Chapter 1

Swing Trading from A to Z

In This Chapter

- Contrasting swing trading with other types of trading
- Deciding how much time you want to devote to swing trading
- Getting strategic by preparing your trading plan
- Avoiding the mistakes that many swing traders make

You can earn a living in this world in many different ways. The most common way is by mastering some skill — such as medicine in the case of physicians, or computers in the case of information technology experts — and exchanging your time for money. The more skilled you are, the higher your compensation. The upside of mastering a skill is clear: You're relatively safe with regard to income. Of course, there are no guarantees. Your skill may become outdated (I don't believe that many horse carriage manufacturers are operating today), or your job may be shipped overseas. You also have a maximum earning potential given the maximum hours you can work without exhausting yourself.

But there's another way to make a living. Swing trading offers you the prospect of earning income based not on the hours you put in but on the quality of your trades. The better you are at trading, the higher your potential profits. Swing trading takes advantage of short-term price movements and seeks to earn a healthy return on money over a short time period.

REMEMBER

Swing trading is a good fit for a minority of the population. It involves tremendous amounts of responsibility. You must rely on yourself and can't be reckless or prone to gambling. If you're not disciplined, you may end up with no income (or worse).

This book is a guide for those of you interested in swing trading. To understand swing trading, you should understand what it is and what it isn't.

What Is Swing Trading?

Swing trading is the art and science of profiting from securities' short-term price movements spanning a few days to a few weeks — one or two months, max. Swing traders can be individuals or institutions such as hedge funds. They're rarely 100 percent invested in the market at any time. Rather, they wait for low-risk opportunities and attempt to take the lion's share of a significant move up or down. When the overall market is riding high, they go long (or buy) more often than they go short. When the overall market is weak, they short more often than they buy. And if the market isn't doing all that much, they sit patiently on the sidelines.

Uncle Sam differentiates between trading time frames

What would a discussion of swing trading be without mentioning our good old friend Uncle Sam? He has a say in your profits and losses because you presumably pay taxes. And he treats profits and losses differently depending on whether you're a day/swing trader or the buy-and-hold variety.

The factor that determines how you're taxed is based on your holding period. If you hold a position for 366 days (one year and one day) and then sell it, any profits from that position are taxed at a lower rate than your ordinary income tax rate (which can be as high as 35 percent). Presently, this rate is 15 percent for most people (5 percent for lower-income individuals, as defined by the federal government). However, this rate can change due to tax law changes. The 15 percent tax rate is set to expire at the end of 2010.

Swing traders, of course, are unlikely to qualify for this lower tax rate on positions. Holding periods for swing traders are measured in days, not years. Short-term profits are likely to be taxed at an individual's ordinary income tax rate.

But there's an exception. The government provides special tax treatment to people it considers pattern day traders. *Pattern day traders* must trade four or more round-trip day trades in five consecutive business days. Pattern day traders must also maintain a brokerage account with at least $25,000 worth of equity (cash and stock). The government allows pattern day traders to treat profits and losses as costs of doing business. This means you can categorize home-office expenses as business expenses (and lower your overall tax rate). More important, you can convert capital gains and losses into ordinary gains and losses under the IRS accounting rules.

A swing trader who trades part time may have difficulty convincing the IRS that he or she is a pattern day trader. But if you're a full-time swing trader, you should be able to take advantage of the special treatment of pattern day traders. Otherwise, expect to pay taxes on profits at your ordinary income tax rate.

However, swing trading in tax-deferred accounts — like in an Individual Retirement Account (IRA) or a 401(k) Plan — takes care of the tax issue. Gains and profits in such accounts aren't paid until the account holder withdraws the assets (usually at retirement). Because taxes change often and depend on an individual's situation, I strongly recommend consulting an accountant or tax professional to understand how swing trading will affect your taxes.

Swing trading is different from day trading or buy-and-hold investing. Those types of investors approach the markets differently, trade at different frequencies, and pay attention to different data sources. You must understand these differences so you don't focus on aspects that are only relevant to long-term investors.

The differences between swing trading and buy-and-hold investing

If you're a buy-and-hold investor in the mold of Warren Buffett, you care little for price swings. You don't short because the overall market trend has generally been up. You study, study, and study some more to identify promising candidates that will appreciate over the coming years. Short-term price movements are merely opportunities to pick up securities (or exit them) at prices not reflective of their true value. In fact, buy-and-hold investors tend to have a portfolio *turnover rate* (the rate at which their entire portfolio is bought and sold in a year) below 30 percent.

Buy-and-hold investing is an admirable practice, and many investors should follow this approach, because it's not as time-intensive as swing trading and not as difficult (in my opinion). But if you have the work ethic, discipline, and interest in swing trading, you can take advantage of its opportunities to

- **Generate an income stream:** Buy-and-hold investors are generally concerned with wealth preservation or growth. They don't invest for current income because they sometimes have to wait a long time for an idea to prove correct. Swing trading, on the other hand, can lead to current income.
- **Time your buys and sells and hold a basket of positions to diversify your risk:** The majority of people aren't interested in closely following their finances and are best served by investing in a basket of domestic and international mutual funds covering stocks, commodities, and other asset classes. Swing traders can hold a few securities across asset classes or sectors and generate higher profits than those who invest passively.
- **Profit from price declines and excessive euphoria through shorting, which buy-and-hold investors simply can't replicate:** The essence of *shorting* is that it allows traders to profit from price declines as opposed to price increases. But shorting involves risks not inherent in buying. When you buy a stock, your loss is limited to the amount you trade. Your potential profit is unlimited, but you can only lose what you put

into the security. Shorting carries the exact opposite payoff. A stock can go up over 100 percent, but the theoretical maximum amount of profit a short position can make is 100 percent if the security's price falls to $0.

Although shorting allows you to profit from the decline of a security, the potential losses from shorting are theoretically unlimited, and the potential gains are limited to the amount you short. So if a security jumps up in price by 30 or 40 percent or more, you may end up owing your broker a tremendous amount of dough.

The differences between swing trading and day trading

Opposite the buy-and-hold investor on the trading continuum is the day trader. Day traders don't hold any positions overnight. Doing so would expose them to the risk of a gap up or down in a security's price that could wipe out a large part of their account. Instead, they monitor price movements on a minute-by-minute basis and time entries and exits that span hours.

Day traders have the advantage of riding security price movements that can be quite volatile. This requires time-intensive devotion on their part. Near-term price movements can be driven by a major seller or buyer in the market and not by a company's fundamentals. Hence, day traders concern themselves with investor psychology more than they do with fundamental data. They're tracking the noise of the market — they want to know whether the noise is getting louder or quieter.

But it's not all cake and tea for day traders. They trade so often they rack up major commission charges, which makes it that much more difficult to beat the overall market. A $5,000 profit generated from hundreds of trades may net a day trader a significantly reduced amount after commissions and taxes are taken out. This doesn't include additional costs the day trader must sustain to support his or her activities.

Swing traders also face stiff commissions (versus the buy-and-hold investor), but nothing as severe as the day trader. Because price movements span several days to several weeks, a company's fundamentals can come into play to a larger degree than they do for the day trader (day-to-day movements are due less to fundamentals and more to short-term supply and demand of shares). Also, the swing trader can generate higher potential profits on single trades because the holding period is longer than the day trader's holding period.

What Swing Trading Is to You: Determining Your Time Commitment

Getting started in swing trading requires some reflection. Before you rush out to buy that slick PC or set up that brokerage account, you need to think about what kind of swing trader you want to be. (Yes, swing traders come in different shapes and sizes.)

Your first step is to determine just how much time you can commit to swing trading. You may be a full-time trader for a firm, in which case you should consider yourself as trading for a living. Or you may be doing this part time for income with the intention (and hope) of becoming a full-time trader.

Many swing traders have full-time jobs and have little time to devote to trading, so they trade primarily to improve the returns of their investment accounts. Or perhaps they're already in retirement and swing trade to grow their assets over time. These swing traders watch the market during the day but rely on orders placed outside market hours to enter or exit their positions. And if they trade in tax-deferred accounts, like an Individual Retirement Account, they can ignore the tax issue.

REMEMBER

The point is, you can swing trade whether you have a full-time job or not, but you need to make adjustments depending on whether you're able to watch the market all day. And by the way, watching the market all day long doesn't necessarily improve your returns. In fact, doing so can lower them if it causes you to overtrade or react to market gyrations.

Swing trading as your primary source of income

If you intend to swing trade as your primary means of generating income, be prepared to spend several months — if not years — gaining experience before you're able to give up your job and trade from home full time. Swing traders who trade full time devote several hours a day to trading. They research possible trades before, during, and after market hours. And they handle pressure well.

Many traders find that they can't handle the stress of trading full time. After all, if swing trading is your main source of income, you face a lot of pressure to generate consistent profits. And you may be more tempted to gamble if you encounter a string of losses. What many traders fail to realize is that the correct response to a series of losses isn't *more* trading but *less* trading. Take a step back and evaluate the situation.

REMEMBER

Swing trading for a living isn't difficult in the sense that to excel at it requires some kind of amazing IQ level or insane work ethic. Rather, it requires an incredible amount of self-restraint, discipline, and calm. A swing trader who trades for income must always be unemotional. When things don't work out, he or she doesn't try to get even but moves on to another opportunity.

So don't quit your day job just because you generate impressive profits for a few months. The name of this game is to always have enough capital to come back and play again. If you plan on living off of $5,000 per month, for example, you can't expect to generate that kind of profit on $30,000 of capital. That would require a monthly gain of 16.67 percent! Some of the best all-time traders in the world topped out at returns of 20 to 25 percent *annually* over 20 or 30 years.

Swing trading to supplement income or improve investment returns

This category likely applies to the lion's share of swing traders. Swing trading with an eye on earning additional income or improving the returns on your portfolio is less stressful than swing trading for a living. You still have something to fall back on if you make a mistake, and you can swing trade while holding down a full-time job.

Part-time swing traders often do their analysis when they get home from work and then implement trades the following day. Even though they may not be able to watch the market all the time, they can enter stop loss orders to protect their capital.

If you want to eventually swing trade full time, you should go through this phase first. Over time, you'll be able to determine how well you've done. And if you follow the other recommendations in this book (like keeping a trading journal, which I cover in Chapter 3), you'll learn from your mistakes and improve your techniques.

Swing trading part time is suitable for those individuals who

- Have a full-time job
- Can devote a few hours a week to analyzing markets and securities
- Have a passion for financial markets and short-term trading
- Have the discipline to consistently place stop loss orders
- Are achieving subpar returns in their current investment portfolios from a financial advisor or third party
- Don't gamble with their own money and are unlikely to fall prey to doubling down or taking major risks

If you fit these criteria, then part-time swing trading may be for you. When you first start out, I recommend swing trading with just a small portion of your portfolio so any early mistakes don't prove too costly. Although paper trading can be beneficial, it can't compare to the emotions you'll be battling as a swing trader when you put your own money on the line.

Swing trading just for fun

Some swing traders get a rush from buying and selling securities, sometimes profiting and sometimes losing. Their motivation isn't to provide or supplement current income. Rather, these swing traders do it for the excitement that comes from watching positions they buy and sell move up and down. Of course, this can lead to significant losses if they abandon the rules designed to protect their capital — rules that I outline throughout this book (specifically in Chapter 10).

If you want to swing trade solely for fun, my advice is: don't. I recommend that you get your kicks at a bowling alley or basketball court. The danger of trading for fun is that you're using real money with real consequences. You may begin to risk more of your capital to satisfy your need for excitement. If you lose, you may take extreme action to prove yourself right in the end, like putting all your money into one or two securities. By then you're really in the realm of gambling.

If you insist on trading for fun, at least restrict yourself to a small amount of your assets and never touch your retirement nest egg. Remember that you're competing with traders who are motivated by profit, not just excitement. That gives them an advantage over someone who just enjoys the game.

Sneaking a Peek at the Swing Trader's Strategic Plan

Plan your trade and trade your plan.

Fail to plan and you plan to fail.

Countless clichés address the importance of a trading plan. A trading plan is the business plan of your trading business. Without the plan, you're likely to fall into the trap of making things up as you go. Your trading will be erratic. You won't improve because you won't have the records on your past trading. You may think your trading plan is in your head, but if you haven't written it down, for all intents and purposes it doesn't exist.

Throughout this book I cover all the important parts of swing trading strategy in detail. In the following sections, I preview the critical parts of the strategy, trimming them all down into one neat little package. (For more on your trading plan, see Chapter 10.)

The "what": Determining which securities you'll trade

Your trading plan should identify the securities you trade. As a swing trader, you can choose from a variety of securities:

- **Public equity (stock):** This category is perhaps what you're most familiar with. Common stocks, American Depository Receipts, and exchange traded funds fall under this rubric. Swing traders often trade stocks exclusively because of the variety, ease, and familiarity of trading corporate stocks. Most stocks listed in the United States trade every day, but stocks in foreign markets may trade infrequently (perhaps once a week). To make your entries and exits as painless as possible, you must focus only on those stocks that meet a specified level of volume. Trying to sell 1,000 shares of a stock that trades 5,000 shares in a day can be extremely costly. I recommend you use stocks due to the abundant information on firms domestically and even internationally.

  One of the beauties of stocks is how efficient they are to trade, partly because they offer exposure to other asset classes. For example, you can gain exposure to the commodity gold by trading an exchanged traded fund with underlying assets in gold bullion. I stick to stocks myself because that's my area of expertise, and I recommend them because of this exposure to other asset classes and because of the variety of positions you can choose from. But you may wish to trade other asset classes as well — that's your call.

  - **American Depository Receipts (ADRs):** ADRs have become increasingly important in today's globalized world. Simply put, an ADR allows U.S. investors to buy shares of foreign companies. ADRs are quoted in U.S. dollars and pay dividends in U.S. dollars. Trading ADRs is much more cost efficient than setting up accounts in several foreign countries, converting your dollars into foreign currencies, and so on. And because the economic growth of emerging nations is outstripping the growth of developed countries, ADRs can offer strong profit opportunities. ADRs of companies based in emerging markets (like Brazil or China) are sometimes highly leveraged to a particular commodity, making ADRs one way to profit from commodity price strength.

- **Exchange traded funds (ETFs):** ETFs are pooled investments. The most common ETFs mirror the movement of an index (such as SPY, a popular ETF that tracks the S&P 500 Index) or a subsector of an index. If you want to ride a coming tech bounce, you may be better served trading a technology ETF than choosing a particular tech company that may or may not follow the overall tech sector. That's because if you're right on the move, you'll profit from a diversified technology ETF. However, a single technology security may buck the trend. ETFs also offer you the ability to profit from international indexes and commodities.

- **Closed end funds:** These funds are basically mutual funds that trade on a secondary exchange. Traditional, open end mutual funds are priced according to their *net asset value* — or the value left after subtracting the fund's liabilities from its assets. Closed end funds are different. They're priced according to the supply and demand for shares of that particular fund. Sometimes, a closed end fund will trade for more than its net asset value; other times, it will trade for less. Closed end funds may be an efficient way to profit from international markets.
- **Fixed-income markets:** These markets include securities issued by governments on the federal, state, and local level, as well as those issued by corporations. The value of fixed-income securities depends on interest rates, inflation, the issuer's credit worthiness, and other factors. Because the fixed-income market tends to have less volatility than stocks and other asset classes, many swing traders usually avoid trading it.
- **Futures contracts:** Standardized contracts to buy or sell an underlying asset on a certain date in the future at a certain price are known as *futures contracts.* Futures are traded on commodities and financial instruments, such as equity indexes. Technically, the buyer and seller don't exchange money until the contract's expiration. However, futures exchanges require traders to post a margin of 5 percent to 15 percent of the contract's value. This means that traders can employ extreme leverage, if they choose, by putting down only a small amount of the contract's value.

TIP

I strongly recommend avoiding the use of such extreme leverage because of the potential to lose most, if not all, of your assets due to an unexpected move in a security. Newcomers in particular should avoid using leverage. Even experienced swing traders can become careless or arrogant before the market educates them.

- **Commodities:** This security type is perhaps the biggest asset class receiving attention today other than stocks. With the boom in the prices of everything from gold to crude oil, commodities are attracting more money from swing traders. Commodities — including energy commodities, agricultural commodities, and precious metals — are traded in the futures markets.

  You can profit from commodity price movements through stocks or exchange traded funds. For example, swing traders wanting to profit from movements in gold prices can trade streetTRACKS Gold shares, which tracks the movement of gold bullion prices. But trading commodities involves risks and issues that differ from trading equities. (See *Commodities For Dummies* by Amine Bouchentouf, published by Wiley, for more information on trading commodities.)
- **The currency market:** Often called the foreign exchange market or forex market, the *currency market* is the largest financial market in the world. According to the Bank of International Settlements, the average daily turnover in the foreign exchange markets is $3.21 trillion. Like the futures market, trading in the currency market allows for extreme leverage.

  TIP

  Not all brokers offer trading in foreign exchange, so make sure you check whether your broker has the capability. Unlike stocks, trading in the currency market is concentrated in a few currencies: the U.S. dollar, the euro, the Japanese yen, the British pound sterling, and the Swiss franc. If you plan on using fundamental analysis to complement your technical analysis as a swing trader (see the definitions of both terms in the section "Establishing your analysis techniques" later in this chapter), be prepared to learn about the various factors that affect the value of foreign currencies: inflation, political stability, government deficits, and economic growth — to name a few. (See *Currency Trading For Dummies* by Mark Galant and Brian Dolan, published by Wiley, for more information on trading currencies.)

  WARNING!
- **Options:** Investment contracts that give the purchaser the option, but not the obligation, to buy an underlying asset at a specified price up until the expiration date are known as *options.* Options are highly risky and not efficient swing trading vehicles because of their illiquidity.

The "where": Deciding where you'll trade

Where you trade depends a great deal on what you trade. Stocks, commodities, currencies, and bonds trade on different markets.

The New York Stock Exchange (NYSE), American Stock Exchange (AMEX), and NASDAQ list stocks based in the United States and abroad (they also list other investment vehicles, like exchange traded funds, that enable you to profit from movements in prices of commodities and other asset classes). The NASDAQ differs from the NYSE and AMEX in that it's completely electronic and allows for efficient transaction and order routing.

Not all stocks trade on these markets. Recently, electronic communication networks (ECNs) have emerged as an efficient way to match buy and sell orders. ECNs connect individual traders with major brokerage firms. You sometimes can get a better price by submitting orders to an ECN instead of a broker. The easiest way to access ECNs is by subscribing to a broker who provides direct access trading.

But swing traders can buy and sell other securities on other markets. For example, if you want to trade an actual commodity, the Chicago Board of Trade (CBOT) lists several commodities: ethanol, gold, silver, corn, oats, rice, soybeans, and wheat. The New York Mercantile Exchange (NYMEX) also lists popular commodities like crude oil, coal, natural gas, and gold. But you must consider the additional risk factors if you venture outside trading stocks. For example, commodities require different margin requirements than stocks. Not properly employing a risk management system can lead to losing your entire capital on a single trade. Commodities also trade on different fundamentals than companies or fixed-income securities.

REMEMBER

If you want to trade commodities, currencies, or other investment vehicles, you need to trade via firms authorized to transact in those markets.

The "when" and the "how": Choosing your trading style and strategy

Whether you enter orders during or after market hours affects your entry and exit strategies.

- Part-time swing traders enter orders when markets are closed and rely on limit and stop losses to execute this strategy.
- Full-time traders, on the other hand, can execute their entries and exits during the day and incorporate intraday price action into their timing of trades. They also find more trading opportunities because they have more time to devote to swing trading.

How you trade refers to your various trading strategies, which I outline in this section.

Establishing your analysis techniques

Swing traders rely on two major analysis techniques: technical analysis and fundamental analysis. *Technical analysis,* broadly speaking, encompasses chart pattern analysis and the application of mathematical formulas to security prices and volume. *Fundamental analysis* covers earnings, sales, and other fundamentals of a company or a security.

In my experience, most swing traders rely solely or in large measure on technical analysis. However, I explain both analysis techniques in this book because I strongly believe that understanding and using both improves the odds of success.

Both analysis techniques have their advantages:

- **Technical analysis can be quickly and easily applied to any market or security.** For example, a trained swing trader can use technical analysis to quickly decide whether to buy or sell a security using chart patterns of technical indicators. In contrast, a swing trader relying on fundamental analysis needs more time to read about a company, its business, and its earnings before coming to a conclusion. Whether you're trading commodities, currencies, stocks, or bonds, you can apply technical analysis uniformly to these markets. In other words, if you know how to interpret a chart, then the kind of security being plotted is largely irrelevant. In my opinion, the ease of application is the biggest advantage technical analysis has over fundamental analysis.
- **Fundamental analysis can answer questions that are beyond the scope of technical analysis, such as, "Why is this security price moving?"** Swing trading on the long and short side based, in part, on fundamentals is like having a head start in the 100-meter dash. Rallies and declines that are driven by fundamentals are more profitable to trade than rallies and declines that are simply the result of noise in the markets (such as a large mutual fund liquidating or buying a position). Over the long term, security movements are driven by the securities' underlying fundamentals. Crude oil prices rise when demand exceeds supply or when supply becomes scarce — not, as technical analysis may superficially indicate, because the chart developed a bullish formation. (Of course, crude oil — or any security — can rise or fall due to non-fundamental reasons. But such rallies and declines are often fleeting and not as strong as fundamentally driven price moves.)

  Some swing traders shy away from learning about a company's fundamentals. Generally, fundamental analysis is seen as long, laborious, and not always right. But you can improve your swing trading by getting to the essence of a company's fundamentals, even though it does require extensive reading, researching, and modeling.

Just how much should you care about a company's fundamentals? The general rule of thumb is that the longer your investment horizon, the more important fundamental analysis becomes. The shorter your horizon, the less important fundamental analysis is in trading securities. This is because short-term movements are driven by momentum, noise, and other factors. Over the long term, however, fundamentals always win out.

But just because you understand how to apply fundamentals doesn't mean you'll make money. Markets don't rise simply because they're undervalued, or fall simply because they're overvalued. Markets can remain under- or overvalued for long periods of time. That's why I don't recommend swing trading on fundamentals alone. Fundamental analysis tells you which way the wind is blowing so you're prepared, but technical analysis provides the important timing components.

Choosing candidates to buy

You can find promising securities in two main ways — the top-down approach and the bottom-up approach. Both are covered in detail in Chapter 8, but here's a brief rundown:

- **Top-down:** Swing traders who prefer the top-down approach identify opportunities beginning at the market level, drill down to the industry level, and finally look at individual companies. If you fit this category, your entry strategy should begin with an examination of the overall markets, then trickle down to the major sectors in the market, and then to the industries within the strongest or weakest sectors. At this point, you rank the securities in the industry on some technical or fundamental measure (more on that in Chapter 8). Then you select the securities that meet your entry strategy.
- **Bottom-up:** Swing traders who use the bottom-up approach are grassroots-oriented individuals who look for strong securities and then filter promising ones by their industry groups or sectors. If you fit this category, your approach begins with a screen of some sort (a *screen* is a quantitative filter), sometimes depending on whether growth or value stocks are in favor at that particular point in time. If that's the case, you then compare the relative strength of the growth and value indexes (and possibly also the market capitalizations of the market). After identifying which securities rank highest in the screen, you determine which securities meet your entry rules, and then you trade only those securities that reside in leading or lagging industry groups, depending on whether you favor buying or shorting.

Planning your exit

Most swing traders focus almost entirely on their entry strategy, but it's the exit strategy that determines when you take profits, when you take losses, and when you exit a meandering position so you can put the capital to better use. So although planning your entry is important, you need to spend equal (if not more) time on your exit.

REMEMBER

Your exit strategy is most likely going to be technically driven, and it's threefold:

- **Determine when you exit for a profit.** Don't take profits based on a gut feeling — rely on a trigger or catalyst instead. For example, some exit strategies for profits stipulate that the time for departure arrives when prices reach the implied target based on a chart pattern, or when shares close below a moving average.
- **Determine when you exit for a loss.** Your exit strategy for losses should be based on the breach of a support level, a resistance level (in the case

of shorting), or some type of moving average (for example, the nine-day moving average). (*Support levels* are simply price zones where securities stop falling, and *resistance levels* are price zones where prices stop rising.) This keeps your losses limited to some known quantity (barring, of course, a gap up or down in the security price, which must be addressed by proper position sizing and other risk management techniques).

- **Determine when you exit if a trade generates neither profits nor losses.** That is, it meanders sideways and results in dead weight. Some swing traders exit a position quickly if it doesn't perform. I prefer to give a position a few days to prove itself one way or the other. So I recommend exiting a position after ten days if it hasn't hit your stop loss level or triggered a profit-taking signal.

You should outline your exit strategy by making sure your trading plan addresses when you exit for profit, loss, and capital redeployment.

Settling on when you'll net long or short

Swing traders sometimes short securities to profit from price declines. If you choose to incorporate shorting into your trading strategy, you must determine when you'll be net long or net short.

Net long means that the majority of assets you've invested in are on the long side of the market. *Net short* means that the majority of assets you've invested in are on the short side of the market. And if your long and short assets are equal, then you're *market neutral.*

Generally, the decision to be net long or net short is driven by the state of the major market index. When the S&P 500, for example, is in a bull market, then most swing traders are net long. When the S&P 500 is falling, most swing traders are net short. And when the market is in a trading range, swing traders may be market neutral.

Preparing your risk management plan

The most important part of your trading plan is how you manage risk. Risk management, which I cover in detail in Chapter 10, addresses how you manage risk on an individual security level and on the portfolio level as a whole. A trading plan with a weak entry strategy and a weak exit strategy can still be profitable if the risk management strategy limits losses and lets profits run.

In order to effectively manage your risk, you need to account for the following aspects of your trading plan:

- **How much you risk on an individual position:** Your trading plan must spell out how much you plan on allocating to a single position.
- **How much you risk of your overall portfolio:** You determine how much of your total portfolio is at risk on a single position. Generally, this figure should be 0.5 to 2 percent (see Chapter 10).

- **How to achieve proper diversification:** Diversification means more than adding several securities. You need to have exposure to different asset classes, sectors, and market capitalizations.
- **How you combine long and short positions:** Combining long and short positions enables your portfolio to benefit in up and down markets.
- **How you implement the 7 percent rule:** How much you risk on a single position is different from how much you risk of your total portfolio. The 7 percent rule caps your total risk at 7 percent.
- **How you determine your exit points:** Your exits should be driven by support and resistance ranges, technical indicators, and profit targets.
- **What triggers an exit:** An exit may occur due to a loss, a profit, or a lack of meaningful market action.
- **How you manage your emotions:** No matter how effective a risk management system is, it ultimately must be enacted by a human being. Thus, this last point is paramount, because humans are affected by emotions, experiences, and hopes. This fact can cause a swing trader to abandon the stringent rules he or she has fashioned and may have been following for years.

  I've found that managing emotions is the most difficult aspect of swing trading. The better you get at trading, the more likely your emotions will convince you to cut corners and abandon the rules that got you to where you are. But emotions can be managed. You can limit their impact by, for example, implementing stop loss orders that get you out of a security without your interference.

The preceding bullets all boil down to two categories of action: position sizing and limiting losses at the portfolio level. So what's the difference between the two? Alexander Elder, a trading expert, once differentiated between losses suffered at the individual stock level and the portfolio level through an analogy of sharks and fish. Specifically, he said that position sizing is done to reduce the risk that your portfolio will suffer a "shark bite" loss from a single position. That is, a single major loss that wipes out your account value.

On the other hand, portfolio risk management is done to prevent several small losses from killing you — or as he described it, death by piranha bites. A single small piranha may not be able to kill a larger mammal, but dozens of piranha working together can be deadly.

Similarly, a small loss is not life threatening for a portfolio. The risk is that several small losses may gang up and cause major loss. That's why you must limit losses on an individual stock level (and avoid those shark bites) while also limiting losses on the portfolio level (to prevent death by piranha bites).

Building Your Swing Trading Prowess

Staying on top of your game means you can never stop learning or improving yourself. Sadly, you can't simply become a swing trading extraordinaire and implement your trades with nary a single problem. Heck, a master martial artist doesn't stop after earning his or her black belt — why would a swing trader?

The following action items will help you stay strong throughout your swing trading career:

- **Admit to losses when they occur.** Markets have a way of humbling even the most skilled traders if they let their egos get in the way of their trading. Some traders hold onto losing positions in the hopes that they can eventually break even — a policy that devastates an account in the long run. A losing position not only may lose more money but it also ties up capital that could be invested in more promising trading opportunities.
- **Be a student of the markets.** Successful swing traders never stop absorbing information. The markets are always changing, with new investment vehicles appearing and new laws being introduced. As a swing trader, you must maintain intellectual curiosity. Reading books is one way to continually stay informed. Take an interest in understanding your positions and reading the pro and con arguments on them.
- **Try to insulate yourself as much as possible from others' opinions, whether the person is an Average Joe or a Wall Street analyst.** Remember, Wall Street is a community, and analysts send out their opinion reports to hundreds, if not thousands, of traders and portfolio managers. Reading those reports can lead you to think like the analyst does — and like hundreds of others do. Good performance doesn't come by copying what everyone else is doing.
- **Don't frequent message boards.** Message boards often foster a group mentality that a position should behave a certain way. You don't want to gather knowledge from just anyone on the Internet. Rather, stick to trusted sources and form your own opinion on matters.