

Introduction

Technical analysis has come a long way in the past few decades, and today traders of every level make the most of this very useful tool. So, this book is for institutional traders and individual investors alike. Although it takes you through the basics from square one, as well as covering advanced topics, it also offers some unique insights based on my work on cycles for timing trades and on the work of Kerry Denny on evaluating market news, which is not something you will find in most other books available on technical analysis.

I begin with a discussion of fundamental vis-à-vis technical analysis, including the historical causes of technical analysis overtaking fundamentals as the preferred approach among professional traders and money managers. I then cover the essentials of reading price charts, followed by adjunct tools such as indicators and Market Profile for assessing volume. To that solid foundation, I add Kerry Denny's work and my cyclical model, which I use as an overlay on standard technicals for precise timing of trades. Finally, I discuss building a complete trading program and sound money management principles.

To date no analyst has been able to accurately forecast market prices 100 percent of the time. Armed with massive computerized number-crunching and modeling capabilities and futuristic neural nets, current state-of-the-art analysis still falls short of National Weather Service meteorological forecasts, which are generally extremely accurate for three days into the future. The difference lies in cause-and-effect factors. Wind vectors and ocean currents are juggernaut forces that are not easily swayed from their course of movement, whereas markets consisting of mass auctions involving a multitude of humans making trading decisions based on emotions and occasionally reason are subject to winds of commerce that can be very fickle indeed.

Like millions of butterflies with fluttering wings, traders, when observed in real time, seem to embody jumbled chaos that only rarely coalesces into some semblance of order that allows one to tie a rise or dip in prices to a set of clearly identifiable statistics of supply and demand. Sudden spikes in intraday price levels often can be seen following major economic reports, but they rarely have any follow-through, and the price settles back into the typical narrow trading range before the end of the regular session. With these spikes, it's as though the markets were a hornet's nest, and the Brownian motion of the swarming winged insects gets temporarily disrupted as they fly into a fleeting frenzy. On the other hand, markets do make huge moves from time to time. Savvy traders who are prepared to capitalize on such larger swings can make huge profits when they get on the right side of the move and have the bravado to ride out the roller coaster without jumping off prematurely. Not-so-savvy traders can rack up unnerving losses when they see a big move get under way, proceed to jump in just before a correction, get whipsawed and shaken out of their positions, and end up kicking themselves when the market turns right around and heads screaming back in their direction as they stand on the sidelines dumbfounded and frustrated. (That is assuming they actually get an order filled and don't end up chasing the market with limit orders that fail to get matched under fast market conditions.)

Designing a killer trading system is only half of the equation. Following that system according to your preset rules is the other piece of the puzzle. Without that premise, the whole thing falls apart, and what should be a smoothly running machine ends up a jerky, out-of-control monster that causes money to spill out of your trading account and into the hands of professional floor traders, specialists, market makers, and large institutions. Curve fitting your analysis is the deadliest of sins. It is the ultimate vanity: the belief that your own conception is superior to the reality of market turbulence that is ready to strike like a Category 5 hurricane on the ill-prepared.

An interesting fact about traders is that they have an entirely different mindset from those who are purely investors. An investor likes to buy and hold, collecting dividends or accrued interest and hoping for some additional rate of return when, for instance, their shares of stock increase in price over periods of years or even decades. By contrast, a trader has a take-the-money-and-run attitude with the goal of parlaying a series of (one hopes) successful trades into a sum of money that is many times the original amount in the trading account. Trading then becomes a business, just like any other type of business. Although to the casual observer it may seem that a trader is engaged in a hobby that either increases the trader's net worth or decreases it, a serious trader puts in many hours of preparation studying markets, researching price data and (with many of them) charts, and planning specific trading strategies.

I have never worked on an exchange floor. I have visited traders in the pits in Chicago and taken a few cursory glances at the seemingly haphazard flow and execution of buy and sell orders, but that is not quite the same thing as transacting business in such an environment. I have always traded from "upstairs," armed with up-to-the-second charting software containing all sorts of specialized studies. Some floor brokers find trading in the pits virtually impossible and prefer trading from off the floor, because it is too difficult to assess price action from that vantage point. Other traders have had the opposite reaction, going through a period of adjustment when they leave the pits and can no longer assess the order flow firsthand. They devise other means of making their assessments, which are an integral part of their trading decisions.

Twenty years ago, I used to trade at home with electronic quotes and charts, but I still had to call my broker to get any orders executed. Today, it is an entirely different world. I get real-time quotes and charts and execute trades over a highspeed Internet connection, and need to pick up a phone only when there is an outage. My preliminaries and equity runs come by e-mail prior to the next day's trading session. It is a solitary pursuit.

Anyone who wants to graduate from amateur to professional trader needs to view trading as a business just like any other type of enterprise. There are costs of doing business, and there are inherent risks. There are matters of accounting and taxes and disaster recovery plans. There is a minimum investment in terms of time and capital to make any business a success, even if there is a sound business plan in place.

The message for my readers is that if they proceed methodically with a sound plan, they

can be successful as traders. In the absence of such discipline, they may get lucky, but will lose in the long run, for the odds are against them. They basically have two choices: 1) Find a system devised by someone else and trade it mechanically, or 2) do their own homework and devise their own system. In the first case, they run the risk of most systems in that the systems tend to run hot and cold. Once they start losing money, they will tend to abandon the system and look for another one, ultimately becoming system hoppers and never succeeding in the long run. My opinion is that most people are better off tailoring a system to their own needs and their own trading style based on their unique personality. What works for one person may not work for another. Jack D. Schwager interviewed many prominent successful traders for his book, *The New Market Wizards* (HarperCollins, 1992), and it is striking how very different each of them is from the others featured in those pages. One common trait they share, however, is that they are self-made and self-sufficient. They are true mavericks.

My hope is that each person who reads this book will be inspired to find his own path to success and sufficient confidence to be able to actually follow that path without deviating. Overcoming fear is a critical factor in all endeavors, but it is particularly critical in the arena of trading. Having a plan that you have constructed on your own can go a long way toward instilling confidence, and may get you through the inevitable losses along the way that take the faint of heart out of the game for good.

The chapters that follow provide some valuable information for any prospective trader regarding time-tested approaches to technical analysis, such as Market Profile, which many floor traders and institutional money managers have utilized for over two decades. Although the scope of this book does not allow for an exhaustive treatment of any specific method, my objective is to provide some insight to guide the reader in selecting one or more avenues of research.