

# TUTORIALS IN APPLIED TECHNICAL ANALYSIS

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**The Australian Internet Trading Weekly with independent analysis**  
**INCLUDES SEMINAR DETAILS!**


Weekly for Saturday May 28, 2005 Based on Thursday's Close 21 pages

Edited by Daryl Guppy with contributions from T D'Angelo, L Wilson, and P Rak.

*Guppy Trading Essentials Chart pak, Metastock, Ezy Charts & SuperCharts. Data from JustData, Paritech, MarketCast & theNextView.*

## Stocks mentioned in this issue

MCC, XJO, ADB, CLV.

Note. The more computer icons  
 appearing after a section heading,  
the more advanced the material.

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## AVERAGE MANAGEMENT

By Daryl Guppy

Two weeks ago we started a new exercise designed to test the effectiveness of some new insights into crowd behaviour provided by the book **The Wisdom of Crowds**. For new readers, we include a reprint summary of the background to this exercise and the progress at the end of these notes.

So far we have used this process to select a stock, to set price targets, and this week, we take the test one step further with a new exercise for readers.

The core concept is that a diverse crowd making independent decisions about a single event is able to make a better judgement than a small group of experts. This is not a pooling of ignorance, but a way to combine the diverse talents of many people to reach a better decision. The collective wisdom of the crowd is not the result of discussion, argument, endless meetings, coordinated analysis, or agreement. It is an aggregate of individual guesses and calculations.

This idea suggests that the collective wisdom of all participants is a consistently better indicator of the 'best' choice than the choices of any single individual.

In the first week, we asked readers to select a stock from a list of stocks.

In the second week, we asked readers to vote on the preferred stop loss and profit target points. Again our objective is to gather diversified opinions, so voting is not restricted to those who voted previously. Anybody can participate in this test. Ask you friends, relatives and others to become involved.

We gave two questions to voters.

- Based on an entry price of MCC, how high do you believe this stock can go? We will use the average of these votes to set the profit exit target. The average target price was \$7.99. In the case study trade, we will use this as the profit exit management technique.

**SUBJECT SUMMARY**

**WORKING WITH PROBABILITY**

Chart analysis is often confused with predicting the market. Chart analysis uses the action of price and volume to clearly show how the market has behaved. For traders, the past pattern of behaviour helps to identify market situations that have a high probability of a specific action. The trading approach requires the trader to develop a plan to cope with the probability, or when that probability does not eventuate.

Many trading techniques use higher probability situations to project future price action and act in anticipation of this. Here we stand at the traffic lights, stepping out confidently when the walk sign flashes. Sometimes we get wiped out as a car crashes through the walk signal, but most times the signal is reliable. When we see the signal, we can forecast the action for a selected period of time. Here traders act when the event occurs.

Prediction is a different beast altogether. It carries a high level of certainty about the occurrence of events at a specific time. Some Gann and Elliott wave analysts make quite specific predictions. This is like saying that I know there is a set of traffic lights at the end of the block, and that at 10.38 am the signal will be flashing walk. This leaves little room for probability, although there are times when such predictions match the co-incident events. This means the predictions come true. Separating the co-incidence for accurate predictive ability is difficult.

The focus of this newsletter is in making the most effective use of probability analysis.

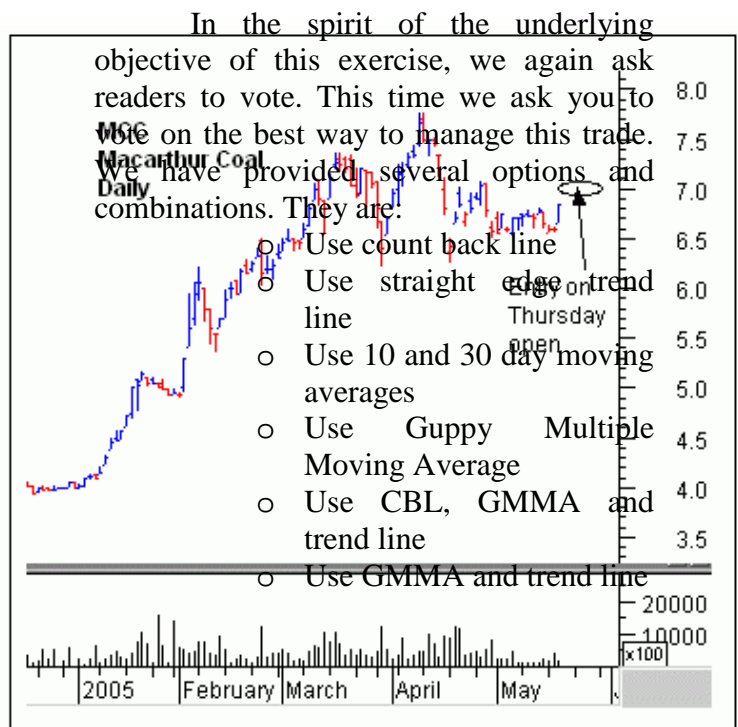
- Based on the entry price at \$7.00, how low do you think this stock can go and remain consistent with the current anticipated rising trend? In other words, how far can a price retreat fall before we are forced to close the trade? Readers applied a wide range of techniques in reaching this decision. We are interested in the collective wisdom, not in the validity of one technique compared with another. Again we use the average of readers' choices to set this figure and it will become the stop loss management technique applied to this sample trade.

The average stop loss price selected was \$6.47.

Now we have the stop loss figure, we adjust position size in the newsletter case study trade so that it is compatible with the 2% rule.

This week we have decided to extend this concept one step further. Our original intention was to take the stock selected by readers, use the stop loss and profit target points, and manage the trade using the most appropriate technique. In other words, take the average conclusions from readers and then execute the trade using more 'expert' techniques. This would be inconsistent with the very approach we are discussing. The whole point of the exercise is to use

the wisdom of a diverse crowd rather than the opinion of a smaller skilled group.



- Use 10 and 30 MA and CBL
- Use momentum indicator MACD – Exit on turn down above upper trigger level
  - Use momentum indicator RSI – Exit on turn down above upper trigger level
  - Use stochastic – standard default settings and trading method.
  - Set sell at average target level and hold until target is reached.

We ask you to vote on-line for each trading method on a scale of 1 to 10 where 10 = most appropriate trading method and 1 = least appropriate trading method. Please cast a vote for each of the 11 management methods. The chart is also shown on [www.guppytraders.com/gup249.htm](http://www.guppytraders.com/gup249.htm).

We use the same chart as last week because this was the information available at the time of the initial test, so we feel it is more appropriate to also base the trade management assessment on this information. Of course, we expect some voters will look at current charts. That is OK. It is the diversity of opinion that is important.

Simply cast your vote in the box and click to send the results.

Here is the methodology we are going to use to test this idea.

- We calculate the average vote value for each management method.
- We calculate the average value of all votes for all the management methods.
- We select the stock where the average value is closest to the average value of votes for all management methods.

We have absolutely no idea how this exercise will work out, but we believe it has some very interesting potential. As this test progresses, we will share with you the conclusion and analysis, along with any specific trading techniques that we develop based on these concepts. We encourage you to vote by going to page [www.guppytraders.com/gup249.htm](http://www.guppytraders.com/gup249.htm). This is a diverse approach, so encourage your friends, relatives and others to also vote.

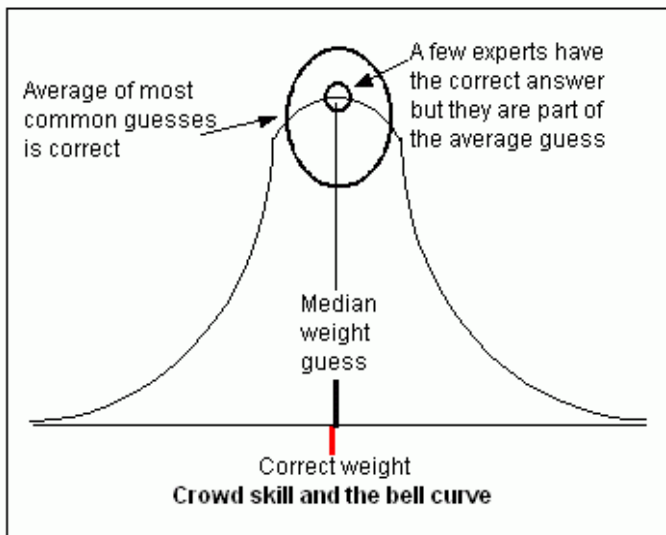
## **REPRINT OF THE PHILOSOPHY UNDERPINNING THIS EXERCISE**

Our understanding of crowd behaviour comes from the classic work by Charles Mckay – **Extraordinary Popular Delusions** – and Gustave LeBon – **The Crowd**. It can be summed up with the comment that “A crowd is about as intelligent as the most stupid person in the crowd.”

But what if the collective wisdom of the crowd, as reflected in price and other behaviour, was much more intelligent? British scientist, Francis Galton, introduced us to the familiar bell curve. The curve is a graphic representation of clustering and is so commonly accepted that we call it “normal distribution.” When students take an exam we expect some students to do very poorly, and some to do very well. The bulk of students will perform about average. If we graph these results, we get a bell curve.

Towards the end of his life, Galton found an interesting anomaly. He attended an agricultural show where there was a weight guessing competition. The challenge was to guess the weight of the bullock after it had been slaughtered – the dressed weight. People from all walks of life estimated the final figure. Some were skilled butchers, others were experienced farmers, some were housewives, while others were simply passing and attracted by the opportunity to bet. (It’s all a bit like setting price in the market where we assume that price is the product of the knowledge of all participants, good, bad and indifferent).

When the competition was finished, Galton was given the betting slips. He plotted the estimates, expecting to find a bell curve distribution where the average guess bore little relationship to the experts’ guess. He expected to see just a handful of people – presumably experts and the lucky – get the weight correct. He also averaged the price of all the estimates. The shape of the curve remained as he expected, but the average of guesses was astoundingly accurate. The slaughtered and dressed beast weighed in at 1,198 pounds and the crowd had estimated, on average, that it would weigh 1,197 pounds. Collectively, the crowd was particularly intelligent.



This observation has been repeated in many experimental situations since and we aim to add to this body of knowledge in a way that has not been done before.

There are several key elements in these observations. They include:

- Decisions were made independently by many participants.
- Participants came from a wide variety of backgrounds, skilled, unskilled, expert, novice.
- The average of results is not a consensus opinion. A consensus opinion is one where

most people agree. The average of results, the exact figure of 1,197 pounds, is a figure about which most people disagree. The people on either side of this average point did not agree with the average figure of 1,197. It is entirely possible that no single individual actually nominated this figure.

- The collective wisdom of the crowd is not the result of discussion, argument, endless meetings, coordinated analysis, or agreement. It is an aggregate of individual guesses and calculations.

Our first task in the voting in the past week was to establish if the wisdom of the crowd applies to stock selection. Readers could apply whatever analysis techniques they thought were appropriate. They could use the knowledge of the stocks' behaviour in the days that followed the last newsletter. Despite this opportunity, we found that the vast majority of votes arrived over the weekend before the market opened. We also invited trial readers to participate, and our office staff and their friends. The decisions, and the methods by which they are reached, are independent of every other voter and include a very diverse range of views and skills.

Each of the 10 stocks offered a voting choice on a scale of 1 to 10 where 10 = excellent trading opportunity and 1 = not a good trading opportunity. Here is the methodology we use to test this idea.

- **We calculate the average vote value for each stock.**
- **We calculate the average value of all votes for all stocks.**
- **We select the stock where the average value is closest to the average value of votes for all stocks.**

MCC passed this test.

This exercise is very different from classic methods of assessing market opinion. Superficially it resembles the idea that we look at brokers' recommendations or recommendations in Shares magazine and use this as a basis for stock selection. It is different from these in two important ways.

- Brokers' recommendations come from 'experts'. The author of **The Wisdom Of Crowds** convincingly illustrates how decisions by a small group of experts are less reliable than decisions made by a diverse group of people from many different areas using many different perspectives. Readers might like to examine the chapter on the Shuttle disaster for a more detailed insight into the problems inherent in using a small group of experts.
- Using this method, the usual approach is to select the stock that is supported by most brokers. This believes the majority verdict is most likely to be correct. The idea that we are testing is that the average of opinion is most likely to be the best guess rather than the majority of opinion.

**NB.** There are no management notes for this week. Please follow next week's newsletter for the continuation of these notes.

# SIMPLY BETTER TRADING

## Making and Keeping Profits in Nasty Markets

**GET THE BEST OUT OF THE MARKET BY USING EASY TO  
MANAGE TRADING TECHNIQUES AND BETTER RISK  
MANAGEMENT TO BEAT A 27% MARKET RETURN!**



In the 12 months to the end of February 2005 the market added 27%. This is the type of investment and trading return that should have been achieved in this period, either in your own trading, or by your fund manager. (Even a simple Exchange Traded Fund strategy outperformed the market with access to full dividends from the top 200 companies).

This is the starting point for measuring return, but simply better trading tactics can improve these returns further with better analysis and better application of stop loss and protect profit strategies. This seminar will teach you how the Guppy trading tools and indicators are combined with effective risk management to improve your trading results in the changing market conditions. We use material also used when we teach international professional traders and dealers. You can learn how they use risk management in their trades. It is risk management that underpins continued trading success.

**THE TOOLS. Do you really know how to use these most effectively together?** The Count Back Line and the Guppy Multiple Moving Average form the core of a proprietary trading technique developed by Daryl Guppy and covered in his books. The first session details how these two indicators are used to identify and manage trades. Our focus is on applications in current market conditions. We will apply them to trades nominated by you.

**MANAGING RISK. Learn what works and why.** Traders need to understand the relative effectiveness of various technical based stop loss techniques and the way these need to be applied appropriately to different types of trades. Few traders take the time to calculate risk reward ratios, yet these form a significant way of selecting trades and identifying the best opportunities. We compare, evaluate and apply several techniques used to set financial stops, protect capital stop loss and a protect profit stop. We show you what works and why.

### SEMINAR VENUE DETAILS Includes a light meal

<b>SYDNEY</b>	<b>Tuesday June 14</b>	<b>BRISBANE</b>	<b>Wednesday June 15</b>
<b>MELBOURNE</b>	<b>Wednesday June 22</b>	<b>PERTH</b>	<b>Thursday June 23</b>

DETAILS ON: <http://www.guppytraders.com/gup173.htm>

# USING A PRIVATE INDEX

By Daryl Guppy

## INDICATOR BUILDER THE PRIVATE INDEX

The idea of a private index was introduced in **Share Trading**. The private index is derived from a user specified group of stocks. This might include just the stocks he is trading, or just those in an investment portfolio. It may also include a collection of stocks that the trader consistently tracks in the market looking for opportunity.

The private index is calculated by taking the closing price of each stock in the group and determining the average of this. The manual process for this is covered in **Share Trading**. This value is plotted on a chart. The final display is shown as a line chart with the index value for each day shown.

The private index is usually displayed against a benchmark market index, such as the XJO market index. This allows the trader to see how his selected area is performing. The objective is to outperform the market most of the time. This tool provides an important way to monitor trading and stock selection performance.

A private index is a tool for monitoring the effectiveness of your selected trading techniques. It is sometimes confused with a portfolio tracking tool which tracks the success of individual trades. The private index helps you to understand how well you are doing in relation to the market. Are you in touch with the market, or are you losing touch? Is the failed trade part of a pattern, or just a normal part of the balance of probabilities in trading? The private index helps to answer these questions.

Usually, at the end of any selection process, we have to make an intuitive choice between two or more equally valid trading candidates. Luck sometimes plays a role and we select the best, or worst, performing of these three candidates. When the trade fails, we may assign the result to bad luck, but this failure may mask a developing failure in our selection technique. When a trade succeeds, we assume this is due to our skill, but even this may be due to luck and mask a failure in our selection techniques. The Private index provides a way to monitor the ongoing success of our selection and analysis process.

The starting point for a private index is our personal selection processes. For simplicity, we assume traders have just a single selection process. In reality, traders often have several distinct selection methods and these can all be tracked with individual private indices. A selection process is a consistent series of steps used to identify and select stocks for further analysis. We could use a technical search that selects stocks where the 7 day moving average has crossed above the 21 day moving average sometime in the past 5 days. Filter these results to eliminate those where the degree of separation between the averages is less than 3% or more than 8%. Further filter the results to remove stocks where the average 10 day value of trading has been less than \$100,000 per day. Finally, focus only on those stocks where price is between \$0.40 and \$1.50.

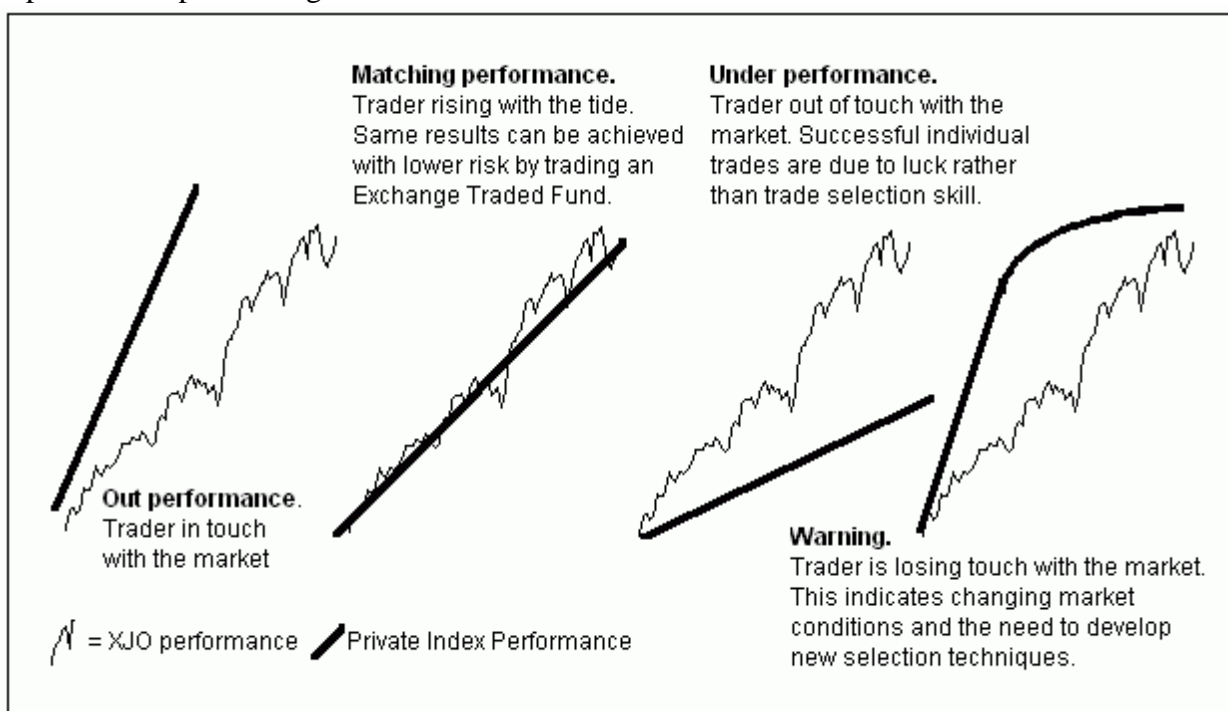
This is not a particularly complex search technique, but like all technical searches, it reflects our belief about the market and opportunity. This search tells us that the trader believes the market offers trending opportunities in stocks with consistent liquidity and that these opportunities are best exploited using a reasonable level of price leverage. Further, this search is interested in finding newly established breakout opportunities as a new uptrend emerges. Armed with this approach, the trader searches for just this particular type of opportunity, because he believes this is the best way to trade the market at this time.

But is it? Most times we track the success of our selected approach by looking at the individual trades we actually take based on this search. However, this skips a very important step. At the end of this search, the trader may have a list of 30 candidates, particularly if his selected search is compatible with current market behaviour. From this list, he may narrow the choice down to perhaps 10 candidates, all of which are virtually indistinguishable. We call them finalists. They all look equally good, so how do we choose between the finalists? We simply give our biases free range, rejecting stocks in sectors we think will not perform, cutting those we have read bad reports about, ignoring those where we think the price is too high. The final selection is a very intuitive process based on guesswork, instinct, gut feel and luck. It is often an ignominious end to a process that has been carefully controlled up until this point. It is relatively acceptable because the stocks we are choosing between are all excellent opportunities. We have to make a single choice because we do not have enough capital to trade all the choices.

Once we have selected a stock to trade, we usually forget the other finalists that were on the list. These forgotten stocks tell us important things about the overall success of our preferred selection method, and by implication, about our understanding of the market. We compile this information using a personal or private index that tracks the ongoing performance of the stocks that made it to the final selection list. In this example, these are the 10 finalists.

If our selection and stock screening process is valid, then we expect it to consistently turn up winners. These stocks, as a group, should out-perform the market. If they do not out-perform the market, then our selection process is flawed. If these 10 finalists under-perform the market, then our understanding of the market is not appropriate. We are simply out of touch, and although some individual trades may be winners, on balance our selection process is going to deliver a list of losers.

The starting point for comparison is the general market index. We use the XJO as the benchmark because the selection process described above searched for any stocks within the entire market that met the conditions. If the search was limited to a particular sub-sector, then that sub sector index is the appropriate benchmark. In all cases, our objective is to verify that our selection process is capable of outperforming the market.



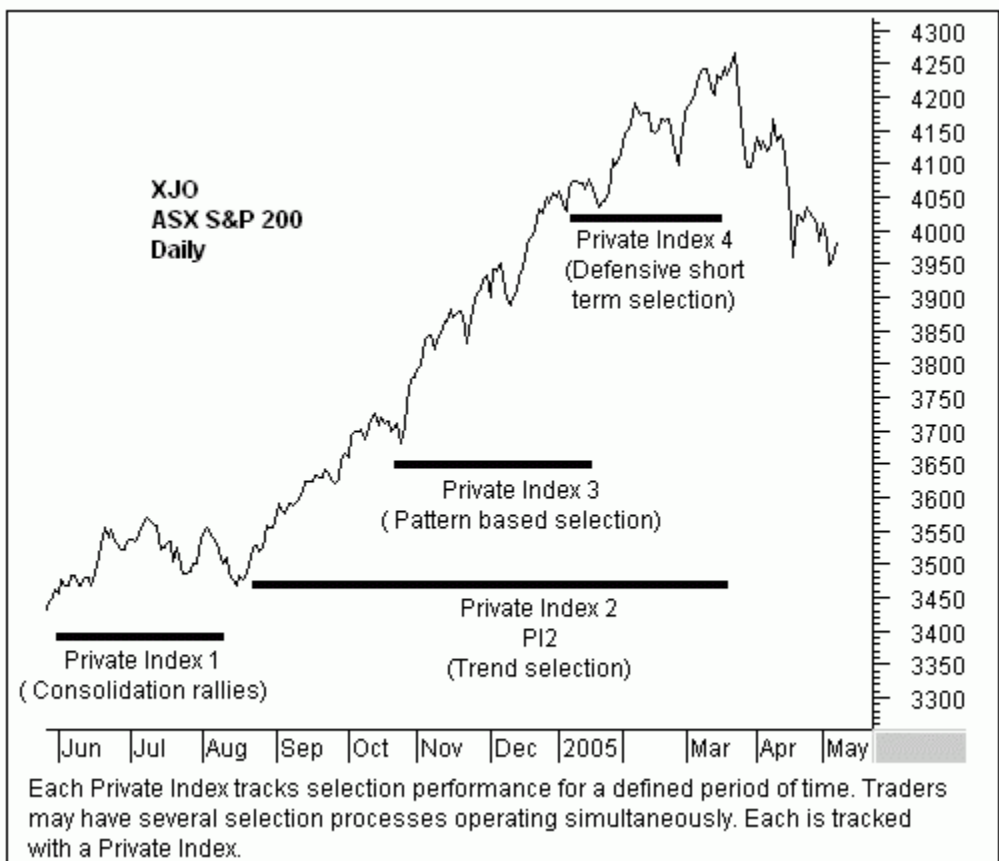
The market index is an ongoing, extended, continuous calculation that extends back for many years. Our selection process does not have this longevity and this raises important questions about how we apply a private index. The private index is not an exercise in back testing. We are evaluating current stock selections – the 10 finalists – against the current performance of the market. Our intention is to evaluate these selections from the time they were made to the time when the selection process is no longer valid.

Our sample selection looked for stocks that had recently broken into an uptrend. Previously, they were in a downtrend. If we used previous price data while they were in a downtrend, then as a group they would under-perform a rising market. Such information is irrelevant to our task because these stocks were not selected while they were in a downtrend. Our purpose in the private index is not to assess the performance of an individual stock, or the long term performance of a trading system based on a 7 and 21 day moving average.

Our objective is to assess the success of our current stock selections in comparison to the current market. The construction of the private index starts on the day on which the 10 finalists were selected. For this example, we use August 1 and call this PI2. The value of this index continues to be calculated every day until we stop using this particular selection method. The index tracks the performance of our selection method by aggregating the performance of the top 10 finalists. This

requires closer management than we usually apply to the finalists who did not actually make it into a trade based with cash.

The market index is adjusted regularly, with stocks added and others dropped. We do the same with the private index. The 10 finalists that initially make up PI2 are paper traded using the same management techniques we apply to the actual trade based on this selection technique. If the trading plan calls for an exit when the 7 day moving average crosses below the 21 day moving average, then this is applied to the 10 finalists. When these conditions are met, the stock is dropped from the index. The same applies when a stop loss condition is met. The result is a private index that reflects not only the choices made, but the ultimate success or failure of those choices. After all, once the new uptrend ends and turns to a downtrend, we would not want to trade the stock, so its performance should no longer be included in the private index calculations.



This is a dynamic calculation. When the real trade is closed, we may choose to repeat the search, again looking for suitable trading candidates. The performance of the private index will tell us if it is worthwhile using the same search and selection method. Even if the individual real trade was not particularly successful, the selection process captured and tracked in the private index may still be outperforming the market. In this case, we can use the

selection process with confidence. If the selection process, as tracked by the private index, is under performing the market, then we know we need to re-assess the way we search for opportunity.

When the search and selection is repeated, the 'finalists' are also added to the private index. At this point, the index may consist of several stocks from the initial search which have not yet triggered exit signals, and the stock finalists from the new search. Potentially, this index can expand to include 20 or 30 stocks, each of which is paper traded and closed based on the trading plan conditions applied to the genuine open trade.

If we use several distinct analytical approaches to the market, then we should use a separate private index for each. This is particularly useful if we want to test a particular approach because we believe market conditions are changing. The private index will tell us when the new approach is an effective solution to the change in the market. This sounds like hard work, but it is both necessary and less work than expected. Private Index construction can be achieved in three ways.

- At the initial data supply point. Data software, such as Bodhi Freeway, allows users to create a private index by nominating the stocks to be included. It creates a separate data file which is displayed just like any other stock.

- Some charting software will allow data manipulation to create a synthetic stock. Both Metastock and EzyCharts, for example, have this capacity. Ease of use varies considerably.
- Creating a spreadsheet and entering closing prices by hand. This is time consuming, but achievable if the index contains only a handful of stock finalists.

Trading offers many challenges. Of these, the most significant is the trader's ability to remain in-touch with the market. Although there are times when the market appears to set an established and long lasting pattern of behaviour, there are always subtle changes developing. Long term success in the market demands that we recognise these changes and adjust our trading strategies accordingly. The analysis and search techniques that turn up successful trading opportunities in one phase of the market become less successful as the market changes. In extreme cases, they become completely inappropriate and the first we know of it is when trades start to fail.

Here is the danger. The trade fails. We accept that this is consistent with the average rate of success. We expect some failures. After a string of successful trades, we can accept a string of unsuccessful trades because the overall average of trading success remains above 70%. Sometimes the expected 30% of losing trades do clump together, one after another. But what if this clumping occurs because we have lost touch with the market conditions? Now it is our initial selection process that needs to be changed.

If we focus just on the performance of our open trades, we miss the forewarning provided by tracking the general performance of the finalists found using our preferred scanning and screening process. If our open trades start to fail, and the finalist trades also fail, then we are looking at a broad failure of our selection processes. We are losing touch with the market and it is time to change tactics and analysis methods.

The private index tracks the ongoing performance of all selection choices you intend to trade. These are the finalists. The combined success, or failure, of this group is an index of the success or failure of our chosen selection method. If we know our selection method is generally outperforming the market in the current period, then we can use the same selection method to find new opportunities as capital becomes available. The private index gives traders a more complete picture of their ability to stay in touch with the market and changes in the market.

Next week, we will look at building a private index using BodhiGold from JustData. BodhiGold gives you the tools to manipulate the data directly, making it easy for users to effectively create their own private index.

## **GOT A QUESTION YOU WOULD LIKE TO ASK?**

**This is the only chat room where you will find Daryl Guppy and other recognised traders and authors. Post a question and get quality answers. Just visit and browse the discussion boards for educational information on trading techniques, using Metastock, and the questions that we all need to ask. This chat room has an international audience.**



**[www.stockmeetingplace.com](http://www.stockmeetingplace.com)**

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# THE EDGE: WHO HAS IT AND HOW TO GET IT – PART 1

By Tom D'Angelo

## SUBJECT SUMMARY

### THE BUSINESS OF TRADING

Trading is a business. The trader deals in buy and sell contracts and has an inventory of shares that are the same as the 'stock' in a retail shop. His customers do not walk in the door. They are found throughout the country and are connected by a broker and an exchange which facilitates the sale of 'shares'. Every business has its profitable and less profitable sections. Trading is no different and our profits come from particular techniques and processes. Successful traders create a professional trading environment to manage their trading activities similar to a successful business.

Good software assists in this process. These articles explain how ManusRisco money management software is used to improve the business control and management of trading.

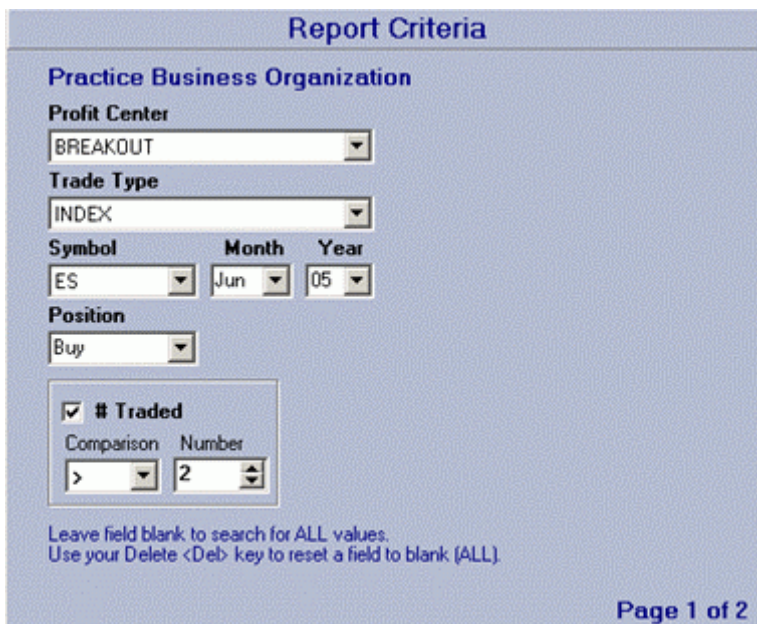
Failure to adopt a professional, disciplined businesslike approach towards speculation and investment will significantly decrease your chances of achieving long term profitability in today's volatile trading arena. These articles are designed to teach you how to create a professional trading environment so you can manage your trading activities similar to a successful business and make confident, disciplined trading decisions.

Over the next few weeks we will cover these topics:

- Introduction - How successful businesses are organised
- The Profit Centre business model applied to trading
- A professional, disciplined money management methodology
- Positive and negative expectation games
- Drawdown
- Return on Investment
- PTR / UTR
- Breakeven Analysis
- **The edge: Who has it and how to get it.**

In previous articles, we learned how to create a Profit Centre structure designed to organise our trading results similar to a successful business. We also took a look at the Drawdown, Return on Investment, PTR / UTR and Breakeven reports, which can be created from the trading results we entered into our Profit Centres.

The two images below display various Report Criteria which can be selected to create custom designed Analysis Reports. The first image displays the Report Criteria for the trade elements, and the second image displays the Report Criteria for the type or report and the time period.



The information displayed on the Analysis Reports enables the trader to confidently and professionally manage his trading business.

The money management methodology described in previous articles provides the structure which organises your trading results so that the Analysis Reports can be quickly and efficiently created.

We will now take a look at what every trader is seeking - the edge.

*"The race is not always to the swift, nor the battle to the strong, but that's the way to bet it!"*

Damon Runyon

The edge, also called the advantage, comes in three forms:

- The perceived edge
- The actual edge
- The variable edge

**Summary Time Period**

Individual Trades  
 Daily  
 Weekly  
 Monthly  
 Yearly

Start Trade Date     Stop Trade Date

Page 2 of 2

## The Perceived Edge

The perceived edge is perceived because it is not certain. The perceived edge is the advantage the trader thinks he has because he has developed and tested a trading methodology which has shown a profit, either in hypothetical back testing or in actual trading. For example, a trader develops a trading system and back tests it over 10 years of historical price data and rejoices in the fact that the system has produced a \$500,000 profit over the 10 year period. He then commences to trade the method since he perceives he has the advantage based on extensive back testing of the system.

Another example is where a trader does not back test a trading system but instead can discern visual or intuitive signals on a price chart which he instinctively recognises as a Buy or Sell trading opportunity. For example, if the TICK does not make a new high but the E Mini price does make a new high, and the premium rises to a certain level, the trader may instinctively sell short the E Mini based on this divergence and the high premium since he has perceived over many years of trading that this trade has a high probability of success.

The perceived edge is so named because the market could not care less about how many years you have back tested a trading system or what your intuition or instincts tell you about a trade. The market is going to do what it is going to do and could not care less about all your back testing and intuition. You perceive you have the edge, but that's all it is - a perception.

The perceived edge always occurs before the trade is taken. If the perceived edge did not exist, there would be no trading and no markets since no one would take a position because no one would think they have an advantage. If there is no perceived advantage, then there is no reason to trade.

A clothing retailer buys \$20,000 worth of pants at wholesale because he thinks he has a perceived edge of selling the pants at retail for \$30,000 and making a \$10,000 profit. **If** he sells the pants at a profit, this will become a profitable trade resulting from a perceived edge which through hindsight he now realises, after the fact, actually existed.

The edge is perceived because the pants may go out of style, or the economy can go into a recession, or the pants may be stolen or destroyed in a fire and he is forced to sell the pants at a price lower than his \$20,000 cost and take a loss. If he sells the pants at a loss, then this is an unprofitable trade resulting from a perceived edge which, through hindsight, did not really exist.

The perceived edge only exists in our imagination, but it is the foundation of modern civilisation and is absolutely required for any type of economy to exist. If the perceived edge did not exist, there would be no business, no commerce, no markets, no trading and no economy.

## The Actual Edge

On the other hand, the actual edge is a statistical certainty given a sufficiently large sample size. Casinos enjoy a built in actual edge in games like roulette, keno, baccarat and dice. This advantage arises by paying out lower than fair odds if you win a bet (like roulette) or the advantage is built into the way the rules of the game are set forth (like baccarat).

The statistical advantage of these games is pre-determined statistically down to the third decimal place. In the short run, anything can happen in a casino. Players can win thousands or millions of dollars. But in the long run, the house will win very close to its predicted advantage.

Casinos enjoy the actual edge because the game is "fixed" in favour of the house and the edge is statistically "guaranteed" if they can get into the long run. They get into the long run by taking many small bets, none of which will jeopardise the casino's bankroll. A casino will never take a single bet

which will cause the loss of a significant percentage of the house's bankroll.

When you are playing a game where you enjoy an actual edge, you should only make many small bets, never jeopardise your bankroll and get into the long run so the inevitable statistical advantage can grind out its handiwork.

Since markets are not 'fixed' in the trader's favour, and traders do not possess the holy grail trading system which produces statistically guaranteed profits, the only locations where you will find the elusive actual edge are Las Vegas, Reno or Atlantic City casinos, or any other locality where there are gambling establishments, legal or otherwise.

Which bring us to the most important edge of all - the variable edge. We will discuss the variable edge and how it is based on a constantly changing game next week in part 2 of this article.

Tom D'Angelo is the CEO of ManusRisco Inc. The money management methodology described in these articles is used by ManusRisco money management software which can be found at [www.manusrisco.com](http://www.manusrisco.com) This software adds an important business dimension to the business of share trading.

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# READERS' QUESTIONS: INITIAL HIGHS – PART 1

By Leon Wilson

## SUBJECT SUMMARY

### SYSTEM TESTING

System testing is a software approach to rule based trading systems. Advanced system testing software performs analysis with any of the following combination:

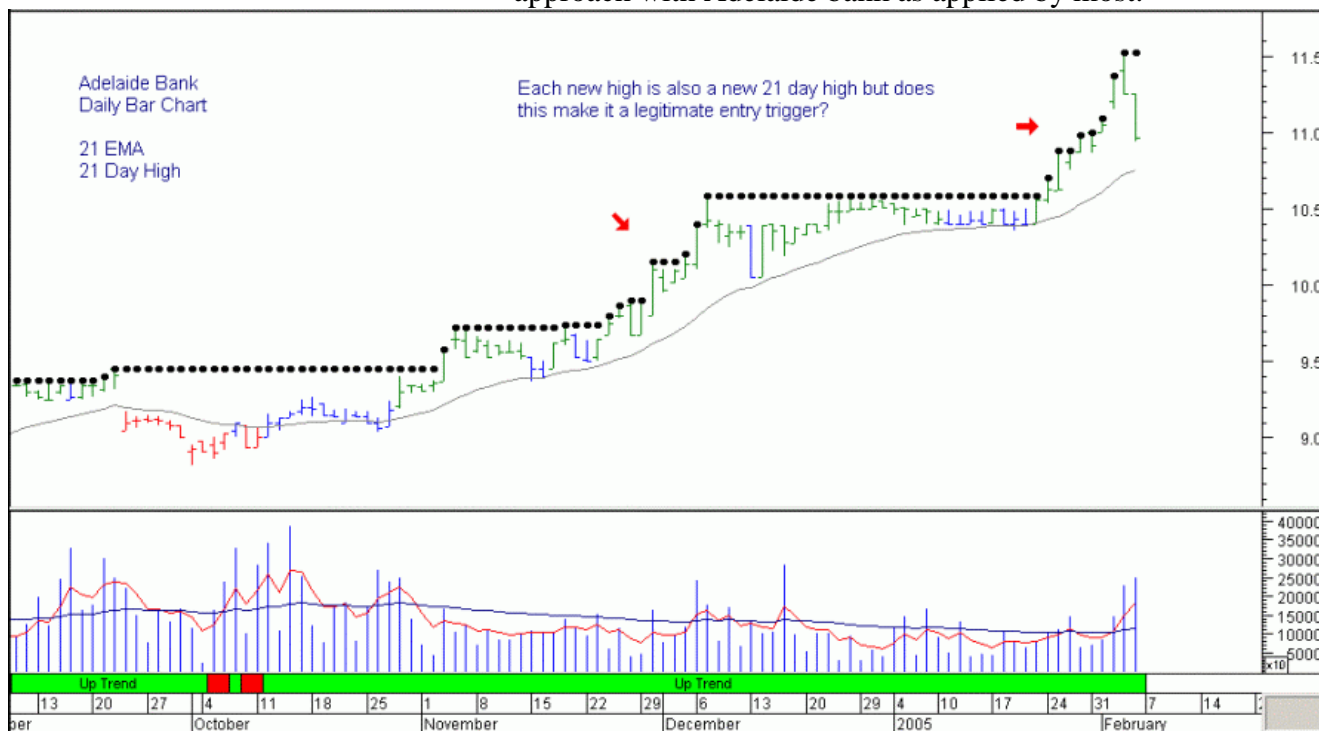
- A single system applied to a single security
- A single system applied to multiple securities
- Multiple systems applied to a single security
- Multiple systems applied to multiple securities

Good system testing software displays these results in a graphic as well as table format. Advanced system testing offers additional features such as true 3-D plotting seen in advanced mathematics and statistical packages, along with better equity curve analysis. They also offer access to fuzzy logic approaches that allow the system to incorporate a number of self adapting rules.

These advanced system testing modules often call for strong computer skills.

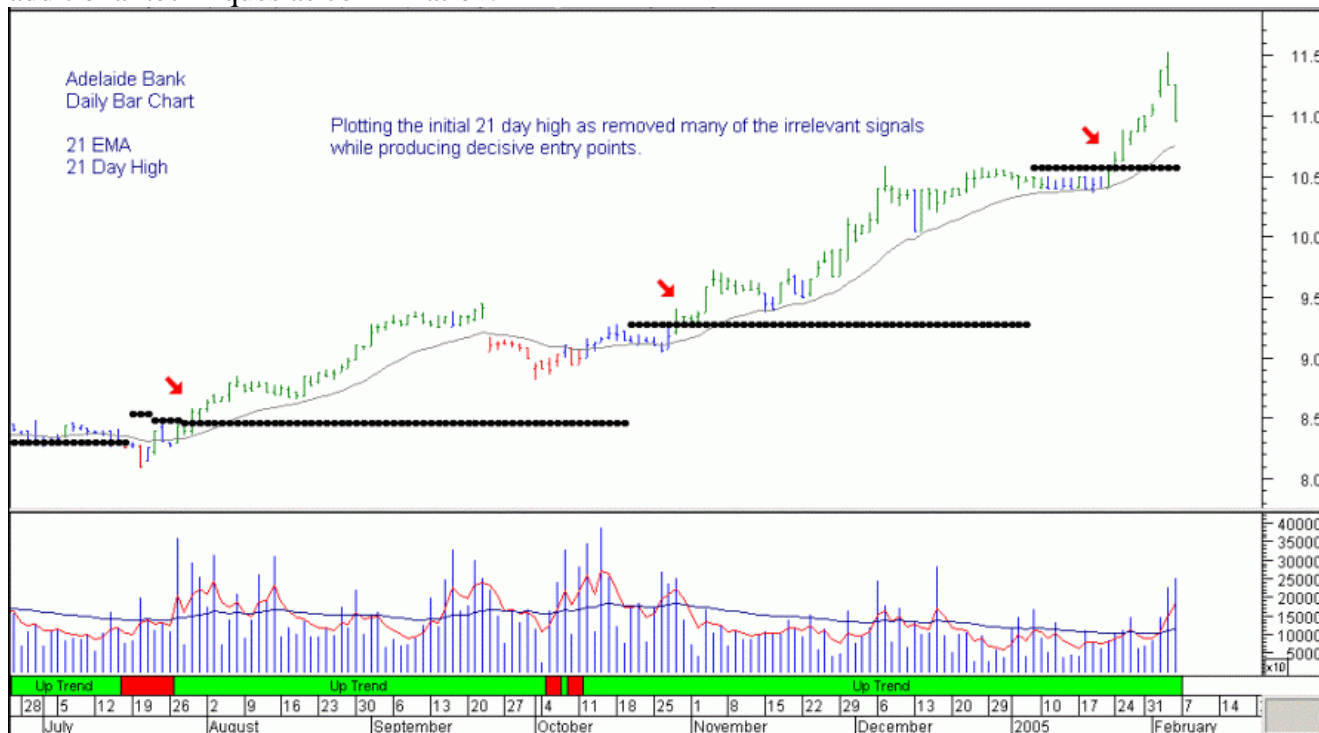
Trading 21 and 30 day highs is a very common approach, but is this universally accepted technique as effective as we are lead to believe without additional confirmation or refinement? The concept in its original format, involves the identification of the highest high price in the most recent 21 days, then entering once price action moves beyond this point in accordance with our strategy.

Obviously I have no problems with the new high concept, as I have traded the technique over an extended period, just not in the same manner as most. I initially found that some trading strategies based on the principles of new high development were too loose in their construction for my personal liking. I have a personal preference for trading 21 day highs, however, it must be the initial 21 day high. By initial high, I am only interested in the very first 21 day high. Beyond this, I ignore all following 21 day highs until a new initial 21 day is generated. Every new high that occurs following the initial 21 day high is in its own right a new 21 day high, however, does this mean that every new high produced is a legitimate entry trigger? I think not. Some will argue that many opportunities are missed by solely focusing on the initial high and this is fair comment, however, the primary focus of my discussion is about defining a consistent entry trigger, not chasing price action. I have highlighted the original 21 day approach with Adelaide bank as applied by most.



The preferred method of trading 21 day highs is to enter following a temporary pause in price action. This is sound in theory, however, the period of inactivity is open to personal interpretation and somewhat governed by experience. I decided that I needed to refine the process by focusing on the first 21 day high for two reasons, early trend entry and the removal of all additional 21 day signals. If I

could define a definitive entry point in price action, then I could build on this foundation by using additional techniques as confirmation.



Having redesigned the original 21 day high entry trigger into something that is hopefully more effective, the only task left is to test the concept. When we first test our refinements, we need to assess its performance in its rawest form. I decided to test both concepts using TradeSim, which is a specialised testing programme. The entry trigger was the first close above the highest high in 21 days. The only filter applied was the requirement that price action be above the 125 day moving average. The trailing stop was three times the average true range. Before you dismiss the results off hand, we are comparing the trigger refinement, not overall strategy performance. Unfortunately many of us concentrate solely on increased net return as a gauge of improvement, however, risk/return, win/loss, average draw down and the number of signals produced are all contributing factors that warrant further consideration when testing. I have condensed the testing results, however, they have been reprinted without alteration and are based on average results produced through repeated testing.

### (Original 21 Day High)

#### Trade Parameters

Initial Capital: \$50,000.00  
 Maximum number of open positions: 15  
 Trade Size (\$ value): \$5,000.00  
 Transaction cost (Trade Entry): \$20.00  
 Transaction cost (Trade Exit): \$20.00  
 Total Trading duration: 3832 days

#### Profit Summary

Profit Status: PROFITABLE  
 Starting Capital: \$50,000.00  
 Finishing Capital: \$53,041.84  
 Gross Trade Profit: \$98,505.43 (197.01%)  
 Gross Trade Loss: -\$95,463.59 (-190.93%)  
 Total Net Profit: \$3,041.84 (6.08%)  
 Total Transaction Cost: \$16,440.00  
 Annualized Compound Interest Rate: 0.5641%

### Trade Statistics

Trades Processed:	4236
Trades Taken:	411
Trades Rejected:	3825
Winning Trades:	141 (34.31%)
Losing Trades:	270 (65.69%)
Average Win/Average Loss:	1.8423
Maximum Trade Profit:	\$6,269.12
Minimum Trade Profit:	-\$2,789.78
Average Winning Trade Profit:	\$698.62
Average Losing Trade Profit:	-\$353.57

The original entry technique without some form of confirmation is ordinary to say the least. The average success rate was 34.31% with a risk/return ratio of 1.84:1. The annualised return failed to make 1%, which is worse than bank interest. Compounding our dilemma is the appearance of 4236 entry triggers generated by the top 300 stocks listed on the ASX. Sorting through such a significant number of signals in order to consistently select suitable stocks could be considered as impractical for real time application.

### (Initial 21 Day High)

#### Profit Summary

Profit Status:	PROFITABLE
Starting Capital:	\$50,000.00
Finishing Capital:	\$75,848.58
Gross Trade Profit:	\$108,383.34 (216.77%)
Gross Trade Loss:	-\$82,534.76 (-165.07%)
Total Net Profit:	\$25,848.58 (51.70%)
Total Transaction Cost:	\$15,960.00
Annualized Compound Interest Rate:	4.0501%

#### Trade Statistics

Trades Processed:	2354
Trades Taken:	399
Trades Rejected:	1955
Winning Trades:	166 (41.60%)
Losing Trades:	233 (58.40%)
Average Win/Average Loss:	1.8432
Total Net Profit:	\$25,848.58
Maximum Trade Profit:	\$5,689.34
Minimum Trade Profit:	-\$2,789.78
Average Winning Trade Profit:	\$652.91
Average Losing Trade Profit:	-\$354.23

By redirecting our entry analysis toward the initial 21 day high rather than ensuing highs, we experience a notable improvement in trigger effectiveness. The success rate of trading the initial high is 41.60% on average. The number of entry signals has dropped dramatically, however, they continue to remain excessive for practical application. While the average profit/loss remains largely unchanged, the improvement in signal effectiveness has led to an increase in the annualised net return.

So, have we made any improvements? Definitely. It is common for an improvement in one area to cause the deterioration of another. The win/loss ratio may improve dramatically, however, the net return can decline significantly indicating late entry. In this situation, the refinement to our entry technique, simply by selecting the initial 21 day high, has led to an improvement across the board. From here, we now have something to work with.

Next week, we will look at some basic improvements, indicator coding and explorations.

# 1 Day - Trading Work Shops

## Initial Highs, Volatility & Momentum Break Outs

Melbourne - Sunday 26th June

Sydney - Sunday 10th July

Brisbane - Sunday 24th July

Perth - Sunday 7th August

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## CHART TECHNIQUE BRIEFS: CLV

By Petra Rak

### TRADING TECHNIQUES

#### CBL TRAILING EXIT

The count back line can be used to set a trailing stop loss and trigger an exit when a trend starts to decline. This stop loss rule uses the range activity of the stock to set a stop loss point. The range is the distance between the high and the low for the day. It is calculated using the Count Back Line approach. Taking the most recent highest high in the current trend, the stop loss point is calculated by counting back three lower bars. The horizontal line drawn at the bottom of the third bar is the trailing stop loss point. This stop loss is not related to the 2% rule. The line suggests the conditions where the trend may be weakening. When used with open profits, it provides an exit signal to protect those profits. The CBL signal should always be verified with other trend indicators.

CLV was previously covered in these newsletter notes on the 2<sup>nd</sup> of October 2004.

When we last looked at CLV, prices had recently broken out of a long-term downtrend, and CLV was in a short term uptrend, with prices just under a key resistance at \$0.38 which had capped the initial breakout rally. Continued upside movement (and potential opportunities) depended on a breakout above this resistance.

This breakout did not eventuate: instead, the short term upward trend line was broken, and CLV headed back towards a support at \$0.28 which had halted the previous downtrend, and the subsequent retreat from the initial breakout rally. A continued support at this level would have signalled likely sideways movement between \$0.28 and \$0.30.

However, in late February, CLV also fell through this support, and continued falling towards a historical support at \$0.16. Prices fell slightly under this historical level, but developed a small upside triangle underneath it, and have since rallied above \$0.16. Overall, the development is a good example of the failure of a potential trend reversal.

#### UP CONDITIONS

CVL is now located just under the downward trend line that defines the recent retreat. Continued upside movement depends on the ability of prices to rise above the downward trend line and the \$0.28 resistance. There is some support for such a breakout in the GMMAs, where the short term group is currently challenging a flattened and narrowing long term group, setting up a potential bullish GMMa crossover.

Entry opportunities into the potential re-activated reversal will

vary in accordance with each trader's risk levels: more aggressive traders will consider a position shortly after a breakout above the downward trend line with a tight CBL stop loss, while more conservative traders will consider an opportunity upon breakout above the \$0.28 resistance, with a likely target at \$0.38. A continued cap at \$0.38 will signal likely sideways movement between \$0.28 and \$0.38, which may deliver channel trading opportunities (potential ~30% return).

In the longer term, the trend reversal will be confirmed by a break above the \$0.38 level. Such a breakout will signal another opportunity and move the indicative target to the next key resistance, at \$0.47. Trading opportunities in this area are likely to be trend trading (as opposed to shorter term breakout rally) opportunities, with key tools being an upward trend line and the GMMA's which we expect to turn upward and broaden as any uptrend develops, indicating increased investor and trader support.

CLV Weekly Price Bar Chart



## DOWN CONDITIONS

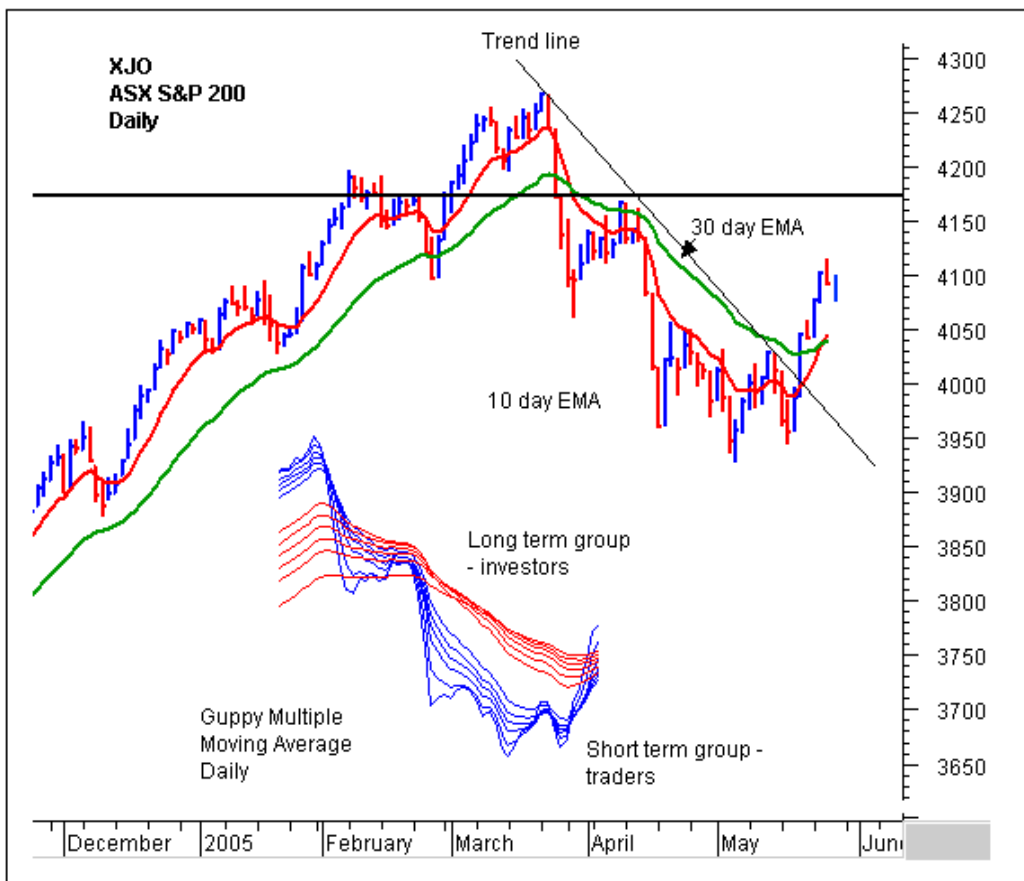
Failure to rise above the downward trend line will indicate a continued downtrend, with a likely retreat back towards the \$0.16 support area. At this point, traders will watch for the support to hold, and a new rebound and challenge to the downward trend line to develop. Failure of this \$0.16 support area will constitute a serious downside signal confirming the ongoing downtrend.

## NEWSLETTER OUTLOOK – RALLY OR TREND BREAK?

By Daryl Guppy

**Rally or a trend break? This is the key question and the answer is in part determined by the top of the right hand shoulder. On many criteria, this is a potential trend break.**

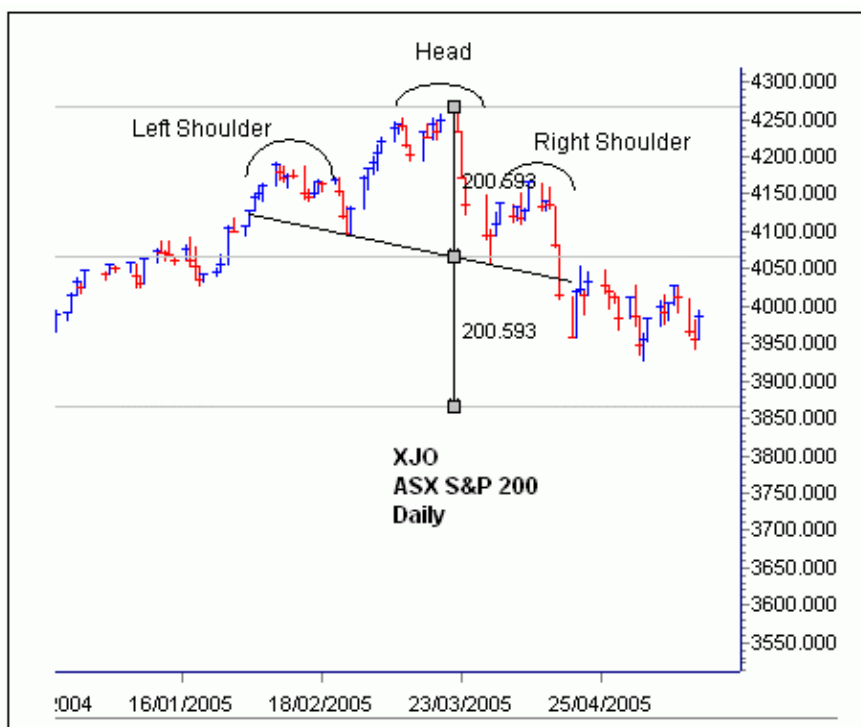
- **The 10 day moving average has moved above the 30 day moving average. This has been a reliable way to define the XJO trend.**
- **The downtrend line from the peak in March has been broken.**
- **Short group in the GMMA has moved above the long term group.**
- **Long term GMMA group has turned up.**



All of these are strong bullish features. However, the level of the shoulders in the head and shoulder pattern at around 4170 has not been broken. This suggests that this rally will retreat and rebound. It is this rebound that both defines the nature of the emerging trend and provides an entry opportunity. Until this second rebound point is created we cannot effectively define the emerging trend.

The downside targets for the head and shoulder pattern were not reached. This pattern verifies a reversal. It is a mistake to use the projection targets as exact reversal points, although on occasion they do prove very accurate. We use the head and shoulder pattern as a guide to market conditions. Traders are now alert for the potential for the market to rebound from the trend line area. The GMMA suggests this is most likely to be a rally.

Classic chart analysis remains a simply powerful tool.



The head and shoulder pattern consists of four elements.

- A left shoulder.
- A head.
- A right shoulder.
- A neckline, which in this case slopes downwards.

The pattern is applied by measuring the distance between the head and the neckline, and then projecting this downwards from the neckline. The downside target is approximate, and is best verified against a nearby established support area. Full confirmation of the pattern comes when prices drop below the neckline after forming the right hand shoulder.

**The pattern is not used as a timing tool.** It does allow the trader to set an estimated potential bottom for the price decline, as shown with the GTE Toolbox display. How the market behaves once this target level is reached is an entirely different question. The power of the pattern lies in its ability to confirm a trend change, and to set potential downside targets.

The head and shoulder pattern gives a downside target of around 3860. This also matches the support levels we have identified in previous market outlook notes. These targets can be reached quite rapidly, and in so doing inflict significant financial damage on those who fail to heed the early trend weakness signals.

Sounds frighteningly impossible? Readers with access to the Kuala Lumpur Composite Index can see the usefulness of this technique. In our sister publication, the Asia and China newsletter, we noted the head and shoulders pattern in February and set the downside targets at 860. They were hit several weeks ago and now the market has rebounded powerfully away from these points.

We note that after the sharp rebound that the KLCI rapidly fell back. It is this collapse that provides both fast short trading opportunities and rebound entry opportunities. One of the advantages of intermarket analysis is that a leading market can provide clues about how a lagging market may develop. The KLCI pattern leads the behaviour of the XJO in this sense.

Each week we make a choice about the material we include and the subjects we cover. The selection is based on our outlook for the current and coming market. Our objective is to illustrate effective trading strategies that readers can apply to current market conditions. We do not identify recommended individual stocks. We identify opportunities and appropriate trading methods for them. Our outlook is not a forecast. It is a probability framework. Use it as just one part of the other information you are reading about the market. Our summary outlook will be included each week.

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## NEWSLETTER NOTES

### GUPPYTRADERS TOOL BOX – PRE-RELEASE VERSION AVAILABLE FOR DOWNLOAD FROM [WWW.GUPPYTRADERS-ESSENTIALS.COM](http://WWW.GUPPYTRADERS-ESSENTIALS.COM).

The new GuppyTraders Essentials Toolbox and charting program is in final testing stages and we have released a fully functional pre-release version. This will only be available as a free 30 day trial period version as we are particularly interested in user feedback and comments. Once feedback comments have been incorporated, we will offer a full release version. We will also offer an attractive changeover path to those who wish to *changeover* from the original Market Analyst version of the GTE charting package or toolbox. We own the licensing and copyright to these products and they are no longer associated with Market Analyst. The new version of the GTE Toolbox produced by Guppytraders will be available by the end of May 2005. (OK, we got a little enthusiastic with progress).



#### Features include:

- Full count back line capability. This is CBL for long side trading, and for short side trading
- GMMA display
- Parabolic trend line plots – including long side and short side plots. Also includes convex plots as shown in Leon Wilson books.
- Symmetrical and a-symmetrical saucer plotting
- Pattern price projection tools
- Darvas boxes including:
  - Modern
  - Classic
  - Ghost boxes – just click and add.
- An effective ATR plot that operates as a stop loss display as well as a standard indicator display option.
- ATR stop loss configured for both long side and short side trading.
- One click display of 1, 2 and 3 moving average combinations.

The GTE Toolbox is designed to work with a variety of data formats. It is a small utility application that gives traders access to a selection of Guppy tools and indicators that might not be included in the charting program they are currently using. We are currently upgrading the GTE Toolbox and adding some new indicators and other enhancements.

If you want first access and leading development then this is available through our weekly newsletter and the Guppytraders version of GuppyTraders Essentials toolbox and charting program. Please note that Market Analyst stopped working with GuppyTraders.com in mid-2004 as they made a decision to stop producing the GTE toolbox and the GTE Charting package. We no longer provide Market Analyst with access to updated tools and techniques. Market Analyst, like

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The workbook is well set out with clear screen shots of the processes under discussion. The trading strategies include the Berg Volatility Indicator which has been featured in Technical Analysis of Stocks and Commodities magazine. The full coding steps for all indicators are included, along with detailed explanation of how the strategies are implemented. This guide is now available through our Guppytraders store at

<http://www.guppytraders.com/gup240.htm>

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I am confident that [www.stockmeetingplace.com](http://www.stockmeetingplace.com) will develop into a premier educational chat room which will attract a quality group of people who genuinely want to learn about the market and assist others. That is why I have agreed to exclusively participate in this chat room. This chat room has an educational bias where traders from around the world come to exchange ideas, swap exploration formulas and discuss trading techniques. I am active in several sections. If you want to ask me a specific question, this is the best place to go. You will receive a reply from me, and also additional information from StockMeetingPlace regulars. There are many solutions to any question and StockMeetingPlace taps into a wide range of trading experience.

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Want to know more about tactics?	Trading Tactics	Beginner to experienced
Want to improve your trading results?	Better Trading	Experienced to professional
Want to master simple but powerful techniques?	Trend Trading	Beginner to experienced
Want to understand short term trading?	Snapshot Trading	Experienced to professional
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## PORTFOLIO CASE STUDIES - MONEY MANAGEMENT

### PORTFOLIO CASE STUDIES - MONEY MANAGEMENT

Starting cash position \$100,000 - no brokerage or slippage 2% of risk = \$2,000

**NOTE** Entered date is the *newsletter date* which contains the case study discussion.

Stock	Price	Qty	Pur Value	Close	Cur Val
xx	\$0.000	-	\$ -	\$ -	\$ -
		Newsletter date	11-Sep	Open Profit	0.00
			dividend Jan 6		464.48
				profit	464.48

Percentage #DIV/0!

Stock	Price	Qty	Pur Value	Close	Cur Val
MCC	\$7.000	2,890	\$ 20,230	\$ 6.82	\$ 19,710
Average choice		Newsletter date	21-May	Open Profit	-520.20
Stop loss \$6.47				profit	-520.20
				Percentage	-2.57

## SUMMARY MONEY MANAGEMENT

**Overall profit to date since July 1, 2004 = \$82,472 or 82.5% return on trade equity.**

Profit 2003/04 = 48.7% return on trade equity. Profit 2002/03 = 75.9% return on trade equity.

Profit 2001/02 = 71.3% return on trade equity. Profit 2000/01 = 59.2% return on trade equity.

Profit 99/00 = 111.2% return on trade equity. Profit 98/99 = 102% return on trade equity.

Profit 97/98 = 94% return on trade equity. Profit 96/97 = 66.5% return on trade equity.

**Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. Results reflect absolute trading stop loss discipline. Case study trades are monitored**

**and managed in real time, and management reports are delivered every week in the newsletter. Except where noted, all case study trades are notional examples using reasonably attainable entry and exit points.**

**Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actually been executed, the results may have over or under compensated for impact, if any, of**

**certain market factors, such as lack of liquidity. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Full trade summaries, with charts, are provided every six months.**

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