Big Money, Less Risk Trade Options

One

Pointing the Way with Technical Indicators

IN THIS CHAPTER

- Examining support and resistance
- The power of moving averages
- Discovering Average True Range and Inertia
- Combining indicators for effective trading

I'm a strong believer that your success with options is contingent on the use of technical indicators, which is why I chose to start the book here. This chapter will outline some of the many technical indicators that you can use within the market. We will go through the basics such as support and resistance levels, moving averages, Stochastics, and MACD. We will also head further into advanced technical indicators such as Bollinger Bands, Fibonacci retracements, Ease of Movement, Inertia, and Average True Range (ATR). The more indicators you have within your tool box, the better prepared you'll be for any market condition or type of trade. Mastering these technical skills will be necessary for you to become a successful options trader.

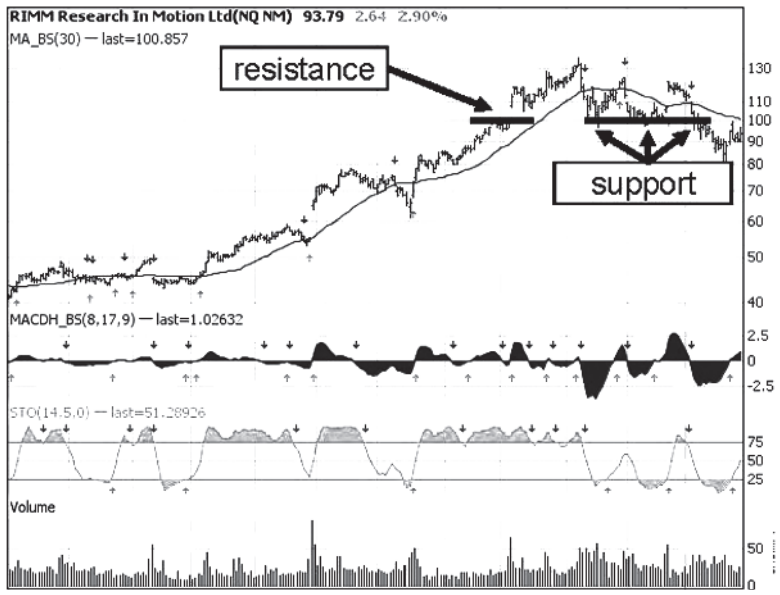
Support and Resistance Levels

There are price points when stocks will often make a change in direction and move from an upward direction (resistance) to a downward direction (support) and vice versa from support to resistance.

Keep in mind that an old resistance level will become the new support level when the movement is breaking upward and old support will become new resistance in a downward trend. Let's look at a few charts that highlight these levels of support and resistance.

Figure 1.1 shows both the support and resistance levels, beginning with resistance on the left side. Our chart shows that when the stock was moving higher, it reached a level of resistance, which you'll notice was established at the price of $100. Once the stock broke up through this resistance level of $100 (which is often on increased volume), the stock continued higher until reaching a high of $130, which again became resistance. After the stock reached $130, the price dropped back to the $100 level (old resistance now new support) where it finally on the third attempt failed to stay above $100 (support) and dropped to about $80 per share.

FIGURE 1.1 Support Level



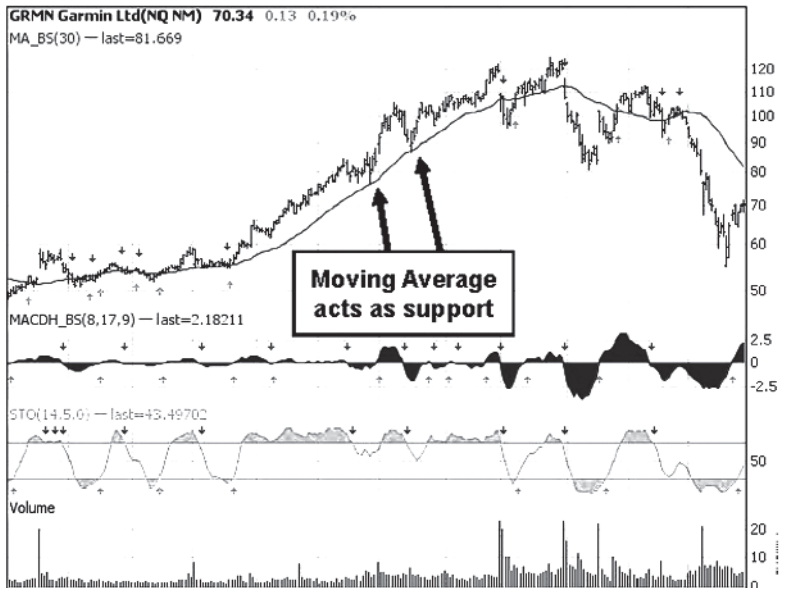
For color charts go to: www.traderslibrary.com/TLECorner • Chart by: thinkorswim.com

Moving Averages

Moving averages are price indications as to what the average price of the stock is over a certain given time frame. For example, let's begin with a 30-day simple moving average; it represents the average price of the stock for the last 30 days. As a trader, moving averages are helpful in many ways, but we use them primarily to determine our entry or exit points.

During an uptrend (Figure 1.2), the 30-day moving average acts as a support level and as long as the stock price remains above this level, the stock should continue back up. If you look at Figure 1.3, you'll notice that when stock price does not stay above the 30-day moving average, it drops further down and even faster than when it went up. When the stock does begin its next upward movement,

FIGURE 1.2 Garmin 30-Day MA (Bullish)



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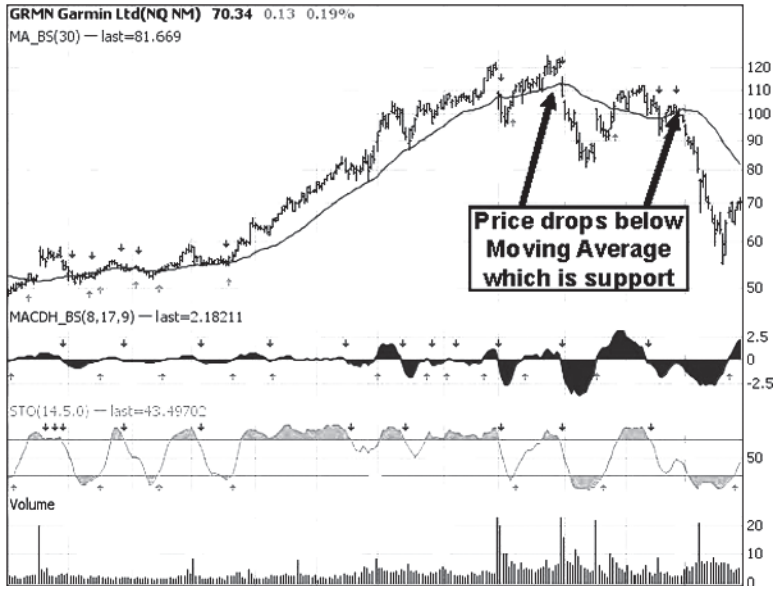
it will more than likely have a tough time getting above the 30-day moving average because what was support will often become resistance. With this example we were using a 30-day moving average as short-term support and resistance levels. In the next example, you'll see how we can use multiple moving averages like the 30-, 50-, 100-, and 200-day moving averages.

Multiple Moving Averages

Using several moving averages helps us determine what the next point of support or resistance will be. It's said that when a stock drops below its 30-day support level, it will move towards its 50-day moving average, which will be another level of support. When breaking that level, it will test its 100-day and then final-

FIGURE 1.3 Garmin (Bearish)



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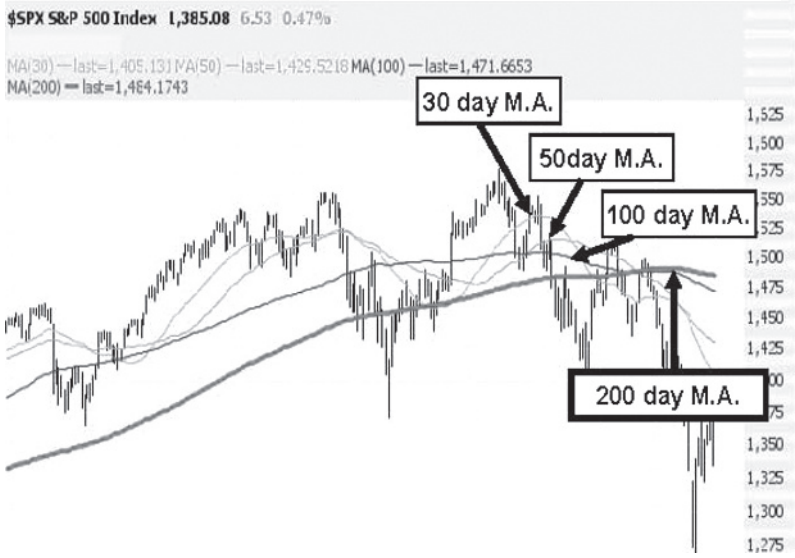
ly its 200-day moving average. When the stock drops below it's 200-day moving average, which is referred as the strongest point of support (on downward moving stocks), the stock has broken its long-term support and now its downward trend will increase even more. This 200-day moving average acts the opposite when stocks are moving off of their lows and heading up because the 200-day is now resistance. If the stock can increase above this level, it is considered a very bullish sign and the stock now has great upside potential. I'm going to begin showing you several different charts with four moving averages.

As you can see in Figure 1.4 for the S&P 500 we have four different settings, 30-, 50-, 100-, and the 200-day moving average. When I trade, I use various colors to set up my moving averages

FIGURE 1.4 Multiple Moving Averages- S&P 500



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so I know which ones are which (on this chart they are labeled for you). For example the 30-day moving average is the short-term support level if the stock is above it and is short-term resistance if the stock is below. The 50- and 100-day moving averages are the next points of support when trending down. The all-important 200-day moving average is the long-term support level for any stock or index. Keep in mind that these are levels of resistance as stocks or indexes move upwards.

If you take a quick snapshot of the S&P 500 chart (Figure 1.4), you'll see that when the price of the index is above all four moving averages, then the index has a tendency to be bullish and move upward; yet, when the price of the index begins dropping below the 30-day moving average, we see our first signs of weakness (you should begin to determine your exit or place stop losses now). At this point, the index will tend to move to the next level of support, which will be the 50-day. If it can stop at that level, it will move higher, making the 30-day the resistance level; however, when it drops below the 50-day, it's going to move towards the 100-day and look for support. If it cannot stop (which it did not in this example), the index will drop towards the 200-day and if this fails,

Insider Secret

Think of each moving average as a different testing level of support (on downward moving stocks) or resistance (on upward moving stocks). The stock or index will keep pushing in its given direction until one of these levels of moving averages stops it. If none of them hold, then you can be sure that the movement of the stock will be strong in its original direction.

As a general rule, when long the market, you want prices to stay above these moving averages and when short, you want prices to stay below them.

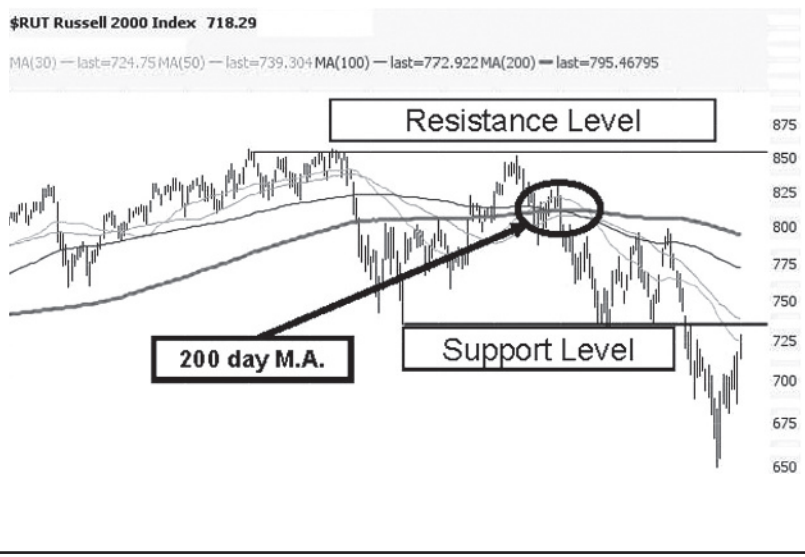
then you know you'll have the greatest odds of a bearish downward move.

I know it sounds confusing, so let's look at a second and third example. We'll review the Russell 2000 index (Figure 1.5) and GRMN (Figure 1.6) to simplify the importance of the multiple moving averages.

Looking at the example of the Russell 2000 index (Figure 1.5), you'll notice several points of interest. First, I always like to determine the long-term one year support and resistance levels, which are not just based on the use of moving averages but also on the highs and lows of the 12-month chart (as we talked about earlier).

We determined the resistance (ceiling) was the 850 point because the index could not move above this area after making several at-

FIGURE 1.5 Multiple Moving Averages- Russell 2000



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tempts to do so. The support level (floor) was between 725 and 750, so we'll call it 735. Now that we know what to expect during a bullish and bearish move, let's look at the location of the index price in relationship to the four different moving averages.

The last time the index attempted to move through its resistance of 850, it failed and began a bearish downward movement. It attempted to move higher afterwards; but, if you'll look at the chart, you'll notice I circled the four moving averages showing the price of the index (800) was below these moving averages. It was also below the 200-day moving average, which is a very bearish sign. The index then dropped 150 points to about 650 before finding new support.

Watch Breaks of the 200-day Moving Average

To give you an idea of how far this drop was, the Dow Jones would need to drop about 100 points for the Russell 2000 to drop 15 points; so, the 150 point drop in the Russell 2000 amounted to 1500 points within the Dow Jones. By the way, this also occurred within 15 days. So before I move on to an example of multiple moving averages on the stock Garmin, let me give you a final thought about the importance of using four moving averages. If stocks or indexes are moving up, you want the prices to be above these moving averages; however, when the price drops below the 30-day, you'd better know your exit because if the price drops below the 50, then it's going to the 100-day. If it drops below the 200-day, it's "good night Irene" (a saying from a favorite movie of mine *The Perfect Storm*). You'll see not only the largest but often the fastest drop beginning the day that happens, and if you don't know how to weather this type of storm, you'll be seeing a huge drop within your portfolio. Also, if you're seeing the prices of the major index such as the QQQQ (Powershares), $RUT (Russell 2000), $INDU (Dow Jones), or $SPX (Standard and Poors 500)

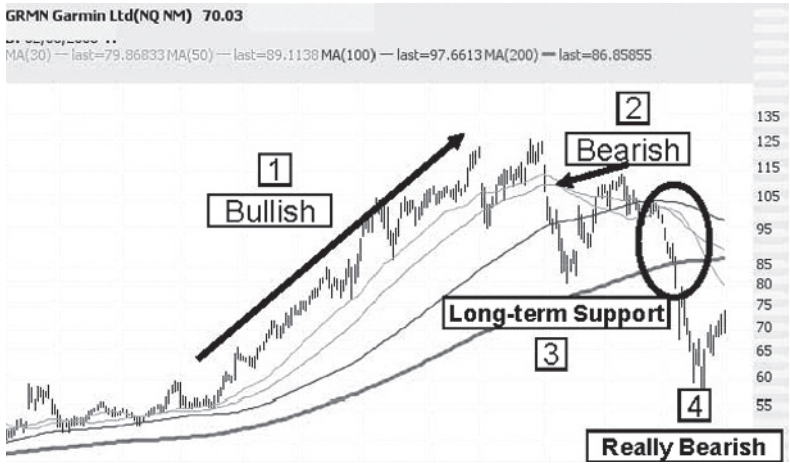
drop below their 200-day moving averages, it may be a good time to close out your mutual funds, go to a cash fund, and weather out the storm until you have bullish buy signals within these major indexes.

Summarizing the Uses of Moving Averages

Looking at the GRMN chart (Figure 1.6) you'll notice I have placed four numbers within the chart. Let's review these four numbers in detail so you'll have a greater understanding of how important the use of various moving averages can be.

Beginning with number 1, you'll see that the price of the stock was above the moving averages at about $55 per share and continued

FIGURE 1.6 Multiple Moving Averages-Garmin



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above them until reaching a price of $125. At this time the price dropped below the top moving average (30-day) and then the second moving average (50-day) and stopped at $95 per share before moving back up to $125 per share. So what just happened?

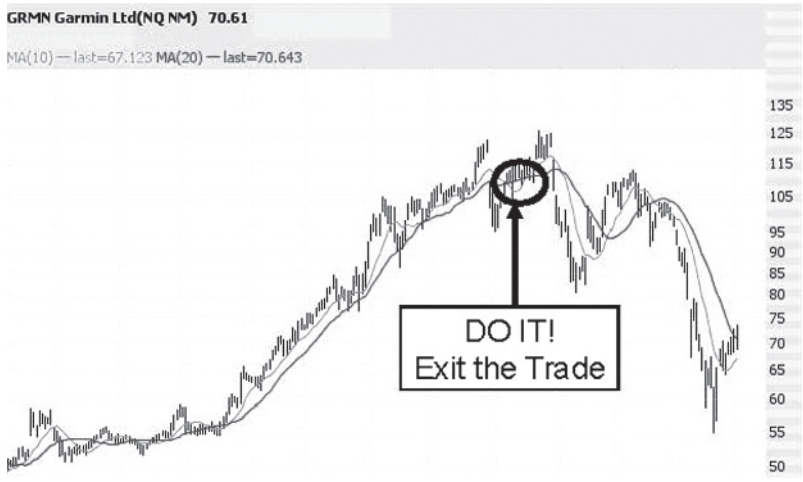
The stock reached a price resistance level of $125, failed to break up through that price, and pulled back down to $95, stopping at that level and not moving towards the next lowest moving average of 100 or even worse, the 200. If the price dropped below the 100-day moving average, its natural reaction is to go to the long-term support level of 200 and, if failing that, (go ahead and say it) "good night Irene."

Before you read on, let's add more value by asking one simple question: if you were to buy the stock (or call option) when the stock was trading at about $55 per share, when would you have exited the trade and taken your profit? Would you have sold when the stock was at $65, $75, $85, $100, $110, $125, or would you still be in the trade when it's at $70? Any answer would be correct because you would have made a profit and as the saying goes, "you can't go broke taking a profit."

How about exiting the trade when the stock reached $105 per share? Why that price instead of some other price? In my mind, it was just time to "do it"! Look at Figure 1.7 and notice that this is when the 10-day moving average dropped below the 20-day, which is a sign of weakness and possibly a bearish downward move. If that wasn't an exit opportunity for you, then you would have been praying you had a stop loss in place because while the stock did move back up to the $125 resistance level, it failed to go higher and dropped to $75 per share.

If you were using the Average True Range indicator (which we will discuss later in this chapter) as a tool for placing stop loss orders, your exit price would have been $115 per share, which is still

FIGURE 1.7 Garmin "Do It"



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better than watching the stock drop to $75 or owning the stock at $70 per share. I'm excited to share my knowledge of the Average True Range indicator (ATR). If you're new to the market, you probably don't know much about stop loss orders; and if you're an experienced trader, you may not be using stop loss orders because you've been burned in the past. Get over it, because it will happen again; however, with the use of the ATR, your odds of it happening as often will dramatically decrease.

THE "DO IT" INDICATOR

As more of a short-term trader I use a combination of a 10- and a 20-day simple moving average to help determine the stock's current momentum (bullish or bearish). I actually refer to these set-

LINGO

Simple versus Exponential

The difference between a simple and an exponential moving average is in how each stock price is weighted. In a simple moving average, the stock prices used in the specific time period are all given the same weight. With an exponentially weighted moving average, the latest data is given more weight. For this reason, an exponential moving average tends to react quicker; however, when you hear the term "moving average" it is most likely referring to the simple calculation. (Source: Investopedia.com)

tings as my "Do It" indicators because if I have not made my decision after reviewing various other technical indicators and price patterns, this gives me the confidence to pull the trigger (Do It) and place the trade.

I wish I could say that I thought of the name but it actually came from Carol and Osvaldo, who were great students and are now good friends. Carol once said, "if I wasn't sure what to do after looking at other technical indicators, I would look at the crossing of the two moving averages (10 and 20) and feel better about what direction the stock was moving," then place the trade accordingly (Do It).

By watching the crossing of the 10 and 20, we're able to determine a better entry and exit point for the trade as well as determine if the stock or overall market has current bullish or bearish momentum. Next, we're going to examine the details of buy and sell signals. First, I will cover the bullish entry showing the 10- and 20-day simple moving averages as they head higher. Then, we'll cover the bearish exit showing the 10- and 20-day moving lower. Again, these are indicators that help a trader better determine the short-term visual of the investment; it's up to you to determine what investment strategy to utilize—and that's where the rest of this book will come into play. Later on, I will teach you the particular option strategies that will work best under different market conditions.

FIGURE 1.8 Dow Jones One Year

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On this one year Dow Jones chart (Figure 1.8), you can see the bullish and bearish markings I've added. More important, you can see that every time the Dow Jones showed great upside potential, the faster 10-day moving average moved up through the slower 20-day moving average and resulted in a bullish entry point.

Let's put some numbers to the chart and say that the Dow Jones was trading between 12,000 and 12,250 at the time of the upward crossing, because at that bullish signal the Dow Jones moved up to a price of about 13,500. Knowing this increase of at least 1,250 points for the Dow Jones before the crossing meant that you could have profited on bullish investments on stocks that trade within the Dow Jones. Or, as an option trader, you could have purchased call options on the DIA (diamonds), which is an Exchange Traded Fund (ETF).

Of course, what goes up must come down. Let's look at the far right side of the same chart. You'll see that later that year, the 10-day crossed below the 20-day moving average as the Dow Jones dropped from a price of 13,250 to 11,750, for a drop of 1,500 points in 1 month. This was the time I began writing this book, and it indicated that this may be another really bearish market. Whether I'm right or wrong about the future direction of the market, I can say this right now, "I would not want to own stocks within the Dow Jones after the crossing of the 10-day moving average began at 13,250."

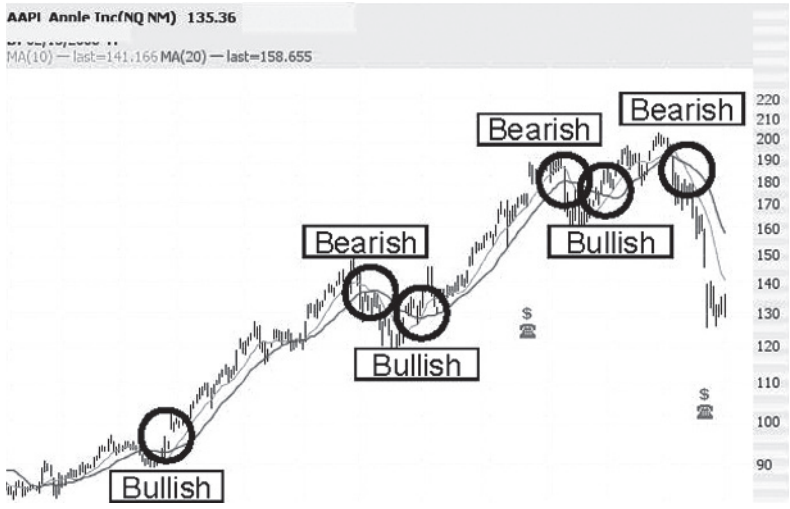
Also you'll notice several other times when the index was bullish and bearish throughout the year. If you're a buy and hold long-term investor, then you may not use these type of technical settings; but, if you're a shorter-term trader using your "get rich" bag of money, then these indicators will help you select the best timing opportunity based on the odds of the market going higher or lower.

These indicators will help you select the best timing opportunity based on the odds of the market going higher or lower.

Multiple Uses for the "Do It" Indicator

I'm now going to show you how the "DO IT" indicator could benefit you in determining when to enter and exit single stocks and in understanding how the signals will give you a better feeling about a company's earnings before their release. That's correct; you may use the same process to evaluate a stock to determine if they will have good or bad earnings and be able to exit the trade to avoid larger drops if the company's earnings are disappointing. Take a look at the chart for Apple Computers (Figure 1.9) and you'll be amazed at how powerful the use of technical indicators can be.

FIGURE 1.9 Bullish Entry & Exit (APPL)



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Using shorter-term moving averages and their crossings, let's compare the three different buy and sell opportunities versus the buy and hold opportunities. As you'll see, each time the 10-day moving average crossed through the 20-day moving average, the stock showed greater signs of bullishness. Each time the 10-day moving average crossed below the 20-day moving average, the stock showed signs of being bearish (Figure 1.9). Taking this information and using it to our advantage, look at our buy and sell opportunities:

1. Buy @ $95 – Sell @ $135 = 40 points
2. Buy @ $135 – Sell @ $170 = 35 points
3. Buy @ $180 – Sell @ $185 = 5 points

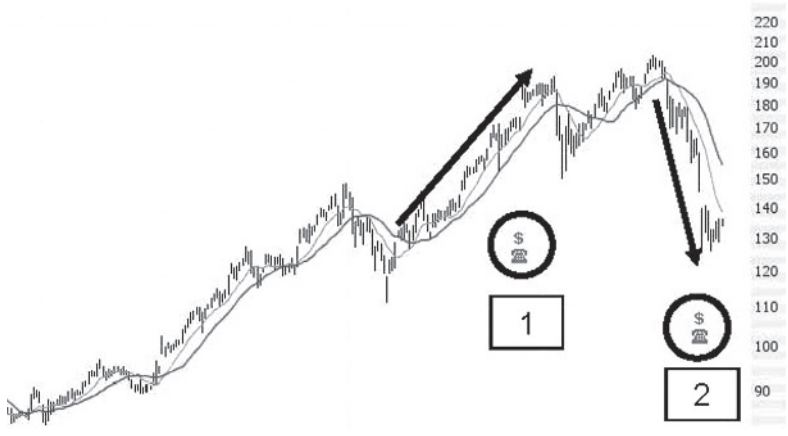
With the use of these two moving averages, you were able to identify better buy and sell opportunities, which totaled 3 trades for a profit of 80 points during the 12-month time frame. If you bought Apple at $95 and still owned it 12 months later, your profit would be 40 points ($135 - $95 = 40 points). By using the "Do It" indicator instead of buy and hold, you earned double the return with less risk.

Look at Figure 1.10. There are dollar sign symbols that represent the release of the company's earnings. I'd ask myself, "is the 10-day moving average above the 20-day before the company releases its earnings?" Looking at the two different earnings release icons ($) for Apple, you'll notice that Apple did move higher in the first example (number one) but dropped over 60 points prior to its next earnings release (example two).

Let's take a closer look. Number 1: The 10-day was above the 20-day moving average, which occurred at the $130 price. This is a bullish upward signal. If I were long the market during the release of the company's earnings, this would help me feel much more comfortable about doing so because the 10 stayed above the 20 going into the release of earnings. Number 2: The 10-day was below the 20-day at the price of $190, which is a bearish downward signal. This is a good sign that once the company releases its earnings, it may go much further down, which was indeed the case with Apple. This stock dropped $30 when earnings were released and continued down to the $120 price before finding its level of support and moving higher.

Will these two moving averages always tell us if the company's earnings will be good or bad? No, but again I use these indicators to show the current momentum of the stock: 10 above 20 is bullish momentum; 10 below 20 is bearish momentum.

FIGURE 1.10 Apple Earnings



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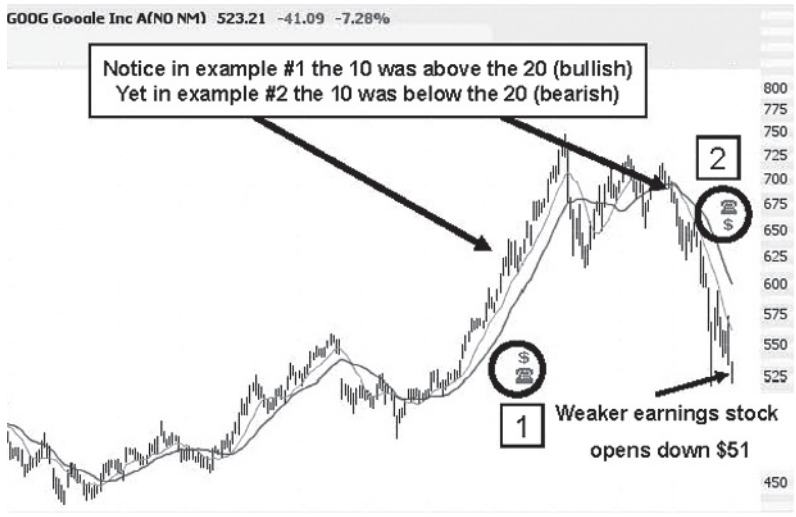
With the use of these two moving averages, you should always be prepared to make some type of a decision. If you're not going to sell when the 10 crosses below the 20, then you should at least place a stop loss to avoid bigger losses. I'll cover a great technical indicator known as ATR (Average Trading Range) later in this chapter so you'll be able to really fine tune your stop loss orders.

Just for the sake of you Google lovers, let's see how beneficial the same indicator settings would have worked during Google's earnings (Figure 1.11). Number 1: The 10-day was above the 20-day, which began at the $525 price and continued up to about $750 before the 10-day crossed down.

INSIDER SECRET

The crossing of the 10- and 20-day moving averages is an extremely useful indicator. Remember, the 10 above the 20 means bullish momentum; and the 10 below the 20 is bearish momentum.

FIGURE 1.11 Google Earnings



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More important, prior to the company's next earnings release (represented by Number 2), the stock began a downward movement as the 10-day crossed below the 20-day at the $675 price. The day after earnings were released, the stock traded down another $51 to a price of $512.

Using these indicators, you would have done one of three things at the $675 price; you could have 1) exited the bullish trades, 2) placed a stop loss, or 3) even better yet, took on a bearish trade with the purchase of a put option.

FIBONACCI RETRACEMENTS

Fibonacci retracements are technical analysis tools that show the likelihood of an investment price retracing a large portion of an

original move to find support or resistance at key Fibonacci levels before continuing in the original direction. These levels are created by drawing a trend line between two extreme points and then dividing the vertical distance by the key Fibonacci ratios of 23.6%, 38.2%, 50%, 61.8% and 100%.

LINGO

Fibonacci Numbers and Ratios

The Fibonacci number sequence was discovered by Leonardo de Pisa. The first number is a 0, the second a 1, and each subsequent number is generated by taking the sum of the two preceding it. Here's how the first part of the Fibonacci sequence looks: 0,1,1,2,3,5,8,13,21, 34, 55, 89, 144, 233, 377, 610, 987, and so forth to infinity.

Traders use the mathematical relationships between the numbers to help determine retracements and support and resistance. Some of the key numbers for retracement studies are:

- **1.618:** approximately how many times greater each number is from the one before it.
- **61.8%:** found by dividing one number by the one that follows it. This is the "Golden Ratio," which has many occurrences in nature.
- **38.2%:** found by dividing one number by the number two places to the right of it.
- **23.6%:** found by dividing one number by the one that is three places to the right of it.

(For more information, please visit www.investopedia.com)

Fibonacci retracements are popular tools used by many technical traders to help identify strategic places for transactions, target prices, or stop losses. As you'll see in Figure 1.12, we have drawn a Fibonacci retracement using a one-year chart beginning at the extreme low of about 12,000 and drawing upwards to the extreme

high of about 14,200. Using this example, you'll notice that after the Dow Jones reached its high, it began a downward move. During this time, an investor educated in Fibonacci would anticipate the Dow Jones stopping at the 23.6%, 38.2%, 50%, 61.8% or 100% retracement levels before beginning an upward move again.

This was not the case with the Dow Jones because as the price reached each of these levels, it only continued down showing greater signs of bearish momentum. Now that you can identify the weakness as the Dow Jones moves below these retracement levels, you can determine your exit point just below any of the five retracement levels, which is often once the investment breaks down through the 23.6% level. It is said that if the investment, in this case the Dow Jones, drops down through the 50% retracement, then the drop will only be intensified with a faster downward drop. The

FIGURE 1.12 Fibonacci on Dow Jones

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Fibonacci retracements can also be used to help determine resistance on an upward level after testing the lower retracement.

Figure 1.13 shows a Fibonacci retracement on a stock, and as with the previous example, we've drawn the retracement line from the extreme low to the extreme high using a one-year chart. The important lesson to learn here is that the price of $100 became an area of resistance on the way up and, after reaching higher highs and drawing the retracement, this area was the 38.2% retracement on the way down (support). Once failing this level and dropping to a lower retracement level, this 38.2% retracement becomes resistance on the way up (this can be seen within the boxed section A).

It is extremely common for prices to react this way at certain retracement levels especially if the retracement level is formed at

FIGURE 1.13 Fibonacci on Rimm

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price points such as $100. These price points and retracement levels often become major areas of support on downward trends and major areas of resistance on upward trends. This is similar to how we use multiple moving averages. If you like Fibonacci Retracements, then you need to pick up the book *Chart Your Way to Profits* by Tim Knight (founder of Prophet.net) and read about the powerful Fibonacci Fans.

Average True Range Indicator (ATR)

If you have ever placed a stop loss on an investment, you'll know how important it is to determine an appropriate price to help avoid selling too soon or too late. This by far has to be one of my favorite tools for helping determine a stop loss price for either the stock or option. Let's begin with a simple explanation of the Average True Range (ATR), which settings work best, and why various investments will require different settings.

The true range indicator is the greatest of the following: the absolute value of the current high less the previous close or the absolute value of the current low less the previous close.

If you understand that equation, then good for you! In my opinion, I don't need to know the math, I just need to know how to use it and more important, how it can benefit my trades. I will start with an example of a very expensive stock (Google), then go to a much cheaper stock (Boeing). Finally, I'll share with you my personal secret on how to use the ATR as a stop loss for my directional (calls and puts) option trades.

Example 1 – Google

Figure 1.14 of Google shows a current ATR setting of (14) and a last price of 24.51 (bottom left side of chart), which really means

FIGURE 1.14 ATR and Google

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that for the past 14 trading days Google's average daily trading range has been about $24.51 per day. That's correct; its recent average daily movement up or down is about $24.51. You may be wondering how this will benefit you as a trader. Well, whether you're a stock investor or option investor, you know now that you should be willing to give up $24.51.

For example, say the stock closed today at $525 per share and you wanted to place a stop loss because it's been moving down a lot recently (seen in the right side of the chart). You would need to place your stop loss at a price greater than $24.51. To calculate—subtract $24.51 from the stock price of $525 so your stop loss would be set at the price of $500.49. Be careful though—$500 can be a huge level of support. You might want to place the stop loss a few dollars below $500 to allow your stop loss to be just below support and not above it.

A $24.51 stop loss is large; however, if you look at this next example (Figure 1.15) of Google, you'll see that during the bullish upward trend the ATR had a daily average of $13.98. The ATR number tells us that during this upward bullish trend, the stock moves less on average. Your stop loss will be lower to allow for less of a loss during the upward trend. Note that the ATR increased to a daily average of $24.51 during the downward trend; again confirming that stock prices drop faster when going down and move up slower when bullish.

You may want to also make note that the ATR chart (across the bottom) shows the average price throughout the chart along with various numbers on the right side (10,15,20,25), which you can use to see the average ATR price during the chart's time frame. Looking at the ATR line and referencing the various numbers on the

FIGURE 1.15 ATR During Uptrend

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right side of the ATR chart, you can see the average ATR range during the entire 12 months. At certain times throughout the year the stock has a higher ATR while other times throughout the year it shows the ATR as being lower.

This could be that the stock itself or the stock market as a whole reacts differently during certain months of the year, which creates more volatility (movement) than average and, therefore, the ATR number fluctuates. The same applies to an individual stock during earnings; stocks tend to be more volatile going into earnings, which will increase the ATR. This is good because we'll be able to set proper stop loss expectations and hopefully avoid getting stopped out too early or at the wrong price.

Example 2- Boeing

Looking at the ATR (14-day range) for Boeing, which is highlighted on the left side of the chart (Figure 1.16), we see a current price of $2.47. This number represents the average daily price movement for the past 14 trading days. Now it's up to you to decide if you're going to use a stop loss of $2.47 or double the ATR number and place a stop loss at $4.94.

In our previous example with Google, the stock recently had an ATR of $24.51, so doubling that number to about $49 is too large a number for a stop loss; but, with a less expensive stock such as Boeing, doubling the ATR would be a good idea. With the Boeing stock trad-

Insider Secret

When using ATR to determine your stop loss, use the price of the stock to help determine if you should use the base number or if you should double it. With expensive stocks, the current ATR should be adequate, whereas with lower priced stocks (like Boeing), you may find that doubling it provides a better stop loss point.

FIGURE 1.16 ATR on Boeing

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ing at $79, we would be setting a stop loss at about $74 per share, which is the current ATR of $2.47 doubled to about $5.

Now that we have discussed the use of ATR for both high and low priced stocks, let's give you a short example of using ATR with options. Taking the example of Boeing, let's say that you have established a price for the stop loss, which in this example we decided that $5 (or two times the current ATR of $2.47) below the current stock price was sufficient. We will place a contingent order to sell our option when the price of the stock reaches $74, which is $5 below the current price of the stock. Not all of your brokerage firms allow this type of execution order. If this is the case, you can also place the contingent order to sell your (call) option when the stock trades at the price of $74 per share. In short, we're agree-

Review

Want More?
I hope that you'll take advantage of what you've learned here because the cost of this book has more than paid for itself with just this explanation of ATR. If you're really interested in seeing this in detail, invest in *The Complete Guide to Technical Indicators,* which is a complete 6 hour 4-DVD set of my favorite indicators such as Average True Range. The investment will be well worth it as I show you when to buy and when to sell, as well as which indicators work best and with which settings.

ing to sell our option at the bid price if the stock trades at a price of $74. As you'll learn later, if you're not willing to own the stock then don't bother owning a call option.

This type of decision making will help you become non-emotional about your investments and allow for a more consistent plan of action. If you were trading put options to invest in a stock dropping in value, then you would reverse your thought process and set a stop loss on your option when the stock moved up a certain amount. If your ATR was $3, you want to double that to $6 and place an order to sell the put option if the stock moves up $6 per share.

Inertia Indicator

If I haven't used the word favorite, then allow me to do so here. Out of over 200 different type of technical indicators, I give the Inertia indicator the most credit for helping me determine when the markets or individual stocks are bullish or bearish. Developed in 1995, the Inertia indicator is relatively simple to interpret. If the Inertia indicator is above 50, it is known as positive inertia and it defines the long-term trend as up while the indicator remains above 50. If the Inertia indicator is below 50, it is known as nega-

tive inertia and it defines the long-term trend as down while the indicator remains below 50.

I think this indicator works similar to an American football game. If you were to place the football in the center of the field, the game's objective is to control the ball and move it into the end zone by keeping the momentum moving until you score (exit the trade). If at any time during possession of the ball you lose it, then the opposing team takes control and will attempt to move the ball to the opposite end zone. In trading, the two different teams are known as the bulls and the bears.

You want to move with the trend and as the Inertia moves up through 50, the odds of bullish momentum are great. Once the

FIGURE 1.17 Inertia Indicator

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momentum drops down through the 50, the momentum is now bearish with great odds of the market or stocks dropping.

Looking at Figure 1.17, you'll notice we are using the Inertia indicator with a setting of 10-14-20, which seems to work well for the indexes such as the Dow Jones, S&P 500, and Russell 2000. You'll also find that these settings actually work really well for stocks too. Now keep in mind that what works today doesn't mean it will work years from now; but, because this indicator is used as a long-term momentum indicator, you shouldn't need to change the settings that often. It is a good idea, however, to check that what worked today is still working months or even years from now.

Using the Inertia indicator with this stock, you'll see that there were two really nice moves up and down. With the use of the

FIGURE 1.18 Inertia and Stock Chart

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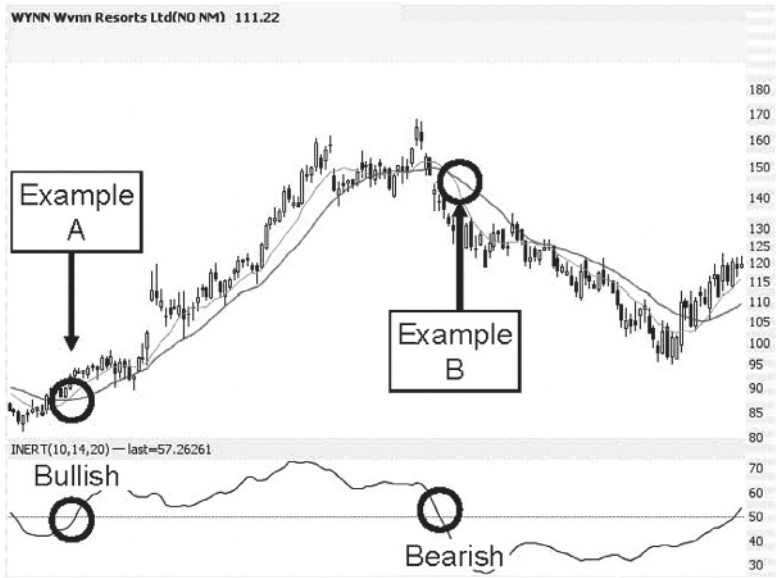
indicator, you would have been able to benefit by using a bullish investment strategy when the stock moved up from $105 to $165 and by using a bearish strategy when it dropped from $150 to $95 (Figure 1.18).

Wouldn't it have been nice to know it was time to exit the trade at about $150 when the Inertia indicator crossed from positive to negative (seen within the circled area) instead of holding on to the stock and watching it drop back to $95 per share? This is a perfect example of why you need to trade both directions of the market and not just the up side. As I've said earlier, there isn't a stock from 1998 that I'd still be holding today because I would have lost a lot of money holding those stocks expecting that someday their value would be much greater.

FIGURE 1.19 Inertia and 10- and 20-Day



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Now if you'll take this same example and add the 10- and 20-day simple moving average (the "Do It") settings to the chart, you would be able to better determine your buy and sell opportunities (Figure 1.19). Entering a bullish trade when the Do It crossed upward (example A), you would have seen an increase in the stock price from $90 to $170. When the Do It and Inertia gave you bearish signals (example B), you would have been stopped out of the trade at about $163 because the ATR showed a 14-day average price movement of $7 during the bullish move up. It was also possible to have placed a bearish trade as the stock dropped from the $140 range to $95 when both the Inertia crossed the center line and the 10- and 20-day simple moving average crossed downwards.

Adding It All Up

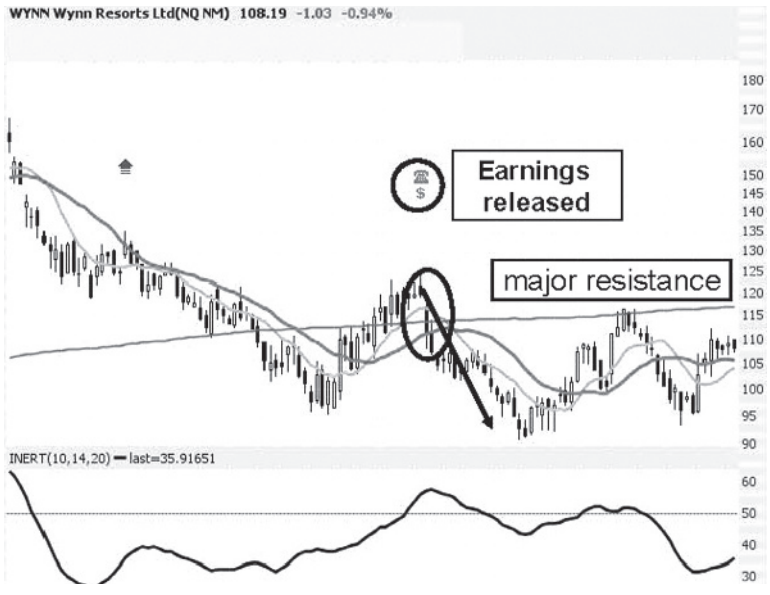
Now that you've had a chance to review the power of not just the Inertia indicator but also the support of the Do It settings, you should have less fear and more confidence about placing a trade. In this case, would have profited $73 per share during a 5-month time frame. You could have made even more if you traded the stock downwards (put option) from the $140 price to $95 price range before the Inertia moved back above the center (50) and the 10- and 20-day also crossed up.

You can't rely on just one or two indicators if you want to be really successful in the markets. You need to be able to understand and examine how they work together in order to find the highest probability trades.

Looking at the far right side of the Wynn chart, you may be thinking it is time to be bullish on the stock and that may be true; however, you have to beware of the 200-day moving average and how powerful it is because it can act as a stock's major support level (floor) or major resistance level (ceiling).

Looking at Figure 1.20, it should validate that you can't rely on just a few technical indicators if you're going to be really good at

FIGURE 1.20 Wynn Earnings & Resistance



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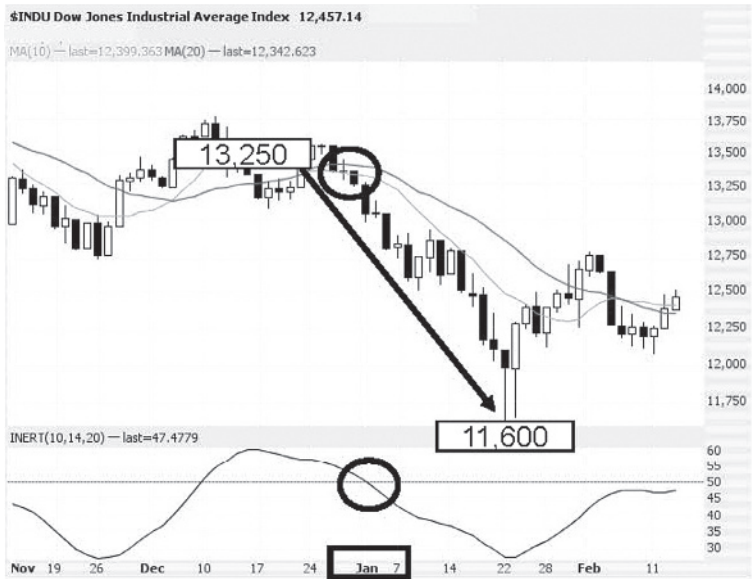
trading the market up and down. You can see how the 200-day moving average affects the stock and why trading into an earnings release could increase your risk.

If you look carefully, you'll notice that the stock dropped on the release of its earnings, putting the price below the 200-day moving average, which now becomes a major level of resistance for the price as it moves upward. You can actually see that at the $115 price the stock failed to move higher through the resistance level (ceiling), dropped back down to the $95 price, and is currently trading at $108 per share.

I can't end this section without sharing why I said in the opening chapter that this would be the worst January in stock market history. If you'll look at Figure 1.21 you'll see the same two indica-

FIGURE 1.21 Dow Jones Sell Off



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(Bearish signals as the Dow Jones dropped from 13,250 to 11,600 at which time the 10 & 20 day Moving Average crossed down and the Inertia Indicator crossed down also)

tors we just referenced, Inertia and Do It, being used on the Dow Jones. This three-month chart shows bearish signals the first week of January. The information from these indicators gives you, the investor, the confidence to place stop losses on your stocks, exit your bullish option trades, and maybe even move your mutual funds into a cash type position as the Dow Jones quickly dropped 1,650 points from 13,250 to 11,600 in 20 days.

You should have no question that the Dow Jones is not ready to move much higher. One major sign is that the Inertia indicator is below the center line giving us a bearish signal.

Of the various chapters within this book, this section will by far give you the greatest opportunity to beat the market, and the rea-

FIGURE 1.22 Dow Jones Bullish or Bearish

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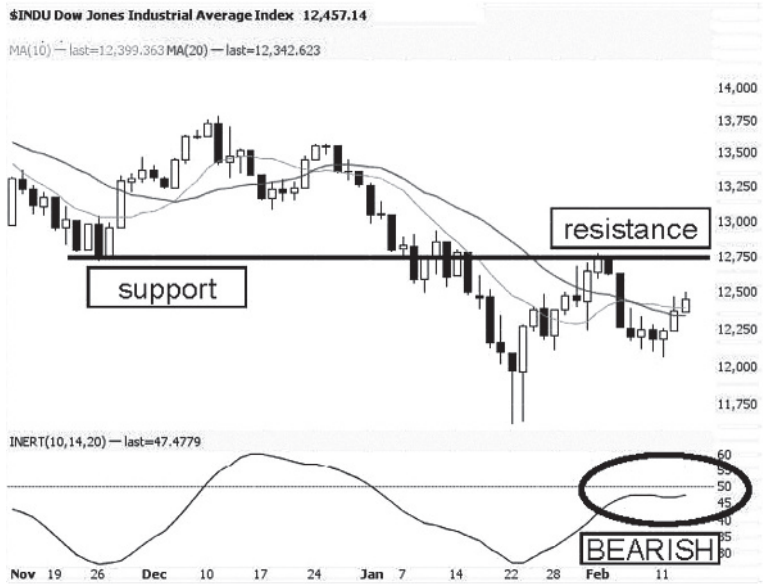
Having patience is important as you'll see the Inertia Indicator is neither bullish nor bearish as it's trending sideways.

son I say that is because of timing. You can buy stock or trade options but your success will be dramatically increased by timing the investment opportunity and trading with the current market trends and not against them. Please keep in mind that life isn't perfect and nor will your trading decisions be, but the right tools and education will increase your odds of success and limit your losses.

There is no one strategy or indicator that I reference within my book that will give you the perfect buy or sell opportunity or the perfect buy or sell price, but do I think it will increase your odds of success? You better believe I do! It's why I've taken the time to write this book. It's about time you learn how to control your own financial future and join the 5% of people who will not rely on

FIGURE 1.23 Dow Jones Resistance Level



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Dow Jones is showing strong Resistance at about 12,750 as the Inertia Indicator is still bearish as it remains below the center line.

Social Security or any other government subsidized income during retirement. Your money will be working for you instead of you working for your money.

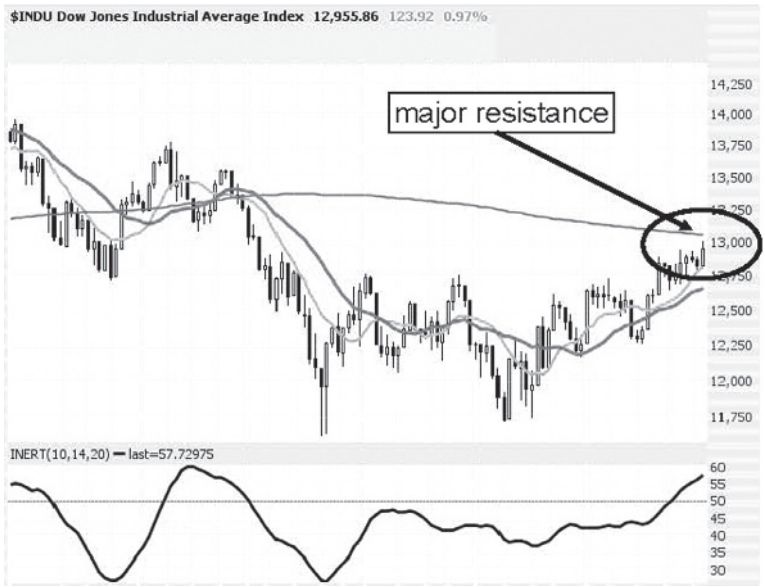
Let's take one last look at the Inertia indicator (Figure 1.22). Is the Dow Jones bullish or bearish? If you're not sure, the answer is on the chart, and if you think it's moving much higher, look at one more chart (Figure 1.23). Studying technical indicators is extremely important to trading success—check out my DVD course *The Complete Guide to Technical Indicators* for more information. A review of the three different charts shows that you should have exited the market during the first few days of January. At this time, the Inertia indicator is below the "50 yard line" (center line) yet

the 10- and 20-day moving averages are slightly bullish; however, if the Dow Jones does move higher, it will reach a level of resistance at 12,750 at which time, if it does not move higher, it will only move lower again until it finds another support level.

If it does break higher, its next level of resistance (ceiling) will be the 13,000 level, which is where the 200-day moving average is. Again, remember the 200-day moving average is a major level of support or resistance.

Whether you believe the chart is helping confirm that the market is neutral to bearish, we know one thing for sure: it's only bullish until it reaches 13,000, at which time we could see a change of direction. You'll want to focus on spread trades because your odds of success are much greater than if you were to purchase

FIGURE 1.24 Dow Jones and 200-Day MA



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stocks or buy call options at this time. After looking at the Dow Jones and its 200-day moving average (Figure 1.24), I would choose to be in cash or willing to only hold conservative spread trades until the market makes its next decision to move higher and head back towards the all-time high of 14,200 or down to another level of support or new lows. The 13,000 level is a major level of resistance so unless it breaks up through this level, the markets will move sideways or down.

Volatility Indexes

If you're going to be an active trader, you'll need to have a better understanding of not just the various investment strategies or technical indicators but also the various volatility indexes such as the VIX, VXO, and VXN. We'll focus on the VIX indicator (the CBOE volatility index), which measures investor fear of a market decline. In general, volatility indexes are contrarian indicators (i.e. when the indexes are going down, the markets are rising. When the indexes are going up, the markets are falling).

Lingo

VIX: The Chicago Board of Exchange (CBOE) volatility index based on the S&P 500.

VXO: The CBOE volatility index based on the S&P 100 (OEX).

VXN: The CBOE volatility index based on the NASDAQ.

(For more information see: The CBOE's website at http://www.cboe.com/micro/IndexSites.aspx)

When fear of a market decline is rising, traders generally begin selling positions and market prices tend to go down in response. When fear is subsiding or optimism is high, traders are buying and the market prices tend to rise in response. When the VIX is low and moving higher, investors tend to sell and when the VIX is high and moving lower, investors

FIGURE 1.25 VIX Weekly Chart

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tend to buy. Hence the saying, "When the VIX is high, it is time to buy; and when the VIX is low, it is time to go."

The theory is that fear in the market should be at its highest when the stock prices are at their lowest (just prior to turning back up). Likewise, when the index is at its lowest point, market prices should be reaching a high (just before turning down). So theoretically, selling when the volatility index is low should result in selling at a market high. Buying when the volatility index is high should result in buying in at bottoming price levels.

Let's look at several charts to see how powerful the VIX indicator is when determining market highs and market lows. Keep in mind that when the VIX is high, the market tends to have less fear; and

FIGURE 1.26 Dow Jones (VIX)

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when the VIX is low, the market tends to have greater fear, which could be an early sign of market weakness.

Let's begin with Figure 1.25, which is a 12-month weekly chart of the VIX. As you'll notice within the circled areas, the VIX reached lows in October, December, and March, which again is a sign of weakness in the stock market. As the saying goes, "when it's low, look out below."

By looking at Figure 1.26, you'll see that during the three months of October, December, and January, the Dow Jones was higher before moving lower. As a perfect example you can see that the Dow Jones reached a record high of about 14,200 during October and at the same time the VIX was trading at its low of about 17.

Within the next 7 weeks, the Dow Jones dropped from its record high of about 14,200 to 12,700, resulting in a 1,500 point drop in that time frame.

I hope you'll never forget "when the VIX is high, it's time to buy; when the VIX is low, look out below." From this day forward, I encourage you to use the VIX indicator to plan your trades and more important, to plan the type of trades you should be placing based on the market's direction.

In our last example (Figure 1.27) we are comparing the VIX to the Dow Jones. Number one shows the Dow Jones at a high at the same time the VIX was at a low, which resulted in the Dow Jones making a large downward movement. Number two is the point where you can see the VIX at a high when the Dow Jones was at

FIGURE 1.27 Dow Jones and VIX

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a low, which resulted in the Dow Jones rallying to the upside. At this point you shouldn't need to question how powerful the VIX is when it comes to timing the market. Be sure you're placing the correct trades based on the market's direction.

After clipping the charts above, the next day I decided to add a third example that shows the current VIX at about 17.50, which is below the previous VIX low of 18 back on December 24th. What happened today? Well, Figure 1.28 tells the story.

Looking back at Figure 1.27 and referring to number three, I had said that with the VIX being at a low, the Dow Jones could move even lower. And it did, moving down another 227 points and closing at the low of the day. This soon may mark the bottom of the market because the VIX moved up over one point on the day to

FIGURE 1.28 VIX Drops Lower

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18.59. It's now time to start selecting your investments and investment strategy based on the market's next move.

As I close out this section, I would like to encourage you to become more of a technical trader and not just a fundamental trader. Timing the market has to be by far the most important aspect of being successful. With the use of various technical indicators, you'll be able to reduce your fear and increase your confidence, which will create greater success. Keeping in mind that what goes up will go down, and the only way you'll know if your investments will drop is if you know how to use technical indicators to identify the changes. If you're looking to learn more about technical indicators, visit my website at www.whymoney.com and view the educational information I've made available.

I believe technical indicators are the key to perfecting your trading and building your confidence. Study chapter one thoroughly and you'll find that with the help of my favorite indicators, you'll be finding higher probability trades and winning more often.

Now that we have learned how to read the market, let's get started on our options education.

Self-test questions

1. Of the three different moving average settings, which one is referred to as the strongest point of support or resistance?

    A. 50-day moving average
    B. 100-day moving average
    C. 200-day moving average

2. The Average True Range Indicator works best to determine what?

    A. When to buy
    B. When to sell
    C. Where to place a stop loss

3. If a stock is about to reach a resistance level (ceiling), when would be the best time to buy?

    A. Before it breaks up through the resistance level
    B. After it breaks up through the resistance level with increased volume
    C. After it breaks up through the support level

4. Fibonacci Retracements are used to predict a stock's movement and during a downward movement, which of the three retracement levels is more important?

    A. 23% level
    B. 38% level
    C. 50% level

5. When using the Average True Range Indicator as a stop loss guide, it is best to double the 14-day average if the stock is very volatile and has a lot of movement.

    A. True
    B. False

6. With the use of a 10- and 20-day moving average, a stock tends to be more _____ when the 10-day crosses up through the 20-day.

    A. Bullish
    B. Bearish
    C. Neither

7. One of my favorite technical indicators is the Inertia Indicator, which works during what type of market?

    A. Upward Market
    B. Downward Market
    C. Both

8. My Inertia settings of choice are?

    A. 8, 14, 20
    B. 10, 14, 20
    C. 12, 14, 20

9. The Inertia Indicator works best to confirm which one of the three?

    A. Bullish upward movement
    B. Bearish downward movement
    C. A confirmation of a change from bullish to bearish or bearish to bullish.

10. When the VIX Indicator is low, it can be a sign that the market will move in which direction?

    A. Up
    B. Down
    C. Sideways

For answers, go to www.traderslibrary.com/TLEcorner.