Chapter 1

The Ups and Downs of Trading Stocks

In This Chapter

- Making sense of trading
- Exploring trading types
- Gathering your trading tools
- Discovering keys to success

Making lots of money is the obvious goal of most people who decide to enter the world of trading. How successful you become as a trader depends on how well you use the tools, gather the needed information, and interpret what you've got. You need to develop the discipline to apply all that you know about trading toward developing a winning trading strategy.

Discovering how to avoid getting caught up in the emotional aspects of trading — the highs of a win and the lows of a loss — is key to developing a profitable trading style. Trading is a business and needs to be approached with the same logic you'd apply in your approach to any other business decision. Setting goals, researching your options, planning and implementing your strategies, and assessing your success are just as important for trading as they are for any other business venture.

In this book, we help you traverse these hurdles, and at the same time, we introduce you to the world of trading. In this chapter, we give you an overview of trading and an introduction to the tools you need, the research skills you must use, and the basics of developing all this information into a successful trading strategy.

Trading versus Investing

First, we need to discuss how trading differs from investing. Investors buy stocks and hold them for a long time — many times too long, riding a stock all the way down and possibly even buying more along the way. Traders, on the other hand, hold stocks for as little as a few minutes or as long as several months, and sometimes possibly even a year or more. The specific amount of time depends on the type of trader you want to become.

Investors want to carefully balance an investment portfolio between growth stocks, value stocks, domestic stocks, and foreign stocks, along with long-, short-, and intermediate-term bonds. A well-balanced portfolio generally offers the investor a steady return of between 5 percent and 12 percent, depending on the type of investments and amount of risk he or she is willing to take.

For investors, an aggressive portfolio with a mix of 80 percent invested in stocks and 20 percent in bonds, if well balanced, can average as high as a 12 percent annual return during a 20-year period; however, in some years, the portfolio will be down, and in others, it will go through periods of high growth. The opposite, a conservative portfolio with 20 percent invested in stocks and 80 percent in bonds, is likely to provide a yield on the lower end of the spectrum, closer to 5 percent. The volatility and risk associated with the latter portfolio, however, would be considerably less. Investors who have 10 or more years before they need to use their investment money tend to put together more aggressive portfolios, but those who need to live off the money tend to put together less aggressive portfolios that give them regular cash flows, which is what you get from a portfolio invested mostly in bonds.

REMEMBER

As a trader, you look for the best position for your money and then set a goal of exceeding what an investor can otherwise expect from an aggressive portfolio. During certain times within the market cycle, your best option may be to sit on the sidelines and not even be active in the market. In this book, we show you how to read the signals to decide when you need to be in the market, and how to find the best sectors in which to play the market and the best stocks within those sectors.

Why Trade?

Improving your potential profit from stock transactions is obviously the key reason most people decide to trade. People who want to grow their portfolios rather than merely maintain them hope that the way they invest in them does better than the market averages. Regardless of whether traders invest through mutual funds or stocks, they hope the portfolio of securities they select gives them superior returns — and they're willing to work at it.

People who decide to trade make a conscious decision to take a more active role in increasing their profit potential. Rather than just riding the market up and down, they search for opportunities to find the best times and places to be in the market based on economic conditions and market cycles.

Traders who successfully watched the technical signals before the stock crash of 2000 either shorted stocks or moved into cash positions before stocks tumbled and then carefully jumped back in as they saw opportunities for profits. Some position traders simply stayed on the sidelines, waiting for the right time to jump back in. Even though they were waiting, they also carefully researched their opportunities, selected stocks for their watch lists, and then let technical signals from the charts they kept tell them when to get in or out of a position.

Successful Trading Characteristics

To succeed at trading, you have to be hard on yourself and, more than likely, work against your natural tendencies, fighting the urge to prove yourself right and accepting the fact that you're going to make mistakes. As a trader, you must develop separate strategies for when you want to make a trade to enter a position and for when you want to make a trade and exit that position, all the while not allowing emotional considerations to affect the decisions you make on the basis of the successful trading strategy you've designed.

You want to manage your money, but in doing so, you don't have to prove whether your particular buying or selling decision was right or wrong. Setting up stop-loss points for every position you establish and adhering to them is the right course of action, even though you may later have to admit that you were wrong. Your portfolio will survive, and you can always reenter a position whenever trends indicate the time is right again.

You need to make stock trends your master, ignoring any emotional ties that you have to any stocks. Although you may, indeed, miss the lowest entry price or the highest exit price, you nevertheless will be able to sleep at night, knowing that your money is safe and your trading business is alive and well.

Traders find out how to ride a trend and when to get off the train before it jumps the tracks and heads toward monetary disaster. Enjoy the ride, but know which stop you're getting off at so you don't turn profits into losses.

Tools of the Trade

The first step you need to take in becoming a trader is gathering all the right tools so you can open and operate your business successfully. Your computer needs to meet the hardware requirements and other computer specifics we describe in Chapter 4, including processor speed, memory storage, and screen size. You may even want more than one screen, depending on your trading style. High-speed Internet access is a must; otherwise, you may as well never open up shop.

We also introduce you to the various types of software in Chapter 4, showing you what can help your trading business ride the wave to success. Traders' charting favorites such as Metastock and Trade Station are evaluated along with Internet-based charting and data-feed services. We also talk about the various trading platforms that are available and how to work with brokers.

After you have all the hardware and software in place, you need to hone your analytical skills. Many traders advocate using only technical analysis, but we show you how using both technical and fundamental analyses can help you excel as a trader.

Taking Time to Trade More than Just Stocks

The ways traders trade are varied. Some are day traders, while others are swing traders and position traders. Although many of the tools they use are the same or similar, each variety of trader works within differing time frames to reach goals that are specific to the type of trades they're making.

Position trading

Position traders use technical analysis to find the most promising stock trends and enter and exit positions in the market based on those trends. They can hold positions for just a few days, a few months, or possibly as long as a year or more. Position trading is the type of trading that we discuss the most in this book. After introducing you to the stock markets, the types of brokers and market-makers with whom you'll be dealing, and the tools you need, we discuss the basics of fundamental analysis and technical analysis to help you become a better position trader.

Weathering a bear market

Housing stocks crumbled in the housing crunch. Financials were crushed in the credit crisis.

We can't claim any special foresight or knowledge to know when a stock is about to take a big plunge or a company is going to be taken over by the Feds. We don't have a crystal ball.

But we are able to keep most of our money safe from the ravages of a down market. By using strategies that we discuss throughout this book, we can exit positions before giving back most of our accumulated profits — while many others unfortunately do just that.

An impending pullback is not illuminated with flashing beacons. There is no instant indicator telling us that it is time to sell everything. Instead, we close individual positions as each stock's technical conditions deteriorate. The tools we describe in this book enable us to recognize when risk levels have changed, when few stocks are attractive, and when simply leaving most of our trading capital in cash is the best course of action.

We have no idea how long the current credit crunch will affect the market. In fact, it's already gone on longer and been much more brutal than we had guessed. Nevertheless, adhering to the techniques featured in this book has kept us from committing the bulk of our trading capital to failing stocks. We will weather this market with the majority of our trading capital intact and even make a little money by shorting a few stocks or buying some short or double-short exchange-traded funds. Thanks to the tools we show you in this book, we will be ready to trade aggressively when the technical condition of stocks begins improving.

Short-term swing trading

Swing traders work within much shorter time frames than position traders, rarely holding stocks for more than a few days and looking for sharp moves that technical analysis uncovers. Even though we don't show you the specifics of how to become a swing trader, we nevertheless discuss the basics of swing trading and its strategies in Chapter 16. You can also read about the basics of technical analysis and money management strategies, both of which are useful topics to check out if you plan to become a swing trader. However, you definitely need to seek additional training before deciding to pursue this style of trading — reading *Swing Trading For Dummies* by Omar Bassal (Wiley) would be a good start.

Day trading

Day traders never leave their money in stocks overnight. They always cash out. They can trade into and out of a stock position in a matter of hours, minutes, or even seconds. Many outsiders watch day traders in action and describe it as more like playing a video game than trading stocks. We discuss this high-risk type of trading in Chapter 17, but we won't be showing you the specifics of how to do it. If day trading is your goal, this book will only take you part of the way there. You'll discover the basics of technical analysis, but you need to seek out additional training before engaging in this risky trading style — check out *Day Trading For Dummies* by Ann C. Logue (Wiley).

Going Long or Short

Before you start trading, you absolutely have to know what stocks you want to buy and hold for a while, which is called *going long,* or holding a long stock position. You likewise have to know at what point holding that stock is no longer worthwhile. Similarly, you need to know at what price you want to *enter* or trade into a position and at what price you want to *exit* or trade out of a position. You may be surprised to find out that you can even profit by selling a stock without ever owning it, in a process called *shorting.* We discuss these vital trading strategies in Chapter 13.

You can even make money buying and selling options on stocks to simulate long or short stock positions. Buying an option known as a *call* enables you to simulate a long stock position, in much the same way that buying an option known as a *put* enables you to simulate a short stock position. You make money on calls when the option-related stock rises in price, and you make money on a put when the option-related stock falls in price.

When placing orders for puts and calls, you're never guaranteed to make money, even when you're right about the direction a stock will take. The values of options are affected by how volatile stock prices are in relationship to the overall direction (up or down) in which they are headed. We discuss options and how they work in greater detail in Chapter 18.

Managing Your Money

Managing your trades so that you don't lose a bunch of money is critical. Although we can't guarantee that you'll never lose money, we can provide you with useful strategies for minimizing your losses and getting out before your stock portfolio takes a huge hit. The key is knowing when to hold 'em and when to fold 'em, and we cover that in great detail in Chapter 12.

One thing that we can't emphasize enough is that you must think of your trading as a business and the stocks that you hold as its inventory. You can't allow yourself to fall in love with and thereby hang on to a stock out of loyalty. You'll find it especially hard to admit you've made a mistake; nevertheless, you have to bite the bullet and exit the position before you take a huge hit. You'll discover that housecleaning and developing successful strategies for keeping your inventory current are important parts of managing a trading portfolio.

Setting a target price for exiting a position before ever trading into it is the best way to protect your business from major losses. Stick with those predetermined exit prices and you'll avoid a major pitfall that many traders face — holding a position too long and losing everything. You obviously don't want to turn a profit into a loss, so as your position in a stock produces a profit, you can periodically raise your target exit price while continuing to hold the position to ensure that you keep most of that profit.

Understanding your risks — market risks, investment risks, and trading risks — helps you to make better trading decisions. We review the different kinds of risks as they relate to specific situations at several points throughout the book.

Understanding Fundamental Analysis

You've probably heard the phrase, "It's the economy, stupid." Well that's true, and we show you how understanding the basics of the business cycle can help you improve your trading successes. In Chapter 5, you find out how to identify periods of economic growth and recession and how these differing periods impact bull and bear stock markets. We also explore sector rotation and how to use it to pick the right sectors for your trading activities.

You can also discover plenty of information about how money supply, inflation rates, deflation, joblessness, and consumer confidence impact the mood of the market and stock prices and how the economy can be driven by how confidently (or not) political and monetary leaders speak out about it. We discuss the role of the Federal Reserve (Fed) and how when the Fed Chairman speaks, the markets listen.

Understanding how the economy works isn't the only fundamental analysis tool that's important to you. You also need to read financial statements to understand the financial status of the companies you want to buy. We delve into financial statements in Chapter 6.

A company's income statements, on the other hand, give you a look at the results of the most recent period and provide a basis for comparison with prior years and periods. You can use these statements to look at whether revenues are growing, and if they are, by what percentage. You also can see how much profit the company is keeping from the revenue it generates. The cash flow statement shows you how efficiently a company is using its cash and whether it's having problems meeting its current obligations. The balance sheet gives you a snapshot of a company's assets and liabilities and stockholder's equity.

You can use this information to develop your own estimate of a company's growth and profit potential. In Chapter 6, we show you how to do a few basic ratio calculations that you can use to compare similar stocks and then choose the one with the best potential.

TIP

Analysts use this information to project a company's financial growth and profits. You never should depend entirely on what analysts say, but you always should do your own research and collect the opinions of numerous analysts. One of the best ways to find out what analysts are saying and what aspects of the financial statements may raise a red flag is the analyst call. In Chapter 7, we explain how you can listen in on these calls and understand the unique language used in them to make better choices when selecting stocks. We also discuss the pros and cons of using analyst reports.

Getting a Grip on Technical Analysis

You use fundamental analysis to determine what part of the business cycle the economy is in and what industries offer the best growth potential. Then you use that information to select the best target companies and identify prices at which you'd want to buy their stocks.

After choosing your targets, you then use technical analysis to follow trends in the prices of the target stocks, so you can find the right time to get in and ultimately to get out of a stock position. These targets become part of your stock-watch list. After you've established that list, you then use the tools of technical analysis to make your trades.

In Chapter 8, we introduce you to the basics of technical analysis, how it works, and how it needs to be used. Although some people think of technical analysis as no more than fortune-telling, others believe it yields significant information that can help you make successful trades. We obviously believe that technical analysis provides you with extensive tools for your trading success, and we show you how to use those tools to be profitable.

Your first step in technical analysis is finding out how to create a chart. We focus on the most popular type — bar charting. In Chapter 9, you discover the art of deciphering simple visual stock patterns and how to distinguish between trends and trading ranges, all so you're able to spot when a stock moves from a trading range into either an upward or downward trend and know when you need to act.

In Chapter 10, we show you how to use your newfound skill of identifying trends to locate areas of support and resistance within a trend that ultimately help you find the right times to make your move. You find out how to read the patterns in the charts to identify trading signals and what to do whenever you've acted on a failed trading signal.

Chapter 11 fills you in on moving averages and how to use them to identify trends. You also find out about oscillators and other indicators that traders use for recognizing trading signals. As a newbie trader, you'll probably find that your greatest risk is paralysis of analysis. That's where you may find that you're having so much fun reading the charts or are just so confused about which chart has the right signal that you feel paralyzed by the variety of choices. We show you how to create and use a tiny subset of tools that is available in today's charting software packages to simplify your life and make your choices easier. You'll likewise discover how to use such odd-sounding but critical tools as an MACD indicator or a stochastic oscillator, and we help you take advantage of the powerful concept of relative strength.

Putting Trading Strategy into Practice

After you get used to using the tools, it's time to put your new skills into practice making money. In Chapter 13, we show you how to put your newfound affinities for fundamental analysis and technical analysis together to develop and build your trading strategy. Using fundamental analysis, you can

- Determine which part of the economic cycle is driving the market.
- Determine which sector makes the most sense for stock trading.
- Figure out which sectors are in the best positions to go up.
- Find out which stocks are leading in the ascending sectors.
- Evaluate where the Fed stands on the economy and which potential moves by the Fed can impact the strength of the market.
- Evaluate and hopefully anticipate potential shocks to the market. Although doing so may seem like gazing into a crystal ball, you really can pick up some signs by checking out the key economic indicators. We show you what they are.

After you complete your fundamental analysis, we show you how to use your new technical analysis skills successfully. Using them, you find out how you can

- Trade within the overall technical conditions.
- Confirm which economic cycle a market is in by using index charts.
- Determine whether an ascending sector is stuck in a range or ready to enter a new upward trend.
- Determine whether leading stocks are stuck in ranges or ready to break out in upward trends.

Finally, we show you how to use your newfound skills to manage risk, set up a stop-loss position, and choose your time frame for trading.

After honing your skills, you're ready to start trading. So in Chapter 14, we focus on the actual mechanics of trading by

- Discussing how to enter or trade into a position
- Explaining bid and ask prices
- Discussing the risks of market orders
- Explaining how to use limit and stop orders

We also explore how to exit or trade out of a position and still stay unattached emotionally, when to take your profits, and how to minimize your losses, in addition to discussing potential tax hits and how to minimize them.

Now that you know how to research the fundamentals, effectively use the technical tools, and mechanically carry out a trade, the next step is developing and managing your own trading system. We explore the basic steps to developing the system, which include

1. **Designing and keeping a trading log.**
2. **Identifying reliable trading patterns.**
3. **Developing an exit strategy.**
4. **Determining whether you'll use discretionary trading methods or mechanical trading. We explore the pros and cons of each.**
5. **Deciding whether to develop your own trading system or buy one of the ones available off the shelf.**
6. **Testing your trading systems and understanding their limitations before making a major financial commitment to your new system.**

We also discuss assessing your results and fixing any problems.

After you've designed, built, and tested your system, you're ready to jump in with both feet. The key to getting started: Make sure you begin with a small sum of money, examining your system and then increasing your trading activity as you gain experience and develop confidence with the system that you develop.

Trading at Higher Risk

Some traders decide they want to take on a greater level of risk by practicing methods of swing trading or day trading or by delving into the areas of trading derivatives or foreign currency. Although all of these alternatives are valid trading options, we steer clear of explaining even the basics of how to use these high-risk trading alternatives, and instead, we provide you with a general understanding of the ways these trading alternatives work and the risks that are unique to each of them.

If you decide, however, that you want to take on these additional risks, don't depend on the information in this book to get started. Use the general information that we offer you here to determine what additional training you need to feel confident before moving into these trading arenas.

Remember: Have Fun!

Although you are without question considering the work of a trader for the money you can make, you need to enjoy the game of trading. If you find that you're having trouble sleeping at night because of the risks you're taking, then trading may not be worth all the heartache. You may need to put off your decision to enter the world of trading until you're more comfortable with the risks or until you've designed a system that better accommodates your risk tolerance.

You may find that you need to take a slower approach by putting less money into your trades. You don't need to make huge profits with your early trades. Just trading into and out of a position without losing any money may be a good goal for you when you're just starting out. If you notice your position turning toward the losing side, knowing that you can trade your way out of it before you take a big loss may help you build greater confidence in your abilities.

Remember, making a losing trade doesn't mean that you're a loser. Even the most experienced traders must at times face losses. The key to successful trading is knowing when to get out before your portfolio takes a serious hit. On the other side of that coin, you also need to know how to get out when you're in a winning or profitable position. When you're trying to ride a trend all the way to the top, it sometimes starts bottoming out so fast that you lose some or possibly even all of your profits, causing you to end up in a losing position.

Trading is a skill that takes a long time to develop and is perfected only after you make mistakes and celebrate successes. Enjoy the roller coaster ride!