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TRADING ETFs

SECOND EDITION 2

GAINING AN EDGE WITH TECHNICAL ANALYSIS

DERON WAGNER

TRADING ETFs

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TRADING ETFs

Gaining an Edge with Technical Analysis

Second Edition

Deron Wagner

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For my lovely wife and children—Bee, Ben, and Ocean.
Thanks for the positive mental attitude and for always
giving me the inspiration to be the best I can be.

Contents

Foreword

Top traders rarely call attention to their many accomplishments, content to execute and perfect their own market views, free from self-promotion and outside noise. Deron Wagner is that type of rare individual, a two-decade trader and long-time fund manager, with unique market insights that are simple, profound, and highly actionable. For that reason, I'm pleased to introduce readers to the second edition of his book *Trading ETFs: Gaining an Edge with Technical Analysis.*

I first met Deron just outside a lecture hall in Dallas, TX back in the year 2000, right after the Internet bubble burst. He had just released his first book, at the same time that my first book, *The Master Swing Trader*, was set to hit the financial bookshelves. That brief meeting and industry chit chat fostered a mutual respect and partnership that has endured for the last twelve years.

For a good part of the last decade, I've been fortunate enough to publish Deron's daily market insights at my web site, "Hard Right Edge." It's been the site's most popular column throughout its tenure, hands down, but I'm not surprised because his technical proficiency reflects a depth of knowledge and confidence that inspires traders at all experience levels to return on a daily basis. Clearly it's become an invaluable tool in their trading methodologies.

In addition, Deron's long-time focus on exchange-traded funds (ETFs) has honed a market strategy perfectly in tune with today's fast paced derivative-driven electronic market environment. For that reason alone, I expect that readers of *Trading ETFs: Gaining an Edge with Technical Analysis* will gain valuable insights that are unavailable through any other market source, online or in print.

Don't be fooled by the apparent simplicity of Deron's systematic approach. Under the hood, he presents a powerful trading system based on classic market principles that work in euphoric bull markets as well as gut-wrenching bear markets. More importantly, these reliable strategies are unaffected by the computer-driven program algorithms we've come to know as high-frequency trading (HFT).

This is an amazing accomplishment in a challenging environment that's forced all types of market players to reassess the positive expectancy of their trading edges. This resilience offers another advantage in reading this excellent book. Simply stated, it will help your own strategies to overcome the dominance of lighting fast computer trading in the day to day price action.

So, whether you're a new trader just starting out on your journey, or a seasoned veteran looking for new insights and a stimulating read to get your performance back on the fast track, I'm proud to recommend this outstanding book.

Alan Farley
November 2011

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Finally, thanks to the entire team at Wiley for working hard to pull this all together!

TRADING ETFs

PART I

ETF Overview and Selection

CHAPTER 1

Why Use Technical Analysis with ETFs?

Unlike most books on exchange-traded funds (ETFs), this one offers you strategies based on technical analysis, not fundamental analysis. When I began trading professionally in 1999, before ETFs took the market by storm, people tried to convince me of the merits of studying fundamental factors, such as price-to-earnings (P/E) ratios, balance sheets, earnings growth, and news events. I've always believed that a deep knowledge of these items is theoretically important, but fundamentals seem to have a direct impact only on the long-term direction of a stock. In the short to intermediate term, the correlation between the actual price action of an ETF and its fundamentals is rarely significant. Technical analysis, however, tells me everything I need to know about the odds of a trade continuing in the current direction or reversing.

Because an ETF consists of a diverse plethora of individual stocks, using fundamental analysis of the underlying stocks to predict the price movement of the actual ETF brings less than satisfactory results. The only way to have a greater than 50–50 chance of predicting the short- and intermediate-term trends of ETFs is through sound technical analysis. This is why my hedge fund, Morpheus Capital LP, is one of the few professional hedge funds that primarily bases its investment and trading decisions on the technical analysis strategies I share with you in this book, rather than more traditional fundamental analysis and "long-term" investing. Although the techniques presented here are designed to work ideally with ETFs, individual stock traders can successfully apply the same techniques.

To understand the problems with a fundamentals-based system of analysis, consider the effect news events such as earnings reports often have on stocks and ETFs. How many times has a company reported what is perceived as a strong earnings report, only to see the stock price go down several points the next day? A positive price reaction to a poor earnings report is equally common. The increase or decrease in the price of the stock that can occur in anticipation of a positive or negative earnings report is one of the reasons these inverse price reactions occur. With technical analysis, however, news events are irrelevant to your analysis. The price and volume of the stock or ETF already tells you everything you need to know. If the equity has been trending higher for quite some time, odds are favorable that it will continue to do so.

Likewise, a stock or ETF stuck in a protracted downtrend will remain that way until the chart pattern proves otherwise.

I have designed this book to provide a logical, step-by-step process that enables you to easily master ETF trading using technical analysis. Whether you're a professional, full-time investor or someone who wishes to learn new techniques for actively managing his personal portfolio, you will benefit from the strategies.

In Part I, the first chapter provides you with a brief history of the growth of ETFs, which has made my strategies possible, as well as my thoughts on some of the advantages of investing and trading in ETFs instead of individual stocks. Chapter 2 describes the numerous fund families from which you can choose ETF products, as well as the unique types of ETFs that began coming to market around 2005. In addition to the popular ETFs composed simply of individual stocks, ETF offerings on the market now include currency, commodity, fixed-income, inversely correlated "short ETFs," leveraged ETFs, and even ETFs that are both inversely correlated *and* leveraged. There are also ETNs (exchange-traded notes), which are structured as financial instruments, similar to bonds but possessing credit risk.

In Part II, I dive into the "meat and potatoes of the strategy by showing you specifically how technical analysis is used to trade ETFs. Chapter 3 details my top-down strategy of ETF trading, which always improves your odds of success by identifying the overall trend of the broad market, determining which sector indexes are showing the most relative strength compared to the overall stock market, and then selecting the specific ETF family with the most relative strength compared to the corresponding sector index. Chapter 4 details the method of finding the sector indexes with the most relative strength. Chapter 5 drills down to the specific ETF families with the most relative strength, and Chapter 6 provides supplemental technical indicators and chart patterns.

After learning how to select the best ETFs for trading and investing, the next step is figuring out the proper timing for entries and exits into those positions. This is covered extensively in Part III. Chapter 7 provides strategies for determining ideal entry points, and Chapter 8 shows you when to exit your positions. Chapters 9 and 10 put it all together by graphically walking you through actual trades I have made using the strategies offered in the first eight chapters. The actual outcome of the trades, using real capital, is also presented. Chapter 9 discusses 10 actual ETFs I bought long. Chapter 10 discusses 10 ETFs I sold short. Many nuances of the entire technical analysis strategy can be gleaned from these two chapters, as they are real-life situations, not merely the theory behind the strategy.

In Part IV, I provide you with a host of pointers to help fine-tune your strategy after you put it into action. Topics such as position sizing, getting efficient ETF executions, and identifying relative strength intraday are all covered in Chapter 11. Chapter 12 provides some final thoughts and pointers to "take along with you." I encourage you to take your time reading the material, unlike a novel you might breeze through, so that you can fully digest the concepts presented. You may realize the greatest benefit through first reading the book cover to cover, and then going back and reviewing the more detailed sections to ensure you have a thorough understanding of the key points.

History and Growth of ETFs

Although you probably already have a basic understanding of ETFs, it's important to understand just how many options you have when selecting potential ETF trades. The astonishing growth both in the quantity and types of ETFs may surprise you.

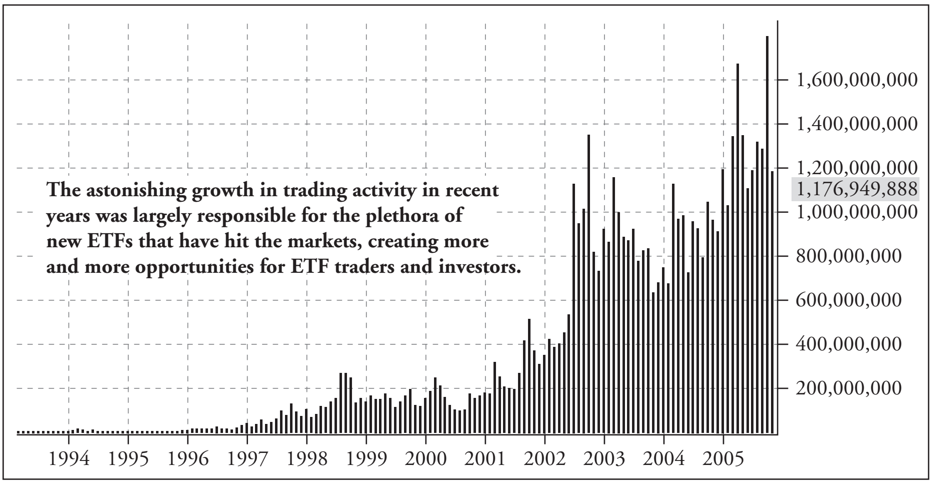
An exchange-traded fund is a basket of stocks that trades on an exchange with the same simplicity and liquidity of an individual stock. Traders and investors can buy or sell shares in the collective performance of an entire stock, bond, commodity, or even currency portfolio by buying or selling a single security. ETFs add the flexibility, ease, volatility, and liquidity of stock trading to the benefits of traditional index-fund investing. The American Stock Exchange (Amex) launched the first U.S.-based ETF in 1993 as a simple way for more aggressive retail investors to buy the entire realm of stocks that made up the Standard & Poor's 500 Index. Trading under the ticker symbol SPY, the Standard and Poor's Depositary Receipt (SPDR) was born. The Amex devised the ETF because it wanted to attract stock market investors who had become more interested in trading and investing in individual stocks than mutual funds. Although many investors enjoyed the high rates of return that individual stocks provided throughout the 1990s, many people still preferred the perceived "safety" that traditional mutual funds offered. Hence, the ETF was introduced as a way for investors to combine the potentially high returns of individual stock trading with the benefits of diversification that mutual funds provided.

In February 1994, one year after its official launch, SPY was trading an average daily volume of only 250,000 shares. Its popularity quickly spread, and the average daily volume of SPY increased more than 12 times to over 3 million shares per day by the beginning of 1998, five years after its launch. Although such a large initial increase in volume may seem impressive, it was only the beginning for the popularity of SPY. The absolute lows of last decade's equity bear market, which were set in October 2002, marked the largest percentage increase in the average daily volume of SPY. In October 2002, the 50-day average daily volume of SPY was 48 million shares per day. By mid-2007, SPY was already clocking in at more than 200 million shares trading hands on an average day. That represented an astronomical increase in daily trading activity of approximately 80,000 percent in 13 years.

The bear market of 2000 to 2002 was partially responsible for generating interest in SPY and other ETFs as investors grew tired of attempting to pick individual winning stocks during such adverse conditions and found it easier to simply choose an ETF that suited their goals. SPY and other major ETFs have seen a remarkable increase in turnover, which began accelerating parabolically in the years 2000 through 2006. To grasp the astonishing growth of the first domestic ETF, look at the volume bars on the monthly chart of SPY in Figure 1.1.

Thanks to SPY, the concept of having transparent exposure to an entire broad-based index through the simplicity of buying an individual stock caught on quickly. This popularity rapidly spurred demand for the launch of more diverse ETF offerings. A second domestic ETF was launched in 1995, and the rest is history. By 2003, just 10 years after the introduction of SPY, the number of domestic ETF offerings had

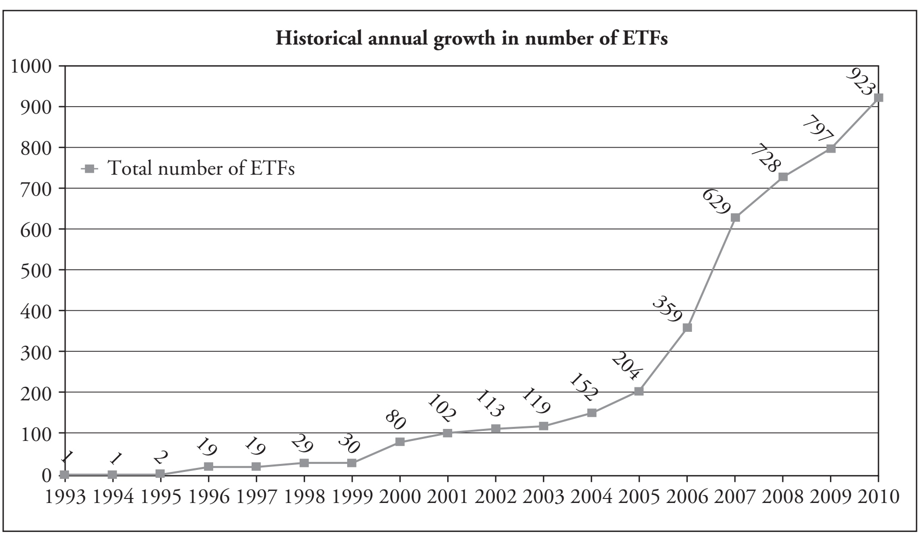
FIGURE 1.1 S&P 500 SPDR (SPY) Monthly Volume Chart from 1993 to 2006



Source: TradeStation

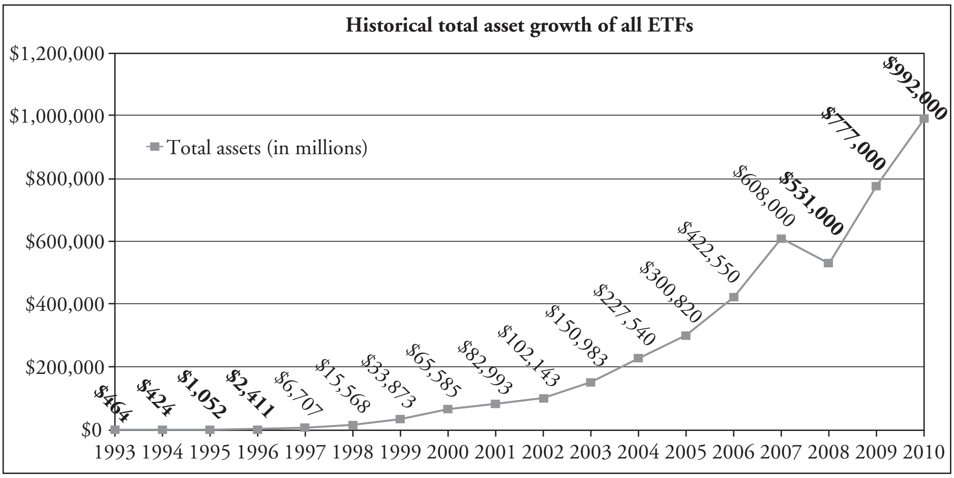
grown to 119. Four short years later, by 2007, the number of ETFs traded on the U.S. exchanges had increased fivefold to more than 600. As of the end of 2010, the number of ETFs had swollen to nearly 1,000. Now, as of July 2011, there are more than 1,000 ETFs. Figure 1.2 shows how rapidly the total number of ETFs has multiplied since SPY was launched in 1993.

FIGURE 1.2 Annual Growth in Number of ETFs since 1993



Data: Investment Company Institute (ici.org)

FIGURE 1.3 Total Combined Asset Growth of ETFs since 1993



Data: Investment Company Institute (ici.org)

But it's not only the number of ETFs that has increased dramatically: The total asset growth of ETFs has been equally impressive. Figure 1.3 illustrates the total combined asset growth of ETFs since 1993.

From 1994 to 2000, total assets in ETFs doubled every year. Since 2000, the growth has obviously slowed a bit, but combined assets are still increasing at nearly 50 percent per year. The only year with declining asset growth was in 2008, which was probably attributed to a sharp decline in global equity markets that year.

Considering that the birth of these innovative instruments began with a single ETF just 18 years ago, the growth is astounding. With no signs of waning interest, the asset growth shown in the preceding figure indicates that there is enough sustainable demand to continue meeting the constantly expanding number of ETF offerings.

The diverse mix of ETFs provides technical traders with more opportunities than ever. While you are probably familiar with the commonplace ETFs that track major indexes such as the S&P 500, the Dow, or the Nasdaq, it's important to understand the full range of instruments in your ETF trading arsenal. The next chapter looks at each of the major types of ETFs, as well as at the popular ETF families that constitute each type.

Trading ETFs versus Individual Stocks

Although I invest in and trade both individual stocks and exchange-traded funds, ETFs have some unique benefits over stocks. The following are the reasons I initially became attracted to trading ETFs as a great alternative to trading individual stocks:

Safety through diversification. Do you ever wonder if you are going to wake up in the morning and find out your stock dropped 50 percent because the CEO was