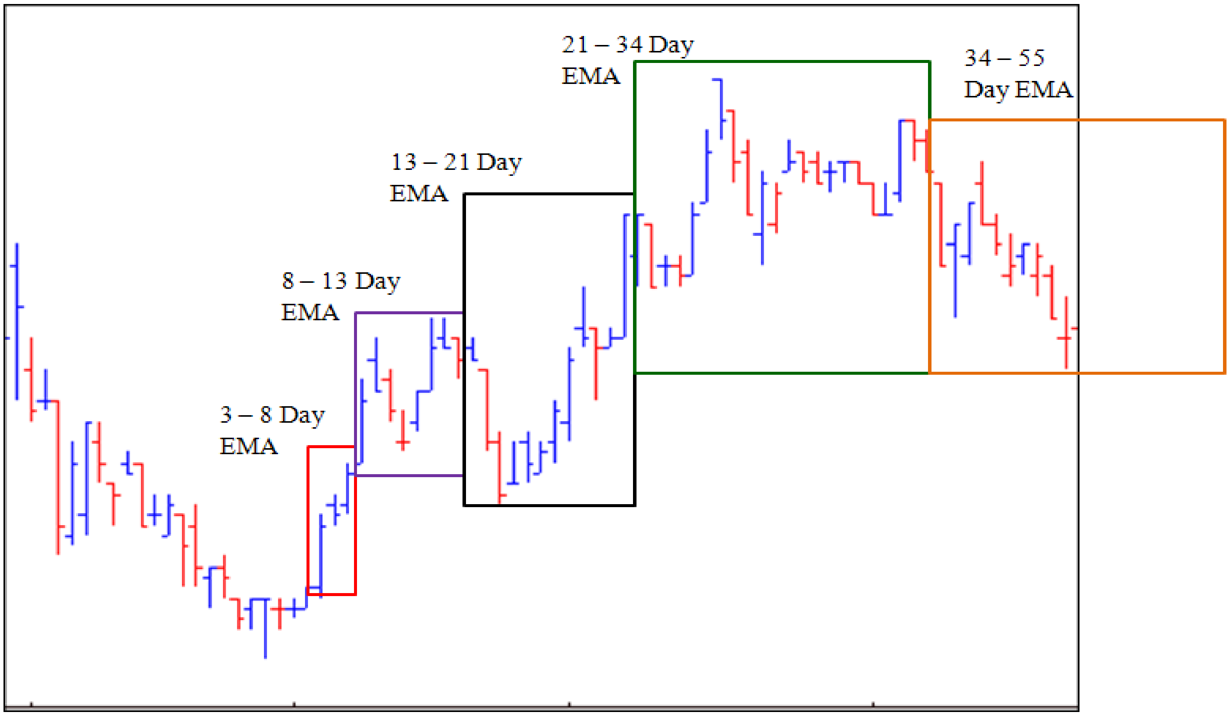
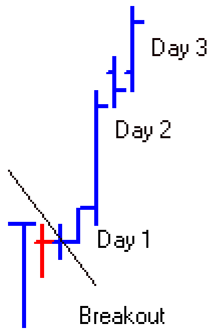
Simple Tactics, *Profitable* Trading



Paul Doggett



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Simple Tactics, Profitable Trading
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Disclaimer

C o n t e n t s

PLEASE NOTE:
The current edition of this book has had limited editorial additions and corrections since it was first published in 2006. This means that some references and charting examples used are approximately a decade old.
However, we have shown more recent charting examples in some instances for the specific purpose of demonstrating the value of the analytical techniques discussed in this book over the long term and through bull and bear markets.

Preface

The Goldilocks Enigma says that the cosmos is 'just right' for life due to a series of accidental coincidences of chemistry. Others would say that the universe has been deliberately designed to create and then sustain life by a higher power. So ask yourself, is your trading strategy based on a series of accidental coincides or has it been deliberately designed?

This is an exceptionally important question. You see, if you believe that share price fluctuations over the long term are merely a random walk, then why would you attempt to design a trading system? After all, do you really think you can design a trading system that captures randomness?

If you think you can, put this book down now, it is not for you.

If on the other hand, you believe that markets are inherently systematic, that is, traders and investors seek out the better companies with the better future prospects to make better returns over pre-determined time frames, then yes, it does make sense that you should deliberately set out to design a trading system that will capture the underlying systematic nature of markets.

Random walkers along Wall Street argue that markets are accidental and without design. Others, such as myself, argue that the human element in the markets make them inherently more designed than random. If this is the case and *if* I am correct, then it means that we can develop trading techniques that help us detect and exploit the correlation of underlying human behaviour and price movements, with a higher probability of success rather than relying on random chance to do all the work for us. And by that I mean, throwing money at the market and relying solely on *chance* or *luck* to get us into profitable stocks and helping us to avoid getting into loss making stocks. Personally I prefer to put in a bit of ground work rather than closing my eyes and hoping for the best.

So I use technical analysis as part of my ground work. Many technical analysis indicators are available to the general public and are widely used. They help traders to design an approach to the market based on an understanding of the relationships between price and volume or price and pattern based behaviour. Many of these tools such as the RSI, MACD and Elders Force Index are standard technical indicators in off-the-shelf trading software. It doesn't all have to be technical. We can also use balance sheet analysis which offers a series of statistical ratios such as price to earnings, return on equity, dividend growth and so on. These fundamental analysis tools also help investors design an approach to the market based on understanding the financial health of a company. Personally, I prefer the technical approach over the fundamental approach, but when push comes to shove, I much prefer the fundamental approach over the close-my-eyes-and-hope-for-the-random-best approach.

This book offers the reader some new technical methods to understand the mood of the market and to capture the profit offered by the market mood swings. I have utilised off-the-shelf technical indicators which the seasoned trader will be familiar with. But I have used them in either a non traditional way (E.G. see my 55 day slow stochastic technique) or I have broadened an application of an old technique (E.G. the moving average - see my DEMAC technique). These personally devised techniques have been back tested and successfully applied for many years.

They have featured in various articles to trading newsletters over the past decade and they come together under the one title for the first time in this book.

If you are looking for new and easy trading techniques to help you understand, monitor and profit from the market, then I hope you enjoy this book. It may just be what you have been looking for.

All the best, Paul Doggett
January 2017

Chapter One

What does it take to be a trader?

I knew three Australian stock traders who were riding high on the back of a four year Bull Run until the following stocks in their private portfolios began to take their toll on their profits and their emotions at the start of 2008. Table 1.1 refers to these three traders.

Table 1.1

Trader #1	Wiped out due to Opes Prime scandal	Amount lost: $60,000
Trader #2	Suffered big losses with various Australian stocks such as:	ABS, MON, CRE and BVA
Trader #3	Suffered big losses with various Australian stocks such as:	BLD, JHX, THR and TTY

Look these stock codes up now on the Australian Stock Exchange (ASX) and some won't appear. The companies no longer exist. Some of them may even look like solid trading opportunities. But they were not always 'solid' trading opportunities. The three traders I knew, scratched and shook their heads in disbelief, during the worst time in their lives and wondered where to turn to next. They asked themselves and their friends if it was truly possible to beat the market after the financial beating that the market had given them during the Global Financial Crisis (GFC). Essentially they asked themselves the question, "What does it take to be a trader?"

So what exactly does it take to be a trader? This is the eternal question for all those who attempt to become successful in the markets. Here goes my answer.....

Firstly, it takes hands on practice. This involves *making* and *losing* money in real trades. Sorry but it DOES involve losing money. All traders lose money. The better traders devise strategies to LIMIT the money they are DESTINED to lose, regardless of the techniques or tactics they use in the market.

Secondly, it takes time to establish a personal set of rules. This means you've got to back test ideas and strategies that you think will work for you and then systematically apply these strategies or techniques to the market day in, day out. It also means you cannot flip flop between being a trader and an investor – you are either one or the other. It means you have to understand that when you buy a stock you are buying risk. Risk is 100% guaranteed in every stock purchase. The fact is that whenever we buy a stock, we immediately carry 100% of the inherent risk in the trade and we have to accept that a profit is a zero percentage proposition at the very start.

No two traders are alike and this is why the trading apprenticeship takes every one of us along a highly personal and unique journey that leads us all to the same end point....more or less. Some will prosper others won't. Some will get off to a flying start, others won't. Some will be big winners, some will be big losers. Some will drop out due to lack of finances or lack of enthusiasm. Others will continue to fight on despite the lack of finances. It is a completely different journey for all comers but typically most of us will follow a similar, broad based sequence of events.

This sequence typically involves self education through books, newsletters and courses as well as hands on experience. We typically spend time trying to understand how to apply complex methods such as Gann and learning where to correctly place Fibonacci levels on a chart. Some of us struggle for years trying to understand Gann's biblical references and master his intricate approach of angles, squares and trines. Others give up believing that trading isn't for them. Others lose a lifetime's fortune and become bitter and tell anyone who cares to listen that the market is rigged and that all trading educators are charlatans.

But there are those traders, who, with a little trading experience under their belt, step up a level and very quickly realise that complexity doesn't necessarily equate to superiority or consistency in the markets. In fact, those who survive for years in the markets come to realise that consistency comes with simplicity, not complexity.

In his book called, "Simplicity", Edward de Bono tells us, "As an idea develops it may go from simple to complex and then back to simple. Growth may be excluded if complexity is excluded." If Edward de Bono is right, then traders actually need to follow a path that takes them from trying the simple things or analytical techniques, to the complex things or techniques in order for growth as a trader to occur. As de Bono points out, if we don't take this journey from simple to complex and back to simple, then we may never grow and mature (into better traders). It's almost a rite of passage that you need to take if you are ever going to become a successful private trader.

It is inevitable that during our apprenticeship we will become frustrated by complex trading methods such as Gann's technique. It is inevitable that we will become frustrated by attempting to devise a philosophy or a framework-of-understanding which helps us to cope with market volatility. Working through such frustrations is all part of the apprenticeship and working through such frustrations is what it takes to be a trader.

The anecdotal evidence I have collected suggests that many seasoned traders would not have developed and reached a fairly consistent level of trading success if they had not experienced the highs and lows, frustrations and delights of self discovery while attempting to understand complex trading techniques. Without this experience, many traders such as myself would never have been inspired to develop their own approach to the market. Approaches which we've nurtured over many years to suit our own personalities, budgets and personal tolerance levels of risk.

Of course there are traders out there who travel the same educational path as the rest of us and who succeed in making complex methods work for them. But this is certainly the minority in a world where consistently profitable traders are already a minority. But some make the complex work for them because that approach suits their personality. I, however, am not one of these traders and I believe, neither are 99% of the people reading this book.

My trading life changed when I began concentrating on repeating a successful formula which came down to understanding the three simple trading principles repeated throughout this book:

- position
- risk, and
- planning

These three principles provide an easy to follow trading framework from entry to exit. They are principles shared by many traders around the world and which you can find discussed on the internet and in many other books. So if that is the case, what makes this book so different?
Good question. Here's the answer.

This book is different because it introduces new techniques. In particular, my application of the 55 day slow stochastic indicator, Doggett's Exponential Moving Average Crawl (or DEMAC for short), my practical application of Ari Kiev's theoretical profit-target-setting approach for Wall Street traders, my macro and micro planning approach which incorporates my concept of annual loss expectancy, my RCR technique and the way I monitor the creation of price patterns and trends using my three-crowds-in-every-trend theory......all these things separate this book from others which you may have read.

These techniques have developed over more than twenty years involvement in the Australian stock market. These techniques have been developed to suit my needs as those needs arose. I have grown in confidence using these techniques through trial and error and as I have done so, my trading psychology has responded and changed accordingly. The most important change I had to make mentally was to accept that every trade works or fails on its own accord. It doesn't matter what I do. Ultimately the market will make each and every trade work or fail, regardless of my techniques, tactics, hopes or desires.

What you have just read, is my trading philosophy in a nutshell. It's my answer to that eternal question, 'What does it take to become a trader?'. My view of the market will challenge some readers. In fact it has to challenge you because you are different to me and therefore you are not expected to share my philosophy or approach to the market or my approach to trading in its entirety, without any personal input from yourself.

Take for example the line I wrote above: "*every trade works or fails on its own accord. It doesn't matter what I do.*" You may think, "this guy is crazy – the market decides for him if he is profitable or not? How come he doesn't decide that for himself?" You have to be challenged in your way of thinking in order to help you forge your own style of trading. Such a comment will challenge most people.

One of the hardest things to learn and to accept in the market is the role we actually DO play as a trader. Our role is to back test a strategy, feel secure that it works, apply it, using our own money, then sit back and watch what happens. That is it. Share price direction is totally out of our control. We can establish methods that help us determine the likelihood of the immediate future of share price direction, but ultimately it is out of our control. What is within our control is our ability to apply robust techniques that help us determine good buying opportunities and helps us to set price targets which we can use as 'identity markers'. These 'price identity markers' will either signal time to profits or time to exit in order to limit losses.

As traders our focus should be on the best way to manage our open positions and the best way to find opportunities in a market where odd behaviour can sometimes appear to be the norm. My philosophy is that I cannot outsmart the millions of people each and every day in the market, so I don't even try. Instead, I let the millions of people in the market guide me. Not one of them can hide in the market and their collective actions are all exposed on a chart so that is why I use charts.

Charts show us that there are only two best case scenarios in trading: a trading profit and a minimal loss upon exit. Without exception, every trade we make reaches one of these two conclusions at some point. Figure 1.1 shows an ascending triangle pattern with a support and a resistance line. Regardless of my actions the market will take every trading opportunity such as this one to either a profitable or loss making conclusion. I personally cannot make the stock move either up or down. It is out of my control. My sole input is understanding that there are only two best case scenarios in trading and a chart will often help me to define where one of these outcomes occurs first. This is one of the founding philosophies of this book.

Fig. 1.1 Two best case scenarios

A break above the horizontal resistance line in Fig. 1.1 indicates an upside breakout which in turn indicates a time to buy or to hold a stock – not to sell it. A price break below the rising support line indicates time to sell the stock if held, not to hold onto it and certainly not a time to buy into it.

This is an example of how a chart pattern can help a trader to quickly identify the two best case scenarios or outcomes in stock price action. While we cannot personally influence the stock price moving in one direction over the other, we can use the collective underlying sentiment to inform us of a higher probability outcome based on whether the support line or the resistance line is broken in a repetitive chart pattern such as the one shown in Fig. 1.1.

As I say, the most important change I had to make mentally was to accept that every trade works or fails on its own accord. It doesn't matter what I do. The market will make each and every trade work or fail, regardless of my techniques, tactics, hopes or desires. All I can do is design techniques that help me to identify trading opportunities with a high probability level of success and which help me to identify when to exit a trade and when to avoid buying in at the wrong time. It was not an easy journey that led me to this view.

I wish I could have taken a short cut. I know many new traders are quietly confident that they can find that short cut but that reminds me of that old Zen story where a martial arts student heard about a great martial arts teacher so he went to him and said that he wanted to learn from the master. "How long would it take to be a master like you?" he asked. The teacher replied: "Ten years." The student, who was impatient by nature, was unsatisfied with that answer. He said, "But I want to master it faster than that so I will work twice as hard. How long would it take me to be a master then? The teacher replied: "Twenty years." The moral of the story is that you can't rush the basics because they set the foundation upon which the more advanced techniques are built.

I may not have convinced some of you yet that we need to lay down the basics in order to be ready to build a strong base for further development, but regardless, I will continue on as if I have convinced every reader of this fact. Therefore, I will assume that everyone accepts that while we will end up being different traders with different beliefs about the market and trading techniques, we all agree that each of us will go through a similar metamorphosis from novice to intermediate to advanced and as de Bono pointed out, this metamorphosis will probably involve attempting to trade using a simple method, gravitating towards more complex methods, then ultimately returning back to a simpler and more personalised method. We need to go through this cycle of experimentation in order to grow and mature as traders.

In support of de Bono's theory, let's consider the biographical accounts of Jesse Livermore in "Reminiscences of a Stock Operator" and Nicolas Darvas in "How I Made $2,000,000 in the Stock

Market". In 'Reminiscences' Jesse Livermore went from the bucket shops to the broking houses and back to the bucket shops as he made and lost fortunes. His alter ego, Larry Livingstone, makes many fundamental mistakes which put him on the wrong side of trades. Sometimes he was on the wrong side of the trade with a position size that was far too large. Other times he sold what showed him a profit and kept that which showed him a loss. This is a mistake all of us will make as we go through our cycle of learning and adapting ideas and techniques to see which work best for us personally and which doesn't.

Nicolas Darvas took tips and learned the hard way that tips are for waiters, not for traders. He also learnt that remaining aloof from the noise of the markets was advantageous especially after he moved to New York to be close to the action. Once he was close to the action he became swept up in the action and lost his focus and started losing money so he switched back to his aloof approach which involved going back on a world dancing tour and reading Barron's research that was around a week old (a copy was sent to him by his broker as Darvas travelled the world). Once he was back dancing, his fortunes on Wall Street flourished again.

It was a technique that worked for Darvas because it allowed him to accumulate weeks and months worth of data which was more beneficial to him and his personally devised Darvas Box trend trading technique, rather than being wrapped up in the daily data while living in New York. Darvas is a clear example of several things. First he writes about his apprenticeship as a novice trader and all the basic mistakes he made, (which we all seem to typically make). Secondly, he writes about trying to follow the methods of other people. This typically involved trying trade stocks based on fundamental data which he found to be slow in generating buy and sell signals. And finally, he is a great example of a trader who, through trial and error, years of practice and persistence, was able to devise a unique and highly personal trading approach which worked for him.

Both Darvas and Livermore experienced profits and losses, experimented with techniques, grew psychologically through the years of battling with the market and both developed a set of trading rules which helped them succeed. The general rule is this: if you can't develop your own trading style then you can't make it in the market. In fact, all the best literature on how to trade the market concludes that the traders who make it on their own, do so because they develop, refine and use a trading methodology or system which is uniquely their own and which works hand in hand with their personalities.

The successful traders interviewed in books like Market Wizards by Jack Schwager, point out that by and large, they developed their own approach and as such books like Market Wizards confirms that we need to do the same thing and develop our own approach.

So what does it take to be a trader? It takes time to experience profits and losses and to develop something in your approach which is strongly identified with who you are and how you want to trade. So that being said, where do we begin in developing our own approach? We need something to kick start the process that transforms us from amateur to advanced trader. This book will help kick start you on that journey as I outline my own personally devised techniques because it helps if we can see how other trade in order to broaden our own knowledge and ideas so that we too can develop into better and more educated traders. Learning how others trade often provides a working model upon which to base our own system or approach to the market. We can add or delete things from the working models of other traders and over time, our own system will evolve. This is exactly how my personal trading system developed.

For example, I read the work of Ari Kiev and it inspired me to develop my 'macro-micro plan' idea. In his books, The Psychology of Risk and Trading to Win, Kiev promotes the idea of creating large targets on a weekly, monthly or yearly basis and then committing ourselves to achieving those targets. I like that idea. I used it to develop my broad macro plan. The macro trading plan is to return a minimum 50% (for example, $25000 net profit from a starting capital of $50000) and risking only a maximum of 16% over the course of the trading year (for example risking only $8000 in annual losses for every $50,000 in your starting account). These are the broad guidelines. The micro plan takes care of all the other smaller, more precise details such as deciding what trading technique to use and to answer questions such as; “Can I take this trade and if so, how much can I risk seeing I can only loose $8000 for the year?”

I didn’t come up with my macro-micro plan idea by myself, I was inspired by something Ari Kiev wrote about and I took it and turned it into something that suited my personality and my approach.

Here is something else I developed after being inspired by the writing of other people. My sliding scale risk model was inspired by the work of Nobel Prize winning behavioural psychologists Daniel Kahneman and Amos Tversky. The reduction in the size of the amount I wish to leave at risk in the market after my position has moved into profit ends up acting as a percentage based value trailing stop (we will look at this technique in greater detail later in this book). As with any trailing stop, it puts the onus onto the stock to continue making money for the trader.

The concept of “onus” is an important one in my approach and is discussed at different points throughout this book. You got your first taste of my concept of “onus” where I stated whenever we buy a stock we buy risk. So the onus of risk management falls squarely on our shoulders and not on that of the market. But I do place the onus of profit or loss squarely on the shoulders of the market and know that the market will move every position I hold into one of the two best case scenarios – a profit or a small loss, triggering my exit. Profit and loss is not the same as risk management. Risk management sits with us and is something we can control (to a large degree, but there are black swan events out there that sometimes takes it out of our control).

Finally, let me say that I use the Guppy multiple moving average indicator as one of my indicators in my system. Obviously I got that from Daryl Guppy (see www.guppytraders.com). But I also use a non traditional application of the fifty-five day slow stochastic indicator in a manner that I devised by myself for myself through hours of back testing a variety of standard indicators found in most charting software packages. The application of the fifty-five day slow stochastic indicator is discussed in chapter three.

So that is a brief bit of personal history that will show you how it is possible to manipulate and apply the ideas of others to suit ourselves. We all get our start from somewhere and for most of us we get our start in fundamental or technical basics. While the basics, learnt properly at the start, always forms a solid base from which to grow, there is still one thing missing. That thing is mindset. You need to take those technical basics and run with them in a direction which wholly and solely compliments your personality or mindset and benefits nobody else but you. It is such an important and large subject that I dedicated a whole other book to it – Trader Psychology: Winning the Mental Tug of War on Stock Markets.
But for now, in the limited space afforded for trader and market psychology, let me say that while I use a technical rather fundamental approach to trading the market, I also use my understanding of psychology and heuristics when making trading decisions. I apply this understanding to both myself and my mental state and I apply my knowledge of psychology to the broader market as a whole when possible so I can ascertain a much deeper level of analysis.

So in closing this chapter we come back to that all important question; “What is required to become a trader?” I hope I have covered a range of topics that I think are inextricably linked in providing my answer. In summary we know that we have to conquer the basics - money (risk management), method (analysis and execution) and mindset (psychology) and out of this we have to develop our own trading style. One way to develop your own style is to take our favourite pieces of other people’s trading approaches and bring them together to form our own unique approach. We can do this several times over from several different traders until we find a suitable combination. For those lacking ideas of where to start, there are several ideas outlined in the rest of this book which will hopefully spur you on, in your journey.

Chapter Two

The importance of position (learning to pick the easy fight)

There is a famous Japanese story about a samurai warrior which goes like this: A man peacefully ate his supper in a small inn, ignoring four flies buzzing around his head. While he ate, three more samurai warriors, who did not know the one eating his supper, came in and sat down. They noticed the first samurai eating at the table and the two magnificent swords fixed in his belt. The three samurai decided to rob him. They began making fun of him, hoping to provoke him into a duel.

But the first samurai remained calm and ignored them. Upon finishing his supper, he raised his chopsticks and with lightening speed, struck down each of the four flies which had been buzzing around his head. Then he put down the chopsticks on the table and sat, head bowed in silence. The three samurai realized that before them was a man of formidable mastery which frightened them so much, that they fled. Later they learned that the man who had spared them their lives was called Miyamoto Musashi.....the greatest samurai who ever lived.

This famous Japanese legend is a good reminder to us that we must pick and choose our trading candidates very carefully because behind every trading candidate sits a potential Miyamoto Musashi, ready to beat us in a duel. Behind every trading candidate sits a bullish or bearish group of investors and traders who are a formidable force. These bulls and bears are our ‘opponents’, laying in wait for us and who are often more skilful than us, or by sheer weight of numbers are far more powerful than us. If we go up against a more powerful opponent, we will often lose.

The parallels I’m drawing here between Samurai legend and trading applies in practice if, for example, we take the opposite view of the more formidable force in the market, such as being bullish on the stock which is in a downtrend (Fig. 2.1).

Fig. 2.1

That formidable force here is the downtrend. The importance of good positioning in the market relies on us being able to pick the easy fight. It’s not a case of cowardice. It’s a matter of practicality. We have to be aware of which group has control of a stock before we consider buying it. In Figure 2.1, the bears have control. If we buy this stock, we are taking up the fight to a much more powerful opponent. If you bought this stock anywhere between $2.40 and 60 cents, you would be losing money. If you bought this stock at $2.40 and were still holding it at 60 cents you would be suffering a 75% loss (and counting). So why get involved in the fight in the first place? Better positioning relies upon us knowing our opponent and taking on the easy fights, not the hard ones.