LATEST RESEARCH

TradingMarkets 10 Rules for Lifelong Trading Success

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TradingMarkets 10 Rules for Lifelong Trading Success

PowerRatings (for Traders) are a proprietary stock rating method which ranks stocks on a scale of 1-10. The higher the rating, the greater the one week historical gain has been for stocks with that rating.

PowerRatings Platinum introduces traders to our research, teaching you a number of advanced trading techniques. Much of the information we're going to share with you here is incorporated into the PowerRatings Platinum service.

In this special report, you're going to learn more about our philosophy on the markets and trading. You're also going to see some concepts that you may already be familiar with, along with some new ideas and research that you have likely never seen before.

As you learn more about these techniques and embrace our methodology, you will discover new strategies that further utilize these concepts. In simulated trading, these concepts have historically outperformed the market by a substantial amount.

1. Keep an Open Mind, but Quantify Everything

What we'd most like to emphasize here is the importance of keeping an open mind. At TradingMarkets we keep an open mind to everything, but we always want to make sure there is statistical evidence to support any claims made. In other words, we want to quantify everything to do with the markets and trading.

Nowadays, it's possible to quantify the insight and knowledge of many successful traders and hedge funds. Year after year, day after day, they are making decisions based on their market knowledge, and they share our trading philosophy. What we aim to do is to quantify their knowledge by running statistical studies of historical market data.

There are many trading strategies that sound logical, or even appear to work over a short period of time, but when you quantify them, you find out that they haven't worked over time.

By always keeping an open mind, we try to stay consistent with our process, and share the results with you. It's important to know not just what has worked, but also what hasn't.

2. Always, Always Buy Low

Our research shows that we always want to be buying low, and the lower, the better. We can't stress this enough.

The bull market of the 1990's bred a generation of traders who buy high, and hope to sell even higher. While this strategy has worked well for some traders, after looking at millions of trades, we have been unable to find any statistical evidence to support it. This is not based upon opinion; we base this conclusion on the statistics.

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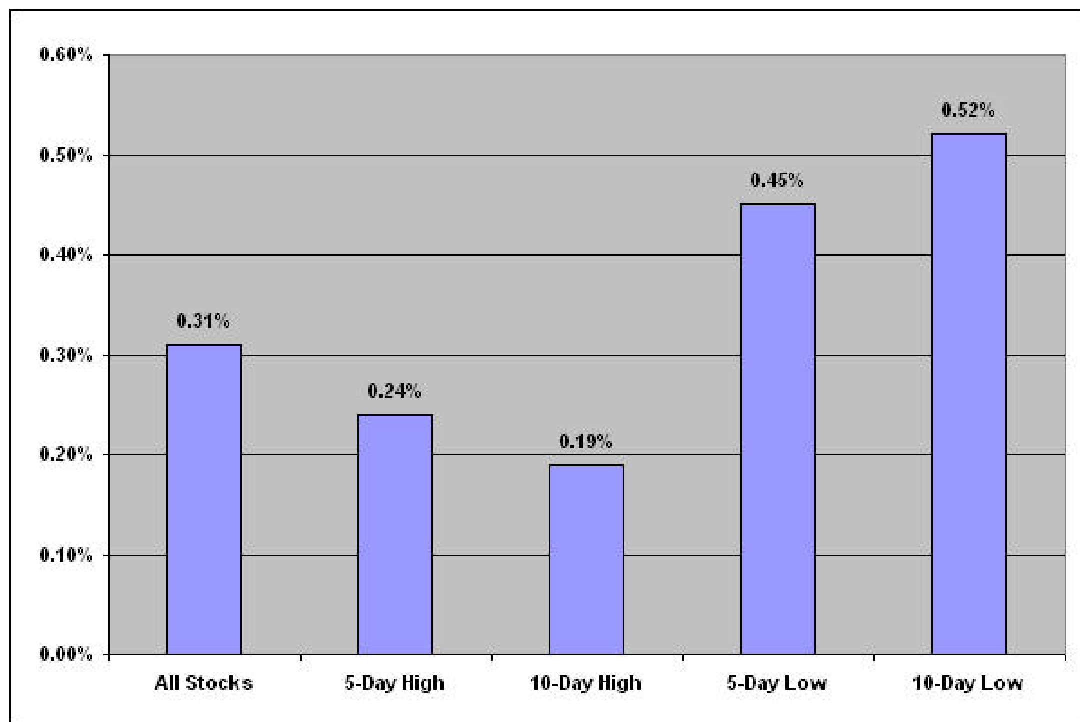
Our database contains more than 8 million trades, and we looked at all of them going back to 1995. That means our study is based upon a huge sample size. And, one of the most basic themes that we see, over and over, is that it pays to "buy low."

For example, had you bought every stock, and exited after five days, you see the market has had an upward bias. If you compare that with if you had bought every stock that makes a 5-day high (see below), you see the returns lessen, and the returns fall even more had you bought stocks that made a 10-day high.



The chart also shows what happens had you bought 5-day lows and 10-day lows instead. As you can see, the edge is clearly with traders that buy lows.

If you take a moment to think about the underlying philosophy, really all we're doing is trying to buy things as cheaply as possible. Essentially, we're buying pullbacks, or put another way, buy low, sell high. Obviously we didn't come up with this, but we are trying to quantify the market conditions that define that statement.

So when looking at a database of millions of potential trades, the research keeps indicating that the historical edge has been found by buying lows.

3. It Pays to Hold Positions Overnight

Technology and the 1990's bull market dramatically altered the trading styles of millions of investors. Technological advances and the modernization of the financial industry both helped to lower the cost of trading. These changes led to a huge influx of traders, many of whom preferred not to hold positions

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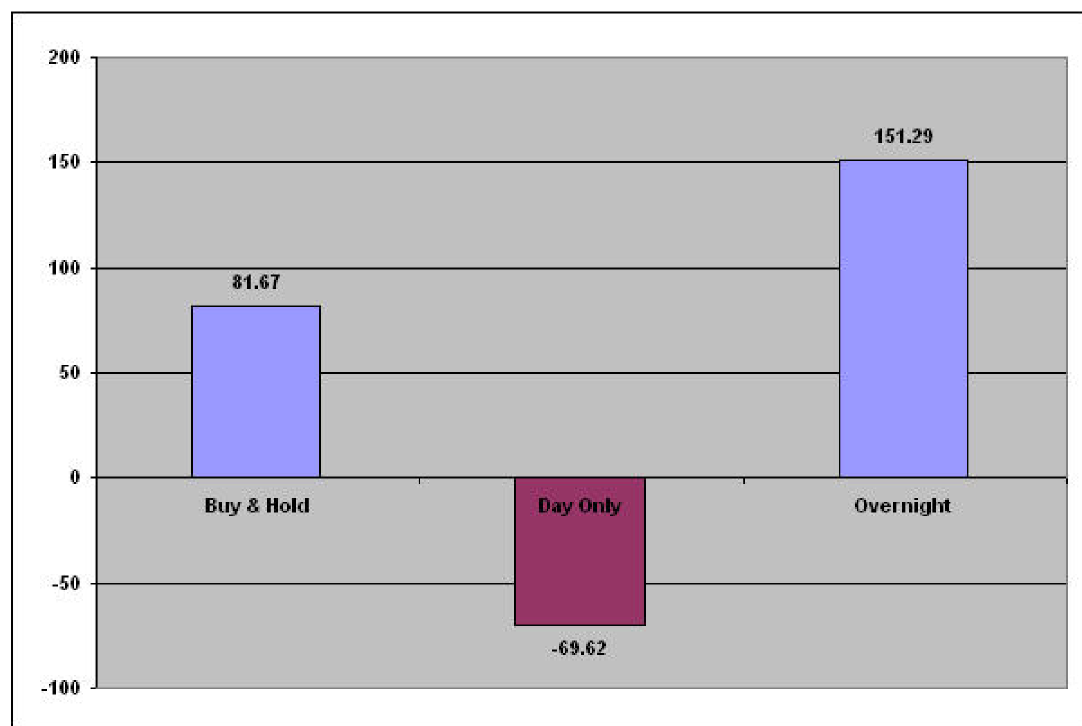
overnight. The growth of day trading has in itself created opportunities for traders willing to hold positions overnight. Of course there are risks with holding positions overnight, but we can statistically show that you would have been well compensated for that risk, and how to control it.

The easiest way of illustrating this point is to look at this graph of the SPYs.

We compared the returns of three different strategies:

1. Buy & Hold
2. Day Only (buy on the open and sell on the close)
3. Overnight (buy on the close and sell on the next open)

The results are clear to see. Holding positions "Overnight" outperformed "Buy & Hold" by almost 2:1 and "Day Only" by more than 3:1.



So when the urge is there to lock-in your profit at the end of the day and get out before the close, the rewards were potentially much greater for those willing to take that overnight risk. The results were the same for the SPYs and the QQQQs.

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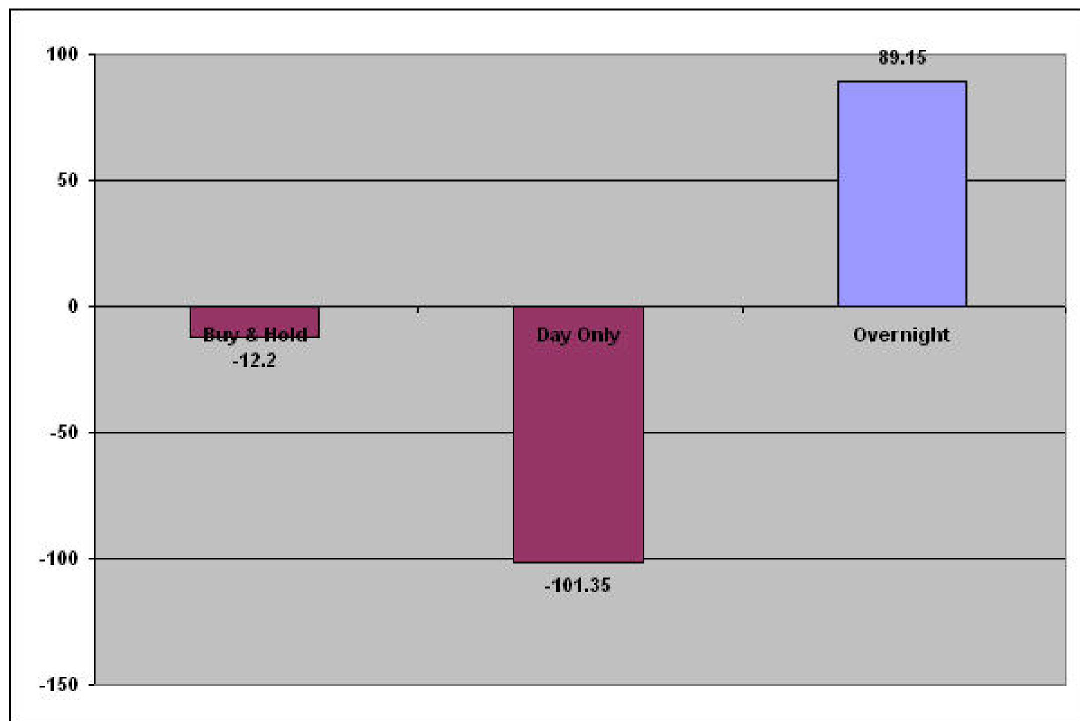

Paul Sabo always talks about how he has had better luck trading to the short-side during the day, and this graph shows why. Historically, the market has fallen during the day; meaning over the years, the gains that the markets make usually come overnight. Therefore it has paid to hold positions overnight.

4. Stops Hurt

Many of you will find these results very surprising! Books, websites and traders will tell you that using stops is an essential part of trading. In the past, we've even been guilty of doing the same on the TradingMarkets website. However, we found out, that's not the best way to trade.

Most tests that we ran where we use stops have decreased the portfolio's return. Specialists on the floor, professional traders and fund managers, are fully aware of the key stop levels. And, they have their finger on the trigger, gunning for those levels. Stops are supposed to protect you, but in the end, our tests have shown they bring you down.

With our methodology, we found that stops have greatly hindered performance. But looking at them a different way, stops placed by other traders can potentially be used to your advantage. In simulated trading, we found there are certain stop-loss levels (like 3%, 5%, 7% and 10%), where most people are all getting out, that we have been able to get good fills at these levels. Essentially, we become liquidity providers for those other people looking to get out. And we've seen this over and over, not just in simulated trading but with our actual systems too. When a stock reaches a common stop-loss level, it will often accelerate downwards as a flurry of sell orders are executed. Only then, when the selling pressure has been exhausted, will the stock reverse course. These are the kind of levels where we look to enter trades.

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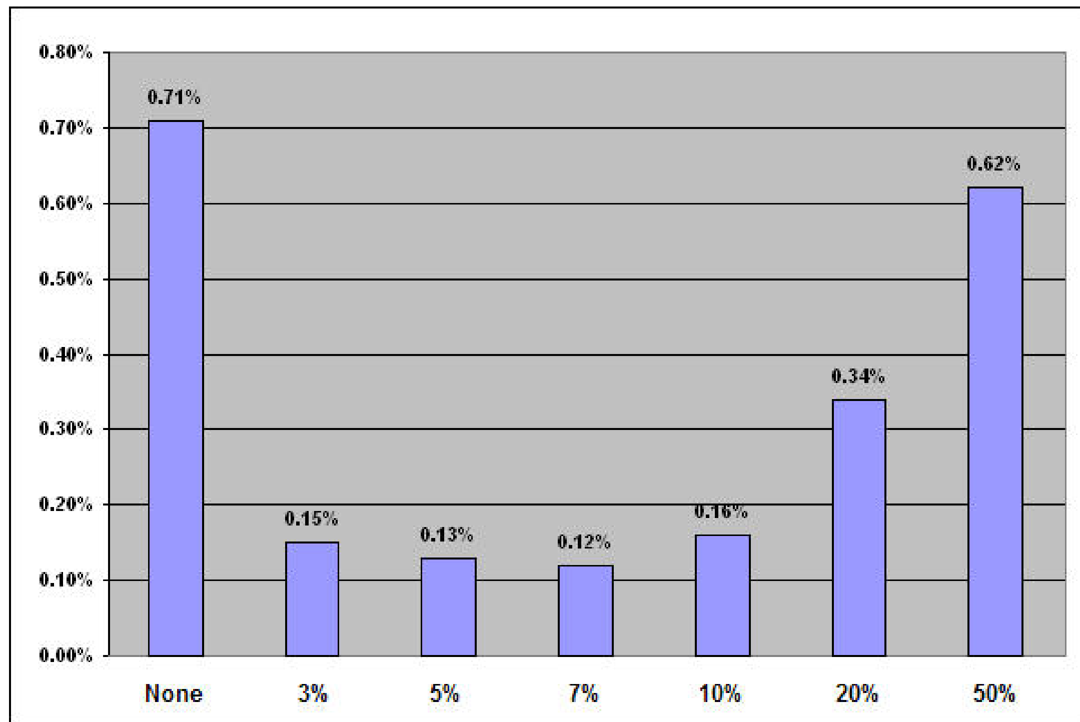
The following chart shows just how much stops hurt your overall performance.



5. Volatility Helps

Over the years, we have created many successful volatility-based methodologies. Ideally, we want to take advantage of volatility. In fact, the higher volatility, the better. That's because a lack of volatility usually means fewer trading opportunities.

It's much harder to capture short-term profits in low volatility stocks. Profitable trades are easier to find when there is an increase in volatility and uncertainty.

The graph below is just one example that shows how volatility helps. We looked at 5-day lows with varying degrees of historical volatility (HV). As you can see, the greater the volatility, the greater the historical edge has been.

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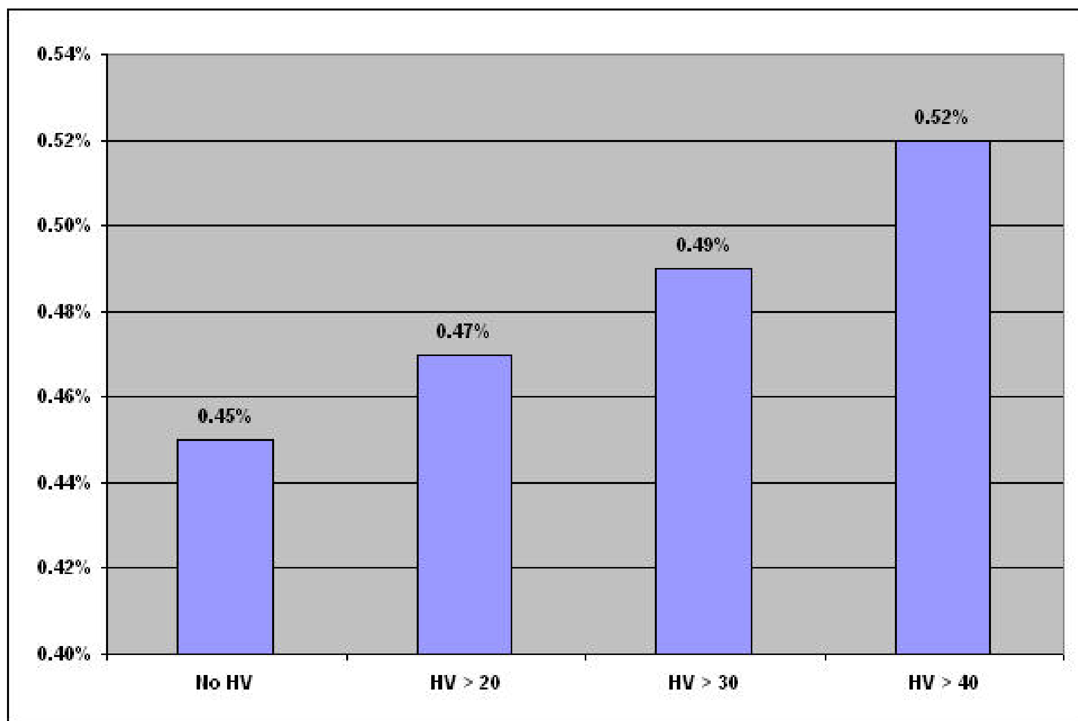

6. The 200-Day Moving Average is a Good Filter

The 200-day moving average is by far the most widely followed indicator. Institutional investors from mutual funds to hedge funds all follow it; specialists, professional traders and even many fundamental analysts watch the 200-day MA.

It has stood the test of time, and research shows the 200-day MA is an excellent trend filter. We consider stocks above the 200-day MA to be in up-trends and those below to be in down-trends.

The graph below shows that stocks above their 200-day MA have performed significantly better than those below. This is why we look to buy pullbacks in up-trending stocks.

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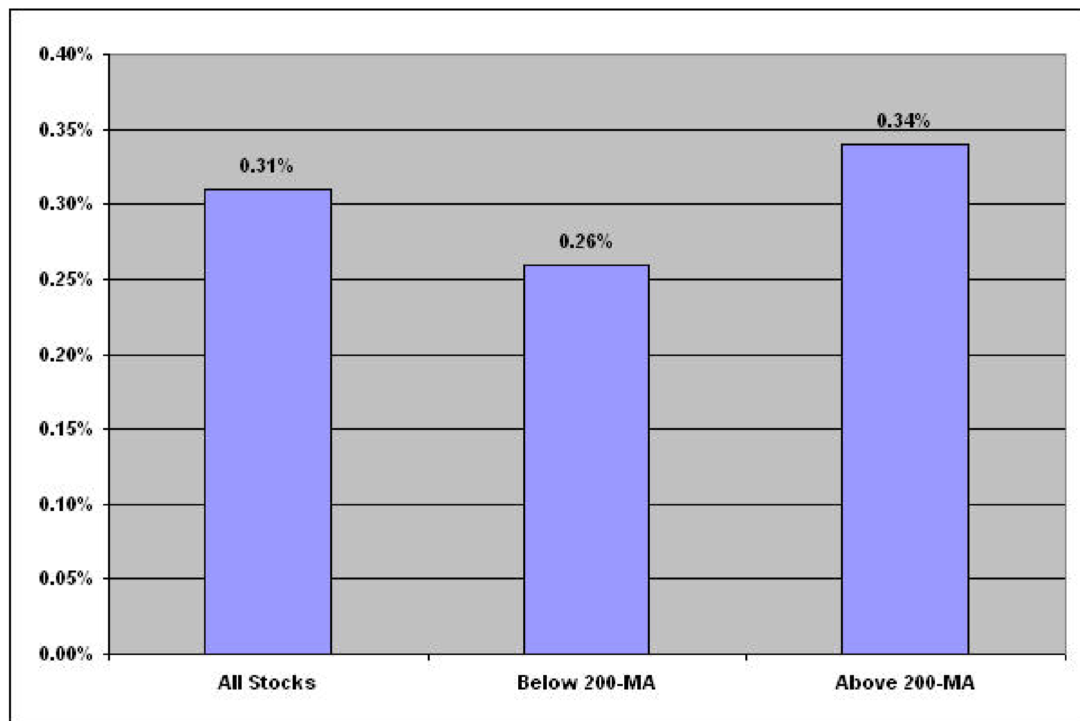

7. Use Multiple Positions to Lessen Corporate Risk

Everyone knows about corporate risk. Having too much money invested in any one stock can be disastrous. If that stock releases bad news when the market is closed, it's not uncommon to see a large gap down on the next open.

While there is nothing you can do to prevent these types of situations, you can still protect yourself from the price action that follows. The best way of achieving this is by diversifying your portfolio. By that, we mean keeping positions size small, and having a lot of different positions, each with its own edge. That basically just means that you will never have too great an investment in any one stock. So even if a company announces terrible news, you know what your maximum exposure is.

8. Buying Intraday Weakness

This is really just an extension of something we covered earlier, "Always, Always, Buy Lows".

Our research shows that as a stock falls further during the day, the edge has increased to the upside, because all the stock is really doing is becoming more extended. This presents us with an opportunity to be buying lower, and one of the best ways to do that, is to wait until the stock falls to a pre-set limit (like 3%, 5% or 7%), and then have a buy order at that limit price.

This goes back to defining a "pullback." A pullback is a momentary weakness in a strong stock. The best way to take advantage of that momentary weakness is by using intraday limit orders. As we said earlier, we are trying to buy low, and this lets us buy even lower.

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One thing to remember is that by using this strategy, you will be placing a lot of orders that don't get filled. After all, not all the stocks on our watch list will fall to these lower levels, and fewer still will reach the deepest pullback levels.

The important thing to remember is that the deeper the pullback, the greater the potential edge, but there will be fewer opportunities.

9. 5 to 8 Days is the Sweet Spot

We've run all sorts of tests for holding periods for swing trading. Our conclusion, based upon these tests, suggests that, on average, the sweet spot has been 5 to 8 days.

There's no single magic number here. What you see is that holding periods between 5 to 8 days had the greatest historical edge. We think that this is behavioral in nature, that it takes a certain number of days after bad news is released before buyers will return to a stock.

10. Trade Multiple Strategies

In one way or another, we trade all of our strategies with real money accounts, and they all experience periods of strength and weakness. Losing trades are inevitable, but as long as the strategy is sound, it will usually perform well.

However, the best solution for these ebbs and flows is to have multiple strategies that are designed to take advantage of different market conditions or even different markets. That way, when there are dry spells in one strategy, another one may be taking off.

This also ties into diversifying your portfolio. Just like you can't predict when a stock is going to break down, you can't tell when a strategy will experience losses. But, by trading multiple strategies, if one is struggling, another one will be there exploiting different opportunities.

Ideally, we want to be trading a balanced portfolio through the use of multiple strategies.

Take the Guessing out of Your Trading with PowerRatings Platinum

Now that you understand our philosophy, it's time to actually put it into practice. As stated earlier, many of the concepts described above are incorporated into PowerRatings. And, we provide signals each evening showing where to potentially place orders for the upcoming day for the best PowerRatings stocks. You'll always be looking for signals to buy stocks that have pulled back to levels which they have historically risen from. This allows you to save time, and also allows you to focus on the better opportunities for the upcoming day.

Plus, with PowerRatings you'll know whether or not you should be exiting your position on the next trading day and where that exit price should be. Follow our methodology everyday and take the guessing out of your trading.

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If you would like to learn more about how to apply PowerRatings to your trading, or if you are interested in applying some of the other concepts shown in this report, please call us at 213-955-5858 Ext 1 or click here for more information. We have programs designed to take you all the way up to the professional trader level.

Larry Connors *is CEO and Founder of TradingMarkets.com.*

Mr. Connors has over 24 years experience working in the financial markets industry. He started his career in 1982 at Merrill Lynch and later moved on to become a Vice President with Donaldson, Lufkin, Jenrette.

Mr. Connors has authored top-selling books on market strategies and volatility trading, including How Markets Really Work, Street Smarts *(with Linda Raschke), and* Investment Secrets of a Hedge Fund Manager. Street Smarts *has recently been selected by* Technical Analysis of Stocks and Commodities *magazine as one of "The Classics" for trading books written in the past century. His books have been translated into German, Italian and Japanese.*

Mr. Connors' opinions and insights have been featured or quoted in: the Wall Street Journal, New York Times, Barron's, Bloomberg TV & Radio, Dow Jones Newswire, Yahoo! Finance, E-Trade Financial Daily, Futures Magazine, Technical Analysis of Stocks and Commodities, and others. Mr. Connors has been a featured speaker at a number of major investment conferences over the past decade.

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