sound like something that would be all that important, knowing exactly what type of trader you are can make or break your investing career. Imagine the aforementioned in terms of a football team. The players are all quite talented; most can run fast, hit hard, and have the dexterous ability to throw and catch the ball. However, some are more skilled than others in certain areas. Receivers catch better than kickers; it's just part of their makeup. However, if the receiver were to attempt to do the kicker's job, most likely not many field-goal points would be scored.

Investing in the market is the same. Within your personality makeup, you are probably well suited for a particular type of trading; the only question is what type is it? In general, there are three types of traders within the market: position traders, swing traders, and day traders.

- **Position Traders:** These investors are generally the buy-and-hold type of traders who stick with their stocks over the long haul. Guys like Warren Buffett fit precisely into this category. Position traders can be both long and short; however, one theme constantly surfaces: These guys are in it for a large, long-term move. Usually, position traders only buy stocks, as over time, markets usually ascend. Take the Dow Jones Industrial Average (INDU) for example. Over the past 13 years, the Dow is up about 800 percent, something buy-and-hold investors in Dow stocks are likely to be thrilled with. Options traders can also be position traders, too, though usually they do so through covered calls, that is, attempting to lower their cost basis in select stocks, while also buying LEAP options. (See Chapter 19 for more on covered calls and LEAP options.)

- **Swing Traders:** Investors who take shorter-term positions in anticipation of quick market movements over a series of days, or weeks, generally fall into this category. Swing traders are possibly the most dynamic of the three types of traders, as they are able to switch up holding times quickly, as the market demands. Swing traders move both long and short, taking advantage of technical analysis, earnings, fundamentals, and macro market events.
- **Day Traders:** We'll call these guys the kings of stress. Day traders attempt to capitalize on intraday movements with the markets, often trading on momentum and news. Day traders sometimes become swing traders, if a position warrants holding for a longer period. Moreover, from our experiences, day traders can often become position traders, when they hold a loser for way too long! Day trading is ideal for those who are able to handle erratic market movements, while also having the time to actually monitor positions throughout the day. It's important to note that if you don't want to trade for a living, or don't have the luxury to watch your trades every moment, day trading should be left to the pros. In essence, day trading is the riskiest of all three styles, as often short-term momentum can trigger positions against the larger trend. While the same occurs in swing trading from time to time, the erratic behavior of day trading against the trend can lead to large losers, should the position turn in the wrong direction.

With these definitions in mind, note that we have compiled this book with strategies that we find really work for swing traders in almost any market environment. What's more, as you're about to see, swing trading is a much better alternative to day trading for those who are seeking slightly less stress in their lives that what day trading entails. With the proper analytics and timing, swing trading can be immensely profitable for those with patience, research, a wide variety of tools (which you'll read about here), and rock-solid money-management skills.

WHY SWING TRADING IS A BETTER ALTERNATIVE TO DAY TRADING

Day trading is, without a doubt, the toughest way of the three previously mentioned trading styles to consistently make money. However, many people are attracted to the glamour and excitement of day trading, which unfortunately hardly ever ends well, especially if the trader has no previous

P1: JYS
c01 JWBT029-McCall October 29, 2008 15:8 Printer: Yet to come

professional market experience. Like many things in this world, when it comes to day trading, probably only 10 percent of the people make 90 percent of the money. Fact is, most independent traders usually blow up and fade away.

I (Whistler) began my trading career on a day-trading floor in the dot.bomb era. When I started trading, there were about 25 guys on the floor, all trading breakout momentum. When I moved on to trade professionally, there were only about three or four of the original guys left. Almost all of the others lost virtually all of their money. We used to joke with one another when we'd see a new trader come in who didn't have much experience. We'd say, "Hey pal, why don't you give me half of all of your money right now and take the entire year off. You'll have more money at the end of the year, if you do." While it seemed funny at the time to see the reaction of the poor bloke attempting to break into the floor, the joke was actually the truth. Really, it wasn't funny at all.

Swing trading, on the other hand, can be a much more effective trading style, especially for newer traders. By holding positions overnight and even for a few weeks, traders can expose less money for larger moves. Think about it for a moment.

If you were to invest $10,000 in a $50.00 stock and it moved $3.00, the day trading profit would be $600. Equally, the swing trading profit would be $600 as well. However, on an intraday basis, the stock would have to move 6 percent to make the aforementioned event become a reality. However, if you were to hold that same stock for two weeks, you would only need to see the stock rise 0.006 percent per day (assuming 10-trading days), something much more feasible than the intraday move in terms of percentages.

At the end of the day, what it comes down to is the fact that by swing trading instead of day trading, investors are able to commit less capital to the markets to reach extraordinary gains. It is important to note that swing traders do take on "overnight risk," something day traders do not have. Overnight risk is the odds swing traders hold that a position gaps away from them when markets open in the morning, usually after unforeseen news. However, with the proper research, the swing trader actually seeks to make overnight gap risk another tool in their repertoire that actually helps increase their bottom line.

The question, then, is what types of strategies constantly return profits that will make investors wealthy over the long run? We are happy to tell you that *The Swing Trader's Bible* attempts to answer that question.

At the end of the day, the strategies here have helped us book profits day in and day out over the years, with significantly less stress than day trading, or than long-term buy and hold when the market upends.

It is important to reiterate one very important point. The concepts in this book have been intentionally simplified. There are plenty of complicated quant-based trading programs in the market, creating the false impression that overcomplicating the market through math is the only way to truly make money. What's more, many math-based traders often ridicule those who keep their trading simple, as there is a sense of market elitism that often comes with quant-based system traders.

I (Whistler) will tell you one thing, though. I've been on many trading floors and have personally seen some of the greatest traders at work. What I know from my years is this: some of the wealthiest traders in the world are not those who overcomplicate the market through math, fundamentals, or technicals. Truly prosperous traders—more often than not—are the people who understand the big picture, know how to keep it simple, take time to look at fundamentals, economics, and technicals, while also having a solid predetermined money-management plan in place. These supertraders have a solid sense of trading instinct, based on many years of understanding the larger dynamic ebb and flow of money in the market. Many of these guys are swing traders with one very similar trait: they know how to dissect markets, news, fundamentals, and technicals, while still keeping the information at a simple, commonsense level.

See, when we overcomplicate things, we often lose sight of common sense, something that is vital to continual profitability within the markets. I remember on the floor, some of the most profitable momentum traders would joke that they made a point to never read about the companies they traded. The philosophy was that by actually knowing what was happening on a fundamental level in the company, the trader would have an opinion about the stock and thus fail to be able to trade impartially with market momentum. We are clearly *not* recommending this strategy here but are simply pointing out something interesting. To be profitable as a swing trader, it is important to do all of our research; however, if at any point our opinions about a company or market begin to sway our common sense, it's time to take a step back and not trade. Should common sense fade because we're too close to the situation, we are unlikely to be able to make the right decisions when the heat kicks up.

Thus, always keep an open mind about the swing trading strategies presented here. The strategies do work, but they are not going to work 100 percent of the time. That's just the way it is. In the markets, nothing works all the time, and eventually every trader is going to be faced with a losing position. It's when the walls start to crumble that we earn our way, and with the strategies in this book, most traders should be able to fall back or switch methodologies to either recoup or trade out of losing positions—but only if they are strong enough to never break their money-management rules, yet also open-minded and able to switch from something that's not working to something that is.

Often, day traders don't have the same time luxury that swing traders have, and it's important for swing traders to remember that they have plenty of tools to adapt to changing market circumstances, should they be savvy enough to choose to use them. Next we'll cover what you need to know to use this book effectively and to trade profitably while living a low-stress investing life.

HOW TO SUCCESSFULLY IMPLEMENT WINNING TRADES

First and foremost, it's important to understand—and embrace—the concept that investing is not easy. If it were, everyone would be doing it. However, because it is one of the most competitive, relentless, and unforgiving methods of growing wealth, there's also another side to the coin. For those who truly understand markets and take the time to learn about investing, the profits can be staggering. Unlike owning a business, real estate, or even your career, investing has one unique advantage: you can turn it off at any moment. If a position goes against you, the trade can be closed at any moment, thus containing losses, while giving you the opportunity to look for new—and profitable—setups within the market. Yes, businesses can restructure, houses can be sold, and careers can be changed, but rarely overnight. If you remember that swing trading and investing provides you with the instant ability to change your fate, the sky will never grow dark, and should a position move against you, your losses can be shut off by simply closing the trade.

To use this book effectively, you must have solid money-management skills, and also take the time to understand investment psychology. Our emotions can easily get the best of us when a trade starts to fail; however, if we have rock-solid money-management skills in place, we can easily keep our emotions in check. It is highly recommended for investors to take the time to sit down and evaluate their money-management plans to effectively use this book. If you do, if you have a money-management plan in place before ever trading, you will be head and shoulders above many who attempt to make money in the markets. To help cover this area, we discuss money management through effectively using stop losses in Chapter 2. However, without the discipline to stick to stops (and a larger money-management plan), investors may as well toss their money on the craps table in Vegas.

To effectively use this book, swing traders also need to understand the larger paradigm of herd mentality in the market. Consider these two quotes by nineteenth-century playwright Henrik Ibsen:[1]

> *"The majority is always wrong; the minority is rarely right."*
> *"The strongest man in the world is he who stands most alone."*

These quotes tell us a few very important things. First, like Galileo proved the sun does not orbit the earth, rare individuals are able to transcend major herd market mentality, thus making major breakthroughs not only in their own lives but in society, too. However, the majority is often wrong, something we've seen time and time again in the markets, economics, society, and politics.

Just a few examples include the dot.bomb bubble of the late 1990s and the subprime real estate mess of the past few years. Fact is, whenever the herd is making money hand over fist in some area of the market or economy, be very, very afraid, because exuberance has set in, and the herd is probably about to find their rears handed to them on a silver platter. Then, the blame game begins Repeatedly, this truth prevails.

What's more, in Ibsen's quote where he states, "the minority is rarely right" we find another truth about the markets. Yes, Columbus proved the world is not flat, and in the 1980s currency trader George Soros booked $1.1 billion—in a single day—by shorting the British pound, against the herd. However, those who triumph in the minority are a rarity. Usually, the minority is wrong, especially those who call for market crashes or for huge stock rallies based on expected earnings that are completely unrealistic. What all of this means is that we want to be part of the minority that is right—to take massive chunks of money out of the market—but we must continue to maintain a sense of reality and not let our own minority exuberance get the best of us.

The second quote by Ibsen reminds us that to truly make significant amounts of money in the markets, we must remember that at times we will need to find the strength to stand alone, something reiterated in the first quote, too. Superinvestors like Warren Buffett know this all too well.

In April 2008, Warren Buffett spoke to a group of business students at the Berkshire Hathaway headquarters in Omaha, Nebraska. *Fortune* magazine was on hand to record his words, quoting Buffett as saying:

> *"You know, I always say you should get greedy when others are fearful and fearful when others are greedy. But that's too much to expect. Of course, you shouldn't get greedy when others get greedy and fearful when others get fearful. At a minimum, try to stay away from that."*[2]

Here is the crux: we must remember to buck herd mentality within the markets (at least when trading against the trend), while making sure to not to fall victim to exuberance when greed sets in. However, to do so, we must be strong enough to stand alone.

Case in point: In 2008, when the subprime debacle rattled U.S. housing markets, most investors ran from housing stocks like lemmings over a cliff. What's more, media headlines only helped to reiterate the fear by constantly pumping doom-and-gloom headlines about elevated foreclosure rates, housing prices falling through the floor, and the dismal future for homebuilders. The media did a good job of it, too, as most investors fearfully turned away from homebuilding stocks, assuming there was no hope. Funny thing, though, as Figure 1.1 shows, the U.S. Dow Jones Homebuilder's Index (DJUSHB) bottomed out in January 2008 and posted solid returns during the first quarter of the year, for those who bought housing stocks when the masses ran in fear. It's important to note the DJUSHB did fall to a new low in the summer of 2008, however, the index also remained reasonably resilient when the Dow fell through the floor in October of the same year. As of the time of this writing, the DJUSHB was still holding up from July lows, while the major indices had been crushed. As of the first week of October, the DJUSHB was down just over 9 percent for the year, while the Dow Jones Industrial Average had fallen over 27 percent. It's shocking to think housing was outperforming the broader market overall, something not many were aware of. (As this example shows, Warren Buffett's quote couldn't be any truer.)

Really, then, the second point of what investors need to know to make the most of this book is a point of common sense, though one that often bucks the intuition of the masses. No matter what any of the strategies

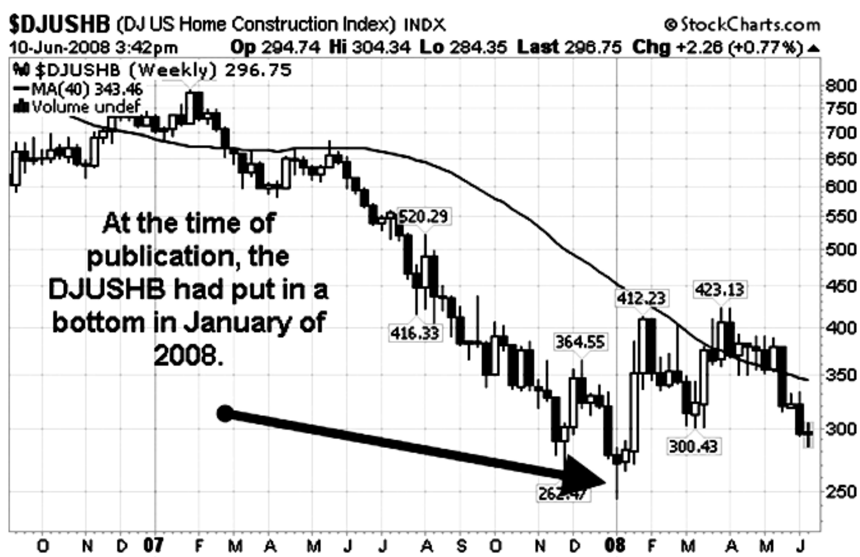

FIGURE 1.1 Dow Jones U.S. Homebuilder's Index (DJUSHB)
Source: Chart courtesy of StockCharts.com

P1: JYS
c01 JWBT029-McCall October 29, 2008 15:8 Printer: Yet to come

within this book show you regarding a trade setup at any moment within the markets, it is vital for investors to remember to step back from the present state of affairs and consider the larger picture. A few savvy investors profited handsomely in homebuilding stocks during the first half of 2008 while the majority (fueled by media headlines) ran from housing like lemmings, but those savvy investors were only able to do so by stepping back from the situation, assessing the larger picture, and then having the mental fortitude to look beyond the problems at hand.

With all that you've just read in mind, please remember that if you take the time to remain objective, even while using any one of the strategies outlined in *The Swing Trader's Bible*, you stand the chance of seeing windfall profits in the years to come. Swing traders who had the insight to foresee the housing rebound of 2008 in December 2007, or even in January and February of 2008, could have used the LEAP covered call strategy outlined in Chapter 19 to protectively take positions in housing stocks. The point is that the strategies in this book are tools to help you successfully implement winning trades, based on both larger market ideas and micro technical occurrences. However, to be able to use these tools effectively, we must always step back from the masses and evaluate the bigger picture of every trade idea, headline, market paradigm, and even our own emotions. If we are able to do so, there is nothing stopping anyone at all from making all of their financial dreams come true.

Moving on, in Chapter 2, we will cover the first rule of profitability: stop loss, something that is vital for every trader to take the time to understand. By the end of Chapter 2, it will be clear that stop losses are more than just a way to contain losses. Rather, understanding how to use stop losses effectively is a tool that can increase your profitability over the long run.