CHAPTER 1

Subjective Doesn't Work in the Market

Technical Analysis Is the Objective Standard

Webster's Dictionary defines subjective as "characteristic of or belonging to reality as perceived rather than as independent of mind." When we want an opinion from a critic on how good a movie is, we are expecting a subjective review. When we read a restaurant write up, we also get a subjective review. We may see the movie or eat the meal, and have a different experience than the critic did. We will tend to follow the critics who agree with our subjective notions.

This is fine for movies and dinner and many other things in life. But the market is not a matter of opinion. There are several ways in which "subjective" enters the marketplace. Subjectivity can enter when traders try to rely on the latest guru in the marketplace, when they try to use fundamental analysis in their decision making process, and when they use technical indicators on their charts. While there are some others, these are the three biggest culprits. I am going to explain how you can fall into each of these traps, and how you can avoid them.

THE GURU SYNDROME

The first common way in which people let subjectivity enter their trading comes to people before they decide to do it on their own. There is a tremendous tendency for people to want to follow a guru, or anyone who speaks with authority. Often these people are followed without any track record, simply because they say things that "make sense" or agree with our views in some way. Unfortunately, what appears to be common sense rarely works in the market place.

If you take a look at the famous gurus over the years that made a name for themselves, most of those names are gone. There may be new names today, but they will be gone tomorrow. People make names for themselves by standing up and taking a firm stand on the market. For example in the 1990s, you may remember (if you were following the market then) several big names who decided to take a very bullish stance once the market began moving up. As time went on they got fame for their "prediction" and continued to pound the table to be long. When the market turned in 2001, it also turned on them. They dropped off the map or were even heckled for their views. Very few gurus maintained a name for themselves when the market turned. Just like many did with their stocks, these gurus rode fame as the market rallied, and crashed with the market.

Did some predict the crash? Sure. The problem here is that many predicted the crash up to eight years earlier. Again, little fame is justified for such predictions. In every market you will find bulls and bears. Some are right, some are wrong. Those that are consistently right are harder to find. Those that are consistently right are often looked at as foolish for periods of time where they go against popular opinion, even though it is the right thing to do at the time. They have found their own method or style, and know how to use it properly. New people to the market usually find in short order that the "experts" on TV are not making them any money.

After a while, many learn it may be best to find a way to develop a system, method, or style of interpreting the market, or individual stocks, in order to find their own plays. For traders or investors of the market who decide to do the work themselves, there are still two ways in which subjectivity is introduced to their studies. The first way is by relying on fundamental rather than technical analysis. While this debate has continued since the beginning of time, my view is unquestionably that there is no debate: technical analysis is what works in the marketplace.

However, even when traders take the technical route subjective issues can still creep in through the use of technical indicators. Following is a discussion of both of these issues that new self-directed traders may face.

THE PITFALLS OF FUNDAMENTAL ANALYSIS

Going back to the first time anyone charted the price of something that was sold in an open market, the debate between fundamental and technical analysis has existed. Fundamentalists claim that technicians are trying to look at the past and predict the future. Technicians claim that fundamentalists are trying to find the value of a company, which is impossible to do, and that is not relevant even if you determine what it is.

Fundamentalists look at the accounting numbers of the company. They look at things like price to earnings ratios (PE ratios), book value, and other accounting type numbers. They also look at things like the ability of current management, new products coming out, and recent acquisitions. They then take all this information, and come up with an exact price that the company should be worth. From that, they calculate the price per share, and if the number is higher than the current stock price, they consider it undervalued, and a buy.

On one hand, it sounds like looking at hard numbers may be very objective. But there are several problems with this. First, how do you know to trust the numbers you are looking at? Back when Enron was trading over one hundred dollars a share, it was considered a great fundamental value. The problem was, of course, that the numbers that were being looked at were all lies. They were made up by accountants and CEOs. Was that an isolated incident? Not in the least. WorldCom and many other companies have gone out of business or had huge price swings as the underlying accounting numbers were found to be a "tad bit off."

Even if you are less skeptical, talk to an accountant of any business. There are huge ranges in acceptable accounting measures that are allowed. Some are just allowed, while some are in constant debate as to what is correct. So the officers of a company can have huge swings in their profit and loss statements, based on the decisions made on how to account for certain big numbers. Fundamentalists often look to a change in profits by even a penny as being a big deal, when the accounting choice may have changed the outcome by a dollar. It becomes quite silly at some point. So, using the fundamental numbers of a company is a very subjective way of valuing a company when you come right down to it.

Beyond that, there is a more basic problem with fundament analysis that makes it even more subjective. It assumes that someone knows the value of a company based on last year's or last quarter's numbers. But that picture is immediately clouded when an analyst says, "That was last year, you should see what they are likely to do this year." So now they start talking about increasing the value of their "objective" analysis by a guess as to what may happen in the future. This is why hundreds of companies in the 1990s (and this still continues today) had soaring stock prices, with no earnings. Fundamentally, without earnings, there are really no numbers to work with to justify any price, let alone a higher value than the current price. Yet the promise of future earnings had stocks rise from one dollar to literally hundreds of dollars, based simply on the promise of great earnings someday. Does that sound like how you want to make your trading and investing decisions?

There is one more problem that puts an end to the conversation. It simply does not work. Many companies that show undervalued prices, and have low PE ratios are often undervalued for a reason. There is a tendency for the cheap to just get cheaper. They are rarely good buys. Likewise, companies, or their stocks, that seem overvalued, rarely come down when analysts say they should. They are overvalued for a reason. If you have ever tried investing using fundamental numbers, you have likely discovered these issues for yourself. Fundamental analysis is actually totally subjective, hiding under only a veil of objectivity.

Most Wall Street analysts use fundamental analysis, though the number of technical analysts has increased dramatically. The opinions of Wall Street analysts on a particular stock or the overall market really have not been much help at all to investors and traders over the years. Take a look at Figure 1.1. Back in 2000 as the price of the stock was reaching all-time highs, everybody loved shares of Yahoo. Merrill Lynch had it as one of their best ideas. As the price declined they reiterated their buy recommendation believing

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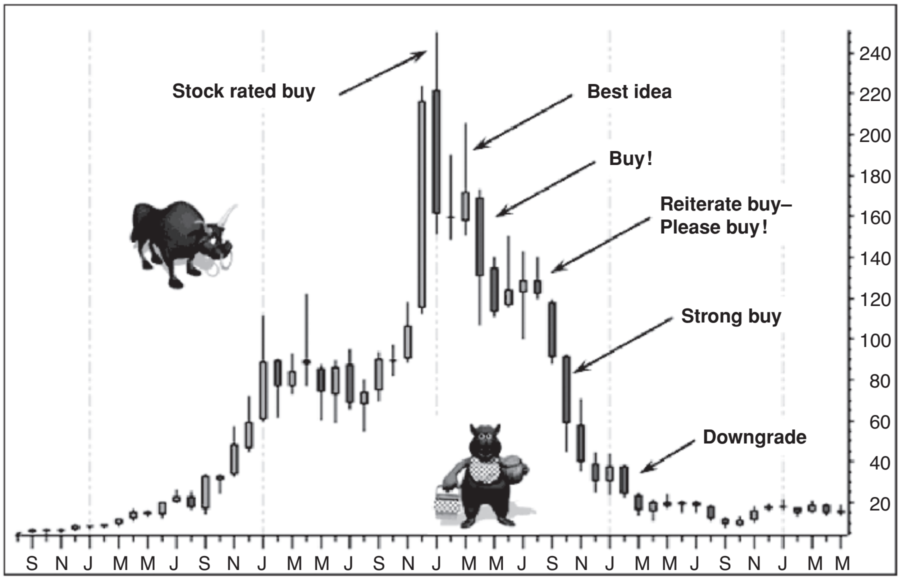

FIGURE 1.1 Actual Analyst Calls Getting Yahoo! 100 Percent Backward
Chart courtesy of Mastertrader.com.

it was such a great company the price of the stock had to rebound. The price continued to decline throughout the year as the Wall Street analysts continued to suggest investors snap up the shares. Finally when the stock had declined by about 90 percent, Merrill Lynch downgraded the stock and stopped urging investors to buy!

Technical analysis, on the other hand, looks to one thing: what the company, or price of the stock, is *actually selling at*. Technical analysis assumes that the price a stock is selling at is the perfect price based on the fact that all known quantities, whether in the past, or anticipated in the future, are built into the price. Tens, hundreds, thousands of investors and traders take positions on both sides of the stock price, and it trades at the price that they have determined based on supply and demand. It *is* the price. There can be no argument. When you think of it that way, any other method is useless.

Now, to determine the future price, technical analysis relies on patterns. Seeing prices that occur consistently in such a way it shows that there is ongoing demand for, or supply of, a stock. Learning these patterns is exactly what learning technical analysis is all about. Are their drawbacks? Of course, or else this debate would not exist. However, all drawbacks are a function of not understanding how to use technical analysis. For example, technical analysis finds patterns that are predictable, but it does not mean that every pattern you see will be a predictable pattern. Another example is the concept of multiple time frames. Smaller patterns exist inside bigger patterns, and if you do not know how they should interact, it can appear random. These concepts will be discussed more, later in this book. Most important for this chapter, regarding subjectivity, is the

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misuse of technical indicators. Many traders rely on technical indicators, but unfortunately these indicators take the objective chart and turn it subjective.

TECHNICAL INDICATORS: ADDING SUBJECTIVITY TO THE CHART

The term "technical indicator" refers to all the things on a chart other than price, which are derivatives of price. You may know some of them: Moving Average Convergence Divergence (MACD), Relative Strength Index (RSI), Stochastics, Gann Lines, Elliott Waves—the list goes on and on. There are charting programs that literally have over 200 of them. This alone should tell you the value of any one indicator. Even moving averages are technical indicators. While moving averages can have a useful purpose, they too are often used subjectively to a trader's detriment.

Technical indicators are subjective in nature for a couple of reasons. They all rely on past prices. Also, while they claim to add objectivity, they all have so many settings that it comes down to everyone's individual opinion of how to read them.

It Is All in the Past

As I just mentioned, all technical indicators rely on past prices and apply a mathematical formula, which is supposed to help predict the future move. The past prices are already on the chart in front of you. This is the objective part of the chart. Price is what matters. Once you create a derivative of that price, it is open to interpretation as to what it means.

Some who use indicators say that they remove the noise from the price movement. However, it's that noise that can provide some of the most valuable information to us. We'll get to this later on.

There is some subjectivity in reading a price pattern. Trading will always have some subjectivity. If it did not, the future of all prices would be known to all and there would not be a market. Our job as traders is to keep things as simple and objective as possible, to find the patterns we know. Indicators add just another layer of mystery, and rely on someone else's setting to tell us what is happening.

It Is Still a Matter of Opinion

Indicators rely almost entirely on opinion or how each individual reads the tea leaves of the various indicators. There have been literally hundreds of different oscillators and indicators developed over the years and when most of them have the option to change the settings it makes the choices endless. The simple truth is that they alone do not tell you anything about what is going on in a stock or in the markets. Investors and analysts over the years have developed countless methods to take the measure of the market.

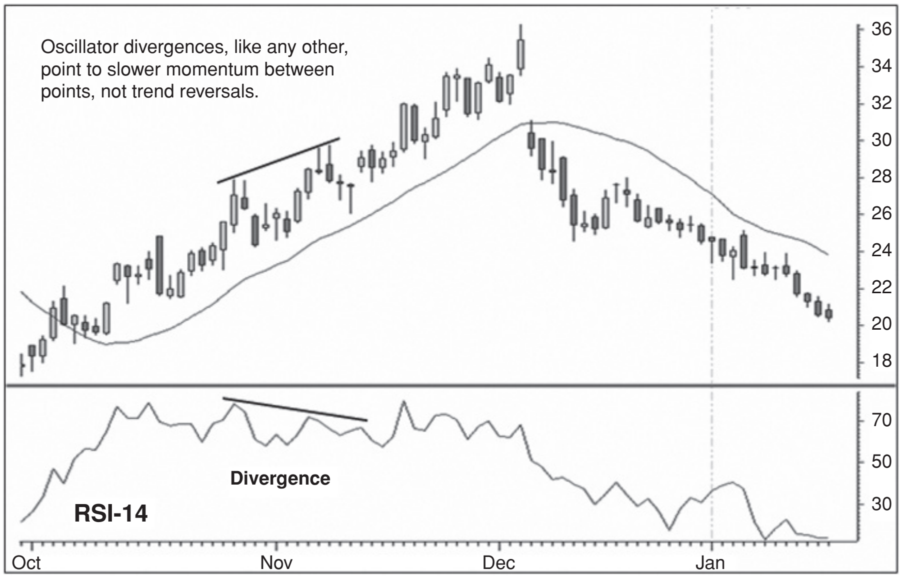

FIGURE 1.2 An RSI Divergence Is Often Meaningless
Chart courtesy of Mastertrader.com.

In reality, you do not need to measure or guess the market. The answer is in the price and it will tell you what it is going to do if you know how to listen to it.

Subjective analysis is based on what you think is happening. In contrast objective analysis is based on what is happening. Prices are directly observable in the real world and tell us what we need to know. Making decisions on subjective measurements leads to what we at Pristine (recall that I am president of Pristine.com, and may occasionally reference what we do there; please see the preface for more comments about my trading company, Pristine) call "mirage trading." It almost always leads to failure. A stock can hit its moving average and go down just as often as it might go up. A stock can remain oversold for months at a time. Perhaps you have already made some of these observations.

Take a look at Figure 1.2. You can see a clear divergence in the 14-day RSI, a very popular oscillator. A divergence such as this would tell the trader that since the oscillator is going down, the stock price should follow according to traditional technical analysis. As you can see that simply does not happen. All an oscillator can measure is slower momentum between price points. This does not necessarily mean that prices will change direction any time soon. Momentum can increase and decrease and the trend remain the same for a long time.

As we can see in Figure 1.3, using absolute levels for many of the indicators does not work either. In this example the RSI never reaches the levels that would indicate the stock was oversold and should be purchased. The price just kept going up for months. This leads to traders trying different settings until the indicator reaches the buy and sell levels where prices turned in the past assuming that this will predict the turns in the

FIGURE 1.3 Most of This Move Was Missed by the RSI Indicator
Chart courtesy of Mastertrader.com.

future. As the market environment changes or a different stock is used the indicator doesn't line up any more. This typically leads to a long cycle of constant changes in settings and indicators to find the perfect indicator.

Unless there is a very strong trend in place, using oscillators leads traders to buy tops and sell bottoms in stocks. The tools you learn in this book will show you to focus on the price itself. It does not matter if you are a day trader using five-minute charts or a long-term investor looking at weekly ones, all the information you need is in the price bars themselves. Why use anything else? The price is the truth.

You may notice that these conversations can flip back and forth between a stock and the market. That is intentional. The market is just a sum of several stocks. What is taught in this book works across all price patterns on anything that is bought and sold in an open market, with sufficient volume. Stocks, futures, commodities—the market itself—they are all the same.

Another problem with some of the technical systems that traders use is that they may lead the trader to believe with 100 percent conviction that the trader knows what will happen next. These are the ultimate in providing those new to the technical analysis with a false sense of security. Everyone wants to feel secure—to know what will happen next. This is human nature, but this is a major obstacle to succeeding as a technical trader or investor. Methods like Gann Angles, Cycle analysis, and Fibonacci retracements profess to offer precise measurements and predictors of stock movements. This creates a belief for traders that they know what is going to happen and can lead traders to make serious mistakes. If your conviction causes you to over-bet on a particular trade the results can be disastrous. Operating with a false sense of belief can also cause you to stay with a losing trade far too long, rather than exit with a small loss when the market told you your bet was wrong.

APPROACHING THE MARKETS OBJECTIVELY

To succeed at trading and investing you need to develop confidence, patience and discipline. I have found over the years that the key to developing these traits includes, ironically, operating in a state of not knowing what will happen next. This is just the opposite of what the majority of technical analysis techniques are based on. You have to eliminate subjective analysis based on indicators from your day-to-day activities in the market. To do this we need to learn a systematic objective approach to the markets.

At Pristine, we teach traders to recognize two key factors when approaching the markets:

1. A stock is always in one of four stages: we name those stages simply stage one, two, three, and four. All stocks, markets, anything, are always in one of these four stages. This is what I consider to be the first basic truth of trading and investing. Understanding this will always keep you on the right side of a move, and also let you know when it is best to leave a stock alone as it becomes less predictable. This is a basic concept to our method that I will be referring to throughout this book.
2. The stages always come in the same order. Once we know what stage a stock is in, there are very specific strategies used to play the stock, and this process keeps us objective in our trading.

The Four Stages of the Markets

For every stage, there is a correct way to play the stock. There is a direction, and there are certain strategies that can be played that will maximize the movement due to the stage we are in. Once you know what stage you are in, you know *how* to trade the stock, and you will know what *strategy* to use on the stock, which will tell you *when* to enter the position. Simple, objective, clear. Trading against the stage a stock is in accounts for 80 percent of losses.

Is it always easy to tell what stage a stock is in? No, of course not. In hindsight it is. In real time it is sometimes easy, and sometimes more challenging. Subjectivity can never be totally eliminated in technical analysis; you must accept this. But it must be controlled, minimized, and understood.

Here is an important point to remember: *When it is not easy to tell what stage a stock as in, you, as a trader, have the right to pass that particular trade. Wait for a better stock, or a better time.*

Re-read this paragraph; it is one of the keys to trading in my view.

Winning traders and investors are those who have learned to identify which cycle a stock or market has entered and buys or sells accordingly. You want to buy at the beginning of stage two and sell it before it enters stage three. Again, this is true regardless of whether you are day trading or investing for the long term. Losing traders and investors are those who react emotionally or rely on subjective indicators. Inevitably these individuals will buy late in stage two as the excitement peaks and sell near the end of the fear stage when all hope of an imminent recovery is gone.

Stage One: A Time of Ambivalence In stage one, the stock is in what I call a state of ambivalence. Nobody really cares much about the stock, and the stock trades back in forth in a range. There is usually very low volume, as there is little interest in the stock. The range is usually very small, as again, no one cares about this stock. Stage one always follows a period of selling, and often this selling can be enough to totally turn off the bulls from trying to buy any more. They are wounded, hurt, out of money, and no longer interested in the stock. Other bulls may be watching, and may soon want to buy, but at the moment, no one is interested as this stock is weak, and no one knows how far it may fall. There are many failed breakout and breakdown attempts, as neither bulls nor bears can find follow-though anymore, as there is just not enough interest. Breakouts always fail, as all the traders that held the stock long on the way down, sell into rallies trying to recoup their money.

Stage Two: The Uptrend After enough time goes by, many of these sellers exit or give up, and are no longer selling on rallies. All of a sudden, instead of a rally getting slapped down, it holds. Bulls look around and notice there are very few bears left. This attracts the attention of other bulls, and a snowball effect develops. When selling does come, it is just profit taking from the new bulls, and the stock doesn't go as low as it was before. More bulls come in and the next rally goes to new highs when compared to the prior rally. If this process continues, the early bulls are rewarded as the stock continues to set higher highs on rallies, and higher lows on pullbacks. This turns into an actual uptrend and attracts more buyers. This is now stage two, the time of buying: bulls, uptrends, and the emotion is greed. In the beginning this is what drives the price higher, and the beginning of stage two is the sweet spot that traders should strive to hit. You can see this in Figure 1.4.

Stage Three: Uncertainty Sets In Even after stage two has been in place a while, it can continue higher. Never bet that a trend is going to end unless you have good evidence. One of the odds we have in the market is relying on the power of the trend. At some point, new intelligent buying now becomes irrational exuberance. However, sometimes after a reasonable move, traders take profits, and new bulls are not as easy to find. The stock or market cannot find enough buyers on breakouts and they fail. Yet, when things seem weak, potential buyers who missed the move view dips and breakdowns as buy opportunities, and breakdowns do not work. The stock or market goes sideways, in a very sloppy manner in a wide range. The bulls and bears have to battle it out until a victor

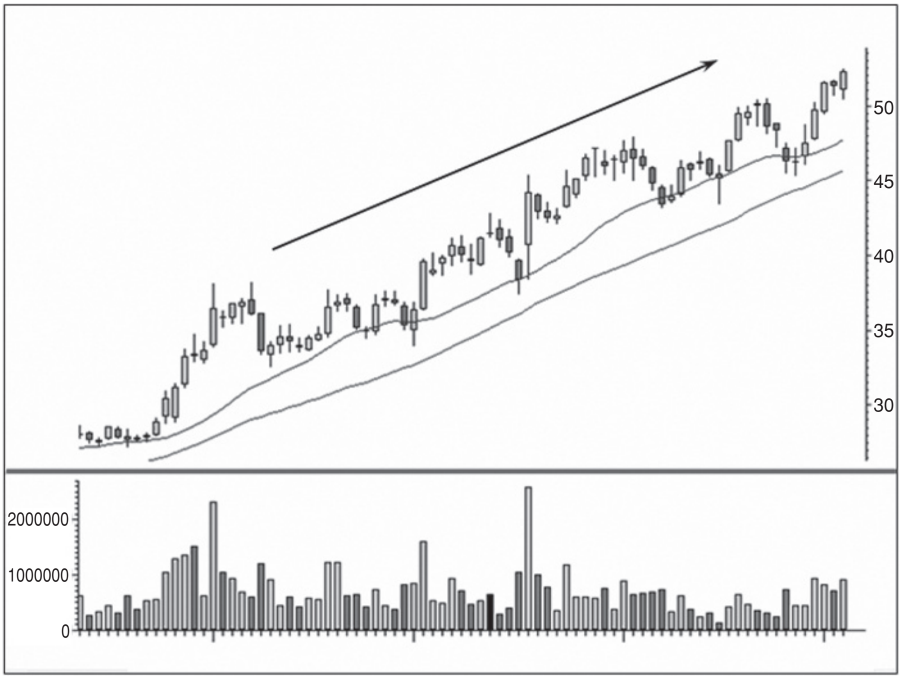

FIGURE 1.4 The Power of a Stage Two
Chart courtesy of Mastertrader.com.

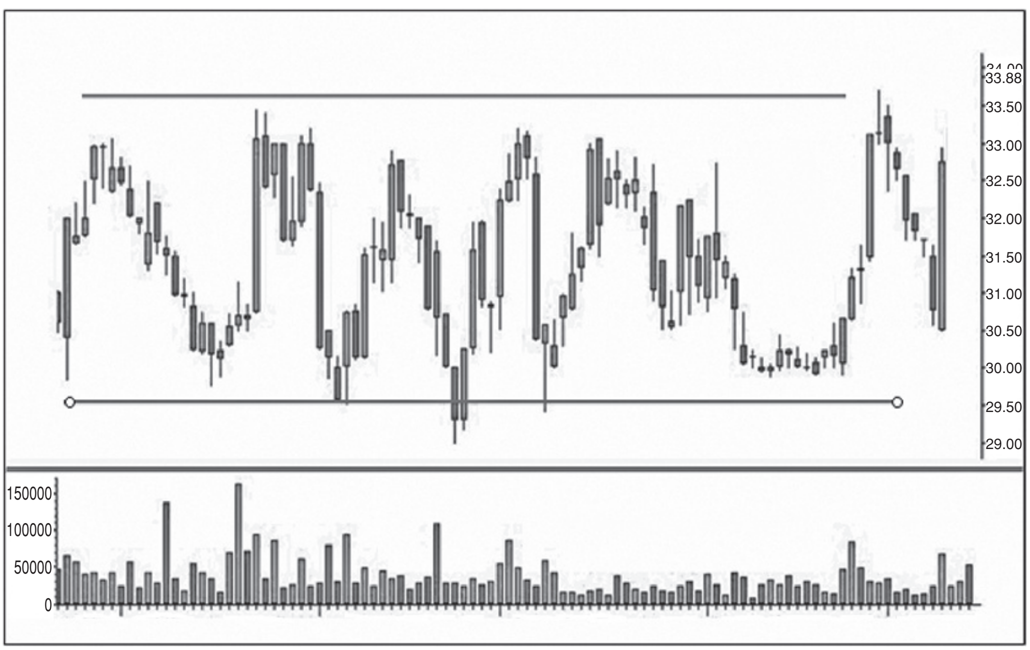

FIGURE 1.5 The Uncertainty of Stage Three Produces a Wide Sideways Pattern
Chart courtesy of Mastertrader.com.

is found. This is a period of indecision, where prices go sideways, and where unknowing traders try to play breakouts and breakdowns and they lose money, never knowing why.

Stage 4: The Downtrend The pattern may settle down and simply go higher, which would continue the original stage two. This is known as a pause in stage two, and can be distinguished. We will discuss these two types of bases in more detail later. But sometimes the balance of power changes and, all of a sudden, one of those breakdowns does not find buyers and the price drops. The bulls who have been relying on that base to hold now realize they are in losing positions, and they begin to exit. Again, the snowball starts rolling and selling begets more selling. The rallies stop short of prior rallies, and the declines go lower than the last decline. Selling, fear, good news is bad news, are all the signs of stage four (see Figure 1.6).

As fear accelerates, selling increases and begets more selling. This drives prices to the point that even those who swore they would not sell cannot stand the pain and they sell, vowing never to buy another stock again. At some point all sellers, that are ever going to sell, have sold. The stock has run out of sellers and it stops falling. There are no buyers, as the pain has kept old bulls away, and the falling stock has kept new buyers away. So the stock drifts sideways, with no one caring. We are back to ambivalence; we are back to stage one.

FIGURE 1.6 Stage Four: The Bears Take Control
Chart courtesy of Mastertrader.com.

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This will play out across all time frames. You will see it on intraday charts every day. You will see it on daily and weekly charts.

Observing Trends: Up, Down, or Sideways

The second truth is that throughout these stages, a stock or market can really do one of three things. Go up, go down, or go sideways. When a stock goes sideways, it can trend sideways in a reliable pattern, or it can be sideways in a wild erratic pattern.

Stocks go up in up trends (stage two), where the price movement forms higher peaks at the highs and higher dips at the lows. Stocks go down in down trends (stage four), where the price movement forms lower peaks at the highs and lower dips at the lows. A sideways price pattern will have a series of roughly equal high peaks and low dips and requires a slightly different approach to trading. Knowing which condition exists is a key to consistently making money in the markets. Once we know which stage and trend a stock or market is in at a point in time, we can begin using what prices are telling us to find: high probability price movements.

One of our biggest tools to help spot where we are and how to read what the prices are telling us, are what I call the Pristine Buy Setup and Pristine Sell Setup. As you can see in Figure 1.7, I use candlestick charts to read the price of a stock or index. For analyzing

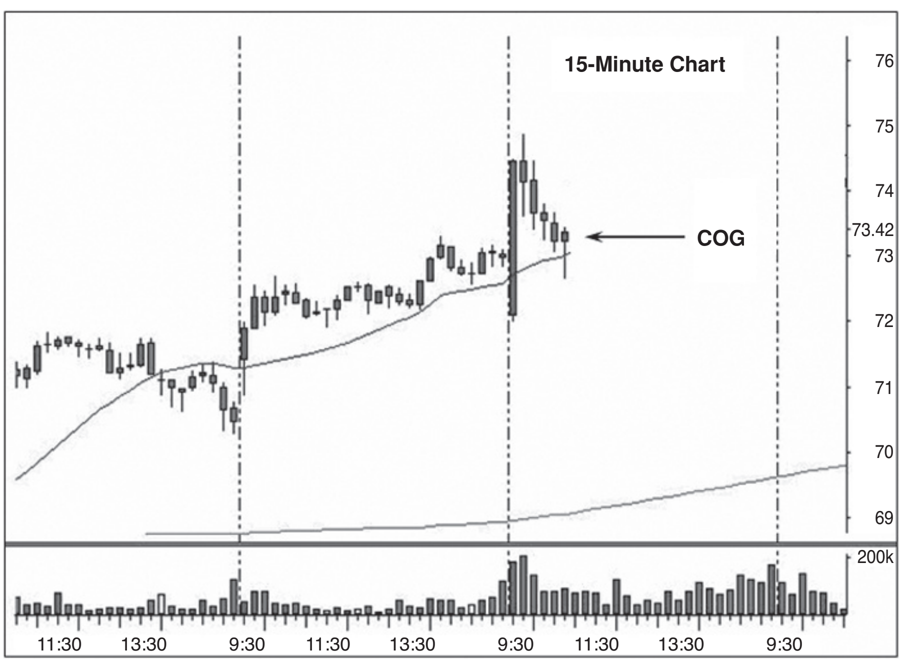

FIGURE 1.7 A Bullish Changing of the Guard Bar Tells Us the Stage Two Uptrend May Be Ready to Resume
Chart courtesy of Mastertrader.com.

FIGURE 1.8 A Bearish Changing of the Guard Bar Completes This Sell Setup
Chart courtesy of Mastertrader.com.

all normal price action on most charts, I do not consider a chart useful unless it uses candlesticks. I will explain why in greater detail in Chapter 2.

For now let's take a look at what this chart is telling us. The big picture of this stock is a bullish stage two, moving up with higher highs and higher lows. The recent pattern shows the stock has been moving down for several bars in a row, but has not violated the stage two pattern. Once we get a reversal of this price action, as long as we have identified that the stock is still in an uptrend, or in the early part of stage two, it is time to buy. We also call this reversal bar the "changing of the guard" (COG).

In Figure 1.8 we can see that a Pristine Sell Setup (PSS) is simply the reverse of this. The big picture of this stock is a bearish stage four, moving down with lower highs and lower lows. The recent pattern shows the stock is moving up for several bars but has not violated stage four. If we looked at the movement as a line it would be pretty much a straight line up. When the price action reverses it is time to sell or short the stock.

These setups can be used in any time frame. They can be used to establish short-term swing trades or to time long-term stock purchases. It is an easily recognizable pattern that uses a specific series of candlestick charts. Generally speaking once we get reversals we find out very quickly if we were right or wrong and can react to what the market tells us most of the time. Generally this set up occurs when there has been a countermove due solely to profit taking, and the buying or selling activity of the underlying trend is going to reassert itself. Because we already know that we do not know exactly what is going to happen we can let the price tell us what to do once we place the trade.

There are several beautiful things about this Pristine Buy or Sell Setup you may have noticed. First, we are playing in the direction of the primary trend. Second, we are not

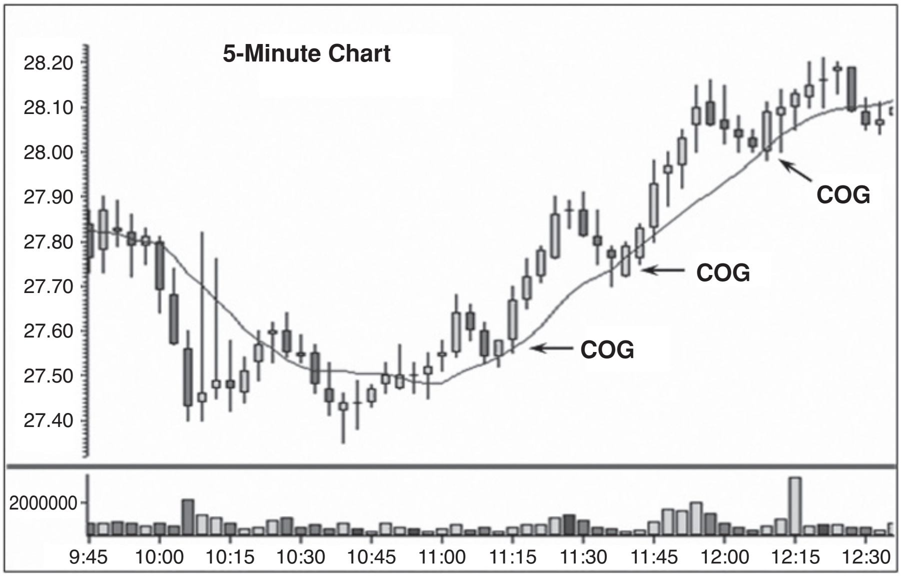

FIGURE 1.9 The Uptrend Is Punctuated with Bullish Changing of the Guard Bars
Chart courtesy of Mastertrader.com.

chasing high prices, we are getting in right at the maximum pullback. Which leads to the next beautiful thing, we have a larger move to whatever price target may be out there. We also have a place to limit our losses very quickly, because if we are right, that entry bar should be the resumption of the trend. If it does not hold, we will be out quickly.

Take a look at Figure 1.9. The stock opens up and begins an uptrend around 10:30 A.M. Then, at 11:15 A.M., we get a changing of the guard buy setup. After momentum stalls and the stock fades out, we pull back setting up another buy signal and move still higher into the close. The patterns are very precise and easy to recognize.

Once we eliminate emotional thinking and subjective analysis we can begin to read what the market is saying. The price is the truth and it is all we need to determine what trading or investing action to take next. We do not need to rely on indicators and tools that are derivatives of price when we can use the price itself. There are no fundamental or technical measurements that will allow you to develop absolute certainty about what is going to happen next. Using the tools you will learn in this book you can tip the odds in your favor but you have to be willing to trade based on probability, not absolute certainty. This allows you to react properly to what does happen and to profit.

IN SUMMARY

The price patterns that form every day and every week are true objective indications of what is actually happening to prices. When stocks are being bought or sold they usually

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develop very specific patterns that can be learned and identified. Relying on or even considering any of the subjective notions we discussed is only a mirage as they do not involve the truth.

We are going to build on this notion. I have introduced you to the concept of the four stages of price action. We now get more specific and look at the basic units that make up these trends, starting with the individual candlesticks that make the charts we follow.