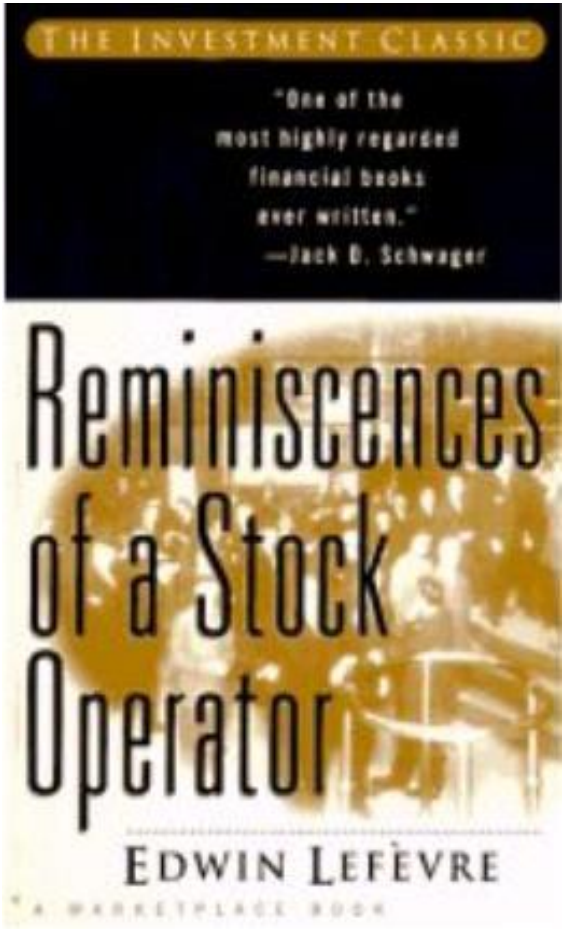
Equity Trader 101

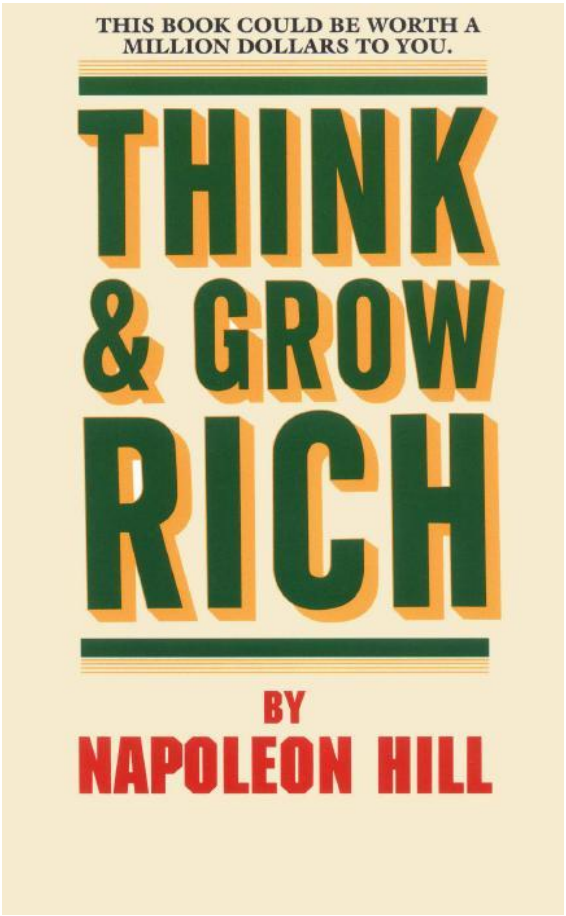
presented by

Keystone Trading Concepts

A complete business plan for operating a profitable stock trading business

Recommended books





Advice from the baseball hall of fame

- “I focused on the process, not the outcome.” Sandy Koufax.
- As we progress through this course you should be focusing on the steps and mindset that go into producing high probability trades, the process of finding a good trade and then the mindset for managing that trade.
- Equity Trader 101 will provide you with a simple, proven system. Executing the system is up to you.

Advice from Keystone Trading Group

- The process of earning consistent money as a professional stock traders is as follows:
- Develop trade scenarios (based on price action of stock and market in multiple time frames, market internals and volume) **A full 70% of your time will be here!!!**
- Determine probability (based on scenario)
- Accept a risk amount (based on probability)
- Determine entry price, initial risk point and first profit target (based on charts)
- Determine share size acquisition method before trade: *Build a position method* and get paid for order flow if scalping; *price confirmation method* if longer term trade expectation.

Chapter 1

The Stock Market

Introduction to common stock, the stock market and the business of bringing buyers and sellers together

Chapter Goals

- Understand common stock and the role of the stock market.
- Learn who is involved
- Understand how interaction takes place.
- Understanding the opening

Common stock

- Common stock is the most popular form of equity in a corporation.
- Companies issue stock through a stock exchange for the purpose of raising capital to operate a business venture.
- Stocks are issued as shares, the amount of shares available is called the float.
- Financing a company through the sale of stock is known as equity financing. Hence the term, Equity Trading.
- The first company to issue shares of stock was the Dutch East India Co. in 1602.

The stock market

- The stock market is an arena for the trading of company stock. The owners of such securities are known as shareholders.
- The U.S. stock markets are made up of the NYSE, NASDAQ, Amex, plus several regional exchanges such as Chicago, Boston.
- Bulletin board and Pinks Sheet markets do not impose reporting requirements to companies listed there and are far riskier stocks to trade.
- We will be primarily discussing NYSE and NASDAQ stocks.

The stock exchange

- A stock exchange provides the market for buying and selling shares of publicly traded companies. As we will see, this can be done online or person to person.
- Market making firms and specialist firms interact with floor brokers, large institutions, hedge funds and the public.
- Major exchanges have minimum listing requirements for securities to maintain a quote.
- Electronic Communication Networks are also available to execute trades. (very popular, more on this later)
- We will discuss in detail later in the program why you may use one routing destination over another.

Brief history of NYSE

- The New York Stock Exchange is over 200 years old.
- The origin of the NYSE can be traced to May 17, 1792, when the Buttonwood Agreement was signed by twenty-four stock brokers outside of 68 Wall Street
- On March 8, 1817, the organization drafted a constitution and renamed itself the "New York Stock & Exchange Board".
- In general, listed securities (NYSE traded) are large capitalization companies that have a historical record of earnings.
- Stocks listed on the NYSE or AMEX have 3 symbols or less. For example: F= Ford, HPQ= Hewlett Packard, AA=Alcoa

The NYSE in action

- The New York Stock Exchange is the largest stock exchange in the world by **dollar volume**.
- On the trading floor, the NYSE trades in an auction format.
- There is one specific location on the trading floor where each listed stock trades.
- A specialist broker acts as an auctioneer in an open outcry market environment to bring buyers and sellers together and to manage the actual auction.
- Specialist involvement has decreased significantly since the adoption of the hybrid trading system by the NYSE in early 2007.

The specialist

- The difference between the NYSE and the NASDAQ is the manner in which each provides liquidity to the public.
- The person in charge of creating a fair and orderly market for a particular "listed" stock is known as the **specialist**.
- Interaction on the floor of the NYSE between institutions, the public, floor brokers and the specialist provides efficient price discovery in an auction environment that is designed to produce the fairest price for all parties.

Specialist responsibility

- The specialist works for a specialist firm that is responsible for making a market in a particular stock.
- He is responsible for maintaining order in the market for a stock and posting the best buy and sell orders first.
- If the orders become unbalanced, the specialist must try to get the stock back into order even if it means buying or selling against the market out of his firms own account to achieve some balance to the buy and sell orders.
- This means a specialist is a buyer of stock as a stock moves down, and a seller of stock as it moves up should this imbalance exist.
- This risk is an inherent part of his job to provide a fair and orderly market to the public.

NYSE trading

- The human interaction and expert judgment as to order execution differentiated the NYSE from fully electronic markets. However, today in excess of 80% of all order flow is now delivered to the floor electronically.
- This specialist interaction is what up until recently separated intra day NYSE trading from its counterpart, the NASDAQ. Order flow was much easier to interpret by watching the specialist activity, therefore making NYSE stocks easier to trade intra day.
- When we refer to order flow in this course we are referring to monitoring the bias between supply and demand and determining who is in charge.
- With the increase of electronic activity, exchange mergers and the new Hybrid system, the edge of day trading one market over the other (NYSE/NASDAQ) has lessened.

Brief history of NASDAQ

- **NASDAQ** (originally an acronym for National Association of Securities Dealers Automated Quotations system) is an electronic stock market. It was founded in 1971 by the NASD.
- When it began trading on February 8, 1971, it was the world's first electronic stock market. At first, it was merely a computer bulletin board system and did not actually connect buyers and sellers.
- The NASDAQ quotes helped lower the spread but became unpopular among brokerages because they made much of their money on the spread. (the spread is the difference between the bid price and the ask price of the stock)
- Eventually, NASDAQ became more of a stock market by reporting trades and volume and adding automated trading systems

The NASDAQ stock exchange

- Stocks listed on NASDAQ have symbols of **four** letters and are more often than not, technology companies.
- It is the largest electronic screen-based equity securities market in the United States. On an average day, more **shares** are executed on NASDAQ than any other US exchange.
- The NASDAQ is a **negotiated** market where the computer network posts prices from different buyers and sellers. The best prices get filled first. If you want to sell your stock, you'll need to post the best price.
- NASDAQ allows approved *competing* market making firms to provide liquidity and to trade for their own accounts.
- * A NYSE specialist is actually a "market maker" but is called a specialist because he makes a market in only one stock.

Evolution of NASDAQ executions

- Typically, for day traders reading market maker actions is not as conclusive as reading the specialist, because there are many competing market makers as opposed to one specialist in a particular stock. In this case, order flow is **not** centralized.
- Prior to the 1987 market crash most NASDAQ trades took place over the phone. Market makers would agree on transactions with a phone call. When the crash occurred, many market makers did not answer the phone because they would have lost fortunes being on the "wrong" side of the trade.
- From this occurrence, the SOES system was created for retail traders to interact electronically with a quote from a market maker. (SOES = small order execution system)

NASDAQ: market makers

- NASDAQ relies on many market makers instead of a single specialist to provide liquidity.
- Market makers combine their efforts to create a fair and orderly market for a stock.
- Unlike specialists at the NYSE, the market makers interact through a computer network rather than on the floor of a physical exchange
- This is a big distinction from NYSE, many firms are trying to fill orders and create a market in a stock, as opposed to one person (specialist).
- A market maker will: execute orders for clients accounts, trade their own money and make a two sided quote in the stocks they represent to provide liquidity to the public.

Market makers and specialists in action

- Whenever a stock is bought or sold, there can be someone on the other end of the trade, within seconds of placing your order it can be filled.
- A market maker or specialist will post a firm bid/ask quote every second of the trading day.
- They will actually purchase the stock from you, even if they don't have a seller lined up. When they do this they are literally "making a market" for the stock.

Giving the opening price action structure

- NASDAQ market makers and NYSE specialists have a very unique job. The business they are engaged in is to "create a fair and orderly market."
- This means it is their job to provide liquidity to the investing and trading public. Lets think about the implications of this.
- If we have an opening where there is an imbalance of buy and sell orders, there will be a markup or markdown on the opening in that direction.
- Let's say there is a good news story out and the stock is set to open much higher than the previous close.

a. That means that these professionals will be on the opposite side of the open providing liquidity and a fair market to the public. Simply put, they will be on the wrong side of the trade.

Morning order flow

- Once the morning influx of buy and sell orders is complete and the dust begins to settle (this can take from 15-45 minutes after the open) market makers and specialists have to pay attention to something very important:
- They need to decipher if the order imbalance that opened the stock higher (or lower) was created by retail order flow or institutional order flow.
- What's the difference? Everything!!

Order flow: retail vs. institutional

- **Retail order flow** does not have the staying power that institutional orders have. More often than not, around 9:45-10am est. retail orders are usually completed.
- This allows the specialist or market makers to bring the stock back to a price where they can cover their position. They can do this because the pressure is gone or depleted. They can recover their money.
- **Institutional order flow** is a very different animal. If the opening imbalance is from the big boys and they are going to build a position, they will further support the imbalance with new orders after the open.

Trading significance of reading morning order flow: **structure!**

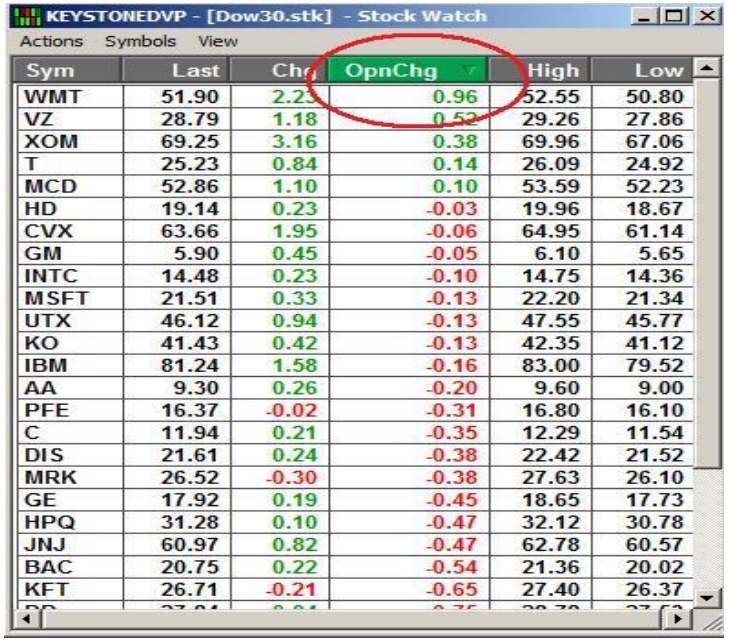
- The opening price range which professionals will identify as the first 15 minutes of trading is the starting point for your intra day trend analysis.
- There is much that can happen between the previous nights close and the current days opening range, for our trading plan the change from the opening price is more important than the change from the previous close.
- The price action that trades around the opening 15 minutes will clearly show you **today's order flow.**
- ** From a risk perspective, trading in the direction above or below the opening price will allow you to be on the correct side of the intra day trend.

Net change / change from open

- **Pre market** set your stock watch to "net change" so you can spot an obvious imbalance to possibly trade. Pay attention to pre market volume in those stocks with an imbalance, if significant this could be a clue to institutional order flow and good follow through after the open range has formed.
- When the **opening bell rings**, change your stock watch to "change open" this will be the first clue to intra day order flow.



Sym	Last	Chg	OpnChg	High	Low
MRK	26.79	-0.03	0.00	0.00	0.00
HD	19.20	0.29	0.00	0.00	0.00
AIG	1.65	0.30	0.00	0.00	0.00
PFE	16.69	0.30	0.00	0.00	0.00
INTC	14.63	0.38	0.00	0.00	0.00
VZ	28.00	0.39	0.00	0.00	0.00
HPQ	31.57	0.39	0.00	0.00	0.00
DD	28.25	0.45	0.00	0.00	0.00
AA	9.50	0.46	0.00	0.00	0.00
MSFT	21.65	0.47	0.00	0.00	0.00
C	12.25	0.52	0.00	0.00	0.00
GM	5.99	0.54	0.00	0.00	0.00
DIS	21.99	0.62	0.00	0.00	0.00
GE	18.40	0.67	0.00	0.00	0.00
BAC	21.25	0.72	0.00	0.00	0.00
PG	58.09	0.72	0.00	0.00	0.00
JPM	34.77	0.77	0.00	0.00	0.00
T	25.18	0.79	0.00	0.00	0.00
KO	41.84	0.83	0.00	0.00	0.00
AXP	24.01	0.93	0.00	0.00	0.00
CAT	33.75	0.97	0.00	0.00	0.00
MCD	52.77	1.01	0.00	0.00	0.00
WMT	50.70	1.03	0.00	0.00	0.00
UTX	46.25	1.07	0.00	0.00	0.00
MMM	61.45	1.08	0.00	0.00	0.00
JNJ	61.26	1.11	0.00	0.00	0.00
CVX	63.50	1.79	0.00	0.00	0.00
IBM	81.77	2.11	0.00	0.00	0.00
XOM	68.68	2.59	0.00	0.00	0.00
BA	46.15	3.79	0.00	0.00	0.00



Sym	Last	Chg	OpnChg	High	Low
WMT	51.90	2.25	0.96	52.55	50.80
VZ	28.79	1.18	0.52	29.26	27.86
XOM	69.25	3.16	0.38	69.96	67.06
T	25.23	0.84	0.14	26.09	24.92
MCD	52.86	1.10	0.10	53.59	52.23
HD	19.14	0.23	-0.03	19.96	18.67
CVX	63.66	1.95	-0.06	64.95	61.14
GM	5.90	0.45	-0.05	6.10	5.65
INTC	14.48	0.23	-0.10	14.75	14.36
MSFT	21.51	0.33	-0.13	22.20	21.34
UTX	46.12	0.94	-0.13	47.55	45.77
KO	41.43	0.42	-0.13	42.35	41.12
IBM	81.24	1.58	-0.16	83.00	79.52
AA	9.30	0.26	-0.20	9.60	9.00
PFE	16.37	-0.02	-0.31	16.80	16.10
C	11.94	0.21	-0.35	12.29	11.54
DIS	21.61	0.24	-0.38	22.42	21.52
MRK	26.52	-0.30	-0.38	27.63	26.10
GE	17.92	0.19	-0.45	18.65	17.73
HPQ	31.28	0.10	-0.47	32.12	30.78
JNJ	60.97	0.82	-0.47	62.78	60.57
BAC	20.75	0.22	-0.54	21.36	20.02
KFT	26.71	-0.21	-0.65	27.40	26.37

The initial 15 minutes of trading

- There DOES NOT need to be a gap for you to monitor the open 15 minutes. You should monitor the price action around the open range no matter how high or low the stock and market open.
- A gap is an extreme imbalance and can be traded very profitably using the open price range method.
- This focus of the open range will give price action structure!
- This structure is the foundation of tape reading.

Recap

- Public companies issue stock and bring that stock to market to raise capital to run their business.
- Stock exchanges provide and regulate the market to buy and sell those securities.
- Market makers and specialists provide liquidity and stability to price fluctuations to the market.
- Opening range order flow is important to monitor for intra day bias.

Chapter 2
The business plan

The trading plan

The game plan

The business objectives

Goals

- To understand you are in the business of managing money, the same business as a hedge fund or a mutual fund.
- To understand your #1 business objective is to preserve capital.
- Your #2 business objective is to understand how to grow your capital consistently.
- To understand as a trader you will grow your capital consistently when you realize your job is risk management, not predictions.
- As a trader you will make consistent money by mastering the relationship between probability, risk and leverage.
- We will outline the requirements to succeed.

Private wealth management

- As a money manager you have the responsibility of seeking out scenarios that are low risk but have the potential to produce an acceptable rate of return for the risk taken.
- Becoming a profitable trader is hard work, the first skill to learn is to never lose big. Keep small losses small.
- As a trader who is managing money on a short term basis, you must learn to make quick definite decisions.
- As a trader you must never let past trades affect future trades. Each trade is unique.

Business objective #1: Preserving capital and managing loss

- Placing a trade that doesn't make money is okay, it is a part of the business.
- As a trader you must develop the discipline to take losses quickly without emotional regard to the outcome.
- In order to become a consistently profitable trader you must master the skill of accepting risk and managing loss as a part of the business.
- Your losing trades will dictate what you earn as a trader, preserve your capital and that will allow you to learn how to master winning trades.

Business objective #2: Growing your capital consistently

- As a trader your money will grow consistently when you master a technique you believe in, one you believe works.
- The only way your money will grow consistently is if you follow a proven method with **discipline**.
- To earn consistent money as a trader you must focus on technique, not the outcome of each trade.
- Consistently profitable traders have mastered exiting trades for small losses and will decisively enter another trade to earn the money back.
- Short term traders have high activity rates in order to take advantage of leverage and direct access to the markets.

Business Goals (Keystone Platinum)

- The goal of any business owner is to earn an acceptable return on capital.
- As that capital base grows and you as a business owner master the art of running your business, you will be earning a significant return on your capital on a larger and larger capital base each year. This is where wealth is created.
- The first definite goal that we have for our Equity Trading business is to find and manage three trades per day that we can build a full size position and earn at least .15 on the trade.
- For a new trader we expect that "full position" to be 1,500 shares within the first 3-6 months of learning Equity Trader 101.
- 1,500 shares for.15 profit three times per day =$675. Twenty trading days times $675 = $13,500 for the month.
- Do you think you can find three .15 trades in 6 ½ hours of trading? Of course you can. This is only the beginning. We will learn when to get much larger than that as we gain more experience and our capital base grows.
- We wanted to show you that it is not necessary to take huge risk to make a good living from the stock market.

A trader is a risk manager

- A risk manager never predicts, a good trader will focus on what the market is telling him right now.
- When sitting at your trading desk each day, your job is to develop trading scenarios and assign a probability to that scenario
- When you have more screen time, you will have more confidence in certain probabilities (trading scenarios) because you have experienced watching them play out over and over.
- When you gain this experience and confidence, you will be able to manage leverage more aggressively in relation to risk taken and the probability of the trade.

Fundamental vs. technical

- **Fundamental analysis** – is the study of financial statements, management and competitive advantage. This is done to determine if the current price is cheap or expensive to it's value.
- **Technical analysis** (chart reading) – is the study of the relationship between price patterns, price action and volume.

a. TA seeks to interpret the most recent price action to forecast the next probable outcome.

b. Technical analysis assumes that all factors affecting value are already reflected in the current price. The Equity Trader 101 trading plan is based on technical analysis.

The Equity Trader 101 business plan

- Our stock market business will seek to identify two proven scenarios and three set ups in actively traded, *liquid* stocks
- We will place trades on both the long and short side of the market.
- Disciplined use of planned exit strategies will preserve capital and secure profits. (stop loss and profit targets)
- A Keystone graduate will actively trade intra day and will also seek swing trades in which he or she can build a position for a 2-5 day holding time.
- Money management and risk management decisions will always be decided before placing a trade.

Game plan/trading plan

- The game plan will identify which stocks based on technical set ups from daily charts or news, we will be trading long or short the following day.
- The trading plan is a set of rules to enter and exit trades.
- The trading plan also includes how much capital will be at risk per trade and share size for the trade based on entry and exit criteria.

The two distinct trading opportunities we will be pursuing

- The first skill to learn is reading your stocks and the market intra day in regards to both momentum and the trend.
- As you learn to read intra day activity you will learn to master the skills of entry and exit on a short term intra day basis. These intra day momentum trades will be your bread and butter.
- Once intra day analysis and trading skills have been mastered, we will seek to use those same skills to build a longer term position we plan to hold for a period of two-five days.
- 1) intra day trades 2) swing trades.

The skills needed to implement plan.

- Mastering how to think like a professional trader
- Identifying and outlining trade scenarios using charts and chart patterns.
- Clearly understand ***all*** entry and exit scenarios.
- Mastery of volume analysis and tape reading.
- Mastery of short term "market analysis."
- Trade execution skills, routing orders for effectiveness and cost efficiency.
- Mastering entry techniques, position sizing and trade management.
- Understanding green on the screen is the first goal.

Chapter 3

Candlestick Analysis

A short term picture of supply and demand. Timing entries and exits

Goals

- To introduce candlestick charts and to understand the price action that forms the candlestick.
- To introduce specific candlestick patterns and understand how to apply them.

candlestick charts: a little history

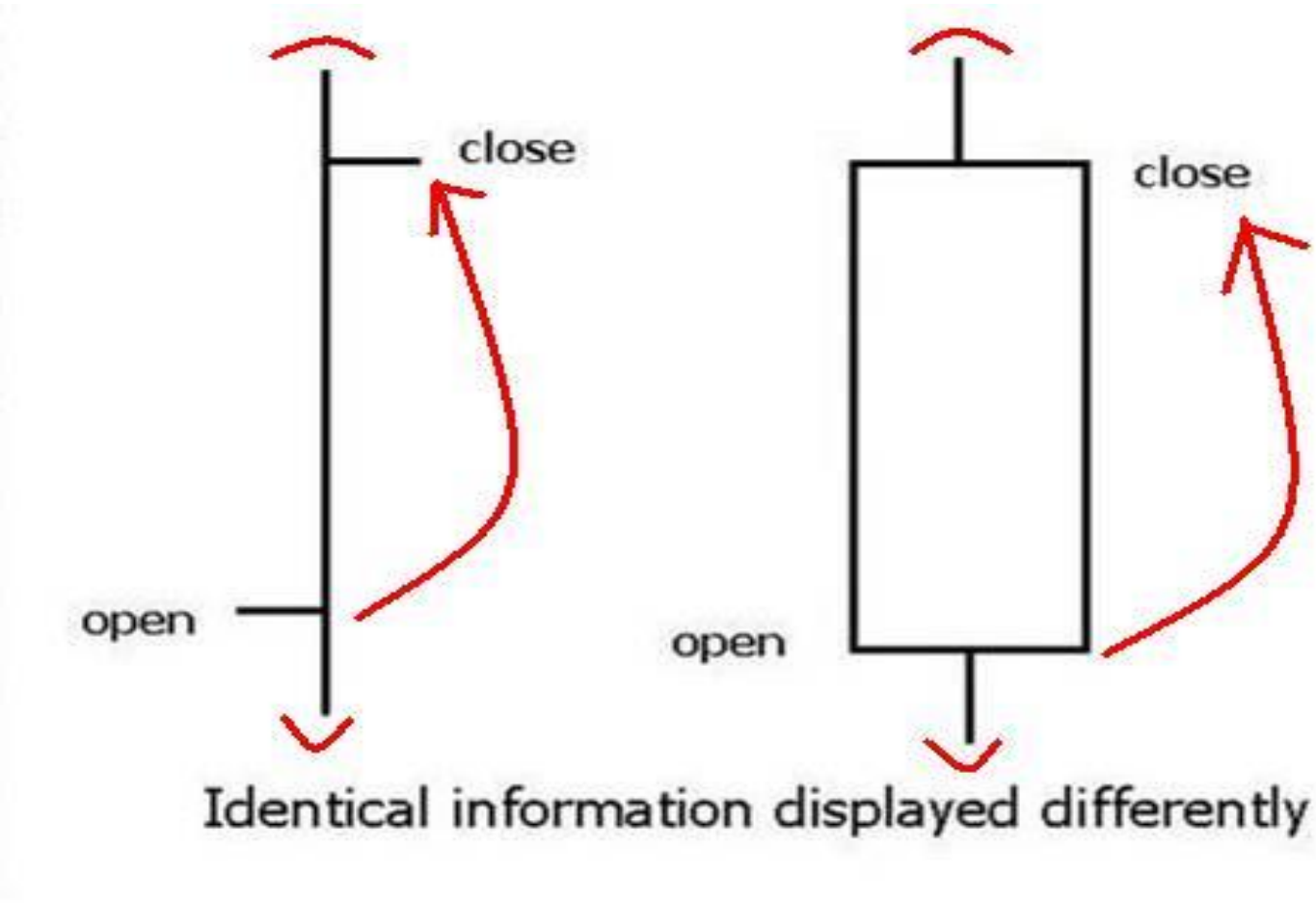
- Candlestick charts were developed in Japan in the late 1700's.
- Candlestick charts display a stocks price action using color to show us what happened.
- The trades that occur between the open, high, low and close will form a pattern.
- Candlesticks place emphasis on the most current battle between supply and demand.

the forming of the candlestick

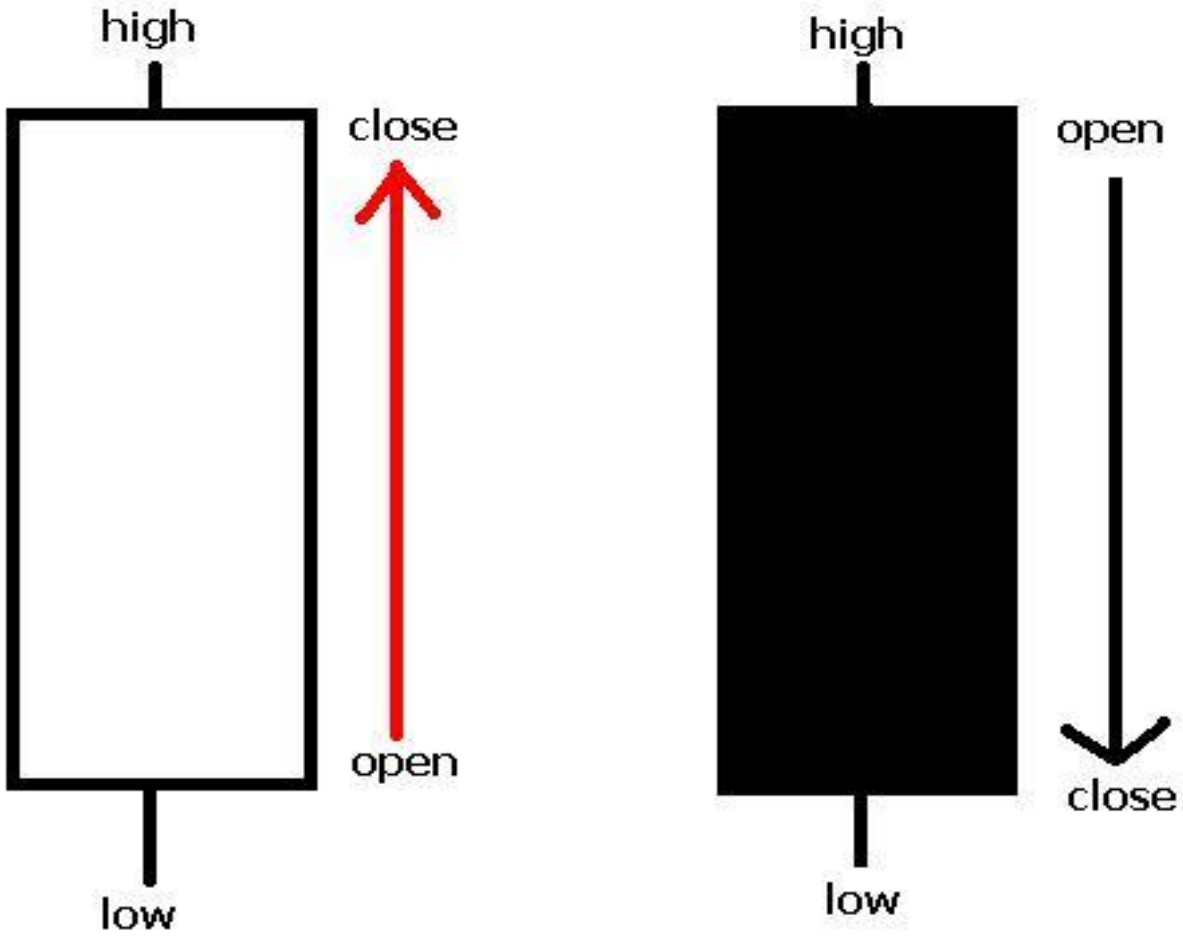
- Each candlestick has a body and a wick.
- The color of the body shows the relationship between the opening and the closing price, the color is a very important characteristic.

1. A white (green) body is formed when the closing price is ***above*** the opening price. These candles are **bullish**, showing us the buyers won the battle.
2. A black (red) body is formed when the closing price is ***below*** the opening price. These candles are **bearish**, the sellers won the battle.
3. The wick is the part of the candle above and below the **body**. The wick shows us the high and low of a candle.

bar chart vs. candlestick



Viewing the supply/demand battle



Candlestick Patterns

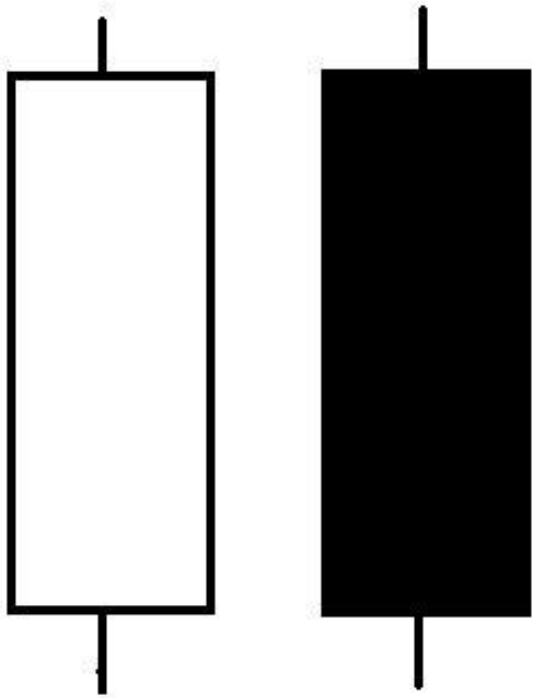
- Candlestick charts will provide us with the following patterns:

1. The start of a move
2. End of a move
3. Momentum slowing down

- * Remember these patterns should be only viewed in the context of the bigger picture

Energy candlesticks

- Bullish energy candlesticks have **large bodies**, open near their low and close near their high.
- Bearish energy candlesticks have **large bodies**, open near their high and close near their low.
- Typically this price action represents a high energy move.
- *Where* it occurs in price action will tell you if it is **stored up energy or exhaustive energy**.



Fuel: the start of a new trend

- Fuel is an energy candlestick that starts a new trend
- Fuel is a large body candlestick emerging from a consolidation.
- Fuel must be accompanied by significant volume compared to previous candlesticks.



Exhaustion: the end of a momentum move

- Exhaustion is an energy candlestick that displays to us the end of a move.
- It is easily identified by a large body candle that has quickly moved a significant distance from its 20sma.
- The large body candle must be accompanied by significant volume.
- This volume spike displays the end of the buying or selling pressure that created the move.



"**melted candle**": reversal of momentum



- Melted candles represent a potential reversal of momentum
- Melted candles are recognized by a small body, the color of the body is not important.
- Look for melted candles to slow price action after at least two consecutive higher highs or lower lows.
- The closer you get to six consecutive higher highs or lower lows the more likely a reversal will occur after a melted candle.

Melted candles in action



U-Turn candlesticks

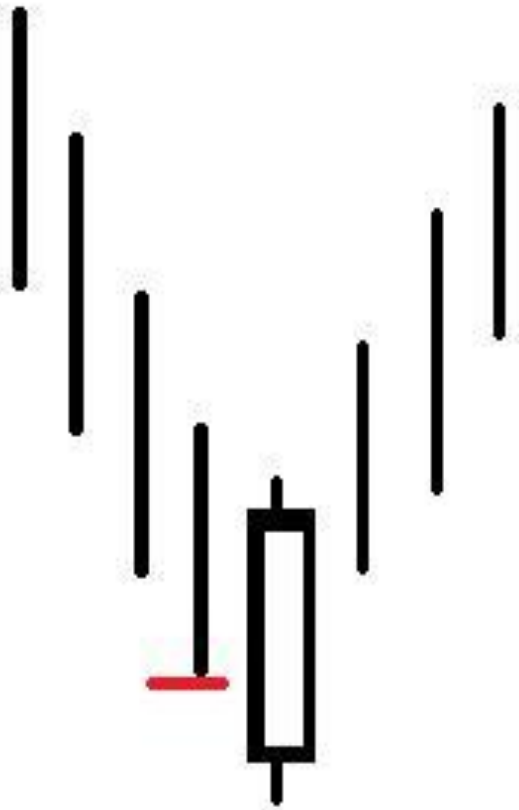
- Similar to melted candles, U-Turn candlesticks display a potential change of short term momentum.
- Much like a melted candle, look for the U-Turn after:

1. two or more consecutive higher highs or lower lows.

- The more consecutive candles involved, the more potent the reversal will be.
- U-Turns are a very effective entry and exit pattern because they trap many participants on the wrong side, this is why we named it U-Turn.

Bullish U-Turn

- A Bullish U-Turn will occur after two or more successive lower lows.
- The current candle must trade below the prior candlestick low, the further below the better.
- The current candle must now reverse and close above the open and above the prior candles low.

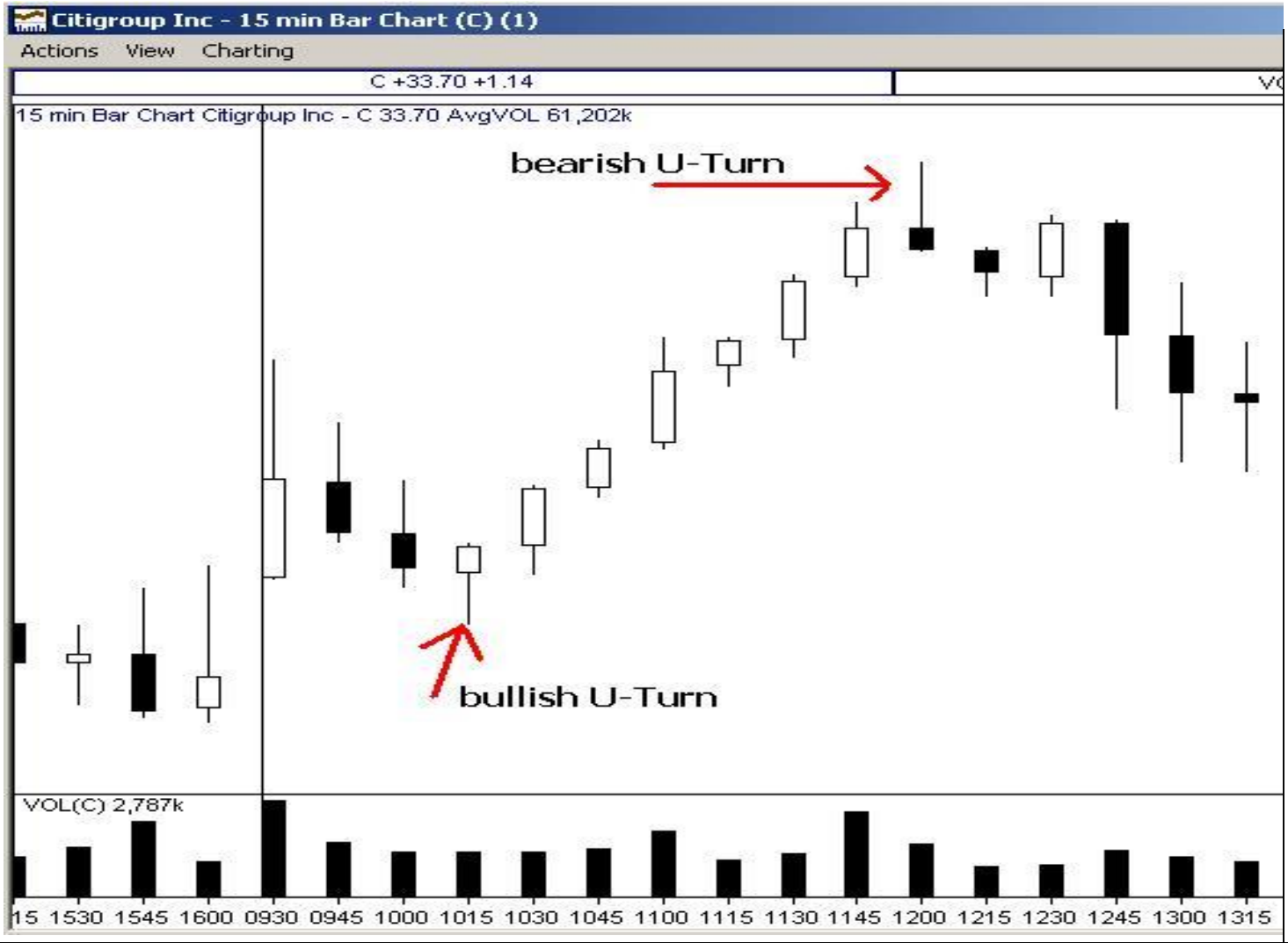


Bearish U-Turn

- A Bearish U-Turn will occur after two or more successive higher highs.
- The current candle must trade above the prior candlestick high, the further above the better.
- The current candle must now reverse and close below the open and below the prior candles high.



U-turn in action



Trading with melted candles and U-Turns

- Candlestick reversal patterns set up a potential change of momentum. **Always wait** for price to confirm the reversal in the new direction before you initiate a new trade or before you exit a profitable trade. ** essential to success using candlestick reversal patterns!!
- Will be monitored on all of our standard charts daily, 15 minute and 5 minute.
- Will be used to enter a new trade (after a pause) or to tighten up a trailing stop on a profitable trade (after a momentum move).

Chapter 4

Price Action

Paying attention. Giving structure to price action so you can anticipate what is likely to happen next.

Goals

- To learn the basic structure of price action so that price movement will never be random.
- To understand how the basic price structure is created by market participants.
- To begin forming trading scenarios based on recognition of the basic price action structure.

Charts and Technical Analysis

- Charting monitors price action, that price action creates patterns and those patterns create trading scenarios.
- Our goal is to study and memorize repeating chart patterns and volume so that when the pattern presents itself again, we can take advantage of a high percentage trade scenario.
- You absolutely must have a structure for price action or ALL movement will be random and confusing!
- Price action MUST look very specific before you take action and risk capital!

Accumulation

- Accumulation: Where institutions and hedge funds are buying shares as quietly as possible, as price moves lower in a down trend.
- This will be buying ending a down trend leading to a consolidation or a pull back. They are beginning to accumulate a position.
- Most traders who are objectively watching this stock are selling, and with good reason it is going down.
- Since the stock is going down it will be easy for the funds to begin accumulating the position quietly. Sellers are abundant as price moves lower.

Accumulation in action

- When a institution has a large order to fill, they will try to do it as quietly as possible.
- The reason for wanting to do it quietly is simple, if they tip their hand on the size of the order they will push the price up on themselves.
- They will passively buy as many shares as they can until the selling dries up. If they need more, they will need to pay higher prices.

a. Can be seen on a chart as a PAUSE in the trend (**consolidation** or a **pull back** with heavier than normal volume after a downtrend.)

buying urgency

- The Markup: The large buyer in need of more shares, must start to pay higher prices to fill the order.
- The PAUSE that was formed by the large buyer has caused many traders who were selling to stop, the stock is no longer going down.
- We now have two groups of traders who need to buy stock. Traders who sold the stock short short (and are now wrong) and the larger buyer who needs more stock.
- The only logical thing that can happen now is that prices will rise.

The Markup=an uptrend

1. Demand eventually overtakes supply and the price action begins to break out of the PAUSE with larger volume traded in the direction of the break out.
2. The markup starts with larger green body "energy" candles, accompanied by significant volume.
3. An urgency to acquire shares has arrived.

- This Markup is what we all know as an uptrend.
- A markup with good order flow will be identified with higher highs and higher lows with light volume pauses in between.

Distribution: end of an uptrend

- When the large buyer has filled the majority of the order, the markup will typically end with an obvious increase in volume.
- For this to be distribution and the end of the markup, there will be a heavy volume pause or a heavy volume very fast move.
- The large buyer is selling the end of the order while prices are still in an uptrend.

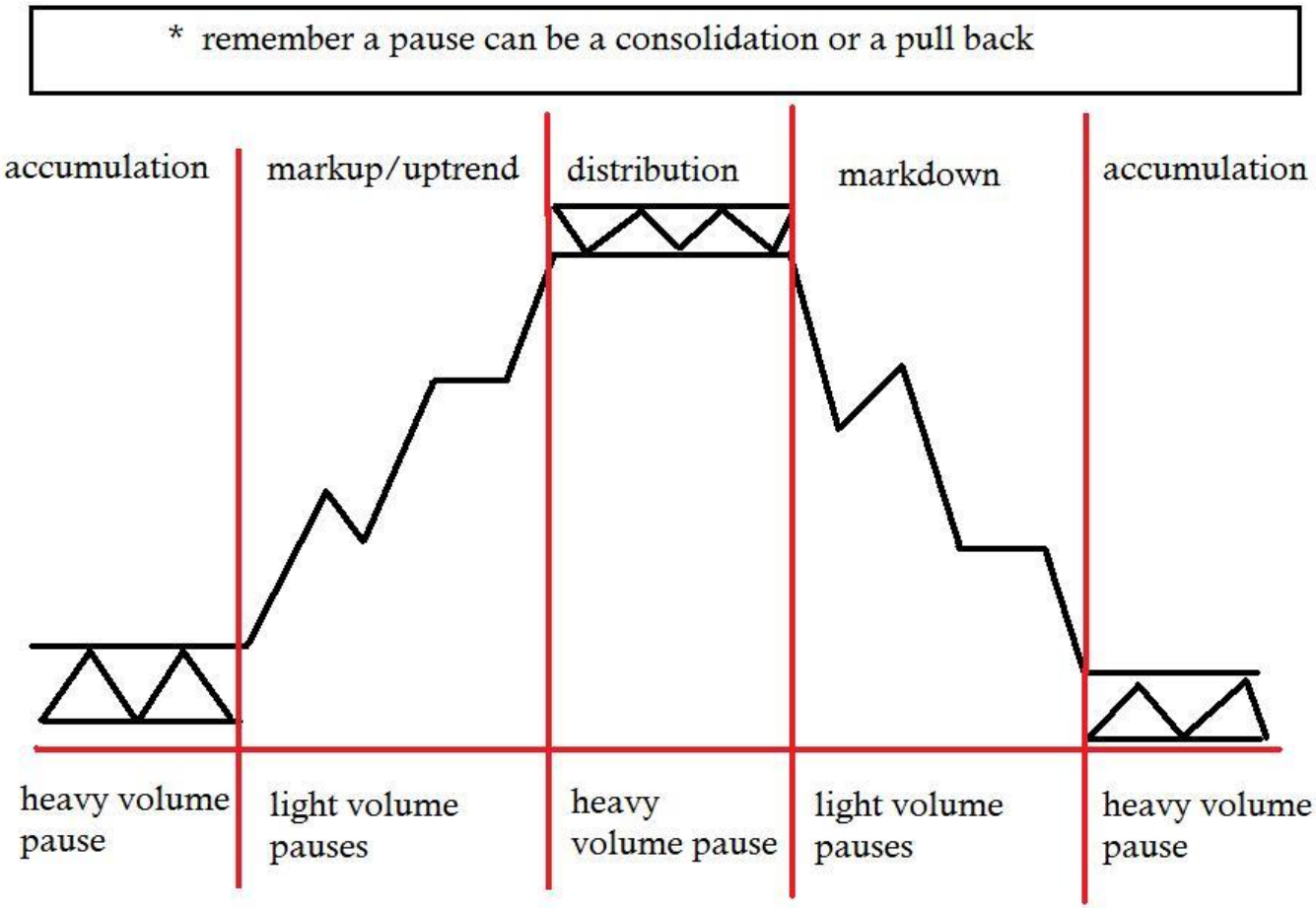
1. After the markup, many shares are trading **after** significant price movement upward price movement.
2. Can be seen on a chart as a pause (consolidation or pullback) with heavier than normal volume after an uptrend. Or a huge spike in volatility with heavy volume **after** a fast move up.

The Markdown: selling urgency, the downtrend

- At this phase institutional buying has slowed and the stock no longer has the demand to support the high prices.
- Traders sensing that the demand has exhausted itself, will now begin to test the short side by selling stock.
- Traders that bought stock late into the markup are now long and wrong. These late entrants must now sell to exit their positions, creating selling urgency.
- When previous support levels are broken, these two selling forces will add fuel to the downside.

1. The Markdown starts with “energy” red candles leading to a down trending stock with light volume pauses between lower lows and lower highs

Picture perfect price action



Price action phase: 5 days



Price action structure

- The markup and markdown are what traders know as a trend. The trend will consist of momentum and light volume pauses.
- As a trader you will assume the trend will continue until you recognize a pause or parabolic price action with heavier than normal volume.
- This heavy volume price action will be the first clue to a potential change of trend.

Price action phase: trend or pause

- Your first consideration should be are we trending or pausing.
- If a trend is present, you will be patiently waiting for a pause in price action to get involved.
- That pause will be a consolidation or a pullback.
- Volume during the pause will give you clues to the move after the pause.
- Light volume during the pause equals trend continuation, heavy volume during a pause or after a fast move signals a trend reversal is coming soon.

The Basic Move: giving structure to momentum or a pause during a Markup or Markdown.

- The Basic Move is a two-six candlestick move with consecutive lower lows and lower highs, or consecutive higher highs and higher lows.
- There are two types of Basic Moves:

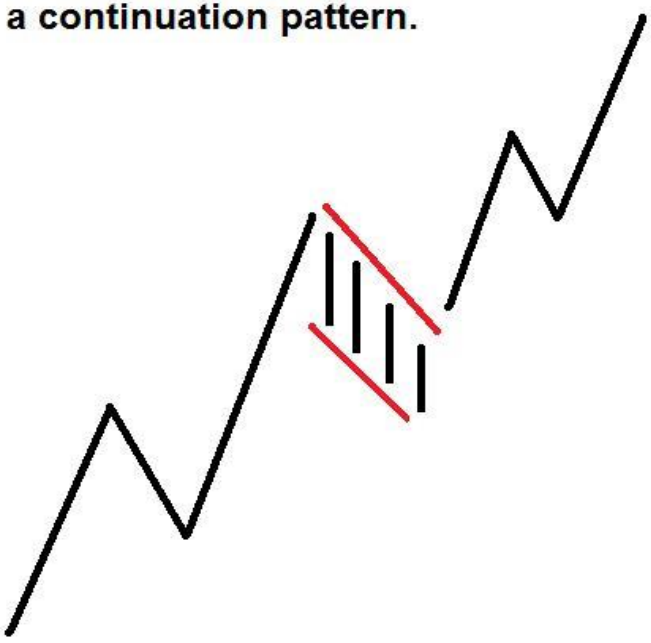
1. Against the trend
2. With the trend

Basic Move *against* the trend

- A Basic Move against the trend is called a **Flag Pattern**
- Flag Patterns represent a **pause** in the trend a pullback from the most recent high or low.
- For a flag to indicate order flow for the trend is still valid, volume should be light.
- Bull flag: occurs in an uptrend (markup) and typically retraces 2-6 candlesticks (LH/LL)
- Bear flag: occurs in a downtrend (markdown) and typically retraces 2-6 candlesticks (HL/HH)

Bull Flag / Bear Flag: Basic Move against the trend

A Bull Flag is a mini consolidation tilted down in an uptrend. Represents a pause in the trend, viewed as a continuation pattern.





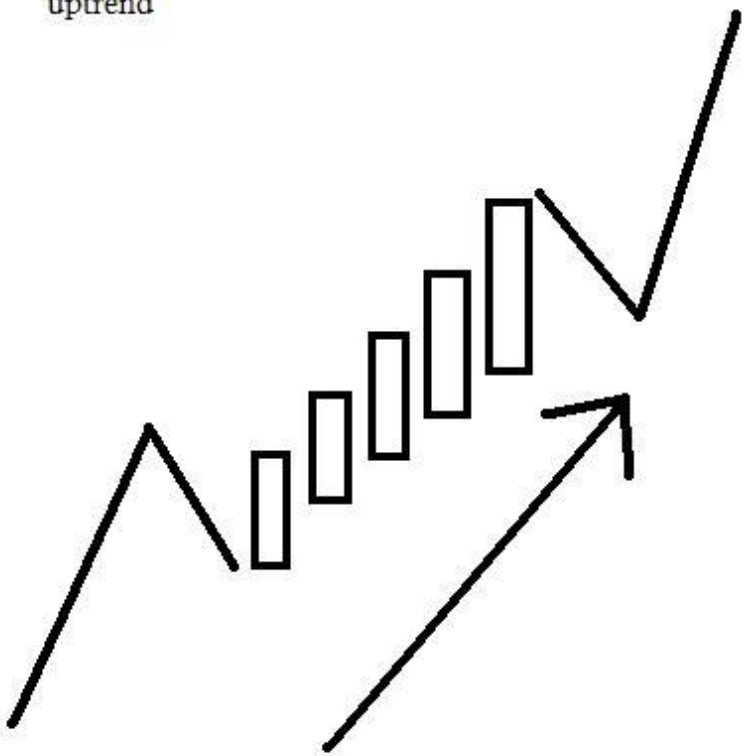
A Bear Flag is a mini consolidation tilted up in a downtrend. Represents a pause in the trend, viewed as a coninuation pattern.

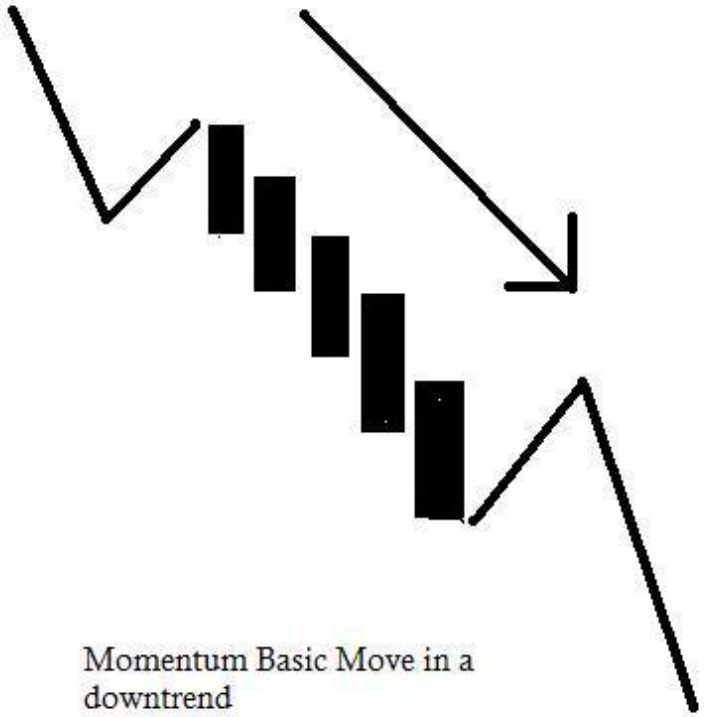
Basic Move *with* the Trend

- The Basic Move in the direction of the current trend is called the **momentum**
- Momentum is typically a faster move than a Flag and should travel further in price action. For good reason. It is moving WITH the order flow!
- Momentum moves should at the very least lead to a test of a previous high or low. (price action structure)
- Momentum Moves lasting more than six candles will typically end with an obvious increase volume.

Momentum Basic Moves

Momentum Basic Move in an uptrend





Momentum Basic Move in a downtrend

Swing points: defining short term highs and lows

- Our goal here is to identify the end of a Basic Move (flag or momentum on any time frame)
- **Short term low:** any time there is a low made with higher lows on both sides.

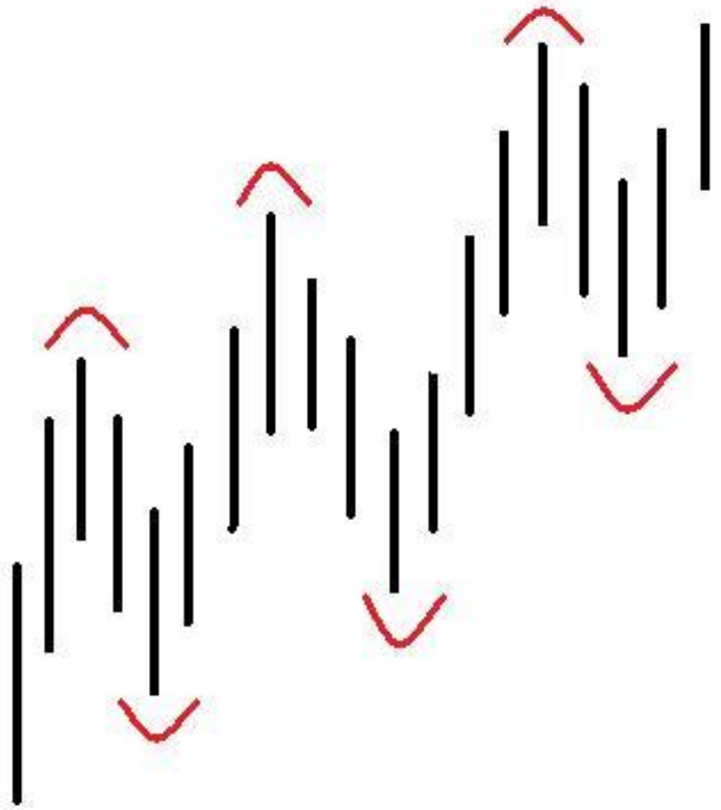
a. The Basic Move failed to make a new low **after** the low, creating the short term ***swing low***. (failed test)

- **Short term high:** any time there is a high made, with lower highs on both sides.

a. The Basic Move failed to make a new high **after** the high, creating the short term ***swing high***. (failed test)

Swing points:
Identifies the end of a Basic Move.

- The reason we want to identify swing points is to avoid guessing the end of a Basic Move.
- Using swing points (and candlesticks), the price action itself will tell us when the flag or momentum has ended.
- The higher the time frame, the more significant the swing point. (change in short term momentum)



price movement between swing points identifies the current Basic Move



Price Action analysis made simple

- Markup (uptrend) and markdown (downtrend) are made up of basic moves and consolidations
- There are two Basic Moves: flag or momentum. Basic moves typically start and end with swing points
- There are three types of consolidations:

1. accumulation
2. distribution
3. continuation pause (light volume).

- Consolidations end with a volume breakout.
- Volume in a flag or consolidation will give clues to the next move.

Our first two trading setups

- High probability trades occur when there is an obvious trend (scenario).
- Our objective is to wait for a pause in the trend. This pause represents our first two trading setups:

1. The flag: ends with a swing point, melted candle or U-turn
2. The consolidation breakout: ends with a "energy candle" (large candlestick increased volume)
3. When a TREND is obvious on your main trading time frame, develop a scenario for one of these two PAUSE setups to initiate a trade.

Price action and profitable trading

- **Profitable** traders make the majority of their living taking advantage of obvious order flow (trend). If order flow is not obvious to find they don't commit capital.
- **Unprofitable** traders trade any movement/price action, they aren't patient to wait for obvious price action.
- **Unprofitable** traders frequently do not wait for a pause in price action to initiate a trade which increases risk.

Chapter 5

Support and Resistance

Identifying where supply and demand have taken control.

Trading the TEST setup.

Goals

- To define support and resistance.
- To identify key support and resistance levels for trading.
- To understand how to trade support and resistance.

Support/Resistance

- Support and resistance are key price levels where buyers and sellers take a stand.
- When a support or resistance level is broken, it signals a change in order flow.
- Identification of key support and resistance levels is a necessary skill to be a successful technical trader.
- Support and resistance levels are not an exact science, but understanding their significance to the mass of traders will aid you in managing trades and developing scenarios.

support

- Support represents areas of demand where buying occurred and can be expected again.
- Support is a price level where demand is stronger than supply. This can be viewed on a chart as a previous price level where buying prevented prices from declining.
- As price declines towards a previous support level, buyers will tend to buy again and sellers will be inclined to sell less.

resistance

- Resistance represents areas of supply where selling occurred and can be expected again.
- Resistance is a price level where supply is stronger than demand. This can be viewed on a chart as a previous price level where selling prevented prices from advancing.
- As price rises towards a previous resistance level, sellers will tend to sell again and buyers will be inclined to buy less.

Thought process behind support and resistance

- Support and resistance is the tendency for prices not to exceed previous prices levels.
- They are easy to see on charts and therefore are psychologically significant to many traders.
- This belief in support and resistance causes it to become a self fulfilling phenomenon.
- Generally speaking the higher the time frame you are identifying a support or resistance level, the greater number of participants who will have given it significance. (daily vs. 5 minute)

Significant support and resistance levels to monitor

- Opening price range: high and low of the first 15 minutes-half hour of trading
- Today's high and low. Intra day levels.
- The previous days highs and low.
- The previous high or low for the last twenty trading days. This is an area for many trend following breakout trading systems.

Intra day support and resistance



Yesterdays high and low

- For short term trading, the previous day's high and low are major areas of support and resistance.
- These were definitive points where buyers and sellers took a stand the day before.
- Represents yesterdays orders flow. If price trades through this point it tells us there is new order flow in that stock today.
- Your stock will either test and reverse off these points or break through and start a new trend.
- **The highest percentage trades are the first pause after yesterdays high or low is broken!

Trading support and resistance

- How to execute **BREAKOUT TRADES**
- **IF** order flow on your traded trend is clearly defined (rising 20SMA and last price is > yesterdays high or declining 20SMA and last price is < yesterdays low)
- **THEN**: enter on breakout or breakdown looking for FUEL
- **IF** price action on your traded trend is trendless, then order flow is weak
- **THEN**: enter a breakout or breakdown AFTER the first pause

Initiating TEST trades at these levels

- How and when to **trade a TEST**
- order flow is weak and 20SMA is trendless
- Last price is inside yesterdays trading range

- THEN: BUY a test of support or SELL SHORT a test of resistance
- **Considerations:**
- Never “test a trend.” In other words never sell short a resistance level in an established uptrend and never buy a support level in an established downtrend.
- Double tops and double bottoms in a trend should be a sign that order flow may be changing in the trend. It is a very low probability scenario to initiate a new trade against obvious order flow.

Exiting a profitable trade at these levels

- Booking profits at support or resistance is a different mindset than opening a new trade.
- Exiting a profitable trade as it approaches a previous support or resistance level should be done **before** it reaches the level. This is opposite of entering a new position.
- A scaled exit into this area is the best approach. If price makes a successful test and continues, you can always add to the position again.

Exiting an unprofitable trade at support or resistance (your stop loss point)

- Your stop loss will be a test of a previous support or resistance level that you expect to not be penetrated.
- If it is broken, you must exit quickly and decisively and move to the next trade. *Decisive action is especially important when trading a TEST, price can move quickly against you if a break out is real.
- To properly place your stop loss, it must be "just beyond" the exact number of the high or low. Therefore, price must be penetrated in order to exit a losing trade it must not merely test the area.

Two day support and resistance levels



The inside day



- The Inside Day is basically a day that forms a one day consolidation.
- As we already have learned, one of our trading scenarios is a breakout from a consolidation.
- An inside day sets up a trade where you will trade the breakout of the inside days high or low.
- You will expect a trend type day to unfold and you will expect to see short pauses in the trend.
- You will add to the position as the pauses occur.

Our 3rd trade setup: the Test

- Should only be initiated when order flow is weak (trendless)
- Trading a test means buying at or above support or selling short at or below resistance.
- Trading a test allows you to use more leverage because your risk point is very well defined.
- When a test is made with lighter volume than the previous high or low, the odds of the support or resistance holding increases.

Chapter 6

Trend Analysis: order flow

Identifying our traded trend

Recognizing intra day order flow

Goals

- To easily identify if you should be buying, selling short or doing nothing.
- To quickly identify trend strength
- To identify Basic Moves (flags and momentum) in relation to the trend
- To introduce moving averages
- To identify a potential change of trend
- To identify when a trend has changed so we can adjust our trading bias.

Trend analysis: simple but very important

- During the second half of 2000, most analysts were calling a downtrend that lasted for over 2 years a healthy pullback.
- There are two consistent reasons many traders, especially short term traders lose money.

1. They have not clearly defined the trend they are trading, *before* they enter a trade, creating many low percentage trade scenarios
2. Trying to guess where it will end, in other words picking tops and bottoms.

- *** When you remove the ego based desire to pick tops and bottoms from your trading, you will immediately become a better trader!

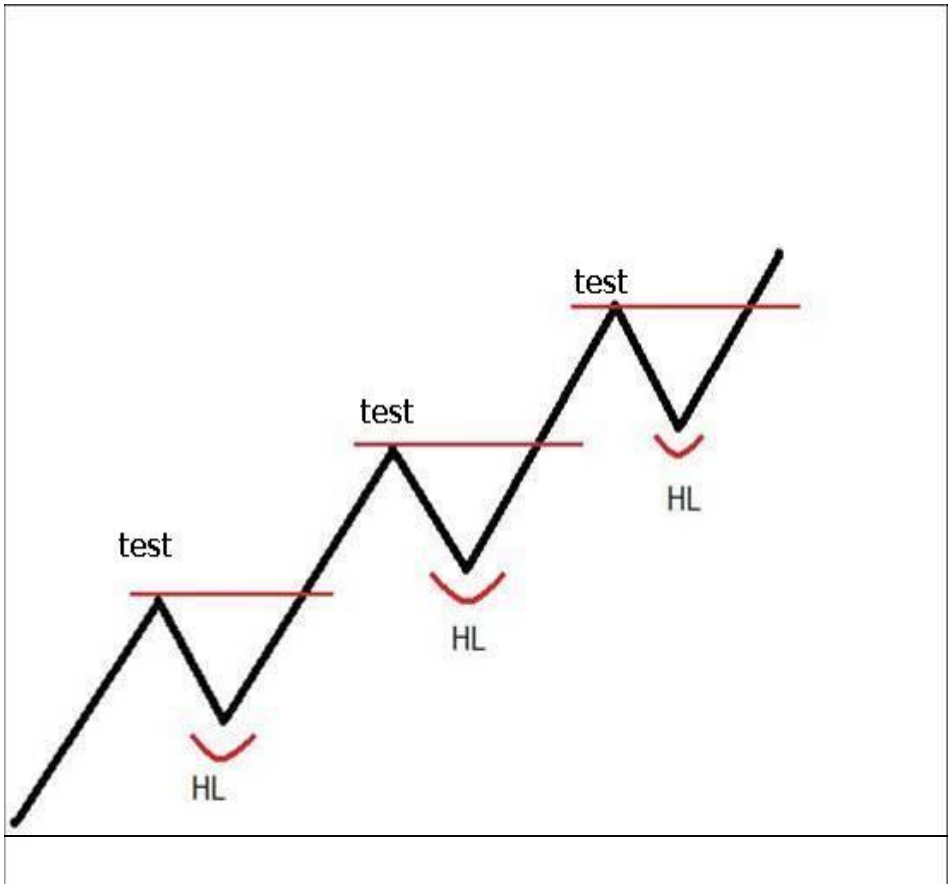
Identifying the trend/order flow

- The reason identifying a trend is so important is **we do not want to predict.** We want an obvious answer to the question of "what is the order flow *right now*?"
- If the answer is clear, we want to be on the same side of the dominant force of buying or selling at that moment. If the answer is not clear, we can trade a TEST.
- Understanding how to identify a trend and the intra day order flow is only part of the equation, we need to know which trend we are using to identify OUR trend.
- *****For our intra day trading it is the trend on the 15 minute chart. We will identify the intra day order flow from the trend on the 15 minute chart.

The trend is the order flow. The trend is the “idea.”

- A simple but effective visual image to use while you are in a trade is to think of the trend as the IDEA behind order flow.
- As long as the trend is obvious and there are no clues of accumulation or distribution volume, you should remain confident in the order flow you are trading.
- This will allow you to hold good trades longer and not be shaken out of a good idea because of minor price fluctuations.
- You should always be asking yourself “is the idea” (order flow) still good?” If you don’t see anything that would lead you to believe the idea or order flow has changed, stick with the trade, continue to trade that side

Trend Analysis: identifying order flow through price action

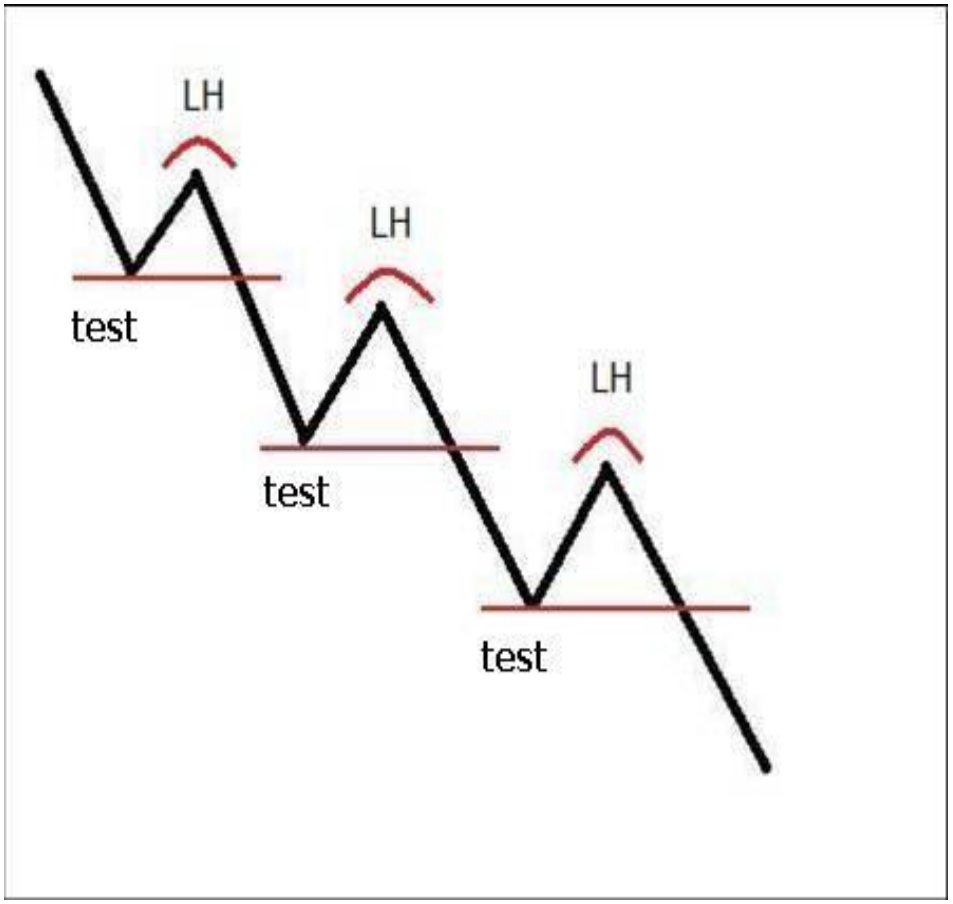


- The order flow is clearly up once the first higher low (HL) leads to a successful test and a higher high.
- High probability trades are to the long side.
- This is obviously the markup phase of price action and should be traded long aggressively.

Uptrend intra day



Trend Analysis / identifying order flow through price action

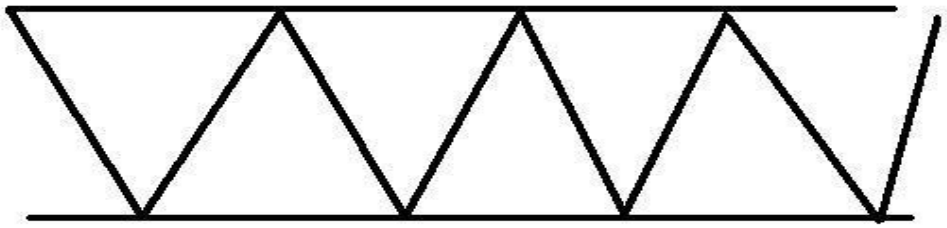


- The order flow is clearly down once the first lower high (LH) leads to a successful test and a lower low
- High probability trades are to the short side.
- This is obviously the markdown phase of price action and should be traded short aggressively.

Intra day down trend



price consolidation/pause



- If there is no obvious trend you should be waiting for a breakout or breakdown or trading a TEST.
- If this occurs after a mark up or mark down, pay attention to volume.

a. Heavy volume would lead you to anticipate accumulation or distribution.

b. Light volume would lead you to expect a continuation pause of the trend.

moving averages

- Used by technical traders to monitor trends.
- We will be using the same moving averages on all our charts, the 20 period Simple Moving Average.
- A moving average is an average of successive closes over a specified time period
- It is constantly updated by dropping the oldest number and adding the most recent number to get a new average. Hence the term “moving average”
- So a 20SMA (20 period simple moving average) is the average of the last 20 closes.

using moving averages properly

- Smooth's out market “noise,” this allows us to pay attention to the trend once in a position and not every price fluctuation.
- Displays direction and strength of the trend
- Presents *anticipated* support and resistance levels, an area to “look for” melted candles, U-Turns and swing points.
- Gives us a reference point to identify a change of order flow.

Trend direction and trend strength

- When price is trading above a rising 20sma, we have an *uptrend*. When the slope of the rising 20sma is exaggerated, we have a *strong uptrend*.
- When price is trading below a declining 20sma, we have a *downtrend*. When the slope of the declining 20sma is exaggerated, we have a *strong downtrend*.
- This method of quickly spotting where price is relative to the 20sma is easier to use than finding the perfect higher high or lower low

Trading with the trend: identifying order flow

- * the trend or lack of trend, on the 15 minute chart should be your first consideration.
- Is the 20 SMA rising, declining or flat?
- If it is rising or declining there is order flow in that direction, you will look for a pause to enter a trade in that direction. You will look for the pause and time the entry on the five minute chart.
- If it is flat, you are in a pause on a higher time frame, look at the volume (heavy or light?), trend and momentum on the five day and daily charts to see where you are in the price action phase.

Knowing what “should happen”

- In order to develop consistently profitable trading scenarios it is imperative you always consider what “should happen next”
- If your stock makes a new high it “should” retest that high on the next pause. You should continue to develop scenarios *only* in that direction until it what “should happen” does not.
- In other words if a failed test unfolds you should anticipate a change in order flow. What should have happened did not.
- If price is pausing, it “should” remain in a range until you see FUEL. Develop a test scenario trade.

5 day 15 minute chart: trend or pause/support and resistance levels



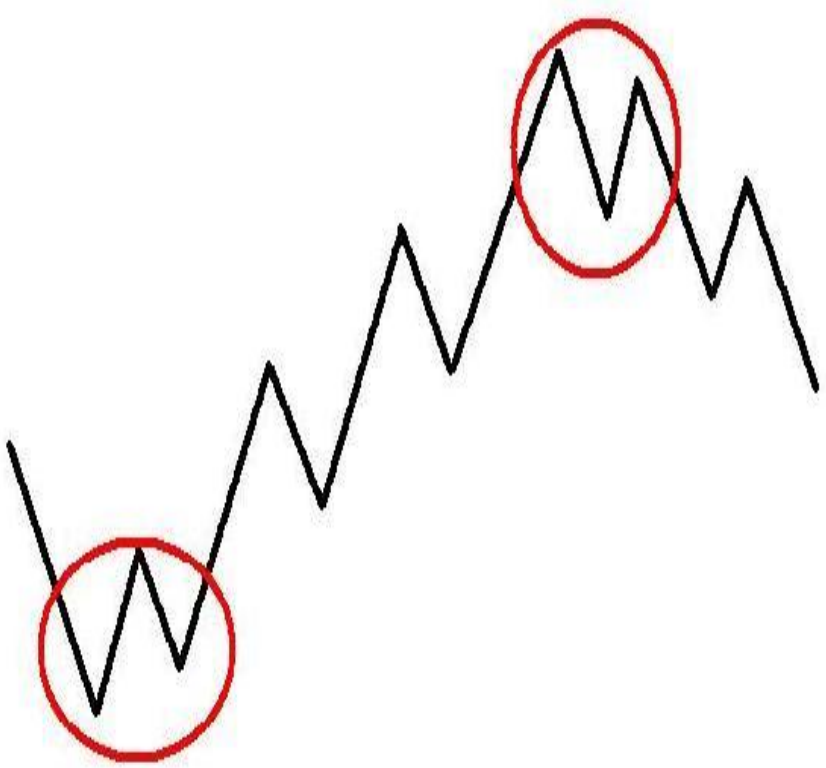
15 minute chart: intra day order flow, momentum, open range breakout



Criteria for an intra day trade to the long side

- Price should be trading above the 20sma on the 15 minute chart
- The 20sma on the 15 minute chart should be rising indicating obvious order flow.
- Enter a long position on the first pause on the 5 minute chart
- Remain long until a swing high, melted candle or U-turn forms on the five minute chart.
- Continue to look for long entries until a swing high, melted candle or U-turn forms on the 15 minute chart.

Spotting a potential change of trend: failed test

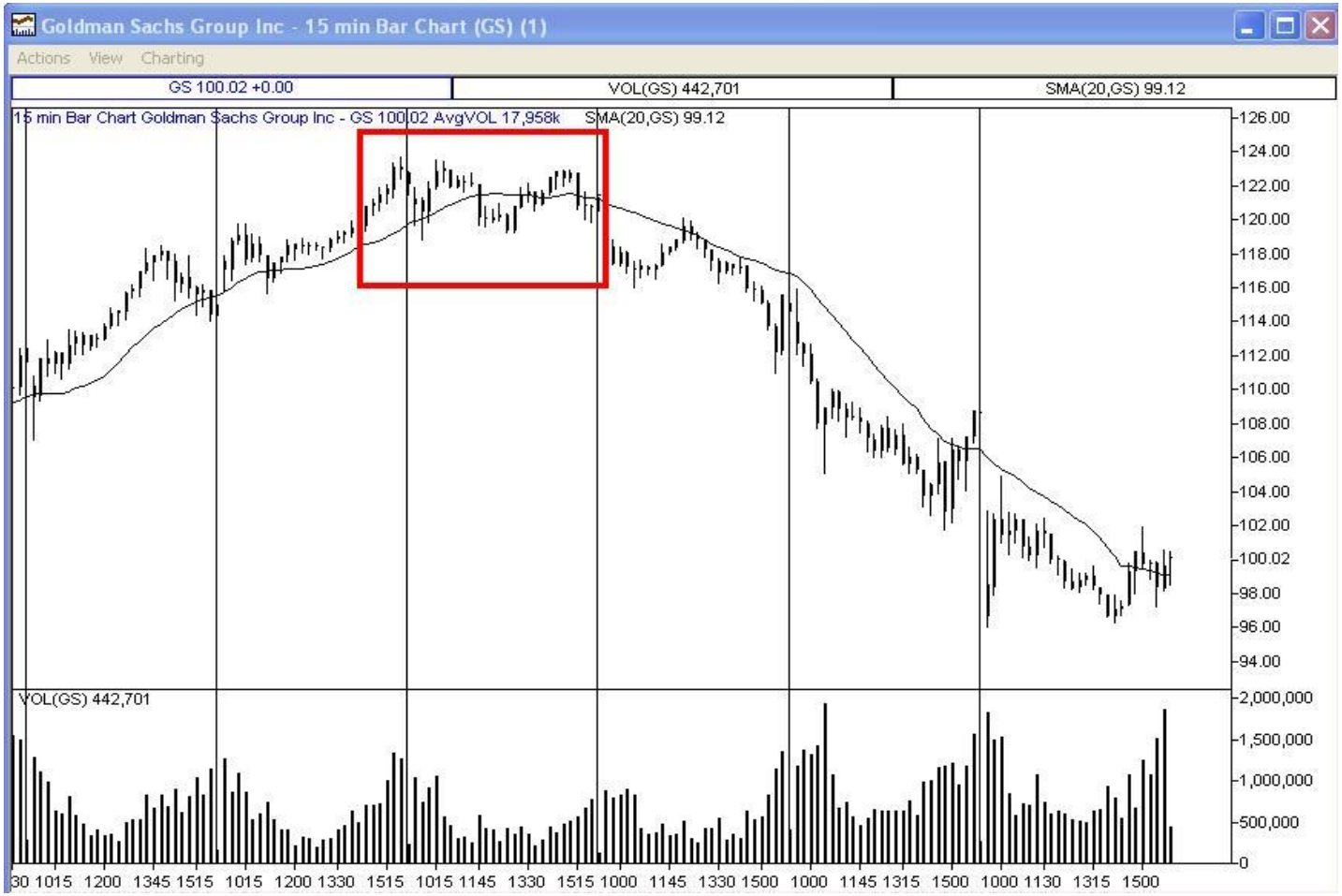


- When price action forms a "W" pattern this is a failed test of a low, it can also be spotted as a two consecutive swing lows after a downtrend, the second swing low higher than the previous one.
- When price action forms a "M" pattern, a failed test of the high, this is a potential change of the uptrend.
- A failed test represents a potential change of order flow, a potential change of trend.

“W” bottom: failed test of the previous low



“M” top: failed test of the previous high



Combining momentum and order flow

- The purpose for using moving averages is to identify order flow very quickly.
- We will monitor one step further and combine momentum and the trend.

1. **Momentum:** Swing points, U-turns and melted candles will show us the start of momentum.
2. **Trend:** The direction of the 20sma, on any time frame will show us the current order flow.
3. ***The trades you can expect follow through occur when you initiate momentum trades in the direction of the trend. This is the "best case" scenario.*

Trend reversals

- A potential trend reversal can be signaled by an “M” top or a “W” bottom. Remember these are only potential reversal signals.
- An actual change of an uptrend is when:

a. Price that was previously above the 20sma trades below the 20sma and forms a swing high or bearish U-turn below the 20sma, indicating bearish momentum below the 20sma.

- An actual change of a downtrend is when:

a. Price that was previously below the 20sma trades above the 20sma and forms a swing low or bullish U-turn above the 20sma, indicating bullish momentum above the 20sma.

Trend Reversals





Playbook for: trends and trend reversals

- When price is trading above a rising 20sma on the 15 minute chart you should only trade from the long side.
- When price is trading below a declining 20sma on the 15 minute chart you should only trade from the short side.
- When the daily 20sma is in the same price action phase as the 15 minute trend, use more leverage.
- The steeper the slope of the 20sma, the stronger the trend.
- Price action between swing points, U-turns and melted candles is the current flag or momentum.
- An “M” or “W” pattern in price action displays a potential change of trend.
- An uptrend reverses when a swing high, U-turn or melted candle forms below the 20sma. A downtrend reverses when a swing low, U-turn or melted candle forms above the 20sma.

Chapter 7

Multiple Time Frame Analysis

The key to managing risk, assessing probabilities and assigning leverage to a trade idea.

Goals

- To gain a clear perspective of longer term trends and how they set up trade entries.
- To understand market conditions that will dictate when probabilities are in our favor so we can increase leverage.
- To understand how shorter time frames interact with larger time frames to help us manage risk and time entries.

Multiple Time Frame Analysis

- Our job as traders is to identify scenarios that have a high probability, not one that will definitely work, **probably**. There is no guaranteed trade.
- Institutions will make investments that will move a stock in a direction for days, weeks and months.
- Our job as traders is to:

1. identify these bigger commitments (obvious order flow)
2. enter trades in that direction using short term patterns to manage risk.

- When multiple time frames are on the same side of a trend (order flow) you can expect follow through and a move of significant magnitude.

Dow Theory: MTFA origins

- The assumption made is that there are three movements for a stock or the market, all of which are in progress at the same time:

a. The Primary Trend: is the longer term trend, defined as the broad upward and downward movements known as bull or bear markets.

b. The Intermediate Trend: An important rally or decline in a primary trend. (this will be our main focus for a trend/order flow)

c. The short term trend: Fluctuations of price action. The traders use of this trend is to maximize profits and minimize losses by timing buys and sells within this movement.

MTFA=Top down analysis

- **All trade analysis starts from the longer term and moves down to the shorter.
- Weekly, daily, hourly and 15 minute.
- Long term trends are the dominant order flow, it takes significant money to move a stock for days, weeks and months.
- Long term trends are made up of short term momentum, flags and consolidations.
- Our job is to find a short term pause in a long term trend and climb aboard.

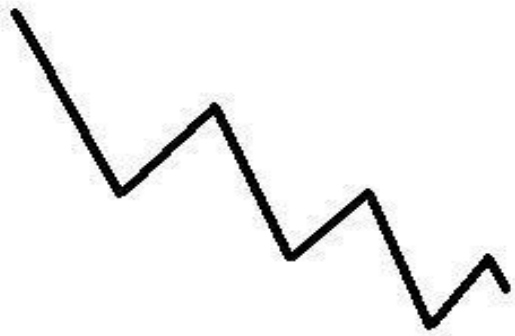
MTFA and trade scenarios

- All trade scenario analysis starts from the higher time frames. That is where the dominant order flow is.
- There is no reason to look at the shorter time frames until you have determined there is an obvious order flow on your main time frame.
- This cannot be emphasized strongly enough, if the order flow on your main time frame is hard to read or not obvious, there is absolutely no reason to look for entry signals!

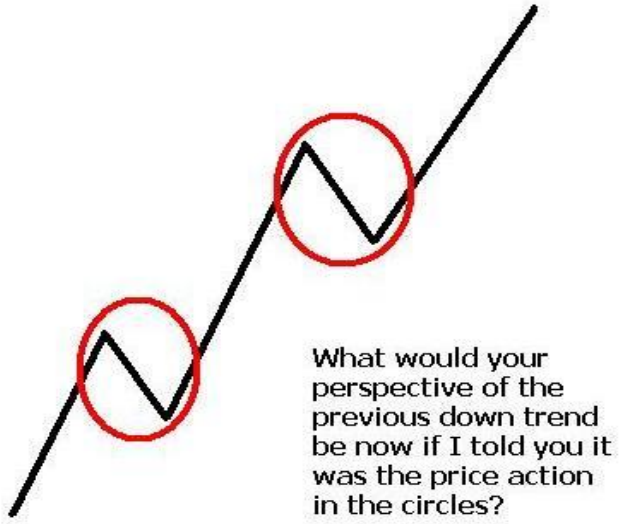
Short term trading

- In our business the **primary trend** (longer term trend), is the 20SMA on the daily chart.
- Our "traded trend" or the intermediate term trend, is the 20SMA on the 15 minute chart.
- Our "timing chart" will be the five minute chart
- There will be times when our traded trend (15 minute) **will be** moving in the same direction as the primary trend (daily), this is when you will use more leverage, the probabilities are on your side.
- There will be times when our traded trend will **not be** moving in the same direction as the primary trend, that is OK, we will enter the trade but will use less leverage.

MTFA: how to use multiple charts of the same stock



up trend or down trend?



- This simple picture illustrates the power of multiple time frame analysis.
- The image should be burned into your memory!

Daily, 5 day, intra day momentum, timing

(notice no 20sma on the 5 minute chart, it is not a trend identifier!)



MTFA recap

- When multiple time frames are in sync in regard to order flow the probability of a trade making money and following through in its intended direction increase significantly.
- When price action phase is similar in multiple time frames you must use more leverage.
- You will use the higher time frames as a trend filter for direction, then the lower time frame to time exits and entries.
- Entries on the shorter time frames will be a pause; a consolidation or a flag. Entry signals are swing points, U-turns, melted candles and fuel.

Chapter 8

Trading Setups

The Big 3

Training your eye

- As we introduced in Chapter 4; the Price Action Phase gives structure to volatility so that price movement will never be random.
- Price must fit within our strict parameters of TREND or PAUSE in order for us to develop a trade scenario
- Once we have identified TREND or PAUSE we then can move to one of the Big Three trading setups: TEST, FLAG or Breakout

Reading the 15 minute chart

- Our analysis of the 15 minute chart is to identify trend, pause (5 day) or momentum (1 day).
- If the 15 minute chart is sideways in both price action and or the 20sma you should be looking to trade a **TEST** of support and resistance levels on your 5 minute and 15 minute charts. (because you are not expecting follow through)
- If the 15 minute chart is rising or declining order flow is obvious so you should be looking to trade a **flag** or **consolidation pause (break out)** on the 5 minute chart. (because you ***are*** expecting follow through)

Entries for the Big 3

- When your 15 minute chart is **flat**, you will be stalking a TEST. You would like to see "noticeably" lighter volume on a test of support or resistance. Your entry will be after a candlestick reversal pattern forms.
- When your 15 minute chart is **trending** you will be stalking a FLAG or Consolidation breakout.
- Entry will be a candlestick reversal pattern on the five minute chart for a FLAG.
- Entry for the consolidation breakout or breakdown will be a FUEL candlestick on the five minute chart.

PAUSE CHART:

conditions to trade the TEST



Trending 15 minute chart



Golfing and trading

- When you are on the golf course you take a particular club out of your bag based on your location on the course. In other words where you are on the course will dictate which club to take out of your bag.
- Each scenario calls for a particular club.
- When you are trading the same mindset applies. The scenario (where you are in price action) will dictate which trade you will pull out of your bag!
- No obvious order flow or a flat market on your 15 minute chart will tell us to trade a TEST of support and resistance.
- An obvious trend on your 15 minute chart will tell us to look for a pause (flag or consolidation) on the 5 minute chart and expect a continuation of the trend.

Chapter 9

Volume

The Power behind the “IDEA”

Goals

- To understand how volume will start, confirm or end a move.
- To learn to recognize the clues volume leaves behind both on the charts and on the tape.
- To understand that ***where*** volume occurs in the price action phase or during a chart pattern is significant to assess the probability of the next move.

Intro to Volume

- There are 3 types of volume we will be monitoring, average daily volume, today's volume and the volume trading right now.
- Average daily volume will tell you what a "normal" activity level for the stock is.
- Today's volume will tell you if the stock is trading on pace for it's average and will dictate your activity level for the day.
- The volume trading "right now" can be viewed in time and sales and will help you with routing orders as well as reading the tape (more on this later)
- We must not only monitor how much volume is occurring, but also WHERE it is occurring in price action.

Fuel: volume that starts a move



Volume that validates the trend



Exhaustion: volume that ends a move



the 7 Rules of Volume

1. Volume should be significant for price action in the direction of the current trend, to validate the IDEA/ trend.
2. Volume should decrease during a pause (pullbacks/consolidations) against the current trend for the current trends IDEA to remain valid.
3. Breakouts from a consolidation should be accompanied by significant volume for the breakout to be a valid. (Fuel)
4. Significant volume during a pause (pullback/consolidation) is accumulation or distribution. Anticipate a reversal.
5. Volume should be monitored from the current “prints” to at least the last twenty trading days.
6. Volume and liquidity will influence a traders activity level.
7. A fast move a significant distance from the 20sma with increased volume, will usually end the momentum. (Exhaustion)

volume considerations

- Volume ***combined*** with price action will show you if the "idea" behind a trend is still valid.
- In other words the trend (order flow) is assumed to remain intact as long as volume traded in the direction of the trend remains strong and volume during a pause is light.
- Understanding the phases of price action, volume analysis, pattern recognition and candlestick charting will provide you with a solid foundation to make educated trading decisions.

Chapter 10

Order Entry Techniques
Risk management

Understanding how to manage risk and share size.

Entry patterns.

Goals

- To learn the different types of orders and when to use them
- To learn how a professional manages risk while in a trade and the importance of re-entry.
- To learn trade entry and exit strategies that incorporate MTFA, chart patterns and candlestick patterns .
- Risk Management includes how you will manage capital in regards to entry price, initial stop loss and share size allocation

Most common orders

- Limit order: an order to buy or sell at a specified price or better. A specific price is entered.
- Market order: an order to buy or sell at any price available in the marketplace. No price is entered.
- Stop limit: a limit order is triggered once the specified stop price is reached.
- Stop market: becomes a market order to buy or sell once a specified price is reached. (price above or below the current market)
- Trailing stop limit: a sell order for a long position sets the stop price at a fixed amount below the current market price.

Trade entry considerations

- Once you have determined the condition for both the market and your stock (trend or pause) there are three criteria to consider for a trade entry.

1. Trade set up: flag, consolidation, test
2. Timing the entry: determining the price you are going to enter the trade.
3. Share size allocation: how many shares for this trade

Trade set up: Flag

- Entry pattern: bull flag, bear flag,
- Once you have identified a trend on the 15 minute chart you will wait for a pause to time an entry on the 5 minute chart.

1. Bull flag: Uptrend; now forming a 2-6 candlestick pull back on the 5 minute chart
2. Bear flag; Downtrend; now forming a 2-6 candlestick pull back on the 5 minute chart

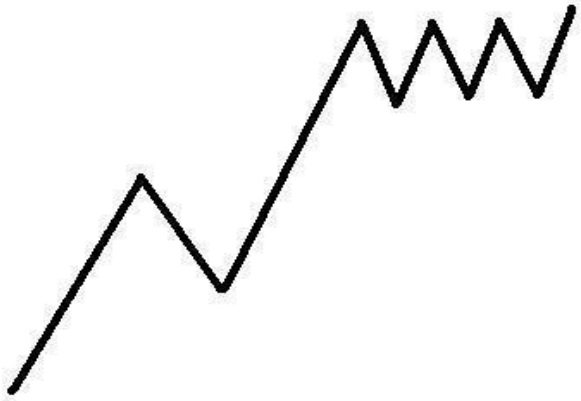
- Entry price **area** is a swing point, melted candle or U-Turn candle.

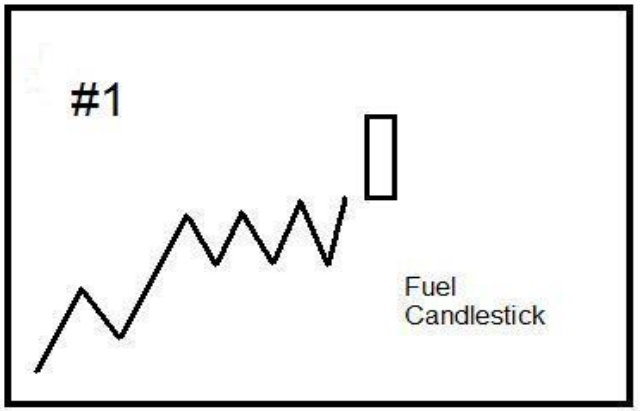
15 minute downtrend/ 5 minute Bear Flag

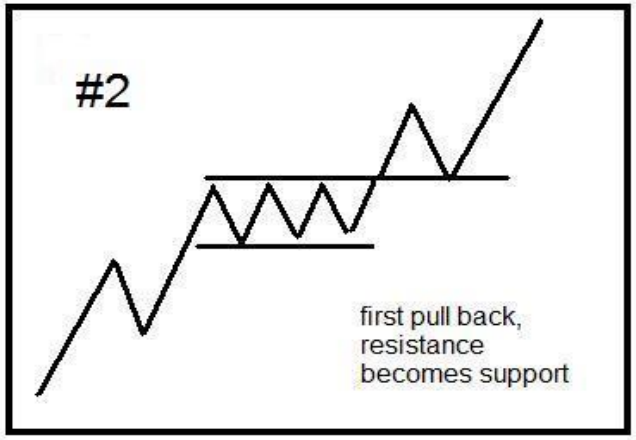


Break out trade: #1 trend/#2 weak trend/no trend

Once the uptrend is identified and the consolidation forms, there are two entry patterns.
1) Fuel- Large body candlestick that is accompanied by increased volume.
2) First pull back to new support which was the previous resistance level.





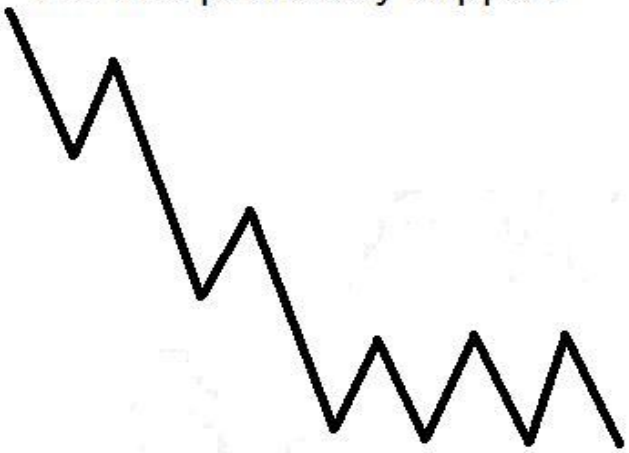


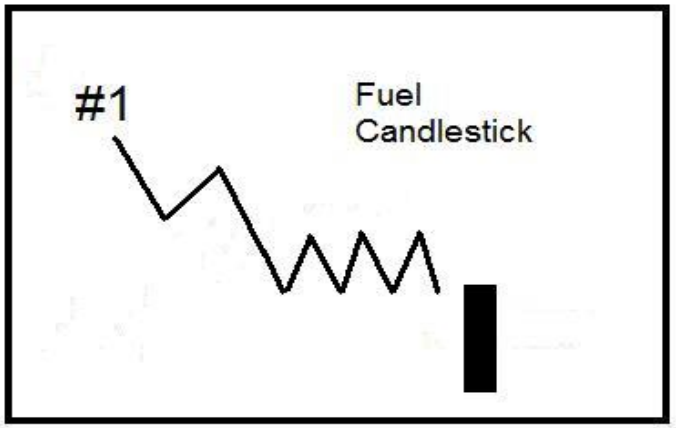
Fuel (break out)

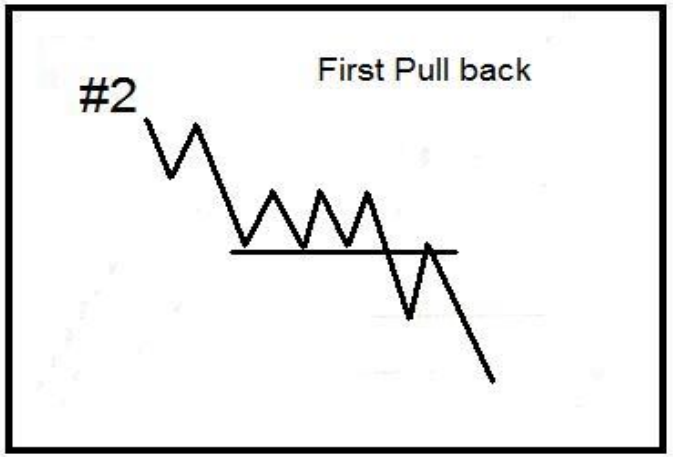


Break out trade: #1 trend/#2 weak trend/no trend

Once the down trend is identified you have two patterns for entry:
1) Fuel candlestick
2) First Pull back to resistance the was previously support.







Breakdown/first pullback



Wait for the entry price and signal

- The significance of waiting for the entry price and signal cannot be overstated.
- Too many traders are anxious to get into an existing trend and jump in too early. Wait for a pause and let price itself tell you when to get in!
- Swing points, melted candles, U-Turn candles and fuel, are the signals. Memorize them!
- Many traders make the mistake of entering a trade as soon as a moving average is touched, wait for price action in the form a candlestick entry pattern to form and wait for price to be moving in your direction before getting involved.

Timing the entry: price confirmation

- Price confirmation : Entering a position on a scaled basis. One half of your position is entered to initiate the trade.
- After the initial entry, **you add to your position only after it is working in your favor.**

a. Entry points will be an exact price as determined by a candlestick chart.

1. Reentries, reducing risk during a trade and small losses are common before price confirmation is achieved.
2. Discipline to take the small loss is very important for success.

Managing risk while in the trade

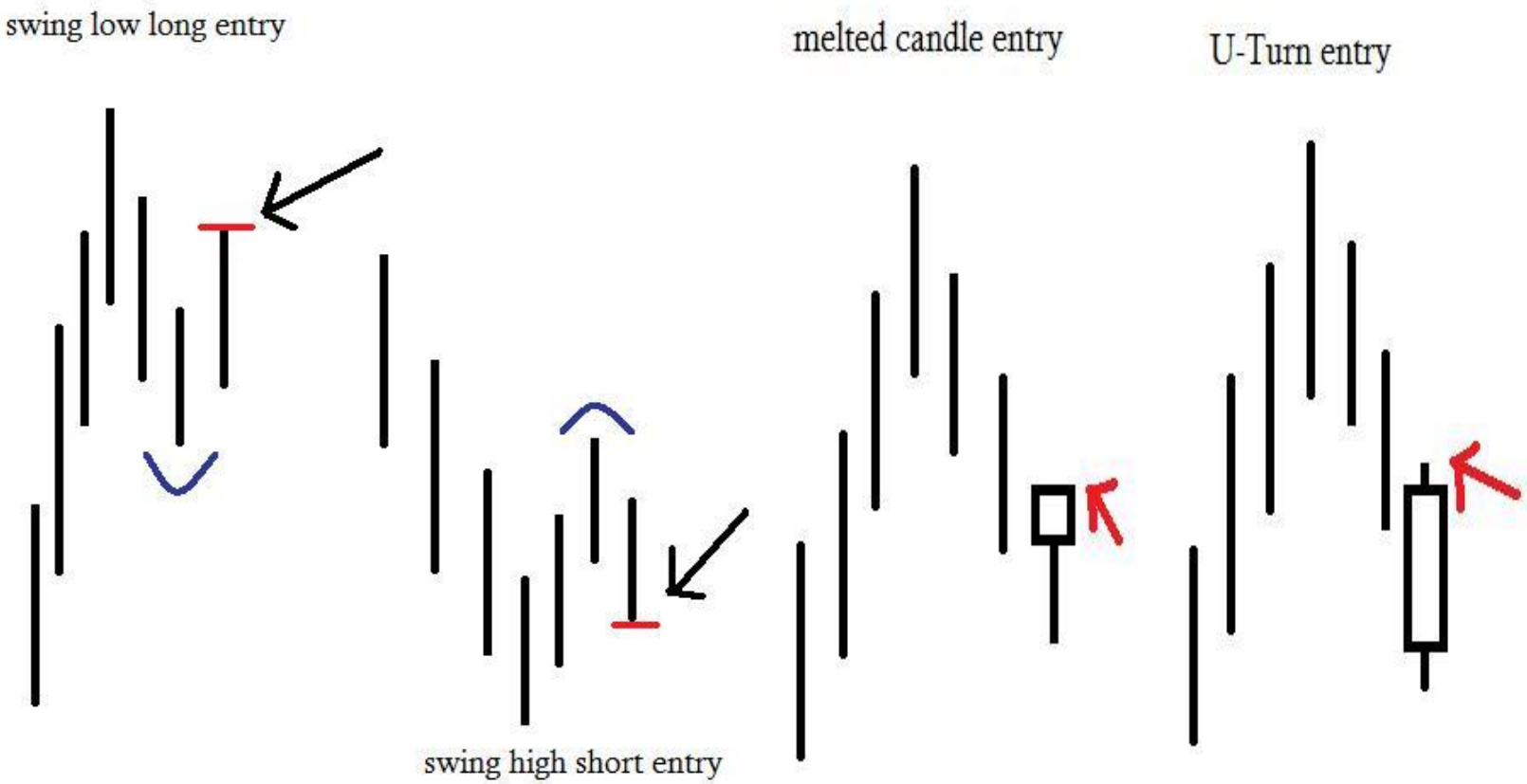
- Your goal for every trade is to manage risk and leverage before and during the trade, not only before the trade.
- *** Your initial assessment of risk does not need to be your final decision.
- It is very important that you understand you can and should adjust risk during a trade.
- It can be very common to adjust share size up or down while in a trade
- It would be terrific if a trade did exactly what you wanted it to after your entry and moved "cleanly" in your favor quickly, but that is just not real world trading.

Real world trade sequence: price discovery

- Initial share size 1000 shares
- Moves against me cut 500 shares
- Moves past initial entry add 500 shares
- Moves further in my favor add 500 shares
- Moves back down to my initial entry cut 1,000 shares

1. Moves against me get out of trade
2. Moves in my favor in a big way, scale out and trade around core position

Entry area


swing low long entry
melted candle entry
U-Turn entry
swing high short entry

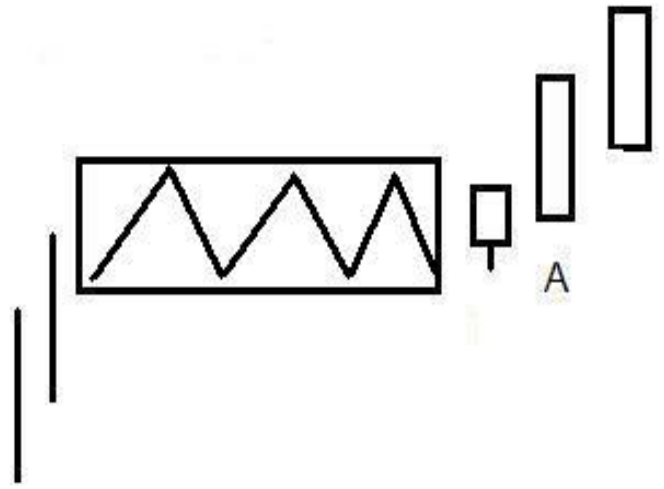
How to place your order (long position)

- Swing point low entry.
- Entry candle high= $34.45
- When the bid becomes $34.45 you will advertise to buy on the bid using an ECN
- If price moves up and you can't get filled you will buy at the ask on the route with the most liquidity.
- As you get quicker at making this decision, you will route it to the destination that has the most liquidity on the ask, as well as the destination that cost the least to remove liquidity!
- Short sales are reversed.

the breakout entry: fuel candlestick

- As a stock consolidates, we have learned you will be looking for a fuel candle to initiate a new trade.
- When a breakout with volume occurs, you will initiate a position with half your intended share size.

1. Entry price will be a fuel candle closing above or below the consolidation. Buy on the close.
2. Stop loss will be below the low of the consolidation.



A = entry bar when accompanied by significant volume.

Trading the TEST

- A Test is a trade scenario where a previous support or resistance level is being approached on light volume during a pause in order flow.
- You DO NOT want to initiate the trade until after the support or resistance level proves that it has held.
- You always want price to be moving in your direction before you initiate a trade.
- Because your stop loss point is so well defined (the support or resistance level) you can use extra leverage on the trade.

Trading a TEST: always wait for price to be moving in your favor first



opening range breakout trade

- Opening range breakout (first 15 minutes)

a. Enter (for a long) at the high of the opening range. Use the price confirmation technique for share size

b. Initial stop loss should be the low of day. Use your judgment if the candle has an abnormally large high-low range for initial stop loss.

c. Add to the position each pause on the 5 minute chart.

Opening range breakout



Gap trading and the Open Range

- A gap occurs after a stock has opened much higher or lower than the previous close. A true gap occurs above or below the previous day high or low.
- Gaps typically occur after a significant fundamental story about a company is released. Usually an earnings surprise, upgrade/downgrade, competition, legal issues or a change of executive leadership.
- Here is the most important point to remember when trading a gap: you do not need to interpret the news to make money trading the gap!
- Let your knowledge of the open price range and the job of the specialist give you clues to who created the gap. You need to decipher if it was institutions or retail overreaction.

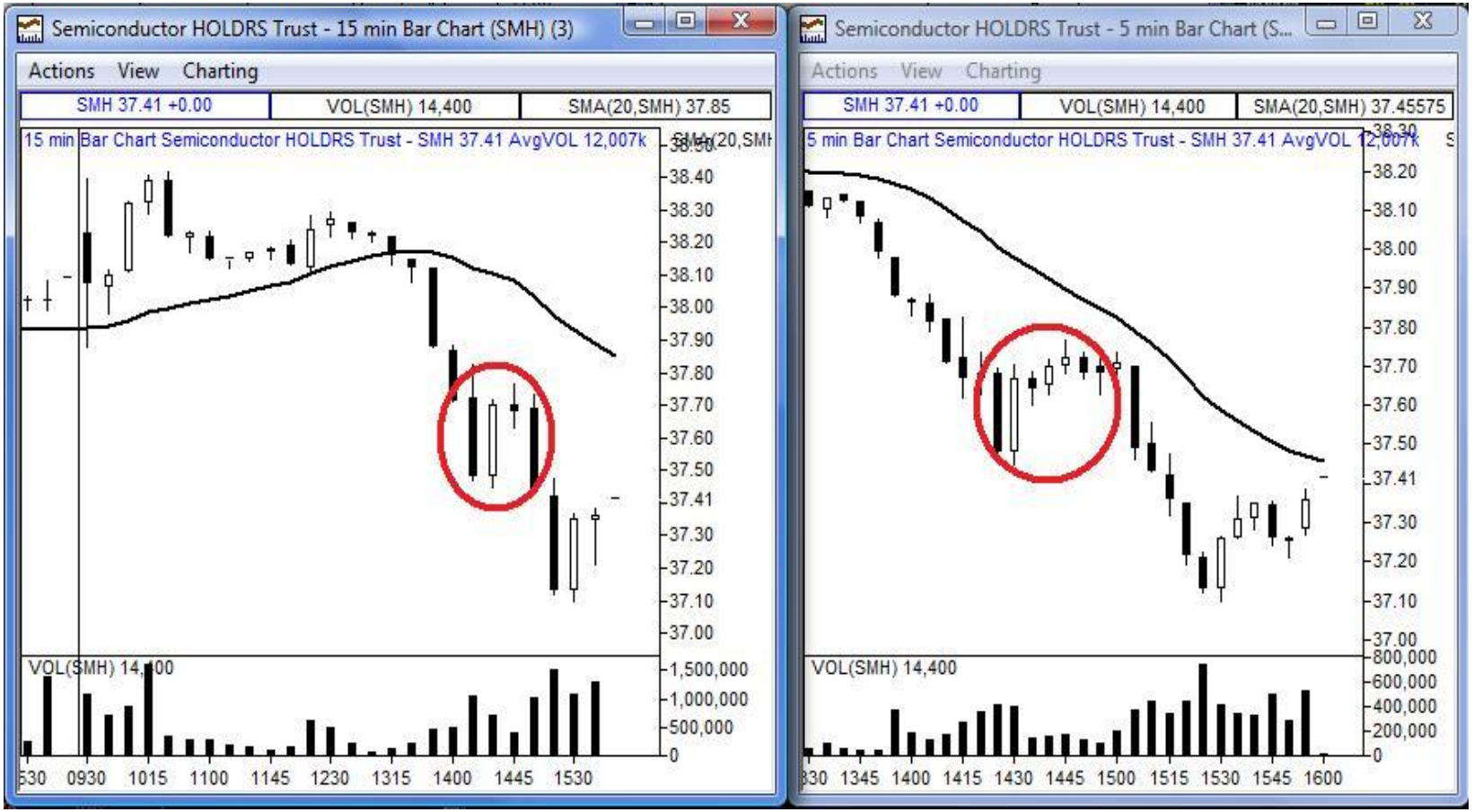
Classifying the Types of gaps

- Retail Gaps: When nothing fundamentally about the stock has changed overnight no significant volume is trading. Maybe a popular TV host mentioned a stock or the futures are trading up or down significantly. Either way nothing about the stock has changed to justify the gap.
- Professional Gap: Associated with heavy volume and significant fundamental or economic news. For this to be a Professional Gap you should see block prints trading and pre market volume should be significant.

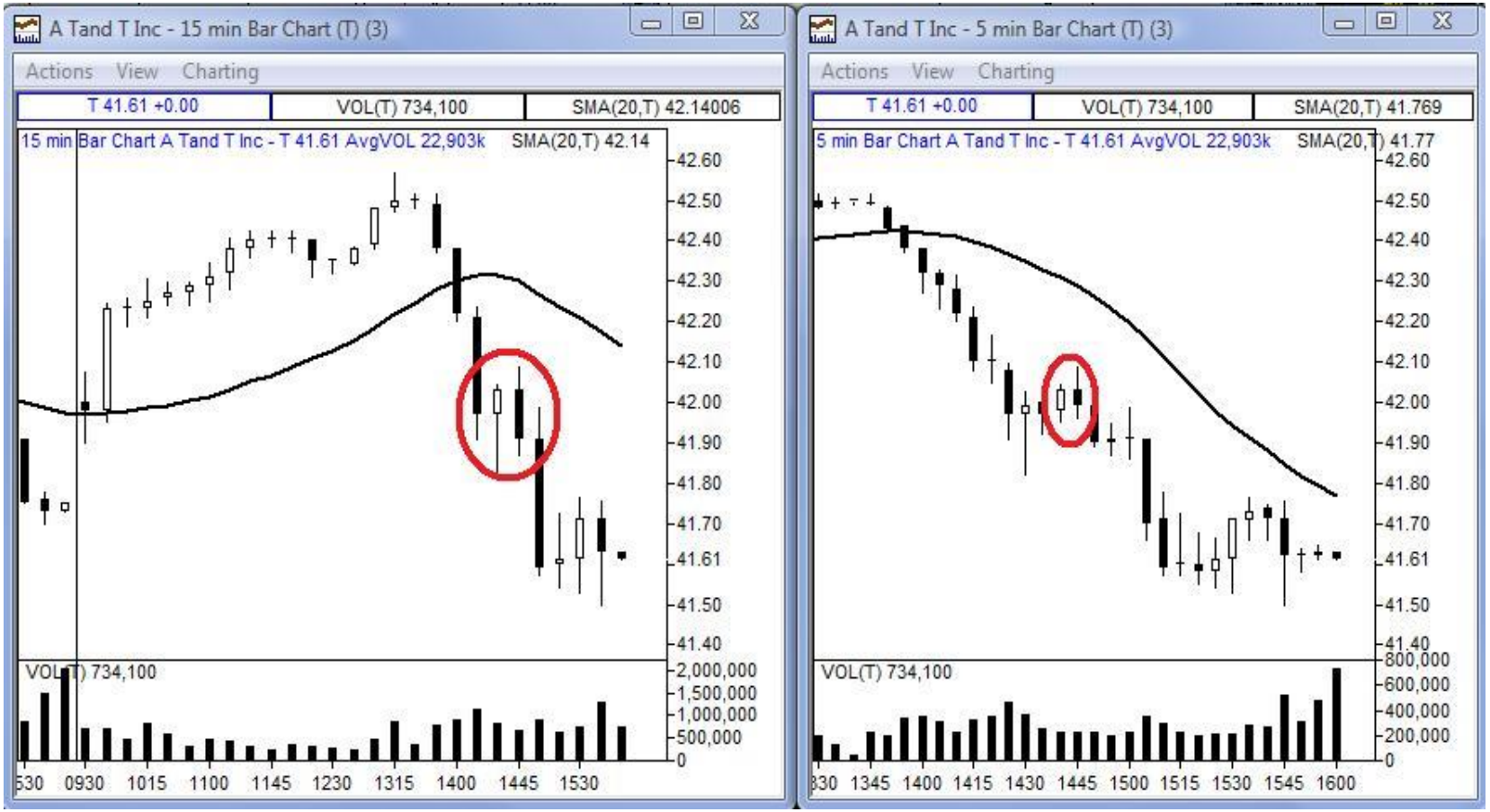
How to trade the Gaps

- **Retail Gaps** are gaps that the specialist or market makers WILL be able to bring the stock back to a level where they can recover the risk capital they lost taking the other side of the retail order flow. If volume is light and price starts to trade in the opposite direction of the gap after the open range you can join the specialist fading the gap.
- **Professional Gaps** are gaps where there is **institutional order flow** and heavy volume involved in the gap. You will see block prints consistently printing on the tape in the direction of the gap. After the open price range has formed, as long as volume continues to be heavy, you will trade the direction of the gap.
- Many traders make the mistake of fading every gap. Do not make this mistake. Read the gap, the open range and volume, be a pro!
- Technical trading gap basics: in an established downtrend short sell a gap up below the open range, in an established up trend buy a gap down above the open range.

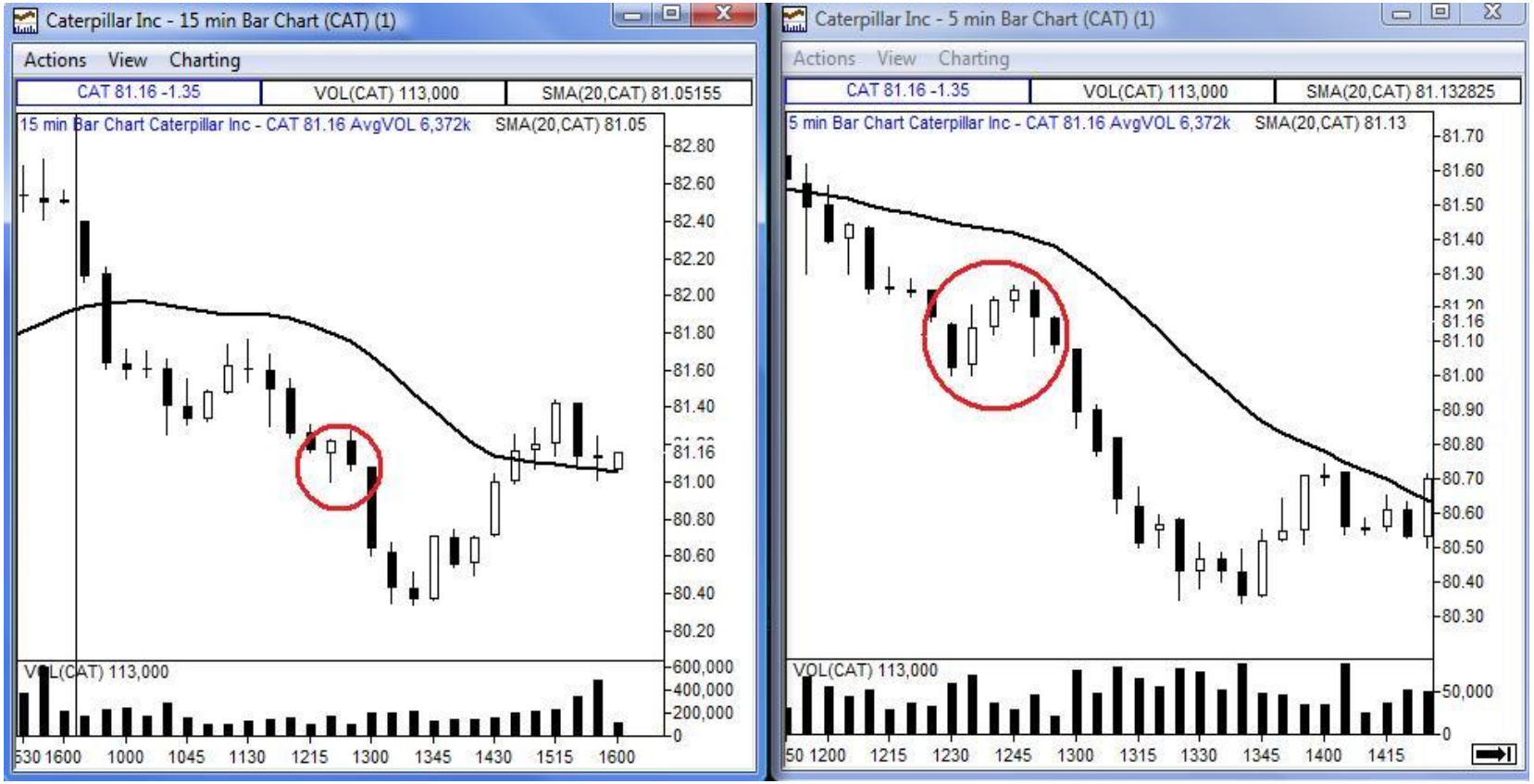
15 minute down trend/5 minute bear flag



15 minute down trend/ 5 minute flag > bearish U-turn entry



Downtrend/bear flag/swing high



Money management

Defining your risk for each trade and managing leverage. Truly understanding that preservation of capital is your first priority

Keys to the treasure chest

- Simply put:

1. Money management is how much capital you are going to put at risk for each trade.
2. Risk management is how you will put that capital to work regarding trade management and share size. (this is your trading plan)

- Good trading creates income, **good trading with proper money management creates wealth**

Definitions

1. **Money Management:** Is the proper use of capital. How much of your account equity will be at risk on the next trade.

- Takes into consideration trade probability and the value of your entire account.

1. **Risk Management:** Taking small losses and managing the rewards in relation to the potential risk.

- Entry point: setups that get you into the market based on your structure of price action.
- Exit point: Planned price objectives and price action scenarios that will dictate immediate action. These exits are stop loss areas and profit targets.
- Share size for initial trade entry will be determined by above before the trade

Money Management Formula

- Proper money management is the foundation for long term profitable trading.
- *It is one of the few components of a trading plan that the trader has complete control over.*
- The Keystone Trading money management formula will teach you to determine a dollar amount to risk.
- This dollar amount must be a number you are comfortable placing at risk for each trade.

Being prepared to accept risk.

- There is a very important reason for your need to accept this dollar amount before the trade.
- If the trade should happen to **not** be a winning trade and you need to execute a stop loss, you will execute it flawlessly because you have already accepted the risk. **The dollar amount.**
- In other words, "if this trade moves against me, I am okay with losing or risking $X because of the potential profit."
- Most traders turn small losses into big losses because they are not prepared mentally to exit a trade that is not working. They are only ready to book a profit!

The 2 % Principle: calculating risk amount and position size

- No more than 2% of your equity should be lost on any individual trade.
- Note this does **not** mean only 2% of your equity should be allocated to a trade. It means no more than 2% should be at risk on any one position.
- Note we are talking about your equity here (cash), not your buying power.
- The 2% Principle limits trader losses, preserves capital and gives the trader a definite dollar amount at risk, based on account size, before entering a trade.

The 2% calculation and determining share size

1. Multiply equity balance x 2%. This will give you maximum dollar risk per trade.
2. Determine the difference between your stop loss point from entry price.
3. Calculate position size:

- Maximum dollar risk per trade divided by the difference between the entry price and stop loss point.
- The beauty and simplicity of this method is that it completely neutralizes the volatility of expensive stocks that can move quickly. Whether you are trading a $15 stock or a $150 stock it doesn't matter! You are risking the same dollar amount, the risk amount and stop loss will tell you how many shares.

share size calculation

Position size =

[2% of equity balance /(entry price – stop loss point)]

- For example:

1. Equity balance = $5,000. 2% x $5,000 = $100
2. Entry price =$20.20, stop loss = $20. This is a .20 difference.
3. $100 / .20 = 500 shares for this position.

Average dollar profit per trade

- As you gain experience and a track record you will have a better idea of how much profit you “usually” earn on winning trades on average.
- When you reach this level of experience you will risk your average profit per trade.
- Most professional traders are willing to risk on a trade what they feel thy can make back immediately on the next trade.

Entry signal recap

- 1st: consider MTFA (trend, support/resistance, momentum on 15 minute and daily charts)
- 2nd: Trade set up – Flag, Test or Consolidation
- 3rd: Share size will be dictated by accepted dollar amount of risk, entry price and stop loss point.
- 4th: Entry signals are fuel, melted candle, U-Turn or swing point.
- Melted candles and U-turns are aggressive entries, swing points are conservative.

Chapter 11

Trade management strategies and thought process

Stop loss strategies

Profit taking scenarios

Goals

- To understand the mindset for successfully managing risk as a career
- To understand there is a huge difference between a bad trade and a losing trade.
- To accept the fact that losing trades are a very common part of trading and should be viewed as nothing more than the cost of doing business

perspective on the stop loss

- *"EXECUTING A STOP LOSS IS NEITHER GOOD OR BAD, IT IS SIMPLY A PART OF DOING BUSINESS."*
- When you adjust your share size down while in a trade that moves against you, or when you execute a stop loss you are doing nothing more than managing risk!
- *It is NOT an assault to your ego!!!!*
- Easily the single biggest reason a trader will **not** make it as a professional trader is because he or she personalizes a trade that is not making money.
- When you personalize a losing trade you turn a reasonable small loss into career ending disaster.

Stop loss mindset

- Proper management of your losing trades will dictate what you TAKE HOME every month, not how much you make on winning trades.
- Notice we said "take home." Anybody can make money on a trade or on a given day, but your ability to manage risk and deal with losses with the proper mindset will earn you a consistent income.
- As we have said, the stop loss must be a dollar amount you accept **before** you place the trade.
- You have "accepted" the risk, you have accepted the fact that there may be a loss on the trade. This acceptance is crucial to flawless execution.

A trader is an entrepreneur

- You are accepting putting money at risk as a part of doing business just like any other business owner. You are spending money to make money.
- What this translates to is that when it comes time to execute a stop loss you will do it unemotionally because you understand it is a part of doing business.
- The most common reasons traders blow up their accounts are too much leverage relative to their skills and not truly accepting the risk.

Stop loss strategies

- Initial Stop Loss: Risk point as defined by your original entry.
- Break Even Stop Loss: When a position moves in your favor, you move the stop loss point from the original spot to your break even area.
- Trailing Stop Loss (profit taking): Used to protect profits on a winning position. Objective is to lock in all or part of profits.

Initial stop loss

- For short term trading, you will determine the area to place the initial stop loss from technical analysis.
- The proper area is just beyond the significant reference point you have identified from the charts, **never place it exactly at the number.** You want to be taken out of a trade because the circumstance has changed, NOT because price just barely touched a number!
- This area must be determined before you enter the trade, not after! This will ensure accepting the risk.
- ** Remember your initial assessment of risk does not have to be your final one. You DO NOT have to remain in your full original share size if the position should happen to move against you quickly.

Initial stop loss area

- For a TEST: the initial stop loss area for a test is a break of the support or resistance you were expecting to not be broken.
- For a FLAG: Just beyond the swing point, the U-Turn or melted candle entry signal.
- For a Breakout or Breakdown from a consolidation: Price should NOT penetrate back into the support or resistance it just broke out from with any kind of volume. If it does exit the trade and re evaluate.

Breakeven stop loss

- When a trade that has moved in your favor, has clearly made an attempt to get back to your entry price, but could not do so. This is a very good sign for your position.
- Your intention here is to get a “risk free ride” on your profitable trade and a worst case scenario of no cost except commissions on the trade.
- There is of course the possibility of getting stopped out for break even and the trade moves in your intended direction. This is fine, you will simply re-enter the trade.
- Remember it is very important to follow our plan, that is what we always have control over. Getting stopped out and re-entering is part of the business.

trailing stop/stop loss

- Used when your position has produced an acceptable profit.
- As a trade moves in your favor you will continue to set a price level or dollar amount that you will not allow to be penetrated (in the other direction) without booking the profit.
- Helps you overcome one of the biggest problems new traders face… holding on to winning trades! It provides a systematic method to let your profits run.
- Scaling out of trades as it moves in your favor takes the pressure off getting the exit "perfect."
- Melted candles, swing points, U-turns and exhaustion are the signals for getting ready to set a trailing stop.

The buy limit and sell limit. Important orders to learn for getting tough fills.

- Used in place of market orders.
- Intention is to take advantage of liquidity and get price improvement.
- Helps get filled in "fast market" conditions, but cannot get a worse fill than the limit price entered (as is possible with a market order).
- An active buy limit placed **above** the current best offer will price improve to the best available shares for sale
- An active sell limit placed **below** the current best bid will price improve to the best available shares to buy.

1) An order to sell here @19.46 would be filled at 19.50, but no worse than 19.46.
2) An order to buy here @ 19.55 would be filled at 19.51, but no worse than 19.55.
* Use when you have urgency!

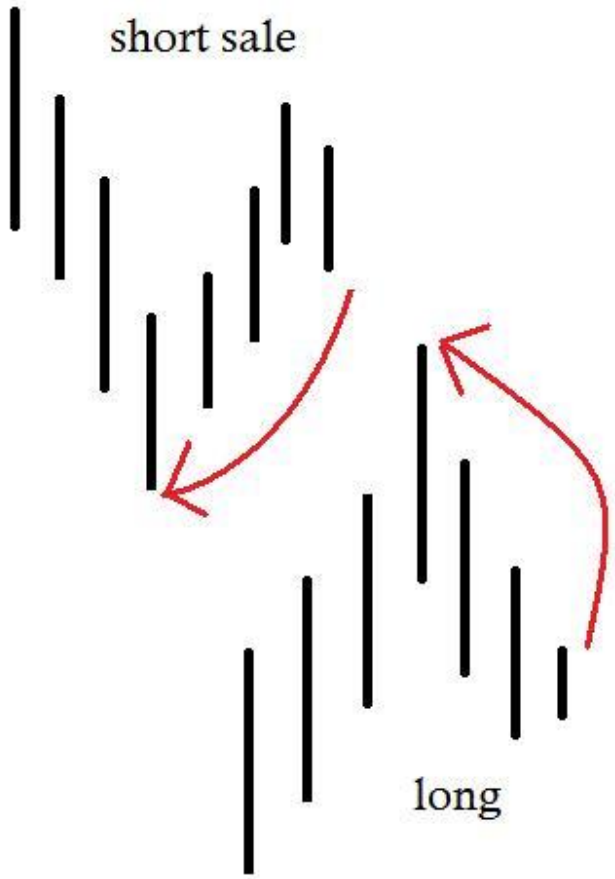
BID		ASK	
19.50	3,000	19.51	4,000
19.49	4,000	19.52	3,000
19.48	8,000	19.53	6,000
19.47	6,000	19.54	5,000
19.46	3,000	19.55	4,000

5 possible profit taking scenarios

1. Exit at a clearly defined support or resistance point on a chart, such as a previous high or low. *We recommend this be your primary profit target as you learn the business.
2. Scale out of a good trade, if you still like it, you can always get back in with profits in pocket.
3. Exit into momentum moves such as **exhaustion** as viewed with candlesticks and volume.
4. Exit when you have identified a scenario that you expect the entire market to lose momentum and turn around (discussed in market analysis)
5. Exit or tighten a trailing stop when a swing point, melted candle or U-Turn candle has formed.

Profit targets

- The skill of booking profits believe it or not is the hardest one to teach.
- The reason for this is it can be more subjective than setting a stop loss.
- We teach that the previous support or resistance should be your initial target



Chapter 12

Level 2 and direct access trading

Understanding quoted prices and executed trades.
Learning direct access routing strategies

Goals

- To understand the difference between online trading and direct access trading.
- Learning the difference between level one quotes and level two quotes.
- Introduction to Time and Sales
- Determining where your routing skills are now and where you want them to be.
- To review the choices for direct access order routing and how to use them.
- To understand how true direct access trading can **and should** significantly lower your monthly operating costs through proper routing decisions.

Understanding your online retail orders

- Self directed online accounts are most likely not direct access.
- Most retail brokerage houses route your orders to a trading desk or to a third party.
- Some exchanges and market making firms actually pay retail brokerages for the privilege of filling their customers orders. This is called “payment for order flow.”
- This is one of the ways your broker can make money executing your trade for only $9.99
- More often than not these firms can fill your retail order from their own inventory and make a profit.

Direct Access orders

- Your direct access orders will be sent directly to the specialist, market maker or an ECN.
- The most popular (liquid) ECN today is ARCA who has recently merged with the NYSE.
- Direct access to the markets gives you fair access to the true market, you will receive the best execution and you can actually receive price improvement if available.
- A true direct access professional trader will route his order to a specific route at a specific price (for the lowest cost as your skills improve)

Level one quotes: inside market

bid		ask
3,000 @ 20.55	X	5,000 @ 20.56

- Level one quotes give the trader a snapshot of advertised supply and demand. **Advertised** was used very intentionally.
- The bid side shows the total amount of shares and the highest limit price traders are willing to buy stock.
- The ask side shows the total amount of shares and the lowest limit price traders are willing to sell stock.
- Bid and Ask quotes are **advertisements** to buy or sell. They are no different than price tags on a pair of shoes at a store.

Level 2 quotes



- Shows the same basic information as level one **but with more detail.**
- How many shares are available to buy or sell at each price on a particular routing destination
- The depth of where and how many will help us decide where to route our direct access orders.
- Where refers to the specialist, market maker or ECN.

Level 2 and routing orders

- How many shares quoted at a price are very important information when deciding where to route your own orders.
- **Who** is quoting those shares is not as important as it once was when trying to decipher if a specific market maker is a big buyer or a seller.
- Who is quoting those shares however ***is*** important when it comes to making a routing decision based on cost, not all routes cost the same to access.
- Many bids or offers with size presents you with liquidity which increases your chance to buy or sell shares if you are urgent.
- Few shares quoted on the bid/offer presents you with an opportunity to advertise your buy or sell order at the best available price. Shares are filled first come first served, if you are first you are the front of the line on that route.

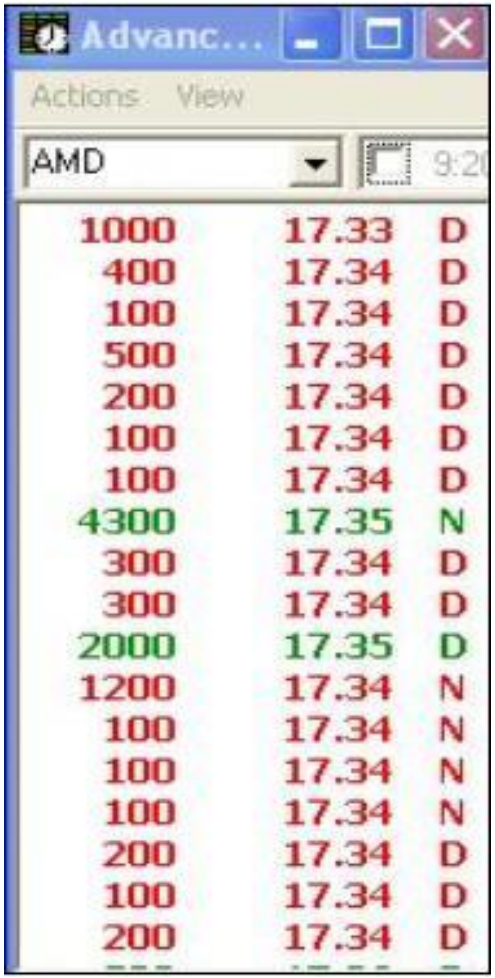
Time and Sales: urgency in action

- Level 2 shows advertisements. Time and sales shows actual trades.
- L2 is the passive part of a trade, time and sales shows the active part of the trade, urgency to get in or out. These trades are called the "prints."
- Time and sales tells us:

a. how many shares traded,

b. the price those shares traded

c. The routing destination the trade was executed



Interpreting level 2 / time and sales

- If someone is advertising to sell stock and he is able to sell the stock, it is because another trader bought it from him.

a. The other trader did so because he felt he felt urgency to buy now. He paid the higher price. He most likely tried to advertise and could not get filled.

- If someone is advertising to buy stock and he is able to buy the stock, it is because another trader sold it to him.

a. The other trader did so because he felt he felt urgency to sell now. He sold at the lower price.

How time and sales will affect your **activity** level

- If time and sales is busy and consistent:

a. Traders are displaying more urgency

b. The more obvious the urgency (buying or selling) the more obvious what other traders feel about the future price of the stock.

c. ** the more consistent the prints and more obvious the urgency (trades occurring on the same side and the larger the size of those trades) the busier you should be.

- If time and sales is slow and sporadic, you should not be actively trading

What to focus on

- Level 2 is advertisements, times and sales is the active part of the trade.
- Level 2 action can be confusing for a new trader, focus on liquidity for routing purposes.
- The level 1 quote is also known as the "inside market"
- Action in time and sales that is red is active selling, green is active buying. Active = urgency.
- When you have more experience and can make quicker decisions you will be able to quickly read level 2 / time & sales and direct a trade for better fills and lower costs.

Routing choices available to direct access traders

- DOT: filled by an exchange specialist
- Hybrid: electronic order removes shares from specialist Open Book quotes.
- ECN: electronic order used to post bids or offers, can also remove shares from bid/offer. As a general cost, ECN's give a rebate of $2/1,000 shares to add shares, and charge $3/1,000 shares to remove shares. (cost can vary per ECN). Can and should be used for listed and NASDAQ trades.
- Supermontage: electronic order removes shares from a NASDAQ market makers quote.

Placing orders in NYSE stocks

- Direct access traders should place orders for NYSE stocks using DOT or an ECN.
- DOT stands for Direct Order Turnaround. This order is sent to the specialist and he will literally look for a match.
- The specialist will look for a match in the pool of existing orders he has.
- These orders are limit orders compiled in what is called his **open book**.
- Orders displayed in the specialist **open book** are limit orders to buy or sell at a certain price through the specialist.

NYSE hybrid executions

- Hybrid: is the next generation of the Direct+ execution. It is essentially the same functionality wise but has no restrictions.
- **** Hybrid executions have changed the responsibilities of the specialist dramatically. Since the specialist now has unlimited exposure for his quotes, it has affected a traders ability to get a consistent, quality limit order fill from his open book quotes.
- The reason for this is that the liquidity is removed much quicker than before. It is hard for the specialist to keep up.
- Most specialist Open Books are now monitored by computer algorithms, The majority of intra day quote management is done by machines.

ECN executions

- ECN= Electronic Communication Network.
- It is a routing destination we can use for both NYSE and NASDAQ trading.
- The most liquid (popular) are: ARCA, EDGX and NSDQ. BATS ecn recently became an exchange
- ECN's make money by charging you to remove shares (urgency) from their liquidity pool.

a. ECN's pay you to add shares (advertise) in their liquidity pool.

b. *When you reach higher levels of trading mastery you will be able to reduce your trading costs significantly using ECN's properly.

Placing orders in NASDAQ stocks

- Direct Access traders can place orders for NASDAQ stocks by using an ECN or Super-montage.
- Super-montage is the next generation of SOES executions. It is a method of executing a trade against a market makers quote. (sell at the bid, buy at the ask. An active order.)
- The routing fees for ECN's when trading NASDAQ stocks are all very similar, we recommend you take advantage of the tremendous liquidity on the ECN's ARCA, EDGX or NASDAQ

Understanding your orders and liquidity: the **bid**

BID			ASK		
NYSE	17.33	4,000	NYSE	17.34	4,000

- **The bid: 17.33 advertisement to buy**
- If you try to **buy** 1,000 shares on the **bid** routing your order to NYSE, the 4,000 will become 5,000. You *added* liquidity.
- If you **buy** 1,000 shares at the **ask** using NYSE, the 4,000 shares will become 3,000 shares. You *removed* liquidity.
- *** you can buy on the bid AND buy at the ask.

Understanding your orders and liquidity: The **Ask**

BID			ASK		
NYSE	17.33	4,000	NYSE	17.34	4,000

- **The ask: 17.34 advertisement to sell**
- If you try to **sell** 1,000 shares on the **ask** routing your order to NYSE, the 4,000 will become 5,000. You *added* liquidity.
- If you **sell** 1,000 shares at the **bid** using NYSE, the 4,000 shares will become 3,000 shares. You *removed* liquidity.
- *** you can sell on the ask AND sell to the bid.

ECN rebates

- You can significantly reduce your monthly fees by routing orders properly to ECN's to get paid a rebate.
- You should do this when the momentum is in your favor or if you have no urgency to get in our out of a trade.
- When you ADD liquidity you get paid by the ECN. This will increase your net profitability. *adding liquidity and getting the rebate applies to the bid or the offer
- When you REMOVE liquidity, you get charged by the ECN.

routing clues from Level 2

- Level 2 quotes can provide us with valuable information to help get the best fills.
- **The main question we need to ask before we route an order is this: Do I need to get filled immediately?**
- This has implications on two levels:

1. The less urgent you are, the better the price you will get AND the lower the cost for the trade.
2. The more urgency you have, the more you will need to pay attention to WHERE you will route your order. You will be looking for liquidity.

Making a routing choice: less urgency

- Less Urgency: (long: selling stock you own)

1. If you are in a profitable trade you can advertise to sell on the offer and get the best price available.
2. If you advertise on the offer to sell stock because you believe you have a very good chance to get filled (the momentum is in your favor), **you should use an ECN** to do so.
3. You will get a rebate from the ECN which will reduce your commission cost.
4. In the previous example you would be advertising to sell on the ask @ 17.34, adding liquidity to the offer.

Making a routing choice from Level 2 information: Urgency

- **Urgency!** (long: selling stock you own *or* taking a loss)

1. If you are in a trade that you need to exit quickly you will sell your stock actively to traders advertising to buy on the bid. This is called "hitting the bid" in trader talk.

- When you need to exit a trade quickly, Level 2 will help you decide WHERE to route your order. When you need to be active, you want to choose the routing destination that has the MOST shares quoted.
- To take this one step further, when you become more skilled at reading the tape, you will choose the destination that is the cheapest for you to do so.
- In the previous example, you would be hitting the bid @17.33

Direct access routing decisions

- Listed trading:

1. For adding liquidity use ARCA or EDGX, they currently pay the highest rebate.
2. To remove liquidity (urgent orders) use a DOT order (to the specialist)

- For NASDAQ trading:

1. For adding liquidity use ARCA or EDGX, they currently pay the highest rebate.
2. To remove liquidity (urgent orders) use ARCA or EDGX

Routing Strategies per market: Long (buying stock)

- If long (any stock) and the stock moves in my favor I will attempt to exit into momentum *by advertising on the ask* using the ARCA ecn. In this case I will be adding liquidity and will get paid for my order flow selling stock I own.
- If long a **listed stock** and the stock moves against a winning position or is a losing position and I need to exit with **urgency** *I will need to "hit the bid" by selling actively to the buyers on the bid.* I will first look to see if the "free route" EAB is available on the bid, if they are not I will use SRDOT. In this case I will be removing liquidity.
- ** ARDOX is the routing choice for the free route in the Sterling software. In other words it will show EAB in level 2, but the routing destination is ARDOX.
- For a NASDAQ stock you need to exit with urgency use ARCA to hit the bid if the free route EAB is not present.
- **Terminology: Buy to enter, sell to exit**

Routing Strategies per market: Short sale

- Short sales:
- If short (any stock) and the stock moves in my favor I will attempt to exit into momentum *by advertising on the bid* using the ARCA ecn. In this case I will be adding liquidity and will get paid for my order flow.
- If short a **listed stock** and the stock moves against a winning position or is a losing position and I need to exit with **urgency** *I will need to "take the ask" by buying actively from the sellers on the ask.* I will first look to see if the "free route" EAB is available on the ask, if they are not I will use SRDOT. In this case I will be removing liquidity
- For a NASDAQ stock you need to exit with urgency use ARCA to take the ask if the free route EAB is not present.
- **Terminology: sell short to enter, cover to exit**

Direct access recap

- You have the choice to route your order to a particular destination.
- Level 2 shows us where liquidity is or where it isn't.

a. You want more liquidity when you need to be active. (L2)

b. You want less liquidity when you are going to advertise. (L2)

c. You want momentum in your favor and the busier destination when you are going to advertise. (T&S)

d. A skilled direct access trader can reduce his or her costs by thousands of dollars a month simply by properly routing to ECN's.

e. You should always negotiate a deal that allows you to take advantage of those pass through fees offered by the ECN's.

Chapter 13

Tape Reading

Understanding urgency, when you should be busy and forecasting the next immediate move.

Goals

- The goal of this chapter is to give you an understanding of what you should be paying attention to in level 2 and time and sales and how it relates to price action.
- Learning how to focus on what bids and offers do in relation to the prints in time and sales and giving meaning to that action.
- Understanding what price action “should do” based on the prints.

Reading the most immediate price action

- Tape reading is the skill of reading price action, the prints and quotes to determine what is the order flow ***right now?***
- It is a method of forecasting, from what is taking place now, to anticipate what is likely to happen next.
- Are institutions "marking up" or "marking down" their inventory? (are bids and offers moving in an obvious direction)
- How urgent are other traders? You will see this in time and sales. (frequency and the price the trade prints)
- Tape readers don't care who or why the stock is moving, just follow what the tape is telling you.

Tape reading 101

- The essence of tape reading is:

1. Watching the **size, price** and **frequency** of the prints
2. Monitoring what bids and offers do after those prints
3. Observing where in price action the prints are happening on the charts.

Watching the size and frequency of the prints

- Larger prints trading consistently **at the ask** shows there is an aggressive buyer.
- Larger prints trading consistently **at the bid** shows there is an aggressive seller.
- ***You must watch a stock for a while to "know" what is a large print for that stock.
- Consistent prints on the tape, displays to us the stock is active enough to be trading.
- Sporadic prints show us not to get involved

Observing **where** the prints are trading on the charts

- Are large prints occurring at a breakout point? This would indicate the start of a new trend. **FUEL**
- Are large prints occurring after a parabolic, fast move? This would show a likely end of the move. **Exhaustion**
- Are prints small during a pause? This is good news for the continuation of that trend.
- Are prints large during a pause? That is not good news for the prevailing trend.

What do bids and offers do after those prints?

- If large prints trade at the bid and the bid/offer moves lower, that is bearish, price follows urgency.
- If large prints trade at the bid and the inside market **moves higher**, that is bullish. *There is a buyer not showing his hand yet!*
- If large prints trade at the ask and the inside market moves higher, that is bullish, price follows urgency.
- If large prints trade at the ask and the inside market **moves lower**, that is bearish. *There is a seller not showing his hand yet.*

a. The tape leaves clues to anticipate the next move.

Combining charts and the tape

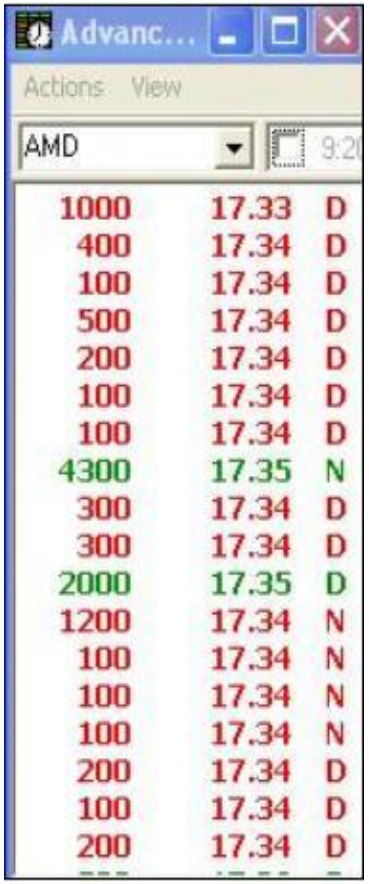
- The charts will **always** be where you get your ideas from.
- The tape reading techniques should be a secondary tool to help forecast price action.
- When mastered, you will execute the timing of your entries and exits at much better prices.

Reading the tape with a game plan.

- When you are watching time and sales, you want to be watching with a purpose.
- You should **not** be watching every single print! You should train your eyes to watch significant prints for *that stock.*
- More often than not, 100 share prints will NOT move a liquid stock, train your eyes for bigger prints.
- You are scanning for when when someone is showing urgency, buying or selling size for that stock.
- When large prints occur, identify its significance in relation to price action. Is it starting (fuel), ending (exhaustion) or confirming a move.

Tape reading bonus: reading **where** it is printing

- Reading WHERE trades are printing can help you increase chances of getting an execution.
- Time and sales not only shows price, size and side of trade, it also shows you where the trade was executed.
- If you are trying to advertise to get a fill and notice a consistent flow of prints occurring at a particular routing destination, route your order to that location to get a quicker fill.
- Contact your software provider to interpret the symbols in T&S. In this example you can see stock trading on NYSE (N), ARCA ecn (P) and NASDAQ ecn (T), EDGX ecn (D)



Chapter 14

Market Analysis

Is the wind at your back? Learning to use overall market conditions to your advantage.

Goals

- To introduce a complete system of market analysis to your stock trading decisions
- To introduce market internals and how to use them.
- To discuss another element of Dow Theory and its relation to market timing

Reading the Market 1986 vs. today

- **Stock market 1986** : "Today the Dow was up 72 pts."
- (300 mil) total NYSE/ (350 mil) total OTC
- Dow Jones = 30 stocks

- **Stock market today**
- A good volume day NYSE/NASDAQ =2 Billion shares for each market
- Today's busy and complex market requires we monitor the 3 major indices together.
- DOW, S&P500, NASDAQ Composite

Defining “the market”

- When someone refers to “the market,” they are usually referring to the major indices.
- These indices tell us the approximate strength or weakness of the environment we are trading.
- According to Dow Theory, the indices discount everything. The market indices present us with a consensus of opinion expressed with money invested in the market.
- To the experienced trader, the major indices will show the direction and strength of those opinions, as well as, when those opinions have changed.

the three major indices that compose the general market

1. **The Dow Jones Industrial Average:** Consists of 30 of the largest and most widely held public companies in the United States. The "industrial" portion of the name is largely historical — many of the 30 modern components have little to do with heavy industry.
2. **NASDAQ Composite Index:** Index of stocks listed on the NASDAQ stock market. It currently has over 4,000 components. Follows the performance of stocks of technology and fast growth companies.
3. **S&P 500 Index:** index containing the stocks of 500 large cap corporations. Presents a broader **more up to date** view of market action than the DJIA.

Professional market analysis

- Your odds for success will increase dramatically when you trade on the same side as the overall market.
- The best and only way to get a feel for market strength and true direction is to monitor volume and price action every day.
- Your goals for your market analysis are:

1. determine the trend, strength of the trend support and resistance levels and momentum
2. be able to recognize through price action and market internals, when the trend may be losing momentum, when it has reversed and when it should follow through.

the **tick** : measuring market momentum

- The TICK is an indicator that measures the number of NYSE stocks that are up ticking versus down ticking.
- For example if there are 1,000 stocks up ticking and 400 down ticking at that moment the TICK reading will be +600.
- Identifies market extremes intra day, identifies when institutions are active and alerts you when to decrease your activity level and when to lower your expectations for follow through (look for TEST type trades).

Considerations when monitoring the TICK

- Excessive pessimism and enthusiasm are usually seen at market tops and bottoms.
- +1,000 is considered overbought (exhaustion buying), -1,000 is considered oversold (exhaustion selling).
- Extreme TICK reading like this will indicate to you institutional order flow is present, you should be using more leverage and expect follow through.
- The zero line indicates a balance between up ticking and down ticking stocks.
- If the TICK does not read higher than +500 or -500, there is no institutional order flow, you should not be too active, not expect follow through, you should look for TEST trades.

More Tick considerations: momentum and order flow

- When the market makes new *highs* but the Ticks DO NOT, consider this a loss of momentum and buy the next pause less aggressively.
- If the market makes an attempt to test the previous highs and the ticks make a second or third lower high, consider this a potential change of demand order flow! You should be alert for a change of trend.
- When the market makes new *lows* but the Ticks DO NOT, consider this a loss of momentum and short sell the next pause less aggressively.
- If the market makes an attempt to test the previous lows and the ticks make a second or third higher low, consider this a potential change of supply order flow! You should be alert for a change of trend.

Trading with the TICK

- When the Tick has a reading of +1,000 or greater, expect that to be the extreme of up ticking momentum. *Scale out or book profits if long. DO NOT enter a new long here!*
- When the Tick moves from +1,000 you should be aggressive trading the next pullback expecting a successful test of the previous high, this is a very high percentage trade.
- When the Tick has a reading of -1,000 or greater, expect that to be the extreme of down ticking momentum. *Scale out or book profits if short. DO NOT enter a new short sale here!*
- When the TICK moves from -1,000 you should be aggressive short selling the next pullback expecting a successful test of the previous low, this is a very high percentage trade.

A chart of the Tick



Can clearly see here no reason to look for a short sale after 1pm.

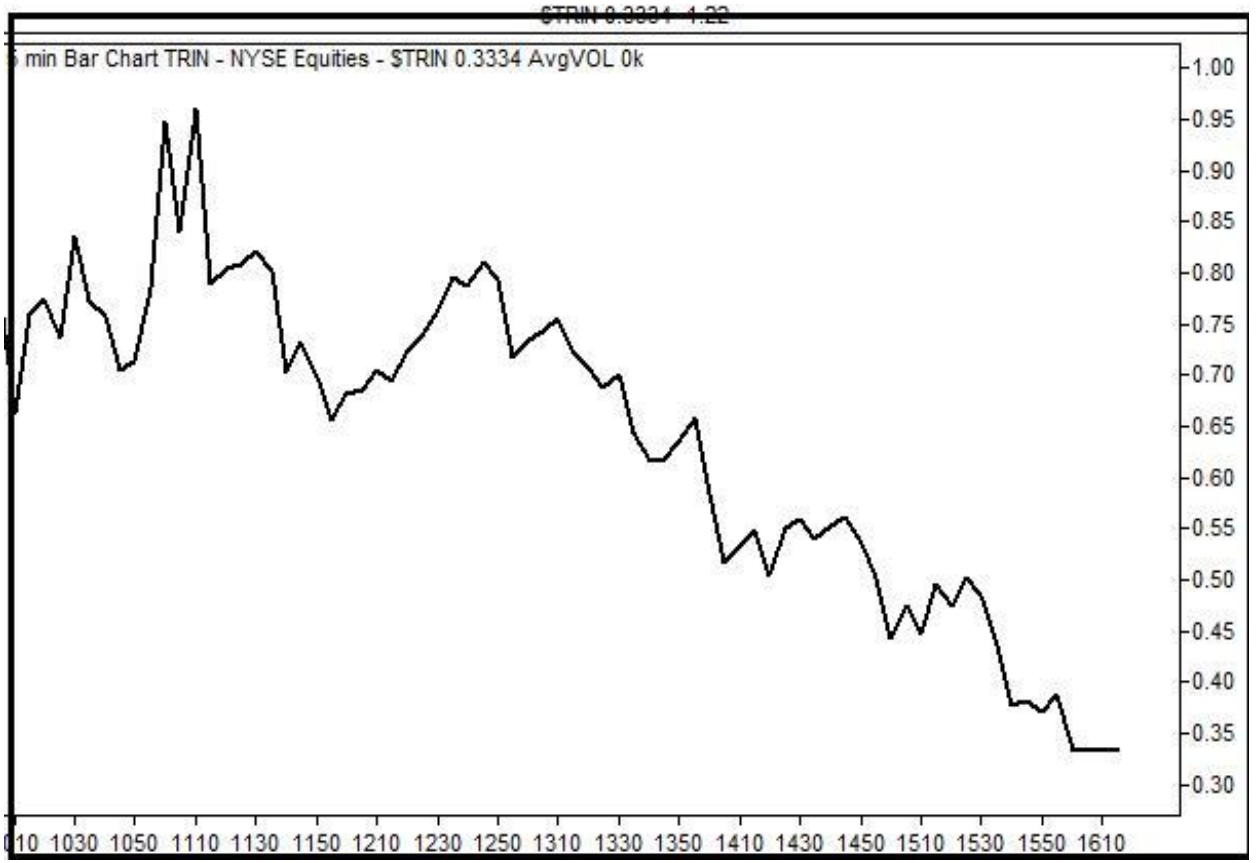
the **TRIN**:
measuring under the hood of the market

- The TRIN is a leading market indicator that displays an intra day snapshot of volume and price action to assess the true strength of the market.
- Measures the ratio of advancing stocks to declining stocks and compares it to the ratio of advancing volume to declining volume.
- A TRIN reading of 1.0 is considered neutral.
- We monitor the TRIN using a 1 minute line chart.

Considerations when monitoring the TRIN

- Because the TRIN is a *leading* indicator think of the TRIN as the markets "gas pedal."
- A TRIN reading above 1.2 is considered bearish. A TRIN reading below .80 is considered bullish.
- The trend of the TRIN is more important than the actual number of the TRIN.
- If the TRIN is **falling**, this is bullish, buying with volume is coming into the market.
- If the TRIN is **rising**, this is bearish, selling with volume is coming into the market.
- Drawing trend lines on your chart of the TRIN will help you to assess the bias and when it has changed.

A chart of the trin: very bullish



More Dow Theory: indices must confirm

- Originally written in 1932 as “The movements of both the railroad and industrial stock averages should always be considered together.”
- The movement of one price average must be confirmed by the other before reliable analysis may be drawn.
- Conclusions based upon the movement of one average, unconfirmed by the other, are almost certain to be misleading.
- The market has changed dramatically since then, but basic principles remain the same.
- In today's market this part of Dow Theory still holds true, but because of the complexity and volume, we replace the railroad with the NASDAQ and the S&P 500.

two special market scenarios

- One of the biggest mistakes a trader can make in trading today's equities markets is to draw conclusions based upon the movement of just one market average.
- If you are trading NASDAQ stocks it is a mistake to only watch the NASDAQ composite, if you are trading a listed stock, it is a mistake to only watch the DOW for a market opinion.
- Think of the three indices as legs of a stool. They are all working together and you can trust the stool, or if one leg is not cooperating and you can't expect it to hold up.

1. We started this chapter talking about the incredible daily volume in today's market, as active traders, we want to know if all that volume is on the "same page" or if it's not.

Scenarios we are monitoring for from the major market indices

- The price action we are monitoring is 2 day highs and lows.

a. We are watching today's high and low, and the previous trading days, high and low.

- Very simply, are the 3 indices making new **intra day** highs or lows together?
- Are the 3 indices making new **two day** highs or lows together?
- If they are **NOT** hitting these levels together, how do we use that information?

Scenario #1 CONFIRMATION

- All three indices are making new **intra day** highs or lows together.
- All three indices are making new **two day** highs or lows together.
- Monitor for when the NASDAQ, S&P and Dow are making new **intra day** highs (or lows) or **two day** highs (or lows) *at approximately the same time.*

1. When this occurs, you can *expect* a move of significance in that direction.
2. This means you can anticipate squeezing more out of an existing trade, or adding to an existing position.
3. *You are expecting follow through.*

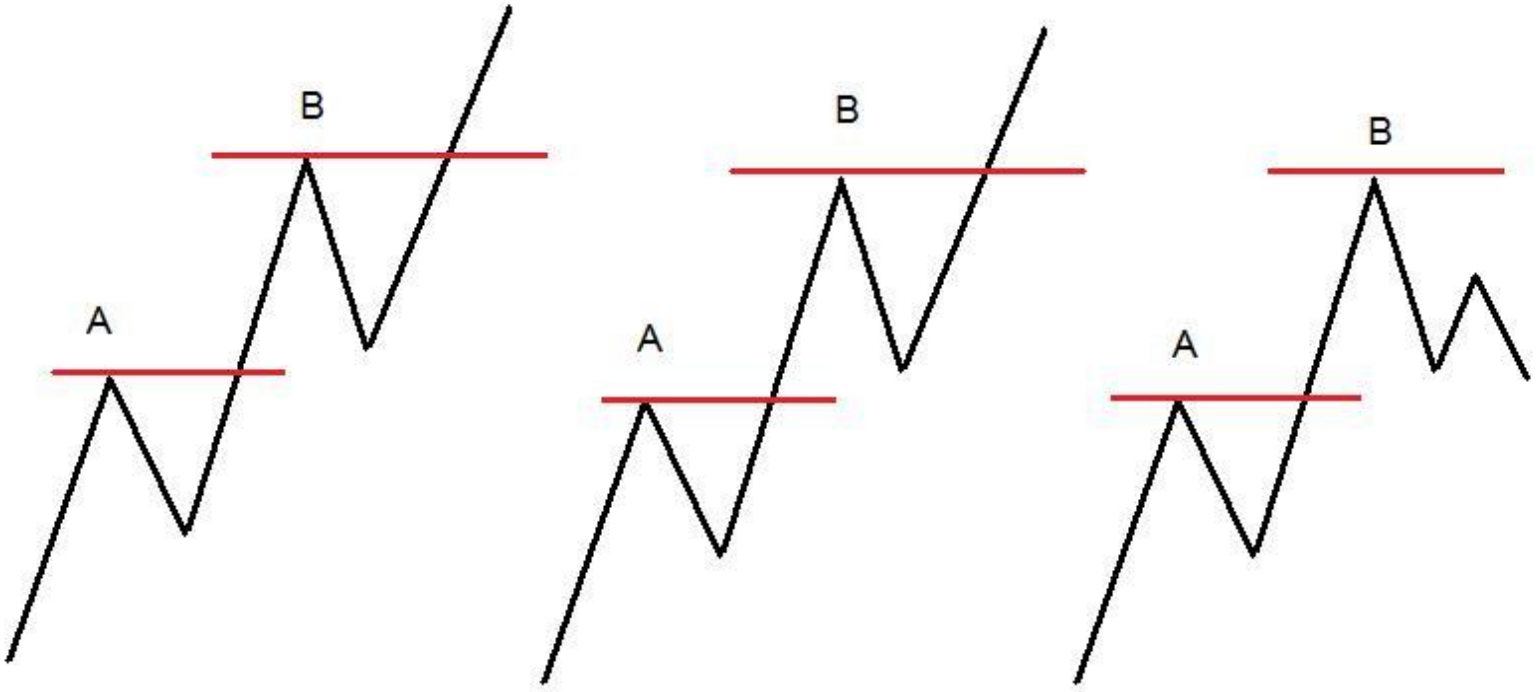
Scenario #2: DIVERGENCE

- **Any one** of the 3 indices is NOT confirming new **two day** highs (or lows), **intra day** highs (or lows) occurring in the other 2 indices.
- It could be any one of the 3 indices, on any particular day.
- For example: The Dow and the S&P are making new intra day highs, but the NASDAQ is not.

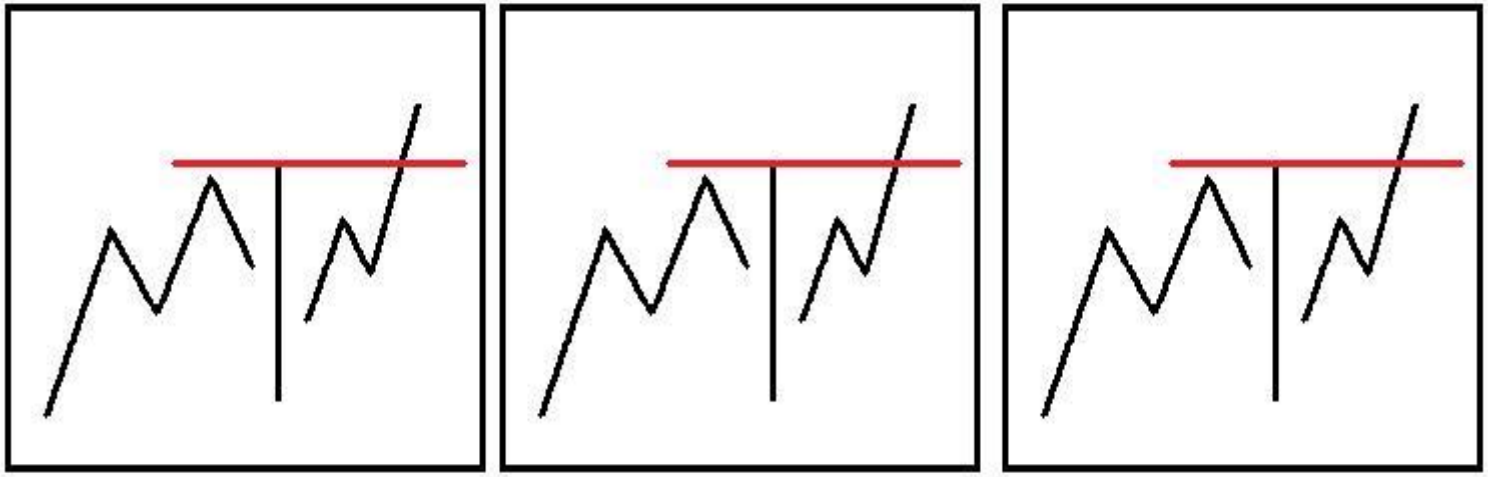
1. At this point, you can *expect* this to be a reversal of that new high or low.
2. **Do not** trade the direction of the break out or break down aggressively.
3. This is a potential change of trend for the **entire market**.
4. Look for a swing point or a U-Turn or melted candle in the **lagging market** to time the reversal.

confirmation/divergence: monitoring intra day

Point A all three indices confirming new highs, point B the last one is showing us a divergence.

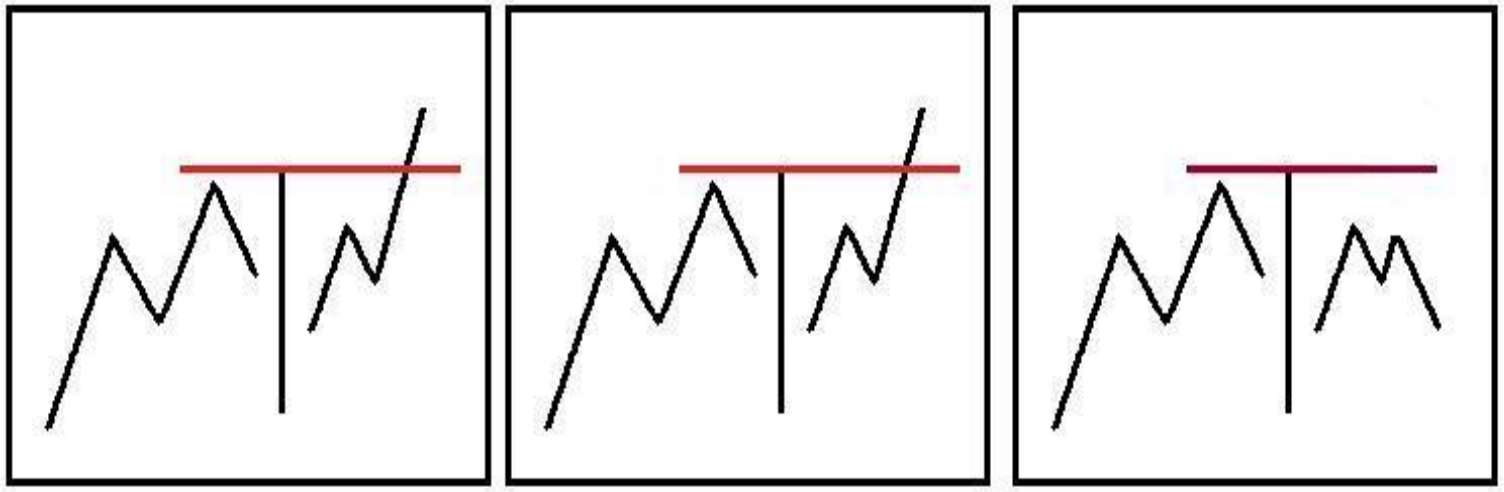


confirmation: two day



Two day confirmation: you can clearly see here that on the second trading day, all three indices are taking out the two day highs at the same time. This is a price action scenario where you can be agressive, expecting follow through.

Divergence: two day's price action

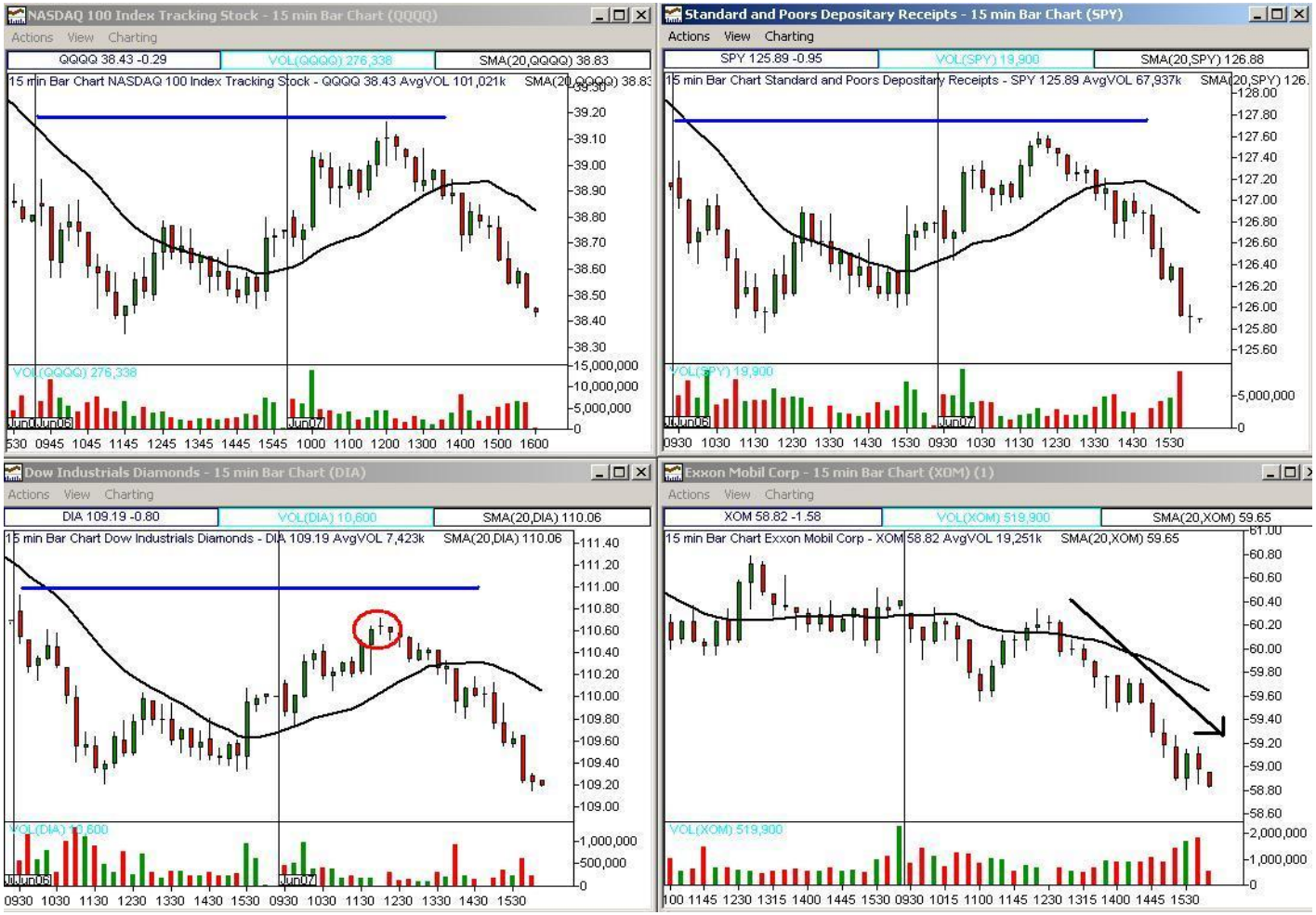


Two day Divergence: Here you can clearly see the price action of the third indice is NOT confirming the two day price highs of the other two. This is a DIVERGENCE, when you see this happen you will not expect follow through.

Sell Divergence (twice in 1 day)



Sell Divergence



Buy Divergence



Market analysis recap

- For an accurate picture of market action you should monitor the three major indices using MTFA (trends, support/resistance, momentum, price action phase)
- Use the TICK as a tool to anticipate the extreme of a move (+1,000 or -1,000), and to aid in gauging your activity level (+500 or -500 extremes), momentum divergence and a potential change of order flow.
- Use the TRIN to get a true gauge of the price volume relationship intra day and to filter out price fluctuations.
- Use Dow Theory Confirmation and Divergence to determine if the market should or should not follow through at new highs or new lows.

Chapter 15

Trading Psychology

Developing the winning mindset. Understanding what it takes to trade for a living.

Goals

- Learn the mindset for winning trading
- Learn why you don't need to predict the markets next move to earn a consistent living from the stock market.
- How to **think** like a profitable trader.
- Recognizing fear in your trading
- Defining discipline for a trader
- Steps to becoming a consistent trader

The winning mindset

- To have the winning mindset, **you must be willing to be successful**.
- To be a winner, you must learn what works and then have the discipline to apply it consistently. Knowing what to do and doing it is not the same thing, winners and profitable traders take planned purposeful action.
- In order to be a winner, you must always take responsibility for the outcome of every trade.
- You must be willing to make a commitment to think in terms of results, not feelings of progress.
- To produce results, you must learn from every single trade.

The profitable traders thought process.

- "I don't need to know what's going to happen next to make money consistently.
- It is much more important to know what I am going to do next, than it is to predict what is going to happen next."
- *** This of course assumes I have a written trading plan that I understand and believe in.*

Trading to win: control

- When you are trading to win, you will never feel the market “must” do something. If you are asking the market to do you a favor, get out of the trade, you are now hoping and no longer have any control over the outcome of the trade.
- Having the discipline to book a profit or loss without emotion is what separates the average trader from the one who takes home a check with consistency.
- When you are trading to win, you will move from one trade to the next effortlessly.

The effortless mindset

- Every trade should have the same mindset:

a. Identify what is probably going to happen.

b. Have a scenario in place for if the trade moves in your favor or against you.

c. Place the trade.

d. Let the market unfold.

e. Do what you said you would

f. Start at letter A again

Focused thoughts

- If you are ever in a trade that you are not confident about, ask yourself this question: "If I did not have the position, would I want it?" The best answer will always be the first one that comes to mind.
- Being right and trading to make money is not the same thoughts process.
- Eliminate thoughts of right or wrong based on profit or loss of the trade.
- Ask yourself this question after every trade: **"Would I take that trade again?"** If the answer comes back yes you are focusing on the process and the structure of the trade. You are on the track to success.

Trading nervous or with fear

- New traders often get nervous when they are in a trade. They **think** it is because they don't know what's going to happen next. They are trading scared.
- When this happens, what you actually fear is one of two things:

1. You don't know what you are going to do next under any circumstance
2. You know what you should do but don't trust yourself to do it.

- These thoughts usually stem from a desire to predict the next move. No one can predict the market, stop trying right now.

Focused thoughts for managing a trade

- Cut your losses and let your profits run: The proper thought process- you are fearful your losses will get bigger and hopeful your profits will grow.
- Cut your profits short and let your losses grow: The wrong (and most common) thought process- you hope your loss will come back and you are afraid your small profit will be taken away.
- It is crucial to pay attention to what you are focusing on when you are managing a trade.

What it takes to succeed as a trader/risk manager

- Understand your job is to monitor price action and volume to develop trade scenarios, asses risk and manage leverage, your job is not predictions.
- It is absolutely imperative that you are disciplined and patient, both to wait for good scenarios and while you are in a trade.
- Always remember that you can and should adjust risk (share size) while you are in a trade. If a trade moves against you quickly there is no reason to sit in a losing position with full size. It is much cheaper to get back in!
- Know what each trade could possibly look like in either direction before you enter.
- Be quick to take losses and slow to book profits.
- Understand you are placing trades based on what is *probably* going to happen, not what is going to happen.
- You must be completely comfortable with the fact that losing trades are a big part of the business.

Discipline: as it relates to trading

- Discipline: the ability to follow your plan.
- If your plan has an edge, it is a matter of following it to make money.
- This is easier said than done because most traders trade from ego and emotions.
- The only reason not to take a predefined loss is because you are trading to prove your analysis, instead of trading to grow your capital.

- Discipline applies to:

1. taking losses, booking profits
2. which stocks to trade, how to manage risk in each stock
3. when to be aggressive, when not to trade.
4. Managing hope, fear and greed
5. Doing homework, being prepared for the day

running your business

- All month you will be putting lines in the water so to speak, if the position does not work out, you take small losses and small profits or a flat. If the trades works out you will add to it and those are the trades that pay your bills.
- You must place trades to learn, it's the only way to learn. You must place trades to make money, you must get involved. Your #1 goal should be to distinguish between a good trading day and a tough one. Your # 2 goal is to learn how to manage a good trade.
- You will make consistent money because you are good, consistent traders are good because they are prepared and disciplined, not because they are lucky.

Stress free way to profits

- We have taught and mentored thousands of traders over the last 10 years and over 90% of those make the business much harder than it has to be.
- Unprofitable traders place trades and hope the market makes them money. If it doesn't they say "this doesn't work." They are not proactive while managing the trade.
- The consistently profitable traders that we have worked with over the years don't care at all if a trade doesn't make money. They spend their entire trading day assessing market conditions (strong/weak/flat) developing scenarios, placing a probability on the scenario based on the assessment of conditions and then place a risk amount based on all of the above.
- There is NO "right or wrong" in the thought process. There is only "how likely" is this going to follow through?
- Put on a trade and then reassess after the trade is placed. There is no stress because they are managing risk and probability. They are not trading to prove themselves "right."
- Relax when you are at your seat and constantly refocus your thoughts on the probabilities, not the outcome.

Chapter 16

Homework

Giving structure to preparation and a repeatable Game Plan.

Homework: a simple and repeatable GAME PLAN

- The bulk of this course has been about building a trading plan and how to implement that plan.
- Your homework is your game plan
- The game plan consists of:

a. Market review and sector scanning.

b. Stock scanning for tomorrows trades and "batting practice."

Market review

- Market review:
- Scan the major indices (Dow Industrials, NASDAQ and S&P500) using MTFA
- Is the overall market in an uptrend, downtrend or no trend? Where are they in relation to the 50SMA and 200 SMA on the daily charts? This will clue us into a longer term bullish or bearish bias.
- Is there confirmation or divergence on the daily charts?
- How is today's volume? Does recent price action and volume indicate accumulation, distribution or continuation?

Sector Scanning

- Scan major sectors or industry for obvious MTFA set ups: Trend or Pause?
- Identify the liquid stocks in those sectors and make note if they are similar to the sector chart. These stocks will go in your list for tomorrow.
- Which sectors were the strongest or weakest today?
- Which sectors have been the strongest or weakest this week? This month? This Quarter?
- Are they setting up a trade for tomorrow? A test, a flag, consolidation, or candlestick entry signal?

Stock scanning: building lists

- Make a list of the stocks in the Dow, the NASDAQ 100 and the top 100 stocks in the S&P500.
- Make a list of at least three market leaders in every sector you scan.
- Make note of the stocks making 52 week highs and lows. Are they breaking out on volume? Is there more than one stock in that sector doing the same?

Scanning your lists: on a treasure hunt

- You are looking for:
- Price action phase: is it obvious?
- Chart patterns: Daily charts setting up a longer term move you can trade tomorrow?
- Entry signals: Swing points, U-Turns, melted candle, fuel, exhaustion. Inside day. 20 day break out or break down. Test of support or resistance.
- Make a list of stocks you will be trading ***long and short*** tomorrow depending on market action.
- Make a scenario for each trade.

Batting Practice

- Every single night review a huge list of stocks for today's best order flow
- Identify the scenario, the entry signal and price, the stop loss ad the first profit target.
- Write down the order flow in the market at that time and what the market internal readings were at that time
- The purpose of batting practice to is to train your eye to identify the best order flow so you can take advantage of it as it occurs in a live market and to identify and stay away from weak order flow, thus eliminating mediocre trades.

Scenarios and trades to look for

- Swing high: down trending day tomorrow
- Swing low: up trend day tomorrow
- Melted candle: end of daily basic move
- Bullish U-turn: up trend day tomorrow
- Bearish U-turn: down trend day tomorrow
- Inside Day: break out or break down of yesterdays trading range
- 20 day break out or break down. If it is a “real” break, you should see light volume pauses leading to a continuation of the breakout direction. If you do not see this by 9:45-10am, expect a U-Turn type of day and many traders caught on the wrong side of the break out or breakdown.

Key Support and resistance levels

- Test of opening range high or low
- Test of today's high or low
- Test of yesterday's high or low
- Test of high or low for the week
- Test of 20 day high or low
- Test of any other significant support or resistance level on the daily charts.

Trade Scenarios: ideas for tomorrow

- I will buy a test of the two day low in the morning. I expect this to be support.
- The stock has been up four consecutive days and is coming into resistance. I will sell short if the resistance holds on the open.
- Volume breakout from consolidation today, I will expect follow through tomorrow.
- A melted candle formed in this stock today after a three day pullback, I will trade it long above the opening range tomorrow.
- Relative strength play: I will look to short these stocks tomorrow if a weak market or buy these if a strong market tomorrow.

Where to start

- As a new trader all this work can seem a daunting task, don't feel that way.
- You are on a hunt every night for money, be disciplined and persistent in your nightly routine.
- We strongly suggest that you go through the process of working on your game plan every night… **however, we recommend you have no more than 3-5 stocks to concentrate on each day so that you can pick the best of the best to trade.**
- One way to get consistent from the beginning is to pick a sector or two and focus solely on those sectors and the liquid stocks in those sectors. If you specialize and get to know the personalities of those stocks your confidence will grow quickly. You will be ready.