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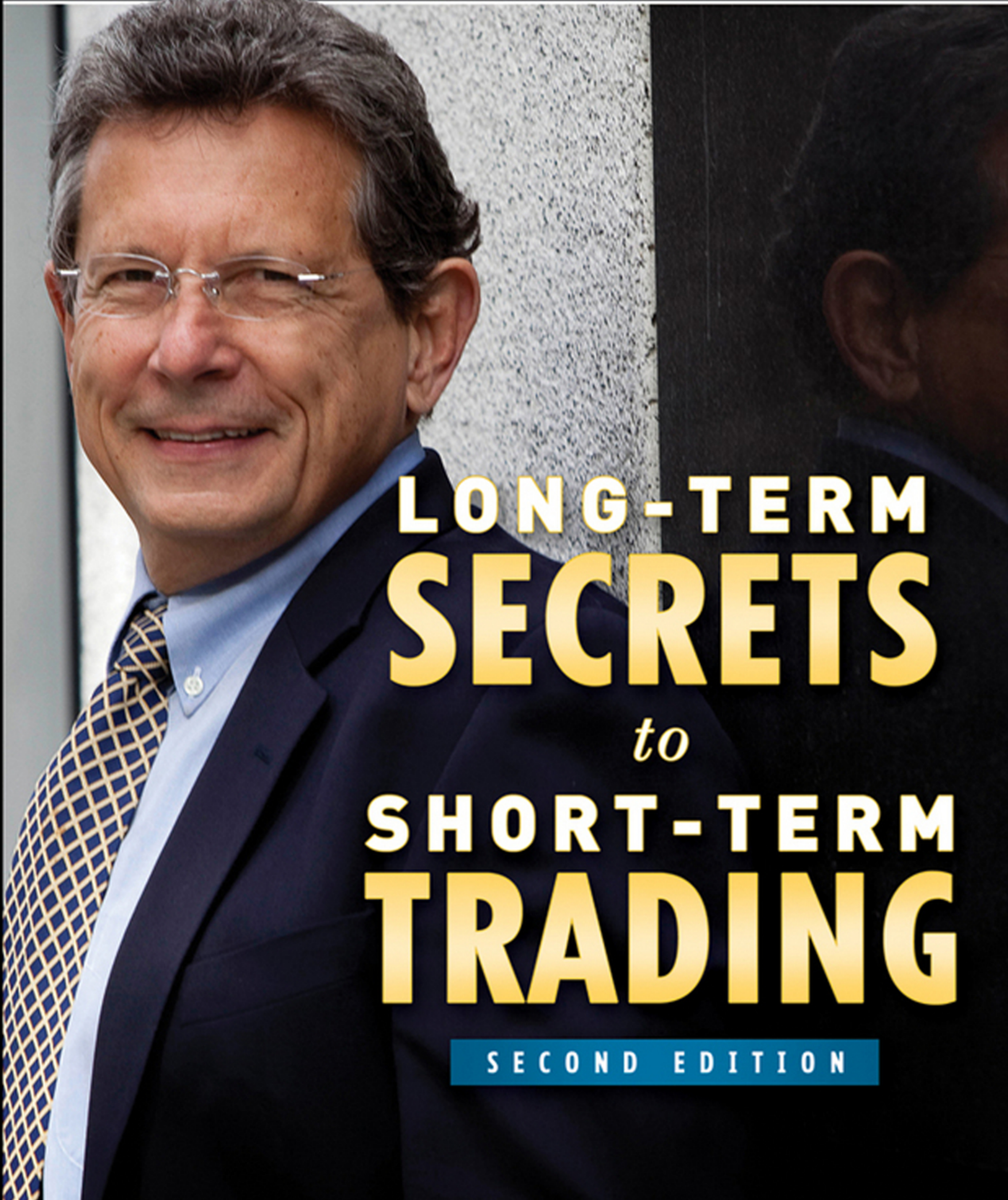

LONG-TERM SECRETS *to* SHORT-TERM TRADING

SECOND EDITION

LARRY WILLIAMS

Long-Term Secrets to Short-Term Trading

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With best wishes to all.

Larry Williams, 2011
St. Croix
US Virgin Islands

INTRODUCTION

You Are Already a Commodity Trader

In the ensuing years since the first edition of this book was published, more and more people have become stock, commodity, and Forex traders. The guy who does our yard work trades, as does my dentist and favorite chef. Why?

I suspect there is more to it than the thrill of speculation; now, more and more people want a *way out*. They don't want to be an employee, nor do they want to be a boss. They want to be independent and that seems to be possible only as a trader. It is a dream that many have followed, and which has become a surprising reality for countless traders. There is a way out . . . that's what this book is really all about: showing you the tricks and techniques of my craft.

Whether you know it or not, you have been trading commodities all your life. Sure, you may have never traded a contract of Pork Bellies, but you have almost certainly traded a possession like a car, house, or antique for someone else's money or possession. If you have never done that, for sure you have traded time for money. You have traded your time as a teacher, lawyer, pipe fitter, or ditch digger for someone else's money. So, you are halfway there, you just never knew it!

When we trade our time, we are actually trading our time plus our skills. That is why a brain surgeon gets more per hour than a knee surgeon. That is also why an outstanding quarterback gets more than a tackle and surgeon combined. He has a greater career risk. It is not that one skill is inherently more valuable than the other, it is that one is more difficult to come by and carries higher risk. This characteristic generates more dollars for the person selling his or her time and skills.

There is no intrinsic value to Michael Jordan's dribbling and shooting skills, but the owner of the Chicago Bulls saw an opportunity to make a great deal of money with those seemingly valueless skills by packing stadiums and getting television revenues. Thus, something of "no value" may have great value.

At a trading seminar, I once demonstrated this point by placing a personal check in a sealed envelope and then added it to 14 similar, sealed envelopes in a clear plastic bag. The attendees each had the opportunity to reach in and draw out an envelope. The person who drew the one with the $5,000 check would be allowed to keep it.

The bag contained 14 worthless envelopes, but suddenly they had value! Although all but one were empty, there was a 1 in 15 chance of winning $5,000; thus each envelope, or opportunity to take out an envelope, was worth $333.33. Once the participants began taking envelopes out of the bag, those empty, worthless envelopes gained in value. After all, once five empty envelopes were removed, there was now a 1 in 10 chance and the value had risen to $500. When just two envelopes were left in the bag, people in the audience were willing to pay $2,500 to dip their hand in and pull out an envelope! Suddenly, what was worthless had great value!

That is your first lesson in becoming a more aggressive commodity trader. Value, like beauty, is in the mind of the beholder. As a trader, the lesson is to never second-guess what value really is: It is what the market will pay. It (the market or collective judgment of other traders) may not pay that value for long, but price is king: It is what is. I learned long ago not to argue with what is.

In 1974, I reached a value judgment that the price of Cattle would skyrocket so I began loading up, taking my first position at 43 cents a pound. I “knew the value” of Cattle; at this price, it was way under value, offering a sure trade. So, as price drifted to the 40-cent area, I bought more. After all, if 43 cents was cheap, 40 cents was even better.

At 38 cents, where price next went, I had a steal, and being no dummy, I stole some more, only to see price plummet to 35 cents, then 30 cents, and finally 28 cents—where, dear reader, I was tapped out. My resources were limited; this move cost me about $3 million, all in less than 30 days.

Two months later, the price of Cattle soared to over 60 cents a pound. But I was not there—a sure-thing trade had set me back dearly and helped contribute to rumors, afloat still today over a quarter of a century later, that I blew out trading, despite a few successes I will get to later in this book.

Reflecting on this experience over the years has enabled me to formulate two important rules. The first is that value is ephemeral: It can be anything, and anything can and will happen when trading commodities, or stocks for that matter.

The second rule, which carries greater weight, is that although market trend and direction are major concerns, knowing how to deal with your resources has the highest priority. After all, had I marshaled out my resources on the Cattle trade so I could have ridden through the bad times, I would have made a respectable killing.

You never know when the markets will do what you think they are supposed to do. Many times, like God, the market does not deny, it just delays. Serious traders weave protection against this delay into the fabric of their program. There is no greater rule to learn than that of money management. All the horror stories you have heard about commodity trading are true. Good people have been totally wiped out by doing the wrong thing. That wrong thing has never been the market, nor the fact the trader made a bad call. Indeed, every successful trader will have bad calls and losing trades. And lots of them.

The wipeouts you have heard about, every single one of them, have come from placing too large a bet on a trade or holding onto a losing position too long. The sooner you learn to master your defeats, the sooner you will be on your way to amass the wealth that is possible in this business. It is your failures, not your successes, that kill you in this business. Failures do not build character; instead they destroy your bank account.

The foundation to all your success can be found in the preceding paragraph. Psychics may or may not be able to predict the market, and value may or may not prevail. The world of speculation is about predicting the future and that is difficult at best. The fabled U.S. intelligence community, which has supposedly bankrolled and trained the brightest of the bright, was not able to predict the fall of the Berlin Wall! So how can you and I hope to do better?

Our inability to see the future is proved yearly by such august sports magazines as *Sports Illustrated.* In 1997, their oracles predicted Penn State would be the number-one football team, ranking Michigan number 18. By the end of the season, Michigan was number one and Penn State was floundering. Washington was supposed to be number three, but was beaten by lowly Washington State, a team not mentioned in any top 20 list, that went on to win the Pac 10 championship and almost upset Michigan in the Rose Bowl!

History repeats itself; Mike Tyson is living proof of that. An interesting side note here: Montana's banker of the year, a few years back, was actually embezzling bank funds. To redeem himself and pay back the thievery, he took out another $1,000,000 to bet on "Iron Mike" Tyson, who of course lost the fight against Buster Douglas. The bank buster was tapped out, discovered, and went to prison.

Who could have predicted the demise of newspapers, or Tiger Woods?

People who make their living looking into crystal balls are destined to eat a lot of broken glass.

But take heart: Although neither you nor I can divine the future, especially price action, we can learn to control our losses. That is a certainty, based on math, that will provide the building blocks for your successes. Each and every one of them.

For years, I chased the prophets of profit, those financial soothsayers who claimed that they, or their indicators, could reveal the future. Eventually, I realized that God does not want us to see the future. It is as simple as that.

If we could see "out there," we could all be millionaires many times over. We would bet the ponies, spin the roulette wheel, and roll dice, except, of course, that no casino would back the other side of an unwinnable wager. Besides, how thoroughly boring would life become if we could know today how every day of our future would be? Who would want to live that way? Where's the joy of discovery, the magic of the unknown, the thrill of victory, the challenge of overcoming limitations?

If we could all be rich from our powers of foresight, who would work for us, grow wheat, or raise cattle? There would be no phone company, no movies, and no television, as no one would need to work. Worse yet, who would hire us?

As I have said, God in His infinite wisdom does not want us to know much about the future and, certainly, very little about the future of futures. Would-be speculators think that this is a game of knowing the future, of knowing what cannot be known. It is not.

This is a game of developing strategies with winning advantages, getting the odds on your side, working those odds, and staying alert to any potential changes in the game, including new players or new ideas and concepts.

The word *speculate* comes from the Latin *specular*, meaning “to observe,” as also found in the word *spectacle* (such as your eyeglasses). We are not like gamblers, who enter a game they cannot win over time. All they can do is hope that chance will run their way, not the way of the house. We speculators observe how things should happen in the future, but because we know there are no guarantees, we protect our positions with appropriate techniques to preserve capital, so that we can win at our game.

The art of speculation requires one part observation tossed together with one rather large dose of preservation.

MY MOST IMPORTANT MARKET BELIEF

Based on my research and experience, I have developed a powerful and profitable belief system:

> *I believe the current trade I am in will be a loser . . . a big loser at that.*

This continues to be my most important market mantra. Winners we can handle, it’s the losses that kill you.

This may sound pretty negative to all you positive thinkers, but positive thinking can give way to thinking you will win—a surefire formula for buying and selling too many contracts and holding on too long. After all, if you are positive things will work out, you are certain to hold for a bounce or turn that never comes.

I look at it this way: If you get all pumped up over positive beliefs about your market success, your conviction will lead you to mismanage losing trades. That is why belief systems are so important to a trader. If your belief system tells you that your current trade will be a winner—and it isn’t—the need to confirm that belief in your mind will literally force you to let losses run, to stay with losers, which is something that no successful trader ever does. An outrageously positive belief that the next trade or two will turn your account around or make a small fortune for you is most dangerous.

Now let’s look at my belief that the current trade I am in will be a loser, that I have no pact with God for success on this trade. Indeed, I genuinely believe the market is not precisely perfect. Keep in mind that the data for this belief overwhelmingly supports it: 75 percent of mutual fund managers do not outperform the Dow, 80 percent of short-term traders lose their risk capital. On a personal note, many of my own trades do not make money, and I can positively guarantee that many of yours will not succeed.

No major loss I have ever had, and I have had more than my fair share of them, has been the market’s “fault.” “They” were never out to get me. I got myself by believing my current trade would be a winner, which led me to neglect to follow the rules of the game.

I agree with those who say you are only as powerful as your belief system because that belief will give you the power of taking an action with more certainty and less hesitation. We act out what we believe: Those mental beliefs are the scriptwriters for our play of life.

Adopt my belief that the current trade will most likely not work out, and you sure as heck will protect yourself with stops. You will control disasters, taking the first lifeboat possible instead of going down with a sinking ship.

Adopt my belief that the current trade will most likely not work out, and you sure as heck will not load up on a trade, banking on it to bail out all your problems. A tiny loss can wipe you out when you have taken a very large position or number of shares or contracts.

Positive beliefs about future results cause us to take on undue risk. Doing that in a game where the odds are unfavorable to begin with is a sure invitation to disaster.

THE BEGINNING OF MY CAREER AS A SPECULATOR

I ride rodeo because I'm too lazy to work and too honest to steal.

——Freckles Brown, world champion bull rider

My career as a speculator began in the seventh grade when a kid named Paul Highland showed me how much money could be made flipping coins, matching quarters, or odd-man-out for the shiny silver dollars we lugged around in our Levi's. Growing up in Billings, Montana, was an excellent precursor to speculation. Flipping quarters was my start; sure I lost some, but if there was anything I understood, other than my art classes and playing football, it was that there was plenty of really easy money to be made gambling for quarters and dollars.

It may well be that everything I needed to know about speculation I learned in junior high school. It took a while, but I finally figured out that Paul and Virgil Marcum were taking my money by teaming up. One would control his coin so a head came up, the other a tails so I could not win. Later they split the proceeds, and I had my first lesson on market manipulation.

I did not call the police or any authorities. I handled it in my own way, and to this day distrust the bureaucrats that are supposed to right such wrongs. They don't . . . at least not in time to help you or me.

Jack McAferty was the toughest kid in Billings. Fact is, he was the toughest kid in the entire state of Montana and that's saying a lot, considering the number of cowboys, roughnecks, and miners we had in the Treasure State. When a big guy hits you on the arm it hurts. When Jack, who was not a big guy, socked you on the arm, your bone ached. He had unbelievable power, which served him well in every single fight I ever saw him in. No one came close. Fighting became his way of life, but Jack was killed by an L.A. policeman, supposedly on a freeway chase. The truth, however, is that Jack, a real ladies' man, had been dating the cop's wife.

Most of the guys who were coin-matching speculators would not play with Jack. Usually he would pay off and give you his quarter, but if he decided not to, what was your choice? Threaten him and get the living crap beat out of you? Ah, another lesson in speculation: Choose your partners and business associates carefully.

Years later, we took a $5,000 account to over $40,000 by trading a Cattle system that Richard Ulmer developed. This happened at a brokerage firm owned by George Lane, a guy who claims he is the originator of the widely followed Stochastics Index. Well, George did not invent Stochastic, and I did not get my $40,000 from the brokerage. The regulators closed old George up, and just before they did the funds were drained from my account!

Another thing I learned from Jack was that strong people do not respect weak ones. I had put up with enough of Jack's reneging on our coin flips so that when he decided not to pay up and kept his quarter, I blasted him in the stomach as hard as I could. Astonished, he glared at me, asking, "Why the hell did you do that? You know I'm going to clean your clock now."

All I could say was, "Well, go ahead and do it, I'm just tired of you not playing by the rules. I know you're going to break every bone in my body and you'll get a lot of pleasure out of that, but it won't compare to how I feel knowing I stood up to you."

Jack shot back, "I like that, I respect you," handed me the quarter I had just won, and walked away. We became pretty good friends after that, but we never matched coins again.

Everyone in Montana works hard. Certainly, my dad worked as hard as anyone, putting in over 40 hours a week, then more hours on weekends at Doc Zinc's stinky sulfur refinery. And as if that weren't enough, he would stay up late at night reading books, taking courses on electronics so he would be more valuable to Conoco, his career employer. The gambit of hard work and loyalty paid off—he got promoted.

One of the advantages of having a father working at the refinery was that his kids could get summer jobs there if they were in college. I did that, too, and it reinforced my strong desire to not do what these guys did: work. They worked long hours, ever-changing shift work. One week, you went to work at 3:30 PM, the next week at 11:30 PM, and the following week you might pull the 3:30 shift or start at 7:30 AM There was neither rhyme nor reason to the schedules that I could see. All I saw was the unending hours of voluntary servitude in a hot, stench-filled, noisy refinery, a place where nothing made sense to me.

There must be a million valves in an oil refinery and I am certain they all turn on and off the same way. My problem was I could never figure out which way was the right way. That was frustrating, not only because it showed my ineptitude, but also because it also reflected on my father, who had all this mechanical stuff down pat. There really was nothing mechanical he could not fix. If I were to have open-heart surgery, I would trust him more than a doctor.

Dad knew how to build things (our house, delicate cabinetry for Mom) and knew how to fix things—in part, I am sure, because we did not have money to pay to get things fixed. Poor people develop more skills than rich people.

My ineptness also held me up to ridicule when people compared me with my older brother, who just naturally knew what to do at the refinery, and seemingly got along well with the older men. My general laziness coupled with a desire to be alone and a total inability to do anything well, but draw, caused me to feel inadequate. My initial response to find self-esteem came from sports. But that sense of approval only lasts through the game. I would lay awake in bed dreaming, scheming about a way to have a better life, wondering how the few people with really big houses achieved success. I was not content; what I wanted was a way out.

Flipping coins seemed reasonable; making fake driver's licenses (for $5 each, and fake birth certificates for $20) paid a lot better. My limited artistic talents made more money and let me work by myself. It also included a healthy dose of risk. I liked knowing that I was doing something the average person couldn't or wouldn't; and I certainly was not going to find that kind of satisfaction in what I saw at the time as my father's humdrum existence. My dad did everything by the book and followed all the rules—with one exception.

When deer season came, the rulebook went out the window. We killed enough deer, antelope, and elk to feed our family for the year. We used the same deer tag or license three or four times. When it comes to survival, I learned there are no rules: People must take risks, even my Pops. What did I like most about those hunting trips: bagging my deer or taking the chance of getting caught with too many deer, fish, or other game? I have often thought about that. In their own way, they are both thrilling—my speculative career began on a roll.

Really good speculators like thrill, indeed they seek it out, as some sort of intellectual rush.

Maybe that is why I liked selling newspapers on the street corners after school, or selling Christmas cards and garden seeds door-to-door to pick up spending money. I was at risk, never knowing if I would make a sale, but I also might make some decent money for just being there, talking, and showing some stuff.

I had seen enough hard work to know I did not covet it. Like rodeo riders, I was "too lazy to work" and had been raised to be "too honest to steal." Hence going to college or joining the Navy after high school seemed to be the right direction, and it was one that my mom and dad encouraged. They always told us to do better, that there was an easier life, and that college was the door to that life.

In 1962, I asked someone what the "most active" list of stocks in the newspaper meant. I was hooked when he replied, "Well, see that the stock for General Motors was up 1.5 for the day? Had you bought it yesterday, you would have made $150 today."

$150 in one day!

Wow, this sure beat flipping quarters! Back then, $150 was more than guys at the refinery made in a week. This looked easy, and the winnings were staggering. My only two questions were, how did one get started and where had I been all my life? There was an instant affinity between me and what looked like easy money!

That affinity led to the greatest challenge of my life, something I have worked hard at just about every day since 1962. Really, my only time off from the markets occurred when I ran for the U.S. Senate in 1978 and 1982. Other than those two interruptions, I have spent every day of my life "working," much to my father's pleasure, I am certain, but it has never resembled work at the refinery or the jobs I held during and after college.

From this experience, I believe three motivators are found in the heart of a successful speculator: an intense desire to make a lot of money, a longing or yearning to show somebody else up, and an internal discontent with how things are. Great big chunks of unrest seem to be an important asset for a speculator. Although most people seek balance in their life, I have never found that very healthy; no great achievements were ever made by perfectly normal people. Sometimes I think about living a more balanced life. That thought usually lasts a couple of seconds. I guess my unrest will never go away, but if my lifestyle suggests anything, it is that unrest fans the flames of a speculator's internal fires.

THE RIDE OF A LIFETIME

I would probably trade the markets without wanting profits if it proved my worth to the world, to an old girlfriend, to my parents, my brother, or even to someone I cannot identify or dredge from the recesses of my mind. Saying I am ego-driven may be correct, but it is not about bragging, it is about showing them that I can overcome adversity.

It is about letting the world know that I found a way out. This book is about showing you that same door; it is about showing you what I learned over the past few years, how the markets have changed, and what we can do to continue as successful traders.

There is so much more I have learned in the past few years; above all, I have learned to adapt to market changes, so you will be learning more than a few more *Long-Term Secrets to Short-Term Trading* . . . you will also learn the art of adaptation.

If these words have resonance for you, cinch up your seat belt, you are going on the ride of your life.

The ride has continued for me, while most who are my age, the cusp of 70 years now, are retired and content to surf the Internet and doze away while watching *American Idol*. I am still fascinated by these damn markets. They keep me alive and thinking as I continue to trade, often more than 1,000 contracts a month. You can read more about these exploits on my web site, www.ireallytrade.com.

The markets keep you alive; I cannot imagine another way to live or a life more fortunate than the one I have.

My father's great life lesson to me was this: "Son, you only get out of life what you put into it." If you want to succeed at speculation, give it your heart and soul. The rewards run deep.

CHAPTER 1

Making Order Out of Short-Term Chaos

There are two primary ways we make money trading: catching a big price move with a small position or having a large position and catching a small move.

—Bill Meehan

If what I have written so far has meshed with your speculative goals, it is time to learn how markets operate. Speculation—stock and commodity trading—is not for everybody; it may not be for you. I have even wondered at times if it is for me!

It's striking how little has changed in this chapter. The concepts presented here are the same now as 10 years ago, or 20, or 100. This is the foundation for my trading. My view is that there is definite market structure and a map or way that price moves from one point to another. Once you identify that, it will hold just as true in the pit session markets as it will in the electronic session markets. There is a language to how prices move that is based on an alphabet of each day's opening, high, low, and closing price. It has been my mission to decode these hieroglyphics so we can all "read" the markets better. I am still at that task, like some archeologist hunched over the Sumerian Records, seeking truth.

The curve ball we have been thrown since the first edition of this book is this: Thanks to computers, trading pits have given way to electronic trading. These new electronic markets now open somewhere in the world just a few hours after they closed. The influence of pit trading in open outcry markets has vanished.

HOW I LEARNED ABOUT THE MARKET

My career as a trader began in Portland, Oregon, where I had met a Merrill Lynch broker who thought we could make some money together. He was half right: We got lucky immediately. He made good money on his commissions and I lost money. Worse yet, the money wasn't mine; a fellow I had never met had asked me to invest it. In hindsight, the initial beating I took was more than fortunate, it was life changing.

That event hardened my desire to learn the business; after all, if it was that easy to lose, it had to be pretty easy to win, right? My broker was as new to the game as I was and really had very little advice or suggestions. His market insight was to buy good stocks and hold on to them (a brilliant insight), but my aptitude or desire was to make money from catching short-term market swings. Thus began my education as a short-term trader.

I had no teacher and knew no other traders, so I naturally turned to books to help solve my problems, just as you have in buying this book. The authors all made it sound so easy. I read Joe Granville's classic work on technical analysis and began keeping track of daily open, high, low, and closing prices on stocks as well as other indicators that Joe said we should follow. Joe, a true legend, is still worth reading. Before I knew it, I was not only totally consumed by the markets but spending five to six hours a night and all my weekends trying to beat Wall Street, in the meantime gaining a fortune and beginning to lose a marriage.

My first wife, Alice Fetridge, had become a "chartist's widow" yet still supported my habit. We eventually left Portland and moved to Monterey, California. We both had jobs, and I was also working on my law degree. I even sat for and passed the "Baby Bar Exam" (the test given to night school and correspondence students). By then, however, I had pretty much given up on becoming a lawyer, especially after working for one. I had thought being a lawyer meant being in court, saving people's lives; the reality was that it mainly meant collecting money from judgments, finding deadbeats, and representing bums and outright criminals. It was not like trading.

Fortunately in Monterey, I met two brokers who, like me, kept charts. Joe Miller and Don Southard were soon swapping war stories with me, teaching what they knew about the markets. We were all big followers of Joseph Granville's on-balance volume (OBV) work and kept OBV charts on the 30 to 50 stocks we followed. I also started to keep moving averages, another tool espoused in all the books back then, just as they are today.

My stock trading met with some success, but what accelerated my career was a book by Gil Haller, unabashedly called *The Haller Theory of Stock Market Trends* (Gilbert Haller, 1965). I learned a lot about stocks and speculation from the book, then got to know Gil and to this day appreciate the support and encouragement he provided. Gil's concept—we are talking 1963—was to buy stocks that had already moved up a lot. This is now a methodology used by the funds to buy what they call "momentum stocks." Haller was doing it way back in 1964 and making a living. But, he didn't live the way I wanted to! His desk was an old door atop cinder blocks, stationery was the back of a letter someone had written to him. Gil was not cheap, just a frugal spender who precisely counted and saved every extra penny.

Eventually, I began to envision a theory of how markets work: In the short term, markets spurt in rallies and declines, moving above and below a balance point I could call the "average" price. My object was to determine when price was low and should move back to the average. That meant I needed to identify an overextension of price and then have something that would tell me when this move was over and the spring back to the average had begun. Because it all seemed so easy, I was sure there must be some master theory or code to how all this was done. There must be some basic undeniable way the market—all markets—moved from point A to point B, I reasoned.

What I eventually found out is that this original thesis is true: There is a way markets move. The good news is that there is a structure in how prices move from point A to point B. The bad news is that the structure is imprecise. Nevertheless, there is a semblance of order to price action, and, like a foreign language, it can be learned. It has taken most of my life to figure out the basics of this language that the market speaks, and I am more than happy to help you learn to use my magic decoding ring.

CHARTING THE MARKET

If you have begun your study of the markets, you already know it is a visual world, where charts prevail. As shown in Figure 1.1, the common charts represent each day's opening price with a horizontal slash mark to the left side of each bar and the closing price with a horizontal slash on the right side of the bar. The topmost point of the bar reflects the highest price reached by the stock or commodity during the day while the bottom of the bar represents just the opposite, the lowest price the commodity traded at on that day.

The opening price, as you will see later on, is the most important price of the day. I developed this notion with Joe Miller, Don Southard, and Curt Hooper, a naval postgraduate student who—in 1966—was the first person I ever worked with while

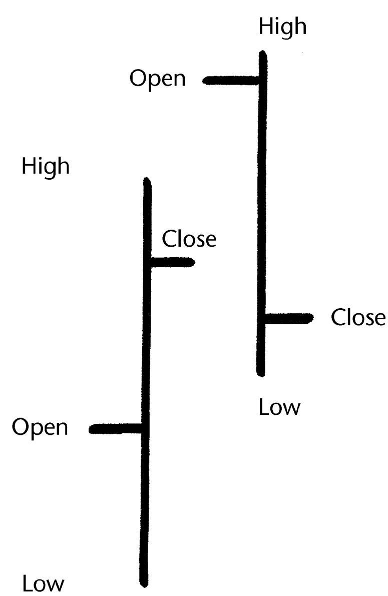

FIGURE 1.1 Typical Chart Showing Openings, Closings, Highs, and Lows

using a computer to arrive at answers. While we were impressed with OBV, we wanted a more reliable formula, and once we learned that the original OBV work came from two guys from San Francisco, Woods and Vignolia, we thought that we, too, could create a better approach.

Our chart-reading problem begins and leads to chaos when we start combining these daily bars of price action on a chart. These graphic representations of price action were “read” for years by folks calling themselves “chartists.” By and large, chartists were about as welcome as your unemployed brother-in-law until the early 1980s.

This crowd gleaned over chart formations, found patterns, and gave them names like wedges, head and shoulders, pennants, flags, triangles, W bottoms and M tops, and 1-2-3 formations. These patterns were supposed to represent the battle of supply and demand. Some patterns indicated selling, others professional accumulation. Fascinating stuff, but wrong-headed. These same precise patterns can be found in charts of things that do not have a supply/demand factor.

Figure 1.2 shows a chart of the 150 flips of an old silver dollar that graphs out to look much like a chart of Pork Bellies. Next, Figure 1.3 is a chart or graph of temperature extremes, or is it Soybeans? Who knows? What we do know is that plotted data of nonmarket or economically driven information charts out just like data for stocks and commodities, producing the same patterns that are supposed to reflect buyers and sellers. I caution you against confusing chart forms with intelligence.

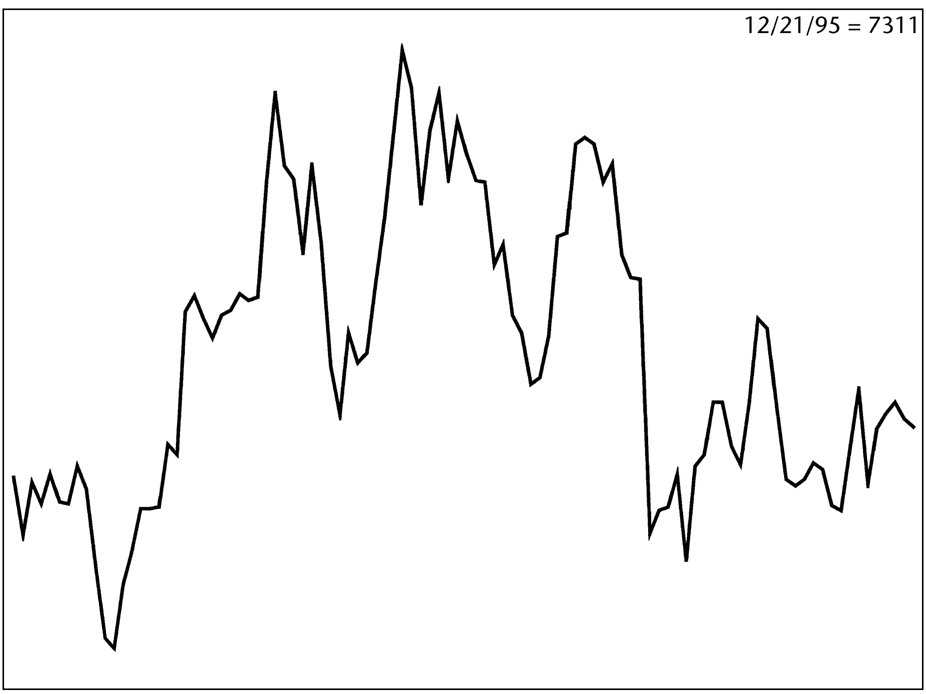

FIGURE 1.2 A Flip of the Coin Heads and Tails on Accumulative Basis

FIGURE 1.3 A Stock? No, Daily Temperature; High for the Day; Low for the Day; Last Reading

Chartists became "technical analysts," severing their ties from Ouija boards and charts in favor of computers. Computers made chartists look and sound more respectable, like scientists. In fact, many books came out with titles like *The New Science of . . .* or *Scientific Approaches to . . .* Is there science to this madness?

By and large, I think not.

Prices do not dance to the beat of some mystical, magical drum that hides deep in the recesses of a plush room in New York City, and has a rhythm only a few insiders recognize. Prices jump all over the place, and our charts become erratic because human emotions are influenced by news and brokers' hot tips of immediate boom or gloom.

THE NONRANDOM MARKET

For the most part, commodity prices are like a drunken sailor, wandering down the street without any knowledge of where he is going, or where he has been. Mathematicians would say there is *no correlation* between past price activity and future trends.

TABLE 1.1 Commodities: Closing Price Compared to Opening Price

Commodity	Percentage of Times That Close > Open
Bellies	51
Cotton	53
Beans	51
Wheat	52
British Pound	56
Gold	52
Nekii	55
Eurodollar	57
U.S. Bonds	52
Standard & Poor's 500	53
Average % Higher	53.2

My trading friend Vic Niederhoffer has written extensively about this to his beloved "Spec-List" followers as well as in his magnum opus, *The Education of a Speculator* (John Wiley & Sons, 1997). I suspect we differ on how prices meander around the charts, but I will suggest there is *some correlation.* Why? Because, although that drunken sailor does swagger, stagger, and seemingly move in a random fashion, there is method to his madness. He is trying to go someplace, and we can usually find out where. We must understand his madness to know where he is headed.

While price action involves a large degree of randomness, it is far from a totally random game. If I cannot prove that point, right now, early on in this book, the remaining chapters should be devoted to learning how to throw darts. In a random game, the dart thrower will outperform the experts.

Start with a given—if we flip a coin 100 times, it will come up heads 50 times and tails 50 times. Each time it comes up heads, on the next flip we will have 50 percent heads and 50 percent tails. If heads has now appeared two times in a row and we flip again, the results continue to be 50/50 that a head will appear on the next flip. As you have probably heard, the coin, die, or roulette wheel has no memory. The odds are fixed, as this is a random game.

If that were true of the market and prices close higher 50 percent of the time, then after each up close we would expect to see another up close 50 percent of the time, and following that up close again 50 percent odds of another up close. The same thing should apply to a down close: 50 percent of the time following one down close, we should see a repeat; and again 50 percent of the time following two in a row, a third down close should appear. In our real world of trading, it does not turn out that way, which can only mean *price action is not totally random!*

Table 1.1 shows the percentage of time that prices closed higher in a wide variety of markets. There were no criteria; the computer just bought on the open each day and exited on the close. Instead of having a 50/50 result we have a slight skewing, in that 53.2 percent of the time price closed higher than the opening. This shouldn't be.

Well, if this "shouldn't be," how about buying on the opening following a down close? In theory, we should see the same percent of up closes shown in Table 1.1. The problem is

TABLE 1.2 Commodities: Percentage of Times Higher Closing Prices Follow One-Down Closes and Two-Down Closes

Commodity	Number of Times after One-Down Close	% Up Next Day	Number of Times after Two-Down Closes	% Up Next Day
Bellies	3,411	55	1,676	55
Cotton	1,414	53	666	55
Beans	3,619	56	1,612	56
Wheat	3,643	53	1,797	55
British Pound	2,672	57	1,254	56
Gold	2,903	58	1,315	55
Nekii	920	56	424	60
Eurodollar	1,598	59	708	56
Bonds	961	54	446	52
Standard & Poor's 500	1,829	55	785	53
Average + Close		55.8		55.2

(for college professors and other academics who are long on theory and short on market knowledge) that it does not turn out this way. Table 1.2 shows the number of times price closed higher following a number of down closes.

This is not earth-shaking news to a trader; we know market declines setup rallies. The exact percentages were not known in the past, and I would never use these tables to take or stay in a trade. That is not the point: The point is we should have seen an average up close of 53.2 percent following the one minus close as well as two consecutive minus closes. The fact we did not suggests that the market is not random; patterns do "predict" and now we can proceed, sans darts.

Here is an update on the Dax index from 1998 to mid 2011: If you buy after every down close, and exit on the same day's close, there are 1,591 trades with 52 percent winners but a staggering loss: –$60,558. Allow for two consecutive down closes and we find 724 trades with 52.2 percent winners and we also see losses, but a lot less: –$1,568.

If you have the patience to wait for three down closes in a row you are rewarded with 334 trades, and 55 percent made substantial money: +$25,295. Want to do better than that? Some days of the week the Dax is more prone to rally than others, so let's buy only on Tuesdays, Thursdays, and Fridays when there have been three down days in a row. The results are far better: 204 trades, 58 percent accuracy, and a net profit of $44.795.

What you see is that years later and in a different market, not active when this book was first written, the same principles are still afoot in price action.

UNDERSTANDING MARKET STRUCTURE

Whereas chartists have strange names for almost every market wiggle and waggle, they have seemingly missed the major point of the market, which is that price (as represented by daily bars, where the top of the bar is the highest point prices traded on that day and the bottom of the bar the lowest price traded) move in a well-defined and amazingly mechanical fashion. It is similar to learning to read a new alphabet—once you understand the characters, you can read the words, and once you know the words you can read the story.

The first letter to master tells you what market activity causes the formation of a short-term high or low. If you learn this basic point, the meaning of all market structure will begin to fall into place.

I can define a short-term market low with this simple formula: Any time there is a daily low with higher lows on both sides of it, that low will be a short-term low. We know this because a study of market action will show that prices descended in the low day, then failed to make a new low, and thus turned up, marking that ultimate low as a short-term point.

A short-term market high is just the opposite. Here we will see a high with lower highs on both sides of it. What this says is that prices rallied up to the zenith of that middle day, then began to move back down, and in the process formed a short-term high.

I initially called these short-term changes "ringed" highs and lows in deference to the work done in the 1930s by Henry Wheeler Chase. In the days before computers, we kept

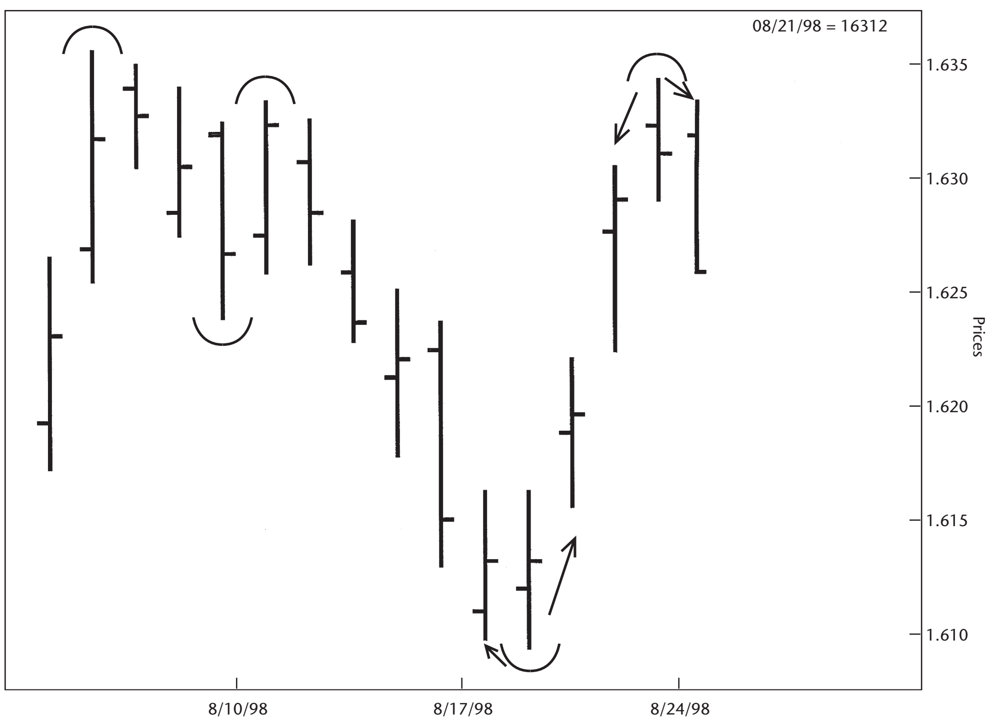

FIGURE 1.4 British Pound (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)