

## Chapter 1

# Wrapping Your Brain around Technical Analysis

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### *In This Chapter*

- ▶ Understanding the basic principles of technical analysis
  - ▶ Recognizing how crowd extremes and market sentiment influence trading action
  - ▶ Examining and choosing indicators that match your trading style
  - ▶ Starting your journey as a technical trader
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**T**echnical analysis is a set of forecasting methods that focus on the price and volume of a security rather than the fundamentals (supply and demand for commodities, earnings per share for companies, and so on). In technical analysis, you observe how prices move without regard for what analysts are saying about the price (such as whether it's above or below "fair value"). You use past regularities in price movements to predict future regularities. This chapter gives you basic information about technical analysis. Consider it the foundation on which to understand and use the topics in the rest of Book X.

## *Realizing That the Trend Is Your Friend*

*Technical analysis* is the study of how securities prices behave and how to exploit that information to make money while avoiding losses. With technical analysis, you work to identify price trends (a *trend* is a discernible directional bias in the price — upward, downward, or sideways). These basic observations underlie technical analysis:

- ✔ Securities prices move in trends much of the time, and trends remain in place until some major event comes along to stop them.

- ✓ Trends can be identified with patterns and indicators, including the core concept of *support and resistance* (covered in Chapter 4 of Book X).
- ✓ Primary trends (lasting months or years) are punctuated by secondary movements (lasting weeks or months) in the opposite direction of the primary trend. Secondary trends, or *retracements*, are the very devil to deal with as a trader. See the later section “Retracements” for details.



Your goal is to forecast the price of the security over some future time horizon in order to buy and sell the security to make a cash profit. The emphasis in technical analysis is to make profits from trading, not from owning a security as some kind of savings vehicle. You may *also* do that — own securities with no intention of selling in order to get a dividend or long-term gain — but technical trading by definition entails selling in order to realize gains in cold, hard cash. The purpose of technical trading is to build capital. In conventional investment management, the purpose is to preserve capital. In the technical mindset, the security you’re trading is only a vehicle for making profits. If you find it hard to sell a security because you’re emotionally attached to it, that security belongs in your “buy-and-hold” portfolio, not your “technical trading” portfolio.



Technical trading entails selling at a gain or a loss according to specific rules that you devise yourself. Many indicators have embedded buy/sell rules, but those rules may entail losses beyond what you can tolerate. Even after you pare down and refine your indicators to suit your risk preferences — that is, your tolerance for losses — you will still take losses. Taking losses is part of the technical trader’s *modus operandi*; your goal is to design a trading regime that produces more gains than losses. Learn to take losses without emotion and move on to the next trade.

The following sections discuss having reasonable expectations about technical analysis and charting trends.

## *Using reasonable expectation*

Critics say technical analysis–based trading is speculation. *Speculation* is a semantically-loaded word and sometimes confused with gambling. But technical analysis–based trading offers a reasonable and measurable expectation of gain, while gambling does not. The probability of heads coming up more than 50 percent of the time in a fair coin toss is zero. The gambler has no realistic expectation of a gain on any single play, whereas the probability of a gain in each trade by a skillful technical trader should be well over 50 percent. A good technical trader never takes a trade unless he has a reasonable expectation of a gain. Just about every technical trader can recite his

gain-loss ratio, such as 3 to 1 (meaning he makes \$3 for every \$1 lost). While the gambler has no edge in the face of randomness in coins, cards, or roulette wheels, the technical trader does have an edge — the technical tools.

Technical traders observe that while some price changes in securities markets are indeed random, much of the time prices move in regular patterns that can be identified and exploited. To the technical trader, securities prices are not random. If prices were random, you couldn't identify trends — and you can identify trends. You can't do it all the time, but trendedness is visible on every chart of every security in some timeframe.

## Charting course

The technical analysis toolkit contains techniques for winnowing out useful forecasting ideas (the *signal* or *trading trigger*) from the noise of massive amounts of price data. Technical indicators may be expressed as statistics, tables of numbers, and other formats, but the central workspace is the chart, like the one shown in Figure 1-1, which illustrates a classic uptrend following a downtrend.

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**Figure 1-1:**  
Uptrend and  
downtrend.

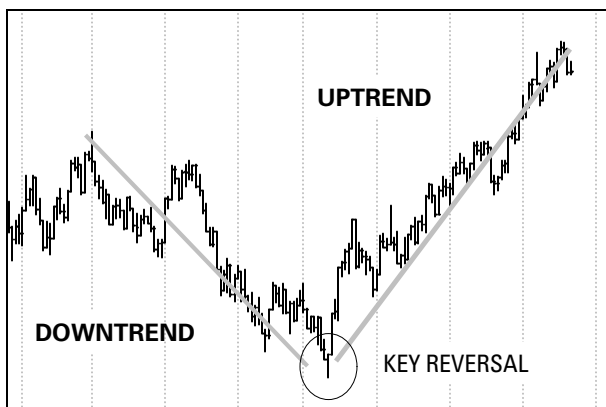


Illustration by Wiley, Composition Services Graphics



At the most basic level, your goal is to buy a security whose price is moving upward and to shun or go short a security that is visibly on a downward trajectory. It's up to you whether to buy a security that's a real dog just because its price is going up and offers a profit opportunity. You may choose to trade only securities that meet some criteria of worthiness. But technical analysis would have you sell even your gold-plated favorite security if indicators were to point to a price drop. You can always buy it back later.

## Knowing What to Do about Crowd Extremes

Technical analysis is the art of identifying crowd behavior in order to join the crowd and take advantage of its momentum. This is called the *bandwagon effect*. Here's how it works: A fresh piece of news comes out, a majority of traders interpret it as favorable to the security, and buying overwhelms selling so that the price rises. You profit by going with the flow, without necessarily knowing the news that triggered the rally. Then when everyone is jumping off the bandwagon and preferably just before, you jump, too.

As market participants get excited about a security, they become increasingly bullish and either buy for the first time or add to positions, a phase named *accumulation*. When traders become disillusioned about the prospect of their security price continuing to rise, they sell, in a phase named *distribution*.

After traders have been accumulating the security on rising prices, eventually the price goes too far. *Too far* is a relative term and can be defined in any number of equally valid ways, but basically it means any price extreme that specific indicators identify as showing traders' positions are extended and overdone. For example, say a security has rallied 40 percent in ten days, and such a big rally in so short a time is wildly abnormal behavior for this security. You suspect it's time to take profit, but you use indicators to confirm the judgment and to refine the timing of your exit. The following sections describe a few terms that are used when prices go too far.

### Overbought and oversold

When a price has reached or surpassed a normal limit, it's at an extreme. In an *upmove*, everyone who wanted to buy has already bought. The market is called *overbought*, a term specific to securities trading. In a *downmove*, everyone who wanted to sell has already sold. The security is called *oversold*. The concept of overbought/oversold is applied to market indices as well as individual securities. It's usually measured by the momentum indicators described in the later section "Examining how indicators work."

### Retracements

When a price has gone too far and traders deem the security overbought or oversold, the price stops rising or falling. Instead of hovering at a particular

level, however, the price moves in the *opposite* direction for a while. A move in the opposite direction of the main trend is named a *retracement*. (Other names for it are *correction*, which explicitly recognizes that the security has gone too far and is now correcting course; *pullback*; and *throwback*.) The following sections explain how to recognize a retracement and estimate when it will end.

### Recognizing a retracement



Prices seldom move in one direction for long. Even a major trend exhibits retracements. When the market runs out of cash, traders have to close positions to get their cash back so they can put on new trades. If they've been buyers, they need to sell. If they've been sellers (shorting the security), they need to buy. Position squaring always causes a price move in the opposite direction of the trend. Therefore, at the extreme outside limit of a price move, you should expect a temporary, minor reversal of the previous price move. In an uptrend, a retracement is always a drop in price. In a downtrend, a retracement is always a rise in price.

Figure 1-2 shows a primary trend with several retracements, each outlined by an ellipse. In this instance, the retracements last only a day or two — but retracements can last a lot longer, several weeks on a daily chart, for example. They can also retrace over more ground.

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**Figure 1-2:**  
A trend  
with four  
retracements.

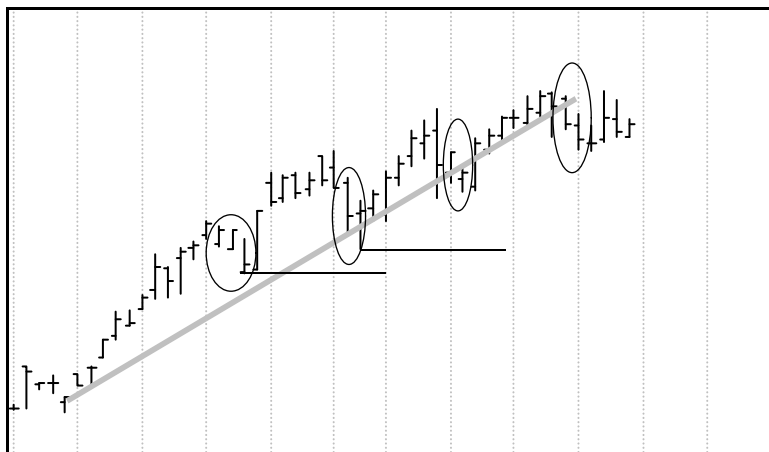


Illustration by Wiley, Composition Services Graphics



When a retracement starts, you don't know for sure that it *is* a retracement. Maybe it's a full reversal, with the price switching direction. This is one of the occasions when it may pay to check the *fundamentals* (the news and events pertaining to the security). An ordinary retracement caused

by normal position squaring can suddenly turn into a full-fledged rout in the opposite direction if fresh news comes out that supports a reversal.

### ***Catching a falling knife: Estimating when a retracement will end***

Trying to estimate where a retracement will stop is called *catching a falling knife*. Unfortunately, no reliable rules exist to tell you where a trend correction will end or when the primary trend will resume. One of the chief uses of indicators and combined indicators is to get guidance on where and when a retracement will stop.



Your tolerance for retracements is the key to deciding what time frame you want to trade in. If the specific security you want to trade has the bad habit of regularly retracing 50 percent, but the prospect of losing 51 percent turns you into a nervous wreck, you need to trade it in a shorter time frame — or find another security.

Acknowledging that no one can forecast a retracement hasn't stopped technical traders from trying to establish forecast rules. The following rules are generally helpful:

- ✓ **Assuming a retracement won't exceed a significant prior high or low:** In Figure 1-2, for example, the second retracement doesn't challenge the lowest low of the first dip, and the third retracement doesn't challenge the second.
- ✓ **Looking for round numbers:** Research shows that support and resistance levels (see Chapter 4 in Book X) occur more often at round numbers than chance would allow.
- ✓ **Observing the 30 percent rule:** Measure the percentage change and assume that a majority of traders will place stops to avoid losing more than *x* percent, such as 30 percent. The problem with this idea, and it's a chilling one, is that you're measuring from a peak and you don't know the price level where the majority of traders entered.

Logically, if any or all of these guidelines are violated — the price does exceed the previous high or low, it does surpass a round number, or it moves over 30 percent — you don't have an ordinary retracement and may have an outright reversal.

## ***Looking at Market Sentiment***

In technical analysis, sentiment comes in two flavors: *bullish* (the price is going up) or *bearish* (the price is going down). Sometimes the bulls and bears

are slugging it out so strenuously that the net price move by the end of the day is zero. After several days of little or no closing price change, the market is described as *congestive* or *consolidative*, meaning the two sides are equally matched.

In that situation, you have to wait for one side or the other to win. Sometimes you get lucky and the price chart exhibits a particular bar configuration or pattern that you know from past experience means one side is winning. In order to get into the trade in the right (profitable) direction, you work extra hard to identify these reversal indicators. Unfortunately, the best ones, like the key reversal bar or island reversal pattern, are fairly rare. Most reversals are messy, and price patterns can be ambiguous for long periods. The following sections highlight factors to look at as you try to understand market sentiment.

## Tracking volume

*Volume* — the number of shares or contracts of a security traded in a period — is the most powerful confirming indicator of a price move, and *confirmation* is a key concept in technical analysis.



You can feel more confident that a price move has staying power if you know that many traders — not just one or two — are involved. In technical trading, therefore, you use volume to measure the extent of trader participation. When a price rise is accompanied by rising volume, you have confirmation that the direction is associated with participation. Similarly, if you see a price fall by a large amount unaccompanied by a change in volume, you can deduce that the price change was an aberration.

Volume often leads price. The most obvious situations are when volume spikes. A *spike* is a volume number that is double or more the size of volume on the preceding days. Say volume has been running at 100,000 shares per day for several days or weeks, and suddenly it explodes to 500,000 shares. If the price has been in a downtrend, this wild increase in volume means that the crowd is throwing in the towel and exiting en masse. You need to wrap your mind around the initially counterintuitive idea that a wild increase in selling is an indicator of an imminent buying opportunity.



A volume spike is one of the occasions when fundamental information is complementary to a technical observation. If volume spikes higher but price fails to rise proportionately and you can't find fresh news that should inspire new buyers, for example, be wary. Chances are the top is in. If the security has new, legitimately exciting news, you can reasonably deduce that it has attracted new buyers.

You have several indicators to measure volume in conjunction with price. One is *on-balance volume* (OBV), an accumulation of volume data that can be charted as a single line on the chart. You add volume to a cumulative total for each day that the close is higher than the day before and subtract volume for days that the close is lower than the day before. The OBV doesn't work all the time, but a change in the indicator often precedes a change in the price. Several OBV variations and refinements have been developed over the years.



The divergence of price and an indicator that normally rises and falls in tandem is a wake-up call. For example, if prices are consistently putting in new highs but *closing* a bit lower, you may think the security is still on an uptrend and your position is safe. But even if volume is steady at more or less the same levels, when OBV starts to fall, it's showing you something you can't see with the naked eye — the exhaustion of the buyers.

## *Understanding market effects*

An old saw in trading lore has it that a rising tide lifts all boats. Some percentage of any security's price move is attributable to changes in the market environment. You may have the inside scoop on the best stock ever, but if the entire market has a case of the collywobbles, your best-ever stock is likely to fall, too. Conversely, when the market is in a manic phase, even the worst of stocks gets a boost.

To get a handle on possible market effects on a specific security, technical traders measure overall market sentiment by looking at market statistics. Strictly speaking, market statistics are not technical analysis, which is the study of how specific prices behave. Nevertheless, sentiment measures (see the next section) can be very helpful as a supplement and complement to work on your individual charts.

## *Sampling information about sentiment*

Most sentiment indicators look outside the price dynamics of a particular security or index of securities for information about whether the trading crowd is humming along normally or is forming a plan to jump ship. In technical trading, the key principle is to study what people *do* (price and volume), not what they *say*. Following are a few suggestions:

- ✓ **The bull/bear ratio** is an indicator published by vendors such as Investors Intelligence. The metric measures when a majority (60 percent or more) of investors are bullish or bearish. When a high percentage are bullish, it's getting to be time to exit — the market is getting overbought.



- ✓ **Breadth indicators** measure the degree of participation by traders in the overall market represented by an index, such as the Dow or NASDAQ. Breadth indicators include the ratio of advancing to declining issues, which measures the mood of the market, and the difference between issues making new highs and those making new lows. If more stocks in an index are closing at higher prices than the period before, bullishness is on the rise. When a higher number of stocks are putting in new lows, supply is overwhelming demand and the mood is bearish.
- ✓ **The put/call ratio** published by the Chicago Board Options Exchange (CBOE) is an indicator of whether sentiment is bearish or bullish. A high put/call ratio means bears are winning. The same line of thinking holds true for a low put/call ratio: When emotions are strongly optimistic, watch out for an opportunity to take advantage of a change. (Chapter 4 in Book II has more information on put/call ratios.)
- ✓ **The volatility index (VIX)** is a contrary indicator. When the crowd is feeling an extreme emotion, like anxiety, it's usually wrong. Therefore, a high VIX value means exactly the opposite of what it seems to mean — the bottom isn't coming, it's already in! When VIX is low, traders are complacent; they're projecting the same price levels, or nearly the same levels, into the immediate future with little variation and therefore little risk. When VIX is either abnormally high or abnormally low, you know it's the right time to trade against the crowd.
- ✓ **Seasonality** (also known as *calendar effects*) refers to the natural rise and fall of prices according to the time of year. Heating oil futures go up as winter heads for Chicago, for example, and prices of agricultural commodities rise when the crop is poor and fall when farmers get a bumper crop. Equities and financial futures exhibit a similar effect. The changes are regular and consistent enough to warrant your attention. Here are a few:
  - **January barometer:** When the S&P 500 closes higher in January, it'll close the year higher than it opened.
  - **"Sell in May and go away":** For decades, it has been observed that selling all equities at the end of April and buying them back on November 1 increases total gains by a very large amount. Recent research indicates this is true in non-U.S. equity markets as well.
  - **President's third year:** Since 1939, the third year of a presidential term is always an up year for the Dow.
  - **Presidential election cycle:** Wars, recessions, and bear markets tend to start in the first two years, while prosperity and bull markets tend to happen in the second two years.

## Using Chart Indicators

Technical traders go to great lengths to remove emotion and impulsiveness from decision-making. The chief tool for squelching emotion is the *indicator*, a calculation that you put on a chart to identify chart events, chiefly whether the price is trending, the degree of trendedness, and whether a trend turning point is being reached. The purpose of indicators is to clarify and enhance your perception of the price move. These indicators come in two varieties:

- ✓ **Judgment-based indicators**, including visual pattern-recognition methods such as bar, line, and pattern analysis, as well as candlesticks (see Chapters 2 through 4 in Book X for details)
- ✓ **Math-based indicators**, including moving averages, regression, momentum, and other types of calculations (see Chapter 5 in Book X)

Because some randomness exists in every market, plus imperfect information or at least imperfectly distributed information, no indicator works all the time. Each indicator works best in one situation and not as well in others. Technical traders argue the merits and drawbacks of indicators in each situation, and the indicator you choose for each task depends, to a certain extent, on the security and also on your choice of analytical time frame.

## Examining how indicators work

An indicator is usually an arithmetic rearrangement of the four basic components of the price bar: the open, high, low, and close (OHLC). Indicators aren't inherently tied to a particular time frame; you could be looking at the OHLC of 15-minute price bars rather than the more usual daily bars. The sections that follow describe the general way indicators work, but be aware that technical traders are inventive and use indicators in an infinite variety of ways.

### *Finding relevant time frames*

Most indicators measure price and volume changes relative to previous prices and volume over a specific *look-back* period, such as 12 days or 21 days. For example, you can divide the closing price today by the closing price 12 days ago to create a momentum indicator and graph it on a chart. When this indicator is rising, you have a different and more context-rich way of looking at an uptrend than just looking at prices alone. Now say the momentum indicator stops rising, even though closes are still higher. The point of the momentum indicator in this case is that closes are not *relatively* higher. This is a valuable indication that the upmove is losing momentum. You may not want to sell just yet, but you have an alert.



With the exception of historic highs and lows, most indicators have a range of time in which research shows they work best. This is why charting software has preformatted indicators with default parameters specifying a particular time range, such as 12 days for a simple momentum indicator. However, adopting the default parameter doesn't mean that you must trade according to that time range. Consider it a starting point; if the default doesn't work for you, use a different number of periods.

Most indicators work equally well on any time frame. Intraday bars (such as hourly bars) are like microcosms of daily bars, and daily bars are like microcosms of weekly or monthly bars. Traders respond to price changes in regular, consistent, and repetitive ways whatever the time frame. This is called the *fractal* nature of securities prices; therefore, you can't tell whether an unlabeled chart represents hourly bars or daily bars.

### *Heeding indicator signals*

Indicators are designed to give buy and sell signals, although in many instances, like the momentum indicator, the signal is more like a warning and doesn't have a black-and-white embedded decision rule. The following list introduces signals to pay attention to:

- ✓ **Crossovers:** Crossovers — when one line crosses another line — include the price crossing a fixed historic benchmark, the indicator crossing the price or the price crossing the indicator (called a *breakout*), or one line of a two-line indicator crossing the other.
- ✓ **Breakouts:** The breakout concept is one of the most important concepts in technical analysis. A breakout occurs when the price or an indicator exceeds some kind of benchmark, such as support or resistance, a moving average, a statistical measure of the normal move, or lines devised to signify important levels, such as pivot points.
- ✓ **Range limits:** A variety of indicators fall into this category:
  - **Darvas box:** The most simple range limit indicator, the Darvas box (named after its inventor) draws a horizontal line off the last two lows into the so-far uncharted future and, when the price is rising, assumes the maximum drop will be at the last low (support), and the maximum rise will be the same number of points as the distance in points between the first two lines.
  - **Oscillators:** Fancier than Darvas boxes, oscillators describe where today's price stands relative to its recent trading range. They're usually based on 100, so they range from 0 to 100, -100 to +100, or some other variation using the number 100. In practice, the scope of the price range usually falls under the outer limits and doesn't vary by more than 20 to 80 percent of the total possible range.



Traders draw maximum likely range lines at 20 percent and 80 percent. When the indicator approaches one of the lines, you know that the price is nearing an extreme of its recent range and is likely overbought or oversold.

- **Channels, bands, and envelopes:** *Channels* are generally straight lines drawn on either side of a central line like a linear regression line, while *bands* and *envelopes* are terms used to describe dynamic or wavy lines formed by adding space on both sides of a wavy line like a moving average. The outer limits of the channel or band are determined arithmetically by applying a standard deviation of the prices to a moving average of prices, or the standard error to a linear regression, or by devising pivot lines based on past price performance.

✓ **Convergence:** *Convergence* refers to two indicator lines coming closer to one another, indicating less difference between their numerical values. Convergence generally means that the price action is starting to go sideways or has a narrower high-low range, or both. A sideways move, in turn, generally leads to a breakout.

✓ **Divergence:** *Divergence* refers to two indicator lines moving farther apart, as when the spread between two moving averages widens, or when an indicator and the price go in different directions. Advanced momentum indicators, in particular, reshuffle the components of the price bar to come up with the rate of change of a price, so that the slope of the indicator is a sophisticated measure of the strength of a trend. When the price is still rising (making new highs) as the momentum indicator starts to fall (making progressively lower highs), the price and indicator are diverging, which is an important leading indicator that the price rise is probably ending. (See Chapter 5 in Book X for more on momentum.)

## Choosing indicators

Indicators only *indicate*; they don't *dictate* the next price move. In other words, you may buy a security because your indicator tells you to, only to find out that the indicator's wrong. After you buy, the price falls. What you do next is a function of your risk appetite plus your confidence in the indicator. If you find losses hard to stomach, you exit the trade upon losing a certain dollar amount and chalk the loss up to experience. You may also decide to change the parameters of your indicator or start looking at additional indicators that would have kept you from the losing trade, a process called the *confirmation approach*. Or, if you're stubborn and have faith in the indicator, you may keep holding the losing position until it turns around into a winning position — or the loss becomes catastrophic.



Make the exit decision before you place the trade. You should know in advance how much you can expect to gain from a specific trade and how much you're willing to lose. If you back-test an indicator, such as the price crossing the 20-period moving average, you'll get an estimate of how this indicator worked in the past — the win-loss ratio. But you always need to acknowledge that the indicator won't perform in the future exactly the same way it did in the past.



Indicators are useful only in the context of your appetite for risk, which is another way of saying your tolerance for losses. Your indicator may be perfectly good in the long run and may deliver the expected gain, but not before retracement losses force you to exit early, either because the losses scare you or because you've run out of money. Tolerance for loss is deeply personal, but it's also a function of how much starting capital you have.

The following sections provide some important guidelines for choosing indicators.

### *Looking at your starting capital*

Starting capital is the starting point for choosing indicators and trading style (covered in the next section). You don't want to select the price crossing the 20-day moving average as your sole indicator to buy or sell if you have so little starting capital that you'd be wiped out at the first normal retracement, based on the history of the indicator. But the 20-period moving average may be just the ticket when applied to a 4-hour moving average, depending on the amount of your starting capital.



You don't have to be a rich trader with a high capital stake in order to trade on daily or weekly indicators. But how much capital you have does impact your holding period. If you have less capital, your holding period shouldn't be weeks and months because of those pesky retracements (discussed earlier in this chapter). A skilled trader can identify and evade retracements using daily indicators, but it does mean more frequent trading. This situation may take some getting used to.

### *Choosing an analysis style*

Your choice of indicators and indicator parameters should also be a function of your analysis, or trading, style. Picking a trading style before getting a good grip on indicators may seem to be putting the cart before the horse, but as long as you're reprogramming your mind to accept the usefulness of indicators, you may as well begin to imagine trading on shorter time frames.

Trading more frequently than you previously did doesn't mean you'll become a minute-by-minute fiend handcuffed to the computer screen every hour of every day. It does mean, however, that whatever your capital stake, you need

to have an exit plan that minimizes losses and preserves the stake. You want to pick indicators and indicator parameters that, based on past experience, would have done just that (even though traders know, from sad experience, that indicators don't work the same way all the time).

In general, trading styles are a function of the holding period, or how much time elapses between buying and selling the security.

- ✓ **Position traders** identify big-picture trends lasting weeks and months, and are willing to sit out retracements and sideways range-trading situations until they resolve back into a trend. Position traders hold securities for weeks, months, and years.
- ✓ **Swing traders** buy at relative lows and sell at relative highs, with *trend* defined as any move that indicators show is likely to persist for some additional time. Swing traders have a holding period of 3–10 days, although analysts argue over the “right” holding period.
- ✓ **Day traders** are a subset of swing traders who prefer to get in and out in a single day, sometimes more than once. Day traders apply indicators to short-term charts, such as the 15-minute and one-hour charts, in order to identify micro-trends that may last only two or three hours. The micro-trend could even be a counter-trend to the big-picture trend on the daily chart.
- ✓ **Scalpers** have a holding period of seconds and minutes. The term *scalping* originally referred to taking advantage of the big-offer spread available by different parties or parties in different places, but with the advent of super-fast computer programs, scalping now includes algorithmic trading that automatically places rule-based buy and sell orders based on a few seconds' advantage in obtaining information or identifying a technical pattern.

## Getting Started

You can get started as a technical trader in one of two ways:

- ✓ **Taking a systematic, security-centric approach:** You find indicators that would have worked on your favorite securities to generate more gains than losses and apply them going forward. It's always wise to pretend-trade for a while before committing actual money.  
  
Say the indicators you're comfortable with would have generated a gain/loss ratio of \$2.50 for every \$1 in losses over the past five years using daily data and a holding period averaging five days. Now you know: You're a swing trader, and applying indicators on daily data works for

you. Now imagine that applying your indicators on 4-hour bars of the same security would have generated \$4.50 for every \$1 in losses. This is a better gain/loss ratio but involves more trades, say, triple the number of trades. You decide the extra gain is worth the extra time and commission expense. Now you're a day trader. In both cases, you're applying the same indicators to the same security and taking every trade the indicators tell you to take. This is a systematic, security-centric approach.

- ✓ **Taking an opportunistic, indicator-centric approach:** You scan the universe of securities for candidates that are displaying a pattern or bar configuration that your review of historical prices tells you resulted in big gains in the past. These are sometimes called *setups*. You may know nothing about the security, only that it has just put in a historic low, a volume spike on a downtrend, an island reversal, or some other indication of an impending price change. Your goal is to get in early on the breakout or reversal for a fast profit. Whether this style makes you a swing trader or a day trader depends on the time frame to which you apply the indicator. The opportunistic approach requires more knowledge of indicator behavior and the ability to troll for the opportunities.

The systematic, security-focused approach has the advantage of helping you develop real skill in a small set of indicators and deep familiarity with a small set of securities. The drawback is that when using a trading system, you must take every trade the indicators tell you to take, because you never know in advance which signal will deliver the abnormally big gain.

In contrast, the opportunistic, indicator-based approach has the advantage of letting you choose where and when to trade — you don't have to take every trade, just the most promising setups. This approach makes you a guerilla rather than a foot-soldier. The drawbacks are that the scanning or screening process may be badly programmed or biased to certain types of securities, or the scanner may misrepresent the track record of the indicators.



Whichever approach appeals to you, you can literally begin applying it immediately. It takes about an hour to plot an indicator on a chart of a specific security and see how it would have worked in the past. It takes about an hour to apply screening software to a universe of available securities (usually equities) and see what opportunities the indicators identify. You may want to check out both approaches to see what suits your personality and capital stake.

