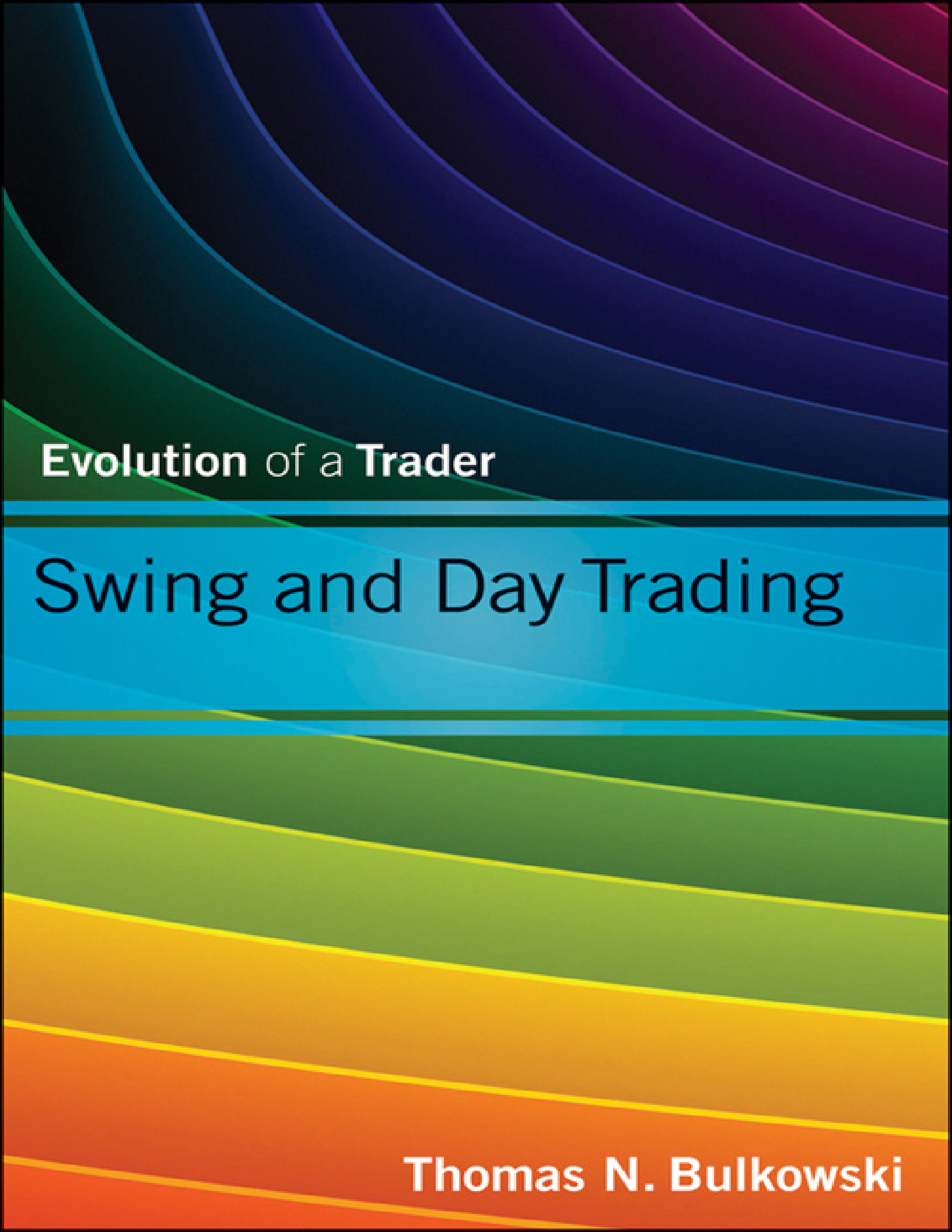




Evolution of a **Trader**

Swing and Day Trading

Thomas N. Bulkowski

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Swing and Day Trading

Evolution of a Trader

THOMAS N. BULKOWSKI



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Preface

Are you like John?

He learned early in life to save his money for a rainy day. Instead of putting it into the bank, he put it into the stock market. He bought Cisco Systems in mid-1999 at 35 and watched the stock soar to 82 in less than a year.

"I'm looking for my first 10-bagger," he said, and held onto the stock.

In 2001, when the tech bubble burst, the Cisco balloon popped, too, and it plunged back to 35. He was at breakeven after seeing the stock more than double.

"It'll recover," he said. "It's a \$200 stock. You'll see."

The stock tunneled through 35 then 30, then 20, and bottomed at 15, all in *one* month. When it hit 10, he sold it for a 70 percent loss.

"I should have sold at the top. Buy-and-hold doesn't work." But it did work. Cisco more than doubled, but he held too long.

Next, he tried position trading to better time the exit and chose Eastman Chemical. He bought it in 2003 at 14, just pennies from the bear market bottom, and rode it up to 21 before selling. He made 50 percent in a year. Was he happy?

"I sold too soon." The stock continued rising, hitting 30 in 2005. He disliked seeing profits mount after he sold, and wanted to profit from swings in both directions.

He switched to swing trading in 2005 and tried his old favorite: Cisco. The stock bounced from 17 to 20 to 17 to 22 over the next year, but he always bought too late and exited too early. He made money, but not enough.

He took a vacation from his day job and watched Applied Materials wave to him on the computer screen, inviting him to come day trade it. So he did. He made \$400 in just 15

minutes. “If I can make \$400 a day for a year, I’ll make”—he grabbed his calculator and punched buttons—“\$146,000! No, that’s not right. How many trading days are there in a year?”

He redid the math and discovered that he could make \$100,000 a year by nibbling off just 40 cents a share on 1,000 shares every trading day. “Wow. Count me in.”

After paying \$5,000 for a trading course and more for hardware, software, and data feeds, he took the plunge and started day trading full time.

It took a year to blow through his savings. Another three months took out his emergency fund. He moved back in with his parents while he looked for a real job.

Now, he is saving again and putting it to work in the market. “After reading the manuscript for this book,” he said, “I found a trading style that works for me. I’m a swinger—a swing trader. And I’m making money, too.” He handles not only his own money but his parents and siblings as well, providing them with extra income and building a nest egg for their retirement.

EVOLUTION OF A TRADER

John represents an amalgam of traders, a composite of those searching for a trading style that they can call their own. He suffered through many failed trades before finding a trading style that worked for him. I wrote the *Evolution of a Trader* series to help people like John.

Evolution of a Trader traces my journey from a buy-and-hold investor to position trader to swing trader to day trader as I searched for styles that worked best when markets evolved. However, these are not autobiographical. Rather, they are an exploration of what has worked, what is supposed to work but does not, and what may work in the future.

This series dissects the four trading styles and provides discoveries, trading tips, setups, and tactics to make each style a profitable endeavor. I have done the research so you do not have to. I show what is needed to make each style work.

CONTENT OVERVIEW

The three books in the *Evolution of a Trader* series provide numerous tips, trading ideas, and setups based on personal experience and that of others.

Easy to understand tests are used to confirm trading folklore and to illustrate ideas and setups, and yet the books are an entertaining read with an engaging style that appeals to the novice.

Each section has bullet items summarizing the importance of the findings. A checklist at chapter's end provides an easy-to-use summary of the contents and reference of where to find more information.

At the end of each book is a topic checklist and reference.

Trading Basics

The first book in the series begins with the basics, creating a solid foundation of terms and techniques. Although you may understand market basics, you will learn from this book.

How do I know? Take this quiz. If you have to guess at the answers, then you need to buy this book. If you get some of them wrong, then imagine what you are missing. Answers are at the end of the quiz.

From Chapter 2: Money Management

- 1.** True or false: Trading a constant position size can have disastrous results.
- 2.** True or false: A market order to cancel a buy can be denied if it is within two minutes of the Nasdaq's open.

3. True or false: Dollar cost averaging underperforms.

From Chapter 3: Do Stops Work?

1. True or false: Fibonacci retracements offer no advantage over any other number as a turning point.

2. True or false: A chandelier stop hangs off the high price.

3. True or false: Stops cut profit more than they limit risk.

From Chapter 4: Support and Resistance

1. True or false: Peaks with below average volume show more resistance.

2. True or false: Support gets stronger over time.

3. True or false: The middle of a tall candle is no more likely to show support or resistance than any other part.

From Chapter 5: 45 Tips Every Trader Should Know

1. True or false: Fibonacci extensions are no more accurate than any other tool for determining where price might reverse.

2a. True or false: Only bullish divergence (in the RSI indicator) works and only in a bull market.

2b. True or false: Bullish divergence (in the RSI indicator) fails to beat the market more often than it works.

3. True or false: Price drops faster than it rises.

From Chapter 6: Finding and Fixing What Is Wrong

1. True or false: The industry trend is more important than the market trend.

2. True or false: Holding a trade too long is worse than selling too early.

3. True or false: Sell in May and go away.

The answer to every statement is true.

Fundamental Analysis and Position Trading

This book explains and describes the test results of various fundamental factors such as book value, price-to-earnings

ratio, and so on, to see how important they are to stock selection and performance.

The Fundamental Analysis Summary chapter provides tables of fundamental factors based on hold times of one, three, and five years that show which factor is most important to use for those anticipated hold times. The tables provide a handy reference for buy-and-hold investors or for other trading styles that wish to own a core portfolio of stocks based on fundamental analysis.

Chapters such as “How to Double Your Money,” “Finding 10-Baggers,” and “Trading 10-Baggers” put the fundamentals to work. The chapter titled “Selling Buy-and-Hold ” helps solve the problem of when to sell long-term holdings.

Position Trading

The second part of *Fundamental Analysis and Position Trading* explores position trading. It introduces market timing to help remove the risk of buying and holding a stock for years.

Have you heard the phrase *Trade with the trend*? How often does a stock follow the market higher or lower? The section in Chapter 19 titled, “What Is Market Influence on Stocks?” provides the answer.

This part of the book looks at how chart patterns can help with position trading. It discloses the 10 most important factors that make chart patterns work and then blends them into a scoring system. That system can help you become a more profitable position trader when using chart patterns.

Six actual trades are discussed to show how position trading works and when it does not. Consider them as roadmaps that warn when the road is bumpy and when the market police are patrolling.

Swing and Day Trading

The last book of the series covers swing and day trading. The first portion of the book highlights swing trading techniques, explains how to use chart patterns to swing trade, and explores swing selling, event patterns (common stock offerings, trading Dutch auction tender offers, earnings releases, rating changes, and so on), and other trading setups.

It tears apart a new tool called the chart pattern indicator. The indicator is not a timing tool, but a sentiment indicator that is great at calling major market turns.

Day Trading

Day trading reviews the basics including home office setup, cost of day trading, day trading chart patterns, and the opening range breakout. It discusses research into the major reversal times each day and what time of the day is most likely to set the day's high and low—valuable information to a day trader.

An entire chapter discusses the opening gap setup and why fading the gap is the best way to trade it. Another chapter discusses the opening range breakout setup and questions whether it works.

Ten horror stories from actual traders complete the series. They have been included to give you lasting nightmares.

INTENDED AUDIENCE

The three books in this series were written for people unfamiliar with the inner workings of the stock market, but will curl the toes of professionals, too.

Research is used to prove the ideas discussed, but is presented in an easy to understand and light-hearted manner. You will find the books to be as entertaining as they

are informative and packed with moneymaking tips and ideas. Use the ideas presented here to hone your trading style and improve your success.

Whether you are a novice who has never purchased a stock but wants to, or a professional money manager who trades daily, these books are a necessary addition to any market enthusiast's bookshelf.

Acknowledgments

So many people are involved in bringing a manuscript to life, and I play a small role. To all of those workers at John Wiley & Sons, I say thanks for the help, especially to Evan Burton and Meg Freeborn. They ironed the wrinkles and made the trilogy presentable, even fashionable.

CHAPTER 1

Introduction to Swing Trading

Swing trading reminds me of standing on the shore of an ocean, watching the waves. Each wave has a crest and trough—a swing from high to low or low to high that mimics the up and down motion of stocks. Swing traders do not try to surf that wave by riding near the crest, but by sailing their boat from trough to crest like in scenes from *The Perfect Storm*.

WHAT IS SWING TRADING?

There are two types of swing trading styles. The first is to range trade, that is, buy and sell as price bounces between a low and high price. If you know what a rectangle chart pattern is or a channel, then you can buy near the bottom and sell near the top repeatedly. I find that the profit potential of range trading is not exciting enough for me.

- Range trading is buying and selling as price bounces between highs and lows.

I prefer to catch a swing as soon as it starts and hold it until it ends. It is the same idea as a range trade but the high-low range is often much larger (if you are lucky) and you only trade it once.

- A trend trade buys near the swing low and sells near the end of a short-term trend (or the reverse: sell high and buy low).

Swing trading is trying to catch price as it moves between peaks and valleys. Another way to say this is that swing

trading is capturing the move between layers of support and resistance.

Why not just hold onto the stock and ride it? You can do that, of course, but swing traders believe that they can increase profits by participating as the stock oscillates up and down like waves on a pond.

Look at [Figure 1.1](#). If investors bought the stock at A and sold it at E, they would have made almost nothing since price did not change between those two points. However, perfect swing traders would sell short at A, cover at B and buy long, sell at C and go short, and so on, profiting from each swing of the stock. They could have captured roughly \$3 per share on each of the AB and BC moves, and \$2 on each of the CD and DE moves for a total of \$10 per share. That is not bad for a stock that ends where it begins.

[FIGURE 1.1](#) This trade shows a perfect entry and sale on the day the stock peaked. Trailing stops mark the way higher.



WHO SHOULD SWING TRADE?

As the hold time for a trade shortens, there is less room for error. You can ignore a stock for years using a buy-and-hold strategy and still turn a profit. With swing trading, a trader's skills need to identify turning points with accuracy. One mistake can be costly, which is why stop placement is important.

Swing trading demands a different personality than the longer hold time brethren. While a buy-and-hold investor watches autumn leaves changing color on the back porch, a day trader is injecting caffeine and hanging onto the computer desk, knuckles white. A swing trader is not as nervous as a day trader, but you get my point. Swing traders have to pay closer attention to their trades than do those with a longer hold time horizon.

One novice swing trader I know waits for his favorite stocks to drop by 20 percent before he buys. Then he closes his eyes and waits for them to recover, hoping for a 30 percent move before he cashes out. He turned an investment of \$25,000 into almost \$100,000 in a year using this simple idea.

He has three keys to success. First, he chooses to ignore mistakes. If the stock continues to drop, it turns into a buy-and-wait-for-recovery trade, praying for breakeven. Second, the stocks were also cheap, in the \$2 to \$4 range (like Citigroup) with high volatility. In the days of the banking crisis (2009), he could peel off a 30 percent gain in about three days, but would become trapped in a loser for weeks. Fortunately for him, his picks recovered and allowed him to minimize losses. Third, the banking industry was in turmoil, making large swings every few days, catering to his trading setup.

He enjoys this fast-paced trading action. It is not day trading, so he can still monitor his stocks a few times each day from his day job without getting into trouble. Recently, though, the setup has not been working as well as in the past. He has moved from banking stocks to housing stocks, and those do not bounce around as much. Any recovery for a losing position now takes not weeks but months.

- Swing trading is best suited for people who are accustomed to using stops and like to follow the market daily.

A SWINGING EXAMPLE

Perfect trades are rare, but I have made a surprising number. I am not claiming to be a perfect trader—not by a long shot—but the timing on some of them is well done. A trade in Exxon Mobil Corp. (XOM) is a particularly good

example of a nearly perfect swing trade. [Figure 1.1](#) shows the setup.

On one of the passes through the nearly 700 securities that I look at, I spotted a rare bird: an ascending triangle. Normally I dislike trading ascending triangles because price rises 5 to 10 percent before reversing.

I logged the ascending triangle into my database two days before the breakout and then started my research. After looking at other stocks in the industry, I concluded that the oils were boiling, and I wanted to participate. I placed a buy stop at 52.06, which is a penny above the top of the triangle.

I scored the chart pattern and this one had a -1 score, meaning it was unlikely to reach the 65.91 price target.

Using the height of the chart pattern projected a more conservative target of 55.20, a gain of about three points over the expected fill price. I will explain the measure rule for calculating price targets in Chapter 3 (under the heading “Measuring Swings”).

The company released earnings the day before the breakout. The next day (E), the buy stop filled a penny higher because price blew the lid off the top of the ascending triangle.

I always assume a throwback will occur, but it did not. Price just kept on rising. After entering the trade, I placed a stop at 49.21 that same day. I positioned the stop below the bottom of the chart pattern using the minor low (D) at the start of January as the reference.

As price climbed, I raised the stop as the chart shows, to 51.07. On February 10, I raised the stop to 52.93, using a 62 percent Fibonacci retrace of the move up from January 28 low (51.11, two days before the breakout) to the current high of 56.62, minus about 25 cents.

On February 16, I raised the stop to 53.93, again using a 62 percent Fibonacci retrace to price the stop. Two days

later, I wrote in my notebook: “Stop raised to 55.93. I am getting nervous about the straight-line run, so I am tightening up the stop. A quick decline often follows a quick rise, so. . . .”

I continued to raise the trailing stop and ended with it at 61.15. However, in a late-day sell off, the stock blew through my stop and filled at 60.90.

On the day I sold, the stock reached a new high of 64.37, fulfilling the scoring system’s prediction that it would *not* reach 65.91.

Selling was the right move since the stock tumbled back to a low of 52.78 in less than three months. I captured a dividend payment during the hold time, giving me a net gain of 17 percent.

Why do I consider this a perfect swing trade? Entry was within 2 cents of the optimum breakout price and the stock peaked on the day I sold. Yes, the stop cashed me out near the low for the day, but that happens sometimes. Seeing the stock tumble after I sold gave me a warm feeling inside, but it could have been the jalapeños I ate.

- The ExxonMobil trade started with the breakout from an ascending triangle and ended using a stop.

LOOKING AHEAD

The pages that follow discuss the techniques that I use to swing trade and some tips from others. Since I like chart patterns, I will discuss event patterns and how you can profit from them. Those can be quite important for swing traders because the patterns have an opportunity to repeat periodically (such as every quarter).

The inverted dead-cat bounce is one of my favorites. Not only do you cash out when price shoots up, but you cannot beat the feeling of price confirming it by tumbling after you exit.

The event pattern is an easy way to capture profits. Sometimes price continues rocketing skyward after you sell, but the probabilities suggest a return to earth. I have developed a fondness for parachutes instead of moon shots. Perhaps you will, too, after reading about the inverted dead-cat bounce.

I have discussed busted chart patterns but they deserve another look. They represent a low-risk, high-success setup, and in Chapter 3 I discuss how to profit when you see them.

CHAPTER CHECKLIST

- Range trading is buying and selling as price bounces between highs and lows. See “What Is Swing Trading?”
- A trend trade buys near the swing low and sells near the end of a short-term trend (or the reverse: sell high and buy low). See “What Is Swing Trading?”
- Swing trading is best suited for people who are accustomed to using stops and like to follow the markets daily. See “Who Should Swing Trade?”
- The Exxon Mobil Corp. trade started with the breakout from an ascending triangle and ended using a stop. See “A Swinging Example.”

CHAPTER 2

Swinging Techniques

The key to swing trading is learning to identify when price is going to turn. If you can do that, then it is easier to profit from a move.

Figure 2.1 shows an example of how that key turning point works in action. In early November 2010, Boeing (BA) gapped down and made a straight-line run lower until it found support at 62. The speed of the decline and the support layer that it would slam into made me feel confident that the stock was due to bounce. But how high would it bounce?

FIGURE 2.1 A potential swing trade would have missed its exit price by just 4 cents.



My guess was that the bounce would carry the stock back to the bottom of the gap, stopping at 67.69 (the high the day before the gap). I considered taking a huge position in the stock to boost the profit potential, but decided not to. I paper traded it instead. Why I chose to step aside is hard to explain, but I just did not feel confident that the trade would work as I expected.

Entry would have been at about 63.35 (the open on the day shown), and I would have planned to exit a bit shy of the target, say 67.43 (below the round number 67.50), probably using a limit order.

Since the stock dropped like a stone through water on the way down, I expected (hoped, really) a *quick* bounce. Instead, the stock seesawed up and down, taking its time as it trended higher. Three weeks later, the stock peaked and reached a high of 67.39, just 4 cents shy of my exit price!

Although that sounds like a near perfect call, it is a lot like throwing horseshoes or hand grenades: closeness counts. Missing by a few pennies would have turned a winning trade into a less profitable one, certainly, and my guess is it would have been much worse.

Since I am an end-of-day trader, the best I could have hoped for would have been an exit at the open the next day, at 66.19. More likely, though, I would have postponed selling for another day, exiting near 65.50. A trade worth \$4 per share had turned into one making only about \$2. That is still a profit, but it hardly compensates for playing with hand grenades.

I made the right choice to watch this trade from the sidelines. The stock dropped back to 63 in short order and got stuck at 65.

This chapter will give you several tools to help identify those swings in a timely fashion. I will expand the tool count in the later chapters. My favorites are *support and resistance* and *trendlines*.

QUICK REVIEW: SUPPORT AND RESISTANCE

I dedicated Chapter 4 in *Trading Basics*, the first book of this series, to support and resistance, but the topic is worth a quick review. [Table 2.1](#) shows the percentage of how often the technical features work to stop price movement.

TABLE 2.1 Support and Resistance Summary

Description	Percentage
Horizontal consolidation regions showing support	55%
Horizontal consolidation regions showing resistance	41%
Corrective phase of a measured move up or down stopping power	35%
Peaks showing resistance	34%
Valleys showing support	33%

Gaps showing resistance	25%
Round number support and resistance	22%
Gaps showing support	20%

For example, a horizontal consolidation region (HCR)—which is when price travels horizontally and has either flat tops, flat bottoms, or both—acts as a support area and stops price 55 percent of the time. When it acts as overhead resistance, it is not as effective, stopping price 41 percent of the time.

HCRs top the list for effectiveness. At the bottom of the table are gaps. In candlestick-chart-speak, traders call them rising windows or falling windows, but whatever you call them, they do not work well, showing support or resistance just 20 to 25 percent of the time.

Determining where support and resistance will cause price to reverse is crucial to making money. Buy at support and sell at resistance is one way to swing trade (like the example in [Figure 2.1](#) shows). Another way is to sell short at overhead resistance and cover at support. Since price tends to drop faster than it rises (I described this phenomenon in *Trading Basics*, Chapter 5; see tip 23), you can make more bucks by shorting than going long. I am not recommending that you short stocks, just making an observation.

For more about determining support and resistance areas (and how to trade using them), refer to discussions of the following points in *Trading Basics*, Chapter 4.

- Price drops faster than it rises.
- Making money is almost as easy as determining where support and resistance are.

TRENDLINE TRADING

I discussed trendlines in *Trading Basics*, Chapter 3 (in the section “The Truth about Trendlines”), and showed how they